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Heipertz, Martin; Verdun, Amy

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## The dog that would never bite? The past and future of the Stability and Growth Pact

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## **MPIfG Working Paper 03/12, November 2003**

### **The Dog that Would Never Bite? The Past and Future of the Stability and Growth Pact [ 1 ]**

Martin Heipertz, Max Planck Institute for the Study of Societies,  
and Amy Verdun, University of Victoria, Canada

#### **Abstract**

This paper analyses the underlying reasons for the creation of the Stability and Growth Pact (SGP) and its subsequent development in recent years. The paper examines the economic and political factors behind it, including the role of economic ideas, experts, politicians, institutional arrangements in the Maastricht Treaty, domestic politics, and the exceptional position of Germany in the realm of monetary integration in the EU. It concludes that a set of commonly held beliefs together with a corresponding power-political constellation explain the creation of the SGP.

#### **Zusammenfassung**

Das Papier analysiert die grundlegenden Bedingungen für das Zustandekommen des Stabilitäts- und Wachstumspakts (SGP) und seiner Entwicklung in den Folgejahren. Es werden ökonomische und politische Faktoren untersucht, insbesondere die Rolle wirtschaftspolitischer Vorstellungen und den Einfluss von Experten, Politikern, institutioneller Regelungen im Maastricht Vertrag, innenpolitischer Vorgänge und die Sonderstellung Deutschlands im Bereich der Europäischen Währungsunion. Die gemeinschaftlichen wirtschaftspolitischen Vorstellungen werden als notwendige Bedingung für die Schaffung des Paktes aufgefasst, und ihr Zusammentreffen mit einer entsprechenden machtpolitischen Spielkonstellation wird als dessen hinreichende Erklärung verstanden.

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## 1 Introduction

In 1997 the European Council adopted the Stability and Growth Pact (SGP) which was inspired by a 1995 memorandum written by the then German Finance Minister Theo Waigel. The SGP institutionalises the deficit limit of three per cent of Gross Domestic Product (GDP) laid down in the Treaty on European Union (TEU) for Member States of the European Union (EU) that participate in Economic and Monetary Union (EMU). It regulates procedures of budgetary surveillance and the imposition of financial fines for unauthorised breaches of the deficit limit. At the time, it was hoped that these sanctions would effectively serve as a deterrent that was never to be used. Yet in the second half of 2002, the excessive deficit procedure (EDP) was initiated in the cases of Portugal, Germany, and France (and it is possible that Italy might be next). Formally, when the Council decides that an excessive deficit exists, the country concerned is obliged to reduce its deficit below three per cent of GDP according to the recommendations of the Council or face sanctions at the end of a drawn-out procedure. [2] These ultimate sanctions are serious. They first take the form of a non-interest-bearing deposit with the Commission of 0.2% of GDP plus a variable component linked to the size of the deficit. Subsequently, the deposit is converted into a fine if the excessive deficit has not been corrected after two years. In other words, the once thought "paper deterrent" (or perhaps a dozing dog) turned out to be a real factor to deal with, especially as core European countries find themselves in an economic crisis.

What are the underlying reasons for the creation of the SGP and what is its immediate purpose? We distinguish between economic and political reasons. The economic reasons include that the fiscal provisions in the Maastricht Treaty for maintaining budgetary discipline were not clearly spelt out and it was felt that additional rules were needed. The political reasons behind the emergence of the SGP can be traced back to the domestic circumstances of the Waigel memorandum, based on the perceived need to secure, in a visible way, a Germanic conception of "stability culture" for the future EMU as well as to the need to find a political compromise on how to run EMU once stage III had begun.

The actual purpose of the SGP was to strengthen the fiscal regime of EMU. It would not only make the existing rules and exemptions more rigorous, concrete, coherent and credible, but it would also reduce some ambiguities in the Treaty, such as the originally very imprecise provisions on sanctions. It is noteworthy that the eventual SGP adopted in 1997 differed considerably from what Waigel had called for. The SGP demands a balanced budget or even a surplus over the medium term, whereas the original proposal only suggested a medium term deficit of one per cent of GDP. In addition, Waigel's proposed automatic sanctions were replaced by a politicised process.

The SGP has recently received considerable criticism and will likely remain controversial as it is being applied. In light of that, this paper poses a number of questions: (1) Why was the SGP created? (2) What purpose was it supposed to serve? (3) What underlying conditions supported its creation? (4) Have they changed since? (5) What can be expected to be its future?

The relevant literature on the SGP is dominated by economists. Few authors discuss the origins of the SGP or the politics of its creation, which is what we find particularly interesting and intriguing. This paper seeks to understand and provide an analysis of the outcome of the SGP negotiations. We argue that the SGP was possible due to a convergence in basic ideas about the relationship between monetary and fiscal policies held by the monetary experts in Ministries of Finance, central banks, the Commission and

others in academia and prominent international organisations. Yet there was no consensus on a specific agreement (if at all). Taking this into account, we seek to explain the process that led to the convergence that ultimately provided the basis for the compromise that was found during the Dublin summit in December 1996. Thus, the consensus among experts on principles was a necessary though not sufficient condition for a political agreement on the SGP. We offer various power political reasons (e.g. the role of the Bundesbank and Germany as a prominent Member State) that need to be considered in order to explain the eventual outcome.

The paper is structured as follows. The first section examines why the SGP might be necessary, taking insights from both economics and politics. The second section describes the actual story of the creation of the SGP. The two subsequent sections offer the core analysis based on an actor-centred institutionalist approach. The third section examines the broader framework in which the SGP was created. Under the heading of "actor orientations" it focuses on the role of ideas, experts and the anticipated shift in broad political leaning of Member States governments (from right to left). Section four provides an analysis of the actor constellation. The fifth section draws some lessons from the past for the current situation. The final section concludes.

## **2 Why Might an SGP be Necessary? – Lessons from Economics and Politics**

### **2.1 The Economics of the SGP**

The Maastricht Treaty has provided the monetary constitution for EMU. However, its specifications for the future fiscal regime are incomplete and ambivalent. [3] It only contains rather loose stipulations on the excessive deficit procedure (EDP), (TEC Article 104 ex 104c) and budgetary coordination (TEC Article 99-/103 ex 103). From the viewpoint of economics, several arguments speak in favour of complementing the fiscal arrangements of the Treaty (for a detailed discussion see Heipertz 2003). The most prominent reasons behind more stringent rules are (1) a need for consolidation (2) concerns about externalities, (3) the credibility of ECB independence and (4) the need for a more coherent framework of economic policy coordination.

The first difficulty is a general need for *consolidation*, resulting from the expansionary stance of fiscal policy in most of the OECD countries since the "golden age" of Keynesianism and welfare-state expansion. Soaring interest rates, which were the result of high inflation rates of the time, reduced investment and contributed to weak growth and underemployment. Governments found themselves redirecting an increasing portion of their revenue into debt servicing. Furthermore, ageing populations in Europe imply that maintaining generous welfare states will be increasingly expensive and will require a fundamental reallocation of public spending.

