The stability and growth pact: lessons from the great recession.

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Lessons from the Great Recession.

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Abstract

While current instruments of EU economic policy coordination helped stave off a full-scale depression, the post-2007 global financial and economic crisis has revealed a number of weaknesses in the Stability and Growth Pact, the EU framework for fiscal surveillance and fiscal policy coordination. This paper provides a diagnosis of how the SGP faired ahead and during the present crisis and offers a first comprehensive review of the ongoing academic and policy debate, including an account of the reform proposals adopted by the Commission on 29 September 2010. In our view, the current system of EU rules is unbalanced. It consists of (i) very specific provisions on how to conduct fiscal policy making in normal times with no effective enforcement mechanisms, and of (ii) no or extremely tight provisions for really bad economic times, like the Great Recession. A two-pronged approach as outlined in this report is needed to revive the Pact: tighter enforcement, coupled with broader macroeconomic surveillance, in good times and an open window for exceptionally bad times, including a crisis resolution mechanism at the EU level.

Key words: Stability and Growth Pact, EU, Europe, the euro, Great Recession, fiscal sovereignty

JEL classification: E62, E63, H6.

Disclaimer: The authors are writing in a personal capacity and their views do not necessarily coincide with those of the European Commission, the OECD or the Swedish Fiscal Policy Council. Paul van den Noord contributed to this paper in his earlier capacity of Economic Adviser in the European Commission.

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You never let a serious crisis go to waste. And what I mean by that it's an opportunity to do things you think you could not do before.

Rahm Emanuel, White House Chief of Staff, 19 November 2008.

Governments use the myth of nationhood to which they owe their existence to obstruct or delay a EU government, and to cling to the simulacrum of their power even now that the problems they need to address have become so much larger than they can handle.

Tommaso Paddoa Schioppa, former member of the ECB Board and Italian Finance Minister, Chairman of Notre Europe, BEPA Monthly Brief, Issue 27, May 2010.

[For] all its merits, the original system of governance for the European single currency was intellectually and politically schizophrenic. On the one hand, it represented the culmination of 40 years of integration, based on the obvious inadequacy of national procedures to confront continental and global challenges. On the other hand, it was concerned with preserving absolute national sovereignty in fiscal, budgetary and macroeconomic matters.

Peter Sutherland, Former European Union Commissioner, Financial Times, 30 June 2010.

1. INTRODUCTION

The financial crisis that hit the global and European economies since the summer of 2007 is without precedent in post-war economic history, comparable to the events that triggered the Great Depression of the 1930s (European Commission, 2009). Fortunately, the lessons from the Great Depression have been taken at heart. In the Great Recession governments and central banks have been well aware of the need to avoid the policy mistakes that were common at the time, also in the EU and the euro area. Large-scale bank runs have been avoided, monetary policy has been eased aggressively, and governments have released substantial and targeted fiscal stimulus. Countries have not resorted to protectionism at the scale of the 1930s. It demonstrates the importance of EU economic policy coordination.

Nevertheless, the post-2007 global financial and economic crisis has revealed a number of weaknesses in the EU fiscal surveillance framework, the Stability and Growth Pact (SGP). Policymakers ended up doing the right things, not because of the framework, but in spite of it. In clear contrast to the first crisis of the Pact in November 2003, when Germany and France decided to flout the provisions of EU fiscal surveillance, many observers no longer believe the Pact can be mended. The focus is no longer on how to improve this or that part of surveillance as was the case in 2004-05 (see Jonung et al. 2008). The prevailing view seems to be the following: do not shed additional tears on a dead body; rather concentrate on what to do when the chips are down (see for instance Baldwin and Gros, 2010). We do not share this gloomy view. We acknowledge the shortcomings of the Pact mark-II, yet believe it is worth preserving and can and should be revived.

In 2007 many Member States recorded fiscal balances which, on the face of it, looked pretty comfortable: in the euro area as a whole the headline deficit declined to 0.6% of GDP, down from 1.3% of GDP in 2006, the lowest level in more than a decade. In terms of the prevailing macroeconomic paradigm the situation looked fairly virtuous. Progress towards fiscal sustainability coupled with low and stable inflation was exactly what macroeconomists prescribed. Other macroeconomic imbalances such as large current account deficits, booming real estate and asset prices in some peripheral European countries were not completely ignored but were not thought to pose serious risks to overall macro financial stability either.

Then came the crisis which imposed a sobering reassessment of the economic situation. On the fiscal side it became clear that seemingly favourable figures had masked at least two important elements. First, budgetary improvements, achieved on the back of particularly tax rich economic growth, had partly been used to increase government expenditure. As the crisis unfolded, the ensuing free fall of revenues exposed the missed opportunity to consolidate and weighed markedly on the available fiscal space. A similar, yet much less pervasive pattern had been observed during the ITC boom-bust cycle of the late 1990s and early 2000s. Second, as they started unwinding, imbalances outside the government sector translated, to a significant degree, into government liabilities; e.g. large amounts of liquidity were pumped into the banking sector in a bid to prevent a financial meltdown. The Pact failed to prevent this from happening.

Another major flaw emerging from the crisis has been the lack of provisions to manage and mitigate severe economic stress and/or outright crisis. Although the 2005 reform of the Pact had introduced a considerable degree of flexibility, the SGP did not and still does not allow for discretionary fiscal expansions, unless a country has significantly overachieved its budgetary objectives. The stabilisation function of fiscal policy is entrusted exclusively to automatic stabilisers which may be allowed to play fully only if a Member State has reached its medium-term budgetary objective (MTO). In this respect, the call for expansionary fiscal policies included in the European Economic Recovery Plan adopted by the Commission and endorsed by the Council at the end of 2008 was in conflict, probably not with the spirit, but certainly with the letter of the Pact.

Aside from the Pact's failure to either prevent or cater for the mitigation of the current crisis, EU economic governance also lacks a framework for crisis resolution, notably when it becomes a sovereign debt crisis. EU economic governance was again flat-footed when faced with the Greek sovereign debt crisis. A scenario had opened that had not been considered by the architects of the Treaty and the SGP, namely that of a member of the euro area becoming insolvent and/or defaulting on its debt. To avert the worst, ad hoc measures were put in place in far from ideal conditions.

To be fair, it would be wrong to conclude the European Commission or the Council took faulty policy decisions in the face of the crisis. But when the crisis hit, policy makers were confronted with a challenge that simply could not be met within the remit of the existing rules: actively leaning against the wind while respecting the fiscal rules, helping illiquid or insolvent countries while respecting the no-bail-out clause. The main purpose of the Pact was precisely to avoid the notorious flaws of discretionary fiscal policy making by adopting a rule-based system, which, if applied fully, was believed to avert any form of debt crisis.

When designing the rules in the 1990s, two key elements were overlooked or addressed with the (im)providence of political opportunity or both:

- First, enforcement of the agreed set of rules for national fiscal policy making was essentially entrusted to the sense of responsibility for the common EU interest among Member States. Except for peer pressure and moral suasion at the EU level, the agreed set of rules does not provide for effective instrument at the EU level to cope with deviations from the path of virtue. The threat of a no bail out was assumed to prevent extreme fiscal follies.

- Second, the designers of the SGP seem to have turned a blind eye on the fact that even the most sophisticated system of rules would not be able to account for all contingencies. As a result, the EU fiscal architecture does not have robust escape clauses that would kick in when the rules are objectively no longer viable. In addition, the flexibility introduced by the 2005 revision of the Pact was not the type of flexibility required to address major unforeseen events. It was flexibility at the margin that weakened the degree of commitment in normal or good times.

It was just a question of time before the EU fiscal framework would run into problems: not effective enough in normal, and especially in good times, and too rigid in really difficult times such as a deep crisis. At the end, because of (i) inadequacies in auditing Member States' government finances; (ii) the failure to effectively enforce its rules before the crisis; and (iii) not recognising the fiscal risks implied by other macro imbalances, the EU was forced to resort to financial assistance, which while legally in line with the no bail-out clause, nevertheless implied less stringent constraints on mutual financial support than foreseen by the fathers of the Treaty.

The major policy challenge going forward will thus be to rebalance the trade-off between commitment - a rule based system - and flexibility - escape clauses, in other words, to strengthen the bite of the rules under normal circumstances and increase its flexibility when it is most needed, notably in truly exceptional circumstances.

By now, the need to rethink the EU's fiscal framework is commonly acknowledged. A number of important steps have already been taken. Some were forced by events, such as the adoption of the financial stability instruments on 9 May 2010, others are part of the official reform process, notably two Commission communications - 12 May and 30 June 2010 - outlining options for strengthening EU economic governance, followed by a comprehensive package of draft EU legislation adopted by the Commission on 29 September 2010.

The remainder of this paper is organised as follows. Section 2 presents a brief survey of fiscal developments in the euro area during its first 10 years to serve as background for the subsequent evaluation of the Pact. Section 3 describes the major flaws of the existing system of governance that led to the present crisis. Section 4 discusses and presents a set of proposals to counter existing weaknesses. It also includes a first brief overview of the concrete reform proposals advanced by the European Commission on 29 September 2010. Section 5 summarizes and concludes.

2. THE FACTS

The creation of the single currency in Europe is undoubtedly among the most fascinating experiments in modern economic history. It is unique in the sense that the monetary union was established prior to a strong political and fiscal union. A monetary union without a well-built fiscal union gives rise to major challenges, not least that of keeping fiscal policies in check as free-rider opportunities emerge. These are well documented and analysed in the literature and include the incentive to run fiscal deficits in the pursuit of electoral success while largely exporting the financial crowding-out effects to other participants in the monetary union (European Commission, 2008).

This is precisely why the least profligate countries (led by Germany) insisted on the adoption of the SGP prior to the creation of the single currency, to tie the hands of the spendthrift peers. As is well known, the Pact commits countries to keep their fiscal deficits below 3% of GDP, except in exceptional circumstances, and to ensure their public debt levels fall to 60% of GDP or stay at or below that level. The exact formulation of the fiscal rules embedded in the Pact is well documented, so we will refrain from rehearsing them here. However, it is important to stress that the rules are fundamentally asymmetric: there are alarm bells and sanctions if countries breach (or fail to converge to) the deficit and debt "reference values", but there are no political rewards for doing better than this even in economic good times ("sticks without carrots").

The question then is how euro-area members have fared in terms of their fiscal behaviour since the start of the monetary union. This has already been analysed in numerous contributions, but it is only now that we can assess the developments from the perspective of an incipient sovereign debt crisis. Before the crisis, the assessment was mixed to positive, but we now know that the first decade of EMU was exceptionally benign. The crisis changed everything.

A quick inspection of Figure 1 to Figure 3 would make one believe that the euro-area wide fiscal position has been well-behaved, moving up in economic good times and moving down again in downturns. Also the cyclically-adjusted position looks well-behaved, suggesting a counter-cyclical stance of fiscal policies over the business cycle (with the exception of 2001-2002 when several countries were led to hand out windfall gains from the dotcom boom amid a busy election calendar).

But this is to deny the exceptionally favourable macroeconomic conditions that were prevalent in the first ten years of EMU. Much more progress with fiscal consolidation should have been made in that period in order to better weather the storm of the financial crisis that unfolded in 2008-2009. Euro-area countries have not done this collectively. But some did worse than others. We find it convenient to make a distinction between those that at least during the first full cycle (from the Asian crisis in 1998 via the dotcom boom in 1999-2000 to the dotcom bust in 2001-2003) did or did not make any progress in terms of achieving their medium-term objective of a fiscal position "close to balance or in surplus" as enshrined in the Pact and projected in the annual updates of their Stability and Convergence Programmes (SCPs). We call the former the "early flouters", which include the three largest euro-area countries along with Portugal and Greece (Figure 4).

The behaviour of the "early flouters" in the period 1998-2003 is in sharp contrast with that of the "early compliers" (Figure 5). Prominent among those are Spain and Ireland, very much helped by an exceptionally tax-rich growth pattern (with fast real estate development squeezing exporting industries). Austria, the Netherlands and Belgium were also "early compliers", although less driven by real estate developments, but buoyant financial asset and housing markets did play a role in the case of the Netherlands as well while Belgium benefitted from an inversion of its debt snowball. Notably Spain and Ireland now look less compliant than they seemed at the time, as the exceptional buoyancy of asset and housing markets proved ephemeral, but they could have done worse nonetheless.

Germany and France were the first countries to breach the 3% of GDP deficit limit in 2003 and thereby also the first to become subject to an Excessive Deficit Procedure (EDP). This is somewhat ironic because the Pact had been the fruit of a German initiative, watered down somewhat by extensive arm twisting by France. The designers of the Pact were thus the first to breach it. This was never the intention. It is therefore not surprising that both countries colluded to "put the EDP in abeyance", which eventually led to a revision of the Pact in 2005. It became more lenient in some respects, but it was hoped that by increasing the "ownership" of the Pact by the members, compliance would improve.

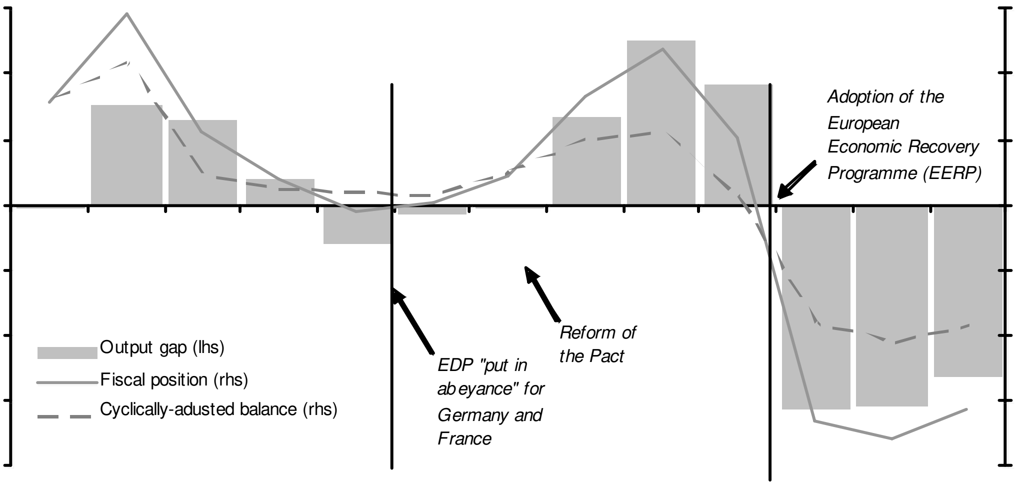
On the face of it, however, compliance did not improve. The "early flouters" saw their fiscal positions improve, but again the business cycle helped and the medium-term budgetary objectives (MTO) remained moving targets (Figure 4). The "early compliers" continued to behave, at least apparently for a while, until the financial crisis broke out and their overblown real estate and financial activities melted down (Figure 5). The same happened among the "early flouters", but here the contrast with their past performance is less stark. Now that budget deficits have soared across the board, all countries still promise to respect their MTO, as depicted in the figures. Are these promises credible? Perhaps they are as financial markets now kick in, that is, exert a strong pressure on domestic fiscal policy makers (see below).

The 60% of GDP reference value for public debt has traditionally received somewhat less attention than the deficit criterion. This has clearly changed since the financial rescues in the wake of the crisis led to massive increases in public indebtedness. Before the crisis, the "early flouters" routinely promised to reduce their debt ratios in their SCPs and also routinely failed to achieve this (except initially Italy, helped by low interest rates interacting with a high initial debt level; see Figure 6). The "early compliers" did achieve a secular decline in their debt-to-GDP ratios, but were all severely hit by the financial crisis, which led to an abrupt reversal of this tendency (Figure 7).

What role have financial markets plaid in this saga as a signalling device concerning national debt imbalances? One of the basic assumptions underpinning the SGP is that financial markets in a monetary union will not differentiate sufficiently between countries in terms of their sovereign risk while the exchange rate risk has been removed altogether. If financial markets fail to discipline countries through these channels, something will need to do it for them. This was the Pact supposed to do. For quite some time the market failure premise seemed to be correct: cross-country differences in fiscal performance were significant, yet this was not reflected in sovereign risk premiums (Figure 8). The standard explanation was that bond markets had integrated and risk premiums had been arbitraged away.

