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The new reality of fiscal policy and its implications for Spain

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Theme[1]

Public debt has risen sharply during the pandemic. Paradoxically, however, in advanced economies it now appears to be more sustainable than before the crisis. But will this situation persist?

Summary

Levels of public debt have risen sharply during the pandemic. Paradoxically, however, they are now more sustainable than before the crisis. This analysis considers the potential for changes in the key variables that will determine the sustainability of public debt for advanced economies over the next few years. It also discusses the options for the reform of the EU's fiscal rules, arguing for major changes to rules that were originally agreed by Member States in a world markedly different from today's.

Analysis

Fiscal policy, supported by monetary policy, has been the first line of defence against the significant economic fall-out from the pandemic. Perhaps unsurprisingly, in advanced economies, public debt as a percentage of GDP has surged by between 15 and 30 percentage points (Figure 1). Emerging and developing economies have also made active use of fiscal and monetary policy to counteract the fall in economic activity. However, their relative lack of fiscal room for manoeuvre and the relative exposure of their currencies has kept the rise in public debt below that of advanced economies.

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Figure 1. Public debt, 2016-26 (% of GDP)

							Forecasts				
	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
Global	83.2	82.0	82.3	83.7	97.3	98.9	99.0	99.4	99.5	99.5	99.3
Advanced economies	105.5	103.0	103.0	104.0	120.0	123.0	122.0	122.0	122.0	121.0	121.0
Canada	91.7	88.8	88.8	86.8	118.0	116.0	113.0	109.0	106.0	102.0	98.1
Eurozone	90.1	87.7	85.8	84.0	96.9	98.2	96.5	95.6	94.4	93.1	91.9
France	98.0	98.3	98.0	98.1	114.0	115.0	114.0	115.0	116.0	116.0	117.0
Germany	69.3	65.1	61.8	59.6	68.9	70.3	67.3	64.8	62.2	59.6	57.1
Italy	134.8	134.0	134.0	135.0	156.0	157.0	156.0	155.0	154.0	152.0	151.0
Spain	**99.2**	**98.6**	**97.4**	**95.5**	**117.0**	**118.0**	**117.0**	**117.0**	**117.0**	**118.0**	**118.0**
Japan	232.5	231.0	233.0	235.0	256.0	257.0	254.0	253.0	253.0	254.0	255.0
UK	86.8	86.3	85.8	85.2	104.0	107.0	109.0	111.0	111.0	112.0	113.0
US	106.6	106.0	107.0	108.0	127.0	133.0	132.0	132.0	133.0	134.0	135.0

Source: IMF.

Accepting a rise in deficits and debt levels has undoubtedly been a good idea. However, it would not have been possible without the spectacular intervention of central banks, which have implemented asset purchasing programmes (including public debt) on a massive scale. For the eurozone, this has meant a radically different response compared with the financial/euro crisis of 2008-12, with a substantial shift in both the framing of the crisis and the response in terms of economic policy. According to IMF estimates at the global level, the damage to production and job losses would have been three times greater without the fiscal support. The organisation also forecasts a strong economic rebound that will allow the stabilisation of debt to GDP ratios at their current high levels without major difficulties. In a certain sense, the pandemic has been like an alien invasion. In the heat of the moment (at least in the movies), when people are attempting to defeat the aliens, no one is worrying about the rise in the deficit. It can be dealt with after.

However, the time of reckoning is now in sight, at least for advanced economies like Spain with high vaccination levels. This raises some important questions: what to do with public debt? Does it make sense to maintain an active approach to fiscal policy over the coming years to finance the recovery? In the European or Spanish context, should we work on the basis that public deficits will disappear and that debt will not become explosive? Can we assume that bond yields will stay low in the long run? Lastly, what about the redesign of European fiscal rules, necessary despite their obsolescence to correct the bias towards running a deficit, which is particularly dangerous for an incomplete monetary union like the eurozone?

While there are no easy answers to these questions, this analysis sets out some ideas. It begins by revisiting consensuses –old and new– on the sustainability of public debt in advanced economies in the context of the Next Generation EU programme, before turning to the debate on reforming the EU's fiscal rules. Understanding the behaviour of inflation going forward is key to the discussion of these issues, since changes may depend on action by central banks, interest rates and, by extension, the sustainability of public debt.

A fresh look at debt sustainability

Let us start by recalling the dynamic of public debt sustainability and how this should be interpreted in the current macroeconomic context of low interest rates and uncertainty surrounding inflation and growth. The best way to bring down a high debt to GDP ratio is to increase the denominator by boosting production. This is a long-term approach achieved through productivity gains (however, despite signs of productivity increasing, it is not clear if this will be permanent or transitory). It is also useful to have a primary budget surplus (where income covers spending without taking into account interest payments on debt) and low interest rates can be taken advantage of to refinance debt smoothly, extending repayments as far as possible into the future to guard against sudden spikes in risk premiums. In contrast to other countries with more balanced public finances, Spain is currently failing to do this. Furthermore, the presence of inflation makes it easier to repay debt (although other problems may arise, particularly if rising prices result in spiralling prices and wages, as was the case in the 1970s). Similarly, if central banks continue to buy public debt, part of the debt will be automatically refinanced (remember that the ECB is owned by the eurozone countries, meaning its profits, part of which come from the interest of debt on its balance sheet, will find their way back to national exchequers).

