DISCRETIONARY VERSUS AUTOMATIC STABILIZATION IN RELATION TO INDICATORS ASSOCIATED WITH NOMINAL ECONOMIC CONVERGENCE CRITERIA

CSIII, Ph.D. Alina Georgeta AILINCĂ
“Victor Slăvescu”Financial and Monetary Research Center, Romanian Academy, Romania
E-mail: alina.glod@gmail.com

Abstract: *About economic convergence has been written a lot, especially about the nominal one. The nominal economic convergence criteria of the Maastricht Treaty as they are known and imposed on countries wishing to join the Eurozone are both controversial in the academic world, with voices calling for either their relaxation or completion, or at least for a better calibration of them. Without starting from redesigning, the article aims to analyse in its current form which is most effective: discretionary stabilization or the design of a mechanism rather automatic in reaching the thresholds imposed by the Maastricht criteria? The arguments formulated in this article and the results obtained can guide us towards the use of an automatic type of stabilization mechanism.*

Keywords: *convergence, macroeconomic stabilization, European integration.*
JEL Classification*: E63, E32.*

1. Introduction

As we know, to become part of the euro area, the EU member states must go through the stage of meeting the nominal convergence criteria imposed by the Maastricht Treaty. Currently, 19 EU Member States are also members of the euro area, and another 9 states have not yet adopted the European currency. Britain and Denmark have notified their non-entry to the third stage of Economic and Monetary Union (EMU), and the UK has also voiced its exit from the European Union via a 2016 referendum. Thus, only 7 states, especially those from Central and Eastern Europe, can run for entry to the euro area.

At the same time, there is the question of constancy or sustainability in respecting the nominal economic criteria, knowing that once the European currency is adopted, euro area member states no longer bear the burden of strict adherence to them, they beeing rather a simple set of "entry" criteria. In addition, the sanctions that could be administered to these countries, amid the over-lapping of the budget deficit and public debt criteria, are often remaining in expectation, especially for the old countries which stood at the base of the formation of the EU and the euro area.

At present, compliance with the nominal economic convergence criteria is made by each Member State individually and under discretionary terms, more exactlly through explicit and indirect policies, mechanisms and measures, when it maybe more appropriate the implicit and indirect, non-discretionary or automatic policies, measures and adjustment mechanisms at both EU and Member State levels. Thus, in a first phase, we can raise the question of the necessity of automatic stabilization or better said of the compliance with the nominal economic convergence criteria and of their maintenance by automatic mechanisms. This is the subject of this article and this has not been done yet.

2. Description of the Problem and Literature Overview

The profile literature is extremely rich both in terms of convergence and automatic stabilization, but the grouping of the two subjects, however intense it seems, has not been achieved so far.

In the exogenous neoclassical growth model of Solow (1956), a steady state towards which an economy converges is due to decrease returns to investment in physical capital, assuming that countries are equal in all issues except their initial point of per capita capital. Thus, poor countries have higher marginal productivity of capital than rich countries, growing much faster than rich countries, proces ending only when the outputs per capita of the two set of countries is equal (absolute convergence hypothesis or Beta-convergence). But, in reality, in the empirical studies, growth rates per capita show little correlation with the starting levels of GDP per capita (Barro, 1991; Barbone and Zalduendo, 1996). This is because, in reality, a great variety between countries exists with regard to the growth relevant factors and because each country may have its own growth steady level. Taking into consideration in the Solow's model of the integration process, this should accelerate the convergence as capital should go to the poor countries in order to obtain higher returns. But in the long term the model will lead to an unaltered steady growth path.

Another approach, named endogenous growth theory (Romer, 1986; Abramowitz, 1986) sees the economic integration process as a generator of increasing scale effects, having a positive impact on the growth for old and new member countries (Landau, 1995, Henrekson, Torstensson and Torstensson, 1997). Looking to the new accesion countries of EU against those which entered in the EU erlier, led us to the conclusion that the new members have been prepared more adequately for the enlargement and adding the impact of structural funds, it can be said that the new accession countries face an opportunity to achieve a much faster convergence process in order to reach the income level of the EU (Varblane and Vahter, 2005). But in this view, the large-scale effect depends on research and development, knowlege and human capital accumulation, institutional framework, technological and investitional absorbtion capacity, infrastructure and social capability. This is why, not only convergence but also the divergence concept might have sense, especialy for the new countries of European Union.

