

Paper from the Colloquium:  
**The Politics and Economics of the Euro Crisis**  
Institute for European Studies  
University of Malta  
2 December 2011

## Preventing another Euro Area Crisis: EU Economic Governance 'Six Pack' – a case of too little, too late?

### Summary:

The 'Six Pack' forms part of the economic governance reforms which are being implemented in order to prevent a repeat of the current sovereign debt crisis in the Euro Area. This legislative package involves strengthening the Stability and Growth Pact, with stronger financial sanctions and more focus on debt; a new directive on national budgetary frameworks and a new framework to monitor and correct macroeconomic imbalances. Furthermore, the implementation of the 'Six Pack' also involves procedural reforms, in particular reverse majority voting, as well as more oversight by the European Parliament.

Inter-institutional negotiations on the 'Six Pack' took over a year. In the meantime, the sovereign debt crisis had deepened and broadened, implying that the 'Six Pack' may have come 'too late'. The 'Six Pack' has also proved to be 'too little' to address the crisis and by the time it entered into force, further measures and proposals to strengthen economic governance had to be made.

Nevertheless, the 'Six Pack' comprises some positive developments. In particular, recognising that fiscal policy is a matter of national sovereignty, it sets a new approach which relies on institutional reforms at national level. As such, it constitutes a first, small step to improve economic governance in the Euro Area.

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### Introduction

As part of the European response to the ongoing Euro crisis, the European Union (EU) has embarked on a process of reforms in order to strengthen economic governance in the Euro Area. This constitutes a long term process aimed at preventing further sovereign debt crises in the future. This paper deals with this preventive aspect of the European response to the crisis, and specifically with the EU economic governance 'Six Pack'.

Before assessing this legislative package, this paper outlines why fiscal discipline is important in a monetary union and reviews the framework for economic policy coordination and fiscal surveillance, which was in place before the crisis.

### Fiscal Discipline in a Monetary Union

Political considerations determined the design of the Euro Area. Governments' reluctance to surrender national competence in fiscal policy implied that the Euro Area was constructed with a common monetary policy but decisions on economic and fiscal policies remained at a national level. The Euro Area is thus

different from other monetary unions, which have a fiscal federal structure, in that fiscal competence in the Euro Area remain largely at national level (De Grauwe, 2009).

Due to the lack of common economic and fiscal policies, since the inception of EMU, there have been two conflicting objectives – the desire to retain flexibility in national policies whilst at the same time the need to maintain coordination and fiscal discipline given that, as the current crisis has clearly shown, the economic policies of one member state can have the negative spillover repercussions on the others.

According to the optimum currency area theory, in a monetary union, stabilisation mechanisms are important to deal with asymmetric shocks (De Grauwe, 2009). In the EU, the central budget is small and inflexible, implying that it cannot be used for stabilisation purposes. This implies that some degree of flexibility is required in national fiscal policies so that governments can deal with shocks affecting only their country's economy (Majocchi, 1999). How can fiscal discipline be maintained in a monetary union of

this kind? De Grauwe (2009) presents various arguments in this regard. Unsustainable fiscal policies in one member country can have negative spillover effects on other countries. In particular, if a country spends and borrows more, this will stimulate demand also in other members, especially in a single market such as the EU where economies of member countries are highly integrated. This could lead to inflationary pressures in the whole Euro Area, and as a result a restrictive monetary policy by the European Central Bank which would affect demand and borrowing costs of other members of the monetary union. Furthermore, the higher interest rate in the Euro Area would also cause the euro to appreciate, leading to a deterioration in the overall trade balance. De Grauwe (2009), Hallerberg (2004) and Heipertz and Verdun (2004), also argued that unsustainable fiscal positions in member countries could potentially lead to interference in the conduct of monetary policy as countries negatively affected by high interest rates could put pressure on the ECB to relax its monetary policy stance. According to De Grauwe (2009) it could also be argued that EMU itself could bring fiscal laxity. With flexible exchange rates, if a country pursues an unsustainable fiscal policy, it would face a higher risk premium because its currency would be expected to depreciate. Adoption of the single currency implied that financial markets could no longer impose this constraint of discipline through the exchange rate. However, De Grauwe (2009) also provides a counterargument to this line of thinking pointing out that countries participating in EMU could no longer monetise their debt. Thus, it is debatable whether participation in EMU brings less fiscal discipline or not.

