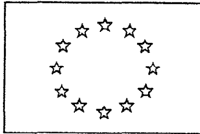

EUROPEAN COMMISSION
DIRECTORATE-GENERAL II
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 18 March 1996
II/163/96-EN

A STABILITY PACT TO ENSURE BUDGETARY DISCIPLINE IN EMU

(Note for the Monetary Committee)

CONTENTS

page

I. INTRODUCTION 3

II. ECONOMIC AND BUDGETARY ASPECTS 3
II.1 MACROECONOMIC STABILISATION IN STAGE THREE OF EMU 3
II.2 ENSURING FISCAL DISCIPLINE IN STAGE THREE: THE GERMAN STABILITY PACT PROPOSAL 4
II.3 THE MEDIUM-TERM OBJECTIVE OF FISCAL POLICY 5
II.4 THE ECONOMIC AND BUDGETARY FRAMEWORK OF A STABILITY PACT 7

III. INSTITUTIONAL AND LEGAL QUESTIONS 5
III.1 TWO MAIN OPTIONS 8
III.2 THE LEGISLATIVE PROCESS 9

IV. IMPLEMENTATION ASPECTS 10
IV.1 STRENGTHENING SURVEILLANCE AT EU LEVEL 10
IV.2 IMPROVING BUDGETARY DISCIPLINE AT NATIONAL LEVEL 12

V CONCLUSIONS AND ISSUES FOR DISCUSSION 13

ANNEX: REINFORCING MARKET PRESSURE ON FISCAL BEHAVIOUR 15

I. INTRODUCTION

The present note is intended as a further contribution to the debate sparked off by the German proposal for a "stability pact for Europe" aiming at ensuring fiscal discipline in Stage three of EMU. Compared to the previous notes established for the attention of the Monetary Committee (II/011/96-EN and II/099/96-EN), a number of specific, though still tentative, proposals for devising and implementing a stability pact are put forward. The note, which is drawn under the responsibility of Commission services, takes into account the discussions that have already taken place in the Monetary Committee and aims at gathering a consensus on a possible way forward. However, it is no way attempts to set out the conclusions that the Commission may reach at the end of the current discussions or prejudge the preferred option by the Commission.

The various aspects of a possible pact - economic, budgetary, legal and procedural - are examined. An annex deals with the possible ways to increase market pressure in the direction of fiscal prudence.
A number of items require more in-depth exploration. In particular, the question of how to implement the agreement in practice, including the need for specific secondary legislation, needs further analysis. The question of the appropriate scale of sanctions to be applied in the case of excessive budget deficits has not yet been addressed.

II. ECONOMIC AND BUDGETARY ASPECTS

II.1 MACROECONOMIC STABILISATION IN STAGE THREE OF EMU

The introduction of a single currency and the creation of a European Central Bank implies that a single monetary policy is set for EMU as a whole. Moreover, the priority objective of the ECB is to preserve price stability. Therefore, budgetary policy, which remains under the responsibility of national authorities, will have a more important role in macroeconomic stabilisation across the economic cycle and in the event of asymmetric shocks[1].

[1] Other mechanisms of adjustment play an equally important role. In particular, higher wage flexibility and better functioning goods and service markets are needed in preventing country-specific shocks from resulting in heavy output and job losses.

Fiscal policy needs to pursue a twofold aim:

- perform a shock-absorption function at the national level; and
- allow the establishing of an optimal macroeconomic policy mix at the EMU level.

In order to meet the first objective, a degree of flexibility has to be left to national budgets in order to let automatic stabilisers work across the cycle and to allow discretionary measures in the case of country-specific shocks. Preserving the necessary flexibility to cope with adverse economic events requires a sound fiscal discipline under normal economic circumstances so as to prevent the emergence of unsustainable budgetary positions which would risk jeopardising the financial stability of EMU. The dual constraint of discipline and flexibility is clearly recognised by the Treaty which, whilst leaving budgetary policy under the responsibility of Member States, sets Community rules and procedures to avoid excessive public deficits and debts.