Second, there are *externality problems* related to EMU specifically. [4] The most prominent concern was that Member States would increasingly destabilise each other involuntarily through negative financial spill-overs of their fiscal policies. [5] A bond-financed increase in government spending would cause the money supply in the Eurozone to rise, thereby fuelling inflationary pressures. In response, the ECB would be forced to increase the interest rate, depressing investment and consumption. Furthermore, the higher interest rate would cause the common currency to appreciate and the trade balance to deteriorate. Another externality effect results from the fact that participating in a monetary union implies having abandoned national exchange rates. Thus, the absence of individual

national exchange rates entails that the disciplinary effect affects the whole currency zone, thereby reducing the impact on the individual "sinner" while increasing it for the others. This effect should aggravate an already existing deficit bias of public finance (Beetsma 1999). Member States were feared to free-ride on each other in the sense of under-providing consolidation and overspending on their budgets. [6] Thus strict rules on budgetary deficits were deemed necessary. It is noteworthy that the need for limits on budgets had already been mentioned in the original EMU blueprint laid out in the "Delors Report" (Committee for the Study of Economic and Monetary Union 1989). Further justification for limits on budgetary deficits were spelt-out by the Commission (Commission of the European Communities 1990, 1991).

A third concern is that excessive deficits could undermine *central bank independence*. In other words, actors at the time were worried that ECB independence and specifically the "no bail-out" clause [7] of the Treaty (TEC Article 101 ex 104 and 103 ex 104c) would be politically endangered by unsustainable fiscal paths of certain Member States. Sargent and Wallace's model of debt monetisation (Sargent/Wallace 1981) supports this view. Their study shows that an unsustainable fiscal path eventually forces the central bank to buy government bonds. More recently, the Fiscal Theory of the Price Level (FTPL) argues in a similar direction (Woodford 1994; Leeper 1991). Grossly simplified, the FTPL states that inflation control by the central bank through the interest rate is jeopardised by an excessive fiscal stance that disturbs household expectations and unsettles private sector budget constraints. Public demand substitutes private demand and artificially expands aggregate demand, eventually causing the price level to rise. Monetary independence, in particular its effectiveness and its credibility, needs to be supported through the fiscal regime in addition to the monetary constitution. [8]

Fourth, in a monetary union the role of economic policy changes and *coordination* becomes pertinent (Begg 2002). The aim of coordination should be to attain an appropriate policy-mix between monetary and fiscal policy that is required to obtain an efficient use of these policies. The fact that the "one-size-fits-all" monetary policy of the ECB is necessarily destabilising for countries with an inflation rate significantly off the Eurozone average has increased the need for strategic and coordinated fiscal counteraction, potentially even going beyond the automatic stabilisers. This does not always require fiscal retrenchment, especially when there is a danger of deflation. The coordination issue grows in importance with the likelihood of asymmetric shocks and increasing divergence between the Eurozone economies. Currently, a secular growth-shortfall due to structural rigidities is amplified by a cyclical recession. A strict interpretation of the pact would require a contraction to attain the extremely serious magnitude of two per cent (with discretion applying down to 0.75 per cent) until fiscal counteraction would be authorised. [9] Until then, governments that have manoeuvred themselves close to three per cent would have to implement pro-cyclical policies of cutting (investment) expenditures and increasing (tax) revenues. Many economists have interpreted the SGP in this way and strongly criticised it for not enabling but – even hindering – countercyclical moves in these cases (Eichengreen 1996; Eichengreen/Wyplosz 1998). The importance and usefulness of stabilisation policy and even discretionary measures beyond automatic stabilisation is debatable. Instead of providing the framework for a coordinated and strategic response to the cyclical component of Europe's weakness, the SGP is seen to stand for rudimentary and improvised coordination, only asking Member States to "keep their house in order" (Issing 2002).

However, this critical view of the SGP underestimates the degree of flexibility that is built into the legal texts. The pact can be applied "intelligently" in the sense of allowing the limit to be surpassed for a number of years without losing credibility. This requires both a

co-operative attitude of the governments concerned and a radical improvement in the communication of the budgetary situation and medium-term aims. Furthermore, it is perhaps an unfair criticism to state that the pact is an inferior regime of policy coordination. After all, the legal documents of 1997 could not transcend but had to be based on the Treaty, which did not contain any more far-reaching institutional solution on this issue.

## 2.2 The Politics of the SGP

The Maastricht Treaty is an incomplete contract as far as rules on EMU are concerned. The convergence criteria only dealt with the run-up to EMU; however, there were no rules or arrangements in place for stage III, except the stipulations of Articles 99 and 104 (ex 103 and 104c; see footnote 3 above). Theoretically there were two options. The first would be the *status quo*, relying essentially on voluntary arrangements. The Member States would all agree to continue to meet the convergence criteria even after EMU had started. The second option was to impose explicit rules that would elaborate on, and even go beyond, the Treaty stipulations. This issue was left open precisely because it was highly contentious and exposed fundamentally different views on economic policy. [10] Voluntary arrangements had been the implicit road that was chosen in the Maastricht Treaty. However, particularly the Germans and the Dutch favoured a more explicit, rule-based system. The aim was to restrict budgetary deficits once EMU was fully operational. The fear was that without rules, it would be very attractive to spend more than the agreed norm, which would lead to the free-riding problem discussed above. This concern became especially relevant with respect to a number of (Mediterranean) countries that were making strenuous efforts to be part of the first wave – against all odds at the outset. [11] So, the larger the future membership to EMU was appearing to become and the less likely a postponement, the more urgent the need for Germany to reinforce at least the deficit criterion. This situation has been described as an "endgame" for the transition towards stage III (Crowley 2002).

We find that a central part of the political background of the pact can be traced back to German domestic politics. The Stability Pact was a way to comfort public opinion by appeasing the Bundesbank in particular. There is no doubt that the German public needed reassurance on EMU. [12] The population had become extremely anxious about giving up the well-proven Deutschmark (Risse-Kappen et al. 1999) and replacing it with a new currency that had not proven itself and would not only include traditionally weak economies, but also lack a tradition of stability culture. [13] Politically, there was a risk that the opposition and even Waigel's own party in Bavaria under Prime Minister Edmund Stoiber would capitalise on this sentiment and run on an anti-EMU platform (e.g. Frankfurter Allgemeine Zeitung: 04.11.1995. Note that at this point in time both men were contenders for party leadership). Besides the general public, the German monetary authorities did not trust their counterparts in other Member States. Another factor of mistrust was that the conservative political parties, still in power in most EU Member States in the mid 1990s, were concerned that once social democratic parties could come to power they would start pursuing a "tax-and-spend" policy. Therefore, they were eager to perpetuate their economic views into the politically indeterminate future. Hence, at the source of the motivation to propose the SGP, we see a layered prevalence of German mistrust towards European partners, potential political successors and political discretion in general.

The gradual nature of the process of economic and monetary integration, especially the

experience with the European Monetary System (EMS), was also important. Cooperation in the context of the EMS implied that most monetary authorities had contributed to factual convergence in monetary policy resulting in de facto fixing of exchange rates. What had been happening over the 1980s was a "shadowing" of Bundesbank policies. The resulting convergence implied that monetary authorities had learnt lessons about economic and monetary governance. Yet some feared that national governments would become more "relaxed" once EMU would be fully operational and return to old practices. The fear was that, without the disciplining factor of exchange rate fluctuations, governments would move to more expansionary policies, for example tolerate undue wage increases as well as expand public debt and implicitly destroy the (anti-inflationary) discipline that had been built up in many countries throughout the 1980s and 1990s.

