Fiscal Policy, Budget Deficits and the Economic Crisis

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Intermediate macroeconomics

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Three lines of defence against the economic crisis

1. Measures to deal with the acute financial crisis
2. Monetary policy
3. Fiscal policy

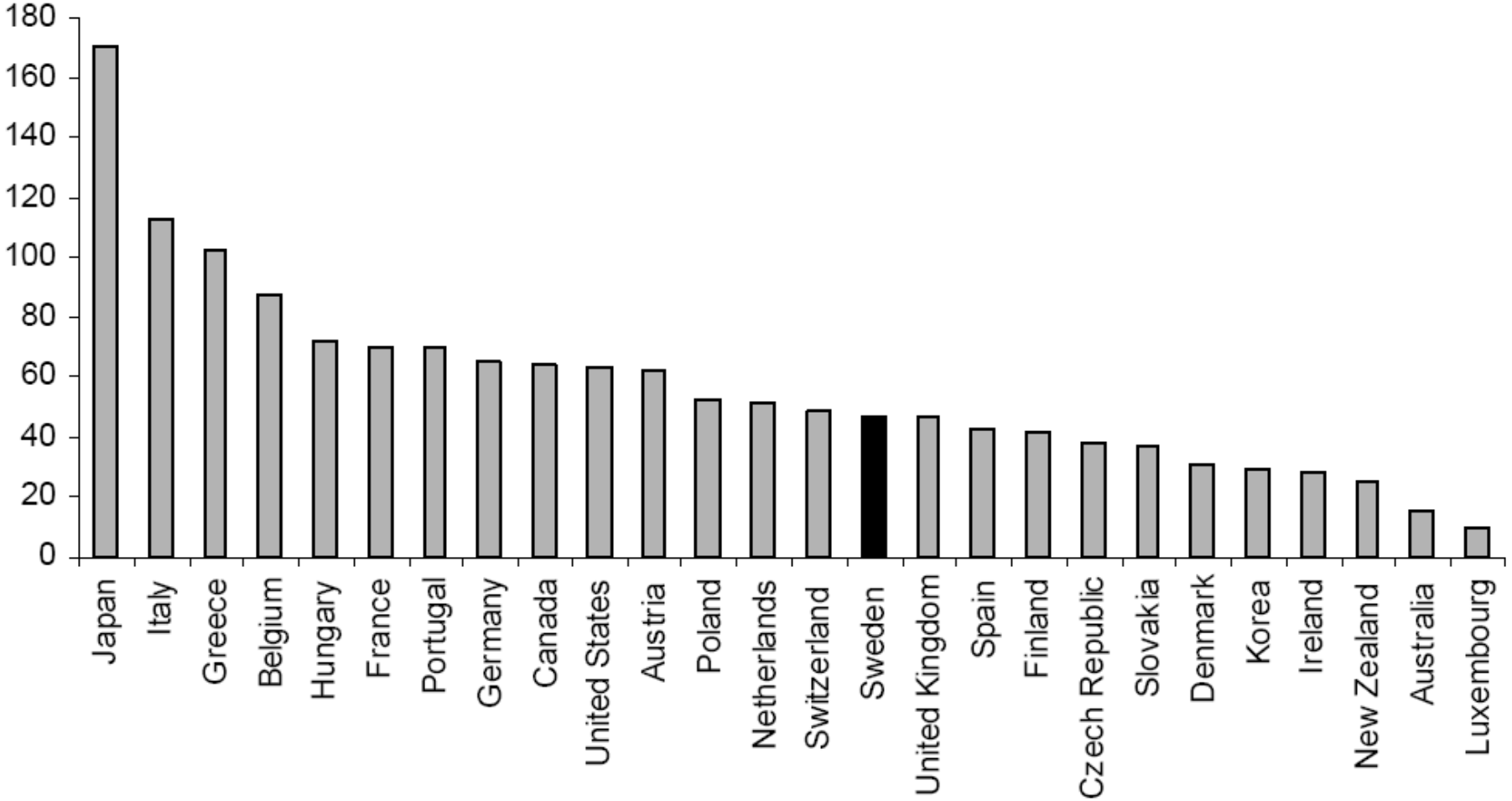
Conventional wisdom

- Under normal conditions monetary policy and the automatic stabilisers of fiscal policy should be the stabilisation policy tools used
- Discretionary (active) fiscal policy should be avoided
  - risk of wrong timing
  - deficit bias
- The other tools were not sufficient in the current recession
  - zero interest-rate bound
- But weak public finances in many countries before the crisis

