PRELIMINARY TEXT – NOT FOR PUBLIC QUOTATION

REAL AND FINANCIAL CONVERGENCE: IS FISCAL POLICY THE RIGHT REGULATOR ?

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Abstract

This paper considers the scope for fiscal policy to act as a "regulator" of the economy by preserving stability during real and financial convergence. As background, it discusses risks to stability that may take on particular importance during convergence – when the financial sector is likely to expand strongly in a setting of high real rates of return and rising income expectations. The paper suggests that fiscal goals should take into account the transitory swelling of revenues during credit and asset price booms, and that periods of rapid convergence offer scope to accelerate progress toward medium-term goals. It argues that debt ratio objectives should build-in headroom for identified contingent liabilities, and possibly also for latent risks. Trade-offs between growth and stability are recognized to reflect country-specific conditions, and medium-term goals thus need to be evaluated on a case-by-case basis. A prudent fiscal policy, the paper notes, is particularly crucial where other policies are constrained in addressing stability concerns; but it should not seek to substitute for monetary autonomy by fine-tuning: discretionary action should be exceptional. Also, in assessing the impact of fiscal policy on stability, important micro aspects deserve careful review. Central bank Financial Stability Reports can help analyze the stability challenges for policy, and a confidential forum of key policy-makers to explore their implications could be valuable. In conclusion, the paper suggests that market contagion risks prior to euro adoption make these matters of common concern: surveillance through the EU's convergence dialogue can play a potentially valuable role.

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Executive Summary

This paper probes the scope for fiscal policy to help regulate private sector activity during real and financial convergence, in the sense of containing risks to financial stability. It explores whether this places unusual demands on fiscal design and implementation, and discusses the implications for policy and surveillance in the new EU Member States. Financial stability risks, the paper recalls, are not unique to converging economies. However, they may be especially challenging in this context, given the need to integrate complex reforms in the private and public sectors; to sustain balanced access to capital markets through a convincing mix of macro and micro measures; and to avoid the risk of serious damage to output during boom-bust cycles. Several aspects of the convergence setting are particularly relevant here: high real rates of return, rising permanent income expectations, and the burden on financial market risk premia in preserving stability.

The paper places the role of fiscal policy in the context of each economy's policy system, including the level of imbalances in the economy and the scope for other policies to pre-empt and respond to financial stress. These elements are not static: private sector leverage is rising; so is unhedged currency exposure – which limits the margin for manoeuvre of monetary policy; and monetary regimes will one day be adjusted to adopt the euro. Macroprudential issues may prove complex to address, especially in a setting of cross-border ownership. In this context, sound medium-term fiscal strategies play a key role in containing stability risks. Ensuring an adequate contribution from fiscal policy requires an assessment of evolving policy and market risks: analysis of this can be assisted by central bank Financial Stability Reports, perhaps complemented by a high-level forum among policy-makers. It is also important to review relevant micro aspects of fiscal policy – such as distortions caused by mortgage subsidies and interest deductibility.

The paper advances five principles to assess the stance of policy. First, a baseline of even progression to a primary balance that assures a debt ratio sufficiently below 60 percent to allow headroom for identified – and perhaps also latent – contingent liabilities. Second, when credible and front-loaded fiscal reforms are underway, acceptance in principle of a more gradual deficit path, with somewhat more favourable long-run growth assumptions. Third, assessment whether the implied balance adequately supports the monetary regime, in terms of market confidence and room for stabilizers. Fourth, at times of strong credit and asset price rises, to allow for the impact of transitory "boom" revenues; and more generally to use periods of strong growth to accelerate progress toward medium-term goals. Finally, to limit discretionary tightening, otherwise, to times when there are risks of losing market confidence – while addressing such risks as far as possible ex ante through credible and transparent fiscal frameworks. Trade-offs between growth and stability differ, and medium-term goals must be assessed on a case-by-case basis.

Stability risks during convergence, the paper notes in conclusion, can be a matter of common concern – notably through market contagion before euro adoption. How to handle these issues under EU surveillance depends in part on how the governance debate evolves. The paper suggests tentatively that the EU's convergence dialogue with Member States, including on ERM-II as such, is an operational context in which to consider them.

I. Introduction

This paper addresses the scope for fiscal policy to stabilize private sector activity during real and financial convergence. It takes as given some "universal" features of sound fiscal design. These are, first, that fiscal policy provides a bedrock of stability by targeting a medium-term path of public debt sustainability (factoring in demographic pressures). Second, that room is needed for the play of automatic stabilizers around that path. Third, that policy acts in part by influencing expectations; that this channel can be enhanced by transparent, rule-based, frameworks; and that a medium-term focus helps also to protect tax and expenditure priorities favourable to growth. Fourth, that the influence of fiscal policy on the real exchange rate needs to be borne in mind, since a balanced policy mix can help ensure real and financial stability. Finally, that rigorous accounting standards are critical for informed policy judgments, market assessments, and surveillance.

The discussion that follows considers how fiscal policy, while following these principles, can contribute to fostering stable conditions during convergence. What channels of influence are crucial? Is the convergence setting so different – in kind or degree – that it demands a modified frame of reference for fiscal policy? It might do so, for example, if it changes fundamentally the range of issues that fiscal policy needs to address; the relationship in which it stands to other policies; or the basic trade-offs with which fiscal policy-makers have to grapple. These are questions relevant to policy design and implementation in the new EU Member States, and potentially also to EU surveillance.

In the event, the characterisation of risks during the convergence process suggests an approach to fiscal analysis that places major weight on financial stability considerations and to the role of fiscal policy – at the macro- and microeconomic level – as one part of a country's policy system. But this does not imply substitutability between policies: as monetary autonomy is relinquished, the burden on fiscal policy is increased; but fine-tuning is not a practical or desirable substitute.

To shed light on these questions, the paper discusses in turn the stability characteristics and risks of the convergence process; the comparative advantage of the major branches of policy in fostering stability; the specific contribution of fiscal policy; an approach to calibrating fiscal objectives – and the relevance of these issues to EU fiscal surveillance. Key data are presented in Annex I, and a list of text references appears in Annex II.

II. The Nature of the Issue

The convergence process

If one looks for factors that differentiate private sector incentives and performance in a convergence setting, the key lies predominantly in a single nexus: the coincidence of low levels of income, capital intensity and financial intermediation. When convergence is stimulated – for example, by macroeconomic and structural reforms (including bank restructuring), and by the prospect of EU membership – this is likely to trigger a shift in

private sector financial balances and debt ratios. The corporate sector should be expected to swing more deeply into deficit to finance strong investment, while households borrow more heavily in anticipation of permanent income gains.

In this benign scenario, risk premia play a crucial role in tempering agents' response to the high rates of return available in the real economy, and to the prospects for income growth – thus helping avoid a dangerously rapid rise in leverage and risk exposure in the financial economy (Borio et al 2001).[2] These trends are thus equilibrium adjustments.

