



Debt spiral or exit strategy

What does the Stability and Growth Pact have to offer?

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The economic crisis is also a stress test for the EU's Stability and Growth Pact (SGP). Automatic stabilisers and discretionary measures are causing the government deficits in Europe to increase. Most of the 27 EU member states will substantially exceed the SGP's deficit ceiling of 3% of GDP.

The huge budgetary deficits cannot be blamed on the SGP. It is a sensible instrument for the coordination of economic policy even during the crisis, as long as the European Commission and the Council use their discretionary scope responsibly. The high debt levels remain a problem, however.

The EU needs a fiscal exit strategy that can coordinate, monitor and enforce the national consolidation efforts. Reason: Excessively high government debt is the bane of economic growth in the long term.

An effective European fiscal exit strategy ought to fulfil five criteria: 1. In the short term it should pave the way for stimulus packages to be unwound. 2. In the medium term it should create incentives for budgetary consolidation. 3. In the long term it should ensure structural reforms that bring about budget relief. 4. Member states must be given the latitude to follow individual time lines with their stimulus measures, since the economy will not start to recover at the same time everywhere. 5. The measures require a binding sanctions framework.

Members of the European Economic and Monetary Union (EMU) can coordinate their fiscal exit strategies via the corrective arm of the SGP. The binding sanctions framework and the recent efforts of the Euro-group enable targeted and effective coordination.

EU-27 countries can coordinate their efforts via the preventive arm of the SGP. The Broad Economic Policy Guidelines can, at best, flesh out these efforts with content, but they cannot replace it. By contrast, ad hoc coordination modelled on the European Economic Recovery Plan does not have a targeted focus.

In the case of the non-EMU countries, there are no official sanctions to keep them on track. This gap could theoretically be closed by the corrective forces of the capital markets. In the first quarter of 2009 the markets have already signalled that they will punish countries with excessive deficits and no prospect of consolidation by demanding higher risk premiums on their government paper.

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The economic crisis has triggered a huge collapse in gross domestic product (GDP) across Europe. Governments have undertaken enormous financial commitments to cushion the impact.

Bank bail-outs and fiscal stimulus packages were pushed through and these were able to stabilise the economy. In the wake of these short-term rescue actions the focus has increasingly turned to medium-term risks resulting from the policies of the past two years. One central aspect in this light is the burden on public budgets ensuing from expansionary fiscal policy.

The member states of the European Union coordinate their fiscal policies via the Stability and Growth Pact (SGP). This raises various questions regarding the effectiveness of the pact under the tougher conditions unleashed by the crisis, especially:

- Is the SGP an effective tool for the coordination of fiscal policy also in times of crisis?
- What role can the SGP play in the implementation of a fiscal exit strategy and in the return to sustainable fiscal policy in the E(M)U countries?

This report analyses the challenges facing the SGP because of the crisis and seeks to provide tentative answers to these questions.

1. The logic of the SGP

No monetary union without fiscal coordination

It is now generally accepted that in a monetary union with centrally governed monetary policy it is imperative that national fiscal policies be coordinated. For excessive deficits can have a negative impact on monetary policy, even if the central bank is independent in its decision-making, as is the case in the European Economic and Monetary Union (EMU). Despite the high degree of independence enjoyed by the European Central Bank (ECB), investors might assume that, in the event of government debt ballooning, there could be increased political pressure on the ECB to relax its grip on **inflation** in order to lower the real level of government debt. Such inflation expectations could also apply to international investors: if these expectations shake their confidence in the euro, it risks losing ground as an international **reserve currency**. Given such developments an independent ECB could see itself compelled to raise **interest rates** – which would have negative repercussions for the euro-zone economy.

Over the past few months a fourth factor has gained significance, and it is also linked with the confidence of international investors. The **risk premiums** on government bond yields reflect the thinking of international investors that an excessive debt level in some countries could, in the long run, lead to national bankruptcy. This even heightens the pressure on the budgets of these countries.

As long as fiscal coordination also functions in times of crisis, investors regain confidence that national fiscal policies are reined in by effective external disciplinary action. For this reason, an effective coordination of policy is in the interest of all the EMU countries.

SGP: Rules-based self-commitment ...

This is why the European Union has the SGP: it is a monitoring system with a set of graduated sanctions and restrictive measures

Exceptional and temporary

According to ECOFIN* the terms “exceptional” and “temporary” are defined as follows: “exceptional” requires that the excess has to result from an unusual event outside the control of the member state concerned. This includes the case of a severe economic downturn. Such a downturn is defined as an annual decline in real GDP of at least 0.75%, provided there is evidence of a sudden economic downswing accompanied by an output gap. Since the SGP was reformed in 2005 a protracted period of economic stagnation or very low annual GDP volume growth has also been considered an exceptional case. “Temporary” means that forecasts provided by the Commission have to indicate that the general government deficit and debt will fall back below the reference value within a foreseeable period.

*ECOFIN (2005): Specifications on the implementation of the Stability and Growth Pact. ECOFIN document. October 11, 2005. Brussels.

... with broad discretionary scope for Commission and Council ...**... and far-reaching exceptions**

to coordinate fiscal policy. It was established in June 1997 by the Treaty of Amsterdam and reformed in 2005.¹

The SGP tackles the issue of budgetary deficits using both prevention and correction.

- The **preventive arm** provides for medium-term budgetary planning of the member states, in collaboration with the European Commission, on medium-term objectives which are set out in stability and convergence programmes. Countries are required to reduce their structural deficit in good economic times by at least 0.5% of GDP annually, as long as they have not yet achieved a medium-term fiscal objective established ex ante. Countries with low debt and high growth potential may post structural deficits of 1% of GDP over the long term, whereas countries with soaring debt and low growth potential are required to show a balanced structural budget.
- The **corrective arm** is particularly relevant in the crisis: excessive budget deficits are sanctioned. If a country fails to achieve the objective of keeping its deficit below the reference value of 3% of GDP, it will usually stand to face a so-called excessive deficit procedure (see opposite page).

The deficit procedure is not triggered or implemented automatically. Rather, the Commission and the Council have considerable discretionary scope in two respects: first, in establishing the existence of excesses and, second, in implementing the procedure.

The Commission possesses discretionary scope in how it establishes excessive deficits. This latitude is set out by the exceptions defined in Article 126 (2)a of the Treaty on the Functioning of the European Union (TFEU).²

The ratio of the planned or actual government deficit to GDP must not exceed 3%, unless

