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The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact

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The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact

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ABSTRACT This article analyses the creation of the Stability and Growth Pact. It examines the economic and political factors behind it, including the role of economic ideas, experts, politicians, institutional arrangements in the Maastricht Treaty, domestic politics, and the exceptional position of Germany in the realm of monetary integration. It concludes that a set of commonly held beliefs together with a corresponding power-political constellation explain the creation of the SGP. As these parameters change, they inform our understanding of the current crisis.

KEY WORDS Budgetary discipline; economic and monetary union; Germany; monetary integration; rules; Stability and Growth Pact.

1. INTRODUCTION

The Stability and Growth Pact (SGP) consists of two Council regulations and a resolution of the European Council.[2] It specifies the deficit limit of the Treaty Establishing the European Community (TEC 104). In the second half of 2002, its excessive deficit procedure (EDP) was initiated in the cases of Portugal, Germany, and France. Formally, when the Council decides that an excessive deficit exists, the country concerned is obliged to reduce its deficit below 3 per cent of gross domestic product (GDP) or ultimately face financial sanctions. Metaphorically speaking, the 'dozing watchdog' has thus turned out to be rather snappish. However, on 25 November 2003 the Council of the European Union for Economic and Financial Affairs (Ecofin) suspended the EDP for France and Germany, which has plunged the Eurozone into an institutional crisis. On 13 July 2004 the European Court of Justice (ECJ) nullified the Econfin Council Conclusions on France and Germany. However, it confirmed that the Council may indeed effectively suspend the EDP by not adopting a Commission recommendation.

The present situation is not detached from the factors that led to the creation of the SGP but has to be seen in their context. From this broad perspective, the article poses the following questions: (1) Why and how was the SGP created? (2) What underlying conditions supported its creation?

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(3) Have they changed since? (4) How do they inform our understanding of the current situation? This article analyses the origins, process and outcome of the SGP negotiations and thereby aims to provide some background and clarification of the ongoing debate. We argue that the SGP was possible due to a convergence in basic ideas about the relationship between monetary and fiscal policies held by experts in Ministries of Finance, central banks, the Commission as well as in academia and international organizations. Yet there was no precise idea of a specific arrangement beyond the Maastricht Treaty. Ideational convergence provided the basis for a political compromise. Expert consensus on principles was a necessary though not sufficient condition for the intergovernmental agreement. The complete analysis has to include power-political factors which relate to the prominent position of Germany in the creation of economic and monetary union (EMU).

The remainder of the article is structured as follows. The next section examines why the SGP was considered necessary. The third section describes the actual story of its creation. The fourth section examines the ideational context from which the SGP originated and provides an analysis of the achievement of the political compromise. The final section concludes and assesses the current situation.

2. WHY MIGHT AN SGP BE NECESSARY? LESSONS FROM ECONOMICS AND POLITICS

2.1 The economics of the SGP

The Maastricht Treaty has provided the monetary constitution for EMU. However, its specifications for the future fiscal regime are incomplete and ambivalent.[3] It only contains rather loose stipulations on the EDP and budgetary co-ordination. From the viewpoint of economics, several arguments speak in favour of complementing the fiscal arrangements of the Treaty (for a detailed discussion, see Heipertz 2003). The most prominent reasons behind more stringent rules are (1) a need for consolidation, (2) concerns about externalities, (3) the credibility of European Central Bank (ECB) independence and (4) the need for a more coherent framework of economic policy co-ordination.

A general need for **consolidation** results from the expansionary fiscal stance in most of the Organization for Economic Co-operation and Development (OECD) countries since the 'golden age' of Keynesianism and welfare-state expansion. Soaring interest rates, which were the result of high inflation rates of the time, have reduced investment and contributed to weak growth and underemployment. Government revenues flow into debt servicing at the same time as ageing populations require a fundamental reallocation of public spending.

