Challenges of ensuring fiscal discipline: The role of fiscal regulators and financial markets

6th Annual Meeting of OECD-CESEE Senior Budget Officials
Budva, Montenegro
23-24 September 2010

Gonzalo Caprirolo
Senior Economist
Institute of Macroeconomic Analysis and Development
The views expressed are those of the author and do not necessarily represent those of the IMAD
1. The fiscal challenge ahead: consolidation and locking consolidation gains

2. The role of financial markets in delivering fiscal discipline: before and after the crisis

3. The role of fiscal institutions and fiscal developments before the crisis

4. Addressing the challenge of fiscal consolidation: Rules, independent fiscal institutions and fiscal consolidation strategy

5. Locking post stabilization gains: internalization of experience or/and changing the institutional setting

6. Conclusions
• Most advanced economies have to adjust fiscal accounts by large amounts

• The main challenge for fiscal policy is to develop credible consolidation strategy

Source: AMECO
This time the adjustment has to be simultaneous on the back of uncertain economic background.
The role of the market in imposing fiscal discipline

Through the 1980s severe financial market discipline forced governments to reduce primary deficits or run surpluses.
Yields broadly mirror government balances

Source: Eurostat and OECD

Graph showing Government 10-Y bond yields (b.p 00) and government balance (% GDP) from 1970 to 2009.
On the run to EMU the market signals consistent with gradual consolidation

Government debt % GDP

Belgium
Denmark
Germany
Ireland
Greece
Spain
France
Italy
Netherlands
Austria
Portugal
Finland
Sweden
United Kingdom

Source: Eurostat
Since 2007 a simultaneous upward turnaround in debt dynamics

Up to 2008 historically low bond yields (low inflation, global savings glut) contributed to consolidation and shield governments from pressures to reduce their borrowing

Source: Eurostat
2001-2007 low inflation and strong global liquidity; with the crisis market conditions change fundamentally

- Yields still reflect global risk factors (Flight to safety and liquidity)
- Market seems to discriminate more based on fiscal variables
- The issue is pro-cyclical risk aversion or shift in market attitude towards fiscal developments?
Liquidity is affected by credit risk considerations: Permanent or temporary development?

Before the crisis, when money was abundant, liquidity was the most important concern when pricing.

Source: MTS
Significant change in market perception

Relation between spread over benchmark (10-y bund) and CDS

- $R^2 = 0.1964$
- $R^2 = 0.7609$

2008
2009
Markets: different look at government balance

Source: Eurostat
The debt level also more important

Source: Eurostat
Government balance more preeminence within groups of countries

Empirical evidence (IMF 2009) at the time of crisis indicates that expected government debt and deficits (government announcements of financial rescue packages) account for about one-third of the movements in euro area spreads.

Source: Eurostat
Sovereigns facing not only impact of worsening credit risk but also liquidity risk

10-Year government bond yields and bid ask spreads (July 2008-July 2010)

Source: Eurostat and MTS
Spillovers from worsening sovereign credit risks to the financial sector

Sovereign and bank 5Y CDS spreads (b.p) 30 Sep. 2009 and; (*) 30 Mar. 2010

Source: ECB
Pass-through of sovereign credit risk to bank funding costs further incentive to fiscal consolidation
### Stepped up downward trend in credit ratings after crisis

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2007</th>
<th>2008</th>
<th>2009/4</th>
<th>2010/8</th>
</tr>
</thead>
<tbody>
<tr>
<td>DE</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>FR</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>LU</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>NL</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>AU</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>FI</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>BE</td>
<td>AA+</td>
<td>AA+</td>
<td>AA+</td>
<td>AA+</td>
<td>AA+</td>
</tr>
<tr>
<td>ES</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AA+</td>
<td>AA-</td>
</tr>
<tr>
<td>SI</td>
<td>AA-</td>
<td>AA+</td>
<td>AA</td>
<td>AA</td>
<td>AA</td>
</tr>
<tr>
<td>IR</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
<td>AA+</td>
<td>AA-</td>
</tr>
<tr>
<td>IT</td>
<td>AA-</td>
<td>A+</td>
<td>A+</td>
<td>A+</td>
<td>A+</td>
</tr>
<tr>
<td>CY</td>
<td>A</td>
<td>A+</td>
<td>A+</td>
<td>A+</td>
<td>A+</td>
</tr>
<tr>
<td>SK</td>
<td>A</td>
<td>A</td>
<td>A+</td>
<td>A+</td>
<td>A+</td>
</tr>
<tr>
<td>PT</td>
<td>AA</td>
<td>AA-</td>
<td>AA-</td>
<td>A+</td>
<td>A-</td>
</tr>
<tr>
<td>MT</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>EL</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>A-</td>
<td>BB+</td>
</tr>
</tbody>
</table>

