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► **To cite this version:**

| Jean-Paul Fitoussi. Fiscal Indiscipline: Why no reaction yet by the markets?. 2005. hal-00972764

HAL Id: hal-00972764

<https://sciencespo.hal.science/hal-00972764>

Submitted on 3 Apr 2014

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European Parliament

COMMITTEE FOR ECONOMIC AND MONETARY AFFAIRS

Briefing paper n° 2 – May 2005

Fiscal Indiscipline: Why no reaction yet by the markets?

Jean-Paul Fitoussi

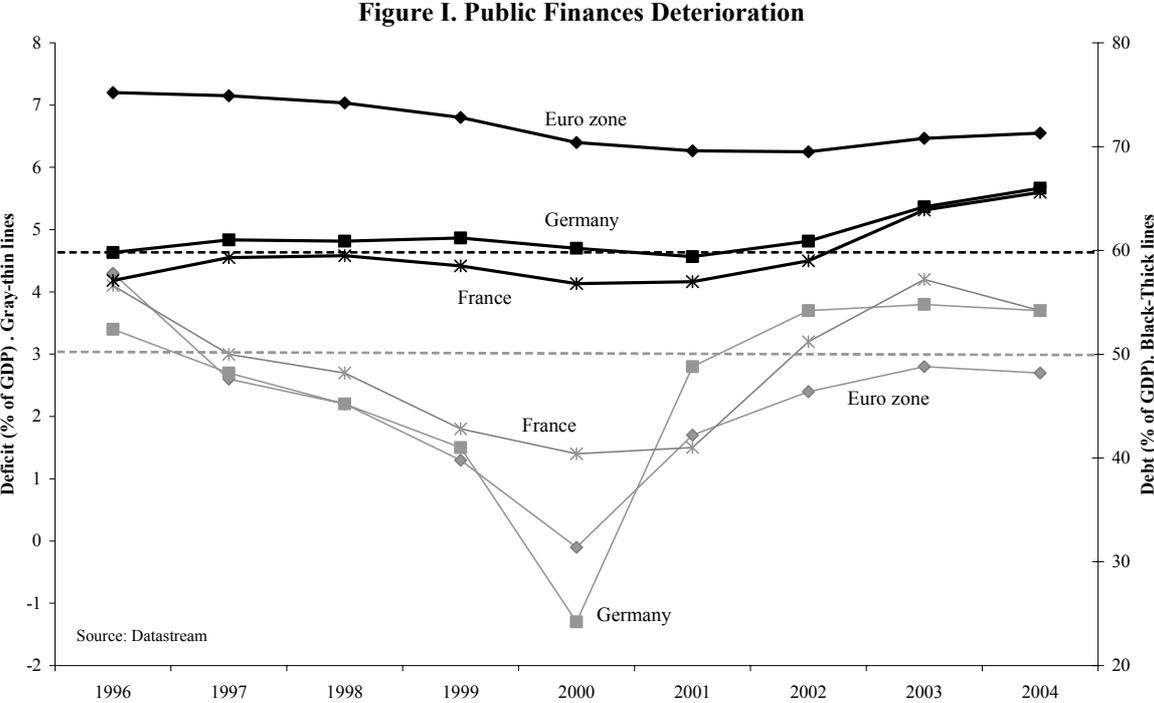
Executive Summary

Two stylized facts emerge as we observe the evolution of public finances in the past few years. The first is a general trend towards a deterioration of fiscal positions, mainly due to cyclical factors (the persistently deceiving growth performance of the Euro zone). The second, a remarkable lack of reaction of financial markets (long term rates) to this deterioration. This is a puzzling set of findings, as the theory tells us that long term rates should react to larger deficits either because they indicate future tightening of monetary policy, or because they require a risk premium. A first explanation of this puzzle is straightforward: markets have perceived the system as well designed in spite of the latest development and hence did not react to the worsening of fiscal position, seen as temporary and harmless; such an interpretation nevertheless may be dismissed on the ground that if the system was perceived as good and well functioning, its very recent modification (March 2005) should have triggered a negative reaction that until now did not materialize. A more convincing explanation recognizes that markets do not focus on public finances alone, but look at more general conditions concerning Saving and Investment. With such a global perspective in mind, long term sustainability does not seem more at risk today than it were a few years ago; hence, the lack of reaction of markets is all but paradoxical, but may simply reflect the lack of credibility of the current formal fiscal framework for Europe.

Introduction. A generalized deterioration of Fiscal Positions in the EMU.

The first five years of this decade have seen a general trend towards a deterioration of public finances in the Euro zone, and notably in the largest countries (Germany and France, but also Italy). Figure I shows that both debt and deficit, for France and Germany, have been above the Maastricht reference values since 2002. A number of smaller countries have seen their finances deteriorate as well, and the euro zone average is close to the limit.