Second, there was a fear of **externality problems** related specifically to EMU.[4] The most prominent concern regarded the negative effects of fiscal spill-overs on increasingly interdependent participating economies. A bond-financed increase in government spending would cause the money supply in the Eurozone to rise, thereby fuelling inflationary pressures. In response the ECB would be forced to increase interest rates, depressing investment and consumption. Furthermore, the higher interest rate would cause the common currency to appreciate and the trade balance to deteriorate.[5] Another externality effect results from abandoning national exchange rates. The effect of depreciation due to fiscal profligacy now affects the whole currency zone, thereby reducing the impact on the individual 'sinner' while increasing it for everybody else. This reduced disciplinary effect on national authorities aggravates an existing deficit bias of public finance (Beetsma 1999). Member states were feared to free-ride on each other by overspending on their budgets.[6] Thus strict rules on budgetary deficits were deemed necessary. It is noteworthy that the need for limits on budgets had already been mentioned in the original EMU blueprint laid out in the 'Delors Report' (Committee for the Study of Economic and Monetary Union 1989).

A third concern is that excessive deficits could undermine **central bank independence**. Actors at the time were worried that ECB independence and specifically the 'no bail-out' clause[7] would be endangered by unsustainable fiscal paths of certain member states. Sargent and Wallace's (1981) model of debt monetization supports this view. Their study shows that an unsustainable fiscal path eventually forces the central bank to buy government bonds. The fiscal theory of the price level (FTPL) argues in a similar direction (Leeper 1991; Woodford 1994). Grossly simplified, the FTPL states that inflation control by the central bank through the interest rate is jeopardized by an excessive fiscal stance that disturbs household expectations and unsettles private sector budget constraints. Public demand substitutes private demand and artificially expands aggregate demand, eventually causing the price level to rise. Hence, monetary independence and the effectiveness and credibility of monetary policy need to be supported through the fiscal regime. The SGP appeared desirable as a way of 'safeguarding the credibility of ECB independence' (Artis and Winkler 1999).

Fourth, in a monetary union the role of economic policy **co-ordination** becomes pertinent (Begg 2002), aiming at an appropriate policy-mix between monetary and fiscal policy. The fact that the 'one-size-fits-all' monetary policy of the ECB destabilizes countries with an inflation rate significantly off the Eurozone average has increased the need for strategic and co-ordinated fiscal policy, potentially even going beyond the automatic stabilizers. The co-ordination issue grows in importance with the likelihood of asymmetric shocks and increasing divergence between the participating economies. Weak economic growth in the Eurozone is due to structural rigidities but becomes amplified by cyclical swings. Governments would be ill-advised to implement pro-cyclical policies of cutting (investment) expenditures and increasing (tax) revenues during a downturn. Some economists have misinterpreted the SGP in this way and strongly criticized it for hindering counter-cyclical moves

(Eichengreen 1996; Eichengreen and Wyplosz 1998). This view is exaggerated but the SGP is still not a suitable framework for a co-ordinated and strategic response to the cyclical component of Europe's weakness. Co-ordination *à la* SGP complements the European Union (EU) economic co-ordination framework centred on the Broad Economic Policy Guidelines (BEPG)[8] but remains rudimentary and improvised, only asking member states to 'keep their house in order' (Issing 2002). A more effective solution for economic policy in Europe could be a positive outcome of the current crisis.

2.2 The politics of the SGP

The Maastricht Treaty is an incomplete contract as far as rules on EMU are concerned. Theoretically there were two options. The first would be the status quo, relying essentially on voluntary arrangements. The member states would all agree to continue to meet the convergence criteria also after EMU had started. The second option was to impose explicit rules that would elaborate on and even go beyond the Treaty stipulations. This issue was left open precisely because it was highly contentious and exposed fundamentally different views on economic policy.[9] Voluntary arrangements had been the implicit road that was chosen in the Maastricht Treaty. However, the Germans and the Dutch in particular favoured a more explicit, rule-based system that would restrict budgetary deficits once EMU was fully operational. This concern seemed especially relevant with respect to a number of (Mediterranean) countries that were making strenuous efforts to be part of the first wave – against all odds at the outset.[10] The larger the future membership of EMU was appearing to become and the less likely a postponement, the more urgent grew the need for Germany to reinforce at least the deficit criterion. This situation has been described as an 'endgame' for the transition towards stage III (Crowley 2002).

