Otmar Issing: A framework for stability in Europe

Speech by Professor Otmar Issing, Member of the Executive Board of the European Central Bank, at the University of London, European Economics and Financial Centre, London, 19 November 2004.

1. Introduction

The formation of Economic and Monetary Union (EMU) has created a framework for economic policy-making in Europe which is unique in history. While the single monetary policy is oriented towards a union-wide objective, namely the maintenance of price stability, the other policy areas - involving fiscal and wage policies - largely remain the competence of national governments and other national actors, such as the social partners.

The combination of a centralised monetary policy and decentralised other policies has led to the evolution of a new set of rules and objectives for national and supranational policy-makers. The Maastricht Treaty and the secondary legislation, including the Stability and Growth Pact, established the basic set of rules and objectives to lay out a framework for stability in Europe.

2. Responsibilities under the “Maastricht assignment”

With regard to monetary and fiscal policies, the assignment of responsibilities is defined by the Maastricht Treaty and the Stability and Growth Pact, respectively. The Treaty has assigned the maintenance of price stability as the primary objective to the single monetary policy conducted by the ECB for the euro area as a whole. Without prejudice to its primary objective, the ECB shall support the general economic policies in the European Community. For fiscal policies, which continue to be largely a national responsibility, the Treaty sets out a framework of surveillance and disciplining mechanisms in order to maintain sound public finances. These indispensable cornerstones of the institutional framework agreed in Maastricht have been confirmed by the Constitution recently signed by the Heads of State and Government in Rome.

The Stability and Growth Pact, which was agreed by all governments in 1997 after the signing of the Maastricht Treaty but before the launch of the single currency, sought to provide additional incentives for maintaining fiscal discipline at the national level by operationalising the excessive deficit procedure of the Treaty. It also specifies a commitment to achieving medium-term budgetary positions “close to balance or in surplus” and incorporates multilateral surveillance procedures and the exchange of information in conjunction with medium-term stability programmes submitted by national governments.

Assigning the overriding objective of price stability to the single monetary policy is an example of the benefits of a clear division of responsibilities between different policy actors. The delegation of the single monetary policy to an independent central bank enhances credibility, increases transparency and also facilitates accountability. Similarly, the Stability and Growth Pact provides a basic set of rules for the conduct of sound and disciplined fiscal policies by national governments, while in principle preserving sufficient room for manoeuvre for the operation of automatic stabilisers without infringing the 3% ceiling for the deficit-to-GDP ratio.

Of course, safeguarding the soundness and discipline of fiscal policies that largely remain the competence of national governments presents a particular challenge. Ultimately, it must be ensured that twelve national budgets taken together are consistent with sustained stability for the euro area as a whole. In this regard the Stability and Growth Pact provides for a clear allocation of responsibilities between the Commission and the ECOFIN Council. The Commission is responsible for compiling the necessary information and analysis for effective multilateral surveillance, for formulating recommendations for decisions by the Council, and for overseeing the correct application of the Pact. The Council is responsible for taking the final decisions and it thus has the ultimate responsibility for enforcing the Pact. These two principles of surveillance and enforcement form the basic idea of the Stability and Growth Pact and must not be put into question.

Having said that and in the light of the ongoing discussions on the future of the EU fiscal framework, let me re-affirm the ECB’s view that the Stability and Growth Pact is appropriate in its present form, but that there is scope for improving its implementation. Specifically, given that the experience with the Pact since 1999 has been mixed at best, there is a need to provide enhanced incentives to comply
with the commitments under the Pact and to increase peer pressure towards enforcing the rules. At the same time, there is a need for increasing the awareness of the basic principles underlying the surveillance and enforcement process. Ultimately, this requires striking a delicate balance between the sovereignty of national governments, the responsibility of the ECOFIN Council for enforcing the Pact and the independence of the Commission, the latter being essential for an effective assessment of national budgetary positions.

