CONGRATULATIONS TO CFP ON THE FIRST DECADE – AND TO PORTUGAL

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It is an extraordinary honour and pleasure to be at this event to celebrate the first decade of the Portuguese Fiscal Council (CFP). The presence today of the highest level of leadership from government and major public institutions in Portugal is a testimony to the esteem in which the CPF is held. That the Prime Minister of Portugal has chosen to make this event an occasion for making a major speech on economic policy is a further illustration, which I have not observed in other EU countries that set up an independent fiscal council a decade ago.

There is, indeed, something to celebrate, also for someone looking in from the outside, in my case the European Fiscal Board (EFB), engaged in monitoring fiscal governance in the EU. The first decade of the CPF is to me a promising case study in how governance can be improved by combining the roles of policy rules on the one hand and of independent analysis and advice on fiscal policy from independent national institutions such as the CPF on the other. In this way, the national experience of Portugal is of relevance for the EU governance reform which is, hopefully, about to start in the European Commission and Council.

I shall first make a few observations about the economic performance of Portugal in its interaction with the European Union (EU) and as compared to some other Member States. I then turn to the CPF from its origins a decade ago and try to make some inferences about its impact on the course of economic governance in Portugal. Finally, I link these topics to the discussion, now finally about to move on in the EU, on the future of EU governance with possible rebalancing of rules and institutions - and the implications for independent national advice as input into this process.

I should underline that my remarks and views are personal. While I have had the privilege to chair the EFB, an imperfect EU analogy to national fiscal councils, for the past six years and have learned very much from interacting with my colleagues and our Secretariat, I would not want them to be held accountable for my free-wheeling observations - on Portugal, the CPF and the future of EU economic governance.

A BACKGROUND PERSPECTIVE ON PORTUGAL AND THE EU

Before I try to illustrate these points, allow me to reflect from a highly personal perspective on how far the Portuguese economy and its policy framework have come over the past several decades and how crucial the interaction with the EU has been throughout. The first conference I attended in this country as an economist took place in this splendid museum in 1976. It was organised by Vítor Constâncio to take in advice on how to tackle the enormous challenges facing Portugal following the revolutionary regime changes and challenges of 1974-5. It was a truly brain-storming event; sessions ran late into the night. I recall vividly a strong desire to draw on experience elsewhere in Europe – even though that was certainly not very promising at a time of high inflation and major divergences within the EU in the aftermath if the first energy shock -as well as the sharpness and realism of many Portuguese speakers.

This impression was confirmed when, on the same trip, I visited the Banco do Portugal, meeting Teodora Cardoso, to become the highly-respected first Chair of the CPF 36 years later, then a key analyst in the Research Department of the Bank. She was engaged in how to improve management of the escudo in a turbulent and inflationary environment, using the state-of-the-art approach of visiting US economists, notably Paul Krugman, then a Ph.D. student at MIT. There was obviously a very long way to go for Portugal in developing a policy framework, but no shortage of analytical ability and of the drive to start addressing the main issues.

Indeed, hopes of a rapid catch-up seemed to be confirmed over the two decades that followed. Portugal started negotiations to join the EU only two years later, and it was not the fault of Portugal or of her highly skilled Chief negotiator, Ernani Lopes, that the process dragged on for 7-8 years. When the Maastricht Treaty was agreed, another able and independent academic colleague, Jorge Braga de Macedo, had become Finance Minister and swiftly took the escudo into the Exchange-Rate Mechanism, signalling ambition to be in the first group to adopt the single currency. And during the technical discussions to prepare the EMU Treaty, young officials from the Finance Ministry and the Bank – Vitor Gaspar and Antonio Borges – developed a reputation for expertise and ability to find compromises that put them in central positions. Vitor Gaspar remained a key figure in the negotiations on the Stability and Growth Pact which implemented the fiscal provisions of the Treaty a few years later.

In the run-up to 1999, Portugal remained a promising example of how the “Maastricht bargain” worked - fiscal prudence in return for lower and more stable inflation and interest rates than she could have delivered by herself – at least in qualifying for entry. But the first decade of EMU became increasingly painful. Portugal, in contrast to Ireland and Greece that were to precede her into adjustment programmes in 2010-11, never had a boom, at least outside the construction sector. Growth slowed, the current account deficit rose beyond 10%, mainly due to imbalances in the household and corporate sectors. Inflation rose well above the EU average, draining competitiveness.

