

**Both the UK's fiscal framework and the EU's Stability and Growth Pact (SGP) are designed to ensure sound public finances, as a pre-requisite to achieving stable long-term economic growth.**

**A comparison between the respective frameworks is not straightforward because of the different environments in which they operate: the UK framework applies just to the UK while the EU framework is designed to ensure consistency between the overall objectives of a number of decentralised fiscal authorities.**

**The UK fiscal framework is underpinned by a Code for Fiscal Stability which, given its legislative basis, secures credibility. Fiscal policy is set over the economic cycle which allows the necessary flexibility, while a number of mechanisms in place for regular reporting help to achieve legitimacy.**

**The EU fiscal framework operates at a number of levels which together set out rules and mechanisms for achieving effective surveillance of Member States' fiscal positions and for ensuring sound public finances across the EU. The framework is intergovernmental which is the basis of its legitimacy.**

**Both the UK and EU frameworks represent significant steps forward in recognising the importance of long-term budgetary discipline. Both are facing challenges in the current environment, as they have done in the past. Current experience suggests that the frameworks are potentially robust to cope but that they also need to evolve to deal with new challenges.**

## INTRODUCTION

**Theoretical basis 4.1** This section examines the fiscal policy frameworks in the UK and the EU (the fiscal policy framework generally operates at an EU rather than a euro area level). The operation of fiscal policy at a macroeconomic level has received less attention than monetary policy in the theoretical and applied literature. However, as introduced in Section 2, there appears to be a prevailing consensus that, in the medium to long term, fiscal policy should ensure the sustainability of the Government's fiscal position while, in the short term, it can be used to smooth output (at least to some extent).

**4.2** Both the UK and the EU frameworks for fiscal policy distinguish between the short term and the medium to long term. In the UK framework, the Government's fiscal rules are set *over the economic cycle*. In the Stability and Growth Pact (SGP), the fiscal rules contain a target budgetary position of close to balance or in surplus *in the medium term* – that is, over the course of the cycle.<sup>1</sup> There are differences of approach to exactly how these aims should be achieved, reflected in the implementation of fiscal policy in the UK and the EU. The UK framework attempts to ensure sustainability by identifying a level of net debt;<sup>2</sup> the SGP does so by limiting the permitted nominal budget deficit.<sup>3</sup> These potentially important implementation issues are addressed in detail below.

<sup>1</sup> The 2001 Code of Conduct on the content and format of stability and convergence programmes – endorsed by the ECOFIN Council – states that “*The time frame for interpreting the medium term would be the length of the business cycle*”. The Code of Conduct is available at <http://ue.eu.int/newsroom>.

<sup>2</sup> Other things being equal, net debt will be maintained below 40 per cent of GDP, over the economic cycle.

<sup>3</sup> Through a 3 per cent deficit ceiling and a medium-term requirement of budgetary positions close to balance or in surplus.

**4.3** A straight comparison between the UK and the euro area fiscal frameworks is inappropriate because their objectives and the environments in which they operate are very different. The EU rules are principally designed to provide a set of minimum standards for policy and to ensure consistency between the overall objectives of decentralised fiscal authorities. The UK framework is, by contrast, designed for the UK alone.

**4.4** Both the UK and the euro area fiscal frameworks are facing challenges at present, as they have done in the past. But current experience suggests that both frameworks potentially have the robustness to cope with this.

**4.5** While rules for fiscal policy are principally EU-wide, there are some important changes that EMU membership would entail for the UK. This study examines how the fiscal policy frameworks operate in general (the functioning of the SGP already has a bearing on UK fiscal policy) and the specific issue of the likely effects of the changes that a decision to join EMU would bring.

**Section structure 4.6** The first part of the section considers the motivation for fiscal rules across a monetary union of many nation states. The second part describes the main features of the current UK and EU fiscal frameworks. The third part outlines how EMU membership would change the UK's fiscal framework. The fourth part provides a substantive assessment, addressing some key questions, based around the objectives of credibility, flexibility and legitimacy:

- **credibility:** are the frameworks credible, including through ensuring long-term **sustainability**?
- **flexibility:** do they allow for short-run **stabilisation**, at least for countries with sustainable positions, and do they provide room for policies to improve the **quality** of public finances?; and
- **legitimacy:** do the **institutional arrangements** provide for policy processes which are the basis for the necessary public support?

**4.7** The final part of the section considers possible future developments.

## THE NEED FOR A FISCAL FRAMEWORK IN A MONETARY UNION

**4.8** It is not immediately clear that a move to a single currency necessitates the adoption of an overall fiscal framework covering the members of the monetary union. Why then are binding rules to ensure fiscal discipline required? There are two key risks from countries within a monetary union conducting their fiscal policies without any overarching framework or guiding principles:

- **free-rider problems:** which would arise if one member country sought to loosen fiscal policy in the expectation that other member countries would offset this by tightening policy. An overarching fiscal framework can help provide for effective coordination between the fiscal authorities participating in the monetary union, and this has benefits for the overall fiscal-monetary policy mix, as discussed in detail in Section 5; and
- **spillover effects:** as individual member countries alone may fail to take into account the impact of other member countries' fiscal policies. For example, a fiscal expansion in one country may push up interest rates faced by other countries, which in turn may generate an appreciation of the exchange rate. This is discussed in more detail below.

**Sustainability is key...** **4.9** The long-term goal of fiscal policy should be to ensure the sustainability of the public finances. High deficits and debts sustained over a period of time raise the risk of insolvency and could lead to a financing crisis. More broadly, unsustainable policies violate the principle of intergenerational equity, by forcing tomorrow's citizens to pay for today's current expenditure.

**...but only relevant if there are negative externalities** **4.10** However, if the costs of unsustainable policies fall entirely within the country that carries them out, they need not be the concern of area-wide rules. While damaging, they are a matter for the government and electorate of the country involved. Unsustainable policies are therefore most relevant if they have substantial negative externalities associated with them; that is, if the citizens of other countries suffer from the policies of a fiscally lax member country of a monetary union which 'free rides' on greater fiscal discipline elsewhere.<sup>4</sup> Were this so, it could suggest that national policies would be overly lax on average.

**Financing crises: three possibilities** **4.11** Such negative externalities do exist. A country within a monetary union that became unable to finance its expenditure would face three options:<sup>5</sup>

- it could default on its debts;
- it could receive direct transfers from other euro area countries or another international organisation to finance its expenditure; or
- it could persuade the central bank to cut interest rates, so reducing the cost of debt financing.<sup>6</sup>

**4.12** All three options would be harmful, for both the country involved and for other member countries. Debt default could result in higher future borrowing costs for the defaulting country,<sup>7</sup> and could increase the borrowing costs of other members ('contagion'). It is likely that direct transfers would be very unpopular with taxpayers in other member countries, as well as possibly setting a dangerous precedent by creating a 'moral hazard' problem whereby countries feel able to borrow recklessly in the knowledge that they will be bailed out by others. Were the central bank of the monetary union to cut interest rates (or refrain from raising them) when it was necessary to do so, this could result in excess inflation and the associated economic costs, as well as damaging the central bank's credibility.

**Larger negative externalities inside monetary union** **4.13** To take the example of the EU, while such negative external effects would affect all EU members, countries inside EMU would suffer more, for three reasons:

- since government debts are all denominated in the same currency, the risks of contagion could be greater;
- an interest rate cut for debt financing reasons could stimulate excess inflation across the euro area, with all of the negative effects this entails; and
- more broadly, the credibility of the euro area could be called into question by a debt crisis, especially in the early years of its existence.

<sup>4</sup> See, for example, Thygesen (2002).

<sup>5</sup> It is assumed that other methods of financing, such as a large tax rise or a large cut in public spending, have been exhausted, or are infeasible. Such moves can in any case be counter-productive, because of their dampening effects on domestic demand.

<sup>6</sup> In the extreme, it could get the central bank to print money to pay off government debts directly, as occurred in Germany in the 1920s.

<sup>7</sup> Though the example of Mexico since its default shows that such effects need not be long-lasting.

**4.14** Debt crises could also be more likely in a euro area country than in a country with independent monetary policy, since the former does not have the insurance against default provided by the possibility of a bail out by its central bank (as explained below). It is thus in a situation like that of many developing countries, with debts denominated in a ‘foreign’ currency.

**4.15** Arguably, therefore, one might expect large external negative effects of a debt crisis, which would not be taken fully into account by individual countries of a monetary union. It is sometimes argued that financial markets will discipline fiscally profligate countries by increasing their borrowing costs. There is, however, no reason to expect markets to internalise the costs and benefits of society as a whole (rather than those of investors); they are therefore unlikely to provide sufficient incentives for restraint. Moreover, market signals are only useful to the extent that governments respond to them appropriately. The occurrence of previous debt crises in emerging markets – despite rising borrowing costs in the period running up to the crisis – indicates that market signals are not always enough to bring about policy changes.<sup>8</sup>

**4.16** In the case of EMU, the Treaty explicitly rules out bail outs of one Member State by another, or by the ECB (Articles 101 and 103), as well as ruling out the influencing of the ECB by any national authorities (Article 108). This appears to confine the costs of insolvency to the country involved, which would have to default on its debts. However, some have suggested that the ‘no bail out’ clause is not credible.<sup>9</sup>

**Area-wide rules necessary...**

**4.17** On the assumption that there could be substantial external effects of a financing crisis, area-wide rules to support long-term sustainability would be useful. Such rules should also aid short-term stabilisation at a national level, by providing the credibility needed to borrow in a downturn. Of course, a financing crisis would always affect domestic taxpayers most, resulting in strong domestic pressures to avoid one, but area-wide rules could reinforce these pressures.

**...but fiscal federalism unjustified...**

**4.18** This could suggest that a central fiscal authority with the ability to spend or tax appropriately to stabilise output across a monetary union could be needed for the monetary union to function effectively.<sup>10</sup> Box 4.1 sets out the arguments for and against a federal fiscal policy, showing that the arguments for retaining control of fiscal policy at a national level are, in practice, clearly stronger than the theoretical arguments for implementing a federal fiscal policy. The case for fiscal federalism in the context of the US is considered in the EMU study by HM Treasury *The United States as a monetary union*, which concludes that:

- the degree of insurance provided by national fiscal systems within the euro area at least matches that provided by the US Federal Government;
- the US provides a greater degree of stabilisation through federal level fiscal policy than is provided (at the Community level) by the EU; and
- EU Member States have correspondingly greater freedom to run independent fiscal policies than US states.

<sup>8</sup> See Giavazzi and Favero’s contribution to the EMU study *Submissions on EMU from leading academics*.

<sup>9</sup> See, for example, Bean (1998a). Though von Hagen and Eichengreen (1996) conclude that the tax raising powers of national governments should help to buttress the clause’s credibility.

<sup>10</sup> See European Commission (1977) and Goodhart and Smith (1993).

...so rules should preserve national autonomy

**4.19** Area-wide rules should thus aim to reduce or eliminate the negative externalities of unsustainable policies within individual countries, while preserving a high degree of national autonomy and discretion. Within EMU, the loss of an independent monetary policy makes it important to preserve national room for manoeuvre – either in the face of country-specific shocks, or common shocks which impinge asymmetrically. In addition, structural reform is arguably even more important within EMU than outside, so governments need room to use fiscal policy to enhance supply side performance and flexibility. This is a key issue, which is analysed in depth in the EMU study by HM Treasury *Fiscal stabilisation and EMU*.

#### **Box 4.1: Federal fiscal policy – the case for and against**

It is sometimes argued that a federal fiscal policy is required to complement the single monetary policy (for example, ‘The MacDougall Report’, European Commission, 1977). Arguments for doing so, which are also set out in the EMU study by HM Treasury *The United States as a monetary union*, include:

- it would eliminate the free rider problem and ensure that spillover effects were fully taken into account;
- it enables the pooling of risk – fluctuation in one Member State’s budget could be offset by changes in other Member States’ deficits; and
- it may respond more quickly to economic circumstances in situations where individual countries may disagree about the course of action, perhaps resulting in lengthy negotiation and therefore raising the possibility that a delayed fiscal policy response actually further destabilises the economy.

However, as concluded in Currie (1997), there are stronger arguments for retaining control of fiscal policy at national level (for example, Korkman, 2001). In particular:

- the current EU budget cannot provide the degree of automatic stabilisation that is necessary and, crucially, there is no political appetite for a fully-fledged federal fiscal policy, which would raise further uncomfortable issues, such as national sovereignty and income redistribution;
- many Member States already have significant automatic stabilisers within their own national fiscal systems. Therefore it is unclear what a federal stabilisation scheme could achieve over and above what is possible by allowing the automatic stabilisers of the EU countries to operate;
- individual Member States have much greater expertise regarding their own economic circumstances and are better able to develop policies that reflect the preferences of their populations. Therefore they may be able to identify issues and respond more quickly;
- individual Member States can spread risk over time, by varying the deficit; and
- the benefits of a federal policy can also be realized by ensuring transparent fiscal objectives and reporting at the national level and by initiating a process of intensive dialogue so that all Member States are aware of what each is doing. This process can be backed up by sanctions to prevent extreme policies that stand clearly against the common good.

In his contribution to the EMU study *Submissions on EMU from leading academics* Fatás argues that “the implementation costs [of a European fiscal federation] are too large to compensate for the small potential benefits”.

**Comparison with the UK not straightforward** **4.20** This discussion makes clear that a simple comparison between the UK and EU fiscal frameworks would be inappropriate, because of the different challenges faced and the need to preserve national autonomy in the case of the EU. But in both cases, the importance of both the short term and the medium to long term, which is a key theme of this study, holds – in the medium to long term, fiscal policy needs to ensure sustainability while, in the short term, fiscal policy needs to help stabilise the economy. So comparison can be useful.

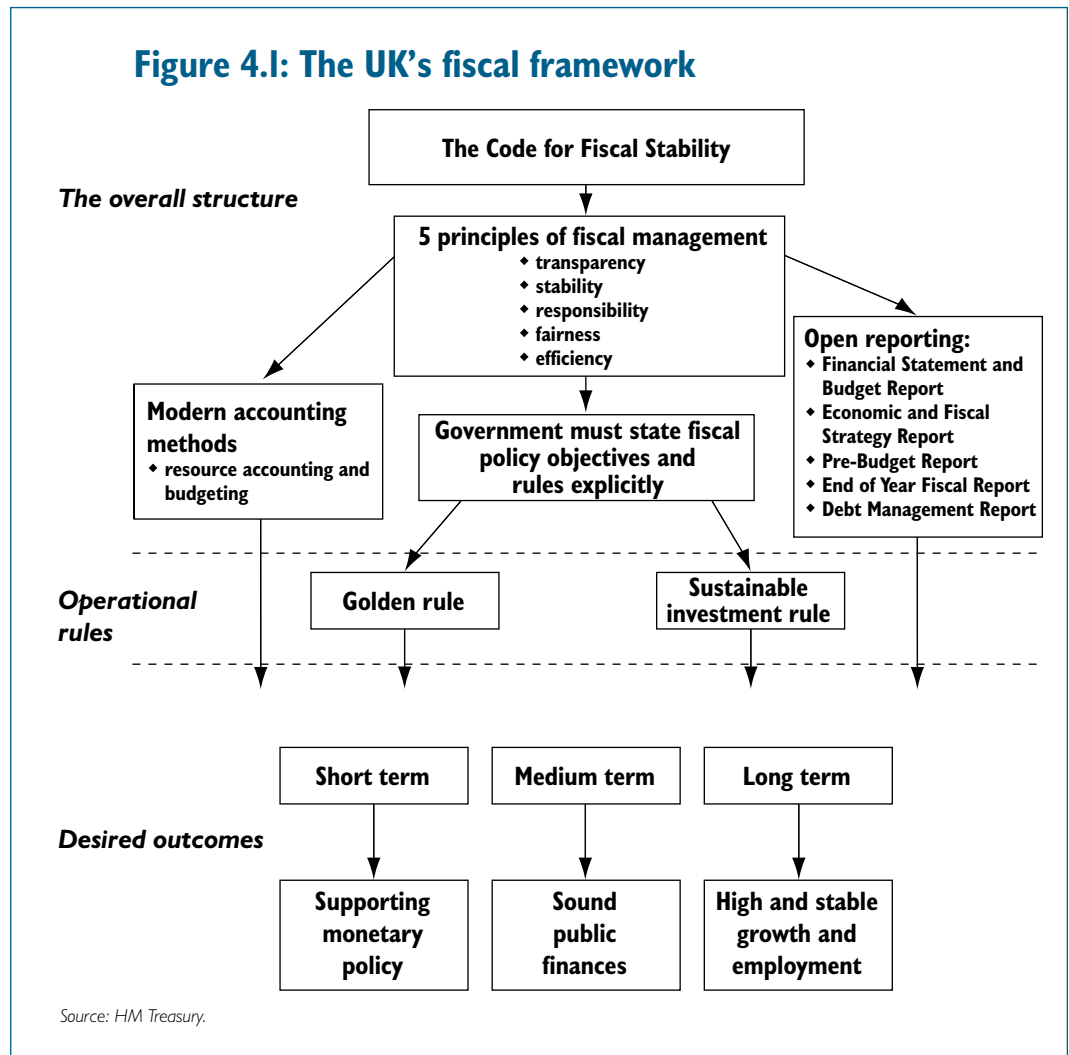
## **KEY FEATURES OF THE UK AND EU FRAMEWORKS**

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**4.21** This sub-section paves the way for subsequent analysis by examining the current fiscal frameworks in operation in the UK and the EU.

