Economic policy and fiscal crises

Lars Calmfors

Beyond the crisis? The financial crisis and its global impact

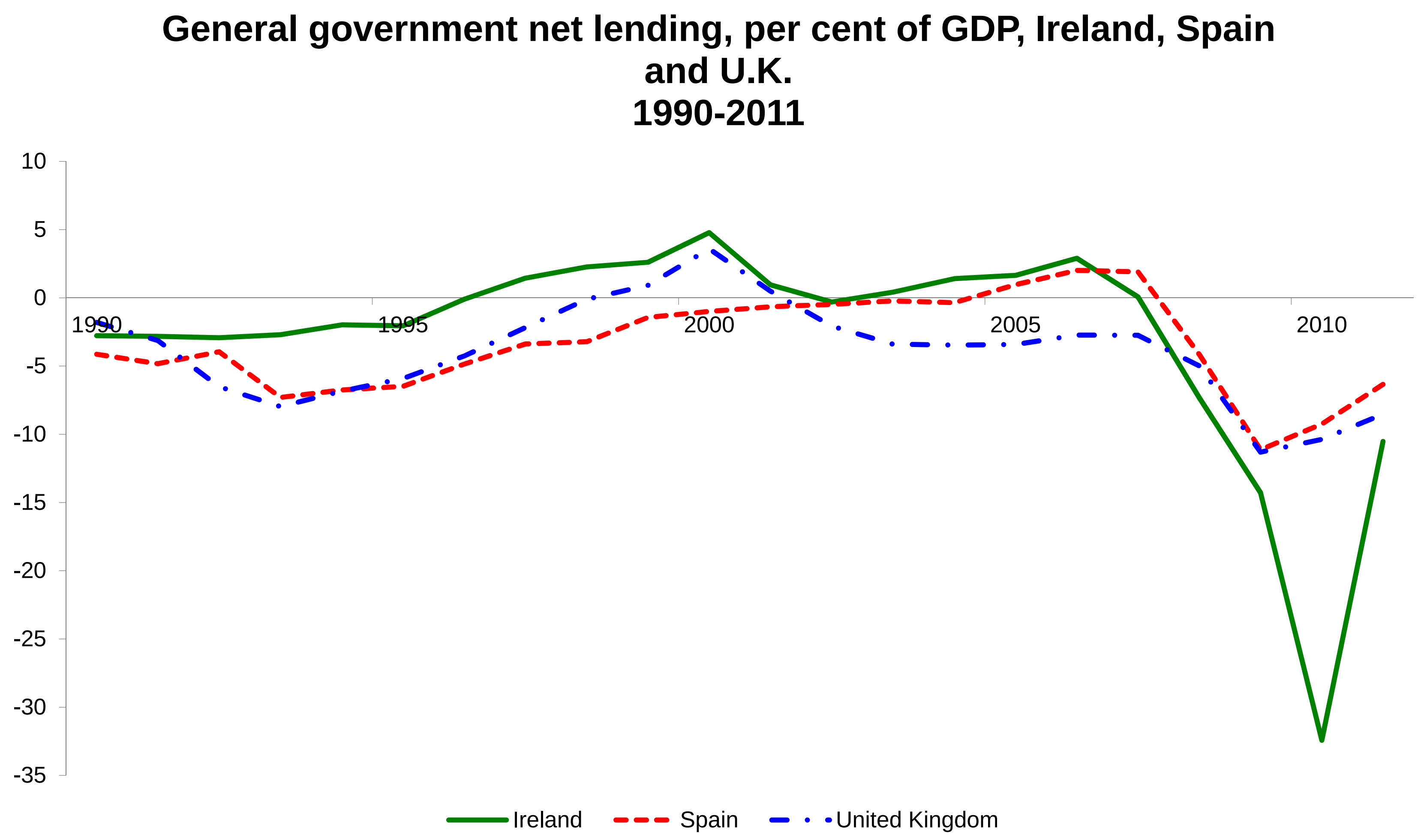
Pufendorf symposium, Lund University, 2 September 2011

