Mr. Duisenberg comments on the importance of the European pact for stability and growth Address by Dr. W.F. Duisenberg, President of the Netherlands Bank and the Bank for International Settlements, on the occasion of his acceptance of the Business Week Award, awarded by the Business Week Committee of the Economische Faculteitsvereniging of the Erasmus University in Rotterdam on 20/3/97.

It is a great honour for me to accept one of the two Business Week Awards of 1997. I would like to thank the Business Week Committee for awarding me this prestigious prize. Also, I would like to congratulate my fellow award-winner professor Franco Modigliani, whose work has covered many fields in economics in general, and in the theory of monetary policy and finance in particular.

As the theme of this year’s Business Week, the organising Committee chose “IMPACT: all things are in a flux and nothing remains”. The first part of the theme, “impact”, is certainly valid for the world of banking and finance. Shifts in international capital flows have important repercussions on economic developments in individual countries and regions. Changes in interest rates influence economic decisions by private companies and households, and consequently have an impact on our daily lives. Furthermore, the establishment of European Economic and Monetary Union will drastically change the institutional setting of money and monetary policy in the member states of the European Union, and will have a strong positive impact on the economic development of Europe in the next century. The second part of this year’s theme, “all things are in flux and nothing remains”, is somewhat more difficult for me to subscribe to. Being a central banker, it is almost against my basic instinct to see all things as being in flux and that nothing remains. By nature, central bankers are strongly in favour of smooth and stable developments. However, this does not imply that we are against change. For example, the movement towards European Economic and Monetary Union is a fundamental change from the past. What is important is that changes which have a significant impact on monetary and economic developments are embedded in structures of stability. The combination of policy impact and stability, that is the crucial issue for central bankers. Therefore, in the European Economic and Monetary Union, the policy impact and stability will be provided by an independent European Central Bank, the primary objective of which is to maintain price stability. To support this objective, the European Economic and Monetary Union will have several institutional features which are aimed at providing an underlying framework of stability for the ECB’s monetary policy. For example, a mechanism for exchange rate stability is presently being designed to ensure that the countries which do not meet the convergence criteria in time can retain close links with the core group.

Moreover, a mechanism is presently being developed that aims at realising fiscal stability in EMU as well. This mechanism is the pact for stability and growth, and was agreed upon during the summit of the European Council in Dublin last December. Given the importance of fiscal stability for achieving monetary and price stability in EMU, I would like to touch upon three issues related to the pact for stability and growth. First, why do we need the pact as a fundamental characteristic of EMU? Second, what are the elements of the pact? Third, what are the misunderstandings about the pact?

The first issue – the reasons why we need a pact for stability and growth in EMU – may be explained by my fundamental belief that a lack of fiscal discipline would negatively affect the ability of the European Central Bank to achieve its primary objective to maintain price stability. First, if the ECB is to be able to pursue a price stability-oriented monetary policy, loose fiscal policies in Member States must be avoided, as such a situation would endanger the credibility of the ECB and would place a heavy burden on the ECB’s monetary policy. Loose fiscal policies might push up interest rates, with the ECB being blamed for pursuing an overly strict monetary policy. Although a central banker is used to being blamed for all kinds of unsatisfactory economic developments, it is better to prevent this to the extent possible. The pact aims at ensuring that fiscal discipline will be achieved, not only before the start of EMU, but thereafter as well. Member States have agreed to pursue medium-term objectives for a budget close to balance or even in surplus. The likelihood of interference with monetary policy is thus reduced. As a result, the foundation for a stable and sound economic development in Europe is established. Not without reason is the pact referred to as the pact for stability and *growth*. Second, because of fiscal imbalances, aggregate demand can expand and may directly cause upward pressure on prices. As a result, given its primary objective of price stability, the ECB will be obliged to offset this expansion by implementing a restrictive monetary policy. In the end, the European economy will be confronted with higher fiscal deficits and higher interest rates, similar to the bad experiences of the seventies and early eighties. Third, high and persistent fiscal imbalances indirectly fuel inflationary expectations, because they raise the issue of sustainability. Fourth, an additional reason for the establishment of a pact for stability and growth is the possible danger of "free rider" behaviour by individual Member States. If national fiscal policies would not be governed by certain explicit and clear rules, individual Member States could implement unbalanced fiscal policies and to a large extent pass on the negative consequences to the other Member States. Fifth, the introduction of a stability and growth pact will safeguard the fiscal convergence that has been achieved during recent years, when EU Member States started to bring down fiscal deficits in order to meet the Maastricht criteria. Sixth, against the background of growing government fiscal deficits, both in Europe and the United States the fiscal situation of the government has become an issue of growing academic concern. As a result, a substantial number of important studies on the need for balanced budget rules have been published, establishing the theoretical framework for the necessary change towards fiscal consolidation. It should be noted that fiscal imbalances of the government are a relatively recent phenomenon. As has been stated regarding the United States by Nobel prizewinner professor James Buchanan, who is one of the strongest supporters of balanced budget rules:

"Traditionally, before the 1960's, governments had resorted to debt as a means of financing only extraordinary expenditures, for the most part expenditures that were necessary to finance wars and other short-lived emergencies. Public debt, so created, was always substantially reduced, or paid off, after most wars for most countries". [1]

Also in Europe, during the sixties and the early seventies, budgets close to balance or even in surplus were regarded as normal. It will not be a surprise that I think that we should go back to normal. For example, the average of total government gross debt for the present 15 EU Member States in 1970 was 34.6% of GDP. In 1995, this figure had risen to 71.7% of GDP, a doubling in 25 years. In the case of the Netherlands, the figure for government debt rose from almost 47% of GDP in 1980 to around 80% of GDP in 1995, an increase of 70% in just 15 years. However, the rapid growth of government debt did not result in a significant reduction of unemployment. On the contrary: the doubling of the average EU government debt level in 25 years was accompanied by a more than quadrupling of the average unemployment level. Also in the Netherlands, rapid increases in government debt were attended by increasing unemployment levels. These recent experiences show that accommodative fiscal policies are not a guarantee for reducing unemployment.

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1 J.M. Buchanan, "The Deficit and American Democracy, Center for Study of Public Choice", George Mason University, 1984, Mimeograph, pp.8-9.

Let me now briefly discuss the second issue – what are the elements of the pact for stability and growth? The pact for stability and growth will take the form of two regulations, and a political resolution from the European Council. The resulting regulatory framework represents a judicious balance between prevention – via the strengthening of the surveillance of budgetary policies - and deterrence – via the establishment of a dissuasive set of rules. The pact will oblige Member States (or the "ins") to submit stability programmes. In these programmes, medium-term budgetary targets will be stipulated, which should be set close to balance or even at a small surplus. Non-euro Member States (or the "pre-ins") will submit convergence programmes. Furthermore, the pact will include a sanction mechanism that will be used when countries fail to meet the 3% reference value. If the Council of Ministers judges that a Member State has an excessive deficit, sanctions would, as a rule, be imposed in the calendar year following the year in which the excessive deficit was recorded or identified. The sanction would consist of a non-interest-bearing deposit between 0.2% and 0.5% of GDP. In the case of the Netherlands, this would imply a maximum fine of somewhat over 3 billion guilders. The third element of the pact, the *European Council resolution*, will reflect the political commitment to a strict and timely application of all the provisions of the pact. Thus, the resolution will provide firm political guidance to the parties who will implement the pact for stability and growth. Both regulations, together with the resolution, constitute an important framework for stability. If the countries adhere to the provisions of the pact, they will observe a safety margin in respect of the fiscal deficit to make sure that, even in times of cyclical adversity, the deficit will not exceed the 3%-reference value of the Maastricht Treaty. The stability pact aims at ensuring that countries, once they have joined EMU, will continue to abide by the rules for sound public finance.

Finally, I would like to address some misunderstandings about the pact. It is often said that the major drawback of the pact for stability and growth is that it takes away all flexibility and sovereignty in the budgetary area. This is not correct. As soon as a structural budgetary position of close to balance is reached, any negative cyclical development is allowed to feed into the deficit, that is, up to the 3% limit, agreed upon in the Maastricht Treaty six years ago. Calculations show that this gives ample room for the so-called automatic stabilisers to do their job. That is to say, if in times of economic fortune Member States establish sound fiscal positions, they will have sufficient budgetary room to react adequately to economic downturns. In this respect, the pact for stability and growth is nothing more than the communal equivalence of the Dutch saying "Save first, spend later". Thus, budgetary flexibility is explicitly part of the pact. As regards sovereignty, it has to be recalled that only the level of the deficit will be restricted. No limits or guidelines will apply to the size or composition of government receipts and expenditures. The sovereignty of national parliaments will remain fundamentally intact. In my opinion, it is even of the utmost importance that this sovereignty will remain intact: if the stability and convergence programmes are to be credible, they have to be supported by the national parliaments. Some critics of the pact claim that it allows for too much flexibility. To them, I would like to emphasise that the pact for stability and growth will introduce a high degree of automaticity in the assessment of Member States' budgetary policies. Only under exceptional circumstances – such as occurred in less than 6% of the cases in the past 35 years – may Member States be allowed a budget deficit above the 3%-reference value of the Maastricht Treaty; even then this excess will need to be temporary and limited. Thus, the pact constitutes a careful balance between flexibility and automaticity, and between prevention and deterrence. As you might know, the details of the pact for stability and growth are now being worked out. I expect that at its June 1997 meeting in Amsterdam, which will be hosted by De Nederlandsche Bank, the European Council will reach full agreement on this most important issue.

To conclude, from a central banker's perspective, the crucial issue for stable and sound economic developments is the impact of stability. More specific, what is important is the impact of price stability, achieved through the interrelated set of monetary stability, exchange rate stability and fiscal stability. That is why the pact for stability and growth is one of the cornerstones of the EMU. It will establish a foundation of fiscal stability under the operations of the European Central Bank, and thereby contribute to the impact of its policies.