Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

Secretariat

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Draft

OPINION OF THE COMMITTEE OF GOVERNORS ON FISCAL DEVELOPMENTS IN THE COMMUNITY - FOR PRESENTATION BY THE CHAIRMAN AT THE ECOFIN MEETING IN JULY 1993 -

The Committee of Governors of the central banks of the Member States of the European Economic Community has recently examined fiscal developments in the Community. The Committees deems it necessary to present its opinion to the Council of Ministers in conformity with the tasks assigned to it in the Council Decision of 12th March 1990.

The review of recent fiscal trends in the Community as a whole has confirmed the concern which had been expressed in the 1992 Annual Report of the Committee of Governors. The budgetary situation of Member States is rapidly deteriorating and according to the latest estimates by the Commission, the aggregate public sector deficit as a percentage of Community GDP is expected to increase to about [5½]%* this year - the highest level ever recorded in the history of the Community. At the same time, the ratio of public debt to GDP, which stabilised for a brief period towards the end of the 1980s, has begun to rise again in recent years and is estimated to reach a new record high of [66]%* in 1993.

Concern about the present state of public finances in the Community is particularly warranted since the rise in budget deficits over the last few years cannot simply be ascribed to the cyclical downturn but mainly reflects structural factors. This is all the more worrisome because the opportunities to correct structural budgetary imbalances were not sufficiently exploited during the period of strong economic growth in the second half of the 1980s.

These developments are alarming. Not only does public sector borrowing absorb a large share of the Community's private savings, thereby driving up real interest rates and reducing productive investment, but the persistence of fiscal imbalances has also seriously constrained the capacity of macro-economic management. Owing to the failure to consolidate fiscal positions in the past, there is now little, if any, room for letting automatic stabilisers work. At the same time the task of monetary policy to attain price stability has been complicated and high budget deficits and debt levels narrow in many Community countries the scope for lowering official interest rates despite the

* Preliminary figures which are likely to be changed after the new Commission forecast has been released.

weakness of economic activity. The key to reducing real interest rates - and thus stimulating economic growth - is a decrease in the public sector's claims on private saving. This will, in turn, expand the room for monetary policy action without jeopardising the progress made in fighting inflation.

While the deterioration in the Community's aggregate fiscal position masks different situations in individual countries, there can be no doubt that in virtually all Member States there is an urgent need to correct fiscal imbalances. The reversal of budgetary trends must be guided by a medium-term strategy while the timing and the extent of the necessary retrenchment measures may have to differ from country to country. In some instances, especially in countries with a high level of public debt and/or excessive budget deficits, there is practically no choice but to bring down rapidly the size of the deficit, even if this is particularly painful in present circumstances. In other countries the necessary consolidation may be achieved more gradually, provided the firm adherence to the medium-term strategy is demonstrated - as recent examples have shown - by enacting quickly the legal and administrative measures which will ensure the return to a more balanced fiscal position over time. Convergence programmes can certainly play a very useful role in this context, provided such programmes show clearly the determination to persevere in the process of fiscal consolidation for an extended period and contain concrete steps which allow markets to assess reliably the targeted improvements in fiscal positions.

A credible, predetermined and irreversible path towards fiscal balance is a crucial element for promoting market expectations of lower real interest rates and better growth prospects. Such expectations will help to bring forward the beneficial effects of fiscal consolidation and are likely to mitigate the adverse impact which fiscal adjustment inevitably exerts in the short-run on aggregate demand.

In summary, the correction and, eventually, the elimination of fiscal imbalances is an indispensable prerequisite for improving the potential of the Community's economies on a durable basis. This is also recognised in the Maastricht Treaty which bestows sound public finances a central role in a successful future Economic and Monetary Union. The criteria for public finances included in the Treaty set a benchmark to evaluate the progress of individual countries in the coming years. A failure to exercise fiscal restraint, or a postponement of the necessary measures, would only make the ultimately unavoidable consolidation process more difficult since it would imply a further rise in the public sector debt ratios, in interest payments and thus in the structural part of budget deficits. This would not only impair seriously the growth and price performance in the Community, but the impression that public finances are drifting away from the reference values established in the Treaty also risks undermining the credibility of the EMU process.