### **The UK framework**

**4.22** The UK's fiscal policy framework, outlined schematically in Figure 4.1, was established in 1998 and designed to overcome some of the problems experienced in the past. When the Government took office in 1997, it was faced with a large structural fiscal deficit, a legacy of low net investment, rising public debt and falling public sector net worth. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and parliamentary scrutiny. The Government therefore took steps to implement a new framework for fiscal policy – one that complements the Government's significant reforms to the monetary policy framework. The new fiscal framework is based on five key principles of fiscal management – transparency, stability, responsibility, fairness and efficiency.



**4.23** These principles were enshrined in The Finance Act 1998 and in the Code for Fiscal Stability (HM Treasury, 1998a). The Code explains how these principles are to be reflected in the formulation and implementation of fiscal policy. In addition, the Code requires the Government to set out its fiscal policy objectives and the rules by which it intends to operate fiscal policy. The Code also specifies extensive economic and fiscal reporting requirements on the Government to ensure the transparency of fiscal policy, including through annual reporting in the Budget and Pre-Budget Reports. The latest innovation to enhance further the reporting of fiscal developments was the publication in November 2002 of the first of what will be an annual End of year fiscal report (HM Treasury, 2002e). The Government is accountable to Parliament and the public for its conduct of UK fiscal policy, in particular through regular scrutiny by the Treasury Select Committee.

**Objectives 4.24** The Government's desired outcomes for fiscal policy are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- over the short term, to support monetary policy; and, in particular, to allow the so-called 'automatic stabilisers' to play their role in smoothing the path of the economy.

**4.25** In the long run, fiscal policy supports the Government's long-term goals by ensuring that the public finances are sustainable, contributing to a stable environment that promotes high and stable growth and employment.

**Fiscal rules 4.26** These objectives for fiscal policy are implemented through the Government's two fiscal rules, which also reflect the Government's commitments to fiscal sustainability and intergenerational fairness:

- **the golden rule:** over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- **the sustainable investment rule:** public sector net debt as a proportion of GDP<sup>11</sup> will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

**Public spending framework 4.27** In parallel to the reforms to the fiscal framework, the UK Government has created a modern and effective framework for planning and control of public spending which is delivering improvements in the quality and cost effectiveness of public services. Within this spending framework, current and capital budgets are managed separately, consistent with the distinction in the fiscal rules. The Government has also introduced resource accounting and budgeting (RAB) for the public sector, such that resources are now accounted for when they are used, not necessarily when they are paid for.

**Constrained discretion 4.28** While requiring fiscal policy to comply with these fiscal rules, the framework provides substantial flexibility, embodying the principle of constrained discretion. In particular:

- the rules are set over the economic cycle, allowing the fiscal balances to vary between years in line with the cyclical position of the economy. This allows the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the interaction of the two rules promotes capital investment while ensuring sustainable public finances over the long term. Promoting capital investment is particularly important in the UK given historical under-investment in public assets. The golden rule allows borrowing over the cycle for capital spending, while the sustainable investment rule ensures that borrowing for investment is conducted in a responsible way.

## The EU framework

**4.29** While individual tax and spending policies remain a matter for EU Member States, there is an EU framework to promote and maintain sound public finances and to aid coordination between the fiscal authorities. The main objective for fiscal policy which Member States have agreed in the EU is to safeguard sound government finances as a means to strengthen the conditions for price stability and for strong sustainable growth conducive to employment creation. This framework, which applies to all EU members, including the UK, has three levels:

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<sup>11</sup> Public debt figures can be quoted gross or net. *Gross* figures capture the total amount of the Government's financial liabilities - they take no account of offsetting financial assets. These figures are readily available and widely publicised, thus making them useful for international comparisons. The Maastricht public debt criterion is based on a gross measure of public debt. *Net* debt figures subtract a measure of liquid financial assets from the measure of gross debt. Because net debt provides a fairer reflection of a government's immediate solvency, this is the measure preferred by the Government.

- the **Excessive Deficit Procedure (EDP)**, agreed as part of the EC Treaty at Maastricht in February 1992;
- the **Stability and Growth Pact (SGP)**, adopted as a Council Resolution and two Council Regulations by the European Council in Amsterdam in June 1997, which builds on the EDP; and
- implementation through the **Code of Conduct** on the content and format of Stability and Convergence Programmes, agreed as an EFC Opinion endorsed by ECOFIN in October 1998, and revised in June 2001.

**4.30** As Allsopp (2002b) notes, the fiscal convergence criteria introduced for EMU entry, and the subsequent introduction of the SGP was a response to the “*explosive*” debt trend in Europe: “*it is worth recalling that the debt ratio for Europe as a whole more or less doubled from 40 per cent of GDP to about 80 per cent of GDP in the fifteen years from the 1980s to the mid 1990s*”.

**4.31** Table 4.1 compares the main features of the two fiscal frameworks.<sup>12</sup> As already noted, the UK and the EU fiscal frameworks operate at different levels, and – even outside EMU – the UK is obliged to follow many of the requirements of the EU framework, except the characteristics which, as discussed below and in Annex A, are specific to EMU.

**Table 4.1: Fiscal policy frameworks compared**

	<b>EU</b>	<b>UK</b>
<b>Objectives</b>		
Overall objective	To safeguard sound government finances through the avoidance of excessive deficits	Over the medium term, to ensure sound public finances; over the short-term, to support monetary policy; and over the long term to contribute to high and stable levels of growth and employment
Specific objectives	Deficits should be less than 3 per cent of GDP, debt less than 60 per cent of GDP. Budgetary position close to balance or in surplus in medium term	Net debt kept at stable and prudent level over the cycle (currently 40 per cent of GDP ceiling). Over the cycle, borrowing only to invest, not to fund current spending
Objectives set by	Member States, through European Council agreed EC Treaty, Council Resolution and Regulations	UK Government, underpinned by Code for Fiscal Stability
<b>Communication / Accountability</b>		
Reporting and publication requirements	EU Member States submit Stability or Convergence Programmes annually. Council publishes its Opinions on these (i.e. peer review)	Includes annual Budget and Pre-Budget Report; End of year fiscal report; and Debt Management Report.
Accountability	National governments responsible to own parliaments and electorates. European Parliament receives reports from Commission and Council on results of multilateral surveillance and can call Council President to appear	Government accountable to Parliament and people, especially through Treasury Select Committee

<sup>12</sup> Though certain specific features, such as the EU framework’s sanctions procedures, have no clear analogue in the other framework.

## How EMU would change the UK's fiscal framework

**Four changes** 4.32 Much of the discussion above has been concerned with the EU as a whole, rather than with the euro area specifically. So it is important to ask how a decision to join EMU would affect UK fiscal policy. Membership would mean that the UK would:

- be obliged to avoid excessive deficits rather than just endeavour to do so. The UK could be subject to sanctions were it judged to have an excessive deficit;
- have a vote in decisions on whether to impose sanctions on euro area members under the Excessive Deficit Procedure;
- submit annual Stability Programmes rather than Convergence Programmes (though the content would be unchanged); and
- participate in Eurogroup discussions, which aim to coordinate policy between the euro area fiscal authorities, and between the fiscal and monetary authorities.

4.33 Of these, the first and last are by far the most significant – the last is analysed in detail in Section 5. The first means that a breach of the limits of 3 per cent of GDP for deficits and 60 per cent of GDP for gross debt would raise the possibility of the imposition of sanctions. However, the sanctions would only be applied on the basis of a decision by the Council if an excessive deficit had not been rectified after a Council recommendation to do so. The imposition of sanctions also involves a lengthy process and follows an assessment that takes into account, among other things, the country's level of public investment and its medium-term economic and budgetary position. Sanctions are mainly designed to address persistent failure to meet the rules of the SGP. They have not been applied to date. As noted earlier, no changes could be required by the Council to specific tax or spending measures.

**The debt limit** 4.34 As already noted, the UK's sustainable investment rule states that, over the economic cycle, the ratio of net debt to GDP will be held at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle. Although the EU framework's 60 per cent limit is expressed in terms of gross debt it is still very unlikely that the UK would meet the sustainable investment rule while failing to meet the EU's debt limit,<sup>13</sup> so this change should not affect the UK's current framework.

**The deficits limit** 4.35 A more difficult question is whether the 3 per cent of GDP limit for deficits would impact on policy. This has not been an issue for the UK to date. The golden rule and sustainable investment rule, operating together, have both allowed the automatic stabilisers to operate fully over the economic cycle, contributing to macroeconomic stability, and allowed the government to undertake much needed quality public investment, whilst staying within the 3 per cent nominal deficit limit. Within EMU, however, it is not clear that monetary policy would always afford the same contribution to output stability as might be expected from a national central bank, the Bank of England in the UK case. If the UK were to enter EMU, to the extent that the UK were subject to asymmetric shocks, there would be a case for an enhanced stabilisation role for fiscal policy. This might be expected to involve wider fluctuations in the deficit, either from the full operation of the automatic stabilisers alone or their combination with supplementary discretionary fiscal action. These issues are explored more fully in the EMU study by HM Treasury *Fiscal stabilisation and EMU*.

<sup>13</sup> In 2001-02, UK general government gross debt (at 38.2 per cent of GDP) was only 7.8 percentage points higher than core debt (30.4 per cent of GDP). Core debt excludes the estimated impact of the economic cycle on public sector net debt – see HM Treasury (2002c). Debts are not very cyclically sensitive – for example, between 1989 and 1992 the UK's deficit level rose from a surplus of 0.8 per cent of GDP to a deficit of 6.4 per cent, but debts only rose from 43 per cent of GDP to 49.2 per cent (OECD data).

## Assessment of the issues

**4.36** The following sub-section considers to what extent the likely effects of EMU membership on UK fiscal policy would be beneficial, focusing on the four key questions introduced at the beginning of this section:

- **credibility:** are the frameworks credible, including through ensuring long-term **sustainability**?
- **flexibility:** do they allow short-term **stabilisation**, at least for countries with sustainable positions, and do they provide room for policies to improve the **quality** of public finances?; and
- **legitimacy:** do the **institutional arrangements** provide for the necessary public support?

**Prudent interpretation** **4.37** This assessment should be seen against the UK Government’s consistently stated position on the SGP. As set out in Box 4.2, the Government supports a prudent interpretation of the SGP that takes into account the economic cycle, sustainability and the important role of public investment. A prudent interpretation of the SGP would provide a long-term solution and strengthen fiscal discipline.

### Box 4.2: A prudent interpretation of the SGP

The Government supports the principle of a strong SGP founded on sensible fiscal policy coordination, as set out in the EC Treaty. It supports a prudent interpretation of the SGP, which takes into account the following factors:

- **the economic cycle** – allowing the automatic stabilisers to operate fully and symmetrically over the cycle will ensure that fiscal policy supports monetary policy in smoothing economic fluctuations. It is therefore important to focus on cyclically-adjusted fiscal balances when assessing public finances and subsequent policy decisions;
- **sustainability** – low debt levels enhance the sustainability of the public finances, allow more room for the operation of the automatic stabilisers and provide a sound basis for investment in public services and reforms to encourage productivity, employment and fairness. In considering the sustainability of public finances, it is necessary to examine the budgetary impact of an ageing population and, where possible, generational accounts; and
- **public investment** – against a background of sound public finances and economic stability, public investment contributes to the provision of high quality services and can help to raise the overall productive potential of the economy.

A prudent interpretation of the SGP will lock in longer-term fiscal discipline and sustainability, enhancing credibility, while allowing the automatic stabilisers to smooth fluctuations in output and appropriate increases in investment in public services.

## Credibility: the overall frameworks

**4.38** As with monetary policy, it is important that fiscal policy is credible. If the framework is not credible, its rules will be ignored and it may fail to achieve the desired objectives.

### Code the bedrock of UK credibility

**4.39** By providing a legislative basis for the way in which fiscal policy is determined, the Code for Fiscal Stability is the bedrock of the credibility of the UK fiscal policy framework. It provides for:

- a high degree of transparency, through the requirements that the Government: state explicitly its fiscal policy objectives and operating rules, and justifies any changes to them; publish annually a Pre-Budget Report, a Financial Statement and Budget Report and an Economic and Fiscal Strategy Report; and disclose all decisions and circumstances which may have a material impact on the economic and fiscal outlook;
- independent auditing of changes in the key assumptions and conventions underpinning the fiscal projections by the National Audit Office (NAO);
- the use of best-practice accounting methods, including a resource accounting and budgeting approach for planning and accounting for the costs of resources consumed by Government; and
- accountability to Parliament and the public, particularly through the Treasury Select Committee (TSC). Every report published as a requirement of the Code is referred to the TSC.

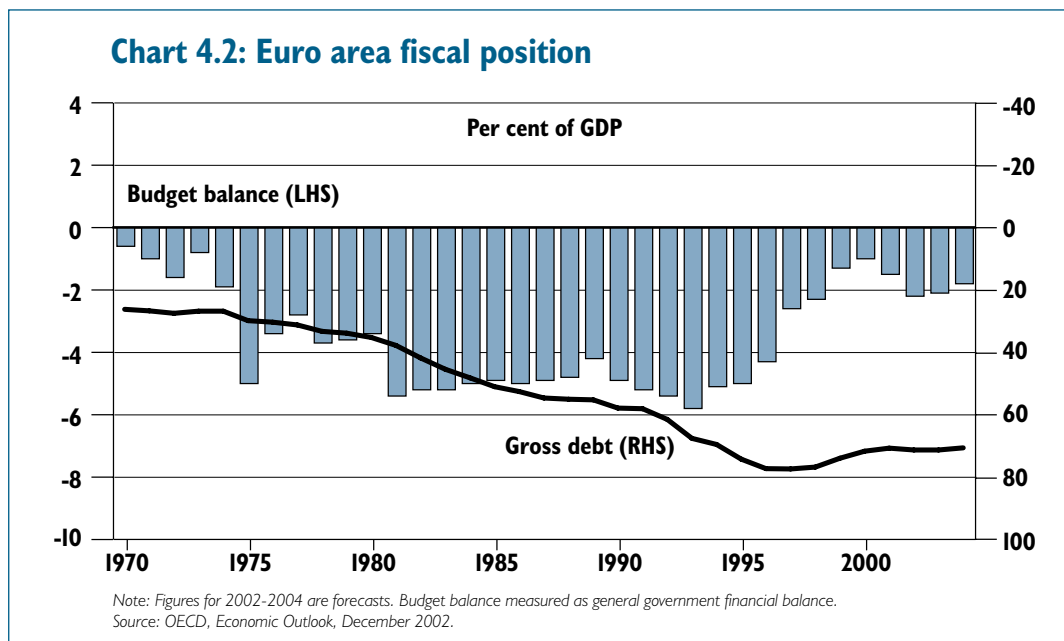
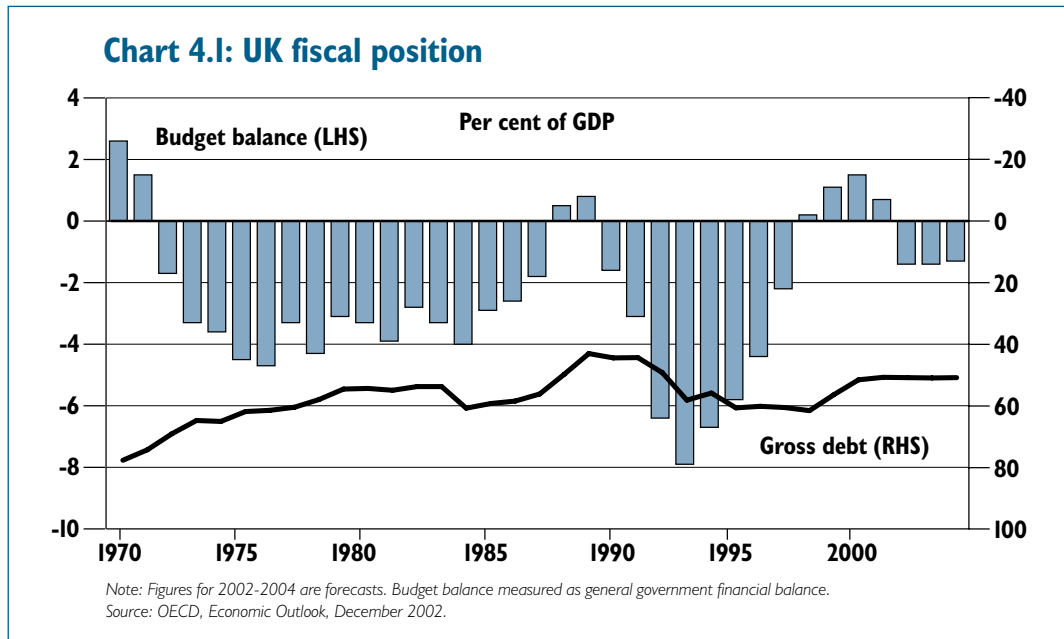
**4.40** The Government has also taken some measures to enhance credibility further, including by the publication of more information. For example, the Government publishes the details of the methodology it uses in assessing the UK's rate of trend growth and its cyclical position.<sup>14</sup>

**4.41** A further degree of credibility is provided by the use of cautious assumptions in calculating the public finance projections. In particular, the public finance projections are based on a trend rate of growth  $\frac{1}{4}$  percentage point below the Government's neutral view. This level of caution builds in a safety margin reducing the possibility of unexpected changes in taxation or spending, in order to meet the fiscal rules.

### Reinforced by track record

**4.42** The strength of the UK public finances in recent years has reinforced the credibility provided by the Code for Fiscal Stability. Despite the testing conditions of the recent economic downturn, UK deficits have been much lower than in previous periods when the economy was below trend, and public sector net debt has fallen from nearly 44 per cent of GDP in 1996-97 to under 31 per cent in 2001-02. Charts 4.1 and 4.2 show comparative deficit to GDP and (gross) debt to GDP figures for the UK and the euro area, both historically and projected into the future.

<sup>14</sup> See HM Treasury (2002b).



