

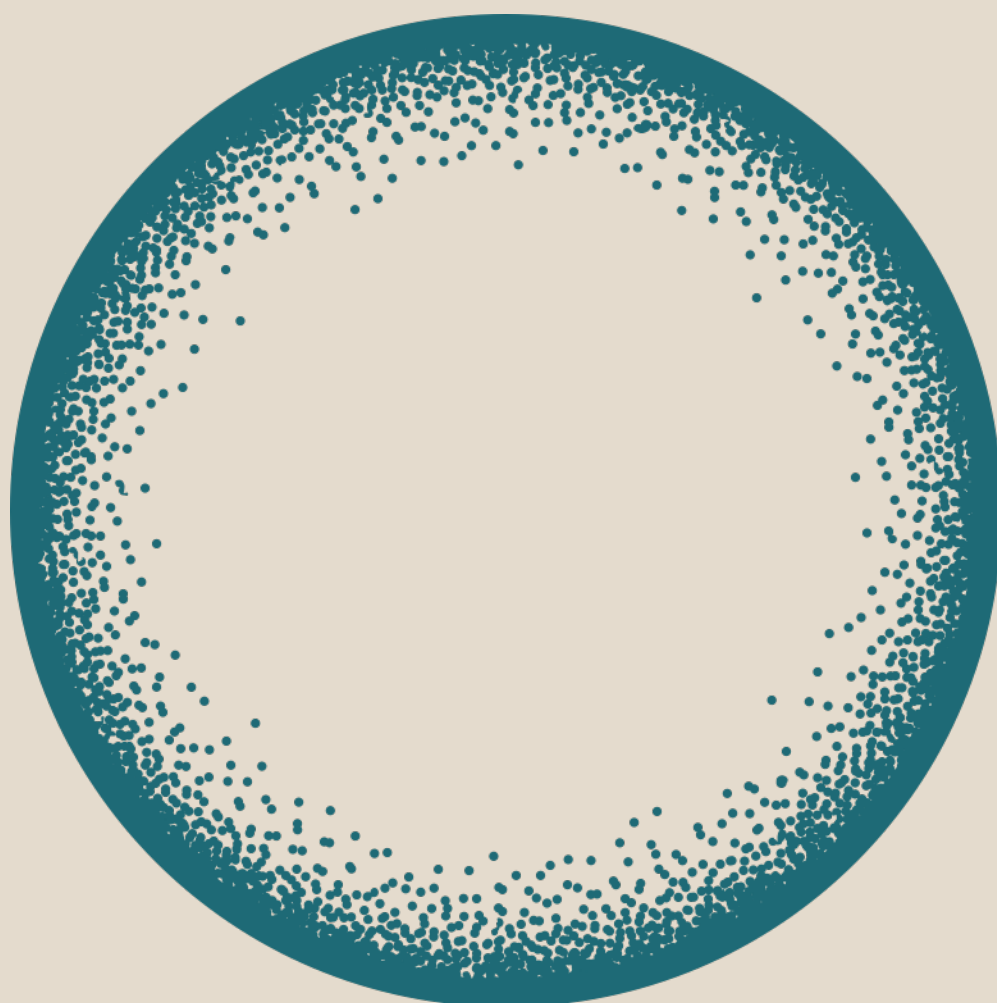
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The Prudence Principle: A New Framework for Euro-
zone Fiscal Policy

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THE PRUDENCE PRINCIPLE: A NEW FRAMEWORK FOR EUROZONE FISCAL POLICY

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Abstract

This working paper is an intervention into the on-going debate over the future of fiscal rules in the European Union. It argues that rather than writing down rules and expecting the world to conform to them, a better approach is to make the concept of ‘fiscal space’ operational by tying it explicitly to rates of interest on government debt. This permits huge flexibility in the size of the deficit, in the debt/GDP ratio, leaves inflation targeting to the central bank, and guarantees debt sustainability. It would also provide clarity to the public that the government is honoring its word.

JEL codes: E5, E58, E62

Keywords: debt, fiscal policy, monetary policy, interest rates, functional finance

The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of Forum New Economy.

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1. INTRODUCTION

The word prudence has an interesting lineage in the English-speaking economic world. Beyond its everyday usage, it was popularized during the 1990s and early 2000s by the then British finance minister Gordon Brown whose ‘prudential’ approach to ‘no more boom and bust’ presided over the biggest boom and bust in British history. It then reappeared in the immediate post crisis period as ‘macro-prudential’ regulation. This was a very clever set of ideas about de-risking the banking sector that ran into the rather obvious problem that the entire point of a banking system is to concentrate and manage society’s risk. Despite these inauspicious beginnings we hope to resuscitate the concept to describe what we see as a workable alternative to either ridged numerical targets as fiscal guardrails or the return of pure discretion via delegation of policy to a council of wise men.

