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Stability by Balanced Growth

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Expertise on the reform of the Stability and Growth Pact for the Group of the Progressive Alliance of Socialists & Democrats in the European Parliament

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Executive Summary

1. The Commission's proposal comprises a clear commitment to the close-to-balance approach, based on debt and deficit criteria and sanctions for member states deviating persistently from targets and recommendations of the Commission. It mainly introduces two new elements: a strengthening of the 60% debt-to-GDP criterion by the introduction of a numerical benchmark for the reduction of debt and a new excessive imbalance procedure dealing with macroeconomic imbalances in the euro area. Moreover, surveillance and coordination is improved.
2. The commission's proposal on reforming the Stability and Growth Pact (SGP) is still focusing on public debt despite all efforts to include a broader range of factors determining economic developments within Europe. Fiscal restraint, institutionalised by the 3% of GDP deficit criterion and the strengthened 60% debt-to-GDP criterion, cannot cope, however, with the economic challenges that led to the economic and the euro crises of the last two years. To be more precise, this restrictive focus itself can be an obstacle to sound macroeconomic developments in the future.
3. The inclusion of a framework for tackling macroeconomic imbalances could be an important step in broadening this narrow and inadequate focus. It could potentially

lead to the incorporation of factors essential for a sound growth path. In the current form, however, a latent conflict between the excessive deficit procedure (EDP) and the new excessive imbalance procedure (EIP) exists.

4. What is needed, against the background of the enormous economic challenges the European Union has had to face after the recent crises, is not sound fiscal policies but stability by balanced growth. Fiscal policies can contribute to a stabilisation of economies, a reduction of macroeconomic imbalances, sound infrastructure and strong domestic demand. Public budgets kept close to balance or in surplus, however, may conflict with this. Balanced growth between and sufficient growth within the member states is essential for restricting public debt to an adequate level.
5. Some amendments suggested by the rapporteurs and the changes of the S&D group of the European Parliament are an important step towards this aim of stability by growth. Transparent procedures and the involvement of a broad range of actors and institutions help to incorporate all relevant arguments. Moreover, to strengthen the automatic stabilisers and the counter-cyclicality of fiscal policies dampens the effects of business cycles, which can lead to a higher growth path. Furthermore, a sound level of public investment stabilises domestic demand and increases future potential growth. National ownership, i.e. the establishment of a fiscal framework at national level similar to the SGP, can contribute to compliance with the pact – but this would only make sense if the rules of the SGP were economically feasible. But they are not.
6. To improve the growth-orientation of the reform of the SGP more attention should be laid on a deeper integration of both excessive procedures, EDP and EIP, which promises to allow for a broad analysis of the problems that economies face including the state's fiscal position, but not restricting policies to it. Priority should be given to the current account as the most relevant indicator, covering both public and private debt. Recommendations have to be addressed to member states with current account deficits but also to those with surpluses. In order to support the member states by correcting macroeconomic imbalances and to address price competitiveness directly, the inclusion of more actors than mentioned in the legislative texts would be helpful, especially the European Central Bank and the Macroeconomic Dialogue.

Stability by Balanced Growth[1]

1. Past and Present of the Pact

The SGP was introduced in 1996 in order to strengthen the coordination of fiscal surveillance, which seemed necessary to support and to safeguard the establishment of the monetary union. Its aim was to make it impossible to endanger the euro by budget deficits of the member states. Thus, two criteria, restricting the ratio of debt-to-GDP to 60% and the annual deficit to 3%, were institutionalised and the EDP was created for corrective measures. The annual deficit limit was chosen against the assumption of an annual nominal GDP growth of 5% on average. Since its inception, the emphasis was on the deficit criterion, whose violation may result in sanctions. The aim of the pact is a budget close to balance or in surplus, which would result in an absolute reduction of public debt in the long run to zero or even to positive net financial assets.

Fiscal difficulties in France and Germany, which resulted in EDPs from 2003-07 against these member states, triggered a reform of the pact. Its main elements being to take into account country-specific developments and to allow for more temporal leeway for consolidation as well as the introduction of cyclically-adjusted values for the deficit, i.e. a concretisation of the 3% deficit criterion as a structural deficit of 0.5% of GDP (Le Cacheux/Touya 2007).

