



Future of Fiscal Rules in the Euro Area

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

DG ECFIN

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Vitor Gaspar

Director

Fiscal Affairs Department

Outline

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WHY FISCAL RULES?

02



WHAT HAVE WE LEARNED OVER 30 YEARS?

03



WHAT ARE THE POLICY OPTIONS?

04



CONCLUSIONS

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WHAT ARE THE POLICY OPTIONS?

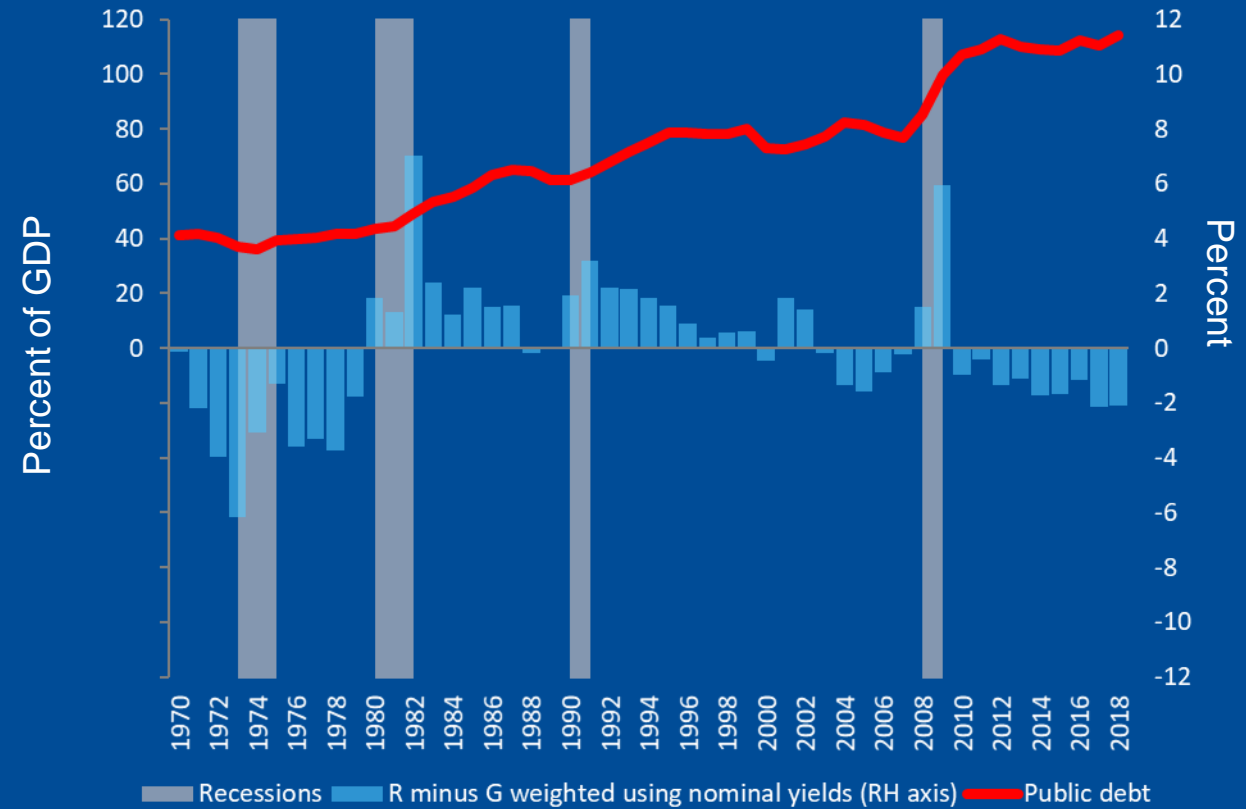
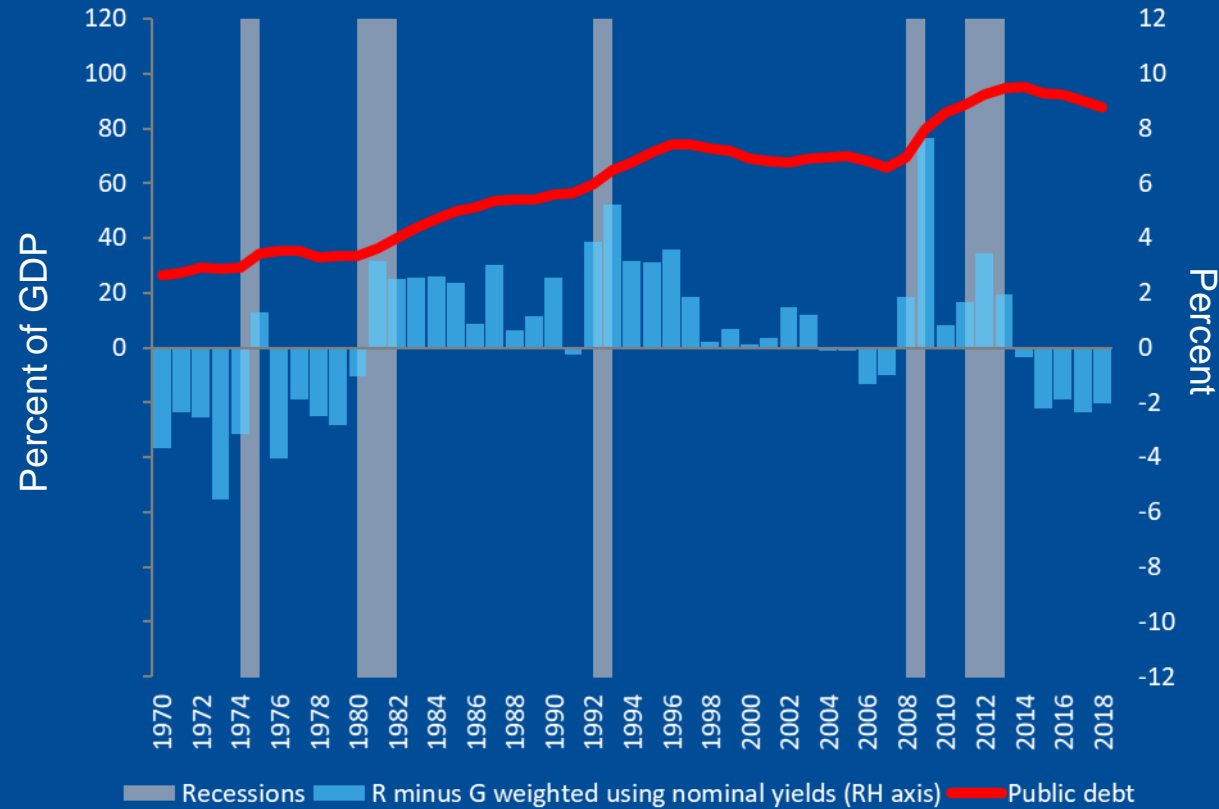
04



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.

Note: recession episodes are those for the US as identified by NBER.

Sources: IMF Global Debt Database, IMF WEO, CEPR, NBER and the author's calculations.

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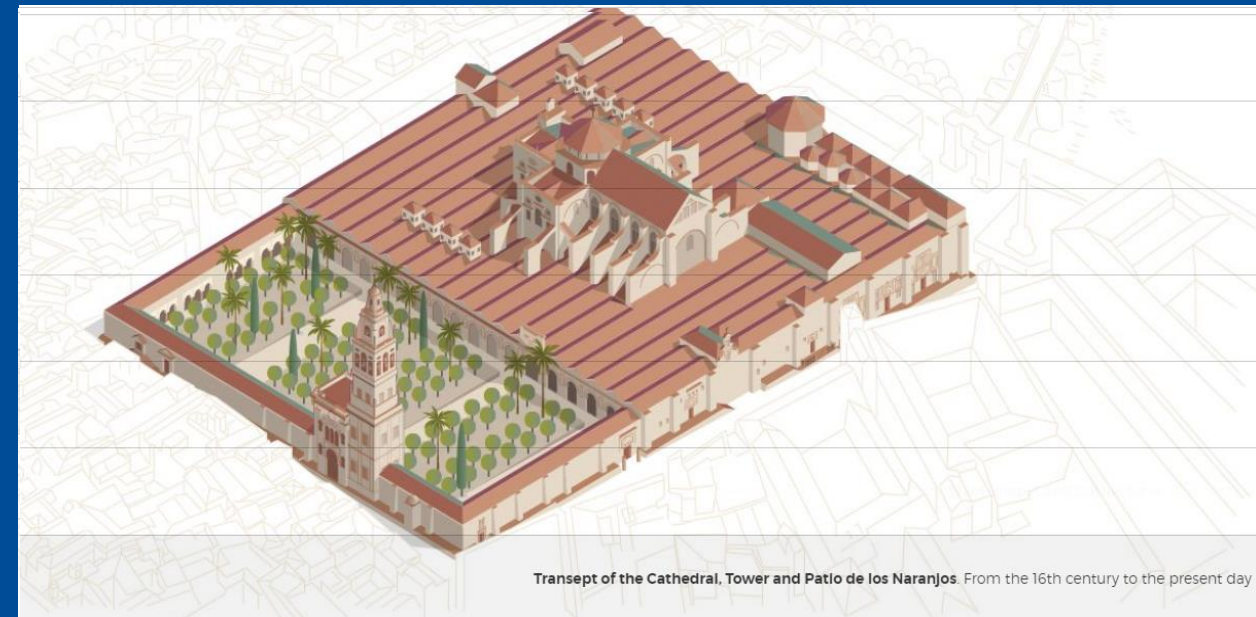
Layers over Layers of Complexity

Evolution of the EU Fiscal Rules over time



Source: Deroose Carnot, Pench and Mourre (2018)

