Axel A Weber: Stability and growth

Closing remarks by Professor Axel A Weber, President of the Deutsche Bundesbank, at the European Banking Congress, Frankfurt, 19 November 2004.

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1. Introduction

Ladies and gentlemen

Although I have been entrusted with delivering today's closing remarks, I am unwilling to say goodbye to Lisbon.

The Lisbon agenda started off as a visionary project in March 2000, which was at the very peak of the hype surrounding the New Economy, the pinnacle of irrational exuberance in the stock market - if I may refer thus to Alan Greenspan -, and the high point of overconfidence. At times like those, visions tend to become oversized - which is fine for visions.

European Monetary Union started off once as a seemingly oversized vision, too. The original plan was aired as early as 1970. From then on, it took more than 30 years before you could feel the change in your pocket. Now that we are almost six years into the euro era, we can safely conclude that the euro was a vision worth pursuing. The vision of a stable single European currency has come true.

The Lisbon project basically aims at boosting the EU member states' potential for dynamic growth. Progress towards the Lisbon goal hinges crucially on the efforts of national governments. For keeping up spirits during the nitty-gritty of making this vision become reality, European leaders need, as the Kok report rightly states, "to instil (the) hope that tomorrow will be better than today". This visionary stance contrasts sharply with the present reality, where there is a prevalent, rather vague sense of Europe being an underachiever.

2. Institutional foundations of stability

The two big European visionary projects - EMU and the Lisbon agenda - are interrelated. First, reinvigorating the growth dynamics in Europe is crucial for fully exploiting the potential of a stable single currency. Second, sustainable economic growth requires more than Lisbon-style reforms; price stability is of the essence for sustainable economic growth. Stability and growth go hand in hand.

Stability must be safeguarded by a cleverly designed institutional framework that generates proper incentives. I very much welcome the fact that this year's Nobel Prize for Economics rewards theoretical research on the importance of a sound institutional setting. It should come as a useful and timely wake up-call for those who are, in effect, contemplating watering down the institutional foundations of the euro's stability.

Reforming the Stability and Growth Pact under the pretext of rendering it more growthfriendly would be the wrong path to take. There is no such thing as the alleged trade-off between economic growth and fiscal prudence! Nor is the budgetary discipline to be guaranteed by the Stability and Growth Pact a hardship that central bankers wish to impose on finance ministers. Budgetary discipline is a "must" in a monetary union of sovereign states. That is because the consequences of fiscal misbehaviour would have to be borne by all the participants in the form of higher interest rates - which in itself might weigh on growth. In history, currency unions used to fail due to a lack of fiscal commitment. Fiscal rules are of the essence, and they need to promote sustainable fiscal positions.

The Maastricht Treaty enshrines the core fiscal rules of the EU: the obligation to avoid excessive deficits, the practice of budgetary surveillance, and the excessive deficit procedure. The Stability and Growth Pact clarifies these rules and puts them in more concrete terms: member states have committed themselves to the aim of achieving budgetary positions close to balance or in surplus and to submitting to annual stability (or convergence) programmes. Rules need to be straightforward, transparent and binding. In its present shape, the Stability and Growth Pact is straightforward and transparent. Its Achilles heel lies in its unsatisfactory lack of binding character in practice.

3. Changes to the Stability and Growth Pact

Let me comment briefly on the changes now envisaged for the Stability and Growth Pact. This week the ECOFIN Council discussed the "strengthening, clarification and better implementation" of the Pact. The new framework is scheduled to be finalised in spring 2005. The debate keeps on going under its own momentum, and new proposals are constantly being ventilated.

Against this backdrop, it may be worthwhile recalling the basic economic idea behind the Stability and Growth Pact: Sound public finances are to prevent the emergence of conflicts between monetary and fiscal policies right from the outset. The state of sound public finances is characterised by a balanced budget and a low level of public debt. This state of sound public finances is to be realised as soon as possible. Nobody has ever refuted the underlying economic rationale of the Stability and Growth Pact. Thus, the Pact suffers from neither a lack of economic reasoning nor a lack of clarity.

For a monetary policymaker committed to stability, the ongoing debate on revising the Stability and Growth Pact is utterly uninspiring. Placing greater weight on the long-term sustainability of public finances sounds reasonable; however, this provision should not be used as a "back door" for introducing all kinds of exceptions. Discriminating between good and bad types of expenditure is of no help either. I have serious misgivings about any endeavours to loosen the obligation to trim excessive deficits in a speedy manner and about tolerating excessive deficits in periods of economic stagnation or low growth.

Overall, the debate on reforming the Stability and Growth Pact has the air of reshaping the rules to fit current fiscal practice - instead of reshaping fiscal practice to fit the pre-agreed rules.

Basically, the proposals now under discussion amount to substituting discretion for rules. The implications of this paradigm shift must be borne in mind: heightened complexity, reduced transparency, and discarding the principle of equal treatment. Abandoning rules in favour of discretion would represent a major step backwards. EMU was once meant to be placed on a solid institutional foundation instilling credibility. Rewriting the Pact as envisaged would deal another blow to the credibility of the fiscal framework of the monetary union. From the viewpoint of a monetary policymaker committed to stability, the envisaged change to the nature of the Stability and Growth Pact would not yield any major benefits. It could, however, come at a great cost.

4. Fiscal policy and structural reforms

The growth policies agreed on in the Lisbon agenda are, amongst other things:

- the completion of the internal market,
- stimulating competition and deregulating the product markets,
- reforms improving flexibility in the labour market,
- generating a climate conducive to entrepreneurial activity, to research and development.

I very much support this agenda. I do, however, not support proposals which, with reference to the Lisbon agenda, suggest that expenditure related to growth policies should be disregarded when calculating the deficit. In my, view, using the Lisbon agenda as an excuse for weakening the Stability and Growth Pact amounts to upending conventional economic wisdom. The correlation between debt and deficits, on the one hand, and economic growth, on the other, is negative. Never in economic history have spendthrift policies produced sustainable growth. The opposite is true, and all the more so as all European countries have to brace themselves for sharply rising fiscal costs resulting from the pending demographic shift in an ageing society. Loosening budgetary discipline is no viable option for promoting economic growth. On the contrary, it would undermine the long-term sustainability of fiscal positions and thereby weigh heavily on future growth.

Public finances in Europe are already characterised by a large sustainability gap. Future pension obligations in most countries are several times higher than the explicit debt burden revealed in the national accounts. By a very rough calculation, it would, for example, take Germany three and a half years' output to honour its combined explicit and implicit debt. If future generations are to handle this sizeable burden - in Germany as well as elsewhere - there is, first, no way of getting around a tough course of fiscal consolidation, which has to be augmented, second, by coherent policies to lift growth potential - as agreed on in the Lisbon agenda.

I appreciate the fact that, last year, Germany directed its attention to structural reforms in the spirit of the Lisbon agenda - even if this was driven more by the "push" of persistent economic stagnation than by the "pull" of the Lisbon vision. Under the Federal Government's "Agenda 2010", labour market flexibility has been improved in terms of the institutional framework, collective wage bargaining agreements and working hours. Reforms in the social security systems have been enacted and will help to contain the implicit debt burden. Among the remaining tasks, priority status should be given to untying the link between labour costs and social security and to raising the statutory retirement age.

5. Concluding remark

Stability and growth go hand in hand. The Lisbon agenda and the Stability and Growth Pact complement each other in lifting the EU's growth potential. Both are needed and we should not say goodbye to either of them.