

Reforming the Stability and Growth Pact: Size and Influence in EMU Policymaking

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The Stability and Growth Pact, originally designed to protect the integrity of monetary union based on price stability and fiscal discipline, has created a rift between states and institutions. Larger states like Germany and France have repeatedly violated the terms of the pact, while smaller states like the Netherlands and Austria have steadfastly defended it. This paper explores how size has affected the economic interests of the Eurozone countries and how these interests will translate into policy changes, taking into account the possibility of coalitions forming between states as well as across institutions, with the European Central Bank taking the position of the smaller states in defending the original pact.

The Stability and Growth Pact (SGP) has proven to be far more contentious than one might have expected, given its origins. Devised in 1995 by German Finance Minister Theo Waigel in order to ensure the continued observance of strict fiscal policies after monetary union commenced, the country that originated the SGP became one of its first transgressors. Indeed, several countries have earned the Commission's ire as a result of their inability to remain under the deficit ceilings mandated by the Pact. Concern over the inability of these countries to fulfill their SGP requirements has been matched by concern over the differential treatment of these economies by their peers in the Ecofin Council; while larger states like Germany and France are able to repeatedly violate the Pact, seemingly with impunity, smaller countries like Portugal and Greece seem to be held to a higher standard and are expected to bring their economies back in line more quickly. In addition, the attitudes of the Finance Ministers in regard to the strictness of the interpretation of the Pact has also varied according to size; while larger countries like Italy (and France and Germany, not surprisingly) have advocated reform, smaller countries like Austria and the Netherlands have warned of the loss of credibility that would ensue a loosening of the Pact.

This paper considers the role that country size plays in the operation of the Stability and Growth Pact, arguing that it impacts the SGP in three interrelated ways: the country's economic interest, its policy options, and the reaction of other countries to those options. The following section briefly explains the technical operation of the Pact and how it relies primarily on reputation concerns to keep participating countries in line. The widely discussed consensus regarding the importance of tight monetary policy and by extension fiscal balance should make this process relatively straightforward: if the

countries agree on the importance of these economic objectives, non-adherence to them should be a cause for concern among all the parties. In practice, however, this has not been the case, and countries have demonstrated different levels of tolerance for the Pact's stringent requirements. Numerous reforms have been suggested, but agreement has been difficult to achieve. Battle lines have been drawn largely along country size.

Country size affects a state's economic interests, its policy options, and the reactions of fellow Member States and EU institutions. Economic research demonstrates that smaller countries have less of an ability to run counter-cyclical cycles than larger countries, making the SGP more costly for the latter as it closes off policy options that are not available to its smaller counterparts. In addition, the larger size of these countries gives them more voting weight within the Council of Ministers, and therefore it is costly in the long run for smaller countries to alienate these larger states by voting against them. The built-in influence that these countries enjoy by virtue of their larger size makes punishment by "naming and shaming" also irrelevant. Moreover, the larger countries have been leading the way in monetary integration for years, helping to create the stability culture (Germany) and the potential for the politicization of policy (France), making the SGP controversy a continuation of a battle of ideas that now have the two countries on the same side.

The final section examines the short history of the Stability and Growth Pact and how it has treated its transgressors. Larger countries like France and Germany were able to escape formal and to a large extent informal censure in a way that smaller countries like Portugal and Greece were not. Until the economic circumstances become more

favorable to these larger states, they will continue to breach the SGP unless it is reformed to accommodate their interests and deal with all of the states more flexibly.

The Logic of the Stability and Growth Pact: Questioning the Strength of the Consensus

The Maastricht Treaty outlined plans for monetary union by requiring would-be participants to achieve the convergence criteria in order to ensure that the Eurozone would be comprised of economies that would not threaten Germany's price stability. By the late 1980s, monetary politics in the EC followed the lead of West Germany, whose currency formed the unofficial anchor of the system. Ideas regarding the long-term trade-off between inflation and unemployment were replaced by a consensus on the need for low inflation in order to be able to keep interest rates low, thus spurring economic growth (McNamara 1998). The Maastricht Treaty thus demanded convergence in inflation, exchange rates, interest rates, debts and deficits for the participants, though countries could be approaching the required levels and still be admitted to EMU, so long as the other Member States agreed (as was the case for Italy and Belgium). The pursuit of economic growth through an independent central bank and fiscal policies that would limit the ability of governments to intervene in the economy reflect the neoliberal consensus that prevailed in the 1990s (Fitoussi and Saraceno 2004).

However, there were no mechanisms to ensure that the fiscal rectitude would continue once monetary union began, prompting German Finance Minister Theo Waigel to construct the Stability Pact. The Pact would also have the additional benefits of buttressing the credibility of the nascent monetary union as well as provide participants with a framework for policy coordination post-EMU (Heipertz and Verdun 2004). The

Stability Pact was renamed the Stability and Growth Pact in 1996 on the initiative of the French government; French Finance Minister Dominique Strauss Kahn argued that they were “entering into a new phase of European politics...[and a] policy mix that supports growth,”¹ emphasizing the importance of policy objectives besides price stability to Germany’s partners (Chang 2002). Though the importance of controlling inflation has been emphasized repeatedly throughout the monetary union process, the issue of how EMU does (and does not) promote growth was sidelined in favor of constructing a credible institution (the European Central Bank) and system (comprised of the ECB, the Eurogroup, and Ecofin councils) that would not jeopardize the pursuit of price stability. Therefore the Eurogroup had to settle for informal status, to the chagrin of those who had tried to make it an economic government to counterweight the independent ECB, and additional legislation was passed to ensure continued vigilance against fighting inflation. The concern for growth later would be resurrected by France as well as its former opponent-turned-ally in the SGP reform debate, Germany, shortly after the introduction of the euro.

