

Towards a Credible Excessive Deficits Procedure

**by
Daniel Gros**

CEPS Working Document No. 95

Towards a Credible Excessive Deficits Procedure

by
Daniel Gros

CEPS Working Document No. 95

July 1995

CEPS Working Documents are published to give an early indication of the work in progress within CEPS' research programmes and to stimulate reactions from other experts in the field. Unless otherwise indicated, the views expressed are attributable only to the author in a personal capacity and not to any institution.

ISBN 92-9079-197-7

© Copyright 1995, Centre for European Policy Studies.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means — electronic, mechanical, photo-copying, recording or otherwise — without the prior permission of the Centre for European Policy Studies.

Centre for European Policy Studies
Place du Congrès 1, B-1000 Brussels
Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51

Table of Contents

Abstract	1
Introduction	2
1. Why Limits on Excessive Deficits?	3
2. The Existing Enforcement Mechanism	5
3. A Concrete Proposal	9
a) A Last Chance	9
b) For Persistent Offenders: Exclusion!	10
c) Who Decides?	13
4. A Contract for the Transition	14
5. Concluding Remarks	19
Annex: Summary of Proposed Additions to Article 104c	20
References	21

Towards a Credible Excessive Deficits Procedure

by
Daniel Gros*

Abstract

There are two strategic issues concerning EMU as it is presently designed:

- i) The normal enforcement mechanisms of the Treaty can not be used to ensure that member states obey the prohibition of excessive deficit. Instead the entire excessive deficits procedure has been assigned to the ECOFIN Council, which has never been able to agree tough measures towards member countries that have clearly not followed its recommendations. Hence there is a legitimate doubt in some countries whether the prohibition of excessive deficits will be enforced effectively once EMU has started.
- ii) The creation of a core may make it even more difficult for the peripheral countries to catch up.

The paper proposes that the enforcement mechanism of the excessive deficit procedure be strengthened. First, countries with an excessive deficit should be automatically required to sequester spending and increase taxes. Second, if they do not follow this last call to order, they should be relegated to an associated status in EMU. ECOFIN would have no discretion in this procedure and only the countries that are in EMU should be allowed to participate in these decisions.

Countries that have converged in terms of inflation, but have fiscal problems because of high interest rates, should be encouraged to peg unilaterally to the core EMU (in effect acquiring an associated status) when the third stage begins. They would agree at the same time to be subject to the full excessive deficit procedure. This should give them important interest savings and make it easier for them to satisfy the fiscal convergence criteria which, will remain the *conditio sine qua non* for full participation in EMU.

* Centre for European Policy Studies (CEPS), Brussels and Johann Wolfgang Goethe Universität Frankfurt am Main. I wish to thank Erik Jones and Peter Ludlow for fruitful discussions and comments. This research was done in connection with the CEPS "Economic Policy Group" project which has received financial support from the Bundesbank, Banco d'España, Sverige Riksbank and the German Marshall Fund (Grant No: B-0119). The opinions offered and proposals made in this paper are my own and do not necessarily reflect the views of CEPS or the members of the Economic Policy Group.

Introduction

At present (end 1995) there seems to be wide agreement among the officials preparing the 1996 Intergovernmental Conference (IGC) that the EMU chapter of Maastricht should not be re-opened. At the same time, however, there is growing unease among policy analysts and financial authorities with two aspects of the system as it was designed in 1991.

The first is that the enforcement of the prohibition of excessive deficits is assigned to the ECOFIN Council, which has never taken any real decision in the sense that it has never imposed any tough measures on countries that systematically flout the basic rules of the Union. In the case of Greece, it has not even been able to impose a conditionality like that used by the IMF. The last ECOFIN meeting only started to discuss the possibility of cutting structural funds to countries that do not follow their own convergence programme. The prospect of a Union of 25 members makes a strengthening of the excessive deficits procedure even more urgent since several of the candidates are likely to have serious fiscal problems.

It is symptomatic that there has been no public discussion of the astonishing fact that the prohibition of excessive deficits cannot be enforced by the Court of Justice as other provisions because paragraph 10 of Article 104c rules this explicitly out. This is the fundamental reason why the Maastricht Treaty had to contain a special procedure to enforce the prohibition of excessive deficits.

The second cause for concern arises from the realisation that EMU will not come for all countries at the same time. How can one then avoid the situation in which the creation of a core will make it even more difficult for the peripheral countries to catch up? Recent events in financial markets suggest that this is a valid concern.

This paper addresses these two strategic issues. The concrete proposal is to make the excessive deficit procedure much more automatic and based on firm rules, thereby reducing the room for discretion exercised by ECOFIN. Once this has been done it would be possible to give countries that are very close to fulfilling all the criteria a sort of 'associated membership' in EMU which should accelerate convergence and hence the time needed to

reach full membership.

