



**The Dog that Would Never Bite?
What We Can Learn from the
Origins of the Stability and Growth Pact**

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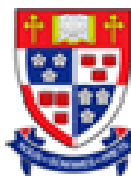
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1 Introduction

In 1997 the European Council adopted the Stability and Growth Pact (SGP), which was inspired by a 1995 memorandum written by the then German Finance Minister Theo Waigel. The SGP institutionalises the deficit limit of three per cent of Gross Domestic Product (GDP) laid down in the Treaty on European Union (TEU) for Member States of the European Union (EU) that participate in Economic and Monetary Union (EMU). It regulates procedures of budgetary surveillance and the imposition of financial fines for unauthorised breaches of the deficit limit. It was hoped that these sanctions would effectively serve as a deterrent that was never to be used. Yet in the second half of 2002 the excessive deficit procedure (EDP) has been initiated in the cases of Portugal, Germany, and France. Formally, when the Council decides that an excessive deficit exists, the country concerned is obliged to reduce its deficit below three per cent of GDP according to the recommendations of the Council or face financial sanctions at the end of a drawn-out procedure.¹ Metaphorically speaking, the 'dozing dog' has thus turned out rather snappish as core European countries find themselves in economic crisis.

What are the underlying economic and political reasons for the creation of the SGP and what is its immediate purpose? The economic reasons include that the fiscal provisions in the Maastricht Treaty for maintaining budgetary discipline are not clearly spelt out and thus additional rules had to be created. The political reasons behind the emergence of the SGP were the domestic circumstances of the Waigel memorandum. Waigel reacted to the growing domestic opposition against EMU by proposing a Stability Pact to EMU Member States that was based on the Germanic conception of 'stability culture'. The outcome is a political compromise on how to run EMU once stage three had begun. The actual purpose of the SGP was a strengthening of the fiscal regime that would make the existing rules more rigorous, concrete, coherent and credible as well as reduce some ambiguities in the Treaty, especially concerning sanctions.

The SGP has recently received considerable criticism and will likely remain controversial as it is being applied. The present situation is not detached from the factors that led to the creation of the SGP but has to be seen in this context. From this broad perspective, the paper poses the following questions: (1) Why and how was the SGP created? (2) What purpose was it supposed to serve? (3) What underlying conditions supported its creation? (4) Have they changed since? (5) What can be expected to be its future?

This paper analyses the origins, process and outcome of the SGP negotiations and thereby aims to provide some background and clarification to the ongoing debate. We argue that the SGP was possible due to a convergence in basic ideas about the relationship between monetary and fiscal policies held by experts in Ministries of Finance, central banks, the Commission as well as in academia and international organisations. Yet there was no precise idea of a specific arrangement beyond the Maastricht Treaty. Ideational convergence provided the basis for a political compromise found during the Dublin summit in December 1996. Thus the expert

¹ The ultimate sanctions have serious implications. They first take the form of a non-interest-bearing deposit of 0.2% of GDP plus 0.1% for each decimal point that the deficit exceeds 3%. Subsequently, the deposit is converted into a fine if the excessive deficit has not been corrected after two years.

consensus on principles was a necessary though not sufficient condition for the intergovernmental agreement. The complete analysis has to include power-political factors which relate to the prominent position of Germany in the creation of EMU.

The paper is structured as follows. The first section examines why the SGP was considered necessary, taking insights from both economics and politics. The second section describes the actual story of its creation. The two subsequent sections offer the core analysis based on an actor-centred institutionalist approach. The third section examines the ideational context from which the SGP originated under the heading of ‘actor orientations’. Section four provides an analysis of the ‘actor constellation’ and the achievement of the political compromise. The final section concludes and assesses the current situation reflecting on the SGP’s origins.

2 Why might an SGP be necessary? – Lessons from economics and politics

2.1 The Economics of the SGP

The Maastricht Treaty has provided the monetary constitution for EMU. However, its specifications for the future fiscal regime are incomplete and ambivalent.² It only contains rather loose stipulations on the excessive deficit procedure (EDP), (TEC Article 104 ex 104c) and budgetary coordination (TEC Article 99-/103 ex 103). From the viewpoint of economics, several arguments speak in favour of complementing the fiscal arrangements of the Treaty (for a detailed discussion see Heipertz, 2003). The most prominent reasons behind more stringent rules are (1) a need for consolidation, (2) concerns about externalities, (3) the credibility of ECB independence and (4) the need for a more coherent framework of economic policy coordination.

The first difficulty is a general need for **consolidation**, resulting from the expansionary stance of fiscal policy in most of the OECD countries since the ‘golden age’ of Keynesianism and welfare-state expansion. Soaring interest rates, which were the result of high inflation rates of the time, have reduced investment and contributed to weak growth and underemployment. Governments have found themselves redirecting an increasing portion of their revenue into debt servicing. Furthermore, ageing populations in Europe imply that maintaining generous welfare states will be increasingly expensive and will require a fundamental reallocation of public spending.

Second, there was a fear of **externality problems** related specifically to EMU.³ The most prominent concern regarded the negative effects of fiscal spill-overs on increasingly interdependent participating economies. A bond-financed increase in

² This lacuna is related to the fact that the negotiating parties were unable to agree on a Political Union in 1991. They seem to have been aware of the shortcomings and even issued the task to draft additional legislation (TEC Article 99v ex 103v and Article 104 ex 104c, paragraph 14): “Further provisions relating to the implementation of the procedure described in this Article are set out in the Protocol on the excessive deficit procedure annexed to this Treaty. The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the ECB, adopt the appropriate provisions which shall then replace the said Protocol. Subject to the other provisions of this paragraph, the Council shall, before 1 January 1994, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.” (Article 104, ex 104c paragraph 14).

