



No 2006 – 06
March

A Dynamic Perspective for the Reform
of the Stability and Growth Pact

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A DYNAMIC PERSPECTIVE
FOR THE REFORM OF THE STABILITY AND GROWTH PACT

SUMMARY

Six years have passed since the creation of the common money. It has become a fact of the Euro area citizens' daily life and the Euro-system with its central institutions and procedures functions satisfyingly. The problematic aspect of the monetary integration in EMU concerns the European co-ordination and surveillance of Member states' budgetary policies, institutionalised in the Stability and Growth Pact of 1997. A number of important Member states have repeatedly breached the rules set by this Pact, causing grave concerns for its survival and in consequence, for the protection of EMU monetary policy against pressures from overindebted Member states.

In June 2005, the Pact has been reformed. This paper explores the Pact's prior functioning, the causes, and the principal axes of the 2005 reform, and the main arguments advanced to defend or to criticise it. It reaches a *contradictory* result.

As to the Pact's prior functioning, this is a success story for almost all Member states of small and medium size, and the reform appears apt to facilitate the Pact's future implementation. But as to the larger Member states plus the two least developed of the small ones, the Pact experience is a history of non-observance.

The contradictory experiences of small/medium and of large Member states can be summed up in three conclusions :

- The Pact can be respected, resulting in an indirect but effective co-ordination of budgetary policy among the complying Member states.
- Respecting the Pact does not prevent Member states –by applying autonomous national economic policies– from achieving relatively high growth, plus structural reforms, resulting in a positive longer-term perspective for Pact-observance.
- The ability of the small/medium MS to respect the Pact in the short and in the long run, is higher than that of the larger ones.

These contradictory experiences do lead to a negative judgement on the functioning of the SGP altogether. But recognising the success of the compliers' group, and not only the failure of the non-compliers, contributes to vindicate the Pact's basic logic in the face of the most commonly heard general indictments, and thus permits to sharpen the analysis. These points are explored later in this paper.

What explanation to this finding ? A first reaction was to look at whether small-medium Member states tended to apply some different and more effective budgetary stabilisation approach, compared to the larger Member states. This possibility could be excluded and attention turned to structural factors.

In economic terms, larger Member states, as compared to smaller ones, are marked by a structural disadvantage in this respect, caused principally by the closed internal sector constituting a larger share of their economy. In consequence, carrying through structural reforms which improve their competitiveness, does not procure them positive effects within the same short delays and of the same proportion. In a keynesian interpretation, one could also presume that the amount of growth foregone, in consequence of reducing public expenses, is comparatively larger than in smaller states, because of the larger fiscal multipliers in the former. Reform could thus be seen to be more expensive in terms of foregone growth; in any case its positive effects are smaller, and slower to make an effect, over time, than in the smaller MS.

At the political level, incentives to comply with the Pact rules, appear to be smaller for large MS governments, be it because of the just mentioned higher economic cost or be it because of the relatively smaller political cost for decision-makers, linked to non-compliance.

Given the Pact's objective to limit public debt for all MS in the same proportions, its procedures do not make any allowance for these structural differences, except of the possibility to exploit the margins offered by the difference between the treaty objective of zero deficit or surplus in public budgets, and the maximum permitted public deficit of 3 percent-of-GDP, the first practised by the small-medium, and the second by the large Member States.

As to the reform, both the Pact's objective, and the Member states' competency to conduct their budgetary policy in national responsibility, have been explicitly confirmed by it, in spite of their partial contradiction, and Member States appear intent to preserve their competencies for the foreseeable future. This partition of competencies includes a Council decision making mode which allows them to decide themselves about the rigour with which they apply the rules of the Stability Pact against each other. Insofar there is little chance for further centralisation of budget policy of EMU Member States which might give European institutions the competency to set explicitly differentiated deficit targets for different national governments, in order to compensate different structural conditions.

This being so, *negative* assessments appear especially justified when looking at the reform in a *static perspective* and taking it as it is, tel-quel: It does not appear to correct the most evident drawbacks of the Pact and of its application. In consequence it appears unfit to prevent further deterioration of the larger Member states' Pact observance, and therefore of the Pact's general functioning. But a *more positive* assessment appears possible, if one views the reform in a *dynamic perspective*, implementing it in a forward-looking manner.

Given the narrow limits for effective reform at EMU level, three approaches are privileged more specifically, in this paper:

- first look at the Member states' internal set-ups and improve their national ability to respect the rules of the Stability Pact,
- second give a more dynamic perspective to the limited reforms of the EMU institutions and procedures, by operationalising them,
- and third improve the soft-law context by supporting financial market actors' reactivity to Member state fiscal policy.

As to the internal set-ups, recent analyses of many OECD states have demonstrated the weaknesses of central governments in controlling public expenses and deficits of intermediate levels of public authority. Reform efforts at these levels might well improve the chances of central governments to keep their SGP engagements.

As to the reformed SGP and especially its newly inserted so-called "relevant factors", their credibility would profit from an operationalisation which would also reduce their arbitrariness and condition their application by the Council, on the provision by the applicant governments, of standardised packages of supplementary information for each case.

And finally, as to financial market actors' reactivity, the Council should send clear signals that they –including the European Central Bank– would encounter no political opposition when downgrading the creditworthiness of national debt titles emitted by overindebted Member states, and asking for risk premia when accepting them as collateral.

ABSTRACT

This paper explores the functioning of the EMU Stability and Growth Pact from 1999 to 2005, year of its first explicit reform. The causes and the principal axes of that reform are analysed, as well as the main arguments for defending or criticizing it.

As to the Pact's prior functioning, for almost all small and medium Euro area states this is a success story and the reform appears apt to facilitate the Pact's future implementation. As to the larger Member States, the Pact experience has been a history of non-observance which the Pact's reform appears only to condone and abet. This contradictory experience leads to a negative judgement on the functioning of the SGP as a whole. But recognising the success of the compliers' group, and not only the failure of the non-compliers, justifies the Pact's basic logic, as against certain commonly heard indictments. It permits to sharpen the analysis. These points will be explored later in this paper.

As to the reform, it does not appear to correct the most evident drawbacks of the Pact and of its application. A negative assessment appears especially justified in a *static perspective* and taking the reform as it is, tel-quel. But a more positive assessment appears possible, if one views the reform in a more *dynamic perspective*, implementing it in a forward-looking manner, by operationalising the new concepts of the reform (the “relevant factors”), and by further improving the context: first by developing Member states’ capacities to better apply the Pact, and eventually also counting on a stronger influence of financial market actors, on public borrowing.

JEL Classification: E61, E62

Keywords: Economic and Monetary Union, EMU, Stability and Growth Pact, Single European Currency, Reform of the Stability and Growth Pact, Surveillance and co-ordination of economic and budgetary policies in EMU.

UNE PERSPECTIVE DYNAMIQUE POUR LA RÉFORME DU PACTE DE STABILITÉ ET DE CROISSANCE

RÉSUMÉ

Cela fait six ans que la monnaie unique a été créée. Elle fait partie du quotidien des citoyens de l’Euro zone et l’Euro-système, avec ses institutions et ses procédures centralisées, fonctionne de manière satisfaisante.

Les difficultés concernent la coordination et la surveillance des politiques budgétaires des Etats membres, institutionnalisées par le Pacte de Stabilité et de Croissance de 1997.

Les règles du Pacte ont été enfreintes à répétition par certains Etats-membres importants, jusqu’à susciter de graves inquiétudes quant à sa survie et quant à la capacité de maintenir la politique monétaire de l’UEM à l’abri des pressions exercées par le niveau d’endettement de certains membres. Le Pacte a été réformé en juin 2005. Ce texte examine le fonctionnement antérieur du Pacte, les raisons de sa réforme, les principales innovations qu’elle introduit ainsi que les arguments de ses partisans comme de ses adversaires. Il parvient à des conclusions partagées.

Le fonctionnement du Pacte est une réussite pour presque tous les Etats membres de *taille petite ou moyenne* pour qui la réforme devrait faciliter sa mise en oeuvre. Mais pour les *grands* Etats membres (et les deux moins développés des petits), l’expérience du Pacte peut se résumer à l’inobservance de ses règles.

Cette différence entre petits-moyens et grands Etats amène trois conclusions :

- Primo, le Pacte peut être respecté et il permet une coordination indirecte mais efficace de la politique budgétaire des pays qui le respectent.
- Secundo, respecter le Pacte n’empêche pas les Etats membres –grâce à des politiques économiques autonomes– d’atteindre une croissance relativement élevée et de mener des réformes structurelles, ce qui, à terme, renforce leur capacité à respecter le Pacte.
- Terzio, cette capacité est plus grande chez les petits et moyens Etats que chez les grands.

Ces expériences contradictoires conduisent, globalement, à formuler un jugement négatif sur le fonctionnement du Pacte. Mais l’analyse gagne à prendre en considération la réussite des Etats qui se sont conformés aux règles, et à ne pas se limiter à l’échec de ceux qui ne les ont pas respectées : on retrouve alors la logique de base qui justifie le Pacte et permet de répondre aux critiques les plus couramment formulées.

Quelle explication peut-on trouver aux expériences contradictoires des différents pays? Une première explication serait que les petits et moyens Etats membres ont appliqué des stratégies de stabilisation budgétaire d'un autre type et plus efficaces que les grands. Mais ceci n'est pas vérifié et il faut s'orienter vers des explications plus structurelles.

Les économies des grands pays sont caractérisées par un désavantage structurel du fait que leur secteur interne, « fermé », constitue une part plus grande de leur économie. En conséquence, les bénéfices tirés des réformes structurelles n'y sont ni aussi importants ni aussi rapides que dans les petits pays. Selon une interprétation keynésienne, on peut aussi considérer que l'impact négatif sur la croissance d'une réduction des dépenses publiques est plus important dans un grand pays que dans un petit, du fait de multiplicateurs budgétaires plus puissants. Au total, les réformes seraient moins bénéfiques et plus coûteuses en termes de croissance dans les grands pays que dans les petits.

Au niveau politique, les incitations à respecter les règles du Pacte paraissent plus faibles pour les gouvernements des grands Etats, non seulement parce que le coût économique d'une stabilisation budgétaire est plus élevé, mais aussi parce que le coût politique de l'inobservance des règles est moins important.

Ces différences structurelles ne sont pas prises en compte par le Pacte qui fixe les mêmes limites à l'endettement et au déficit publics de tous les membres. Seule existe la marge opérationnelle entre l'objectif du traité d'un déficit zéro ou d'un léger excédent, et le déficit maximal de 3 % du PNB : le premier est respecté par les petits et moyens Etats, le dernier est exploité par les grands.