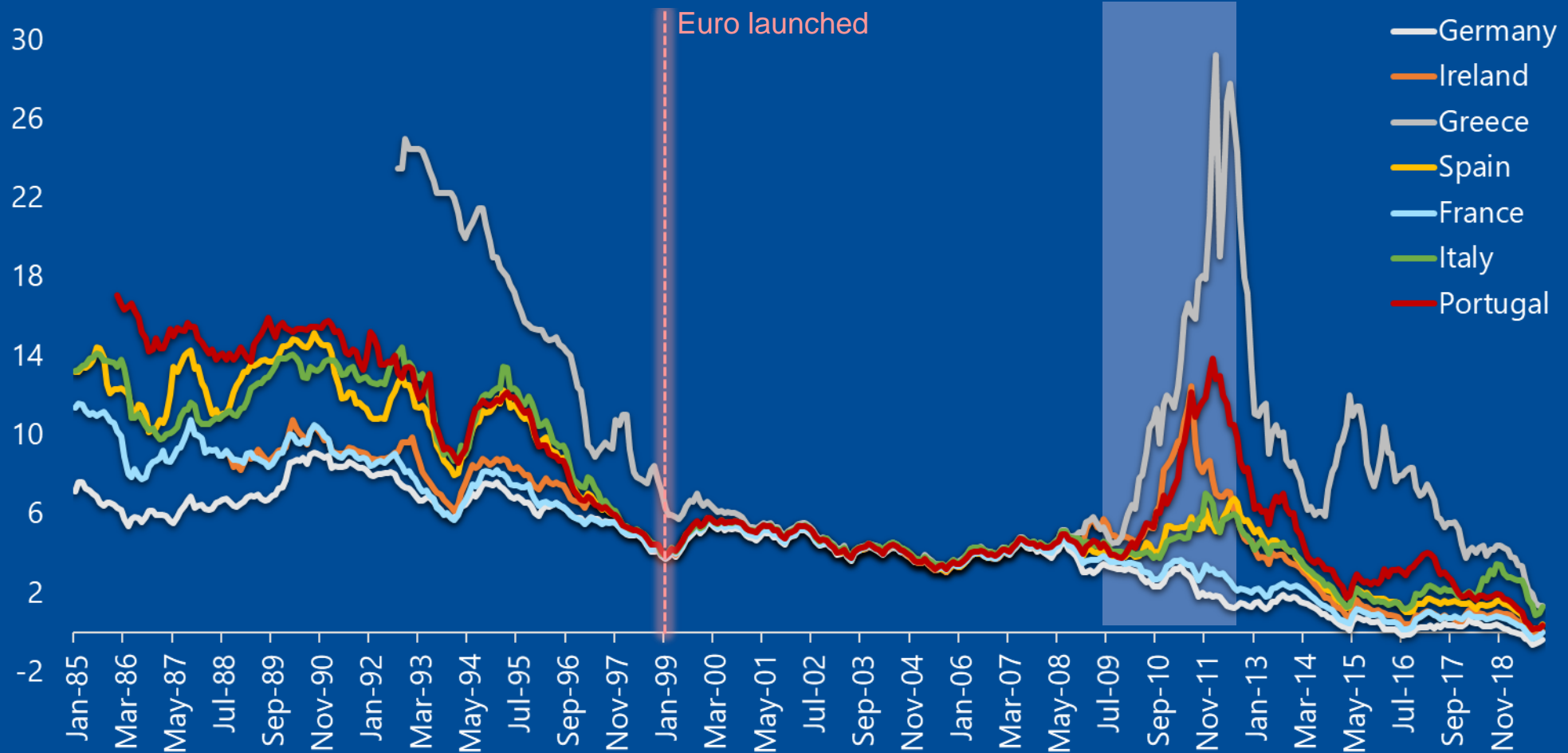
Construction Phases of The Mosque-Cathedral of Cordoba



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 rule

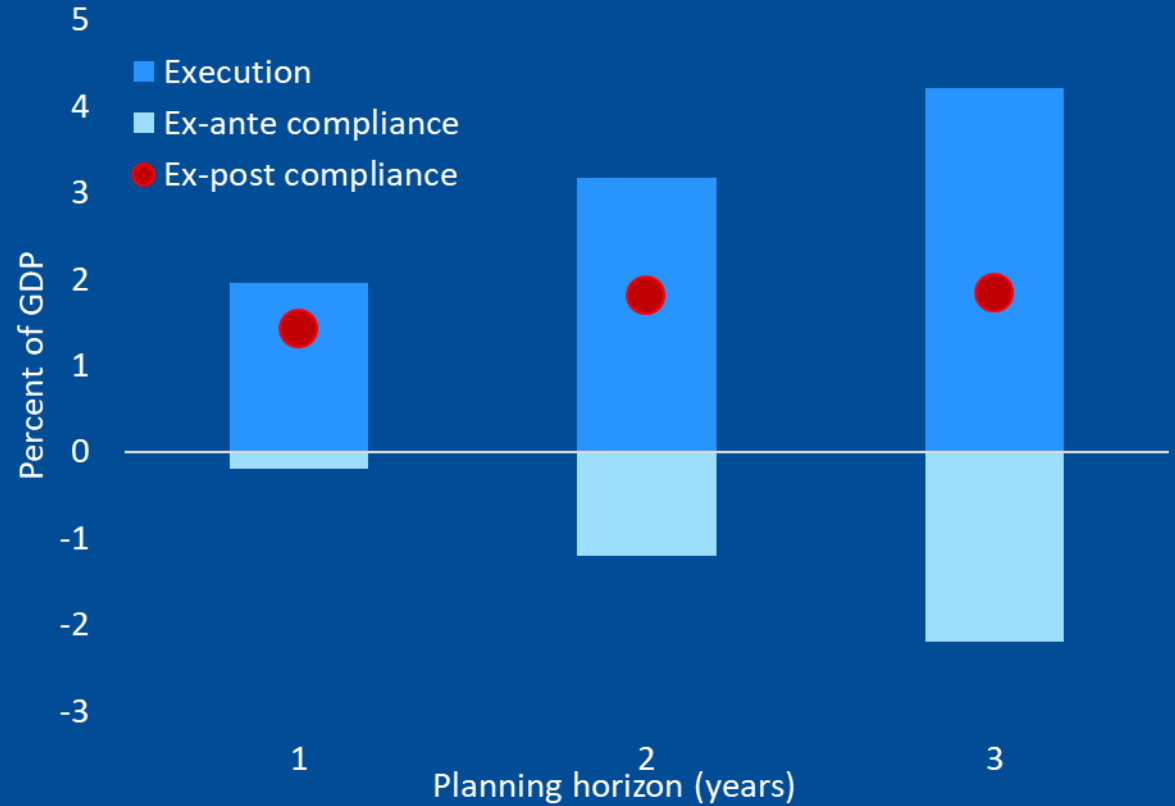
4 rules



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.

Source: Eyraud, Gaspar, and Poghosyan (2017).

Decomposition of Deficit Rule Slippages*

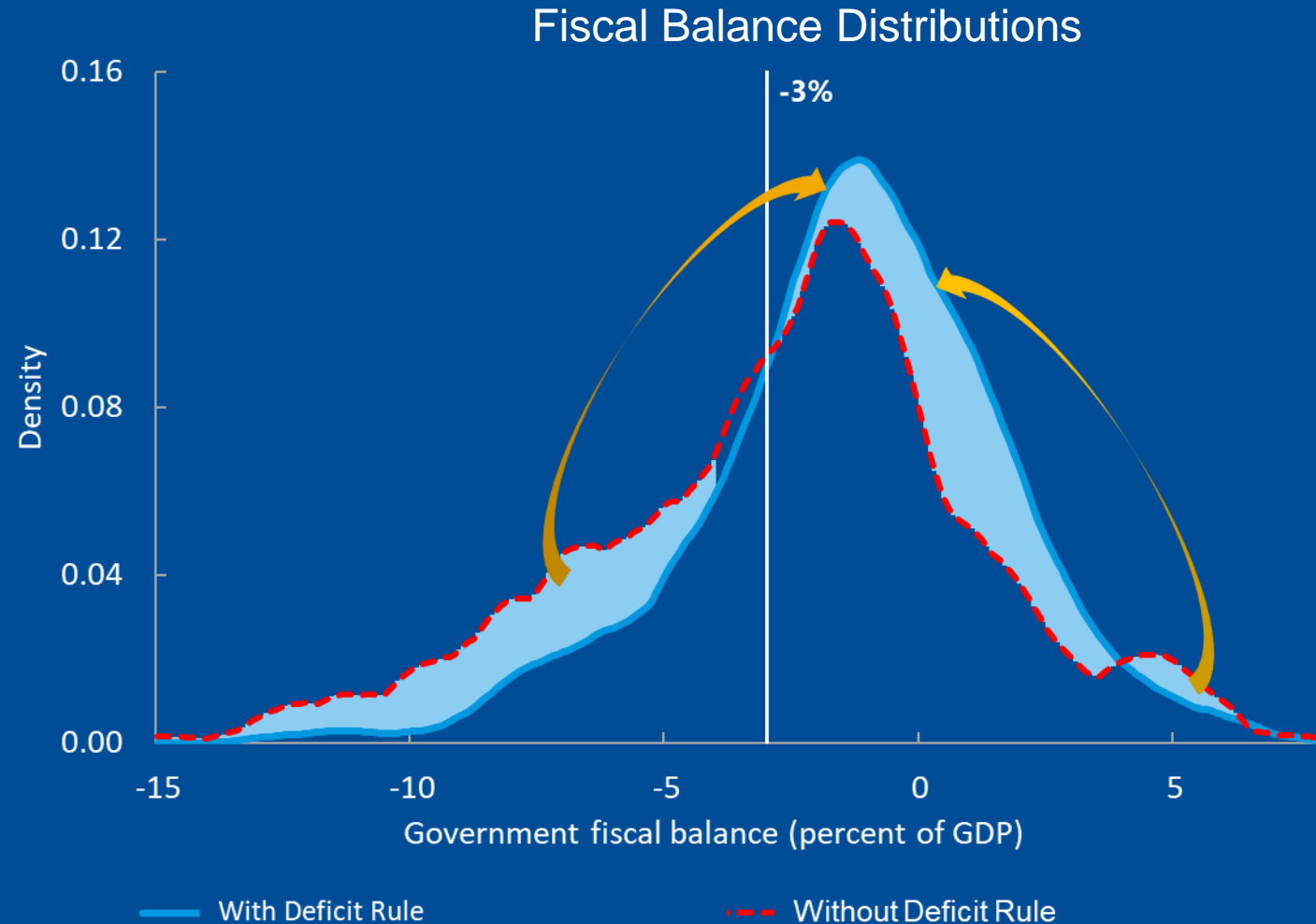


$$* \text{ Decomposition formula: } \underbrace{DEF_{t|2016} - 3}_{\text{Ex-post slippage}} = \underbrace{(DEF_{t|2016} - DEF_{t|t-i})}_{\text{Execution}} + \underbrace{(DEF_{t|t-i} - 3)}_{\text{Ex-ante compliance}}$$

Medians reported.

Source: Eyraud, Gaspar, and Poghosyan (2017).

