Fiscal Policy: Rules versus Discretion

Introduction of Dr. Willem Duisenberg, president of the European Central Bank by Dr. Emsley D. Tromp, president of the Bank van de Nederlandse Antillen on the occasion of the Fundraising Lecture, celebrating the 175th anniversary of the Bank van de Nederlandse Antillen.
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Ladies and gentlemen, good morning,

It is for me a great pleasure to introduce to you Dr. Willem Duisenberg, president of the European Central Bank who is our keynote speaker today. Wim, we are very grateful that, despite your very busy schedule, you agreed to deliver today's keynote address on this very important milestone in the Bank's existence. Ladies and gentlemen, Dr. Duisenberg will share with us his views and experiences on fiscal policy, a topic that has been on the forefront of national agenda both in Europe and here in the Netherlands Antilles.

I think that there is no one more qualified than Dr. Duisenberg to elaborate on this important topic. As Minister of Finance of the Netherlands, President of the Nederlandse Bank and now as President of the European Central Bank he has always shown a keen interest in and has followed very closely the economic and financial development in the Netherlands Antilles. And I also have to add, just like on this occasion, we could always count on his wise counsel, support and assistance. Wim, I would like to thank you once more for your support and assistance.

Ladies and gentlemen, the interrelationship between monetary policy and fiscal policy is well established. They both affect key macroeconomic variables. Lack of coordination between fiscal and monetary authorities in the conduct of their respective policies can place an undue burden on the other thereby rendering the other less effective.

Dr Duisenberg as Minister of Finance, President of the Netherlands Bank, President of the EMI and now in his current position as President of the ECB has had a great deal of exposure to this topic.

The Netherlands Antilles during the past six years has embarked on an ambitious structural program aimed at restoring order in its public finances with mixed results. On the one hand, considerable progress has been made in reducing the government bureaucracy, improving cost efficiency, enhancing tax compliance and collection, and strengthening the financial administration and reporting. On the other hand, our public finances are still characterized by large disequilibria. The total government debt is estimated at 3.7 billion guilders at the end of 2002, equivalent to 82% of GDP and the general government deficit is projected at 175 million guilders in 2003, equivalent to 4% of GDP.

To deal with these daunting challenges, the government of the Netherlands Antilles recently announced the implementation of rules based fiscal policy and the establishment of a committee to come up with recommendations to effectively deal with the increasing debt to GDP ratio. Mr. Duisenberg will share with us the experiences and the wisdom of rules based fiscal policy and the importance of a sustainable level of debt to GDP ratio.

Wim, I certainly hope that your views and experiences will help us in the design and implementation of a credible fiscal program and hence to the resumption of economic growth.

Ladies and gentlemen, I would like now to invite Dr. Duisenberg to deliver his address.

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Speech by Dr. Willem F. Duisenberg, President of the European Central Bank, on the occasion of the 175 anniversary of the Bank van de Nederlandse Antillen in Willemstad, Curaзao, Netherlands Antilles.

Introduction
Your Excellencies, Mr. Tromp, ladies and gentlemen.
It is a great honour and pleasure for me to speak to you here just two days before the actual day 175 years ago, on which Johannes van den Bosch, the Dutch Commissioner-General for the Dutch West-Indian Possessions, signed the Proclamation on a Statute for the Curaзao Bank, as the Bank van de Nederlandse Antillen was initially called. The history of this Bank and that of the central bank I presided over for 16 years, namely De Nederlandsche Bank, are

largely comparable. The Charter of De Nederlandsche Bank was used as the basis for the Statute of the Curaзao Bank, as there was no comparable financial institution anywhere in the Caribbean region or Latin America at that time. Thus, the Curaзao Bank could truly be considered a pioneer in this part of the world. Both banks were founded with the active support of King William I, with the aim of promoting trade and of reforming the fragmented currency system prevailing in the Netherlands and in Curaзao and Dependencies, as the Netherlands Antilles and Aruba were called at the time. Also, both were set up as commercial credit banks, a function that they have maintained until the middle of the 20th century, when they were formally transformed into central banks with sole responsibility for monetary policy and banking supervision as well as other central bank-related tasks. For a very long time now, and from the different positions I have held, I have closely followed economic and financial developments in the Netherlands Antilles and the key role played by the Bank van de Nederlandse Antillen in this regard.

