

*Comment to Lucio Pench:*

# **The new fiscal rules – what will change in practice?**

ETLA Fiscal Policy Seminar, Helsinki, 16<sup>th</sup> October 2012

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# My message:

Every crisis is a window of opportunity.

A window for learning and thus for changes in the institutional framework for policy making.

“We” are now learning from the policy mistakes of the past.

But are we learning the right lessons?

I will focus on the lessons from:

a) The Stability and Growth Pact

*Joint work with Martin Larch and Paul van den Noord*

b) The history of fiscal federalism  
(US, Canada, Argentina and Brazil)

*Joint work with Michael D. Bordo and Agnieszka Markiewicz*

# The unique features of the euro area

## ***Centralized monetary policy making***

ECB - with the goal of price stability.

## ***Decentralized fiscal policy making***

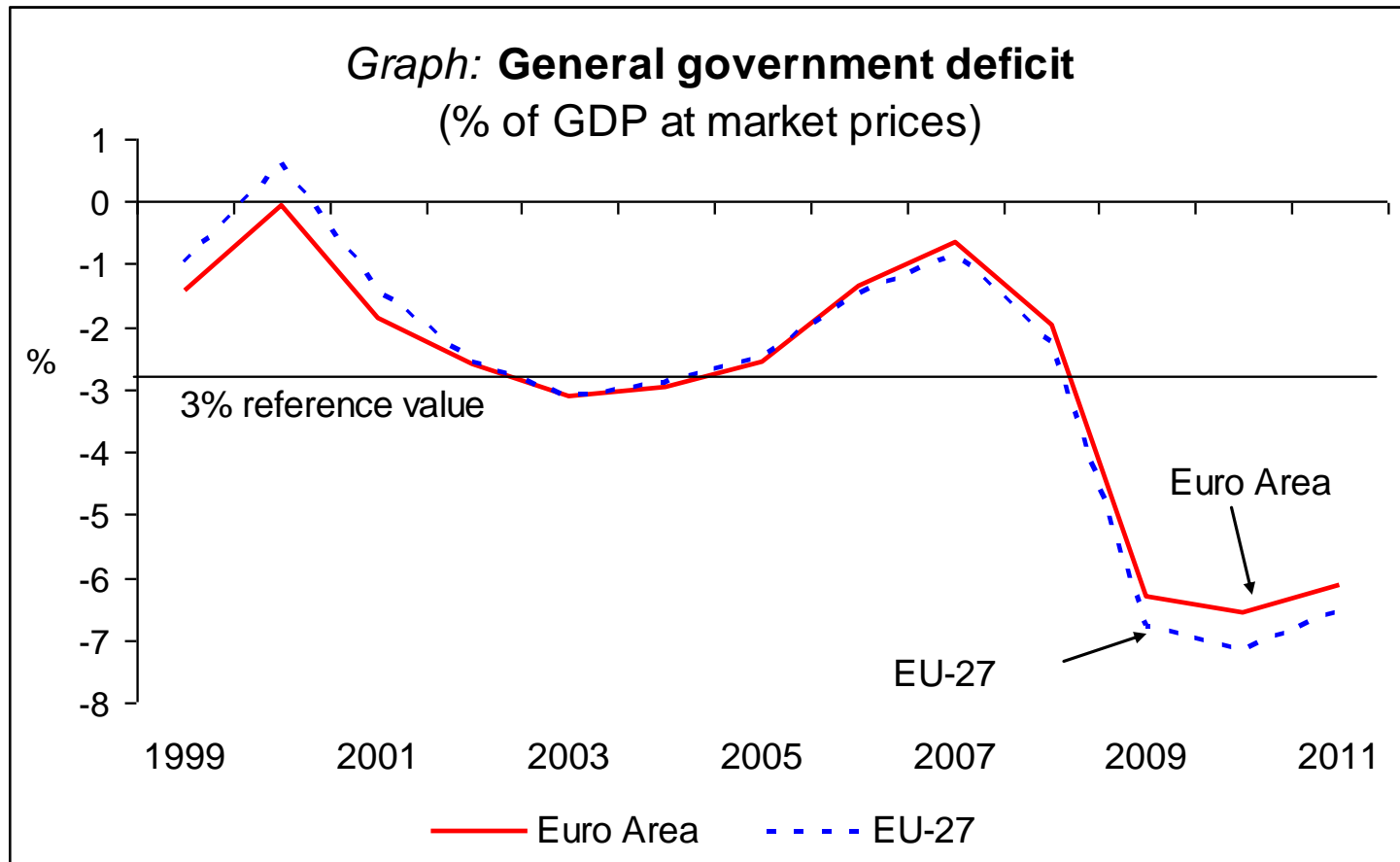
No previous case in the history of monetary unions is similar to the euro area.