**EU framework – 4.43** initial success... Chart 4.2 shows that there was substantial fiscal consolidation in the euro area from the mid-1990s, spurred on by the conditions for EMU entry. The euro area's cyclically-adjusted general government deficit declined from 4.9 per cent of GDP to 1.6 per cent between 1995 and 1999. In contrast, as Allsopp (2002b) notes, “*whether one looks at actual or structurally-adjusted deficits, there was only a single year in the period 1980-95 when Europe as a whole would have met the Maastricht 3 per cent limit (and that was the boom year 1989)*”.

**...backed up by 4.44** useful reforms... The multilateral surveillance provided for under the SGP has enhanced its credibility. Assessment of growth and public finance projections by the Commission and by other Member States introduces an element of peer review, and helps constrain any bias towards over-optimism.<sup>15</sup>

<sup>15</sup> See, for example, the Council Opinion on the 2002 French Stability Programme, which states that the Council considers the ‘cautious’ scenario for GDP growth to be “*the more plausible one*”. This is available at [http://www.europa.eu.int/comm/economy\\_finance/about/activities/sgp/year20022003\\_en.htm](http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/year20022003_en.htm).

**...but criticisms have emerged** **4.45** However, credibility has suffered recently. Three particular criticisms which have been raised are:

- rules without a clear economic rationale;
- moving targets; and
- statistical difficulties.

**4.46** These issues have prompted considerable debate and reflection amongst all 15 Member States and the ECOFIN Council, particularly following useful proposals made by the European Commission to strengthen the coordination of budgetary policies in the EU. This is discussed in more detail below.

**Rules without clear economic rationale** **4.47** Of the three particular issues highlighted, perhaps the most damaging to the SGP's credibility is the accusation of a lack of clear economic rationale for some of its provisions.<sup>16</sup> This could be harmful to the achievement of the SGP's goals, as a lack of credibility makes enforcement of the rules difficult. The lack of economic justification could also cause difficulties in distinguishing between a breach of the rules by a state with fundamentally sound policies and finances and one by a state without. The current SGP leaves little scope to differentiate between countries on the basis of their individual economic circumstances, beyond deficit levels. Concerns that such a country-by-country approach might be perceived as a weakening of the SGP has led to a move to the other end of the spectrum: the imposition of mechanistic targets which take no account of individual circumstances. For example, in October 2002,<sup>17</sup> Eurogroup (with the exception of France), together with the Commission and ECB, agreed that those countries which had not yet reached the objective of close to balance or in surplus, needed to pursue continuous adjustment in their underlying balances of at least 0.5 per cent of GDP per year. The UK was not party to this commitment. As already noted, the Government believes that the SGP rules could do more to take account of individual economic circumstances, including the effects of the economic cycle, sustainability, and the role of public investment.

**Moving targets** **4.48** The medium-term objective of close to balance or in surplus, set out in Regulation 1466/97 has never been formally defined. As part of subsequent versions of the Broad Economic Policy Guidelines (BEPGs), Member States have agreed deadlines for the achievement of close to balance or in surplus. However, as it has become clear that such targets would be difficult or impossible to achieve they have been frequently revised. For example, the 1999 BEPGs urged Member States to achieve budgetary positions of close to balance or in surplus by the end of 2002; the 2002 BEPGs moved the target to, at the latest, 2004; while the October 2002 Eurogroup terms of reference implicitly moved the date back to 2006. While such changes may have been economically rational, they clearly show several countries failing to do what they said they would do, a key component of credibility.<sup>18</sup> And it also demonstrates the problems of setting single targets for all Member States which do not take into account the overall combination of Member States' circumstances, including their debt levels and public investment requirements.

<sup>16</sup> In his contribution to the EMU study *Submissions on EMU from leading academics*, Buiter states that the SGP's rules are not credible because they "are arbitrary and rigid in design." In his contribution to the EMU study *Submissions on EMU from leading academics*, Méltz argues that "The means of enforcing the ceiling are too weak, and this is true in no small extent because of the limp justification for the ceiling". See also Pisani-Ferry (2002), page 7, where he says "It is a fact of life that a law that has lost justification is not considered legitimate anymore and cannot be credibly enforced for long".

<sup>17</sup> Eurogroup 'Terms of reference on budgeting developments in the euro area', 7 October 2002. This is available at <http://www.ypetho.gr.eurogroup>.

<sup>18</sup> According to Blinder's (1999) definition.

**Statistical difficulties** 4.49 Statistical difficulties have also been highlighted. The existence of an excessive deficit in Portugal for 2001 was only identified by ECOFIN in November 2002, following the release of substantially revised statistics. The frequent use of one-off measures to reduce the reported deficit in a given year has also been a factor<sup>19</sup> – the IMF (2002b) argue that such measures do not reflect genuine sustained consolidation and should therefore be excluded when possible. However, there have recently been useful moves to improve the reliability of statistics, including ECOFIN's adoption of a Code of Best Practice on compiling and reporting data in the context of the EDP on 18 February 2003.

**Box 4.3: The credibility of the sanctions procedure**

Some commentators have suggested that the SGP's sanctions procedures might not ever be used in practice.

However, Council Regulation (EC) No 1467/97 lays out a very clear procedure for implementing sanctions, with 'get-out' clauses tightly defined, making the system perhaps 'semi-automatic'.<sup>a</sup> Indeed, while it is true that major sanctions would only be imposed after a lengthy procedure, with numerous opportunities for ECOFIN to halt the process, the Council has already shown itself prepared to implement the procedures of the EU's fiscal policy framework, for example by judging that Portugal and Germany are in excessive deficits positions. The fact that the Member State concerned does not get a vote on Council decisions relating to any sanctions on them (Article 104(13)) might limit the scope for political dealings.

Furthermore, punishment of an overly lax country can be provided by peer pressure from EU partners: a government that was consistently judged by the Council to be running excessive deficits without a legitimate reason could lose its domestic credibility.

The Excessive Deficit Procedure could also serve to reinforce market pressures. A country whose fiscal position is in the political spotlight is likely to be subject to intense market scrutiny as well. If it failed to take corrective action it could face increased risk premia. The fines available to the Council at the end of the process exist mainly for particularly persistent offenders.

<sup>a</sup> As argued by Costello (2001).

## Credibility: sustainability

4.50 Credibility can also be assessed by considering whether the rules, if strictly adhered to, would ensure long-term sustainability. This requires analysis not just of explicit liabilities measured by debt ratios, but also of any implicit liabilities, such as those arising from the costs of an ageing population. As Jacquet and Pisani-Ferry (2001) put it "*the monitoring of the current deficit and debt ratios does not provide a sufficient assessment of the actual state of public finances. This is particularly true if there are implicit and other "off budget" liabilities (such as public sector pension commitments or guarantees to public entities) that may threaten fiscal sustainability in the long run. Instead, one needs to have a medium to long-term vision, based on the concept of sustainability*" (page 11).

<sup>19</sup> See Easterly (1999).

- UK framework** 4.51 In the UK framework, the sustainable investment rule ensures sustainability. By maintaining the net debt to GDP ratio at a stable and prudent level over the cycle debt levels do not have an opportunity to move onto an explosive path.
- UK: high degree of long-term analysis** 4.52 The UK fiscal policy framework incorporates a high degree of long-term analysis, notably in the requirement in the Code for Fiscal Stability that the Government publish illustrative long-term fiscal projections at least once a year. And the Government has gone beyond this requirement, by also initiating the annual publication of a Long-term public finance report in November 2002 (HM Treasury, 2002f).
- Debt reduction particularly important in euro area...** 4.53 Debt stabilisation and reduction are especially important in the euro area, which experienced steadily increasing debt levels until the mid 1990s. Afonso (2000) argues that only three EU countries followed clearly sustainable fiscal policies over the 1968-97 period.<sup>20</sup> In theory, the deficit, debt, and close to balance rules in the euro area framework should ensure sustainability. Indeed, strict adherence to the SGP might be expected to reduce debt levels to close to zero in the long term. While sustainability may in theory be guaranteed by strict adherence to a 3 per cent deficit limit, such strict adherence might become politically and economically unfeasible if a country were facing large increases in its pensions payments that would require large tax rises.<sup>21</sup>
- ...but has stalled recently** 4.54 However, while there was clear consolidation in the run up to EMU, debt reduction now seems to have stalled, with the European Commission expecting the euro area's debt to GDP ratio to fall only marginally in the coming years.<sup>22</sup>
- The problem of ageing** 4.55 As already set out, the EC Treaty includes debt levels alongside deficits as criteria for fiscal discipline though to date these have not been made operational in the EDP. ECOFIN emphasised in its declaration of 1 May 1998, accompanying the decisions on the first wave of EMU membership, the importance of reducing debt to more sustainable levels, stating "*the higher the debt-to-GDP ratios of participating Member States, the greater must be their efforts to reduce them rapidly.*" But given that debt consolidation now seems to have stalled, this suggests there may be insufficient incentives in the SGP to encourage sustainability. Indeed, on 7 March 2003 ECOFIN agreed conclusions which re-emphasised the importance of debt reduction, noting the EDP could legally be triggered for a country with stubbornly very high debt, but a deficit below 3 per cent.
- 4.56 Long-term analysis is also less fully integrated into the EU fiscal framework than the UK, but there have been some moves in the right direction. For example, Stability and Convergence Programmes are now required to include sections looking at questions of longer-term sustainability.<sup>23</sup> Many of the latest Council Opinions on these programmes<sup>24</sup> emphasise the importance of a comprehensive 'three-pronged strategy' to address the budgetary costs of population ageing (consisting of debt reduction, raising employment rates of older workers and reform of pension and health care systems). The Economic Policy Committee (EPC), one of ECOFIN's supporting committees, also published a major study analysing the fiscal impact of population ageing in October 2001 (EPC, 2001). The EPC study demonstrates that some EU countries face very substantial increases in public pension expenditures in the coming decades (see Table 4.2). This makes consideration of the costs of population ageing (which go beyond pension costs and include healthcare and other social services) vital in assessing the sustainability of public finances.

<sup>20</sup> Germany, Austria and the Netherlands. The UK's fiscal policies were judged sustainable at a 90 per cent confidence level, but not at 95 per cent.

<sup>21</sup> See Minford's contribution to the EMU study *Submissions on EMU from leading academics*.

<sup>22</sup> From 69.3 per cent of GDP in 2001 to 68.2 per cent in 2004 (European Commission Autumn 2002 forecasts).

<sup>23</sup> The 2001 Code of Conduct states that "*Given the impact of longer-term demographic developments on the sustainability of public finances, information over a longer period should be included...*".

<sup>24</sup> Available at [http://www.europa.eu.int/comm/economy\\_finance/about/activities/sgp/year20022003\\_en.htm](http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/year20022003_en.htm).

**Table 4.2: Public pension expenditures (including most public replacement revenues) to people aged 55 or over, before taxes**

Per cent of GDP	2000	2010	2020	2030	2040	2050	Peak change <sup>1</sup>
Belgium	10.0	9.9	11.4	13.3	13.7	13.3	3.7
Denmark	10.5	12.5	13.8	14.5	14.0	13.3	4.1
Germany	11.8	11.2	12.6	15.5	16.6	16.9	5.0
Greece	12.6	12.6	15.4	19.6	23.8	24.8	12.2
Spain	9.4	8.9	9.9	12.6	16.0	17.3	7.9
France	12.1	13.1	15.0	16.0	15.8	15.8	4.0
Ireland	4.6	5.0	6.7	7.6	8.3	9.0	4.4
Italy	13.8	13.9	14.8	15.7	15.7	14.1	2.1
Luxembourg	7.4	7.5	8.2	9.2	9.5	9.3	2.2
Netherlands	7.9	9.1	11.1	13.1	14.1	13.6	6.2
Austria	14.5	14.9	16.0	18.1	18.3	17.0	4.2
Portugal	9.8	11.8	13.1	13.6	13.8	13.2	4.1
Finland	11.3	11.6	12.9	14.9	16.0	15.9	4.7
Sweden	9.0	9.6	10.7	11.4	11.4	10.7	2.6
UK	5.5	5.1	4.9	5.2	5.0	4.4	-1.1
EU	10.4	10.4	11.5	13.0	13.6	13.3	3.2

Source: EPC (2001).

<sup>1</sup> The peak change refers to the maximum change over the period 2000 to 2050 for any year (and not just the 10-year intervals reported in the table).

See EPC (2001), page 22, for more details.

**4.57** Sustainability is one of the key areas being considered by ECOFIN and the Member States following proposals made by the European Commission in November 2002 to strengthen the coordination of budgetary policies in the EU. This is discussed in more detail below.

### Flexibility: short-term stabilisation

**4.58** In the short term, provided that rules are adhered to and sustainability is not in doubt, fiscal policy should be flexible enough to be able to support monetary policy in smoothing economic fluctuations and stabilising output growth. To this end, fiscal policy should be *counter-cyclical* – the fiscal position should be looser in recessions and tighter in booms.<sup>25</sup> A *counter-cyclical* fiscal policy will be more feasible if fiscal policy is sustainable. Sustainability gives greater flexibility to react optimally to unexpected events.<sup>26</sup> And sustainability may be enhanced by certain tax and public spending measures which effect structural reforms which, in turn, improve such flexibility. The general role of fiscal policy in stabilisation is discussed in detail in the EMU study by HM Treasury *Fiscal stabilisation and EMU*.

#### High degree of stabilisation possible in the UK...

**4.59** In the UK, the fiscal rules are set over the economic cycle. This provides room for the automatic stabilisers to operate and also allows for changes in the fiscal stance to restrain or stimulate demand, provided that any change is symmetrical – a fiscal stimulus in a downturn is matched by a restraining measure in a boom.

<sup>25</sup> Counter-cyclical fiscal policy may also be justified by tax-smoothing considerations – see Barro (1979).

<sup>26</sup> See Buti et al. (1997), who show that, in recessions during the 1961-96 period in the EU, more fiscal stabilisation was carried out by Member States with relatively low deficit and debt ratios.

**...less in the euro area** **4.60** With monetary policy no longer able to react to country-specific shocks, there could be a greater need for fiscal stabilisation at a national level within the single currency. Despite this, there is less emphasis on the role of the economic cycle in the euro area framework, and the 3 per cent Treaty deficit limit is defined in nominal rather than cyclically-adjusted terms. This introduces an asymmetry that could reduce the degree of fiscal stabilisation in a downturn; a country whose deficit was close to 3 per cent of GDP might not allow the automatic stabilisers to work fully. Combined with the lack of deterrent to discourage countries from adopting lax fiscal policies in a boom, this could encourage pro-cyclicality: countries may loosen policy in booms and be forced to tighten them in recessions.

**Costs of high surpluses** **4.61** It could be argued that the SGP permits as much short-run stabilisation as a country wants, so long as the country has achieved a high enough surplus in normal times to permit it.<sup>27</sup> However, structural surpluses (or balanced budgets) could be undesirable if sustained for two reasons:

- depending on the circumstances and institutional setting, they could harm intergenerational equity. In particular, they could mean that the current generation pays for measures from which the next generation will benefit. This could place a squeeze on important public investment,<sup>28</sup> which may be particularly important for the EU accession countries, given their often higher nominal GDP growth potential and poor public infrastructure;<sup>29</sup> and
- they could damage financial market efficiency. Government securities are an important benchmark asset in financial markets. Were they to be reduced to zero, as structural surpluses could eventually imply, this could have a detrimental impact on efficiency.

**4.62** Notwithstanding this, some countries still have very high debt levels, and/or large unfunded liabilities arising from the costs of population ageing. For them, a position close to balance or in surplus in normal times may well be appropriate to aid sustainability,<sup>30</sup> but this does not mean that all countries should have to reach such a position.<sup>31</sup>

**Euro area policy less counter-cyclical** **4.63** The impact of the different prominence given to the economic cycle in the UK and the euro area frameworks can be seen in Charts 4.3 and 4.4. These confirm that in the run-up to EMU euro area fiscal policy was tightened at a time of economic weakness, prompted by EMU entry grounds. The charts demonstrate that fiscal policy has been considerably more counter-cyclical in the UK than in the euro area in recent years, thereby providing a greater degree of stabilisation.<sup>32</sup> However, it should be remembered that these charts are adjusted for the automatic effects of the cycle; the automatic stabilisers have generally been able to operate at least partially in the euro area.

<sup>27</sup> For this reason, the Swedish Government Commission on Stabilisation Policy recommended that the Swedish government run surpluses of over 2 per cent of GDP in normal times. See Government of Sweden (2002).

<sup>28</sup> Easterly (1999) claims that the Maastricht deficit rules harmed many public investment projects.

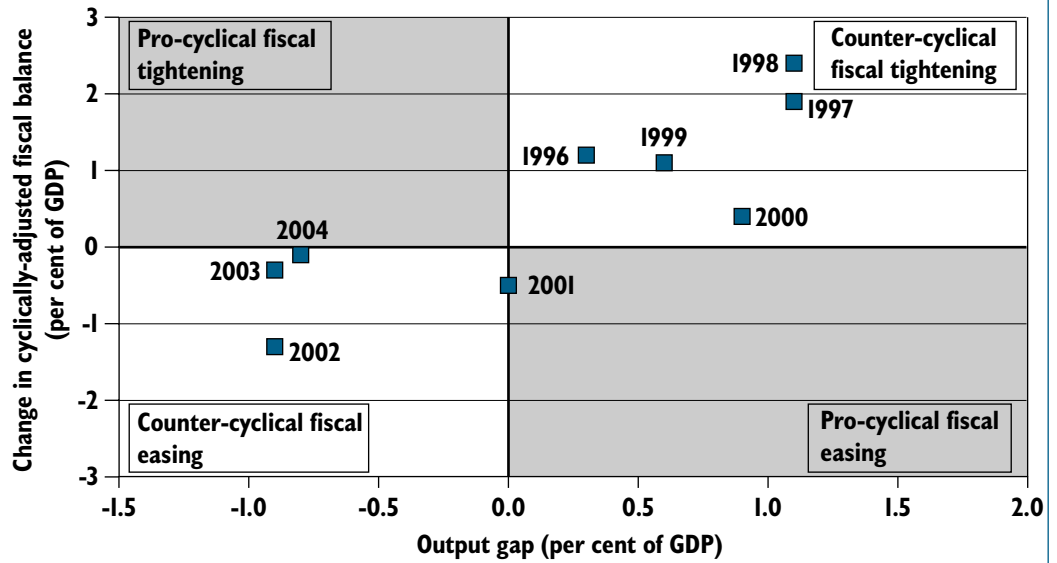
<sup>29</sup> See Buiter and Grafe (2002).

