

Fiscal policy and the euro crisis

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Public finances 2011

	Government net lending (per cent of GDP)	Consolidated gross government debt (per cent of GDP)
Greece	9.1	165.3
Ireland	-13.1	108.2
Italy	-3.9	120.1
Portugal	-4.2	107.8
Spain	-8.5	68.5
Belgium	-3.7	98.0
France	-5.2	85.8
Germany	-1.0	81.2
Sweden	0.3	38.4

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

- myopic behaviour
- more heavy discounting by politicians than voters
- strategic behaviour and political polarisation

4. Time inconsistency

- stabilisation policy (like monetary policy)

EU fiscal rules

- Deficit ceiling of three per cent of GDP
- Maximum consolidated gross debt of 60 per cent of GDP: if debt is higher it shall be "sufficiently diminishing" and approaching the reference value "at a satisfactory pace"
- Medium-term fiscal target of "surplus or close to balance"

Stability pact

Preventive arm

- Stability (convergence) programmes
- Evaluation by Commission and Ecofin Council

Corrective arm

- Excessive deficit procedure
- Ecofin decisions on proposals from the Commission
 - recommendation
 - notice
 - non-interest bearing deposits (up to 0.5 per cent of GDP)
 - fines (up to 0.5 per cent of GDP)

Could the euro crisis be foreseen?

Asymmetric shocks

- A common interest rate can be wrong for a member state with different cyclical developments
- Real exchange rate changes are hard to achieve without an own currency

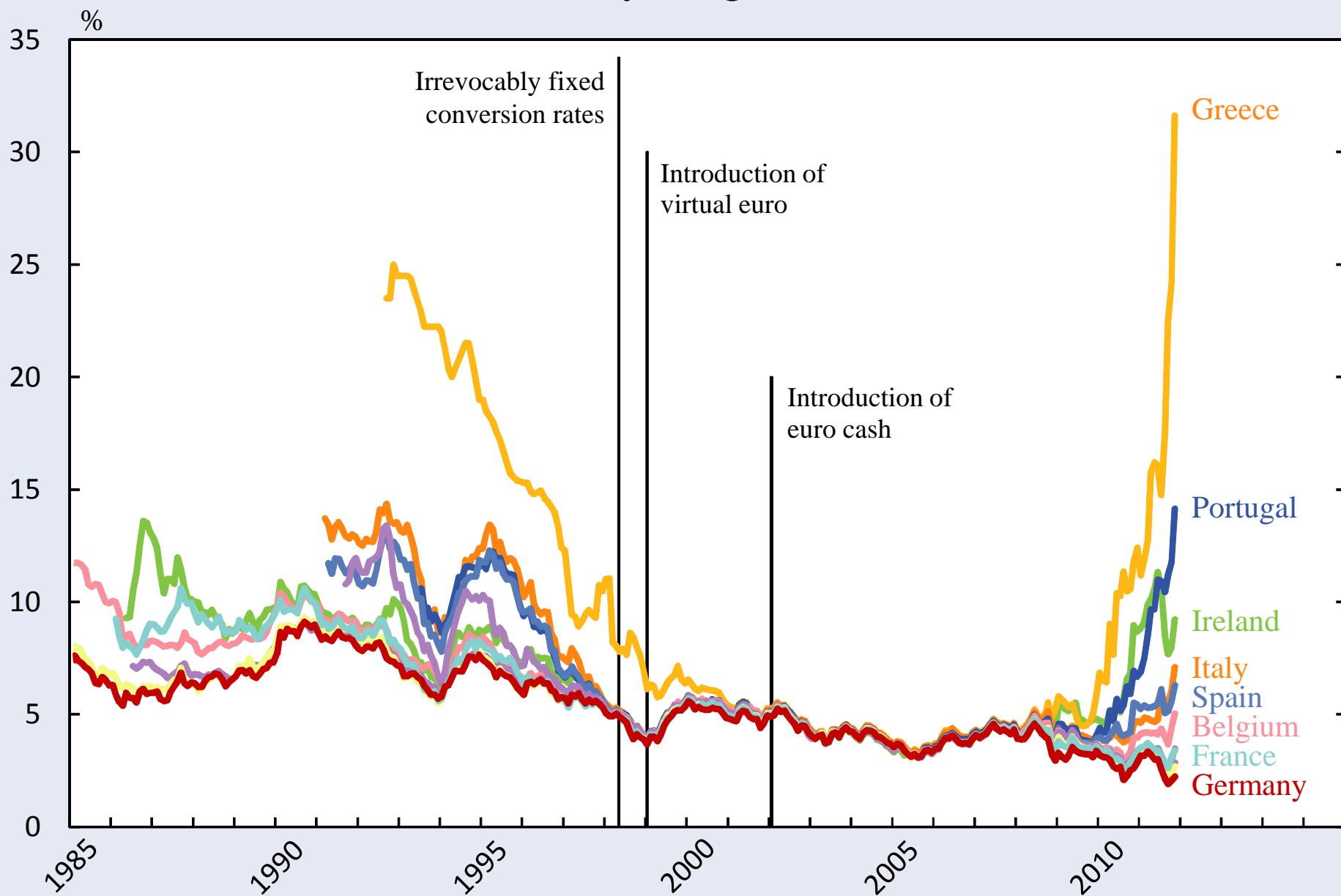
Risk of bail-outs

- Moral hazard because of strong incentives to grant aid to indebted member states
- No-bail-out clause and a ban on central bank financing of deficits
- Excessive Deficit Procedure and the Stability Pact

Gigantic asymmetric shock when the euro was introduced

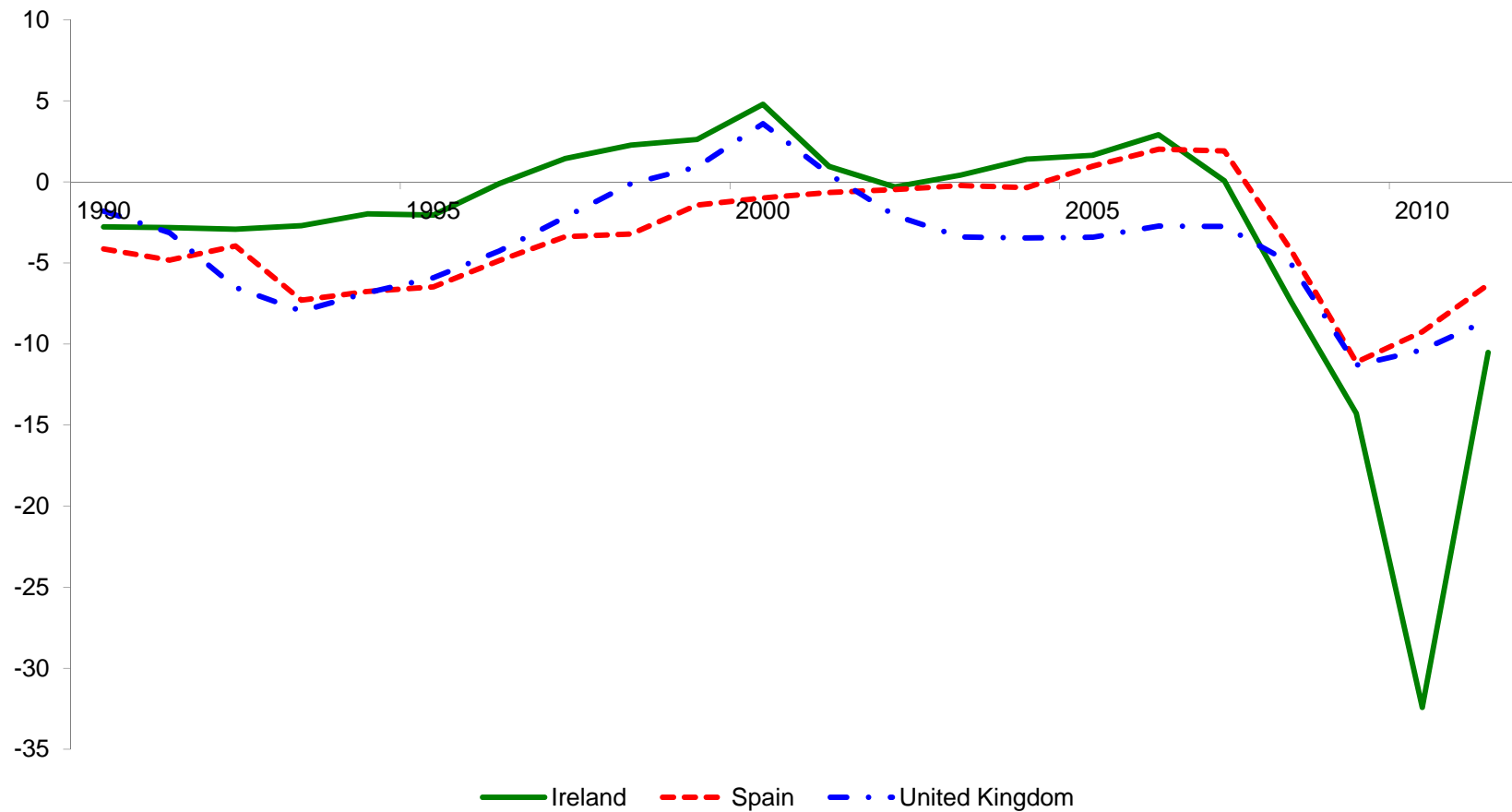
- Large interest rate fall in PIGS countries
- Excessive borrowing in the public sector in Greece and Portugal
- Excessive borrowing in the private sector in Ireland and Spain

