ARTICLES

THE REFORM OF THE STABILITY AND GROWTH PACT

Economic and Monetary Union needs fiscal rules that secure sustainable fiscal policies. Such policies promote stability, growth and cohesion in the euro area. They also support monetary policy in its task of maintaining price stability. Against this background, this article explains and assesses the recent reform of the Stability and Growth Pact (SGP).

Changes to the preventive arm of the SGP, which concerns the surveillance process and the attainment of sound medium-term targets, have the potential to strengthen the framework by making it more adaptable to country-specific circumstances and by more explicitly calling on Member States to speed up budget consolidation in good times. However, these changes also reduce the clarity and simplicity of the rules and do not specifically tackle shortcomings in the incentives for compliance.

Changes to the corrective arm, which aims to deter excessive deficits and ensure their prompt correction should they occur, place greater emphasis on flexibility and discretion in subjecting countries to the excessive deficit procedure and in requiring prompt corrective action. In the view of the Governing Council of the ECB, changes to the corrective arm entail risks of weakening the SGP. That is why it had recommended not to modify the corrective arm and expressed its serious concern about these changes in its statement of 21 March 2005.

Now that a new framework has been agreed by the ECOFIN Council, the consequences of the reform of the SGP will depend on its implementation. Member States, the Commission and the ECOFIN Council need to respond to the considerable short and long-term fiscal challenges that lie ahead. These include the prompt correction of existing budgetary imbalances, the reduction of debt ratios, and reforms to deal with the approaching fiscal pressures related to population ageing. It is essential that, in applying the new framework, the right precedents are established from the outset. A rigorous and consistent implementation of the revised rules would be conducive to fiscal discipline and would help to restore the credibility of the EU fiscal framework as well as confidence in prudent fiscal policies.

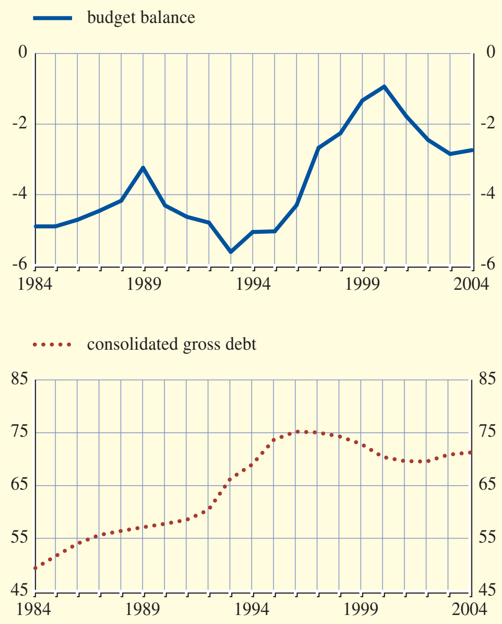
1 INTRODUCTION

A well functioning monetary union requires not only a stability-oriented monetary policy, but also the maintenance of fiscal discipline among its constituent member countries. Acknowledging this, the Treaty establishing the European Community (the Treaty) contains provisions for the monitoring and coordination of EU Member States' fiscal policies. In particular, it states that EU Member States shall avoid excessive government deficits, and provides for an excessive deficit procedure (EDP) to deter and correct such deficits should they occur. The SGP, which was adopted in 1997 and consisted of two Council Regulations and a European Council Resolution, sought to strengthen the fiscal framework of the Treaty by laying down more detailed rules and procedures for budgetary surveillance, and by speeding up and clarifying the implementation of the EDP.

In the mid to late 1990s, euro area Member States made considerable progress in consolidating their fiscal positions as they sought to meet the convergence criteria for adoption of the euro. Since 1999, however, fiscal performance has been rather mixed (see Chart 1). While deficits have not returned to the very high levels of the early 1990s and the rapid increase of debt ratios experienced in those years has not reoccurred, fiscal consolidation has stalled or even gone into reverse in most euro area countries. Initially, a relatively favourable economic environment masked this development, but in the context of the economic downturn that began in 2001, fiscal balances soon deteriorated and an increasing number of Member States ran the risk of or incurred excessive deficits. At the same time, the ECOFIN Council did not always implement the rules and procedures of the SGP in a rigorous manner. Notably, in November 2003, the ECOFIN Council decided not to act upon

Chart 1 General government budget balance and debt in the euro area

(as a percentage of GDP; annual data)



Sources: European Commission and ECB calculations.
Note: Budget balance figures exclude proceeds from UMTS licences.

Commission recommendations to move to the next steps of the EDPs for France and Germany and instead adopted "conclusions" putting the procedures in abeyance subject to certain undertakings by the countries concerned. These conclusions were later annulled by the European Court of Justice, although the latter also confirmed the prerogative of the ECOFIN Council to exercise discretion in the implementation of the procedure.

The deterioration of budgetary positions in recent years and the increasing reluctance to follow agreed rules and procedures eroded confidence in the EU fiscal framework and intensified criticisms of the SGP that have been voiced ever since its inception. Against this background, the European Council, in June 2004, issued a declaration in which it looked forward to proposals to strengthen and clarify the implementation of the SGP. In September 2004, the Commission issued a communication presenting its ideas for "strengthening economic governance and clarifying the implementation of the Stability and Growth Pact". Following intensive discussions on the suggestions put forward by the Commission and by member countries, the ECOFIN Council adopted, on 20 March 2005, a report on "improving the implementation of the Stability and Growth Pact", setting out proposals for reform, which were subsequently endorsed by the European Council. The ECOFIN Council's report now forms part of the SGP, updating and complementing the previous European Council Resolution. Corresponding amendments to the Council Regulations have also been introduced.

