We evaluate the successes and shortcomings of the European fiscal rules in the first 20 years of the Euro. We focus on the European fiscal rules’ role in: (i) fostering sound fiscal policies and the convergence of EMU countries’ fiscal position; (ii) leading to a pro-cyclical or counter-cyclical fiscal policy stance; and (iii) having an impact on EMU countries’ borrowing costs and ability to recover and redistribute income after the European sovereign crisis.

Our analysis shows that, overall, the benefits of the European fiscal rules have outweighed their costs. Fiscal rules have been effective at fostering convergence of government deficits and in lowering governments’ borrowing costs. Moreover, countries with more stringent fiscal rules and sounder fiscal positions experienced a faster economic recovery in the aftermath of the global and the European sovereign crisis. Finally, fiscal discipline did not have a detectable negative impact on countries’ ability to redistribute income.

We also show that, at the Euro area level and in most Member States, fiscal policy has played a counter-cyclical role, on average, over the first twenty years of the Euro. However, fiscal rules have not induced governments to tighten fiscal policy more in good times than in bad times. During the European sovereign and banking crisis in 2011-2013, fiscal tightening had been pro-cyclical at the area level, but fiscal consolidations were driven by different needs in different countries and occurred in an expansionary phase of the cycle in the EMU core.

Looking ahead, in the near term, on the back of populist demands, we expect that de facto fiscal constraints will become less binding and that fiscal policy will be looser than in the past few years in the Euro area. Recent events in Italy and France point in this direction. Our analysis suggests that this will come at the expense of higher borrowing costs and wider intra-Euro area government spreads.

Finally, we briefly discuss some proposals that could gain traction in the policy debate on reforming the European fiscal framework. We expect more focus on numerical expenditure benchmark rules to enforce fiscal discipline in EMU countries in good economic times.

Investors should consider this report as only a single factor in making their investment decision. For Reg AC certification and other important disclosures, see the Disclosure Appendix, or go to www.gs.com/research/hedge.html.
Since the birth of the European Monetary Union (EMU), the enforcement of the European government deficit and public debt criteria set by the Stability and Growth Pact (SGP) has been a source of tension among Member States. Due to the fiscal policy choices of the Italian government and, more recently of the French Executive, these tensions have come once again to the fore of the policy debate in the Euro area. Some governments have pushed for a stricter implementation of the fiscal criteria to foster sound fiscal positions in all Member States. Others have criticized the SGP fiscal rules for being the cause of low growth, high unemployment and poverty in the EMU.

As the Euro area business cycle matures and eventually turns, the appropriateness and effectiveness of the European fiscal rules is likely to become an even more controversial but relevant policy issue, because monetary policy could be short of tools and policymakers might need to consider a more active use of fiscal policy to stimulate aggregate demand. In this context, EMU countries are likely to face difficult policy choices that could lead to an evolution of the current European fiscal framework.

In this *European Economic Analyst*, we evaluate the successes and limitations of the European fiscal rules in the first twenty years of the Euro to highlight the dimensions along which a potential evolution of the European fiscal framework can be considered positive or negative for EMU countries’ economic performance and their fiscal outlook. In particular, we focus on the European fiscal rules’ role in: (i) fostering sound fiscal policies and the convergence of EMU countries’ fiscal position; (ii) leading to a pro-cyclical or counter-cyclical fiscal policy stance; and (iii) having an impact on EMU countries’ borrowing costs and ability to recover and redistribute income after the European sovereign crisis. Finally, we discuss some changes to the European fiscal framework that in our view could happen in coming years.

Our analysis shows that the benefits of the European fiscal rules have outweighed their costs. We find that:

- Fiscal rules have been effective at fostering convergence of government deficits around the 3% threshold, even though they did not impose sufficient fiscal discipline in high debt countries to generate convergence of public debt levels across EMU Member States, particularly between core and peripheral countries. That said, in the absence of the fiscal rules, it is possible that the divergence in EMU countries’ fiscal positions could have been even wider than it currently is.