What we propose is simpler, transparent, and recognizes what we are doing already. We argue that despite tacit adherence to existing fiscal rules, as a practical matter, fiscal space is determined by prevailing levels of interest rates. Furthermore, we believe policy economists adapt their beliefs about fiscal policy based on long-term and persistent changes in average interest rates, as have occurred over the last twenty years. We conclude by arguing that this reaction function, or rule, should be made explicit. We have outlined the broad structure such a rule should have, but a precise working rule will require more discussion and analysis. For simplicity, we will present our arguments and then contrast them to the proposals, by Olivier Blanchard and others, to move from rules to ‘standards.’ But before we begin we spend a little time laying out why it is necessary to rethink the utility of fiscal rules in the first place.

As Blanchard et al (2020: 2) make clear, the Eurozone has a rules-based macroeconomic framework to control for the “adverse effects of unsustainable sovereign debt in one member country on other member countries, either through the spillovers of fiscal crises, or through fiscal dominance of monetary policy, forcing the ECB to monetize...leading to inflation.” Additionally, as Martin et al (2021:2) argue, “the conceptual framework prevailing when the Maastricht Treaty was drafted was based on a disbelief in the capacity of fiscal policy to promote growth...[and a view that]...an increase in the budget deficit of a Euro Area country would raise interest rates in all countries, thereby penalizing investment.”

This is undoubtedly correct, insofar as it describes the rationale for the rules that we currently have, but it is worth recovering how and why these ideas became the dominant ‘conceptual framework’ for EU economic governance in the first place. Moreover, if that framework simply no longer fits the facts on the ground today, then while the challenge of debt sustainability always remains, addressing that challenge requires a deeper rethinking of the causal drivers of debt sustainability than

most analysts suggest if the economy today operates in ways that fundamentally differ from how it operated at the time of Maastricht (Bacarro, Blyth and Pontusson 2021).

2. WHY WE ENDED UP WITH RULES

As noted above, scholars such as Blanchard and Martin commonly list three reasons for why the EU has the set of rules that it does. First, there is a free-rider problem. Without rules, or perhaps more accurately, if all sovereign debt came with an implicit area-wide guarantee, fiscal policy has spillover effects. Second, there is an assumed causal relationship between deficits and interest rates, which lowers investment via crowding out effects. Third, too much debt leads to fiscal crises that impact other member states potentially forcing the ECB into debt monetization. To these we could add a few more. One is the ‘Luxembourg problem’ whereby fiscal stimulus in small open economies leaks out to neighbors to no great domestic effect. Another is the belief that in a world of open economies and unhindered capital flows Mundell-Fleming dynamics dictate that the independent monetary policy of a small open economy is formal rather than effective. As such, governments should concentrate on stabilizing the exchange rate (hence the logic of EMU) while working to improve the supply side of the economy through structural reforms.

Behind all of this, as is enshrined in the ECB’s 2 percent inflation target, is a still-deeper fear of the return of the inflation of the 1970s as an ever present possibility. Driving this, in turn, is this is a set of lessons drawn from the experience of the Bundesbank during that period that inform much policy today. Specifically how non-accommodative monetary policy produced better outcomes than accommodation (McNamara 1998), and where the villain of the piece is always a public sector with time inconsistent preferences sowing the seeds of inflation through profligate spending.

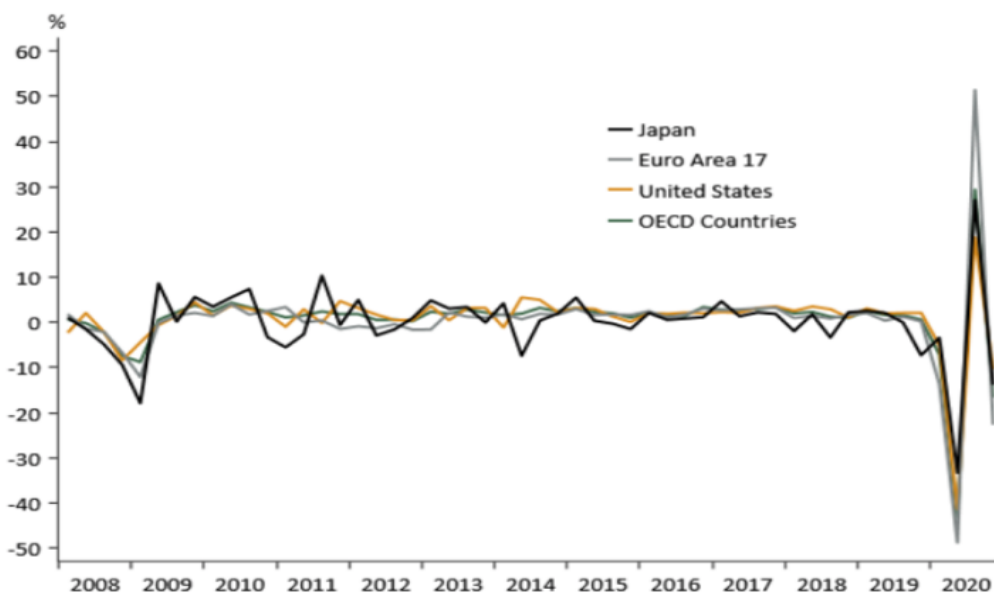
Given this, the question we should be asking before we ask about possible alternative rules is not only ‘how did we get here?’ and ‘are these rules still appropriate?’ but ‘why would we think that the underlying causes of the great inflation of the 1970s still haunt us today?’ For if these causes are not to be found, then much of the above falls into question. Indeed, it would strongly suggest that rules intended to safeguard economies against forces that no longer exist may prove to be at best counter-productive, if not downright harmful.