General government consolidated gross debt and net lending, per cent of GDP 2011

Country	Consolidated gross debt	Net lending/borrowing
Belgium	97.0	-3.9
Ireland	112.0	-10.5
Greece	157.7	-9.5
France	84.7	-5.8
Italy	120.3	-3.9
Cyprus	62.3	-5.1
Portugal	101.7	-5.9
Sweden	**36.5**	**0.6**
United Kingdom	84.2	-8.5
United States	98.3	-10.0
Japan	236.1	-9.7

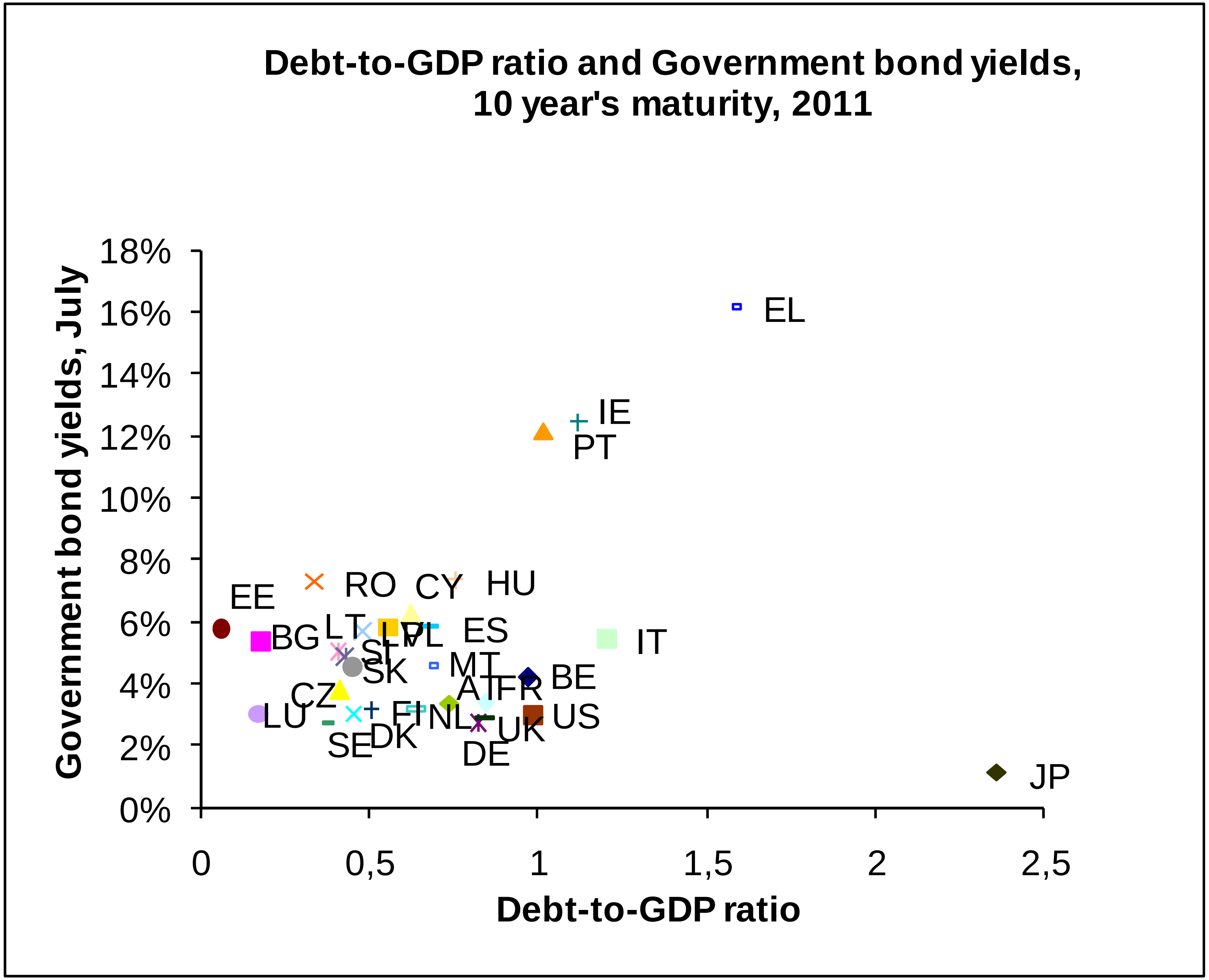
Lessons from the fiscal crises