During the discussions on reforming the SGP, the ECB consistently stressed the need for a sound fiscal framework in EMU. Following the adoption of the ECOFIN Council report, the Governing Council of the ECB issued a statement and the ECB issued opinions on the Commission's proposals to amend the Council Regulations (see Box 1).

This article explains in more detail the ECB's views on the recent SGP reform. Section 2 provides a brief overview of the main changes. Section 3 assesses these changes, and Section 4 concludes with some remarks about the challenges facing the revised framework in the months and years ahead.

2 MAIN ELEMENTS OF THE REFORM

The reform of the SGP introduces several changes into the original framework. According to the ECOFIN Council report of 20 March, the aim of these changes is to improve governance, strengthen the preventive arm, and improve the implementation of the corrective arm.

CHANGES UNDER THE PREVENTIVE ARM

The preventive arm of the SGP is governed by Council Regulation 1466/97 (now amended by Council Regulation 1055/2005) on the

Box 1

STATEMENT OF THE GOVERNING COUNCIL OF 21 MARCH 2005

"The Governing Council of the ECB is seriously concerned about the proposed changes to the Stability and Growth Pact. It must be avoided that changes in the corrective arm undermine confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States. As regards the preventive arm of the Pact, the Governing Council also takes note of some proposed changes which are in line with its possible strengthening.

Sound fiscal policies and a monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union. They are prerequisites for macroeconomic stability, growth and cohesion in the euro area. It is imperative that Member States, the European Commission and the Council of the European Union implement the revised framework in a rigorous and consistent manner conducive to prudent fiscal policies.

More than ever, in the present circumstances, it is essential that all parties concerned fulfil their respective responsibilities. The public and the markets can trust that the Governing Council remains firmly committed to deliver on its mandate of maintaining price stability."

ECB Opinions of 3 June 2005 on amendments to Council Regulations 1466/97 and 1467/97[1]

In its Opinions, the ECB did not comment on specific provisions of the proposed regulations, but expressed its views in a more general manner. Both Opinions argued that:

"Sound fiscal policies are fundamental to the success of economic and monetary union. They are prerequisites for macroeconomic stability, growth and cohesion in the euro area. The fiscal framework enshrined in the Treaty and in the Stability and Growth Pact is a cornerstone of EMU and thus key to anchoring expectations of fiscal discipline. This rules-based framework, which aims to secure sustainable public finances while allowing the smoothing of output fluctuations through the operation of automatic stabilisers, needs to remain clear, simple and enforceable. Compliance with these principles will also facilitate transparency and equal treatment in the implementation of the framework."

In addition, in its Opinion on Council Regulation 1466/97, the ECB "endorses the aim of improving the surveillance and coordination of economic policies so as to achieve and maintain medium-term objectives that ensure the sustainability of public finances". In its Opinion on Council Regulation 1467/97, the ECB "reiterates that the EDP needs to be both credible and effective as a safeguard against unsustainable public finances, maintaining a strict time frame". The ECB also stressed that "a rigorous and consistent implementation of the surveillance procedures and of the EDP would be conducive to prudent fiscal policies".

1 The initial SGP consisted of the following texts: (i) Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (the preventive arm); (ii) Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (the corrective arm); (iii) Resolution of the European Council on the Stability and Growth Pact, adopted in Amsterdam on 17 June 1997. These were later supplemented by a Code of Conduct on the content and format of stability and convergence programmes, the latest version of which was endorsed by the ECOFIN Council on 10 July 2001. The reformed SGP consists of the ECOFIN Council report of 20 March 2005, together with the European Council Resolution of June 1997, which the former updates and complements, and Council Regulations 1466/97 and 1467/97 as amended by Council Regulations 1055/2005 and 1056/2005, to take into account the substance of the ECOFIN Council report. The aforementioned Code of Conduct is also being updated.

strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. Under the preventive arm, Member States submit stability or convergence programmes in which they detail their medium-term budgetary plans. Under the original SGP, Member States were required to pursue the medium-term objective of budgetary positions that were "close to balance or in surplus". While Council Regulation 1466/97 did not prescribe the adjustment path towards this objective, the Eurogroup had agreed in October 2002 that all euro area Member States that had not achieved such positions should improve their underlying balances by at least 0.5% of GDP per annum.[1] The ECOFIN Council later clarified that this improvement should be measured by changes in the cyclically adjusted balance, while one-off measures should be considered on their own merits on a case-by-case basis.[2]

The reform makes various refinements to the SGP provisions concerning the setting of and progress towards safe medium-term budgetary positions.

DEFINITION OF THE MEDIUM-TERM BUDGETARY OBJECTIVE

Each Member State will present its own country-specific medium-term objective (MTO) in its stability or convergence programme, which will then be assessed by the ECOFIN Council. These country-specific MTOs will be differentiated and may diverge from the close to balance or in surplus requirement depending on the current debt ratio and potential growth. Implicit liabilities should also be taken into account as soon as criteria and modalities for doing so have been established. The MTOs should pursue a triple aim; namely, to preserve a safety margin with respect to the 3% of GDP reference value for the government deficit ratio, ensure rapid progress towards sustainable public finances and, taking this into account, allow room for budgetary manoeuvre, in particular so as to accommodate public investment needs. For euro area and ERM II Member States, the range of country-specific MTOs will be, in cyclically adjusted terms and net of one-off and temporary measures, between -1% of GDP and "in balance or surplus". MTOs will be revised when a major structural reform is implemented and, in any case, every four years.

