Eva Srejber: Greater budgetary discipline in the EU through transparency and national ownership

Speech by Ms Eva Srejber, First Deputy Governor of the Sveriges Riksbank, at a breakfast seminar organised by Ernst & Young, Stockholm, 26 September 2006.

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Fiscal and monetary policy are interdependent. A government needs transparent and consistent monetary policy to know how to conduct fiscal policy. Similarly, no monetary policy will be sustainable if there is a rapid accumulation of debt. This is what Sweden witnessed in the 1980s and the early 1990s. 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, General Council decided that the Riksbank should work towards a direct inflation target. The Riksbank determined that the target would be two per cent. Today this policy 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 macroeconomic set-up as a whole credible. It was only then that inflation expectations among the public finally fell to the target of 2 per cent, and interest rate spreads against Germany were reduced substantially.

This fiscal tightening could in turn be based on the predictability of the new monetary regime with a clear inflation target. And the tighter fiscal policy would eventually allow less restrictive monetary policy.

Why are budgetary rules needed at EU level?

This interaction is fairly well understood, if not always acted upon, at national level.

But at the EU level there is an extra dimension. Many countries' fiscal policies are now matched by a single monetary policy. One possible risk is that the ECB would in the end have to bail out a fiscally undisciplined country from an unsustainable debt. However, many EU member states' unwillingness to meet the Stability and Growth Pact has shown that problems can arise before matters have gone as far as to a full-blown 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 that there will be a strong temptation to "free-ride" by expanding the budget at the expense of fellow euro area 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 in a credible fashion.

But, in addition, the conclusion is also that the temptation to over-expand is as strong during an upturn as during a downturn. In fact this is what we have seen in the euro area during the heyday of the late 1990s and the beginning of the 21st century – a much too expansionary fiscal stance in some euro area countries, especially in good times, which led to tighter monetary policy by the ECB and thus an incentive for others to further weaken fiscal discipline.

When the downturn eventually came, the euro area entered this phase with large deficits instead of surpluses. What the Pact then required, a 180-degree turnaround in fiscal policy to a tighter stance, reinforced the downturn and was considered by some as stupid. In fact it was the lack of savings

during the boom that was stupid. Thus, rules would be needed not only for a maximum deficit in a downturn, but equally some forceful rule for fiscal rectitude in good times.

How has the Pact changed?

The fiscal problems encountered by some countries during the downturn triggered a change of the Stability and Growth Pact. In my view, changes were necessary and many of the amendments to the Pact go in the right direction. However, some of them make the framework less predictable.

The change consists of three parts: better governance, changes in the preventive arm and changes in the corrective arm.

Better governance

Better governance includes better budgetary discipline at national level, more realistic forecasting and more reliable statistics. National budgets should be complementary to the member states' commitments under the Stability and Growth Pact. National institutions could play a more prominent role in budgetary surveillance through increased attention to the development of public finances in public opinion. But apart from those general words, the reformed pact does not spell out any guidelines for appropriate developments of national institutions. Within the EU we have now begun to analyse various forms of national regulations. I hope that the continued work will lead to stronger anchoring of fiscal policy among the member states. I will return to this question a little later.

More realistic forecasting consists of having some common assumptions, mainly on external developments, in the stability and convergence programmes. The experiences from the first year of the reformed Pact indicate that it has led to more realistic national growth forecasts.

More reliable statistics refer to budget data problems ranging from creative accounting via methodological problems to understaffed and non-independent statistical compilers. The problems are tackled by strengthening Eurostat and allowing it to make methodological visits in the member states, to discuss budget issues. A new high level group with a mandate to advise Eurostat will be established. As Eurostat monitors the member states' compliance with the agreed practice, the high level group also, indirectly, advises the member states.

My view is that all the reforms in this area of the Stability and Growth Pact go in the right direction since they encourage fiscal prudence. However, given the complicated process and the short time since the Pact was changed, it is too early to determine whether the changes have been a complete success.

Changes in the preventive arm

Changes in the preventive arm have been made in the area of medium term objectives (MTO) for the budget balance. Member states are divided into groups depending on their debt level. Stricter MTOs are required for countries with higher debt. The MTOs for the euro area and the ERM2 countries range from a deficit of 1% of GDP to balance or surplus depending on the debt level.

