

Europe, the Euro and the ECB:¹ Monetary Success, Fiscal Failure

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After six years, the euro and the ECB have settled into a period of normalcy. The main lesson to be drawn from their early operation is that the predictions of both their most ardent champions and harshest critics were overblown. Contrary to the warnings of some extreme critics, the imposition of a single monetary policy over much of Europe has not led to an irreparable rupture between countries in different economic circumstances. And, contrary to the promises of the most enthusiastic supporters, the advent of the single currency has not inaugurated a golden age of flexibility and economic growth. To be sure, the critics can point to the slowness of growth in Germany compared to the rest of the euro zone and to that country's preference for lower interest rates. But this early experience has not led to serious calls from disaffected countries for abandoning the project. The champions can point to the rapid growth and integration of European securities markets, the markets for speculative grade corporate bonds in particular. Financial market integration has stimulated merger-and-acquisitions activity and improved the competitiveness of European firms by enhancing their access to external finance. In turn, this increase in market liquidity is directly attributable to the advent of the euro.² But no one believes that the coming of the euro has magically solved all of Europe's problems.

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² The connections between corporate bond market integration and the advent of the euro are explored by Pagano and von Thadden (2004).

Another sign of normalcy is that, at the time of writing, criticism of the ECB is divided about equally between those who would prefer a slightly looser and tighter monetary stance. Those preferring a tighter policy observe that inflation in the euro zone continues to marginally exceed the 2 per cent upper bound of the ECB's target range. Those preferring a slightly looser policy point to the decline of the dollar and argue that the ECB should loosen in order to preempt the deflationary pressure that will eventually stem from the euro's sharp appreciation. I will not offer a view on this debate here, since the right answer may well change between the time of writing and the appearance of this paper. But the fact that criticism is so evenly divided suggests that the ECB has not gotten things terribly wrong one way or the other. The same conclusion flows from studies showing that the ECB's policy rates closely track those generated by the Taylor rule.³

A final sign of normalcy is that this large swing in the value of the dollar has not created financial problems like those that often arose in the past. Traditionally, when the dollar fell, the deutschemark rose against other European currencies, creating strains and even currency crises in Europe. Interpretations of this dollar-deutschemark "polarization" varied; the dominant one was probably that the liquidity of German financial markets and the Bundesbank's commitment to price stability rendered the deutschemark a closer substitute for the dollar than other European currencies.⁴ But while the dollar's recent fall has squeezed European exporters, it has not precipitated

³ Precise conclusions here differ because operationalizing the Taylor rule requires one to make an assumption about full capacity output or feasible growth rates in Europe. Observers differ in particular about whether they assume that equilibrium unemployment is higher and full capacity output is lower in Europe than in the United States. See for example Ullrich (2003), Sauer and Sturm (2003) and Gerlach-Kristen (2003).

⁴ For discussion of this phenomenon see Frankel (1986).

major financial problems.⁵ One can say the same about the effects of the bombings in Madrid and other terrorist incidents: in the absence of the euro, these might have led to sharp and potentially destabilizing swings in intra-European exchange rates. This suggests that one goal of the euro's founders, namely the creation of a zone of monetary and financial stability, has been successfully achieved.

The one aspect of Europe's monetary project that is in serious trouble is the Stability and Growth Pact (SGP). The SGP was adopted in the late 1990s to guard against members of the euro zone running excessive deficits and to facilitate the coordination of monetary and fiscal policies. It has succeeded at neither of these tasks. It has not prevented France and Germany from breaching the 3 per cent reference value that indicates the existence of an excessive deficit. Nor have the Commission and the Council been able to proceed with sanctions and fines, given the considerable influence of these large countries in the institutions of the European Union. This is part of the explanation for why the ECB has been reluctant to loosen monetary policy in response to the rise in the euro against the dollar: it is waiting for the French and German governments to first display greater fiscal discipline. The result is that Europe has been saddled with precisely the wrong policy mix – a loose fiscal policy combined with a tight monetary policy, resulting in high interest rates – in a period when the priority for growth should be to encourage investment.