The political background of the SGP can be traced back to German domestic politics. It was used to comfort public opinion and to appease the Bundesbank. The German public needed reassurance on EMU as it had become extremely anxious about giving up the well-proven Deutschmark in favour of a new single currency that would include traditionally weak economies which lacked a stability culture. Politically, there was a risk that the opposition and even Waigel's own party in Bavaria under Prime Minister Edmund Stoiber would capitalize on this sentiment and run on an anti-EMU platform.

More subtle forces were also at work. Of importance was the gradual nature of economic and monetary integration, especially the experience with the European monetary system (EMS). Co-operation in the context of the EMS had implied that most monetary authorities had contributed to factual convergence in monetary policy with the de facto fixing of exchange rates as its result. What had been happening over the 1980s was a 'shadowing' of Bundesbank policies. The resulting convergence meant that monetary authorities had learnt lessons about economic and monetary governance (Verdun

2000a). Experts feared that national governments would become more 'relaxed' and return to old practices once EMU would be fully operational. They were keen to perpetuate the stability orientation of economic policy in Europe.

3. NEGOTIATING THE PACT

How did the SGP come about? The idea of some sort of 'stability treaty' was in the air in early 1995. The Maastricht Treaty had already stipulated the need for further legislation (see above). Since the beginning of stage two of EMU in 1994, the Monetary Committee (MC) had deliberations on this matter. Officials in the German Ministry of Finance were also discussing this topic amongst themselves. The *Sachverständigenrat*, an advisory board to the federal government, had already demanded in its 1992 annual report that the sanctions be made more precise and be applied in a strict manner (Sachverständigenrat 1992: 433). It became the subject of a public debate orchestrated by Bundesbank President Hans Tietmeyer. The debate picked up during autumn 1995. The *Institut für Weltwirtschaft* (IfW) in Kiel published a discussion paper on how to make the Maastricht stipulations workable (Lehment and Scheide 1995). The IfW proposal suggested automatic, interest-free deposits with the ECB for countries exceeding 3 per cent that should be paid back as soon as the excessive deficit was removed. The paper was prominently discussed in the *Frankfurter Allgemeine Zeitung* (*FAZ*, 12 October 1995) and was seconded by positive comments of the Bundesbank (*FAZ*, 15 October 1995). The arguments reappeared as demands for a 'budgetary pact' in the 1995 report of the *Sachverständigenrat* (Sachverständigenrat 1995: 446).

Waigel and Kohl were now under severe political pressure. As was briefly alluded to above, public opinion was becoming very negative towards EMU. The SPD opposition party was making populist remarks on the dangers to stability stemming from the EMU project and demanding stricter rules, thereby literally mirroring Bundesbank statements (e.g. Scharping 1995). In September 1995, Waigel had been informally talking to his colleagues about his desire to formalize the rules on budgetary policy in EMU (Milesi 1998: 95-6; Stark 2001: 89 and interviews with German Ministry of Finance officials, June 2003). Four weeks later (7 and 10 November 1995), Waigel announced his version of a 'Stability Pact' (Bundesministerium der Finanzen 1995) to the public during the second reading of the 1996 budget (Waigel 1995a, 1995b). Parallel to that, Waigel commissioned an official at very short notice to write up an English draft for his European colleagues. These however responded with reserved support.

The idea that the Maastricht Treaty could be subject to renegotiations was out of the question. Yet, an intergovernmental agreement in the form of a new treaty *à la* Schengen, as originally envisaged by Waigel and his state secretary, Jürgen Stark, was unacceptable to the other countries. The Commission also realized the dangers of an intergovernmental solution because it would imply the marginalization of Community institutions and procedures. The Council therefore prompted the Commission to propose a solution within the Community framework. Its proposal, released in October 1996 (COM (1996) 496), was closer to the Maastricht Treaty than to the Waigel paper. It developed the 'surveillance arm' of the SGP as a rudimentary device for economic policy co-ordination. However, it did not include automatic fines but reduced the sanctions to a discretionary measure of the Ecofin Council. The fact that Ecofin ministers have to judge each other poses an obvious incentive problem.

