



FISCAL AFFAIRS

The Future of the EU Fiscal Governance Framework

NOVEMBER 2021

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Director
Fiscal Affairs Department

Outline

01



Introduction

02



Is $r-g < 0$ a distraction?

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What Changed?

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Revisiting Maastricht

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What are the policy options?

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Introduction

Fiscal Rules Help Address:

1. Short-sightedness of Political Process.
2. Debt Bias.
3. Pro-cyclicality Bias.

European Dimensions:

1. Monetary union
 - Financial Integration and
 - Financial System Stability .
2. National fiscal policies
 - Single monetary policy.
 - Single financial market - Single financial system.
 - Internalize cross country spill overs.

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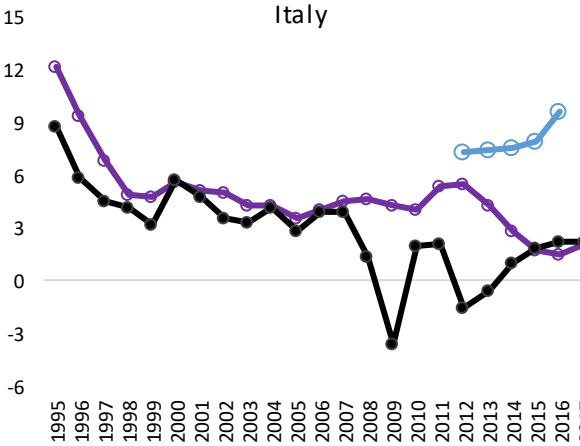
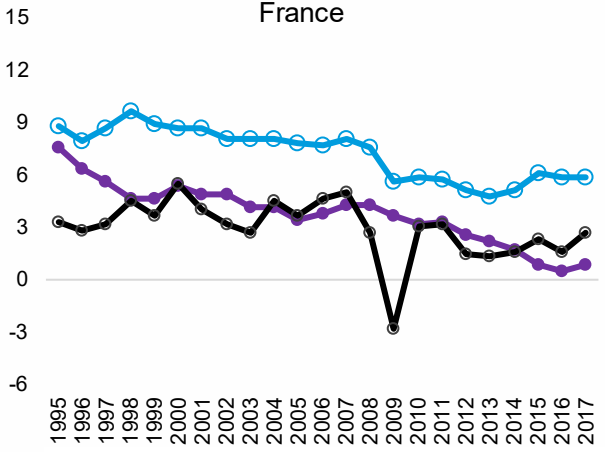
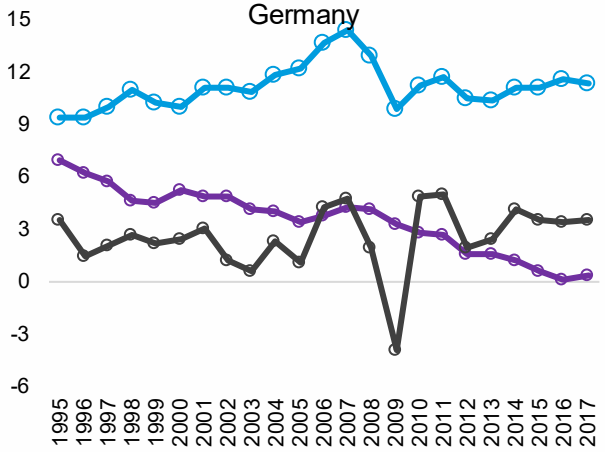
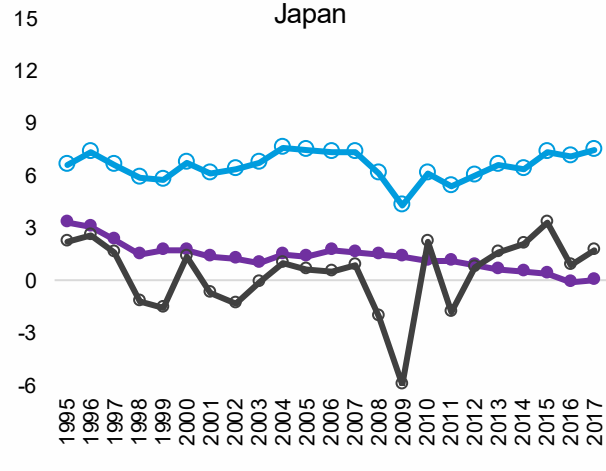
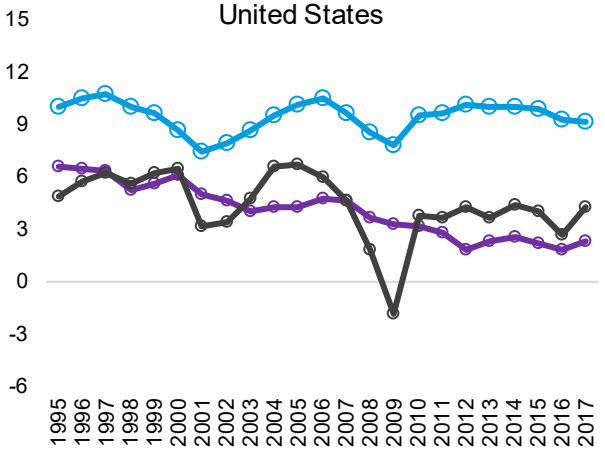
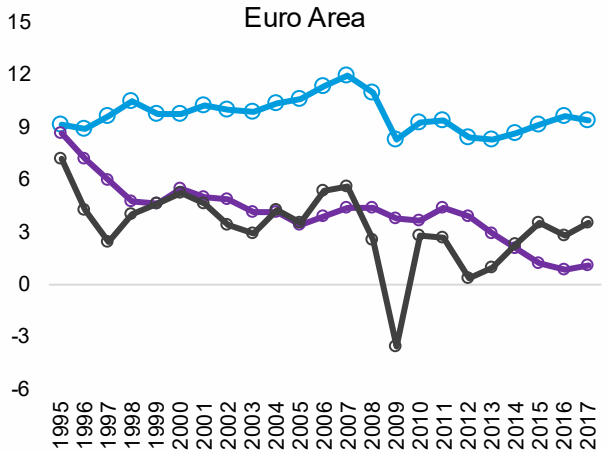
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What are the policy options?

Returns on Treasuries and Private Capital

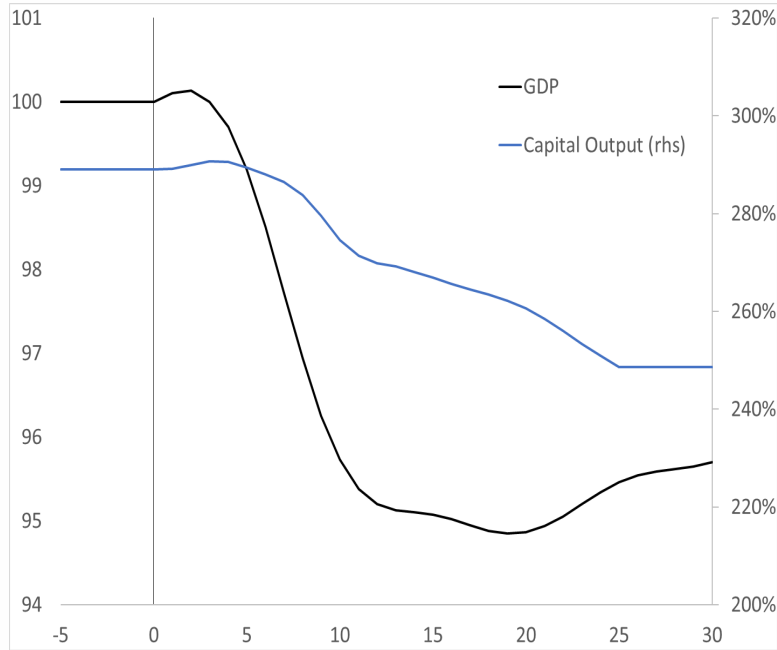


- Earnings over capital at replacement cost
- 10-year bond yield
- Nominal GDP Growth

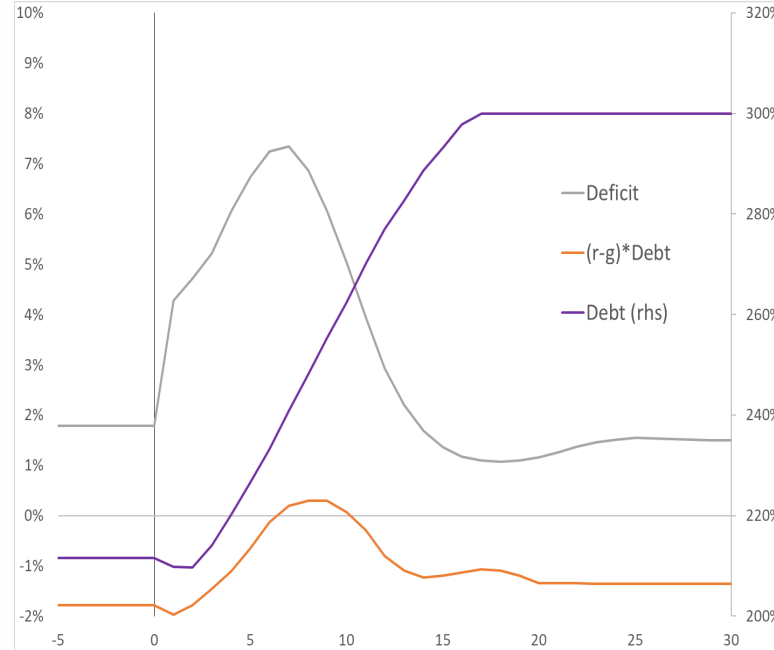
Sources: OECD; WEO; and IMF staff calculations.

Increasing Debt with negative r-g

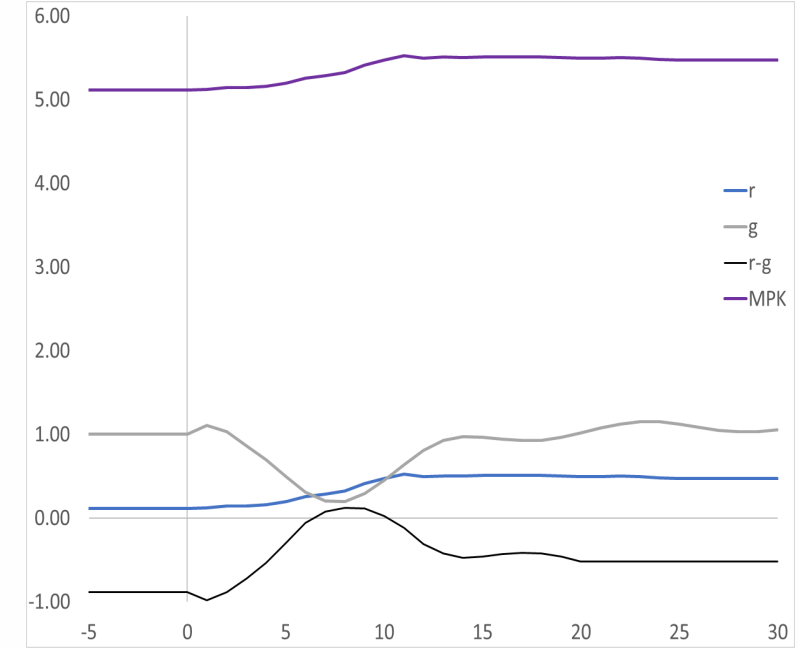
GDP and Capital Output
(Standard OLG Model)



Debt Decomposition
(Standard OLG Model)



Interest on Debt, MPK, and GDP Growth
(in %, Standard OLG Model)



Sources: IMF Staff Calculations

Notes: Simulations based on a heterogeneous agent OLG model with two assets. In these illustrations the economy starts at steady state (periods -5..-1). In period 0 a new path of debt accumulation is announced and there are no other shocks.