Source: S&P

*Before the crisis ratings change slowly coinciding with reduction/slow pace of debt accumulation*
Market conditions aligning incentives for fiscal consolidation and policy intentions

- This time might be different due to simultaneity of the fiscal challenge (yields reflect global risks)
- After “weak” enforcement (2001-2008) discipline is enforced more forcefully (yield discrimination)
- Debt and deficits are more important in yield movements
- Crisis has also impact on liquidity
- Spillovers from sovereign credit risk to banks funding costs strengthens incentive for consolidation
- Faster downward action of credit institutions

CONCLUSIONS

- Market at this time is effectively imposing fiscal discipline
- Is the role of the market pro-cyclical or reflect fundamentals?
- Permanent or temporary shift in market attitude
### Fiscal institutions and fiscal discipline (Transparency and accountability)

**Objectives:** 1 = yes; 0 = no

<table>
<thead>
<tr>
<th>Objective</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>GOV has to consult FC during the budgetary process (4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assess quality of PF (10)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enhance transparency in the conduct of FP (15)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent assessment of compliance with SGP fiscal rules (4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent assessment of compliance with national fiscal rules (9)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ensure that GOV policy is adequate in cyclical conditions (7)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ensure consistency of GOV policy with sustainability of PF (8)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Tasks:** 1 = yes; 0 = no

<table>
<thead>
<tr>
<th>Task</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent analysis on FP developments (20)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent forecasts of macro or/and budgetary assumptions (15)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normative statements on conduct of FP (8)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recommendations on FP (16)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source:** European Commission data base on fiscal institutions

---

- UK National Audit Office
- SI Institute of Macroeconomic Analysis and Development
- SE Swedish Fiscal Policy Council
- SE National Institute of Economic Research
- PT Unidade Técnica de Apoio Orçamental (UTAO)
- PT Court of Auditors
- NL Netherlands Bureau for Economic Policy Analysis
- LU Court of Auditors
- LT National Audit Office
- IT Institute for Studies and Economic Analyses
- HU State Audit Office
- FR Commission Economique de la Nation
- FR Court of Accounts
- ES National Committee of Local Administration
- ES Court of Auditors
- EL Centre for Planning and Economic Research
- ENEational Audit Office of Estonia
- DK Danish Economic Council
- DE German Council of Economic Experts
- DE Working Party on Tax Revenue Forecasting
- DE Joint Economic Forecast project group
- DE Advisory Board to the Federal Ministry of Finance
- BE National Accounts Institute
- BE High Council of Finance - Section "Public sector borrowing requirement"
- AT Government Debt Committee
- AT Institute for Advanced Studies
- AT Austrian Institute of Economic Research

---

- SI Institute of Macroeconomic Analysis and Development
- SE Swedish Fiscal Policy Council
- SE National Institute of Economic Research
- PT Unidade Técnica de Apoio Orçamental (UTAO)
- PT Court of Auditors
- NL Netherlands Bureau for Economic Policy Analysis
- LU Court of Auditors
- LT National Audit Office
- IT Institute for Studies and Economic Analyses
- HU State Audit Office
- FR Commission Economique de la Nation
- FR Court of Accounts
- ES National Committee of Local Administration
- ES Court of Auditors
- EL Centre for Planning and Economic Research
- ENEational Audit Office of Estonia
- DK Danish Economic Council
- DE German Council of Economic Experts
- DE Working Party on Tax Revenue Forecasting
- DE Joint Economic Forecast project group
- DE Advisory Board to the Federal Ministry of Finance
- BE National Accounts Institute
- BE High Council of Finance - Section "Public sector borrowing requirement"
- AT Government Debt Committee
- AT Institute for Advanced Studies
- AT Austrian Institute of Economic Research
Independent fiscal institutions and fiscal balance

