Olli Rehn: Fiscal statistics and fiscal rules - some lessons from recent years

Keynote speech by Mr Olli Rehn, Governor of the Bank of Finland, at the high-level seminar "Building Trust – the Role of Supreme Audit Institutions in Ensuring the Reliability of Fiscal Data", organised by the National Audit Office of Finland Helsinki, 28 November 2019.

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Accompanying slides of the speech.

Ladies and Gentlemen,

I wish to thank the organisers for the invitation to address to such a distinguished audience and to so many European friends.

I also want to congratulate the organisers for the choice of the venue, as the Finlandia Hall was the venue of the signing the Final Act of the CSCE (Conference on Security and Co-operation in Europe) in 1975. As a kid I started to follow the Europe pretty much thanks to the CSCE. Even your choice of the dinner venue is in line of this, since Kalastajatorppa hosted the famous CSCE reception with the participation ranging from Urho Kekkonen to Olof Palme, Valéry Giscard d'Estaing to Helmut Schmidt, as well as Harold Wilson to Gerald Ford, not to speak Leonid Brežnev to Erich Honecker. It is a historical fact that the CSCE Final Act was a one critical factor of creating the Europe whole and free.

In recent years, fiscal statistics have played a role in my professional life in various ways, when I have worked as member of the European Commission, as Finland's Minister of Economic Affairs, and as a central banker. As Commissioner I was also responsible for Eurostat in 2010–11, until I was appointed Vice-President with stronger competences in fiscal surveillance, when we created a firewall inside the commission and separated these two functions.

As you can probably imagine, data generally are very much present in a central bank governor's typical working day. It starts with a quick look at most recent financial market data and continues with work based, to a large extent, on statistics, regarding particularly inflation and other macroeconomic developments. Banking statistics play a special role, as for Finland they are compiled by the Bank of Finland.

The importance of fiscal data for us follows from the objectives given to the European System of Central Banks. The primary objective is price stability, and it cannot be achieved in the long run without fiscal sustainability. Therefore, while the responsibility for fiscal policy obviously rests with the governments, central banks cannot ignore issues related to fiscal sustainability.

In the European Union, our common fiscal rules play an important role in safeguarding fiscal sustainability. In a moment, I will address some issues related to EU fiscal rules.

However, before that, let me go back in time a few years to a situation where issues related to fiscal sustainability and the reliability of fiscal data suddenly became headline news in Europe. I am referring to Greece and my years as the EU Commissioner for Economic and Financial Affairs.

Slide 2 – summary

The global financial crisis rocked the financial system and the world economy starting in 2008. The first signs of the crisis emerged in the United States, but it soon became clear that the crisis will not remain outside the borders of Europe.

Certain European countries came to suffer more from the crisis than others. In many countries, household borrowing and house price increases were unsustainable, risks had accumulated in the banking system, and large current account deficits marked wide imbalances in the economy. However, fiscal policies also played a role.

Almost exactly 10 years ago, in October 2009, the financial crisis took a new turn in Europe. It morphed into a sovereign debt crisis. Upon taking office, the Prime Minister of Greece, George Papandreou, revealed that the fiscal deficit in Greece was significantly larger than previously reported. As it later turned out, the deficit was above 10% of GDP in 2008 and above 15% of GDP in 2009, which triggered and caused the Greek crisis.

As investors became aware of the real state of Greek public finances and of the systematic falsification of statistics, investors woke up to the risk attached to the sovereign bonds of not just Greece but also other vulnerable euro area countries. Papandreou's announcement caused a shock in the financial markets and stupefied political decision makers. The yields on Greek sovereign bonds began to rise to unsustainable levels.

By May 2010, the yield on 10-year Greek sovereign bonds had risen to over 10 percentage points above those of Germany. Greece would no longer have been able to finance its public expenditures. The government did not have many options: Greece had its back against the wall. It had to choose between a default and a request for international support.

A contagion effect was soon felt in other vulnerable countries: Portugal and Spain also saw their credit ratings downgraded in March-April 2010. The crisis was widening and deepening with accelerating speed.

One critical lesson is, that at the time, the EU and the monetary union did not have proper tools to deal with such situations. Those tools needed to be created, and they were. The euro area countries in biggest problems received financial support conditional on stabilisation programs. Setting them up took a fair amount of time and effort.

The acute crises were tamed, and with time, economic healing processes began. However, the losses in economic well-being suffered by so many euro area citizens were grave, and the healing process was in some cases painfully slow. In Greece, it is still ongoing.

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But let me go back to the role of fiscal statistics. Still in 2009, Eurostat, or the European Statistical Agency in Luxembourg, had no authority to audit accounts in the member states. The Commission had actually proposed this in 2005, but the proposal was rejected by the member states in the Council. Hence, the operation of the EMU with respect to the monitoring of public finances was based on trust, not control.

That did not quite work out, as we have witnessed. The system functioned as well or badly as would function a football match where the head coach of one team doubles as the referee of the match!

When I learned out about these quandaries, I started working to reinforce Eurostat's audit authority and committed to this endeavour in the hearing at the European Parliament at the beginning of January 2010. When Barroso's second Commission finally took office in February 2010, its very first legislative proposal in its very first formal meeting was indeed the proposal to provide auditing powers to Eurostat. This time the Council and the Parliament processed the proposal quickly, so the new powers entered into force in August 2010.

In September 2010, Eurostat's auditors flew to Athens and delved into the Greek national accounts and began to reform its statistical institution Elstat. For the following year's assessment, Eurostat verified the reliability of the operations of the Greek Statistical Authority and the accuracy of its statistics. Today, Greece's statistics should be as reliable as those in any Member State, and Eurostat normally validates them without reservations.

