Lars Heikensten: Stability and Growth Pact needs reinforcement

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at a conference organised by the European Commission, Brussels, 15 December 2004.

*   *   *

Thank you, Mr Chairman.

I very much appreciate this opportunity to comment on the work of the Commission. Perhaps the invitation is particularly pleasing for me as, unlike the other members on the panel, I do not come from a country that has introduced the euro.

I should also immediately say that I very much enjoyed reading the background report and the communication on the Stability and Growth Pact produced by the Commission.

Let me begin by characterizing the experiences from the Monetary Union so far. There is no doubt that the regulations on fiscal policy laid down in Maastricht had clearly positive effects up until the euro was launched. They are still having the same impact on those countries that remain outside the single currency and have the ambition of joining in the future. Far-reaching measures were taken, and are also being taken today, to enable entry into the Monetary Union. Noting the progress, some people have even claimed that earlier less well-functioning national economic-political cultures have been replaced by a more stability-oriented common European culture. But since the start of Monetary Union, this momentum has been lost. Several countries have returned to their old behaviour even though there are good examples of the contrary. And this is not primarily the result of an unusually long slowdown, as many have claimed. The preceding boom was also unusually long. Furthermore, we knew that there were large risks associated with the fiscal policies conducted in the initial years of the Monetary Union. The discussions on fiscal policy were occasionally rather acrimonious in the EFC, for example. Several of us gave clear warnings regarding the fiscal policies pursued by, for instance, France and Germany at the time. The Stability and Growth Pact obviously did not serve as the deterrent it was supposed to be, at least not sufficiently. Nor did EMU - so far anyway - contribute as much as we had hoped to making the European economy more efficient. Perhaps there are a few exceptions here related to the financial sector and the financial markets.

It is my intention in this introductory remark to focus on some suggestions for the future. In doing this, I will talk about macroeconomic issues, rather than dealing with the severe structural challenges Europe is confronted with. However, before doing this let me make a general comment.

In the present debate some conclude that the current policy framework should be relaxed, which is normally expressed as saying it should become more flexible. I have difficulty understanding this view. On the contrary, I think the developments in recent years have strengthened the arguments in favour of a regulatory framework. From the start there were concerns about “free riders”. These concerns were confirmed sooner than expected. There was also some unease that small countries could be affected if the larger ones did not maintain discipline. Here, too, developments have given cause for concern, at least as regards the implementation of the regulations. Allow me to add a third argument. During the decades before the start of Monetary Union, economic policy in the EU was dominated by Germany. This was because of Germany’s size, of course, but it was also due to Germany’s economic success over several decades and its stable economic policies. There was almost a moral dimension to Germany’s actions. I still remember the meeting in the Monetary Committee when it became clear that Germany’s public finances in the coming years would be as weak as Italy’s. The dynamics in the room changed as if by magic. Since then no country has been able to take over the leader’s mantle. In such a situation peer pressure can easily turn into peer protection.

Let me now turn to the future. In doing so I have tried to be constructive and limited myself to proposals I believe to be politically feasible. I will be happy to return to any of the subjects I will bring up.

I. My first point concerns the division of labour and the cooperation between fiscal and monetary authorities. This is firmly established in the Treaty. The only uncertainty relates to the responsibility for exchange rate policy. Of course all parties must respect the existing rules. The demands that fiscal authorities can impose on the ECB are that the bank conducts a clear, consistent monetary policy aiming at price stability for the Union as a whole, which can be understood and predicted. In the same way the authorities responsible for monetary policy should be able to count on a clear, predictable and long-term fiscal policy targeted at achieving balance over the economic cycle (after taking account of the demographic changes that now lie ahead). More generally, I think that we in Europe should model our approach on cooperation between the monetary and fiscal authorities along the lines of the relationship between the Fed and the Treasury during the Clinton years. Europe would also be better off if the finance ministers followed the advice of my British colleague at a recent meeting “ask not what the ECB can do for you, but what you can do for the ECB”. There may also be a need for more collegial leadership from the euro area’s finance ministers, particularly if rapid coordinated action is required, something that can not be ruled out. One example could be a situation with a dramatic and substantial change in the exchange rate, another a financial crisis. A strong Euro-group with a respected chairman should be positive in this regard and should facilitate an effective dialogue with the ECB.

