Future-proofing fiscal policies: Caution and robustness

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Two basic principles I want to keep in mind

1. It‘s great to know what <u>**optimal**</u> policy is - whether monetary, fiscal or other areas of policy

- Yet, it always depends on the view taken how the economy works, the model used, the uncertainties and risks considered, …
- Instead, an alternative is to search for and consider (simple) rules that are <u>**robust,**</u> that is, rules that deliver reasonably good performance across a range of „world“ views and set boundaries to avoid worst-case outcomes.

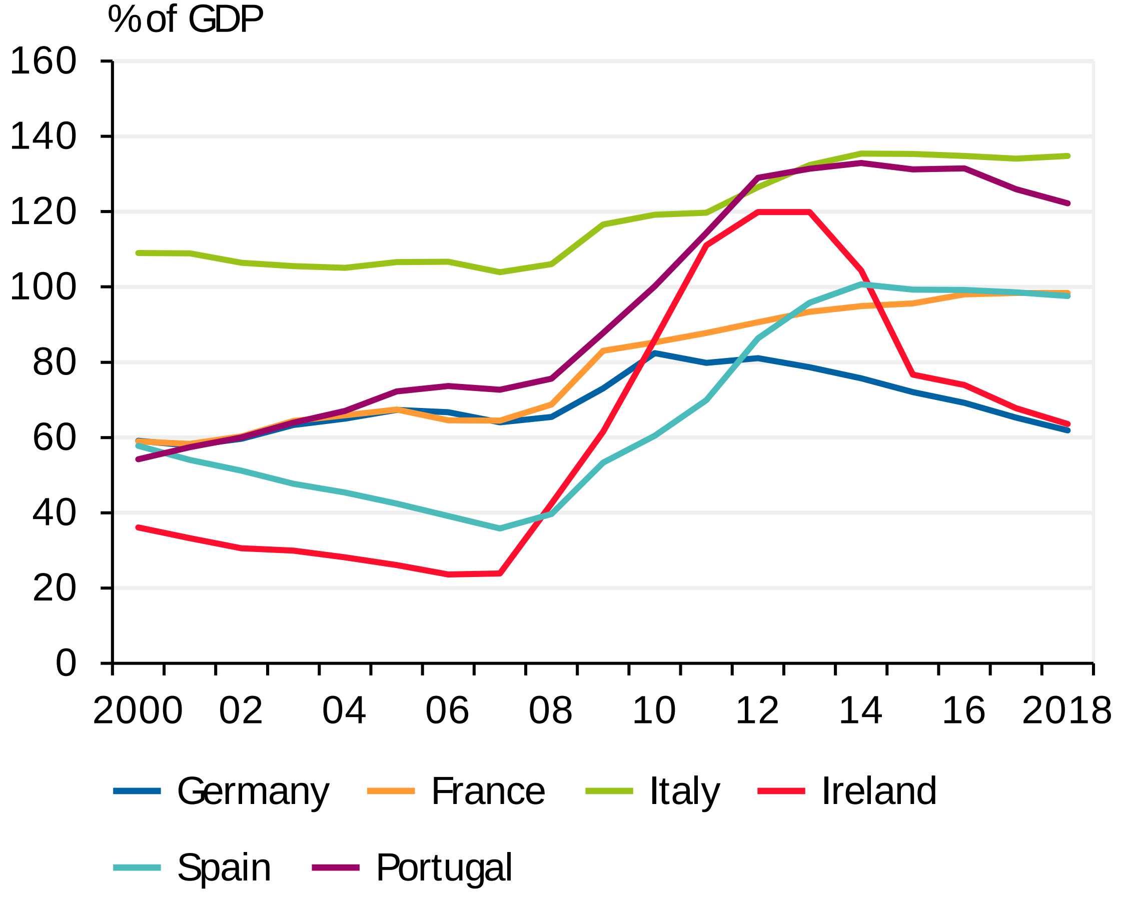
Two basic principles I want to keep in mind

2. It‘s good to know whether a central authority would be better at running fiscal policy.

- Yet , EU/euro area is a union of sovereign member states held together by treaties. And budgets, taxation and expenditures are central to providing a basis for national political decision making.
- Thus, unless steps towards political union come first, some potential benefits of centralization cannot be realized.