In the new EU Member States of the Baltics and central Europe, households are indeed increasing their leverage rapidly, starting from ratios that are low even relative to incomes. Corporations in most countries are also gearing up – but typically not at a very rapid pace: in much of central Europe the private sector is consequently running a small overall surplus. This behaviour of firms may be cyclical, and as regards domestic credit it may partly reflect the scope of cross-border financing – but it could also result from structural problems that inhibit commercial credit (e.g., because debts are hard to collect). As a broad picture, nonetheless, levels of credit to the private nonfinancial sectors in the new Member States show a rising medium-term trend relative to GDP.

Sources of financial instability

Where do stability concerns potentially arise? Abstracting from shocks and policy errors, the inherent risks of real and financial convergence lie largely in capital market imperfections, and particularly distortions of risk premia. The literature abounds in evidence that risk premia can perform poorly over the short and medium term. Pro-cyclical distortions in risk premia are a particular concern, and underlie many features of boom-bust cycles. Risk premia can decline steeply and remain low for an extended period, inflating asset prices and narrowing spreads – even though leverage levels are rising on a path that suggests increasing levels of systemic risk. Such distortions, today captioned as "financial exuberance," frequently involve a strong cycle of credit growth and asset price appreciation (Borio et al 2001). A different but equally important distortion lies in moral hazard: in particular, a perceived guarantee of wholesale bank liabilities that can encourage heavy interbank borrowing, including across borders.

Countries moving to a higher equilibrium growth rate; experiencing a secular downward shift in inflation, and thus in nominal interest rates; or completing banking reforms are prime candidates to experience financial stress or instability, perhaps especially with an open capital account. This is mainly because private market participants find it hard to price credit appropriately in a setting where information asymmetries are particularly impenetrable, or are shifting particularly fast. In converging economies with a credible monetary policy, moreover, base real interest rates may be very low relative to real returns on investment (and indeed in CPI terms they may be negative): in such a setting there may be particular concern about the burden of restraint borne by risk premia.

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[2] Risk premia are not the only factor: as per Feldstein and Horioka, there is more general tendency across countries for domestic saving and investment to move in synchrony, so that national imbalances do not widen as much as relative rates of return might imply.

Excessive credit booms (and subsequent busts) are thus mishaps to which economies undergoing real and financial convergence could easily fall prey. At the macroeconomic level, the excessive expansion of borrowing may result in steeper real appreciation than is warranted by sectoral productivity; and to the extent this is driven in part by distortions it will at some stage need to be reversed. In the downswing of such a cycle, the risks to growth will depend on the resilience of real and financial markets. Where there are large unhedged foreign currency liabilities; where real sector markets are not flexible; or where credit contraction and asset price declines feed on each other to an extent that erodes bank capital and causes a credit crunch, this can be costly to growth. The extent of the cost will depend on the degree of misallocation of credit – whether capital has been invested reasonably productively overall. To the extent risk premia are uniform between domestic and international markets, a related effect may be a shift from feast to famine in the availability of capital flows to finance the external current account deficit.[3]

Less obviously, perhaps, the costs in terms of output will depend also on how market rigidities map to the monetary and exchange regime. High costs can result in particular from unhedged currency borrowings under a floating or adjustable rate (directly, from the impact of depreciation on balance sheets; and indirectly because this may curtail the freedom of monetary policy to respond to output declines). The corollary is that, under a fixed rate regime or monetary union, it is wage or insolvency system rigidities that can inflict particular damage on growth (because relative prices may be slow to adjust, and it may take a long time to achieve restructuring of the corporate economy after a shock).

Thus, under floating or potentially adjustable exchange rates, the central concern is a market crisis – affecting the exchange and interest rates in the first instance, but with a possible balance sheet impact on growth. Under monetary union, stresses would emerge, at least in the first instance, as a "growth crisis," in which the real economy adjusts only slowly after a boom-bust cycle – though, with serious distortions in the banking system, market problems in the form of interbank funding stress could not be ruled out.

Smooth real and financial convergence, in sum, relies on risk premia functioning well, and on policy regimes that impart resilience to the economic system in the event of shocks or shifts in expectations. Official policies need to factor these issues in – by addressing risks ex ante, and by allowing headroom for the ex post costs of distress.

Problems in monitoring and predicting instability

Before we turn to policy roles, it is worth exploring one further dimension of the financial stability issue, because it conditions the nature of an effective policy response. This is the early warning dilemma – in general, and in converging economies specifically. On the one hand, in the case of foreign exchange market crises, the literature tells us a certain amount about the signs that precede such events. The variables featured in Early Warning

[3] The levels of risk premia on the domestic currency public debt of some converging economies, and the fluctuations in these premia, suggest that ease and cost of access to external financing remain key issues.

Systems such as KLR and DCSD appear fairly robust, and performed well since the early 1990s, including in eastern Europe (Berg et al 2004, Schardax 2003).

The difficulty is much greater with domestic financial crises, and associated balance sheet effects. These become of increasing relevance in converging economies as levels of intermediation, leverage, and foreign currency borrowing begin to rise. The fact is that we know less about the warning signs for domestic financial crises. But increasingly the literature focuses on the need to monitor cumulative deviations from trend in a few key variables such as credit, asset prices and the real exchange rate. In the convergence setting, however, there is a particular catch with this prescription. The approach of cumulative deviations from trend – and other rule of thumb benchmarks, such as the pace of real credit growth to the private sector – break down. It is hard to establish the trend with which to compare potentially distortionary shifts in the real exchange rate (which may be undergoing a trend real appreciation for Balassa-Samuelson reasons), or in the growth of credit – which models predict to be rapid, during convergence, under equilibrium circumstances (Cottarelli 2004; IMF 2004). Difficulties in predicting financial system and balance sheets stresses in advance raise the awkward possibility that markets (with some privileged information) may perceive these before a consensus develops among policy-makers that there is a need to act: under such circumstances a self-fulfilling crisis could occur.

This does not mean that monitoring is valueless – quite the reverse. But in a convergence setting it has to concentrate on interpreting credit and exchange rate developments in the context of the real economy and of balance sheet exposures as directly observed. Asset prices, again, need to be assessed in terms of the supply response they are eliciting, and in light of the leverage of agents on asset collateral. Such analysis is difficult, and by nature imprecise. Relying on symptoms, it may lag events. For both reasons, it may not trigger timely awareness or response.

The implication for policy regimes of the risks and monitoring difficulties discussed above is that certain design features become extremely attractive. These are features that incorporate dynamic elements that – without discretionary adjustment – help pre-empt risk, or at least contain it in a timely manner. Examples are stress tests in assessing capital adequacy; or, in fiscal policy, the scope for automatic fiscal stabilizers to play.

Countervailing priorities

Aside from stability risks, there are two further features of converging economies that we need to bear in mind in thinking about the role of fiscal policy. The first is the potentially high returns to public as well as private investment – and also to other fiscal priorities such as education or taxation reform. The second is that economies transforming so rapidly over a lengthy period may be subject to social speed limits and adjustment fatigue. If we were to conclude that stability concerns point to more ambitious fiscal consolidation over the medium term, these are countervailing considerations that need to be weighed. For the moment, it is useful to flag upfront the possibility of trade-offs in these areas: when considering fiscal policy design and calibration we will return to them.

