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A dead stability and growth pact and a strong euro:

There must be a mistake!

**An “embedded” intergovernmentalist perspective to
the credibility of European exchange rate
commitments**

Abstract

When it was adopted by the European council in Amsterdam in 1997 the Stability and Growth Pact (SGP) was proclaimed to be the main pillar of the credibility of the forthcoming Economic and Monetary Union, the guarantor of the stability and strength of the newly born common currency, the German enforcement mechanism to constrain the free-riding attitude of the club-med. In 2003, the Stability and Growth Pact died at the hands of its father and mother, Germany and France. Yet, contrary to all expectations the euro did not plunge. Indeed, it remained stronger than ever and the markets did not even think about speculating on the lack of credibility of a post-SGP EMU. Here a fundamental paradox arises: how can a currency strengthen in the midst of a serious crisis of the fiscal rule?

This article seeks to explain the paradox within the framework of a revised, “embedded” version of intergovernmentalism based on Andrew Moravcsik’s liberal intergovernmentalism (Moravcsik, 1993a), which adds to the traditional intergovernmentalist framework an explicit theory of national preferences formation.

Key words:

Stability and Growth Pact, Economic and Monetary Union, European Political Economy, exchange rate credibility, euro, embedded intergovernmentalism

Introduction

When it was adopted by the European council in Amsterdam in 1997 the Stability and Growth Pact (SGP)ⁱ was proclaimed to be the main pillar of the credibility of the forthcoming Economic and Monetary Union, the guarantor of the stability and strength of the newly born common currency, the German enforcement mechanism to constrain the free-riding attitude of the club-medⁱⁱ. In 2003, the Stability and Growth Pact died at the hands of its father and mother, Germany and Franceⁱⁱⁱ. Yet, contrary to all expectations the euro did not plunge. Indeed, it remained stronger than ever and the markets did not even think about speculating on the lack of credibility of a post-SGP EMU^{iv}. Here a fundamental paradox arises: how can a currency strengthen in the midst of a serious crisis of the fiscal rule?

This counterintuitive phenomenon raises a set of fundamental questions concerning the European macroeconomic regime after the establishment of EMU. On what is the credibility of exchange rates commitments grounded? What kind of considerations induce financial markets to keep or withdraw confidence in a currency? Is fiscal stability in any way related to exchange rate credibility?

In political science there is considerable disagreement among various interpretations of these events, ranging from intergovernmentalism to neo-constructivism.^v At the same time, economists continue to dominate the debate about both the credibility of the exchange rates and fiscal co-ordination in a monetary union^{vi}. In this article, I seek to explain the paradox within the framework of a revised, “embedded”^{vii} version of intergovernmentalism based on Andrew Moravcsik’s liberal intergovernmentalism

(Moravcsik, 1993a), which adds to the traditional intergovernmentalist framework an explicit theory of national preferences formation.

As applied to the working of the SGP, intergovernmentalists would predict that the interests of the most powerful member states prevail over the ones of smaller states in the ECOFIN decision-making process. Embedded intergovernmentalism traces the interests of the most powerful euro-zone member states in the macroeconomic preferences of their leading socio-economic sectors (Talani, 2005). This means that the relaxation of the fiscal rules corresponded to the needs of the dominant socio-economic sectors in both Germany and France. However these were the same actors which had supported a strict interpretation of the fiscal rule as a founding principle of economic and monetary union through the adoption of the Maastricht requirements and of the Stability and Growth Pact. Indeed, the credibility of the monetary enterprise had been grounded on the adoption of a rigid interpretation of an anti-inflationary fiscal policy particularly by Germany with the full support of its leading economic elites (Moravcsik, 1998). What changed in 2003? Did the relaxation of fiscal policy indicate a lack of commitment to an anti-inflationary EMU by the most powerful European States and their leading interest groups?

The hypothesis tested in this article is that the shift of emphasis from strict fiscal policy to more relaxed ones enshrined in the new outlook of the SGP did not detract to the credibility of the member states commitment to EMU and, therefore, did not produce a row on the exchange rates. This is why, after the decision by the ECOFIN not to impose sanctions on France and Germany, financial markets did not bet on a depreciation of the euro, whose value kept on increasing vis-à-vis the dollar. Neither did

financial operators ask higher yield to keep assets denominated in euros. This article employs a definition of credibility of EMU rooted in the consensus of the most powerful socio-economic actors (Talani, 2000). Here, credibility derives primarily from structural considerations relating to the institutionalisation of a set of favourable macroeconomic policies following from this particular form of monetary union (Gill, 1997). Adopting a tripartite distinction of the levels of analysis in: “political economy” analysis (Talani, 2000); “purely economic” analysis; and “purely political” one; it is argued here that at the political economy, structural level, the leading socio-economic actors continued to support the set of anti-inflationary and supply-side policies that were enshrined in EMU. Indeed, it was precisely because at the purely economic level and at the purely political level the SGP had turned into an obstacle for the implementation of those same policies that its stricter constraints were abandoned for the time being by Germany and France. The second level of analysis, “purely economic analysis,” focuses on the identification of the concrete interest groups' preferences in a short-term time-scale. It is at this level that is possible to trace back changes in the attitude of socio-economic groups in relation to their macroeconomic preferences. In the context of this analysis, the economic interests of the French and German business sectors, previously relying on the devaluation of the euro, now focused on a reduction of taxes and on the implementation of the structural reforms to improve their competitiveness in the global economy (Crouch, 2002). In turn, at the political level of analysis, the adoption of structural reform in a neo-corporatist system had still to rely on the consensus of the trade unions. This means that when the external, international conditions cannot be modified by their previous institutional referents, such as the ECB, socio-economic groups and the

governments supporting their interests may modify their policy preferences and decide to target other referents, as, in this case, the ECOFIN.

Insert table 1 Three level analysis of the demise of the SGP

On the basis of similar considerations it is possible to explain why, from 2002 onwards, given the unlikelihood that the ECB could reverse or even slow down the depreciation of the dollar, the most powerful member states, namely Germany and France, sought to obtain a relaxation of the macroeconomic policy framework, much needed by their economic domestic actors, by loosening the grip of the SGP. The exact timing of the crisis, in turn, was defined by the political needs of the German government, which in November/December 2003 was involved in the final stages of a tough negotiation with both the opposition and the trade unions for the approval of a package of structural reforms denominated agenda 2010. As noted above, however, the demise of the SGP did not signify an abandonment of the EMU project, but only a short-term, contingent shift of the economic interests of the most powerful euro-zone states. Therefore the credibility of their commitment to EMU remained intact, and the markets did not feel the need to attack the euro in the aftermath of the abandonment of the fiscal rule or to bet against the stability of EMU asking for higher yields. In brief, the credibility of the EMU project was still rooted on structural considerations, while the decision to relax the fiscal rule was justified by a change of macroeconomic preferences by the leading socio-economic groups at the “purely economic” and at the “purely political level” of analysis.

Summing up, the article tests, on the basis of empirical evidence, the following hypotheses:

- The credibility of the EMU was not undermined by the collapse and reform of the SGP.
- Financial markets hardly budged at the news of the collapse of the SGP.
- The German and French commitment to the fiscal rule of the SGP was relaxed as a consequence of the need to obtain the consensus to the structural reforms of the social partners.
- The abandonment of the SGP was often related to the strength of the euro in the domestic debates.
- The leading socio-economic sectors in the big euro-zone countries welcomed the relaxation of the fiscal rule.

To address these issues, the article is divided into three sections. The first section establishes the theoretical background. It explores different political economy approaches to European monetary integration and monetary policy-making and defines the theoretical context to address the issue of exchange rate credibility. The second section reviews different theories explaining the collapse and reform of the SGP, with a particular focus on International/European Political Economy ones. It proposes an embedded intergovernmentalist approach to the explanation of the paradox arising from the collapse of the SGP and sets out the main hypotheses to explain it. The third section introduces empirical evidence to test the hypotheses. It explores the reaction of financial markets to the freezing of the SGP in November 2003 and traces back the domestic economic considerations at the roots of German and French failure to stick to the fiscal

rule. It also highlights the shift of opinion of the leading socio-economic sectors in France and Germany towards the fiscal straightjacket, which the two countries had previously strongly supported. The final section concludes by assessing the validity of various the theoretical interpretations of the collapse of the SGP. It proposes an “embedded” intergovernmentalist explanation to account for the paradox of the lack of reaction by the markets to the death of fiscal co-ordination in the euro-zone.

1. Setting the theoretical context: “embedded” intergovernmentalism within a structural interpretation of credibility

1.1 Socio-economic interest and the making of EMU

Because of the intergovernmental nature of the decision-making leading to the establishment of EMU, many scholars have stressed the central role played by the nation state and national interests in the evolution of European monetary integration and policy making^{viii}. Both realists and intergovernmentalists postulate that nation states dominate EU politics and that outcomes directly reflect the interests and relative power of the member states. Thus, both of these related schools of thought explain EU policies in terms of the strategies pursued by rational governments acting on the basis of their preferences and power. However, whereas realist scholars tend to identify the interests of the state in geopolitical terms^{ix}, intergovernmentalists assert the primacy of political economy considerations. Thus intergovernmentalist theory seeks to analyse the process of European economic integration as the result of strategies pursued by rational governments acting on the basis of their preferences and power, assuming that national preferences in foreign economic policies are dictated by specific economic interests.

