EUROPEAN CENTRAL BANK

EUROSYSTEM

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Fiscal Management in Europe: Lessons from the Crisis

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The views expressed are my own and should not be reported as representing the views of the ECB.

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Overview

Lessons from the literature

Characteristics of optimal fiscal rules:

Well-defined legal basis (observable variables, avoiding too much complexity)

Transparency on assumptions and procedures (prudent implementation)

Flexibility to use fiscal buffers for unexpected circumstances (escape clauses)

Compliance monitored independently (national fiscal council)

Accountability for decisions (justification to parliament)

Proper incentives and ownership to comply in a monetary union (combining market discipline with effective surveillance, peer pressure and enforcement)

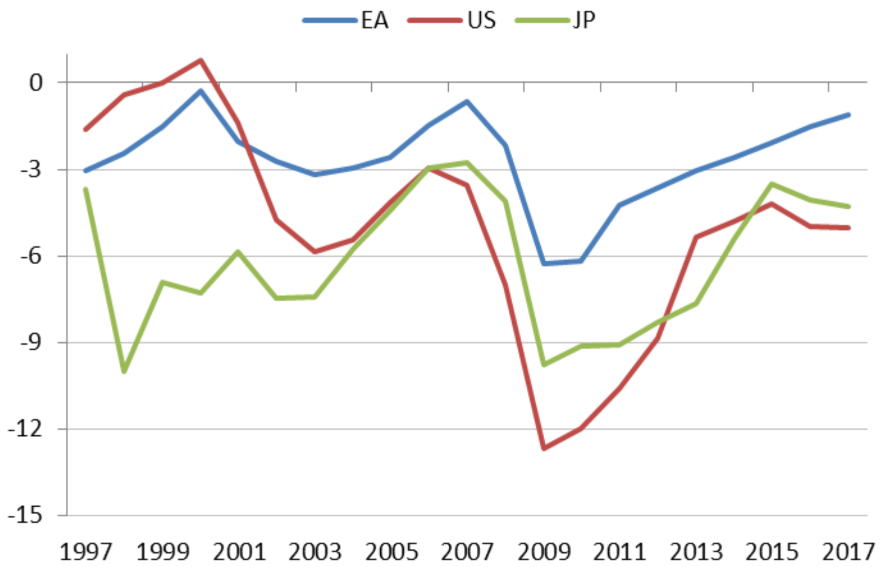
Reward is high credibility of fiscal rules and anchoring of expectations of sound public finances and government debt as a 'safe' asset.

Allows medium-term perspective on meeting fiscal targets, with some discretion to accept short-term deviations for a fiscal stance that stabilises the economy.

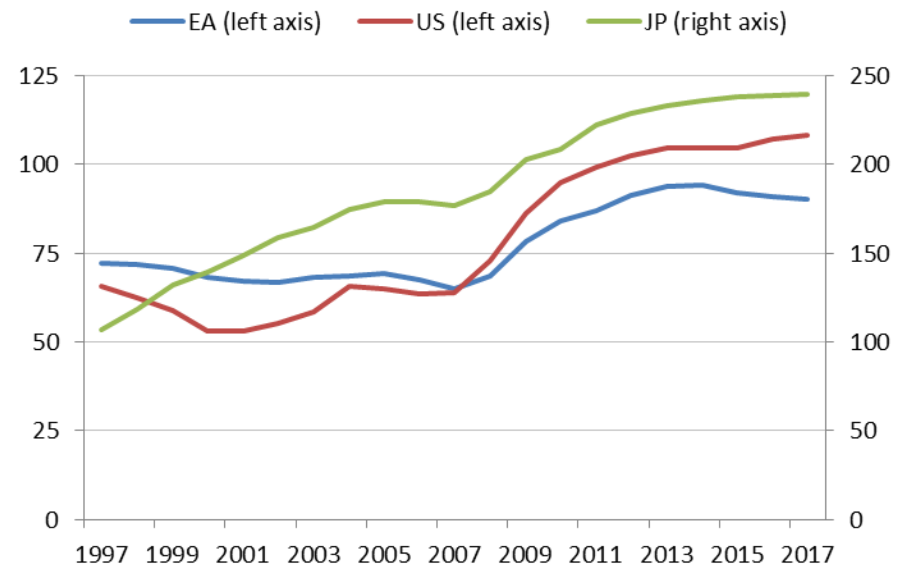
Question: what is the euro area crisis experience with fiscal rules?