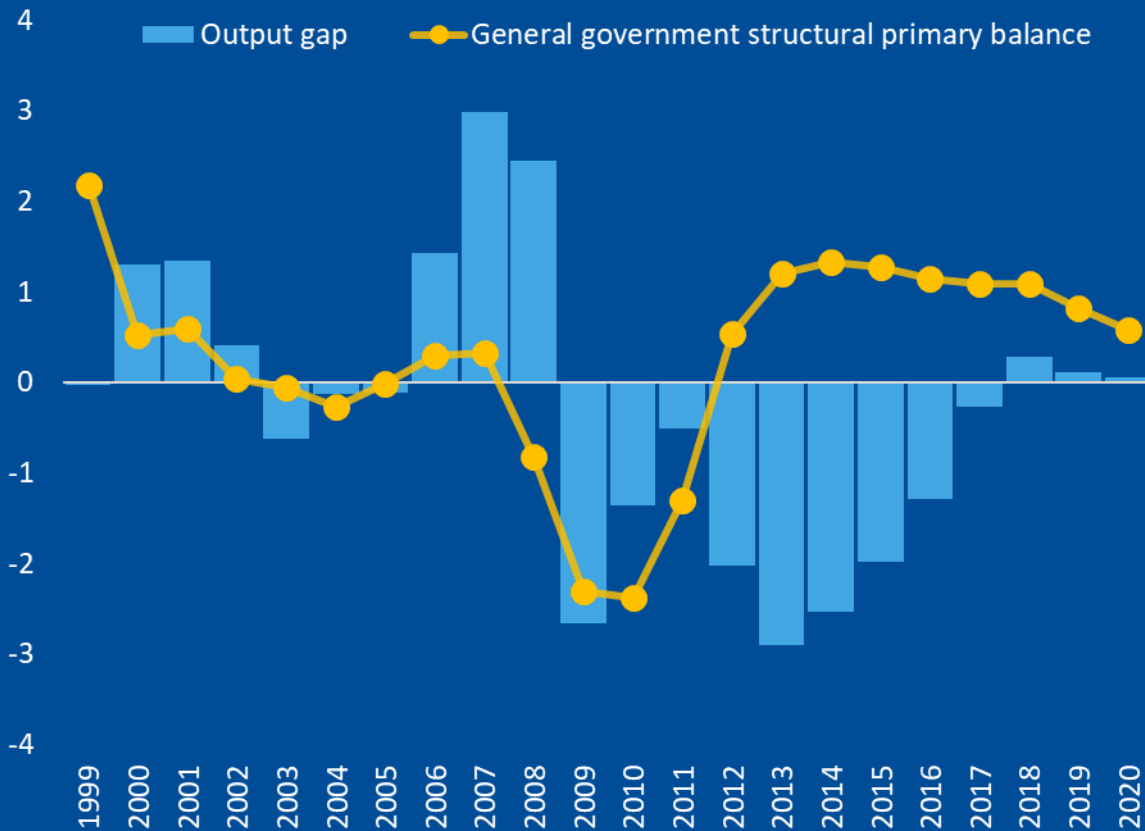
Rules as an Effective Pulling Force



Source: Caselli and Wingender (2018)

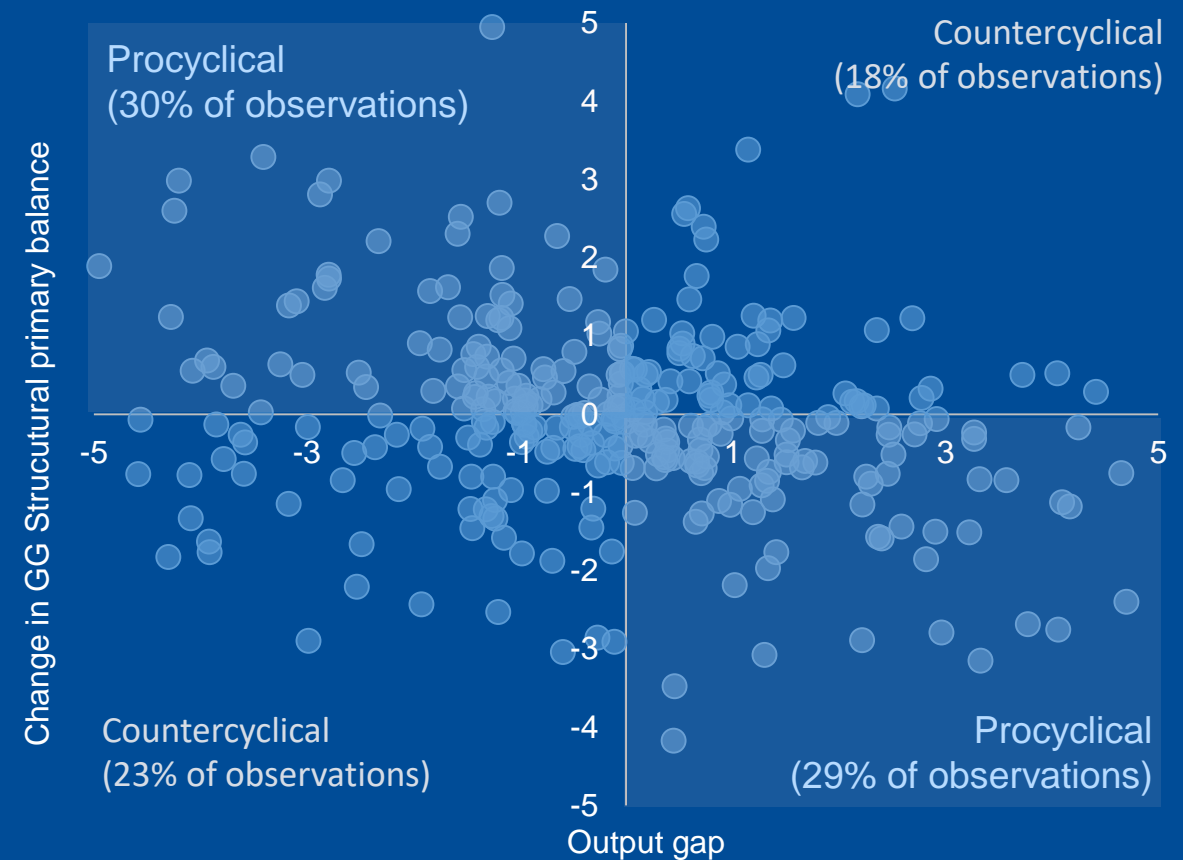
Mostly Procyclical Fiscal Policies

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



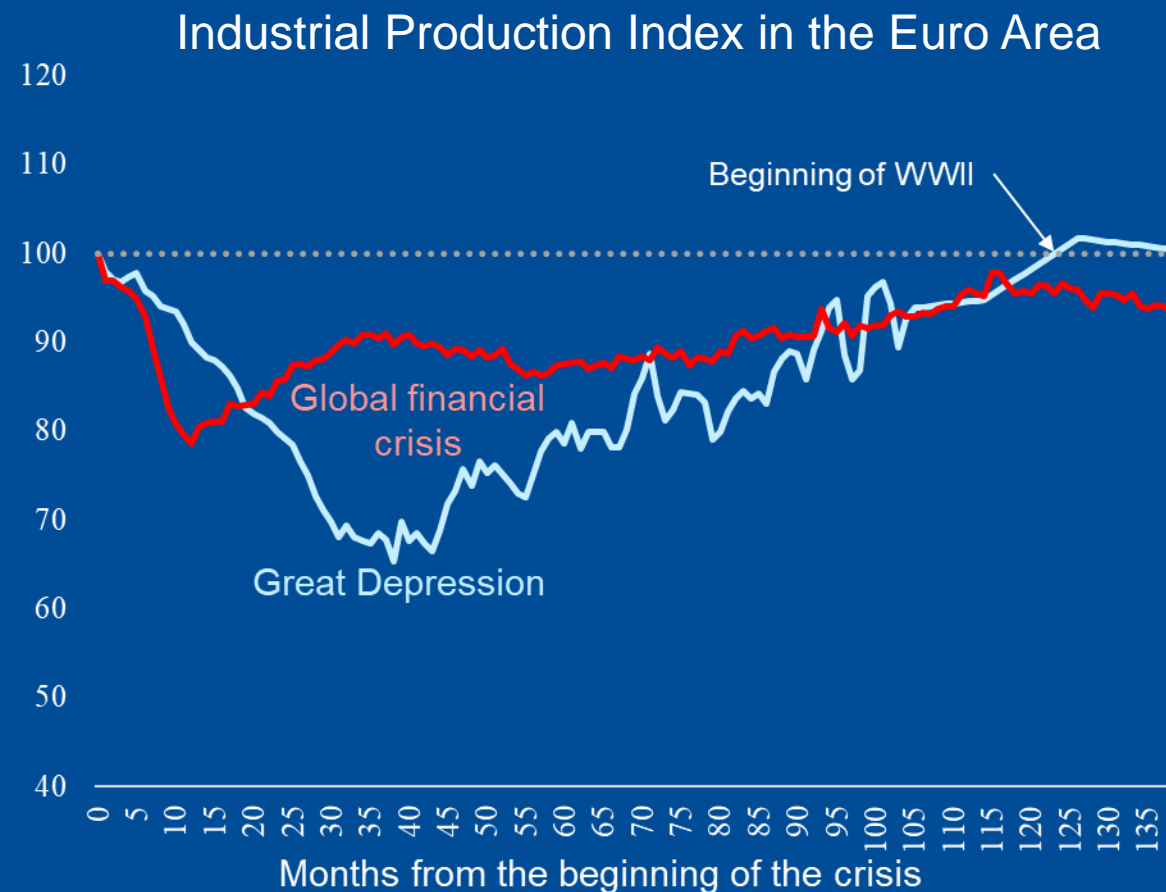
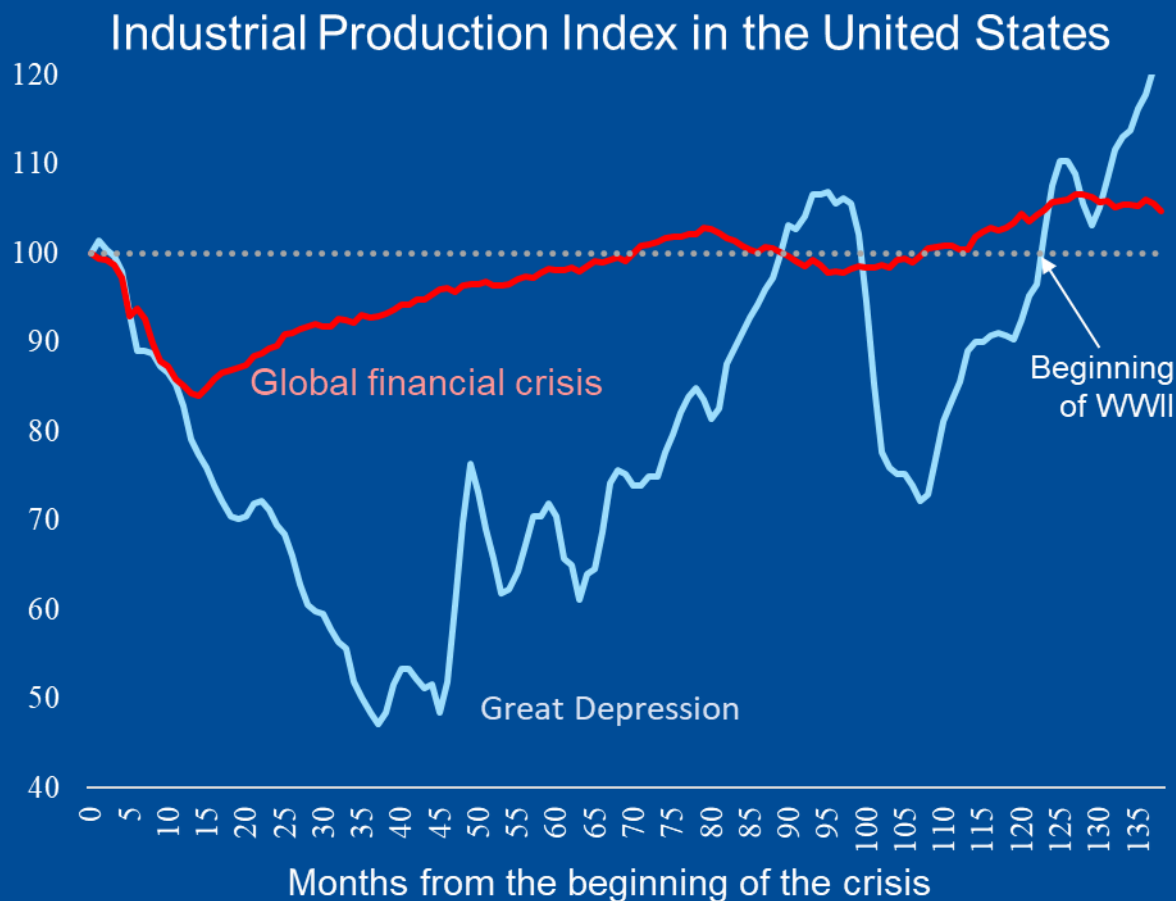
Source: IMF World Economic Outlook