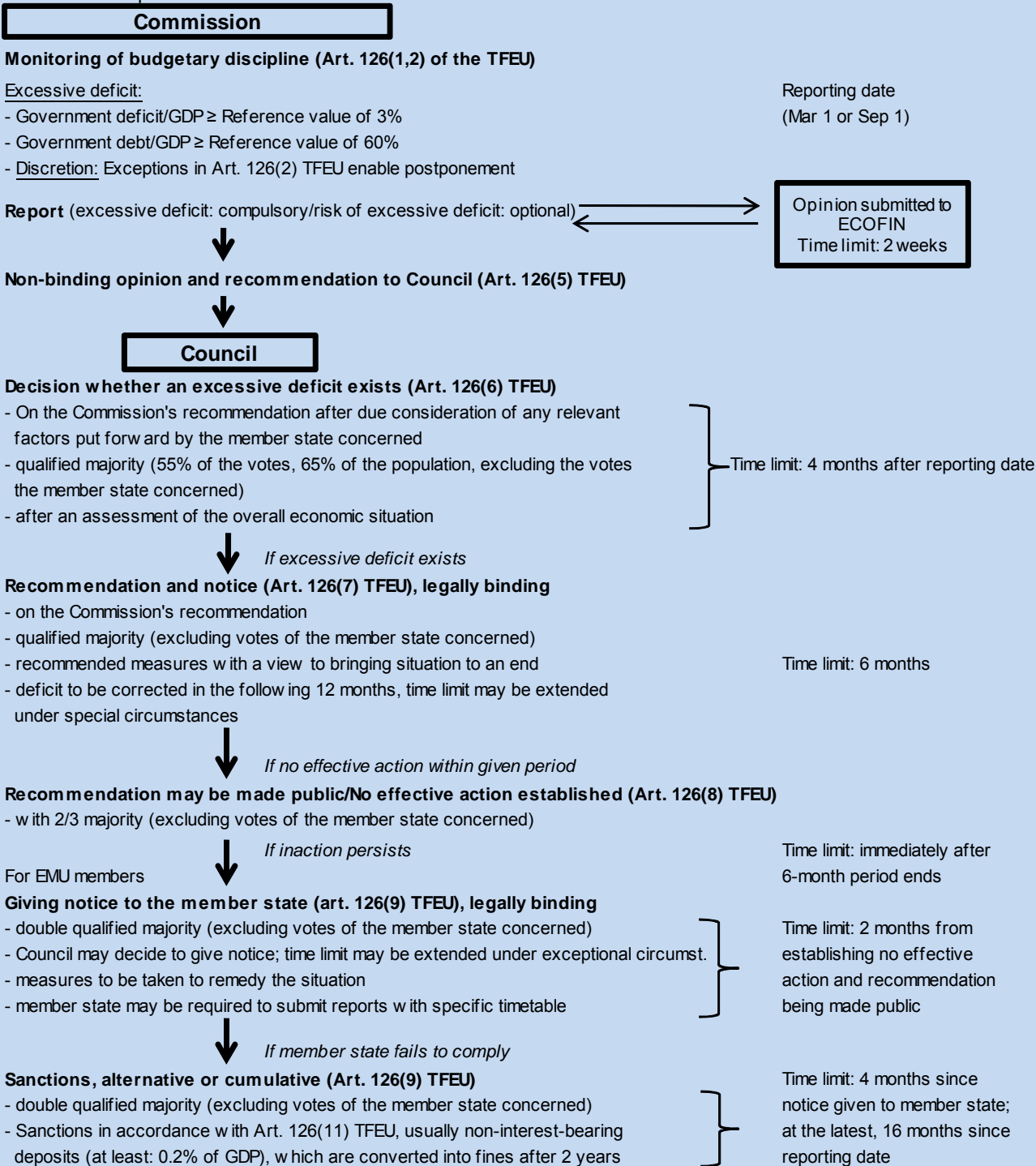
- the ratio has declined substantially and continuously and has reached a level that comes close to the reference value, or
- alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

These exceptions determine the Commission’s discretionary scope. If a country reports a deficit that exceeds 3% of GDP, the Commission drafts a report. In this report it establishes, among other things, whether the exception criteria are met. If so, the Commission initially refrains from recommending that the Council introduce an excessive deficit procedure.

¹ For a detailed explanation of the SGP reform in 2005 see Becker, Werner (2005). Reform of the stability pact – a licence to run up debt. EU Monitor. DB Research. Frankfurt am Main.

² The current EC Treaty has been amended and renamed the Treaty on the Functioning of the European Union by the recently ratified Lisbon Treaty, to enter into force as of December 1, 2009.

The deficit procedure in detail



Article 126 TFEU sets out the sequence of events in the deficit procedure. The Commission monitors the budgetary discipline of the member states. It observes the likely or actual government deficit and debt in relation to GDP. Budgetary discipline is being exercised as long as the reference values (deficit ratio: 3% of GDP; debt ratio: 60% of GDP) are complied with.

If there is a risk of an excessive deficit, the Council can, upon recommendation of the Commission, issue an early warning. Alternatively, the Commission can also address the member state with direct political recommendations. If one criterion or both criteria are not met, the Commission compiles a report that takes the medium term economic and budgetary outlook of the member state into account. If the Commission establishes that the member state has an excessive deficit or that it is likely to have an excessive deficit, it submits its opinion and recommendation to the ECOFIN Council accordingly.

The Council then decides by a qualified majority (i.e. 55% of the votes in the council, representing 65% of the population) whether an excessive deficit exists. If this is the case, the Council issues recommendations on how to bring the situation to an end. If the deficit is not reduced to less than the reference value of 3% of GDP within a specified adjustment period, the Council decides on further steps after obtaining the Commission's recommendations. Pressure on the member state can be increased by making the recommendations public. For the next step the government of the member state can be "given notice". The Council sets a time limit within which the member state has to take action to reduce its deficit. As its ultimate instrument, the Council can impose sanctions, one example being non-interest-bearing deposits which can be converted into fines after two years.

Apart from these exceptions, when drafting its report the Commission must not only take into account an extensive list of criteria³ which, among other things, address the medium-term economic and budgetary position of the member state. It must also give due consideration to all the other factors which the member state concerned deems significant. From this point, the Commission is no longer solely responsible for the course of the procedure.

The discretionary scope of the Council comes into play in the further implementation of the deficit procedure. On the basis of the Commission's report the Economic and Financial Affairs Council (ECOFIN) can establish the existence of an excessive deficit and make recommendations to the member state. Deficits must start to be corrected in the year after they have been identified. As a guideline for corrections, the pact stipulates that the structural deficit be improved by 0.5% of GDP per year.

Deficit procedure can be extended

If there is a deterioration of the economic conditions in the member state concerned, the Council can extend the deficit procedure by means of various mechanisms:

- First, the Commission's recommendations themselves can be altered. This requires a double qualified majority.
- Moreover, the adjustment periods starting after the recommendation and the giving of notice may be extended or repeated.
- Furthermore, the procedure may be suspended ("held in abeyance") if the member state follows the recommendations of the Council within the given time limits.

Flexibility at two levels

So the pact offers flexibility at two levels:

- For one, the Commission has substantial discretionary scope for establishing whether a member state has an excessive deficit.
- For the other, the ECOFIN Council can determine the course of the procedure via a number of other steps at its own discretion.

The exceptions defined in Article 126 TFEU enable the Commission to act flexibly in its assessment of developments in the growth cycle. Its flexibility is shored up by political independence. At the Council level, by contrast, discretionary decisions are not taken in an atmosphere free of political considerations, since they are subject to the voting conduct of the member states.

The implications that these circumstances harbour for the effectiveness of the SGP during a crisis will be discussed in the following section.

³ These factors are listed in Council Regulation (EC) No 1056/2005 of June 27, 2005. Reports are to take into account developments in the medium-term economic position (potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster research and development and innovation) and developments in the medium-term budgetary position (in particular, fiscal consolidation efforts in "good times", debt sustainability, public investment and the overall quality of public finances). Furthermore, any other factors which, in the opinion of the member state concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the member state has put forward to the Commission and to the Council. In that context, special consideration shall be given to budgetary efforts towards increasing or maintaining at a high level financial contributions to foster international solidarity and to achieve European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a member state.

2. Impact of the crisis on budgets

Government revenues

declining

Tax receipts and other revenues
as % of GDP, 2008-2010

Germany	-1.5
France	-1.4
Italy	-0.2
Spain	-3.8
UK	-2.4
EU-27	-0.8

Sources: OECD, The Economist **2**

Automatic stabilisers and discretionary measures weigh on budgets

The economic and financial crisis is weighing on the public-sector budgets in the European Union. In eleven member states these burdens have already triggered excessive deficit procedures. Others will follow. The crisis has an impact on the government finances of the EU member states in two respects:

- First, there are the automatic stabilisers. Economic output is set to contract by 4.1% in the EU this year and expand only slightly in 2010. This will have repercussions for tax revenues: for the euro area, the OECD estimates that revenues will decline by 0.8% of GDP during the period 2008 to 2010 – and by 1.5% in Germany alone.
- Beside these factors on the revenue side there are automatic stabilisers on the expenditure side: by this we mean outlays and relief mechanisms which are automatically triggered during an economic downswing, for example unemployment and social-security benefits. The decline in the aggregate cyclical balance within the EU-27 by 2.5% to -1.4% of GDP in 2009 gives an idea of the overall size of the automatic stabilisers.

On top of the automatic stabilisers come discretionary measures for the bank bail-outs and stimulus packages. Support measures for banks covered, for instance, recapitalisation moves, direct government loans and guarantees for the financial sector's obligations. However, the latter will not, for the time being, have any direct impact on the budgets as long as they are not called up. table 3 indicates the burdens on the budgets resulting from these measures.