The current reform is a result of the financial market crisis. In all member states public debt has risen. Before the crisis in 2007, the debt-to-GDP ratio of the euro area as a whole was clearly below 70%, while in 2010 it was above 80%. This, however, did not cause problems for all member states in financing their public debt. The financial markets only lost trust in some countries, namely Greece, Ireland, and to a lesser extent Portugal and Spain. To counter this development, a rescue package for Greece was established in mid-2010, and in the end of 2010 Ireland was supported by a package comprising of resources from the IMF, the Commission and the newly founded European Financial Stability Facility (Horn et al. 2011). Greece with its doubtful statistics and very low tax revenues, is a special case. Leaving Greece aside, the fiscal behaviour of the other countries was adequate in the crisis although the result was an increase in debt. They managed to dampen the

[1] This expertise renders a strictly macroeconomic assessment. Legal issues as well as matters of legitimacy, as far as economics is not concerned directly, are not discussed here.

effects of the financial market crisis by assuming private debt – i.e. toxic real-estate and bank credits – and by stabilising the economy. Furthermore, some of these member states followed the rules of the SGP before the crisis exemplary. Since the beginning of the monetary union until the crisis, Ireland and Spain have not violated the 3% deficit criterion and have even achieved surpluses; Ireland in all years except 2002, and Spain since 2005 until the crisis began. Moreover, Ireland and Spain reduced their debt-to-GDP ratios. In 2007, Ireland had a debt-to-GDP ratio of 25%, Spain of 36% – both far below the 60% deficit target. Due to high nominal GDP growth, even Greece reduced its debt-to-GDP ratio before the crisis.

The main reason for the problems that these member states had in accessing the credit market during 2010 is not the increase in public debt *per se* – other member states starting from higher levels of debt than Spain and Ireland did not face the same problems. It is due to a similarity between these countries which has not really been addressed before the crisis by economic policies in general or by the SGP: persistent and increasing current account deficits in these member states in the last decade (Joebges et al. 2010a, Dullien 2010 and 2009). Unit labour costs have increased since the establishment of the monetary union (in the case of Greece: since its accession) faster than in the euro area as a whole and especially faster than in Germany. Consequently, price competitiveness decreased, which has put successively more burden on exports. Additionally, domestic demand in these countries performed very well due to low real interest rates, but also fostered increasing imports and triggered further current account imbalances. As a further consequence the external indebtedness of the state and/or the private sector increased. Therefore, the high risk premiums for credits for some member states of the euro area are (partly) grounded in fundamental facts. Macroeconomic imbalances in the euro area – i.e. diverging price competitiveness and, as a consequence, persistent current account deficits in some countries and surpluses in others – contributed to the current euro bonds crisis. If some member states manage to keep their wage increases persistently near the inflation rate target of the ECB, which holds *cum grano salis* for Germany since the establishment of the monetary union, all other members of the euro area have to follow in order to prevent rising imbalances and a deterioration of price competitiveness. Moreover, Germany is a good example here: low inflation went hand in hand with low increases in domestic demand and as a consequence lesser opportunities for other countries of the euro area to export to Germany. For Germany, too, this development was not a success – in comparison to the rest of the euro area GDP

growth was insufficient (Joebges et al. 2010b). Of course, current account deficit countries also contributed to an increase in the divergence of imbalances with inflation rates significantly above the ECB target. The ECB as well as the Commission did not problematise this point, as they did with public deficits.

What are the conclusions? First, that member states with current account deficits as well as with surpluses bear responsibility and that, secondly, monetary policy and wage developments have to be carefully coordinated with fiscal policies, the SGP, and the new EIP.

Against this background, and with the possibility of problems for further member states of the euro area – Portugal, maybe Belgium and who else within the coming months? – to preserve their access to the credit market, the success of the reform of the SGP depends on its potential to contribute not only to sound fiscal policies but also to a prevention of new government bonds and financial market crises. For this purpose, the proposal has to be internally consistent, which concerns the relationship of EDP and EIP, and externally consistent, i.e. in its relationship to other European procedures. Furthermore, this is one important lesson of the crisis, public *and* private debt have to be monitored. And finally, stabilisation policies have their merits and, experiences of successful consolidation examples in the 1990s show this, growth is crucial to consolidation.

