COMMENT

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Official views about the appropriate role for fiscal policy have changed considerably during the post-war period. In the 1950s and 1960s, it was mostly used as a short-term demand-management tool to keep unemployment low. Most OECD countries ran surpluses on average, debt/GDP ratios fell from their WWII and Korean War peaks, and this was regarded as a normal and desirable development in peacetime. Real growth rates were almost certainly higher than real interest rates for much of the period, so the dynamic efficiency conditions did not hold. Things changed after the oil shocks of the 1970s. Growth slowed down, unemployment rose, and ambitious social spending programmes dating from the 1960s began to cover more people more generously. Public finances moved into deficit for most OECD countries. Policies were aimed at bringing inflation down and keeping it low. It was agreed at that time that the appropriate role for fiscal policy was to assist monetary policy in a medium-term framework. In principle, that meant that fiscal policies should err on the side of restrictiveness, and that public sector finances should go back towards surplus.

This did not happen, and the reasons are probably rooted in political economy considerations. If Ministries of Finance and Economics had had their way, the deficits would probably have vanished quite soon during the 1980s. But spending ministries were apparently too numerous or too powerful. Around this time, the notion of "sustainability" began to be discussed. The precise meaning of sustainability was not defined, what

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finance and central bank officials seemed to have in mind was the prospect of deficits and rising debt ratios “as far as the eye could see.” Medium-term projections, for example those coming from the OECD Interlink model, did show this kind of development happening under a fairly wide range of plausible assumptions. The mechanics of debt dynamics started to be analysed for example by Blanchard at the OECD at the end of the eighties, which put some more precision into the notion. There was much hand-wringing about their implications but it is hard to know how seriously these analyses were taken at a high level.. Meanwhile, sustainable or not, the deficits were in fact sustained somehow, giving ammunition to the proponents of higher spending or lower taxes.

It is very striking that this mindset vanished almost overnight, once the Maastricht criteria for EMU were agreed upon at the highest political level. Suddenly, it became politically necessary, desirable and possible to take decisive steps to bring public finances under control. What is also striking is the contrast between the elegant -- if ambiguous -- theory of sustainablity as outlined in the Balassone/Franco paper and others, and the brutal arbitrariness of the 3% deficit and 60% debt rules decided on in Brussels. Instead of being measured in terms of country-specific present discounted values of debt to GDP ratios or whatever, sustainability was simply defined as a one-size-fits-all pair of numbers.

Michael Artis has already commented very ably on the papers we heard this morning. I strongly support the view in the Frederiksen paper that any policy-relevant analysis of sustainability has to be forward-looking, because of looming public pension strains in most OECD countries. Richard Hemming’s exposition of how the IMF actually goes about assessing the fiscal policies in its client countries was a fascinating glimpse into the workings of our sister institution. It was interesting to learn that a good deal of pragmatism and flexibility goes into their assessments and that they are not as monolithic as the media would have us believe.