There are different ideas of what to do about this. Some critics of the SGP are inclined to say “good riddance.” The argument that monetary union requires strong central oversight of national fiscal policies was exaggerated in the first place, in their view. With all members of the euro zone now consigned to accepting the same monetary

⁵ At least in Europe, that is, and at least yet.

policy, it always made more sense to leave the participating member states free to choose different fiscal policies. Defenders of the SGP continue to insist that monetary unification creates free-rider problems for national fiscal authorities, justifying surveillance, sanctions and fines administered at the EU level. Rather than being abandoned, the pact should be rationalized and strengthened. Unfortunately, there is no agreement about precisely how to go about this rationalizing and strengthening.

Not surprisingly, the European Commission is of the second view, and in the autumn of 2004 it offered its own proposals for revitalizing the pact. Rather than focusing on arbitrary 3 per cent reference values for deficits, it recommended concentrating on medium-term debt sustainability. According to its proposal, countries whose debts were forecast to converge to acceptable levels would be allowed to run larger deficits. So would countries whose deficits rose because their rates of economic growth had dipped temporarily, implying little long-term change in debt ratios, as would countries whose deficits reflected growth-friendly investments or the adoption of structural reforms implying lower debt ratios down the road. Under its proposal, the Commission itself would undertake this analysis of debt dynamics. Because the resulting recommendations for corrective action would have a stronger economic rationale – they would more effectively distinguish countries with sustainable and unsustainable fiscal policies – they would be more readily accepted and enforced.

I agree with the premise underlying the Commission's deliberations, that what to do about the Stability and Growth Pact is the most important question facing the euro zone going forward. I also agree that a set of fiscal rules and procedures firmly grounded in economic logic is superior to one organized around an arbitrary and capricious 3

reference value for budget deficits. But I have problems with the Commission's proposed reforms and doubt whether this way of proceeding will succeed in saving the pact.

1. Rationales for the SGP

The SGP was adopted in the late 1990s as a way of addressing (primarily German) fears that the excessive deficits of participating member states would put pressure on the ECB to run inflationary monetary policies. After six years the problem of excessive deficits has not been solved, but there is little sign of the ECB succumbing to pressure to inflate. Does this mean that the SGP can be safely abandoned? Or are the adverse consequences of excessive deficits there but just not yet apparent? Perhaps we simply have to wait for this pattern of excessive deficits to cumulate into unsustainable debts before the pressure for an inflationary debt bailout becomes evident.

Answering these questions requires one to consider both the rationale for the SGP and the early evidence in more detail. The argument that excessive deficits will eventually force the ECB in the direction of more inflationary policies runs as follows. Imagine that, as the result of a pattern of fiscal profligacy, a member state finds itself unable to service its debts. Its decision to suspend debt service payments could call into question the liquidity or solvency of banks and other financial institutions holding large amounts of its paper. Holders of its bonds might be forced to sell other assets in order to raise liquidity, leading to a generalized decline in the market and potentially damaging the balance sheets of financial institutions with concentrated stakes in these other claims. Investors may be inclined to further revise their evaluations of the sustainability of the

debts of other governments, causing the demoralization of the market to spread still further. To prevent all this from happening, the ECB will have to respond as the Fed responded in 1998 to the all-but-collapse of Long-Term Capital Management, by injecting liquidity into the market, with inflationary consequences.

Once the rationale for the SGP is stated this way, it is immediately clear that it is shot full of holes. For one thing, it is not certain that the debt problems of one euro-zone government will automatically destabilize banks and other financial institutions.

Historically, deficit-prone European governments used capital controls and financial regulation to make domestic banks a captive market for their debt. Because the banks were required to hold concentrated stakes, debt problems on the part of the issuer could put financial stability at risk. Now, however, with the abolition of capital controls and deregulation of financial markets (including the adoption of regulations and guidelines designed to discourage portfolio concentrations), this danger is correspondingly less. Banks can hold better diversified asset portfolios, including an internationally diversified portfolio of government bonds. The early evidence suggests that asset management practices have indeed moved in this direction.