III. Policy assignments in a convergence setting

The convergence setting highlights the question how different branches of policy, and various instruments, can help preserve financial stability – and in particular (for the purposes of this paper) how fiscal policy can best contribute. With the passage of time and accumulation of experience, this issue has become more tractable in some respects. Policy-makers can stand on others' shoulders – seeing the benefits, for example, of strong financial supervision. In the setting of EU enlargement, the transplant of the *acquis communautaire* has served as a short-cut to sound policy frameworks. Moreover, heavy cross-border investment in banking has helped tap experience elsewhere to jump-start standards of risk assessment. All this experience is a fine thing, but even in advanced economies with emulated policy regimes it is not wholly clear how different branches of policy are meant to address financial stability in the short run (Borio and White 2003).

The dilemma of policy assignment

For reasons that have to do with influencing expectations, as well as accountability, economic theory has been tempted to assign policy instruments tidily to policy goals. Monetary policy is assigned to inflation; fiscal balance policy to sustainability (and fiscal composition to growth); and prudential policy to the health of individual financial institutions, viewed on a consolidated basis from a home country perspective.

All of these goals, of course, are strongly congruent with financial stability over the long run. But in the short-term, discretionary adjustments for stability reasons may be difficult to justify, particularly in the context of pre-empting potential risks. Monetary officials wedded to inflation forecast targeting are cautious about responding to developments in credit or asset prices except as these influence consumer price inflation over a 2-year period. Supervisors find it hard to justify higher provisions on pre-emptive grounds (indeed, these typically fall foul of accounting as well as tax rules). Fiscal policy-makers have been urged to fight shy of discretionary measures aimed at influencing demand.

Over the long run, in other words, financial stability has many parents; but in the short run it is a policy orphan. Central banks frequently have the duty of assuring it without the specific instruments to do so (Oosterloo and de Haan). This matters in most economies. But the issues above suggest that it may matter particularly in the convergence setting.

Comparative advantage in the policy system

Suppose, for a moment, that policy-makers in a country have agreed to conserve – in some or all policies – a degree of freedom to pre-empt or cope with episodes of financial stress during convergence. Where would the comparative advantage of each branch of policy lie in addressing stability risks? And how far would they fulfill these roles ex ante, through prevention, or ex post? These are useful questions to consider before assigning a role to fiscal policy. A rough set of assignments is attempted in Text Table 1 (page 8).

Such an assessment of comparative policy contributions to fostering financial stability suggests three reflections as a context for asssessing the role of fiscal policy:

- A wide range of policy instruments is potentially available to address risks of instability, with fiscal policy being only one weapon in the armoury;

Table 1. Direct (Short-run) Relevance of Policies to Financial Stability

Policy Branch	Aspect/Instrument	Pre-emptive or contemporaneous	Ex post Relevance
Monetary	Exchange regime Interest rates*	Foster hedging; exit from exchange risk under euro Can puncture bubbles	
Prudential	Capital adequacy, } provisioning rules, }* loan to value rules } Liquidity guidelines* LOLR/Insurance	Can address credit risk (potentially including diversification, indirect currency risk) Avoid funding risks	 Avoid crisis spread Limit wealth effects
Real sector	Wage flexibility Insolvency regime		{Rapid adjustment {after shocks
Fiscal**	Sustainable debt path Automatic stabilizers Policy mix input* Debt/deficit headroom	Stable expectations Real sector stability Takes pressure off rir, reer	 Absorb/cushion impact
* Potential candidate for short-term discretionary adjustment to address emerging stability risks ** The concern here is with fiscal balances, but the issue of interest deductibility is also important.			

- There may not always be consensus on the use of such instruments – e.g., that interest rates should be raised to puncture a developing asset price bubble;

- There may be practical constraints on using one or more instrument: for example, foreign bank supervisors may not be sensitive to local market risk concentrations.

A more complex implication is that policy-makers, as they consider regime choices and policy settings, may need to consider which branches of policy and which instruments are free – in principle and in practice – to address a stability problem in the future. In designing regimes ex ante, thought should be given to preserving sufficient degrees of freedom in the system to address such risks adequately.

For example, interest rates may be on autopilot under a currency board regime. Or it may be unclear whether foreign (home country) bank supervisors will respond pre-emptively to local market risks of a systemic nature to which establishments of their banks may be contributing but which do not cause a problem (perhaps not even a ripple) in terms of the baking group's aggregate risk exposure or asset diversification. In these circumstances, fiscal policy cannot substitute for an autonomous national monetary policy, or for attention by supervisors to risks across borders or inherent in classes of assets. But the room for manoeuvre required of fiscal policy to address stability risks, and the need for flexibility in the working of real sector markets in case of a crisis, will be all the greater.

Central bank Financial Stability Reports are a vehicle that, by taking a systemic view, can help identify emerging risks and also match the form of risks to the potential for policy action – or even advise in favour of, or against, changes in policy regimes. This could make a key catalytic contribution to assuring that an economy's fiscal, monetary, prudential and real sector frameworks build-in safety margins and degrees of freedom to pre-empt crises and limit spillovers. In addition to public reports, a forum of senior policy-makers to discuss stability risks could play a valuable co-ordinating role.

With this rough framework of policy assignments in mind, including the thought of interdependency and complementarity within the regime system, it is time to turn to the specifics of fiscal policy design in a convergence setting.

IV. Fiscal policy in a convergence setting

The discussion so far suggests that one should try to define the role of fiscal design and implementation not in isolation but as part of a systemic stability approach. Fiscal strategy would be one element in a policy system oriented toward pre-empting instability, and limiting spillover costs and facilitating adjustment in the event a crisis does occur.

Under floating exchange rates, the prime suspect as a trigger for instability would be a market crisis (involving the exchange and interest rates, but with possible balance sheet repercussions on growth). Under monetary union, by contrast, one would be concerned in the first instance more about a "growth crisis," in which the real sector adjusts only slowly after a boom-bust cycle.

In defining the scope for fiscal policy to act as a "regulator" of financial stability in a convergence setting, three sets of issues need to be addressed:

- What is the distinctive contribution of fiscal policy to preserving financial stability – through long-run public debt goals; impact on the saving-invesment balance; the influence of its microeconomic characteristics; and through support for the actual and prospective monetary regime?

- As fiscal policy seeks to promote stability, does it face problematic trade-offs vis-à-vis its other contributions to fostering convergence (e.g., supporting growth)?

- While trade-offs may differ across countries, can one arrive at a limited number of clear and simple steps to calibrate fiscal policy on a case-by-case basis?

a. The contribution to stability

The issues of basic debt sustainability, including demographics, of policy mix, and of monetary regime support are relevant to all economies. But are there considerations that govern fiscal strategy specifically under convergence conditions?

Public debt headroom

Our starting assumption here is that the public finances need to be set on a sustainable course in terms of debt dynamics – taking into account the chosen national approach to addressing demographic pressures. In other words the primary surplus needs to be set at a level that avoids the public debt ratio rising toward imprudent levels. 60 percent is a useful reference point as a limit – but for middle income economies very much an outer limit (IMF WEO 2003, IMF 2004). It is hard to overstate the importance of public debt sustainability in contributing to financial stability. It effects are pervasive – from the benchmark yield curve in the economy to the comfort of external capital providers.