2. The Proposals by the EU Commission, the rapporteurs, and the S&D group

This section reviews three legal texts including amendments by the rapporteurs of the European Parliament and changes by the S&D group, in the version of December, 20th, 2010. These texts are: (1) a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies including amendments by the rapporteur Mrs. Wortmann-Kool and changes by the S&D group; (2) a Proposal for a Council Regulation amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure including amendments by the rapporteur of the European Parliament Mr. Feio and changes by the S&D group; and (3) a Proposal for a Regulation of the European Parliament and of the Council

on the prevention and correction of macroeconomic imbalances including amendments by the rapporteur of the European Parliament Mrs. Fereira and changes by the S&D group.

2.1 Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

Commission: The center of the regulation is still the medium-term budegetary objective of public debts close to balance or in surplus including a safety margin of 3% of GDP and a benchmark of cyclically-adjusted 0.5% of GDP. Deviations should be matched by increases in government revenue or reductions in expenditures. Member states missing the medium-term objective have to improve their cyclically-adjusted budget balance by 0.5% of GDP annually; for member states with a high level of debt and/or excessive macroeconomic imbalances more adjustment is necessary. Severe economic downturns and overachievement of the medium-term budgetary objective allow for a deviation from the deficit and the debt criteria. Structural reforms are key to achieve a sound fiscal position, if the criteria are missed. Special attention is given to pension reforms as a suggested structural reform.

Rapporteur: The rapporteur proposes to strengthen economic coordination and pleads for a closer involvement of the European Parliament and other actors in order to improve transparency and democratic legitimacy. Although already decided on and therefore not part of the original legislative draft by the Commission, the European semester is explicitly mentioned and included into the legislation to strengthen the ties between the procedures. She also suggests an institutional framework at national level similar to the SGP framework at European level in order to improve national ownership. A detailed analysis and description of the composition and evolution of public debt at the national level is deemed necessary. The stability programmes should be based on a transparent and broad collection of forecasts.

S&D group: The S&D group, although acknowledging the role of national ownership, does not support the implementation of the EU fiscal framework into national law. It also aims at supporting economic recovery in stagnative phases, in case of imbalances and by adverse economic circumstances by permitted deviations from the medium-term objective.

2.2 Regulation on speeding up and clarifying the implementation of the excessive deficit procedure

Commission: The Commission's proposal comprises a clear commitment to the close-to-balance approach, based on debt and deficit criteria and sanctions for member states deviating persistently from targets and recommendations of the Commission. It mainly introduces two new elements, the acknowledgement of private pensions as a reason for deviating from the deficit criterion and a strengthening of the 60% debt-to-GDP criterion by the introduction of a numerical benchmark for the reduction of debt.

The debt criterion, though part of the pact since the beginning, was up to now neither in the public focus nor at the same level of importance in the regulation on surveillance and the EDP in comparison with the 3% criterion. The changes proposed by the commission will change this by introducing a numerical benchmark for the pace of the reduction of debt towards the debt level of 60%. It suggests that the differential between the excessive debt and the target of 60% of GDP has to be diminished by one-twentieth per year. Compliance to this rule is measured against the time frame of the average of the previous three years. This implies c.p. that after 20 years the member state has to reach the target value in order to comply to the pact and to prevent sanctions. It means also that both criteria have to be fulfilled at the same time.

In case of a non-permitted deviation from the target values, corrective measures have to take place oriented on figures for government expenditures and for discretionary measures on the revenue side from the Commission. It has to be noted, that the Commission suggests to extend the deadline for corrective measures and to give more fiscal leeway in cases of severe downturns and sluggish growth. Moreover, it wants to include more factors than only the numerical benchmark in its assessment on the opening of an EDP. The acknowledgement of these factors is dependent on a debt level below 60% or the existence of a deficit that is only temporary and close to the reference value. This is a continuity of the reform of 2005 that introduced country specific assessments and consideration of growth issues and cyclical adjusted growth figures.

