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The 2005 Reform of the Stability and Growth Pact: Too Little, Too Late?[♣]

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Abstract

This paper analyses the main critiques addressed by the literature and the policy-makers to the 1997 Stability and Growth Pact. It further indicates to what extent the 2005 reform of the Pact meets those critics. It finally argues that the 2005 reform may be too little and arrive too late to restore the Pact credibility, ensure its enforceability and correctly set the derogations to the excessive deficit procedure on the nature of the shocks which cause the output gap rather than its size: a 3% of GDP limit on deficit spending may be a too binding constraint in front of a strongly negative demand shock, while it is irrationally large in front of a supply shock. Some empirical evidence is provided to identify in the last years strongly negative demand shocks from other shocks in the 25 EU Member States. Had this identifying method been adopted in November 2003, the European Commission and the Council would have both agreed to stop the excessive deficit procedure against Germany, but they would have both proceeded against France which apparently was not at the time hit by a strongly negative demand shock.

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"At the moment, EU Member States often cooperate in areas where they should compete, and compete in areas where they should be speaking with a single voice"

(Mark Leonard, 2002, p. 146.)

1. Introduction

Of the two major macroeconomic policies (monetary and fiscal policy), surprisingly enough, the former benefits from a large space in the existing (consolidated version of the) Treaty Establishing the European Communities (TEC) and in the future, still potential, Treaty Establishing a Constitution for Europe (CON), while it is hard to find even the location[1] of fiscal policy both in the current and in the possibly future primary norms of the European Union. That does not mean that the European fiscal policy is literally ignored by norms, for two reasons. First, because the most important component[2] of that policy is discussed both in TEC (Article 104) and, almost identically, in CON (Article III-184) and in their annexed Protocol on "excessive

[1] At first, fiscal policy appears indeed to be almost absent in European primary norms, if one looks at the level of disaggregation given by Parts, Titles, Chapters and Sections of the Treaties. That policy is not even mentioned in the principles and in the long list of policies provided in TEC (Articles 2 and 3 in Part 1 and Part 3 Titles I-XXI); and the same impression is given by CON, if one reads the objectives of the Union (Article I-3 in Part 1 Title I), the Union competences and the list of more than 25 economic policies described there (Articles I-11 – I-17 in Part 1 Title III and Part 3 particularly Title III Chapters 1-5).

[2] But there are two other TEC Articles important for the European fiscal policy: Article 99 concerns the "multilateral surveillance", as "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council" and "the Council shall…monitor…the consistency of economic policies with the board guidelines"; Article 103 regards the no-bailout constraint, as both the Community and each Member State "shall not be liable for or assume the commitments of central Governments, regional, local or other public authorities".

deficit procedure" (EDP), but it is hidden in these texts under the too general label of "economic policy" (a Chapter in TEC, which becomes a Section in CON): that requires from the reader a special digging in one of the TEC 200 pages (or in one of the 500 pages of CON!).

Second, because the Treaties are the only primary source of European norms, but by no means the only source of the latter. A very significant part of the European fiscal policy, formally born in 1997 with the Stability and Growth Pact (SGP) mark 1 (hereafter labelled as SGP1), thanks to a European Council Resolution (in Amsterdam) and two Council's Regulations (1466/97, 1467/97), is derived from secondary norms. The differences between primary and secondary sources and within each of those sets are relevant from the point of view of potential reforms. To change the Articles of the Treaties, the ratification procedure directly or indirectly involves almost 500 million people belonging to 25 European countries. To modify the Protocols it is sufficient to have the unanimity of the European Council, i.e. it is not necessary to consult the Member States' electorates or their representatives. The same unanimous procedure is needed to amend the Resolution and the most important of the two Council's Regulations (1467/97), while the other Regulation can be reviewed by simple Council majority.

In this paper I will give (in Sections 2 and 3) a rapid[3] description of Article 104 in TEC, and of the initial Stability and Growth Pact, including the 2003 first revisions (SGP1). I will then analyse (in Section 4) the main critiques addressed to the SGP1 mainly in the two years preceding its reform and its 2005 transformation in the Stability and Growth Pact mark 2 (SGP2) through a European Council and two Council Regulations (1055/2005 and 1056/2005), examining the position of experts and policy-makers. I will discuss later (in Paragraph 4.6) my own critical position and my reform proposal, based on a simple theoretical model (4.6.1) and on some empirical evidence derived from macroeconomic data on unemployment and inflation and from the harmonised EU-25 Business Surveys (4.6.2). In the following Section 5, I will illustrate the major novelties of the SGP2 relative to the SGP1, indicating to what extent the 2005 reform of the Pact satisfies the multiple previous critiques. I will finally argue (in Section 6) why, in my opinion, the Pact innovations introduced in 2005 may turn out to be too little and possibly arrive too late, to restore its credibility and enforceability and to correctly reset the rational limits of Member States' deficit

[3] A longer description of the SGP1 can be found in Kostoris Padoa Schioppa (2005).

spending in front of strongly negative demand shocks. Consequently, the first impression got by an occasional reader of the Treaties, according to whom there does not exist any effective European fiscal policy, may after all be more correct than many academic papers on European matters, showing a scholarly, full knowledge of every SGP1 and SGP2 detail.

2. The Treaty's Article 104 and the Protocol on the Excessive Deficit Procedure

Article 104 of TEC (corresponding to Article 104C of the Maastricht Treaty), to which I will refer as it is the law actually in force, explicitly imposes reference values for the public deficit/GDP and debt/GDP ratios of all Member States in the Union. The annexed Protocol on the excessive deficit procedure[4] simply states that "the reference values - referred to in the Treaty – are 3% for the ratio of the planned or actual Government deficit to gross domestic product at market prices [GDP]; 60% for the ratio of Government debt to GDP".

Four elements of these primary norms on the European fiscal policy deserve the maximum attention: their objectives, the derogations to the budgetary surveillance general rules, the mitigating factors in evaluating the Member States' General Government deficit and debt, finally, the system of decisions, recommendations, sanctions regarding countries' public finance disequilibria.

According to Article 104, the objective of the Commission's monitoring "of the budgetary situation and of the stock of Government debt in the Member States" is to identify "gross errors". Some derogations relative to the reference values have to be taken into consideration. In fact there does not exist an excessive deficit if the ratio of the planned or actual Government deficit to GDP exceeds the reference value, but "either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value". Similarly, there is no excessive debt if its ratio to GDP, though exceeding the reference value, "is sufficiently diminishing and approaching the reference value at a satisfactory pace". Whenever "a Member State does not fulfil the requirements under

[4] This is n. 20 in TEC, n. 5 in the Maastricht Treaty and very similarly n. 10 in CON.

one or both of the criteria” mentioned above, the Commission’s judgement is not mechanical, as Article 104 foresees that “the Commission shall prepare a report” which “shall also take into account whether the Government deficit exceeds Government investment expenditure and take into account all other relevant factors, including the medium term economic and budgetary position of the Member State”. Finally, following Article 104, if the Council “decides”, on the basis of “a recommendation from the Commission”, that “an excessive deficit exists”, it “shall make recommendations to the Member State concerned with a view to bringing that situation to an end within a given period”, not rigorously specified.

As a summary, it is easy to understand that the binding constraints imposed by the Treaties at the European level on each Member State’s fiscal policy concern, on the one hand, the steady state ratio of debt to GDP (at 60%), and, on the other hand, the ratio to GDP of the balance between public expenditures and taxes (at 3%, unless exceptional and temporary circumstances arise). Each country is therefore free to choose the level and the composition of public spending, fiscal rates, General Government assets and liabilities compatible with those constraints.

3. The Stability and Growth Pact Mark 1 (Sgp1)

The Stability and Growth Pact is defined in a formal sense by the European Council Resolution issued in Amsterdam on June 17, 1997 and by Council Regulations 1466/97 and 1467/97 of July of the same year. The basic philosophy underpinning the SGP1 remains that of the TEC, but in a more severe, narrower way. “Sound Government finances are crucial – it is stated in the Netherlands’ capital - to preserving stable economic conditions in the Member States and in the Community. They lessen the burden on monetary policy and contribute to low and stable inflationary expectations such that interest rates can be expected to be low. They are an essential condition for sustainable and non-inflationary growth and a high level of employment”.

In 1997, there is an additional medium term objective (MTO) introduced by the SGP1 relative to the TEC, i.e. the requirement to reach a balanced budget in the medium-long run, while the 3% has to be considered a ceiling never to overcome in the short term. More precisely, since the Amsterdam summit, the EU Member States are requested to pursue the MTO of a “budget close to the balance or in surplus”, and, if necessary, to adopt corrective measures to eliminate the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Indeed, the SGP1, on the one side, implacably sets the timing and modalities[5] of the excessive deficit procedure (EDP) for the surveillance of budgetary flow positions (ignoring for incomprehensible reasons the stock problems) and, on the other side, specifies the sanctions on defaulting Member States[6].

The reinforcement of the SGP1 relative to the Treaty is perceived also by looking at the 1997 illustration of the derogations to general rules, in particular at the exact definition of "the concept of an exceptional and temporary excess over the reference value as referred to in Article 104". Indeed, Regulation 1467/97 states that "the excess of a Government deficit over the reference value shall be considered exceptional and temporary, […] when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the General Government, or when resulting from a severe economic downturn […].The Commission …shall, as a rule, consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%. […] The Council shall, in its overall assessment, take into account any observations made by the Member State showing that an annual fall of real GDP of less than 2 % is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends […]".

These are severe, quantitative limitations of Member States' fiscal policy, which become even more severe in the first, significant revision of the 1997 Stability and Growth Pact, made in 2003, though the latter has been labelled for political

[5] The Amsterdam Resolution states that: "the Council is committed to a rigorous and timely implementation of all elements…; in particular:

- pursuant to Article 104 C, Section 7, it recommends the timely correction of excessive budgetary deficits upon emergence or within the following year, unless there are special circumstances;
- it shall impose sanctions on Member States failing to act in compliance with the Council decisions;
- it shall require a non-interest-bearing deposit whenever the Council decides to apply sanctions to a participating Member State in accordance with Article 104c (11);
- it is invited to convert deposits into fines two years after the decision to sanction the defaulting Member State in accordance with Article 104c (11)".

[6] Article 11 of Regulation 1467/97 states that: "when the excessive deficit results from non-compliance with the criterion relating to the Government deficit ratio in Article 104c (2) (a), the amount of the first deposit shall comprise a fixed component equal to 0,2 % of GDP, and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 % of GDP".

motivations as a mere reinterpretation. On March 7 2003, the ECOFIN adopted, under the Greek Presidency of Mr. Nikos Christodoulakis, a Report (6877/03–Presse 61) on "Strengthening the Co-ordination of Budgetary Policies", initially drawn up by the Commission in November 2002, which has been later endorsed by the European Council in Brussels on March 20-21 2003[7]. In that Report, the Council, among other things[8], was asking for a further surveillance on structural balances, alongside with the control of the non-cyclically-adjusted budget balances (the only ones really monitored up to that time). Indeed, the Member States of the Eurogroup whose budget was in deficit were requested to fulfil an additional constraint, reducing annually by 0.5% of GDP their structural balance, net of automatic stabilizers: "Member States' Stability and Convergence Programmes must continue to present nominal data. Compliance with the close to balance or in surplus requirement of the SGP should be assessed in cyclically-adjusted terms; one-off measures should be considered on their own merits on a case-by-case basis. […] Those euro-area Member States whose deficits exceed the close to balance or in surplus requirement are committed to a minimum annual reduction of 0.5% of GDP".

4. The Criticisms to the SGP1

The 2003 significant revision of the Pact was motivated by serious difficulties incurred by various countries in their compliance with the Stability and Growth Pact rules. By 2002 the two biggest EMU Members (Germany and France) were already unable to set their deficit to GDP under the ceiling of 3% and their cyclically adjusted negative balance was up to 3.5 and 3.8% respectively. In that situation, policy-makers and experts were increasing their criticisms to the SGP1. A survey of the six most important kinds of critiques follows.

[7] The Presidency Conclusions of the Spring European Council 2003 declare: "against this background, the European Council endorses the Key Issues Paper adopted by the Council (ECOFIN), which together with these Conclusions will be the basis of the forthcoming Broad Economic Policy Guidelines….while inviting the Council and Member States to implement its Conclusions".

[8] The Council for the first time introduced in the formal SGP the requirement that the budgetary surveillance and the excessive deficit procedure should also contribute to ensuring a satisfactory debt (and not only deficit) decrease: "the pace of decline in public debt plays an important role in budgetary surveillance, especially in highly indebted countries. In conformity with the Treaty provisions, the excessive deficit procedure should contribute to ensuring a satisfactory pace of debt reduction".

4.1. Is the coordination of national fiscal authorities in EMU necessary, as proposed by the 1989 Delors Report?

The first set of critiques concerns the assumed necessity in a monetary union of an ex ante fiscal coordination between European countries, as it is the case in the SGP1. The basic idea behind that hypothesis had been discussed by the 1989 Delors Report (see Committee for the Study of Economic and Monetary Union, 1989). The reasons for coordinating fiscal policy rules, thus constraining budget deficits, were twofold: on the one hand, to be able to conduct a stabilisation policy at the national level, consistent with an appropriate fiscal-monetary policy mix at the Union level; on the other hand, to avoid pressures on the ECB, which would ultimately lead to a nominal instability and/or loss of credibility of the Central Bank.

Starting with the first argument made by the Delors Report, one critique to this assumed necessity of fiscal coordination between national fiscal authorities through the SGP1 is derived from the model of the optimum currency areas. If the eurozone were close to such condition, the sufficient degree of wage and price flexibility and of productive factor mobility would imply, on the one side, well performing European markets and, on the other side, it would make desirable to centralise fiscal budgets (De Grauwe, 2005). In that event, the SGP1 would be useless. But EMU is not an optimal currency area and therefore “the main [negative] lesson from this literature is the absence of adjustment mechanisms… and the stabilisation of country-specific disturbances rests entirely on national fiscal policies” (Beetsma-Debrun, 2004a).

In this perspective, any justification of the need for budgetary coordination of national fiscal authorities must rest on a demonstration that there are considerable spillovers on EMU partners: a statement by Buti-Sapir eds. (1998), largely agreed by most experts when the euro adventure started in January 1999. If one looks at the basic spillovers, three principal channels are observed: the export-import quantitative channel on aggregate demand, the terms of trade and the common interest rate in a monetary union. Opinions differ strongly as far as the relative empirical weight of these spillovers is concerned. While the first two of them are presumably positive externalities, the latter is negative. The sort of prevailing conventional wisdom in the late 90’s was that the two positive externalities were of limited empirical importance, but the negative one was relevant. “This implies that there could be a general tendency among EU participants not to take negative interest rates and exchange rate effects adequately into account” (Buti-Sapir eds., 1998), thus deciding for too large deficits[9]. Today, some authors deny the importance of this third externality. For example Fitoussi-Saraceno (2002), in describing the "negative externality [which] would induce national Governments to run excessive budget deficits allowing them to make the other countries pay part of the bill, [state that] the first objection to this argument is purely quantitative, considering that a one percent increase in the national fiscal deficit would imply a one or two tenths of percent increase at an European level. Barely significant, and unlikely to cause a change in the interest rate. More importantly, from a theoretical viewpoint, the externality argument can be reversed: suppose a budget deficit expansion occurred in one country. If this were unwarranted, it would result in inflationary pressure, and hence in reduced competitivity. On the other hand, if the deficit responded to a slump in production, it would sustain demand and hence income and imports. In both cases, demand for the other countries' production would increase, and their deficit (thanks to increased fiscal revenues) would be reduced. Models with either negative or positive fiscal policy spillovers have flourished in the recent literature, but nothing, from a theoretical point of view, may induce to think that the negative externality would be larger in size than the positive one".

Beetsma-Uhlig (1997) show in a theoretical model that in EMU short-sighted Governments fail to fully internalise the inflationary consequences of their debt policies, thus proceeding to an excessive debt accumulation. Therefore, while in the absence of EMU, Governments have no incentive to sign a Stability Pact, under an EMU they prefer a Stability Pact which diminishes excessive debt accumulation. The combination of a centralised monetary policy with a decentralised budgetary policy subject to Community rules, "provides – according to Buti-Sapir eds. (1998) and most other experts in the late 90's – for a simple and clear assignment of policies: the single monetary policy would, within the framework of preserving price stability, be able to provide a common response to aggregate economic developments, whereas decentralised budgetary policies and other national economic policy instruments would be available for responding to country-specific circumstances". But "in special

[9] Some had previously questioned these statements: for example Sibert (1992) proved that, under certain conditions, in a common currency area "as long as fiscal policies are uncoordinated, the outcome is *deflationary* relative to the optimum…as income taxes are set too high". Among the first authors who modelled the three forms of spillovers and the consequent gain from fiscal policy coordination in EMU were Levine-Brociner (1994), who compare a cooperative equilibrium with a non-cooperative Nash equilibrium.

cases of severe common shocks or imbalances, there may be a role for jointly agreed and announced budgetary policy action".

While my own, partial critique to this approach (distinguishing only between symmetric and asymmetric shocks and not also between demand and supply shocks) is delayed till Section 4.6, it is worth noticing some recent critiques to the argument on welfare improvement induced by fiscal rules on national authorities, in the presence of the three spillovers. Beetsma et al. (2001) demonstrate that ex ante fiscal coordination is not always desirable: what is "crucial for the desirability of fiscal coordination is the reaction of the ECB to changes in national fiscal policies….given the potentially adverse reaction by the ECB (as a result of free-riding or a conflict on the orientation of the policy mix) fiscal coordination is likely to prove counterproductive when demand or supply shocks are highly symmetric across countries and the Governments are unable to acquire a strategic leadership vis à vis the ECB…In that respect it is interesting to note that the conventional wisdom according to which fiscal coordination is called for only when large symmetric shocks occur is at odds with our results…Fiscal coordination is most likely to be desirable when the European economy is hit by asymmetric (demand and supply) disturbances".

While we will see later that these different results highly depend on the particular assumptions made in the theoretical model and sometimes in the specific parameters' values, I like to stress that they concern an ex ante fiscal coordination not an ex post one, of the kind the SGP1 is. On the other hand, the Beetsma et al. (2001) idea of counterproductive coordination is by no means isolated. It existed, in the literature on monetary and fiscal policy strategic interaction, at least since the seminal paper by Blinder (1983) and it is flourishing now, as shown by the review on this subject written by Beetsma-Debrun (2004a): "In the case of common adverse demand shock, fiscal coordination leads to more expansive fiscal policies. The additional monetary tightening that this induces may leave both players worse off... Since counterproductivity stems from the adverse reaction of the ECB to coordinated fiscal actions, fiscal coordination is more likely to be beneficial the less intense the Central Bank's reaction is to the disturbances…This result is valid for demand as well as for supply shocks…[Hence] fiscal coordination not based on a strong precommitment capacity of the fiscal authorities is likely to be counterproductive".

This argument is, to some extent, related to the one on the preference of rules versus discretion, on precommitment in the ex ante coordination (like in the SGP1) relative to the ex post coordination (of the kind established within the Eurogroup), finally on the preference of automatic stabilisers relative to fiscal activism (see also Fatás-Mihov, 2003a, for other reasons related to negative effects on output volatility and growth induced by aggressive fiscal policies).