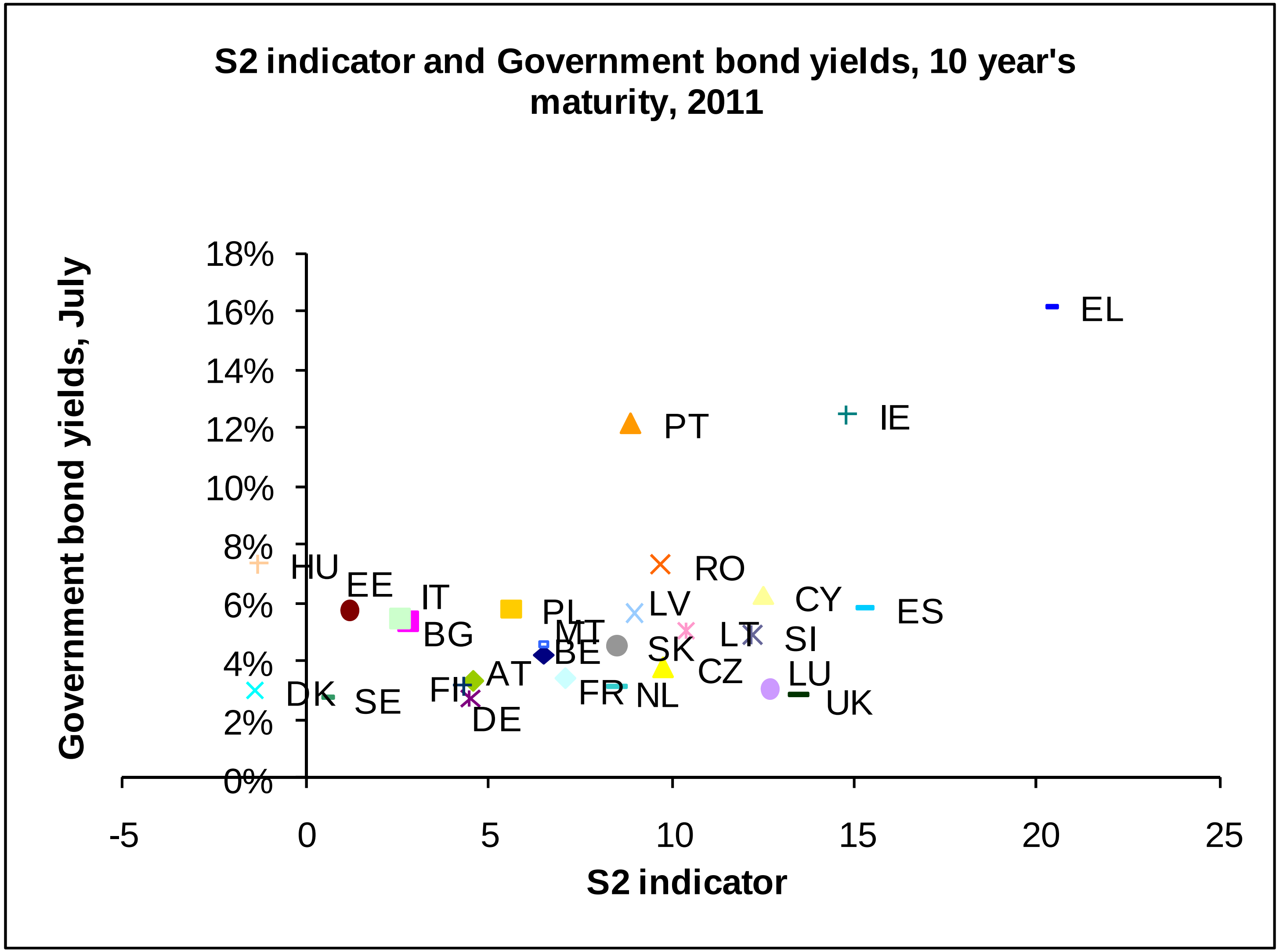
1. Dangerous with fiscal misbehaviour in good times
2. The end of unsustainable booms may cause dramatic fiscal deteriorations
3. Dangerous with fiscal stimulus in recessions if the underlying fiscal position is weak
4. Difficult to predict when government debt becomes a problem
5. Financial market risk premia in normal times are an ureliable indicator of future debt problems


