Reforming European Fiscal Rules

Discussion of the Reports:

"European Fiscal Rules Require a Major Overhaul"
Conseil d'Analyse Économique (CAE)
and
"Refocusing the European Fiscal Framework"
Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (GCEE)

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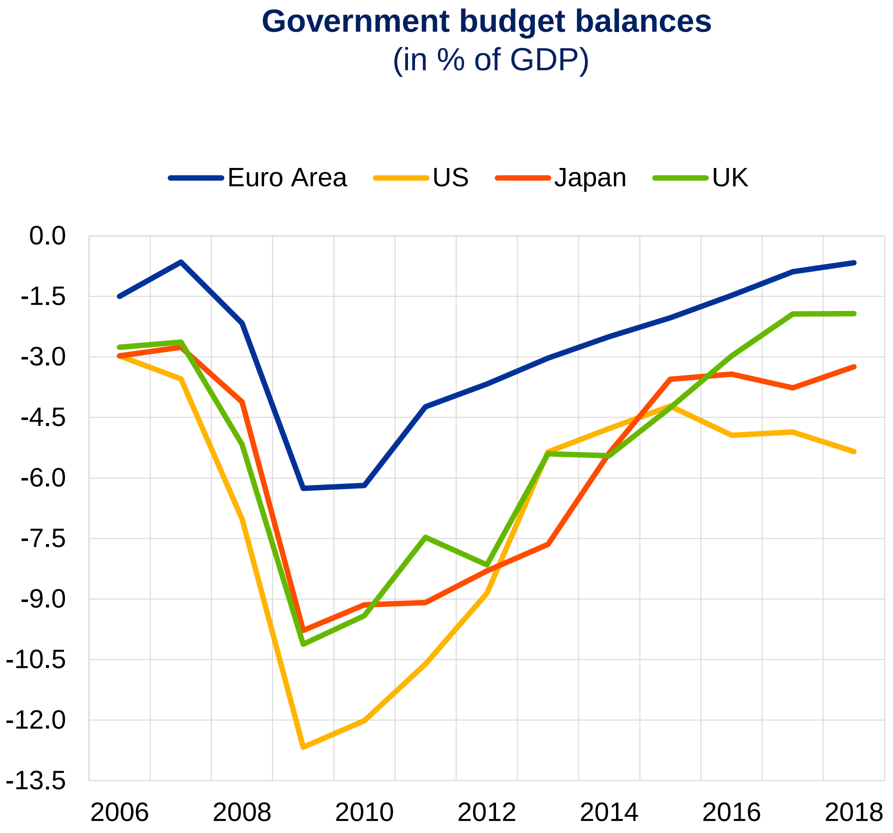
12 September 2018

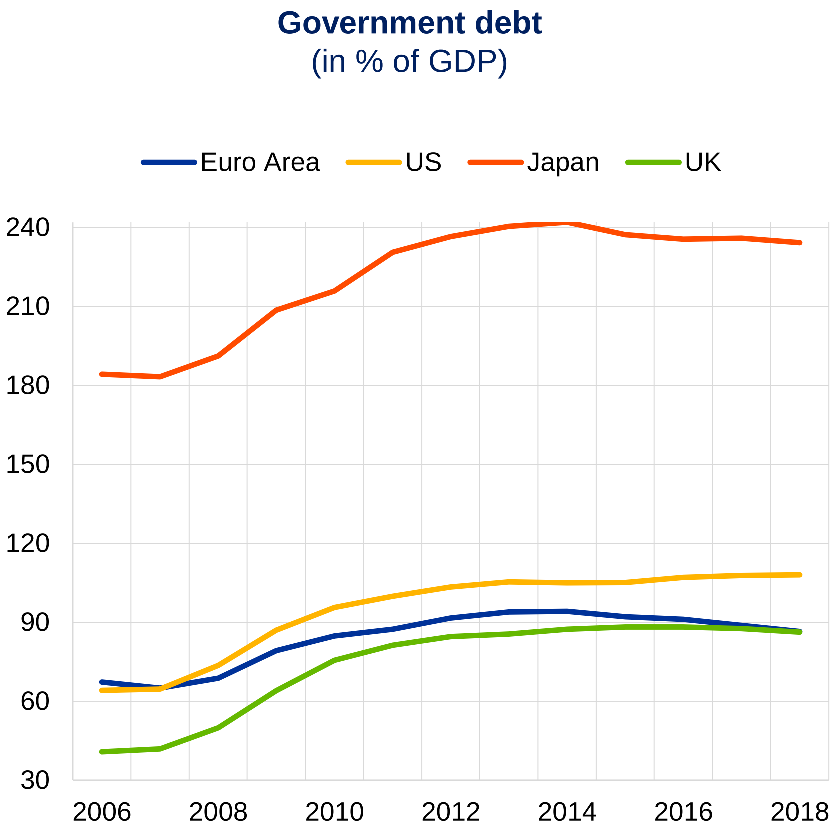
Why this debate is important for monetary policy?

