# Stability and Growth Pact and Fiscal Discipline in the Eurozone*

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**Abstract**

The Economic and Monetary Union in the European Union relies on fiscal coordination among member states to prevent excessive levels of deficit and debt and to ensure the stability of its single currency. This paper examines the framework of fiscal rules put in place before and after the launch of the euro. I find that enforcement of the budgetary limits in the Stability and Growth Pact was insufficient at the institutional level by the European Commission and by the Economic and Financial Affairs Council (ECOFIN), as well as at the level of the financial markets. In order for fiscal rules across the Eurozone to be successful, proposals for reforming the Pact, including the Six-Pack and the Fiscal Compact Treaty, will need to address enforcement problems on both political and market levels.

**Keywords:** Stability and Growth Pact; fiscal rules; deficits; budgetary discipline

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## Executive Summary

The 2008 financial crisis, sparked by the U.S. subprime mortgage crisis, is one of the first financial crises to be truly global in nature. Not only did the crisis deliver a severe shock to the world's financial system, symbolized by the fall of Lehman Brothers in 2008, in addition to throwing advanced economies in the world into a deep recession, it also challenged the existence of the European Union's (EU) single currency, the euro, and the EU as a whole, in terms of its political, institutional, social, economic, and monetary policies. The sovereign debt crisis in Europe has raised doubts over the Union's institutions and the rules that are supposed to provide for the proper functioning of monetary union. For over 50 years, the institutions of the EU have been built in "small steps" and the Union has gradually expanded throughout the years from 6 to 27 members. In 1999, European cooperation and unity became much more concrete with the launch of the third stage of the Economic and Monetary Union by 11 member states and permanent abandoning of national currencies. To achieve this end, all countries had worked for several years to stabilize inflation, lower government spending, reduce debt and avoid devaluation of the currency, in order to achieve the convergence criteria of the Maastricht Treaty required to create such a monetary union.

The euro has symbolized a new stage in European integration and the monetary union was to be the poster child of the success of EU cooperation. Given the variability of national budgets and the lack of formal budget limits on member states after the adoption of the single currency, and in order to reassure critics of the euro and financial markets, regulations on public finances of Eurozone countries became indispensable to the functioning and stability of the euro, so as to avoid spillover effects on all Eurozone countries. Financial mismanagement in a country could reduce market confidence and lead higher borrowing rates for all countries. Introduced in 1997 as resolutions of the Council for Economic and Financial Affairs (ECOFIN), which includes finance ministers from each member state, the Stability and Growth Pact (SGP) was designed to strengthen fiscal discipline on deficits and debt levels of member states.

The responsibility for enforcing limits on deficit and public debt of all countries of the Eurozone, set at 3% and 60% of gross domestic product (GDP), respectively, fell on two players. First, member states were held responsible for observing the Pact by the European Commission and ECOFIN, which regularly monitor compliance and issue warnings as necessary. Second, the financial markets had the power to affect interest rates on sovereign debt, thereby signaling its level of confidence with the country's public finances. On March 20, 2005, following an informal agreement with Germany and France, the SGP was "reformed" by ECOFIN to relax the enforcement of the fiscal criteria. In the few cases where the European Commission believed there to be a violation of the deficit limit, it recommended that ECOFIN launch the Excessive Deficit Procedure against the member state concerned.

This paper shows that the implementation of the Maastricht convergence criteria for joining the monetary union and for the SGP was insufficient on both institutional and financial market levels. Upon accession to the euro area, the levels of debt and deficit relative to GDP in several countries, including those of Greece and Italy, were well above the limits established by the Maastricht Treaty. However, stipulations in the Treaty granted an exception to these countries provided that the level of debt was declining. After the official implementation of the SGP after the launch of the euro, the levels of deficit and debt of many member states climbed, without significant reaction from either the European institutions or the financial markets, where borrowing rates were at record lows for Eurozone states. Financial sanctions, permitted by the Treaty, were never applied on any member state.

The Eurozone and Europe cannot be fully satisfied by reform proposals that do not bring a permanent solution to the problem of implementation of the budget limits at the institutional and market levels. First, the issue of lack of discipline and motivation remains relevant, despite discipline tools established by the Treaties. Since the power to sanction is granted exclusively to the ECOFIN Council, which includes finance ministers from each member state, countries with high levels of deficits are incentivized to vote against sanctions for fear that these would be applied against themselves. After accession to monetary union, each country would no longer have the same motivation to reduce the debt and deficit, as the convergence criteria have been met and the country is already benefiting fully from the euro. Moreover, in the financial markets, the growth of debt had little impact on premiums for credit default swaps (CDS), an agreement that insures against risk of sovereign default. With the advent of the crisis in Europe, the situation worsened with the dramatic rise in CDS premiums and interest rates for many Eurozone countries, as well as with a general deterioration of credit ratings on sovereign debt by rating agencies, all of which made borrowing more difficult for countries in trouble.

The Fiscal Compact Treaty, signed in March 2012, would put in place strict budgetary rules for countries that have ratified the treaty. The rule would have to be included in national constitutions and the correction mechanism would also become automatic. However, the new compact only reinforces the rules and sanctions that already exist in current treaties. Therefore, the effect of the new Treaty on financial markets is also doubtful. This paper examines alternative proposals that attempt to reform the Stability and Growth Pact to solve its implementation problems. To this end, the study of SGP could help reflect upon questions of governance for European institutions and on the policies that could bring stability and stimulate growth in the Eurozone and throughout Europe.

## 1. Introduction

After the Second World War, the idea of European integration, or the creation of pan-European institutions, was built upon the belief of bringing permanent peace to the continent. For over half a century, the institutions that eventually became the European Union (EU) took steps to "lay the foundations of an ever closer union among the peoples of Europe" and to "ensure the economic and social progress of their States by common action to eliminate the barriers which divide Europe" (Treaty of Rome, 1957). On May 9, 1950, Robert Schumann, then French Minister of Foreign Affairs and considered one of the founding fathers of the European Union, said the following on the subject of European integration:

« *L'Europe ne se fera pas d'un coup, ni dans une construction d'ensemble : elle se fera par des réalisations concrètes créant d'abord des solidarités de fait.* »

(Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity.)[1]

The statement remains one of the founding principles of the EU, where a "step-by-step" method of integration ("Monnet Method") gradually increases the level of cooperation among European countries as the EU expands its membership. Having created a single market and established the freedom of movement of goods, people, and capital in the union, the EU saw the adoption of a common currency as yet another important milestone and a further step toward "ever closer union". The success of the euro not only had serious implications for the experimenting monetary union, but also for the European Union as a whole.

Yet, just as the euro was celebrating its tenth anniversary in 2009, Europe's common currency faced one of its greatest challenges. With the onset of the global financial crisis, the viability of the euro was put in doubt by financial markets, and the ratings of sovereign debt of

[1] Declaration of 9 May 1950 ("Schuman Declaration")

all member states in the Eurozone faced downgrading by ratings agencies. Since the ratification of the Treaty of Maastricht in 1992 that provided the legal foundation for the introduction of the euro, there has been thorough and in-depth discussion about the feasibility of such an ambitious project. While currency unions have been attempted previously in Europe, notably the Latin Monetary Union in the nineteenth century,[2] there was widespread disagreement about whether twelve or more disparate countries, at various stages of economic development, could abandon their original currencies and transfer national sovereignty over monetary affairs to a supranational authority, the European Central Bank.

One particular point of concern, particularly in traditionally fiscally conservative countries such as Germany, was the high levels of debt and budget deficits present in many other European countries that were about to join the new currency union (the "Eurozone"). German experiences with hyperinflation meant that the German voting public placed substantial significance on price stability, which remains the core mission of the German central bank, the Bundesbank. In order to reassure many of the euro's detractors, the Treaty of Maastricht put in place specific economic criteria to fulfill before a country could enter the monetary union (commonly referred to as the Maastricht convergence criteria). These included minimal conditions for budget deficits, debt levels and inflation rates. It was argued that in order to keep the euro strong and stable, the finances of all of its underlying member states must be well-

[2] The Latin Monetary Union, established in 1865, was a monetary union in Europe that formed part of the international monetary system based on the gold standard. The four founding countries (France, Belgium, Italy, and Switzerland) fixed their national currencies to a standard of 4.5 grams of silver or 0.29032 gram of gold and made their currencies freely interchangeable. They were joined by Greece three years later. Numerous other countries, including Austria-Hungary, Spain, Romania, Serbia, and Bulgaria either concluded bilateral accords with the Union or adopted the standards unilaterally. The Union also inspired the creation of a Scandinavian Monetary Union between Denmark and Sweden. The proper functioning of the Latin Monetary Union was impaired by the fluctuations in the price of silver and gold, as well as fluctuations in the actual value of the currency relative to its legal value, which resulted from the issuance of paper currency and the debasing of coins. The system lasted in practice until the outbreak of the First World War, when many countries suspended the convertibility of national currencies to gold. The Union was formally dissolved in 1927.

managed as well as to reassure the financial markets and to discourage fiscally imprudent policies from damaging the whole of the currency union. Most countries, with a few exceptions, fulfilled their targets before the deadline and successfully transitioned into the single currency union.

Given the permanent nature of monetary union, there was a need for a set of rules to govern public finances of member states once they entered the Eurozone. To ensure that Eurozone members continued maintain sound public finances necessary for the stability of the euro, the Stability and Growth Pact (SGP) was later established to provide continuity after the economic criteria in the Maastricht Treaty were fulfilled.

One of the widely cited causes for the euro sovereign debt crisis that began around 2009 was overspending and unsustainable debt levels among countries in the Eurozone in the decade after the euro was launched. In response, politicians from across the Eurozone have demanded and announced austerity measures to reverse this trend and restore lower deficit and debt levels. However, it is worth noting that the Maastricht convergence criteria for entry into the monetary union and the subsequent Stability and Growth Pact were created with the explicit purpose of keeping overspending and excessive indebtedness in control. The debt crisis calls into question the effectiveness of the convergence criteria and the inability of the SGP in averting the crisis.

This paper examines whether the economic criteria enshrined in the Maastricht Treaty and in the Stability and Growth Pact were effective fiscal targets for the 12 original Eurozone countries: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, as well as Greece, whose date of adoption was delayed by two years to 2001 (EU-12). Eurozone, as referred to in this paper, does not include Slovenia, Slovakia, Malta, Cyprus, and Estonia, which have subsequently adopted the euro (EU-17). Since their entry into the Eurozone occurred almost a decade after the formation of the euro, each of these countries adhered to the Maastricht convergence criteria and the Stability and Growth Pact on a separate timeline. Therefore, their deficit and debt levels cannot provide direct comparison with those of other Eurozone countries with regards to the effectiveness of fiscal targets and should be examined separately in another study.

In analyzing this topic, the paper first gives an overview of the historical background for the adoption of both the Maastricht convergence criteria and the SGP and their mechanisms for enforcement at the European institutional level. The paper then further looks at whether there was sufficient enforcement, institutional and market-based, of these standards in the period leading up to the European sovereign debt crisis. Following this is an evaluation of the effectiveness of these criteria and examines current literature on the subject, outlining the major issues that affect their enforcement. Finally, the paper concludes by a discussion of the Fiscal Compact Treaty and the impact of the SGP on Greece and its sovereign default, followed by an examination of other alternatives to enforcing fiscal discipline in the Eurozone countries and their feasibility in maintaining stability of the Eurozone and preventing deterioration in the fiscal conditions of member states.

## 2. Background of the Maastricht Convergence Criteria and the Stability and Growth Pact

### i. Maastricht Convergence Criteria

The euro, the single currency of the monetary union created for member states of the European Union (EU), was established by the provisions of the 1992 Maastricht Treaty (formally the Treaty on European Union, signed in Maastricht, Netherlands). The Treaty provided the legal foundation for the creation of the single European currency, later named the euro. To enter into the monetary union, member states were required to adhere to "convergence" criteria, including rules on budget deficit levels, debt levels, low inflation, and interest rates close to the EU average.

The first attempt at the creation of a common currency zone as a step in European integration goes back to an initiative in 1969 by the European Commission to integrate Europe's monetary policies,[3] and the Werner Report published in 1970 outlined steps for cooperation in economic and monetary policies. Over the following decade, the proposed Economic and Monetary Union (EMU) was given serious consideration for the adoption of monetary cooperation in several stages, culminating in the establishment of the European Monetary System (EMS) by 1979, which linked exchange rates between member states. The MacDougall Report (1977) was one of the first reports published on role of public finance in an integrated Europe.[4] The report came down in favor of greater fiscal coordination among member states and a substantially larger budget devoted to the European Economic Community for better

[3] Commission Memorandum to the Council on the Co-ordination of Economic Policies and Monetary Co-operation within the Community ("Barre Report"), http://ec.europa.eu/economy_finance/emu_history/documentation/chapter2/19690212en015coordineconpoli.pdf
[4] MacDougall Report, Vol I: "The role of Public Finance in European Integration" (1977/04/01)

integration, which were arguments later used to support fiscal coordination as part of a monetary union. In Robert Mundell's seminal 1961 paper on optimal currency areas (OCA), he argues that members of any successful monetary union must allow for fiscal transfers between areas that vary in prices and wages to adjust for regional shocks to the economy. However, this is difficult to achieve in Europe, where strong national identities make any substantial risk sharing politically unviable. Nonetheless, there is a perceived need to align fiscal conditions in member states to avoid larger divergences. The Delors Report (1989) outlined the three stages for the EMU, including the achievement of economic convergence and the definition of future governance in the Eurozone.[5] (See Appendix 1)

The criteria for economic convergence for countries to qualify for entry into the monetary union as part of the third stage of the EMU were enshrined in the Maastricht Treaty, adopted in 1993. The four main Maastricht convergence criteria are based on Article 109 j of the Treaty (subsequently renumbered as Article 121(1) and then Article 140 by the Treaty of Lisbon [2009] into the consolidated Treaty on the Functioning of the European Union):[6]

> - *the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;*
>
> - *the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6);*
>
> - *the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;*

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[5] European Commission, http://ec.europa.eu/economy_finance/euro/emu/road/delors_report_en.htm

[6] Consolidated versions of the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2010:083:SOM:EN:HTML

*- the durability of convergence achieved by the Member State and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in the long-term interest rate levels.*

The reference values were defined in the annexed protocols on the excessive deficit procedure and on the convergence criteria:[7]

**Inflation rates**

- Cannot exceed 1.5 percentage points above average of the three member states with the lowest inflation rates

**Government Finance**

- **Annual government deficit:** Deficit-to-GDP must be close to or be under 3% except for exceptional cases
- **Government debt:** Gross debt-to-GDP ratio cannot exceed 60%. If not achieved, then the ratio must be diminishing and approaching the reference value.

**Exchange Rates**

- Joined the exchange-rate mechanism (ERM) under the European Monetary System (EMS) for two consecutive years and cannot devalue currency during the period

**Long-term Interest Rates**

- Nominal long-term interest rate cannot exceed 2 percentage points above average of the three member states with lowest inflation

The Maastricht Treaty obliged most EU member states to adopt the euro upon meeting certain monetary and budgetary convergence criteria, although not all states have done so. In the Treaty, the United Kingdom and Denmark, per their request, were granted "opt-out" exemptions from having to move to the stage of monetary union which would result in the introduction of the euro. However, Denmark has participated in the ERM II mechanism since 1999, tying the exchange rate of the Danish krone to within 2.25% of the euro, effectively pegging its currency

[7] Treaty on European Union (TEU), http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html

to the euro. Sweden, although a member of the EU, remains outside of the currency zone by not meeting all of the monetary and budgetary requirements of the convergence criteria following a referendum in 2003 rejecting the introduction of the euro.

Since the Maastricht Treaty is primary law for all members of the EU, the Maastricht convergence criteria were also applied to countries that have entered the zone subsequently and to the remaining member states in the European Union that have pledged but have so far not joined the monetary union. Since the United Kingdom and Denmark were exempt from the third stage of monetary union, they are not bound by the convergence criteria unless they decide to adopt the single currency. However, they will still need to adhere to limits on government finances as discussed in the next section.

The purpose of setting the Maastricht criteria was to maintain the price stability within the Eurozone and for the new currency, and establish standards that new member states that can work towards. Since monetary union was to be a permanent change, the criteria were established so that members of the monetary union would not harm the stability of the single currency and that their inherent economic conditions are conducive to a successful transition to the euro. Article 104b in the Maastricht Treaty (renumbered TFEU Article 125 by the Treaty of Lisbon) prohibits transfer of funds between member states, for fear that fiscally irresponsible states would be able to borrow at lower rates at the expense of more frugal states that have lower levels of debt and deficit levels relative to their economy and would expect transfers from other countries when they suffer from excessive debt.

In particular, there were concerns among the voting public in Germany and other countries such as Netherlands about the new currency. One reassurance that was made to them was that the euro would be governed and run by an impartial central bank, the European Central Bank, and that the new currency would be as stable as the Deutsche Mark. It was argued that once all of the countries' fiscal conditions were in line, with low debt and deficit levels, the probability of default on any country's debts were reduced and alleviated fears that one country would bankrupt the entire monetary union. The Maastricht convergence criteria provided countries such as Italy and Greece with the incentive to cut down on their public expenditures and debt levels in order to meet the criteria for entering the euro. Eager to join a political club of advanced nations, these countries also wanted to reap the benefits of the monetary union, the most notable of which include lower borrowing costs, low inflation, exchange-rate stability for engaging in external trade, and expanded trade within the EU's internal market.

As seen in the table in Appendix 2, many countries did not in fact meet all of the reference values for entry in the Eurozone with regards with government finances. However, the Treaty stipulated that if countries were approaching the specified levels of each condition, they could be considered to have satisfied the condition. For example, Italy had a debt-to-GDP ratio of 113.6% in 1999, but fell from 137.8% to 113% between 1993 and 1999 (Eurostat). It was believed that by joining the euro, Italy could continue to cut down on its debt levels without having to delay the launch of the new currency. If on the other hand, the country were denied entry into the monetary union, it would risk failure for the project, since Italy was one of the core members of the European Union.

Few countries in fact met all of the conditions if reference values were applied strictly and some have not reached those levels for many years prior to accession to the EMU. As shown in Appendix 3, in 1998, the Council of ministers considered 11 countries to have satisfied the Maastricht Convergence criteria, with the notable exception of Greece, which in 2000 was subsequently granted admission to the EMU, effective on January 1, 2001. However, only France, Ireland, Luxembourg, Portugal and Finland satisfied the debt-to-GDP reference ratio of 60%. For the remaining countries, debt levels were considered to have been sufficiently declining and did not preclude their accession to the single currency.