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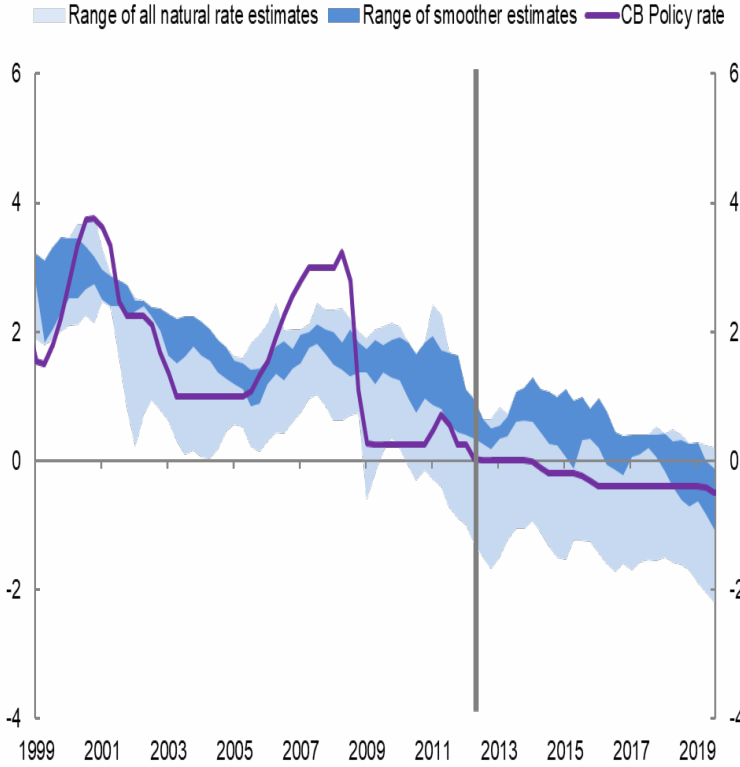
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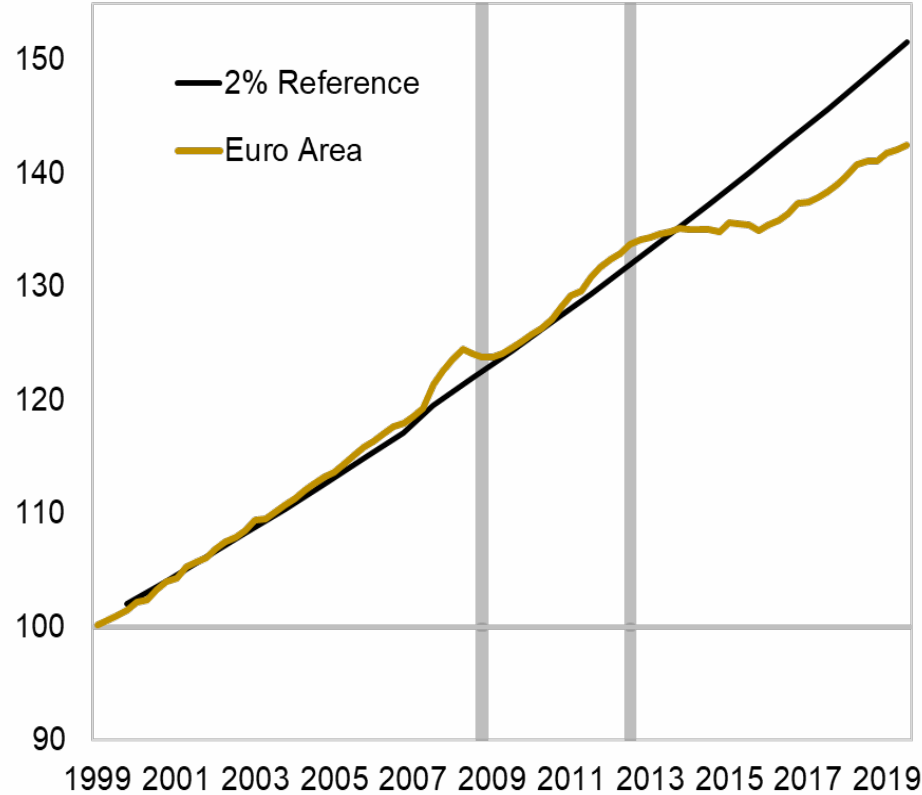
What are the policy options?

Secular Declines in Interest Rates (EA)

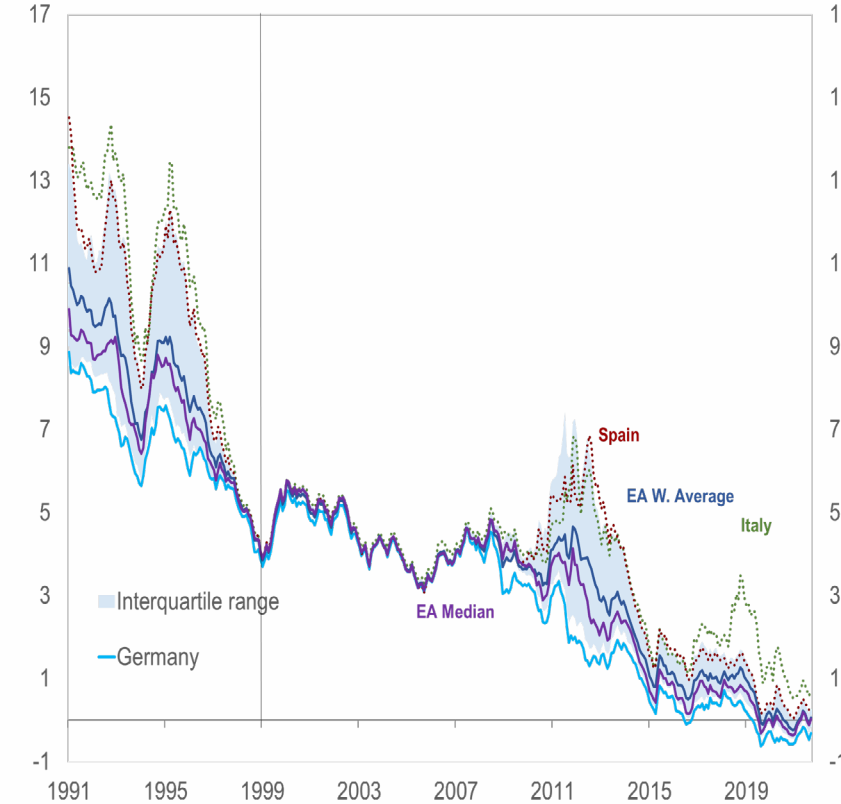
Estimates of the Natural rate and Policy Rate (% per annum)



Price Level



Government Bond Yields (% per annum)

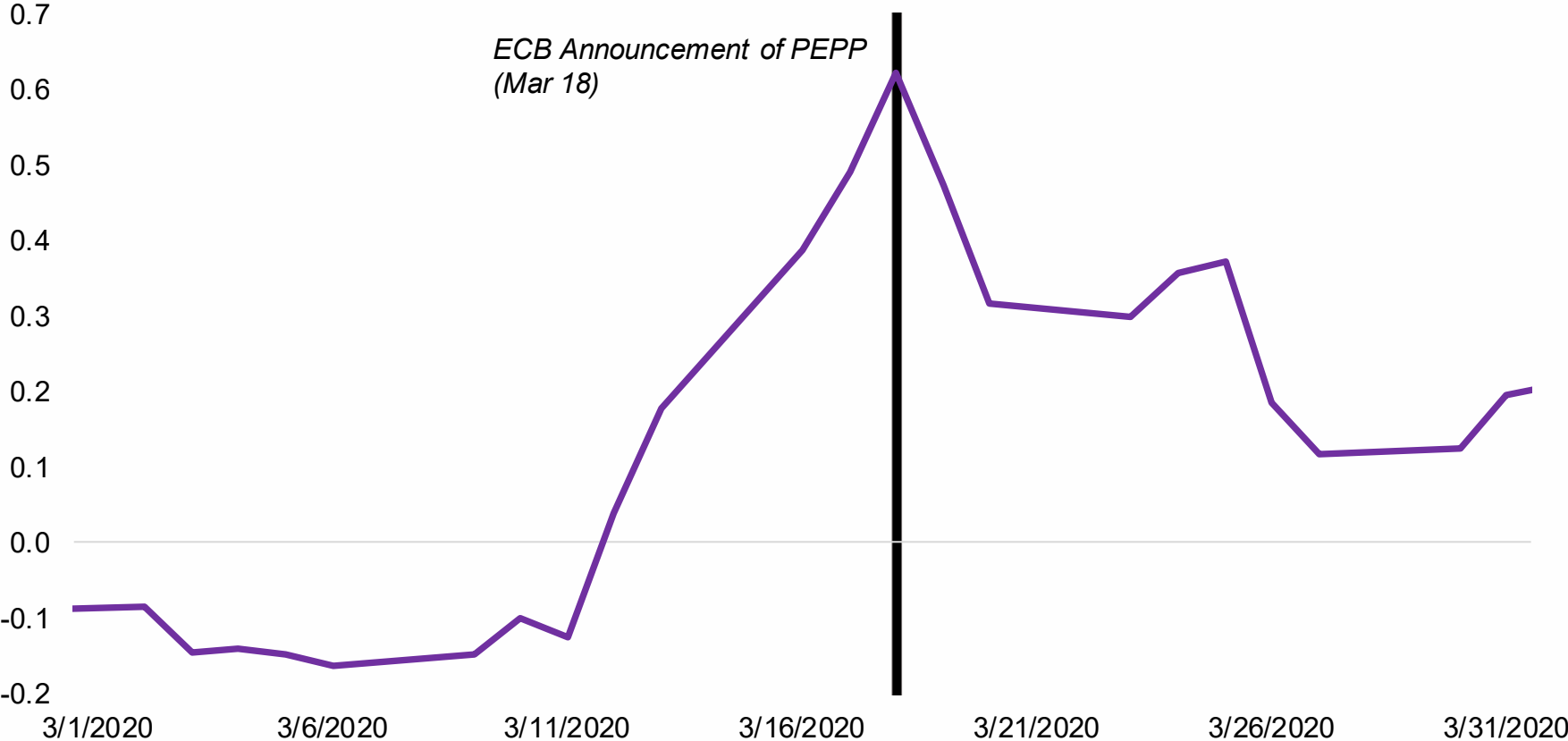


Sources: WGEM Report “The natural rate of interest: estimates, drivers, and challenges to monetary policy”, OP, No 217; Ajevskis (2018); Brand, Goy, Lemke (2020); Brand, Mazelis (2019); Fiorentini, Galesi, Pérez-Quirós, Sentana (2018); Geiger and Schupp (2018); Holston, Laubach, Williams (2017); Jarocinski (2017); Johannsen and Mertens (2021); Thomson Reuters Refinitiv & Eurostat; IMF WEO & Staff Calculations

Notes: Ranges span point estimates across models to reflect model uncertainty and no other source of r^* uncertainty. The dark shaded area highlights smoother r^* estimates that are statistically less affected by cyclical movements in the real rate of interest. Latest observation: 2019Q4.

Markets Under Stress During COVID-19

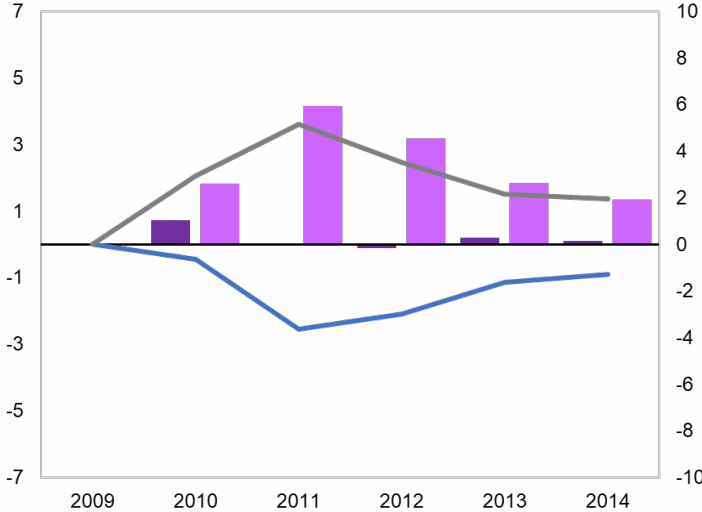
10-year Sovereign Bond Yields in Euro Area (percent)



