

Heipertz, Martin

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The Stability and Growth Pact - Not the best but better than nothing. Reviewing the debate on fiscal policy in Europe's Monetary Union

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The Stability and Growth Pact – Not the Best but Better than Nothing. Reviewing the Debate on Fiscal Policy in Europe's Monetary Union

Martin Heipertz, Max Planck Institute for the Study of Societies

Abstract

This paper aims to review the economic literature on the Maastricht deficit rule and the Stability and Growth Pact. The author tries to expose the contradictions and inconclusiveness of the debate, highlighting both the criticism and the defense of the fiscal policy regime in EMU. The paper is non-technical and seeks to provide an overview for a readership outside the economics profession. The concluding judgment is that the pact can be criticized on a number of grounds, but that the lack of a politically feasible alternative makes it a second best solution that should not be undermined in the present crisis.

Zusammenfassung

Dieses Papier ist eine summarische Auswertung der wirtschaftswissenschaftlichen Fachliteratur zur Defizitregel des Maastrichter Vertrages und dem Europäischen Stabilitäts- und Wachstumspakt. Der Autor versucht, Widersprüche und fehlenden Konsens der Debatte darzustellen, indem die Argumente für und gegen das fiskalpolitische Regime der Währungsunion einander gegenübergestellt werden. Der Aufsatz ist nicht technisch und dient dem Zugang einer an der Materie interessierten, aber wirtschaftstheoretisch nicht vorgebildeten Leserschaft. Das abschließende Urteil sieht den Pakt als in einer Reihe von Punkten kritikwürdiges Provisorium an, das jedoch mangels einer realisierbaren Alternative nicht ausgehebelt werden sollte.

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1 Introduction [1]

The Excessive Deficit Procedure (EDP) of the Stability and Growth Pact (SGP) has been initiated by the European Commission and the Council on Economic and Financial Affairs (ECOFIN) against Portugal, Germany and France – with Italy likely to be the next candidate. With the 'paper tiger' showing its teeth (at least for the moment), it is obvious that the SGP has arrived and is likely to stay in the focus of academic and public debates on Economic and Monetary Union (EMU). So far, the scientific analysis has been dominated by (political) economists. Political science is only beginning to take up the issue. In order to facilitate communication between the two neighboring disciplines, a review of the economic arguments for a readership of primarily political scientists seems wanting and is attempted in this paper.

I try to condense more than a decade of economic literature on the deficit rule of the Maastricht Treaty (MT) and its strengthened version in the SGP. My aim is to situate the SGP debate within the context of wider, more fundamental themes in economic thinking, while refraining from inferring strong conclusions from what is essentially still an open and ongoing discussion. The discourse in the first section is organized around four 'grand debates'. I assess to what extent the need for budgetary discipline rather than flexibility has been convincingly established in the first place. This is logically the first step in any economic justification of the pact. Second, the traditional theme of 'rules versus discretion' in fiscal policy is applied to interpret the EMU regime. Third, the need or inappropriateness of fiscal coordination in a monetary union is discussed. Finally, the trade-off between counter-cyclical demand-side stabilization and budgetary consolidation is examined. The subsequent section introduces the interaction of fiscal policy with the monetary side of the macroeconomic policy mix, since the pact has often been justified by the need to defend the independence of the European Central Bank (ECB). This section also poses the obvious question of whether or not the pact will be adhered to and lists a number of proposals for improvements and alternatives to the regime. Short of a political consensus on major improvements, however, the conclusion portrays the pact as a second best solution that should not be undermined.

2 Grand Debates

What would, in theory, be the features of a 'good' fiscal system, particularly in the eurozone case of a supranational monetary policy interacting with decentralized fiscal authorities? Furthermore, a monetary union among economies that, for all that we know today, tend to diverge rather than converge in their fundamental parameters. And – in contrast to the optimal solution – how should we judge the specific regime that has been installed for Economic and Monetary Union (EMU)? With respect to the SGP, the logical question to start with is whether or not a general need for fiscal discipline – in the institutionalized form of a rule-based scheme at the cost of demand-side policies – has been convincingly established.

2.1 Discipline versus Flexibility

Fiscal discipline is seen in the literature as the precondition for a balanced policy mix, since high levels of debt are likely to induce a restrictive stance of monetary policy (Buti et al. 1998; Thygesen 1999). In other words, the SGP allows the ECB to be less

restrictive compared to the stance that it would otherwise have to adopt in the face of fiscal laxity (Beetsma/Uhlig 1997). In contrast, it is sometimes argued (e.g. Deubner 2001) that financial markets provide a sufficient guarantee for fiscal discipline on their own. However, being far from perfect, financial markets react with a lag, have a tendency to overshoot the equilibrium rates and can cause negative contagion effects as well as spillovers to other countries (Thygesen 1999; Artis/Winkler 1999).

A further argument is that political control over fiscal policy usually suffers from a deficit bias due to incentives for overspending. Those in charge of 'spending ministries' do not internalize the social cost of providing benefits within their specific portfolio. Normally, tendencies to overspend are partially counteracted by the risk of incurring higher interest rates, not least because of increased inflationary pressure from a depreciating exchange rate. Yet entry into a monetary union spreads that risk to all members and thereby increases the relative weight of the incentives for overspending. The unwanted negative effects of expansive fiscal policy are externalized onto the community. Conversely, member states cannot only externalize negative effects of overspending but also free-ride on the interest-rate benefits achieved by the consolidation efforts of their partners. EMU therefore aggravates perverse incentives for fiscal looseness and exacerbates a politically induced deficit bias (Beetsma 1999, 2001). Then again, this EMU-induced increase of the deficit bias finds new compensation through export losses. The inflationary result of increased deficits can, inside a monetary union, no longer be cushioned by exchange rate depreciation (or devaluation) and will therefore lead to reduced exports. These should go some way toward substituting the disciplinary effect of the exchange rate in the form of the export-sector lobbying the government to prevent greater deficits. [2] Overall, the jury is out and a risk-averse strategy would imply devising additional safeguards against fiscal irresponsibility.