Fiscal position of euro area (EA) is more favourable than in United States (US) and Japan (JP); but euro area aggregate hides large national differences

General government budget balance
(in % of GDP)



General government gross debt
(in % of GDP)



Source: European Commission Economic Forecast, Spring 2018 (AMECO)

Crisis observation no. 1

At start of the 2008 crisis, the record of compliance with fiscal rules was mixed and that has not changed much. Fiscal policies were pro-cyclical, based on too rosy assumptions and cared little about building buffers:

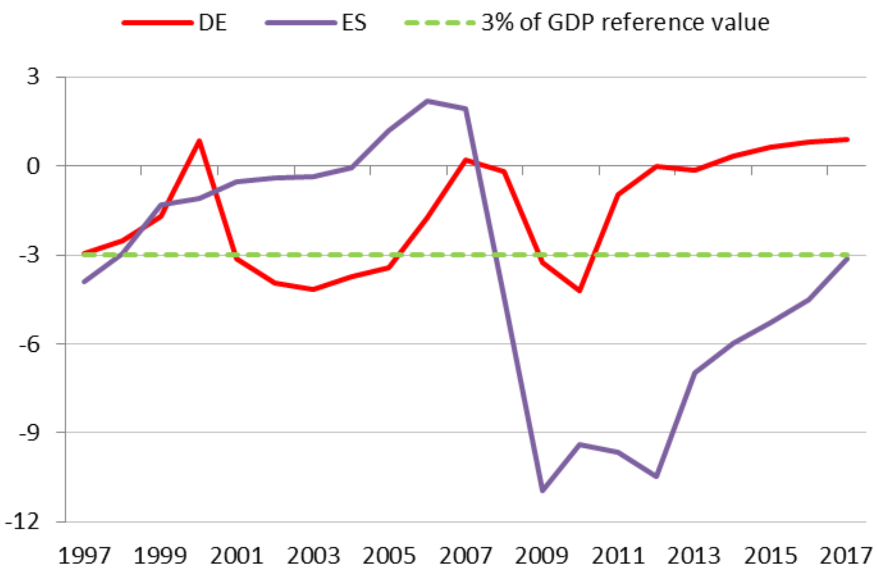
- Slow correction of nominal budget deficits > 3% of GDP reference value
- Medium-term objective (MTO) of balanced budget or surplus was seldom attained
- Government debt-to GDP often remained > 60% of GDP reference value
- No positive incentives to comply, financial sanctions never implemented

Lesson 1: need for more strict and rigorous application of fiscal rules, based on prudent assumptions to preserve fiscal room for manoeuvre.

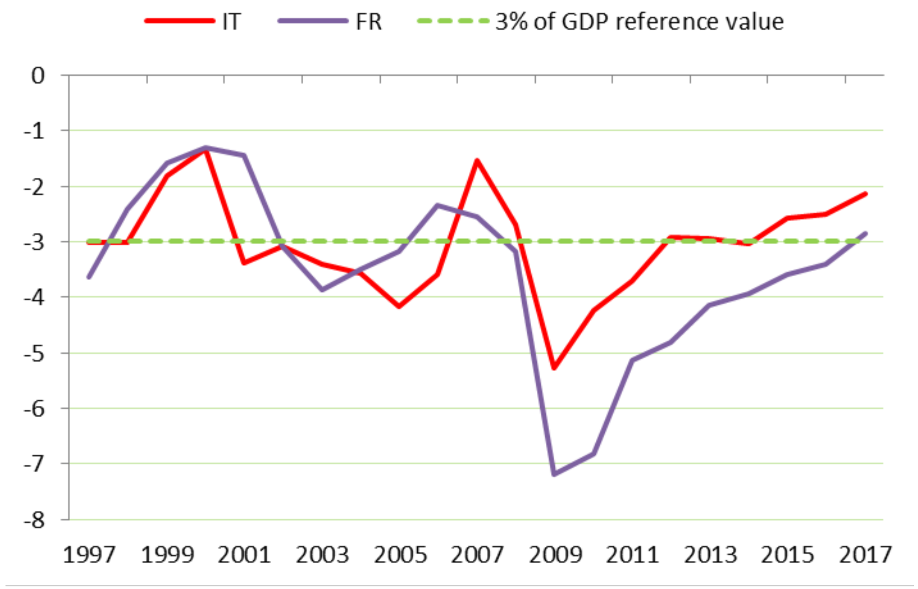
Targeting balanced budget or 3% deficit in euro area countries?