When assessing debt dynamics, of course, a crucial override concerns the impact of demographics. Unless a credible strategy exists to address this through structural reforms, and credible steps in this direction are in hand, then (as a fall-back strategy) the primary surplus needs to provide for debt reduction to a level that ensures long run sustainability through a mix of interest savings and debt ratio headroom. Experience so far in the new member states supports the view that they will adopt the former, more growth-friendly strategy, accepting the initial primary balance costs of contribution transfers.

From the starting point of basic public debt dynamics it is a small step to consider a first additional option: the possibility of allowing headroom for other contingent liabilities. The obvious candidate it unanticipated costs of financial or real sector restructuring. The likelihood of future costs will be the less to the extent policy-makers are confident that monetary and prudential policies can act pre-emptively, and the real sector is flexible. Historic experience across a range of economies suggests that the impact on the public debt can be significant (Hemming et al 2003):

- It appears, first, essential to identify ***specific contingent liabilities that are expected to crystallize over the medium term***, and to allow headroom for these in arriving at public debt goals.

- In addition, a case can be made in terms of prudence for allowing some additional headroom for risks of ***contingent liabilities that are latent – or which may build-up during periods of financial market exuberance***. This is a subject that deserves further research and policy study. Such caution needs to be weighed in terms of

growth trade-offs (see below), but also in terms of the risk of engendering moral hazard if the motivation is made too explicit.

Taken together these two considerations could suggest an operational debt ratio ceiling, judged on a case-by-case basis, that is well below 60 percent of GDP.

This tells one nothing about the transitional path to a medium term primary surplus goal; but unless there are other compelling considerations (including political economic opportunities), an evenly paced progress over four to five years is probably as long a period as governments can commit to credibly. Even so, the medium-term goal would need to allow, of course, for additional debt accumulated during those transition years.

The impact on demand and the saving-investment balance

A further set of issues concerns whether or when to use fiscal policy to dampen aggregate demand or moderate the domestic savings-investment imbalance (and vice versa). Other things being equal, a "tighter" fiscal stance has the potential to offset heavy private sector pressure on resources, contain the external current account deficit, and – for any given stance of macroeconomic policy – achieve a less appreciated real exchange rate (or, under monetary union, implicit real exchange rate).[4] Under floating rate regimes, domestic real interest rates will also be lower.

There are, to begin with, several circumsatnces in which it may be warranted to depart from a planned medium-term fiscal balance goal (even assuming that this goal is specified in cyclically adjusted terms):

- Where economic growth is well above its medium-term trend, and there is a possiblity that stability risks in the economy be are intensifying – as evidenced by strong real appreciation and asset price inflation – this is a perfect opportunity to ***accelerate fiscal consolidation toward a medium-term*** goal (if that has not yet been attained).

- During such periods fiscal receipts are frequently swollen ***by extraneous elements that are mistakenly assumed to be structural***, but in fact reflect the ongoing asset price boom: capital gains levies, securities transactions taxes, etc. It would be prudent to aim for a higher nominal surplus during such boom periods (say, on the order of 1 to 2 percent of GDP) to provide for the day when this process goes into reverse. These gains are not cyclical in the conventional sense, but are transitory.

- If there is a ***danger of losing financial market confidence*** – with potentially damaging effects to output – then fiscal policy can have a strong signaling effect to markets. A major danger in boom-bust cycles is that access to capital flows may suddenly shift from feast to famine. This could occur in the late stages of a

[4] Tightening in this discussion refers to a temporary or permanent increase in the medium term fiscal goal, or an accelerated path toward it. An exception to the points made here is where fiscal tightening restores lost credibility and, under floating rates, the nominal and real exchange rates appreciate in consequence.

domestic boom, when the external current account may have widened sharlpy, and could result in very harsh adjustment requirements. Pre-emptive fiscal tightening in response to deteriorating market conditions for public or esxternal borrowing could help head-off such risks. While the impact of fiscal policy on the external current account may be modest, tightening provides a clear signal of policy orthodoxy and political-economic readiness to address stability problems. This said, there are complementary routes to preserving market confidence that require a longer lead-time but are less costly: these would comprise a medium-term effort to strengthen policy transparency and credibility, which may help insulate the economy from market risks, including contagion.

The circumstances above illustrate cases in which one-off fiscal tightening can play useful role. While discretionary tightening is open to many critiques, it could be costly over the longer run to miss such opportunities for timely adjustment. The first two cases apply under all exchange regimes. The third does not apply under monetary union, and is more likely also to arise where transparency and credibility have not been fostered adequately, or where there are serious constraints on action through other branches of policy.

The opportunity to influence the economy in this way raises complex issues, including because it is hard to disentangle the direct impact of tightening from its signaling effect vis-a-vis financial markets. Quite obviously there are times when risks of a loss of market confidence must trigger a once-off fiscal tightening, to avoid a disaster. But ending up in this situation is costly, and there are three countervailing reasons, in particular, to be cautious about discretionary fiscal measures that depart from medium-term policy settings and the play of automatic stabilizers:

- ***The fallacy of eternal tightening***: It sounds attractive to tighten fiscal policy in order to pre-empt or moderate a private sector boom that threatens to distort resource allocation, particularly where there are concerns that international capital flows may shift from feast to famine as the external current account deficit widens. This requires an increase in the structural primary surplus. But, then, where to stop? Once cannot tighten eternally. And, with a convergence process set to last several decades, how can some symmetry in policy be achieved over time?

- ***The fallacy of unambiguous effects***: The assumption behind fiscal tightening in this setting is that sector balances respond along Mundell-Flemming lines so that, for example, the real exchange rate depreciates. Clearly, if the country risk premium is high, tightening could trigger, instead, Ricardian effects: at the extreme, with the private sector instantly responding, real interest rates and the real exchange rate would be unchanged. But one does not have to take such extreme assumptions to see that, over a period, the decline in real interest rates engineered by fiscal tightening could in fact further stimulate an asset price boom and associated wealth effects.

- ***The fallacy of nimble mid-course correction***: Efforts to fine-tune fiscal policy on an *ad hoc* basis suffer from the familiar problems that it is hard, and often costly in terms of growth, to cut spending quickly. Action on taxes can be quicker, but is recognized to be less effective in influencing demand and probably also less credible in terms of convincing markets or eliciting non-Ricardian effects (Daban et al 2003). It also has to be remembered that in some of these economies the public sector is quite small; in all, given their degree of openness, the impact of policy on demand is subject to sizable leakages. Policy, moreover, takes time to adjust and affects demand with a lag – heightening the risk of mistiming a restrictive impulse. Moreover, recourse to discretionary measures provides an ideal opportunity for special interests to condition their support on exemptions and loopholes – or additional expenditures – of a distortionary nature, incurring efficiency costs (Solow 2002; Buti, M., and P. van den Noord 2004).

Once countries join monetary union, it also need to be borne in mind that the merits of offsetting private sector trends through fiscal action are even more complex. A key route by which the economy returns to internal balance after overheating is now through the adjustment of relative prices: to the extent that tightening cushions or retards this process, it is undermining the mechanics of inter-country adjustment.

