The implementation of the Stability and Growth Pact

Sound government finances are a means of strengthening the conditions for price stability and for strong, sustainable growth conducive to employment creation. The Treaty establishing the European Community as amended by the Treaty of Amsterdam (the Treaty) and the Stability and Growth Pact signed in Amsterdam in June 1997 provide countries in the EU, and in particular those which have adopted the euro, with a common code of fiscal conduct that is expected to uphold discipline in the management of government finances. Budgetary positions close to balance or in surplus will enable all Member States to deal with normal cyclical fluctuations while keeping the government deficit below the reference value of 3% of GDP. Low deficits, along with steadily declining debt burdens, would contribute to keeping inflationary expectations low, thus facilitating the Eurosystem s task of maintaining price stability. Between late 1998 and early 1999 all EU countries submitted stability and convergence programmes informing the ECOFIN Council and the European Commission about their current budgetary positions and their fiscal plans for the future. Although they were found to comply in broad terms with the norm of fiscal discipline established in the Stability and Growth Pact, no additional safety margins appear to have been incorporated into the programmes presented by a number of countries to provide for unforeseen contingencies, to speed up the pace at which debt levels are being worked down, or to prepare government finances for the great strains expected as a result of imminent demographic developments.

1 Introduction

Attaining and preserving a macroeconomic balance as a prerequisite for economic and social progress has been the foremost objective guiding European economic and monetary integration in the 1990s. The aim both to buttress the mandate of the European System of Central Banks (ESCB) to safeguard price stability and to apply the principle of subsidiarity to non-monetary policies of participating governments figured high on the agenda of the founders of Economic and Monetary Union (EMU). At the same time they held the belief that sound government finances are an indispensable requisite for macroeconomic stability, and that financial stability is also rooted in disciplined fiscal policies. Hence an EU-wide commitment to sound public finances, such as that laid down in the Treaty and further developed in the Stability and Growth Pact, commands respect and constitutes a permanent guarantee that a responsible course of fiscal policy will be pursued.

The experience accumulated in past decades has shown that increased debt ratios as well as the implicit debt associated with social security systems in ageing societies cast a permanent shadow over economic prospects and, together with large deficits, constantly limit the scope for fiscal policy to act as a stabilising instrument. Long-term real interest rates are higher, private investment is lower and physical capital formation is at least partially crowded out. This reduces production, output suffers a permanent loss and consumption possibilities are diminished in the long run. Indeed, empirical evidence points to a significant negative relationship between fiscal imbalances and total gross domestic investment, and between deficits and income per capita over the medium term.

Moreover, fiscal laxity also appears to reduce the flexibility with which fiscal structures respond to economic fluctuations and help to dampen their effects on aggregate income. Fiscal structures have become more rigid over the past few decades. This has been partly due to discretionary policies to increase government employment or implement high replacement ratios and early retirement dates for pensioners, and has been partly a budgetary by-product of adverse demographic trends which have increased the proportion of retirees in populations. Far from facilitating the smoothing of income through the different phases of the cycle, growing structural deficits have systematically impeded the policy-makers response to severe recession, even when endogenous spending and tax adjustments were most needed.

Inflation is a monetary phenomenon in the medium to long term. Since the long-run association between the monetary financing of fiscal deficits and inflation is well established, a credible and definitive prohibition of this, along with an institutional framework that assigns the monetary authority a credible and lasting mandate to pursue an objective of price stability, are essential preconditions for the maintenance of price stability over the medium term. However, the task of a stability-oriented monetary policy can also be affected by the stance of fiscal policies. In the short run regulated prices and indirect taxes have a direct impact on HICP inflation. Over an extended period of time, unbalanced public finances have a negative impact on economic efficiency and hence on the process of price formation. High structural deficits tend to divert resources from private capital formation and to increase the gap between aggregate demand and supply. This tends to alter the composition of aggregate supply and creates rigidities and bottlenecks that contribute to heightened pressures on prices. In this way, persistent deficits might force monetary authorities to keep short-term rates higher than would otherwise be necessary. By contrast, an institutional framework that guarantees sound government finances fosters macroeconomic stability conducive to sustained growth in output and employment, and supports the maintenance of price stability as well as a steady improvement in living standards.

In certain circumstances, fiscal policies might also affect expectations and exacerbate the effects of economic and financial shocks. If market participants perceive fiscal structures to be overly exposed to economic fluctuations or changes in interest rates (e.g. because of insufficient safety margins built into primary balances to withstand adverse contingencies) such shocks might lead to increases in risk premia and long-term interest rates.

In a monetary union among sovereign states the case is strengthened for a responsible policy course with regard to fiscal choices. A newly established monetary union eliminates long-standing interest rate differentials which used to compensate investors for differences in inflation and depreciation prospects across the range of previously existing currencies. In this way, borrowers lose an element a depreciating national currency which used to signal market distress over misguided policies, not least on the fiscal front. At the same time, as national financial markets become more integrated, sovereign issuers can draw on a larger and more liquid capital market than was possible under monetary autonomy. For those member countries that had been penalised in relative terms in the market for government loans, vanishing risk and liquidity premia may consequently make borrowing a more attractive policy option than non-deficit spending as a means of financing public expenditure. This feature, in turn, tends to lend a deficit bias to the area as a whole, which, again, provides a major incentive for an economic constitution which discourages unsound fiscal practices.

When the fiscal authority is dispersed, errant fiscal choices pursued by individual members of a monetary union can have negative repercussions on their neighbouring economies. These negative external effects are generally transmitted via long-term interest rates, as fiscal laxity in one country and the drain that this exerts on union-wide private savings both put pressure on the cost of long-term finance for the area as a whole. In principle, market forces could act as an effective deterrent against deviant policies. Indeed, even in the absence of explicit institutional constraints on fiscal deficits, the possibility of country-specific default premia penalising excessive borrowing could discourage deviation from fiscal discipline by individual governments. However, in practice there seems to be no firm evidence that the discipline exerted by financial markets has been sufficient to induce governments always to take heed of long-term budget constraints. Under such circumstances, unfettered fiscal regimes at the national level are inevitably conducive to tensions, and there is an obvious argument for supplementing market forces with commonly shared rules of fiscal restraint. These induce national policy-makers to internalise the area-wide impact of their decisions. In so doing, supranational rules improve co-ordination and inspire mutual trust among members.

2 The Treaty and the Stability and Growth Pact: institutional and procedural aspects

The budgetary rules of the Treaty

In Stage Three of EMU budgetary policy remains an exclusive competence of the Member States. This contrasts with the existence not only of a single monetary policy, but also of common policies in the areas of agriculture, trade and competition. Within the framework of the Treaty, the budgetary autonomy of Member States is, in formal terms, absolute. However, the conduct of national budgetary policies is subject to rules of budgetary discipline and co-ordinating procedures at the Community level laid down in the Treaty (Title VII, Chapter 1 on Economic policy). (In this article all references to provisions of the Treaty are taken from the consolidated version provided by the Treaty of Amsterdam, which came into force on 1 May 1999.) The basic rule of budgetary policy enshrined in the Treaty is that Member States shall avoid excessive government deficits. This norm is developed in Article 104 (ex Article 104c) and in Protocol No. 5 on the excessive deficit procedure annexed to the Treaty. Article 104 (ex Article 104c) comes after general guidelines and rules for economic (non-monetary) policy co-ordination, as well as a set of restrictions on the financing of public sector borrowing requirements. These guidelines and restrictions are established in Articles 98 to 100 (ex Articles 102a to 103a) and Articles101 to 103 (ex Articles 104 to 104b), respectively.

The general guidelines and rules provide that Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community (see Annex 1). According to Article 2 (ex Article 2) of the Treaty, these objectives are

> to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States .

Moreover, they must regard their economic policies as a matter of common concern, on the basis of the close co-ordination of Member States economic policies within the ECOFIN Council. The latter body is composed of the Ministers of Finance and Economy of the Member States. The guiding principles set out in Article 4 (ex Article 3a) of the Treaty are stable prices, sound public finances and monetary conditions, and a sustainable balance of payments. The ECOFIN Council is required to formulate broad guidelines for the economic policies of the Member States and to monitor economic developments within a multilateral surveillance framework. For this purpose, Member States must forward, inter alia, information about important measures they have taken in the field of their economic policy responsibilities. Should the economic policy conduct of a Member State be inconsistent with the broad guidelines or risk jeopardising the proper functioning of EMU, the Council may address a recommendation to the Member State concerned and decide to make this recommendation public.

The restrictions on the financing of public sector borrowing requirements establish a prohibition on overdraft facilities or any other type of credit facility with the ECB or with national central banks in favour of any public sector institution at the national or the Community level (see Annex 2). They also prohibit the ECB and the national central banks from purchasing debt instruments directly from these institutions and the Member States from granting them privileged access to financial institutions, unless this is based on prudential considerations. Moreover, the Treaty stipulates that the debts of public sector institutions of any Member State shall not be assumed by the Community or by any other Member State. This provision, which is generally known as the no bail-out clause , means that, in the event of the insolvency of any of these institutions, neither the Community nor the other countries will be held responsible for the debt of the insolvent institution.

