

Redesigning European Fiscal Rules

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1. Why are there EU rules in the first place?

Governments should be free to pursue the fiscal policy they want,
subject to one exception: Debt spillovers if default.

Saw the danger during the Global Financial Crisis. “Doom loops.”

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Worries about default of banks led to worries about public debt

True always, but particularly so if common currency and high level of integration: EU

So the EU should monitor fiscal policies to make sure debt is sustainable. (but no more)

2. The initial rules. Maastricht.

Introduced a very simple rule 60% debt. 3% maximum deficit

At the time, the issue was credibility, and simplicity was a major plus

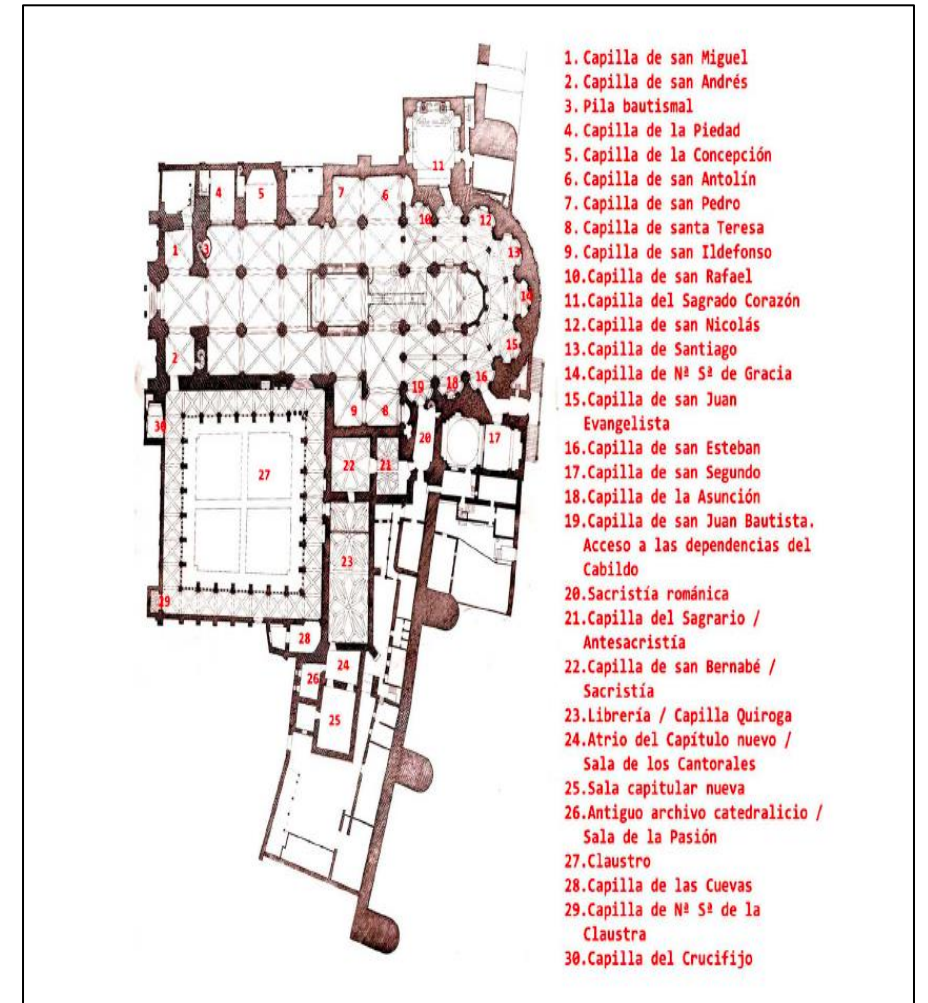
But it was too simple, not allowing for enough fiscal expansion when needed.

E.g. too much fiscal austerity in 2010/11.

