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

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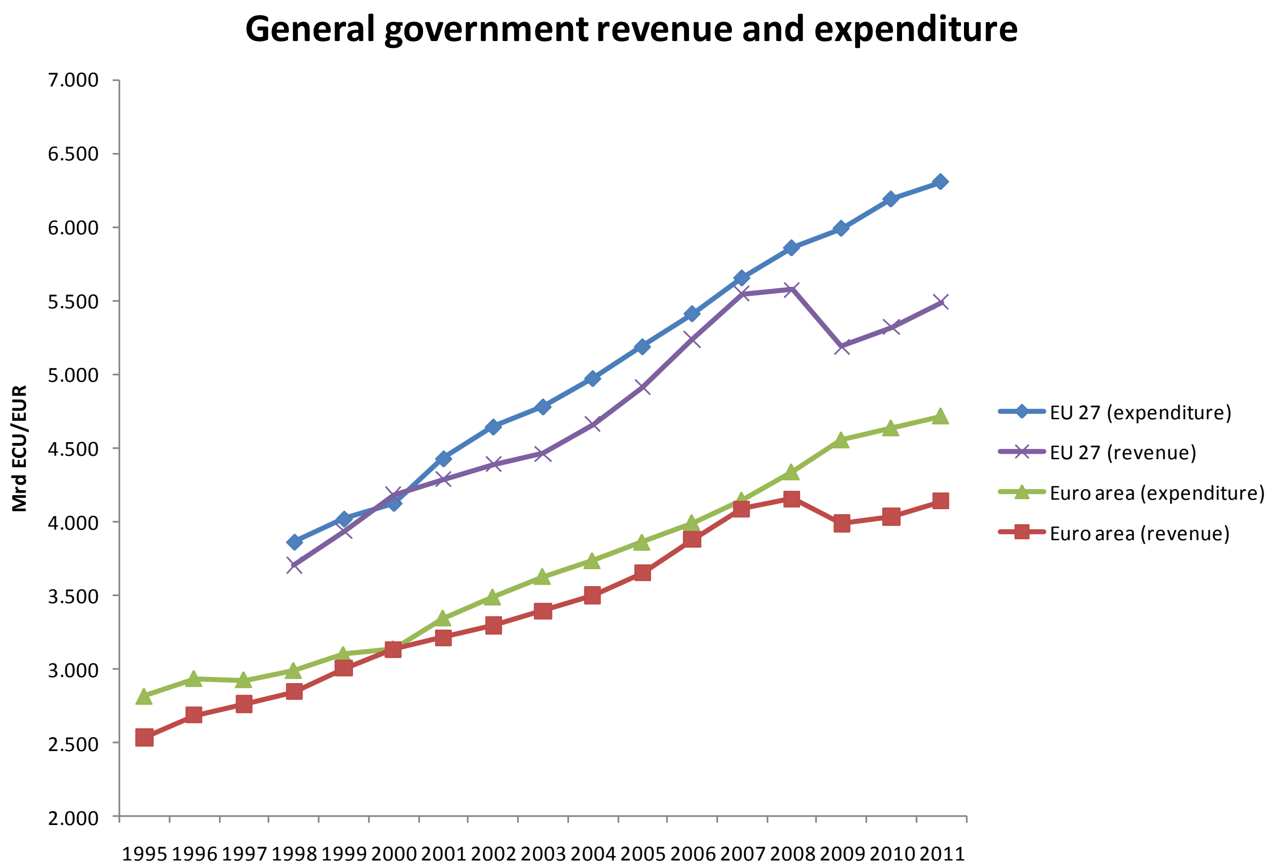
The views expressed are those of the author and do not necessarily represent those of the IMAD

Outline

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

The fiscal challenge: Consolidation or Fiscal Discipline (Deficit Bias)

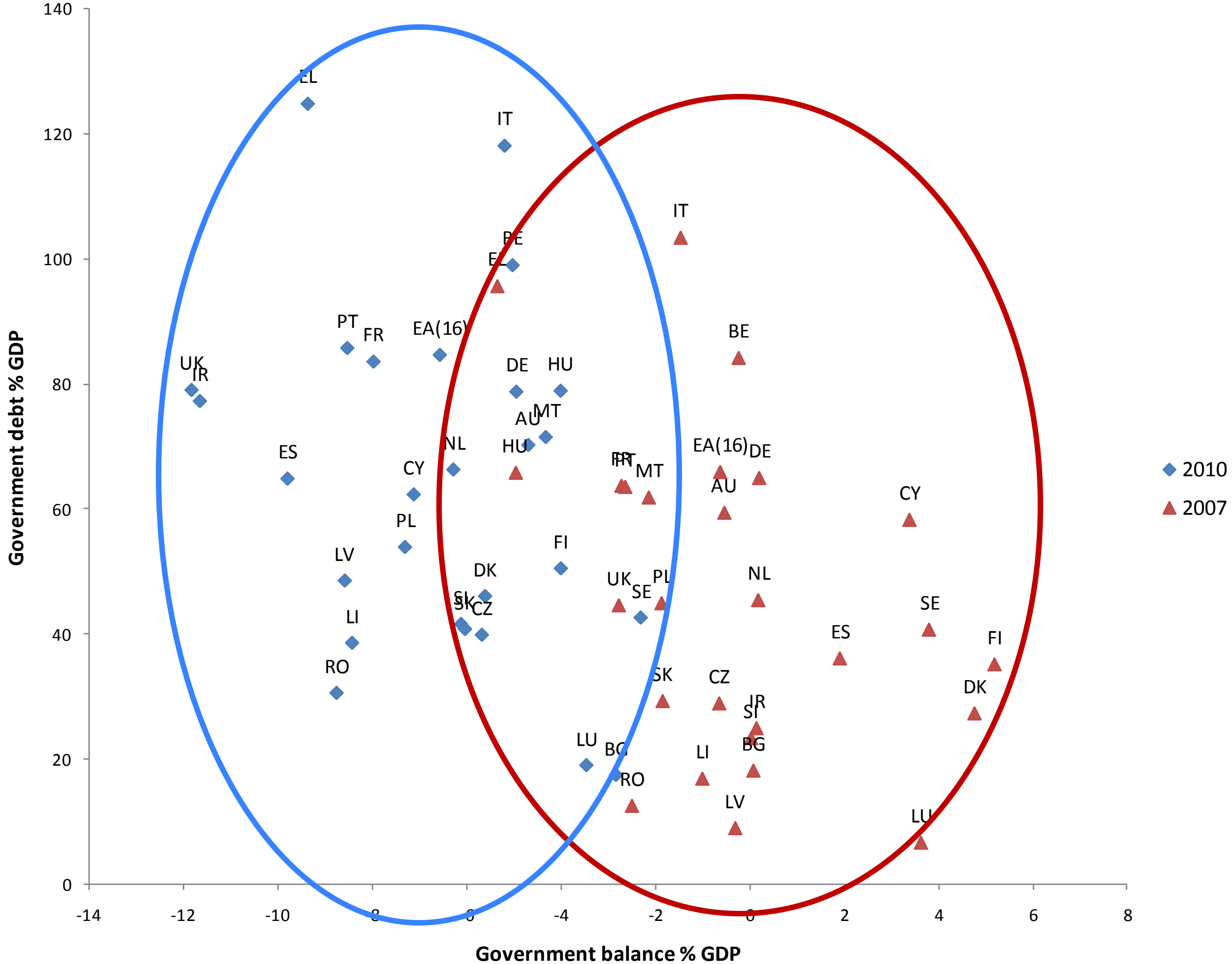


Source: AMECO

- Most advanced economies have to adjust fiscal accounts by large amounts

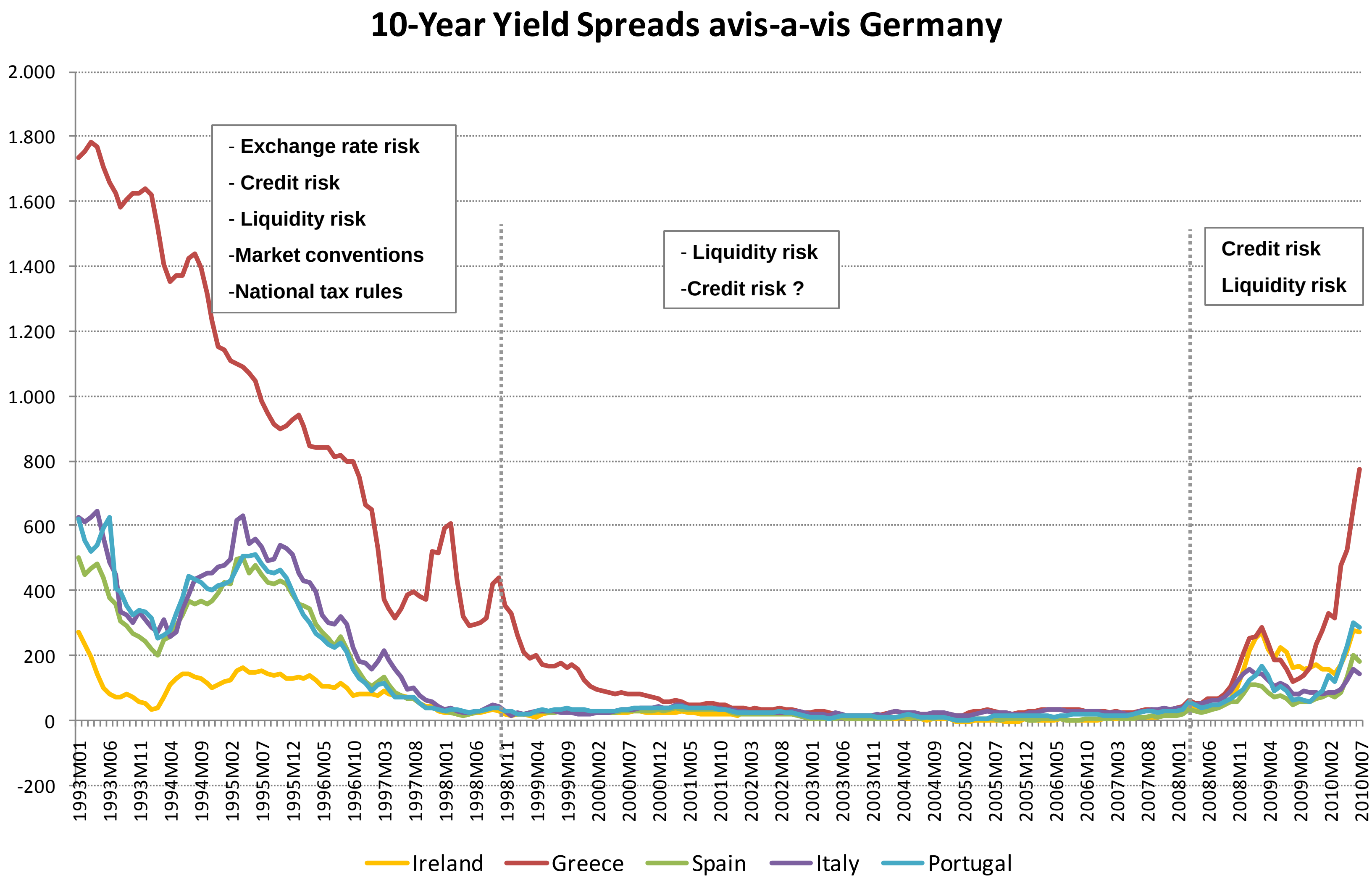
- The main challenge for fiscal policy is to develop credible consolidation strategy