Differences between figures used in Appendices 2 and 3 can partly be explained by manipulation of official statistics. Appendix 2 data are figures adjusted by Eurostat to account for fraud in the case of Greece, and "creative accounting" by countries such as Belgium, France, and Italy to artificially lower published deficit and debt statistics (De Grauwe, 2009). There is further discussion of this phenomenon in Section 5. Although each of the 11 original Eurozone countries is judged to be fully compliant with the Maastricht convergence criteria in 1999 (with the addition of Greece in 2000), revised data show that without stipulations in the Treaty that allowed for deviations from the reference values, many of the countries would not have been able to adopt the euro. (See Section 3 for data regarding compliance with deficit and debt targets from 1995 to 2007)

The rest of this paper focuses on the provisions relating to government finances from the Maastricht Treaty regarding deficit and debt levels. On the whole, countries have been satisfactory with the fulfillment of the other convergence criteria on price stability, the exchange rate mechanism, and long-term interest rates.

**ii. Stability and Growth Pact**

While the euro is a supranational currency, the EU has few rules beyond the Maastricht convergence criteria regarding policies in taxation and government expenditure in member states once they joined the euro, despite the fact that this has an important impact on the sustainability of the currency union.

The Maastricht Treaty partly addressed this issue with the Excessive Deficit Procedure, but the latter was criticized as vague and unsatisfactory. Article 104c requires governments of member states to avoid excessive deficits and the European Commission, the executive body of the EU, was to monitor deficit levels of each country and report to the Council of the European Union, a body of national ministers from all member states, if there are gross deviations from the reference values. The Council has the power to issue warnings to member states and impose fines as recourse.

The idea of a more detailed set of procedures to handle excessive debts, or a “Stability Pact” was proposed by German finance minister Theo Waigel in the mid-1990s. Germany had long maintained policy that emphasized low inflation, which had been an important part of the German economy's strong performance since the 1950s and subsequently. The German government hoped to ensure the continuation of that policy, which would limit the ability of governments to exert inflationary pressures on the European economy. Justification for such a pact was twofold: first, excessive debt cannot be financed in public markets and can lead to monetary financings by central banks; second, a free-rider externality problem exists where debt-ridden countries could overspend to a point where they could demand support from other countries (Wyplosz, 2006). Given that countries needed to forego control of monetary and exchange rate policies, countries were presumed to gravitate towards the use of fiscal policy and excessive fiscal deficits to manage macroeconomic shocks (Goodhart, 2006).

On the initiative of the German government, member states met to discuss putting together a pact to deal with excessive deficits and debt levels after the introduction of the euro to replace the incomplete set of procedures under the Maastricht Treaty. With 11 to 12 members to enter the Eurozone, European leaders negotiated to establish a method to ensure the continued compliance of the Maastricht convergence criteria once the member countries were in the union.

In 1997, leaders agreed to a set of fiscal rules, titled the Stability and Growth Pact (SGP), governing these matters.[8] The SGP is an agreement that is to be applied to all member states of the European Union and was set up to complement the creation of the EMU. Elaborating and supplementing the general provisions in the Maastricht Treaty, the purpose of the SGP was to maintain and enforce low budgetary deficits in the EMU and safeguard "sound public finances" (TFEU Article 119), and that Member states having adopted the euro and met the Maastricht convergence criteria would continue to observe them. (For an analysis of the origins of the SGP, see Heipertz and Verdun, 2004)

The two major SGP criteria that member states must respect are:

(1) Annual government budget deficit no higher than 3% of Gross Domestic Product (GDP)

(2) Government debt lower than 60% of GDP, or diminishing and approaching that value.

The SGP became the rule-based framework to coordinate national fiscal policies in the EMU and consists of a preventive and a dissuasive (corrective) arm.[9]

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[8] Council Regulations 1466/97 and 1476/97, Council Resolution 97/C236/01-02

[9] European Commission, http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

Based on the concept of "multilateral surveillance" as established in the Maastricht Treaty,[10] the preventive arm requires member states to submit annual stability programs (for Eurozone countries) or convergence programs (for countries outside the Eurozone) to the Commission and the Economic and Financial Affairs Council (ECOFIN), showing how they plan to achieve or safeguard sound fiscal positions to meet their budgetary objectives. The Commission then assesses these programs and ECOFIN gives an opinion on them and may make its recommendations public. The preventive arm includes two policy instruments.

First, in addition to the existing GDP deficit limit of 3 percent, the preventive arm also requires countries to strive for a medium-term objective (MTO). In the original agreement from 1997, countries were urged to attain a common "close-to-balance or in surplus" position to deal with normal cyclical fluctuations. The MTO was at the time interpreted as a deficit no larger than half a percent of GDP over the cycle (Annett, 2006). To avoid breaching the 3 percent reference value, member states needed a narrower range to allow for a sufficient cyclical safety margin when automatic stabilizers are operated in an economic downturn. In the 2005 revision, however, countries could set their own MTOs based on sustainability factors, within certain limits (including a maximum 1% of GDP deficit).[11] MTOs are set in structural terms and are cyclically adjusted with respect to the economic cycle, and exclude one-off and temporary measures. ECOFIN can ask a member state to adjust its convergence or stability program and monitors implementation of the programs to identify divergence from the MTO or the adjustment path towards it (European Commission, 2011).

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[10] TFEU Article 121

[11] Summaries of EU Legislation, "Council Regulation (EC) No 1466/97", http://europa.eu/legislation_summaries/economic_and_monetary_affairs/stability_and_growth_pact/l25019_en.htm

Second, ECOFIN can issue an early warning to prevent the occurrence of an excessive deficit. With the use of official policy advice, the Commission, through ECOFIN, can directly address policy recommendations to a member state with regards to the broad implications of its fiscal policies. ECOFIN can make a recommendation to a member state to take prompt corrective measures if the excessive deficit persists or worsens.[12] According to von Hagen (2010), the preventive arm had little prominence and did not gain much attention in public debates.

The dissuasive or "corrective" part of the Pact governs the Excessive Deficit Procedure (EDP) created by the Maastricht Treaty.[13] The SGP provides specific definitions to breaches of the 3% deficit limit with regards to triggering the EDP. If it is decided that the deficit is excessive in the meaning of the Treaty, ECOFIN issues recommendations to the relevant member state, providing guidance to correct the excessive deficit and gives a timeframe for doing so. If the ECOFIN believes that the member state has failed to comply with the recommendations, it can trigger further steps in the procedures such as requiring publication of information and demanding a non-interesting bearing deposit with the EU. ECOFIN abrogates the EDP decision when the excessive deficit is corrected by the member state. However, if the member state fails to comply, the Council can decide to move to the next step of the EDP, the ultimate possibility being to impose financial sanctions. (See Appendix 5 for a more detailed outline of steps under the preventive and the correct arms of the SGP) The SGP in effect shifted the role of the Commission and increased the importance of ECOFIN in taking action against member states. Since ECOFIN is composed of ministers from member states, this reduced the credibility of the framework since they are reluctant to impose serious sanctions on other member states.

[12] Article 121(4), TFEU
[13] Article 126, TFEU

However, in 2002, Germany avoided an early warning from the Commission for failing to adhere to the deficit criterion in the SGP and approaching the 3 percent limit for its deficit by striking a deal with ECOFIN. In January 2003, ECOFIN issued an early warning to France to urge it to balance its budget. In November 2003, the Commission presented its findings to ECOFIN, stating that both Germany and France had not taken adequate steps to reduce excessive deficits.

ECOFIN decided not to proceed with the EDP against France and Germany, which was, however, later declared by the European Court of Justice (ECJ) to be an inadmissible decision since it was not preceded by a Commission proposal. Political pressure from these two countries led to the effective suspension of the Pact and the EDP was formally suspended in December 2004.

The reform of the fiscal regime was subsequently announced in March 2005, with more “flexibility” for countries to account for running large deficits but “essentially the same form as previously” (Andrews, 2010). Reference values were left untouched since they were part of the TFEU and discretionary powers were extended. The most important changes include revised MTOs that account for national differences, as well as clarification of “exceptional and temporary” excesses and “other relevant factors”.

Compared to the original SGP which purported to enable the Commission and ECOFIN to react quickly to deteriorations in fiscal policies and to impose sanctions within 10 months, the 2005 “reformed” SGP loosened the escape clauses, lengthened deadlines for taking action, and expanded the circumstances under which longer adjustment periods are permitted (Annett, 2006). These parameters included the behavior of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures. No EDP procedure will be launched if the excess of the government deficit over the 3% of GDP threshold is considered temporary and exceptional and the deficit remains close to the threshold.

Under the "two-pillar approach" of the reformed SGP, countries were also expected to undertake a minimum improvement in their structural balance of 0.5% of GDP as a benchmark, in addition to meeting its 3% of GDP deficit limit.[14] It was argued that with an aging population, member states faced the challenge of ensuring the long-term sustainability of public finances, and that this needed to be taken into account when assessing stability programs submitted to the Commission. The second pillar places an expenditure benchmark that requires countries to keep expenditure growth at medium-term rate of potential growth, unless it was offset by a revenue increase.

The ECOFIN officially agreed on the reform of the SGP in June 2005. The ceilings of 3% for budget deficit and 60% for public debt were maintained, but the decision to declare a country in excessive deficit can now rely on certain parameters: the behavior of the cyclically adjusted budget, the level of debt, the duration of the slow growth period and the possibility that the deficit is related to productivity-enhancing procedures (Senior, 2009).

Although deficits and debts remained high during the few years following the introduction of the euro, levels were coming down and it was believed that there would not be a significant strain on the European economy. Especially since France and Germany broke the rules in 2005, there was little political incentive to follow these conditions to the letter, since

[14] Council Regulation of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (EC/1467/97)

none of the member states was willing to impose financial sanctions on a fellow member, thereby worsening the fiscal conditions of the country.

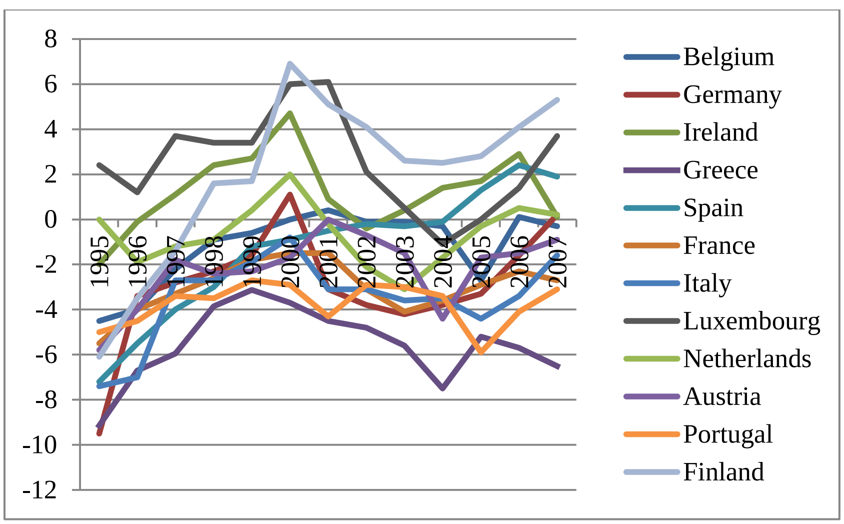
With the arrival of the global financial crisis in 2007, most countries went into a continent-wide recession, driving up the magnitude of deficits as countries attempted to inject stimulus into a recessionary economy. In addition, they were also faced with higher unemployment benefits and other costs related to economic downturns. Countries reasoned that this qualified as an exceptional circumstance as defined in the SGP, and increased their deficit levels well beyond 3%, arguing that over the long-term, the deficit level would remain under that standard.

In the subsequent sovereign debt crisis that began in 2009, debt and deficit levels of each country came into the spotlight and questions were raised about the effectiveness of the Maastricht criteria and the Stability and Growth Pact in preventing such a crisis. In the following section, the actual performance of the Maastricht criteria and the Stability and Growth Pact will be examined from the signing of the Maastricht Treaty to the onset of the global financial crisis in 2007.

## 3. Economic Figures and Target Achievement 1995-2007

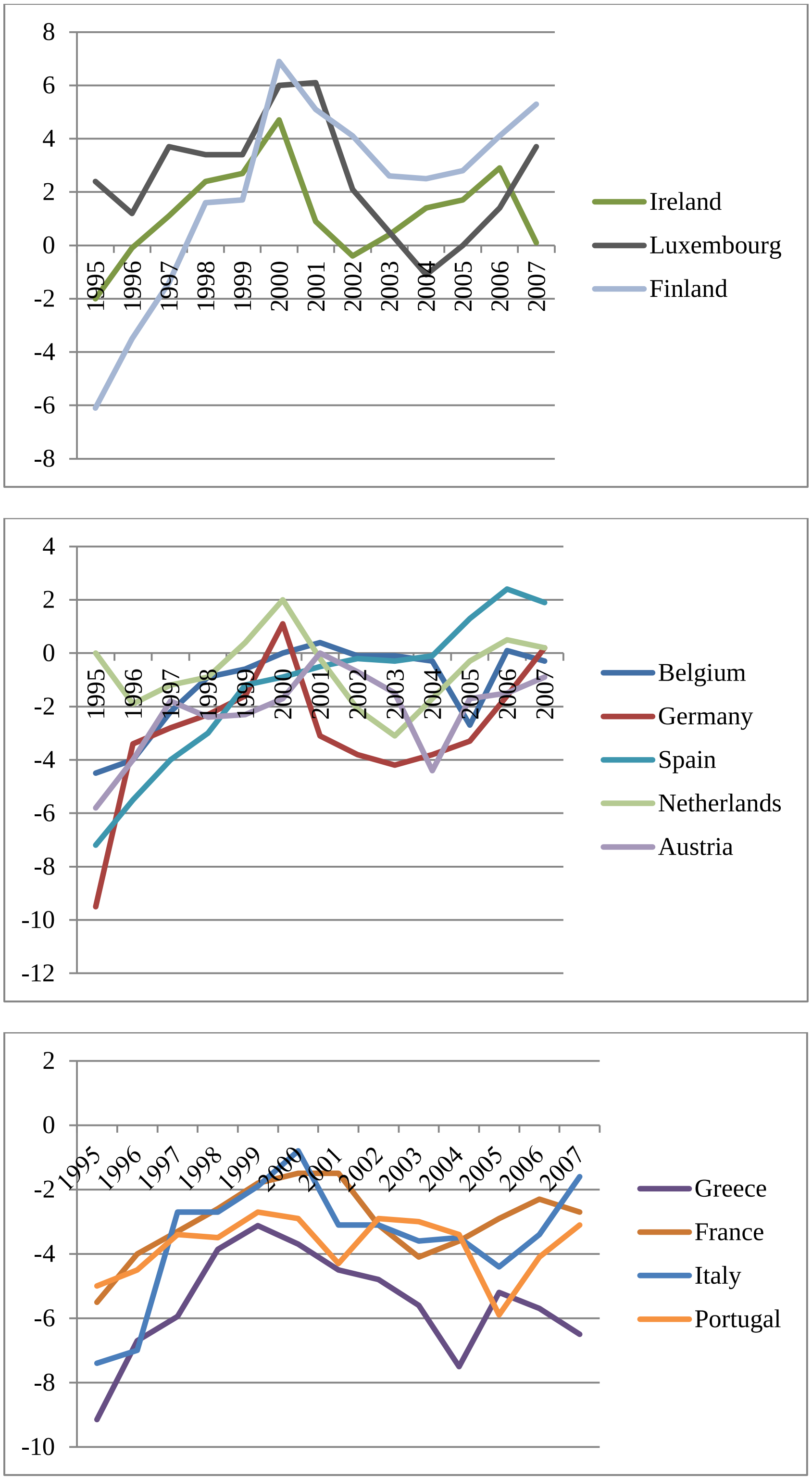
Given the range of economic performance in the 12 Eurozone countries, the twelve Eurozone countries have been categorized according to their performance with respect to government finances in this section.

In the charts below, the general government deficit/surplus is defined as general government net borrowing/lending according to the European System of Accounts. Primary budgetary balance is the difference between the revenue and the expenditure of the general government sector, which comprises the sub-sectors of central government, state government, local government and social security funds. The series are presented as a percentage of GDP and in millions of euro. GDP used as a denominator is the gross domestic product at current market prices (Eurostat).




Source: Eurostat

**Figure 1.1: Eurozone government surplus/deficit as percentage of GDP**




Source: Eurostat

**Figures 1.2: Government Surplus/Deficit as Percentage of GDP**

During the period from 1995 to 2007, all Eurozone countries, with the exception of Luxembourg and Ireland, had deficit levels exceeding 3% of GDP at some point during the period. However, as observed in Figure 1.2, Finland made substantial efforts to improve its deficit levels. Ireland, which was a country later hit severely by the sovereign debt crisis, held surpluses for almost the entirety of this period and fully complied with the deficit rule.

Meanwhile, in the second group of countries, Germany and Spain made substantial efforts to have fiscal surpluses but most still remained deficit countries. Nonetheless, their deficit levels were still within 3% of GDP in order to meet the Maastricht convergence criteria by 1998.

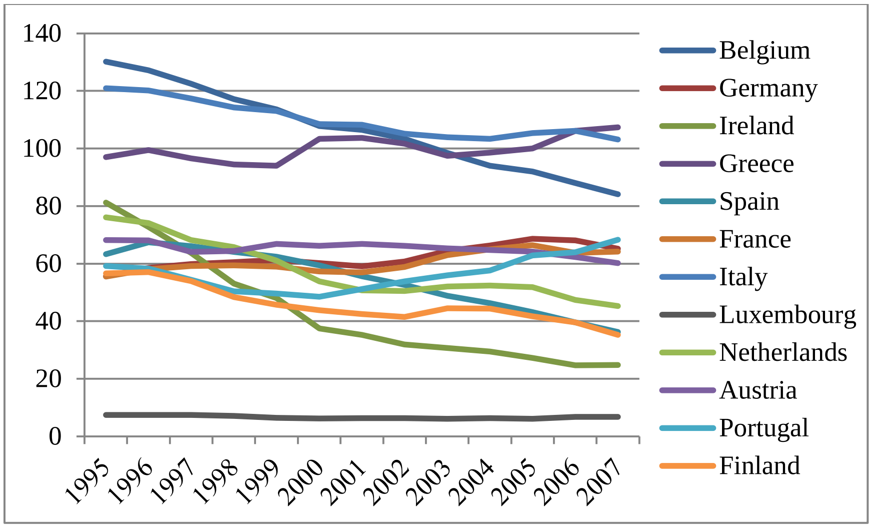
The last group of countries maintained high deficit levels, especially after 1999 and admission to the Eurozone. Greece and Portugal in particular had deficit levels that have remained higher than the 3% level and did not fully adhere to the government deficit requirement under the SGP. It is noteworthy that France, considered a core member of the monetary union, also had a high level of deficits, and although having lowered that to below 3% of GDP before entry into the Eurozone, it increased its deficit again after 2001.

