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Panel 4

THE FUTURE OF THE EUROPEAN GROWTH AND STABILITY PACT

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Introduction

In its short life, the Stability Pact has accomplished many good things. It has reminded governments to avoid policies that can jeopardize financial stability. It has signaled that the euro area takes seriously its commitment to a sound and stable currency. It has given the European Commission an opportunity to remind governments that the greying of populations implies the need to start saving more.

But it is important to recognize that the pact is now on life support. France and Germany, the two large countries at the heart of Europe, are both violating its strictures. While they have made significant progress in the direction of fiscal consolidation, they now show signs of reform fatigue. Their deficits having remained too close to the 3 percent reference value during the period of expansion, they now threaten to breach that ceiling in the current slowdown unless governments raise taxes and cut public spending at the worst possible macroeconomic time.

In principle, of course, the 3 percent reference value leaves adequate room for Europe's automatic fiscal stabilizers to operate if countries keep their deficits close to zero, or preferably in slight surplus, in expansions. So what is the problem? It is not only that some European governments have not displayed the discipline needed to keep their budgets at or close to balance during expansions; it is that, given the structure of their budgetary processes, there is reason to worry that they may fail to do so again. This explains why officials continue to attach such importance to the mutual surveillance of fiscal policies in expansions and also why the 3 percent ceiling is problematic in slowdowns.

It is no coincidence, then, that the recent flurry of suggestions for revising the Stability Pact coincided with an economic slowdown. Proposals range from abolishing the pact, to cyclically adjusting the 3 percent ceiling (equivalently, keying it to the constant employment budget balance), to exempting public investment, to shifting from a deficit ceiling to a public debt ceiling. I will not say more about abolishing the Stability Pact. Among other things, the fact that Europe has committed to the pact makes it difficult to abandon it in midstream without sending a negative signal to the markets.

Unfortunately, existing reform proposals all have a weakness in common with the existing pact. They all focus on numerical reference values for debts and deficits, whether cyclically adjusted or unadjusted, whether inclusive or exclusive of defense and public investment spending, whether for debts or deficits. These numerical values are arbitrary. They have no clear economic rationale. There is no a priori reason to think that dire economic consequences will follow if the 3 percent rule is violated or that all will be well if the deficit comes in below 3 percent. This numerical threshold is not well grounded in theory. Whether it implies a sustainable public debt depends on the real interest rate, the real growth rate, and other variables that vary over time – unlike the 3 percent reference value, which is set in stone.

It is this fact – that the 3 percent ceiling is arbitrary, capricious, and not grounded in a clear conceptual framework – that robs it of political legitimacy and explains why member states and their constituents are able to resist the Commission when the latter attempts to enforce it. They can always say "We are a fast growing accession economy with high real growth rates and low real interest rates; hence a deficit in excess of 3 percent does not imply the

same problems of debt sustainability as for other countries." Or "We have fewer unfunded pension liabilities than other countries; there is therefore no reason to be worried about this year's 3 percent deficit." These and other arguments are credible. An arbitrary 3 percent ceiling is not.

The argument, then, is that the Stability Pact as currently configured can never be efficient and legitimate: if enforced, it will not have the desired effect of preventing chronic deficits without interfering with the normal operation of automatic fiscal stabilizers and sensible discretionary fiscal policies, and consequently it is unlikely to ever garner the political support necessary to be enforced. Reform schemes which simply replace one set of arbitrary numbers with another set of arbitrary numbers will not be seen as any more legitimate or enforceable.

An Institutional Alternative

These problems can be solved if the pact is reformed to focus on fundamental fiscal institutions rather than transitory fiscal outcomes. Specifically, the EU should design an index of institutional reform with a point each for pension reform, unemployment and disability insurance reform, and revenue sharing reform. Countries receiving three points would be exempt from the pact's guidelines, since there is no reason to expect that they will be prone to chronic deficits. In contrast, the others, with weak institutions rendering them susceptible to chronic deficits, would still be subject to the pact's warnings, sanctions, and fines.

One can imagine various objections to this proposal.