With regard to budgetary policy, the rule is that Member States shall avoid excessive deficits (see Annex 3, Article 104 (1) (ex Article 104c (1)). Compliance with budgetary discipline is to be examined on the basis of reference values for the general government deficit and gross debt in relation to GDP, whereby a number of qualifications can be applied. In particular, only an exceptional and temporary excess of the deficit over the reference value can be exempt from being considered excessive, and then only if it remains close to the reference value. In assessing the budgetary position, further information can also be taken into account, e.g. the level of public investment in relation to the government deficit. The decision as to whether a Member State is in an excessive deficit position lies with the ECOFIN Council, acting upon a recommendation by the European Commission.

The budgetary rules of the Stability and Growth Pact

The European Council decided to provide clarification of the Treaty s budgetary rules in 1997 by implementing the Stability and Growth Pact, which lays down the rules for economic policy co-ordination and defines the conditions under which to apply the excessive deficit procedure in Stage Three of EMU. The Pact mainly aims at (a) ensuring lasting compliance of fiscal policies with the requirement of budgetary prudence, and (b) monitoring fiscal developments with a view to releasing early warnings in the event of budgetary slippage. In this context, the European Council underlines the importance of safeguarding sound government finances as a means of strengthening the conditions for price stability and strong sustainable growth conducive to employment creation. The Stability and Growth Pact, which provides for both prevention and deterrence, consists of a Resolution of the European Council (Amsterdam, 17 June 1997), in which the commitments of the Member States, the European Commission and the European Council itself are specified, and two ECOFIN Council Regulations. Council Regulation (EC) No. 1467/97 of 7 July 1997 brings forward and clarifies the implementation of the excessive deficit procedure. Council Regulation (EC) No. 1466/97 of 7 July 1997 deals with the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies and defines the content of the stability and convergence programmes.

As the main provision to ensure sound budgetary policies on a permanent basis, the Resolution of the European Council on the Stability and Growth Pact incorporates the Member States commitment to respect the medium-term budgetary objective of positions close to balance or in surplus (see Annex 4). This objective will allow all Member States to deal with normal cyclical fluctuations, while keeping the government deficit at or below the reference value of 3% of GDP. Deficits of above 3% of GDP will be regarded as excessive, unless they are expected to be temporary and have occurred under exceptional circumstances. In any case, the deficit has to remain close to the reference value. Circumstances are qualified as temporary and exceptional if the deficit overshoot is driven either by an unusual event beyond the control of the Member State or by a severe recession. An excess over the reference value resulting from a severe economic downturn will, as a rule, only be considered to be exceptional by the European Commission if there is an annual fall in real GDP of at least 2%. A smaller decline in real GDP can only be considered as exceptional by the ECOFIN Council, on the initiative of the Member State concerned, when this is suggested by supporting evidence, related in particular to the abruptness of the downturn or the accumulated loss of output relative to past trends. In evaluating whether or not an economic downturn is severe, as a rule Member States will take as a reference point an annual fall in real GDP of at least 0.75%. The temporary nature of a deficit exceeding the 3% level will be apparent from budgetary forecasts as provided by the European Commission indicating that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn (see Annex 5).

If a Member State s government deficit is considered excessive, the ECOFIN Council will formulate recommendations for the correction of this budgetary imbalance. Effective measures to this effect have to be taken by the Member State concerned within four months. If, in the ECOFIN Council s judgement, such effective action is not taken, the Council can impose sanctions. These initially take the form of a non-interest-bearing deposit quantified in relation to the Member State s GDP, which may be converted into a fine should the excessive deficit persist for more than two years.

In order to monitor budgetary developments and to receive signals of any potential budgetary slippage, as well as to facilitate the co-ordination of economic policies, an early warning mechanism has also been established in the context of the Stability and Growth Pact. For this purpose, Member States shall submit to the ECOFIN Council and the European Commission annual stability programmes (if they have adopted the single currency) or convergence programmes (if they have not adopted the single currency) specifying their medium-term budgetary objectives. The content and format of stability programmes follow an agreed pattern (see Annex 6). The requirements for convergence programmes are similar. The Council shall deliver an opinion on the programmes and request adjustments, should it consider a strengthening of the objectives and contents to be necessary. Moreover, the implementation of the programmes shall be monitored by the Council and a recommendation shall be made to the Member State concerned if the Council identifies any significant divergence of the budgetary position from the medium-term budgetary objectives laid down in the programme.

The implementation of the excessive deficit procedure

The different steps to be followed in the process of implementing the excessive deficit procedure (EDP) are summarised in Diagram 1 (page 52), which deals with the decision of the ECOFIN Council on the existence of an excessive deficit, and in Diagram 2 (page 53), which describes the follow-up procedure.

Step 1 is preliminary and refers to the notification of budgetary data by Member States to the European Commission by 1 March and 1 September of each year.

In Step 2, the European Commission examines the compliance of Member States with budgetary discipline on the basis of the criteria set out in Article 104 (2) (ex Article 104c (2)) of the Treaty. If Member States fulfil the requirements under both criteria on budgetary discipline (a government deficit of below 3% of GDP and a government debt of below 60% of GDP unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace) and if the European Commission is of the opinion that there is no risk of an excessive deficit, the excessive deficit procedure is not initiated. In other cases, or whenever the planned or actual government deficit of a Member State exceeds the reference value of 3% of GDP (see Annex 3, Article 104 (3) (ex Article 104c (3)), and Annex 4, commitment 3 of the European Commission), the European Commission shall prepare a report triggering the application of the EDP.

In Step 3, within two weeks of the preparation of the European Commission s report, the Economic and Financial Committee in which representatives of the governments and the ESCB participate shall formulate an opinion on this report and submit it to the ECOFIN Council (Article 104 (4) (ex Article 104c (4)). Taking this opinion fully into account, the European Commission shall address an opinion to the

ECOFIN Council (Article 104 (5) (ex Article 104c (5)) together with a recommendation if it considers that an excessive deficit exists. If the European Commission finds that a deficit exceeding 3% of GDP is not excessive and if this opinion differs from that of the Economic and Financial Committee, the European Commission is committed to present the reasons for its position to the ECOFIN Council in writing.

Step 4 is the decision of the ECOFIN Council on whether an excessive deficit exists in a Member State, after an overall assessment, acting by a qualified majority on a recommendation from the European Commission, and having considered any observations which the Member State concerned may wish to make (Article 104 (6) (ex Article 104c (6)). The decision should be taken within three months of the notification of budgetary data to the European Commission by Member States.

In Step 5, if the ECOFIN Council decides that there is no excessive deficit, the excessive deficit procedure is concluded. However, if the decision is that an excessive deficit does exist in a Member State, the ECOFIN Council shall at the same time make recommendations to the Member State under Article 104 (7) (ex Article 104c (7)). These recommendations are adopted on a recommendation of the European Commission, by a qualified majority excluding the votes of the representative of the Member State concerned, and are not made public. The ECOFIN Council shall recommend that excessive deficits be corrected as quickly as possible after their emergence (see Annex 4), and shall establish two deadlines. One deadline is of a maximum of four months for effective action to be taken by the Member State concerned. The other deadline is for the correction of the excessive deficit, which should be completed in the year following its identification, unless there are special circumstances.

Step 6 (in Diagram 2) initiates the follow-up to the ECOFIN Council decision that an excessive deficit exists in a Member State. The ECOFIN Council will consider whether effective action has been taken in response to the recommendations it made in accordance with Article 104 (7) (ex Article 104c (7)), and will base its decision on publicly announced decisions made by the government of the Member State concerned. The decision is taken on a recommendation of the European Commission by a qualified majority excluding the votes of the representative of the Member State concerned.

If, in Step 7, the ECOFIN Council decides that no effective action has been taken, it may make its recommendations public under Article 104 (8) (ex Article 104c (8)) immediately after the expiry of the deadline set previously (a maximum of four months). In that case, for participating Member States only and within one month of the decision, the ECOFIN Council may decide under Article 104 (9) (ex Article 104c (9)) to give notice to the participating Member State concerned to take, within a specified time limit, measures to reduce the deficit. This decision and the subsequent decisions within the procedure shall be taken on a recommendation of the European Commission by a qualified majority excluding the votes of the representative of the Member State concerned. However, if the ECOFIN Council decides that the Member State concerned has taken effective action in compliance with its recommendations under Article 104 (7) (ex Article 104c (7)), the excessive deficit procedure shall be held in abeyance. The European Commission and the ECOFIN Council shall monitor the implementation of the action taken.