These considerations underscore the attractions of having available instruments other than fiscal policy – or in addition to fiscal policy – to address stability issues. And they certainly should give pause for thought to the instinctive fiscal tightener. However, as discussed above, this is not a diagnosis of fiscal impotence or a prescription for inaction under all circumstances.

Microeconomic aspects of fiscal policy

When considering the influence of fiscal policy on economic and financial stability, microeconomic aspects of policy need to be evaluated carefully - albeit this is less familiar territory than their influence on medium-term economic growth. There is a potentially important research agenda in this area – particularly relevant in cases where monetary policy is decreasingly available to address stability issues at the national level:

- A key microeconomic priority is to avoid creating distortions that could amplify boom-bust cycles in the private sector. Prime examples are untargeted mortgage subsidy programmes, and interest rate deductibility schemes.

- A second, more complex issue concerns in-built fiscal stabilizers. There is not necessarily a negative trade-off between improving the efficiency of fiscal policy and enhancing the role of automatic stabilizers (Buti, Martinez-Mongay et al 2002). This will depend on the specific changes and the characteristics of the economy.

- A related challenge is how to craft structural features of fiscal decentralization. Over time, there may be pressures for national fiscal frameworks to build-in

greater decentralization to lower levels of government, as there have been in some of the EU-15 economies. For this to support, not weaken, the effectiveness of policy, close attention must be paid to the design of control mechanisms – a structural feature that has considerable macro importance. These need to set strong incentives to keep the public finances on a sustainable course, but ideally should also avoid inhibiting the operation of stabilizers – a particular challenge in designing workable rules for lower levels of government (Daban et al 2004).

- Distinct from automatic stabilizers in the customary cyclical sense, there is the interaction between revenue policies and longer-run credit/asset price cycles that are a particular concern in this paper. The paper by Jaeger and Schuknecht (2004) addresses this from a cautionary standpoint – not to overestimate the sustainable component of revenues in a boom. This can be turned around into a question: are revenue policies set up in ways that will indeed capture and cream-off some of the income effects of a boom, albeit these must not be analysed incorrectly when estimating the sustainable long-run balance?

- Public borrowing is a further key microeconomic strategy issue – and especially the currency denomination of government funding. Borrowing in foreign currencies (directly, or by guaranteeing public utilities' debt) may appear superficially attractive in terms of current budgetary savings, due to the low nominal interest rates. It has major drawbacks however. It insulates policy-makers from market feedback on policy risks and inconsistencies (because domestic currency markets are sensitive to a wider range of policy risks, including notably inflation). And it exposes the public sector and national balance sheet to risks of major depreciation (notably if the exchange rate overshoots). Over time, in any case, the interest savings of foreign currency borrowing are likely to prove illusory, to the extent long-run parity conditions apply.

Fiscal support for the monetary regime, and balance sheet effects

The question of fiscal support for the prevailing monetary regime is not a precise science. Nonetheless, experience has led policy-makers to associate differing degrees of prudence with alternative monetary and exchange regimes.

At one end of the spectrum, in this regard, are *currency board regimes*. Traditionally, these are associated with balanced budget rules (and hence an implied long-run public debt ratio objective – demographics aside – of zero). The symbolic value of "absolute" fiscal restraint is clear, buttressing a regime designed to be impregnable. But in terms of the framework of analysis suggested above, there are stability arguments to support such a strategy, going well beyond symbolic or confidence effects. Specifically, (1) the CBA regime removes all ability to influence demand and the saving-investment balance through autonomous interest rate policy; (2) it places squarely with the fiscal authorities the direct funding of any liquidity support to the banking system (except to the extent that the CBA has excess reserves); and (3) the permanency of the regime encourages a build-up of foreign currency borrowing in the economy, to the extent that some CBAs (such as

Estonia) formally remove matching requirements even in the banking system. Thus failure of the CBA could cause something close to a balance sheet meltdown, and the public sector is implicitly keeping available its full faith and credit to support the regime.

More difficult to analyse, from a fiscal perspective, are *exchange rate targeting regimes that stop short of being full currency boards*. If we maintain a financial stability perspective, there are two types of constraint on fiscal policy here that go beyond underlying debt dynamics. First, these regimes, again, are potentially hazardous in terms of fostering unhedged borrowing in the nonfinancial private sector. This is an empirical issue, because market factors can foster such borrowing under various regimes (as discussed in connection with free floating below). But if such borrowing builds up it begins to constrain monetary policy significantly – including the ability to support demand in the event of a crisis. Second, if a narrow band is followed or shadowed, this curtails monetary autonomy (that is of course the objective). Third, during approaches to euro adoption, markets will assess the exchange rate path in terms of fiscal performance relative to the Maastricht criteria: a loss of fiscal credibility can cause a sharp adjustment, though whether this has real costs will depend on balance sheet exposures.

By definition, none of these points applies – at least to the same degree – under *freely floating exchange regimes*. Interest rate policy remains autonomous; the central bank is free to create currency to bail out banks; and – provided unhedged borrowing is kept in check by exchange rate volatility and prudential monitoring of indirect credit risk – the exchange rate provides an alternative safety valve to government fiscal support. Nonetheless, where domestic interest rates are high and the nominal exchange rate is fairly stable (e.g., it may be underpinned by continuing FDI inflows) then unhedged borrowing can still build up. If prudential policy and intermittent market volatility do not pre-empt this, then similar concerns for fiscal policy emerge as those discussed above.

Under *monetary union*, finally, the constraint on fiscal balances becomes the concern of partner members, as they seek to discourage free-riding. Mutually agreed fiscal balance rules offer an explicit discipline – based in the case of the euro on a rough approximation of debt sustainability and automatic stabilizer principles. (The more closely these principles are mimicked, the less difference there is between the disciplines of monetary union and the underlying sustainability constraints that apply under free floating.) In the run-up to monetary union, a key consideration for fiscal policy will thus be to ensure adequate room for manoeuvre vis-à-vis the 3 percent deficit ceiling – suggesting that a credible path should be engaged that will bring the deficit significantly below this level shortly after euro adoption at the latest.

b. Trade-offs between stability and growth

This brings us inevitably to the question of trade-offs between stability and growth. The returns to public expenditure on education or infrastructure during convergence are presumed to be high, and so are the potential benefits of accepting certain gross revenue losses (notably, a portion of pension contributions to state schemes, and also of taxes and social charges on labour income, which in some cases are disproportionately high). The

composition of such high-yielding changes does not map very naturally to a Golden Rule approach, but there is an obvious question whether deficits wider than 3 percent of GDP over the medium term – or a gradual decline from present levels of 5 percent of more – would reduce short-run risks of damaging growth or hitting social speed limits. The case would have to be made that higher spending (or lower taxes) should increase deficits even after allowing for the projected net revenue boost from EU transfers (Hallett, 2004).