Another justification of the pact is provided by the concern over fiscal spillovers in the sense of negative externalities of fiscal profligacy on other, 'innocent', member states within the eurozone. This danger is also the main argument of the proponents for increased policy coordination and has been claimed to grow in line with economic integration (Masson 1996; Artis/Winkler 1999). However, recent research suggests that fiscal spillovers are largely absent in reality (Thygesen 1999; Gros/Hobza 2001). Finally, there are reasons for consolidation independent of EMU. These justify any rule that helps to contain public spending. At the outset, we can expect a substantial and long-term improvement in growth performance from fiscal retrenchment (Gros/Thygesen 1998). Even more important is the inevitable need to prepare public budgets for the demographic change of the coming decades. The opportunity cost of not promptly addressing this challenge is rising continuously.

To summarize; the essence of the arguments supporting the SGP is the need for fiscal discipline in itself. This need is increased by the specific requirements of monetary union, where fiscal policy in general and budgetary deficits combined with the resulting build-up of debt in particular are seen as the principal menace to monetary solidity. The pact is perceived as helpful because price stability itself is argued to be poorly safeguarded by the institutional independence of monetary policy (Giovannini/Spaventa 1991; Grilli et al. 1991). A politically induced deficit bias, exacerbated by entry to EMU, has to be institutionally contained in order to enable a growth-enhancing policy mix. However, the debate seems to be inconclusive as to the initial question of whether or not the need for fiscal discipline really requires the imposition of a rigid system of rules that come at potentially substantial costs. In other words, is there no better alternative?

The main criticism of the rules-based approach to fiscal discipline is that the SGP in its present form is excessively tight and inflexible and thereby hampers automatic stabilizers in the eurozone (Andersen/Dogonowski 1999; Eichengreen 1996; Eichengreen et al. 1998; Eichengreen/Wyplosz 1998; Hagen/Eichengreen 1996). The budgetary stance, it is argued, remains procyclical and there seems to be a considerable danger of deflationary tendencies occurring due to the rise in real interest rates (Hughes Hallett/McAdam 1996).

Since the EDP is the only component of the SGP that is equipped with sanctions, the whole edifice ends up being too strong and, at the same time, applicable only in an asymmetrical way during economic downturns, as is presently the case. The pact does not encourage discipline and consolidation when it could be achieved at a much lower cost, i.e. in upswings, [3] but is confined to requiring procyclical measures in times of weak or falling growth. Furthermore, it completely fails to promote an improvement in the quality of consolidation and in public finance generally. It would be useful to favor expenditure cutting over tax rises and subsequently consumption cutting over investment cutting. There is ample empirical evidence that the 'correct' kind of expenditure cutting is more likely to last and be successful than tax increases (Alesina/Perotti 1995; Alesina/Perotti 1997; Buti/Sapir 1998; Buti et al. 1998; Perotti 1996).

The true danger to stability from fiscal policy is unsustainable public debt, not deficits. The likelihood of public pressure on monetary policy is most closely related to the cost of debt servicing, which is a function of the debt level and the interest rate. Of course, the debt level is determined over the medium term by the succession of annual deficits (as well as by growth, inflation and the interest rate). But it remains paradoxical that the SGP exhibits an unjustified overemphasis on deficits rather than the more substantial debt problem (Rostagno et al. 2001; Missale 2001; Pisani-Ferry 1996). The explanation is to be found in a reasoning of political economy: It is easier to control the deficit by rules rather than the debt level. Yet one wonders if the pact is not overambitious: if the balanced budget requirement is actually adhered to, debt will virtually disappear and almost certainly end up below a socially optimal level (determined by considerations of intergenerational justice and liquidity constraints). The question remains whether debt limits would not represent a superior alternative.

Besides potentially disabling cyclically required stabilization measures on the demand side and the relative lack of importance attributed to the debt level, the SGP focus on the deficit could deflect policymakers' attention away from the structural problems of the European economy. Not only does the preoccupation with a few decimal points of the budget deficit detract from the necessary structural reforms (Eichengreen/Wyplosz 1998; Masson 1996), it might even jeopardize their implementation. Governments wishing to ease the transition costs for those sectors of the economy that are negatively affected by the inescapable adjustments could be impeded to do so, therefore finding it impossible to 'sell' reforms to the electorate. This problem is aggravated by an absent overall framework that puts fiscal policy in relation to monetary policy and is geared towards a growth-enhancing policy mix (Allsopp/Vines 2000).

Lastly, arguments based on game-theoretic reasoning can be raised in criticism of the non-cooperative nature of the present EMU regime (Dixit/Lambertini 2001). In the model of Dixit and Lambertini, monetary and fiscal authorities minimize a quadratic loss function of inflation and output with varying payoffs. Their finding is that 'fiscal discretion destroys monetary commitment' on the part of the ECB, which justifies the imposition of budgetary rules when there is a conflict of objectives between monetary and fiscal authorities. However, if both sides agree on the ultimate policy targets in what the

authors call a situation of 'monetary-fiscal symbiosis', then the preferred outcomes can be achieved. [4] This result holds when the model is extended to the EMU case of several fiscal players. The ideal levels of output and inflation can be attained despite ex post monetary accommodation of fiscal expansion and without fiscal coordination because all equilibria collapse into one solution once the ideal points of the monetary authority coincide with those of all the fiscal authorities. These findings, if at all applicable to the 'real world', suggest that achieving a consensus among policymakers on the target levels of output and inflation is more important than stringent budget limits. In other words, a binding version of the 'Cologne Process' [5] or other forms of higher-level coordination would make the SGP increasingly superfluous.

In sum, the critics of the pact do not deny the need for fiscal discipline and its increased importance under the conditions of monetary union. However, concerns about the ability of fiscal policy to fulfill its equally enhanced responsibility for anti-cyclical stabilization of the demand side give grounds for considerable doubt as to whether the particular institutional solution that has been adopted represents a good choice. Its only effective component, the EDP, focuses asymmetrically and mechanistically on an arbitrary level of nominal deficits, putting automatic stabilizers, the priority of structural reforms and an improved overall policy mix at risk — thereby possibly undermining the performance and hence the success of EMU at large.

2.2 Rules versus Discretion

Departing from the issue of discipline, how should the fiscal branch of economic policy be procedurally organized? The alternatives are located on a continuum between complete political discretion at one end and a fully de-politicized scheme of rules and technocratic agencies at the other end. The Keynesian tradition would justify a strong and discretionary role for national governments. It refers to persistent market failures, which lead to underemployment equilibria through demand insufficiency. An ideal regime would allow coordinated discretionary action in monetary and fiscal policy, pertaining to a growth-inducing policy mix, such as the combination of fiscal expansion and monetary reflation during a recession. Adherents reject any institutional solution impinging on the discretionary margin of fiscal policy (Pisani-Ferry 1998; Grauwe 1998).