- At the Euro area level and in most Member States, fiscal policy has played a counter-cyclical role, on average, over the first 20 years of the Euro. However, fiscal rules have not induced governments to tighten fiscal policy more in good times than in bad times. Moreover, during the European sovereign and banking crisis in 2011-2013, fiscal policy had been pro-cyclical in some EMU countries and had amplified the downturn. This occurred in those Member States that had been less compliant with fiscal rules before the crisis and that had little fiscal space. In our view, markets, rather than European fiscal rules, forced these governments to take pro-cyclical fiscal policy measures.
Countries with more stringent fiscal rules have had lower borrowing costs. These countries also experienced a faster economic recovery in the aftermath of the global and the European sovereign crisis. Finally, countries adopting more stringent fiscal rules have not been less able to redistribute income.

Notwithstanding the evidence suggesting that the advantages of pursuing sound fiscal policies outweigh the costs, in the near term, on the back of populist demands, we expect that de facto fiscal constraints will become less binding and that fiscal policy will be looser than in the past few years in the Euro area. Recent events in Italy and France point in this direction. Our analysis suggests that this will come at the expense of higher borrowing costs and wider intra-Euro area government spreads.

Turning to the potential evolution of the European fiscal framework, proposals on limits applied to government expenditure items that react less to the state of the business cycle are likely to gain traction, in our view. The aim is to focus the European fiscal framework around a numerical expenditure benchmark rule that is transparent, and easy to implement and enforce. We expect that some margins for discretion and flexibility will be retained in any future rule-based European fiscal framework. These might be achieved by excluding from fiscal limits some items of the government budget rather than by introducing additional state-contingent escape clauses (such as those on countries passing structural reforms)\(^1\).

On a longer time horizon and/or in response to another severe crisis, the Euro area fiscal architecture could evolve toward more fiscal integration and risk-sharing. But, we expect that to go hand-in-hand with a higher degree of fiscal risk reduction at the country level. The recent discussion by Euro area policymakers on the creation of a Euro area budget is a positive step in the direction of more fiscal integration, but it falls short of the original proposal of France’s President Macron. Compared with what happened during the European sovereign crisis, in our view, more fiscal integration and some mutualisation of risk across the Euro area will likely lead to more extensive private sector debtor bail-ins in countries in need of fiscal transfers and fiscal support. Populist and nationalist political parties are a larger majority in national parliaments now than they were in 2010-2013. This, in our opinion, leaves less room for substantial forms of risk-sharing across countries.

The theoretical case for and against numerical fiscal rules in the EU

All EU Member States are committed to pursue sound and sustainable public finances under the Stability and Growth Pact. As a medium-term objective (MTO), the SGP sets a structural budget balance. In addition, the SGP and other related legislation establish: (i) government deficit and government debt limits (at 3% and 60% of GDP, respectively), (ii) a benchmark rule for public spending growth (general government primary expenditure net of tax revenue must not rise faster than medium-term potential

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\(^1\) For proposals on reforming the European fiscal framework see: Roel Beetsma, Niels Thygesen, Alessandro Cugnasca, Eloïse Orseau, Polyvios Eliofotou, Stefano Santacroce: ”Reforming the EU fiscal framework: A proposal by the European Fiscal Board.” 26 October 2018, VOX, https://voxeu.org/article/reforming-eu-fiscal-framework-proposal-european-fiscal-board and references of this article.
growth), (iii) procedures to monitor and enforce countries’ compliance with the fiscal rules, and (iv) adjustment paths countries have to follow if they need to change the fiscal policy stance to reach the fiscal targets (See Box 1 at the end of this report).

Two market failures argue in favour of numerical fiscal rules rather than a discretionary approach to fiscal policy to target sound public finances. These are:

1. A common-pool problem: Politicians elected in a particular college have an incentive to over-spend and over-provide public goods, particularly ahead of elections. Their constituency receives the full benefit of the public good, but the cost is spread among a broader pool of taxpayers. Hence, politicians do not fully internalize the cost of public spending, thus inducing moral hazard.

2. A financial market failure: Financial markets fail to impose fiscal discipline on an ongoing basis, and when they do it, it might be too late. In that case, the repricing of risk premia is very sharp and costly for economies (Exhibits 1 and 2).

Sound public finances are a key objective to achieve robust and resilient growth and to allow the European Central Bank (ECB) to meet its inflation mandate. Limiting the growth of government deficits and public debt is the means to prevent political influence on the ECB to monetize public debts. This, in turn, avoids the formation of high and unanchored inflation expectations that would compromise the ECB’s ability to deliver stable and low inflation.

