

COMMENTS ON SESSION II: PUBLIC DEBT AND FISCAL RULES

*Sandro Momigliano**

The extremely insightful papers included in this session cover a wide range of important issues. For the sake of both concision and effectiveness, I will discuss only a few of them. Moreover, a large part of my comments will deal with a single theme, present in the majority of the papers: the relationship between fiscal policies and interest rates.

The Mink and Rodriguez-Vives paper is mainly concerned with methodological aspects in the measurement of government debt, but also provides very useful quantitative data on different definitions of debt for the euro area. I found of particular interest the information on the net government debt for the recent years, derived by subtracting government holdings of financial assets from gross debt. When assessing the state and developments of public finances, net debt seems a more appropriate aggregate, as it is also pointed out in the Wood contribution. I would welcome a more extensive use of this information in the context of the European multilateral surveillance.

The Boothe and Woods papers discuss, among many other issues, the rationale of having debt in a fiscal rule. Both papers take advantage of the experience gained, respectively, in Canada and the UK.

The Booth paper analyses the relationship between accounting regimes and fiscal rules, an issue relatively new in the literature, drawing a number of important normative suggestions. In particular, it indicates that, when moving from a cash to an accrual accounting regime, a greater focus on net debt may be appropriate, with a view to the transparency of budgetary decisions and to the accountability of policy makers. The indication has immediate relevance, as Canadian provincial governments are moving to accrual accounting for capital but do not plan to change their fiscal rules. I find the analysis in the paper extremely useful but I wonder whether focusing on the different treatment of public investment does fully capture the implications of switching from a cash to an accrual regime of accounting. In the European context, for example, the switch from the 1979 European Standard of Accounts (ESA79) to ESA95, which represented a partial movement in the direction of accrual accounting, did not imply a change in the treatment of investment expenditure, but nevertheless significantly affected budgetary decisions.

The paper by Wood describes the fiscal rules currently followed by the UK Government, focusing on that concerning the debt. The paper is comprehensive and extremely informative, providing historical statistics and analyses on public debt

* Bank of Italy, Research Department. E-mail: sandro.momigliano@bancaditalia.it

developments in UK, as well as the theoretical background and motivations for the decision concerning the UK debt rule, which requires the Government to hold public sector net debt stable at 40 per cent of GDP over the economic cycle. The author makes the point that economic research has not lead to a precise analytical answer to what the optimal debt level is, but for long-term fiscal sustainability this may matter less than having a clear and credible target for the debt ratio. In two respects the concept of debt used in the UK system appears more adequate than that adopted in the EU fiscal context: the debt is netted by liquid financial assets (to better reflect the government's immediate solvency) and includes the liabilities of public corporations. The transparency of the reporting on public finances in UK is further enhanced by legislation requiring public bodies to publish extensive information on their activities, among which are contingent liabilities, which are not included in national accounts' measures of debt.

As for the other papers in the session, they are all concerned with the question whether developments in budgetary balances and public debt affect interest rates. This is a very important issue but one extremely difficult to answer by means of the empirical analysis. In particular, as mentioned in the paper by Laubach, "endogeneity problem in such regressions is most likely severe".

Cyclical conditions tend to affect both the budget balance, via the automatic stabilizers and the reactions of discretionary policy and interest rates, via market mechanisms and monetary policy. When interest rates are regressed on fiscal balances, this causal effects determine a bias (usually positive) on the value of the coefficient of the latter (the bias is usually negative if the balance is defined in terms of net borrowing or the debt ratio is used as regressor). This problem will be the main focus of the remaining part of my comments, as I review the empirical analyses included in these papers.

Both the paper by Balassone, Franco and Giordano and that by Faini examine the impact of fiscal developments on interest rates (or credit ratings) in order to draw conclusions relevant for the current debate concerning the Stability and Growth Pact.