- *Selective exemptions are not politically acceptable.* It might be argued that European countries will never agree to differential treatment – to a situation where some countries are subject to the Stability Pact while others are exempt. However, there is a sense in which this is precisely what the Commission's recent reform already proposes to do – that is, to apply the pact differentially to countries with and without sustainability concerns. My proposal is simply to recognize this decision and give it legitimacy by defining clearly and precisely the criteria that will be used in determining which countries are exempt. This is more transparent and objective than leaving the decision of whose debts are "sustainable" to the discretion of the Commission.
- *An institutional index would be less credible.* It can be argued that an index of fiscal institutions would be less transparent, less easily monitored, and therefore less credible than a 3 percent reference value for the consolidated budget deficit. The appeal of simple rules is that they are easily verified and, other things equal, easily enforced. And what could be more simple than a 3 percent ceiling for deficits? The problem is that simple rules that bear little relationship to the ultimate goals of policy are too simple. They can be so misleading as to be unenforceable when push comes to shove. Consider the following analogy. Once upon a time central banks were instructed to adopt a fixed growth of the M1 money stock rule to guide their policy. An unchanging 3-percent-a-year-rate-of-growth rule for the money supply is the ultimate simple rule, but in practice it was too simple to be efficient or practicable. Central banks have therefore gravitated toward a more complex inflation-targeting rule, where they consider the relevance of a range of different variables for observed policy outcomes. Simplicity may be a virtue, other things equal, but other things are not always equal.
- *An index of fiscal institutions would be too difficult to calculate.* In fact, economists have considerable experience in constructing simple quantitative measures of the relevant fiscal institutions precisely in order to show that these are robustly correlated with observed fiscal outcomes. And the question, in any case, is whether these institutional measures would be harder to calculate than the deficit ratio that is currently the focus of the Stability Pact. In this connection we should not overlook the ability of governments to fudge their fiscal accounts. Recall Italy's budget deficit in 1997, or more recent restatements of the Portuguese public accounts. And remember that any problems that the opacity of these countries' accounts has created for Eurostat will be dwarfed by problems of statistical disclosure, coverage, timeliness and reliability in the accession economies. My institutional indices may be disputable, in other words, but what about your deficit figures? Are measures of the adequacy of fiscal institutions really that much more difficult to calculate than accurate and economically meaningful deficit figures that include estimates

of, inter alia, unfunded future pension liabilities, which are totally neglected by conventional budgetary accounting? Are they really more problematic than calculations of cyclically adjusted deficits based on questionable estimates of the output gap, or forecasts of debt sustainability predicated on forecasts of growth rates, interest rates, etc.?

- *The appropriate fiscal institutions are context specific.* What fiscal institutions help to avoid a bias toward excessive deficits may change over time, or they may be context specific, rendering it a mistake to codify them. But permitting the politicians and officials responsible for the Stability Pact to alter the index of budgetary institutions would open the door to lobbying and backroom deal-making. I therefore propose creating an independent committee of fiscal policy experts to define the index. (It may or may not be desirable for the members of that committee to also rate member states' compliance; I have an open mind on this question.)
- *Such a powerful independent committee would not be politically acceptable.* In fact, this committee would have much more limited powers than the one Ricardo Hausmann, Jurgen von Hagen and I (1999) recommended for Latin American countries some years back, or that suggested by Charles Wyplosz (2002) and Simon Wren-Lewis (2000). Recall that the Eichengreen-Hausmann-von Hagen proposal was for an independent committee with the power to determine the deficit, presumably with cyclical conditions in mind, the idea being that countries with very serious political distortions should delegate the power to make this decision. But political distortions are not so severe in Europe as in Latin America; hence European countries do not require such radical measures. Under my proposal for reforming the Stability Pact, the power to decide the size of the deficit would still rest with national politicians and officials. The committee would only decide on the criteria determining whether or not a country was subject to the 3 percent limit. In effect, my committee would have much more limited powers than, *inter alia,* the Board of the European Central Bank.