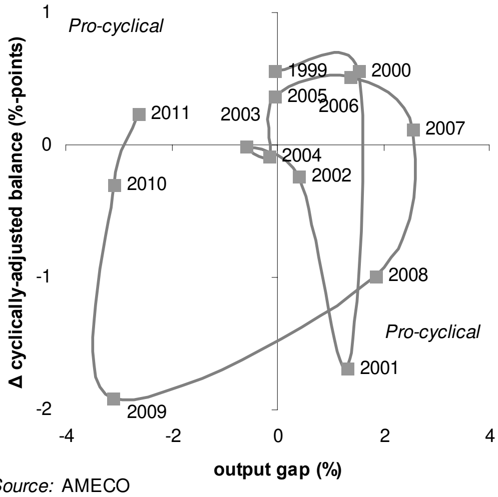
We now know better. In fact, the "Great Moderation" rhetoric along with the liquidity glut stemming from the US-Chinese external imbalance produced a hunt for yield and an underestimation of risk. Arbitrage surely occurred, but was not driven so much by "financial integration" *per se*, but rather by excessive liquidity in financial markets. This, of course, suddenly changed with the financial crisis when underlying sovereign risk differentials were at last revealed. The fiscal consolidation need facing euro-area countries, like that of their peers elsewhere in the developed world, is daunting. Can the existing set of fiscal rules deliver this? Or are modifications needed? What severely complicates the issue is that not only fiscal consolidation is needed, but also markets have become quite nervous about the euro area's aptitude to deliver this and to rescue a Member State that threatens to sink – as the Greek example has shown. A crisis resolution scheme is well underway, but it is still not clear whether this will be a permanent feature of EMU governance and even less clear if governments can muster the political will to restore their public finances on a permanent basis.

Figure 1: Fiscal position and the output gap in the EU, 1999-2011



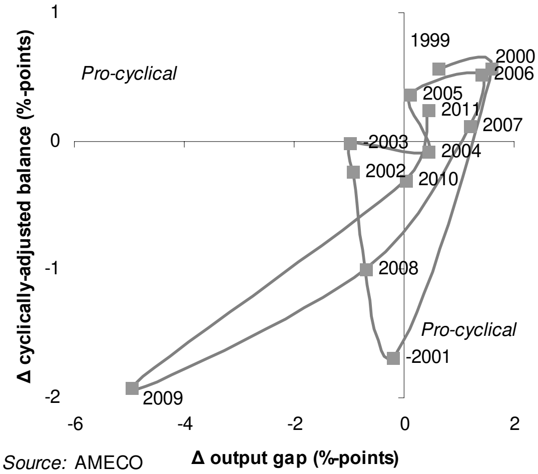
Source: AMECO, European Commission Spring 2010 Forecast

Figure 2: Fiscal stance and the output gap



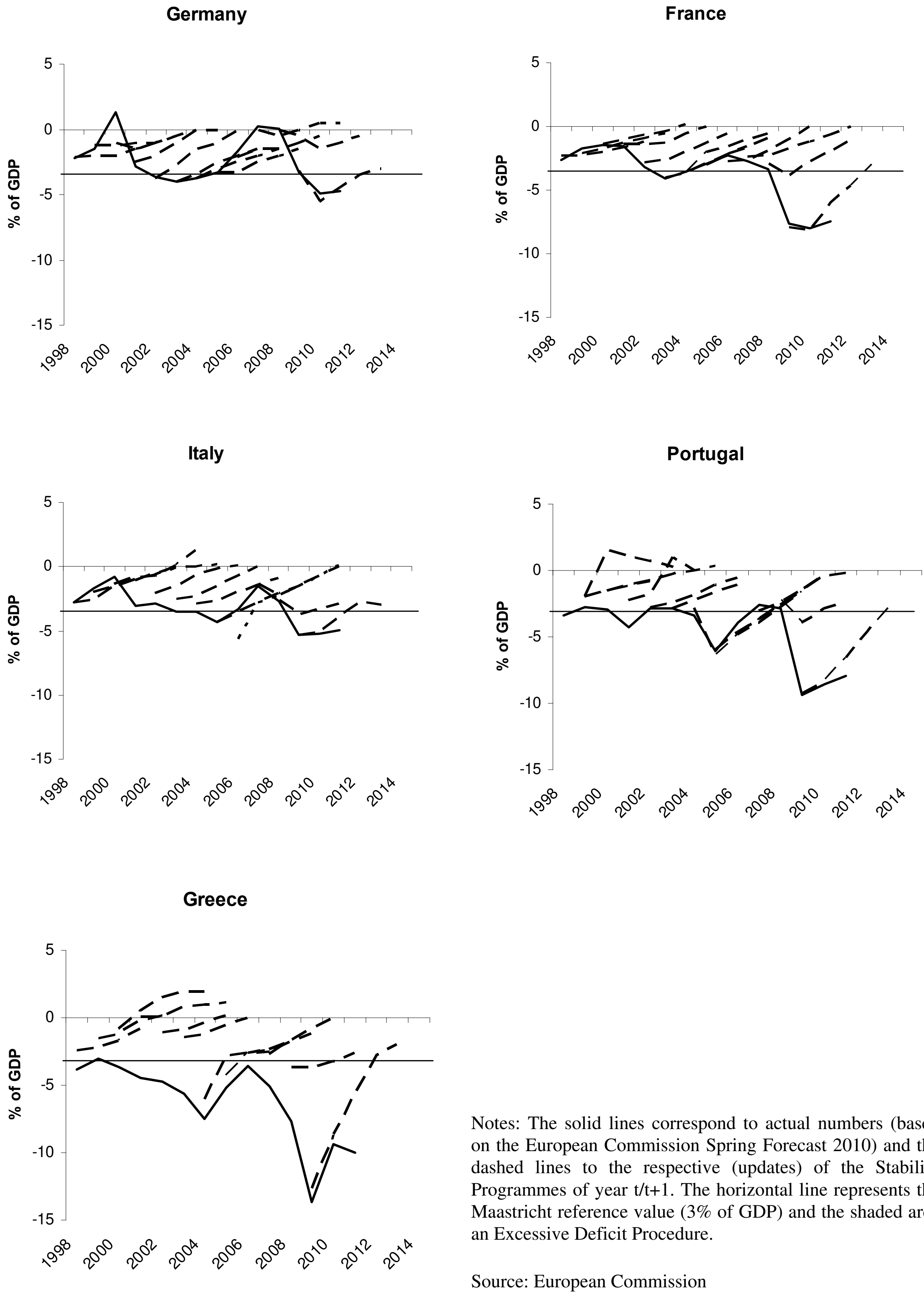
Source: AMECO

Figure 3: Fiscal stance and the change in the output gap



Source: AMECO

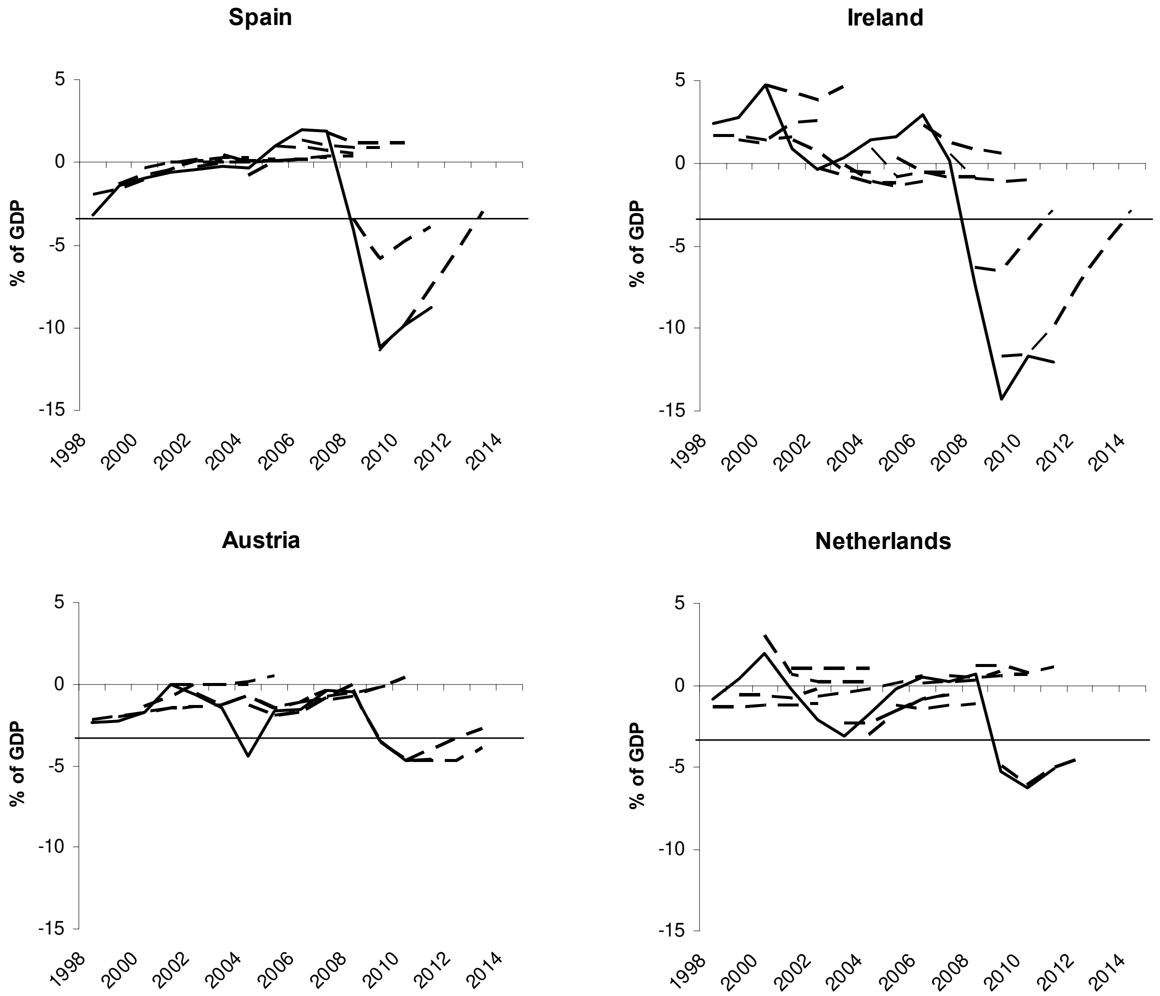
Figure 4: Targeted and actual fiscal positions: the "early flouters"

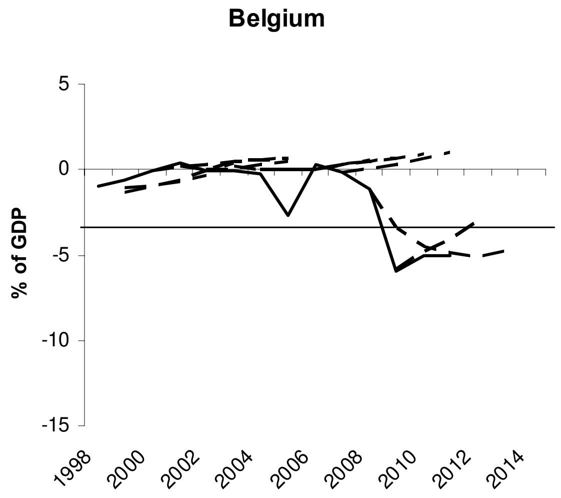


Notes: The solid lines correspond to actual numbers (based on the European Commission Spring Forecast 2010) and the dashed lines to the respective (updates) of the Stability Programmes of year t/t+1. The horizontal line represents the Maastricht reference value (3% of GDP) and the shaded area an Excessive Deficit Procedure.

Source: European Commission

Figure 5: Targeted and actual fiscal positions: the "early compliants"

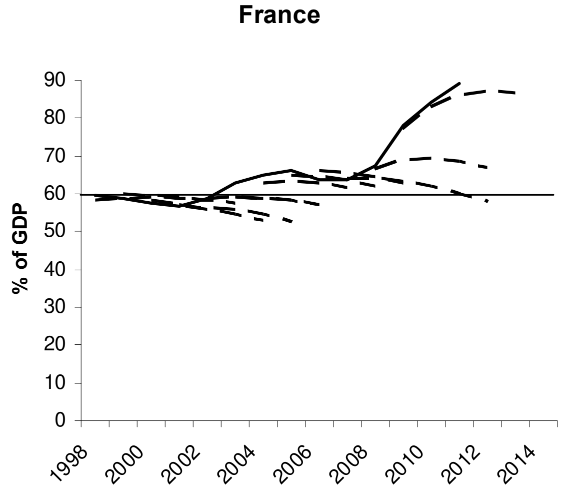


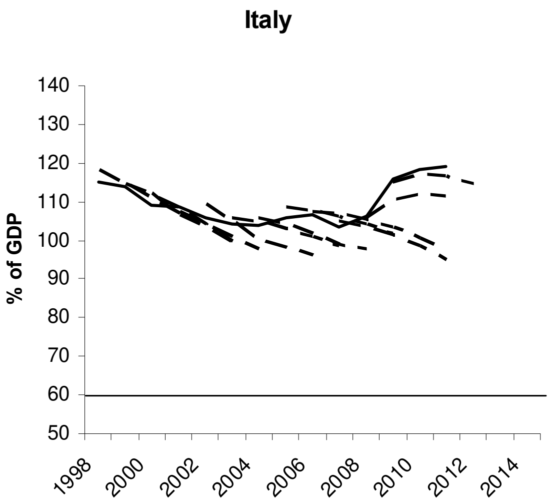


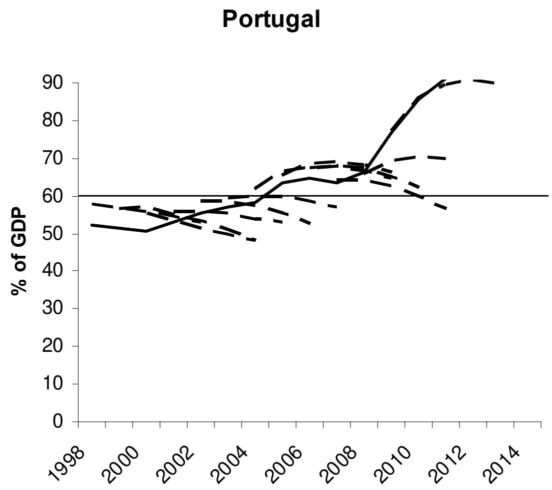
Notes: The solid lines correspond to actual numbers (based on the European Commission Spring Forecast 2010) and the dashed lines to the respective (updates) of the Stability Programmes of year t/t+1. The horizontal line represents the Maastricht reference value (3% of GDP) and the shaded area an Excessive Deficit Procedure.

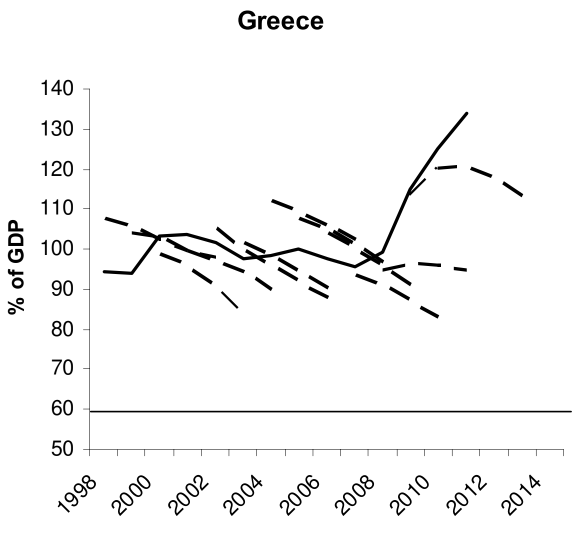
Source: European Commission

Figure 6: Targeted and actual public debt positions: the "early flouters"





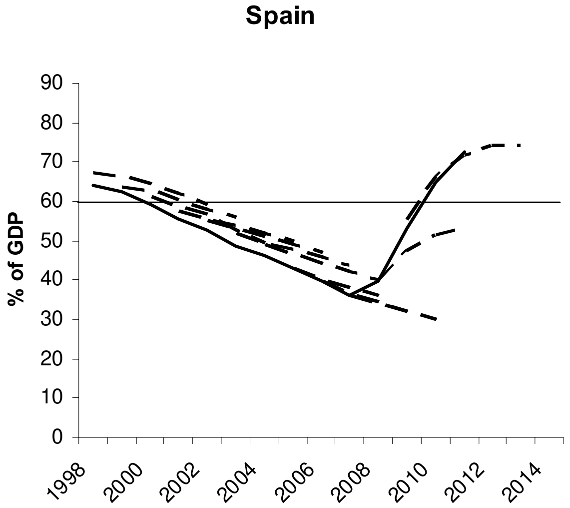


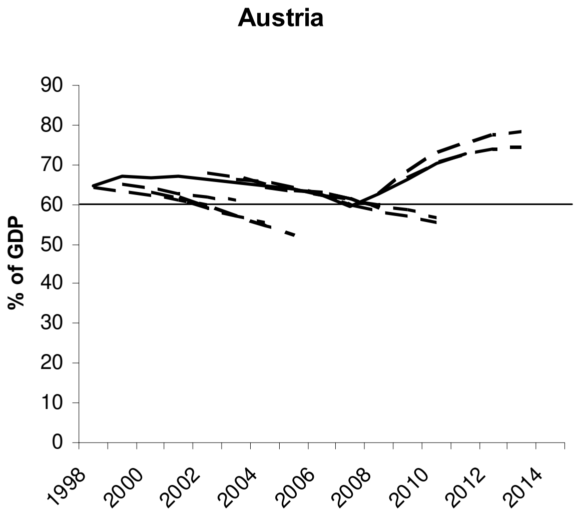


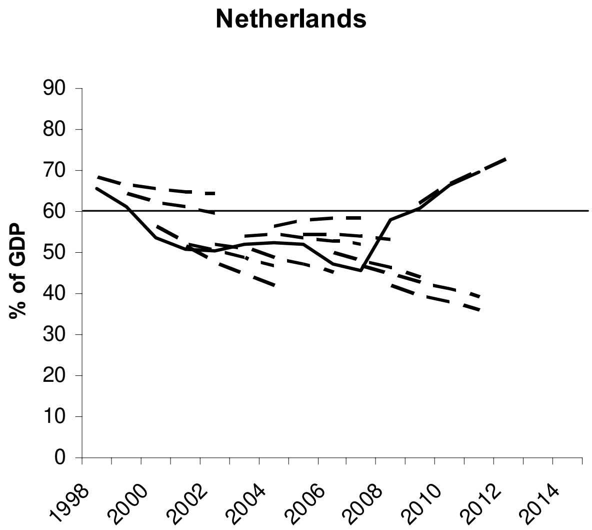
Notes: The solid lines correspond to actual numbers (based on the European Commission Spring Forecast 2010) and the dashed lines to the respective (updates) of the Stability Programmes of year t/t+1. The horizontal line represents the Maastricht reference value (60% of GDP) and the shaded area an Excessive Deficit Procedure.

