ShowCASE

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Editorial

The ever-spiking budget deficits in 2020 and rather hazy outlook for 2021 lead many governments and economists to agree on the short-term need for fiscal stimulus in response to the Covid-19. Some, however, see the current willingness to expand public spending as a welcome indication of a long-term shift in government's approaches to fiscal policy.

Against this background, in this edition of showCASE we join a long-lasting debate on the appropriatness and relevance of the EU-wide fiscal rules as well as alternative approaches to public deficit and debt in the EU.

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Expansionary Fiscal Policy in Times of Covid-19: a Crisis Measure or a Long-Term Shift?

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A Shift in Macroeconomics?

From the onset of the pandemic, there has been a widespread acceptance among economists and governments that to protect households and firms and boost demand in response to the Covid-19 crisis, governments must temporarily accept a large increase in public debt.

The OECD argues that in case the recovery lacks vigor, it might be necessary to continue expansionary fiscal policy for a sustained period to stimulate broader household consumption and business investment. This willingness to increase government spending, with government debt reaching up to 89.8% of GDP in the EU in Q3 2020 (up from 79.3% in the same period the year before), represents a new way of thinking in macroeconomics for some, while being strictly a crisis measure for others. In this edition of showCASE, I will shed light on the ongoing debate on fiscal policy and debt sustainability and will discuss its potential impact on the future of fiscal policy.

Debt Sustainability in the EU

Following the 2008 crisis, the European Commission introduced changes in the EU fiscal policy that strengthened the monitoring of Member States' budgetary position and aimed to encourage more responsible budgeting. The crisis showed a weakness in the EU's economic governance and demonstrated a need for increased policy coordination to prevent the rise of imbalances and to ensure stability. There is now a greater emphasis on improving public finances in structural terms including more guidance on how to achieve this, combined with a better warning system of unsustainable debt and wider sanctioning options.

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Nevertheless, one could argue that two reference values remain central. While routinely surpassed by a portion of the Member States – for e.g., reaching close to 180% in Greece, exceeding 120% in Italy, and nearing 100% in France and Spain in 2018/2019 – the 60% gross debt-to-GDP ratio and the 3% of GDP overall deficit limit arguably retain an important role in the eyes of the public as an insurance that Member States would not take on excessive, or in other words, unsustainable, debt.

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Already before the outbreak of the Covid-19 pandemic, Blanchard has repeatedly argued that in an environment of low interest rates, public debt can be increased without significant fiscal costs if the growth rate exceeds the interest rate – a major intellectual shift in macroeconomics. According to Blanchard, increased government spending can be vital for securing the livelihoods of workers or the survival of businesses. Inversely, the economic costs of not doing so could be substantial. Choosing fiscal prudence out of a desire to remain below the debt limit of 60% would – in Blanchard's mind – be unwise, as the benchmark is highly context-specific and there is a room to increase public debt throughout the EU without running unmanageable risks.

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Not all Member States agree with that logic. In the Netherlands, the Studiegroep Begrotingsruimte (SBR), a nonpartisan national advisory group on budgetary principles, which has made recommendations on budgetary policy since 1971, recently issued their recommendations for the coming government term. The SBR claims that, while low interest rates make borrowing cheap, they certainly do not make it low risk.

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Currently, indeed, the difference between the interest rate and the growth rate is negative, which creates an ever-low debt quote. However, the SBR stresses that one cannot rely on this differential to remain negative. In the past, both the Netherlands and other countries have known as many periods of negative interest-growth differentials as periods of positive ratios. In case of a positive interest-growth differential, the deficit and debt will get bigger and bigger. On the other hand, even with a negative interest-growth rates differential, debt sustainability is not a given as interest rates could increase over time or once the European Central Bank (ECB) halts its loose monetary policy.

Fiscal Rules vs Fiscal Standards

'*There is no single, time-country-invariant, magic debt or deficit number*'. This is the key point made in a paper by Blanchard, Leandro, and Zettelmeyer. In the eyes of Blanchard et al., this conclusion has major consequences for the way debt sustainability should be assessed and enforced in the context of the EU and beyond. They argue that in the EU, fiscal rules based on the 60% gross debt ratio and the 3% overall deficit limit should make way for fiscal standards based on principles accompanied by guidelines.

> Therefore, they argue that rules should be abandoned altogether in favour of standards which are based on principles accompanied by guidelines.

