PANEL DISCUSSION

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It is a pleasure to contribute to the panel discussion on new rules for EMU. I will try to be pointed and provocative in order to stimulate the discussion and I will focus briefly on two issues: First, the general framework of the monetary union and, second, the European fiscal rules. To summarize: With regard to both frameworks, I am worried that we are not moving towards a stable framework in the medium to long term.

The most general question with regard to rules in EMU is: Do we need rules at all?

Being as German as possible my answer is: "I have rules, therefore I am."

A French person might answer: "Of course we need rules, and I will sign up to all of them, but: what are rules?"

Both of these exaggerations may reflect the traditions of the countries concerned. France has a history of centralisation, where the nation votes for its president and government, and these take decisions for the nation as a whole and have quite large scope for discretion. The President of France decides on French matters and represents the French people.

Germany is more federalist in structure. Its regions have a larger role in the political decision-making process. There is no single central decision-maker taking decisions on a discretionary basis. Instead, there is greater reliance on *ex ante* contracts and rules – kind of treaties under which the regions have agreed to give up sovereignty to the center where the major decisions are taken.

Setups like the EU and the European monetary union still consist of highly individual countries, which still feel themselves as nations. They retain important powers at the national level. From my (German) point of view, such a setup needs credible treaties and rules and a particular trust in the legal framework. These are important for living together and further integration because credible treaties are needed when the countries give up some of their sovereignty. Negotiations are conducted, compromises are found and in such a setup it is crucial that everyone can rely on compliance with the agreements. For example, a country agrees to something which it does not like too much, but which is important to another country, and, in exchange, it may be provided with a regulation it likes, but with which the other country is not so happy. A fiscal rule might, for example, be granted in exchange for greater mutualisation, but there must be trust that the rule is not just on paper.

We would face severe problems if the various countries and as well private actors had doubts about the ability to reach credible agreements that are also binding in the medium to long term. Therefore, I am convinced that EMU and its further integration cannot be built on discretion but only on credible treaties, agreements and rules. Of course, if the environment or opinions change, it should be possible to change things. But, in such a situation, it is, in my view, important to amend the treaties and agreements in the context of a regular democratic decision-making process.

I fully agree that a crisis calls for a certain degree of give and take and, of course, treaties, rules and agreements should allow a certain amount of flexibility and room for interpretation. However, I fear that we risk overdoing it.

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By observing the European debate, there is sometimes the impression that policymakers want to change things, but that they are afraid of the general public, because the general public might not agree, for example, to the amendment of existing treaties. Therefore, rules, treaties and agreements are reinterpreted. Strange and extremely complex legal constructions are assembled in order to make them hopefully conform with the pre-existing framework - or in case of doubt make them incomprehensible for the public at large. There is a tendency to a high level of discretion and decisions are shifted away from populations and parliaments towards councils and, at best, to the ECB and the Eurosystem, which, being independent, is the furthest removed from democratic processes and theoretically, of course, has unlimited financial resources.

I fear that we are putting acceptance of the European integration process at risk, that we risk undermining trust in the legal principle and, as a central banker, I fear in particular that we risk overburdening monetary policy.

In the Workshop also the opposite was said: namely, that there is a risk that monetary policy could overburden fiscal policy. In my view, this clearly indicates the pressure monetary policymakers will be facing in the future. As soon as an interest rate increase is deemed to be appropriate in the face of mounting price pressures in the euro area as a whole, we will certainly face calls for delaying that increase on the grounds that it will place too great a burden on some countries and on fiscal policy. The resulting risk for financial stability will be emphasised and monetary policy will be called on to assume responsibility for financial stability and keep the interest rate low.

Now, let me turn more specifically to fiscal rules in EMU.

In my view, the changing framework of governance in EMU means, if anything, that the importance of fiscal rules has increased. Even though many things have changed in the crisis, the deficit bias of politics in the short term is still there.

At the same time, in response to the crisis, one important disciplining mechanism has been weakened: market discipline.

- The “no bail out” provision has been transformed more or less into a “bail-out promise”.
- The fiscal support mechanisms have mutualised debt and there is almost no interest surcharge, which I feel is a very problematic incentive.
- The Eurosystem has announced that it will do “whatever it takes” - within its mandate.

So, given the less pronounced roles played by market discipline, “no bail-out” and the prohibition of monetary financing, the role of credible fiscal rules has become more important.

We have heard earlier in this session what credible fiscal rules are. In my view, in particular:

- They should be not too complex, so some “stupidity” is unavoidable. Of course some exemptions are needed, but they should be as clearly defined as possible.
- The rules should be set as an upper limit, so that the government has full flexibility when being below the threshold. The rules should not be an instrument for fine-tuning the fiscal stance.
- The rules should be understandable for the policymakers and the general public.
- They should be implemented rather strictly and, in particular, they have to build up credibility after being reformed, which could be achieved by an even stricter implementation.
- It is crucial that the general public can follow, so that the rules can increase the political cost of higher deficits and thereby counter the deficit bias. The rule is a potential tool for the opposition, which can blame any government’s unsound fiscal policy more easily.