According to the second objective, national budgetary policies should together achieve an appropriate fiscal stance for EMU as a whole. Fiscal prudence is essential in order to preserve a stability-oriented monetary policy[2]. However, attaining the appropriate EMU-wide fiscal stance and, in turn, the right fiscal and monetary policy mix, also requires addressing the issue of fiscal policy co-ordination over the cycle or in the face of common symmetric shocks. This would then entail the assessment of the ex-ante consistency of national budgetary policies in the final equilibrium - when medium-term targets will have been attained - as well as in the transition period. Treaty provisions concerning budgetary policy co-ordination - within the broader scope of economic policy co-ordination as covered by art. 103 - are less detailed than those related to fiscal discipline and still in an early stage of implementation.

II.2 ENSURING FISCAL DISCIPLINE IN STAGE THREE: THE GERMAN STABILITY PACT PROPOSAL

As stated above, maintaining budgetary discipline in stage three is an essential condition to reap all the benefits of the single currency. Sound public finances are important not only to allow automatic stabilisers to function without giving rise to unsustainable budgetary positions, but also to foster low and stable inflationary expectations, to provide conditions

[2] Fiscal discipline will play a particularly important role in the initial period of EMU to reduce the likelihood or the costs of a possible market testing of the anti-inflationary credibility of the newly established ECB.

for higher medium-term growth and in order to address the budgetary consequences of ageing.

In this light, the overriding concern of the stability pact proposal is to provide the necessary conditions to ensure fiscal discipline in stage three of EMU. While clearly stating that no re-negotiation of the Maastricht criteria for participation in the single currency is envisaged, the draft stability pact puts forward a number of proposals to implement a permanent fiscal discipline in stage three. Member States should enter a voluntary commitment encompassing the following elements:

- respecting the 3% deficit limit set in the Treaty, even in economically unfavourable periods, with exceptions being granted only in extreme cases;
- setting a medium-term goal of 1% of GDP for the budget deficit, thereby providing a safety margin of 2% of GDP under the 3% mandatory ceiling;
- reducing progressively the stock of debt even below the level of 60% of GDP indicated in the Treaty;
- keeping down the share of the public sector in the economy by, in particular, bringing down the rate of growth of public expenditure below that of nominal GDP.

According to the proposal, this set of commitments, by ensuring a reduction in the interest burden on public debt, would allow the focusing of government expenditure on public investment, whilst gaining room for manoeuvre to limit future budget risks.

II.3 THE MEDIUM-TERM OBJECTIVE OF FISCAL POLICY

In order to provide guidance to markets and to orientate the adjustment efforts of policy makers, it seems appropriate to set a medium-term target for budgetary policy.

Whilst a single target across EMU members has the clear advantage of simplicity and visibility, it is also characterised by a number of drawbacks. In particular, in view of differing degrees of real convergence and demographic prospects amongst Member States, national budgetary policies face different medium-term constraints. Furthermore, the budgetary room for manoeuvre needed to accommodate cyclical developments varies across Member States and it is frequently higher - especially amongst smaller countries - than that allowed by the stability pact proposal. Finally, whatever medium-term target is eventually retained, as the "degree of hardship" in bringing down and sustaining a lower deficit depends on the initial level of the stock of debt, different time spans for the transition are likely to be called for. It is also important to stress that a uniform target would in no way replace the co-ordination effort addressed in section II.1.

A sustained budget balance below the Maastricht reference value automatically implies that the public debt ratio converges - and reasonably quickly, under normal assumptions on the rate of growth of nominal GDP - to a long run equilibrium level well below 60% of GDP[3]. Therefore, imposing a further constraint on the debt level seems redundant and risks to overdetermining the system unnecessarily.

As to the indication of progressively reducing the public expenditure ratio, any implementation would need to take into account the below-average levels of expenditure in the catching-up countries and their greater public investment needs. Furthermore, while restraining public expenditure increases should be the preferred approach in many countries, as stated by the broad economic policy guidelines, this recommendation essentially applies to the transition period rather than to the final equilibrium. Although some developments (e.g. tax competition on mobile factors or welfare state reform) will point in the longer run to a lower share of government in the economy, the choice of the combination of expenditure and revenue to sustain the medium-term budgetary position will largely lie with the political preferences of national authorities.