³ Negative externalities are welfare or opportunity costs not fully accounted for in the price and market system, usually occurring to a third party not being part of the transaction.

government spending would cause the money supply in the Eurozone to rise, thereby fuelling inflationary pressures. In response the ECB would be forced to increase interest rates, depressing investment and consumption. Furthermore, the higher interest rate would cause the common currency to appreciate and the trade balance to deteriorate.⁴ Another externality effect results from the fact that participation in a monetary union implies abandonment of national exchange rates. The disciplinary effect of the exchange rate depreciating due to fiscal profligacy affects the whole currency zone, thereby reducing the impact on the individual 'sinner' while increasing it for everybody else. This reduced disciplinary effect on national authorities aggravates an existing deficit bias of public finance (Beetsma 1999). Member States were feared to free-ride on each other by under-providing consolidation and overspending on their budgets.⁵ Thus strict rules on budgetary deficits were deemed necessary. It is noteworthy that the need for limits on budgets had already been mentioned in the original EMU blueprint laid out in the 'Delors Report' (Committee for the Study of Economic and Monetary Union 1989). Further justification for limits on budgetary deficits was spelt-out by the Commission (1990, 1991).

A third concern is that excessive deficits could undermine **central bank independence**. Actors at the time were worried that ECB independence and specifically the 'no bail-out' clause⁶ would be endangered by unsustainable fiscal paths of certain Member States. Sargent and Wallace's (1981) model of debt monetisation supports this view. Their study shows that an unsustainable fiscal path eventually forces the central bank to buy government bonds. The Fiscal Theory of the Price Level (FTPL) argues in a similar direction (Leeper 1991; Woodford 1994). Grossly simplified, the FTPL states that inflation control by the central bank through the interest rate is jeopardised by an excessive fiscal stance that disturbs household expectations and unsettles private sector budget constraints. Public demand substitutes private demand and artificially expands aggregate demand, eventually causing the price level to rise. Hence, monetary independence and the effectiveness and credibility of monetary policy need to be supported through the fiscal regime. This support was seen as being not sufficiently guaranteed by the monetary constitution alone. The SGP appeared desirable as a way of 'safeguarding the credibility of ECB independence' (Artis and Winkler 1999).

Fourth, in a monetary union the role of economic policy changes and **coordination** becomes pertinent (Begg 2002). The aim of coordination should be to attain an appropriate policy-mix between monetary and fiscal policy. The fact that the 'one-size-fits-all' monetary policy of the ECB may be destabilising for countries with an inflation rate significantly off the Eurozone average has increased the need for strategic and coordinated fiscal counteraction, potentially even going beyond the automatic stabilisers. The coordination issue grows in importance with the likelihood of asymmetric shocks and increasing divergence between the participating economies. The currently weak economic growth in the Eurozone is due to structural rigidities but

⁴ However, recent research suggests that the overall size of fiscal spillovers within the euro area can be expected to be rather small as the several types of spillovers to a large extent neutralise each other (Gros and Hobza 2001).

⁵ The deficit bias is partially counteracted through an increase in relative prices in the expansionary country. The resulting export loss should provide and re-internalise part of the necessary discipline.

⁶ The no-bailout clause implies that neither the ECB nor the Community will provide funds to or buy bonds of a national government that becomes insolvent (Art 101 ex Art 104; and Art 103 ex Art 104b).

gets amplified by a cyclical recession. A very strict interpretation of the pact would require the contraction to attain the extremely serious magnitude of two per cent until fiscal counteraction would be authorised for countries above the three per cent limit.⁷ Until then, governments would have to implement pro-cyclical policies of cutting (investment) expenditures and increasing (tax) revenues. Some economists have interpreted the SGP in this exaggerated way and strongly criticised it for not enabling but – even hindering – countercyclical moves in these cases (Eichengreen 1996; Eichengreen and Wyplosz 1998). The importance and usefulness of stabilisation policy and even discretionary measures beyond automatic stabilisation is debated, but instead of providing the framework for a coordinated and strategic response to the cyclical component of Europe's weakness, the SGP is seen to stand for rudimentary and improvised coordination, asking Member States to 'keep their house in order' (Issing 2002). In that sense, it complements the EU economic coordination framework centred on the Broad Economic Policy Guidelines (BEPG).⁸

The critique that the SGP hinders countercyclical stabilisation in fact underestimates the degree of flexibility that is built into the legal texts. The pact can be applied 'intelligently' in the sense of allowing the limit to be surpassed for a number of years without losing credibility. However, this requires both a co-operative attitude of the governments concerned and a radical improvement in the communication of the budgetary situation and medium-term aims. Furthermore, it is perhaps an unfair criticism to state that the SGP is an inferior regime of policy coordination. After all, the legal documents of 1997 could not transcend but had to be based on the Treaty, which did not contain any institutional solution on this issue. A positive outcome of the current crisis could be the move towards a more effective overall solution for economic policy in EMU.

2.2 The Politics of the SGP

The Maastricht Treaty is an incomplete contract as far as rules on EMU are concerned. The fiscal convergence criteria stem from a snap-shot of the average situation in the early 1990s and only dealt with the run-up to EMU. There were no explicit rules or arrangements in place for stage III, except the stipulations of Articles 99 and 104 (ex 103 and 104c) (see footnote 3 above). Theoretically there were two options. The first would be the *status quo*, relying essentially on voluntary arrangements. The Member States would all agree to continue to meet the convergence criteria also after EMU had started. The second option was to impose explicit rules that would elaborate on and even go beyond the Treaty stipulations. This issue was left open precisely because it was highly contentious and exposed

⁷ There are only four cases of recessions exceeding two per cent in the history of the current Eurozone economies: Italy (-2,7 per cent in 1975), Portugal (-4,3 per cent in 1975), Finland (-7,1 per cent in 1991), and Sweden (-2,2 per cent in 1993) (Eichengreen and Wyplosz 1998).

⁸ According to Article 99 (ex 103) TEC, EU Member States "regard their economic policies as a matter of common concern". The BEPG procedure serves this end in the following way. The Commission recommends the guidelines for each country to the Council of Ministers on Economic and Financial Affairs (Ecofin), which decides on a draft by qualified majority. The draft is then put before the European Council of the Heads of State and Government. Based on the European Council conclusion, Ecofin decides on individual recommendations, again by qualified majority. Since the recommendations are not backed by sanctions, the BEPG procedure is considered as 'soft' coordination.

fundamentally different views on economic policy.⁹ Voluntary arrangements had been the implicit road that was chosen in the Maastricht Treaty. However, particularly the Germans and the Dutch favoured a more explicit, rule-based system. The aim was to restrict budgetary deficits once EMU was fully operational. This has to be seen in the context of the early 1990s when due to the economic downturn the budgetary performance of most Member States deteriorated. In this situation and without strict rules, it would be very attractive to spend more than the agreed norm, which would lead to the free-riding problem discussed above. This concern seemed especially relevant from the German point of view with respect to a number of (Mediterranean) countries that were making strenuous efforts to be part of the first wave – against all odds at the outset.¹⁰ The larger the future membership of EMU was appearing to become and the less likely a postponement, the more urgent became the need for Germany to reinforce at least the deficit criterion. This situation has been described as an ‘endgame’ for the transition towards stage III (Crowley 2002).