General government net lending, per cent of GDP, Ireland, Spain and U.K.
1990-2011
10
5
0
-5
-10
-15
-20
-25
-30
-35
1990
1995
2000
2005
2010
Ireland
Spain
United Kingdom

Lessons from the fiscal crises

1. Dangerous with fiscal misbehaviour in good times
2. The end of unsustainable booms may cause dramatic fiscal deteriorations
3. Dangerous with fiscal stimulus in recessions if the underlying fiscal position is weak
4. Difficult to predict when government debt becomes a problem
5. Financial market risk premia in normal times are an ureliable indicator of future debt problems


Debt-to-GDP ratio and Government bond yields,
10 year's maturity, 2011
Government bond yields, July
Debt-to-GDP ratio
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
0
0,5
1
1,5
2
2,5
EL
IE
PT
RO
CY
HU
EE
LT
LV
PL
ES
IT
BG
SI
SK
MT
BE
CZ
AT
FR
LU
FI
NL
US
SE
DK
UK
DE
JP

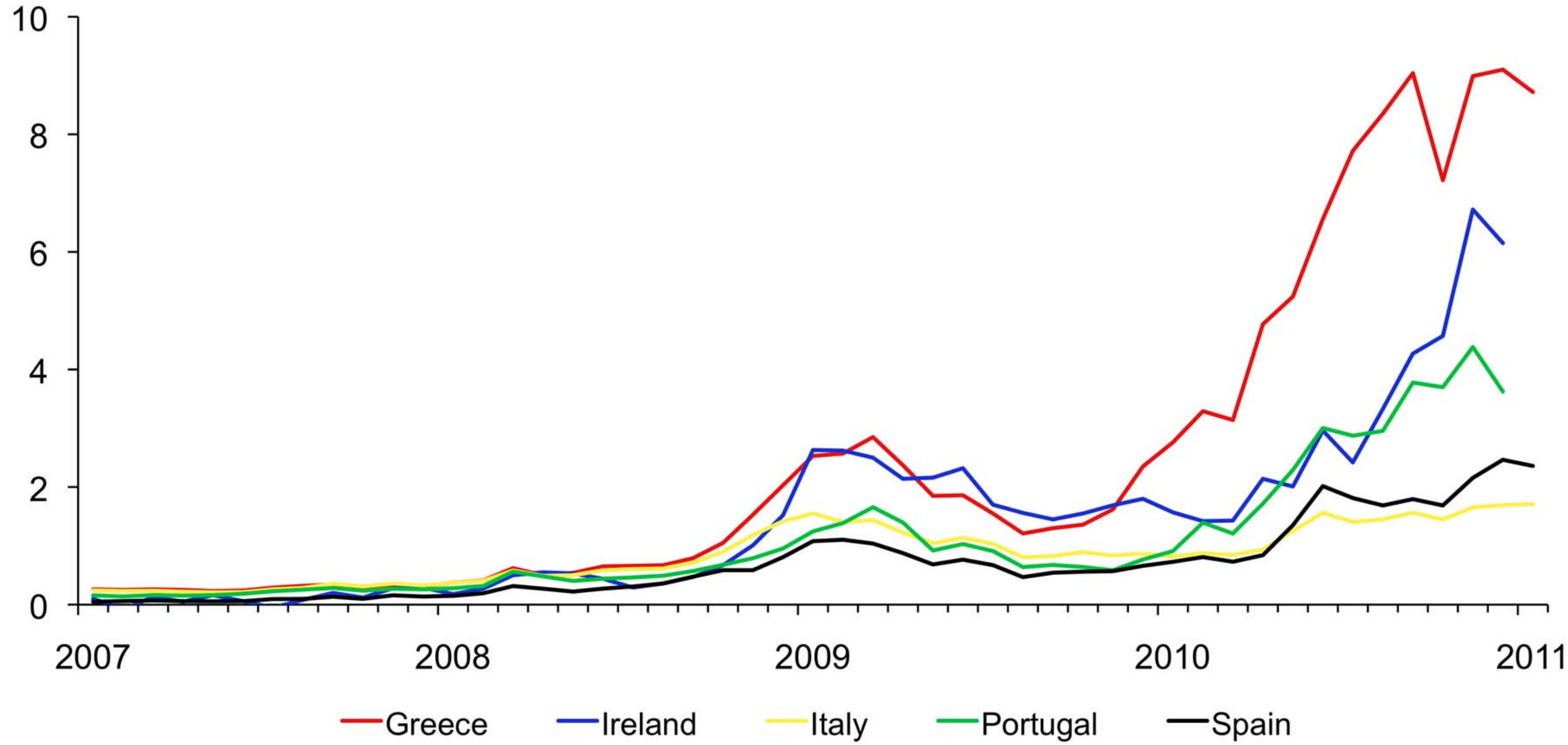


S2 indicator and Government bond yields, 10 year's maturity, 2011
Government bond yields, July
S2 indicator
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
-5
0
5
10
15
20
25
EL
PT
IE
HU
EE
IT
BG
PL
MT
BE
RO
LV
CY
ES
LT
SI
SK
CZ
LU
UK
DK
SE
FI
AT
DE
FR
NL

Lessons from the fiscal crises

1. Dangerous with fiscal misbehaviour in good times
2. The end of unsustainable booms may cause dramatic fiscal deteriorations
3. Dangerous with fiscal stimulus in recessions if the underlying fiscal position is weak
4. Difficult to predict when government debt becomes a problem
5. Financial market risk premia in normal times are an ureliable indicator of future debt problems

Interest rate differences to Germany, per cent government bond yields, ten years' maturity



Topics

1. Fiscal policy
2. Macroprudential regulation
3. Monetary policy
4. Exchange rate policy
5. Policy to deal with sovereign debt crises