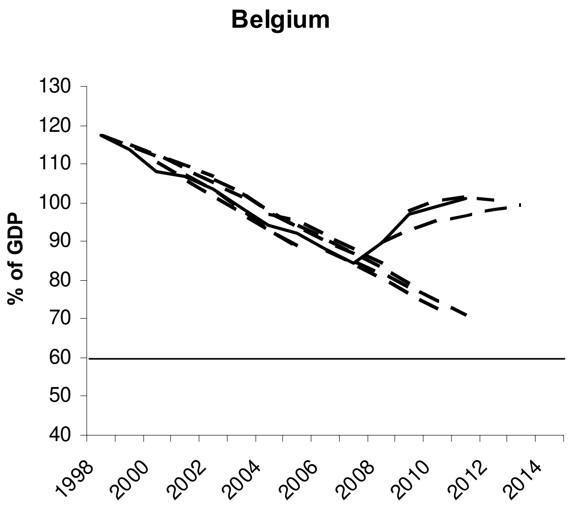
Source: European Commission

Figure 7: Targeted and actual public debt positions: the "early compliers"





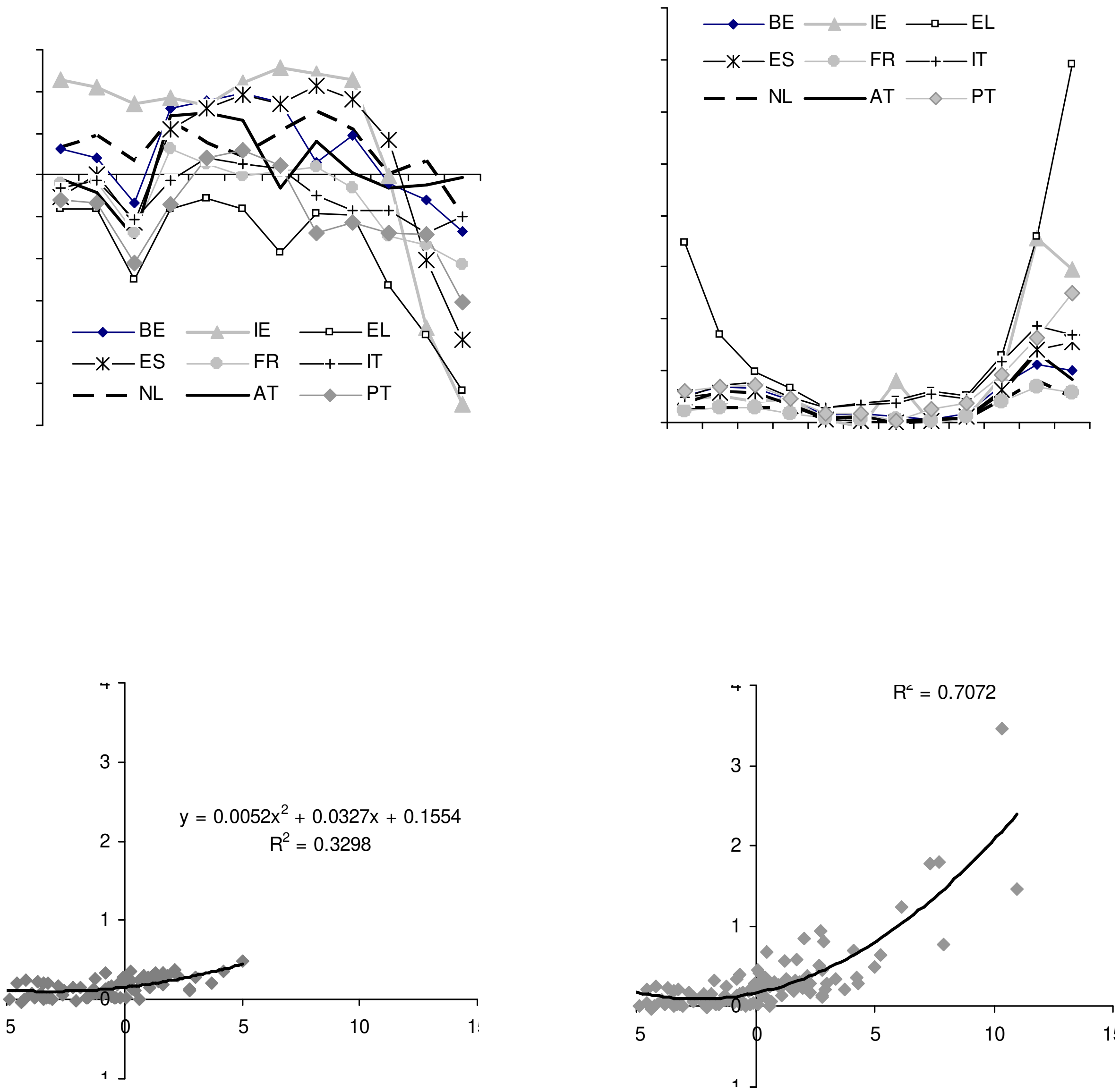




Notes: The solid lines correspond to actual numbers (based on the European Commission Spring Forecast 2010) and the dashed lines to the respective (updates) of the Stability Programmes of year t/t+1. The horizontal line represents the Maastricht reference value (60% of GDP) and the shaded area an Excessive Deficit Procedure.

Source: European Commission

Figure 8: Fiscal deficit and sovereign yield spreads



Source: Commission services

3. THE FLAWS

The SGP has attracted scepticism and criticism from the very beginning, even before it entered into force. Especially academic commentators have argued that, although well-intentioned and addressing relevant issues, its specific design was off-the mark or too strict or both. Prominent examples of early critical views of this kind are Buiter et al. (1993) and Eichengreen and Wyplosz (1998), who were followed by a veritable avalanche of judgemental contributions once the SGP had become effective, in particular shortly before and after November 2003 when the Council decided not to follow the provisions of the Pact in relation to the EDP for France and Germany.[1]

In spite of such persistent, primarily academic, scepticism, partly and understandably fuelled by the novelty and uniqueness of the experiment, a broad-based consensus had formed whereby, even if not perfect, the SGP had, after all, contributed to fiscal prudence, in particular compared to the late 1980s and early 1990s when some EU Member States had been running two-digit budget deficit-to-GDP ratios. In the two years preceding the Great Recession, public finance developments seemed to vindicate this assessment.

Many Member States could have made greater fiscal efforts, not least because economic conditions were favourable and economic growth particularly tax rich. This point was repeatedly brought home by the European Commission, see for instance European Commission (2007) and (2008a). But then, based on information available in real time, most EU countries appeared to have reached or were close to reaching their MTO. There were isolated concerns relating to the sustainability of revenue and expenditure growth in countries like Spain or Ireland.[2] On the whole, however, everything looked fine. When the first ten years of the euro area were celebrated, there was a general feeling of the euro being a success, although requests were made for stricter fiscal discipline and concerns were raised about growing imbalances between countries sharing the single European currency.[3]

The present crisis has completely altered the predominant assessment of the SGP. At the time of writing, there are very few, if any, observers who would still see no major shortcomings in the EU fiscal surveillance framework. The prevailing diagnosis encompasses several flaws, some of which were apparent and a source of concern prior to the crisis, other were more difficult to anticipate

3.1. Flaw Nr. 1: weak statistical surveillance

Reliable, complete and timely public finance data are essential for the success of any rule-based system of fiscal surveillance. This was clear from the very beginning of the process leading to the SGP and is reflected in specific provisions laid out in secondary EU legislation.[4] These provisions detail a series of obligations regarding the reporting of

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[1] For a comprehensive review of the debate on the SGP see Jonung et al (2008).

[2] See for instance Martinez-Mongay et al (2005).

[3] See for instance the assessment in European Commission (2008b) or Buti et al. (2010) for a general review of the first decade of the euro.

[4] Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, amended by

government data by the Member States such as the type of information, the quality of data, the frequency of reporting and the interaction between the Member States' statistical offices and the European Commission as represented by Eurostat.

With the benefit of hindsight, we know now that the existing provisions concerning the reporting and assessment of government statistics relevant for fiscal surveillance did not guarantee the necessary quality of data across all countries. Minor reporting issues came into view in many countries, but it was the case of Greece which highlighted the limits of a system that essentially trusts the capacity and willingness of national authorities to provide complete, reliable and timely government accounts. The long series of major revisions of Greek government data was certainly not the sole cause of the 2010 sovereign debt crisis, but they revealed how the domestic authorities for a long time had been masking the true extent of the fiscal imbalances and, as a consequence, had been delaying appropriate actions. [5]

The provisions on statistical reporting related to fiscal surveillance - Council regulation No. 3605/93 and its successive amendments – give the possibility to carry out so-called methodological visits to Member States '*in cases where substantial risks or potential problems with the quality of data are identified*'; and this possibility was used in practice. However, the provisions did not allow for an effective and comprehensive auditing.

At the end of the day, the European Commission had to rely on the readiness of national authorities to provide accurate data and, if prompted, to provide access to information necessary to ultimately check the quality and reliability of national accounts. In most cases, and for most countries, this principle of trust and voluntariness worked reasonably well. Nevertheless, the crisis revealed that the cases of non-compliance were serious enough to question the existing statistical reporting and data monitoring as a whole.

3.2. Flaw Nr. 2: the (non)preventive arm of the Pact in good times

As fiscal imbalances are taken to threaten macroeconomic stability in the EMU, the main objective of the SGP is to ensure sound public finances in the Member States. To this end two main instruments are available: the preventive and the corrective arm of the Pact.

The preventive arm endeavours to avert excessive deficits. Under the provisions of the preventive arm Member States are required to adjust their fiscal balance towards a medium-term budgetary position, the MTO, which would safeguard against the risk of breaching the 3% of GDP threshold of the Treaty and ensure long-term sustainability of public finances. In case the preventive arm is insufficient, the corrective arm defines the procedures aimed at correcting excessive deficits once they occur; it also foresees sanctions in case excessive deficits are not corrected.

Council Regulation (EC) No 475/2000 of 28 February 2000, Commission Regulation (EC) No 351/2002 of 25 February 2002, Commission Regulation (EC) No 2103/2005 of 12 December 2005.

[5] A detailed account of the repeated revisions of Greek government data and the underlying issues can be found in the Report on Greek Government Deficit and Debt Statistics released by the European Commission in January 2010. The report is available at http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/COM_2010_REPORT_GREEK/EN/COM_2010_REPORT_GREEK-EN.PDF .

In theory, the combined effect of fiscal surveillance under the preventive arm and the threat of sanctions included in the corrective arm should have encouraged Member States to run responsible fiscal policies. In practice, however, things did not work out as expected for a number of reasons.

The provisions of the preventive arm turned out to be less effective and persuasive then planned. In particular, they did not cure one of the key pathologies of fiscal policy making: pro-cyclical fiscal policy in good times. As shown in the previous section, since the inception of the Pact in the late 1990s, several Member States went through two episodes of the following type: instead of accelerating fiscal adjustments during economic booms, revenue windfalls were used to ease fiscal policy just to find out during the subsequent downturn, that fiscal space had been exhausted and that government deficits surpassed the 3% of GDP reference value. This very pattern was observed during both the ICT boom-bust cycle of the late 1990s, early 2000s and in the second half of the 2000s when a relatively strong and tax rich economic recovery ended in the Great Recession.

The consistent failure of the Pact to encourage fiscal adjustment in economic good times originated in a combination of three factors. First, there is considerable uncertainty surrounding the measurement of the crucial yardstick of EU fiscal surveillance, the cyclically-adjusted budget balance (CAB). All fiscal requirements to be met by Member States under the provisions of the preventive arm are expressed and assessed net of cyclical conditions and net of one-off and other temporary measures, notably the annual benchmark adjustment towards the MTO of 0.5% of GDP, the MTO proper, and the minimum benchmark, that is, the maximum level of the CAB that provides a safety margin against breaching the 3% of GDP threshold of the Treaty with normal cyclical fluctuations.

In view of the large degree of uncertainty surrounding both output gap estimates and tax elasticities, the opportunities offered by economic good times were generally ascertained only when it was too late, with the benefit of hindsight. A case in point is 2007, the last year before the Great Recession. In autumn of that year, the Commission services autumn forecast estimated the CAB of the euro area at -0.7% of GDP. Based on the figures available at the time, most countries were considered to be close or approaching their respective MTO. This was the combined effect of misjudging the economy's position in the cycle and higher than average tax elasticities. Less then three years later the assessment had changed significantly. Using the nominal deficit figures of October 2007 and applying the output gap estimates of the latest Commission forecast (Spring 2010), the 2007 CAB declined by 2/3 of a percentage point, to -2.0 % of GDP. If this estimate had been available in real time, for a number of countries it would have implied a different – more negative - judgement about the relative position with respect to the MTO and possibly also with respect to the minimum benchmark.

Second, even when risks to fiscal virtue were visible, the surveillance instruments and, more specifically, the instruments of peer pressure offered by the preventive arm of the Pact, such as the Council opinions on the SCPs or the warning (foreseen by Art. 121 of the Treaty), did not necessarily produce the desired results. In particular, temporarily throwing the spotlight of public attention onto observed or projected deviations from the required path of fiscal adjustment and recalling the principle of fiscal rectitude enshrined in the Pact at best induced Member States to adjust their plans but not their actual policies. As a result, one could observe an increasing gap between fiscal projections and actual outcomes. Ultimately, the instruments of the preventive arm where not effective in shaping the behaviour of fiscal authorities; moral suasion was not sufficient.

Third, the ultimate reason for controlling government deficits is to ensure public debt remains on a sustainable path. Often ridiculed as completely arbitrary, the 3% of GDP reference value was actually chosen because in the early 1990s, when the Maastricht Treaty was signed, it was the maximum deficit which, with an average growth rate of 3% in real terms and an inflation target of 2%, was consistent with a declining debt level. Over the years two complications arose: (i) average economic growth has consistently declined especially in the aftermath of the crisis; and (ii) stock-flow adjustments, the residual element of debt dynamics which over time should average close to zero, in some cases turned out to systematically increase the debt, while the deficit remained below the threshold.[6]

The weaknesses of the preventive arm of the Pact came to a head already in the early years and eventually triggered the 2005 reform of the surveillance framework. One of the declared objectives of the reform was indeed to strengthen the preventive arm. The prevailing diagnosis at the time was that by strengthening the economic rationale of the Pact, including a stronger focus on government debt, Member States would feel a stronger ownership and, in the end, self-enforce the rules. Stronger external (dis)incentives were not considered, as the existing system of rules was generally found to be too tight. In line with this diagnosis, the 2005 reform added some economic flesh to the economic narrative underpinning the Pact but mostly introduced a higher degree of flexibility in the application of the corrective arm, a flexibility that was meant to account for changing economic circumstances.

In light of the experience accumulated since the adoption of the reform in 2005, it is clear that the reform has not produced the intended outcome. The extra degree of flexibility, such as the possibility of taking into account other relevant factors when assessing the existence of an excessive deficit, was of limited use during the Great Recession and the changes to the preventive arm have not induced Member States to take advantage of the good times leading up to the crisis.

