

Europe's fiscal rules – up for debate

By [Pierre Aldama](#) and [Jérôme Creel](#)

At the euro zone summit in December 2018, the heads of state and government hit the brakes hard on the reform of fiscal governance: among the objectives assigned to the euro zone's common budget that they are wishing for, the function of economic stabilization has disappeared. This is unfortunate, since this function is the weak point of the fiscal rules being pursued by the Member States.

In a [recent article](#), we assessed how governments use the fiscal tools at their disposal to respond to information about trends in the public debt or the economic cycle that is at their disposal when they make their budgetary decisions. Thus, instead of evaluating the properties of fiscal rules using data that may well be revised retrospectively, we evaluated them “in real time”.[\[1\]](#)

Three main results emerged from our study. On the one hand, European governments ensure that their public debts are sustainable by improving their fiscal balance when the public debt increases. On the other hand, we found a trend towards fiscal consolidation at the bottom of the cycle in the euro area: fiscal policy is then rather destabilizing. Finally, euro area Member states have adopted a behaviour that was not found in the non-European countries in our sample: the euro zone Member states, unlike the others, continued to stabilize their public debts at the bottom of the cycle and during the crisis years. Thus the fiscal policy in the euro zone countries appears rather clearly to be untimely and inappropriate.

The results obtained as a whole for the euro area argue for a

reform of Europe's fiscal rules, but not necessarily in the sense most commonly accepted. The issue of stabilizing the public debt does not seem to be essential in so far as this is already being taken care of by the fiscal policies being implemented. Rather, what is needed is to rebalance these fiscal policies in favour of macroeconomic stabilization, especially if no common mechanism – such as a euro zone budget – has been set up for this purpose. European fiscal policies need to be more flexible and less prescriptive, with a focus on the dynamics of macroeconomic stabilization. Since no progress is envisaged at the European level, national automatic stabilizers need to be reinforced, increasing tax progressivity and the responsiveness of social spending to changes in economic activity in order to deal with the next cyclical downturn, both individually and collectively.

[1] One of if not the first article that focuses on evaluating fiscal policy using “real-time” data is by Golinelli and Momigliano ([Journal of Policy Modeling, 2006](#)). This literature is summarized in Cimadomo ([Journal of Economic Surveys, 2016](#)).

What options for the European Central Bank?

By [Paul Hubert](#)

All eyes are now on the ECB, whose recent statements indicate that it is concerned about the risk of deflation in the euro zone. The further downturn in inflation in May to 0.5% year on

year is a reminder that this risk [is increasing](#). This could lead the ECB to take action at the monthly meeting of the Board of Governors being held today, or in the months to come. This post provides a brief summary of the possible options available to the ECB.

1. To lower the key interest rate (main refinancing operations rate, the MRO rate), which is currently 0.25%. The consensus in the financial markets is for a reduction of around 10 to 15 percentage points, which would further cut financing costs for banks that are still dependent on ECB liquidity. However, this would have a marginal impact on the rates of refinancing operations (MRO and long-term refinancing operations, or LTRO), which would not have much influence on financing conditions and thus not much benefit for Spanish and Italian banks (the main users of this option).

2. To lower the deposit facility rate from zero to a negative rate (again by 10 to 15 percentage points). This option has been largely anticipated by the financial markets. A negative interest rate on deposits should also be accompanied by a change in the policy on the ECB's excess reserves by capping the amount of commercial banks' excess reserves on the ECB's balance sheet or by applying the same negative rate to excess reserves. Otherwise the banks would simply transfer their funds from deposit accounts to excess reserves. A combination of these two policies should lead to a lower Euro OverNight Index Average (EONIA) rate of between zero and 0.05%. The incentive for banks to keep their cash at the ECB would thus be reduced, thereby stimulating the distribution of credit to the non-financial sector.

3. An extension of the policy of providing liquidity in unlimited amounts at a fixed rate (fixed-rate full allotment) from mid-2015 to late 2015 or even mid-2016 is considered by most to be an easy and quick option that would provide additional assurance on the markets before the LTRO deadlines in early 2015. This kind of measure would ensure the liquidity

of the banking system but its impact on activity and inflation could be limited, in so far as the banks would prefer to place their cash with the central bank.