The ECB has always considered the fiscal rules enshrined in the Treaty and the Stability and Growth Pact as an essential element of Monetary Union. These rules already contain significant scope for flexibility. While the implementation of the preventive arm of the Pact could no doubt be strengthened, in particular to enhance incentives for compliance in good times, we reject proposals that would undermine the Pact’s corrective arm and the excessive deficit procedure contained in the Treaty.

If all policy areas concerned respect the aforementioned allocation of objectives and responsibilities and act accordingly, they will already be making the best possible contribution to the Community objectives.

3. A sound institutional arrangement

A clear allocation of responsibilities is essential for well-designed policy-making, especially in a complex institutional set-up as the one governing monetary union in Europe. At the same time, a continuous dialogue between different policy actors on the basis of the allocation of tasks is also important for effective governance. An open exchange of views and information between individual policy actors - without any commitment or mandate to take and implement joint decisions - will strengthen economic governance if it manages to improve the common understanding of the objectives and responsibilities of the respective policy areas and does not dilute accountability.

The central legal basis for economic policy co-ordination among Member States within monetary Union is specified in Article 99 (ex 103) of the Maastricht Treaty, which states that “Member States shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council.” On the basis of this principle, the framework for the definition of economic policy priorities is provided by the “Broad Economic Policy Guidelines” adopted by the Council each year. These channels for policy co-ordination among Member States do not involve the independent monetary policy of the ECB.

Any form of exchange of views and information, however, should clearly be distinguished from an attempt to co-ordinate macro-economic policies ex ante, which would give rise to serious information, incentive and enforcement problems. Ex ante co-ordination among different policy actors would blur the fundamental responsibilities of the respective policy areas under the Treaty. This, in turn would reduce accountability of individual policy actors and ultimately increase uncertainty about the policy framework.

Given the Eurosystem’s monetary policy strategy, there should be no ambiguity how the single monetary policy will respond to developments in fiscal policies and wage settlements to the extent that they will affect the maintenance of price stability. As a result, national governments and wage setters alike should be able to design and implement the policies under their responsibility in a manner that allows for the interdependencies of these policies with the single monetary policy. Obviously, if they take the single monetary policy’s credible commitment to maintain price stability as given, this will help to align expectations and condition their behaviour in a favourable way. National governments and wage setters, in turn, are reassured that monetary policy will respond favourably to appropriate fiscal policies and wage settlements which allow to maintain price stability over the medium term.

Sustained stability - be it maintenance of price stability or stability in a wider sense - needs a sound institutional framework. As regards monetary policy the independence and clear mandate of the ECB provides the best possible arrangement. At the same time it is obvious that a monetary union which is not a mature political union also requires a framework for fiscal policy. This framework must respect the sovereignty of national governments and parliaments on the one hand and the need to ensure sound fiscal policy across the euro area on the other hand.

Both, sound monetary and fiscal institutional arrangements are indispensable for a consistent and sustainable stability framework. The success of EMU rests not only on the ECB and its monetary policy but also on a robust framework for national fiscal policies.
On 1 May 2004 ten more countries joined the EU - all of them committed to join monetary union one day. The framework for stability already plays the role of an anchor for guiding convergence as shown e.g. in the Convergence Reports of the ECB and the European Commission. The new member states see the euro as the centre of gravity. This makes it all the more important that the basic rules of the game underpinning the existing framework for lasting stability in Europe are not put at risk.

No doubt the institutional framework for EMU is at a critical juncture. At the same time one must not forget the fact that the first (almost) six years of the euro have been a resounding success. Notwithstanding severe exogenous shocks the stability of the currency has been preserved, inflation expectations have remained under control and the ECB has earned a degree of credibility which is outstanding for a new institution.

Also the role played by the fiscal framework should not be underrated. The consolidation of public finances achieved during the latter half of the 1990s in many European countries had been unthinkable only a few years previously. These achievements must not be thrown away but need to be re-enforced to build a strong and stable future for Europe.