All this said, fiscal rules are not a free lunch. In the presence of fiscal rules, policymakers cannot use with full discretion fiscal policy as a stabilisation and/or a redistributive tool. Compliance with strictly enforced fiscal rules could, for example, deepen a recession and slow the recovery phase. We document the extent of these trade-offs in the next section.
An assessment of the successes and limitations of the European fiscal rules

To assess empirically the impact of the European fiscal rules on economic and fiscal indicators, we face a variety of challenges (data availability, measurement issues, the econometric issue of endogeneity and self-selection) and make some methodological choices that could potentially affect the soundness of our results. First, we measure compliance and enforcement of the European fiscal rules along the following dimensions: (i) where countries’ government deficit/GDP and public debt/GDP stand in comparison with the EU thresholds of 3% and 60%; (ii) level and changes of the government structural total and primary balance to measure where countries stand vis-a-vis the numerical criteria of achieving a structural balance and to measure discretionary fiscal policy choices that pursue this objective; and (iii) countries’ rankings based on the fiscal rules index constructed by the European Commission. This index measures the strength of all fiscal rules in force in each of the EU countries since 1990 using information on the legal base of the rule, its binding character and application to various levels of government (national, local), monitoring bodies, correction mechanisms, resilience of the fiscal rule and its application in the face of shocks. Second, our analysis is based on a statistical description of the data and panel regression analysis which may not properly account for the econometric issues indicated above. As such, our results need to be interpreted with caution. That said, our results are consistent with the existing economic literature that address these issues in more depth, and we provide a broad assessment of the role played by fiscal rules in the past. This, in our opinion, is an informative and useful exercise to assess potential reforms of the European fiscal framework that are under discussion.

European fiscal rules’ role in fostering sound fiscal policies and the convergence of EMU countries’ fiscal position

1. Compliance with European fiscal rules has been loose since the birth of the Euro area, but it has improved in recent years

Since the birth of the European Monetary Union, our analysis shows that compliance with the European fiscal rules has been loose. To begin with, countries with public debt-to-GDP ratios above the 60% Maastricht Treaty limit were allowed to adopt the Euro. Afterwards, several countries breached the 3% government deficit-to-GDP ceiling and/or did not follow the adjustment path required by the fiscal rules to reduce public debt.

On average, peripheral Euro area countries that received financial assistance from European institutions and the IMF in 2010-2013 had deviated more significantly than core Euro area countries from fiscal plans that aimed at pursuing structural balanced budgets over the medium term (Exhibits 3 and 4).
More recently, however, compliance with the European fiscal rules has improved, not just in core countries, where fiscal discipline has led to budget surpluses, but also in the periphery countries whose fiscal outturns have moved closer to fiscal plans approved by the European Commission (Exhibits 5 and 6).

In our view, the legislative changes implemented by European policymakers since 2011 have led to a strengthening of numerical fiscal rules not only *de jure*, but also *de facto*. In this context, however, the *compromise* between the European Commission and the Italian government around the 2019 government budget and the acquiescence of the European Commission on the fiscal measures announced by French government in response to the ‘yellow vest’ (gilets jaunes) could lead to a loss of credibility of European fiscal institutions, just when some credibility was being restored.

Exhibit 5: In recent years, in Germany, the government surplus has been larger than projected and...

Government deficit, actual and forecast, in Stability Programmes submitted to the European Commission since 1998 (% of GDP) - Germany

Exhibit 6: ...even in Italy, up until last year, the actual government deficit-to-GDP ratio has been closer to that projected, indicating a higher degree of compliance to fiscal rules than in the past

Government deficit, actual and forecast, in Stability Programmes submitted to the European Commission since 1998 (% of GDP) - Italy

Source: European Commission, IMF
2. Fiscal convergence across Euro area countries is not a fully developed process

Establishing causality between fiscal rules and fiscal outcomes poses challenges. On the one hand, EU fiscal institutions and rules promoting fiscal discipline can foster fiscal outcomes. On the other hand, countries with lower government deficits and public debt can choose to adopt stricter fiscal rules at the national level, and/or follow EU fiscal rules de facto, not just de jure. Recent economic literature that addresses this reverse causality problem shows that fiscal rules and fiscal institutions promoting fiscal discipline lead to lower government deficits and public debt in developed and developing countries.2

In the Euro area, we also find evidence pointing in this direction. For example, Exhibit 7 shows that countries with more stringent fiscal rules had sounder public finances at the onset of the global financial crisis.