As described on the Europa website,² the SGP entails three elements: 1.) a *political commitment* to a budget surveillance process, with the desired effect being that “effective peer pressure is exerted on a Member State failing to live up to its commitments”; 2.) *preventive elements* to stop countries from exceeding the 3 percent reference value, with Member States submitting stability and convergence programs to the Council. The Council (acting by a qualified majority), on the recommendation of the Commission, can issue an early warning to Member States before an excessive deficit

¹ Reuters, November 16, 1998

² http://europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm),

occurs, with the expectation being that the transgressing state will take steps to rectify its budgetary situation; 3.) *dissuasive elements* in the form of the Excessive Deficit Procedure, which demands immediate action on the part of the Member State and can entail the imposition of monetary fines. Such sanctions begin as a non-interest-bearing deposit with the Commission that equals 0.2 percent of GDP plus a figure linked to the size of the deficit. The Council may intensify these sanctions each subsequent year with the imposition of additional fines that may not exceed 0.5 percent of GDP on an annual basis. The deposit becomes a fine if the excessive deficit remains after two years. Exceptions can be made if an unusual event beyond the Member State's control impacts its financial situation or if the country experiences a severe economic downturn that causes its real GDP to drop by at least 2 percent.

Adopted in 1997, the aforementioned disagreement over the name of the Pact proved prescient in the subsequent arguments regarding the Pact's overall utility for the EMU project as well as criticism in regard to how the SGP has been implemented. While a widespread consensus existed for the emphasis placed on price stability in monetary union, the role of the coordination of fiscal policy in the form of the SGP has come under debate since its inception. The role of various EU institutions (national governments versus European institutions such as the Commission) and the way in which the Pact should be interpreted have been the focus of most of these debates. Disagreement between Member States and also other EU institutions prompted the European Commission to involve the European Court of Justice when it sued Ecofin in 2004 for suspending the Pact's rules; after winning its court case, the Commission proceeded to issue proposals for its reform. The topic has also preoccupied both the Ecofin Council

and, to the chagrin of some of the Finance Ministers, heads of government, prompting both to consider reform.

The Commission adopted a communication on September 3, 2004, in which it advocated that the sustainability of public finances play a stronger role in the SGP and that the different economic situations of the Member States in the EU-25 must be accounted for. In order to strengthen the credibility and enforcement of the SGP, the Commission's proposals focused on a more serious consideration of the debt criterion (as opposed to the deficit), looking at the medium and long-term sustainability of a nation's debt, incorporating a myriad of factors that could influence the development of the debt. In addition, the proposal advocates the weighting of "more country-specific circumstances" when determining whether or not a country is "close to balance or in surplus." Finally, economic circumstances and developments must be taken into account when deciding to implement the Excessive Deficit Procedure, as "exceptionally weak economic growth" should be factored into any identification of an excessive deficit as well as in the policy recommendations made to rectify the deficit. The onus of economic adjustment remains with the Member States, however, as they are expected to "correct inadequate budgetary developments" and to strive for budget surpluses during economic good times in order to weather economic downturns.³ Commission President Barroso emphasized that the SGP needed to be "adjusted, but not killed" (*La Stampa*, 1/13/2005).

In January 2005, German Chancellor Gerhard Schroeder offered his thoughts on the reform of the SGP,⁴ arguing for a loosening of the Pact's rules and for a curtailment

³ http://europa.eu.int/comm/economy_finance/publications/sgp/com2004581_en.htm

⁴ On July 14, 2003, French President Jacques Chirac called for a "softening" of the Pact, but did not have specific reform proposals. This announcement was rejected by the Commission and criticized by EU Finance Ministers. (*Financial Times*, 7/14/2003)

of the Commission's ability to intervene in fiscal affairs of Member States (*FT Deutschland*, 1/17/2005). For example, he argued that the quality of the debt undertaken should be considered; if structural reforms in taxes, labor markets, education, or research and development caused a government to exceed its fiscal deficit limits, this should not be punished automatically. Under Schroeder's proposal, it would be much more difficult for the Commission to initiate Excessive Deficit Procedures (*Financial Times* 1/16/2005). German Finance Minister Hans Eichel emphasized that the goal was not to weaken the Pact but to have a more reasonable implementation of its criteria (*FT Deutschland*, 1/18/2005). Many criticized Schroeder's involvement; Luxembourg Prime Minister and Finance Minister Jean-Claude Juncker noted, "He is not in charge of the European economy, he is not a head of state either, he's just a head of government," (*Financial Times*, 1/19/2005). Belgian Finance Minister Didier Reynders questioned the overall utility of the proposals, arguing that Schroeder's motives are the result of Germany's inability to achieve the SGP's guidelines rather than something that would benefit EMU overall, while Austrian Finance Minister Karl-Heinz Grassler warned of the danger of political leaders becoming involved in matters for Finance Ministers (*Le Figaro*, 1/18/2005). Dutch Finance Minister (and one of the authors of the SGP) Gerrit Zalm echoed this sentiment (*FT Deutschland* 1/18/2005), and he called such political intervention to loosen the SGP a "horror scenario" (*Financial Times*, 1/16/2005).