Interest rates, ten-year government bonds

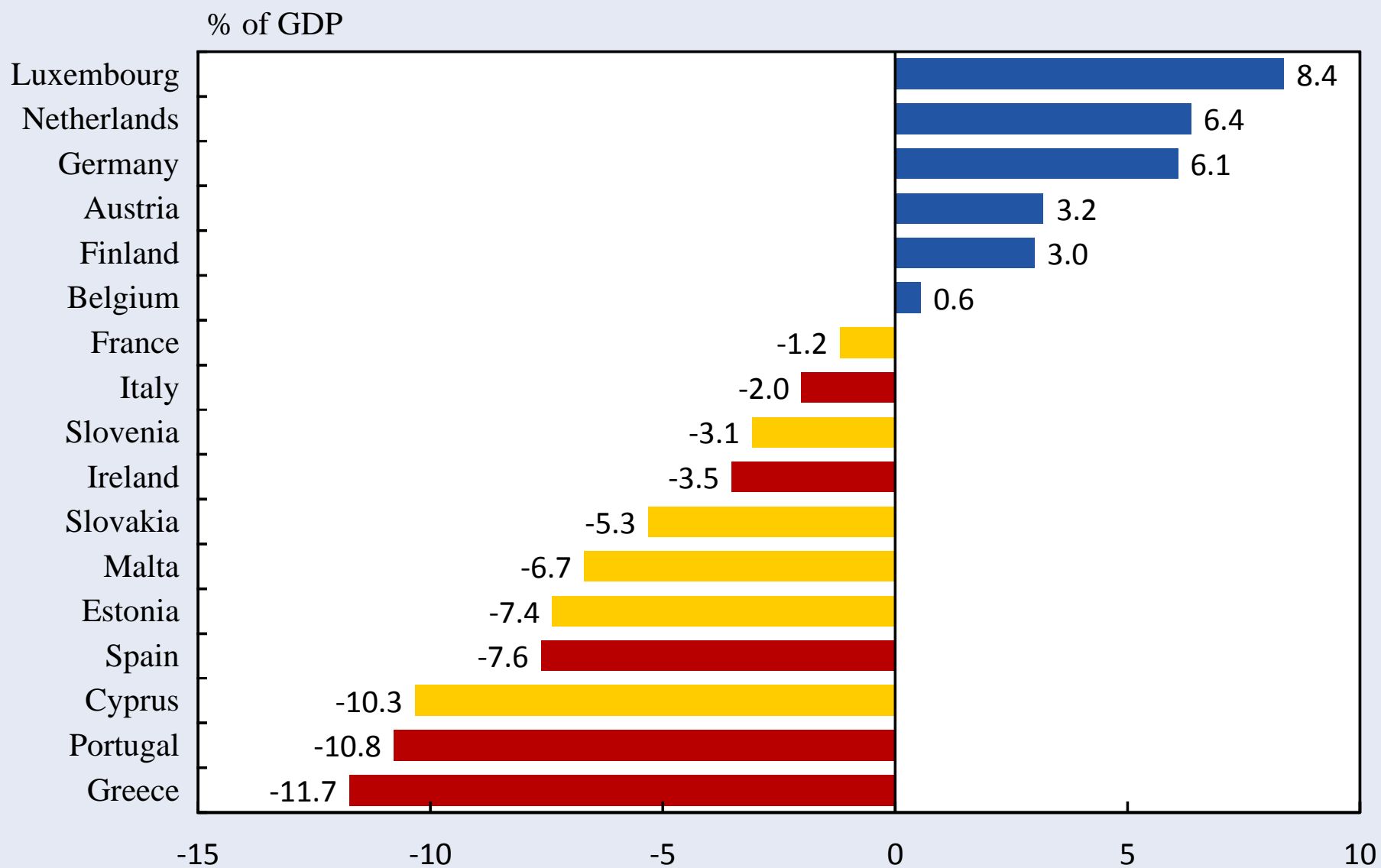


Source: Thomson Reuters Datastream.

General government net lending, per cent of GDP, Ireland, Spain and U.K.
1990-2011