Going now to briefly discuss the second argument in favour of fiscal coordination made by the 1989 Delors Report, I recall that Fitoussi-Saraceno (2002) debate this problem: "excessive deficits may end up in insolvency, forcing the Central Bank to intervene (against its own statute) to bail out the country involved; otherwise, banks owning the debt would see their financial soundness hampered, and face the risk of depositors' runs. The moral hazard aspect of excessive deficits could hence undermine the Central Bank credibility in its commitments to fight inflation. Furthermore, as the costs of an ECB bailout would be sustained by all EMU citizens, this would encourage irresponsible behaviour of Governments. A constraint on deficits can avoid this risk. This argument may be dismissed on several grounds. The first is the scarce plausibility of a debt crisis in the present context. Since 1945, even in far more turbulent times, European countries never seriously risked default on their debt. Eichengreen and Wyplosz (1998) further notice that contrary to Mexico and East Asia during the crises of the 1990's, the European banking system exposure, and the term structure of public debt seem more solid, so that the bailout risk is not particularly relevant. And, at any rate, they argue that such a risk would be better dealt with by improving public debt management and bank regulation". On this second motivation for fiscal coordination offered by the 1989 Delors Report, not only most experts seem to be critical today, for example Canzoneri-Diba (2001), but, unlike on the first, even the initial positions taken by the literature were much inconsistent with the viewpoint of the Committee for the Study of Economic and Monetary Union (1989). Eichengreen-von Hagen (1995) disagree with the idea "that monetary union requires restrictions on the fiscal autonomy of the Member States to prevent them from overborrowing because excessive debt may lead to a bailout by the Union and threaten the stability of the common currency. This bailout might take two forms: an ex post bailout, involving monetarisation of Government debt, or an ex ante bailout, entailing policies designed to keep interest rates on Government debt artificially low and thereby to keep debt from rising to unsustainable levels. Either policy would give rise to union-wide inflation and threaten the stability of the common currency. This is in contrast to the situation in which each State issues its own lender of last resort and therefore internalises the bailout risk". Eichengreen-von Hagen (1995) challenge this view, recalling that the political costs of default are quite high only for Central Governments, which are unable to refuse the request for bailout coming from sub-national Governments, thus threatening the national monetary policy stability, and consequently trying to impose fiscal restraints at the decentralised levels. The implications for today's Europe are clear. "Only if one imagines that monetary union is accompanied by fiscal centralisation, the pressure for bailout will become equally intense. But in Europe the EU has only limited taxation and expenditure authority" and "this is certain to remain so in the foreseeable future. This suggests that the rationale for the excessive deficit procedure is weak".

In summary, one has to agree with Bryant (2001) when stating that "the existing theoretical and empirical evidence is unfortunately inconclusive [on whether] coordination on macroeconomic policies yield large gains in welfare…My personal eclectism leads me to give more weight to the potential benefits of attempted coordination than to the potential risks".

While my own reasons for taking this attitude will be clearer later in spite of the elements of inappropriate coordination existing in the SGP1, I now examine five more sets of critiques addressed to the SGP1. The starting point for them is the following: even though fiscal coordination in EMU is presumably improving the economic results of the eurozone and even though an ex ante coordination with strong precommitments is better than an ex post, soft one, the question remains whether the specific fiscal coordination provided by the SGP1 is optimal or at least good for the stated goals and, in particular, for stabilisation purposes. Five kinds of critical answers are given to this question: one of a methodological type, discussed in 4.2, and four related to the content of the SGP1, including its governance and its economic rationale, discussed in 4.3, 4.4, 4.5, 4.6.

4.2. The SGP1 methodological problems

The methodological question regards problems like the choice between numerical targets and procedural rules, a subject which Corsetti-Roubini (1992), Alesina-Perotti (1996a, 1996b) and Franco et al. (1992) addressed long before the creation of the

SGP1. Immediately after the Pact creation, the common opinion of European experts was very much influenced by the successful performance of the Maastricht parameters. Buti-Sapir eds. (1998), after recalling that the Maastricht convergence criteria were examples of numerical targets, note that "they increase the transparency and comparability of budget figures among EU Member States. Thus, they restrain the tendency of policy-makers to try to obtain a strategic advantage by creating confusion concerning the Government's underlying budgetary situation (Alesina-Perotti, 1996b). By imposing increased transparency, the Maastricht targets also increase the feasibility of expenditure control". Buti et al. (2005) insist that "replacing the numerical limits with procedures ensuring sound budgetary positions would raise…problems" of lower transparency, cross-country comparability and potential inconsistency with national institutions and traditions. Procedural rules, on the other hand, "do not set specific numerical targets, but directly impose changes on the procedures according to which Government budgets are presented, adopted and carried out".

The numerical targets and the procedural rules are not necessarily inconsistent, although they may so become. For example, the Maastricht numerical fiscal parameters (3% of deficit/GDP and 60% of debt/GDP) are perfectly consistent with the procedural rules stating that the deficit to GDP should equal the public investment to GDP (according to the golden rule) and the debt to GDP should equal the deficit to GDP divided by the nominal GDP growth rate (as the differential equation on the debt formation requires), if public investment is 3% of GDP and the latter's nominal growth rate is 5%, as it happened to be the case in the eurozone when the Maastricht Treaty was signed, which partly explains its success. But procedural rules are more invariant in time and thus much more robust in their validity and effectiveness than numerical targets, although they do not have the same appeal of simplicity and transparency. This is why I share only partially the preference that European policy-makers and most experts reveal for numerical targets, in spite of their recognition (Buti-Sapir eds., 1998) "that strict numerical rules reduce the responsiveness of Government budgets to the cycle and therefore limit the extent to which budgetary policies may contribute to the stabilisation of cyclical fluctuations in economic activity". At most, one can agree with Beetsma (2001) that this is a second best solution. He states that "the threat of exclusion from EMU has disappeared and many countries can expect steep increases in public spending…The first-best solution to fiscal profligacy is to eliminate the distortions in the budget process. Budgetary reform is often politically difficult to achieve. Outside pressure, such as agreements at the European level on how to reform national target processes is easily seen as Europe dictating what countries should do. At the supranational level, fiscal rules such as the SGP [mark 1] seem to be the maximum which is achievable".

Simplicity and transparency are, according to a wide literature based on the seminal paper by Kopits-Symansky (1998), two of the eight characteristics ideal fiscal rules in EMU should have: they should be well-defined, transparent, simple, flexible, adequate relative to final goals, enforceable, internally and externally consistent, underpinned by structural reforms. The last four features cannot be discussed without analysing the content of the SGP1, which will be done later. Indeed these are not methodological aspects but they concern the Pact content. The first four features, on the contrary, are truly methodological. Buti et al. (2003) give a good grade (a B+) to the SGP1 fiscal rules for their definition, transparency and flexibility and an excellent mark for their simplicity. Overall, the evaluation seems too optimistic, especially as far as flexibility is concerned. In fact, after acknowledging that "there are tradeoffs between the various criteria", the three authors indicate that "on the one hand, there may be a preference for simplicity and transparency over flexibility to allow peer pressure, central monitoring and prevent moral hazard. On the other hand, a multiplicity of countries increases heterogeneity and dispersion of preferences, with the consequence that one-size-fits-all fiscal rule is likely to be sub-optimal".

A further deepening on flexibility leads to understand that this concept may have two different meanings. According to the Commission of the European Communities (2005), "there are basically two distinct options to allow for greater flexibility in the application of fiscal rules. Either the sophistication of the provisions themselves is increased by adding more contingencies to the rules while their implementation is kept straightforward, or the rules are kept simple, but a more flexible application is introduced, thus exerting more economic judgement of the individual case". While my preference for the former form of flexibility is obvious, given my preference for procedural rules rather than numerical targets and given my Socratic acceptance that "pacta sunt servanda", a further deepening by Buiter-Grafe (2004) clarifies that "an optimal rule is both credible and flexible. Flexible needs not mean opportunistic. Credible needs not mean rigid and inflexible. Indeed, arbitrary and inflexible rules are not credible. Commitment isn't necessarily sacrificed when a rule is made contingent on observable, verifiable events".

Moreover, while many experts disagree with the very high score to the SGP1 methodological aspects given by Buti et al. (2003 and 2005), for example, Eichengreen (2003), Buiter (2004), Creel (2003), I believe that simplicity, transparency, flexibility and any other methodological element of the so-called optimal fiscal rules may turn out to imply the best possible outcome only if the rule is in its content good, otherwise the worst result is obtained; by contrast, if the rule is in its content bad, the best possible outcome is reached when it is badly-defined, difficult to understand, complex and rigid. This is to say that these methodological problems are, as such, minor problems relative to those concerning the content of the SGP1.

4.3. Is the SGP1 adequate relative to final goals of fiscal policy and externally consistent?

Turning to the exam of the SGP1 in terms of its adequacy relative to the final goals of the European fiscal policy, it appears that the latter are not clearly defined. The Commission (see Commission of the European Communities (2005) and the experts who are very close to it (for example Buti *et al.,* 2003), stress the idea that "the goal of the EU fiscal rules is ensuring budgetary prudence", although the former source acknowledges that "the concept of budgetary prudence has widened over the years" to include, for example, long-term sustainability[10]. In this sense, from a preliminary quite rude viewpoint, it seems that the SGP1 has not performed very well, given that by now all the big Member States and some of the small ones in the EU exceed the ceiling imposed on deficit/GDP. But other experts question the assumption that the adequacy of the SGP1 relative to its goals should be measured only in relation to budgetary prudence. Coeuré-Pisani Ferry (2005) "assess the SGP1 against three metrics: fiscal discipline, macro stabilisation, and support to long-term growth [concluding that] it is not excessive to state that it has failed on all three… Having failed to take advantage of the 1998-2001 upswing to improve their structural fiscal position, EMU countries soon found them to be contradictory. Faced with the post-2001 slowdown, they had to choose between pursuing fiscal consolidation and supporting economic activity: like Buridan ass, they decided to do neither. The SGP1

[10] This is recognised also by high officials of the European Commission (see Deroose-Langedigk, 2005) and of the International Monetary Fund (see Annett *et al.,* 2005).

thus failed to correct the deficit bias of EMU… The cyclically-adjusted aggregate public deficit of the eurozone actually increased from 1.6% on 1999 to 2.6% in 2004… The fiscal stance was generally mildly procyclical in the eurozone in the period 1997-2005”, implying that the stabilisation and growth function of the public budget was not realised.

The question of fiscal procyclicality is a highly-debated one, as the current opinions largely diverge in academic as well as in political European circles. Galí-Perotti (2003) provide an econometric estimate of the fiscal behaviour of EMU countries during what they consider to be the most recent three recession episodes (early 80’s, early 90’s and 2001-2002) and compare it with the behaviour of non-EMU European countries and of non-European countries. According to Galí-Perotti (2003), in the early 80’s, the fiscal policy stance (measured by the exogenous primary balance) of both the former and the latter groups is procyclical. In the early 90’s, the EMU Member States show again a procyclical discretionary policy, while the other countries were adopting a countercyclical discretionary fiscal response. “But perhaps – the two authors conclude – the most surprising result lies in the fiscal stance among EMU countries during the most recent downturn, which happens to be the first one where the constraints developed by the Maastricht Treaty and the Stability and Growth Pact have been effectively in place. Interesting enough, that circumstance has not prevented EMU countries from pursuing countercyclical fiscal policies during the recent recession... suggesting a weaker countercyclical policy in the average EMU country [than in the other two groups]. Furthermore, the pattern is not uniform across EMU countries, with Germany, France and Ireland being responsible for much of the change”.

In Paragraph 4.6 expressing my own critiques to the SGP1, I will indicate why this result would be less surprising if the analysis on fiscal responses to recessions were, more correctly, conducted looking also at the specific kind of shocks hitting in various years the different countries (demand or supply shocks). But one has to recognise that most of the papers in the literature I am reviewing ignore the fundamental distinction between demand and supply shocks, faced by countries when deciding their fiscal policies (starting with Buti-Sapir eds., 1998). Here, however, I want to stress two kinds of opposite arguments against the finding of a countercyclical fiscal policy of EMU countries, one of a superconservative, another of a superprogressive flavour.

The first is exemplified by Fatás-Mihov (2003b), who, on the one hand, estimate "a reduction in the use of discretionary policy over the last two decades", but, on the other hand, consider that this is a merit, not a defect of the SGP1, as it provides "a protection against the undesirable consequences of policy discretion". The second viewpoint consists of stating that the SGP1 does not allow a sufficiently strong countercyclical fiscal stance. For example, Fitoussi-Saraceno (2004) state that one of the biggest limitations of the current fiscal policies in Europe is that "any active fiscal policy at the national level is ruled out. No actor is supposed to take care of common real shocks, as the ECB only has to deal with inflation…According to many commentators (e.g. Blinder and Yellen, 2001), the positive performance of the US in the past two decades may largely be attributed to their activist policy and to good coordination of monetary and fiscal policies". "In a nutshell – writes Fitoussi (2006) – the structure of power is such in Europe that those institutions who have the instruments to react have not the legitimacy to do so while those which have the legitimacy have no more the instruments. Hence the passivity of European policy reactions".

Fitoussi (2006) complains also about the insufficient fiscal expansion, due to the SGP1, adequate to support growth. He writes that the SGP1 rules "were motivated, among other things, by an attempt (failed) to exclude from the euro the so-called 'Club Med' countries (Italy, Spain, Greece, Portugal). The norm that emerged with non-economical motivations is now trapping those who wanted it… The responsibility of bad macroeconomic management in the soft growth regime which characterises Europe since at least fifteen years has for long been recognised: the abnormally high level of real interest rates in the 90's, the procyclical evolution of the real exchange rate of the euro, the absence of reactions of fiscal policy to the succession of shocks in the present decade. So absent macroeconomic policies and growth policies, the only apparent way out would then be structural reforms, a leaner welfare state and a lower level of public spending. The course of European macroeconomic policies can be seen as a way to force structural reforms so as to achieve the required increase in inequality".

The latter viewpoint is taken by most post-Keynesian scholars, convinced that deficit spending helps solving the existing cyclical and long term economic problems in any case (independent of the nature of the shocks or the type of structural market failures).

It is also shared in the non experts' public opinion by many detractors of the so-called "Europe of bankers", that monetarist eurocracy perfectly embodied by the Executive Board of the European Central Bank, which is thought to be too stability-oriented and too little growth-oriented, as if there existed a clear tradeoff between the two targets: a tradeoff inexistent when the supply-side problems dominate and precisely denied by the approach underpinning the SGP1. Many majority parties, in spite of their different political inspirations (from Social-democrats to Conservatives), join that view (see CAE, 2004), particularly in large European countries experiencing a scarce growth, partly because they wish to please their electorates through an expansionary use of public budgets, while opposition parties usually favour a much tighter fiscal policy for similar and opposite reasons of political economy (Buti-van den Noord, 2003 and 2004).

AS we have already seen, the (external) consistency between fiscal rules and other European policies is considered to be a desirable methodological aspect of the SGP1. This is not the reason why this composite group of neo-keynesian academicians, median voters and policy-makers asks "to lisbonise" the Pact, that is to connect it more to the Lisbon Agenda, where the Portuguese capital refers to the Presidency Conclusions of the Lisbon European Council of March 23-24, 2000. The required connection between the SGP1 and the Lisbon Agenda is in fact rather difficult. Admittedly, the Pact is the expression of a systematic supply-side approach, where the structural rigidities of the system, the insufficient accumulation, the excessive presence of the State on the market cause at the same time inadequate growth and some propensity for inflation, so that fighting in favour of a higher nominal stability would also lead to boost growth. The Lisbon Agenda, on the contrary, stems from a compromise between a supply- and a demand-management approach. It shows optimism and euphoria for the European economic situation, perhaps because the year 2000 (when it was signed) is the only one in the past decade when the European growth rate was above 3%, so that, according to the Lisbon Presidency Conclusions, "the Union [was] experiencing its best macro-economic outlook for a generation". Hence, at the time it seemed right to "sustain the healthy economic outlook and favourable growth prospects by applying an appropriate macro-economic policy mix", the latter being the typical tools of the Keynesian panoplia, under the hypothesis of a tradeoff between inflation and unemployment, and no concern for long-term effects and sustainability. However, the Lisbon Agenda does not imply abandoning the traditional EU supply-side approach: in fact, the Lisbon Presidency Conclusions affirm that "the new strategic goal for the next decade - to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion -" requires stepping up "the process of structural reforms for competitiveness and innovation and ... completing the internal market".

Buti *et al.* (2003a) examine another case of potential inconsistency of the SGP1 relative to structural policies, worrying that the strong emphasis of fiscal policy rules on annual targets may deter reforms with long run effects, for example from unfunded (pay-as-you-go) to funded pension systems. Beetsma-Debrun (2004b) show that the SGP1 erodes incentives to carry out structural reforms sacrificing future growth for present stability. They "conclude that a 'smart' (i.e. welfare-improving) Pact should take into account the budgetary consequences of structural reforms. Indeed, Article 104 of the Treaty (but not the SGP1) makes reference to the role of medium-term economic targets in public finances, which are potentially inconsistent with short-term goals. In this same vein, the former German Chancellor, Gerard Schröder, in his letter-manifesto to the *Financial Times* of January 17, 2005[11], criticises the Pact, writing that "in the short time, reforms – as provisions…to safeguard the social security system, improve the labour market or introduce fiscal reforms – may obstacle growth or increase the deficit. But, in the medium run, their impact on growth, employment and public budget is definitely positive. Expenditures on education, innovation, research and development can also have a positive effect".

[11] Schröder, in the same letter-manifesto to the *Financial Times* states that "the Commission and the Council should take due account of the Member States' contributions to the euro-zone stabilisation,…of specific constraints, of solidarity initiatives within the Union…the German constraints include…the payment of huge sums to the European Union…Besides, the Member States' competence on their economic and budget policies should be respected". This argument is politically strong, as it represents a credible threat, especially on the part of Germany, which is the maximum net contributor to the EU budget (in 2003, by 0.36% of its GNI, a figure close to the difference between the amount "requested" by the Commission to reduce the German deficit and the sum "offered" by Berlin in the famous ECOFIN meeting of November 2003). However, from a technical viewpoint, it would be wrong to subtract 0.36% of GNI from the calculation of the German deficit/GDP ratio, because without that EU budget, according to Gros (2005), Berlin would spend even more and would produce an even larger public deficit for its Eastern Länder. Moreover, according to Begg-Schelke (2004), most Member States currently in the dock "are net contributors to the EU budget who would have the credible option of retaliating by suspending their fourth resource payments to Brussels. Even net recipients always have the credible threat of blocking EU business in an 'empty chair' protest" (see the data, reported by the Commission of the European Communities (2004a) and re-examined by Gros-Micossi (2005).

4.4. Is the SGP1 internally consistent?

As indicated by Kopits-Symansky (1998), another desirable methodological aspect of fiscal policy rules for EMU countries is their internal consistency. Hence, some critics of the SGP1, perhaps more royalist than the King or more catholic than the Pope, focus on the differences between the Treaty (Protocol included) and the 1997 Pact, including the 2003 reinterpretation. They rightly point out that Article 104, unlike the SGP1, concerns the debt as well as the deficit to GDP and illustrates the awareness of the qualitative distinction between public expenditure in current and in capital account. Indeed, deficit spending for investment creates no burden for public finances inasmuch the larger productivity it triggers eventually induces a tax rise which tends to offset the initial imbalance. Consequently, a revision of the Pact is demanded, based on the golden rule, which is already present in Article 115 of the German Basic Law of 1949, amended in 1976 (see, for example, Blanchard-Giavazzi, 2003, but also Balassone-Franco, 2000); in 2004, this argument has become very popular among policy-makers, like the British Chancellor of Exchequer, Gordon Brown, the Italian Prime Minister, Silvio Berlusconi, and the French President, Jacques Chirac, who all have advocated this approach. The major critiques to those critical comments of the SGP1 are summarised in Buti *et al.* (2005)[12].

