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SPEAKING NOTE
for Mr K. Regling
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The framework for fiscal discipline in EMU and the challenges ahead: does the euro area need a change in its economic governance?

Ladies and gentlemen,

It is a real pleasure for me to be here to take part in the debate on economic governance in the euro area, since it is an issue to which I attach great importance.

Ever since the euro was launched almost six years ago, the framework for economic governance in the euro area has been hotly debated. This is in large part due to its unique institutional set-up with centralised monetary policy and decentralised fiscal policies. The budgetary co-ordination framework in particular has been at the core of the debate.

Now that we have had almost six years of EMU, it seems appropriate to assess how well the budgetary surveillance framework has functioned so far and to think about what, if any, changes need to be made. Today I will look back on the experience of the first few years – not only the achievements but also the problems we have experienced. I will then go on to present some ideas on how to strengthen economic and budgetary co-ordination in order to capitalise on the advantages brought about by the euro.

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This morning, you already discussed the *achievements* of the first years of EMU.

A key conclusion was that the EU economic governance has helped to deliver macro-economic stability. On the fiscal front, impressive budgetary consolidation was achieved in the years preceding the launch of the euro. The improvement of budgetary positions helped to create more room for manoeuvre for the automatic stabilisers and to improve the quality of public finances. The result is that the current budgetary situation compare favourably with the past, when economic downturns were typically accompanied by a serious deterioration in budgetary positions. Thus, the EMU framework has also contributed to improving the sustainability of public finances.

However, we have encountered a number of problems in *implementing* the fiscal framework.

The EU coordination framework for economic policy has been perceived as focusing predominantly on budgetary balances and fiscal discipline, while the link between guidelines on economic policies and recommendations for fiscal policies has been weak.

The existing framework also lacks incentives for prudent behaviour in good times. In 2003, fewer than half of all Member States complied with the objective of a budgetary position close to balance or in surplus. We have witnessed considerable deviations from planned adjustment paths, with the “close to balance or in surplus” objective becoming a moving target. We have also seen many instances where attempts to comply with the deficit ceiling have led to the adoption of one-off measures, “creative accounting” or pro-cyclical policies.

In addition, the EU fiscal framework has not sufficiently taken into account differences between countries in terms of their debt levels, economic growth and long-run demographic trends. At the same time, we have neglected the debt criterion of the Treaty, which is becoming increasingly important as our ageing societies force us to focus more on long-term fiscal sustainability.

Thus, the implementation of the fiscal framework has not always been consistent with the spirit and the letter of the Treaty and the Stability and Growth Pact. This has led to a loss of credibility and ownership and, ultimately, to institutional uncertainty at the European level.

The Commission therefore considers that economic governance, in particular the Stability and Growth Pact, needs to be strengthened. Everybody agrees on that. But there is no agreement – yet – on how to do it. Personally, I believe some changes in the framework itself are necessary, for the following reasons:

i. First of all: *credibility*. Over the last few years, we have tried to improve the implementation of the Pact through a more flexible interpretation of its rules. I believe that this approach cannot be pushed any further without losing credibility and putting the rules-based system at risk. We could easily end up with a discretionary system.

ii. The second reason, then, is *equal treatment*. A discretionary system, relying on an excessive interpretation of the existing rules, cannot guarantee equal treatment.

iii. The third argument is an *economic* one. We need more room for economic judgement in implementing the rules. This is completely in line with the approach in the Treaty where both the 3% and the 60% are reference values that call for economic judgement on what are the risks of breaching these reference values. And we need economic judgement on the appropriate adjustment path for each country.

iv. Finally, we should also accept that certain parts of the fiscal co-ordination framework need to *change over time*, in line with changing economic circumstances. For example, for most Member States, the current rule of reaching balanced budgets or surpluses is entirely appropriate in the light of the ageing population and of existing debt levels. This approach is the best way to prepare budgets for demographic problems. If it is successful, debt levels will decrease significantly in a decade or so. This will then create room for small deficits when the impact of ageing hits budgets.

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With this assessment, what should our next steps be? Well, the Commission Communication released earlier in September presented four ideas on how to strengthen economic governance and improve the Stability and Growth Pact.

The **first** is to put more focus on debt and sustainability in the surveillance of budgetary positions. In several countries we have seen a weakening link between budgetary balances and debt dynamics. Increased focus on debt would complement continued rigorous attention to deficit developments and should help achieve prudent debt positions.

The **second** idea is to take into account differing economic conditions when defining the medium-term objective. This is particularly important since the enlargement of the Union to 25 Member States. A uniform specification of the medium-term objective for all countries is no longer adequate.

Specific economic circumstances and developments could also be taken more into account in the implementation of the excessive deficit procedure. This could be achieved by two means:

- on the one hand, the definition of “exceptional circumstances” which exempt the country concerned from being placed under the excessive deficit procedure when deficits are above 3% of GDP could be adapted in order to better cater for protracted slowdowns.

- on the other hand, the adjustment path for the correction of an excessive deficit could be reconsidered, taking into account cyclical conditions and risks to sustainability. The principle remains that an excessive deficit should be corrected promptly, but the influence of economic developments outside the control of the government on the budgetary outcome should be taken into account.

The **third** issue is how to strengthen enforcement. Ambitious action in good times and prudent, symmetric-over-the-cycle behaviour should be pursued. The available enforcement mechanisms, including early warnings, should be used promptly and effectively. But a more effective enforcement of the co-ordination mechanism also requires strong institutions.

At the same time, the shortcomings in the collection of national statistics in some Member States that have been identified over the last five years must also be addressed. It is of the utmost importance to ensure minimum European standards for the institutional set-up of statistical authorities and we need to accept tougher surveillance mechanisms by Eurostat in this domain. Efficient budgetary and economic surveillance is impossible without reliable statistics. The experience of the revision of the Greek fiscal data has shown this clearly.

The **fourth** point is that budgetary policies should do more to help achieve the economic objectives set in the Lisbon strategy. Of course they do that by ensuring macro-economic stability. But this is not enough. Budgetary policies should be conducted in such a way that they help increase growth potential, while still respecting the objectives of the EU budgetary framework. This can be achieved by improving the quality of budgets on both the expenditure <u>and</u> the revenue side and, to do this, the link between the Broad Economic Policy Guidelines and the Stability and Growth Pact should be reinforced.

In practical terms, this would mean adjusting the economic policy calendar by bringing forward the submission and assessment of the Stability and Convergence Programmes from December to before the summer. This would enable the content of the Broad Economic Policy guidelines and the Opinions on the Programmes to be more effectively taken into account in the preparation of national budgets in the second half of the year. The creation of a proper EU semester for economic policy is likely to increase the Member States’ ownership of EU policy co-ordination, by making the interaction between European and national levels more coherent. In addition, better involvement of national parliaments should increase the legitimacy of the EU fiscal framework.

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To sum up the situation, then, both the declaration of the June European Council on the Stability and Growth Pact and the statement issued by the informal ECOFIN Council earlier this month reflect the growing consensus that it is necessary to strengthen and clarify the Stability and Growth Pact. In doing so, due consideration should be given to reinforcing the Pact's economic rationale and implementation, focusing more on debt and sustainability, and strengthening the preventive arm. ECOFIN Ministers reaffirmed the role of the Pact in contributing to sound budgetary positions, low inflation and low interest rates, and stressed the need to keep the Treaty provisions, including the two nominal reference values, unchanged.

I hope we can also reach a consensus on the ideas presented by the Commission. That would move us to a more appropriate, more economic Pact that would also be suitable for the new Member States.

Thank you for your attention.