Fiscal Convergence and Stability in the EMU: Alchemy, Missed Opportunities, and Commitment Institutions

by

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Abstract

Since the spring of 2002, there has been renewed debate and discussion regarding the value and pertinence of the Stability and Growth Pact (SGP) of the European Monetary Union (EMU). This debate arose because Germany and Portugal have breached the reference value set out in the SGP for budget deficits and France and Italy are dangerously close to breaching it. Furthermore, France has until now categorically refused to respond to warnings from the Commission and the Council of Ministers and, therefore, play by the rules of the SGP. In light of this alleged crisis in the EMU, the paper explains how the crisis came to take place, to what extent the EMU's fiscal policy institutions are to blame, and how, as a result, they can be improved. Finally, it assesses whether the alleged SGP crisis threatens the future stability of the EMU.

KEY WORDS: European Monetary Union, Fiscal Policy, Fiscal Rules, Stability and Growth Pact

Introduction

Since the spring of 2002, there has been renewed debate and discussion regarding the value and pertinence of the Stability and Growth Pact (SGP) of the European Monetary Union (EMU). Calls have been made ranging from scrapping the Pact to reinforcing it (for details, see Buti et al. 2003). The renewed debate surrounding the SGP arose as a result of (1) Portugal having a fiscal deficit of 4.2 percent of GDP in 2001, thereby breaking the 3 percent threshold imposed by the SGP; (2) Germany coming close to the reference value with a deficit of 2.8 percent in 2001 and surpassing it in 2002; and (3) France and Italy facing projected budget deficits close to the reference value in 2002. In all cases, the member states were moving away from their SGP commitment to balance their budgets. The debate regarding the SGP centers around two issues. The first issue is the value of the SGP in forcing member states to reduce their budget deficits in the midst of an economic slowdown by threatening to impose sanctions if the necessary corrective fiscal measures are not undertaken. In this sense, the Pact is critically viewed as being pro-cyclical and favoring stability rather than growth. Secondly, the SGP is being criticized for not preventing some member states from being or likely to be in an "excessive deficit" position, i.e. having a budget deficit greater than the ceiling of 3 percent of GDP. This criticism questions the value of the SGP in ensuring the stability of the euro and the euro-zone economy if it acts only as a corrective mechanism after the fact that excessive budget deficits have been incurred. In sum, the debate and discussion surrounding the SGP revolve around whether the SGP is doing what it was set out to do.

Four years after the start of EMU on January 1999, it seems appropriate to review the SGP and its effectiveness and determine whether there is cause for concern for the

future stability of EMU in light of the current fiscal imbalances experienced by the three largest member states of the euro-zone along with Portugal. In order to do so, a number of questions demand answers. First, how did the euro-zone get into the current situation? In qualifying for EMU, euro-zone member states had to meet the convergence criteria set out in the Maastricht Treaty, the key one being a budget deficit of 3 percent of GDP or less. So why is it that five years later convergence is loosening up? Second, why were the SGP and European Union (EU) institutions unable to prevent the alleged current crisis from arising? After all, EU institutions played an instrumental role in ensuring that EMU would take place as planned at Maastricht (see Leblond 2003). Why did they not save the day once again? Finally, should we be concerned about the future stability of EMU? In other words, is the current crisis real or just part of the normal course of EMU and its fiscal policy institutions? In answering this set of questions, the present paper, despite the weaknesses of the Maastricht Treaty and the SGP regarding fiscal convergence and stability, aims to provide reassurance to the reader that the future of EMU is not threatened and that the current crisis of legitimacy for the SGP is only part of the natural evolution of a young monetary union.

The paper is structured as follows. The first section shows how some of the euro-zone member states came to breach the SGP. The argument here is that by resorting to fiscal alchemy in the qualifying phase of EMU, these member states missed a first opportunity to produce a sustainable consolidation of their fiscal positions. Furthermore, once EMU began these same member states missed a second opportunity to consolidate their fiscal stance by taking advantage of a growing economy. The second section deals with the nature and performance of the institutions (rules and organizations) surrounding

the conduct of fiscal policies before and after EMU took place. The argument here is that rational member states are likely to the test the limits of the rules they face and that, in the case of fiscal policy, EU agencies like the Commission and the European Monetary Institute (EMI)/European Central Bank (ECB) have limited powers to prevent the rules from being tested and occasionally breached. The third section assesses the SGP's performance as well as the risk of future instability in the EMU. It also indicates ways in which the SGP can be improved. After reviewing market reactions to the current crisis and examining the responses by the EU and the member states, it concludes that there is no reason to be concerned with EMU's stability. The final section concludes.

I. Fiscal Alchemy and Missed Opportunities

EU member states began the 1990s with high fiscal deficits. For example, the average budget deficit in the EU was 6.1 percent of GDP in 1993. However, it ranged from 13.8 percent in Greece to 2.4 percent in Ireland.[1] By signing and ratifying the Maastricht Treaty and committing themselves to EMU, all the member states (except Denmark and the U.K.) signaled their intention to meet the convergence criteria set out in the Treaty in order to qualify for EMU. These criteria, especially the one on budget deficits, were an opportunity for the member states to reduce their fiscal imbalances by the end of the decade. The launch of EMU on January 1, 1999 coincided with a period of economic expansion in the EU and provided a new opportunity to bring budgets into balance. Unfortunately, a number of member states missed these opportunities, thereby causing the SGP's current crisis of legitimacy. Furthermore, these misbehaving member states

[1] Luxembourg was the only member state in a surplus position, at 1.7 percent of GDP.

happen to count the largest euro-zone members: France, Germany, and Italy. Therefore, their current fiscal imbalances have the possibility to threaten the future stability of EMU.

Qualifying for EMU: 1993-1997

In order to qualify for EMU, member states had to satisfy the convergence criteria set out in the Treaty on European Union agreed to at Maastricht in 1991. These criteria concerned the average rate of inflation (no more than 1.5 percentage points above the three best performing states), the average long-term interest rate (no more than two percent above the three best performing states on inflation), the budget deficit (no more than 3 percent of GDP), the public debt (no more than 60 percent of GDP), and the exchange rate (within the normal fluctuation bands of the Exchange-Rate Mechanism (ERM) for at least two years).[2] However, the key criterion for membership in EMU quickly became the one dealing with fiscal deficits. The ability of the member states to bring down their budget deficits from 6.1 percent of GDP on average in 1993 to less than 3 percent of GDP by 1997, the deciding year for assessing member states' performance on the convergence criteria, was seen a credible signal of their true commitment to EMU's stability (McNamara 2001, 8; Winkler 1996). However, in most cases the member states met the budget deficit criterion only in 1997 (see Table 1), thereby making the credibility of the signal questionable.[3] Only Denmark, Ireland, Luxembourg, and the Netherlands managed to meet the criterion before 1997. Waiting until the last minute to meet this convergence criterion made sense for the member states that started out with high budget deficits in 1993. Given that the EU economy was in recession and that

[2] See Article 121(1) of the Consolidated Version of the Treaty Establishing the European Community (TEC).

average unemployment stood at close to 11 percent in 1993, it was politically very difficult for most EU member states to reduce their fiscal deficits by more than three percentage points on average in one year or two. Consequently, it was rational for member-state governments to want to postpone the pain of fiscal consolidation for as long as possible. As Youngs (1999) observes, domestic actors such as political parties, trade unions, public opinion, and even business organizations reacted against the introduction of reforms to meet the convergence criteria.[4] Moreover, before the summit of the European Council in Madrid in December 1995 there was a lot of uncertainty regarding EMU (see Leblond 2003). Thus, there seemed little point for member-state governments to consolidate their fiscal positions and, as a result, demand unpopular sacrifices from their populations until there was a good deal of certainty with respect to EMU. It made sense for EU governments to minimize as well as concentrate the pain imposed on their citizens. This explains why the great majority of member states waited until 1997 to meet the convergence criterion on budget deficits. After all, 1997 was the only year that mattered for qualifying for EMU membership on its starting date of January 1, 1999.