Please allow me to use this opportunity to underscore that this is also the case, albeit from a somewhat different perspective, in my current position. For a major central bank like the European Central Bank (ECB), the broad trends in economic and financial developments in Latin America and the Caribbean do matter and are, therefore, followed closely. In its short history, several initiatives have thus been taken by the ECB to build up relations with this region. Among these were a seminar held last year for Eurosystem and Latin American central banks to discuss selected policy issues of common interest. And just last week, the Executive Board of the ECB decided to initiate the procedure for the ECB to become a collaborating member of Centre for Latin American Monetary Studies (CEMLA). Over the past few years, ECB officials have already participated in CEMLA Governors' meetings on a regular basis. We felt, however, that a collaborating membership would enhance our possibilities for building up relations with the central banking community in Latin America and the Caribbean.

Close relations between the euro area and the Latin American and Caribbean region provide a platform for an exchange of views and experience in the field of – in our case – economic and financial policies. Topical issues for both the euro area and Latin America and the Caribbean are fiscal policies and debt sustainability. In the euro area, as in other economic and monetary unions, fiscal policies are enshrined in rules or pacts. Whereas the use of clear strategic frameworks for the conduct of monetary policy is already broadly accepted, this appears to be less so in the case for fiscal policy rules. Against this background, I should like to discuss today the benefits of fiscal rules compared with discretionary fiscal policies.

The rationale for fiscal policy rules

When referring to fiscal rules, I mean a rule-based framework for the adoption of fiscal policy decisions. In practice, almost all such rules take the form of a medium-term target for the government budget balance, but the debt ratio is often also the subject of a fiscal rule. Setting fiscal policy in a rule-based framework contrasts with an ad hoc, discretionary approach to fiscal policy-making. Under an ad hoc approach, the decision on the budgetary target is made without having to adhere to explicit criteria when determining the size of the budget balance in a particular year, or over the medium-term.

Conducting budgetary policy on the basis of disciplining rules has become increasingly popular, following disappointing experience with discretionary fiscal policies. One of the main problems of discretionary policies is to be found in the long time-lag between the preparation of , the decision on and the implementation of discretionary measures, in particular those aimed at stabilising the business cycle. Consequently, policy measures frequently only become effective when the economic cycle has already changed, often resulting in a pro-cyclical policy stance. This may destabilise economic developments. Furthermore, discretionary policies are often conducted asymmetrically, driven by short-term electoral considerations. While governments show little hesitation in increasing expenditure or decreasing taxes in periods of economic slowdown, there is reluctance to initiate unpopular consolidation measures once prosperous times return. As a result, a ratchet effect occurs: deficits only go up, not down.

Appropriate fiscal policy rules add to macroeconomic stabilisation. While discouraging discretionary fine-tuning, they allow a full operation of automatic stabilisers. These automatic stabilisers result in lower tax receipts and higher unemployment-related government expenditure in the event of an economic downturn, thus supporting aggregate demand and income. An appropriate medium-term reference value for the government budget balance also prevents the sustainability of fiscal policies from becoming a problem, a subject on which I will say more in a few moments.

More generally, a rule-based system for fiscal policy provides clear yardsticks against which other policy-makers and the public can measure the current and future course of policies. It sets up a stable and predictable environment, which allows markets to operate more efficiently, and supports longer-term decision-making by the public and by corporations. Moreover, fiscal rules regarding budget deficits have the advantage of promoting an efficiency analysis of government plans. If a government wants to increase certain expenditure when the route to deficit-financing is blocked, it has to weigh the benefits of such expenditure against the cost of increasing taxes or decreasing other expenditure.

