Fiscal policy in an uncertain environment: introductory remarks

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Welcome

I am glad to welcome you today to the annual fiscal policy workshop of DG ECFIN. We launched this workshop series a while ago to exchange views and ideas between academic and policy circles. We have strongly benefitted from this fruitful exchange.

Today's workshop deals with a very topical subject, namely fiscal policy in an uncertain environment. Indeed, uncertainty stands very high on the policy agenda. For instance, the latest Commission forecast finds that the EU economy is entering a period of heightened uncertainty. More recently, the IMF warned at the World Economic Forum in Davos that uncertainty was threatening to drag down global growth even further. Genuine uncertainty linked to political developments (e.g. Brexit, trade war between China and the US, populist push, EMU architecture) is difficult to quantify.

Allow me to share a few introductory remarks with you, which will be structured in three parts.

1) What are the key sources of fiscal uncertainty in the EU?
2) What has been achieved to reduce fiscal uncertainty in the EU in recent years?
3) What are the key remaining challenges to make EU economies more resilient to uncertainty?

1) What are the key sources of fiscal uncertainty in the EU?

There are three sources of uncertainty: (a) Uncertainty about fiscal outcomes and variables, (b) uncertainty in the conduct of fiscal policy and implementation of fiscal rules and (c) uncertainty of the economic environment, in which fiscal policy operates on fiscal outcomes.

There is the well-known distinction between short- and long-term sources of fiscal uncertainty. Let me be very short here:

- Over the ***short-term***, much of the fiscal uncertainty is related to the business cycle, i.e. it stems from shocks to the macroeconomic environment and the impact of these shocks on fiscal variables.

- Over the ***longer-term***, the main sources of fiscal uncertainty are related to potential growth, interest rate on public debt, health care/ageing expenditure and contingent liabilities.

Beyond the short- and long-term distinction, there are several euro area-specific features of fiscal uncertainty. These features are linked to the unique institutional architecture of the European Economic and Monetary Union (EMU). The so-called Maastricht assignment combines a supranational monetary policy, conducted for the euro area as a whole, with decentralised fiscal policies, which remain largely the responsibility of national governments. This set-up can lead to three *additional* layers of uncertainty for public finances.

- First of all, uncertainty can arise from ***externalities across countries***. For instance, a banking crisis in one region may spill-over to other regions. As shown by Commission analysis, these spillover effects can be non-negligible in a ZLB environment (in't Veld, 2016). In addition, an extreme amplification of spillover effects can lead to "contagion" effects as nicely explained in the seminal paper by Allen and Gale (2000). In the case of EMU, these contagion effects even questioned the viability of the euro area project as a whole.

- Second, uncertainty can come from ***adverse incentives***. In a monetary union, it remains primarily the country relaxing its budgetary policy that enjoys the short-term political benefits. In doing so, it can put upward pressure on interest rates in the whole euro area. If excessive borrowing in one country or group of countries can lead to a risk of default, the implications in terms of monetary policy and financial stability will be felt by all members of the currency union.

- Finally, the ***incomplete institutional architecture*** of the euro area added an additional layer to uncertainty for public finances at least during the Great Recession and the years that followed.

Please do not get me wrong: The EMU-specific features of uncertainty do not necessarily increase fiscal uncertainty in euro area countries. Instead, the stronger institutional EMU framework has probably (partly if not fully) offset the additional elements of uncertainty. My current hypothesis is that we have observed two opposing effects: While EMU membership has decreased uncertainty in normal times, it has contributed to higher uncertainty at least during the Great Recession and its aftermath. The incomplete nature of EMU's architecture is part of the story.

2) What has been achieved to reduce fiscal uncertainty in EMU in recent years?

The Great Recession revealed critical gaps in the original institutional framework of EMU. EU and euro area leaders reacted to these challenges by improving the EU's institutional architecture in several steps.