The Stability Pact dossier was discussed in the Monetary Committee (MC), the Ecofin Council, the European Council and at Franco-German meetings. The bulk of the work was completed in the MC. Only very few open issues had to be referred to Ecofin. The major controversy was that Germany's partners agreed on the principle of mutual surveillance and reinforced dissuasion of excessive deficits, but did not accept automatic sanctions. The focal point of dissent became the clause that stipulates the exemptions from sanctions, since here lies the ultimate lever for political discretion. Waigel was completely isolated in requiring nothing less than an 'exceptional' GDP contraction of 2 per cent or worse as a qualification for an exemption. The compromise reached in Dublin during the early morning of Friday, 13 December 1996 in parallel sessions of Ecofin and the European Council states that a recession of less than 0.75 per cent 'as a rule' does not qualify as exceptional, whereas a recession of over 2 per cent automatically does. If the size of the recession is between 0.75 and 2 per cent, Ecofin determines whether or not it is deemed 'exceptional'.[11] Once the sanctioning procedure (TEC 104 IX) has started, only EMU member states have a vote, excluding the country in question. A voting alliance against the SGP then becomes even more concrete and likely, as eventually occurred on 25 November 2003.

The SGP has delivered some 'added value'. It has shortened the timeline of the sanctions mechanism, defined the distribution of the fines (among the 'virtuous' member states), clarified the notion of 'exceptional' and 'temporary' deficits as exemptions from sanctions, introduced an urgency procedure, enabled the suspension of the EDP, and improved the juridical procedures of the steps involved. Yet, due to the politicized nature of the EDP, the essence of the pact is not a mechanism of 'quasi-automatic sanctions' but the institutionalization of a *political* pledge to aim for low deficits. The procedures cannot be enforced by legal means. This has been confirmed by the ECJ on 13 July 2004. The court overturned the Ecofin conclusions on France and Germany of 25 November 2003 but not the decision to halt the EDP.

4. ANALYSING THE BIRTH OF THE STABILITY AND GROWTH PACT

For the analysis of the birth of the SGP we combine an ideational approach with an actor-centred, institutionalist perspective. First, we focus on how ideas came to shape the preferences of actors and, second, on how their constellation and interaction produced the outcome. Following Scharpf (1997), 'actors' are defined as individual or corporate strategic agents (mostly administrative bodies such as ministries and the Commission). They are capable of intentional action, are internally organized along hierarchical lines, and are characterized by preference orientations as well as action resources. Furthermore, they are embedded in an institutional context, which we use as explanatory shorthand for structural factors and external influences on the actors themselves, such as the influential role of financial markets at certain stages in the negotiation process. We define the executive agents of the negotiating ministries, of the Commission and of central banks as 'experts'. They are in contact with 'non-actor experts' who shape ideas but not decisions, such as academics, journalists and institutions like the OECD or the International Monetary Fund (IMF). On the highest levels of deliberations, we introduce 'non-expert actors', holding the final and democratically legitimated decision-making competence – 'politicians'. The orientations of experts are defined by specific converging 'ideas' about economic policy, influenced indirectly by non-actor experts. The orientations of politicians are crucially influenced by experts. A graphical illustration summarizes how experts ('actors' as well as 'non-actors') and ideas came to shape politics, thereby converging on the compromise that enabled the conclusion of the SGP.

4.1 Ideational convergence

From an ideational perspective the creation of EMU can be seen as the result of policy learning and policy convergence, based on convergence in ideas about monetary policy-making. When EMU was first conceived in the late 1960s and early 1970s, ideas differed widely, i.e. on the question of whether to converge policies first or whether to proceed with monetary integration and assume that convergence would result. Concepts varied on the policy objectives and on the institutional design of EMU. The 1970 Werner Plan on EMU reflected a time when governments were frequently pursuing Keynesian policies (Committee on the Realization by Stages of Economic and Monetary Union 1970).