ADJUSTMENT PATH TO THE MEDIUM-TERM OBJECTIVE

Member States that have not yet achieved their MTO should undertake consolidation efforts to do so. The adjustment effort should be greater in good times and could be more limited in bad times. Good times are defined as "periods where output exceeds its potential level, taking into account tax elasticities". As a benchmark, the euro area and ERM II Member States should pursue an annual adjustment in cyclically adjusted terms, net of one-off and temporary measures, of 0.5% of GDP. Member States that do not follow the required adjustment path should explain the reasons for the deviation in the annual updates of their stability and convergence programmes. The Commission should issue "policy advice" to encourage Member States to adhere to their adjustment path.

STRUCTURAL REFORMS

When defining the adjustment path towards the MTO or allowing Member States to deviate temporarily from the MTO if they have already reached it, the implementation of major structural reforms will be taken into account. However, only reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable positive impact on the long-term sustainability of public finances, will be taken into account. Furthermore, a safety margin with respect to the 3% reference value must be preserved, and the budgetary position will be expected to return to the MTO within the programme period. Special attention will be paid to pension reforms introducing multi-pillar

1 See Eurogroup terms of reference of 7 October 2002 on budgetary developments in the euro area.
2 See ECOFIN Council report of 7 March 2003 on strengthening the coordination of budgetary policies.

systems that include a mandatory, fully funded pillar. Member States implementing such reforms will be allowed to deviate from the adjustment path to their MTO or from the MTO itself, with the deviation reflecting the net cost of the reform to the publicly managed pillar, provided the deviation remains temporary and that an appropriate safety margin with respect to the 3% of GDP reference value for the government deficit ratio is preserved.

CHANGES UNDER THE CORRECTIVE ARM

The corrective arm of the SGP is governed by Article 104 of the Treaty and by Council Regulation 1467/97 (now amended by Council Regulation 1056/2005) on speeding up and clarifying the EDP. The early stages of the procedure concern the identification of excessive deficits. The procedure is triggered by the preparation of a Commission report (under Article 104(3)) when a government deficit exceeds the reference value of 3% of GDP. It can also be initiated if the debt-to-GDP ratio exceeds the reference value of 60% and is not "sufficiently diminishing and approaching the reference value at a satisfactory pace". However, the Treaty also provides for deficit ratios above 3% to be considered not "excessive", as long as the breach is small, temporary and due to exceptional circumstances.

When the ECOFIN Council decides (under Article 104(6)) that an excessive deficit exists, the procedure provides for a sequence of steps to be taken that should intensify the pressure on the Member State concerned to take effective action to correct its excessive deficit. For each step, the ECOFIN Council adopts the necessary legal acts on the basis of recommendations by the Commission. The process begins with a recommendation from the ECOFIN Council (under Article 104(7)) to the Member State in question to take measures to bring the excessive deficit situation to an end. Compliance with the Council's recommendation is then monitored and, if action is not taken or is not effective, the Member State shall be given "notice" (under Article 104(9)) to take measures to remedy the situation. Failure to comply with the notice should, as a rule, lead to the imposition of sanctions (under Article 104(11)), including the requirement for the Member State concerned to make a non-interest bearing deposit, which, if non-compliance persists, is eventually turned into a fine.

Under the reform of the SGP, a number of elements in the EDP have been changed.

NEW DEFINITION OF "SEVERE ECONOMIC DOWNTURN"

Under the original SGP, a government deficit ratio in excess of the 3% of GDP reference value could be considered "exceptional" if it resulted from a severe economic downturn, which was defined as a fall in annual real GDP of at least 2%. A fall of between 0.75% and 2% could also be considered 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. Under the revised SGP, a severe economic downturn will now be defined as a negative annual real GDP growth rate or an accumulated loss of output during a protracted period of very low annual real GDP growth relative to potential growth.

"OTHER RELEVANT FACTORS"

The Treaty (Article 104(3)) specifies that the Commission, in its report that constitutes the first step of an EDP, should take into account "all other relevant factors, including the medium-term economic and budgetary position of the Member State". However, neither the Treaty nor the SGP elaborated further on what these other relevant factors might be. It has now been decided that relevant developments in the medium-term economic position include, in particular, potential growth, the prevailing cyclical conditions, the implementation of the Lisbon agenda and policies to foster research and development and innovation, while relevant developments in the medium-term budgetary position include, in particular, fiscal consolidation efforts in good times, debt sustainability, public investment and the overall quality of public finances. Moreover, consideration should be given to any other factors which, in the opinion of the Member State concerned, are relevant to a comprehensive assessment of the excess over the reference value in qualitative terms. Special consideration will be given to budgetary efforts towards increasing or maintaining a high level of financial contributions to fostering international solidarity and achieving European policy goals, notably the unification of Europe, if they have a detrimental effect on the growth and fiscal burden of the Member State. When assessing whether or not a deficit above 3% of GDP is excessive, the other relevant factors shall be taken into account only if the government deficit remains close to the reference value and the excess over the reference value is temporary. If the ECOFIN Council has decided that an excessive deficit exists, the other relevant factors will be considered when issuing recommendations or notices to the Member State concerned.

PENSION REFORMS

For a Member State whose deficit exceeds but remains close to the 3% of GDP reference value, the Commission and the ECOFIN Council will also take into consideration the cost of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar. In particular, consideration will be given to the net cost of the reform to the publicly-managed pillar. This will be done in a degressive manner over a period of five years. Such reforms will also be taken into consideration when assessing whether an excessive deficit has been corrected and whether the deficit has declined substantially and continuously, reaching a level that comes close to the reference value.