When EMU was launched, the fear of unsustainable fiscal positions in some member states outweighed the need for flexibility in national fiscal policies (De Grauwe, 2009). Convergence criteria were established for participation in the final stage of EMU, which included fiscal criteria. These required that government deficits are kept below three per cent of GDP whilst debt ratios were not to exceed 60 per cent of GDP, unless they were declining and approaching this benchmark at a satisfactory rate. Eventually, all members who wished to join EMU were able to do so, and eleven participated in 1998 while Greece joined in 2001<sup>1</sup>. Some of these countries joined EMU despite very high levels of debt

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<sup>1</sup> Only one prospective applicant to the Euro Area was refused entry – this concerned Lithuania in 2006 which was not considered to have met the convergence criteria due to a marginal breach of the criterion on inflation. At the same time, Estonia did not apply for euro area membership for the same reason, but eventually Estonia adopted the euro in 2011.

and a number of them breached the 3 per cent deficit threshold as soon as the European economy slowed down again. EMU thus involved countries which did not share the same culture of fiscal discipline. Germany's role was also crucial. Heipertz and Verdun (2004) argue that Germany had both economic and political reason to insist on rules for fiscal discipline after EMU: to ensure a strong and credible central bank and low inflation and to appease German opposition to EMU. A single currency without Germany was inconceivable and hence Germany was in a strong position to enforce its wishes on the other member countries.

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### Economic Policy Co-ordination before the Crisis

In this context, the Amsterdam European Council in June 1997 agreed on the Stability and Growth Pact (SGP) in order to regulate national fiscal policies after EMU membership. The SGP has a corrective arm, which involves the excessive deficit procedure, and a preventive arm, which concerns the medium term fiscal policy (European Commission, 2011). The corrective arm mainly requires members to keep their deficits below the three per cent of GDP threshold, with the eventual possibility of financial sanctions if they do not comply with the respective Council Recommendation to correct the excessive deficit (European Commission, 2011). The preventive arm requires members to achieve their medium term budgetary objective, which in general would be a broadly balanced budget over the business cycle. Members of the Euro Area are required to prepare

annual Stability Programmes<sup>2</sup> which outline the medium term budgetary plan, and which are then assessed by the Council particularly to determine whether the country concerned is making sufficient progress towards its medium term budgetary objective (European Commission, 2011). The underlying idea underpinning the preventive arm is that if countries achieve their medium term budgetary objective, then they would have sufficient 'fiscal headroom' in case of economic shocks, thus meeting the need for flexibility in national fiscal policies, outlined earlier.

However, the current sovereign debt crisis has made it amply clear that the framework for fiscal surveillance in place in the Euro Area was not sufficient to ensure fiscal discipline. Important weaknesses of the SGP include a lack of transparency and problems of enforceability (Alves and Afonso, 2007). In particular, financial sanctions can only be imposed at the discretion of the Ecofin Council through a qualified majority. However this implies a situation of judges judging themselves, with finance ministers being reluctant to impose sanctions on other countries when in the future they themselves could very well be at the receiving end. Indeed, the financial sanctions provided for by the SGP were never imposed, resulting in the SGP being described as "a dog that would never bite" (Heipertz and Verdun, 2004: 778). This was the case with respect to the situation of France and Germany in 2003/4 where the Council decided to put the respective excessive deficit procedures in abeyance, rather than impose sanctions, a decision later overruled by the European Court of Justice and to the 2005 reform of the SGP (Alves and Afonso, 2007). At that time, the credibility of the SGP was weak with the then President of the European Commission, Romano Prodi, describing the Pact as 'stupid' since it was not flexible enough to allow countries to deal with the economic crisis (Alves and Afonso, 2007). The 2005 reform of the SGP resulted in a more flexible SGP and also increased the possibility of political judgement in the process, particularly as regards the factors that can be considered when deciding on whether an excessive deficit persists (Alves and Afonso, 2007).

The framework for economic policy coordination amongst members of the Euro Area which was in place before the crisis started largely involved fiscal surveillance. As regards structural economic reforms, only non-binding guidelines known as "Broad Economic Policy Guidelines" were agreed to. These required member states to prepare national reform

programmes outlining their structural reform plans (Europa 2006). This "soft" approach on structural reform occurred despite the importance of flexible labour and product markets as adjustment mechanisms in a single currency area in case of economic shocks. Nevertheless, and despite the thrust towards reform supplied by the Lisbon Strategy as from 2000, most member states made insufficient progress in terms of structural reforms (Allard and Everaert, 2010).

