

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

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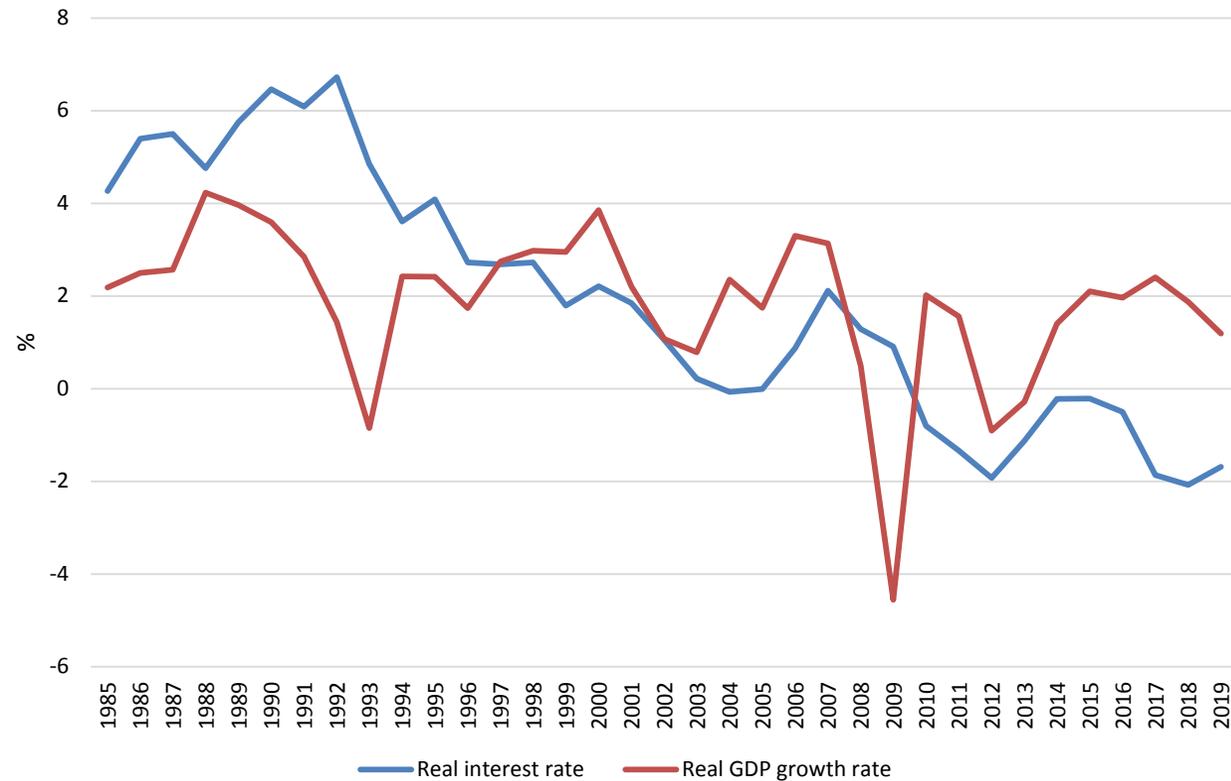
Based on paper with Jeromin Zettelmeyer and Alvaro Leandro

The argument

1. Interest rates very likely to be low for long.
Need to think in terms of regime change
2. Implications for fiscal policy, applied to EU members
Smaller cost of debt.
More need for output stabilization through fiscal policy
3. Implications for EU-level rules . Externalities
Debt externalities: less relevant.
Demand externalities: more relevant.
4. Three EU reform proposals
To achieve output stabilization: Dealing with demand externalities.
To protect public investment : Golden rule accounting
To achieve needed flexibility : Shift from rules to standards

