Peterson Institute for International Economics

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

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Based on a paper with Jeromin Zettelmeyer and Alvaro Leandro

The argument

1. Interest rates likely to be low for long.

2. Implications for fiscal policy, applied to EU members
   - Smaller costs of debt.
   - Larger benefits of fiscal policy
   - Need for change in national rules

3. Implications for EU-level rules. Externalities
   - Debt externalities: less relevant.
   - Demand externalities: more relevant.
   - Need to allow changes in national rules
   - Need to take into account changes in externalities

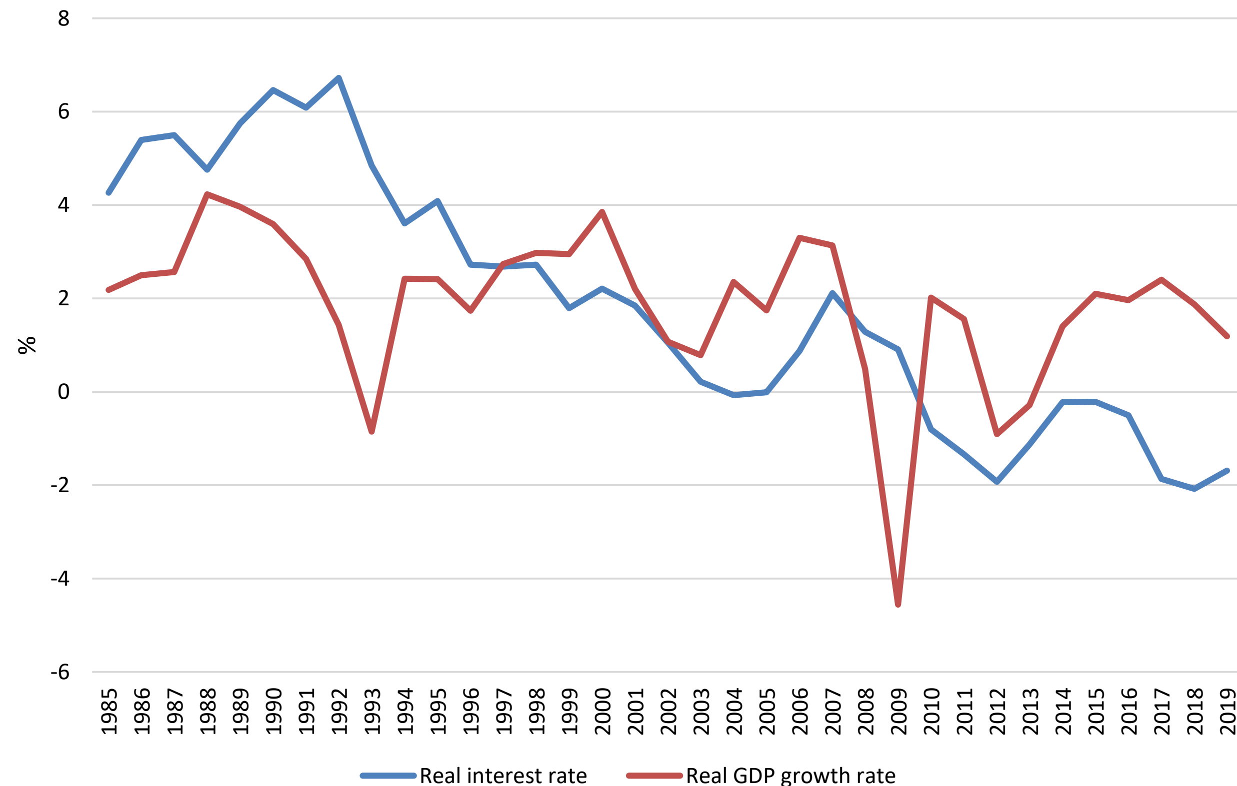
4. Three EU reform proposals
   - To achieve needed flexibility : Shift from rules to standards
   - To protect public investment : Capital budgeting
   - To achieve output stabilization : Dealing with demand externalities.

