BANQUE DE FRANCE
EUROSYSTÈME

FISCAL RULES, DEBT SUSTAINABILITY & INFLATION

BANQUE DE FRANCE – CEPR WORKSHOP ON FISCAL GOVERNANCE

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Usual disclaimer applies – Views expressed here are personal

THE 'SEPARATION PRINCIPLE' BETWEEN MONETARY AND FISCAL POLICIES WHICH PREVAILED AT THE START OF EMU…

- Monetary policy
  - Price stability → independence & prohibition of monetary financing
  - Common shocks

- Fiscal policies
  - Fiscal sustainability → public debt and deficit limits/rules (SGP)
  - Country-specific shocks → automatic stabilizers if adequate buffers

…HAS SOMEWHAT BEEN BLURRED OVER TIME

- ‘Lowflation’ environment of the past decade
  - Interest policy constrained by low r* and the ELB
    - Unconventional monetary policy → purchases of government bonds
    - Fiscal policies: more effective (higher multipliers at the ELB) with more space (r<g)

- Current inflation environment
  - Not only demand shocks but supply shocks and relative price shifts
    - ‘Unconventional fiscal policies’ in order to mute the effects of the increase in energy prices
  - Impact of higher interest rates on the consolidated central bank-government budget constraint
    - Remuneration of excess reserves in order to keep control of market interest rates in a floor system

HOW TO ENSURE A COHERENT AND TIME CONSISTENT POLICY-MIX WITHOUT ENDANGERING MONETARY INDEPENDENCE ?

- Need to prevent not only fiscal dominance but also overburdening monetary policy
  - Not credible/desirable: emergency fiscal facility [des-]activated by the central bank (e.g. Blackrock 'Going direct' proposal)

- MP and FP should remain fully independent but with clear, credible and predictable reaction functions
  - Mainstream practice for central banks (although easier in theory than in practice)…
    - Mandate/objective/instrument, Taylor-type rules, communication/guidance, sequencing/exit
  - …but not for fiscal authorities
    - Disciplinary fiscal rules (limits/constraints) do not remove the need of more explicit fiscal reaction functions
    - Annual budgetary process
    - Weak central coordination of national fiscal policies

HOW TO EXPLICIT FISCAL REACTION FUNCTIONS ?

- **3 types of approaches (which are not mutually exclusive)**

1. **Taylor-type fiscal rules**
   - Carnot (2014), Fournier (2019)
   - Proscribing vs. Prescribing/Benchmarking rules ; Outcome-based vs. Instrument-based rules
   - Short term economic stabilization under LT debt sustainability constraint ; feed-back mechanisms - > expenditure rule linked to a debt anchor

2. **Semi-automatic stabilizers**
   - Blanchard-Summers (2020)
   - Triggers for entry/exit
   - Could also work for 'unconventional'/emergency fiscal policy measures

3. **Commitment on the medium-term path for the fiscal instrument**
   - National medium-term fiscal/structural plans (Commission's proposal)
   - Operational instrument trajectory (unlike outcome trajectory in Stability programmes): net primary expenditure, i.e. net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure

- **Those approaches are no substitutes to the broader fiscal discipline framework and should be consistent with it**

WHAT COULD FACILITATE A MORE CONGRUENT POLICY-MIX FROM THE CENTRAL BANK'S STANDPOINT ?

- Expenditure benchmark : in nominal terms based on the ECB's symmetric 2% inflation target?
  - Tighter (resp. looser) fiscal stance when inflation is above (resp. below) 2%
- Expenditure benchmark : not excluding interest payments?
  - Automatic feedback mechanism when the cost of debt increases/diminishes
  - Tighter (resp. looser) fiscal stance when interest rates rise (resp. decline)

- Reminder: the use of the Eurosystem toolkit (PEPP flexibility, TPI, OMT) requires a credible and effective European fiscal framework