The rationale for the limits on excessive deficits in the Maastricht Treaty has been hotly debated among economists. Some maintain that in an ideal world there is no need for special rules on excessive deficits since it would be out of the question that the Union would ever bail out a member state and the European Central Bank (ECB) would ever be deflected from its anti-inflationary stance by fiscal policy problems. Others argue that in reality the no bail-out rule cannot be enforced under all circumstances and therefore a public debt crisis in any one member state would affect the others and would likely make it more difficult for the ECB to pursue a tough anti-inflationary policy.

There is little disagreement, however, that the Maastricht Treaty (Treaty on European Union or TEU) lacks a credible mechanism to enforce the fiscal criteria (maximum 3% of GDP deficit and a debt level converging toward 60% of GDP). The main purpose of this paper is to discuss a way to make the excessive deficit procedure more credible. The solution proposed below is to exclude countries with persistent excessive deficits from the decision-making process in the ECB and ECOFIN. This rule can also be applied to the transition phase: countries whose fiscal problems are exacerbated by higher interest rates might elect to seek a sort of *Anschluss* (or rather a currency board) to the core EMU. Full participation in EMU would, however, remain subject to meeting the convergence criteria.

This paper is organised as follows: Section 1 recapitulates briefly the main arguments for limits on deficits. Section 2 provides a critique of the enforcement mechanism in the Maastricht Treaty, and Section 3 offers a concrete counter-proposal. Section 4 then argues that once the defence of the anti-inflationary stance of the ECB has been hardened, some countries that suffer from high interest rates could be encouraged to participate unilaterally in the start of EMU in order to facilitate budgetary adjustment. Section 5 presents conclusions.

1. Why Limits on Excessive Deficits?

Before going into a discussion of how to enforce the excessive deficit limits, it is useful to recall briefly the reason why limits on excessive deficits are needed. There are two main arguments that speak in favour of limits on excessive deficits. The first argument is that the accommodation of large public debt might lead to instability in financial markets which in turn would make it difficult for the ECB to follow a tough anti-inflationary policy. The second argument is simply that large public-sector deficits take up private sector savings that would otherwise go to investment. Hence, large deficits lower growth prospects in the medium to long run. For an elaboration of these ideas, see Box 1 below or Gros and Thygesen (1992).

These two arguments suggest potentially valid economic reasons for rules against excessive deficits that lead to an unsustainable build-up of public debt. In addition to these economic arguments, one must also take account of the fact that the German Constitutional Court decided in a landmark ruling that strict observance of the convergence criteria is a condition for German participation in EMU. The ruling implies that any German government would be entitled (required?) to pull out from EMU when a danger to the stability of the common currency arises.¹ This provides an additional reason why it is important to have an enforcement mechanism that works. The threat of German withdrawal will act as a deterrent, but it cannot be the sole sanction because the costs of German withdrawal (implying effectively a dissolution of EMU) would be borne by all countries, not just the one that has the excessive deficit and caused the upheaval.

For the discussion below, the main point to keep in mind is that the excessive deficit procedure should have an exceptional character: it should be used only if the fiscal situation in a country becomes unsustainable to the point that the danger of a fiscal crisis exists. Practical examples of this include the present situation in Italy and the mini debt crisis in

¹ Statements by politicians from all the major parties continue to underline that strict observance of the fiscal criteria is a *conditio sine qua non* for German participation in EMU. All this risks leading to the typical situation of "irresistible force meets immovable object". Special domestic interest groups represent the irresistible force that drives deficits against the immovable object in the form of the judgement of the German Constitutional Court.

Box 1

Arguments Against Excessive Deficits

The first argument is based on the way financial markets work. Experience shows that financial markets do not work with smooth supply curves of credit. If the credit-worthiness of a borrower deteriorates interest rates increase at first; but once a certain threshold has been passed, credit is just cut off. Furthermore, theoretical considerations and experience suggest that a slight change in overall financial market conditions can trigger a run on weak creditors which are then at least temporarily excluded from further access to financial markets. This threat of exclusion explains why "junk bond" markets are highly vulnerable. If a run on the public debt of a member state were to occur, the ECB would be under immense pressure to lower interest rates. Under these circumstances, a number of large banks might become illiquid and require emergency credits to convince the banking system that it is safe to deal with them. For these reasons, the ECB would be hard pressed in such a situation not to loosen its anti-inflationary policy stance in general. The result could be an increase in the European rate of inflation.

The counter argument is that this danger to price stability could be eliminated by building the appropriate early warning signals to financial markets through a regular rating of public debt and by forcing banks to recognise that, in EMU, national debt carries a similar default risk as local debt does at present. Banks would then be required to hold the appropriate reserves against this risk. Even an appropriate risk rating of public debt, however, will never be sufficient to eliminate the problem entirely.

