Lucas Papademos: The political economy of the reformed Stability and Growth Pact - implications for fiscal and monetary policy

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the Conference "The ECB and its watchers VII", Frankfurt, 3 June 2005.

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Introduction

I would like to start with two propositions and two observations about the Stability and Growth Pact. The first proposition is that in a monetary union, which is characterised by a single monetary policy and decentralised national fiscal policies, there is a need for a fiscal policy framework that ensures that excessive budget deficits are avoided over the medium term and that national fiscal policies are effectively coordinated to that end. The second proposition is that the best means to achieve the necessary coordination is a rules-based framework which fosters transparency, consistency and equal treatment across countries in fulfilling their commitment to avoid excessive deficits and attain sound budgetary positions. I believe we can all agree about the validity of these two propositions.

The two observations concern the experience with the Stability and Growth Pact over the past six years. The first is that the SGP did not succeed in preventing the occurrence of excessive deficits in several euro area countries – though I am convinced that those countries' budgetary positions would have been worse if the Pact did not exist. The second observation is that the Pact's rules and procedures for the correction of excessive deficits proved inadequate to guide fiscal policies towards a prompt and steady reduction of deficits and the achievement of a balanced budgetary position. Consequently, there was a need to strengthen the Pact's preventive arm and to improve the implementation of the excessive deficit procedure. This was the view of the ECB in the light of the experience of the past few years and not on the basis of theoretical arguments concerning the features and modalities of the Pact. I will not address the reasons for the ineffective functioning of the Pact in the past, though I believe that a correct diagnosis of the cause of observed failures would be useful in assessing the prospects for success of the reformed framework. I will directly focus on four key topics concerning the implications for fiscal and monetary policy of the agreed changes to the original framework.

I. Consequences for fiscal sustainability and stabilisation

First, what are the likely consequences of the recent changes to the Stability and Growth Pact for fiscal sustainability and for fiscal stabilisation policy? The general answer is that it is too early to judge the implications of the recent reform of the SGP for the sustainability of public finances and for the stabilisation role of fiscal policy in Europe. Ultimately, it is the implementation of the revised rules that will provide the definite answer. The outlook for fiscal policies in many countries (as reflected in plans and forecasts), the excessive deficit procedure's loss of some "teeth" and the unchanged incentives for compliance and strict implementation suggest that one should be sceptical. At the same time, governments have unanimously stressed their commitment to sound fiscal policies. What can we really expect as a result of the agreed reform of the Pact?

In trying to assess the possible implications of the changes, it is useful to distinguish between the SGP's preventive and corrective arms. It is also useful to recall the lessons from past experience and from political economy regarding the main characteristics of good fiscal rules. To be meaningful and effective, fiscal rules should be based on a sound economic rationale and be sufficiently flexible to allow for appropriate policy responses. But good fiscal rules should also be sufficiently simple, clear and enforceable.

Seen from this perspective, some of the changes introduced into the **preventive arm** strengthen the economic underpinnings of the SGP and address certain past criticisms of the rules. These changes include: (i) country-specific medium-term objectives that take into account potential growth and debt levels; (ii) the benchmark of a 0.5% annual adjustment with more consolidation in good times but possibly less in bad times; (iii) the definition of the medium-term objectives and the adjustment path in cyclically adjusted terms; and (iv) the netting of temporary measures. By allowing broader economic conditions and specific budgetary positions to be taken into account to a greater extent than in the past, such changes have the potential to strengthen fiscal coordination and surveillance, and thereby also the contribution of the SGP to fiscal sustainability and stabilisation.

But this potential strengthening of the preventive arm and the associated benefits will only materialise if these changes are accompanied by a renewed political commitment to enforcing the rules. Moreover, a downside risk is that these changes might make the rules more complicated and less transparent. In particular, problems of definition and measurement (e.g. estimating potential output and measuring the costs and benefits of structural reforms) could make surveillance and implementation difficult.