On the other hand, neo-classical and monetarist authors have contrasted market failures with even greater government failures. Economic policy is said to suffer inevitably from 'time inconsistency' (Kydland/Prescott 1977). Without a credible (i.e. discretion-removing) commitment to an ex ante optimal plan, policymakers will always find it rational to deviate ex post from their announced course. The implications of assuming 'rational expectations' have been formulated in the 'Lucas Critique', which denies the applicability of economic models to policymaking altogether (Lucas 1976). Furthermore, fully rational expectations would imply that fiscal action has no effects due to 'Ricardian equivalence' (Barro 1974). Public deficits do not matter because private agents, insofar as they have rational expectations, anticipate future repayment through higher taxes and, accordingly, adjust current savings upwards. Therefore the effect of deficit spending on aggregate demand is qualitatively and quantitatively the same as the result of taxation: reduced private sector activity. Hence, government action should be constrained by rules or even delegated to an independent agency. [6] This demand has been implemented for monetary policy in the form of a 'conservative central bank' (Rogoff 1985), which is independent of time-inconsistent governments and can follow a predictable rule (Taylor 1993).

Dismissing Ricardian equivalence for certain policies, the requirement of fiscal discipline is alternatively established by the 'Fiscal Theory of the Price Level' (Leeper 1991; Leith/Wren-Lewis 2000; Woodford 1994, 1995, 1996, 2001). [7] Whereas Barro's contribution described fiscal policy as 'irrelevant' in the sense of public debt and taxation being equivalent in their effects on the economy, Woodford et al. confirm the possibility of a non-Ricardian regime. Nevertheless, price stability implies not only commitment to a monetary policy rule but also an appropriate fiscal framework. Non-Ricardian properties are still consistent with rational expectations if the budget does not always neutralize the effects of fiscal disturbances. The main channel of transmitting effects from fiscal policy to the price level is through fiscally induced disturbances of private sector budget constraints, which in turn affect aggregate demand, assuming that government expenditure substitutes for private consumption. It is important that already the *expectation* of a deteriorating government balance can cause the price level to rise in Woodford's model. He sees a monetary rule with predictable interest reactions to inflationary developments ('Taylor rule') plus nominal deficit targeting (resembling closely the actual EMU regime) as a system that is not only consistent with price stability but also excludes self-fulfilling deflationary spirals precisely because it constrains fiscal *expectations*.

The emerging theoretical near-consensus between rules and discretion seems to point towards 'rules with discretion' or 'rule-bound discretion'. In the short run, output and employment are indeed affected by shifts in aggregate demand. [8] A higher budget deficit or an expansionary monetary policy is thus able to decrease unemployment. However, in the long run, structural parameters determine a 'natural level' of growth and employment. Increased money growth only translates into inflation, whereas public debt decreases capital accumulation and thereby lowers the prospects for growth. Therefore, in theory, an adequate system of fiscal policy should generally aim for long-term budgetary consolidation, while leaving room for automatic or even *ad hoc* discretionary stabilization in the face of short-term fluctuations. [9] In the context of EMU, rule-bound discretion would translate meaningfully into a regime curtailing the *overall, Union-wide* level of debt and, possibly, deficits with the objective to contain inflationary pressures, while leaving discretionary margins to national policy. The framework should be geared towards a favorable policy mix through long-term consolidation, while retaining the option to engage in short-term stabilizations in response to country-specific output gaps. Does the EMU system correspond to these theoretically desirable features?

The actual arrangement is characterized by a central, supranational monetary policy on the one hand, in contrast to a decentralized set of cumbersome national budget-making processes on the other hand, involving ministerial direction and parliamentary cycles under a European fiscal rule (Hagen/Eichengreen 1996; Hagen/Harden 1995). The national fiscal authorities are subject to a common rule-based framework, legally founded upon the relevant provisions of the Maastricht Treaty [10] and the SGP, which itself consists of a resolution of the European Council [11] and two ECOFIN regulations. [12] The framework is therefore, laudably, constrained-discretionary. However, it suffers from poor effectiveness with respect to its own stated aims and contains unavoidable time lags in its implementation. The actors cannot promptly change the stance of fiscal policy without jeopardizing their credibility and succumbing to time inconsistency. Worse still, instead of targeting the union-wide debt level in the medium term, the system prescribes a permanent and narrow band for national deficits. These deficiencies continue to bear on the quality of fiscal policy in Europe.

Legally, the SGP is an instrument of secondary Community law. Its effectiveness hinges on voting behavior in ECOFIN, which has to decide by qualified majority whether an excessive deficit exists in a member state (Article 104 TEC). Qualified majority means that 22 out of the 87 weighted votes would be sufficient to prevent the declaration of an excessive deficit. ECOFIN members normally do not vote but aim at consensus decisions. [13] This habit even enhances the likelihood of successfully opposing the rule-conforming application of the deficit criterion. ECOFIN could therefore easily derail the 'quasi-automatic' sanctions of the EDP at several stages of the process. A member state or Community institution could, according to Article 232 TEC, bring an action for failure to act before the European Court of Justice if the Council fails to decide on the existence of an excessive deficit or if it fails to impose sanctions, given that the existence of an excessive deficit is asserted. [14] Nevertheless, there is no means to force the Council to declare a deficit excessive (Hahn 1998; Steuer 1998). Even a rule-conforming interpretation allows significant leeway for only applying the definition loosely. A deficit of three percent or more of GDP is not excessive if it is exceptional and temporary. The exceptionality condition is fulfilled in the event of an annual fall of real GDP of two percent or more. Furthermore, according to Article 2, third indent of Council Regulation 1467/97, a milder recession can in principle be claimed to be exceptional, too. As for the second condition, the deficit is temporary if it is forecast by the Commission to fall below three percent following the end of the downturn. The deficit rule has therefore rightly been described as formally too rigid but *de facto* too loose (Corsetti/Roubini 1992, 1993).