S'agissant de la réforme du Pacte, celle-ci a explicitement confirmé—en dépit de leur contradiction partielle—à la fois l'objectif du Pacte et la compétence des Etats dans la conduite de leur politique budgétaire nationale. Les Etats sont désireux de préserver l'un et l'autre. Ce partage des responsabilités comporte une procédure de décision du Conseil qui permet aux Etats de décider eux-mêmes de la rigueur avec laquelle ils appliquent les règles du Pacte. Ceci laisse peu de chance à davantage de centralisation de la politique budgétaire des Etats membres, qui donnerait aux institutions européennes la compétence de fixer des cibles nationales de déficit, différenciées selon les conditions structurelles.

Dans ces conditions, un jugement négatif de la réforme se justifie si on se place dans une perspective purement statique. Dans ce cas, elle ne semble pas à même de corriger les inconvénients les plus évidents du Pacte et de sa mise en œuvre ; elle ne pourra pas éviter l'inobservance du Pacte par les grands Etats membres et la détérioration de son fonctionnement général. Cependant, une appréciation plus positive peut être formulée si l'on considère la réforme dans une perspective dynamique. A cet égard, dans les marges étroites qui existent pour une réforme du fonctionnement de l'UEM, trois approches sont privilégiées dans ce papier :

- (i) examiner les institutions internes des Etats membres et améliorer leur capacité à favoriser le respect des règles du Pacte.

- (ii) donner une perspective plus dynamique aux réformes limitées des institutions et procédures de l'UEM, en les formulant de façon plus opérationnelle.
- (iii) améliorer le contexte de « soft-law » en encourageant la réactivité des acteurs du marché financier à la politique budgétaire des Etats membres.

(i) Concernant les institutions internes, des analyses récentes portant sur de nombreux Etats membres de l'OCDE ont montré les faiblesses des gouvernements centraux, quant au contrôle des dépenses et des déficits des niveaux intermédiaires d'autorité publique. Des réformes dans ce domaine pourraient améliorer la capacité des gouvernements centraux à respecter leurs engagements vis-à-vis du Pacte.

(ii) S'agissant du Pacte réformé (en particulier, de son catalogue des « facteurs pertinents » pouvant être invoqués pour justifier des déficits), il gagnerait à être précisé de façon plus opérationnelle. Exiger, par exemple, de chaque pays voulant se prévaloir d'un « facteur pertinent » un ensemble standardisé d'informations complémentaires auquel serait conditionné l'accord du Conseil, permettrait de réduire l'arbitraire du catalogue actuel.

(iii) Finalement, concernant la réactivité du marché financier, le Conseil devrait confirmer clairement à ses acteurs —y compris la BCE— qu'ils sont pleinement dans leur rôle et ne risquent pas de susciter de réaction politique défavorable s'ils dégradent les titres de dette des Etats sur-endettés et qu'ils réclament des primes de risque élevées pour les accepter en collatéral.

RÉSUMÉ COURT

Ce texte examine le fonctionnement du Pacte de Stabilité et de Croissance, de 1999 à 2005, année de sa réforme. Il présente les objectifs de cette réforme et les innovations qu'elle introduit, puis expose les principaux arguments de ses partisans et de ses adversaires.

Le fonctionnement du Pacte est un succès pour pratiquement tous les *petits ou moyens* Etats membres, pour qui la réforme devrait faciliter sa mise en œuvre à l'avenir. Mais pour les *grands* Etats membres (ainsi que pour les deux moins développés des petits), l'expérience du Pacte est celle d'un non-respect des règles, que la réforme ne fait qu'excuser et risque à l'avenir d'encourager.

Ces expériences contradictoires conduisent, globalement, à formuler un jugement négatif sur le fonctionnement du Pacte. Mais l'analyse gagne à prendre en considération la réussite des Etats qui se sont conformés aux règles, et à ne pas se limiter à l'échec de ceux qui ne les ont pas respectées : on retrouve alors la logique de base qui justifie le Pacte et permet de répondre aux critiques les plus couramment formulées

S'agissant de la réforme, celle-ci ne semble pas en mesure de corriger les inconvénients les plus évidents du Pacte et de son application. Une appréciation négative paraît donc s'imposer, du moins si l'on considère la réforme dans une perspective purement statique. Un jugement plus positif semble en effet justifié dans une perspective dynamique où les nouveaux concepts introduits par la réforme (« facteurs pertinents ») reçoivent un contenu opérationnel et où le contexte dans lequel la réforme est mise en oeuvre est amélioré sur deux points principaux : *primo*, les capacités nationales à respecter le Pacte, et *secundo* l'influence des acteurs du marché financier sur l'endettement public.

Classification JEL : E61, E62

Mots clés : Union Economique et Monétaire, UEM, Pacte de Stabilité et de Croissance, Monnaie Européenne Unique, Réforme du Pacte de Stabilité et Croissance, Surveillance et coordination des politiques économiques et budgétaires en l'UEM.

A DYNAMIC PERSPECTIVE FOR THE REFORM OF THE STABILITY AND GROWTH PACT

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I. INTRODUCTION

The creation of the common money in 1999 was the culmination of a development toward monetary unification in the European Community which had already begun in the late 1960s, under the motto “One Market, one Money”. The principal stages of this development were the Werner Plan of 1970, the agreement of Basel with the “Snake in the Tunnel” of 1972, the European Monetary System and Exchange Rate Mechanism (EMS/ERM) of 1979 and the Economic and Monetary Union EMU, for which the most important conceptual basis was laid in the Delors Report of 1989. Whereas the Snake in the Tunnel and the EMS/ERM foundered in the repeated crises of the international financial system of the 1970ies and 80ies, the Member States succeeded in their third attempt, by creating the EMU and the common money in 1992 (Treaty of Maastricht), and by the decision of the European Council (96/736/EC) to begin EMU with the introduction of the common money, on January 1st, 1999.

Six years have passed since that date, the common money has become a fact of the Euro-zone citizens' daily life and the Euro-system with its central institutions and procedures functions satisfyingly. The problematic aspect of the monetary integration in EMU concerns the European co-ordination and surveillance of Member states' budgetary policies, institutionalised in the Stability and Growth Pact of 1997. A number of important Member states have repeatedly breached the rules set by this Pact, causing grave concerns for its survival and in consequence, for the protection of EMU monetary policy against pressures from overindebted Member states.

In June 2005, the Pact has been reformed. This paper explores the Pact's prior functioning, the causes, and the principal axes of that reform, and the main arguments advanced to defend or to criticise it. It reaches a *contradictory* result.

As to the Pact's prior functioning, for a large group of Member states this is a success story and the reform appears apt to facilitate the Pact's future implementation; as to the others it

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is a history of non-observance which the Pact's reform appears only to condone and abet. For the monetary Union as one whole, there can obviously only be one result, and this is negative. But recognising the success of the compliers' group, and not only the failure of the non-compliers, permits to sharpen the analysis, and improves the legitimacy of the Pact's basic logic, as against certain commonly heard arguments. These points will be explored later in this paper.

As to the reform, negative assessment of the reform appears especially justified in a *static perspective* and taking the reform as it is, *tel-quel*: it does not appear to correct the most evident drawbacks of the Pact and of its application. But a more positive assessment appears possible, if one views the reform in a more *dynamic perspective*, implementing it in a forward-looking manner, by operationalising the new concepts of the reform (the "relevant factors"), and by further improving the context: first by developing Member states' capacities to better apply the Pact, and eventually also counting on a stronger influence of financial market actors, on public borrowing. A number of proposals will be made in that sense.

II. THE FIRST LIFE OF THE PACT (1999 – 2005)

1. The Basic Compromise between a *Europeanized* Monetary Policy, and *National Economic and Financial Policies*

The basic compromise of the Monetary Union consisted in putting two levels of co-ordination in place, an *almost fully europeanised one* for monetary policy, consisting of the European System of Central Banks and the institutional safeguards for protecting its autonomy against governments (no financing of governments by central banks, no bail-out of their debt by the latter), and an *intergovernmental one* consisting of a system of surveillance and co-ordination of budgetary policies of Member States to better protect the Central Bank and the common monetary policy against the pressures resulting from excessive public debt and threats of public bankruptcies in Member States. It is the second of the two, a set of rules and institutions, which is meant when one talks about the Stability and Growth Pact (SGP).

A contradiction in objectives and institutions

Introducing a common money and an accompanying budgetary surveillance policy between sovereign nation states meant coming to grips with a basic contradiction at the level of objectives and of institutions.

As to the objectives

- On the one hand preserve the marges of manœuvre for the economies and societies of the Eurozone to apply the policies and methods best adapted to their specific national

situation and their needs of growth and development, in spite of having lost the important instrument constituted by a national monetary policy.

- But on the other not permit that these national policies create constraints for, or menace, the capacity of the Central Bank to conduct a stable monetary policy for the whole Euro zone.

As to the institutions and procedures

- On the one hand have an almost completely centralised monetary policy actor, the European System of Central Banks with the European Central Bank,
- and on the other not touch the full national competency of Member States for the conduct of their economic, social and financial policy.

The compromise which the governments had found after long-drawn and difficult negotiations in 1992, was the following :

As to objectives

The acceptance of an upper limit to public debt, expressed in a maximum level of borrowing –the deficit-to-gdp ratio of 3 percent– and in a maximum level of public debt – the debt-to-gdp ratio of 60 percent– constituted the compromise between freedom of national adaptation, and the respect of a centralised policy to preserve a stable money. Underlying the engagement as to these limits, was a second engagement of each Member State to keep its budget in balance or in a light surplus, as the *n o r m a l* line of conduct.

As to institutions and procedures

Here, the maximum which the Member States were willing to cede, of their political autonomy, to support the common monetary policy, was the mutual obligation to participate in a procedure of regular mutual surveillance of their economic and budgetary policies, to accept mutual counsel and admonishments as to their respect of engagements, and eventually accept fines, in the case of non-respect of these upper limits.

The Pact

This ensemble of objectives, institutions and procedures is grouped together in a number of legal texts,

- in the Treaty of the European Community, its articles 98 to 104, especially nos. 99 and 104 (TEC 1997),
- the Protocol on the procedure in case of an excessive deficit (ibid),
- the Decision of the European Council on the Stability and Growth Pact (1997),

- and in the two Regulations 1466/97 and 1467/97, added in 1997,² in the interest of operationalising the criteria and the procedures, and of rendering their application as binding and timely as possible.

The decision plus the two regulations have been baptised the Stability and Growth Pact (Regulation 1466/97 introduction par.(2)) and it is only the latter which have been changed by the recent reform. But insofar as they constitute in reality the “instruction manual” for applying article 104, it is the ensemble which has come to be called the “Pact”.