This time the adjustment has to be simultaneous on the back of uncertain economic background



Source: Eurostat

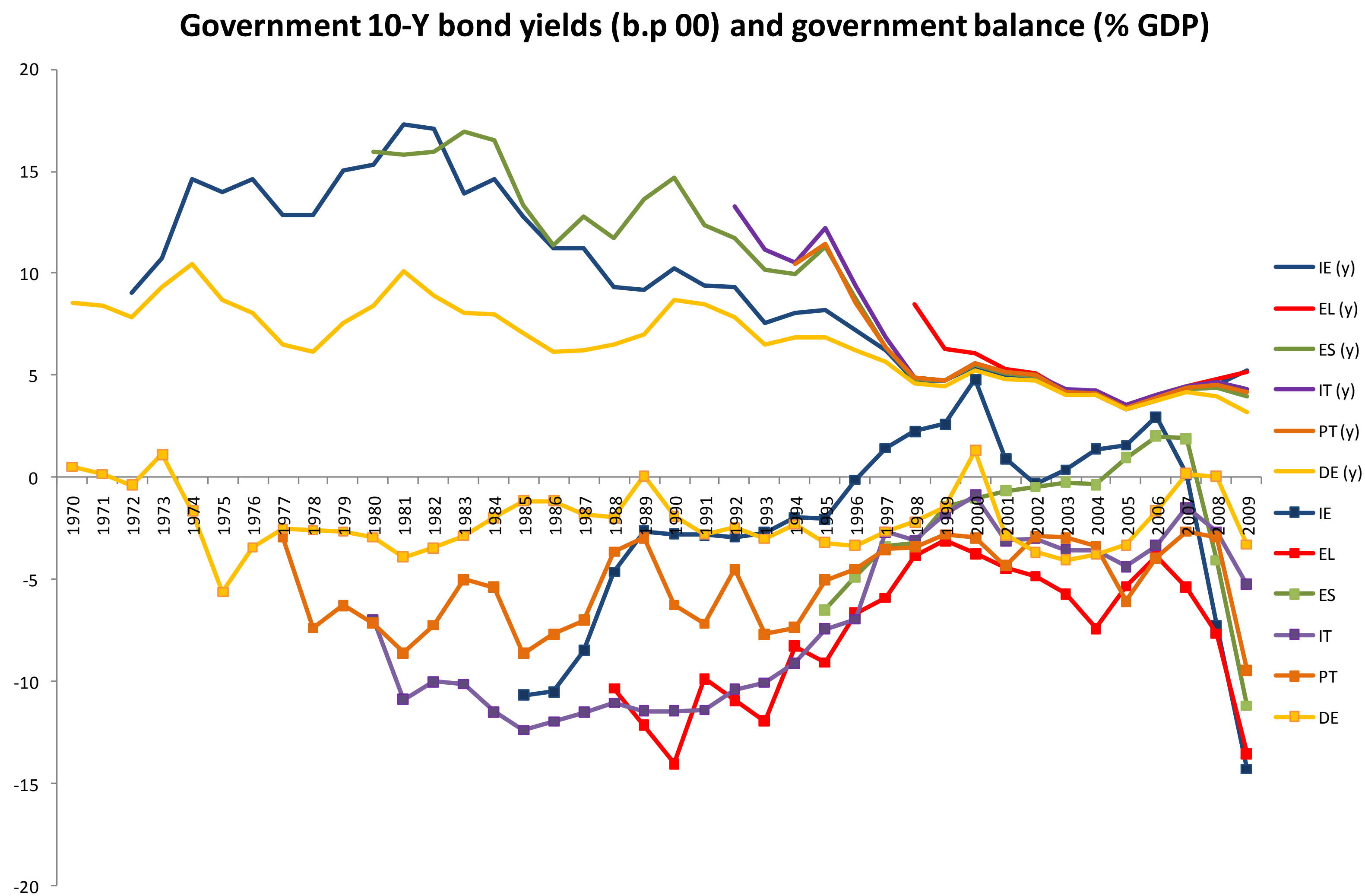
The role of the market in imposing fiscal discipline



Source: Eurostat

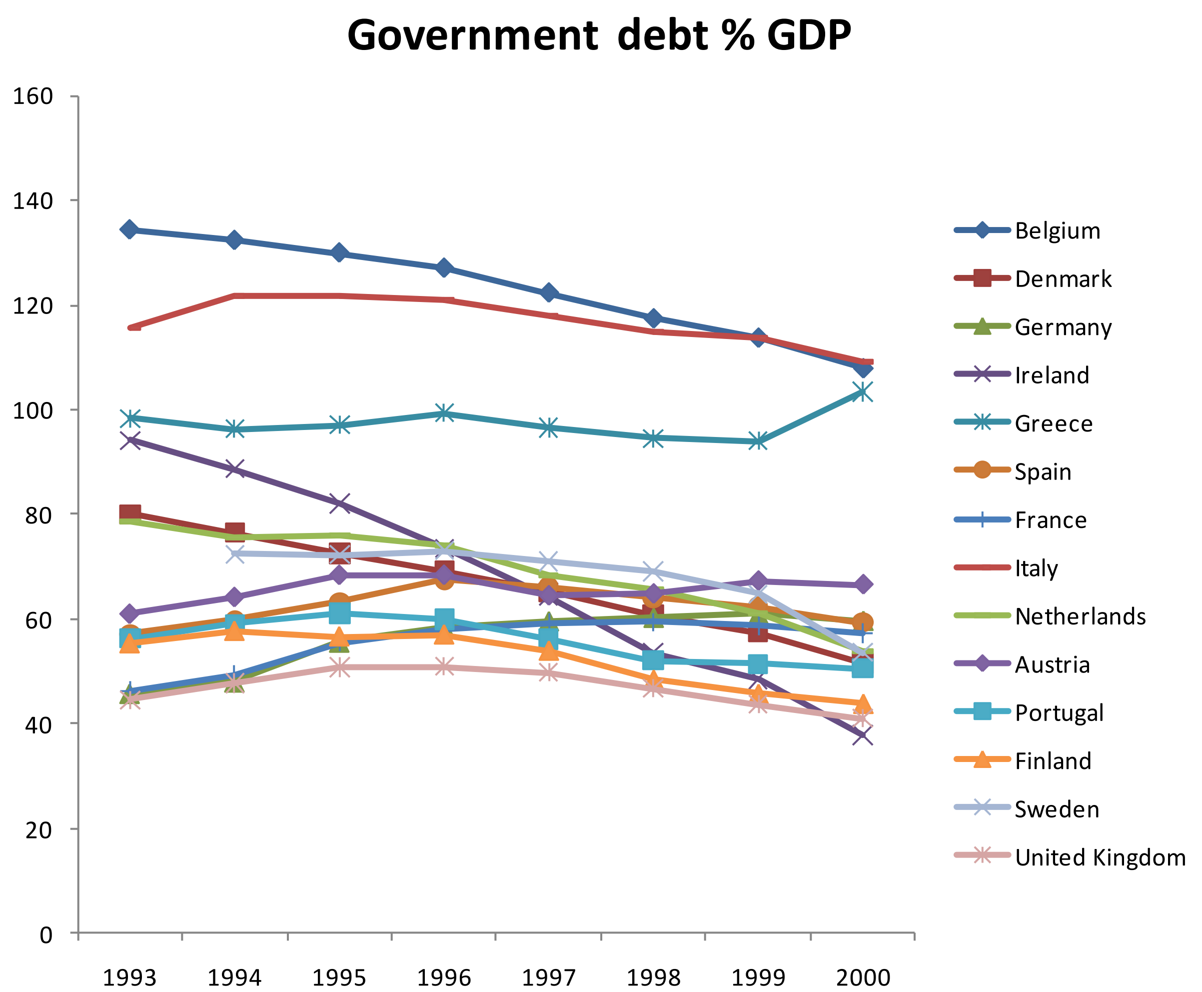
Through the 1980s severe financial market discipline forced governments to reduce primary deficits or run surpluses