- **Well explained by the CAE paper**
- **No bail-out clause,** but accumulation of high debt **increases risk of fiscal dominance and sovereign-bank nexus**
- **Activism in fiscal policies** might endanger business cycle synchronisation, **highly problematic for proper transmission of monetary policy**
- **In EMU stronger spillovers and contagion from bad policies**
- **Building buffers in good times** reduces risks of pro-cyclical policies in recessions, allows to lever on the concept of **aggregate fiscal stance,** when monetary policy at the ELB

Where the problem lies?

- **Not obvious if we look at the EA as a whole**
- **But large cross-country differences within the EA**





Source: European Commission (Spring 2018)

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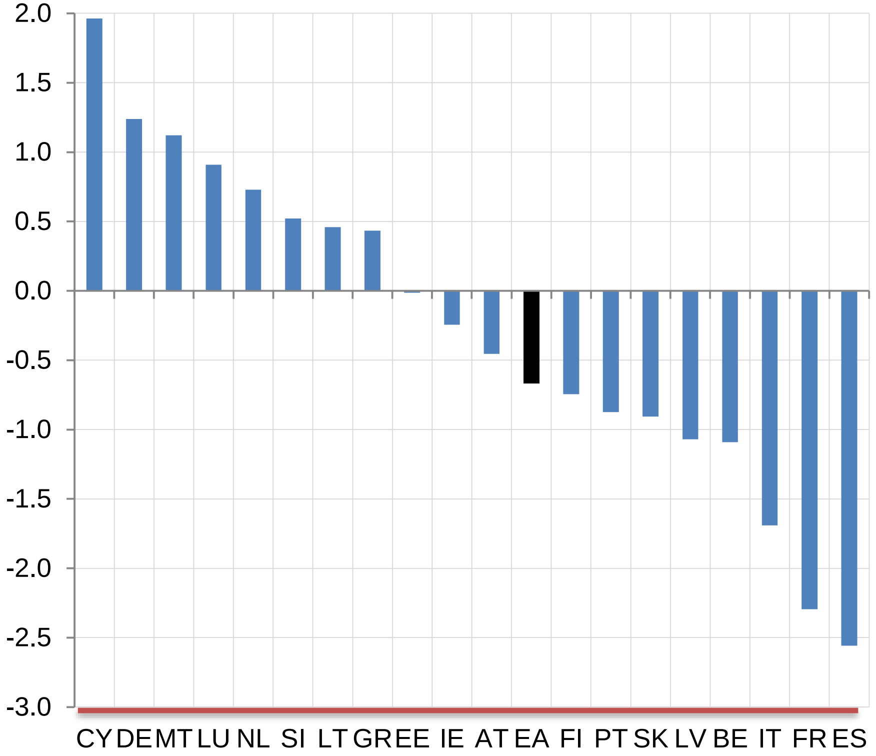
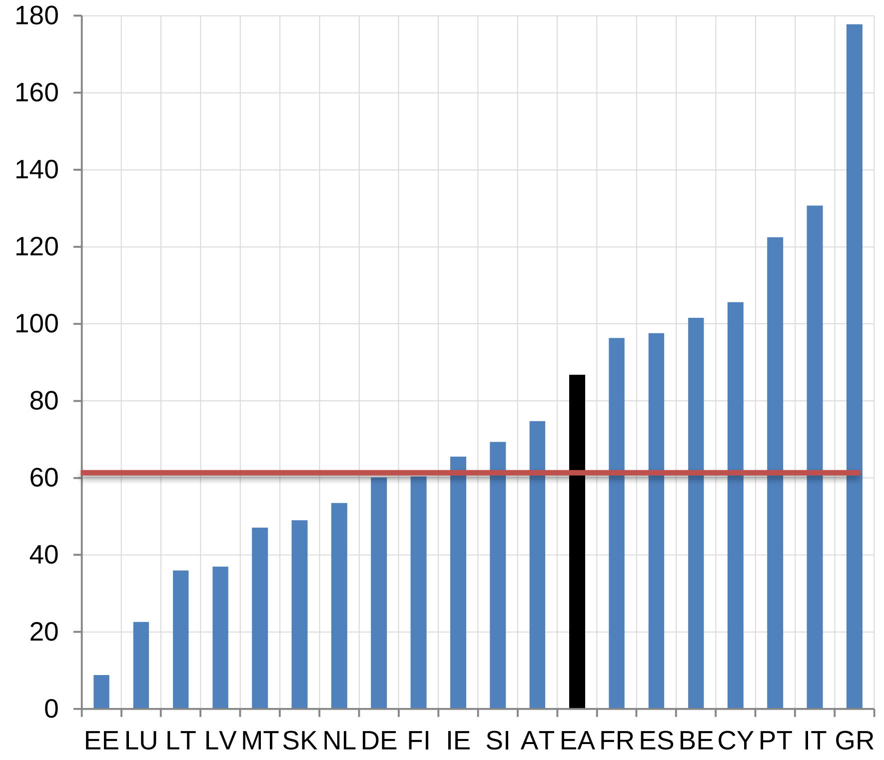
Government budget balances in 2018
(in % of GDP)