What did the decision and the two regulations add to the Treaty text ? To the norms to be respected (maximum levels of public deficit and debt), and the basic procedural steps to be taken, they adjoined:

- a formal demand by the European Council, directed at Member states and institutions, to fully respect the engagements entered into especially by TEC Art.103 and 104, as to the norms and to the procedures;
- norms of stable fiscal policy to be adhered to, or to be pursued (budget close to balance or in surplus, and a debt ratio clearly below 60%), important qualifications as to the exceptions conceded from the full respect of these norms, in special circumstances as economic downturns, and regular reporting and surveillance obligations as to the adherence to these norms, for the Member States, the Commission and the Council (Decision, and Regulation 1466/97);
- and it set a time schedule to be respected for the sequence of steps – Commission reports and recommendations, Council decisions and Member State correction periods– constituting the excessive deficit and the sanctions procedure (Regulation 1467/97).

Nevertheless, the Member States had not let themselves fully bind into this sequence of steps and delays. The Pact did preserve the essence of their flexibility and autonomy in the final decisions concerning their budgetary policy. Insofar it became a policy integration project marked by a deep contradiction between its ambition as to the declared common objective of the co-ordination, and the absence of effective coercive instruments conceded to the Union, to reach this goal.

Other Options

It is significant to note that many other options of a political-institutional flanking of the common money have been intensively debated in the run-up to introducing the common money. One finds many of those options which have been re-discussed again on the occasion of the recent Pact reform. Some of those options plead for less, many of them also for more constraint, than the actual Pact, in co-ordinating Member States’ economic and

budgetary policy (Cf. Patat 2005, p.58, Begg and Wyplosz 1993 p.49, Bini Smaghi et al 1993 p.4, 34ff., Delors Report 1989, p.25).

But in the end, neither in the preparation of the Monetary Union, nor in its reform of 2005, have Member states been willing to concede more than the minimum compromise laid down in the Pact. And besides that, what has counted most, were the simplicity, the transparency and the applicability of the criteria and the procedures.

2. What is the Pact and how should it function ?

If one resumes as briefly as possible,

- The explicit prime aim of the Pact is to prevent Member States from entering into (or remaining in) excessive and non-sustainable public debt.
- A general line of conduct is stipulated, under the name of “medium term objective, MTO”, to keep budgets in balance or slight surplus, and public debts clearly below 60 percent of gdp. A red line is drawn for the limit not to be overstepped by Member governments, the 3 percent public deficit-to-gdp ratio, (and the non-enforced 60 percent public debt-to-gdp ratio), the “stability criteria”.
- The Pact institutes first a surveillance and control for both, adhesion to the MTO and complicity with the stability criteria, called the “preventive arm” of the Pact (the first of the two regulations dealing with it). There is a second part called the “corrective arm”, supposed to give the tools for inducing or constraining governments to correct excessive deficits and debts.

Whereas one may consider the “preventive arm” as “soft” law of the Union³, Member States being engaged in an open co-ordination kind of dialogue about their budgetary and general economic policy, with no constraint stipulated, the “corrective arm” applied against those who have overstepped the red line of the 3 percent, constitutes “hard” law, in two steps, in the sense that first Member States are declared in excessive deficit and exposed to explicit corrective programs which are urged on them by the Council, and in a second step, when correction is not forthcoming, they are given notice and have to pay a substantial fine⁴, should they not move back behind the “red line”, within a final delay of correction accorded to them.

A number of exceptions permit the Member States to apply these rules with a certain discretion, especially in cases where the red line has only been overstepped very briefly and

³ For a recent presentation of the concept linked to “soft” and “hard” law in EMU, cf. Trubeck et.al 2005.

⁴ Which again takes two forms, first a non-interest-bearing deposit and then, in case of further persisting non-compliance, of an outright fine.

² Of 17th and 16th June 1997 respectively, the two regulations dating of 7th July 1997.

by very little, and where a prolonged economic recession has rendered compliance with the rules temporarily impossible for the Member State.

The preventive and the corrective arm of the Pact, excluding the sanctions part, apply to all EU Member States, including those which have not yet adopted the Euro.

If this is the text and the theory of how the Pact should function, it remains to be seen how it was actually applied.

3. Successes and failures of the Pact

Five years after the introduction of the Euro, in 1999, and starting the application of the Pact, governments, European institutions and experts alike, agree first about a remarkable success of the new common policy, and secondly about important failures.

First the success-story: All medium and smaller Member States (with the signal exceptions of the least developed among them, Greece and Portugal) have in fact managed to respect the medium term objectives of the Pact, realising budgets in balance or even in surplus, and avoiding –with very short exceptions– excessive deficits. This success concerns more than half of the EU Member States.

But only few of the media and political commentaries, remark this success, concentrated as they are on the grave problems which the other and mainly the larger Member States experienced. They have not –after 1999– succeeded in controlling their borrowing; they have passed the red line of excessive deficit again and again. In 2005, the three largest and most important economies of the Euro-zone, Germany, France and Italy, plus the principal one outside of it, the United Kingdom, find themselves in the excessive deficit procedure.

As to the causes of this contradictory performance, the following analysis will try to look at the most important factors.

a) *Soft law*

Effects of Non-Compliance with the Pact

- *As to external consequences*

The first question is why about half of the Member States prefer to comply, and why the others and especially the largest, together with the least developed of the smaller ones, do not prefer to comply with the Pact, out of their own best interest. To understand this better one can look at the way that the consequences of profligate budgetary behaviour affect the concerned Member states' interests and whether they do so in negative ways.

We will not look at the externalities affecting all Euro zone Member States but at those consequences liable to affect specifically the non-complying countries themselves. They are of two kinds, one being increasing risks to the essential economic and financial functions and benefits which the common money procures to them as to all other members and which might be harmed by non-compliance with the Pact. Another might be damage done to the Member State's "political capital" of power and reputation in EMU and EU decision making.

As to the *strictly monetary and economic interests*, especially *financial markets* could theoretically transmit negative consequences. This aspect has been much debated and the potential of such consequences certainly exists,⁵ for instance as to the risk of interest premia demands which profligate governments are faced with when financing new debt. Even so, up to 2005 such premia remain insignificant, even for the least virtuous among them. As for the stability of the Euro and for its exchange rate, financial markets have not drawn any manifestly negative consequences either, out of the numerous breaches of the SGP. Thus governments' perceptions of strictly financial risks appear not to have been big enough to re-orient their behaviour.

Small-Large Member States

There is a first difference between larger and smaller Member States, concerning financial markets. It concerns the greater liquidity of the larger MS' public debt titles. It does not yet appear to play an important role.

Another strictly economic consideration concerns the high dependency of small-medium Member States' economic activity on external economic exchanges with the large Member States and in consequence on the development of their internal demand. All measures liable to reduce the latter, for instance a rigorous application of the Pact during a period of economic downturn, would appear to reduce the growth perspectives of the small-medium Member States.

Theoretically this link could provoke a paradoxical reaction, namely that small-medium Member States would not insist on enforcing the Stability Pact against the larger ones, for fear that the latter's macro-economic demand, on which their own activity depends in a disproportionate manner, suffer too much. In fact, no such reaction has been visible up to now. In January 2006, it is rather the Commission which invokes this factor to explain its hesitation to demand action against Germany under TEC Article 104 par. 9.⁶

⁵ Cf. a detailed debate of this question further down in this article.

⁶ As to this, a comparison of the voting behaviour of small-medium Member States in Council, at the end of 2003, and of their dependency on exports to Germany and France, does not permit to confirm this

The large-small divide seems to play a bigger role concerning the effects on the *political – institutional level*. De Haan et al.(2005) have pursued that question in a political economy analysis, calculating the relative weight of considerations of power and reputation, versus that of longer-term fiscal cost, for decision makers in small and large countries. Considerations of power and reputation actually appear to incite voluntary compliance, and *they do so mostly for smaller Member states*. The assumption of these authors is that small countries, with a small voting weight in Council and a limited power status, find their political position in the EU influenced much more negatively by a sanction in the SGP, than do large countries for whom voting weight and power status compensate any such consideration.

Another aspect of this consideration could well concern the formally equal voting weight in the ECB council, for all members irrespective of the weight of their Member States' Ministerial Council vote (Protocol to the Treaty of Maastricht, on the Statute of the ECB, Article 10). Small and medium Member States' special interest to protect and enhance this very advantageous position, may well constitute an additional motivation for complying with the Stability Pact.

In a more general vein, small countries in geopolitical proximity of larger ones tend anyhow to be "structural adapters" to the conditions set within this context. The evidence of their relative dependence on larger neighbours is so indisputable that they have less domestic political problems with adaptation than have the large Member states.

- As to internal consequences

The Pact's credibility is also bedevilled by the important and persisting debates of economists, about the *intrinsic merits of the SGP criteria*, especially the supposedly negative economic effects which their rigorous application might have on Member States, thereby seriously weakening the legitimacy of all arguments about the supposed detrimental consequences of non-compliance.

But the fact that smaller and medium Euro zone Member states (up to and including Spain!) have been able to succeed in complying with the SGP, parting from substantial structural reform and enjoying above-average growth at the same time (cf. table p. 44), would seem to invalidate the most general arguments of this kind against the SGP.

Small-Large Member States

Again, a central concern must be to explain the difference between the larger and the smaller Member States' performances. Just recall: Whereas the "smaller" ones (up to and

including Spain !) kept close to balance or even in surplus during the upswing up to 2000, and afterwards, and managed to weather the downturn with only slight dents in their budgetary stability, letting automatic stabilizers work, the larger ones had preserved substantial deficits (with Germany's one-year exception in 2000) even in the upswing, which they widened during the downturn (Marinheiro 2005). Research also appears to show that in this period, the smaller Member states achieved significantly more structural reforms apt to reduce their deficit tendencies, than did the larger ones (Duval 2005, Duval and Elmeskov 2005) and growth statistics show them to be out ahead of the rest, over the whole decade (cf. table p. 44).

Can the smaller and medium Member states' successes in budgetary stability, based on more structural reform and combined with above-average growth, be explained by different concepts of budgetary stabilisation compared to the larger ones ? Or is it that the accepted models for success are the same for all, but that smaller Member States face fewer obstacles in actually implementing them, than do larger ones? Then the issue would be the differences in obstacles, and the question would be whether these latter are concomitant to bigness of Member States and render the larger ones structurally less capable of conforming to the Pact over the long run.

First results of studies in the OECD appear to point in this latter direction (Duval 2005, Duval and Elmeskov 2005). Once inside the monetary union and the SGP, large Member States appear to have comparatively fewer incentives than the smaller ones, to undertake the necessary structural reforms to reduce their deficit tendencies, given the inability to cushion negative social effects of such reforms and compensate their numerous losers, by the previously used methods: devalue on the one hand, increase public debt on the other.(Duval, Elmeskov 2005, 9ff., 35f; cf already Eichengreen and others in 90ies). *Smaller countries* with much higher trade ratios stood to gain so much from structural reforms, in terms of export competitiveness and increased trade, that they continued them irrespective of the immediate SGP relevance of such efforts. Economic incentives thus worked in very contradictory ways. Bodo Herzog (2005) has recently highlighted another aspect of the same problem: Parting from the statement that for smaller economies the variations of output, in consequence of deviations from the economic trend, are larger than for the big countries and happen more often, Herzog concludes that smaller countries have greater need of a budget with an intact stabilizing function for their economy. In consequence they can be shown to consolidate their budgets more rapidly than do the bigger Member states.

