

Nils Bernstein: The fiscal compact

Speech by Mr Nils Bernstein, Governor of the National Bank of Denmark, at the hearing on the fiscal compact conducted by the European Affairs Committee of the Danish Parliament, Copenhagen, 9 February 2012.

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What is the essence of the fiscal compact?

The new element is that there will be even more focus on the structural budget balance and that the commitment to fiscal discipline will be anchored in national legislation. The structural balance is the cyclically adjusted budget balance stripped of the effects of cyclical developments and special circumstances. In Denmark's case, special circumstances include pension yield tax, proceeds from North Sea oil and this year also reimbursement of early retirement contributions. In future, it will be a requirement that the structural deficit for a single year does not, as a main rule, exceed ½ per cent of GDP, and that any substantial deviation will trigger an automatic adjustment mechanism to restore the structural deficit to balance or surplus. As I have already mentioned, these provisions are to be incorporated into national legislation. At a later point, the Commission will issue guidelines for the content of the automatic adjustment mechanism. Indications are that it will be an obligation to take action, not an automatic mechanism as such. The structural deficit is an expression of the "sustained" balance situation, be it a budget deficit or surplus.

Until now, the main focus area – besides observing the 3-per-cent requirement for the actual budget balance – has been to ensure continuous annual improvement of the structural balance by at least 0.5 per cent of GDP for member states not observing the medium-term objective of balance or surplus. In practice, one of the weaknesses has been that the adjustment process has been too slow. Another weakness has been that the structural balance was overestimated in the good times before the financial crisis. The value of current-account deficits, housing bubbles and loss of competitiveness as indicators that output and employment were well above the underlying potential was underestimated.

This pattern has exacerbated the deficit during the cyclical downturn so that, on aggregate, debt has increased over the business cycle.

If the government budget must, as a main rule, be structurally in balance every year, this reduces the likelihood that the total debt grows over time. Deficits in bad times must be matched by surpluses in good times.

Under the existing Stability and Growth Pact, the structural balance has mainly been used to lay down a medium-term objective – that is, a target to be met sometime in the future. And by then things will have improved, or so we assume in our planning.

Now the structural balance will be an annual target which can only be deviated from in exceptional circumstances or in the event of a severe economic downturn.

Will the new fiscal compact mitigate the debt crisis?

First and foremost, the new fiscal compact is aimed at preventing a recurrence of the present situation in the euro area – with a debt crisis in several euro area member states that is threatening to spread. Here it could be argued that serious observance of the existing rules combined with responsible macroeconomic and macroprudential policies could have provided the same result.

The fiscal compact and other initiatives will ensure that deviations are to a larger extent exposed – and addressed.

So agreement between the euro area member states and other member states on the fiscal compact may help to boost market confidence in Europe in general. But the present debt crisis should primarily be addressed through direct measures in the member states in question and via the international assistance programmes already in place.

So what are the advantages of the compact?

The main advantages of aiming for and realising a structural balance are that growth in government debt over the business cycle is curbed and that each member state has fiscal scope to stimulate its economy in a recession. The foundations must be laid when the economy is not under pressure.

The fiscal scope is greater if the structural balance is positive.

But it is important to realise that aiming for sound public finances is not enough. Wage and productivity developments and other structural factors impacting on competitiveness, the labour market and the balance of payments must also contribute to a sustainable development. This is also an element of fiscal policy.

Viewed in a broader perspective, the fiscal compact – together with the new six-pack, which focuses on issues such as member states' broad macroeconomic development and tightens the sanctions regime against euro area member states – is a prerequisite for preventing future debt crises that bring the coherence of the euro area into question.

Like other EU member states, Denmark has benefitted hugely from the European project, including the single market and the euro.

This project cannot be rolled back without substantial costs. So it is very much in Denmark's interest that the European project does not strand.

Are there no drawbacks or reservations in relation to the fiscal compact?

In an ideal world, I believe that each member state should be free to conduct responsible economic policy without the need for a legal framework that is controlled by courts of law. No legislation takes into account the multitude of factors at play in real life. Undoubtedly, issues such as how to calculate the structural balance, whether exceptional circumstances exist or when a downturn can be characterised as "severe" will give rise to disagreement. As a result, the legal rules may have to be expanded or clarified at some point. Europe is wrapping its economic policy in red tape. But I have to say that this is necessary in the current situation. The risk is that, on the one hand, the system will not be sufficiently flexible to allow for appropriate adjustments, and, on the other hand, flexibility will be used to avoid implementing the required adjustments. Experience shows that particularly the large member states find it difficult to accept regulative restrictions in good times. We'll just have to see what happens.

Should Denmark adopt the fiscal compact?

Despite my reservations, the answer is yes.

Being a small country with an open economy, we will, at any rate, have to observe the standards it sets for responsible budget policy. Irrespective of the fiscal compact, a Danish Budget Act is forthcoming that is to prevent overspending year after year. It is long overdue.

And being a small country with an open economy, we need to be present when the external framework for our economic policy is laid down. That is our best opportunity to have a say – be it ever so small – and to learn what is going on. It is in our own interest to comply with the obligations we are now essentially taking on. That gives us greater freedom to determine

our own policies. At the same time, we are signalling to the world that Denmark wishes to remain committed to stability-oriented economic policy.

Thank you for your attention.