How would such a committee be appointed? It would be important to avoid a system where each country appointed a member who then became an advocate of that country's fiscal institutions. Better would be to emulate the Executive Board of the ECB, which is made up of members at large who are prohibited from taking instructions from their national governments. Appointees should serve reasonably long terms in office and not be eligible for reappointment to prevent them from being partial to their friends in government. Making the Commission rather than the Council responsible for their appointment might be considered as a way of further loosening the link with national governments.

Finally, there is the objection that countries would not tolerate having a committee of the EU prescribe the structure of their fiscal institutions. As Buti, Eijffinger and Franco (2002, p. 15) put it, "the adoption of harmonized budgetary procedures would raise fundamental problems from the point of view of national sovereignty and might conflict with national institutions and traditions." But no one is talking about harmonized institutions. My committee would not have the power to make a country to modify its institutions. If countries prefer institutional arrangements that have proven to be conducive to chronic deficits in other times and places, they would be free to adopt them. They would then be subject to the surveillance and reference values of the Stability Pact, of course, but if they were able to keep their deficits below 3 percent, contrary to the experience of other countries with similar institutions, they would not be subject to fines, non-interest-bearing deposits, or warnings. And, if they kept their budgets near balance or in surplus in normal times, there would be room for their automatic stabilizers to operate.

While this proposal might seem radical, in fact it is not unlike procedures already followed by commercial rating agencies. The rating agencies assign numerical ratings (or their alphabetic equivalent) to countries on the basis of a combination of quantitative and qualitative inputs, including information about the structure and efficiency of their institutional arrangements. In other words, the rating agencies already consider institutions. They have not found it impossible to translate information about them into numerical indices on which banks, pension funds and other market participants already base economically consequential decisions. Questions can be raised about the efficiency with which commercial ratings predict future economic problems, of course, but the same can be said about the EU's current procedures, and in particular

about the Stability Pact's crude numerical ceilings. In comparison with the SGP, the procedure I propose should be more information efficient, in the sense that it would take a broader range of economic, financial and institutional variables into account.

With EU enlargement, an even greater premium will be placed on flexibility and structural reform. As Buti, Eijffinger and Franco note, the tradeoff between simplicity and flexibility will shift with enlargement of the EU and its monetary union. As the euro area is enlarged to include accession economies with very different real interest rates (reflecting common nominal interest rates in conjunction with different inflation rates due to the operation of the Balassa-Samuelson effect) and different growth rates (reflecting the scope for catch-up growth in the new members), the uniform 3 and 60 percent reference values will be even less suitable to the members as a whole. To the extent that the need for structural reform is especially urgent in the accession economies, a reformed SGP that focused directly on this desiderata would become all the more desirable.

Von Hagen (1998) makes a similar point when he observes that small countries tend to rely on numerical limits on deficit spending while large ones tend to rely on procedural rules. Numerical limits are simple to administer, and in small, homogeneous countries that simplicity presumably comes with few associated costs. In contrast, large countries encompass local economies with different economic structures that are subject to different economic conditions; simple rules that make no allowance for those differences tend to result in inefficient outcomes, leading these countries to opt for more flexible procedures that better accommodate the heterogeneity of their parts. The EU is a very large, heterogeneous entity in the relevant economic sense. Complaints that the numerically-oriented Stability and Growth Pact has fitted its very different members to a single fiscal strait jacket is a manifestation of this fact. It will become even larger and more heterogenous in 2004.

As always, the proof of the pudding is in the eating. The table below therefore constructs a provisional ranking of European countries according to my index. Column 1 denies one point to countries whose public pension expenditures to persons over 55 years in age are projected to rise by at least

Who would be exempt from sanctions and fines?
(3 points indicate exemption)

Country	Criterion		
	Limited future pension liabilities	Appropriate fiscal institutions	Adequate labor market reforms
Belgium	1	1	1
Denmark	0	0	1
Germany	1	0	0
Greece	1	1	0
Spain	1	0	0
France	0	1	0
Ireland	1	1	1
Italy	1	1	0
Luxembourg	1	1	1
Netherlands	0	0	1
Austria	1	1	1
Portugal	0	0	0
Finland	1	0	1
Sweden	1	0	1
UK	1	1	1

Source: See text.