Bail-out measures for the financial sector

% of GDP

	Capital injections	Government loans or asset purchases	Guarantees (excluding deposit insurance)	Current funding requirements
FR	1.4	1.3	16.4	1.6
DE	3.7	0.4	18.0	3.7
IT	0.8	0.0	0.0	0.8
ES	0.0	4.6	18.3	4.6
UK	3.9	13.8	51.1	18.9*

*Includes government support from the Bank of England.

Source: IMF **3**

Stimulus packages of the member states

Discretionary measures of selected
member states (% of GDO)

Country	2009	2010
Germany	1.4	1.9
France	1.0	0.1
Greece	0.0	0.0
Ireland	0.5	0.5
Italy	0.0	0.0
Spain	2.3	0.6
UK	1.4	0.0
EU-27	1.1	0.7

Source: European Commission **4**

Burdens from the European economic stimulus packages arise via spending programmes, tax reductions, direct consumer aid and guarantees for businesses that are aimed at fostering investment and consumption. It holds here, too, that guarantees for businesses do not have a direct impact on budgets, weighing in only if the guarantee needs to be used. According to Commission estimates, these government pledges will add up to 1.8% of EU GDP in 2009/10.

These burdens are leaving their mark on European budgets. The cyclical deficits that arise via one-off expenditures and cyclical factors such as the automatic stabilisers have reached major proportions in many countries. However, the structural deficits,

which the Commission forecasts will soar in 2009 and 2010, will have an even stronger impact. The reason for this is the strong contraction of the economies and the resultant increases in the output gaps. Furthermore, the national economic stimulus and bank bail-out packages, which also account for a considerable portion of the burdens, are counted towards the structural deficits.

Deficits in the EU: Commission forecasts
% of GDP

	Deficits		Cyclical deficits		Structural deficits		Of which: Fiscal packages	
	2009	2010	2009	2010	2009	2010	2009	2010
Germany	3.4	5.0	1.5	1.4	1.9	3.6	1.4	1.9
France	8.3	8.2	1.3	1.2	7.0	7.0	1.0	0.1
Greece	12.7	12.2	0.1	0.9	12.6	11.3	0.0	0.0
Ireland	12.5	14.7	2.9	3.2	9.6	11.5	0.5	0.5
Italy	5.3	5.3	1.8	1.6	3.5	3.7	0.0	0.0
Poland	6.4	7.5	0.1	0.9	6.3	6.6	1.0	1.5
Spain	11.2	10.1	1.2	1.6	10.0	8.5	2.3	0.6
UK	12.1	12.9	1.6	1.5	10.5	11.4	1.4	0.0
EMU	6.4	6.9	1.4	1.5	5.0	5.4	1.1	0.8
EU-27	6.9	7.5	1.4	1.5	5.5	6.0	1.1	0.7

Source: European Commission 5

EMU bond spreads strongly up from early 2008 levels
10-year government bond spreads versus German Bunds, bp



Sources: IHS Global Insight, DB Research

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This leads to yet another problem. Those countries in which high deficits ensured a rapid increase in government debt and in which growth prospects are poor must boost the attractiveness of their government bonds by offering significant **risk premiums**. These reflect the reward which investors demand for shouldering the higher risk of default if a country has to declare bankruptcy.

This can be the start of a vicious circle, for risk premiums rise primarily in countries which carry a heavy government debt load anyway and whose growth prospects are poor because of a low level of competitiveness. This heightens the pressure on the budgetary situation.

These countries saw the yield spreads between their paper and German Bunds widen substantially up to March 2009. Since then the situation has eased slightly, however. This might be due to the fact that the economy has stabilised to a certain degree. Furthermore, the European Commission⁴ and the EU member governments⁵ indicated that the countries affected could under certain circumstances count on the support of the EU or perhaps other member states.

⁴ We refer to a speech given by Commissioner Joaquín Almunia at a conference of the European Policy Centre in Brussels on March 3, 2009.

⁵ See German finance minister Peer Steinbrück's speech on the willingness to engage in a bilateral bail-out delivered at an SPD event in Dusseldorf on February 16, 2009.

3. Ongoing and looming deficit procedures

Laggards, borderline cases and star performers

The budgetary situation differs from country to country in the 27-member EU. The countries can be divided up into three categories.

- Laggards: Countries with large deficits and high total debt. In these cases, it is important that the countries return to budgetary surpluses after the crisis so they will be able to reduce their overall debt. Examples: Italy and Greece.
- Borderline cases: A further group includes countries which despite the boom of the past few years still failed to achieve budgetary surpluses, while indeed managing to keep their total debt close to the reference value of the SGP. Examples: Germany and France.
- Star performers: The third group consists of countries with low government debt that were able to run deficits even during the boom years without their debt levels coming close to the SGP limit. Examples: the Netherlands, Finland and some of the recently acceded member states from Eastern Europe.

These different positions are also likely to play a role in the reduction of the deficits and debt.

Risk of huge breach of deficit ceiling

The unfavourable developments in European budgetary policy are reflected in the deficit procedures now facing the member states. Even countries which have hitherto always pursued sound budgetary policy are finding themselves in the cross-hairs of the Commission. The Commission forecasts that 21 of the EU's 27 members will breach the 3% deficit ceiling of the SGP in 2009, and 26 in 2010.

In what follows, our interest will focus particularly on the 16 EMU countries: there, deficit procedures may ultimately result in the imposition of heavy sanctions. Twenty deficit procedures are currently ongoing in the EU-27 (see table 7)⁶, 12 of them in EMU countries. The deadlines to eliminate the excessive deficits set by the Commission vary among the different member states: while France, Germany and Spain have been granted a grace period until 2013, Greece and Malta must polish up their performance no later than 2010. EMU countries face sanctions if they do not comply with the Council's demands for improvements.

Since the crisis clearly fulfils the condition of "unexpected adverse economic events with major unfavourable budgetary effects"⁷, however, the time limits could be extended or individual steps of the deficit procedure could be repeated. The countries affected will point this out in order to ensure that potential sanctions are postponed. Using the GDP decline of 0.75% taken by the Council as the yardstick for the exceptional circumstances set out in Art. 126 (2)a TFEU, a repetition of the steps of the procedure would probably apply to all the member countries – for Spain and Ireland also in 2010.

It can be seen from this development that the crisis will boost the importance of the way and extent to which the Commission uses its discretionary scope in the years ahead. The same applies to the ECOFIN Council. The discretionary scope available to the Commission and the Council has raised fears about whether the SGP is still an appropriate instrument during the crisis in the first place.

⁶ In the case of nine countries, the decision of the ECOFIN Council on the existence of an excessive deficit is still pending.

⁷ Art. 3(5) and Art. 5(2) of the Council Regulation (EC) No. 1467/97 in the amended version Council Regulation (EC) 1056/2005.