Exhibit 7: A majority of EU countries with more stringent fiscal rules had sounder public finances at the onset of the global financial crisis

Government debt/GDP in 2007, (%)

Moreover, over time, the Euro area fiscal framework has also been successful at fostering some convergence in fiscal position across Member States. The dispersion of government deficits across Euro area countries has fallen, and a larger number of countries are currently running government deficits closer to the 3% limit than they did in the past (Exhibit 8). However, fiscal rules did not impose sufficient fiscal discipline in high debt countries to prevent a growing divergence of public debt/GDP ratios (Exhibit 9).

In our opinion, this points to fiscal adjustment fatigue and to the challenge of enforcing fiscal discipline to the extent needed for high debt countries to be, de facto, in compliance with the public debt rule. For the same reason, it seems difficult for these countries to achieve the medium-term objective of a structural balanced budget (Exhibit 10).

Overall, in our opinion, although mixed, these results do not provide a strong justification for the criticism that the Euro area fiscal framework has been unfit to promote fiscal discipline. To the contrary, we interpret the evidence as pointing toward a somewhat more positive assessment of the ability of EU fiscal rules to foster sound public finances. Moreover, in the absence of the fiscal rules, it is possible that the divergence...
of core and peripheral countries’ fiscal positions could have been even wider than it currently is.

**European fiscal rules and the business cycle: “one size” does not fit all**

1. **Euro area fiscal policy counter-cyclical on average over the past 20 years, procyclical in some countries and/or in particular time periods**

As in all major developed economies, fiscal policy is counter-cyclical in almost all Euro area countries. The government balance worsens when the output gap is negative and widening and, vice-versa, improves when cyclical conditions become more favourable. This is due to the role played by the so-called automatic stabilizers: government spending for unemployment benefits increases (decreases) and tax revenues decrease (increase) in a slowdown (boom).

That said, there is a significant variation in the degree of counter-cyclicality of fiscal policy among Member States. The beta of government deficits to the output gap is: (i) negative in Greece – a feature that suggests a pro-cyclical fiscal policy, usually observed in emerging economies; (ii) positive but very low in Italy; and (iii) positive and very high in Finland, France, and Ireland (Exhibit 11).

Moreover, when we estimate if EMU countries implement a tighter fiscal policy stance when business cycle conditions improve, we find that the opposite occurs in many of the EMU Member States (i.e. the cyclically adjusted government total and primary balances improve (deteriorate) when the output gap falls (increases)) (Exhibit 12).

Finally, as Exhibits 13, 14 and 15 show, fiscal policy was used to stimulate aggregate demand between 2008 and 2010 at the Euro area level and in the largest four

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3 We estimate the coefficients shown Exhibit 11 via fixed-effect regressions of the change of each fiscal variable on the lagged value of the fiscal variable and the output gap. We allow the coefficient of the output gap to vary across countries. Our data include all the Euro area countries from 1999 till 2017.

4 We estimate the coefficients shown Exhibit 12 via fixed-effect regressions of the change of each fiscal variable on the lagged value of the fiscal variable and the output gap. We allow the coefficient of the output gap to vary across countries. Our data include all the Euro area countries from 1999 till 2017.
economies. However, during the European sovereign and banking crisis in 2011-2013, EMU countries tightened fiscal policy. Cumulatively, the size of the fiscal contraction in 2011-2013 was larger than that of the fiscal expansion in 2008-2010, not just in Italy and Spain but also in Germany and France. That said, fiscal consolidations were driven by opposite goals/needs in core and periphery countries in 2011-2013. On the one hand, real GDP growth was robust in Germany and France in 2010-2011, and Germany tightened its fiscal stance the most in 2011, when real GDP grew at an annual rate of 3.7%. Hence, policymakers in core Euro area countries were rebuilding fiscal space and pursuing a counter-cyclical fiscal policy. On the other hand, government bond yields soared in peripheral countries in 2011 on the back of public debt sustainability concerns. Hence, policymakers in these countries were forced by financial markets, more than European numerical fiscal rules, to tighten fiscal policy when real GDP growth was falling in their economies.

A negative by-product of such divergence was the fact that policymakers in core countries did not internalize (and, hence, did not attempt to offset) the negative externality on economic activity and inflation that the tightening of fiscal policy and the severe credit crunch in peripheral countries would have had not just in these economies, but more broadly, at the Euro area level. Policymakers in core countries were adopting what in 2010-2011 appeared to be the appropriate policy stance from the perspective of their own citizens. Ex-post, it became clear that it could have been beneficial to redistribute resources to peripheral countries, even for core countries, and that the Euro area could benefit from an institution with central fiscal capacity that could internalize negative externalities from a subset of countries and pursue a more appropriate fiscal policy stance for the Euro area.