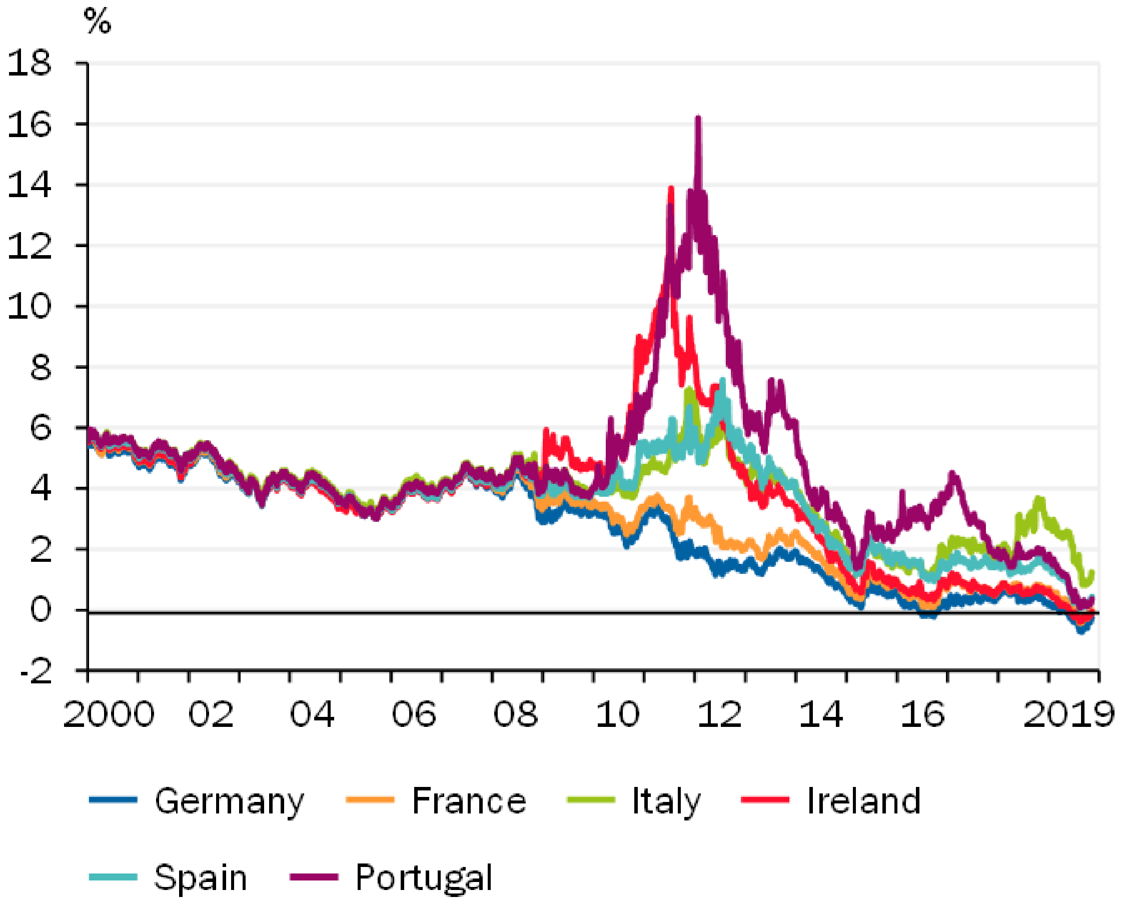
Recent history: Debt to GDP ratios and interest rates can rise sharply and unexpectedly

General government gross debt to GDP ratio
2000 - 2018



Source: Eurostat

10-year government bond yields



Source: Refinitiv Datastream

Long-term interest rates very low in recent years

Reasons

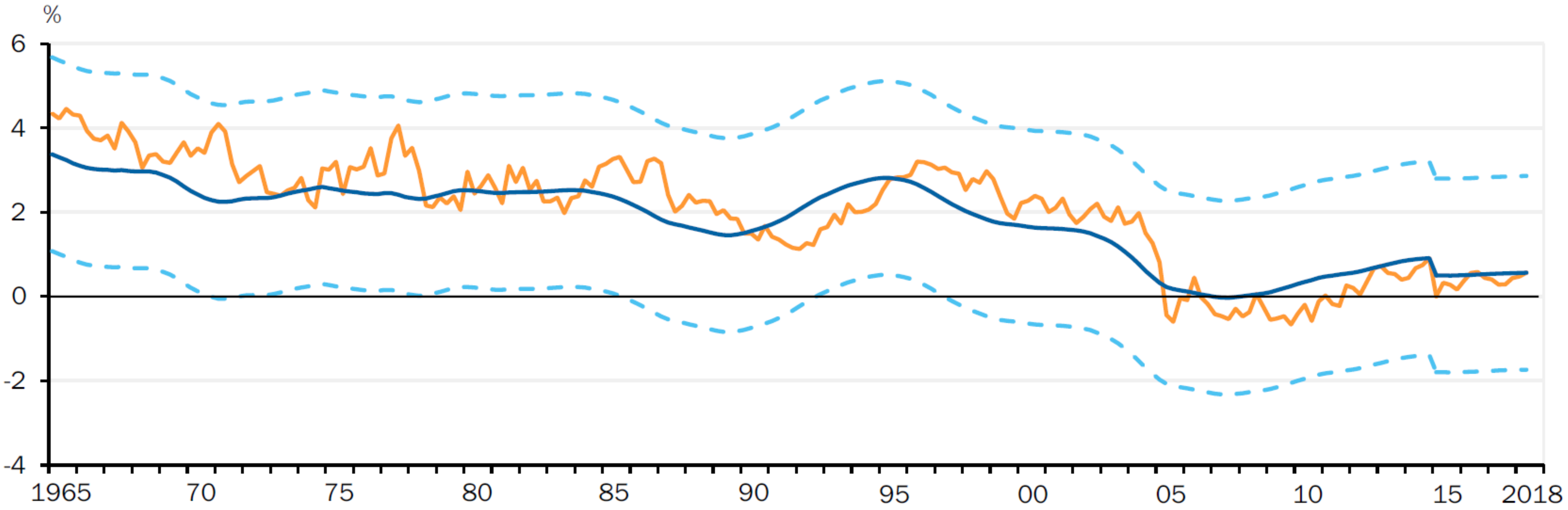
- Monetary policy: forward guidance and quantitative easing
- Decline in medium- or long-term equilibrium interest rates: savings glut/safe assets demand