Yields broadly mirrow government balances



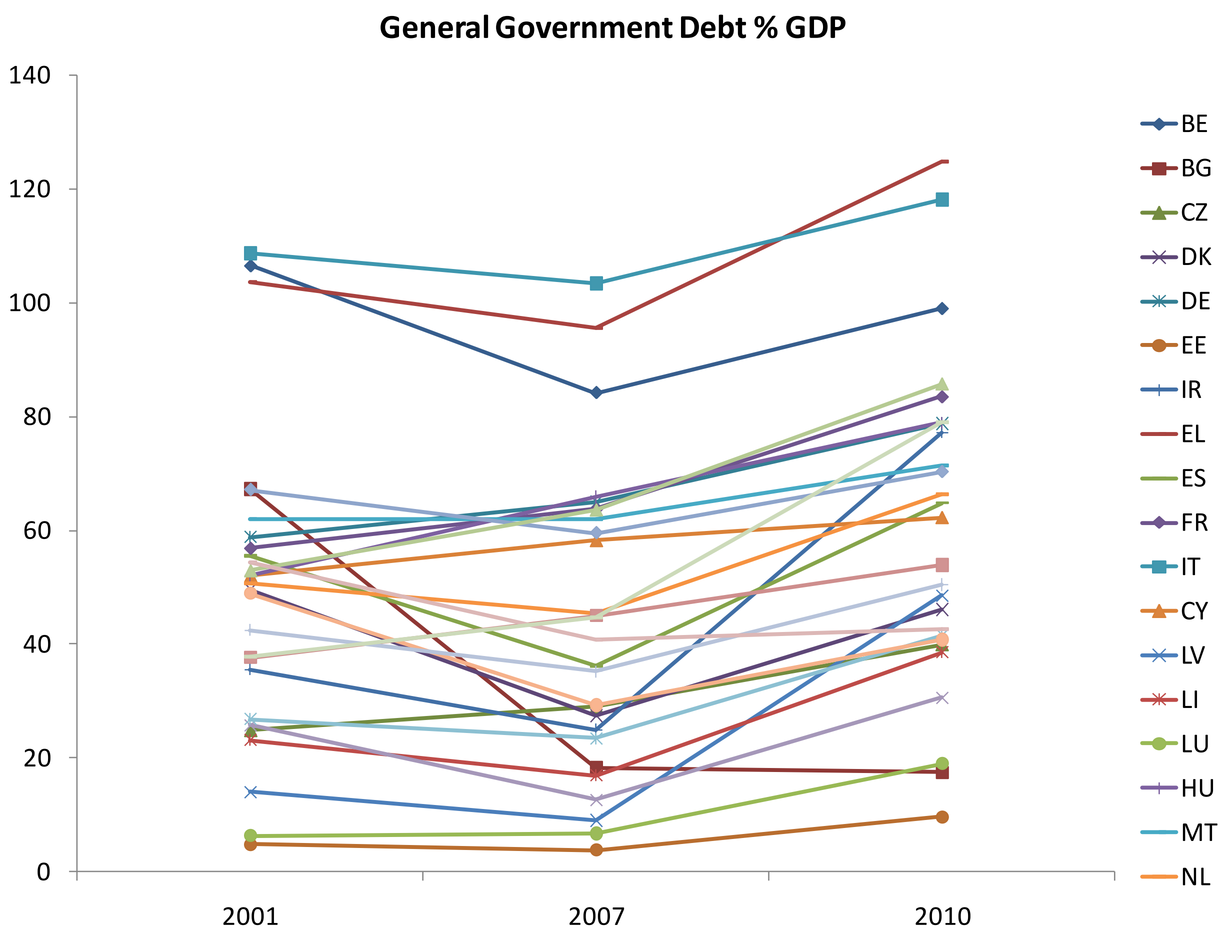
Source: Eurostat and OECD

On the run to EMU the market signals consistent with gradual consolidation



Source: Eurostat

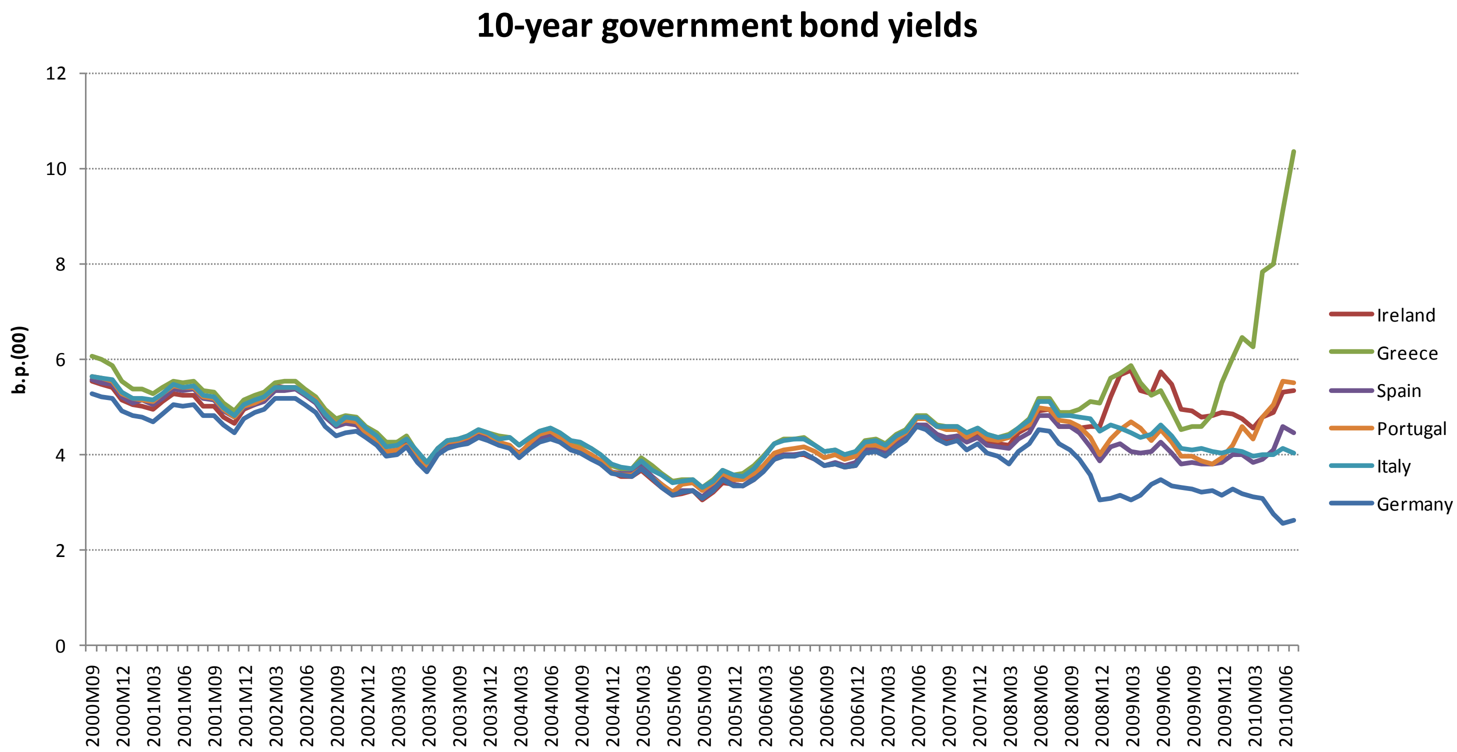
Since 2007 a simultaneous upward turnaround in debt dynamics



Source: Eurostat

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

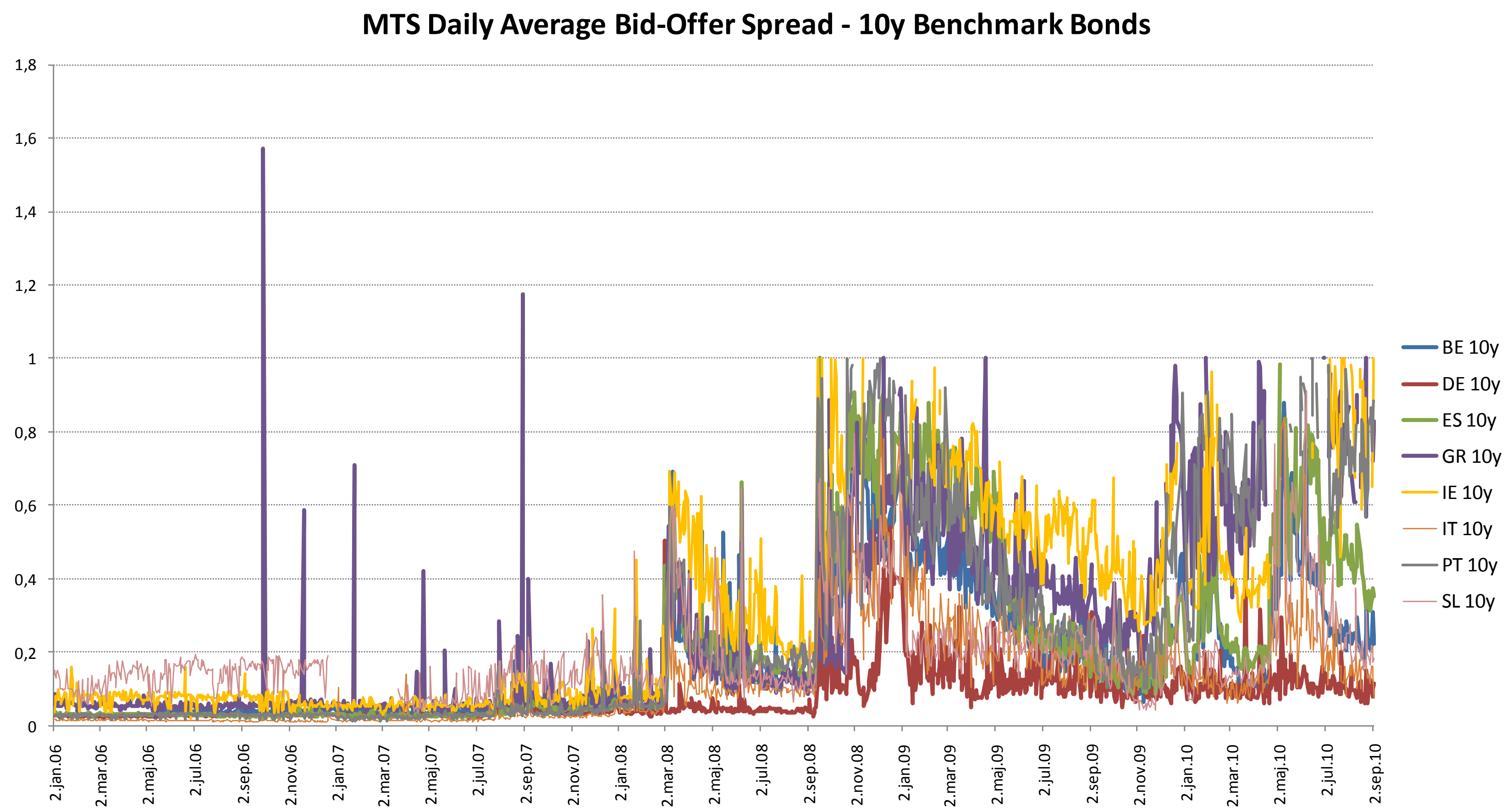
2001-2007 low inflation and strong global liquidity; with the crisis market conditions change funamentally



Source: Eurostat

- 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?