Europe's Finance Ministers have also been hard at work at reforming the SGP. Under the Luxembourg Presidency, Juncker presented a 14-page text to Ecofin in early March 2005. This proposal attempted to reach a compromise among the factions that divide largely along size, with France, Germany, and Italy leading the way for a

reinterpretation of the Pact's rules that would make it more flexible and politicized versus smaller states, led by Austria and the Netherlands, arguing for adherence to the original Pact. The text alters the original SGP by taking into account the "quality of expenditures", the cost of structural reforms (in which the costs of German unification would be a factor), and external shocks. Contrary to Germany's wishes, however, the proposal allows the Commission to retain its power in SGP procedures; Schroeder had hoped for a political judgment instead (*Le Monde*, 3/8/2005).

Unable to reach an agreement at this session, another meeting was scheduled for March 20, just before the EU summit of heads of state and government set for March 22-23. The Eurozone members seemed more amenable to make compromises quickly, but the new member states from central and eastern Europe were loathe to allow reforms that could jeopardize monetary union in advance of their membership, which they hope to achieve in short order. According to Juncker, "Many of the new member states want to avoid absolutely every change to the pact that could weaken the credibility and stability of the single currency" (*Financial Times* 3/8/2005).

Finally, a compromise was reached in which the "unification of Europe" was deemed an acceptable justification for its breach of the SGP, and Germany was allowed to offset reunification costs at 4 percent of GDP a year. In exchange, Schroeder agreed to abandon his efforts to reduce the role of the Commission in policing the Pact. Italian Finance Minister Domenico Siniscalco remarked that the revisions seek both stability and growth (*La Repubblica*, 3/21/05), as the name of the SGP implies. Indeed, pension reforms will be considered when evaluating large budget deficits in excess of SGP limits,

as will spending for research and development and the pursuit of policies “achieving European goals.”

Which factors would be relevant varies according to each Member State, which determines for itself what factors should be considered by the Commission and Ecofin. This was done to resolve another bone of contention in which larger states wanted a longer list of relevant factors in the proposal, while the smaller states thought there were too many; in the end, the list itself was abandoned (euobserver.com, 3/21/2005).

In the event that a country is found to have an excessive deficit, the deadline to correct it has been extended from one year to two, and that this grace period could be extended further in the event of "unexpected adverse economic events with major unfavourable budgetary effects occur during the excessive deficit procedure," so countries could have as long as five years to correct their deficit. Juncker noted that once again, while the Eurozone members agreed to the reforms relatively early on in the discussions, it took considerably longer to bring the EU-25 on board (*Financial Times* 3/20/2005), indicating that the small states versus larger states battle has not yet abated despite the successful conclusion to this Ecofin meeting.

In addition to the talks by policymakers on the need to reform the SGP, economists were also quick to point out its weaknesses, and some of these criticisms factored into the aforementioned policy decisions. Early reports expressed concern that the SGP would divert efforts towards more necessary economic reforms in the European labor market, for example (Eichengreen and Wyplosz 1998). More recent analyses suggest that while the EDP places too much emphasis on the government's budget deficit, a greater emphasis on the sustainability of the government's public debt levels

would provide a better indicator as to whether or not its budget deficit is excessive (Mortensen 2004), a factor that was introduced in all of the reform proposals discussed above. In addition, tight monetary and fiscal policy may be strategic substitutes for one another, with looser fiscal policy promoting tighter monetary policy and vice versa (Mélitz 1997), possibly making the SGP less critical to EMU's success given the ideational convergence on tight monetary policy and lack of a similarly strong consensus on tight fiscal policy.

One of the most common criticisms brought about in policy circles is that the SGP is counterproductive in achieving one its nominally central tenets, that of economic growth. Economists have argued, tight monetary policy may also be counterproductive within the context of EMU because it punishes offending countries when they are likely to be facing an economic recession, thus exacerbating their problem (Buiter, Corsetti, and Roubini 1993). Many of the problems facing the countries of the EU are the result of weak economic growth and in some cases, negative growth.

Table 1 GDP growth rate, deficit/surplus in EU by country, 2001-2004

Country	GDP growth rate (%)	2001	2002	2003	2004
	Government deficit (-)/surplus (+) as percentage of GDP				
Belgium	GDP growth rate (%)	0.7	0.9	1.3	2.5
	Government deficit (-)/surplus (+) as percentage of GDP	+0.6	+0.1	+0.4	+0.1
Czech Republic	GDP growth rate (%)	2.6	1.5	3.7	4.0
	Government deficit (-)/surplus (+) as percentage of GDP	-5.9	-6.8	-11.7	-3.0
Denmark	GDP growth rate (%)	1.6	1.0	0.4	2.0
	Government deficit (-)/surplus (+) as percentage of GDP	+3.2	+1.7	+1.2	+2.8
Germany	GDP growth rate (%)	0.8	0.1	-0.1	1.6
	Government deficit (-)/surplus (+) as percentage of GDP	-2.8	-3.7	-3.8	-3.7