A much stronger internal inconsistency within the SGP1 exists, if one looks, on the one hand, at the MTO (with its required balanced structural budget) and, on the other hand, at the 60% target of a stable debt to GDP ratio. Another way of expressing this inconsistency is by remarking that all the SGP1 rules and in particular those concerning the MTO are identical for each country, independent of their level of debt and their nominal growth rate. This correct critique is based on the logical relation between the deficit and the debt to GDP, which I mentioned in Paragraph 4.2: in the

[12] They write: “First, the alleged incompatibility between the SGP and a properly defined golden rule is questionable. In order to spread the burden of capital spending over the different generations of taxpayers, the rule would have to refer to net spending”. “Second, if applied to gross public investment, the golden rule would be an obstacle to deficit and debt reduction. Given the ratio of public investment as a percentage of GDP, the long-run equilibrium level of government debt could be quite high, especially in an environment of low inflation. Third, singling out public investment from other budget items makes little sense. What is important is overall capital accumulation in both private and public capital”. “Moreover, a golden rule may distort expenditure decisions in favour of physical assets and against spending on intangibles that can make a relevant contribution to economic growth, for example, those increasing human capital. Fourth, the golden rule would make the multilateral surveillance process more complex, by providing leeway for opportunistic behaviour since Governments would have an incentive to classify current expenditure as capital spending. Finally, there are problems of cross-country comparability of the data concerning amortisation”.

steady state, if no variation occurs in the financial assets and liabilities (which play a role in the debt and not in the deficit creation), the debt/GDP ratio equals the deficit/GDP ratio divided by the nominal GDP growth rate. Thus, a numerical coherence between the two public finance parameters (3% and 60%) existed around the years when the Maastricht Treaty was signed (in 1992), but it has gone lost in the following decade and no longer exists today, owing to the slowdown of the European economies combined with an inflation decrease and to a reduction in public capital accumulation. Furthermore, the logic is completely missing in the SGP1, because it is simply impossible to obtain a balanced budget in the medium run together with a constant debt/GDP ratio equalling 60% or any other number different from zero, according to the Treaties, unless the unlikely and unfavourable hypothesis of a zero growth rate is assumed.

Precisely for this reason, growing countries with debt/GDP ratio below 60% should register a deficit in order to obtain that target, while countries above 60% with the same objective should develop and maintain a budget close to balance or in surplus. In any case, the sacredness of a medium–term balanced budget has to be questioned, as it is incomprehensible. De Grauwe (2005) puts it in this way: "The idea that countries should comply with a numerical constraint of 3% irrespective of their debt levels and underlying economic conditions is 'stupid' (the word used by Romano Prodi when he described this rule in an interview in *Le Monde* 2002)". This idea is shared also by many policy-makers. The SGP1 reform proposals of some Conservatives, such as those of the Dutch Finance Minister, Gerrit Zalm, who more than anyone else in 1997-1998 opposed, together with his then colleague Theo Weigel from Germany, the entry of Italy into the Eurogroup, go exactly in this direction. They (rightly) recall that the TEC and its Protocol (but not the SGP1) create a consistent link between the deficit/GDP and the debt/GDP ratios. Thus, in his interview released to the Italian newspaper *Il Sole 24 Ore* on January 10, 2005, Mr. Zalm asks that the reform of the SGP1 should envisage a "diversified treatment among countries according to their debt levels…Hence, Italy, Belgium, Greece…and the countries with a public debt above 60% of GDP have to make greater efforts to reduce it and must set more severe MTOs in order to tend to a budget surplus. Countries with debts below 60% may pursue a less stringent policy and may have limited medium-term deficits". This kind of criticism has been already made upon the birth of the SGP1, as even Theo Weigel, who longed for a sharp 3.0% maximum deficit to GDP ratio in the short-term, was willing to allow in certain cases for a medium-term negative balance of 1% of GDP (see Stark, 2001). At the same time, Minister Zalm is very aware of the fact that, while in the steady state the faster is the economic dynamics the higher may be the deficit/GDP ratio for a given target on the debt/GDP ratio, in the short run, a procyclical policy has to be avoided being preferable “to be more rigorous in managing public accounts when the economic cycle is favourable and more flexible in downturns”.

4.5. Is the SGP1 enforceable?

One of the weakest aspects of the SGP1 is its limited enforceability. A weakness which is illustrated in almost all the analytical papers on the subject (for example, Buti et al. 2003a and 2005; Buiter, 2004; Buti-Pench, 2004; Buti, 2006; De Grauwe, 2005, and especially Calmfors, 2005) and it is recognised even by the Commission of the European Communities (2005), but it is totally ignored (pour cause!) by policy-makers.

This critique is sometimes conducted in very radical terms, in other cases it is described as the by-product of the particular governance of the Pact, or of the particular circumstances weakening the sanction system.

The former, radical critique essentially states that selfenforcement is impossible if the basic rules of the SGP1 remain flawed. For example, Buiter (2004) writes that “it has become clear even to its most ardent supporters, that the Pact’s arbitrary and rigid design provides a ready-made excuse for ignoring its restrictions to all those who consider themselves unduly constrained by them. Adherence to the Stability and Growth Pact rules would almost surely guarantee fiscal-financing sustainability, but would do so at the expenses of macroeconomic stability and the efficient intertemporal allocation of public spending and taxation. These disadvantages of the Pact have now become so patently obvious that the Pact’s enforcement is becoming impossible. A fiscal rule that is not credible and is honoured more in the breach than in the observance, undermines the very principles it is intended to promote”. The already-quoted critiques by Fitoussi-Saraceno (2004) also draw similar conclusions: “The poor growth performance has built tensions that are finally calling into question the institutional set up… The Stability Pact is probably going to be substantially ignored". In the same vein, Enderlein (2004) states that "the SGP now looks like a classic example of how an institution can miss its target, generate unintended consequences and even result in negative consequences for its initial sponsor. EMU has manifestly created largely unexpected problems of domestic fiscal stabilisation… Instead of trying to square the circle, the responsible actors in EMU might be better off by scrapping the SGP… This approach... could function more effectively than a badly-reformed SGP [mark 1]".

With a softer attitude, Beetsma-Debrun (2005) argue that "the failure to enforce the Pact's most stringent provisions points to two possible interpretations… The first interpretation emphasises a fundamental lack of enforceability, rooted mainly in the fact that the 'responsibility for making the Member States observe budgetary discipline lies essentially with the Council' (European Court of Justice, 2004), that is with (some weighted average of) Member States themselves. The second interpretation stresses… that the current procedure pays excessive attention to the letter of the regulation… [not to] its spirit, which is to avoid that fiscal expansions reduce the benefits of a union-wide commitment to financial stability. Hence the failure to recognise that some fiscal expansions are actually warranted made the Pact's implementation procedure excessively rigid, leading a number of Member States to worry that the fiscal framework might too early conflict with their interest. This might explain why the Commission's recommendation to proceed… against France and Germany did not win the required majority in the Council".

While this latter interpretation joins to some extent and in some specific circumstances the radical critiques described above, the former interpretation relies on the idea that the insufficient enforceability is totally due to the peculiar governance of the Pact for three complementary reasons. First, even if the Council were willing to adopt the excessive deficit procedure and to decide that a cicada-State needs to be corrected and eventually sanctioned, the Council, according to Article 104, could only "make recommendations to the Member States concerned"[13] : the latter are not strong

[13] In fact, this recommendation is only a first step. At a later stage, according to Article 104 Paragraph 9, "if a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation». And finally «as long as a Member State fails to comply with a decision taken in accordance with Paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

instruments[14] for the SPG1 effectiveness, as they essentially consist of forms of moral suasion, obtaining the desired results only to the extent that the preaching institution has a charisma. Second, because the Council is presumably not willing to take that decision, on the basis of a recommendation by the Commission, as it consists of national politicians, subject to the "tyranny of the democracy", unlike the Commission or a potential super-partes Authority, if it were created in the wake of a new common Code of Conduct for budgetary positions in Europe. They tend to collude both because the rationale of the Pact is weak and because they are short-sighted as usually is the case among Government policy-makers. In that event, obviously, policy coordination – traditionally encouraged and considered a plus in the European Treaties – becomes, on the contrary, an instrument for weakening the enforcement of fiscal rules in Europe. If this is the situation, the SGP1 governance is highly imperfect, because, as Juvenalis used to say, "quis custodiet ipsos custodes" (who will watch the watchmen)?15

In the last years, the SGP1 enforceability has further weakened for at least three reasons. First, the probability of sanctions diminishes as the number of cicada-States increases and the sanctions to them are not promptly adopted. As a matter of fact, the majority of EMU countries is more and more often in one of the two following situations: either the country has already overcome some parameters of the Pact (such as Ireland or Portugal, who received an early warning in 2001 and 2002 respectively); or the country is presently exceeding or is about to exceed the deficit/GDP ceiling (among others in 2005 Germany, Italy, Greece and Portugal, in 200616, probably Germany, Italy, France, Greece and Portugal, while among the non-euro EU Member States many more are above the 3% limit, including the United Kingdom). Facing this rising number of "fiscal delinquents", the excessive deficit procedure is endorsed with

- to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities,
- to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned,
- to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected,
- to impose fines of an appropriate size".

[14] Notice that the "recommendation" is in the European jargon, unlike the "decision", not more than a non-binding opinion (see Leonard, 2005).

[15] See Buti-Franco eds. (2005) for a complete overview of the debate. In particular, Buti (2006) confirms that "a legitimate criticism of the Treaty and the old SGP is that enforcement is partisan: national authorities are supposed to apply the rules to themselves and therefore have strong incentives for collusion and horse-trading".

[16] See Commission of the European Communities (2005 and 2006).

more and more caution, damaging the sanctions' credibility: the probability of sanctions diminishes when the number of "fiscal delinquents" increases, because, as indicated by de Haan et al. (2003), presumably it is "politically easier (or less costly) to sanction one country for fiscal misbehaviour than many".

Second, the SGP1 credibility has been wounded in the ECOFIN of November 2003: then the Finance Ministers opposed the recommendations of the Commission concerning the excessive deficit procedure for France and Germany, also because these two big countries found the obliging support of the ECOFIN temporary President, the Italian Minister of Finance Giulio Tremonti, who was probably following a do ut des strategy17. Given that in that moment a somehow discriminatory form of soft interpretation of the SGP1 was adopted by the ECOFIN for strong countries, whereas in the past a hard implementation of the norms had been obtained for weak countries, the Commission resorted to the European Court of Justice. The Court ruling of the following 13 July 2004 is unanimously considered "solomonic" and ambiguous: on the one side, it finds legitimate the Council's choice not to have proceeded against Berlin and Paris, in contrast with the Commission's recommendation, but , on the other side, it "annuls the Council's conclusions of November 25, 2003 towards France and Germany, as the Council holds the excessive deficit procedure in abeyance and modifies the recommendations previously made by the Council to each Member State for correction of their excessive deficit". As Calmfors (2005) puts it: "the credibility loss necessarily follows "from the demonstration that the EU fiscal rules are endogenous and likely to be adjusted in response to violations".

Third, the importance of rewards and penalties has considerably diminished since the Maastricht Treaty: "with the move to a single currency,… the market incentives were reduced with the convergence of interest rates and the carrot of entry was eaten, while the stick of exclusion was replaced by the threat of sanctions under the SGP that might only materialise at a late stage if at all" (Buti, 2006).

[17]This exchange of favours between European Governments may help them but sometimes can damage their countries, particularly those where the external constraint is the main instrument to transform myopic cicadas into far-sighted ants (see Kostoris Padoa Schioppa, 2001). As we will se later, the ECOFIN approach may have been rational relative to Germany, but probably was not correct relative to France.

Finally, it is worth noticing that, besides the probability of sanctions, even their cost diminishes when the number of "fiscal delinquents" rises: this is because the cost has a reputational component, beyond the pecuniary one, and it is negatively correlated with the frequency of cicada-States.

4.6. Why is the SGP misspecified in ignoring the difference between demand and supply shocks especially in large countries?

Furthermore, the reputational cost is not identical for every Member State, notably being smaller for larger countries, by nature more inward looking. As an interesting model by de Haan et al. (2003) shows, "a country that perceives the penalty for fiscal misbehaviour as low, perhaps because its size makes the ensuing loss in political reputation negligible, will have no incentive to choose a tight fiscal policy. Independently from the behaviour of other euro area Members,… the expected utility from selecting a loose policy will always exceed the expected utility level under a tight policy… An equivalent result holds at the opposite end of the spectrum. [For] the small country case tight fiscal policy dominates. If a country perceives the penalty for not playing according to the rules of the SGP as sufficiently high, for instance because its bargaining power within the euro area or EU is otherwise limited, it will always prefer to play according to the rules of the SGP… The expected utility level under a tight policy will always exceed that under a loose policy, rendering the former a dominant strategy independent of fiscal policy decisions elsewhere". This same idea, focusing on the relevance of the countries' size in the weight assigned by them to the compliance with the SGP1 rules, is already explicit in a previous paper by von Hagen (2003): he suggests "that the fiscal framework is indeed more effective in the small than in the large States, which implies that it is most effective where it matters the least, since a fiscal crisis in a small EMU Member State would hardly threaten the stability of the common currency"18.

Buti-Pench (2004) provide a thorough review of the debate on the importance of the country size in determining the relevance and the effectiveness of the SGP1.

[18] Von Hagen looks at the empirical change in the debt ratio during the sub-periods 1992-1997 and 1997-2001, distinguishing worse performing, large States (Germany, France, the United Kingdom, Italy and Spain), intermediate States (Belgium, the Netherlands, Austria and Sweden) with intermediate performances, and best performing small States (the other six of the EU-15). The distinction is made according to the 1997 national GDP percentage relative to EU-15 (the former group consisting of Member States with a GDP larger than 7%, the latter group with a GDP smaller than 2%).

"Explanations offered in the literature appeal to economic and institutional/political economy arguments. A first argument of traditional Keynesian flavour emphasised by the 'French school'… is that the cost of fiscal consolidation tends to be larger in large countries and this would explain their reticence to reduce the deficit towards close-to-balance… In this interpretation, the lack of consolidation in the period of strong growth in the first years of EMU was not a policy failure, but a 'regression to the mean' after years of Maastricht-induced belt tightening (Fitoussi-Saraceno, 2002).More specifically, according to this view, the call simultaneously to pursue budgetary retrenchment and structural reforms… would not suit large economies while it may run in small countries where 'the best demand policy is supply-side policy'. Compared to large, relatively closed economies, smaller, open economies have a stronger incentive to undertake supply-side reforms rather than pursuing an expansionary fiscal policy, since reforms not only boost potential output directly, but also reduce inflationary pressure which allows them to gain competitiveness and increase external demand… A second type of argument is that effective fiscal consolidation needs strong growth… Since large countries have grown considerably more slowly than smaller countries, their retrenchment efforts have been hampered… Clearly, there could be an interplay between the two types of arguments developed above: because of smaller external spillovers, large countries have lower incentives to pursue structural reforms. As a result, the economy tends to run in a lower gear and the country gets locked into a low-growth, high-deficit equilibrium". Two other arguments of a political economy nature have been put forward to explain the different degree of compliance with EMU's budgetary rules between large and small countries: one concerns the already-quoted question of probability and cost of sanctions; the other is related to "the quality of domestic budgetary institutions… Large countries are usually delegation States where the common pool problem is overcome by a strong agenda-setter, typically the Finance Minister who is primus inter pares within the Government… Instead, most smaller Member States achieve domestic budgetary coordination via commitment, whereby different parties negotiate a 'fiscal contract' involving strict budgetary targets… The SGP appears to be less suited to fiscal institutions prevailing in delegation States… Whether the size or the quality of domestic institutions matters is, however, open to question".

The size of the country is certainly relevant for our understanding of the difficulty some Member States showed in complying with the SGP1 rules, but it cannot explain, by itself, the particular problems large Member States met starting in 2002, while in the first three years after the EMU introduction they were able to follow those SGP1 rules. Germany was big both before and after 2002, but it became unable to stick to the Pact in that year, while in 1997 it was the most severe proponent of a rigorous application of the drei comma null ceiling for the deficit to GDP; in the last twenty-five years, Germany had never overcome for three consecutive years the 3% deficit to GDP ratio as it did in the four-year interval 2002-2005 and not even in 1993 its deficit exceeded 3%, when Germany had the sharpest decline in the last 20 years in its GDP (-0.8%).

In my opinion, the large size of a country becomes an element of the explanation of the excessive deficit, once it is combined with a large demand shock. According to this approach, the missing distinction between a supply and a demand shock in the SGP1 is a major flaw: it is not sufficient to focus on the output gap; ignoring whether this gap is the outcome of a supply or a demand shock implies ignoring whether the deficit spending is irrational or rational from the viewpoint of any Member State, because an expansionary fiscal policy is an incorrect reaction to a supply shock involving higher inflation, while it is correct in front of a negative demand shock. In particular, a strong negative demand shock requires a deficit spending able to minimise the welfare loss of any country internalising all the effects this expansionary fiscal policy entails in terms of a rising interest rate. In this case, it is a mistake to impose a numerical target on that reaction. The SGP1 has a supply side logic which probably corresponds to the structural conditions of big countries in continental Europe, but not necessarily to their short term conditions. Facing a strong demand shock, a lax fiscal policy is not the result of the well-known free-riding problem. Quite to the contrary: this may be the result of a perfectly rational large Member State not subject to this kind of free-riding. Small countries belonging to the same single currency tend to be, on the contrary, more prone to free-riding and therefore want to "tie their hands and those of large countries" through the coordination of their fiscal policies, without allowing any special concession to anybody. Thus, they show to prefer even in the circumstance of a very negative demand shock a more contractionary fiscal policy for all Member States.

A simple model will show the rationale for a very large country hit by a strong demand shock to ignore the precise rules on the deficit/GDP ceiling imposed to all

Member States belonging to the same currency union, while the same behaviour is irrational for small countries in identical circumstances. On the other hand, those rules are easy to follow, as they are non-binding even for large countries in all other events (supply shocks, small demand shocks).

4.6.1. The model

The model utilised here follows in particular the one by Uhlig (2003) and, as he says of his own, "has a number of limitations and should be seen in light of what it is meant to do: highlight the free-riding issue in a simple framework and provide some policy-relevant insights, at the risk of neglecting some key issues".

All variables are defined in terms of percentage deviations from their long run values, except for the interest rate, i, and are described by capital letters. All parameters are in small letters and are non-negative. Ignoring (unlike Beetsma et al., 2001) all the spillovers, except the one derived from the single currency monetary policy, let us assume that the output gap Ya of country a depends only on the deficit gap of that country, Defa, on the expected real interest rate, (i - Πea) with Πea equalling the expected inflation rate in country a and on a demand shock, Ea. The inflation rate, Πa, is an increasing function of the output gap and of a supply shock, Ua.

Let us first consider in isolation the equilibrium of country a. Aggregate demand is

$$Y_a = c_a \, Def_a - v_a \, (i - \Pi^e{}_a) + E_a \, . \qquad (1)$$

Given that the relation between the deficit and the structural deficit ($Defs_a$) depends on the output gap, as indicated by

$$Def_a = Defs_a - m_a Y_a \quad , \qquad (2)$$

where $m_a Y_a$ shows the automatic stabilisers,

$$Y_a = f_a \, Defs_a - k_a \, (i - \Pi^e{}_a) + h_a E_a \quad , \qquad (3)$$

where

$$f_a = c_a/(1 + c_a \, m_a) \; ; \; k_a = v_a/(1 + c_a \, m_a) \; ; \; h_a = 1/(1 + c_a \, m_a) \, .$$

Aggregate supply is

$$\Pi_a = n\, Y_a + U_a \quad , \tag{4}$$

with the slope of the curve, n, assumed to be identical in all countries to simplify calculations.

