Revisiting the EU fiscal framework in an era of low interest rates

by Blanchard et al.

Session discussion by
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Policy in low interest environment: sustainability

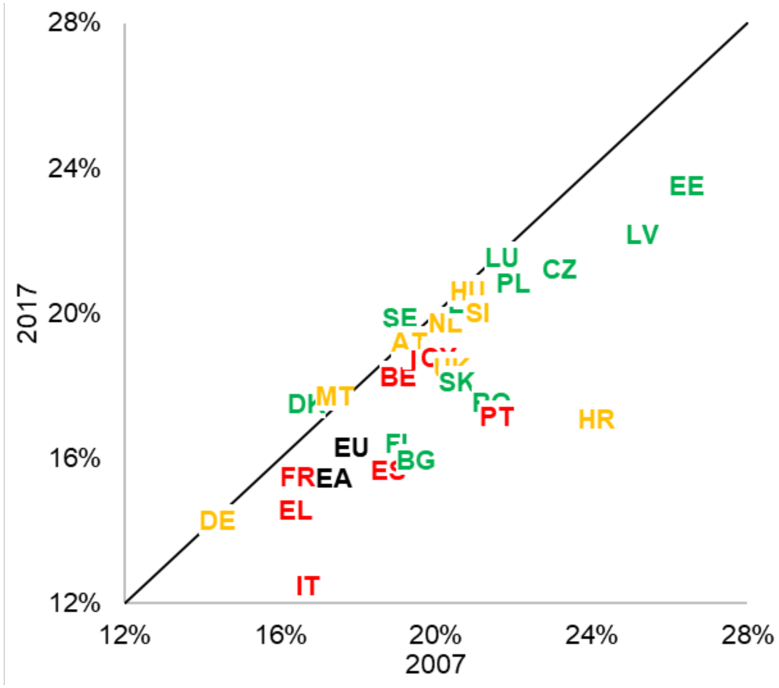
- Thought-provoking paper
- Authors point to possibility to raise debt at no or low cost if nominal GDP growth exceeds nominal interest rate
- However, they also qualify statement by pointing to positive relationship of debt interest rate and debt ratio (Italy may be case in point)
- Note that higher steady-state debt level means more vulnerability of public finances to changes of interest rate around expected level (more safety by issuing at longer maturity)

Policy in low interest environment: quality of public finances

- Crucial is how additional debt issuance will be spent
  - Infrastructure is in many countries in a deplorable state
  - This also holds for other productive spending
  - More spending of this type is desirable: will this raise level or growth rate of GDP; higher nominal GDP growth also benefits public finances by enforcing snowball effect associated with outstanding public debt.

Policy in low interest environment: quality of public finances

- Productive spending (includes spending on R&D, education and transport) in % of total public spending before and after crisis



Policy in low interest environment: fiscal stabilization

- Limitations on monetary policy have implications for fiscal policy
  - Monetary policy based on country average; with slow relative price adjustment, there is a role for fiscal policy
  - Effective zero lower bound
- Implications for trade-off stabilization – sustainability:
  - Fiscal stimulus to raise output has little effect on debt ratio
  - Fiscal consolidation has little benefit in terms of debt ratio
- Effect of low interest environment on cross-border spill-overs of fiscal policy? Demand externalities likely become stronger due to neither inflation nor central bank policy rate moving

Implications of low interest rates for EU fiscal framework

- National fiscal rules may deal with policy bias in the direction of excessive deficits and debts
- EU level fiscal rules justified by externalities related to high debt
  - Monetization pressure on ECB and crisis contagion
  - Positive aggregate demand externality produces too tight stabilization policy (when monetary policy constrained)
- Demand externalities have become relatively more important
- The rules mostly treat current and capital spending the same way