Estonia	GDP growth rate (%)	6.4	7.2	5.1	5.9 f
	Government deficit (-)/surplus (+) as percentage of GDP	+0.3	+1.4	+3.1	+1.8
Greece	GDP growth rate (%)	4.3	3.8	4.7	4.2
	Government deficit (-)/surplus (+) as percentage of GDP	-3.6	-4.1	-5.2	-6.1
Spain	GDP growth rate (%)	2.8	2.2	2.5	2.6 f
	Government deficit (-)/surplus (+) as percentage of GDP	-0.5	-0.3	+0.3	-0.3
France	GDP growth rate (%)	2.1	1.2	0.5	2.4 f
	Government deficit (-)/surplus (+) as percentage of GDP	-1.5	-3.2	-4.2	-3.7
Ireland	GDP growth rate (%)	6.0	6.1	3.7	5.2 f
	Government deficit (-)/surplus (+) as percentage of GDP	+0.9	-0.4	+0.2	+1.3
Italy	GDP growth rate (%)	1.8	0.4	0.3	1.2
	Government deficit (-)/surplus (+) as percentage of GDP	-3.0	-2.6	-2.9	-3.0
Cyprus	GDP growth rate (%)	4.1	2.1	2.0	3.7
	Government deficit (-)/surplus (+) as percentage of GDP	-2.3	-4.5	-6.3	-4.2
Latvia	GDP growth rate (%)	8.0	6.4	7.5	8.5
	Government deficit (-)/surplus (+) as percentage of GDP	-2.1	-2.7	-1.5	-0.8
Lithuania	GDP growth rate (%)	6.4	6.8	9.7	6.7
	Government deficit (-)/surplus (+) as percentage of GDP	-2.0	-1.5	-1.9	-2.5
Luxembourg	GDP growth rate (%)	1.5	2.5	2.9	4.0 f
	Government deficit (-)/surplus (+) as percentage of GDP	+6.2	+2.3	+0.5	-1.1
Hungary	GDP growth rate (%)	3.8	3.0	3.5	4.0
	Government deficit (-)/surplus (+) as percentage of GDP	-3.7	-8.5	-6.2	-4.5
Malta	GDP growth rate (%)	-1.7	2.2	-1.8	1.5
	Government deficit (-)/surplus (+) as percentage of GDP	-6.4	-5.9	-10.5	-5.2
Netherlands	GDP growth rate (%)	1.4	0.6	-0.9	1.4 f
	Government deficit (-)/surplus (+) as percentage of GDP	-0.1	-1.9	-3.2	-2.5
Austria	GDP growth rate (%)	0.7	1.2	0.8	2.0
	Government deficit (-)/surplus (+) as percentage of GDP	+0.3	-0.2	-1.1	-1.3
Poland	GDP growth rate (%)	1.0	1.4	3.8	5.3
	Government deficit (-)/surplus (+) as percentage of GDP	-3.9	-3.6	-4.5	-4.8
Portugal	GDP growth rate (%)	1.7	0.4	-1.1	1.0
	Government deficit (-)/surplus (+) as percentage of GDP	-4.4	-2.7	-2.9	-2.9
Slovenia	GDP growth rate (%)	2.7	3.3	2.5	4.6
	Government deficit (-)/surplus (+) as percentage of GDP	-2.8	-2.4	-2.0	-1.9
Slovakia	GDP growth rate (%)	3.8	4.6	4.5	5.5
	Government deficit (-)/surplus (+) as percentage of GDP	-6.0	-5.7	-3.7	-3.3
Finland	GDP growth rate (%)	1.1	2.2	2.4	3.7
	Government deficit (-)/surplus (+) as percentage of GDP	+5.2	+4.3	+2.5	+2.1
Sweden	GDP growth rate (%)	1.0	2.0	1.5	3.5
	Government deficit (-)/surplus (+) as percentage of GDP	+2.5	-0.3	+0.2	+1.4
United Kingdom	GDP growth rate (%)	2.3	1.8	2.2	3.0
	Government deficit (-)/surplus (+) as percentage of GDP	+0.7	-1.7	-3.4	-3.2

Source: Eurostat (2005) f=forecast

The political and academic controversy over the SGP indicates that a consensus has not been reached in regard to how the Eurozone does and should operate, making the imposition of a policy as rigid as the original SGP problematic (Allsopp and Artis 2003). Economic research indicates that country size can have a strong effect on a country's economic interests, making such disputes a predictable outcome of this one-size-fits-all policy. In addition to these economic realities, political realities also deem that larger countries play a different role in the management of the SGP than smaller ones.

Country Size and Economic Interests

In a recent symposium in the Journal of Common Market Studies, authors summarized the different schools of thought in relation to how country size affects its economic interest (Buti and Pench 2004). First, larger countries find fiscal consolidation to be more costly due to the larger impact that an increase in government expenditure has in big countries versus small countries (Fitoussi and Saraceno 2004; Laurent and Le Cacheux 2004). Second, larger countries in the EU have been growing more slowly than their smaller counterparts, making fiscal consolidation more difficult. Third, unlike small countries, large countries need not fear the political fallout that may ensue a violation of the SGP. While a small country may pay a penalty in terms of a loss of reputation or influence within the EU should it breach the Pact, concerns over their reputation with other Member States or institutions weighs less heavily than domestic political imperatives (von Hagen 2002). Larger countries would also be less likely to suffer from any sanctions from fellow Member States, particularly if several countries violate the pact. Larger countries innately possess influence, and if more than one country

transgresses, it becomes even less likely that any punishment will be doled out (De Haan, Berger, and Jansen 2004).