<sup>30</sup> See Cabral (2001).

<sup>31</sup> A point made forcefully in Charles Wyplosz's contribution to the EMU study *Submissions on EMU from leading academics*, which states that "a single quantitative limit for each and every country flies in the face of common sense", because of different debt levels and public investment needs.

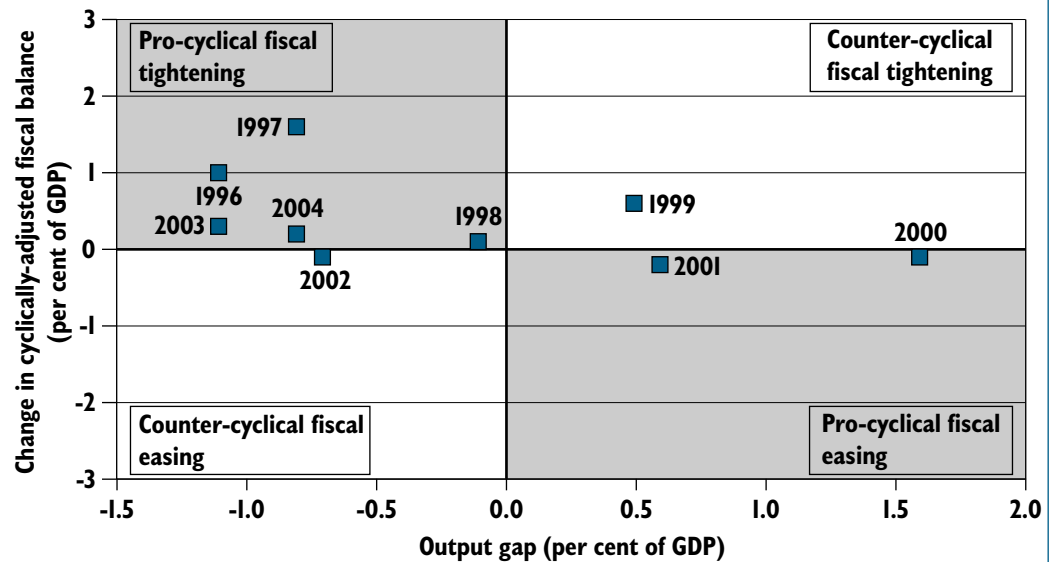
<sup>32</sup> The situation is similar for individual euro area countries; for example, fiscal policy in Germany is expected to be pro-cyclical in all but two of the ten years between 1995 and 2004.

**Chart 4.3: Cyclicality of fiscal policy in the UK<sup>1</sup>**



<sup>1</sup> This chart is based on Graph 1.2 of *Public Finances in EMU - 2002*, European Commission (2002a). It differs from Graph 1.2 in that it shows the change in the cyclically-adjusted fiscal balance rather than the cyclically-adjusted primary balance as the former is more commonly used as a measure of the change in the fiscal stance. Figures for 2002 to 2004 are forecasts. Source: European Commission forecasts, Autumn 2002.

**Chart 4.4: Cyclicality of fiscal policy in the euro area<sup>1</sup>**



<sup>1</sup> This chart is based on Graph 1.2 of *Public Finances in EMU - 2002*, European Commission (2002a). It differs from Graph 1.2 in that it shows the change in the cyclically-adjusted fiscal balance rather than the cyclically-adjusted primary balance as the former is more commonly used as a measure of the change in the fiscal stance. Figures for 2002 to 2004 are forecasts. Source: European Commission forecasts, Autumn 2002.

**Greater stabilisation may become possible under the SGP** **4.64** There is increasing recognition in the SGP of the importance of taking account of the economic cycle. For example, the 2001 Code of Conduct makes clear that the assessment of the appropriateness of Member States' medium-term objectives and the examination of their fulfilment have to take explicit account of the cyclical position and its effect on the budget. The use of automatic stabilisers to achieve greater stability was reiterated in the conclusions of the Ghent European Council in 2001.<sup>33</sup> The idea of taking more account of the cycle is recognised in the ECOFIN conclusions of 7 March 2003 following proposals made by the European Commission in November 2002. This is discussed in more detail below.

### Flexibility: quality of public finances

**Room to improve quality important** **4.65** For countries with sound public finances and economic stability, the fiscal framework should provide maximum capacity to adopt measures to implement structural reforms and improve the quality of public finances. In particular, there should be room for policies that help deliver structural reform and long-term economic benefits but require significant investment in the short run. The principle of intergenerational equity suggests that governments should borrow to finance such policies, meaning that the generations that benefit contribute to the cost.

**4.66** In the UK case, with a legacy of underinvestment in vital public services such as health and education, the ability to increase public investment is key.<sup>34</sup>

**UK framework** **4.67** The UK framework permits borrowing to finance priority public investment through the golden rule, subject to meeting the sustainable investment rule. It thus promotes long-term investment in public infrastructure. Public sector net investment in the UK is planned to more than double over the coming years, helping to address historically low levels of investment.

**EU framework** **4.68** The EU framework recognises, to some extent, the importance of public investment. For example, Article 104(3) of the EC Treaty states that assessment of whether a country's deficit is excessive should take into account "*whether the government deficit exceeds government investment expenditure*". Indeed, initial proposals for a fiscal stability pact explicitly called for "*priority in government spending for public investment*",<sup>35</sup> but the final Council Regulations on the SGP did not go any further than the provision contained in the Treaty.

**Recent discussions** **4.69** It is now widely recognised throughout the EU that greater investment in priority public services is crucial to raising growth and employment. As a result, the issue of providing for public investment within the EU fiscal framework is increasingly discussed at a European level. The President of the European Commission stated in a speech to the European Parliament in October 2002<sup>36</sup> that the SGP's clear rules need to be compatible with recognition that they "*apply to different countries in different situations as regards debt, financial burdens arising from the ageing of the population and public investment requirements*". The Commission has also carried out research that attempts to assess the overall quality of a country's public finances, though this work is still at an early stage.<sup>37</sup>

<sup>33</sup> Available at <http://ue.eu.int/en/info/eurocouncil/index.htm>.

<sup>34</sup> Erenburg (1994) shows that public investment could provide substantial benefits to economic growth.

<sup>35</sup> Waigel (1995), page 3.

<sup>36</sup> 'A stronger, better Stability and Growth Pact' (SPEECH/02/505). Available at <http://europa.eu.int/rapid/start/cgi/guesten.ksh>. In its assessment of the UK's latest Convergence Programme, ECOFIN refers to "*the welcome reversal of the historic decline of net public investment relative to GDP*".

<sup>37</sup> See European Commission (2002a).

**Looking forward** **4.70** Improvement of the quality of public finances will be a particularly important issue for the accession countries because of the state of their existing infrastructures (see Table 4.3). With this in mind and considering the public investment needs of some other countries, including the UK, the SGP could benefit from greater recognition of the importance of measures that will have long-term gains, even if they require significant investment in the short run. This is covered by proposals made by the European Commission in November 2002, discussed in more detail below.

**Table 4.3: Gross public fixed capital formation (per cent of GDP)<sup>1</sup>**

	2000	2002-2005
<b>Average EU15</b>	2.6	2.7
<b>Average of eight accession countries<sup>2</sup></b>	3.9	4.3
Czech Rep	5.9	6.1
Estonia	3.2	3.9
Hungary	5.0	5.3
Latvia	4.0	5.2
Lithuania	1.9	2.3
Poland	3.1	3.8
Slovak Rep	3.6	3.8
Slovenia	4.1	4.1

Source: Buiter and Grafe (2002).

<sup>1</sup> Note that the figures in the table show gross investment, while the UK's golden rule is based around net investment.

<sup>2</sup> Malta and Cyprus are not included in the Buiter and Grafe figures.

## Legitimacy

**4.71** As introduced in Sections 1 and 2, legitimacy means that policy decisions engender enduring public and parliamentary support. Accountability and transparency are key contributors to legitimacy, but legitimacy can also be measured by whether the policy framework gives policymakers the democratic mandate to take action on behalf of the public.

**The UK framework** **4.72** Transparency is one of the five principles of the UK's fiscal policy framework. The Government has taken many steps to ensure that this transparency occurs in practice, including through the publication of the annual Budget and Pre-Budget Report, the End of year fiscal report and the Debt Management Report.

**4.73** More widely, legitimacy in the UK framework is secured by the fact that decisions on fiscal policy objectives and on implementation of policy to achieve those objectives is in the hands of democratically elected politicians. The Government is, therefore, directly accountable to the public through its actions.

**4.74** The UK's fiscal framework enhances this accountability substantively through the Treasury Select Committee of the House of Commons. This Committee plays an important role in scrutinising the conduct of fiscal and debt management policy and Treasury Ministers and officials appear before the Committee to answer questions on fiscal policy when requested. The Committee's scrutiny role is set out formally in the UK's Code for Fiscal Stability, which states explicitly that all reports produced under the Code must be referred to the Committee.

**The EU framework** **4.75** Some commentators (for example, Berglöf *et al.*, 2003) have expressed concerns about the degree of transparency in the SGP framework. However, the Council does publish its Opinions on individual Member States' Stability and Convergence Programmes, as well as any decisions that an excessive deficit exists in a Member State.

**4.76** There are less formal parliamentary mechanisms for ensuring accountability at an EU level, though the EC Treaty does require that the President of the Commission and the Council report to the European Parliament on the results of multilateral surveillance and the Parliament can call the President of the Council to appear. And there is also a role for national parliaments.<sup>38</sup>

**4.77** In terms of considering whether the processes for fiscal policy coordination at an EU level are legitimate, it is important to examine the division of responsibilities. With fiscal policy decisions remaining firmly within national competence, legitimacy is achieved through the usual democratic mandate, i.e., decisions made by elected politicians (Hodson and Maher, 2000). Although the European Commission has the right of initiative on, for example, recommending that a Member State has an excessive deficit, it is the Council which has the ultimate right of decision and can choose whether to accept or reject Commission recommendations. The Council is an intergovernmental institution so, together with the fact that the Council makes the final decisions, the system ensures there is legitimacy. As Hodson and Maher (2000) state, “*the case of the EDP shows that even when economic policy is defined in terms of regulations (the most rigorous form of legal rule within the EU legal order) it remains fundamentally intergovernmental*” (page 13).

**4.78** Given this, the proposals being made as part of the Convention on the Future of Europe, including by the Commission, to increase the role of the Commission in EU fiscal policy – at the expense of the Council and, therefore, Member States – could have implications for the legitimacy of the EU fiscal framework. See Box 4.4 and Section 5 which sets out the UK Government position on the issue of economic governance more generally.

#### **Box 4.4: The European Convention and fiscal policy**

**As part of the discussions currently underway in the European Convention, a number of proposals have been made which could have implications for the legitimacy of the EU fiscal framework, by shifting the institutional balance away from the Council and towards the European Commission.**

**These proposals, which have been made by the Commission themselves, by the Convention’s Working Group on Economic Governance and by individual Member States, include:**

- **allowing the Commission to issue ‘early warnings’ on excessive deficits (under Article 99(4)) directly to the Member State concerned, bypassing the Council;**
- **allowing the Commission to make proposals, rather than recommendations, to the Council on the existence of an excessive deficit (under Article 104(6)) or non-compliance with the BEPGs (under Article 99(4)) by a Member State. Proposals can only be amended by unanimity in the Council, rather than the qualified majority voting which operates for recommendations;**
- **excluding the Member State concerned from voting on whether to issue them with an ‘early warning’ on an excessive deficit and whether an excessive deficit exists in that Member State (the Member State concerned is already excluded from the latter stages of the Excessive Deficit Procedure).**

**It is expected that the Convention will finish its work in June 2003, in time for the European Council in Thessaloniki. The Convention will be followed by an Intergovernmental Conference (IGC).**

<sup>38</sup> Indeed, the Treasury Select Committee and the EU committee of the House of Lords are currently both considering recent developments in the SGP.

## Possible future developments

**Government position** 4.79 The Government has consistently emphasised its support for a prudent interpretation of the SGP, that takes into account the economic cycle, sustainability and the important role of public investment.

**The effects of enlargement** 4.80 Unlike in the case of monetary policy, enlargement will not necessarily affect the operating procedures of the EU's fiscal policy framework, though it could make it more difficult to reach consensus on how policy should operate. Enlargement will, however, bring countries into the EU whose fiscal positions are rather different from most existing members. In particular, as is clear from Tables 4.3 and 4.4 accession countries have, overall:<sup>39</sup>

- lower debt to GDP ratios;
- higher deficits;
- greater public investment needs; and
- higher nominal GDP growth potential,<sup>40</sup> meaning that debts will be eroded more quickly.

4.81 These different characteristics can be expected to increase the challenges faced by the existing SGP, making Member States more aware of the need not to constrain unduly the policies of countries whose public finances are fundamentally sound.

**Table 4.4: Fiscal positions of the accession countries, 2001**

Per cent of GDP	Deficit	Debt
<b>Average EU15</b>	0.9	63.0
Czech Rep	5.2	17.3
Estonia	-0.5	4.9
Hungary	4.1	55.0
Latvia	1.6	14.1
Lithuania	1.9	23.6
Poland	3.9	40.9
Slovak Republic	5.4	32.4
Slovenia	2.5	25.8

Source: European Commission.

**Academic ideas for reform** 4.82 Academic ideas for reform of the SGP are manifold, and this study does not attempt to summarise them all, instead looking at some of the most recent and most prominent proposals.<sup>41</sup> They can be divided into changes in the rules by which the SGP operates, and changes in its operational procedures and institutional make up, and are discussed in Box 4.5.

<sup>39</sup> See Buiters and Grafe (2002).

<sup>40</sup> Both because of faster real growth and because of the faster inflation it brings, due to the Balassa-Samuelson effect.

<sup>41</sup> Coeuré and Pisani-Ferry (2003) provide a helpful summary of recent ideas.

**Box 4.5: Academic ideas for SGP reform**

**Debt rather than deficits:** Many commentators think the SGP should focus on debt levels rather than deficits, since debt levels are most important for fiscal sustainability. Pisani-Ferry (2002) envisages a ‘Debt Sustainability Pact’, which would allow a country to opt-out of the SGP provided that its debt remains below, say, 50 per cent of GDP, that it publishes a comprehensive government balance sheet, including future liabilities, and that it sets a target for the public debt to GDP ratio. Any sanctions would result from high debt levels, not high deficits, providing more flexibility and more responsiveness to economic conditions, to those countries that are in a sustainable position.<sup>a</sup> Countries whose budgetary positions were not yet clearly sustainable would continue to be subject to the existing SGP.

**Allowance for public investment:** Blanchard and Giavazzi (2003) argue that the capital budget of Member States should be excluded from the SGP, permitting borrowing for net public investment. They argue that this would increase transparency, bring governments’ budgets in line with best practice in private companies, permit quality investment, and prevent pro-cyclical tightening of fiscal policy in the short run.<sup>b</sup>

**A ‘permanent balance’ rule:** Buiter and Grafe (2002) favour a ‘permanent balance’ rule, whereby the share of government taxes in GDP is kept constant at a value no less than the permanent public spending share in GDP, adjusted for expected future inflation and real growth, and taking into account the initial debt stock. Although some of the variables are not directly observable, Buiter and Grafe see the benefits of allowing for counter-cyclical policy and public investment that generates future cash flow for the government, outweighing any implementation costs.

**Institutional proposals:** While many academic economists agree that the SGP could be improved by a greater focus on debt levels and cyclically-adjusted deficit figures, there is less consensus on the institutional changes that might be helpful. Some examples are:

- **Fiscal policy committees** – Wyplosz<sup>c</sup> argues that major institutional changes are needed to improve the functioning of the SGP, including through the creation of new fiscal policy committees in each Member State. These would have authority over the annual deficit in each country, but no say on the size and composition of expenditure and taxes. They would be given the long-term mandate of maintaining debt at a certain target, but would be able to vary the deficit in the short term to stabilise the economy. Because, like independent central banks, they would have no incentive to jeopardise the long-term goal, they could have more flexibility than elected governments in the short term to promote economic stability.
- **New monitoring institutions** – Though more sophisticated rules might be economically sensible, they place greater pressure on surveillance, particularly if accountability and transparency are to be preserved. This places a premium on ensuring the integrity and credibility of the body undertaking the surveillance. For this reason, Begg *et al.* (2002) argue that the EU should delegate monitoring to an independent body. This would avoid concerns that estimates of the structural deficit would be subjective or open to political manipulation, enhancing the credibility of the Pact.
- **Tradeable deficit permits** – Casella (2001) argues that the rules-based approach of most proposals should be replaced by a market-based solution. He proposes the establishment of tradeable permits to run deficits, akin to those used to reduce pollution at the lowest possible cost. Countries that wanted to run higher deficits would have to buy such permits from others before they could do so.

<sup>a</sup> Other writers to suggest a focus on debt levels include Gros (2003) and De Grauwe (2002b).