Ongoing and looming deficit procedures

Countries undergoing a deficit procedure

		2008		2009		2010		ECOFIN decision on deficit	Time limit for correction	Repetition of procedural steps possible?
Country	Category	Debt ratio	GDP % yoy	Deficit ratio	GDP % yoy	Deficit ratio	Deficit ratio			
EMU-members										
AT	Borderline case	62.6	-3.7	4.3	1.1	5.5	pending*	2013	2009	
BE	Laggard	89.8	-2.9	5.9	-0.6	5.8	pending*	2012	2009	
DE	Borderline case	65.9	-5.0	3.4	1.2	5.0	pending*	2013	2009	
ES	Star performer	39.7	-3.7	11.2	-0.8	10.1	Apr 09	2013	2009, 2010	
FR	Borderline case	67.4	-2.2	8.3	1.2	8.2	Apr 09	2013	2009	
GR	Laggard	99.2	-1.1	12.7	-0.3	12.2	Apr 09	2010	2009	
IE	Borderline case	44.1	-7.5	12.5	-1.4	14.7	Apr 09	2014	2009, 2010	
IT	Laggard	105.8	-4.7	5.3	0.7	5.3	pending*	2012	2009	
MT	Borderline case	63.8	-2.2	4.5	0.7	4.4	Jul 09	2010	2009	
NL	Star performer	58.2	-4.5	4.7	0.3	6.1	pending*	2013	2009	
PT	Borderline case	66.3	-2.9	8.0	0.3	8.0	pending*	2013	2009	
SK	Star performer	27.7	-5.8	6.3	1.9	6.0	pending*	2013	2009	
SI	Star performer	22.5	-7.4	6.3	1,3	7.0	pending*	2013	2009	
Non-EMU members										
CZ	Star performer	30.0	-4.8	6.6	0.8	5.5	pending*	2013	2009	
HU	Laggard	72.9	-6.5	4.1	-0.5	4.2	Jul 04	2011	2009	
LV	Star performer	19.5	-18.0	9.0	-4,0	12.3	Jul 09	2012	2009, 2010	
LT	Star performer	15.6	-18.1	9.8	-3.9	9.2	Jul 09	2011	2009, 2010	
PL	Star performer	47.2	1.2	6.4	1.8	7.5	Jul 09	2012	no	
RO	Star performer	13.6	-8.0	7.8	0,5	6.8	Jul 09	2011	2009	
UK	Borderline case	52.0	-4.6	12.1	0.7	12.9	Jul 08	2014/15	2009	

Countries not undergoing deficit procedure

		2008		2009		2010		Excessive deficit	Exception in acc. with Art. 126 (2) TFEU possible?
Country	Category	Debt ratio	GDP % yoy	Deficit ratio	GDP % yoy	Deficit ratio	Deficit ratio		
EMU members									
CY	Borderline case	48.4	-0.7	3.5	0.1	5.7	2010	no	
FI	Star performer	34.1	-6.9	2.8	0.9	4.5	2010	2009	
LU	Star performer	13.5	-3.6	2.2	1.1	4.2	2010	2009	
Non-EMU members									
BG	Star performer	14.1	-5.9	0,8	-1,1	1.2	no	2009	
DK	Star performer	33.5	-4.5	2.0	1.5	4.8	2010	2009	
EE	Star performer	4.6	-3.7	3.0	-0.1	3.2	2009, 2010	2009	
SE	Star performer	38.0	-4.6	2.1	1.4	3.3	2010	2009	

*Commission has compiled a report with a deadline for correction, the corresponding decision by ECOFIN is expected in December 2009.

Sources: European Commission, DB Research

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4. Is the crisis a crisis for the SGP?

The economic crisis is seriously testing the mettle of the reformed SGP. In this context, doubts are often heard as to whether the Commission's and the Council's discretionary scope is even still appropriate or whether it undermines the original intention of the SGP. There are three concerns in public and academic debate which will be examined more closely in the following.

- First of all, there is criticism that the pact is being undermined by the politico-economic dynamics of decision-making processes in the Council.
- Moreover, critics say that the deficit procedures might be allowed to drag on because of overly generous discretionary scope.
- Furthermore, it is objected that the rules of conduct for the SGP are inadequate instruments for effectively reducing general government deficits and debt in times of crisis.

Is political economy undermining the SGP?

The first concern refers to weaknesses in the decision-making structures of the pact. Most of the member states are groaning under huge fiscal burdens. Those countries which violate the 3%-of-GDP deficit rule have, on paper, the given double qualified majority in ECOFIN needed to launch a deficit procedure against individual states. Every country which agrees to the introduction of a deficit procedure against another country must worry that the latter country will act similarly when the tables are turned. It is thus feared that these countries might hinder the introduction of a deficit procedure.

This could be the start of reciprocal no-action tactics. The mutual serving of self-interest would thus undermine the application of the pact, and ultimately the Commission's recommendation would be disregarded. Critics consider the abrogation of the deficit procedures against Germany and France in 2003 in return for conditions which these countries set for themselves as a precedent.

However, three arguments refute these concerns:

1. A look at the 13 other deficit procedures (see table 8) introduced since the SGP came into existence shows that the Council has so far not softened the recommendations of the Commission. Rather, it followed the recommendations of the Commission both in launching the procedures as well as in stopping them.
2. A further reason addresses the issue of the countries' self-interest: fiscal coordination via the pact shapes expectations – also in the capital markets. The countries subject to the biggest risk premiums on their government bond yields have an interest in a certain degree of constancy and credibility in coordination. Otherwise the risk premiums would perhaps be much higher and approach the levels of the 1990s. For this reason, those countries which – solely in view of their own tight budgetary situation – would be quite likely to plead for a tolerant interpretation of the deficit procedure would have no interest in a major destabilisation of the pact. The risk of negative voting practices gaining currency in SGP procedures is therefore much smaller than often feared.
3. One final argument has to do with the role of the Commission as the guardian of the SGP: with its appeal to the ECJ following the Council's discontinuation of proceedings against Germany

Abrogation of deficit procedures against Germany and France:

A didactic study in political economy

In November 2003, ECOFIN stopped the deficit procedures against France and Germany – on conditions proposed by these countries themselves. Since Commission proposals were not taken into account, the Commission filed suit against the Council before the European Court of Justice (ECJ).

The ECJ's judgement confirmed that the Council was within its rights to deviate from the recommendations of the Commission and halt the procedure. However, such a step may only be linked with conditions set by the Council or by the Commission and not with conditions set by the member states concerned themselves.

The Council may alter the recommendations of the Commission if this move is endorsed by double qualified majority. This means that the Commission must anticipate the decision of the Council when drafting its recommendations.

The Commission's work is thus indirectly dependent on political decision-making processes in the Council.

and France, the Commission underscored the fact that it would as a matter of principle not tolerate the political undermining of the deficit procedure. Further attempts at this type of political intervention thus stand to face substantial hurdles.

Closed deficit procedures

Country	Date of Commission report (Art. 126(3) TFEU)	Debt ratio in year of Commission report (as % of GDP)	Council decision (Art. 104(12) of the TEC) abrogating the decision on the existence of an excessive deficit	Debt ratio in year of abrogation
Poland	May 12, 2004	45.7	July 8, 2008	47.1
Portugal	June 22, 2005	63.6	June 3, 2008	66.4
Italy	June 7, 2005	105.8	June 3, 2008	105.8
Czech Republic	May 12, 2004	30.4	June 3, 2008	29.8
Slovakia	May 12, 2004	41.4	June 3, 2008	27.6
Cyprus	May 12, 2004	70.2	June 11, 2006	64.6
Malta	May 12, 2004	72.1	May 16, 2007	62.1
UK	September 21, 2005	42.3	September 12, 2007	44.2
Greece	May 19, 2004	98.6	May 16, 2007	94.8
Netherlands	April 28, 2004	52.4	June 7, 2005	51.8
Germany	November 19, 2002	60.3	May 16, 2007	65.1
France	April 2, 2003	64.9	January 30, 2007	63.8
Portugal	September 24, 2002	55.6	May 11, 2004	58.3

Source: European Commission

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Is there a risk of the deficit procedures being dragged out?

Another fear is that the excessive use of discretionary scope and recourse to exceptional circumstances could drag out the deficit procedure. Theoretically, if all facets of discretionary scope were tapped, a violation of the deficit rule in 2009 would not be punished until 2016 when non-interest-bearing deposits would have to be made. These would not be called in as a final punishment until 2018.

Not only the sanction per se, but also the probability of the punishment actually being carried out is what makes a rule work. The fear is often expressed that too little external consolidation pressure would arise on countries in the present, since they would not have to reckon with sanctions until sometime in the distant future: the actual objective of securing fiscal discipline through an effective threat on the horizon could not be fulfilled this way.

This entails the risk that the flexible interpretation of the deficit procedure will turn fiscal policies originally intended to be anticyclically expansionary into procyclical ones – with all the inherent negative consequences for the long-term sustainability of the budgets. The pact does indeed allow flexibility for such “dragging on”.