Exhibit 13: In the Euro area, fiscal policy was used to stimulate aggregate demand between 2008 and 2010, but not during the European sovereign and banking crisis in 2011-2013

<table>
<thead>
<tr>
<th>% of potential GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
</tr>
<tr>
<td>2008</td>
</tr>
<tr>
<td>-5.0</td>
</tr>
</tbody>
</table>

Exhibit 14: The fiscal contraction in 2011-2013 in Italy and Spain was driven by the need to reassure markets, while...

% of potential GDP

Source: European Commission, Goldman Sachs Global Investment Research
2. A weak link between European fiscal rules, the stance of fiscal policy and the business cycle

We now investigate whether fiscal rules are the cause of the pro-cyclical or counter-cyclical behaviour of fiscal policy in EMU countries. In particular, we check whether: (i) countries in which fiscal policy is negatively correlated with the business cycle (counter-cyclical fiscal policy) are also countries that have tighter fiscal rules (we measure the tightness of fiscal rules using the European Commission index described above); (ii) countries with stricter fiscal rules pursue more sizeable fiscal adjustments; and (iii) fiscal rules have led governments to tighten fiscal policy more in good times than in bad times.

We find that there is a weak positive correlation between the beta of government deficits to the output gap (i.e. the estimated coefficient shown in Exhibit 11, which measures the degree of cyclicality of fiscal policy) and an index that measures the strictness of fiscal rules in Euro area countries. Moreover, stricter fiscal rules have a positive and statistically significant effect on changes to the government cyclically adjusted primary balance, indicating that countries with stricter fiscal rules also pursue a more conservative fiscal policy. Finally, when we test whether countries with stricter fiscal rules also tighten fiscal policy more in good times than in bad times, we find no statistically significant evidence pointing in this direction (Exhibit 16).

Overall, based the evidence discussed above and our reading of developments during the European sovereign and banking crisis, we conclude that markets, more than European fiscal rules, forced these governments to take pro-cyclical fiscal policy measures.
Fiscal discipline, fiscal rules, economic and financial outcomes

1. Fiscal discipline lowers countries’ borrowing costs...

Sovereign borrowing costs increase and intra-EMU government bond spreads tighten if the government debt-to-GDP ratio decreases and government primary balance (i.e. the difference between total government spending net of interest rate payments and tax revenues) improves. Moreover, countries with stricter fiscal rules also experience lower yields and tighter spreads to German Bunds (Exhibit 17). Finally, making fiscal rules stricter is particularly advantageous in terms of lower borrowing costs and tighter spreads, in high debt countries (Exhibit 18). A fiscal framework that is more effective at enforcing fiscal discipline could be perceived as an institutional safeguard and guarantee of fiscal sustainability.

2. ...and did not impair growth after the European sovereign crisis, nor...

There is a vast amount of literature on fiscal multipliers and fiscal austerity that attempts to measure the impact of fiscal policy shocks and large fiscal consolidations (or expansions) on economic activity. We take a narrower view here, and show some correlations between fiscal rules and fiscal space and Euro area Member States’ economic performance in the aftermath of the global financial crisis. As shown above (Exhibit 7), data suggest that countries adopting more stringent numerical fiscal rules in their legislation entered the global financial crisis with a lower stock of public debt. These countries were those that also experienced a more rapid recovery (Exhibit 19).
3. ...countries’ ability to redistribute income

Finally, another criticism of the SGP is that it has constrained countries’ ability to redistribute income and to fight poverty. As with all the evidence above, reverse causality and the absence of a counterfactual makes it difficult to assess whether inequality and poverty would have been lower if European fiscal rules had been designed and implemented differently. That said, Exhibit 20 shows that countries with more stringent numerical fiscal rules, and lower government deficits and public debt at the onset of the global financial crisis are also those where poverty and inequality increased the least.