If a member state does not comply with the suggested corrective measures, sanctions can be applied. The new numerical benchmark for the reduction of the debt level implies that c.p. the probability for sanctions has increased.

A topic that was present before in other procedures of the European level but not in the pact is the pension reform. It is given some space in the legislative text. The introduction of such a reform would be reflected in the assessment of the Commission on opening an EDP, i.e. the cost of a reform can – under certain conditions – be deducted from the deficit.

Rapporteur: The amendments of the rapporteur were guided by six objectives. First, he wants to strengthen the ties between the EDP and other procedures on the one hand and this regulation and the EIP and the European semester on the other hand. Secondly, he intends to amplify the involvement of the European Parliament in the pact and to make the procedure more transparent to the parliament and the public which also includes a review clause, i.e. an institutionalised supervision of the procedure by the Commission. Thirdly, the rapporteur suggests implementing an institutional framework at national level similar to the SGP framework at European level and a more intense surveillance at national level by more pronounced surveillance visits. Fourth, a detailed analysis and description of debt at the national level and its potential development against the background of European and national forecasts is deemed necessary. Fifth, suggestions by the Commission specifying permitted deviations from the debt and deficit criteria are withdrawn, and the role of the Commission against the Council is reinforced. Sixthly, the rapporteur proposes to reduce the role of the Council and strengthens the Commission's position when deciding on sanctions via a reversed quality majority voting in the Council.

S&D group: Contrary to the rapporteur, the S&D group does not support the implementation of a fiscal framework similar to the EU framework at national level, and it does not support a too-detailed analysis of composition and evolution of debt. Throughout the text, the importance of public investment and of counter-cyclical fiscal policies is stressed and deviations from the standard procedure should be possible not only in case of exceptionally severe downturns but also in case of severe downturns. Concerning the new numerical benchmark for the debt criterion, the group is proposing member states with growth below 2% should be given more leeway to approach the debt target of 60% of GDP. Moreover, the Commission should be given the option to allow member states subject to an EDP to deviate from a minimum annual improvement of 0.5% of GDP and to reduce the deficit

more slowly if otherwise pro-cyclical fiscal developments would result from the corrective measures.

2.3 Regulation on the prevention and correction of macroeconomic imbalances

Commission: With this regulation a second, new procedure is introduced parallel to the EDP. Persistent and excessive macroeconomic imbalances should be identified and addressed by structural reforms of – from the point of view of the Commission: too rigid – labour and product markets to undo the deterioration of competitiveness. Imbalances are specified as deteriorations in competitiveness and negative external effects for other member states and the euro area. A scoreboard of indicators – covering internal and external imbalances and internal market developments – should be established to support the assessment on imbalances. An alert mechanism with (mostly symmetric) lower and upper thresholds signals whether corrective action might be adequate or not. The thresholds and scoreboard are not fixed indefinitely; their appropriateness and their methodological underpinning will be reviewed regularly and may be altered if necessary. If the scoreboard and alert mechanisms signal the existence of a problem, an in-depth review based on economic and country-specific expertise will be prepared by the Commission. This review should offer an assessment of potential risks and mal-developments and their causes from a broad perspective taking into account country-specific circumstances and a broad range of variables and their interplay. The Commission can issue recommendations to member states with imbalances and, if they are persistent and excessive, can suggest to the Council to open an EIP. The member states subject to an EIP have to conduct corrective actions and to issue a corrective action plan which is monitored by the Commission. The Commission can close the EIP (if the imbalances are resolved); place it in abeyance (if the member states comply but reforms take time to become effective); or increase the peer pressure or suggest a yearly fine for non-compliance if the addressee is a member of the euro area. This fine should be 0.1% of the member state's GDP of the previous year. This is not part of any of the articles of the regulation but is laid down in the Explanatory Memorandum.