The political background of the SGP can be traced back to German domestic politics. The Stability Pact was a way to comfort public opinion by appeasing the Bundesbank. The German public needed reassurance on EMU as it had become extremely anxious about giving up the well-proven Deutschmark.¹¹ German identity was connected with economic success in the post-war area, where the Deutschmark had played an integral role (Risse-Kappen, Engelmann-Martin et al. 1999). But Germans were also concerned about adopting a new single currency because it would include traditionally weak economies which lacked a stability culture.¹² Politically, there was a risk that the opposition and even Waigel’s own party in Bavaria under Prime Minister Edmund Stoiber would capitalize on this sentiment and run on an anti-EMU platform (e.g. *Frankfurter Allgemeine Zeitung*, 04 November 1995). Besides the general public, the German monetary authorities did not trust their counterparts in other Member States. Another factor of mistrust was that the conservative political parties, still in power in most EU Member States in the mid 1990s, were concerned that once social democratic parties would come to power they would start pursuing a ‘tax-and-spend’ policy. They were therefore eager to perpetuate their economic views into the politically indeterminate future. Hence at the source of the motivation to propose the SGP we see a layered prevalence of German mistrust towards European partners, potential political successors and political discretion in general.

This mistrust had to be overcome. EMU is, above all, the economic means for the political end to firmly integrate re-unified Germany into Western Europe. Germany

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

¹⁰ Ironically, in 1995 Germany itself breached the three per cent limit for the first time.

¹¹ According to Eurobarometer data (MM4/95), 65 per cent of the German public was opposed to a single currency in the first half of 1995 (Commission of the European Communities 1995).

¹² German public opinion was heavily influenced by a ‘manifesto’ of sixty German economists against the Maastricht Treaty (*Frankfurter Allgemeine Zeitung*: 11 June 1992) and a ruling of the German Constitutional Court (BVerfG 89, 155) in 1993, demanding EMU to be geared towards monetary stability. Even more prominent was the continuous stream of criticism coming from the Bundesbank (see, for example, (Deutsche Bundesbank 1992).

had the most to 'lose' by giving up the *de facto* leading currency in Europe. Furthermore, the German economy represents about a third of the Eurozone. Germany's membership of EMU is therefore absolutely central, both economically and politically. Its reservations had to be overcome. Without Germany there would be no EMU.

More subtle forces were also at work. Of importance was the gradual nature of economic and monetary integration, especially the experience with the European Monetary System (EMS). Cooperation in the context of the EMS had implied that most monetary authorities had contributed to factual convergence in monetary policy with the *de facto* fixing of exchange rates as its result. What had been happening over the 1980s was a 'shadowing' of Bundesbank policies. The resulting convergence meant that monetary authorities had learnt lessons about economic and monetary governance. Some feared that national governments would then become more 'relaxed' and return to old practices once EMU would be fully operational. Without the disciplining factor of exchange rate fluctuations, governments would move to more expansionary policies, for example tolerate undue wage increases as well as expand public debt and thus implicitly destroy the (anti-inflationary) discipline that had been built up in many countries throughout the 1980s and 1990s.

Finally some authors have stressed the fact that EMU has been created with too much emphasis on credibility but much less so on legitimacy issues (Hodson and Maher 2001, Scharpf 2003, Verdun and Christiansen 2000). The argument is that EMU was designed with a strong monetary authority but with no proper provisions in other domains (i.e. it was asymmetrical; Verdun 1996, 2000a). The SGP negotiations became a vehicle for achieving more European integration in the economic domain. The choice of a rule-based and mechanistic strategy can be traced back to the fact that Germany was the most dominant country regarding monetary matters and thus able to push through its opinion. Yet, the SGP does not address the concerns that the French and others had, namely that the ECB should be flanked by an economic government (Verdun 2003). Their initial response to Waigel's proposal was positive partially due to the opportunity it provided for putting the cart before the horse. The initially suggested 'Stability Council' seemed to be malleable into the desired '*gouvernement économique*'. For precisely that reason the idea of such a Stability Council was dropped on the other side of the Rhine.

Summarising, in 1995-1997 there were sound economic and political reasons for reinforcing the set of rules that limit budget deficits. Without such rules it would seem to be too attractive for countries to run temporarily a higher deficit without having to 'pay' for that. The costs of that type of policy would have to be borne by the other Eurozone countries. The opportunity cost was especially high for Germany. When Germany insisted on creating a pact that would impose rules it was in a very strong position to make its case.

3 Negotiating the pact

How did the SGP come about?¹³ The idea of some sort of ‘stability treaty’ was in the air in early 1995. The Maastricht Treaty had already stipulated the need for further legislation (see above). Since the beginning of stage two of EMU in 1994, the Monetary Committee (MC) had deliberations on this matter. Officials in the German Ministry of Finance were also discussing this topic amongst themselves. The *Sachverständigenrat*, an advisory board to the federal government consisting of the directors of the five most prominent German economics institutes, had demanded already in its 1992 annual report to make the sanctions more precise and apply them strictly (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung* 1992: 433). The discussion became a public debate because of a speech given by the President of the German association of cooperative banks, the *Bundesverband der Volksbanken und Raiffeisenkassen* (BVR), Wolfgang Grüger, who proposed to conclude an intergovernmental stability treaty among the future EMU states (*Handelsblatt* 9 May 1995). This public request by the BVR was engineered by the Bundesbank under Hans Tietmeyer.¹⁴ Tietmeyer did not want to be associated publicly with a new initiative on hardening the EMU regime and hence suggested that Grüger, perceived as a neutral player from the private sector, should make the move. The debate then picked up during autumn 1995. The *Institut für Weltwirtschaft* (IfW) in Kiel, independently of the Grüger proposal, published a discussion paper on how to make the Maastricht stipulations workable through a complementary agreement (Lehment and Scheide 1995). The IfW proposal suggested automatic, interest-free deposits with the ECB for countries exceeding three per cent that should be paid back as soon as the excessive deficit was removed. The paper was prominently discussed in the *Frankfurter Allgemeine Zeitung* (FAZ, 12 October 1995) and was seconded by positive comments of the Bundesbank (FAZ, 15 October 1995). The arguments re-appeared as demands for a ‘budgetary pact’ in the 1995 report of the *Sachverständigenrat*, where the IfW has a seat (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung* 1995: 446).