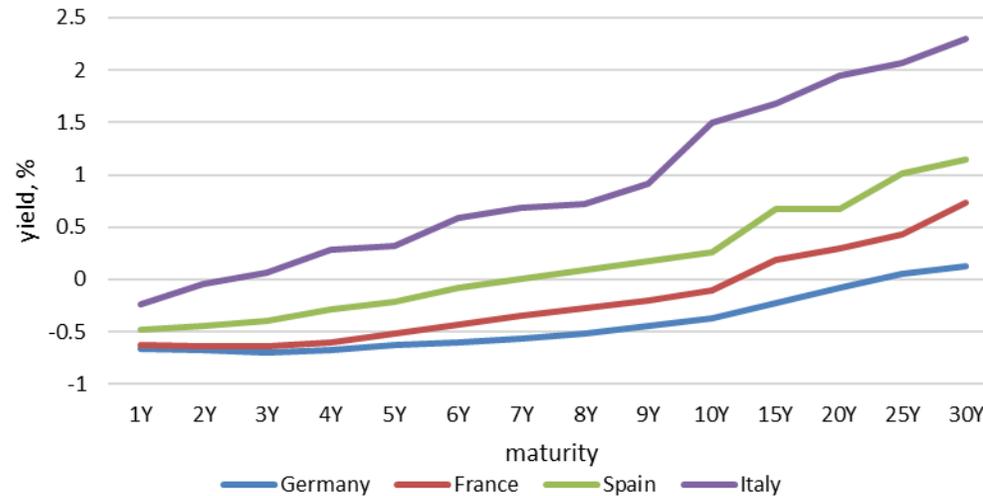
Looking back: A long and steady decline of interest rates

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 from option prices. Prob that 3-month libor rate exceeds a given threshold:

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

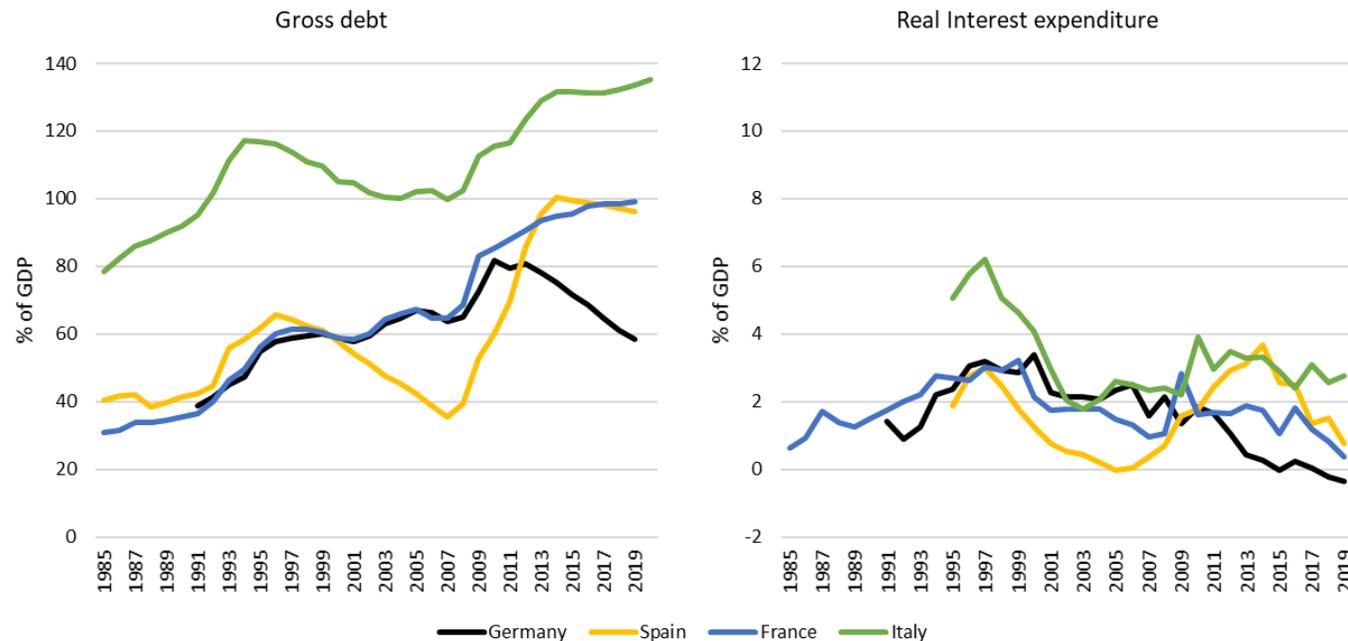
Start with “pure public finance” (i.e. ignoring effect on demand/output):

1. Lower fiscal costs of debt.

Extreme version:

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

More generally, low cost of debt:



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.