Proposals to revise fiscal framework: stabilization

- Fiscal policy could be collectively too tight – solutions:
  - Central fiscal capacity with borrowing capacity
  - Provision (in primary and specified in more detail in secondary law) that requires countries with fiscal space to undertake fiscal expansion; neither new institution nor common debt issuance is needed
  - Coordinated fiscal expansion based on some trigger underpinned by independent verification
- CFC has advantage of not forcing overheating countries to expand and access can be made conditional (see EFB); Article 126 modification would not need new institution, but would be politically acceptable to some countries only when other countries strictly obey the rules

Proposals to revise fiscal framework: golden rule accounting

- Current balance excludes gross investment but is modified cover both depreciation and the difference in market and “actual” financial return
- Since market return may exceed financial return, restrictions may be needed on current and/or capital account
- This allows differentiation of constraints: constraint on capital account can be friendlier to public investment then constraint on overall balance
- Accounting needs to be overseen by independent supra-national institution:
  - What qualifies as public investment?
  - Estimate depreciation rates in these categories
  - Set methodological standards for estimating social rates of return

Proposals to revise fiscal framework: golden rule accounting

- Education spending would need to be excluded from golden rule because of high degree of depreciation (replacing skills and knowledge of parents):
  - Not convinced that this is the case: computer and digital skills were never taught to parents
  - The problem of "underprovision" of educational investment, because the benefits are mostly reaped in the future (by current non-voters):
  - Also, current voters could reap benefits from higher growth resulting in better pension provision
  - Weigh incentives for under-provision educational spending against problems with classifying under golden rule

From fiscal rules to fiscal standards

- Agree that rules with complex and detailed contingencies do not work: observability of indicators may be problematic; not clear what optimal contingency looks like, etc.
- Authors advocate fiscal standards that lay out standards of behavior, but do not define precisely ex ante how standards are to be met
- So describe settings, in qualitative terms, in which either fiscal tightening or loosening would be appropriate
- Avoid the need to write out contingencies; circumstances change all the time

From fiscal rules to fiscal standards: comments

- How should these standards be enforced?
  - Authors are rightly skeptical about enforcement via financial markets
- Hence, need for adjudicator
- Authors favor European Court of Justice:
  - Is this practically feasible? Would potentially need to consider many cases
  - Assessment of violation of norm may come with quite some delay, so timely correction could be in danger
- Relying on initiative right of Commission may lead to under enforcement (RQMV seems to have had similar effect – see EFB, 2019), so national governments should also have possibility to bring violator to court

From fiscal rules to fiscal standards: comments

- Can we really do away with numerical rules?
- The economic motivation for 60% is quite weak; however, it is in the minds of politicians and public, and aids in commitment to sustainability

How remote effectively from EFB proposals?

ONE fiscal anchor: debt ceiling at 60% of GDP

- Focus on sustainability
- Simple and observable

ONE operational indicator: expenditure benchmark

- Largely observable
- Built-in stabilising effect
- 3-yr ceiling: medium-term perspective
- Annual monitoring with compensation account

ONE escape clause replacing all existing flexibility provisions

- Flexibility without current complexity and “complete contract” approach
- Triggered based on independent analysis

Demarcate policy decisions from economic analysis

- Isolate underlying staff analysis from political considerations

How remote effectively from EFB proposals?

Limited Golden Rule

- Protects investment by exempting specific categories of growth-enhancing expenditure from the expenditure rule
- Exemption applies to EU spending programmes
- Classification monitored by IFIs and national statistical offices

Possible extensions: rules

Differentiated national debt targets or adjustment paths

- In function of key socio-economic indicators: differences in saving, pension systems, borrowing costs, current account balance
- To be agreed within Council

From fiscal rules to fiscal standards: comments

- EFB argues that, once we can go beyond Treaty, there is a case for differentiation of debt targets (to be reset at given time intervals):
  - Countries with fiscal space could be required to aid in stabilizing the euro area business cycle
  - More importantly, targets could be set with a view of intergenerational equity: spreading age-related and climate-related spending
- EFB argues for general escape clause, with analysis and advice by independent body; then, decision moves to political level which has to comply or explain

Thank you!

Link EFB review report:

https://ec.europa.eu/info/publications/assessment-eu-fiscal-rules-focus-six-and-two-pack-legislation_en