In addition, it is not clear that the debt problems of one euro-zone government will automatically damage confidence in the sustainability of other governments' debts. There is some evidence of declining cross country confidence spillovers (declining contagion) in international financial markets with improvements in the information environment and reductions in leverage ratios since the late 1990s.⁶ In any case, the information environment of European financial markets is well developed compared to

⁶ The relevant citations are too numerous to name. But the World Bank maintains a useful site with links to empirical research on contagion at www1.worldbank.org/economicpolicy/managing%20volatility.

the developing-country context that is the subject of the bulk of the contagion literature. To be sure, interest rate spreads on the government securities of different euro zone countries differ only modestly.⁷ Some will see this as evidence of the very bailout guarantee that excites supporters of the SGP. But others will observe that default risk is still extremely low even in the most profligate countries, providing little justification for a substantial interest differential even in the absence of bailout risk.

Finally, even if the ECB had to intervene in response to distress in financial markets, it is not obvious that this would have persistent inflationary consequences. When the Fed injected liquidity into U.S. financial markets in response to the distress of Long-Term Capital Management, it was able to withdraw that same liquidity once the crisis passed and fears receded that other financial institutions and markets would be destabilized. Its intervention did not unleash a wave of inflation. There is no obvious reason why the ECB could not respond similarly.

A second rationale for the SGP is to facilitate the coordination of monetary and fiscal policies. Unfortunately, as is the case of the policy coordination literature in general, the precise nature of the problems that arise when monetary and fiscal policies are formulated separately and hence the precise gains from coordination are ambiguous in the large. Results, in other words, are model specific.⁸ My own preferred model in the European context is Uhlig (2002). Uhlig analyzes a simple stochastic model in which desired government spending may differ from actual government spending by a random shock. Each government has a quadratic loss function that is increasing in deviations of output from steady-state levels and deviations of government spending from steady-state

⁷ Studies of the phenomenon include Geyer, Kossmeier and Pichler (2001) and Bernoth, von Hagen and Schuknecht (2003).

⁸ I return to this point below.

levels. Thus, if returning public spending to preferred levels reduces output relative to those levels, the authorities may not fully offset the spending shock. The central bank also has a quadratic loss function, which in its case is increasing in deviations of output and inflation from their target levels. Finally, inflation in each country is increasing in output and subject to a random disturbance.

In this model, a positive shock to government spending that raises demand and output also raises inflation. Because both inflation and output are now higher, the ECB pushes them back down toward pre-shock levels by raising interest rates. But even if inflation is no higher in the resulting equilibrium, interest rates are higher. The composition of spending is inferior, since higher interest rates mean less investment than in the first-best outcome. In a model with one government, the fiscal authority would be more inclined to take this consequence into account and address the shock to its fiscal stance, bringing the economy closer to the first best. But the larger the number of governments, the less is the incentive for each to internalize the consequences for euro zone output and inflation as a whole, and the greater the incentive for governments to instead free ride on the monetary union. This is not a bad way of thinking about the policy-mix problem in Europe at the moment.

But this rationale for fiscal surveillance and coordination does not justify anything remotely resembling the SGP. This argument for internalizing the cross-border repercussions of national fiscal policies and taking into account the induced response of the ECB does not point to the relevance of a 3 per cent threshold for fiscal policies or suggest that coordination is a non-issue when deficits are below that level but suddenly a problem when they exceed it. Nor does it support a reformed procedure like that

proposed by the Commission that would allow policy freedom for countries with low and falling debt ratios while constraining the policies of countries with high and rising ones. Moreover, one can also imagine other shocks and spillovers. In general, both the nature of the cross-border spillovers and the inefficiency of the noncooperative equilibrium are sensitive to the specifics of the shock and the structure of the economy. Even if one believes that cooperation yields superior results, it is not plausible that a set of simple rules like those of the SGP would be helpful for achieving it under most circumstances.

