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The Sustainability of Public Finances and Fiscal Policy Coordination in the EMU

Juergen von Hagen

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CASE-Center for Social and Economic Research on behalf of CASE Network

12 Sienkiewicza, 00-010 Warsaw, Poland

tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69

e-mail: case@case-research.eu

http://www.case-research.eu

Contents

Juergen von Hagen *(born 1955) received his PhD in economics from the University of Bonn. He held academic positions at Indiana University and the University of Mannheim and currently teaches at the University of Bonn, where he was a director of the Center for European Integration Studies from 1996 to 2005. He is author of numerous books and scholarly articles. Von Hagen is a member of the Academic Advisory Committee of the German Minister of Economics and served on the French National Economic Committee from 1999 to 2002. He has been a consultant to the IMF, the World Bank, the European Commission, the ECB, and national governments in Europe and beyond. Von Hagen is a fellow of the Center for Economic Policy Research (CEPR) in London and a member of Germany's National Academy of Science, Leopoldina.*

Abstract

The financial crisis of 2007-2009 led to a renewed increase in government deficits and debts in many EU countries, causing a full-fledged fiscal crisis in Greece and severe fiscal pressures in other euro-area countries. This has prompted a series of proposals for improving the fiscal framework of the European Monetary Union, the Excessive Deficit Procedure and the Stability and Growth Pact. The first part of this paper reviews the main properties and developments of that framework until 2007. On that basis, it discusses the recent proposals for reform, which range from marginal improvements of the existing framework to the introduction of an explicit framework for managing fiscal crises in the member states, and the expansion of the scope of policy coordination to address macro economic imbalances and the competitiveness of the member states. We find the proposal of a mechanism for dealing with government default most useful. Attempts to suppress current account imbalances and to target national competitiveness positions would most likely result in serious economic losses and do damage to the internal market of the EU. This would increase the wedge between members and non-members of the euro area.

1. Introduction: The EU Framework for National Fiscal Policies

European Union (EU) membership has important consequences for the conduct of fiscal policies. While fiscal policy remains a national competence, the EU puts various constraints on the fiscal policies of its member states both at the micro and at the macro levels. In this paper, we focus on macro fiscal policies.[1] Constraints on macro fiscal policies arise from two EU goals: the wish to coordinate the policies of the member states and the need to maintain sound public finances. Formally, these two goals are reflected in two different policy frameworks at the EU level. Coordination works primarily through the *Broad Economic Policy Guidelines* (BEPG) and several *coordination procedures*. Sustainability is the focus of the *Excessive Deficit Procedure* (EDP) and the *Stability and Growth Pact* (SGP). Because many issues are affected by these various processes and regulations, it is important to have a comprehensive understanding of them before focusing on individual parts.

The Treaty on the European Union (TEU) establishes “sound public finances” as one of the guiding principles of economic policy in the EU (Art 119:4). Member states regard their economic policies as a matter of common concern and coordinate them through the ECOFIN Council and on the basis of BEPG (Art 121). In this context, the term “economic policies” is commonly understood to include government tax and expenditure policies. According to Art 125 of the TEU, the EU and its institutions and individual member states are protected against becoming responsible for financial liabilities of other member states against their own will. Until recently, this so-called “no-bailout clause” was commonly understood as including a ban on the voluntary assumption of the responsibility of a member state’s financial liabilities by other member states. The events surrounding the public debt crisis in Europe during the first half of 2010, when the member states of the euro zone decided to give a loan to Greece in order to keep it from defaulting on its debt, have proven this assumption wrong.

EU Procedures that are relevant to the conduct and coordination of fiscal policy are: the Mutual Surveillance Procedure (Article 121), the Excessive Deficit Procedure (EDP, Art. 126

[1] Fiscal policy constraints at the micro level arise both from the common external trade policy and the Single Market policy of the EU and affect taxation, border tariffs, the regulation of financial markets, and the conduct of public enterprises.

and Protocol No. 12 of the Lisbon Treaty), and the Stability and Growth Pact (SGP, Council Regulations 1466/97, 1476/97, Council Resolution 97/C236/01-02; Declaration on Art. 126 of the Treaty on the Functioning of the EU). The multilateral surveillance procedure includes the possibility of making confidential or public assessments of the policies of individual member states and to give confidential or public recommendations to their governments. The BEPG consolidate the various policy coordination processes at the EU level and aim to exploit the synergies between them.[2] The BEPG also act as a reference for the multilateral surveillance procedure, under which the consistency of national economic policies with the BEPG and the functioning of the EMU in general are monitored. The European Council decides on the BEPG based on proposals by the European Commission and recommendations by ECOFIN.

The EDP sets up a detailed process of monitoring the public finances of the member states with a view to ensuring that they remain sustainable. It includes the mandate (Article 3 of Protocol No. 12) that member states of the European Economic and Monetary Union (EMU) shall implement appropriate procedures in the budgetary area that enable them to fulfill their obligation to maintain sustainable finances. The practical meaning of this obligation, however, is vague. Member states can be formally required to change their institutions only if they can prove that this would enable them to maintain sustainable public finances (Commission, 2010f, P 5).

There is an important distinction between policy coordination and the requirement to maintain sound public finances. Coordination seeks to improve upon the results of independent, national fiscal policies. The EU and its core common policies, the Single Market, and the monetary union can function without coordination, though perhaps not as well. In contrast, as explained below, sound public finances are necessary for the EMU to function properly. This distinction explains why the commitment to policy coordination is politically but not legally binding (DG ECFIN, 2002). Apart from peer pressure, there are no formal penalties for governments failing to adhere to coordination. In contrast, maintaining sustainability is a legally binding commitment; countries in the EMU can be penalized if they fail to maintain sustainable public finances.

[2] These are the “Luxembourg Process,” which aims to coordinate national employment policies, the “Cardiff Process,” which aims to coordinate structural and competition policies, and the “Cologne Process,” which aims to coordinate macroeconomic and wage policies in the EU. See von Hagen and Mundschenk (2002) for details.

The TEU (Art. 119:4) also declares a “sustainable balance of payments” as a goal of economic policy in the EU, committing the member states to avoiding fiscal policies that could lead to balance of payments crises. Should a member state find itself in a currency or balance-of-payments crisis, the TEU (Art 143) calls upon the European Commission to investigate the situation and make appropriate recommendations. The article is meant to prevent the possibility of unilateral actions taken to counteract such crises undermining the functioning of the integrated EU markets. If necessary, the European Council can, upon a recommendation from the Commission, grant financial assistance to the member state concerned. For members of the Euro area, this article has no relevance, since a balance of payments in the traditional sense of the term, i.e. the net change in the central bank’s international reserves, no longer exists at the national level.

This paper explains the framework for national fiscal policies in the EMU in more detail, focusing on the EDP and the SGP. It reviews the EU’s experience with this framework and develops some proposals for further development. Section 2 deals with policy coordination. Section 3 discusses the EDP and the SGP. Section 4 reviews the current proposals for reform of these two. Section 5 ends with some considerations of policy options for Poland.

2. Economic policy coordination in the EU

According to the TEU (Art. 121), member states coordinate their economic policies at the EU level within the Council of Ministers with the participation of all member states and the presence of the European Commission and ofthe European Central Bank where deemed necessary. The Council for Economic and Financial Affairs (ECOFIN) is the relevant council for discussion and decisions about government deficits, spending, and taxation, while the Employment/Social Affairs Council deals with employment and social policies. The European Commission and the Economic and Financial Committee serve as the secretariats to the Council. In the coordination procedures established by the TEU, the Council adopts policy guidelines and recommendations by majority voting on a proposal from the Commission. As such, they are following the conclusions of the European Council, the Heads of State of the member states, and the highest level of coordination. Although the title of ECOFIN suggests otherwise, it is noteworthy that the members of this body are far from being a homogeneous group, as the functional and the political roles of the finance ministers vary considerably across EU member states. Therefore the degree to which individual members can enter credible commitments for the macroeconomic policies of their countries also varies.

In December 1997, the European Council in Luxembourg agreed to the establishment of the Euro Group of finance ministers of the euro-area member states, in recognition of the specific coordination requirements among participants of the euro area. Since the Euro Group has no legislative responsibility, its role is to assess the economic situation and to discuss the major policy issues for the euro area. It is chaired by a minister of a participating EMU member state, even in periods when the EU presidency is held by a non-EMU member. It meets in connection with ECOFIN meetings. In its first few years, the presidency of the Euro Group changed annually. However, in order to strengthen policy coordination, this was changed in 2004. Since then, the president of the Euro Group is elected for a renewable term. Protocol No. 14 of the Lisbon Treaty formally recognizes the existence of the Euro Group. It recognizes it as a body of finance ministers of those countries whose currency is the euro who meet informally. It fixes the term of the presidency to 2.5 years and determines that the European Commission takes part in the meetings and that the ECB will be invited to take part.

Compared to ECOFIN, the Euro Group allows for a more concentrated debate on fiscal policy in the euro area. However its role is limited since decisions can be taken only at the Council level. Jacquet and Pisani-Ferry (2000) argue that the Euro Group has played a useful role in developing the quality of economic policy debates among its members, but that the role of this group is largely exhausted with this function. Most recently, the Euro Group gained visibility and importance as the political body that set up and activated the financial support for Greece.[3] This would imply that a coordination body has acquired competence for solving crises which arise out of failures of the rules-based framework for safeguarding "sound public finances." But the complaints of its president, Jean-Claude Juncker, about the increasing tendency of Euro-Group members to meet and negotiate agreements bilaterally

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[3] "Statement on the Support to Greece by Euro area Member States", Brussels 11 April 2010. http://www.eu2010.es/export/sites/presidencia/comun/descargas/Economia_Hacienda/ue-grecia.PDF

during crisis periods (Frankfurter Allgemeine Zeitung, 29 July 2010) suggests that the true power status of the Euro Group is still an open matter.

The European Commission is present both at Council and Euro Group meetings. The Commission has the right to set the policy agenda for Council meetings and to provide analysis for multilateral surveillance. The EFC has advisory and preparatory functions for Council meetings. It consists of representatives of national administrations and national central banks, as well as two representatives of the European Commission and the European Central Bank (ECB). While the European Commission and the EFC cover macroeconomic and financial issues, the Economic Policy Committee, which consists of officials from economics ministries, is primarily concerned with structural policies.