The future of the European fiscal framework

The European fiscal framework has been reformed several times since the signature of the Stability and Growth Pact (see Box 1). These reforms have made the SGP fiscal rules less pro-cyclical, but more complex and less transparent. Given the criticisms of the current framework, over the next few years, Euro area fiscal rules and fiscal institutions are likely to continue to evolve. In our opinion, the evolution will remain gradual and incremental and it will not end the debate on the appropriateness and effectiveness of the framework. In the near term, on the back of populist demands, as recent events in Italy and France have shown, it is likely that de facto fiscal constraints will become less binding and fiscal policy looser than in the past few years. Based on our analysis above, this will likely come at the expense of higher borrowing costs and wider intra-Euro area government spreads.
In the near term, we expect that a revision of the SGP that focuses on an expenditure benchmark rule, with elements of the Darvas et al., Feld et al., and European Fiscal Board’s proposals, is likely to gain traction. This could simplify, add transparency, and enhance fiscal discipline in the Euro area, particularly in good economic times. These proposals suggest a focus on the growth of a clearly specified public expenditure indicator (either gross or net of the discretionary growth of tax revenue), as the primary, most relevant numerical fiscal criteria Euro area countries have to follow to pursue sound fiscal policy. The proposed public expenditure indicators exclude from total government expenditures the items that are not under “direct” control of politicians (namely interest rate expenditures and expenditures on unemployment benefits that are largely driven by the business cycle), and, in some proposals, also expenditures on public investment.

In the medium term, a Euro area budget could be established with the goal of fostering convergence and competitiveness, but, in our opinion, it will be limited in size and scope, and progress of its implementation will likely be slow. In addition, there are a number of other proposals that could come to the fore of the policy debate to make the European fiscal framework more credible, realistic and incentive-compatible. For example, as discussed in this report presented to the European Parliament, the current system of sanctions has proved to be inapplicable for political reasons and could be revised with a system that combines the “carrot” with the “stick.” We leave an analysis of proposals to reform the Euro area fiscal framework for future work.
Box 1: The evolution of Euro area fiscal institutions: from the Maastricht Treaty to the Two-Pack

The Maastricht Treaty, signed in 1992, defined two benchmark fiscal rules for countries wanting to adopt the Euro: (i) their general government deficit-to-GDP ratio should be no higher than 3%, and (ii) their public debt-to-GDP ratio should be no higher than 60%.

The fiscal rules were then embedded into the Stability and Growth Pact (SGP), the budgetary pillar of the Economic and Monetary Union, signed in 1997, and applying also to EU non-Euro area countries. These numerical fiscal rules are also only part of the toolbox that promotes fiscal discipline and safeguards the independence of the European Central Bank: the ‘no bail-out’ clause and the prohibition of monetary financing are also embedded in EU legislation to serve these purposes.

The SGP’s main goal is to foster sound public finances in Member States. In addition to the government deficit and government debt limits, the SGP sets the medium-term objective of a structural budget balance.

The SGP is composed of a preventive and corrective arm (also called excessive deficit procedure (EDP)). At the core of the preventive arm is the country-specific medium-term budgetary objective (MTO), which corresponds to a structural budgetary position that a country should achieve and maintain over the cycle to ensure sustainable public finances and avoid the build-up of excessive deficits and debts. For Member States that are not at their MTO, an appropriate path is designed to which the country should adhere. The adjustment path to the MTO could take the implementation of major structural reforms into account, provided that they have a verifiable impact on long-term public finance sustainability, either directly (such as for pension reforms) or by raising the growth potential (and thereby lowering the level of public debt as a percentage of GDP). The MTO is revised by the European Commission (EC) every three years, but the EC assesses every year countries’ progress toward their targets on the basis of countries’ stability and convergence programmes (SCPs) and draft budgetary plans during the so-called ‘European Semester’. If the fiscal policies of a Member State result in a significant deviation from their MTO or the adjustment path towards it, the Commission shall recommend the Council to open a so-called Significant Deviation Procedure. This gives national authorities the opportunity to return to a more prudent fiscal policy, and avoid the opening of an Excessive Deficit Procedure under the corrective arm of the Stability and Growth Pact.

At the core of the corrective arm, there is the excessive build-up of deficit and/or public debt. The EC report in the context of the Treaty provision on excessive deficit prohibition (namely Article 126(3) of the Treaty) aims to assess whether an Excessive Deficit Procedure (EDP) must be launched against a Treaty. In practice, this report analyses in details the Member State’s deficit and/or debt position to assess whether or not a country is non-compliant with the EU fiscal requirement.