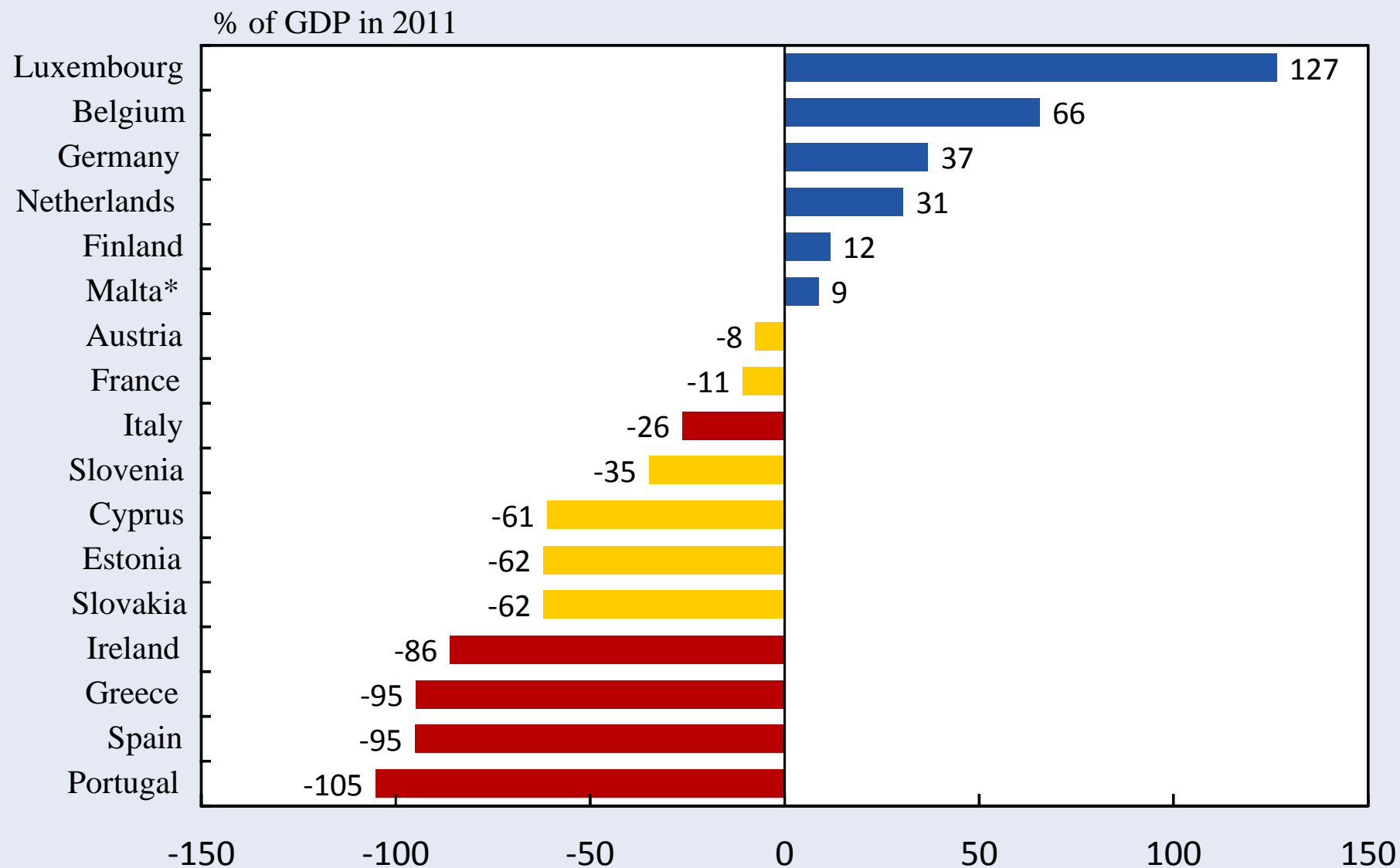
Current account balances 2005-2010



Source: Eurostat, Ifo Institute calculations.

Net foreign position relative to GDP

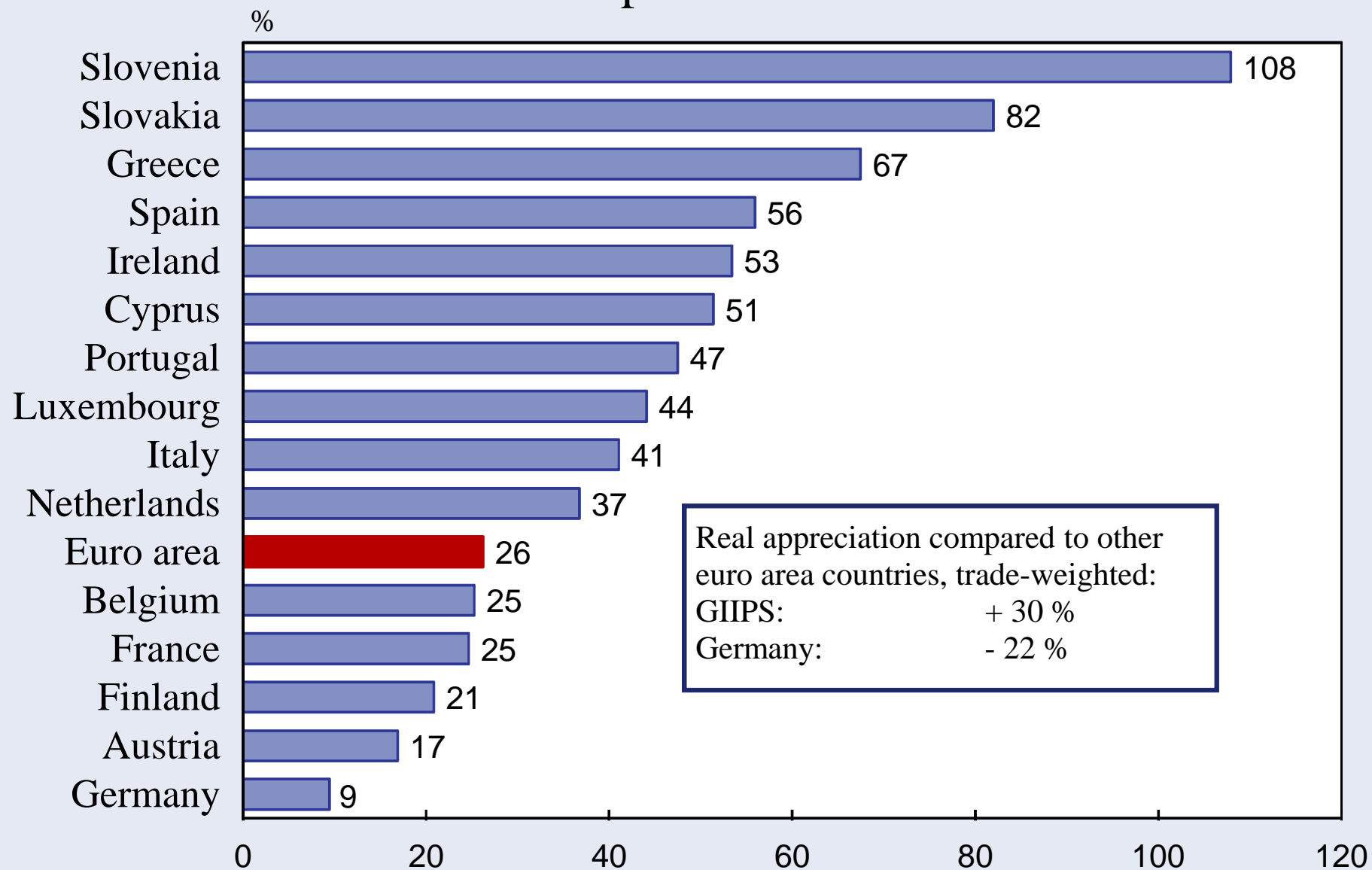
End of June 2011



*End of December 2010.

Source: Eurostat, Ifo Institute calculations.

Price developments 1995-2008



Note: Price change and exchange rate realignments (before May 1998).

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

The largest support to the crisis countries has come via the Eurosystem (ECB and national central banks)

- Private capital flows financing the current account deficits of PIGS countries dried up
 - transfer of liquidity from PIGS countries to Germany
- In a fixed-exchange-rate system the outcome would have been **balance-of-payments crises** and **devaluations**
- Instead liquidity support from national central banks in PIGS countries (against low-quality collateral)
- National central banks in PIGS countries have acquired debt against ECB in the **Target system**
- Bundesbank has instead acquired claims on ECB in the **Target system**

Figure 2:

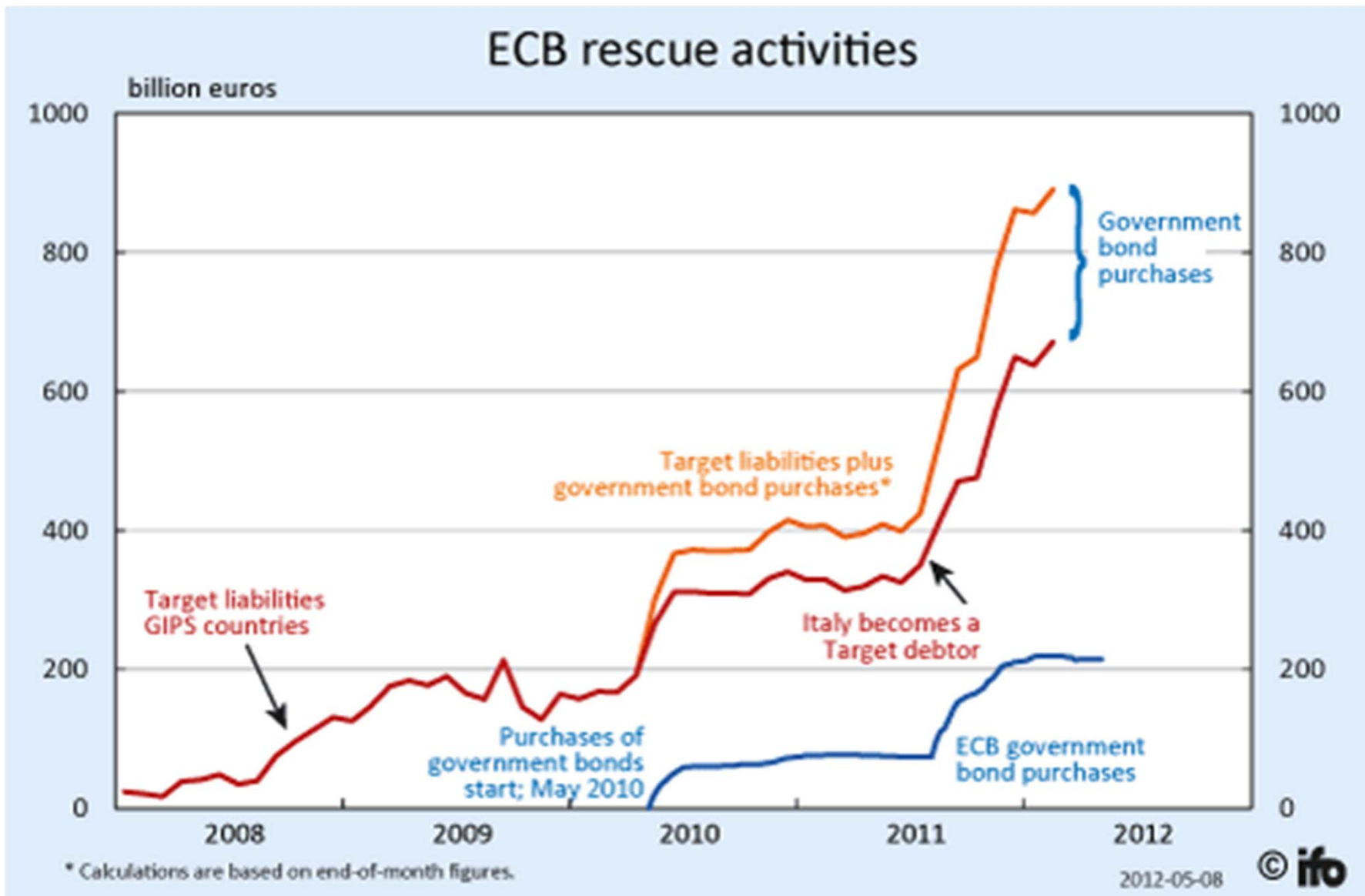
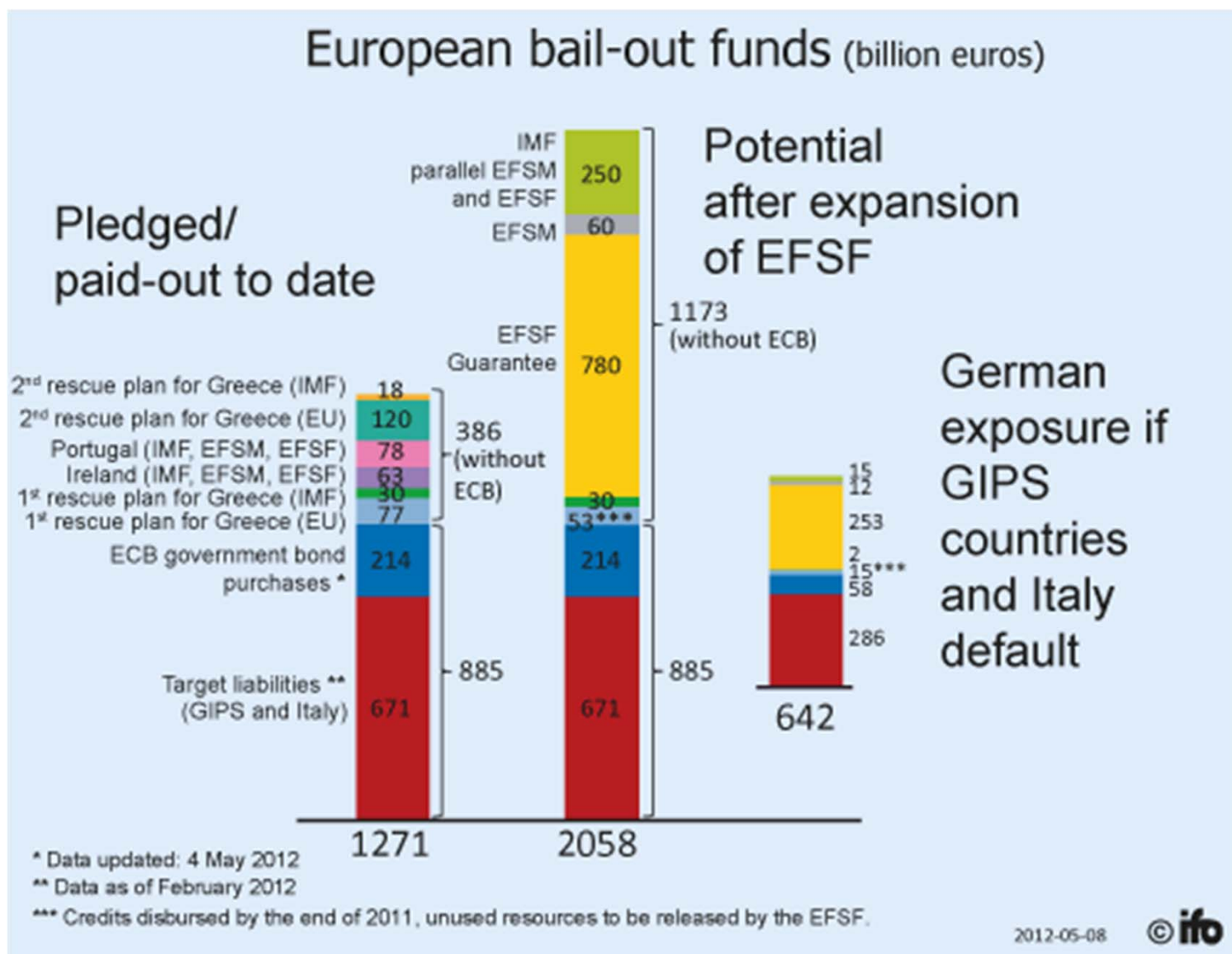
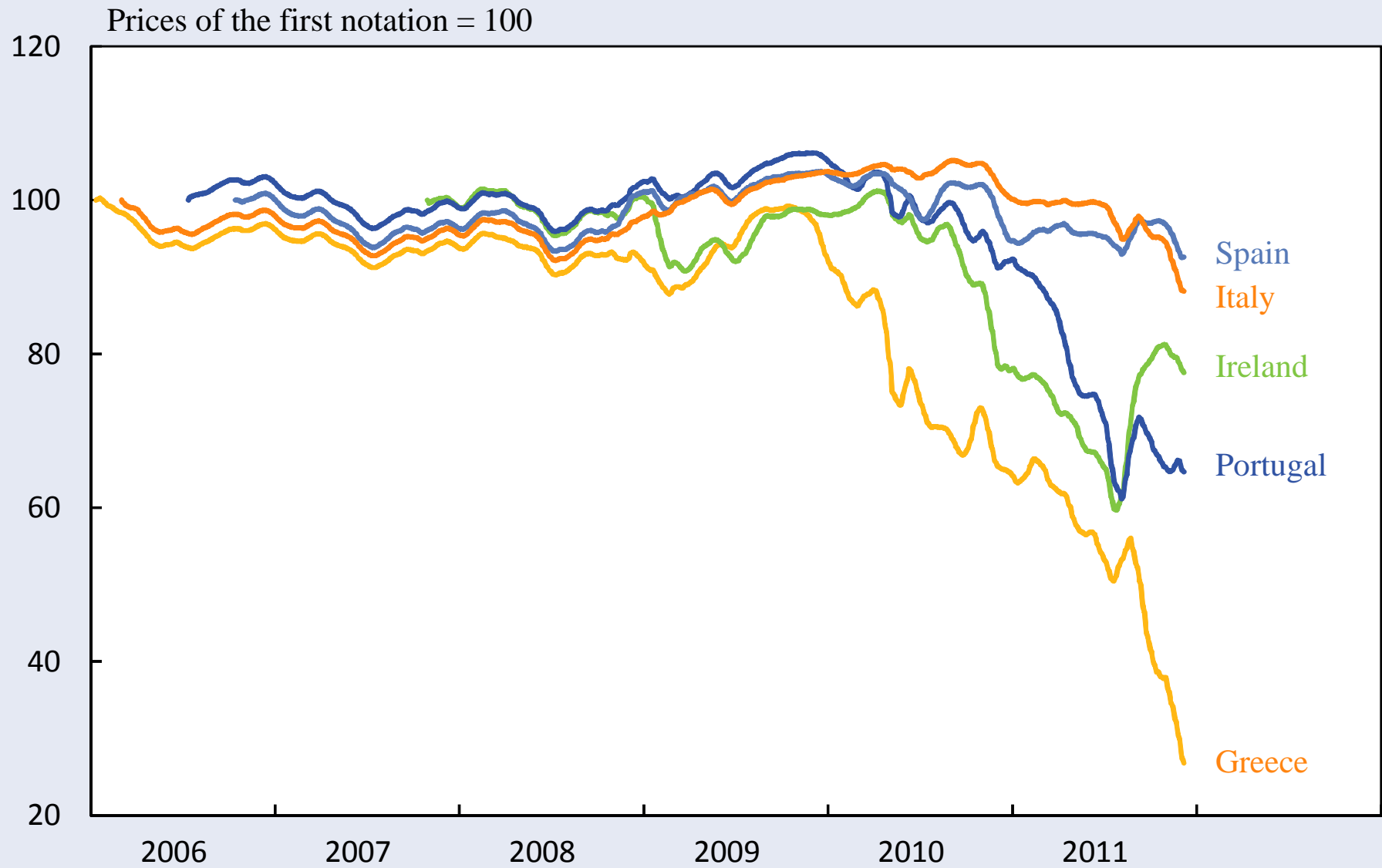