3. Sustainability of Public Finances: The EDP and the SGP

Since the beginning of the European debate over a common currency, there was a general agreement that the stability of the currency could be undermined by a serious lack of fiscal discipline in individual member states and that, therefore, the monetary union needed rules safeguarding sound public finances in the member states. During the 1990s, the German government in particular insisted on this requirement, mainly in order to persuade German voters, a large majority of whom never liked the idea of a monetary union, that the monetary union would not deliver a currency less stable than the Deutsche Mark. Importantly, the same point of view was adopted by the German Constitutional Court in its ruling on the constitutionality of Germany's adoption of the euro. The Court ruled that the German government might be compelled to leave the euro if it should turn out that the common currency was not stable.[4] This ruling and its potential consequences still linger as a constraint over European policy debates. There is currently a case pending regarding Germany's participation in the May 2010 rescue operation for the euro.

In terms of technical economic analysis, sound public finances have been equated with the sustainability of public finances. Sustainability relates to a government's "intertemporal budget constraint." This is the requirement that, *in the long run, the discounted sum of a*

[4] http://www.focus.de/politik/deutschland/bundesverfassungsgericht-historische-mission_aid_166370.html

government's expenditures cannot exceed the discounted sum of its revenues. Public finances are sustainable if a government's current and expected future revenues and expenditures meet this requirement (for example, Chalk and Hemming, 1980). Obviously, sustainability does not rule out even prolonged periods of large government deficits, as long as these are compensated by future surpluses. Since the intertemporal budget constraint extends over a very long time horizon, and governments can easily promise lower spending or higher revenues in the future, it is obvious that sustainability does not have strong implications for current fiscal policies. [5]

The intertemporal budget constraint establishes an important link between monetary and fiscal policy. It can be stated in two ways. Traditional analysis sees seignorage, i.e., the revenue from issuing money, as part of a government's revenues. Given an expected stream of expenditures in the future, and given an expected stream of tax revenues, seignorage has to make due for any shortfall of the latter over the former. If closing the gap requires printing more money, this will result in inflation. (e.g., Sargent and Wallace, 1981)

In the EMU, the issue is somewhat more complicated, because the member states have given up the right to print money. Seignorage is paid to them in the form of national central bank profits and ECB profits, which are distributed according to the countries' capital shares. Since the central banks are politically independent and, by virtue of Art. 130 of the TEU and Art. 21.1 of the ECB Statutes, they cannot directly monetize public sector deficits, seignorage is exogenous to government policies. That is, given an expected stream of expenditures and an exogenous flow of seignorage, the governments must adjust taxes to assure that the intertemporal budget constraint holds. Otherwise, they would be forced at some point to default on their debts. A fiscal crisis would arise, but it does not create inflation in the monetary union unless the central bank bails out the troubled government.[6]

[5] To distinguish sustainability from solvency, the former is sometimes defined as the requirement that the intertemporal budget constraint hold with unchanged fiscal policies. See for example Croce and Juan-Ramon (2003) or Perotti et al. (1998) who use an operational definition of sustainability as the absence of a need for large policy adjustments. While assessments of sustainability are conventionally based on expectations for revenues and expenditures, Barnhill and Kopits (2003) suggest a method of evaluating sustainability in the presence of uncertainty.

[6] Note that, while the ECB cannot legally bail out a government in fiscal difficulties by buying its debt directly, it can still do so indirectly if it wants to. A bailout could be ex post, with the central bank buying up large amounts of government debt in the market, or ex ante, with the central bank holding down interest rates to reduce the government's interest payments.

The critical question here is whether or not the ECB's institutional independence and its determination to safeguard price stability are strong enough to withstand any political pressures to provide a bailout. The ECB's decision in May 2010 to begin a large-scale bond purchasing program to sustain the prices of primarily Greek government bonds, which came in connection with the EUR 750 billion stabilization package agreed by the EU governments and the IMF, suggests that the ECB's independence from the governments has its limits.[7] It also shows that actions to support individual national governments can be disguised technically as measures to maintain orderly market conditions.

Alternatively, one may regard the intertemporal budget constraint as a macro economic equilibrium condition, which is the essence of the so-called fiscal theory of the price level (Leeper, 1991; Cochrane 2010). To better understand this view, it is convenient to restate the intertemporal budget constraint as follows: *The government's total nominal obligations (money and bonds) outstanding divided by the price level must be equal to the expected present value of all future real government budget surpluses.* Suppose that at some moment, the expected present value of all future real government surpluses falls short of a government's total liabilities outstanding. This would imply that the government would not be able to service its debt. Foreseeing this, those who hold government debt would try to sell their bonds and exchange their money for goods. As a result, inflationary pressures would emerge, pushing the price level up until the real value of the government's liabilities has decreased sufficiently. Following this line of reasoning, fiscal deficits can create inflation even if the central bank does not buy additional government debt.

Monetary union complicates these issues because, in order to safeguard the stability of the common currency, the intertemporal budget constraint must hold at the level of the monetary union, but not necessarily at the level of each country. A member country's government might well be outside its intertemporal budget constraint with no consequences for the stability of the euro, provided that the governments of the other member states are willing to pay transfers to this government or bail it out in the case of a fiscal crisis. Thus, the common currency creates a public-goods problem: Its stability is maintained as long as all countries collectively adhere to the collective intertemporal budget constraint. Given that the other countries do, an individual government can relax its fiscal discipline with no consequences

[7] http://www.reuters.com/article/idUSLDE64U0OS20100531

for the common currency. This implies that the self-interested incentives to maintain sound public finances are weaker for a country inside a monetary union than for a country with a national currency. This moral hazard problem suggests that rules to preserve sound public finances in the EMU should address individual countries and governments rather than the group of member states collectively.

The conclusion from these considerations is that the EMU needs some rules preventing national governments from running up excessive levels of debt that would, in the long run, threaten the common good of the monetary union, that is, price stability. This basic insight has left its mark in all documents and decisions leading up to the creation of the EMU and is the basic rationale behind the EDP and the SGP. Obviously, the *Union*'s concern for the sustainability of public finances in countries not participating in the EMU is much weaker. Therefore, member states with a derogation from the EMU cannot be formally punished for non-compliance with the procedures designed to assure sustainability. However, since participation in the EMU is considered the normal case in the EU, even member states with such a derogation are subject to the unconditional obligation of maintaining sound public finances, and compliance with the relevant procedures is an important part of qualifying for the adoption of the euro.

The difficulty with this basic conclusion is in the question of how to translate it into a framework that guides and constrains the governments' fiscal policies effectively. In a world with perfect information and no transaction costs, one could adopt a policy rule stating in detail what governments should do under what circumstances to meet the intertemporal budget constraint. In reality, the world is too complex and uncertain to do that. A *simple* fiscal rule limiting annual government deficits or debts is of little use under such circumstances, because it would constrain fiscal policies either too much or too little in the short run. Either way, it would lack credibility. In the first case, because it may force sovereign governments under some circumstances to adopt policies that are unreasonable or even damaging for their own countries; in the second case, because it would not bind government actions sufficiently in the short run.

Furthermore, simple rules are not adequate in the EU context of supra-nationality, because a rule must treat all member states equally, even if they are unequal. Consider the following example. The annual budget deficit ratio, d, is linked to the ratio of public debt to GDP, b, through the following relationship: $d = [(1+g)(1+\pi)-1]b$, where g is the real trend growth rate and π the long-run average rate of inflation. In view of this relationship, a rule for the annual budget deficit ratio must be based on an assumption about the long-run real growth rate and the long-run rate of inflation, π, if it is to stabilize the debt ratio, b. Given the ECB's desired rate of inflation in the euro area of two percent annually, the allowable deficit ratio is $d = [(1+g)(1+0.02)-1]*b$. With $b = 0.6$, the allowable ratio is 4.9 percent for a country like Finland growing at six percent on average, but only 1.8 percent for a country such as Germany, whose trend growth rate is about one percent.

Finally, the distinction between sustainable public finances and optimal public finances is important. Optimal public finances are the solution to an optimization problem which consists of a set of policy goals, political preferences regarding policy outcomes, resource constraints, and (assumptions about) the laws describing the functioning of the economy. Designing optimal policies is, therefore, by nature a political task. Sustainability is just one of the resource constraints that must be fulfilled in this task, that is, all optimal policies are sustainable, but not all sustainable policies are optimal. In view of this distinction, a careful balance must be sought between constraining long-term fiscal trends to maintain sustainability and making room for optimal policies. The more a framework meant to achieve sustainability constrains short-term fiscal policies, the more likely it is to get in the way of optimal policy choices. Too much emphasis on the short run, therefore, has the result of politicizing the framework for sustainability to an unnecessary extent. The failure to find a better balance between short-term and long-term exigencies for fiscal policy was critical in the crisis that led to the demise of the SGP in 2005.[8]

In a world with perfect information and no transaction costs, one could write a complete fiscal policy rule stating what governments should do under all circumstances to meet the intertemporal budget constraint. In reality, the world is too complex and uncertain to do that. Relying on simple numerical rules is of little use, because such rules would constrain the

[8] For a more detailed analysis see below and Fatas et al. (2003). There is also a possibility, however, that constraints on short-term policies aimed at sustainability such as numerical deficit rules improve the performance of short-term fiscal policies, for example Beetsma and Debrun (2004, 2005). These authors consider scenarios where unconstrained short-term policies are optimal from the point of view of the government in power, but not from the point of view of the representative citizen because of distortions arising from the political system, for example. However, arguments of this kind ignore the notion that there are better ways of correcting the underlying distortion.

governments' fiscal policies either too much or too little in the short run. Either way, it would lack credibility. In the first case, because they may force governments under some circumstances to adopt policies that are deemed unreasonable or even damaging for their own countries; in the second case, because it would not bind government actions sufficiently in the short run. The proper response, therefore, is to design a framework that combines guidelines for short run budgetary policies with proper judgment about current and future developments. This is what the EU procedures try to do.