This appears a very worrying finding, implying as it does that large Member states are less capable than others to proceed in good time and voluntaristic manner, to the structural reforms necessary to reduce their tendency to public deficits. For them, things might still have to get clearly worse, before they would come around to the necessary reforms. Worrying also, given the great importance of large Member states' budgetary policy for the cumulative budgetary stability of the Euro zone as a whole, and given the importance of a shift in the large Member states' budgetary policies for the future credibility of the Stability

hypothesis (calculations of the author). Additional research might here be in order. For the Commission, cf. reporting in Le Monde, 25.01.2006 "La zone euro connaît une reprise, les déficits sont en baisse".

and Growth Pact altogether. In a Keynesian interpretation, one could also presume that the amount of growth foregone, in consequence of reducing public expenses by a certain quota, is comparatively more important in large, than in smaller and more open states, because of the larger fiscal multipliers in the former.⁷ Reform could thus be seen to be more expensive in terms of foregone growth; in any case its positive effects in large Member states are smaller, and slower to make an effect, over time, than in the smaller ones.

The weight of these considerations for large Member states would appear to be increased by what might be called “conflicting interests” of governments. The temptation to borrow excessively is often created by following short-term political values or traditional political behaviour (path dependency): win an election, grant welfare benefits which are considered legitimate parts of national social tradition. A number of studies have in fact shown for the election aspect that Member state governments follow the temptation to spend in the interest of preserving power (von Hagen 2003, Mink and de Haan 2005). A frequent explanation is the *time inconsistency problem*, that incumbent governments will not themselves be confronted with the longer-term consequences of their acts in budgetary policy, for instance on the common money.

Fortunately, the arguments of Duval/Elmeskov do not seem valid for all cases in point. Spain, after all, is not really a “small country” with a specially high foreign trade ratio, nevertheless it has implemented very successful structural reforms (Rato 2004). And the influence of important variables on the probability of structural reform is much disputed, for instance as to the stability of the budget, or the macroeconomic situation of the moment. Whereas a stable budget permits to assume the political cost of structural reform, an urgent and costly stabilisation effort (f.i. in the SGP context) will reduce the room for additional consolidation for reform’s sake, but budget instability may also increase reform urgency. As to growth, it facilitates structural reforms in limiting sacrifices and giving alternatives to losers. But growth may also discourage structural reforms because of reducing their perceived urgency, all in enabling governments to reduce deficits and respect the Pact. This would justify the view “that fiscal consolidation is especially likely to succeed – in terms of positive growth effects – when countries approach a critical level of macroeconomic instability (...for instance...) as the result of a chronic tendency to increase budget expenditure, debt problems ...” (Rato 2004, p.4; likewise in reference to economic crisis

situations Duval/Elmeskov 2005, p.35). Further research in this field appears certainly in order and Duval himself explicitly asks for it (Duval 2005 p.32)⁸.

Taken at face value, these results also say that there is no new success recipe to discover in smaller Member states’ budgetary policies, that these latter only face fewer obstacles in applying Pact rules. The structural reform options are well-known and accessible to all Member states, and the larger ones will have to overcome their specific obstacles to apply them in their turn.

Problems of economic cycles

Coming back for a moment to the *intrinsic merits of the SGP criteria* and the perverse economic effects which their rigorous application might have on Member States, a more specific version of this argument concerns Member states’ budgetary policies adaptation to economic cycles: Experts and certain governments have accused the Pact with its rigid quantitative deficit limits to provoke pro-cyclical budgetary policies of Euro-system States which would prevent governments from stabilising economic growth over the cycles and on the contrary even exacerbate cyclical downturns.

This assertion has been confirmed, but more indirectly than directly, and the rigid application of the Pact has not been the primary concern – rather the contrary. In fact, numerous studies show that larger Euro zone Member states have frequently preferred to overshoot the Pact’s limits to public borrowing and risked non-compliance with the deficit criterion rather than cut expenses in economic downturns (Marinheiro 2005, Cimadomo 2005, Artus 2004, de Haan et al 2003). One could infer that only this non-compliance has averted the danger of pro-cyclical acceleration of economic downturns in the Euro-zone.⁹

But it is also true that large Member states have not taken the necessary measures for reducing their deficits during the upswing before and up to 2000, preferring –like France and Germany, against the explicit warnings of the European Commission– to cut taxes and bet on “growing out” of their budgetary difficulties by increasing their tax revenues later on, in the hoped-for upswing. This behaviour already reduced the effect of the automatic stabilisers during the upswing, and then –logically– when the downturn came, perhaps the

⁸ One condition of the Duval-Elmeskov argument to apply in a large majority of cases would be that, as a rule, fiscal adjustment can be shown to be contractionary. This creates the dilemma for the larger countries, which is in the center of their argument. Recent research and the experiences of countries like Spain in the second half of the nineteen-nineties do not seem to confirm that condition. In fact, there are a whole number of interesting cases of expansionary fiscal contractions in European countries, not just limited to smaller states - the Spanish case being one of them. Cf. Rato 2004.

⁹ Other motivations of Member States continue to influence their fiscal policy and blur the role of this consideration : Even political budget cycles have survived under the Pact, as other recent research has amply demonstrated (Mink, de Haan 2005, von Hagen ...).

⁷ “The size of the multiplier, however, is affected by a number of factors which may entail crowding-out effects, such as... the degree of openness of the economy ...”. “Fiscal expansion is likely to have a standard Keynesian impact in a relatively closed economy. Such an impact, however, is weaker for open economy”. Cf. Briotti 2005, p. 9, 19. Cf. also Roeger/in’t Veld, p. 27: “The positive short run output effects (of govt. spending increase) are much less pronounced in countries like Ireland, Belgium and the Netherlands, where the high degree of openness means that a much larger share of the fiscal impulse leaks abroad via higher imports. In these small open economies the price level rises less than in the other countries, as the share of imports is much higher. With a smaller inflationary response to the fiscal expansion there is a smaller reduction in real short interest rates and the impact multiplier is accordingly smaller or even negligible”.

decisive explanation of their bad record on Pact compliance (for the mechanism, cf. EU Commission 1998: 134 ff.).

Thus again, these results cannot really be blamed upon the intrinsic functioning of the Pact, but rather upon its faulty application by the non complying Member states.

There may be just one serious remaining problem in this context, namely the deficit dynamic inherent in longer lasting economic downswings which can then reduce public revenues even of virtuous Member states beyond the point where their previous adherence to a balanced budget would permit them to avoid a procyclical stance if they want to respect the deficit criterion at the same time (De Haan, Berger, Jansen 2005).

Problems of criteria

Experts seem unanimous about one principal cause as to the scepticism vis-à-vis criteria: The sustainability of public debt is not addressed with sufficient rigour, by the surveillance, correction and sanctioning procedures of the Pact. But in strictly economic terms it is debt sustainability which experts consider to be the crucial variable to support the common monetary policy, whereas the deficit ratio can send wrong signals.

Lack of implication of national institutions

Finally, there are the evident questions to be subsumed under the notion of « ownership » of the rules. Breaching the rules or not breaching them is decided on grounds of fiscal and economic urgency, on grounds of procedural leeway and absence of clear incentives and impartial authority at the European Union level. But it is also decided by national governments acting in a frame of explicit or implicit national references, on grounds of the relative values attached to the different options, including how the act of non-compliance itself is appreciated by the domestic and by international audiences. The issue of central national governments' control over spending and borrowing by sub-national authorities under their jurisdiction is another important component of "ownership".

A potential for improving such ownership of the SGP rules and thereby the incentives for compliance would certainly appear to exist in several Member states.

b) "Hard Law": On problems of institutions and procedures

The institutional and procedural instruments of constraining fiscal policy co-ordination under the Pact could not compensate this lack of incentives at the level of financial, economic and status interests of the larger Member states. They have not been used with the necessary rigour. If its excessive-deficit procedure has been used with few problems and in very numerous cases, its giving-notice-and-sanctioning mechanism has never been activated until spring 2005.

Experts agree about the most important cause for this lack in rigour, at the same time the central institutional weakness of the SGP : that it is the *Euro-system States themselves* which *judge* and sanction –in the Ecofin Council– their respective compliance/non-compliance with the SGP fiscal policy rules (cf. Buiters 2003). This is a *direct and intended result of the original compromise* at the genesis of the EMU, which was already pointed out.

This being so, the Member state governments need strong legal and institutional incentives to resist the temptations of excessive borrowing, and the complying governments equally need strong incentives in the Treaty rules and institutions to act against their non-complying peers in the interest of the Euro-system as a whole. Such incentives do not exist. Such decisions have to be taken by a Council majority of Member States, by *sanctioning the non-complying behaviour of certain ones among them*, in rigorously applying the respective rules in Council. But as the situation is today, such a majority requires the co-operation of some of the non-complying Member States. And these can avert the application of the rules to themselves (cf. for this and the following de Haan, Berger, Jansen 2005, 12 ff.).

- Under the treaty, MS have means to evade the opening of sanctions procedures, by setting the application of the rules aside or by deferring it, using discretion and invoking flexibility justified by "specific circumstances".
- Under the treaty, non-complying Member States thus have large possibilities to prevent the complying ones from having the Council accept decisions which would affect them negatively, especially in giving them notice and threatening sanctions.
- Finally, all those governments who have reason to fear an excessive deficit situation for their own country, have an especially strong disincentive to apply the rules with too much rigour against the others.
- This appears only rational, given that all EU governments participate in Council votes on excessive deficits, with the exception of cases according to Art.104, 8-11. But even here, all the Euro governments have the right to vote, including those in manifest non-compliance with the SGP. No reduction of this voting right is foreseen for the latter.¹⁰ Strong formal institutional incentives to compensate the "temptations" to borrow excessively, cannot thus exist, for most Member states of the Euro system.