Before the crisis: move to close to balanced budget or surplus in Germany (DE) and Spain (ES); but apparent focus on 3% of GDP as a deficit target instead of ceiling in France (FR) and Italy (IT)

General government deficit
(in % of GDP)



General government deficit
(in % of GDP)



Source: European Commission Economic Forecast, Spring 2018 (AMECO)

Crisis observation no. 2

Aim to increase economic reasoning and national ownership by adding flexibility to fiscal rules and accommodating relevant factors and exceptions; complexity and margin of discretion undermined credibility:

- Judgement on effective action depends on unobservable / debatable output gap
- Ample policy space to deviate from stepping up the procedures
- Government debt-to-GDP reduction to 60% of GDP is inconsistent with MTO
- Fiscal rules have become overly complex and their application discretionary

Lesson 2: need for stronger national incentives to comply with fiscal rules based on observable variables and semi-automatic procedures.

Continuous weakening of clarity of Stability and Growth Pact

SGP 1.0 (1997): nominal budget balance as anchor

- simple but **pro-cyclical**, referred to as **'stupid'**

SGP 2.0 (2005): structural budget balance as anchor

- **pro-cyclical in practice** (mismeasurement of business cycle, revenue windfalls/shortfalls)
- more **"relevant circumstances"** affecting implementation

SGP 3.0 (2011/13): six-pack/two-pack/fiscal compact

- stronger preventive arm – but: **"overall assessment"**
- government debt rule – but: **more "relevant factors"** (also non-quantifiable ones)
- more immediate sanctions – but: **"exceptional circumstances"**
- suspension of EU structural funds – but: **"social and economic circumstances"**

SGP 3.1 (2014): new effective action methodology in corrective arm

- new compliance indicators: **adjusted structural budget balance, bottom-up approach**

SGP 3.2 (2015): new flexibility clauses in preventive arm

- **modulation of required adjustment effort** according to cyclical conditions, structural reforms, public investment, refugee- and security-related spending