By the end of 2004, only half of the euro area countries had fiscal positions that could be deemed as "close-to-balance or in surplus," defined as a minimum one-half percent cyclically adjusted deficit. These countries included Belgium, Finland, Netherlands, and Spain. Countries such as France, Germany, Greece, Italy, and Portugal remained far off their objectives. As a result, these countries ended up posting deficits in excess of 3 percent that pushed them close to triggering the Excessive Deficit Procedure.

Government deficit levels of smaller countries began to diverge from those of larger countries. The SGP tended to have a much more important impact for a core group of smaller countries, in addition to Spain, while a weighted average of the three largest countries, i.e. France, Germany, and Italy, moved away from the targets (Annett, 2006; Buti and Pench, 2004). The SGP was originally intended to reassure German voters, but France and Germany ended up having above-average deficit levels.

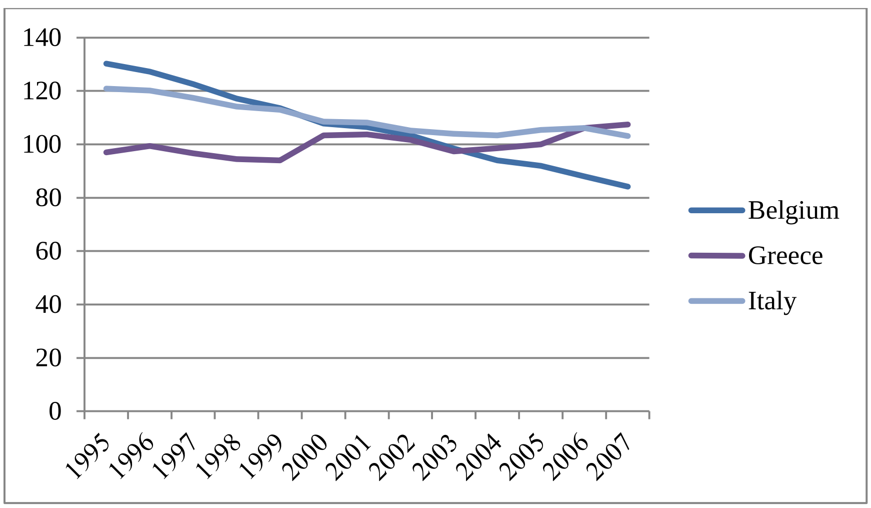
Although in the annual stability programs that member states submit to the Commission tended to show structural positions moving towards MTOs, the Commission (2011) finds that in practice, there was substantial divergence from the stated targets despite positive economic conditions. The preventive arm of the SGP was unable to prevent the trend towards weaker public finances and lax fiscal policies. The Commission also found that slippages in meeting the MTOS were better accounted to poor projections of expenditures, since revenue projections were generally realistic.

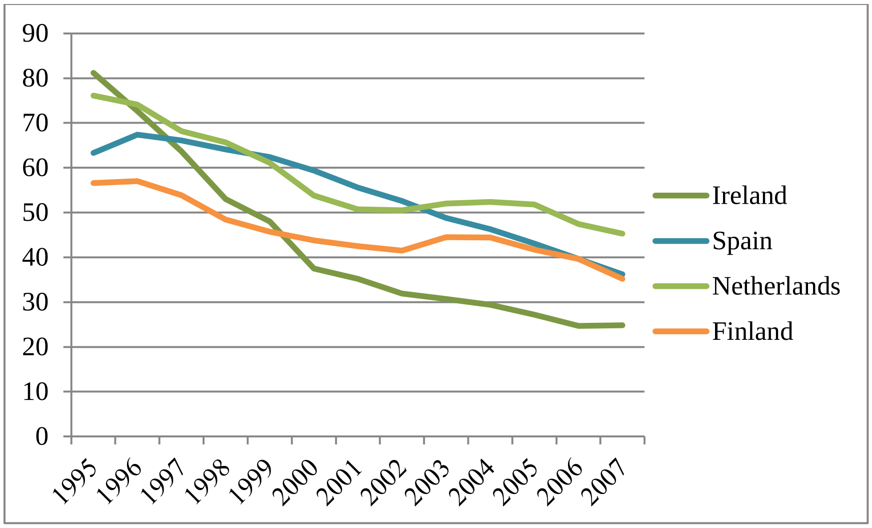
The other major criterion outlined in the SGP was debt levels as a percentage of GDP. General government gross debt is defined in the Maastricht Treaty as consolidated general government gross debt at nominal value, outstanding at the end of the year in the following categories of government liabilities as defined in the European System of Accounts: currency and deposits, securities other than shares excluding financial derivatives, and loans. Government and GDP are defined in the same way as with the data on deficits.  Data expressed in national currency are converted into euro using end-year exchange rates provided by the European Central Bank (Eurostat).

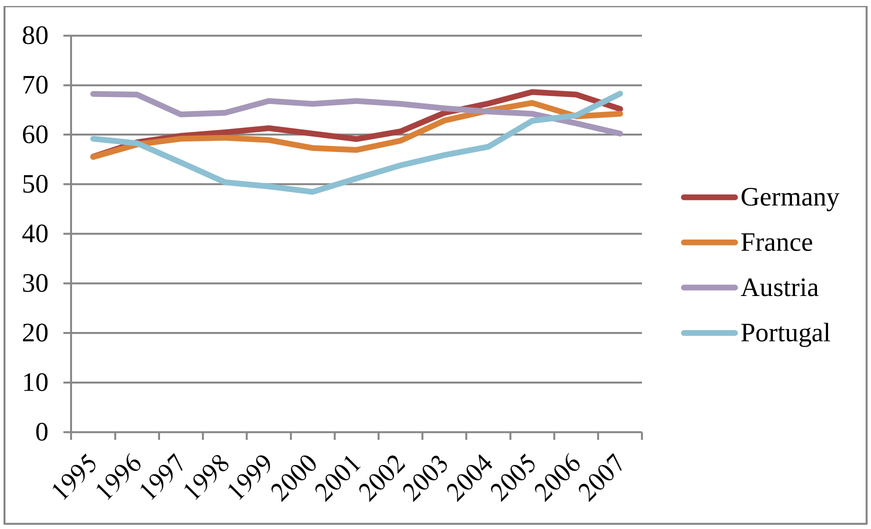



Source: Eurostat

**Figure 2.1: Eurozone government gross debt as percentage of GDP**






Source: Eurostat

**Figure 2.2: Government gross debt as percentage of GDP**

The worst performing countries with respect to debt levels were Belgium, Italy, and Greece. Belgium showed substantial improvement over the period, justifying their claims that they were actively reducing their debt to fulfill the Maastricht convergence criteria. Italy also cut down its debt from 120.9% of GDP to 103.1% over the period. However, Greek's debt levels did not seem to decline and increased by about 10 percentage points over the period.

Ireland, Spain, Netherlands, and Finland had declining levels of debt since the introduction of the single currency and consistently kept it below 60% of GDP until 2007.

On the other hand, countries such as Germany, France, Austria, and Portugal maintained debt levels around the 60% of GDP specified by the Maastricht Treaty. Portugal, although having fulfilled the criterion before its admission, had its debt levels climb steadily, where 60% was surpassed in 2004 and continued to increase.

Overall, from observing the charts above, countries have generally been consistent with their deficit and debt policies. The Maastricht convergence criteria had a positive influence for many countries such as Italy, which attempted to bring down its debt and deficit levels prior to joining the euro, and have maintained consistent levels after adoption of the euro. With the different set of incentives under the Stability and Growth Pact, there was no significant improvement in standards in many countries. Even though there was a rebound in deficits and debt levels after the 2005 reform of the SGP, most countries' finances did not diverge widely. Countries like France and Germany did not improve their debt levels to bring them into line with the SGP, while countries such as Ireland actively brought them down to healthy levels.

Nonetheless, with the exception of Greece, all of the Eurozone countries had debt levels already below 60% of GDP, were close to it, or made substantial efforts to lower it to satisfy the SGP.

The Maastricht convergence criteria had a generally positive effect on entrants to the Eurozone. As seen in Appendix 2, debt and deficit levels declined in all countries, and only two countries did not meet the deficit criterion when using revised numbers, and all members complied with the deficit criterion when using figures officially published in 1998. Countries scrambled to meet the deficit and debt criteria after ratifying the Maastricht Treaty and most underwent substantial fiscal adjustment in the 1990s. Comparing the Maastricht era (1992-98) with the period 1980-91 shows an average improvement in the cyclically adjusted primary balance (Annett, 2006). Galí and Perotti (2003) found that after the implementation of the Maastricht Treaty and the economic convergence criteria, the new fiscal rules did not harm flexibility for EMU countries and in fact they had the effect of being countercyclical automatic stabilizers. However, several studies, such as Candelon et al. (2009) and Marinheiro (2008) come to the conclusion that discretionary fiscal policy remained procyclical, though this was partly attributed to supply constraints during expansionary periods.

Ioannou and Stracca (2011) corroborate the finding that SGP did not have a significant impact on Eurozone countries in their fiscal policy. After accounting for a large number of possible control variables such as time-lagged primary balance, trade openness, and timing of legislation elections, the most optimistic interpretation would be that the SGP prevented member states from adverse fiscal behavior that would have harmed the euro as a whole. However, it was also found that the SGP deepened the political dimension to fiscal policies, with political cycles having a more important impact on deficit levels after the implementation of the SGP.

It was suggested by Wyplosz (2006) that the apparent relaxation in reducing debt and deficit levels after countries entered the euro could be explained by a "post-Maastricht fatigue" effect. Comparing budgetary stabilization efforts before and after the euro, and comparing the change between the Eurozone and the rest of the OECD, the Eurozone countries did not perform better, showing that the SGP has had a limited effect.

By the end of the 2000s and several years after the launching of the reformed SGP, expenditures grew remarkably and this effect was the most pronounced in countries that did not meet their medium-term objectives (Lemmer and Stegarescu, 2009) These countries also tended not to consolidate their public finances in subsequent years to reverse the trend in spending, especially when they faced unexpected revenue windfalls.

Much of the literature published after the reformed SGP agree that the actual performance in fulfilling SGP targets have fallen, and given that the SGP has failed in enforcing low deficit and debt levels, they point to other explanations for the purpose for the SGP and some provide proposals to enforce fiscal discipline by other means. The following two sections examine some of the reasons why the SGP was not adhered with a focus on financial markets, the European institutions and their respective enforcement mechanisms.

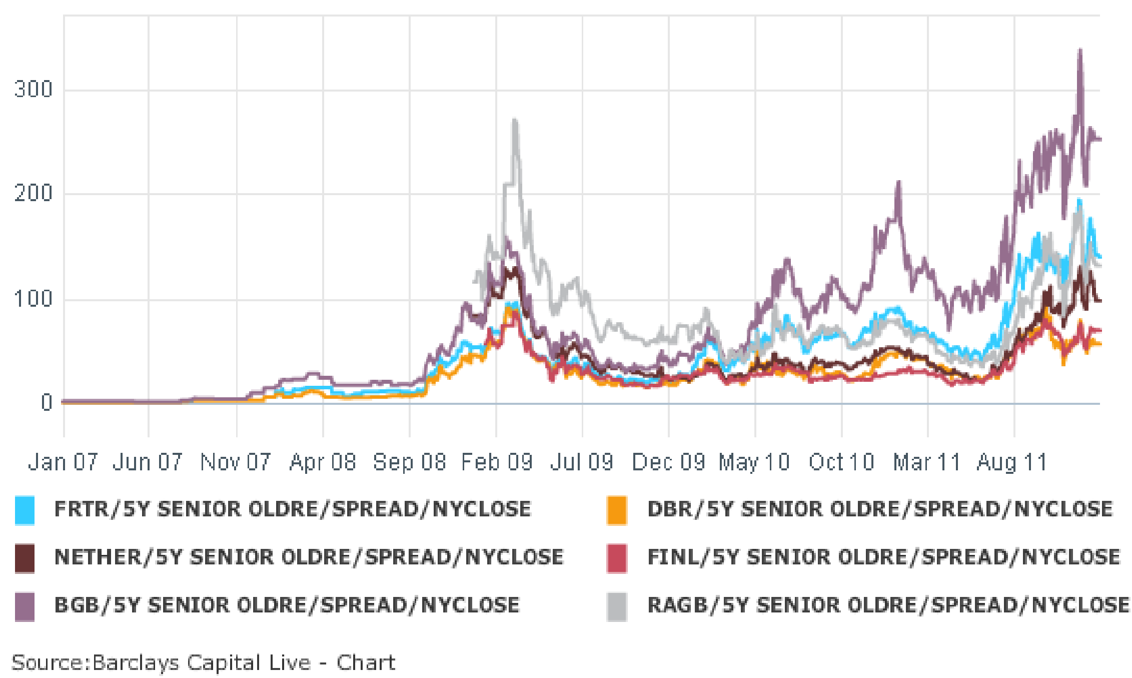
## 4. Market Enforcement

As much as the Maastricht convergence and the subsequent Stability and Growth Pact were political agreements among member states, the success of the monetary union depended partly on acceptance in the financial markets. The EU need to assure investors of the benefits of a common currency and member states need to convince markets that the default risk of their sovereign bonds declined as a result of joining the euro.

One of the most commonly used measures of risk of sovereign debt beginning from the mid-2000s was the credit default swap. A credit default swap (CDS) is an agreement that the seller of the CDS will compensate the buyer in the event of a loan default. The buyer of the CDS pays fees or a “spread” to the seller and, in exchange, receives a payoff if the country in question fails to make payments.

Prior to 2008, since the probability of default was deemed to be small, particularly for AA and AAA-rated countries in Europe, credit default swaps were not widely traded and were considered an instrument of protection in the unlikely event of the default of a sovereign bond. Furthermore, the premium paid on the CDS was much lower, around 100 basis points, which, however, began to rise following the collapse of Lehman Brothers and the onset of the financial crisis. For example, CDS premiums for Greek debt at one point reached 10,000 basis points (100 percentage points). This reflected the declining value of Greek bonds and investors’ loss of confidence in the country’s finances, as markets began to believe that the rate of default would increase dramatically. As a result, the price of insurance went up correspondingly. Throughout the crisis, this derivative instrument that was rarely used before began to be traded widely as a financial product that allowed investors to express a negative opinion on the viability of European nations’ finances.

The following graphs show that, even for countries such as Germany and France, the rates paid on CDS rose in large increments beginning in 2009, reaching several multiples of its level only 12 months prior.


(DBR – Germany; RAGB – Austria)


**Figure 3.1 Price for Credit default swaps (CDS) of 5-year sovereign debt for Eurozone (2007-2011)**

Prior to 2008, European sovereign bonds were widely perceived to be relatively safe investments, since they were highly rated and backed by governments that used the common currency. Interest rates fell substantially as investors sought low-risk investments. Greek borrowing costs, although higher than the average for the Eurozone, were much lower than prior to the country's entry into the euro. Investors went after high-return and low-risk investments, and thus Greek bonds became attractive, especially for large European financial institutions. However, when the sovereign debt crisis began, it became clear that a restructuring was possible and that default cannot be completely ruled out. Given that Article 125 of the TFEU forbids fiscal transfers between member states for the purpose of bailouts and fiscal imprudence and that Germany insisted on the Private Sector Involvement (PSI) in the case of Greek debt restructuring, investors began to consider using CDS as an instrument to protect themselves against potential losses.

In the period from 2007 to 2010, CDS rates did not move in lockstep with deficits or debt levels that each country faced. For example, despite the rapid increase in deficit levels in Ireland, its CDS rate did not rise nearly as quickly as that of Greece. Even prior to the gain in popularity of the CDS before 2008, there was a general lack of discipline from the markets vis-à-vis the fiscal situation of each country. Whenever countries overspent, there were no immediate consequences in the bond and CDS markets to reflect the deteriorating conditions and markets often assumed near-zero probabilities of default.

Schuknecht, von Hagen, and Wolswijk (2010) also found that after September 2008, markets penalized fiscal imbalances much more strongly than before the crisis. However, they also found that from 1991 until May 2009, economic principles accounted for much of the variation in long-term government bond yields. Nonetheless, after the crisis, coefficients for deficit differentials were 3-4 times higher after the crisis began, suggesting a rapid increase in risk aversion.

Another important instrument that market players use are credit ratings reports by credit ratings agencies. As seen in the charts below, downgrades to sovereign debt ratings did not occur in lockstep with deteriorating deficit, debt or inflation rates. Rather, sovereign debt ratings were downgraded to reflect worsening market confidence in the finances of the different countries. Confidence, although tied to the general trustworthiness of the country's government and its past performance in the two fiscal measures as required by the SGP, in specific moments, depended more heavily on news items and announcements from European institutions and national governments.

For ratings from the three major credit ratings agencies (Standard and Poor's, Moody's, and Fitch) the large majority of downgrades occurred between 2009 and 2012 during the sovereign debt crisis, with increased frequency for Greece, Portugal, Ireland, and Spain in 2011. At this point, downgrades reflected more of increases in market bond yields for long-term debt than rapid deterioration in public finances of the countries concerned. A similar relationship is found in the study by Alfonso, Fuceri, and Gomes (2012), in which it is argued that government bond yield spreads and CDS yields reflect changes in rating notations and outlook. In addition, there was a spillover effect from lower rated countries to higher rated countries that participated in the EMU during the sovereign debt crisis. From the following tables, it can be noted that even when countries were issued warnings by the EU, for example Portugal in 2002, France, and Germany in 2004, the effect on credit ratings was negligible. In fact, Greece maintained an "A" rating from all three ratings agencies until late 2009, despite reaching a deficit level of 9.8% of GDP and a debt level at 113% of GDP in the previous year, with limited signs of recovery. Proposals to ban credit ratings in late 2011 reflected popular sentiment in the European press that credit ratings agencies had substantial influence in the financial markets, while ratings downgrades occurred rapidly after the advent of the sovereign debt crisis.[15] Changes in CDS became much more sensitive to ratings downgrades and negative announcements after 2008, with a persistence effect for countries that were recently downgraded (Alfonso et al., 2012). The debt crisis had a much larger effect in attracting the awareness from capital markets towards macroeconomic and fiscal fundamentals of individual countries than the SGP itself.