Fiscal balance, per cent of GDP

	2009	2010
Denmark	-2.5	-5.4
Finland	-2.3	-4.8
Greece	**-12.7**	**-9.8**
Iceland	**-15.7**	**-10.1**
Ireland	**-12.2**	**-12.2**
Italy	-5.5	-5.4
Japan	-7.4	-8.2
Spain	**-9.6**	**-8.5**
Sweden	**-2.0**	**-3.0**
United Kingdom	**-12.6**	**-13.3**
United States	**-11.2**	**-10.7**
Euro area	-6.1	-6.7
Total OECD	-8.2	-8.3

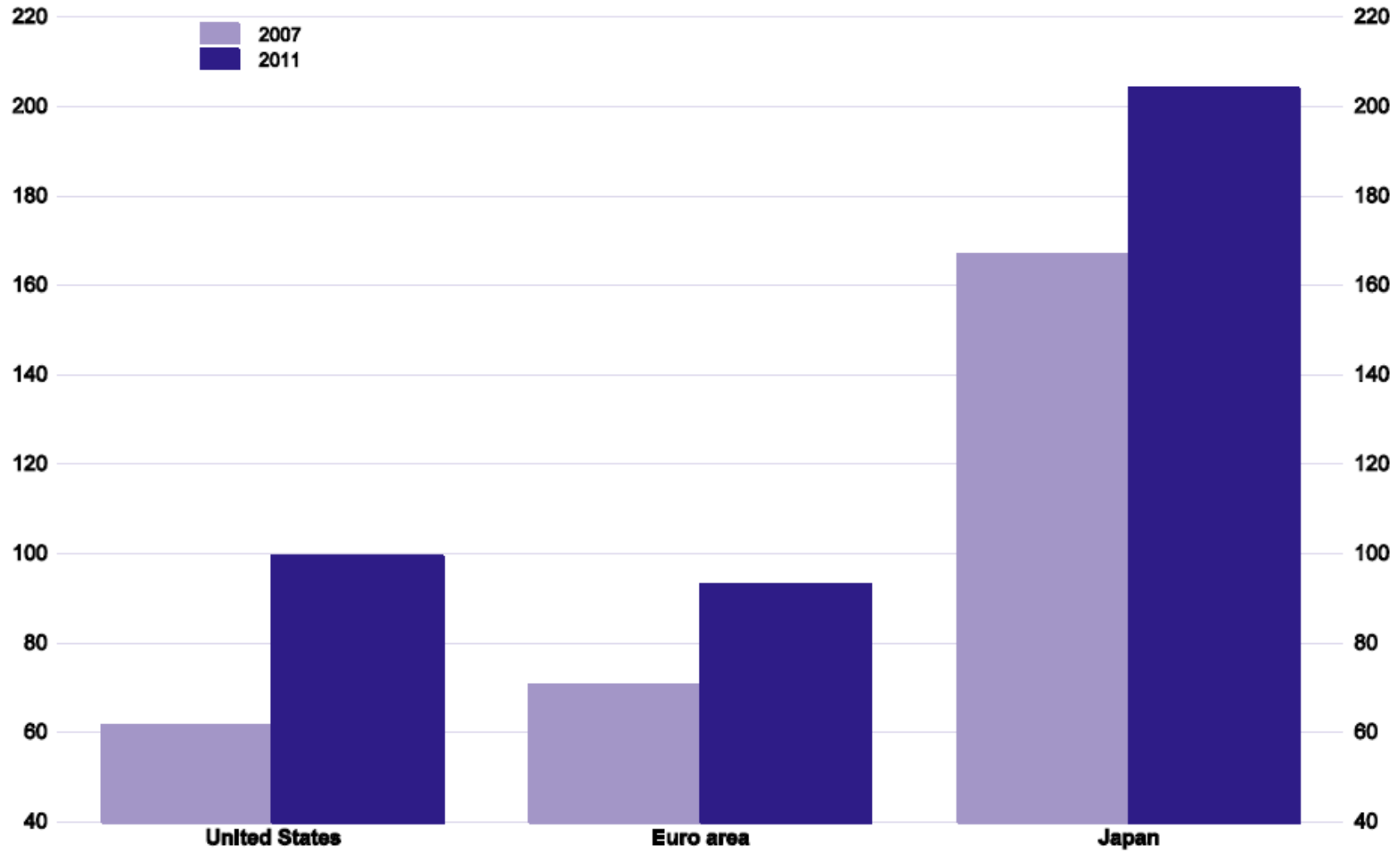
Figure 1.8 General government gross debt in per cent of GDP