Difficult to disentangle the impact and contribution on independent fiscal institutions


Source: European Commission data base on fiscal institutions; Eurostat
Independent fiscal institutions and debt


Source: European Commission data base on fiscal institutions; Eurostat
Perception of institutions’ contribution to discipline and outturn varies

Perceived impact of fiscal councils and fiscal stance before the crisis (2007)

Perceived impact on fiscal discipline (Maximum score is 10)

Source: Debrun and Kumar (2008); Public finances in EU 2007, European Commission
Coalition agreements undepinns fiscal targets and performance of the best performers

Source: Stability programs and Eurostat
The assessment of fiscal stance in 2008

Public finances in EMU - 2008

- Budgetary positions improved for the fourth year running in 2007
- Structural fiscal deficits estimated at their lowest levels since the early 1970s
- Member States have reached or are close to reaching MTOs
- Public debt dropped below the 60% of GDP (2007) in the EU; Euro area it is approaching to threshold
- Member States face stiff challenges in safeguarding their fiscal consolidation gains
- Revenue windfalls used to cover expenditure slippages

Euro-area fiscal stance and output gap

Source: Commission services' spring 2008 forecast.
Not enough consolidation in good times: Cyclically adjusted balance: before (A07) and after the crisis (S07)

EC. Autumn (2007) and Spring (2010) forecast
Assessment after the crisis

- Fiscal policy did not play a major role in the run up to the crisis
- Assessment of cyclical conditions quite challenging
- Countries should consolidate during good economic times to build a “fiscal cushion (low debt)” to have sufficient room for manoeuvre during an economic downturn or a crisis
- Tax policy also encouraged debt financing in recent years
- Fiscal policy should take into account the challenge of ageing

Issues
  - How to consolidate
  - What is the optimal level of “surplus”
Fiscal discipline (good times): **compensate for in-built deficit bias**
- Miopic behavior of politicians
- Pro-cyclical behavior
- Common pool: Use common resources to particular goals disregarding fiscal stance
- Time inconsistency: repealing commitments

Fiscal consolidation (time of crisis): **delivering sizable fiscal adjustment**
- High starting levels of deficits
- High level of risk premia (effective market discipline)
- Strong correlation between fiscal position and banks credit risk
- Negative debt dynamics
- Large exchange rate depreciation
The choice of instrument and the delivery

♦ **Instruments to compensate for in-built deficit bias or lock consolidation gains:**
  
  — Fiscal rules
  — Independent monitoring fiscal institutions

♦ **Instruments to ensure durable fiscal consolidation:**
  
  — Consolidation strategy
Relevance of measures/policies in dealing with the immediate consolidation challenge

♦ **Fiscal rule**: imposing a quantifiable permanent constraint on fiscal policy

♦ **Independent fiscal institution**: Transparency (independent forecast) and accountability (monitoring compliance with stability objectives)
  - Independent projections and macro-forecast (for budget preparation or costing budget proposals)
  - Ex-post monitoring of government compliance with rules or with sustainability objectives. Provide advice on “sound fiscal policy”. Facilitate public debate

♦ **Fiscal rule + fiscal institution**: Enhanced enforcement of rule
  - The presence of fiscal councils appears to contribute both to the emergence of fiscal rules and to their effective enforcement

♦ **Consolidation strategy**: Design set of credible measures to bring fiscal policy back on track towards sustainability
  - Pace of consolidation, instruments chosen, sustainability, quality
The issue of credibility taking into account market incentives to consolidate

Signaling commitment to consolidation by:

1. Setting a rule to put fiscal adjustment in motion

2. Creating an institution to monitor the consolidation strategy quality and compliance of government with fiscal sustainability objectives

3. Designing a realistic credible medium-term fiscal plan with a visible anchor (in terms of either an average pace of adjustment, or of a fiscal target to be achieved within a time frame)
Role of rules in consolidation episodes