3.1. The Excessive Deficit Procedure

The EDP is the cornerstone of the fiscal framework of the EMU. It combines the unconditional obligation of member states to avoid "excessive deficits" with a procedure providing a regular assessment of fiscal policies in the EMU and, if necessary, penalties for profligate behavior (Article 126 TEU). The TEU charges the European Commission with the task of monitoring budgetary developments and the stock of public sector debt of the member states, checking in particular their compliance with two *reference values:* for the ratio of the deficit to GDP and the ratio of public debt to GDP. The two reference values are set at 3 and 60 percent, respectively (Protocol on the EDP). If a member state does not comply with these reference values, and unless the deficit and the debt are approaching their reference values in a satisfactory way or the excess of the deficit over the limit is exceptional and temporary, the Commission writes a report to the European Council. The report takes into account whether the deficit exceeds public investment spending and "all other relevant factors, including the medium term economic and budgetary position" (Art 104(3)) of the country concerned.[9] If the Commission decides that an excessive deficit exists, it makes a recommendation to the European Council, which votes on it by qualified majority after taking into account any observations the country concerned may make and the opinion of the EFC. The decision whether or not an excessive deficit indeed exists is made by ECOFIN.

If ECOFIN decides that an excessive deficit prevails, it makes confidential recommendations to the country concerned on how to correct the situation within a given period of time. If the

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[9] According to Art. 126, the Commission may also prepare a report if a member state complies with the criteria but the Commission sees the risk of an excessive deficit nevertheless.

country does not take appropriate action and does not respond to ECOFIN's recommendations in a satisfactory way, ECOFIN may make its views and recommendations public, ask the government concerned to take specific corrective actions, and, ultimately, impose a financial fine on the country. In that case, the country would first be required to make a non-interest bearing deposit with the Community. If the excessive deficit still persists, this deposit would be turned into a fine paid to the Community.[10] The Council can abrogate its decisions under the EDP upon a recommendation from the Commission. All Council decisions in this context are made by qualified majority; once a country has been found to have an excessive deficit, its votes are not counted in these decisions.

In the context of the EDP, the numerical criteria for deficits and debts thus serve as triggers for an assessment prepared by the European Commission and made by the European Council. They do not themselves define what an excessive deficit is, nor does breaching them imply any sanctions *per se*. Since they merely serve as triggers for a more precise assessment of the situation, there is no need to make them responsive to economic circumstances, for example, by redefining them to exclude interest spending or cyclical effects on spending and revenues. These and other circumstances can be accounted for in the Commission's analysis, EFC's opinion, and the Council's judgment. In view of the need to balance long-term objectives with short-run constraints on actual policy, such a trigger-role is appropriate for the numerical criteria.

An important feature of the EDP is that the governance of the procedure is shared between the European Commission and ECOFIN. The Commission initiates the process, delivers the analytical input to the assessment, and makes proposals and recommendations to ECOFIN. ECOFIN acts as the ultimate judge of fiscal performance. Since ECOFIN is composed of the national finance ministers, all of whom are susceptible to running excessive deficits, this structure has been interpreted as making a group of "sinners" judge the performance of fellow "sinners." Judging the performance of other governments, ECOFIN members have good reasons to be lenient and avoid actions that could be politically costly for fellow members, anticipating that they might be in a similar position in the future. This makes serious judgment and the application of sanctions by ECOFIN unlikely. As a result, the EDP lacks credibility.

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[10] Note that neither the deposit nor its conversion into a fine affect the budget of the country in question as both are financial transactions.

The European Council made its decision regarding the qualification of the EU member states for membership in the monetary union in May 1998 on the basis of 1997 fiscal data. In the mid-1990s, the Council decided that excessive deficits existed in most member states; these decisions were formally abrogated in time so that they would not stand in the way of the membership decision. After the economically benign years of the early 2000s, between 2003 and 2007 France, Germany, Greece, Italy, the Netherlands, Portugal, and the UK were declared to have excessive deficits. Following the large fiscal expansions during the economic crisis of 2008-2009, all member states of the euro zone except Luxembourg and Finland have been declared to have an excessive deficit. The Commission has already presented its recommendation for a similar declaration regarding Finland. The experience thus shows that Excessive Deficit Procedures come in waves, each involving a large group of member states.

This observation suggests that the Council is reluctant to single out individual countries with weak fiscal disciplines and prefers to declare a status of excessive deficits in groups of countries instead. From a political-economy perspective, this is easy to understand: The political pressure on a government resulting from an excessive deficit declaration is easier to tolerate and deflect when other countries are in the same situation. However, this tendency contradicts the design of the procedure which focuses entirely on individual performance.

At the same time, this observation may indicate that fiscal developments in the member states are more strongly correlated than the design of the EDP has assumed. If so, fiscal developments should be monitored not only at the level of the individual member states but also at the level of the monetary union. As explained above, this would be more consistent with the nature of the intertemporal budget constraint in the monetary union than the current practice.

3.2. The Stability and Growth Pact

Public fears arose in Germany in the mid-1990s that the EDP might not suffice to discipline fiscal policies in the EMU. Theo Waigel, Germany's then finance minister, responded to these fears by proposing a "Stability Pact" for the EMU, which was later adopted as the

"Stability and Growth Pact" (SGP) by the European Council.[11] The SGP modifies the EDP in several ways. First, it sets up an early warning system strengthening the surveillance of the public finances of member states. This "preventive arm" of the SGP is formally based on the Multilateral Surveillance Mechanism of Art. 121 of the Treaty. Euro-area member states submit annual Stability Programs to the Commission and ECOFIN explaining their intended fiscal policies and, in particular, what they plan to do to keep the budget close to the new and stricter medium term budgetary objective of "close to balance or in surplus." Implementation of these programs is subject to ECOFIN's scrutiny. Based on information and assessments by the Commission and the EFC, ECOFIN can issue early warnings to countries that risk significant deviations from the fiscal targets set out in their Stability Programs. The goal of the Stability Programs is to achieve and maintain budgetary positions of close to balance or in surplus.

Second, the "corrective arm" of the SGP relates to the implementation of the EDP. It gives more specific content to the notions of exceptional and temporary breaches of the three-percent limit. By defining the rules for financial penalties, it speeds up the process by setting specific deadlines for the individual steps. Third, the dissuasive arm of the SGP gives political guidance to the parties involved in the EDP, urging them to implement the rules of the EDP in an effective and timely manner. It commits the Commission in particular to using its right of initiative under the EDP "in a manner that facilitates the strict, timely, and effective functioning of the SGP."

The rules of the SGP were further developed in a set of ECOFIN decisions regarding the format and content of the Stability Programs.[12] In October 1998, ECOFIN endorsed a Monetary Committee (the precursor of the Monetary and Financial Committee) opinion, the "code of conduct" specifying criteria to be observed in the assessment of a country's medium-term budgetary position and data standards and requirements for the Programs. In October 1999, ECOFIN recommended stricter compliance with and timelier updating of the Programs. In July 2001, ECOFIN endorsed an appended code of conduct refining the format and the use of data in the Stability Programs, including the use of a common set of assumptions about economic developments outside the EMU. The Commission (2000) has

[11] For an account of the genesis of the SGP see Stark (2001).
[12] See European Commission (2002), p. 23

produced a detailed framework of interpretation of divergences from the targets set in the Stability Programs.

Compared to the original EDP, the main impact of the dissuasive arm of the SGP has been to reduce the Commission's role and to raise the importance of ECOFIN judgments and decisions, thus shifting the balance of power from the institutional guardian of the Treaty to the representatives of the member states. This could only reduce the credibility of the fiscal framework further. As a result, European public opinion and financial markets have taken the numerical deficit criteria more seriously in recent years than the formal rules and sensible economic reasoning would warrant, anticipating that ECOFIN will tend to avoid serious judgment and the application of penalties. Thus, the SGP has reduced the weight of sound economic judgment and created the perception that the process was more rigid than it really is.

The preventive arm of the Pact never gained much prominence in political debates and has remained largely ineffective. This is most clearly visible in the fact that the "medium term budgetary objectives" and the goal of keeping budgets "close to balance or in surplus" have never gained any attention in public debates outside technical circles and the European Union institutions. Governments and the media have consistently argued that a country's fiscal performance is okay as long as its budget deficit is below three percent of GDP. Except in a few countries, such as the Netherlands, where rules-based budgetary policies and numerical budgetary objectives were part of the national political practice, the Stability Programs and the fiscal targets they develop have played a minor role at best in the annual budget process.

3.3. SGP Crisis and Reform

In early 2002, a few months before national elections in Germany, the Commission noted that Germany had missed its Stability Program targets by a significant margin and was approaching a deficit of three percent of GDP. The Commission proposed to issue an early warning. To avoid that, the German government struck a deal with other governments in ECOFIN in which Germany promised to balance the budget by 2004 in return for not receiving an early warning. After its reelection in September, the government revealed that

Germany was going to exceed the three-percent deficit ratio by a large margin in 2002 and 2003. In January 2003, ECOFIN decided that Germany had an excessive deficit. But already in May 2003, the Commission found that the German government had made sufficient efforts to reach budget balance and that there was no need to consider financial fines. It turned out later that Germany did not bring its deficit below three percent of GDP in 2003, nor did it do so in 2004 or 2005. “Effort”, in the Commission’s view amounted to mere declarations of intent rather than real policy adjustments – a mistake that is in line with the TEU but a fallacy in real life.

Also in the spring of 2002, the newly appointed French government announced its intention to postpone balancing the budget until 2007, three years later than its commitments in its previous Stability Program. France had a deficit ratio in excess of three percent in 2002; yet the French finance minister did not respond to the Commission’s request for an adjustment program. In the summer of 2002, the Italian government also stated that it intended to postpone the budget balance required under the SGP. ECOFIN issued an early warning to the French government in January 2003, and declared that France had an excessive deficit in June 2003. In June and July 2004, ECOFIN declared that the Netherlands and Greece had excessive deficits. In July 2004, ECOFIN also found that several of the new member states that entered the EU in May of that year had excessive deficits, that is, the Czech Republic, Cyprus, Hungary, Malta, Poland, and the Slovak Republic.