A third rationale for the SGP is simply as a way of strengthening national fiscal discipline, which is of value quite independent of the fact of monetary union. European countries exhibited inadequate fiscal restraint over much of the 1980s and 1990s. After a brief period of fiscal consolidation in the period leading up to the decision of who qualified for participation in the monetary union, laxity then set in again.⁹ The closer economic relations that result from the adoption of the single currency provide a valuable opportunity, in this view, for peer pressure for fiscal restraint. Euro zone finance ministers meet together regularly. They can use those meetings to develop a common resolve on the need for fiscal restraint and utilize the resulting solidarity to encourage good behavior among their fellows. The argument is that this precious opportunity should be capitalized upon.

Here too, it is not clear that an arbitrary 3 per cent threshold for budget deficits like that enshrined in the SGP is a sensible and therefore effective focal point for efforts to enhance fiscal discipline. It is not clear whether bundling together adoption of the euro and efforts to encourage fiscal discipline is productive or counterproductive. If peer pressure is helpful for fiscal restraint, why then should the Denmark, Sweden and the UK

⁹ Briotti (2004) is a systematic study of the record.

be excluded from contributing to such pressure, and why for that matter should they not be equally subject to it? Nor is it obvious that external pressure is an effective mechanism for fiscal restraint. Recent experience has provided many examples of the scope for governments to use creative accounting and other forms of subterfuge to create the appearance of responding to external pressure for fiscal consolidation while in fact taking no meaningful action. Finally, there is a sense that relying on external pressure for fiscal discipline may be counterproductive. Domestic stakeholders who see their favored public-spending programs threatened by the SGP may regard such foreign pressure as illegitimate and be less willing to accept the sacrifices needed for fiscal consolidation than if the decision to do so had been taken through consensus building at home.

There may still be no agreement about which of these rationales for the regional surveillance and coordination of fiscal policies holds the most water, but it is interesting to note that the European Commission, for one, has reached a conclusion. By proposing to refocus the SGP on medium-term debt sustainability, it has implicitly set aside the argument for EU procedures to facilitate the coordination of fiscal and monetary policies on an ongoing basis, as well as the argument that strict numerical guidelines imposed from outside are needed to encourage fiscal discipline. Instead, it has emphasized the threat that unsustainable debts pose to financial and price stability in the monetary union. By implication, a weakness of its reform proposals is that it has not addressed head on the objections enumerated above to this rationale for the SGP.

3. More Discretion for the Commission

The Commission's proposals are a step forward in that they recognize the folly of treating all deficits alike and of taking an arbitrary figure like 3 per cent of GDP as the threshold above which these suddenly become a problem. According to the Commission's plan, a country with low levels of outstanding debt would be allowed to run deficits in normal times (that is, to run a medium-term budget deficit) without exciting the EU's fiscal watchdogs. In contrast, a country with a high debt would have to run a balanced budget to permit economic growth to progressively reduce its debt ratio. In recessions, the low-debt country would also have more time to correct the temporary increase in its deficit induced by the fall in tax revenues and rise in cyclical spending. Similarly, a country with a high level of productive public investment on the outlay side of the budget would be cut additional slack on the grounds that the induced increase in growth would limit the rise in the debt ratio, in contrast to a country whose deficit reflected public consumption or whose public investment was judged unproductive. The same differential treatment would apply when a country's deficit reflected the costs to the budget of growth-promoting structural reforms, whose implications would be the same as (and which are analytically indistinguishable from) productive public investment. Responsibility for making these judgments would reside with the Commission, which would base them on an analysis of the sustainability of each country's public debt.

Unfortunately, "debt sustainability analysis," which is also *de rigueur* at the International Monetary Fund, is a fancy label for what simply amounts to a small simulation model of the evolution of the public debt, with assumptions about, *inter alia*,

interest rates, growth rates, and the growth effects of different forms of public spending.¹⁰ The results that one gets out depend entirely on the assumptions one puts in. And, in practice, many of the key assumptions are at best arguable and at worst arbitrary. What should we assume about the growth effects of the construction of additional public schools? And if the government of a member state decides to pay additional teachers instead of erecting additional school buildings, should we assume that the growth rate goes down, since more of its outlays are now classified as current spending rather than investment spending? Allowing the decision of how strictly to enforce the SGP to hinge on the Commission's evaluation of the sustainability of a government's debt is thus a formula for abandoning the rules-based approach almost entirely and vesting very considerable discretion with the EU's technocrats.