- Deficit requirement: A country will be considered as non-compliant if its general government deficit is above 3% of GDP, unless the excess over the reference value is only exceptional and temporary (i.e. unexpected adverse economic circumstances with a significant impact on public finances) and the deficit ratio remains close to the reference value.

- Debt requirement: A country will be considered as non-compliant when its general government debt level is greater than 60% of GDP and not declining at a satisfactory pace.
Starting from 2011, other legislation has been introduced to make the SGP framework more effective at fostering fiscal discipline but also more flexible to account for countries’ economic and initial fiscal conditions.

First, the so-called ‘Six Pack’ (five Regulations and a Directive) was introduced in 2011 to strengthen the preventive safeguards against the build-up of fiscal and macro imbalances. It added: (i) a debt reduction benchmark rule aiming at making operational the debt reduction criteria of the SGP (for countries with a debt-to-GDP ratio above 60%, a reduction of the gap between a country’s debt ratio and the 60% of GDP limit by 1/20th annually on average over three years), and (ii) an expenditure benchmark rule (public spending, net of interest rate expenses must not rise faster than medium-term potential growth, unless faster spending growth is financed with fiscal revenue increases).

Then, The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) with its main provision, the Fiscal Compact, was agreed on an intergovernmental basis and entered into force on January 1, 2013. The TSCG was politically tied to the provision and extension of financial firewalls in the form of the European Financial Stability Facility and the European Stability Mechanism, which was adopted as a permanent facility in 2012. Financial assistance can be granted only to countries that have ratified this treaty.

Finally, in 2013, the ‘Two-Pack’ was adopted to integrate some elements of the Fiscal Compact into Union law, including the existence of independent bodies that have to monitor the compliance with national fiscal rules, produce, or at least endorse, the macroeconomic projections used for budgetary plans, and play a role in activating the correction mechanism in case a country deviates from the fiscal rules.

The Fiscal Compact and the related regulation was designed to better foster budgetary discipline and increase national ownership of the fiscal governance framework.

Among the main requirements of the Fiscal Compact and the Two-Pack, we highlight the following features that aim at fostering fiscal discipline:

- a balanced budget rule in domestic legal orders;
- a strengthening of the excessive deficit procedure;
- a numerical benchmark for debt reduction for Member States with government debt exceeding the 60% of GDP (i.e. the difference between government debt-to-GDP ratio and 60% of GDP needs to be reduced at an average of one-twentieth per year);
- adjustment mechanisms automatically triggered to correct deviations of a country’s structural balance from the adjustment path and the correction of the cumulative deviations on government debt dynamics;
- Member States to report ex ante their public debt issuance plans;
- Member States in the Excess Deficit Procedure to prepare economic partnership programmes to correct the imbalances; and
- the creation of independent bodies that monitor the compliance with national fiscal rules, produce, or at least endorse, the macroeconomic projections used for budgetary plans, and play a role in activating the correction mechanism in case a country deviates from the fiscal rules.
The Fiscal Compact and the related regulation also extended more flexibility to countries to comply with the above requirements via the following channels:

- the fiscal rule that requires the general government budget to be balanced or in surplus is considered respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a government deficit in structural terms of 0.5% of GDP (or 1% for low debt countries);
- for countries with a structural balance not in line with the medium-term objective, the concrete timeframe for the adjustment is specified by the European Commission, which could also make the adjustment plan more gradual if countries implement structural reforms (for example, reforms of labour, product markets, and pension systems) that would increase long-term growth and the sustainability of public debt; and
- there are exceptional circumstances (an unusual event outside the control of the country or a severe recession) during which countries may temporarily deviate from the medium-term objective.
Exhibit 23: The evolution of Euro area fiscal institutions: from the Maastricht Treaty to the Two-Pack


Maastricht Treaty signed
Preventive arm enters into force
Stability and Growth Pact agreed
Global Financial Crisis
Six-Pack enters into force
Greece First Programme
Corrective arm enters into force
Structural balance takes central stage
Two-Pack enters into force
Fiscal Compact agreed
Communication: Flexibility within existing rules

Source: Vox EU
Disclosure Appendix

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I, Silvia Ardagna, hereby certify that all of the views expressed in this report accurately reflect my personal views, which have not been influenced by considerations of the firm’s business or client relationships.

Unless otherwise stated, the individuals listed on the cover page of this report are analysts in Goldman Sachs’ Global Investment Research division.

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