Let us turn to the downsides and benefits of fiscal standards versus rules. To start, why is there a need for EU fiscal rules? Fiscal rules were designed to mitigate debt externalities in the course of the transition and formation period of the euro. The desire for transparent and simple rules was driven by the fact that national fiscal rules do not provide adequate constraints and a suspicion that some governments might, for opportunistic reasons and a short-term focus, take on unsustainable amounts of debt. The transparent and simple nature of the rules such as the 60% debt-to-GDP ratio and the 3% of GDP deficit limit was seen as essential for their credibility.

Blanchard et al. argue that, while in the formation period of the euro such rules might have been justifiable, over time they proved to be too restrictive and call for a major rethink. More importantly, in their opinion, the sheer complexity of the issue of debt sustainability, being highly time- and country-specific, makes it impossible to be captured *ex ante* using fit-all rules. Therefore, they argue that rules should be abandoned altogether in favour of standards which are based on principles accompanied by guidelines. These fiscal standards could be based on the current EU's fiscal principle that *'Member States shall avoid excessive government deficits'* (Article 126 TFEU) and would be followed by guidelines on how to apply the standards and methods on how to assess whether debt is excessive, or in other words, unsustainable.

In the panel discussion of Blanchard's paper on October 22, 2020, Davide Debortoli, Micheal McMahon and Jakob von Weizsäcker brought forward several challenges related to the proposal, touching upon communication, credibility, and urgency. According to von Weizsäcker, the possibility and application of escape clauses in the EU's fiscal rules already provides a level of flexibility sufficient to deal with the current crisis. Second, as mentioned by Debortoli, the application of standards can pose a threat to credibility. The use of complex econometric tools to assess debt sustainability without set limits creates a situation where even a more technical audience may be feeling left in the dark about the methodology of calculations. There is a risk that, just as the current 60% debt level is seen as arbitrary by opponents, so will be perceived the country-specific calculations of debt limit.

On this note, recent research highlights how politicised statistics are, with statisticians and politicians having a level of discretion in dealing with data. Mügge describes the way economic data is frequently used selectively and strategically, with the statistical practices of many countries falling into a grey area between full compliance and data manipulation.

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Relating to communication, a point highlighted by McMahon, standards and particularly the methods used to asses whether standards are met are very difficult to communicate clearly to the public. This is not to be taken lightly, as it is essential to the functioning of the EU that its citizens believe that there are clear rules in place which are uniformly applied and that, therefore, all countries are treated fairly.

Conclusions

Against the background of ever-spiking budget deficits in 2020 and rather hazy outlook for 2021, many governments and economists agree on the short-term need for fiscal stimulus in response to the Covid-19. Some economists see the current willingness to expand public spending as a welcome indication of a long-term shift in government's approaches to fiscal policy.

For the long-term, however, expansionary fiscal policy should be approached with caution, as we cannot rely on interest rates remaining low. If the ECB was to halt its loose monetary policy, interest rates could go up.

While acknowledging that the reference values for the gross debt-to-GDP ratio and the GDP overall deficit are routinely exceeded, for the EU to leave out these limits altogether would mean letting go of a certain form of safeguarding. To abandon the limits now included in its fiscal rules, and to make the shift from rules to standards, several things would be needed: a wider consensus among countries on the long-term benefits of taking on larger public debt as well as a higher degree of trust among member states to not take on an unsustainable amount of public debt. I would argue both of these elements are currently lacking.

For the near future this, in my view, will most likely lead to the continuation of the use of the escape clauses combined with minor adjustments of the EU's fiscal rules. Yet, while this analysis focused mainly on the EU's fiscal rules, in the absence of a fiscal union, domestic frameworks continue to play a major role in how budgetary policy is developed and implemented throughout the Member States. Within the boundaries of the EU's fiscal rules, Member States may seek to adjust their national fiscal governance with a leaning towards higher public spending.

Highlights

Trade, Innovation, and Productivity

On February 11, European Commission published its winter interim European economic forecasts. It shows that the EU real GDP is expected to grow by 3.7% and 3.9% in 2021 and 2022, respectively. The EU inflation rate is projected to increase slightly in 2021 – from 0.3% in 2020 to 1.4% - with a moderate decline to 1.3% by 2022. Member States, however, would experience different economic trends and speeds of recovery. For instance, the real GDP growth in Poland is expected to reach 3.1% in 2021 and 5.1% in 2022 with a 2.3% and 2.9% inflation rate in 2021 and 2022, respectively. The report suggests that the EU economy would reach the pre-pandemic level of production earlier than predicted in the earlier forecast as a result of a more substantial economic recovery in the second half of 2021 and 2022. Compared to the last forecasts, the report accounts for the recent developments of the epidemiological situation across Member States, launch of mass vaccination campaigns, and the effects of the Trade and Cooperation Agreement (TCA) reached between the European Commission and the United Kingdom on 24 December 2020.