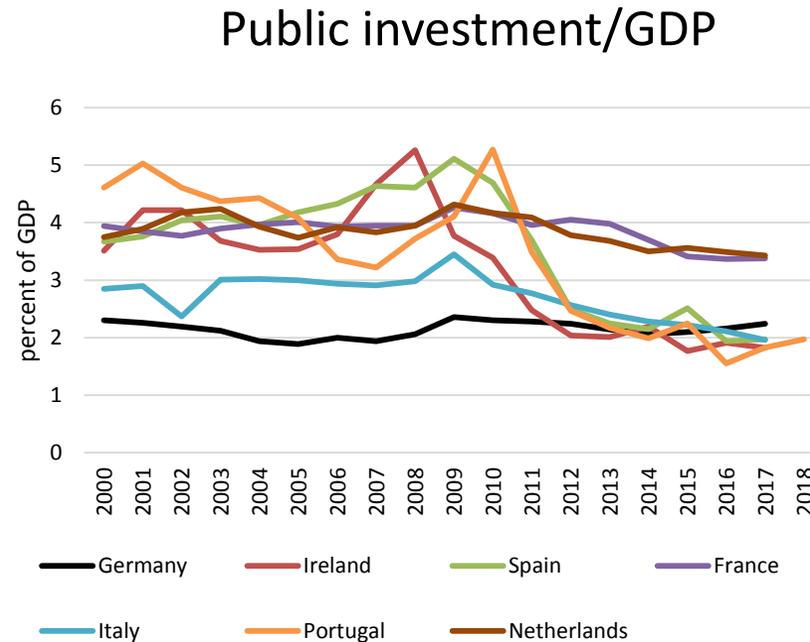
Thus, little or no opportunity cost from lower capital stock

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 decreased a lot:



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: assume multiplier 1: so 1% increase in output
Effect on ratio of deficit to GDP: 0.7%. (auto-stabilizers)
3. Effect on debt to GDP ratio depends on initial debt ratio:

$$\Delta d = \frac{\Delta D}{D} - \frac{\Delta Y}{Y} = \frac{\Delta D}{Y} \frac{Y}{D} - \frac{\Delta Y}{Y} = 0.7\% \frac{1}{d} - 1\%$$

If $d=100\%$, then debt ratio down by $0.7\% - 1\% = -0.3\%$

If 50% , then debt ratio up by $1.4\% - 1\% = 0.4\%$

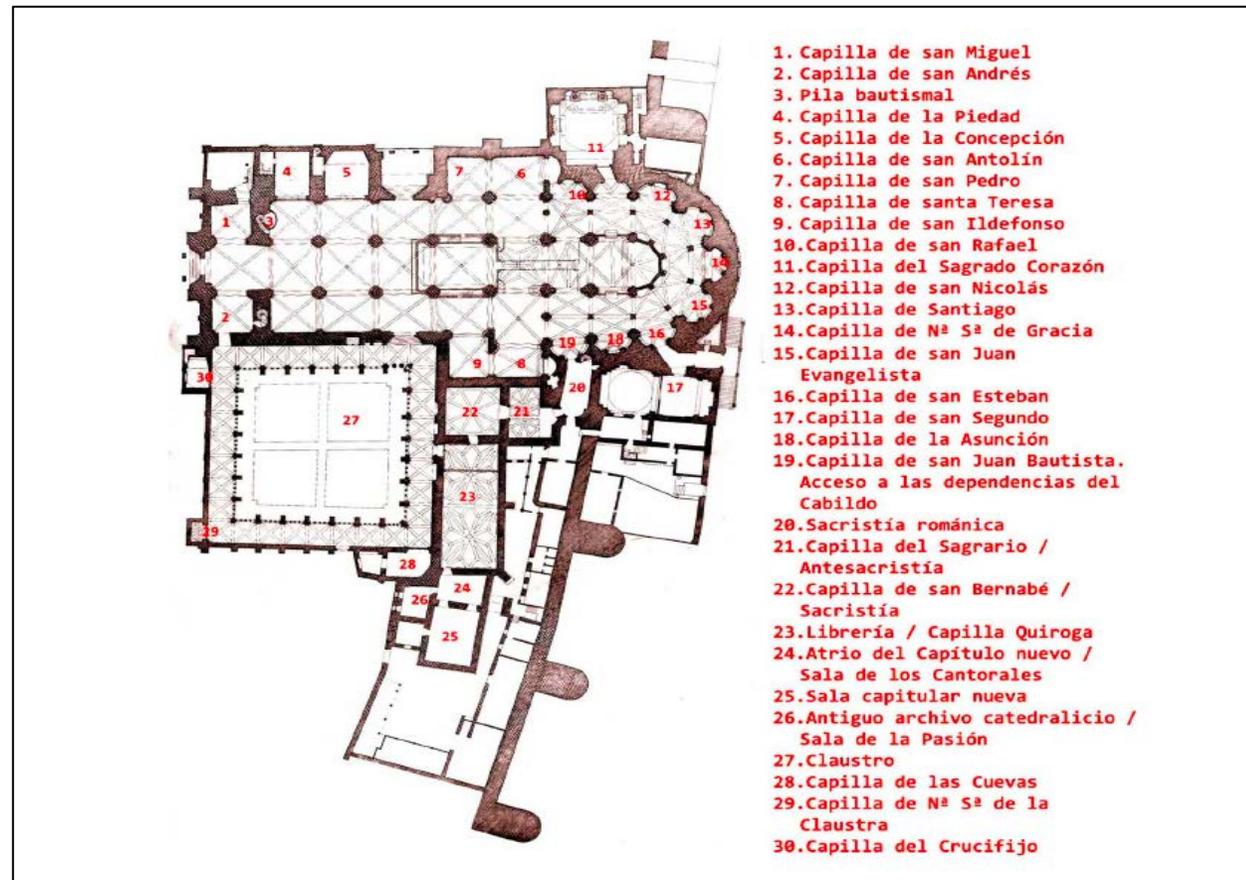
3. Unattractive trade off: 1% less output for at best small change in debt ratio
4. Over time, if $r-g < 0$, debt returns to initial value.