Finally, some authors have stressed the fact that EMU was created with too much emphasis on credibility but much less so on legitimacy issues (Hodson/Maher 2001; Scharpf 2003; Verdun/Christiansen 2000). The argument is that EMU was created with a strong monetary authority but with no proper provisions in other domains; that is, it was asymmetrical (Verdun 1996, 2000). The SGP negotiations were also used as a vehicle to create more European integration in the economic domain. The choice of a rule-based and mechanistic strategy can be traced back to the fact that Germany was the most dominant country regarding monetary matters, and thus able to push through its opinion. On the other hand, the SGP does not address the concerns that the French and others had, namely that the ECB should be flanked by an economic government (Verdun 2003). Their initial response to Waigel's proposal was positive partially due to the opportunity it provided for putting the cart before the horse. The initially suggested "stability council" seemed to be malleable into the desired "*gouvernement économique*." This is precisely why the idea of such a council was dropped on the other side of the Rhine.

Summarising, between 1995-1997 there were sound economic and political reasons to create a set of rules that would put limits on budget deficits. It was clear that *Member State governments* might be tempted to "free ride" once EMU was fully operational. Without such rules, it would be very attractive for countries to temporarily run a higher deficit without having to "pay" for that. The costs of that type of policy would have to be borne by the other Eurozone countries. Because it was obvious that some rules were necessary, when Germany insisted on a pact that would impose rules, it was in a very strong position to make its case.

### **3 Negotiating the Pact**

There are very few accounts of the pact's genesis and those that exist are mainly descriptive (see for example Stark 2001; Passalacqua 2000; Konow 2002 and Costello 2001). The idea of some sort of "stability treaty" was in the air in early 1995, being part of contributions to the public debate [14] in Germany as well as featuring in informal discussions of experts and policymakers at the national and European levels. With the beginning of stage II of EMU (in 1994-95) members of the Monetary Committee started discussing the idea of more stability oriented rules as the Treaty had stipulated the need for further legislation (interviews with Members of the Monetary Committee, June and July 2003). Officials in the German Ministry of Finance were also discussing this topic among themselves during 1994-95. The *Bundesbank*, in particular, liked the idea of further legislation because it went some way towards addressing its concerns about a lack of stability-orientation in EMU. However, at no point before November 1995 did any of these informal discussions lead to a formal proposal on stability oriented rules. In

September 1995 Waigel had been talking to his colleagues informally about his desire to formalise the rules on budgetary policy in EMU [(Milesi 1998), 95-6 (Stark 2001), 89, and interviews with Ministry of Finance officials, June 2003]. Waigel made his move at a time when public opinion was turning very negative on EMU. Pre-empting the opposition, Waigel announced his proposal for a "Stability Pact" [15] to the public and his European partners in November 1995 (Bundesministerium der Finanzen 1995) in the second reading on the 1996 budget (Waigel 1995b; Waigel 1995a), reacting to opposition demands for stricter rules that would guarantee the stability of EMU (Scharping 1995). Waigel was under pressure to gain the lead in this debate that was becoming politically uncomfortable for the Kohl government. The fear was that the eurosceptic public opinion could become politicised and, thus, further mobilised by the opposition. Waigel's behaviour might be seen as an attempt to pre-empt such a polarisation of the debate on Europe. Therefore, he commissioned an official in the Ministry at very short notice to write up the ideas on a Stability Pact that had been discussed for months in order for them to be circulated among his European colleagues. A second draft, which was completed within three weeks, further explained the proposal to Waigel's colleagues who, at first, received it favourably

After the Danish "no" and the French *petit oui* in the referenda on the Maastricht Treaty in 1992, there was no question of what was referred to as "opening Pandora's box" (renegotiating the Treaty). Yet, an intergovernmental agreement, as originally envisaged by Waigel and his state secretary, Jürgen Stark, was unacceptable to the other countries. At the same time, the Commission also realised the dangers of an intergovernmental solution in the form of a new treaty *à la* Schengen that would imply its marginalisation. The Council was prompted to propose a solution within the Community framework, which was prepared under Commissioner Yves-Thibault de Silguy and released in October 1996 [COM (1996) 496]. The proposal turned out to be much closer to the Maastricht Treaty than to the Waigel paper. Crucially, it did not include automatic fines under the supervision of an independent "Stability Council," but reduced the sanctions to a discretionary measure of the Ecofin Council, which evidently comes close to asking turkeys to vote for Christmas (Begg 2003). On the other hand, the Commission proposal also elaborated on the "surveillance arm" of the pact, more or less designing the SGP as the rudimentary device for economic policy coordination that we know today.

The Stability Pact dossier went through the various EU committees and institutions. It was discussed in the Monetary Committee (MC), the Ecofin Council, the European Council (both prepared by the Committee of Permanent Representatives, COREPER) and at Franco-German summits, meetings and workshops. The bulk of work was completed in the MC. Only very few open issues had to be referred to the ministerial level of Ecofin. The major controversy was that Germany's partners agreed on the principle of mutual surveillance and reinforced dissuasion of excessive deficits but not on automatic sanctions. The focal point of dissent became the clause that was going to stipulate the exemptions from sanctions, since the lever for political discretion laid here. Waigel was completely isolated in requiring nothing less than a GDP contraction of two per cent or worse as a qualification for an exemption. The compromise reached in the morning hours of the Dublin summit in December 1996 stipulates that a recession of less than 0.75 per cent "as a rule" does not qualify as exceptional, whereas a recession of over two per cent automatically does. If the recession is in between these two figures, it lies with the Ecofin Council to determine whether or not the recession is exceptional. The result is a rule that can be overturned by an Ecofin blocking minority of at least 26 out of 87 weighted votes or covering at least six member states [TEC Articles 104 VI (ex-Article 104 C VI) and 205 II (ex-Article 148 II)] that refuse to label a budgetary deficit of over three per cent as excessive, depending on the economic situation of the country involved. A voting alliance



against the SGP is, therefore, a concrete and not unlikely possibility.

Nevertheless, the SGP has delivered some legal "added value." Among other things, it has shortened the timeline of the sanctions mechanism, defined the distribution of the fines (among the "virtuous" member states), clarified the notion of "exceptional" and "temporary" deficits as exemptions from sanctions, introduced an urgency procedure, enabled the suspension of the EDP and, finally, improved the justiciability of the procedural steps involved. Yet, due to the politicised nature of the EDP, the fundamental essence of the pact is not a mechanism of "quasi-automatic sanctions," but the institutionalisation of a political *pledge* to aim for low deficits. In that way the SGP can be seen as an act of "symbolic politics" (Sarcinelli 1987). As a face-saving device for the French, it was renamed "Stability and Growth Pact," since rising unemployment was increasingly becoming the stumbling stone for the Juppé government. In the official rhetoric, sound public finances are not an alternative to growth, but a facilitator of the overall aim of higher growth and more jobs (European Council 1996).

#### **4 Analysing the Birth of the Stability and Growth Pact**

In order to analyse the genesis of the pact, we combine two explanatory variables. First, we see a fundamental role for specific ideas about economic policy in EMU that were held by experts and that came to underlie the regime created. Second, we believe that only a combination of those ideas and a supporting power-political constellation enabled the actual outcome. To show this, we discuss the interaction between the realm of experts and the realm of politicians. These categories are used to differentiate between the two variables. Within the political sphere, we locate specific national preference points. These aggregate positions of countries are ultimately composed of the preferences of individual actors. Therefore, we lower the level of analysis as far as necessary to arrive at a satisfactory explanation. Additionally, we discuss the special dynamics of the Franco-German interaction at the core of the negotiation. Our analysis should explain how and why positions merged, starting from very different preference points to form a consensus.