By that time, Waigel and Kohl were under severe political pressure. Public opinion was turning very negative on EMU (see above). The SPD opposition party was growing more confident in making populist remarks on the dangers to stability stemming from the EMU project and demanding stricter rules, thereby literally mirroring Bundesbank statements (e.g. Scharping 1995). In September 1995, Waigel had been talking to his colleagues informally about his desire to formalise the rules on budgetary policy in EMU (Milesi 1998: 95-6, Stark 2001: 89 and interviews with German Ministry of Finance officials, June 2003). The IfW paper was used as a direct input for drafting a proposal in the ministry under time pressure and the need to preempt the opposition. On the same day that it was presented to the public (FAZ, 12 October 1995), the authors received a call from the ministry, asking for the paper to be faxed immediately.¹⁵ Four weeks later (7 and 10 November 1995), Waigel announced his version of a ‘Stability Pact’ (Bundesministerium der Finanzen 1995) to the public and to his European partners during the second reading of the 1996 budget (Waigel 1995a, 1995b). Parallel to that, Waigel commissioned an official at very short

¹³ There are very few and purely descriptive accounts of the pact’s genesis (see for example Passalacqua 2000, Costello 2001, Stark 2001 and Konow 2002).

¹⁴ Interview with BVR official, 4 November 2003.

¹⁵ Correspondence with IfW, 3 November 2003.

notice to write up the ideas on a Stability Pact in English in order for them to be circulated among his European colleagues. These received the initiative favourably – in principle. First positive reactions came out in individual statements, then jointly at a Meeting of the Council of Ministers of Economic and Financial Affairs (Ecofin) in Brussels on 27 November 1995.

However, after the Danish ‘no’ and the French *petit oui* in the referenda on the Maastricht Treaty in 1992, there was no question of what Commissioner Yves-Thibault de Silguy referred to as ‘opening “Pandora’s box”’ (i.e. renegotiating the Treaty). Yet, an intergovernmental agreement in the form of a new treaty *à la Schengen*, as originally envisaged by Waigel and his state secretary, Jürgen Stark, was unacceptable to the other countries. The Commission also realized the dangers of an intergovernmental solution because it would imply the marginalisation of Community institutions and procedures. It was therefore prompted by the Council to propose a solution within the Community framework. Its proposal, prepared under de Silguy, was released in October 1996 (COM (1996) 496) and turned out to be much closer to the Maastricht Treaty than to the Waigel paper. Crucially, it did not include automatic fines under the supervision of an independent ‘Stability Council’ but reduced the sanctions to a discretionary measure of the Ecofin Council. This means that the ministers themselves have to judge each other, which comes close to what Begg has labelled ‘asking turkeys to vote for Christmas’ (2003: 3). The Commission proposal also elaborated on the ‘surveillance arm’ of the SGP, designing it as the rudimentary device for economic policy coordination that we know today.

The Stability Pact dossier went through the various EU committees and institutions. It was discussed in the Monetary Committee (MC), the Ecofin Council, the European Council and at Franco-German summits, meetings and workshops. The bulk of work was completed in the MC. Only very few open issues had to be referred to the ministerial level of Ecofin. The major controversy was that Germany’s partners agreed on the principle of mutual surveillance and reinforced dissuasion of excessive deficits but not on automatic sanctions. The focal point of dissent became the clause that was going to stipulate the exemptions from sanctions, since here lays the lever for political discretion. Waigel was completely isolated in requiring nothing less than a GDP contraction of two per cent or worse as a qualification for an exemption. The compromise reached in the morning hours of Friday, 13 December 1996 in parallel sessions of the Ecofin Council and of the European Council in Dublin stipulates that a recession of less than 0.75 per cent ‘as a rule’ does not qualify as exceptional, whereas a recession of over two per cent automatically does. If the recession is in between these two figures the Ecofin Council will determine whether or not the recession is exceptional. The result is a rule that can be overturned by an Ecofin blocking minority of at least 26 out of 87 weighted votes or covering at least six Member States (TEC Articles 104 VI (ex 104 C VI) and 205 II (ex 148 II)) if they refuse to label a budgetary deficit of over three per cent as ‘excessive’. Once the sanctioning procedure has started, only EMU Member States have a vote, excluding the country in question (TEC Article 104 IX (ex 104 C IX)). A voting alliance against the SGP then becomes even more concrete and likely.¹⁶ Already the early warning that was not sent to Germany in early 2002 and much more so the current crisis on (not) triggering

¹⁶ A crucial difference to the Waigel proposal is that the burden of proof has been reversed for each decision; i.e. it is a qualified majority that has to initiate each single step in the procedure.

sanctions against France shows that the politicized processes do not run as promised in 1996.

