Introduction[1]

Leila Simona Talani

When it was adopted by the European Council in Amsterdam in 1997 the Stability and Growth Pact (SGP)[2] was celebrated as the guardian of the strength and credibility of the forthcoming Economic and Monetary Union (EMU), and as an additional support for German fiscal conservatism against the inflationary, free-riding proclivities of the 'club-Med'. Yet, ironically, when in 2003 the SGP died at the hands of its mother and father, Germany and France,[3] the Euro appeared to be stronger than ever. There was, moreover, little evidence that the markets questioned the credibility of a post-SGP EMU.

The Maastricht Treaty protocols on EMU resolved the long-lasting controversy between the 'monetarist' and the 'economist' approaches to monetary union. The distinction between 'monetarists' and 'economists' emerged in the course of the discussions over the Werner Plan (1969) and referred to the strategy to be adopted during the transitional period leading up to monetary union. The 'monetarists' stressed the importance of achieving exchange rate stability through European institutional arrangements, while the 'economists' pointed out the necessity of policy coordination and, ultimately, convergence before agreeing on the adoption of a European fixed exchange rate regime or a currency union.[4] The Treaty established a rigid institutional framework with a clear-cut economic objective (that of pursuing price stability) and a three-stage timetable to achieve EMU (cf. Gros and Thygesen, 1998). At the same time, it devised a set of convergence requirements to which applicant member states had to conform before entering. These requirements included permanence in the 'new' Exchange Rate Mechanism (ERM) (within 15 per cent bands) for at least two years; inflation rates no more than 1.5 per cent higher than the average of the three most virtuous member states (that is, the member states with the lowest levels of inflation); interest rates no more than 2 per cent higher than the average of the three most virtuous member states; a debt-to-GDP ratio not exceeding 60 per cent, subject to conditions; and, most importantly, a deficit-to-GDP ratio not exceeding 3 per cent (TEU art. 104(c) and art. 109 (j)).

Whilst the Maastricht Treaty set out strict anti-inflationary requirements, the emphasis on price stability was buttressed by the adoption of the

Stability and Growth Pact in 1997 (Eichengreen and Wyplosz, 1998: 71). The pact confirmed the objective of a deficit-to-GDP ratio not exceeding 3 per cent and commited EMU member states to a medium-term budgetary stance close to balance or in surplus. It also defined the terms and sanctions of the excessive deficit procedure (EDP). Exemption from respecting this fiscal criterion within EMU was allowed only in the case of a decline in GDP of 2 per cent or more and of a temporary and small excess deficit. With a GDP declining by between 0.75 and 2 per cent, the decision on exemption from sanctions was left to the Council of Ministers. With lower decreases in GDP, the excessive deficit procedure was to be implemented in any case, and countries obliged to keep up to 0.5 per cent of their GDP in non-interest-bearing mandatory deposits with the ECB until the excess deficit was re-absorbed. If this did not happen within two years, deposits were transformed into outright transfers (Gros and Thygesen, 1998: 341).

The book examines the demise of the original version of the SGP and the consequences of its subsequent reform. It recognises that debates concerning whether there actually was any demise of the SGP and what were the implications of the reform remain open. Nevertheless it demonstrates that the events of November 2003 and the changes to the SGP adopted in March 2005 configure a different political and economic instrument from the one which had been originally approved.[5] This is why the authors often refer to the crisis of the SGP as its demise or death despite the fact that we still have a (reformed) SGP. The book questions the rationale of similar events from both the political and the economic standpoints. Political scientists have adopted different interpretations and theoretical perspectives in order to understand the complex issues surrounding the SGP. Among economists, there is a great deal of controversy concerning the scope for, and direction of, fiscal coordination in the EMU.

Accordingly, the contributors to this volume examine the demise and reform of the SGP from different and yet complementary perspectives. They seek to find a solution to the dilemmas posed by fiscal policy coordination in the context of a single currency area and to compare and contrast the utility of alternative heuristic frameworks and theoretical perspectives on the EMU and SGP. Special attention is devoted to the question of credibility. Chapter 1 addresses the definition of credibility of international economic agreements in theory from the political scientist and from the economic perspective. Chapters 2–4 focus on the performance of the Stability and Growth Pact in terms of credibility from three different perspectives. Chapters 5 and 6 put forward proposals to ensure the future credibility of the European fiscal rule.