<sup>b</sup> Balassone and Franco (2001) also discuss the idea of providing greater room for investment in the SGP.

<sup>c</sup> In his contribution to the EMU study *Submissions on EMU from leading academics* and expanded in Wyplosz (2002).

**European Commission proposals** **4.83** In November 2002, the European Commission made detailed proposals for reform of the SGP in a Communication to the Council,<sup>42</sup> following a remit from the 2002 Spring European Council for the Commission to present proposals for strengthening economic policy coordination in time for the Spring 2003 European Council.

**4.84** The Commission's proposals focused on ways to improve the interpretation and the implementation of the existing Treaty provisions and the SGP. They did not propose changes to the Treaty or SGP, nor suggest the introduction of new budgetary objectives or rules. Following discussions in EFC and ECOFIN, Member States have agreed a report which responds to the Commission's proposals<sup>43</sup> and which has been endorsed by Heads of State or Government at the Spring 2003 European Council. The key elements of the report agreed by ECOFIN Ministers are:

- compliance with the close to balance or in surplus requirement of the SGP should be assessed in cyclically-adjusted terms;
- countries with deficits exceeding close to balance or in surplus must improve their cyclically-adjusted budget position;
- automatic stabilisers should operate symmetrically over the cycle and, to this end, Member States should avoid pro-cyclical policies, especially when growth conditions are favourable;
- in assessing close to balance or in surplus particular attention shall be paid to country-specific circumstances, in particular to (i) the long-term sustainability of public finances, (ii) sufficient safety margins at all times, including an allowance for automatic stabilisers to operate fully without breaching the 3 per cent reference value and (iii) the coherence between the evolution and quality of the public finances in the Stability and Convergence Programmes and the close to balance or in surplus requirement;
- greater attention must be paid to the longer-term sustainability of public finances, including through the determined pursuit of a comprehensive strategy to meet the challenges of ageing populations. The assessment of the sustainability of public finances should be upgraded, including by improving the quality and comparability of long-run budgetary projections;
- with the pace of decline in public debt playing an important role in budgetary surveillance, especially in highly indebted countries, the Excessive Deficit Procedure should contribute to ensuring a satisfactory pace of debt reduction (in conformity with the Treaty provisions); and
- within the overall constraints of the SGP, greater attention should be paid to the quality of public finances, with a view to raising the growth potential of the EU economies in line with the Lisbon agenda.

**4.85** The UK Government welcomes the focus given in the ECOFIN report to taking account of the economic cycle, sustainability and the quality of public finances in interpreting the SGP. Such improvements in the interpretation of the SGP will inevitably increase demands on policy analysis and assessment, which will need to become more sophisticated. This is discussed in more detail in the EMU study by HM Treasury *Fiscal stabilisation and EMU*.

<sup>42</sup> European Commission (2002c).

<sup>43</sup> See Conclusions from ECOFIN, 7 March 2003. Available at: <http://ue.eu.int/newsroom>.

## CONCLUSIONS

**Large steps forward...** **4.86** The UK and EU fiscal frameworks represent significant steps forward in recognising the importance of long-term budgetary discipline. The combination of the EC Treaty, EDP, SGP and Code of Conduct has instituted a number of important measures to improve the surveillance of policies and to encourage a longer-term approach to fiscal planning. It also contributed to substantial fiscal consolidation in the euro area from the mid-1990s, spurred on by the conditions of EMU entry.

**...but problems have emerged in the EU** **4.87** However, the SGP has faced a number of challenges over the recent past, which called the credibility of the current framework into question. Budgetary consolidation in the euro area has stalled or gone into reverse, a particular problem in the light of the population ageing to come.

**Clear, though, that the SGP is evolving...** **4.88** Despite this, there have been improvements to the interpretation of SGP over the recent past, particularly in the 2001 Code of Conduct endorsed by ECOFIN. More recently, ECOFIN's report to the Spring 2003 European Council demonstrates that the SGP is evolving. In particular, Member States and the Commission have agreed on the importance of taking more account of the effects of the economic cycle and the need to avoid pro-cyclical policies, the importance of the long-term sustainability of the public finances including through a strategy to meet the challenges of ageing and by taking full account of the role of debt in the EDP, and paying greater attention to the quality of public finances.

**4.89** Making these proposed changes operational should improve the credibility of the SGP going forward and will be important in allowing the SGP to deal with the challenges posed by EU enlargement.

**...but institutional proposals could harm legitimacy** **4.90** However, the proposals being made in the European Convention, to shift the institutional balance in the EU fiscal policy framework away from the Council to the European Commission, could have a negative effect on legitimacy.

**4.91** Both the UK and the euro area fiscal frameworks are facing challenges, as they have done in the past. Current experience suggest that the frameworks are potentially robust to cope but that they also need to evolve to deal with new challenges.

**4.92** Fiscal policy, in particular, is a moving target in EMU because of the combination of EMU being an unprecedented project and the challenges faced, including through enlargement. Already the three levels of the EU fiscal policy framework introduced at the start of this section have evolved and they may be further enhanced in the future.

In principle, policy coordination can bring substantial gains helping to produce an optimal policy mix and supporting overall economic stabilisation.

There are two main forms of policy coordination: coordination between the monetary and fiscal authority, and coordination between fiscal authorities.

Policy coordination is fairly straightforward in the current UK system. There is a single monetary authority and one main fiscal authority which have complementary objectives, both set by the Government. Policy coordination is assisted by high levels of information sharing between the two authorities.

The situation is necessarily more complex in the euro area, with a single monetary authority but multiple fiscal authorities.

This creates greater challenges, but the UK Government is strongly supportive of the intergovernmental approach, which is the foundation of policy coordination and the basis for economic governance in EMU. In order to achieve a good mix between fiscal and monetary policy, effective coordination between the euro area's fiscal authorities is important – individually each fiscal authority will only have a limited impact on the ECB's decision making, but collectively they can have a large effect. Information-sharing between the monetary and fiscal authorities is important, allowing the ECB to assess the likely aggregate fiscal stance in the future and the fiscal authorities to base their decisions on accurate predictions of how monetary policy will affect aggregate demand. There are several mechanisms for such information-sharing, although there is some suggestion that they may not currently be used to their full potential.

## INTRODUCTION

**5.1** In principle, policy coordination can bring substantial gains, helping to produce an optimal policy mix and supporting overall economic stabilisation. This section assesses whether the current UK and euro area policy frameworks allow these gains to be realised.

**5.2** Throughout this section, a broad definition of coordination is used, encompassing, among other things, information-sharing, agreement on how the system should operate and on its objectives and agreement on how targets should be met in each particular instance.<sup>1</sup>

**5.3** In EMU, policy coordination and economic governance more generally<sup>2</sup> is founded on the principle of an intergovernmental approach which means Member States acting together to take decisions. This will help preserve legitimacy whilst delivering credibility and it is a principle which the UK Government supports. Though a number of writers have argued for new coordination mechanisms in the euro area, many believe that the costs of increased coordination, in terms of reduced national autonomy and responsiveness to shocks, could outweigh any benefits.

**5.4** Any decision to join EMU would result in three principal changes to the current UK framework for policy coordination:

- the UK Government would no longer set the objectives of monetary policy;

<sup>1</sup> See OECD (2002), building on Currie *et al.* (1989). Deroose and Mills (2001) also provide a helpful list of levels of coordination.

<sup>2</sup> Economic *governance* is different to economic *government*, as Jacquet and Pisani-Ferry (2001) explain. Economic governance suggests a number of actors working together to agree and adopt best practice in economic policy; economic government, on the other hand, suggests that a supranational body exists to set economic policy.

- a representative of the UK fiscal authority would no longer attend (in a non-voting capacity) meetings to set interest rates, though the UK fiscal authority would be represented at ECB Governing Council meetings via the President of ECOFIN/Eurogroup; and
- the Chancellor of the Exchequer would attend meetings of Eurogroup, the informal grouping of euro area Finance Ministers.

**Section structure 5.5** This section is structured as follows:

- the first part explains why policy coordination can be beneficial;
- the second considers the UK mechanisms for policy coordination, illustrating that coordination is fairly straightforward in the UK structure;
- the third part discusses the euro area system, describing the greater complexity involved in policy coordination; and
- the fourth part examines current proposals to improve coordination.

## POTENTIAL BENEFITS OF COORDINATION

**Three kinds of benefit 5.6** The most researched form of policy coordination is that which takes place between the monetary authority and the fiscal authority. It is this type of policy coordination which is therefore used to explain the potential benefits of coordination. However, as is clear from the remainder of this section, it is not the only form of policy coordination (particularly in the case of EMU which operates with a number of national authorities pursuing their own fiscal and structural policies). The main benefits from coordinating monetary and fiscal policies are:

- preventing the strain caused by over-use of one policy instrument;
- achieving a preferred policy mix; and
- harmonising objectives.

**Reducing the strain 5.7** Ahearne *et al.* (2002) note that “*use of both policy levers at the same time may reduce the undesirable side effects that each entails, by reducing the need to push one instrument too far*” (page 37). In general, if variability of each policy instrument is costly, and the costs of this variability increase at more than a linear rate,<sup>3</sup> there can be benefits from using both policy instruments together. In the case of fiscal policy, tax smoothing considerations<sup>4</sup> suggest that there are costs from varying tax rates considerably over the cycle, and varying expenditure could also be costly through an adverse impact on longer-term planning. In the case of interest rate volatility, costs could arise through volatility of variables affected by interest rates, such as variable mortgage rates and asset prices, or through the damaging effects on credibility of large and frequent interest rate changes.<sup>5</sup> Moreover, high variability of interest rates increases the risk of encountering the zero bound on nominal interest rates, with the possibility of a damaging deflationary spiral. It is for this reason that there is generally a consensus over the fact that monetary policy should have primary responsibility for managing aggregate demand so as to maintain low inflation, while the primary objective of fiscal policy should be to maintain sound and equitable public finances over the long term.

<sup>3</sup> Formally,  $c(2v) > 2c(v)$ , where  $v$  is variability and  $c$  is cost.

<sup>4</sup> See Barro (1979).

<sup>5</sup> See Goodhart (1999).

**5.8** In principle, monetary and fiscal policy coordination can be helpful in reducing the costs of economic stabilisation, particularly in response to large shocks when one instrument alone might be insufficient to return the economy to trend. More generally, any uncertainty over the transmission mechanisms of monetary and fiscal policy strengthens the case for a mix of policies, which may be particularly relevant in EMU.

**Achieving a good policy mix**

**5.9** Given the different transmission channels of monetary and fiscal policy, variation in the mix between these instruments has implications for the distribution of economic activity across regions or sectors of the economy, even if aggregate output remains unchanged. For example, a tight monetary policy and a loose fiscal policy would place more pressure on the tradeable sectors of the economy, because monetary policy tends to have a greater impact than fiscal policy on the exchange rate. Moreover, variation in the policy mix might be expected to affect intermediate variables such as the exchange rate and other asset prices.

**5.10** Therefore, coordination on a certain policy mix could be beneficial either to influence the distribution of economic activity across regions or sectors, or to target intermediate variables such as the exchange rate. This could help to prevent economic imbalances emerging.

**Harmonising objectives**

**5.11** Policy coordination could also help to avoid conflicting monetary and fiscal goals. For example, if the fiscal authority has a preference for higher steady-state inflation than the monetary authority, the result could be continual high fiscal deficits and tight monetary policy. If objectives are coordinated, this situation is less likely to occur. The idea of the monetary and fiscal authorities working to achieve harmonised objectives is sometimes described in terms of ‘club goods’ (see Jacquet and Pisani-Ferry, 2001). In terms of macroeconomic policy coordination, ‘club goods’ might be price stability and sound public finances. The theory of achieving harmonised objectives is illustrated in the Nordhaus model of policy coordination,<sup>6</sup> discussed in Box 5.1 below.<sup>7</sup>

**Benefits increase with the size of spillovers and with uncertainty**

**5.12** In general, the benefits of coordination will increase with the size of the ‘spillovers’ between policy areas. For example, an economy in which the public sector accounted for only 1 per cent of GDP would have much less need for coordination between fiscal and monetary policy than one in which the public sector was much larger. The benefits of coordination between monetary and fiscal policies will also be larger the greater is uncertainty about the way in which the economy works, since information-sharing in particular then becomes more important.<sup>8</sup>

## THE UK FRAMEWORK

**Features of system**

**5.13** The UK framework is characterised by a single fiscal authority and a single monetary authority. The following discussion therefore considers only coordination between the fiscal and monetary authorities (‘fiscal-monetary’ coordination).<sup>9</sup>

<sup>6</sup> See Nordhaus (1994).

<sup>7</sup> As set out in Box 5.1, if fiscal and monetary authorities do not work together to achieve complementary objectives the outcome might be a policy mix which is biased towards a loose fiscal and tight monetary policy, characterised by Strauss-Kahn (1998) as ‘Reagan-Volker’, as opposed to the tight fiscal-loose money stance of ‘Clinton-Greenspan’, referring to the experience of the US.

<sup>8</sup> See Meyer *et al.* (2002).

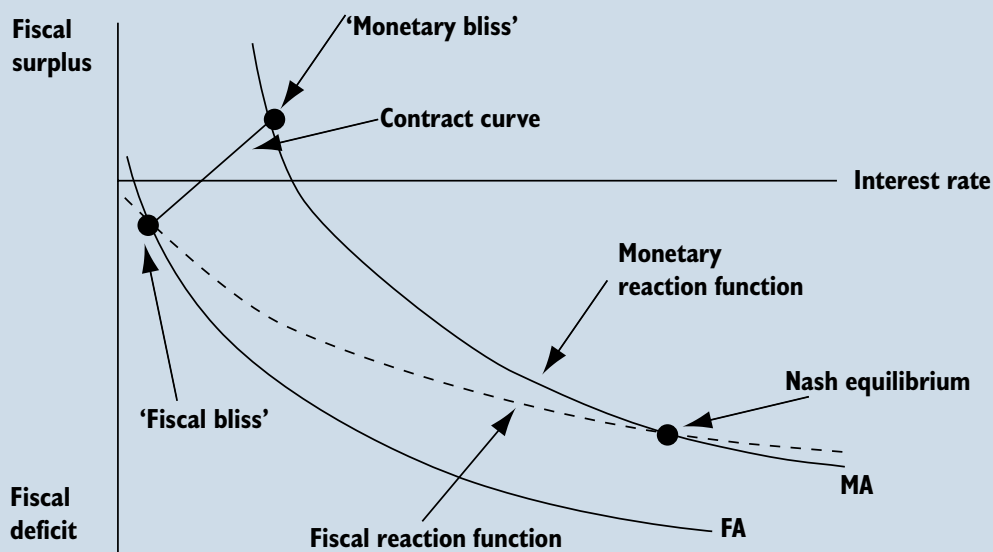
<sup>9</sup> There is, of course, some coordination between different levels of Government within the UK.

### Box 5.1: The gains from policy coordination

A simple intuitive model illustrating the gains from macroeconomic policy coordination was developed by Nordhaus (1994).

The model assumes a fiscal authority and a monetary authority, with responsibility for setting the fiscal stance and interest rates respectively. Each have different preferences over the path for aggregate demand in the economy, which can be achieved with differing combinations of interest rates and the fiscal balance.

The monetary authority sets interest rates, conditional on the forecast fiscal policy stance, so as to ensure that aggregate demand is consistent with price stability. In the diagram below, the point labelled 'monetary bliss' represents a combination of interest rates and the fiscal balance which produces a level of aggregate demand acceptable to the monetary authority. The curve MA through this point represents other combinations of interest rates and the fiscal balance which produce a level of aggregate demand acceptable to the monetary authority. Less positive fiscal balances have to be met with higher interest rates to leave aggregate demand unchanged. The MA curve can be interpreted as the monetary authority's reaction function.



The fiscal authority prefers a higher level of aggregate demand (or at least the monetary authority perceives this to be the case). The point labelled 'fiscal bliss' in the diagram represents a combination of interest rates and the fiscal balance acceptable to the fiscal authority, and is characterised by both lower interest rates and a weaker fiscal position (as shown by a deficit) than preferred by the monetary authority. Again, it is possible to draw a curve through this point (labelled FA in the diagram) representing alternative combinations of interest rates and the fiscal balance which result in the same level of aggregate demand. However, assuming that the fiscal authority also cares about its fiscal balance, its reaction function is less steep than that of the monetary authority – with higher levels of interest rates being offset only partially with looser fiscal policy. The reaction function of the fiscal authority is thus characterised by the dashed line in the diagram.

In the situation in which the monetary and fiscal authorities refuse to cooperate, neither will move from its respective reaction function. The non-cooperative equilibrium occurs where the two reaction curves cross. This is the 'Nash' or non-cooperative equilibrium indicated in the diagram. Alternatively, in the situation where the monetary and fiscal authorities decide to cooperate (policy coordination), they will negotiate a solution somewhere along the line which joins their bliss points (the contract curve). Exactly where on the contract curve a bargain is struck will depend on the relative bargaining power of the monetary and fiscal authorities.

Notably, the non-cooperative solution involves tighter monetary policy and looser fiscal policy than the cooperative solution, so that both authorities are worse off than they would be if they chose to cooperate. Thus in the absence of policy coordination, the policy mix will tend to place a greater burden of maintaining low inflation on the tradeable goods sector than would be the case with coordination between the authorities.

