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Exceptional Circumstances

The drafters of the euro area's Stability and Growth Pact provided for the possibility that "exceptional circumstances" could allow member states' budget deficits to exceed the 3% limit. But the definition they gave has shown itself to be too restrictive: none of the countries facing deficit problems while suffering from poor growth has been able to use this justification. The clause therefore appears as virtual and the European Commission is proposing to change it. What could the new definition of exceptional circumstances be? Should a rate of growth be used, as is presently the case, but at what level? Or should a "threshold of exceptionality" be considered? Should an absolute standard be defined for all member states or should a standard be adapted to the potential growth levels of different countries? The various possibilities are examined here: they would have led to exceptional circumstances being invoked for between 20% and 50% of the excessive deficit cases which arose from 1997 to 2003.

Excessively Exceptional Circumstances

In its original, 1997 version, the Stability and Growth Pact (SGP) set a ceiling of 3% of GDP on public deficits to be allowed for euro area countries. The short history of the Pact illustrates the problems, which were anticipated in various academic studies,[1] countries would have in respecting this constraint when they have not been able to achieve a structural balance in public finances. The rules of the SGP did not indeed encourage countries to benefit from tax receipts during the prosperous years of 1999 and 2000 in order to achieve such balances. As a result, several countries have reached or even breached the 3% ceiling, during the subsequent slowdown.

That said, the drafters of the SGP had indeed taken into account the mechanical consequences of a slowdown in growth on budget balances (see box), by allowing that "exceptional circumstances" could lead to the suspension of procedures for excessive deficit: if, within the space of a year, GDP falls by at least 2%, the procedure would be halted automatically; for a cut in GDP of between 0.75% and 2%, the "exceptional circumstances" clause could be invoked, following a decision by the Council and after justification of the sudden nature of the recession. However, growth within the euro area has never fallen strongly enough to reach these thresholds, since the SGP came into force in 1999 (see Table 1).[2] "Exceptional" circumstances have indeed been living up to their name. But at the same time, breaching the 3% deficit ceiling has been far from exceptional (the green, shaded area in the Table). The utility of this clause may therefore be questioned, given that not only has it never been invoked since 1999, but also that it would not have been invoked in the years before the Pact came into force either. Its virtual character has limited political support from Member States for the constraints imposed by the SGP.

Table 1 – GDP in volume terms (year-on-year growth rate in %)
*The green, shaded areas indicate cases where public deficits have exceeded 3% of GDP**

	1999	2000	2001	2002	2003
Austria	2.7	3.5	0.7	1.0	1.2
Belgium	3.2	3.7	0.8	0.7	1.2
Finland	3.4	5.5	0.7	1.6	2.2
France	3.2	3.8	2.1	1.2	1.1
Germany	2.1	2.9	0.6	0.2	0.4
Greece	3.6	4.2	4.1	4.0	3.6
Ireland	11.1	10.0	5.7	6.0	3.3
Italy	1.7	3.1	1.8	0.4	1.0
Netherlands	4.0	3.3	1.3	0.3	0.5
Portugal	3.8	3.7	1.6	0.5	0.5
Spain	4.2	4.2	2.7	2.0	2.0

*The figures for public deficits are given in Table 5.
Source: European Commission.

The Pact was amended in March 2003 to better take into account fluctuations in the business cycle: stability programmes (the procedure by which Member States indicate their strategies for returning to budgetary balance) must henceforth be formulated in terms of structural deficits, i.e. cyclically adjusted. This allows a certain amount of flexibility in phases of economic slowdown and

1. See B. Eichengreen & C. Wyplosz (1998), "Stability Pact: More than a Minor Nuisance?", *Economic Policy*, Vol 13, No 26, pp 66-113, or M. Buti & A. Sapir (2001), "EMU in Early Days: Differences and Credibility", CEPR *Discussion Paper Series*, No 2832, June.
2. Excessive deficits will be even less exceptional in 2004, probably affecting six out of twelve countries in the euro area.