Ladies and Gentlemen,

During and after the European sovereign debt crisis, the EU economic governance has been substantially reinforced when it comes to rules and surveillance of macroeconomic imbalances – as well as fiscal rules and fiscal surveillance. Likewise, financial regulation and supervision have been strengthened, and the European Banking Union created.

It is sometimes claimed that even the current EU fiscal rules do not work. However, evidence from recent years tells a different story.

Slide 3 – Fiscal deficit

In the EU countries, budget deficits have been reduced during the recent period when fiscal policy supported by the reformed rules has been effectively applied.

This is not to say that the rules are perfect. Perfect rules may not even exist. Creating rules that ensure optimal countercyclical fiscal policies and fiscal sustainability is inherently difficult. Still, I would argue that EU fiscal rules can work, do work – and they can and must also be further improved.

In the future, the Economic and Monetary Union can work smoothly only if the public finances of all member countries are credibly on a sustainable footing. A functional combination of fiscal policy rules and market discipline is necessary to achieve this. Fiscal rules should be sufficiently well-designed and simple to ensure that, in normal circumstances, we can expect that they will be adhered to when budgets are prepared.

Rules that support sustainability have become commonplace since the 1990s. According to the IMF, nearly 100 states apply national or supranational fiscal rules. Fiscal rules have been linked with a more steady development of budget deficits.

When fiscal rules operate correctly, they do indeed support the conduct of responsible fiscal policy, long-term sustainability of public finances, and the objective of keeping public debt financing costs low. The goal of the EU's fiscal rules is to ensure the sustainability of public finances and, within that framework, to enable sufficient fiscal room for manoeuvre to stimulate the economy in a member state in recession.

Not enough attention was paid to the level of public debt before the financial crisis. During the ensuing recession, debt levels rose sharply due to stimulus measures and weak macroeconomic developments. In the most vulnerable countries, risk premiums rose sharply.

This led to a negative spiral in which a number of countries ultimately had to tighten fiscal policy, even though economic conditions were difficult. This should be avoided in the future.

The EU's fiscal rules have last been revised relatively recently, in 2011. While the body of rules has produced results, it has become rather extensive and sometimes inconsistent. Interpretation of the rules, with all the flexibility options, has become complex and difficult to predict.

More simple fiscal rules would probably serve debt sustainability better, and also increase transparency and facilitate ex-post verification of policies. In the best case scenario, the predictability of fiscal policy and its credibility in the eyes of the public would be enhanced. In exceptional situations, the rules need to allow flexibility, but this should be based on predetermined and consistent criteria.

An expenditure rule can be defined as a medium-term ceiling for the growth of government expenditure, set in relation to the estimated future economic growth and taking into account the stock of public debt. Such a rule would probably serve more effectively as an operational fiscal policy guide than the current rule that is based on the structural fiscal balance.

The so-called automatic stabilizers, such as increased expenditure through unemployment insurance in an economic recession, are important mechanisms of economic adjustment in the Eurozone countries. The expenditure rule would not prevent the operation of automatic stabilizers.

The expenditure rule supports responsible fiscal policy, as we have seen in countries like the Netherlands, Sweden and Finland where it has been used over the past decades. Recent research by the IMF has come by and large to a similar conclusion: the compliance rate of expenditure rules is greater than that for budget balance rules, especially if it is directly under the control of the government and the rule is enshrined in law or in a coalition agreement. Empirical research also indicates that the presence of expenditure rules is associated with stronger fiscal performance, i.e. a higher primary balance and countercyclical fiscal policies.

Finally, it is essential to repeat the paramount importance of national ownership of responsible fiscal policies. Both an expenditure rule and an independent fiscal council can be valuable tools for that goal – but they are only tools, which should be used well. It is worth quoting the director of the IMF's Fiscal Department, Vitor Gaspar, and his co-authors: "One extreme and dangerous manifestation… is the expressed perception by many analysts that European fiscal governance releases countries from their national responsibilities. Nothing could be further from the truth: fiscal policy is, first and foremost, a national responsibility."

Several EU member states have in fact lived in line with Gaspar's recommendation and used the EU rulebook as an instrument to reinforce national ownership of fiscal policy. Belgium, Denmark, Luxembourg and the Netherlands introduced national expenditure rules in 1992 in response to the Maastricht Treaty and its debt and deficit rules. Sweden and Finland followed suit after becoming members of the EU in 1995. Germany went so far as to introduce a constitutional debt brake, which has recently been discussed in Germany and criticised for its excessive rigour that may prevent the country from meeting its national needs of public investment.

An expenditure rule could well be applied across the EU by including it in the next reform of the Stability and Growth Pact. It could help redress one major problem: before the crisis, the rate of expenditure growth exceeded the growth rate of potential output in many countries, and there were no adequate buffers.

Particularly when economic growth is strong, there are all the good reasons to pay attention to fiscal responsibility. Good times should be used for building fiscal buffers.

Ladies and Gentlemen,

Our experiences during the past years have underlined the importance of fiscal policies that support the long-term economic well-being of euro area citizens. The monetary union needs fiscal rules. It needs rules that reinforce countercyclical policy and fiscal sustainability, as I write in my forthcoming economic policy thriller "Walking the Highwire – Rebalancing the European Economy in Crisis", to be published in February 2020.

Slide 4 – Walking the highwire

However, neither rules nor market discipline can work properly without timely and reliable fiscal data. Perhaps the most devastating failure of fiscal policies took place in Greece before the sovereign debt crisis.

Without reliable fiscal data, rules and market discipline did not work, and Greek fiscal policy was unsustainable for too long. The results were tragic. One may ask, how much of the ensuing suffering would have been avoided had only fiscal data been reliable.

Fortunately, it looks like we can now be confident that history will not repeat itself at least in this case. I wish you a pleasant and productive conference!