Figure 1:



Prices of ten-year government bonds



Note: Year of issue: 2006; Ireland: 2007.

Source: Thomson Reuters Datastream.

Skulddynamik

$$d_t - d_{t-1} = p_t + (r-g) d_{t-1}$$

Grekland

$$d_{t-1} = 160 \% ; g = 0$$

$$r = 20 \% \Rightarrow (r-g) d_{t-1} = 32 \%$$

$$r = 10 \% \Rightarrow (r-g) d_{t-1} = 16 \%$$

$$r = 4 \% \Rightarrow (r-g) d_{t-1} = 6,4 \%$$

$$\text{Idag: } p_t = 2,1 \%$$

Two views

Self-fulfilling expectations

- Massive support reduces interest rates and make the crisis countries solvent
- The support is only liquidity support with no long-run costs

Insolvent crisis countries

- Massive aid means that governments take over the private lenders' claims
- In the end large capital losses for tax payers in the member states granting aid

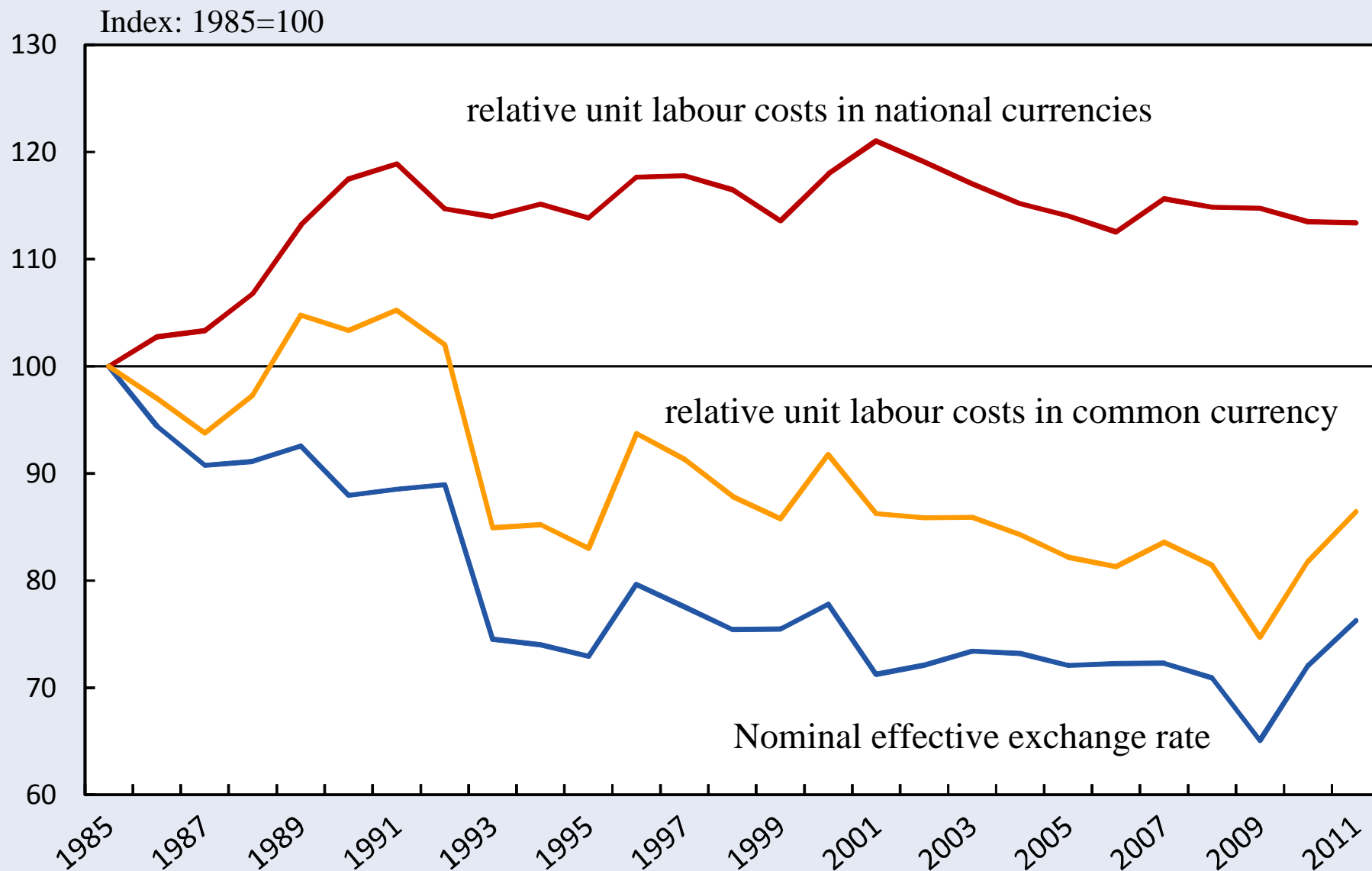
Difficult trade-offs

- Government defaults can trigger a new financial crisis but need not threaten the euro
- Massive support likely to cause political backlash at both ends
 - in crisis countries because of harsh conditionality (fiscal austerity)
 - in the countries granting aid because of costs to tax payers

