The new fiscal reality

By Jean Pisani-Ferry

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"When the facts change, I change my mind. What do you do, sir?" This, reportedly, is how Keynes replied to the criticism that he had changed his position on the policy response to the Great Depression. Pragmatism of this sort is not that common: policy views are often characterized by considerable inertia. Too frequently, today's perspectives remain shaped by yesterday's facts.

Fiscal policy is a case in point. Facts have changed in two significant ways. First, for sovereign states long-term borrowing costs are exceptionally low. At end-October, the annual yield for government bonds issued by France, a country with public debt approaching 100% of GDP, was 0.5% for ten-year bonds and 1.6% for 50-year bonds. Italy and Spain, both of which faced investors' reluctance five years ago, have also been able to tap the market for 50-year bonds. As long as high demand for government debt securities lasts (a subject of debate among economists), it offers an unprecedented opportunity to finance public investment.

A key factor in determining whether to borrow is the difference between the rate of nominal GDP growth and the interest rate: if it is negative, debt can easily be repaid, because nominal income grows faster than the interest burden. Using the (fairly miserable) past as a yardstick, it is hard to believe that French nominal GDP will increase by less than 0.5% annually over the next ten years: from 2005 to 2015, nominal growth averaged 2.1%. So low interest rates are an opportunity that should not be missed.

The second way facts have changed is that output growth has been disappointing. In its latest World Economic Outlook, the International Monetary Fund noted that, despite the drop in oil prices and favorable monetary conditions, output and investment in advanced countries have consistently remained below expectations over the last two years. The outlook for the eurozone is especially underwhelming: the IMF expects output growth to slow from 2% in 2015 to 1.7% in 2016 and 1.5% in 2017.

With the European Central Bank's asset-purchase program close to reaching its limits, an investment-oriented fiscal stimulus would help reverse this weakening. It would also help reverse the slump in public investment experienced by several countries as a consequence of fiscal austerity in recent years.

But, while facts have changed, minds have not. On average, governments are using the gains implied by lower interest rates to spend a bit more or to reduce taxes, rather than to launch comprehensive investment programs. The IMF expects the structural fiscal balance for the eurozone to be roughly the same level in 2017 as in 2014. The same applies to the United States. Some countries, like the United Kingdom, are still in a fiscal tightening phase. Italy is in an expansionary phase, but it is facing criticism from the European Union for non-compliance with its commitments under the Stability and Growth Pact (SGP). Overall, there is no discernible momentum in either direction.

But is there really fiscal space for action? With gross public debt close to 100% of GDP in the US, the UK, and the eurozone, and much higher in Japan (though net debt is less frightening), there is admittedly cause for concern. Market sentiment can change quickly, and some European governments remember how precipitously they were forced to change course in 2010-2011, after having embarked on fiscal expansion. It would be unwise to assume that low interest rates will last forever and simply relax fiscal discipline.

The solution is an approach that combines, on one hand, the continuation of fiscal consolidation, with a view to putting the debt-to-GDP ratio on a steadily declining path, and, on the other hand, special investment programs financed at exceptionally low interest rates. This would serve the medium-term goal of public-finance sustainability, while treating the interest-rate level as a one-off windfall that can be used to address priority investments and strengthen growth potential.

There are several types of investments worth undertaking. In some countries – especially the US – infrastructure is in need of a significant upgrade. In others, like Spain or France, human capital should be given priority, with an emphasis on improving school performance and the skills of the labor force. For countries that must invest in reforms, budgetary support would help overcome political obstacles to institutional transformation. Mitigation of climate change through investment in renewable energy, insulation of buildings, and low-carbon transportation networks is an overwhelming requirement in virtually all countries. In several areas, well-chosen investment – for example, upgrades of equipment and information systems in health care – could even reduce future public spending, thereby strengthening long-term fiscal positions.

In the EU, it is sometimes argued that the way to trigger these investments is to exclude capital spending from the SGP and monitor only the balance for current spending. This would not be the appropriate solution. Brick-and-mortar public investment is often less valuable than spending on education or institutional improvement, and can end up financing "white elephants" of dubious social worth. Moreover, there are few arguments for treating capital spending separately under normal economic conditions. What applies to the current zero-interest rate environment should not be made permanent.

Rather, governments should borrow now to finance special physical and institutional investment programs to be carried out over the next few years. These programs should be given defined goals and be subject to strict governance. In the EU, they should be exempt from SGP rules, but subject to an assessment by the European Commission that they contribute to improving growth and fiscal sustainability in the medium term. And they should be designed in such a way that they can be interrupted if bond-market conditions normalize and interest rates return to historical levels.

We should not be hostage to a false choice between budgetary responsibility and economic revitalization. The facts have changed. We can do both.

Jean Pisani-Ferry is a professor at the Hertie School of Governance in Berlin, and currently serves as Commissioner-General of France Stratégie, a policy advisory institution in Paris.