1 percent of GDP between 2000 and 2010. Denmark, France, the Netherlands, and Portugal are the problem countries.[1]

Column 2 gives a point to countries which use either targets or delegation to limit the common pool problems and deficit bias that arise from decentralized spending decisions. The binary indicators used here are drawn from Hallerberg, Strauch and von Hagen (2001), who show that countries that either delegate spending decisions to a strong finance minister or use targets at the national level to constrain spending, generally adjust more quickly to disturbances and display less deficit bias than countries where neither device is used. I assign a point either when the finance minister has significant agenda setting and veto powers in at least three of the four stages of the budgetary implementation process distinguished by Hallerberg, Strauch and von Hagen, or when there are formal rules requiring specific forms of adjustment to shocks in at least three of the four cases considered by these authors.

Column 3 gives a point to countries that have taken significant steps to enhance labor market flexibility by reducing hiring and firing costs and facilitating temporary employment. It is based on the composite indicator constructed by Nicoletti,

[1] Note that this list includes one country, Denmark, that European Commission (2002) applauds for its sustainable public finances and in particular for its explicit objective of running budget deficits over the coming decade. There is no contradiction; the increase in pension liabilities does not imply unsustainable finances, only that the country cannot afford to run large budget deficits as those liabilities come due, and that it should be subject to the SGP if its deficits suddenly widen.

Sarpetta and Boyland (1999) for 1998 on the basis of 15 detailed indicators. These include measures of the burden of procedural requirements that must be followed in order to lay off permanent workers, notice and severance pay requirements, penalties for unfair dismissals, and limits on the use of temporary contracts. Countries receive a point if they having a rating of 2.5 or less on Nicoletti, Scarpetta and Boyland's 6 point scale (where higher values indicate more restrictions). It will be seen that the resulting binary indicators map fairly neatly into conventional understandings of which countries have done the most extensive labor market reform.

These calculations suggest that Belgium, Ireland, Luxembourg, Austria, and the UK would be exempted from the numerical ceilings of the Stability Pact under my proposal. Other member states, in contrast, would still be subject to existing EU procedures. In particular, the four large countries of the continent – France, Germany, Italy and Spain – would still be subject to the warnings, non-interest-bearing deposits and fines of the Stability Pact, given the shortcomings of their institutional reform programs. Some might draw from this the conclusion that the reform I suggest here is a political non-starter. Perhaps, but these countries are already subject to the warnings, non-interest-bearing deposits and fines of the existing pact. It is not clear that they should be even less happy about the institutional alternative I propose.

Conclusion

In this paper I have argued that Europe would be best served by focusing on the fundamental problems for fiscal policy – public enterprises that are too big to fail, unfunded public pension schemes that are too big to ignore, inefficient and costly labor market and social welfare programs, and budget making institutions that create common pool and free-rider problems – rather than on arbitrary numerical indicators like whether the budget deficit is above or below 3 percent of GDP. So long as Europe continues to focus on "reference values" for fiscal policy that are only very loosely related to the central problem of chronic budget deficits, and that are prone to interfere with the efficient setting of fiscal balances when chronic deficits are not a problem, the Stability Pact will never be regarded as legitimate; consequently, it will never be rigorously enforced. Better would be to reorient the pact toward the institutional weaknesses that in fact create the danger of chronic deficits and that should be the focus of policy makers' concern. By now, the double meaning of my title should be clear. Not only are institutions important for fiscal stability, but, in addition, institutions should be the focus of the revised Stability Pact.