4. An ECB announcement of the end of sterilization through the Securities Markets Programme (SMP), a programme for purchasing the sovereign bonds of euro zone countries in difficulty. The markets seem divided on this issue. The ECB has not managed to attract sufficient demand to completely sterilize this operation in the last eight weeks. This would add 164.5 bn euros (the SMP target amount) of liquidity to the system and take the EONIA rate to zero or even into negative territory, and could reduce the volatility that has appeared in recent months. This measure would therefore also cut the interbank refinancing rate, which would more or less amount to the first option.

5. A conditional and targeted LTRO programme could see the light of day. This would consist of copying the Funding for Lending Scheme (FLS) set up by the Bank of England, in which cheap financing is arranged for banks in exchange for granting new loans to the real economy. However, it would take time to implement this, and even more before there is any real impact on the economy. It would nevertheless probably be the most effective way to stimulate activity, because it would go beyond interbank operations in influencing refinancing conditions.

In any event, the economic situation in the euro zone for both the business outlook as well as for the situation on the labour market calls for a strong response from the ECB so as to ensure that the euro zone does not incur deflation. The effect of the signal may be just as important as the measure actually implemented by the ECB. By demonstrating in today's meeting that it is active, the ECB would show its determination to fight against the risk of deflation, which could at least change agents' expectations. While any action by the ECB would be welcome, it is still the case that the

current economic situation is also the result of the restrictive fiscal policies that have hit activity (see [here](#)).

The misfortunes of virtue*

By [Christophe Blot](#)

** This text summarizes the outlook produced by the Department of Analysis and Forecasting for the euro zone economy in 2012-2013, which is available in French on the [OFCE web site](#)*

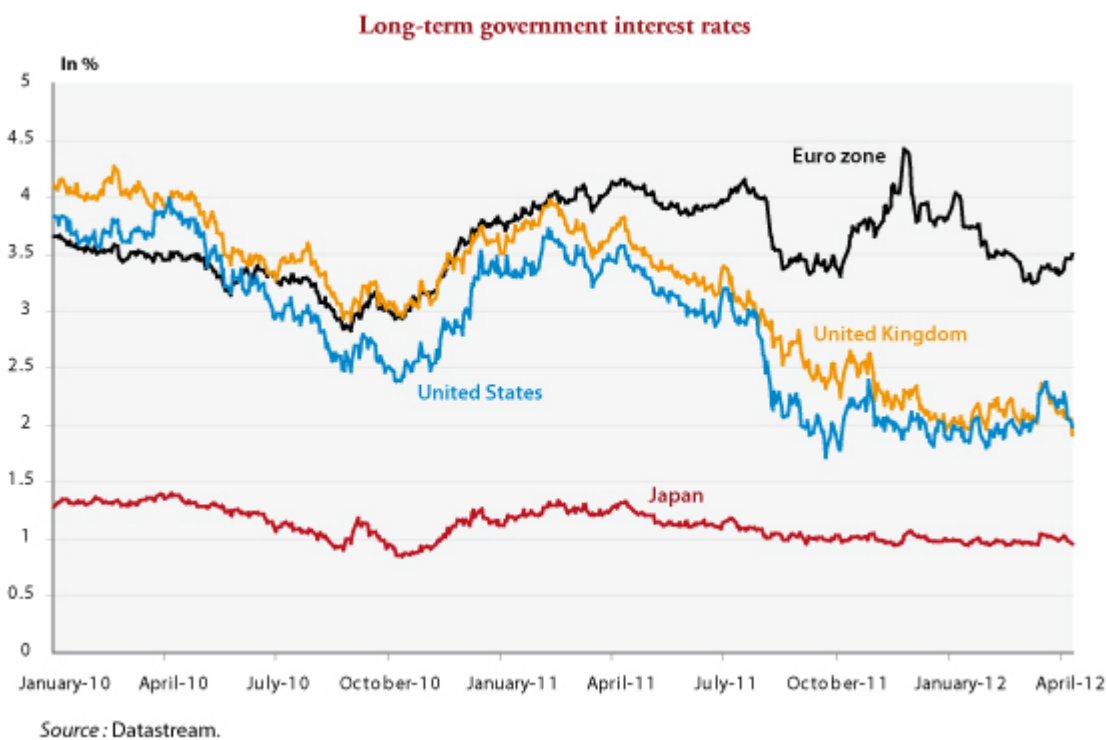
The euro zone is still in crisis: an economic crisis, a social crisis and a fiscal crisis. [The 0.3% decline in GDP in the fourth quarter of 2011](#) is a reminder that the recovery that began after the great drop of 2008-2009 is fragile and that the euro zone has taken the first step into recession, which will be confirmed in early 2012.