The latest versions of intergovernmentalism introduce an explicit theory of domestic politics to account for the set of economic interests states choose to pursue in international arena as well as an explicit theory of bargaining in international negotiations. The need for such an analysis was indeed noted by Moravcsik himself. Building on his earlier intergovernmentalism, he proposed a novel "liberal intergovernmentalism", which refines the theory of inter-state bargaining and institutional compliance and adds an explicit theory of national preference formation grounded in liberal theories of international interdependence (Moravcsik, 1993a; Moravcsik 1998).

In particular, as Moravcsik points out (Moravcsik, 1993a, p.387) this domestic politics approach would explain why the position of Germany in the negotiations over EMU did not reflect the strong anti-inflationary position of the Bundesbank but rather a compromise between the Bundesbank's strict anti-inflationary stance and the preferences of the business sector for a devalued exchange rate, low interest rate and macroeconomic flexibility (Moravcsik, 1998, p. 401). These two conflicting positions did in fact dominate the German domestic debate in the run-up to the Maastricht negotiations and agreement. As a result, in the IGC in Maastricht Germany supported an EMU that fulfilled almost all the "economist^x" conditions posed by the Bundesbank, but also paved the way for a softer currency than the DM, a welcome outcome for German exporters (Moravcsik, 1998, p. 404). However, the stress on macroeconomic flexibility, especially labour market flexibility, by the business community required a fiscal straightjacket such as the one devised with the Stability and Growth Pact in 1997. Indeed, in the lack of a common fiscal policy or even tax harmonisation, the Maastricht path to EMU,

complemented by the fiscal constraints of the SGP, identified labour market flexibility as the only feasible tool to react to asymmetric shocks and to tackle unemployment. The connection between EMU and labour market flexibility was clearly expressed in the rhetoric and practice of the EU Commission's interventions within the framework of the European Employment Strategy^{xi}. Therefore, the attempt by German finance minister Oskar Lafontaine to give a new priority to growth and employment objectives through Keynesian-style demand management, and to accompany monetary union with exchange-rate stabilization and tax harmonization, represented a fundamental challenge not only to the interests of the Bundesbank, but also to the German business community. The outcome of this confrontation was his sudden resignation in March 1999 and his replacement by Hans Eichel who advocated supply-side reforms and restructuring of the welfare state and of labour markets to be achieved in a neo-corporatist fashion (Dyson, 2000, p. 66) (Dyson, 2002).

On the French side, it is indisputable that the country's interest since 1983 was to increase the symmetry of the European monetary arrangements, which, after the implementation of the ERM of the EMS, had clearly been dominated by Germany as the "hegemon" of the system^{xii}. However, according to Moravcsik what is important to verify are the reasons underlying this particular policy preference. Geopolitical factors, especially those related to the need to keep Germany firmly within Europe after its unification, are discounted on the grounds that the French policy preferences did not change with the collapse of the Berlin wall or with the unification of Germany, but rather remained consistent from 1983 until the Maastricht negotiations. Indeed, political economy motivations ultimately explain French policies and actions. In fact EMU was

entirely consistent with longstanding French international monetary goals. France had been committed to an anti-inflationary policy and had supported a strong franc (the so called franc-fort policy) and capital liberalisation since Mitterrand's macroeconomic policy shift in 1983. However, the European monetary arrangements established with the ERM of the EMS gave a structural advantage in terms of monetary policy-making to Germany. Therefore France had a clear interest in seeking to retain the same policy preference within the more symmetrical Maastricht system for the establishment of the ECB. In this regard, a more symmetrical monetary policy offered more advantages than the asymmetrical EMS, including lower interest rates and exchange rate volatility, greater political legitimacy and more symmetrical obligations vis-à-vis Germany which would translate into looser constraints on macroeconomic policy and therefore in a slightly more competitive currency. All these factors explain the very strong support given to EMU by the French business community (Moravcsik, 1998, p. 411).

Finally, the case of British opposition to EMU also shows conclusively that national preferences reflected domestic political economy considerations and not geo-political or neo-constructivist factors. Whilst there is little evidence that Britain's rejection of EMU was based on "antipathy" towards Germany, there is a great deal of evidence in favour of a political economy approach. Political economy theory, according to Moravcsik, correctly predicted that the British would accept only minor monetary or exchange rate commitments, mainly favoured by the British business elites for they were concerned on the one side by "the slide in competitiveness that might result from any firm commitment to stable exchange rates" (Moravcsik, 1998, p. 417). On the other hand, they "would seek to avoid any permanent exclusion from monetary arrangements, for

exclusion was perceived as undermining the global position of British industry and, above all, finance^{xiii}.” The interests of the politically decisive financial community lay outside EMU, and the fear of being sidelined in the European integration process by remaining outside EMU led the British Government to try and destroy, or, at least delay, the process of European monetary integration (Talani, 2000b).

The intergovernmentalist approach is in stark contrast with neo-constructivist interpretations of the process of European monetary integration. Neo-constructivist accounts of the establishment of EMU can be divided into two basic groups:

1. Identity oriented constructivists
2. Economic ideas oriented constructivists

The first group of scholars^{xiv}, is, to a certain extent, more radical in the adoption of neo-constructivist assumptions. This group believes that the process of monetary integration, and, in particular, the establishment of EMU can be explained within the context of identity politics. Their effort is therefore mainly oriented to asserting the “symbolic” nature of the “euro” in relation to the national collective identity and symbols. Importantly, these authors discard as contradictory economic motivations for EMU and attribute explanatory value only to non-economic political constructions. For example, because French and German political elites of all political orientations have incorporated the European identity into the national identity, the debate in these two countries was not about whether to join EMU but when and how. With respect to Britain, on the other hand, Europe remains outside and, to some extent, contrary to the collective definition of the British identity. Hence political elites continue to resist joining EMU (Risse, 1998).

Insofar as this strand of constructivism highlights the cultural terrain on which debates on European union are generally framed, it has a certain appeal. However, the approach is problematic because it is based on a tautology: every single step in the process of European integration, including EMU, can be referred to a particular aspect of the collective perception of national vis-à-vis European identity. Thus constructivist approaches to EMU face the same problem as all idealist explanations in the social sciences: the analysis takes the existence of ideas as given rather than seeking to explain how and why ideas originated and changed as a result of political and economic factors. Moreover, the definition itself of national/European identity is not as straightforward as Risse and others seem suggest, and might be the object of even more controversies than the author claims is the case in relation to the definition of the economic interests involved in EMU. Indeed, constructivist approaches discard too easily the economic case for the single currency.

The second group of authors, particularly Kathleen McNamara (1998) and Kenneth Dyson (2000), still attributes importance to economic factors to explain EMU, but stresses the role of economic ideas as opposed to economic interests. In their view, EMU became a necessity in the context of the establishment of a new economic consensus, the neo-liberal “consensus of competitive liberalism” amongst the political elites of all EC member states^{xv}. According to Dyson, “the success of the economic paradigm of sound money in becoming dominant in the design of the euro-zone was the result of the failure of the Keynesian paradigm of the managed economy to tackle the insidious combination of inflationary and unemployment problems in the 1970s and 1980s” (Dyson, 2000, p.

30). This change in the ideological paradigm allowed the ECB to acquire a central role in the EMU, what Dyson calls an “ECB centric euro-zone” (Dyson, 2000, p. 11).

Clearly, the change in the prevailing ideological paradigm from the mid ‘70s onwards is one side of the spread of the new credo in macroeconomic policy emphasising strict monetary and fiscal policy in the context of exchange rate stability. However, this interpretation fails to give account of the reasons why this shift happened in that particular historical moment. The solution to this dilemma is to be found in a more comprehensive analysis of the economic interests underpinning this ideological shift and of the related socio-economic groups taking advantage of it. The consensus of the leading socio-economic groups is a necessary and sufficient condition of the credibility of exchange rate commitments.

1.2 Interests or expectations? A political economy analytical framework to the credibility of exchange rates commitments.

Economists and political scientists offer competing interpretations of exchange rate credibility. While political scientists focus primarily on a socio-political analysis aimed at tracing back the “interests” underlying exchange rate commitments, economists tend to give importance to purely financial and economic variables as connected to the “expectations” of the markets. However, more recently political scientists have sought to devote more attention to the issue from an integrated political economy perspective, which is however mainly focusing on the role of partisanship and governments’ stability in influencing speculative behaviour (Leblang, 2002)^{xvi}. Yet, there remains considerable scope for speculation on the relation between socio-political and economic accounts of

financial phenomena. There is, in a few words, the possibility of finding a “synthesis” of the two cognitive and interpretive model. Taken separately, economic and political perspectives can provide only a partial representation of reality.

The political economy approach to the credibility of exchange rate proposed in this contribution challenges the belief that markets, in general, and financial markets in particular stand aside of history and society and behave independently from social and political considerations. The approach proposed here grounds financial market behaviour in the underlying political economy structure of capitalist economies subordinating their expectations to the interests of the leading socio-economic groups^{xvii}. It challenges the assumption of the infallibility of the markets and of their independent "inner rationality" and proposes an alternative political economy rationality, which embeds markets' expectations into a given socio-economic structure.