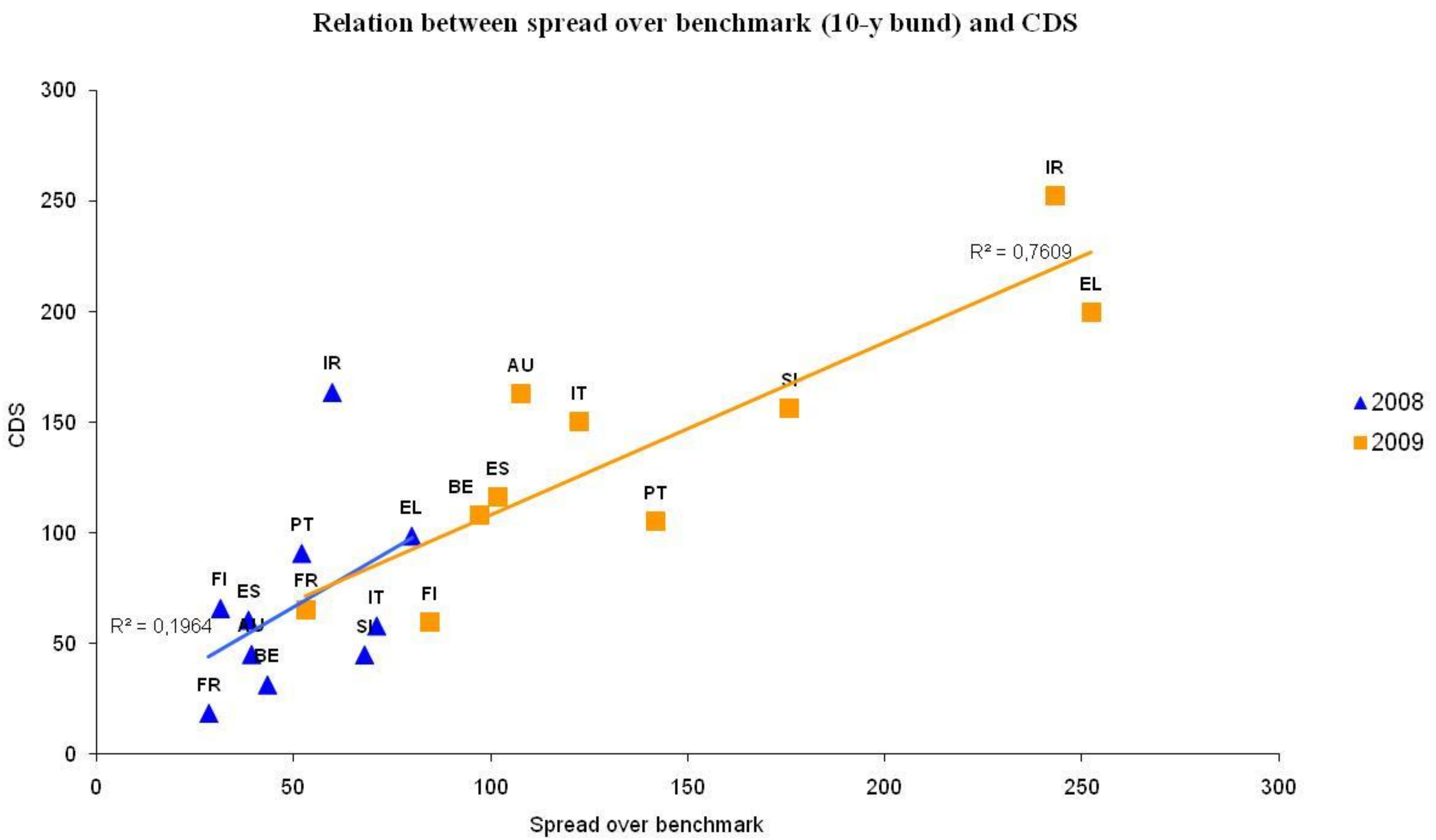
Liquidity is affected by credit risk considerations: Permanent or temporary development?



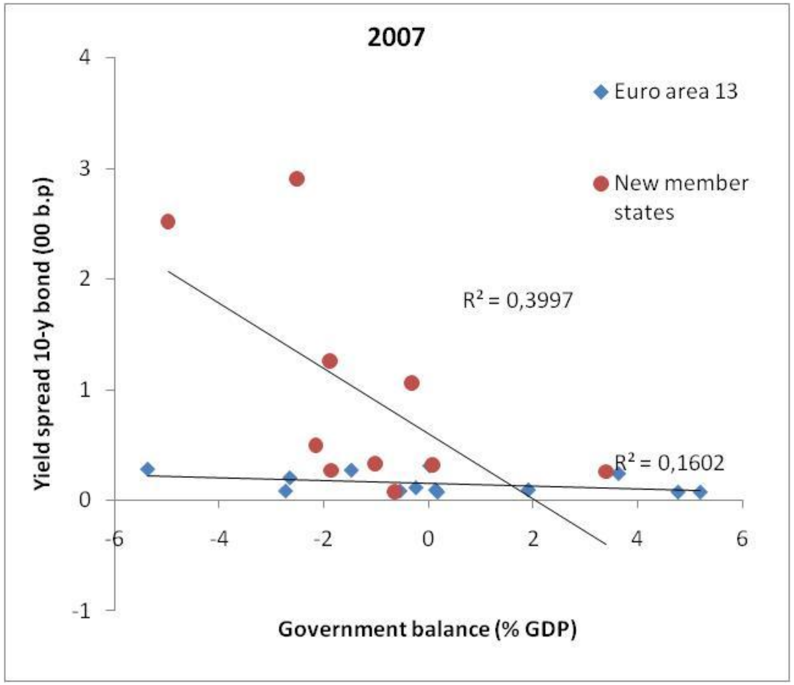
Source: MTS

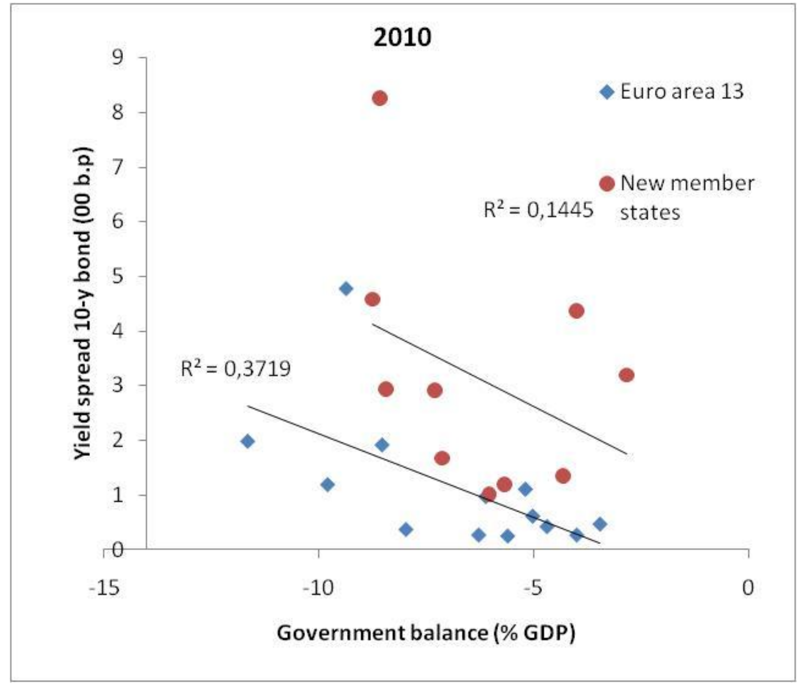
Before the crisis, when money was abundant, liquidity was the most important concern when pricing

Significant change in market perception



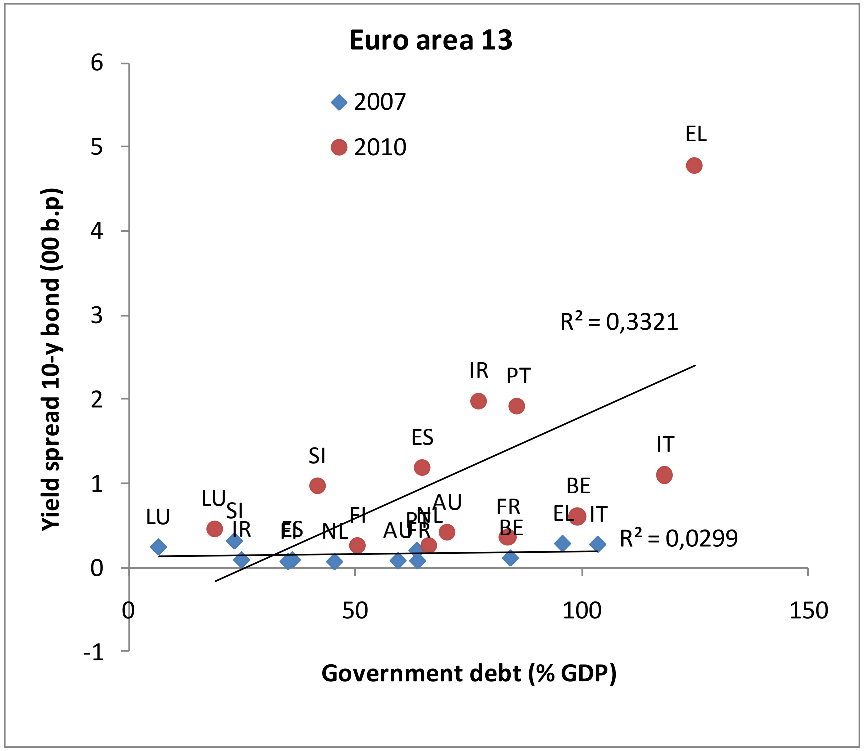
Markets: different look at government balance