3. WHY THESE RULES MAY NO LONGER APPLY

First of all, it was always a bit of a myth that heroic central bankers with time consistent preferences rates bravely faced down spendthrift politicians thereby garnering the credibility that saved the system from democracy. As the election of center right governments everywhere in the 1980s showed us, there was a rather large anti-inflation coalition waiting around to be picked up once the ‘68 generation traded their rebellions for houses and pension plans. The asset rich public supported disinflationary policies and structural reforms once given the chance to do so.

What this led to, and is still germane today, is a world where rather than central bankers holding the line against profligate spenders, what really began in the 1980s was an extreme fiscal timidity among governments, long before any rules were enforced, which has had deleterious effects on public investment and growth in its own right.¹ But what is perhaps most important is how, alongside this timidity, the inflation that needed to be guarded against at all costs, most memorably seen in ex-ECB president Trichet's decision to raise interest rates twice in 2011 in the middle of a recession, singularly failed to show up, ever, as the following charts make plain

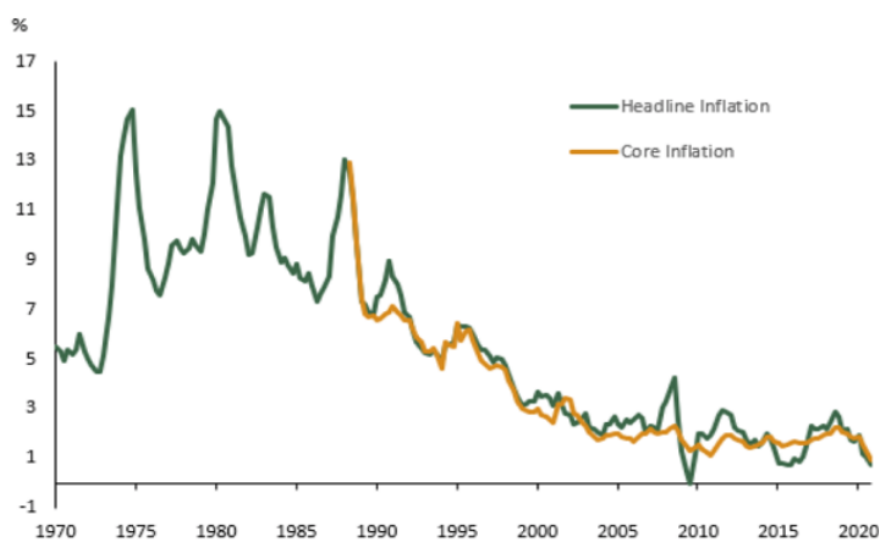
Figure 1: Real GDP growth (% , q-o-q, annualized)



Notes: Q3 2020 and Q4 2020 are estimates. Source: Macrobond and Llewellyn Consulting.

¹ Italy running a surplus for years on end and it has done nothing to enhance its growth prospects.

Figure 2: OECD headline and core CPI inflation rates (% , y-o-y)



Source: Macrobond and Llewellyn Consulting.

This was not unforeseen; it was just heavily discounted by the (the) new mainstream macroeconomics of the period. Indeed, Blinder (1981) famously argued that the main drivers of the great inflation, namely oil price shocks and food price spikes, were temporary phenomena that were bound to dissipate as economies adjusted, which they did by the mid 1980s. Recent work on the 1970s likewise sees these inflationary forces as transitory, with factors as diverse as the incorporation of women into the labor market without capital deepening, the militancy of labor of the period, and the cartel-like nature of national product markets being invoked (Lonergan and Blyth 2020). Politically, once the costs of inflation became apparent, and anti-inflation coalitions became dominant political forces, inflation drivers were either allowed to run their course (in the form of higher unemployment) or were targeted as problems to be removed (labor market rigidities – aka Trade Unions - and other labor market protections). Furthermore, the world changed, with a disinflationary bent, through globalisation, technology, product market deregulation, and demographic shifts.

The economic ideas that at that time sought to explain these inflationary forces were not much attuned to such factors since they sought causes in the general rather than the particular. The first was, broadly speaking, monetarism, which sought to tie increases in the money stock to increases in inflation as a causal relation. That attempt failed quite early on even if the mantra that ‘inflation is always and everywhere a monetary phenomenon’ lives on today.² The one that persisted and became central to the understanding of inflation that lies behind the fiscal rules today is based upon inflation-

² As someone at the Fed once quipped, it’s also true that ‘shootings are always and everywhere a ballistic phenomenon,’ but knowing that doesn’t tell us much about who died and why.

ary expectations, where expectations of future price increases become embedded such that the inflationary process takes on a self-fulfilling dynamic. To counter such processes an independent and non-accommodating monetary authority is needed to credibly commit to raising rates to counter such a pathology. This one sticks around today despite there being many problems associated with it.

