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

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Based on paper with Jeromin Zettelmeyer and Alvaro Leandro

The argument

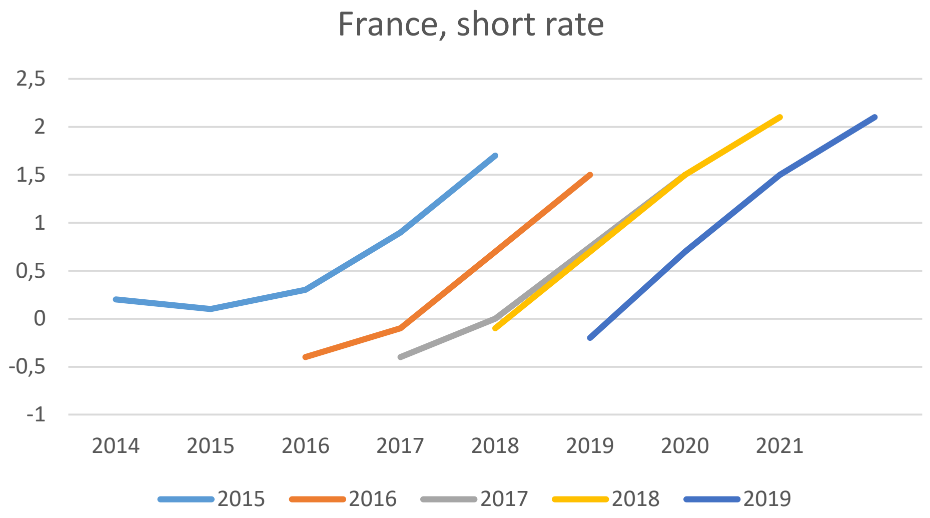
1. Interest rates very likely to be low for long.
   Need to think (fiscal) regime change

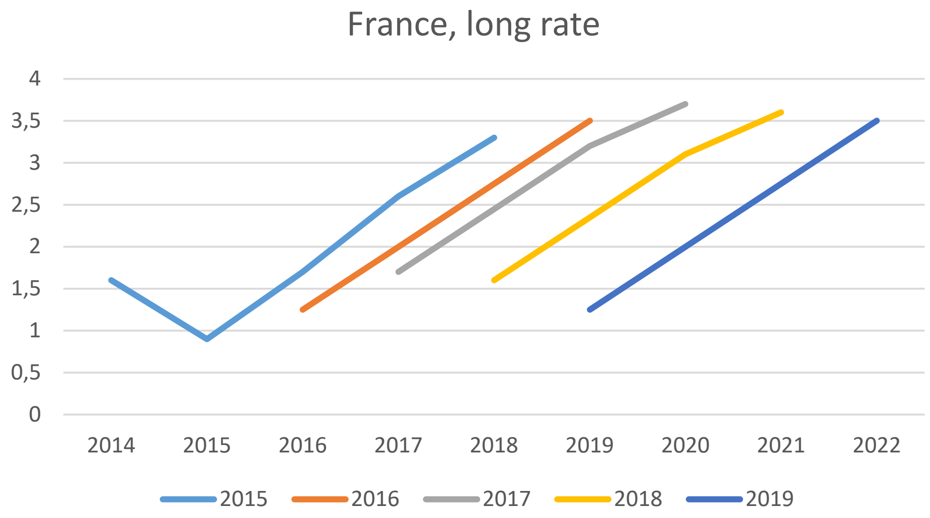
2. Implications for fiscal policy, applied to EU members
   Modified trade-off between output and debt

3. Implications for EU level rules
   Modified trade-off between debt and demand externalities

4. Three reform proposals
   Balancing externalities.
   Introducing golden rule accounting
   Shifting from rules to standards

Since 2014, interest rates have been expected to increase. They have not.