The second argument is less technical. It is actually similar to the line of thinking that led to the European Monetary System (EMS) and the idea that an independent central bank is useful. This approach, pioneered by Buchanan (1977), starts from the fact that in most cases the benefits of a given fiscal measure, say a transfer or expenditure programme, accrue to a well defined group that will thus have an incentive to lobby for it. The cost has to be borne by all tax payers and contributors to social security who will find it more difficult to organise opposition to spending decisions because their interests are more dispersed. Hence, the process by which fiscal decisions are taken in a democracy entails a "deficit bias". On average special interest groups win, although the cost of the overall set of all these decisions has to be paid by everybody, including these interest groups. The outcome then is a public sector that is too large and a tendency to let future generations, who constitute the least effective lobby, pay for the debt that has been accumulated in the meantime.

The most important consideration might thus be that, even if the monetary policy of the ECB could be protected in other ways against the inflationary fall-out from excessive deficits, little is lost by introducing additional safeguards against policies that are in any event not in the long-term interest of any country.

Sweden in 1994.

2. The Existing Enforcement Mechanism

How credible is the enforcement mechanism provided for in the Maastricht Treaty? The Treaty of Rome already had a strong enforcement mechanism, namely the Court of Justice, that applies in principle for all provisions, including the chapter on EMU that was added in Maastricht. However, it has been little noticed so far that the article dealing with the excessive deficit procedure excludes specifically in its paragraph 10 the normal enforcement mechanism of the Treaty via the Court of Justice.² This is why article 104c had to contain a new enforcement mechanism specifically designed to overcome the problem that it would be impossible to make member countries obey the prohibition of excessive deficits if there were no sanctions. It is strange that this fundamental reason for the existence of the complicated 'excessive deficit procedure' is seldom mentioned in public.

The excessive deficit procedure detailed in Article 104c of the TEU starts with a recommendation and could finally entail sanctions. A closer look at the graduated response set forth in the article, however, suggests that it does not constitute a credible threat. Paragraph 11 is the key provision, which reads as follows:

As long as a Member State fails to comply with a decision taken in accordance with paragraph 9 [i.e. notification by ECOFIN of a time limit and measures to eliminate an excessive deficit] the Council may decide to apply or, as the case may be, intensify one or more of the following measures:

- to require that the Member State concerned shall publish additional information, to be specified by the Council, before issuing bonds and securities;
- to invite the European Investment Bank to reconsider its lending policy towards the Member State concerned;

² 104c (10) reads as follows: 'The rights to bring actions provided for in Articles 169 and 170 may not be exercised within the framework of paragraphs 1 to 9 of this Article.'

- to require that the Member State concerned makes a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;
- to impose fines of an appropriate size.

Until now, no member state has openly defied the legal and judicial system of the Community (for example, by refusing to implement a directive). This might be the reason why the TEU does not contemplate the possibility that a member country would not heed the requests for fiscal adjustment addressed to it. Fiscal criteria, however, are *a different matter* since fiscal policy remains fully under national control — even under EMU. Hence, the effectiveness of the excessive deficits procedure will depend on the sanctions that underpin it.

How should one evaluate the sanctions listed above? They seem to consist mainly of peer pressure. Their direct deterrent effect would be minor and hence they would do little to resolve the problem, as spelled out below.

- i) Requiring a state to publish additional information would not seem to be a very strong deterrent. What information that is not already widely known could be revealed in this way?
- ii) The EIB finances long-term investment projects at market rates of interest. It cannot hold up work on projects already begun and at any rate, there is almost no subsidy element in its lending. The threat of withholding structural funds would probably have a strong impact in the four main recipient countries, but this sanction has not been retained — probably because it would appear unjust to subject only poorer countries to this discipline.
- iii) What would be the appropriate size of the non-interest-bearing deposit? One percent of GDP (about 10 billion ecu at current exchange rates for Italy)? At interest rates of 8%, this would amount to an annual cost (in terms of interest foregone) of 0.08% of GDP, hardly a strong deterrent.

iv) What would be the appropriate size of the fines? In the hundreds of millions or in the billions of ecu? A large fine (say 1 % of GDP) would only increase the deficit and make it even more difficult to get it below 3 % of GDP. What should the money be used for?

Another drawback of this approach is that enforcement is discretionary (sanctions may be imposed), requiring a decision by ECOFIN for each specific step. This body has not even been able to impose IMF-type conditionality towards Greece in the context of large support programmes. Thus, sanctions need to be made not only more concrete, but also more automatic. Some action or decision needs to be triggered automatically once a certain threshold has been passed. Moreover, the purpose of the excessive deficits procedure should not be to "punish" the offending state, but to help it get its fiscal accounts under control.

In this context, one must keep in mind that a likely circumstance under which a country does not follow the recommendations of the Council is when the national government concerned is weak or when there is no working majority in parliament that is willing to take the unpopular decisions needed to redress the budgetary problem. It is unlikely that a member state government possessing a clear majority in the national parliament will openly defy the EU by acting against the letter and the spirit of the TEU.