In Step 8, if in the view of the ECOFIN Council the excessive deficit has been corrected, it shall abrogate some or all of its decisions on recommendations and notices given. If the recommendations have been made public, the ECOFIN Council shall make a public statement that an excessive deficit no longer exists in the Member State concerned. However, if a participating Member State fails to act in compliance with the successive decisions of the ECOFIN Council giving recommendations and notices, the Council shall impose sanctions in accordance with Article 104 (11) (ex Article 104c (11)), no later than two months after the decision giving notice to the Member State concerned and within 10 months of the reporting dates for submitting budgetary data to the European Commission. Moreover, an expedited procedure can be used in the case of a deliberately planned deficit that the ECOFIN Council considers to be excessive. Another possibility is that, while the excessive deficit procedure is held in abeyance, action by a participating Member State is not being implemented or actual data regularly notified by Member States to the European Commission by 1 March and 1 September of each year indicate that the excessive deficit has not been corrected by a participating Member State within the time limits specified in the recommendations issued under Article 104 (7) (ex Article 104c (7)). In such a case, the ECOFIN Council shall immediately take a decision to give notice to the participating Member State concerned to take, within a specified time limit, measures to reduce the deficit.

In Step 9, if the participating Member State acts in compliance with the notices issued by the ECOFIN Council in accordance with Article 104 (9) (ex Article 104c (9)), the excessive deficit procedure shall be held in abeyance. The period for which the procedure is held in abeyance shall be included neither in the two-month period nor in the 10-month period mentioned in Step 8 as deadlines for the imposition of sanctions. The European Commission and the ECOFIN Council shall monitor the implementation of the action taken.

In Step 10, if in the view of the ECOFIN Council the excessive deficit has been corrected, the procedure will be concluded as described in Step 8. However, if the action taken by the participating Member State is proving, in the view of the ECOFIN Council, to be inadequate or if actual data regularly notified by Member States to the European Commission by 1 March and 1 September of each year indicate that the excessive deficit has not been corrected by a participating Member State within the time limits specified in the notices issued under Article 104 (9) (ex Article 104c (9)), the ECOFIN Council shall immediately take a decision to impose sanctions in accordance with Article 104 (11) (ex Article 104c (11)). The sanctions will consist, as a rule, in a non-interest-bearing deposit and the ECOFIN Council may decide to supplement this deposit with the measures provided for in the first and second indents of Article 104 (11) (ex Article 104c (11)). When the excessive deficit results from non-compliance with the deficit criterion, the amount of the first deposit shall comprise a fixed component equal to 0.2% of GDP and a variable component equal to one-tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP. In each following year, Step 10 is repeated until the decision on the existence of an excessive deficit is abrogated. In its annual assessment, the ECOFIN Council shall decide to intensify the sanctions unless the participating Member State has complied with the Council s notice. If a decision is taken in favour of an additional deposit, it shall be equal to one-tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP, without exceeding the upper limit of 0.5% of GDP. A deposit shall, as a rule, be converted into a fine if, two years after the decision requiring the participating Member State concerned to make a deposit, the excessive deficit has not been corrected. These fines shall be distributed among those participating Member States not running an excessive deficit, in proportion to their share in the total GNP of the eligible Member States. In accordance with Article 104 (12) (ex Article 104c (12)), the ECOFIN Council shall abrogate the sanctions referred to in the first and second indents of Article 104 (11) (ex Article 104c (11)) depending on the significance of the progress made by the

Diagram 1

The ECOFIN Council decision on the existence of an excessive deficit

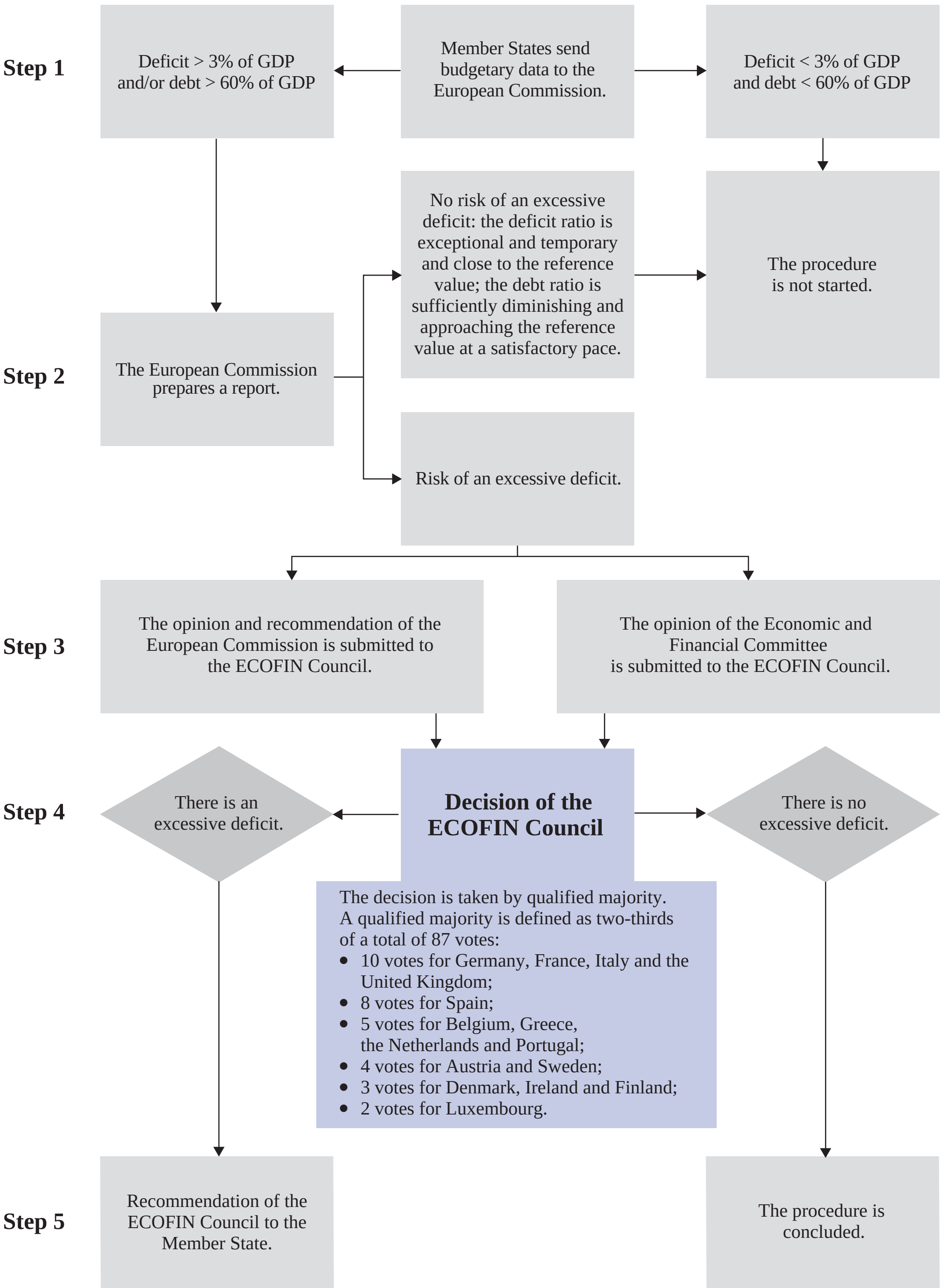
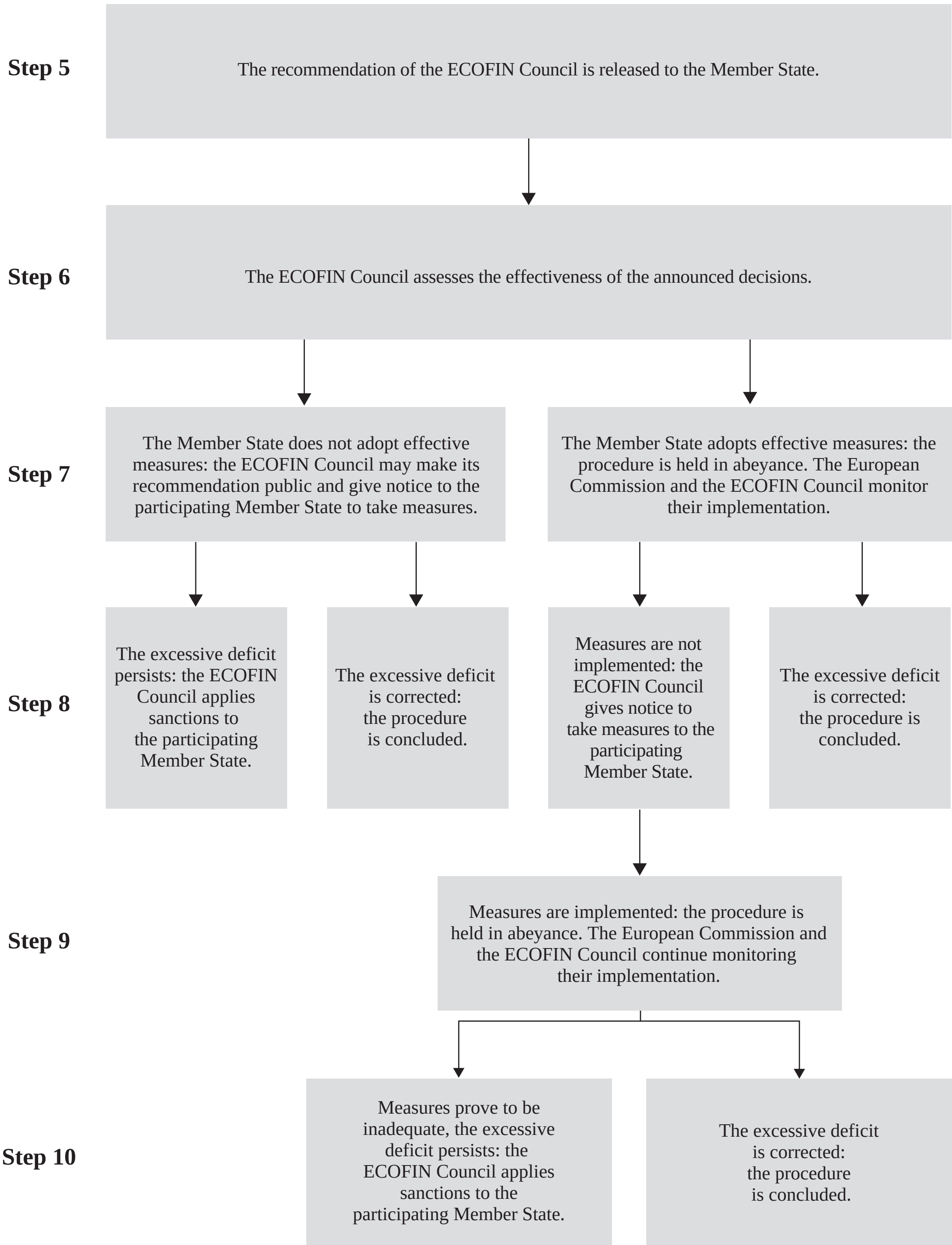