We choose an actor-centred, institutionalist perspective. First, we focus on how ideas came to shape the preferences of actors and, second, on how their constellation and interaction produced the outcome. The analytical approach most suited for this endeavour proved to be actor-centred institutionalism. According to Scharpf (1997), "actors" are defined as individual or corporate strategic agents (mostly administrative bodies such as ministries) which are capable of intentional action. They are also internally organised along hierarchical lines, and are characterised by preference orientations as well as action resources. Furthermore, they are embedded in an institutional context, which we use as explanatory shorthand for structural factors and external influences on the actors themselves, such as the influential role of financial markets at certain stages in the negotiation process. We define the executive agents of the negotiating ministries, of the Commission and of central banks as "experts." They are in contact with non-actor experts, such as academics, journalists and institutions like the OECD or the IMF, who shape ideas but not decisions. On the highest levels of deliberations, we introduce non-expert actors, holding the final and democratically legitimated decision-making competence – "politicians." The hypothesis is that the orientations of experts are defined by specific converging "ideas" about economic policy, influenced indirectly by non-actor experts. Furthermore, the orientations of politicians are crucially influenced by experts, even if their "ideas" were initially different. We provide a graph that shows how experts (actors as well as non-actors) and ideas came to shape politics, thereby converging on the

compromise that enabled the conclusion of the Stability and Growth Pact.

#### 4.1 Actor Orientations

Let us first turn to the broader ideational factors that help explain why EMU happened. The creation of EMU was the result of policy learning, convergence in policies but also in ideas about monetary policy-making. When EMU was first conceived in the late 1960s and early 1970s, the six Member States were still split on a number of issues. This split was originally referred to as the difference of opinion of the "economists" versus the "monetarists" – or to use contemporary language the "coronation" versus "locomotive view" of economic and monetary union (for a discussion see (Kruse 1980; Tsoukalis 1977; Dyson/Featherstone 1999). The monetary authorities of the six Member States were split on how to create EMU (i.e. whether to converge policies first or to move to further monetary integration and hope that convergence would result). They were also divided on its main focus (policy objectives) and on the institutional design of EMU (some wanted immediate transfer of sovereignty to a supranational institution, whereas others were more cautious). The 1970 EMU plan (also known as the Werner Plan) came at a time when governments were frequently pursuing Keynesian policies during down-turns (Committee on the Realization by Stages of Economic and Monetary Union in the Community 1970).

Though the actual institutional design of EMU as envisaged by the Delors Committee in 1989 did not differ too much from its 1970 design, a number of important developments occurred in the years between the two plans. First, economic and monetary integration had achieved a next level of integration in both the area of economic and monetary policy-making projects: The process of completing the internal market was underway, financial markets had become further integrated and the European Monetary System had been working for a decade. [16] Second, as was mentioned above, policy learning had taken place. Monetary authorities in the Member States had realised that monetary policies were only successful if they were in line with that of the dominant Member State, namely Germany. The Deutschmark played the role of anchor currency. France learnt this lesson in March 1983 when Mitterrand chose to stay in the EMS and refocus its policies towards that objective. Italy converged in the second half of the 1980s and was one of the last to keep exchange rates stable and maintain the lira in the EMS. The EMS witnessed many devaluations between 1979-1983 but much fewer between 1983-1987. After the Basle/Nyborg meetings in 1987 until the EMS crises of 1992/1993, there were no realignments. Third, the ideas regarding monetary policy-making had changed (see *inter alia* McNamara 1998 and Marcussen 2000). Whereas in the 1960s and 1970s Keynesian principles lay still at the heart of national government economic policies, by the late 1980s monetarist policies dominated. In the late 1970s and the early 1980s the United States, the United Kingdom and Germany were at the forefront of this change, which by the late 1980s had taken place in all West European Member States. The change in belief was that there was no long-term trade-off between inflation and unemployment and that sound money was important for growth. Hence, policy-makers started putting more emphasis on the need to keep inflation low to create an economic climate of low interest rates in which economic growth would be more likely.

In their effort to proceed with monetary integration, the governments of Member States were aided by a so-called "epistemic community." Members of central banks, ministries of finance and academics held similar views about the main aim of economic and monetary policy-making. There were a few important venues where experts shared ideas and socialisation occurred. This took place above all in the Monetary Committee (MC) –

now called the Economic and Financial Committee (EFC) – which consists of representatives of central banks and Ministries of Finance of the EU Member States (Verdun, Amy 2000), as well as in other influential EC committees (see Rosenthal 1975 and Kruse 1980) and international fora. The MC convenes in the "comitology" form of an advisory committee set up according to Article 114 (ex-Article 109 C) TEC. The members of the MC meet Haas' four principles that define the existence of an epistemic community. First, they shared beliefs for a value-based rationale of social action. Second, they shared causal beliefs, which are derived from their analyses of problems which then serve as the basis for understanding the linkages between policy actions and desired outcomes. Third, they have shared notions of validity – that is intersubjective understandings that help them weigh ideas within their area of competence. Fourth, they have a common policy enterprise and common practices associated with a set of problems to which competence is directed (Haas 1992: 3). It is no surprise that the Member States Heads of States or Governments relied on the MC for proposals and suggestions for action. The literature on epistemic communities indeed suggests that a group of experts is often called upon when national governments are unable to come up with a proposal for intergovernmental collaboration. The MC (now the EFC) is an ideal group to ask for advice as its members can wear double hats: They can act as independent experts, yet they are fully aware of the political issues at stake. [17]

Common ideas on the purpose of economic and monetary policies in the 1980s were crucial for the creation of EMU in the 1990s. It can be seen as a paradigm shift. It was accepted by parties of the political left and the political right, as well as by major domestic actors. Nevertheless, an important political change did occur in the 1990s that could possibly have challenged this new economic and monetary paradigm. Whereas in the late 1980s many governments in power were of the centre-right, by 1997 this had changed. At this time, West European governments were typically composed of parties belonging to the political left. Some observers were concerned that this shift in political leaning might undermine the paradigm on the basis of which EMU was created. Yet, it is noteworthy that the period between 1997-2002 did not see any major changes to the institutional design of EMU. Nevertheless, it is possible that these left-of-centre parties in government will be less positive to the SGP principles as they restrict governments' use of budgetary deficits (traditionally associated with left-of-centre governments). However, what we argue here is that the shift in paradigm from monetary to Keynesian policies in the 1980s was so profound that it stretches beyond the usual day-to-day politics of left versus right. Indeed it is noteworthy that the parties of the political left witnessed a major identity crisis throughout the 1990s. The political left that came to power in the late 1990s had reformed itself and no longer subscribed to the traditional principles of many years ago (such as re-nationalisation or heavy tax-and-spend policies). In fact, it had adopted a number of principles that traditionally were considered typical for the political right (such as a focus on market principles and limiting the role of the state). Some argue that the British Labour Party is the epitome of this transformation in politics and jokingly say that Tony Blair completed what Margaret Thatcher had started.