The SGP has delivered some ‘added value’. It has shortened the timeline of the sanctions mechanism, defined the distribution of the fines (among the ‘virtuous’ Member States), clarified the notion of ‘exceptional’ and ‘temporary’ deficits as exemptions from sanctions, introduced an urgency procedure, enabled the suspension of the EDP, and improved the juridical procedures of the steps involved. Yet, due to the politicised nature of the EDP, the fundamental essence of the pact is not a mechanism of ‘quasi-automatic sanctions’ but the institutionalisation of a *political* pledge to aim for low deficits. It is unclear whether the procedures can be enforced by legal means. The proof of the pudding is in the eating and it is not at all unlikely that the SGP will end up before the European Court of Justice. In our view, the only legal enforcement of the pact is through an ‘appeal for failure to act’ according to Article 232 (ex 175) TEC. Through this instrument, a member state (say, The Netherlands) or a Community institution could enforce formal adherence to the EDP. It could therefore ‘call the bluff’ – however without thereby inducing the desired verdict of the Council.¹⁷ In that way the SGP can be seen in essence as not much more than an act of ‘symbolic politics’ (Sarcinelli 1987).¹⁸

4 Analysing the Birth of the Stability and Growth Pact

For the analysis, we choose an actor-centred, institutionalist perspective. First, we focus on how ideas came to shape the preferences of actors and, second, on how their constellation and interaction produced the outcome. The analytical approach most suited for this endeavour proved to be actor-centred institutionalism. Following (Scharpf 1997), ‘actors’ are defined as individual or corporate strategic agents (mostly administrative bodies such as ministries). They are capable of intentional action and internally organised along hierarchical lines. They are characterised by preference orientations as well as action resources. Furthermore, they are embedded in an institutional context, which we use as explanatory shorthand for structural factors and external influences on the actors themselves, such as the influential role of financial markets at certain stages in the negotiation process. We define the executive agents of the negotiating ministries, of the Commission and of central banks as ‘experts’. They are in contact with non-actor experts who shape ideas but not decisions, such as academics, journalists and institutions like the OECD or the IMF. On the highest levels of deliberations, we introduce non-expert actors, holding the final and democratically legitimated decision-making competence – ‘politicians’. The

¹⁷ The Dutch Minister of Finance, Gerrit Zalm, has accordingly threatened to take the Commission to the European Court of Justice if it does not enforce the EDP against France (*NRC Handelsblad*, 11 September 2003). In taking this strong stance, the Dutch are seeking support from other small Member States such as Austria, Belgium, and Finland. The Dutch find it unfair that now that the larger countries are facing the same difficult situation, their budgets should be allowed to rise and go beyond the agreed ceiling. This difference in behaviour between large and smaller Member States reinforces the view, for some, that the EU works with separate rules – for large and small countries.

¹⁸ Also symbolically and as a face-saving device for France, it was renamed ‘Stability and Growth Pact’, since rising unemployment was increasingly becoming the stumbling stone for the Juppé government. The official conclusions to the summit state that sound public finances are not an alternative to growth but a facilitator of the overall aim of higher growth and more jobs (European Council 1996).

hypothesis is that the orientations of experts are defined by specific converging ‘ideas’ about economic policy, influenced indirectly by non-actor experts, and that the orientations of politicians are crucially influenced by experts, even if their ‘ideas’ were initially different. A graphical illustration summarizes how experts (actors as well as non-actors) and ideas came to shape politics, thereby converging on the compromise that enabled the conclusion of the Stability and Growth Pact.

4.1 Actor orientations

Let us first turn to the broader ideational factors that help explain why EMU happened. From the ideational perspective, the creation of EMU can be seen as the result of policy learning, convergence in policies but also in ideas about monetary policy-making. When EMU was first conceived in the late 1960s and early 1970s the six Member States were still split on how to create EMU (i.e. whether to converge policies first or to move to further monetary integration and hope that convergence would result). They were also divided on its main focus (policy objectives) and on the institutional design of EMU (some wanted immediate transfer of sovereignty to a supranational institution, whereas others were more cautious). The 1970 EMU plan (also known as the Werner Plan) came at a time when governments were frequently pursuing Keynesian policies during down-turns (Committee on the Realization by Stages of Economic and Monetary Union in the Community 1970).

Though the actual institutional design of EMU as envisaged by the Delors Committee in 1989 did not differ too much from its 1970 design, a number of important developments occurred in the years between the two plans. First, economic and monetary integration had achieved a higher level of integration in both the area of economic and monetary policy-making projects: the process of completing the internal market was underway, financial markets had become further integrated and the European Monetary System had been in place for a decade. Second, as was mentioned above, policy learning had taken place. Monetary authorities in the Member States had realised that monetary policies were only successful if they were in line with that of the dominant Member State, namely Germany. The Deutschmark played the role of anchor currency. France learnt this lesson in March 1983 when Mitterrand chose to stay in the EMS and refocus its policies towards that objective. Italy converged in the second half of the 1980s and was one of the last to keep exchange rates stable and maintain the lira in the EMS. The EMS witnessed many devaluations between 1979-1983 but much fewer from 1983-1987. After the Basle/Nyborg meetings in 1987 until the EMS crises of 1992/1993 there were no realignments. Third, the ideas regarding monetary policy-making had changed (see *inter alia* McNamara 1998 and Marcussen 2000). Whereas in the 1960s and 1970s Keynesian principles still lay at the heart of national government economic policies, by the late 1980s monetarist policies dominated. In the late 1970s and early 1980s the United States, the United Kingdom and Germany were at the forefront of this change, which by the late 1980s had diffused throughout Western Europe. The change in belief was that there was no long-term trade-off between inflation and unemployment and that sound money was a precondition for growth.

In their effort to proceed with monetary integration, the governments of Member States were aided by a so-called ‘epistemic community’. Members of central banks, ministries of finance and academics held similar views about the main aim of economic and monetary policy-making. There were a few important venues where

experts shared ideas and socialisation occurred. This took place above all in the Monetary Committee (MC) – now called the Economic and Financial Committee – which consists of representatives of central banks and Ministries of Finance of the EU Member States (Verdun 2000b), as well as in other influential EC committees (see Rosenthal 1975, Kruse 1980, and Verdun 1999) and international fora. The MC convenes in the ‘comitology’ form of an advisory committee set up according to Article 114 (ex 109 C) TEC. The members of the MC meet Haas’ four principles that define the existence of an epistemic community (Haas 1992: 3). First, they shared beliefs for a value-based rationale of social action. Second, they shared causal beliefs, which are derived from their analyses of problems which then serve as the basis for understanding the linkages between policy actions and desired outcomes. Third, they have shared notions of validity – that is intersubjective understandings that help them weigh ideas within their area of competence. Fourth, they have a common policy enterprise and common practices associated with a set of problems to which competence is directed. It is no surprise that the Member States’ Heads of States or Governments relied on the MC for proposals and suggestions for action. The literature on epistemic communities indeed suggests that a group of experts is often called upon when national governments are divided on intergovernmental collaboration. The MC was an ideal group to ask for advice as its members can wear double hats. They can act as independent experts yet they are fully aware of the political issues at stake.¹⁹

