COMMENTS ON SESSION 2
FISCAL RULES AND INSTITUTIONS IN THE EUROPEAN UNION

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I have been asked to comment on three papers. Two of them – the one by Barnes and the one by Larch, Pench and Frayne – are very similar in terms of coverage, dealing both with the reform of the EU fiscal governance system, while the third deals with the progress in strengthening fiscal sustainability in Greece under the program supported by EU and IMF financing.

Let me start with a few words on the paper on Greece. It is a very useful description of the progress made so far and of the challenges faced by the Greek authorities. Several implementation risks remain and my IMF colleagues working on Greece from the IMF's European Department or those from the IMF's Fiscal Affairs Department dealing with technical assistance to Greece in the fiscal area would perhaps be in a better position to comment on this. Here the point that I want to raise relates to what I would call the elephant in the room, an elephant that the paper does not address but that is in the mind of all investors. The elephant is the question: all these reforms are fine but can some form of default or debt restructuring be avoided?

My answer to this question is: yes. I have already expressed this view in the past but I would like to reiterate briefly why I think this is so:

- First, debt is high, but the extent to which this is a problem depends on the interest rate that is being charged on debt. Unlike countries that defaulted in the past, the average interest rate on Greek debt is not high at present. The high interest rates on the secondary market are irrelevant as Greece is not borrowing at those rates. Moreover, the maturity of Greek debt before the crisis was the second longest maturity among advanced countries (after the U.K.), so Greece is still benefitting from low pre-crisis rates. Finally, the support from the IMF and the EU allows Greece not to go back to the market for some time. This should give time to investors to revise their expectations if they see the program being implemented successfully.
- Second, the problem of Greece is a large primary deficit, which would have to be corrected even if a large haircut were applied on existing debt. One can do the math and see that, even assuming a haircut of 50 per cent, the correction in the primary balance would not be much lower with respect to a scenario in which there is no default.
- Third, while defaulting would reduce somewhat the extent of fiscal adjustment needed, default also has costs for the economy. First, access to markets for several years would be much more difficult for Greece. Second, default is a tax and has negative implications for the income and wealth of bondholders. About 30 per cent of central government debt is held domestically and this is not a trivial percentage. Moreover, even taxing the foreign bondholders is not without costs both economically – for example, bank problems in the rest of Europe caused by a Greek default would spill over to Greece as well – and politically – as other countries could complain.

There are several other reasons why I do not regard default as inevitable, but if you are interested you can read a paper on this issue that we published a few months ago in the IMF Staff Discussion Note series.[1]

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[1] See *Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely*, by Carlo Cottarelli, Lorenzo Forni, Jan Gottschalk, and Paolo Mauro. Available in http://www.imf.org/external/pubs/ft/spn/2010/spn1012.pdf.

Let me move to the other two papers, both dealing with EU fiscal governance. All agree it needs to be fixed, although I believe that in the absence of the SGP, things could be much worse: there has been perhaps too much SGP-bashing recently.

Both papers describe developments and express views on the quality of the SGP reforms. So I guess I will have also to express views on what is happening in this area.

In general, the reforms are an important step forward but it is not a secret that they fall short of what the Commission itself had initially supported. In some respects, they also complicate significantly the monitoring of policies, although this was in part inevitable to make the monitoring more meaningful.

I support many aspects of the reforms and here I will focus only on what I find more problematic. Let me start with some relatively technical points.

To fix the preventive arm, the EC proposes to address the tendency to spend revenue windfalls in good times by introducing a cap on total expenditure growth, corrected for changes in taxation. This makes sense. However, the remaining difficulty is to assess potential growth and this is a key issue. It is in my view likely that a good chunk of the extra spending that took place in the pre-2008 good times was due primarily to an overestimation of potential growth, rather than to non-growth related revenues. It is therefore critical to estimate how much of the temporary revenue buoyancy would have been captured if the new approach were followed, using the potential growth estimates existing at that time.

On the corrective arm, operationalizing the debt criterion is a priori a good idea. However, I have three concerns about the specific approach followed (1/20th of the excess debt). First, nobody will achieve the 60 per cent target following this rule, as it works only asymptotically, and it is not clear why this approach was followed as simple alternative formulations could be found (for example, reductions specified in percentage points for various debt brackets). Second, for countries starting with very high debt and facing a sizable interest rate growth differential, the implied primary level would be initially huge. For example, for a country with a debt-to-GDP ratio of 150 per cent and facing a growth-adjusted interest rate of 300 basis points, the new debt rule requires an initial primary surplus of 9 per cent of GDP. Third, and this is my main problem, the targeted decline in debt is unadjusted for cyclical factors, which is inconsistent with the attention to cyclical considerations underscored in the paper. Moreover, I do not understand the explanation given in the paper for this shortcoming, namely that there are no good ways to cyclically adjust the debt ratio. Well it may be difficult but is not impossible. The U.K. Treasury did it: it is basically enough to find a year, far back in time, when the cyclically adjusted and the headline debt ratio could be regarded as close. Moreover, and more importantly, here the issue is to cyclically adjust not the level of the ratio but the change in the debt ratio, which depends primarily (although not exclusively) on the deficit which can be easily cyclically adjusted. The debt stock also enters the formula but it can be shown that only very large mistakes in assessing the initial level of the debt ratio would affect the results. It is therefore much worse to disregard this issue altogether than to have a less-than-perfect treatment.

Also on the corrective harm, it is not clear what the Commission intends to do regarding systemic pension reform that affect the intertemporal distribution of pension deficits, for example the creation or the elimination of a fully-funded component. This is a key issue at the moment and we have recently published a paper to discuss possible solutions to this problem.[2]

2 See *A Fiscal Indicator for Assessing First and Second Pillar Pension Reforms*, by Mauricio Soto, Benedict Clements, and Frank Eich. Available in http://www.imf.org/external/pubs/ft/sdn/2011/sdn1109.pdf.

But these are relatively technical points. The two key issues that have weakened the SGP are:

- First, that the enforcement of the SGP has been subject to political capture by the Council. This by the way led the Commission to adopt a legalistic approach to fiscal surveillance narrowly focused on fiscal deficit numbers. Economic judgment was often left aside by fear of a clash with the Council, a fact that is implicitly acknowledged by the authors when they argue that surveillance was incomplete. And a fact that explains why the new SGP involves more parameters than the old (for example a numerical target for the decline in the debt ratio), thus adding complication.
- The second is the absence of crisis management and resolution capabilities: even the safest buildings and aircrafts have emergency exits... but not the SGP. This issue is not really discussed at length in the paper.

We know that reforms have been implemented to address these issues. But how effective are they?

Here my main concern relates to the enforcement mechanism. It is clear that the key issue is the role of the Council. The reverse majority rule is one interesting approach but it is not extended to all decisions taken by the Council, in particular to the critical decision to place a country under Excessive Deficit Procedure (EDP). So the decision to start the EDP itself would still be governed by the old qualified majority process. Altogether, it remains to be seen whether the implementation of the SGP – including of the critical parts that have not been reformed – will in the future be more effective than in the past.