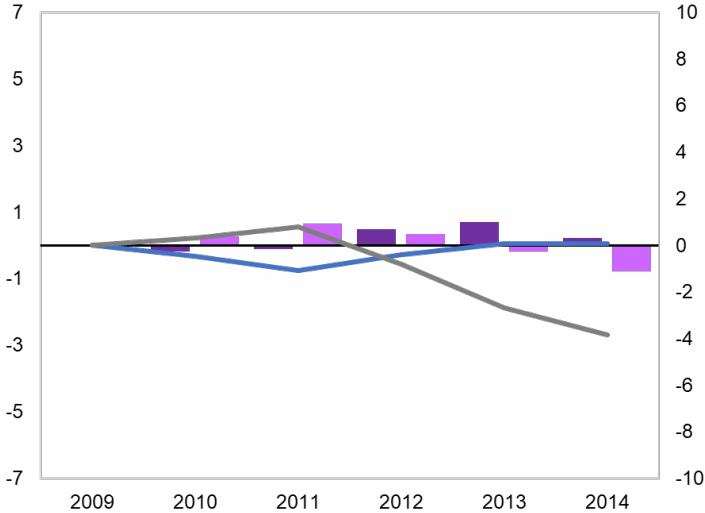
Source: Datastream

Debt crises vs COVID-19

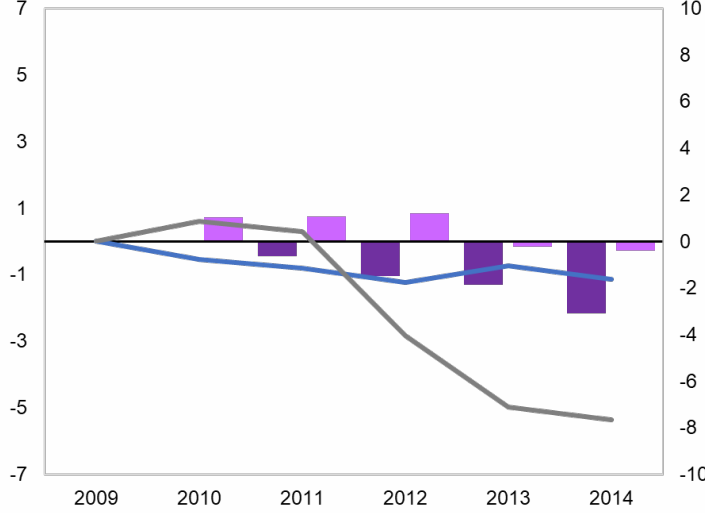
Germany



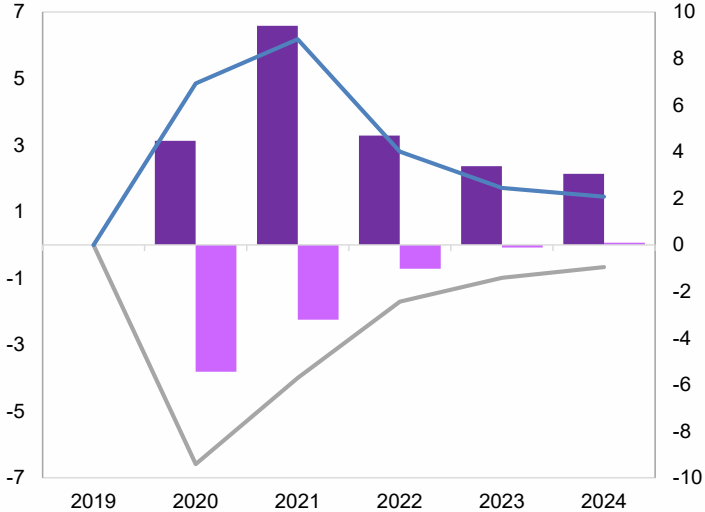
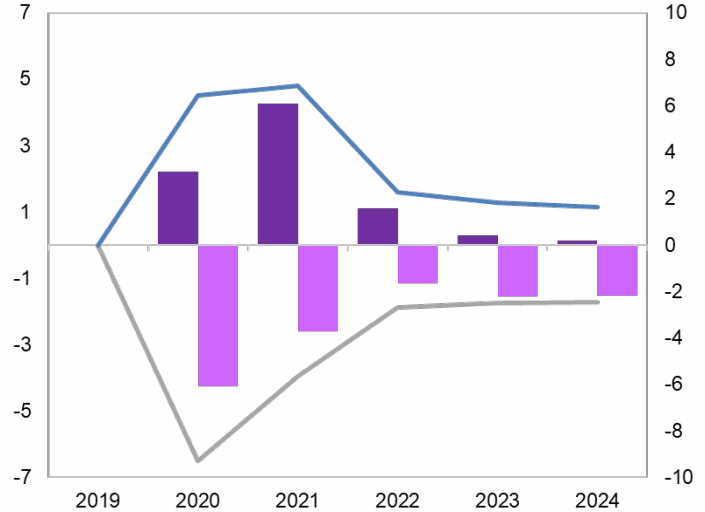
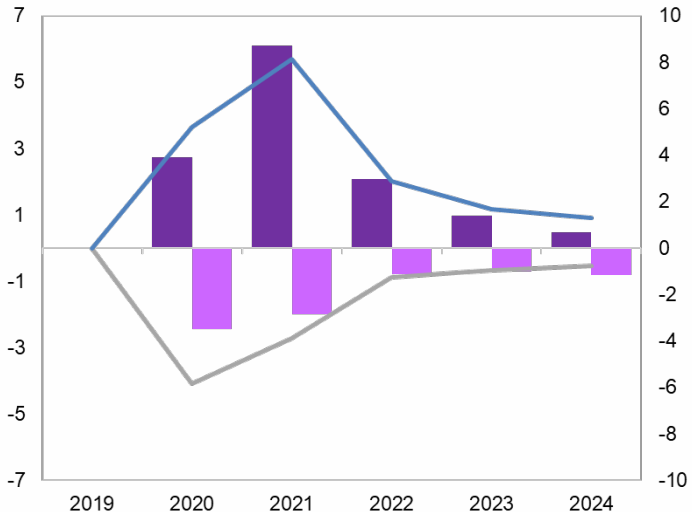
France



Italy

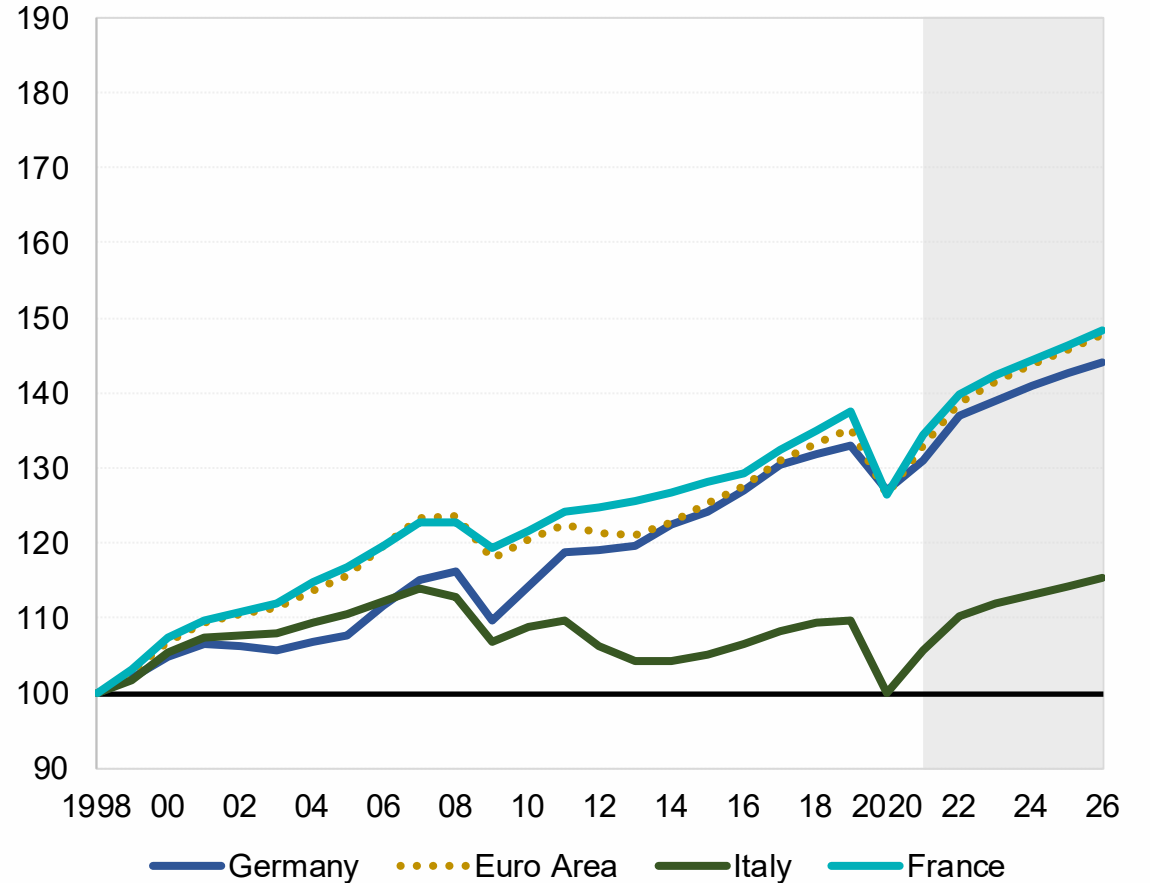
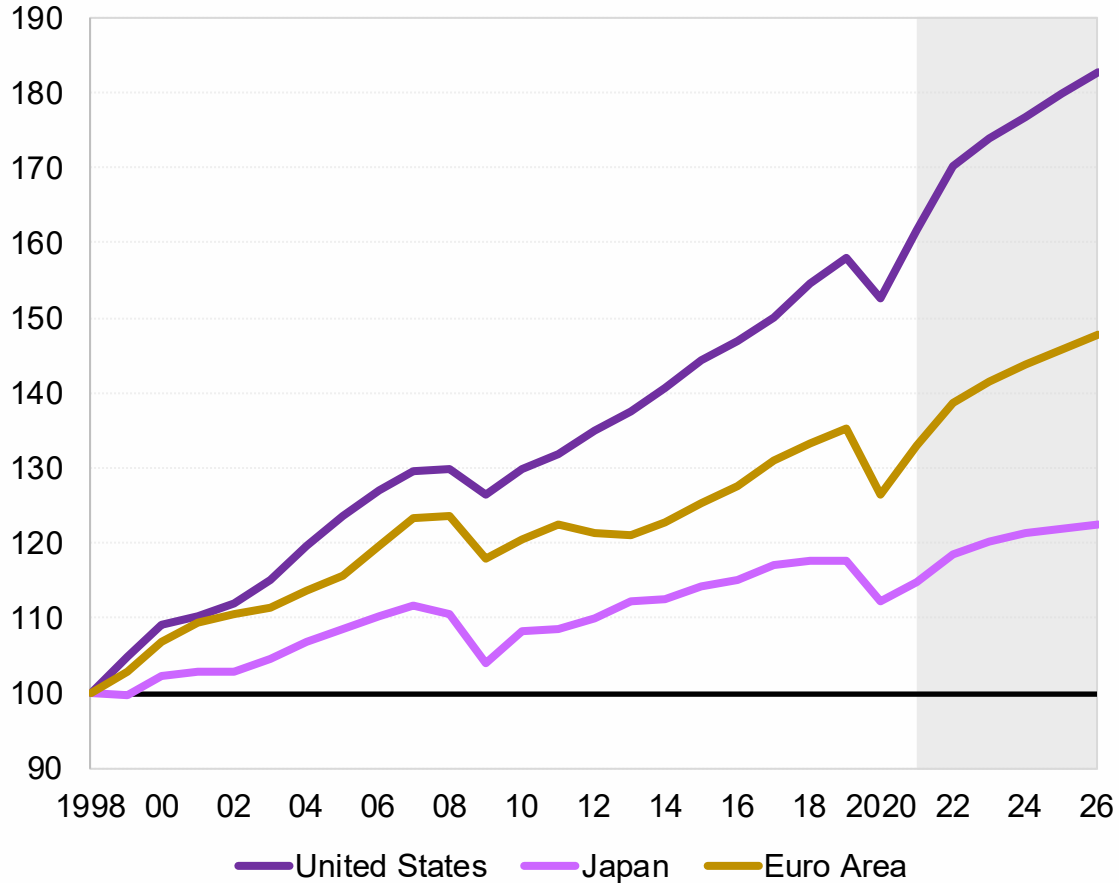


■ Deviation of primary expenditure ■ Deviation of revenue
— Deviation of Primary deficit (RHS) — Deviation of growth (RHS)