This political economy approach to the credibility of exchange rate commitments and of the rationality of financial market behaviour thus seeks to transcend a-historical and abstract explanations without falling into the trap of historical or cultural relativism. It also provides the theoretical underpinnings for a rigorous analytical framework consisting of different levels of explanations structured in a clear-cut hierarchy. By introducing the crucial assumption that power relations are, eventually, the main heuristic tools in any attempts to explain socio-economic events, it inserts the notions of power and power struggles into the analysis. These power struggles are not, however, assumed to be confined to the state, but rather extend to the socio-economic groups which define the particular capitalist structure of a given nation-state. Purely economic

explanations or purely political ones are not, of course discarded, but are situated within the analysis of the underlying political economy structure.

The political economy approach adopted in this article is based on three different levels of analysis, which correspond to three different levels of explanation. The first level of analysis might be called the “political economy analysis”^{xviii}. It is represented by an organic analysis of the domestic structure of capital and of power relations between the various socio-economic actors as historically developed. It represents the limits within which further developments must necessarily take place. This first level of analysis, then, allows for the identification of the power relations among the social forces under consideration within a given mode of production and historical conjuncture. It also provides a basis for comparison with different sets of power relations in different countries.

However, these kinds of structural considerations cannot in themselves account for the whole history of European monetary integration. Nor can they provide the basis for reliable predictions of future behaviour. Therefore, it is necessary to connect this first level of analysis to the more conjunctural analysis of the second and the third levels, in order to obtain a dynamic picture of the phenomenon under consideration. The second level of analysis, “purely economic analysis,” focuses on the identification of the concrete interest groups' preferences in a short-term time-scale. It stresses the concrete struggle for economic power, and particularly on the competition amongst interest groups to obtain favourable economic policies. It is at this level that classifications of socio-economic preferences towards exchange rates and regimes may be tested empirically^{xix}. Finally, the third level, “purely political analysis,” focuses, once again,

on the short-term time-scale: the day to day political struggles or the specific means by which economic interests become policies after having been processed through the political and institutional system. It is here that the political bargaining process, the role of political parties and leaders, and the incentive/disincentive mechanism are taken into consideration.

A comprehensive explanatory model requires a synthesis of each of these levels in order to provide the most reliable picture of the phenomenon under analysis. This reflects the fact that in the real world there are overlapping relationships of mutual reciprocity between the economic structure, the economic interests promoted by socio-economic groups, and the political and institutional life.

This analytical framework makes it possible to derive a “phenomenology of credibility” of the international economic commitments and, in particular of exchange rate commitments. Credibility is not based on pure economic expectations, but rather on a more complex set of political economy considerations. In particular, it is possible to hypothesise that the more foreign economic commitments in general, and exchange rate policies in particular, are rooted in the interests of a given hegemonic bloc, the more these commitments are credible. That is, in the case of fixed exchange rates or target zone commitments, the more they can count in the “consensus” of the most powerful sections of society, the less likely they are to be challenged by the markets. Indeed, there is a dialectic relation between interests and expectations; expectations of the markets are deeply influenced by the interests and preferences of the leading socio-economic sectors of the country under consideration. Market expectations, and thus also markets' behaviour, are crucially affected by considerations about something “more fundamental

than the fundamentals”: the economic structure and the way in which it is reflected in economic and political life. This definition is perfectly consistent with the political scientists’ view that exchange rate commitments are international agreements and therefore need to be based on the existence of a domestic “consensus” rooted in the “interests” of domestic actors.

From the economists’ standpoint, this approach to the credibility of exchange rate pegs could help reconciling the two opposing theories on speculative attacks. The contemporary debate in exchange rate economics is in fact characterised by the opposition between “fundamentalists”, i.e. supporters of the thesis that real exchange rate fluctuations largely reflect changes in macroeconomic fundamentals^{xx}, and those who believe that:

“Foreign exchange markets behave more like the unstable and irrational asset markets described by Keynes than the efficient markets described by modern finance theory^{xxi}”.

The latter approach assumes that speculative attacks are self-fulfilling, or that in a multiple equilibriums environment, the markets produce their own exchange rate expectations without any intelligible connection with fundamentals^{xxii}. In turn, these expectations produce speculative attacks, which ultimately compel governments to abandon the exchange rate peg and to adopt ex-post softer monetary stances. A compromise approach has been proposed which allows for multiple equilibriums only within a certain range of fundamentals’ performance^{xxiii}. Alternatively, economists tend to overcome the problem by lifting the assumption of market participants’ complete information on the performance of economic fundamentals^{xxiv}.

Here it is argued, however, that the failure of the “fundamentals” to explain speculative attacks does not necessarily imply that exchange rate markets act “irrationally” or “inefficiently” or that they are constrained by the lack of information. It can also mean that the markets, in deciding which of the multiple equilibriums is more likely to be adopted by the government after a speculative attack, evaluate a wide range of events, including socio-political and structural ones. Thus the credibility of an exchange rate commitment is crucially dependent on the behaviour and interests of socio-economic actors in a particular historical moment.

Of course, this model is not static and changes may occur at each level of analysis. At the first level of analysis, changes are certainly long-term ones and are represented by substantial transformation of the underlying structure of power. At the second level of analysis, the preferences of the socio-economic groups considered may vary from time to time and from country to country. Finally, at the third level, changes are linked to the decline of the leadership of given political parties or leaders.

2. Theorising the domestic politics of fiscal co-ordination in Europe.

The subject of fiscal policy in EMU is still dominated by economists^{xxv}. Recently, however, political scientists have proposed some useful analytical frameworks to explain key developments in the euro-zone. For example, Amy Verdun has applied a neo-constructivist approach to the formation and collapse of the SGP (Heipertz and Verdun, 2004). She argues 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 organizations. However, ideational convergence provided only the basis for a political compromise. The final decision to adopt it was possible thanks to the prominent position of Germany in the intergovernmental talks leading to the approval of the SGP and the creation of a convergence of interests with France in a typical power-politics fashion. (Heipertz and Verdun, 2004, p 1-2) However, as Verdun rightly states, “designing rules is one thing, applying them another” (Heipertz and Verdun, 2005, p.16)

In seeking to explain the (non) application of the SGP Verdun presents an eclectic mixture of four theoretical approaches: intergovernmentalist, neo-functionalism, domestic politics, and ideationalist approaches (Heipertz and Verdun, 2005, p. 2). The neo-functionalist and the ideationalist approaches, however, are applied mainly to the questions relating to the making of the SGP, which is out of the scope of this discussion, although Verdun acknowledges that the adoption of the SGP was conditional on an agreement between France and Germany, as intergovernmentalist would predict. As regards the implementation or non-implementation of the SGP, Verdun retains the intergovernmentalist lense in asserting that “France and Germany while no longer holding the same degree of influence over specific outcomes, were still able to shape events according to their national interest”. (Heipertz and Verdun, 2005, p.3)

However, Verdun utilizes a domestic politics approach to scrutinize the internal situation of the relevant governments in their respective countries, again: Germany and France. Adopting a neo-institutionalist/neo-constructivist account of the role of domestic actors in the making of EMU (Dyson and Featherstone 1996, Martin 1994, McNamara 1994, Sandholtz 1993, Young 1999) Verdun identifies as the most relevant domestic actors all political parties (in government and opposition) and the central banks. Other actors

(parliaments, trade unions etc.) were only influential on EMU and the SGP insofar as they succeeded in influencing public opinion and the national governments. (Heipertz and Verdun, 2005, p. 10)

Thus, in seeking to explain the decision to suspend the implementation of the Excessive Deficit Procedure (EDP) on 25 November 2003 Verdun emphasizes the desire of the French and German governments to respond to their electorates, mainly by cutting tax, and therefore abandoning their fiscal pledges. This, despite the fact that in neither case the elections were close and that promises to cut tax had been broken before, particularly in France. Verdun argues here that, having broken his promises about tax cuts before, Chirac this time decided to go ahead with them, arguing that they were a necessary complement to pension reform. For Schröder, the application of the SGP in November 2003 would have implied a loss of face domestically and put oil on the fire of the opposition. Potential sanctions could have eventually become a concrete possibility in 2006, which would be an election year (Heipertz and Verdun, 2005, p.15). But why did Chirac decide to cut tax in November 2003? Why was Schroeder so worried about losing face in front of the electorate in 2003 when the elections would be only in 2006? Who wanted to cut taxes? Was the tax cut so necessary as to jeopardize the SGP that France and Germany had wanted so much? Was the cut in tax the only reason why Germany and France could not stick to the fiscal rule? And what about the credibility of EMU after this decision?

In sum, what is debatable in Verdun's analysis is whether the only relevant actors were institutional ones. The exclusive focus on governments, parties, and central banks, risks resulting in a rather descriptive account of the domestic politics of formal decisions, while from a more analytical point of view it would be important to ask why

those decisions were taken by investigating on their distributional effects. In a few words it is worth asking who win and who loses from the adoption of certain decisions, and which socio-economic interests were at play. Indeed, other domestic politics perspective might adopt a different understanding of domestic politics. In particular, it is necessary to understand the distributive effects of the fiscal rule on socio-economic sectors.

