FISCAL POLICY IN A TURBULENT ERA

Background for remarks in SUERF panel, 22 May 2024

By Niels Thygesen*

Chair European Fiscal Board (EFB); the views do not necessarily reflect those of the EFB

A WIDENING GAP BETWEEN FISCAL AMBITIONS AND THE RESOURCES FOR MEETING THEM

- Analogies and differences with the earlier phase of fiscal policy (over)ambition – late 1960s-1973/4
- A growing confidence in the potential of fiscal policy to stabilize the economy at high levels of capacity utilization and rapid growth
- US inspiration in both political – the Kennedy-Johnson Admins - and analytical – the CEA (Walter Heller) and the model builders - terms
- Heller et al. (1968) and aspects of the Werner Report on EMU reflect this optimistic and activist vision of fiscal policy

RECOLLECTIONS OF A RECONSTRUCTED KEYNESIAN

- Political ambitions to foster growth by bold demand management was apparently supported by evidence
- Low public debt ratios posed no clear constraints, and refined fiscal indicators (cyclically-adjusted balances) were introduced
- The Werner Report in Europe reflected some of that “fiscal idealism”
- Even cross-border transmission effects were studied (in preparation of the Smithsonian Agreement disaggregated multipliers identified)
- The bitter end came in 1973/4 with the first energy price hike

A DECADE OF FISCAL DISILLUSION FROM 1973

- Deep policy disagreements over reactions to supply shock - priority to employment or inflation?
- Widespread indexation, accommodating monetary policies and flexible exchange rates greatly aggravated problems, worst in Europe, where disintegration of performance and of markets was evident
- Should the EU integration process be restarted with fiscal policy and conditional lending rather than by reviving ideas of a currency union?
- Neither - until the mid-80s, when radical steps became a prerequisite for the Single Market, but based on a very different vision of policy

FISCAL POLICY TO BE (MAINLY) RULES-BASED

- Inspired by the new approach to macroeconomics – commitment to medium-term objectives, and a (mainly) rules-based trajectory
- Highly independent European Central Bank, underpinned by fiscal prudence; strong separation of monetary and fiscal policies
- The “Maastricht Bargain”: weaker economies could obtain lower and more stable interest rates in return for extra fiscal prudence , while stronger economies saw themselves as exporting stability to partners
- No provisions for conditional lending or debt restructuring; national responsibility for financial stability

TWO REFORMS IN DIFFERENT DIRECTIONS

- More flexibility and national differentiation in 2005, but tighter surveillance from 2010-13 - after financial and sovereign crises
- Crisis management (ESM) to allow conditional lending, to strengthen monitoring nationally by Independent Fiscal Institutions and budgetary processes and transparency
- Over the slow recovery 2014-19 fiscal policy was prudent in most EU countries, but debt ratios diverged and buffers were not built.
- No appetite for further reforms – and the pandemic de facto suspended the entire framework for four years

THE RESTORATION OF FISCAL POLICY – WHY?

- Fiscal action, nationally and jointly, became essential to counter the deep downturn of the pandemic – and worked better than expected
- It was also important in dampening the impact of the energy shock following the Russian invasion of Ukraine
- The central role of fiscal policy in facing deep challenges was based on exceptional role in providing insurance for households and firms
- Other, mainly social, expenditures have continued to rise strongly
- The perception that interest rates could remain near historical lows promoted the impression that the “Maastricht Bargain” had lost its relevance, removing concerns over debt financing – prior to mid-2022

EXISTENTIAL GEO-ECONOMIC CHALLENGES

- While the challenges to public finances from the pandemic and the energy shock many have faded, other even larger challenges loom:
- The EU has to continue the green and digital transitions, to allow defense and security to catch up after many years with a “peace dividend”, and to take the major responsibility in rebuilding Ukraine
- These challenges are existential, but meeting them will not add greatly to future incomes and debt-servicing capacities; growth projections are low
- Furthermore, EU citizens watch the superior growth performance of the US and China, the competitiveness of which they have to match

AN UPHILL FIGHT FOR FISCAL SUSTAINABILITY

- It will be an uphill fight in the EU to improve the prospects for fiscal sustainability – the laudable main aim of a recently agreed reform
- The main features are (1) a medium-term perspective of 4-7(!) years; (2) national differentiation according to debt sustainability risks; (3) stronger national ownership and – hopefully domestic legitimacy and commitment; (4) focus on expenditure growth as the policy indicator
- No commitment to more expenditures at EU level, financed jointly; fiscal federalism still below the horizon; lessons from China?
- The separation of fiscal and monetary policy is increasingly blurred

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- Thank you for your attention