# The unique features of the euro area

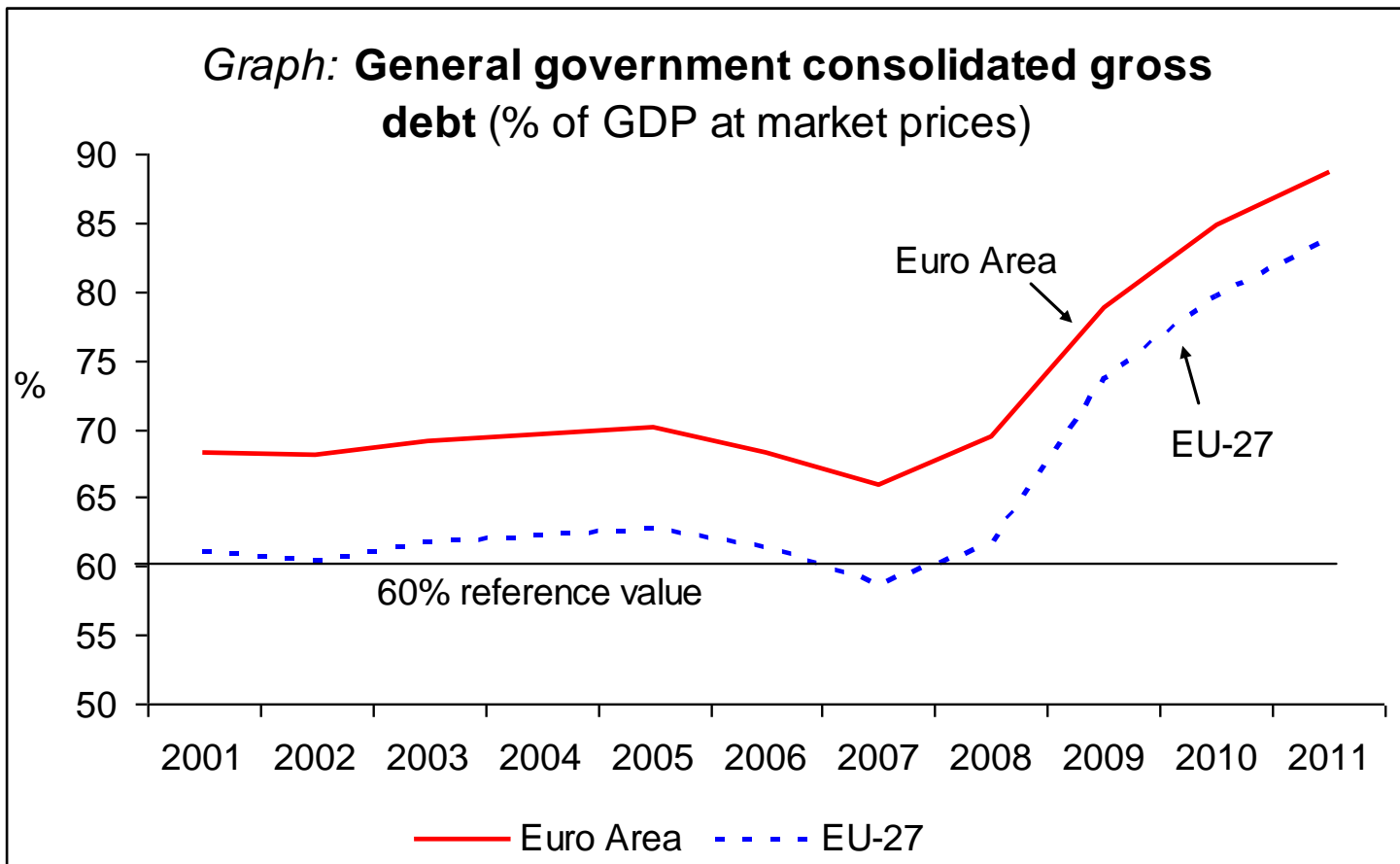
The Stability and Growth Pact was designed to discipline the fiscal policy of the member states.