The main explanation of this deterioration is the prolonged slowdown of the European economy. While the US quickly recovered from the 2001 recession, Europe got trapped in a period of slow growth, characterized by inertia in the conduct of both monetary and fiscal policies.



The fact that Germany and France were among the countries breaching the limits has given an important political impulse to the discussion of the reform of the current fiscal framework for the European Monetary Union, that after a sometimes confuse process yielded the reform approved by the Council in March 2005. The reformed Stability Pact should be more flexible, and should take into consideration country specific factors in the assessment of fiscal discipline. Quite interestingly for our purposes, the "New" Stability Pact has been received

with scepticism and concern by the ECB that publicly denounced it as a step towards fiscal relaxation¹.

The Puzzle of Interest Rates Inertia

Besides the direct effect on the demand of loanable funds, the evolution of public finances, deficit and debt is supposed to affect interest rates through two channels. The first is the variation in country risk that yields an increase in the rates investors demand to hold bonds in their portfolio. Country risk, even if very weak, can explain the persistence of differences in the interest rates we observe in a monetary union. The other channel is the expectation of changes in future monetary policy. Standard theory sees the long term interest rate as the average of expected future short term rates. If the fiscal position deterioration triggers the expectation of a future ECB rate increase aimed at contrasting inflationary pressures, then long rates should also show an upwards tendency. While the empirical evidence on the relationship between debt/deficit and long term rates is mixed², the main theoretical channels remain those we just outlined.

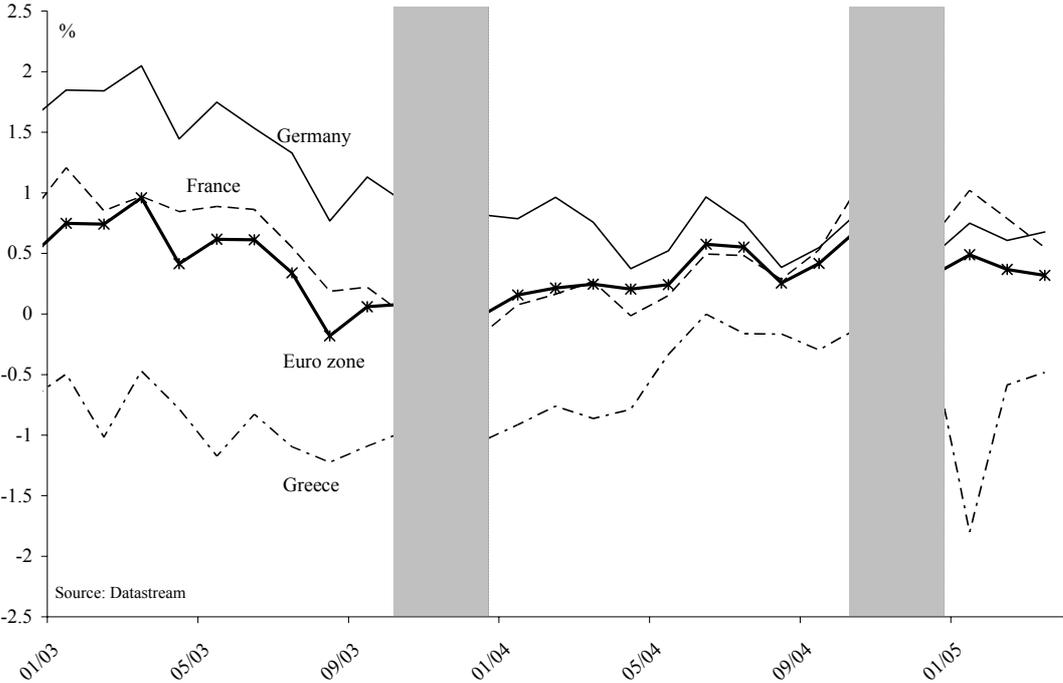
If we look at the behaviour of interest rates we can observe a second somehow puzzling fact. The past two years have witnessed increasing turbulence, with the European economies trapped in a low growth – high deficit path, with conflicts among European institutions, with an exhausting debate on the reform of the Stability Pact, and with the general perception of an increasingly lax fiscal stance; thus we have witnessed, at least apparently, a weakening (first *de facto* and then *de iure*) of the fiscal framework for Europe, that should have entailed a sizeable increase of long term rates. Yet, in spite of all these elements, interest rates spreads (that we measure here as the difference between real long term rates of selected European countries and the equivalent in the US) did not react as could be expected, as can be seen in figure II. In fact, we can observe first that since the beginning of 2003 there is no clear upward trend in the spread. (If one looks at the level of interest rates rather than at the spread, one sees that there is no tendency towards an increase in the level of European interest rates; rather the contrary). Then, we can also see that the countries that had more trouble (France and Germany on one side, and Greece on the other) do not show a tendency that contrasts with the average of the Euro zone. The two light grey areas highlight two particular episodes that can be identified as crises. The first is the clash between the Commission and the Council, in November 2003, when the latter refused to follow the recommendation of the former to