What then induces ECOFIN to assert an excessive deficit in the cases of Portugal, Germany and France without the legal obligation to do so? The rule might already have acquired some institutional backing of its own, not least through the influence of professional experts in the respective ministries and in the Monetary and Financial Committee (MFC). Another part of the answer could be that the ECB has implicitly threatened not to lower interest rates if ECOFIN decides the other way. [15] This should be cause for concern. Strategic conflict between the fiscal and monetary authorities frustrates the attainment of an optimal policy mix between the two sides even further.

2.3 Budgetary Coordination

(Begg et al. 2003) describe fiscal coordination as a means of addressing two simultaneous dilemmas. Next to the procedural difficulties of providing a purposeful framework for twelve interdependent fiscal policies vis-à-vis a single monetary policy, there is the problem of collective action as affects the guarantee of central bank independence in a decentralized fiscal environment. But not only credible independence is a public good in the context of monetary union. A coordinated approach to consolidation is more effective than uncoordinated attempts by individual countries because consolidation under EMU has the characteristics of a prisoners' dilemma (Allsopp et al. 1999). Here arises a second problem of collective action. One country benefits from another country's consolidation in the form of a positive externality, primarily through the interest rate channel, and therefore has an incentive to free-ride and underprovide consolidation itself. The SGP can hence be seen as a device to impose the cooperative solution in a consolidation game as well as a guarantee of central bank independence vis-à-vis potentially irresponsible spending behavior (Artis/Winkler 1997). Yet, in conjunction with the framework of Broad Economic Policy Guidelines (BEPG), it is but a very rudimentary approach to ensuring overall coherence of the national fiscal stances, both in the fiscal domain itself and in the context of the European-level policy mix with the monetary authority.

The question of economic policy coordination (see, for example, Alesina/Tabellini 1987; Korkman 2001; Remsperger 1999) should be seen in the context of the wider debate on policy coordination in general, where the principal categorization falls into 'hard' and 'soft' forms, depending on whether the mechanisms are fitted with sanctions. For monetary union, one should distinguish between two further concepts of economic policy coordination. [16] First, a limited type would comprise a reciprocal kind of (intergovernmental) adjustment of national fiscal policies with the minimal aim of avoiding negative externalities and spillovers between member states. The SGP surveillance component contains a partial element of this type of coordination, which is geared towards the medium-term aim of balanced budgets (Thygesen 1999). The 'hard' element of the SGP is asymmetrically focused on preventing excessive deficits and is therefore insufficiently comprehensive as a coordination device (Crowley 2001; Korkman 2001). The sanction mechanism does not cover cases that exhibit negative spillovers or inflationary characteristics but are sufficiently distant from the three percent limit, such as the expansionary Irish budget of 2000/01. Already the fiscal backslide in most member states during 1999 and 2000 shows the prevalent imbalance of the present regime, which is evidently unable to induce anti-cyclical consolidation during upswings.

Second, some authors advocate coordinating the *aggregate* of decentralized fiscal policies with the centralized monetary policy, aiming for an 'optimal policy mix'. Inasmuch as this 'higher-level' type of coordination involves political guidance overriding the independence of monetary policy, it is what predominantly French authors have in mind when they speak of economic coordination in general or a *gouvernement économique* in particular (e.g. Delors 1997; Marx 2001; Boyer 2000; Conseil d'analyse économique 1998). Higher-level coordination is, however, not the only way to achieve a favorable policy mix. The limited, exclusively fiscal form of coordination could still allow mutual adjustment between monetary policy and fiscal policy.

For proponents of a higher-level system of coordination that in one way or another encompasses monetary policy, the SGP is by definition insufficient (Hughes Hallett/McAdam et al. 1999; Willet 1999; Collignon 2001) or even counterproductive (Breuss/Weber 1999). The EDP constitutes the 'hard' part of the SGP but comprises only a partial aspect of fiscal policy coordination, i.e. the avoidance of excessive deficits. The surveillance mechanism, geared towards achieving balanced budgets over the medium term, provides a broader approach but is 'soft', as are the more encompassing coordination mechanisms, above all the BEPG and the procedures dealing with employment and open-market issues. Only the 'macroeconomic dialogue' or 'Cologne Process' explicitly involves the ECB but is, unsurprisingly, 'soft'.

2.4 Stabilization versus Consolidation

Under normal conditions, cyclical swings of the economy are smoothed through the so-called 'automatic stabilizers' operating in the public sector in the form of higher government expenditure (e.g. social transfers) and lower receipts (taxes) at times of economic downturn (Frenkel/Razin 1987). Empirical research suggests that European economies have experienced extensive stabilization effects through fiscal policy (Sorensen/Yosha 1998). One can estimate that changes in government revenues across Europe regularly offset between a third and a half of the initial variation in disposable income (Bayoumi/Eichengreen 1995). The automatic stabilizers reduce the first-year effect on real gross domestic product (GDP) of a five-percent reduction in the marginal propensity to consume by up to 50 percent. As a rule of thumb for the EU average, the

deficit responds to every percentage point of a cyclical swing with a countermovement of around 0.5 percent of GDP (Bundesministerium der Finanzen 2001). [17] The importance of automatic stabilization has even increased with EMU because the common and, by definition, 'one size fits all' monetary policy is bound to be destabilizing for countries that find themselves off the inflation average of the zone (Enderlein 2001; Hughes Hallett/Warmedinger 1999).

EMU is designed to accommodate the conflicting requirements of long-term consolidation and short-term stabilization (including in principle even discretionary measures) under the assumption that budgets start from a sufficiently 'safe' position at the beginning of a downturn – ideally from budgetary balance as envisaged by the Stability Pact. The fact that budgetary balance had not been achieved in about three quarters of the eurozone economy by 2001 (despite reasonable strong growth in 1999 and 2000) cannot be attributed to the Treaty or the SGP. However, given the negative starting position in a number of core economies and a currently growing output gap, the system now has a tendency to impose consolidation at the cost of stabilization and technically requires procyclical retrenchment in those countries that are close or above the three percent limit. This at least partially disables the beneficial effects of the automatic stabilizers; the loss in output and employment is larger than necessary. The automatic stabilizers were already completely or strongly hampered in Belgium, Germany, Greece, Ireland, Italy, the Netherlands and Spain during the recession of the first half of the 1990s, when countries were striving to fulfill the Maastricht criteria (Bundesministerium der Finanzen 2001). It seems unlikely that the present slowdown should show a different picture for countries close to the three percent limit. Particularly worrisome in this context seems the reduction in public investment associated with the consolidation effort. [18]

On the other hand, a lot of the academic criticism voiced along these lines against the SGP is exaggerated. The pact is considerably more flexible than its critics suggest. A sanction procedure is extremely unlikely to be launched as long as a member state government cooperates and takes measures in accordance with ECOFIN recommendations. [19] The fact that the pact can be applied in a flexible – "intelligent" – manner has not sufficiently been communicated so far. This lack of communication could be attributed to the political purpose of the pact in the late 1990s, when it was principally sold as a rock-hard guarantee for fiscal discipline in order to make EMU more acceptable to a skeptical German public (Heipertz/Verdun forthcoming). The pact endangers automatic stabilization only if it is applied with excessive rigor (which seems unlikely at present) and only in those countries that have failed to 'do their homework' in the sense of building up budgetary reserves during periods of growth, which would have placed them comfortably below the three percent line.