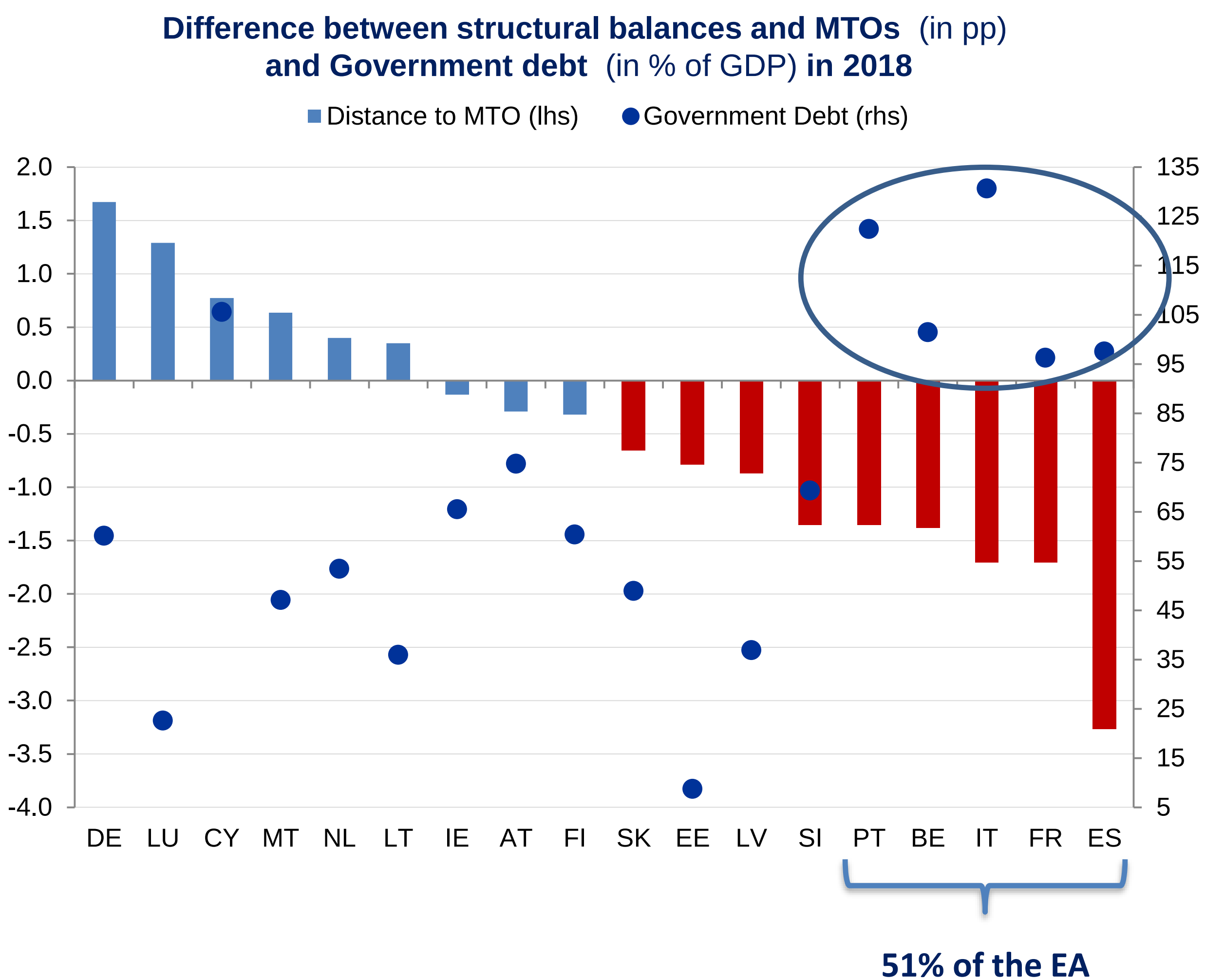
Government debt in 2018
(in % of GDP)