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



Source: following Andrieu and others (2015) using data from IMF WEO (2019).

Weak and Fragile Recovery in Industrial Production

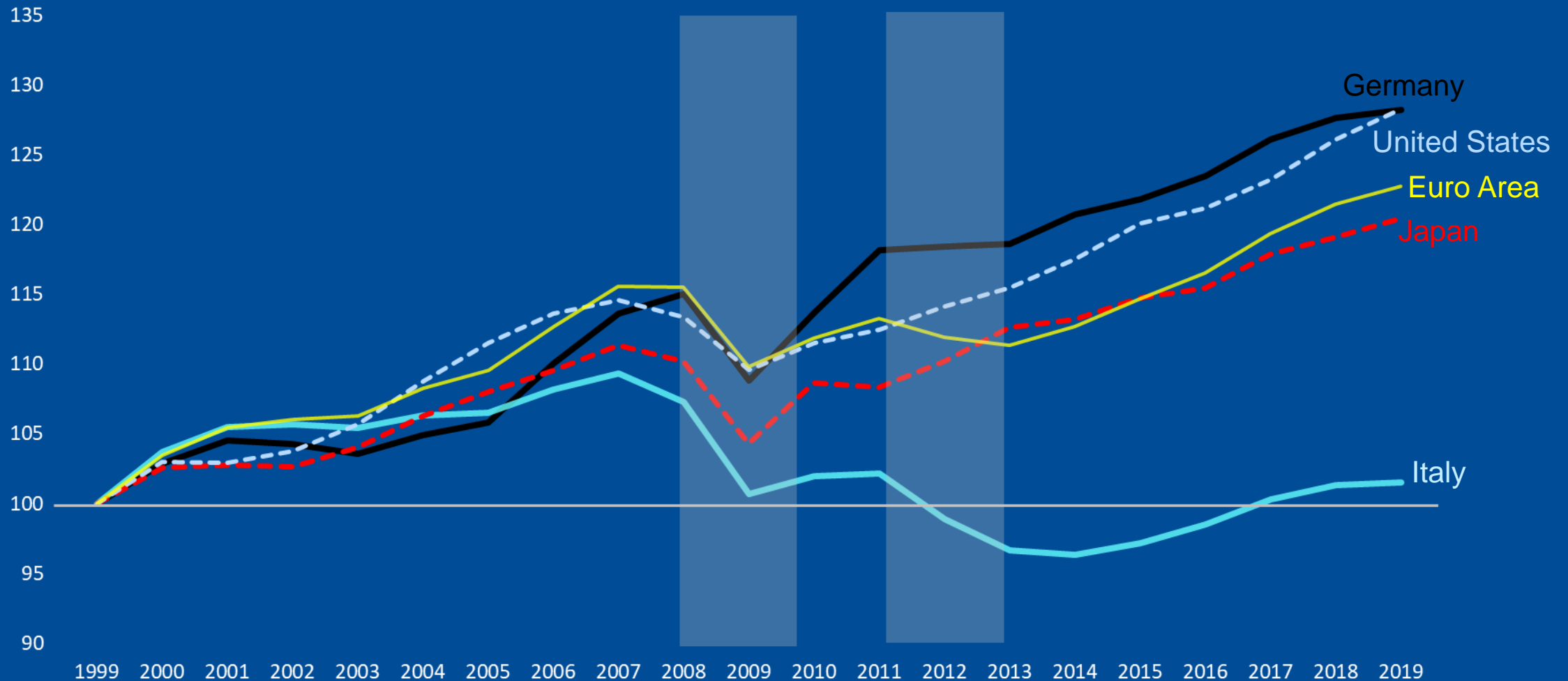


Source: Eichengreen, B. and K.H. O'Rourke (2010) "What do the new data tell us?" VoxEU.org , 08 March; League of Nations Statistical Yearbooks 1934-38 made digitally available by Northwestern University Library at <http://digital.library.northwestern.edu/league/stat.html> ; Federal Reserve Bank of St. Louis; Haver Analytics; International Financial Statistics; and IMF staff estimates.

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

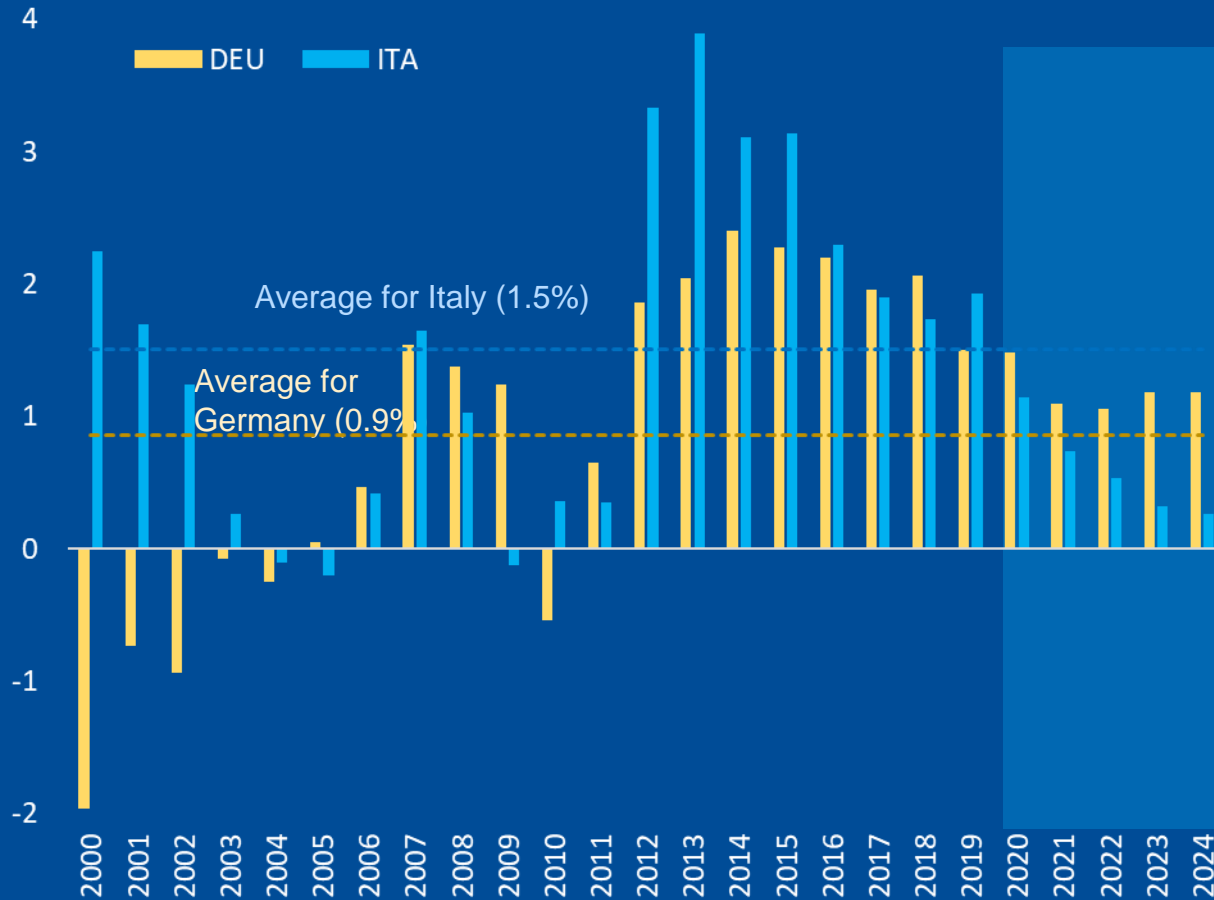
Real GDP per Capita in PPP
(1999=100)



Source: IMF World Economic Outlook.