Common ideas on the purpose of economic and monetary policies in the 1980s were crucial for the creation of EMU in the 1990s. It can be seen as a paradigm shift. It was accepted by parties of the political left and the political right, as well as by major domestic actors. Nevertheless, an important political change did occur in the 1990s that could possibly have challenged this new economic and monetary paradigm. Whereas in the late 1980s many governments in power were of the centre-right, by 1997 this had changed in favour of the left. Some observers were concerned that this shift in political leaning might undermine the paradigm on the basis of which EMU was created. Yet, it is noteworthy that the period 1997-2002 did not see any major changes to the institutional design of EMU. Nevertheless, it is possible that these left-of-centre parties in government will be less positive to the SGP principles as they restrict governments’ use of budgetary deficits (traditionally associated with left-of-centre governments). However, the shift in paradigm from monetary to Keynesian policies in the 1980s was so profound that it stretches beyond the usual day-to-day politics of left versus right.

What mattered at the time is that conservative governments in power were concerned about their potential left-wing successors not respecting the monetary and budgetary regime that was being created. However, this fear was partly unfounded. In the current situation we find results that oppose the conventional wisdom. Left-of-centre governments are willing to restructure and aim at sound monetary and fiscal policies. At the same time the fear that support for strict rules could decline was indeed justified. Currently, some left-of-centre as well as some right-of-centre governments are less inclined to take the SGP seriously – at least rhetorically. For example, the current French government under Jean Pierre Raffarin and the Silvio Berlusconi government in Italy seem not to be willing to comply with the strict reading of the

¹⁹ One participant described their role as that of ‘financial diplomats’ (interview with the authors, 4 July 2003).

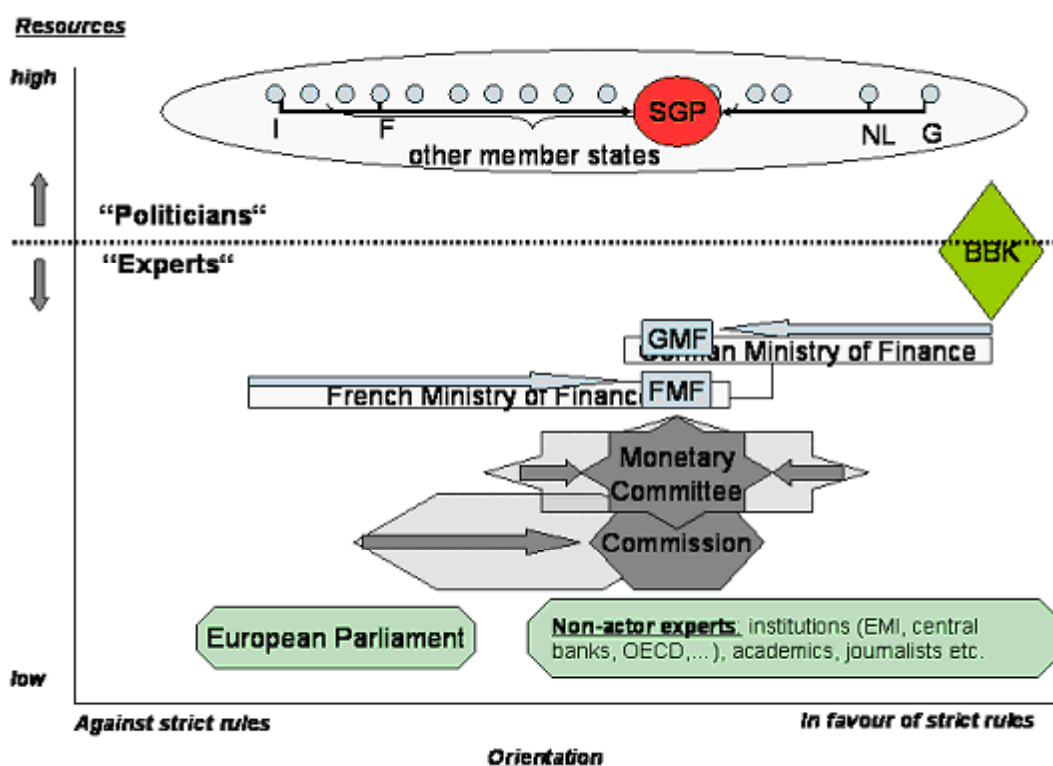
SGP. Thus, these initial findings challenge the established view that left-wing governments spend and that right-wing governments aim for balanced budgets.

Another change that occurred in the 1990s was economic growth performance. In the first half of the 1990s growth was sluggish. It was also the reason why the convergence criteria were not easily met. Some countries that wanted to be absolutely sure they would be allowed to join EMU (such as Italy, Spain and Portugal) focused on reforms that they hoped would lead to a reduction of the budgetary deficit and public debt. Others such as France and Germany had initially been in a better situation but saw their record deteriorate over time. All of them found ways to reduce the budget and the public debt and were criticised for not playing by the rules (or for engaging in ‘creative accounting’). The exclusion from EMU at the outset was such an effective sanction that most governments – including those of less likely participants of EMU such as Italy and Spain – were willing and able to proceed with radical reforms and thereby accepting the straightjacket of the convergence criteria.

It was crucial that the actors had learnt certain lessons and held certain common beliefs. But those ideas alone were insufficient to produce the concrete SGP. Having described the changing orientation of actors, we now turn to the strategic pattern of their interaction that enabled the conclusion of the Stability and Growth Pact.

4.2 Actor constellation

The figure below presents an overview of the most important actors, grouped according to their resources and initial orientations when Waigel issued his proposal in November 1995 as well as the subsequent convergence. The horizontal axis depicts their politico-ideologically shaped preferences for or against strict rules for fiscal discipline, whereas the vertical dimension shows their power resources and decision-making capabilities. We distinguish between a ‘political’ and an ‘expert’ sphere. Political decision-makers can of course have considerable relevant expertise, but our distinction highlights the fact that politicians – not experts – settle the most controversial issues. The stylised process is that the whole negotiation dossier is split up into a set of issues (timeline, exemptions from sanctions, distribution of fines etc.) which are discussed at the expert level. Experts receive their instructions from politicians but are free to reach agreement within these bounds. Politicians will in most cases simply tick off the agreements reached among the experts. Only issues on which there is no consensus move up for discussion at the political level. Here, experts can influence politicians since they possess intimate knowledge of the relevant issue as well as detailed information on the bargaining positions of the other players. They can indicate potential solutions and hence possibly prevent the discussion from being deadlocked. We will now briefly discuss each actor in turn.