Fiscal consequences

- Very large interest cost savings, lock-in of low long-term rates
- Debt-GDP ratios stabilized at high levels, in a few cases decline towards or below 60% limit

How long will this situation persist?

Estimates of (medium-run) equilibrium real rate for Germany



One-sided estimate two-side estimate 68% confidence interval

Beyer and Wieland (2019, updated): Laubach-Williams /Garnier-Wilhelmsen methodology

Reversal risk of r<g: Non-trivial from a historical perspective

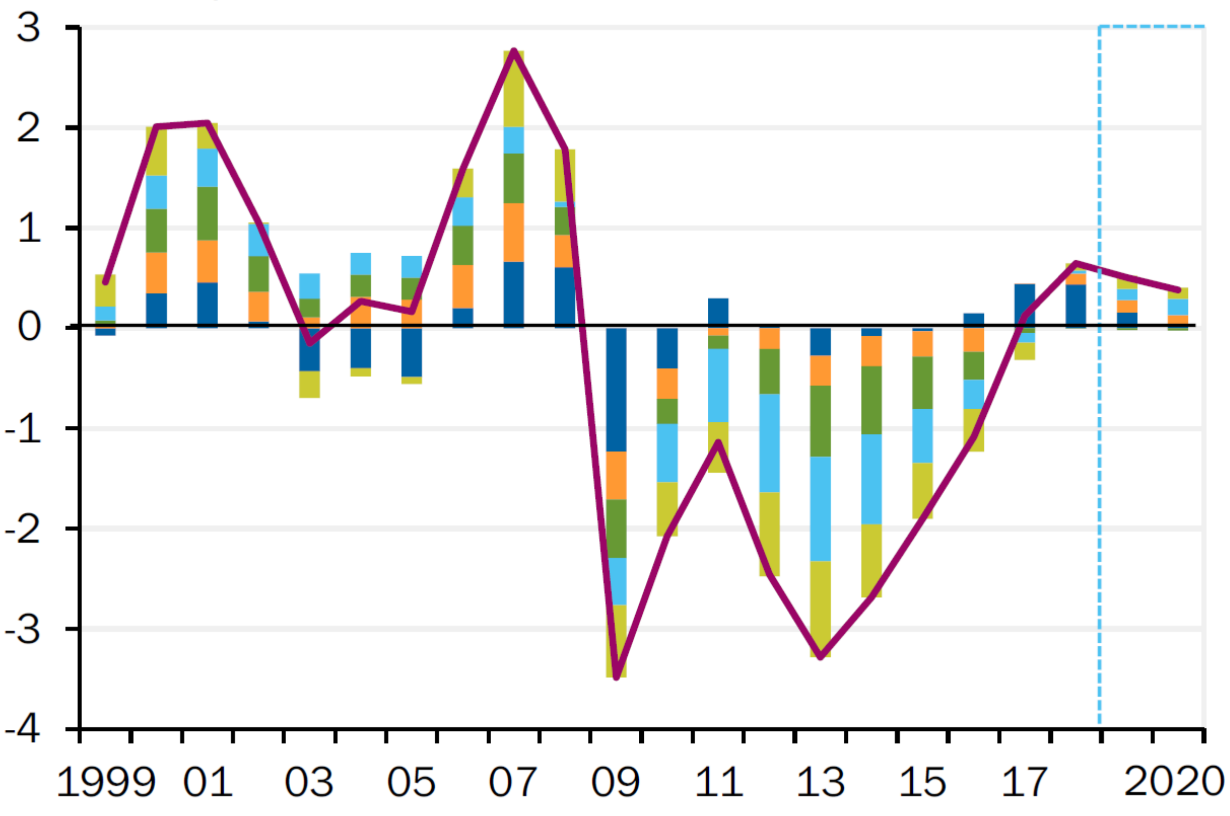
Reversal probability of the interest rate-growth differential in the historical perspective