INCREASING THE FOCUS ON DEBT AND SUSTAINABILITY

The debt surveillance framework should be strengthened by applying the concept of a government debt ratio that is "sufficiently diminishing and approaching the reference value at a satisfactory pace" in qualitative terms, as well as by taking into account macroeconomic conditions and debt dynamics. For Member States with a debt ratio above the 60% of GDP reference value, the ECOFIN Council will formulate recommendations on debt dynamics in its opinions on the stability and convergence programmes.

EXTENSION OF DEADLINES FOR THE CORRECTION OF EXCESSIVE DEFICITS

The original SGP provided for the correction of an excessive deficit to be completed "in the year following its identification unless there are special circumstances", but did not specify what these "special circumstances" might be. Following the reform, the initial deadline for correcting an excessive deficit should remain, as a rule, the "year after identification". However, the setting of this deadline and consideration as to whether there are special circumstances justifying an extension by one year should take into account a balanced overall assessment of the "other relevant factors" mentioned above. Moreover, the initial deadline for correction should be set such that the Member State with an excessive deficit will have to achieve a minimum annual improvement in its cyclically adjusted balance of 0.5% of GDP as a benchmark, net of one-off and temporary measures. The initial deadline can be revised if an ECOFIN Council recommendation or a notice is reissued, which can happen if unexpected adverse economic events with major unfavourable budgetary effects occur, and if effective action has been taken in compliance with the earlier recommendation or the earlier notice.

EXTENSION OF PROCEDURAL DEADLINES

A number of procedural deadlines have also been extended. These include the deadline for the ECOFIN Council to issue its recommendation to the Member State in excessive deficit (extended from three to four months after the date on which the excessive deficit was reported), the deadline for effective action in response to an ECOFIN Council recommendation (extended from four to six months), the deadline for the ECOFIN Council to issue a notice if it has established that no effective action has been taken in response to its recommendation (extended from one month to two months), and the deadline for taking effective action in response to a notice (extended from two to four months).

GOVERNANCE

The Member States, the Commission and the ECOFIN Council each have distinct responsibilities as regards the implementation of the SGP and they all made specific commitments in this respect in the aforementioned European Council Resolution. Member States are responsible for the conduct of their own fiscal policies, but committed themselves to pursuing these policies in line with the objectives of the SGP and recommendations of the ECOFIN Council. The Commission has the exclusive right of initiative to submit recommendations for actions by the ECOFIN Council, and committed itself to exercise this right in a manner that facilitates a strict, timely and effective functioning of the SGP. Finally, the ECOFIN Council is ultimately responsible for enforcing the SGP and has a margin of discretion in doing so, but committed itself to a rigorous and timely implementation of all elements of the SGP.

Without changing this basic division of responsibilities, the reform of the SGP includes some suggestions for improving its governance. It calls for closer cooperation between Member States, the Commission and the ECOFIN Council, as well as for improved peer support and peer pressure. It also calls for the development of national budgetary rules, the continuity of budgetary targets when a new government takes office, and greater involvement of national parliaments. Furthermore, it stresses the importance of reliable macroeconomic forecasts and budgetary statistics.

3 ASSESSMENT FROM AN ECB PERSPECTIVE

RATIONALE FOR FISCAL RULES IN EMU

The main rationale for constraining fiscal policies via rules lies in the temptation for governments to spend more than they can afford and pass the burden onto future taxpayers. If unchecked, this results in a deficit bias where high deficits lead to growing debt levels that can cast a permanent shadow over economic prospects. High deficits and debt result in higher long-term interest rates and lower private investment as they compete for private savings. This can lead to a permanent loss of output over the long run.

Fiscal policies can also have implications for the conduct of monetary policy. In particular, high deficits can give rise to demand and inflationary pressures, potentially forcing the monetary authority to keep short-term interest rates at a higher level than would otherwise be necessary. Fiscal policies may also undermine confidence in a stability-oriented monetary policy if private agents come to expect that excessive government borrowing will ultimately be financed through money creation, and thus adjust their inflation expectations accordingly.

In a monetary union among sovereign states, the deficit bias of fiscal policy is likely to be exacerbated. The adoption of a common currency eliminates the exchange rate risk and the associated interest rate risk premia among the participant countries, thus blunting the discipline normally exerted by financial markets on governments' fiscal behaviour. As national financial markets become more integrated, sovereign issuers can draw on a larger and more liquid currency area-wide capital market. A government that increases its deficit will be able to finance the additional expenditure more easily because the cost of the additional borrowing in terms of higher interest rates is, at least partly, spread across the entire currency area.[3]

3 See the article entitled "Fiscal policy influences on macroeconomic stability and prices" in the April 2004 issue of the ECB's Monthly Bulletin.

Consequently, the spillover effects from deficit spending in one country on other countries are also greater in EMU, making the participant Member States' fiscal policies all the more a matter of common concern.

A further rationale for fiscal rules is to create room for fiscal policy to stabilise output and avoid pro-cyclical fiscal policies. In particular, the operation of automatic stabilisers, resulting from cyclical fluctuations of government revenue and expenditure which unfold in an "automatic" and timely manner over the course of the economic cycle, has proven to be effective in smoothing fluctuations in output and demand. In a monetary union, the importance of fiscal policy as an instrument for smoothing output fluctuations at the national level becomes even greater in view of the loss of national monetary policies. Euro area-wide interest rates cannot be geared to the national economic situation, whereas automatic stabilisers can help to offset any unduly contractive or expansionary effects on domestic demand.[4] However, if deficits and debt are high, the resultant further increase in the deficit may undermine confidence in the future soundness of public finances, which could prompt private agents to save more and thus offset the forces of automatic stabilisation.