3 The Political Economy of the Pact

A political interpretation of the pact is that it was proposed by former German finance minister Waigel in 1995 not primarily as a response to the recognized need for enhanced fiscal discipline but, more profanely, in order to counter the growing fears of the German public about EMU and to pre-empt moves of the opposition, poised to capitalize electorally on these worries. At the time, according to officials in the German ministry of finance, 'nobody calculated the effects of such a rule.' [20] Nevertheless, Waigel's negotiation mantra was that EMU required additional measures for fiscal discipline. The major political-economy argument in favor of the pact is that it serves to guarantee the credibility of the political independence of the ECB, whose stability orientation is called

into question by the inflationary effects of fiscal policy, if not openly jeopardized by bail-out demands. What, then, are the channels of transmission from fiscal to monetary policy, in addition to the private sector budget constraint mechanism explored by the Fiscal Theory of the Price level?

3.1 Fiscal–Monetary Interaction

Essentially, the debt ratio affects the equilibrium inflation rate through the government budget constraint and, like in the FTPL, leads to a higher interest rate (Grauwe 1996). What is important about this result is the fact that there is an additional channel, via government preferences, through which public debt has a positive influence on inflation. Adding a typical central bank reaction function (Taylor 1993), one would expect the monetary authorities to increase the nominal interest rate and stifle growth in consequence.

By preventing and even reversing further rises in the debt level, the Stability Pact is supposed to pre-empt political pressure for monetary leniency while ruling out the possibility of and hence demands for a monetary bail-out in the event of fiscal insolvency (Artis/Winkler 1999; Papadia/Ruggiero 1999; Thygesen 1999; Willet 1999). However, it would be more helpful and consistent to have a regime that explicitly establishes monetary leadership over fiscal policy rather than merely an institutional setting that only strengthens monetary policy in its interaction with fiscal policy without securing clear primacy (Beetsma/Bovenberg 1995). Nevertheless, the pact can be seen as a useful commitment device of policymakers vis-à-vis their domestic constituencies (Buti/Sapir 1998) and a welcome source of external discipline (Allsopp/Vines 2000).

The SGP at first sight appears to possess favorable political economy characteristics. The three percent limit, originally introduced in France to redress the effects of Mitterrand's Keynesian experiment of the early 1980s, is admitted to be somewhat arbitrary but nevertheless helpful because it is transparent and at least consistent with a sixty percent ratio of public debt under conditions of five percent of nominal growth. Other advantageous political economy features are high public visibility, the clear incentive structure, political ownership, transparency enhanced by easy monitoring, and credibility (Buti/Giudice 2002), (Canzoneri/Diba 2001; Beetsma 2001).

On the other hand, should ECB credibility be the problem at issue, then the ECB's reputation for 'toughness' that it has successfully built up since 1999 is increasingly making the pact superfluous (Canzoneri/Diba 2001). What is worse, it could even prove to be counterproductive. Assuming higher deficits or purely monetary conditions spur the need to raise interest rates, then countries with high levels of public debt will immediately blame the ECB that this increases their interest payments to an intolerable extent and thereby pushes them closer to or beyond the three percent limit. In this way the pact would in fact provide additional ammunition for high-debt countries to pressurize the ECB. This scenario is not at all unlikely, at least for economies with a short-term debt maturity structure (Artis/Winkler 1999). Another reason for increased rather than decreased political and public pressure on the ECB is the hampering of automatic stabilizers by the pact (Grauwe 1997; Grauwe 1998). After all, it is also a monetary task to address the danger of deflation in Germany. The vicious circle is that the more politicians and the public at large demand interest rate cuts, the less inclined the ECB directorate will be to implement them at the cost of their reputation – central bankers like to describe themselves as cream that gets stiffer when it is whipped. Yet, when the ECB

finally is pressurized into monetary leniency, the negative effects of the worsened policy mix on output and employment could be aggravated by capital outflows (Nordhaus 1994). In both cases, the consolidation achievements of the 1990s would quickly be put at risk by a prolonged period of substantial output gaps and severe underemployment. There is therefore a considerable risk that the entirety of the EMU institutional set-up, including ECB independence, will be threatened by low growth, high unemployment and potentially ensuing political radicalization (Willet 1999).

3.2 Will the Pact be Adhered to?

Problems of non-compliance with the pact are not surprising, given alone the pact's incompatibilities with some of the national fiscal-policy arrangements across the eurozone. National fiscal systems follow either a delegation approach or a contract approach (Hallerberg/Hagen 1998). In the former case, hierarchical relationships are centered in the hands of a dominant budgetary decision-maker (mostly the finance minister) with strategic powers over the other players. This system internalizes the inherent externalities of the budget (consisting of the fact that 'spending other people's money' inevitably involves incentives towards socially wasteful behavior). In contrast, the contract approach rests on horizontal relationships. The participants negotiate key budgetary parameters, and some degree of internalization of the externality problem should ideally occur through the process of negotiation, which is only monitored but not controlled by the finance minister.