Insert Table 1 approximately here

In addition to reserving most of the reduction in their budget deficits for 1997, many member states tried to ensure that the pain imposed by these harsh reductions

[3] Greece waited until 1998 to bring its budget deficit under the three percent of GDP threshold.
[4] Rotte and Zimmermann (1998) argue that EU member states were able to reduce their budget deficits to meet the Maastricht convergence criterion because of the support for the EU among their populations. However, Freitag and Sciarini (2001) dispute those results.

would be limited. They did this by resorting to fiscal alchemy. In analyzing the way EU governments managed to bring their budget deficits under the 3 percent threshold we must discern between factors that are not directly controlled by governments (i.e. cyclical factors) and those over which governments are directly responsible (i.e. discretionary factors). Cyclical factors include such things as economic growth and interest rates while discretionary factors include elements such as government revenues (tax rates and tax base, privatizations, etc.) and public expenditures (current and capital). Discretionary factors can be split into temporary (e.g., increases in revenues and reductions in capital expenditures) and (more permanent) structural (e.g., reductions in current primary expenditures) measures.[5] It is important to determine which type of fiscal measures member states resort to in reducing their deficits because it affects the cost imposed on the electorate as well as the sustainability of the fiscal reduction. As the European Commission (1998) states:

> [D]eficit reductions which take place through cuts in current primary expenditure rather than tax increases are less likely to be reversed in the future. Budgetary adjustments strongly based on cuts in current primary expenditure are often more difficult to implement and their adoption is therefore a clear sign of the government's commitment to budgetary discipline and of its determination to maintain these efforts in the future (p. 105).

Similarly, von Hagen and Strauch (2001) find evidence that successful fiscal consolidations come as a result of expenditure cuts, especially current government spending, that account on average for 50 percent of the total budgetary reduction. On the other hand, unsuccessful consolidations rely almost exclusively on increasing revenues.

Given that it was in EU governments' best interest to minimize the pain, if any, imposed on their electorate from reducing budget deficits, we need to examine to what extent cyclical and temporary factors played a role, relative to structural factors, in

[5] Von Hagen and Strauch (2001) call these structural measures "good quality" fiscal adjustments.

reducing fiscal deficits by 3.7 percentage points on average for the EU between 1993 and 1997. For the EU as a whole, total cyclical factors accounted for one fourth (24.3%) of the total reduction in budget deficits while temporary discretionary measures accounted for 35%. This means that discretionary structural measures represented less than half (40.5%) of the decrease in fiscal deficits that took place between 1993 and 1997 (see Table 2).

Insert Table 2 approximately here

With respect to specific member states, cyclical factors accounted for more than half of the reduction in fiscal deficits for Belgium, Denmark, Finland, Ireland, Italy, and the Netherlands. For example, in Belgium and Italy more than 35 percent of the decrease resulted from the reduction in interest payments, owing to lower interest rates on their high public debts.[6] A panel data linear regression of budget deficits on interest rates, unemployment, economic growth, public debt per GDP and a one-year lag of fiscal deficits confirms that interest rates and economic growth were both substantively and statistically significant in accounting for fiscal convergence in the EU between 1993 and 1997 (see Table 3). This means that for those member states where cyclical factors such as economic growth and reduced interest rates were the main determinants of their fiscal-deficit reductions, the governments should have faced reduced, if any, opposition from the electorate to the consolidation of the country's fiscal situation.

[6] See Leblond (2003) on how EU institutions contributed to pushing down long-term interest rates across the EU.

Insert Table 3 approximately here

Of the member states where discretionary measures represented more than half of the reduction in their fiscal deficit, only Austria, Germany, Spain, and Sweden resorted to cuts in current primary expenditures (see Table 2). In contrast, France, Greece, Portugal, and the United Kingdom relied predominantly on revenue increases and reductions in capital expenditures. The issue then is whether these revenue increases were achieved as a result of greater administrative effectiveness (e.g., increased tax collection) or one-off measures like privatizations and special taxes. In practice, the member states tended to resort to both kinds of measures, with heavy reliance on privatization and other schemes to generate revenues in 1997 in order to meet the 3 percent criterion.

Taking a closer look at the four member states currently facing fiscal imbalances (France, Germany, Italy, and Portugal) and causing the current upheavals with the SGP, we can see that the fiscal alchemy that they cooked up to qualify for EMU left them in a vulnerable position at the end of 1997. Looking at Figure 1, we can see more clearly that France relied predominantly on revenue increases and to a lesser extent on capital expenditure reductions to bring its budget deficit to 3 percent of GDP in 1997. To increase revenues, France raised rates on corporate tax, capital gains, social security, and value-added tax (VAT). She also privatized a number of public enterprises. Bazen and Girardin (1999) estimate that the additional tax burden corresponded to a revenue increase of one percent of GDP. Finally, she received a one-time transfer from France Telecom in 1997 amounting to 0.5 percent of GDP. This transfer was in exchange for taking over the pension liabilities of France Telecom employees. Hence, France barely

qualified for EMU and did so mainly on the back of discretionary fiscal measures of a temporary rather than a sustainable nature.

To meet the Maastricht criterion on budget deficits, Germany did not face a huge challenge. In fact, from 1993 to 1997, it had to reduce its deficit by 0.5 percentage points of GDP (see Table 2). However, in Figure 1 we can see that Germany had to reduce both current primary expenditures and capital expenditures by close to 2 percent of GDP each in order to qualify for EMU. This is because she also faced a decrease in fiscal revenues amounting to 1.3 percent of GDP between 1993 and 1997. Von Hagen and Strauch (1999, 83) point out that this reduction in revenues was due to tax avoidance and evasion, which arose as a result of too many tax exemptions, the increasing complexity of the tax system, and the increasing tax burden to finance reunification. They also argue that Germany saw her budgetary institutions deteriorate during this period, affecting her capacity to control spending in the future. Consequently, they conclude on Germany's fiscal position at the start of EMU in the following way: "Germany's post-Maastricht fiscal institutions are much weaker than before and Germany's fiscal policy outlook is a liability rather than a stronghold of stability for the EMU" (71).

With respect to Italy, we have already mentioned that close to 60 percent of the fiscal-deficit consolidation of seven percentage points of GDP between 1993 and 1997 was a result of the improved economic cycle and lower interest rates (see Table 2). However, on Figure 1 we can see that Italy also reduced both her current primary expenditures and her capital expenditures. Decreases in current primary expenditures were due to fiscal reforms undertaken during the first half of the 1990s (e.g., pension reforms) as well as lower transfer payments between 1995 and 1997 (von Hagen et al.

2001, 110). Nevertheless, in order to meet the 3 percent threshold in 1997, Italy had to reduce her deficit by 4 percent of GDP in one year. Italy managed this feat through lower interest payments on the debt, a "Europa" tax, which the government promised to pay back later and did so in 1999, privatizations of public enterprises, and an increase in VAT (McNamara 2001, 13-14; Chiorazzo and Spaventa 1999). However, all these temporary measures made it difficult for Italy to pursue her fiscal consolidation toward a balanced budget once inside EMU as interest rates did not fall much further since they had come to within a few basis points of German rates by 1998, falling from a spread of more than 600 basis points in mid-1995 (see Chiorazzo and Spaventa 1999, 133).

In Figure 1 we can see that the large portion of Portugal's decrease in her budget deficit between 1993 and 1997 came from higher revenues. This increase was a result of efficiency reforms and tax collection improvements as well as privatizations (McNamara 2001). Portugal also benefited from a reduction in interest rates, which lowered her interest payments. Unfortunately, Portugal used an important portion of the revenue windfall and lower interest payments to increase social programs spending (see Figure 1 and von Hagen et al. 2001, 115). This increase in current primary expenditures of a permanent nature left her fiscal position vulnerable to an economic slowdown and a decrease in privatization revenues.

In sum, back in May 1998, when the first EMU participants were chosen, there were already indications that convergence was on shaky ground for a number of member states, especially the larger ones. France, Germany, Italy, and Portugal all seemed to be in relatively precarious fiscal situations, having relied extensively on cyclical and temporary

discretionary fiscal measures to qualify for EMU. The honor was saved but not for long for some member states.

Fiscal Policies in the Euro-Zone: 1998-2002

Given that EMU would not begin until January 1, 1999, the year 1998 should have been somewhat of a lost year on the fiscal policy front for those member states that had qualified for EMU. After all, the convergence criteria had been satisfied and the SGP would not come into effect for another seven months. Therefore, as long as the euro-zone member states continued to satisfy the convergence criteria, there was no real incentive for them to pursue fiscal consolidation toward achieving balanced budget positions. In fact, the overall fiscal deficit for the euro-zone fell only by 0.4 percent of GDP in 1998. Apart from Belgium, Finland, Ireland, and Greece, all the other euro-zone member states suspended their drive toward fiscal consolidation (see Table 4).[7] This was in spite of the fact that the euro-zone economy pursued its expansion (see Table 6). In cyclically-adjusted terms, the euro-zone fiscal deficit remained stable in 1998, dropping by only 0.1 percent of GDP from 1997 (see Table 5).