No risk of dragging on

However, the contention that deficit procedures could be launched but dragged out for a long time by flexible interpretation of the given rules only holds water at first glance: for as long as the Commission continues to play its advisory role to the same degree as in the past and the Council adheres to its recommendations, there is little reason to expect exaggerated flexibility to become the rule and thus undermine the credibility of the pact.

Flexibility is necessary in the crisis

Note, on the other hand, that the flexibility of the SGP is extremely important now in the midst of the crisis. It allows latitude for the expansionary budgetary policy needed in the short term with targets which can be calibrated at country level. The discretionary scope of the Commission and the Council can be used responsibly also during the crisis. In the actual crisis phase, the slump in the economy, the pact indeed proved its worth as an instrument of fiscal coordination. The current experience has thus at least proved those critics wrong who considered the pact harmful on the assumption that it would impose overly tight constraints on fiscal policy during a major slump.

No hurries: Potential delays in the deficit procedure

Year	Strict interpretation	Tolerant interpretation	Maximum tolerance
2009	Deficit >3% of GDP	Deficit >3% of GDP	Deficit >3% of GDP
2010	Council decision and recommendation	Council decision and recommendation	Exceptions in acc. with Art. 126(2) of TFEU
2011	Time limit for correction		Council decision and recommendation
2012	First non-interest-bearing deposit	Extended deadline for correction	
2013	Second non-interest-bearing deposit	Renew ed recommend. and ext. of deadline	Extended deadline for correction
2014	First deposit turns into fine	First non-interest-bearing deposit	Renew ed recommend. and ext. of deadline
2015		Second non-interest-bearing deposit	Warning and renew ed extension of deadline
2016		First deposit turns into fine	First deposit turns into fine
2017			Second non-interest-bearing deposit
2018			First deposit turns into fine

Source: Calmfors, L. (2006): The Revised Stability and Growth Pact – A Critical Assessment, *The Journal for Money and Banking of the Bank Association of Slovenia*, Nov. 9

Deficit procedures are successful in reducing budgetary excesses ...**Are the rules of the SGP inadequate?**

Moreover, there has been criticism that the rules of the pact per se are inadequate to hinder a prolongation of excessive deficits. A look at the deficit procedures to date shows however that deficits indeed were effectively driven back to below the 3%-of-GDP threshold. This resulted in the procedure being discontinued. The reason here no doubt was the strong economic growth since 2003 which boosted state revenues (particularly in France, Germany and Portugal). However, there were also structural reforms in budgetary policy (e.g. in Cyprus, Czech Republic, Germany, Italy, Poland, Slovakia and the United Kingdom) as well as spending cutbacks (e.g. in the Netherlands and Portugal).

... but not debt levels

The story is different in terms of the debt ratio (60% of GDP): in this case, only some of the procedures resulted in an effective decrease in government debt. For the time being, this will probably remain difficult to achieve since the deficits will be much higher than the small pre-crisis excesses which, as a rule, were for structural reasons.

In the near future, the main focus will be on whether it will still be possible to count on the coordination mechanisms in the course of economic recovery and with the necessity of reversing fiscal and budgetary policies in the EU countries. Analysis to date has shown that the risk of the flexible interpretation of the SGP being overstretched will remain small in the foreseeable future, since the Commission and the Council have no interest in a de facto undermining of the pact.

Therefore, major significance will be attached to the possibilities of coordinating fiscal policies when debt levels are being reduced – and to a fiscal exit strategy made possible by coordinating economic policies within the framework of the SGP.

Origin of the deficit and debt ratios

The deficit and debt limits date from the days of the Maastricht Treaty (1993). It was originally assumed that if GDP grew by 5% in nominal terms, it would be possible to maintain a debt level of 60% of GDP on a budget deficit of 3%. Conversely, this means that the deficit ratio must equal 0.6 times the nominal growth rate. However, these considerations do not tally with reality: to give an example, Germany had an average deficit ratio of 2.01% of GDP between 2000 and 2008 and an average nominal growth rate of 2.19%. On this nominal growth rate an average deficit ratio of 1.31% of GDP would have been required in order to keep the debt level constant.

For this reason, the proposition is often heard in academic debate that there should be a reduction of the debt limit for countries with low trend growth. However, reform initiatives to this end have not been embraced as yet.

**Short-term burden:
economic slump, fiscal packages
and bail-out measures**

**Medium-term burden: higher interest
rates because of rising government
debt**

5. High government debt requires fiscal exit strategy

The long-term reduction of general government debt is a mammoth task, the reason being the large budget deficits in years of crisis. Unlike pre-crisis deficits, these are not merely marginally higher than the tolerance level defined in the SGP; rather, they greatly exceed it. This poses even more of a problem insofar as these limits are based on inappropriate assumptions anyway and they are much too broad to allow a sustainable general government debt position (see box). This results in a heavy debt burden lasting indefinitely.

If no attempts are made to reverse this development by running down deficits there is a risk of the public debt level remaining excessively high or, in some countries, rising further. This danger results from the confluence of short, medium and long-term risks to the sustainability of public finances which were caused by the crisis itself or accentuated by it.

Short, medium and long-term budgetary burdens

In the short term, economic stimulus and bank bail-out packages will weigh on government budgets and widen the deficits. As long as these measures are only temporary they may fulfil their role as a stabiliser during a recession. Ideally, deficits resulting from an economic slump ought to be neutralised via subsequent surpluses during the recovery phase. However, this is doubtful in the current situation not least because of the scale of government intervention to tackle the crisis.

The deficits have been expanded to an extraordinary degree in the crisis. They exceed the threshold value in the pact several times over and are sending debt levels up sharply. It is possible to understand the logic behind the crisis-induced deficit surge and it is accounted for by the exceptions foreseen in the pact. These considerations show that the crisis introduced a dilemma to budgetary policy. The SGP cannot be blamed for it, though.

However, subsidies granted as part of the stimulus packages may easily become entrenched over time. Politically, it is difficult to abolish them as long as the providers shy away from taking unpopular measures and the recipients lobby for their interests. This raises the danger that cyclical deficits will turn into higher structural deficits.

A further reason is political inertia, with policymakers being too slow in launching consolidation measures or failing to do so. One of the consequences, for instance, is that the deficit and debt ratios continue to rise even when the downswing is over. In this case, our analysis shows that the pact does not increase this risk but instead mitigates it.

In the medium term there is even more risk of a spiralling debt load being triggered by large deficits and a steadily growing interest burden as interest rates are likely to start rising again in the foreseeable future. Moreover, interest payments increase disproportionately on higher government debt in countries with a low degree of competitiveness and low trend growth. For with rising debt levels and unfavourable redemption prospects due to sluggish growth the risk premiums on government paper demanded by investors often tend to increase.

Maastricht debt ratio requires large surpluses

Primary surplus as % of GDP (2008) required to maintain debt ratio at 60% of GDP (from 2012) or to reach this level (by 2027)

Germany	2.8
France	2.7
Greece	4.2
Ireland	5.3
Italy	5.6
Netherlands	0.6
Spain	1.2
UK	2.6

Source: IMF **10**

Long-term burden: demographic challenge

table 10 shows that the debt service obligations of some countries are already very high – and the huge amount of new debt issued in 2009 and 2010 is not even factored in yet. To meet the debt ratio criterion of 60% of GDP by 2027, the primary surplus – defined as the budget surplus minus interest payments on government debt – in Greece, Italy and Ireland would have to reach high levels which far exceed the trend growth rate of these economies.

Beside these crisis-induced short and medium-term factors, the government budgets are going to be burdened **in the long term** by the demographic challenge. It will limit the scope of budgetary policy for future consolidation efforts. A key indicator for this trend is the old-age dependency ratio. This measure sets the economically dependent cohort of the 65-plus age group in relation to the population of working age. Eurostat forecasts that the dependency ratio in the EU-27 will double from 25.4% in 2008 to over 53.5% in 2060.

As long as the old-age pension systems are not changed in timely fashion to include more elements of personal provision or are not increasingly converted to a funded basis, the consequence will be a heavy burden on the national budgets. Accordingly, the level of implicit government debt ensuing from future burdens will also climb if policies remain unchanged. This long-term pressure on the public budgets could be reduced via structural reforms to old-age security or by raising the retirement age. Both options would aim to secure the contribution level of the pay-as-you-go pension schemes and thus ease the pressures on budgetary policy. The implicit government debt would decline.

