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The 'Advantage of Tying One's Hands' revisited. LSE Seminar, 13.2.06

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- The original argument addressed the question of why the old EMS was an effective disciplinary device for inflation-prone countries. The answer was that the EMS brought potentially large credibility gains to policy makers in such countries. It did so on the basis of attaching an extra penalty to inflation. But, crucially, it also did so by tackling the public's mistrust in the authorities – as it made the public aware of the penalties facing the policy makers.
- So, we might say, the 'political science' dimension enveloped the 'economic'. The crucial constraint was one of a behaviour shift on the part of state actors and changing perceptions of them by the wider public. Governance and the citizens' relationship to it were being transformed. Of course, the focus was on a subset of states: the quality of monetary stability in Germany, for example, was in stark contrast to that of others.
- The perspective resonated well with the southern European context. The collusion of the 'party-state', of clientelism, and of repeated corruption created a context of the weakness of the policymaker when faced with vested political interests. Fiscal laxity and policy immobilisme characterised the general landscape. Moreover, the economy lacked the flexibility of adjustment and compensating exchange rate devaluations were all too tempting.
- In Italy, the utility of an external discipline to lever domestic reform was highlighted in the memoirs of Guido Carli. As former Governor of the Banca d'Italia and former Minister at the Tesoro, he'd struggled to maintain policy credibility in the face of the likes of Andreotti and Craxi. Indeed, Carli recalled that the Italian agenda in the EMU negotiations was governed by a search for a solution to the lack of capability of the domestic system.
- He argued for the utility of the 'vincolo esterno'. The discipline of Bretton Woods, of the EMS, and of EMU were all part of a pattern: the external discipline kept the excesses of domestic politicians within some kind of limit.
- Following Carli, the need for a 'vincolo esterno' clearly stems from a particular set of political conditions. State institutions must be seen as failing to deliver, posing a credibility problem. Moreover, the restricted autonomy imposed by 'Europe' must be seen as politically acceptable. These are general conditions that connect the EMS of 1979 to the updated Lisbon agenda of 2005.
- So, I follow the Carli argument, but re-reading Giavazzi and Pagano, I wasn't clear why they might think the discipline of the EMS had to be trumped by the discipline of a single currency regime. Perhaps you could expand on: What had gone wrong or what was missing?

- To the question of ‘what had gone wrong’?, we might add what have been the benefits to Italy of the single currency? Would we compare the performance of recent years favourably with the performance in the EMS? Perhaps you could say more on this experience. I understand Italian competitiveness has declined substantially since the year 2000, as measured by relative unit labour costs.
- To the question, ‘what was missing?’, in the EMS we can compare the Italian stance in EMU. From the beginning, Italian negotiators sought to resist strict fiscal rules. At first, this was probably a matter of maximising the prospects for Italian entry, but subsequently I have the impression that Italian policy was to seek a looser interpretation of the SGP, easing the external constraint. So, in the absence of tight fiscal rules, what was EMU likely to deliver that the hard EMS could not? And where does this leave the ‘tying hands’ perspective?
- And this brings us to Portugal. If ‘tying hands’ is needed in order to achieve desirable outcomes, then what is the Portuguese experience indicating to us about the role of government? Domestic government intervention is still needed and in new areas. There seem to be shifting notions of ‘governance’ here and perhaps you could clarify the logic. ‘Tying hands’ is needed, but it never seems to be enough.
- The discussion on the Lisbon agenda seems to reinforce the argument of Guido Carli. With their discretion, governments cannot be relied upon to deliver the necessary structural reform. The Lisbon agenda, however, lacks all of the key qualities that EMU has had: the timetable; the seemingly clear rules; the insularity of the policy process; the concern over exclusion. So, what is the most effective solution? More hands to be tied more tightly? And if this is the logic, then what of democracy and accountability?
- If ‘tying hands’ is the solution, then how are we to regard the performance of the ECB and the effectiveness of the fiscal rules of the SGP? This is a matter of both design and implementation. The ECB’s lack of transparency in its decisions and forecasts creates problems for expectations and adjustment by market actors. This is the case also with its inflation target or target range. Moreover, tying hands to poorly designed rules is a problem: when France and Germany avoid penalties for breaking the 3% limit on deficits, the credibility of the SGP is undermined. Yet, if they had been penalised, the action could have been more strongly procyclical. What is the advantage of tying hands, if the ties that bind are badly designed?
- So, as a non-economist, I found your paper to pose many questions about governance, both domestic and European. How can states be helped to deliver reform? How can the EU manage a system of fluctuating performances on reform? Essentially, it seems economists have to bring the politics back in....