The Treaty and the SGP provide a rules-based framework that is intended to achieve sustainable and stability-oriented fiscal policies. The preventive arm prescribes the path for sound fiscal policies around which automatic stabilisers can operate. The corrective arm is intended to prevent "gross policy errors" by deterring excessive deficits and requiring their prompt correction should they occur. In particular, the 3% ceiling for deficits should provide for a minimum level of fiscal discipline in EMU and therefore anchor expectations of sustainable public finances. Within these constraints, which are not only in the interest of the euro area as a whole but also of the individual Member States, the SGP is fully consistent with and does not restrict national sovereignty over fiscal policies.

PRINCIPLES OF GOOD FISCAL RULES IN EMU

Fiscal rules are not unique to EMU. A number of countries both inside and outside the EU have adopted a variety of fiscal rules. As more and more experience has been gained in the implementation of fiscal rules, important lessons can be drawn as to the principles according to which they should operate if they are to be effective. Fiscal rules must be founded on sound economic reasoning. In particular, they must be adequate in the sense that they satisfy the objectives they are intended to achieve and should be consistent with the broader economic policy framework. They should also be flexible enough to allow for appropriate policy responses to exceptional events outside the control of governments. Fiscal rules that are inconsistent with rational economic policy choices are unlikely to garner sufficient public support and political commitment to be viable in the long run.

At the same time, fiscal rules need to be clear and enforceable. This requires transparency and a sufficient degree of simplicity. Compliance with the rules must be relatively easy to monitor if they are to serve as an effective disciplining device. Accounting and measurement must be reliable. Non-compliance also needs to entail sufficiently predictable and severe consequences if it is to be effectively deterred. In addition, fiscal rules should be readily understood, as this enhances incentives for sound fiscal policies stemming from the external discipline exercised by financial markets and the public at large. In the multilateral setting of EMU, the need to ensure equal treatment among Member States provides a further rationale for simple, clear and enforceable rules.

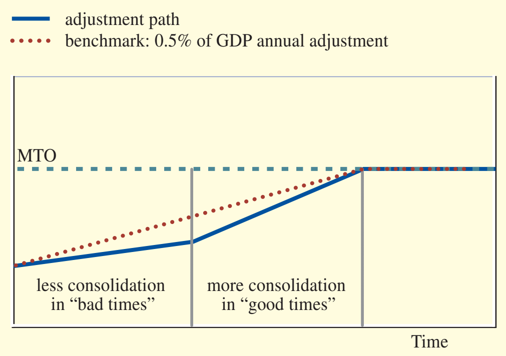
Obviously, the above principles often imply trade-offs. In particular, a greater degree of flexibility can be at the expense of simplicity and clarity. This can be seen clearly in the

4 See the article entitled "The operation of automatic fiscal stabilisers in the euro area" in the April 2002 issue of the ECB's Monthly Bulletin.

original design of the SGP. The two main arms are intended to combine relatively flexible rules and "soft" procedures for fiscal surveillance under the preventive arm, with stricter rules and "harder" procedures where these are needed to define, deter and correct excessive deficits under the corrective arm. While the reform of the SGP has not fundamentally changed this "two-armed structure", the relative emphasis with regard to the different principles that characterise good fiscal rules under the two arms has changed significantly.

Chart 2 Adjustment path towards the MTO

(Budget balance adjusted for the impact of the cycle)



THE PREVENTIVE ARM: A MORE SOPHISTICATED APPROACH TO FISCAL SURVEILLANCE

The changes to the preventive arm aim to address a number of criticisms of the original framework. These included disapproval of a "one size fits all" budgetary target for all Member States given differences in growth, debt and ageing-related challenges as well as the argument that incentives to conduct policies in a counter-cyclical and growth-friendly manner needed to be strengthened.

Changes in the definition of the appropriate medium-term policy objectives towards more country specificity are based on the reasoning that differences in potential growth, debt ratios and implicit liabilities call for different deficit targets. Moreover, the intention is to strengthen incentives for major structural reforms, which could result in the revision of MTOs towards less ambitious targets if such reforms strengthen the outlook for sustainability. The required path of adjustment towards the MTO has also been revised in a manner that should, in principle, discourage pro-cyclical fiscal policies and favour structural measures instead of one-off or temporary measures that do not have a beneficial long-term impact on public finances.

Chart 2 illustrates how the overall adjustment path and the variation of consolidation efforts in good and bad times could work in practice. The chart assumes a deviation from the MTO as a starting-point and output is initially below potential ("bad times" defined as a negative output gap). Some consolidation would have to be undertaken but less than the 0.5% of GDP annual adjustment benchmark. Consolidation efforts would then have to be more substantial during the subsequent period when output rises above its long-run potential level ("good times" defined as a positive output gap). Assuming a symmetric occurrence of good and bad times as in Chart 2, and their accurate identification in real time, overall consolidation efforts would average those implied by the 0.5% benchmark, but fiscal policy would have been allowed greater freedom to fine tune consolidation efforts to the cyclical environment. Box 2 illustrates the implications for long-term debt dynamics of compliance with the MTO under the revised preventive arm.