Initial preferences and subsequent convergence

Actors at the level with the highest resource capabilities are **Member State governments**. Their decisive position in the deliberation process corresponds to the concept of ‘power politics’ (Garret 1994). Agreement among them leads to decisions that are the basis for laws. The nevertheless important role of other actors is only indirect via the influence they have on the *orientation* of the governmental actors. The actual players in the form of state actors are either Ministers in the Ecofin Council or Heads of State or Government in the European Council. The preference points on this level initially cover the entire range between pro and contra Waigel’s proposal – Germany being on the right end, closely followed by the Netherlands, whereas France and other Mediterranean states initially found themselves on the other side.²⁰ The German **Bundesbank** (BBK) figures as a special player with the resources of an informal veto. We will discuss its double-role between the spheres of experts and politicians later in more detail. Of the **national treasuries**, we only show the two most important ones, the Ministries of France and Germany. The German Ministry holds a relatively coherent position, showed as a narrow preference set. On the French side, we find both support and opposition. For the sake of simplicity, we assume each country to support either France or Germany, depending on who ever of them lies closer to their preference point.²¹ Each Ministry and each central bank plus the Commission had two representatives in the **Monetary Committee** (MC), which was

²⁰ The preference set is large since the initially positive response to Waigel’s proposal has to be seen as rhetoric because it did not include true assent to its most important component, automatic sanctions.

²¹ Following (Scharpf 1997), we assume that different positions within a ministry disappear as consensus is imposed upon the officials. This happens through hierarchical direction and the ‘shadow of hierarchy’ within the organisation.

crucial in preparing the ground for the compromises found in the political sphere.²² Its crucial role is best interpreted by the notion of an ‘epistemic community’ as was mentioned above. In terms of power resources, it lies below national ministries and the political level, but its importance relates to the fact that it was the actual forum in which the compromise was found. The **Commission** (at the time under President Jacques Santer and Commissioner de Silguy) is placed low in terms of decision-making power but successfully achieved a solution within the Treaty framework, and thus prevented an international agreement *à la* Schengen. Another success for the Commission was the inclusion of the surveillance procedure in the SGP. It nevertheless had to depart quite considerably from its initial preference, which had been more to the left of the negotiated outcome. The **European Parliament**, with a rather negative stance towards a strict pact, was unable to bring substantial influence to bear on the deliberations and is therefore placed on the lowest level. Finally, a set of **experts** not affiliated to any actor previously described was able to make its influence felt through informal and professional contacts, communication and the gradual shaping of ideas that underpinned the slow process of ideational convergence: the European Monetary Institute (EMI), precursor to the ECB, and the central banking community with a close affinity to the Bundesbank position, should be explicitly mentioned as well as institutions such as the OECD, academic think-tanks, private-sector researchers, academics etc. The influence of all their reports, papers, speeches and statements combined was not directly crucial in the decision-making process but, in our view, fundamentally shaped the orientations of the political actors and other expert actors with high levels of resources and access to the political sphere.

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

The final result shows that Germany benefited from a privileged position of asymmetric bargaining power, since it had to make substantially fewer concessions than the countries from the critical side. The reasons for this privileged position were fourfold. Germany gave up the anchor-currency of the preceding regime, the EMS. Unlike the other countries, it had to accept the opportunity cost of losing monetary discretion and was able to ask for a higher price – a fact all too well known from the Maastricht negotiations (Dyson and Featherstone 1999). Second, the German position

²² Formally, the sessions of the European Council as well as of the Ecofin Council are prepared by the Committee of Permanent Representatives (COREPER) according to Article 207 (ex 151) TEC, which *de iure* involves the foreign offices of the Member States in the process. We disregard this peripheral scene of negotiation on monetary matters and take the *de facto* preparatory role of the MC as decisive. The MC convened at two levels. At the higher level the representatives of Ministers (state secretaries or junior ministers) and Deputy Governors of the central banks met. At the lower level, that of the so-called ‘alternates’, the committee dealt with intricate technical issues.

resembles Putnam's two-level game-constellation with the Bundesbank as an informal veto player (Putnam 1988). Due to its reputation and popularity, the Bundesbank had a strong influence on German public opinion towards EMU. If it were to oppose publicly the entry of a large 'wave' of countries into stage III, it would make it politically extremely costly for the Kohl government to press ahead. From this perspective, the creation of the SGP was a strategy to reduce public resentment through appeasing the Bundesbank. The effect this had on the negotiations is that the German preference set was narrowed through the informal (declaratory) veto exercised in Frankfurt. A narrower preference set is welcome in the sense that a solution has to lie closer towards the German preference point.²³ Third, Germany could credibly threaten to exit the process towards EMU – though at a much higher price than at Maastricht. In fact, this threat has implicitly been used repeatedly by German negotiators in the MC.²⁴ Fourth, the second-worst threat-scenario was if Germany would oppose membership of 'Club Med' countries, Italy in particular. These countries had an incentive to agree to the pact so that Germany might be more acceptant of their membership. In the end, it took a whole series of Ecofin meetings and European summits to implement the MC-outcome in the political sphere. But eventually convergence had taken place, feeding through from lower to higher levels of decision-making. Even though the outcome is situated towards the German preference point, the German government had to give in as well. Most importantly, automatic sanctions had to be dropped from the agreement in favour of political discretion.

Turning to the institutional context, which is part of the structural framework for the previously described constellation, we find that three parallel processes were crucial in shaping and facilitating the agreement. These are, first, the Franco-German 'axis'; second, a process of political deliberations in the European Council parallel to the Ecofin negotiations; and, third, pressure from financial markets.