In November 2003, the Commission presented an assessment of the French and German fiscal performance and budgetary plans to the European Council. The Commission concluded that neither state had taken adequate steps to reduce the excessive deficits and that their plans for the following years were also inadequate. The Commission therefore recommended to the Council that it decide that France and Germany had not taken adequate steps and to make very specific policy recommendations to the two governments. The Council, however, failed to adopt the Commission’s recommendation with a sufficient majority. Instead, it decided that the two countries had not taken adequate measures and to hold the EDP against them in abeyance. From the point of view of the Commission, the Council overstepped its authority in doing so, since it can only act following a Commission recommendation in matters of the EDP. In a decision on 13 July 2004, the European Court of Justice annulled the Council’s decision in this regard.

Meanwhile, the governments of Germany, France, and other countries had started pushing for a reform of the SGP, allegedly asking for more "flexibility."[13] Specifically, Germany wanted to have its large net contribution to the EU budget and the alleged fiscal costs of German unification recognized as excuses for running large deficits. In December 2004, ECOFIN decided to suspend the ongoing procedures under the EDP until after a reform of the SGP.

The European Council adopted such a reform in March 2005 (European Council 2005).[14] Its main points are the following:

(1) the medium term objective for national budgetary positions to be "close to balance or in surplus" may now be differentiated according to national circumstances, allowing for room for more budgetary maneuvers, taking into account the need for public investment and the fiscal consequences of structural reforms

(2) a clarification of the term "exceptional and temporary" excess of the deficit over the reference value of 3 percent of GDP, considering "as exceptional an excess over the reference value which results from a negative growth rate or from the accumulated loss of output during a protracted period of very low growth relative to potential growth." (p. 33)

(3) a clarification of the term "all other relevant factors" in the assessment of a country's deficit, taking into account the fiscal consequences of structural reforms, and "financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe." (p 34) The latter would allow Germany to use German unification as a convenient excuse for its lack of fiscal discipline. Notice the prominence of the terms "structural reforms" and "potential output growth," which are open to broad interpretation and concern matters over which the Commission has no competence. In light of the huge uncertainty of any estimates of the fiscal consequences of structural reforms[15] and potential output growth, national governments would be able to specify whatever they wish as excuses for large deficits.

(4) The Council recognized the importance of national budgetary institutions and rules such as explicit balanced-budget requirements, debt limits or the use of multi-annual planning frameworks for the effective implementation of the EDP and the SGP. Member states are now expected to report and discuss domestic fiscal institutions in their Stability

[13] See Fatas et al (2003) for a review of the reform debate and proposals.
[14] See also http://ec.europa.eu/economy_finance/sgp/pdf/coc/2005-03-3_council_presidency_conclusions_en.pdf
[15] See Beetsma and Debrun (2004) and IMF (2004) for a discussion.

and Convergence Reports and the Commission has presented extensive material on these issues.[16] The Council has not, however, made any recommendations concerning the design of such rules and institutions.[17]

(5) Improving and strengthening the statistical framework of the SGP and the EDP.

The 2005 SGP reform also introduced the "Commission policy advice," which allows the Commission to address a member state directly and publicly with a recommendation regarding the conduct of its fiscal policies. This is weaker than an "early warning," but the instrument is owned entirely by the Commission. In principle, the Commission could use it to admonish governments with lax fiscal policies even in situations where the European Council is, for political reasons, unwilling to issue an early warning. So far, however, the Commission has been very reluctant to use its new competence.[18] This suggests that the Commission is eager to avoid conflict with the member governments over its views concerning the sustainability of public finances.

Clearly, the request for more flexibility in the EDP and the SGP was odd, because the procedures contained a lot of room for judgment from the beginning and the numerical criteria were never meant to be binding thresholds. While many economists participating in the public debate affirmed the need to take into account cyclical conditions, public investment, and the quality of economic policies, they seemed to overlook the simple fact that judgments of this kind were already possible under the existing rules.[19] Thus, the real issue between the national governments and the Commission was the governance of the procedures, that is, who has the right to exert judgment when a country's fiscal policy is being assessed. The political outcome confirms that this view is correct. In principle, specifying the nature of possible excuses for large deficits restricts the scope of economic judgment that can be brought into the procedure and is, therefore, is a *loss* of flexibility, not an increase. But the real purpose of the reform was to further curtail the Commission's influence in the process, and this has been achieved. With ECOFIN dominating the

[16] E.g. Commission (2009).
[17] For the design of national budgetary institutions and their impact on the sustainability of public finances, see Hallerberg et al. (2008).
[18] Only two recommendations were issued so far, one addressing France and one Romania, both issued in 2008.
[19] For example, the Commission (2002) and Buti et al. (2004) proposed to focus on structural balances rather than the actual deficit, a suggestion that was already incorporated in the 2001 Code of Conduct. Giavazzi and Blanchard (2002) call for a "golden rule" excluding investment spending from the budget, which the EDP rules hint at. Coeuré and Pisani-Ferry (2003) recommend that the emphasis should be shifted to the debt ratio.

assessment of sustainability, the reform has further destroyed the credibility of the framework.[20]

3.4. Fiscal Adjustments under the SGP

In 1992, the EU's average debt ratio was almost 60 percent of GDP – hence the 60 percent limit foreseen in the Maastricht Treaty.[21] It climbed to almost 75 percent in 1997, the base year for the May 1998 decision on which countries could enter the EMU. Between 1997 and 2002, the average debt ratio of the EU-15 fell to less than 63 percent, but then it started to rise again. In 2010, it stands at 82 percent. In contrast to what EU officials and politicians like to claim, the data do not show that the Maastricht process for fiscal consolidation was successful.

Several qualifications apply. First, the increase in the average debt ratio during the 1990s was driven mainly by debt expansions in five states: Germany (from 44% to 61%), France (from 40 % to 56%), Spain (from 48% to 70%), Italy (from 109% to 124%), and the UK (from 42% to 55%). While Belgium and Luxembourg almost stabilized their debt ratios, the Netherlands and Ireland enjoyed falling debt rations during this period. The debt ratios of the other states were stabilized or fell after 1992.[22]

Do the EDP and SGP work more effectively in small states than in large ones? To answer this question, Table 1 reports the average changes in the debt to GDP ratios for large states (states whose GDP in 1997 was at least seven percent of EU GDP - Germany, Spain, France, Italy, and the UK), intermediate states (states, whose GDP is between two and seven percent - Belgium, the Netherlands, Austria, and Sweden), and small states (whose GDP was less than two percent of EU GDP - Denmark, Greece, Ireland, Luxembourg, Portugal, and Finland). The combined GDP of the large states was 80 percent of EU GDP,

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[20] See Calmfors (2005:70) for a similar conclusion.
[21] The 3 per cent deficit limit under the EDP derives from the 60 per cent debt limit assuming an average nominal GDP growth rate of five per cent in all EMU member states.
[22] Austria's and Finland's debt ratios increased after 1992, but these countries were not bound by the EDP at the time.

that of the intermediate states 13 percent, and the small states had a combined GDP of 7.7 percent of EU GDP. The table shows that, between 1992 and 1997, the average debt ratio of the small states increased by just 3.3 percent, much less than that of the large states, which rose by almost 19 percent. Between 1998 and 2003, the small states achieved an average reduction in their debt ratios by seven percent, more than the 4.9 percent achieved by the large states. Intermediate states reduced their debt ratios on average by 10.5 percent. Finally, during the years of the SGP crisis (2004-2006), the large states achieved almost no reduction in their debt burdens, while the intermediate and small states reduced their debt burdens on average by four percent. During the most recent economic and financial crisis, debt burdens increased the most in the large states and the least in the intermediate states.

This indicates that the EMU fiscal framework is indeed much more effective in the small and intermediate than in the large states. There are two reasons for this. The first is that EU affairs and compliance with EU rules are politically much more important in small EU states than in large states, where politics are dominated by domestic matters. Large EU states have never assumed ownership of the EU procedures and have rather been willing to work around them. The second reason is that the small and intermediate states are typically governed by coalition governments. The target and rules-based EU framework has been easy to translate into fiscal targets embedded in coalition agreements, which has given them internal political importance. The party systems in the large states do not lend themselves easily to such arrangements (Hallerberg et al, 2008).

Table 1: Government debt since 1992

Period	Change in Debt Ratio (percent)			
	All EU-15 States	Large States	Intermediate States	Small States
1992-1997	15.8	18.8	4.1	3.3
1998-2003	- 4.7	- 4.9	-10.5	- 7.1
2004-2006	- 0.4	- 0,4	- 4,0	- 3.9
2007-2010	21.8	22.3	17.6	19.7

Source: European Economy Statistical Appendix Spring 2002, Fall 2003, Spring 2010

The second qualification is that the observation of fiscal consolidations in some EU states during the 1990s cannot simply be attributed to the Maastricht process. Since most European countries had had sizeable fiscal expansions during the 1970s and 1980s, a period of consolidation could be expected in the 1990s anyhow. A study of European fiscal policy in the 1990s (Hughes Hallett, Strauch and von Hagen, 2001) considers this argument in detail. It shows that most of the observed consolidations in the 1990s could well be expected just by extrapolating patterns of fiscal behavior of EU states in the 1970s and 1980s. The evidence of a “Maastricht effect” speeding up or enforcing consolidations is weak at best.

Finally, Table 1 shows that the large states on average accumulated more debt during the crisis years of 2007-2010 than the intermediate and small ones.

In an empirical study of fiscal policy in the EU, von Hagen (2006) shows that fiscal impulses, defined as the change in the primary deficit which is not explained by the change in GDP, react negatively to past increases in the debt ratios. This can be regarded as a necessary condition for fiscal sustainability, as the debt ratio would be unbounded without such a reaction. Furthermore, the average fiscal impulse was significantly more expansionary after 1999. This is consistent with the notion of *consolidation fatigue* (Harden and von Hagen, 1997) which is that once the EMU was founded, euro-area states relaxed their fiscal discipline after the consolidation efforts of the 1990s. Finally, the most expansionary fiscal impulses after 1999 occurred predominantly in election years. This result is consistent with similar findings in Buti and van den Noord (2003). It suggests that the fiscal framework of the EMU does not keep governments from creating political budget cycles.