[15] Barker, A. (2011, Nov 14). Brussels to unveil curbs on rating agencies. *Financial Times.* Retrieved from http://www.ft.com/intl/cms/s/0/44075da2-0edc-11e1-b585-00144feabdc0.html

| Country | Rating | Effective Date |
|---|---|---|
| **Luxembourg** | AAA | (Apr 1994) |
| **Netherlands** | AAA | (Dec 1992) |
| **Germany** | AAA | (Aug 1983) |
| **Finland** | AAA | (Apr 1972) |
| | AA+ | (Mar 1992) |
| | AA- | (Mar 1993) |
| | AA | (Dec 1996) |
| | AA+ | (Sep 1999) |
| | AAA | (Feb 2002) |
| **France** | AAA | (Jun 1989) |
| | AA+ | (Jan 2012) |
| **Austria** | AAA | (Jul 1975) |
| | AA+ | (Jan 2012) |
| **Belgium** | AA+ | (Dec 1992) |
| | AA | (Nov 2011) |
| **Spain** | AA | (Aug 1988) |
| | AA+ | (Mar 1999) |
| | AAA | (Dec 2004) |
| | AA+ | (Jan 2009) |
| | AA | (Apr 2010) |
| | AA- | (Oct 2011) |
| | A | (Jan 2012) |
| | BBB+ | (Apr 2012) |
| **Italy** | AA+ | (Dec 1992) |
| | AA | (Mar 1993) |
| | AA- | (Jul 2004) |
| | A+ | (Feb 2011) |
| | A | (Sep 2011) |
| | BBB+ | (Jan 2012) |

| Country | Rating | Effective Date |
|---|---|---|
| **Ireland** | AA- | (Nov 1989) |
| | AA | (May 1995) |
| | AA+ | (May 1998) |
| | AAA | (Oct 2001) |
| | AA+ | (Mar 2009) |
| | AA | (Jun 2009) |
| | AA- | (Aug 2010) |
| | A | (Nov 2010) |
| | A- | (Feb 2011) |
| | BBB+ | (Apr 2011) |
| **Portugal** | A+ | (Dec 1992) |
| | AA- | (May 1993) |
| | AA | (Dec 1998) |
| | AA- | (Jun 2005) |
| | A+ | (Jan 2009) |
| | A- | (Apr 2010) |
| | BBB | (Mar 2011) |
| | BBB- | (Mar 2011) |
| | BB | (Jan 2012) |
| **Greece** | BBB- | (Dec 1992) |
| | BBB | (Nov 1998) |
| | A- | (Nov 1999) |
| | A | (Mar 2001) |
| | A+ | (Jun 2003) |
| | A | (Nov 2004) |
| | BBB+ | (Dec 2009) |
| | BB+ | (Apr 2010) |
| | BB- | (Mar 2011) |
| | B | (May 2011) |
| | CCC | (Jun 2011) |
| | CC | (Jul 2011) |
| | SD | (Feb 2012) |
| | CCC | (May 2012) |

**Table 1.1 History of Foreign Currency Long Term Debt credit rating downgrades (Standard and Poor's)**

| Country | Rating | Effective Date |
|---|---|---|
| **Luxembourg** | Aaa | (Jul 1999) |
| **Netherlands** | Aaa | (Jul 1999) |
| **Germany** | Aaa | (Apr 1993) |
| **Finland** | Aaa | (Feb 1986) |
| | Aa1 | (Oct 1990) |
| | Aa2 | (Jan 1992) |
| | Aa1 | (Jan 1997) |
| | Aaa | (May 1998) |
| **France** | Aaa | (Feb 1992) |
| **Austria** | Aaa | (Jun 1977) |
| **Belgium** | Aa1 | (Mar 1988) |
| | Aa3 | (Dec 2011) |
| **Spain** | Aa2 | (Feb 1988) |
| | Aaa | (Dec 2001) |
| | Aa1 | (Sep 2010) |
| | Aa2 | (Mar 2011) |
| | A1 | (Oct 2011) |
| | A3 | (Feb 2012) |
| **Italy** | Aaa | (Oct 1986) |
| | Aa1 | (Jul 1991) |
| | Aa3 | (Aug 1992) |
| | A1 | (May 1993) |
| | Aa3 | (Jul 1996) |
| | Aa2 | (May 2002) |
| | A2 | (Oct 2011) |
| | A3 | (Feb 2012) |

| Country | Rating | Effective Date |
|---|---|---|
| **Ireland** | Aa3 | (Jul 1987) |
| | Aa2 | (Aug 1994) |
| | Aa1 | (Feb 1997) |
| | Aaa | (Apr 2009) |
| | Aa1 | (Jul 2009) |
| | Aa2 | (Jul 2010) |
| | Baa1 | (Dec 2010) |
| | Baa3 | (Apr 2011) |
| | Ba1 | (Jul 2011) |
| **Portugal** | A1 | (Nov 1986) |
| | Aa3 | (Feb 1997) |
| | Aa2 | (May 1998) |
| | A1 | (Jul 2010) |
| | A3 | (Mar 2011) |
| | Baa1 | (Apr 2011) |
| | Ba2 | (Jul 2011) |
| | Ba3 | (Feb 2012) |
| **Greece** | Baa3 | (May 1994) |
| | Baa1 | (Nov 1996) |
| | A2 | (Dec 1996) |
| | A1 | (Feb 1998) |
| | A2 | (Jul 1999) |
| | A3 | (Nov 2002) |
| | Ba1 | (Oct 2009) |
| | B1 | (Mar 2011) |
| | Caa1 | (Jun 2011) |
| | Ca | (Jul 2011) |
| | C | (Mar 2012) |

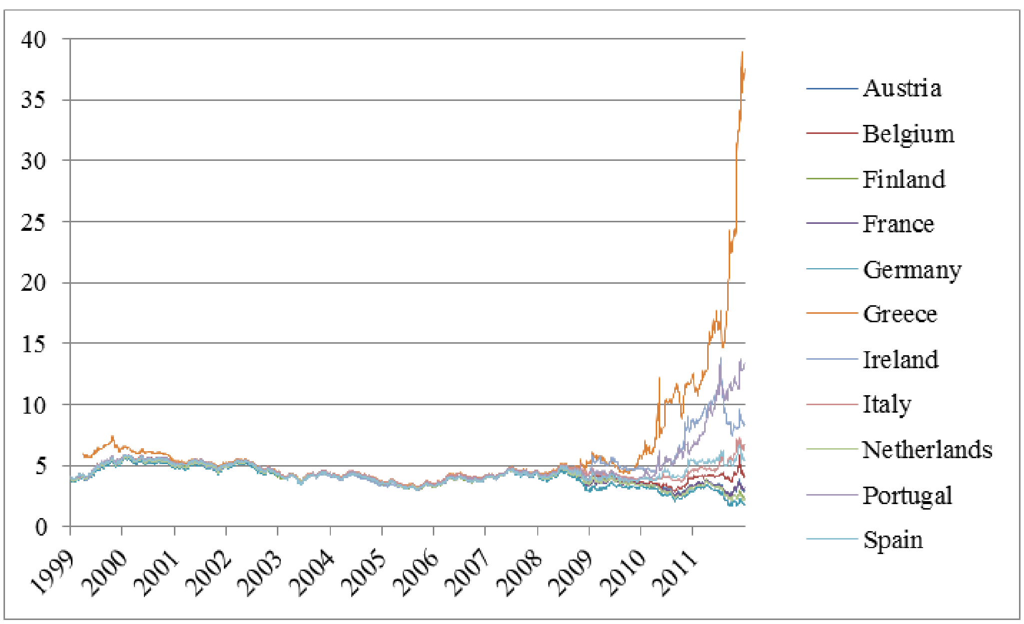
**Table 1.2 History of Foreign Currency Long Term Debt credit rating downgrades (Moody's)**

| Country | Rating | Effective Date |
|---|---|---|
| **Luxembourg** | AAA | (Aug 1994) |
| **Netherlands** | AAA | (Aug 1994) |
| **Germany** | AAA | (Aug 1994) |
| **Finland** | AA- | (Aug 1998) |
| | AA | (Mar 1996) |
| | AA+ | (Apr 1997) |
| | AAA | (Aug 1998) |
| **France** | AAA | (Aug 1994) |
| **Austria** | AAA | (Aug 1994) |
| **Belgium** | AA+ | (Aug 1994) |
| | AA- | (Dec 1998) |
| | AA | (Jun 2002) |
| | AA+ | (May 2006) |
| | AA | (Jan 2012) |
| **Spain** | AA | (Aug 1994) |
| | AA+ | (Sep 1999) |
| | AAA | (Dec 2003) |
| | AA+ | (May 2010) |
| | AA- | (Oct 2011) |
| | A | (Jan 2012) |
| **Italy** | AA | (Aug 1994) |
| | AA- | (Feb 1995) |
| | AA | (Jun 2002) |
| | AA- | (Oct 2006) |
| | A+ | (Oct 2011) |
| | A- | (Jan 2012) |

| Country | Rating | Effective Date |
|---|---|---|
| **Ireland** | AA+ | (Oct 1994) |
| | AAA | (Dec 1998) |
| | AA+ | (Apr 2009) |
| | AA- | (Nov 2009) |
| | A+ | (Oct 2010) |
| | BBB+ | (Dec 2010) |
| **Portugal** | AA- | (Aug 1994) |
| | AA | (Jun 1998) |
| | AA- | (Mar 2010) |
| | A+ | (Dec 2010) |
| | A- | (Mar 2011) |
| | BBB- | (Apr 2011) |
| | BB+ | (Nov 2011) |
| **Greece** | BBB- | (Nov 1995) |
| | BBB | (Jun 1997) |
| | BBB+ | (Oct 1999) |
| | A- | (Jul 2000) |
| | A | (Jun 2001) |
| | A+ | (Oct 2003) |
| | A | (Dec 2004) |
| | A- | (Oct 2009) |
| | BBB+ | (Dec 2009) |
| | BBB- | (Apr 2010) |
| | BB+ | (Jan 2011) |
| | B+ | (May 2011) |
| | CCC | (Jul 2011) |
| | C | (Feb 2012) |
| | RD | (Mar 2012) |
| | B- | (Mar 2012) |
| | CCC | (May 2012) |

**Table 1.3 History of Foreign Currency Long Term Debt credit rating downgrades (Fitch)**

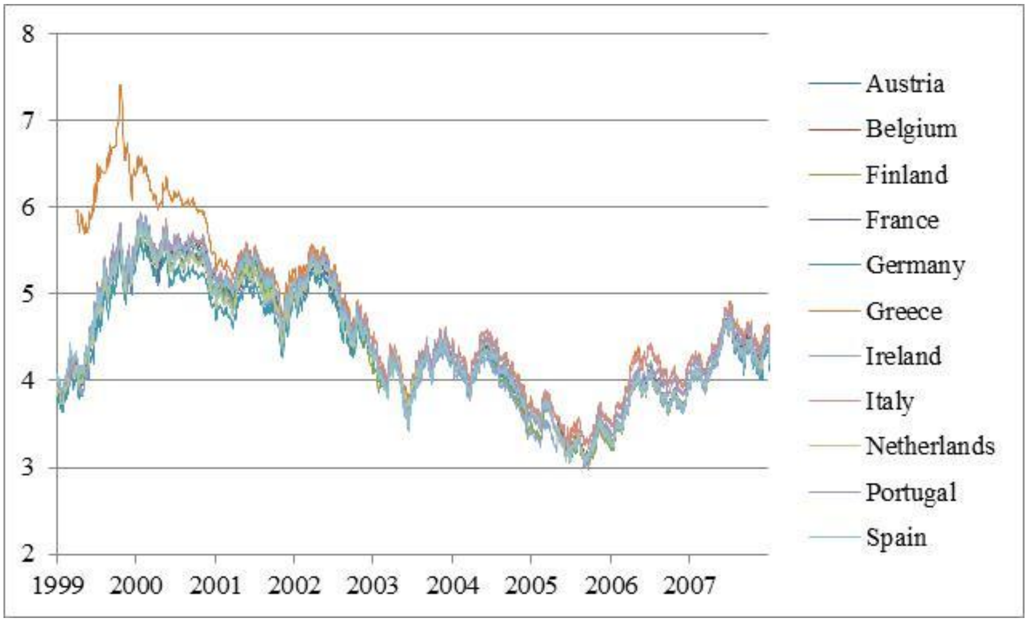
Long-term government bond yields show similar results. After the formation of the monetary union, interest rate spreads between Germany and other Eurozone countries were almost constant, reflecting confidence in the market that participation in the Eurozone reduced the risk of default substantially even in countries that formerly had high levels of government debt and deficit. In addition, financial investors perceived the Commission to be a credible enforcer of SGP rules, which would assure the viability of the euro (Goldbach and Fahrholz, 2011). Even when deficit levels diverged between countries before the sovereign debt crisis, bond yields demonstrated little movement away from the Eurozone average. The deficit and debt levels were effectively not enforced in any significant way in the financial markets, allowing countries such as Greece to borrow at substantially much lower rates than they otherwise would have been able to. Default risk and currency risk were deemed to be low.




Source: Thomson Reuters Datastream

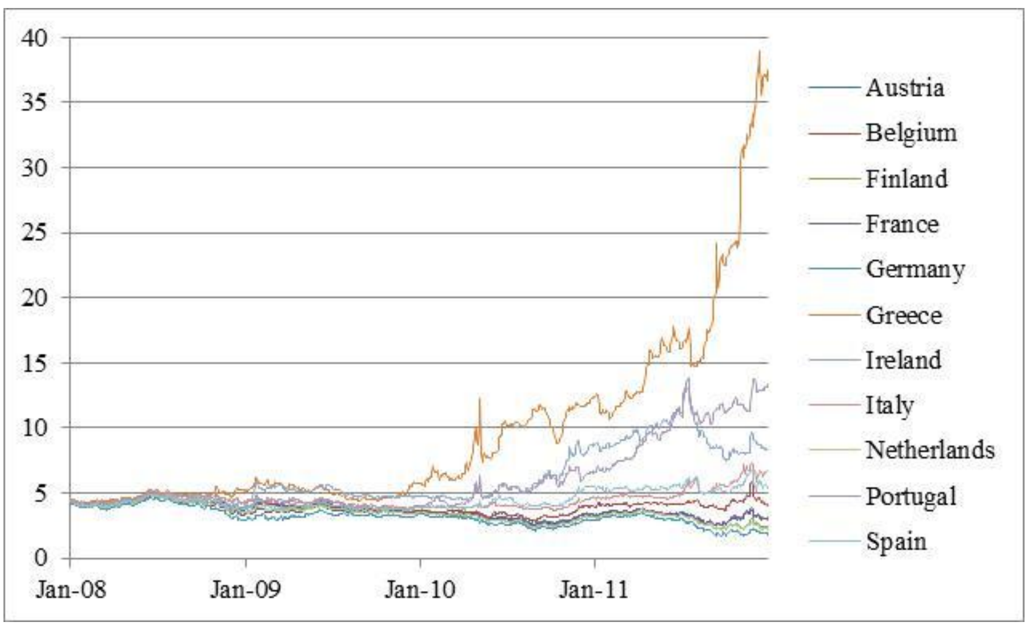
**Figure 4.1 Ten-year Government Bond Yields for EU-12 (1999-2011)**[16]

[16] Luxembourg was excluded since the country only began issuing ten-year government bonds in 2010.



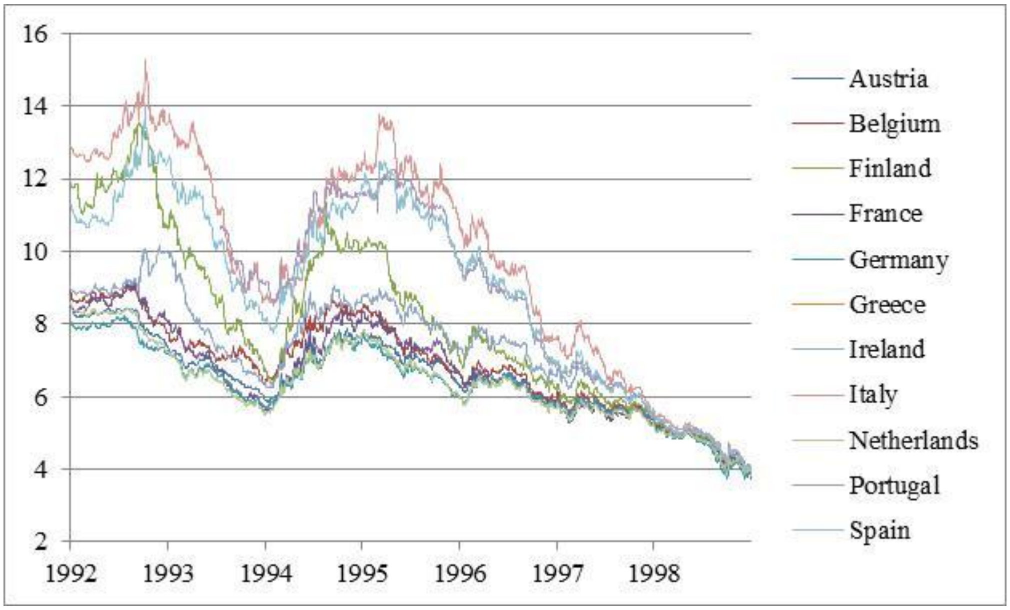

Source: Thomson Reuters Datastream

**Figure 4.2 Ten-year Government Bond Yields for EU-12 (1999-2007)**




Source: Thomson Reuters Datastream

**Figure 4.3 Ten-year Government Bond Yields for EU-12 (2008-2011)**




Source: Thomson Reuters Datastream

**Figure 4.4 Ten-year Government Bond Yields for EU-12 (1992-1999)**

In the context of SGP targets, market enforcement of politically defined deficit and debt standards was insufficient to pressure EMU countries into continued fiscal consolidation after entry into the Eurozone. As Leblond (2006) argues, the Stability and Growth Pact transitioned from being a political act to more of an economic nature. Despite the effective suspension of the Excessive Deficit Procedure in November 2003, which violated the spirit of the SGP, long-term European government bond-holders did not react and yields barely moved. Leblond found that investors relied on the political message delivered by the SGP rather than its enforcement. What mattered was an "implicit economic pact" that investors make with each member state.

Goldbach and Fahrholz (2011) demonstrate in a formal model that from 1999 to 2005, the European Commission's lack of proper enforcement of SGP rules with respect to deficit and debt levels did not result in any substantial response from the markets. Similarly, their impact analysis shows that decisions and statements from ECOFIN had little effect on the financial markets. Common default risk premium remained at similar levels despite multiple breaches of

SGP rules. However, they showed that such political statements from the Commission and ECOFIN reduced volatility in common default risk premiums and by extension the sovereign creditworthiness of the Eurozone. Investors tended to hinge on the Commission rather than on ECOFIN, and the authors postulate that this was because decisions could be blocked by a minority in the latter, adding to the uncertainty of outcomes.