Insert Table 4 approximately here

Insert Table 5 approximately here

[7] Greece joined EMU in January 2001. It therefore made sense for her to pursue a policy of fiscal consolidation given her desire to meet the convergence criteria.

Once EMU had started in January 1999, we should have seen a renewed push toward fiscal consolidation from those countries still far away from achieving a balanced budget position, namely Austria, France, Germany, Italy, Portugal, and Spain. This should have proved relatively easy given that the euro-zone economy kept on experiencing strong growth in 1999 and 2000 (see Table 6). In practice, this is what seems to have happened. Only Portugal did not reduce her budget deficit in the years 1999 and 2000 (see Table 4). However, if we examine cyclically-adjusted budget balances in Table 5, we observe that Austria, France, and Germany also did not really consolidate their fiscal positions in 1999 and 2000. In the case of Italy, consolidation was tepid at best and limited to 1999. In fact, the reductions in budget deficits came from two sources: (1) the strong growth that their economies experienced (see Table 6); (2) one-off proceeds from the sale of third-generation (3G) mobile phone licenses.[8] For example, Germany received 50.8 billion euros from the sale of mobile phone licenses in 2000, equal to 2.5 percent of GDP, while Italy received 13.8 billion euros, equal to 1.2 percent of GDP (European Commission 2002b). As a result, Austria, France, Germany, Italy, and Portugal were in vulnerable fiscal positions for the economic slowdown that took place in 2001 (see Table 6).

Insert Table 6 approximately here

Table 4 indicates that fiscal positions in Germany, Italy, and Portugal deteriorated significantly in 2001. For instance, Germany saw her budget balance move from a surplus of 1.1 percent of GDP (which included the proceeds from mobile phone licenses)

[8] Proceeds from the sale of mobile phone licenses are not included in the cyclically-adjusted data in Table 5.

to a deficit of 2.8 percent of GDP. For its part, Portugal saw its deficit jump from 2.9 percent of GDP to 4.2, breaching the ceiling of 3 percent of GDP imposed by the SGP. As for France, her fiscal situation remained stable in 2001 as she was less affected by the economic downturn in the euro-area (see Table 6). Nevertheless, there was no movement toward balancing the budget in the near future. Surprisingly, Austria achieved a modest budget surplus of 0.2 percent o GDP in 2001, despite a low rate of economic growth of 0.7 percent. This strong fiscal performance is attributable to the new conservative government that came into power in the beginning of 2000. Given that euro-zone economy continued to stagnate in 2002, budget balances generally worsened for all the member states (see Table 4). This means that Germany is expected to breach the reference value imposed by the SGP in 2002. Portugal is also expected to breach the SGP limit, once again, with a deficit of 3.4 percent of GDP in 2002. Nevertheless, this is a significant improvement from 2001 given the economic slowdown that her economy is facing. France will come close to breaching the limit with an expected deficit of 2.7 percent of GDP.[9] This is because the French government has refused to renege on spending promises made by Jacques Chirac during the presidential election campaign in the spring of 2002. In any event, France is not moving closer to a balanced fiscal position as the SGP requires and does not plan to do so for many years to come. Like France, Italy's fiscal position is also slowly edging closer to the reference value in 2002.

In sum, the year 1998 was a lost year with respect to fiscal consolidation in the euro-zone, as one should have expected given that the incentive of qualifying for EMU membership had passed and that the rules of the SGP had not yet begun to apply. This

[9] The French government has now admitted that its budget deficit will "probably" be greater than 3 percent of GDP in 2002 (*Financial Times*, February 26, 2003).

means that given the limited extent of their sustainable fiscal consolidation efforts in order to meet the convergence criteria set out at Maastricht, Austria, France, Germany, Italy, Portugal, and Spain began their life inside the euro-zone facing fiscal imbalances that demanded consolidation and reform. Of this group, only Austria and Spain took the necessary measures to bring their budgets into a sustainable balance position. For their part, France, Germany, Italy, and Portugal instead took advantage of the good economic times in 1999 and 2000 to move closer to a balanced budget. However, when the economy suddenly slowed down in 2001, they were left with growing deficits. Once again, they missed an opportunity to improve their fiscal stance by choosing to play by the rules of the game but not its spirit. This means that they are now in a position where they are required by the SGP to consolidate their budgets in the midst of a major economic slowdown. Portugal and Germany have taken on this challenge. France and Italy remain reluctant to do so, claiming that there is not yet cause for alarm and that it makes little sense to impose further economic harshness on their populations.

II. Fiscal Policy Institutions in the EMU

We have already seen that the main institutional framework within which fiscal policy took place in the EU during the transition to EMU was the convergence criteria set out in the Maastricht Treaty on European Union for qualifying for EMU. However, the member states did not need to satisfy these criteria until the evaluation, which ended up being 1997. Indeed, as mentioned earlier, most of the member states waited until 1997 to satisfy the crucial convergence criterion on fiscal deficits. Although the Maastricht Treaty states that EU member states were also to avoid "excessive government deficits" during the

transition to EMU, the rules governing sanctions found in Article 104 TEC did not apply (Article 116 TEC).[10] The role of EU institutions was limited to monitoring the progress made by member states regarding economic convergence. Based on reports produced by the European Commission and the EMI, the Council of Economic and Finance Ministers (ECOFIN) had to assess member states' progress on meeting the convergence criteria in accordance with Article 104. According to Schimmelfennig (2001), the fact that the Commission's and the EMI's reports were made public should have been an effective means of ensuring that member-state governments would avoid being in an excessive deficit position before the key year of 1997. He argues that such a name-and-shame strategy can be very effective to ensure compliance with some stated objective:

> To be effective, shaming requires that actors have declared their general support of the standard of legitimacy at an earlier point in time [...] so that when actors would prefer to deviate from the standard because it contradicts their self-interest, members of their community can shame them into compliance by exposing the inconsistency between their declarations and their current behaviour (p. 64).

Unfortunately, the name and shame strategy did not work. The reason might be that in this case the stated objective was qualifying for EMU, not avoiding "excessive deficits" *per se*. In other words, the clear sanction for member states in an excessive deficit situation was exclusion from EMU, not the sanctions mentioned in Article 104 (TEC) that were to apply only after the euro had been introduced. Hence, the objective to avoid excessive deficits can be said to have taken its full meaning in terms of stability (as oppose to convergence) only once EMU took flight.

Under EMU there are two separate EU-level mechanisms for ensuring the stability of the euro: the Broad Economic Policy Guidelines (BEPGs) and the Stability

[10] A member state was deemed to be in an excessive deficit situation if its budget deficit was more than three percent of GDP and if its public debt ratio was above 60 percent of GDP. A member states could

and Growth Pact. The BEPGs are a tool for economic policy coordination that are passed every year by ECOFIN following a recommendation by the Commission and are usually made public.[11] Then ECOFIN and the Commission determine whether actual economic policies pursued by the member states are in line with the BEPGs. If the policies are deemed not in line with BEPGs, ECOFIN may make a recommendation to the member state(s) concerned. It may also choose to make this recommendation public. It is worth noting that the BEPGs are not limited to fiscal policy but also encompass the whole array of economic policies: monetary policy, labour market policy, industrial policy, etc. In practice, the BEPGs tend to be vague and their only power resides in ECOFIN's ability to make its recommendations public in the case where a member state is found not to follow them (see also Hallerberg 2002).

The SGP was officially adopted at the Amsterdam summit in June 1997. Its goal was to clarify the provisions found in the Treaty (Article 104 TEC) to avoid "excessive deficits" once member states entered EMU (Hallerberg 2002, 143). Specifically, the SGP fleshes out the sanctioning mechanism for member states deemed to be in an excessive deficit situation and not taking the necessary corrections. ECOFIN may at first require the member state concerned to make a non-interest bearing deposit with the Commission of up to 0.5 percent of GDP.[12] If the member state still has not corrected its excessive deficit after two years, the deposit can be converted into a fine. There are, however, escape clauses. A deficit can be above 3 percent of GDP and not be deemed "excessive" if it is

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avoid being in an excessive deficit position even if its public debt ratio was above 60 percent of GDP as long as it was declining (see Protocol #20 on the Excessive Budget Procedures [TEC]).