The SGP and particularly its EDP resemble the contract approach plus an external enforcement agent (Hagen/Hughes Hallett/Strauch 2001). [21] Based on the experience of OECD countries, one can expect that this method is not going to be adequate for the supervision of single-party governments and countries applying the delegation approach. However, it is complementary to countries that have themselves implemented contract approaches at the national level and can be expected to perform reasonably well in these cases. An important insight from studies on the implementation of European legislation in member states is that domestic parameters 'frame' the ways in which national actors deal with European provisions. The more European requirements are compatible with national approaches, the better they will be implemented (see, for example, Börzel/Risse 2000). The size of the 'misfit' between European and national institutions (in the sense of rules) is a fair measure of the adaptation pressure, which in the case of the SGP can be expected to translate into non-compliance. This discussion not only allows us to highlight the risks of non-compliance with the pact in those countries that experience a high misfit but also stresses the need to reform national budget-making procedures in line with the European approach. It is insufficient to simply superimpose a rule and take its subsequent implementation for granted.

Furthermore, the pact's effectiveness hinges crucially on the negotiating weight of the enforcement agent (here represented by the functions of the Commission and ECOFIN). Let us suppose that their influence on large countries is less than on small ones. [22] Then only small countries with the contract approach at the national level will pay attention and comply. There seems to be initial empirical evidence that this is the case. Among the countries close to the deficit limit, Germany follows a delegation approach, is a large country, would like to comply, but is unable to do so. [23] France follows the delegation approach and is a large country — it even actively undermines the pact, based on its traditional view of economy policy. Italy has a fragmented system of fiscal policymaking and is a large country. Its stance against the pact is more subtle but no less aggressive

than the French one. However, Portugal, with a contract approach and small in size, seems to be willing to comply — based on its rhetoric and information from Commission officials that the Portuguese administration goes out of its way to cooperate on the EDP. [24]

A further indicator of compliance problems is that one can observe strongly varying patterns of the degree to which fiscal rules have been implemented as a result of the pact (Hallerberg et al. 2001; Fischer/Reitano 2001). The measures taken range from the formulation of internal fiscal targets in the context of the Stability Programmes, in conjunction with detailed ministerial arrangements for staying close to the announced targets, on the one hand, to virtually non-existent links between the Stability Programmes and the budgetary process, on the other hand. A similar variety is to be found among arrangements at the sub-national level. Additionally, annual budgetary cycles are usually completely out of tune with the reporting schedule of the surveillance processes, making it virtually impossible to accommodate Council recommendations in time. In sum, a strict application of the framework cannot be taken for granted (Wessels 1998). The consequences of non-compliance would be a general undermining of the pact due to lost credibility, possibly triggering the whole range of problems associated with fiscal looseness that the pact was designed to prevent.

3.3 Must a Policy Rule be Stupid?

The President of the Commission of the European Communities, Romano Prodi, famously described the SGP as 'stupid' in the sense of it being a simple and inflexible rule preventing the adjustments of fiscal policy needed to deal with the current situation (Le Monde, 17/10/02). This remark suggests that there could be a fiscal policy rule that, unlike the SGP, qualifies as 'intelligent' in the sense of not hampering (automatic) stabilization in the short run while achieving consolidation in the long run. Indeed, some changes to the present regime have been discussed in the literature.

Most often heard is the demand to use structural rather than nominal indicators, in particular to replace the blunt budget deficit by a cyclically adjusted or structural measure (Buiter/Corsetti/Roubini 1993; Eichengreen 1996). Excessive deficit evaluations based on structural figures would leave enough room for automatic stabilizers, but still pose considerable problems of definition and implementation. The suggestion is also to amend the asymmetrical focus on deficits by including indicators for debt and possibly inflation. This would not only give more flexibility to short-term fiscal policy but also take into account the more substantial danger to stability stemming from debt rather than deficits.

Furthermore, one could envisage measures that account for both the quality of public finance (particularly the investment content) and the quality of consolidation (favoring expenditure-based retrenchment over tax-based consolidation and reducing government expenditure rather than public investment). Additionally, national or even European buffer funds could be devised, such as those that seem to be increasingly popular with Scandinavian governments. Their function is to automatically cushion the amplitude of cyclical fluctuations, quite similar to a water reservoir that is full in times of ample supply, providing reserves for meager periods. They could represent a useful enhancement of the automatic stabilizers (Buti/Giudice 2002; Swedish Ministry of Finance 2002).

Another deficit rule was already in existence before EMU. The 'golden rule' basically

states that the deficit must not be greater than the volume of public investment. It is enshrined in Article 115 of the German Basic Law and also applied by the UK Treasury. [25] In essence this approach has the clear advantage over the SGP that it differentiates between public consumption and public investment. The latter has more significant growth effects, increases the asset side of the public balance sheet and is seen as a very suitable instrument for anti-cyclical stabilization. One could even envisage a definition of the structural deficit that includes a permanent level of acceptable deficit financing for investment purposes, as now demanded by the Italian government (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung 1998; Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung 2000). [26] The concept, however, suffers like the structural deficit from the problem that both the definition and the empirical assessment of public investments currently pose insurmountable obstacles, almost inviting budgetary tricks and 'cosmetic accounting'.

A necessary complement to the SGP would be the introduction of effective national stability pacts in countries where the central government does not fully control the overall budget deficit. In the absence of national stability pacts, sub-central governments and other sources of public expenditure do not internalize the negative effects of their overspending, which are exclusively born by the central government. The ensuing problems of moral hazard would have to be addressed, possibly also leading to tax autonomy for sub-central governments (Hagen/Eichengreen 1996; Scharpf 2002).

Designs for fiscal responsibility that represent substantially different alternatives to one form or another of a deficit rule are few in number. Among the hypothetical possibilities, ranging from a comprehensive reform program of fiscal policy (Eichengreen 1996) to budgetary control through financial markets, only a concept of tradable deficit permits has been seriously discussed in the literature. Casella (1999) has received some attention for her proposal to establish deficit vouchers as a market-based solution for the allocation of entitlements to public borrowing, similar to emission permits as a way of achieving an efficient reduction of air pollution. However, a European stabilization and transfer system in the form of fiscal federalism [27] and any radical changes and supranational solutions required currently seem out of political reach. This also holds for the theoretically most appealing solution perhaps, an independent fiscal agency.