Recent events in Italy show that it is precisely the lack of a clear majority that might make fiscal consolidation difficult. Although no significant political group denies the urgent need for drastic action, very little can be done until the domestic political situation has been clarified.

Automatic emergency measures proposed in a concrete form by a neutral body would presumably be accepted in such a situation, since they would actually allow politicians to avoid taking some unpopular decisions. By contrast, "fines" imposed by the Council might not be enough to produce the working majority necessary to increase taxes or reduce expenditure. A government that has only a very limited time horizon would not be impressed by fines, nor by a higher interest rate premium imposed on public debt.

One has to recognise that fiscal "sovereignty" ultimately remains in national hands, even after the third stage of EMU has begun. If a country is really determined to accumulate excessive deficits, the EU will not be able to stop it. Nevertheless, the Union also has the right to say that under such circumstances, a country that continues to flout its basic rules cannot continue to be part of EMU. The ultimate sanction must thus be exclusion. This means that member countries retain their fiscal sovereignty, but they pay a price for clearly deviant behaviour. In the final analysis, member countries retain a clear choice: participation in the common currency area or the freedom to pursue irresponsible fiscal policies.

Moreover, given that satisfying the Maastricht fiscal criteria has been made a condition for entering EMU, it is only logical that a blatant violation of these criteria should also be grounds for expulsion from EMU.

One might object to the sort of interference in national economic policy-making proposed here, on the grounds that it constitutes "process bail-out". According to this view, the underlying problem is that the process by which budgetary decisions are taken at the national level produces a systematic bias towards deficits. What needs to be changed is the constitutional set-up that determines budgets at the national level.³ One could argue that the EU should not take these fundamental decisions that need to be taken at the national level. Box 2 on the following page presents arguments from the field of political science that have been used in opposition to the idea that external constraints can actually be beneficial.

3. A Concrete Proposal

How can one make the excessive deficits procedure more credible? This section proposes three small amendments to the TEU that could be discussed at the 1996 IGC. The first two points are that a country with an excessive deficit should be given a last chance before it is

³ The term "process bail-out" was suggested by Ian Harden. See von Hagen and Harden (1994) for a concrete proposal.

Box 2
Process Bail-out

The view that process bail-out is not desirable loses much of its force if one considers that in a certain sense one of the main features of the European integration process has always been to constrain the freedom of member states in their own long-term interest. The customs union is the first example of this approach, but the best known example of governments willing to have their hands tied is the EMS. Upon entering the EMS, participating countries did not agree to alter the constitutional procedures that determined national monetary policy; they only introduced an external constraint. The system turned out to be useful because the external constraint was a shield against domestic political pressures. Only with the Maastricht Treaty did member states agree to modify their constitutional set-up in the monetary area. This was possible because a consensus existed that only an independent central bank can deliver price stability in the long run.

Requiring constitutional changes in all member states is not appropriate in the fiscal area since there is no similar consensus that only one particular set-up will deliver a sensible fiscal policy. Moreover, fiscal policy involves incomparably more political decisions about redistribution than does monetary policy. Hence, it is much more difficult to design a mechanism that channels the political pressures acting on fiscal policy into a process that will give the desired result, namely a reduction in the fiscal bias.

eliminated from EMU. In order to put this idea into practice, the existing version of paragraph 11 of Article 104c should be eliminated and substituted by the following two items:

a) A Last Chance

Paragraph 11 of Article 104c should begin with the following text:

Once a member state has become subject to a decision under paragraph 9 [i.e. notification by ECOFIN of a time limit and measures to eliminate an excessive deficit] the ECB and the Commission will report on compliance every three months. If the compliance reports of the ECB and the Commission indicate that a Member State has failed to comply with a decision taken under paragraph 9,⁴ the Council will

⁴ The procedure leading up to the decision in paragraph 9 could be shortened by eliminating the step foreseen in paragraph 8, but this a question of detail in this context.

request the member state concerned to limit spending by the national government on a monthly basis to the same amounts as in the previous year and to increase the rate of value-added tax by an amount sufficient to eliminate the excessive deficit within one year.

The advantage of such a formulation is that it gives the government a precise indication of the provisions it must propose to its national parliament. These emergency measures would therefore be removed from the domestic political debate because they would be seen as coming from a neutral authority. This would serve to galvanise the sort of bi-partisan support that can only be mobilised under extreme circumstances. It should be stressed that there is no presumption that sequestering expenditure and raising VAT is the optimal way to reduce the deficit. These measures are proposed only because they are relatively transparent and easy to implement and monitor.⁵

b) For Persistent Offenders: Exclusion!

