



I want to make a general observation and then emphasise three specific points in relation to the 'fiscal compact'.

My general comment is that there is no consensus among economists about how best to manage budgetary policy, particularly over the short-term, and there is certainly no consensus that legally binding targets are superior to more discretionary and flexible fiscal policy.

- Virtually everyone agrees that economies need responsible fiscal policy to thrive, with deficits under control and sustainable debt ratios;
- Yet, targets and timing should follow sound theoretical principles and best available evidence – and as evidence of best practice changes we should have the flexibility to adjust accordingly;
- Experience suggests that fiscal policy requires flexibility in the short-term, and would be unduly restricted by 'rigid targets'.

The first specific point I want to make is that the 'deficit brake' and 'debt brake' provisions outlined in Article 3 and in Article 4 are potentially seriously flawed.

This includes the mechanism that requires countries with debt to GDP ratios over 60 per cent to reduce that excess by an average of one-twentieth per year.

- The idea of a 'debt brake' superseding other economic considerations is problematic. It can prevent governments from borrowing to make investments that pay long-term dividends, such as in education or in the provision of General Purpose Technologies. Unless the peripheral countries have the flexibility to borrow to close their infrastructure deficits relative to the Euro zone core they will continue to struggle within the currency union;
- The proposed 'one-twentieth' rule would kick in as soon as Ireland left the EU/IMF programme of assistance;
- The debt to GDP ratio is likely to peak at approximately 120 per cent of GDP. Reducing the excess at the rate implied by the 'one-twentieth' rule will choke off any nascent recovery in the Irish economy;
- The ongoing deleveraging in the private sector, fiscal consolidation in the public sector, as well as weakening prospects for exports, will constrain Ireland's growth outlook in the short and medium-term. The 'one-twentieth' rule will trigger a prolonged period of fiscal tightening – that is continued tax increases and public spending cuts beyond the current 2015 time horizon.

Secondly, there are conceptual and quantification issues that make the measurement of the structural deficit highly controversial – if not practically impossible. This has implications for compliance and monitoring of the proposed 'fiscal compact'.

- Economies are highly complex and dynamic systems and there is disagreement about what long-term baselines should be used to indicate how much of a deficit is 'structural' as opposed to a function of the economy's place in the business cycle;

- Previous attempts to measure structural deficits by bodies like the IMF have been subject to major retrospective changes in more recent years. This illustrates how difficult it can be to accurately forecast a country's structural deficit.

Thirdly, the 'fiscal compact' does not address the existing design flaws that lie at the heart of the Euro zone.

- There is a problem with focusing solely on the 'fiscal compact' as it can at best only offer a partial solution;
- It only provides a few pieces of a much more complex 'jigsaw' of rules and institutions that are required;
- The usefulness or not of the 'fiscal compact' can only be judged in the context of a fuller set of reforms and supports for sustainable growth at European level.

A number of solutions are required at European level to compensate for the fact that the Euro zone is not an 'optimal currency area'.

- Euro zone member states need a guaranteed lender of last resort – which requires us to change the mandate of the European Central Bank;
 - At present, governments cannot oblige their central banks to buy government debt. Governments can literally run out of money which creates the risk of sovereign default. As the fiscal balance deteriorates in a recession the risk premium increases thereby creating a progressively worsening feedback loop. This is known as the multiple equilibrium problem;
 - Yet a guaranteed lender of last resort creates issues of moral hazard and the risk of cheating. This is why there is a need for fiscal rules. But these rules must have a sufficient degree of flexibility.
- Other flexibilities are also needed in terms of policy, not least measures to counter-balance the one-size-fits-all interest rate that creates localised private credit bubbles and amplifies the cycle of boom and bust. In this context we must recognise that successful currency unions require some form of cyclically-based fiscal transfer mechanism. Fiscal federalism of course brings its own concerns;
- There need to be clear rules for managing future crises, including protocols and conditions for writing down and restructuring sovereign debt;
- We also need Europe-wide special resolution mechanisms for insolvent banks as part of centralised Euro zone financial regulation.

In summary, economists do not agree that a debt brake is a good idea – and there is certainly not strong evidence in favour of the type of mechanism proposed in the 'fiscal compact'...

There are technical problems with measuring structural deficits that could seriously impede attempts to monitor member states' structural deficits...

At best, the fiscal compact is incomplete and there are various other 'jigsaw pieces' needed at Euro zone level to resolve the crisis.

At worst it will damage recovery in the Irish and other European economies.