The interest rate is supposed to be determined by the Central Bank "so as to ensure expected price stability in the mediun run, i.e. in the absence of shocks", as assumed for example by Buti-Giudice (2002). Hence, $\Pi^e_a = 0$ and $i = f_a Defs_a/k_a$. As Buti-Giudice (2002) put it, "this implies that in the medium run monetary policy will offset any effect of fiscal policy on output and prices via an appropriate level of the interest rate but in the short run the Central Bank does not react to shocks".

Let us assume that the Government of country a fully internalises the reaction function of the Central Bank and the increase of i due to deficit spending. Let us also suppose that the Government cares both about the fiscal rule, setting a ceiling on Defs and Def, and about output stabilisation, and it wants to minimise the following quadratic loss function L_a:

$$L_a = ½\, [Defs^2_a + l_a\, Y^2_a] \quad , \tag{5}$$

where l_a captures the relative preference for output stabilisation relative to the fiscal rule.

Optimisation leads to

$$Defs_a = 0 \quad , \quad Def_a = -\, m_a\, h_a\, E_a \quad \text{with} \tag{6}$$

$$Y_a = h_a E_a \quad \text{and} \quad \Pi_a = n\, h_a\, E_a + U_a \tag{7}$$

The optimum solution is a structural balanced budget, combined with a deficit spending in the short run, utilising automatic stabilisers to counterbalance any possible negative demand shock (Ea< 0). Under these circumstances, the output gap becomes negative and inflation declines, which happens also with a positive supply shock (Ua< 0). Notice that, when the demand shock Ea is negative, the deficit gap has to be positive and any numerical constraint on the deficit spending under the level $-m_a\, h_a\, E_a$ is not a first best (for example, at 3% of GDP): indeed, there may exist a logical inconsistency between $Defs_a = 0$ and $Def_a \leq 3\%$ of GDP, a problem similar to the logical inconsistency between $Defs_a = 0$ (which is the MTO of the SGP1) and Debt/GDP kept at a stable level higher than zero. On the other hand, no logical inconsistency arises if the demand shock is smaller, so that $-m_a h_a E_a \leq 3\%$ of GDP, or if there is a supply shock, given that in this event no deficit would be optimally chosen.

Let us now suppose that two countries, a and b, have a common currency and a common nominal (i) and expected real interest rate (i - Πe); while they take into account the feedback rule followed by the Central Bank in setting the nominal and the real interest rate, they do not coordinate their fiscal policies, playing a Nash non-cooperative game.

Their aggregate demand and supply are functionally similar, but their parameters differ (i.e. fa ≠ fb; ka ≠ kb; ha ≠ hb, but n is common to both countries). The monetary policy is now determined in a slightly more complicated way, so as to make the average expected inflation rate equal to zero, in the absence of shocks, i.e.

$$(\alpha Y^e{}_a + \beta Y^e{}_b) = 0 \,, \tag{8}$$

where the superscripts e indicate the expected values, α and β identify the weights of country a and b respectively, with $\alpha + \beta = 1$ and both positive. Hence

$$i = (\alpha f_a Defs_a + \beta f_b Defs_b) / (\alpha k_a + \beta k_b) \tag{9}$$

Countries a and b, taking into account the Central Bank reaction function (9), minimise their loss function La, as in (5), and similarly Lb, as follows:

$$Defs_a = l_a Defs_b \frac{\beta^2 f_a k_b f_b k_a}{(\alpha k_a + \beta k_b)^2 + l_a (f_a \beta k_b)^2} - l_a E_a \frac{h_a f_a \beta k_b (\alpha k_a + \beta k_b)}{(\alpha k_a + \beta k_b)^2 + l_a (f_a \beta k_b)^2} \,, \tag{10}$$

$$Defs_b = l_b Defs_a \frac{\alpha^2 f_a k_b f_b k_a}{(\alpha k_a + \beta k_b)^2 + l_b (f_b \alpha k_a)^2} - l_b E_b \frac{h_b f_b \alpha k_a (\alpha k_a + \beta k_b)}{(\alpha k_a + \beta k_b)^2 + l_b (f_b \alpha k_a)^2} \tag{11}$$

Equations (10) and (11) show why there are negative spillovers created by the existence of a single monetary policy, without any coordination between fiscal policies. Each country attaches only a limited importance to the impact of its deficit on the interest rate, effectively free riding in its fiscal decisions. On the other hand, each country reacts to the deficit increase in deficit of the other country, leading to an excessive deficit bias. The structural deficit is not set to zero any longer due to a coordination failure. "Ideally – as Uhlig (2003) recalls – fiscal policy should respond to the country-specific 'fiscal demand shocks', leaving it to the European Central Bank to respond to the average of the country-specific cost-push shocks. However, each fiscal authority will be tempted to try to improve the situation for its own country by, for example, expanding Government demand or Government deficits precisely when the ECB needs to combat cost-push shocks via higher interest rates. With all countries doing so, the ECB ends up combating not only the cost-push shocks, but the additional fiscal demands as well. While the ECB may ultimately be successful in avoiding any consequences for European inflation rates, the end result would be higher nominal interest rates and a situation that is worse for everybody. To avoid this free-riding problem, institutions need to be found that will ensure that country-specific fiscal policies stick to the task at hand and avoid this free-riding issue. The Stability and Growth Pact can be seen as doing exactly that: by limiting country-specific deficits, the temptation in each country to seek an improvement in its situation at the expenses of all other Members of EMU will be limited".

The imposition of fiscal rules, according to an *ex ante* coordination formula, binds the deficit ceiling of each country: this reduces the excessive deficit bias and implies an optimal solution whenever there is a supply shock or when the demand shock is limited, but it is only a second best solution, if there is a strong demand shock which cannot be fully compensated. As repeatedly observed, among others, by Beetsma-Debrun (2004a), "although significant spillovers are necessary to make a case for closer fiscal coordination, they are not sufficient to establish that such coordination would be welfare-improving". And Calmfors *et al.* (2004) add that, in the short run "there is no reason… to believe that the automatic stabilisers give an optimal degree of stabilisation… [On the contrary] if there are permanent supply shocks, the automatic stabilisers tend to prolong the adjustment process and cause budget effects that must ultimately be eliminated through discretionary action".

It is now important to recognise that the free-riding behaviour of different countries, connected by a single currency and a single monetary policy, *coeteris paribus* differ according to their size. In order to see it, let us now assume that country a is extremely large and country b extremely small, so that $\alpha \sim 1$ and $\beta \sim 0$. This means that the Central Bank reacts (almost) exclusively to the inflation pressures coming from country a and equation (10) is (almost) reduced to

$$Defs_a = 0 \ , \quad Def_a = - m_a h_a E_a \ , \text{ with } Y_a = h_a E_a \text{ and } \Pi_a = n h_a E_a + U_a : \tag{10'}$$

this exactly corresponds to the optimal solution (6) – (7) obtained in the absence of any free-riding. Thus, a large country is almost able to fully internalise the full effect of its deficit on the interest rate. On the contrary, equation (11) is (almost) transformed into

$$Defs_b = l_b \, Defs_a \frac{f_a \, k_b f_b}{k_a \, (1 + l_b \, f^2_b)} - l_b E_b \frac{h_b f_b}{1 + l_b f^2_b} \ ,$$

$$Def_b = Defs_b - m_b Y_b \ ,$$

$$\text{with } Y_b = \frac{- h_b f_a}{k_a \, (1 + l_b \, f^2_b)} \, Def_a + \frac{E_b \, h_b}{1 + l_b f^2_b} - \frac{E_a m_a h_a \, h_b f_a}{k_a \, (1 + l_b \, f^2_b)}$$

$$\text{and } \quad \Pi_b = n \, Y_b + U_b : \tag{11'}$$

unlike the large country, the small country belonging to the currency union is negatively hit by the deficit spending of the other country, and by the demand shock of the latter (besides by its own). It is much more in the interest of the small than of the large country to fix some fiscal rules limiting the deficit spending of everybody. By contrast, the large country tends to ignore the spillover problems and takes into consideration almost the full effect of its behaviour on the interest rate, therefore reacting essentially only to an asymmetric demand shock hitting itself, E_a, not to a supply shock, nor to a demand shock regarding another country. The large country is indifferent to an *ex ante* coordination limiting its deficit spending in case of a supply shock: it would not proceed to an expansionary fiscal policy anyway. It is in its own interest to balance its structural budget, using in the short run only the automatic stabilisers to fully compensate even a large demand shock.

The problem and the solutions are slightly different if the countries, playing a Nash non-cooperative game, look at their own real interest rate: in this case, the aggregate demand of country a depends on $i - \Pi^e{}_a$, the aggregate demand of country b depends on $i - \Pi^e{}_b$. Again, if a is very large and b is very small, $\Pi^e{}_a$ is (approximately) equal to the average Π^e and is almost zero, reaching an optimal solution (approximately) with (10'). On the contrary, country b would choose a structural deficit level described by

(11'')

$$Defs_b = I_b\, Defs_a \frac{f_a k_b f_b}{k_a\,[(1 - nk_b)^2 + I_b\, f^2{}_b]} - I_b E_b \frac{h_b f_b\ (1 - nk_b)}{[(1 - nk_b)^2 + I_b\, f^2{}_b]} :$$

this is similar to (11') and identically suggests an excessive deficit bias, possibly to attenuate through an ex ante fiscal coordination between countries.

Finally, if all countries were similar from every point of view including size and parameter values (now described without subscripts), equations (10) and (11) would be transformed as follows:

$$Defs_a = I\,\left[\frac{f^2 Defs_b - 2hfE_a}{4 + f^2 I}\right], \qquad (12)$$

$$Defs_b = I\,\left[\frac{f^2 Defs_a - 2hfE_b}{4 + f^2 I}\right] : \qquad (13)$$

the deficit bias would reappear in all countries, so that, without any fiscal coordination, the structural balance would differ from zero.

4.6.2. My reform proposal of the SGP1 and the empirical evidence

It is by now clear even from this simple model that a reform of the Stability and Growth Pact should neither treat as identical all the shocks (of the demand or of the supply kind) creating an output gap, nor should it consider as identical the incentives different countries have in complying with the SGP1. The country size makes a difference in the degree of myopic fiscal free-riding and on the weight attached to spillovers. One should also consider that, while in the long run, starting from a balanced structural budget, the deficit spending counterbalancing a negative demand shock may be limited within the binding constraints of the automatic stabilisers, in the transitory phase, starting from a debt and a deficit position above the reference values, the necessary deficit may have to overcome that limit, and a fortiori the 3% ceiling. As Fitoussi-Saraceno (2004) put it, "the Pact was designed assuming that Governments would accumulate surpluses in good times to allow the operation of automatic stabilisers in bad times. This ideal scenario, though, did not take into account the fact that this symmetry would only be attained after a long transition. In the meantime, Governments are being forced to adopt restrictive fiscal policies…The three largest countries, Germany, France and Italy do not even have room for the automatic stabilisers to play". While I do not fully agree with the last sentence for reasons which will soon appear clearer, I recall that this ideal scenario is a limit of all our theoretical models. Another rather unrealistic element is to consider that the national fiscal decision-makers have a quadratic loss function to minimise. It is more realistic to assume that for political reasons those decision-makers prefer to expand fiscal policy in front of a negative demand shock, rather than restrict it in front of a positive shock: this asymmetry implies that the optimal solutions found in Paragraph 4.6.1. hold true only when Ea<0, Eb<0, which correspond, however, to the most relevant case. Finally, the public opinion and the median voter being more concerned with the unemployment rate above the "normal" level (the long term, natural) than with the somehow obscure19 concept of output gap, a more realistic loss function than the one used in my model should take into consideration that aspect. This would not change our conclusions, if one adopts the Okun law, establishing a precise linear relation between the two gaps.

My personal proposal for the reform of the SGP1 at this point consists of explicitly considering among the reasons for derogations to the excessive deficit procedure and to allow a deficit beyond the 3% of GDP, the possible existence of strong demand shocks. Looking only (and simultaneously) at the exceptionality of the excess deficit origin, at the temporariness and at the closeness to the reference value is not adequate.

[19] The concept of output gap is obscure for the public opinion, as it is the one of the natural rate of unemployment. Therefore in our empirical part we will adopt the simplifying hypothesis that the public opinion considers an increase in the unemployment rate as a signal of its abnormally high level.

In particular, as far as the first condition for derogation is concerned, applying the exceptionality clause, as it is currently done, only when the excess of the deficit over the reference value results from an unusual event outside the Member State's control and/or in the presence of a severe economic downturn, without a proper distinction between supply and demand shocks appears incorrect: a negative supply shock should not be cured through deficit spending, contrary to a negative demand shock; taking only into consideration the output gap and not its source is therefore misleading.

An immediate critique to my proposal could be twofold. Someone would probably point out that it is not only hard for the European Commission and the Council to distinguish the nature of the country-specific shock, but it is also difficult to adopt a common, and therefore homogeneous European methodology to detect such nature in every Member State. I consider this critique partly invalid. It is currently possible for the European guardians of the Stability and Growth Pact to utilise three data-set which have been already homogenised by the European Commission Services for all the EU countries (and have been existing for many years in the euro area), but have never been exploited up to now in this context: they appear to provide a sufficient support for that purpose. Adopting this approach, a strong negative demand shock would be identified by the simultaneity of the three following empirical evidences: (1) an increase relative to the normal trend of the quota of firms declaring to be constrained by insufficient demand rather than by insufficient capacity or insufficient profitability; (2) an increase in the unemployment rate coupled with (3) a decrease in the inflation rate, as it is well known that a negative supply shock always implies a rising inflation rate. The unemployment rates have been already estimated for many decades by Eurostat on comparable grounds across Europe. The inflation rates have been calculated on common European standards through the private consumption price deflator for many decades, but since 1997 it is available in the Union a (preferable) inflation series based on an harmonised consumer price index[20]. Finally, the European Business Surveys, indicating the percentage of firms constrained either by their output demand, or by their capacity and profitability, or by their difficulties in finding the proper labour force have been based on common methodologies and common statistical standards ever since 1985 for EU Member States[21] (see Tables 1

[20] Of course, the inflation rate based on a non-harmonised CPI has been calculated for many decades in each European country.

[21] In many European countries and in the United States, these Business Survey data have been existing much before, generally starting in 1965.

and Graphs 1). To the best of my knowledge, these latter data have very rarely been utilised not only for analytical purposes, but also as policy-instruments in addressing European problems. A notable exception is the so-called European Unemployment Program, initiated in the mid-80's (see Drèze-Bean, 1990).

For various reasons, both statistical ad political, special attention will be devoted to the period 1997-2005, as the SGP1 was born in 1997 and all the three harmonised data-sets exist since then. In practice, we will identify in a country, in a given year, a strong demand shock when we will contemporaneously observe in that year an increase of the unemployment rate (u), a decrease of the harmonised inflation rate (π) and a rise of the demand relative to capacity constrained quota of firms above the average, called detrended demand relative to capacity constrained regime [(D – C) / (average D-C 97-05), using the symbols explained in Tables 1 and Graphs 2]. Therefore, we will say that there exists a strong demand shock when in the same year u is growing, π is falling and (D-C)/(average D-C 97-05) is bigger than 1.

The three combined indicators suggest that in the years 2002-2003 some, but not all, Member States have suffered from a strong, negative demand shock. The fact that it was a country-specific shock is shown both by the fact that not even within the euro area (called EUR-12 in the Graphs) all countries were characterised by identical paths, but also that, consequently, that path was ambiguous[22] at the EMU level. However, given that some European countries outside the euro area were equally hit by a strong, negative demand shock, the EU as a whole appears to be hit by a strong negative demand shock.

Looking at the data and at the Graphs 2, one can see that Germany is the only big country to have suffered in the years 2002-2003 from a strong negative demand shock. Clearly, according to our indicators, this is not the case for the other four major European countries (France, Italy, the United Kingdom and Spain). This can be possibly explained recalling that after the soft landing of the United States in 2001 and particularly after 9/11, Germany discovered, contrary to everybody's expectations, that not only it was unable to substitute the United States' "locomotive", taking up the economic Western leadership, but additionally it was about to undergo a

[22] I use the term ambiguous to indicate hat the threefold signal of a strong negative demand shock appears in only one of the two years not to indicate that only some of the three variables show the required sign.

very serious downturn. Starting in 2002, Germany has undergone a long stagnation with a clear recession in 2003. The economic sentiment of German firms reveals those years' total loss of confidence, as indicated for example by the IFO index, which reaches between the end of 2001 and the end of 2003 minimum values relative to the trend (see ISAE, various years). The internal demand in Germany was lacking in those years, while the external demand was weakened by the slowdown of the world trade, although Germany was continuing to gain market shares. If one takes the overall annual export of the five major European countries equal to 100, Germany is the only one which presents an ever growing quota from 2000 on (38.3% in 2002, 41% in 2005, while in the same time interval Spain goes from 7.8% to 7.9%, France declines from 20.6 to 19.4%, the U.K. from 17.4 to 16.2%, Italy from 15.8 to 15.5%, as illustrated by ISAE, 2006). In 2002-2003 and possibly later, the United Kingdom, being outside the euro area, certainly suffered from a too strong exchange rate relative to our single currency, but overall has observed in the period 1997-2005 a continuous decrease of the unemployment rate. Among the big European countries, Spain is the only success story of the last decade in the Continent and does not seem to be hit by any negative shock. By contrast, in the years 2002-2003, the possibly negative demand shock is outweighted by a negative supply shock in France, with productivity gains limited by delays in technological innovations and reductions in working hours, France being the only OECD country with increasing rigidities in the labour market between the end of the 80's and the end of the 90's (with no significant subsequent fall, see OECD, 2004). Consequently, in France, unemployment and inflation both grew in those years, while firms were declaring an increasingly insufficient demand for their expensive products.

Italy, in the meantime, shows an actual decrease in productivity, as output stagnates while employment rises and unemployment declines. Inflation, on the contrary, increases. Its loss of competitiveness relative to emerging developing countries like China is dramatic, especially in traditional sectors, as textile. This is a (probably long lasting) negative supply shock which could be only aggravated by deficit spending, especially taking into consideration Italy's enormous debt level. Yet, both France and Italy, as much as Germany, start overcoming the 3% ceiling around those years (Italy continuously since 2001, with the exception of 2002, France continuously since 2002, with the exception of 2005), for motivations that can be explained by political economy but (unlike those of Germany) are not optimal in terms of our simple model.

A similar reasoning holds true for another big "fiscal delinquent" of the euro area, Greece. There is no evidence there of lack of demand in the years 2000, able to rationally explain the highest deficit to GDP ratio in Europe (always above 4%), combined with the highest debt to GDP ratio (never below 107.5%). On the contrary, the deficit spending of Portugal above 3% since 2004 may have a logical motivation in the strong negative demand shock regarding that country in the period 2002-2004.

Another interesting case to focus our attention is that of two small countries, traditionally economically closed to Germany, as Austria and the Netherlands, which appear to suffer of a strongly negative demand shock in the years 2002-2003, but in the ECOFIN maintain their rigour asking Germany to follow the SGP1 rules, even though the Netherlands breaks them in 2003 (reaching a deficit/GDP ratio of 3.1%) in front of a decrease in GDP by -0.1%, after a stagnation comparable to Germany (its GDP growth being 0.1 in 2002, as in Germany). This attitude of small countries, even when attained by the same strong (and possibly stronger) demand shock as Germany, seems to be possibly explained through our simple model: for them, negative spillovers weigh more and fiscal coordination is more desirable.

