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

- Distortions that feed credit/asset price booms (such as interest rate deductibility and 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
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
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
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.
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