David McKay has in fact addressed the issue of the impact of fiscal co-ordination on the behaviour of domestic political actors (McKay, 2002). He identifies three dimensions of the EU fiscal policy: fiscal federalism, fiscal co-ordination through the implementation of the SGP and fiscal harmonisation. For each of these dimensions, he proposes hypotheses relating to the effects of fiscal policy on domestic politics. Leaving aside the questions relating to fiscal federalism and fiscal harmonisation, which are outside the scope of this analysis, it is worth recalling the implications of the SGP for the domestic structure. One obvious consequence, often emphasised in the literature (McKay, 2002; Talani, 2004; Crouch, 2002) is that budgetary constraints would imply a reform of the domestic labour market structure, activating the key socio-economic domestic actors: trade unions and the employers' organisations. The rationale, in its simplified form, is that lacking other tools to react to asymmetric shocks, euro-zone member states would have to revert to labour market flexibility to solve their economic unbalances (Talani, 2004). What is relevant for McKay, however, is what kind of response the structural reforms brought about by the SGP will have on the electorate once it recognizes that labour market practices are being abandoned and social benefits are being reduced as a consequence of the implementation of this particular form of EMU. While some political scientists address this issue in terms of legitimization crisis

(Weale 1996, Verdun and Christiansen 2000), McKay is interested in how single countries would react to these developments. From his point of view, reactions will be different in different countries, and might produce, in times of recession, a breach of the fiscal rules adopted through the SGP. Indeed this prediction is in line with those of many economists who had forecasted that the SGP would not hold in many circumstances (Eijffinger and de Haan, 2000, 92-93). And indeed, this is exactly what happened with the crisis of the SGP in November 2003. What however McKay failed to realise is that this would not have major consequence for the euro, the ECB or indeed the EMU project. His idea was that:

”Unchallenged fiscal recidivism on the part of some members would damage the euro on the foreign exchanges, and, via imported inflation, might undermine the whole project” (McKay 2002, p. 84).

But this is exactly what did not happen. Other domestic politics approaches might help to explain this seeming paradox. Colin Crouch (Crouch, 2002) provides an analysis of the impact of EMU and the budgetary constraints of the SGP on labour markets and trade unions. He focuses on the ways in which national governments will react to the lack of competitiveness of their labour markets absent the possibility of competitive devaluation. In particular, he identifies three phases in the development of an EU industrial relation system as a consequence of the establishment of EMU: short term, medium term and long term. Leaving aside the long term in which the possibility of the creation of a transnational, European collective bargaining system is envisaged (Crouch, 2002, 297), Crouch focuses particularly on the short and the medium term. In the short term, the devaluation of the euro is considered the means by which nation states have addressed the

lack of competitiveness of their industrial sectors. In this context, the policy of benign neglect towards the devaluation of the euro, implemented by the ECB in the first years of activity (Talani, 2004) should be regarded as a short term surrogate of the national competitive devaluations lost with the establishment of EMU. As a consequence, it was accepted with great enthusiasm by the socio-economic sectors of the main members of the euro-zone hoping for an export orientated growth of their economies (Crouch, 2002, p. 282). It is important to note that according to Crouch this policy was perfectly in line with the previous behaviour of Germany, which had relied on a weak although stable currency for most of the '70s (Crouch 1994, Streeck 1994). It is also consistent with the intergovernmentalist view that Germany decided to enter EMU to guarantee a stable but slightly less strong currency to its industrial sector (Moravcik, 1998).

Crouch argues, however, that the euro-devaluation strategy could not be sustained for too long, and would be substituted in the medium term by social pacts and labour market reforms. What is particularly important here is that, according to Crouch, structural reform in the euro-zone member states would take place in a neo-corporatist fashion (for similar arguments see Boyer 2000, Marsden 1992; Pochet 1999). Neo-corporatism is defined more as action co-ordination amongst social partners than institutionalisation of corporatist practices. It can take various forms, including organised decentralisation, which is defined as “a shift away from centralised bargaining managed by employers’ organisations and trade unions (Crouch, 2002, p.293). In turn, the relationship between the government and the social partners is one of mutual dependence, as the government needs consensus of the social partners to ensure smooth acceptance by the electorate of the structural, welfare policy reform while social partners, particularly trade unions, need

neo-corporatism to keep being involved in the decision making process (Crouch, 2002p. 285). This is true, according to Crouch, for the great majority of western European countries, excluding only the UK. Also according to Martin Rhodes (Rhodes 2002), the reform of the labour markets and of the welfare state would not happen in a deregulatory fashion, but through a neo-corporatist strategy, or better, as he calls it, “competitive corporatism” (Rhodes, 1997). Paradoxically, EMU, instead of decreasing the power of social partners, increases their role in the welfare and wage bargaining processes. For our purposes it is important to note that these neo-corporatist practices entail that structural reforms need to rely on the consensus of the social partners. Indeed, as Dyson points out, (Dyson 2002, p. 182), Shroeder, his economic adviser Klaus Gretshmann, finance minister Hans Eichel, economics minister Werner Muller and labour and social affairs minister Walter Riester all agreed that the way for Germany to improve its competitiveness was “managed capitalism”. Managed capitalism required co-operation, co-ordination in wage bargaining, dialogue with the social partners and consensus in managing supply-side reforms. Consensus was indeed the main principle of managed capitalism and was deeply entrenched in both the political and economic German systems (Dyson, 2002). By the same token, France’s recipe to combat the loss of competitiveness attached to globalisation implied a short term reliance on competitive devaluation and a medium term consensus by the social partners to structural reforms (Crouch 2002). It is true that, since 1983 Mitterrand’s decision to keep the franc in the ERM, the process of European monetary integration had been seen as a tool to reinforce domestic economic reform. However, particularly after German re-unification, the constraints of EMU were increasingly blamed for the French economic crisis (Howarth

2002). Indeed, the substantial decline of the euro in relation to the dollar and the yen suited French preferences. Throughout the 1990s the French government had argued that European currencies were overvalued in relation to the dollar (Howarth 2002). My hypothesis is that in both Germany and France consensus to structural reform in the absence of the possibility of a devaluation of the euro would mean relaxing the adherence to the SGP budgetary constraints. However, this would not reduce the credibility of the EMU project because it would signal a change of preferences of the socio-economic groups only at the level of purely economic or purely political interests, and not at the political economy level. In the next section, therefore, the following hypotheses will be tested:

- The credibility of the EMU was not undermined by the collapse and reform of the SGP
- Financial markets hardly budged at the news of the collapse of the SGP
- French and German commitment to the fiscal rule of the SGP was relaxed as a consequence of the need to obtain the consensus of the social partners to the structural reforms
- The abandonment of the SGP was often related to the strength of the euro in the domestic debates
- The leading socio-economic sectors in the big euro-zone countries welcomed the relaxation of the fiscal rule

3. A dead stability and growth pact and a strong euro: is there a mistake?

“Refrigerated,” “hospitalised,” “dead”^{xxvi}: these were the adjectives the press used to describe the SGP on the eve of the historical ECOFIN decision not to impose sanctions on the delinquent French and German fiscal stances. The fate of the SGP was settled in the early hours of November, the 25th 2003 in what was a true institutional crisis between the European Commission and the ECB on one side, demanding that the rules be applied, and the intergovernmentalist ensemble of the euro-zone finance ministers rejecting the application of sanctions to the leading EU member states^{xxvii}.

The positions were clear: Romano Prodi, European Commission president, and Jean-Claude Trichet, European Central Bank president, led demands for the rules to be applied. Smaller countries, led by Gerrit Zalm, Dutch finance minister, claimed Germany was exporting its excessive budget deficit to other countries through higher interest rates^{xxviii}. Hans Eichel, German finance minister refused to accept the Commission recommendation, backed by the threat of sanctions, to make a further €6bn (\$7bn, £4.2bn) of budget cuts in 2004^{xxix}. France, overshooting the 3% deficit to GDP rule for the second time in a row^{xxx}, supported Germany as did Italy, holder of the rotating EU presidency. The Italian EU presidency pushed through a political declaration asking France and Germany to bring their deficits within the 3 per cent limit by 2005, but lifting the threat of fines if they failed. Eventually, the Italian compromise proposal, put forward by Giulio Tremonti, chair of the meeting, was approved by the ECOFIN. Only

Austria, the Netherlands, Finland, and Spain voted against this political declaration to suspend the operations of the stability pact for Germany and France^{xxxix}.

The atmosphere after the meeting was heated. Nervous ministers and EU leaders raged over the decision to freeze the pact. Yet all of this *sturm und drang* contrasted with the reaction of the markets, which accepted the decision calmly and did not budge at the news of the collapse of the Pact. And this despite the fact that economists and financial experts had warned in many occasions, even on the day of the crisis^{xxxix}, that euro-zone states should take into consideration the reaction of financial markets before deciding to scrap the European fiscal rule.

Markets were supposed to have a disciplinary effect on member states. Cassandras proclaimed that a departure from fiscal discipline by a particular government was supposed to trigger a run on the euro and reduce investments in the whole area. A reduced demand for bonds denominated in euros would have meant higher yields and higher borrowing costs^{xxxix}. Indeed, in the immediate aftermath of the Pact's suspension the ECB indicated that the collapse of the pact could force up euro-zone interest rates. Gerrit Zalm, Dutch finance minister and one of the fiercest critics of the deal, warned of higher long-term interest rates^{xxxix}.

What happened to financial markets after the crisis of the 25th of November? How did foreign exchange markets react to the bad news coming from Brussels? How did bonds yields move as a consequence of the loss of creditworthiness of the euro-zone fiscal straightjacket? Surprisingly enough, hardly anyone in the financial markets mourned the death of the SGP^{xxxix}. The euro slipped less than half a cent, from about \$1.181 at the opening to about \$1.177 in the late afternoon on November the 25th, but the following

day it had already recovered to 1.828 to continue rising happily vis-à-vis the dollar thereafter.