The countries that have not achieved their MTOs are supposed to follow an adjustment path to the objectives. The path requires more consolidation in good times. For the euro area and ERM2 states, the adjustment requirement is a yearly improvement of the cyclically adjusted deficit net of one off effects by 0.5% of GDP.

This is a strengthening compared to the earlier agreement among the euro area countries, changing the requirement from targeting the cyclically adjusted deficit to targeting an improvement in the structural deficit. When deciding the adjustment path, public investment and structural reforms can be taken into account. If structural reforms are to be taken into account, they should have a large and proven positive effect on the economy and there should be a safety margin to the 3% deficit floor.

My view is that there is a possibility to use the newly defined MTOs in a wise manner, more closely adapted to the situation of the individual country. However, the scope for interpretation is so large that there is a high risk of lax and uneven implementation. The experiences of the first year indicate that some member states have more ambitious MTOs than required by the Pact. This is often countries with their own national budgetary rules, such as Sweden, which comprise MTOs. At the same time,

there are other member states who need to do more to achieve their MTOs. The measures are often postponed too far ahead and are not sufficiently explicit and concrete.

Changes in the corrective arm

The third part of the changes refers to what happens when a country has an excessive deficit. As before, exemptions can be granted if the country is suffering from a severe economic downturn that it could not foresee, so called exceptional circumstances. The definition of a severe economic downturn has been changed, however. According to the old agreement, a country experiencing a fall in GDP of 0.75% could be exempted from the EDP and a fall in GDP by 2% always led to exemption. Now the GDP requirement is changed to negative growth or a period of very low growth relative to potential.

Exemptions can also continue to be granted by taking into account other relevant factors, on condition that the deficit is temporary and close to the reference level. But the number of other relevant factors to be included in the judgement of whether an EDP should be initiated or not has been increased. Such factors now include not only public investment but also potential growth, the Lisbon agenda achievements, R & D, pension reforms, international solidarity, and European policy goals.

In my opinion, there is a risk here that the Pact could be interpreted differently and be applied differently to different countries. It will therefore be important to closely follow up how the revised Pact is applied in this respect. So far, however, no exemptions have been granted under the new Pact. The countries that have exceeded the three per cent limit have also been assessed to have an excessive deficit.

If countries are found to have an excessive deficit, they now can have a longer time frame for taking effective action to correct the deficit and a longer timeframe to the initial deadline for correcting the excessive deficit. Normally, the timeframe will continue to be 2 years after the excessive deficit occurred. However, the revised Stability and Growth Pact now allows for the possibility to extend this timeframe to 3 years. In my view, this is a positive change since the earlier system in practice meant that countries only had a few months to correct an excessive deficit, and this did not increase the respect for the Stability and Growth Pact. However, in addition, a possibility to revise the initial deadline has been introduced which creates a risk for an excessively prolonged EDP.

To summarise, some of the changes in the Stability and Growth Pact thus go in the right direction and might enhance the discipline, while other changes introduce a flexibility that could be abused. As always, the proof of the pudding is in the eating. So far, budget plans have not moved in the stricter direction despite the fact that growth prospects have improved. The yearly average deficit for the euro area will stay at about 2.4% of GDP for the next couple of years according to present plans. The structural deficit is expected to improve only marginally between 2005 and 2006 – from 2.2 to 2.1 per cent – despite a strong economy. It is important to stock up now ready for future times with lower growth. The recovery and consolidation of the EU’s largest economy, Germany, is of central importance in this context.

Why have we not seen the problems earlier?

The question is why we didn’t see the problems in the Stability and Growth Pact from the beginning? Perhaps because we were fortunate to have something that could work as a temporary replacement for rules: clear objectives, strong leadership and the market as a quickly reacting judge. Most countries wanted to meet the convergence criteria and thereby join the euro area. Germany led the way, both in terms of its economic size and its example of fiscal discipline. Now the objective of joining the euro has been achieved for many countries, and, in addition, Germany has lost its leading role and the markets react less to fiscal laxity.

Instead of national leadership towards clear objectives we have 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 within the countries puts narrow national political interests first the agreed rules become moot – “peer pressure” becomes ”peer protection”.

Incorrect facts have been more or less deliberately sent to the Commission ahead of sensitive elections. A study by Barclays Capital shows that during the years 2000-2003 growth projections were overestimated by 1.5 percentage points on average each year by the euro area countries, leading to fiscal balances turning out worse than expected on average by about 1% of GDP per year. In fact, a

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% of GDP. The same result was indicated in a study by Lars Jonung and Martin Larch.