If the provision proposed above is followed, there should be no need for further sanctions. In order to clarify in advance the consequences of declining to take advantage of this last chance, however, the Treaty should also specify the ultimate sanction: exclusion. This would further increase the likelihood that the national parliament will not torpedo the measures prescribed above. Thus, the second recommendation is that the new text proposed above for the opening of paragraph 11 of Article 104c would continue to read as follows:

If the Council finds, acting on a proposal from the ECB and after consulting with the European Parliament, that a Member State has failed to comply within 3 months with the obligations foreseen in the previous indent, the Member State concerned shall have a derogation as defined in Article 109k, 3.

Receiving a derogation would effectively relegate a persistent offender to the ranks of those who do not participate in EMU. The automatic element in this provision is essential. The ECOFIN should not be given the opportunity to "go soft".

⁵ A temporary surcharge on income tax (like the German *Solidaritätszuschlag*) might also be useful.

What happens "the day after"? In legal terms, what happens in the monetary area is determined by Article 109k, paragraph 3 which implies that the governor of the national central bank of the country that has been given a derogation (i.e. has been excluded) would no longer participate in the decisions concerning the common monetary policy.⁶ Furthermore, the decisions of the ECB would no longer automatically apply to the country concerned (Article 105), and the national central bank would regain its freedom to set monetary policy independently. If the third recommendation presented below is also implemented, an additional (and logical) consequence would be that the country that had been given a derogation would no longer participate in ECOFIN decisions concerning the excessive deficit procedure.

Under the proposed scheme, however, the EU would not be able to force the country concerned to re-introduce a national currency. One has to distinguish here between two possible scenarios. Let us assume in the first instance that expulsion takes place before the common currency is introduced in the form of bank notes. The national currency in physical form would still exist whether or not the country is in EMU. Under this scenario then, the main decision to be taken by the authorities of the excluded country would be whether to de-link their currency from the ecu or whether to continue "as if" they were still members of EMU, i.e. to peg unilaterally and without any margins of fluctuations to the currencies of the remaining "core". Any country with a derogation could thus chose to maintain a sort of 'associated membership' of EMU.

If expulsion comes at a time when coins and notes in the common currency are already in circulation, separation would be more difficult. Continued, unilateral participation in the common currency area would then actually be easier. The country concerned would just have

⁶ Article 109k, 3 specifies that the following provisions do not apply to a country with a derogation:

- 104c(9) and 11 (excessive deficit procedure),
- 105(1),(2),(3) and (5) (monetary policy),
- 105a (notes and coins),
- 108a (empowering the ESCB),
- 109 (exchange rate system with rest of world),
- 109a(2)(b) (membership of the executive board of the ESCB),
- Chapter IX of ESCB Statutes.

to maintain the common currency of the EMU as the national currency and the national central bank would have to continue following the decisions of the ECB.

The crucial question is to what extent such unilateral participation is credible with financial markets. If this sort of "currency board" were credible, interest rates in the country concerned would remain very close to those of the rest of the EMU. Given that the country concerned was excluded on grounds of accumulating an excessive fiscal deficit, however, it is likely that financial markets would add a risk premium to the interest on its public debt. If there are serious doubts about the solvency of a government, its continued unilateral participation in the common currency area would lack credibility with the likely result that interest rates on all instruments issued domestically would increase. Another possibility, however, is that domestic interest rates would increase even more if the country concerned signalled its unwillingness to return to sound fiscal management in the near future by re-introducing a national currency, which thus might not be an attractive policy.

Re-introducing a national currency would not be easy. It is possible as demonstrated by the separation of the Czech and Slovak currencies. But in that case, the financial markets were rather rudimentary so that all bank deposits could be nationalised according to the bank at which they were held. In the EU, separation would be incomparably more complicated given the large volume of cross-border activity. Moreover, households and enterprises would start to shift their deposits massively towards other EU countries in anticipation of such a move.

Countries that have been excluded would thus have a strong incentive to continue to behave as if they were still in the common currency area⁷ until they have eliminated their excessive deficit and can be re-admitted. Expulsion would thus, *de facto*, mean *only* that the governor of the national central bank no longer had a vote on the Council of the ECB. While this might not appear to be a strong sanction it would fulfil the more important aim of protecting the rest of the Union from being influenced by this member state.

⁷ This would also imply that they would share in the profits of the ECB according to Article 32 of the ECB statutes.

c) Who Decides?