Government debt

- No good theory of optimal government debt
- Social efficiency tax smoothing considerations suggest random-walk debt
- But fears of interest rate hikes and default give a strong precautionary motive for low government debt

Explanations of deficit bias

1. Informational problems
   - ignorance of intertemporal budget constraint
   - overoptimism
   - informational asymmetries
2. Externalities
   - common pool problems
   - intergenerational exploitation

Explanations of deficit bias cont.

3. Impatience
   - short-sighted behaviour
   - strategic behaviour and political polarisation
4. Time inconsistency
   - stabilisation policy (like monetary policy)
   - time inconsistent preferences

Fiscal rules

European rules

- Deficit ceiling of 3 per cent of GDP
- Debt ceiling of 60 per cent of GDP or debt falling ”at a satisfactory pace”
- Medium term objective of ”close to balance or surplus”

National rules

- Sweden
  - surplus target
  - expenditure ceiling
- UK
  - golden rule
  - net debt ceiling of 40 percent of GDP

Table 1 Breaches of the stability pact

	99	00	01	02	03	04	05	06	07	08	09	10
Austria	x		x			x				x	x	x
Belgium										x	x	x
Bulgaria											x	x
Cyprus						x					x	x
Czech Republic							x				x	x
Denmark												x
Estonia												
Finland												x
France				x	x	x	x		x	x	x	x
Germany	x			x	x	x	x			x	x	x
Greece		x	x	x	x	x	x	x	x	x	x	x
Hungary						x	x	x	x	x	x	x
Irland										x	x	x
Italy			x		x	x	x	x		x	x	x
Latvia										x	x	x
Lithuania										x	x	x
Luxemburg												
Malta						x				x	x	x
Netherlands					x						x	x
Poland						x	x	x		x	x	x
Portugal			x			x	x	x		x	x	x
Romania										x	x	x
Slovakia								x			x	x
Slovenia											x	x
Spain										x	x	x
Sweden												
UK					x	x	x			x	x	x