**5.14** Three features of the UK system are especially relevant in examining how the UK secures the potential benefits from policy coordination:

- the Government sets the objectives for both monetary and fiscal policy. Indeed both arms of policy have the same fundamental objective of helping to achieve high levels of long-term growth and employment by delivering economic stability.<sup>10</sup> Monetary policy does this by aiming to deliver price stability, while fiscal policy aims to deliver sound public finances. If the Government did not set an inflation target that was consistent with its fiscal objectives, the MPC would, through its monetary policy decisions, counteract any fiscal impulse that put at risk the inflation target;
- the objectives of both arms of policy are clear and the procedures transparent, which means that both sets of policymakers are aware of what the other is trying to achieve and how the other will react to their policy decisions; and
- a (non-voting) representative from HM Treasury attends MPC meetings and is able, in particular, to provide information on fiscal policy. This includes detailed presentations on the Budget and the Pre-Budget Report.

**No conflict in objectives...** **5.15** Taken together, these features mean that the gains from policy coordination can be fully realised without requiring more explicit cooperation between the monetary and fiscal authorities on, for example, what the interest rate should be at a certain point. Central objective setting means that there is no risk of a conflict in objectives between the two authorities. Nordhaus's (1994) policy game, in which the fiscal and monetary authorities bargain over steady-state inflation, output and the fiscal surplus, is therefore not applicable in the UK's case.

**...and high levels of information-sharing** **5.16** The high levels of communication between the monetary and fiscal authorities, both through the transparency of the frameworks and the presence of a Treasury representative at MPC meetings, reduces the risk of either party being misinformed about the policies of the other.<sup>11</sup> Communication also ensures that the MPC's reaction function is transparent and well understood. Since fiscal policy is generally thought to act more slowly on the economy than monetary policy,<sup>12</sup> the fiscal authority can be seen as a Stackelberg leader:<sup>13</sup> it sets the fiscal stance in the light of knowledge of the monetary authority's reaction function and overall objectives, thus enabling it to achieve its preferred policy mix.<sup>14</sup> In this way, the clear reaction function of the monetary authority can impose an important discipline on fiscal policymaking.<sup>15</sup>

## THE EURO AREA FRAMEWORK

**Coordination more complex** **5.17** The euro area framework is characterised by a single monetary authority but a number of decentralised fiscal authorities (currently 12). This makes policy coordination intrinsically more complex because of the need for coordination between the various fiscal authorities ('fiscal-fiscal' coordination) before there can be effective coordination between the fiscal and monetary authorities ('fiscal-monetary' coordination).

<sup>10</sup> See O'Donnell and Bhundia (2001).

<sup>11</sup> Blake and Weale (1998) show that such a lack of information could be very costly.

<sup>12</sup> Perhaps for political economy reasons (for example, lags in the policy implementation process) rather than purely economic ones.

<sup>13</sup> Broadly, the first mover in a two-agent game in which both have complete and perfect information – see Gibbons (1992).

<sup>14</sup> See Bean (1998a).

<sup>15</sup> See Kilpatrick (2001).

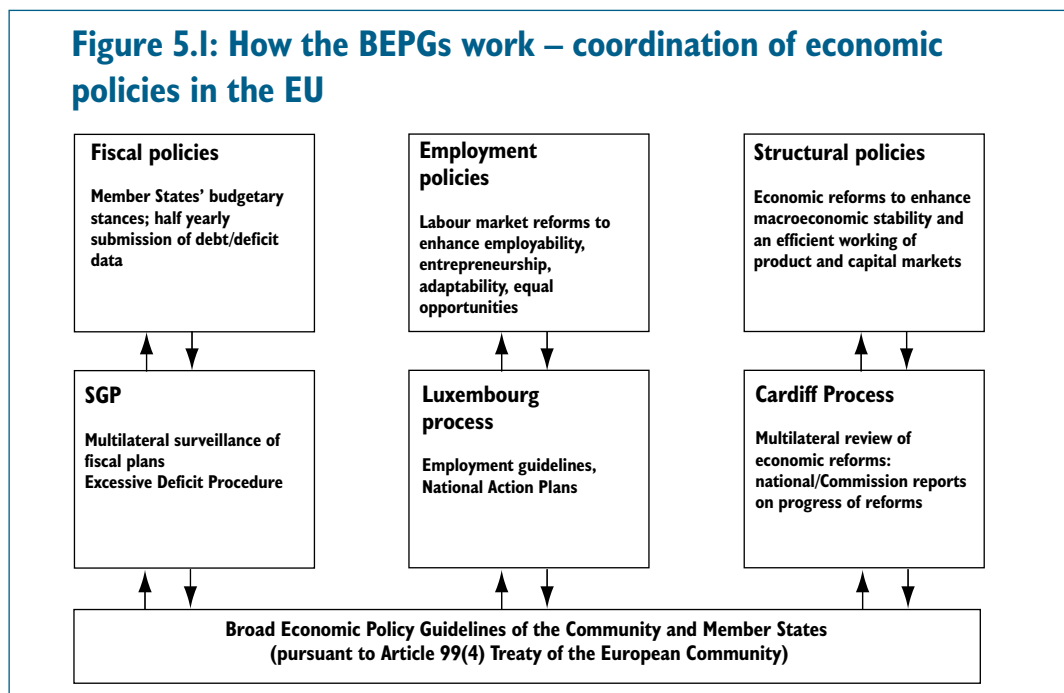
## Fiscal-fiscal coordination

**5.18** Section 4 introduced the idea that there could be benefits to effective coordination between the fiscal authorities in a monetary union, to avoid ‘free-rider’ problems. These could arise if one Member State sought to loosen fiscal policy in the expectation that other Member States would offset this by tightening policy, so that there was no overall effect on the aggregate fiscal stance of the euro area as a whole. Coordinating fiscal policy to implicitly achieve a desired aggregate fiscal stance could aid fiscal-monetary coordination and thereby contribute to economic growth and stability.

**5.19** Of course, each fiscal authority makes up only small proportion of euro area GDP (a proportion which will fall further if more countries join EMU). This may suggest that, in practice, the gains from fiscal policy coordination are small since any change in fiscal stance by a single fiscal authority will only have a limited impact on the aggregate fiscal stance.<sup>16</sup> However, the three largest EMU members account for about 70 per cent of total euro area GDP so their impact and the corresponding gain will be quite significant.

**5.20** Indeed, if all fiscal authorities were to assume the impact of their fiscal decisions was negligible, then the combined impact on the overall fiscal stance could be significant. This could have implications for the fiscal-monetary policy mix (discussed below) as well as less direct implications, for example on the credibility of the system. So even if, as Huart (2002) argues, the direction and intensity of fiscal spillovers are ambiguous,<sup>17</sup> coordination could be valuable. It should aid the achievement of shared objectives, as described earlier; an explicit commitment on behalf of both the fiscal and the monetary authorities that they share the same objectives builds trust in what is a repeated game (i.e., each time a policy decision is made by the fiscal authorities the Nordhaus policy game starts over).

**5.21** The euro area framework contains a number of mechanisms to enable coordination between the various fiscal authorities, including the Stability and Growth Pact (SGP), the Broad Economic Policy Guidelines (BEPGs) and the Eurogroup.<sup>18</sup>



<sup>16</sup> See Fitoussi and Creel (2002).

<sup>17</sup> See also von Hagen and Mundschenk (2001).

<sup>18</sup> The first two are EU-wide frameworks, but they can help to promote coordination within the euro area specifically.

**The SGP 5.22** The SGP is discussed in Section 4. This is the key mechanism for fiscal policy coordination in the euro area. The surveillance processes set up under the SGP are important in enabling euro area countries to share information with each other about their fiscal policy plans, and thereby aid policy coordination. The growing standardisation of the Stability Programmes submitted by EMU members, encouraged by the Code of Conduct, means that the Programmes contain increasingly useful information as a basis for more effective coordination of policies.

**The BEPGs 5.23** The BEPGs are an additional tool to promote coordination of economic policies between Member States. They are agreed by EU Heads of State or Government and published annually,<sup>19</sup> and are the key economic policy document of the EU. The BEPGs go wider than fiscal policy, also covering the full range of structural policies, including on employment as well as a description of monetary policy. To this end, a number of EU processes feed into the BEPGs, as illustrated in Figure 5.1. The BEPGs set out recommendations to Member States in these areas. Although the recommendations are non-binding, under Article 99(4) of the EC Treaty, ECOFIN can issue a recommendation to a Member State whose policies are deemed inconsistent with the BEPGs.<sup>20</sup> In this way, the BEPGs aid fiscal policy coordination in the euro area through exerting peer pressure, which will be enhanced if their focus on assessing implications increases.

**Eurogroup 5.24** Eurogroup was established at the 1997 Luxembourg European Council as an informal means of policy coordination between euro area members. Its members are the Finance Ministers of euro area countries, who may also invite the Commission and the ECB to participate.

**5.25** The Luxembourg Council Resolution on economic policy coordination in stage three of EMU<sup>21</sup> give Ministers of participating Member States the right to meet informally among themselves “*to discuss issues connected with their shared specific responsibilities for the single currency.*” Eurogroup therefore concentrates on promoting the exchange of information between countries participating in EMU about economic trends and policy decisions, including on fiscal policy; and on monitoring macroeconomic trends and budgetary developments in the individual Member States, and therefore in the euro area as a whole. For example, following discussions within Eurogroup, the participating Member States have in the past issued statements setting out their collective view (for example, in October 2002 Eurogroup issued such a statement on budgetary developments in the euro area). The Eurogroup cannot, however, take decisions about fiscal policy, for example on whether to launch the Excessive Deficit Procedure against a Member State. Such decisions remain a matter for the ECOFIN Council as a whole.

**5.26** Eurogroup has developed over time to improve its effectiveness, in particular by:

- devoting more time to meetings (including by making them meetings in their own right, rather than addenda to ECOFIN meetings);
- broadening the scope of issues discussed to include, for example, structural reform;<sup>22</sup> and

<sup>19</sup> The 2002 BEPGs are available at [http://europa.eu.int/comm/economy\\_finance/publications/european\\_economy/2002/ee402en.pdf](http://europa.eu.int/comm/economy_finance/publications/european_economy/2002/ee402en.pdf).

<sup>20</sup> It issued such a recommendation to Ireland in 2001.

<sup>21</sup> Available at <http://ue.eu.int/emu/en/index.htm>.

<sup>22</sup> The Nice Council Conclusions of December 2000 stated that the European Council “*welcomes the intention to extend the range of mainly structural matters dealt with in this forum...*”. These are available at <http://ue.eu.int/newsroom>.

- increasing visibility by holding press conferences following Eurogroup meetings.

**5.27** These mechanisms are helpful in promoting the exchange of information between EMU members, letting each country know the likely path of fiscal policy in other states and therefore some idea of fiscal policy in the euro area as a whole. The increasing detail of Stability and Convergence Programmes, and the raised profile of Eurogroup, have also been helpful in this respect. Such a high degree of information sharing is especially important in the EMU context, where this is the main building block of policy coordination.

**5.28** One weakness which has been identified in the literature is the fact that there is little explicit agreement on how policy should react in the event of a shock – for example on the extent to which the automatic stabilisers should be allowed to operate.<sup>23</sup> This may make the likely reaction of fiscal policy unclear to other participants, and thereby impact on fiscal-monetary coordination. Proposals to improve fiscal-fiscal coordination by agreeing principles for responding to shocks are outlined below. Box 5.2 looks at the proposals being made in the European Convention on issues of relevance to fiscal policy coordination in the euro area.

#### **Box 5.2: The European Convention and policy coordination**

**As part of discussions currently under way in the European Convention, proposals have been made to reform the Eurogroup. These centre around the idea of setting up a ‘euro-ECOFIN’ perhaps with a formal Treaty basis, which allows Finance Ministers of the countries participating in EMU to take certain decisions. These include decisions on areas such as the existence of an excessive deficit in a euro area member, Opinions on Stability Programmes and the euro area section of the BEPGs.**

**Another area of relevance to fiscal policy coordination which is being discussed as part of the European Convention is tax. Proposals in this area centre around the idea that there should be a broader use of qualified majority voting for tax issues directly related to the internal market. Some have suggested that such a move could be a pre-cursor to tax harmonisation in the EU or in the euro area.**

**The UK Government opposes unnecessary tax harmonisation which would constrain Member States’ economic success. Tax harmonisation should not be seen as an inevitable consequence of EMU. EMU does not require, either in principle or practice, the harmonisation of direct taxation. The EMU study by HM Treasury *The United States as a monetary union* shows that a monetary union can function effectively while maintaining independence on tax rates and tax takes. The example of the US also demonstrates that ‘harmful’ tax competition between states and regions is best tackled by improving the flow of information between tax authorities, not by harmonising the rates.**

**It is important not to confuse the case which might be made for better and more intense communication between the various fiscal authorities in EMU, with the case for more harmonisation at EU level of specific individual taxes. In practice, the two might well point in opposite directions. Without the monetary policy instrument, Member States participating in EMU might need fewer rather than more constraints on variations in their individual tax rates and bases.**

<sup>23</sup> As Eichengreen and Wyplosz (1998) predicted, the asymmetry of the SGP has worsened this problem, with some countries in the recent downturn finding themselves unable to allow the automatic stabilisers to act in full because of the 3 per cent deficit limit.

## Fiscal-monetary coordination

**5.29** Coordination between the fiscal authorities and monetary authorities is important in order to achieve an appropriate policy mix across the euro area as a whole. The literature identifies one particular scenario that might occur without effective fiscal-monetary coordination: budget deficits which are too high on average and monetary policy which is too tight.<sup>24</sup> This is because a fiscal expansion in one country could induce the ECB to raise interest rates, reducing demand in other countries.<sup>25</sup> Other countries might want to mitigate the negative spillover effects from high interest rates by initiating their own fiscal expansion, and the final result is a ‘prisoner’s dilemma’<sup>26</sup> in which each country would prefer looser monetary policy and tighter fiscal policy – because of the crowding-out effects of loose fiscal policy on private investment and perhaps because of the risk of debt default – but it is not individually rational for any country to tighten its fiscal stance.<sup>27</sup> Effective policy coordination between the fiscal and monetary authorities could help to prevent such adverse policy competition. More generally, coordination could be valuable if the individual incentive structure differs from what is collectively best.<sup>28</sup>

**Fiscal-fiscal a pre-requisite** **5.30** With decentralised fiscal authorities in EMU, effective coordination between the fiscal authorities is an essential pre-requisite to effective fiscal-monetary coordination. Without effective coordination among the fiscal authorities it is difficult for the monetary authority to judge the overall fiscal stance in the euro area as a whole, and therefore difficult to work with the fiscal authorities to achieve a desirable policy mix.

**Information-sharing important...** **5.31** Information-sharing between the monetary and fiscal authorities is important. It allows the ECB to assess the likely aggregate fiscal stance in the future, and the fiscal authorities to base their decisions on accurate predictions of how monetary policy will affect aggregate demand.<sup>29</sup>

**5.32** There are no formal mechanisms for coordination between the fiscal and monetary authorities in the euro area, for example to agree an appropriate interest rate and fiscal stance. This is right given the primacy attached to achieving stability and the primary role monetary policy must have in that. There are, however, several mechanisms for information-sharing to help the fiscal and monetary authorities to better understand each other’s reaction functions:

- the ECB is party to all Economic and Financial Committee (EFC) and Eurogroup discussions of fiscal policy, allowing it to gain a great deal of information about the likely path of future policy;
- the Commission and the chair of Eurogroup have the opportunity to attend ECB Governing Council meetings and learn about the factors influencing the ECB’s decision making; and
- the publication of a range of documents on monetary and fiscal policy also facilitates information exchange. For example, the Commission publishes ‘Public Finances in EMU’ annually, the ECB publishes its annual report and monthly bulletins and the Stability and Convergence Programmes of Member States are in the public domain.

<sup>24</sup> See Korkman (2001).

<sup>25</sup> This could be a particular problem within EMU, since fixed exchange rates make fiscal policy more effective (there is less ‘crowding out’ from nominal exchange rate appreciation, though a real exchange rate appreciation could still occur).

<sup>26</sup> That is, a situation in which it is individually rational for each player to act in a way that produces an outcome that is worse for each player than another possible outcome – see Axelrod (1984).

<sup>27</sup> See also the similar discussion in Bini-Smaghi (2002).

<sup>28</sup> This could also occur if countries wish to free ride on the stabilisation provided by others – see Allsopp and Vines (1998) and Fitoussi and Creel (2002).

<sup>29</sup> Allsopp (2002c) argues that knowledge of the reaction function of the monetary authority is important in ensuring sound fiscal policies.

**...but perhaps not used optimally so far** **5.33** The ECB has played an active role in discussions of fiscal policy at EFC and Eurogroup, enabling it to learn the fiscal authorities' plans and to gauge the credibility of their projections. This provides it with a great deal of insight into the euro area aggregate fiscal stance. However, some of the fiscal authorities so far seem to have been less interested in active engagement with the ECB, with the Eurogroup presidency not always taking advantage of their right to attend ECB Governing Council meetings.<sup>30</sup> It appears that there is also no formal dissemination of any information gained at Governing Council meetings to other fiscal authorities at Eurogroup.<sup>31</sup> This could hinder the fiscal authorities' understanding of the central bank's reaction function and outlook, especially in the absence of published minutes of Governing Council meetings.

**SGP should prevent a bias** **5.34** Notwithstanding this, the rules of the SGP could be expected to prevent a scenario of large deficits and tight monetary policy. While nominal euro area deficits have increased since the start of EMU in structural terms, they are still very low compared to the early 1990s, and both short and long-term interest rates remain close to recent lows.

**5.35** The SGP should be able to prevent a situation in which private investment is squeezed out because of overly high government deficits, suggested by Korkman (2001). However, the nominal deficit limits which are at the centre of the SGP do not separate out the effects of the economic cycle and so cannot distinguish between a policy-induced fiscal expansion and one that is due to economic fluctuations. They are, therefore, limited in the extent to which they can contribute to a good policy mix.