Source: European Commission (Spring 2018)

“Wrong correlation”:

High fiscal buffers in low debt countries, high fiscal shortfalls in high debt countries

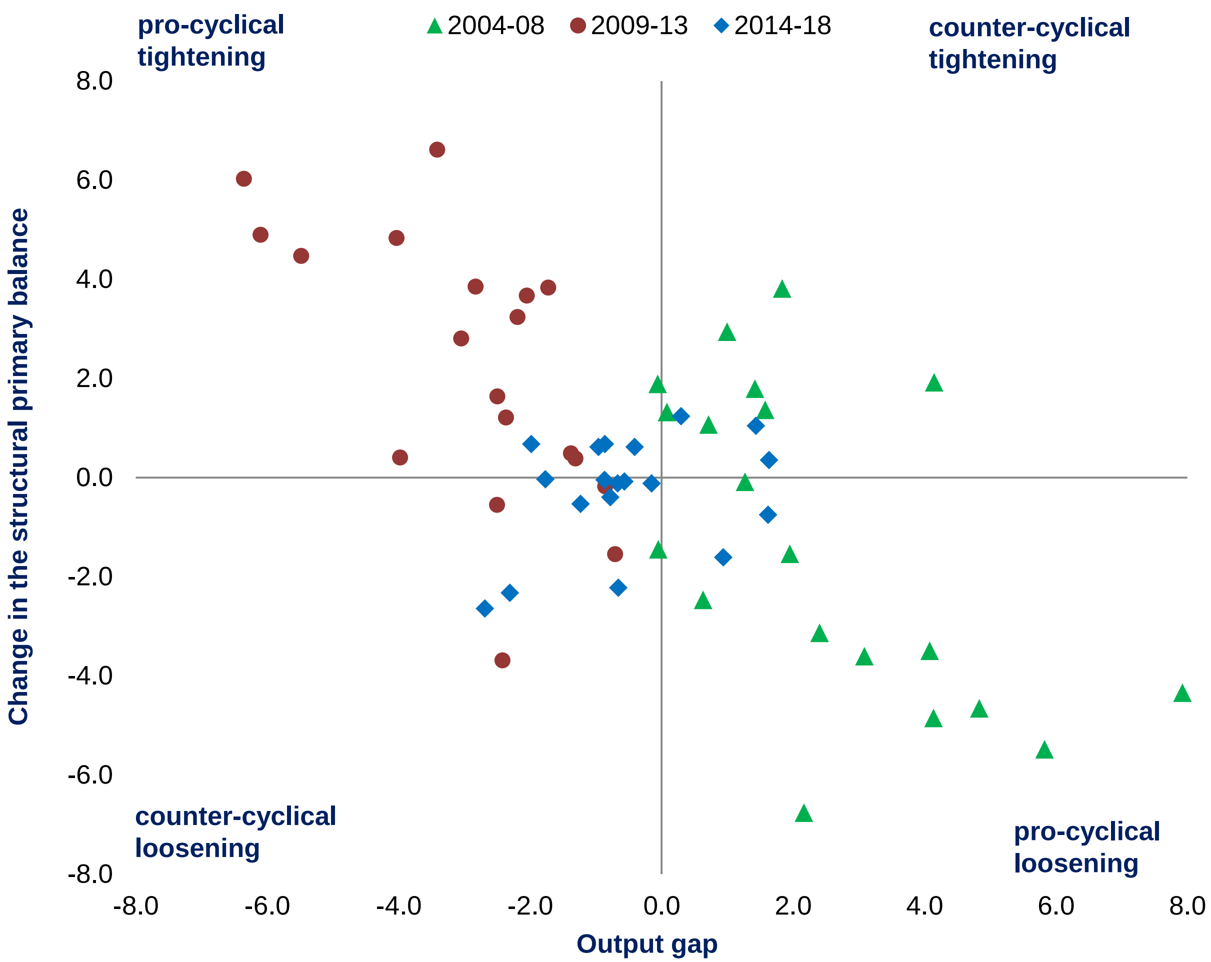


Source: European Commission (Spring 2018)