In the agency approach, a council of independent experts, the fiscal pendant to Rogoff's 'conservative central banker', should determine and, if necessary, re-adjust the annual surplus or deficit for each country according to its output gap (Buti/Giudice 2002; Peffekoven et al. 2002; Swedish Ministry of Finance 2002; Wren-Lewis 2000; Wyplosz 2001). This, unlike the rule-bound parliamentary process used today, would allow counter-cyclical stabilization as well as credible ad hoc readjustment in the light of changing circumstances. Controlling the excess or shortfall of public revenue over public spending, the agency would still leave the total size of the budget and its redistributive dimension to political choice. What it would predetermine, however, is the cyclical effect of the budget. The Belgian *Conseil Supérieur des Finances* can be seen as a first and successful step in this direction (Hagen et al. 2001). Waigel's original proposal for the SGP contained an independent 'Stability Council' that would have been responsible for determining the existence of an excessive deficit in the place of ECOFIN (Bundesministerium der Finanzen 1995). However, a real transfer of fiscal competence to a non-political, independent expert body is at the moment not politically feasible. Appropriating the state budget for electoral purposes while hiding behind the fig leaf of democratic legitimacy is still too much of a temptation for current decision-makers. Yet even if there were progress in that direction, instinctive French inclinations to turn the

agency into a *gouvernement économique* with jurisdiction over the ECB would make the idea unacceptable to the Dutch and Germans.

Budgetary rules are generally quite successful disciplinary devices in federal states but usually fall short of their stated goals (Poterba 1996; Alesina/Bayoumi 1996). In comparison to US balanced budget rules, the SGP appears to be more effective with respect to ex post evaluation and the toughness of its sanctions (Eijffinger/Haan 2000; Inman 1996). Also judged against the Kopits-Symansky desiderata of 'good' fiscal rules, [28] one can confirm a satisfactory performance of the SGP (Buti/Giudice 2002). The effects of the Maastricht convergence process that it tries to secure for Stage III are seen to have been beneficial on the whole (Buti/Sapir 1998). A number of member states have corrected their unsustainable fiscal paths (Corsetti/Roubini 1992; Masson 1996), and the consolidation even triggered non-Keynesian effects. [29] However, these events are probably unique, at least in their magnitude, because of the one-off chance to consolidate parallel to interest rates falling from historic heights. The success is also overshadowed by accounting tricks and one-off measures. The strong political incentives provided by the selection of entry to Stage III are only imperfectly substituted by the SGP incentive structure. This justifies the concern that the criteria have either lost or are soon going to lose a great deal of their political force, making way for 'convergence fatigue' (Hardenet al. 1995).

All in all, there is no lack of amendments and changes being proposed for a more useful type of arrangement – including joint deliberations by the French and German treasuries to introduce inflation measures into the fiscal rule (Le Monde, 15/10/02). Yet, skepticism remains warranted even with regard to an 'intelligent' rule. The more complicated and elaborated the rule becomes, the more prone it will be to abuse, accounting tricks and measurement failures. It will lose its transparency and visibility in the public eye, and thereby a lot of its bite. I fear that, for reasons of political economy, a fiscal rule will have to be either 'stupid' and effective or 'intelligent' and ineffective. An intelligent and effective solution, if it exists, is not within political reach for the moment.

4 Conclusion

This paper has attempted to condense the economic debate on the Stability and Growth Pact, concentrating on the core issues. The current regime can be seen as enabling 'rule-bound discretion'. It allows for fiscal flexibility up to the 3% limit at which discipline is enforced – albeit to a less rigid degree than hitherto expected. The sanctions are politicized and function asymmetrically in the realm of *dissuasion*, not for the sake of *preventing* budgetary slippages. In doing so, the pact shows a potentially costly preference for consolidation over stabilization, the need for the latter having greatly increased through EMU. This is the case irrespective of the valid point that all European governments have to address the challenge of budgetary consolidation and that a number of them have failed to do so in time. Obviously, the 'soft' incentives for prevention provided by the SGP framework have been insufficient in this respect. Even the most essential aim of the pact might be badly served: It is at least unclear whether the political economy of EMU will not develop strong tendencies towards an undermining of both fiscal discipline and central bank independence. Even short of that, the present system is likely to impose substantial costs through a discordant rather than consensual way of monetary-fiscal interaction.

The stability pact is part and parcel of an economic policy design which forces the

member states to focus on short-term budget deficits at the expense of anti-cyclical stabilization, structural reforms and medium-term debt consolidation. This approach could prove counterproductive and its legitimacy is debatable. Governance in the EU and economic policy in the eurozone in particular are void of opportunities to provide 'input legitimacy' in the form of voter participation. If Europe, on top of this, confines itself to solutions that do not demonstrate the necessary problem-solving capacity, then the corresponding lack of 'output legitimacy' will contribute to a further undermining of popular support for EMU, for the wider field of European integration and, ultimately, for national systems of democratic governance altogether (Scharpf 1999). At Maastricht, there was no window of opportunity for the design of comprehensive economic institutions under the label of 'political union'. EMU was created with a focus on monetary policy and entirely along the lines required by the 'paradigm of sound money' (Dyson 2000). With this unilateral and asymmetric approach, it contributes to rather than reverses a process through which nation states are becoming increasingly impotent in addressing the challenges of globalization. On the other hand, given the lack of political will to design a truly bold and comprehensive regime that would effectively address the entirety of economic policy dimensions in relation to monetary union, the pact goes a long way to remedying the shortages of the Maastricht Treaty. It is surely not the optimal solution. However, the second best is still better than nothing. Those governments who currently make it their business to undermine the pact will have to show that they in fact prefer a superior alternative to the vacuum that an undermined pact would leave. For the moment, you cannot beat something with nothing.

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Notes

1

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2

I owe this point to Fritz W. Scharpf.

3

Most large economies of the eurozone did not use the opportunity for further consolidation during the growth period of 1999/2000.

4

This issue is also stressed by Demertzis et al. (1999), who highlight the risk of heightened conflict between left-wing governments and the central bank, which would increase the gains from co-ordination. An earlier approach along the same lines was followed by Alesina/Tabellini (1987), who analyze a game-theoretic model where a monetary regime with commitment does not necessarily improve welfare compared to a discretionary regime unless fiscal policies are coordinated.

5

The Cologne Process was initiated by the German presidency in 1999, aiming at an encompassing 'macroeconomic dialogue' that involves not only Member State governments and the ECB but also 'social partners' in the wider sense, particularly trade unions and employer organisations. The process has never taken off towards effective coordination of macroeconomic policies and remains a mere forum for the exchange of views.

6

Both the rule and the agency could then follow Keynesian premises in theory, while in practice being rightly associated with neoclassical and monetarist theorists. I owe this point to Anke Hassel.

