The crisis encountered by the Stability and Growth Pact has put the new enlarged Europe at a crossroads: either we get our act together and produce better checks and balances in our institutions or we are going to move down a path of looser fiscal policy and tighter monetary policy.

Both fiscal and monetary policy need the other to be predictable: a government needs the predictability of a transparent and consistent monetary policy to know how to conduct fiscal policy, and of course no monetary policy will be sustainable if poor fiscal policies lead to a rapid accumulation of debt. This is what Sweden witnessed in the 1980s and the 1990s. In the 1980s we had an unsustainable mix of fixed exchange rates and lax fiscal policy, which led to high inflation and eventually to a crisis that landed us with an even higher mountain of debt. When the regime collapsed in 1992 we introduced a target for inflation of two per cent, which today is hailed as a success. However, the real breakthrough for the new regime was in the mid 1990s when a forceful implementation of fiscal consolidation, supported by a broad political majority in parliament, made the whole macroeconomic set-up credible. It was then that inflation expectations among the public finally trended down to the target of 2 per cent, and that interest rate spreads against Germany were reduced to fractions of a percentage point. This fiscal tightening could in turn be based on the predictability of the new monetary regime that would eventually allow less severe monetary policies.

This interaction is rather well understood, if not always acted upon, at the national level. But on the European level there is a twist, as the single monetary policy is now matched by a multitude of fiscal policies. The risk that is often discussed is that the ECB would in the end have to bail out a single fiscally undisciplined country from unsustainable debt. But as the Stability Pact crisis has shown, the more immediate problem might be more prosaic than a cataclysmic debt crisis: the problem might be a bias towards fiscal laxity that has to be counterbalanced by tighter monetary policy - hence a bad policy mix.

With a single monetary policy the effect of fiscal stimulus in one country will be diluted in the whole area and will therefore by definition meet with less of a monetary policy response than it would if monetary policy had been national. Furthermore the nature of the political set-up makes it more difficult for the ECB to comment on individual national budgets. This means there will be a strong temptation to “free ride” by expanding the budget at the expense of fellow European nations. But the dilemma goes further - given that it is rational for others to expand their budgets it becomes rational for your own country to do so too - even if your instinct is not to “free ride”. Otherwise you might rationally expect to end up among the small minority that does not expand and at the same time still have the tighter monetary policy that results from everyone else expanding. This is the classic “prisoner’s dilemma” from game theory.

The conclusion is that it is necessary to have rules for fiscal policy that limit deficits and debt when monetary policy is united and fiscal policy divided, and that these rules need to be followed. But the conclusion is also that the pressure to over-expand is as strong during an upturn as during a downturn. In fact this is what we have seen in the euro zone during the heyday of the late 1990s - a much too expansionary fiscal stance in some euro zone countries, which led to tighter monetary policy and thus an incentive for others to weaken fiscal discipline. The euro zone then started the downturn with large deficits, considering the earlier boom, instead of surpluses. What the Pact then required, a 180-degree turnaround in fiscal policy to a tighter stance, reinforcing the downturn, was considered by some as stupid. In fact it was the lack of savings during the boom that was stupid. Thus, we would need rules not only like the Stability Pact, for a maximum deficit in a downturn, but equally some forceful rule for fiscal rectitude in good times. Those rules are difficult to state as clearly as the 3 per cent limit, but one way ahead could be to define annual targets for actual net lending based on the predicted output gap.

But why didn't we see these problems from the beginning? Perhaps because we were fortunate to have something that can work as a temporary replacement for rules: clear objectives, strong leadership and the market as a quickly reacting judge. This existed not so long ago in Europe. The objective was to join the euro zone and achieve the convergence criteria. The leadership was provided...
by Germany both in terms of its economic size and its example of fiscal discipline. Now the objective of joining the euro has been achieved, and, in addition, Germany has lost its leading role and the markets react less to fiscal laxity.

Instead of leadership towards clear objectives we have recently seen the opposite - the political exploitation of the gap between the national and European level. The requirements of the Pact are blamed on heartless “accountants in Brussels”, and when a majority puts narrow national political interests first the agreed rules become moot - “peer pressure” becomes “peer protection”. Incorrect facts are more or less deliberately sent to the Commission ahead of sensitive elections. In fact, a recent study by the ECB shows that the closer a country comes to an excessive deficit, the more likely it is that the forecast the government presents officially will later turn out to be wrong. There is a strong bias towards unrealistic optimism once a country’s deficit approaches 3 per cent of GDP.

Let me say something in this respect about the new member states. It is all too apparent that the collapse of Germany’s leading role in fiscal discipline has also set a bad example for some of the larger new member states. Given that public finances have deteriorated so much in Poland, Hungary and the Czech Republic during the first years of this century it is fortunate both for themselves and for the euro zone that these countries have postponed joining ERM II and the attempt to rapidly adopt the euro. Had they tried and locked their currencies within ERM II they may well have stayed in that position for a long time, becoming in the meantime targets for speculation - as their poor public finances would have lent little credibility to their overall economic policy. This was Sweden’s experience with the combination of a currency peg and deteriorating public finances in 1991-1992. But now there is another danger. Given that the target of imminent euro adoption is gone, and the large euro zone nations do not provide real leadership on fiscal soundness, there is less incentive for some of the new member states to stick to the consolidation of their public finances from today’s deficits above 5 per cent of GDP. The consolidation plans are already too dependent on a continued upturn.

