Lucas Papademos: Some reflections on the Stability and Growth Pact

Speech by Mr Lucas Papademos, Vice-President of the ECB, at the annual dinner of the Institute of Chartered Accountants in Ireland, Dublin, 5 April 2004.

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Mr President, ladies and gentlemen,

I understand that in addressing you this evening I am following in the footsteps of very distinguished speakers, including both the current and the previous Presidents of the Irish Republic. This is both an honour and a daunting task for a central banker such as myself. Unlike many heads of state, central bankers are not, in general, renowned for their great oratory. But I will do my best not to disappoint. And I feel reassured by the audience tonight. Central bankers and accountants have certain things in common. We both spend a considerable part of our time looking at, counting and assessing numbers.

Central bankers like counting numbers. But we don't like to have to count too far. For example, with regard to inflation, at the ECB we like to count only up to two, that is "two percent". Actually, "below but close to two percent" is our stated preference. If we are measuring the size of euro area countries' budget deficits, we really don't like to have to count much at all. And, in fact, my colleagues and I can get quite irritable if we have to count above three percent. This is because the Maastricht Treaty and the Stability and Growth Pact say that we should not have to do so, or at least not very often. And if an occasion should arise when we do have to count above three percent, then a procedure is foreseen to ensure that this state of affairs does not last for too long.

Unfortunately, we have been doing a lot of counting above three percent recently. And last November, the ministers of economy and finance in the ECOFIN Council decided that the procedure designed to correct this state of affairs could be put on hold for the time being.

My colleagues and I in the Governing Council of the ECB have made clear our concern about the ECOFIN Council's decision last November. And our concern has increased in the light of information that has recently become available indicating that public finances in a number of EU Member States have deteriorated since then. Mr President, in your letter inviting me here this evening, you mentioned that the banking and wider business community is also concerned and that you would welcome my observations on these developments. Let me make these observations by answering the following questions. First, why should we be concerned about these developments? Second, how concerned should we be? And third, what should be done about it?

Why should we be concerned?

Let me start with why we should be concerned. This is, in my view, a question that we should take care to answer, and to answer properly. We should not assume that everyone knows the reasons for our concern. It should be clear that the Governing Council does not simply support the rules and procedures of the Stability and Growth Pact for the sake of the rules and procedures themselves. If we defend the Pact, it is because we believe that it makes good economic sense. It can contribute to the attainment of our societies' fundamental economic objectives.

By respecting the rules of the Pact, a Member State pursues a sound fiscal policy. And this is in its own interest. A government that maintains a budgetary position that is close to balance or in surplus over the medium term and reduces its debt to a low and sustainable level has room to pursue its desired tax and spending policies. It also creates scope and increases flexibility to cushion the effects of the economic cycle. By contrast, a government that pursues an inappropriate fiscal policy, resulting in persistent deficits and higher levels of debt, increasingly limits its room for policy action. Money spent paying interest on higher levels of debt cannot be used to provide public services or to lower taxes. And experience has shown that while such a trend of high deficits, higher debt and higher interest payments, and thus still higher deficits and so on, can easily be established, it is much harder to reverse.

There is no fundamental choice between stability and growth. Sometimes there seems to be such a choice. But it is either temporary or illusory. In the longer term and in reality, stability is a precondition for growth. They are two sides of the same coin. And sound public finances create conditions which are conducive to stability and sustainable growth. Nowhere is there a better example of this than here in Ireland. In the late 1970s and early 1980s, Ireland's debt increased dramatically and economic growth slowed. Then, in the mid-1980s, Ireland changed course. It began to put its fiscal house in order. We all know what has happened since then. Over the last 15 years, Ireland's debt ratio has been reduced from over 100% to around 30%, now one of the lowest in the EU. And over the same period Ireland has had an average growth rate of around 7%, by far the highest in Europe.

A government that pursues a sound fiscal policy will ultimately be rewarded. A government that does not do so will ultimately be punished. In the past, this punishment used to be imposed fairly promptly by markets: primarily the foreign exchange market, but also money and financial markets. This is no longer true for a euro area country. Member States are now largely shielded from this discipline. But this does not mean that they are shielded from the effects of inappropriate fiscal policies. Instead, the effects will now appear in terms of lost competitiveness, reduced confidence and, as a consequence, slower growth and higher unemployment.

The problem is that these mechanisms operate slowly. So the symptoms of an inappropriate fiscal policy may only show up when the disease has already spread far and wide. And then the required medicine is likely to be more drastic and painful. In a monetary union there is no automatic wake-up call to alert a Member State to its deteriorating state of fiscal health. There is no early warning system; unless, that is, we create one in the form of a fiscal rule.

A sound fiscal policy, and a good fiscal rule, is in a country's own interest. In a monetary union such as the euro area it is also a truly common interest. An inappropriate fiscal policy in one country directly affects the other countries as the impact on interest rates will no longer be confined to one country but will spread across the euro area. The countries of the euro area now live in the same monetary house. When you live in the same house, you need to have some rules to ensure that the house is kept in order. And once you have agreed on the rules, you have to apply them consistently and in the same way to all. Otherwise the members of the household will feel that they are not treated equally. Each member will have his own reason for not obeying the rules. And in the end, you may not have viable rules at all.

So my colleagues in the Governing Council and I are concerned, because we believe that fiscal rules such as those of the Stability and Growth Pact are necessary in a monetary union; and recent fiscal developments raise doubts about Member States' commitment to these rules.

How concerned should we be?