7

Other, less prominent theoretical foundations than the Fiscal Theory of the Price Level are the Domar-Tobin Formula (which can be used to check the consistency of deficit

criteria and debt levels – 60% debt level is sustainable with a 3% annual deficit if nominal growth is at 5% p.a.; Domar 1944, Tobin 1984) and Dornbusch's Commitment Model, where policymakers have an incentive to reduce the real value of debt through inflation (Dornbusch 1997). They both also point to the need for fiscal discipline.

8

Fundamental to this view has been the New Keynesian explanation of sluggish wage and price adjustments through staggering, efficiency wages, menu costs, etc. (see, for example, Mankiw 1985).

9

It has to be noted that, starting from a position of balanced budgets, the SGP would in principle exactly fulfill that function (Buti/Sapir 1998). The major policy error, then, lies in entering stage three of EMU *prior* to completing the transition to balanced budgets (Eichengreen 1996). On the other hand, it is doubtful whether the incomplete convergence and consolidation process could have been implemented at all without the incentive of hitting the 1999 deadline.

10

Article 104 and Protocol 20 of the Treaty establishing the European Community

11

Resolution of the European Council on the Stability and Growth Pact, O.J. 1997, C 236/1

12

Council Regulation No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, O.J. 1997, L 209/1; and Council Regulation No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, O.J. L 209/6.

13

The Council decision to send an early warning to France on 21 January 2003 was the first time that member states proceeded in voting relative to the pact. France abstained; the other 14 finance ministers of the EU – including the 'outs' – voted in favor.

14

The government of the Netherlands has threatened to do so in the current crisis (Handelsblatt 12.09.2003).

15

Interview with a former member of the Economic and Financial Committee, December 2002.

16

Hallerberg (2001) lists four goals for the coordination of fiscal policy: (1) avoidance of moral hazard problems (one country free-riding on the consolidation benefits of another or externalizing the costs of fiscal profligacy), (2) exchange of information and analysis, (3) mutual adjustment of national fiscal policies, improving convergence, and (4) promotion of fiscal discipline and more prudent macroeconomic policies.

17

The effect of automatic stabilization can be enhanced by discretionary measures adopted

by the fiscal authorities. However, the beneficial nature of discretionary stabilization policy is highly debatable. Above all, even if the fiscal authorities could react swiftly and appropriately, how should they know in advance their position in the economic cycle and the future development of the latter? Additional problems are posed by inevitable judgment errors of the output gap and time lags in the policy implementation, not to mention the overarching concern of time inconsistency.

18

In this context, it is interesting to note that the official attitude toward the balance between stability and stabilization is not biased against the requirements of fully functioning stabilizers: "Since, after the introduction of a single currency, the adjustment to adverse cyclical developments and country-specific disturbances will to an important extent rest with budgetary policy, it will be of paramount importance to ensure that the automatic stabilisers will be able fully to play their role." (Council of the European Union 1998, Section 5)

19

This is precisely the difference in behavior between Portugal and Germany on the one hand, who at least pretend to play by the rules, and France on the other hand, openly challenging them.

20

Interview with senior official in the Federal Ministry of Financial Affairs on 12 December 2002.

21

More precisely, the function of the enforcement agent is split between the Commission and ECOFIN, so it is only partially external.

22

Small countries tend to pay more attention to international organizations, even more to the degree that they receive financial transfers through them (Katzenstein 1991).

23

There are structural reasons why Germany's deficit will continue in the current downturn to push beyond three percent (Allsopp 2002). The finance minister will be frustrated in his efforts to contain the slippage as long as an effective national stability pact cannot be signed by the federal government, the *Länder* and the major social insurance schemes.

24

Author's interviews in the Directorate General for Economics and Finance of the Commission of the European Communities, 2002/3.

25

The Kohl government's habit of using off-budget funds for the financing of unification-related transfers was only the last in a series of steps that have undermined the rule in Germany. The golden-rule debate is summarized in Balassone/Franco (2001).

26

According to Milesi (1998), the German government sought to introduce a golden-rule type arrangement into the Maastricht Treaty, and it was Mitterrand who preferred a nominal deficit rule, which had already been employed in the French consolidation

exercise of the 1980s. This choice was favored by monetarist circles in France and seems to have framed the French approach to the formulation of a European rule.

27

The MacDougall Report (MacDougall Committee [Study Group on the Role of Public Finance in European Integration], 1977) stresses the need for fiscal federalism at the scale of at least five percent of European GDP to offset asymmetric shocks in a monetary union. Italianer/Pisani-Ferry (1991) devise a system that manages with only two percent of GDP. The Delors Report (Council of the European Union / Committee for the Study of Economic and Monetary Union, 1989) admits, however, that fiscal federalism is politically not feasible. The generally assumed reason for the political infeasibility of fiscal federalism is a lack of the degree of solidarity that is present at the national level.

28

According to Kopits/Symansky (1998) and Kopits (2001), a 'good' fiscal rule should be well-defined, transparent, simple, flexible, adequate relative to the final goal, enforceable, consistent with other policies, and underpinned by public finance reforms.

29

Traditionally, one expects a dampening of economic activity to result from fiscal retrenchment. 'Non-Keynesian effects' operate in the opposite direction, through a consumption and investment impact of lower anticipated future taxes and increased confidence. These effects seem to be stronger for expenditure-based consolidation than for tax-based consolidation, and are positively correlated to the size of the retrenchment. They have been studied by, among others, Giavazzi/Pagano (1990), Giavazzi/Pagano (1995), Perotti (1996), and Roeger/in't Veld (1997). Buti assumes non-Keynesian effects under EMU to coincide with enhanced liquidity due to financial liberalization and the associated diversification of financial instruments, thereby further enhancing domestic consumption. For Germany, non-Keynesian effects seem to be relevant over the long term, whereas government expenditure is positively correlated with growth in the short term (Bundesministerium der Finanzen 2001). Non-Keynesian effects seem to have been present in Italy during the 1990's consolidation (Commission of the European Communities 1999). Also Hagen et al. (2001) note a 'Maastricht effect' and the presence of non-Keynesian effects, but question whether they can prevail once the high visibility of the Maastricht convergence is over with the start of Stage III. The signaling and commitment powers of the Maastricht criteria are no longer existent, so the cost of consolidation can be expected to have risen again.

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