Sunday Wrap

Happy Sunday,

This past week, on the occasion of its Annual Meetings, the IMF published its new global forecasts in the World Economic Outlook (the WEO) and its thoughts on fiscal policies in the Fiscal Monitor, titled "Strengthening the Credibility of Public Finances". What a strange title of this key fiscal publication now 18 months after fiscal policy came to the rescue of the world (that's what I call credibility) and now needs to take over from monetary policy! Let me explain:

The global growth forecast was revised down only marginally from the July report (to a still robust 5.9% this year, followed by 4.9% next year), but the aggregate disguises a greater moderation in growth among the industrialized countries (mostly due to supply constraints) as well as in several low-income countries (mostly COVID related), while the forecasts for several commodity producers were revised up.

I share the concern that the global recovery may peter out once we get through the pre-pandemic GDP levels, and hence well before we get back to the extension of the pre-pandemic trend line. (I have discussed this in recent weeks, as you may know.)

We are likely to get a significant drag from China as their credit impulse is now turning south big-time (there is a strong correlation between the Chinese credit impulse and global manufacturing PMIs 12 months later) and their coal and electricity prices are skyrocketing. Meanwhile, the policy mix in the OECD area is unlikely to help get us to where we ought to be in terms of GDP levels.

In a nutshell, monetary stimulus is about to be reduced almost everywhere: In the US and UK for quite good reasons because of the inflation outlook (in the US helped by the fiscal stimulus, in the UK sadly because of additional post-Brexit supply issues), while in the eurozone it'll be driven mostly by the urge to end PEPP. But across all the different reasons for a reduction in monetary stimulus I have heard this past week lies a common theme of discomfort with the level of QE and/or balance sheets. But will fiscal policy fill the void?

The FT's Martin Wolf put it succinctly in his piece on Wednesday: "As economies exit the pandemic, [policy] assistance can be less generous and better targeted. This means that it should come from the fiscal authorities. High-income countries confront no fiscal crisis. The premature austerity that followed the global financial crisis must not be repeated…. Meanwhile, a number of central banks need to start withdrawing today's ultra-loose monetary policy. Such a rebalancing of fiscal and monetary policies would help both the people and the economy… In the US and UK, the time for this is now."

Note that Martin Wolf (rightly) did not include the eurozone here and yet, the eurozone is more at risk than most other places of not letting fiscal policy do its job – because of a misguided understanding of what "fiscal credibility" is.

I'll elaborate on this in three segments today:

- **On Friday, Germany took a big step closer to forming an unprecedented 3-party coalition, and – as expected – it looks like they'll pencil over the apparently unresolvable conflict between an obsession with the debt brake and a clear public demand for more investment. This will complicate Germany's fiscal policy and muddle the much needed update of the EU's fiscal rules.**

- **The European leadership vacuum on fiscal policy. The ESM's Klaus Regling has stepped up his attempt to help get European policymakers to appreciate the obvious need for better fiscal rules – without saying what exactly he thinks they should be …**

- **... So I'll give you my view on that - not that I have any illusion …**

1. The next German government in the making: Penciling in over the otherwise conflicting demands of fiscal policy.

Friday afternoon, the SPD, the Greens and FDP announced that they have made major progress towards forming a coalition government. The present state of negotiations is summarized in a 12-page so-called "results of soundings" paper, which – as my colleague, Andreas Rees, put it – bears the hallmarks of a classic compromise. It'll form the basis for the coming weeks' detailed negotiations which almost certainly will result in a new government in about two months' time.

As expected, the three parties haven't managed to cut the Gordian Knot of German politics: On the one hand, they agreed to stick with the debt brake (which will limit the structural budget deficit to 0.35% of GDP from 2023) while, on the other hand, substantial increase public investment without raising taxes or cutting pensions. As Andreas has pointed out, to square the circle, they'll most likely end up creating some sort of off-budget funds and/or build up a huge reserve in next year's budget.

The same messy approach is implicitly reflected in their outline for the European fiscal rules: They stress the importance of the Stability and Growth Pact, noting that it's been flexible enough to allow for the response to the crisis. Yet, they also commit to much higher public investment throughout Europe, particularly for climate change. But maybe – just maybe – there is enough wriggle room here to declare the climate change a crisis which also justifies flexibility?

