# Fiscal rules: Drawing lessons from the past - speech by Klaus Regling

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**“Fiscal rules: Drawing lessons from the past”**
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(*Please check against delivery*)

Good afternoon.
In a broad sense, the Stability and Growth Pact (SGP) was set up because in a monetary union, where monetary policy is fully centralised while fiscal policy is conducted at national level, fiscal policies must be coordinated. It was feared that irresponsible fiscal policies, particularly in large countries could give rise to inflationary pressures.

In addition, sound government finances are important to preserve debt sustainability, maintain trust between the member states, and strengthen confidence of the general public and financial markets in the single currency.

The initial 1995 proposal made by German finance minister Theo Waigel was designed to complement the fiscal criteria, to be met by countries before joining the monetary union, already anchored in the Maastricht Treaty.

The final political agreement was reached after dramatic negotiations between French President Chirac and German Chancellor Kohl at the Dublin European Council in December 1996.

They agreed on a simple set of rules, which were to become the core of the pact. It included the two famous reference values of 3% as the deficit limit to GDP and 60% for debt to GDP. The selection of these values was not random. They made sense in light of the nominal GDP growth at the time of Maastricht negotiations, and the 3% limit defined for the deficit was regarded as generous.

The pact went further than limiting deficit and debt levels. It specified that the member states should aim for a balanced budget or have budgetary surpluses on average over the cycle. The aim was to have fiscal space in a recession, when the fiscal deficit could move from balance to a maximum deficit of 3% of GDP. This would allow member states to conduct countercyclical policies. In addition, the SGP introduced an escape clause that allowed more significant deviations, for example, in case of fall in annual real GDP of more than 2%.

However, the subsequent implementation of the pact turned out to be highly procyclical. Most governments did not use unexpected revenues in cyclical upturns to reduce deficits or save for worse times. The period of economic growth at the end of the 1990s was not used to create sufficient buffers. This meant that fiscal policy was often procyclical during good times. Consequently, dealing with an economic downturn required procyclical tightening or violations of the rules. The latter was precisely what France and Germany did in 2002-2003.

In accordance with the SGP, the European Commission proposed in 2003 to move France and Germany another step up in the Excessive Deficit Procedure, just one step before sanctions would have been triggered.
The peer pressure expected to support the SGP failed as other countries supported the fiscal sinners during the vote in the Council. With the smallest possible margin, the Council decided not to vote on the Commission proposal but to approve different Presidency conclusions instead.

In 2004, the European Court of Justice confirmed the right of the Council to procedurally postpone the decision on Commission proposals. But it confirmed that the Council cannot approve its own conclusions without a fresh recommendation from the Commission. Financial markets did not react to this erosion of the rules.

The subsequent reforms resulted in a more sophisticated pact, increasing the importance of cyclical elements. It provided a bigger scope for economic judgement. However, the greater flexibility and the stronger economic foundation of the new pact decreased its transparency and simplicity.

To conclude, I would like to stress that despite its shortcomings, the Stability and Growth Pact has overall had a positive impact. The euro area fares better on debt and deficit-related statistics than other advanced economies; this was particularly in 2007 and 2019.

Although the pact has been the subject of numerous reform proposals over the years, nobody has ever suggested its abolition. The reasons why it was created continue to be valid.

In February this year, the European Commission launched a review and public debate on reforming the pact. For the moment, the discussion has been overshadowed by the ongoing pandemic crisis, which has driven public debt and deficits to unprecedented levels. Higher public deficits and debt are necessary and legitimate in response to the crisis. But higher debt can depress future growth, as economic research has shown.

In my view, what is needed at the moment is clarity on the fiscal path for member states in the next two or three years. At the same time, we should start thinking about the steady state – how to shape our fiscal rules so that they are transparent and effective. It is a challenging task for the Commission and I am looking forward to Paolo's intervention.  Thank you.

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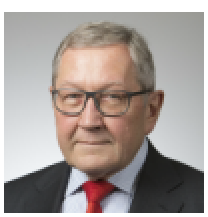

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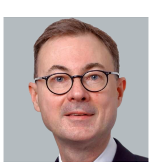

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