Need for real depreciation

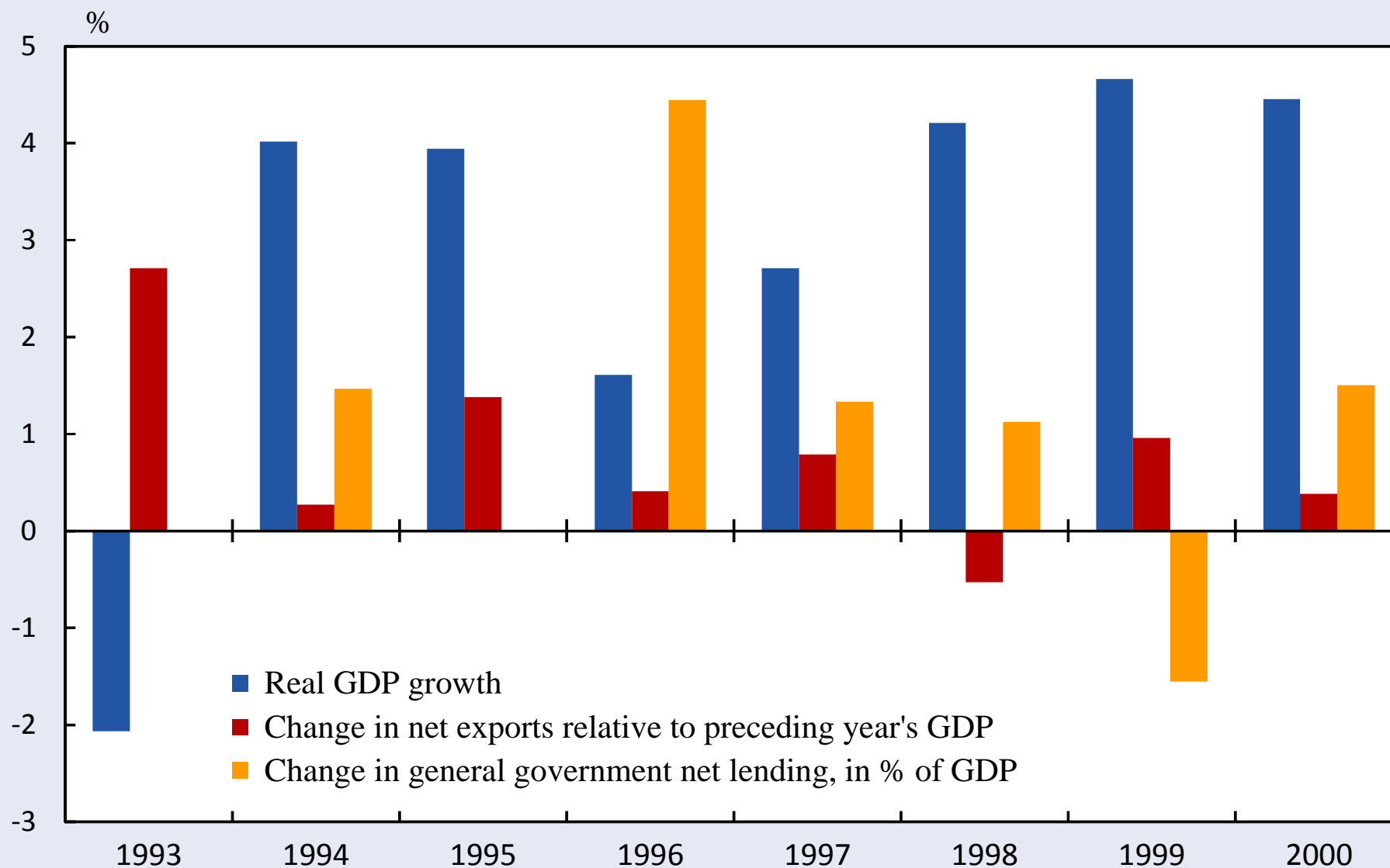
- Only small reductions in deficits with fiscal austerity
 - aggregate demand and tax revenues fall
- Real depreciation is needed to give growth through increasing net exports
- This can only be achieved through cuts in relative wages and increases in relative productivity

Nominal exchange rate and relative unit labour costs vis-à-vis EU-15 for Sweden



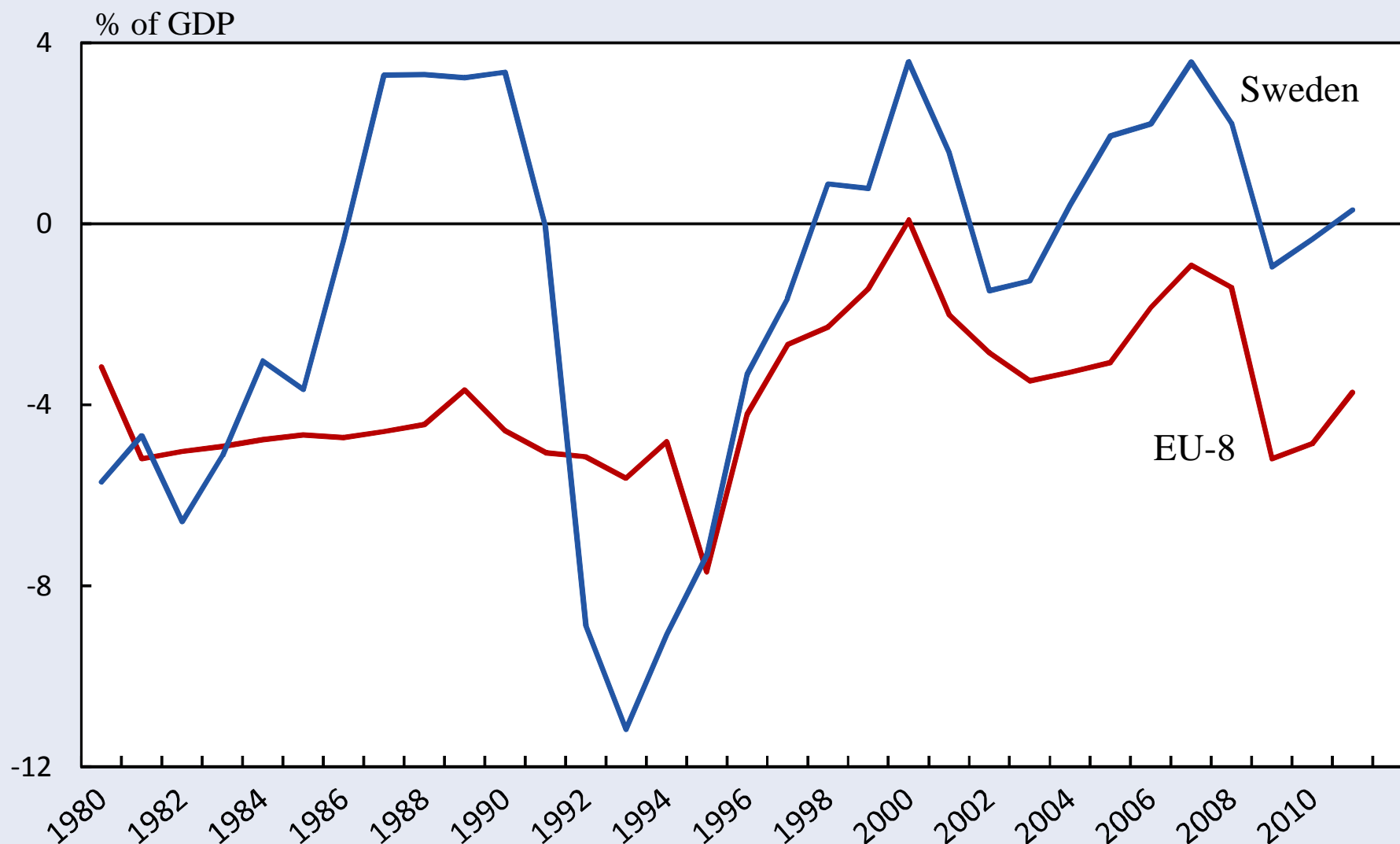
Sources: Ameco and own calculations.