Noting that the fiscal framework of the EMU relies heavily on fiscal plans presented by national governments and that these plans focus on macroeconomic and fiscal forecasts, recent literature has studied the quality of these forecasts in the euro area (Brück and Stephan, 2006; Jonung and Larch, 2006; Moulin and Wierts, 2006; Pino and Alvarez, 2007; von Hagen, forthcoming). These papers find that the fiscal forecasts contained in Stability and Convergence Programs and those made in the context of the EDP are systematically biased and, therefore, unreliable. Jonung and Larch notice that the macro economic forecasts in many cases are overly optimistic. They propose the creation of independent forecasting institutions in the member states, patterned, e.g., after the Dutch Central Planning Bureau, to free the forecasts from political bias and to improve their quality. Von Hagen (forthcoming) shows that the direction of the bias depends critically on the nature of the domestic fiscal institutions, which in turn are shaped by the characteristics of a country’s electoral system and political party system. This indicates that the forecasts are used strategically in the budget process and respond to political incentives.

At the European Council in Lisbon in 2000, the EU called upon its members to improve the "quality" of public finances. Without defining precisely what the "quality" of public finances means, the Council recognized that the structure of public spending and taxation has important consequences for economic growth and decided that the EU member states should aim at a more growth-friendly structure of public finances. Endogenous growth theory broadly suggests that a shift from taxing factor incomes to taxing consumption and a shift from public consumption and transfer spending to public investment has positive growth effects (Aghion and Howitt, 1998). Empirical results in this area are mixed, but they suggest that fiscal policies do have effects on growth.[23] Furthermore, empirical evidence, albeit only suggestive, indicates that countries that relied more on tax increases to consolidate their budgets ended up with lower real growth rates and only short-lived consolidation successes. Other countries, in contrast, relied more on spending cuts and managed to cut tax rates and to protect public investment more than the first group. These countries experienced higher real growth rates and longer-lasting consolidation successes. These experiences suggest that the quality of fiscal policies should be a dimension in the assessment of the sustainability of public finances. So far, this idea has been recognized in the 2005 reform of the preventive arm of the SGP, but not in the dissuasive arm.

4. Greek Crisis and Proposals for Reform of the SGP

As a result of the huge financial interventions to stabilize the banking systems and to fend off the worst recession in post-World War II history, most euro-area member states have accumulated large amounts of public debt since 2007, and the debt ratios are projected to increase further in the next couple of years. The Greek debt crisis of 2010 added to the public and the markets' awareness of the renewed public debt problem in these countries. Rating agencies downgraded the debt of several euro-area countries including Greece, Portugal, and even Spain, and interest rates on public debt rose sharply in several countries, reflecting the markets' fears that governments might turn out to be unable to service their

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[23] See for example Kneller et al. (1999, 2000), Fölster and Henrekson (1999), Tanzi and Zee (1997).

debts. In April and May, Greece seemed to reach the point where markets were no longer willing to lend to the government even to roll over its existing debt.
The Greek crisis also brought out some disillusioning facts about the governance of the EDP and the SGP. In October 2009, the new Greek government revealed that the 2009 budget deficit stood at 12.5 percent of GDP rather than at the 3.7 percent reported earlier that year. The difference was due to budgetary slippage, economic conditions, and, importantly, creative accounting. Shortly afterwards, the Greek government was forced to revise this figure upwards again to 13.6 percent. While the Greek deficit reported from 2000 to 2008 averaged 2.9 percent of GDP, the real number was 5.1 percent (Pisani-Ferry, 2010). As it turned out, the government had ignored and circumvented the statistical rules set by EUROSTAT for reporting public debts and deficits. It had also used accounting gimmicks such as unrealistic exchange rate assumptions in accounting for foreign liabilities and the sell-off of future revenues from public utilities to hide public debts.

For the informed observer, the use of such practices by euro-area countries should not have been a surprise, although the sheer magnitude was perhaps stunning. As documented by Wolff and von Hagen (2006) and Koen and van den Noord (2006), there is ample evidence of creative accounting in all EU-15 member states, and euro-area countries have shown a tendency to use creative accounting systematically to circumvent the three-percent deficit limit of the EDP since the start of the EMU. Furthermore, it was known that the Greek government used some creative accounting to make the deficit criterion for entry to the euro area in 2001 (Calmfors, 2005:73). Clearly the political desire of the other euro-area member governments to enlarge the monetary union had overruled appropriate scrutiny at the time, as it also had been, for example, when Germany qualified for the euro only with the help of creative accounting.

European sovereign debt markets became increasingly volatile in the wake of the news about Greece and the mounting doubts about the credit quality of other euro-area countries. In an effort to calm markets and to prevent the public debt crisis from becoming another banking crisis in Europe, the EU governments, with the assistance of the IMF, eventually decided, first, to set up a rescue package for Greece and then the EUR 450 billion European Financial Stability Facility, EFSF. This, together with a EUR 60 billion contribution from the European Commission and a EUR 250 billion contribution from the IMF, created the European Financial Stabilization Mechanism as a safety net for the debts other EU governments that might come under severe financial pressures.[24] It took an open breach of the European Treaty and the creation of the EFSF as a "Special Purpose Vehicle," i.e., outside the EU legal framework, to finance the member states' contribution to implement these rescue packages.

As a result, the EU's fiscal framework and its credibility have been seriously damaged. Many commentators have argued that the SGP has openly failed.[25] In view of this, the member states, the Commission and the ECB have repeatedly affirmed their commitment to sound public finances and the need to return to lower deficit and debt ratios in the near future. Meanwhile, the EU has asked a taskforce headed by its President, Herman van Rumpuy, to develop a plan for reforming the SGP. Several reform proposals for the fiscal framework have been made. In this section, we review these proposals. They can be classified into three groups: marginal improvements of the SGP and the EDP, strengthening the framework by making bold institutional amendments to the current fiscal framework, and proposals that miss the point.

4.1. Strengthening the SGP: Marginal Improvements

A first initiative for strengthening comes from the European Commission (2010a) with support from the European Central Bank (2010a). The gist of the proposal is to improve the effectiveness of the corrective arm of the SGP, to make the preventative arm more powerful and to enlarge the scope of multilateral surveillance under the SGP. Furthermore, the proposal aims to strengthen the national fiscal frameworks.

It is noteworthy to point out that the Commission talks about stronger economic governance. It thereby alludes to the old debate about whether or not a monetary union can survive without a political union as a back-up, i.e., some form of overarching government that the national governments would be subdued to. Without entering into that debate, one should keep this issue in mind when discussing the current proposals for reforming the fiscal framework of the EMU. Clearly, the Commission has an interest in promoting a political

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[24] http://www.efsf.europa.eu/
[25] E.g. Aznar (2010)

union, as this can only expand the scope of its powers. At the same time, it is unlikely that non-euro-area countries would go along with a more political union. Moving in that direction might well deepen the gap between the two groups of countries.

Improvements in the SGP may strengthen the functioning of the rules, but they also carry two important risks. The first is that any move in the direction of a speedier and more automatic application of the procedural steps under the EDP will further reduce the scope for informed judgment on the part of the Commission and therefore further increase the room for discretionary maneuvers on the part of the governments represented in the European Council. Like the 2005 reform of the SGP, this will ultimately make the framework less credible. The Commission has already responded to this threat by proposing the use of a host of additional indicators and rules, but it is doubtful whether this will make the procedures more effective. Given that the concept of sustainability is necessarily somewhat elusive, the idea to measure compliance with it with an ever increasing range of statistical variables is not convincing. Once the crisis is over, national governments and parliaments will increasingly dislike what they perceive as the growing tendency of the Commission to meddle with internal affairs and politics which its bureaucrats do not properly understand. As a result, they will seek ways to circumvent the framework and undermine its effectiveness.

The second risk is that, the more the EU via the Commission gets involved with a country's fiscal and economic policies, the more it will create the perception on the part of national policy makers that they have a right to receive financial assistance from the Union in times of economic and fiscal problems, arguing that they just did what the Commission told them to do. Thus, the Union cannot avoid assuming more responsibility for the economic performance of its member states. The result will be further moral hazard problems. Governments expecting assistance from the EU in times of economic difficulties will pay less attention to avoiding such difficulties in their own economic policies. More and increasing demands for bailouts and other forms of transfers will follow.

Will the marginal improvements bring greater fiscal stability to the euro area? Most likely, they will not. The belief that a group of sovereign states which fundamentally differ with regard to political and economic characteristics could be governed through a mesh of statistics and numerical rules remains an illusion. The SGP never gained the support and ownership of the political classes nor the broad public in the member states. There is no reason to believe that this will change.

4.1.1. Improving the Effectiveness of the Preventive Arm

The Commission's proposal to strengthen the preventative arm of the SGP seeks to ensure the application of the statistical concepts and definitions at the national level and to make sure that the national statistical offices have the capacity to comply with EU reporting standards. In this context, it asks all member states to apply the same cash-based accounting rules for reporting budgetary developments and to use transparent and reliable forecasting procedures for the forecasts of macro economic variables and the budgetary aggregates underlying the national fiscal policy plans and reports. The Commission suggests that forecasting procedures could be subject to some type of auditing.

According to the proposal, the assessment of the sustainability of a country's public finances should pay greater attention to its public debt and, in particular, to exogenous forces affecting the debt. For this purpose, the maturity and the currency structure of a country's public debt and the role of and potential risks connected to implicit liabilities such as future pensions and contingent liabilities such as guarantees for private sector debt should be assessed more carefully and explicitly than in the past.

In order to raise the stakes for non-compliance with the medium-term goals of the SGP, the Commission asks for the right to impose sanctions on countries which do not make sufficient progress with budgetary consolidation. The Commission could impose an interest-bearing deposit on such a country if it has received an early warning and does not stick to a pre-set path of expenditure targets. Similarly, the Commission might cut disbursements of structural or cohesion funds to such countries.

To strengthen mutual surveillance in the areas of public finances and macro economics, the Commission proposes the creation of a "European semester" during the first six months of every calendar year. The European semester would be a period of intensified monitoring and coordination of economic policies in Europe. For this purpose, all member states would submit their Stability and Convergence Programs and their annual budget plans in time for the Commission to review them and make recommendations before the national budgets are adopted by the national parliaments. The Commission would also review the national budget plans in order to determine their combined macro economic impact at the level of the monetary union and the EU. The European Semester would start with the presentation of a report on the economic policies of the member states by the Commission. The scope of this report would be very broad, including all aspects of economic policy (Commission, 2010e).