This means there is no beforehand sustainable or unsustainable level of debt to GDP, such as the 60% figure in the Maastricht Treaty or the 90% figure that rose to prominence during the last financial crisis. Everything depends on the rate of economic growth, changes in the cost of financing, inflation and the attitude of the central bank. When all is said and done, this is not a technical issue but a political one, because the capacity for reform (on pensions, fiscal policy and in other areas) depends on the balance of power in individual countries.

A final key point when analysing debt sustainability is the distinction between flows and stocks. The public deficit and interest payments on debt (commonly measured as a percentage of GDP) are flows. The volume of debt is a stock. Debt sustainability is primarily a matter of flows, since it depends on the ability of the state to service its debt in a given year. Naturally, the lower the stock of debt, the easier it will be to refinance debt, since investors will feel more comfortable lending to countries with lower stocks of debt. However, situations can also arise, such as the current circumstances in Spain, where debt stock can be higher *and* debt can be more sustainable at the same time. Spain currently has significantly more debt in circulation than in 2012, when it paid more than double the current level of annual interest (as a percentage of GDP). Back then risk premiums were also rising, with fears that the country might lose access to the markets, whereas the cost of new debt continues to fall and is already negative. Countries like

Japan, whose debt to GDP ratio is over 250%, do not have problems when it comes to sustainability.

In the US this situation has led both the Biden Administration and economists such as Blanchard and Krugman to argue that, so long as the current conditions hold (and the key question here is if they will), the public debt to GDP ratio may fall automatically. They regard it as highly likely that equilibrium interest rates, which balance the supply and demand of funds for lending (*r** in macroeconomic models), will remain low for structural reasons, such as demographics, technological change, high levels of inequality and globalisation, all of which will make it possible to continue issuing debt at rock-bottom rates. They also believe that growth (*g* in the models) will pick up and the central bank will be more 'permissive' with inflation, leading to the conclusion that so long as the real growth rate of the economy is higher than the real interest rate of its debt (in macroeconomic terms, $g>r$), there is no cause for concern. This is the philosophy behind the huge US stimulus packages, which economists like Summers have warned may be too large, since consumption is automatically rebounding in response to a prolonged period of enforced savings). This means the economy could overheat in the medium term, fuelling inflation and forcing rate rises that bring instability, reduce growth and even affect emerging markets. We must not lose sight of the fact that the biggest macroeconomic threat going forward for emerging markets (particularly in Latin America), which have suffered the most from the pandemic, both in health and economic terms, would be a situation like at the start of the 1980s, when the US abruptly hiked interest rates to rein in inflation, leading to an appreciation of the dollar and a rise in global interest rates, prompting sovereign defaults in Brazil, Mexico and Argentina and resulting in the so-called 'lost decade', which began in 1982.

There are, however, major differences between the eurozone and the US. Fiscal stimulus in the US has taken place on a much larger scale than in the EU (approximately three times the drop in GDP in 2020 and concentrated over a two-year horizon, while the European response has been approximately the same size as the drop in activity in 2020, with implementation spread over three years). This is why the US economy has bounced back quicker, with inflation picking up, wages starting to rise and the Federal Reserve signalling its intention to begin the gradual normalisation of monetary policy, starting with the reduction in asset purchases at the start of 2022 (albeit following a cautious approach and taking pains to avoid a repeat of the 'taper tantrum' in 2013, when a sudden normalisation of monetary policy in the wake of the financial crisis caused serious financial turbulence and exchange-rate fluctuations). For the time being, while the macroeconomic variables of the eurozone are moving in the same direction as the US economy, they are doing so at a slower pace, suggesting a more gradual normalisation of monetary policy. Inflation will remain the key variable, particularly in terms of expectations. There is broad consensus on the inevitability of a strong rebound in prices, due to both supply-side factors (bottlenecks in production and transport, the restructuring of supply chains, and higher energy and commodity prices) and demand-side ones (acceleration of spending due to increased consumption after a period of forced savings). However, it remains to be seen if price rises will be transitory or permanent, whether they will result in higher wages and, when all is said and done, if they will have a significant effect on inflation expectations, which have remained extremely low for years.