Fiscal consolidation, GDP growth and change in net exports in Sweden, 1993-2000



Sources: Ameco and own calculations.

General government net lending in Sweden and the euro area



Note: EU-8 is a weighted average for Austria, Belgium, Finland, France, (West) Germany, Italy, the Netherlands and Portugal.

Sources: OECD Economic Outlook No. 89 (Sweden); and Ameco and own calculations (EU-8).

**Cumulative change 2009-2011 relative to Euro area
(absolute values in paranthesis)**

	Relative wage cost	Relative productivity	Relative unit labour cost
Greece	-8,1 (-2,3)	-5,8 (-4,5)	-2,3
Ireland	-10,4 (-4,6)	7,2 (8,5)	-17,6
Italy	-0,1 (5,7)	-1,0 (0,3)	0,9
Portugal	-0,7 (5,1)	1,0 (2,3)	1,7
Spain	-0,6 (5,2)	6,1 (7,4)	-6,7

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
Ireland										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.

EU fiscal rules were not applied

- 45 breaches out of 177 possible cases before 2008
- Yet no sanctions were applied
- Excessive deficit procedures against Germany and France were broken off in 2003-2005
- Watering down of the Stability Pact in 2005 to ex post justify the treatment of Germany and France
 - extended deadlines to correct excessive deficits
 - deposits (fines) after seven (nine) years instead of after three (five)

Problems with the fiscal rules

- Atomic bomb character – very harsh sanctions from the start when applied
- Pecuniary sanctions worsen deficit problems
- Sanctions only in the case of violations of deficit criterion, not in the case of violations of the debt criterion
- Each step in the excessive deficit procedure required a qualified majority in favour in the Ecofin Council
- Ministers reluctant to punish their peers
- No rules on fiscal policy in booms
- Insufficient monitoring of quality of statistics
- Disconnect between fiscal policy discussion at European and at national levels

Reforms of EU economic governance

- Changes in the Stability Pact
 - new regulations
- New fiscal compact
 - intergovernmental treaty

Summary of reforms

- Earlier and more graduated sanctions
 - both in the stability pact's preventive and corrective arms
 - interest-bearing deposits, non-interest-bearing deposits and fines up to 0.2 per cent of GDP
- Operationalisation of the criterion that government debt in excess of 60 per cent of GDP shall be "sufficiently diminishing"
 - excess shall be reduced each year by 1/20
- Reversed qualified majority in the excessive deficit procedure
- European semester

Summary of reforms cont.

- National budget balance rules to be written into national constitutions (law)
- Automatic national correction mechanisms if budget balance rule is violated
- European Court of Justice to monitor the establishment of national budget balance rules
- Common principles on public finance statistics
- Broader macroeconomic surveillance with an **excessive imbalance procedure**

Remaining problems

- Steps in the excessive deficit procedure still require **political** decisions
- Sanctions are still pecuniary
- European Court of Justice does not monitor adherence to the rules (only imposition of national budget balance rules)
- Balanced budget requirement is for the structural budget balance (the cyclically adjusted budget balance)
- No clear criteria in the excessive imbalance procedure

Remaining problems cont.

- Do voters accept the reforms?
- Are they fully aware of them?
- Will there be new political negotiations on them?
- What is the credibility of the new rules?
- The bail-outs being undertaken represent Treaty violations
 - moral hazard
 - why should fines work as deterrents if you can borrow to pay the fines and then have someone else pay?

Comparison with Sweden

Europe

- Strict formal rules on fiscal targets
- Automatic correction mechanisms
- Sanctions

Sweden

- Flexible rules
- No automatic correction mechanisms
- No sanctions
- Transparency and qualified public debate
 - information given and required by the government
 - monitoring institutions

Political consensus on budget discipline and fiscal framework in Sweden

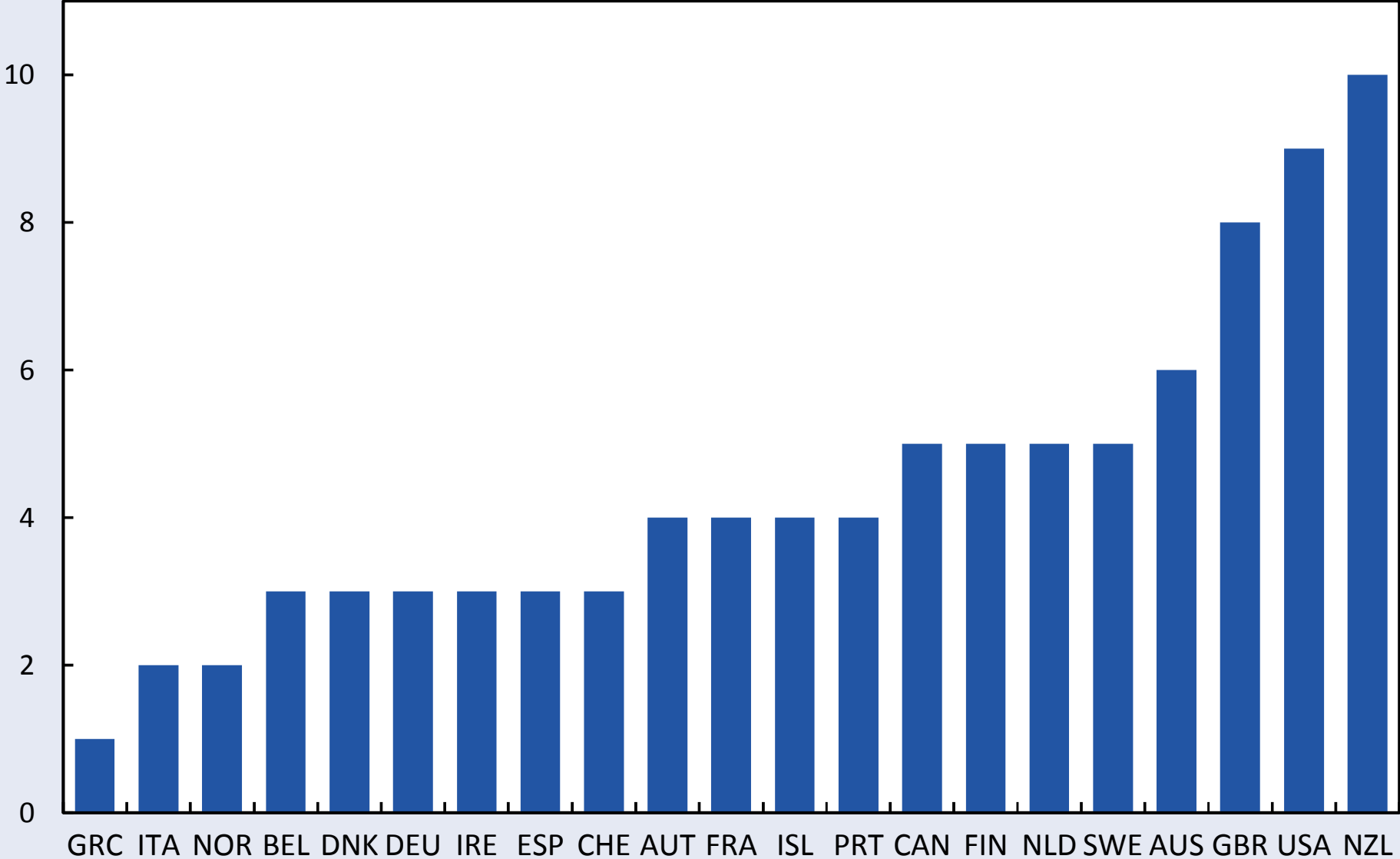
- Top-down budget process
- Fiscal surplus target of one per cent of GDP
- Central government expenditure ceiling
- Local government budget balance requirement
- Reformed pension system
- Monitoring institutions with substantial independence
- Government calculations of the annual **scope for reforms**
- **Fiscal culture likely to be much more important than formal rules**
 - cf Greece and Sweden