3.3. Flaw Nr. 3: other macroeconomic imbalances ignored

The architecture of the EU system of economic governance incorporates a key tenet of the macroeconomic paradigm that prevailed in the decades preceding the Great Recession. It was built on the premise that low and stable inflation (monetary stability) combined with sound fiscal policy (fiscal stability) were sufficient to safeguard overall macroeconomic stability. Imbalances other than fiscal ones where taken to be the result of loose monetary and/or fiscal policy, rather than constituting independent risks for

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[6] The elements in the stock flow adjustment which systematically increased debt in some countries include subsidies to companies outside the government sector disguised as capital transfers, or systematic differences between cash based-revenues und accrual based revenues (e.g. actual social contributions received versus due contributions) which should disappear over time but showed a suspicious degree of persistence in some cases.

policy making.[7] To maintain monetary and fiscal stability, the room for discretionary monetary and fiscal policy actions should be limited through the establishment of independent central banks with the goal of price stability (low inflation) and the reliance on automatic fiscal stabilizers. This view was enshrined both in the ECB institutional framework and in the Maastricht Treaty and the ensuing SGP.

The boom-bust dynamics leading to the Great Recession has exposed a severe weakness in this approach. Ever since governments and central banks in Europe, and beyond, had to step in massively to rescue financial institutions that had accumulated an excess of 'bad' assets on the back of housing and asset bubbles, it has become clear that the sustainability of public finances requires more than 'just' keeping the fiscal house in order; additional policies are needed.

The crisis has demonstrated that the sustainability of public finances can also be affected by economic imbalances which, in situations of economic stress and/or if they go beyond a certain level, risk turning into government liabilities and/or end up on the balance sheets of central banks. This risk became particularly evident in EU Member States which in the years preceding the Great Recession had been attested sound fiscal positions in terms of the formal requirements of the preventive dimension of EU fiscal surveillance, but suddenly found themselves in deep fiscal difficulties as the unwinding of other imbalances spilled-over to the government sector.

The most obvious cases in point are Spain and Ireland. Both countries recorded a staggering swing from seemingly sound budgetary surpluses before the crisis to very large budget deficits in the wake of the crisis. In 2006, Ireland posted government revenues in excess of total expenditure of 3% of GDP, Spain of 2 % of GDP. Three years later, government expenditures surpassed total revenues by 14.3% of GDP and 11.2% of GDP respectively. At the same time government debt increased by significantly more than the budget deficit as a result of government interventions aimed at restoring and safeguarding financial stability mainly through capital injections to banks and other financial institutions. [8]

As became clear quickly, the dramatic deterioration of public finances in the two countries had gone well beyond the impact of the cycle. In view of the extent of the problem, fiscal authorities had to acknowledge without reservation that a significant part of government revenues had been linked to unsustainable developments in the housing market and to capital inflows mirroring large and persistent current account deficits. A large structural gap in government accounts had suddenly emerged due to the boom-bust cycle.

In spite of the narrow focus on fiscal developments, the EU fiscal surveillance did not completely ignore the potential risks to public finances associated with macroeconomic imbalances outside the government sector. In its recommendation for a Council opinion

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[7] A succinct review of the macroeconomic paradigm dominating the years and decades prior to the Great Recession is provided in Blanchard et al. (2010).
[8] In the case of Ireland, government transfers to the banking sector in 2010 were recorded 'above the line' bringing the deficit to above 30% of GDP. These measures did not qualify as a financial transaction ('below the line') because the receiving banks were not considered to be economically viable.

on the 2006/07 updates of the Spanish and Irish stability programme, the Commission made reference to rising external imbalances and the existing inflation differential within the euro area as well as to the unbalanced growth pattern which was led by strong housing sector developments.[9]

Although the macroeconomic risks of the housing boom were broadly known, the overall assessment of the Spanish and the Irish fiscal positions and plans was approving, not least because the two countries were in full compliance with the provisions of the SGP. The rules did not provide for the possibility to ring the alarm bells and to deploy the formal instruments of peer pressure (e.g. the warning under Art. 121 of the Treaty) on the basis of developments outside public finances.

3.4. Flaw Nr. 4: weak EU enforcement

As the euro area is a monetary union without a strong fiscal union, the scope for effectively influencing fiscal policy making at the supranational level clashes with national sovereignty. The circle is formally squared by submitting the national prerogative of fiscal policy making to the commonly agreed rules of the SGP. The ultimate decision making authority in charge of implementing the rules are the Member States within the Council. Based on the initiatives and recommendations of the European Commission, the Council approves or rejects the legislative instruments which are meant to ensure the functioning of the Pact. Decisions are generally taken with a qualified majority and Member States are expected to adhere to the decisions taken.

The two main instruments available to the Council to encourage compliance are peer pressure (under the preventive arm of the Pact) and the deliberation of financial sanctions (under the corrective arm of the Pact) if an excessive deficit persists and the Member States concerned repeatedly fail to comply with the recommendations and decisions of the Council.

With the benefit of hindsight we know that these instruments of economic governance have not been sufficient to ensure compliance with the rules. The presumption underpinning the design of the SGP whereby Member States would follow the rules so as to avoid sanctions turned out to be too optimistic. Instead the Council has emerged as the weak link in the EU governance structure, serving rather as a gentlemen's club avoiding or minimizing confrontation among its members.

While fiscal surveillance is effectively carried out by the European Commission whose statutory independence should ensure impartiality of its assessments; this impartiality has not always been visible in the final acts approved by the Council. For many years, up until 2006, the Commission recommendations for Council acts were not accessible to the general public; only the version amended and adopted by the Council was. While the substance of the two documents may not have differed much in most cases, the version

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[9] The full list of SCPs, the Commission assessment, the Commission recommendations for a Council opinion and the Council opinion proper can be found at http://ec.europa.eu/economy_finance/sgp/convergence/programmes/2006-07_en.htm. Explicit comments on the potential risks related to housing bubbles were given in research documents produced by Commission services. Martinez-Mongay et al. (2007), for instance, clearly pointed to the fiscal risks associated with the housing boom in Spain. They pointed to the large revenue ensuing from transaction taxes and VAT on housing and that a large part of those revenues could not be sustained indefinitely.

finally adopted by the Council very often included important modifications to the wording and sometimes also to the overall message. Typically, the Member States concerned by the Council act were particularly active in proposing and defending modifications of the Commission recommendations. In 2006, it was eventually decided to make the Commission recommendations public albeit only after the Council had amended and adopted the document.

The authority of the Council goes beyond the redrafting of legal documents proposed by the European Commission. Past practice encompasses instances that clearly qualified for an early warning but where the Council decided not to follow up on the respective recommendation of the European Commission and to close the procedure. This was, for instance, the case for Italy in April 2004.[10] The Council's decision was typically based on a commitment by the country concerned to correct fiscal developments. Unfortunately, such commitments were not always honoured and/or the reasons or responsibilities for not delivering (bad luck or lack of effort) became an issue of contention.

This is not to say that the Council repeatedly acted in conflict with the Pact.[11] Rather, the point to be stressed here are the type of problems that ensue from an architecture of fiscal surveillance that lacks effective enforcement mechanisms, as Member States remain *de facto* fiscally sovereign.

Conceptually, the problem can be framed in terms of what in the literature is called a public goods game: there is an incentive to free ride on fiscal sustainability, if sustainability is provided by others, while it is optimal to contribute to fiscal sustainability if it is not provided by others. In this game, the SGP represents the set of rules that should make sure the players don't give in to the temptation to believe that whatever they do, others will provide the public good, in the extreme case including a bail-out.

The Commission, is entrusted with monitoring compliance with the requirements of the Pact but apart from moral suasion has no enforcement power, neither has the group of countries which at the end of the day has to trust the willingness of its individual members to abide by the rules. Formally, the group can, with a majority decision, agree to proceed against a non-compliant member. However, blocking coalitions can easily be formed.

3.5. Flaw Nr. 5: lacking provisions for mitigation of severe economic stress

One of the pillars of modern macroeconomic policy thinking is the notion that in order to ensure macroeconomic stability policy makers should be guided by rules rather than

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[10] The council decision to close the early warning recommended by the Commission is available at: http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/81342.pdf#page=9

[11] It did so once in November 2003, but in relation to the implementation of the corrective arm of the Pact. The Council decided not to adopt the Commission recommendations under Article 104(9) for Germany and France and to adopt its own conclusions instead. The Commission brought the case before the Court of Justice of the European Communities, which on 13 July 2004 annulled the Council conclusions in so far as they aimed at formally suspending the excessive deficit procedure and modifying the existing recommendations.

discretion. This view emerged *inter alia* from the unflattering experience of the 1970s and 1980s that saw an accumulation of unsustainable government deficits and debt levels. In addition, there is little evidence that with normal cyclical fluctuations discretionary fiscal policy provided any significant contribution to economic stabilization: (i) its effect on output is limited or uncertain, (ii) it is slow-moving as it requires a considerable amount of time to be activated; (iii) it may interfere with the stabilisation objective of monetary policy making; and (iv) discretionary fiscal policy measures may be motivated by goals other than economic stabilisation.[12]

The rule-based system of fiscal surveillance codified in the SGP essentially builds on the orthodox scepticism vis-à-vis fiscal discretion. Under the provisions of the Pact, the stabilisation function is entrusted to automatic fiscal stabilisers and fiscal discretion is to be used for the purpose of fiscal consolidation only, unless a country has more than achieved its MTO, which in practice did not happen very often.

The crisis undermined the restrictions on discretionary fiscal stabilisation. In the face of an alarming contraction of economic activity, the working of automatic stabilisers was soon considered to be insufficient to mitigate the impact of the crisis. Confronted with the choice of remaining faithful to the rules of the EU fiscal framework or leaning against the severe and unprecedented economic downturn, priority was eventually given to the latter. In its European Economic Recovery Programme (EERP), adopted at the end of 2008 and subsequently endorsed by the Council, the Commission encouraged Member States, including those that had not reach the MTO yet, meaning the vast majority of Member States, to ease fiscal policy in a timely, targeted and temporary fashion. At the same time, and in line with its legal obligations, the Commission decided to apply the provisions of the corrective arm of the Pact, notably to open EDPs for all countries with a deficit in excess of 3% of GDP; as of 2009 this was the case for almost all EU Member States, also and in particular on account of the fiscal stimulus packages encouraged by the EERP.

The degree of flexibility provided by the Pact for assessing the existence of an excessive deficit, which include the possibility of a waiver in the event of a serve economic downturn,[13] were too tight to encompass the budgetary repercussions of the Great Recession. Based on the prevailing interpretation of the Pact, a deficit of more than 3% of GDP may not be considered excessive if and only if it is stays close to the threshold. In most countries, the excess of the government deficit over the 3% of GDP threshold of the Treaty was far too large in 2009 and 2010 to draw on this provision.

Even the additional degrees of flexibility introduced with the 2005 reform of the SGP were of limited use in the crisis. They provide for more judgement in the assessment of compliance and for the possibility to stretch the length of procedural steps of the EDP or to repeat them depending on economic circumstances.[14] As a result, during the crisis the Commission was in a position to define sufficiently long adjustment paths so as to account for the exceptional depth of the crisis. However, in several cases this margin of

[12] For a comprehensive discussion see for instance Taylor (2000).
[13] Council regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure amended by Council Regulation (EC) No 1056/2005 of 27 June 2005.
[14] For a detailed review of the 2005 reform of the SGP see European Commission (2006).

flexibility was applied to excessive deficits that *inter alia* had resulted from a concerted violation of the rules.

Undoubtedly, the forced combination of accepting violations of the Pact on the one hand and insisting on the formal, although more flexible implementation of the EDP, on the other has not strengthened the already battered credibility of the surveillance framework. At the same time it is fair to say that alternative courses of action were not necessarily more attractive. On the contrary, if, in the face of the Great Recession, the Commission had stubbornly insisted on the strict application of the Pact, including the ban of discretionary fiscal expansions, a severe confrontation with the Member States within the Council would have been very likely. With monetary policy constrained by the zero bound of nominal interest rates, discretionary expansions were the sole instrument left in the tool box of economic policy makers. In the face of the worst economic downturn in the post-war period fiscal inactivity was not an option from a political point of view and probably irresponsible in view of the risk of a systemic economic meltdown.

Ultimately, this episode brings to the fore an important, although not new, insight concerning the design of rule-based policy frameworks. In view of the inherent uncertainty of economic development, there will always be major unforeseen adverse events. From a practical point of view this means that it will be impossible to conceive a rules-based framework that *ex ante* accounts for all possible states of the world; contingent flexibility is required.

The credibility and sustainability of a rules-based framework depends on whether it includes robust escape clauses that allow policy makers to cope with particularly adverse circumstances when sticking to the rules is no longer viable.[15] Once the adverse shock, like an extreme crisis, has been dealt with, and normal circumstances prevail, a return to the rules can take place. Escaping temporarily and in a pre-designed way from the rules is thus a method to maintain a rule-based framework in the long run.

3.6 Flaw Nr. 6: lacking provisions for sovereign debt default

The Great Recession has revealed the drawbacks of the lack of crisis resolution mechanisms. As the sovereign debt crisis escalated in Greece, the conclusion was drawn that an uncontrolled default should be avoided in the interest of financial stability of the euro area as a whole; but no instrument was at hand. As a result, a lengthy and, at times, painful search for an *ad hoc* solution took place which ended in an agreement that foresaw intergovernmental loans from euro area countries and a contribution from the IMF. There was of course a discussion about whether financial support to Greece by other euro-area members would violate the no-bail-out clause of the Treaty (Art. 125). But this issue was soon put aside.

Had Greece been outside the euro area, financial assistance from the EU could have been brokered through the provisions of Art. 143 of the Treaty, as was for instance the case for

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[15] Our plea for an escape clause in a rule based system is similar to the analysis of the gold standard as a contingent rule. Under exceptional circumstances, countries could leave the gold standard, and return back without losing credibility. The escape clause actually fostered the credibility of the gold standard as long as expectations of a rule based policy in normal times were maintained. See for example Bordo and Schwartz (1998) and Bordo and Kydland (1996).

Hungary in 2008 or Romania in 2009. However, for countries adopting the single currency, the Treaty does not provide such an option. The SGP was built on the assumption that fiscal surveillance would work and, thus, that no crisis resolution would be necessary. The no-bail-out clause was part of this thinking. It was supposed to act as a powerful disincentive against the temptations of moral hazard. As we know now, things turned out differently.

The *ad hoc* package for Greece in the spring of 2010 did not calm markets for long. Shortly after the Greek government had agreed on an adjustment programme with the Commission and the IMF, pressure in sovereign debt markets started mounting again, this time involving also Portugal and Spain. In an emergency meeting held on 9 May 2010 the Ecofin Council adopted the blueprint of a temporary but more general rescue mechanism – the European Financial Stabilisation mechanism (EFSM) and the European Financial Stability Facility (EFSF) - aimed at providing help to euro area countries that run into financial trouble.[16]

As the recent debt crisis in the euro area unfolded, policy makers - instead of relying on a formal institutional set-up - were forced to improvise. The 'no-assistance' principle of the SGP, whereby fiscal sovereignty was expected to apply also in times of crises, including the possibility of default, turned out not to be credible in extreme circumstances.

Although a formidable sign of solidarity, the decision to go to Greece's rescue was not completely altruistic. It originated in the understanding that with an integrated financial market, the default of one sovereign debtor, even of a relatively small one measured in terms of the share in euro-area GDP, can have serious repercussions via contagion for the rest of the euro area, both via the confidence channel and the more mundane bank balance sheet channel - the latter being particularly dangerous in view of the dire state of the banking sector.

The crisis also showed how uncertainty about the 'end game', arrangements for handling cases of sovereign illiquidity or insolvency, would fuel worries among financial market participants and significantly amplify risk aversion towards sovereign debt of countries with still liquid yet strained public finances.

Finally, the lack of crisis resolution mechanism has also weighed on the ECB's independence. The monetary authority of the euro area was basically 'forced' by events to engage in non-orthodox monetary policy measures to safeguard the stability of the financial systems, at the risk of potentially jeopardising its statutory objective of price stability and erasing the boundary between monetary and fiscal policy, so important for the credibility of the ECB.[17]

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[16] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf

[17] In mid-May 2010, amid renewed tensions in the financial systems of some euro-area Member States and following the ECOFIN council meeting of 9/10 May 2010, the ECB started buying government bonds of troubled EU countries on the secondary market. While the quantities involved are relatively minor compared to the ECB's overall balance sheet and the central bank announced that the purchase of government bonds would be sterilised, observers worried that this move would eventually undermine policies aimed at price stability and reward fiscally irresponsible Member States.