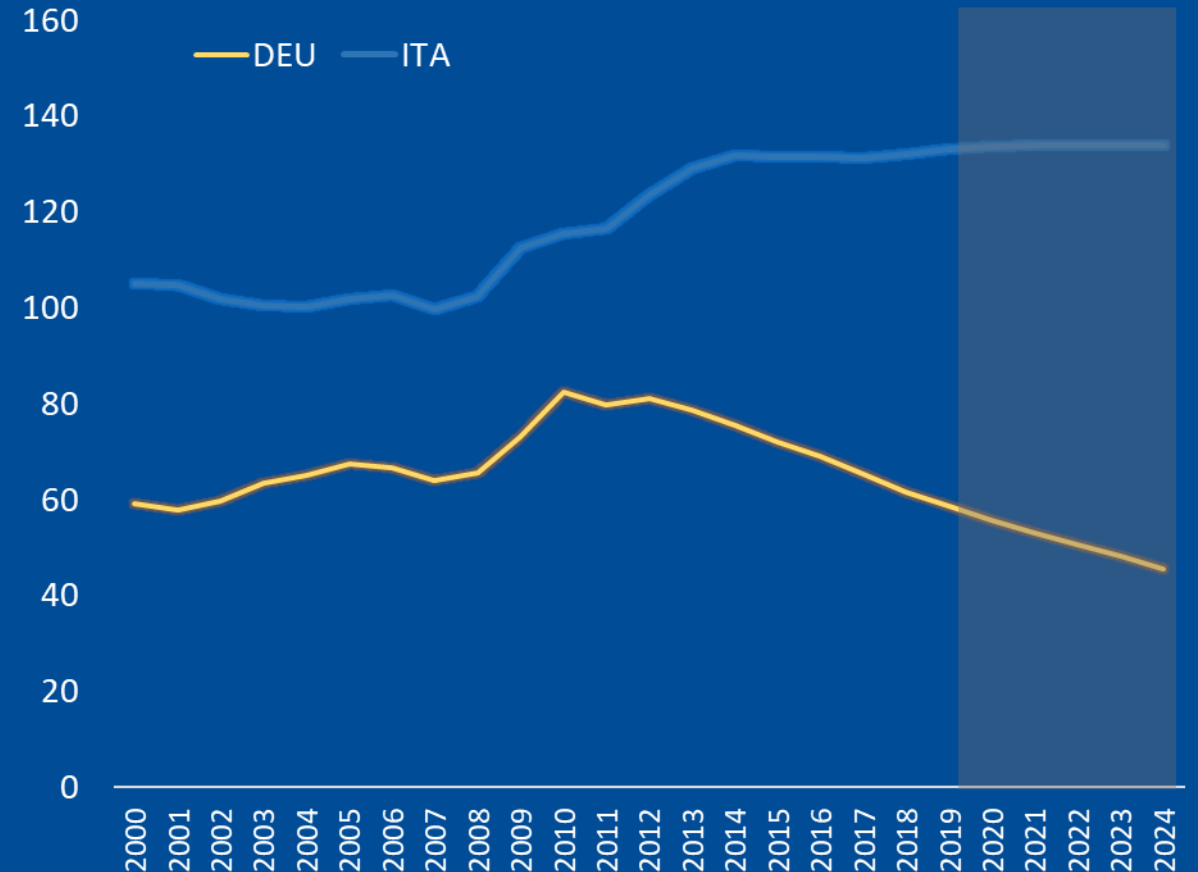
Deficits and Debt in Italy and Germany

Structural Primary Balance (in percent of potential GDP)



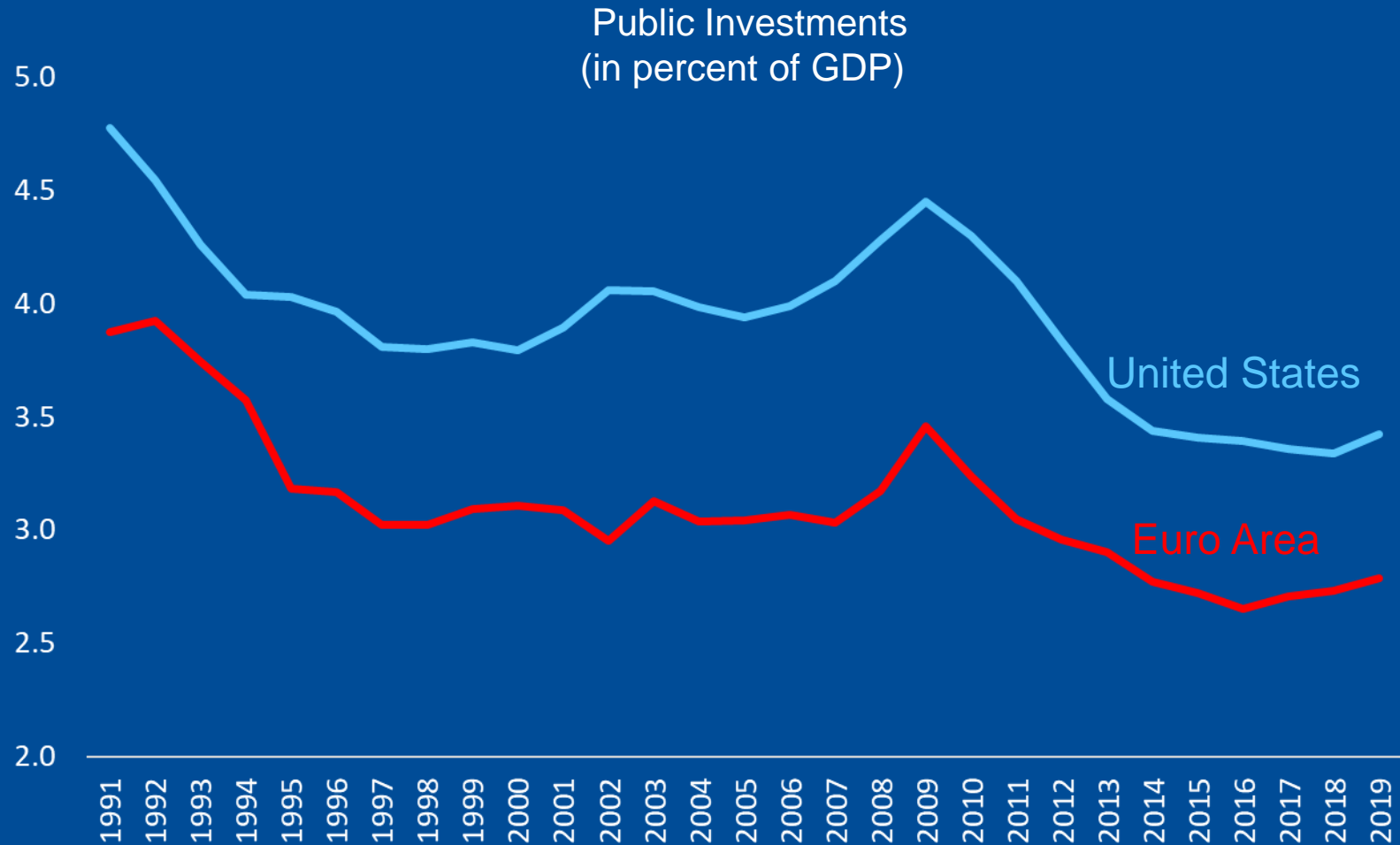
Sources: IMF WEO and IMF staff calculations.

General government Gross Debt (in percent of GDP)



Sources: IMF WEO and IMF staff calculations.

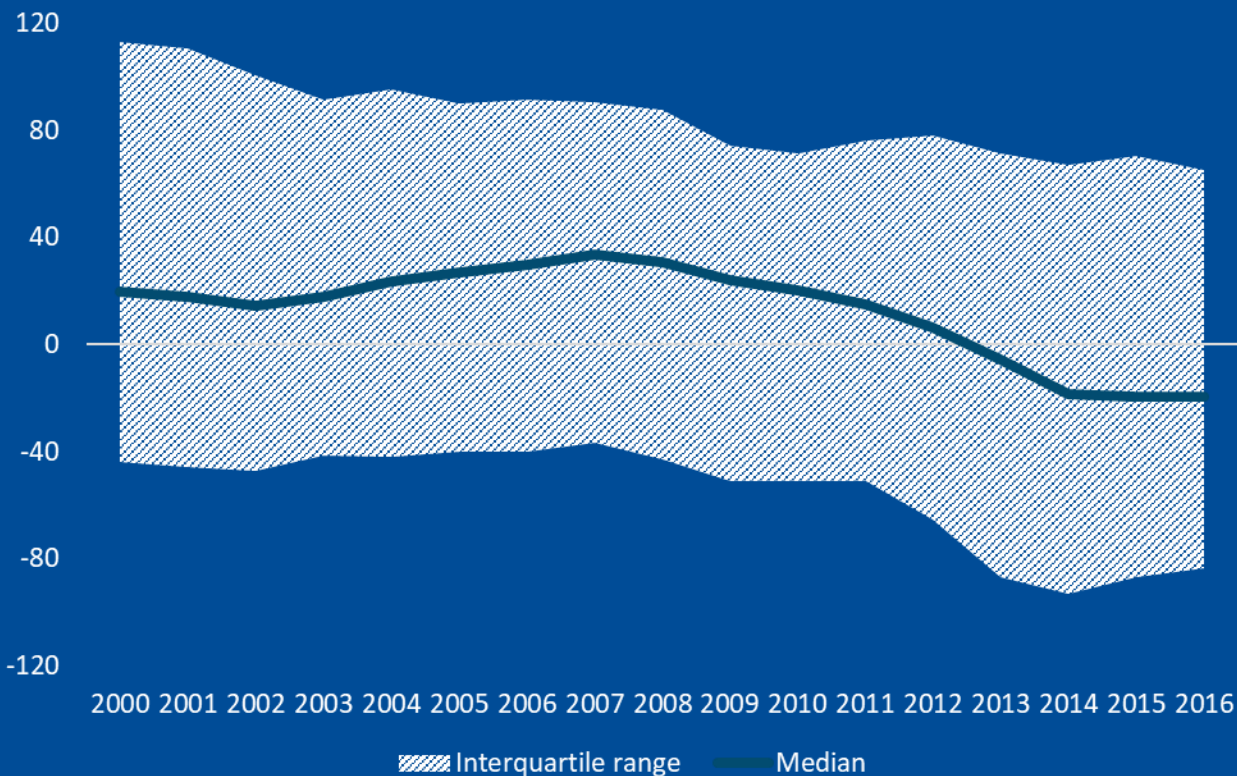
Declining Public Investment



Source: IMF WEO.

