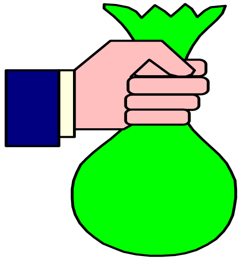
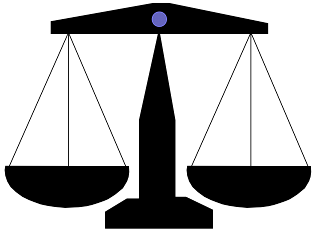
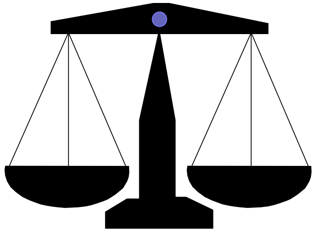
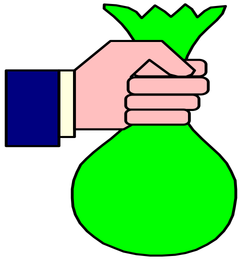


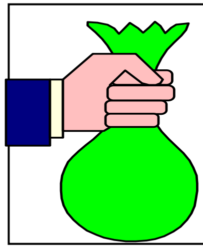


Real and Financial Convergence

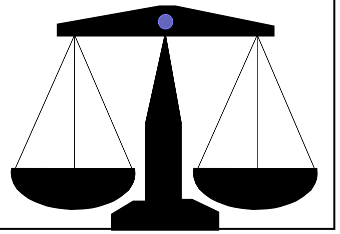
Is Fiscal Policy the Right Regulator?



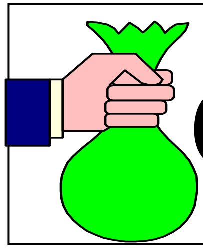




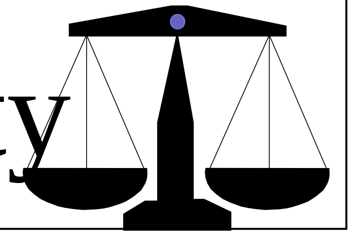
Outline



- Financial stability during convergence
- Policy assignments
- The fiscal contribution to stability
- Stability/growth trade-offs
- Calibrating fiscal policy
- Modalities of EU surveillance
- Conclusions and research priorities



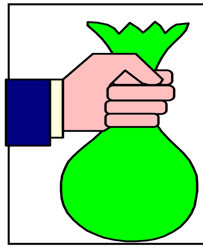
Convergence & Stability



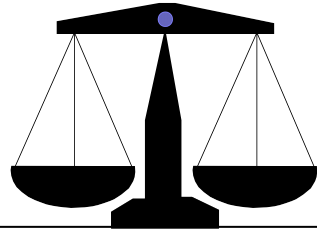
There are always risks to financial stability, but during convergence key risk factors:

- High rates of return and rising income expectations
- Real base interest rates declining to low levels
- Open capital accounts and currency borrowing
- Financial sector expanding steeply
- Institutional settings still deepening

Burden on risk premia to preserve balance: heightens endogenous boom-bust risk (pro-cyclical risk premia)

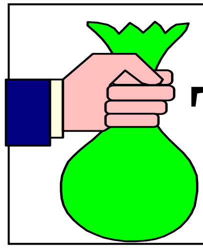


Policy Assignments

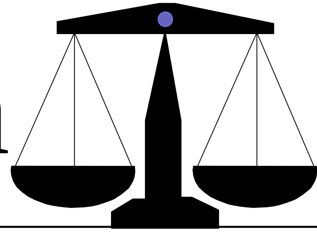


Fiscal, monetary, prudential goals foster long-run financial stability: but short-run needs study:

- Monetary regimes can influence hedging behaviour through variability of exchange rate
- Real sector frameworks key to contain output risks
- Prudential policy may internalize latent risks during boom-bust cycles; indirect exposures; sector risks
- Fiscal policy can influence financial stability through both macro and micro design features
- Financial stability reports and discussions valuable