[11] This is not a Treaty obligation. The latter requires that the European Parliament be informed of the BEPGs. The workings of the BEPGs are described in Article 99 (TEC).

[12] The deposit comprises of a fixed amount of 0.2% of GDP and a variable component equal to 0.1 of the difference between the member state's budget deficit and the reference value of 3% of GDP (See Council Regulation [EC] No. 1467/97 of 7 July 1997).

considered "exceptional." This clause applies automatically if the deficit occurred when GDP fell by more than 2 percent. A decline in economic growth of between 0.75 percent and 2 percent requires a decision by ECOFIN on the exceptional nature of the deficit. Any fall in GDP above 0.75 percent cannot be considered exceptional.

To strengthen the monitoring of budgetary discipline and the coordination of economic policies, the European Council passed a regulation in July 1997 (Council Regulation [EC] No. 1466/97 of 7 July 1997). It requires all member states to submit "stability" (euro-zone members) and "convergence" (non euro-zone members) programs to the Commission. The first programs had to be presented before March 1, 1999. The programs are required to provide a medium-term (at least three years) objective to achieve a budgetary position of "close to balance or in surplus" and explain how it would be achieved, including the underlying assumptions. Moreover, member states must make their programs publicly available. Following a recommendation from the Commission and a consultation with the Economic and Financial Committee (EFC), ECOFIN has to give its opinion on the programs, including ensuring that they are consistent with the BEPGs. Then, again with the help of the Commission and EFC, it monitors the implementation of the programs. If there should be a significant divergence from the program, ECOFIN has to address a recommendation to the member state concerned with the hope of avoiding the occurrence of an excessive deficit. If the divergence persists, ECOFIN can make a new recommendation proposing corrective measures, which can be made public.

As long as member states are not in an excessive deficit position, the Council of Ministers, either in the form of ECOFIN or the European Council, cannot threaten to

impose the sanctions planned for in the SGP in order to get the member state to adopt the appropriate corrective measures. This is the problem with the SGP. It cannot prevent a member state from finding itself in an excessive deficit situation. It cannot even prevent it from staying just under the 3 percent of GDP threshold. Only the surveillance mechanism outlined above, where the Council can make a recommendation to a member state about a divergence from the stability program, can prevent a member state from attempting to run budget deficits just below 3 percent of GDP for an extended period. However, the Council cannot force a member state to take the necessary corrective measures to bring its budget deficit in balance or surplus. Only peer pressure and naming and shaming are at work here. So how effective has this early warning mechanism been so far?

We mentioned earlier that Austria, France, Germany, Italy, Portugal, and Spain began their EMU lives in a more vulnerable fiscal position than their partners like Belgium, Finland, or Ireland. However, budget deficits were still below (i.e. above) the SGP ceiling of 3 percent of GDP and public debt levels were decreasing (see Table 7). Hence, there was no real cause for concern in 1999 and 2000. The stability programs provided by the member states all pretty much planned to achieve a balanced or surplus fiscal position in the medium term if it had not already been achieved (European Commission 2000, 40). Economic growth was expected to keep its momentum at around 2.7-2.8 percent over the period 2000-2003 (European Commission 2000, 39). However, in its 2000 report on public finances in the EMU, the Commission "call[ed] into question the credibility of the consolidation process" proposed by Portugal's updated stability program (123). It complained that consolidation relied primarily on revenue increases rather than primary expenditure reductions and was concentrated in the latter years of the

program. The Commission was also critical of Austria's updated program presented in March 2000 by the new government, where the objective was to reach a balanced budget in the "long run" rather than the "medium run" (120). It also complained that achieving the planned targets relied heavily on one-off measures (121). All the other stability programs did not pose problems.[13]

Insert Table 7 approximately here

In its 2001 report, the Commission was less enthusiastic about the fiscal situation of many member states. In the case of Germany, it stated that her 2001 budgetary position did not "fully comply with the requirements of the [SGP] of a medium-term budget position of close to balance or in surplus" (European Commission 2001, 126). Because of reforms to the tax system, corporate and income tax revenues were to fall temporarily. However, as the economy slowed down, this fall became more pronounced. Moreover, social security expenditures began to rise. This is why the Commission issued a recommendation to ECOFIN on January 30, 2002 to give Germany an early warning to prevent the occurrence of an excessive deficit. However, the Council refused to adopt such a measure because it thought that the German government had provided the necessary commitments to rectify the situation.[14] Thus, in its opinion on Germany's updated stability program for 2001-2005 published a month later, the Council limited itself to pointing at the risk of the budget deficit coming even closer to the reference

[13] One issue of concern was the need to undertake further pension reforms as the euro-zone population is ageing; however, this is a longer-term issue that has less effect in the short and medium term.
[14] See Statement by ECOFIN SN 1382/1/02 REV 1.

value of 3 percent of GDP as the economy was continuing to slow down (OJ C 51, 26.2.2002, p. 1). In the case of France, the Commission's 2001 report assessed that the balance of risk was now "clearly [...] on the downside" as a result of worsening economic conditions (European Commission 2001, 137). This is because budget projections were based on projected GDP growth of 3.3 percent in 2001 and at least 2.5 percent in 2002 to 2004. The Council confirmed this assessment of the existence of a downside risk in its opinion of February 12, 2002 (OJ C 51, 26.2.2002, p. 4). The Commission was also concerned with Italy's budgetary position in 2001. In its 2001 report, it stated that "there is a concrete possibility of a very significant slippage from the revised general government deficit projection of 1.0% of GDP in 2001" (European Commission 2001, 145). Given that 2002 to 2004 projections were based on GDP growth of 3.1 percent, further slippage was likely. In its opinion of Italy's program, the Council confirmed the existence of downside risks as the projected macroeconomic scenario was too optimistic (OJ C 51, 26.2.2002, p. 5). It also complained that budgetary targets in 2002 and 2003 relied heavily on one-off measures such as the sale of publicly-owned assets. With regards to Austria, the Commission's 2001 report was much more positive. It states that "The December 2000 update of the stability programme, covering the period 2001-04, represents a major policy shift and profound revision of the medium-term budgetary adjustment path" (European Commission 2001, 159). Finally, the Commission viewed Portugal's continued commitment to fiscal consolidation with skepticism as it was based on bullish growth forecasts (over 3 percent). It also noted that the Portuguese government had problems keeping expenditures under control and that tax revenues were already decreasing, contrary to expectations. At the end of January 2002, the Commission

even issued a recommendation for a Council recommendation to give Portugal an early warning regarding the possibility of an excessive deficit. However, ECOFIN decided against issuing such a recommendation. Even if the estimated deficit for 2001 was 2.2 percent of GDP as of the end of February 2002, double that originally planned for, the Council did not yet see a risk for an excessive deficit. So in 2001 and early 2002, as the euro-zone economy was experiencing a rapid slowdown, there were already concerns from the Commission and the Council with the budgetary positions and plans of France, Germany, Italy, and Portugal, which relied on bullish economic growth projections. However, no actions were taken by the Council. After all, no rules had yet been broken nor did they look likely to be broken given the commitments made by the respective member-state governments.

In its 2002 report, the Commission indicated that Germany planned a deficit of 2.6 percent for 2002. However, the Commission expected the deficit to be 2.8 percent (European Commission 2002c, 168). However, there was no mention of the risk of an excessive deficit. In her updated stability program Germany still planned for a balanced budget in 2004 and the Commission seemed to think it remained feasible. Unfortunately, as Germany's economic situation did not improve, the deficit has kept on increasing. The Commission, in its autumn forecast, estimated it at 3.8 percent of GDP (see Table 4). As a result, ECOFIN issued a recommendation on January 21, 2003 indicating that an "excessive deficit" existed in Germany and called upon the German government to take effective action within four months to rectify the situation. In light of her dire fiscal position, Germany updated its stability program in December 2002 and aimed at a deficit of 2.5 percent of GDP in 2003 and a balanced budget by 2006, instead of 2004 as

originally planned for. This way, the German government is trying to show its strong commitment to fiscal discipline as well as to the SGP, despite facing a stagnating economy. However, in its opinion on Germany's latest stability program, ECOFIN noted that the 1.5 percent rate of economic growth on which the 2003 budget forecast was based appeared optimistic. Furthermore, it indicated that there is a "non-negligible risk that the general government deficit in 2003 may again exceed the 3% of GDP reference value" (OJ C 26, 4.2.2003, p. 1). Thus, Germany faces great skepticism regarding its stability program for the period 2003-2006. However, now that an official reprimand has been issued by the Council, Germany faces the possibility of seeing sanctions imposed if it does not show clear signs by May 2003 that the deficit in 2003 will be below 3 percent of GDP. In any case, the German government accepts the criticism it is facing and indicates that it will abide by the SGP rules (see *New York Times* January 22, 2003).