## POSSIBLE FUTURE DEVELOPMENTS

**Academic ideas for reform** **5.36** There are a range of academic proposals for reform of the euro area's coordination framework, and this study looks only at a small sample, dividing them into proposals to develop coordination between fiscal authorities and proposals to develop coordination between the monetary authority and the fiscal authorities. These are discussed in Box 5.3.

<sup>30</sup> Bini Smaghi and Casini (2000) write that "In practice, ... the Presidency participates in such meetings only once every six months. No real dialogue with Finance Ministers seems to take place at the meetings of the ECB Governing Council..." (page 7). It is unclear whether attendance by the Eurogroup chair is now more regular than it was in 2000.

<sup>31</sup> See Bini Smaghi and Casini (2000).

**Box 5.3: Academic ideas for policy coordination reform**

**Fiscal-fiscal: a new level of commitment:** Pisani-Ferry (2002) argues that Eurogroup should agree on a set of broad policy principles that would provide greater clarity of fiscal policy reaction functions. This would be non-binding, but would outline the common understanding of euro area members, describing principles for responding to shocks, rules of conduct for the management of fiscal policy over the cycle and a statement on the rationale and scope for coordination. They could be given considerable informal force through peer pressure, provided that Member States felt sufficient ownership of the policy principles. Along similar lines, Pisani-Ferry argues for greater information in Stability and Convergence Programmes, which would describe how Member States' budgets would react to various events.

**Concentration on the euro area fiscal stance:** Collignon (2001) makes the case for more attention on the euro area budgetary position, rather than on the position of any one Member State, particularly to aid coordination between monetary and fiscal policies in the longer term. He writes that “*Optimising the economic policy mix would require the definition of a coherent aggregate fiscal policy stance which would allow the ECB to set interest rates in response...*” (page 31).

**Eurogroup strengthening:** Jacquet and Pisani-Ferry (2001) suggest that coordination could be improved by transforming Eurogroup into a collective executive body, not just an informal discussion forum. They argue that Eurogroup, being smaller than ECOFIN, is better able to promote dialogue on essential policy choices. This is in line with some of the proposals being made as part of the European Convention described above.

**Less, not more:** Though a number of writers have argued for new coordination mechanisms in the euro area, there is no consensus on this in the academic literature, and many believe that the costs of increased coordination, in terms of reduced national autonomy and responsiveness to shocks, could outweigh any benefits. For example, Calmfors (2001) argues that there is little need for coordination beyond mechanisms to ensure fiscal sustainability. He claims that coordination costs are likely to be substantial, accountability could suffer and inter-country adjustment could be made more difficult.<sup>a</sup>

**Fiscal-monetary: greater information-sharing:** In order to increase information exchange between monetary and fiscal authorities, Bini Smaghi and Casini (2000) recommend the full implementation of Article 113 of the Treaty “*in order to make the Ecofin Presidency attend regularly ... the meetings of the ECB Governing Council and discuss relevant issues for the EU economy. The EU Presidency would report on the outcome of the discussion to the members of Euro-11*” (page 15).

**More clarity of monetary reaction function:** Allsopp (2002c) argues that a key requirement for effective coordination is an “*appropriate and transparent monetary policy reaction function*”, that will be perceived to be thus, believing that this will incentivise sound fiscal policies.<sup>b</sup> Lack of a clear reaction function could be a particular problem if monetary and fiscal authorities have different preferences over which institution should provide the bulk of economic stabilisation.<sup>c</sup>

**ECOFIN objective-setting:** As discussed in Section 3, Favero *et al.* (2000) believe that there could be benefits for fiscal-monetary coordination from having ECOFIN set the objectives for ECB monetary policy.

<sup>a</sup> See De Grauwe (2002a) for a similar view.

<sup>b</sup> See also Allsopp and Vines (1999), who argue that, because of its area-wide scope, the ECB has a pivotal role in euro area coordination.

<sup>c</sup> See Allsopp (2002b).

## CONCLUSIONS

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- Coordination fairly straightforward in the UK** **5.37** In the current UK system, coordination between monetary and fiscal policy is fairly straightforward, since both operate principally at the same level (national) and the roles assigned to the respective policies are clear: monetary policy is assigned the primary role in macroeconomic stabilisation and the role of fiscal policy is to support it where possible. The UK system also ensures that the fiscal and monetary authorities have complementary objectives, since the Government sets both. Knowing how the monetary authority will react, the fiscal authority can set policy to achieve its preferred overall outcome.
- But more complex in the euro area ...** **5.38** However, coordination is intrinsically more complicated in the euro area system, not least because of the number of actors involved: a single monetary authority and a decentralised fiscal authority from each participating Member State. The single monetary authority for the euro area, the ECB, also operates at a different level from any of the fiscal authorities, whose policies will have their main impact in their own countries. Unlike in the UK system, there is no built-in guarantee that the fiscal and monetary authorities will have consistent objectives.
- ... with coordination between fiscal authorities important ...** **5.39** In order to achieve a good mix between fiscal and monetary policy, effective coordination between the euro area's fiscal authorities is important. This is because, individually, each fiscal authority will only have a limited impact on the ECB's decision making, but collectively they can have a large effect. Getting the collective balance right and ensuring coherence of fiscal policies is vital.
- 5.40** This might become even more important as the number of fiscal authorities participating in EMU increases further following EU enlargement, especially if the new members have different policies and needs to the current EMU members.
- ... and scope for better information-sharing** **5.41** While there are no mechanisms for formal coordination between the fiscal and monetary authorities in the euro area, several mechanisms are in place for information-sharing between the authorities. However, evidence suggests that these may not currently be used to their full potential.

Arrangements for ensuring financial stability are an important component of the macroeconomic policy framework.

The key goal of the UK's financial stability arrangements is to prevent the emergence of a systemic crisis that could threaten the stability of the financial system, and therefore the entire economy.

The UK has established clear responsibilities for the three public authorities with roles in this field – HM Treasury, the Bank of England and the Financial Services Authority – with a clear structure for coordination between them. The arrangements are based on principles of accountability, transparency of responsibilities, avoidance of duplication of responsibilities and regular information exchange. Arrangements are in place for undertaking lender of last resort operations.

There is no EU or EMU level responsibility for financial supervision, which remains the responsibility of individual countries. The UK Government, like many others, believes that lender of last resort operations remain a national responsibility for euro area members. While steps have recently been taken to clarify the position on how official support operations in the euro area would function in practice, a clearer assertion of the position would be helpful to avoid a lack of clarity which could hamper the response to a crisis.

## INTRODUCTION

### Important component of macroeconomic stability

**6.1** Stability of the financial system is an important component of overall macroeconomic stability. The financial system, in this respect, cannot be seen simply as another industrial sector, since the collapse of one financial institution could lead to contagion and could damage the functioning of the entire economy. The Great Depression in the US<sup>1</sup> and Japan's low growth in the 1990s were both significantly exacerbated by financial system problems.

**6.2** For this reason, reforms to the UK's framework to ensure financial stability constitute one of the three pillars of the UK's macroeconomic framework. The UK has established a clear structure of responsibilities for the three public authorities with roles in this field, and for cooperation between them. This is set out in a Memorandum of Understanding (MoU) between HM Treasury, the Bank of England and the Financial Services Authority (FSA).<sup>2</sup> It reflects, in particular, the creation of a new independent single regulatory and supervisory body in 2000 – the FSA – and the change in the Bank of England's role from responsibility for banking supervision to focusing on stability in the financial system as a whole.

**6.3** This section first describes the arrangements in place for ensuring financial stability in the UK, focusing on the mechanisms for handling a systemic crisis, since this is one area where there could in theory be substantial changes were the UK to join EMU. It then looks at existing arrangements in the EU in the field of financial services legislation and supervision. The final part of the section assesses the likely response of the euro area to a financial crisis, and suggests that greater clarity of the arrangements here could be helpful.

<sup>1</sup> The EMU study *The United States as a monetary union* contains more detail. See also Romer (1993) and Nakaso (2001).

<sup>2</sup> Available at [http://www.hm-treasury.gov.uk/Documents/Financial\\_Services/Regulating\\_Financial\\_Services/fin\\_rfs\\_mou.cfm](http://www.hm-treasury.gov.uk/Documents/Financial_Services/Regulating_Financial_Services/fin_rfs_mou.cfm).

## FINANCIAL STABILITY IN THE UK<sup>3</sup>

### Three public authorities involved

**6.4** In the UK, the public authorities concerned with financial stability are HM Treasury, the Bank of England and the FSA. The MoU for cooperation between them, described above, is based on principles of accountability, transparency of responsibilities, avoidance of duplication of responsibilities and regular information exchange.

**6.5** The key responsibilities for ensuring financial stability in the UK are as follows:

- the **Treasury** is responsible for the regulatory framework and legislation. It has a macroeconomic and a microeconomic interest in financial stability and in the efficiency of the financial system, and responsibility for any consequent risks to the public finances;
- the **Bank of England** has responsibility for the stability of the financial system as a whole. Its role includes taking a broad overview of the system as a whole and oversight responsibility for payment systems; and
- the **FSA** is the single supervisor and regulator of all financial services firms and recognised market bodies. It has overall responsibility for maintaining confidence in the financial system and for authorisation and supervision of firms, the supervision of financial markets and clearing and settlement systems, and for the associated regulatory policies. Its functioning is described in more detail in Box 6.1.

**6.6** With its latest review of the UK economy published in March 2003, the IMF (2003c) says that “*the UK financial stability policy framework is at the forefront internationally in many respects*”.

### Information exchange important

**6.7** Ongoing information exchange between the three authorities is important in making the arrangements work in practice – in particular in respect of work to maintain and promote financial stability. The MoU provides for a forum for such cooperation – the UK Standing Committee on Financial Stability. The Committee brings together the Treasury, the Bank of England and the FSA. Formally, its members are the Chancellor, the Governor of the Bank of England and the Chairman of the FSA. In practice, their deputies meet approximately once a month.

### Lender of last resort operations...

**6.8** The key goal of the UK’s financial stability arrangements is to prevent the emergence of a systemic crisis that could threaten the stability of the financial system, and thus of the entire economy. But there will inevitably remain some risk of such a crisis occurring. In such a case, there might be a justification for official financial support operations, often known as lender of last resort operations, in which the authorities would provide official financial support to a financial institution or market. Financial support might be justified if the alternative were to involve severe consequences for the financial system as a whole.

<sup>3</sup> See Balls and O’Donnell (2002) for more detail on the recent reforms of financial regulation in the UK.

**Box 6.1: The Financial Services Authority (FSA)**

The FSA was established as the UK regulator of financial services by the Financial Services and Markets Act (FSMA) of June 2000.<sup>a</sup> Its responsibilities include the regulation of banks, building societies, investment firms, insurance companies and friendly societies; and the supervision of financial markets and of clearing and settlement systems.

The FSA acts as a single integrated regulator, replacing nine previous regulatory bodies for particular sectors. It is designed to ensure consistency of regulation across the financial sector and to reduce coordination problems.

The FSA's aims are set out in the FSMA. They are its 'regulatory objectives' of:

- market confidence;
- public awareness;
- the protection of consumers; and
- the reduction of financial crime.<sup>b</sup>

Clearly, regulatory style cannot be wholly determined by statute. It includes a strong implicit 'cultural' element determined by the management and heritage of the regulator. But the FSA is given a strong and explicit statutory steer in respect of its regulatory style.

The FSMA<sup>c</sup> requires it to have regard to:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised firms;
- the principle that any burden or restriction imposed should be proportionate to the benefits which are expected to result;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and markets and the desirability of maintaining the UK's competitive position;
- the need to minimise the adverse effects on competition; and
- the desirability of facilitating competition between those who are subject to FSA regulation.

<sup>a</sup> The FSA assumed its full powers under the FSMA on 1 December 2001.

<sup>b</sup> Sections 2(2) and 3-6 of the FSMA.

<sup>c</sup> Section 2(3).

- ...only in exceptional circumstances** **6.9** The MoU outlines how the UK system would respond to a systemic crisis. It envisages the Bank of England undertaking official operations to support a financial institution, though only in “*exceptional circumstances*”. It states that such an operation “*would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance to the UK economy*” (paragraph 11).
- Close coordination** **6.10** A lender of last resort operation would require close coordination between the Bank of England, the FSA (given its supervisory role) and the Treasury (given its capital and tax raising powers, and macroeconomic responsibilities). In identifying a circumstance in which a lender of last resort operation may be required, the MoU requires the Bank of England and the FSA to inform and consult with each other immediately. They are also required to inform the Treasury immediately, including to give the Chancellor the option of refusing support action that could be costly to taxpayers.
- Constructive ambiguity** **6.11** The operational framework for carrying out lender of last resort operations is thus clear. However, the question of whether a specific support operation will be undertaken is governed by the principle of ‘constructive ambiguity’.<sup>4</sup> This is to avoid a moral hazard problem, whereby an institution, knowing that it will be bailed out if it fails, undertakes excessively risky lending. To reduce the risk of this problem further, the authorities would only provide official support on penal terms and after commercial solutions had been fully investigated. Only when such options have been exhausted would the authorities consider providing support themselves. Even then they might decide against it.<sup>5</sup>

## FINANCIAL STABILITY IN THE EU

- Member State responsibility** **6.12** There is no EU or EMU level responsibility for financial supervision; this remains the preserve of individual Member States. ECOFIN has noted the importance of subsidiarity in EU arrangements on financial services “*since supervisory tasks are best performed as close as possible to supervised entities and since financial crises may have implications for public finances*”.<sup>6</sup> There is substantial heterogeneity of supervisory systems across the EU, as Table 6.1 demonstrates.<sup>7</sup>

<sup>4</sup> See Freixas (1999).

<sup>5</sup> See George (1994) for a similar policy discussion (in the context of the previous institutional framework).

<sup>6</sup> ECOFIN minutes of 7 May 2002, available at <http://ue.eu.int/newsroom>.

<sup>7</sup> Favero et al. (2000) contains a similar table.

**Table 6.1: Competent supervisory authorities in Europe**

	Banking	Securities	Insurance
<b>Austria</b>	Single supervisor (central bank has significant operational role)		
<b>Belgium</b>	Banking and securities supervisor		Insurance supervisor
<b>Denmark</b>	Single supervisor		
<b>Finland</b>	Banking and securities supervisor (operates in connection with central bank)		Insurance supervisor and government department
<b>France</b>	Banking supervisor staffed by central bank	Securities supervisors	Insurance supervisor and government department
<b>Germany</b>	Single supervisor (central bank has significant operational role)		
<b>Greece</b>	Central bank	Securities supervisor	Government department
<b>Ireland</b>	Single supervisor under central bank		
<b>Italy</b>	Central bank	Securities supervisor	Insurance supervisor
<b>Luxembourg</b>	Banking and securities supervisor		Insurance supervisor
<b>Netherlands</b>	Central bank	Securities supervisor and central bank	Insurance supervisor
<b>Portugal</b>	Central bank	Securities supervisor and central bank	Insurance supervisor
<b>Spain</b>	Central bank	Securities supervisors	Government department
<b>Sweden</b>	Single supervisor		
<b>UK</b>	Single supervisor		

*Note: Table includes some simplification. Some arrangements are subject to change.*

**EU policies based on Single Market Programme and cooperation**

**6.13** At the EU level, Member States are involved in two broad strands of activity in relation to the financial services sector:

- action to ensure a genuine Single Market in financial services in the EU; and
- cooperation between national regulators to exchange information, including about emerging threats to financial stability.

**6.14** Both of these strands function at an EU level, not for euro area countries alone, so the UK is fully and directly involved.

**Single Market...**

**6.15** There is a long standing agenda to ensure a genuine single market in financial services. In 1999, the European Council endorsed the Financial Services Action Plan (FSAP), which identifies key measures aimed at removing a range of barriers to the single market and sets a timetable for their adoption.<sup>8</sup> The FSAP's relationship to financial stability is limited, though one of its strategic objectives is to ensure state-of-the-art prudential rules and supervision.

**...a key goal of the UK Government**

**6.16** The UK Government believes that a dynamic single market in financial services is key to achieving fundamental economic reform and prosperity across Europe. The Government believes that such a single market should be based around mutual recognition of minimum standards and exchange of information. It should focus on measures which will deliver early economic benefits for citizens and business across the EU.<sup>9</sup>

<sup>8</sup> The plan is available at [http://europa.eu.int/comm/internal\\_market/en/finances/general/actionen.pdf](http://europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf). It is discussed in more detail in the EMU study by HM Treasury *The Location of financial activity and the euro*.

<sup>9</sup> See HM Treasury (2002a).

**Cooperation between national regulators and supervisors**

**6.17** Of more direct relevance to financial stability are the mechanisms for facilitating cooperation between national financial regulatory and supervisory bodies. In particular:

- following publication of the Lamfalussy report in 2001,<sup>10</sup> two new EU securities committees have been established. The committees' members are high-ranking experts from each Member State (from Finance Ministries and supervisory authorities respectively). These committees, however, have only a limited involvement in ensuring financial stability. ECOFIN has agreed on the extension of the Lamfalussy arrangements to the banking and insurance sectors and reinforcing cooperation between regulators and between supervisors.<sup>11</sup> This will help progress towards a dynamic and effective single market in financial services, including through boosting consultation and transparency in EU work on financial services; and
- there are some mechanisms for cooperation between national authorities<sup>12</sup> in the context of prudential legislation supporting the European single market in financial services. Following the 'Brown-Eichel' initiative, ECOFIN has recently agreed arrangements for the EFC to act as "*the primary source of advice on issues related to economic and financial developments for the ECOFIN Council*".<sup>13</sup> The Financial Services Committee (FSC) of financial sector experts from Member States has been set up to support the EFC in this work and on other financial services issues.