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The Stability and Growth Pact: An Asset Rather than a Liability

Introduction

The Stability and Growth Pact (SGP) is a central component of the macroeconomic policy framework of the European Union. Since last year, the Pact has been severely tested as a number of European countries have been facing difficulties in complying with its rules during the economic slowdown. Partly because of these developments, the Pact has been subject to strong criticism from some policy-makers, academics and commentators. According to its critics, the Pact is unnecessarily rigid, especially during times of economic downturn, and limits the ability of fiscal authorities to stabilise aggregate demand and/or to finance structural reforms and public investment to expand aggregate supply. In other words, the Pact is accused of »choking« economic growth in Europe at a time when fiscal policy is actively employed to support economic activity and long-term growth in the United States. Some of the critics renewed earlier calls to abolish the Pact. Others, who accept the usefulness of the Pact, focused their criticism on certain features and implementation modalities, and proposed a more flexible and prudent interpretation of the Pact and application of its rules. A general point that is made, linked to the previous arguments, is that the credibility of the Pact is undermined by the fact that some of the larger EU Member States, which should be the engines of economic growth in Europe, are currently facing severe policy constraints as a result of the Pact's rules.

Reacting to the fiscal strains and associated criticisms, the European Commission made proposals in November 2002, which were aimed at strengthening the co-ordination of budgetary policies. In March 2003, the European Council endorsed a report which had been adopted earlier by the ECOFIN Council in response to the Commission's proposals.

In this presentation, I will address some of the criticisms levelled against the Pact and try to assess its effectiveness in contributing to the attainment of the Union's economic policy objectives, also in the light of the recently endorsed report by the EU Council. I will focus on three questions that are pivotal for assessing the usefulness and effectiveness of the Pact. First, are the fiscal rules of the Pact necessary to secure sound and sustainable public finances in the European Union? Second, if the answer is positive, as I believe it should be, are the specific parameters of the Pact's policy framework appropriate and its implementation procedures and enforcement mechanisms effective for achieving its objectives? Finally, does the Pact impair the ability of Member States to conduct effectively fiscal stabilisation policy? As the overall theme of this Munich Economic Summit is to assess to which extent the European economy can match the United States, I will draw some parallels between the Stability and Growth Pact and fiscal rules at the state level in the United States, fully acknowledging the caveats of such a comparison.

Does the European Union need fiscal rules?

Let me start by addressing the question whether the European Union, and in particular the euro area, needs fiscal rules. Most economists and policy makers agree that fiscal discipline and sound public finances are conducive to sustainable economic growth and social welfare. Sound public finances contribute to maintaining a stable macroeconomic environment, allowing all economic actors to take decisions, be it consumption or investment decisions, without being hindered by distortions in the functioning of the economy, caused by the threat of tax increases or ad hoc fiscal measures, crowding out of private investments or relatively high real interest rates, which might all be the consequences of unsustainable fiscal

policies. Moreover, as a central banker, I can, of course, not neglect the importance of fiscal discipline for maintaining price stability over the medium and longer run. For instance, large fiscal deficits can adversely affect inflation through an undue increase in demand or the need to correct these deficits by means of tax increases, thereby complicating the task of central banks aiming for price stability. More recently, the need for fiscal consolidation and sound public finances has become intrinsically linked to demographic developments and their implications for the non-funded liabilities of pension systems. The ageing of the population, which is expected to reach its peak in the middle of this century, will ceteris paribus imply a substantial increase in public expenditures for health care, pensions and social security. There is some evidence that the impact of the ageing of the population is, already now, felt by a number of countries, both in and outside Europe.

Economists do not agree on how to precisely define and make "operational" the concept of fiscal discipline. The Stability and Growth Pact defines fiscal discipline as the obligation to pursue – over the medium term – a balanced budget or a surplus. It cannot be derived from economic theory that countries should always pursue a balanced budget (and this is not exactly what the Pact prescribes). However, from a political-economy point of view, such a rule seems to make sense, as it provides a credible anchor for fiscal policy makers.