A potential weakness in the Pact's preventive arm is a bias towards negative output gaps or "bad times" (that would require less adjustment), coupled with the provision that medium-term objectives do not necessarily have to be reached within the horizon of a country's stability programme.

In sum, the preventive arm of the Pact, as recently revised, provides a useful framework for surveillance and benchmarking of sound fiscal policies and the reform might strengthen the pertinent provisions. However, if it is implemented in a minimalist fashion, the required adjustment and fiscal policy paths may not be consistent with determined consolidation, sufficient safety margins and adequate debt reduction.

As regards the **corrective arm**, it should be recalled that the original SGP aimed to strike a balance between the quasi-automatic application of the excessive deficit procedure and the inherent room for discretion in the procedures and in the role of the ECOFIN Council. This combination of automaticity and discretion was intended to deter (and, if necessary, ensure the prompt correction of) excessive deficits. And this, in the opinion of the ECB, would anchor expectations of fiscal discipline in EMU.

The reform of the SGP's corrective arm makes decisions on the existence of excessive deficits and on the setting of deadlines for correcting them less automatic and more explicitly conditional on discretion in the assessments of the underlying economic and budgetary situations. The reform even relaxes certain rules. For example, the softening of the exceptional circumstances clauses and the list of other relevant factors are indicative of the increased discretion and potential relaxation of fiscal discipline. It can, of course, be argued that this enhanced flexibility in assessing the existence and correction of deficits by itself does not impose a looser application of the procedure compared with what was done in the recent past. Yet it can facilitate a more lax implementation, which could imply higher and more protracted deficits for a member country and the euro area as a whole. This is a cause for serious concern.

II. Implications for the interaction of fiscal and monetary policy

The second set of questions I would like to address is as follows: what are the implications of the SGP reform for the interaction of fiscal and monetary policy? And what role should the European Central Bank play in this context? Given the impact of fiscal policies on key macroeconomic variables, it goes without saying that fiscal policies can have significant implications for monetary policy. Indeed, the danger that unfettered fiscal policies could create tensions in EMU and undermine macroeconomic stability, in general, and monetary policy, in particular, is the *raison d'être* for the SGP. At the same time, there can be no mechanical reaction of monetary policy to fiscal policies or to changes in the fiscal framework. Unsound fiscal policy, which results in excessive and persistent budgetary deficits, is one source of risks to price stability that has to be assessed in the formulation of monetary policy.

From the perspective of monetary policy, what matters most are the effects that the changes to the Stability and Growth Pact might ultimately have on the behaviour of the fiscal authorities and on the expectations of markets and the public in this regard. These effects cannot be prejudged *a priori*, independently of experience.

What role should the ECB play in this context? The ECB has always maintained that the interaction between the single monetary policy and national fiscal policies in EMU needs to be based on a clear allocation of responsibilities, with each party (institution or authority) being responsible for achieving its objectives and delivering on its own mandate. The role of the ECB is determined, first and foremost, by its mandated primary objective to maintain price stability in the euro area. The public and financial markets must rest assured that the ECB will successfully carry out its mandate. Correspondingly, the ECB expects and calls on the Member States, the Commission and the ECOFIN Council to deliver sound fiscal policies in line with their respective responsibilities. This requires that they implement the reformed rules of the Pact rigorously and consistently.

Beyond this, the ECB naturally shares its analysis and assessment of the economic situation, including its assessment of fiscal policies, with the fiscal authorities in bodies such as the Eurogroup and the Economic and Financial Committee. In so doing, the ECB has a duty to be frank in presenting its views.

The ECB has an additional role to play in the context of its communication policy. It has to explain and support the need for rules-based fiscal policies in EMU since this is essential for ensuring long-term price stability and sustainable growth. This is why, in recent months, the ECB has consistently argued that the SGP provides an appropriate framework for fiscal policies in EMU, even if its implementation could and should be improved in certain respects. And this is why the ECB has considered it necessary to express its concern about some aspects of the recent reform and to stress the need for a rigorous implementation of the new framework. At the same time, the ECB fully respects the prerogatives and responsibilities of Member States, the Commission and the ECOFIN Council in the fiscal domain.