Conditional probability in %: r>(ĝ+n)	1870–2016					1946–2016				
	Germany	France	Italy	Spain	Average	Germany	France	Italy	Spain	Average
Scenario 1										
in 5 years	12.8	11.6	30.8	9.5	16.2	10.6	8.3	34.6	5.7	14.8
in 10 years	30.3	30.5	47.1	24.9	33.2	36.4	38.0	57.7	31.1	40.8
Scenario 2										
in 5 years	44.5	44.3	66.2	40.8	49.0	40.8	38.0	70.1	31.6	45.1
in 10 years	50.6	52.1	68.0	48.3	54.7	54.5	56.4	76.9	50.4	59.5

Sources: Jordà-Schularick-Taylor Macrohistory Database, Jordà et al. (2019), IWF, Refinitiv Datastream, own calculations

Where we stand in terms of monetary policy: Euro area output gap and inflation measures

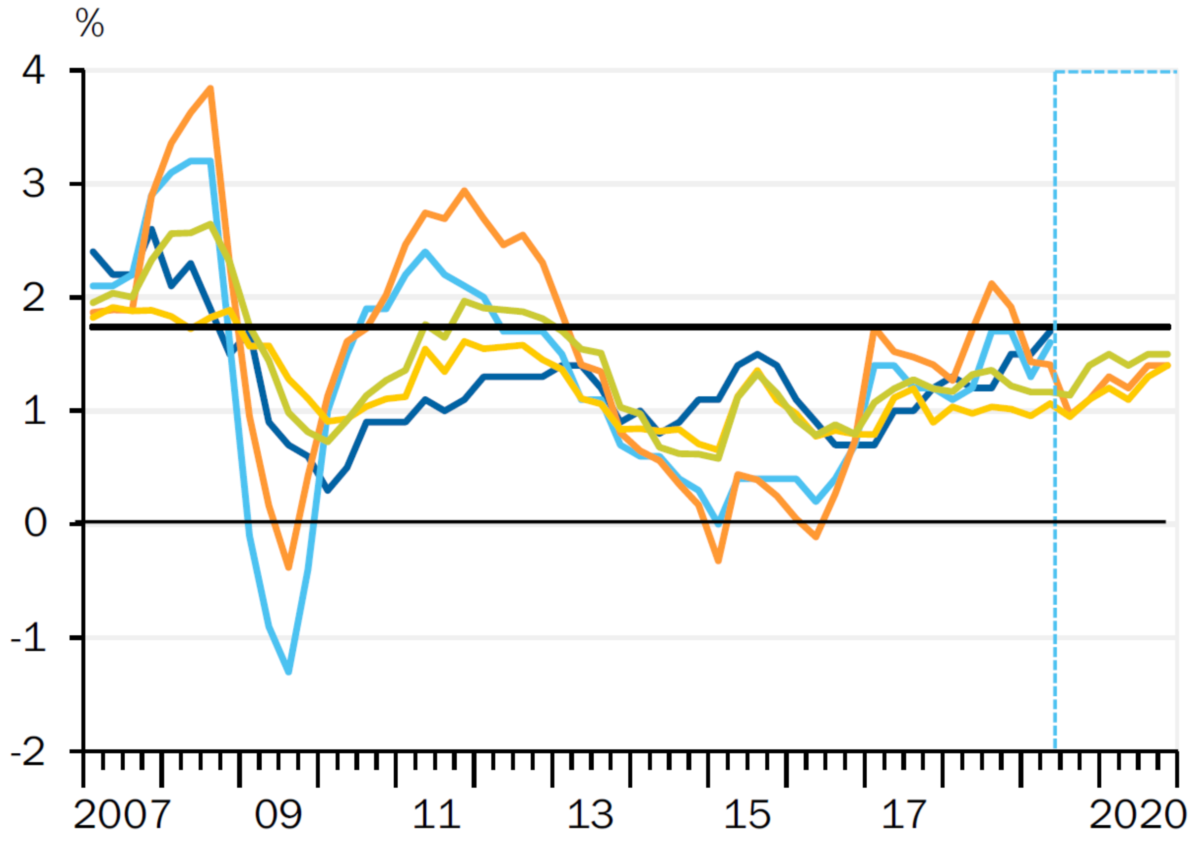
Output Gap



€ area

Contributions: France Germany Italy Spain Other

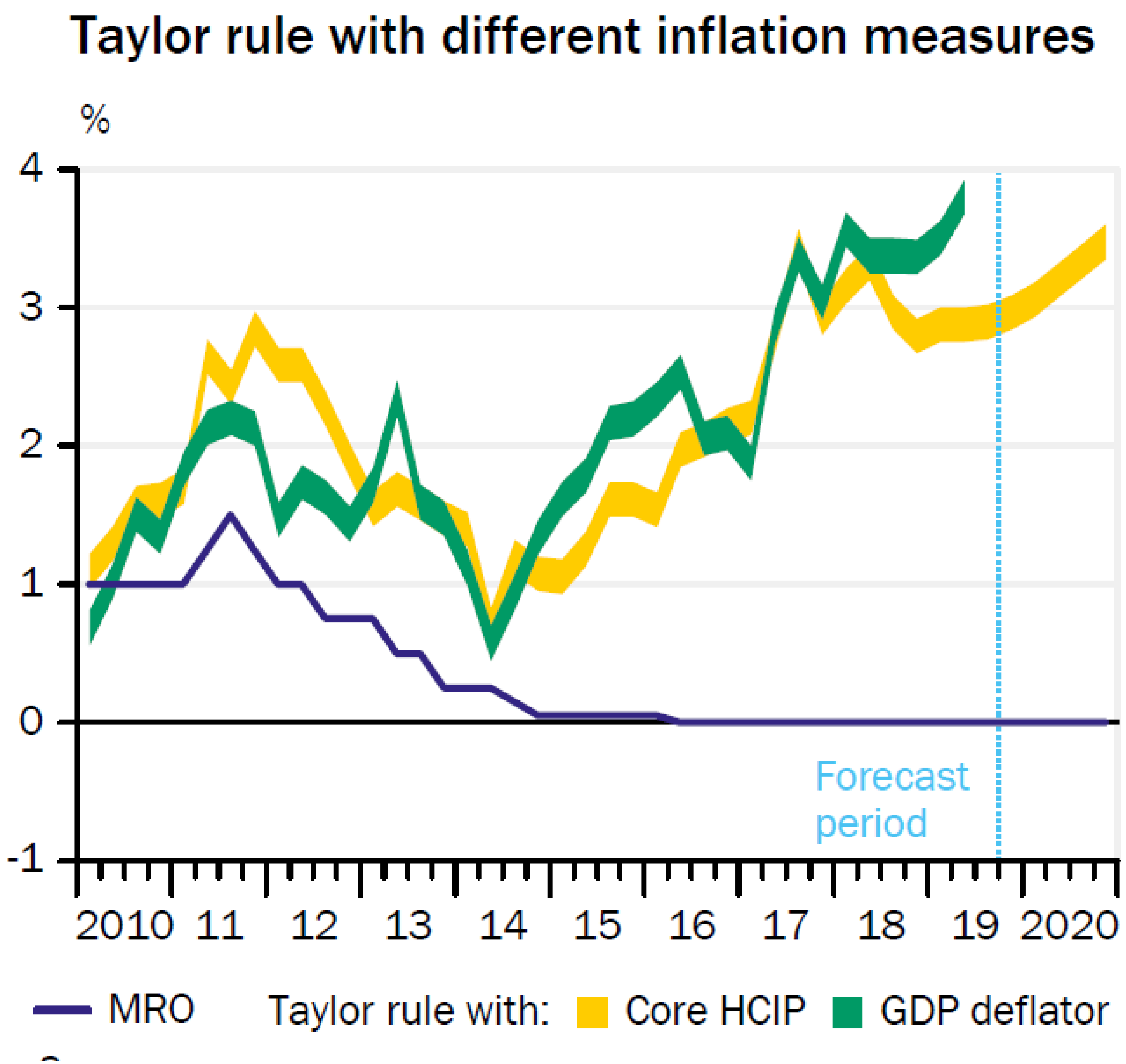
Inflation measures



BIP deflator PCE deflator HICP

core HICP HICP ex energy

Taylor rule translates output and inflation gap into interest rate prescription



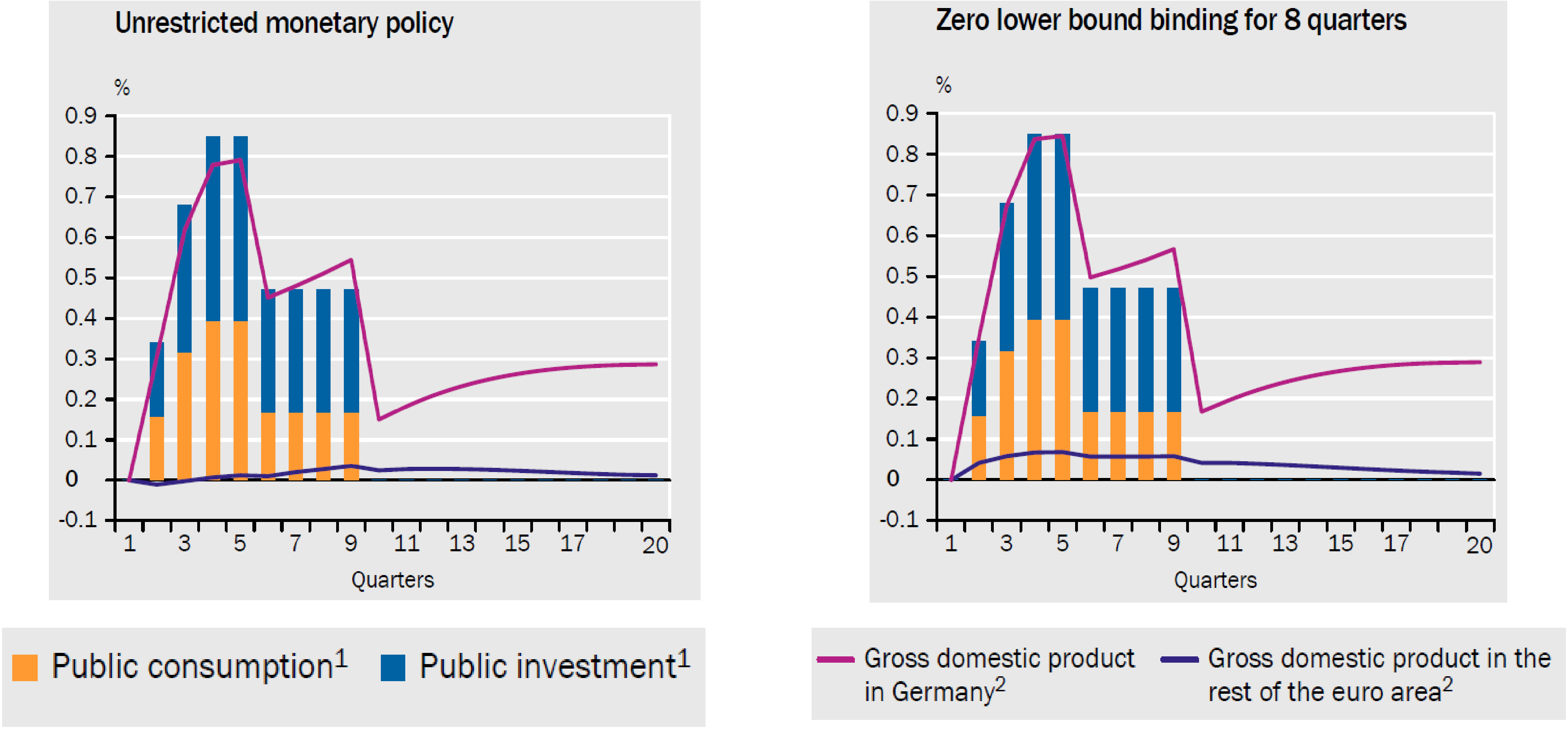
Rule shown with r*=2%

Prescription at or near zero with r*=-1

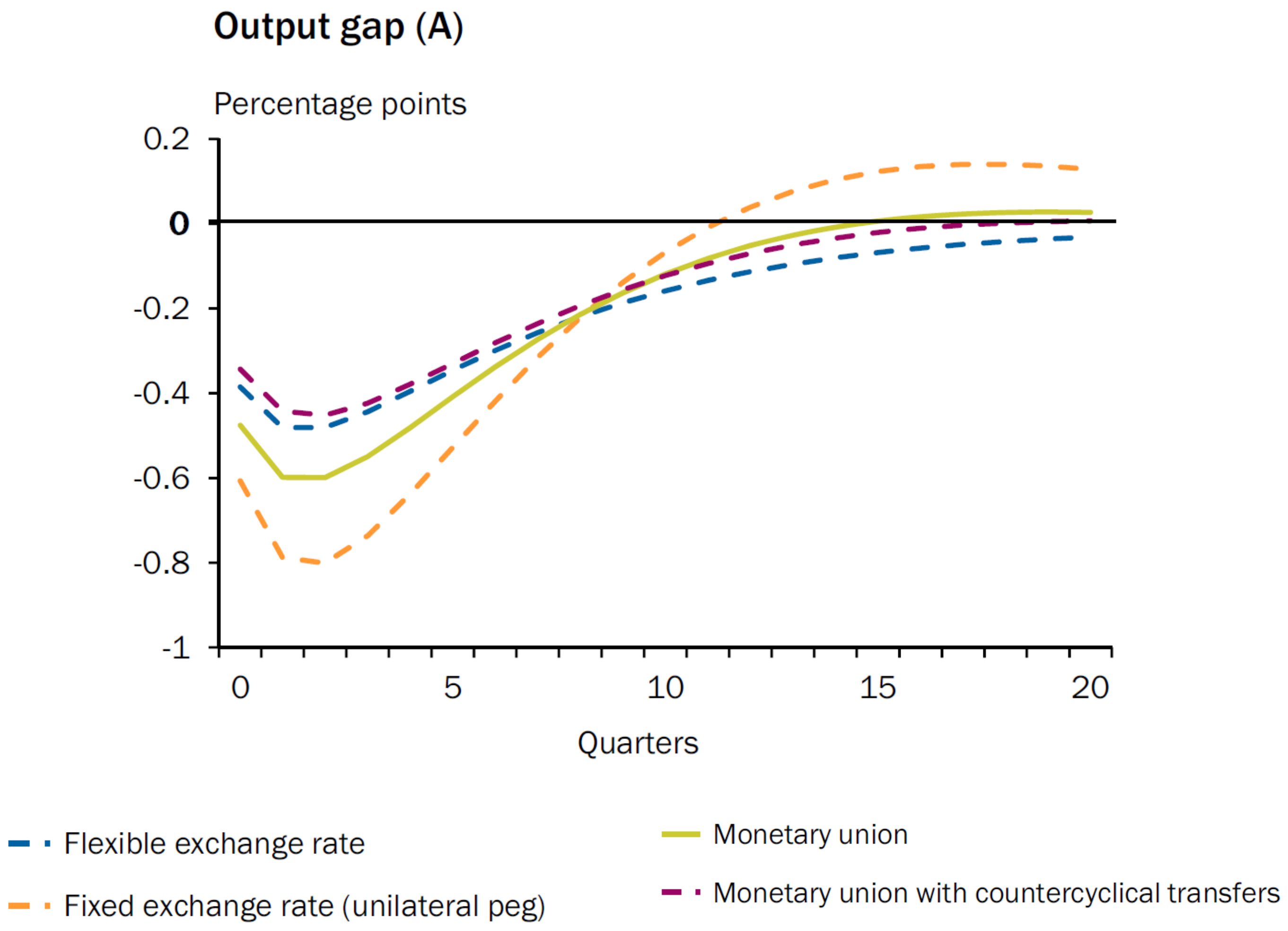
➔ Current ECB policy is already very accommodative, even considering low r*

Further easing is possible: negative rates, QE (corporate bonds, stocks, ..).