Another important point related to the enforcement of the limits on deficits concerns the composition of the (ECOFIN) Council when it has to decide on these matters. Paragraph 13 of Article 104c specifies that the country concerned does not vote on an action involving itself. Moreover, paragraphs (3) and (5) of article 109k imply that countries with a derogation do not participate in the decisions on the (weak) sanctions foreseen in the current version of article 104c. Article 109k (4), however, does not state that a country with a derogation cannot participate in the voting (with weighted two-thirds majority) under paragraph 13 of Article 104c, which determines how decisions under the excessive deficits procedure are taken. This is a mistake that should be rectified. There is no reason why countries that do not participate in EMU should have a voice in deciding whether a country that is in EMU has an excessive deficit or whether a country should be excluded from EMU. This is a matter that affects primarily the interests of member countries of EMU. Countries that do not participate in the third stage of EMU have only a limited interest in protecting the monetary policy of the ECB from the danger of financial market crises and could be influenced in their position by other issues. Moreover, it is conceivable that in the beginning a majority will be composed primarily of countries that do not participate in EMU.

In the long run, when all countries participate in EMU, this problem will disappear. However, it is now likely that it will be several decades before all present and future member countries will participate in EMU. This issue will thus remain important for some time to come.

As a consequence, it is further recommended that the expression "without a derogation" should be inserted in paragraph 13 of Article 104c as follows (proposed change underlined):

When taking the Council decisions referred to in paragraphs 7 to 9, 11 and 12 the Council shall act on a recommendation from the Commission by a majority of two thirds of the weighted votes of its members without a derogation as defined in Article 109k, 3 weighted in accordance with Article 148(2) and excluding the votes of the representative of the Member State concerned.

4. A Contract for the Transition?

It is now certain that only a core group of countries will be able to enter the third stage of EMU in 1999. What does this imply for those left behind?⁸ There is a growing fear in some countries that those that are left behind will face more difficulties in the catching-up process once the others have already gone ahead because their interest rates might rise even further. Is there anything the Union can do to help the "excluded"?

For those countries for which fiscal adjustment is the central issue, i.e. for those countries where inflation is under control, exclusion from the first wave of EMU could be interpreted by financial markets as a signal that adjustment is now less likely and at any rate more difficult. This could lead to an increase in interest rates that would indeed constitute an additional burden. This problem is especially acute in countries such as Italy and Sweden, which now have to pay a very high risk premium on their public debt. In the case of Italy, the differential vis-à-vis Germany has gone to 7 percentage points for some maturities, and one could argue that half of the Italian fiscal problem is due to this high interest burden, which until now, is only partially offset by higher growth in nominal GDP. Nevertheless, if financial markets persist in setting extremely high nominal interest rates, the Italian government will not be able to pay the extremely high real interest rates that would result if inflation were to remain really low. Table 1 below shows the interest burden carried by some of the highly indebted member countries.

⁸The exchange rate regime between this core and the rest of the Union has not been defined in the Treaty. It is likely to be a rather loose arrangement, rather like the current wide-band EMS.

Table 1
Interest Rate Burdens in Select Member States

	Debt/GDP	Yield on Public Debt	Savings at German Yield	Inflation	Savings at German Real Yield
Germany	35.8	7.0		2.4	
Belgium	130.0	7.9	1.2	1.7	2.1
Netherlands	60.1	7.2	0.1	2.4	0.1
Italy	117.9	13.0	7.0	4.3	4.8
Spain	42.2	12.0	2.1	4.8	1.1
Sweden	80.0	11.0	3.2	2.6	3.2

Note: This table is intended simply to give an idea of the order of magnitude of the problem. A more detailed empirical analysis would first of all have to take into account the average maturity structure of public debt.

Source: *The Economist*, 1-7 April 1995, for yields on public debt; *OECD Economic Outlook*, 56, December 1994, for net financial obligations (net government debt).

Given that the debt of the Italian government is now equivalent to over 120% of GDP, even an interest rate differential of "only" 5 percentage points implies an additional debt burden of 6% of GDP. Even if Italy made considerable adjustment efforts, it still might end up having an overall deficit of, say 6%, which would exclude it from EMU. But this deficit would be eliminated at one stroke if it were able to obtain German interest rates on its debt.⁹

⁹ Fortunately, the debt crisis has not lasted so long that the Italian government is paying over 12% interest on all of its debt. Given that the average maturity of Italian public debt is about two to three years, the full effect will be felt within this time span. There is thus still time to act.

What should be done?

Countries such as Italy (or Sweden and possibly Spain) need some reassurance from the Union that the constitution of the core group is only a temporary measure and that the others will be invited to join once they have converged. But what if initial exclusion makes convergence much more difficult? One solution might be *associated status* in EMU (or rather the initial core group). Italy could be invited to come under the EMU umbrella to benefit from lower interest rates, but it would not participate in the management of EMU until it had converged in fiscal terms as well.