How did it work?

# It looked OK before the crisis: Euro-area budget deficits



# It looked OK before the crisis: Euro-area debt/GDP-ratio



# To conclude:

The Stability and Growth Pact failed.

It did not deliver fiscal discipline at the national level.



# Two questions about the SGP:

1. Why did the SGP (EU fiscal policy governance) fail?
2. How should it be repaired (lesson learning)?

Lucio Pench describes the repairing going on.

# The flaws of the SGP

## **Problem 1. Weak statistical surveillance**

Reliable, complete and timely public finance data is essential for the success of any rule-based system of fiscal surveillance.

The case of Greece: creative national accounting.

# The remedies of the SGP

## **Solution (Lesson 1). More reliable government finance statistics**

The quality of government finance statistics can be improved by enhancing Eurostat's access to information required to effectively verify compliance with existing rules.

EU is moving in the right direction.

# The flaws of the SGP

## Problem 2. Lax fiscal policy in good times: the (non)preventive arm of the Pact

The consistent failure of the Pact to encourage fiscal adjustment in economic good times originated in a combination of two factors:

1. Uncertainty surrounding the crucial yardstick of EU fiscal surveillance, the cyclically-adjusted budget balance (**CAB**). Non-observable concept.
2. Even when risks to fiscal virtue were visible, the **peer pressure** offered by the preventive arm of the Pact did not produce the desired results.

# The remedies of the SGP

## **Solution (Lesson 2). Making the preventive arm more effective**

New types of rules, sanctions and surveillance are now being put in place.

EU is moving in the right direction.

# The flaws of the SGP

## **Problem 3. Fiscal blinders: other macro imbalances ignored**

The radar screen did not pick up relevant threats to macroeconomic stability. Why?

The old architecture of EU economic governance incorporated a key tenet of the macroeconomic paradigm that prevailed in the decades preceding the Great Recession.

It was built on the premise that **low and stable inflation combined with sound fiscal policy would be sufficient to safeguard overall macro-financial stability.**

# The remedies of the SGP

## **Solution (Lesson 3). Going beyond the fiscal area: broader economic surveillance**

**Fiscal discipline is a necessary, yet not sufficient, condition for overall macroeconomic stability.**

In order to safeguard overall macro-financial stability, monetary and fiscal policy making, the two classical tools of macro policy, need to be combined with other policy instruments, in particular, **macro-prudential tools**.

EU is moving in the right direction.

# The flaws of the SGP

## **Problem 4. Issues of governance: EU rules versus national fiscal sovereignty**

As the EMU is a monetary union without a strong political union, the scope for effectively influencing fiscal policy making at the supranational level clashes with national sovereignty.

The ultimate decision making authority in charge of implementing the rules are the Member States within the Council. Based on the initiatives and proposals of the European Commission, the Council approves or rejects the legislative instruments which are meant to ensure the functioning of the Pact.

**‘Gentlemen’s agreement’** making the center weak.



# The remedies of the SGP

## **Solution (Lesson 4). Sovereignty versus fiscal responsibility**

The quality of domestic fiscal governance should be improved. The fiscal sovereignty of Member States should be limited.

Strengthen domestic fiscal frameworks through fiscal policy councils etc.

EU is moving in this direction.

