COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS
OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY

THE CHAIRMAN

Basle, 19th June 1993

Mrs. Marianne Jelved
President of the Council
of the European Communities
Rue de la Loi, 170
B-1049 Bruxelles

Dear Mrs. President,

As a contribution to the discussions under the item "Multilateral Surveillance" on the agenda for the meeting of the ECOFIN Council on 12th July 1993, I intend to present, in my capacity as Chairman of the Committee of Governors, the enclosed opinion of the Committee on fiscal developments in the Community.

I would be grateful if the Secretariat of the Council would circulate the opinion to the members of the ECOFIN Council ahead of the July meeting.

With kind regards,

Yours sincerely,

W.F. Duisenberg

Enclosure

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

19th June 1993

OPINION OF THE COMMITTEE OF GOVERNORS* ON FISCAL DEVELOPMENTS IN THE COMMUNITY

In its Annual Report for 1992 the Committee of Governors had expressed concern about fiscal developments in the Community. Indeed, a review of recent fiscal trends, conducted by the Committee of Governors, has confirmed that the budgetary situation of Member States is rapidly deteriorating. According to the latest estimates by the Commission, the aggregate public sector deficit as a percentage of Community GDP is expected to increase to more than 6% 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 close to 67% 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. They also reflect to a significant extent structural factors which have been adding to imbalances since 1989. 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 have meant that public sector borrowing has absorbed a large share of the Community's private savings, thereby driving up real interest rates and reducing productive investment. 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 in some countries; in others the scope for their use has been substantially reduced. The key to reducing real interest rates (particularly long-term rates) - and thus stimulating sustainable 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. The current high budget deficits and debt levels complicate the task of monetary policy to attain price stability and may make it more difficult in some Community countries to lower official interest rates despite the weakness of economic activity.

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* This opinion has been prepared in accordance with Article 3 of the Council Decision of 12th March 1990 which states that one of the tasks of the Committee of Governors is "to express opinions to individual governments and the Council of Ministers on policies which might affect the internal and external monetary situation in the Community and, in particular, the functioning of the European Monetary System".

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 will naturally 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 little choice but to take prompt action to reduce 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 of fiscal imbalances is an essential prerequisite for improving the potential of the Community's economies on a durable basis. This is also recognised in the Maastricht Treaty which bestows on 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.