Not only are larger countries less likely to suffer if they breach the Pact, they are more likely to benefit than smaller countries would. Pre-EMU, larger states either set monetary policy (Germany) or could adjust their exchange rates periodically (France and Italy); smaller states were more likely to have followed a policy of a hard peg to the DM, making the adoption of the Maastricht Treaty convergence criteria and the SGP less costly for them (Posen 2004). In effect, the smaller states enjoyed less autonomy due to their size, so the restrictions of the SGP are less constraining than for large states, which would try to offset their loss of monetary autonomy with more flexible fiscal policy. Politics and ideas surrounding the importance of European unification guided Germany towards surrendering its currency, rather than strong expectations of economic benefits (Baun 1996; Dyson and Featherstone 1999). For the small states, the choice for monetary union was more obvious, as they would benefit from the lower interest rates and greater credibility that monetary union could provide without paying the cost in the loss of monetary sovereignty, something they had already abandoned during their years in the European Monetary System. Therefore, damaging that credibility by engaging in fiscal behavior that could weaken the SGP held greater costs for smaller states.

Much concern had been expressed regarding the wisdom of imposing a single interest rate on a region that had not yet achieved the criteria advised by optimum currency level theorists (Dibooglu and Horvath 1997; Eichengreen 1992; Mundell 1961). Though the Maastricht Treaty convergence criteria were clear in regard to establishing clear thresholds and goals that countries needed to achieve in order to make EMU a

success, it was not inflexible, owing to the political exigencies of trying to allow as many Member States as possible to join EMU (albeit to the annoyance of some states, such as the Netherlands, which would have preferred a stricter interpretation of the convergence criteria). Though the EMU states may be moving towards an optimum currency area as a result of monetary integration and the expected increase in trade (Frankel and Rose 1998), the component Member States still do not have the same economic experience that makes one policy optimal for all states. Potentially fiscal policy could alleviate some of the tensions that this situation gives rise to, but the potential for moral hazard and the inflationary consequences of the bailout of profligate governments made the SGP an important component of buttressing the credibility of EMU.

However, some have argued that the SGP does not constrain fiscal policy as much as economist, policymakers and the media have argued. Empirical tests demonstrate that discretionary budget deficits have become even more countercyclical since EMU began a trend present in non-EMU countries as well (Gali and Perotti 2003).

The controversy over the SGP can be viewed in some ways as a continuation of the debate on the wisdom of monetary integration among still disparate economies with different economic incentives. The basis of many of these differences depends on country size.

Country Size and Policy Options

As the Melian Dialogue in Thucydides' Peloponnesian War explained, the strong do what they can and the weak suffer what they must. This explanation of international relations has informed many analyses, especially those subscribing to realist principles.

International organizations like the European Union attempted to rise above the nation-state in order to foster more peace and cooperation through interstate treaties as well as the development of supranational forms of governance that would upgrade the common interest and provide Member States with long-term benefits despite having to pay costs in the short-run. A long-running debate among EU scholars focuses on the relative importance of nation states versus supranational institutions and transnational actors (some prominent examples include (Haas 1957; Hoffmann 1966; Lindberg and Scheingold 1970; Moravcsik 1998; Sandholtz and Zysman 1989). More recently, some theorists have tried to bridge this gap between intergovernmentalism and neofunctionalism with frameworks of analysis that incorporate both sets of actors and ascribe them with important powers and functions which vary by issue area and level of governance (Peterson and Bomberg 1999; Pollack 1997).

In reference to European monetary union in particular, nation states, especially Germany (Chang 2002; Heisenberg 1998; Kaltenthaler 2002; Loedel 1999; Moravcsik 1998), and ideas (Dyson and Featherstone 1999; McNamara 1998; Verdun 1999) have been the primary explanatory variables for the timing, pace and content of monetary integration. Though economic, ideational and organizational factors play a role, all of the aforementioned theories to varying degrees have given Germany pride of place in explaining why EMU occurred and why it looks the way that it does. Historically the long-term success of monetary union has depended on either the presence of a dominant state that can maintain order within the region, or a broad network of institutional linkages across nation states that make reduced national autonomy acceptable to participants (Cohen 1994). EMU has made use of both mechanisms, but German

consent, as the anchor of the European Monetary System, was necessary for a viable monetary union. As the holder of the unofficial leading currency of the EMS, Germany had the most to lose by changing the status quo and giving up its stable and credible currency for one forged with its European partners. Germany agreed to monetary union due to their desire to integrate Germany further with Europe prior to unification in order to assuage remaining doubts and fears about its geopolitical aspirations (Kaltenthaler 2002). Given its importance to EMU due to its size and its leading role in the existing arrangement for monetary cooperation, Germany could frame much of the debate and institutionalize its preferences in the form of the ECB's independence, the Maastricht convergence criteria and the SGP, in addition to preventing an economic government from forming as a counterweight to the ECB.

But economic conditions have changed since the 1990s, and so have Germany's interests. Unemployment has been a vexing problem since unification, and its economy still has not recovered from the costs of this massive project. Moreover, the urgency felt by earlier statesmen for solidifying European cooperation no longer exists. Europe lacks any grand projects to propel integration forward, bringing the risk of stagnation, particularly as new members with divergent interests continue to join the EU. The costs to Germany for not cooperating with the rules of EMU are relatively low. Without German leadership, will monetary cooperation stagnate and become less credible?

