To the point.
Information from the Federal Ministry of Finance.

NEW BUDGETARY SURVEILLANCE IN THE EU

Towards a stability union
Dear Reader,

Our single currency not only keeps prices as stable as in times of the Deutschmark; it also guarantees stable exchange rates with other currencies, such as the US dollar. The euro offers a reliable basis for calculations and is in high demand as a reserve currency throughout the world. Some 330 million people across 17 European countries benefit from its strength as well as its economic and political advantages. There is no euro crisis.

However, there have been a number of other crises in recent years. What began as a banking crisis developed into a financial crisis, which in turn triggered an economic crisis, eventually throwing the budgets of several euro countries into disarray. Some member states were no longer able to service their debts. As a result of the sovereign debt crisis, the economic and monetary union experienced a crisis of confidence – despite the stability of the euro.

Germany is the country that benefits most from the common currency. That is why we Germans have the greatest interest in seeing the European and monetary union become a stability union. Together with our European partners, we have taken a series of measures to tackle the European sovereign debt crisis at its root. The aim of these measures is to restore confidence in the eurozone on a long-term basis in order to ensure that the euro remains strong.

The Federal Ministry of Finance is serious about its responsibility and obligation to provide information about its policies on creating stability in the euro area. After all, politics will not succeed if policy-makers fail to provide the general public with clear explanations of the decisions they make. That is why we have created a site providing information about euro stability, available in German at www.stabiler-euro.de, and produced a four-part series of documents setting out the key points of the different measures involved in overcoming the sovereign debt crisis.

This issue focuses on the new measures for budgetary surveillance. The rules that were previously in place could not prevent huge amounts of debt from accumulating in individual member states. That is why new rules and a uniform planning and reporting cycle have been introduced. This brochure offers detailed information about the fiscal compact, the enhanced Stability and Growth Pact and the European semester.

The Federal Ministry of Finance
Reforming the economic and monetary union

A number of European countries have experienced financial difficulties in the wake of the global economic and financial crisis. This was due to a lack of structural reforms and insufficient competitiveness, but also imprudent budgetary policy and inadequate financial market regulation. Although the internal value (i.e., the inflation rate) and the external value (i.e., the exchange rate) of the euro remained stable throughout the crisis, the monetary union came under immense pressure. A comprehensive range of measures were adopted to ensure the long-term stability of the eurozone:

I. **New budgetary surveillance:** The fiscal compact and new fiscal rules under the Stability and Growth Pact are intended to reduce and limit public debt in the member states and prevent structural deficits from arising in the first place. To monitor this, member states regularly have to report to the European Commission in what is known as the European semester.

II. **New economic governance:** The common growth strategy, the Compact for Growth and Jobs and the Euro Plus Pact have been introduced to make euro countries more competitive. The new procedure to avoid and correct economic imbalances will help to coordinate and monitor economic policy.

III. **Financial market regulation:** National, European and global measures for financial market regulation are creating a new regulatory framework that will help the financial sector regain its function of serving the real economy.

IV. **Stability mechanisms:** The European Stability Mechanism (ESM) and the temporary rescue fund (EFSF, EFSM) are effective instruments for getting future crises under control quickly.

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### Measures for the long-term stability of the euro

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**Stability mechanisms**

- European Stability Mechanism (ESM)
- European Financial Stability Facility (EFSF)
- European Financial Stabilisation Mechanism (EFSM)
New budgetary surveillance in the EU

European countries have created a powerful fiscal surveillance system by introducing the enhanced Stability and Growth Pact, the fiscal compact and the European semester. The new system will improve budgetary discipline in the individual countries and help to ensure that public finances remain healthy.

Stability and Growth Pact

The European Stability and Growth Pact (SGP) has its roots in the Maastricht Treaty of 1992. Countries that wanted to join the monetary union had to meet the “convergence criteria”. The idea was to ensure stable prices, stable long-term interest and exchange rates, and a deficit ceiling for member states. The Pact was introduced in the economic and monetary union in 1997, establishing a clear legal framework for coordinating and monitoring national financial policies in the EU. Among other things, the annual deficit ceiling was set at three per cent of a country’s gross domestic product (or GDP), and government debt was capped at 60 per cent of GDP on a permanent basis. The aim was to prevent financial policy mistakes from being made in good economic times which would then become unmanageable in bad times.

Reforming the Stability and Growth Pact

The sovereign debt crisis revealed the weak points in the economic and monetary union. To rectify these problems, the EU member states undertook further extensive reforms to the Pact. The new rules entered into force in December 2011. The following changes were made in order to improve budgetary discipline:

• Alongside the deficit ceiling of three per cent of GDP, a second focus of the Stability and Growth Pact is the medium-term goal of structurally balanced budgets (i.e., adjusted for cyclical and one-off effects), similar to the German debt brake.
• EU countries whose debt ratio exceeds 60 per cent of GDP are required to reduce it by one-twentieth of the excess amount each year.
• A graduated and largely automatic sanctions procedure was introduced. A sanctions resolution recommended by the Commission becomes effective unless it is rejected by qualified majority in the Council (composed of eurozone members). This requires what is known as reverse qualified majority voting.
• National budgetary rules in EU member states must fulfil certain minimum standards in order to ensure cross-border transparency and comparability.
Fiscal data are collected according to strict standards, and compliance is monitored by the European statistics authority EUROSTAT. Countries that submit fraudulent statistics on their new borrowing and overall stock of debt have to pay substantial fines.