All in all, the agreement so far between the three parties sounds a lot like the expectations for the next German government which I have discussed in recent weeks: There'll be a sea-change in the attitude to public investment (great), there'll be a more concrete commitment to Europe (great), but it'll be done in a less transparent way than what it should be, which will complicate European policies (bad).

To be sure, Germany is far from the only country that struggles to make its fiscal approach transparent and predictable.

At the extreme, in the US, the Congressional Republican minority is repeatedly attempting to block President Biden's policies by refusing to increase the debt limit (incidentally debt incurred by fiscal decisions agreed on in previous years by the very same members of Congress), thereby threatening to force a default on the federal government's debt. (Latest, they agreed not to filibuster a moderate increase in the debt ceiling, which will take us to early December, when the music then will likely start again.)

Apart from seemingly trying to violate the US Constitution ("the validity of the public debt …shall not be questioned" is written into the US Constitution's 14th amendment), this strategy is obviously irresponsible beyond what any reasonable person would expect of a civilized democracy. Personally, I don't understand the relatively relaxed attitude to this suicidal gamesmanship by most observers, including markets and credit rating agencies. The fact that you survived Russian Roulette a few times does not mean that you'll keep being lucky.

And in the UK, we learned on Friday that Chancellor Rishi Sunak has asked the Office for Budget Responsibility to produce the forthcoming budget forecasts on the basis of outdated (and more pessimistic) data than what's now available. By doing so, he'll almost certainly be able to show a big improvement for the following budget in a year's time, "raising his chances of having a public finance windfall for pre-election tax cuts", as Chris Giles put it in the Weekend Edition of the FT.

2. The European leadership vacuum on fiscal policy.

As you know, the EU's fiscal rules are presently suspended to deal with the pandemic, but on present policy, they'll be re-instated from 2023 on, which means that any decision to change the rules to something more appropriate will need to be made by the spring of next year.

To remind you, the fiscal rules include the requirement of a simply defined nominal budget deficit below 3% of GDP, although reinterpreted following the previous crisis as a structurally balanced budget within the constraint of reducing public debt above 60% of GDP by one-twentieth per year until it reaches the 60% of GDP level. While the change almost ten years ago to focus on the structural budget balance was an analytical improvement, it has proven operationally problematic because of the uncertainties associated with the estimation of potential output. While a meaningful longer-term concept, it has simply varied

too much over short periods of time to be a constructive guide for the annual fiscal policy processes. The IIF's Robin Brooks has documented this extensively in recent years, and I have written a fair chunk on it as well.

Yet, any change of the rules will be complicated by the requirement of unanimity – and the incomprehensible objection to a change by a small number of small member states, led by The Netherlands and Austria. To overcome such opposition, we'll need serious leadership in coming months, leadership that – realistically on this topic – can come only from Germany, France and/or the European Commission.

However, with the German government in caretaker mode and the next coalition still in its early stages of negotiations (and with a very vague stance on the issue) and France moving towards its own election campaign, such leadership really needs to come from the European Commission. But the Commission is fighting its own civil war on this issue, with the two most relevant commissioners, Dombrovskis (against a change in the rules) and Gentiloni (in favor) at odds, and with, as far as I understand, von der Leyen taking virtually no interest in the topic.

In recent weeks, the ESM's Klaus Regling has stepped into this most unfortunate vacuum to help provide some much-needed intellectual leadership to persuade the decision-makers throughout Europe that the rules really need to be changed. While Regling is uniquely placed to drive this debate (in previous roles he played a key role in the design of the existing rules as an aide to then German Finance Minister Waigel, and in policing them as a top economic official in the Commission), I am not sure he'll win this debate, unfortunately – un less he can trigger a forceful engagement by Scholz, Macron or von der Leyen.

Most recently in an interview with Der Spiegel on Friday, Regling reminded us, "The world is a different place today. Many things that were right in the mid-1980s are not necessarily relevant in today's economic environment anymore" – adding that "debt is increasing, but due to low interest rates, the debt burden has decreased significantly".