Markets did not have an important impact on fiscal consolidation prior to the sovereign debt crisis, and countries with divergent economies and finances had similar rates on CDS and long-term government bond yields, usually no more than 50 basis points above German ten-year bonds. This confirms Hallerberg's finding (2010) that market pressure on the Eurozone in the context of the SGP has been "low" prior to 2009, though countries with more robust finances had lower borrowing costs. Markets may have relied on the presence of the SGP to control deficits even when they anticipated some probability of default (Eichengreen, 2009).

Market responses to changes in deficit and debt levels after 2008 were much more pronounced, and many of the changes in CDS rates and bond yields were disproportionate to the relative changes in debt levels. In other words, markets treated the effectiveness of the SGP differently before and after the beginning of the sovereign debt crisis. De Grauwe (2009) attributes this to panic in the financial markets and flight to safety to German and American bonds, putting substantial pressures on Greek, Spanish, and Italian bonds. Interest rates for Greece, Portugal, Italy, and Ireland increased substantially with the sovereign debt crisis. Rapidly rising borrowing costs have in all likelihood made meeting the SGP thresholds even more difficult, as seen with the remarkable increases in debt for Ireland and Greece since the sovereign debt crisis.

In fact, Eurozone countries faced less market discipline than those outside the Eurozone (Eichengreen, 2009). While arguably beneficial to provide more flexibility during economic cycles, the relaxed market enforcement of SGP rules undermined the effectiveness of the targets, and when an economic recession hit, the countries had little room for maneuver to prevent falling into excessive deficit and debt levels.

## 5. European Institutional Enforcement

In the years following the enactment of the SGP, there was an ineffective enforcement mechanism due to the lack of financial sanctions imposed on countries despite the inability of many countries to comply with targets, most notably France and Germany. Imposition of sanctions required consent of ECOFIN, where France and Germany held a large portion of votes. In other words, member states easily overturned mechanisms that they devised when their deficit and debt levels did not fall under the previously agreed levels.

When France and Germany decided to impose a looser interpretation of the SGP in 2003 to avoid sanctions, the SGP was no longer fully operative, this being only four years after the establishment of the single currency. Many warnings and reports were issued by the European Commission on member countries' fiscal policies but no action was taken by ECOFIN. Prior to the crisis, an official early warning was issued to France in 2003 only after the 3% of GDP deficit threshold was breached, but not to Germany, Portugal, and Italy, for which the Commission recommended early warnings. Since these European institutions were not directly elected, it was also difficult to impose sanctions on national governments that were popularly elected. No fines have ever been imposed on a member state, despite the power of ECOFIN to do so under the dissuasive arm of the SGP. (ECOFIN threatened to suspend Hungary's access to 2013 development funds in March 2012, but the decision could be reversed if Hungary shows improvement in reducing its deficit level.)

By 2011, all Eurozone countries had been involved in the Excessive Deficit Procedure (EDP). Although the Commission still argued that the SGP was a method by which member states could return to sound fiscal policies, few countries adhered to the Commission's recommendations. In addition, since 23 of 27 EU countries were subject to the EDP, the likelihood of any sanctions imposed by ECOFIN was significantly reduced.[17] (For a history of the EDPs launched against member states, see Appendix 4)

The case of Greece could be used to demonstrate the relaxation of the SGP before and after the reform. Having had levels of debt and deficit exceeding reference values even before entering the Eurozone, the Commission issued a report in June 2004 reviewing the problem of excessive deficits in Greece as part of the "surveillance" system of the preventive arm. The country subsequently received six reports from the Commission and from ECOFIN regarding its fiscal situation. Finally, in June 2007, in a separate Council decision on excessive deficits, ECOFIN abrogated its earlier decision threatening to impose sanctions and deemed it unnecessary for the Council to pursue further action against Greece. The country's government deficit as a percentage of GDP was reported to be 6.2% in the decision, but ECOFIN explained that because of improvements in the structural balance, they considered the excessive deficit to have been corrected. Debt was also considered to have been "sufficiently diminishing", thereby fulfilling the debt criterion under the SGP, despite starting at 103% of GDP in 2003 and moving to 107.8% in 2007.[18] An EDP was not launched again until 2009, while debt levels continued to climb.

Even during periods of rapid growth, countries still ran deficits or had fiscal policy that did not vary from previous periods (Annett, 2006). The Commission and ECOFIN were unable to convince member states to consolidate their fiscal situations with the SGP. Belgium, Ireland, Germany, Greece, and Italy all loosened during both phases of the cycle. In fact, Finland was the

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[17] Excessive Deficit Procedure, European Commission, http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

[18] Decision 2007/465/EC, Retrieved from http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-12_council/2007-06-05_el_104-12_council_en.pdf

only country to undertake substantial adjustment over this period. During downturns, due to the SGP, countries ran structural fiscal balances that were countercyclical as they had failed to consolidate their position during economic booms.

Annett (2006) notes several issues with countries that have continued their path of profligacy under the SGP, including overly optimistic assumptions on growth, thereby allowing for unrealistic medium-term adjustments and overly loose fiscal policy over the economic cycle (Jonung and Larch, 2004). The Commission exacerbated the problem by assuming that improvement in debt-to-GDP ratio would directly result from adherence to the deficit criterion by making the overly optimistic assumption of 5% nominal GDP growth rate in EU economies. As a result, debt ratios in France, Greece, Germany and Portugal climbed over the first decade of the euro without much attention from the Commission (European Commission, 2011).

In an effort to hide problems with deficits and to circumvent SGP fiscal rules, governments began substituting stock-flow adjustments (SFA) for budget deficits, the former being the difference between the change in government debt and government deficit/surplus for a given period. A positive SFA indicates that debt has increased more than the deficit has increased. This often has a legitimate explanation, being primarily financial operations such as financial acquisitions, debt issuance policy to manage public debt, privatization receipts, and impact of exchange rate changes on foreign denominated debt. In general, SFAs should tend to cancel out over time and Eurostat considers it a statistical residual. However, Eurostat also monitors figures submitted by member states for large and persistent SFAs, as they may have resulted from inaccurate reporting of financial statistics (including inflated debt levels) and would ultimately result in upwards revisions of deficit levels. Since more attention is generally paid to deficit levels under the SGP, governments have the incentive to underreport deficit levels and over-reporting SFAs.

Von Hagen and Wolff (2006) provide evidence for this form of "creative accounting" that allowed countries to bypass the 3 percent deficit limit and to change reported numbers. Since this form of manipulation was responsive to cyclical parts of deficits, SGP rules were vulnerable to creative accounting and incentivized this behavior, making the cost of reducing debt much larger during recessionary periods. In its monitoring of SFA figures, Eurostat found that from 2007 to 2010, a large majority of member states had positive SFAs.[19] "Creative accounting" adjustments existed before the introduction of the euro, but its role in altering deficit figures became systematic with the introduction of the SGP fiscal framework (von Hagen and Wolff, 2006).

In addition to SFA manipulation, a similar issue that arises from the issue of European institutional enforcement is the reliability of the data supplied by member states. The most poignant example is that of Greece. Creative accounting was often used to mask government debt levels. Eurostat often found that important data "cannot be confirmed" or has been requested but "not received". Billions of euros in military expenditures and hospital debt were left out, and after recalculation, Eurostat found that deficit levels had been far higher than 3% of GDP. The highly unprofitable Greek railway system sold shares to the government to cover billions of euros in losses, so that they would count as financial transactions rather than

[19] "Stock-flow adjustment (SFA) for the Member States, the euro area and the EU27 for the period 2007-2010, as reported in the October 2011 EDP notification", Eurostat, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/STOCK_FLOW_2011_OCT/EN/STOCK_FLOW_2011_OCT-EN.PDF

expenditures and would not appear on the balance sheet.[20] The Council now has the power impose a fine on a member state that intentionally misrepresents its deficit and debt statistics, under the “Six-Pack” (discussed in Section 8).[21]

The press reported in 2010 that Goldman Sachs sold complex financial derivative instruments in 2002 that helped the Greek government mask the true extent of its deficit to avoid breaking the Maastricht convergence criteria. The deal involved “cross-currency swaps” in which government debt issued in a foreign currency was swapped for euro debt for a certain period, to be exchanged back into the original currencies at a later date. At some point the so-called cross-currency swaps will mature, and threaten to swell Greece’s bloated deficit.

Such transactions are part of normal government refinancing since governments often obtain funding in dollars and yen, which needs to be converted to euros for use. At maturity, bonds are repaid in the original foreign denominations. However, in the case of Greece, the cross-currency swaps were devised with fictional exchange rates, which enabled Greece to receive more euros than they otherwise could have on the market. Through these swaps, Goldman Sachs secretly arranged additional credit of up to $1 billion for Greece.[22]

The artificially deflated credit would then also be decreased in published Greek debt statistics, and would legally circumvent Eurostat’s rules on reporting statistics for the purpose of fulfilling Maastricht convergence criteria. The originally reported deficit figure for 2002 of 1.2% of GDP had to be reviewed and recalculated by Eurostat, which subsequently determined the real figure to be 3.7%, later revised to 5.2%. The transactions, in fact, worsen Greece’s deficit

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[20] Little, A. (2012, Feb 2). How 'magic' made Greek debt disappear before it joined the euro. *BBC News.* Retrieved from http://www.bbc.co.uk/news/world-europe-16834815
[21] Regulation 1173/2011 on the effective enforcement of budgetary surveillance in the euro area
[22] Balzli, B. (2010, August 2). How Goldman Sachs helped Greece to mask its true debt. *Spiegel Online*. Retrieved from http://www.spiegel.de/international/europe/0,1518,676634,00.html

problem since the country pays a large commission to Goldman Sachs for the instrument and will have to repay the debt in the currency in which it was issued.

The situation is not unique to Greece. Italy was also reported to have used a similar trick to alter its deficit numbers reported to the EU. Germany and France also used one-time sales of state assets to deflate deficit numbers prior to accession to the EMU. [23]

Creative accounting decreases confidence in published statistics and renders enforcement difficult for the EU and for the markets. To date, no sanctions have been launched against Greece for its use of incorrect statistics.

Both Annett (2006) and Ioannou & Stracca (2011) demonstrated that electoral cycles had an impact on the application of the SGP. There is an expansionary bias in numerous countries during elections, with governments choosing to cut taxes and increase spending. Politicians are more myopic than the general public since they are concerned with securing re-election. The long-term effects of running up debt are not correctly discounted against the short-term electoral gain from increased spending.

The Commission and ECOFIN either did not have the capability of preventing these problems or were not willing to impose sanctions as a result. The SGP is highly political in nature (Segers and van Esch, 2007) and the outcome of the 2003 compliance crisis showed that there are serious compliance issues with the SGP. At the genesis of the SGP, Germany may have prevailed; however, in its application, the lack of enforcement suggests that SGP has not been entirely successful in maintaining low deficit and debt levels.

[23] Castle, S. & Saltmarsh M. (2010, February 15). Greece Pressed to Take Action on Economic Woes. *New York Times.* Retrieved from http://www.nytimes.com/2010/02/16/business/global/16euro.html

The lack of enforcement of SGP rules gives rise to questions about the effectiveness of the Commission and ECOFIN, as well as the enforceability of the SGP itself. Fourçans (2007) examines incentives in the context of the SGP and finds that there are issues with moral hazard in the EMU. Member states are less inclined to abide by the SGP after the 2005 reform and continued to engage in moral hazard behaviors. The study analyzes using a game theoretical approach to moral hazard to show that fiscal rules with lax enforcement provide little incentive for countries to engage in fiscally prudent behavior.

The institutional setup of the SGP, including the facility with which it could be amended by member states, demonstrates the obstacles that EMU countries must overcome to make fiscal rules enforceable. Any new design of SGP needs to assess the objectives of the fiscal constraints and the problems they are intended to solve. Preventing spillovers across the EMU can be partly rectified by corrective taxes imposed on excessive debt or deficit, giving member states the incentive to consolidate fiscally. However, if the objective is to correct for domestic policy failures, then the same procedures cannot be applied. Lindbeck and Niepelt (2006) suggest procedural rules requiring increased transparency may be an answer.

The SGP had major flaws in terms of a lack of benefits for countries that commit themselves to use fiscal policy to offset shocks and the absence of an effective disciplinary mechanism (Goodhart, 2006). The originally proposed German Stability Pact was renegotiated in favor of the SGP, in which it was made clear that the Council and the political dimension of the pact trumped the budgetary discipline that it was supposed to regulate (Segers and van Esch, 2007).

In order to better understand why the SGP was not enforced, in particular after the financial crisis, the political architecture that underlies both the Maastricht criteria and the SGP must be understood in order to analyze its distortion in fiscal policy. Changes in fiscal policy discretion stems from the fact that democratically elected governments seem to have a built-in bias toward excessive deficits and debt.

As previously discussed, incentives for adherence are weak, especially for large countries that have substantial political influence in the EU. De Haan (2004) notes that the details for the implementation of the “multilateral surveillance” part of the SGP is based on a Council decision (“soft law”), rather than enshrined in treaty (“hard law”), as is the EDP. Externalities for noncompliance are small and member states receive minimal benefit from enforcing a non-binding political commitment. Moral hazard is exacerbated when changes in the interest rate risk premium is no longer applied directly to a country, lessening the effectiveness of fiscal discipline, passing on additional costs to all countries of the EMU. Termed the “logic of the standard pool model” by Annett (2006), the relatively small costs of profligacy worsen the general deficit bias. The sovereign debt crisis showed that in effect, the cost of a member state’s fiscal problems are partially shared by other countries, which have to fund rescue packages and bailout funds, while the European Central Bank purchases sovereign debt through its Securities Market Program (SMP) to “address severe tensions” and ensure liquidity in the public debt market.[24]

Path dependency could also be argued to account for the failure of the SGP to pressure member states to reduce deficit and debt levels. Fiscal records were widely divergent prior to the signing of the Maastricht Treaty. Many countries ran persistent and unsustainable deficits that

[24] European Central Bank, http://www.ecb.int/mopo/liq/html/index.en.html#portfolios

fed through to rapid public debt accumulation – countries like Belgium, Greece, Ireland, and Italy saw their debt spiraling above 100 percent in the 1980s and early 1990s with deficits hovering around 10 percent of GDP. Given a similar political climate after the introduction of the euro, without direct accountability to the Commission, member states did not have the incentive to stop the trend of debt accumulation.

Nonetheless, the SGP had varying effects on different countries. Annett (2006) argues that Eurozone countries can be categorized as "delegation" and "commitment" countries. In a delegation country, the finance minister is granted a leading role in the budget process, thereby avoiding a common problem. In a commitment country, different parties negotiate a "fiscal contract" involving strict budget targets, typically spending commitments through formal rules. SGP was more adapted to countries that adopt commitment rather than the delegation form of fiscal governance, and the former tended to be smaller countries. The SGP provided impetus for the government to impose fiscal consolidation with coalition partners and with the voting public. He suggests that commitment countries are more likely to adopt cautious forecasts. The commitment form of fiscal governance contributed more to fiscal discipline in the post-SGP period.

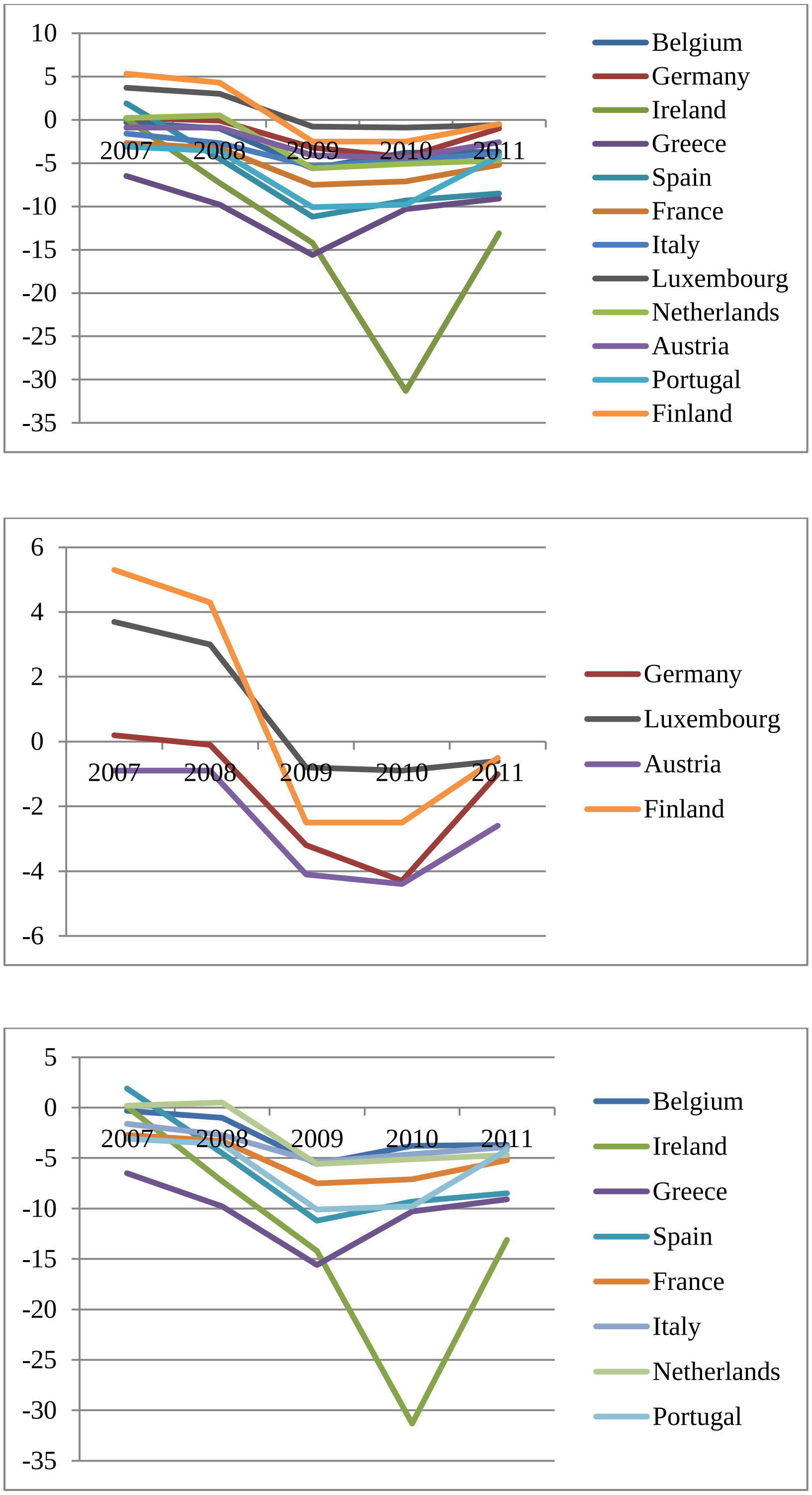
The inability to enforce automatic sanctions, as Germany had demanded before the introduction of the SGP, is a limit that renders enforcement against countries with excessive deficits or debt difficult. Under primary law in the EU, the Commission and the Council are granted discretionary powers and automatic sanctions would most probably require a new treaty (Siekmann, 2011, p. 20). A reform of the SGP would need to address the lack of effective enforcement mechanisms that govern the fiscal limits and consider the political and legal implications of such enforcement by the Commission and ECOFIN and compliance incentives by member states.