Procedures under the Stability and Growth Pact

The Stability and Growth Pact contains rules to avoid debt (known as the preventive arm) and rules to limit debt (known as the corrective arm).

- **Prevention**: Member states are required to submit annual Stability or Convergence Programmes outlining the measures taken to achieve a structurally balanced (or close-to-balanced) budget. They are reviewed by the European Commission and the Council of the European Union. If a member state deviates considerably from sound budgetary policy, the Council can recommend corrective measures. Penalties can be imposed if the member state does not take effective measures within the deadline set.

**Stability and Growth Pact: New rules to prevent excessive deficits**

<table>
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<th>Scenario 1</th>
<th>Member state</th>
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|            | - Complies with 3% deficit ceiling  
|            | - Deviates significantly from medium-term goal of a balanced budget |

**Early warning**

- Commission issues early warning and recommends certain measures to Council
- Council requires member state to take specific measures

**Review**

- Commission reviews implementation of measures

**In the case of inadequate implementation**

- Council determines inadequate implementation

**Sanctions for euro countries**

- Commission recommends sanctions (0.2% of GDP as interest-bearing deposit)
- Sanctions resolution comes into force after 10 days unless rejected by qualified majority in the Council
• **Correction:** A “deficit procedure” is launched if a member state exceeds the statutory ceiling on net borrowing (“deficit limit”) or fails to reduce its debt-to-GDP ratio sufficiently. In a deficit procedure, the Council recommends corrective measures and sets deadlines for their implementation. Since the 2011 reform, financial penalties are now imposed at the outset of the multi-stage deficit procedure. The member state in question has to deposit a fine. If it does not comply with the recommendations by the stipulated deadline, further sanctions can follow.

**Stability and Growth Pact: strict rules to limit debt**

<table>
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<th>Scenario 2</th>
<th>Member state</th>
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<td>- Fails to comply with 3% deficit ceiling and/or - Fails to bring down debt-to-GDP ratio sufficiently</td>
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**All EU member states**

**Euro countries**

**Corrective arm**

**Initiation of deficit proceedings**

- Commission determines that deficit is too high or that debt-to-GDP ratio has not been brought down sufficiently
- Council opens procedure and sets strict deficit/debt-to-GDP ratio reduction targets. Implementation period: 6 months (3 months in serious cases)

**In case of inadequate implementation on part of member state**

- After a maximum of 1 month: imposition of non-interest-bearing deposit (0.2% of GDP)

**Notice**

- Council does not see suitable corrective measures and sets further targets for budget consolidation within 2 months

- After a maximum of 1 month: fine

**Stricter sanctions imposed if member state still fails to comply with requirements**
The fiscal compact

In March 2012, twenty-five EU member states concluded the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, or “fiscal compact” for short. It will supplement and strengthen the reformed Stability and Growth Pact. Under the fiscal compact, countries have committed themselves to introducing uniform and binding budgetary rules into their national legal systems, preferably at constitutional level. The treaty entered into force on 1 January 2013. Countries that have signed the fiscal compact and use the euro as their currency (or have made a declaration) are required to enact the treaty’s fiscal rules in their national legislation. In Germany, the Bundestag and the Bundesrat adopted the new legislation on 29 June 2012. The fiscal compact changes the existing legal situation in the following ways:

• **Lower deficit limit**: The annual structural net borrowing (i.e., adjusted for cyclical and one-off effects) of each country must not exceed 0.5% of GDP, unless its debt-to-GDP ratio is well below 60% of GDP.

• **Binding legal force**: Countries must introduce binding and long-term national legislation on the debt brake, preferably at constitutional level.

• **Court actions and sanctions**: The enactment of the debt brake in national legislation is enforceable via the European Court of Justice (ECJ). Member states that ignore a decision of the ECJ will have sanctions imposed on them, usually in the form of financial penalties of up to 0.1% of GDP.

• **Accountability and monitoring**: Member states that undergo an excessive deficit procedure have to put a budgetary and economic partnership programme in place. It is authorised and monitored by the Council of the European Union and by the European Commission.

• **Voting in the excessive deficit procedure**: The excessive deficit procedure is triggered and escalated quasi automatically. If a member state breaks the rules, sanctions can only be prevented if a qualified majority of member states votes against the proposal issued by the European Commission (reverse qualified majority voting).