The Franco-German exchange (institutionalized in the 1963 Elysee-Treaty) is on several levels equivalent to a subset of the negotiations on the European scene. Its most important function is a radical reduction of the number of negotiators involved, thereby decreasing the transaction costs of any agreement, and increasing the chance of finding a compromise solution. These summits are important as France and Germany often represent different perspectives on these issues and thereby different groups of countries. As happens in other types of bargaining, it is as if France and Germany are 'delegated' to negotiate a settlement.²⁵ The actual solution was often not reached during Franco-German summits or economic consultations, but the subsequent meetings on the European scene benefited from the prior exchange of views and signals.

In addition to the Franco-German deliberation process, the negotiations of the Ecofin Council were seconded by a parallel political process of summit meetings in the form of European Councils. Konow (2002) stresses that, unlike the role of the European Council as defined in the Treaty, the Heads of State or Government did not confine to

²³ According to Milesi (1998: 137), Waigel stated in the Ecofin: « Si le pacte n'est pas assez rigoureux, la Bundesbank pourrait déclencher ses foudres, ce qui risque de me déstabiliser politiquement. »

²⁴ Interviews, 4 July 2003.

²⁵ Milesi (1998: 145) quotes a delegation member of the Dublin summit: "C'est un problème franco-allemand (...) Mettez-vous d'accord entre vous et nous accepterons votre solution."

providing merely the initial political impetus. Instead, they punctuated and guided the negotiations throughout the process, thereby removing important obstacles to compromise, most notably in the case of the lower end of the definition of a severe recession that would constitute an exemption from the imposition of sanctions. The European Council did not only issue strategic political aims but rather defined operative solutions in surprising detail and delegated their attainment and the legal framing to the Ministers of Finance as well as to the Commission. The experience of the SGP negotiations should be seen as an important step in the institutionalisation of the European Council.²⁶

Finally, financial markets were influential in forcing the negotiators to agree on highly contentious issues. The fact that the Deutschmark rocketed against all other currencies involved whenever a deadlock seemed to jeopardise the course towards Stage III of EMU imposed a substantial cost of failure on all negotiating partners. This disciplining factor contributed to the omnipresent pressure to reach consensus. It made all actors involved rather give in on issues that were credibly posed as *conditiones sine qua non* by their counterparts than leave the negotiation room empty-handed. Summarising, this section has sought to explain how ideational convergence, facilitated by asymmetric bargaining power and the institutional context, enabled the political compromise.

6 Conclusion

The watchdog has begun to bark. Will it break loose and bite or will it be forced to tug its tail and whine? There is still a chance that its barking alone will drive the intruders away... We started off by asking why the Stability and Growth Pact was created, what purpose it was to serve and what underlying conditions supported its creation. We examined a number of economic and political reasons. The actual case study of the creation of the SGP sheds light on the more general question of why the SGP was created. The Economics literature at the time stressed the importance of consolidation, externality problems in EMU, the importance of securing central bank independence and coordination of monetary and fiscal policies. Political factors include the fact that the Maastricht Treaty had not specified clear rules for the post-EMU period, German domestic politics, policy learning and the need for further integration in the area of EMU due to legitimacy issues. Ideas on the relationship between monetary and fiscal policy and the role of monetary policy in society more generally had changed over time and enabled a broad consensus in favour of fiscal discipline. The case study indicates that the genesis of the concrete outcome lay in Germany and that its creation was due to an asymmetric power constellation. These two factors, ideas and power, together explain the origins of the SGP.

Designing rules is one thing, applying them another. A number of countries no longer act as if the SGP budgetary ceilings are to be taken seriously. In part it may be that politicians are opportunistic and underrate the repercussions of rising budgetary deficits as they pursue other domestic objectives. At the same time, it should be

²⁶ This process has received a preliminary climax with Articles 20 and 21 of the Draft Treaty establishing a Constitution for Europe, where the European Council is not only institutionalized but also receives a President with a renewable term of 30 months.

stressed that EMU and the SGP are likely only to have a positive effect on growth if structural reforms are implemented. Some governments seem to have ignored the fact that without these reforms, budget deficits may rise anew. They now wonder whether the SGP can be seen as a watchdog that only barks but does not bite and is on a chain, or whether they have created a horrible unleashed pit-bull terrier that could drive them into a prolonged recession. Some have argued that the SGP may not be the right pact to enforce fiscal discipline. We have stressed that even though that may be the case its very effect on credibility depends on how it is treated when Member States encounter fiscal difficulties.

The introduction asked what has changed since 1995-97 – the period in which the SGP was created – and what lessons can be drawn from that period for the future of the SGP. Our analysis suggests that what matters for the SGP are bargaining power and ideas. Regarding the former, some changes have occurred. The power constellation has changed for two reasons. First, Germany has lost some of its bargaining power due to the fact that Stage III of EMU started in 1999. Germany no longer has the same possibility to threaten not to join EMU or to create barriers to keep some (notably the Mediterranean countries) out. Second, Germany itself is no longer the exemplary Member State it once was regarding budgetary discipline. As a result, partly because of the financial effects of reunification, partly because of changing political preferences, Germany no longer fully backs the SGP. It is mainly the Dutch government, aided by Austria, who now plays that role but is endowed with less bargaining power than Germany before. Regarding the role of ideas, we see a smaller change. The consensus among politicians on the importance of fiscal discipline may seem to be fading away under the effects of the recession. However, we argue that there is still strong support for the regime among the main actors on the expert level. The SGP was created to build credibility. Irrespective of whether it is a ‘smart’ or ‘stupid’ pact, it will only be able to do its job if Member State governments do not mess too much with it – at least in the short run. Experts seem to agree on this matter. It is likely that they will use their influence to affect the thinking in governments.

If one was to give a policy recommendation we would suggest that Member State governments should at least aim at *seeming* to be applying the SGP and operate within its framework, even if in practice they might be testing its boundaries. If they sought to go to the limit, their strategy should be to use all the flexibility built into the SGP while publicly signalling that the rules of the SGP are taken seriously. The strategy is playing by time and of course grows increasingly risky as credibility fades away. It seems to us that it would be better for EMU if the SGP does not get openly challenged in the course of applying the EDP but receives a wholesale reform once the crisis is over. For the time being, one hopes that Europe is able to ‘grow’ out of the crisis thanks to the start of the economic recovery. However, if budgetary deficits remain excessive and pitch Member States against each other, the issue might well end up before the European Court of Justice. Time will tell whether our analysis and subsequent speculations are correct.

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