Diagram 2
Follow-up of the ECOFIN Council decision that an excessive deficit exists



participating Member State concerned in correcting the excessive deficit, and all outstanding sanctions shall be abrogated if the decision on the existence of an excessive deficit is abrogated. However, fines will not be reimbursed.

3 The implementation of the Stability and Growth Pact

The procedure for the implementation of the Stability and Growth Pact starts with the presentation of the stability and convergence programmes by Member States. After that, the European Commission has to adopt a recommendation on each programme. This recommendation will constitute the basis on which the ECOFIN Council will elaborate an opinion, after consulting the Economic and Financial Committee, within two months of submission. The ECB participates in the Economic and Financial Committee, where its members have the opportunity to discuss in depth the programmes presented by Member States. If the ECOFIN Council considers that the objectives announced in the programme should be strengthened, it invites the Member State concerned to do so. In the event of significant divergence from the objectives set in previous programmes being detected, the ECOFIN Council has the prerogative to issue a recommendation urging the Member State concerned to adopt offsetting measures. Annual updates of the programmes shall provide a detailed account of plans to offset deficit overruns in the short term. This latter requirement is aimed at preventing the medium-term objective of a budget in balance or in surplus from being deferred indefinitely.

In view of the fundamental role of the stability and convergence programmes in the process of multilateral surveillance, it was considered important for their information content to be appropriate and to allow for comparison across Member States. Since Member States had to draw up their programmes for submission before the end of 1998, as agreed by the ministers in their joint declaration of 1 May 1998, the Monetary Committee (now the Economic and Financial Committee), drawing upon useful contributions from European Commission staff, discussed possible complementary guidelines and agreed upon an Opinion addressed to the ECOFIN Council. This Opinion was endorsed at the ECOFIN meeting in Luxembourg (12 October 1998). This section first presents this Opinion, which established a code of conduct on the format and content of the stability and convergence programmes. It then describes formal compliance with this code of conduct in the steps taken to date to ensure implementation of the Pact. Finally, three key issues of substance are stressed which, in accordance with the Opinion of the former Monetary Committee, were addressed by the ECOFIN Council when examining the medium-term budgetary objective of positions close to balance or in surplus proposed in the stability and convergence programmes.

A code of conduct on the stability and convergence programmes

The former Monetary Committee considered that the essential requirements of the stability and convergence programmes set out in Council Regulation (EC) No. 1466/97 might usefully be complemented by a number of guidelines on the content and format of the programmes, building upon the previous code of conduct presented in the former Monetary Committee s report of 14 February 1994. The experience gathered so far with the old convergence programmes showed, according to the Opinion of the former Monetary Committee, that such guidelines not only assist the Member States in drawing up their programmes, but also facilitate their examination by the European Commission, the former Monetary Committee and the ECOFIN Council. The agreed guidelines and suggestions on the format and content of the stability and convergence programmes (see Annex 7), acknowledging the fact that the programmes are the responsibility of national authorities and that possibilities and practices differ from one country to another, are of an indicative nature.

The main considerations included in the Opinion of the former Monetary Committee can be summarised as follows:

A fundamental element of the stability and convergence programmes is the medium-term objective for the budgetary position to be close to balance or in surplus. It was therefore clear, according to the Opinion of the former Monetary Committee, that the assessment of the appropriateness of Member States medium-term objectives and the examination of their fulfilment had to take explicit account of the cyclical position and its effect on the budget. The time frame, in terms of the interpretation of medium term , would therefore be the length of the business cycle. In practice, an approximate approach has to be adopted when assessing how actual and expected budgetary developments compare with the requirement of medium-term budgetary positions close to balance or in surplus. In particular, the likely impact of cyclical effects on current and future developments in budgets must be assessed. This exercise requires the adoption of an appropriate method.

Obviously, each method has its strengths and weaknesses and therefore the results need to be interpreted with caution. Bearing this in mind, the former Monetary Committee adopted the present European Commission services cyclical adjustment method which was considered to be a useful approach for assessing budgetary developments. Further analysis, taking into account other relevant factors including country-specific circumstances, would be needed to arrive at more firmly based judgements. In making such judgements, where appropriate, results from other methods may also be considered.

On the basis of their cyclical adjustment method, European Commission staff examined for each Member State which underlying (cyclically adjusted) budget balance would allow it to deal with adverse cyclical developments while respecting the government deficit reference value. Clearly, other considerations are also of major importance in setting an appropriate medium-term objective which observes the requirements of the Stability and Growth Pact, such as the need to take account of other sources of variability and uncertainty in budgets, to ensure a rapid decline in high debt ratios and to cater for the costs associated with population ageing. In line with this, Member States that wish to make use of discretionary policy should create the necessary room for manoeuvre.

It is important to prevent the medium-term budgetary position of close to balance or in surplus from becoming a moving target. The former Monetary Committee considered that the stability and convergence programmes to be submitted at the latest by the end of 1998 should show the medium-term objective of the Stability and Growth Pact as being achieved as quickly as possible. Furthermore, the former Monetary Committee held, on the basis of the European Commission s analysis, that this objective should be achieved by the end of 2002 at the latest.

Compliance with the code of conduct

In conformity with the Council Regulation on the Stability and Growth Pact referred to above, all EU countries submitted their stability and convergence programmes to the ECOFIN Council and the European Commission before the deadline of 1 March 1999. Most programmes arrived before the end of 1998, as had been agreed by the ministers in their joint declaration of 1 May 1998.

Stability and convergence programmes were generally found to comply formally with the code of conduct outlined above with regard to the length of the time horizon covered, the breadth of the information provided and the depth of the commitment to stability-oriented policies manifested by governments. Some countries went beyond the minimum standards agreed, by providing far-reaching accounts of the evolution of important expenditure items in the longer run.

However, a few formal shortcomings were also identified during the discussions held by the Economic and Financial Committee. Four programmes did not extend the planning horizon beyond 2001, thus failing to provide valuable information on the end of the time span recommended by the guidelines. While generally deemed realistic, external and domestic macroeconomic assumptions were sometimes found to be either outdated or even slightly optimistic in view of the uncertainties surrounding medium-term economic forecasting. Great determination with regard to the policy action needed to achieve the targets was often affirmed, but this was not always substantiated in detailed sets of measures. Nor was it always possible to clearly discern trend or planned developments in the primary budgetary components. In addition, given that government investment in most countries was subject to a disproportionate adjustment in the years up to 1997, it was felt that more attention should probably be given to this expenditure component in future updates of the programmes. Finally, in a few instances the Economic and Financial Committee lamented recourse to highly aggregated projections or an outright lack of evidence on key economic variables as clouding the transparency of the underlying scenarios. In some cases, the scant information provided and the absence of sound indications as to the sensitivity of the official targets to changes in macroeconomic assumptions were seen as preventing a fully grounded judgement within the context of the mutual surveillance exercise.