What mattered at the time was that conservative governments in power were concerned with their potential left-wing successors not respecting the monetary and budgetary regime that was being created. However, we note today that this fear was partly unfounded. In the current situation, we find results that oppose the conventional wisdom. We see left-of-centre governments willing to restructure and aim at sound monetary and fiscal policies. At the same time, the fear that support for strict rules could decline was indeed justified because we find both some left-of-centre and some right-of-centre governments who are less inclined to take the SGP seriously, at least rhetorically. For example, the current

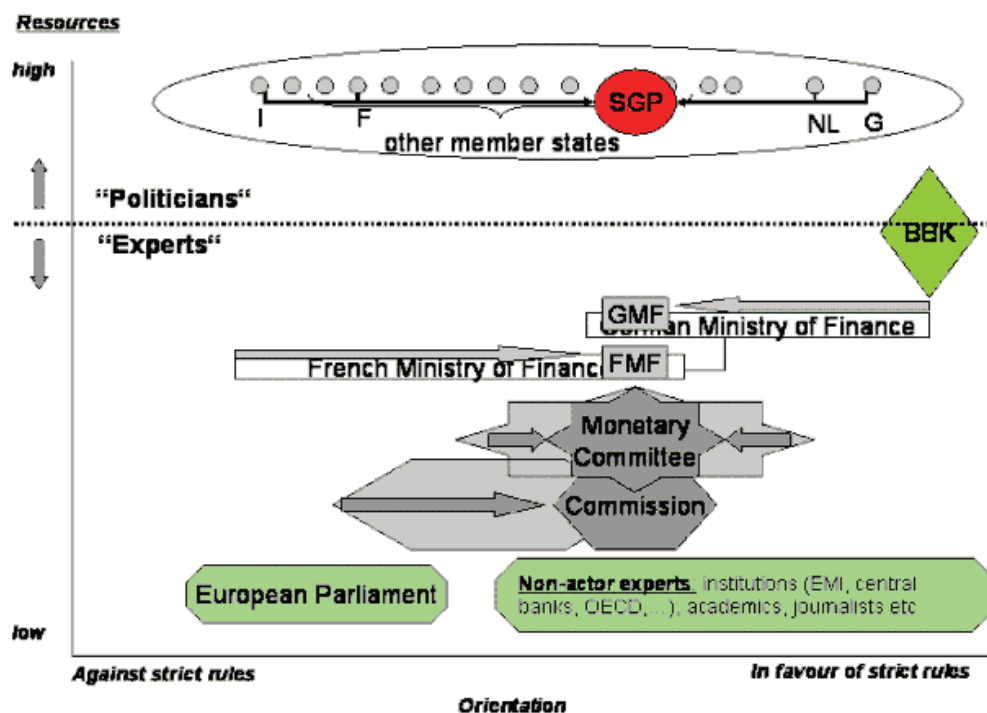
French government under Jean Pierre Raffarin and the Silvio Berlusconi government in Italy seem not to be willing to comply with the strict reading of the SGP. Thus, these initial findings challenge the established view that left-wing governments spend, and right wing governments aim for balanced budgets.

Another change that occurred in the 1990s was economic growth performance. In the first half of the 1990s growth was sluggish. This was also the reason why the convergence criteria were not easily met. Some countries that wanted to be absolutely sure they would be allowed to join EMU (such as Italy, Spain and Portugal) focused on reforms that they hoped would lead to a reduction of the budgetary deficit and public debt. Others such as France and Germany had initially been in a better situation but saw their record deteriorate over time. All of them found ways to reduce the budget and the public debt, and were criticised for not playing by the rules (or for engaging in "creative accounting"). The exclusion from EMU at the outset was such an effective sanction that most governments – including those of less likely participants of EMU such as Italy and Spain – were willing and able to proceed with radical reforms, thereby accepting the straightjacket of the convergence criteria.

It was crucial that the actors had learnt certain lessons and shared certain commonly held beliefs. But those ideas alone were insufficient to produce the concrete SGP. Having described the changing orientation of actors, we now turn to the strategic pattern of their interaction, leading to the conclusion of the Stability Growth Pact.

#### **4.2 Actor Constellation**

The figure below presents an overview of the most important actors, grouped according to their resources and initial orientations when Waigel issued his proposal in November 1995 as well as the subsequent convergence. The horizontal axis depicts their politico-ideologically shaped preferences for or against strict rules for fiscal discipline, whereas the vertical dimension shows their power resources and decision-making capabilities. We distinguish between a "political" and an "expert" sphere. Political decision-makers can of course have considerable relevant expertise, but our distinction highlights the fact that politicians – not experts – settle the most controversial issues. The stylised process is that the whole negotiation dossier is split up into a set of issues (timeline, exemptions from sanctions, distribution of fines etc.) that are discussed at the expert level. Experts receive their instructions from politicians but are free to reach agreement within these bounds. Politicians will, in most cases, simply tick off the agreements reached among the experts. Only issues on which there is no consensus move up for discussion at the political level. Here, experts can influence politicians since they possess intimate knowledge of the relevant issue as well as detailed information on the bargaining positions of the other players. They can indicate potential solutions and possibly prevent the discussion from being deadlocked. We will now briefly discuss each actor in turn.



### Initial preferences and subsequent convergence

Actors at the level with the highest resource capabilities are Member State governments. Their decisive position in the deliberation process corresponds to the concept of "power politics" (Garret 1994). Agreement among them leads to decisions that are the basis for laws. The nonetheless important role of other actors is only indirect via the influence they have on the *orientation* of the governmental actors. The actual players in the form of state actors are either Ministers in the Ecofin Council, Heads of State, or Governments in the European Council. The preference points on this level initially cover the entire range between pro and contra Waigel's proposal – obviously Germany being on the right end, closely followed by the Netherlands, whereas France and other Mediterranean states initially found themselves on the other side. [18] The German *Bundesbank* (BBK) figures as a special player with the resources of an informal veto. We will later discuss in more detail its double-role between the spheres of experts and politicians. Of the *national treasuries*, we only show the two most important ones, the Ministries of Germany and France. The German Ministry holds a relatively coherent position, showed as a narrow preference set. On the French side, we find both support and opposition. For the sake of simplicity, we assume each country to support either France or Germany, depending on which lies closer to their preference point. [19] Each Ministry and each central bank, plus the Commission, had two representatives in the *Monetary Committee* (MC), which was crucial in preparing the ground for the compromises found in the political sphere. [20] Its crucial role is best interpreted by the notion of an "epistemic community" as was mentioned above. In terms of power resources, it lies below national ministries and the political level, but its importance relates to the fact that it was the actual forum where the compromise was found. The *Commission* (at the time under President Jacques Santer and Commissioner de Silguy) is placed low in terms of decision-making power. However, it successfully achieved a solution within the Treaty framework, preventing an international agreement *à la* Schengen. Such an intergovernmental arrangement would have marginalised the role of European institutions. Another success for the commission was the inclusion of the surveillance procedure in the SGP. Yet, it had to depart quite considerably from its initial preference, which was not very much in favour of stricter

rules. The *European Parliament*, with a rather negative stance towards a strict pact, was unable to bring substantial influence to bear on the deliberations; therefore, it is placed on the lowest level. Finally, a set of *experts* not affiliated to any actor previously described was able to make its influence felt through informal and professional contacts, communication and the gradual shaping of ideas that underpinned the slow process of ideational convergence: The European Monetary Institute (EMI), precursor to the ECB, and the central banking community with a close affinity to the Bundesbank position, should be explicitly mentioned as well as institutions such as the OECD, academic think-tanks, private-sector researchers, academics etc. The influence of all their reports, papers, speeches and statements combined was not directly crucial in the decision-making process but, in our view, fundamentally shaped the orientations of the political actors and other expert actors with high levels of resources and access to the political sphere.