Increasing Debt and Declining General Government Net Worth

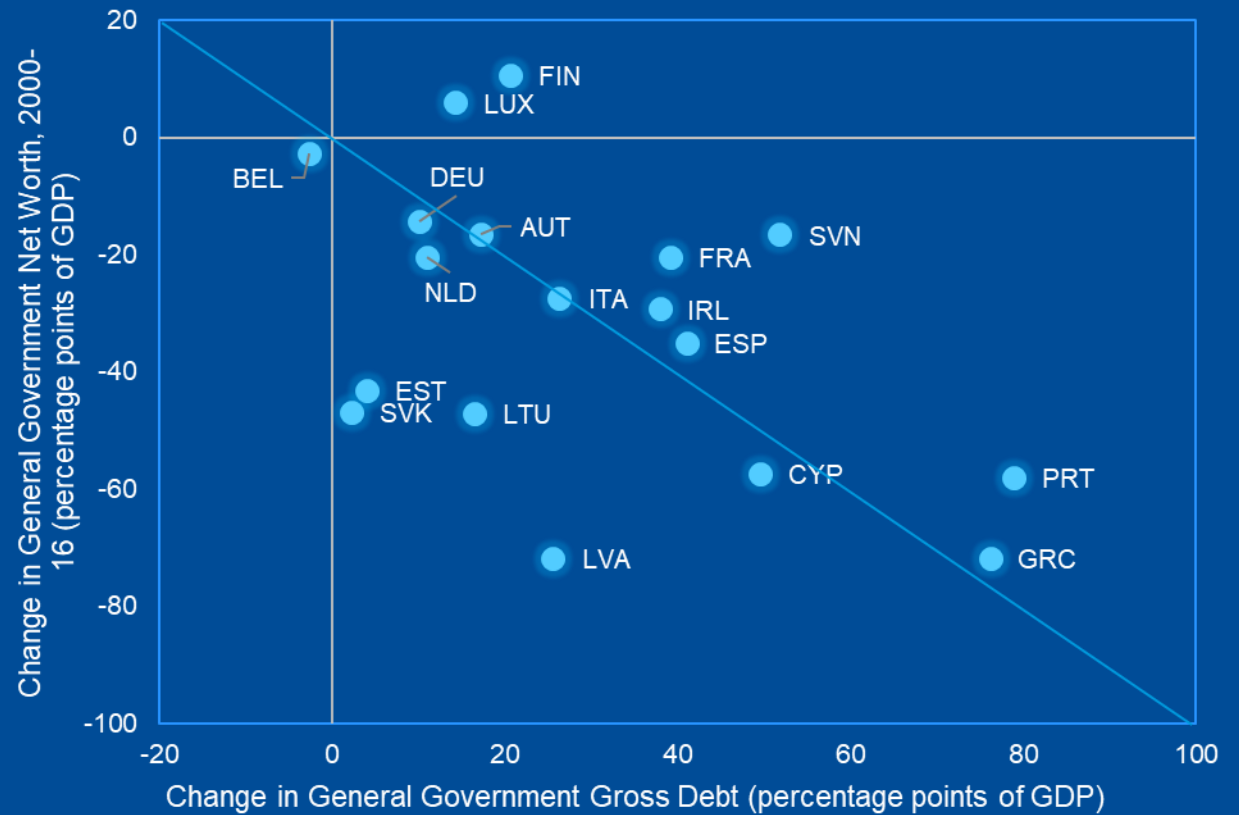
Euro Area General Government Net Worth
(in percent of GDP)



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

Source: IMF Public Sector Balance Sheet Database.

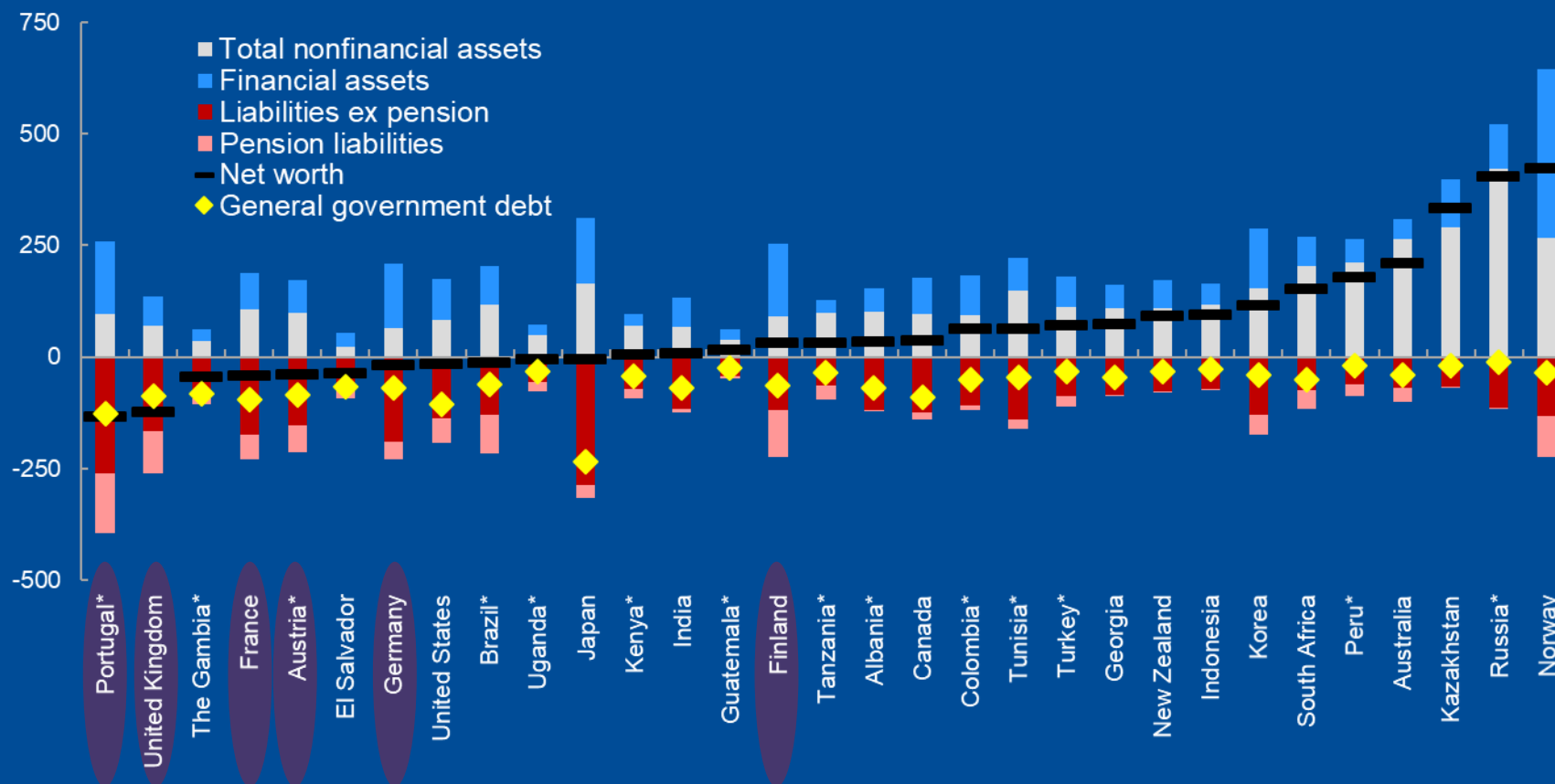
Changes in General Government Net Worth and Gross Debt,
2000-16



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)

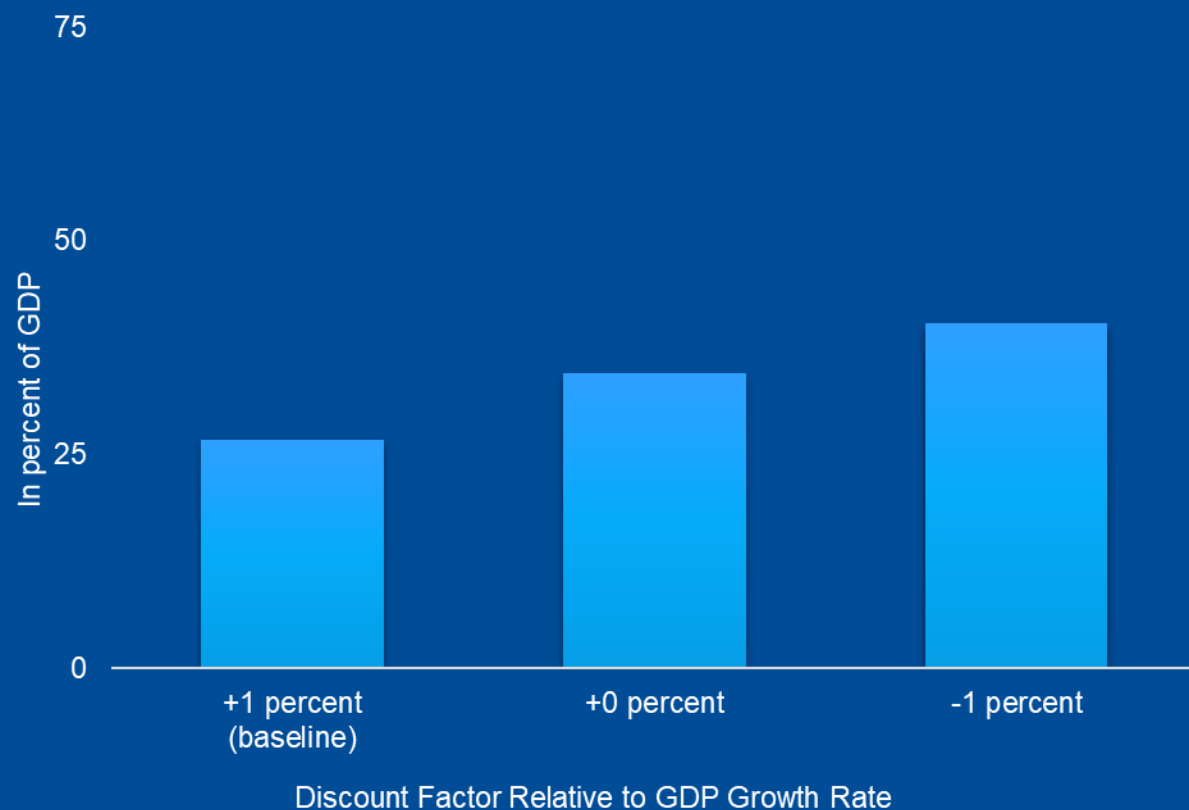


Note: Data for starred countries is based on a single year of data, in most cases compiled as part of fiscal transparency evaluations. The countries in the circle represent Euro Area countries.

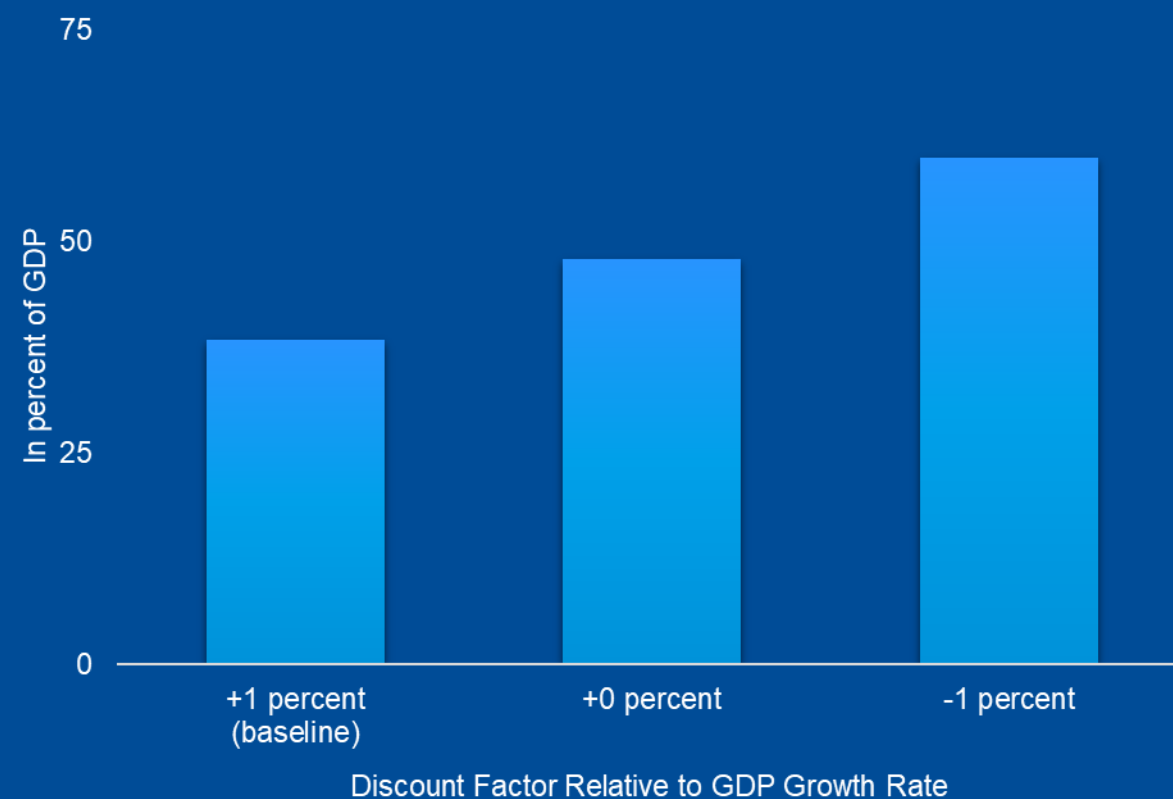
Source: IMF Public Sector Balance Sheet Database.