A *second group of causes* concerns the *mutual relations of EU institutions* in the handling of the SGP. The most important aspect here concerns the Commission. It is the only institution competent to call Member States to their duty: alerting them officially to a potential threat to stability (TEC Art.104). Independent institutions have no official access. And: the Commission is a weak actor, not possessing the monopoly of initiative in this field, leaving the Council in a very powerful situation as long as it can muster a majority for

¹⁰ Such a reduction has been repeatedly suggested in the past, by prominent experts, but never put into the treaty.

a decision. The Commission's role as guardian of the Treaties and the application of the SGP, and its substantial obligations in the implementation of the latter, nevertheless motivate it to develop explicit substantial positions on the issues treated in the SGP, and to press for their being taken into consideration.¹¹

Another one of these causes concerns the relationship between the European Council and the Ecofin Council. The European Council does not figure in Treaty and SGP. Even so, it is of the highest importance, in setting the tone for the EU economic policy co-ordination (in the BEPG procedure and the Lisbon process). And it directly determines the further evolution of the SGP itself, as in March 2005 when deciding on the reform of the SGP which is the subject of this article. But at the same time the Heads of State and Government of the Euro-States do not bind themselves explicitly to the monetary and fiscal policy decisions taken on behalf of their states, in the Ecofin Council, by their ministers of finance. Thus, the European Council's economic policy will continue to be drafted in an only verbal attachment of the management of the money and the fiscal policy directly linked to it. In fact, the Chiefs of state and of government of the Euro-Zone will continue to be able to stay clear, in their domestic role and their policy on EC level, of the disciplines of the SGP under which their finance ministers have to work.

There is one *important variant* to the standard sanction of an eventual fine: Member states which receive *cohesion fund benefits* are subject to a direct budgetary policy conditionality: "If the Council finds that a Member state has failed to take action to correct an excessive deficit or 'has not respected the Stability and Growth Pact', then the Council may not provide funds for new projects or even for new stages of (already existing) important projects"¹² This conditionality is liable to be preserved for the new regime which is going to succeed the present one in 2007.¹³ Of the old Member states this rule concerns two of the least complying ones: Greece and Portugal. And it concerns all of the new Member states. This is not an instrument of the SGP, but of the cohesion programme. But it is in the toolbox of the same Council which decides on SGP issues and adds a welcome additional instrument of control and sanction, and a potentially highly effective incentive for respecting the SGP.

Unfortunately the application of this conditionality has been subject to the same kind of hesitation, on the side of complying Member states, as the SGP sanctions rules proper.¹⁴

¹¹ The tensions resulting out of the contradictions inherent in this role broke out into the open during the conflict between Ecofin Council and Commission over the latter's recommendations for Germany and France in fall 2003, and the resulting case brought against the Council, by the Commission, in 2004. Cf. Dutzler and Hable 2004.

¹² Jones 2005, p.5, Council regulation (EC) 1164/94, 16.05.1994, and Council regulation (EC) 1264/99, 21.06.1999.

¹³ cf. draft regulation diffused by the Commission ...

¹⁴ Its application would not be mentioned in the excessive deficit documents of Commission or Council. But recent interviewing of high officials in the Council secretariat and the competent Commission DG

One may speculate whether the reasons for this are the same – this is non unpalatable; additional research here might be interesting. In consequence, the Member states in breach of rules have no incentive either, out of this special rule, to better respect the SGP.

A final group of causes may concern *conflicts of competencies within national systems* which prevent EU Member states from keeping their engagements vis-à-vis the Currency Union. Sub-national authorities may for instance borrow more than wanted or foreseen by the central state government. The OECD has published a series of papers on its member countries, and a synopsis of these country studies in 2003 (Joumard and Kongsrud 2003), in which it presented the methods which Member states use to handle this dilemma, which constitutes a problem for almost all of them.

c) *Summing up*

As to "soft law" aspects:

In spite of formal equality of rights and obligations of all Member states the Euro zone is marked by a striking difference of de-facto SGP-observance.

1. The group of the three largest Member states has remained in permanent budget deficit since one decade –with the single exception of Germany in the year 2000–, breaching the reference value since 2001/2, and all the other ones, small and medium, with the exception of Portugal and Greece have remained in or close to balance, or in surplus, for the same period.
2. Non-legal determinants appear to play a decisive role for their respective behaviour, a first element comprising comparative size and diversification of the economic structure, and the dilemma of time inconsistency, a second one considerations of power and reputation. There is little that can be done to ease the larger Member States' leaderships' special dilemma –compared to those of the smaller MS– with the social and political cost of adaptation to the Pact's disciplines. The weakness of financial markets as disciplining factors for governments' budgetary policy can be considered an important additional element.

As to "hard law" aspects:

There are two contradictory interpretations of the functioning of the Pact, inspired by two different visions of the Pact and of its principal objective. As has become evident by now,

confirmed that the application of this conditionality has internally been evoked as a possibility, but has never been raised in an official discussion with one of the concerned non-compliant Member states.

they also concern different groups of countries, the first one the non-compliers, the second one the compliers.

1. Rules and reference values of the Pact are not adapted to the true objective which consists in the medium- and long term sustainability of public finances in the Member States. They even risk to be counter-productive. Therefore they have to be changed especially in differentiating the diagnosis and the therapy given to the different Member States, putting the sustainability of public debt in the center of concern.
2. Rules and reference values of the Pact are the appropriate instrument to aid the Member States in orienting themselves towards the true objective, sustainability of public finances. The problem is that they leave too many loopholes for non-application and that Member states have to activate their application against themselves. In consequence they are not applied with rigour and equity. It is there that things have to be improved.

III. THE REFORM OF THE PACT, OF JUNE 2005

1. Overview of the Reform

The first reform of the Pact has been enacted, between March and June 2005, by a Council Report to the European Council on “Improving the implementation of the Stability and Growth Pact” (23 March 2005) and the revision of the two regulations 1466 and 1467/97 (27 June 2005). This reform does not modify the Treaty. More specifically, it does not affect its Article 104 which remains the base on which the changes of implementation can be tested and can evolve.

Criteria of evaluating Member States’ fiscal situation

The new text preserves the deficit-to-GDP ratio as the central reference value for deciding about the excessive deficit of a Member State. It also upholds the margins of discretion which the old one already contained and within which a Member State can be conceded attenuating factors against this decision, provided that the deficit-to-GDP ratio can be shown to stay close to the reference value, and be only breached exceptionally and temporarily, or to have moved close to the reference value (Art.104(2), or that a Member State is faced by an event outside its control or by a severe economic downturn. Commission and Council share in the appreciation of these factors. The important changes brought by the SGP reform come in these margins of discretion.

- The severe economic downturn

The first change at this stage concerns the definition of a “severe economic downturn” which in turn justifies to term a breach “exceptional” and temporary, and therefore permits a more lenient assessment of this breach in the course of an excessive deficit procedure.

The other justifying factor, namely an “event outside the control of the MS concerned” (Art.2(1) of the resolution 1467/97), remains in place unchanged.

In the past already, the severe economic downturn was not rigidly defined. It could be conceded when real GDP would have receded within one year. Two institutions shared in the concession procedure: the Commission in its report according to ECT Art.104(3) was supposed (cf. Art.2(2) of the resolution 1467/97) only to concede it when the recession of GDP would have amounted to at least 2 per cent within one year, and when it considered that the deficit would return under the reference value when the economic downturn ended. But the Council, in deciding about whether to declare an excessive deficit, according to ECT Art.104(6), could be more lenient and concede a severe economic downturn even when the recession was clearly less than 2 percent in one year (Art.2(3) of the regulation 1467/97) after having taken account of all remarks of the Member State concerned, and of all relevant circumstances¹⁵ (The Decision of the European Council on the Stability and Growth Pact, of 17 June 1997 speaks of a reference point of at least -0,75, in fact a window between -0,75 and -2,0 % has been practised. One confirmation of this in Bundesbank 2005, 17).

The new SGP regulation 1056/2005 suppresses this minus-2%-recession criterion altogether. Instead, it opens the window even wider by permitting that the severe economic downturn already “result from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential” (Regulation 1056/05 Art.2(2)).

Thirdly, Commission and Council now have to share the responsibility for this appreciation and for an eventual “leniency” from the beginning.

- The decision on the fiscal situation

The introduction of pre-formulated “relevant factors” and the changes concerning the “close to reference value” cases.

Concerning the report to be established by the Commission in case that a Member State did not comply with the reference values, the unchanged EC Treaty Art.104(3) had already demanded that the Commission include a full assessment of the Member State’s deficit and debt situation, in relation to public investments and all other relevant factors, including the MS’ medium term economic and fiscal situation.

¹⁵ The Decision of the European Council on the Stability and Growth Pact, of 17 June 1997 speaks of a reference point of at least -0,75; in fact a window between -0,75 and -2,0 % has been applied. One confirmation of this in Bundesbank 2005, 17.

The Council could then decide whether an excessive deficit existed, in referring itself to the Commission recommendation, but also to the remarks of the Member State concerned, and after an examination of the over-all situation which it could conduct in autonomy (EC Treaty Art.104(6)).

The reform does not change this primary law which already acknowledged three categories of “relevant factors”, and a certain discretion for the Council decision. But the reform explicitly “fills up” each of the three categories with a number of ready-made attenuating factors which are ipso facto already principally considered legitimate, and which would formerly have needed to be introduced and defended ad hoc. Most of these factors are not well defined and quantitatively circumscribed. (A notable exception being the one concerning pension reform (regulation 1056/05 Art.2(7)).

A number of these newly established factors reflect the admission of old requests from certain Member States which had demanded more leniency under the SGP: Budgetary efforts towards ... achieving European policy goals, notably the unification of Europe, ... fostering international solidarity, ... implementation of the Lisbon agenda or R&D and innovation efforts, are to be taken into consideration when deciding about declaring a Member State in excessive deficit (Regulation 1056/2005 Art.2).

Secondly, the manner in which the Treaty is being applied (according to the Pact), changes in the following aspects :

- *Preventive arm, this concerns the criteria, the economic cycles and effects* : for the complying Member States, a certain limited differentiation of their budgetary policy will be accepted, according to the situation of the concerned Member State : Those with a lower debt level and a higher potential of growth will be authorised to a small margin of deficit. The same concession will be made to Member States which introduce costly structural reforms which are likely to reduce their tendency to deficit in the future.

Member States are encouraged more explicitly to anti-cyclical policies, especially in growth periods. But the reform does not include steps to *constrain* governments in this direction. The reasons for this probably lie in the well-known technical difficulties of presenting a calculation of the cyclically adjusted deficit at a given point of the business cycle and of agreeing to a unique institution authorised to undertake these calculations and to pronounce binding results.

- *Corrective arm : this concerns mainly institutions and procedures, and « ownership »* : Non-complying Member States not respecting the Medium Term Objectives or the deficit reference value, are entitled, already in setting the initial deadline for the correction of an excessive deficit, to an intensified analysis of their budgetary and economic situation by the Commission according to Article 104,3, which is also

explicitly supposed to refer to the different elements of flexibility and interpretation which may justify a longer-than-standard correction delay.¹⁶

If such states only breach the reference values by a small margin and for a short time, they can be spared the excessive deficit procedure if these elements of flexibility can be invoked in their favor.

The same holds for the determination of the correction delays accorded to Member States, after being given notice, and leading up to eventual sanctions according to Art. 109, 8 ff.. Longer delays are put at their disposal and may be prolonged later on¹⁷ (cf. also Regulation 1056/2005, Art.5 par.2).