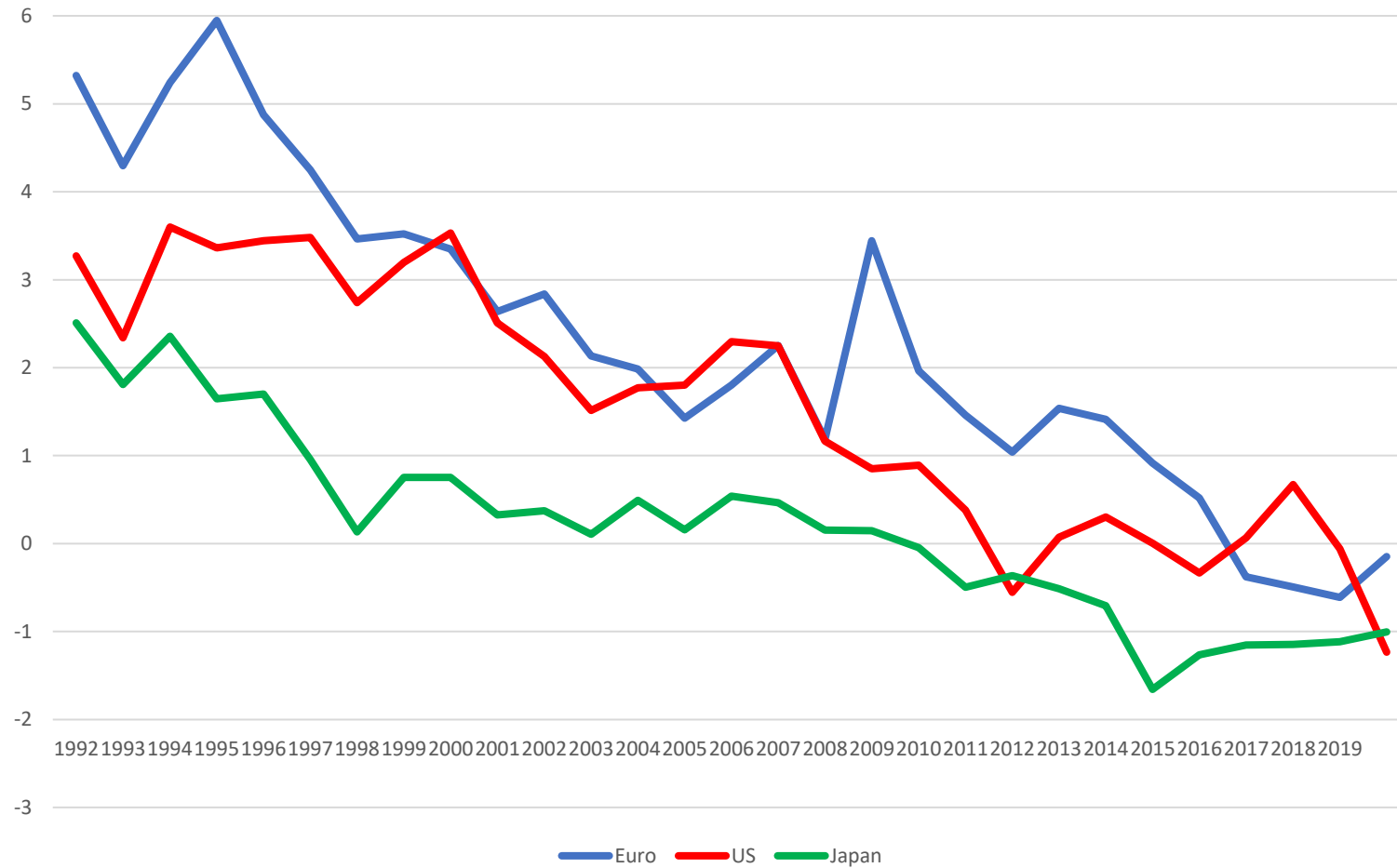
So over time, complexified. More and more legs. Now truly incomprehensible.

And it did not adjust to a changing environment: lower and lower real interest rates. *(next slide)*

Result has been a mess. And not respected by countries. France, Germany.



US, Euro, Japan 10-year real rates, 1992-2020



3. When covid crisis started, it was clear that the rules did not fit.

So the rules were suspended in early 2020, now probably until 2023.

But the plan is to have (some) rules back in place by then.

Clearly cannot go back to the old rules.

Debt ratios are now around 100+%. No hope of getting close to 60% any time soon

Following the rules would require a very strong fiscal contraction

Given the ZLB, the ECB could not offset the adverse effects on aggregate demand.

Many proposals, some to simplify, some to complexify further.

Neither will work.

Reason is debt sustainability depends on many factors, too hard to capture in a rule.