SGP 3.3 (2018): overall assessment in preventive arm

- proposal to add **"margin of discretion"** in deciding on effective action

Crisis observation no. 3

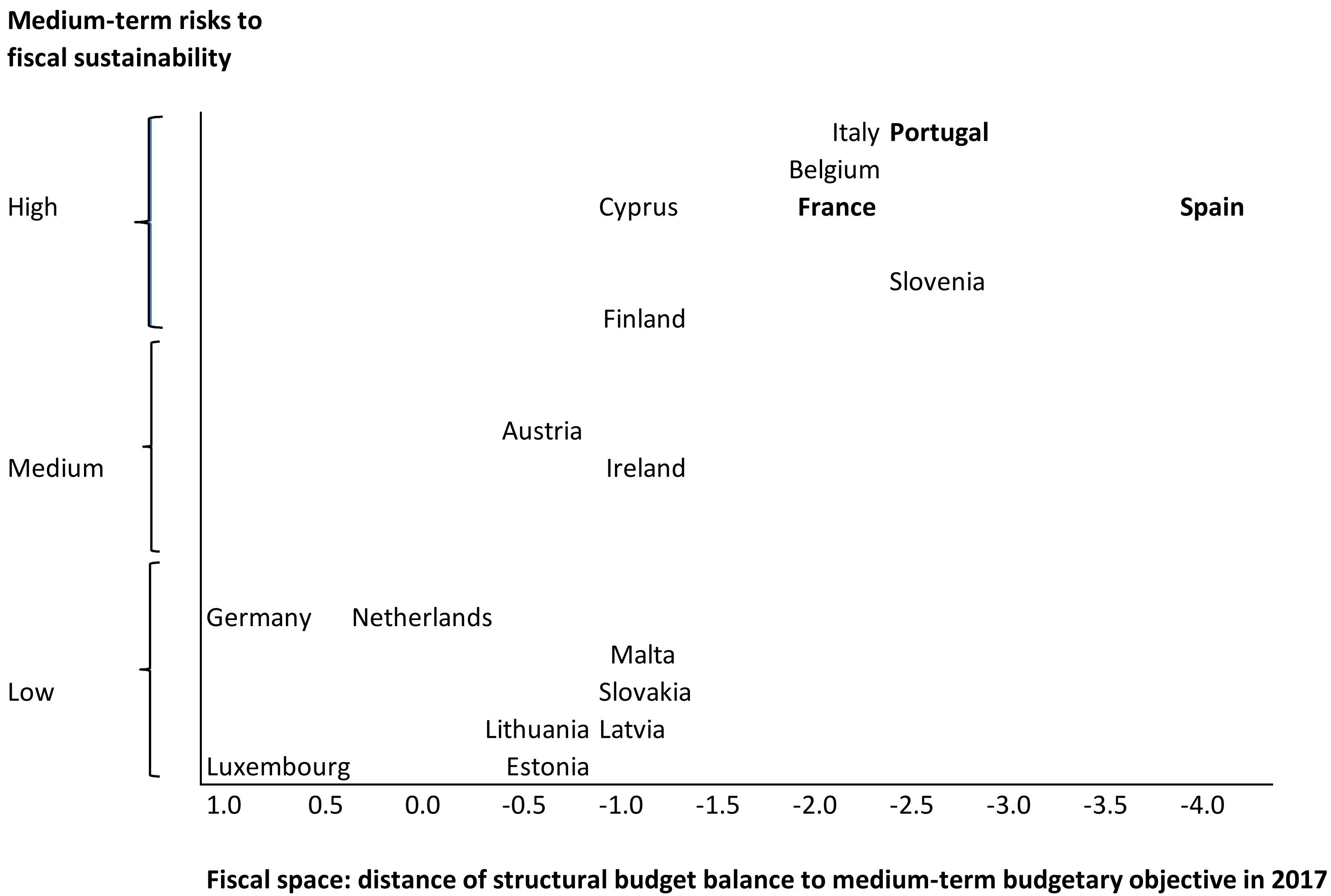
Fiscal space was constrained by too high structural budget deficit, but also by high level of government debt as well as contingent and implicit liabilities, which all turned into a market concern:

	Direct liabilities	Contingent liabilities
Explicit liabilities	• government (net) debt	• government guarantees
Implicit liabilities	• future welfare payments	• government bail-outs

- Fiscal rules tend to focus on government spending/taxes, deficits and debt
- Fiscal management covers broader set of risks to fiscal sustainability
- Anchor expectations of sound public finances and safe government debt

Lesson 3: look beyond fiscal rules for standard budget variables and assess medium-term risks for fiscal sustainability

Trade-off national fiscal space and risks to fiscal sustainability in 2017



Sources: van Riet (2018), ECB (2017), based on European Commission, Debt Sustainability Monitor 2016 and Economic Forecast Winter 2017.
Note: Countries in bold were subject to the Excessive Deficit Procedure in early 2017; the chart excludes Greece. Data in % of GDP.