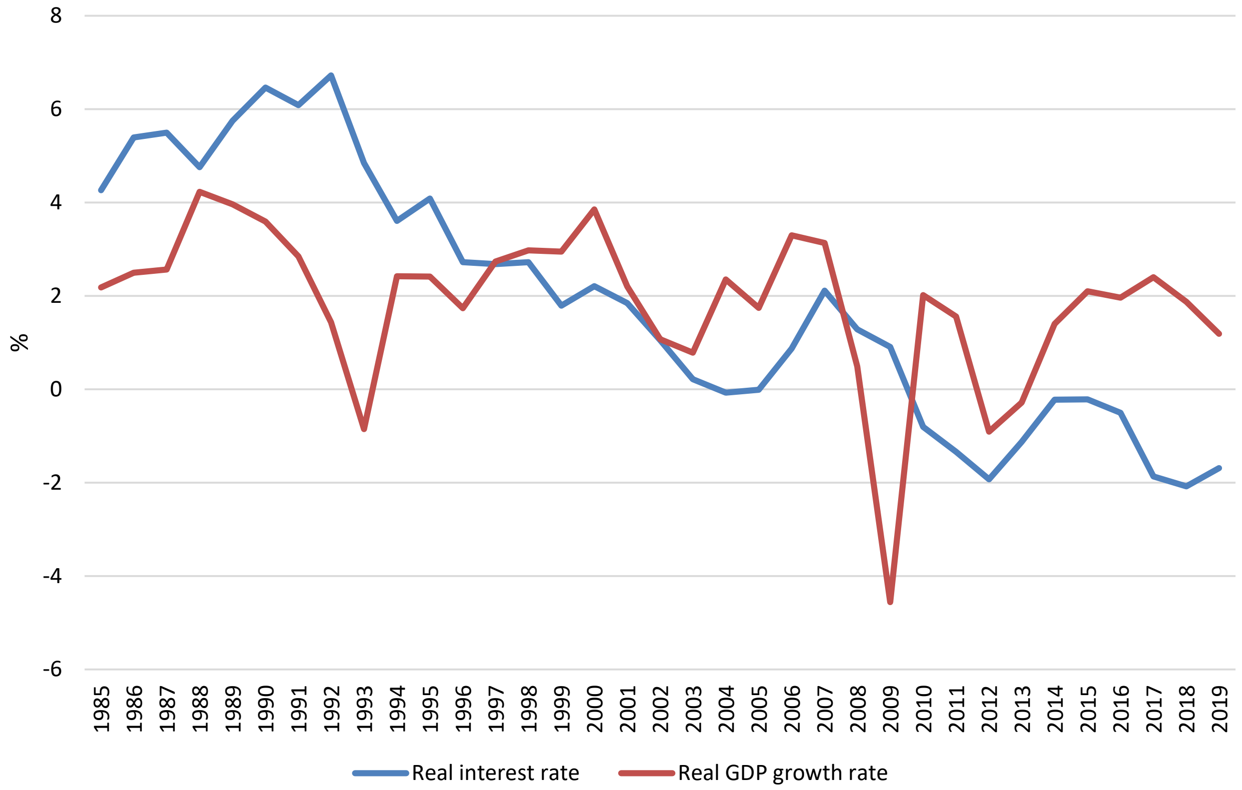




(Interest rate assumptions in stability programs.)

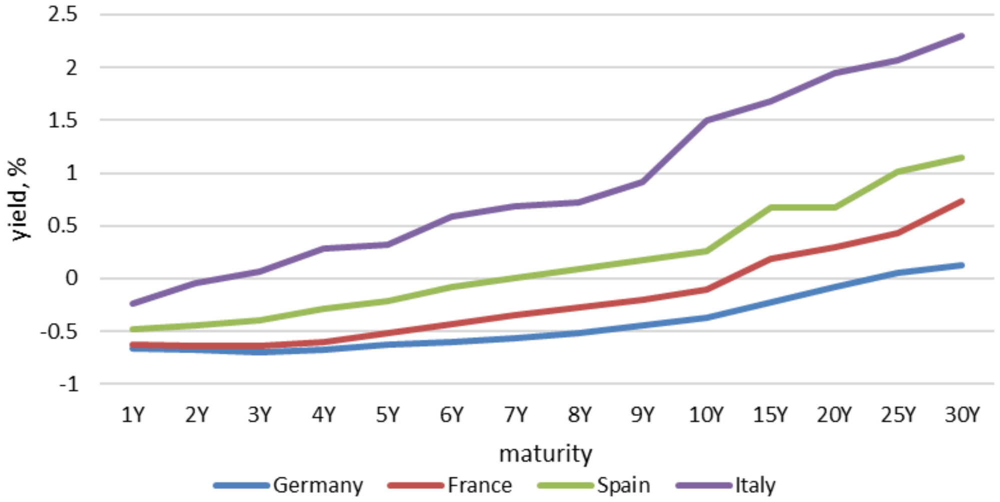
Looking back: A long and steady decline of interest rates

Real interest rate (Eonia and reconstructed) and growth rate, euro area



Looking forward: Interest rates will most likely be low for long:

The signals from the yield curves



The signals fro … or rate exceeds a given threshol

Horizon		Threshold				
		>0%	>1%	>2%	>3%	>4%
5 years		33%	9%	3%	1%	0%
10 years		55%	40%	24%	14%	8%

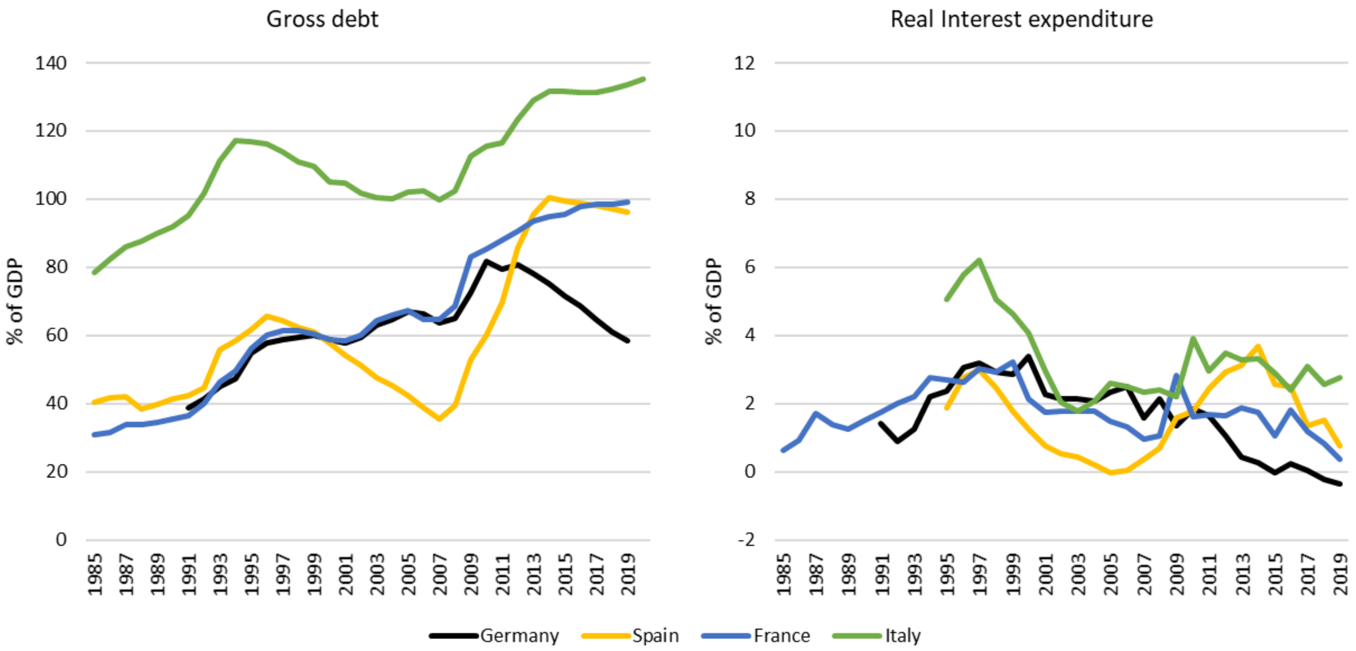
Fiscal policy implications: Pure public finance

Start with “pure public finance” (i.e. ignoring effect on demand/output):

1. Lower fiscal costs of debt.

   Extreme version:

   If r<g. No need to offset primary deficits by primary surpluses lat



Fiscal policy implications: Pure public finance (continued)

2. Lower fiscal risks

Extreme version: if $r<g$, for given arbitrarily large primary deficit, debt/GDP does not explode but converges to possibly high ratio.

Caveat. As debt increases, r increases. Thus, at some level of debt, $r>g$. Then need primary surplus.

3. Lower welfare costs

Low safe interest rates: signal of low risk-adjusted MPK.