The analysis of fiscal and monetary policy in EMU in general – and of the role of the SGP in particular – has been dominated by economists who, responding to domestic and/or to international developments, have offered policy recommendations for the EU as a whole or for specific member states.[6] In contrast, most political scientists have drawn from a number of disparate theoretical traditions. Scholars working within the framework of intergovernmentalism have sought to describe and explain the development of the SGP with reference to domestic politics and conflict among member states. They have studied decisions taken by the heads of individual member states, while emphasizing the central role played by the nation-state and national interests in the evolution of European integration.[7] For example, Moravcsik has adopted a domestic politics approach to explain why the position of Germany in the negotiations over EMU did not reflect the strong anti-inflationary position of the Bundesbank but rather a compromise between the Bundesbank's strict anti-inflationary stance and the preferences of the business sector for a devalued exchange rate, low interest rate and macroeconomic flexibility (Moravcsik, 1993a: 387, 1998: 401).

Another important application of a domestic politics perspective is that of Frieden *et al.* (1998). These scholars sought to develop an analysis of European monetary policy by using a two-level game framework that examined national monetary policy objectives with reference to domestic sectoral interests. The model identifies economic sectors' preferences vis-à-vis the two interrelated dimensions of exchange rate regimes (fixed or flexible) and levels (appreciated or depreciated).

Neo-constructivist perspectives on the establishment of EMU can be divided into two basic groups: 'identity oriented constructivists' and 'economic ideas oriented constructivists'. The first and, perhaps, more radical group includes scholars such as Minkkinen and Potomaki (1997) and Risse (1998). These scholars argue that the process of monetary integration, and in particular the establishment of EMU, can be explained within the context of identity politics. Their effort is therefore mainly oriented to asserting the 'symbolic' nature of the 'Euro' in relation to the national collective identity and symbols. Importantly, these authors discard as contradictory economic motivations for EMU and attribute explanatory value only to non-economic political constructions.

In the second group are scholars such as McNamara (1998) and Dyson (2000). This group acknowledges the importance of economic factors in the development of EMU, but also stresses the role of economic ideas as opposed to economic interests. According to these scholars EMU became a necessity in the context of the establishment of a new economic consensus, the neo-liberal 'consensus of competitive liberalism' amongst the political elites of all EU member states.

Some political scientists have developed more eclectic approaches that combine elements of neo-constructivism and intergovernmentalism (Dyson and Featherstone, 1996; Martin, 1994; Sandholtz, 1993; Young, 1999). Verdun, for example, has adopted a neo-constructivist framework to analyse the establishment of the SGP while applying a more eclectic approach to its demise (Verdun and Christensen, 2000; Heipertz and Verdun, 2004, 2005). She argues that the signing of the SGP was made possible by a convergence in basic ideas about the relationship between monetary and fiscal policies held by experts in ministries of finance, central banks and the Commission and by academics and relevant international organizations. However, ideational convergence only provided the basis for a political compromise. The decision to adopt that compromise was possible thanks to the prominent position of Germany in the intergovernmental talks that led to the approval of the pact and to the creation of a convergence of German and French interests of a sort that is typical of international power-politics (Heipertz and Verdun, 2004: 1–2).

The domestic actor perspective is exemplified by the work of McKay (1999, 2002), who addresses the issue of the fiscal coordination. While some political scientists have considered this in terms of a legitimization crisis (Verdun and Christensen, 2000; Weale, 1996), McKay is interested in how individual countries would react to the requirements of coordination. He argues that reactions will be different in different countries and that, in times of recession, member states might seek to breach fiscal rules such as those included in the SGP. This prediction is in line with those of many economists who had forecast that the SGP was unlikely to be sustainable (Eijffinger and De Haan, 2000).