Finally, among the Central-Eastern Member States of the Union, only the three most developed have been hit by a strongly negative demand shock in 2002-2003, Slovenia, Hungary and Poland, but only the two latter have shown a deficit to GDP beyond 3% in those years. One has to understand, however, that not only they do not belong to EMU but have entered into the EU only in May 2004. Today, of the eight Central-Eastern newcomer countries, only Hungary exceeds the 3% deficit to GDP ceiling.

5. The SGP2 After the 2005 Reform of the SGP1

The next step consists of testing whether the SGP1 reform, introduced by the Brussels European Council of March 22-23, 2005 and ratified by two Council Regulations of June 27, 2005 (numbers 1055/2005 and 1056/2005), satisfies the six types of criticisms mentioned above. The premise, of course, is that the Pact can be modified only within the limits set by Article 104 of the Treaty and can thus, on the one side, include those elements which are present in that primary norm but are absent from the

1997 and 2003 SGP1 rules, and, on the other side, can exclude those aspects which are present in the 1997 and 2003 secondary norms but not in the Treaty.

My brief evaluation on the SGP2 is the following. The amendments introduced last year on the SGP1 are not only consistent with the Treaty, but are somehow closer to its spirit than the Pact itself, as they reach a good compromise between some (but not all) of the requests for revision, emerged in the past two years, illustrated in Section 4. The overall outcome is, however, disappointing. The reason for this assessment will clearly appear from the wording of the Presidency Conclusions of the March 2005 Brussels European Council (to which I will refer in this Section, see 7619/05) but could, alternatively, be derived from the secondary norms of the June 2005 Council Regulations.

The reader may find useful to look at Table 2 produced by the European Commission with the purpose to offer a detailed comparison between the SGP1 and the SGP2. I will keep examining the fiscal rules of the SGP2, as I did with the SGP1 and with Article 104: analysing four elements, objectives, derogations to the excessive deficit procedure, mitigating factors and sanctions. On short-term objectives, the European summit has introduced a more dynamic approach. Indeed, “Member States that have not yet reached their MTO should take steps to achieve it over the cycle. Their adjustment effort should be higher in good times; it could be more limited in bad times. In order to reach their MTO, Member States of the eurozone or of ERM-II should pursue an annual adjustment in cyclically adjusted terms, net of one-offs and other temporary measures, of 0.5% of GDP as a benchmark. ‘Good times’ should be identified as periods where output exceeds its potential level, taking into account tax elasticities”. More generally, the need to “avoid pro-cyclical policies” is reiterated, as asked for by many experts recalled in Paragraphs 4.1 and 4.3 and some policy-makers like Mr. Zalm, in order “to actively consolidate public finances in good times”.

Furthermore, on the medium- and long-term objectives, the Brussels Spring summit recognizes, as Paragraph 4.4 has indicated, that due account must be taken of the connection between public deficit and debt and, as proposed by the former Chancellor Schröder, “of the growing economic and fiscal heterogeneity within the EU-25”. Thus, the Presidency Conclusions state that “MTOs should be differentiated and may diverge from positions of close to balance or in surplus for individual Member States on the basis of their current debt ratio and potential growth, while preserving sufficient margin below the reference value of 3% of GDP. The range for the country-specific MTOs for euro area and ERM-II Member States would thus be, in cyclically adjusted terms, net of one-off and temporary measures, between -1% of GDP for low debt-high potential growth countries and balance or in surplus for high debt-low potential growth countries. The long-term sustainability of public finances would be supported by the convergence of debt ratios towards prudent levels. Implicit liabilities (related to increasing expenditure in the light of ageing populations) should be taken into account, as soon as criteria and modalities for doing so are appropriately established and agreed by the Council".

The novelties introduced by the European Council of March 22-23, 2005 in the area of derogations to the excessive deficit procedure are equally important, as in this case, too, significant, sensible changes rather than simple additions are observed. Indeed "the Council considers that the current definition of a 'severe economic downturn' given in Regulation 1467/97 is too restrictive… The Council considers the Paragraphs (2) and (3) of Article 2 in Regulation 1467/97 need to be adapted in order to allow both the Commission and the Council… to consider 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". The negative sign of the growth rate becomes therefore sufficient for derogations. This allows for some more fiscal expansion in downturns and therefore may meet some of the critiques made by neo-Keynesian experts and by Governments, as seen in Paragraph 4.3, but still does not satisfy my own critical comments (see Paragraph 4.6) on the absence of any recognition of the difference between a country-specific supply and demand shock.

With reference to the mitigating factors and debt which the Commission should consider in evaluating budgetary positions, the Conclusions of the European summit of March 2005 state that "special attention must be paid to pension reforms introducing a multi-pillar system including a mandatory fully-funded pillar. Although those reforms entail a short-term deterioration of public finances during the implementation period, the long-term sustainability of public finances is clearly improved. Thus…Member States implementing such reforms should be allowed to deviate from the adjustment path towards the MTO, or from the MTO itself". This seems to be an acknowledgement of the necessity to improve the consistency of the

Pact relative to other policy objectives of the European Union, as indicated in Paragraph 4.3.

Finally, dealing with the timing and modalities of sanctions, the Brussels summit of March 22-23, 2005 introduces the novelty to postpone deadlines and soften sanctions relative to Regulation 1467/97. In particular, in special circumstances “the initial deadline for correcting an excessive deficit could be set one year later, i.e. the second year after its identification and thus normally the third year after its occurrence”.

In the Presidency Conclusions some further lip service is offered to large countries: “An improved national ownership of budgetary policies” is hoped for, and special consideration is given “to budgetary efforts towards increasing or maintaining at a high level financial contribution …to achieving European policy goals, notably the unification of Europe [in primis of Germany!]” and “ to fostering international solidarity”, as asked for by President Chirac. There are also some nice words able to please those (the English and the Italians) who were asking that productive public expenditures (in particular for research and employment) should be considered separately: “the Commission’s report … should appropriately reflect developments in the medium-term economic position (…the implementation of policies in the context of the Lisbon Agenda and policies to foster R&D and innovation) and developments in the medium-term budgetary position (…debt sustainability, public investment and the overall quality of public finances)”.

Finally, very promising but utopian sentences are offered by the March 2005 Presidency Conclusions both to those who thought the old SGP1 was not rigorous enough, and to those who felt the Pact was not flexible enough. Indeed, the new SGP2’s “aim is not to increase the rigidity or flexibility of current rules but rather to make them more effective… It is essential to secure a proper balance between the higher degree of economic judgement and policy discretion in the surveillance and co-ordination of budgetary policies and the need for keeping the rules-based framework simple, transparent, enforceable”. But no innovation is introduced in the governance of the Pact, so that the problem of enforceability examined in Paragraph 4.5 remains essentially identical in the SGP2 as it was in the SGP1.

The overall evaluations of the SGP1 reform greatly vary according to the interpreters of the revision. In synthesis, some authors give a fail mark to the SGP2, some a pass, none consider it a straight A.

Von Hagen (2006) thinks that "since the start of EMU, the disciplinary effect of the fiscal rule in EU has vanished… In March 2005, the European Council adopted an explicit list of excuses for persistent Government deficits and debt in excess of the thresholds set by the EDP. This decision further deprives the European Commission of its right to exert independent judgement on the fiscal performance of the EU Member States and effectively marks the end of the rule-based regime for fiscal policy in Europe"23. Coeuré-Pisany Ferry (2005), quite to the contrary, welcome in particular two elements introduced by the SGP2: "First, a consensus has emerged to give to the Commission the right to bark and bite, i.e. to send an early warning to a Member Country without the approval of the Council, although the corresponding legal provision has been a victim of the rejection by French and Dutch voters of the draft Constitution… Second, with the SGP2, the eurozone has moved away from its initial emphasis on governance by fixed rules and has reintroduced discretion. However… the risk of undisciplined case-by-case decisions guided by political pressure and horse-trading is significant". Buti (2006), on the one hand, acknowledges that the changes induced by the SGP2 "got a mainly sceptical reception. Some commentators argued that, given the list of exceptions to the 3% rule and the greater discretion left to the Council, the Pact was de facto dead (Buiter, 2005; Calmfors, 2005)". But, on the other hand, he believes that there exist "two alternative prospective readings [of the SGP2]: an opportunistic 'collusive' deal and a 'genuine' adherence to the revamped rules… Whether and when a call for stronger fiscal discipline will arise depends on politics, the key factor being renewed ownership of the rules In the end, the new rules can be rigorously applied only if they are backed by key players and fully integrated in their natural policy framework".

[23] De Haan *et al.* (2003) provide an ex ante evaluation equally drastic: "In fact, the reform will only make the Pact less credible as there is now even more scope for politically motivated manipulation of the process. So even though the Stability and Growth Pact will not be dead *de jure*, it seems likely that *de facto* the SGP rules will be put aside. Some authors would welcome this, as they feel that the rules in place lack legitimacy. For instance, Wyplosz (2002) argues that rules 'tend to be rigid and artificial, which makes them ultimately impossible to defend in the face of public opinions'. We disagree, it will be much more difficult for Governments to explain convincingly why they put the same rules aside that they embraced unanimously earlier, now that these rules may start to bite".

The Commission of the European Communities (2005), not surprisingly, gives a quite positive assessment to the 2005 reform of the Pact, concluding that "overall, the analysis suggests that the changes result in a broadly balanced set of new rules… The Kopits-Symansky score deteriorated on the criteria on which the SGP [mark 1] scored high… In particular, it appears that in comparison to the original Pact, the new provisions are less well-defined, contain a higher risk of interpretative ambiguity and are less transparent and more complex. On the other five criteria, when the ratings had been less positive, its score improved".

Buti et al. (2005) are less optimistic. In evaluating the SGP2, they consider that four elements of the SGP1 had to be changed: overcoming excessive uniformity, correcting procyclicality, increasing transparency and strengthening enforcement. According to their opinion, the SGP2 involves a positive modification relative to the SGP1 only in the first two aspects, while it is unclear to them whether there has been a deterioration or an improvement in the last two. In synthesis, they state that "the major weakness of the old rules was poor enforcement mechanisms. Will the new rules be more effectively enforced? The fact that in the new Pact there is a greater margin for discretion, but no independent enforcer, may increase the incentives for collusion by the Council in subverting the implementation of the rules. If so, lack of enforcement would persist or even be aggravated. However, as the new Pact encompasses better economic rationale and may improve national ownership and fiscal transparency, there may be a better chance that it becomes selfenforcing". This position seems to be shared also by Beetsma-Debrun (2005).

But on enforceability most experts agree that no step forward has been made by the SGP2 relative to the SGP1. Calmfors (2005) writes that "the exact damage from the reform of the Stability Pact will depend on how the revised rules are applied over the next few years. The current large deficits in especially France, Germany, Greece, Italy and Portugal will provide defining test cases. A loose interpretation of the revised rules, exploiting to a maximum degree the new exemption possibilities, will effectively kill off most of the remaining credibility of the EU fiscal framework. In the future, the 3% of GDP deficit ceiling will then at most operate as a non-binding benchmark in the public debate. A strict interpretation of the revised rules, involving sanctions in the case of continued excessive deficits in France, Germany and Greece, could, however, establish a precedent and put a limit to the weakening of the Stability

Pact. But such a development is unlikely, as the same forces that caused the breakdown of the enforcement mechanism in 2003 and the subsequent revision of the Pact continue to operate".

6. Conclusions

The March 2005 reform of the 1997 Stability and Growth Pact has been extensive but has not been realised in the most proper way. The revision is still incomplete and insufficient to allow for a better performance of fiscal policy in Europe. I think that the two major weaknesses of the SGP1 were its limited enforceability (due to badly-conceived governance with the coincidence of guardians and delinquents) and its insufficient economic rationale (due to the absence of any identification of supply and demand shocks in the output gap). No improvement has been obtained by the new 2005 SGP2 relative to the old SGP1 on these fronts; to some extent, they may even have worsened.

It is true that the SGP2 has become more "intelligent", with a more balanced mix between rules and discretion, so as to take into account in a less uniform way the different Member States' situations, cyclical conditions, growth potentials and public finance historical disequilibria. But ultimately the SGP2 remains not really clever because, when more discretion is introduced, both in the number of contingencies to consider for applying the rules and also in the adoption of the excessive deficit procedures, the policy design concerning the governance of the Pact should improve and be redefined so as to be able to address the new major problems; however, this has not been the case, as the SGP2 has made no innovations following the lines indicated by Paragraph 4.5. Unfortunately the internal conflict of interests, stemming from the overlapping between controllers and controlled within the governance body responsible for the budgetary surveillance, has not been solved neither through a transfer of powers from the Council to the Commission or to any other possible future independent Authority, nor through a better balance of powers between the different European institutions involved in the European fiscal policy implementation. In fact, deep distortions remain in the governance of the SGP2, the surveillance of Member States' budgets still being (irrationally, though comprehensibly) under the exclusive control of national Governments, namely of those who should be controlled. Their coordination policy, in this perspective, is perverse. Moreover, the Council's effectiveness in recommending fiscal adjustments to Partners in excessive deficit and eventually in sanctioning them only relies on moral suasion. Unless those distortions are eliminated, the higher degree of discretion and flexibility introduced by the 2005 SGP2 will become a new source of difficulties for the Union's stability and growth. The result that optimistic observers expect from the 2005 review of the Pact – which is now perceived as more rational, hence more enforceable – risks to become an illusion eventually ending up in a weaker, more unreliable constraint easy to be bypassed, as pessimistic observers would say, especially considering that after November 2003 the Pact has lost its original credibility, being strictly applied to small countries while it seems to be favourably interpreted for the large ones. If, according to the new 2005 SGP2, the cicada-States felt more free to enlarge their deficits, this would probably cause higher inflationary pressures, particularly in those large European countries dominated by structural supply problems, and would not increase output either in their domestic markets or, given the existing spillovers, in the rest of the Union. On the contrary, interest rates would have to rise, justifying the stand of the European Central Bank which has insistently invited to avoid any Pact reform, perhaps drawing inspiration from that founding father of the European Community, Jean Monnet, who used to say that "before sending a letter you have to be sure to be able to write the answer".

This potentially negative outcome depends on the fact that the new 2005 Pact, as much as the old 1997 one, does not introduce the fundamental distinction between supply and demand shocks. Whereas an expansionary fiscal policy would be illogical in the former case, it may be optimal in the latter. If the country-specific demand shock is very strong, the deficit to GDP should be allowed to overcome, if necessary, the 3% ceiling. Given that this numerical target is stated in the Treaty itself, those considerations should appear in the list of derogations, as an amendment of the exceptionality clause, whereby the severe downturn would occur even in the absence of a GDP decline when there is a strong negative demand shock. The SGP2 would not need particular amendments in front of a modest demand shock or of a supply shock, although in the latter case it would be preferable to inhibit any counterbalancing deficit increase.

The European Commission and the Council would certainly find some empirical difficulties in identifying asymmetric demand and supply shocks in the EU, and they should adopt an harmonised methodology and common data-set in order to be politically accepted by all Member States. To start, my suggestion is to look at the simultaneous movements of three variables, whose statistics are already based on homogeneous standards in the Union: the firms' constraints indicated by the European Business Surveys, the unemployment rate and the harmonised inflation rate.

If, in a given year, in a given country, the latter declines and the unemployment rate rises, while the output demand relative to the capacity firms' constraint exceeds the average trend, there is the presumption that this Member State is then facing a strongly negative demand shock. Had the Commission used this method in November 2003, it would have probably agreed with the Council that Germany (but not France) was deserving a derogation in the excessive deficit procedure. If this method were applied now, the custodians of the Stability and Growth Pact should, on the contrary, very rigorously adopt that procedure without further delays not only with Germany, but also with Italy, Greece and Portugal.

In conclusion, big innovations have been introduced in the 2005 SGP2 relative to the 1997 SGP1. But the question arises: Is it too little, given that the rationale of the Pact is still very imperfect? Is it too late to restore its credibility, severely wounded in November 2003, in front of the deepest institutional crisis of the EU?

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Table 1

Firms' constraints, unemployment and inflation in the euro area (EUR-12) (1985-2005)

	No constraint	Demand constrained	Capacity constrained	Labour supply constrained	Unemployment rate	Inflation rate measured on the private consumption price deflator
	(NO)	(D)	(C)	(LS)	(u)	(Π deflator)*
1985	0.525	0.855	0.097	0.052	9.3	5.7
1986	0.545	0.842	0.100	0.058	9.3	3.4
1987	0.548	0.878	0.080	0.042	9.2	3.0
1988	0.580	0.769	0.155	0.076	8.9	3.3
1989	0.589	0.635	0.230	0.135	8.2	4.6
1990	0.589	0.347	0.418	0.236	7.6	4.4
1991	0.559	0.648	0.197	0.155	7.8	4.9
1992	0.572	0.883	0.060	0.058	8.2	4.4
1993	0.470	0.950	0.028	0.022	10.1	3.8
1994	0.562	0.870	0.073	0.057	10.7	3.1
1995	0.663	0.739	0.170	0.091	10.5	2.6
1996	0.571	0.880	0.078	0.042	10.7	2.1
1997	0.611	0.829	0.099	0.072	10.6	1.7
1998	0.658	0.736	0.144	0.120	10.1	1.1
1999	0.618	0.779	0.125	0.097	9.2	0.8
2000	0.624	0.588	0.211	0.202	8.2	2.5
2001	0.620	0.658	0.137	0.205	7.9	2.4
2002	0.591	0.803	0.109	0.088	8.3	1.9
2003	0.581	0.832	0.113	0.056	8.7	2.0
2004	0.573	0.717	0.226	0.057	8.9	2.0
2005	0.574	0.723	0.221	0.056	8.6	1.9
1985-2005	0.582	0.760	0.146	0.094	9.1	2.9
1997-2005	0.606	0.740	0.154	0.106	8.9	1.8

Table 1 (continued)

Firms' constraints, unemployment and inflation in the European Union (EU-25) (1996-2005)

	No constraint	Demand constrained	Capacity constrained	Labour supply constrained	Unemployment rate	Inflation rate measured on the private consumption price deflator
	(NO)	(D)	(C)	(LS)	(u)	(Π deflator)*
1996	0.482	0.821	0.114	0.061	10.4	2.7
1997	0.508	0.748	0.150	0.102	10.1	2.2
1998	0.546	0.683	0.192	0.125	9.4	1.7
1999	0.518	0.751	0.153	0.096	9.1	1.2
2000	0.522	0.606	0.213	0.181	8.6	2.4
2001	0.523	0.652	0.167	0.181	8.4	2.4
2002	0.490	0.768	0.144	0.088	8.8	1.8
2003	0.484	0.784	0.150	0.066	9.0	2.0
2004	0.469	0.673	0.253	0.074	9.1	1.9
2005	0.468	0.674	0.252	0.075	8.7	1.9
1996-2005	0.484	0.730	0.166	0.104	0.1	0.1
1997-2005	0.503	0.704	0.186	0.110	0.1	0.1

* This inflation rate (Π deflator) has been existing for many years. On the contrary, the inflation rate based on harmonised consumer prices (Π), utilised in the Graphs, has been existing only since 1997 for all the EU Member States, except Malta and Cyprus, therefore ignored in our data-set.

Sources: Commission of the European Communities, *Statistical Annex of European Economy*, Spring 2006; Commission of the European Communities, *European Business Surveys*, various years.