Rapporteur: The revision of the scoreboard should be conferred on the Commission for periods of five years automatically, if neither the Council nor the European Parliament

revoke this delegated power. Moreover, they can object to delegated acts. (It should be noted, that it was not clear what exactly was covered by delegated acts and if the delegation referred only to the scoreboard, or to recommendations derived from the assessment.) Concerning the assessment of corrective action, the rapporteur proposes to involve the Council again when revised recommendations are addressed to a member state. In the case of persistent non-compliance a fine can be imposed. As part of the monitoring process, dialogue visits within the member states and surveillance visits should be carried out by the Commission. A review clause is introduced to evaluate the contribution of the EIP to compliance of member states and progress in regard to intra-EU coordination and potential needs for revision.

S&D group: The group aims at simplifying the review clause, Article 12 new (1).

3. An assessment: A wrong design and some good starting points

In a nutshell, the Commission's proposal introduces a new numerical benchmark for the debt criterion and a second procedure, the EIP, embedded in the European semester. On the one hand, this reinforces the close-to-balance approach; on the other hand the EIP offers potentially a broader assessment of the economic situation of member states, not restricted to public debt. The amendments by the rapporteurs aim at strengthening the involvement of the European Parliament and the links between the procedures. Moreover, evaluation and adaptation is emphasised. Although some of this has its merits, the lessons of the last crises were not learned. In the following, the main points of the proposals will be discussed.

The rapporteurs suggest to involve the Parliament and other actors to a greater extent. This stronger involvement and shift of responsibility from the Commission to other bodies could lead to more transparency of the SGP and to a broader assessment of economic developments, which is not only important for democratic legitimacy but serves economic purposes as well. The financial market crisis showed that some of the theoretical building blocks of the economic profession are in dire straits. A crisis of this severity and kind was not foreseen and cannot be comprehensively explained by the mainstream models. Widening the perspective and integrating more arguments and points of view may help to develop

a better equipped institutional system (Colander 2009). Therefore, a broader involvement of actors is welcomed. Similarly, an ongoing evaluation and adaptation of the processes, as suggested, is very sensible, and should involve the European parliament and other actors.

If this involvement successfully increases the legitimacy of the rules of the pact it will also promote the implementation of the rules of the pact at national level and compliance to it. It has to be mentioned, however, that a successful implementation of rules and compliance to them is crucially dependent on their economic feasibility. In other words, if the rules allow indebted countries to grow adequately and if the rules are economically well designed then sound fiscal policies are possible.

But do the rules of the SGP correspond to these requirements?

The disadvantages of the medium-term budgetary objective and the deficit criterion are still effective despite the last reform of the SGP. Now in certain situations there is more leeway for counter-cyclical policies but the target of 0.5% cyclically-adjusted deficit, derived from the 3% target, is still a relatively restrictive one. Additionally, balanced budgets cannot be realised directly. The government can control its expenditures, but it cannot control its revenue side. In a dynamic economy – even if there are rough estimates of the business cycle available – the exact amount of tax revenue is uncertain and unexpected downturns can disturb the *ex ante* budget plans and lead to unexpected deficits.

By introducing a numerical benchmark the debt criterion is strengthened, but the deficit criterion is kept as well. Thus, the current proposals reduce the leeway for fiscal policy further. This happens when both criteria are inconclusive, i.e. one signals consolidation, the other does not. In this inconclusive case, fiscal consolidation will be recommended by the Commission. How is it possible that the criteria deviate? The growth rate of an economy is of utmost importance for the debt criterion but not for the deficit criterion. Even if the deficit is above the 3% target value, the debt-to-GDP ration can decrease when the nominal growth rate is high enough. Although in a situation of strong growth, deficits above 3% might not cause economic problems, consolidation has to be recommended by the Commission.

The numerical benchmark for the pace of the reduction of debt towards the debt level of 60% of GDP of 1/20 per year could be too ambitious for member states with a debt-to-GDP ratio far above 60% because it implies a time horizon of adaptation of only 20 years to reduce the debt level to the 60% target. For a country like Greece, with a debt level of currently above 140%, this is only possible through very high growth rates. In the current

situation with strict consolidation programmes and efforts to reduce wages in order to raise price competitiveness, thereby depriving private consumption, to achieve the necessary growth rates for the reduction of public debt within 20 years is extremely optimistic. If the Greek government fails to achieve the deficit target within the next years even more consolidation – with all negative, restrictive fiscal effects – is foreseeable. Therefore, both the target value of 1/20 as well as the combination of debt and deficit criteria might imply heavy fiscal burden for some of the member states.