A drawback of the more sophisticated approach to fiscal surveillance and coordination implied by these changes is the reliance on a number of concepts that generate problems of definition and measurement. In particular, uncertainties surrounding the measurement of unobservable variables such as potential output, output gaps and cyclically adjusted balances could make the assessment of compliance with consolidation requirements in good and bad times very difficult in practice. Experience

Box 2

IMPLICATIONS OF THE REFORM OF THE PREVENTIVE ARM FOR GOVERNMENT DEBT DYNAMICS – SOME SIMULATIONS

There are several ways of analysing the dynamics of the debt ratio. One of the simplest is to simulate the evolution of government debt depending on different potential growth rates and deficit assumptions. This helps to abstract from the short-run variations of debt owing to the business cycle, and to concentrate on long-term trends. The evolution of a country's debt ratio can be expressed by the following equation:

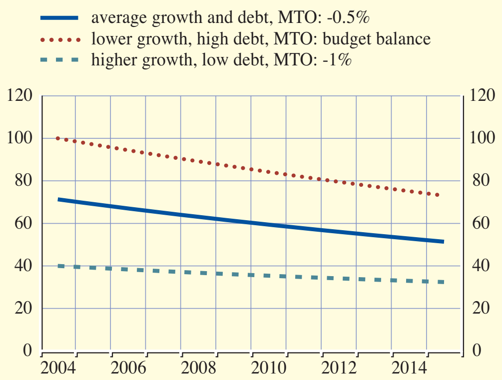
$$d_t = \frac{d_{t-1}}{1+y} + def_t$$

where *d* represents the debt-to-GDP ratio, which depends on *y,* the growth of nominal output, *def,* the deficit-to-GDP ratio, and its own past level.

This approach can be used to simulate the impact of compliance with the preventive arm of the SGP on debt. The level of the MTO, the initial debt ratio and the growth assumption affect the evolution of the debt ratio over time.[1] The chart illustrates how the debt ratio could develop in stylised scenarios that broadly cover the range of economic and fiscal situations across euro area countries. It shows that in a country characterised by high initial debt and low growth, even compliance with an MTO set at budget balance only leads to a slow decline of debt. In such a scenario, public debt would not reach the 60% threshold even within 15 years. A country with an initial debt ratio and economic growth that correspond to the average of the euro area in 2004 reaches a debt ratio below 60% after six years and falls to about 50% of GDP within 15 years, if it complies with an MTO of -0.5% of GDP. Finally, an MTO of -1% of GDP keeps the debt ratio broadly stable in a country starting with a low debt ratio and high growth. The main insight of these very simple simulations is that even continuous compliance with the MTO will drive down the debt ratio only rather slowly in high debt countries.

Simulation of the effect of compliance with the MTO on government debt dynamics

(as a percentage of GDP)



1 The simulation is based on a euro area nominal growth rate of 3.9% and a debt-to-GDP ratio of 71.3% in line with the Spring 2005 Economic Forecasts of the European Commission. High growth is defined as the euro area growth rate plus 1%, low growth as the euro area growth rate minus 1%. The debt ratio is assumed at 100% in a high debt country, at 71.3% in an average debt country and at 40% in a low debt country. The simulation also assumes an absence of deficit-debt adjustments.

has shown that negative output gaps tend to predominate in the ex ante assessment of countries' economic positions (times are rarely deemed to be good). There is hence a risk of seeing few instances of significant adjustment above 0.5% of GDP and more cases of adjustment plans falling short of this benchmark. Much will depend on the quality of the calculation of the underlying variables in real time.

Particular attention must be paid to the implementation difficulties associated with the increased differentiation across countries' MTOs and the more generous provisions for deviations from these objectives. More leeway to deviate from close to balance or in surplus budgetary positions means that safety margins with regard to the 3% of GDP reference value could be reduced, thus increasing the risk of excessive deficits. Significant measurement problems are also likely to arise when attempting to assess the budgetary costs and benefits of structural reforms. The precise quantitative effects of specific reforms are often difficult to estimate ex post, let alone ex ante. Moreover, there is no obvious trade-off between fiscal consolidation and structural reforms. On the contrary, the experience of a number of countries suggests that fiscal consolidation and structural reforms are best pursued in tandem as part of a comprehensive economic strategy.[5] In this context, structural reforms may even support demand and, in turn, public finances if they inspire confidence and induce favourable supply-side responses.

Overall, the more sophisticated approach to surveillance introduced by the reform has the potential to strengthen the preventive arm if the changes are accompanied by renewed commitment to comply with and enforce the rules. However, one must be particularly attentive to the potential loss of clarity and simplicity, which may render equal treatment more difficult and create potential for lax implementation.

THE CORRECTIVE ARM: INCREASED FLEXIBILITY AND DISCRETION

While maintaining essential elements of the framework, such as the 3% and 60% reference values for deficit and debt, the reform of the SGP has introduced notable changes to the functioning of the corrective arm. A certain amount of flexibility and discretion was always inherent in the EU legal and institutional framework, on which the SGP is based. However, when first signing up to the SGP, the Member States, the Commission and the ECOFIN Council committed themselves to a strict enforcement of a clear and simple deficit limit. Such a commitment was considered necessary to bolster the credibility and the deterrence effect of the EDP. The reform of the corrective arm marks a move towards more flexible standards and a greater emphasis on discretion. Consequently, decisions in the context of the procedure may become less strict and more conditional on the judgement of the parties involved.

In principle, the new rules relax the conditions for enhanced surveillance under the EDP. The modification of the exceptional circumstances clause and the drawing up of a long list of "other relevant factors" increase the likelihood that deficits in excess of the reference value will not be considered excessive, even though it is understood that such breaches should remain small and temporary. In addition, the changes in the provisions allow for more leeway in the time frame for correcting excessive deficits, even if the "normal" deadline of two years ("the year after identification") remains. There is also now more room for granting additional time for correcting an excessive deficit.