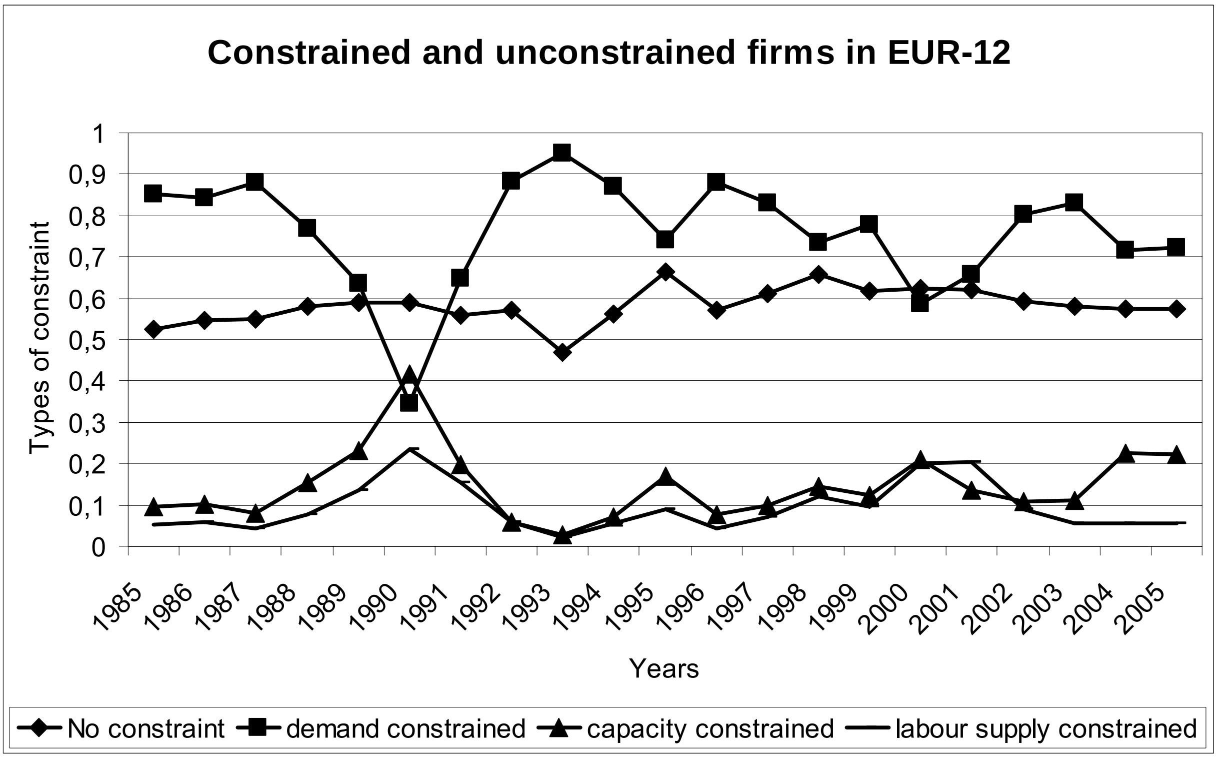
Table 2. : Main changes to the Stability and Growth Pact following the Council agreement of 20 March 2005

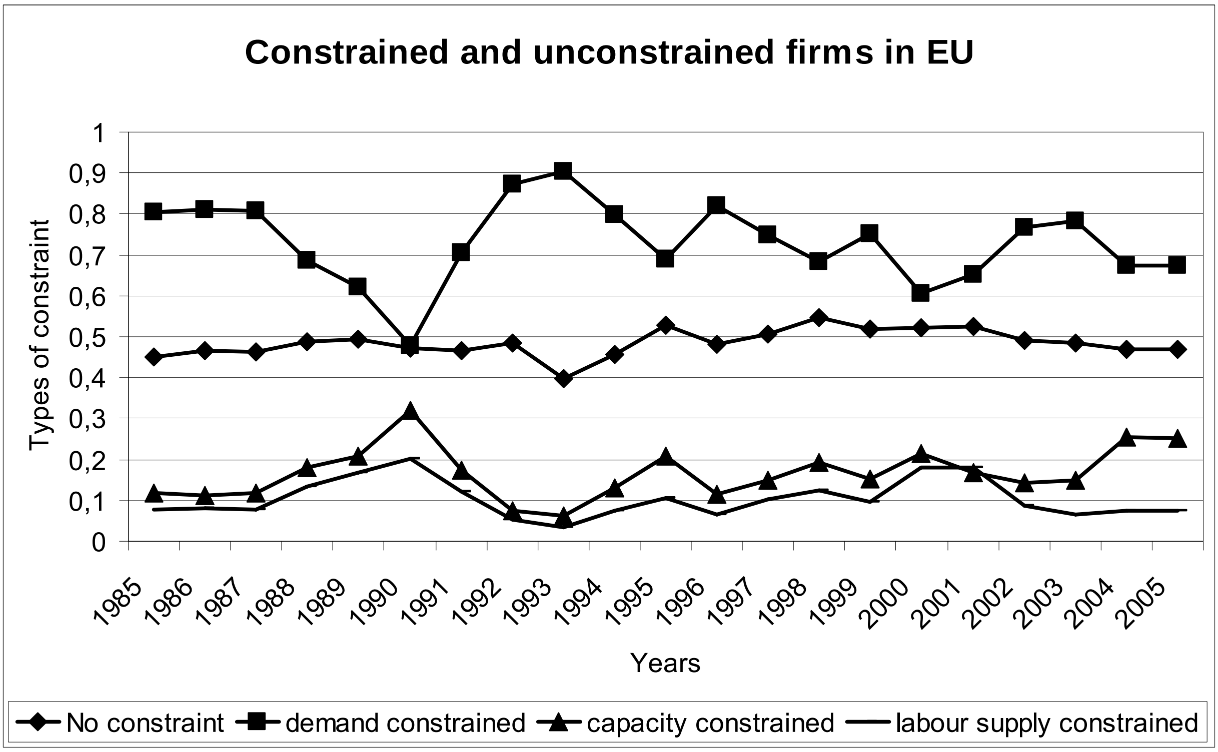
	Original	Revised
1. Changes in the preventive arm		
Medium-term objective (MTO)	All Member States (MS) have a medium-term budgetary objective of 'close to balance or in surplus'.	• Country-specific differentiation of MTOs according to stock of public debt and potential growth. • MTOs for euro-area and ERM II MS are set between –1 % of GDP and balance or in surplus (in cyclically adjusted terms and net of one-offs). • Implicit liabilities to be taken into account at a later stage, when modalities for doing so are agreed by the Council.
Adjustment path towards the MTO	No specific provisions.	• MS to take active steps to achieve the MTO. • Annual minimum adjustment for MS of the euro area or of ERM II of 0.5 % of GDP. • The effort should be higher in 'good times'. • 'Good times' are identified as periods where output exceeds its potential level, 'taking into account tax elasticities'.
Early policy advice	Early warnings are adopted/addressed by the Council, upon recommendation of the Commission.	In addition, the Commission can issue direct 'early policy advice' to encourage MS to stick to their adjustment path. To be replaced by 'early warnings' in accordance with the Constitution once applicable.
Structural reforms	No specific provision.	Reforms will be taken into account when defining the adjustment path to the MTO and may allow a deviation from it under the following conditions: • only major reforms (direct/indirect impact on sustainability); • safety margin to the 3 % reference value is guaranteed; • the deficit returns to the MTO within the programme period; • detailed information is provided in the stability/ convergence programmes. Special attention to systemic pension reforms.
2. Changes in the corrective arm		
Preparing a report under Article 104(3)	No obligation for the Commission to prepare a report if a deficit exceeds 3 %.	• The Commission will always prepare a report in cases where there is a deficit above 3 %. • The report will examine whether the exceptions in Article 104(2) apply. • It will take into account whether the deficit exceeds government investment expenditure and all 'other relevant factors'.
Severe economic downturn	'Severe economic downturn' if there is an annual fall in real GDP of at least 2 % for the preparation of the report under Article 104(3) by the Commission, and in decisions under Article 104(6) by the Council, if observations by the Member State concerned show that the downturn is exceptional in light of evidence of the abruptness of the downturn and the accumulated loss of output with respect to past trends. The MS commit not to invoke the severe economic downturn when growth is above – 0.75 %.	An economic downturn may be considered 'severe' in cases of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth.
'Other relevant factors' (ORFs)	No specific definition of 'ORFs' and their role in the excessive deficit procedure.	The Commission report under Article 104(3) will take into account: - developments in the medium-term economic position (potential growth, cyclical conditions, implementation of

		policies); - developments in the medium-term budgetary position (public investment, quality of public finances, as well as fiscal consolidation in 'good times', debt sustainability); - any other factors, which, in the opinion of the MS, are relevant in order to assess the excess over the reference value. • ORFs will be considered in the steps from Article 104(4) to (6) only if the excess over the reference value is temporary and the deficit remains close to the reference value. Any deficit above 3 % that is neither close to the reference value nor temporary will be considered excessive. • If the Council has decided that an excessive deficit exists, the ORFs will also be onsidered in the subsequent procedural steps of Article 104 (except in Article 104(12), i.e. abrogation, and when deciding to repeat steps in the EDP).
Systemic pension reforms	No specific provision	• These are treated like an ORF, but under strict conditions also with a role in abrogation. • Consideration to the net cost of the reform will be given regressively for the initial five years after an MS has introduced the reform (or five years after 2004).
Increasing the focus on debt and sustainability	No specific provision	• The debt criterion, and in particular the concept of a debt ratio 'sufficiently diminishing and approaching the reference value at a satisfactory pace', will be applied in qualitative terms. • The Council will formulate recommendations on the debt dynamics in its opinions on the stability and convergence programmes.
Extending the deadlines for taking effective action and measures		• Deadlines are extended: for a decision under Article 104(6) — from three to four months after notification; • for taking effective action following Article 104(7) — from four to six months; • for moving to Article 104(9) — from one to two months; • for taking action following a notice under Article 104(9) — from two to four months.
Minimum fiscal effort	No specific provision	Countries in excessive deficit are required to achieve a minimum fiscal effort of at least 0.5 % of GDP as a benchmark.
Initial deadline for correcting the excessive deficit	The excessive deficit has to be corrected in the year following its identification, unless there are 'special circumstances'.	The rule remains; possible extension by one year based on ORFs and on the condition that minimum fiscal efforts have been taken.
Repetition of steps in the EDP	Not foreseen	Deadlines for correcting the excessive deficit can be extended if: • effective action has been taken by the MS concerned in compliance with the initial recommendation or notice, and • unexpected adverse economic events with major unfavourable budgetary effects occur during the correction phase.

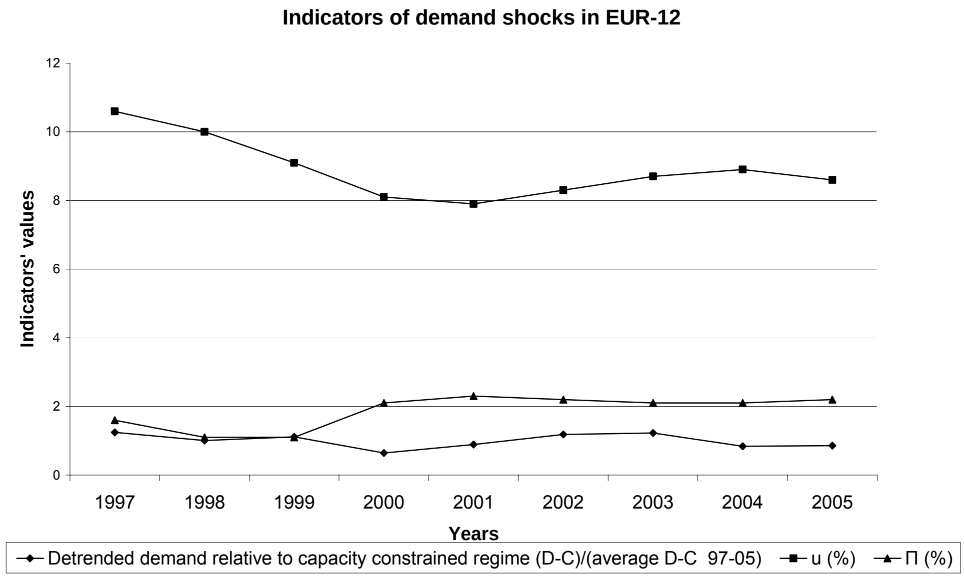
Source: Public Finances in EMU 2005, European Economy, Number 3, 2005

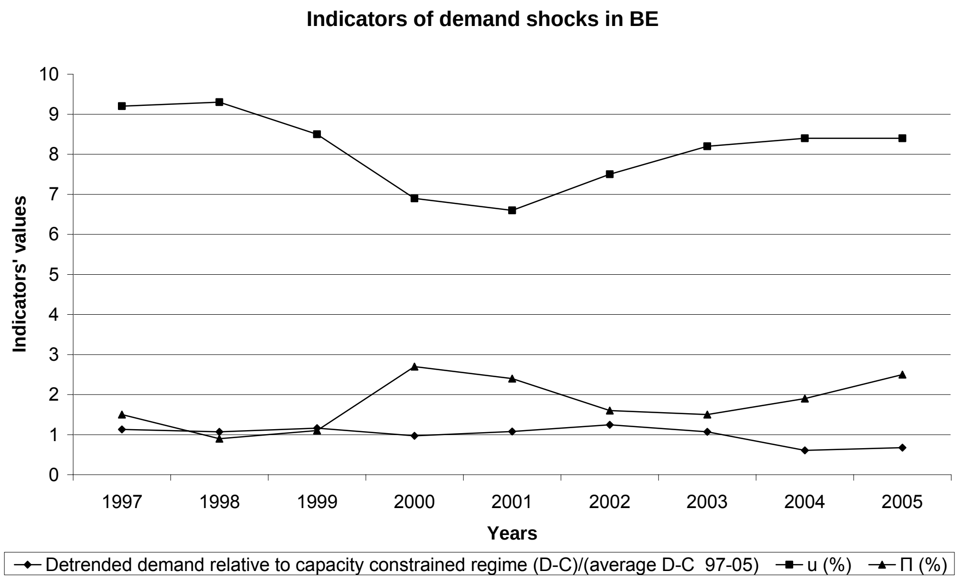
Graph 1

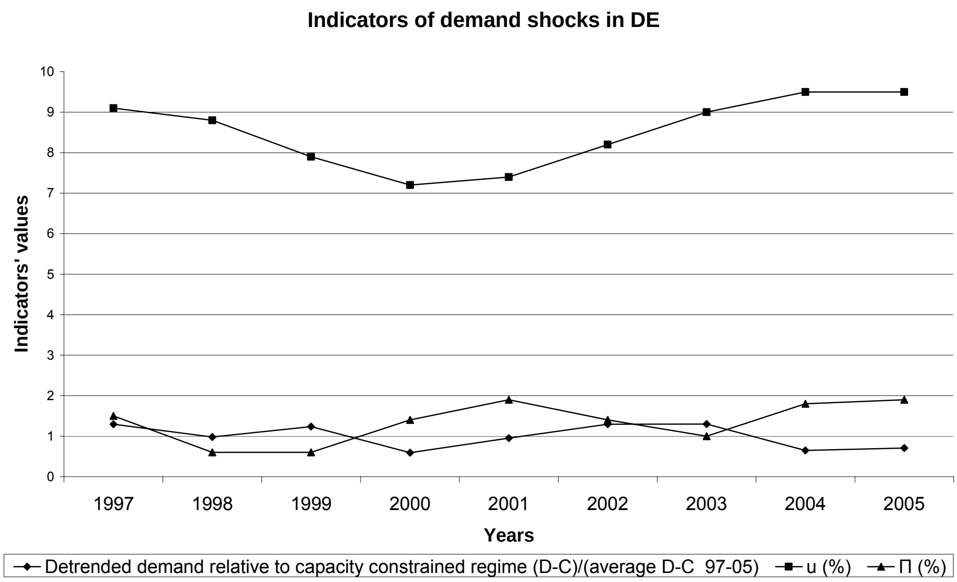

Constrained and unconstrained firms in EUR-12
Types of constraint
1
0,9
0,8
0,7
0,6
0,5
0,4
0,3
0,2
0,1
0
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
No constraint
demand constrained
capacity constrained
labour supply constrained

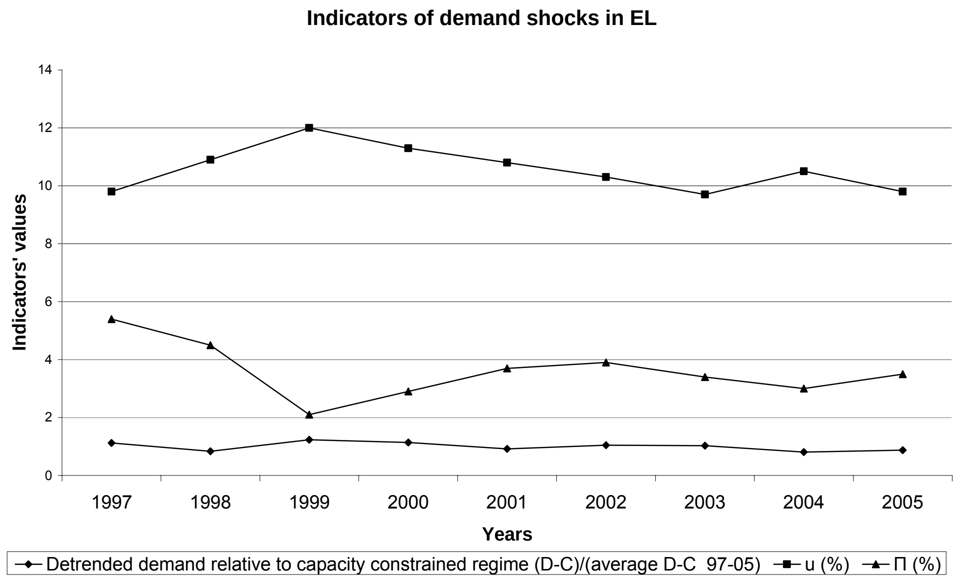

Constrained and unconstrained firms in EU
Types of constraint
1
0,9
0,8
0,7
0,6
0,5
0,4
0,3
0,2
0,1
0
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
No constraint
demand constrained
capacity constrained
labour supply constrained

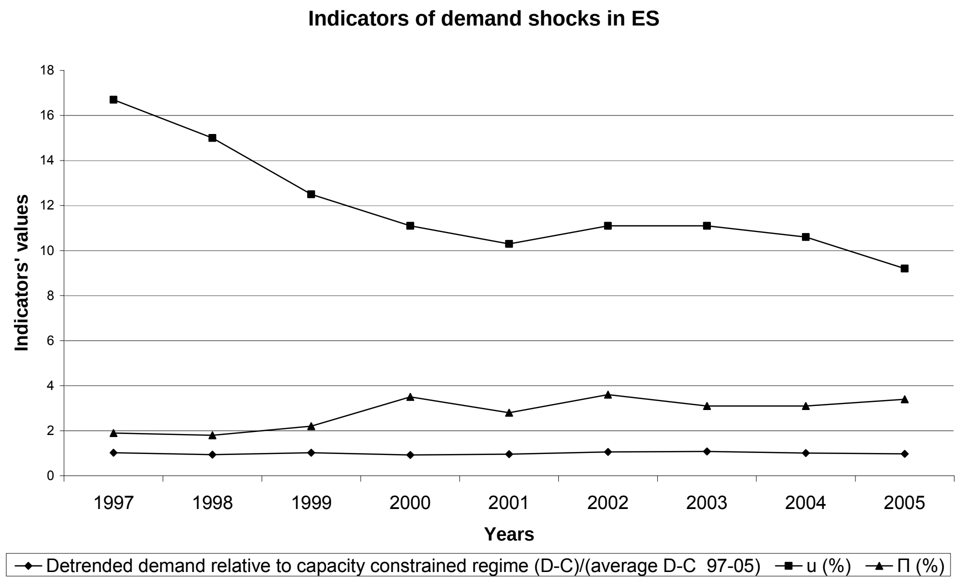
Graph 2

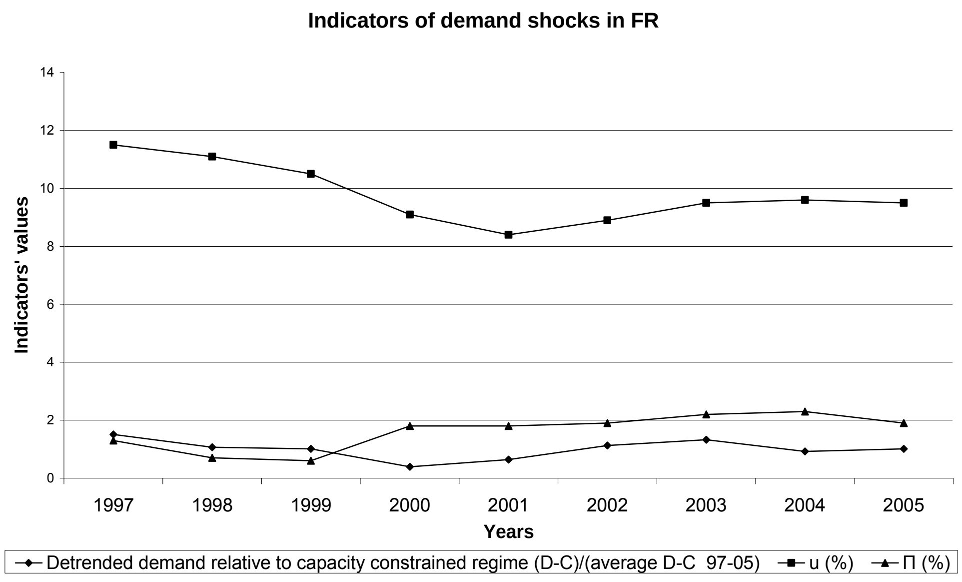

Indicators of demand shocks in EUR-12
Indicators' values
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