Up until the arrival of a new center-right government in France in the spring of 2002, Commission had no major concerns with France's stability program (see European Commission 2002c, 184). Trouble started when President Chirac was able to install a center-right interim government that planned to delay France's fiscal consolidation for a couple of years in order to make good on Chirac's campaign promises such as cutting taxes (*Financial Times*, May 10, 2002). This was considered a repudiation of France's accepted stability program and, coincidently, a contravention of the SGP. Moreover, as economic growth was lower than projected, France's budget deficit was deteriorating rapidly (*Financial Times*, June 21, 2002). Nonetheless, President Chirac and his government refused to budge from their position. Consequently, on January 21, 2003, ECOFIN issued an official recommendation warning France to "prevent the occurrence

of an excessive deficit." The French prime minister has even admitted that the 2002 budget deficit was likely to be above 3 percent of GDP. As a result, France stands to receive an official reprimand from ECOFIN. However, the French government has so far defied the warning and indicated that it would pursue fiscal consolidation following its own rhythm (*Financial Times*, February 26, 2003).

In its 2002 report, the Commission did not significantly disagree with the target that Italy provided in her 2001-05 stability program. It indicated that the 2002 deficit would probably be higher than the target but still below the 2001 result (European Commission 2002c, 196). However, as with the other member states growth slowed more rapidly than expected. In light of the worsening economic situation, the Italian government refused to modify its fiscal stance at first (*Financial Times*, May 16, 2002). Actually, it even proposed tax cuts and increased unemployment spending to boost the economy (*Financial Times*, June 24, 2002). However, in early July Italy faced a setback when the Commission's Eurostat agency declared that Italian accounting practices regarding the securitization of real estate and lottery revenues were inappropriate and, therefore, demanded that her budget deficit for 2001 be restated from 1.6 percent of GDP to 2.2 percent of GDP (*Financial Times*, July 5, 2002). At once, this made that Italy's fiscal situation was edging closer to the SGP's reference value instead of moving toward a balanced position. Nonetheless, the Italian government vowed to pursue with its planned tax cuts and increased spending, indicating that Italy would delay the achievement of a nearly-balanced budget until 2004, as opposed to 2003 as originally proposed in the stability program (*Financial Times*, July 8, 2002). However, these new proposals were based on optimistic growth scenarios of 2.9 or 3 percent for each of the

next four years. In any event, it is noteworthy that the Italian government has vowed not break the SGP reference value and, to that effect, even imposed some corrective measures on rising expenditures. But there remains much doubt as her capacity to bring her budgetary position into balance by 2004 (see Council Opinion in OJ C 26, 4.2.2002, p. 7).

In Portugal, following the early warning received at the end of January 2002, a new center-right government came into power in May and vowed to return the country on the path of fiscal rectitude (*Financial Times*, May 2, 2002). So far it seems to be delivering on its promise to respect the SGP rules and bring about a balanced budgetary position as the fiscal deficit for 2002 is estimated at 3.4 percent of GDP, down from 4.2 percent in 2001 (see Table 4). The Portuguese government has even revised its projected budget deficit for 2002 downward to 2.6 percent of GDP (*Financial Times*, January 23, 2003). Nevertheless, the Council was forced to issue Portugal with an official reprimand when it became clear that her budget deficit for 2001 was above the reference value of three percent of GDP (*International Herald Tribune*, November 6, 2002).

In sum, Germany and Portugal are now in an "excessive deficit" position. They have received official recommendations from ECOFIN to adopt corrective measures immediately. So far, it appears that they have complied, despite the political difficulties involved in pursuing fiscal consolidation in times of economic stagnation. On the other hand, France has until now refused to heed the official warning of an excessive deficit it received from the Council. Now that it looks probable that her budget deficit for 2002 will be above the reference value, she should expect to receive an official reprimand from ECOFIN, as have Germany and Portugal. Thus, it remains to be seen whether the French

government will continue to oppose the SGP once it will be official that it has broken the rules. Finally, it appears that the Italian government is intent on avoiding an official warning but will delay progress toward a balanced budget. In this sense, Italy's strategy seems to be to break the rule that is less visible and more vague (i.e. taking measures to achieve a balanced budget in the medium term) while avoiding to breach the one that everyone seems to focus on (i.e. the 3% of GDP reference value).

III. The SGP as a Commitment Institution and the Future Stability of the EMU

During the transition from Maastricht to EMU, the member states relied on the EU institutions to provide for a smooth transition and convince private economic agents that EMU was going to happen as planned and that the latter should prepare accordingly (see Leblond 2003). Although the convergence criteria were a key element of the transition to EMU, most of the member states waited until 1997 (the only evaluation year) to satisfy the criteria, especially the crucial one on budget deficits, as well as relied on an alchemy of cyclical and temporary fiscal measures to do so. This way they could not use the satisfaction of the criteria as their signal to private economic agents that they were committed to EMU. Only the relentless work of the Commission and the EMI managed to get the member states, through the European Council, to indicate their commitment to EMU. However, the Commission's and the EMI's work dealt with legal, technical, and logistical issues regarding the changeover to a single currency. It did not really deal with fiscal policy convergence because their powers in this field were limited to monitoring member states' performance.

Once EMU began, however, the Commission gained new powers in the fiscal policy realm. It could now make an official recommendation to ECOFIN in view of giving an early-warning to a member state likely to be in an "excessive deficit" position in the short and medium term. Then the Council would have to act on the recommendation, either accepting it and issuing its own official recommendation to the member state concerned or refusing the Commission's recommendation and having to explain why it does so. When a member state's budget deficit had breached the reference value of 3 percent of GDP, then the same procedure could take place with the Commission issuing a recommendation to ECOFIN with respect to reprimanding the member state in an excessive deficit situation and the Council facing the same choice as in the early-warning case.

So far, as seen above, the Commission first made use if its power to force ECOFIN to consider issuing an early-warning in January 2002, in relation to the deterioration of Portugal's budgetary situation. The Council refused to act on the Commission's recommendation. Nevertheless, it did force the Council to impose some peer pressure on Portugal. Some specific commitments could be extracted in exchange for not issuing an official early-warning, which could affect Portugal's position in the financial markets. Moreover, the Commission made the existence of its recommendation public upon releasing its assessment of Portugal's updated stability program (on January 30, 2002). As a result, Portugal did undertake to adopt the necessary corrective measures, but only once the new center-right government came into power. Here, contrary to the argument advanced by Clark and Hallerberg (2000), increasing public spending before national elections—to the point of breaching SGP rules and making Portugal a fiscal

pariah—did not help the incumbent government to remain in power. In fact, it became an election issue that led to the downfall of the socialist party. The only problem with the Commission's work is that it could have issued its recommendation earlier since Portugal had abandoned fiscal consolidation in 1998 since the cyclically-adjusted budget deficit did not improve after 1997.

In the case of Germany, the Commission did issue an early-warning recommendation to ECOFIN in good time when it did so at the end of January 2002. Again, the Council refused to act upon the Commission's recommendation. However, it did shed public light on Germany's rapidly deteriorating fiscal situation. Unfortunately, the incumbent party coalition in government refused to acknowledge the possibility of an excessive deficit until after the national election in the fall of 2002. After that, the German government decided to take action but much damage had already been done. In Italy, the simple threat of an early warning seems to have been sufficient to bring about corrective measures. Only France has steadfastly refused to heed the Commissions and ECOFIN's warnings. France's refusal to abide by the rules of SGP, along with the breaches that occurred in Germany and Portugal, has created a crisis of legitimacy with the SGP. There are also concerns that the future stability of EMU might be endangered.

The fact that the SGP has been challenged during the first economic slowdown faced by the euro-zone economy should not be surprising. It should be even less surprising in light the missed opportunities of several member states to pursue sustainable fiscal consolidation policies in the run up to qualify for EMU and in the years 1998 to 2000 when the economy was growing vigorously. As Buti et al. (2003) mention: "In a way, these policy problems and debates are related to the success of EMU rules in

curbing deficits" (1). The fact that only one member state, namely France, is not abiding by the rules, testifies to the value of the SGP. Moreover, it should be remembered that France's budget deficit has yet stray too far from the reference value of 3 percent of GDP. And it remains to be seen how the French government will react once it receives an official reprimand from ECOFIN. There is a possibility that it will fall into line once France has been officially shamed.