Crouch also has examined the EMU and SGP from the perspective of domestic politics. He has focused on the impact of EMU and the budgetary constraints of the SGP on labour markets and trade unions (2002), seeking to understand how national governments will react to the lack of competitiveness of their labour markets without the option of competitive devaluations. Along similar lines, Martin Rhodes (1997, 2002) had argued that the reform of labour markets and of the welfare state would not happen in an unregulated fashion, but through a neo-corporatist strategy or, as he calls it, through 'competitive corporatism'. Paradoxically, rather than decrease, the EMU would increase their role (although not necessarily their power) in the welfare and wage bargaining processes.

This book will provide a deeper analysis of the subject of the Stability and Growth Pact from the perspectives outlined above, focusing in particular on:

- What happened to the credibility of the EMU with the collapse and reform of the SGP?
- Which is the role of the nation states and their domestic constituencies in the crisis of the fiscal rule?

- How did financial markets react at the news of the collapse of the SGP and why?
- What was the impact of the strength of the Euro on the SGP?
- Does the crisis of the SGP signal a crisis of the European integration process?
- Is the reformed pact a guarantee of growth and stability?
- What kind of technical solutions have been devised to solve the shortcomings of the previous versions of the pact?
- Where does this leave the EU and its economic future?

The book is aimed at political scientists and political economists with an interest in European policy making.

CHAPTER OVERVIEWS

In Chapter 1 Leila Simona Talani and Giorgio Fazio apply a political economic approach to the problem of exchange rate credibility, which is treated as an example of international economic agreements. Whilst political scientists focus primarily on a socio-political analysis aimed at tracing back the 'interests' underlying exchange rate commitments, economists tend to focus exclusively on financial and economic variables as connected to the 'expectations' of the markets. Only recently have political scientists sought to devote more attention to the issue from an integrated political economy perspective, which mainly focuses on the role of partisanship and governments' stability in influencing speculative behaviour (Leblang, 2002; Leblang and Bernard, 2000).

Despite these important contributions to the development of this branch of international political economy (IPE), there is still some scope for speculation concerning the relation between socio-political and economic accounts of financial phenomena. There is, in a few words, the possibility of finding a 'synthesis' of the two cognitive and interpretative models and this is, ultimately, the aim of Talani and Fazio's contribution. Accordingly, they argue that each of these perspectives taken separately can account only for a partial representation of reality and does not prove exhaustive of the many implications arising from the issue of exchange rate credibility. Therefore, the study of exchange rate credibility requires an integrated political economy model like the one which is defined and tested in the chapter. The theoretical aim of this chapter is that of confronting economists' and political scientists' approaches to exchange rate commitments and trying to reconcile them in an integrated political economy model, where 'interests' and 'expectations' appear as the two sides of the same coin.

In particular, this contribution seeks to explain why a country commits itself to fixing its exchange rate, and why, at a certain point, the credibility of this commitment may fade, triggering the rational expectations of the financial markets to re-orient towards a realignment of the exchange rate, eventually producing speculative attacks.

In Chapter 2 Alan Cafruny and Magnus Ryner adopt a structural approach to account for the crisis of the SGP. They argue that the fate of EMU – and by implication the SGP – is closely tied to transatlantic relations and Europe's subordination to what they term US 'minimal hegemony'. Cafruny and Ryner argue that the design of EMU is inconsistent with the goal of European autonomy and growth (although this is not to say that policies do not serve the interests of particular – and powerful – European class fractions and regions). Finally, they address the socially disintegrative implications of EMU. Focusing on France and Germany – EMU's core states – they account for a crisis of representation resulting from a politics of welfare state retrenchment that is counterproductive in its objective to revive growth in the European economy or indeed to underwrite the long-term stability of pacts such as the SGP. The EU's aspiration to build a monetary union to promote competitiveness, sustained growth, regional autonomy and social cohesion is self-limiting because the Maastricht design of the EMU is inherently connected to a neo-liberal transnational financial order that displaces socio-economic contradictions from the US to other parts of the world, including Europe. Europe's subordinate participation within this order pre-empts the possibility of resolving structural problems of post-industrial or, better, post-Fordist society in a manner consistent with Europe's social and Christian-Democratic social accords. Economic stagnation, uneven development, and the widening gap between new forms of economic governance and social citizenship amplify legitimation problems and political conflicts, with adverse effects on the EU's political ability to mobilize as a counterweight to the US.

