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GOVERNMENT DEBT POST COVID-19:

BACK TO GOLDEN RULES

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Abstract

The COVID-19 crisis has caused public debt to increase dramatically, which is why the German and European fiscal rules are currently suspended. In addition to the new assessment of the fiscal costs at low interest rates (r < g), the discussion on the reintroduction of fiscal rules in Germany and Europe should take into account the function of government bonds as a safe asset and an instrument to combat the liquidity trap as well as the net return on productive government investments. For practical reasons, the return to the classic Golden Rule, which aims to limit net debt and promote government investment in the interest of future generations, is recommendable.

Keywords: Government Debt, Fiscal Rules, Low Interest Rates

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The COVID-19 crisis has caused public debt to explode, which is why the German and European fiscal rules are currently suspended. Researchers have controversially discussed the reintroduction of fiscal rules in the light of the prolonged low interest rate regime. The independent European Fiscal Board (2020) at the European Commission calls for a simplification of the fiscal rules and recommends a target for government debt and protecting investment. Blanchard et al. (2020) argue for abolishing the rules in favour of "fiscal standards" to address the complexity of the debate on debt sustainability. In this line, Hüther and Südekum (2020) call for a "flexible" debt brake in Germany and a government ’investment budget’.

The discussion takes place against the backdrop of the ongoing low-interest phase, which also influences the costs of government debt (Krämer and von Weizsäcker, 2020). Since the ratio of the interest rate r and the growth rate g is less than one, government debt does not entail any fiscal costs (Blanchard, 2019). If the interest rate would be larger than the growth rate ($r > g$), the numerator of the government debt ratio would increase faster (due to cumulated interest rates over time) than the denominator (due to growth and inflation) if this increase were not offset by primary surpluses. At low interest rates or $r < g$, on the other hand, the ratio of government debt to gross domestic product (GDP) declines of its own accord. In the U.S. as well as in Germany, France, and Italy, $r < g$ is the historical norm for government bonds (Blanchard, 2019 and Barro, 2020). This relationship was viewed differently ten years ago when the debt brake was introduced. Following the inflation- and interest-rate-driving events of the 1970s, 1980s (oil price crises) and 1990s (reunification), rising risk premiums on government bonds during the financial crisis contributed to concerns that government debt at high interest rates ($r > g$) would impose fiscal burdens. This explains the prevailing approach at that time to introduce tight fiscal rules, aimed at limiting deficit and thus debt ratios at low levels and not to allow exceptions for investment or countercyclical stimulus.

Many current reform proposals share the view that investment should be preferential. In this respect, a return to the Golden Rule, as specified in Article 115 of the German Constitution

(‘Grundgesetz’) until 2010, would be reasonable. This allowed net borrowing in the amount of gross government investments and was thus systematically linked to government savings. There are three central arguments in favour of the Golden Rule:

First, the deficit as a target in the fiscal rules reduces incentives to invest. Particularly because fiscal rules are justified in the interest of future generations, there is no sense in limiting spending on investments. In fact, net investment in Europe's peripheral countries has been negative for a long time so that public infrastructure is deteriorating, which has been the case in Germany for a long time, as well. Criticism of the classic Golden Rule points out that in addition to construction and investments in fixed assets, other growth-enhancing expenditures and corresponding depreciations should also be taken into account. However, since a consensual and practicable alternative definition of ‘investment’ is lacking so far, the classic Golden Rule is recommendable for pragmatic reasons, using gross government investment (or a combination of deficit target plus net investment). This would initially favour investment in fixed capital formation and allow increases in future-oriented investments that are relevant today, e.g. in digitisation, public transport, as well as climate, environment, and energy. The additional investment required in Germany is estimated at around EUR 45 billion per year (1.3% of GDP) over the next ten years.

Second, the target value for limiting the debt ratio of the classic Golden Rule is pragmatic. The recent deficit limits of the German debt brake since 2010 (0.35% of GDP) and the fiscal compact (0.5% and 1% of GDP, respectively) are substantially tighter than the Maastricht ceiling of 3%. They allowed the debt ratio to converge at the ratio of the deficit to the growth rate, resulting in debt ratios of 10% to 15% and 30% respectively at nominal growth rates of around 3.5%.

The argument in favour of higher targets, in addition to the ‘no fiscal cost argument” at low interest rates ($r < g$), is that government bonds also offer safe assets, which are in short supply (Caballero and Farhi, 2017). Therefore, it is questionable whether a rapid and painful reduction of debt ratios from significantly higher levels (around 100 to 140%) in Western Europe is reasonable, appropriate and realistic. The classic Golden Rule, on the other hand, would allow deficits equal to government gross investment, which in Germany today corresponds to estimated depreciation on the government capital stock (approx. 2.1% of GDP). With nominal growth of 3.5%, this would stabilise gross debt at exactly 60% of GDP - the Maastricht criterion. Similarly, an increase in net investment would shift the target value of the gross debt ratio but leave the relevant net debt unaffected.

Third, fiscal rules should allow for a healthy degree of stabilisation policy. Since monetary policy is not very effective at the zero lower bound, fiscal policy should play an active role in the liquidity trap (Truger, 2020). The return to the Golden Rule would allow countercyclical measures in the form of public investment programmes. As before, the deficit ceilings need an additional cyclical component, although the methodology for calculating cyclical deficits needs a reevaluation (Brooks and Fortun, 2020 and Heimberger, 2020).

In addition to the new assessment of the fiscal costs at low interest rates ($r < g$), the discussion on the reintroduction of fiscal rules in Germany and Europe should take into account the function of government bonds as a safe asset and an instrument to combat the liquidity trap as well as the net return on productive government investments. For practical reasons, the classic Golden Rule, which aims to limit net debt and promote government investment in the interest of future generations, is recommendable.

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