Box — The Links between the Business Cycle and the Budget Deficit*

When an economy slows down, tax revenues accruing to government fall, because the tax base (final consumption, household revenue, the total wage bill, *etc.*) contracts. Furthermore, social transfers (unemployment benefits, income support, *etc.*) tend to rise. This automatic cut in tax revenues and the rise in transfers support households' disposable income, thus limiting the fall in demand. These effects, which occur when tax and social legislation is unchanged, are known as "automatic stabilisers": a slowdown in growth leads to a rise in budget deficits, but this rise in deficits limits the slowdown in growth.

It is generally considered that a one percentage-point fall in GDP below its long term trend, raises budget deficits in the major countries of the EU by about half a percentage point.** On the other hand, automatic stabilisers help bring the fall in output, back to a level of 1% *ex ante* and 0.75 *ex post*. Hence, a country which initially has a balanced budget can manage a 6 percentage point fall in growth *ex ante* (e.g.: +3% to -3%) before running up against the 3% threshold. Its budget deficit would indeed fall by 3 percentage points (from zero to -3%), due to automatic stabilisers. But thanks to the latter, its growth rate will "only" fall by 4.5 points (0.75 x 6%), bringing the change in GDP to -1.5% rather than -3%. However, a country which initially has a public sector deficit of 2%, can only cope with a fall in GDP relative to its potential GDP growth path of 2%, as the public deficit runs up against the 3% threshold. For a country initially running a deficit in the order of 3%, it becomes impossible to allow automatic stabilisers to work, without breaking the SGP.

*This box draws on A. Bénassy-Qquéré & B. Coeuré (2002), *Economie de l'Euro*, La Découverte, p. 77.
**See M. Buti & A. Sapir, eds., (1998), *Economic Polcy in EMU*, Oxford University Press, p. 132.

encourages the fact that "tax windfalls" are not spent during expansions. However, the 3% limit and the Pact's "exceptional circumstances" have remained unchanged. In autumn 2004, the European Commission announced a certain number of principles relating to adjustments in the SGP.[3] These include the possible relaxation of the definition of "exceptional circumstances":

> *"In order to cater for periods where growth is still positive, but for protracted time very low, and when such developments are unexpected, possible improvements could include the redefinition of the severe economic downturn and a clarification of the 'abruptness of the downturn' and 'the loss of output relative to past trends' "*[4].

So far, the relaxation put forward by the Commission remains vague: what exactly does it mean for growth to be "*positive, but for protracted time very low*"? To specify this concept, different possible definitions of exceptional circumstances are analysed here and their consequences are evaluated in terms of the probability of a Member State having recourse to such conditions, when its public deficit exceeds 3%.

The Universal Criterion of Recession

A first possibility for reform would be based on altering the threshold used by the SGP to trigger exceptional circumstances – presently a decrease in GDP of 0.75% within a year – and using the common definition of a recession: a fall in GDP during two consecutive quarters.

Were exceptional circumstances to be defined as a fall in activity over two consecutive quarters in the year for which a deficit is recorded, then six countries would have experienced exceptional circumstances, at least once since 1999, and some of them twice (Germany, Italy and Portugal). To be sure, it is not possible to examine this question with only a five-year period, as this does not cover the whole cycle. Data going back to 1995 can be used, but in this case many countries will have recorded excessive deficits under SGP criteria (see Table 5), as the process of Maastricht convergence was not yet completed. A median solution involves going back to 1997, when excessive deficits were examined for entry into monetary union.