Note: The crosses show that a country has a government deficit exceeding three per cent of GDP, or a gross government debt exceeding 60 per cent of GDP that is not falling (or both). A grey field indicates that the country, at the time, was not an EU member state.
Source: ECB.

Why have rules not worked better?

- Fundamental legitimacy problem with European rules
- Fundamental conflict between **simplicity** and **flexibility**

Fiscal watchdogs (councils)

<u>Earlier existing institutions</u>
CPB – Netherlands
CBO – US
HCF – Belgium

<u>Recently established institutions</u>
FPC – Sweden
PBO – Canada
OBR – UK

<u>Institutions underway</u>
Australia
Ireland
Portugal

What can fiscal watchdogs do?

1. Alleviate informational problems
   - strengthen accountability of policy makers
2. Complement to fiscal rules
   - increase reputation cost of breaching rules
3. Alleviate conflict between **simplicity** and **flexibility**
   - departure from simple rule
   - monitoring of complex rule

Fiscal councils are no panacea

- Time to build up reputation
- Sophisticated debate with engaged and well-educated voters

Macroprudential regulation

1. Financial supervisory authority
   - coordination problems with monetary policy
2. Central bank
   - less interest in financial stability than in the inflation target?
   - advantage with non-political decision-making?

Macroprudential regulation cont.

3. Financial stability council

   - focus on financial stability

   - risk that it becomes toothless

Monetary policy

- Stabilisation of inflation (and output) is too simplistic goal formulation
- Financial stability as an additional goal
- Macroprudential regulation may not be enough to handle financial stability as regulations are always lagging financial innovations
- Higher inflation target reduces the risk of hitting zero interest rate bound
- The burden of fiscal policy in recessions would be lessened
- Inflation expectations could be destabilised
- But small problems for countries with small government debt - Sweden