When the apparently skeptical interviewer asked: "But would not the Stability Pact lose all credibility if the debt rules were eased further?", Regling makes the single most important point in this entire debate, by noting that "you can also lose credibility by sticking to rules that have become economically nonsensical." The relatively short interview is worth reading in its entirety. It's here in English: Klaus Regling in interview with Der Spiegel

Understandably, Klaus Regling has stopped short of suggesting what exactly he thinks the new rules should look like – so let me try and help ….

3. My two cents on the need for better fiscal rules.

What Klaus Regling - and everyone else arguing for a revision of the rules - points out is that during the past two to three decades, globalization and demographics have put downward pressure on wages and inflation, which has contributed to a lower natural interest rate, with clear implications for both public and private debt – as well as for investors' asset allocation. In addition, the urgent need to address climate change, to bring Europe properly into the digital age, to navigate what appears to be the end of the post-1989 peace dividend, etc., surely call for different parameters and priorities than what guided policymakers 30 years ago.

In a note published by PIIE in February, Blanchard, Leandro and Zettelmeyer argued that the world will always be too uncertain for predetermined fiscal policy rules to be helpful. They recognize the usefulness of the safety valve in the form of the right to suspend the rules, but what good are rules which can, and will, be suspended when they become inconvenient? (The core of Regling's concern about credibility.) Therefore, rather than relying on "rules", Blanchard et al proposed a set of fiscal "standards" to guide fiscal policy.

As I discussed back then, I really like Blanchard et al's approach, but the European political reality is such that "rules" will have to remain the anchor of European cooperation. So, let me use the opportunity to suggest a compromise.

The undisputable key to any approach in this area is, of course, public sector debt sustainability, which – importantly – is a function of several factors, including debt levels, debt service costs, growth, tax revenue and political commitment.

To capture this, I suggest two anchors:

First, "standards" are needed for a growth enhancing distribution between public investment and consumption, but within an overall objective of a declining debt ratio during "good years" for the highest indebted member states.

Second, we need a higher-frequency "rule" to flag potential trends early on which might compromise future public debt sustainability. The best such rule is a cap on projected interest payments as a share of fiscal revenue because it is forward looking (given the existing maturity structure of debt) and yet it does not include the uncertainties of forecasting.

Let me explain:

The "standards" for a healthy budget composition should include an agreed on minimum ratio of public investment, including for climate change, and maybe for education and defense, relative to GDP. Policymakers should also agree on a "rule" that countries with public debt in excess of a certain level of GDP (e.g. 100% of GDP – but let's be clear that this will always be a somewhat arbitrary level to settle on) will reduce that ratio during "good years". I define "good years" as years when the level of GDP exceeds its estimated potential, i.e. the country runs a positive output gap. Given the uncertainties associated with the estimation of potential output, historical averages would be my preferable measure.

This "trend-objective for debt levels" should really be symmetric. You can have "too much" debt, but you can also have "too little" debt, particularly if you hope for currency to gain a role in international trade and finance.

In addition to the trend-objective-for-growth, a higher-frequency measure of developments in debt sustainability, properly defined, should be added to leave zero room for doubt about the sustainability of European public debt. In a well-functioning civilized society, there must be no question about the validity of (and commitment to) the signature of the democratically elected government, including for debt creation.

To fully grasp the issue of public debt sustainability, it is important to recognize that - apart from the most extreme cases of failed states - default on public debt is always the result of a political decision. The very role of governments is to prioritize competing demands on its resources, and to decide the level of those resources via taxation and the potential disposal of public assets.

In a quantitative way, therefore, public debt sustainability is a function of the share of available resources needed to service the debt, and the political commitment to honor its and its predecessors' signature on the loan documents, versus other subsequent contractual, and non-contractual – but maybe, nonetheless, politically important – commitments, within the willingness to tax society.

With this in mind, the single most important gauge of debt sustainability is the ratio of interest obligations to public revenue. Because the average maturity of the public debt stock in Europe is roughly seven years, the interest/revenue ratio is the most forward looking and relevant concept available without the uncertainties of forecasting. Even a sudden and sizable increase in interest rates would only begin to burden the budget after several years.