Using seasonally adjusted, quarterly growth rates for the last nine (1995-2003) or seven (1997-2003) years, it is possible to calculate the realised probabilities which make it possible to answer the following two questions: 1) Would countries with excessive deficits have been able to escape from procedures set out in the SGP? 2) Conversely, would exceptional circumstances have accompanied excessive deficits, due in particular to automatic stabilisers (see box)? Table 2 provides answers to both these questions.[5] It shows that when using this definition of exceptional circumstances, countries which suffered from excessive public deficits (EPDS) would have had recourse to the excessive deficit procedure in 15% of cases, for 1995-2003, and in 20% of cases for 1997-2003: it should be recalled that under the present definition of exceptional circumstances as given by the SGP, these could never have been invoked. It may also be observed (the last two columns in the table) that during two-quarter recessions, the probability of accumulating EPDS is not negligible: 33% of all cases for 1995-2003, and 20% for 1997-2003.

Table 2 – The impact of various definitions of exceptional circumstances

	Pr(CIRC/EPD)*		Pr(EPD/CIRC)**	
	1995-2003	1997-2003	1995-2003	1997-2003
1997 SGP	0%	0%	-	-
CIRC = recession	15%	20%	33%	20%
CIRC = 1st growth decile	23%	50%	35%	25%
CIRC = 1st output gap decile	31%	36%	90%	50%
CIRC = 1st national growth decile	31%	50%	29%	20%

*Probability of a Member State with an excessive public deficit (EPD) being able to justify exceptional circumstances (CIRC). **Probability of a Member State experiencing exceptional circumstances (CIRC) finding itself with an excessive public deficit (EPD).
The realised probabilities are calculated with 9 x 11 = 99 observations for 1995-2003, and with 7 x 11 = 77 observations for 1997-2003. Luxembourg is excluded from the analysis as quarterly data are not available. Greece is only included for the calculation using the output gap (line 4).
Source: authors' calculations.

3. European Commission (2004), "Strengthening economic governance and clarifying the implementation of the stability and growth pact", Communication from the Commission to the Council and the European Parliament, COM(2004) 581 final, 3 September.
4. European Commission *op. cit.*, p5.
5. Eichengreen & Wyplosz (1998) have already carried out this kind of exercise, *op. cit.*.

As with the current criterion of the GSP, this definition of exceptional circumstances is based on the level of growth which is fixed arbitrarily. It is possible to imagine another way of defining exceptional circumstances. Instead of setting a growth threshold and deducing what could be considered as exceptional, it would be possible to set a level of "exceptionality" and deduce a corresponding level of growth. For example, a 10% threshold of "exceptionality" would signify that policymakers hold growth to be exceptionally weak when it falls within the first decile of the distribution.

A Risk Threshold Applied to Growth

Looking at the period 1995-2003, a 10% threshold of "exceptionality" would have meant that a country having experienced two quarters of growth below 0.2%, within a year, would have escaped from the excessive deficit procedure. This figure is close to 0% when exceptional circumstances are defined as the occurrence of a recession during a year. It nevertheless leads to relaxing the criterion for triggering exceptional circumstances considerably, as shown in Table 2 (3rd row): for the years 1997-2003, 50% of EPDS (5/10) occurred in situations when growth was less than 0.2% for at least two quarters, and would have been classified as exceptional circumstances according to the new criterion, as opposed to only 20% of all cases using the recession criterion. This would notably have allowed Germany and France to escape the EPD procedure in 2002-2003, and Portugal for 2001 and 2003.

This "statistical" definition of exceptional circumstances, which stresses frequency, has the advantage of giving policymakers a transparent choice about what may be considered as exceptional. However, as with the present criterion and the recession criterion, this definition too is based on a threshold which is established independently from the growth trends of the Member States. Thus, countries on high growth trends are unlikely to resort to exceptional circumstances, even though they may also experience difficult situations in which GDP falls violently with respect to its potential level. In contrast, countries on low growth trends are favoured by a criterion which is defined in an absolute manner for all Member States.[6]

A Risk Threshold Applied to the Output Gap

A simple way of taking into account the varying average growth levels of Member States involves looking not at actual growth rates, but rather reasoning in terms of output gaps, in other words the percentage difference between actual GDP and its potential level. Potential growth may lead to different estimations, however, as measuring output gaps is often controversial. The calculations carried out here use annual output gaps calculated by the European Commission and employed in stability programmes (Table 3).