Clearly, countries at risk of having their debts declared as of questionable sustainability will have multiple grounds on which to challenge the Commission's assumptions and procedures. When the Commission's evaluation reaches the Ecofin Council, the national representatives assembled there will be able to reject the conclusion that a country's debt is unsustainable even more easily than they have been able in the past to reject a recommendation that they declare a country's deficit as excessive on the basis of the unreformed SGP. One way of evaluating the effectiveness and credibility of a set of fiscal arrangements, following to the Kopits and Symansky (1998) criteria, is in terms of their simplicity and clarity of definition (the idea being that procedures that are insufficiently simply and clear will make it too easy for violators to wiggle out). The Commission's proposals for revising the SGP fail miserably on this score.

¹⁰ See for example the discussion in IMF (2004).

4. More Enforcement Power for the Commission

A possible response to this problem is to marry more discretion for the Commission with more enforcement power. The draft constitutional treaty negotiated in 2004 takes a step in this direction by making the Commission responsible for issuing the “early warning” of an excessive deficit, whereas previously the Commission was empowered only to recommend such a warning while the actual decision was taken by the Ecofin Council. But even if the draft constitution is adopted, the final decision to proceed from the wrist-slap of an early warning to sanctions, non-interest-bearing deposits and fines would still rest with the Council. It would be possible to go further by giving the Commission the power to decide not just on the early warning but also the sanctions, deposits and fines. One of Kopits and Symansky’s eight criteria for an optimal fiscal rule is enforceability, and this reform would be a clear improvement along that dimension. If governments believed that sanctions and fines would be triggered automatically when their debts were judged unsustainable by the independent technocrats of the Commission, they would be less inclined to skate close to the edge of sustainability.¹¹

The problem with this line of thought is that power must be married with accountability. National governments have been reluctant to delegate considerable powers over the conduct of national fiscal policies to the Commission on the grounds that the latter is only loosely accountable to the European public. The members of the Commission are not elected. The Commission can be removed from office through a vote of no confidence by the Parliament but only in its entirety, by a two-thirds

¹¹ To the extent that the Kopits-Symansky criteria also include flexibility, consistency, and adequacy relative to the final goal (presumed to be the minimization of pressure for a debt bailout by the ECB), combining discretion for the Commission with enforcement power becomes more attractive still.

supermajority, and on grounds of gross dereliction of duty. Even if some of these obstacles were relaxed, the Commission possesses a large number of separate functions, making it extremely costly to remove it in response to even intense dissatisfaction with how it carries out one such task.

In addition, taxation and public spending programs have prominent distributional consequences, making fiscal policy a sensitive function – even more so, many would argue, than monetary policy. This makes accountability an especially important issue in the fiscal context. The proposal described here would delegate oversight of fiscal policy not to a group of independent experts appointed by national governments, as in the case of the ECB board, but to a group of independent experts appointed by the EU Commission, which is itself appointed by national governments. This makes the accountability deficit larger still.

5. Delegating Responsibility for the Conduct of Monetary Policy

An alternative approach, popularized by Wyplosz (2002), would delegate the relevant fiscal powers not to an international body like the Commission but to a committee of independent national experts. Wyplosz proposes requiring each member state to establish an independent fiscal policy committee. Both the procedure and the strategy would be analogous to the case of monetary policy. Just as the Treaty of European Union required each member state to strengthen the independence of its central bank, member states could be required by treaty to create a committee of independent experts responsible for setting the deficit and adopting automatic procedures to be set in motion if the committee judged that its deficit target was not being met. Accountability

would be less of a problem insofar as this would be a purely national committee and there already exist mechanisms at the national level for removing from power governments and their appointees when the latter do not pursue policies that are judged socially and politically acceptable. To the extent that ownership is essential for the maintenance of support for fiscal restraint, much less for fiscal consolidation, this scheme has the strength of transferring responsibility for hard decisions back to the national level. It would be harder for governments to deflect the call for fiscal cuts by questioning the authority and competence of the outside authority issuing it, since they would have appointed all of the members of the national fiscal commission themselves.