There is also less unanimity among economists and policy makers whether imposing fiscal rules on policy makers is necessary for ensuring sound public finances. Some claim that governments running unsustainable public deficits or debts will be forced by financial markets to adjust their policies, as markets eventually will no longer be willing to finance these deficits and debts. However, experience has shown that financial markets are not always the best judge of fiscal authorities' abilities to ensure fiscal discipline. Markets, more often than we would expect, react too little or too late to imprudent and unsustainable fiscal policies, allowing the gradual build-up of large imbalances, the correction of which is often abrupt and painful, both in economic and social terms. Hence, there are arguments supported by evidence that a set of fiscal rules may be necessary to ensure fiscal discipline, at least in some countries where budgetary institutions are inadequate and where short-term political considerations tend to outweigh long-term budgetary objectives.

In the context of a monetary union, such as the euro area, the adoption of fiscal rules becomes indispensable. In a monetary union, the spillovers from unsustainable fiscal policies from one member of the union to another are potentially much larger than in an environment of flexible or adjustable exchange rates. To conclude, fiscal discipline is beneficial for the European Union and the euro area. To ensure such discipline in the Union, where the responsibility for the conduct of fiscal policy is decentralised, requires the imposition of a set of rules.

Is the Stability and Growth Pact framework appropriately specified?

This automatically leads me to the second issue I should like to address, i.e. the extent to which the framework of the Stability and Growth Pact is adequately specified. Indeed, as I have already referred to, it is important to distinguish between the objectives and underlying principles of the Stability and Growth Pact, being the maintenance of sound public finances – in particular running balanced budgets or surpluses in the medium term – and the parameters and modalities of the Pact, that is the set of rules and implementation procedures that aim to ensure the achievement of its objectives. Indeed, some critics, who accept the usefulness of the Pact but regard it as too rigid, have argued that the Pact would require greater parametric variability. At the moment, the rules are identical for all countries, although circumstances, such as economic structures, the size of the public debt and the potential fall-out of demographic developments on public finances, differ.

It is not possible to discuss in detail the substantive arguments supporting these views, which are partly based on economic reasoning and partly reflect political considerations. The European Commission's proposals communicated last November to some extent tried to respond to these views. The aim of the Commission's Communication was to improve the implementation of the Pact, fully respecting its fundamental principles and without changing its key parameters. For example, it was proposed and endorsed by the EU Council to place more emphasis on the public debt ratios and the

pace of debt reduction in the budgetary surveillance process. In addition, the possibility of allowing small deviations from the close to balance requirement was explored for countries with debt ratios well below 60 percent of GDP. This option was not endorsed so as to avoid introducing new rules which could complicate the rules and the implementation procedures of the Pact, but it was accepted that the assessment of the fulfilment of the balanced budget requirement would take into account "country-specific circumstances". On the whole, it has been confirmed that the key parameters of the Pact and its implementation procedures, as recently agreed in the EU Council report, are appropriate and adequate. I should like to stress that it is not advisable to alter or, in particular, to weaken "the rules of the game", when the participants have just started playing it. The credibility of any set of rules – and thereby their effectiveness – is also measured against the willingness of the players of the game to adhere to the rules, also in times when changing or weakening the rules would offer, at least in a short-term perspective, an easier way out.

Although I cannot enter into a detailed discussion about the parameters of the Pact, it is at this stage that I should like to draw some parallels between the fiscal rules in Europe and the fiscal rules at the state level in the United States. Indeed, most states have introduced balanced-budget or other rules in order to ensure fiscal discipline, some of them dating back to the 19th century as part of these states' constitutions. As I have already mentioned, such a comparison suffers from many caveats and the conclusions should be treated with caution. First, the fiscal-federalist framework in the United States is different from the framework in the European Union and the euro area. If one would compare the states in the US with the Member States of the European Union, and the US federal government with the authorities at the EU level, US state expenditures amount to almost 10 percent of US GNP, while the federal expenditures amount to approximately 25 percent; EU "federal" expenditures are not even 2 percent of EU GDP. Moreover, the functions of US states and hence the corresponding fiscal instruments are different from the functions and fiscal framework of EU Member States, the most important difference being that EU Member States are responsible for the stabilisation function of the budget, whereas this is clearly a federal responsibility in the United States.