## 6. Fulfillment of Targets during the Sovereign Debt Crisis

As mentioned in the previous section, from late 2009, a sovereign debt crisis began to develop as financial investors became increasingly concerned about rising government debt levels across the Eurozone. During the global financial crisis that began in 2008, several countries bailed out the banking industry by assuming heavy losses. As bond yields rose for several peripheral Eurozone countries such as Greece and Ireland, on May 9, 2010, the Council approved a rescue package worth €750 billion to help these countries and maintain financial stability in the Eurozone. This occurred only a week after having agreed jointly with the International Monetary Fund (IMF) to loan €110 billion to Greece.[25] Several rescue packages followed, including debt restructuring agreements concluded between Greece and financial investors.

The beginning of the global financial crisis in 2008 pushed Europe into a recession and put pressures on member states in the EMU from meetings its targets under the SGP. This section examines changes in the deficit and debt levels beginning in 2007 and how the sovereign debt crisis that ensued impacted on the implementation of the SGP.

[25] "EU Turns to 'Nuclear Option' to Halt Euro Speculation." (2010, May 10). *Spiegel Online*. Retrieved from http://www.spiegel.de/international/europe/0,1518,693997,00.html



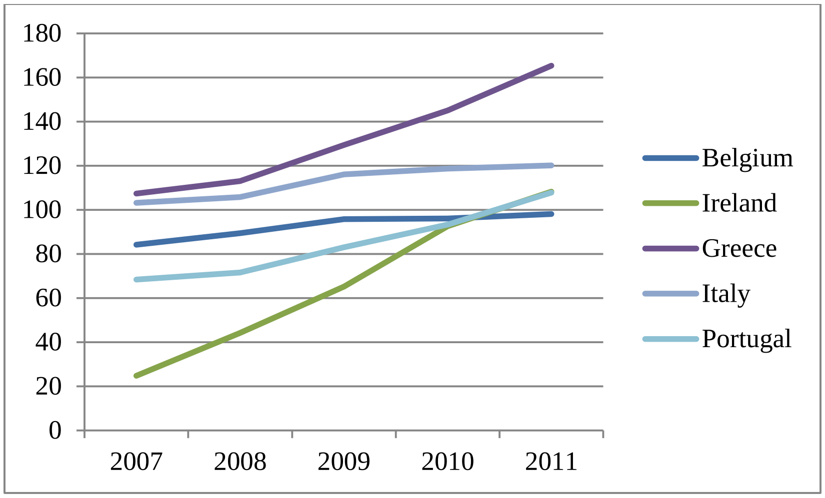

Source: Eurostat

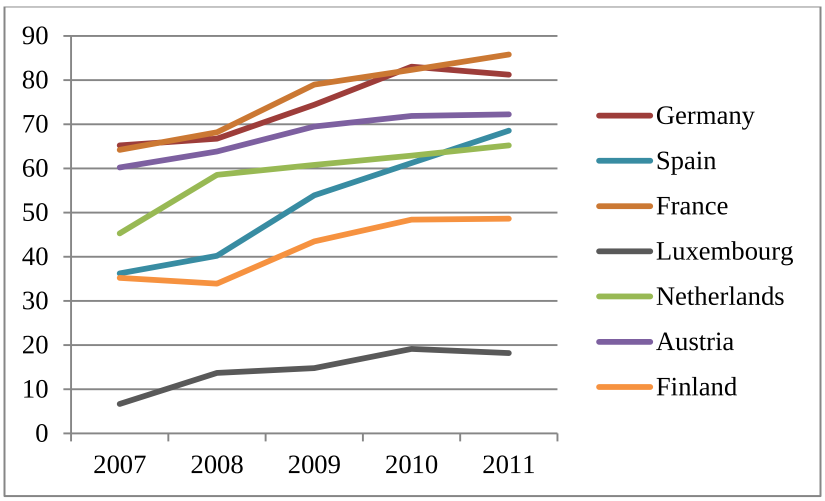
**Figure 5.1 Eurozone government surplus/deficit as a percentage of GDP after 2007**

Traditionally fiscally conservative countries such as Germany, Luxembourg, Austria, and Finland, managed mostly to avoid a fiscal deficit until they faced the full brunt of the sovereign debt crisis. By 2009, these countries had hit the deficit zone, but managed to maintain near the 3% reference value for deficit levels as required under the Stability and Growth Pact.

In the rest of the Eurozone, with the exception of Greece, most countries managed to maintain their deficit levels low in 2008. By 2009, only Belgium, Netherlands and Italy kept their deficit levels under 5% of GDP, while the rest of the group fell into deficits at or near 10% of GDP. Notably, due to the bailouts to financial institutions by the governments of Ireland, deficit there dipped into 31.3% of GDP (Whelan, 2011, p. 51).

The Commission (2011) notes that assessment of structural balance was often deficient in the first decade of the euro, and in addition to the fact that the effect of changes in the output gap on tax revenues was often incorrectly estimated, there was little attention paid to changes in government revenues that were due to asset cycles in the financial and housing markets, rather than to the general economic cycle. When the crisis hit, countries lost important sources of revenue from those markets and were left with a larger deficit than they otherwise would have had.




Source: Eurostat

**Figure 5.2 Eurozone government debt as a percentage of GDP after 2007**

Belgium, Greece, Italy, and Portugal, which already had high debt-to-GDP ratios before the crisis, had debt levels increase dramatically, with Greece ending up with a value greater than 160%. An interesting case, however, was that of Ireland. It performed relatively well with the SGP targets prior to the crisis, yet when under pressure to save failing financial institutions, it was forced to be indebted at much higher levels, reaching over 100% of GDP by 2011.

Looking at the rest of the Eurozone, Luxembourg maintained its traditionally low debt ratio in this period. The rest of the monetary union saw a steady climb in debt ratios, and with the exception of Finland, went above the targeted 60% of GDP.

Given the economic downturn and the push for stimulus, countries in general ignored the limits set by the SGP as most believed that they were facing one of the worst economic recessions since end of the Second World War, which would qualify as an "exceptional and temporary" situation.

As observed in Section 4, markets reacted rapidly to changes in confidence in the different countries, with spikes in bond yields and credit default swap premiums.

In the midst of a debt crisis, with bond yields increasing rapidly, the European Commission and ECOFIN made no attempt to sanction any country for ignoring the SGP targets, as most of them had breached them. No EDP sanctions were triggered to this end. As the debt level for countries such as Greece continued to climb, there were no institutional attempts to pressure the Greek government to reverse the change. And as bond yields escalated in the market, countries continued to be hit hard with large borrowing costs, at the risk of defaulting.

One of the original intentions of the SGP was to enforce strict fiscal rules and promote prudence in government finances during most of the economic cycle, so that in "exceptional" circumstances, countries would be able to run deficits without falling away from its Medium Term Objective (MTO). Indeed, the global financial crisis had serious repercussions in Eurozone economies and it is questionable whether the SGP could have prevented the precipitous rise in debt levels in cases such as Ireland, a country that was in full compliance with the rules prior to the crisis. However, the general lax enforcement of the SGP in the years before the sovereign debt crisis made any quick return to sustainable deficit and debt levels difficult. This major shortcoming of the SGP meant that its credibility was questioned as countries grappled with the effects of the sovereign debt crisis, where Eurozone countries were widely criticized for their finances.

## 7. Alternative Proposals for Enforcing Fiscal Discipline

Given the relative inefficacy of the Stability and Growth Pact to prevent member states from excessive deficit and debt levels, and the failure of the Preventive Arm and the Excessive Debt Procedure to realistically caution countries against further spending, several proposals have been made in the literature as alternatives to the Stability and Growth Pact as it existed after to its renewal in 2005.

In March 2011, the EU adopted a new reform under the "Open Method of Coordination", aimed at addressing the ineffective enforcement mechanism.[26] The resulting new Euro Plus Pact was designed to make the SGP more stringent and address its weaknesses. The Euro Plus Pact's four broad strategic goals are: (1) fostering competitiveness; (2) fostering employment; (3) contributing to the sustainability of public finances; (4) reinforcing financial stability. An additional fifth issue is tax policy coordination. With respect to public finances, member states commit themselves to enshrining fiscal rules into national legislation and imposing "debt brakes" on primary balance and expenditures at both the national and sub-national levels.[27]

In December 2011, at the German government's initiative, EU member states met to discuss launching a new multilateral treaty that requires fiscal rules to be written into national constitutions. (See Section 8 for a detailed discussion of the Fiscal Compact Treaty)

While there was debate prior to the sovereign debt crisis focusing on the merits of deficit and debt limits and the necessity of a pact to enforce budgetary discipline, as shown in

[26] "Open Method of Coordination", European Commission, http://ec.europa.eu/invest-in-research/coordination/coordination01_en.htm
[27] European Council conclusions, EUCO 10/1/11, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf

Savage and Verdun (2007), much of the current literature on the SGP has accepted the premise of budgetary rules and relates to proposals for its improvement. Jonung et al. (2008) in particular explain that the multitude of proposals is due to disagreement regarding the role of fiscal policy, while most agreed that markets alone could not be the sole enforcer of fiscal rules.

Many authors have also noted the weak enforcement mechanism of the SGP as it is being implemented in the EU. Credibility is the key argument for the existence of the SGP, and Fitoussi and Saraceno (2008) argue that the SGP was successful when it was perceived as a public social norm, where reputation of individual countries in the union was at risk. Lindbeck (2006) notes that politicians must determine the objectives of fiscal constraints and that any new institutional design must account for the fact that politicians take policy decisions that may be in their own interest rather than those of the citizens that they represent. De Haan (2004) has the same finding that SGP enforcement mechanisms are too weak. He argues that any reform of the Pact should aim at stricter, instead of more flexible, rules and should not rely on cyclically adjusted deficit estimates. Bofinger (2010) also argues that the rules themselves were not strict enough, which was made worse by inconsistent enforcement. He proposes a new European "Consolidation Pact" - supply loan guarantees in exchange for a fee and stricter budget consolidation measures that would help countries exit from the sovereign debt crisis.

Busch (2011) recognizes that a surveillance framework is needed for member states beyond just government finances as required by the SGP. Surveillance is also needed for wider macroeconomic factors but Busch questions whether they should be applied symmetrically to all members of the EMU. A more focused and expansive role for supervision is required of the Commission and the political cost of deviating from debt targets must be enforced to encourage debt reversal (Muscatelli, Natale, and Tirelli, 2012). Goodhart (2006) goes further by arguing in favor of a Europe-wide “fiscal institute” of independent observers to evaluate each country’s fiscal policies. He argues that the proper response to excessive debt and a contagious effect to domestic financial intermediaries is enforcement of significant incremental capital requirements on financial institutions’ holdings of sovereign debt. Hallerberg (2010) cites the example of Brazil’s fiscal responsibility law in the aftermath of the crisis in 1999, where independent fiscal councils monitor public finances at the state level and in the case of violation of budget caps, states can lose fiscal transfers from the federal government. Reliable and accurate fiscal information is fundamental for markets to evaluate budgetary policies of a member state and can make market discipline more effective at restraining states. Transparency of fiscal policy not only allowed the EU to enforce rules more easily, it allowed the market signals to play a role in monitoring public finances and also the voting public to exercise more power over fiscally imprudent behavior from politicians.

Other authors argue for more fundamental changes to the fiscal rules. Few other countries have as extensive deficit and debt rules in a multi-regional area as the EU, even federal countries such as the United States and Germany. Savage and Verdun (2007) find that the American experience with deficit targets suggest that they may actually act as an incentive for political leaders to engage in noncompliant behavior. He argues that compliance with new rules would increase if targets were revised to be easier to achieve. Hallett and Jensen (2011) argue that fiscal targets should be long-term objectives, while the central bank should be involved with short-term stabilization. Debt targets should be observed and a reformed EDP could be constructed to provide better enforcement.

Nonetheless, macroeconomic stability and debt reduction ultimately calls for changes to the economy. Von Hagen (2010) notes that for the EMU to be successful, member states may have to expand the scope of policy coordination to address macro-economic imbalances and the competitiveness of the member states.

As addressed in this paper, the SGP has problems with its institutional and market enforcement. Therefore, radical reforms of public finance and structural reforms enhancing efficiency of the market as an adjustment mechanism would be able to address those issues. Bukowski (2011) argues that the establishment of the European Stabilization Mechanism and European Financial Stability Facility cannot be a replacement for an effective reform and that the socioeconomic model must be changed to address fundamental issues in the European economy.

Proposals for more European integration include the French proposal for a "gouvernement économique" (economic government or governance) to transfer economic competencies from national governments to EU institutions. Saint-Etienne (2007) is in favor of such a plan to exploit the full potential of an integrated European economy and to put an end to non-cooperation among member states, citing the large commercial surplus that Germany enjoys as a result of low costs of production. SGP ranked low on the EU's list of priorities with regards to economic integration, and fiscal federalism or supranational economic government would bring a long-term-oriented and coordinated set of macroeconomic policies to the Eurozone (Boyer, 2007). Howarth (2007), however, notes the absence of concrete details for such a proposal and the lack of support among member states of the EMU. Although economic governance at the European level may be a desirable goal for member states in the EMU, the current enforcement issues with SGP suggest that this is only realistic in the long-term. Countries continually face the dilemma of retaining national sovereignty in the control of macroeconomic policy or transferring the competency to a supranational level that could better coordinate such policies to maintain stability in the monetary union. Christine Lagarde, managing director of the

IMF and formerly the French Minister of Finance, took a similar view to the French and German governments that deeper, political, economic and fiscal integration are necessary to make the Eurozone sustainable and strengthened.[28]

It is widely recognized that the euro, as an unprecedented experiment in monetary union, is built on political foundations. Countries with widely disparate economies have to be bound together to share multiple risks across a large economic area and the implicit transfer of sovereignty requires that the countries be bound by much more than legal requirements.

This paper shows that, the current SGP, as it stands, is ineffective from both market and institutional (political) standpoints. Many of the new proposals, such as those above, attempt to address these two problems. In order for the rules to be respected, there must be an active mechanism for enforcement, not only with financial sanctions, but also with political sanctions. Without a true underlying force that incentivizes countries to maintain their targets, the burden of community-wide costs of profligacy are spread evenly over all countries, making the prospect of default and difficulty ever more dangerous for the monetary union as a whole. With the Maastricht Treaty, the criteria incentivized the countries to fulfill the criteria in order to have the chance to enter the monetary union, but there must be a way to continue to enforce these standards after the countries have entered the union. If not, this gives an incentive to any later entrants, such as Slovakia and Estonia, which are still among the least developed economies in the Eurozone, to ignore fiscal rules.

While Hallerberg (2010) argues in favor of strict enforcement of rules and the necessity of countries to learn from financial crises to reform their fiscal policy framework, the severity of

[28] "Christine Lagarde: Emerging Market Nations Will Get More Power in the IMF", *Knowledge @Wharton*, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2968

austerity measures in countries like Spain is provoking questions about the optimality of strict enforcement of deficit limits that is countercyclical and prevents automatic stabilizers from functioning fully. There are worries that it inhibits economic growth and renders balanced budgets even more difficult to achieve. A permanent solution to the debt crisis may not perhaps come through fiscal policy constraints, but perhaps through “Eurobonds” or fiscal union that allows for large transfers between countries.

A decisive end to doubts about the fiscal conditions of Eurozone countries and the viability of the euro as a single currency will depend on a credible enforcement of some form of the SGP. In order for the euro to survive its debt crisis, political leaders will need to determine a way to bind themselves to objective targets and instill confidence in both the market and to other member states.

## 8. Six-Pack and Fiscal Compact Treaty – lasting reform of the SGP?

As the sovereign debt crisis heightened after 2009 and bond yields rose to substantial levels for several countries that were considered to have poor finances, European leaders sought to reassure the financial markets of their determination to maintain sound finances in the future and of their commitment to the continuity of the single currency.

Special purpose vehicles (SPVs) were introduced during the crisis, designed to provide financial assistance to member states. All Eurozone countries contributed to the establishment of the European Financial Stability Facility (EFSF), while the European Commission created the European Financial Stability Mechanism (EFSM) with the EU budget funds as collateral. Both are due to be replaced by the European Stability Mechanism (ESM) in July 2012. Since Greece, Ireland, and Portugal were given financial rescue packages, other member states are seeking fiscal consolidation in the Eurozone and assurances that appropriate measures were taken to reduce deficit and debt levels across Europe, in particular in countries that were receiving aid.

In late 2010, Germany made proposals to reform the SGP, also known as the "Competitiveness Pact" to strengthen economic coordination in the Eurozone, which was supported by several member states and later formed part of the Euro Plus Pact as discussed in the previous section.

Given the limitations of the existing SGP, with 23 of 27 member states in EDP,[29] the EU attempted to reinforce it by launching the "Six-Pack", which is a legislative package of six legal acts (five regulations and one directive) that entered into force on December 13, 2011. Forming a part of EU secondary law, the Six-Pack had the aim of creating an enhanced framework for

[29] "EU Economic governance "Six-Pack" enters into force", EU Press Releases, http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898

economic and fiscal policy coordination and surveillance. The package applies to all member states, with additional rules for Eurozone members.

The Six-Pack has two major foci: fiscal surveillance and macroeconomic surveillance. Specifically, the EU Six-Pack relates to the following regulations and guidelines: [30]

**Fiscal Policy**

- Regulation: Strengthening of budgetary surveillance and coordination of economic policies
- Regulation: Speeding up and clarifying the implementation of the excessive deficit
- Regulation: Effective enforcement of budgetary surveillance in the euro area
- Directive: Requirements for the fiscal framework of the Member States

**Macroeconomic Imbalances**

- Regulation: Prevention and correction of macroeconomic imbalances
- Regulation: Enforcement action to correct excessive macroeconomic imbalances in the euro area

With the objective of preventing further crises, the Council and the European Parliament wanted to use the Six-Pack to strengthen enforcement of the SGP. In response to claims that the Preventive Arm of the SGP was ineffective, the Six-Pack empowers the Council to impose financial sanctions before even launching the Excessive Deficit Procedure. With regard to deficits, the Six-Pack defined quantitatively what “significant deviation” from the

[30] 1. Regulation 1173/2011 on the effective enforcement of budgetary surveillance in the euro area;
2. Regulation 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area;
3. Regulation 1175/2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies;
4. Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances;
5. Regulation 1177/2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure;
6. Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States

adjustment path toward the MTO meant, in the preventive arm of the SGP. Half a percent of GDP in one year or 0.25% per year in two consecutive years from the MTO would be considered a "significant deviation". In March 2012, Hungary was effectively sanctioned for failing to meet deficit targets by ECOFIN, with development funds for 2013 withheld until further review.[31] Furthermore, the Six-Pack enhances the power of the Council to launch the EDP for countries with a debt-to-GDP ratio of above 60% that are not diminishing towards the reference value.