¹ "Statement of the Governing Council on the ECOFIN Council's report on Improving the implementation of the Stability and Growth Pact". 21 March 2005 (<http://www.ecb.int/press/pr/date/2005/html/pr050321.en.html>).

² In fact, a great number of other factors may play a role, as the behaviour of private savings, the Ricardian behaviour of consumers, the inflationary effects of public deficit, the distance of the economy from its potential income, and so on. Thus, it is not surprising that empirical analyses are unable to robustly assess the sign of the relationship.

start an excessive deficit procedure against France and Germany. The second, in the fall 2004, when the frauds regarding Greece's national accounts became public knowledge. In both cases, the evolution of the spreads for the countries concerned was completely in line with the Euro zone average, showing a substantial indifference of the markets for the political and institutional evolution.

Figure II. Spread on LongTerm (10 Year Government Bonds) Rates



Alternative explanations of the puzzle

The puzzle can be tentatively explained in two different ways. The first is to consider that the SGP has substantially well functioned; in spite of the recent deterioration of public finances, and of the breaching of the 3% limit by the most important countries of the EMU, the use of fiscal policy as a countercyclical tool was negligible. The following table shows cumulated fiscal impulses (i.e. the change in cyclically adjusted budget deficit ratio) since 2000, highlighting a striking difference between the Euro zone on one side, the US and the UK on the other.

Table I. Cumulated fiscal impulses

	2000	2001	2002	2003	2004
<i>Euro Zone</i>	0.5	0.9	1.0	0.6	0.6
<i>UK</i>	0.2	0.8	2.9	4.5	4.6
<i>USA</i>	-0.7	0.7	3.9	4.7	5.0

<i>Japan</i>	0.6	-1.1	0.1	0.2	-0.4
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Source: OFCE

Not only, the cumulated impulse is about 0.5 per cent of GDP, but it went down, between 2002 and 2003, (of 0.4 points, from 1.0 to 0.6), denoting a mildly procyclical fiscal policy in the Euro area. Thus the table shows that if the SGP was breached *de iure*, it was *de facto* very effective in constraining fiscal policy. If this is the case, and if markets perceived this adherence to the fiscal framework as credible and good, then it is no surprise that long term rates did not move during this turbulent period: the deterioration of public finances has simply to be attributed to cyclical factors, with a very "responsible" behaviour of fiscal authorities as far as the sustainability of public finances is concerned.

But this interpretation encounters a problem once we dig deeper into the events. If the interest rate inertia could be explained by a substantial adherence of governments to a rule perceived by markets as good, then, we should have observed a change of attitude of markets once the debate on the pact headed towards a reform supposed to substantially slacken the constraints. In other words, if markets had trust in the old framework, they should have reacted negatively to its modification. This is what was hinted by the ECB governing council in the statement we cited above, but until now there is not trace of such a reaction.

