Future of Fiscal Rules in the Euro Area

Workshop on “Fiscal Rules in Europe: Design and Enforcement”

DG ECFIN

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Outline

01 WHY FISCAL RULES?
02 WHAT HAVE WE LEARNED OVER 30 YEARS?
03 WHAT ARE THE POLICY OPTIONS?
04 CONCLUSIONS
Debt Bias

General Government Debt and Interest Rate-Growth Differential

Euro Area

Advanced Economies excluding Euro Area

Note: recessions in the Euro area follow the definition by CEPR.
Sources: IMF Global Debt Database, IMF WEO, CEPR, NBER and the author’s calculations.

Note: recession episodes are those for the US as identified by NBER.
Evolution of the EU Fiscal Rules over time

- 1989 Delors’ Report
- 1992 Maastricht Treaty
- 1997 Stability and Growth Pact
- 1998 Preventive Arm
- 1999 Corrective Arm
- 2005 Structural Balance
- 2010 First European Semester
- 2011 Fiscal Compact Six Pack
- 2012 Two-pack
- 2013 Communication Flexibility
- 2015 Two-pack

Source: https://mezquita-catedraldecordoba.es/en/descubre-el-monumento/el-edificio/
Sovereign Debt Crises in the Euro Area

10-year Government Bond Yields, percent

Source: Eurostat.
Poor Compliance

Euro Area Countries that did not comply with

At least 1 rule

At least 2 rules

At least 3 rules

Percent of total


Decomposition of Deficit Rule Slippages*

Note: Reported is the share of euro area countries that did not comply with the following fiscal rules: (1) Deficit rule = overall deficit-to-GDP ratio should not exceed 3%, (2) Debt rule = public debt-to-GDP ratio should not exceed 60%, (3) Medium-Term Objective (MTO) rule = structural deficit ratio should not exceed the MTO, and (4) Fiscal effort rule = decline in the structural deficit ratio should be at least 0.5% in a given year when the structural deficit exceeds the MTO in the previous year. The assessment is illustrative and subject to a number of caveats.


* Decomposition formula:

\[
\text{DEF}_{t|2016} - 3 = \frac{\text{DEF}_{t|2016} - \text{DEF}_{t-i}}{\text{Ex-ante compliance}} + \frac{\text{DEF}_{t-i} - 3}{\text{Execution}}
\]

Medians reported.

Rules as an Effective Pulling Force

Fiscal Balance Distributions

Source: Caselli and Wingender (2018)
Mostly Procyclical Fiscal Policies

Euro Area: General Government Structural Primary Balance and Output Gap (percent of potential GDP)

Source: IMF World Economic Outlook

Weak and Fragile Recovery in Industrial Production

**Industrial Production Index in the United States**

- **Global financial crisis**
- **Great Depression**

**Industrial Production Index in the Euro Area**

- **Beginning of WWII**
- **Great Depression**


Note: For the Euro Area, 1929-38 series corresponds to the average for France, Germany, and Italy; and the 1939-40 the averages for Germany and Italy.
Divergence in the Euro Area: Italy vs. Germany

Real GDP per Capita in PPP (1999=100)

Source: IMF World Economic Outlook.
Deficits and Debt in Italy and Germany

Sources: IMF WEO and IMF staff calculations.

Structural Primary Balance (in percent of potential GDP)

Sources: IMF WEO and IMF staff calculations.

General government Gross Debt (in percent of GDP)

Sources: IMF WEO and IMF staff calculations.
Declining Public Investment

Public Investments
(in percent of GDP)

United States

Euro Area

Source: IMF WEO.
Increasing Debt and Declining General Government Net Worth

Euro Area General Government Net Worth (in percent of GDP)

Note: covers general government balance sheet data for all Euro area countries.

Source: IMF Public Sector Balance Sheet Database.

Changes in General Government Net Worth and Gross Debt, 2000-16

Sources: IMF Public Sector Balance Sheet Database and IMF WEO.
The Role of Public Sector Balance Sheets

Public Sector Balance Sheets (in percent of GDP)

- Total nonfinancial assets
- Financial assets
- Liabilities ex pension
- Pension liabilities
- Net worth
- General government debt

Note: Data for starred countries is based on a single year of data, in most cases compiled as part of fiscal transparency evaluations. The countries in the circle represent Euro Area countries.
Source: IMF Public Sector Balance Sheet Database.
Low Interest Rates and Future Liabilities

Net Present Value of Pension Spending Change, 2018–50

Net Present Value of Health Spending Change, 2018–50

Sources: national authorities; and IMF staff estimates and projections.
Negative Nominal Interest Rates in Advanced Economies

Nominal Interest Rate (percent)

Sources: Global Financial Data; and IMF staff calculations.

Note: 10-year bond yields. The chart is based on 24 advanced economies. Germany was removed for the years 1920 and 1922-24 due to the hyperinflation episode.

Sources: Bloomberg; and IMF staff.
Interest Rate-Growth Differentials

Note: The chart is based on unbalanced dataset consisting of 24 advanced economies (including 11 Euro Area Economies). Interest rate-growth differential is calculated as the difference between the effective interest rate and the nominal GDP growth rate. Source: Jing and Mauro (2019);
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Strengthening the Euro Area Architecture
Improving the Fiscal Framework

Consolidating the Preventive and Corrective Arms
Shifting to a Single Fiscal Anchor and a Single Operational Target
Central Fiscal Capacity
Shifting to a Single Fiscal Anchor — Public Debt

Given debt dynamics equation:

\[ d_t \approx (1 + r_t - g_t) \times d_{t-1} - pb_t \]

Lower interest rates do not necessarily create more fiscal space:

If \( \Delta r = \Delta g \), \( \Delta d = 0 \) if \( pb \) is constant (implying an improvement in the headline balance equal to the interest rate savings).

Sources: Bloomberg; WEO and IMF staff calculations
Reforming the Institutional Set up – Fiscal Councils

Reform of Fiscal Councils

Forecast Preparation Forecast Assessment Recommendations Long-Term Sustainability Consistency with objectives (beyond fiscal rules) Costing of Measures Monitoring of Fiscal Rules

Austria Fiscal Advisory Council
Belgium High Council of Finance - Public Sector Borrowing Section
Belgium Federal Planning Bureau
Cyprus Fiscal Council
Estonia Fiscal Council
Finland National Audit Office of Finland
France High Council of Public Finance
Germany Independent Advisory Board to the German Stability Council
Greece Parliamentary Budget Office
Ireland Irish Fiscal Advisory Council
Italy Parliamentary Budget Office
Latvia Fiscal Discipline Council
Lithuania National Audit Office
Luxembourg National Council of Public Finance
Malta Malta Fiscal Advisory Council
Netherlands Netherlands Bureau for Economic Policy Analysis
Netherlands Raad van State
Portugal Portuguese Public Finance Council
Slovakia Council for Budget Responsibility
Spain Independent Authority of Fiscal Responsibility

Note: the highlighted boxes point to the existence of the respective fiscal council remit.
Source: IMF Fiscal Councils Database (2016).
European Network of Independent Fiscal Councils
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Conclusions

The euro area architecture requires the completion of banking union, capital markets union and a central fiscal capacity.

The review of the ECB’s monetary policy strategy is timely.

There is ample room to simplify fiscal rules for the euro area by using a single debt anchor and a single operational (nominal) spending target.

The added complexities associated with constraints on policy rates and the intertemporal dimension of population dynamics and green and digital transformations point to:

- *better information based on accrual accounting and the PSBS approach*;
- *reinforced role for a system of independent national fiscal councils with an independent European Fiscal Board, at its center*. 
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