The question has to be considered from three perspectives:

- From the point of view of market confidence, temporarily larger but transparent and *high quality* and fiscal deficits may be neutral, at worst, and could even be somewhat favourable in terms of country risk and credibility assessment. While the literature has examined Ricardian aspects of credible adjustment, the impact of compositional quality/transparency on spreads would be valuable to research.

- From the point of view of demand pressures and the saving investment balance, it very much depends on the composition of the "additional" deficit components. Notably, pension reforms may widen the fiscal deficit, yet leave the overall saving-investment balance of the economy unchanged.

- Similarly from the point of view of public debt sustainability: pension reforms enhance this, while a case can be made that productive infrastructure, or skill-enhancing education reforms, also contribute by enhancing growth prospects.

The other side of the coin is to probe the perceived costs of accommodating reform programs without increasing deficits. The key question is whether growth-enhancing programs can be accommodated by cutting existing unproductive expenditures. For example, subsidies or untargeted transfers may offer scope to both cut spending and further enhance medium-term growth prospects. The same is true of an important microeconomic factor: the tax deductibility of interest payments (and the related policy of subsidizing house purchase). In advanced and converging economies, suppression of such programs eliminates a distortion that can amplify real estate booms.

It is hard, of course, to separate what is technically possible from what is feasible in terms of political economics. In the real world, fiscal reform and adjustment do not go on interrupted. It is unsurprising ex post that the early 1990s shock treatment in Poland was followed by a period of fiscal drift; or that in Hungary the sharp income compression of the mid-1990s was followed after a few years by boosts (however injudicious) to popular and middle class spending power. In other words, there are speed limits of a social or political kind, and a wise fiscal policy tries to internalize these and manage them to some degree. Towers built to resist tremors preserve some capacity to flex.

In fiscal policy, this does not necessarily imply a gradualist approach, however. More likely it means that periods of impressive reform followed by pauses or even setbacks. Decisive phases of reform, especially if expenditure-based, are in any case least likely to damage growth; but over a period of ten years the average pace of adjustment is slowed

to some degree compared with the technically optimal. If we think in those terms, a country such as Slovakia is clearly in a stage of "two steps forward." But others – such as Cyprus, the Czech Republic, Malta, Hungary and Poland have been experiencing an adjustment lull. In the next four years renewed ambition is needed in these latter cases. In terms of debt ratio latitude, including contingent liabilities, this is now pressing. The 2004 convergence programs of these countries embody an intention to achieve renewed and decisive consolidation in the period ahead (European Commission 2004).

A related consideration is that other steps can be taken to bolster market credibility, though they need to be taken well in advance. Medium-term expenditure frameworks can help foster transparent, strategic choices, and protect spending priorities – thus enhancing both credibility and efficiency (Daban et al 2003). Of course, circumstances can shift suddenly, and potential growth rates projected to underlie such frameworks can prove wrong (not just in a convergence setting). Where tax cuts are envisaged, they should be phased prudently to reflect these uncertainties. And there need to be clear rules about "windfall" receipts from higher than projected growth – to avoid imparting a pro-cyclcial bias to activity. Overall, though, there is significant scope to strengthen further the institutional framework surrounding policy in the new Member States (Ylaoutinen 2004).

In sum, reforms brought on in the context of a front-loaded and transparent program may well justify somewhat slower consolidation towards a target primary surplus, and probably some easing of that surplus target in itself – at least by giving the benefit of the doubt to higher numbers in the long-run potential growth calculation. Still, depending on existing rigidities in real and financial markets, any benefits to growth that could result from larger fiscal deficits need to be weighed against the risks of a setback to convergence if there is a financial or growth crisis – particularly if market rigidities mean that it if major balance sheet problems were triggered, or (under the euro) if it took a long time to correct the real exchange rate through relative price adjustments. This underscores the case for assessing carefully scope to accommodate reform costs through a restructuring of existing programs that could itself be growth-enhancing.

c. Approaches to calibrating fiscal policy during *c*onvergence

One thing is to spell out considerations for policy qualitatively along the lines attempted above. But fine words butter no parsnips: it is much more demanding to try to translate such qualitative considerations into quantitative objectives.

At least as a vehicle for exposition, one can try to formulate in five steps the task of arriving at an appropriate medium-term goal, and a prudent pace of progress towards it:

Step 1 – Develop as a baseline an evenly paced 5-year path to a primary balance that will ensure a long-run debt ratio that is sufficiently below 60 percent to allow headroom for identified – and perhaps also latent – contingent liabilities.

Step 2 – When credible, front-loaded fiscal reforms are underway, transparently explained, accept a more back-loaded deficit path and less stringent growth assumptions.

BOX 1. CONSTRAINTS AND TRADE-OFFS - REFLECTIONS ON GROUPS OF COUNTRIES

The determination of prudent fiscal balance goals, and the scope to cut unproductive expenditures or broaden tax bases to accommodate growth-supportive programs, need to be assessed on a case by case basis. For the purposes of this paper, a step in that direction is to think in terms of rough country groupings:

- In the Baltic states, budgetary positions are quite close to balance, and the private sector is in a phase of strong expansion. In some cases, there is scope for expenditure restructuring – but ratios to GDP are quite low, and a broadeneing of tax bases may hold more promise. External current accounts deficits are quite wide, but real exchange rates may not be significantly misaligned, and asset prices are only booming patchily. Public debt ratios are not a binding constraint for practical purposes. In this setting, the key concern is to avoid additional stimulus to a booming economy – in other words to ensure that automatic stabilizers are functioning fully. It may also be relevant to consider whether current fiscal performance is benefiting in a transitory manner – beyond normal cyclical fluctuations – from revenues associated with boom convergence. Together with the need to support currency board regimes, this could strengthen the case for nominal balances in surplus over the next few years. Slovenia, with the prospects of interest declines ahead during its ERM II period, falls into this category also.

- In the central European majors, the evidence suggests that there is much scope to cut unproductive expenditures and broaden the tax base, and thus accommodate reform-related programs (Feldman and Watson 2002). Deficits are currently quite wide, and debt ratios are high in some cases. Nonetheless, strong internal policy coordination and credible approaches to reform could help make a case for gradualism in reducing deficits to long-run goals (assuming that some delay in euro adoption is accepted as necessary). In practice, however, there have been instances of major stresses in internal coordination, and back-loaded reforms, as consolidation resolve in these larger economies petered out around the end of the first transition decade (Berger et al 2004).

- In Cyprus and Malta (though these new Member States have income levels that barely put them still in the convergence category, and are financially well-developed) there is little question that major expenditure reforms would be beneficial to growth – indeed in Malta major steps have recently been taken, leading to a one-off rise in the fiscal deficit. Cutting distortive programs could cause a compensating rebound in the private sector, at least over the medium term. This is an important consideration given well-acknowledged concerns to address the public debt situation and outlook.

Step 3 – Assess if the balance implied by 1 or 2 above adequately supports the planned monetary regime (market confidence; room for manoeuvre, including stabilizers).

Drawing these initial three elements together, ex ante, will involve assessing trade-offs between stability risks and the case for deficit spending that may be favourable to growth. Such trade-offs differ markedly across countries, including as a function of the scope to restructure existing expenditures in a growth-supportive fashion. Thus prudent debt ratios and medium-term fiscal goals must be evaluated on a case-by-case basis (Box).

