**Sustaining the Recovery: Strategies and Policies for Growth and Stability**

**Session 1: Lessons from the crisis response for the way forward**

***Brussels Economic Forum***

By Reza Moghadam

Director of European Department, International Monetary Fund

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It is a pleasure to be here in Brussels today—and not for crisis talks as it has often been the case over the last few years, but an opportunity to reflect on the crisis and the way forward. Let me also pay tribute to the other members of the panel, each of whom has played a key and highly successful role in steering Europe through the crisis.

In dealing with the crisis, Europe has made great strides in strengthening the architecture of both the euro area and the EU to make Europe more resilient for example, in setting up the ESM, enhancing the monetary policy framework, moving toward a banking union, to name a few areas.

Today, I will focus my remarks on a specific part of this architecture, namely fiscal governance. This is an area where there has been much progress and evolution but also some frustration with complexity and implementation. I have three simple points—recognizing that nothing is “simple” when it comes to EU governance:

• First, Europe needs a governance framework that anchors debt sustainability so that it is less complex and easier to communicate than the current regime.

• Second, more thought needs to be given to more credible enforcement of fiscal rules.

• And third, the framework needs to facilitate more infrastructure investment in the region.

But before getting to this, we need to be clear about how we got to where we are—what is good and right about it, and what could be improved.

***Gaps Exposed in Maastricht’s Fiscal Governance Framework***

I draw four main lessons for fiscal governance from the crisis experience[1](http://www.imf.org/external/np/speeches/2014/061014.htm" \l "P28_1849)

**• First, countries should have built stronger fiscal positions *prior to* the crisis.** Public finances deteriorated significantly with the crisis: the average public debt-to-GDP ratio in the euro area soared by about 30 percentage points. Most of this deterioration was not due to discretionary fiscal stimulus—it was mostly the effect of automatic stabilizers (as revenues fell and expenditures rose in the recession) and exogenous factors (like the bail-out of the banking sector). In essence, countries did not enter the crisis with strong enough fiscal positions to withstand such large shocks.

**• Second, the focus on nominal rather than structural targets, as well as weak enforcement, provided little incentive to build fiscal buffers.** The 3 percent of GDP nominal deficit ceiling did not prevent countries from spending their revenue windfalls in the mid-2000s. While revisions to the fiscal framework in 2005 did introduce structural balance targets, compliance was, and remains, very weak. Apart from Finland and Luxembourg, euro area countries have struggled to consistently meet their structural balance targets since the late 1990s*.*

**• Third, the design of fiscal rules lacked flexibility**. With deficit rules defined in nominal terms, the rules implied procyclicality and politically difficult tightening at the worst possible time. The rules did not include escape clauses to deal with exceptional economic circumstances. Consequently, many rules had to be suspended during the crisis on an *ad hoc* basis to avoid damaging fiscal tightening.

**• Fourth, good fiscal governance is necessary, but not sufficient—good *economic* governance is also key to minimizing fiscal risks.** We have seen in recent years that private sector imbalances can rapidly end up as public sector imbalances. Conversely, public sector imbalances can hit private sector spreads and balance sheets. The well-known bank-sovereign feedback loop evident during this crisis has brought home just how complementary fiscal and economic governance are.

***Lessons Learned? Progress in Reforming the Fiscal Framework***

Since its introduction in 1997, the Stability and Growth Pact has been reformed several times between 2005 and 2013. These reforms have helped in multiple ways:

**• There are better incentives to build fiscal buffers in good times**, including through medium-term objectives defined in structural terms.

**• Fiscal rules are more sophisticated and flexible.** Many countries have adopted so-called “second generation” fiscal rules, which give them more room to accommodate economic shocks, and the “Six Pack” introduced escape clauses for severe recessions as well as new cyclically-adjusted fiscal indicators.

**• Both private and public sector imbalances are monitored.** The Macroeconomic Imbalance Procedure goes beyond fiscal metrics to look at private debt, external current accounts and net international investment positions. The banking union, especially the bail-in regime, better aligns incentives in the financial sector and hopefully will reduce taxpayer exposure to banking sector losses.

