The Stability and Growth Pact tried to strike a delicate balance. On the one hand, it imposed constraints on national fiscal policy that were deemed necessary to protect the new European Central Bank (ECB) from outside pressures, especially during the period in which it tried to establish credibility. At the same time, the Pact allowed some flexibility for a counter-cyclical fiscal policy. This too was deemed necessary in European Monetary Union (EMU): a stable ECB policy might be expected to create stable macroeconomic conditions for the euro zone as a whole, but it could not be expected to iron out regional cyclical imbalances. Did the Pact strike a workable balance? Or is the Pact an unnecessary albatross that could seriously hamper the whole EMU project?

To answer these questions, one needs to analyse the flexibility that is embedded in the Pact, and one needs a well-articulated explanation of the credibility problem that the Pact is supposed to address. Official institutions – the EU Commission, the OECD and the IMF – have done the former, but the official community has not really provided the latter. The academic literature provides a number of possible explanations, but it is not clear which, if any, of the explanations capture the concerns of the official community.

In section 3.1, we outline the key elements of the Pact, compare them with the convergence criteria in the Maastricht Treaty, and ask which fiscal criteria should be the focus of attention. In section 3.2, we
review official institutions' studies of the flexibility embedded in the Pact. Our review finds a strong consensus: the Pact's Excessive Deficit Procedure seems likely to constrain counter-cyclical fiscal efforts in the years ahead, or at least until EU governments make one last fiscal retrenchment to bring their structural deficits into balance. In sections 3.3, 3.4 and 3.5, we review conventional academic arguments that suggest a new central bank might need to be protected from external pressures, and we ask if the constraints that were actually written into the Pact are likely to be helpful in this regard. In section 3.6, we present our conclusions. We may as well give our bottom line at the top: if the Excessive Deficit Procedure continues to be the main focus of the Pact, then we think that the Pact will be an albatross, and not a delicately balanced package of necessary fiscal constraints; if, on the other hand, the level of debt and the (implied) commitment to structural balance become the focus of the Pact, then our assessment would be more positive. We make three recommendations on how to proceed.

3.1 THE STABILITY AND GROWTH PACT

As explained in several chapters in this volume the Stability and Growth Pact has several elements:

1. EU countries have committed themselves to 'medium-term' budgets that are 'close to balance or in surplus'; we will interpret this as an implied promise to balance structural (or cyclically adjusted) budgets.

2. EU countries have to submit annual programmes specifying medium-term budgetary objectives; so, there will be a track record for the Council or the public to examine when assessing a country's compliance with the terms in the Pact (or the 'convergence criteria' in the case of those who are not in the euro zone).

3. Countries in the euro zone that run excessive deficits will be subject to financial penalties and public approbation; we think that the punishment for excessive deficits will be sufficient to affect government behaviour.

4. Deficits are 'excessive' if they exceed 3 per cent of GDP, unless they occur under 'exceptional' circumstances. An annual decline in real output of more than 2 per cent of GDP would be considered exceptional; a decline of 0.75 per cent of GDP might be deemed exceptional if there is additional supporting evidence.