Insert Figure 1: euro-dollar nominal exchange rates October/November 2003

The reaction in the bond markets was similar: interest rates on European government bonds relative to US Treasuries barely twitched. By the close, the FTSE Eurotop 300 index was virtually unchanged, unfazed by the suspension of the European Union's stability pact^{xxxvi}. Both the 3 months and the 6 months euro LIBOR deposit rates remained substantially stable. Yields (interest rates) on German and Italian long-term bonds actually decreased by about one basis point (0.01 percentage point) from November 25, 2003 to November 26^{xxxvii}.

In sum, markets reacted calmly. Yields on German government bonds, for example, rose less than US Treasury yields from their low in June 2003. The concerns expressed by the ECB that the crisis would necessarily bring about an increase of the euro area repurchasing rates failed to impress the financial sector.

Insert Figure 2: euro Libor 2003-2005

Perhaps even more strikingly, the euro-zone was the place to invest in 2003. Since the start of the year, equity markets in Germany, France, Italy and Spain rose by 33 per cent, 14 per cent, 17 per cent and 25 per cent respectively. Americans had even more reason to buy European assets. With the 20 per cent appreciation of the euro, the dollar return on investing German equities was some 57 per cent, far higher even than investing in the

soaring Nasdaq index^{xxxviii}. Overall, the decision by European finance ministers to freeze the mechanics of the euro-zone's stability and growth pact was expected to underpin the economic recovery^{xxxix}.

"Our view is that it is not that big a deal," declared Ben Broadbent of Goldman Sachs.

"It's a good thing that the stability pact in its strictest interpretation is dead . . . its interpretation is moving in the direction of allowing more cyclical leeway for budget deficits during economic downturns, and that is something that we think should have been there from the beginning^{xl}." Michael Hartnett, strategist for Merrill Lynch, proclaimed that "In the medium term, anything that boosts growth expectations in Europe is positive for the euro^{xli}". The relaxation of the pact was intended by the financial community as a means for Europe's leading countries to introduce tax cuts and spending that will give their economies a boost. "A bit of fiscal stimulus is really needed in Europe to get these economies going," in the words of Karen Olney, strategist at Dresdner Kleinwort Wasserstein. Hartnett added that "Markets have been concerned for some time about the growth potential in Europe and one of the concerns has been about the handcuffs of the inflation target and the stability and growth pact^{xlii}." In fact, investors had also been focusing much more on the US economy and the direction of the dollar than on the euro-zone. For example, Bear Stearns strategists had made it explicit in a note to clients that there would not be a better time to bury the stability pact. "The eyes of the world are on the fragility of the dollar and this has provided the perfect smokescreen to pull the teeth out of the stability pact without the euro screaming," the broker claimed.

The behavior of the financial operators clearly supports the initial hypothesis that the crisis and collapse of the stability and growth pact had little to do with the lack of credibility of the European monetary union, which remained substantially unquestioned by the markets. Instead, it was rooted on purely economic and purely political considerations, regarding mainly the capacity of France and Germany to emerge from their economic crisis without impairing the achievement of structural reforms. The markets simply knew that, with a depreciating dollar and an impotent ECB, the only way for the biggest euro-zone's countries to pull out of the economic crisis was to relax their fiscal policy, allowing for tax cuts and some increase in expenditure which, in turn, was what socio-economic actors were asking in exchange for the implementation of structural reforms. And this is why no-one in the financial world mourned the death of the SGP from the hands of its father and mother, France and Germany.

The financial sector had warned already in many occasions that the strength of the euro was not helping the economic revival of the euro-zone. Indeed, in May 2003 the level of exports from euro-land had decreased by 5.3% with respect to the same month of the previous year, and in June the fall was 8.6%^{xliii}. Of course, the fall was particularly worrisome in the bilateral trade with the US and the biggest EU economies.

Insert table 1: Exports to US, QUANTITY of goods (100KG)

On Average, Germany lost 15% of its exports in goods to the US over previous year between July and December 2003, France 7%, Italy 16% and the euro-zone overall 11% (Eurostat).

Insert figure 3: Exports to US (quantity)

Given that in 2002 the US absorbed 17% of exports from the euro-zone (Eurostat), those figures were considered relevant^{xliv}. Moreover, the fiscal straightjacket was increasingly deemed unsustainable by both financial markets and domestic actors^{xlv}.

The difficulties of the three biggest euro-zone countries in sticking to the Pact were indeed well known. When the Pact was frozen for Germany, the country had already breached the 3% deficit to GDP rule for the third time. The government's deficit for the year 2003 amounted to €13.4bn, more than twice the €18.9bn figure originally envisaged^{xlvi}. The German finance minister, Eichel, asked for a relaxation of the fiscal rule on the basis that the economic situation of the country would not be able to sustain further subsidy cuts to cover a shortfall in the following year's budget of €6bn (\$7.1bn, £4.2bn). Commentators noticed that such an amount, measured against a planned €2bn tax cut for the following year, hardly seemed insurmountable. "With federal and regional governments accounting for just under half of Germany's GDP of about €2,000bn, you would think they could have found €6bn", noted Elga Bartsch, Morgan Stanley economist in an interview to the FT^{xlvii}.

What was really at stake in the internal debate in Germany? The main point was that for the economy to grow faster, structural reforms, including the labour law, tax and social security reforms, had to be adopted. However, as pointed out above, this would require a strong socio-economic consensus. Indeed, the crisis of the SGP happened in the midst of the talks over Agenda 2010. The talks were expected to last until mid-December

and the Government was trapped between the opposition-dominated upper House of Parliament and the necessity to keep social consensus on the hard set of measures the reform entailed. In this context the Social Democratic government feared a loss of bargaining power if it was seen by the social actors as unable to control the country's fiscal policy^{xlviii}. Indeed, the German Chancellor, in an interview to *La Repubblica* in September 2003^{xlix} had already anticipated that the German government attached a great importance to an interpretation of the SGP focusing on growth more than stability and that the objectives of the structural and fiscal reform made it necessary to adopt a more flexible interpretation of the Pact. Hans Eichel, reiterated, in an interview to the *FT* on November the 17th, that the problem for Germany was not so much stability as growth^l.

Germany was a stronghold of price stability. At 1.2 per cent, German inflation rate was the lowest in the EU. The crucial challenge for Germany was to promote sustainable growth. The means by which the German government had planned to increase growth was Agenda 2010. This entailed undertaking far-reaching reforms in the social system. At the same time, the measure had to be accompanied by bringing forward the third stage of tax reform to 2004. Again, it was clear that an adaptable interpretation of the SGP was the price to pay to obtain the necessary consensus to Agenda 2010.

When the reform package was approved, in mid December 2003, then the negotiating positions of the social actors were clearly revealed^{li}. The adoption of the bills, in an unprecedented voting marathon by parliamentarians, marked the end of nine months of often strident talks since the chancellor unveiled Agenda 2010 on March 14. German Chancellor Gerhard Schröder had struck a landmark political deal on economic reforms with opposition leaders, but was forced to compromise on the volume of tax cuts for the

year 2004. In June the German chancellor, decided that a €15.6bn (\$19.2bn, £11bn) tax cut that should have started in 2005 would be brought forward by a year, largely to be financed by new debt. The tax cut had been the price trade Unions wanted in exchange for very tough labour and social security reforms.^{lii} The latter included new exclusions from Germany's strict job protection rules for companies with up to ten employees, and sharp cuts in unemployment benefits for the long-term unemployed. Jobless people will in future also be forced to accept jobs below local wage levels.

The CDU withdrew demands for a law to increase collective bargaining flexibility at the local level, settling instead for a joint declaration that this would be necessary in a year's time if such flexibility is not achieved on a non-regulatory basis. Heinrich Oberreuter, politics professor at Passau university, commented that compromises arose because both sides could ill-afford failure: the chancellor because his political reputation hung on implementing his Agenda 2010 programme, and the opposition because it feared a popular backlash if it blocked the tax cuts^{liii}.

The DGB trade union federation welcomed the tax cuts but complained that the relaxation of job protection rules would leave 5.3m employees without this protection.

The agenda was welcomed by business as an important first step towards broader structural reforms^{liv}.

It was paradoxical that trade unions and the left wing parties had supported tax cuts, while the CDU had fought to reduce them. That was an entirely political decision taken by Angela Merkel, CDU leader, which was not supported by business. The CDU withheld its support to tarnish the government's reputation for implementing reforms and to further undermine the SPD's poor poll ratings^{lv}. In sum, the tax cuts, and the related

breach of the 3% deficit to GDP for the following year, could count on the support of all the relevant socio-economic sectors in Germany^{lvi}.

Equally broad was societal support to French abandonment of the Stability and Growth Pact. When Paris defaulted on the deficit to GDP ratio in November 2003, it was the second time in a row and the excessive deficit procedure had been started already in 2002^{lviii}. Given the economic downturn, the Commission had granted France an extra year to comply with the 3 per cent rule. In 2003 the Commission expected a French deficit of 4.2 per cent of GDP based on a real annual growth rate of 0.1 per cent. The deficit was forecasted to fall to 3.8 per cent the following year, assuming a growth rate of 1.7 per cent. This was judged insufficient to a return to below 3 per cent in 2005. Therefore the Commission asked for an additional 0.4 per cent cut in the cyclically adjusted budget deficit on top of the cuts already included in the budget^{lix}.