Step 4 – During periods of strong credit growth, asset price rises and real appreciation, correct the short-run "structural" balance prudently for non-cyclical but temporary revenue boosts, aiming for a smaller nominal deficit/higher surplus; and more generally, use phases of strong economic growth to accelerate progress toward medium-term consolidation goals.

Step 5 – If public or external funding risks emerge, threatening serious adjustment costs for the real sector, resort to discretionary tightening, particularly if other policies are constrained in addressing this and there is a risk of losing market confidence. But here it is worthwhile exploring ahead of time medium-term approaches that limit exposure to such market risks, including contagion, by strengthening transparency and credibility.

This approach applies before and after the point in time when converging economies adopt the euro. The object of discretionary tightening after euro adoption would be to take pressure off the nontraded goods sector, limit implicit real appreciation, and thus reduce the potential for serious output costs at a time of future reversal.

The judgment to accelerate consolidation toward an established medium-term goal would be a relatively easy one to take, conceptually: the issue of symmetry or long-term unwinding of the change does not arise. The same applies if tightening of the conventionally measured structural balance amounts to prudent allowance for possible inflation of fiscal receipts by factors that are transitory (taxes on appreciating policies or heavy securities turnover), and thus are distorting the apparent structural balance. By contrast, one-off tightening that changes the underlying medium- to long-run goal of policy would be exceptional. It reflects a negative judgment on the pre-emptive effectiveness of prudential and monetary policies, as well as strong concern about the resilience of real and financial markets in a crisis. This is tantamount to saying that it is a second- or third-best policy option, but in some circumstances it could make a critical contribution to stability.

V. The EU's Fiscal Surveillance Procedures

This brings us to the question how EU fiscal surveillance procedures could reflect these financial stability considerations in Member States undergoing real and financial convergencence. First, to what extent policy requirements in a majority of the new Member States should be seen as different. Second, where should be the locus of

surveillance over these aspects of fiscal policy: should it be primarily, for example, the BEPGs rather than SGP? And in each case an important dimension of the question is whether a judgement relates mainly or wholly to the period before they adopt the euro?

Are converging economies different?

First, none of the challenges for policy reviewed above is different in kind from issues that confronted advanced economies over the past decade and a half. Experience in three European economies – Iceland, Sweden and the United Kingdom – illustrates this admirably. Between them, since the early 1990s, they experienced all the real and financial challenges to policy considered above: institutional frailties in supervision; tough trade-offs concerning speed limits and the opportunity costs of public investment; regime shifts that raised growth, and hence permanent income, expectations; lending and real estate booms, and the dilemma whether policy should address these pre-emptively; the balance sheet impact of unhedged borrowing, taken on during periods of unwarranted real appreciation; secular declines in inflation and interest rates; concerns about the implications of the policy mix for the real exchange rate; unease about real sector adjustment mechanisms in the event of sharp changes in the real exchange rate; speculative pressures transmitted through the exchange market during ERM II; and shocks to the public debt from a financial crisis. The triggers for these events differed, but they did not include real convergence factors.

The other potential difference that could be discussed is euro area membership. None of the economies just discussed was a member of the monetary union (Iceland, of course, not being even an EU member). However, there is no reason to think that, had they adopted the euro, they would have avoided a strong cycle in bank lending, real estate prices, and the real exchange rate. However, the growth implications would potentially have differed: there would have been no nominal exchange rate impact on balance sheets, and output costs would have reflected the flexibility of real and financial markets in the downswing. The credit boom and its aftermath in Portugal, during its convergence process under the euro, illustrate this.

So in terms of "being different" the fact that the new Member States are converging, and their position outside the euro system, do not make them vulnerable to different kinds of stability risks or policy dilemmas, compared with other EU members. What is distinctive is the nexus of real and financial changes – discussed above – that may leave the economy inherently more prone to such stability risks. In addition, the convergence setting, as noted, brings with it an intrinsic difficulty in interpreting trend data, making it somewhat harder than usual to monitor and forestall risk systemic risk.

The locus of surveillance

So, for these different but not-so-different economies, how can EU surveillance practices help foster effective fiscal strategies?

As a bold generalization, the indications for fiscal policy in the Stability and Growth Pact are concerned primarily with avoiding economic damage to others, while those in the Broad Economic Policy Guidelines (BEPGs) are mainly about avoiding damage to oneself. This distinction helps locate the financial stability issue, from the perspective of EU surveillance. If fiscal policy fails to address stability issues in the private sector – or to come to the rescue of other policies when they fail to do so – can this cause direct damage to other Member States through market spillovers? Or is the damage largely to domestic growth (inflicting damage on others only through diffuse real sector linkages)?

The answer to this is clear – though what to do about it may be less so.

In the period prior to euro adoption, there is a tangible risk that financial instability in one economy may be transmitted to others through contagion. This channel has been statistically verified between financial markets in Hungary and Poland; it appears to be emerging between the two korunas; one can infer – from experience in Asia – the potential for it to operate through common creditor as well as trade channels in the Baltics; and one can wonder about contagion between the two island economies, with their common exposure to tourism and offshore centre activities, and their long-standing but potentially adjustable exchange rate pegs. Past experience with ERM II – albeit with a narrower formal band – does nothing to dispel these concerns.

We are considering market spillovers that differ in their specifics from those addressed by the authors of the SGP. They had in mind mainly real interest rate and bail-out risks flowing from free-riders toward other members of the area. But the spillover risks among the new Member States are more concrete, more direct, and potentially more damaging. And in the case of contagion among the new Member States, one cannot make the argument that integrated capital markets dilute the importance of such influences: they are highly specific. This contrasts with one of the two original SGP issues – where it could be argued that US fiscal free-riding on the global savings pool can do more to raise world (and hence euro area) real interest rates than a Greece, or even an Italy, ever could.

So the stability risks are unquestionably a matter of common concern. How to handle this issue under EU policy surveillance depends in part how that surveillance evolves in the context of the governance debate. But if the BEPGs remain largely focused on national growth potential and on optimal policies, then the concerns raised by stability spillovers would not fit there. On the other hand, the EU's convergence dialogue with Member States, including on ERM-II as such, seems a possible locus in which to consider them. It is operational in focus. And it is appropriate insofar as adoption of the euro will transform the nature of stability risks, with exchange market spillovers absent, and risks to growth more prominent – reflecting the time needed, under the common currency, to unwind excessive implicit real appreciation after a boom.

VI. Conclusions

This paper has probed the scope for fiscal policy to help stabilize private sector activity during real and financial convergence; considered whether this places unusual demands

on fiscal design and implementation; and explored possible implications for policy management and surveillance in the new EU Member States. The issues are complex, and uncertainties always surround the convergence path. But the conclusions boil down to some relatively simple approaches, rules, and trade-offs – which can be grouped under three captions.