Linking the aspect of integration with the aspect of stabilisation can be seen fugitive in some particular empirical works, where the macrostabilisation policies (including for achieving the nominal convergence, especially for limiting inflation) was made on the expence of the reduction of the number of employees, on the decrease of the wage bill, on the reduction of the aggregate demand and on the incomes of the population. But the reduction of the income of the population, inequality problem (Caminada, Goudswaard and Wang, 2012) and mitigating the transition and economic crisis effects are the favorite subject of automatic stabilization area. Also, in many studies the production, the degree of openness and the size of public sector are analysed also through the lenses of automatic stabilization (Auerbach and Hassett, 2002). In general, the battlefield between discretionary (Romer and Romer, 1994) and non-disretionary policies (Van der Noord, 2000; Baunsgaard and Symansky, 2009) concerns the fiscal field, but the most interesting might prove the monetary field or, even better, the integrated fiscal and monetary approach.

The appearance of strong negative externalities of convergence indicates the need to understand the convergence process from the knowledge of the criteria, its critical judgment, the understanding of the stabilization concept and the concept of automatic stabilization, as well as the limits of automatic and discretionary stabilization.

3. Data Sources and Methodology

The paper proposes a theoretical, critical and, at the same time, new approach, linking the issue of stabilization and, in particular,of the automatic stabilisation with the aspect of economic convergence, and here we will refer strictly to the criteria of nominal economic convergence imposed by the Maastricht Treaty. Critical analysis is based on the definitions outlined in the Treaty, surprising aspects that can be improved. At the same time, starting from their official definition, we can suggest elements regarding the necessity, possibility and opportunity of stabilization through discretionary or automatic mechanisms.

4. Results Obtained – critical aspects of the nominal economic convergence criteria but also the expression of the necessity, possibility and opportunity of their automatic stabilization

It should be noted that the institutional entity that evaluates and monitors the stage of nominal economic convergence is the European Central Bank through the regular convergence reports on the candidate countries to the euro area. It is interesting to analyze why the euro area Member States are not further assessed at the same level as newcomers or candidate countries. This would reveal whether and to what extent the nominal convergence criteria are solid or not, providing important milestones for convergence or vice versa once they have met, removes or might remove the Member States from the idea of convergence. Another important point that needs to be mentioned is that although convergence is specified in the Treaty is not the ultimate goal - the argument for the establishment of the EU and the euro area – thus, convergence remains a simple way to be followed. This is highlighted by the fact that convergence can not be an end in itself but in the idea of finalizing a stage of integration. Also, integration itself is relevant only in the context of a higher purpose, such as the harmonious sustainable development of all Member States, the achievement of a high degree of prosperity for citizens, or the creation of a major pole of global economic and financial power or allof the above, etc. The absence of the final destination of the European convergence process involves the natural confusion of the metaphor of geting into the subway without knowing the station where you have to get down, pendulating between stations and never reaching the final destination.

But let us first recall the nominal economic convergence criteria to be able to guide us properly in the plea for automatic stabilization.

Nominal economic convergence criteria can be considered to be divided into monetary and fiscal-budgetary criteria. Monetary measures address to the subject inflation, long-term interest rate and exchange rate, and fiscal-budgeting criteria refers to public debt and general government deficit.

The inflation criterion refers to the compliance with the ceiling of the arithmetic mean of inflation of the first three Member States with the lowest inflation rates, analyzed over a one-year period prior to the examination, to which is added 1.5 percentage points (pp).

The long-term nominal interest rate criterion refers to the fitting into the ceiling of the arithmetic mean of the long-term nominal interest rates of the three EU Member States. which have the lowest inflation rates plus 2 percentage points.

The exchange rate according to the criterion should vary around the central nominal exchange rate parity set at the moment of entry into ERM2 in the ± 15% band. At the same time, the exchange rate must not be subject to serious tensions during at least two years before the examination, more precisely during this period, not to devaluate its own currency against the euro on its own initiative.

Fiscal-budgetary criteria change the register of monetary criteria flexibility, more exactly they are fixed and are divided by GDP. Thus, the general government deficit in GDP must fall within the 3% of GDP threshold, and the total government debt-to-GDP ratio should not exceed 60% of GDP.

Along with these indicators, also other relevant factors are further analyzed in the above criteria to outline the convergence and economic integration of the EU countries in the euro area.

From a methodological point of view, the indicators chosen for shaping economic convergence are purely retrospective and are analyzed and interpreted individually based on actual data. Thus, according to the ECB, the convergence criteria are built on the idea of achieving an integrated, common, transparent, accurate, consistent, simple, coherent framework, lacking a strict hierarchy and requiring cumulative fulfillment. At the same time, the analysis of these criteria over the past 10 years aims to reveal the sustainability of reaching convergence and the extent to which the present achievements are determined by the structural changes in the past.