In Chapter 3 Leila Simona Talani assesses the credibility of the fiscal rule with reference to the performance of the Euro after the collapse of the SGP. With the crisis of the SGP a fundamental paradox arises: how can a currency remain as strong as ever in the midst of a serious crisis of the fiscal rule? This paradox seems to point towards a political economy interpretation of the making and enforcement of fiscal coordination in the Euro area.

The explanation for the paradox is sought within the framework of a revised, 'embedded' version of intergovernmentalism based on Moravcsik's liberal intergovernmentalism (1993a), which adds to the traditional intergovernmentalist framework an explicit theory of national preferences formation. As it is applied to the working of the SGP, intergovernmentalists would predict that the interests of the most powerful member states will prevail over those of smaller states in the ECOFIN decision-making process. Based upon previous research (Talani, 2004), embedded intergovernmentalism would trace back the interests of the most powerful Euro-zone member states to the position of their leading socio-economic sectors. Therefore, the shift of emphasis from strict fiscal policy to more relaxed fiscal policy enshrined in the new outlook of the SGP does not detract from the credibility of the member states' commitment to EMU. This is why, after the decision by the ECOFIN not to impose sanctions on France and Germany, financial markets did not reduce the value of the Euro, which indeed continued to increase in relation to the Dollar. This chapter employs a definition of credibility rooted in the consensus to EMU of the most powerful socio-economic actors. Here, credibility derives primarily from structural considerations relating to the institutionalization of a set of favourable macroeconomic policies following from this particular form of monetary union.

In Chapter 4, Benedicta Marzinotto provides an analysis of the credibility of the ECB from a German perspective. She adopts a domestic politics perspective to explain the collapse of the SGP in a country that has a long history of fiscal discipline, mostly pursued with the tacit support of the principal social actors. Different hypotheses have been put forward in the literature to account for Germany's undisciplined behaviour. Some observers still insist on the revolutionary impact of the 1991 re-unification on public finances. Deviation from the 3 per cent deficit target would thus be indicative of the difficulty in funding welfare programmes, especially in eastern Germany, at a time when unemployment in this part of the country remains comparatively high. For others, instead, the presence of fiscal rule imposed from above is in itself responsible for fiscal misbehaviour in periods of slow growth. The argument is that the SGP has forced fiscal authorities into a pro-cyclical action, thus depriving economic policy of any stabilization function. A relatively stringent fiscal policy in recession is believed to further compromise growth, leading to even greater fiscal imbalances in the following years. Against these explanations, Marzinotto argues that the timing of fiscal deterioration is not well explained by the re-unification shock. Fiscal discipline relaxed quite remarkably after 1999, and the same happened in most Euro-zone countries. This suggests that the establishment of EMU has probably softened the incentive structure in favour of fiscal discipline. In addition, Marzinotto addresses the issue of pro-cyclicality and argues that it is inappropriate to state that the SGP has twisted fiscal authorities' arms into pro-cyclical action. Empirical evidence shows that German fiscal policy has been fairly pro-cyclical since the early 1990s and earlier. In this respect, it can hardly be said that the SGP, whether strictly applied or not, is a self-defeating device. Why, then, is fiscal 'misbehaviour' more evident under EMU than in the preceding period? The argument developed here is that German social actors have resorted to fiscal authorities more than in the past to obtain compensations in exchange for wage moderation. Strong domestic pressures would thus be at the root of fiscal misbehaviour.

In Chapter 5 Robert Woods evaluates the SGP with reference to the analysis of effective macroeconomic policy frameworks. He considers the impact of recent reforms of the SGP and the challenges that are likely to arise in the immediate future. Effective macroeconomic policy frameworks help to achieve high and stable levels of economic growth and employment. Accordingly, Woods offers a set of general principles for effective policy frameworks characterised in terms of credibility, flexibility and legitimacy. Experience has led countries to adopt frameworks with 'constrained discretion', including clear long-term goals, a pre-commitment to sound institutional arrangements, and maximum transparency.

Evaluating the performance of the SGP with respect to the three criteria of credibility, flexibility and legitimacy, Woods argues that the recent reforms can improve the operation of the SGP. He concludes by discussing future challenges in implementing the pact, including: the development of complementary national fiscal frameworks and increasing ownership; taking structural reforms into account; the challenge of EU enlargement; discretionary fiscal stabilization in the context of a monetary union; and data surveillance and transparency.