Labour Market and Environment

In January 2021, the Ministry of Climate and Environment submitted the draft 'Polish Hydrogen Strategy until 2030 with a perspective until 2040' for public consultation. A document sets ambitious goals for the buildout of hydrogen technologies in Poland. It defines the goals and activities related to the development of national competences and technical infrastructure for building a low-emission hydrogen economy. They relate to the three sectors of hydrogen use – energy, transport, and industry as well as its production, distribution, and the necessary legal changes and financing. The publication of the draft Strategy is a positive signal as it gives hope that Poland will join other European countries at an early stage of creating new technological solutions and supply chains. It gives an opportunity to build national potential in a new industry and create jobs. The hydrogen strategy, however, has yet to be reflected in other governmental action plans on future priorities, thus one may wonder to what extent it will be incorporated in the ongoing green transition scheme.

Macro and Fiscal

On February 9, the European Parliament adopted the Recovery and Resilience Facility (RRF) Regulation, which paves the way for the Member States to officially submit their national recovery and resilience plans to access the funds under the RFF. The RRF with a total amount of EUR 672.5 billion is the main instrument of NextGenerationEU, a recovery plan to repair the economic and social damage caused by the Covid-19 pandemic where the disbursement of funds will be financed through borrowing on the markets. The RFF funds will be distributed in the form of loans (up to EUR 360 billion) and grants (up to EUR 312.5 billion). Spain and Italy have the largest access to the grants among the Member States with allocations of up to EUR 69.5 billion and EUR 68.9 billion in current prices, respectively. The largest grant amount that Poland could access under the RFF is EUR 23.9 billion in current prices. The member states can request a loan worth up to 6.8% of their 2019 Gross National Income under the RFF.

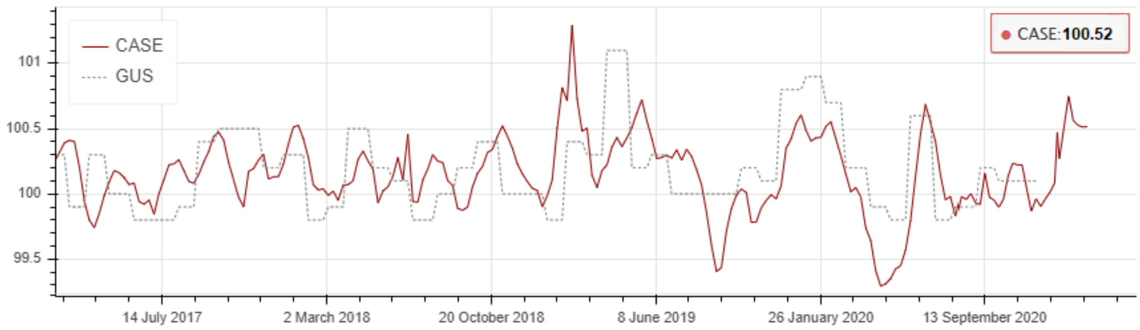
Other CASE Products

The Weekly Online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly. For more information on our weekly online CASE CPI, please visit: http://case-research.eu/en/online-case-cpi.

The mid-February readout of Online CASE CPI shows that inflation has not slowed down significantly compared to January. While the overall index has not fallen below a 100.5 level, the factors behind that measurement have changed since last month. Prices of "Food and Beverages", which previously drove the inflation, were on average the same as a month ago. On the other hand, we notice a significant increase in prices of "Transportation" (2%) and "Housing" (1.4%) with the latter being primarily caused by a 3.5% increase in prices of "energy carriers" (mainly electricity). It is worth to mention that average prices in certain categories of the inflation basket have dropped in February – for e.g., "Other goods and services" (by 0.8%) and "Health" (by 0.5%).

Our Weekly Online CASE CPI



Monthly CASE Forecast for the Polish Economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, investments, industrial production, growth of nominal wages, and the CPI.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2021	4.1	4.5	3.3	7.5	2.3
2022	4.0	4.5	6.5	5.9	2.7

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