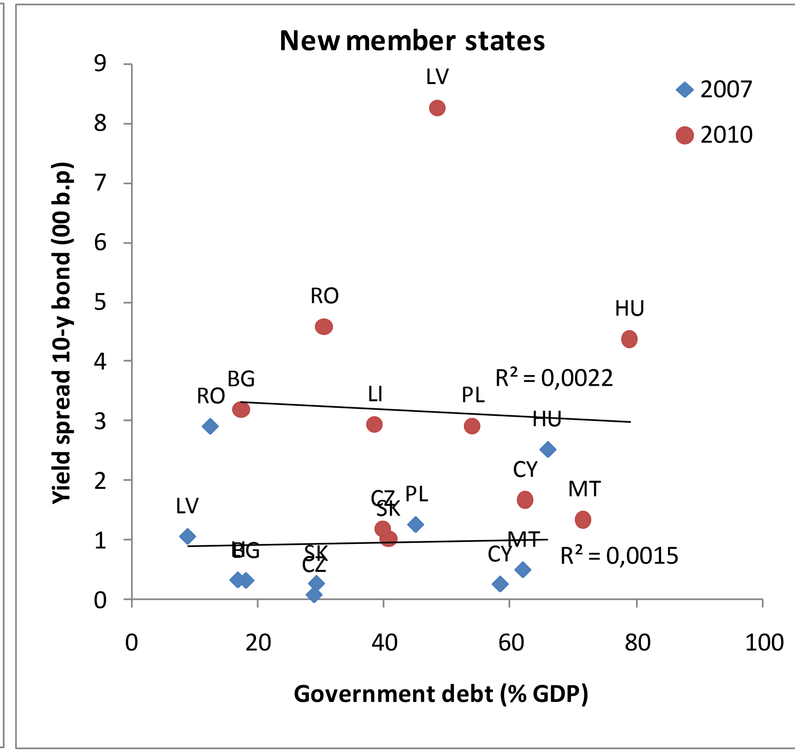




Source: Eurostat

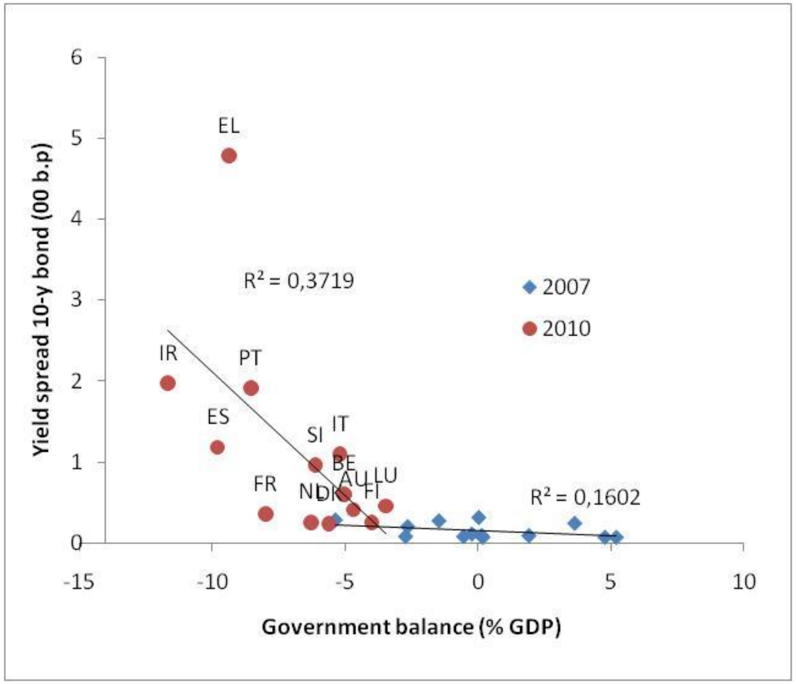
The debt level also more important

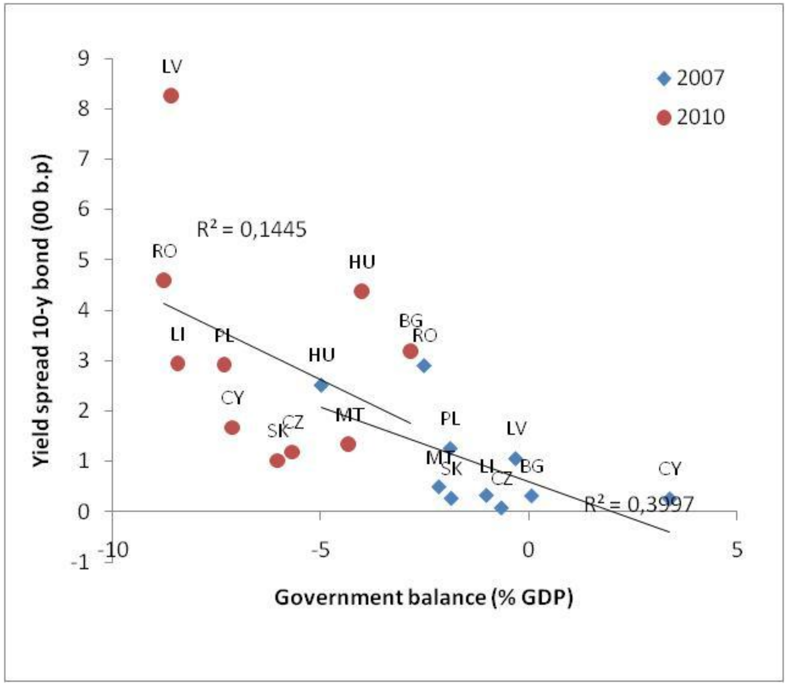




Source: Eurostat

Government balance more preeminence within groups of countries

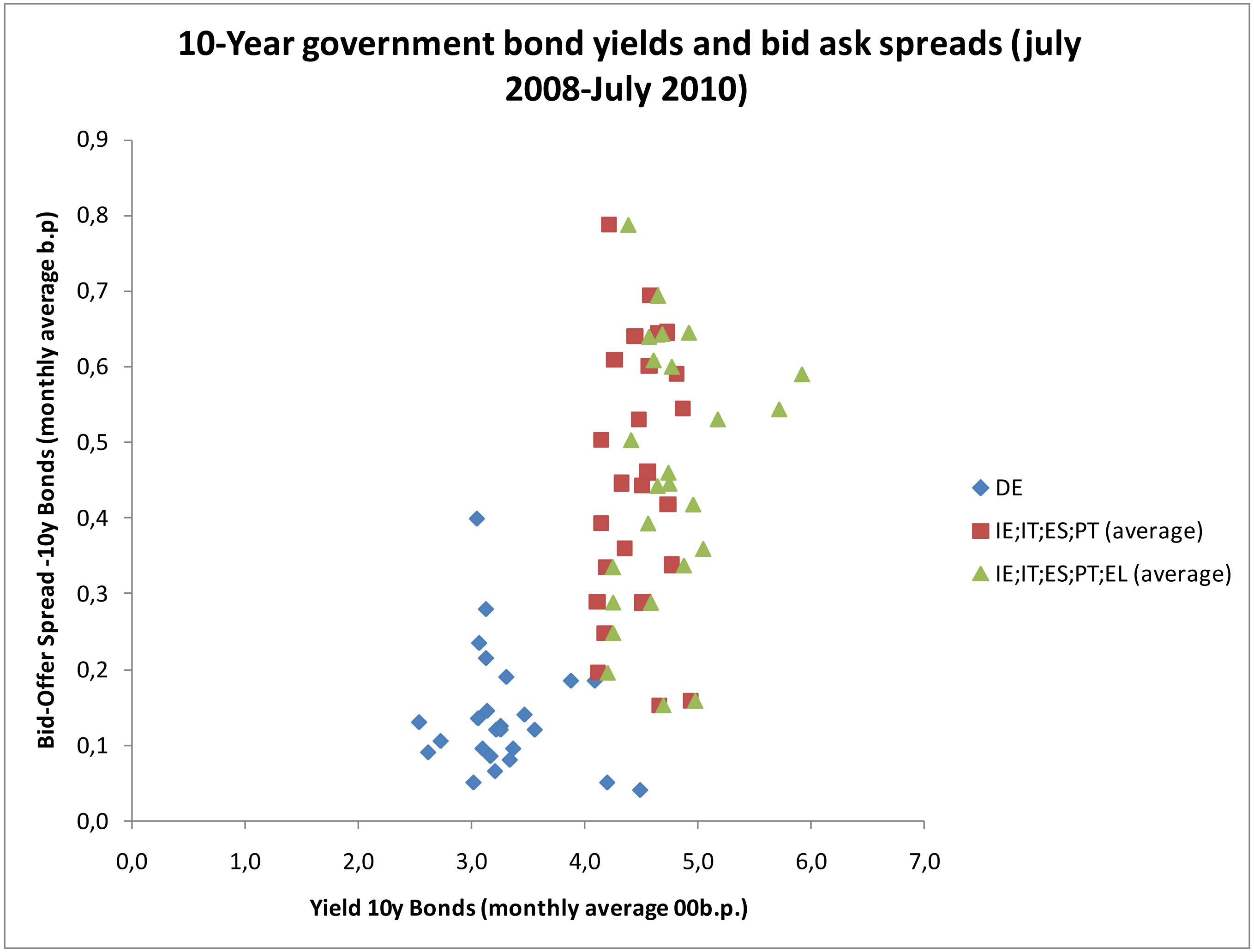




Source: Eurostat

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

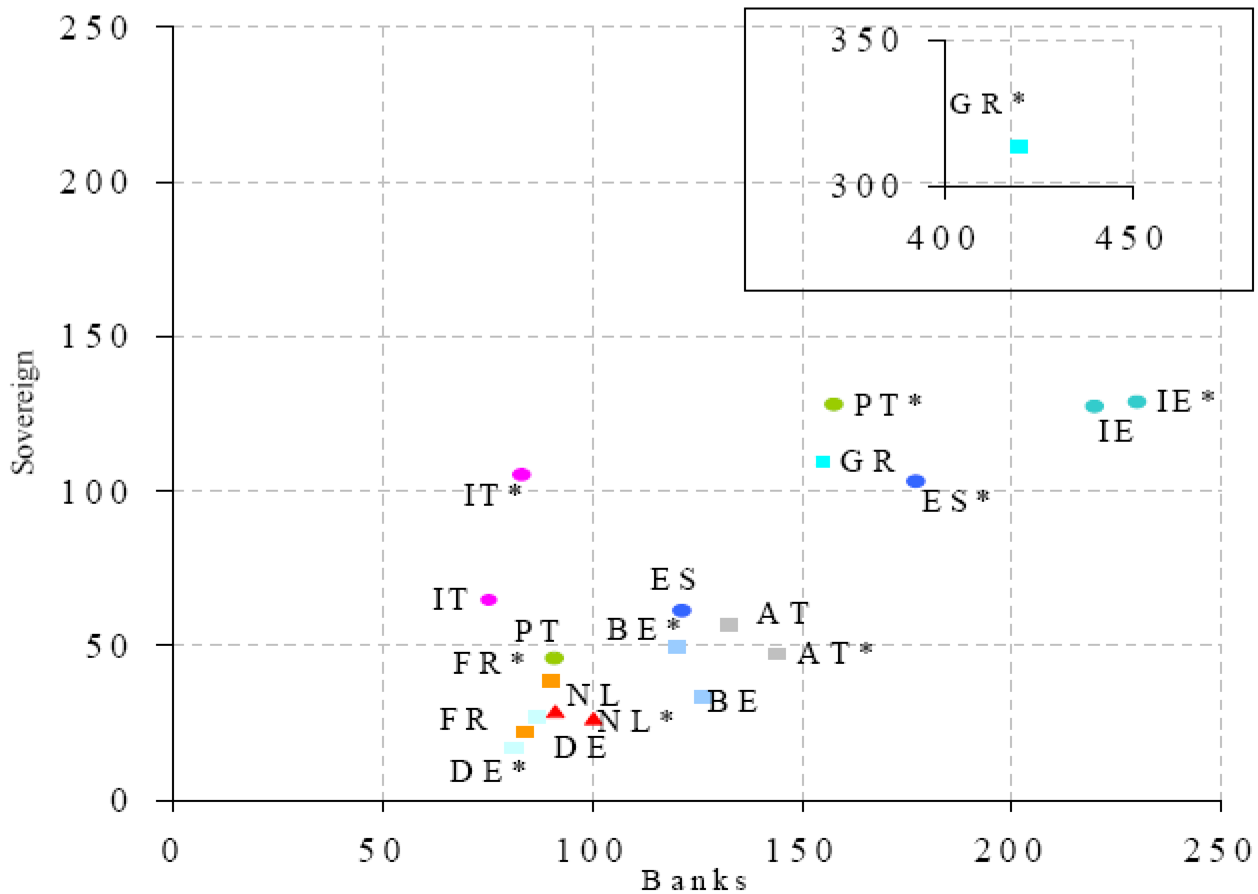
Sovereigns facing not only impact of worsening credit risk but also liquidity risk



Source: Eurostat and MTS

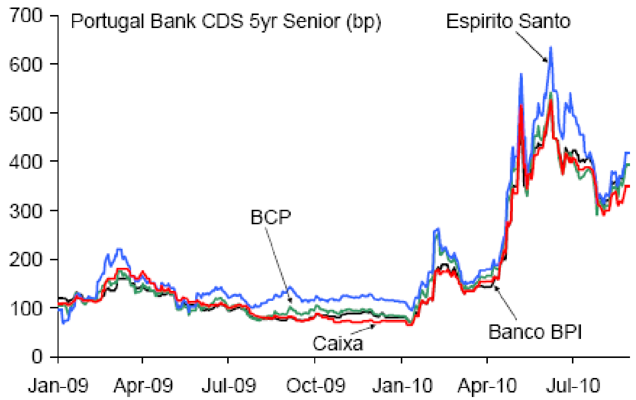
Spillovers from worsening sovereign credit risks to the financial sector