GDP

**Euro Area GDP (PPP constant international dollars) against comparators
(indexed at 1998=100)**

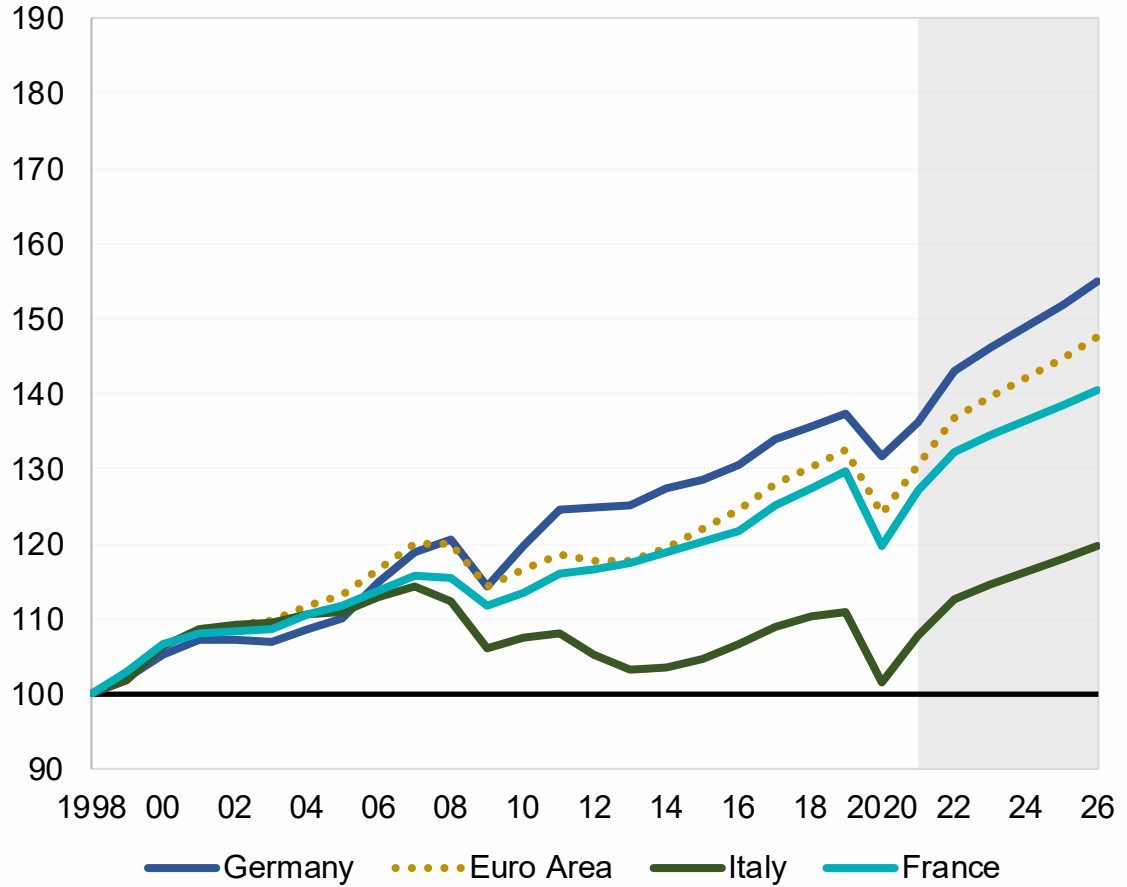
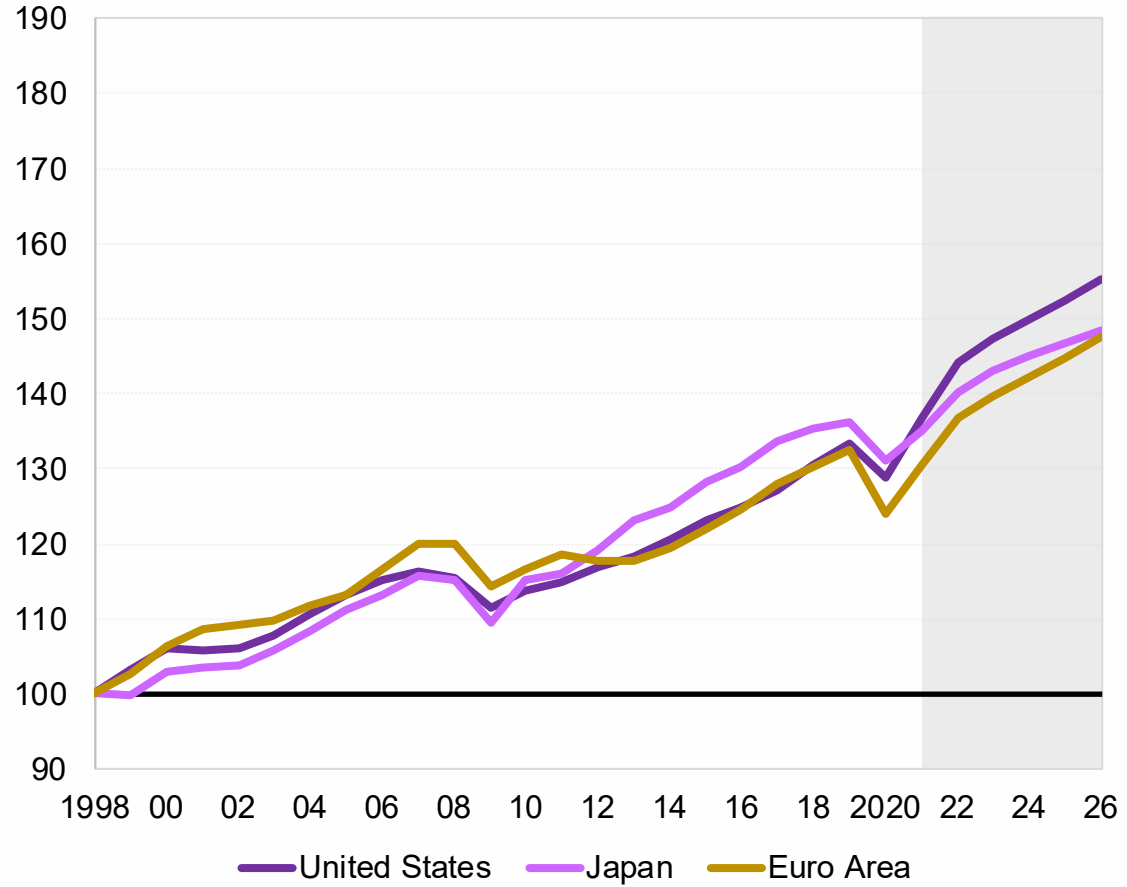


Source: IMF WEO & Staff Estimates

Note: Income aggregates are based on IMF WEO classifications. The shaded region are forecasts for 2021-2026.

GDP per Working-Age Person

Euro Area GDP working-age (15-64) person (PPP constant international dollars) against comparators (indexed at 1998=100)

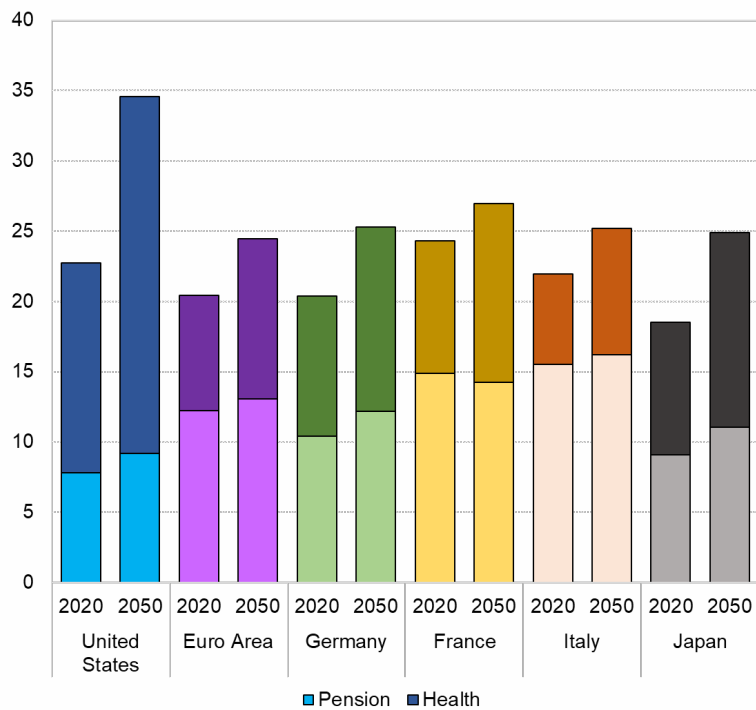


Source: IMF WEO & Staff Estimates

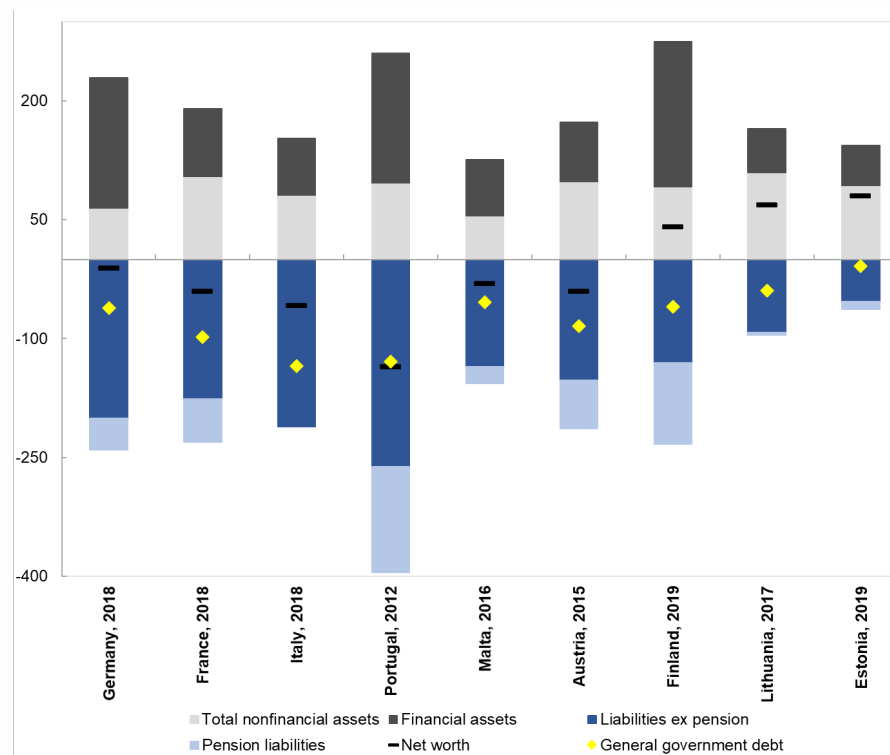
Note: Income aggregates are based on IMF WEO classifications. The shaded region are forecasts for 2021-2026. Working age population is defined as persons of the age 15-64 years.

Impact of Demographic Changes on Public Finances

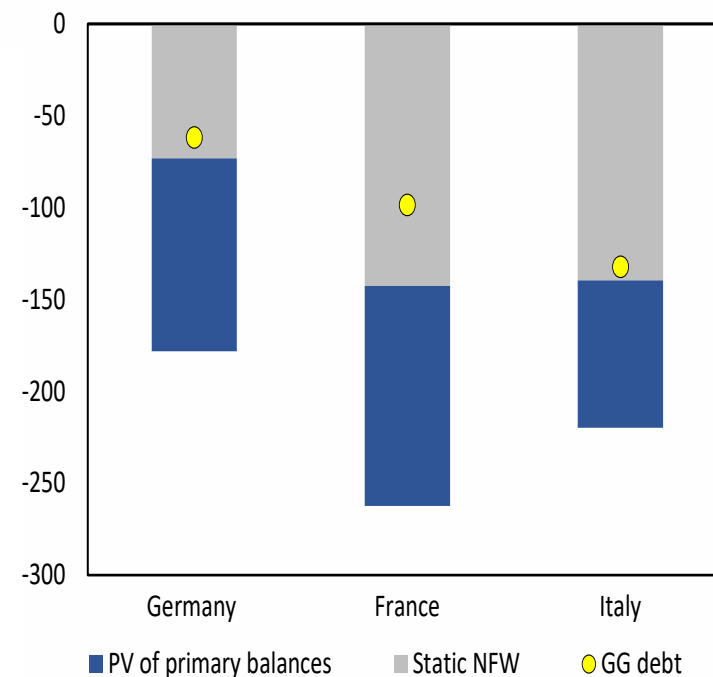
Public Spending on Pensions and Health relative to GDP



Public Sector Balance Sheets (Percent of GDP)



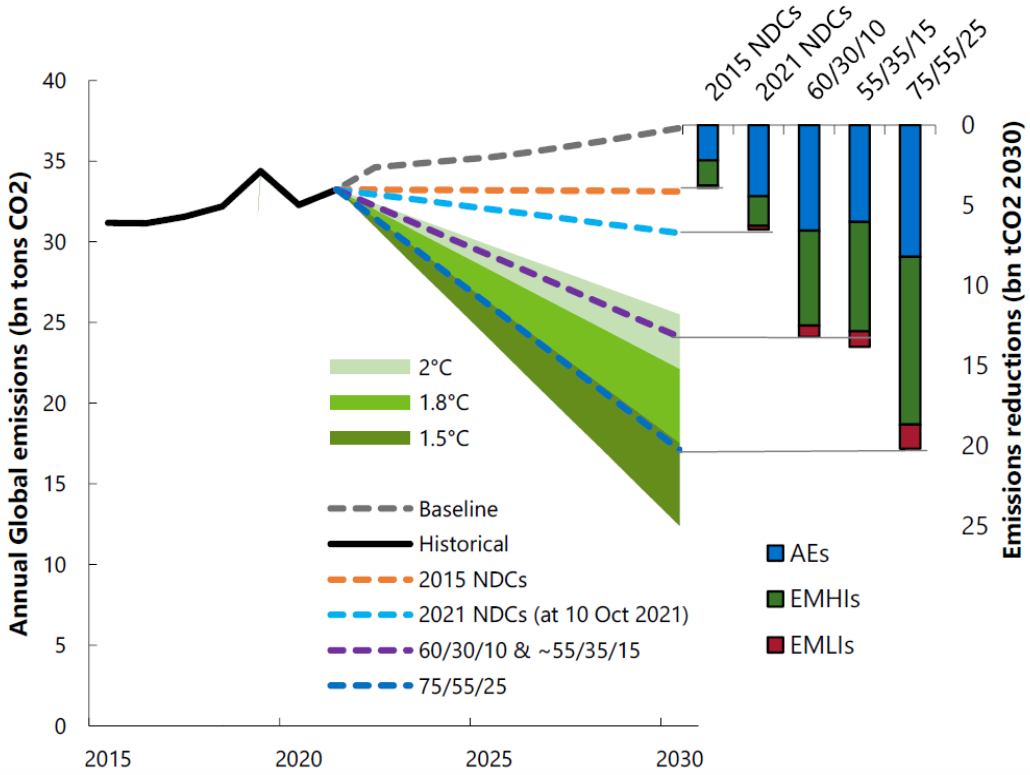
Intertemporal Net Financial Worth (2018, Percent of GDP)



Source: IMF Fiscal Monitor (FM), Country Fiscal Transparency Evaluations and IMF staff estimates.