Table 3 – Output gaps (in %)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Austria	-0.6	-0.9	-1.5	0.1	0.7	2.2	1,0	0.2	-0.3
Belgium	-0.7	-1.5	-0.1	0	1,0	2.2	1,0	-0.1	-0.6
Germany	0.5	-0.5	-0.8	-0.5	0	1.4	0.5	-0.7	-1.7
Finland	-2.5	-1.1	1.7	2.8	2.3	4.3	1.4	-0.1	-0.6
France	-1,0	-1.4	-1.4	0	1,0	2.2	1.5	0.4	-0.7
Greece	-3.3	-3.1	-2.2	-1.5	-0.7	-0.1	0.9	1.4	1.7
Ireland	-1.6	-1,0	1.7	1.9	4.4	6,0	3.7	2.3	-1.1
Italy	0.2	-0.1	0.3	0.3	0.2	1.3	1,0	-0.5	-1.1
Netherlands	-0.6	-0.4	0.5	1.8	2.8	3.3	1.8	-0.2	-1.7
Portugal	-2.3	-1.4	-0.3	1,0	1.7	2.4	1.3	-0.8	-2.6
Spain	-2.1	-2.5	-1.5	-0.2	0.9	2,0	1.7	0.7	-0.2

A negative value indicates that output is below its potential.
Source: European Commission.

The example of Ireland shows how the output gap may be the best adapted measure to take into account national situations. Growth in Ireland has indeed been very strong since the mid-1990s, and was still running above 6% in 2003. Ireland has not therefore been concerned by the exceptional circumstances as defined above. Still, the output gap appeared to be negative in 1995, 1996 and 2003, reflecting a slowdown in growth (Table 3).

An "exceptionality" threshold may be defined on the basis of annual output gaps, as was done with quarterly growth rates, and hence be set by policymakers. Output gap levels defining exceptional circumstances could then be inferred for all countries. In terms of the first decile, the output gap threshold then becomes -1.7% for the period 1995-2003, and -1.4% for the period 1997-2003.[7] Exceptional circumstances could have been evoked in 36% of excessive deficits cases during the years 1997-2003 (2nd column, Table 2). This would have been more than under the present criterion (0%) but less often than with the preceding criterion (50% of cases according to the first decile of quarterly growth). In this case, growth has to be low for the whole of the year for exceptional circumstances to be declared. In contrast, a country whose output gap lies in the first decile has a 50% chance of experiencing EDP during this period (the last column in Table 2). This proportion rises to 90% when taking into account 1995-2003.[8]

6. This critique is all the stronger as the SGP has mainly been broken by the larger, low growth countries. Attention must be paid to the fact that any re-designing of the SGP should not favour these countries.
7. These figures mean that GDP of less than 1.7% or 1.4% of its potential level is held to be exceptional.
8. Only the Netherlands in 2003 had an output gap which was strongly negative, though it did not breach the deficit ceiling.

With the output gap criterion, Germany and Portugal (though not France) would have escaped EPD procedures in 2003. Greece too could have benefited from exceptional circumstances in 1997-1998, even though growth was running at over 3% in both years (Table 1). The same holds for Spain in 1997. Thus, this criterion permits all countries, and not only those experiencing low growth, to qualify for exceptional circumstances.

Another way of taking into account the diversity of national situations with respect to growth trends is to consider the distribution of quarterly growth rates, country by country. This makes it possible to go back to growth rates, which are less contentious than output gaps, but by adapting the criterion to the average annual growth rate for each country. Such an approach also allows differences in the distribution of growth rates for countries to be taken into account, with extreme growth rates being more common among smaller than larger countries.