Though Germany played a leading role, it was not the only important actor in monetary integration. For example, France made significant contributions to monetary integration (Chang 2002; Howarth 2000). France's longstanding attempts to make monetary cooperation in Europe more symmetrical finally gained German consent in the

late 1980s, in part as the result of the politics surrounding reunification. While Germany demanded adherence to strict economic criteria, France made the adjustment to EMU easier and more feasible for a larger group of states by making membership a decision made by politicians rather than central bankers or even finance ministers. Similarly, SGP rules do not automatically impose fines; they must first be approved by Ecofin, and in the wake of the recent reforms to the SGP, there even more room exists for political discretion.

Though France has not been ascribed the hegemonic status of Germany, it is one of the leading countries in the EU and in EMU. This was evidenced by the unprecedented support that Germany offered France during its currency crisis in 1992, prior to its referendum on the Maastricht Treaty. Though the British government complained bitterly about how Germany and in particular the Bundesbank handled the crisis (Connolly 1995; Major 1999), French participation in monetary union was nonnegotiable in a way that the participation of other countries (even a large and powerful state like Britain) was not.

France and Germany have been the leading engines of European integration, including monetary integration. Major projects have required their cooperation and active involvement for success. This power means that they have policy options that are open to them in a way that they are not open to other EU Members, as if they do not lead the way or actively consent to major projects, its chances of success are limited. Not only have they initiated many ideas related to European integration, they have also been able to amass coalitions with other nation states in order to achieve their objectives. In the case of the monetary union project, for example, Germany led smaller states like the

Netherlands in its quest for a monetary union that made the pursuit of price stability paramount. France, on the other hand, joined together with Italy for a monetary union that would take into account political constraints and would be less rigid than what its German counterpart would have preferred. The need to have both members on board allowed for compromises between these different interests.

The current difficulties with the SGP that France and Germany face indicate a congruence of interests. What are their policy options, and how do they differ from those of smaller states? First, it is difficult to imagine a coalition among other Member States that would be able to counteract effectively an alliance between the largest and politically most influential states in the EU. First of all, they have ideational influence. Many of the ideas relating to the structure of monetary union bear their imprint, and they are obvious sources for future ideas and leadership in this issue area. Working together, one can imagine them changing the debate and emphasis of monetary integration towards growth in a way that enhances long-term cooperative prospects for Europe.

For example, in the Eurogroup session preceding the Ecofin meetings of late March 2005, German Finance Minister Hans Eichel was reportedly isolated in his efforts to have German unification be given special consideration when accounting for its deficits. According to Belgian Finance Minister Didier Reynders, it was “11 to 1” against Germany. Eichel rationalized that the SGP already makes allowances for cases in which a recession necessitates a higher budget deficit, but allowing for structural reforms would have an even stronger impact and would essentially be a preventative measure against future budgetary problems. In addition, the inclusion of German unification was reworded to European unification (an idea attributed to French Finance Minister Thierry

Breton), demonstrating how these states are shifting perceptions and expectations of monetary integration and once more framed it as an issue of concern for Europe, rather than one of domestic politics (*Frankfurter Allgemeine Zeitung*, 3/21/2005; *Le Monde*, 3/22/2005).

Second, France and Germany, as two of the largest countries in the EU, have greater voting power in the Council of Ministers, making their cooperation important to agreements regarding monetary union. This is particularly true when considering the addition of large states like Britain and Italy to their alliance, and clear battle lines have been drawn between the large states and small states. Leading the way for the smaller states was the Austrian government, and though it had been zealously guarding the SGP, in the end it, too, gave in to the compromises demanded by the larger states, with Grasser conceding, “This wasn’t the best solution imaginable” (*Le Monde*, 3/22/2005). The institutional structure of Ecofin that weights votes according to country size makes it difficult for smaller states to defeat the larger ones so long as a few of the smaller states are willing to defect. This once again gives France and Germany policy options that are less readily accessible to smaller nations. The possibility of issue linkage and desire for support from France and Germany in other issue areas raises the prospects for cooperation with these two nations rather than banding against them.

Another policy option would be for alliances across institutions. For example, the ECB could punish the Member States should SGP rules become too lax by raising interest rates; however, if these fiscal decisions do not affect inflation, the ECB would be reluctant to use this option (Howarth and Loedel 2004). The ECB did threaten to use this weapon in the wake of the March 2005 SGP reform decision, having consistently

criticized attempts to weaken the SGP (*FT Deutschland*, 3/22/2005). Yves Mersch of the ECB's Governing Council stated, "It is the opinion of the Bundesbank that the Pact, with the new rules, has been critically weakened," warning that this would have consequences for monetary policy (*Die Welt*, 3/23/2005)

The efficacy of linking up with the ECB in order to alter monetary policy is questionable, however. Much of the influence of its predecessor, the Bundesbank, rest not with its official position but with its reputation, record of success, and the perception that is possessed superior ideas and information in regard to monetary policymaking that enabled it to form relationships with other influential actors, including the financial community (Bernhard 1998; Goodman 1992; Heisenberg 1998; Kaelberer 2003; McNamara 1998). The ECB does not have the same track record or comparable influence in regard to its ideas.