Furthermore, structural reforms could simultaneously boost trend growth in the economy. This would be helpful to meet the aims of the SGP in the long run, since GDP is the denominator for both criteria in the pact.

High government debt erodes growth opportunities

When government debt is being reined in it is not simply a matter of meeting particular criteria that are only a means to an end, but ultimately a matter of preventing situations that could jeopardise potential growth.

For one thing, because of related high interest payments, a large amount of government debt limits the **budgetary scope** for growth-fostering public-sector investment. Furthermore, during growth phases in particular, there is a risk of private-sector demand for credit being crowded out by excessive public-sector demand for credit – with corresponding negative consequences for private-sector investment.

Moreover, debt service requirements increase the **burden of taxes and social-security contributions**. These eat into the disposable income and assets of households and companies. In this way, high government debt becomes a curb on growth.

The degree to which there is a risk of excessive government debt resulting in a prolonged, serious weakening of growth opportunities in the individual EU countries is a matter for debate. This issue cannot be settled here. One thing is clear, though: the risks resulting from the current widening of the government deficits in many countries have increased substantially.

The first question asked at the outset of this report, as to whether the SGP is an effective instrument for coordinating fiscal policy also

Rising dependency ratio

Old-age dependency ratio for selected years up to 2060 (%)

	2008	2020	2040	2060
EU-27	25.39	31.05	45.36	53.47
DE	30.29	35.28	54.73	59.08
IE	16.31	20.23	30.60	43.57
GR	27.77	32.75	48.25	57.12
ES	24.15	27.42	46.39	59.07
IT	30.47	35.47	54.07	59.32
PL	25.43	27.19	41.29	68.97
UK	24.27	28.58	36.92	42.14

Sources: Eurostat, EUROPOP 2008
Convergence scenario **11**

Is the solution a reform of the SGP?

Those from the academic community calling for a suspension of the deficit procedure or the abandonment of the pact have not thought the matter through. They often argue that the SGP restricts the active use of fiscal policy to deal with deficits. However, the pact does allow such flexibility.

At present, debate focuses on France's proposal to exclude crisis-induced expenditures from the SGP's measure of the deficit. The demand to factor certain budgetary items out of the pact formula is nothing new. This same demand was heard in 2004 in relation to expenditures on national defence. But in this case, the problem is to identify which expenditures are crisis-induced and which ones are not. Beside the definition problem, this proposal misses the point: after all, heavy burdens from debt service would continue to weigh on the budget even on a temporarily tolerant interpretation of the deficit criterion.

Suspending the deficit procedure would not defuse the debt problems either. There would be neither an incentive to allocate budgetary funds appropriately nor to address structural reforms.

The damage to confidence resulting from suspension or abandonment of the SGP would be greater than the benefits allegedly to be gained over those already available with the flexible status quo. The loss of confidence would possibly lead to a further increase in risk premiums on government bonds and thus only further boost the aggregated national debt level in many countries.

Political opportunism and misguided regulation extend stimulus packages**Exit strategy is a matter for member states ...**

in times of crisis, must therefore be answered at a number of different levels.

As long as the provisions of the pact are applied in such a way that deficits are reduced again rapidly after the crisis, the pact is an appropriate tool for coordinating fiscal policies that leads in the right direction not only in the normal growth cycle, but also in times of crisis.

However, the problems of the higher debt load can neither be addressed properly by the pact nor by respective proposals to reform the pact (see box).

Circumstances therefore call for a fiscal exit strategy – i.e. coordinated action on the part of all the EU member states in order to run down discretionary spending for growth-supporting measures and thus reduce government deficits and debt over the long term. The idea is not to replace the stability pact but to complement it.

One key question is whether an exit strategy can be implemented in the framework of the existing SGP rules or whether further-reaching complementary measures will be required. We shall examine this aspect in the following section – and thus tender an answer to the second question leading into this report, i.e. what role can be played by the SGP in the return to sustainable fiscal policy in the E(M)U countries?

6. Requirements for a fiscal exit strategy in Europe

The European Economic Recovery Plan of December 2008 already provides that the stimulus packages implemented by the EU members should not only be timely and targeted, but also temporary. While the member states have largely fulfilled the first two criteria, the nature of the crisis has meant that the measures have yet to be unwound.

True, many elements of the national stimulus and bank bail-out packages have expiry dates in some member states (e.g. Germany and the UK). Nonetheless, the possibility looms large that the stimulus may be extended owing to political pressure – especially for packages that send political signals. This was the case in Germany with the car scrappage bonus and just recently with the fiscal support for short-time work, and there is talk in the UK of the VAT reduction being extended beyond December 31, 2009.⁸ The problems are even dicier in countries (e.g. France) which have not set an expiry date on their measures.

Thus the ultimate decision on how to go about exiting the stimulus packages and deficits lies squarely in the hands of the member states – but the very job of timely and targeted implementation of the said exits requires coordinated action. This could lead to tensions, for on the one hand it is necessary to coordinate national exit strategies to prevent negative spillover effects – such as competitive distortions in the context of national spending programmes or negative repercussions from higher government debt. At the same time, though, it is difficult to coordinate an exit because unlike at the beginning of the recession, when the crisis sent shock waves through the economies simultaneously, the

⁸ See e.g. Prosser, D. (2009). VAT cut helped to boost struggling retail sales. In *The Independent*. April 13, 2009.

... but its coordination is a matter for the Union

Five criteria guarantee an effective exit strategy

ECOFIN Council takes first steps

In its meeting on October 19 and 20, the ECOFIN Council had already determined its view on a coordinated exit strategy for the EU. The principles laid down in the Council conclusions provide that a fiscal exit strategy should be timely, take the country-specific situation into account and be coordinated within the framework of a consistent implementation of the SGP. As a first step, fiscal stimulus measures should be phased out, with fiscal consolidation starting in 2011 at the latest. In most member states, the overall fiscal consolidation effort is meant to go well beyond the benchmark of 0.5% of GDP p.a. (structural deficits) as determined in the preventive arm of the SGP. In addition, the Council proposes flanking policies at the national level, such as strengthened national budgetary frameworks and structural reform efforts to enhance productivity. The Council recommends that first steps should be reflected in the Stability and Convergence Programmes which will be submitted by the member states to the Commission in January 2010.

recession will not end at the same time in all member states. In countries which experienced major turmoil in the banking system and/or in the real estate markets the sluggishness will tend to persist longer than in export-oriented countries whose economic collapse was more likely attributable to the slump in world trade. This means a higher level of coordination – not only in qualitative and quantitative terms but also over a longer time span.

These considerations and the ones above on rising debt levels suggest that a European fiscal exit strategy ought to fulfil five criteria.

1. It should ensure in the **short term** that **economic stimulus packages** are not extended on account of political pressure.
2. **In the medium term**, it should create incentives to cut national deficits and reduce **debt levels**.
3. **In the long term**, the way should be paved towards implementing **structural reforms** in the areas of social security and pension provision so households can cope with the demographic challenge.
4. Furthermore, member states should be able to establish **individual roadmaps** for the implementation of their measures, for the crisis hit them to differing degrees and along differing time lines.
5. Also, a fiscal exit strategy should have a **binding sanctions framework** in order to raise the opportunity cost of poor implementation.

In what follows we shall, on the basis of these five criteria, examine the corrective arm of the SGP, the Eurogroup, the preventive arm of the SGP, the Broad Economic Policy Guidelines (BEPGs) and the possibility of ad hoc coordination as means of economic policy coordination.

7. Instruments to coordinate an exit strategy in EMU

The instruments to be considered for coordinating an exit strategy in EMU are the corrective arm of the SGP and the Eurogroup.

Corrective arm of the SGP: Effective coordination with sanctions option

The **corrective arm of the SGP** already compels a country to exercise budgetary restraint via the deficit procedure. As explained above, the discretionary scope available to the Commission and the Council enables deficit procedures to be adapted in accordance with national economic performance. Therefore, the Commission holds a key role as it can take account of national consolidation efforts in the reports it compiles as part of the deficit procedure.