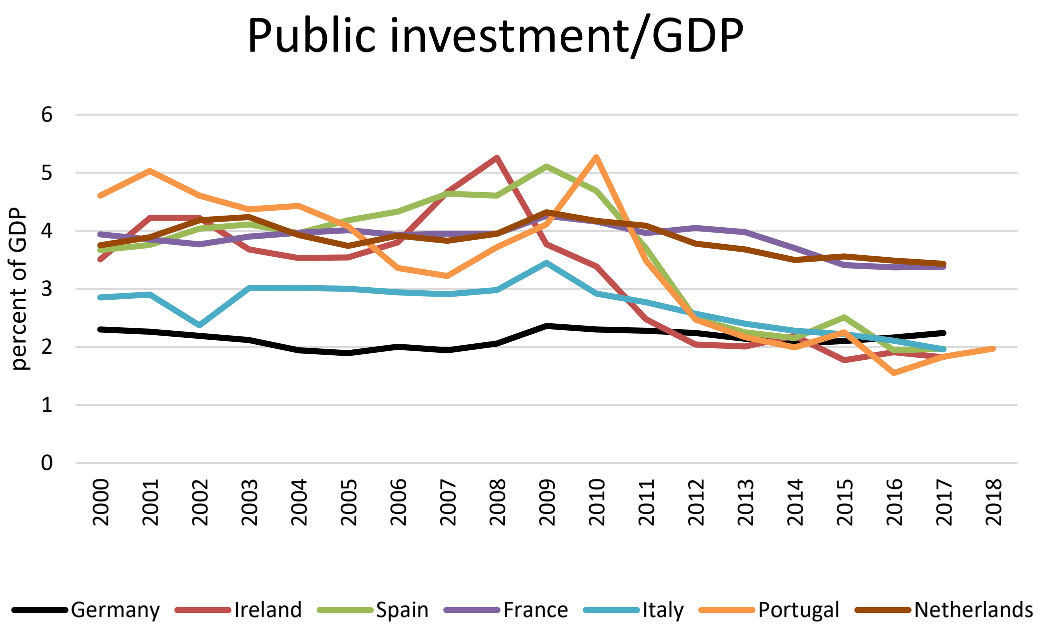
Thus, little or no opportunity cost from lower capital stock

Fiscal policy implications: Pure public finance (continued)

4. Higher optimal public investment

   If risk adjusted social rate of return has not decreased.

   Yet, public investment has:



Fiscal policy implications: Functional finance

1. Reintroduce nominal rigidities, and role for aggregate demand
   In response to a negative output gap
   Use monetary or fiscal policy?

2. Absent constraints, theory suggests: Use mostly monetary

3. Two constraints on monetary policy in context of euro area
   Old: ECB at euro level. Not at national level
   Need something else to adjust: limited relative price adj
   New, and linked to low rates:
   ECB limited by ELB/reversal rate.

4. Then have to take macro into consideration for fiscal:
   "Functional finance" (Hansen)

Fiscal policy implications: Functional finance (continued)

1. Trade off: A simple computation. Assume

   Fiscal consolidation of 1% of GDP

   ECB at ELB, so unable to help

2. Effect on output: multiplier 1: 1%

   Effect on ratio of deficit to GDP: 0.7%.

   Effect on debt to GDP ratio depends on initial debt ratio:

   If 100%, then debt ratio down by -1%+0.7% = -0.3%

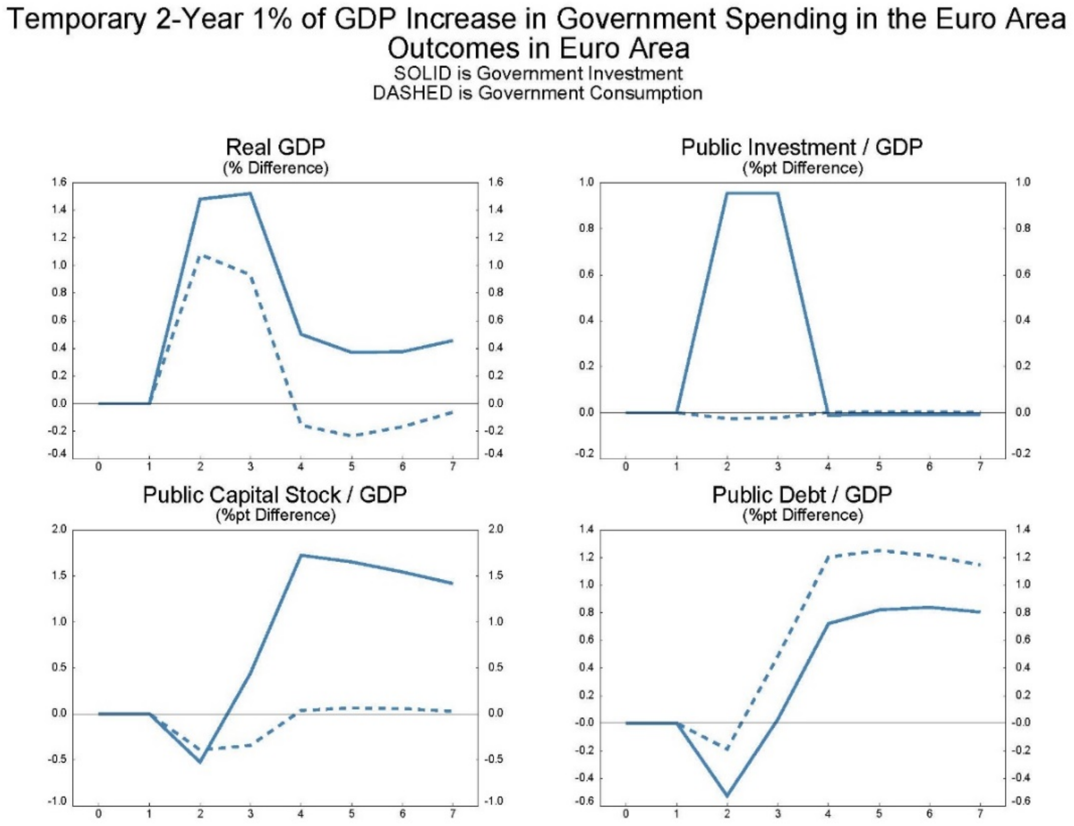
   If 50%, then debt ratio up by 0.7%-0.5% = 0.2%

