Europe must fix its fiscal rules

By Olivier Blanchard

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In an environment of persistently low interest rates and below-potential output, economic policymakers must rethink the prevailing approach to public debt. For the eurozone, this means creating a common budget, or at least overhauling the fiscal rules that have tied member-state governments' hands for no good reason.

Earlier this year, I argued that in countries where interest rates are extremely low and public debt is considered safe by investors – making it less costly from both a fiscal and economic standpoint – larger fiscal deficits may be needed to make up for the limitations of monetary policy. The eurozone has now reached this stage.

After the 2008 financial crisis and subsequent euro crisis, monetary policy played a key role in stabilizing and reviving the eurozone. It took pragmatism, creativity, and political flair on the part of European Central Bank President Mario Draghi to accomplish this feat. But while monetary policy hasn't quite run out of fuel, it cannot be expected to serve the same role again.

By contrast, fiscal policy, the other key component of sound Keynesian macroeconomic management, has been underused as a cyclical tool, with the result that eurozone output still is not at its potential level. This is an urgent problem that cannot be solved by any one country alone; it demands a concerted eurozone response. But while the need for a common eurozone budget from which to draw additional spending is more pressing now than in the past, this would entail risk-sharing among the member states, which is a politically difficult issue.

Still, there are other measures the eurozone could pursue, starting with a fiscal rule change. With interest rates so low, a 60% debt-to-GDP limit is not the right target (if it ever was to begin with). Not only should it be higher, but the requirement that member states that exceed the limit adjust back to it at a certain speed should be loosened. Moreover, because monetary policymakers have little room to maneuver, the European Union must grant governments more freedom to stimulate demand through fiscal policy. That means loosening the 3%-of-GDP limit on fiscal deficits, too.

To be sure, governments should not be given *carte blanche*; but they should not have their hands tied so tightly, either. What the EU needs is a new rule-making philosophy. The eurozone has gone so far in piling up constraints, on the assumption that governments will always misbehave or try to cheat, that the result is sometimes incomprehensible.

As a first step, the European Commission should stop micromanaging member states' fiscal policies. The Commission should intervene only when a government is on a trajectory toward amassing truly unsustainable debt (which certainly can happen under irresponsible leadership). Otherwise, the Commission's main job should be to provide information to the markets about the health of a member state's economy and its likely path of debt.

This way, the markets would decide. Fiscal space, after all, is in the eye of the investor. Japan has a large public debt, but investors do not seem worried; Italy, where investors are now demanding a large risk premium, is another matter. The challenge for a member-state government, then, would no longer be to please the Commission, but to convince

investors that it is operating responsibly with respect to the debt.

As a second step, the eurozone must improve its fiscal- and monetary-policy coordination. (In fact, it has always needed to do this; but now the matter is especially urgent.) At this stage, monetary policy cannot do the job alone. Stimulus must take the form of a fiscal expansion to make up for what the ECB cannot provide. Yet no country has an incentive to do this on its own, because, with member states so deeply integrated, some share of any fiscal expansion will inevitably be lost to spillover in the form of increased imports.

What is needed, then, is either a coordination device through which each country commits to a larger, self-financed fiscal expansion, or, preferably (but more controversially) a common budget, funded by euro bonds, which can then be used to finance higher spending in each country, when and if needed.

The stakes are high. Without higher limits on debt and better coordination – through a new mechanism or a common budget – fiscal policy will remain too tight, economic activity too low, and the risk of populists emerging to offer simplistic solutions too high. That is the last thing the eurozone needs.

Olivier Blanchard, a former chief economist of the IMF, is Professor of Economics at MIT and Senior Fellow at the Peterson Institute for International Economics.