The case for fiscal rules is even stronger in a monetary union like the euro area. With a centralised monetary policy and decentralised fiscal policies, there could be a temptation to have higher deficits. This is because part of the consequences of lax fiscal policies, in the form of higher real interest rates, will be borne by all the other participants in the monetary union. Thus, in order to avoid such spillovers to countries pursuing sound fiscal policies, a fiscal framework is required, even more so than in the case of an individual country.

While there are thus many advantages to fiscal rules from a fiscal and general macroeconomic angle, I also support the conduct of fiscal policy on the basis of predetermined rules from a monetary policy point of view. Monetary and fiscal policy are interacting, as they both have an impact on key macroeconomic variables. Fiscal policy, for one thing, affects prices via its effects on aggregate demand, or via changes in indirect taxes. Monetary policy, on the other hand, affects short-term interest rates, which influences the government budget and the economic environment in which governments operate. This implies that actions by one authority have an impact on the variables underlying the policy objectives of the other.

Given these linkages and spillovers, it is crucial to have a clear institutional framework, which governs the interactions between monetary policy and fiscal policy. Important in this context is the issue of the division of responsibilities. Those taking macroeconomic action should be given clear mandates which they can fulfil and for which they can be held accountable. Monetary policy-makers should be responsible for price stability and fiscal policy-makers should keep public finances sound with a view to providing the best contribution to enlarging the growth potential of the economy. Such a clear separation of mandates avoids problems with regard to implementation and incentives that would otherwise be bound to occur if monetary and fiscal policies had constantly to be co-ordinated on an ad hoc or a discretionary basis.

The euro area experience

Having elaborated on the need for a clear institutional framework, let me now turn specifically to the euro area, and discuss how these insights have found their way to the policy framework of the European Union (EU). The introduction of the euro posed a unique challenge to devise principles reflecting the considerations I have just highlighted.

As to the common monetary policy, the Treaty establishing the European Community unambiguously identifies price stability as the primary objective for the ECB, as this is the only objective monetary policy can be expected to deliver in the long run. The ECB and the national central banks of the Eurosystem are granted independence in the pursuit of this objective, so that they are shielded from possible short-term political interference by governments.

At the same time, fiscal policies remain the exclusive responsibility of national governments, although they are subject to EU-wide rules. The Maastricht Treaty states that countries should avoid excessive deficits. Important reference values for this assessment are a government deficit level of 3% of GDP and a debt-to-GDP ratio of 60%. In addition, countries have committed themselves in the Stability and Growth Pact to respect the medium-term objective of a budgetary position of “close to balance or in surplus”. Attaining this position implies that automatic stabilisers can operate freely over the cycle without running the risk of exceeding the 3% reference value.

Additional elements in the EU policy framework that have an impact on fiscal policies are the prohibition of any monetary financing of government deficits, which implies that governments cannot resort to central banks for the financing of their budgets, and the no-bail-out clause. Under the latter provision, none of the participating countries can be held responsible for the debt of any other governments. This provision provides an additional incentive for governments to “keep their own house in order”.

As to the monetary side of the EU policy framework, the ECB has announced a medium-term-oriented monetary policy strategy setting out how it goes about fulfilling its mandate under the Treaty. In order, in particular, to enhance clarity, to anchor expectations and to offer a yardstick against which the ECB can be held accountable, a quantitative definition of price stability has been provided. Longer-term inflation expectations indicate that the ECB’s definition of price stability over the medium term, an annual rate of inflation of less than 2%, is perceived to be credible, both by market participants and the general public. Furthermore, on the basis of its strategy, the ECB regularly explains its monetary policy decisions and its assessment of economic developments. With this high degree of transparency, the ECB provides the public and the fiscal authorities with extensive information on how to understand, and thus to anticipate, responses of monetary policy to economic developments, including those concerning fiscal variables.

Current experience with this policy framework in the EU is satisfactory. The Maastricht Treaty provides for a clear and consistent allocation of mandates and objectives to the policy-makers. It includes transparent frameworks and procedures. Monetary and fiscal policy are offered steady guidance for action, while short-sighted behaviour is discouraged.