The above considerations point to the following conclusions:

a) a certain degree of differentiation in national medium-term budgetary targets appears to be desirable from an economic point of view;
b) a deficit target of 1% of GDP - as in the stability pact proposal - seems therefore arbitrary and, in the case of several countries, not sufficient either to accommodate cyclical developments or face the budgetary consequences of the ageing structure of the population;
c) once a credible medium-term budgetary target well below the 3% of GDP is retained at the national level, there is no need for additional constraints on the public debt-GDP ratio.
d) a budgetary target for EMU as a whole which would represent a sort of "medium-term fiscal anchor" would help in stepping up co-ordination efforts and, by increasing visibility and transparency, would foster surveillance by the market.

---

[3] For instance, a sustained budget deficit of 1% of GDP implies, under a "normal" rate of growth of nominal GDP of 5%, a long run equilibrium level of 20% of GDP. Furthermore, under the same assumptions, a country with an initial level of debt of 120% of GDP would reduce its debt ratio by almost 40 points within ten years.

II.4 THE ECONOMIC AND BUDGETARY FRAMEWORK OF A STABILITY PACT

On the basis of the conclusions of the previous section, the stability pact could encompass the following elements:

1. *EU and national budgetary targets*
   - an EMU-wide medium-term budgetary goal of close to balance, as set in the broad economic policy guidelines, taking into account that some factors would allow a certain degree of national differentiation both in the objective and in the transition adjustment path;
   - the requirement for Member States to set a national medium-term target, the path to achieve it and the self-correcting mechanisms/measures which would be implemented in the case of slippage not justified by purely cyclical developments.

2. *Community "green light" and monitoring*
   - the credibility and the appropriateness of national budgetary targets and adjustment paths will be assessed at the EU level, in particular with a view to identifying the risk of budget deficits overtaking the 3% reference value and their compatibility with the EMU budgetary stance;
   - a regular surveillance of budgetary developments will take place at the EU level, which in particular assesses deviations from the medium-term target and monitors the implementation of the agreed correcting measures. This monitoring exercise is particularly important during the transition period in which automatic stabilisers, if allowed to operate fully, could easily exhaust the available room for manoeuvre under the 3% ceiling in the case of adverse cyclical behaviour. It also represents an essential building block of any co-ordination effort to be carried out in assessing the overall consistency of the budgetary stance at the EMU level.

These aspects will be addressed in greater detail in section IV.

III. INSTITUTIONAL AND LEGAL QUESTIONS

III.1 TWO MAIN OPTIONS

The Treaty already enshrines the objectives of the proposed stability pact and provides scope for the adoption of secondary legislation which could incorporate many elements of Mr. Waigel proposal[4]. Two broad legal options are available which could be used together to apply a stability pact. Co-ordination measures could be developed in the broad economic policy guidelines and multilateral surveillance procedure set out in Article 103, whereas control aspects could be defined in the excessive deficit procedure of Article 104c. The use of other Treaty provisions (e.g. Article 235) or the adoption of inter-institutional agreements for developing aspects of a stability pact would not be appropriate.

Article 103: The broad economic policy guidelines and multilateral surveillance procedure provide a framework for the co-ordination and monitoring of Member States' economic policies outside the disciplinary framework of the excessive deficit procedure. The broad economic policy guidelines are adopted annually by the Summer European Council and focus on medium and long-term economic strategies. As such, it might be desirable to enshrine the basic objectives of a stability pact in the broad economic policy guidelines: however, it would not be a suitable place for establishing operational rules and procedures of a pact.

There exists considerable scope for developing the operational procedures of the multilateral surveillance exercise.[5] Legislation could be adopted on the basis of Article 103(5) by qualified majority voting in accordance with the procedure of article 189c (i.e. after having obtained the opinion of the European Parliament). It could govern all aspects of the multilateral surveillance procedure including the adoption of stability programmes by Member States. Legislation could also specify procedures under 103(4), e.g. the conditions under which the economic policies of a Member State would not be considered "*consistent with the broad guidelines .... or risk jeopardising the proper functioning of economic and monetary union*". In addition, it would be possible to elaborate the conditions under which the Council would make its recommendations public.