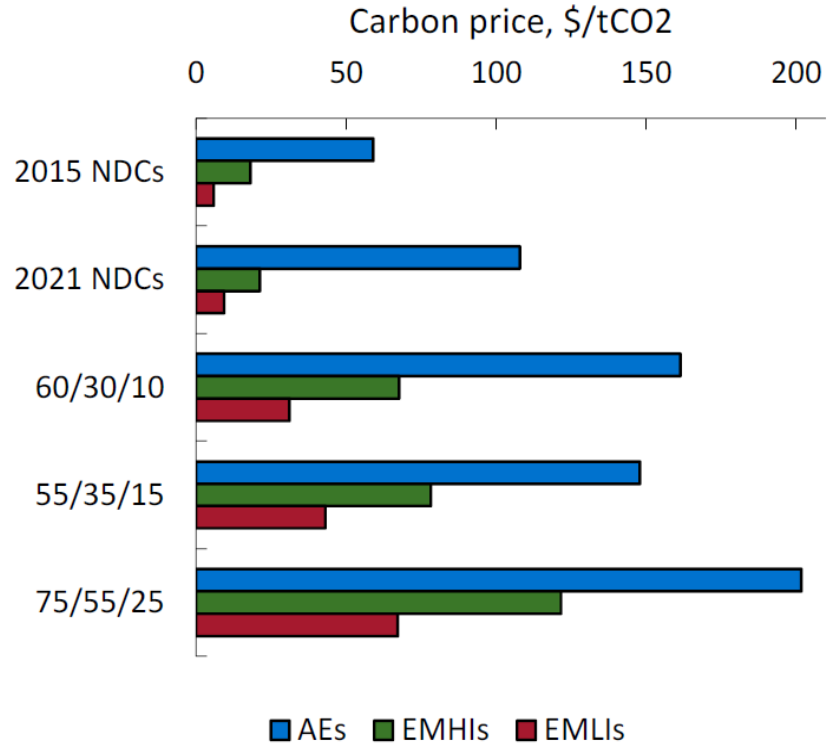
Emissions and Carbon Prices

Energy-Related CO2 Emissions Projections, Targets Aligned with Temperature Goals, and Potential Options to Close Policy and Ambition Gaps to 2030



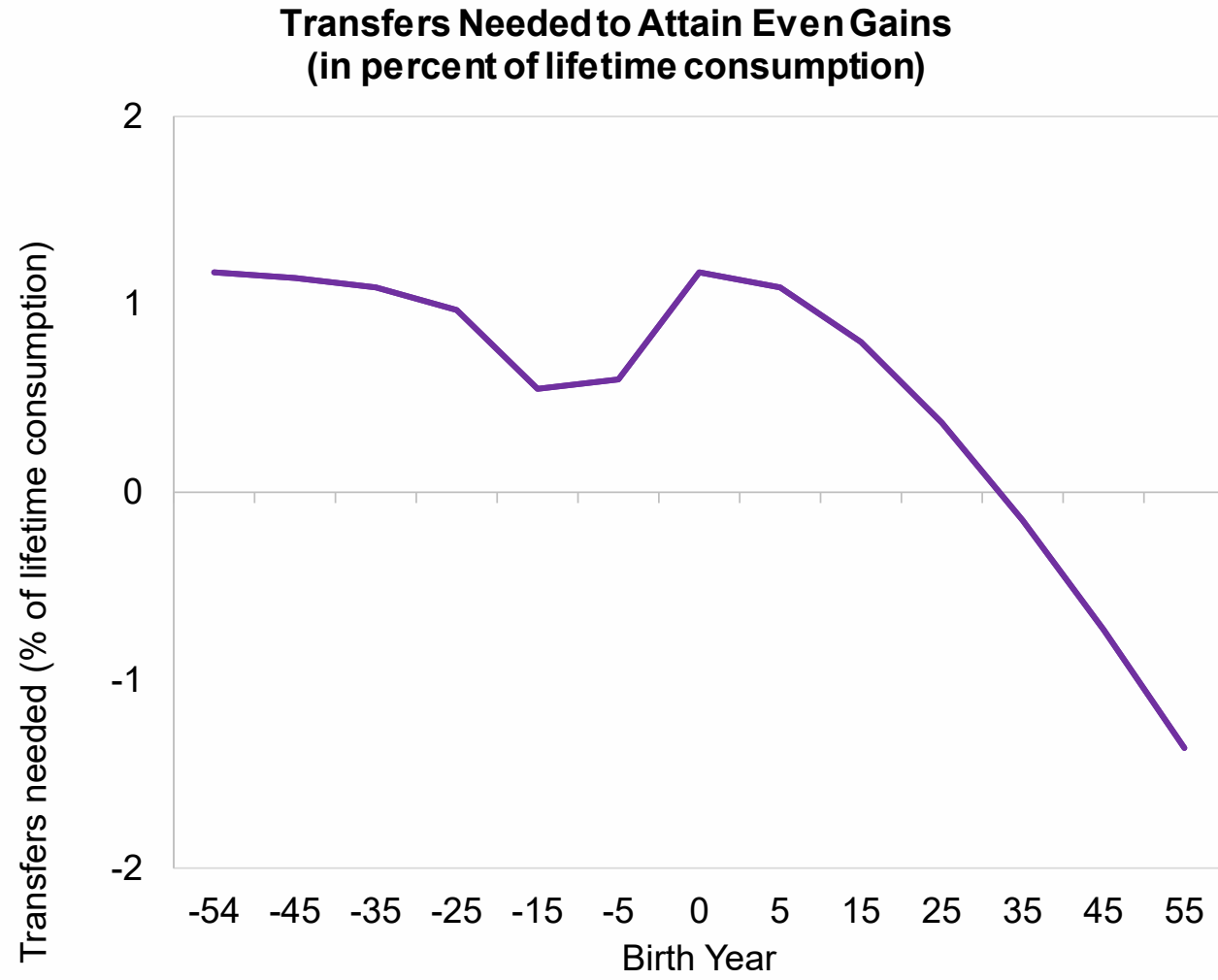
Source. IMF staff calculations, and IPCC (2021).
 Note. Shows energy-related CO2 emissions (excluding international aviation and maritime).

Implied Carbon Prices by Ambition Allocations



Source. IMF staff calculations.
 Note. Carbon prices weighted by baseline CO2 emissions in 2030 for each group.

Quantifying the Intergenerational Challenge



Source: L. Kotlikoff, F. Kubler, A. Polbin, J. Sachs, and S. Scheidegger “Making Carbon Taxation a Generational Win-Win,” NBER Working Paper 25760, NBER, Cambridge, MA 021138

Note: LSRA Net Transfer as Share of the Cohort’s Present Value of Remaining or Total Life-time Consumption

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Role of Monetary Policy – Conventional Response

Wicksell's interest rate rule to deliver price stability:

So long as prices remain unaltered the banks' interest rate is to remain unaltered. If prices rise, the interest rate is to be raised; and if prices fall, the interest rate is to be lowered; and henceforth the interest rate is to be maintained at its new level until a further movement in prices calls for a change in one direction or the other.

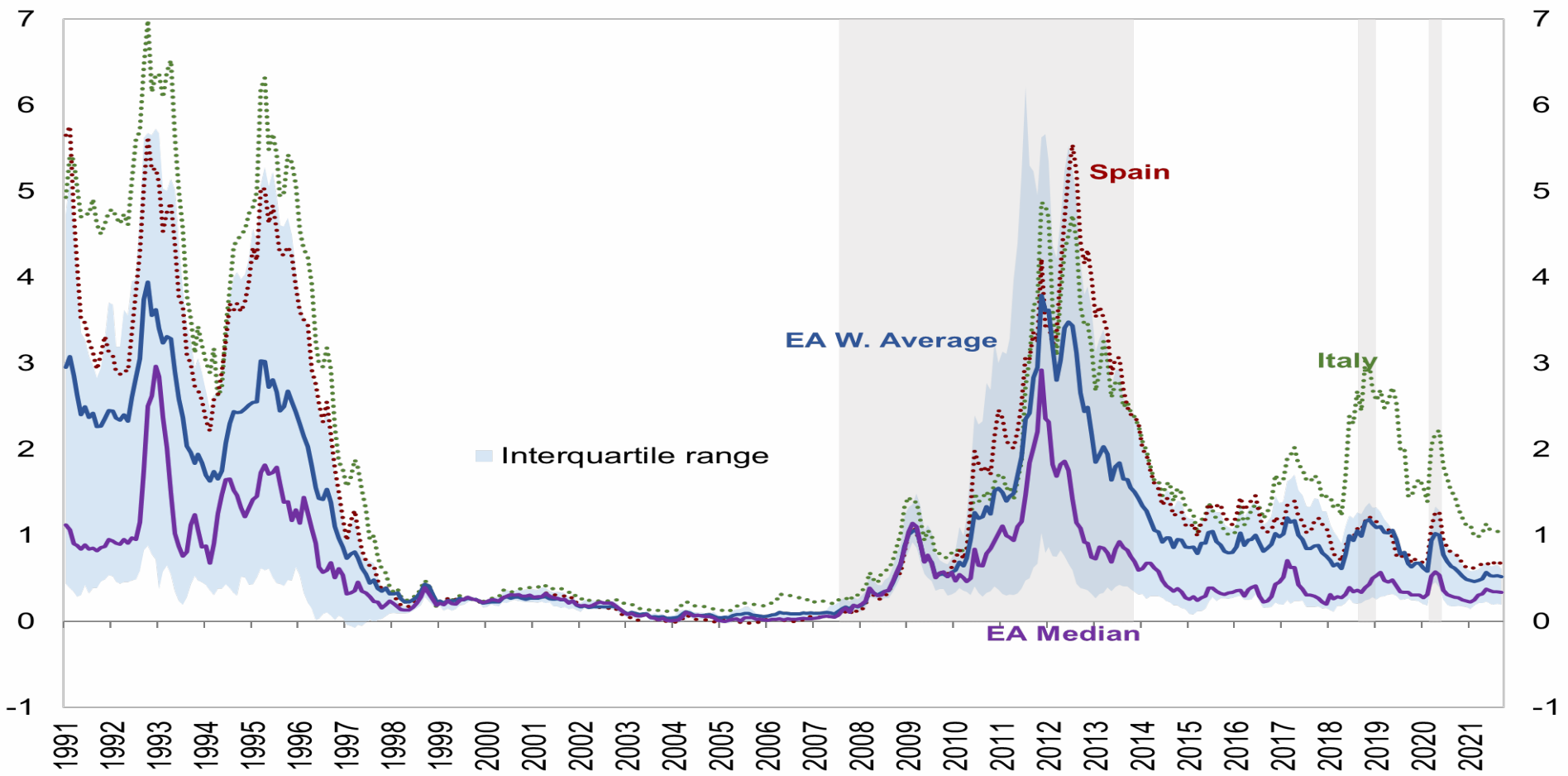
*Knut Wicksell, Interest and Prices, Macmillan, London, 1936. Translated from the German original *Gelzins and Guterpreise*, 1898.*

New Keynesian Models (e.g. Clarida, Gali and Gertler (1999), Woodford (2003).)

- Interest Rates as main instruments of monetary policy
- CB responds to demand shocks that disturb output