First, almost all measures of such expectations are derived from movements in financial indices that may be moving around reasons unrelated to inflationary expectations, such as swaps and break-evens. Second, for such credible signalling to work, someone has to be listening to the signals. As Posen showed a long time ago, those most likely to listen are those with financial assets at risk, which is not wage earners or the general public at large (Posen 1995). And even among investors and business there is little evidence that central bank signals play any real role in decision-making (Kumar et al 2015).³

The focus on the public sector as the main generator of inflation risk, and of inflation risk as being the only risk worth bothering about, in turn, bred its own pathologies. As Johnson (2016) demonstrated, the focus on inflation and monetary policy as the primary tool of economic policy led to the serious neglect of bank supervision and the acknowledgement of the financial sector being a source of risk in its own right, which became all too obvious in the euro crisis. It also led to an underappreciation of the role that government debt plays in bank and non-bank financing through repo-markets, with some scholars referring to central banks as the ‘collateral factories’ for market based finance, which has consequences for both the value of government debt (in repo swaps) and the reduction of debt (which would increase the price of such collateral) (Gabor and Ban 2016). In short, public sector spillovers are far from, if indeed they ever were, the primary source of risk that the Eurozone faces (Gabor 2021).

Finally, if we place all of this in a longer time frame it is hard not to conclude that we may be dramatically oversampling an anomaly (the inflation of the 1970s) and generalizing from that to the whole distribution of possible outcomes in way that simply is not warranted. Recent work makes the case that long run real rates have been falling for some 700 years, with the 1970s and 1980s being anomalous cases of unusually low and then unusually high real rates (Schmelzing 2019). Meanwhile, even if one accepts the expectations logic of the inflationary process, recent work seems to suggest that Philips curves are not just flatter now, they may have always been flatter (Hazell et al 2020). And while the cause of the flattening matters for the policy response (Occhino 2019), the fact that we have been living in a world where neither sudden yield spikes nor inflation really is the threat that was supposed back in the 1980s and 1990s surely matters. Indeed, it strongly suggests not just a rethinking

³ Indeed, the fact that the entire world, with the exception of capital importing and commodity exporting countries disinflated as much as those following such policies suggests a certain ‘bystander’ effect that may have been taken to be a causal effect.

of the rules because of the ‘covid debt bulge,’ but on a more fundamental level, because they have probably been a cause of excess unemployment, lower growth, stagnant wages, and a collapse in public investment over the past two decades. And if you are still not sure about this, consider the following.

Thinking in this framework brought us the idea of expansionary fiscal contraction in the period 2010-2013, which proved to be a massive unforced policy error. Austerity did not produce growth and investment (Blyth 2013). It produced a lost decade and the beginnings of populism. Rising deficits in the period after the GFC did not crowd-out investment since banks create credit money and lend on the basis of profitability, not the supply of loanable funds. Instead, the much feared bond vigilantes failed to show up despite the increase in deficits, and the policy of QE increased bank reserves, which caused interest rates to decline, not rise. Finally, consider that running the US economy ‘hot’ since 2017 raised real wages without inflation (Perkins 2021) and that Bidenomics, if it is anything, is a one way bet that the NAIRU is relatively flat, and that if we don’t take advantage of this fiscal space to increase the real wage and employment protections of our voters, populism becomes structural. If you take all that on board, you must conclude that we really need to rethink not just the rules, but the whole fiscal framework. We do so next by examining the traditional approach to constructing fiscal rules, some alternatives, and then contrasting those approaches with our own.

4. HOW TO MAKE A RULE: ORTHODOX EDITION

Devising a rule that allows the public to assess the sustainability of government spending is a major challenge in political economy. The traditional approach to constructing fiscal rules uses sustainability equations aimed at stabilizing the public sector debt to GDP ratio to determine borrowing targets.⁴ On the face of it, this makes compelling sense. A fiscal stance that results in a constantly rising debt to GDP ratio will surely end in tears with default, inflation, austerity – or some unpleasant combination of all three.

In practically implementing this approach, policymakers have typically assumed that nominal growth and interest rates are both known and relatively stable. Otherwise it makes no sense to have a target for the fiscal balance. This is a logical result of the basic equation for fiscal sustainability:⁵

$$b_t - b_{t-1} = \left(\frac{r - g}{1 + g} \right) b_{t-1} - s$$

⁴ <https://www.politicaleconomy.group.cam.ac.uk/presentations/simonwrenlewisoct2014>

⁵ See Blanchard et al, 2021. <https://www.piie.com/sites/default/files/documents/wp21-1.pdf>

Where b_t is the ratio of debt to GDP at the end of period t , b_{t-1} is its lagged value, r is the interest rate on sovereign debt, g is the GDP growth rate, and s the ratio of the primary balance to GDP. If we solve this equation forward in time, r and g are typically not viewed as under the control of the fiscal authorities, but needs to be estimated. The ‘control’ variable is the primary balance, which governments have typically targeted in order to stabilize b , the public sector debt to GDP ratio.