There is also a somewhat anticipative approach to addressing the nominal economic convergence criteria in order to understand and integrate the role of macroeconomic policy measures (especially fiscal-budgetary policy) in terms of their adequacy to future challenges. The institutional, legal, governmental and financial framework of a country is analyzed from the point of view of its robustness and forecasts are taken into account from a number of sources, both national (eg the most recent convergence program of each Member State under review) (eg the Alert Mechanism Report and the Economic Forecasts of the European Commission).

It should be noted that, according to Article 140 of the Treaty on the Functioning of the European Union, the state-by-state analysis, although aimed at achieving the aforementioned compliance attributes, may still not allow for an integrated, regional vision and to detect potential effects of contagion, which are otherwise difficult to manage individually by each Member State.

Another interesting methodological aspect is that although the European Central Bank (ECB) monitors and analyzes the fulfillment of the nominal economic convergence criteria, the information is provided by the European Commission (EC), less for exchange rate and long-term interest rates, for which cooperates with the ECB. This is somewhat incomplete, in the sense that also for inflation, an element considered as the basis for establishing the long-term interest rate criterion, should also be established by the collaboration between the ECB and the EC. However, this somewhat elusive methodology on inflation may indicate that inflation includes aspects of long-term interest rates and exchange rates.

Also, the time consistency invoked in the analysis of the criteria is "disturbed" by the fact that, for example, data on the evolution of prices and long-term interest rates are presented up to a certain month within one calendar year (eg March), different for example for the exchange rate (eg April) and those completely downward in relation to data on government debt and government deficit that are analyzed by the end of the previous year. Or, simultaneous fulfillment of criteria with different statistical references can no longer provide a correct picture of this methodology, surprising almost two by two criteria in other time windows.

Taking part of each criterion, a number of additional critical elements may can be drawn.

Thus, it is unclear why achieving a high degree of price stability is linked to inflation close to that of at most the three best performing Member States in terms of price stability, why not five or seven countries? A larger number of states would have ensured some degree of homogeneity in the criterion, and maybe over time, let's say at five-year intervals, the number of states should gradually decrease to three and stay that way.

In addition, inflation, or as mentioned in the Treaty of Maastricht and ECB report "inflation rate", refers to the variation recorded by the most recent annual average available of HICP compared to the previous year's average, which is a rhythm which increases the inability of methodological integration between monetary criteria and between them and fiscal-budgetary ones that are expressed as a share of GDP.

The choice of the three states is based on the "best results in price stability" whether or not countries are members of the euro area, suggesting the need for structural homogeneity between the EU and the euro area. In addition, the expression "no more than three Member States" leaves to the reader's understanding that at one point the three states may actually be two or even one, setting the criterion at a single geographic point in the EU.

It is worth mentioning that, the inflation criterion is one constructed relative to the geographical perspective, with inflation being related to inflation recorded by other Member States, while the exchange rate criterion is reported to the euro and the fiscal-budgetary criteria refer only to the state under review. From this perspective, perhaps the widening and flexibility (eg, band of variation) of the reference to the fiscal-budgetary criteria may be necessary to capture the deviant effects of possible joint shocks from the set targets.

In addition, the inflation criterion defines the concept of "exception" for referential in the sense that: the average annual inflation recorded by a particular Member State is significantly lower than comparable inflation in other Member States and the evolution of prices has been considerably affected by exceptional factors. This aspect of the exception, if it was introduced with the idea of streamlining fiscal-budgetary criteria, could capture possible institutional anomalies in managing government deficit and debt if they were significantly lower than the other countries chosen as reference.

At the same time, inflation is calculated using the consumer price index on a comparable basis, and in the context of sustainable development, in an innovative note, it may be more interesting to analyze the consumer price index of some specific resource categories, possibly rare. From this perspective, the meaning of the phrase "best results in price stability" would revert the criterion of inflation in the sense that for the reference of inflation would count only countries that will keep up and above the price of their rare resources.

For the long-term average nominal interest rate, it is assessed over a period of one year before the examination and may not exceed by more than 2 percentage points that of at most the three best performing Member States in price stability. At the same time, interest rates are calculated on the basis of long-term government bond yields or comparable securities taking into account national specificities.

If we look at the exchange rate criterion, assessing its stability against the euro indicates if the exchange rate is close to, or removed from, the MRS II central rate, irrespective of the fluctuation margins width under MRS II. Of course, this is explained by the fact that the band of ± 15% is sufficiently "generous" to allow a lightweight ranking of all member countries with a relatively stable exchange rate. It is advisable to extend the criterion to the other monetary criteria, but especially to the fiscal-budgetary ones, by fitting into bands of variation. Also, the combination of the idea of the band and the "first three Member States ..." (taken from the inflation criterion) would provide the necessary flexibility and the fiscal-budgetary criteria, the bands being limited by the levels of the indicators of the first three states with the lowest levels plus / minus a certain margin.