What challenges does the future hold?

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. This despite the fact that Germany now appears to be in the process of correcting its deficit.

Given that public finances did deteriorate 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 area that these countries have postponed joining ERM II and the attempt to rapidly adopt the euro. They have made clear that their government finances must be in order before the process of joining the euro area begins. 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 area 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. This is especially obvious for Hungary, where the deficit was 7.5 per cent in 2005 and is, according to present plans, expected to increase to around 10% this year. For Poland and the Czech Republic the deficits will stay at the present level of around 3% in the coming two years.

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 and globalisation and enlargement, all of which supports this process. These trends will eventually help productivity and growth in Europe to start catching 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 a dramatic decrease in employment in the euro area; hence, the upturn is probably also less likely to lead to rapid job creation.

Both of these factors create new incentives for fiscal policy to focus more on short-term job creation schemes and less on long-term fiscal soundness. 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 from this perspective, too, the hope that the recovery alone will "fix" the European deficit problem might be too optimistic.

In addition, structural fiscal deficits in many of the euro area member states might be larger than present calculations show since there is a large risk that potential growth is lower than commonly assumed. Estimates of potential growth for the old Europe have successively been lowered as labour productivity growth has fallen gradually during the last two decades from around 2% to about 1% per year. However, the figures for the second quarter of this year were the highest we have seen for some time. The IMF's latest potential growth estimate for the euro area is about 1.8%.

Nevertheless, inflation has been remarkably stable, just above 2% in recent years despite poor growth and presumed large negative output gaps. If potential growth is lower, the need for fiscal consolidation is even higher than present consolidation programmes show.

Let me summarize the problem. Countries with larger fiscal deficits have had a more procyclical policy both in good times and in bad times. A Commission paper finds a significant impact of elections on procyclicality, especially procyclical tax cuts. In addition, the structural deficits are most likely higher than presumed. With lower potential growth, the ECB will need to push the brakes earlier and more forcefully than most people assume. Hence, the long awaited help from growth to fix the deficit problems and the debt-to-GDP ratios will most likely not materialize. Deficits and debts could

deteriorate even further when pressures from an ageing population will kick in within the next five years.

Is there a solution?

Let me first note an interesting development: 1999-2004 the average yearly fiscal *deficit* in the euro area has been 1.9 per cent of GDP while the average yearly (unweighted) *surplus* of the three old out-countries (the UK, Denmark and Sweden) has been 1.1 per cent of GDP. This despite the fact that the UK has moved from a comfortable surplus position to a deficit of 3.3% of GDP in 2004.

Some euro-sceptics will of course attribute this difference to monetary union itself but I think the difference is rather 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 targets, 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 Sweden and Denmark which put the problems squarely in the sight of the public.

Considering the UK fiscal deterioration the last couple of years, one might draw the conclusion that the so called golden rule, i.e. only borrowing for public investment, is not a clear enough rule, but that expenditure ceilings and targets for the fiscal balance are more effective. In fact those euro area countries that have some sort of national transparent targets and evaluation of fiscal policy have managed to retain some order in their public finances; Finland being a prominent example.

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. Is fiscal policy in line with the target, or is it deviating from target? 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 society in a compulsory way, are less transparent, less well audited and less understood than the accounts of companies listed on the stock exchange, which only affect few people.

Sweden has pre-decided ceilings on government expenditure three years ahead and 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” in Brussels or other nations 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.

The expenditure ceilings have been respected but to some extent with the help of creative accounting. In addition, the last couple of years no decisions have been taken on the ceilings for all three years, as was intended. Sweden would perhaps need an even more formal external fiscal evaluation.

What are the conclusions?

This leads to an important conclusion for the implementation of the “reformed” Stability and Growth Pact of the EU. Perhaps the solution to regain credibility is 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 protocol on the Excessive Deficit Procedure (EDP) attached to the Treaty 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 Treaty to have EU countries commit themselves to establishing these kinds of bodies.

Independent forecasts 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 Hungary and most spectacularly in Hungary and Greece.

Happily, there have been some improvements in some member states since the Pact was reformed in March 2005. If they had a similar role to 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, Finland 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.