Typically, in designing fiscal rules and targets we have assumed that r and g are known and relatively stable. Under those conditions it makes sense to allow both cyclical variance in the budget deficit and a target on which the debt/GDP ratio should converge. This framework is implicit within Eurozone fiscal rules, which have been designed to provide scope for cyclical fiscal stimulus, while maintaining a stable target for the public sector debt/GDP ratio.

5. HOW TO MAKE A RULE: FUNCTIONAL FINANCE EDITION

Before we clarify the obvious problem with this framework – namely, the implicit assumption that r and g are fixed – it is worth briefly considering the main alternative view from functional finance, which has recently been popularized by economists such as Stephanie Kelton.⁶ Clarity of thought and pointing out alternatives is the great strength of this tradition. Abba Lerner, the originator of this approach, questions the economic relevance of debt to GDP ratios:⁷

“The national debt is not a burden on posterity because if posterity pays the debt it will be paying to the same posterity that will be alive at the time when the payment is made...The national debt is not a sign of poverty any more than the certificates of ownership of government bonds are a sign of national wealth – the two amounts exactly cancel out in any measure of national wealth.”⁸

The clarity of reasoning in functional finance has long been recognized. Milton Friedman (1947) points this out in his original review of Lerner’s *The Economics of Control* where he says, “Lerner’s discussion of functional finance is a brilliant exercise in logic. It strips governmental fiscal instruments to their essentials: taxing and spending, borrowing and lending, and buying and selling; and throws into sharp relief the function of each.”

Stephanie Kelton (2020), following in Lerner’s tradition, and consistent with more modern theorists, such as Chris Sims⁹ and *The Fiscal Theory of Price Level (FTPL)*, views inflation as the binding constraint on fiscal policy. Inverting this observation, Kelton, in effect advocates that the

⁶ <https://www.philosophyofmoney.net/functional-finance-fiscal-rules-synthesis-part-ii/> Lerner, A. *The Economics of Control* (1944).

⁷ Conveniently ignoring distributional issues, it should be noted.

⁸ Lerner (1944), p303. Now ignoring debt held by foreigners – a point he subsequently acknowledges.

⁹ Sims, C. *The Fiscal Theory of Price Level* (lecture)

https://mediacentral.princeton.edu/media/The+Fiscal+Theory+of+Price+Level/1_7suikujp

fiscal authorities target inflation.¹⁰ Again, this insight goes back to Lerner who argued that under a functional finance framework, “the purpose of taxation is never to raise money but to leave less in the hands of taxpayers.”¹¹ On the face of it, functional finance seems to have the benefit of flexibility in light of uncertainties around r and g . In this framework you don’t need to know r and g . The fiscal authorities simply ease if inflation is too low and tighten if inflation is too high.

6. REINVENTING THE WHEEL?

The obvious challenge to the functional finance view of the world is that we already have an institution targeting inflation – the central bank. As such, wheels do not need to be reinvented, they simply need to be recalibrated. The work of Simon Wren-Lewis and Jonathan Portes provides us with such a recalibration.¹² They effectively embrace a switching model, where fiscal policy operates conventionally (although with far greater flexibility than prevail under current Eurozone rules), balancing the cyclically-adjusted current balance over rolling five-year periods, with a ‘knock-out’ rule whereby if monetary policy hits the lower bound fiscal policy switches-in to provide cyclical support.¹³ In a sense, this proposal successfully squares the circle between orthodox and functional finance views. In conditions where central banks are effective at managing the economic cycle, it makes sense for the fiscal authorities to focus on debt stabilization, but if the conditions render monetary policy redundant, fiscal flexibility should be embraced. This allows Portes and Wren-Lewis to maintain a rules-based system, a clear institutional separation of powers, and flexibility to respond to monetary policy failure.

Indeed, one could argue that the United States under the Biden administration has effectively embraced such a framework, without being explicit about it. While maintaining institutional and political independence there is both a clear division of labor between the Fed and the Treasury, and yet clear cooperation. For example, Treasury Secretary Janet Yellen has made clear that the Fed – operating independently – may need to raise rates,¹⁴ and the Federal Reserve chairman has made clear that they both welcome stimulus from fiscal policy and do not deem it likely to cause an inflation problem. In doing so the Fed is tacitly acknowledging their limited ability standalone to meet their mandate. Functional finance it seems, with its integrated balance sheet approach to public finance, is being honored in the breach.

¹⁰ Lonergan, E. Functional Finance and Fiscal Rules – a synthesis (Part II), blog. <https://www.philosophyofmoney.net/functional-finance-fiscal-rules-synthesis-part-ii/>

¹¹ Lerner (1944), p307.

¹² Issues in the design of fiscal policy rules, <https://onlinelibrary.wiley.com/doi/epdf/10.1111/man>

¹³ To be clear, Wren-Lewis and Portes do not, to our knowledge, have an explicit rule, but have outlined the principles a rule should take into account. See “Issues in the design of Fiscal Policy rules”, NIESR discussion paper No 429 <https://www.niesr.ac.uk/sites/default/files/publications/dp429.pdf>.