Notwithstanding this important debate and the fact that the eurozone appears to be following the same trajectory as the US (albeit with a lag and with less intensity), Spain's public finances are in a more delicate situation than the eurozone average. The country has a high structural public deficit (around 4.5% of GDP, according to the Spanish Independent Authority for Fiscal Responsibility), meaning it must either increase income or reduce spending (or both) to prevent its debt to GDP ratio rising, despite solid economic growth. The main reason for this situation is that it is not yet clear if Spain will be able to maintain strong enough growth to increase the denominator of the debt to GDP ratio once the 2021-22 rebound has run its course. Moreover, public spending is almost certain to rise in order to pay for pensions and other recently adopted but necessary measures, such as the minimum living income. Spain aside, however, there are major differences between the eurozone and the US economy. The eurozone is neither a fiscal nor a political union. Nor is there any certainty that the European Central Bank will tolerate inflation to the same extent as the Federal Reserve. What will happen if prices in the eurozone rise by more than 2% for consecutive months? What if this threshold is breached in Germany? All this implies the risk of rising risk premiums, either due to internal difficulties or contagion. Moreover, it is to say nothing about the uncertain political outlook. What will happen in Italy after Draghi? Who will govern post-Merkel Germany? What if Le Pen wins the French election?

Reforming the EU's fiscal rules

This brings us to the debate on the reform of the EU's fiscal rules, which will determine the legal framework for Spanish fiscal policy from 2023 (the escape clause of the Stability and Growth Pact is currently activated, meaning that, while the rules still exist, they are not being applied). The current framework was already under review, due to a range of problems: the rules have been criticised as being overly complex; their application often results in pro-cyclical policies (cuts during recessions and an inability to build up buffers during booms); the framework is based on concepts like the structural balance and the output gap (which are not observable and are volatile); and its application remains 'politicised', since fines are not applied (the fact that sanctions have never been imposed, not because the European Commission has not identified instances of non-compliance but because the European Council has vetoed the application of fines, or, more recently, because the Commission itself has adopted a much more flexible approach to evaluating compliance with the rules, such that violations are hardly ever found).

However, in addition to these problems, the rules cannot be reapplied as they stand, since this would condemn countries to long-term and counter-productive austerity policies to bring their debt to GDP ratios down to the magic 60% threshold enshrined in the Maastricht Treaty (the product of a different world, when the eurozone had still to be created). Indeed, a realistic analysis leads to the alarming conclusion that no one over the age of 40 will live to see public debt below 60% of GDP in almost all eurozone countries (Figure 1 shows that under current policies, the debt to GDP ratio will continue to worsen in France, will stabilise at high levels in Spain but will fall in Germany until reaching 60% of GDP, a dynamic that has the potential to fuel the dangerous narrative of the virtuous countries of the North versus the profligacy of the South). This means the time has come for ambitious reform of the Stability and Growth Pact to adapt it to the new macroeconomic reality, replacing the magic numbers of 60% of debt and a deficit ceiling of 3% (this does not require treaty change) to ensure its credibility going forward. However, this reform must also be part of a broader package of changes to the governance of the eurozone to complete the banking and capital market unions, reform the European Stability Mechanism (which now has €80 billion of paid-up capital but which no country wants to call on because of the stigma associated with the previous crisis) and make the logic of Next Generation EU permanent (reform and investment in countries in return for transfers financed by shared debt, always through political dialogue to ensure lasting change).

Lastly, we must also acknowledge that, as long as interest rates remain at zero and monetary policy has limited room for manoeuvre, it makes sense to maintain a more active fiscal policy, although we must be ready to revisit this approach if and when interest rates rise. The reforms are sure to be the subject of robust debate and the outcome of the process is far from certain. The European Commission must set out a bold package of reforms able to force debate among Member States and lead to real change. However, the risk is that the complexity involved in reaching an agreement may mean that reform will fall short or the status quo may prevail (albeit under a more flexible approach).

Spain has a strong interest in ensuring the ambitious reform of European fiscal rules. Completing the monetary union and ensuring the efficacy and credibility of the rulebook is a foreign policy priority for the country. However, to ensure its voice is heard in Brussels, Madrid must first deliver on its commitments: it is essential that the country implements its Recovery Plan effectively, making investment and carrying out reforms, and it must close its structural deficit through bold fiscal reform, which can also act as a lever for adapting the economy to the structural changes taking place, which are about more than just digitalisation and sustainability.

Conclusion

As advanced economies emerge from the pandemic, they are awaking to the enormous amounts of public debt stored up for the future. Few people would dispute the Keynesian and activist response to the pandemic (both monetary and fiscal). However, concerns are growing about the sustainability risks posed by public debt in some countries and the threat of a surge in inflation forcing an abrupt change of course on monetary policy, with all the negative consequences this would bring for economic growth and the ability of States to repay the sums they have borrowed without defaulting. On the other hand, there are those who argue that the new macroeconomic reality represents a break from previous decades and that the structural forces that have led to low interest rates and inflation will persist over the coming years, with a strong economic recovery driven by public investment by governments in response to the pandemic. This leads them to the conclusion that debt to GDP ratios will remain stable or even fall, meaning it is essential to ensure that countries do not have structural public deficits from 2022-23.

This analysis has sketched the contours of the terms of the debate, emphasising the fact that European countries, particularly Spain, are subject to an additional limitation, since their fiscal policy is bound by the EU's rules, although these are set to be reformed over the coming year as part of more ambitious changes to the economic governance of the Eurozone.