Finally, in Chapter 6 Michael J. Artis and Luca Onorante propose an economic reading of the reformed SGP that challenges the widespread assumption that the demise and reform of the SGP have rendered it useless. They treat the SGP as an example of regime-based international policy coordination. Drawing on a comparison of the SGP and the Bretton Woods System, they point out that both regimes were founded on rule-based coordination, multilateral surveillance, a central inspection body, and sanctions that were ultimately unenforceable. These arrangements do work, but are always subject to contestation and the need for revision. What did we learn from the recent reform of the SGP? The answer, according to the authors, is almost nothing. This means that the formal sanctions procedure of the SGP is still unreliable and the system is likely to come under stress in periods of slow growth/recession. Nevertheless, surveillance 'works' and the '3 per cent' has acquired credibility. The reforms capitalize on this credibility despite the limited capacity for real sanctions.

The reforms retain the emphasis on the deficit constraint of 3 per cent, but they admit some relevance for debt considerations and they relax the conditions under which an excessive deficit procedure would be inaugurated and extend the adjustment period, whilst substantially adjusting the role of the medium-term target.

As far as cyclical adjustment is concerned, the SGP started with a declaration of a medium-term aim of reaching balance or slight surplus. Subsequently – and now – this takes the form of a cyclically adjusted target which in the reformed version (a) is designed to ensure that the actual deficit will not exceed 3 per cent and (b) can be modified to ensure a transition to a stable debt ratio. The reform is based on two arms: a preventive arm and a corrective one. The preventive arm rests on Medium-Term Objectives (MTOs). These are differentiated among member states. They may diverge from a close-to-balance or in-surplus position depending on their current debt ratio and potential growth, will provide a safety margin with respect to the 3 per cent deficit limit and will ensure rapid progress towards sustainability. Country-specific MTOs would be, in cyclically adjusted terms and net of one-off and temporary measures, between −1 per cent of GDP and in balance or surplus.

With respect to the corrective arm, there are different scenarios:

- free fiscal policy (no pact)
- SGP: below 3 per cent after two years, −0.75 per cent threshold, immediate correction
- (severe) economic downturn: 0 per cent threshold
- one more year to go back to 3 per cent
- progressive structural consolidation(−0.5 per cent structural yearly)
- the three above (interaction effect?).

The evaluation criteria are the variability of the cycle and the average deficit.

It is of course very difficult to define which scenarios are more likely and draw elaborate conclusions. However, the authors demonstrate in the chapter that the new range of MTOs appears reasonable overall.

The current and modified rules of the SGP are unlikely to bite and, therefore, they will make little difference to stabilization.

NOTES

1. This is to express my gratitude to Professor Alan Cafruny, who read and edited this Introduction and the Conclusions.
2. When European finance ministers agreed at the Dublin Summit in 1996 on the need for a fiscal framework to reinforce the powers of the future European Central Bank, they called it the Stability Pact. The words 'and Growth' were added later, at the Amsterdam European Council of 1997. The Amsterdam resolution establishing the Stability and

Growth Pact may be found at the following web-site: http://www.ena.lu/mce.cfm, accessed on 6 September 2005. The EU legislation relating to the Stability and Growth Pact may be found at the following web-site: http://europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htmb, accessed on 6 September 2005.

3. For a thorough account of the role of France and Germany in the making of the SGP see Heipertz and Verdun (2005).
4. For more details see Tsoukalis (1997).
5. For other references to the death of the SGP see *Financial Times*, 22 March 2005, 'Death of a Pact'; and *Economist*, 29 November 2003, 'The Death of the Stability Pact: Europe and the Euro'.
6. For the most recent literature see Allsopp and Artis (2003); Annett, Decressin and Deppler (2005); Artis (2002); Artis and Buti (2000); Balassone and Franco (2000); Balassone *et al.* (2004); Begg and Schelkle (2004); Buti and Franco (2005); Eijffinger (2005); and Wyplosz (2002, 2005).
7. For a complete analysis of the neo-functionalist and institutionalist approaches to EMU see Talani (2004), Ch. 1.

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