The policy and market context. In addressing private sector imbalances, it is prudent to evaluate the role of fiscal policy pre-emptively, assessing its contribution as part of each economy's policy system – and in light of financial stability risks to the real economy. The goals for fiscal policy, and the pace of advance toward those goals, need to take adequate account of the imbalances in the economy and the strength of other sector balance sheets. The burden falling on fiscal policy, moreover, will be the greater to the extent that monetary, prudential, and real sector policies experience weaknesses or constraints. Moreover, these elements are not static. Exogenously, monetary regimes will one day be adjusted to adopt the euro. Endogenously, leverage in the private sector will increase over time. Unhedged currency exposure may well rise also, and if so will progressively raise the potential real sector costs of depreciation – thus limiting the margin for manoeuvre of monetary policy. Some means to analyse and foster consensus on the implications of this evolving policy and market context is indispensable: regular central bank Financial Stability Reports are a tested vehicle, and a confidential forum to discuss their implications among key policy actors could play a useful role.

Calibrating fiscal policy. The current stance would be based on five principles. First, as a baseline, to project an evenly-spaced path to ensure within about five years a primary balance consistent with a public debt ratio that leaves adequate headroom for identified – and perhaps also latent – contingent liabilities. Second, when credible and front-loaded fiscal reforms are underway, and are transparently explained, to accept a more back-loaded deficit path and less stringent long-run growth assumptions. Third, to assess whether the balance implied under steps 1 and 2 adequately supports the present/planned monetary regime (e.g., in terms of market confidence, and of room for manoeuvre, including automatic stabilizers). Fourth, during periods of strong credit growth, asset price rises and real appreciation, to correct the structural balance (at least crudely) for non-cyclical but temporary factors; and more generally, to take opportunities of strong economic growth to advance more rapidly toward medium-term fiscal goals. Fifth, to engage otherwise in discretionary tightening if there is a proximate risk of losing market confidence with resulting serious damage to the real economy. (This underscores the case for exploring medium-term approaches that limit exposure to such market risks, including contagion, by strengthening transparency and credibility.) Trade-offs between deficit spending and stability constraints depend on country-specific circumstances, and prudent targets for the public debt ratio therefore need to be evaluated on a case-by-case basis.

This approach would remain relevant after converging economies adopt the euro, when the rationale for a relatively more prudent fiscal stance would be to limit unwarranted implicit real appreciation. But fiscal policy cannot substitute for an autonomous monetary policy by continuous fine-tuning: discretionary action should remain truly exceptional.

The locus of EU surveillance. Financial stability risks during the convergence process are unquestionably a matter of common concern – particularly through the potential for market contagion ahead of and during the ERM-II phase. To the extent these specific spillover risks diminish sharply on euro adoption, the SGP (which applies to all Member States) might be excessively encumbered by these policy layers. Of course, how to handle this issue under EU policy surveillance depends in part how that surveillance evolves in the context of the governance debate. But if the BEPGs remain largely focused on national growth potential and optimal policies, as distinct from minimum standards of behaviour in areas of common interest, then these concerns are perhaps not of a nature to fit there. The EU's convergence dialogue with Member States, including on ERM-II as such, seems a possible locus in which to consider them. It is operational in focus, and also appropriate to the extent these stability issues will change form after euro adoption – being largely transformed into risks to national growth, without exchange market spillover risks.

A final thought is that such policy issues are far from unique to converging economies. However, they may be especially relevant there, given the need to integrate complex reforms in the private and public sectors; to avoid risks of serious damage to output as a result of boom-bust cycles, in a setting where risk premia bear a very heavy burden in preserving financial stability; and to sustain balanced access to capital markets through a convincing mix of macro and micro measures. In a majority of the new EU Member States such approaches could thus make a valuable contribution in assuring a sustained catch-up of income levels – avoiding the risk of major setbacks in a region that, through the force of history, has already lost decades enough.

ANNEX I

Table 1: Selected macroeconomic and financial indicators

Countries	GDP growth '98-'02	GDP growth 2003	GDP per capita (PPS) 2003 (% of euro area)	GFCF 2003 investment ratio (% of GDP)	CA (% of GDP) 2002	CA (% of GDP) 2003	Net FDI 2002 (% of GDP)	Domestic Bank Claims to private sector 2003 (% of GDP)	Domestic bank Claims to private sector (% change Dec.03/Dec. 02)
CZ	1.6	3.1	64.8	26.7	-6.3	-6.2	11.2	30.9	8.6
EE	5.3	5.1	46.4	28.4	-10.2	-13.2	2.2	33.1	32.6
CY	4.1	2.0	78.2	17.4	-4.6	-3.5	5.9	122.8	5.1
LV	5.9	7.5	41.8	24.2	-7.0	-8.6	4.1	34.6	45.3
LT	4.5	9.0	44.2	20.8	-5.2	-6.6	5.0	20.6	58.9
HU	4.3	2.9	55.9	22.0	-7.1	-8.9	4.0	43.0	33.3
MT	2.5	-0.1	67.7	21.5	-1.1	-5.3	-10.5	114.8	2.0
PL	3.0	3.8	43.9	18.3	-2.6	-2.0	2.0	29.0	6.7
SI	3.8	2.5	72.2	23.9	1.4	-0.4	3.4	41.5	15.4
SK	3.2	4.2	49.8	25.7	-8.2	-1.1	17.2	31.7	13.9
Euro area	2.3	0.5	100.0	19.9	0.9	0.4	-0.1	112.1	5.5

Source: AMECO, Eurostat, IMF IFS, national sources.

Table 2: Selected fiscal indicators (% of GDP)

Countries	GG Deficit 2002	GG Deficit 2003	GG Expenditure (1) 2002	GG Expenditure (1) 2003	GG Revenue (1) 2002	GG Revenue (1) 2003	GG Gross Debt 2002	GG Gross Debt 2003	GG Investment (GFCF) 2002	GG Investment (GFCF) 2003
CZ	-6.8	-12.6	46.9	54.5	40.2	41.9	28.8	37.8	3.7	4.2
EE	1.4	3.1	36.6	35.8	38.0	38.9	5.3	5.3	4.7	3.4
CY	-4.6	-6.4	41.9	46.1	37.3	39.7	67.4	70.9	3.1	3.4
LV	-2.7	-1.5	35.8	36.0	33.1	34.5	14.1	14.4	1.3	1.5
LT	-1.5	-1.9	34.3	34.1	32.8	32.3	22.4	21.6	2.8	3.0
HU	-9.2	-6.2	52.7	49.8	43.4	43.6	57.2	59.1	4.9	3.4
MT	-5.8	-9.6	45.5	49.4	39.7	39.8	62.7	71.1	4.5	5.2
PL	-3.6	-3.9	48.9	47.6	43.9	43.7	41.1	45.4	3.6	3.4
SI	-2.4	-2.0	48.1	48.2	45.7	46.2	29.5	29.4	2.8	2.8
SK	-5.7	-3.7	50.9	39.2	45.2	35.4	43.3	42.6	3.3	2.6
Euro area	-2.4	-2.7	48.5	49.0	46.1	46.3	69.4	70.7	2.5	2.6

Source: AMECO.
(1) In some countries, expenditure- and revenue-to-GDP ratios are not yet fully compliant with ESA95 standards (e.g. due to differences in the consolidation methodology)

ANNEX II

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