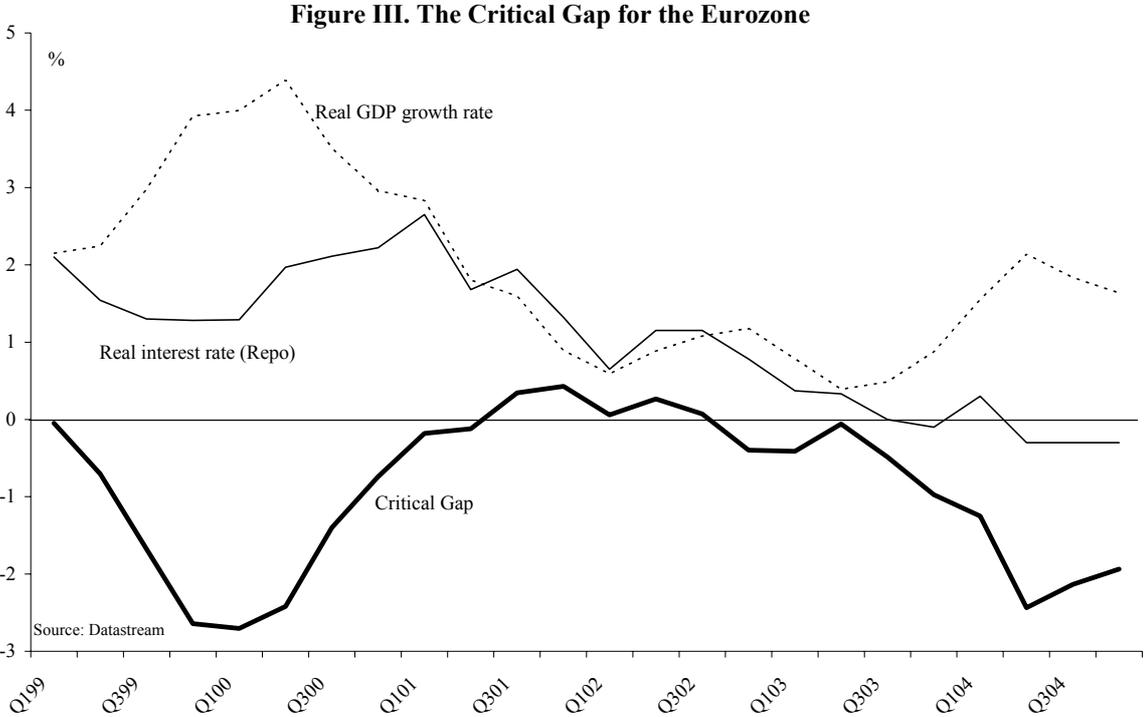
We can then advance a second line of interpretation, based on the recognition that markets have a broader perspective than to simply focus on public sector debt. Then, we can observe that in the past few years the increase of deficits has been matched by an increase in private savings, due to the "quasi-stagnation" of the economy. The increase of private savings, together with the cyclical nature of public deficits, reduced the possibility of a textbook type crowding out of private expenditure. In fact, a look at the "critical gap", i.e. at the difference between the real interest rate and the real growth rate, shows that it has been substantially decreasing since the first quarter of 2003, a sign that long term sustainability is not at risk (figure III). Thus, if we take this broad perspective, we can conclude that the long term prospects of public finances are no worse today than they were only a few years ago; they are better, if anything. Then it is no surprise that long term rates did not increase following the latest developments.

This brings us to the more general question of the current European institutions and of their fitness for the scopes set forth in a monetary union.

We argued that from the markets viewpoint, credibility and sustainability of fiscal policy are associated with long term solvency; on the other hand, the framework currently in place in Europe does associate credibility with the respect of quantitative limits. The two notions of credibility coincide only when the quantitative limits are in fact designed to guarantee long

term sustainability of public finances, i.e. when the fiscal rule is appropriately designed. When it is not the case, then markets will ignore the respect of the rule, and focus, as happened in Europe, on other factors.

In fact, the SGP blends an excessively strict long term objective (the requirement of a budget "close to balance or in surplus over the cycle" yields in fact a long term tendency towards a zero level of debt), with a monitoring scheme that is based exclusively on short term indicators, as the yearly deficit. As many argue, this mix is too straight a jacket to be credible, as most of the time it would require a procyclical fiscal policy. From a long term perspective, such a policy may be so destabilizing that it may (indirectly) lead to unsustainability. Thus it is not surprising that markets did not react to a revision of the SGP, if they consider the new framework as less destabilizing.



The consolidated deficit of the Euro zone has in the recent past been among the lowest of OECD countries (see table II). Furthermore, a number of important structural reforms that significantly reduce implicit government liabilities were put in place by some large European countries. These factors were most likely considered more important in ensuring, long term sustainability, than the widely publicized but substantially unimportant formal infractions to the SGP threshold.

Table II. Budget Deficit as a % of GDP

	2003	2004	2005*	2006*	<i>Average 2003-2006</i>
<i>Euro Zone</i>	2.7	2.9	2.7	2.6	2.7
<i>USA</i>	4.6	4.3	4.0	3.5	4.1
<i>UK</i>	3.3	3.4	3.0	3.0	3.2
<i>Japan</i>	7.7	6.5	6.6	6.4	6.8

*: *Forecasts*

Source: National accounts Eurostat and OFCE forecasts

These conclusive remarks also point at a further hypothesis, not necessarily alternative to the previous one. The lack of reaction of markets to the changes in the European fiscal framework may be ascribed to the fact that the change in the rules has done nothing than internalize a change in behaviour that had already been incorporated in market values. This carries the important implication that, being impossible to foresee if and how the new framework will alter the behaviour of governments, it is also very hard to forecast the direction of market changes. In fact, were the applications of the new rules in the next months perceived as allowing more convincing countercyclical fiscal policy, we could even observe a positive reaction of markets. The missing element, in today's Europe is growth, not long term sustainability.