These actions go some way towards filling the gaps revealed by the crisis. That said, the rules are overlapping, over-specified and divert attention from the ultimate objective: debt sustainability. They are also complex. This makes them difficult to communicate to the public.

***A Robust Fiscal Framework for the Long-Term***

Let me suggest three areas of reform to ensure the viability of the fiscal governance framework.

**Reform 1: Simplify the rules while keeping some flexibility—make the change in the public debt-to-GDP ratio the ultimate objective and reduce the number of operational targets.**

By successively layering new constraints and procedures on top of old constraints and procedures, overlaps and inconsistencies are created*.* For example, the 3 percent nominal deficit rule was initially meant to stabilize public debt at 60 percent of GDP, assuming that nominal growth would be 5 percent per year. However, downward revisions of nominal long-term growth to around 3 percent in many euro area countries suggest that debt would instead converge toward 100 percent of GDP.

Simplification should be a priority*.* Right now, there are far too many operational targets: to name a few, (a) the 3 percent deficit; (b) the expenditure benchmark; (c) the nominal deficit targets under the EDP; and (d) various structural balance targets, in levels and changes. The labyrinth of rules is difficult to communicate to the public, and the number of rules needs to be cut down. Debt dynamics, i.e., the evolution of the debt-GDP ratio, should be the single fiscal anchor, and a measure of the structural balance the single *operational target*. This would go a long way to simplifying the system while retaining flexibility against cyclical shocks.

**Reform 2: Strengthen enforcement mechanisms.**

Compliance with fiscal targets in Europe has been low since the late 1990s, reflecting weak incentives. Enforcement mechanisms in Europe are not as strong as in other federations. Sanctions typically take the form of deposits subject to loss, like posting a bond. But the conditions to convert these deposits into outright fines are very strict and so far have never been applied. The corrective actions required in case of non-compliance are also relatively weak, reflecting the inability of the center to impose direct controls on national budgets.

There are no easy solutions here, especially in a framework founded on peer pressure and moral suasion. More automaticity in enforcement could help: if sanctions cannot be avoided *ex post*, then they are likely to be more effective *ex ante*.

**Reform 3: Enhance the framework for public and private investment.**

There is a worry that the fiscal framework actively discourages public investment, which is already too low in Europe*.* This is an old debate that has arisen again: the financial crisis prompted politically easier cuts in public investment, reinforcing a pre-existing downward trend.

How to deal with this? Removing public investment from any fiscal balance calculations is undesirable in my view, as it encourages “creative accounting” and weakens the link between debt-to-GDP and operational targets. A better approach would be to boost the ability of the *center* to fund public infrastructure projects, such as cross-border investment in transportation, communications, and energy networks. This could be done in the form of public-private partnerships, while keeping national budgets within the bounds of the fiscal framework. This raises the politically difficult question of how such European-level projects should be financed. But just because it is a difficult political question doesn’t mean that it should be set aside. Low public investment is a serious issue for in the euro area, and has serious implications for potential growth and thus debt sustainability.

Separately, with bank credit to the private sector still falling and with banks’ capital still constrained, capital market development can go a long way towards facilitating access to funds for investment by European corporates. I see a lot of potential for supporting growth through this route.

**A final word**

I realize that the issues I have raised today are not easy ones, not least because the current fiscal governance framework has been arrived at through difficult negotiations and compromises. Yet if the goals of that framework are to be achieved, and if public disillusionment with complexity is to be overcome, its mechanisms must be the subject of further scrutiny and reform. The IMF staff is looking at many of these issues with our euro area member countries and we look forward to contributing to progress in these areas ahead.

Thank you.

[1](http://www.imf.org/external/np/speeches/2014/061014.htm" \l "P28_1850) See also Allard and others, 2013, “Towards a Fiscal Union for the Euro Area,” Staff Discussion Note 13/09; and IMF Board Paper, 2013, “Reassessing the Scope and Modalities of Fiscal Policy in Advanced Economies.”