The French government argued that the Commission's plan would destabilise the economy and refused to comply with the request. In turn, French economic difficulties were explicitly related to the performance of the euro^{lx}. A strong euro was a problem for the French government, not only because it impaired the reprisal of the French economy, but, most importantly, because it represented a potentially explosive subject in both the internal and the external debate in France^{lxi}.

In May 2003, when the euro was valued 1,15 to a dollar, Jean-Pierre Raffarin defined this level « préoccupant » (worrying). The opponents of the strong euro had to be found amongst the same groups who had opposed the policy of the “franc fort” (the strong franc)^{lxii}. The ECB was accused of being unable to guarantee the competitiveness of the euro-zone^{lxiii}. Moreover, it would have been necessary for the ECB to explain why an

average deficit GDP of 2.6% in the euro-zone should be considered a bigger inflationist threat than a deficit to GDP of 5% in the US or 7% in Japan^{lxiv}. Therefore, the decision of the ECOFIN not to impose any sanction on France and Germany was welcomed in the French internal debate as a legitimate re-nationalisation of the economic policies^{lxv}.

As far as Italy is concerned, Silvio Berlusconi, the Italian prime minister, had called in many occasions for a looser interpretation of the rules of the SGP^{lxvi}. He also indicated that the ECB should loosen its monetary policy in view of Europe's difficult economic situation. In October 2003 he claimed that: "The main remit of the ECB is to combat inflation, but combating inflation obviously has to be reviewed when the economy is stagnating^{lxvii}." This comment was one of the strongest pleas by a European head of government for the ECB to focus more on helping revive economic growth in the euro-zone. Berlusconi proposed that the 3 per cent should not be taken as an absolute value beyond discussion and might be adjusted down by one or two percentage points or up to 4 or 5 per cent in case of economic stagnation. Besides, the Stability Pact, the EU and the euro were to be blamed for the economic stagnation of Italy^{lxviii}.

Did Berlusconi's position reflecting the opinion of the leading Italian socio-economic actors? Mr. D'Amato, then leader of Confindustria, in the course of the debate over the approval of the budget in September 2003, had reminded the government that it should not sacrifice stimulating growth to the SGP objective of controlling the deficit. This basically meant that, despite the restraints imposed by the SGP, the government should keep the fiscal level low and should allow for investment related expenditure and public investments, including research and development^{lxix}. In his words: "The Stability Pact is becoming a cage of over-regulation and high taxes which does not protect but threatens

its goods”^{lxx}. Of course, cuts had to focus on the health care system and, more controversially, on the planned reform of the pension scheme. And of course, the trade Unions, CGIL, CISL and UIL strongly opposed similar cuts and were organizing, in the fall of 2003, a general strike against the proposed change of the pension law (the so called “Dini law”). With regard to the SGP, the general secretary of the CGIL asserted that keeping the debt to GDP ratio stable implied a de facto, reduction in social expenditure^{lxxi}.

It was therefore not surprising that when the Pact was eventually suspended for France and Germany, the Italian political elite, as well as societal groups, did not mourn its death for too long, if at all^{lxxii}. Only Romano Prodi, then president of the EU, and Carlos Azeglio Ciampi, Italian president, were left defending the fiscal rule. The whole Italian government, instead expressed its consensus to the decision of the ECOFIN, which was publicly defined wise and responsible^{lxxiii}.

As far as the social partners are concerned, the President of Confindustria underlined that if the constraints of the Stability Pact could be justified at the onset of EMU, in the light of the latest events they had to be reinterpreted, discussed and redefined^{lxxiv}. According to Savino Pezzotta, leader of the CISL, the pact was not a totem to which sacrifice everything, but an agreement amongst sovereign States. For Guglielmo Epifani CGIL, the rules had to be changed for everyone, not only for France and Germany.

4. CONCLUSIONS: AN ALTERNATIVE DOMESTIC POLITICS ACCOUNT OF THE DEMISE OF THE SGP

Were the markets mistaken in failing to react to the demise of the SGP in November 2003? What was market rationale behind their somewhat surprising display of coolness and *sangfroid* in the aftermath of the failure of Germany and France to respect the fiscal rule? In this article I have sought to answer these questions by adopting an embedded intergovernmentalist perspective to the suspension of the SGP in 2003, based on the assumption that the credibility of exchange rate regimes is dependent on the consensus to it by the leading socio-economic groups of the most powerful member states.

In November 2003 this commitment was not put under discussion by the failure of Germany and France to respect the fiscal constraints of the SGP. Financial markets knew this, and did not question either the credibility of the euro or the survival of the monetary union. Some scholars have explained this paradox by claiming that the economic pact of the governments with the markets remained intact and therefore the markets did not react^{lxxv}. This however leaves open the question of the reasons why the crisis happened at the end of November 2003, and not later or before. Indeed, what was put under discussion by the leading socio-economic groups in Germany was the necessity of sticking to a the 3% deficit to GDP rule in a precise historical moment. This happened because their contingent macroeconomic preferences, what has been termed in the theoretical context their “purely” economic interests”, as well as, particularly in the case of Germany, their political needs, changed and required the abandonment of the pact for the time being.

What were those purely economic interests and purely political needs provoking German decision to throw all its weight in the ECOFIN to avoid imposition of sanctions and made France and Italy and many others follow suit? In the case of Germany the answer is that at precisely the same time when the EDF was being put under question, Chancellor Shroeder was involved in the very late stages of very delicate negotiations over the approval of the structural reform package denominated Agenda 2010. The reform was crucial to the interests of the business sector, which actively supported it but needed the approval of the trade unions, also because part of the electoral constituency of the social democratic government coincided with the pool of organised workers and pensioners who would be hit hared by the programmed structural reforms. And the trade unions required, in exchange for their consensus to agenda 2010, a wave of tax cuts and increase in expenditures hardly compatible with the fiscal rule. This interpretation of the timing of the crisis is indeed consistent with all analyses dealing with the new involvement of trade unions in a neo-corporatist, managed capitalist or competitive corporatist fashion in the restructuring of the labour markets and in their flexibilisation. In turn, the business sector not only was actively supporting structural reforms in Germany, but was also pleased by the fiscal reform, which was opposed only by Mrs Merkel in an attempt to gain some political traction by placing the blame for the failure of the agreement on the Chancellor. Indeed, following Crouch, it can be argued that the most relevant worry of the Continental European industrial sector, and, given the nature of the capitalist structure of France and Germany, also of the banking sector (Dyson, 2002), was that to improve their competitiveness. The standard tool that Germany, France and Italy for that matter, had traditionally reverted to in order to increase

competitiveness, was devaluation. And in the short term the devaluation of the euro within EMU appeased the business sectors' worries. However, as the euro started rising again vis-à-vis the Dollar, the French and the Italian business sectors started showing signs of hostility towards the fiscal constraints. When the occasion came the mighty German economy, for reasons explained above, decided that the Pact could be put on ice. The French and the Italian socio-economic actors were more than happy to help.

In conclusion, consensus on the broader project of EMU did not weaken and the markets had no reasons to attack the euro or to bet against the stability of the euro by asking higher yields to hold assets denominated in euros. What had changed were the short term, contingent economic and political preferences of the leading socio-economic sectors and that provoked a suspension of the Pact which appeared to the financial markets as an entirely "natural" outcome.

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ⁱ When European finance ministers agreed at the Dublin Summit in 1996 on the need for a fiscal framework to reinforce the powers of the future European Central Bank, they called it the Stability Pact. The words 'and Growth' were added later, at the Amsterdam European Council of 1997. The Amsterdam resolution establishing the Stability and Growth Pact may be found at the following web-site: <http://www.ena.lu/mce.cfm> accessed on September 6, 2005. The EU legislation relating to the Stability and Growth Pact may be found at the following web-site:

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ⁱⁱ For an account of these reactions see Keegan, W., (2003), "On firmer ground without Stability", *The Observer*, Sunday November 30, 2003 web-site:

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ⁱⁱⁱ For a very thorough account of the role of France and Germany in the making of the SGP see Heipertz, M. and Verdun, A., (2005), "The Stability and Growth Pact – Theorising a Case in European Integration" Paper prepared for delivery at the Ninth Biennial International European Union Studies Association Conference Austin Texas, 31 March – 2 April 2005

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^{vi} For the most recent literature see Allsopp, C. and M. Artis (2003), 'The Assessment: EMU Four Years On', *Oxford Review of Economic Policy*, 19(1): 1-29; Annett, A., J. Decressin and M. Deppler, (2005) 'Reforming the Stability and Growth Pact', *IMF Policy Discussion Paper*, PDP/05/2.

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^{viii} For a complete analysis of the neo-functional and institutionalist approaches to EMU see Talani, L.S., (2004), Ch. 1

^{ix} For a realist interpretation of the process leading to EMU see Baun, M., J., (1996) *An imperfect Union: The Maastricht Treaty and the new politics of European Integration*, Boulder: Colo. See also Middlemas, K., (1995), *Orchestrating Europe*, New York. See also Andrews, D.M., (1993), "The global origins of the Maastricht Treaty on EMU: closing the window of opportunity", in Cafruny, A. and Rosenthal G.G., (1993), *The state of the European Community: the Maastricht debate and beyond*,

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^x The distinction between “monetarists” and “economists” emerged in the course of the discussions over the Werner Plan and referred to the strategy to be adopted during the transitional period. The “monetarists” stressed the importance of achieving exchange rate stability through European institutional arrangements, while the “economists” pointed out the necessity of policy co-ordination and, ultimately, convergence before agreeing on the adoption of a European fixed exchange rate regime or a currency union. For more details see Tsoukalis (1997).

