Olivier Blanchard, Álvaro Leandro, and Jeromin Zettelmeyer: Revisiting the EU fiscal framework in an era of low interest rates

Discussion
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Comments

1. *Thought provoking paper, constructive*

2. Important to distinguish *marginal and average fiscal cost of debt*

3. At least reforms 1 and 2 proposed in this paper are not really related to level of interest rates

4. Given reform proposal 1, explain in greater detail why proposal 2 is necessary (no golden rule type proposal)

5. I think making debt restructuring in the case of unsustainable public debt credible is more important than fiscal rules; fiscal rules are useful, but do not expect too much from them

Distinction between the average and marginal fiscal cost of debt is important

- Interest rate on debt is not independent of the level of debt – if the interest rate increases with higher debt the marginal cost of higher debt is very high (Gros, 2019)
- Assume the interest expense is given by the formula (given d>60)

$$interest\ expense\ ratio = d/100[r + \alpha(d - 60)]$$

Then the marginal cost of an increase in d is

$$\frac{\partial(interest\ expense\ ratio)}{\partial(d)} = [r + \alpha(2d - 60)]/100$$

- Empirical estimates of α: between 0.03 and 0.04

Distinction between the average and marginal fiscal cost of debt is important

- Assume r=1%, then Italy (d=130) has a risk premium of 245 basis points and interest expenses of 4,5% of GDP

- Portugal (d=100) has a risk premium of 140 basis points and interest expenses of 2,4 % of GDP

- Implication: reduction of debt ratio in Italy from 130% to 100% would reduce interest burden by almost 50%

Reform proposals in the paper:

1. Replace fiscal rules by *fiscal standards*
2. Introduce *capital budgeting (deficit should not exceed net public investment)*
3. Develop a *fiscal mechanism to respond to low demand* when monetary policy is constrained

Is any of these related to the current low level of interest rates? Maybe 3?

Fiscal standards

- **Fiscal standard:** Member states shall avoid excessive government deficits
- **Criteria explaining how to meet fiscal standards:**
- A member state’s deficit is not excessive when a rigorous debt sustainability analysis indicates that its debt is sustainable with high probability.
- **Problem 1**: When debt is sustainable with low probability it is too late: how about putting in a margin of security?
- **Problem 2**: If debt sustainability analysis is independent, nobody will take it seriously, if debt sustainability analysis is not independent, it will probably be wrong due to political pressure.

Example: Sustainability Analysis for Greece in Spring 2011:

European Commission (2011): The Economic Adjustment Programme for Greece Fourth Review, **Spring 2011:**

- **“**Debt restructuring in Greece would have a severe contagion impact on other EU sovereigns. ……Fiscal discipline and privatisation receipts **will achieve sustainability**. Experience from earlier consolidation episodes in EU countries demonstrates that sizable fiscal consolidation and long periods with large primary surpluses feasible...”

Just a few weeks later it was decided to restructure Greek debt

Capital Budgeting

- Why do we need this if deficit limits are calculated on the basis of a debt sustainability analysis?
- Authors say they do not advocate the 'golden rule' as a fiscal rule primarily because public investment does not necessarily lead to public revenue
- But they write: "The main advantage of capital budgeting is that it allows placing different constraints on current and capital spending ---pressure to use inefficient PPPs are lower" – why and how if the existing rules have been replaced by fiscal standards?
- So is this rather something like a general agreement to be more transparent in public sector accounting?

Fiscal Mechanism to support demand if it is too low

- **Variant 1:** Member countries whose debt is sustainable with high probability – as determined by the **European Commission**, the European Fiscal Board, or both – could be asked to lower their fiscal balance (reduce taxes or increase spending) when ECB interest rates are zero or negative and inflation or inflation expectations continue to undershoot the ECB's stability objective (see below).

- There already is a lot of coordination and consultation going on – do we really want to force countries to act if they do not want to ? Is this justified if inflation is 1 rather than 2 per cent?

- Are we confident that we can determine the appropriate fiscal stance sufficiently well to engage in fine tuning of demand?

- **Variant 2:** European fiscal mechanism; how does it work? Finance public investment if interest rate reaches lower bound? Probably takes too much time. Finance transfers (unemployment insurance)?

Key elements of Eurozone reform in my view:

- Reforms making sure individual countries face hard budget constraints and creditors in financial markets take into account default risks (reducing sovereign exposures, European deposit insurance…)

- European fiscal capacity for large and asymmetric shocks more important

Thank you!

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