As for the correction imposed on Member States found to be in excessive deficit, it is more explicitly justified and it is also fixed in a more rigorous manner, mainly in insisting more than formerly on the sustainable nature of the corrective measures taken (Regulation 1056/2005, Art.3 par.5, and Art.5 par.1).

Have the principal causes of non-compliance, in the “hard law” part of the Pact, as they were presented further up, been addressed by the reform ? To make a long answer short, they have not.

In spite of long continued breaches of the central stability criterion of the Pact, the deficit-to-GDP ratio of -3%, by a number of important Member states, and of the manifest inability of the Union institutions to apply the hard instruments of the SGP against the non-complying Member states, the reform has not opted for improving the applicability of the hard instruments, but rather for modifying the rules in a way that endorses and facilitates this prolonged non-application for the future.

Five and a half years after converting to the new currency in eleven of them in 1999, the Union Member states have thereby confirmed and even re-enforced to their advantage, their original compromise of 1992 and 1997 (Maastricht and the SGP): Namely to only accept co-ordination of their budget policies to the measure that the autonomy of their national fiscal policy would not be infringed by the Union.

The institutions and procedures have not been changed, the incentives and disincentives which they contain, have not been altered either. The Member states continue to be their own judges as to their mutual budgetary performance. They remain in a position to decide with majority, and according to their own judgement, on whether they want to apply or to override the Pact rules in a specific case, when entering into an excessive debt procedure or going one step further, to applying a sanction.

¹⁶ This can be read in the “Council report to the European Council of March 2005” (No. 7619/05, par. 3.7., first indent), the blue-print for the revision. It is more explicit than the regulation itself.

¹⁷ Cf. *ibid.*

The resistance to any reduction of budgetary autonomy of the Member states, by the reform, seems to have been strongest from the largest ones, not astonishing given their budgetary policy record. This basic confirmation has, in consequence, the explicit support of the heavyweights of this Euro system.

This confirmation appears so clear and consequential, following as it does upon prolonged discussions in official and in government circles, and a number of conflicts on these issues, including one between the Commission and the Council before the European Court of Justice in 2004, and being supported by the largest Member states, that it does not leave much hope for any short-medium term move in the opposite direction. The following analysis takes this insight as its point of departure.

The Commission position has only been strengthened in a minimal manner.

The formal institutional incentives to comply or to act against non-compliance of Member states, remain weak.

As to the medium and small countries, one may speculate that they have voted for the same limited reform, precisely because they could consider themselves living proof that the Pact could function, and function well, without harming economic growth in the Member States complying with it. Why should these Member States then plead for or agree to a more radical reform which would only amount to reducing their autonomy in managing their financial and economic affairs ?

These smaller Member States are the only ones who can profit from the flexibilisation of the Pact's preventive part, and from the new possibility of escaping the excessive debt procedure under certain conditions for the time being. They are interested to get official appreciation of their virtuous status under the Pact, all in making sometimes costly structural reforms or mastering an economic downswing, both entailing a sometimes small and passing increase of their deficit

Insofar the first part of the reform, of the preventive part, appears mainly addressed at the virtuous small and medium Euro system states, and aiming also to engage the upcoming new Euro system members coming from Central Europe.¹⁸ It might also have been the compensation for having these states accept the second part, concerning the corrective part, which mainly concerns the larger and non-compliant states of the Euro system, and concedes them substantial added flexibility.

¹⁸ This interpretation was offered in the Council secretariat.

2. Contradictory Assessments

It is easy to understand –even though sometimes surprising¹⁹– that the large majority of external experts and commentators seem to draw the conclusion that the Stability Pact is done with, and so, more generally, the attempt to co-ordinate and correct budgetary policies of Member states in a constraining way: “The End of the Stability and Growth Pact ?” as Bastian de Haan et al. asked already in 2003; in 2005 they would have had to finish with an exclamation mark. But there is also a more positive interpretation, coming, it is true, from the official institutions.

Negative View

The adaptations of the text and the actual policy conducted under the Pact during the year 2005, taken together with the economic situation, justify serious concerns:

- As to the economic situation, insufficient growth, accompanied by high unemployment, and costly stabilisation policy,²⁰ may further contribute to render compliance with the debt criterion difficult;
- As to the Pact-reform, its serious draw-backs are clearly visible:
 - refusal of many MS to give notice to one among them –and especially one of the larger MS– and to expose it to the direct threat of sanctions according to Art. 104, 9 f., favours the formation of a group of long-term “non-compliers” and discredits the notion of a Pact with “a bite”;
 - the excessive deficit cases of Italy, Greece and Portugal (all decided in 2005, and in which correction delays of respectively 2 and 3 years have been stipulated) demonstrate the ease with which –under the revised Pact– the duration of a delay is manipulated and prolonged, which was formerly considered to be limited to one single year (excepting exceptional circumstances);
 - the growing complexity of the Pact, with its newly extended catalogue of ready-made justifications and excuses for deficits and debts, and with its differentiated and widened possibilities of prolonging and cumulating correction delays, reduces its chances to be applied with rigour and equity.

All of this justifies the expectation that the number of non-complying Member States will remain large. These MS may well be declared in excessive deficit according to the rules. But in taking advantage of the modified text, they will be conceded more comfortable correction delays which will then be extended without problems, so that they can easier

¹⁹ Considering the large number of authors who have accompanied the creation of the SGP and especially the stability criteria and the intended rigour of their application, with open criticism, and who have demanded more flexibility.

²⁰ Cf. the announcements of the new German government of Mrs. Merkel in November 2005.

avoid having to accept notice given to them and being fined, according to Art.104, 8 ff.. The antechamber preceding the « hard law » application can thus fill up without the doors toward the fines ever opening. The corrective function, and the threat constituted by the last part of the excessive deficit procedure, disappear, together with its disciplining effect.

Even the compliant Member States could perceive this as a de facto change of the reference values concerning the so-called “medium-term-objective” of close to balance or in surplus, legitimising a less virtuous budgetary stance.

As all of this has not yet come about, the centre of the arguments against the Pact reform lies in the fear that the new text will not be applied in good faith, that it will serve as a pretext for protecting the Member States against every sanction of laxist budgetary behaviours, that it will not, in other words, be taken seriously.

Positive View

Different from the negative interpretations, the positive one is more prevalent among the official Pact institutions as the Council and the Commission or, for that matter, the larger Member States’ governments.

The essence of this view would appear to lie in the declared intention to take the new text seriously and to apply it in good faith, with impartiality, discretion and firmness. More specifically:

- First of all the flexibility condemned in the reformed text, existed already in the original version of 1992 and 1997; only certain of its forms and procedures of application have changed
- In addition, one can point out, in favour of the old and therefore also of the new Pact, that it has impeded the governments from borrowing even more, that it has created a kind of culpabilisation of excessive borrowing which will persist;
- The criteria of good budgetary policy have become more flexible, the justifications of non-respect of the Pact have become more numerous and less simple to understand, the procedures even more complicated. But after all, the large majority of academic economists had asked the governments not to apply criteria which were considered too rigid, too narrow and insufficiently adapted to reality; they favour more flexibilisation and differentiation of these criteria. The reformed Pact would appear an appropriate answer to these demands. It promises to give all EU Member States, even the larger ones, the leeway which they need to start those costly structural reforms which should enable them to avoid excessive deficits in the longer term.²¹

²¹ This is the view very explicitly defended in Beetsma and Ribeiro (2005) who show that “looser sanctions and/or sanctions that take account of reform efforts or the business cycle should all facilitate the implementation of reforms” (Duval 2005, p.32).

- Differentiation of criteria and of rules does not say that it has become impossible to apply them in good faith, carefully adapted to the specific case and with more rigour than in the past. One aspect of this new rigour was the new benchmark of 0,5% for annual deficit reduction, at first view equal to the established practice, but imposing stricter rules than formerly by referring to the cyclically adjusted balance net of one-off measures and measures of short effect.
- Precisely in such a line of argument, Italy and Portugal could also be considered two positive examples of such rule application. The Council has imposed the maximum of correction obligations on the two countries. But it took advantage of the widened possibilities of the reformed Pact to give them the longer correction delays needed so as not to provoke a pro-cyclical process of worsening their economic situation even more.
- Another significant fact confirming this positive view is the Council decision concerning Greece in April 2005, the first occasion on which the Council has been able to find the majority for giving notice to a Member State, implying the threat of a fine if Greece not complies with a catalogue of precise correction demands, within a delay of two years. The Greek case has therefore at long last created the precedent for the application of this procedure, thereby rendering it more accessible than before, for other cases as well.

Commission and Council concur in this general appreciation (especially the larger Member States). Even so, the two great institutions differ as to the elements which justify their respective optimism. And as to the smaller Member States most all of them virtuous participants in the SGP, they appear less likely to share in these positive views.

The Commission appears more concerned to find the instruments which will after all permit to better constrain the Member States, all in conserving their formal autonomy. It’s collaborators tend to find that the instruments of the Pact have become more precise and that its own control over the surveillance and the co-ordination of the national fiscal policies has improved via the reform. Its own capacity of autonomous analysis and evaluation of the fiscal situations of the Member states has also been slightly improved. It declares itself decided to use this plus to establish a specific *Commission* record as to surveillance and proposals, with which it might in the future confront the Council and the European public alike.

As to the Council, its tendency is rather to see the margins of manoeuvre of Member States widened, all in declaring that it wants to go forward as well, to save the system.

The two views share a common analysis of the basic condition of the Pact. Their main difference is one of the strategic interpretation of this analysis. Secondly, one has to concede that the simultaneous presence of the negative and the positive view appear quite understandable, given the remarkable indifference of the Euro vis-à-vis the non-compliance of the biggest Member States, with the stability criteria. Neither the stability of the common money, nor its exchange rates, nor the credit cost in Euroland, demonstrate any negative

effect. In fact, in the Council there is open satisfaction about having better accomplished a stability oriented monetary and budgetary policy in the EMU, than the US or Japan have been able to do it in the same period.

This situation also encourages the sentiment that the Member States and the EU institutions still have a certain time, for even the least compliant of the former, to change their budgetary policies.²² Certain actors may even conclude that respect of the stability criteria is not as necessary as assumed, to preserve all the benefits of the common currency for them, and might be tempted to bet on the preservation of the latter even with a much laxer budgetary behaviour of the Member States.

3. Financial Markets Re-considered

We have seen that the new Pact has nothing better to offer, in terms of institutional incentives for its respect, than did the old one, and that there is very little chance that it be substantially improved in this respect, in the medium term future. Insofar it seemed justified to reconsider the financial regime context in which this reform is going to function, especially as to *certain "soft-law" factors, which might incite governments to adapt their fiscal policy in the sense of the Pact.*

Further up, we mentioned the potential role of financial markets. Numerous studies, especially derived from analyses of US fiscal federalism, have pointed to their disciplinary power (Hedbavny et al 2005, especially their overview in table 2). The most familiar hypothesis is that the most indebted and deficit prone governments would pay a risk premium on their public debt which would make borrowing so much more expensive for them, as to dissuade them from its excessive use.