First, the EU's fiscal framework was strengthened: It turned out that the favourable macroeconomic conditions in the years prior to the Great Recession were not sufficiently used to build up fiscal buffers. Some EU Member States appeared to treat the deficit reference value more as a target than as an upper limit, while high debt ratios did not decline substantially. The Great Recession was (apart from Greece), however, not a fiscal crisis, but the lack of buffers hindered a proper fiscal response. In addition, both rule design problems and governance failures have contributed to a poor enforcement of the SGP (Eyraud and Wu 2015).

As a consequence, both arms of the Stability and Growth Pact (SGP) were reinforced, in particular by introducing an expenditure benchmark, debt benchmark and a medium-term balanced budget rule as well as by launching the surveillance of draft budgetary plans by the Commission.

Second, fiscal rules were implemented with more flexibility. This reflected the greater acceptance of the role of discretionary fiscal policy in tackling large shocks as recently identified by Auerbach. This is especially the case when monetary policy is constrained, as spillovers can be larger and multipliers higher (Blanchard, Dell'Ariccia and Mauro 2010; Blanchard and Leigh 2013) or when economic shocks are deep, requiring complemented action from discretionary fiscal policy (Christiano, Eichenbaum and Rebelo 2011).

As a consequence, a collective "escape clause" was introduced, effectively allowing (but not prescribing) a suspension of the rules in case of "severe economic downturn" in the EU or the euro area as a whole. The reform of the fiscal framework in 2013 (the so-called two-pack) put more attention to the supporting fiscal policy stance at the euro area level. Finally, in 2015 the framework was improved by better taking into account the economic cycle of individual Member States.

Views differ on whether the greater flexibility has increased or decreased uncertainty: While greater flexibility contributed to a better stabilisation of the economy (i.e. less uncertainty), it implied a less predictable implementation of the rules (i.e. more uncertainty). The sign of the "net effect" on uncertainty is subject to discussion. My own view: in normal times, a strict application of the rules decreases uncertainty. However, in exceptional times, the consequences on economic activity arising from a literal, mechanical implementation of the rules would increase uncertainty.

Third, the national ownership of the fiscal framework was strengthened. The gap between national budget discussions and European surveillance was a fundamental weakness of the framework (Buti and Carnot 2012). While fiscal projections as reported by EU Member States in their annual stability and convergence programmes typically moved in line with prescriptions, implementation often diverged from the plans. To strengthen national ownership, national fiscal frameworks were made more powerful.

Finally, the institutional framework was reinforced on several non-fiscal dimensions. Given the fiscal focus of today's conference, let me be brief here.

The governance framework was expanded to also cover macroeconomic developments. Fiscal imbalances were certainly not the only reason for the severity of Europe's Great Recession. Instead, macroeconomic imbalances played a major role in contributing to understanding the crisis.

As a consequence, the European Commission developed a macroeconomic surveillance mechanism, the Macroeconomic Imbalance Procedure. The MIP aims at identifying potential macroeconomic risks early on, preventing the emergence of harmful macroeconomic imbalances and correcting the imbalances that are already in place.

A permanent crisis resolution framework was created. During the first decade of the EMU, financial markets differentiated very little among between sovereign assets across the EMU, encouraged by the growing perception that the bailout clause is not credible (De Grauwe and Ji 2012). When market discipline eventually returned, by the end of the decade, the "sudden stop" threatened the viability of the EMU project as a whole.

Therefore, the European Stability Mechanism (ESM) was established in 2012. Its main purpose it to provide stability support through a number of financial assistance instruments (in particular loans to countries) to ESM member states which are "experiencing, or are threatened by severe financing problems," subject to strict policy conditions.

Financial supervision was strengthened. The vicious feedback cycle between banks and their governments in the EU clearly deepened and accelerated the crisis (Beck 2012; Jordà, Schularick, and Taylor 2016). This "doom loop" was further strengthened by the predominance of bank financing, which transmitted bank problems to the wider economy (Baldwin et al. 2015). To tackle the risks emerging from the sovereign-bank nexus, key elements for a proper Banking Union were launched. These elements had important indirect implications for fiscal policies and outcomes.