Though the actual institutional design of EMU as envisaged by the Delors Committee in 1989 did not differ much from its 1970 design, a number of important developments occurred in the years between the two plans. First, economic and monetary integration had achieved a higher level of integration in both areas: the process of completing the internal market was under way, financial markets had become further integrated and the EMS had been in place for a decade. Second, policy learning had taken place. Monetary policies were only successful if they were in line with that of the dominant member state, namely Germany. Third, ideas regarding monetary policy-making had changed (see *inter alia* McNamara 1998; Marcussen 2000). Whereas in the 1960s and 1970s Keynesian principles still lay at the heart of national government economic policies, by the late 1980s monetarist policies dominated. The change in belief was that there was no long-term trade-off between inflation and unemployment and that sound money was a precondition for growth.

In their effort to proceed with monetary integration, the governments of member states were aided by a so-called 'epistemic community'. Members of central banks, ministries of finance and academics held similar views about the main aim of economic and monetary policy-making. There were a few important venues where experts shared ideas and socialization occurred. This took place above all in the MC – now called the Economic and Financial Committee – which consists of representatives of central banks and Ministries of Finance of the EU member states (Verdun 2000b), as well as in other influential European Community (EC) committees (Rosenthal 1975; Verdun 1999) and international fora. The members of the MC meet Haas' four principles that define the existence of an epistemic community (Haas 1992: 3). First, they shared beliefs in a value-based rationale of social action. Second, they shared causal beliefs, which are derived from their analyses of problems which then serve as the basis for understanding the linkages between policy actions and desired outcomes. Third, they have shared notions of validity – that is, intersubjective understandings that help them to weigh ideas within their area of competence. Fourth, they have a common policy enterprise and common practices associated with a set of problems to which competence is directed. It is no surprise that the member states' Heads of State or Government relied on the MC for proposals and suggestions for action. The literature on epistemic communities indeed suggests that a group of experts is often called upon when national governments are divided on intergovernmental collaboration. The MC was an ideal group to ask for advice as its members can wear two hats. They can act as independent experts yet they are fully aware of the political issues at stake.[12] It was crucial that the actors had learnt certain lessons and held certain common beliefs. But those ideas alone were insufficient to produce the concrete SGP.

4.2 Negotiated compromise

Figure 1 presents an overview of the most important actors, grouped according to their resources and orientations. It shows initial orientations in November 1995 (when Waigel issued his proposal) and the orientations in June 1997 which by then had converged. The horizontal axis depicts the actors' politico-ideologically shaped preferences for or against strict rules for fiscal discipline. The vertical dimension shows their power resources and decision-making capabilities. We distinguish between a 'political' and an 'expert' sphere. Our distinction highlights the fact that politicians – not experts – settle the most controversial issues. The stylized process is that the whole negotiation dossier is split up into a set of issues (timeline, exemptions from sanctions, distribution of fines, etc.) which are discussed at the expert level. Experts receive their instructions from politicians but are free to reach agreement within these bounds. Politicians will in most cases simply tick off the agreements reached

