

Foreword

European Monetary Union (EMU) is an ambitious endeavour and a new historical development. Many countries have given up their own monetary and exchange rate policy and have delegated responsibility to the newly created European Central Bank. Fiscal policy has remained a national responsibility. This creates a new policy framework with new incentives and constraints.

Monetary Union became operational in 1999. In 2002 coins and banknotes were introduced in 12 countries. The common monetary policy has rapidly consolidated and the euro has become part of the European way of life.

The success of the euro contrasts with the problematic developments concerning the fiscal policy framework that was expected to complement and support the common currency. Several countries have deficits in excess of the agreed limits. Procedures have been modified according to countries' pressures. Fiscal rules are widely criticized while reform proposals abound. The endpoint of these development is very much uncertain.

In the debate on Europe's Economic and Monetary Union, fiscal policy has occupied a special place since the beginning. The Maastricht fiscal policy criteria and the Stability and Growth Pact are probably the most contentious building blocks of EMU's institutional architecture. They have aroused heated controversies between academic economists, policy makers and informed observers at large. Positions have often been extreme: those who see the Pact as a fundamentally flawed piece of accounting arithmetic that would not stand the test of reality are opposed by others who view it as an untouchable building block of EMU without which the whole construct of the single currency would crumble.

As EMU's fiscal rules undergo the first severe shock of the severe slowdown of the beginning of the 2000s and an uncertain economic recovery, the radicalism of the debate is far from abating. Europe is still searching for its fiscal soul: 'the Stability Pact is dead, long live the Pact'.

We have been involved in the policy debate concerning European fiscal rules since the mid-1990s. We have long supported the need for rules in the EMU framework. The developments of the last decade have taught us that the implementation of rules is in no way an easy task. Economic problems and political considerations frequently conflict with the required fiscal behaviour.

We have also been taught that there are no miracle solutions to the European fiscal policy dilemmas: the difficult trade-offs between rules and flexibility and between common objectives and national interests will stay with us.

The rules introduced in the 1990s may not be perfect, but no alternative solution has emerged as clearly superior. Better national budgetary procedures, tighter coordination at the European level, greater fiscal transparency and more effective market-based fiscal discipline can all contribute to ensuring a sound fiscal policy framework. But common fiscal rules still represent the main pillar of EMU. Improving their design and implementation while maintaining simplicity and transparency is the main challenge ahead.

It is clear that the EU fiscal rules are not set in stone. While many proposals of reform have been put forward, the mainstream debate revolves around the technical and political issues dealt with in this book: from the nature of the 3 per cent of GDP deficit ceiling to setting the appropriate medium-term budgetary targets, from the role of fiscal policy in cyclical stabilization to the long term sustainability of public finances, from the contribution of public finances to potential growth to statistical governance. These are also the main issues that have been debated in European fora which culminated with the reform of the Stability and Growth Pact in spring 2005. Such chapters are discussed in a Postscript at the end of the volume.

This book is about the origins, the rationale, the problems and the prospects of the European fiscal policy framework. It aims at providing the reader with a roadmap to understand the evolution of the debate on fiscal policy in EMU. Our basic premise is that one cannot fully understand EMU's fiscal rules without placing them in a historical perspective and abstracting from the uniqueness of EMU where sovereign countries retain a large degree of fiscal independence while monetary policy is entrusted to an independent central bank with the overriding mission of maintaining price stability. Hence any relevant analysis of fiscal policy in EMU has to uncover its historical roots, develop a theory of supranational fiscal rules and devote particular attention to its institutional architecture.

The book brings together in a structured fashion work that we have done since 1998. It includes both analytical and policy-oriented studies. Several chapters have been adapted, in particular by dropping clearly outdated sections. Although each chapter is self-contained, we trust that the final outcome will be more than the sum of the individual parts. The completion of this book would have not been possible without the contribution of several people. We are particularly grateful to our coauthors who graciously allowed us to reproduce our joint papers here: Mike Artis, Fabrizio Balassone, Anne Brunila, Sylvester Eijffinger, Mario Nava, Paul van den

Noord, Hedwig Ongena, Werner Roeger, Jan in't Veld and Stefania Zotteri. Their continuous intellectual stimulus and friendship over all these years has been paramount in our endeavour.

Several chapters were originally published in different journals: Chapters 2 and 11 in *Oxford Review of Economic Policy*, Chapters 3, 5 and 9 in *Journal of Common Market Studies*, Chapter 4 in *Empirica*, Chapter 6 in *Fiscal Studies*, and Chapter 8 in *Journal of Public Finance and Public Choice*. We thank the editors of those journals for their permission to use this material.

We are also indebted to Vittorio Gargaro and Renzo Pin who provided excellent editorial support. Finally, the assistance of Luke Adams was instrumental for the rapid publication of the book.