Monetary integration already has seen its share of ups and downs prior to the SGP controversy; in 1993 after widening the exchange rate bands to accommodate the increase in currency speculation, there was concern that this meant the end of EMU's credibility. Some also decried admitting states that had not met all of the convergence criteria to EMU, fearing the loss of credibility before monetary union had even begun. But the Member States forged on and shifted the debate away from this setback and looked forward to the future and how to make monetary union a viable reality. France and Germany, the traditional leaders and proponents of monetary integration, are in the best position to shift the debate once more. Though currently met with skepticism regarding the political motivations behind their ideas, their ideas have found advocates among at least some of the other Member States, and it could be the first step in altering

expectations in a way that does not sacrifice monetary union for the sake of satisfying domestic political demands. This will depend on the reaction of other Member States as well as financial market actors to the Franco-German initiatives to loosen the SGP.

Country Size and Reactions

The reaction of Member States to a government's proposal is crucial because of the preference for operating on consensus. While the SGP allows for punitive measures in the event of noncompliance, its brief history demonstrates how difficult it is to make use of these measures. Indeed, particularly in light of the March 2005 reforms, the French government compared the SGP to "nuclear dissuasion" (*Le Figaro*, 3/23/2005). The most powerful sanction under a system of policy coordination is the public embarrassment of "naming and shaming" recalcitrant members (Meyer 2004). The efficacy of such a procedure will also vary according to country size, as larger Member States will find less damage done to its reputation and its influence in the EU than a smaller state would, giving it more policy options.

Prior to the Ecofin meeting, the Eurogroup finance ministers discuss important issues amongst themselves, in part to share information but also to forge a common ground prior to the more inclusive Ecofin meetings. They have been successful at times at influencing Member State behavior, even among larger states. The Eurogroup successfully dissuaded French Finance Minister Mer from making further defiant comments in regard to France's adherence to the Pact in 2002; indeed, Mer went from stating that France had priorities other than the SGP to reiterating its importance (Puetter 2004). However, the consensus forged among the Eurozone countries apparently has its limits as it has continually been tested since then as larger states strive to incorporate

more flexibility into the system that smaller states prefer to retain as is. Nevertheless, it is not in the interest of any of the participants to give the impression of a bully; German press accounts of the March 2005 Eurogroup meeting report that Eichel clearly avoided the impression that Germany succeeded through brute force against the Pact's hardliners (*Frankfurter Allgemeine Zeitung*, 3/22/2005). Instead he chose to emphasize, "There were no winners and losers" (*FT Deutschland*, 3/22/2005).

The preference for consensus and the decision-making procedure of the SGP may be a problem in and of itself. In December 1996, Otmar Issing, then Chief Economist of Bundesbank, criticized the SGP for allowing the "fiscal sinners" to be part of the negotiating process and be allowed to judge other states in need of reprimand for fiscal profligacy (*Financial Times*, 12/17/1996). Not surprisingly, the ECB was very critical of the reform package agreed upon by the finance ministers in March 2005. The ECB issued a statement expressing its concern that budgetary discipline could be destabilized by the new Pact and hinted that it might have to hike up interest rates to counteract its effect (*Financial Times*, 3/21/2005). While German Finance Minister Hans Eichel made assurances that the new Pact was not "a license to create debt," but rather allows for the consideration of "individual cases," Juncker promised that it "would affect neither the culture nor practice of stability" (*FT Deutschland*, 3/21/2005). Such avowals did little to assuage the concerns of the ECB, but thus far it has not followed through on threats to raise interest rates (Howarth and Loedel 2004).

Other institutions like the Commission and the Court recognized the danger that the actions taken by the larger states posed not only for the SGP but also for their own authority. This is why the Commission took the Council to Court, not only was it

protecting the integrity of the Pact, it was also looking out for its institutional prerogative as watchdog of the SGP. Though there had been speculation in the press that the Court would have little incentive to take action against the two most powerful members of the EU, the Court's ruling was largely in favor of the Commission.

Financial markets would be the most significant arbiters of the SGP, as increased speculation or the selling off of euro-denominated assets would be the proximate cause of such interest rate hikes by the ECB. Various financial market participants were interviewed in the press after the March 2005 reform package was passed, and they delivered quotes expressing disappointment with the results. Overall, however, both the ECB and financial market actors will most likely look at the results of the Eurozone and the extent to which the reform has been a precursor to increased deficits. If this were the case, larger deficits on the part of larger countries would affect the Eurozone more than its smaller counterparts. In addition, as the leading figures in monetary integration, French and German actors set the tone for the rest of the area. But the proceedings against France and Germany were not met with a strong reaction from financial markets, so it remains to be seen if they will respond to this latest political development or continue to keep a watchful eye on how the respective economies of the participating countries progress.

Thus, the question of country size affects the reaction not only of fellow Member States but also other institutions and potentially financial actors. This is because the large states set an example for others as to what kind of behavior can be tolerated, and if the EU is unwilling to punish larger states, it may be difficult to punish smaller states for similar infractions. The following section demonstrates that while the EU has treated

large states differently from smaller states, both have enjoyed considerable leniency given the relatively stringent measures outlined in the SGP.

Evidence: The Handling of Small States Versus Large States in the SGP

Trouble began for the SGP shortly after the introduction of the euro in January 2002. On February 12, Ecofin ignored the Commission's recommendation to warn Portugal and Germany about their budget deficits, which were approaching the 3 percent threshold. This move was widely interpreted as political; German elections were scheduled for later that year, and it would have been awkward to chastise the government on an issue which it had previously championed so close to the election date. Schroeder had begun an intensive lobbying campaign in 2001 to avoid such a warning, and ultimately Ecofin agreed. Portugal was able to ride on Germany's coattails in this instance, and both escaped censure temporarily. It would have been awkward politically to punish one state and not the other for the same violation.