- Econometric evidence on fiscal rules triggering fiscal consolidation in EU is inconclusive (Larch and Turrini 2008)
- Rules can affect the quality of fiscal policy because they are generally silent on the composition of the required fiscal adjustment (Blanchard and Giavazzi 2004).
- Rules per se reflect, rather than create, the motivation towards fiscal discipline. Rules may lack credibility unless they are accompanied by a budget commitment to complete budget transparency (Debrun and Kumar, 2007)

Rules and institutions

- Empirical studies find that both contribute to stronger budget outcomes. They are inconclusive as whether these set ups cause the budget outcomes or whether both they and the budget outcomes are caused by the same third factor(s) (OECD 2010)

Independent fiscal institutions providing forecast can contribute to quality of adjustment strategy by providing consistent forecast and projections
Issues concerning rules and institutions at the time of the adjustment

♦ Rules without commitment or inappropriately designed can erode credibility
  − Rules **might be redundant at start of consolidation** as consolidation entails recognition of unsustainability of imbalances
  − Rules **might not mandate enough adjustment** consistent with consolidation
  − Their **probability of success increases with authorities commitment** and detailed measures to reduce deficit in sustainable manner
  − **Careful attention of certainty of economic environment**
  − Evidence suggest (IMF) that **rules are introduced where progress is already made** in fiscal and economic performance

♦ Creation of new independent monitoring fiscal institutions
  − Carefully crafting its design, mandate and attention to **the level of technical expertise (Reputation from the outset)**
  − They can help monitoring compliance of consolidation strategy and targets **but do not replace government responsibility for policy design**
  − Before their creation **consideration should be given to existing institutional setting**
  − Should independent monitoring institutions’ opinions be enforced or just debated?
Issues in delivering credible and sustainable consolidation strategy

- Fiscal objective and targets based on well specified and sustainable policies in a given time frame
- Consideration to cost and fair burden sharing of adjustment
- Define pace of adjustment and report regularly on meeting benchmarks, and spell out correction
- Endorsement of parliament of overall fiscal strategy
- Implementing consolidation through the budget process taking into account transparency and well defined policies
1. **Internalizing recent lesson in policy formulation within existing frameworks** i.e. countries should consolidate or run prudent policies during good economic times in order to build a “fiscal cushion/low debt” that provides sufficient room for maneuver during an economic downturn or a crisis.

2. **Introducing reforms to the fiscal framework (Internal anchors)**
   - Rules
   - Rules + institutions
   - Fiscal responsibility laws
   - Coalition agreement

3. **International agreements and supranational institutions (external anchors)**
   - EU. European Semester: ex-ante economic policy coordination to strengthen fiscal discipline, macro-economic stability and growth
   - IMF
Beyond consolidation: Level of surpluses in anticipation of future deficit increases

♦ Accountability for taxing above expenditure priorities

   — Set by:
     – Government policy (Government to parliament)
     – Automatic rule (Government to the rule)
     – Rule enforced/Monitor/Co-defined by a fiscal council (government to the rule and to the council)
     – Fiscal responsibility law (co-responsibility of government and parliament to electorate) i.e. Government proposes and parliament endorses fiscal strategic goals
     – Coalition agreement (Government to electorate)

Thinking forward can help to backward design the “optimal” policy framework under a democratic setting
Conclusions

- The immediate challenge is fiscal consolidation rather than deficit bias.

- In “good times”, difficult to disentangle the role of markets and independent institution in delivering “enough fiscal discipline”.

- Markets in the aftermath of crisis are aligning consolidation needs with policy intentions. i.e. Bad performers to be punished regardless the role of independent institutions and rules.

- In the aftermath of the crisis what is crucial is credible fiscal policy in order to deliver sustainable consolidation.

- In the post consolidation period the issues are:
  1. Will markets behave pro-cyclical when assessing fiscal developments in the future?
  2. How to best lock consolidation gains?
  3. Who will determine the “optimal level” of government surpluses?
  4. 2 and 3 to help elucidate the “best” institutional framework to deliver fiscal stability on the back of democratic setting.