Initially, actor preferences are widely dispersed. Once it had changed its view and supported the design of a pact, the Commission was entitled to make its preference the base for the deliberations in the MC. Here, we find a surprisingly rapid convergence tilted more towards the right side of the preference scale, the "German" end. One reason is that a "permissive consensus" (Lindberg/Scheingold 1970) pre-existed already in the MC, whose members had already been in favour of a stability-oriented, rule-based model. In other words, the particular equilibrium solution was not yet determined, but the solution space and, hence, the type of arrangement were already visible.

The final result shows that Germany benefited from a privileged position of asymmetric bargaining power, since it had to make substantially fewer concessions than the countries from the critical side. This was the case for a number of reasons. First, Germany gave up the anchor-currency of the preceding regime, the EMS. Therefore, unlike the other countries, it had to accept the opportunity cost of losing monetary discretion and was able to ask for a higher price – a fact all too well known from the Maastricht negotiations (Dyson/Featherstone 1999). Second, the German position resembles Putnam's two-level game-constellation with the Bundesbank as an informal veto player (Putnam 1988). Due to its reputation and popularity, the Bundesbank was extremely influential on German public opinion towards EMU. If it were to publicly oppose the entry into stage III, it would make it extremely costly politically for the Kohl government to press ahead. From this perspective, the SGP is also a way to reduce public resentment through appeasing the Bundesbank. The effect this had on the negotiations is that the German preference set is narrowed through the informal (declaratory) veto exercised in Frankfurt; therefore, a solution has to lie closer towards the German preference point. Third, Germany could – though at a much higher price than at Maastricht – credibly threaten to exit the process towards monetary union. Fourth, the second-worst threat-scenario was opposition to the membership of "Club Med" countries, Italy in particular. It took a whole series of Ecofin meetings and European summits to implement the MC-outcome in the political sphere. But eventually, convergence took place, feeding through from lower to higher levels of resources. For the reasons described, the solution is situated towards the German preference point. In detail, this means a procedural, legal and especially political strengthening of the existing provisions that in turn can be traced back to German / Dutch negotiation positions in Maastricht. The German side had to give in as well. Most importantly, automatic sanctions had to be dropped from the agreement in favour of political discretion.

We now turn to the institutional context, to be seen as part of the structural framework for the previously described constellation. Three parallel processes were crucial in shaping and facilitating the agreement: first, the Franco-German "axis"; second, a process of

political deliberations in the European Council parallel to the Ecofin negotiations; and third, pressure from financial markets.

The Franco-German exchange (institutionalised in the 1963 Elysee-Treaty) is on several levels equivalent to a sub-set of the negotiations on the European scene. Its most important function is a radical reduction of the number of negotiators involved, thereby decreasing the transaction costs of any agreement exponentially increasing the chance of finding a compromise solution. In our view, these summits are important because France and Germany not only represent different perspectives on these issues, but also different groups of countries. As happens in other types of bargaining, it is as if France and Germany are "delegated" to negotiate a settlement. [21] The actual solution was often not reached during Franco-German summits or economic consultations, but the subsequent meetings on the European scene benefited from the prior exchange of views and signals.

In addition to the Franco-German deliberation process, the negotiations of the Ecofin Council were seconded by a parallel political process of summit meetings in the form of European Councils. Konow (2002) stresses that, unlike the role of the European Council as defined in the Treaty, the Heads of State or Governments did not confine to providing merely the initial political impetus. Instead, they punctuated and guided the negotiations throughout the process, thereby removing important obstacles to compromise, most notably in the case of the lower end of the definition of a severe recession that would constitute an exemption from the imposition of sanctions. The European Council did not only issue strategic political aims, but rather defined operative solutions in surprising detail and delegated their attainment and the legal framing to the Ministers of Finance as well as to the Commission.

Finally, financial markets were influential in forcing the negotiators to agree on highly contentious issues. The fact that the Deutschmark rocketed against all other currencies involved whenever a deadlock seemed to jeopardise the course towards stage III, imposed a substantial cost of failure on all negotiating partners. This contributed to the omnipresent desire to reach consensus and made all actors involved rather give in on issues that were credibly posed as *conditiones sine qua non* by their counterparts, than leave the negotiation room with empty hands. To summarise, this section has tried to explain how ideational convergence, facilitated by asymmetric bargaining power and the institutional context, enabled a political compromise.

## **5 Lessons from the Theory and the Past for the Current Situation**

Reflecting on the analysis of the history, the politics and the economics of the SGP, what can we learn about the current crisis? In recent years the budgetary situation of a number of countries, notably Portugal, Germany, France and Italy has deteriorated. The first three countries are experiencing the initial stages of the EDP. Why did these problematic budgetary situations emerge? These countries failed to pursue policies that would lead to a low budgetary deficit. Part of the reason can be traced back to low economic growth. But critics would stress that these countries could and should have reduced their spending when the going was good. In addition, West European countries need structural reform but governments have put off the necessary unpopular measures. Germany is still facing additional difficulties because of the financing of reunification. Critics of the SGP stress that the Maastricht convergence criteria and the SGP limit both monetary and fiscal policies, thereby reducing the scope for government policies too much. They argue that governments are effectively unable to pursue countercyclical policies to stimulate the

economy in a downturn. Although procyclicality is a negative side-effect, the SGP gives Member State governments a constraint that justifies the difficult restructuring of labour markets and social welfare states. Even in the upswing in the late 1990s, the above-mentioned countries avoided these structural changes. The reforms would have placed their budgets close to balance or in surplus. This budgetary room for manoeuvre would have allowed cushioning the subsequent downturn without having to run excessive deficits.

The reaction to this situation has been diverse. Some politicians have decided to speak out vocally in favour or against the SGP. Commission President Romano Prodi famously called the pact "stupid" (Le Monde: 18.10.2002). In contrast, and not surprisingly, ECB President Willem Duisenberg keeps defending the SGP. His successor, Jean-Claude Trichet, can be expected to represent an equally, if not even more, committed defender of the pact. Member State governments themselves have also reacted quite forcefully. Some of the governments, in particular those of smaller Member States, have complained that they did, in fact, pursue the necessary disciplinary policies to keep their budgetary deficits under control. The Dutch Minister of Finance, Gerrit Zalm, even threatened to take the Commission to the European Court of Justice if it does not hold France to the SGP (NRC Handelsblad, 11 September 2003). In taking this strong stance, the Dutch are receiving support from other small Member States such as Austria, Belgium, Denmark, Finland and Spain. They find it unfair that now that the larger Member States are facing the same difficult situation, their budgets should be allowed to rise and go beyond the agreed ceiling. This difference in behaviour between large and smaller Member States reinforces the view, for some, that the EU works with separate rules – for large and small Member States. In any case, Ecofin Ministers now may have to face the difficult decision of whether or not to impose sanctions if excessive deficits persist.