3.7. Flaw Nr. 7: fiscal consolidation and structural reform seen as substitutes rather than complements

In the policy debate, fiscal obligations under the SGP are often portrayed as obstacles to structural reforms. The narrative underlying this view is that fiscal rules imposing annual ceilings on the government deficit and/or debt ratio may give undue priority to short-run fiscal discipline at the cost of long-run economic growth and, possibly, long-run fiscal sustainability. Among the first studies following this line of criticism were Eichengreen and Wyplosz (1998), Razin and Sadka (2002) and Beetsma and Debrun (2005).

The key premise connecting these and similar studies is simple: beneficial economic reforms are put off because of their short-term budgetary costs which entail the risk of breaching existing fiscal thresholds. As a result, economic growth prospects are weakened, as is, in turn, the long-term sustainability of public finances.

Essentially the same reasoning was vented in the context of the reform process which eventually led to the revision of the SGP in 2005. The idea gained ground among policy makers that in order to enhance the growth oriented nature of the Pact, provisions should be made more flexible so as to account for the short-term costs of structural reforms. This thinking eventually found its reflection in the revised SGP that entered into force in 2005. Since then, countries implementing major structural reform are allowed to temporarily deviate from the required path of fiscal adjustment. In addition, special provisions apply to pensions reforms introducing a fully funded pillar. The costs of the reform to the publicly managed pillar are considered when assessing deficit figures under both the preventive and the corrective arm of the Pact.

Contrary to the predictions of those who considered the SGP as an obstacle, the flexibility introduced with the 2005 revision of the EU fiscal surveillance framework did not spur the reform effort of the EU Member States. The pace of implementation of the Lisbon Strategy - the original name of the EU reform programme set up by the European Council in March 2000 with the aim of turning the European Union into “the most competitive and dynamic knowledge-based economy in the world" – has remained sluggish. One year after the 2005 mid-term review of the Lisbon strategy, Pisany-Ferry and Sapir (2006) concluded that the results of the reform programme had been at best mixed. A similar conclusion is reached by Alesina et al (2008). They acknowledge an acceleration of the pace of structural reform in the product markets since 1997, but do not see any major advancement in the area of labour markets. In a more recent assessment, van Pottelsberghe (2009) argued that, at most, limited progress had been achieved, but nothing significant compared to the original objectives of the strategy.

Interestingly, these assessments do not indicate the SGP rules as the culprit for the implementation gap. Rather, the implementation gap of the reform agenda is mostly, if not exclusively, associated with governance issues. As a matter of fact, the Lisbon Strategy did not rely on hard instruments of co-ordination and enforcement. It was embedded in the basic economic policy coordination mechanisms of the EU whereby, at the end of the day, decisions are taken by the Member States within the Council on the initiative of the Commission. The only enforcement instruments available are moral suasion and peer pressure.

Blaming governance may sound like the generic and unrefined complaint which these days is used for any kind of weakness of EU policy making. In relation to the structural reform fatigue, however, it touches on a pertinent and more profound issue. As eloquently stressed by Ioannou et al. (2008), the sluggish pace of structural reform in the EU is a reflection of a more general resistance that has been acknowledged and extensively examined in the political economy literature well before the SGP came into being. A whole spectrum of convincing explanations exists of why structural reforms are resisted or at best delayed.[18] Leaving aside the idiosyncrasies of these alternative explanations, they all share one common conclusion: reforms are very slow to materialise because of the difficulty of most democratic governance structures to reconcile heterogeneous and conflicting interests associated with the expected impact of reforms, be it within a given state or, as is the case in the EU, across a community of states. The only element that is consistently found to spur reforms is crises: they amplify the sense of urgency and/or boost the costs of non-reform accumulated through persistent procrastination.

Hence, the mixed track record of structural reforms in the EU and in the euro area is very likely to have materialised also in a counterfactual scenario without SGP in place. Evidence corroborating this view, and defying the assumption that reforms are inhibited by annual budget ceilings, is provided in European Commission (2006). On the basis of a comprehensive analysis of actual structural reforms in the EU between the 1970s and the early 2000s, it is shown that, apart from systemic pension reforms, the budgetary position of a country did, on average, not deteriorate in years following the implementation of structural reform packages. Thus, the main enemy of structural reform are not fiscal rules. It is the pervasive political constraints in modern democracies, sometimes denoted as "Juncker's curse" ("We all know what to do, but we don't know how to get re-elected once we have done it"). But in fact Juncker's curse itself is to some extent a myth, something politicians believe in, but which can be empirically shown to be misguided to some extent (see Buti et al, 2009 and 2010).

4. THE REMEDIES

Crises are catalysts of reform and change – they initiate a process of policy learning. This is also true for the Great Recession. In its wake an intensive debate started in both the political and the academic arena on how to redress the shortcomings found in the economic and financial system that may have caused the crisis and contributed to its fast and extensive propagation. This debate also encompasses the role of fiscal policy and, in the European context, the role of EU fiscal surveillance in a monetary union. It has delivered a wide range of proposals some of which are more limited in scope, addressing some of the weaknesses described in the previous sections, others are more comprehensive advancing more fare-reaching plans of reform.[19]

Amid this intensive debate, the Commission, exerting its right of initiative, has put forward a blueprint aimed at strengthening economic governance in the EU. A first communication outlining the main thrust of its view was released on 12 May 2010, followed by a second communication presenting concrete reform proposals on 30 June

[18] A comprehensive review of the relevant literature can be found in Drazen (2000).
[19] See for example the proposals in Baldwin and Gros (2010).

2010.[20] Concrete legislative proposals implementing the ideas presented in the two Communications were adopted by the Commission on 29 September 2010. Alongside the Commission's initiative, the European Council, in its meeting of 25/26 March 2010, created its own Task Force on economic governance which has been discussing various reform options including on the basis of proposals put forward by the Commission. The final report of the Task Force, released on 18 October 2010, broadly overlaps with the legislative proposals. Where they exist, difference, largely relate to implementation.[21]

This section reviews the debate concerning the future of the EU fiscal surveillance framework. On top of our own assessments and ideas, it outlines the official proposals advanced at the EU level. The discussion and presentation is organised around the issues discussed in the previous section. We start with ways to improve the quality of government finance statistics, move on to ideas on how to strengthen the preventive arm of the Pact and finally discuss proposals to complement the Pact with provisions for major unforeseen adverse events. In order to provide a complete panorama of the debate, each thematic section includes, where appropriate, short boxes presenting the proposals advanced by the Commission.

4.1. Remedy Nr. 1: more reliable government finance statistics

A most embarrassing element in the prologue to the Greek sovereign debt crisis in 2010 was the persisting difficulty of the national authorities to report reliable government finance statistics coupled with the limited auditing powers of the European Commission. As a result, and following further major data revisions concerning the Greek fiscal position at the end of 2009, attention and efforts quickly focused on ways to improve the quality of government finance statistics in particular by enhancing Eurostat's access to information required to effectively verify compliance with existing rules. According to existing provisions there is no general obligation for Member States to provide Eurostat with access to all the information requested for the purposes of assessing data quality.

On 12 February 2010, the Commission adopted a proposal for a Council regulation aimed at strengthening the monitoring mechanism in the context of the EU fiscal surveillance framework.[22] The main thrust of the proposal consists in intensifying the cooperation between the Commission and the Member States first by means of more frequent and more comprehensive statistical visits (in the context of the standard EDP procedure and whenever a risk assessment identifies specific and significant problems), and second by providing the Commission (Eurostat) with access to all the information requested for the needs of the data quality assessment. More details about the amended regulation are provided in Box 1.

Box 1: The quality of statistical data in the context of the Excessive Deficit Procedure

Following a recommendation by the Commission of 12 February 2010, the Council has adopted a new regulation on 26 July 2010 on the quality of statistical data in the context of the excessive deficit

[20] The Commission communications are available at:
http://ec.europa.eu/economy_finance/articles/euro/documents/2010-05-12-com(2010)250_final.pdf, http://ec.europa.eu/economy_finance/articles/euro/2010-06-30-enhancing_economic_policy_coordination_en.htm.
[21] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf
[22] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0053:FIN:EN:PDF .

procedure.[23] The primary aim of this regulation is to strengthen data monitoring mechanisms in the context of EU fiscal surveillance. To this end the new piece of legislation proposes to

(i) give Eurostat the right to access public accounts in case there are substantial doubts about the reliability of the statistical data submitted by a national statistical authority; *"Access means the opportunity of consulting any relevant document by receiving a copy of it or on the spot, including, where available, an electronic copy, and of being provided any relevant information. The documents and information requested shall be provided promptly and, where available, be readily extractable from available records or sources*"

(ii) oblige national authorities to make available all of the relevant sources of information: "*Member States shall as promptly as possible provide the Commission (Eurostat) with access to all the information requested for the needs of the data quality assessment, including statistical information such as data from national accounts, inventories, excessive deficit procedure notification tables, additional questionnaires and clarification related to the notifications."*

(iii) ensure from Member States assistance of experts in national accounting: "*Member States shall, at the request of the Commission (Eurostat), provide the assistance of experts in national accounting, including for the preparation and undertaking of the methodological visits. In the exercise of their duties, these experts shall provide an independent expertise. A list of those experts in national accounting shall be constituted on the basis of proposals sent to the Commission (Eurostat) by the national authorities responsible for the excessive deficit reporting."*

Although there is a consensus among European lawmakers and governments about the need to improve the reliability of government finance statistics, Member States have shown some resistance in conceding additional power to the Commission. The amendments advanced by the Council to the Commission proposal seek to tighten the conditions under which more frequent and more comprehensive statistical visits are expected to be carried out.

The Council's reservation with respect to a stronger monitoring power of the Commission is somewhat surprising against the backdrop of the Greek experience, but does not come as a complete surprise. It reflects the inherent tension in the current institutional architecture where national fiscal sovereignty is jealously defended.

Taking for granted the fiscal authorities' shyness to provide 'outsiders' full and unconditional access to its books, a key question is whether one can think of incentive mechanisms that would encourage more openness. One possibility would be to require rating agencies to make their ratings of EU sovereign debt conditional on certain auditing standards. Member States would not be obliged to undergo an auditing process, but would have an incentive to allow auditing in order to benefit from higher ratings and, in turn, lower interest rates. Ideally, the auditing of Member States would be carried out by Eurostat who would make the results of the auditing public.

4.2. Remedy Nr. 2: making the preventive arm more effective

The repeated failure to effectively detect and take advantage of economic good times is one of the main challenges for EU fiscal surveillance. Attempts were made to reduce the uncertainty surrounding real-time CAB estimates, the key indicators in EU fiscal surveillance, or to qualify them with complementary information.[24] However, in spite of

[23] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:198:0001:0004:EN:PDF

[24] See Larch and Turrini (2010) for a detailed account of the use of the CAB in the EU fiscal surveillance.

measurable improvements important insights about the underlying fiscal situation and their risks have continued to reveal themselves only in retrospect.

Some commentators are rather sceptical as to whether improvements in fiscal monitoring would actually make a difference for fiscal performance in the EU. They believe that even the most perfect system of surveillance spotting the actual fiscal stance in real time would not solve the more fundamental problem of enforcement whereby, in a system of fiscally sovereign Member States, sanctions cannot be really imposed at the EU level on democratically elected governments. According to this line of thinking, fiscal discipline should rather be achieved by building institutions at national level that impose effective constraints on the budgetary process (see for instance Wyplosz, 2010).

Other commentators are somewhat more positive about the impact of a better and more effective scrutiny of EU governments' fiscal policy. In their view, the failure of the SGP to spot and denounce breaches of the rules was due to a lack of transparency in the surveillance process and insufficient impartiality on the side of the institutions that are in charge of surveillance. The cure they prescribe is an institutional reform that ensures a more objective evaluation of national budgets. Ideally, this could be achieved by strengthening the EU level's competencies in fiscal policy making vis-à-vis national fiscal authorities. However, since the appetite for devolving fiscal sovereignty is understood to be fairly small, they generally argue in favour of creating independent, extra-national institutions that would guarantee transparency and impartiality (see for instance Burda and Gerlach, 2010 or Fatas and Mihov, 2010, and Bofinger and Ried, 2010).

Our view of what an effective assessment of national fiscal policy making can achieve within the current architecture of EU fiscal surveillance is more nuanced. We believe that, leaving aside the issue of enforcement, fiscal surveillance can be significantly improved if current instruments are complemented by plain operational guidance on the yearly conduct of prudent fiscal policy making.

A promising candidate for such guidance is a simple rule that builds upon the main intuition underlying the notion of fiscal sustainability, namely that over the long term government expenditure cannot grow faster than available government revenues. Keeping in mind that, under unchanged tax policies, government revenues *grosso modo* keep pace with GDP over the medium and long run, the main problem of planning, conducting and monitoring prudent fiscal policy, boils down to keeping an eye on expenditure growth compared to medium-term economic growth.[25]

Anchoring expenditure to an estimate of medium-term GDP growth does not rule out discretionary fiscal policy or changes in the size of government. It simply means that to preserve sustainability discretionary expenditure increases that exceed medium-term

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[25] A simplified version of this intuition can be illustrated by taking the derivative of the budget balance to GDP ratio with respect to time $\dot{b} = \left(\frac{\dot{R}}{R} - \frac{\dot{Y}}{Y}\right)\frac{R}{Y} - \left(\frac{\dot{G}}{G} - \frac{\dot{Y}}{Y}\right)\frac{G}{Y}$ where b stands for the government balance-to-GDP ratio, R for government revenues, G government expenditures and Y for GDP. To the extent that revenues keep pace with GDP over the medium and long run, variations in the budget balance-to-GDP ratio will essentially depend on how expenditure growth compares with GDP growth. As a result, the main problem of fiscal sustainability, and in turn monitoring sound public finances, boils down to keeping an eye on expenditure growth.

GDP growth will have to be matched by discretionary tax increases. This truism is supposed to clarify that an expenditure-rule based surveillance would not constrict fiscal policy making compared to current practice. Rather, it would provide a more practical reference for assessing fiscal policy of the EU Member States. [26]

The main benefits of a surveillance approach centred on a simple rule of prudent fiscal policy making vis-à-vis the one based on the CAB are straightforward. The simple rule can get by without unobservable variables, such as the output gap: both expenditure and GDP are observable and available in a timely fashion. For instance, one possible and useful benchmark for anchoring current expenditure growth is past average GDP growth. Moreover, coupling expenditure growth to an estimate of medium-term economic growth safeguards automatic stabilisation over the cycle: outlays are kept on a sustainable path while revenues fluctuate with economic activity and its tax content.

Finally, a surveillance based on basic principles of prudent fiscal policy making would encourage and/or bolster national fiscal rules, elements of fiscal governance the Commission has been peddling for years. The only practical, yet manageable difficulty of an expenditure-rule-based surveillance is to abstract from price developments as the volatility of prices would add noise to the expenditure rule. In other words, expenditure growth should be benchmarked to the rate of real GDP growth. A quantification/assessment of the potential benefits of an expenditure-rule based surveillance is provided in the Annex.

Box 2: Effective enforcement of economic surveillance

To increase the credibility and the effectiveness of the EU fiscal surveillance framework, the Commission communication of 30 June 2010 on *Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance* and the ensuing legislative proposals adopted by the Commission on 29 September 2010 envisage a number of new elements to enhance fiscal discipline in the EU Member States.

(i) Paying greater attention to expenditure and debt developments.

Weary of the weaknesses of the cyclically-adjusted budget balance as a surveillance tool, the Commission suggests assessing fiscal adjustment on the basis of a simple rule very close to the one discussed above. According to this rule, the annual increase of government expenditure, in conjunction with discretionary revenue measures, should not exceed a prudent rate of medium-term economic growth that safeguards a country's MTO or an appropriate adjustment path towards it.

Although on the same footing as the deficit criterion, the debt criterion foreseen by the Treaty has never been used in the past. All surveillance procedures were opened and controlled on the basis of the deficit. To better allow for the interplay between the deficit and the debt the Commission proposes to have a numerical benchmark of a sufficiently diminishing debt ratio. Specifically, a debt-to-GDP ratio above 60% would be considered sufficiently diminishing if it its distance with respect to the 60% of GDP reference value has reduced over the previous three years at a rate of the order of one-twentieth per year. Non-compliance with this benchmark would not automatically bear procedural consequences. An overall

[26] From a conceptual point of view, the expenditure aggregate for which growth should be benchmarked is current primary expenditure. Interest expenditures are not directly under the control of government. They are determined by existing debt levels and changes in interest rates. Capital expenditure, especially investment expenditure, can be subject to large annual fluctuations depending on the type and size of projects that are deliberated by the government. Current primary expenditure, by contrast, largely results from entitlements geared towards different parts of the population; keeping its growth rate reasonably steady should not pose major technical or legal problems.

assessment of relevant factors would follow taking into account economic conditions, the structure of the debt, implicit liabilities related to ageing.