Crisis observation no. 4

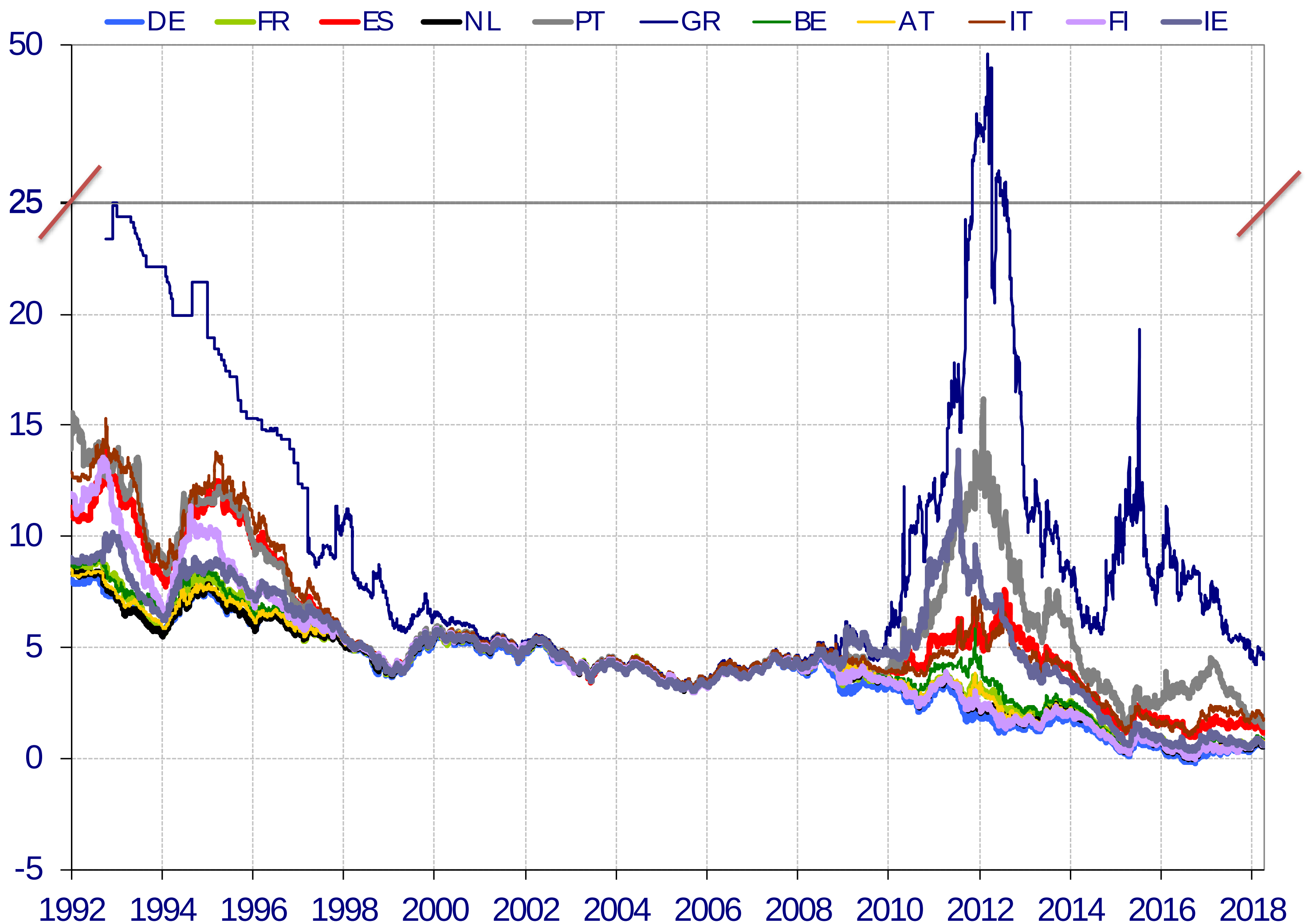
Before the 2008 crisis, market discipline was weak; during sovereign debt crisis fierce market pressure could push a country into default. Policies have since tried to restrict market-based fiscal discipline:

- Efforts to create captive resident demand for public debt during the crisis
- Government debt receives preferential treatment in European financial law
- European crisis facilities provide fiscal backstop and short-term debt relief
- ECB provides a monetary backstop in distressed sovereign bond markets
- Offsetting mechanism for orderly sovereign debt restructuring is missing

Lesson 4: preserve fiscal incentives from financial market pressure as complement to peer pressure and crisis mechanisms

Volatile market reaction to changing perceptions of sovereign risk

Convergence of government bond yields was disrupted in the crisis



Sources: Datastream and ECB. Ten-year government bond yields of first 11 euro area member excluding LU.