A recent position paper published jointly by the French and German governments calls for a more extensive use of policy warnings and recommendations in order to force member states to stick to the objectives of the BEPG.[26] This would change the nature of mutual surveillance in the EU from a political commitment to a procedure to which the Union can enforce compliance with using formal sanctions.

4.1.2. A More Powerful Corrective Arm

Regarding the corrective arm of the SGP, the Commission proposes to create and implement new types of sanctions, which should be used at earlier stages of an Excessive Deficit Procedure than the deposit and financial fines already available. Sanctions should be graded according to the severity of a country's lack of compliance with its medium-term budgetary objectives under the SGP. The Commission proposes to use the Community Budget for that purpose, e.g., by cutting refunds to a national government under the Common Agricultural Policy.

In addition, the ECB calls for non-financial sanctions such as a limitation or suspension of voting rights in the Euro group, or procedural sanctions such as the increased intervention of the Commission into the national budget processes, requirements for a more detailed explanation of adjustment programs, and on-site monitoring by special missions from Brussels. The German-French position paper also proposes that member states which do not comply with their commitment to maintain sustainable public finances be deprived of their voting rights in the European Council. Interestingly, the ECB calls these "token sanctions" suggesting that they are not real sanctions at all. The ECB also calls for earlier and more automatic initiations of sanctions. Depriving member states of their voting rights would be a serious infringement of their sovereignty and democratic representation. It is a fundamental contradiction of the democratic principle of the EU as well as of the nature of the EU as an

[26] "European Economic Governance. A Franco-German Paper." Mimeo, German Federal Ministry of Finance.

association of sovereign states. Even if it seems like a small step, it would be a significant towards a more federal organization of the EU.

The Commission (2010d) proposes a stronger role to be played by the debt criterion of the EDP. Under this proposal, the Commission could open an excessive deficit procedure against a country if its debt to GDP ratio does not converge to the 60 percent threshold in a satisfactory way. Fines could be imposed conditional on deviations from the debt criterion, even if the deficit ratio performs in a way that is consistent with the rules of the SGP. This would require adapting EC Regulation 1467/97 on the application of sanctions under the EDP.

Increasing the importance of the debt criterion is consistent with past academic contributions (e.g., Pisani-Ferry et al, 2008), which argued that the debt ratio reflects the long-run sustainability of a country's public finances better than the annual deficit ratio. Nevertheless, the Commission has so far shied away from paying greater attention to the debt ratio, because this ratio is perceived to be less controllable by the governments than the deficit ratio (Commission, 2010d).

In this vein, von Hagen (2007) shows that sufficiently strong economic growth was a precondition for all successful and lasting reductions in the debt ratios of euro-area countries in the past 20 years. Economic growth was probably fostered by appropriately designed fiscal strategies (see above). In contrast, controlling annual budget deficits was only a necessary condition for reductions in debt ratios. This indicates that a reform of the SGP putting more emphasis on debt ratios would necessarily have to put more emphasis on the "quality of public finances" as discussed above, which is a much more contentious issue and an area where numerical rules and targets make much less sense. Finally, debt ratios have been much more volatile (larger declines in good times, larger increases during the crisis) in small, open economies than in large economies in the euro area. Increasing the emphasis placed on debt ratios would probably place the small economies under more scrutiny than the large ones.

4.1.3. Strengthening National Fiscal Institutions

The Commission proposes an improvement in the statistical framework of the SGP, introducing a clear correspondence between the budgetary and accounting concepts used at the national level and by EUROSTAT. Cash-based data should be reported to EUROSTAT on a monthly basis.

The Commission also recommends the development of multi-annual budget planning processes at the national level and the introduction of comprehensive budgeting processes with clear assignments of budgetary responsibilities in all member states, particularly in those with a high degree of decentralization. Furthermore, the Commission proposes that all member states should put in place fiscal rules anchored in national laws and multi-annual budget plans. Budgetary systems should be comprehensive and include all aspects of public finance. To enforce this proposal, the Commission (2010f) would like to require the member states to report regularly on the fiscal rules and institutions prevailing in their public sectors, although the Commission realizes that compliance would be hard to monitor given that such rules and institutions are not necessarily based on legal provisions.

Strengthening fiscal institutions can be useful to achieve more fiscal discipline. A host of empirical research, however, shows that the effectiveness of fiscal institutions for that purpose depends critically on the electoral and party system prevailing in a country. The type of numerical rules and targets favored by the Commission is effective only in countries where the government is typically formed by multiparty coalitions and based on coalition contracts where the numerical targets are embedded. In other settings, numerical rules and targets have very little commitment power for the government; fiscal discipline is achieved by vesting the finance minister with strong agenda setting and control powers (Hallerberg et al, 2009). Disregarding this fact, the Commission is likely to push for a framework which will work properly in some countries but will not do so in others.

4.2. Bold Improvements: Fiscal Councils

The ECB's (2010) proposal goes beyond the Commission's proposal in one important dimension. It foresees the creation of an independent fiscal agency to monitor the fiscal policies of the euro area countries. This fiscal agency could be located within the Commission, so that it could make use of the Commission's services for its own needs of data and information, but it would be politically independent from the Commission as well as from the national governments.

The ECB's proposal follows earlier proposals for a similar institution made by academics (Harden and von Hagen, 1994; Fatás et al. 2003). These authors suggested that the task of monitoring the sustainability of national fiscal policies should be delegated to independent agencies, *Fiscal Councils* or *Stability Councils*, which could be created both at the national level and at the level of the euro area. Economists from the IMF (Annett, 2005; Annett et al. 2005) have recommended the creation of national fiscal councils as part of a strategy to strengthen the SGP. Leeper (2009) argues that fiscal councils could play a useful role in guiding public expectations about future fiscal policies, which are important determinants of the effectiveness of these policies. In fact, fiscal institutions of this kind have been created in a number of EU countries in the past 20 years, among them the Netherlands, Belgium, Hungary, Austria, Romania, and Sweden.[27]

The original idea of a fiscal council (Harden and von Hagen, 1994) was to create a politically independent actor in the national budget process, which would solve the problem of deficit bias inherent in democracies. This problem results from the fact that individual spending ministers, who represent different sectoral and political interests in society, make demands on public resources without taking into account the full economic cost of their financing. The fiscal council would solve this coordination problem by determining the maximum allowable deficit for the country as a whole each year. It would have the right to impose across-the-board spending cuts if the government did not comply with this limit. Obviously, such an institution could only be created at the national level at the time. In the subsequent debate, it was argued that a fiscal council could become active in the public debate and influence national fiscal policies in that way. This seems to be the primary way in which existing fiscal councils at the national level today are active.

An independent fiscal council created at the level of the euro area would have the advantage of being able to focus on the sustainability of public finances as its sole mission. It could conduct studies on relevant topics and present them to the broader public. Furthermore, it could assume the role of making recommendations to the European Council regarding the existence of an excessive deficit in a member state and the abrogation of an excessive deficit procedure, of making recommendations regarding the country's budgetary policies,

[27] See von Hagen (2010) for a review of the experience with fiscal councils.

and of issuing early warnings if a country deviates from its Stability and Convergence Program and the medium-term objective of "Close to Balance or in Surplus." In doing so, the fiscal council would have the advantage of not having to take into account policies in other spheres of European integration. In contrast, the Commission can never be fully politically independent in these regards, because it needs the cooperation of member states in the implementation of European policies in all fields of integration and with regard to the Commission's own agenda to develop new initiatives for integration. By creating an independent fiscal council, the fiscal framework of the EMU could gain credibility. It would derive its influence by engaging the governments in the public debate, commenting on current and expected fiscal developments and other issues related to fiscal policy.

The ECB also suggests that independent fiscal councils should be created at the national level, an idea that was also proposed by Fatas et al. National fiscal councils would be more visible in the national media and, thus, would be more influential.

4.3. Bold Improvements: Crisis Management Mechanisms

From an economics perspective, there is no reason to believe that a debt crisis in an individual euro-area state would put the stability of the euro itself at risk. The euro's internal stability is not threatened because as long as the ECB does not finance government deficits directly, a government's access to private credit has no implications for the money supply and, hence, for inflation in the euro area. The euro's external stability is not threatened for the same reason. Nevertheless, the recent debt crisis has created a lot of volatility in euro financial markets. This is the consequence of the markets' uncertainty about what would happen in the case of a Greek default on the country's sovereign debt. From the point of view of individual bond holders, there are two relevant sources of uncertainty: uncertainty about the willingness and ability of Greece to honor its financial liabilities, and uncertainty about the behavior of other bond holders. The former is due to the fact that the true state of a country's public finances can only be guessed by outsiders and that the degree of hardship a country's citizens are willing to bear in order to repay its debt is an issue of political judgment. This type of uncertainty leads to a moral hazard problem: a default offers the possibility for a government to free itself from a large debt burden by expropriating its (foreign) creditors. This may be more attractive than servicing the debt, a possibility already foreseen by Adam Smith (Kratzmann, 1982).

The second type of uncertainty raises two coordination problems among creditors. The first is a "creditor grab race," in which individual creditors rush to sell off their bonds or refuse to roll over a given stock of debt, causing a decline in bond prices and causing other creditors to behave in the same way (Thomas, 2004). This may aggravate a financial problem to the point of triggering a crisis that might have been avoided otherwise. The second is a hold-up problem in which a minority of bondholders refuses to agree to a restructuring of a country's debt hoping to be bought out in full by the majority.

A framework for dealing with sovereign defaults in an orderly way in order to avoid such uncertainties could be very valuable to the euro. Two proposals have been made in this regard. One, coming from the ECB and looming behind the German-French position paper, begins with the assumption that euro-area state governments will always be bailed out as Greece was this spring. Thus, it takes the existence of a European Financial Stabilization Mechanism as given and asks how such a mechanism should be supported. The other proposal starts from the assumption that creditors should be involved in the solution and that the European Mechanism is only a temporary arrangement. The German Federal Finance Minister has recently supported such a proposal.

