

Jean Pisani-Ferry: When facts change, change the pact

“When facts change, I change my mind,” John Maynard Keynes famously said. With long-term interest rates currently near zero, the European Union should reform its fiscal framework to allow member states to increase their debt-financed public investments, **writes Jean Pisani-Ferry**



A disingenuous silence

The European Union’s Stability and Growth Pact, which sets fiscal rules for its member states, is like the emperor’s new clothes. Almost everyone sees it has none, yet few admit it openly. This disingenuous silence is bad economics and bad politics.

The pact's rules are so hopelessly complex

For starters, the pact’s rules are so hopelessly complex that almost no government minister, let alone member of parliament, can decipher them. There are now various reform proposals that aim

to simplify things, including by a group of French and German economists to which I belong. Most of these proposals would place less emphasis on estimating member states' cyclically-adjusted budget deficits – a notoriously difficult calculation – and focus instead on monitoring growth in public spending. Concretely, each government would commit to expenditures consistent with the country's economic growth outlook and expected tax receipts, and in line with a medium-term debt target. There would be less micromanagement by EU institutions, more room for national decision-making, and more responsibility for individual governments.

Ministers have so far shown no appetite for such radical reform. But there is now a second reason to overhaul the EU's fiscal framework: today's economic conditions are very different from those when the pact was designed over two decades ago. "When facts change, I change my mind," John Maynard Keynes famously said. And the facts have certainly changed.

The pact initially made sense

The pact entered into force in 1997. At the time, the median public debt among the 11 EU countries that would initially adopt the euro was 60% of GDP, while the forecast was 3% growth and 2% inflation. The risk-free long-term interest rate – at which most eurozone countries would soon borrow – was 5%. Stabilizing the debt ratio at its prevailing 60% level therefore required governments to keep their budget deficits below 3% of GDP – or, put another way, to maintain a primary budget balance (revenues minus spending, excluding interest payments) of zero.

Such guidelines made sense. If growth faltered, revenue shrank, or markets started pricing in a default, there would be a real risk of debt spiraling out of control – as Europe's sovereign-debt crisis of 2010-2012 later showed. The 3%-of-GDP deficit threshold that triggers the activation of a stronger policy monitoring procedure was thus a rough but reasonably calibrated benchmark. Moreover, it was wise to aim for significantly lower deficits, in order to maintain a safety margin.

The big change from two decades ago is the collapse in interest rates

In 2019, the median debt for the same 11 countries is 70% of GDP, while the International Monetary Fund currently forecasts 1.5% growth and 2% inflation (debt is a bit lower and growth a bit higher if all eurozone members are included). True, projected growth is half the level it was in 1997. Nonetheless, stabilizing the debt ratio requires keeping budget deficits below 2.5% of GDP, which remains close to the pact's 3% limit.

The big change from two decades ago, however, is the collapse in interest rates. Investors were recently willing to buy ten-year German government bonds yielding essentially nothing. Taking inflation into account, the real cost of German debt is significantly negative – as it is, to a lesser degree, for France, Spain, and most other eurozone members. Even Italy, with debt exceeding 130% of GDP and dismal growth, was able to borrow at 2.6%, or 2.4 percentage points less than Germany in 1997.

Difficult choices for the EU

Under such conditions, a budget-deficit limit of 3% of GDP is, in fact, fairly lax. If long-term interest

rates remain near zero for a few more years, governments will be able to run primary deficits greater than 2% of GDP without exceeding that limit. Many EU countries are likely to use this opportunity to finance current spending on the cheap. But should financial conditions change abruptly, they will be forced to adjust precipitously.

The European Commission insists that the 3% threshold is only an upper limit. Reforms to the pact in 2011 have tightened the screws. Eurozone countries are expected to keep their structural budget deficit (corrected for cyclical effects) close to zero, and those with a debt ratio exceeding 60% of GDP are mandated to reduce it.

The EU sits between a rock and a hard place

However, the resulting constraints are too tight. The zero target for the structural deficit prevents governments from borrowing at today's negative real interest rates to finance investments and reforms. And, as Olivier Blanchard of the Peterson Institute has forcefully argued, there is no compelling economic reason to cut debt when borrowing is costless.

The EU sits between a rock and a hard place. It should not let member states make a habit of financing recurring current expenditures with debt. But nor should it prevent them from taking advantage of persistently low interest rates to finance economically sound investments that will benefit future generations.

Why fiscal reform is necessary

Europe should therefore reform its fiscal framework. Deficit hawks (especially in Germany) will no doubt protest, but prohibition without a rationale is politically unsustainable. Why wouldn't EU citizens accept channeling debt-financed public investments into environmental research, renewable energy, clean transportation systems, and other efforts to contain climate change, when financial conditions would make such investments collectively profitable?

The need to revise the EU's fiscal rules is clear

Longstanding criticism of the pact for neglecting the distinction between investment and current spending is valid, to the extent that investment is defined economically rather than in accounting terms. The EU should therefore agree on a set of goals – such as the transition to a low-carbon economy, broader access to employment, and output-enhancing economic reforms – that justify public spending temporarily in excess of the fiscal rule (unless, of course, the country is in a financially precarious state). Such an exemption should be conditional on long-term interest rates remaining exceptionally low. If rates were to rise, governments would have to trim and eventually discontinue these investments.

The need to revise the EU's fiscal rules is clear. The main political parties competing in May's European Parliament elections should recognize it and make the case openly. At a time when the EU's very purpose is being questioned, economics taboos are the last thing Europe needs.

[This article first appeared in Project Syndicate on April 29th, 2019](#)

Author

Olivia Grace

Editor

olivia.grace@ing.com

Julian Geib

Junior Economist, Global Trade

julian.geib@ing.de

Zoltán Homolya

Economic research trainee

zoltan.homolya@ing.com

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz

Senior Economist, Poland

mateusz.sutowicz@ing.pl

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@ing.com

Michiel Tukker

Senior UK & Eurozone Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Senior Economist, Healthcare & Technology

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporate Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com