(ii) More effective enforcement instruments, i.e. sanctions/disincentives.

The legislative package of 29 September 2010 foresees a series of graduated sanctions/disincentives to be applied in the successive steps of EU surveillance. Under the preventive arm of the SGP, where peer pressure is currently the only enforcement tool, the Commission proposes the imposition of an interest-bearing deposit in case a euro-area Member State is making insufficient progress with budgetary consolidation. The interest-bearing deposit would be imposed in case a Member States significantly and persistently deviated from the principles of prudent fiscal-policy making.

Additional sanctions/disincentives are proposed for the successive stages of the excessive deficit procedure (EDP) starting with a non-interest bearing deposit when the Council decides that an excessive deficit exists, followed by a fine when the Council decides a Member State has not taken effective action to correct the excessive deficit.

Importantly, all new sanctions/disincentives are planned to become effective semi-automatically, that is once the relevant fiscal circumstances have been formally established, unless the Council finds a majority against it. Due to legal limitations, combined with the fact that countries sharing the single European currency share a larger degree of common responsibilities, the new sanctions would apply to euro-area countries only.

Undoubtedly, the semi-automatic nature of the proposed sanctions/disincentives would constitute a major innovation. So far, and especially when negotiating the SGP in the second half of the 1990s, there has always been a strong opposition to automatic sanctions, and to automaticity in general. The 1997 resolution of Amsterdam, by which Member States committed to a strict and timely implementation of the SGP was, in fact, meant to reassure those Member States (primarily Germany) which had feared that a rules-based system could conceivably work only if political discretion was reduced to a minimum (see Heipertz and Verdun, 2010). With the benefit of hindsight, those fears were justified.

4.3. Remedy Nr. 3: broader economic surveillance

Defying the main premise of macroeconomic thinking that had emerged from the 'Great moderation', low and stable inflation coupled with sound fiscal positions were not sufficient to avert the Great Depression. At the end of 2008, serious threats to the macro-financial stability of the US and the EU materialised as some important macroeconomic imbalances, in particular the excesses in the US subprime residential mortgage market, started to unwind. A chain reaction of negative events was triggered including the default of Lehman brothers, which then resulted in a *de facto* closure of money markets and a near meltdown of financial systems as a whole.

The lessons for EU fiscal surveillance from this, at times, chilling experience are twofold. First, achieving sound fiscal positions as required by the preventive dimension of the Pact is still a relevant condition for the functioning of the EMU. Second, fiscal discipline is a necessary yet not a sufficient condition for overall macroeconomic stability. A truly and effective preventive dimension of economic surveillance needs to go beyond fiscal. It needs to keep an eye on other imbalances as well such as asset and real estate price developments and current account deficits.

More generally, the understanding has gained ground that in order to safeguard overall macro-financial stability, monetary and fiscal policy making, the two classical tools of macro policy, need to be combined with other policy instruments, in particular, macro-prudential tools such as preventive mechanisms to control credit growth and/or asset price bubbles.[27] But how should such a policy be implemented?

As so often, a clear diagnosis does not automatically come with an equally clear idea about the appropriate therapy. What is apparent though is that a broadened economic surveillance, however it may be articulated and designed in practice, is likely to be more complex than the current system of macroeconomic governance. There are at least three major issues to be addressed: actors, enforcement and policies.

Compared to fiscal and monetary policy making, which is controlled by national authorities and the ECB respectively, the responsibilities for important macro-prudential policy instruments (i.e. the regulation of banking operations) are currently shared among different players such as central banks, national regulatory agencies, and the new European supervisory entities.[28] This fragmentation is a challenge for both the formulation and, in particular, the implementation of policy responses. By way of example, if macro-prudential surveillance was allocated across more than one actor, including the ECB, the independence of each institution and its respective policy assignments could be jeopardised.

Assuming that the set of policy actors had been identified, there is then the issue of who does what and how? Conceivably, the European Commission would be in charge of monitoring macroeconomic developments across Member States. It would also raise the flag in case harmful developments or imbalances are detected. But who would take the policy actions? As long as economic policy – except monetary policy - remains a national prerogative, which, in accordance with article 121 of the Treaty, is co-ordinated within the Council, national authorities will remain in charge. The history of the SGP and its successive adaptations and reforms is the best case in point of how difficult it is to make a common system work where participants remain essentially sovereign nations. This is not to say that a broader economic surveillance is bound to fail. Rather, it underscores the importance of effective enforcement mechanisms, a far from trivial issue in the EU.

If, on the basis of a comprehensive assessment, macroeconomic imbalances were found to pose a risk and actors were ready to intervene, there is still the final issue of finding the proper policy response. In the case of the present EU system of fiscal surveillance, the link between policy objective (a sound fiscal position) and the policy instrument (fiscal policy) is fairly direct. An equally direct link cannot be taken to exist regarding other macroeconomic imbalances such as current account deficits, excessive credit growth or asset bubbles. Moreover, and in line with the commonly accepted notation that each policy objective needs its own policy instrument, it would be wrong to assume that fiscal policy could be successfully used to achieve more than one policy objective. A broader economic surveillance must be able to mobilise an array of instruments independently or in combination, including macro-prudential instruments such as counter-cyclical capital requirements for banks, countercyclical loan-to-price ratios for mortgages.

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[27] This point is, for instance, underscored by Blanchard et al. (2010).
[28] http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/434&format=HTML&aged=0&language=EN&guiLanguage=en.

In sum, whilst the crisis told us that stability-oriented macro-policies need to be broadened, the exact and optimal design of a broadened system is far from clear yet. The EU is entering a field which will involve a considerable amount of pioneering effort.

Box 3: Broader Macroeconomic Surveillance

Echoing the painful insight gained during the crisis that well behaved fiscal and monetary policy may not be sufficient to maintain overall macro-stability, the Commission's legislative package of 29 September 2010, following up on the communications of 12 May and 30 June, includes a proposal for a regulation *on the prevention and correction of macroeconomic imbalances*.

The regulation details a new surveillance procedure that looks beyond the remits of fiscal policy making, by monitoring overall macro-economic developments using a broad set of macroeconomic and macro-financial indicators called scoreboard. This scoreboard, which is to be established by the Commission in consultations with the Council, is expected to cover all dimensions of macroeconomic and financial development, which in the light of past boom and bust cycles, may carry useful information about possible risks to the macro-financial stability of a countries. Likely candidates of indicators to be included in the scoreboard are the current account balance, the net foreign asset position, productivity and unit labour costs, the real effective exchange rate, private sector credit growth and asset prices developments.

In analogy to the EU fiscal framework, and as indicated in the title of the legislative act, the new procedure includes a preventive and a corrective part. Under its preventive arm, the procedure seeks to detect, at an early stage, macroeconomic and/or macro-financial imbalances in individual Member States which have the potential to affect the functioning of the economy or the functioning of the Economic and Monetary Union or the Union as a whole. If such imbalances occur, the corrective arm sets out rules and procedures with a view to correcting them.

Concretely, the new surveillance procedure is centred on an annual update of the scoreboard accompanied by a report in which the Commission may identify countries where the crossing of pre-established thresholds of the indicators included in the scoreboard coupled with a broader economic assessment of economic developments, signals the emergence or existence of imbalances. Depending on the degree of the imbalance identified in the monitoring process, the Member States concerned maybe confronted with more or less stringent encouragements to take policy actions. Two types of measures are foreseen. If a Member States is taken to experience imbalances it will be invited, as part of multilateral surveillance in accordance with Article 121 of the Treaty, to address them. If the imbalances are judged to be excessive, a more formal procedure will be opened– an excessive imbalance procedure (EIP) – whereby, very much in line with the EDP, the Member States concerned will be faced with a specific set of recommendations and deadlines towards the correction of the excessive imbalance. The EIP will be closed once the Council, on the basis of a recommendation by the Commission, concludes that the Member State is no longer experiencing excessive imbalances.

In order to ensure enforcement, the legislative package adopted by the Commission on 29 September 2010 also includes a regulation that foresees sanctions for, taking the form of yearly fines of maximum 0.1 percentage point of GDP, in case *euro area* Member States do not comply with the provisions of the EIP, notably if they do not take appropriate corrective actions.

4.4. Remedy Nr. 4: national fiscal frameworks and watchdogs

The experience accumulated since the inception of the SGP has more than once exposed the fundamental dilemma of the EMU, namely that of a monetary union without a strong political union. When the fiscal responsibilities of the Pact clashed with fiscal sovereignty, the latter frequently or even normally prevailed.

A particularly evident example of this pattern was the 2003 crisis of the SGP, when the Council decided not to proceed with the EDP for Germany and France as recommended by the Commission in line with the provisions of the Pact. The current set-up allows for the possibility and opportunity to form sufficiently large coalitions of countries with similar fiscal predicaments so as to avoid sanctions. Even in the preventive arm of the Pact, where the sole surveillance instrument is moral suasion, a practice emerged whereby the Council did not want to consistently play tough with individual Member States mostly on account of solemn yet frequently void promises by national fiscal authorities to take necessary measures in the years to come.

On the whole, the large degree of discretion with which fiscal surveillance is implemented and the ultimate power of the Member States within the Council to implement or not to implement the provision of the Pact are the main challenges to be addressed by any reform of the surveillance framework. Instruments and means have to be put in place to make the fiscal responsibilities implied by the common currency more operational.

Some of the proposals advanced in the draft legislative package adopted by the Commission on 29 September 2010, implicitly or explicitly, draw on this sober and unavoidable conclusion. As indicated in the previous section, they aim at reducing the room for discretion in favour of strengthening the rule-based character of fiscal surveillance, for instance by introducing new sanctions and making them semi-automatic. While sanctions do not limit national sovereignty *per se*, a more automatic and consistent implementation of sanction mechanisms would at least make sure that, in the context of EMU, non-complying Member States have to take responsibility for their actions.

Although the Great Recession made incontrovertibly clear that more co-ordination of fiscal policies would be required in EMU, it is fair to say that Member States are, at the moment, not willing to give up additional sovereignty in the fiscal area. A particularly blunt piece of evidence to that effect is the 2009 ruling of the German constitutional court on the Lisbon Treaty in which fiscal policy is identified as a vital instrument of national policy making. The reticence of devolving fiscal power across a broader set of countries manifested itself clearly when the Commission in the context of the so called EU Budget Review[29] suggested complementing the current financing of the EU budget based on national transfers with appropriate EU taxes.[30] This proposal triggered fierce negative reactions from a series of countries, including Germany, France and the UK, who very much disliked the idea of giving the supranational level the possibility to levy taxes independently or alongside national fiscal authorities.

In such a fairly hostile environment, the only feasible alternative aimed at shaping the Member States' fiscal behaviour in accordance with the requirements of the EMU is the establishment of stronger fiscal frameworks at the national level. In other words, if Member States are not willing to accept further restrictions on their fiscal sovereignty from the EU level, but feel committed to a smooth functioning of the EMU, the necessary fiscal discipline has to be attained by putting in place appropriate institutions, rules and procedure at the national level.

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[29] In December 2005, as part of the inter-institutional agreement underpinning the EU multiannual financial framework, the Council and the Parliament invited the Commission to '*carry out a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resource, including the UK rebate […]*; see Presidency Conclusions of the Brussels European Council of 15-16 December 2005 (15914/1/05) which refer to the agreement on the Financial Perspective 2007-2013 as set out in the document of the Council of the European Union No. 15915/05.

[30] Financial Times of 9 August 2010: Brussels proposes 'eurotaxes' to fund EU.

The importance of national fiscal frameworks had already been acknowledged in the 2005 Council report underpinning the first reform of the SGP, which stated that "national budgetary rules should be complementary to the Member States' commitments under the SGP."[31] However, in spite of this explicit tribute, the actual follow up was fairly weak or uneven, to say the least. Without any formal obligations only few countries, mostly countries with a 'historical' proclivity for fiscal discipline felt inclined to put in place national fiscal frameworks consistent with the requirements of the EU fiscal surveillance framework. [32]

Against this backdrop, progress in the area of national fiscal frameworks can realistically only be expected to take place if Member States are confronted with appropriate incentives or sanctions. This conclusion overlaps with the thinking of Wyploswz (2010) who, as mentioned above, argues that, in the final analysis and barring stronger elements of fiscal federalism, national fiscal policy consistent with a smooth functioning of the EMU can only be expected to materialise if Member States tie their own hands which in turn will only happen if costs of lax fiscal policies are sufficiently high.

Concretely, Wyplosz (2010) suggests a conditionality mechanism whereby Member States would only be able to benefit from EU safety nets such as the new EFSF or the purchase of government bonds by the ECB, if they adopt appropriate national fiscal frameworks. The incentive effect of such an arrangement is clear: the prospect of not having access to rescue mechanisms in times of crisis is expected to encourage countries to put in place rules, institutions and procedures that help avoid fiscal profligacy.

In a similar way, Calmfors (2010) makes a plea for stronger national fiscal frameworks in the EU. In his view these should be based on four major elements: (i) well-defined fiscal objectives, (ii) ex-ante guidelines concerning the use of fiscal policy as a stabilization instrument, (iii) commitments to transparency, and (iv) incentives to avoid deviations from policy objectives. He also proposes the creation of independent fiscal institutions to serve as "watchdogs".

The idea of independent fiscal councils has gained ground in Europe. Several countries, including Sweden, United Kingdom and Hungary, have recently set up such institutions; Portugal is in the process of creating one.[33] Although the record of these newly established councils is to scant for a proper evaluation, they carry, in our opinion, a substantial promise in improving fiscal policies across the EU.[34] A system of EU-wide fiscal councils would be a significant step to foster sustainable fiscal policies at the national level. One key issue in running independent fiscal councils are appropriate institutional safeguards. A case in point is Hungary where at the end of 2010 the incoming government decided to significantly cut the budget and staff of the a body which had been established just two years earlier.

Box 4: Domestic fiscal frameworks

[31] http://ec.europa.eu/economy_finance/legal_texts/compendium_en.htm.

[32] In 2009, Germany adopted the so called debt break, a constitutional law that largely mimics the SGP.

[33]. See for example the survey found on http://www.economics.ox.ac.uk/members/simon.wren-lewis/fc/fiscal_councils.htm.

[34] See for example the analysis of Jonung and Larch (2006) suggesting that independent institutions for forecasting improve the quality of the budgetary process.

Conscious of the fact that the current intergovernmental landscape in Europe does not allow for transfers of fiscal sovereignty to the EU level, the Commission's package of draft legislation adopted on 29 September 2010 does not try to constrain fiscal policy making from the supranational level. Rather, it includes a directive aimed at shaping domestic fiscal frameworks and rules while at the same time respecting national preferences or idiosyncrasies. A domestic fiscal framework is defined as the elements that form the basis of national fiscal governance, i.e. the country-specific institutional policy setting that shapes fiscal policy-making at national level.

Leaving aside the political limits to a further centralisation of fiscal-policy making, the focus on national fiscal frameworks is motivated by the rich literature showing that appropriate budgetary rules, institutions and procedures can improve the fiscal behaviour of a country, in particular they can strengthen the capacity to implement fiscal consolidation and, more generally, the long-term sustainability of public finances (see for instance Debrun et al. 2008). The empirical literature on fiscal frameworks corroborates the more general conclusion in macroeconomic analysis that rules are superior to discretion (see Kydland and Prescott, 1977 and Barro and Gordon, 1983).

With reference to the provisions of Article 3 of Protocol 12 of the Treaty,[35] the directive lists a number of elements and features which, if not already encompassed by domestic fiscal frameworks, Member States are expected to adopt through appropriate national legislative or administrative procedures so as to make national fiscal policy making more consistent with the priorities and objectives of the EU fiscal framework. The required elements indicated in the directive are organised around four headings: accounting and statistics, forecasts, numerical fiscal rules and medium-term budgetary frameworks. Under the first heading, Member States are encouraged to create a domestic system of accounting and statistics that guarantees a comprehensive, consistent and timely reporting in the area of government finances. Under the second heading, the directive recalls that budgetary planning should be transparent and based on realistic forecast. Under the third heading, Member States are asked to put in place numerical fiscal rules that promote the respect of the fiscal requirements of the SGP. The fourth and last heading asks Member States to embed their budgetary planning in a multi-annual framework so as to ensure consistency with the medium-term perspective of the SGP, in particular the achievement of the medium-term budgetary objective.

In accordance with the hierarchy of EU secondary legislation, the actual implementation of the directive is left to Member States, which within a given time period following the entering into force of the directive are required to adopt national legislation/provisions. If this is not the case, the EU can, in principle, launch an infringement procedure against the Member States concerned.