III. Potential effects on interest rates

My third topic concerns the potential effects on interest rates: How will interest rates be affected by the SGP reform in the long run? And what is the markets' assessment? Identifying the impact of fiscal policies on interest rates is a complex task and research conducted in this area in recent years has not resulted in unambiguous conclusions. In addition to seeking to isolate the effects of fiscal policies from other influences (e.g. growth, inflation, exchange rate expectations), a particular difficulty lies in trying to identify when exactly "fiscal policy events" become "news".

The recent agreement on the SGP reform provides a good example of this problem. The announcement and publication of the ECOFIN agreement on 20 March did not give rise to an immediate, significant reaction in government bond markets. This could suggest that markets were not particularly concerned by the changes. Such a conclusion, however, would ignore another fact: that the nature of the reforms had already become apparent gradually over a period of months before the final agreement was signed. Thus, it is likely that, by the time the ECOFIN Council had reached its agreement, the market's view of the changes had already been factored into interest rates.

Nevertheless, a number of studies have provided increasing evidence that interest rate spreads reflect a differentiation of fiscal policies across countries. Recent reactions by rating agencies also point to renewed emphasis on this issue. Whether these reactions are sufficiently strong is a different matter. It has been argued that the EU fiscal framework in the past might have contributed to high confidence in the sustainability of fiscal policies and thus to low spreads.

IV. Financial markets, monetary policy and fiscal discipline

The final question I would like to touch upon is this: how could financial markets help encourage fiscal discipline? In principle, well-functioning financial markets should reward fiscal prudence and punish unsustainable fiscal policies. It is one of the conundrums of modern-day political economy that, except at times of financial crises, this does not appear to be the case to any great extent.

One issue that arises in this context is the extent to which institutional features of financial markets influence such reactions. In the EMU context, the "no bail-out" clause of the Treaty should encourage financial markets to distinguish between more and less risky sovereign issues. But other institutional features may work in the opposite direction. Among these features the favourable treatment of government debt under the new Basel rules as well as regulations which require pension funds to invest a large share of their portfolios in "safe" assets may buttress demand for government paper, putting downward pressure on bond yields. There may, perhaps, be scope for institutional designs that encourage more market discipline. But modifying rules and institutions so as to achieve objectives that fall outside their primary goals may not be appropriate.

In this context, it has been suggested that the ECB's collateral policy could encourage market reactions to fiscal policies, for example, by imposing haircuts for bonds issued by governments that fail to comply with the SGP. While perhaps seeming appealing at first glance, such an initiative does not seem very convincing when scrutinised more closely. The purpose of the ECB's collateral policy is to ensure sufficient availability of collateral to allow a smooth implementation of monetary policy and to protect the Eurosystem in its financial operations. Using the framework for alternative purposes would be contrary to the ECB's mandate. Secondly, debt used by the ECB as collateral is valued daily according to market prices. Thus a negative market assessment of a given asset means that more of that asset is required as collateral against a given amount of central bank financing. So it is unconvincing to claim that the ECB's collateral policy is biased against financial market discipline.

Concluding remarks

In conclusion, I would like to emphasise three points. The consequences of the reformed Pact for fiscal sustainability and stabilisation will depend upon its implementation. A rigorous and consistent implementation, in line with the renewed political commitment to the fiscal framework, is crucial for sound public finances in the euro area. The credibility of the reformed Pact will be tested in the coming months as the budgetary positions of countries with excessive deficits will be assessed by the Commission and the Council. This test should be passed successfully not only because it is important for the credibility of the fiscal framework but also in order to ensure the compatibility of fiscal policies with the stability-oriented monetary policy, the anchoring of expectations of fiscal discipline and the establishment of macroeconomic conditions conducive to sustainable growth.