

Zdeněk Tůma: The role of rules in public finance

Introductory remarks by Mr Zdeněk Tůma, Governor of the Czech National Bank, at the International Institute for Public Finance, Prague, 25 August 2003.

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Ladies and gentlemen, dear colleagues,

It is a great pleasure and honour for me to join the previous distinguished speakers with some introductory remarks to this high level conference.

As a central banker, I would not pretend to be an expert in specific details of public finance. Therefore, I have chosen a general topic that is common to both central banking and fiscal policy. That topic is the application of rules in stabilisation policies. Over the last twenty years, the philosophy of stabilisation policies has evolved substantially. The rules-versus-discretion debate has led to a preference for a rule-based approach to policy making. This has been supported by the negative historical experience with discretionary policies, as well as by a realisation that successful public policies in first place have to be credible and transparent, so as to direct private expectations in a desirable way.

In terms of the actual institutional design, monetary policy has played a leading role, the shift to greater central bank independence with a clear anti-inflationary mandate marking this trend. Nonetheless, three serious questions have emerged as a result. First, whether independence and reliance on strict policy rules has too high costs in terms of macroeconomic instability. Second, how to co-ordinate monetary policy with governmental actions to make a consistent policy mix. And third, how to compensate for the democratic deficit of technocratic monetary policy decision-making.

Concerning the first issue, empirical research has found out that greater central bank independence is on average associated with lower inflation, but not with higher volatility. This “free lunch” was a bit surprising in the light of the “conservative central banker theory”. It reflects the fact that the actual institutional and policy design has evolved over time to guarantee that the mandate to achieve low inflation is not interpreted rigidly. In fact, most central bankers pay attention to real economic developments in their policies. In the last decade, this fact has been formally and institutionally reflected in the “flexible” inflation-targeting regime. This regime is often described as “constrained discretion”, meaning that it aims at making the monetary policy-making constrained by understandable procedures and at the same time flexible in responding to unforeseen shocks.

As far as the democratic deficit is concerned, this issue has been addressed by moving to greater transparency and accountability of central banks. The burden of proof in central banks’ communication has shifted over the last two decades. At present, it is necessary to give convincing arguments if one thinks that the central bank should not give out some information, rather than to argue why something should be revealed. This has been a significant shift in the central banks’ mentality.

Regarding the issue of communication and co-operation between the central bank and government, no universal solution has been found so far. There are many institutional arrangements, ranging from formal contracts between the government and central bank to non-formalised consultations between the two bodies. The efficiency of such arrangements, however, depends in most cases on their actual implementation.

Now I come to the fiscal sphere. A trend towards rule-based policy can be observed here as well, albeit with some time lag and in a different form compared with monetary policy. The difference originates mainly from the fact that fiscal policy is by definition a political issue with strong redistribution aspects, which cannot easily be mandated out of direct democratic control. The independence solution is thus not readily available here, even though there have been such suggestions in the economic literature. This contributes to the fact that no single elegant model has yet been found in practice. The existing rules usually take the form of self-imposed constraints, such as legal constraints (balanced-budget acts in some countries) or international treaties (S&G Pact).

Apart from this difference, though, the aim to implement rules stems from the same reasons and faces similar challenges as in monetary policy. The idea that policy should be designed in a way that does not put short-term political gains above the longer-term interests of society, that takes into account its impact on private expectations, and that is transparent to the public, is common to the monetary and

fiscal spheres. Similarly, the rules must also address the issue of their costs in terms of macroeconomic stabilisation and finding a proper policy mix.

The teething problems with the Stability and Growth Pact have been an example of these challenges. One of the key motivations of the Pact was an effort to avoid free riding by national governments in a multinational currency area. In other words, the desire to achieve a proper policy mix was present at the birth of this rule. In spite of that, the Pact is now criticised for being too rigid, not allowing for a proper policy response in times of distress, and thus ultimately leading to poor real economic performance. This naturally undermines its credibility and supports calls for various "escape clauses", to use the inflation-targeting terminology.

The Pact is thus fighting the same battle that the conservative central banker was some time ago. It should evolve towards a "constrained discretion" system that will fulfil its major goals - sustainability, credibility and co-ordination of stabilisation policies - yet at the same time be sufficiently flexible to allow for proper responses in adverse periods. It has yet to convince policy-makers and the public that it can deliver the lunch without them having to pay too high a price for it in terms of cyclical stabilisation.

So far, the Pact has seemed to be losing the battle. This is somewhat unfair, as the adverse period came before most EU countries had achieved the target of balanced structural budgets, which reduced their manoeuvring space considerably. In a sense, the Pact is thus paying a price for being too lax in the previous period, i.e. not defining a binding convergence path to the target, rather than a price for being too rigid. On the other hand, I also agree with many of the critiques and proposed adjustments to the Pact. Defining a convergence path, looking at structural rather than headline budgets, taking into account public debt levels and sustainability of public finance, etc., are certainly steps towards achieving the "constrained discretion" in fiscal policy I am talking about. The adverse period should thus be taken as an opportunity to modify the rule in a favourable way, rather than as a reason to scrap it completely. I believe that pursuing this opportunity will secure a future for the S&G Pact. I am convinced that some rule of this kind will always have to be in place in the eurozone, and not only because of its multinational nature, but also due to the general advantages of rules.

Let me also mention briefly the importance of the S&G Pact for the Czech Republic and other EU accession countries. The Czech Republic, like many other CECs, is facing the problem of rising budget deficits. This is partly a reflection of the previous transition costs, but these are gradually fading away. The root of the problem is structural, similar to the challenges faced by advanced EU countries as well - population ageing, an overgenerous social system, etc. At present, most countries are preparing consolidation programmes aimed at reversing the negative trends. Usually, the ambition is to bring the public deficits close to, or below, the 3% Maastricht level. For example, the target in the Czech Republic is not to exceed 4% of GDP in 2006.

Nonetheless, it has not yet been fully appreciated that upon EU accession, the Stability and Growth Pact will become relevant to the new member states. Admittedly, the application of sanctions will be postponed until a country becomes a member of the eurozone. But even if a country is not a subject to sanctions, as a member of the EU club it should have in place at least a credible programme towards achieving its objectives. Moreover, if a country targets relatively early eurozone entry, it should first create a sufficient safety margin above the 3% deficit limit to be insured against distress - i.e. it should avoid the mistake that has been made by some of the current eurozone members concerning the S&G Pact. I hope that the uncertainty surrounding the Pact's future would not be viewed as an excuse for delaying necessary fiscal and structural adjustments. Even if redefined in a more flexible way, it is quite clear that the structural deficits currently observed in many of the CECs will not be tolerable under the Pact, as they will not pass the sustainability and policy mix tests. Therefore, the existence of the S&G Pact makes the case for fiscal consolidation even more appealing than it might look at first sight.

To conclude, let me wish you a very fruitful discussion during this conference, as well as a very pleasant stay in Prague. Thank you for your attention.