Crisis observation no. 5

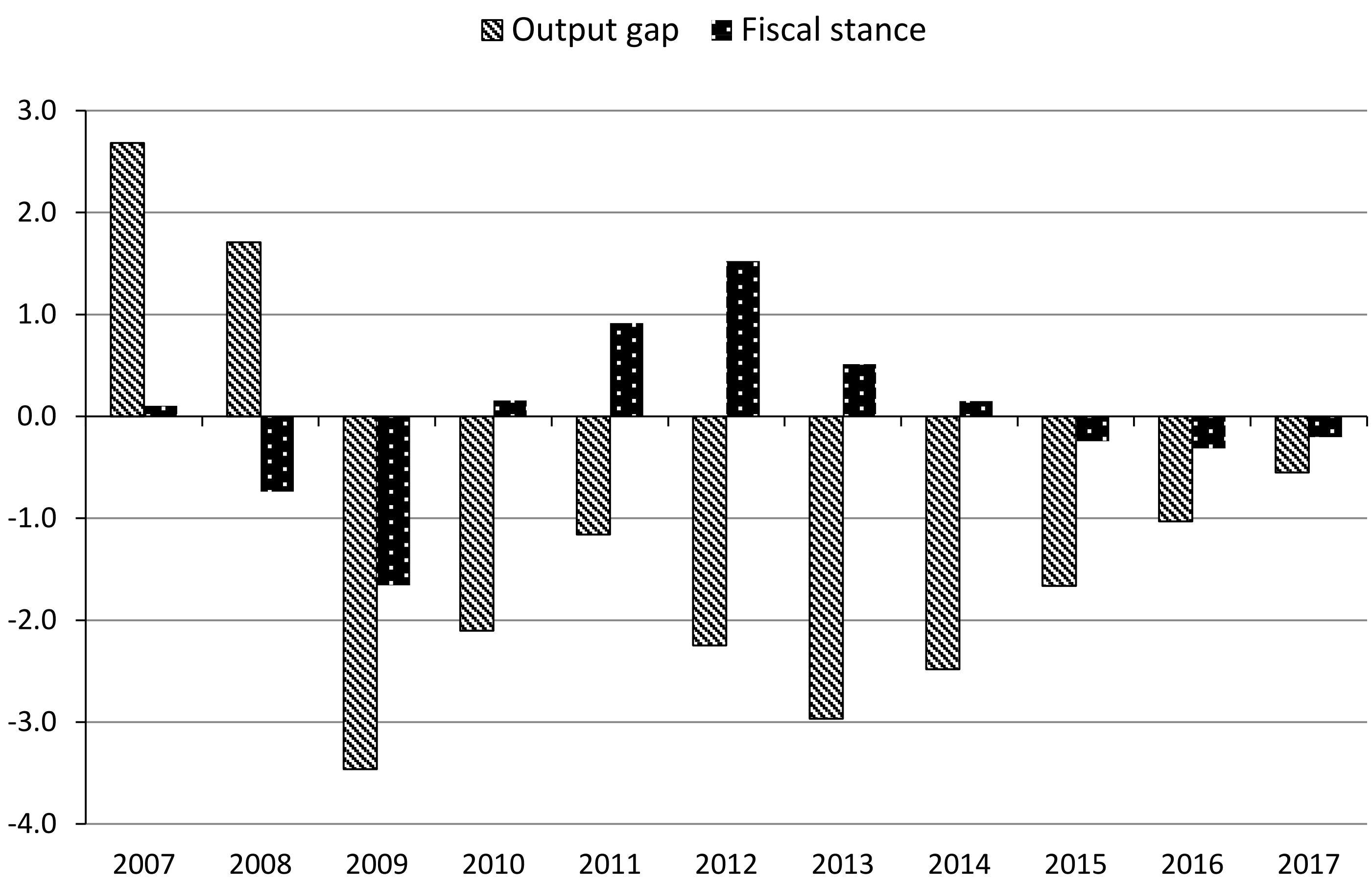
After the 2008 crisis, fiscal rules focus on national budgetary restraint, not on fiscal stimulus. This asymmetry constrained the emergence of a more positive aggregate euro area fiscal stance:

- Coordinated fiscal stimulus in 2008-10 required flexibility in fiscal rules
- Flexibility added to depart from path to MTO in case of severe euro area downturn
- Common shift to fiscal austerity during sovereign debt crisis of 2011-13
- ECB was only game in town, also during 2014-18 at ZLB for interest rates

Lesson 5: advance with fiscal integration and set up central fiscal capacity to steer euro area fiscal stance (which will affect fiscal rules)

Aggregate euro area fiscal stance misaligned with business cycle

Euro area output gap and fiscal stance



Source: van Riet (2018), based on European Commission Economic Forecast, Spring 214 and Winter 2017.
Note: Euro area fiscal stance: annual change in the structural primary budget balance, in percentage points of potential GDP.
Euro area output gap: in percent of potential GDP

Five guiding principles for reform

1) **Fiscal rules should be clear about what will be done and when**. This means less room for discretion and more automatic steps. Rewarding fiscal discipline is complement to sanctioning fiscal indiscipline.