This applies to the Commission's proposal.

The amendments of the S&D group counter a lot of the negative consequences of the Commission draft. The emphasis on automatic stabilisers and the necessity of a sound level of public investment despite consolidation efforts is an effective way to contain the negative effects of the EDP as proposed by the Commission. Nevertheless, the critique remains that the fiscal policies aiming at budgets close to balance or in surplus can inhibit growth. If this analysis is taken for granted then any implementation of deficit and debt criteria at national level similar to the SGP, as suggested by the rapporteur for the EDP, is counterproductive. Therefore, all propositions implying this should be eliminated from the draft.

The introduction of the EIP could serve as a counterforce to potential negative effects of too-restrictive fiscal policies. The indicators of internal and external imbalances – the scoreboard – do not focus on public debt alone. They might lead to an assessment that favours public investment and stabilisation policies instead of consolidation. One problem with the EIP is that it is not fully integrated into the pact. Priority is given to the EDP. Regardless the results of the assessment of the EIP, member states have to consolidate if one of the criteria of the EDP is violated. If, for example, the assessment of the EIP signals that the current account surplus of a country is too high, it could, theoretically, reduce this imbalance by fiscal policy, i.e. investment programmes that foster domestic demand and imports. Against the background of the EDP, however, this would probably result in a violation of the debt and deficit criteria for most countries. There is a potential conflict between the conclusions drawn from EDP and EIP that is not fully acknowledged.

Another weakness of the EIP in its current form is the partly implicit, partly explicit focus on structural reforms, defined as reforms reducing rigidity in product and labour markets, to resolve macroeconomic imbalances. For at least four reasons, this advice is insufficient. Firstly, some rigidity is in fact helpful; e.g. within the crisis the institutionalised cooperation between the social partners prevented wage developments towards a defla-

tionary process, which would have spelled disastrous consequences for Europe. The German labour market, characterised by a high level of external rigidity but a high level of internal flexibility, demonstrated that this 'rigidity' was a massive advantage during the crisis leading to the recent labour market 'miracle' in Germany (Herzog-Stein et al. 2010). In other words, a wage determination that is not erratic is, from a point of view of macroeconomics, preferable. Secondly, to define structural reforms in the way the Commission implies in its proposal is too narrow. For example, minimum wages, a reform of the low-pay sector or an extension of the tax base are also structural reforms which can be applied. Thirdly, the toolbox to counter imbalances offers not only structural reforms. All macroeconomic policies – fiscal, wage and monetary policies – can contribute to a reduction of imbalances. Fourthly, contrary to the assumption of the Commission that a country can resolve its imbalances alone, imbalances are, by definition, one's deficits and another's surpluses. In a union, correction of imbalances should be a common and coordinated task which implies the reduction of excessive deficits as well as excessive surpluses.

The Commission also writes in its draft for the EIP: "Unlike fiscal policy, not all policy levers are under the direct control of national governments when it comes to resolving imbalances." Consequently, if available, other actors or institutions relevant to the correction of imbalances should be integrated in the procedure, namely the ECB and the Macroeconomic Dialogue. The ECB influences not only the price level and investment through its interest rate policy, which are both key to competitiveness in the EU; monetary and fiscal policies can be fruitfully interlinked, in full respect of the ECB's independence. If, due to strained public budgets, fiscal policies are hindered to stabilise monetary policy the ECB, without violating its aim of price stability, can step in and support growth. Vice versa, in the current situation where interest rate policy has its limits, fiscal policies have to support growth. Moreover, the ECB currently plays a vital role in stabilising the market for government bonds and contributes to the regulation of financial markets. Both are helpful in correcting macroeconomic imbalances, the inclusion of the ECB into the EIP is thus a necessity.

