COMMENTS ON SESSION 3
FISCAL POLICY AND FISCAL RULES

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Some remarks on the papers by Barrios, Langedijk and Pench and by Creel and Saraceno

I would like to discuss both papers not on technical terms but taking them as an important part of an ongoing debate about the outgoing (?) crises.

Not only the present but also the future role of fiscal policy is at stake. The role of fiscal policy is a crucial part of the exit strategies, but it is also very important to strengthen our future crises mitigation and adaption system.

Both papers reflect quite important questions on fiscal policy, e.g., on the possible interplay of nominal/real exchange rate depreciation/devaluation with consolidation results and on the role of discretionary fiscal policy concerning (also potential) output.

The main finding of Creel and Saraceno is that empirical evidence shows that discretionary policy could and should still play an important role, and that it could still be a necessary complement, as automatic stabilizers might be ineffective. The Ricardian view conditions are not met, there are no full rational expectations.

Generally speaking, this could lead to a more critical view of rule-based fiscal policy as the underlying paradigm of the SGP. A follow-up question, however, would be if the partly/temporary missing rational conditions could really be crucial for a rule-based policy or whether we have to look at other variables too to judge a concrete case.

The main finding of Barrios *et al.* is that, analyzing consolidation episodes, the best chance of a successful consolidation is given rescuing the banks first, and then implementing a vigorous consolidation policy ("cold showers"). If the initial debt level is high, this approach should be tough and sustained, while in countries better off, *i.e.* with some "fiscal space", a more gradual approach seems preferable.

This result supports the main core of arguments concerning high-debt countries. The general reasoning here might be that better-off countries (Germany *et al.*) might be too tough now. Again, the question might be whether there are other elements to take into consideration. If, in the single currency zone, one anchor country loses credibility – even if this happens only within the country – there could be negative spill-overs in the whole Eurozone. And this might happen even if that country's electorate is oversensitive to debt, compared to other countries.

Barrios *et al.* also conclude that nominal or real exchange rate variations, enacted in order to affect export-led growth, do not facilitate consolidation efforts, even if databases show that for certain cases this statement looks like a generalization. It probably should be checked against different packages of structural reforms, e.g., macro wage packages/social security packages and micro measures enhancing competitiveness and their respective fiscal costs.

It seems somewhat odd that a well-designed export-led growth strategy would not eventually give some positive impact on (potential) growth.

Having said this, let me offer some German views, which of course are entirely personal and do not reflect the view of the Ministry. It is very valuable and timely to discuss such questions.

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Indeed, the institutional architecture and the design of "real" policies might be more crucial now, as globalization will not vanish – quite the opposite, in fact. Therefore, cross-fertilization via financial, fiscal and macro/micro channels will be the forced rule in the 21st century economies.

We still see a rule-based policy in line with a (reformed) SGP as the foundation of the house of fiscal policy. It is an indispensable mainstay for a stable and successful monetary union. In the short run, this means a sensible consolidation as part of a credible exit strategy. At the very least, the German view is that, in addition to the argument that fiscal space in this context does not come too late, there is also the risk that a belated withdrawal of macro/fiscal support (tax cuts, expenditure increase) could be pro-cyclical, hamper credibility and create higher deficits – especially when the population gets used to some of the measures implemented.

Let's take Germany as an example: the large scale enlargement of short-term labour support really played a part in the German success in crises response. Trade unions soon come to look very favourably on an instrument that nevertheless bore high public and private costs. However, making use of this enlargement as a regular recourse would worsen considerably both labour costs and public budgets.

However strong Ricardian effects might be in specific times/cases, in the medium and long run a balanced budget approach makes sense, together with a focus on potential growth. This especially holds for highly developed ageing societies that do not have natural resources, anticipating their respective foreseeable and unavoidable fiscal challenges.

Therefore, in the long run, we clearly see a Ricardian approach in fiscal policy focussing on sustainability and quality of public finance. And, of course, this is the core philosophy behind the German paradigm change concerning the deficit rule in the constitution, which will be very close to the MTO of the SGP.

The last point I would like to make concerns the question whether this is sufficient to tackle the crises.

First, of course, I would not wish to argue that the German view applies necessarily to other countries, as all specific conditions – in the economy, in policy and in society – differ, and this variety of situations is acceptable and even favourable for a federal EU architecture. Each country should make up its own mind – aware, however, of the possibility of spillovers. There should perhaps be some outer limits of policy responses for the eurozone countries, but this is beyond the scope of these comments.

However, I strongly believe that the German response is not only good for Germany but also a big safeguard for the credibility of the eurozone as a whole – positive even for those countries in trouble with sovereign debt. But, of course, Germany has to deliver more, also on macro/structural terms, on opening markets, education and health and it is clear it has to strengthen the internal demand – with one condition: not at the expense of competitiveness, fiscal solidity and credibility.

Second, there is something missing. We have to build additional credible and market-oriented support/debt restructuring mechanisms for sovereign liquidity and, most of all, for solvency problems – complementary to the SGP. This has to be worked out within this year or we will all be in serious trouble.