Fiscal stimulus and spillovers at zero bound: Simulation of German EERP stimulus in 2 region model



Can national fiscal stabilization policy make up for loss of monetary policy?



Estimate two regions model of euro area

Region A: countries that typically devalued vs D-Mark prior to EMU.

Region D: countries that maintained stable exchange rate vs D-Mark

Asymmetric shock in region A under four different regimes:

flexible exchange rate, unilateral peg, EMU, EMU & national stabilization policy (transfers)

EMU & national countercyclical fiscal policy regime comes close to stabilization under flexible rate regime

Standard deviation of output gap, inflation and budget balance[1]

%

	Output gap		Inflation		Budget balance	
	Region A[2]	Region D[3]	Region A[2]	Region D[3]	Region A[2]	Region D[3]
Flexible exchange rate[4]	2.38	2.61	0.96	0.70	0	0
Fixed exchange rate (unilateral peg)[5]	4.73	2.68	1.12	0.63	0	0
Monetary union	3.05	3.77	0.96	0.71	0	0
Monetary union with countercyclical transfer payments[6]	2.46	2.92	0.91	0.67	0.83	1.02

Central fiscal capacity could lead to persistent net transfers across countries (calculation with historical data)

Cumulative net transfers to the twelve euro area member states as part of a fiscal capacity[1]