Similarly, wage developments are an important factor in determining price competitiveness. The institutional setting of the EU includes one body for discussions on this matter, the Macroeconomic Dialogue, bringing together the Council, the ECB, the social partners and members of several committees (Niechoj 2005, Koll/Hallwirth 2009). Incorporating the Macroeconomic Dialogue in the EIP seems consistent and it could be used as

a forum to discuss wage developments and differentials within the EU and the euro area. In the euro area as a monetary union, permanent divergent developments between wages of member states before the crisis have significantly contributed to a deterioration of price competitiveness in a group of countries, especially Greece, Portugal and Spain, and an increase in price competitiveness in other countries like Germany and Austria, which resulted in current account deficits and surpluses, respectively (Joebges et al. 2010a).

Surprisingly, the rapporteur of the EDP includes paragraphs on a detailed surveillance of the composition and evolution of debt. Against the background of the whole design of the SGP one would expect to find such remarks as part of the scoreboard of the EIP, applied both to public and private debt. Within the EDP, an inclusion of composition and evolution of debt is not very helpful, it is more important to guarantee a certain degree of public investment despite consolidation.

4. Conclusions

The consequence of this analysis is that – as the best solution – the whole composition of the SGP should be revised. The medium-term objective and the EDP are far too restrictive. The newly strengthened debt criterion makes it even worse. The EIP, however, may have – in a revised form – the potential to offer a broader and more adequate assessment of the situation within the member states. Therefore, a) the EIP should become the core of the SGP; b) the EDP should be dropped, but the debt-to-GDP ratio as well as the annual deficit should be integrated into the scoreboard of the EIP as indicators; and c) the main focus of the EIP should be on current accounts, deficits as well as surpluses (Horn et al. 2010, Watt 2011, Brecht et al. 2010). Then fiscal policies could be more growth-oriented and the responsibility for reactions to imbalances would be symmetrically shared between countries with imbalances. This would also allow for the full functioning of automatic stabilisers, for public investment fostering domestic demand, and for stabilisation policies in times of crises, if the Commission acts in line with this new approach.

The example of Germany vs. Greece might help to illustrate this. Currently, the SGP and its national counterpart, the German debt brake, prescribe a strict consolidation course for this and the next years for Germany. As a consequence Germany cannot improve its poor level of public investment and foster domestic demand by more expansionary fiscal

policies. Its price competitiveness is very high. Growth is strongly dependent on exports. In Greece, consolidation has to be even tougher in view of the euro crisis, while exports are hampered by the low price competitiveness compared to Germany. Private consumption is shrinking and exports are down. How, in this situation, can Greece's growth gain momentum again? Only in the long run, and after a painful adaptation process, export growth might be possible and sufficient to increase the growth rate; but that presupposes wage increases below the German level, which will deteriorate private consumption further. In this situation it would be helpful for both countries if the focus of the SGP were on a broad assessment of imbalances. Then Germany could foster domestic demand by fiscal policies, and private consumption would be strengthened further if the wage developments were in line with the ECB's inflation target and the increase in national trend productivity. Germany could become a European growth engine and thus would increase its capacity to absorb Greek imports. A revised SGP would hold both parties responsible, the current account deficit and the surplus country.

Such a thorough revision of the pact might be too visionary, especially taking into account the advanced state of the legislative process. Smaller amendments could, however, improve the growth-orientation of the SGP, too. The changes by the S&D group on automatic stabilisers, counter-cyclicality, public investment and the revision of the paragraph on the pace of adaptation (lesser than $1/20^{th}$ per year under certain conditions), already included, are essential to this. Explicit mentioning of the European semester by the rapporteurs, although already decided on, is also important to stress the need to strengthen coordination. Transparency of the results of the stability programmes and how they are achieved by the Commission can be strengthened by including a broad collection of forecasts and scenarios, which is helpful and should be implemented as well. Additionally, the following suggestions might be helpful.