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: The ones underlying existing rules
Spillovers from default
Fiscal dominance of the ECB
Default much less likely when interest rates are low.
4. Demand externalities.
Part of an increase/decrease in demand falls on other countries
Implies insufficient use of fiscal stabilization under Nash
More important when ECB constrained and cannot achieve EU potential

The existing rules

The Cathedral of Seville



The existing rules

Beyond the complexity, the fuzziness of enforcement, etc., three main relevant shortcomings 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. Largely common treatment of current and capital spending. Exceptions more revealing than relevant.
3. Rules, with specific numbers for targets and speeds of adjustment. Set for a different environment than the current low rate one.

Implications for reforms of the EU framework

1. Need to rethink 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. Demand externalities. Nash equilibrium: Too little fiscal response.
If ECB constrained, Euro output below potential.
4. Best solution (old proposal...): Central EU facility, financed by eurobonds.
If persistent short fall. Public (green?) investment (2 externalities)
If transitory short fall. Cyclical tool
6. Second best: Agreement among 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: Balance current account. Finance capital account through debt
2. Arguing for the first part. (Paper gives 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, need for persistent current account deficit
 - 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.

Not a hawks versus doves discussion

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, plausibly higher than before

Enforcement/sanctions ex-post for rules and for standards

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

What EU fiscal standards might look like

1. Standards proper – EU primary legislation, e.g. Article 126.
 1. “Member states shall avoid excessive government deficits”. [unchanged]
 2. “When the European Commission deems a deficit to be excessive, member states shall reduce it at a speed that minimizes harm to their prosperity and those of other member states.”
2. Criteria explaining how to meet standards – EU primary or secondary legislation.
 1. “A member state’s deficit is not excessive when a debt sustainability analysis indicates that its debt is sustainable with high probability.”
 2. “In determining the speed of adjustment, member states shall take into account the probability with which debt is unsustainable, market conditions, the state of the economic cycle of the member state, and whether the ECB is at the effective lower bound or not.”
3. Technical explanations to decide if criteria are satisfied. Stochastic DSAs as one tool.

Enforcing standards

Option 1. A tougher version of current approach.

1. Fiscal surveillance: EC states views on whether deficit is excessive, appropriate speed of adjustment
2. EC can reject budgetary plan and request revisions.
3. If member state does not comply, Council of the EU adjudicates. Qualified majority of member states can overrule or change revisions requested by Commission

Potential problems

Could create even more room for fudging than today (no rules!)

Council is the wrong body to develop a “fiscal standards jurisprudence”.

Option 2. Like option 1, but with an independent body as adjudicator

Could be ECJ or specialized chamber of ECJ; or new body (e.g. upgraded EFB).

ECJ is default option under the treaty (standard treaty infringement procedure).

Potential problems

Judges may not be qualified/process too slow.

“Judges deciding political matters”.

These seem fixable. Can have specialized Judges. Courts constantly decide political matters.

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?