---

4 However, secondary legislation could not provide automaticity in the determination of an excessive deficit situation or the imposition of sanctions. Setting up a Stability Council without participation of all Member States would be incompatible with the Treaty (although the Treaty allows for suspension of voting rights in some cases).

5 The broad content and purpose of the multilateral surveillance exercise was laid down in the Council Decision 90/141/EEC of 12 March 1990, OJ L 78 of 24.03.90.

Article 104c: two legal bases for Council legislation on the excessive deficit procedure are provided in Article 104c(14): replacement of the Protocol on the excessive deficit procedure (2nd subparagraph) and amending Regulation 3605/93 which specifies technical definitions of the provisions of that Protocol (3rd subparagraph)[6]. However, any legislation must not contradict the Treaty. Therefore, procedural arrangements as well as the nature of sanctions which are set out in the Treaty could not be changed. They could only be clarified by definitions, deadlines, etc., provided the principle of proportionality is respected.

There is an important difference in the scope of the two legal bases of Article 104c(14). Secondary legislation for a stability pact may be adopted on the basis of the 2nd subparagraph, i.e. amending the Protocol, as this provides for the adoption of appropriate provisions relating to the *implementation* of the excessive deficit procedure. The potential scope of the Protocol is therefore larger than what is set out in the present Protocol, and could cover the definitions, deadlines etc. mentioned above.

In contrast, the 3rd subparagraph has a much narrower scope limited to the *"detailed rules and definitions for the application of the provisions of the said Protocol"*. It can therefore only be used to provided ancillary technical clarification's of existing provisions in the Protocol. It could not be used to extend the scope of the Protocol[7].

A Stability Council as a decision-making body different from the Council could not be created by secondary legislation, in particular since Article 104c(9) and (11) provide for the Council to decide. It has to be kept in mind, however, that under these provisions, the Council decides with the voting rights of the Member States with a derogation suspended (Article 109k(3) and (5)). For the purposes of Article 104c(9) and (11), the ECOFIN Council could "politically" be referred to as the "Stability Council".

III.2 THE LEGISLATIVE PROCESS

It is worth bearing in mind that the European Parliament has since 1993 called for legislation on the multilateral surveillance procedure: legislation would have to be adopted using the "cooperation" procedure of Article 189c.

---

6 This has already been used for Regulation 3605/93.

7 The deadline *"before 1 January 1994"* is no obstacle to using the 3d subparagraph as a legal basis to amend the Regulation.

As for legislation relating to the excessive deficit procedure, secondary legislation may have to be adopted using the 2nd subparagraph for which the Council must act unanimously after consulting both the Parliament and the ECB. The amendment of the Protocol would *de facto* be a Treaty amendment, with primary law being converted to secondary legislation. While the clarification of interpretations and deadlines would supplement existing provisions of the Protocol, there is a risk that a debate would be opened on the reference values.

To amend Regulation 3605/93 using the 3rd subparagraph, the Council decides on the basis of a qualified majority after consulting the European Parliament.

IV. IMPLEMENTATION ASPECTS

IV.1 STRENGTHENING SURVEILLANCE AT EU LEVEL

The move into stage three implies a need for a reinforced and speedier exchange of information about Member States' budgetary positions and intentions and a stronger interaction between policy-making at Member State level and the EU level. This will be desirable for both budgetary discipline and policy co-ordination purposes.

The idea would be to build on the existing experience with convergence programmes, but to take the opportunity to specify more clearly (in secondary legislation) the obligations on Member States, the Commission and the Council, and the procedures to be followed. The approach is thus first to "give more teeth" to the multilateral surveillance process[8] so that appropriate warnings ("yellow cards") and recommendations can be made to Member States *before* they breach the 3% of GDP deficit limit and so that more attention can be given to achieving an appropriate budgetary stance for the single currency zone as a whole.