The effect of these changes to the corrective arm will depend on their implementation. To illustrate this point, Box 3 describes hypothetical "rigorous" and "lax" scenarios

5 See the article entitled "The need for comprehensive reforms to cope with population ageing" in the April 2003 issue of the ECB's Monthly Bulletin.

and the potentially very different implications of such scenarios for debt developments. In principle, the reform of the SGP does not impose a more lax implementation of the rules and procedures than in the past. However, it could facilitate such an outcome, which might imply higher, more frequent and/or more persistent deficits above 3% of GDP, thereby having an adverse effect on expectations of fiscal discipline and macroeconomic stability.

Box 3

SCENARIOS FOR THE IMPLEMENTATION OF THE REVISED EXCESSIVE DEFICIT PROCEDURE AND IMPLICATIONS FOR GOVERNMENT DEBT

Chart A illustrates two scenarios for deficit developments following a breach of the 3% reference value. It should be stressed that these are not predictions but merely hypothetical scenarios intended to highlight the broad range of possible outcomes, and thus the importance of a rigorous application of the excessive deficit procedure (EDP) in the interest of fiscal prudence.

"Rigorous" scenario:

- In year T a Member State records a deficit in excess of the 3% reference value. This situation is observed in year T+1, and it is concluded that the excess is not due to exceptional circumstances; there are found to be no "other relevant factors" that explain the breach and there are no special circumstances to justify an extension of the deadline for correction. The ECOFIN Council therefore issues a recommendation to the Member State concerned to correct its excessive deficit in the year after its identification.
- The Member State adopts effective consolidation measures and complies with the recommendation, correcting its excessive deficit in year T+2.
- After correcting its excessive deficit, the Member State pursues an adjustment of its cyclically adjusted balance, net of temporary measures, of at least 0.5% of GDP per annum and achieves a close to balance budgetary position over the medium term, which is maintained thereafter.

"Lax scenario":

- In year T a Member State runs a deficit in excess of the 3% reference value. This fact is observed in year T+1 but it is concluded that the breach is only small and temporary and due to "other relevant factors".
- In year T+1 the budgetary situation deteriorates further and in year T+2 it is decided that an excessive deficit exists. However, since an improvement of the cyclically adjusted balance by 0.5% of GDP now appears insufficient to correct the excessive deficit by the year after identification (year T+3), the ECOFIN Council considers that special circumstances exist and decides to extend the initial deadline to year T+4.
- The Member State fails to take effective action and the excessive deficit is not corrected in year T+4. The ECOFIN Council therefore issues a notice to the Member State to take measures to correct the situation in year T+5.
- The Member State complies with the notice, correcting its excessive deficit in year T+5. Sanctions are averted and the EDP is brought to an end.
- Thereafter, progress towards a sound medium-term budgetary position should be made in accordance with the prescribed adjustment path towards the medium-term objective (MTO) . However, given the lack of an adequate safety margin, renewed breaches of the reference value cannot be excluded in the event of adverse economic and/or fiscal developments.

Chart A Scenarios for the implementation of the EDP

(as a percentage of GDP)

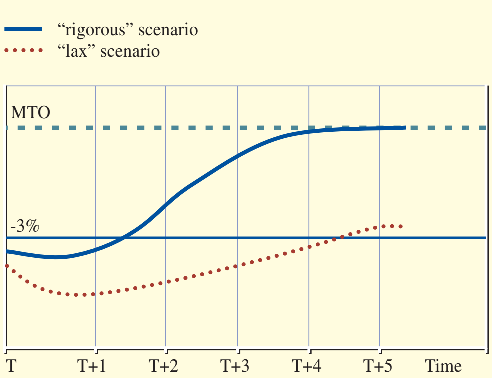
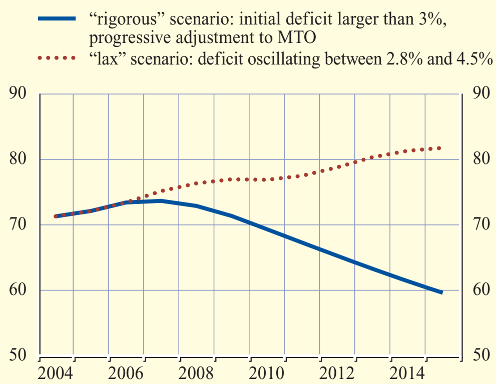


Chart B Simulation of two behavioural scenarios under the EDP and their effect on government debt

(as a percentage of GDP)



The implications of these two scenarios for debt dynamics are simulated in Chart B. In both scenarios, the starting-point corresponds to the average euro area debt-to-GDP ratio of 71.3% and the deficit initially exceeds 3% of GDP. Economic growth is assumed to remain at the euro area average throughout the simulation horizon. The lower line simulates the rigorous scenario. In this scenario, the debt ratio initially increases before falling below the starting value again after six years. The upper line simulates the lax scenario, following which renewed breaches and further lenient implementation imply a deficit that oscillates between just below 3% and some level above (here 4.5% of GDP). In this scenario, the debt ratio rises continuously. Many variations of this scenario are conceivable, where, for example, more ambitious consolidation could lead to lower debt ratios or, alternatively, debt dynamics could be more adverse if economic growth were to be lower than the euro area average and the deficit higher.