4.5. Remedy Nr. 5: escape clauses in times of severe crisis

Ideally, a rule-based policy framework should be as comprehensive as possible, covering all possible states of the world. For the real world, however, it is practically impossible to design a rule that encompasses provisions for all types of contingencies. Unforeseen and unforecastable events will always occur. When they do, rules are likely to become too tight and untenable. The tensions within the EU fiscal surveillance framework arising from the economic and budgetary impact of the Great Recession are a perfect case in point. And there will be extreme events in the future putting pressure on the rules of the Pact as well. While many are tempted to assume or hope that another Great Recession is not likely to happen in the near future, the crisis highlighted that there is scope for rethinking the escape clauses of the Pact.

The general idea is to complement the current set of rules with a pre-defined mechanism that requires national fiscal policy making to follow the rules under 'normal circumstances', but allows them to revert to discretion when economic circumstances

[35] Article 3 of Protocol 12 of the Treaty requires Member States to *'ensure that national procedures in the budgetary area enable them to meet the obligations in this area deriving from these Treaties'*.

turn particularly bad. Such a combination of rules and discretion can be shown to be better than unconditional rules or pure discretion.[36]

In the case of the EU fiscal surveillance framework, the objective of an escape clause would be to temporarily suspend the provisions of the preventive and corrective arm of the Pact, so as to allow for discretionary fiscal expansions or other fiscal measure that would conflict with the provisions of the SGP but are warranted in the crisis context (e.g. support to financial institutions). The suspension should be called only in the event of a very serious economic downturn where automatic stabilisers are deemed to be too weak to prevent a deflationary downward spiral. In the same way, one would return to the rule-based approach and/or not extend the suspension once economic circumstances improve. During the suspension period, discretion would not be without limits. Rather, fiscal expansions would follow specific principles so as to ensure both a high effectiveness (in terms of the expected impact of fiscal policy on output) and an easy reversal.

The adoption of an explicit escape clause for the EU fiscal framework raises two major and interrelated issues: (i) the choice of institution to administer the escape clause, that is to trigger it and to close it, and (ii) the design of the escape clause specifying the circumstances when it could be enforced. To avoid an indiscriminate use, which would undermine the essence of a rule-based system, recourse to escape clauses must be credibly constrained. The escape clause must work as an emergency exit, not as the general exit in case of troubled fiscal times in the EU.

On the first issue, the choice of institution, one effective way of achieving this would be to entrust an independent body or council with issuing a recommendation for switching off and back on the rules on the basis of a thorough assessment of economic circumstances. The recommendation would then be submitted for decision to the Commission. The European Commission by itself may also perform this function. It would carry out the necessary analysis and if warranted issue a recommendation to the Council and the Parliament. The use of an escape clause should be centrally administered and controlled.

On the second issue, the specific design of the mechanism governing the escape clause, there is a question concerning how much of the mechanism should be codified and how much should be left to discretion. The spectrum of options is restricted by two extreme cases. In one case, the margins for discretion would be as limited as possible. The mechanism would not only indicate the responsibilities of the body entrusted with recommending the temporary suspension of the Pact; it would also pre-define the type of crisis and provide indications about the extent of the economic downturn that would allow for recurring to the escape clause. At the other end of the spectrum is the case in which the independent authority is only bound by its conscience and good judgment. The actual choice between the two extremes will *inter alia* depend on the actual degree of independence of the authority: if independence can be expected to be more nominal than real, a tighter design would be preferable.

Box 5: Escape clauses

[36] See for instance Bordo and Kydland (1996) and Drazen (2000).

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In spite of the objective difficulty to accommodate the need for fiscal expansion with the rules of the SGP during the Great Recession, the legislative reform package adopted by the Commission on 29 September 2010 does not include a general escape clause providing for the temporary suspension of the Pact in the event of severe economic stress affecting the euro area or the EU as a whole. Preference was given to more circumscribed mechanisms whereby specific provisions of the preventive and/or the corrective arm can be put on hold or made more flexible if and when an economic downturn risks affecting the smooth functioning of the Economic and Monetary Union.

Concretely, the legislative package foresees two new elements of flexibility in the event of severe economic stress. The first, relating to the preventive arm of the Pact, provides for the possibility to plan and implement fiscal policies which temporarily deviate from the appropriate adjustment path required in normal times. The idea is to allow Member States to implement revenue reducing and/or expenditure increasing measures in difficult times with a view to stabilise aggregate economic activity on top of the effect produced by automatic stabilisers. Under current provisions, Member States that had not reached their MTO were always expected to pursue and achieve an annual improvement of the structural budget balance and to stay clear of expansionary measures.

The second element of flexibility concerns the corrective arm of the SGP. Whilst government deficits in excess of the 3% of GDP reference value will continue to trigger an EDP, the legislative proposal of the Commission offers the possibility to change, and in practice to ease, the recommendations setting the path of budgetary correction in the event of a serve economic downturn that affects the smooth functioning of the Economic and Monetary Union. Compared to current legislation this provisions introduces a sort of safety valve, a mechanism by which Member States concerned will be given a pause for breath when the overall economic situation precipitates.

The main reason for choosing a 'light' and more selective approach to escape clauses as opposed to a more general mechanism is political. With a relatively fresh memory about the lengthy and stony path leading to the adoption of the Lisbon Treaty, it was concluded that a new reform of the EU economic surveillance framework should be implemented taking the existing set of primary laws as given. This political constraint effectively excluded a general escape clause for the EDP, because the key provisions governing that procedure are laid out in the Treaty.

4.6. Remedy Nr. 6: crisis resolution mechanisms

The 'no-assistance' principle of the SGP, whereby fiscal sovereignty was expected to apply also in times of crises, including the possibility of default, turned out not to be credible in extreme circumstances. In 2010, when Greece concretely faced the risk of insolvency, the EU following lengthy negotiations, eventually agreed on a rescue package jointly with the IMF consisting in intergovernmental loans at below-market interest rates.

Although a formidable sign of solidarity, the decision to go to Greece's rescue was not completely altruistic, as we highlighted above. The crisis also showed how uncertainty about the 'end game', arrangements for handling cases of illiquidity or insolvency, would fuel worries among financial market participants and significantly amplify risk aversion towards sovereign debt of countries with still liquid, yet strained public finances. Finally, the lack of crisis resolution mechanism has also weighed on the ECB's independence. The monetary authority of the euro area was basically 'forced' by events to engage in non-orthodox monetary policy measures to safeguard the stability of the financial systems, at the risk of potentially jeopardising its statutory objective of price stability.[37]

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[37] In mid-May 2010, amid renewed tensions in the financial systems of some euro-area Member States and following the ECOFIN council meeting of 9/10 May 2010, the ECB started buying government bonds of troubled EU countries on the secondary market. While the quantities involved were relatively minor

The main challenge associated with the design of a crisis resolution mechanism is the risk of moral hazard. If Member States know in advance that there will be a safety net in the event of a crisis, they may be induced to be less prudent in their conduct of fiscal policy. Moral hazard can be limited in two different ways: (i) by requiring Member States to take their own precautions during normal times, and (ii) by submitting financial support from third parties to strict conditions for the duration of the programme Member States would have to partially wave sovereignty in the field of fiscal and economic policy making. In all likelihood, it was the concern of moral hazard coupled with the resistance to the idea of fiscal federalism that contributed to the drawn-out debate on what to do in the face of the Greek sovereign debt crisis at the beginning of 2010.

A priori, there are at least four instruments that can be used in a crisis situation: loans to illiquid or insolvent euro-area Member States syndicated by a lender of last resort with a below-market interest rate; outright cross-country transfers; national rainy-day funds to be accumulated in 'good' times and to be used in times of financial difficulty; and an orderly restructuring of sovereign debt. The first two involve elements of fiscal federalism (Member States concerned benefit from financial aid granted by the rest of the euro area); the latter two do not.

These four basic instruments of crisis resolution can be combined in different ways within different institutional setups. In the political and academic debate, a range of variants has been put forward and discussed. In fact, among the many issues discussed in this paper, crisis resolution has by far attracted the highest level of attention in the public debate largely because it represented the most evident failing. We would claim this is somewhat flawed: the stronger the provisions for crisis prevention and crisis mitigation are, the less likely it is that a crisis resolution scheme will ever be used.

A prominent proposal is the one of a European Monetary Fund (EMF) advanced by Gros and Mayer (2010). It owes its prominence to at least two elements. First, the proposal is fairly comprehensive combining elements of crisis prevention with elements of crisis resolution. According to the proposal, the EMF would build up rainy-day funds for each Member State financed via penalties to be paid for exceeding the Treaty reference values of the deficit and/or the debt. These funds would then be used in times of financial difficulties up to the amount accumulated by each Member State. Additional money, borrowed by the EMF on the market, would be made available only if the Member State concerned accepted strict conditions of fiscal and economic discipline. If both the accumulated funds and borrowing by the EMF were not sufficient to stem financial difficulties, the EMF would proceed to debt restructuring on the basis of agreed haircuts.

Second, the EMF proposal addresses the moral hazard issue associated with resolution mechanism in more than one way. Member States are first required to make provisions for difficult times whenever they breach the thresholds of the Treaty. If those provisions do not turn out to be sufficient, Member States cannot count on unconditional aid. The price to be paid for financial support would be the actual loss of fiscal sovereignty.

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compared to the ECB's overall balance sheet and the central bank announced that the purchase of government bonds would be sterilised, observers worried that this move would eventually undermine policies aimed at price stability and reward fiscally irresponsible Member States.

In spite of its comprehensive nature and its sound conceptual underpinning, the EMF has not received general approval. Some commentators (Pisani-Ferry and Sapir, 2010) pointed out that an EMF could only be established after a Treaty change, a process which in the recent past proved to be a very tedious, risky and above all lengthy endeavour.[38] The main goals of the EMF à la Gros and Mayer (2010), they argue, can be achieved by making use of and pooling existing institutions, more specifically through a co-operation between the EU and the IMF.

Another recent proposal, advanced by Bofinger and Ried (2010), seeks to combine elements of crisis resolution with elements of crisis prevention. Within a framework dubbed Fiscal Policy Consolidation Pact, Member States would benefit from guarantees for new issuance of government debt provided they accepted a number of restrictions on fiscal policy making; in particular if they committed to (i) achieving a balanced budget through the adoption of stringent expenditure rules, and (ii) adopting an automatic tax increase law that would be triggered whenever a country departs from the agreed adjustment path. An orderly default procedure would apply to countries that decided not to join the consolidation pact.

Although the Consolidation Pact à la Bofinger and Ried (2010) offers an interesting combination of incentives and disincentive, it is not clear if, in the extreme, an orderly default would actually be accepted. In view of the strong degree of interdependence of financial markets in Europe a sovereign default, even if orderly, may carry the serious risk of contagion and thus be shunned.

The issue of orderly default is addressed in greater detail in the proposal by Gianviti et al. (2010). Following up on the idea resolutely advocated by Germany in autumn 2010, they propose a crisis resolution mechanism that combines 'last-resort' financing to financially strained EU governments with a procedure for negotiating debt-restructuring. Specifically, Gianviti et al. (2010) think of establishing a special court, possible a special chamber of the European Court of Justice that would have to balance the interests of the debtors and its lenders and keep moral hazard on both sides to a minimum.

Box 6: Crisis management and resolution

Against the background of pressing events, in particular the 2010 sovereign debt crisis involving primarily Greece but also touching upon Spain, Portugal and Ireland, crisis resolution was the area where EU policy intervention came first. The discussion of alternative crisis resolution regimes tilted very quickly towards rescue mechanisms, involving loans to ailing countries, as any other option, especially default, was deemed to produce effects well beyond the country concerned with the possibility of a general meltdown of financial markets.

Between the end of April and mid-May 2010, three European instruments were adopted: the adjustment programme for Greece, the European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF). An important communality of all three instruments is that loans to Member States are granted subject to strict conditions.

[38] More recently, there seems to have been a reassessment of the political feasibility of a Treaty change. Following the Franco-German agreement of 18 October 2010, the European Council of 29 October 2010 invited its President to undertake consultations with the Member States on a limited change of the Treaty to establish a permanent crisis mechanism to safeguard the financial stability of the euro area; http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117496.pdf

The adjustment programme for Greece constitutes an *ad hoc* intergovernmental arrangement. It was negotiated jointly by the IMF, the ECB and the European Commission.[39] On the European side, the financial aid to Greece takes the form of bilateral loans, loans granted by a group a Member States, amounting to € 80 billion; the European Commission acted as the representative of EU Member States. The IMF agreed to participate in the adjustment programme with an additional pledge of up to € 30 billion.

To accompany the *ad hoc* agreement for Greece, the ECOFIN Council, in an extraordinary meeting held on 10 May 2010, decided to set up a temporary two-tier system aimed at providing financial help to ailing sovereigns, consisting of the EFSM and the EFSF. The EFSM is a community instrument empowering the Commission to borrow up to € 60 billion on the financial markets; EU own resources of the EU budget serve as guarantee. The mechanism is based on the provisions of Article 122 of the Treaty according to which Member States can receive Union financial assistance if '*threatened with serious difficulties caused by natural disasters or exceptional occurrences beyond its control*.'

The EFSM is complemented by the EFSF, an intergovernmental instrument with an overall firing power of around € 440. The EFSF operates through a special purpose vehicle (SPV) located in Luxembourg which issues bonds on behalf of and guaranteed on a *pro rata* basis by participating Member States, i.e. the 16 Member States whose currency is the euro. The funds raised by the EFSF are lent on to euro-area countries subject to strict conditions negotiated by the European Commission in liaison with the ECB and the IMF. Linked to the EFSF operations, the IMF stands ready to add € 250 billion of its own resources. Conscious about the fact that the setting up of the three resolution instruments described in this box was largely motivated by urgency, the Commission in its Communication of 12 May and June 30 2010 underlined that additional work would be carried out to design a robust and more permanent framework for crisis management. Concrete proposals to that effect have not been made public yet.

4.7. Remedy Nr. 7: linking structural reforms and fiscal sustainability

Two years before the introduction of the euro, Obstfeld (1997) offered a wide-ranging review of the pros and cons of the EMU. At the core of his assessment was the insight that countries adopting the single European currency would only survive if they eliminated real rigidities in labour markets because they were faced with the loss of a major channel of adjustment, namely nominal exchange rates. As a result of this insight, he assumed that the introduction of the euro would put pressure on social partners and policy makers to implement the reforms needed to make labour and possibly also product markets more flexible so as to allow for wage and price adjustments necessary to make the euro viable.

With the benefit of hindsight, we know that Obstfeld (1997) was only partially right. He was spot on with his analysis that in the absence of structural reforms existing rigidities in euro-area countries would eventually create serious adjustment problems. The accumulation of large current account imbalances and the underlying cross-country divergences in competitiveness observed in the years ahead of the crisis speaks volumes. But then, he was wrong in assuming that the prospect of more difficult adjustment processes would fuel a comprehensive and serious reform process. To be fair, various reforms have been deliberated and implemented across Europe. Biroli et al. (2010) suggest that the adjustment dynamics of price competitiveness after the monetary union has increased as product and labour market regulations have become less stringent on the back of national reform efforts. On the whole, however, reforms were not very decisive and results have been mixed not least because more tricky issues have not been addressed. In line with the predictions of the political economy literature, it took a major economic and

[39] The economic adjustment programme for Greece can be found at http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf

sovereign debt crisis to remind us that a smooth functioning of the EMU requires labour and product market flexibility so as ensure a balanced economic development across participating countries.

Against the backdrop of the Great Recession, the debate on how to rekindle the European reform programme has again moved up the policy agenda. In March 2010, the European Commission adopted a communication in which it laid out a blueprint for a new and ambitious growth strategy, dubbed Europe 2020, were structural reforms are the main delivery mechanism.[40] Following the Commission communication and discussions held in the Council, the European Council reached an agreement on the new strategy on 17 June 2010 (see Box 7).

Why should the new European agenda for structural reforms work better than its predecessors, i.e. the Lisbon Strategy and the Strategy for Growth and Jobs? A number of facilitating factors can play a role. First, crises typically act as catalysts for major reforms. They frequently emerge from a reform backlog that makes the status quo less and less tenable. This assessment is vindicated by current policy debates in the EU Member States. Structural reforms are receiving increasing attention; e.g. the Spanish government has negotiated and implemented a labour market reform, France a reform of the public pension system, Greece is expected to implement a number of major reforms as part of the EU/IMF rescue package.

Second, and linked to the first point, there is growing awareness and concern that the Great Recession is likely to have a lasting impact on medium to long-term growth. In the face of this possibility, constituencies and policy makers can be expected to be more willing to accept structural change as the benefits (costs) of the status quo are progressively declining (increasing) compared to the benefits (costs) of change.