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

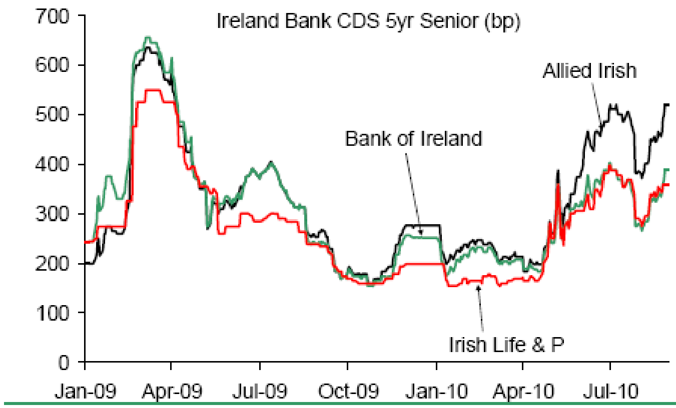


Source: ECB

Pass-through of sovereign credit risk to bank funding costs further incentive to fiscal consolidation



Source: BNP Paribas, *banks presented had CDS prices available



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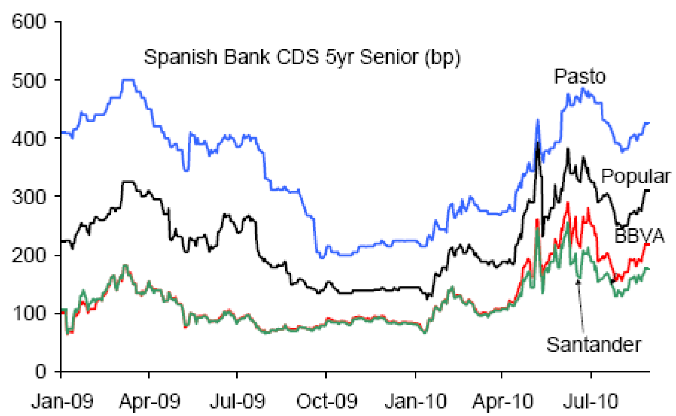

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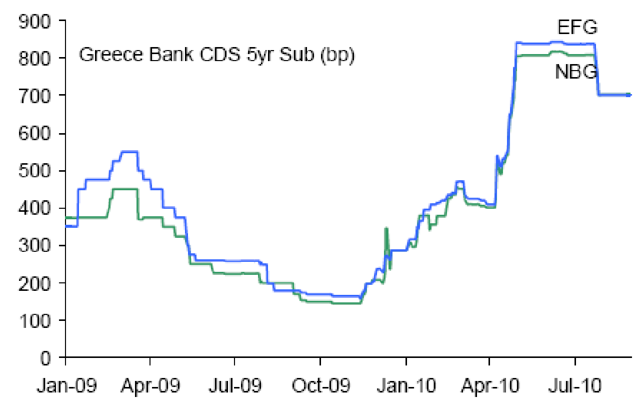


Source: BNP Paribas, *banks presented had CDS prices available

Stepped up downward trend in credit ratings after crisis

	2005	2007	2008	2009/4	2010/8
DE	AAA	AAA	AAA	AAA	AAA
FR	AAA	AAA	AAA	AAA	AAA
LU	AAA	AAA	AAA	AAA	AAA
NL	AAA	AAA	AAA	AAA	AAA
AU	AAA	AAA	AAA	AAA	AAA
FI	AAA	AAA	AAA	AAA	AAA
BE	AA+	AA+	AA+	AA+	AA+
ES	AAA	AAA	AAA	AA+ ↓	AA- ↓
SI	AA-	↑ AA	AA	AA	AA
IR	AAA	AAA	AAA	AA+ ↓	AA- ↓
IT	AA-	A+ ↓	A+	A+	A+
CY	A	↑ A+	A+	A+	A+
SK	A	A	↑ A+	A+	A+
PT	AA	AA- ↓	AA-	A+ ↓	A- ↓
MT	A	A	A	A	A
EL	A	A	A	A- ↓	BB+ ↓

Source: S&P

Before the crisis ratings change slowly coinciding with reduction/slow pace of debt accumulation

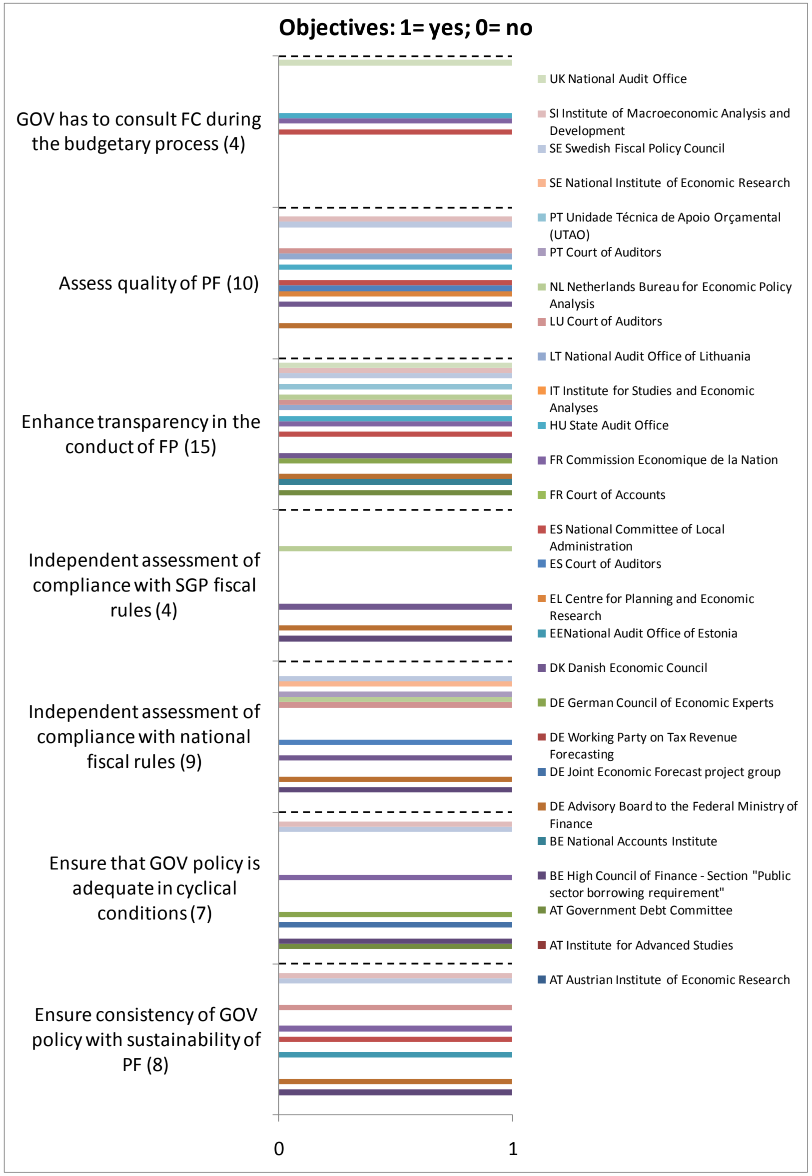
Market conditions aligning incentives for fiscal consolidation and policy intentions

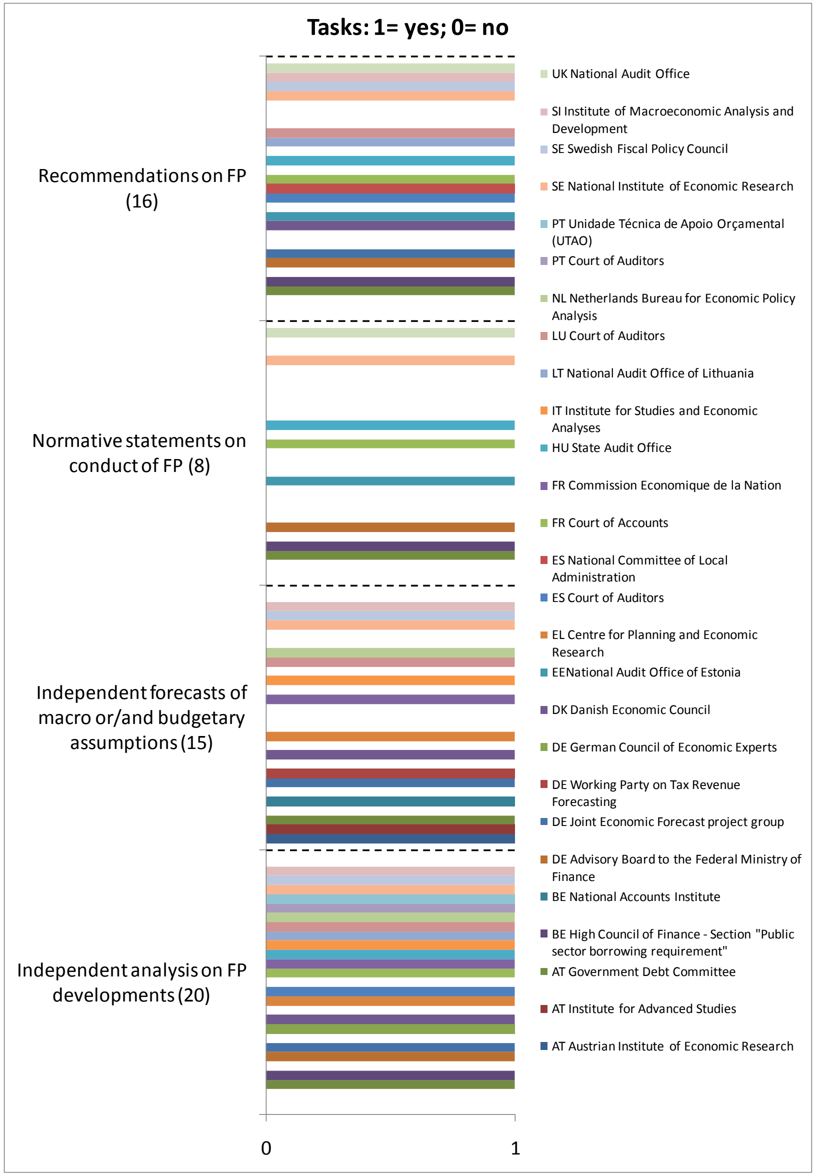
- This time might be different due to simultaneity of the fiscal challenge (yields reflect global risks)
- After “weak” enforcement (2001-2008) discipline is enforced more forcefully (yield discrimination)
- Debt and deficits are more important in yield movements
- Crisis has also impact on liquidity
- 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