Problems were severely aggravated when Portugal, along with most EMU countries under the European Economic Recovery Programme encouraged by the Commission, pursued expansionary fiscal policies in 2009 in the hope that the financial crisis would be quickly overcome. The slogan then – and it will sound familiar from recent experience - was the soothing one of “targeted, timely and temporary” fiscal stimuli. Budget deficits in 2009 and 10 rose by more than 5 percentage points above estimates, debt by 25. A long-lasting legacy had built up.

THE REACTION TO CRISES AND THE SET-UP OF THE CFP

There is a tendency in the literature on independent fiscal councils (IFIs) to distinguish between those that are “home-grown” and those that were set up mainly as a result of external requirements; the latter are suspect of being less robust. Sweden (2007) and the UK (2010) are seen as prime examples of the former; in both a Council was set up in response to the defeat of a long-lived government, perceived to have developed overly lax habits and interpretations of its own fiscal framework. The reform of EU fiscal governance over 2011-13 did require that Member States without an IFI set up one to improve the transparency of fiscal policies and the macroeconomic projections on which they are based as well as compliance with the the agreed rules-based framework, significantly updated ar the time. Is there any evidence that the distinction is important – and where does Portugal fit in?

It must be argued, I believe, that the start of the CFP preceded the external pressure from European partners and international creditors. It was not only home-grown, but had the extra advantage of broad cross-party support, rather than being triggered by a major political shift after an election, hence starting off with a partisan flavour. The mutual blame game between parties, which became observable in Greece and Ireland as well as Spain in this period of time did not handicap the CFP similarly.

The new institution became an integral part of the legislation on the Budgetary Framework Law, advanced in 2010 some time before the sovereign debt crisis crippled Portugal and the official creditors arrived in April 2011. This double strength – home-grown and non-partisan - must have been helpful to the position of the CPF in its first decade, particularly in the early years when the country went through very painful and controversial economic adjustments under the oversight of international creditors, occasionally even running into Constitutional barriers to implementation.

Given the point of departure with major disequilibria, not least in its public finances, Portugal could hardly have been expected to exit from the group of the six countries in EMU which now have debt ratios well above 100 per cent of GDP, far above the euro area (and EU) of average. But it must be a source of satisfaction in Portugal that fiscal prudence has been a bit better observed in recent years than in the other five EMU participants in this group (Belgium, France, Greece, Italy and Spain). Let me summarize some recent data on public finances to illustrate this point. The three latest governments in Portugal should, of course, take the main credit, before looking at the features of the CFP which have allowed it to contribute positively to this relative prudence.

The Commission's 2022 Spring Forecast expects Portugal to be the only country among the six not to have a public deficit above 3% both this year and next, and to have a primary balance in surplus in 2022-3. That is app. 2 percentage points stronger than the average for EMU as a whole. The debt ratio should, in a baseline scenario, have returned to the 2019-level by the end 2023. The other countries in the very-high-debt group (with the exception of Greece) seem to be stuck about 10 percentage points above their respective pre-pandemic levels.

I am not obsessed with fiscal indicators only. However, the relatively good performance of Portuguese public finances has not been at the cost of slower output or employment growth than elsewhere in the reference group. The Portuguese indicators for 2022-3 are, with those of Spain, the best in the group. These achievements will serve Portugal well at a time when sovereign borrowing costs are rising, drawing additional attention to relative performance among the potentially most vulnerable sovereigns.

The CFP has been in a position to push this evolution in the right direction for several reasons. Looking first at the formal criteria developed by the OECD to rank all IFIs in its membership by degree of independence, the CFP ranks second, only superseded by the Office for Budget Responsibility in the UK – hence now first in the EU. The criteria used refer to several dimensions: CFP members must refrain from requesting or receiving instructions – a more explicit commitment than elsewhere – its budget resources are vetted by the Governor of Banco do Portugal and the President of the Court of Auditors and submitted through them to the Minister of Finance; the budget requests have only been marginally lowered in the process. The same two prominent "patrons" submit proposals of candidates for the five members of the CPF to the government, appointed for seven-year terms. Deep expertise and experience in public finance are the criteria for nomination, further helping to make the selection process reassuring (though on one occasion a proposal was not accepted by the government). The presence in the CPF of two non-Portuguese members has added top international analytical capacity and experience, currently represented by George Kopits and Paul de Grauwe. Unfortunately, few other IFIs have so far used non-national members to strengthen their prestige and independence.

Finally, as to access to relevant information, a perennial problem for IFIs, CFP appears to have stronger means to obtain access to government agencies: it can start a naming-and-shaming procedure if its requests are not dealt with – and this provision has been used successfully in one case. Interaction with the government takes place in the public domain through CFP publications and its web page.