Pro-cyclicality:

Past evidence of apparent pro-cyclicality, less obvious currently

Change in the structural primary balance and output gap in EA countries
(5-year averages of OG and change in SPB)



Source: European Commission (Spring 2018)

Why the European Fiscal Framework needs to be changed?

	CEA	GCEE
Too complex	✓	✓
Too many exceptions and escape clauses		✓
Pro-cyclical	✓	
Large measurement problems	✓	✓
Not enforced	✓	✓
Not complied with	✓	✓

How far should we go?

CEA ⇨ **"Major overhaul": Get rid of structural balance concept (and sideline the 3% of GDP deficit limit)**

GCEE ⇨ **"Limited reform": Keep structural balance as medium term target**

What the two proposals have in common?

- **Both proposals are consistent with the EU Treaty**
- **Both argue to keep the long term debt anchor at 60% of GDP**
- **Both propose an operational target: change in nominal primary expenditure net of unemployment spending and of new discretionary revenues measures (ΔG^*)**
- **Both call for escape clauses only for exceptional circumstances**

Convergence of views on the anchor and operational target is also common to an increasing number of studies.

Compared to Structural Balance, ΔG^* is:

- **Under control of the government**
- **Easier to communicate**
- **Simpler to measure**

Not so simple to estimate ex-ante (or even ex-post) the yield of new discretionary revenue measures.

What are the differences?

1. Working of the rule

CEA: $\Delta G^*{}_{i,t} = \Delta LTY_{i,t} + E\pi_{i,t} - \alpha_i\left(\frac{D}{Y} - 60\right)$ *& adjustment account*

Time-varying

- **Not based on formula, but on economic analysis**
- **Country-specific**
- Consistent with the target of 5y moving debt reduction

- Deviation between actual and budgeted spending.
- Can trigger a violation of the rule if adjustment account > 1% of GDP

GCEE: $\Delta G^*{}_{i,t} < \Delta LTY_i + E\pi_i$ & $F\left(\frac{D}{Y} - 60\right)$ *& multi purpose adjustment account*

Constant over time

Structural Balance (SB) rule with constant debt adjustment parameter

1. **Deviation from SB rule** (ex-ante)
2. Ex-post revisions of SB
3. Estimation errors of DRM
4. Deviation between actual and budgeted spending

- Deviations to be offset within a certain period of time (5 years)