We argued throughout this paper that the purpose of the SGP is to underline the importance of fiscal discipline, which comes down in essence to not appropriating the budget for electoral purposes. The SGP was created to institutionalise that conviction, thereby protecting and strengthening the credibility of EMU. Even though the sanctions were designed to scare, the hope was that they would never have to be applied. Indeed the problem is that the draconian measures that are foreseen, if a country has a prolonged excessive deficit, are almost too much to actually apply. At the same time we have argued that EMU still needs to build up its reputation and its credibility. This credibility is at stake if the formal procedures are tempered with as soon as they become demanding. Beyond the SGP, EMU's long-term survival will depend on having a workable regime of fiscal discipline. There is a risk that EMU will fall apart if all Member States start overspending, forcing inflation and interest rates up.

How should the current situation be handled now that several countries do not meet the requirements? Should the application of the SGP be relaxed without changing the legal text and hope that in the future Member States will stick to the rules? The deficits, for example, could be interpreted as having occurred during "exceptional" circumstances (i.e. reduced growth because of a major global economic downturn aggravated due to the spring 2003 war in Iraq, SARS, heat waves, floods, etc.). But if this situation in 2003 is deemed exceptional, then surely the future will bring many other cases that could be labelled "exceptional." Another change would be to redefine the term "budgetary deficit." "Investment spending" could be taken out of the deficit, thereby reducing the defined budget. However, that poses the problem that many countries will define "investments" differently and it could well lead to creative accounting. Alternatively, should one actually apply the sanctions to countries such as Germany so that the SGP will finally get some



"bite" and have the other Member States change their behaviour knowing that the fines are serious? Though this might seem like a wild thought, the German government in principle is in favour of the SGP. In a sense it would mean that the pact could only be rescued by at some point applying its rules. Moreover, the critics will still argue that the SGP is bad for economic growth and that it should not be applied.

The overall problem is that if at this point it is decided to tamper with the rules, it will be very difficult to build-up another credible system of rules and expect Member States to adhere to them. Even if the current rules are imperfect, they apply in the same way and in a transparent manner to all Member States. On the other hand, exceptions for specific Member States under unclear circumstances would undermine the rules. Whether or not that would be fatal to the continuation of EMU depends on what will be created in its place. Even a better regime would have to deal with rebuilding credibility. Member States have invested in the rules and have incurred sunk costs. Thus, switching to another regime would be costly; substituting the SGP by a vacuum even more so.

We think the success of the SGP depends on the economic (and political) performance of domestic economies in Europe (in terms of growth and employment) and how lack thereof is being "sold" to the population. The SGP can be used in many ways. If it is used to blame the European Union for all evil, then the SGP will likely come under further attack and potentially collapse (with the possible negative side-effects on the credibility of EMU). If the disciplining effect of the SGP is accepted, then credibility will be assured. It is not unthinkable that a new regime (or system of rules) may be invented to replace the current rules. But we feel that it would be better if the Member States chose to make changes to the SGP when it is not under pressure, but rather when it seems to be doing just well.

## **6 Conclusion**

The watchdog has begun to bark. At the moment, we are waiting to see whether it will break loose and bite or whether it will be forced to tug its tail and whine. Alternatively, there is still the chance that its barking is already driving the intruders away from the yard. We started off by asking why the Stability and Growth Pact was created, what purpose it was to serve and what underlying conditions supported its creation. We examined a number of economic and political reasons. We listed five economic reasons. First there was a need for independent consolidation of the ambition to create EMU. The ambivalences in the Treaty regarding sanctions and the fact that nothing was formally arranged for the period in which the transition to the euro had taken place meant that a new arrangement would need to be made. Second, the fear was that EMU would imply negative fiscal spill-overs. Third, the normal disciplining effect on national budgets will have disappeared once EMU is fully operational. A fourth reason is that excessive deficits might undermine price stability. Finally, given the need for a good policy mix between fiscal and monetary policy, with monetary policy centralised, more effective fiscal and budgetary policy coordination is needed. Although the SGP was not intended as a way to do that, it can be used as an improvised device for that purpose.

We also pointed to a number of political reasons that help explain the creation of the SGP. First, it was unlikely that Member States would respect a common objective (namely to keep budgetary deficits below three per cent of GDP) without binding rules. But on a more mundane level, the German domestic political situation forced Waigel to demonstrate to an increasingly eurosceptic electorate that EMU would be rooted in a

firmly embedded system of rules. EMU was created to institutionalise the German model. Germany had developed a stability culture and wanted to incorporate that into the EU rules and regulations governing EMU. This German leadership was possible because of the gradual process of economic and monetary integration (which had the Deutschmark as an anchor currency). Convergence had taken place throughout the 1980s and the first part of the 1990s with Germany leading the crowd. This implied that the others had de facto accepted the monetary regime. At the same time, the type of regime created was supposed to reinforce the independence of the European Central Bank. In fact, all possible references to a Stability Council or any other body that could discuss coordination in EMU was quickly abandoned in favour of rules on budgets. Thus, the original idea launched by the Werner Committee to create a Centre for Decision of Economic Policy was never followed up, nor did the French proposals for a *gouvernement économique* even get full attention.

The actual case study of the creation of the SGP sheds light on the more general question of why the SGP was created. The case study indicates that its very genesis lay in Germany and, eventually, was presented as a proposal for an international treaty (*à la* Schengen) to colleagues in the Ecofin Council. It soon became evident that reopening the negotiations on Maastricht was a non-starter. The SGP would be secondary law based on the Treaty (Articles 99-103 ex 103 and 104 ex 104c). Our analysis of the SGP shows the importance of ideas on the relationship between monetary and fiscal policy, and that the role of monetary policy in society, in general, had changed over time. In the 1970s, Keynesian ideas dominated, whereas by the early 1980s these views were changing. Groups of experts (government officials, central bankers, Commission officials, monetary experts in the Ministry of Finance, researchers, journalists, and academics) all contributed to this paradigm shift. This transition from Keynesianism to monetarism and the convergence of ideas regarding the purpose of economic and monetary policies were crucial for the prevalence of a specific model for EMU. It is noteworthy that the SGP was also brought into being because the ruling conservative parties (or right-of-centre governments in office in most West European Member States) feared that successive left-of-centre governments might overturn these decisions once in power and when seeking re-election.

Our paper has analysed the behaviour of the most important actors. The ones highlighted here are: Member State governments, the German and French Ministries of Finance, the Bundesbank, the Monetary Committee, the Commission, the European Parliament and some non-actor experts such as academics and researchers working in the research departments of central banks, the IMF, OECD, and so on. We assume that governments have the highest resource capabilities. Besides them, there are other players that take part in the "game." What is remarkable is that in November 1995 the positions on the SGP were quite dispersed. Positions converged and moved closer to those of the Bundesbank and the "monetarists" in the German and French Ministries of Finance. The reason for this, in our view, is that it was understood that the SGP was to institutionalise the German model, which in the end had the support of a superior bargaining position. We stress the importance of common ideas and beliefs among experts about the budgetary regime required by EMU. Yet, those ideas alone were insufficient to come up with an agreement on the SGP. In the end power politics is crucial to understand the eventual outcome. In other words, one could say that a set of commonly held beliefs was a necessary but not sufficient condition for the creation of the SGP. The sufficient condition was the simultaneous existence of beliefs together with a corresponding power-political constellation. This setting was generated by the powerful position of Germany (which was due to its exceptional standing in the field of monetary integration).