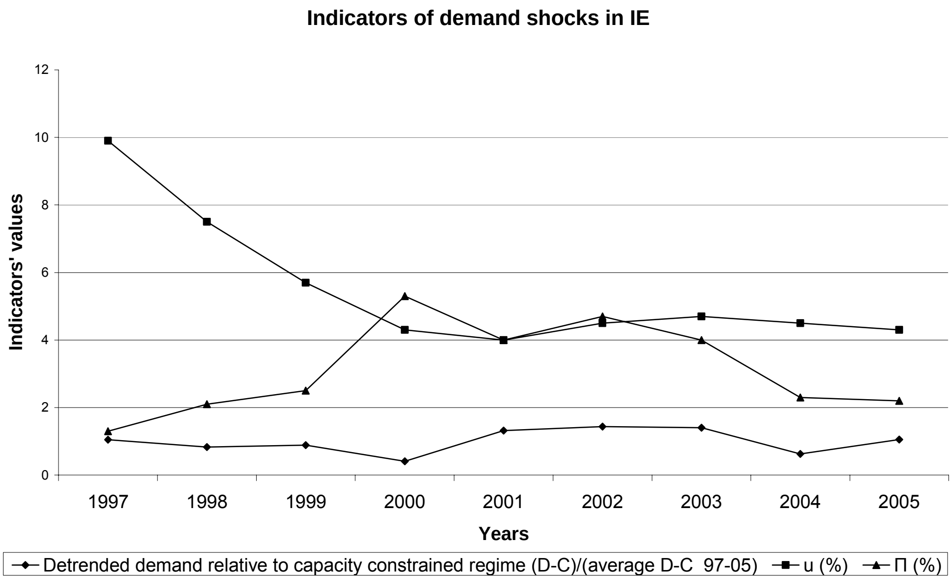

Indicators of demand shocks in BE
Indicators' values
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

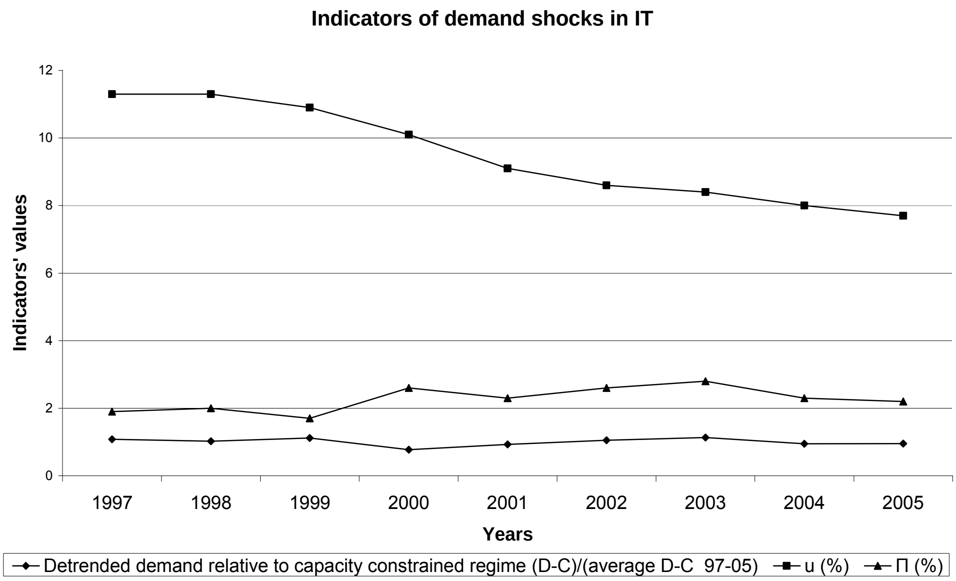

Indicators of demand shocks in DE
Indicators' values
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

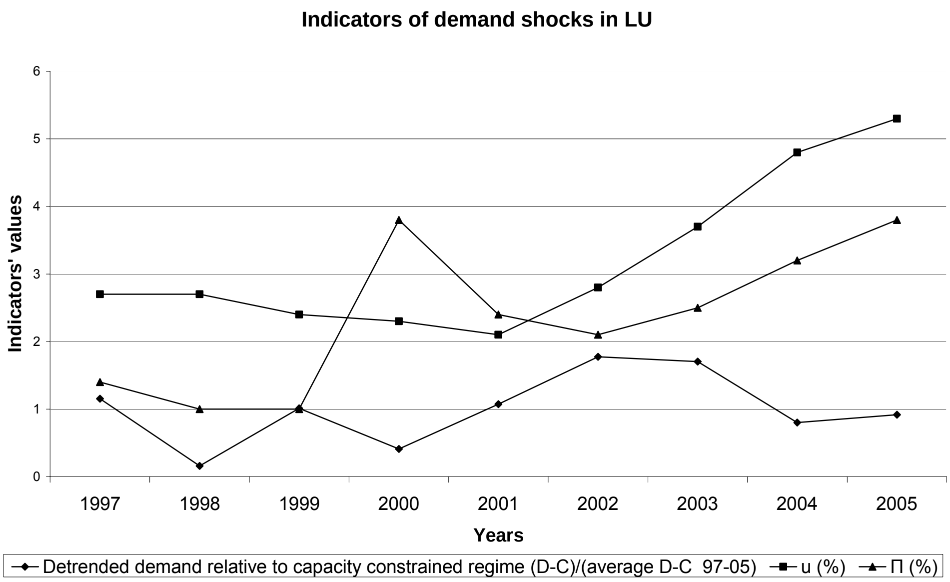

Indicators of demand shocks in EL
Indicators' values
0
2
4
6
8
10
12
14
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

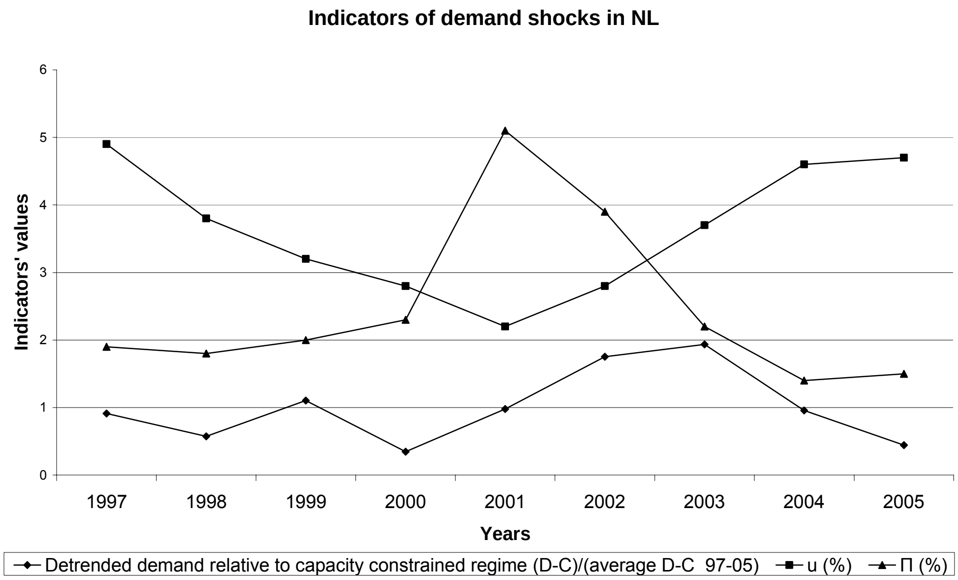

Indicators of demand shocks in ES
Indicators' values
0
2
4
6
8
10
12
14
16
18
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

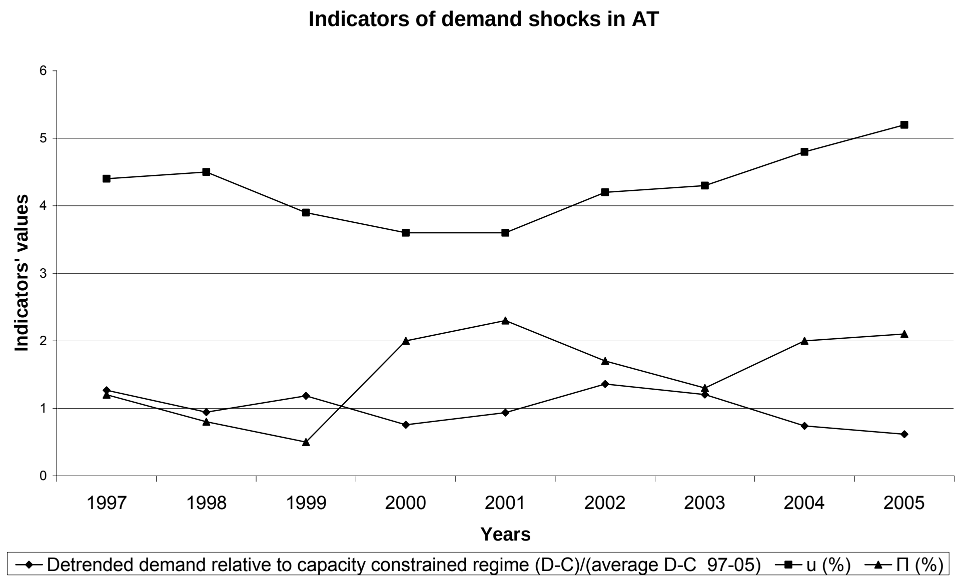

Indicators of demand shocks in FR
Indicators' values
0
2
4
6
8
10
12
14
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

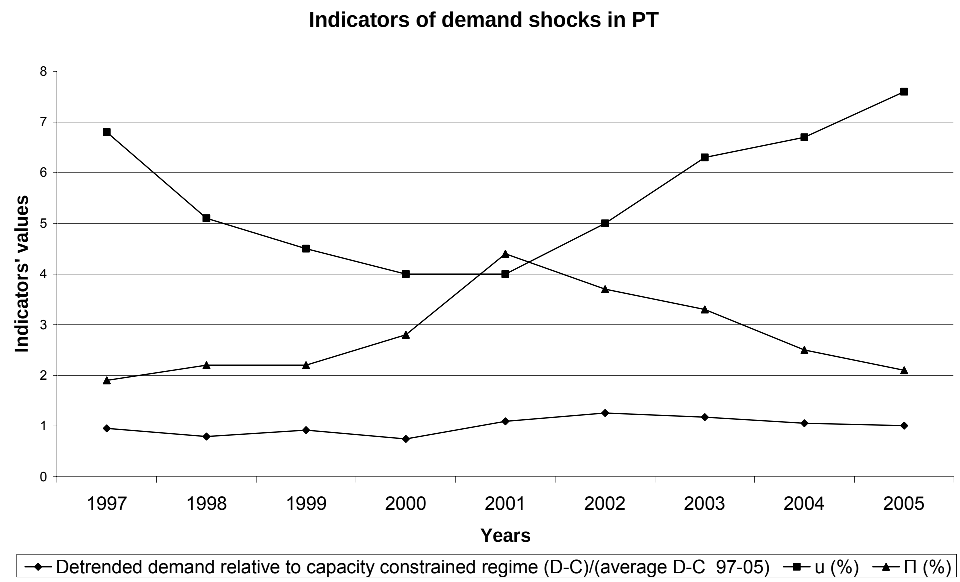

Indicators of demand shocks in IE
Indicators' values
12
10
8
6
4
2
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

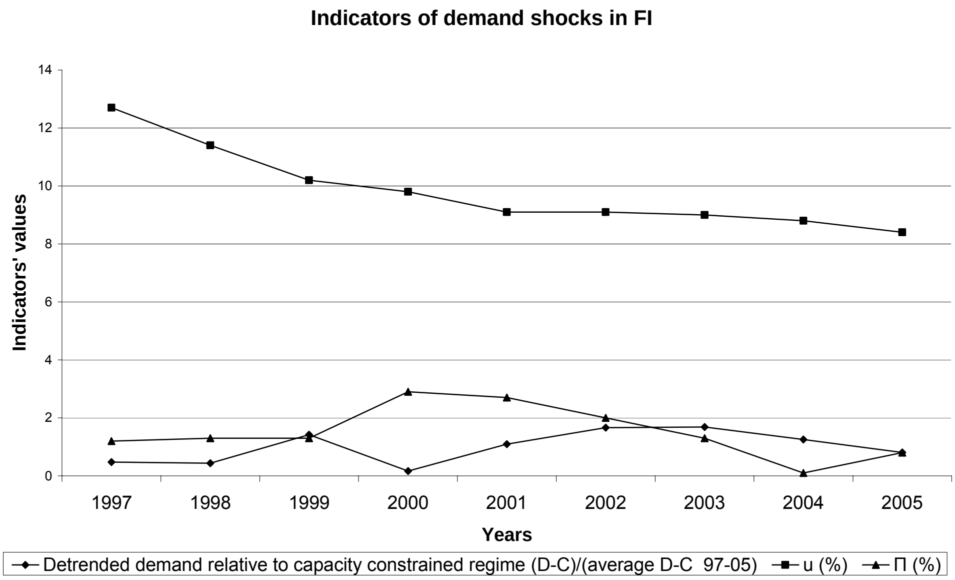

Indicators of demand shocks in IT
Indicators' values
12
10
8
6
4
2
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

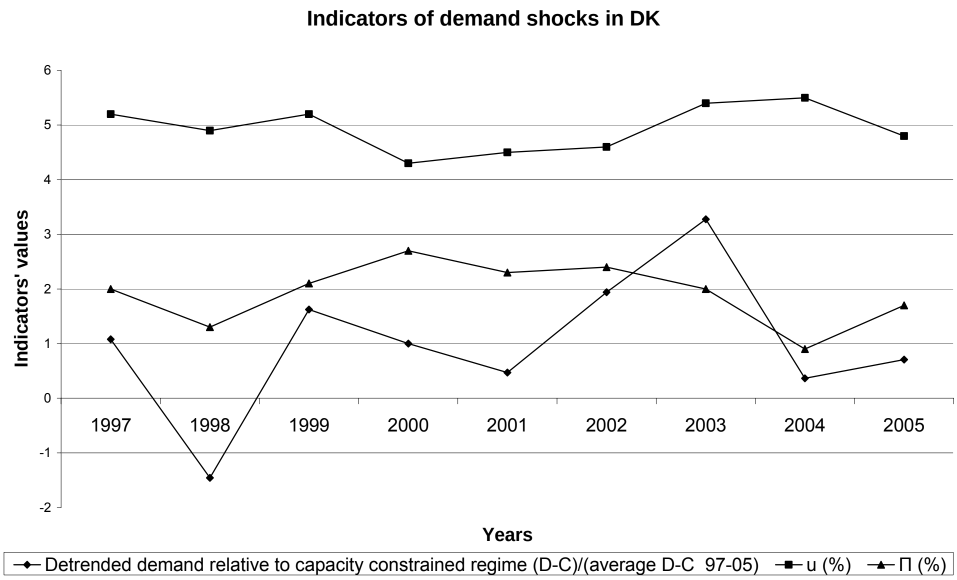

Indicators of demand shocks in LU
Indicators' values
6
5
4
3
2
1
0
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

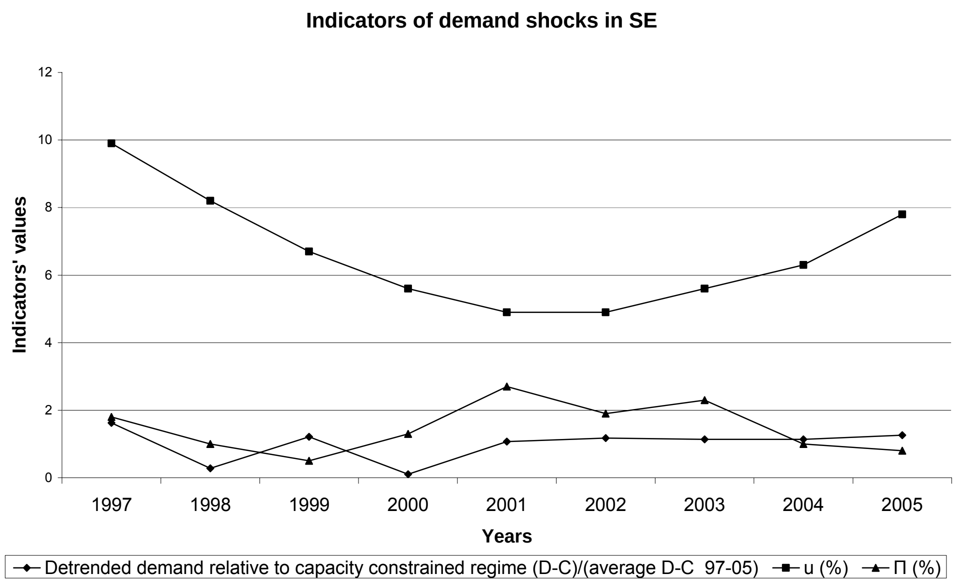

Indicators of demand shocks in NL
Indicators' values
Years
1997 1998 1999 2000 2001 2002 2003 2004 2005
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

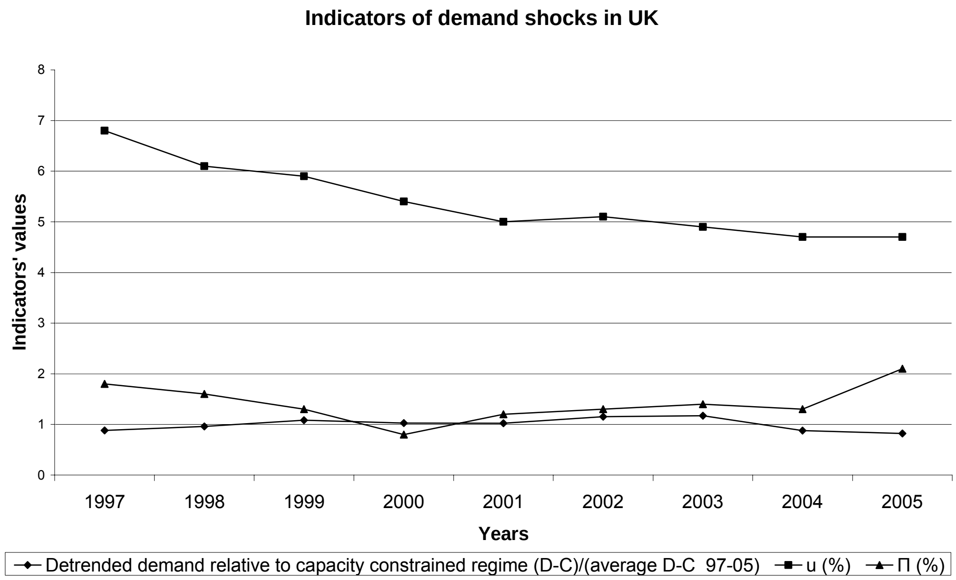

Indicators of demand shocks in AT
Indicators' values
Years
1997 1998 1999 2000 2001 2002 2003 2004 2005
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