#### **The 'Six-Pack' on Economic Governance**

Given these weaknesses, preventing another crisis in the Euro Area required a significant strengthening of the economic pillar of EMU. To this effect, a Task Force to the European Council was set up in March 2010. This task force on economic governance was chaired by the President of the European Council, Herman Van Rompuy, and its members were mainly EU finance ministers. This Task Force presented its final report in October 2010 (European Council, 2010). In the meantime, the European Commission presented its proposals for stronger economic governance in the Euro Area through six legislative proposals (which subsequently became known as the 'Six-Pack') at the end of September 2010 (European Commission, 2011). Intense negotiations on this package followed in the subsequent months in the EU institutions. The Lisbon Treaty had given new powers to the European Parliament in this policy area, and to some extent this was a new experience. Reaching an inter-institutional agreement was a difficult and lengthy process, given the different views held by member states in Council as well as by political groups in the European Parliament. The original target to reach agreement by June was not feasible and a final compromise agreement was achieved in September 2011. The 'Six-Pack' will enter into force by the end of 2011/beginning of 2012 (European Parliament, 2011).<sup>3</sup>

The 'Six-Pack' involves important reforms to the SGP (Buti and Larch, 2010). This includes stricter rules in the preventive arm, including a new rule based on expenditure developments to assess progress towards the medium-term budgetary objective. Furthermore, the reforms entail better enforcement of the preventive arm, including the possibility of imposing warnings, recommendations and also financial sanctions. Previously Council could only issue an opinion on countries' medium-term budgetary plans. The SGP reforms included in the 'Six-Pack' also affect the corrective arm. An important change is that it strengthens the focus on the debt levels of member states. As argued by De

<sup>2</sup> The other EU member states are required to prepare Convergence Programmes.

<sup>3</sup> The EU Economic Governance 'Six Pack' entered into force on 13 December 2011

Grauwe (2009), since the aim of the SGP is to prevent members of the Euro Area from exposing themselves and others to the risk of default, surveillance should focus on debt levels rather than on the deficit. Furthermore, the reformed SGP comprises a numerical benchmark for debt reduction. This is a welcome reform since previously what constituted a satisfactory reduction of the debt ratio was open to interpretation. The 'Six-Pack' also provides for stronger financial sanctions under the corrective arm, which sets in early in the process. This is a significant development since previously sanctions could potentially be imposed only after a country has repeatedly failed to take the necessary action and after subsequent warnings by Council (European Commission, 2011).

In the fiscal field, the 'Six-Pack' also involves other important reforms, namely provisions for better fiscal statistics, including the possibility of fines if member countries misreport data on their deficit and debt as well as measures to strengthen the professional independence of national statistics authorities (European Parliament, 2011). Another important development is the new directive on the national budgetary framework. For the first time, this directive makes specific requirements on the budgetary procedures in member states, including accounting systems, budgetary forecasting practices, fiscal relations between different levels of government, multi-annual perspective in the budgeting, more transparency (for example as regards contingent liabilities) as well as requiring governments to introduce national fiscal rules which are consistent with the Stability and Growth Pact (European Commission, 2011).

The 'Six-Pack' also introduces for the first time a formal framework to detect macroeconomic imbalances and competitiveness problems. This includes a new excessive imbalance procedure which involves an early warning system based on a scoreboard of indicators. It also lays the legal grounds for preventive and corrective actions, including the possibility of financial sanctions (European Commission, 2011).

Besides these strengthened and new aspects of surveillance, importantly the 'Six-Pack' also involves significant procedural reforms. One of the most notable changes is reverse majority voting, whereby a Commission recommendation will be considered as adopted unless a majority of members states in Council vote against it. This is an important development because it will significantly increase the automaticity of sanctions and warnings in the SGP

(European Parliament, 2011). Furthermore, on a procedural level, the 'Six-Pack' provides for significantly more oversight by the European Parliament, including public hearings (European Parliament, 2011).