Fiscal policy developments in the euro area have been somewhat mixed recently. Many euro area countries had undertaken major efforts to reach budget deficits of less than 3% of GDP by 1997, which was a precondition for adopting the euro. Later on, a majority of countries reached the required medium-term positions of budgets close to balance or in surplus. However, some euro area countries still face very high deficit levels that sometimes even exceed the reference value of 3% of GDP. This reflects the fact that these countries did not use the strong economic upturn in 1999 and 2000 to bring their structural fiscal deficits down. As I have already outlined, budgetary discipline is indispensable for the proper functioning of Economic and Monetary Union (EMU). The rules are not the problem, but failing to comply with them is.

Debt sustainability

One of the reasons, perhaps the most important one, for adopting a fiscal rule-based system such as the Stability and Growth Pact is the need to reduce the risk of building up unsustainable fiscal positions. In most euro area countries, the debt-to-GDP ratios have been falling over recent years, but they still remain at high levels. Certainly, the current high debt to GDP ratios need to be reduced. However, even low debt levels today are no guarantee that sustainability is secured in the future. Many economies, yours not excluded, will be confronted with a gradual but steady ageing of the population. In Europe, there are currently about four persons in the work force supporting one person of pensionable age. This ratio will deteriorate substantially in the future – it is estimated to go to two workers for every pensioner in 2050.

Such a huge increase has many macroeconomic consequences, including fiscal ones. Conservative projections indicate that annual government expenditure on pensions and health care in the EU could increase in the order of 4 to 8 percentage points of GDP. Unless there is further policy action, public expenditure would rise significantly, resulting in increases in the public deficit and debt ratios.

There is every reason to prevent such a scenario from occurring. High deficits and unsustainable public debt levels have serious adverse macroeconomic consequences. First, public debt crowds out private investment, thereby hampering economic growth in the medium term. Unsustainable fiscal positions have a negative impact on market interest rates, because of the high additional demand for funds and because of the ensuing negative development of inflation expectations. Ultimately, if risks regarding the future course of fiscal policy are substantial, and if its credibility is undermined, unsustainable fiscal policies will have an impact on the creditworthiness of the government. In the extreme, this may lead to reduced access to capital markets for funding debt. But even more moderate debt levels are problematic. They impair the operation of automatic stabilisers. In addition, the effectiveness of fiscal policy measures could decrease as awareness increases among the public that the fiscal policy course is not sustainable, so that countervailing measures in the future are anticipated. Furthermore, increasing debt ratios lead to rising tax burdens, either now or in the future. This exacerbates current tax distortions and reduces work incentives, thus leading to less economic growth.

The adverse consequences of high and unsustainable debt point to the need to prevent such situations. There is an urgent need for policy adjustments in many EU countries. Measures should be sought in three complementary areas. First, fostering productivity and economic growth broadens the economic basis for financing ageing-related costs. Second, reforming the social security systems should reduce expenditure pressures. Finally, a swift and decisive reduction of current debt levels should contribute to alleviating fiscal burdens and to preparing financially for upcoming ageing. Low debt levels reduce the interest burden on the budget, thus creating more room for growth-enhancing tax cuts or for financing expenditure relating to ageing populations.

Although the ageing of populations is a gradual process, this should not induce us to regard it as less urgent. In Europe, a major acceleration of the ageing process is expected to set in around 2010. Postponing the implementation of the required policy response would, over time, further increase the extent of necessary adjustments, and may shift a larger part of the debt burden to future generations.