4.3.1. ECB Proposal

The ECB (2010) proposal contains a lender-of-last resort mechanism to support euro area member states – presumably meaning governments – in situations where they do not get access to private credit. However, the ECB does not give much detail to this proposal.

The ECB envisions a crisis management framework building on the EFSF and acting as a lender of last resort for public borrowers. The ECB explicitly excludes the use of any funds coming from this agency to bail out private creditors. Bailouts of euro-area countries should not be linked to an expulsion from the monetary union, because this would undermine the credibility of the common currency. Conditions for financial support should come at penalty rates. The ECB proposes to make financial support very unattractive for the recipient government and to extend it only under preferred creditor status and based on good collateral.

Adopting a mechanism of this kind would amount to implementing a permanent bail-out framework. The desired advantage is clear: markets could always anticipate that governments in financial distress receive assistance from the EU. Thus, the kind of market volatility observed in the first half of 2010 would not arise. Note, however, that the ECB's request of preferred creditor status for the bail-out fund would be counterproductive, because private creditors would still face the possibility of losing their money. It would leave banks and investment funds with no guidance for their expectations regarding the solution of a fiscal crisis.

Any framework for a bailout obviously creates a moral-hazard problem. If governments know that a bail-out will be forthcoming, they have less reason to behave in fiscally prudent and responsible ways. Experiences with state debts in federal countries such as Argentina, Brazil, or Germany show that this is a real problem. The ECB's proposal aims at keeping such moral hazard problems small by imposing penalty rates and very harsh conditionalities. The main problem with this, however, is that it lacks credibility. Given the rather soft conditions of the Greek bail-out program, future bail-outs cannot involve more severe conditions without being called unfair.

4.3.2. A Sovereign Default Framework

The German federal government has proposed the development of a framework for the orderly default of public debtors. Chancellor Merkel called for the creation of an orderly default mechanism for euro-area member states in her speech before the German parliament on 19 May 2010, arguing that this would strengthen the incentives for member states to preserve sustainable public finances. According to "Der Spiegel" (11 July 2010)[28], the German Finance Minister is preparing a proposal for the creation of the "Berlin Group" representing the main G20 states. This group would coordinate the demands of bond holders and impose a haircut of at least 50 percent of the face value of the debt of a government in financial distress and would involve the bondholders in the solution. A number of academics have made proposals in the same vein.[29] In the context of the debt crises in South-East Asia, Russia, and Latin America around the turn of the century, the IMF proposed a sovereign debt

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[28] http://www.boerse-online.de/tools/dowjones/20100711LL000376.html
[29] Gros and Mayer (2010), Pisani-Ferry and Sapir (2010)

resolution mechanism (SDRM) as a framework for the orderly bankruptcy of national governments.[30]

Sovereign defaults have been a fact of life throughout history. In the past 100 years, for example, Germany (partially) defaulted on its sovereign debt three times. The most recent case of an open default was Argentina in 2001 (Waldhoff, 2004). Thus, even if the possibility is generally not foreseen in national legal frameworks for default and insolvency, the possibility of sovereign defaults cannot be denied. Under US law, municipalities can declare bankruptcy filing for Chapter 9 of the US Bankruptcy Code, a legacy from the Great Depression; the most recent case involved Orange County, CA. In Switzerland, the city of Leukerbad was allowed to go bankrupt in the early 2000s. Historically, governments with unsustainable debt burdens have often reverted to the money-printing press to inflate away the debt (see the many examples in Rogoff and Reinhart, 2009).

Sovereign defaults are different from private defaults in a number of ways. The first is that, in contrast to a private company, the sovereign entity cannot be dissolved, a forced liquidation of its assets is impossible, and its creditors cannot assume ownership. Furthermore, while a private bankruptcy procedure primarily aims at maximizing the value the creditors can extract from the defaulting institution, a defaulting government must be left with the financial means to perform at least minimal government functions.

Second, under democratic government or a community of democratic states, it is inconceivable that a government be put under receivership, because this would contradict the nature of democracy. Third, the main asset of a sovereign government is its power to tax, which is an intangible. The economic value of taxation depends on the quality of administration and the loyalty of the citizens. While it could limit the national administration's ability to misrepresent tax revenues, imposing administrative oversight from outside the country might also destroy the value of the asset. Fourth, while governments can default on debts owed to their own citizens in their own rights, they cannot, under international law, simply deprive foreign debtors of their financial assets.

[30] See Krueger (2002), Rogoff and Zettelmeyer (2002)

This implies that the instruments to deal with sovereign default in an orderly way are quite limited. They amount to finding an orderly process of restructuring a government's debt through negotiations with its international creditors. So far, this has happened through the Paris Club (involving sovereign lenders) or the London Club (involving international banks). The fact that most government debt today is in the form of bonds suggests that neither Club would suffice to address the current problems of governments in distress. From this perspective, a framework for orderly default could be very useful for the euro area.

Such a framework would have to have three main elements. First, it would need a formal way to initiate bankruptcy procedures. Rules should be conducive to engaging creditors and debtors into an exchange of information and views on the current situation relatively early to reduce the uncertainty of the creditors (Krueger, 2002). Given the potentially large number of creditors/bondholders and because the debtor is a sovereign, the initiative to start bankruptcy procedures can only come from the debtor government. To reduce the moral hazard problem of unilateral debt repudiation, one could conceive of a requirement for the defaulting government to file for default before a special chamber of the European Court of Justice.

Second, the framework would need a mechanism to prevent a minority of bondholders from exploiting the majority by refusing to agree to a restructuring of the debt in the hope that the majority would buy them out. This requires that a super majority of bondholders (say, two thirds) can outvote the minority in the decision to enter into negotiations and conclude agreements with the debtor country regarding a restructuring of the latter's debt. Furthermore, it requires that a stay can be imposed on all litigation against the debtor country to enforce the repayment of any parts of the debt to groups of creditors.

Third, the framework would have to have a mechanism to conduct negotiations. This has two aspects. First, a person or institution must be appointed to the role of inviting bondholders to negotiations. In civil bankruptcy procedures, this is the role of the court-appointed trustee. In the context of sovereign bankruptcy, the sheer size of the task implies that it would have to be assumed by a public institution or a large accounting or legal firm. The IMF and the European Commission would be obvious candidates for that role. The need for a politically independent actor in that role would suggest the IMF to be better fitted to that role than the European Commission, but the IMF could be a creditor itself in the procedure, which would disqualify it. An alternative would be to create an independent institution within the Commission, which would have the right to use Commission resources.

The second aspect is that the valid claims on the defaulting government must be registered and a representative of the bondholders must be appointed. If it exists, the special chamber of the ECJ could handle these tasks.

The debate over the IMF's proposal of a SDRM indicates that there are two ways to implement a framework for default. It could either be based on an international agreement among the EU member states or it could be embedded in the bond contracts in a market based solution. The former would have greater visibility and political weight. The downside is that it might require a change in the TEU. The latter is less visible, but could be implemented without a change in the EU Treaty by an appropriate choice of the law and court governing government bonds issued by euro-area governments, for example UK law and London.[31] An appropriate amendment of the Code of Conduct under the SGP would probably suffice. This would simultaneously solve the potential problem of treating domestic versus foreign debt differentially. During a transition period, the market-based solution has the disadvantage of creating a difference between new debt issued under a debt-resolution mechanism, and old debt issued without it.

Two issues remain in this context. The first is a possible link between an orderly default and fresh credit from the Community to the government in financial distress. In the past, sovereign defaults have often been followed by periods during which the defaulting government did not have access to credit markets any more. To help the government concerned over such a period would be a reasonable thing to do for the EU provided that a restructuring of the country's debt has happened. In contrast to the Greek case, where fresh loans were given to a government that continues to be fundamentally unable to repay and thus public money has been wasted, giving fresh loans conditional on a sound restructuring makes economic sense.

Going in that direction would prepare the way for a combination of the ECB proposal discussed above and an orderly default. In fact, if economic solidarity is a value of the European Union, this combination would be a good way to combine solidarity with sound

[31] See G10 (2002)

economics. One way to do this would be to impose a legal ban on any financial assistance extended to a government with a debt ratio above 60 percent of GDP. This would achieve two things. It would set a benchmark for the size of a haircut facilitating financial aid to a government in distress. At the same time, it would allow the EU to grant financial assistance to a country hit by exogenous adverse shocks from a starting position of sound public finances. This would make sure that the emphasis on discipline would not destroy the possibility of solidarity with well-behaved governments.

The second issue is the link from sovereign default to bank crisis, which was discussed in the context of the Greek crisis. Some observers have suggested that Greece was bailed out because the French and the German governments wanted to make sure that banks in their countries were not being destabilized by a collapse in the value of Greek government bonds.

It is important to recognize that in the context of this discussion, this is a transitional issue. Banks in Germany, France, and other countries bought and exposed themselves massively to Greek debt, because they assumed that Greek debt, like other public debt, is essentially risk free. This is a concept which was justified under pre-monetary union circumstances, when governments could use the money-printing press to pay off their debts. But this is no longer the case. The special status of public debt under the Basle capital rules has promoted the view of public debt as risk free.

Unless a bail-out will be guaranteed in the euro-area automatically in the future (as it would be under the ECB proposal), banks and financial markets will have learned from recent events that this special position of public debt is no longer valid. Installing a framework for orderly default will underscore that point. Adapting the Basle rules to the new circumstances would contribute further to a more realistic view of public debt in the financial sector. As a result, banks and other institutions will know that, in the future, they may take substantial losses from holding government debt and giving loans to governments. This is a desirable result: Knowing that government debt is indeed risky, banks and financial markets will price it more realistically and assure that they will not be exposed to it excessively.

4.4. Monitoring Competitiveness and National Imbalances

The Commission's proposal for a further development of economic governance also includes a mechanism for addressing macro economic imbalances and differences in competitiveness in the euro area. Similar proposals have been put forward by the German Ministry of Economics[32] and the ECB (2010) and most recently in a German-French government position paper.[33] According to the ECB and the Commission, the framework would be embedded in the "Europe 2020" process and aim at better compliance with the goals and targets for structural policies developed there. The German government proposes the strengthening of the Competitiveness Council or the creation of an ECOCOMP Group in charge of monitoring structural policies in the euro area states and the implementation of the Europe 2020 strategy.