4. How should one think of debt sustainability?

Starting point: The dynamics of the debt to GDP ratio:

$$d = (1+r)/(1+g) d(-1) - s$$

Debt to GDP ratio stabilization implies:

$$d=d(-1) \Rightarrow s = (r-g)/(1+g) d < 0 \text{ if } r-g < 0$$

The obvious central role of $(r-g)$:

When $(r-g)>0$, then debt stabilization requires running primary surpluses (higher taxes, lower spending). Standard view

When $(r-g)<0$, (which is where we have been for 20 years, *next slide*), debt stabilization is consistent with running primary deficits.

For example. $i=1\%$, $\pi = 2\%$, so $r=-1\%$, $g=2\%$, $d=100\%$, allows for primary deficits of 3%.

(Today, even larger negative $(r-g)$, as g is high, and inflation is high, so r is very low. But this is temporary)

So can one relax? More than before, but not too much. Two issues: Endogeneity/Uncertainty

(r-g): 10-year forecast US real rate versus 10-year forecast US real growth



5. Assessing debt sustainability.

Back to the equation for debt dynamics: $d = (1+r)/(1+g) d(-1) - s$

The factors that must go into the assessment, and the uncertainty associated with each one:

Interest rate, obviously, both expected and range. (very low now, but how high might the interest rates go?)

Growth rate, again, both expected and range

Primary balance. Implicit liabilities (in what shape is the retirement system?)

Debt sustainability is a probabilistic statement:

Debt is sustainable if, with high probability, the government can generate a primary balance s sufficient to cover interest payments, defined as $(r-g) d$ and thus keep the ratio of debt to GDP from exploding in the future.

A two-step stochastic debt sustainability analysis. (SDSA)

Step 1. Under existing current policies and future hard policy commitments.

Step 2. If probability is not high enough, the question becomes:

Will the government be able to take measures to improve the primary balance sufficiently? Depends on:

Size of the primary deficit to start

Taxation level. If very high, not much room

Nature of the government: coalition/single party. Nature of the PM: Draghi factor.

Maturity of the debt . Gives time to time.

Very much what rating agencies do/try to do. Assessing the credibility of government announcements in step 2.

6. Can it really be done this way?

Our proposal (Blanchard, Zettelmeyer and Alvaro): Set fiscal standards rather than fiscal rules.

Standard: “Keep debt from exploding” and then do the analysis above over say next 5/10 years

Have the EU commission (together with domestic fiscal council) do the SDSA exercise.

Assess if it sees a risk.

If it appears to have a risk, ask the government to present credible measures to reduce the risk

Plenty of hypotheses, so room for discussion. **This is not a flaw, but a strength.**

If disagreement, then decision left to the Council of the EU, or an extended Court of Justice.

Pros and cons. More democratic process versus building jurisprudence

Feasible technically? Doable. SDSA used at the IMF and in a number of countries.

“Fiscal standards” adopted by New Zealand. Government must show actions are consistent

Feasible legally? 60% and 3% are in the Maastricht treaty. Treaty change?

Could keep those numbers.

If a country is not making progress in that direction, recourse to the SDSA.

7. If not standards, what rules can come close?

Main point:

Search for simplicity is an illusion. History of the rules is proof. Maastrich was simple...

Easy to have a rule which enforces debt sustainability: Black zero, original Maastricht

But comes at the cost of limiting stabilization role of fiscal policy

Major cost when monetary policy room is limited by ZLB

Search for complexity is a fool's errand. Too many contingencies.

Some proposals:

Expenditure rules (misnomer, more like cyclical adjusted primary balance rules): minor progress

Moving the critical debt ratio from 60% to 100%: one time fix, requires treaty change...

In general, getting rid of much of the paraphernalia: 1/20th adjustment if debt above 60%, complicated MTOs.

Replacing them by a more flexible assessment. Mix of 60%, 3% and SDSA.

Worth exploring further: More importance to debt service $(r-g) d$ than to debt (see debt dynamics equation), taking however into account the uncertainty.

8. What will actually happen?

My guess:

Political compromise:

On the one hand, keep the Maastricht numbers

Remove much of the additional infrastructure. In particular 1/20th rule.

On the other, allow for largely debt financed public investment projects. (green, covid, defense)

At national or EU level. Next Generation model.

Better ? Yes.

Perfect? No. From a debt sustainability viewpoint, public investment should not be given an automatic debt pass.

Depends on how much revenue it generates for the state.

We shall see. The stakes are substantial.