¹⁴ CNBC, 2021, May 4th <https://www.cnbc.com/2021/05/04/treasury-secretary-yellen-says-rates-may-have-to-rise-somewhat-to-keep-economy-from-overheating.html>

7. PRUDENTIAL RULES OR MORE TECHNOCRATIC FIXES?

Wren-Lewis and Portes “knock-out” rule is introduced as a way of addressing the effective lower bound. They assume, quite reasonably, that monetary effectiveness diminishes around zero interest rates. In these circumstances, stabilising the economy requires that fiscal policy has a freer role. Accepting this in the Eurozone could be difficult, given a philosophical reluctance to embrace anything that might appear like monetary and fiscal coordination. It also risks removing responsibility from the ECB to pursue more radical, but necessary, measures to meet its inflation target. Dual-interest rate via TLTROs already provide the ECB with unlimited monetary power.

We are motivated by the simpler fact, that interest rates affect fiscal space as a practical matter and as a matter of arithmetic, and this should be integrated into the design of any sensible framework. We still have to put the issue of debt sustainability front and center in any new framework even if we downplay inflation as the existential threat, which brings us to a discussion of interest rates and growth rates.

As Blanchard makes clear, a framework for fiscal sustainability is almost entirely determined by whether an economy faces interest rates above or below nominal GDP growth. As he argues:

“One then needs a definition of debt sustainability and, by implication, debt unsustainability. A working definition is that debt is sustainable so long as the probability of a debt explosion, and thus of eventual debt default, remains very low. The challenge is to determine the maximum level of debt that is sustainable...It is useful to make a further simplifying assumption, that future interest rates and growth rates are constant and known with certainty...There are then two cases, depending on whether the interest rate (r) is higher or lower than the growth rate (g), and the discussion depends very much on which case holds.” (Our Italics)¹⁵

We could describe the circumstances where $r > g$ as embedding an austerity bias. If the debt/GDP is close to 100% of GDP, and r is close to or significantly greater than g , a country will typically need to run a primary surplus at some point in order to stabilize its debt/GDP ratio. By sharp contrast, when $r < g$, the debt sustainability equation produces a very different result. As long as the primary deficit itself does not increase year after year, far from exploding, debt will converge to a finite value. Primary deficits can in fact be run forever. As Blanchard acknowledges, the EU fiscal rules were in fact designed assuming $r > g$. “The assumption that $r - g$ was positive and that countries with high debt had to maintain large primary surpluses very much underlay the construction of the EU rules, and is

¹⁵ Blanchard et al, pp. 5-6. See Biblio.

still the way many observers and policymakers think about debt sustainability. But the environment has steadily changed.”¹⁶

Being explicit about this bias, and the redundancy of existing rules is helpful and honest. But it seems odd simply to argue that now the regime has changed we should abandon rules altogether. As Blanchard and his co-authors argue, “the alternative to rules is standards. Unlike rules, standards distinguish good from bad behavior in qualitative rather than numerical terms. This allows an adjudicator to draw on a much larger information set than typically enters rules. It also allows room for judgment.”

8. A PRUDENTIAL ALTERNATIVE?

Putting aside for the moment the obvious political economy problem of granting the European Commission, or some other technocratic organization, even greater discretion over member state fiscal policies in an era of populism as a plausible strategy, Blanchard et al., seem to have abandoned a rule-based framework prematurely, precisely when they have already revealed a very precise rule. That the relationship between r and g effectively creates a rule set that both avoids discretion (or technocratic overreach) and the procyclicality of the current rule set.¹⁷

So what is the alternative? To our knowledge, no current fiscal rules¹⁸ are centered around the market rate of interest on government debt, despite the fact that this is often the practical constraint. Our proposal is to make the concept of ‘fiscal space’ operational by tying it explicitly to rates of interest on government debt. This permits huge flexibility in the size of the deficit, in the debt/GDP ratio, leaves inflation targeting to the central bank, and guarantees debt sustainability. It would also provide clarity to the public that the government is honoring its word.

How would this rule work? To be clear, we are not attempting to redesign Eurozone fiscal rules. There is already a diverse and complex debate around this - so diverse and complex that one would bet against any agreement.¹⁹ Our objective is simpler: to agree on a coherent framework for exemption. Our suggestion is that the member states are exempt from fiscal rules and have the ability to ease fiscal policy (or issue debt for other purposes) as long as the long-term cost of government debt is below nominal GDP growth (this is our practical definition of ‘fiscal space’). To be very clear,

¹⁶ Ibid, p7.

¹⁷ Another fundamental problem with the ‘wise men council armed with stochastic debt sustainability analysis’ alternative to rules proposed by Blanchard et al is admitted by the authors themselves. That is, the presence of “Knightian uncertainty” that would make the values of key variables going forward “impossible to identify ex ante.” (Blanchard et al (2020:17) The authors deploy this as a criticism of rules, but it also applies, perhaps with more force, to the ‘fan chart’ outcomes of SDSA analysis, and the ‘discretion with opacity’ it would encourage.