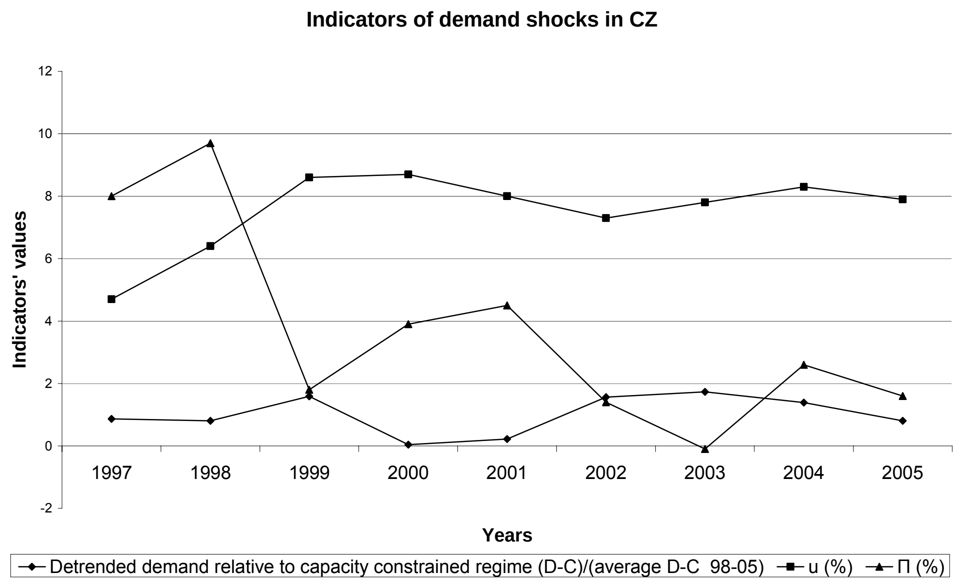

Indicators of demand shocks in PT
Indicators' values
Years
1997 1998 1999 2000 2001 2002 2003 2004 2005
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

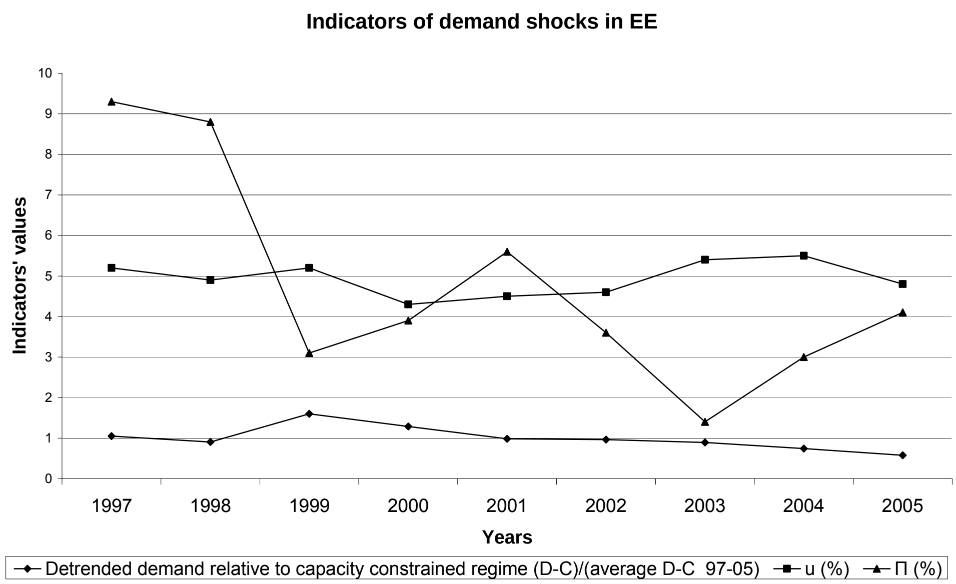

Indicators of demand shocks in FI
Indicators' values
0
2
4
6
8
10
12
14
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

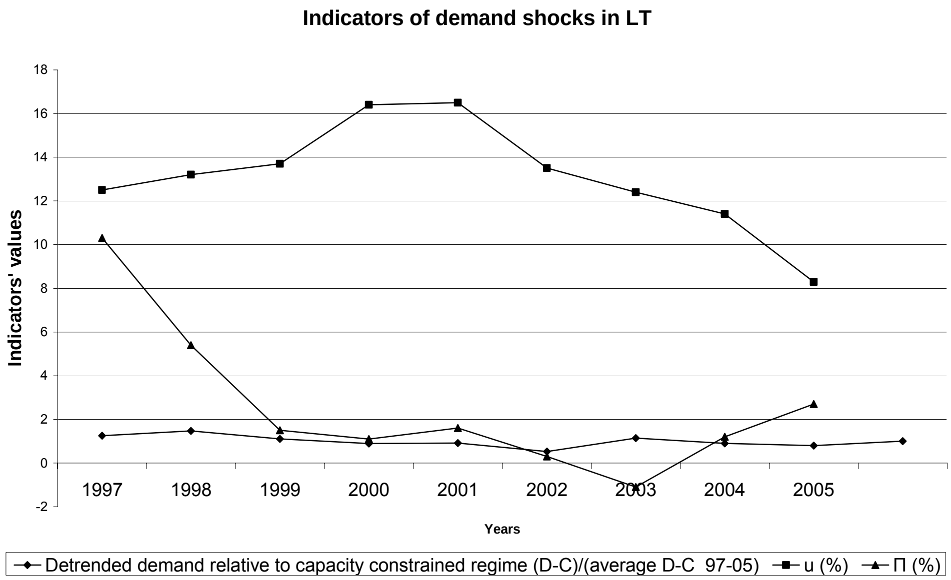

Indicators of demand shocks in DK
Indicators' values
-2
-1
0
1
2
3
4
5
6
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

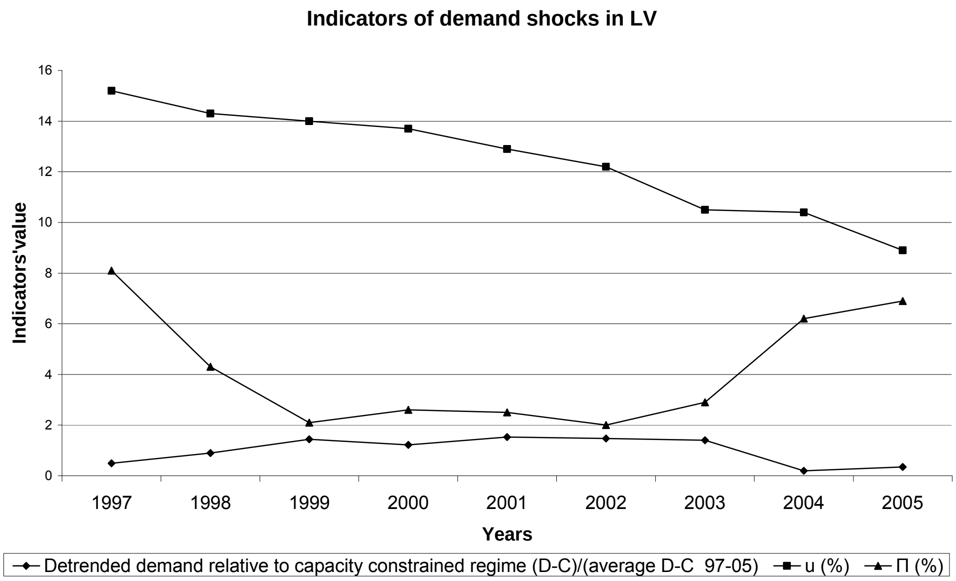

Indicators of demand shocks in SE
Indicators' values
0
2
4
6
8
10
12
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

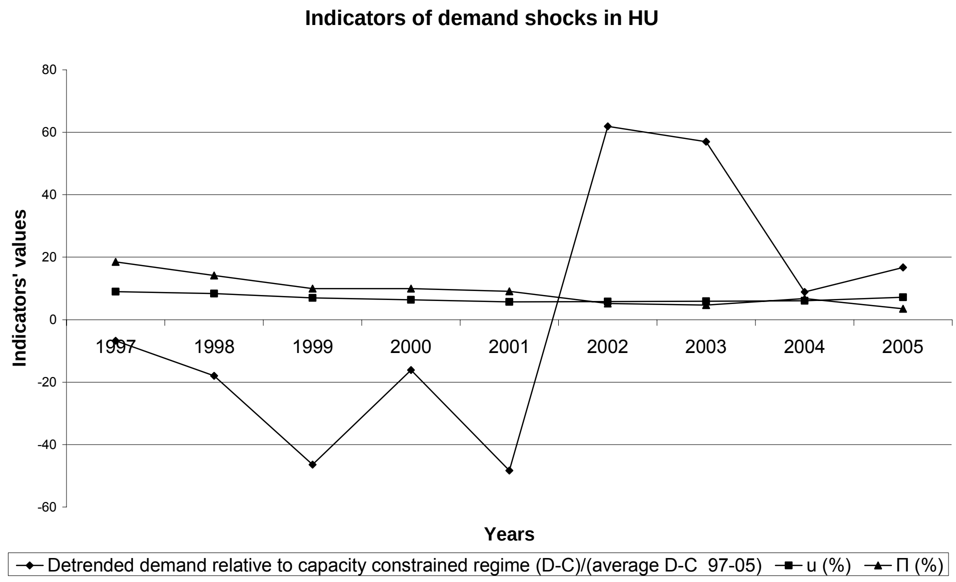

Indicators of demand shocks in UK
Indicators' values
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

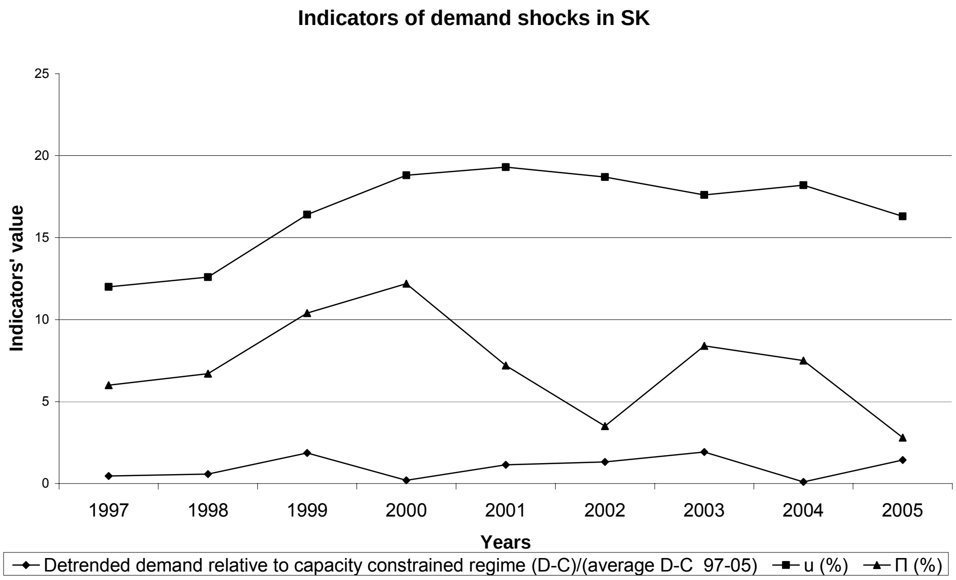

Indicators of demand shocks in CZ
Indicators' values
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 98-05)
u (%)
Π (%)

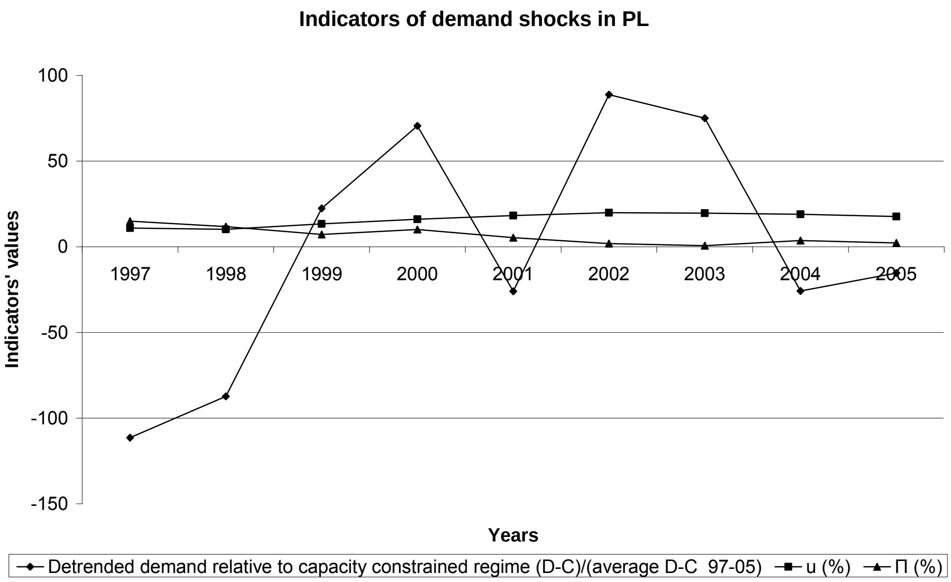

Indicators of demand shocks in EE
Indicators' values
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

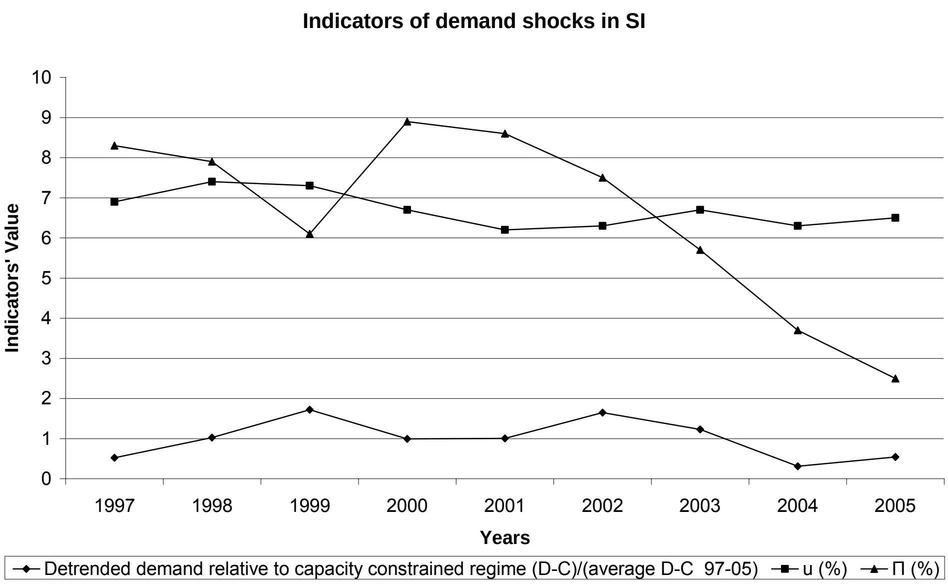

Indicators of demand shocks in LT
Indicators' values
Years
1997
1998
1999
2000
2001
2002
2003
2004
2005
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)

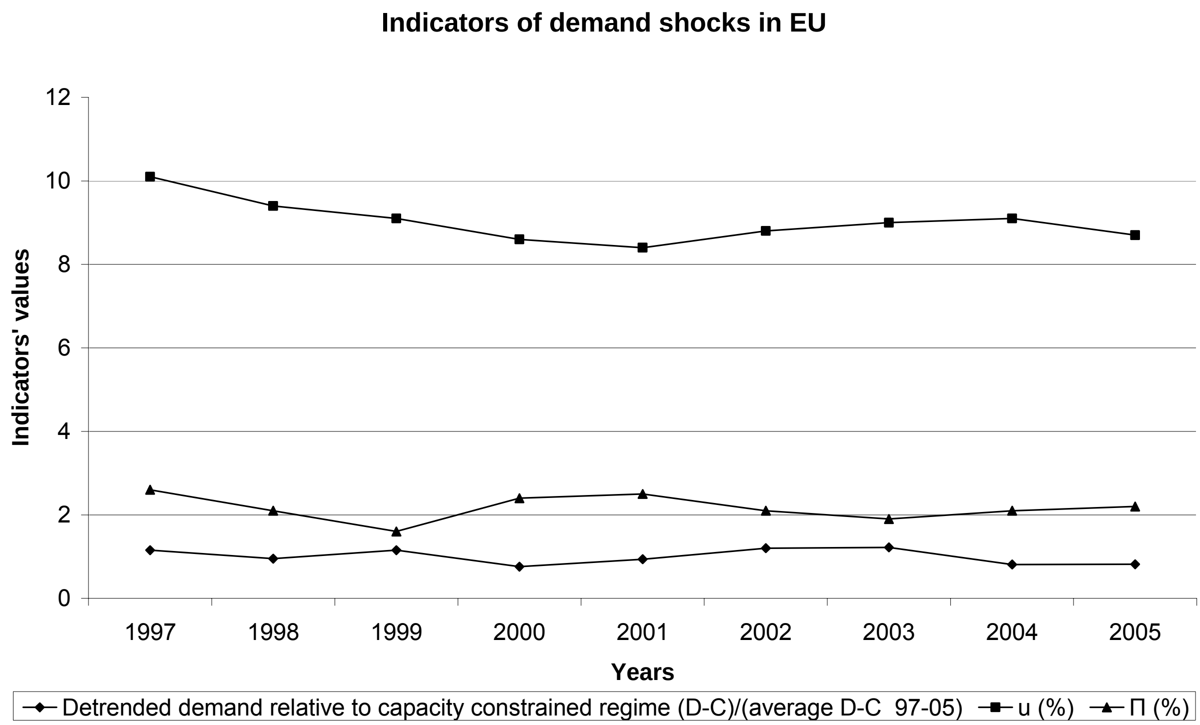

Indicators of demand shocks in LV
Indicators'value
Years
1997
1998
1999
2000
2001
2002
2003
2004
2005
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)


Indicators of demand shocks in HU
Indicators' values
Years
1997
1998
1999
2000
2001
2002
2003
2004
2005
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)


Indicators of demand shocks in SK
25
20
15
10
5
0
Indicators' value
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)


Indicators of demand shocks in PL
100
50
0
-50
-100
-150
Indicators' values
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)


Indicators of demand shocks in SI
10
9
8
7
6
5
4
3
2
1
0
Indicators' Value
1997
1998
1999
2000
2001
2002
2003
2004
2005
Years
Detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05)
u (%)
Π (%)



Sources: For the rate of unemployment (u) Commission of the European Communities, *Statistical Annex of European Economy*, Spring 2006; for the inflation rate based on the harmonised CPI (π), European Central Bank, *Statistics*, various years; for the detrended demand relative to capacity constrained regime (D-C)/(average D-C 97-05), see Commission of the European Communities, *European Business Surveys*, various years.

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