The essence of these proposals is to monitor a range of indicators of competitiveness of the euro area economies such as relative price developments, unit-labor cost developments and others (Commission 2010c). These indicators would be aggregated into national scores via scoreboards which would then be used to identify problem cases, i.e., cases where unfavorable developments of competitiveness could lead to macro economic imbalances. The ECB's and the Commission's proposals foresee the identification of "excessive macro economic imbalances" and, when and where that is the case, the possibility of policy recommendations addressed to the country concerned. Following the logic of a preventative and a dissuasive arm, the Commission proposes to set up penalties for countries which do not follow the policy recommendations. These sanctions could be graded depending on the recalcitrance of the country concerned and the severity of the imbalances considered. The recent German-French position paper even foresees the inclusion of private household debt in the range of variables monitored. The Commission (2010c) argues that the competitiveness indicators should not be used as policy targets. However, this would be unavoidable if these indicators receive special attention and if their performance can lead to policy sanctions.

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[32] Bundesministerium für Wirtschaft (2010).
[33] Wirtschaftspolitische Steuerung in europa. Deutsch-französisches Positionspapier. German Federal Ministry of Finance, Mimeo 21 July 2010.

The economic reasoning behind these proposals is weak at best. A first point is that, while the competitiveness of a company in its market is conceptually easy to understand, the competitiveness of an entire economy is not. Relative prices and relative factor remunerations do not mean much at the aggregate level, because they depend on the complex interactions of labor and capital market institutions. For example, unit-labor costs may rise, because a part of the labor force moves from nontraditional employment not covered by payroll taxes to traditional forms of employment. Judging competitiveness on this basis will necessarily create conflicts with other areas of EU policies such as the common labor market policy.

Furthermore, given current data availability, international comparisons of competitiveness are possible only on the basis of changes in competitiveness, not levels of competitiveness. While the latter might matter for international trade, the former do not; instead, they indicate degrees of convergence of standards of living in the euro area. From that perspective, the European goal of convergence implies that unit-labor-costs should increase faster in relatively poor countries than in relatively rich countries. Again, conflicts with other areas of EU policies are foreseeable.

Second, at a macroeconomic level, there is no obvious relationship between current account imbalances and competitiveness. Under conditions of full capital mobility, which is guaranteed both inside the euro area and between the euro-area states and the rest of the world, a country's current account balance equals the difference between national savings and national investment. Thus, Germany's current account surplus indicates that German savers are unwilling to invest their savings in their own country and prefer to invest them abroad; Greece's current account deficit indicates that foreigners are willing to put their wealth into Greek investments. Competitiveness, if anything, decides at which level of trade these current account surpluses and deficits are realized. There is no reason to believe that an increase in Greek or a decrease in German competitiveness would do anything to reduce the countries' current account imbalances. Data for euro-area countries show no correlation between current account balances and competitiveness.

Third, competitiveness is by definition a relative concept. If one country gains competitiveness, another country must lose competitiveness. Thus, asking one country to improve its competitiveness by lowering wages implies that another country must tolerate an increase in its relative unit labor cost and, possibly, a loss of jobs. Any attempt to plan and enforce competitiveness positions of the euro-area member states, therefore, implies an enforcement of a certain allocation of employment across these states. It is highly unlikely that such a move in the direction of a planned economy would bring about better economic results than market forces.

Fourth, macroeconomic imbalances within a monetary union can be very desirable, because they reflect an improvement of the regional allocation of capital within the union. Schmitz and von Hagen (2010) show that the euro area stands out globally as a region where capital flows from relatively rich to relatively poor countries, i.e., relatively rich countries tend to have current account surpluses, relatively poor countries tend to have deficits. Again, this contributes to convergence.

Fifth, Schmitz and von Hagen also show that government deficits have contributed little to macro economic imbalances in the euro area. Considering a framework to limit macroeconomic imbalances in the context of fiscal policy is, therefore, completely misleading. Furthermore, current account data are currently published only for each euro-area country vis-à-vis the rest of the world. For the purposes of the euro area, one would need current account data for each country vis-à-vis the euro area and vis-à-vis the rest of the world excluding the euro area. Von Hagen and Schmitz (2010) approximate such data based on merchandise trade. They show that there are no clear correlation patterns between countries' balances vis-à-vis the euro area and the rest of the world excluding the euro area.

Finally, current account imbalances can be controlled effectively only if capital mobility is sufficiently constrained. Any framework for controlling such imbalances within the euro area or the EU would necessarily lead to the reintroduction of capital controls. In the EU, capital controls were abolished in the context of the full implementation of the Single Market. This implies that a mechanism to monitor and control current account imbalances would sooner or later raise contradictions to the Single Market policies of the EU. A mechanism to control such imbalances within the euro area alone would necessarily lead to capital control between the euro area and the rest of the EU and contribute to the schism between the euro-area and the non-euro-area countries in the EU.

To conclude, a policy aimed at controlling macroeconomic imbalances in the euro area would be highly likely to lead to undesirable economic outcomes. It would undermine the functioning of the Single Market and create conflicts with other EU policies. Finally, it would create a new layer of economic monitoring and bureaucracy. The experience with similar policies in the labor market and competitiveness indicates that it would achieve little if anything.

4.5. Missing the Point: A European Rating Agency

The president of the Euro Group, Jean-Claude Juncker (2010) has called for the creation of a European rating agency to rate the creditworthiness of euro-area governments and financial institutions.[34] The new agency should be located "close to the ECB," which presumably means that it would operate under ECB supervision and rely on ECB data. Such an agency would presumably give a fairer assessment of European debtors than the US-based agencies. A similar proposal was voiced by the president of the Banque de France, Christian Noyer, who accused the US-based agencies of not basing the downgrades of European public debt on firm information.[35] A related proposal from the European Commission is that rating agencies should be regulated and supervised by a central EU regulatory agency and should be fined if they could not explain how their ratings decisions were made.[36]

Such proposals rest on the assumption that the debt crises that Greece and other euro-area states suffered was the result of irrational speculation in the financial markets driven by irresponsible rating agencies. In fact, the notion of speculative attacks on Greek debt was very popular among European policy makers at the time of the acute crisis. While the political convenience of the argument is clear, there is no evidence for speculative activity driving the events at all. Thus, Issing (2010), the former chief economist of the ECB, calls the argument a "legend." He argues that the crisis was the result of excessive fiscal laxities in some countries, the fact that others chose to ignore those laxities, and the weakening of the SGP in 2002-2005.

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[34] "EU's Juncker calls for European Ratings Agency Overseen by ECB. "*Bloomberg Business Week* 1 June 2010
[35] Ibid. and „Frankreichs Zentralbankchef fordert EU Ratingagentur." *Handelsblatt* 2 June 2010.
[36] „EU wants new credit ratings agencies to rival US firms." *Huffington Post* 14 July 2010

Creating a European rating agency could become damaging for euro-area debt markets if the US-based agencies were driven out of this market at the same time. The reason is that, being created on demand by European governments who are interested in softer credit screening, the European rating agency would most likely have a bias in favor of these governments. Anticipating this, private investors would not lend the new agency any credibility and refrain from using its services, which would make its dependence on the governments even stronger. While the US-based rating agencies, like any business company, are probably far from being perfect, losing them would leave the market with no satisfactory rating institution.

The Commission's argument in favor of regulating rating agencies has more merits. While the Commission claims that there is a lack of competition in the ratings market, the simple fact that there are only three major competitors does not prove that point. More careful economic analysis of the market is necessary. To date, there is not much international experience with regulating such agencies. This may be an argument in favor of creating a regulatory framework for ratings agencies. But the Commission should do this with adequate care.

5. Conclusions: Where the Euro Area Should and Should Not Go

The van Rumpuy Group and the European Commission plan to present a first set of measures for reforming the fiscal framework of the EU to the ECOFIN Council in October and to the European Council later this fall. These measures will most likely be those which are easiest to agree upon and fastest to implement, namely what I called the marginal reforms of the SGP above. Their effects will not be very large. An important exception are the proposals that would deprive member states of their representation and voting rights in EU institutions as a way of penalizing governments for the lack of fiscal discipline. This would contradict the nature of the EU as an association of sovereign, national states and weaken its democratic legitimacy.

Starting in October/November, the Commission and the van Rumpuy Group will turn to the bigger issues and bolder reforms. Any move in the direction of enhanced cooperation on the basis of competitiveness and macro economic imbalances would create risks for serious economic damage. Ultimately, enforcing limits on current account deficits and surpluses will require the reintroduction of capital controls and thus undermine the functioning of the Single European Market. It would also slow down the process of economic convergence and keep relatively low-income states from reaping the benefits of European integration. Similarly, relatively strong increases in real wages, faster productivity growth, and, therefore, greater increases in the price of non-tradables are to be expected in the relatively low-income states as part of the catching-up process. A European procedure aiming at limiting macro economic imbalances and changes in competitiveness would impose unnecessary and inefficient limits on the growth potentials of these countries.

Two initiatives which will be discussed after October deserve support. The first is the creation of independent fiscal councils at the national and perhaps the EU level. Several countries have had good experiences with the positive impact such councils have on the transparency and quality of national fiscal policies. The creation of such councils could help improve the quality of the democratic debate over public finances, raise the awareness of the general public and the policy makers of fiscal risks and adverse developments, and contribute positively to the sustainability of public finances in the EU member states. Having a fiscal council could become a defining feature of those countries who take the commitment to sound public finances seriously.

The second initiative that deserves support is the creation of a framework for orderly sovereign debt restructuring in the EU. It seems likely that a fiscal crisis of the sort recently observed in Greece will be a recurring feature of the euro area as long as the member states' debt ratios are high compared to those of (subnational) governments in other monetary unions or large federations. This implies that the euro area needs a framework for dealing with such crises in an orderly way and one that does not lead to recurrent bailouts that would undermine the stability of the monetary union. Empirical evidence suggests that countries with relatively sound fiscal positions benefit from arrangements facilitating the orderly resolution of fiscal crises in the form of paying lower interest rates on their debt (Eichengreen and Mody, 2004). Thus, creating a framework for orderly debt restructuring in the EU would strengthen the governments' incentives for maintaining sound public finances.

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