How concerned should we be? How concerned should I be as a member of the Governing Council charged with the task of maintaining price stability in the euro area? Obviously I think there are grounds for concern, for the reasons I just mentioned. But I also don't want to exaggerate. We should not be alarmist. We should maintain a reasonable perspective.

Following the ECOFIN decision of last November, many observers promptly proclaimed the Pact to be dead. I do not agree with this fatalistic view. The ECOFIN Council did not kill the Pact or even suspend its basic rules last November. What it did do was to give France and Germany an extra year to adjust their fiscal policies in view of the commitments made by these countries. And in order to do so it decided to put one step of the excessive deficit procedures for these countries on hold pending the fulfilment of their commitments. If the Pact is dead, then why have so many people been talking about it so much in recent weeks and months?

To paraphrase one of Ireland's famous literary geniuses, Oscar Wilde, I would say that "reports of the death of the Pact are wildly exaggerated". The Pact is not dead. It is growing up. It is making the transition from being a set of rules on paper to a set of rules applied in the real world. As is often the case when growing up, there are growing pains from time to time.

Moreover, while the Pact may be experiencing a few growing pains, it still represents an improvement on the past. At present the euro area fiscal deficit stands at just under 3% of GDP. Ten years ago, at a similar point in the economic cycle, it was around 6%. The Pact may not be working as well as we would like, but this does not mean that it has been a failure. By being there, it has had some impact. We should give the rules and procedures of the Maastricht Treaty and the Pact due credit for this.

We should also be reassured by the fact that the euro area has a strong monetary constitution. It has an independent central bank with a clear objective to maintain price stability. Monetary financing of budget deficits and the bailing-out of insolvent governments are prohibited. In short, monetary policy in the euro area is protected more than any other against the possible negative implications of unsound fiscal policies.

I say this because I want to make one point clear. If the Governing Council of the ECB expresses its concern about fiscal developments and the implementation of the Stability and Growth Pact, it is not primarily because we fear the implications for price stability. We have the tools at our disposal to fulfil our objective. European citizens and business can rest assured that the ECB will continue to maintain price stability over the medium term. This is not what we are worried about. Our concern is that if the Stability and Growth Pact is not implemented properly, and if excessive deficits persist and public debt levels remain high or, even worse, increase, there will eventually and inevitably be a cost in terms of lower growth and employment.

What should be done?

If the Stability and Growth Pact is not working as well as we would like, what can be done about it? What should be done in view of the ECOFIN Council decision of last November?

Well, first of all, having made the commitments they did last November, France and Germany must keep their word. And if they cannot do so, the ECOFIN Council should keep its word and apply the next steps of the excessive deficit procedure. Abiding by the commitments made last November would, in my view, go a long way to restoring confidence. We at the ECB think that the decision taken last November was not the appropriate one. France and Germany and the ECOFIN Council can prove us wrong. And in this case I for one will be happy if I am proved wrong.

Beyond this, the question that seems to be on everyone's mind at the moment is whether the recent problems in implementing the rules and procedures of the Pact call for the Pact itself to be changed. My colleagues in the Governing Council and I are not convinced that this is either necessary or desirable. The current rules of the Pact have been agreed upon by all 15 EU Member States, because they make good economic sense. Just because you encounter problems here and there when you first try to apply the rules does not mean that you should re-write the rulebook.

Let me illustrate my views by drawing a comparison with the Highway Code. We all know that driving at excessive speed is dangerous. So for good reason, governments have introduced speed limits. We also know that speed limits have not eliminated speeding completely. Some drivers continue to speed. But this does not mean that you should abolish or revise the speed limits. It means that you still have a job to do in educating drivers about the dangers of speeding and in better enforcing the speed limits.

As in the case of fiscal rules, identifying the optimal speed limit under all circumstances is a highly complex task. Just as economic conditions can differ, so can driving conditions. But you cannot have speed limits that are constantly changing to suit all conditions. And you cannot have different speed limits for different drivers. The technology simply does not exist or is too expensive to put in place. And the driver as well as the traffic authorities would, in any case, become confused. Speed limits need to be clear and enforceable. And you have to rely on the authorities to implement them in a way that makes good sense.

In my view, the same is broadly true of fiscal rules in a monetary union. You need fiscal rules that are clear and enforceable, rules that are the same for everybody and understood by all. Fiscal rules such as those contained in the Pact cannot be optimal at all times. But this does not mean they are bad rules. It means that those responsible for law enforcement, in this case the Commission and the ECOFIN Council, have to implement them appropriately in the light of experience gained.

Recent experience has taught us that there is room for improvement in the implementation of the rules. We know, for example, that the current problems are partly due to the fact that governments failed to strengthen their public finances during periods of robust growth. So it would help to strengthen incentives for fiscal consolidation in good times. We also know that fiscal surveillance has been complicated by the difficulty of identifying underlying budgetary trends as well as by the quality of budgetary data and the - sometimes rather "flexible" - application of accounting rules. It would therefore help if we could improve our analysis of structural budget balances, the credibility of fiscal figures, and the effectiveness of the monitoring and auditing process. All such improvements, however, can be made within the current framework. They do not call for the EU fiscal framework itself to be abolished or re-written.

Ladies and gentlemen,

I have perhaps spoken for too long. But you did invite me to speak on a subject that is of crucial importance and that central bankers are passionate about. Some say that there is nothing a central banker likes more than to talk about fiscal policy. I think I have lent weight to that statement this evening.

Fortunately for me, members of the accounting profession are known for their long concentration spans and for their patience. You have certainly been an attentive and patient audience. I will not test your patience any further.

Thank you.