**The ESCB 6.18** The ESCB has an indirect role in financial stability matters, as set out in Article 105(5) of the Treaty:

*"The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".<sup>14</sup>*

**6.19** In practice, this role is mainly carried out via the Banking Supervision Committee (BSC) of the ESCB which, as well as national central banks and the ECB, includes banking supervisors which are not central banks. Although the UK has a derogation from Article 105(5), the Bank of England and the FSA are both members of the BSC.

**6.20** Article 105(6) of the Treaty leaves open the option of an expanded ECB role here:

*"The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings".*

**6.21** However, this article has not been used. Consistent with its views on the importance of the separation of banking supervision and monetary policy, the UK Government does not consider that such tasks should be conferred upon the ECB.

<sup>10</sup> *Final Report of the Committee of 'Wise Men on the Regulation of European Securities Markets'*. Available at [http://europa.eu.int/comm/internal\\_market/en/finances/general/lamfalussy.htm](http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussy.htm).

<sup>11</sup> This followed an initiative by the Chancellor of the Exchequer and the German Finance Minister Hans Eichel.

<sup>12</sup> See the 'Brouwer Report' – 'Report on Financial Stability', Economic and Financial Committee, 2000 – for more details. Available at [http://europa.eu.int/comm/economy\\_finance/publications/economic\\_papers/economicpapers143\\_en.htm](http://europa.eu.int/comm/economy_finance/publications/economic_papers/economicpapers143_en.htm).

<sup>13</sup> Council conclusions on financial regulation, supervision and stability adopted on 3 December 2002. Available at <http://ue.eu.int/newsroom>.

<sup>14</sup> The UK has derogation from this provision under the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the EC Treaty.

**Unchanged by EMU** 6.22 While important, these elements function at an EU rather than euro area level. UK membership of EMU therefore need not produce material changes to the UK's arrangements to ensure financial stability.

### Official support operations in the euro area

6.23 One area, however, that merits further investigation, is the issue of how official support operations might be arranged in the euro area.

**Apparent national lead...** 6.24 It appears that the competent authorities for financial stability-related issues, including lender of last resort operations, are left at the national level. For example, the Bank of France (2002) states that *"In the euro area, responsibility incumbent upon central banks in terms of financial stability is mainly exercised at the national level"* (page 59). This view is supported by Article 105(5) of the Treaty (see above), which suggests only an indirect role for the ESCB.

6.25 In the event of a crisis in the euro area, official support operations would be carried out by the competent national authorities, coordinating with other national authorities as necessary. Because of its indirect role in financial stability matters, the ECB would be informed. Were the UK to join EMU, it could maintain its existing arrangements for lender of last resort operations.

**...but some conflicting views** 6.26 However, there is some uncertainty about how official support operations would function in practice. Some commentators have argued that the Treaty provides room for an expanded ECB role. For example, Buiter (1999) argues that *"the Treaties do not rule out the ECB and the ESCB fulfilling the lender of last resort"* and that *"the ECB should just get on with it."* (pages 21 and 26). Similarly, Goldman Sachs (2002) believes that the ECB would take an active role in any crisis involving systemic risks. Uncertainty remains because clear assertions of the position have not been made – in Buiter's (1999) phrasing, there is something of a vacuum on this question.

**Recent developments** 6.27 A new Memorandum of Understanding on cooperation and, in particular, information sharing, between banking supervisors and central banks of the EU in crisis management situations took effect on 1 March 2003.<sup>15</sup> Its signatories in the UK are the Bank of England and the FSA. The Memorandum itself is not public, but the press release announcing it states that it *"consists of a set of principles and procedures for cross-border co-operation between banking supervisors and central banks in crisis situations"*. The press release recognises that other institutions, such as Finance Ministries, would have an important role in crisis management procedures, and states that the Memorandum can *"be regarded as a contribution to other co-operation arrangements that might be implemented or may be developed in the future involving other relevant authorities."*

**Greater clarity useful** 6.28 While this is an important development, it does not (and is not intended to) provide a clear delineation of roles if official support operations become necessary. Because the Memorandum is not published, market participants are also unable to understand the system clearly. While ambiguity over whether support will be undertaken in a particular case can be constructive, ambiguity over how the institutional structure will work can be unhelpful.<sup>16</sup> It could potentially slow decision-making at a time when, intrinsically, events are very fast moving. It might equally produce less beneficial outcomes, if decision-making functions are not well constructed in advance.<sup>17</sup>

<sup>15</sup> See the ECB's press release of 10 March 2003. Available at <http://www.ecb.int>.

<sup>16</sup> See Aglietta (1999).

<sup>17</sup> Bean (1998a) sees the lack of clarity about the allocation of lender of last resort responsibilities as *"one of the more worrying features of the Maastricht blueprint"* (page 52).

**Clarification should recognise national lead** **6.29** National financial authorities should make the decision as to whether to undertake support operations because of:

- **informational asymmetries:** because the ECB is not involved in day-to-day supervision, national authorities will know better where problems are and how they can best be solved;
- **fiscal authorities are decentralised:** since they would have to underwrite any large support operation, the full and central involvement of national fiscal authorities in lender of last resort decisions is essential,<sup>18</sup> and
- **substantial risks of increased moral hazard problems:** if support operations are undertaken at a euro area level, there are substantial risks of increased moral hazard problems. National regulators may not undertake sufficiently prudent regulation because they know that a bail out would be paid for predominantly by taxpayers elsewhere. ECB support for a financial institution could create increased moral hazard in all euro area countries, whereas nationally-based support would tend only to increase moral hazard in the country concerned.

## CONCLUSIONS

**No material change to UK system to ensure financial stability...** **6.30** The UK system for ensuring financial stability involves close cooperation between HM Treasury, the Bank of England and the FSA, with clear roles for each authority and a clear structure for coordination between them. This is appropriate for the UK's circumstances, and in line with best practice internationally. The arrangements for undertaking lender of last resort operations in the UK are also clear. UK membership of EMU need not produce material changes to the UK's arrangements to ensure financial stability.

**...but clarity in euro area could be increased** **6.31** However, a clearer assertion of the position on official support operations in the euro area would be helpful to ensure that the euro area avoids creating ambiguity about its approach to lender of last resort functions which could be harmful, and to avoid potential confusion in the event of a financial crisis. Recent developments in this area have been encouraging, but an explicit public statement of the arrangements would increase the certainty and predictability of the system for all market participants.

<sup>18</sup> This is a key contrast with the US and a reason that Buiter's (1999) analogy does not hold.

**7.1** This study has examined the robustness of macroeconomic policy frameworks in the UK and the euro area on the basis that effective policy frameworks can make a significant contribution to prosperity and economic stability. In the context of the Government's decision on EMU the study is most relevant to the fifth of the Government's five economic tests for EMU entry, which asks whether EMU will "*promote higher growth, stability and a lasting increase in jobs*".

**7.2** The starting point for the study is that a single model for policy frameworks is not appropriate in all circumstances and there may be more than one route to achieving stability. This is particularly important when considering the UK and the euro area since their different environments (the UK framework applies solely to the UK while the euro area framework applies to a number of countries which have pooled responsibility for certain functions in EMU) necessarily imply different arrangements.

**7.3** The study has shown that there are a number of similarities between the UK and the euro area policy frameworks. In particular, in both cases there seems to be broad agreement, in line with the academic consensus, that monetary policy should have primary responsibility for managing aggregate demand so as to maintain low inflation, with the primary objective of fiscal policy to maintain sound public finances over the medium term. However, given a counterfactual in which the UK would continue to operate with its current policy framework outside EMU, the study inevitably focuses on the differences between the respective policy frameworks.

**7.4** Both the UK and the euro area frameworks are relatively young and continue to evolve. The Bank of England has instigated reviews of its monetary policy decision-making since the framework was established in 1997 and the ECB has taken steps to increase the clarity of its strategy since it took control of euro area monetary policy at the start of 1999. The ECB is currently undertaking a review of its strategy as well as considering the challenges to effective decision-making posed by EU enlargement.

**7.5** In fiscal policy, too, there is constant evolution. In the UK, the fiscal framework is based on up-to-date, extensive and rigorous analysis reflecting the latest developments, while in the euro area there has been evolution in the interpretation of the framework and, in light of recent and future challenges, Member States have agreed on the need for further improvements.

**7.6** The UK Government plays a full part in the debate over EU and euro area policy frameworks and will continue to do so, inside or outside of EMU. This reflects the Government's commitment to a well-functioning EMU. In these and any other discussions, the Government's approach will continue to be underpinned by its aim to secure robust policy frameworks which achieve the objectives of credibility, flexibility and legitimacy.



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**A1** Section 4 introduced the key elements of the fiscal framework which operates in the EU. This annex describes these elements in more detail.

## The Excessive Deficit Procedure

**A2** Under the Excessive Deficit Procedure (EDP), Member States participating in EMU are required to “*avoid excessive government deficits*”, as defined in Article 104 of the EC Treaty and the Protocol on the EDP, annexed to the EC Treaty. Member States that have not yet adopted the single currency (including the UK) are required to “*endeavour*” to avoid excessive government deficits (Article 116(4)). The criteria used to assess the EDP are as follows:

- whether the ratio of the planned or actual general government **deficit to GDP exceeds 3 per cent**; unless:
  - either the ratio has declined substantially and continuously and reached a level that comes close to 3 per cent of GDP; or
  - alternatively, the excess over the 3 per cent of GDP is only exceptional and temporary and the ratio remains close to 3 per cent.
- whether the ratio of general government gross **debt to GDP exceeds 60 per cent**, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

## Implementation of the EDP

**A3** Article 104 of the EC Treaty explains how the EDP should be implemented.<sup>1</sup> The Commission should prepare a report if it believes that a Member State has exceeded, or is at risk of exceeding, the reference values for deficit and/or debt (Article 104(3)).<sup>2</sup> Following consideration by EFC, the Commission then prepares its official Opinion, addressed to the ECOFIN Council, on whether an excessive deficit “*exists or may occur*” in the Member State.<sup>3</sup>

**A4** The Treaty allows for representations to be made by the Member State concerned (Article 104(6)), and for the Commission to consider the Member State’s levels of government investment and its medium-term budgetary position (Article 104(3)).

**A5** Where ECOFIN judges that an excessive government deficit exists, on the basis of qualified majority voting, it makes recommendations to the Member State concerned with a view to bringing the situation to an end within a given period of time.<sup>4</sup> If a Member State persistently fails to put in place the Council’s recommendations, the Council may give it notice to take the measures necessary to remedy the situation.

**A6** Further measures can be applied to an EMU member with an excessive deficit if they fail to comply with the Council’s recommendations. These are:

- require Member States to publish additional information before issuing bonds and securities;

<sup>1</sup> See also HM Treasury (2003b).

<sup>2</sup> Such reports, because of deficits in excess of the reference value, were quite common when many countries were in the second stage of EMU. More recently, such a report was adopted by the Commission on the Portuguese economy on 24 September 2002, and on the German economy on 19 November 2002. To date, no reports have been prepared on the basis of debt levels in excess of the reference value.

<sup>3</sup> Such an Opinion was prepared by the Commission on the Portuguese economy on 16 October 2002, and on the German economy on 8 January 2003.

<sup>4</sup> On 5 November 2002, ECOFIN adopted a Decision on the existence of an excessive deficit in Portugal, and made a Recommendation to Portugal with a view to bringing an end to the situation. On 21 January 2003, ECOFIN adopted a Decision on the existence of an excessive deficit in Germany, and made a Recommendation to Germany with a view to bringing an end to the situation.

- invite the European Investment Bank to reconsider its lending policy towards the Member State;
- require the Member State to make a non-interest bearing deposit of an appropriate size with the Community, until the excessive deficit has been corrected; and
- impose fines of an appropriate size.<sup>5</sup>

**A7** As described in the UK Protocol to the EC Treaty,<sup>6</sup> sanctions could only apply to the UK if it were to join EMU.

**A8** In line with Article 104(12), when the Council believes the Member State concerned has corrected the excessive deficit, the Council abrogates the excessive deficit, and can abrogate some or all of the decisions made concerning further measures.

**The SGP A9** In order to maintain fiscal discipline after the start of EMU, the Council agreed on the SGP in 1997, consisting of a Council Resolution that is put into practice through two Council Regulations. The SGP has three main characteristics:

- acceleration and clarification of the implementation of the EDP;
- increased surveillance of Member States' budgetary positions, including the possibility of 'early warnings' from the Council in order to prevent the emergence of an excessive deficit in a Member State; and
- the requirement that budgetary positions be 'close to balance or in surplus' in the medium term.

**Clarification of the EDP A10** Council Regulation (EC) No 1467/97 of 7 July 1997, on "*speeding up and clarifying the implementation of the excessive deficit procedure*" builds on the EDP. For example, it describes what is meant by "*exceptional and temporary*" in Article 104 of the Treaty, sets a timetable for applying sanctions to Member States which fail to take action to correct an excessive deficit and describes the level of sanctions to be applied.<sup>7</sup>

**Exceptional and temporary A11** The Regulation makes clear that a deficit over 3 per cent of GDP shall be considered 'exceptional and temporary' if it results from an unusual event outside the control of the Member State concerned which has a major impact on the general government financial position, or if it results from a severe economic downturn. The Regulation defines a severe economic downturn as exceptional only if there is an annual fall in real GDP of at least 2 per cent; though the Regulation goes on to say that the Council is willing to take into account observations from the Member State that a fall of less than 2 per cent is nevertheless exceptional in the light of further supporting evidence, in particular on the abruptness of the downturn or on the accumulated loss of output relative to past trends. In their Resolution on the SGP, members of the Council agree not to invoke this argument unless they are in severe recession, defined as an annual fall in GDP of a least 0.75 per cent.

<sup>5</sup> Deposits will normally be converted into fines if, two years after the decision to require a deposit to be made, the deficit has not been corrected.

<sup>6</sup> The Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the EC Treaty.

<sup>7</sup> The first deposit will be a fixed component of 0.2 per cent of GDP, plus a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 per cent. Each year thereafter, until the situation is corrected, the sanctions will be intensified by one tenth of the difference between the deficit and the reference value, unless the Member State has complied with the Council notice. Any single deposit is restricted to a maximum of 0.5 per cent of GDP.

- Close to balance or in surplus** **AI2** Council Regulation (EC) No 1466/97 of 7 July 1997, on “*the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*” introduces the requirement that, over the medium term, each country’s budgetary position should be “*close to balance or in surplus*” (CTBOIS). This is designed to ensure that Member States can “*deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 per cent of GDP.*”<sup>8</sup>
- Regular surveillance** **AI3** Council Regulation 1466/97 also provides for the regular surveillance of Member States’ budgetary positions in the form of annual Stability (for Member States participating in EMU) and Convergence (for Member States not participating in EMU, including the UK<sup>9</sup>) Programmes. These should detail the country’s adjustment path towards meeting the medium-term budgetary objective of the SGP and the expected path of the general government debt ratio. They should also include the Programme’s assumptions about expected economic developments, such as government investment, GDP growth, employment and inflation.
- AI4** Member States are required to submit updates of their Programmes no later than 1 December each year.<sup>10</sup> Once the programmes are submitted, the Commission produces assessments of each programme which are discussed in detail by the EFC. ECOFIN Ministers then agree and publish Opinions on the programmes of all EU Member States.
- The BEPGs** **AI5** The results of the annual multilateral surveillance that takes place under the SGP feed into the annual Broad Economic Policy Guidelines (BEPGs), the key economic policy document of the EU, which contains non-binding recommendations to Member States on both fiscal policies and structural policies. These are discussed in Section 5.
- Early warnings** **AI6** As described in Council Regulation 1466/97, if the Council identifies a significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it can, “*with a view to giving early warning in order to prevent the occurrence of an excessive deficit*”, make a recommendation to the Member State concerned to take the necessary adjustment measures, in accordance with Article 99(4) of the Treaty. Such a recommendation may be made public by the Council, acting by a qualified majority of all Member States, but it does not compel action. The Commission proposed to ECOFIN on 30 January 2002 to give an early warning to Portugal and Germany. In light of commitments made by the respective Governments, the Council decided not to pursue the early warning in either instance. The Commission recommended to ECOFIN on 19 November 2002 to address an early warning to France; the Council did so on 21 January 2003.
- Code of Conduct** **AI7** The interpretation of ‘close to balance’ and of ‘the medium term’ is not explicit in either the Treaty or the SGP Regulations. The 2001 Code of Conduct, endorsed by the ECOFIN Council, goes some way to clarifying this requirement, aiding the implementation of the SGP. It states that “*the time frame for interpreting the medium term would be the length of the business cycle*”, implying that budgetary positions should be expected to be close to balance or in surplus in normal economic conditions. It also states that “*the medium-term budgetary position which respects the close-to-balance-or-in-surplus rule of the SGP has to take account of several elements*”, including cyclical developments, the costs of population ageing and the need to ensure a rapid decline in high debt ratios. It is perhaps important to note the parallels with the constrained discretion built into the UK framework. Member States circumstances differ, so the Code should embody guidelines rather than a series of mechanistic targets.

<sup>8</sup> Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997. Available at [http://www.europa.eu.int/comm/economy\\_finance/about/activities/sgp/sgp\\_en.htm](http://www.europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm).

<sup>9</sup> The UK’s latest Convergence Programme, *Sustainability for the long term* (HM Treasury, 2002g), was published in December 2002.

<sup>10</sup> ECOFIN has agreed that, because of the different fiscal year, the UK should submit its Convergence Programme as close as possible to the publication of the annual Pre-Budget Report, generally by the end of December.

**A18** Under the specific requirements of the EDP, and the broader requirements of the SGP, the Commission and the Council have a duty to monitor the development of Member States' budgetary positions. In the Code of Conduct, Member States have agreed detailed guidelines for the interpretation of the SGP, helping the Commission in their assessments and the Council in their decisions.