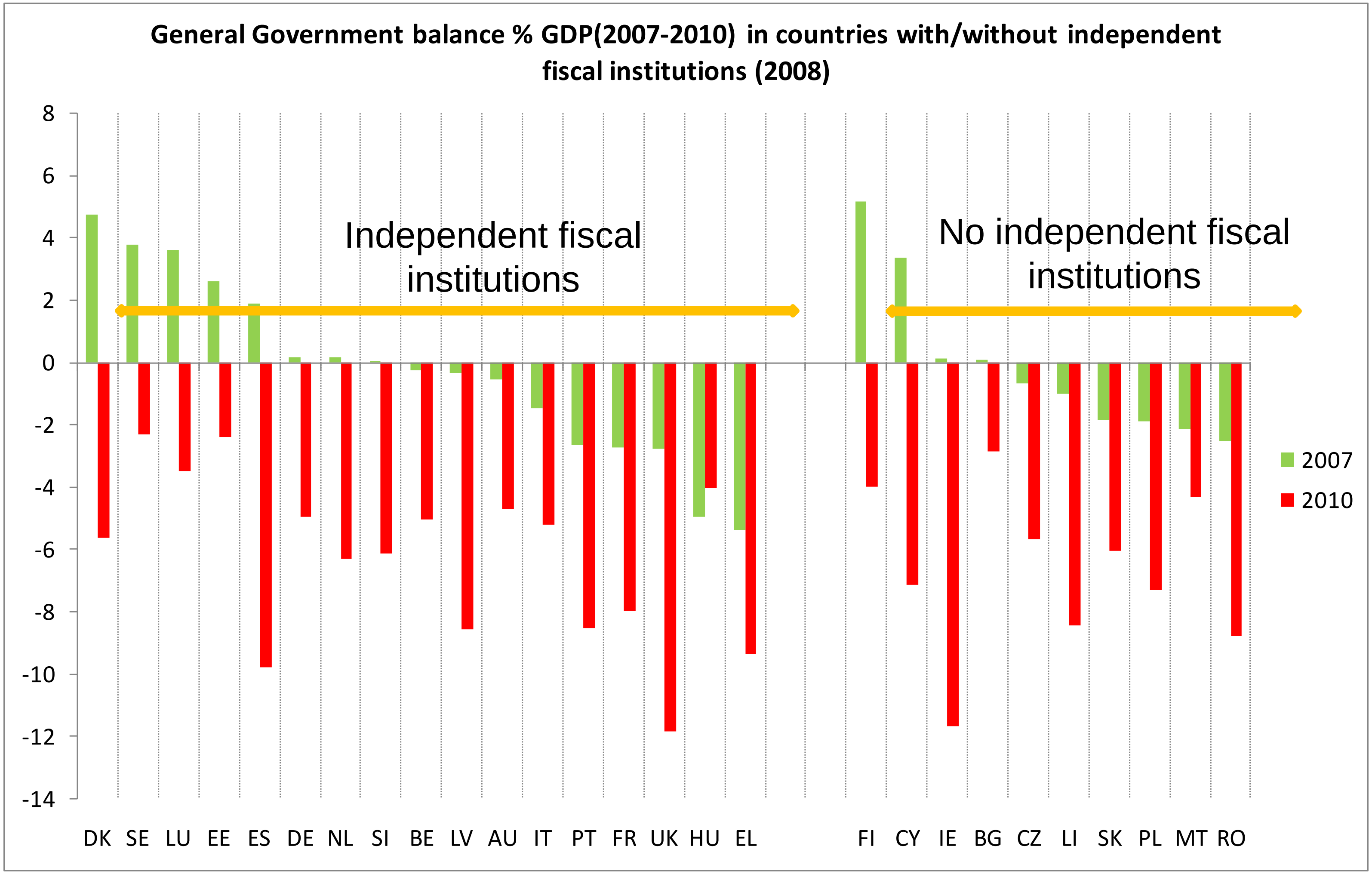
Fiscal institutions and fiscal discipline (Transparency and accountability)





Source: European Commission data base on fiscal institutions

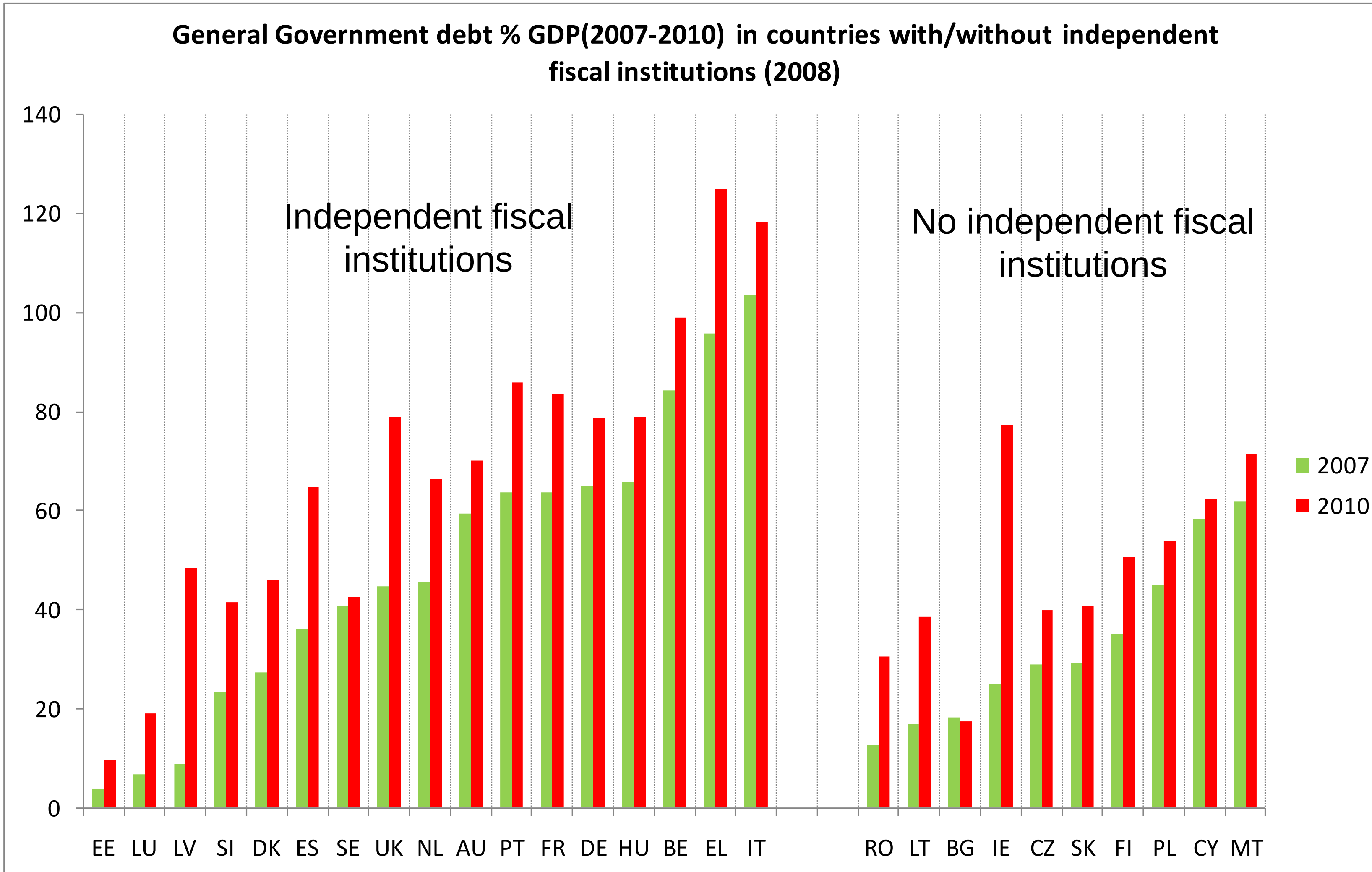
Independent fiscal institutions and fiscal balance



Source: European Commission data base on fiscal institutions; Eurostat

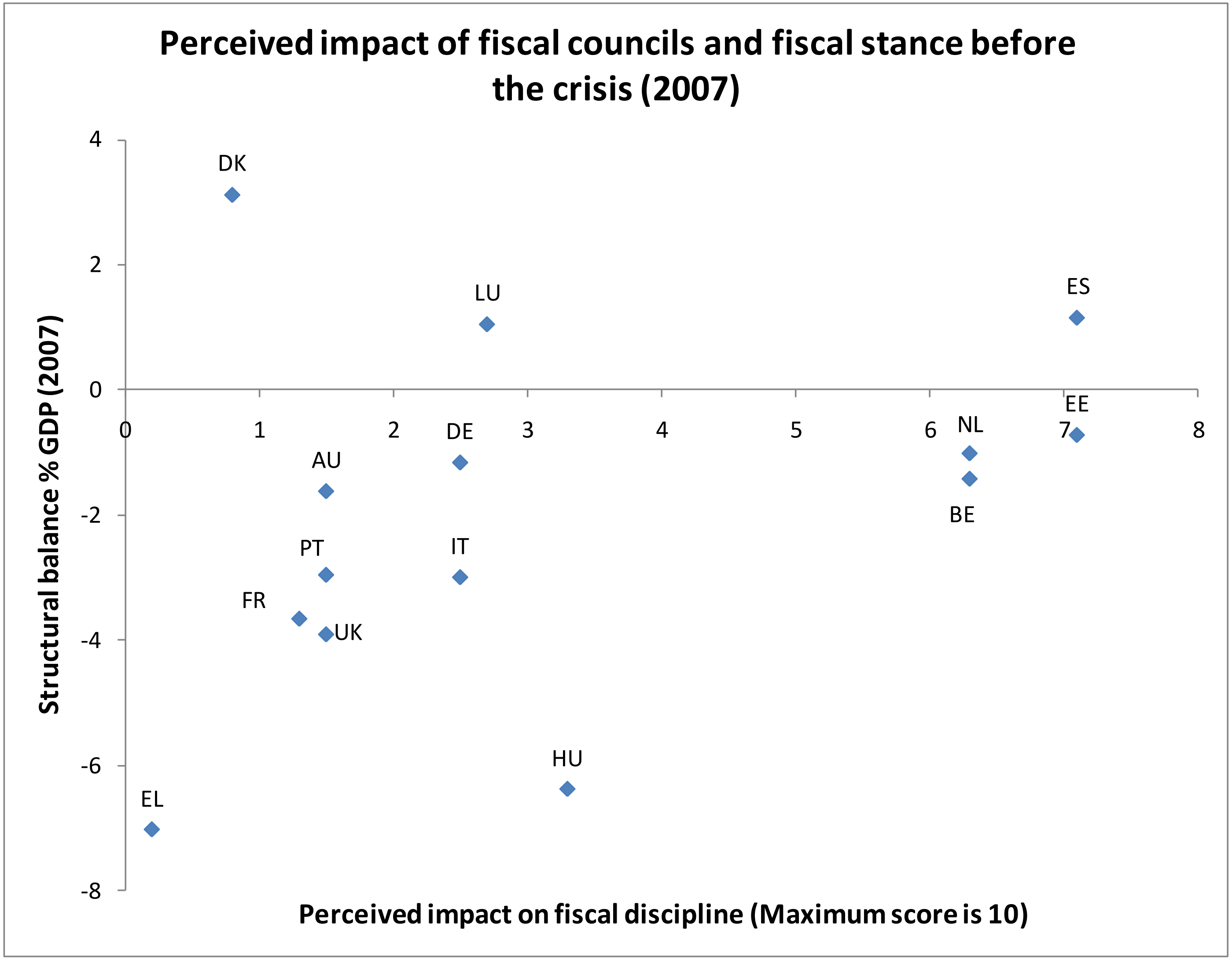
Difficult to disentagngle the impact and contribution on independent fiscal institutions