It should be noted that interest rates have a non-self-dependent reference, being linked to inflation developments in the EU, or all the criteria should either be all linked from the reference point or completely independent. A total independence of long-term interest rates relative to inflation reference would be desirable in the sense that other criteria also have this autonomy and would reflect a stand-alone image and not one imposed by the influence of inflation. Thus, the criterion developed in this form seems to "punish" those countries whose for example long-term interest rates are more efficient, thus lower than inflation, and have a good capacity to attract investors and to reduce and possibly the impact of the echelon of fiscal-budgetary criteria.

With regard to public finances, the high degree of sustainable convergence refers to their solid character, namely a budgetary situation without excessive public deficit, according to Article 126 (6) of the Treaty. This article states that the deficit above the 3% of GDP threshold can be considered excessively less in the following situations: a) the ratio has steadily diminished and is close to the 3% threshold; b) the overrun of the reference is temporary and exceptional and the public deficit ratio to GDP is maintained around the reference, c) the ratio of government debt to GDP exceeds the 60% of GDP reference value, but it decreases significantly and approaches the benchmark. It should be noted that the soundness of public finances is analyzed on the basis of the data obtained from the national accounts of the Member States according to the European System of Accounts 2010.

It should be noted that, although the ECB is considering whether a country is subject to an excessive deficit procedure, only the European Commission has an institutional role in this procedure. In addition, based on the recommendation of the European Commission, the EU Council, on the basis of Article 126 (6) of the Treaty, after a general assessment, and taking into account the observations of that Member State, decides whether or not there is an excessive deficit in that Member State. The Council Regulations (EC Regulation 1467/97 and EU Regulation 1177/2011) further explain how the fiscal-budgetary criteria for the excessive deficit procedure should be interpreted.

Thus, the criteria are considered on equal terms by the implementation of the first (debt), after a three-year transitional period has been granted for Member States where the excessive deficit procedure, launched before 2011, is complete. At the same time, the criterion is considered to be met if, on the basis of the European Commission's forecasts, the required reduction (at an average rate of one twentieth per annum) of the difference between the debt-to-GDP ratio and the reference is reported, and this will take place over three years. Given that it is taken into account the economic cycle's impact on the debt decline rate, the linking of the government debt ratio to GDP to an automatic maintenance management mechanism, in the reference perimeter, seems desirable.

This is further reinforced by the fact that all EU countries except the UK, Croatia and the Czech Republic have adopted in 2013 the Treaty on Stability, Coordination and Governance within the Economic and Monetary Union (TSSG), which indicates a binding budgetary rule on the annual structural balance which must meet the country-specific medium-term objective with a lower limit of the structural deficit of 0,5% of GDP. If the government debt-to-GDP ratio is below 60%, the medium-term target limit may reach a structural deficit of at most 1% of GDP. In addition, the signatory states have the obligation to introduce into the national constitutions or similar national legislation the budget rules imposed by the TSCG together with ***an automatic correction mechanism in case of deviation from the budgetary objective***.

This is a first aspect of the necessity of imposing an automatic stabilization mechanism, but it also requires the formulation of an equation of the budget deficit (just the structural one) depending on the public debt. Discrimination between cyclical and structural effects (permanent or non-cyclical) on the budget deficit is also difficult due to the inclusion in the structural deficit of specific factors and also of the transient effects of macroeconomic policy measures. It is also worth mentioning that, the budget deficits falls strictly under the responsibility and control of national governments and can be more easily manipulated and manipulated by governments in order to comply with the provisions of the Maastricht Treaty, so it can be a command variable.

At the same time, according to EC Regulation No 1467/97 of the Council and of the Directive 2011/85/EU of the Council impose a rule on expenditure reference values so that, if the EU Member States that have not yet reached their medium-term budgetary objective

(MTO), to ensure the mentainance of annual growth rate of relevant primary expenditures below the medium-term reference rate of potential GDP growth, unless the excess expenditure is covered by discretionary revenue measures. This information element links primary budget expenditure to potential GDP growth. It should be noted that during the global economic and financial crisis and the European sovereign debt crisis, there are important uncertainties about the potential GDP level and growth rate.

The analysis of the sustainability of EU Member States' public finances is analyzed dynamically over the last 10 years as well as on the forecasts of the European Commission for the current and future evaluations, taking into account the medium-term fiscal strategies included in the national programs convergence.