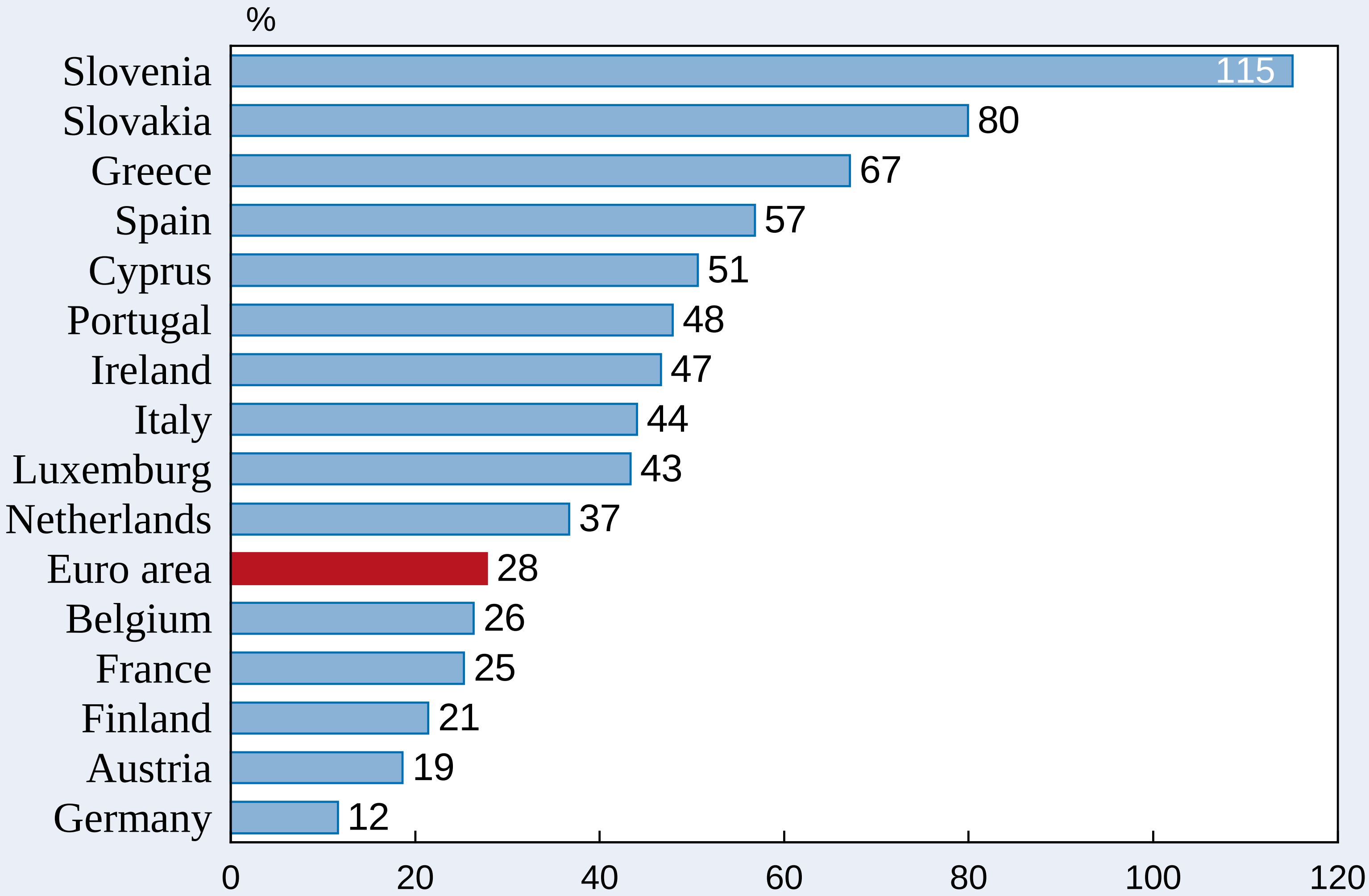
Exchange rate policy

- Strong real appreciations in the euro crisis countries
- Highly questionable that expansionary fiscal contractions exist

  - quoted cases have usually been associated with large real depreciations
- Internal depreciations are very difficult to achieve

  - huge output falls in Latvia and Lithuania

Price developments[a)] 1995-2009



[a)] GDP deflator.

Source: Eurostat, Database, *Economy and Finance, National accounts,GDP and main components* - *Price indices* , 30 November 2010; Ifo Institute calculations.

Temporary exits from the euro?

- Accepted behaviour in the gold standard
- Messy process but likely to restore growth more quickly in crisis countries
- Tougher sanction than pecuniary sanctions
- More interest rate signals in financial markets

The sovereign debt crises in the euro area

- Effect of pecuniary sanctions are diluted with expected bail-outs
- Current strategy: official aid with conditionality

  - but conditionality has not been tested

  - yes-bail-out guarantee rather than no-bail-out clause

  - unlimited support?
- Unlimited support represents huge economic and political risks as do *eurobonds*
- It can only work with joint decision-making on fiscal policy

Rules for orderly default in the EU

- Collective action clauses likely not to be triggered
  - cf current situation
- **EEAG**: haircuts combined with jointly guaranteed replacement bonds to put a floor on lenders' capital losses
- **Calmfors**: partial insurance by European fund
  - independent European council to determine degree of insurance
  - earlier signal to markets

Proposed changes in policy set-up

- More fiscal disciplines in good times
  - stricter fiscal rules
  - establishment of independent fiscal watchdogs
- Strengthen macroprudential regulation with central banks in charge
- Pursue monetary policy with an eye on financial stability
- Raise inflation targets
- Set up a system for allowing crisis countries to leave the eurozone
- Set up a system for orderly default but involving also partial insurance guarantees