Fiscal policy frameworks in other monetary unions

Before addressing the relevance of fiscal rules for Latin America and the Caribbean, let me first say something about the use of fiscal rules in other monetary unions of interest, notably the West African Economic and Monetary Union (WAEMU), the Central African Economic and Monetary Community (CEMAC) and – closer to the Netherlands Antilles – the Eastern Caribbean Monetary Union (ECCU). The programmes agreed upon by the two African monetary unions – the name of one of which has even been based on arrangements in the EU, namely the WAEMU's Convergence, Stability, Growth, and Solidarity Pact – require annual fiscal balances to be in surplus or in balance, a limitation of the domestic and foreign debt ratio to 70% of GDP and a reduction of the inflation rate to 3%. The Monetary Council of the Eastern Caribbean Central Bank, which comprises the finance ministers of its eight member states, has adopted so-called benchmarks, limiting budget deficits to 3% of GDP, outstanding public sector debt to no more than 60% of GDP and debt service revenues to no more than 15% of current revenue.

It may be useful to assess the institutional set-up of these agreements on the basis of EU experience, in particular with regard to the required monitoring, the incentive structure and the time frame. As regards monitoring, on the basis of EU experience, a regular and frank regional surveillance of all participating countries forms an important incentive to compliance. The same applies to the obligation for countries that fail, or that are expected not to comply with the rules, to define a programme of corrective measures. Finally, sanctions in the form of public reprimands and fines should complete this framework. While the West African Treaty includes rather detailed provisions and procedures for monitoring, corrective policy programmes and sanctions, none of these have been put in place in the Eastern Caribbean Currency Union. Furthermore, as is the case in the EU fiscal policy framework, fiscal rules will be more effective when linked to a realistic time frame. In contrast to the two African monetary unions, the Caribbean Union has not explicitly specified such a time path. EU experience confirms the importance of a strong institutional set-up for stability programmes. Against that background, I am convinced that the success of such programmes in other monetary unions will to a large extent also depend on their frameworks for monitoring, incentives and sanctions.

The need for enhanced fiscal discipline in Latin America and the Caribbean

Let me close my presentation by now discussing the need of more fiscal discipline in this region. Both in Latin America and in the Caribbean, fiscal discipline has been low in a large number of countries. On average, public debt-to-GDP ratios in Latin America are not out of tune with those in other emerging market regions, but – overall – vulnerabilities are comparatively larger. These vulnerabilities stem from the fact that a larger share of public debt is financed externally as a result of, inter alia, relatively low savings ratios, while the region's ability to service the associated external debt obligations is hampered by a relatively low level of exports. There are positive exceptions to this general trend of weak fiscal positions, one of which is Chile. Such countries do, indeed, perform much better in terms of national savings and trade openness.

In many countries in the Caribbean, public debt-to-GDP ratios are much higher than in Latin America, although public debt there is not financed externally. Domestic financing of public debt, however, creates a different source of vulnerability. Due to the absence of broad and deep financial markets, government debt is often held by a relatively small number of financial institutions, which creates risks to financial sector stability.

The different factors behind debt vulnerability in Latin America and the Caribbean are often interlinked and mutually reinforcing. In particular, this applies to low savings ratios. The relatively low national savings ratios in Latin America and the Caribbean are largely a reflection of higher public sector deficits. Higher public savings are needed not only to reduce the vulnerabilities associated with high public debt positions, but also to fund public investment and to create reserves for emergency situations. Indeed, in the absence of natural resources and a limited availability of the usual mechanisms for increasing competitiveness, enhancing the public infrastructure is considered crucial for economic growth in this region. In that sense, higher public savings to help funding increased public investment should be considered a necessary complement to a pegged exchange rate, which is also often the rule in this region.

Against this background, I am of the view that increased fiscal discipline is needed to reduce vulnerabilities or, to put it more positively, in setting conditions for stable economic growth in many countries in Latin America and the Caribbean.

Like other central banks in this region, the Bank van de Nederlandse Antillen plays an important role as advisor to the government, also in the field of fiscal policy. Against this background, too, I hold the view that the Bank's main assets are not, as many may think, its foreign reserve holdings, but rather its human capital. My main wish for the future of the Bank van de Nederlandse Antillen is, therefore, that it will be successful in maintaining its position as a centre of excellence in this part of the Kingdom of the Netherlands, to the benefit of the beauty of the islands of the Netherlands Antilles and of all its people.