2) **Fiscal rules need national ownership**. Given national sovereignty, national commitment is essential. Relies on variables the government can control and explain to the public, with assessment by independent national fiscal council.

3) **Fiscal adjustment should provide for larger (smaller) buffers when fiscal sustainability risks are larger (smaller)**. Governments need to maintain their status of safe asset provider at all times.

4) **Compliance with fiscal rules to be supported by market-based discipline**. Risk premia in financial markets should reflect exposure to sovereign risk. Restrict preferential treatment of sovereign debt in financial law, apply exposure limits.

5) **When monetary policy at ZLB, aggregate euro area fiscal stance should be supportive**. This requires adequate central fiscal capacity.

Options for reform of fiscal rules under 1, 2 and 3 are further discussed below.

Options for reform no. 1

Explore use of financial rewards as complement to financial sanctions to achieve more fiscal discipline (carrot versus stick)

- Good or bad budget behaviour affects EMU partner countries, stability of the euro, and these **externalities** are not sufficiently integrated in national decisions
- Repeated non-compliance with fiscal rules undermines confidence, has **negative spill-overs** and should lead to sanctions (as required at present)
- Continued compliance with fiscal rules sustains confidence, serves as **anchor of stability** and could be rewarded (at present some allowance for costs of structural reforms, public investment)

Example: restricting/opening access to EU funds

→ Electorate must accept that EU funds (“own money”) are also used as a reward mechanism and, in part, only paid out when common fiscal rules are respected

→ Non-compliant countries must face domestic political pressure to explain citizens the reasons for suspended payment or non-payment of EU funds

Options for reform no. 2

The structural budget balance aims to account for the business cycle and its change is seen as good proxy for government actions taken

- **Structural balance = nominal balance – ε*OG – one-off measures**

  with: ε being the semi-elasticity of the nominal balance w.r.t. the output gap (OG)

- **Two well-known problems:**

1) The elasticity ε, different from assumption, is not constant over the cycle

➢ Actual revenue elasticities fluctuate in a strongly pro-cyclical way around their long-run value (around 1 for most euro area countries)

➢ Large revenue windfalls in booms (wrongly counted as structural effort), large revenue shortfalls in busts (wrongly counted as shortfall in structural effort)

2) Unreliable output gap estimates distort calculation of structural balance

a) Potential output growth estimates are strongly revised ex post

b) Potential output growth estimates are strongly pro-cyclical (ex ante and ex post)

The structural budget balance is not under the control of governments, a poor indicator of compliance; <u>expenditure growth rule</u> was added, which as observable variable deserves more prominence

Options for reform no. 3

Strengthen role of safe government debt as anchor for fiscal space

Tension between government debt rule and MTO needs to be addressed

A close to balanced budget or surplus as the medium-term objective would bring debt below the reference value of 60% of GDP

This may be justified by the need to account for risks to fiscal sustainability

Anchor confidence in future safety and liquidity of government debt

Conduct fiscal stress tests (e.g. impact of higher interest rates)

Show benefits of structural reforms (higher potential growth)

Give more prominence to contingent / implicit liabilities

<u>Making risks to fiscal sustainability explicit</u> may justify a faster pace of reducing government debt-to-GDP and/or a level below 60% of GDP. The larger the fiscal buffers, the more room for fiscal manoeuvre.

Conclusions

Shortcomings of the fiscal governance framework in Europe:

SGP no disciplining device that guides public finances over the cycle such that output growth can be supported in economic troughs

- Limited EU-level enforcement of the common fiscal rules
- Lack of national ownership to deliver necessary fiscal adjustment
- Focus is on narrow fiscal rules rather than broader fiscal sustainability

More coherent fiscal rules could address these shortcomings:

- Complement financial sanctions with financial rewards
- Rely on variables the government can control and explain
- Make provisions for the risks to fiscal sustainability

Also: fiscal incentives from market-based discipline are curtailed and SGP is no instrument to steer aggregate euro area fiscal stance and support monetary policy

Preserve market discipline and create central fiscal capacity alongside SGP

Thanks for your kind attention!

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