The grace period did not last forever, though. On November 5, 2002, Ecofin began proceedings against Portugal for running a deficit of 4.1 percent of GDP in 2001. This had political consequences, as two months later a general strike (its first in a decade) paralyzed Portugal as workers protested against the reforms undertaken by the government to bring its finance back into line with the demands of the Pact. Despite these difficulties, Prime Minister Barroso vowed to do "whatever it takes" to comply with its provisions (*Financial Times*, 12/12/2002). Portugal's refusal to criticize the Pact differs sharply with French complaints that the Pact worsens economic conditions during

times of recession and Germany's lobbying to avoid an official warning (*Financial Times*, 1/29/2003).

Proceedings against Germany and France began the following year, with the German government facing a gap of 3.8 percent in 2002 and France with a gap of 3.1 percent in 2003. Though the Commission urged the finance ministers to accelerate proceedings against Germany and France, Ecofin settled for wresting promises from both governments in November 2003 that they would reduce their deficits by 2005, thus suspending the SGP. The Commission responded by suing the finance ministers in January 2004 for ignoring the SGP's excessive deficit rules. In July of that year the Court voided the action of the Ecofin council, ruling that a new resolution must be reached with the Commission. In December 2004, the Commission lifted the excessive deficits procedure off both Germany and France, citing new deficit projections from the respective governments for 2005.⁵

In April 2004 the Commission issued a formal warning to Italy over its budgetary situation, while Britain and the Netherlands received informal warnings. At the July 2004 Ecofin meeting, Interim Finance Minister Silvio Berlusconi convinced the other Members to reject the Commission's proposal for an excessive deficit warning by submitting a 7.5 billion euro savings program. The Netherlands was given until October 2 to submit proposals to rectify this situation. At the October 21, 2004 Ecofin meeting, the Council deemed that the Netherlands' fiscal plan was making satisfactory progress towards correcting its deficit.⁶

⁵ http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp/com_com_2004_en.pdf

⁶ http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ecofin/82342.pdf

On September 23, 2004, Eurostat verified that Greece's debt to deficit ratio would be changed from 1.7 percent to 4.6 percent.⁷ Having learned of errors in the budgetary data that Greece provided prior to entering EMU, the Council requested additional data dating back to 1997. Upon entering the Eurozone, Greece had misrepresented its deficit figures, and since then it has been unable to stay below SGP limits. Greece was given until March 21, 2005 to demonstrate what measures it will take to alleviate its deficit (*FT Deutschland*, 2/17/2005).

They were deemed insufficient. "Los grandes no y los pequeños sí" read the opening line of a story in *El Mundo* (2/18/2005) regarding the decision to begin proceedings against Greece while suspending any actions that might be taken against France and Germany. Ecofin had taken this decision on the recommendation of the Commission, which noted that the Greek government had not taken sufficient actions that would reduce its deficit below 3 percent in 2005. However, Ecofin's censure required Greece to get its deficit under control by 2006, a year later than that proposed by the Commission. ECB President Jean-Claude Trichet criticized this decision, "The extension of the deadline, from 2005 to 2006, for correcting the excessive deficit pushes the room for interpretation of the rules and procedures to the limit" (AFX, 3/3/2005).

The Commission has been holding large and small countries alike to the commitments made in the SGP, but standards have been applied differently by the Council of Ministers. The most obvious cases of favoritism are the two largest countries, France and Germany, which faced no repercussions for its transgressions against the Pact

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<http://europa.eu.int/rapid/pressReleasesAction.do?reference=STAT/04/117&format=HTML&aged=0&language=EN&guiLanguage=en>

and were able to secure reforms to the Pact that will keep it out of trouble until after both countries hold major elections in 2006 (Germany) and 2007 (France). Portugal was unable to avoid censure and worked to get its budget into line. Italy and the Netherlands convinced other Member States that they would be able to rectify their fiscal situations quickly without facing formal warnings. However Greece, like Portugal before it, must bring its deficits back into line to escape monetary damages in the future.

Conclusion

The handling of the Stability and Growth Pact resembles the debate over the rules of EMU under the Maastricht Treaty in that both seemed to be quite stringent in laying out quantitative rules and measures that would punish transgressors through exclusion (monetary union) or reputational damage and possibly monetary fines (SGP). Instead, both proved to be remarkably flexible and open to politicization despite the rhetoric surrounding the importance of independence from political actors a decade ago. The reasons for monetary integration were inherently political, and it should come as no surprise that its operations would be subject to political exigencies as well.

France and Germany have had an easier time skirting punishment for their respective infractions against the SGP, even winning an agreement to reform the Pact in a way that makes it more amenable to their interests and more open to political interpretation. Their motives for doing so rest with larger economic and political incentives that large states have to use fiscal policy with more discretion. Economically, larger countries but especially Germany had sacrificed more when they gave up the ability to set their own monetary policy. Politically, larger countries can better

manipulate the rules due to institutional structures that give more voting weight to large states and norms that have made these two countries the leading voices for monetary integration for decades. Though some of the smaller Member States and other institutional actors have decried this differential treatment, thus far their transgressions have not had discernibly negative effects.

The flexibility of allowing states like Belgium and Italy before they met the convergence criteria did not do serious damage to the introduction of the euro. Similarly, the ruckus caused by the relatively loose application of the SGP's mechanisms for punishment are unlikely to be the cause of the euro's demise or the downfall of EMU.

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