A more detailed analysis of the potential contribution of this mechanism to support the SGP gives an ambivalent result.²³ Yes, incentives set by financial markets probably have the potential to support the action of the Stability Pact. For the most recent period, there have been two interesting movements: first the sovereign credit ratings concerning the Member States with the highest deficits and the lowest longer-term credibility (Greece, Italy and Portugal) deteriorated from 2004 to 2005, and secondly in a concomitant movement, the yield spreads for their government bonds have diverged from EMU benchmark, by up to 8 basis points, in the same period. One can imagine that in the foreseeable future, on the condition that the public deficit situation of this group of countries remains bad or deteriorates further, these incentives could become more pressing and help in pushing these governments towards more budgetary restraint. The effect would not be lost on the others.

²² For an explicit formulation of this line of reasoning, cf. Wyplosz 2004, p.42 f.

²³ Cf. for the following Bell 2003, Bernoth et al 2003, Copeland/Jones 1999, ECB 2005-1, ECB 2005-2, Hedbavny et al 2005, Issing 2005, Jordan 1997, Mundell 1998.

On the other hand, in the absence of a clearly visible development in that direction, the influence of financial market generated incentives would likely remain so limited, and governments' spontaneous reaction to them so small, that they would continue to depend on the EMU's institutional and procedural incentives (Pact and ECB) which will first of all aid them in better heeding the signals of the market, and secondly in starting corrective action even in the absence of such signals. The market actors themselves would need this prompting, to improve their reaction.

As to the role of the European Central Bank, there have been initiatives and proposals for instance from certain governments but also out of EU institutions, aiming to have "the ECB ... use its collateral policy as a sanction to exert fiscal discipline on those Euro area member states that breach the 3% limit, (by imposing risk margins when taking in their bonds) making those bonds less attractive (for private banks) to hold and use as collateral in the ECB's regular operations" (Issing 2005). The Central Bank has always spoken out against that line of thinking, arguing that its credibility as an impartial guardian of monetary stability in the Euro area would be endangered by taking on a job of political disciplining. Only recently, it has repeated this position²⁴ Interestingly, at the same time the ECB has made it clear that it would, by its own initiative and in the interest of risk control, apply more radical instruments against government bonds of uncertain liquidity.²⁵

Taking both together, the developments in the financial market and the emerging contours of a more active ECB response, with the perspective that it might be applied against Greece, suggests that in 2006 governments may have to count with a certain disciplining

²⁴ In spring 2003, the Finnish government had started one of the initiatives in this sense, refuted by the Council following negative votes from the Central Bank and the Commission. The newest ECB text on this issue dates from May 2005, suggesting that meanwhile there have been other attempts to push the ECB in the direction of this "idea that seems to gain more and more support" as Otmar Issing complained in a speech held on 20 May 2005.

²⁵ In two texts published this same year, the ECB has explicitly insisted on the instruments it may use of its own initiative, to control risks inherent in accepting public bonds of uncertain liquidity, and on the increasing probability that it might have to do so. The first is ECB 2005-1 of February, an official presentation of instruments and procedures of the Bank's monetary policy. There, on p. 45, one finds a presentation of "risk control measures" applied when taking in assets (=collateral) from private banks for monetary policy operations, taking care to present those which are "currently applied", but also spelling out all those which "are currently not applied by the Eurosystem". The latter range from "initial margins" applied to certain assets, to the "exclusion of certain assets from monetary operations." The second text contains a look at "Recent developments in government bond yield spreads in euro area countries" in ECB 2005-2 of September, which demonstrates the re-emergence of substantial yield spreads of such bonds, since 2004, for Italy, Greece and Portugal, and the deterioration of these countries' credit ratings, down to "A" (S&P) for Greece. Finally the Financial Times published a title story, on November 9, pointing out that the ECB's "eligible collateral list" contained no assets rated below "A-", this reflecting the explicit policy line of the Bank (confirmed by an ECB spokesman, vis-à-vis this author). It speculated about how the Bank might warn the concerned governments about the imminence of such refusal, if the deterioration of their ratings continued.

effect of the financial market, which could then aid the SGP. When, how strongly, with which exact effect, this is matter of speculation.

IV. PROPOSALS

When reflecting on the right line of action to take, after the reform, there are three options,

- (i) in a static perspective, applying the new version of the Pact, telle-quelle, with the two amended regulations,
- (ii) in a dynamic perspective, already orient oneself towards a dynamic interpretation of that reform, in trying to stay within the logic of that reform and taking it seriously, and
- (iii) declaring the failure of the Pact-approach to the budget-stabilisation objective and trying to search another approach.

The third and last line of action (iii) is not the one that is followed in this article because it would either lead to nothing but futile demands for a turn-around in fiscal policy co-operation, towards a more effective centralisation of the control and correction function. Or it would lead to a return to the status quo ante of 1997, when the Treaty article 109 was still considered sufficient for the objective of economic policy co-ordination. But the *first* line (static perspective) alone will not be chosen either, given the obvious weaknesses of the reformed Pact as it stands now.

Rather, the following proposals will take the *second* approach namely to take the reform clauses seriously, which have become legal bases for EU fiscal policy co-operation since June 2005, to apply them conscientiously and in a dynamic perspective, namely in enhancing them by creating binding interpretations of the way they can be implemented. The added flexibility of the reformed rules has to be applied, but in an equitable and rigorous (controllable and controlled) manner. This approach on the level of EMU decision-making has to be supplemented by an approach on the national level of the Member States, to improve their capacities to comply with the SGP. Both need “encouragement” by a less hesitant application of the sanction procedure.

Expressed in theoretical terms, the proposed approach would have to combine elements of the soft law or method of open co-ordination, on the one, and elements of hard law, on the other side, the latter supporting the application of the first.

All of the steps suggested at these two levels will demand time for their full realisation. Insofar it is welcome news that the state of the common money and its international position remains stable and strong, for the time being, and that the possibility of financial market sanctions gains somewhat in credibility.

In line with the arguments made before, the national and the European level offer perspectives for such a line of action. This paper will only look at proposals which do not overturn the competency balance reached in budget policy control, between the national and the European level. This limitation given, the options still at the disposal of decision makers should be fully exploited ! These proposals will thus all amount to an encouragement or an admonition, to use, to use more often or to re-organise and improve the use of, existing competencies of the institutions and the Member states, under the revised SGP.

1. Exploiting reform potential at the national level

The first proposal draws consequences out of the reasons why Member states do not comply. One of them seemed related to the *size of Member States*, a very specifically national variable. Another one concerned *conflicting competencies within Member States' own jurisdiction*, namely their inability to fully control public spending and borrowing at all authority levels.

As to the issue of Member State size, the question was whether the larger ones could “learn” from the medium and smaller Member states’ budgetary policy, especially as to conceiving and introducing structural reforms. First results of studies in the OECD rather point to a problem of size: in trying the same reform strategies, the larger Member states encounter more important obstacles which prevent them from succeeding (Duval 2005, Duval and Elmeskov 2005). To draw full advantage from the lesson given by the small and medium Member states, further research in this field appears in order and Duval himself explicitly asks for it (Duval 2005 p.32).

As to the problem of different governmental authority levels in fiscal policy, the OECD has likewise conducted some interesting research, as shown by the recent study of Joumard and Kongsrud (2003). This work may be interpreted in two different manners. On the one hand it permits once again to realize the limited importance of profligate budgetary behaviour of the sub-national authorities, for the fundamental stability of national fiscal and monetary systems.

But on the other hand the authors show that, all other things being equal, different methods in disciplining their budgetary behaviour make a difference in outcomes for the sub-national units’ budgetary stability. Many studies have shown this especially when comparing the United States of America, where the States have large fiscal autonomy, with a number of European countries. This is what interests us in this study on the SGP.

Analysts agree that improving their control over the borrowing behaviour of the sub-national authorities, could substantially aid Member states in respecting their EMU engagements. Besides, many of the methods for assuring better respect of the Stability Pact, which are today counselled to the EMU, have already been tried out in some of the Member

States of the OECD, where they have had very different kinds of results. Closer analysis of these cases might spare the EMU disappointing experiments.

Trying to improve centralised budgetary control at the national level alone already constitutes a difficult challenge. The recent study of the OECD has shown the enormous difficulties which the Member States have in controlling the budget policy of their sub-national authorities. Concentrating some reform effort on the national level is therefore no easy strategy. But it nevertheless promises some chances of advance in the right direction. It probably does not suffice to look only at (and eventually reform) institutions and procedures along a continuum of more or less –effective– centralisation of borrowing competence, important as this level of action is. Reform efforts have also to extend to the domain of fiscal policy-related preferences of the respective national political cultures, like the attachment to monetary stability and “solid housekeeping” in public budgets. These may also be preferences linked to country size (small-large divide) in the EMU context.²⁶

2. EMU level

Concerning proposals for further reform at EMU level, it is more difficult than at the national level to follow the condition not to overturn the competency balance reached in budget policy control, between the national and the European level.

As to the institutions and procedures of the SGP, only very little further *reform* appears possible. For instance the place of Member governments in voting on Article 104 issues would seem untouchable for the foreseeable future. There may be a possibility concerning the relationship between European Council and Ecofin Council. Benoît Coeuré and Jean Pisani-Ferry (2004) have recently demanded the installation of a restricted European Council formation in Euro-Group composition, which could express the special responsibility of these MS for the common currency and for fiscal policy co-operation, in all the economic and fiscal policy negotiations carried on at this highest EU level. This proposal may still be taken up. It would be possible without touching at the Treaty and the competency balance, with a European Council decision.

We do not explore, in this paper, the possibilities for better Pact-observance between a number of EMU- or Euro-zone- Member states, inherent in closer co-operation between these last. Coeuré-Pisani have explored some of the possibilities (2004), confirming the results of earlier work (Deubner 2000 p.29ff.).

²⁶ These may be, for instance, the reputational values which may be brought in to enhance the political weight of the small country's voice in the Eurosystem, or in EU councils at large, and thereby partly compensate for the smallness of the official voting weight. Cf. de Haan, Berger, Jansen 2003, pp.15ff. One could also imagine that the personal reputation of a policy maker in a small country is more sensitive, in the long run, to false decisions than it would be in a big country.

Some limited leeway still appears to exist as to the application of the Pact. What should be asked for, would be less leniency in extending correction delays for Member States, and the explicit willingness to give notice and envisage sanctions in cases where it can be economically defended, in a stricter application of the Pact rules. Another possible line of action mentioned further up, might be to elaborate further on the application of the new catalogue of « **relevant factors** » of the reformed Pact which supplements since June 2005 the clause on the "special circumstances". Applied in the way they are formulated in the new Pact, these factors invite a pure pro-forma utilisation without any discrimination according to specific situations.