Low Interest Rates and Future Liabilities

Net Present Value of Pension Spending Change, 2018–50



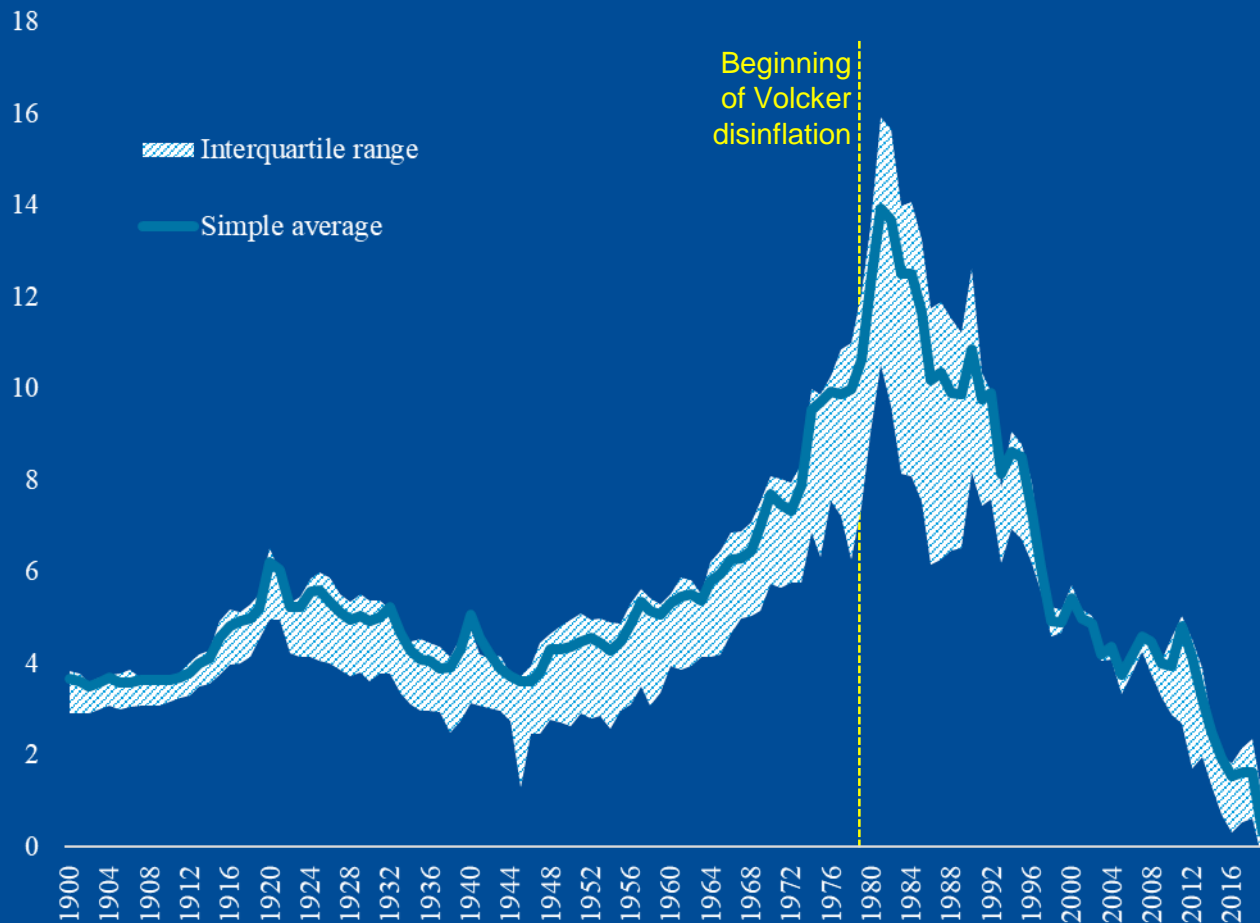
Net Present Value of Health Spending Change, 2018–50



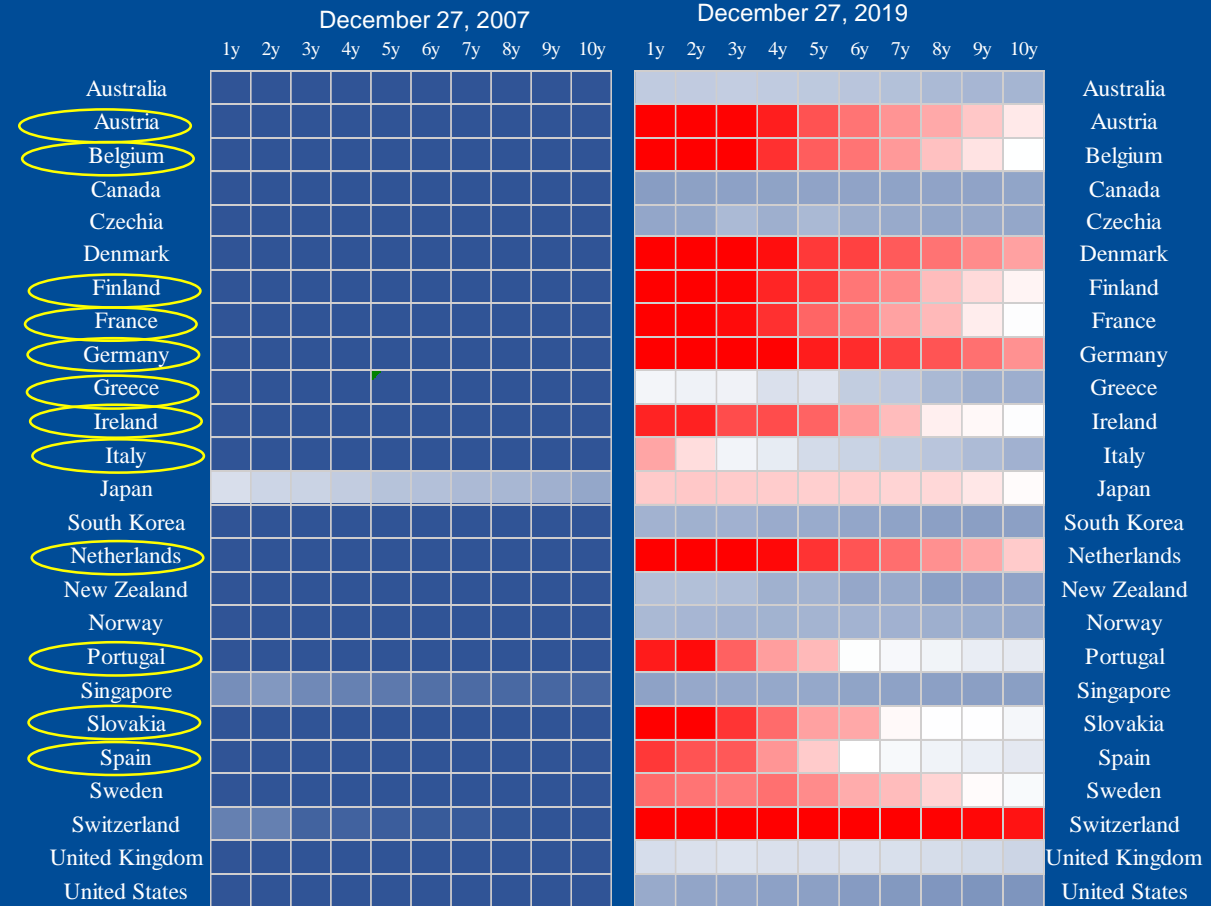
Sources: national authorities; and IMF staff estimates and projections.

Negative Nominal Interest Rates in Advanced Economies

Nominal Interest Rate (percent)



Nominal Interest Rate (percent)



Sources: Global Financial Data; and IMF staff calculations.

Note: 10-year bond yields.