As highlighted earlier, the negotiations on the 'Six-Pack' were long and difficult. Among the more contentious issues in the negotiations was that involving more automaticity in warnings and sanctions. A group of countries, including France, were against the reverse majority voting, but the European Parliament resisted these efforts at watering down the reforms (European Parliament, 2011). The European Parliament also insisted on, and won the right for public hearings. Another contentious issue concerned the sources of macroeconomic imbalances, and specifically whether the focus should be only on countries with persistent and large current account deficits or whether countries with surplus positions on their current account, such as Germany and Netherlands, should also be monitored (European Parliament, 2011). Within the European Parliament's political groupings there was also disagreement on whether the 'Six-Pack' contains too much focus on fiscal discipline, with the Progressive Alliance of Socialists and Democrats arguing that this came at the expense of growth and employment (European Parliament, 2011).

#### **Other EU Economic Governance Reforms**

Whilst negotiations on the 'Six-Pack' were taking place, other EU economic governance reforms were implemented, namely the European Semester and the Euro Plus Pact.

The European Semester was actually part of the recommendations of the Task Force on Economic Governance (European Council, 2010). Agreement on the European Semester was achieved in September 2010, (Council of the European Union, 2010) and this was the first part of the recommendations to be implemented as from 2011. The European Semester has now been integrated in the 'Six-Pack'. The European Semester involves 'upstream' policy coordination and strengthening the EU dimension in national policy making. The process starts with the Annual Growth Survey prepared by the European Commission which gives broad guidance on priority actions at EU and national level and which member states must take into account when they prepare their Stability/Convergence Programmes and National Reform Programmes (European Commission, 2011). These programmes are then assessed by the Commission and Council by mid-year and on this basis, countries are then to prepare their

national budgets. This is a significant departure from the previous procedure where national budgets were assessed after they became law. Furthermore, the new process should increase coordination between budgetary and structural policies as these are now presented and assessed concurrently. Nevertheless, it should be pointed out that the implementation of the European Semester in 2011 was not unproblematic as the measures included in a number of programmes were rather vague. On the other hand, the Commission recommendations were more specific and included deadlines (Europa, 2011a), thus making them more enforceable.

The Euro Plus Pact involves the agreement reached among the Euro Area member states as well as Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania, in March 2011, with the aim of improving economic policy coordination and improve competitiveness and avoid harmful macroeconomic imbalances (European Council, 2011a). The Pact concerns policy areas that fall under national competences, such as wage policy, pension reforms and tax policy coordination, and hence could constitute an important development in the improvement of economic policy coordination amongst the countries concerned. However, its enforceability may be weak because it involves national policy commitments, which are monitored politically, and a similar system based on peer pressure applied in the Lisbon Strategy had not been successful (Wyplosz, 2010).

Throughout the course of 2011, the sovereign debt crisis in the Euro Area became more severe and broader with three countries (Greece, Ireland and Portugal) having been bailed out and intense financial market pressures building on Italy as well as Spain especially since summer. Indeed, the President of the European Commission, Jose Manuel Barroso stated that the 'European Semester and the six-pack legislation need to be strengthened further' (Europa, 2011b). In October 2011, the Commission issued a Communication 'A Roadmap to Stability and Growth' and important decisions were taken in the European Council and Euro Area Summit which met in that month. In particular, the governance of the Euro Area was strengthened. Whilst the Eurogroup had been integrated in the Lisbon Treaty, there had been no provision for meetings for the heads of state or government of the Euro Area members. This has been addressed with the establishment of the Euro Area Summit which will be held at least twice a year and which will have its own President (European

Council, 2011b)<sup>4</sup>. Furthermore, stricter provisions for fiscal surveillance will start to apply, including ex-ante vetting of draft budgets and stricter monitoring of budget execution for countries subject to the excessive deficit procedure (European Council, 2011b). Another development involves reinforced national fiscal frameworks, going beyond the requirements of the Directive included in the 'Six-Pack'. Euro Area member states agreed to implement the Directive in 2012, one year earlier than planned originally and to adopt stricter provisions including independent economic growth forecasts to be used as a basis for budgetary projections and a commitment to introduce national fiscal rules embedding the provisions of the SGP (European Council, 2011b) in national law. Furthermore, economic policy coordination will be improved through an obligation to consult with the European Commission and other Euro Area members before the adoption of major fiscal or economic policy reform plans with potential spillover effects (European Council, 2011b).