The range of the mandate is wider than for most other IFIs. It spans the basic tasks of endorsing government macroeconomic and budgetary projections and evaluating compliance with the Budget Framework Law, including mechanisms for correcting imbalances. Occasional studies of sustainability, and of subnational public finances have been undertaken; it would be desirable to expand the resources of the CFP to deepen its work on these longer-term central issues for public finance - and of fiscal risks.

For our 2022 Annual Report the European Fiscal Board, to be published in the autumn, we are, as usual, preparing a survey of the experience of selected IFIs; CFP is one of the case studies this year, and it will bring out a number of details on how it implements its mandate, what tasks it might additionally take up and some inferences as to its impact on the reliability of the government's macroeconomic projections which CFP is charged with endorsing. The forecast errors were reduced more sharply in Portugal between the early EMU years and the 2014-9 pre-pandemic recovery than in a number of countries that also set up IFIs around a decade ago. The forecast errors even changed signs between the two periods only in Portugal - from overly optimistic to slightly prudent which is what one would hope from the institutional innovation.

Most important – and well documented - in this review of the first decade are a couple of cases when CPF "spoke truth to power" by commenting critically in its endorsement of the macroeconomic projections of the government. The second, and current, Chair of CPF, Nazare de Costa Cabral and her colleagues deserve credit for courage and clarity. On two occasions in 2019 reservations were made: first on the medium-term forecast underpinning the Stability Programme in the spring where the numbers for later years (2021-3) were not endorsed; second on the basis for the 2020 budget when endorsement was severely qualified. No verdict on the substance of the CPF's analysis is possible, since the outbreak of the pandemic a few months into 2020 played havoc with all forecasts for that and the following years. But these examples of the approach of the CPF provides illustrations that the CPF is a watchdog, not a lapdog – to use apt wording in the title of a book on IFIs, edited by two of my EFB colleagues (Roel Beetsma and Xavier Debrun).

REBALANCING RULES AND INSTITUTIONS IN EU ECONOMIC GOVERNANCE

One may wonder, with the benefit of hindsight, why the potential contribution of independent fiscal councils to strengthen economic governance in EMU was well below the radar when the Treaty was negotiated three decades ago – and when its main provisions were implemented from 1999. It was well understood that a common monetary policy had to be underpinned by efforts to dampen centrifugal tendencies, seen to arise mainly from national fiscal policies leading to rapid debt accumulation and risks of destabilising financial flows. But the debate on how best to design the constraints was, in retrospect, perfunctory.

Two approaches were discussed: (1) jointly agreed upper limits to public debt and deficit ratios, monitored centrally by the Council of Finance Ministers (ECOFIN) on the basis of recommendations by the Commission, and (2) exposure of national fiscal policies to financial market discipline, possibly guided by regulation of the capacity of domestic banks to build up holdings of ”their” sovereign debt. But since financial markets were regarded by many policy-makers as being incapable of gradualist monitoring – they were seen as “patient for too long and then too brutal” – the focus in the Treaty turned entirely to rules.

Finance Ministers were the main drafters; most of them welcomed external support – an anchor - in their efforts to contain the expenditure proposals of their domestic government colleagues. Economists label this the Common Pool problem: the difficulties in limiting the growth of public expenditures, due to pressure from strong sectoral interest groups, to the support in the electorate for raising revenues.

Furthermore, the Treaty was agreed following two decades with a disappointing record. A lack of willingness or foresight on the part of governments to implement counter-cyclical fiscal policies was well documented. Claims that cyclical stabilisation had to play a key role in EMU were made, but they lacked credibility. The focus moved to ensuring sustainability through agreeing on simple rules.

A minority of countries wanted upper limits to deficits and debt to be applied with automaticity, particularly when used as criteria for entry into EMU. But this was not acceptable to a majority, and the Treaty left some scope for discretion, including evaluation of exceptional circumstances, in ECOFIN. Avoiding gross errors seemed enough. “Peer pressure” to support compliance with the rules was seen as the best way of repairing the limited mutual trust between governments. However, that mechanism proved to be unreliable five years after the start of EMU, when Germany and France managed to find a majority in favour of not accepting the speed of consolidation of public finances proposed by the Commission. The reform of the rules in 2005 focused on refining the rules and the scope for discretion, but it was only the sequence of a financial and a sovereign debt crisis which brought in the potential role of the IFIs - and of strengthened national fiscal legislation – as important decentralised aspects of surveillance onto the centre stage.