II. Allow me now to comment on the Stability and Growth Pact itself.

It is not difficult of course to see economic arguments in favour of amending the Pact. However, one fundamental problem is that it is difficult to see how a relaxation of rules in certain areas could be compensated by a purposeful tightening in others. Relaxing the 3 per cent rule would thereby imply a weakening of the construction as a whole at a time when - as I mentioned earlier - the conduct in some countries suggests that if anything the opposite appears to be required. There is already flexibility in the regulatory framework for different interpretations of the phrase “exceptional circumstances”. To increase this flexibility by allowing for country-specific factors on a general level would lead to risks. In particular, there is a risk that the rules would be interpreted too much ex post and that small countries would be discriminated against even more than is already the case.

However, there is room for substantial improvements in the preventive arm of the Pact. The Achilles’ heel of the Pact is not actually the 3 per cent limit but its asymmetry; the pact involves gentle warnings in booms but hard sanctions in slowdowns. This means that the pact lacks credibility when, after impotently highlighting indiscipline during booms, it is expected to force governments into highly painful, 180-degree turns towards austerity during slowdowns. It also risks contributing to procyclical policy.

Against this background the Commission has worked hard on improving the preventive arm in recent years. I have sympathy for many of their proposals. Some examples:

- Strengthen incentives in good times. Here, considering the debt level could play a role.
- Timetables could be improved - linking them more closely to national processes.
- Using the now more developed measures of cyclical balances could also be useful in this context.

In general, I think it is important to enable the Commission to dig deeper into these areas and to increase the comparability between different countries. On the basis of this work the Commission’s role should be strengthened as regards giving “early warnings” and proposing measures. I also believe that the Commission should have the task of emphasising its analyses and going public more than it does today, thereby being more effective in the general debate in the individual member states.

III. My third point has to do with consolidating the fiscal institutions and regulations at national level. Here a lot more can be done.

One aspect that too often seems to be forgotten in the debate on the pact is that a balanced, countercyclical fiscal policy is not just a common European interest; it is in the individual interest of each country. Some politicians contribute to this misunderstanding when they depict the commonly adopted criteria as an unreasonable burden from “accountants in Brussels”. One manifestation of the same attitude is the recurring problems with the data that are sent to the Commission. Instead of having a transparent process, increasingly unrealistic figures are being delivered. There are several examples of governments reporting data before an election that after the election proved to be misleading.

The best, and perhaps the only, antidote to these problems is institutionalised transparency; promoting a regular, public debate on sustainable government finances at the national level. This was the Riksbank’s approach ahead of Sweden’s referendum on the euro. We recommended in this context a model that drew on the experience we have gained from conducting a monetary policy with definite, clear targets, consistent openness regarding background material such as forecasts and regular and open assessments and debates.

Key steps in this regard could be taken by any country that wants to do so. But increased support could also be provided by way of common decisions at European level. Technically, the Excessive Deficit Protocol already contains an explicit commitment to create national institutions with a view to developing a fiscal policy framework. The EU leaders can now realise this commitment.

We can also learn from each other in this process. The Commission was quick to perform benchmarking of budget systems in different countries back in the early 1990s. This was of use to Sweden when we reformed our budget process after the crisis in the early 1990s. The Commission could start up this work again. Countries could be studied, compared and put under the spotlight if they have poor fiscal policy institutions. In this way the national debates could be influenced.

Allow me now to conclude with one general reflection in relation to my introductory comments.

Many of us had hoped that the EMU project would be able to contribute to a faster change of our economies in a growth-oriented direction. In some countries there has also been less focus on short-term stabilisation policy issues - if interest rates are 25 basis points up or down - which are not significant in the long run for economic performance, and more on long-term questions that are crucial to growth and prosperity. Comments from the Commission and the ECOFIN council have also had the desired effect in a number of countries. Policies have been put on the right course.

But the exact opposite tendency exists in other countries. The problems are being shifted on to monetary policy, which is being conducted at such a distance that the decision-makers can be blamed without repercussions. Politicians have also tried to take advantage of the situation domestically by making it appear that they are not bowing to Brussels.

The crucial issue for EMU in the period ahead is which of the two approaches will gain the upper hand. If the first approach prevails it will go well. But if the second approach dominates the opposite will be the case. So the trick is to find a system for governance that pulls in the first direction; that focuses both national and European debates and policies on the real issues.

Thank you.