While traditional coordination based on the Commission's discretion can only take place *ex post*, there is also the option of *ex ante* coordination via the SGP: looking ahead, the Commission could declare that the deficit procedure must start to be interpreted only in the narrow sense from a particular date. In this case, too, it would be possible to have a country-specific classification with differing deadlines. Depending on the economic situation in the given country, deadlines to drive down national deficits could then be extended or shortened. The Commission and the Council could

communicate this to the member states at relatively short notice in advance.

The corrective arm of the SGP thus offers the incentive to allow short-term stimulus measures to expire (**critterion 1**) and creates an obligation to consolidate in the medium term (**critterion 2**). However, no incentives are created for structural reforms (**critterion 3**). The country-specific assessment in the framework of the deficit procedure additionally enables country-specific consolidation roadmaps to be established via the Commission and corrected if necessary (**critterion 4**). The sanctions of the deficit procedure would guarantee the enforceability of the recommendations (**critterion 5**).

Eurogroup: New momentum, but lacking sanctions option

Beside the corrective arm of the SGP the **Eurogroup** also offers a forum for coordinating fiscal policies.⁹ The Eurogroup stands for the increased coordination of economic policy between the countries of the euro area.

A recent initiative, from June 8, 2009¹⁰, set out orientations for fiscal policy in EMU member states. This initiative concludes that given the expected stabilisation and eventual recovery of overall economic activity further discretionary budget stimulus is not warranted at the current juncture. Moreover, the statement addresses the issue of fiscal consolidation measures: in line with the SGP, fiscal consolidation should take into account not only the pace of recovery, fiscal positions and debt levels but also long-term factors such as the costs of ageing, external imbalances and risks in the financial sector.

In this context, the Eurogroup said that what is needed are not only that the implications of the ongoing and forthcoming excessive deficit procedures be fully reflected in national fiscal plans, but also national fiscal stabilisation programmes which set ambitious and realistic targets and clearly defined to what extent and by what means (e.g. structural reforms in the area of age-related expenditure) these targets would be reached. Germany's legislated debt cap is a model for such national consolidation programmes.

This new initiative of the Eurogroup clearly has a targeted focus:

- For one thing, it enables the EU to consider the member states' varying preferences in terms of timing and design (income or expenditure-related measures for budgetary consolidation?).
- However, the political implications are at least as equally important: the member states are sent a clear message on their responsibility for consolidating their finances. With nationally based consolidation programmes there is less possibility in the area of political communications for the responsibility for consolidation efforts being shifted to Brussels.

The recent initiative offers the incentive of exiting the stimulus programmes in the short term (**critterion 1**) and initiating medium-term fiscal consolidation (**critterion 2**) and it has a focus on structural reforms in the areas of pensions and social security

Germany's debt cap

Germany's debt cap differentiates between the federal government's structurally and cyclically induced net borrowing requirements: the structural deficit may total a maximum of 0.35% of GDP at the federal level, while no structural deficit is permitted at the state (Länder) level. Exceptions exist for natural disasters and severe recessions. As soon as the debt cap is endowed with a legal foundation from the Constitutional Court it will formally possess considerable legal clout.

Cyclical deficits, by contrast, are permitted – this enables the conduct of anticyclical policy and gives free rein to the automatic stabilisers. To determine the potential cyclical deficit, the authorities calculate the output gap in relation to trend growth. This inevitably results in a surplus during the upswing and higher deficits during the downswing. Using the method of the European Commission to calculate the output gap ensures that trend growth is not deliberately estimated too low.

⁹ This body, which convenes on the evening prior to the ECOFIN Council, includes the finance ministers of the 16 EMU states, the ECB president, the Commissioner for Economic and Monetary Affairs, and the Chair of the Economic and Social Committee.

¹⁰ Eurogroup (2009). In Spring orientation debate on budgetary policies: Orientations for fiscal policies in euro area Member States. June 8, 2009. Luxembourg.

(**critterion 3**). The demand for supplementary national stabilisation programmes underscores the possibility for member states to implement consolidation measures with a national roadmap and timetable (**critterion 4**). Even if coordination via the Eurogroup is missing the important feature of effective sanctioning mechanisms (**critterion 5**), it offers an ideal possibility to realise a fiscal exit strategy within EMU – especially since there is considerable peer pressure among the EMU countries to maintain fiscal discipline.

The coordination of economic policies by the Eurogroup will be even intensified by the Treaty of Lisbon. Though remaining an informal body, the new Art. 136 TFEU provides that the Eurogroup may adopt economic policy guidelines within the Council. These guidelines should be compatible with the Broad Economic Policy Guidelines adopted for the whole of the Union.

To sum up: the corrective arm of the SGP and coordination via the Eurogroup, as mechanisms exclusive to EMU, are effective instruments for coordinating national ambitions to exit the stimulus packages and deficits and ultimately also for enforcing them. Taken together, they can fulfil all five criteria for a fiscal exit strategy.

8. Instruments to coordinate an exit strategy in the EU-27

The instruments conceivably available for coordinating an exit strategy in the EU-27 are the preventive arm of the SGP, the Broad Economic Policy Guidelines and ad hoc coordination.

Preventive arm of the SGP: Close coordination via strictly binding character

Medium-term objectives for consolidation

The **preventive arm** of the SGP could induce all EU member states to launch national consolidation measures in keeping with the multilateral surveillance framework (Art. 121(3) and (4) of the TFEU). The stability programmes of the EMU members contain quantitative medium-term deadlines, the so-called *medium-term objectives (MTOs)*, which fiscal policymakers have to adhere to for orientation. If the medium-term objective is not attained, the structural deficit must be annually reduced by 0.5% of GDP.¹¹ The same holds for the convergence programmes of the non-EMU member states. In these programmes, the member states define the adjustment paths of their government deficits and forecast the probable development of their general government debt ratio.¹²

ECOFIN has key role

On the recommendation of the Commission, the ECOFIN Council can issue an opinion on underlying economic assumptions,

¹¹ The Commission is of the opinion that the EU-27's aggregated debt could stabilise at 98% of GDP by 2020, if members adhered to an annual consolidation target of 0.5% of GDP. In the case of the euro area, the debt level would peak at 94% of GDP in 2016 and subsequently start to recede. The Commission says that individual countries (Ireland, France, Spain) report much higher debt ratios and this means they would require a longer consolidation roadmap. It therefore recommends that in countries with a heavy debt load the annual consolidation target be increased – to as much as 1% of GDP.

¹² In its recent annual report, the German Council of Economic Experts (Sachverständigenrat Wirtschaft) deems the SGP not to be sufficient for the prospective consolidation efforts. The Council proposes the establishment of a supplementary fiscal consolidation pact, implemented via the Stability and Convergence Programmes of the preventive arm of the pact. Though not vested with an additional sanctions framework, the definition of expenditure-based timetables for consolidation could increase pressures from both the political and financial markets side.

adjustment path, MTOs and degree of compatibility with the Integrated Guidelines for Growth and Jobs. This allows the Council to influence the quantitative targets of the member states' consolidation policies, for example, by recommending concrete rules to reduce their deficits. These would inevitably result in the stimulus packages being abandoned. The Commission's demands can be readjusted on an annual basis.

The Commission's individual assessment of the stability and convergence programmes increases the pressure on the member states to cut back their stimulus packages in the short term (**criteria 1**). As with the corrective arm, the measures of the preventive arm may have the effect of ensuring discipline in the medium term in the context of reducing budgetary deficits (**criteria 2**). The programmes contain detailed targets on structural reforms in order to guarantee the long-term sustainability of the public finances (**criteria 3**). Combined with the individual assessment by the Commission and the Council, this enables the member states to pursue individual consolidation strategies (**criteria 4**). The problem remains, however, that the preventive arm of the SGP is not equipped with sanctions (**criteria 5**). Nonetheless, there are two reasons in particular why its impact should not be underestimated:

Indirect sanctions potential

- Information on whether the recommendations of the preventive arm are being followed also flows into the Commission's reports in the framework of the sanctions-equipped corrective arm. Thus, they can influence the decisions of the Commission and the Council in the deficit procedure anyway.
- Furthermore, the Council can decide by qualified majority to publish its recommendations, if the Commission suggests it do so. This would result in a huge reputational loss for the country concerned.