Setting up IFIs has certainly helped to bring more transparency to fiscal policy making, raising the reputational costs to governments of errors of forecasting, hopefully of policies themselves - apparently more so in Portugal than in most other EMU countries, as I have argued in reviewing elements of the CFP and the national experience. At the same time, surveillance from the centre has steadily become a more complex and opaque exercise, due to pressure on the Commission to design additional twists to the rules to meet the need for flexibility in individual national circumstances during the slow 2014-9 recovery from crises. The role of the Council, or of the Eurogroup, in checking excessive discretion and bilateralisation of the process has become less visible. Complexity has been further enhanced by the co-existence of national fiscal rules, often not well aligned with those in the EU.

When the pandemic struck in 2020 a so-called “severe downturn clause”, introduced into the rules a decade ago, has allowed such a degree of flexibility that it effectively has made the whole rules-based framework inoperational. The clause has just been extended by the Commission, with the acquiescence by the Council, to the end of 2023. This decision may be understandable in the light of the uncertainties of the economic impact of the Russian invasion in Ukraine as well as the urgent preoccupation in the EU with other implications of the war. Yet there should be concern over prolonging the vacuum surrounding the future of economic governance.

Attention to the sustainability of public finances, long submerged by very low borrowing costs, new spending purposes in urgent crises, and rising confidence of governments in the role of public expenditures in driving economic progress, should not be further postponed.

The Commission has announced proposals for reforming economic governance by September-October this year. I have no reliable information on what to expect, but a couple of elements seem likely: simplification, a more medium-term implementation of the rules, and efforts to rebalance the roles of central and national surveillance.

Two words frequently heard in Brussels are “national ownership” and “decentralisation”. It is understandable that the Commission hopes to discharge itself of some of its onerous and excessively intrusive role as “Guardian of the Treaty”, but the two labels mentioned require careful scrutiny in the upcoming reform.

To what extent might the three mechanisms of (1) jointly agreed rules with central EU monitoring, (2) critical review of national performance by a national fiscal council, and (3) market reactions to policies be regarded as substitutes? The academic literature, initiated by Wyplosz, sees the first two as complements. Rules and institutions are both desirable and they have to become mutually supportive. National IFIs have improved the transparency and reliability of fiscal policies, but to what extent could they also take on monitoring of compliance with rules basically designed at the EU-level without undermining perceptions of their home-grown status? That is a key question; experience suggest that the two monitors – the Commission and the national IFI – occasionally reach divergent conclusions. In the final stages of formulating guidelines, the Commission will continue to find it hard to avoid its central responsibility and a monopoly of dialogue with the government. “National ownership” must refer to backing by the government of the guidelines; the IFI can help to clarify that process and the Finance Minister’s options, but the final responsibility lies with the government and the Finance Minister.

As the founder of the very impressive US version of an IFI, the Congressional Budget Office, Alice Rivlin, has put it: “..(independent advice) can not mobilise political courage to make unpopular decisions”. The buck stops with the Finance Minister to assure that the myriad of decisions on expenditures and revenues that occupy nearly all political attention do add up to a balance compatible with medium-term sustainability and compliant with the rules-based framework agreed. The final interlocutor will still have to be the EU institution charged with implementing a revised rule book; prior advice from the IFI will have clarified the options – and to both parties. The Finance Minister may also wish as a precaution to form as clear as possible an idea of the thinking of the third type of monitor - financial market participants - in order to assess risks arising from financial instability well before they materialise.

Going beyond the division of roles in surveillance between the national and the EU-level might endanger the perception in a country of its IFI, even when it is home-grown and non-partisan, as is the case with the CFP. Reports from the discussion in several IFIs and in their network seem to recognise this. Many IFIs appear reluctant to go further in the direction of decentralisation and delegation of surveillance of an EU rule book than a reinforced complementarity of roles.

CONCLUSIONS

The first decade of the CFP has been promising. It is a difficult exercise to set up an independent institution to advise on and monitor fiscal policy, a very sensitive area for the government. Even in propitious circumstances there will be scepticism – from the government who suspects that the newcomer may become more useful to the political opposition; from the services of the Finance Ministry because an IFI implicitly raises doubts about the objectivity and reliability of their contributions to policy-making. The CFP has had an auspicious first decade, partly due to the initial agreement between the two main political parties in Portugal to set it up, partly by the subsequent competence of the CFP efforts and its ability to develop constructive and longer-run perspectives on fiscal policies. The CFP adds vitamins to the national debate, improving transparency and assisting more prudence in policy-making. The first two CFP chairs, Teodora and Nazare, if I may, with their colleagues and Secretariat, deserve congratulations and gratitude on these achievements and wishes for their further evolution and development of their resources in the changing environment for surveillance in Portugal as in the EU.