1. Low Interest Rates

Looking back: A long and steady decline of interest rates

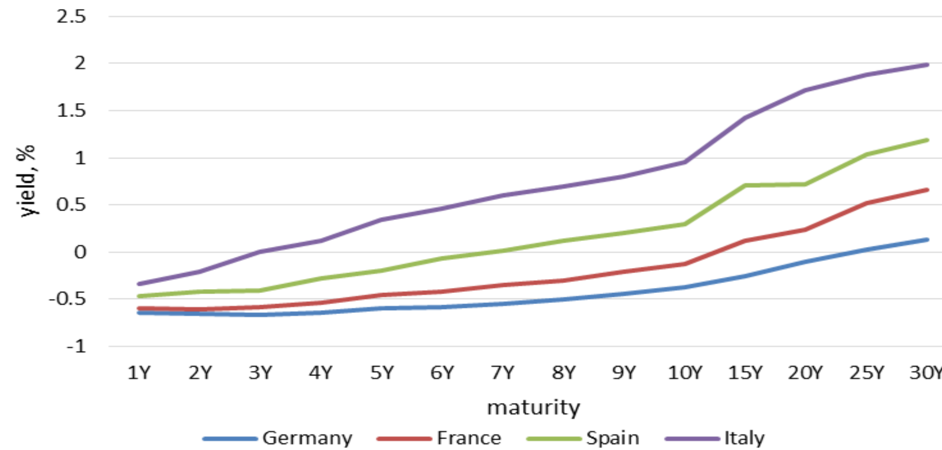
Real interest rate (Eonia and reconstructed) and growth rate, euro area

Interest rate: From 6% to -2% Growth rate. From 3% to 1.5%



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

The signals from the yield curves (January 30)



The signals from option prices. Prob that 3-month Libor rate exceeds a given threshold:

Horizon		Threshold				
		0%	1%	2%	3%	4%
5 years		50%	16%	5%	1%	1%
10 years		66%	40%	20%	9%	4%

2. General Implications for Fiscal Policy

Fiscal policy implications: Pure public finance

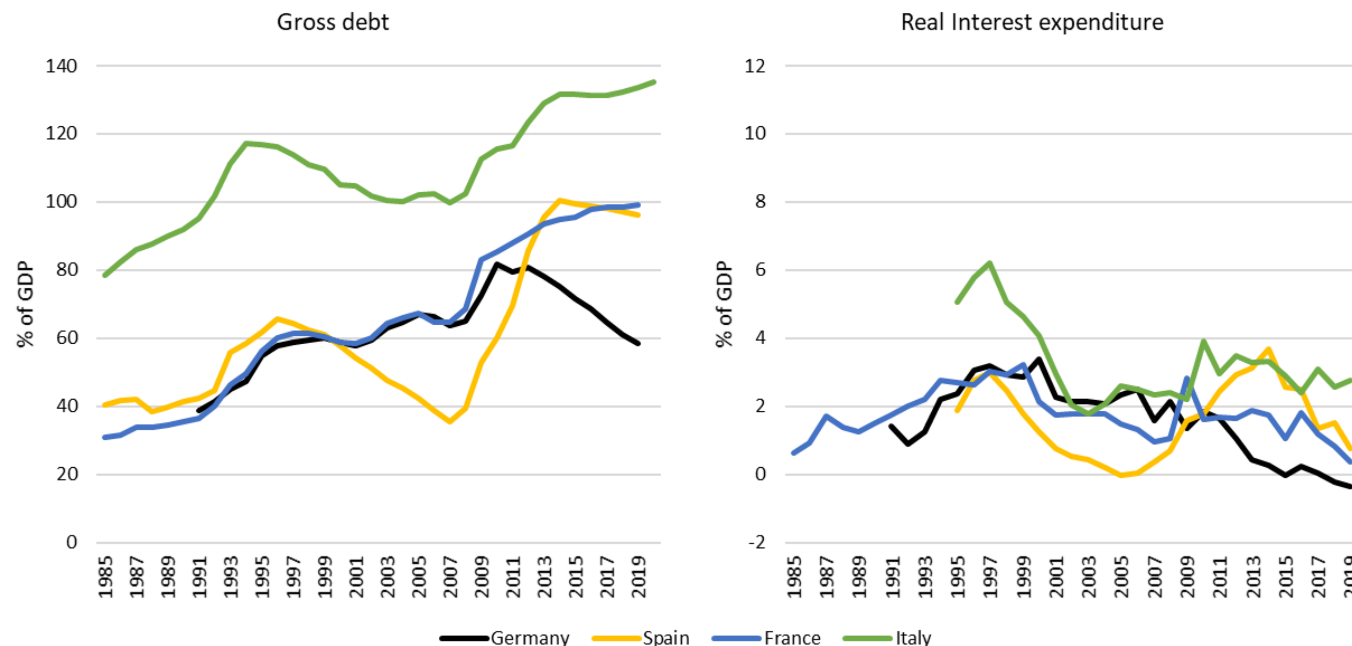
Start with "pure public finance" (i.e. ignoring effect on demand/output):