Broad Economic Policy Guidelines: Country-specific coordination without sanctions

A further option for coordinating national consolidation efforts in the EU-27 is offered by the **Broad Economic Policy Guidelines** (Art. 121(2) of the EC Treaty) for all 27 EU member states.¹³ As part of the Integrated Guidelines for Growth and Jobs, the Broad Economic Policy Guidelines (BEPGs) consist of general guidelines for all member states and structural policy priorities and measures for individual countries. The guidelines are set for a period of three years – the next three-year period running from 2011 to 2013. This interval would allow timely establishment of a consolidation master plan following the crisis years 2009 and 2010.

National reform programmes as a lever

The coordination strategy would work as follows: on the basis of the BEPGs the member states draft so-called National Reform Programmes. In accordance with the objectives of the Guidelines the Commission and the Council evaluate these programmes and issue specific recommendations to the member countries.

The BEPGs would thus enable both a European framework as well as country-specific arrangements. In the general part, the BEPGs could set qualitative targets such as a list of measures from which the member states could make their selection. The country-specific

¹³ The legal foundation for the Broad Economic Policy Guidelines is Art. 121(2) of the TFEU. Therefore, they do not fall under the Open Method of Coordination, since this only applies to areas which do not fall within the legal competence of the Union.

SGP can be complemented by BEPGs

part would then allow the possibility of setting quantitative targets and specifying proposals for structural reforms.

This would indeed be a way to create incentives for member states to allow their stimulus programmes to expire in the short term and, as a result, to restore budget discipline in the medium term and implement structural reforms (**criteria 1, 2 and 3**). This could occur in the framework of national consolidation roadmaps (**criterion 4**). But this still leaves the critical issue of enforceability (**criterion 5**): non-compliance with the recommendations could not be sanctioned.

For this reason it would be advisable for the elements of an exit strategy based on the BEPGs to be implemented at best as a complement to coordination via the SGP in order to offer the national exit strategies a contextual orientation. Confining the coordination of the exit strategy to the BEPGs would not be effective, however.

Ad hoc coordination: Unsuitable during fiscal contraction

One final option is the possibility of **ad hoc coordination** of an exit strategy.

To this end, the Commission would provide the European Council with a short-term recommendation including a detailed list of possible measures. The European Council would then integrate this list into its Presidency Conclusions. Member states could subsequently implement their exit strategies according to predefined measures. The ECOFIN Council would not be involved. One good example of ad hoc coordination of economic policy may be seen in the European Economic Recovery Plan.

Non-binding list of measures would be ineffectual

While ad hoc coordination was an adequate instrument for short-term policy moves in the case of the European Economic Recovery Plan, its application in the case of a coordinated exit strategy would be more of a problem. True, there is a way to offer the member states a choice of measures from a set of policy components so they can wind up stimulus programmes, consolidate their budgets and press ahead with structural reforms (**criteria 1, 2 and 3**). However, this form of coordination would be unreliable and impossible to plan from a time perspective (**criteria 4 and 5**).

- A list of measures would not allow the differences in economic performance of the member states to be taken into account. While ad hoc coordination may indeed be the answer for simultaneous shocks, it can be very difficult to use the same tactic for a staggered recovery.
- One other factor is politico-economic: fiscal contraction is invariably more difficult to push through politically than fiscal expansion. For a contraction to be coordinated between countries there needs to be a binding sanctions framework. However, the possibility to impose sanctions is not available in this type of coordination.
- Last but not least, it would not be wise to circumvent ECOFIN and thus refrain from tapping its expertise by coordinating matters directly between the Commission and the European Council.

Therefore, even though ad hoc coordination was largely successful in the case of the European Economic Recovery Plan, it cannot serve as a model for the coordination of joint fiscal consolidation efforts. Consequently, demands to use the Recovery Plan as a model for a fiscal exit strategy are misguided.

	Exit instruments in comparison				
	<i>Criteria</i>				
	1. Exit from stimulus packages	2. Fiscal consolidation	3. Structural reforms	4. Country-specific roadmaps	5. Sanctions
Instruments for EMU members					
SGP: Corrective arm Eurogroup	✓	✓		✓	✓
	✓	✓	✓	✓	
Instruments for EU-27					
SGP: Preventive arm	✓	✓	✓	✓	(✓)
Broad Economic Policy Guidelines	✓	✓	✓	✓	
Ad hoc coordination	✓	✓	✓		

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No way around the SGP

So if we now take another look at all the measures proposed for the coordination of national exit plans to create a European exit strategy, it is clearly visible that there is no way around utilising the SGP as the key instrument for coordinating economic policy – neither in EMU nor in the EU-27.

Measures such as coordination within the Eurogroup or via the BEPGs can have a complementary effect at best, adding flesh to the bones of coordination. However, the key feature, still, is the possibility of imposing sanctions for non-compliance, as offered by the SGP in the context of its corrective arm (deficit procedure).

Lack of sanctions potential for non-EMU states remains a problem

While exit strategies could be well coordinated and enforced inside EMU, the question remains as to what sanctions may be used for EU countries outside EMU.

EU-27: Capital markets could fill sanctions void

Capital markets price in fiscal misdoing

In this event, the only possibility is to count on the corrective forces of the capital markets, which could punish countries by demanding higher risk premiums on their government paper if their policies strayed from the consolidation target. This would hold all the more for non-EMU countries since in this case the market would price in the minor costs of non-compliance with the recommendations of the Commission, Council and BEPGs in the risk premiums. The more successful the consolidation efforts within EMU, the more this would apply – the spread would widen. Thus the pressure of the capital markets could additionally boost the incentive to cooperate also within the EU-27.

Indeed, this also enables us to answer the second question from the beginning of this report. The SGP can play a central role in sustainable fiscal policy and in a fiscal exit strategy. On the one hand it offers flexibility, but on the other hand it also offers credible sanction mechanisms, so it can compel EMU member states to coordinate and implement their individual exit strategies and it can monitor them accordingly.

9. Conclusion

The Stability and Growth Pact is an effective tool for the coordination of fiscal policy also in times of crisis. The economic downswing does indeed pose a challenge to the SGP – the Maastricht deficit limits are being breached in almost all of the EU countries, and debt levels are skyrocketing.

The currently high deficits cannot be blamed on the SGP, however – even if its incentive compatibility is often questioned in public and academic debate. Empirical analysis shows that the coordination of fiscal policy in the framework of the SGP has done a good job thus far: political intervention is reduced to a minimum by the independent Commission, the deficit procedures have to date ensured improved budgetary policies in the member states and the flexibility of the pact has been used responsibly up to now.

Thanks to its intelligent combination of rules-based coordination and discretionary flexibility, however, the pact offers the member states on the one hand and the Commission and Council on the other a way to master the upcoming challenges of strict budgetary consolidation – in timely, binding and sustainable fashion.

Nonetheless, the member states will need to make additional efforts to reach this target. Large deficits can only be narrowed sustainably if the sizeable outlays of the stimulus programmes and thus the budgetary deficits decrease again. However, this is also not enough to vent the pressure on the public budgets in the long term either: for the demographic challenge will weigh on the public purse via heavy burdens on the social-security system. This suggests that the EU needs a fiscal exit strategy which encompasses short-term budget consolidation and at the same time does not ignore the long-term challenges of demographic changes. The SGP is the only plan which offers the appropriate instruments and adequate flexibility.

If the Commission and the Council apply the rules properly the SGP can become a central pillar of a fiscal exit strategy. The discretionary scope of an independent European Commission and of a responsibly-minded Council will therefore continue to play an important role in future events. While other mechanisms of economic policy coordination may supplement the SGP, they cannot replace it. A fiscal exit strategy in Europe is inconceivable without the SGP.

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