¹⁸ IMF. Fiscal Rules at a glance, March 2017.

<https://www.imf.org/external/datamapper/fiscalrules/Fiscal%20Rules%20at%20a%20Glance%20-%20Background%20Paper.pdf>

¹⁹ See “Fiscal rules in the monetary union”, VoxEU, 10 June 2021. <https://voxeu.org/article/fiscal-rules-european-monetary-union>.

we are not proposing that the government targets bond yields. Instead, we suggest that member states commit governments to flexible fiscal rules along the lines of the those advocated by Wren-Lewis and Portes, if bond yields are close to, or higher than nominal GDP growth.²⁰ If bond yields are materially below nominal GDP growth, the government would be freed from this constraint and has flexibility to pursue policies that would require increased borrowing.

Why might this ‘rule’ be advantageous? Firstly, it is both highly flexible – there are no budget balance targets, no debt/GDP targets, and no difficult estimations of unobservables. The 10-year government bond yield is a market price. Some estimation of average nominal GDP growth is required – the simplest rule-of-thumb would be a 10-year trailing average. Alternately, consensus economic forecasts for long-term growth, provided by the national (or EU level) statistics agency, could be used. With such a set up the government has a very high degree of flexibility to cope with the wide variance of economic outcomes, and it is relatively straightforward to observe non-compliance.

What is the logic behind this rule? As we have already seen, fiscal sustainability is determined by the interaction of four variables – the interest rate the government borrows at, the balance of revenue and expenditure before interest expenses (the primary balance), the rate of GDP growth, and the starting point of the debt/GDP ratio. The typical approach to a fiscal target is to make estimates of the likely cost of debt and trend GDP growth, and then target the balance necessary to stabilize the debt/GDP ratio. But what if there are phases when shifts in the public debt/GDP ratio are beneficial? For example, when large shifts in savings preferences push down real interest rate structures relative to GDP growth. We want to have a rule, which ensures sustainability, retains flexibility, and can’t be gamed by politicians.

Our suggestion is that we reverse engineer the problem, free the deficit and debt/GDP ratios, and make the cost-of-debt constraint operational. In other words, choose a level of interest rates from which it would almost certainly be wise to tighten in response. Is there such a level? The obvious point is when the cost of long-term borrowing to the government is close to, or exceeds, long-term nominal GDP growth. This principle is prudent in the best sense of the word. It appears to be dynamically consistent with debt sustainability, allows policy to respond to changes in trend real interest rates, and provides us with a very transparent yardstick for assessing policy.

²⁰ Our preference, along the lines discussed by Wren-Lewis and Portes, would favour rolling five-year deficit targets, which treat capital expenditure independently. We do not see much logic behind debt/GDP targets. Either way, the purpose of this paper is to advocate an automatic suspension of the rules when prevailing interest rates are significantly below nominal GDP.

9. OBJECTIONS TO THE PRUDENCE PRINCIPLE

The first objection to such a rule is a reluctance to pin government policy on a market- determined price – yields on long-term government bonds. There is little doubt that there is excess volatility in short-run shifts in yields. Even at maturities as long as 30-years, yields can move by over a percent in three months (as we have seen recently)²¹. Revising fiscal policy with this frequency would not be helpful. The logical response to this problem is to use perhaps a three-year average yield, and build in a significant margin of safety.

A second objection is that announcing such a policy would make it inoperable because yields would automatically rise in anticipation. This is possible, but we think unlikely. In a monetarily sovereign developed economy with stable inflation, the center of gravity for government bond yields is determined by interest rate expectations and term premia. The term premium (or discount) is the difference between the actual yield and interest rate expectations, which in turn is determined by the ‘risk’ properties of government bonds – in particular the correlation with cyclical assets, such as equities – and the rate of interest on global bonds. The impact of any fiscal easing on bond yields depends therefore on the effect on interest rate expectations. Any substantial fiscal easing would be expected to raise interest rate expectations relative to the counterfactual, but the probability that markets would price in a perfectly symmetrical response is unlikely. For yields to rise to the level of nominal GDP in an enduring way would require a sustained rise in interest rate expectations, which would imply two beneficial outcomes – very strong growth and a resumption of monetary firepower.