It would already constitute a first rate challenge to impose a certain minimum standard for serious and discriminating applications for such cases. The EMU would have to find a proper form fitting for a case-by-case examination conducted in good faith, in transparency and equity. To reduce the investment of negotiation and work necessitated by this approach, a standard model of application could be put into place, which could be modelled on what is today already demanded by the reformed Pact, for the specific case of introducing privately funded old-age insurance systems. For each of the new “relevant factors” which a Member State would want to invoke, it would require a specific catalogue of complex standardised and verifiable informations to be given, for it to be considered by the European institutions.

Even though the steps recommended here are of a small and incremental type, they are liable to need considerable time to get put into place and be recognised as functioning reform elements. Therefore a strategy like this is also a bet on the long run.²⁷

- that the common money resist still longer against the difficulties experienced by the Pact,
- that the Member States do not, over the time, become convinced that the common money can be preserved without painful budgetary stabilisation efforts,
- that a diagnosis and therapy which is at once more differentiated and adapted, and more rigorous, of the Union vis-à-vis the Member States, become simultaneously more effective, more credible and finally more accepted by the latter, compared to the rigid stability criteria of the Pact's beginning (even taking the underlying flexibility into account).

Same as for improving control of sub-national authorities, the task of spelling out and finding consensual norms for the application of the relevant factors promises to be extremely difficult. Already for a certain time, the Commission and the governments have been working together to find more precise norms for operationalizing some of the basic notions of the old and the reformed Pact. How to formalize the notion of “good economic

²⁷ Cf. Wyplosz 2004, p.42, for an analogous point.

times” for instance, appears to pose considerable problems.²⁸ The governments will be very wary, therefore, to engage themselves even further on such a road.

But if such a formalised but demanding procedure could in the end be conceived for each of the new listed cases, and if it could be applied in a regular manner, this could render the procedure of the « specific circumstances » more rigorous, equitable, and less apt to be applied in an in-transparent, lenient and pro-forma manner.

If the governments preferred not to go in that direction, they might sooner or later have to choose between either a non-committal “open co-ordination” style co-operation in the budgetary policy field –all in conserving the letter of the Treaty– and betting on economic growth to return, on the emergence of financial market actors, and on the responsibility of each partner, or on the other hand on centralising the fixing of norms and their application to individual cases, in one European authority, taking a big step towards a gouvernement économique.

By contrast, a division of labour between the European, and the national institutions, in the authoritative interpretation of the SGP’s stability criteria, for instance via *independent national councils*, is not counselled in this paper.

Many proposals of experts encourage the (European) disciplining institutions to detail the criteria to which they subject the budgetary behaviour according to the Member states concerned, and to differentiate them over time, as to take account of the business cycle, for instance. In such cases, the decisive reference criterion will be the sustainable debt of a country. The calculation of such more detailed and more time- and country-specific criteria is not straightforward and implies a measure of discretion – different institutions may in the best of faith come to different results, at a given moment.

The European institution wanting to impose respect of such criteria on the sole merit of their intrinsic validity would come into a structurally untenable position. It needs an explicit attribution of legitimacy for this role. Certain experts have proposed that such criteria be defined by *independent national councils* (Wyplosz 2005, Calmfors 2005). That would perhaps increase the acceptability of such criteria-setting on a purely national base.

But whenever some kind of equal rule-compliance were expected from all Member States, as in their common utilization of a common good, the Euro, the common interest rate, the common exchange rate, the issue of equity and of free-riding among the Member states of the Euro-system would nevertheless become important. At a given moment, the states concerned would likely ask for equal standards to be applied to them.²⁹ The Calmfors

model would not appear to answer to this need as it does not foresee any EMU-level agreement about Member state-specific budget targets (Calmfors 2005, p.88-91), the Wyplosz model would do so somewhat better, stipulating as it does EMU-wide negotiation and agreement about Member state-specific “budget targets” and “debt targets” (Wyplosz 2005, p.82) but still with serious doubts as to its feasibility.

Either one would have to renounce wholly to the notion of equal rule compliance plus direct and indirect sanctions of non-rule-conforming behaviour. Or, when accepting more complex and differentiated criteria, one has officially to transfer the competence of setting these to one European institution which works with a single set of accounting rules, which are recognised by the Member states *ex ante*, and then one could try to link them to a system of sanctions.

Up to the reform and since, the Member states have never given cause to think that they would agree to this kind of competence for a European institution. Thus the surveillance must remain wholly oriented towards simple *ex post* values like the deficit-to-gnp one, where the Member state is alone and wholly responsible for respecting it, and this respect is the unique criterion on which compliance is judged at the European level.

Much as the reform attempts at the national level, which were proposed earlier on, the ones here proposed for the EU level, also do not put into doubt and much less into risk, the established distribution of competencies between the Union and its Member States. But by entering into a procedure like this, Commission and Council would also extend a praxis of intervention in the internal economic and social policies of the Member States which they have only applied with greatest restraint up to now. A dynamic context could be put into movement, which could in the medium term change the pre-existing distribution of competencies among the Union and its Member States, to the advantage of the former.

3. The financial markets

Given the limits to institutional change, can the Member states and the European institutions do more to aid the functioning of the financial market as factor inciting governments to practise balanced budgets? It would appear important to preserve full visibility of the national emittent institutions’ responsibility for clearly identifiable national debt titles, and to encourage market actors to include the risks of excessive public deficit into their evaluation. Secondly the ECB should hold on to its intention of drawing consequences, in its collateral policy, out of a deterioration of national budgetary policies of emittent Euro area institutions. Incidentally, a further deepening of the internal market for financial services might help to make the monetary policy of the ECB more effective throughout the Euro area and increase financial market transparency, a valuable precondition for better reactivity of financial market actors.

²⁸ According to interviews in one important national Finance Ministry.

²⁹ Jean-Pisani Ferry makes a very explicit point of the importance of EMU-wide recognised common standards and norm-setting authority, in the effort of reforming the Stability pact, cf. Pisani-Ferry 2004, p.12 f.

4. Some additional suggestions at EMU level

A number of additional, punctual proposals come to mind, which might be liable to aid in stabilising Member states' budgetary policies.

- As to debt-to-GDP ratios, one would wish to make them sanctionable. But it is true that given the extreme differences between the Member states in this respect, it appears very difficult indeed to design an equitable way of doing so, for all of them.
- The same is true for the respect of budgetary medium term objectives, MTO, in times of economic upswing. A Commission study of the Nineties already showed that the principal challenge here was not so much one of introducing new tools for rendering budgetary policies more counter-cyclical. The automatic stabilisers all by themselves could be expected to function well enough, and improve the budgetary situation during upswings especially in large (and in Nordic) Member States, by increased tax returns (Buti and Sapir 1998:134 ff.). The challenge inherent in such periods would thus rather be to prevent Euro area governments from attenuating the functioning of the automatic stabilisers, for instance by immediately spending such windfall income or using it to finance tax reductions. Here again, the difficulty seems to be one of translating this intention into consensual and adequate standards to be applied over the cycle, together with a method of measuring compliance with them. This at least is often put forward to explain that the reform has not resulted in better rules.

More political effort should be put into keeping this issue on the Council table and finding a consensus for it.

- As to the beneficiaries of cohesion fund aid, old and newly acceded Member states, the conditionality of their cohesion fund receipts, as to compliance with the stability pact, should not only be spoken of behind closed doors, it should be mentioned in official Econfin Council minutes and in Commission reactions as one of the instruments to encourage these states to improving their sometimes failing stability discipline. One of these beneficiaries, Greece, is in signal and intentional, violation of the Stability Pact since the beginning of the new decade. Nevertheless, the "cohesion" is not even mentioned in the Commission and the Council papers and decisions addressed at that Member state. This practice should change.
- As to the old Member states, the highly overdue first precedent of giving notice to a Eurosystem Member state, including the menace of applying financial fines, which came in February 2005 and concerned GREECE, should be well publicised and Greek performance duly reported on. The extremely important precedent character of this measure must not be forgotten, it should be duly publicised.
- If the hard law menace remains feeble, after all, and if more Member states are bound to spend longer periods in a regime of "excessive deficit", then it is imperative that one part of a positive strategy concern an improvement as to the better utilisation of the correction periods in the interest of durably stabilising budgetary politics.

ANNEXES

ANNUAL GDP GROWTH (IN PERCENT) IN SMALL-MEDIUM AND IN LARGE EU COUNTRIES, 1996 -- 2004

	1996	1997	1998	1999	2000	2001	2002	2003	2004
EU (15 countries)	1,70	2,70	3,00	3,00	3,80	1,90	1,10	1,10	2,30
Denmark	2,80	3,20	2,20	2,60	3,50	0,70	0,50	0,60	2,10
Greece	2,40	3,60	3,40	3,40	4,50	4,60	3,80	4,60	4,70
Ireland	8,30	11,70	8,50	10,70	9,20	6,20	6,10	4,40	4,50
Luxembourg	3,30	8,30	6,90	7,80	9,00	1,50	2,50	2,90	4,50
Austria	2,60	1,80	3,60	3,30	3,40	0,80	1,00	1,40	2,40
Portugal	3,60	4,20	4,70	3,90	3,80	2,00	0,50	-1,20	1,20
Finland	3,80	6,20	5,00	3,40	5,00	1,00	2,20	2,40	3,60
Sweden	1,30	2,30	3,70	4,50	4,30	1,10	2,00	1,70	3,70
Average small countries	3,51	5,16	4,75	4,95	5,34	2,24	2,33	2,10	3,34
Belgium	1,20	3,30	1,90	3,10	3,90	1,00	1,50	0,90	2,60
Netherlands	3,00	3,80	4,30	4,00	3,50	1,40	0,10	-0,10	1,70
Spain	2,40	3,90	4,50	4,70	5,00	3,50	2,70	3,00	3,10
Average medium countries	2,20	3,67	3,57	3,93	4,13	1,97	1,43	1,27	2,47
France	1,10	2,40	3,60	3,30	4,10	2,10	1,20	0,80	2,30
Italy	1,10	2,00	1,80	1,70	3,00	1,80	0,40	0,30	1,20
Germany	1,00	1,80	2,00	2,00	3,20	1,20	0,10	-0,20	1,60
Average large countries	1,07	2,07	2,47	2,33	3,43	1,70	0,57	0,30	1,70
United Kingdom	2,70	3,20	3,20	3,00	4,00	2,20	2,00	2,50	3,20

Source: Eurostat

http://epp.eurostat.ec.eu.int/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=SDI_MAIN&root=SDI_MAIN/sdi/sdi_ed/sdi_ed_inv/sdi_ed1110

Average calculations by the author.

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