Whether in the old or new member states, there is an additional problem, as we are entering a period of intensifying structural changes. Old industrial patterns in Europe are being changed when confronted with both the boost to productivity from IT, as partly realised since the late 1990s in the US, and globalisation and enlargement, all of which supports this process. These trends will eventually help productivity and growth in Europe to start to catch up with the US again. But in the short term the structural changes will lead to higher frictional unemployment as old industries are more rapidly replaced by new ones. In addition, the recent downturn never led to a dramatic increase in unemployment or decrease in employment in the euro area; hence, the upturn is probably also less likely to lead to rapid job creation. Both factors create new incentives for fiscal policy to focus more on short-term job creation schemes and less on long-term fiscal soundness. So from this perspective, too, the hope that the recovery alone will “fix” the European deficit problem might be too optimistic.

And the new member states are not much different in this respect. They have experienced a decade of incredible structural change, and yet more is ahead. Furthermore the new member states have great infrastructure needs and, coupled with high unemployment, there will be continued pressure for fiscal expansion, even in a cyclical upturn.

So what is the solution? Let me first note an interesting development: since 1999 the average fiscal deficit in the euro area has been 1.6 per cent of GDP while the average surplus of the three old countries (the UK, Denmark and Sweden) has been 0.5 per cent of GDP.

Some Euro-sceptics will of course attribute this difference to monetary union itself but I think the difference is that all three out-countries have been forced to find new ways of building a strong national macroeconomic framework based on clearly stated goals and a transparent evaluation of how these goals are to be met, in addition to the common EU rules. The part that has been much in focus has been the monetary policy regime - in Sweden and the UK, inflation targeting with a specific target for inflation and regular and transparent inflation forecasts has worked well. But inflation targeting, or for that matter Denmark’s euro peg, would never have been as successful had fiscal policy not been reformed in parallel, with clear rules and budgetary ceilings in all three out-countries, which put the problems squarely in the sight of the public. In fact those euro zone countries that have some sort of national transparent targets and evaluation of fiscal policy, such as Finland, have managed to retain some order in their public finances.

The power of targets and transparency is that the public, with the help of comments from analysts in the media, can evaluate clearly how the government is doing in relation to a long-term norm. The idea of being on or off target is quite easy to grasp, and if the process is transparent, experts and the public alike will learn to trust the figures. In this area most countries still have a lot to do. It is a pity that
government accounts, which affect everyone in a compulsory way, are less transparent, less well audited and less understood as the accounts of companies listed on the stock exchange, which only affect very few people and at their own risk.

Sweden has a target of a 2 per cent surplus for the public sector over the business cycle, a figure that includes pension savings and that, given an ageing population, is in fact akin to targeting a balanced budget over the cycle. This target is present in the debate of every budget. The National Institute of Economic Research comments on the target and helps the public to understand it. This keeps the government accountable not only in the normal political sense but also in relation to the targets agreed upon. The political debate is in a sense being taught to keep the long term in view. The public then knows from the national debate that fiscal discipline is good for the country and if “accountants” or other nations in Brussels criticise your budget policies, there is a greater chance of the criticism being interpreted as a help towards fiscal soundness. The Swedish trade unions, for example, are among the most vocal defenders of our budget target.

However, the framework might still not be strong enough - the 2 per cent over-the-cycle target has been slipping somewhat out of view given that the government, as I mentioned, is focusing more on the short term recently. Sweden would perhaps need an even more formal external fiscal evaluation.

This leads to an important conclusion for the Pact. Perhaps the solution to regain credibility is neither to water down the Pact, nor to impose even stricter rules centrally. The solution is perhaps to build from below - to complement the European level with national frameworks in the respective European nations so that they come to internalise the need to balance their budget over the cycle and to ensure that the same transparency exists on the fiscal side as on the monetary side. While pressure from fellow finance ministers has apparently not worked well enough, the present attempts at national processes with transparent targets have a better track record.

Why not have all EU countries commit themselves to establishing independent bodies with the responsibility of enhancing transparency by conducting independent forecasts of the countries’ deficits and providing recommendations on a regular basis? They would have only an advisory role and their authority would stem from impartiality and expertise. The subject of their recommendations would be the overall fiscal stance - neither the specifics nor indeed the political orientation of fiscal policy. The Excessive Deficit Protocol (EDP) states that member states shall ensure that national procedures in the budgetary area enable them to meet their obligations. It would therefore be in the spirit of the EDP to have EU countries commit themselves to establishing these kinds of bodies.

At the very least, these independent bodies would be able to make more reliable and unbiased forecasts as a basis for EU recommendations. Such an arrangement would avoid having unreliable deficit figures before elections, only to “discover” the real state of accounts after the vote - such as has been the case in Portugal, France, Germany, and most spectacularly in Greece recently. By having a similar role as the Congressional Budget Office in the US, the bodies would ensure a reliable and unbiased “reality check” in times of fiscal profligacy.

At best the advisory bodies would create a continuous national dialogue with warnings and recommendations to politicians that would boost transparency and put long-term fiscal goals at the heart of the debate - a reinforced version of the process that has helped Denmark, the UK and Sweden to improve fiscal soundness.

The experience of central banks is that transparency and goals help form expectations and behaviour, enlisting the public in the struggle for macroeconomic soundness. After a while, the discipline that initially seemed practically unattainable becomes almost natural.

Thank you.