Market Forces: too Slow and Weak or too Sudden and Disruptive

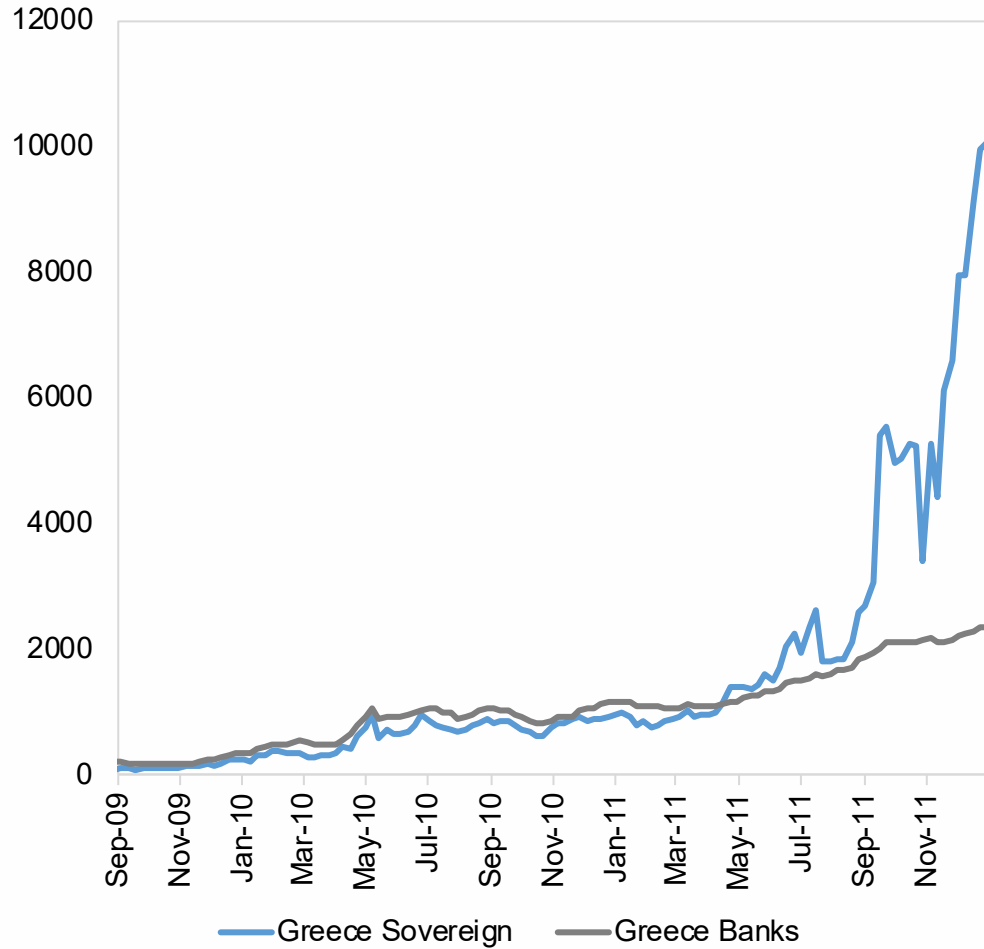
Government Bond Spreads in Euro Area



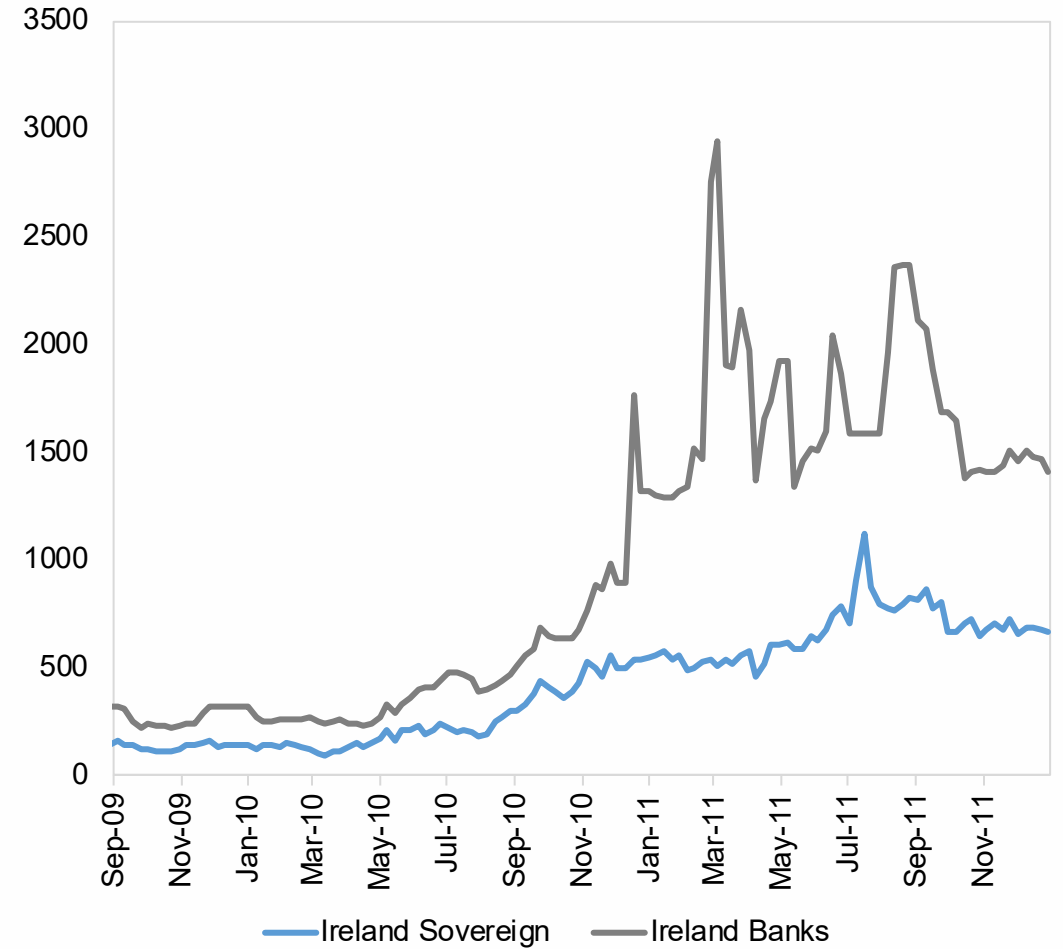
Source: Thomson Reuters Refinitiv & Eurostat

Credit Default Swaps

Greece



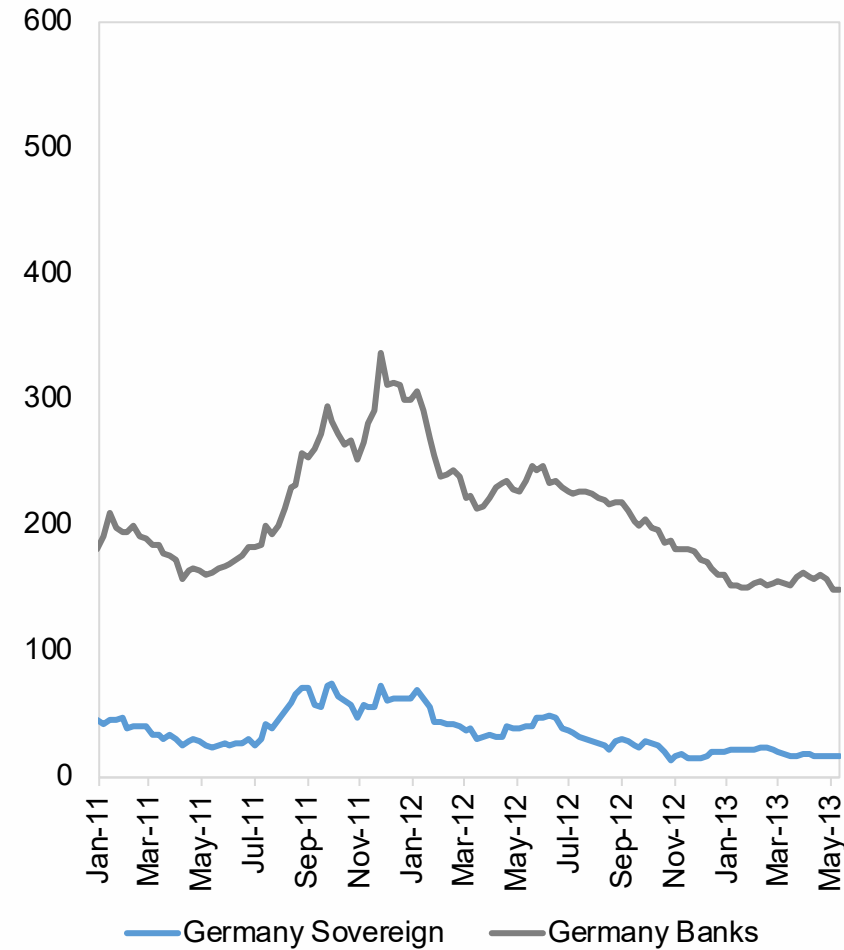
Ireland



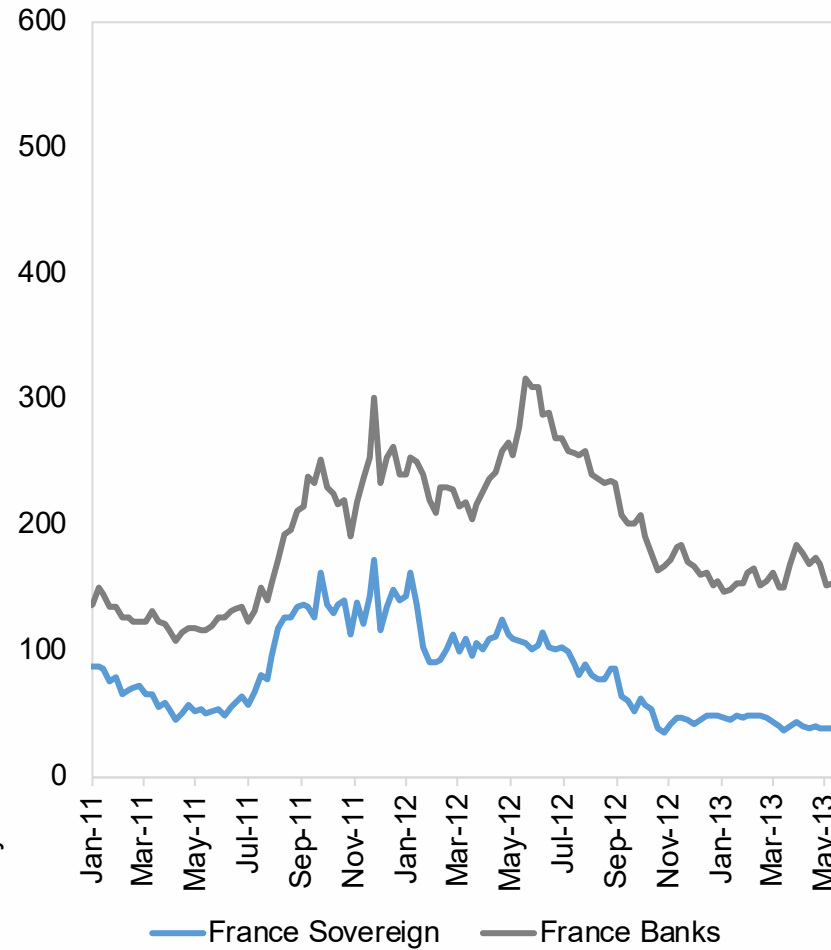
Source: Thomson Reuters Refinitiv & Datastream