– Currently, the EIP is something like a non-binding additional report but it should be integrated into the pact as an essential element. It is not enough to connect both excessive procedures formally, e.g. by a plea in a preamble that both procedures should be coordinated. In the EDP, if corrective measures are concerned, it should be added that this is dependent on the assessment within the EIP and that deficit-financed fiscal stimuli should be applied if the EIP comes to the conclusion that this is necessary to reduce excessive imbalances. In other words, it should be possible to pledge surplus

countries to deviate from the deficit and debt criteria in order to stimulate the economy fiscally and to contribute to export growth in deficit countries. Such a wording would also exemplify the symmetric design of the EIP concerning current account deficits and surpluses and would prioritise the resolving of imbalances which is a *conditio sine qua non* in a monetary union without an extensive fiscal transfer system. The wording within the first regulation – "taking into account the presence of excessive macroeconomic imbalances" –, proposed by the Commission, mentions macroeconomic imbalances but does not clarify that macroeconomic imbalances may lead to a necessary violation of the medium-term objective. Therefore, the wording should be amended stating that deviations from the medium-term objective are allowed if necessary to correct macroeconomic imbalances. Differentiated medium-term objectives for member states deviating from close to balance are sensible and it might be adequate in certain situations to go beyond the 3% safety margin. Therefore, a formulation like "while providing a safety margin with respect to the 3% of GDP government deficit ratio" in the first regulation, article 2c, should be deleted. Moreover, the revision of these medium-term-objectives should not be based on the implementation of structural reforms.

– For an adequately designed SGP, the introduction of the reverse voting mechanism in the Council would be advantageous in order to diminish veto positions. In case of the already fiscally restrictive SGP, this introduction will lead, however, to an even more restrictive pact because it makes fiscal restraint easier to establish. Thus, the second half of Article 4.1 (new) of the EDP draft could be deleted.
– Fines should be designed asymmetrically in case of current account imbalances. A fine for member states with current account deficits is counterproductive. Countries in dire straits should use their fiscal resources to adapt and to catch up. A fine for member states with surpluses might be useful, however. In order to set incentives for member states with deficits, positive incentives have to be established. For example, the proposal by Juncker and Tremonti (2010) on the introduction of euro bonds could implement such positive incentives by granting access to euro bonds for countries that stick to the Commission's recommendation. Alternatively, a new European investment fund could finance investment in deficit countries that comply, which would improve capital stock and productivity in these member states.

- Structural reforms, as defined by the Commission, are not key to the reduction of imbalances. Therefore, the call for a reduction of rigidity in labour markets should be eliminated or could be replaced by a formulation that emphasises the role of functioning wage negotiations of the social partners and its orientation on the ECB's target inflation rate plus the growth of trend productivity. It should be stated that combating imbalances incorporates monetary and fiscal policies plus an assessment of wage developments.
- All formulations that hint at an establishment of national pacts based on similar procedures, as implemented by the EDP, should be eliminated. Especially, in section 1c (new), article 2d (National Ownership), paragraphs 1, 4 and 5, proposed by the rapporteur, should be deleted or are already deleted by the S&D group, in case of paragraph 4. The German debt brake is not a role model for Europe's member states.
- All formulations concerning the composition of debt and its evolution should be deleted from the EDP. It could be mentioned as part of the scoreboard of the EIP. All remarks on pension reforms should be eliminated, too. What is more important is to emphasise the role of public investment and a minimum tax base for all countries.
- Some words in article 7 of the EDP were eliminated by the rapporteur. These changes should be included again. They state that the existence of an EDP caused by the debt criterion should not be based solely on the numerical benchmark but on a broader assessment, which seems economically more adequate and is in line with the EIP to come. Similarly, article 12 in the Commission's proposal takes into account severe economic downturns and should be reintegrated into the text.
- As sketched above, the exact implications of the rapporteur's articles 4a – c (new) are not clear to me. The idea to delegate conditionally and to give the European Parliament and the Council the right to revoke and to object is, however, very interesting and could be applied not only to the scoreboard but also to the Commission's recommendations.
- The existing institutional capacity for resolving imbalances should be used. Therefore, the inclusion of the Macroeconomic Dialogue, as the only body that discusses wage developments in depth, and of the ECB is recommended.

It has to be mentioned that the successful functioning of the reform and its suggested procedures in amended form is crucially dependent on other reforms within the institutional system of the EU, namely progress in the field of financial market regulation in order

to prevent further financial market crises and the establishment of a permanent crisis mechanism for the euro area that, e.g. via euro bonds, guarantees solvency and triggers the reduction of imbalances.

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