In presenting these arguments, the most repeated objection is that we risk introducing an ‘austerity bias’ if a member state faces an interest rate on their debt in excess of nominal GDP growth. This might occur, for example, if the ECB tightens policy material.²²

Italy is in an especially problematic position here insofar as for Italy $r > g$ is a persistent feature. Given our proposal, especially if interest rates rise, would Italy be force into austerity? Two points are important to clarify here. If the European central bank were to raise interest rates significantly, this would logically occur in an economic boom. There would be no grounds for an exemption from a sensible set of fiscal rules. Does our proposal suggest an austerity bias for Italy? That would depend entirely on the prevailing fiscal rules and their implementation in the Eurozone. Our proposal is for an exemption. No member state can be worse off than utilising our exemption. Of course, it cannot compensate for a bad set of fiscal rules. Italy of course is already a systemic risk problem for the Eurozone and the current rules do not help this situation. The prudence principle would at least

²¹ <https://www.cnbc.com/2021/02/25/us-bonds-treasury-yields-rise-ahead-of-fourth-quarter-gdp-update.html>

²² Peter Bofinger “The prudence principle as a new framework for fiscal policy: a comment on Loneragan and Blyth,” Presentation and discussion, New Paradigms workshop, May 27th 2021.

clarify these dynamics and perhaps force the EU to tackle the southern growth problem in a more serious manner.

10. CONCLUSION

There is a growing consensus that fiscal policy needs a rethink in response to the collapse in global interest rates and yield curves. This precedes the pandemic.²³ There are a number of ways to respond to this. The obvious first step is to give central banks the tools to pursue effective policies, and for those that have the means to exert intellectual leadership.²⁴ As regards fiscal policy, there are lots of reasons for exploit the current collapse in the cost of government borrowing – not least, setting up sovereign wealth funds to tackle wealth inequality. It would help if fiscal authorities had a clear framework for responding. The prudence principle for identifying fiscal space is to some extent a statement of the obvious – it’s time to make the obvious policy.

Blanchard et al., agree as much, but see it as a “fool’s errand” to stick with rules (2020:24). Despite the possible technocratic merits, it is unlikely that Europe’s political class will sign up to an expanded European Fiscal Board armed with discretion and fan charts. We agree that rigid numerical targets for fiscal metrics make little sense, if they ever made sense, but that does not apply to the Prudence principle. Let us at least agree on rigorous grounds for suspending rules. Crucially, this principle allows more space for the wage growth and investment that Europe badly needs. Either way, the era of numerical targets and pure monetary dominance is over. It is entirely appropriate to debate what comes next.

²³ Stan Fischer et al, Dealing with the next downturn, August 2019, Blackrock Institute.
<https://www.blackrock.com/corporate/literature/whitepaper/bii-macro-perspectives-august-2019.pdf> and Angrynomics, 2020.

²⁴ Lonergan, E. Redesigning monetary policy. Blog <https://www.philosophyofmoney.net/redesigning-monetary-policy/>

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APPENDIX I

The following comments are retrieved from the IX New Paradigm Workshop of May 2021 where this paper was presented by the authors and commented by Peter Bofinger, Véronique Riches-Flores, and Jakob von Weizsäcker.

Peter Bofinger

The LB-rule:

- If $r \geq g$: “target a stable debt/GDP rule”
- If $g > r$: “flexibility to pursue policies that would require increased borrowing”

But:

- What is the policy rule if $g > r$
- There is no mechanism enforcing a reduction of the debt/GDP levels. If the LB-rule is applied over the longer-term, debt/GDP levels will get out of control
- What happens, if with a very high debt/GDP level a long period with $r > g$ follows?

The level of r is market determined, but:

- r is also strongly influenced by the level of the central bank’s policy rates. This raises a problem for the rule if central banks increase the short-term interest rates which then also has a strong impact on the longer term interest rate.
- If you apply the LB-rule during recessions, fiscal policy will be constrained because it will have to stabilize the debt/GDP ratio and it has no room for any substantial stabilization, so there is a risk of pro-cyclical fiscal policies.

Functional finance as a basis for a fiscal policy rule:

- Applying functional finance as a framework for fiscal policy and identifying the responsibility of fiscal policy for inflation has a lot of potential and opens the space for very new ideas on fiscal rules.

Véronique Riches-Flores

Given that:

- Nominal GDP growth for Italy over the last 10 years has been around 0.5 percent against one percent government interest rates on average (over the last three years it was 1.7); the difference between the two values is very large and the LB rule would suggest that Italy adopts a very strict fiscal policy stance.

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- In Germany nominal GDP growth has been roughly 2.6 over the last 10 years, while interest rates have been slightly above zero percent on average over the last three years; the LB rule suggests that Germany should support a very loose fiscal policy.

This means:

- In the case of Europe – with countries performing still very differently - using such a rule would probably exacerbate the structural gap among European countries, instead of reducing it.

Jakob von Weizsäcker

The role of investments should be considered, i.e. public investments to deal with climate change or other things that really pay off in terms of increasing economic potential. This would be useful because:

- If one borrows in a situation where $g > r$ (not knowing whether this will last forever) and spends those money on things that have a good return in terms of growth potential, one is protected against the risk of interest rate reversal.
- In the European context, while it's hard to force countries to spend, if we have a consensus about spending money to achieve this great transformation (investing in climate issues, human capital and other things that would not only be productive, but also bring equity in societies) it is more likely that countries will voluntarily do what is necessary in order to support monetary policy at the zero lower bound.
- So adding the element of investments to what could be a broad-based strategy resting on three legs (i) $r - g$, ii) zero lower bound, iii) investing into a better future) would lead to a much more stable situation with broader support among European countries.