3. Unattractive trade off: 1% less output for small change in debt ratio

4. Over time, if r-g<0, debt returns to initial value.

Fiscal policy implications: Functional finance (continued)

A simulation based on the GIMF IMF model: 1.4% more output for two years, then 0.4% more. Against a 0.8% increase in D/Y.



Implications for EU fiscal framework

1. Obvious implications of what we saw for national fiscal policy.

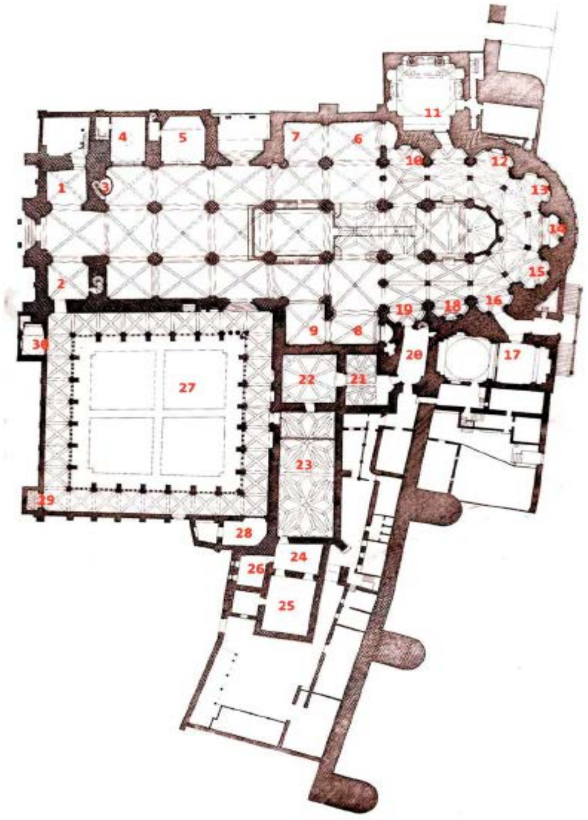
2. Rationale however for a supra national framework?
   - Externalities. Otherwise, let countries do what they do.
   - What externalities? Two types:

3. Debt externalities:
   - Spillovers from default
   - Fiscal dominance of the ECB
   - The ones underlying existing rules
   - Less important when interest rates are low.

4. Demand externalities.
   - Part of an increase/decrease in demand falls on other countries
   - Implies insufficient use of fiscal under Nash
   - More important when interest rates are low, and ECB constrained.

The existing rules

The Cathedral of Seville



1. Capilla de san Miguel
2. Capilla de san Andrés
3. Pila bautismal
4. Capilla de la Piedad
5. Capilla de la Concepción
6. Capilla de san Antolín
7. Capilla de san Pedro
8. Capilla de santa Teresa
9. Capilla de san Ildefonso
10. Capilla de san Rafael
11. Capilla del Sagrado Corazón
12. Capilla de san Nicolás
13. Capilla de Santiago
14. Capilla de Nª Sª de Gracia
15. Capilla de san Juan Evangelista
16. Capilla de san Esteban
17. Capilla de san Segundo
18. Capilla de la Asunción
19. Capilla de san Juan Bautista. Acceso a las dependencias del Cabildo
20. Sacristía románica
21. Capilla del Sagrario / Antesacristía
22. Capilla de san Bernabé / Sacristía
23. Librería / Capilla Quiroga
24. Atrio del Capítulo nuevo / Sala de los Cantorales
25. Sala capitular nueva
26. Antiguo archivo catedralicio / Sala de la Pasión
27. Claustro
28. Capilla de las Cuevas
29. Capilla de Nª Sª de la Claustra
30. Capilla del Crucifijo

The existing rules

Beyond the complexity, the fuzziness of enforcement, etc., three main relevant characteristics for our purposes.