Credit Default Swaps

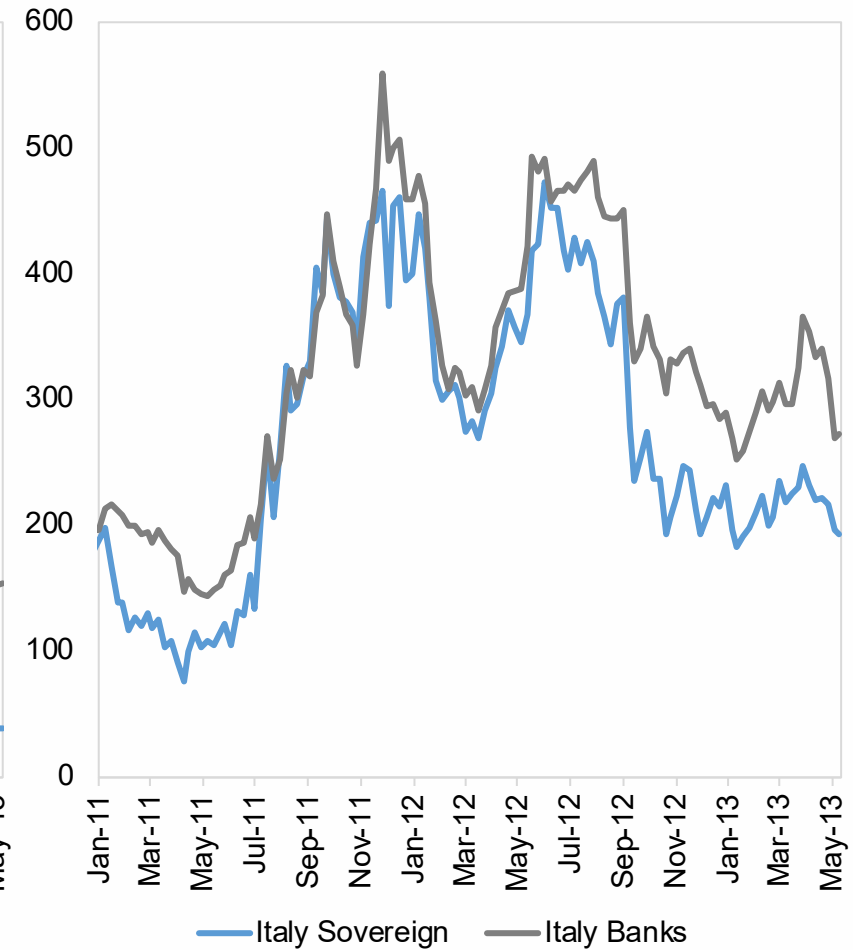
Germany



France



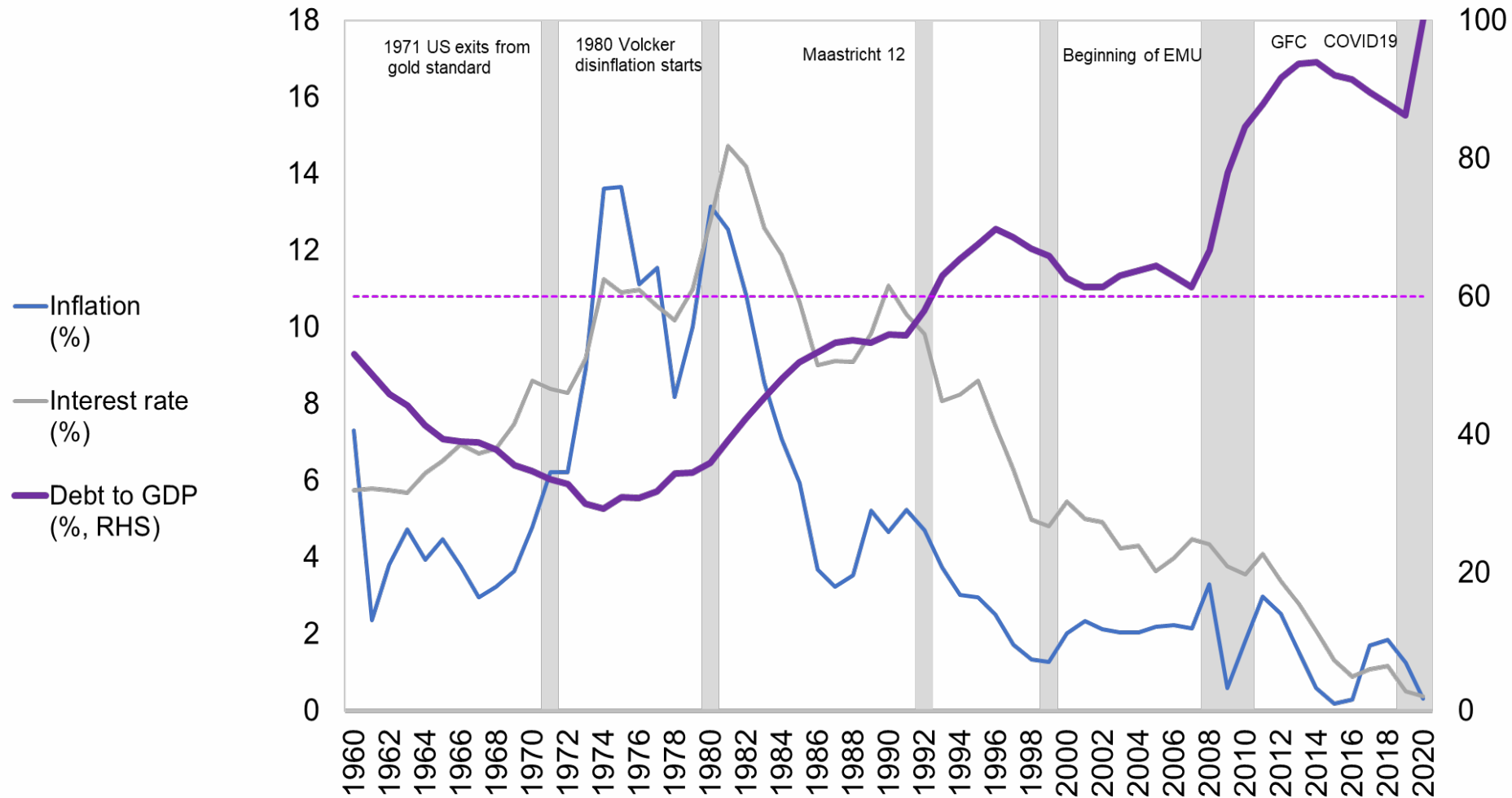
Italy



Source: Thomson Reuters Refinitiv & Datastream

Debt, Inflation, and Interest Rates

Maastricht12



Source: Refinitiv

Note: The values are calculated using a GDP weighted average.

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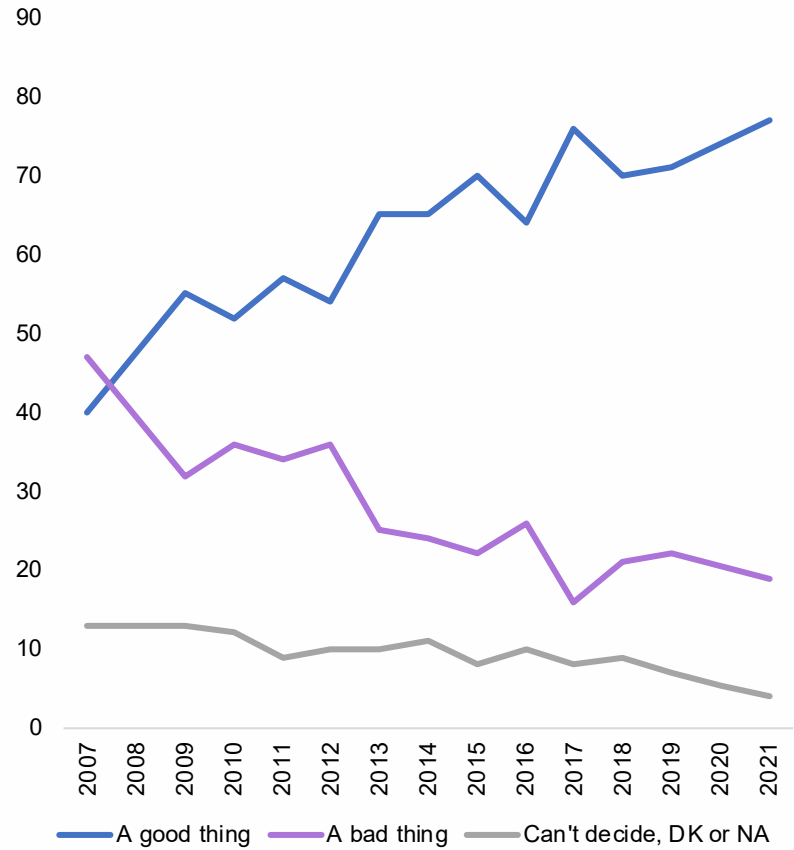
What are the policy options?

Good Government and Good Information

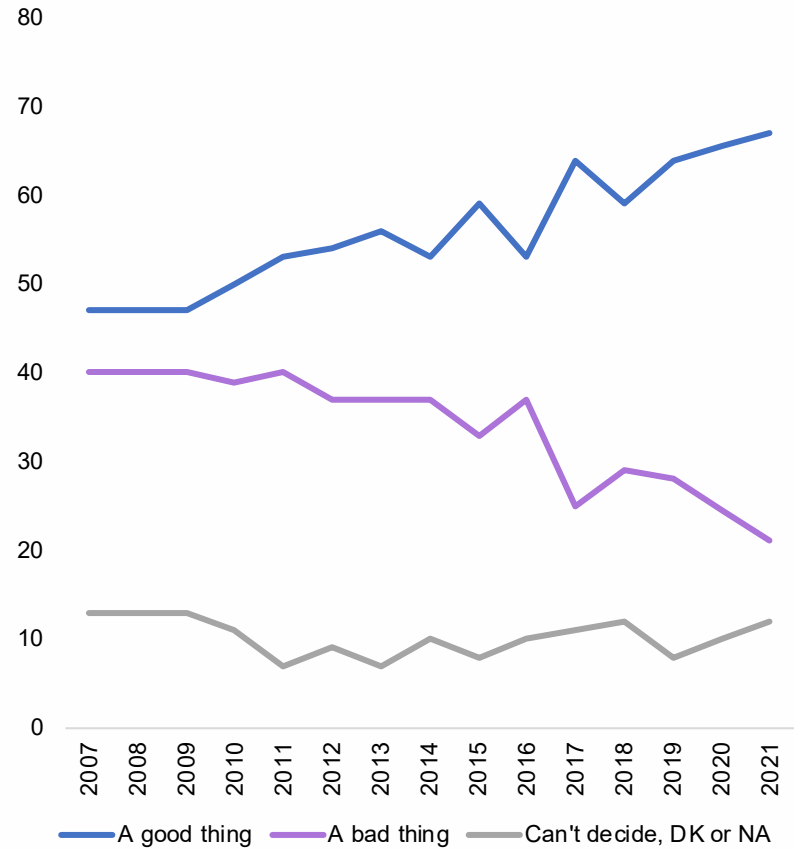


Is the Euro a good thing for your country?

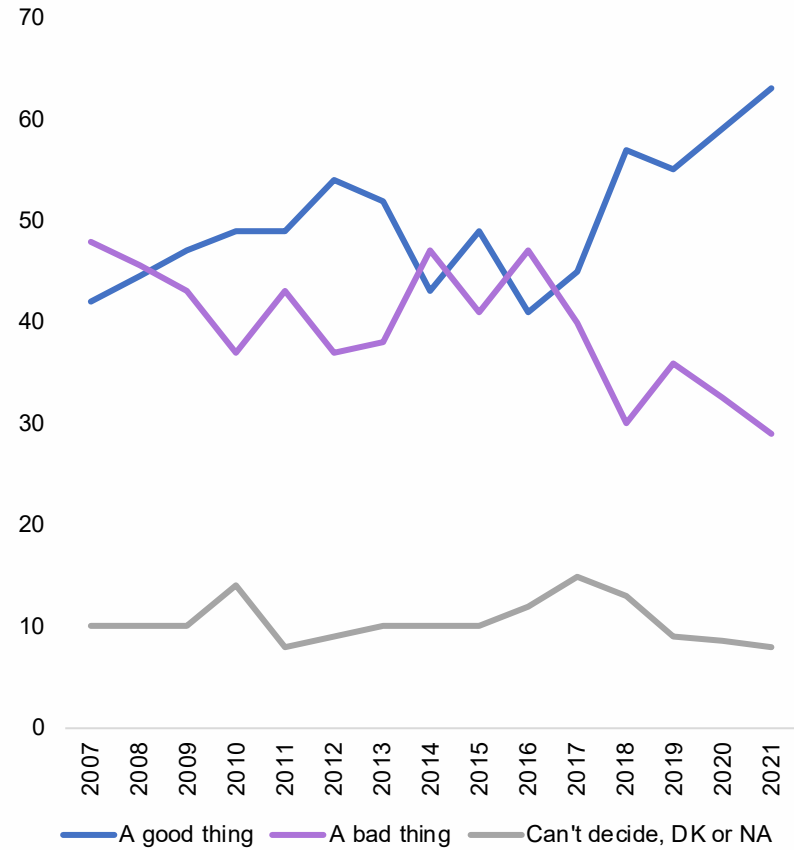
Germany (%)



France (%)



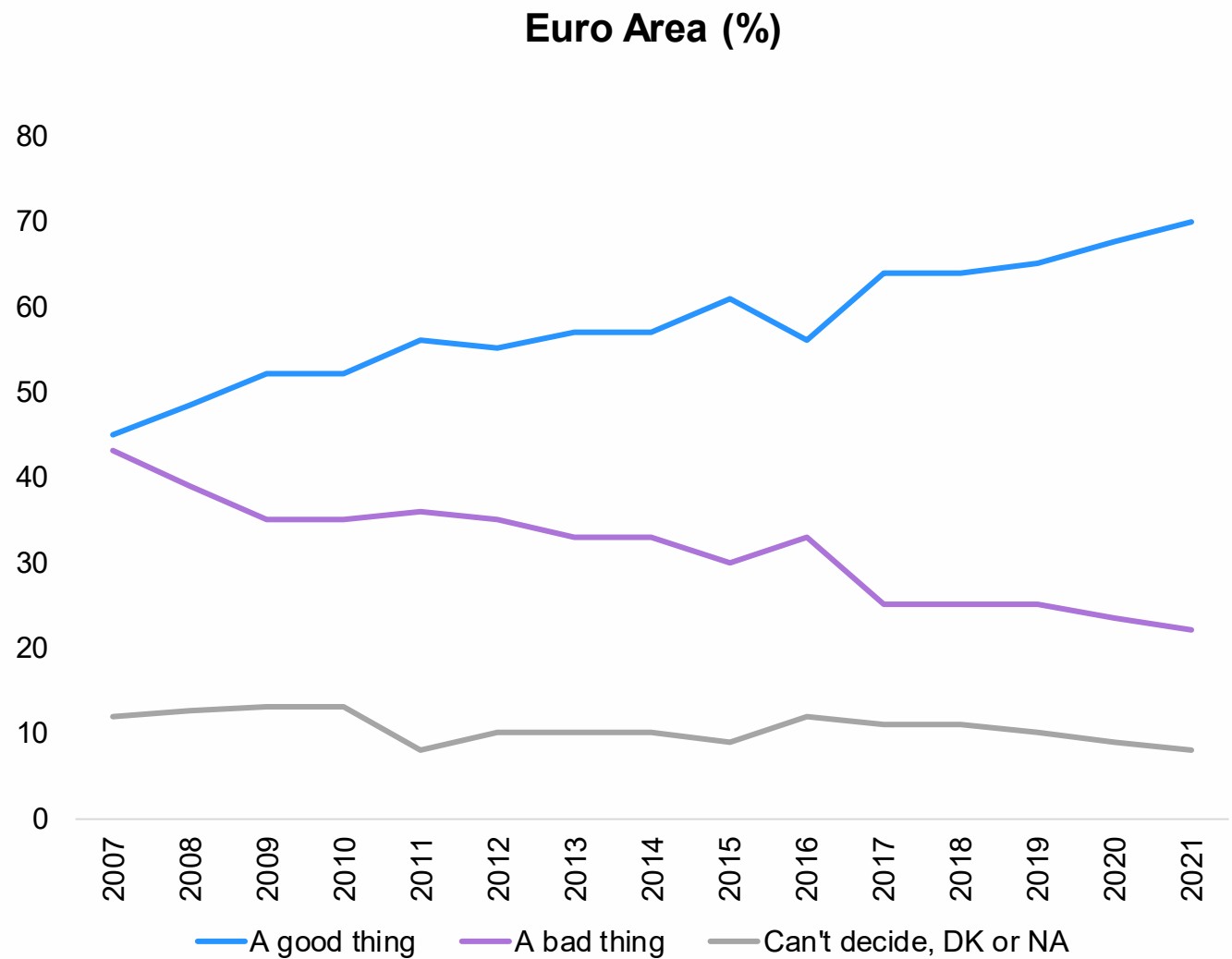
Italy (%)



Source: Data.europa.eu

Note: The data in 2008 and 2020 are the averages of the preceding and succeeding years.

Is the Euro a good thing for your country?