Having said this, I should point out that attempts have been made in the economic literature to assess the effectiveness of the fiscal rules at the US state level, most of which – as I said – have been in existence much longer than similar rules in the European Union, and, on the basis of this experience, to draw conclusions for the functioning of the Stability and Growth Pact. According to this literature, the most effective fiscal rules at the US state level have a number of characteristics. First, the accounting framework underlying the rules should be defined ex post and not ex ante; in other words, compliance with the rules should be assessed on the basis of actual fiscal outcomes, and not planned or budgeted fiscal data. Second, it should not be possible to override or temporarily suspend fiscal rules. Third, the enforcement of the fiscal rules should be the responsibility of an open, politically independent, and non-partisan review panel. When the rules are violated, sanctions should be significant to correct the behaviour of fiscal authorities. Finally, amending the fiscal rules should be difficult.

A comparison of the rules and procedures of the Stability and Growth Pact with these characteristics shows that the European fiscal rules perform reasonably well, which may lead us to conclude that they are – in principle – suited to ensure fiscal discipline. Or, in line with the theme of today's conference, the European fiscal rules match the US fiscal rules rather well. The accounting framework of the Pact is of an ex post nature, the parameters of the fiscal rules cannot be set aside or amended easily and the sanctions in the case of breaching the rules are significant. The weakest part of the European fiscal rules is their enforceability, as the final judges, who are to assess compliance with the rules, are also the ones who eventually can alter the rules, and are subject to the rules. In other words, the situation is similar to that of a potential alcoholic who has been given the key to the mini bar. The latter observation might indeed warrant a greater and stronger role for the European Commission in the implementation procedures of the Stability and Growth Pact, as an independent, non-partisan assessor of the fiscal situation of EU Member States. Indeed, the ECB supports the proposals from the European Commission to strengthen the latter's role in the context of the Stability and Growth Pact.

To conclude, I answer the second question – to which extent is the Stability and Growth Pact

framework adequate? – in the affirmative as well. First, experience with fiscal rules at the US state level shows that the European fiscal framework's parameters and modalities should, at least in principle, ensure sound public finances. Second, the specification of the Pact's rules and procedures is sufficiently flexible as I will argue later on. Moreover, and given the previous assessment, one should not change, or in any case not weaken, the rules when the game has just begun, because some participants are facing problems.

Does the Stability and Growth Pact limit the conduct of fiscal policy?

I will now turn to the last question I should like to address. Does the Stability and Growth Pact impose unacceptable constraints on the stabilisation function of fiscal policy? In my view, it does not. Let me explain. I should first recall a major feature of the Stability and Growth Pact which clearly shows that it allows for a combination of rules – ensuring fiscal discipline – and room for (automatic) fiscal stabilisation. The Pact obliges countries to pursue a balanced budget or a surplus over the medium term, meaning that the actual deficit may deviate from the medium-term target, depending on business cycle fluctuations. In periods of weak or (small) negative economic growth, the deficit is allowed to increase, but not to exceed the threshold of 3 percent of GDP; in periods of economic growth above potential growth, most countries should run fiscal surpluses. Empirical evidence shows that in the European context a margin of 3 percentage points of GDP is, under normal circumstances, adequate to let automatic stabilisers be fully operational, thereby stabilising business cycle fluctuations. In other words, countries that comply with the rules of the game should have ample opportunity for (automatic) fiscal stabilisation. The fact that some countries are currently forced to pursue more or less a pro-cyclical fiscal policy, in order to avoid breaching the 3 percent threshold, should hence not be regarded as a failure of the Pact but as a failure of these countries to sufficiently reduce their budget deficits in periods of stronger economic growth. Indeed, whereas some countries are struggling to keep their fiscal house in order, most countries that have complied with the "rules of the game" are to a lesser extent confronted with the need to adjust fiscal policies and are able to tolerate an increase in the budget deficit.