This proposal is a specific instance of the general line of thought arguing that excessive deficits result from problems with the operation of fiscal institutions and that their solution can be found in fiscal reengineering. Proposals for this particular reform go back at least to Eichengreen, Hausmann and von Hagen (1999). Excessive deficits are identified with the common-pool problem: every special interest group favors a little bit of additional spending on its favored programs; log-rolling results in a higher overall level of spending which exceeds the capacity to tax, resulting in excessive deficits. The fiscal policy committee of independent experts would be in a position to internalize this externality, avoiding excessive deficits in the same way that a single regulator of the world's oceans would avoid excessive fishing.

There are some powerful objections to this idea. In particular, in order for the deficit target to bind, the adjustment mechanism (the automatic tax increases or across-the-board spending reductions that would close the gap between the deficit of the government and the deficit of the committee) would have to be impossible for the

politicians to override under virtually any circumstances. This would almost certainly be viewed as a bridge too far. The fiscal crisis in Europe, if that phrase can be used, is not so far advanced that the citizenry would be prepared to accept weakening political control of fiscal policy in this way.¹² The medicine would probably be regarded as stronger than justified by the disease.¹³

6. Institutional Reform

The merit of the Wyplosz proposal is that it identifies institutional reform as a way of addressing the problem of excessive deficits. It builds on the empirical and theoretical literature showing that different institutional arrangements for formulating fiscal policy result in systematically different outcomes.¹⁴ This literature suggests that fiscal systems characterized by large vertical imbalances between federal and state governments are more conducive to deficit bias in the absence of statutory restraints on spending by lower levels of government. More hierarchically-structured fiscal processes vesting more agenda-setting power with the finance minister exhibit less deficit bias.¹⁵ Countries with proportional representation electoral systems giving rise to coalition governments cannot pursue this approach, since the finance minister inevitably lacks the requisite strength. Instead, they must restrain the tendency to overspend by writing clear

¹² To be clear, under this scheme all control of fiscal policy would *not* be removed from the political sphere and delegated to the committee of independent experts. Only the decision of the size of the deficit would be so delegated. Binding rules for how an excessive deficit would be closed, that could be relaxed only in the event of national emergency, would have to be adopted as well. But, other than this, control over other aspects of fiscal policy, such as the overall size and composition of the budget, would still rest with elected officials, as at present.

¹³ Thus, when Hausmann, von Hagen and I proposed a national fiscal council for certain Latin American countries, we did so against the backdrop of more severe fiscal imbalances

¹⁴ A comprehensive review of this literature and the evidence is Hallerberg, Strauch and von Hagen (2001).

¹⁵ In contrast, more decentralized fiscal systems with more autonomy for individual spending ministries tend to be characterized by larger deficits, since each ministry is likely to expand its domain without taking into account the consequences for the overall fiscal position.

multi-year budget plans into their coalition agreements and adopting ex ante rules for responding to unanticipated shocks.

Emphasizing institutional reform as a strategy for deficit bias has the merit of addressing the underlying cause of the problem, poorly structured fiscal rules and procedures that allow participants in the political process to ignore some of the implications of their decisions, rather than simply treating the symptoms, which are the excessive deficits that result. It places ownership (responsibility for fiscal outcomes) squarely in national hands. At the same time, institutional reforms along these lines, unlike arbitrary numerical ceilings on permissible deficits, leave national fiscal authorities with the freedom needed to respond to changing cyclical conditions. If the bias toward excessive deficits is significantly reduced, eliminating serious risk that debts might become unsustainable and require an inflationary debt bailout, decisions regarding fiscal policy could then be left entirely in national hands.