3) What are the remaining key challenges to make EU economies more resilient to uncertainty?

A key but at the same time very challenging question is how to make the EU economies more resilient to uncertainty? I see in particular three priorities:

First, we need the right tools to deal with uncertainty in fiscal policy. This is challenging, since uncertainty is inherently unobservable and difficult to measure.

In the context of fiscal surveillance, we need a reliable indicator to assess the position of economies in the business cycles to determine the required fiscal adjustment of Member States. For fiscal surveillance, the output gap plays an important role, which is estimated based on a commonly agreed production function approach.

However, despite its conceptual relevance, the output gap faces several challenges, namely (i) it is based on non-observables as it requires an estimate of potential growth, (ii) it is difficult to assess the position in the economic cycle and its dynamics in real time and (iii) it is particularly challenging to estimate the output gap in atypical times.

To signal that output gap estimates may be a subject of a high degree of uncertainty, an expenditure benchmark was introduced in 2011. In addition, a "plausibility tool" was endorsed in 2016. It allows the Commission, under limited and specific circumstances (e.g. slack in the economy during the recent recovery (low inflation, current account imbalances, sluggish investment, entrenched unemployment)), to exercise some "constrained judgement", i.e. to depart from the output gap estimates of the commonly agreed methodology in its assessment of the cyclical position of Member States when conducting its fiscal assessments.

The recent evaluation of the testing period of the plausibility tool suggests that the tool has good real time signalling properties and can serve as a useful complementary tool for signalling those cases where the production function method might be either over- or underestimating output gaps.

Second, a sound approach to fiscal policy requires Member States to react to uncertainty.

According to new Commission analysis published in the Report on Public Finances in EMU (2018), economic shocks – a major source of uncertainty – can have a significant and lasting impact on public finances, particularly on debt-to-GDP ratios.

The report also shows that Member States tend to adjust their planned fiscal effort only very late and asymmetrically to forecast errors, relaxing the fiscal effort in case of positive surprises and leaving it unchanged in case of negative ones. This biased reaction function to uncertain fiscal outcomes is clearly unhelpful for the sustainability of public finances.

As a result, an appropriate policy response to uncertainty should include taking precautionary measures against the possibility of worse-than-expected outcomes. In addition, policies that foster economic resilience can reduce the likelihood of large negative macroeconomic shocks and limit their adverse consequences.

Finally, we need to ensure a viable fiscal governance framework, which strikes the right balance between fiscal sustainability and stabilisation to further mitigate uncertainty. Here again, the sign of the “net effect” between the two objectives on uncertainty is subject to discussion.

The current good economic times should be used to build up fiscal buffers, in particular in highly-indebted Member States, to let automatic stabilisers play fully in the next downturn (Blanchard 2019). This is key as public debt levels are still very high in several Member States and there is need to prepare for a prospective tightening of monetary and financial conditions.

In addition, there is currently no tool in place to help smooth large asymmetric shocks and contribute towards an appropriate euro area fiscal stance in case of large symmetric shocks. As we have seen, the absence of common tools to face the crisis has implied that a symmetric financial shock has generated an asymmetric debt shock, which has been much more difficult to face. In particular, this made it very difficult to adopt a timely discretionary fiscal response to shocks, contrary to the US evidence. Relying exclusively on national fiscal buffers is therefore not a convincing solution. In addition, concerns about moral hazard are exaggerated, since such a tool would only focus on large shocks.

4) Concluding remarks

Uncertainty can have significant and lasting impact on fiscal policies, in particular on public debt in the EU.

Institutional changes since 2011 have reduced certain forms of uncertainty.

However, we still need to improve the countries' resilience to uncertainty. Three priorities should, in my view, be considered:

- First, set up the right tools to deal with uncertainty in fiscal policy;
- Second, take precautionary measures against the possibility of worse-than-expected outcomes;
- Third, ensure that EU's fiscal governance framework strikes the right balance between fiscal sustainability and stabilisation to further mitigate uncertainty.