As the financial markets seemed to remain unconvinced of the effectiveness of the European efforts to stem the crisis, pressures on sovereign bonds of certain Euro Area member states, in particular Italy, continued unabated. In this context, even more radical economic governance reforms were proposed by the European Commission in November 2011, which go beyond the requirements of the 'Six-Pack' and the measures announced in October. Two new regulations to strengthen budgetary surveillance in the Euro Area were proposed (Europa, 2011c). The first regulation concerns member states which are subject to an excessive deficit procedure and involves a common budgetary timeline and common budgetary rules (including independent macroeconomic forecasts and independent fiscal councils to monitor the implementation of national fiscal rules), stronger ex-ante assessment of national budgets by the European Commission and Council as well as graduated monitoring of implementation of fiscal plans. The second regulation applies to Euro Area member states which are receiving financial support or face severe financial stability difficulties and involves stronger monitoring and surveillance procedures. Concurrently with these proposed regulations, the European Commission has also presented a Green Paper with options for euro stability bonds. Indeed, stronger fiscal surveillance is considered as a pre-

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<sup>4</sup> Currently, the President of the European Council, Herman Van Rompuy has assumed this role, but in the future the president of the Euro Area Summit will be elected at the same time when the President of the European Council will be elected.

requisite to the introduction of Euro bonds in order to avoid moral hazard (Europa, 2011c). However, Germany continues to oppose the concept of Euro bonds (BBC, 2011), so that it is not clear what will be the way forward in this regard.

### **Assessment of the 'Six-Pack'**

As highlighted earlier, the process to arrive at a compromise agreement on the 'Six-Pack' between all the EU institutions was long and complex. It took one whole year for an inter-institutional agreement to be reached, after six months of discussion in the Task Force and then in the European Council. Whilst financial markets want fast decisions, decision-making in the EU has been slow and difficult. EU decision making involved different institutions and within each institution there were different views amongst the respective members. For instance, on automaticity of sanctions and warnings there was disagreement between the European Commission, the European Parliament and Council as well as the European Central Bank (European Parliament, 2011), which although it was not directly involved in the decision-making process, was an important stakeholder. Then there were differing views within each institution, particularly amongst member states in Council and between different political groupings in the European Parliament (European Parliament, 2011). By the time, agreement on the 'Six-Pack' was reached in September 2011, it was clear that the requirements of this legislative package were not ambitious enough and more reforms on economic governance were proposed while others were being designed. On this basis, I would conclude that the 'Six-Pack' has been a case of 'too late' and 'too little'.

The EU has addressed the sovereign debt crisis in the Euro Area by taking measures, with one small step being taken each time. This has been the case not only in the economic governance reforms, but also in the establishment of the financial support instruments. In the different European Council meetings (May 2010, July 2011, October 2011), it was hoped that the measures taken would be sufficient to calm financial markets and ease the crisis. However, each time financial markets were not convinced and it was soon realised that the measures announced were not enough and more needed to be done. This situation reflects the fact that there is little appetite among member states for more integration in fiscal policy making (Pisani-Ferry, 2010). Member states do not want more centralisation in this policy area (Buti and Larch, 2010). This was also reflected in the negotiations on the 'Six-Pack', particularly the reluctance by some member states to concede to the reverse majority voting system (European

Parliament, 2011). One may thus conclude that perhaps only such a gradual process of integration was feasible, with member states not willing to accept more fiscal integration than the minimum necessary to address the crisis.

The reforms which were announced in October and November 2011, after the agreement on the 'Six-Pack' were the 'real game changer' in economic governance in the Euro Area, as they involved very specific provisions for national budgetary frameworks and ex-ante assessment of budgetary plans involving substantial changes in the way national fiscal policy making has been implemented up to now. Nevertheless, the importance of the 'Six-Pack' should not be discounted, as it involved some important positive developments. In particular, the 'Six-Pack' increases focus on the debt position of member states; it should ensure better progress to the medium term budgetary objective through the new expenditure rule; it entails wider surveillance including macroeconomic imbalances; and the reverse majority voting system should lead to a less politicised process. The Directive on national budgetary frameworks also constituted the first step to decentralise fiscal governance whilst the European Semester was a first step towards ex-ante coordination of national budgets.