The fall in the average long-term government interest rate in the euro zone seen since the beginning of the year has come to a halt. After reaching 3.25% on 9 March, it rose again due to new pressures that emerged on Italian and Spanish rates. Indeed, despite the agreement to avoid a default by Greece, Spain was the source of new worries after the announcement that its budget deficit had reached 8.5% in 2011 – 2.5 points above the original target – and the declaration that it would not meet its commitments for 2012, which has reinforced doubts about the sustainability of its debt. The Spanish situation illustrates the close link between the macroeconomic crisis and the sovereign debt crisis that has hit the entire euro zone. The implementation of fiscal adjustment plans in Europe, whose impact is being amplified by strong economic interdependence, is causing a slowdown or even a recession in various euro zone countries. The impact of synchronized

restrictions is still being underestimated, to such an extent that governments are often being assigned targets that are difficult to achieve, except by accepting an even sharper recession. So long as the euro zone continues to be locked in a strategy of synchronized austerity that condemns in advance any resumption of activity or reduction in unemployment, the pressure will not fail to mount once again in 2012. Long-term public interest rates in the euro zone will remain above those of the United States and the United Kingdom (see the figure), even though the average budget deficit was considerably lower in 2011 in the euro zone than in these two countries: 3.6% against 9.7% in the US and 8.3% in the UK.

To pull out of this recessionary spiral, the euro zone countries need to recognize that austerity is not the only way to reduce budget deficits. Growth and the level of interest rates are two other factors that are equally important for ensuring the sustainability of the public debt. It is therefore urgent to set out a different strategy, one that is less costly in terms of growth and employment, which is the only way to guarantee against the risk that the euro zone could fall apart. First, generalized austerity should be abandoned. The main problem with the euro zone is not debt but growth and unemployment. Solidarity must be strengthened to curb speculation on the debt of the weaker countries. The fiscal policies of the Member states also need to be better coordinated in order to mitigate the indirect effects of cutbacks by some on the growth of others [1]. It is necessary to stagger fiscal consolidation over time whenever the latter is needed to ensure debt sustainability. At the same time, countries with room for fiscal manoeuvre should develop more expansionary fiscal policies. Finally, the activities of the European Central Bank should be strengthened and coordinated with those of the euro zone governments. The ECB alone has the means to anchor short-term and long-term interest rates at a sufficiently low level to make it possible both to support growth and to facilitate the refinancing of budget deficits.

In two exceptional refinancing operations, the ECB has provided more than 1,000 billion euros for refinancing the euro zone banks. This infusion of liquidity was essential to meet the banks' difficulties in finding financing on the market. It also demonstrates the capacity for action by the monetary authorities. The portfolio of government debt securities held by the ECB at end March 2012 came to 214 billion euros, or 2.3% of euro zone GDP. In comparison, in the United States and the United Kingdom, the portfolio of government securities held by the central banks represents more than 10% of their GDP. The ECB therefore has significant room for manoeuvre to reduce the risk premium on euro zone interest rates by buying government securities in the secondary markets. Such measures would make it possible to lower the cost of ensuring the sustainability of the long-term debt.



[1] See “He who sows austerity reaps recession”, [OFCE note no. 16](#), March 2012.