A new Macroeconomic Imbalance Procedure was also introduced by the Six-Pack as a surveillance mechanism that consists of an early warning system with a scoreboard of ten macroeconomic indicators, a corrective arm as in the SGP, and new stricter rules in the form of a new Excessive Imbalance Procedure (EIP) that allows financial sanctions to be imposed more easily. By having the authority to monitor indicators other than deficit and debt, such as current account balance, house prices, private debt and unemployment, the Commission and Council would be able to spot macroeconomic imbalances that have an impact on a country's competitiveness and issue recommendations, with the possibility of imposing fines, even if deficit and debt reference values have not been breached.

Another important change to the SGP is that reverse qualified majority voting (RQMV) is required to reverse adoption of proposals from the Commission, as opposed to the previous situation where a qualified number of member states had to vote in favor of financial sanctions for the latter be imposed (QMV).

[31] Spiegel, P. (2012, March 13). Hungary sanctioned for missing deficit targets. *Financial Times.* Retrieved from http://www.ft.com/intl/cms/s/0/98cc9d28-6d2f-11e1-b6ff-00144feab49a.html#axzz1ravqV8LV

The following are trigger events for sanctions under the Six-Pack and the relevant penalties:[32]

| Trigger of the sanction | Sanction | Adoption |
|---|---|---|
| Failure to take action in response to a Council recommendation | Interest-bearing deposit (as a rule 0.2% of GDP) | RQMV |
| Existence of an excessive deficit, where interest-bearing deposit already made or there is serious non-compliance | Non-interest-bearing deposit (as a rule 0.2% of GDP) | RQMV |
| No effective action in response to Council recommendation to correct excessive deficit | Fine (as a rule 0.2% of GDP) | RQMV |
| Persistence in failing to put into practice recommendations from the Council to correct excessive deficit | Fine (0.2% of GDP + variable component, up to 0.5% of GDP) | QMV |

Even before the Six-Pack was launched, the ECB criticized it for giving the Council too much room for discretion on the execution of the surveillance procedure in the SGP.[33] Countries with debt exceeding 60% of GDP were given a transition period of up to 6 years. Discussion is underway for two additional resolutions, termed the "Two-Pack" to enhance the surveillance mechanism for countries in excessive deficit.

Even as the Six-Pack was discussed, European leaders openly debated some form of fiscal union as the next step to the EMU and for European economic integration. Ideas of such a union had circulated back in 2007 by former ECB president Jean-Claude Trichet. Faced with the possible collapse of the euro project, many countries believed that a closer economic union was the right step in bringing about a solution to the sovereign debt crisis.

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[32] "EU Economic governance "Six-Pack" enters into force", EU Press Releases.
[33] Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB, at the XXIV Moneda y Crédito Symposium, November 4, 2011. Retrieved from http://www.ecb.int/press/key/date/2011/html/sp111104_1.en.html

In 2009, Germany enshrined in its constitution a law prohibiting federal deficits of more than 0.35% of GDP by 2016, and requiring *Länder* (states) to run balanced budgets by 2020. In May 2010, Germany urged other countries to adopt similar reforms regarding debt and budgetary discipline in their constitutions in order to stabilize the euro.

In March 2011, a new reform of the SGP was initiated, which would be enshrined in EU treaties, responding to the criticism that penalties against deficits were not automatic in the original SGP. German chancellor Angela Markel also urged the involvement of the European Commission and the European Court of Justice in the enforcement of stricter budgetary rules, which would be less than the 3% required by the SGP.

All 27 EU members met in December 2011 at a European Council meeting to discuss a Europe-wide treaty to enshrine budget and debt limits into their respective constitutions, with penalties for violators. Unlike the SGP and the Six-Pack, which are secondary law, the Treaty would be primary law and strictly binding on member states. Since British Prime Minister David Cameron did not agree to the inclusion of fiscal discipline measures in EU treaties unless there were guarantees for the City of London to be excluded from future European financial regulations, including a financial transactions tax, an EU-wide treaty could not be negotiated.

The other members opted for an intergovernmental treaty, titled the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, commonly referred to as the Fiscal Compact or the Fiscal Stability Treaty. It was signed by all of the member states except the Czech Republic and the United Kingdom on March 2, 2012. Unlike the Treaty of Lisbon, and perhaps because of the experience from the failed ratification of the Treaty establishing a Constitution for Europe, ratification by every signatory was not necessary for the treaty to enter into force. The Treaty will enter into force on January 1, 2013, if by that time 12 members of the Eurozone have ratified it.

Heralded as a “reinforced architecture for the EMU”, the Fiscal Compact Treaty requires its parties to introduce a national requirement to have national budgets that are in balance or in surplus (as called for in the Euro Plus Pact). The European Court of Justice (ECJ) would fine a country up to 0.1 % of GDP if this has not done this a year after ratification. Countries have one year to implement balanced budgets, and countries that do not sign on to the new Treaty will not be eligible for funds from the ESM.

Given that subsidiarity is one of the fundamental principles of EU law that states that the EU may only intervene when actions of national governments cannot be sufficient, taxation and fiscal policies remain national competencies. Previously, the SGP was limited in its coordination of fiscal policies by providing a warning and limited dissuasive system, but national governments retained full fiscal powers. In the absence of a fiscal union, national governments were made responsible to prevent divergences in fiscal policy.

Major stipulations from the Fiscal Compact of the Treaty include:

> *Article 3. […]*
>
> *1. (a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;*
>
> *(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0,5 % of the gross domestic product at market prices. […]*
>
> *(e) in the event of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically. […]*
>
> *2. The rules set out in paragraph 1 shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and*

*permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes. […]*

*Article 4.*

*When the ratio of a Contracting Party's general government debt to gross domestic product exceeds the 60 % reference value referred to in Article 1 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, that Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark. […]*

*Article 8.*

*1. […] If the European Commission […] concludes in its report that such Contracting Party has failed to comply with Article 3(2), the matter will be brought to the Court of Justice of the European Union by one or more Contracting Parties. […]*

*2. […] If the Court of Justice finds that the Contracting Party concerned has not complied with its judgment, it may impose on it a lump sum or a penalty payment appropriate in the circumstances and that shall not exceed 0,1 % of its gross domestic product.*

The maximum structural deficit was limited to 0.5% of GDP, as in the Six-Pack, and debt levels must also be reduced by one twentieth of the difference between the current debt ratio and the target of 60%. An exception was made for countries with government debt levels significantly below 60 % and there is low risk with their public finances, which can reach a structural deficit of at most 1.0 % of GDP.

Similarly to the procedures in the SGP, member states in the EDP have to submit an economic program to the Commission detailing the reform it will take to correct excessive deficits. As soon as a member state is recognized to be in breach of the 3% ceiling as under the SGP, the Commission submits a proposal of counter-measures for corrective action to be taken. The Commission would also evaluate progress towards the medium-term objective (MTO) and assess the structural balance as a whole. However, a qualified majority of member states may still reject these proposals. Since the Fiscal Compact Treaty is an intergovernmental treaty that is not signed by the United Kingdom and the Czech Republic, only countries that have signed and ratified the Treaty will have to abide by the more stringent rules required by the Treaty, in addition to the SGP, as revised by the Six-Pack. Remaining member states would continue to be obligated to adhere to SGP rules, but would not be required to enshrine budget rules in their constitution, nor be subject to fines imposed by the European Court of Justice.

In addition, under the Fiscal Compact Treaty, before issuing debt, member states would also be required to submit a report to the Commission and to ECOFIN. This is to ensure that major economic policies are coordinated among member states. Furthermore, Euro Summit meetings will be held at least twice a year to discuss the governance of the Eurozone.

If the Treaty is successfully ratified in the Eurozone, which is highly likely given that this is a precondition for recourse to ESM funds, the new enforcement mechanisms with respect to the SGP should have improved. Governments are required by national legislation to adopt balanced budgets, and any violation would be sanctioned in national courts and the European Court of Justice (ECJ) with penalties up to 0.1% of GDP. However, this requires that another member state take action before the courts and a qualified majority of member states can still reject proposals from the Commission, thereby reducing the threat of sanctions. The Commission possesses a large degree of flexibility in the interpretation of the Treaty stipulations, acting only where there is “serious” non-compliance.

Only within a few weeks of the signing of the Treaty, Spanish Prime Minister Mariano Rajoy openly declared that he would flout SGP rules by increasing the Spanish projected deficit in 2012 from 4.4% to 5.8%, well above the permitted reference values. In the financial markets, there was a perception that Spain was relaxing its fiscal targets, and 10-year borrowing rates rose accordingly.[34]

There is substantial overlap between the Six-Pack and the Fiscal Compact Treaty with regards to financial sanctions in cases of non-compliance, as well as definitions of MTO and exceptional circumstances under which normal rules would not apply. In addition, the Treaty also requires RQMV to reverse recommendations from the Commission. The Council argues that the Six-Pack and Treaty can run in parallel and plans to introduce further legislation to require monitoring budgetary rules at the national level by independent institutions. However, in an article in the *Financial Times*, at the time of the introduction of the Treaty, there was widespread sentiment in the EU that the Treaty was “unnecessary” since it duplicated much of the Six-Pack and that other stipulations could be introduced under secondary legislation (Münchau, 2012).

At a time when Europe is faced with serious impediments to growth and where most member states run significant deficits, the enforcement issues that existed with the SGP have not been eliminated. With low-growth economies and an increasing debt burden, Eurozone countries are forced to strike a balance between growth promotion and budget discipline.

Whether the Fiscal Compact can be an effective successor to the SGP depends on similar factors that affected the success of the SGP, in particular, its institutional (political) and market enforcement. If member states’ commitment to balanced budgets and sanctions in case of violation are credible, the financial markets would not need to assign higher borrowing costs to countries that are perceived to be fiscally imprudent. In other words, compliance with budget

[34] Spiegel, P. (2012, Mar 24). Rehn tells Spain: Stick to deficit targets. *Financial Times*, http://www.ft.com/intl/cms/s/0/6cb50654-75c6-11e1-9dce-00144feab49a.html

deficit rules has to be reliable for the markets and for the EU as a whole for the Fiscal Compact to promote the sustainability of the EMU successfully.

## 9. Greek Default

In February 2012, Greece was facing the prospect of sovereign default and was in need of additional rescue funds from the International Monetary Fund (IMF) and EU before March 20 for its bond payment of €14.5 billion and was negotiating the next lending package, worth €130 billion. The Greek government approved the draft bill of a new austerity plan, including a substantial reduction in minimum wage, permanent elimination of holiday wage bonuses, job cuts, liberalization of several professions and pension cuts.

After passing the new austerity package, one of the hurdles for receiving the new loan was the negotiation of a debt restructure agreement, with a debt write-off worth €107 billion, to be implemented by a bond swap in early March 2012, involving minimum 95% of the private creditors ("Private Sector Involvement", PSI). Under the terms of the deal, investors of €206 billion in Greek government bonds, if they accept the deal voluntarily or by a collective action clause, would have to write down the face value of their holdings by 53.5%, by swapping bonds they hold for longer-dated bonds with a lower coupon. If investors fully participate, the exchange would knock around €107 billion off of Greece's debt load.[35]

Even though European leaders had hoped to avoid triggering a credit default swap (CDS) payout on Greek debt when restructuring sovereign debt, on March 9, 2012, the International Swaps & Derivatives Association (ISDA), the body the regulates the CDS, declared that Greece's €206 billion bond restructuring was a "credit event".

[35] "Greece offers investors bond swap", William L. Watts, Market Watch (Feb 24, 2012), http://articles.marketwatch.com/2012-02-24/investing/31094122_1_credit-default-swaps-european-central-bank-bonds

Fourteen dealer banks set a value of 21.5 per cent of par for Greek bonds, which means that credit default swaps will have to pay 78.5 cents on the euro to settle contracts triggered by the nation's debt restructuring. At a market-wide level, payout was determined to be $2.4 billion in an auction held on March 19. Since Greece was the European Union's first technical sovereign default, there was uncertainty over the workings of the deal. However, the "credit event" was rather uneventful and showed that the CDS market was "viable for hedging" against sovereign risk.[36]

Greece continued to receive bailout funds from the EU and the IMF, averting a deadline for default on March 20. Although investors were only engaged in a debt restructuring and not a full default, the Greek government faces continual pressures to reduce its expenditures and to push forth austerity measures.

The orderly "credit event" resulting from the restructure suggests that CDS remains an effective tool used by market participants to gauge the risk of a country's public finances. The question remains, however, whether the Greek experience with default increases market discipline in the Eurozone with respect to observance of the SGP debt and deficit values, or whether it demonstrates the failure of the SGP in averting such a crisis.

[36] Armitstead, L. (2012, Mar 19). CDS boost as Greece default leads to $2.5bn pay-out. *The Telegraph*. Retrieved from http://www.telegraph.co.uk/finance/financialcrisis/9154136/CDS-boost-as-Greece-default-leads-to-2.5bn-pay-out.html
Oakley, D. (2012, Mar 19). Greece creditors get $2.5bn CDS payout. *Financial Times*. Retrieved from http://www.ft.com/cms/s/0/6c7332ec-71b6-11e1-b853-00144feab49a.html

## 10. Conclusion

The euro has faced its largest challenge since its inception, after an arguably successful first decade. The convergence criteria, enshrined in the Maastricht Treaty, were put in place from Germany, managed to bring down inflation, deficit, and debt levels for many European countries, who sought to join this "club", above all political, of the best European economies. Many countries made a real effort at slashing spending and paying down the debt, while maintaining their economies at a stable level.

The Stability and Growth Pact was a political agreement that purported to keep countries in line with the same deficit and debt criteria after formal entry in the Eurozone in 1999 (2001 for Greece). With both a preventive arm and an excess deficit procedure, the SGP was intended to warn countries ahead of time of deteriorating deficit and debt levels, and to impose sanctions on countries that continued to violate on these conditions.

Countries that ended up with the highest deficit and debt levels did not necessarily begin that way, notably Ireland. Deficit and debt levels were split between two groups of countries, none of which strayed significantly from the targets.

This paper demonstrated that there were enforcement issues at both the market and institutional levels. When fiscal conditions deteriorated, market hardly responded to these changes, and in particular with CDS levels, began to react sharply after the collapse of Lehman Brothers and the revelation of deteriorating fiscal conditions in the Eurozone starting in 2009. Markets often operated under the assumption that the Eurozone would not default, given that countries such as Germany and France had very high credit quality. It was when it was revealed that countries could in fact default that the debt and deficit levels were scrutinized closely by the markets and were reflected in market prices for sovereign bonds and CDSs.

At the institutional level, since the Stability and Growth Pact required a vote by the ECOFIN and the worst transgressors were countries with substantial influence and votes on the Council, financial sanctions have never been imposed and official warnings by the European Commission were ignored. Neither the Preventive arm of the SGP nor the Excessive Deficit Procedure (EDP) proved to be influential in changing spending levels by national governments. In fact, France and Germany suspended the SGP in 2003 and gave its provisions broad interpretations that allowed them to exceed deficit limits by arguing that it was still maintaining medium term objectives, which proved to be false over the five subsequent years. In 2005, even with the implementation of the reformed SGP, effects have been minimal.

During the sovereign debt crisis, deficit and debt levels deteriorated dramatically and while markets reacted negatively to changes in spending, the debt and deficit thresholds have more or less been suspended in light of economic difficulties in all Eurozone countries. One questions whether an actively enforced SGP in the preceding years could have prevented the attacks on several of the Eurozone countries.

Other literature proposes various alternatives proposals to the SGP, but insists on the economic and political aspects of its enforcement. The SGP is above all a political agreement, and proper enforcement of fiscal targets depends on sufficient deterrents that prevent democratically elected leaders from straying from the targets. Resolution of issues with government finances is of particular interest for the monetary union and the European Union. Given the lack of an appropriate response to concerns about profligacy and excessive indebtedness, borrowing costs will remain high for member states and put the stability and the viability of the euro in question.

The SGP is only a piece of the puzzle that is the economic and monetary union. A full resolution to the sovereign debt crisis will need far more than revised fiscal rules, but rather, a reconceptualization of what a single currency for 17 countries means in the context of European integration and changing dynamics for EU economies in the world. Whether the SGP and ineffective EU-wide fiscal enforcement eventually become a chapter in the history of EU integration that propelled member states toward “ever closer union” or whether the crisis signals the end of a flawed process will depend on a thorough evaluation of the inefficacies of the current SGP, as well as a rapid response to bring about a permanent, viable system that is effective at both political and market levels in committing Eurozone countries to enact fiscal policy that will bring stability to the euro and bring growth to the European economy.

## Appendix 1 - The three stages towards EMU

### Stage 1 (1990-1994)

- Complete the internal market and remove restrictions on further financial integration.