Relying on institutional reform to address the bias toward excessive deficits is tantamount to a weaker version of the Wyplosz proposal. Whereas Wyplosz proposes to take the decision of the size of the deficit entirely out of the political domain, the proponents of the institutional and procedural reforms just described suggest that doing so would be too extreme. Accountability and ownership in well functioning democracies require that the decision of the size of the deficit should be taken by elected officials. But allowing them to do so without adequate constraints is likely to lead to inefficient outcomes. Fiscal rules, norms and procedures at the national level that constrain their discretion can eliminate, or at least limit, these inefficiencies without creating a democratic deficit.

What should be the role of the Commission and the European Union generally in encouraging such reforms? The Commission can use its bully pulpit to emphasize the need for the reform of fiscal procedures where they are least adequate. It can employ its staff or an independent panel of experts to rate the adequacy of existing procedures and recommend specific reforms, in the manner of a credit rating agency. It can modify its criteria in light of new research and repeat the process annually.

In a previous paper (Eichengreen 2004) I suggested that these ideas might be incorporated into the SGP. Each country could be graded on the basis of the adequacy of its fiscal rules and procedures, and countries that failed to take corrective action would then be subject to an escalating series of penalties (warnings, non-interest-bearing deposits, fines). Or countries receiving a passing grade might be exempted from the Excessive Deficit Procedure on the grounds that they could be trusted to choose an appropriate fiscal stance, while the others would still be subject to the provisions of the EDP and SGP.

I now think that the other problems with the SGP, enumerated above, make this undesirable. Embedding incentives for institutional reform in the SGP might also be unnecessary. Why not put the SGP on hold and first see how much progress in advancing the relevant reforms can be made by relying on the bully pulpit? Why not see if such progress significantly reduces the incidence of excessive deficits and effectively minimizes the pressure for inflationary debt bailouts? If this limited approach proves inadequate as a means of addressing these problems, then the need for a Stability and Growth Pact can be revisited in the future. By that time the progress of political integration may have made greater discretion for the Commission more politically

acceptable by creating a stronger European Parliament capable of holding the relevant commissioners accountable for their actions.

7. Conclusion

From many points of view, the first six years of the euro and the ECB have been uneventful. This is a happy observation, since in monetary policy “uneventful” is all but synonymous with “successful.” The principal exception has been the operation of the Stability and Growth Pact. The SGP has failed to encourage fiscal restraint in good times. To the extent that it has had an effect, it has limited fiscal stabilization in bad times. It has failed to adequately distinguish the situation of countries in fundamentally different fiscal positions. These are good reasons why the pact has failed to receive political support and why member states have resisted its strictures.

The Commission now proposes to address these problems with reforms designed to facilitate a more flexible and rational application. Countries with low debts will be treated differently than countries whose debts are of questionable sustainability. Deficits reflecting large amounts of public investment or costs of structural reform will similarly be treated more leniently. Deficits resulting from events beyond the control of the country in question will be more freely exempted. The Commission would be empowered to make these judgments.

But while such reforms would make the application of the SGP more flexible, they would also make it more easily disputable. Governments would be able to reject the Commission’s conclusions by rejecting its assumptions. Giving the Commission strong powers to enforce the pact by imposing sanctions and fines would solve this problem in

principle but would not be acceptable in practice given the Commission's limited political accountability.

The unavoidable conclusion is that the SGP pact cannot be saved. The Commission and the Council can announce reforms, but this does not guarantee that SGP will have more influence over the actual conduct European fiscal policies than in the past. The binding constraint is the still limited extent of political integration, which limits the mechanisms available for holding the Commission accountable for its actions and therefore creates understandable resistance to giving it strong enforcement powers over sensitive matters of public spending and taxation.

This suggests not futilely seeking to save what is not savable but instead focusing on the feasible. What is feasible in this context is pressure for the reform of fiscal rules and procedures at the national level. There is a growing body of evidence that such reforms are conducive to better fiscal outcomes. The Commission and other EU bodies can take specific steps to encourage governments to move in this direction. On some future occasion, if and when political integration in Europe is further advanced, there may then be an occasion to revisit the case for a more centralized procedure like the Stability Pact.

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