In the event that Member States did breach the 3% of GDP limit then the full force of the excessive deficit procedure would be brought into play, leading to Council decisions ("red cards", but no sending off) and recommendations, and the imposition of sanctions if adequate corrective action has not been taken by the Member States concerned; all this needs to be carried out expeditiously and in a predictable way so that the excessive deficit

[8] Economic policy and multilateral surveillance are not just about budgetary policy. Secondary legislation to deal with the aspects focused on in this note might also be extended to encompass other concerns.

procedure has genuine deterrent value. To this end the interpretation of the deficit criterion, the delays between the successive steps of the procedure, and the nature of the sanctions and their application should be defined more clearly and tightly. However, it would be incompatible with the Treaty to seek to override the basic provisions on the excessive deficit procedure in the Treaty; some discretion must be retained and Member States should have a minimum period to convert their gross errors.

More concretely, it is proposed that existing procedures should be developed so as to cover the following elements.

Member States participating in the single currency should be required to submit regular statements of their medium-term budgetary strategy ("stability programmes"), indicating in particular:

- the medium-term objective for the general government budget balance;
- the adjustment path to reach this medium-term objective;
- the adjustment measures to be taken to follow this path;
- arrangements for regular (twice a year?), transparent and public self-monitoring of the general government finances and prospects;
- a commitment to take additional (pre-specified?) measures to correct for slippage from the adjustment path not due to the cycle.

Member States should be asked to submit their programme in draft form (i.e. before final adoption by the government and presentation to the national parliament) for prior consultation with and assessment by the Commission and the Council (assisted by the Economic and Financial Committee).

At EU level, the Commission and the Council would:

- assess whether the medium-term objective set by a Member State was consistent with the general objective of the stability pact and appropriate to the specific features of the country (margin for cyclical fluctuations, provision for burden of ageing population, etc.), whether the period of transition was appropriate or appeared unduly long, and whether the measures proposed were sufficient to achieve the adjustment aimed for;
- if necessary, request strengthening of unsatisfactory elements of the programme before final adoption by the Member State government and before formal Council endorsement;

- monitor implementation of the programme and warn a Member State of the need for additional adjustment measures if actual developments (allowing for the cycle) showed slippages from the agreed medium-term path. The Commission might make a report and adopt an opinion (on the risk of an excessive deficit) under paragraphs 3-5 of article 104c or under rules developed for article 103 and the Council could make recommendations to the Member State as in para 4 of article 103;
- review the overall budgetary position in the single currency zone (and the EU as a whole) based on the actual and planned budgetary stances of the Member States, and as a consequence make general recommendations when necessary.

Secondary legislation (on the basis of article 103(5)) could thus:

- include an obligation on participating Member States to submit stability programmes (there would be a parallel obligation on Member States with a derogation to submit convergence programmes);
- define the minimum contents of such programmes, when they should be submitted and in what circumstances or how often they should replaced;
- define the procedures to be followed by Commission and Council in assessing and monitoring stability programmes and in making recommendations to Member States.

Secondary legislation could be adopted on the implementation of all aspects of the excessive deficit procedure on the basis of article 104c(14) with a view to:

- clarifying the interpretation of certain Treaty provisions, for example the definition of effective action in response to Council recommendations under article 104c(8);
- establishing detailed procedural arrangements and deadlines for each step of the procedure, for example the imposition of sanctions as set out in article 104c(9-11);
- laying down the scale of, and further defining the sanctions to be imposed based on article 104c(11).

IV.2 IMPROVING BUDGETARY DISCIPLINE AT NATIONAL LEVEL

The approach described above, based on a strengthening of both surveillance and the excessive deficit procedure, is intended to provide a framework in which corrective measures are taken by Member States before budgetary situations get out of hand, and so the imposition of sanctions, although always there as a deterrent, would hopefully rarely be needed in practice. The setting of budgetary policy remains a national responsibility, but subject to tighter checks and constraints. While the main emphasis of this note is on

developing Community procedures, successful budgetary discipline will in the end depend on improved procedures at national level for setting objectives and taking the necessary measures to remain on track. Enhanced and more transparent self-monitoring, which has already been encouraged during the evolving experience with convergence programmes, is an important first step to taking corrective action. The scope for the triggering of auto-correction mechanisms when slippage becomes evident needs further consideration. Would it be possible for Community legislation to impose a requirement for the establishing (and activation, when necessary) of such mechanisms in each Member State? The diversity of constitutional and budgetary traditions would make a uniform approach difficult, although Member States have certain obligations in this area according to article 3 of the Protocol. As a minimum, each Member State in its stability programme should state a firm commitment to take corrective action when necessary and demonstrate in concrete terms how this commitment would be respected. In some Member States this is likely to require changes in constitutions or budgetary law.