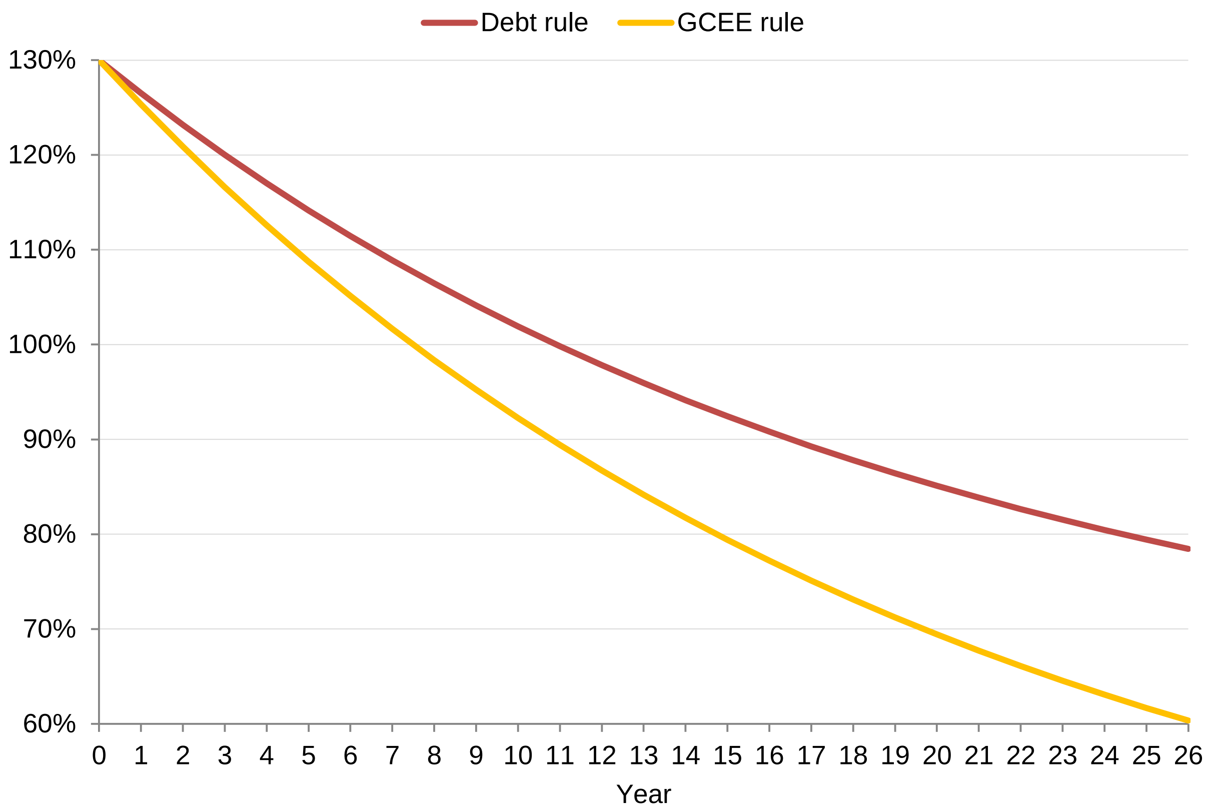
ΔLTY_{it} *= Change in potential growth for country i at time t*

$E\pi_{i\,t}$ *= Expected inflation for country i at time t*

What the Structural Balance rule delivers compared to the SGP debt rule in the GCEE proposal?

A significantly stronger fiscal adjustment. How can it credibly be enforced?

Simulation of the debt-to-GDP ratio according to GCEE (1/50 debt correction) and debt rule



Note: GCEE simulation refers to the 1/50 debt correction assuming 3% nominal GDP growth for a starting debt –to- GDP ratio of 130% and structural balance at -0.5% of GDP.

What are the differences?

2. Enforcement

		CEA	GCEE
Positive incentives	Participation in a Fiscal Stabilisation Scheme	✓	
	ESM lending	✓	✓
Sanctions	Introduce more automaticity via new EU regulation (with predetermined design and size)		✓
	Steer market discipline with junior bonds	✓	
Comply or Explain	Press conference of National Councils / FM testifies in front of Parliament	✓	

3. Governance

CEA
- **Renationalisation** of the fiscal debate
- Stronger role to **national fiscal councils**:
  - Assessment of potential growth, inflation, impact of DRM, DSA
- **"Normal EDP" when ΔG^* rule is violated** (even if 3% deficit not violated)

GCEE
- **New EU regulation introducing automaticity of sanctions**
- Reformed **European Fiscal Board**

Questions:

GCEE proposal

1. Why a **<** in the annual rule? Are the debt feedback mechanism and the multipurpose account not enough taking care of debt reduction / convergence towards MTO?
2. Have the counter-cyclical properties of the rule been tested?
3. What happens to the corrective arm? Once a country is in EDP, how the proposal would avoid that a nominal strategy of deficit reduction continues to be pursued, given that the Treaty remains unchanged?

CEA proposal

1. Is the rule multiannual or annual? Are potential output growth and expected inflation revised annually?
2. How long it takes to reach the MTO, e.g. for France?
3. How can one ensure that the "moving 5-year debt reduction target" is not just a "moving target" (without significant debt reduction), given the unavoidable "discretionary" part involved in the "economic analysis"?

Summing up

- Important debate which needs to complement the ongoing discussions on the fiscal stabilisation function.
- Important common messages:
  - 60% debt limit not questioned and debt reduction key
  - Focus on operational target which can be controlled by the government
  - Improve enforcement with positive incentives
- Differences seem to partly reflect “national preferences”:
  - Automaticity vs economic analysis / discretion
  - Uniformity of rules vs country dimension
  - Encompassing rule vs simplification
- Leveraging more on market discipline not brought-up in the GCEE paper: any difference of views there?

Thank you!