Source: OECD (2008a).

Government debt levels are being pushed to record highs

In per cent of nominal GDP



Source: OECD Economic Outlook 86 database.

Demographic problems

- Budget weakening in the crisis comes on top of the demographic challenges
- **S2 indicator**: necessary permanent annual budget improvement in per cent of GDP necessary for fulfilment of the **intertemporal budget constraint** of the government
- Future budget surpluses must cover interest payments (or amortisation) of outstanding government debt

The S2-indicator on fiscal sustainability

Belgium	5.3
Denmark	-0.2
Estonia	1.0
France	5.6
Germany	4.2
Greece	14.1
Ireland	15.0
Italy	1.4
Latvia	9.9
Lithuania	7.1
Netherlands	6.9
Spain	11.8
Sweden	**1.8**
United Kingdom	12.4
Euro area	**5.8**
EU27	**6.5**

Government debt dynamics

$$d_t - d_{t-1} = p + (i-n)d_{t-1}/(1+n)$$

d = government debt as a percentage of GDP

p = the primary fiscal deficit as a percentage of GDP

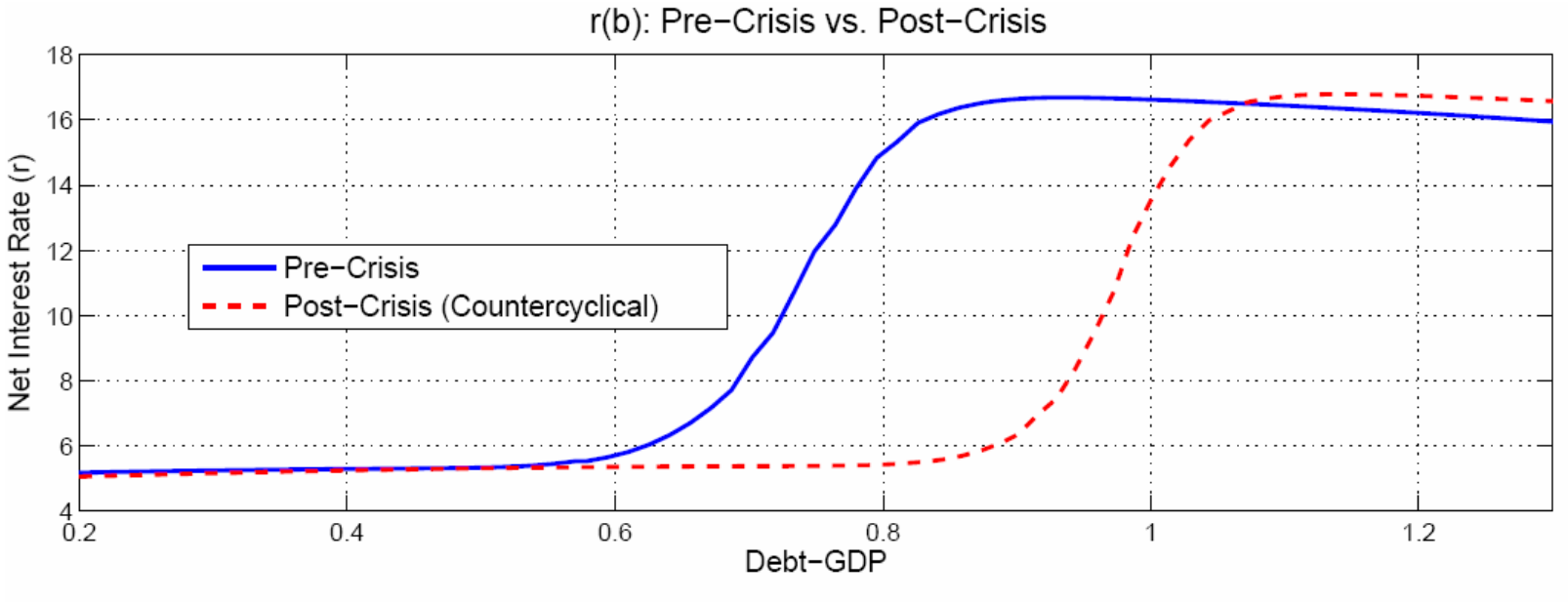
i = interest rate

n = growth rate of nominal GDP

Risk of snowball effects

- Doubts on ability to pay leads to higher risk premiums
- Higher interest rates cause debt to increase faster
- GDP grows more slowly
- The debt ratio increases
- Yet higher risk premiums and so on
- Vicious circle
- Non-linear relationship between long-term government bond interest rates and debt ratio

The relationship between the government debt ratio and the long-term interest rate on government bonds



The large deficits may have contractive effects on aggregate demand

- High interest rates
- Households may save more if they expect future tax rises and government expenditure cuts

  - Ricardian equivalence
- Direct negative aggregate demand effects of measures to reduce deficits

Debate on **exit strategies**

- Difficult trade-off between short-run stabilisation and long-run sustainability
- Less of goal conflicts with changes in pension rules (higher retirement age)
  - positive sustainability effect
  - income cut first in the future
  - credibility?

Why so big deficits?