GOVERNANCE: LITTLE INSTITUTIONAL CHANGE

The need to improve the governance of the SGP, including incentives to comply with and enforce the rules, has been widely recognised. One common criticism is that Member States may be reluctant to enforce the rules strictly because of the consequences this may have for future judgements on their own policies. A further criticism is that, under the current voting rules, a minority of countries (including countries in excessive deficit) can block the procedures and, thereby, render a strict implementation more difficult. The reform has not introduced any fundamental institutional changes in this respect.

There is, however, a new provision allowing the Commission to issue policy advice, while much needed improvements to the institutional framework for statistical governance are also being considered and implemented outside the remit of the SGP reform. At the same time, in view of the dispersion of possible outcomes illustrated in Box 2, the increased sophistication of the new rules and the greater emphasis on discretion and economic judgement will certainly require increased cooperation and "peer pressure" in order to implement the procedures effectively.

A source of uncertainty pertains to the impact of the reform on compliance. On the one hand, by addressing certain criticisms and adopting rules that are easier to respect, the reform could strengthen political ownership and willingness to comply with the rules. On the other hand, the relative complexity of the rules, the relaxed standards for determining the existence of an excessive deficit and the more remote prospect of sanctions are liable to reduce the reputation cost of unsound fiscal policies. Moreover, the increased complexity of the rules may also have implications for the monitoring of fiscal policies by financial markets and the general public.

4 CHALLENGES FOR THE REFORMED STABILITY AND GROWTH PACT

The reform of the SGP has been concluded at a time when fiscal policies in the euro area are faced with considerable short and long-term challenges. Fiscal consolidation has stalled or has even gone into reverse in many euro area countries since 1999. The euro area as a whole has recorded deficits close to 3% of GDP for the past three years, reflecting significant or even severe budgetary imbalances in a number of member countries. These have persisted for a number of years and, in some cases, are becoming worse. Presently, five out of 12 euro area Member States are subject to EDPs. Only a small number of Member States have succeeded in achieving and maintaining close to balance or in surplus budgetary positions. Moreover, the euro area debt ratio has been rising and a growing number of countries have been breaching the 60% reference value in recent years (see table). Excessive deficits are a major factor behind these adverse debt developments. For a number of countries, however, low GDP growth, in some cases reflecting a decline in potential growth, has also had a negative impact on debt dynamics. The implication of this is that merely keeping deficits below the 3% of GDP reference value will not be sufficient to stabilise debt ratios, while regular breaches of the reference value clearly jeopardise fiscal sustainability.

The current outlook for fiscal policies suggests that further policy measures will be needed in many countries if they are to comply with the new framework. Most forecasts of fiscal policies, including the forecasts of the Commission, project that current fiscal policies and plans will not be sufficient to correct the imbalances as required. The Member States presently in excessive deficit are at risk of failing to meet the deadlines for correction set by the ECOFIN Council. Moreover, few Member States would comply with the benchmark 0.5% adjustment path towards safe medium-term budgetary positions prescribed by the revised rules. Debt-to-GDP ratios continue to rise in most of the countries with levels currently above 60% and in only one of the countries with a debt-to-GDP ratio near 100% is the debt ratio on a clear downward trajectory.

Progress with debt reduction is becoming ever more urgent as the impact of population ageing on public finances will start to be felt within the next 10 to 20 years in most countries. Quantifications of this impact are highly uncertain as very long-term projections are acutely sensitive to the assumptions on which they are based. Nonetheless, work undertaken by the EU's Economic Policy Committee, in which representatives from all EU Member States, the Commission and the ECB participate, suggest that by 2050 the burden of ageing-related spending for the euro area as a whole could increase by around 5% of GDP. In some euro area countries, the increase could even be

Euro area deficit and debt-to-GDP ratios in 2004

(as a percentage of GDP)

	Deficit	Debt
Belgium	0.1	95.6
Germany	-3.7	66.0
Greece	-6.1	110.5
Spain	-0.3	48.9
France	-3.7	65.6
Ireland	1.3	29.9
Italy	-3.0	105.8
Luxembourg	-1.1	7.5
Netherlands	-2.5	55.7
Austria	-1.3	65.2
Portugal	-2.9	61.9
Finland	2.1	45.1
Euro area	-2.7	71.3

Source: European Commission, Economic Forecasts Spring 2005.

closer to or in excess of 10% of GDP. Rapidly reducing high debt ratios is crucial if such a burden is to be borne without the need for substantial and potentially disruptive budgetary adjustments. In a number of countries, debt reduction also needs to be complemented by comprehensive fiscal reforms. This will help to contain the cost of ageing-related spending and, more generally, to improve the quality of public finances and hence their contribution to stability and growth in the long run.

Over the medium to longer term, the success of the SGP reform will depend on whether it secures the underlying objective of sustainable fiscal policies that make an effective contribution to growth, stability and cohesion in the euro area. To this end, the revised fiscal framework must provide the right incentives for fiscal policies that reverse the current trend of high deficits and rising debt, and deliver a convergence of debt ratios to more moderate levels.

The implementation of EDP and fiscal surveillance in the coming months will serve as a first test of the new framework's effectiveness. A timely correction of existing excessive deficits and renewed progress towards achieving sound medium-term budgetary positions should be of the highest priority. Especially if pursued as part of a comprehensive economic reform strategy, ambitious and credible fiscal consolidation would provide an important boost to business and consumer confidence.

The reform of the SGP creates an opportunity for renewed commitment to the conduct and enforcement of sound fiscal policies that meet both shorter and longer-term budgetary challenges. A rigorous and consistent implementation of the revised rules is needed to underpin the credibility of the EU fiscal framework and confidence in prudent fiscal policies.