A National Threshold Applied to Growth

An alternative approach is to look at quarterly growth rates of seasonally adjusted data, while taking "exceptional" to refer to years during which economic growth falls within the first decile of the distribution of growth rates, for the country in question. The extreme deciles are shown for each country, in Table 4. The threshold for the first decile varies between -0.065% for Belgium and +0.920% for Ireland. France has a low level of dispersion, measured as the difference between the thresholds corresponding to the last and the first decile. This situation contrasts with those of Finland, Ireland and Portugal.

Table 4 – Decile thresholds for sequential, quarterly growth rates, 1995-2003

%	Deciles			Deciles	
	First	Last		First	Last
Austria	0.198	1.557	France	0.158	1.355
Belgium	-0.065	1.565	Ireland*	0.920	7.130
Finland	0.702	2.117	Italy	0.044	1.803
Germany	-0.052	1.406	Netherlan	0.125	1.616
Spain	0.593	1.734	Portugal	0.004	2.130

*Data not seasonally ajdusted.
Note: Data are not available for Greece.
Interpretation: 10% of sequences (two consecutive semesters) of German quarterly growth rates lie below 0.052%, for the period 1995-2003. 10% lie above 1.406%.
Source: Authors' calculations.

Table 5 highlights the fiscal balances for each country experiencing "low" growth (i.e. growth in the first decile, shown by the grey shaded boxes), or "strong" growth (i.e. growth in the last decile, shown by the green shaded boxes). Boxes in which public deficits exceed the 3% threshold are outlined. Logically, outlined boxes should be the same as the grey shaded boxes. This was especially the case for Germany in 2003, France in 2002 and 2003, as well as Portugal in 2001 and 2003. Since 1999, these five cases of EPD, out of a total of six, could have been justified by exceptional circumstances.

Table 5 – Budget deficits and extreme quarterly growth rates*

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Austria	-5.3	-4.0	-2.0	-2.5	-2.4	-1.6	0.1	-0.8	-1.3
Belgium	-4.3	-3.8	-2.0	-0.8	-0.5	0.1	0.4	0	-0.3
Finland	-3.9	-3.0	-1.3	1.5	2.0	6.9	5.2	4.7	3.3
France	-5.5	-4.1	-3.0	-2.7	-1.8	-1.4	-1.5	-3.1	-3.7
Germany	-3.5	-3.4	-2.7	-2.2	-1.5	1.1	-2.8	-3.6	-3.4
Ireland	-2.1	-0.1	1.4	2.3	2.0	4.5	1.2	0	-0.6
Italy	-7.6	-7.1	-2.7	-3.1	-1.8	-0.7	-2.7	-2.5	-2.3
Netherlands	-4.2	-1.8	-1.1	-0.8	0.7	2.2	0.1	-1.2	-1.6
Portugal	-5.5	-4.8	-3.6	-3.2	-2.9	-2.9	-4.3	-2.7	-3.6
Spain	-6.6	-5.0	-3.2	-3.0	-1.2	-0.8	-0.2	-0.1	-0.4

*The figures in the outlined boxes indicate years in which deficits exceeded 3%. Shaded grey and green boxes indicate "weak" and "strong" growth respectively.
Note: Quarterly growth data was not available for Greece, which is not included in the table.
Source: European Commission.

For 1997-2003, this definition of exceptional circumstances leads to results that are close to the criterion of the first decile, as calculated for all countries (Table 2). This is because countries with strong potential growth rarely experienced deficits above 3% (Greece is an exception to this, but is not included in the calculations).

These results must of course be handled with care. There does not seem to have been a relationship between excessive deficits and growth in the years 1995-1998. Nevertheless, this type of calculation does provide interesting possibilities for alterations to the SGP. In particular, it allows greater flexibility of the SGP when growth is weak, in exchange for being more demanding during phases of faster growth, for example when the latter falls in the last decile of the distribution. Based on this framework, Table 5 shows that some deficits would have been judged as excessive in 1999-2000 (e.g.: the deficits of Austria and France in 1999, and Portugal's deficit in 2000), even though they did not reach 3% of GDP.

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