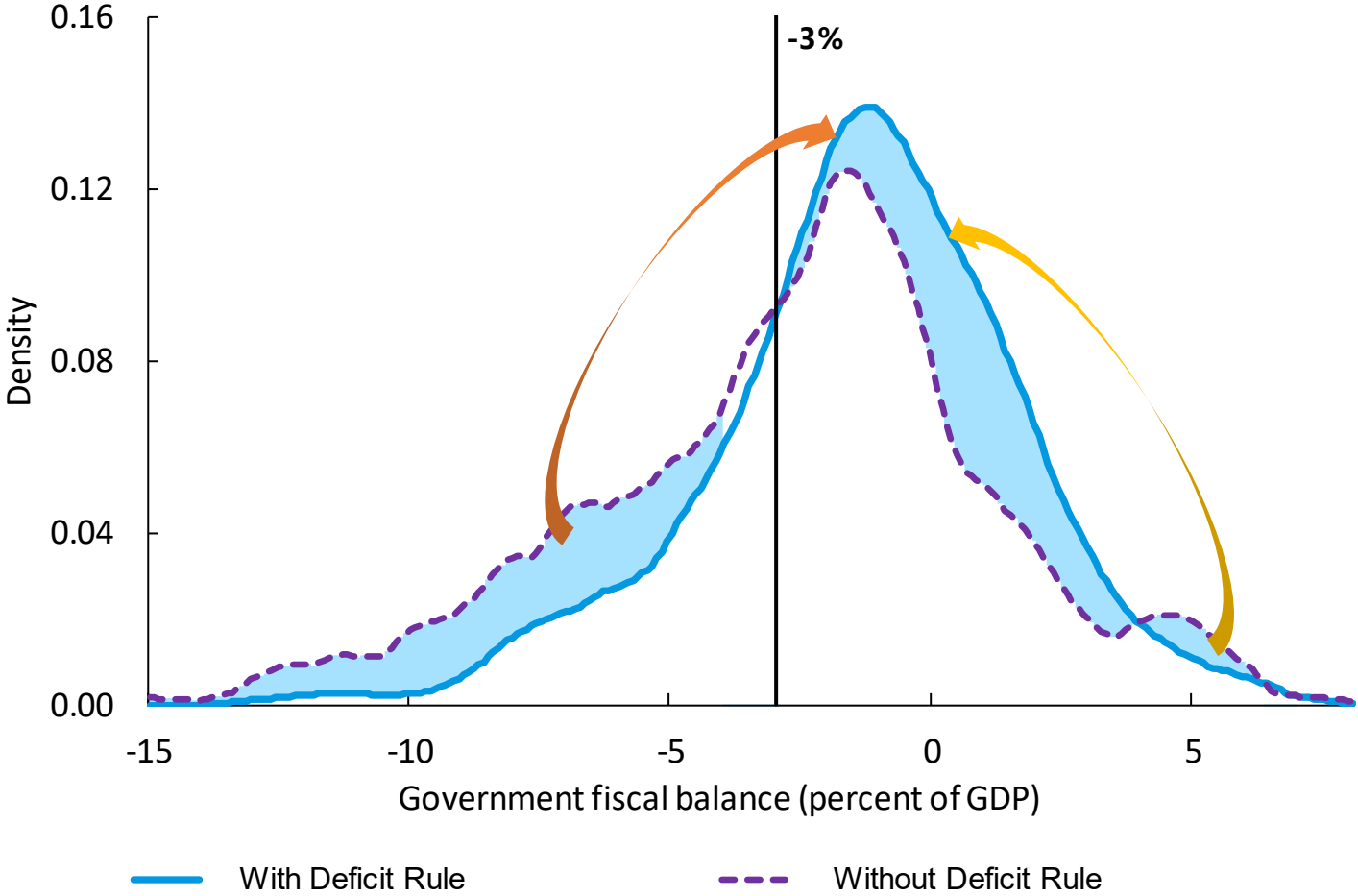


Source: Data.europa.eu

Note: The data in 2008 and 2020 are the averages of the preceding and succeeding years.

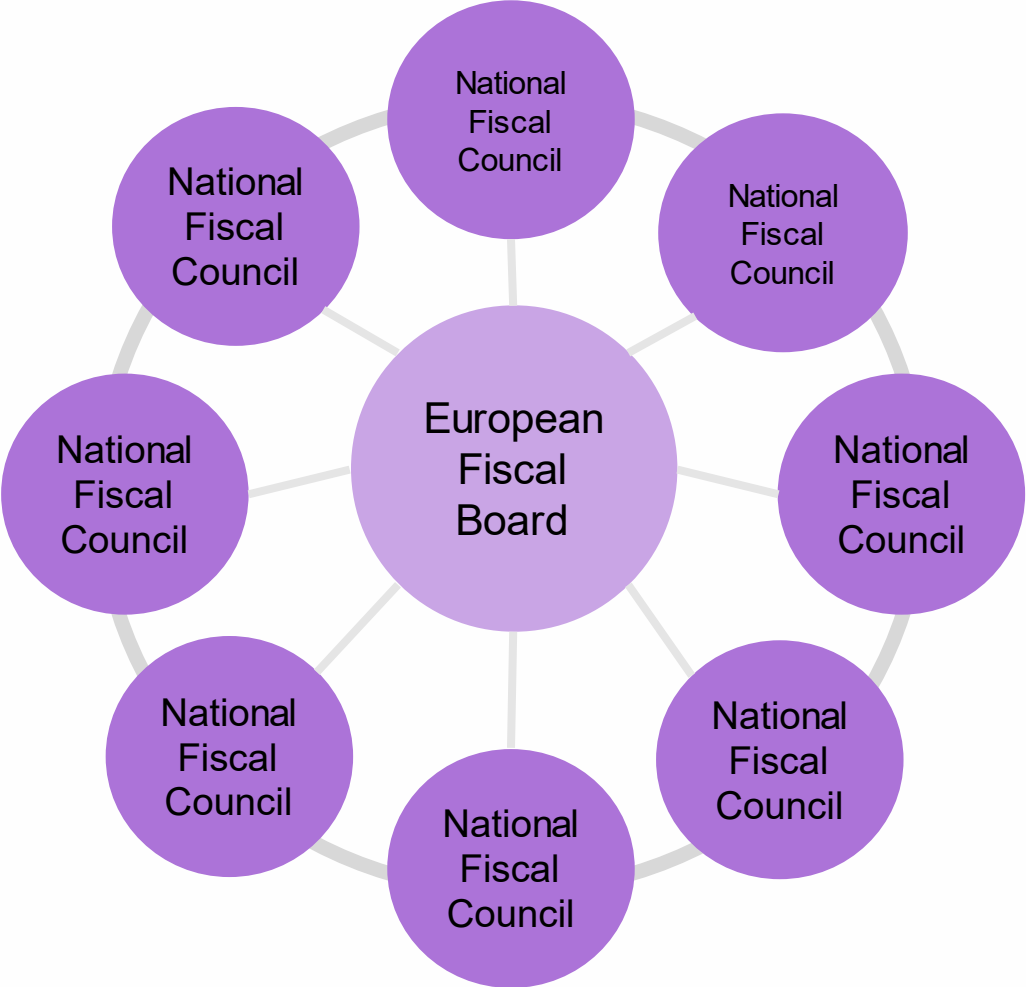
Rules as an Effective Pulling Force

Fiscal Balance Distributions



Source: Caselli and Wingender (2018)

European Network of Independent Fiscal Councils



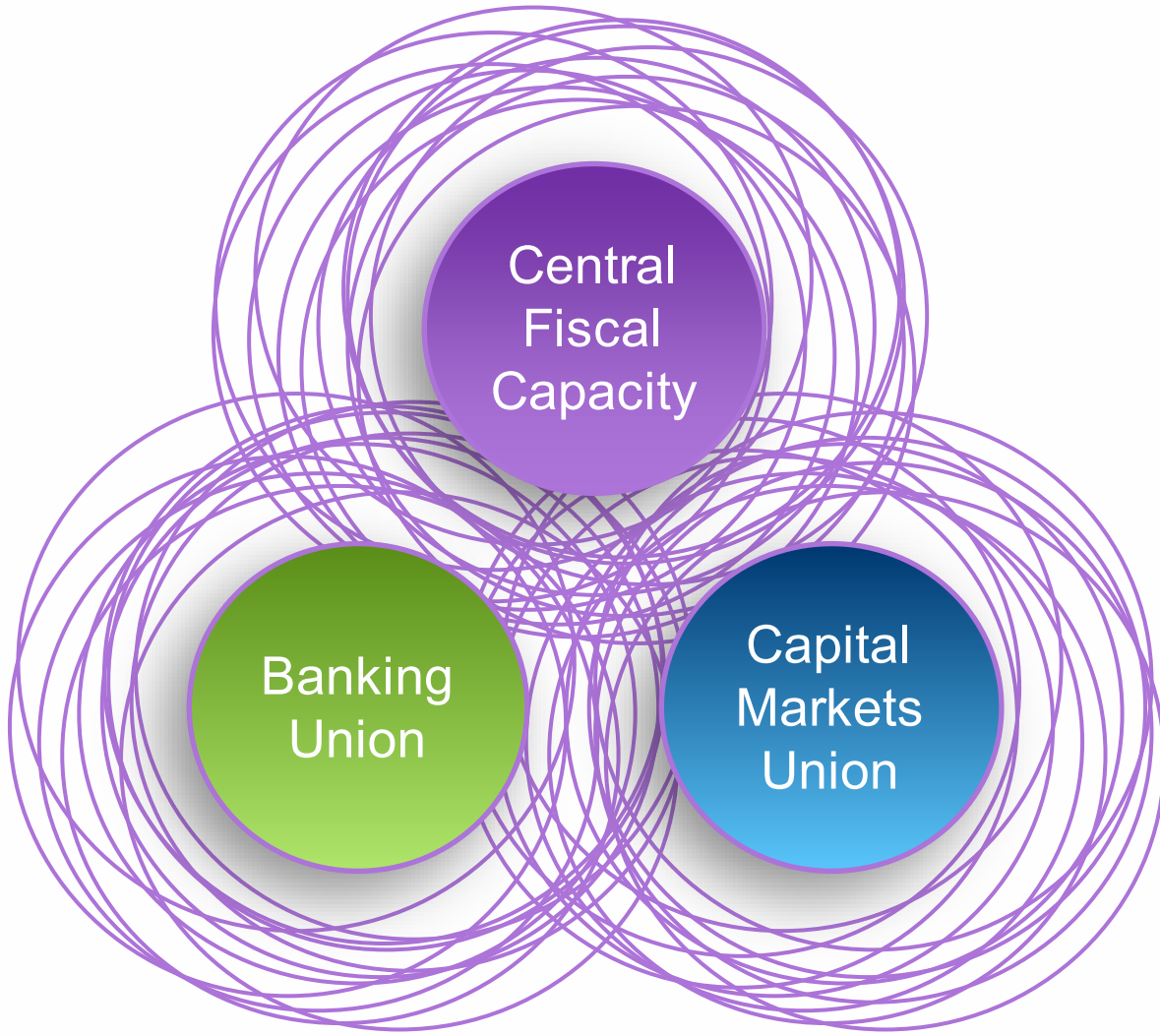
Competences of National Fiscal Councils

		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 (Stabilitätsrat)							
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 ^{9/}	Malta Fiscal Advisory Council							
Netherlands	Netherlands Bureau for Economic Policy Analysis							
Netherlands	Raad Van State							
Portugal	Portuguese Public Finance Council							
Slovak Republic	Council for Budget Responsibility							
Spain	Independent Authority of Fiscal Responsibility							

Source: Data as of 2021, IMF Fiscal Council Database (Forthcoming)

Note: The highlighted boxes point to the existence of the respective fiscal council remit.

Strengthening the Euro Area Architecture



Questions

- 1. Fiscal policies in Europe performed much better during COVID 19 than in earlier crises.** They demonstrated their power to support the single monetary policy and the transition to inclusive, digital and green growth. The use of the general escape clause, the PEPP and the NGEU all played important roles. **How can Europe build on this experience to reshape its fiscal architecture?**
- 2. The general escape clause will expire at the end of 2022.** That is in line with euro area approaching the pre-pandemic growth path. **How to manage the transition? How to avoid risks to stability, growth and structural transformation?**
- 3. Monetary stability and financial stability are crucial elements of a stability-oriented macroeconomic framework.** Crises in the euro area illustrate how disruptive financial instability can be. **How can institutions, rules and procedures be reformed in order to protect monetary stability and deliver financial stability?** Or, from the viewpoint of the central bank: how to avoid fiscal dominance and financial dominance?

Questions

- 4. Countries are very different in their initial conditions, structural characteristics and political priorities.** Fiscal strategies must consider this. The budget lies at the heart of national politics and parliament sovereignty. **Could a network of independent and reinforced national fiscal councils with an independent and reinforced European Fiscal Council at its center provide the right balance between differentiation, flexibility and discipline? Could it provide the right balance between the primacy of national politics and the internalization of European-wide spillovers?** How would this fit with other elements of the fiscal architecture?
- 5. Accrual and double entry accounting are best practice in both private and government sector accounting since the XIV century.** The practice is now the rule among large private sector corporations, but it is the exception in government. But sound accounting is the groundwork for analysis, forecasting, management, policy decision-making and accountability. Good information is a pre-requisite for proper functioning of the political process. **Could Europe take the lead in the adoption of best accounting practices by general government and the public sector?**

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