After reviewing the many recommendations for improving or replacing the SGP, Buti et al. (2003) conclude that the SGP and the BEPGs represents the best institutional alternative at present for managing economic policies in the EU in general and the euro-zone in particular. Nonetheless, they propose some ways to improve the SGP. They make four proposals. First, they argue that stability programs should take into account stocks of public debt, contingent liabilities (e.g., pension liabilities), and public investment needs in order to better reflect the specific needs and situations of each member states. Second, the authors call for greater transparency in current and prospective fiscal accounts (see also von Hagen and Strauch 2001). More specifically, greater publicity should be made of one-off measures that do not follow the spirit of the SGP's goal of medium-term balanced budgets. Moreover, the authors argue in favour of a "structural balance" being computed, which would subtract material one-off measures from the budget deficit/surplus, as the Commission did with proceeds from the sale of mobile phone licenses. In addition, there is the problem of early detection of deviations from specified targets, as was the case with Portugal in 2001. The authors point out that member-state governments can exploit the lack of transparency for their own political benefit (e.g., during election periods). Estimates of off-budget liabilities (e.g., pension liabilities) along with net asset positions

to cover those liabilities should be made available to the public on a regular basis. Third, the authors agree with complaints that the SGP does not provide sufficient incentives for member states to run balanced budgets or pursue fiscal consolidation during periods of economic expansion. As a remedy, they argue for sanctions (e.g., the early-warning procedure) to punish deviations in good times as well as bad times. They also propose the introduction of compulsory rainy-day funds to be built up during periods of strong economic growth. Finally, the authors argue for a less partisan implementation of the SGP rules. Specifically, they propose that the Commission issue the first official early warning to a member state in deviation from targets without ECOFIN's approval. Only if action is not taken following the Commission's warning would the Council be called upon to issue a second warning with prescribed corrective measures. In the final phase, i.e. the application of sanctions, the authors argue that the Council should be called upon to act on a "proposal" from the Commission instead to a "recommendation." This would force the Council to obtain unanimity to refuse to act rather than qualified-majority as is the case with a recommendation. Although these proposals would significantly empower the SGP without changing its nature, the authors realistically point out that the "crucial question is, of course, whether or not the Council is prepared to strengthen the authority of the Commission in the interest of the credibility of EU fiscal rules" (Buti et al. 2003, 27). In response to the challenges faced by the SGP, the Commission published a reform plan in November 2002 (see *Financial Times*, November 28, 2002). This plan is line with the proposals by Buti et al. (2003). Now it remains to be seen if the Council will accept this plan to reinforce the SGP.

After four years, it is fair to conclude that the SGP has achieved the objective it was given to ensure fiscal prudence in the EMU in order to maintain the stability of the euro. It is true that France is currently challenging the rule; however, the French government remains committed to fiscal prudence and aims to achieve a balanced budgetary position before 2007. It may even take corrective measures to reduce its deficit once it has been officially reprimanded and shamed into having breached the 3% reference value. Where it really counts in the end, financial markets have not reacted to the alleged crisis in the SGP. Long-term bond yields in the euro-zone have remained relatively stable and close to one another (see Figure 2 and Table 8). They have even been falling since the beginning of 2002. Hence, financial investors do not seem preoccupied with the SGP and the future stability of the euro-zone.

Insert Figure 2 approximately here

Insert Table 8 approximately here

In sum, the SGP faced its first challenge from France, Germany, Italy, and Portugal in 2002. In spite of being unable to prevent Germany and Portugal from breaching the reference value with their budget deficits in 2002 and 2001 respectively, the SGP, with the Commission being in the driver's seat, has nevertheless managed to rein these two laggards by reprimanding them officially. In the case of Italy, the unofficial warnings from the Commission seem to have been successful in ensuring that Italy will not find herself in an excessive deficit position in short or medium term. However, the SGP is finding it difficult to get Italy to commit to a process of fiscal

consolidation in order to bring her in a position of budgetary balance in the medium term. This is a weakness that proposed reforms to the SGP should redress. The only black spot is France, which refuses to heed the early warning from the Council. Now that her 2002 budget deficit has probably breached the reference value, which should merit an official reprimand, it remains to be seen if her government's refusal to abide by the rules of the SGP will continue. In any case, this alleged crisis appears to be part of the natural evolution of EMU and the SGP. Financial markets indicate that there are no reasons to be alarmed at the future stability of the euro and its member states' finances in the long-term. Therefore, as an institution that faces a challenge to its legitimacy, the SGP will be strengthened and improved and, as such, should provide even greater benefits to the euro-zone economies.

Conclusion

The story of fiscal convergence and stability in the EMU is one of alchemy, missed opportunities, and commitment institutions. The member states used an alchemy of fiscal measures to qualify for EMU at the last minute (i.e. in 1997, the only year used for the evaluation). As a result, many member states missed an opportunity to achieve sustainable fiscal consolidation. Then the year 1998 became a lost year on the fiscal front as qualifying for EMU had already taken place and EMU had yet to begin. There was simply no incentive to continue with fiscal consolidation. Finally, once EMU began many member states took advantage of the strong economic growth of the euro-zone in 1999 and 2000 to continue delaying the consolidation of their fiscal situation. As long as they respected the rules set out in the SGP, namely the reference value of 3 percent of GDP,

there was no institutional mechanism to force further consolidation upon them. However, as the euro-zone economy experienced a rapid slowdown in 2001, the budgetary positions of many member states began to deteriorate. Those of countries such as Germany, France, Italy and Portugal deteriorated more rapidly because they had missed the earlier opportunities to achieve a sustainable position of budgetary balance in the medium term. As a result, they ended up or are likely to end up in an "excessive deficit" situation.

In light of these fiscal policy developments in the EMU, EU institutions and the SGP have managed to keep the situation under control. So much so that financial markets do not show any sign of unease. Obviously, there have been calls for the SGP to be improved and strengthened and the Commission has taken it upon itself to propose a reform plan to the Council this spring. This plan aims at preserving the current qualities of the Pact while making it better adapted to the particular situations of the individual member states. It also aims at preventing missed opportunities in the future. Given that many member states seem more preoccupied with avoiding being shamed (i.e. breaching the reference value) by the SGP than closely abiding to the spirit of the SGP's fiscal rules, the Commission and the Council have to give themselves greater means of ensuring that member states no longer miss out on opportunities to bring their medium-term budgetary situations into a sustainable balance. This requires renewed political will from the Council to modify the rules of the SGP and provide the Commission with greater powers of enforcement and supervision. This is the only way it will provide the SGP with the proper legitimacy among the politicians and the peoples of Europe. As for the future stability of the EMU, the current SGP rules appear to be doing the job they were meant to

do. Even in the case of France, there will come a day when she will face the imposition of monetary sanctions if she refuses to abide by Council recommendations. Then, it will become impossible for her to refuse to cooperate without seriously threatening the stability of the EMU. But given that France continues to be a strong advocate of monetary union in Europe, such behaviour is very unlikely.

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Table 1

Performance on the Fiscal Deficit Convergence Criterion

(Note: Numbers in bold indicate that the country meets the convergence criterion)

(% of GDP)	Surplus (+) / Deficit (-)				
	1993	1994	1995	1996	1997
Austria	-4.2	-5.0	-5.1	-3.7	**-1.8**
Belgium	-7.1	-4.9	-3.8	-3.1	**-1.6**
Denmark	**-2.8**	**-2.4**	**-2.4**	**-0.9**	**0.4**
Finland	-8.0	-6.4	-4.6	-3.1	**-1.2**
France	-5.8	-5.8	-4.9	-4.1	**-3.0**
Germany	-3.2	**-2.4**	-3.3	-3.4	**-2.7**
Greece	-13.8	-10.0	-10.3	-7.5	-4.0
Ireland	**-2.4**	**-1.7**	**-2.1**	**-0.2**	**1.0**
Italy	-9.6	-9.2	-7.7	-6.6	**-2.7**
Luxembourg	**1.7**	**2.8**	**1.8**	**2.8**	**3.8**
Netherlands	-3.2	-3.8	-4.1	**-1.8**	**-1.0**
Portugal	-6.1	-6.0	-5.7	-3.3	**-2.5**
Spain	-7.0	-6.3	-7.1	-4.5	**-2.5**
Sweden	-12.2	-10.3	-6.9	-3.5	**-0.7**
United Kingdom	-7.9	-6.8	-5.7	-4.4	**-1.9**
EU-15	-6.1	-5.4	-5.0	-4.2	-2.4
Reference Value	-3	-3	-3	-3	-3