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.

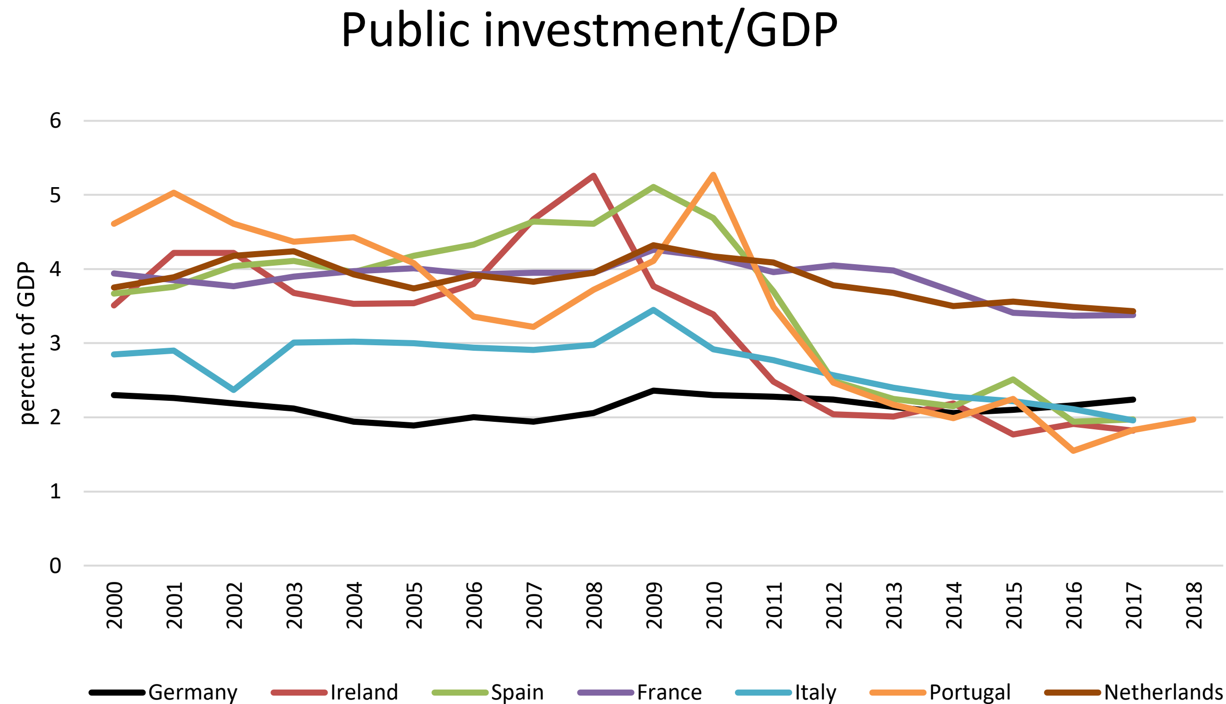
   Thus, little or no opportunity cost from lower capital stock

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% decrease 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 up (!) by -0.7% +1% = 0.3%
If 50%, then debt ratio down by -1.4% +1% = -0.4%