In the US, Summers and Furman have suggested the closely related concept of interest obligations over GDP as a key ratio to watch. The idea is that GDP provides the basis for additional taxation, should that be necessary. Yet, history tells us that during economic downturns (when GDP typically drops further than fiscal revenue), the appropriateness – and political willingness - to raise taxes is far from straightforward. Yet, whether one considers revenue or GDP as the more appropriate denominator is a matter of taste (and who am I to disagree with Summers and Furman – although here I do…). Revenue resembles "the one bird in the hand", while GDP resembles "the ten birds in the bush".

Prior to the COVID crisis, public sector interest payments as a share of fiscal revenue in the EU stood at about 3.5%. It was 1.5%-2.0% in several Northern European countries, including Germany, 3.0%-3.5% in France and about 8% in, e.g., Italy and Portugal. (It was 6% in the UK). During the three years prior to the Greek debt restructuring in 2012, the Greek government paid 15% of its revenue in interest payments; the restructuring helped lower that ratio to roughly 6% last year. (Greece typically paid 20%-30% of its revenue in interest on debt during the late 1990s before adopting the euro; unfortunately, the windfall was not put to good use.)

The ratio is a simple function of the interest rate levels during the past roughly seven years (the typical average length of European public debt maturities), the debt stock and fiscal revenues. The interest rate charged on public borrowing by investors is a function of ECB policies, markets' assessment of fiscal sustainability in the individual countries as well as the availability of alternative investment opportunities. Fiscal revenue is a function of GDP and taxation levels, of course.

Given the higher debt levels now and the apparent political willingness to begin withdrawing policy stimulus well before European GDP catches up with its pre-pandemic trend, it seems reasonable to expect the ratio to increase from the pre-COVID levels by maybe up to one percentage point in most countries during the next year or two, depending on developments in the pandemic and the abilities of the economies to rebound.

More structurally, with interest rates presently compressed to the zero lower bound by ECB policies, it is reasonable to expect – indeed hope for - a future of higher interest rates. It's also reasonable to expect – and indeed hope for – a future of greater appreciation among investors of the interconnectivities of European economic policies. The forthcoming change of guard in Berlin (not only with respect to the government by also the Bundestag) will serve this message well. And, while the Republican side of the US Congress is okay with playing Russian Roulette, markets – and the credit ratings agencies – ought to appreciate European sovereigns' indisputable commitment to their public debt.

That said, if overall borrowing costs for sovereigns move higher in coming years, as is indeed likely, the public sector interest-to-revenue ratio will increase to the extent the interest rates charged by markets move higher at a faster clip than nominal fiscal revenues. Ultimately, whether this will happen or not will depend on the answer to a series of questions mostly around the quality of fiscal policy; hence, the need for the "standards" for sustainable, growth enhancing, fiscal policies, as discussed above. (And no, please don't buy into this latest scaremongering of stagflation. Critically different from the 1970s, long term inflation expectations remain well anchored and today's undisputed central bank credibility will keep it that way.)

But one thing is clear: Given the relatively long average maturities for public debt, the process of driving the critical interest/revenue ratio in one direction or the other will be a gradual one. It is therefore appropriate to assess it on a rolling 2 to 3-year basis.

What level of interest/revenue may be considered problematic is a matter of judgement, particularly with respect to the political commitment of present and future governments to honor the obligations to creditors versus those to other political constituencies. The European Council could consider a repeated projection over a 12 to 18-month period of an interest/revenue ratio above 10% as a yardstick for a "yellow warning light", which would trigger more comprehensive discussions about the need for policy adjustments, with more concrete demands for corrective policy measures kicking in at a projected ratio of 12%-13%. Such a policy would also help incentivize governments to further lengthen the maturity structure of their debt now in order to lock in the presently low interest rates.

Before the suspension of the fiscal rules, a breach of the rules triggered a relatively automatic phasing in of sanctions, starting with recommendations by the Commission, which would go into effect unless revoked by a qualified majority among eurozone members of the Council. Ultimately, fiscal policy is the domain of the national parliaments – but so is the commitment to the EU's fiscal resources. It seems reasonable to me, therefore, for the Council to begin withholding financial transfers to a member state which breaches fiscal standards and rules, after appropriate warnings.

So, with that dream of informed fiscal policy leadership in Europe, I'll leave you for today. I hope the rest of your Sunday will be a good one.

Best

Erik

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