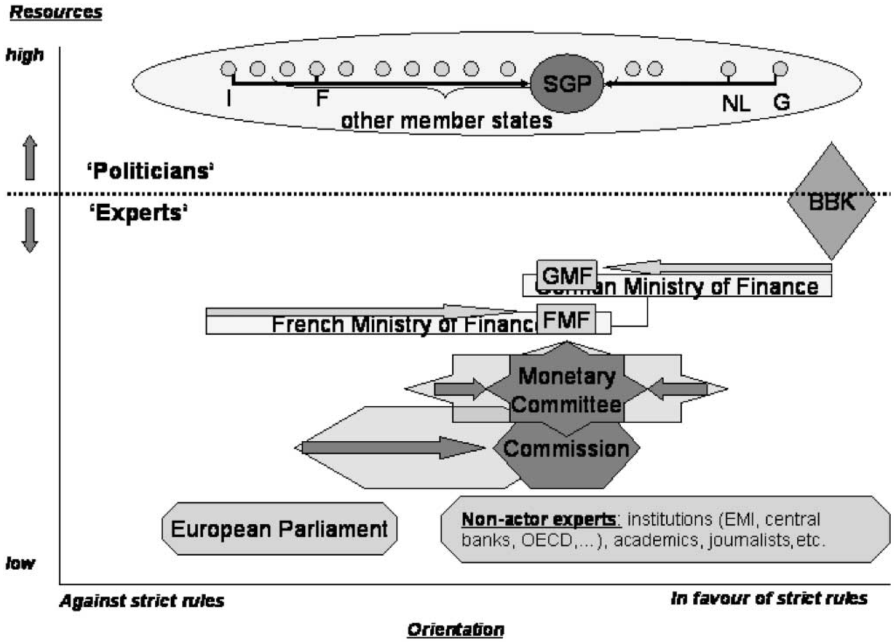

Figure 1 Initial preferences and subsequent convergence

among the experts. Only issues on which there is no consensus are deliberated on at the political level. The decision-making process is hence conceived in a bottom-up manner. Experts are in a strong position to influence politicians since they possess intimate knowledge of the relevant issues and have detailed information on the bargaining positions of the others. They can indicate potential solutions and hence possibly prevent the discussion from being deadlocked. We will now briefly discuss each actor in turn.

Actors at the level with the highest resource capabilities are **member state governments**. Their decisive position in the deliberation process corresponds to the concept of 'power politics' (Garret 1994). They are the legislative body. The role of other actors is only indirect via the influence they have on the orientation of the governmental actors. The state actors are either Ministers in the Ecofin Council or Heads of State or Government in the European Council. The preference points on this level initially cover the entire range between pro and contra Waigel's proposal – Germany being on the right side, closely followed by the Netherlands, whereas France and other Mediterranean states initially found themselves on the other side.[13] The German **Bundesbank** (BBK) figures as a special actor with the resources of an informal veto. Figure 1 displays only the two most important **national treasuries**, those of France and Germany. Each Ministry and each central bank plus the Commission had two representatives in the **Monetary Committee** (MC), which was crucial in preparing the ground for the compromises found in the political sphere. Its crucial role is best interpreted by the notion of an 'epistemic community' as was mentioned above. In terms of power resources, it lies below national ministries and the political level, but its importance relates to the fact that it was the actual forum in which the compromise was reached. The **Commission** is placed low in terms of decision-making power but successfully achieved a solution within the Treaty framework, and thus prevented an international agreement *à la* Schengen. Another success for the Commission was the inclusion of the surveillance procedure in the SGP. It nevertheless had to depart quite considerably from its initial preference, which had been more to the left of the negotiated outcome. The **European Parliament**, with a rather negative stance towards a strict pact, was unable to bring substantial influence to bear on the deliberations and is therefore placed on the lowest level. Finally, a set of 'non-actor' **experts** was able to make its influence felt through informal and professional contacts, communication and the gradual shaping of ideas that underpinned the slow process of ideational convergence: the European Monetary Institute (EMI), precursor to the ECB, and the central banking community with a close affinity to the Bundesbank position, should be explicitly mentioned as well as institutions such as the OECD, academic think-tanks, private-sector researchers, academics, etc. Their influence on the decision-making process was not direct but shaped the orientations of the actors.

Initially, actor preferences were widely dispersed. The Commission, once it had adapted its view and supported the design of a pact, was entitled to make its preference the base for the deliberations in the MC. Of course, it had to propose a pact that was still acceptable to Germany, albeit less strict and without automatic sanctions. In the MC a surprisingly rapid convergence emerged that was situated slightly more towards the right side of the preference scale, i.e. the 'German' end. One explanation of the emergence of this convergence is that a 'permissive consensus' (Lindberg and Scheingold 1970) already pre-existed in the MC, the members of which had already been in favour of a stability-oriented, rule-based model. In other words, the particular equilibrium solution was not yet determined, but the solution space and hence the type of arrangement that the solution would look like were already visible.