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

4. Over time: 1% less output and slow decrease in d: $\Delta d = (r - g)d - 0.7\%$

3. Implications for EU Fiscal Framework

Implications for EU fiscal framework

1. Obvious implications of what we saw for national fiscal policy: Do not stand in the way

2. Rationale 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

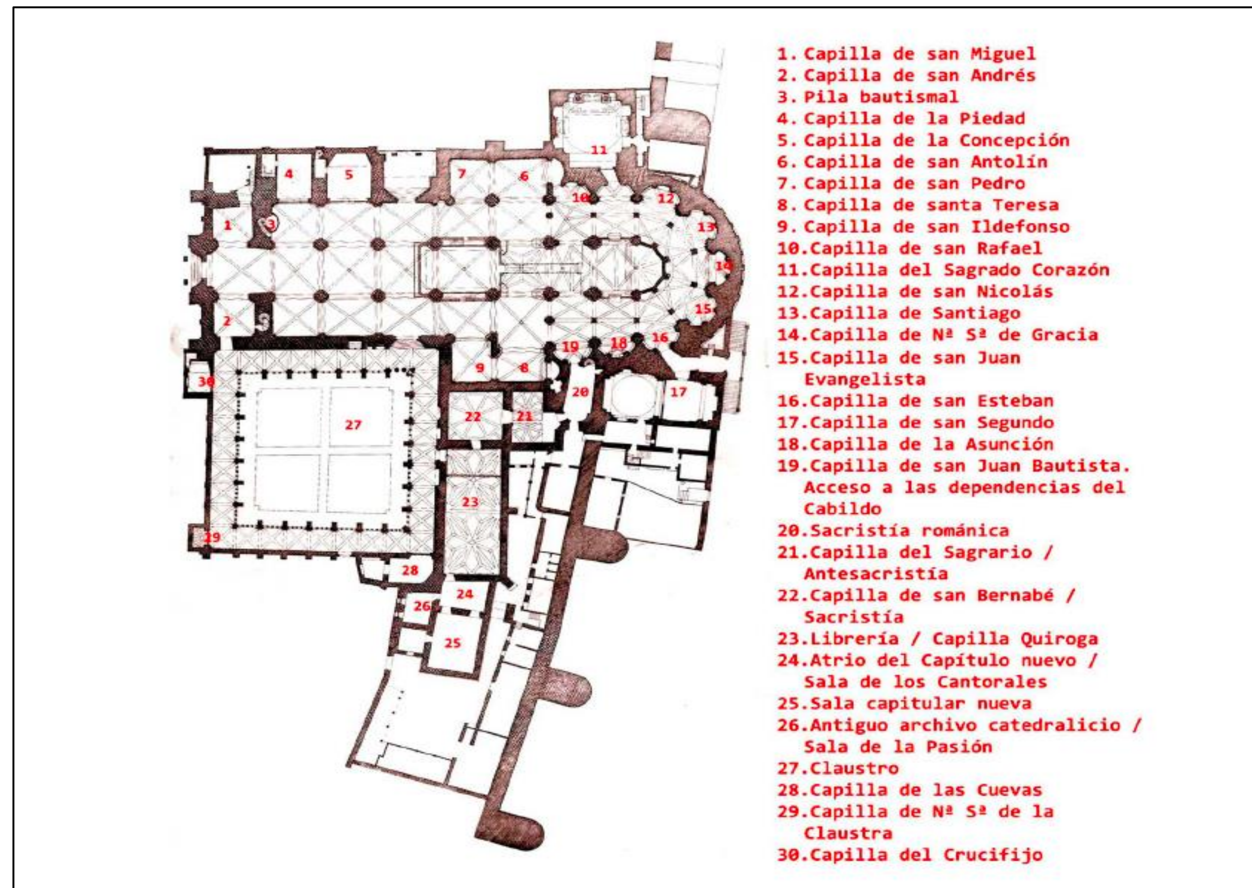
   Default much less likely when interest rates are low.

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 shortcomings for our purposes.

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

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

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

3. Excessive focus on debt externalities at the expense of other externalities. (True before, more true now)

4. Implications for Reforms of the EU Fiscal Framework

Our (blue sky?) proposals

1. Shift from rules to standards
   - Old discussion in the legal literature
   - 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)

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

3. Allow for more use for fiscal policy when monetary policy is constrained.

1. 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.

2. Capital budgeting

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. 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, with financing capacity.
   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.

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?