Source: Eurostat

Table 2

Decomposition of the Percentage-Point Change in Fiscal Deficits (as % of GDP) in the EU, 1993-1997

	Total Change	Economic Cycle	%	Interest Payments	%	Total Cyclical	%	Revenues	%	Current Primary Expenditures	%	Capital Expenditures	%	Total Discretionary	%
Austria	-2.4	-0.1	4.2%	-0.3	12.5%	-0.4	16.7%	0.1	-4.2%	-1.3	54.2%	-0.8	33.3%	-2.0	83.3%
Belgium	-5.5	-0.9	16.4%	-2.6	47.3%	-3.5	63.6%	-1.2	21.8%	-0.6	10.9%	-0.2	3.6%	-2.0	36.4%
Denmark	-3.2	-1.7	53.1%	-1.8	56.3%	-3.5	109.4%	0.5	-15.6%	0.2	-6.3%	-0.4	12.5%	0.3	-9.4%
Finland	-6.8	-6.2	91.2%	1.3	-19.1%	-4.9	72.1%	-0.1	1.5%	-1.6	23.5%	-0.2	2.9%	-1.9	27.9%
France	-2.8	-0.4	14.3%	0.3	-10.7%	-0.1	3.6%	-1.4	50.0%	-0.5	17.9%	-0.8	28.6%	-2.7	96.4%
Germany	-0.5	0.8	-160.0%	0.4	-80.0%	1.2	-240.0%	1.3	-260.0%	-1.6	320.0%	-1.4	280.0%	-1.7	340.0%
Greece	-9.8	-0.7	7.1%	-2.9	29.6%	-3.6	36.7%	-3.2	32.7%	0.6	-6.1%	-3.6	36.7%	-6.2	63.3%
Ireland	-3.4	-3.5	102.9%	-1.8	52.9%	-5.3	155.9%	2.1	-61.8%	-0.7	20.6%	0.5	-14.7%	1.9	-55.9%
Italy	-6.9	-1.5	21.7%	-2.6	37.7%	-4.1	59.4%	0.5	-7.2%	-1.7	24.6%	-1.6	23.2%	-2.8	40.6%
Luxembourg	-2.1	..		..		..		..		..		..		..	
Netherlands	-2.2	-0.7	31.8%	-1.0	45.5%	-1.7	77.3%	4.2	-190.9%	-4.2	190.9%	-0.5	22.7%	-0.5	22.7%
Portugal	-3.6	0.7	-19.4%	-1.9	52.8%	-1.2	33.3%	-4.6	127.8%	2.8	-77.8%	-0.6	16.7%	-2.4	66.7%
Spain	-4.5	-0.2	4.4%	-0.7	15.6%	-0.9	20.0%	1.6	-35.6%	-3.5	77.8%	-1.7	37.8%	-3.6	80.0%
Sweden	-11.5	-3.9	33.9%	0.3	-2.6%	-3.6	31.3%	-2.4	20.9%	-2.9	25.2%	-2.6	22.6%	-7.9	68.7%
United Kingdom	-6.0	-2.7	45.0%	0.8	-13.3%	-1.9	31.7%	-2.3	38.3%	-0.4	6.7%	-1.4	23.3%	-4.1	68.3%
EU	-3.7	-0.5	13.5%	-0.4	10.8%	-0.9	24.3%	0.0	0.0%	-1.5	40.5%	-1.3	35.1%	-2.8	75.7%

Source: European Commission, Convergence Report 1998 (pp. 102, 106); author's calculations

Table 3

The Determinants of Budget Deficit Reductions in the EU, 1993-1997

Regression Equation to be Estimated

$$FISCALDEF = \beta_0 + \beta_1\, LAGFISCDEF + \beta_2\, INTEREST + \beta_3\, UNEMPLOY + \beta_4\, GROWTH + \beta_5\, DEBT + \beta_6\, INTEREST*DEBT + \varepsilon$$

Independent Variables	Budget Deficit
Constant	-2.8996
	(1.8096)
Lagged dependent variable (one-year)	0.7324***
	(.1509)
Interest rate	0.5662**
	(0.2666)
Unemployment rate	0.0255
	(0.0246)
Economic growth (growth in GDP)	-0.3452***
	(0.0957)
Public debt ratio (% of GDP)	0.0262
	(0.0168)
Interest rate * public debt ratio	-0.004
	(0.0025)
Number of observations	75
Adjusted R-squared	0.8469

OLS estimates using panel corrected standard errors; ***$p<0.01$; **$0.01<p<0.05$

Figure 1

Decomposition of the Percentage-Point Change in Budget Deficits in the EU, 1993-1997

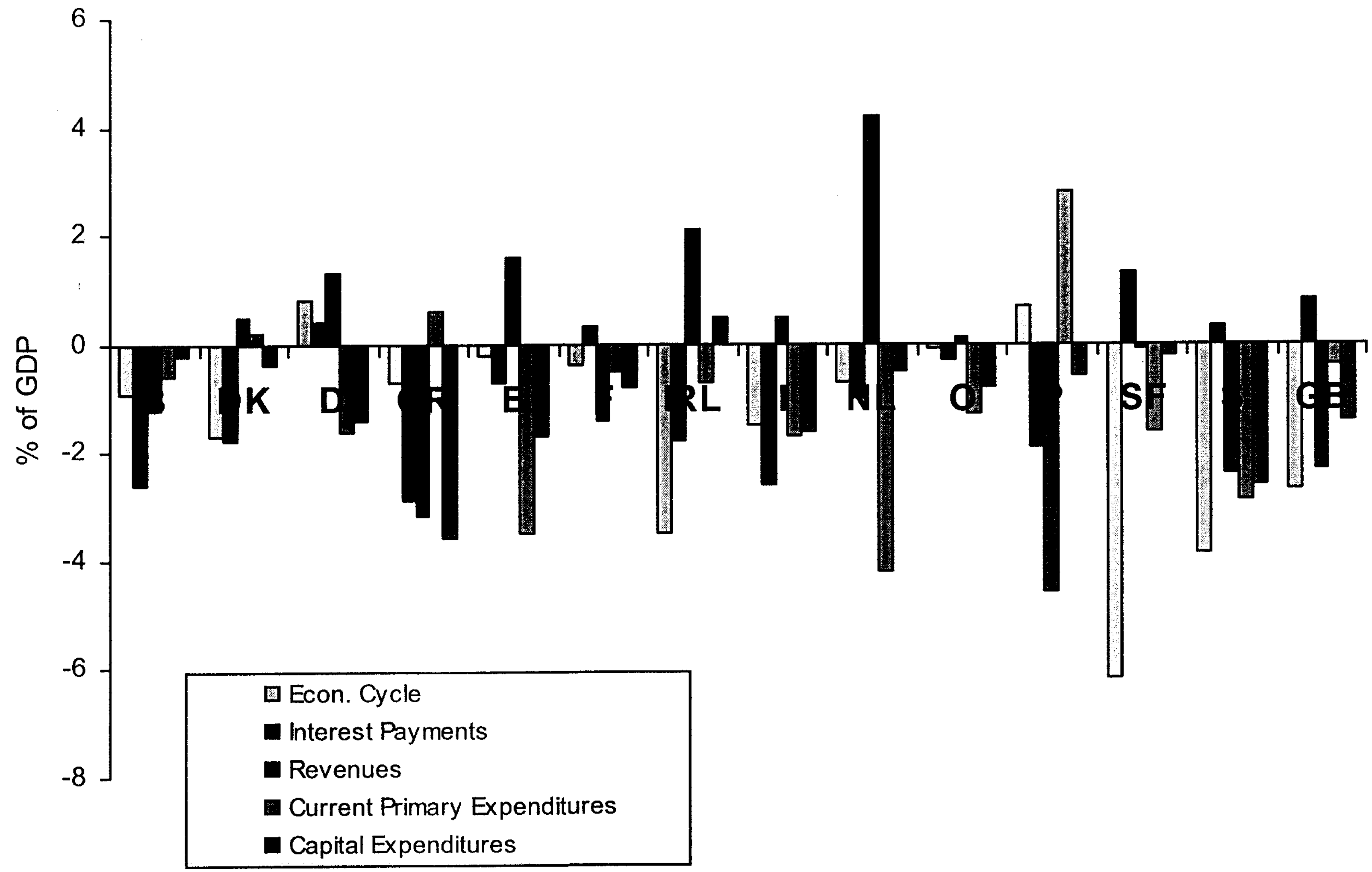


Table 4

Fiscal Performance of the Euro-Zone, 1998-2002

(Note: Numbers in bold indicate that the country breaches the Growth and Stability Pact criterion of 3 percent of GDP)