Independent fiscal institutions and debt



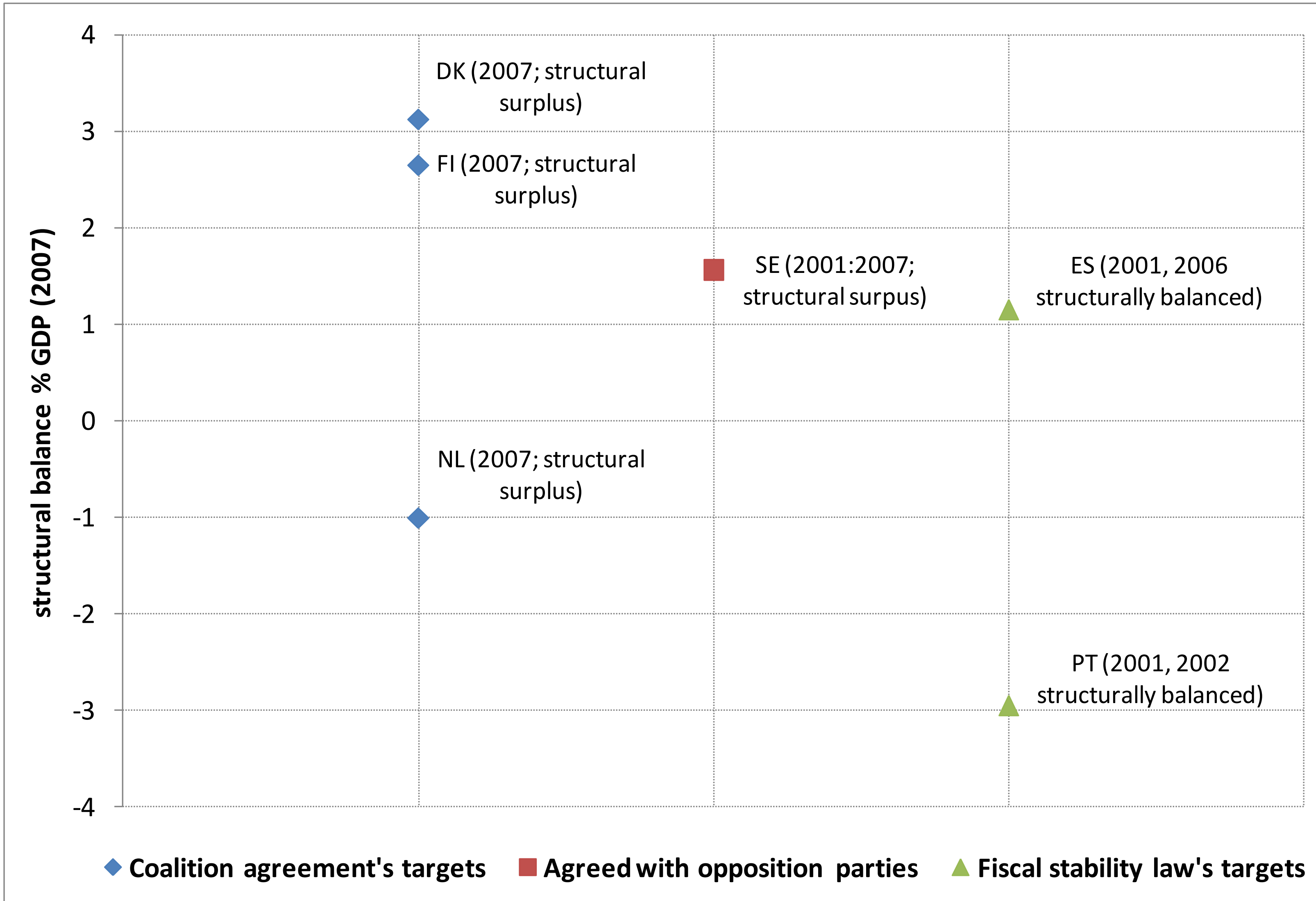
Source: European Commission data base on fiscal institutions; Eurostat

Perception of institutions' contribution to disciplne and outturn varies



Source: Debrun and Kumar (2008); Public finances in EU 2007, European Commission

Coalition agreements undepinns fiscal targets and performance of the best performers



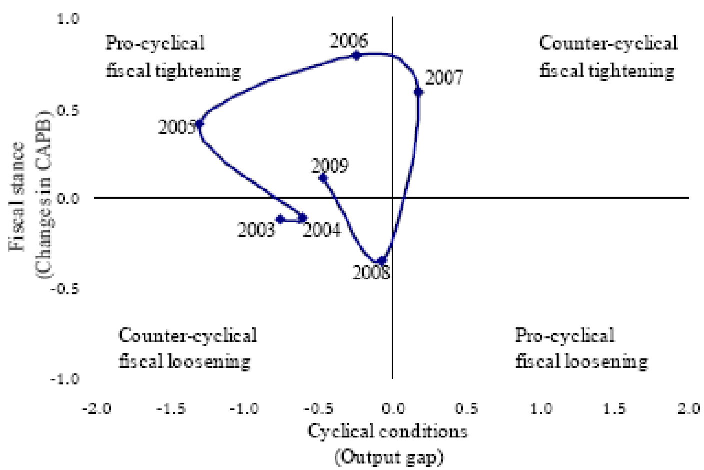
Source: Stability programs and Eurostat

The assessment of fiscal stance in 2008

Public finances in EMU - 2008

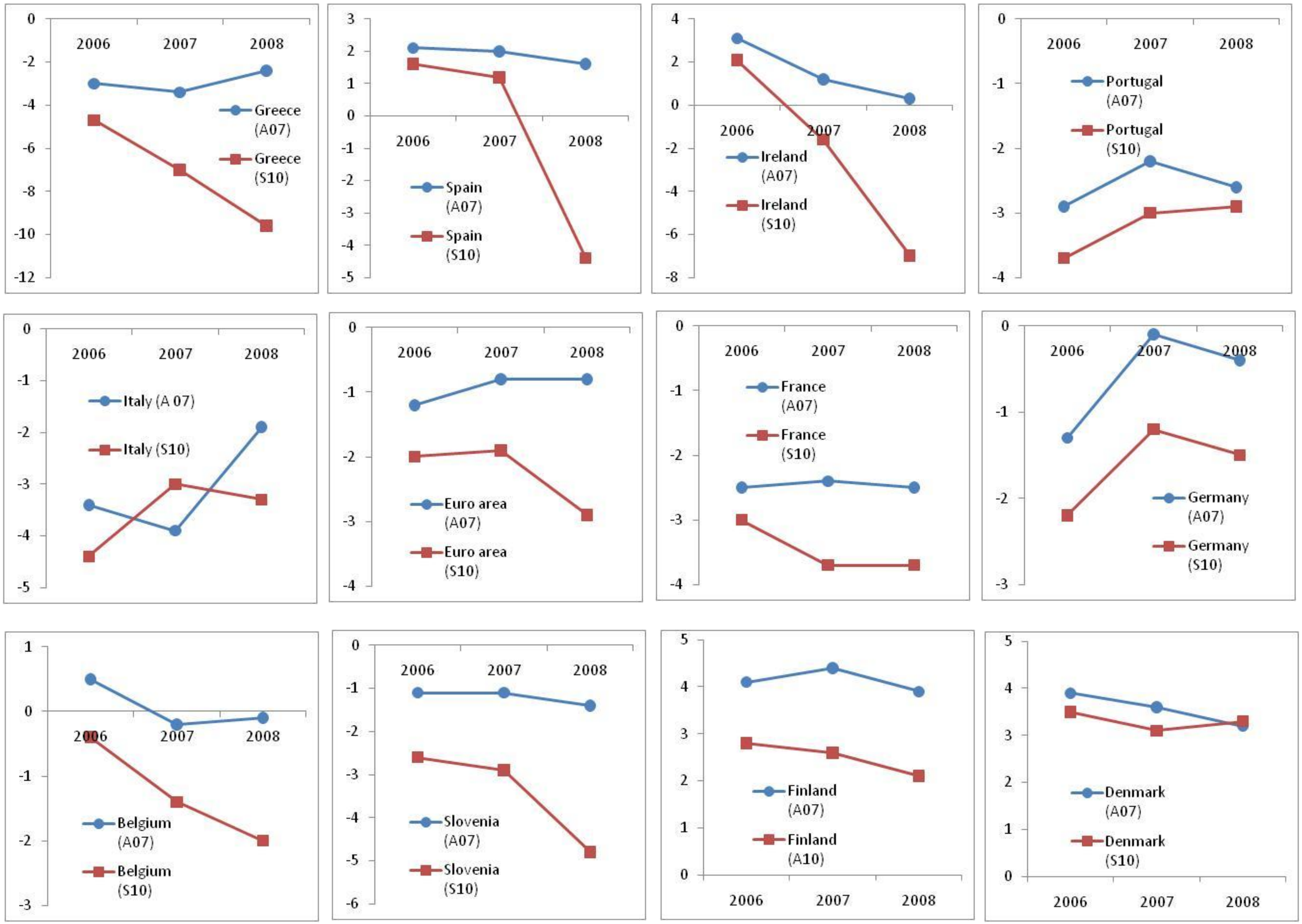
- Budgetary positions improved for the fourth year running in 2007
- Structural fiscal deficits estimated at their lowest levels since the early 1970s
- Member States have reached or are close to reaching MTOs
- Public debt dropped below the 60% of GDP (2007) in the EU; Euro area it is approaching to 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

Assesment 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 dicipline or fiscal consolidation

- **Fiscal discipline** (good times): compensate for in-built deficit bias
  - Miopic behavior of politicians
  - Pro-cycilcal 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 mesures/policies in dealing with the inmediate 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 insitution to monitor the consolidation strategy quality and compliance of government with fiscal sustainability obectives
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)

Rules, institutions at the time of adjustment

- **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

Locking consolidation gains

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

- **<u>Accountability for taxing above expenditure priorities</u>**

  - **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