This arrangement could be achieved technically by a unilateral declaration that the country concerned accepted all the obligations arising from membership in EMU.¹⁰ For public consumption, however, it would be preferable to have *a formal agreement* between the EU (ECB) and the country concerned. The agreement would specify mainly that the national central bank agreed to follow the monetary policy of the ECB. At the same time, however, it would be clear that for purposes of decision-making in the ECB (and ECOFIN), the country would continue to be treated as having a derogation. In essence, the country would give up its national monetary policy and replace it with that of the ECB. More precisely, this means that the exchange rate would be irrevocably fixed, the payments systems would be unified, actions by the ECB would have direct effect in the country concerned and the decisions of the ECB would have to be applied by the national central bank whose foreign exchange reserves would be pooled in the ESCB. Moreover, the country concerned would be subject to the full excessive deficit procedure. Unilateral restricted participation would in effect be a sort of *Anschluss* much like the period when the DM was introduced in the

¹⁰ The government would have to declare that it accepted the obligations arising from Articles 104c(9) and (11) (excessive deficits procedure); 105(1),(2),(3) and (5) (monetary policy); 105a (notes and coins); and 108a (empowering the ESCB). The national central bank would also accept the obligations resulting from the ESCB statutes (Articles 3, 9, 12.1, 14.3, 16, 18, 19, 20, 22, 23, 30–34 and 52). However, the restrictions specified in paragraphs 3 to 6 of Article 43 of the ESCB statutes would apply. In addition, the country concerned would not participate in decisions under Articles 109 (exchange rate system with rest of world) and 109a(2)(b) (membership of the executive board of the ESCB).

territory of the former GDR.¹¹

All this would be officially acknowledged¹² by the Union in conjunction with a convergence programme outlining how the country would, with the help of lower interest payments, satisfy the fiscal criteria by a certain deadline. Acknowledgement by both the Union and the ECB would make this arrangement credible and would ensure that market interest rates in the country concerned converge quickly to the level of the core.¹³

This sort of associated status in EMU will deliver the benefits in terms of lower interest rates only if it is credible. Credibility should come already from the endorsement given by the ECB, but it would be immensely strengthened if markets see that the exchange rate could be defended under any circumstance. This should be the case if one views the proposed arrangement as a "currency board".

A currency board is credible if the national central bank possesses adequate foreign reserves to guarantee conversion of all of their liabilities (the monetary base) into the common currency of the core. Would this be the case? Table 2 below shows that most of the central banks that might be candidates for this approach have indeed enough reserves to make the currency board approach credible. Column (3) shows that the ratio of foreign assets to the monetary base is above, or close to, one for all countries except Italy. If one takes into account that even in a worst-case scenario few people will exchange their holdings of cash, it would be sufficient for a national central bank to have enough foreign assets to cover the remainder of the monetary base (i.e. required reserves). Column (4) shows that this is the case by a large margin for all the countries considered below with the exception of Italy.

¹¹ This might not be a very enticing example. In the case of the EU, however, convergence will take place before, not after, monetary unification. Hence, the economic difficulties that followed German unification should not occur.

¹² Acknowledgement by the Union should not necessarily imply that the ECB, when setting its monetary policy, would take into account economic conditions in the country that participated in the same way as those of "regular" participants.

¹³ The actual debt service burden would decline only gradually, however, until the outstanding high interest debt is retired. Depending on the maturity structure, this might take two years.

Even there, however, the shortfall is rather limited since the existing foreign exchange reserves cover already 80% of the reserves held by Italian banks with the Banca d'Italia. But this result is due to the unusually large required reserves imposed on banks in Italy. The reserve ratios in Italy are at present 5 to 10 times higher than in the rest of the EU and have to be lowered anyway if Italy wants to participate in EMU. Hence even the Banca d'Italia could defend the exchange rate if it previously lowered required reserve ratios towards the EU average, provided, of course, that it does not engage in any sterilization as done so often in the past.

All the candidates for associated membership in EMU could thus be confident of operating a tight link with the core even under a worst-case scenario. If the markets know that there is no chance that they can force a break in the link to the common currency of the core, they will regard it as credible. Any country that chooses this approach could increase the credibility even further by passing a national law that obliges the national central bank to defend the exchange through unsterilized interventions. Moreover, it is likely that if there were really a totally unjustified speculative attack the ECB would help the country concerned. If the underlying fundamentals are sound credibility should thus not be a problem. If the fundamentals are not sound the ECB would anyway not recommend this approach and no country would (and should) dare to try it against its advice.

The political viability of this idea depends upon its presentation. If it is characterised as a means of circumventing the convergence criteria, the core will veto it, which is not the purpose of this proposal. The scheme merely aims to help the peripheral countries bridge the gap that separates them from the core without softening in any way the convergence criteria for full participation in EMU.