The strength of some of these reforms is backed by empirical evidence and academic literature. For instance, fiscal consolidation tends to be more lasting if it is expenditure-based (Alesina and Ardagna, 1998), which should support the use of the expenditure rule to monitor progress towards the medium-term budgetary objective. Similarly, there is abundant empirical evidence that fiscal performance tends to improve with the quality of domestic fiscal governance (Buti and Larch, 2011), thus providing a justification for the Directive on national budgetary frameworks. On the other hand, the effectiveness of other aspects of the 'Six-Pack' still has to be ascertained. In particular, the reverse majority voting system puts significant pressure on the European Commission. The process whereby a fine is imposed on a "friendly" sovereign state with a democratically elected government is a new experiment. The imposition of such a fine by the European Commission is likely to raise anti-EU sentiment in the population of the country concerned (Wyplosz, 2010). So, one has to see whether the European Commission will have the necessary courage to impose such a fine. Furthermore, the surveillance of macroeconomic imbalances will be on the basis of scoreboards and peer pressure despite the fact that this mechanism was applied unsuccessfully in the

### **Concluding Remarks**

The 'Six-Pack' involves reforms on two fronts: 'hardening' the SGP by increasing sanctions and imposing them at an earlier stage in the process of fiscal surveillance and decentralisation of fiscal governance through requirements for national budgetary frameworks. De Grauwe (2010) argues strongly against the first approach, since he considers that an approach where the European Commission is trying to impose discipline on reluctant sovereign states will not be effective. There is also an issue of democratic legitimacy (De Grauwe, 2010; Wyplosz, 2010). A basic principle of our democracies is that you cannot have taxation without representation. In national elections, voters can sanction politicians for irresponsible fiscal behaviour (Wyplosz, 2010). A situation whereby European institutions can impose sanctions on national governments and force them to lower spending and/or increase taxes would thus be a breach of this democratic principle because these institutions do not face political sanctions on these decisions.

On the other hand, the new approach introduced by the 'Six-Pack' and further developed in subsequent economic governance reforms of decentralisation of fiscal governance recognises that fiscal policy is a matter of national sovereignty and requires

institutional reforms in budget rules and institutions at the national level (Wyplosz, 2010). This is in line with the principle that since decisions to spend and tax are taken by national governments and parliaments, then monitoring and control over excessive debts and deficits should be organised at national level (De Grauwe, 2010). In this sense, then the 'Six-Pack' constitutes a first small step in the right direction.

Another option would be for a fully-fledged fiscal federalism with some spending and taxing decisions taken at EU level. In this case, in order to address the problem of democratic legitimacy, there would have to be some transfer of sovereignty from national parliaments to the European Parliament (Wyplosz, 2010). At this point in time, given the political context, such an option is not feasible.

The 'Six-Pack' thus has to be assessed within this context. The member states are not willing to go for a full fiscal union, but we are now closer than ever to this stage. A fiscal union, whatever its form, implies some loss of national sovereignty in fiscal policy. This is being implemented gradually in the EU, with the first step being made in the 'Six-Pack' and developed further in the economic governance reforms which were announced during autumn 2011.

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### *About the Institute*

*The Institute for European Studies is a multi-disciplinary teaching and research Institute within the University of Malta. It runs an evening Diploma course, as well as full-time courses leading to the Bachelor of European Studies degree and to qualifications at MA and PhD level. Each year Maltese and international students enrol in its degree programmes, and through the ERASMUS Programme it offers a number of student and staff exchanges with universities and institutions of higher learning abroad. All of the Institute's courses are fully in line with Bologna Process guidelines.*

*Founded in 1992 as the European Documentation and Research Centre (EDRC), the Institute was granted the status of a Jean Monnet Centre of Excellence in 2004. The Institute is engaged in various research and publication activities in European Integration Studies and is a member of the Trans-European Policy Studies Association (TEPSA), the LISBOAN network, EPERN and the two Euro-Mediterranean networks, EuroMeSco and FEMISE. The research interests of its staff include comparative politics and history of the European Union (EU); EU institutions; EU external relations and enlargement; small states in the EU; Malta in the EU; Euro-Mediterranean Relations; Stability and Growth Pact; Economic Governance of the Euro Area; Europe 2020; EU development policies and Climate Change.*

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