V. CONCLUSIONS AND ISSUES FOR DISCUSSION

The stability pact proposal of Mr. Waigel aims at ensuring the maintenance of budgetary discipline once in EMU; to this end the preceding analysis suggests a fuller specification and reinforcement of the relevant provisions of the Treaty and of existing practices for economic policy co-ordination. A consensus already exists that the requirements for participation in EMU (either in the first group or at a later date) should in no way be changed and, more generally, any new arrangements should be fully consistent with and require no amendment of the Treaty.

Budgetary discipline in stage three of EMU is a pre-requisite for enjoying the full benefits of the single currency. Moreover, by avoiding an overburdening of monetary policy, it is also a necessary, though not sufficient condition for macroeconomic stabilisation at the national and the EU level. Maintenance of sound public finance positions in EMU will require a strengthened commitment from individual Member States which should aim in the medium term for a government balance considerably better than the 3% deficit reference value.

A consensus appears to emerge that:

- the government deficit/surplus should be the operational objective; seeking to impose an additional constraint on the gross debt ratio appears to be superfluous as setting

more ambitious targets than the 3% reference value would ensure a downward trend in the debt ratio to well below 60% of GDP;

- a medium-term objective of a budget position close to balance is appropriate for the Union as a whole, but some differentiation for individual countries is desirable from an economic point of view;
- a reinforcement of surveillance at the national and EU level is necessary to ensure the achievement and the respect of national budgetary targets.

Nevertheless, a number of issues remain to be discussed in detail. In the light of the analysis and proposals in the earlier sections of this note, what is the position of the Committee on the following items:

1. There exists a large agreement on the need to strengthen budgetary surveillance. What are the views of members on the need to establish in legislation the operational modalities of the multilateral surveillance procedure, and if so, what procedures would they propose? Do members consider it appropriate to specify the objectives of a stability pact in the broad economic policy guidelines?

2. Do members agree that Article 104c(14) provides the possibility to amend the excessive deficit procedure to incorporate elements of the proposed stability pact? If so, do members consider the 2nd subparagraph or the 3rd subparagraph to be the most appropriate legal base for adopting the majority of interpretations, deadlines etc. necessary for speeding up the excessive deficit procedure?

3. Do members agree that an essential element of budgetary discipline will be the existence and effective use of credible auto-correction mechanisms at national level? What role can be played at Community level to ensure that such mechanisms are established? What specific ideas do members have about innovations in the budgetary control process which would be helpful in their own countries in this respect? What legal changes in national systems may be needed and appear possible?

4. The necessary drive towards strengthened fiscal discipline needs to be complemented by the appropriate fiscal policy coordination in order to ensure a consistent budgetary stance for EMU as a whole. To this end, is there a need to introduce legislation which clarifies the provisions of Art. 103 of the Treaty in the direction of closer ex-ante coordination of national budgetary policies?

ANNEX

REINFORCING MARKET PRESSURE ON FISCAL BEHAVIOUR

This annex explores some tentative avenues in order to increase market pressure on budgetary authorities. The Commission services are aware of the preliminary character and the possible limitations of these ideas which, in any case, would need to be discussed with the competent supervisory specialists to check their feasibility and effectiveness.