### Stage 2 (1994-1999)

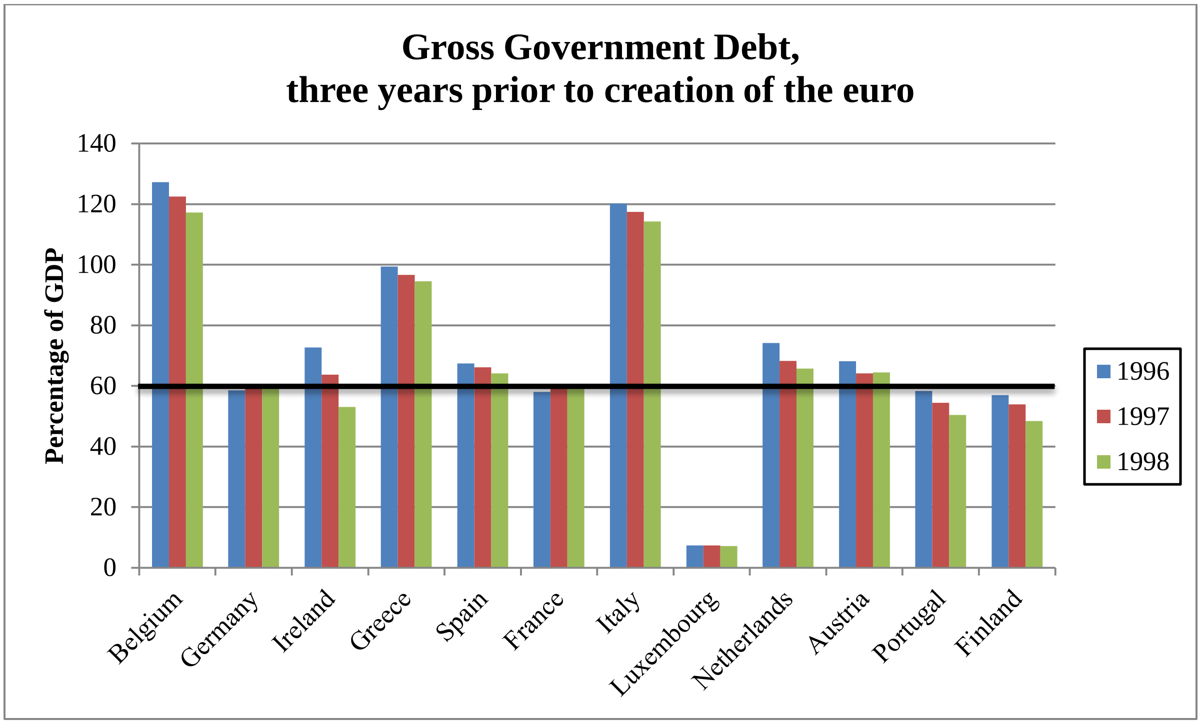
- Establish the European Monetary Institute to strengthen central bank co-operation and prepare for the European System of Central Banks (ESCB).
- Plan the transition to the euro.
- Define the future governance of the euro area (the Stability and Growth Pact).
- Achieve economic convergence between Member States.

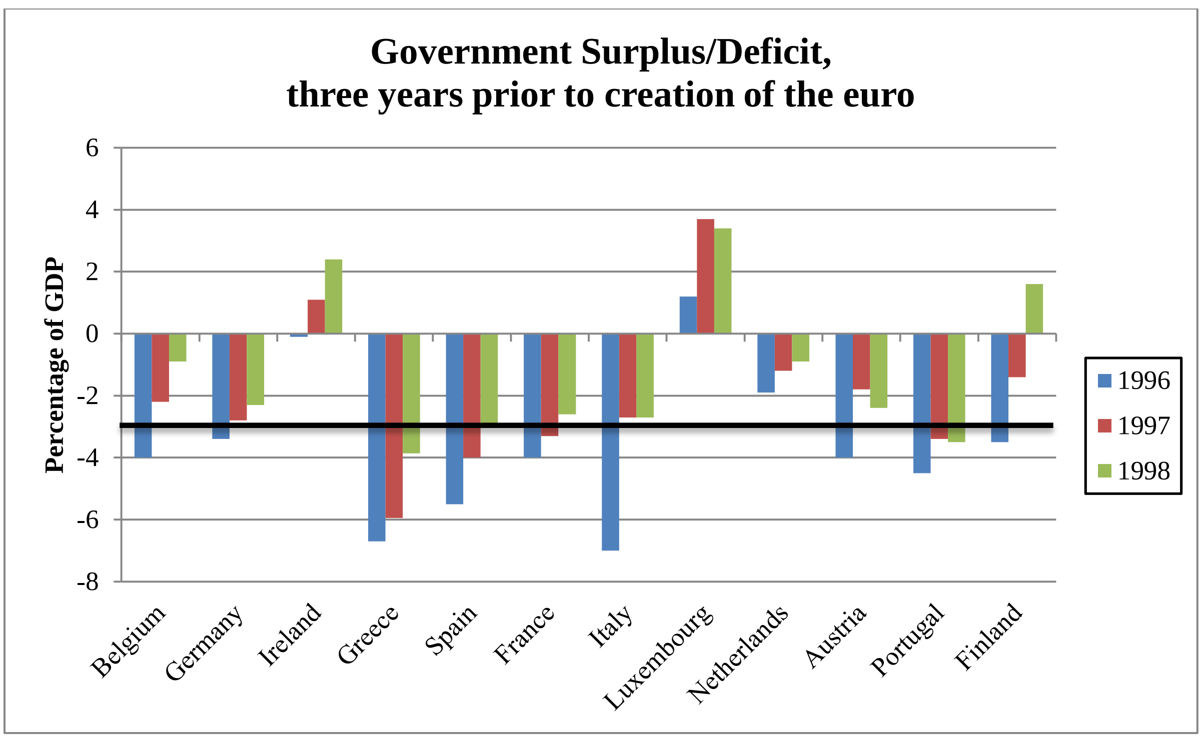
### Stage 3 (1999 onwards)

- Fix final exchange rates and transition to the euro.
- Establish the ECB and ESCB with independent monetary policy-making.
- Implement binding budgetary rules in Member States.

Source: European Commission, Retrieved from http://ec.europa.eu/economy_finance/euro/emu/road/delors_report_en.htm

## Appendix 2 – Pre-Entry to Euro Debt and Deficit to GDP




* Greece entered the Eurozone in 2001

Source: Eurostat

## Appendix 3 – Compliance with Maastricht Convergence Criteria prior to Accession to EMU

| Country | Average Inflation Rate (%) | Excessive deficit | General Government Surplus/Deficit (% of GDP) | General Government Gross Debt (% of GDP) | ERM Participation | Long-term interest rate (%) | Fulfill Convergence Criteria |
|---|---|---|---|---|---|---|---|
| **Belgium** | 1.4 | No | -1.7 | 118.1 | Yes | 5.7 | Yes |
| **Germany** | 1.4 | No | -2.5 | 61.2 | Yes | 5.6 | Yes |
| **Greece** | *5.2* | *Yes* | *-2.2* | *107.7* | *No* | *9.8* | *No* |
| **Spain** | 1.8 | No | -2.2 | 67.4 | Yes | 6.3 | Yes |
| **France** | 1.2 | No | -2.9 | 58.1 | Yes | 5.5 | Yes |
| **Ireland** | 1.2 | No | 1.1 | 59.5 | Yes | 6.2 | Yes |
| **Italy** | 1.8 | No | -2.5 | 118.1 | No* | 6.7 | Yes |
| **Luxembourg** | 1.4 | No | 1.0 | 7.1 | Yes | 5.6 | Yes |
| **Netherlands** | 1.8 | No | -1.6 | 70.0 | Yes | 5.5 | Yes |
| **Austria** | 1.1 | No | -2.3 | 64.7 | Yes | 5.6 | Yes |
| **Portugal** | 1.8 | No | -2.2 | 60.0 | Yes | 6.2 | Yes |
| **Finland** | 1.3 | No | 0.3 | 53.6 | No* | 5.9 | Yes |

* National currency displayed sufficient stability over two preceding years

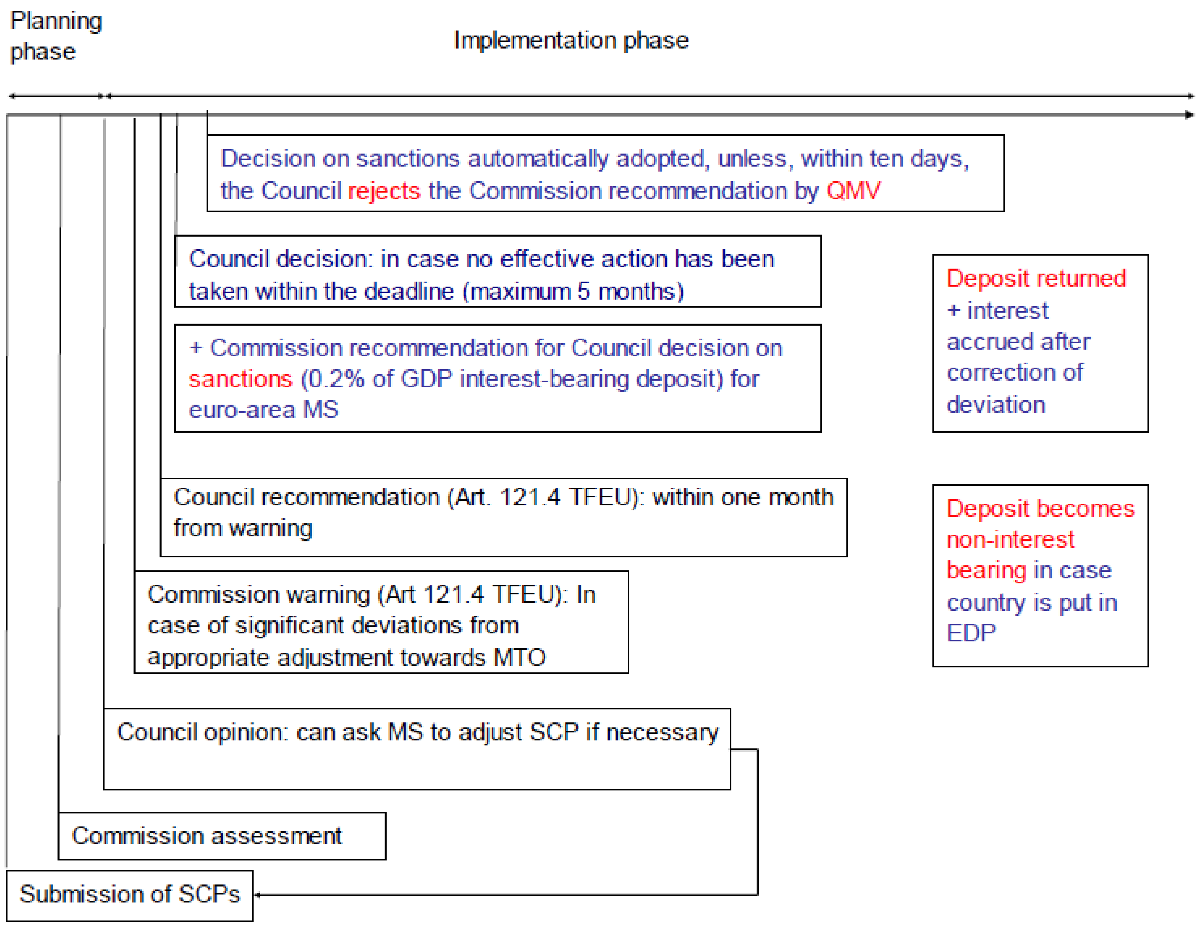
Sources: Council Decision of 2 May 1998 in accordance with Article 109j(4) of the Treaty (98/317/EC) and Convergence Report, March 1998 based on European Commission projections for Spring 1998

| Country | Average Inflation Rate (%) | Excessive deficit | General Government Surplus/Deficit (% of GDP) | General Government Gross Debt (% of GDP) | ERM Participation | Long-term interest rate (%) | Fulfill Convergence Criteria |
|---|---|---|---|---|---|---|---|
| **Greece** | 2.0 | No | -1.3 | 103.7 | Yes | 6.4 | Yes |

Sources: Council Decision of 19 June 2000 in accordance with Article 122(2) of the Treaty on the adoption by Greece of the single currency on 1 January 2001 (2000/427/EC), and Convergence Report, May 2000 based on European Commission projections for Spring 2000

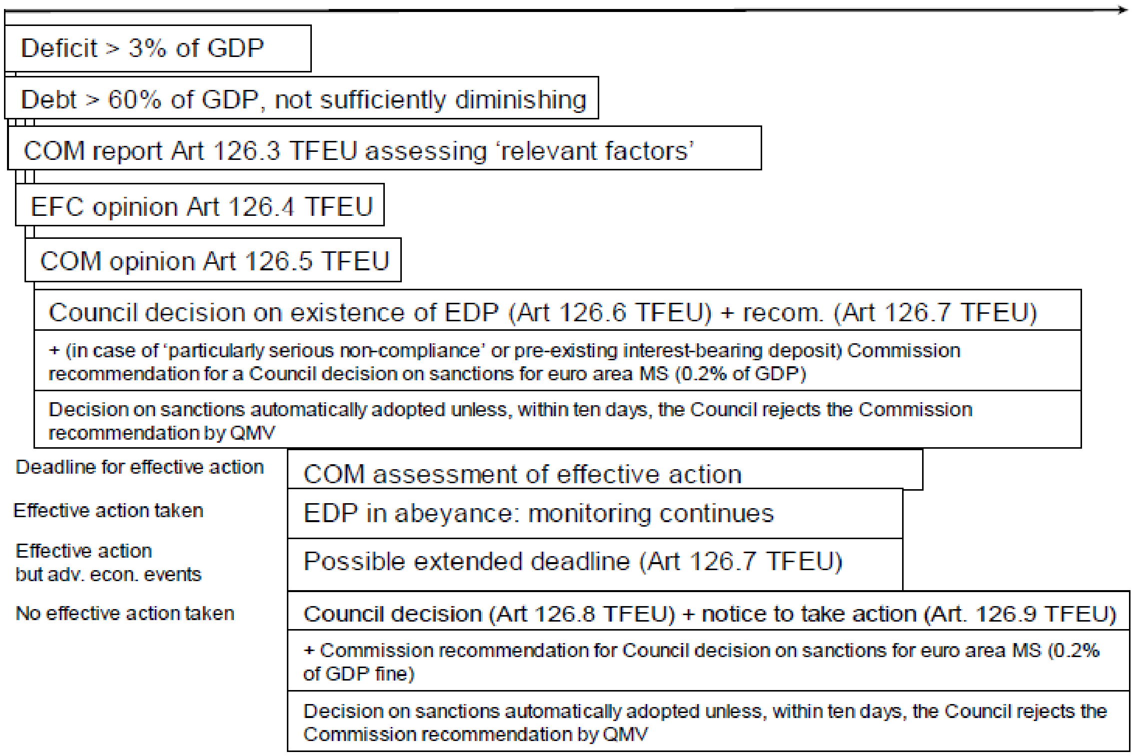
## Appendix 4 – Preventive Arm and Corrective Arm Processes[37]

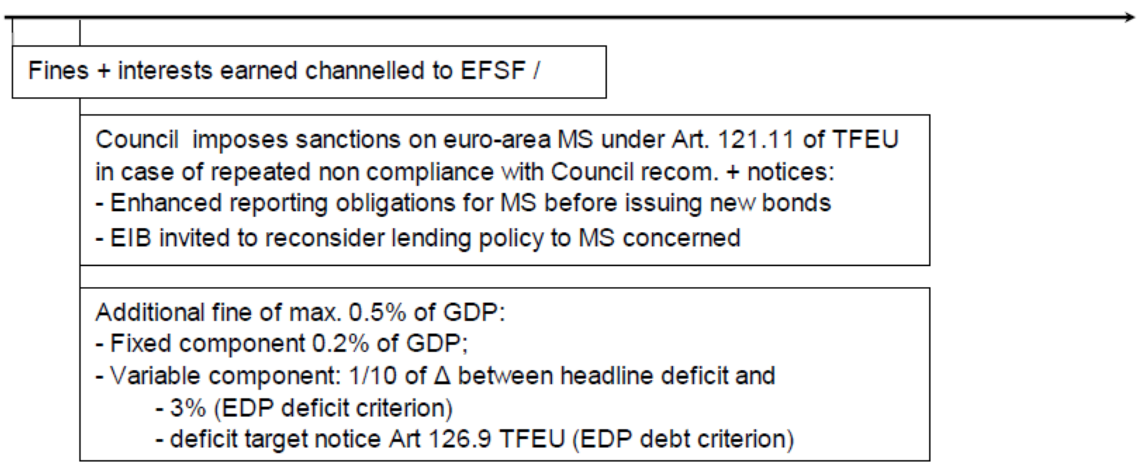
### Preventive Arm




[37] The Preventive Arm and Corrective Arm as depicted here reflect the processes after amendment by the Six-Pack, but do not include changes included in the Fiscal Compact Treaty.

## Corrective Arm




(COM – European Commission; EFC – Economic and Financial Affairs Council)

Source: Public Finances in the EMU 2011, European Commission

## Appendix 5 – History of Excessive Deficit Procedures Launched against Member States

| Country | Commission Report | Abrogation of Council Decision | Result | Correction Deadline |
|---|---|---|---|---|
| **Belgium** | 07.10.2009# | | | 2012 |
| **Germany** | 19.11.2002<br>07.10.2009# | 05.06.2007 | Excessive Deficit Corrected | 2004<br>2013 |
| **Greece** | 19.05.2004<br>18.02.2009# | 05.06.2007 | Excessive Deficit Corrected | 2005<br>2014 |
| **Spain** | 18.02.2009# | | | 2013 |
| **France** | 02.04.2003<br>18.02.2009# | 30.01.2007 | Excessive Deficit Corrected | 2004<br>2013 |
| **Ireland** | 18.02.2009# | | | 2015 |
| **Italy** | 07.06.2005<br>07.10.2009# | 03.06.2008 | Excessive Deficit Corrected | 2007<br>2012 |
| **Luxembourg** | 12.05.2010 | No Council Decision Issued | Commission considered deficit close to criterion value | N/A |
| **Netherlands** | 28.04.2004<br>07.10.2009# | 07.06.2005 | Excessive Deficit Corrected | 2005<br>2013 |
| **Austria** | 07.10.2009# | | | 2013 |
| **Portugal** | 24.09.2002<br>22.06.2005<br>07.10.2009# | 11.05.2004<br>03.06.2008 | Excessive Deficit Corrected<br>Excessive Deficit Corrected | 2003<br>2008<br>2013 |
| **Finland** | 12.05.2010 | 12.07.2011 | Excessive Deficit Corrected | 2011 |

# Ongoing Excessive Deficit Procedure

Source: ECOFIN (http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm)

## Appendix 6 – Acronyms and Abbreviations

CDS Credit Default Swap

ECB European Central Bank

ECJ European Court of Justice

ECOFIN Economic and Financial Affairs Council

EDP Excessive Deficit Procedure

EFSF European Financial Stability Facility

EFSM European Financial Stability Mechanism

EIP Excessive Imbalance Procedure

ESM European Stability Mechanism

EMU Economic and Monetary Union

EMS European Monetary System

ERM Exchange Rate Mechanism

EU European Union

GDP Gross Domestic Product

IMF International Monetary Fund

MIP Macroeconomic Imbalance Procedure

MS Member State

MTO Medium Term Objective

OECD Organisation for Economic Co-operation and Development

PSI Private Sector Involvement

QMV Qualified Majority Voting

RQMV Reverse Qualified Majority Voting

SCP Stability and Convergence Program

SFA Stock-Flow Adjustments

SGP Stability and Growth Pact

SMP Securities Market Program

TEU Treaty on European Union

TFEU Treaty on the Functioning of the European Union

TSCG Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

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