Problems with the rules approach

1. Insufficient legitimacy for European rules
2. Insufficient safety margins and neglect of unsustainable booms
3. Conflict between **simplicity** and **flexibility**

The Alt-Lassen index of fiscal transparency in OECD economies

Index



Source: Lassen (2010).

Independent fiscal institutions

- Fiscal committees with decision-making powers
- Fiscal watchdogs or fiscal councils

Earlier existing fiscal watchdogs

- Central Planning Bureau (CPB) in the Netherlands (1947)
- Economic Council in Denmark (1962)
- Sachverständigenrat in Germany (1963)
- Congressional Budget Office (CBO) in the US (1975)
- Public Sector Borrowing Requirement Section of the High Council of Finance in Belgium (1989)
- Staatsschuldenausschuss in Austria (1997)

Recently established fiscal watchdogs

- Fiscal Policy Council in Sweden (2007)
- Parliamentary Budget Office (PBO) in Canada (2008)
- Fiscal Council in Hungary (2008)
- Fiscal Council in Slovenia (2010)
- Office for Budget Responsibility in the UK (2010)
- Fiscal Advisory Council in Ireland (2011)
- Fiscal Policy Council in Portugal (2012)
- Fiscal Policy Council to be established in Australia (2012)
- Fiscal Policy Council to be established in Slovakia (2012)

Potential contribution of a fiscal council

1. Alleviate informational problems
 - increase accountability of politicians
2. Complement to a fiscal rule
 - increase reputation cost of violating the rule
3. Alleviate the conflict between simplicity and flexibility
 - evaluate when simple rule can be broken
 - monitor adherence to more complex rule

Tasks of a fiscal council

- Forecasts
- Ex ante and ex post analysis of fiscal sustainability and the adherence to medium-term fiscal targets
- Analysis of stabilisation policy
- Evaluation of fiscal rules
- Costing of individual government proposals
- Breadth of remit: employment, growth, income distribution etc.
- Normative recommendations on policy?

Viability of a fiscal watchdog

- Natural to get into conflict with government at times
- Time inconsistency problem for government
 - ex ante incentives to set up fiscal watchdog
 - ex post incentives to restrict its activities or even close it down

Examples of government pressures

- Venezuela – PBO closed down
- Hungary – Fiscal council in effect dismantled
- Canada – budget cut for PBO
- Sweden – threat of budget cut
- Greece – firing of head of PBO

Lines of defence

1. Building a reputation

- but it takes time
- and requires a sophisticated political debate

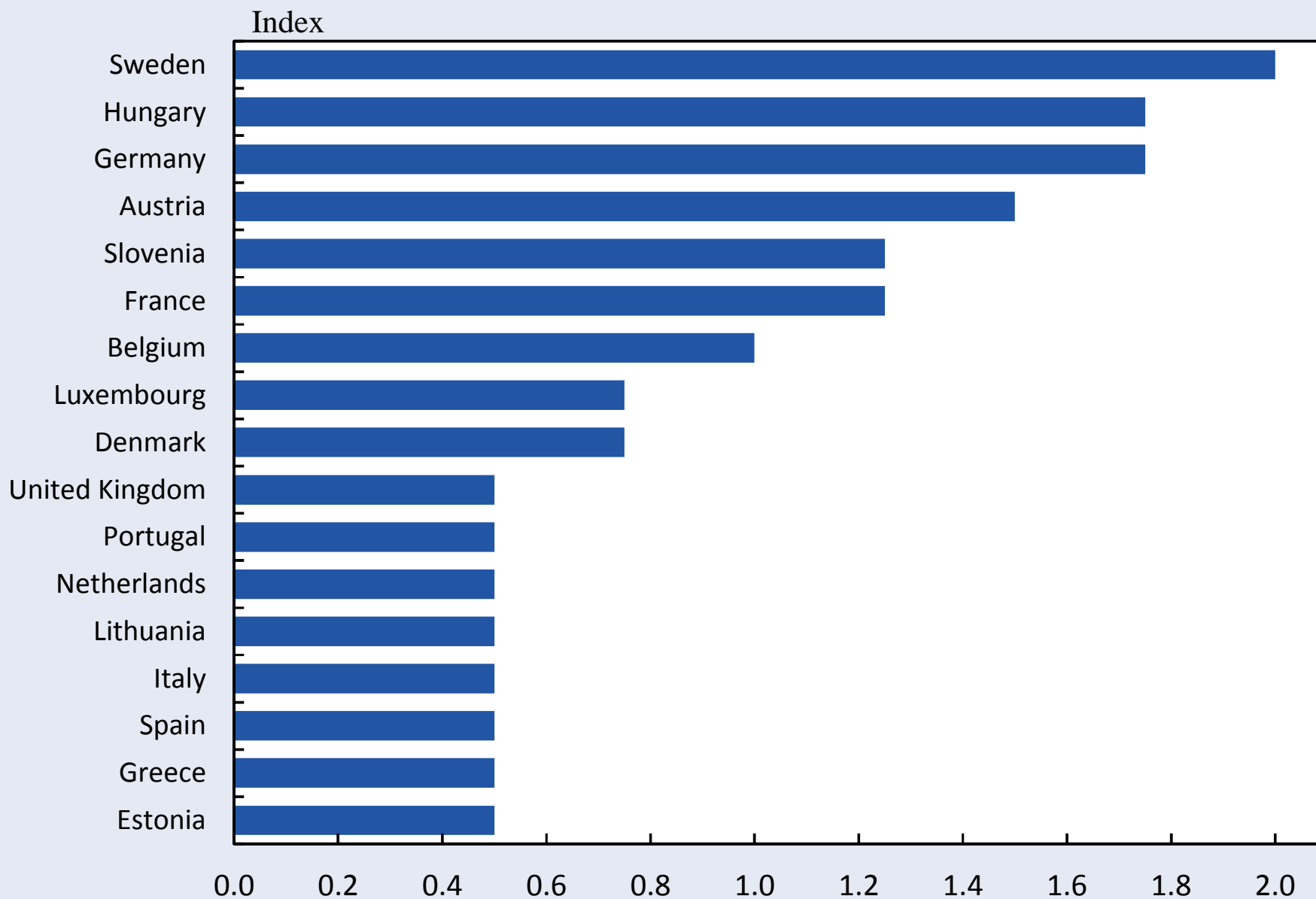
2. Formal provisions

- guarantees against firings
- resourcing
- long-term budget

3. International evaluations

- quality control
- but also defence against politically motivated critique

The strength of fiscal watchdogs in EU member states in 2009



Source: European Commission (2011).