In the introduction we asked what has changed since 1995/97 and what can be expected for the future of the SGP in terms of lessons and informed speculations. We find that the underlying consensus on the SGP assumed that the Member States would have incorporated into their objectives to actually maintain low budgetary deficits. The elites (experts) had fully agreed on this matter. However, a number of countries no longer act as if the SGP budgetary ceilings are to be taken seriously. We stressed that in part it may be that politicians were opportunistic and thought they could get away with letting the deficits rise as they had numerous other domestic objectives. At the same time, it is not forgotten that EMU and the SGP can only have a positive effect on growth if structural reforms are implemented. Some governments seem to have ignored the fact that without those reforms, budgets deficits rise anew. They now wonder whether with the SGP they are facing a watchdog that only barks but does not bite and is fast on a chain, or whether they have created a horrible unleashed pit-bull terrier that will drive them over the brink of deflation. Some have argued that the SGP may not be the right pact to enforce fiscal discipline. But we have stressed that even though that may be the case, its very effect on credibility depends on how it gets treated when the going gets tough.

At this stage it is too early to speculate boldly about the future of the SGP. Furthermore, as academics, based on our analysis, and without the gift of crystal ball gazing, we would suggest that the SGP problems occurred because of the consensus among politicians about the importance of fiscal discipline seemingly fading away. Yet we argue that there probably is sufficient support among the main actors (aided by experts) to support the regime. We would stress once again that the SGP was created to build credibility. Irrespective of whether it is a "smart" or "stupid" pact, it will only be able to do its job if Member State governments do not mess too much with it – at least in the short run. We think experts agree with this analysis, and that they will be influential enough to affect the thinking in governments. These should want to try to at least *seem* to be applying the SGP and operate within its framework, even if they undermine it *de facto* as far as possible. Time will tell whether our analysis and subsequent speculations are correct.

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## Notes

1

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2

The critical year for the critical case – France – is 2005.

3

This lacuna is related to the fact that the negotiating parties were unable to make any substantial progress in the Intergovernmental Conference on Political Union in 1991. The concluding parties seem to have been aware of the shortcomings and included the possibility of complementary regulations for the future (TEC Article 99v ex 103v and Article 104 ex 104c, paragraph 14): "Further provisions relating to the implementation of the procedure described in this article are set out in the Protocol on the excessive deficit procedure annexed to this Treaty. The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol. Subject to the other provisions of this paragraph, the Council shall, before 1 January 1994, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol." (Article 104 ex Article 104c paragraph 14)

4

Negative externalities are welfare or opportunity costs not fully accounted for in the price and market system, usually occurring to a third party not being part of the transaction.

5

However, recent research suggests that the overall size of fiscal spill-overs within the euro area can be expected to be rather small as trade and financial spill-overs to a large extent neutralise each other (Gros/Hobza 2001).

6

The deficit bias is partially counteracted through an increase in relative prices in the expansionary country. The resulting export loss should provide and re-internalise part of the necessary discipline.

7

The no-bailout clause implies that the European Union will not bail-out a national government if it goes bankrupt (Art 101 ex Art 104; and Art 103 ex Art 104b).

8

The logic can be turned on its head. Member States close to the deficit ceiling could argue that a restrictive monetary stance only pushes them to and eventually over the limit (due to interest rate payments and lower growth). Instead of "safeguarding the credibility of ECB independence" (Artis/Winkler 1999), the pact would thereby provide additional ammunition for governments to exert pressure on the central bank (Willett 1999).

9

There are only four cases of recessions exceeding two per cent in the history of the current Eurozone economies: Italy (-2,7 per cent in 1975), Portugal (-4,3 per cent in 1975), Finland (-7,1 per cent in 1991), and Sweden (-2,2 per cent in 1993) (Eichengreen/Wyplosz 1998).

10

A third option would be to have a new economic authority make decisions about these matters. This idea was first raised in the 1970 Werner Report which offered a blueprint for EMU (Committee on the Realization by Stages of Economic and Monetary Union in the Community 1970). It referred to this organ as a "Centre of Decision for Economic Policy." In the late 1980s, the French produced a similar idea when they called for a "gouvernement économique." The creation of such a body has thus far not taken off due to the fear that that it might undermine the independence of the ECB.

11

Ironically, in 1996 it became public that Germany itself had breached the three per cent limit for the first time in 1995.

12

According to Eurobarometer data (MM4/95), 65 per cent of the German public were opposed to a single currency in the first half of 1995 (Commission of the European Communities 1995).

13

German public opinion was heavily influenced by a "manifesto" of sixty German economists against the Maastricht Treaty (*Frankfurter Allgemeine Zeitung*: 11.06.1992) and a ruling of the German Constitutional Court (BVerfG 89, 155) in 1993, demanding EMU to be geared towards monetary stability. Even more prominent was the continuous stream of criticism coming from the Bundesbank, starting with (Deutsche Bundesbank 1992).

14

Influential was a speech given by the President of the German association of cooperative banks, the *Bundesverband der Volksbanken und Raiffeisenkassen*, Wolfgang Grüger, who proposed to conclude an intergovernmental stability treaty among the future EMU states (Handelsblatt: 09.05.1995).

15

The military term "pact" had become quite fashionable in German symbolic politics after two failed attempts at crafting a "Solidarity Pact" for the financing of reunification in 1993. Note also the "Stability Pact for the Balkans," originally proposed in 1993. The term "pact" has also been used in various other Member States in the context of "tripartite social pacts," for example in Italy, in order to restructure pensions. In this sense the term "pact" is used to provide a sense of social concertation as it signals collaboration among various actors (in Germany for example restructuring would require the collaboration from the social partners – trade unions and employers' associations).

16

Note that the Bretton Woods system of fixed exchange rates was still formally operational in 1970 but was starting to show signs of breakdown, which eventually happened on 15 August 1971. In the following years the snake was created, which was a system of fixed but adjustable exchange rates in which most but not all EC Member States (and sometimes a few non-EC Member States) participated. The snake was not very successful as there were frequent realignments and the currencies of various countries, notably France, dropped out a number of times.

17

One participant described their role as "financial diplomats" (interview with the authors in July 2003).

18

The preference set is large since the initially positive response to Waigel's proposal has to be seen as rhetoric because it did not include true assent to its most important component, automatic sanctions.

19

According to Scharpf (1997), we assume that different positions within a ministry disappear as consensus is imposed upon the officials. This happens through hierarchical direction and the "shadow of hierarchy" within the organisation.

20

Formally, the sessions of the European Council as well as of the Ecofin Council are prepared by the Committee of Permanent Representatives (COREPER) according to Article 207 (ex-Article 151) TEC, which *de iure* involves the foreign offices of the member states in the process. We disregard this peripheral scene of negotiation on monetary matters and take the *de facto* preparatory role of the MC as decisive. The MC convened at two levels. At the higher level, the representatives of Ministers (state secretaries or junior ministers) and Deputy Governors of the central banks met. At the lower level, that of the so-called "alternates," the committee met to deal with a range of detailed technical issues.




Milesi (1998: 145) quotes a delegation member of the Dublin summit: "C'est un problème franco-allemand (...) Mettez-vous d'accord entre vous et nous accepterons votre solution."

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MPI für Gesellschaftsforschung, Paulstr. 3, 50676 Köln, Germany



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