Table 2
Reserves and Monetary Base

As of end 1993	(1) Base Money	(2) Foreign assets	Ratios based on:	
			Monetary Base (3) = (2)/(1)	Required Reserves (4) = (2)/[(1) - cash in circulation]
BELGIUM (bill. Franc)	430.4	731.7	1.7	36.0
FINLAND (bill. Mark)	38.0	33.5	0.9	1.2
GREECE (bill. Drachma)	2500.1	2975.5	1.2	4.6
ITALIE (bill. Lire)	201.1	86.6	0.4	0.8
PORTUGAL (bill. Escudo)	3001.3	3706.7	1.2	1.6
SPAIN (bill. Peseta)	7.800	6.152	0.8	4.8
SWEDEN (bill. Kroner)	163.8	175.7	1.1	1.8

Source: International Monetary Fund.

Only countries that have done their basic homework should be encouraged to pursue this approach. In order to qualify, the deficit when calculated at German interest rates should at a minimum fall below 3% of GDP. This discipline would also ensure that the debt ratio would be declining once the lower interest rates took effect. It bears reiterating that the country in question would have a derogation in the decision-making organs of the ESCB, which would imply that the convergence criteria had not been suspended.

In a sense, Belgium has already opted for this course by pegging unilaterally to the DM. Why can't the others follow its example? Some of the other countries face the problem that they are stuck in a low credibility – high interest rate trap out of which it is very difficult to escape without outside help. Gros (1995) provides a formal analysis of the conditions under which this can happen. The decision to participate in EMU, even if essentially on a unilateral basis, would allow them to take one large step away from this trap. Of course, this can only facilitate adjustment. It is in no way a substitute for the resolute fiscal action that has to be

taken anyway.

6. Concluding Remarks

The basic idea presented in this paper is that national governments might stand to gain from tying their hands in the area of fiscal policy. This could be achieved through a credible excessive deficits procedure whose sanctions are triggered automatically if an excessive deficit persists. The ultimate sanction would be expulsion from EMU. It is highly unlikely that the threat of expulsion will ever have to be carried out. The mere existence of such an "ultimate weapon" will already impose a strong disciplinary effect. Moreover, it is likely that a country once expelled from EMU would try to maintain the common currency on an unilateral basis.

The same argument should be applied to the transition to EMU. Some countries could achieve much lower interest rates if they linked their currency unilaterally to the core that will start the third stage in 1999. This could considerably reduce the fiscal adjustment required at present interest rates or at the even higher interest rates that could result if they are excluded from the core. Countries that are reasonably close to achieving the criteria should be invited to peg their currency to the common currency of the core group. They would have a voice in determining common monetary policy, however, only after they had fulfilled all the convergence criteria. (See the Annex for a summary of the proposed additions to the text in Article 104c.)

Author's note: The ideas presented here come from an economist; their expression as formal treaty language will certainly have been imperfect. I trust that the legal experts can provide the proper wording, once the underlying rationale for the recommended changes has been widely accepted.

Annex

Summary of Proposed Additions to Article 104c

- Paragraph 11 of Article 104c should begin with the following text:

Once a member state has become subject to a decision under paragraph 9 [i.e. notification by ECOFIN of a time limit and measures to eliminate an excessive deficit] the ECB and the Commission will report on compliance every three months. If the compliance reports of the ECB and the Commission indicate that a Member State has failed to comply with a decision taken under paragraph 9, the Council will request the member state concerned to limit spending by the national government on a monthly basis to the same amounts as in the previous year and to increase the rate of value-added tax by an amount sufficient to eliminate the excessive deficit within one year.

- Following the new text proposed above, paragraph 11 of Article 104c would continue to read as follows:

If the Council finds, acting on a proposal from the ECB and after consulting with the European Parliament, that a Member State has failed to comply within 3 months with the obligations foreseen in the previous indent, the Member State concerned shall have a derogation as defined in Article 109k, 3.

- The expression "without a derogation" should be inserted in paragraph 13 of Article 104c as follows (proposed change underlined):

When taking the Council decisions referred to in paragraphs 7 to 9, 11 and 12 the Council shall act on a recommendation from the Commission by a majority of two thirds of the weighted votes of its members without a derogation as defined in Article 109k, 3 weighted in accordance with Article 148(2) and excluding the votes of the representative of the Member State concerned.

References

Buchanan, James (1997), *Democracy in Deficit: The Political Legacy of Lord Keynes*, Academic Press, New York.

Giovannini, Alberto and Luigi Spaventa (1990), "Fiscal Rules in the European Monetary Union: A No-Entry Clause", manuscript, December.

Gros, Daniel (1995), "Self-Fulfilling Public Debt Crises", unpublished manuscript, CEPS, Brussels, July.

Gros, Daniel and Niels Thygesen (1992), *European Monetary Integration*, Longman, London.

Gros, Daniel and Guy Vandille (1995), "Seigniorage and EMU: The Implications of Price Stability and Financial Market Integration", *Journal of Common Market Studies*, Vol. 33, No. 2, June.

von Hagen, Jürgen and Ian Harden (1994), "National Budget Processes and Fiscal Performance", *European Economy*, Reports and Studies, No. 3, Brussels, pp. 310-418.