Third, the new strategy includes an important innovation in the governance structure. Learning from past experience, Europe 2020 envisages a clearer focus, with a more limited number of policy goals and transparent benchmarks for assessing progress. Moreover, in an attempt to strengthen ownership on the side of Member States, the European Council will be entrusted with the strategic leadership of the reform strategy. This will mark an important break with the past when the European Council was the last element in the decision making process. By putting the European Council in the 'driving seat', the strategy is expected to receive the necessary political momentum; instead of being perceived as a burden imposed by 'Brussels' it should be viewed as a common responsibility.

Notwithstanding these facilitating factors, the current juncture also holds some potential inhibitors of structural reform, namely a growing suspicion towards the liberalisation of financial markets and, as a result, growing calls on policy makers to tighten regulation. This may pose a problem because, judging from available evidence, financial markets help absorb possible short-term losses associated with major structural reforms (see Buti et al. 2009, 2010).

More generally, there are a number of potential interaction and sequencing effects across markets that need or should be taken into account when designing reform programmes.

[40] http://ec.europa.eu/eu2020/index_en.htm

History teaches us that the design and timing of reform packages can have an important impact on the odds of success. For instance, Nicoletti et al. (2001) and Conway et al. (2005) point out that regulations in product and labour markets are closely related. There is also evidence that product market liberalisation has often preceded labour market reforms (Brandt et al., 2005) because product market reforms can lead to an expansion of activity and labour demand. Higher labour demand in turn provides a favourable environment for labour market reforms as better employment opportunities diminish workers' motivation to ask for more job protections for instance through stricter employment protection legislation (Koeniger and Vindigni, 2003).

Although very comprehensive in terms of the markets that are expected to undergo structural reform, Europe 2020 is silent about the issue of sequencing. It should and can be taken up at a later stage when Member States put forward their concrete reform programmes. A failure to do so could make the reform process much more difficult. This in turn would undermine the over-all credibility of EU economic governance, thus also of the Pact.

Box 7: Structural reforms and integrated assessment cycle.

Under the Europe 2020 strategy, different EU surveillance processes are planned to be combined so as to form one integrated surveillance framework. The procedural innovations underpinning this integration of surveillance is the so called European Semester, which will align the timing of surveillance of fiscal and other macro-economic policies. In practice, Member States will be required to submit Stability and Convergence Programmes (SCP) and National Reform Programmes (NRPs) at the same time, by mid-April each year. On the basis of the two programmes the Commission will prepare concomitantly assessments of the fiscal and macro-structural situation of the Member States which will then form the basis for policy recommendations. The main idea of aligning different surveillance processes is of course to achieve greater consistency. Possible interactions and interlinkages between fiscal policy and structural policies are expected to come out clearer.

Within the integrated assessment cycle of Europe 2020, fiscal policy is expected to play a double role: to deliver fiscal consolidation and to improve the quality of public finances. Getting public finances back on a sustainable path is seen as a crucial condition to restore sustainable growth and jobs. As a result of the crisis, government deficits and debt levels have reached unsustainable levels in most EU countries. They need to be addressed; in some cases the need for consolidation has been heightened by the growing concerns expressed by financial markets. At the same time, when designing and implementing consolidation packages, fiscal policy makers are expected to 'do more with less' by increasing the efficiency and effectiveness of government activities and by prioritising 'growth-enhancing spending’ such as education and skills, R&D and innovation and investment in networks, e.g. high-speed internet, energy and transport interconnections. To achieve this, fiscal authorities will have to implement comprehensive reforms within the government sector and as part of their overall reform strategy.

5. CONCLUSIONS

The euro is a young currency. It has to go through crises and adjustment and learning.[41] We are in such a period. The future sustainability of the euro is dependent on how well policy makers learn and adjust from the present events. Measured by the intensity of the current debate in both the academic and political arena, the intention to draw the necessary lessons from the crisis to improve EU fiscal and economic surveillance is unambiguous. While there is no doubt that the actual triggers of the crisis lay outside

[41] The case for policy learning as a necessary condition for the sustainability of the euro is made in Jonung (2002).

Europe, the prevailing narrative acknowledges that weaknesses in the institutional design of the European and Monetary Union (EMU), including and in particular its economic surveillance framework, contributed to the at times dramatic turns the crisis took in Europe. In case Member States had abided by the rules of the Pact, the crisis would still have seriously affected their public finances, but in many cases the situation would have turned out less dismal and dramatic.

Against this backdrop, the academic and political debate has generated a wide range of policy proposals. In relative terms, and without having a precise count, the issue of crisis resolution has attracted particular attention not least because the acute sovereign debt crisis in Greece in early 2010 was the most severe piece of evidence of the shortcomings of the existing rules.

Alongside the intense academic and political discussion, the European Commission has been active on several fronts. In a bid to stem tangible risk of sovereign defaults, it has, in collaboration with the Member States, brokered a number of new operational instruments for crisis management. At the same time, assuming its right of initiative in these matters it has also mapped out reform of the fiscal and economic surveillance.

Taken as a whole, the Commission's reform proposals are fairly comprehensive. They address or try to address most if not all the weaknesses of the EU fiscal surveillance framework the Great Recession has blatantly exposed. Assuming that the reform will finally be approved, the major innovations include the following points: (i) more power for the Commission to check government finance statistics of Member States; (ii) a new series of sanctions and disincentives, which can take effect semi-automatically at an early stage of the surveillance process; (iii) Member States will be formally required to put in place national fiscal framework to make them compatible with the objectives of the EU surveillance; (iv) a broader surveillance framework looking beyond fiscal developments so as to monitor and correct other macro imbalances that may jeopardise the smooth the functioning of the EMU; (v) a better and more consistent integration of different EU surveillance processes.

Like all reform processes, the ongoing reform of the EU economic surveillance process was carried out subject to a number of important political constraints of which two are of particular relevance.

First, after the very difficult experience with the adoption of the Lisbon Treaty, it became evident that a sufficiently timely reform of the EU surveillance framework could only be had by taking primary legislation as given, that is without further changes to the Treaty. As a result, the reform measures taken by the Commission, and in particular the legislative package adopted on 29 September 2010, are to be seen as the result of a kind of constrained optimisation. Some of the initiative may have taken a different form if changes to the Treaty had been an option. This is for instance the case for robust escape clauses, providing for the possibility to effectively and temporarily suspend the Pact, as opposed to formally carrying on with the standard surveillance procedure when their rational is completely lost in the light of severe economic stress.

Second, and linked with the first point, there is little or no appetite among Member States for further fiscal integration. In spite of the fact that the crisis clearly exposed the limits of decentralised fiscal policy making in a monetary union, restrictions on the national prerogative of fiscal policy making beyond the current provisions of the Treaty would not be accepted at this stage. Evidently, this position has important implications for the design and extent of any reform. It effectively excludes a number of proposals put forward in the policy debate which in one way or another would require a further pooling of economic policy sovereignty at the European level, e.g. any form of EU-based transfer mechanisms. At the same time it is fair to say that many of the proposals advanced by the Commission constitute important progress and would have been completely unthinkable before the crisis. In fact, the legislative proposals advanced by the Commission constitutes a balancing act which seeks to reconcile the needs of a broader and more effective surveillance taking on board the lessons of the crisis with the reality of decentralised fiscal policy making carried out by sovereign actors.

A clear example is the plan to introduce disincentives and sanctions which would be applied in a semi-automatic fashion: they can be avoided only if the Council explicitly votes against them. Such a mechanism, while acknowledging the ultimate authority of the Member States within the Council, underscores the responsibility of national authorities within the EMU. As a matter of principle, sanctions are due if national fiscal policy making deviates from the tenets of the EU surveillance framework. They can only be stopped through a deliberate act by and with the necessary majority within the Council.

The crisis has invited a new-old player to enter the scene as a main actor, namely the financial market. In the thinking behind the original Pact, financial markets were thought to be insufficient to instil fiscal discipline. The ambition was to put in place a set of common rules which beyond the potential role of financial market forces would keep national fiscal policies in line with the overall objectives of fiscal and monetary stability. The past ten years have demonstrated that the EU system has not lived up to its original ambition allowing the comeback of the merciless financial market vigilantes. Giving credit to the promises underlying the original philosophy of the Pact, they had kept quiet for long time. Spreads on sovereign debts were minimal within the euro area.

Now the crisis has allowed the financial markets to make a return as the ultimate and painful signalling device. Through the very high spreads given to sovereign debt of some euro-area countries they have put additional pressure on policy makers to reform the existing EU governance system. Going forward, they are likely to serve as a good complement to the reforms being undertaken. In particular, government bond spreads will signal how credible any reformed EU governance structure will be.

To sum up our discussion, history tells us that deep economic crises initiate a learning process – a search for new policies to avoid future economic calamity. EU is now in the middle of such a learning process. It is impossible to say at this juncture how successful it will be. We do not know if EU will learn the right lessons. However, in the past, EU has been able to adjust to new conditions and new circumstances. There are strong reasons to believe that proper policy adjustments will be forthcoming, initiated and supported by the workings of financial markets. EU has a golden opportunity to learn from the mistakes of the past. Don’t miss a good crisis – like the present one.

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Annex: Quantifying the potential benefits of an expenditure-rule-based surveillance

The potential advantages of an expenditure-rule-based approach outlined in Section 4.2 can be quantified by a simple mechanic simulation. We compare the actual course of public finances in a selection of euro-area countries in 1997-2009 with a counterfactual path where the growth rate of per capita real current primary expenditure is capped at the average rate of per capita real GDP observed in the six preceding years.[42] Everything else is kept unchanged, revenues, capital and interest expenditure, as well as price and growth figures. Real revenues and real expenditures are obtained by applying the GDP deflator. We focus on per capita figures because they give a more intuitive narrative, as they control for the size of population across Member States.

Table 1

General government budget balance
Actual versus counterfactual

	EL		PT		ES		IE		NL		DE		FR		IT	
	Actual	Exp. rule	Actual	Exp. rule	Actual	Exp. rule	Actual	Exp. rule	Actual	Exp. rule	Actual	Exp. rule	Actual	Exp. rule	Actual	Exp. rule
1997	-5.89	-4.79	-3.51	-3.31	-3.38	-3.38	1.44	1.47	-1.25	-1.25	-2.64	-2.64	-3.32	-2.93	-2.67	-2.11
1998	-3.82	-1.79	-3.39	-1.73	-3.22	-2.77	2.27	2.29	-0.87	-0.87	-2.17	-2.17	-2.61	-2.23	-3.07	-2.51
1999	-3.10	0.24	-2.79	0.09	-1.43	-0.80	2.61	2.65	0.41	0.53	-1.46	-0.88	-1.78	-0.79	-1.78	-0.87
2000	-3.73	1.77	-2.97	0.74	-1.00	-0.29	4.79	4.84	1.97	2.08	1.31	1.93	-1.47	-0.49	-0.86	0.32
2001	-4.44	1.58	-4.32	-0.37	-0.66	0.04	0.93	1.54	-0.25	-0.13	-2.82	-2.21	-1.56	-0.57	-3.10	-1.70
2002	-4.84	2.31	-2.89	1.19	-0.48	0.24	-0.31	0.38	-2.11	-1.97	-3.66	-3.02	-3.16	-1.80	-3.01	-1.59
2003	-5.71	2.09	-2.95	1.28	-0.23	0.49	0.41	1.13	-3.15	-2.91	-4.03	-3.40	-4.12	-2.73	-3.54	-2.09
2004	-7.40	0.79	-3.38	1.42	-0.35	0.39	1.41	2.18	-1.77	-1.52	-3.78	-3.15	-3.63	-2.23	-3.56	-2.09
2005	-5.33	2.96	-6.05	-0.09	0.96	1.72	1.67	2.47	-0.28	-0.04	-3.31	-2.68	-2.96	-1.56	-4.37	-2.89
2006	-3.18	5.05	-3.94	1.92	2.02	2.82	3.00	3.84	0.52	2.58	-1.64	-1.04	-2.32	-0.93	-3.33	-1.86
2007	-3.96	5.84	-2.65	3.12	1.91	3.15	0.25	2.24	0.17	2.74	0.19	0.78	-2.73	-1.36	-1.48	-0.02
2008	-7.75	3.11	-2.75	3.72	-4.06	-1.62	-7.15	-3.53	0.68	3.34	0.04	0.63	-3.40	-2.02	-2.72	-1.02
2009	-12.75	-1.27	-7.89	1.51	-11.21	-7.31	-12.48	-7.42	-4.74	-1.09	-3.34	-1.64	-8.27	-6.29	-5.26	-2.99
2010	-12.33	-0.91	-7.96	1.57	-10.06	-6.11	-14.66	-8.75	-6.21	-1.84	-4.93	-2.78	-8.26	-6.28	-5.35	-2.98

Note: The columns entitles Exp. rule report the results of a simulation whereby the annual increase of real current primary per capita expenditure is capped at average real per capita GDP growth observed in the six preceeding years. All other variables (i.e. revenues, GDP and inflation) are unchanged at their actual value.

The results of the simulation (reported in Table 1) clearly show that capping the growth rate of real per capita current primary expenditure at the growth rate of real GDP per capita would have generated much sounder fiscal positions. Starting with a particularly prominent case, if Greece had followed the postulated expenditure-rule and/or if EU fiscal surveillance had succeeded in enforcing the cap on expenditure growth as of 1997, instead of running a headline deficit of 4% of GDP in 2007, the country would have recorded a budgetary surplus of close to 6% of GDP; in 2010 the comparison is between an actual deficit of close to 12.7% of GDP and 0.9% of GDP.

As one would expect, important difference are also visible during the previous boom-bust cycle. In 2001, the last year of the ITC boom, an actual deficit of 4.5% compares with a surplus of 1.6% of GDP. A similar picture emerges in the case of Portugal. If Portugal had applied the cap on real expenditure growth in the sample period, it would have entered both the 2001 recession and the Great Recession with comfortable budget

[42] In years where real current primary expenditure per capita grew faster than the benchmark for real GDP growth per capita (faster than average per capita real GDP growth over the past six years) it is cut back to the benchmark. In all other years we take actual expenditure growth.

surpluses: in 2007 the surplus would have been close to 4% of GDP compared to an actual deficit of 2.7% of GDP.

Less dramatic, although still significant, differences are to be noted also for other countries like Spain and Ireland. In the case of Spain, compliance with the cap on real per capita expenditure growth would have resulted in a budget surplus of 3.1% of GDP in 2007 instead of an actual surplus of 1.9% of GDP. In 2010, even the cap would not prevent a deficit of 6.1% of GDP but would still compare favourably with a deficit forecast of 10.1% of GDP. The relatively large gap mainly originates in 2006-2008 when real current primary expenditure growth per capita accelerated visibly from 2% to 5% per year, while average real GDP growth per capita had slowed significantly from around 3% in 2003/04 to 1.8% in 2007/08.

Essentially the same happened in Ireland: real current primary expenditure per capita rose at increasing rates, on the back of revenue windfall, but coupled with slowing growth. In 2007, the counterfactual Irish budget balance would have been in a surplus of 2.2% instead of just 0.2% of GDP. In 2010, the comparison would be between a deficit of 8.7% of GDP and 14.7% of GDP.

The potential improvement of public finances resulting from the cap on real expenditure growth is lower for countries that are generally more disciplined. Nevertheless, some common patterns are visible also there, notably the spending of revenue windfalls. In the Netherlands, for instance, real current primary expenditures per capita recorded sharp increases in 2006/07 on the back of temporarily higher tax content of GDP, but with unchanged rates of real per capita GDP growth. As a result, the Netherlands entered the Great Recession with a marginal budget surplus of 0.2% of GDP as opposed to a surplus of 3% of GDP that could have been had by anchoring expenditure growth to real GDP growth in per capita terms.

The simulated budget balance assumes that as of 1997 real current primary expenditure per capita is capped at average real per capita GDP growth of the past 6 years. All other variables are unchanged at their actual value.

The expenditure rule would have delivered a better fiscal performance; but what about the fiscal stance? Does the cap on expenditure growth affect the counter-cyclicality of discretionary fiscal policy? The answer to this question is a clear no. Table 2 reports the results of standard panel regressions where the change in the cyclically-adjusted primary balance (CAPB) is modelled as a function of the budgetary situation in the previous year and the cyclical situation (as measured by real GDP growth). The estimates indicate that the changes in the CAPB implied by an expenditure rule are counter-cyclical; i.e. the CAPB increases when real growth turns negative and vice versa.

Table 2

Counter-cyclicality of fiscal policy in euro area countries

Panel regression with fixed effects (1997-2010)

Dependent variable: change in CAPB

	actual	capped expenditure growth
Constant	-1,01	-0,34
	(0.00)	(-0.01)
real GDP growth	0,33	0,22
	(0.00)	(0.00)
budget balance (t-1)	-0,29	-0,24
	(0.00)	(0.00)
No of obs.	195	195
Durbin-Watson	1,8	2,07