So, what about the reformed European rules?

Just after the latest reform process with all the various "pacts", my assessment was rather favourable.

- The statistical production should become more reliable.
- Greater prominence seemed to be given to the debt ratio.
- There was a shift of power from Ecofin, which was quite weak in its decision-making, to the Commission, which should have the potential to be more rigorous.
- The Fiscal Compact and its implementation in national law should have improved national ownership and also focused the national debate more on the existing European rules. It was also intended to make non-compliance a national legal problem.

Overall, in my view, the rules could have been strengthened. But finally it of course crucially depends on the way the rules are implemented. It has to be borne in mind that no national sovereignty has been transferred. We have not entered a fiscal union and national parliaments can, in principle, do what they want.

Now, after the initial excitement, from the present perspective I am somewhat disillusioned with regard to the implementation of the fiscal rules. In the past, when somebody asked me about my profession, I said that I am a fiscal expert. However, I would expect that being a fiscal expert means you should at least roughly understand how the basic fiscal rule is exactly working. I don't any more. So, if someone now asks me about my profession I say that I work on fiscal issues.

I fear we currently risk eroding the fiscal rules. Yes, some flexibility is needed. The rules may not be that simple. A little discretion may be warranted. But current developments are taking things too far.

The rules are becoming incredibly complex, intransparent, arbitrary and discretionary.

There is the impression that they are designed with a search for exemptions in mind. For example, the assessment of "effective action" and hunting for the "green light". My current understanding is:

- If you have reached the nominal target, you are more or less off the hook. Even if it is done with the help of the cycle or one-offs.
- If not, there is a test whether the structural deficit can be used as an excuse. Here, we have the chance to fine-tune the assessment by increasing the real time output gap through changing the underlying methodology – where we may allow even for options for the country to decide on the methodology.
- If this does not work, we correct for alphas and betas where the calculations are complex and, I had the impression, vary somehow.
- If the country fails to comply with the former criteria, we turn to a bottom-up where you take on board country-specific measures. This is a move to the micro level, where almost no-one can follow apart from the Commission and the country in question. Peer pressure from other countries and from the general public is eliminated and we have reached a very high degree of discretion and room for manoeuvre.
- We would reach full discretion if the former five tests were negative, and there would be a final round with an overall assessment, where all other factors could be taken into account which may come to the mind of the national government or the Commission.

All in all, to my mind we are in the process of transforming a rules-based framework into a framework of full discretion, where consolidation risks being postponed and the disciplining power becomes lost.

In my view, the Commission has significantly reinterpreted its role in this process.

Initially, I had the perception that the Commission was interested in stringent rules and that they saw themselves as a referee guaranteeing sound public finances by implementing the existing rules. Having clear-cut rules and a lack of discretion protects the Commission – the referee – from political pressure and influence. As a result, the transparency of the rules should give clear guidance to policymakers and the general public, thereby giving them binding force.

Now, the Commission seems no longer to be interested in being the referee on the basis of rules, but rather in being a decision-maker and negotiator on the basis of a discretionary assessment. However, as there is much discretion, the rule becomes a bargaining process, in which political influence and pressure become important. As a result, if politicians and populations become aware of the available scope for discretion, the rules lose their power, because it is always possible to believe that exemptions can be negotiated.

If it became obvious during a football match that the referee was not applying the rules of the game impartially but was instead blowing his whistle on a discretionary basis, the atmosphere in the stadium would become very heated, but this would certainly not improve the game.

It will be particularly interesting to see how the rules are implemented in the case of Italy and France, whose governments recently announced that they do not care much about deficit reduction.

To avoid any misunderstanding: I am greatly impressed by the work of the Commission: its high analytical power, its European approach, how it handles its role between the Parliament, the Council and the national governments. But, the debate we had in this Workshop on the optimal design of Fiscal Councils supports the view that it is the wrong institution to implement the fiscal rules. I therefore believe it would be a productive idea to shift the task of assessing fiscal developments, plans and compliance with the fiscal rules to an independent institution that has a clear and only focus on that task, which does not have several other policy goals and which is outside the regular European bargaining process.

So, in conclusion: If Europe does not decide on fundamental change and is willing to enter a fiscal and political union, we have to strengthen rather than weaken the current framework, including the incentives for sound public finances.

This means:

- Keeping market discipline alive by ensuring that investors remain responsible for their investment decisions.
- In doing so, it is very important to make financial markets and the banking system much more resilient to pressure so that it can absorb fiscal stress without posing a threat to financial stability in the euro area as a whole.
- Breaking the nexus between banks and governments. Mutualising the risk of the banking systems, which we are currently doing, is one course of action. But to be symmetric, we should also sever this nexus by placing a clear limit on public debt included in the balance sheet of the individual banks. At the same time, we should ensure that taxpayers retain responsibility for electing their national government and, thus, for its economic and fiscal policy. It is therefore advisable to limit bail-outs and to provide support only against interest surcharges and strict conditionality.
- Finally, keeping fiscal rules as simple and transparent as possible and keeping relevant assessments outside the political bargaining process.