A second, more general point I should like to make in this context is the extent to which fiscal policy can effectively be used for stabilisation purposes. Indeed, the experiences of many countries, in particular in the 1970s and 1980s, have shown that active counter-cyclical fiscal policies are not very effective. First, the lead-times between taking fiscal measures and their actual impact on the economy are considerable. Moreover, the timing of such measures is always uncertain and depends on forecasts of future economic developments. Finally, if economic actors anticipate a fiscal stimulus, the impact of such stimulus in terms of increased demand might be small, as economic actors may increase their savings in reaction to the expansionary fiscal policies. In other words, economic actors may have the tendency to free-ride on governments' counter-cyclical fiscal policy. The latter argument may also apply to the working of automatic stabilisers, if anticipated by economic actors. Hence, fiscal policy is increasingly regarded as part of the set of structural policies a government avails itself. In this context, fiscal policy should first and foremost be directed at improving the functioning of economic mechanisms and markets.

Conclusions

I would now like to sum up some of the main points I have made so far and discuss briefly how to best address fiscal policy challenges in the Union. I believe that the arguments I have put forward and the empirical evidence strongly support the view that the Stability and Growth Pact is not a liability, but an asset of the European macroeconomic policy framework. The fiscal rules, as laid down in the Treaty and later elaborated in the SGP, have greatly contributed to fiscal discipline in the EU, both in the run-up to EMU as well as thereafter. Indeed, I am certain that some Member States, in particular those with a less convincing track record, would not have been able to bring their fiscal house in order, without the existence of the European fiscal framework.

Nevertheless, the Pact is currently put to the test, as several countries are increasingly facing difficulties in complying with the "rules of the game". The causes of these difficulties have been unfavorable

fiscal positions, the failure to consolidate public finances during periods of strong economic growth, the adverse effects of the economic slowdown and, in some cases, the relaxation of fiscal policies. These causes can certainly not be attributed to the SGP framework. At the same time, the present situation reveals that the SGP rules and procedures have not been sufficiently effective in preventing the occurrence of excessive deficits in some countries. Since the fundamental principles underlying the Pact are sound and its basic features are appropriate, the reaction to these developments should not be to change – that is relax – the basic "rules of the game", especially when the game has just begun. The appropriate response is to implement the rules in an effective and pragmatic way, taking advantage of the flexibility provided by the rules, but in a prudent manner.

The SGP offers sufficient flexibility to weather the effects of economic downturns and to provide room for fiscal stabilisation policies. First, automatic stabilisers can operate fully, after fiscal positions "close to balance or in surplus" have been reached. Second, SGP implementation procedures permit a higher degree of flexibility and more scope for discretion in the application of rules than is generally realised. Third, the approach to the assessment of Member States' fiscal positions, as specified in the code of conduct concerning the evaluation of stability and convergence programmes, also leaves some room for interpretation. Finally, the conclusions reached by the European Council regarding SGP rules and procedures include elements that are expected to enhance the effectiveness of the Pact, while providing scope for discretion in assessing its implementation, for instance by taking into account "country-specific circumstances". It is essential that greater flexibility and pragmatism in the implementation of the SGP must not lead to the relaxation of the rules, thereby undermining the Pact's credibility.

Looking forward, there are four conditions or policies that are necessary for addressing the present fiscal challenges and enhancing the credibility of the SGP. First, strengthening the rules, in the sense that more incentives – positive or negative – are created to prevent breaching the rules and ensure that countries adhere to them. Enhancing the role of the European Commission in the implementation procedures and increasing peer pressure in the Council would contribute to this end. Second, improving the monitoring of budgetary developments based on rigorous accounting rules and the timely provision of data. Third, implementing structural reforms, so as to improve fiscal positions, both by increasing potential growth and by reforming pension systems and fiscal institutions. Finally and crucially, Member States with fiscal imbalances must pursue their fiscal consolidation strategies in a determined and systematic way in accordance with their commitments, which should be based on realistic assumptions about economic prospects. In the final analysis, sound and sustainable public finances can be achieved only if their importance for securing growth and price stability over the long term is better understood and recognised. Furthermore, the usefulness and effectiveness of the SGP will be enhanced if it is seen as a framework that can foster the attainment of these objectives rather than as a straitjacket which arbitrarily constrains fiscal policy, without reason or cause.