The analysis of the robustness and timeliness of macroeconomic policies used since the adoption of the euro outlines even more the need for an automatic mechanism to quickly and efficiently restore the wanted indicators in the parameters required by the criteria.

As we know, the literature highlights the exchange rate capabilities in automatic stabilization, as well as the budgetary expenditures included in the government-size concept, and the expenditures are a component in the budget deficit. Although revenues are more elastic than spending on economic growth, they can be harder to use in the idea of automatic stabilization, unless they are indeed progressive (especially direct income). So there is the possibility of automatic deficit management to fit into the criterion, and through it and public debt.

Inflation is the preserve of any monetary policy, it is in the center of central bank attention and through central banks numerous and vast instruments the inflation can maneuver, indirectly, within the perimeter of inflation targets. Therefore, it would be interesting and a special opportunity if the criterion could be manipulated indirectly and implicitly than indirectly and explicitly as it is today.

The inflation and long-term interest rates, as they are currently formulated by the criteria, they can be guided in the automatic stabilization perimeter, although naturally they receive and embed information from both the fiscal-budgetary, but also the commercial area, and implicitly more subtle aspects, such as of economic behavior and expectations.

In conclusion, the table below summarizes the information on the necessity, possibility and opportunity of automatic stabilization on nominal economic convergence criteria.

Table no. 1. The necessity, possibility and opportunity of automatic stabilization on nominal economic convergence criteria

	Inflation	Long-term interest rate	Exchange rate	Public debt	Budget deficit
Necesitatea					√
Posibilitatea	√	√	√	√	√
Oportunitatea	√				√

Source: author's conception

5. Conclusion

Although there are many papers addressing the issue of convergence and especially at EU level, as well as works aimed at identifying fiscal-budgetary automatic stabilization, there are no theoretical or empirical facts to clarify the possibility of achieving convergence through automatic type mechanisms.

Thus, this paper, although has rather an introductory character, wishes to discern the extent to which this subject is of interest, is necessary, possible and timely. These aspects can be highlighted through in-depth analyzes on each criterion, but also through a pool of information and links between them.

References:

1. Abramowitz, M., 1986. Catching up, forging ahead, and falling behind. *Journal of Economic History*, 46, pp. 385–406.
2. Auerbach, A.J. and Hassett, K.A., 2002. Fiscal Policy and Uncertainty. *International Finance*, 5(2), pp.229–249.
3. Barbone, L. and Zalduendo J., 1996. *EU Accession and Economic Growth: The Challenge for Central and Eastern European Countries* (Washington, D.C.: Central Europe Department, The World Bank, mimeo, 1996, 44 p.).
4. Barro, R.J., 1991. Economic Growth in a Cross Section of Countries, *Quarterly Journal of Economics*, 106/2, pp. 407–443.
5. Baunsgaard, Th. and Symansky, S., 2009. *Automatic Fiscal Stabilizers: How Can They Be Enhanced Without Increasing the Size of Government?*, IMF staff position note, SPN/09/23,719(2009), pp.1-26. online at: http://www.imf.org/external/pubs/ft/spn/2009/ spn0923.pdf.
6. Caminada, Goudswaard, and Wang, 2012, Disentangling income inequality and the redistributive effect of taxes and transfers in 20 LIS countries over time, LIS Working Paper No. 581.
7. Henrekson, M., Torstensson, J. and Torstensson, R., 1997. Growth effects of European integration. *European Economic Review*, 41(8), pp. 1537-1557.
8. Landau, D. 1995. The Contribution of the European Common Market to the Growth of its Member Countries: An Empirical Test. *Review of World Economics*, 131/4, pp. 774–782.
9. Romer, C. and Romer, D., 1994. *What Ends Recessions?*, NBER Macroeconomics Annual, 9, pp. 13-80.
10. Solow, R.M., 1956**.** A Contribution to the Theory of Economic Growth, *Quarterly Journal of Economics*, 70, pp. 65–94. *Unity, solidarity, diversity for Europe, its people and its territory: Second report on Economic and Social Cohesion* (Luxemburg: EC, 2001).
11. Van den Noord, P., 2000. *The size and role of automatic fiscal stabilisers in the 1990s and Beyond*, OECD Economics Department Working Paper 230, pp. 137-150.
12. Varblane, U. and Vahter, P., 2005. *An Analysis Of The Economic Convergence Process In The Transition Countries*, University of Tartu Faculty of Economics and Business, Administration.
13. Maastricht Treaty, https://eur-lex.europa.eu/legal-content/RO/TXT/PDF/? uri= CELEX:12012 M/TXT&from=EN