The notion of a budgetary position close to balance

In addition to the criteria for formal compliance outlined above, a comprehensive judgement on individual countries programmes needs to be supported by more substantive considerations. The question arose as to whether the pace of deficit reduction envisaged in the programmes could be considered adequate to place the countries on the sound footing recommended by the Stability and Growth Pact. In general terms, this issue can be considered from at least three angles.

First, one aspect which can be explored is whether the targets set by the Member States not yet in compliance with the rules of the Stability and Growth Pact are consistent with the requirement to avoid excessive deficits in the face of normal cyclical fluctuations. As already highlighted above, a country could be considered to have reached a position sufficiently close to balance provided that its economic structure is comfortably resistant to macroeconomic shocks or that its fiscal structure is relatively non-reactive to cyclical swings.

Second, the time span chosen for the completion of the process of fiscal consolidation can also be questioned. In particular, it should be clear whether the time profiles indicated by the programmes for achieving full compliance with the deficit objectives conform to the Opinion of the former Monetary Committee, as endorsed by the ECOFIN Council, which requested that the programmes should show the medium-term objective of the Stability and Growth Pact as being achieved as quickly as possible .

Third, there is the question of whether current plans build into budgets sufficient room for manoeuvre to enable countries to withstand events not necessarily related to the cyclical position of the economy without contravening the Stability and Growth Pact. Unforeseen shocks to interest rates, for instance, and expected demographic developments can greatly impinge on budgetary positions and divert countries from previously prepared plans. Both sources of disturbance can be totally unrelated to short-term macroeconomic developments. In this connection, the former Monetary Committee acknowledged the need to ensure a rapid decline in high debt ratios and to cater for the costs associated with population ageing as considerations of major importance in setting the appropriate medium-term objectives in line with the requirements of the Stability and Growth Pact.

The European Commission observed its mandate to assess the adequacy of Member States programmes, taking due account of national differences and diverse starting conditions. On the basis of the European Commission s recommendations, the ECOFIN Council judged that budgetary strategies, as detailed in the programmes, were in broad compliance with the requirement to bring public finances to positions that are sufficiently resistant to the budgetary effects of normal economic fluctuations. In this sense, the ECOFIN Council considered that countries are currently moving towards the medium-term objective recommended by the Pact. In some cases, however, the ECOFIN Council called for more ambitious budgetary targets, and it advised certain countries to continue their consolidation efforts beyond the horizon covered in order to be in a position to cope adequately with the consequences of population ageing. For high debt countries, in particular, it stressed the importance of maintaining high primary surpluses in order to reduce government debt ratios.

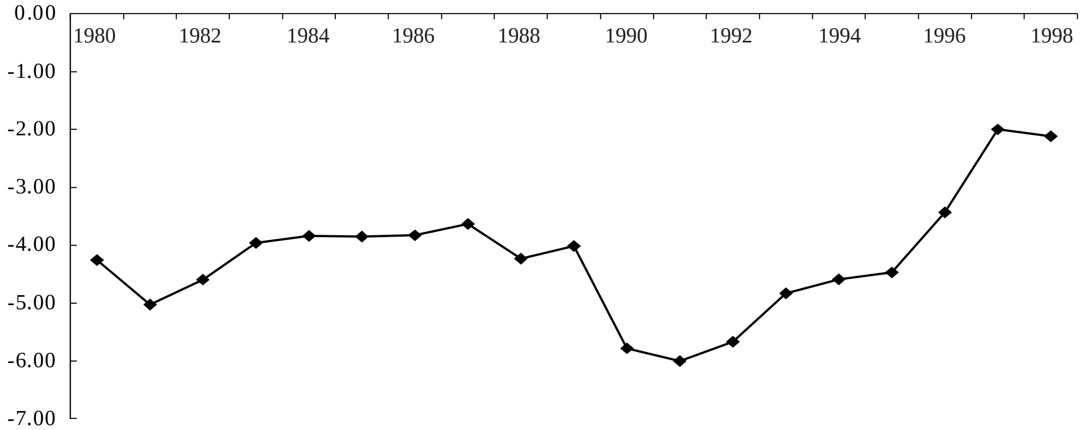
4 Assessment of the implementation of the budgetary rules of the Treaty and the Stability and Growth Pact

Fiscal performance in the very recent past and budgetary plans for the near future need to be set in the context of the considerable adjustments made since the beginning of the decade. Following the sharp deterioration in underlying fiscal positions that accompanied the cyclical upswing of the late 1980s, countries in the EU embarked on a large-scale turnaround in budgetary policy which marked an improvement in structural fiscal positions of almost 4 percentage points of GDP over the five years from 1992. Prospective participants in EMU, in particular, found in the Treaty s framework for sound macroeconomic conduct a decisive impulse towards fiscal consolidation (see Chart 1). Some of these countries, by decidedly embracing the stability culture imposed by the Treaty, were able to prevent impending confidence crises from developing into fully-fledged financial turmoil of unpredictable dimensions.

Chart 1

Cyclically adjusted budget balance in the euro area

(as a percentage of GDP)



Source: European Commission.

The trend towards fiscal discipline accelerated after the hiatus in 1995. In the 11 Member States that adopted the single currency on 1 January 1999 the uncompromising remit to meet the qualifying criteria for participation in EMU from its outset imposed the adoption of fiscal measures of an unprecedented scale. In some countries the magnitude of the required adjustment suggested that recourse to ad hoc provisions with a limited political backlash would be necessary as a useful complement to more substantive and lasting interventions. Government investment cutbacks and adjustments of a temporary nature were thus implemented on the understanding that, after the start of Stage Three of EMU, a more favourable economic environment would permit a prompt replacement of temporary corrections with sustainable and definitive improvements in the underlying positions.

1998 offered a unique opportunity to fulfil this promise. Economic activity was robust in a large proportion of the EU, to an extent that had not been observed since the beginning of the 1990s. A rapid convergence towards the new key interest rate decided in December for the euro area brought substantial cuts in the cost of servicing short-term liabilities for many Member States, at a time when vanishing exchange rate risks were driving long-term interest rate differentials to historical lows. This favourable scenario could have assisted governments in bringing to fruition those tasks which had yet to be completed.

However, the opportunity was largely forgone. Only six EU countries (Denmark, Ireland, Luxembourg, Finland, Sweden and the United Kingdom) literally fulfilled, on the basis of 1998 accounts, the Stability and Growth Pact requirement of a budget close to balance or in surplus. It is remarkable that only three of the six countries mentioned (Ireland, Luxembourg and Finland) figure among the Member States already participating in the euro area. All the remaining EU Member States were still relatively far from the targets that they had indicated in their programmes. Of those countries now participating in Stage Three of EMU, five (Germany, France, Italy, Austria and Portugal) recorded deficits of 2% of GDP or more. The two largest (Germany and France), while both operating close to potential output, posted imbalances not sufficiently far from the value of 3% of GDP set as a reference for deficits at the trough of an economic downturn.

The envisaged strategy for the future provides inadequate reassurance. Plans generally confirm countries resolve to continue along the path of fiscal prudence seen in the recent past. Indeed, the determination expressed by some to earmark tax windfalls from unexpected spurts of growth for further debt reduction should, in some cases, insure against the historical proclivity to loosen the fiscal stance in prosperous times. Nonetheless, the scant safety margins built into budgets so far and the time profile of the adjustment envisaged do not augur well for the capability of public finances in the euro area to withstand a serious turnaround in economic prospects.

Only the stability programmes of Belgium and Spain, of those presented by the Member States not yet in line with the norms of the Stability and Growth Pact, explicitly incorporate balanced accounts by the end of the period covered (see Table 1). The remaining euro area countries (Germany, France, Italy, the Netherlands, Austria and Portugal) implicitly consider a net borrowing of around 1% of GDP by 2001 or 2002 as the conclusion of their consolidation efforts. The three larger economies aim for a primary adjustment, between 1998 and 2001 or 2002, falling short of one percentage point of GDP on average. Two other countries expect their primary surpluses either to virtually stabilise at current levels (Austria) or even to decline (the Netherlands).