1. TREATY PROVISIONS

The Treaty provisions aiming at strengthening fiscal discipline are broader than the excessive deficit procedure. The Treaty contains a number of elements that reinforce the role of market pressure in favour of fiscal discipline. These elements need to be considered as part of the discussion concerning the stability pact.
Markets can play a very strong role in putting pressure on governments in favour of sound public finance. This is the principle behind the approach reflected in the Treaty of placing sovereign governments in as similar position as possible to any other debtor when they need to raise funds.
There are four main provisions in the Treaty stating in concrete terms the above mentioned principle:

- *Article 104 and 104a*: prohibition of monetary financing and privileged access to financial institutions. Central banks of the Member States may no longer grant directly any credit to the public sector. Likewise, the authorities of the Member States and those of the European Union are no longer allowed to impose rules on financial institutions which constitute privileged access of the public sector to the funds of these institutions. The purpose is to submit the public sector in its borrowing behaviour to the same constraints as those of the private sector.

- *Article 104 b*: no bail-out rule: neither the Community nor its Member States shall be liable for or assume the commitments of governments of any Member State. This rule is designed to dispel any investor's doubt, or hope, about the risk they run in financing governments that incur excessive deficits.

- *Article 104c*: excessive deficit procedure. The procedure may lead to the publication of Council recommendations addressed to a specific Member States. Par. 11 also provides for the publication of additional information before issuing bonds and

securities as one of the possible sanctions in the case of persistent budgetary disequilibria. That would result in an increasing market pressure on this country (market asks a higher price on its debt) to adopt corrective measures in favour of fiscal discipline.

In addition, in the single currency area, the power of money creation will rest with the ECB, the independent central bank whose prior objective is price stability. Without the power to print money and with an explicit no bail-out rule, governments will find themselves in a position quite similar to any other debtor. The government will retain its power to tax, but it will be limited by 'tax competition' within the single market.

2. REINFORCING THE SYSTEM OF PRUDENTIAL SUPERVISION

Given the constraints mentioned above, if a Member State has been judged publicly to have an excessive deficit, the market will impose a financial penalty in the form of a risk premium in interest rates on public debt.
Such a situation should be reflected in the system of prudential supervision. On the one hand, the system has to ensure that the financial markets can withstand any shock which may result from unsound public finance. On the other hand, the system could reinforce market discipline on public finance.

There are mainly two concepts of prudential supervision which could be examined in the light of what has been said/id above: (i) the assumption that claims on central governments within the EU countries are all treated the same way; and (ii) that these claims can be considered as risk free. These concepts are at the basis of the system of prudential supervision. They are particularly relevant for the determination of the solvency ratio of credit institutions, large exposures rules and capital adequacy. These concepts could be modified to take account of the differentiated public finance positions of Member States.
The Council Directive 92/121/EEC dictates rules for monitoring and controlling large exposure of credit institutions. This is an integral part of prudential supervision; excessive concentration may result in an unacceptable risk; and such a situation may be deemed prejudicial to the solvency of a credit institution. No Member State is expected to run fiscal policies which might cast doubt on the value of its debts. However, in an extreme case, a Member State could theoretically be tempted to consolitate public debt or apply any other mechanism which might reduce its value. The large exposure directive could be modified to take into account such a possibility, in particular in the definition of limits to be applied to large exposure operations. If that were to be the case, the Member State

running unsound fiscal policies would suffer negative discrimination, since credit institutions would prefer to operate with other Member States' debt.

The capital adequacy requirements, provided for by Council Directive 93/6/EEC, are specifically based on the assumption that all claims on central governments within the EU countries will be treated in the same way. In the case that the excessive deficit procedure reaches a decision to impose sanctions on a specific Member State, would it still be adequate to treat claims on this country in the same way as others? At this stage, it could be considered that the Member State concerned should be treated like any other debtor. This approach could be reflected in particular in the articles of the capital adequacy directive referring to provisions against risk as well as monitoring and control of large exposures.

Financial institutions are required to keep a market value accounting. This concept should cover all types of public debt that are held by all types of financial institution. The system should ensure that any deterioration in the price of a Member State's debts is fully recognised in the profit and loss account of the financial institutions holding such debts. In that way, price changes in the debt reflecting unsound public finance, would immediately be passed through and taken into account by the whole system of supervision.

The implementation of this approach would require a modification of the Community legal acts concerned. Since most of the prudential supervision rules are embodied in Community legislation, it should not be impossible to introduce modifications. However, the consistency of any such modifications with international rules (Basle Agreement, etc.) on prudential supervision would need to be checked.