The first paper aims at assessing whether financial market mechanisms may substitute fiscal policy rule in the current European context. As pointed out by the authors, a positive answer to this question not only requires that the impact of deficit deterioration on rates be significant (and of the correct sign) but also that governments be sensitive to market signals and change their stance accordingly. Overall, the authors conclude that financial markets discipline does not provide an adequate alternative to rules. The negative answer is mainly determined by the analysis on the second requisite. In this respect, I wonder whether the evidence that the authors present is indeed conclusive. Since ratings are, at least in principle, forward looking, they may react to an expected worsening in the future; therefore the evidence that there is no change in the deficit in the period following a change in the ratings does not necessarily imply that governments have not acted.

The first requisite is instead barely attained. The authors point out that the examined evidence unambiguously suggests that markets reward fiscal discipline and punishes fiscal imbalances with higher risk premia, though these reactions tend to be slow and small in size. They review the results of other studies and also carry out a little empirical analysis. This includes two regressions with bond yields as the dependent variable, which is regressed, alternatively, on changes in the debt to GDP ratio and changes in the net borrowing ratio. The variables are all measured in terms of deviation with respect to the German ones. The results show a positive – but not particularly sizable – reaction of yield spreads. However, these results are subject to the possible distortion arising from asymmetric shocks (*i.e.*, shocks specific to an individual country) influencing both the yield and the deficit spreads. The regressions which include credit ratings as a dependent variable may suffer of the same shortcoming, as ratings also tend to be influenced by cyclical conditions.

The paper by Faini points out, in particular, that an expansionary fiscal policy in one EMU country has an impact not only on the interest rate spreads but also on the overall level of interest rates for the currency union as a whole. The evidence presented in the paper indicates the existence of substantial spillovers through the interest rate channel among the member countries. This leads to the conclusion, in line with that of the previous study, that it is important to revive if not to strengthen the Stability and Growth Pact. Coming on the empirical part of the paper, I have two comments. It is not clear to me whether the problem of endogeneity I mentioned before is entirely solved by introducing the output gap among the regressors, as this indicator may not fully capture the actual cyclical conditions. Secondly, I am not sure that expected inflation measured by an ARIMA process is fully adequate in this context, as budgetary developments may have an impact on actual expectations. If this were the case, real interest rates would be measured with an error correlated to the regressor.

The paper by Ber, Brender and Ribon assesses the effects of fiscal and monetary policy on bond yields, on the basis of data for Israel in the Nineties. The paper is particularly interesting because the existence of a sizable market for indexed bonds allows the authors to focus on real yields, without having to decompose nominal yields into a real component and inflation expectations. The effects of the expected deficit, netted by cyclical influences, is found in the study to be significant for all yield terms, ranging from 0.15 for yields of up to one year to 0.21 for the 10-year yields in the case of a 1 percent change of GDP in the balance. The effects of the current deficit (cyclically adjusted or not) were instead not significant. The authors define the expected deficit as the actual deficit in the following 6 months. I find these results surprising. I am a bit skeptical that financial markets are indeed able to predict deficits with sufficient precision, so that future deficits can be a good proxy for expected ones. If I am right we are left with the question of how it is possible that a largely unexpected event in the future can influence yields now.

Finally, the paper by Laubach examines the issue of the effects of budget deficits on interest rates by considering the indications provided by economic theory

as well as the available empirical evidence. The authors note that theory does not provide unambiguous prediction for the interest rate effects of current deficits but, nonetheless, it can be shown that under plausible assumptions these effects are positive. As for the empirical side, the author discusses extensively the problems connected with the endogeneity of fiscal balances and the solutions proposed in the literature. I agree with the author's view that a satisfactory way to tackle the problem is to regress expected future long-term interest rates on expected future deficits (measured by the Congressional Budget Office projections), as Laubach did in a previous study. In that study he finds a relatively strong evidence that increases in budget deficits raise interest rates.

A possible extension of Laubach's analysis, as well as that included in the last papers I commented on, would be to take into account whether the changes in the balance come from revenue or from expenditure developments. A number of empirical studies have recently shown that the composition of adjustment may affect the success and sustainability of fiscal policies; this suggests that, for a given change in the deficit, financial markets should react differently, depending on its composition.