Table 1

Macroeconomic assumptions and fiscal targets contained in Member States' stability and convergence programmes

Country	Real GDP growth				Government balance ratio (% of GDP)				Debt ratio (% of GDP)			
	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
Belgium	2.4	2.3	2.3	2.3	-1.3	-1.0	-0.7	-0.3	114.5	112.2	109.6	106.8
Denmark	1.7	2.0	2.0	-	2.5	2.8	2.6	-	56	51	49	-
Germany	2	2½			-2	-2	-1½	-1	61	61	60½	59½
Greece	3.7	3.9	4.5	-	-2.1	-1.7	-0.8	-	105.8	102.5	99.8	-
Spain	3.8	3.3			-1.6	-1.0	-0.4	0.1	66.4	64.3	61.9	59.3
France	2.7	3.0			-2.3			-0.8	58.7			57.1
Ireland	6.7	6.4	5.8	-	1.7	1.4	1.6	-	52	47	43	-
Italy	2.5	2.8	2.9	-	-2.0	-1.5	-1.0	-	114.6	110.9	107.0	-
Luxembourg	3.4	3.7			1.1	1.2	1.3	1.7	- [1]	- [1]	- [1]	- [1]
Netherlands	2.9	2¼ (1999-2002)			-1.3	-	-	-1.1	66.4	-	-	64½
Austria	2.8	2.6	2.1	2.2	-2.0	-1.7	-1.5	-1.4	63.5	62.2	61.2	60.0
Portugal	3.5	3.5	3.2	3.3	-2.0	-1.5	-1.2	-0.8	56.8	55.8	54.7	53.2
Finland	4.0	2.7	2.6	2.6	2.4	2.2	2.1	2.3	48.5	46.4	44.8	43.2
Sweden	2.2	2.6	2.5	-	0.3	1.6	2.5	-	71.4	66.7	58.0	-
United Kingdom [2]	1	2½	2¾	2½	-0.3	-0.3	-0.1	0.2	46.7	45.4	43.7	42.0

1) *According to Luxembourg's stability programme, general government debt, which in total represented 6.7% of GDP in 1998, will not increase in the forecasting period.*
2) *Presented on a financial-year basis.*

While broadly sometimes only vaguely respecting minimum benchmark positions that would allow them to absorb normal fluctuations without breaching the Treaty s reference value for deficits, countries have been regrettably unambitious. The prevailing minimalist approach to fiscal stability is not satisfactory for a number of reasons.

First, it seems to reflect the concept of a trade-off between consolidation and structural reform. Some programmes build on the notion that the structure of the adjustment should be regarded as a priority, the magnitude of the necessary correction being less important. This stance is not warranted. Focusing policy plans, to an extent unprecedented in the recent past, on tax reductions rather than tax increases is certainly critical for the compensation of efficiency losses that have been accumulated through decades of unrelenting growth in the size of governments. In addition, the aim expressed by countries with mature welfare systems to rebalance government expenditure away from current transfers and in favour of public investment can be an instrument to revitalise the growth potential of their economies. However, deficit correction is an indispensable part of the same policy of structural reform. Those countries within the EU which have been front runners in redressing fiscal imbalances, while at the same time implementing wide-ranging structural measures, give the lie to the idea that the two policy lines should be seen as alternative options. They should rather be pursued as complementary and mutually reinforcing aspects of the same strategy.

Second, governments in a large proportion of the EU Member States have no substantial policies to reduce cyclically adjusted deficits. The deficit correction targeted entails very limited discretionary action and will only be brought about if growth is maintained in a context of financial stability. In the most optimistic scenario, at the beginning of the next century a number of important countries in the EU will be brought to a position from which it will be barely possible for them to withstand normal macroeconomic fluctuations without some risk of breaching the reference value for deficits. No additional scope will be available in their accounts to counteract shocks originating in the financial markets or to respond to unforeseeable events. EMU itself could add to the latter strains. Heightened tax bases and factor mobility within the euro area could undermine the taxation-related power of those Member States imposing larger tax burdens on the gross return from labour and capital services. This will not fail to erode the revenue assumptions on which budgetary plans are currently based. Prospective reductions in the transfer of EU structural funds to countries that are currently net recipients could lead to the same shortfalls in trend receipts. Some countries could also find themselves in need of additional budgetary freedom to provide for an active fiscal policy, as a substitute for the lost exchange rate lever, in order to be in a position to deal with asymmetric shocks. Early budgetary provision against all these contingencies could avoid possibly disruptive measures that would need to be engineered at a later date, when the risks may finally materialise.

Third, planned measures are generally postponed towards the end of the forecasting horizon. The tendency to backload convergence to the target adds political uncertainty with regard to the priorities of the governments which will be in power two or three years hence to the risks already implicit in the underlying scenarios. Thus, stepping up the pace of adjustment would have removed at least one source of risk.

Finally, and perhaps most importantly, very little has been done to prepare budgets for the strains that are expected to emerge after the middle of the next decade. It has been calculated that demographic transition will add some seven percentage points of GDP to pension and health expenditure in the euro area by the end of the third decade of the next century. Recent studies have estimated the scale of the immediate fiscal correction that would be needed in Europe both to absorb the cumulative impact of these implicit commitments and to keep the debt ratios from rising. With minor exceptions, if countries were to observe this additional prudential margin, they would have to move from their current positions to balanced accounts immediately. Some of them would have to do more.

Early provision for the budgetary impact of these extraordinary developments has at least two aspects. One is, of course, to aim for an accelerated improvement in the net liability positions of governments in order to provide scope to deal with spending pressures when these finally intensify. Strict compliance with the letter of the Stability and Growth Pact norm of at least balancing the accounts over the medium term (i.e. over the length of the business cycle, as interpreted by the former Monetary Committee, see Annex 7) would accelerate the decline in public liabilities as a fraction of output. This is calculated to free a significant amount of resources in debt servicing costs, which could usefully be directed towards partial financing of the growing spending exigencies. The second aspect, an early and thorough reform of benefit programmes, would make provision for the remaining portion of the anticipated increase in transfers to the elderly.

5 Concluding remarks

Progress towards fiscal consolidation has been made in the EU in the recent past. Government deficits, a constant drain on private savings and a net subtraction from productive resources, have been cut. Debt burdens, while still sizable, have been diverted from previously ever-increasing trajectories.

The code of conduct on fiscal policy, to which governments anchored their policies when signing the Treaty and adopting the Stability and Growth Pact, is a useful instrument to safeguard sound government finances in the new policy regime. The stability and convergence programmes presented between late 1998 and early 1999 have reasserted political commitment to the continuation of the policies pursued in the recent past. Governments appear determined to ensure that fiscal retrenchment is durable, by compensating for past one-off measures the beneficial effects of which, in terms of curbing deficits, diminish over time. It is also reassuring that the targets previously set for 1999 have been reaffirmed in the notification submitted by Member States to the European Commission.

Fiscal consolidation is, however, an ongoing progress that requires additional input. The prevailing attitude towards the scale and timing of consolidation is to aim for the least ambitious targets consistent with formal compliance with the Stability and Growth Pact. Some countries have prepared their programmes on the basis of predictions of a relatively favourable macroeconomic and financial environment that could, ex post, prove to be over-optimistic. In addition, while determined to overhaul their economic structures in a commendable way, some countries seem to believe that attempts to address structural issues could, at times, justify a more relaxed timetable for completing consolidation. This attitude is not warranted in the light of the most recent experience of those Member States that have taken the lead in redressing both fiscal imbalances and long-standing structural problems.

In the event of a sudden worsening of domestic and international prospects, it is not totally clear precisely what the policy response is intended to be. It is also unclear as to whether, under such circumstances, the established horizon for full convergence with the target would be observed or whether it would be allowed to slide forward. These uncertainties are aggravated by the diffuse practice of back-loading the envisaged adjustment, whereby action is postponed until the more distant and thus more uncertain future. A lack of early provisions against adversities can leave fiscal structures vulnerable to sudden reversals of macroeconomic conditions. Lack of ambition, more generally, is bound to leave government finances in a number of countries unprepared to face the more fundamental challenges that lie ahead.

Sound fiscal policies and low tax burdens not only tend to contribute to lower long-term real interest rates, reduced uncertainty and increased private capital formation, but thereby also to higher real growth and employment in the medium term. They also facilitate the task of monetary policy to maintain price stability. The maintenance of price stability over the medium term is the best contribution that monetary policy can make to improved growth and employment prospects in the long run. This is the case regardless of fiscal developments. However, unsound fiscal policies tend to increase inflation expectations and force monetary policy to keep short-term rates relatively high, thereby reducing the net benefits associated with price stability.

Annexes

1. The co-ordination of economic policies in Stage Three of EMU (excerpts from the Treaty)

Article 98 (ex Article 102a)

Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, as defined in Article 2, and in the context of the broad guidelines referred to in Article 99 (2). The Member States and the Community shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4.

Article 99 (ex Article 103)

1. Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 98.

2. The Council shall, acting by a qualified majority on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Community, and shall report its findings to the European Council.

The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Community.

On the basis of this conclusion, the Council shall, acting by a qualified majority, adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

3. In order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Community as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment.

For the purpose of this multilateral surveillance, Member States shall forward information to the Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary.

4. Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardizing the proper functioning of economic and monetary union, the Council may, acting by a qualified majority on a recommendation from the Commission, make the necessary recommendations to the Member State concerned. The Council may, acting by a qualified majority on a proposal from the Commission, decide to make its recommendations public.

The President of the Council and the Commission shall report to the European Parliament on the results of the multilateral surveillance. The President of the Council may be invited to appear before the competent committee of the European Parliament if the Council has made its recommendations public.

5. The Council, acting in accordance with the procedure referred to in Article 252, may adopt detailed rules for the multilateral surveillance procedure referred to in paragraphs 3 and 4 of this Article.

Article 100 (ex Article 103a)

1. Without prejudice to any other procedures provided for in this Treaty, the Council may, acting unanimously on a proposal from the Commission, decide upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products.

2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control, the Council may, acting unanimously on a proposal from the Commission, grant, under certain conditions, Community financial assistance to the Member State concerned. Where the severe difficulties are caused by natural disasters, the Council shall act by qualified majority. The President of the Council shall inform the European Parliament of the decision taken.

2. Restrictions on the financing of the public sector (excerpts from the Treaty)

Article 101 (ex Article 104)

1. Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the Member States (hereinafter referred to as national central banks) in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the ECB as private credit institutions.

Article 102 (ex Article 104a)

1. Any measure, not based on prudential considerations, establishing privileged access by Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.

2. The Council, acting in accordance with the procedure referred to in Article 252, shall, before 1 January 1994, specify definitions for the application of the prohibition referred to in paragraph 1.

Article 103 (ex Article 104b)

1. The Community shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

2. If necessary, the Council, acting in accordance with the procedure referred to in Article 252, may specify definitions for the application of the prohibition referred to in Article 101 and in this Article.

3. Budgetary discipline rules and the excessive deficit procedure (excerpts from the Treaty, Article 104 (ex Article 104c) and the annexed Protocol (No. 5))

Article 104 (ex Article 104c)

1. Member States shall avoid excessive government deficits.

2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:

either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;

or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to this Treaty.

3. If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State.

The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State.

4. The Committee provided for in Article 114 shall formulate an opinion on the report of the Commission.

5. If the Commission considers that an excessive deficit in a Member State exists or may occur, the Commission shall address an opinion to the Council.

6. The Council shall, acting by a qualified majority on a recommendation from the Commission, and having considered any observations which the Member State concerned may wish to make, decide after an overall assessment whether an excessive deficit exists.

7. Where the existence of an excessive deficit is decided according to paragraph 6, the Council shall make recommendations to the Member State concerned with a view to bringing that situation to an end within a given period. Subject to the provisions of paragraph 8, these recommendations shall not be made public.

8. Where it establishes that there has been no effective action in response to its recommendations within the period laid down, the Council may make its recommendations public.

9. If a Member State persists in failing to put into practice the recommendations of the Council, the Council may decide to give notice to the Member State to take, within a specified time-limit, measures for the deficit reduction which is judged necessary by the Council in order to remedy the situation.

In such a case, the Council may request the Member State concerned to submit reports in accordance with a specific timetable in order to examine the adjustment efforts of that Member State.

10. The rights to bring actions provided for in Articles 226 and 227 may not be exercised within the framework of paragraphs 1 to 9 of this Article.

11. As long as a Member State fails to comply with a decision taken in accordance with paragraph 9, the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

to require the Member State concerned to publish additional information, to be specified by the Council, before issuing bonds and securities;

to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned;

to require the Member State concerned to make a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;

to impose fines of an appropriate size.

The President of the Council shall inform the European Parliament of the decisions taken.

12. The Council shall abrogate some or all of its decisions referred to in paragraphs 6 to 9 and 11 to the extent that the excessive deficit in the Member State concerned has, in the view of the Council, been corrected. If the Council has previously made public recommendations, it shall, as soon as the decision under paragraph 8 has been abrogated, make a public statement that an excessive deficit in the Member State concerned no longer exists.

13. When taking the decisions referred to in paragraphs 7 to 9, 11 and 12, the Council shall act on a recommendation from the Commission by a majority of two thirds of the votes of its members weighted in accordance with Article 205 (2), excluding the votes of the representative of the Member State concerned.

14. Further provisions relating to the implementation of the procedure described in this Article are set out in the Protocol on the excessive deficit procedure annexed to this Treaty.

The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol.

Subject to the other provisions of this paragraph, the Council shall, before 1 January 1994, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.

Protocol (No. 5) on the excessive deficit procedure

Article 1

The reference values referred to in Article 104 (2) of this Treaty are:

3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;

60% for the ratio of government debt to gross domestic product at market prices.

Article 2

In Article 104 of this Treaty and in this Protocol:

government means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts;

deficit means net borrowing as defined in the European System of Integrated Economic Accounts;

investment means gross fixed capital formation as defined in the European System of Integrated Economic Accounts;

debt means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.

Article 3

In order to ensure the effectiveness of the excessive deficit procedure, the governments of the Member States shall be responsible under this procedure for the deficits of general government as defined in the first indent of Article 2. The Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty. The Member States shall report their planned and actual deficits and the levels of their debt promptly and regularly to the Commission.

Article 4

The statistical data to be used for the application of this Protocol shall be provided by the Commission.

4. The commitments of Member States, the European Commission and the European Council (excerpts from the Resolution of the European Council of 17 June 1997)

The Member States

1. commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives;

2. are invited to make public, on their own initiative, the Council recommendations made to them in accordance with Article 103 (4);

3. commit themselves to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes once they receive an early warning in the form of a Council recommendation issued under Article 103 (4);

4. will launch the corrective budgetary adjustments they deem necessary without delay on receiving information indicating the risk of an excessive deficit;

5. will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit, unless there are special circumstances;

6. are invited to make public, on their own initiative, recommendations made in accordance with Article 104c (7);

7. commit themselves not to invoke the benefit of Article 2 (3) of the Council Regulation on speeding up and clarifying the excessive deficit procedure unless they are in severe recession; in evaluating whether the economic downturn is severe, the Member States will, as a rule, take as a reference point an annual fall in real GDP of at least 0.75%.

The Commission

1. will exercise its right of initiative under the Treaty in a manner that facilitates the strict, timely and effective functioning of the Stability and Growth Pact;

2. will present, without delay, the necessary reports, opinions and recommendations to enable the Council to adopt decisions under Article 103 and Article 104 c; this will facilitate the effective functioning of the early warning system and the rapid launch and strict application of the excessive deficit procedure;

3. commits itself to prepare a report under Article 104c (3) whenever there is the risk of an excessive deficit or whenever the planned or actual government deficit exceeds the reference value of 3% of GDP, thereby triggering the procedure under Article 104c (3);

4. commits itself, in the event that the Commission considers that a deficit exceeding 3% of GDP is not excessive and this opinion differs from that of the Economic and Financial Committee, to present in writing to the Council the reasons for its position;

5. commits itself, following a request from the Council under Article 109d, to make, as a rule, a recommendation for a Council decision on whether an excessive deficit exists under Article 104c (6).

The Council

1. is committed to a rigorous and timely implementation of all elements of the Stability and Growth Pact in its competence; it will take the necessary decisions under Article 103 and Article 104c as is practicable;

2. is urged to regard the deadlines for the application of the excessive deficit procedure as upper limits; in particular, the Council, acting under Article 104c (7), shall recommend that excessive deficits be corrected as quickly as possible after their emergence, no later than the year following their identification, unless there are special circumstances;

3. is invited always to impose sanctions if a participating Member State fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council;

4. is urged always to require a non-interest-bearing deposit, whenever the Council decides to impose sanctions on a participating Member State in accordance with Article 104c (11);

5. is urged always to convert a deposit into a fine after two years of the decision to impose sanctions in accordance with Article 104c (11), unless the excessive deficit has in the view of the Council been corrected;

6. is invited always to state in writing the reasons which justify a decision not to act if at any stage of the excessive deficit or surveillance of budgetary positions procedures the Council did not act on a Commission recommendation and, in such case, to make public the votes cast by each Member State.

5. The excessive deficit procedure in Stage Three of EMU (excerpts from Council Regulation (EC) No. 1467/97 of 7 July 1997, Section 1: Definitions and Assessments)

Article 1

1. This Regulation sets out the provisions to speed up and clarify the excessive deficit procedure, having as its objective to deter excessive general government deficits and, if they occur, to further their prompt correction.

2. For the purpose of this Regulation participating Member States shall mean those

Member States which adopt the single currency in accordance with the Treaty and non-participating Member States shall mean those which have not adopted the single currency.

Article 2

1. The excess of a government deficit over the reference value shall be considered exceptional and temporary, in accordance with Article 104c (2) (a), second indent, when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn.

In addition, the excess over the reference value shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

2. The Commission when preparing a report under Article 104c (3) shall, as a rule, consider an excess over the reference value resulting from a severe economic downturn to be exceptional only if there is an annual fall of real GDP of at least 2%.