The final result reflects Germany's asymmetric bargaining power. The reasons for this privileged position were fourfold. First, Germany gave up the anchor-currency of the preceding regime, the EMS. Unlike the other countries, it had to accept the opportunity cost of losing monetary discretion and was able to ask for a higher price – a fact all too well known from the Maastricht negotiations (Dyson and Featherstone 1999). Second, the German position resembles Putnam's two-level game-constellation with the Bundesbank as an informal veto player (Putnam 1988). Due to its reputation and popularity, the Bundesbank had a strong influence on German public opinion towards EMU. If it were to oppose publicly the entry of a large 'wave' of countries into stage III, it would make it politically extremely costly for the Kohl government to press ahead. The creation of the SGP was a strategy to reduce public resentment by appeasing the Bundesbank. Thus the German preference set was narrowed through the informal (declaratory) veto exercised in Frankfurt, which forced others to realize that a solution would have to lie close to the German preference point. Third, Germany could credibly threaten to exit the EMU process. In fact, this implicit threat has repeatedly been used by German officials in the MC.[14] Fourth, the second worst threat-scenario was if Germany opposed membership of the 'Club Med' countries, Italy in particular. These countries had an incentive to agree to the pact so that Germany might be more acceptant of their membership. But even though the outcome is situated towards the German preference point, the German government had to give in as well, most importantly on the issue of automatic sanctions. Turning to the institutional context, we find that three parallel processes were crucial in shaping and facilitating the agreement.

First, the Franco-German 'axis' represents a subset of the negotiations on the European scene. Its most important function is a radical reduction of the number of negotiators involved which increases the likelihood of finding a compromise solution. These summits are important as France and Germany often represent different perspectives on these issues and thereby different groups of countries. As happens in other types of bargaining, it is as if France and Germany are 'delegated' to negotiate a settlement.[15] The actual solution was often not reached during Franco-German summits or economic consultations, but the subsequent meetings on the European scene benefited from the prior exchange of views and signals.

Second, the Ecofin negotiations were seconded by a parallel political process of summit meetings in the form of European Councils. The Heads of State or Government did not confine themselves to providing merely the initial political impetus. Instead, they punctuated and guided the negotiations throughout the process, thereby removing important obstacles to compromise, most notably in the case of the lower end of the definition of a severe recession that would constitute an exemption from the imposition of sanctions. The European Council not only issued strategic political aims but also defined operative solutions in surprising detail and delegated their attainment and the legal framing to the Ministers of Finance as well as to the Commission. The experience of the SGP negotiations should be seen as an important step in the institutionalization of the European Council.

Third, financial markets were influential in forcing the negotiators to agree on highly contentious issues. The fact that the Deutschmark rocketed against all other currencies involved whenever a deadlock seemed to jeopardize the course towards stage III of EMU imposed a substantial cost of failure on all negotiating partners. This disciplining factor contributed to the pressure to reach consensus. Actors would rather give in on issues defended as essential by their counterparts, than leave the negotiation room empty-handed. In summary, this section has sought to explain how ideational convergence, facilitated by asymmetric bargaining power and the institutional context, enabled the political compromise.

5. CONCLUSION

The watchdog has begun to bark. Will it break loose and bite or will it be forced to wag its tail and whine? The latter seems to be the case. We started off by asking why the SGP was created, what purpose it was to serve and what underlying conditions supported its creation. The economics literature at the time stressed the importance of consolidation, externality problems in EMU, central bank independence, and co-ordination of monetary and fiscal policies. Political factors range from the incomplete nature of the TEC to German domestic politics and policy learning. Ideas on the relationship between monetary and fiscal policy and the role of monetary policy in society more generally had changed over time and enabled a broad consensus in favour of fiscal discipline. The case study indicates that the genesis of the concrete outcome lay in Germany and that its creation was due to an asymmetric power-constellation. These two factors, ideas and power, together explain the origins of the SGP.

Designing rules is one thing, applying them another. A number of countries no longer act as if the SGP budgetary ceilings are to be taken seriously. In part it may be that politicians are opportunistic and underrate the repercussions of rising budgetary deficits as they pursue other domestic objectives. At the same time, it should be stressed that EMU and the SGP are likely only to have a positive effect on the economy if structural reforms are implemented. Some governments seem to have ignored the fact that, without these reforms, budget deficits may rise anew. They now wonder if the SGP can be seen as a watchdog that barks but is on a chain. Some have argued that the SGP may not be the right pact to enforce fiscal discipline. We have stressed that, even though that may be the case, its very effect on credibility depends on how it is treated when member states encounter fiscal difficulties.