# The flaws of the SGP

## **Problem 5. Lacking provisions for severe economic stress or crises**

The rule-based system of fiscal surveillance codified in the SGP essentially builds on the orthodox skepticism vis-à-vis fiscal discretion.

Under the provisions of the Pact the stabilization function is entrusted to automatic stabilizers and fiscal discretion is to be used for the purpose of fiscal consolidation only.

Discretionary fiscal expansions are not foreseen, and are in formal conflict with the requirements of the Pact. The crisis forced a change towards discretionary fiscal policies.

# The flaws of the SGP

## **Problem 5. Lacking provisions for severe economic stress or crises**

The credibility and sustainability of a rules-based framework depends on whether it includes robust **escape clauses** that allow policy makers to cope with particularly adverse circumstances, when sticking to the rules is no longer viable.

Is EU moving in the right direction?

# The flaws of the SGP

## Problem 6. Lacking provisions for severe economic stress or crises

On top of the tensions emerging from the absence of robust escape clauses, the Great Recession also revealed the lack of **crisis resolution mechanisms**.

As the sovereign debt crisis escalated in Greece the conclusion was drawn that an uncontrolled default should be avoided in the interest of financial stability of the euro area as a whole; but no instrument was at hand.

In an emergency meeting held on 9 May 2010 the Ecofin Council adopted the blueprint of a temporary general rescue mechanism – the European Financial Stabilisation mechanism and the European Financial Stability Facility – aimed at providing help to euro area countries that had run into financial trouble.

# The remedies of the SGP

## **Solution (Lesson) 6. When worse comes to worse: crisis containment and crisis resolution**

The credibility of the euro area as a well-functioning monetary union is dependent on the existence of a mechanism that can deal with ***solvency*** crises – to prevent them from spreading from one country to all countries, to prevent the ECB from turning into a fiscal agent, and to resolve them if and when worse comes to worse.

EU is moving in the right direction.

# The remedies of the SGP

**Crises are catalysts of reform and change – they initiate a process of policy learning and subsequent changes in institutions and instruments for economic policy-making.**

**Lucio Pench's presentation is a nice illustration of this view.**

# The remedies of the SGP

Question: Are the Europeans learning fast enough and the right lessons?

My answer: Yes, they are learning fast.

New rules, new institutions, new reforms – an avalanche of measures.

But is this the best route?

# A final lesson:

The financial markets – which role will they play in the new institutional framework?

The financial market (the government bond market) was sleeping during the first ten years of the euro.

Now they are awake ...

And they will stay awake.



# ***A final lesson:***

*There are two major methods for disciplining fiscal policy in a monetary union:*

*1) The political system (The Fiscal Compact, the Six-Pack, the Two-Pack, etc.).*

*A very complex, risky and fuzzy process*

*2) The financial market, via the spreads between government bonds issued by euro-area member states.*

*A simple and straightforward process!*

# ***A final lesson:***

*Which method is the better one for a fiscal union like the EU?*

*The lesson from the history of fiscal federalism – the case of the US vs. Argentina:*

*Financial market discipline is the better option but it has to be backed up by proper rules.*

- Strict adherence to a credible no-bailout rule.*
- Steps to make national fiscal policies more transparent.*
- Steps to increase the understanding of the role of financial markets. Don't kill them!*

# ***A final lesson: Stopping the blame-game***

*The financial market route stops the destructive blame-game. It is the financial market (the bond market) which is disciplining domestic fiscal policies – not the rest of the EU. They do it now and they will do so in the future.*

*Are we learning this lesson?*

*I am not sure. When I am optimistic I believe so. When I am pessimistic I fear that the EU will end up in a vicious circle of nationalistic populism, making the EU and the euro scapegoats for domestic unemployment, stagnation and social unrest.*

# ***A last final lesson:***

*“You never let a serious crisis go to waste.  
And what I mean by that, it's an opportunity to do things  
you think you could not do before.”*

Emanuel Rahm, White House Chief of Staff,  
19 November 2008.

*Don't waste the present crisis!*

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