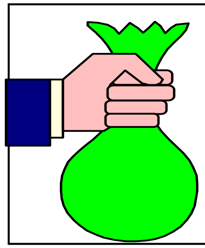


The Fiscal Contribution

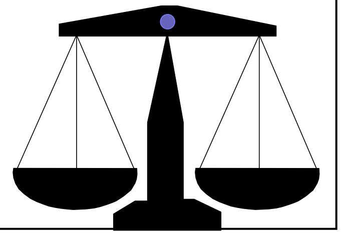


How can fiscal policy help foster stability?:

- ***Public debt***: what headroom is prudent for contingent liabilities?
- ***Saving-investment balance***: when, if ever, is discretionary adjustment warranted?
- ***Microeconomic aspects of fiscal policy***: are these relevant to stability as well as growth?
- ***Monetary regimes***: what support is needed?

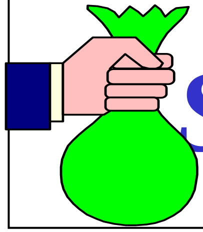


Public Debt Objectives



Are key to defining medium-term fiscal goals: how factor in financial stability…

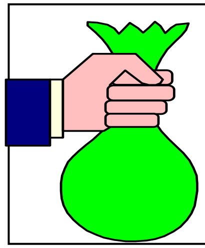
- Baseline: steady medium-term path to "sustainable" primary balance (say, long-run debt ratio < 60 %)
- Population ageing: need clarity how far addressed through structural reforms v. primary surplus
- Headroom for identifiable contingent liabilities
- Headroom for latent risks of contingent liabilities?
- Back-load deficit cuts for credible upfront reforms?
- What about stability-growth trade-off, moral hazard?



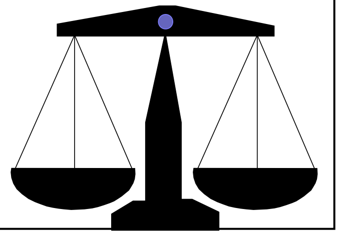
Saving-Investment Balance

Should stability considerations trigger ad-hoc fiscal policy adjustments (fine-tuning)?

- Three circumstances warrant discretionary change: (1) correct for transient boom revenues; (2) strong growth: accelerate path; (3) market access threats (public/external debt) *but ideally pre-empt risks by transparent/credible medium-term frameworks*
- Three "fallacies" argue against fine-tuning: eternal tightening; nimble adjustment (nondistortive, credible & powerful); unambiguous effects (esp. asset prices)

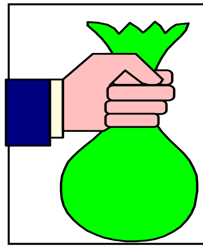


Microeconomic Aspects

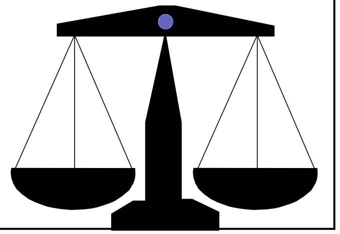


Fiscal policy influences stability, as well as growth, through microeconomic design:

- Distortions that feed credit/asset price booms (such as interest rate deductibilityand mortgage subsidies)
- The implication of taxation and expenditure structures for automatic stabilizers…
- ...& stabilizer constraints in fiscal decentralization
- Extent to which taxation captures “boom” revenues
- Currency denomination of debt: signals and risks

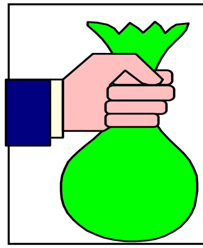


Monetary Regimes

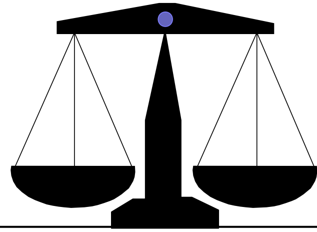


Policy must provide support to monetary regime, but not a precise science:

- Currency boards: historical link to budget balance warranted by inability to respond to booms – but identify true structural balance, and use stabilizers
- Exchange rate targeting regimes: must factor in risks: eg, speculative attack, unhedged borrowing
- Inflation targeting: less demanding, but policy mix matters; & there are still unhedged borrowing risks
- Euro: prepare scope for stabilizers, SGP rules

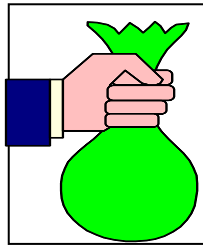


Stability &/or Growth

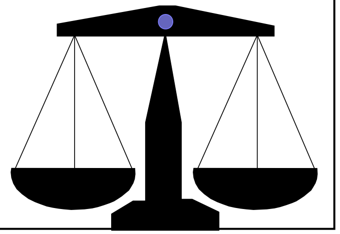


Possible trade-offs are relevant to pace of consolidation, headroom for latent risks:

- Wider deficits: returns to investment, education; may not cut net savings; may enhance sustainability
- Countervailing issues: if stability risks crystallize, can lose a decade; restructuring existing programs can be favourable for growth; credible adjustment can favour private sector expansion
- Implication: prudent medium-term goals must be on case-by-case basis, incorporating micro analysis

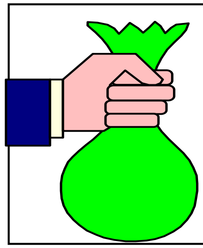


Calibrating Policy

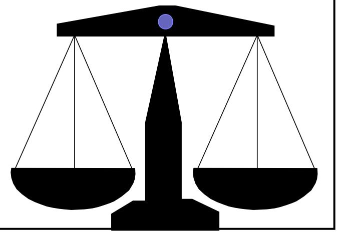


These considerations argue for defining an approach not an equation… Five key steps:

- Baseline medium-term path to primary balance for long-run sustainability, factoring in demographics
- Slower deficit cuts where credible upfront reforms
- Does implied balance support monetary regime?
- During booms, allow for transient revenue boost, & more broadly accelerate medium-term consolidation
- Pre-empt loss of market access – though preferably in advance through credible, transparent framework

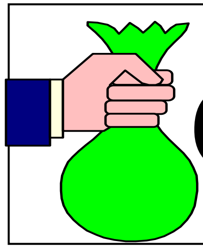


EU Surveillance

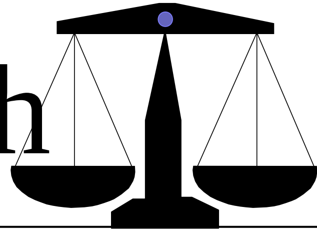


Three questions: equal treatment, common concerns, and locus of a policy dialogue:

- Financial stability challenges emerge at all stages of development, including through endogenous financial risks, but risk factors high in convergence
- Fiscal role in underpinning stability is a matter of common concern – eg, exchange market contagion
- Surveillance dialogue on fiscal policy role can be helpful, and probably fits most naturally in the context of Convergence Programs and Reports

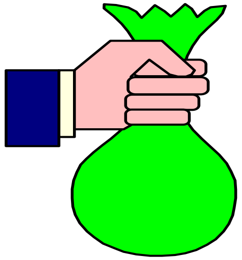


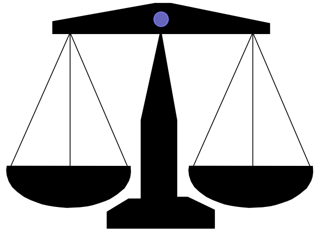
Conclusions & Research



Main conclusion is that fiscal contribution to stability is via medium-term settings:

- Public debt goals need headroom for identified – and perhaps latent – contingent liabilities
- Pace of consolidation should allow for credible front-loaded reforms, subject to monetary regime
- Discount transient revenue gains in boom; accelerate consolidation in upswing; pre-empt market access risks, ideally via credible & transparent frameworks
- Study needed: debt headroom, tax aspects, trade-offs





End of Presentation