The introduction asked what has changed since 1995–97 and what lessons can be drawn from that negotiation period for the future of the SGP. Our analysis suggests that what matters for the SGP are bargaining power and ideas. Regarding the former, some changes have occurred. First, Germany has lost some of its bargaining power due to the start of stage III of EMU in 1999. Germany no longer has the same potential to threaten not to join EMU or to create barriers to keep countries out. Second, Germany itself is no longer the exemplary member state it once was regarding budgetary discipline. As a result, partly because of the continued financial effects of reunification, partly because of changing political preferences, Germany no longer backs the SGP. It is mainly the Dutch government, aided by Austria, which now plays that role but is endowed with less bargaining power than Germany was before. A similar change can be observed regarding the role of ideas. The consensus among politicians on the importance of fiscal discipline may seem to be fading away under the effects of the last recession and the persistent lack of considerable economic growth. However, we argue that there is still strong support for the regime among the main actors on the expert level. The SGP was created to build credibility. Irrespective of whether it is a 'smart' or 'stupid' pact (to use Commission President Romano Prodi's words) it will only be able to do its job if member state governments do not mess too much with it – at least in the short run. It is likely that experts will influence the thinking in governments. They will also be the ones who shape the Commission's proposals for reforming the system.

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NOTES

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2 Resolution of the European Council on the Stability and Growth Pact, OJ 1997, C 236/1, Council Regulation No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies, OJ 1997, L 209/1, and Council Regulation No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, OJ L 209/6.

3 This lacuna is related to the fact that the negotiating parties were unable to agree on a political union in 1991. They seem to have been aware of the shortcomings and included in the EMU Articles the task of producing further legislation (TEC 99 V, 104 XIV).

4 Negative externalities are welfare or opportunity costs not fully accounted for in the price and market system, usually occurring because of a third party not being part of the transaction.

5 However, recent research suggests that the overall size of fiscal spill-overs within the euro area can be expected to be rather small as the several types of spill-overs to a large extent neutralize each other (Gros and Hobza 2001).

6 The deficit bias is partially counteracted through an increase in relative prices in the expansionary country. The resulting export loss should provide and re-internalize part of the necessary discipline.

7 The no bail-out clause implies that neither the ECB nor the Community will

provide funds to or buy bonds of a national government that becomes insolvent (TEC 101, 103).

8 According to Article 99 TEC, EU member states 'regard their economic policies as a matter of common concern'. The BEPG procedure serves this end in the following way. The Commission recommends the guidelines for each country to the Council of Ministers on Economic and Financial Affairs (Ecofin), which decides on a draft by qualified majority. The draft is then put before the European Council of the Heads of State and Government. Based on the European Council conclusion, Ecofin decides on individual recommendations, again by qualified majority. Since the recommendations are not backed by sanctions, the BEPG procedure is considered as 'soft' co-ordination.

9 A third option would be to have a new economic authority make decisions about these matters (Verdun 1998). This idea was first raised in the Werner Report (Committee on the Realization by Stages of Economic and Monetary Union 1970). It referred to this organ as a 'Centre of Decision for Economic Policy'. In the late 1980s, the French produced a similar idea when they called for a '*gouvernement économique*' (Verdun 2003). The creation of such a body has thus far not taken off due to the fear that it might undermine the independence of the ECB.

10 Ironically, in 1995 Germany itself for the first time breached the 3 per cent limit on budgetary deficits.

11 The decision can be blocked by a minority of at least twenty-six out of eighty-seven weighted votes or covering at least six member states (TEC 104 VI and 205 II).

12 One participant described their role as that of 'financial diplomats' (interview with the authors, 4 July 2003).

13 Though member states initially reacted positively to the 1995 Waigel proposal, they disagreed on important details such as automatic sanctions.

14 Interviews, 4 July 2003.

15 Milesi (1998: 145) quotes a delegation member of the Dublin summit: 'C'est un problème franco-allemand . . . Mettez-vous d'accord entre vous et nous accepterons votre solution.'

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