^{xi} For a very detailed account of the relation between EMU and labour market flexibility see Talani, L.S., (2004), Ch. 6

^{xii} For the explanation of the hegemonic role of Germany in the ERM of the EMS see Artis, M., J., and Lee, N., (1997) (2nd ed.), *The economics of the European Union*, Ch.12, p.339.

^{xiii} See Moravcsik, A., (1998), p. 417. For a different interpretation of the political economy motivations lying at the roots of British decision not to enter EMU see Talani, L.S., (2000)a.

^{xiv} For more details about this interpretations see: Risse, T., (1998), “To euro or not to Euro? The EMU and identity politics in the European Union”, *Arena working papers*, WP 98/1. Available on the web at the following address:

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^{xv} A similar interpretation of the role of the ECB may be found in Dyson, K., (2000).

^{xvi} Leblang, D.A., (2002), “The Political Economy of Speculative attacks in the Developing World”, *International Studies Quarterly*, Vol.46, No.1, March 2002, pp. 69-93; Leblang, D., and Bernard, W., (2000), *The Politics of Speculative attacks in industrial democracies*, International Organisation, Vol.54, 2, Spring 2000, pp.291-324. See also

^{xvii} See Gill, S., (1991), "Historical materialism, Gramsci and international political economy", in C.N.

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^{xx} For more details see De Grauwe, P., (1996), *International Money*, Oxford: Oxford University Press, p.71

^{xxi} See Krugman, P., (1989), "The case for stabilising exchange rates", *Oxford Review of Economic Policy* 5, 61-72

^{xxii} For a detailed account of the approach see De Grauwe, P. , (1996).p.75

^{xxiii} See Flood, R.P. and Marion, N.P., (1996), "Speculative attacks: fundamentals and self-fulfilling prophecies", in *National Bureau of Economic Research*, Working Paper 5789, Cambridge (Ma): NEBR

^{xxiv} For an application of this approach to the 1987 crash see Romer, D., (1993), "Rational Asset-Price Movements without news", *The American Economic Review*, Volume 83, Issue 5, 112-1130

^{xxv} For the most recent literature see Allsopp, C. and M. Artis (2003), 'The Assessment: EMU Four Years On', *Oxford Review of Economic Policy*, 19(1): 1-29; Annett, A., J. Decressin and M. Deppler, (2005) 'Reforming the Stability and Growth Pact', *IMF Policy Discussion Paper*, PDP/05/2.

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^{xxvi} See "EUROPE'S STABILITY PACT: Ministers conduct late-night burial for EU fiscal framework"

By George Parker in Brussels, *Financial Times*; Nov 26, 2003

^{xxvii} See Martin Heipertz and Amy Verdun, "The dog that would never bite? What we can learn from the origins of the Stability and Growth Pact",

^{xxviii} See "EUROPE: France and Germany may escape EU fines", By George Parker in Brussels and Bertrand Benoit in Berlin, *Financial Times*; Nov 25, 2003

^{xxix} In 2001, Germany was coming close to the reference value with a budget deficit of 2.8 per cent of GDP. With the budget deficit reaching 3.5 per cent of GDP for 2002, ECOFIN was forced to issue a recommendation to Germany in January 2003. Initially, the German government seemed determined to tackle the deficit head on and bring it back below the 3 per cent threshold. However, as German economic growth continued to decline, the government was unable to abide by its commitment and ran a deficit of 3.8 per cent of GDP in 2003.

^{xxx} France's 2002 fiscal deficit was 3.2 per cent of GDP. It increased to 4.1 and 3.7 per cent of GDP in 2003 and 2004, respectively.

xxxii See "COMMENT: The eurozone cannot escape market discipline", By Lorenzo Codogno Financial Times; Nov 25, 2004

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xxxiv See "Prodi calls for EU economic governance plan", By FT reporters Published: November 25 2003 10:57 | Last Updated: November 26 2003 17:15

xxxv See "EUROPE'S STABILITY PACT: EU may yet feel the bite of paper tiger", By Ed Crooks, Economics Editor, in London Financial Times; Nov 26, 2003

xxxvi See "FT MARKETS: Indices unmoved by 'exceptional' figures, By Michael Morgan Financial Times; Nov 26, 2003

^{xxxvii} See Leblond, P. 2005

xxxviii See "LEADER: Europe's challenge", Financial Times; Dec 20, 2003

xxxix See "Market Insight: A kickstart for the eurozone?", By Deborah Hargreaves FT.com site; Nov 25, 2003

xl See "EUROPE'S STABILITY PACT: EU may yet feel the bite of paper tiger", By Ed Crooks, Economics Editor, in London Financial Times; Nov 26, 2003

^{xli} See "EUROPE'S STABILITY PACT: EU may yet feel the bite of paper tiger", By Ed Crooks, Economics Editor, in London Financial Times; Nov 26, 2003

^{xlii} See "EUROPE'S STABILITY PACT: EU may yet feel the bite of paper tiger", By Ed Crooks, Economics Editor, in London Financial Times; Nov 26, 2003

xliii See "Export e disoccupazione i punti deboli di Eurolandia" La Repubblica, 8 agosto 2003

xliv In 2003 it was 15,76% and in 2004, 15,07% see http://epp.eurostat.cec.eu.int/extraction/retrieve/en/theme6/et_ybk/maintot_ez?OutputDir=EJOutputDir_14

63&user=unknown&clientsessionid=F5685B86525321A6FF705C7198E21971.extraction-worker-1&OutputFile=maintot_ez.htm&OutputMode=U&NumberOfCells=6&Language=en&OutputMime=text%2Fhtml&),

xliv See “Export e disoccupazione i punti deboli di Eurolandia”, La Repubblica, 8 agosto 2003

xlvi See “EUROPE: Berlin to breach deficit rules in 2004”, By Bertrand Benoit in Berlin and Tobias Buck in Brussels, Financial Times; Oct 24, 2003

xlvii See “EUROPE: France and Germany may escape EU fines”, By George Parker in Brussels and Bertrand Benoit in Berlin, Financial Times; Nov 25, 2003

xlviii See “EUROPE: France and Germany may escape EU fines”, By George Parker in Brussels and Bertrand Benoit in Berlin, Financial Times; Nov 25, 2003

xlix See “Schroeder: giustizia sociale, non solo mercati”, ANDREA TARQUINI, La repubblica,

l See “COMMENT: The stability pact is not a blunt instrument”, By Hans Eichel Financial Times; Nov 17, 2003

li See “EUROPE: German economic reform package passed at last”, By Bertrand Benoit in Berlin Financial Times; Dec 20, 2003

lii For a very detailed account of the reasons why trade unions wanted tax cuts see Marzinotto, B., (2005), “Has EMU made Germany worse off? Public Finances, Wage Bargaining and ECB Credibility from a German Perspective”, Paper presented at the University of Victoria, 18-19 August 2005

liii See “EUROPE: German economic reform package passed at last”, By Bertrand Benoit in Berlin Financial Times; Dec 20, 2003

liv See “EUROPE: German economic reform package passed at last”, By Bertrand Benoit in Berlin Financial Times; Dec 20, 2003

lv See “EUROPE: German economic reform package passed at last”, By Bertrand Benoit in Berlin Financial Times; Dec 20, 2003

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- lviii See “France and its deficit dilemma”, FT.com site; Oct 23, 2003
- lix See Charles Wyplosz, “Le pacte de stabilité, machine infernale”, *Le monde* Article paru dans l'édition du 08.11.03
- lx See “Un nouveau dossier brûlant pour Jean-Pierre Raffarin”, *Le monde*. Article paru dans l'édition du 10.12.03
- lxi See “Un nouveau dossier brûlant pour Jean-Pierre Raffarin”, *Le monde*. Article paru dans l'édition du 10.12.03
- lxii See “Un nouveau dossier brûlant pour Jean-Pierre Raffarin”, *Le monde*. Article paru dans l'édition du 10.12.03
- lxiii See “Le pacte des hypocrites”, *Le monde*, Article paru dans l'édition du 04.12.03
- lxiv See “Le pacte des hypocrites”, *Le monde*, Article paru dans l'édition du 04.12.03
- lxv See “UE : la victoire des égoïsmes nationaux” *Le monde*. Article paru dans l'édition du 16.12.03
- lxvi See “INTERNATIONAL NEWS: Berlusconi calls for easing of stability pact”, By Raphael Minder in Strasbourg, *Financial Times*; Oct 23, 2003
- lxvii See “INTERNATIONAL NEWS: Berlusconi calls for easing of stability pact”, By Raphael Minder in Strasbourg, *Financial Times*; Oct 23, 2003
- lxvii See “Il premier parla a un convegno della Confindustria Europea La Repubblica, 14 Novembre 2003
- lxviii See “Il premier parla a un convegno della Confindustria Europea La Repubblica, 14 Novembre 2003
- lxix See “Per viale dell'Astronomia la manovra correttiva per il 2004 rischia di essere più ampia di quella prevista dal governo”, *La Repubblica*, 10 September 2003
- lxx See “Il premier parla a un convegno della Confindustria Europea La Repubblica, 14 Novembre 2003

lxxi See “Slitta la manovra, governo diviso su condono e pensioni”, RICCARDO DE GENNARO *Le Repubblica*, (24 settembre 2003)

lxxii See “Il presidente della Commissione Ue prende ancora le distanze sul blocco delle sanzioni per Francia e Germania”, *La Repubblica*, 27 November 2003

lxxiii See “Il presidente della Commissione Ue prende ancora le distanze sul blocco delle sanzioni per Francia e Germania”, *La Repubblica*, 27 November 2003