(will not go into specific description, done in the paper, well known to this audience)

1. Main focus on debt externalities, leading to a set of upper limits and minimum adjustment rules.

2. Rules, with specific numbers for targets and speeds of adjustment. Set for a different environment than the current low rate one.

3. Largely common treatment of current and capital spending. Exceptions more revealing than relevant.

Implications for reforms of the EU framework

1. Need to rebalance trade off between debt and demand externalities
    - Debt externalities less important
    - Demand externalities more important

2. Adopt golden rule accounting (different from adoption of the Golden rule)
    - to clarify choices and protect public investment
    - To avoid the recent experience (even more important now)

3. Shift from rules to standards
    - Old discussion in the legal literature (and early on in EU)
    - When complex environment, and Knightian uncertainty
        - Rules can be too constraining
        - Standards with ex-post adjudication may dominate.

    (Yes: Old, but still relevant discussions---more urgent given low rates)

1. Rebalancing externalities

1. Even ignoring demand externalities, smaller debt externalities
   Do no harm. Allow countries to use fiscal stabilization.
   Current constraints are too strong

2. Important if low rates, ELB, and insufficient demand at euro level
   Different responses if persistent: Public investment programs
   if transitory: A cyclical response

3. Demand externalities. Nash equilibrium: Too little fiscal response.

4. Best solution (old proposal…): Central EU facility, financed by eurobonds.
   Particularly adapted for green investment (two externalities)

5. Alternative: Treaty change, Art 126, to address demand externalities ("helping, when needed, the ECB achieve its inflation mandate.")

6. More realistically: An agreement among the willing and able (a la 2009).
   If enough members, limits the size of the externalities.

2. Golden rule accounting

1. Two parts to the (fiscal) Golden rule
   - Capital budgeting. Current versus capital account
   - Rule: e.g. Balance current account. Finance capital account through debt

2. Arguing for the first part. (Paper gives a specific description of potential set up)
   - Discussed and rejected in the past. Well known issues:
     - Definition of investment, depreciation.
   - Argue for supra national commission to allow items below the line
     and for a conservative approach

3. We do not argue for the second part
   - If persistently low demand, may need persistent unbalanced current account

   - If social rate of return high but financial rate of return low, financing all of public investment by debt may not be right.

3. From rules to standards

1. An old discussion in the law literature
    Rules: Ex-ante, defining contingent policy, escape clauses
        Hard numbers. 60%, MTO rule, etc.
    Standards: Defining principles
        Appropriate fiscal policy
        Ex-post assessment and judicial adjudication

2. Costs and benefits.
    "55 miles limit, 35 if rain" versus ``Drive carefully"
    Required granularity, complexity of contingencies
    Knightian uncertainty
    Enforcement/sanctions ex-post for rules and for standards

Plenty of examples of standards rather than rules: e.g. EU anti-trust.

From rules to standards. Fleshing it out.

1. Primary legislation: Change in the Treaty:
    - General principles rather than hard numbers
    - Secondary legislation
        - Mapping to more quantitative recommendations
        - Taking into account both types of externalities

2. Enforcement
    - Role of markets
        - Can be substantially improved.
        - Improved Commission DSAs as information providers
        - Clarity on legal framework for debt restructuring, etc

    Not enough however.
    Need a judicial instance, not a political one (not European Council)
    Natural: Commission as prosecutor (Art 258)
    European Court of Justice as adjudicator

Tentative conclusions

1. Interest rates low for long as benchmark.

2. Need a thorough reassessment of fiscal policy in general

3. Need a thorough reassessment of EU fiscal framework

4. Prudence is to change, not to keep.

5. Clear danger: A recession, with an insufficient fiscal response

6. Beyond the framework:
   - Think about appropriate public investment.
     - Global warming?
   - Think about right tool for the cyclical response, beyond stabilizers.
     - VAT rate decrease?