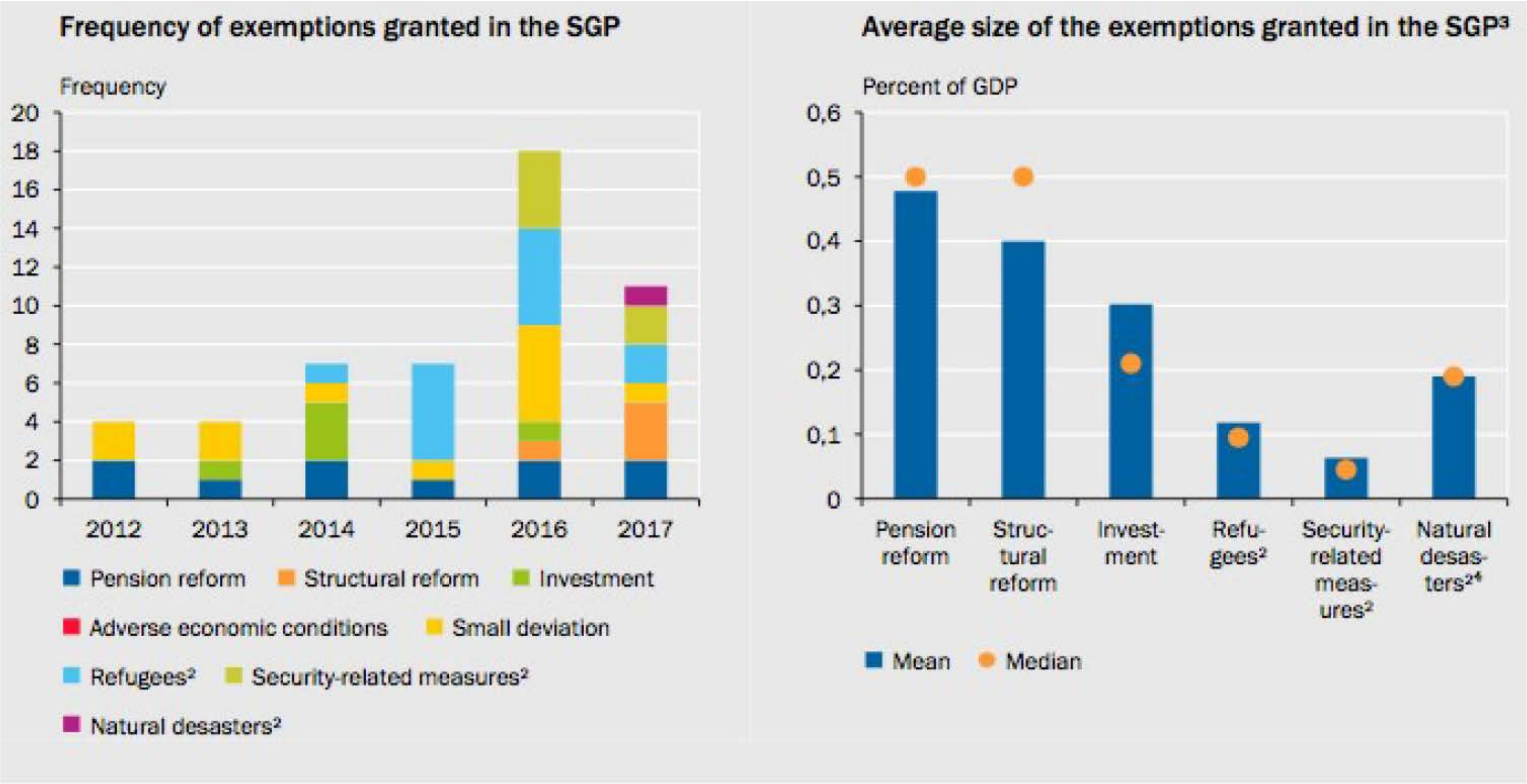
%

		AT	BE	DE	ES	FI	FR	GR	IE	IT	LU	NL	PT
Arnold et al. (2018)[2]	1990 – 2017	– 2.8	– 3.1	– 0.7	20.7	3.5	– 1.4	29.0	5.8	3.3	0.1	– 1.1	9.0
Arnold et al. (2018)[2]	1970 – 2017	– 2.6	– 0.8	0.7	25.2	3.3	0.7	30.8	7.3	4.2	0.3	0.6	10.0
Beetsma et al. (2018)	1995 – 2014	– 0.1	– 1.2	0.2	0.1	2.3	– 0.3	1.7	– 5.5	1.1	– 10.9	– 0.9	1.6

1 – As a percentage of nominal GDP. Time period under investigation determined by availability of data. AT-Austria, BE-Belgium, DE-Germany, ES-Spain, FI-Finland, FR-France, GR-Greece, IE-Ireland, IT-Italy, LU-Luxembourg, NL-Netherlands, PT-Portugal. 2 – Proposal of the International Monetary Fund. Cumulative payouts at the start of each year. Based on the assumption that the fiscal capacity can borrow and lend money on an interest-free basis..

Sources: European Commission, OECD, own calculations

Fiscal rule exceptions



1 – Analysis based on reported figures in the Assessments of the Stability Programmes by the EU Commission. 2 – Exemptions for refugees, security-related measures and natural desasters constitute the exemptions for unusual events. 3 – No size figures are reported by the European Commission in case of the exemptions for adverse economic conditions and small deviations. 4 – Reported size refers to a single observation.

GCEE has a modest proposal for re-focusing the fiscal rules: An expenditure rule with adjustment account

Elements of a reformed expenditure rule