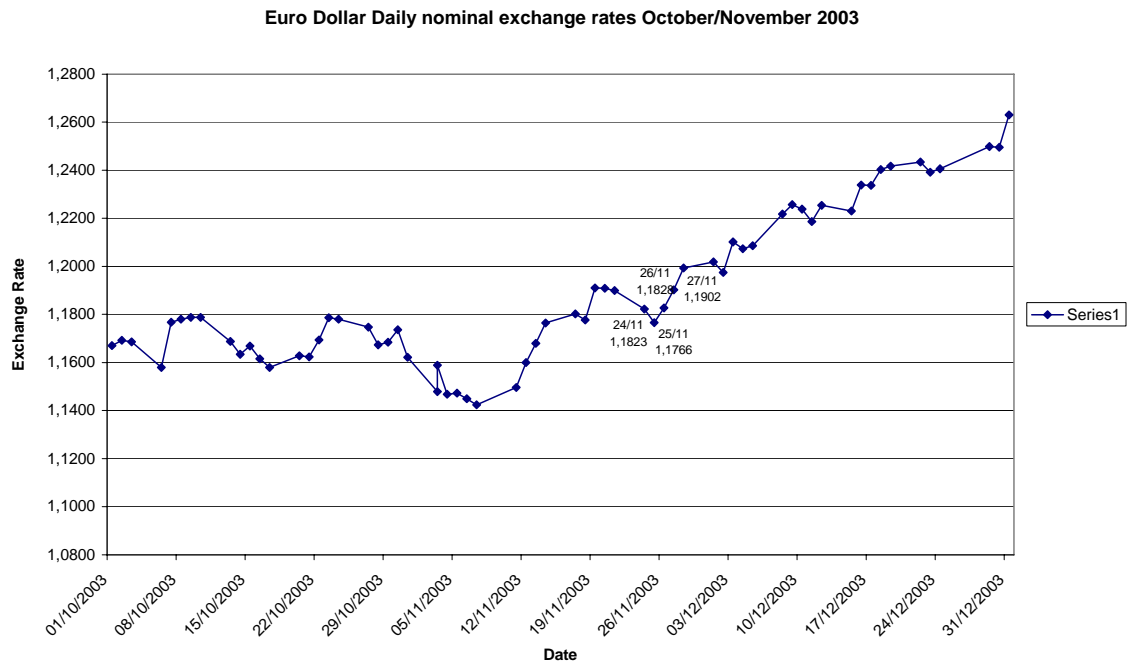
lxxiv See “Il presidente della Commissione Ue prende ancora le distanze sul blocco delle sanzioni per Francia e Germania”, *La Repubblica*, 27 November 2003

^{lxxv} See Leblond, 2005

Table 1 Three-level analysis of the demise of the SGP

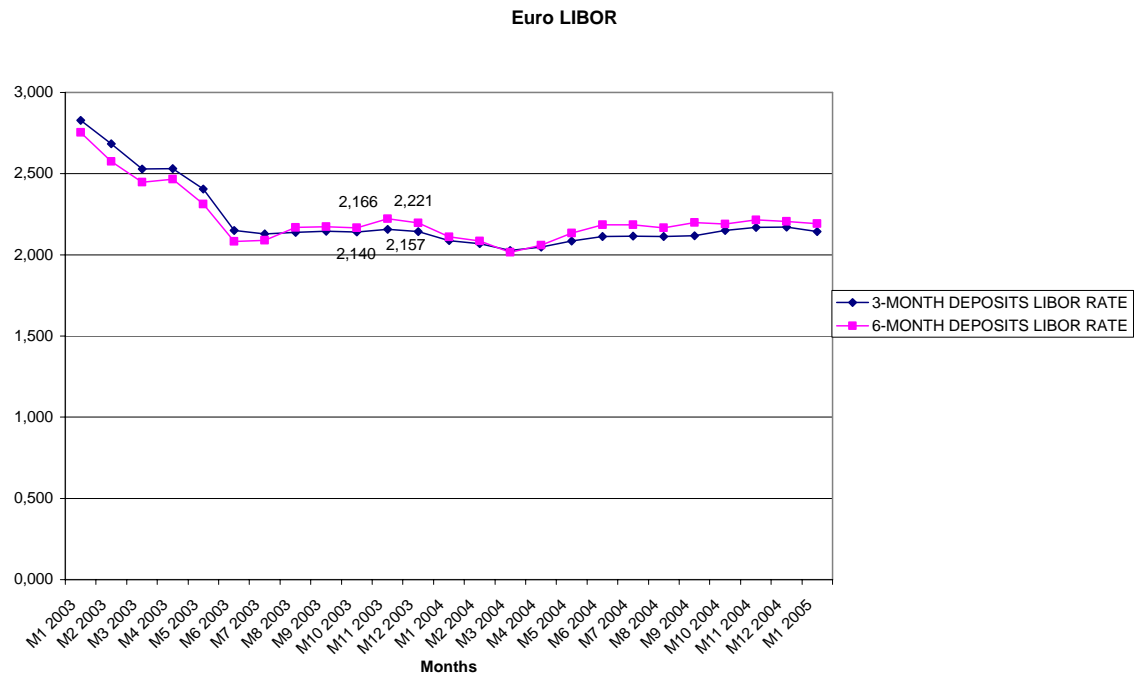
	Prevailing socio-economic interests in most powerful euro-zone member states	Consequences
Political Economy level	EMU credibility based on structural reforms	The crisis of the SGP provokes no reactions by financial markets
Purely Economic level	Increase business competitiveness through competitive devaluations in the short term and structural reforms in the medium term	Benign-neglect of the depreciation of the euro by the ECB – the SGP becomes a straightjacket for business
Purely Political level	Obtain consensus of trade unions to structural reforms	The need of tax-cuts to pass structural reforms brings about the crisis of the SGP

Figure 1: Euro-dollar nominal exchange rates October/November 2003



Source: ECB

Figure 2: Euro-Libor 2003-2005



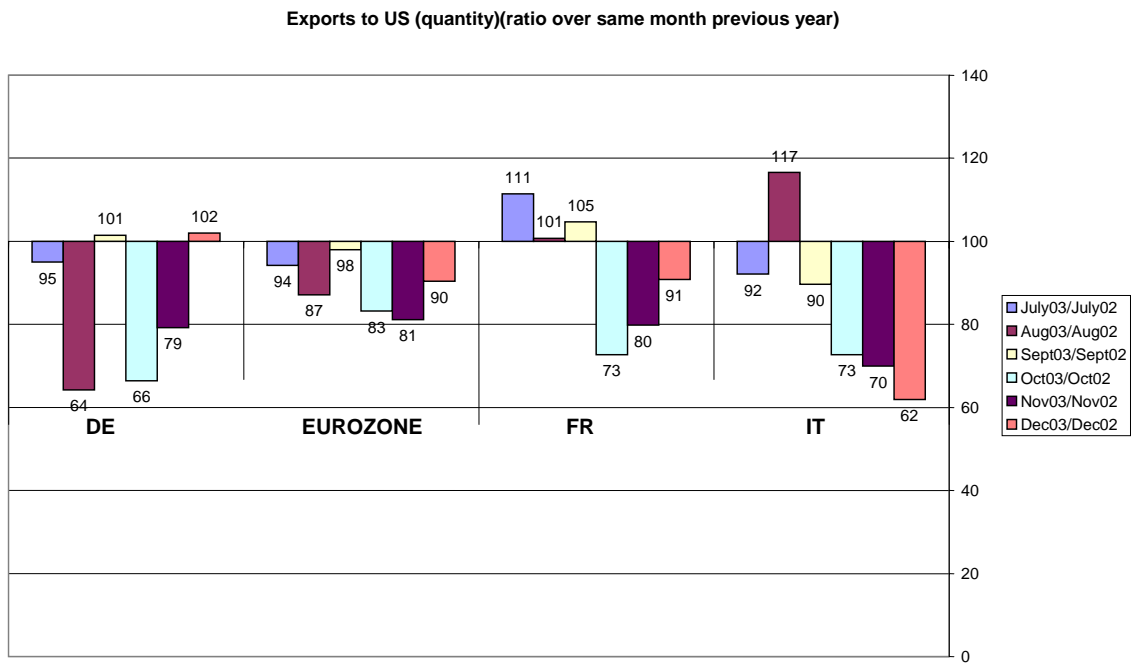
Source: IFS on line

Table 2: Exports to US, quantity of goods

Month	Exports to US, QUANTITY of goods (100KG)		(Ratio over same month previous year)	
	DE	EUROZONE	FR	IT
July03/July02	95	94	111	92
Aug03/Aug02	64	87	101	117
Sept03/Sept02	101	98	105	90
Oct03/Oct02	66	83	73	73
Nov03/Nov02	79	81	80	70
Dec03/Dec02	102	90	91	62
AVG	85	89	93	84

source: Eurostat

Figure 3: Exports to US (quantity)



Source: Eurastat, elaboration of the author