• **Communication at European level**: To improve governance of the eurozone, the fiscal compact calls for Euro Summits to be held on a regular basis – at least twice a year.
Ensuring that the debt brake is enacted in national law

**POINT OF FOCUS**

- Time allowed for enactment of debt brake: 1 year

**Fiscal compact and ESM**

Solidarity and solidarity are two sides of the same coin. That is why financial assistance under the European Stability Mechanism (ESM) is closely tied to the fiscal compact. In future, any country wishing to claim ESM assistance must have ratified the fiscal compact by 1 March 2013 and enacted the debt brake provisions in national law no later than one year after the compact entered into force.
European semester

The “European semester”, which was adopted by the European Council in June 2010, is a coordination cycle for fiscal, economic and employment policy. Systematic communication between national governments and the European Union creates a dedicated time frame for budgetary surveillance and makes it easier to implement the necessary financial and economic policy reforms. In the past, budget policy coordination under the Stability and Growth Pact was separate from economic policy coordination under the Europe 2020 strategy. These two areas have now been harmonised and temporally aligned. They will be supplemented by the new macroeconomic surveillance procedure and the Euro Plus Pact.

The European semester follows a fixed six-month cycle starting at the turn of each year. The member states are given guidelines and recommendations which they are expected to take into account in their national budgetary and economic procedures. The EU, in turn, can respond to developments in the member states at an early stage. This gives the coordination and surveillance of budgetary and economic policies in the EU a more preventive focus. The European semester was implemented for the first time in 2011.

*NRPs = National Reform Programmes
*SCPs = Stability Convergence Programmes
Germany’s approach to reducing debt

Germany is known across Europe for its exemplary budgetary discipline. Its deficit is well below the upper limits defined in the Stability and Growth Pact and the recently concluded fiscal compact. In 2012, Germany was the only country in the eurozone to achieve a budget surplus, with net lending of +0.2% of its gross domestic product (GDP). This is a remarkable achievement considering that the deficit limit under the Stability and Growth Pact (known as the Maastricht reference value) is 3% of GDP. The structural financial balance (“structural” because it is adjusted for cyclical and one-off effects) was even higher, at +0.4% of GDP – the first time it has been positive. This also means that Germany has reached its medium-term budgetary objective ahead of time, remaining safely below its target of a structural deficit no higher than 0.5% of GDP. In other words, Germany is Europe’s anchor of stability.

The success of Germany’s consolidation efforts is evident, especially when compared to the situation at the beginning of the parliamentary term: In December 2009, the EU’s council of finance ministers (ECOFIN) determined that Germany was running an excessive deficit as defined in Article 126 of the Treaty on the Functioning of the European Union. Germany was instructed to bring its deficit to below the reference value of 3% of GDP by 2013.

Because of the crisis, the deficit still stood at 4.1% of GDP in 2010. The German government immediately initiated a sustainable, growth-friendly course of consolidation and fulfilled the promises made to its EU partners ahead of time. As early as 2011 – two years before the deadline – Germany had brought its deficit down to 0.8% of GDP, well below the deficit limit set out in the Stability and Growth Pact. As a result, the excessive deficit procedure against Germany was dropped ahead of schedule, in 2012.

Germany’s growth-friendly consolidation boosted the confidence of businesses and the general public in sound, sustainable public finances. As a result, the economy has performed very well. High employment levels and the global success of German companies have led to noticeable increases in tax revenue, and unemployment has fallen every year, reaching its lowest level since German unification in 2012. Investors across the world have great confidence in the German business environment, as shown by the high inflow of capital and the historically low interest rates on Federal Government bonds. Consolidation and growth go hand in hand.

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* Federal Statistical Office and winter economic forecast of the European Commission
At a glance: new budgetary surveillance in the EU

• A number of factors contributed to the financial difficulties experienced by some EU countries: a lack of competitiveness, unsound budgetary policies in certain cases, and inadequate fiscal surveillance. As a result, the stability of the economic and monetary union was at risk.

• The enhanced Stability and Growth Pact and the new fiscal compact are intended to improve budgetary discipline in the member states. The aim is to reduce government debt and, if possible, avoid new borrowing altogether.

• The reformed Stability and Growth Pact aims for structurally close-to-balanced budgets (i.e., adjusted for cyclical and one-off effects) and presents clear steps for reducing debt. If a country fails to comply with the rules, a deficit procedure is initiated, in which the Council of the European Union recommends corrective measures and sets deadlines for their implementation. The necessary penalties are largely imposed automatically. Moreover, uniform minimum standards for budgetary rules have been introduced, and fiscal data will be collected according to strict standards.

• All euro countries and almost all other EU countries have agreed to the fiscal compact, which complements and strengthens the Stability and Growth Pact.

• Under the fiscal compact, countries must introduce debt brake provisions into their national legislation. The limit on new borrowing has been lowered further, and the procedure followed in the event of non-compliance has also been made largely automatic. The treaty entered into force on 1 January 2013.

• The fiscal compact is being closely linked to the European Stability Mechanism (ESM). Any country wishing to claim ESM assistance must have ratified the fiscal compact by 1 March 2013 and enacted the debt brake provisions in national law no later than one year after the compact entered into force.

• A uniform and systematic planning and reporting cycle – known as the European semester – has been put in place to create closer links between budgetary and economic surveillance and coordination processes as well as to create a dedicated time frame for budgetary control.
Other publications in the 'Towards a Stability Union' series:
Issue #2: New economic governance in the EU
Issue #3: Financial market regulation
Issue #4: European stability mechanisms

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