(% of GDP)	Surplus (+) / Deficit (-)				
	1998	1999	2000	2001	2002*
Austria	-2.4	-2.3	-1.5	0.2	-1.8
Belgium	-0.7	-0.5	0.1	0.4	-0.1
Finland	1.3	1.9	7.0	4.9	3.6
France	-2.7	-1.6	-1.3	-1.4	-2.7
Germany	-2.2	-1.5	1.1	-2.8	**-3.8**
Greece	-2.5	-1.9	-1.8	-1.2	-1.3
Ireland	2.4	2.1	4.4	1.6	-1.0
Italy	-2.8	-1.8	-0.5	-2.2	-2.4
Luxembourg	3.1	3.6	5.6	6.1	0.5
Netherlands	-0.8	0.7	2.2	0.1	-0.8
Portugal	-2.6	-2.4	-2.9	**-4.2**	**-3.4**
Spain	-2.7	-1.1	-0.6	-0.1	0.0
Eur-12	-2.2	-1.3	0.1	-1.5	-2.3

* Forecast

Source: European Commission, General Government Data, Autumn 2002

Table 5

Cyclically-Adjusted Budget Balances in the Euro-Zone, 1998-2002

(% of GDP)

	Surplus (+) / Deficit (-)				
	1998	1999	2000	2001	2002*
Austria	-2.4	-2.5	-2.4	0.0	-1.6
Belgium	-0.6	-0.9	-1.1	-0.3	0.2
Finland	-0.4	0.3	3.8	3.8	3.7
France	-2.6	-2.0	-2.1	-2.0	-2.7
Germany	-1.9	-1.4	-1.9	-2.8	-3.3
Greece	-1.9	-1.6	-1.8	-2.1	-1.7
Ireland	1.8	0.8	2.5	0.2	-1.4
Italy	-3.0	-1.9	-2.1	-2.4	-1.8
Luxembourg	2.7	2.4	1.9	3.9	0.4
Netherlands	-1.9	-1.2	-0.6	-1.2	-0.6
Portugal	-3.0	-3.0	-4.0	-4.3	-3.0
Spain	-2.6	-1.5	-1.4	-0.7	-0.1
Eur-12	-2.2	-1.6	-1.7	-1.9	-2.0

* Forecast

Source: European Commission, Cyclical Adjustment of Budget Balances, Autumn 2002

Table 6

Economic Growth in the Euro-Zone, 1998-2001

(Percentage change in real GDP over previous year)

	Economic Growth			
	1998	1999	2000	2001
Austria	3.9	2.7	3.5	0.7
Belgium	2.1	3.2	3.7	0.8
Finland	5.4	4.1	6.1	0.7
France	3.5	3.2	4.2	1.8
Germany	2.0	2.1	2.9	0.6
Greece	3.4	3.6	4.2	4.1
Ireland	8.8	11.1	10.0	5.7
Italy	1.8	1.6	2.9	1.8
Luxembourg	7.6	6.0	9.0	1.0
Netherlands	4.4	4.0	3.3	1.3
Portugal	4.6	3.8	3.7	1.6
Spain	4.3	4.2	4.2	2.7
Eur-12	2.9	2.8	3.5	1.4

Source: Economist Intelligence Unit

Table 7

Public Debt Ratios in the Euro-Zone, 1998-2002

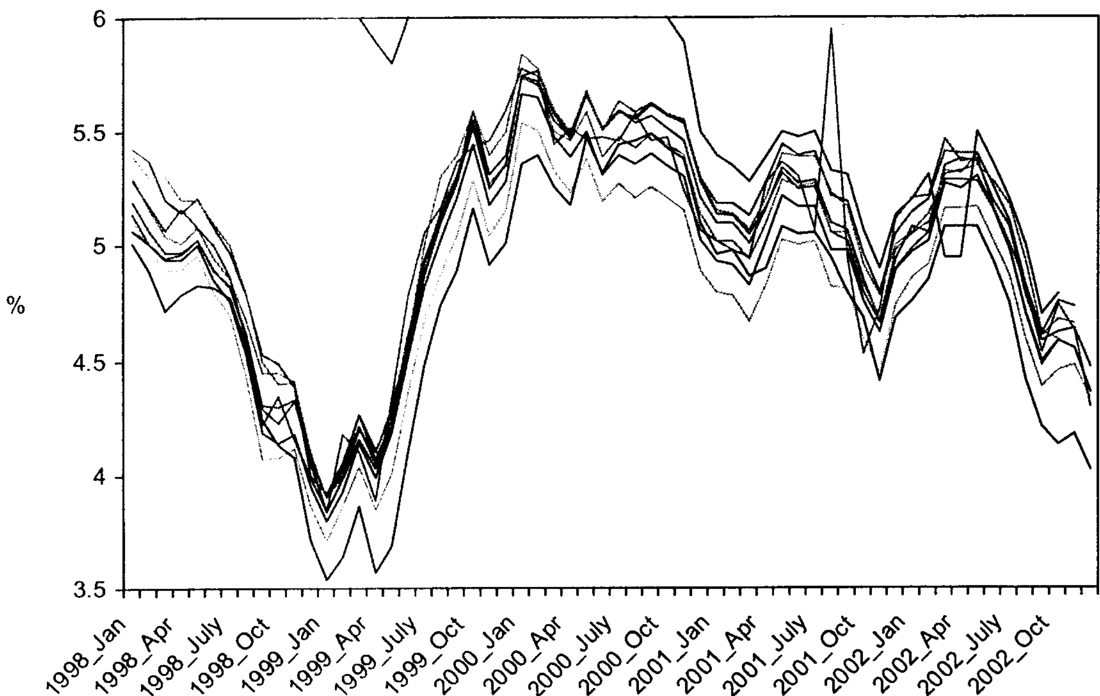
	(% of GDP)				
	1998	1999	2000	2001	2002*
Austria	63.7	64.7	63.0	62.7	63.2
Belgium	119.6	114.9	109.6	108.6	105.6
Finland	48.8	46.8	44.0	43.4	42.4
France	59.5	58.5	57.3	57.3	58.6
Germany	60.9	61.2	60.2	59.5	60.9
Greece	105.8	105.1	106.2	107	105.8
Ireland	54.9	49.3	39.3	36.7	35.3
Italy	116.3	114.5	110.6	109.9	110.3
Luxembourg	6.3	6.0	5.6	5.6	4.6
Netherlands	66.8	63.1	55.8	52.8	51.0
Portugal	55.0	54.4	53.4	55.5	57.5
Spain	64.6	63.1	60.5	57.1	55.0
Eur-12	73.7	72.5	70.1	69.3	69.6

* Forecast

Source: European Commission, General Government Data, Autumn 2002

Figure 2

Long-Term Bond Yields in the Euro-Zone, 1998-2002



Source: Economist Intelligence Unit

Table 8

Long-Term Bond Yields in the Euro-Zone, 1998-2002

	(%)						
	1998	1999	2000	2001	2002	AVG*	STDV*
Austria	4.49	3.94	3.64	3.58	4.10	5.00	0.48
Belgium	4.67	4.71	5.57	5.06	5.00	4.99	0.48
Finland	4.79	4.72	5.48	5.04	4.80	5.01	0.77
France	4.64	4.61	5.39	4.94	4.90	N/A	N/A
Germany	4.73	4.76	5.35	4.90	4.80	4.78	0.45
Greece	8.48	6.31	6.11	5.30	5.20	6.30	1.75
Ireland	3.99	5.60	5.07	5.11	4.30	5.02	0.50
Italy	4.88	4.73	5.58	5.20	5.10	5.09	0.79
Luxembourg	4.70	4.66	5.44	5.03	4.88	N/A	N/A
Netherlands	4.63	4.63	5.40	4.96	4.89	4.90	0.46
Portugal	4.89	4.78	5.60	5.12	4.90	5.10	1.03
Spain	4.55	4.30	5.36	4.87	4.60	4.74	0.52

* Based on monthly data from January 1998 to December 2002.

Source: Economist Intelligence Unit