3. The Council when deciding, according to Article 104c (6), whether an excessive deficit exists, shall in its overall assessment take into account any observations made by the Member State showing that an annual fall of real GDP of less than 2% is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends.

6. The content of the stability and convergence programmes in Stage Three of EMU (excerpts from Council Regulation (EC) No. 1466/97 of 7 July 1997)

Section 1: Purpose and definitions

Article 1

This Regulation sets out the rules covering the content, the submission, the examination and the monitoring of stability programmes and convergence programmes as part of multilateral surveillance by the Council so as to prevent, at an early stage, the occurrence of excessive general government deficits and to promote the surveillance and coordination of economic policies.

Article 2

For the purpose of this Regulation participating Member States shall mean those Member States which adopt the single currency in accordance with the Treaty and non-participating Member States shall mean those which have not adopted the single currency.

Section 2: Stability programmes

Article 3

1. Each participating Member State shall submit to the Council and Commission information necessary for the purpose of multilateral surveillance at regular intervals under Article 103 of the Treaty in the form of a stability programme, which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation.

2. A stability programme shall present the following information:

(a) the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio;

(b) the main assumptions about expected economic developments and important economic variables which are relevant to the realization of the stability programme such as government investment expenditure, real gross domestic product (GDP) growth, employment and inflation;

(c) a description of budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the budget;

(d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position.

3. The information about paths for the general government surplus/deficit ratio and debt ratio and the main economic assumptions referred to in paragraph 2(a) and (b) shall be on an annual basis and shall cover, as well as the current and preceding year, at least the following three years.

Article 4

1. Stability programmes shall be submitted before 1 March 1999. Thereafter, updated programmes shall be submitted annually. A Member State adopting the single currency at a later stage shall submit a stability programme within six months of the Council Decision on its participation in the single currency.

2. Member States shall make public their stability programmes and updated programmes.

Article 5

1. Based on assessments by the Commission and the Committee set up by Article 109c of the Treaty, the Council shall, within the framework of multilateral surveillance under Article 103, examine whether the medium-term budget objective in the stability programme provides for a safety margin to ensure the avoidance of an excessive deficit, whether the economic assumptions on which the programme is based are realistic and whether the measures being taken and/or proposed are sufficient to achieve the targeted adjustment path towards the medium-term budgetary objective.

The Council shall furthermore examine whether the contents of the stability programme facilitate the closer coordination of economic policies and whether the economic policies of the Member State concerned are consistent with the broad economic policy guidelines.

2. The Council shall carry out the examination of the stability programme referred to in paragraph 1 within at most two months of the submission of the programme. The Council, on a recommendation from the Commission and after consulting the Committee set up by Article 109c, shall deliver an opinion on the programme. Where the Council, in accordance with Article 103, considers that the objectives and contents of a programme should be strengthened, the Council shall, in its opinion, invite the Member State concerned to adjust its programme.

3. Updated stability programmes shall be examined by the Committee set up by Article 109c on the basis of assessments by the Commission; if necessary, updated programmes may also be examined by the Council in accordance with the procedure set out in paragraphs 1 and 2 of this article.

Article 6

1. As part of multilateral surveillance in accordance with Article 103(3), the Council shall monitor the implementation of stability programmes, on the basis of information provided by participating Member States and of assessments by the Commission and the Committee set up by Article 109c, in particular with a view to identifying actual or expected significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path

towards it, as set in the programme for the government surplus/deficit.

2. In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, address, in accordance with Article 103(4), a recommendation to the Member State concerned to take the necessary adjustment measures.

3. In the event that the Council in its subsequent monitoring judges that the divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, is persisting or worsening, the Council shall, in accordance with Article 103(4), make a recommendation to the Member State concerned to take prompt corrective measures and may, as provides in that Article, make its recommendation public.

7. The format and content of the stability and convergence programmes (Appendix to the Opinion of the former Monetary Committee on this issue, endorsed by the ECOFIN Council and published after its 12 October 1998 meeting in Luxembourg)

Status of guidelines

The Commission proposes that the guidelines set out in this report should be adopted as a code of good practice and check-list to be used by Member States in preparing stability or convergence programmes. This will facilitate the examination and discussion of the programmes.

The Committee does not suggest that the guidelines be made obligatory, but any departure would have to be justified by the Member States concerned.

Political commitment

In accordance with the provisions of Council Regulation 1466/97, the Member States will submit stability or convergence programmes. It is therefore clear that the governments assume responsibility for them. Each programme might usefully indicate the extent to which it has received support at other levels, notably in the national parliament. In particular, the state of implementation of the measures presented in the programme should be indicated.

Status of data

The status of the quantitative information in the programmes should be clearly established. In order to facilitate assessment, the concepts used should be in line with the standards established at European level, notably in the context of the European System of Accounts. This information may be complemented by a presentation of specific accounting concepts that are of particular importance to the country concerned.

Content

Articles 3 and 7 set out the basic information to be covered by stability and convergence programmes.

Objectives

The programmes should present the medium-term objective for the budgetary position of close to balance or in surplus and, where appropriate, the adjustment path to it, as well as the projected path for the debt ratio (Articles 3 (2a) and 7 (2a)). The time frame for interpreting the medium-term would be the length of the business cycle. The medium-term budgetary position has to take account of the possibility to deal with adverse cyclical developments whilst respecting the government deficit reference value. Obviously, other considerations are also of major importance in setting the appropriate medium-term objective which respects the requirements of the Stability and Growth Pact, such as the need to take account of other sources of variability and uncertainty in budgets, the need to ensure a rapid decline in high debt ratios and the need to cater for the costs associated to population ageing. In line with this, Member States that would wish to make use of discretionary policy should make the necessary room for this.

Member States should specify and explain the factors underpinning their choice of the medium-term budgetary objectives. Where appropriate, government investment objectives might be specified. Convergence programmes shall also present the medium-term monetary policy objectives and their relationship to price and exchange rate stability.

To permit a fuller understanding of the paths of the government balance and the debt ratio and of the budgetary strategy in general, complementary information should be provided on expenditure and revenue ratios, with interest payments separately identified, and on privatisation receipts and other factors influencing the debt ratio. Obviously, the further forward the year considered, the less accurate the information will be.

The budget balances should be broken down by sub-sector of general government (central government, local authorities, social security) where this breakdown is significant.

Assumptions

The programmes should present the main assumptions about expected economic developments and important economic variables which are relevant to their realization such as government investment expenditure, real GDP growth, employment and inflation (Articles 3 (2b) and 7 (2b)). The assumptions on real GDP growth should be underpinned by an indication of the expected sources of growth. Furthermore, the programmes should provide sufficient information about GDP developments to allow an analysis of the cyclical position of the economy. Where these are particularly important to public finances, technical assumptions on interest rates should also be presented.

While there was considerable support in principle in the Committee for the use of a common set of macroeconomic projections, the practical difficulty of arriving at an agreed set of projections was acknowledged. Accordingly, the use of a common set of macroeconomic projections for all programmes is not recommended. However, the macroeconomic projections for the domestic and the world economy underlying the programmes should be clearly specified and the Commission should draw attention to any significant differences from their own projections, the Member State concerned standing ready to justify its assumptions.

Reflecting the general point made above on the standardisation of quantitative information presented, inflation assumptions should be presented in terms of the GDP deflator and, if a Member State considers it useful, the Harmonised Index of Consumer Prices (HICP).

Measures

The programmes should describe the budgetary and other economic policy measures being taken or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the budget (Articles 3 (2c) and 7 (2c)). The measures should be consistent with the broad economic policy guidelines. Measures having significant one-off effects should be explicitly identified. Member States have committed themselves to take the corrective action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives. Structural reforms should be covered where they could contribute to the achievement of objectives of the programmes. Spill-over effects on other Member States should be dealt with by the Commission in its analysis, which does not preclude the Member States from dealing with these effects in their programmes. The programmes could also usefully describe changes introduced to improve expenditure control, tax collection efficiency, and so on. Where appropriate, the programmes should also indicate other possible institutional reforms especially in the budget process.

Sensitivity analysis

The programmes shall provide an analysis of how changes in the main economic assumptions would affect the budgetary and debt position (Articles 3 (2d) and 7 (2d)). This analysis should be complemented by a sensitivity analysis of the impact of different interest-rate assumptions on the budgetary and debt position.

Time horizon

The information about paths for the general government surplus/deficit ratio and debt ratio and the main economic assumptions shall be on an annual basis and shall cover, as well as the current and preceding year, at least the three following years (Articles 3 (3) and 7 (3)); leaving it open to Member States to cover a longer period if they so wish.

Updating of programmes

Annual updates of stability and convergence programmes should show how developments have compared with the programme objectives. When substantial deviations occur, the update should include the steps to be taken to rectify the situation.