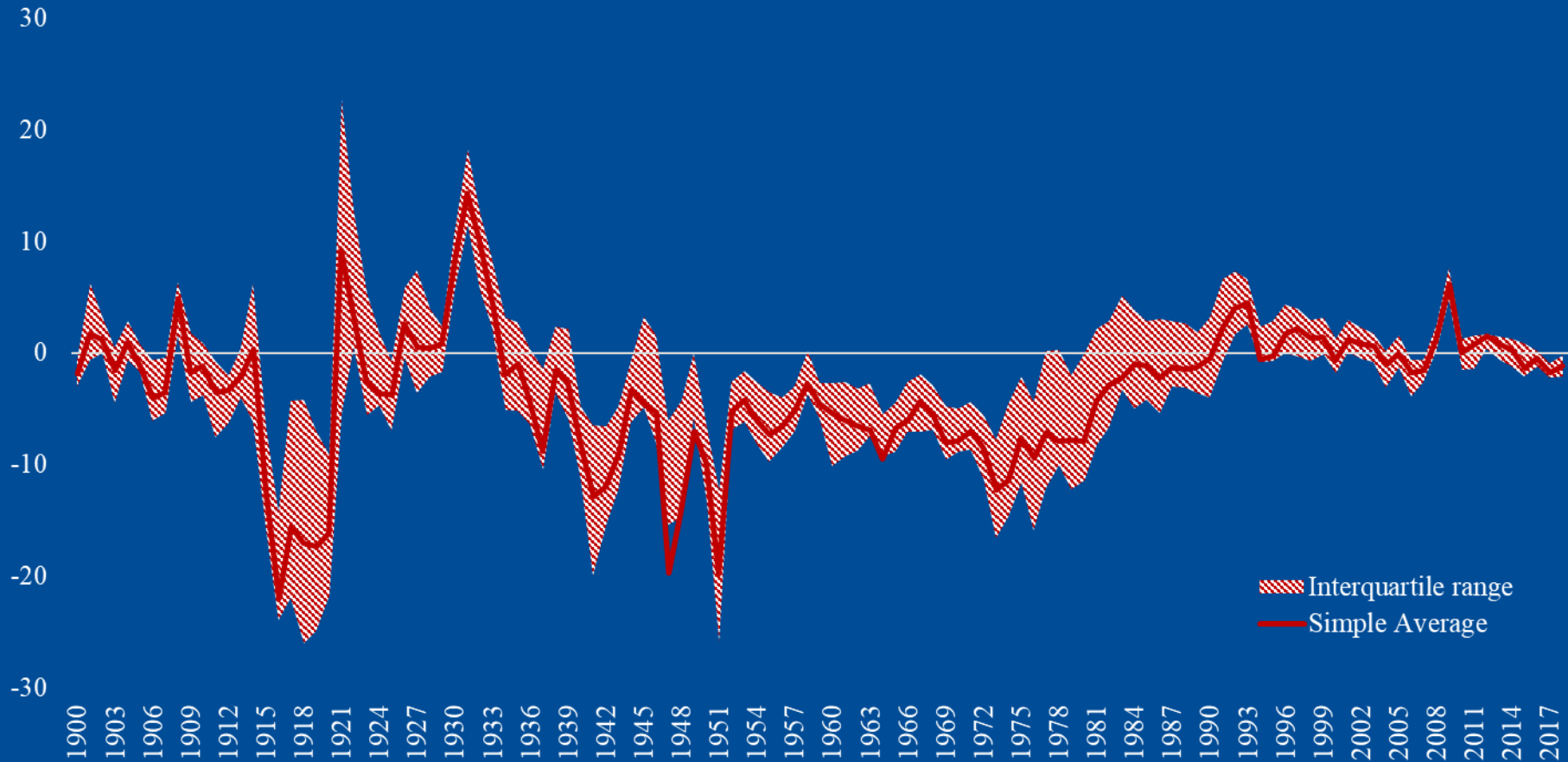
The chart is based on 24 advanced economies. Germany was removed for the years 1920 and 1922-24 due to the hyperinflation episode.

Y implies that the yield curve is inverted. Yield inversion is the 10 year against the 1 year. For maturities where no data is available, the chart uses specific individual bonds as benchmarks that have remaining maturities similar to the term maturities here. For maturities where no data is available in September 2007, the chart assumes that if the next largest and smallest maturity are positive, then the maturity is positive and the yield falls between the two. Yields for Greece in September 2016 are computed using implied benchmark rates. For the gradation, -0.6% is the minimum value for negative rates and 3% is the maximum value for positive rates. 0 and values relatively close to 0 are white (mid-point).

Sources: Bloomberg; and IMF staff.

Interest Rate-Growth Differentials

Interest Rate-Growth Differential in Advanced Economies (percent)



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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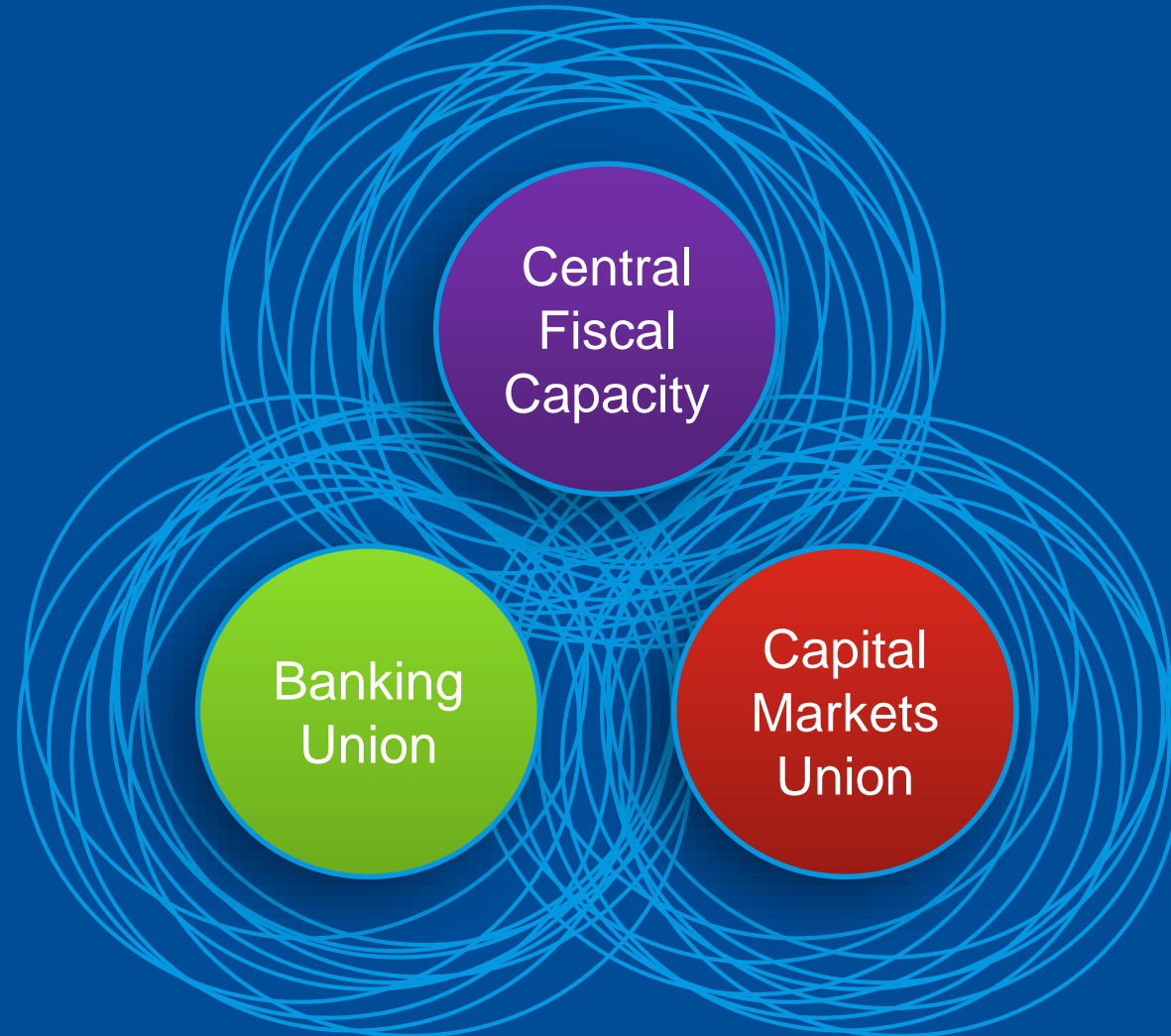
WHAT ARE THE POLICY OPTIONS?

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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

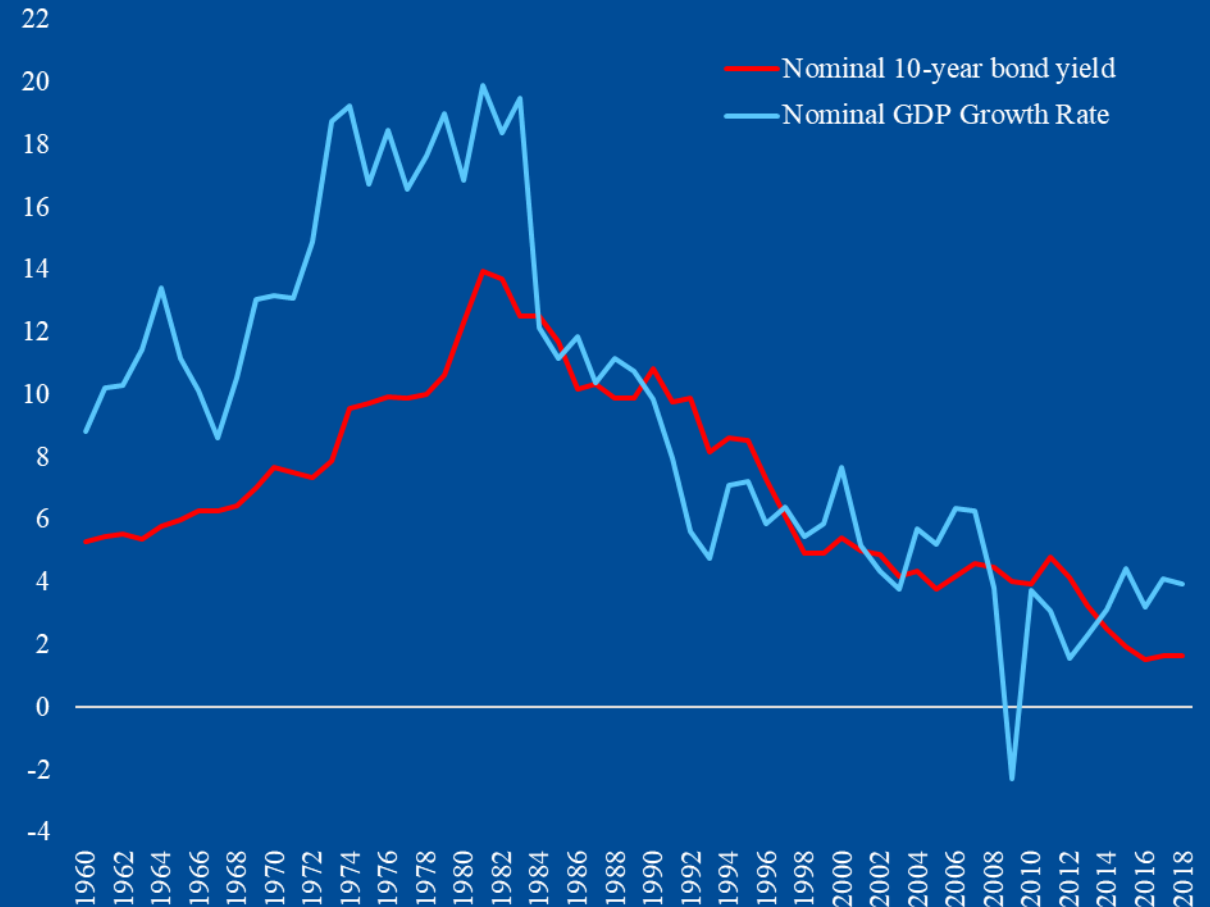
Given debt dynamics equation:

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

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).

Interest and Growth Rates in Advanced Economies (percent)



Sources: Bloomberg; WEO and IMF staff calculations

Reforming the Institutional Set up – Fiscal Councils

Remit 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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