- US: mismanagement of fiscal policy under Bush
- UK: too large deficits in booms, misjudgements, some cheating
- Japan: long period of stagnation
- Ireland and Spain: overheating and the Walters critique
- Portugal: long period of deficit problems
- Greece: mismanagement and a lot of cheating

Overheated economies before the crisis

	Increase in mortgage debt 1998-2007 (percent of GDP)	Increase in construction sector employment (percent of total)	Real appreciation 1998-2007 (percent)	Current account deficit 2007 (percent of GDP)
Ireland	46.8	5.6	11.3	5.4
Spain	37.7	3.0	9.6	10.1
Estonia	32.6	4.4	39.5	18.3
Latvia	33.0	5.3	43.1	22.5
Lithuania	16.6	3.3	33.2	15.1
Euro area	12.4	0		0.7

The Walters critique

Outside EMU

- Overheating with higher inflation
- Nominal interest rate is raised more than inflation
- **Real** interest rate (nominal rate minus inflation) **rises**

Inside EMU

- Overheating with higher inflation
- Nominal interest rate remains unchanged
- **Real** interest rate (nominal rate minus inflation) **falls**

Stability pact

- Stability pact rules were not followed
  - maximum deficit of 3 per cent of GDP
  - maximum 60 per cent of GDP in gross government debt or diminishing debt
  - medium-term objective of ”surplus or close to balance”
- Loosening of pact in 2005
  - lower credibility of sanctions

Table 9 Theoretically possible scenarios for the excessive deficit procedure in case of non-compliance (time until first fine)

Year	Old pact as originally envisaged and strict application of new pact	Lax application of new pact	Very lax application of new pact	Super-lax application of new pact	Maximum laxity according to new pact
t	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP	Budget deficit above 3 % of GDP
t+1	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Council decision on excessive deficit and recommendation	Excessive deficit exception
t+2	Deadline for correction				Council decision on excessive deficit and recommendation
t+3	First deposit	Extended initial deadline	Extended initial deadline	Extended initial deadline	
t+4	Second deposit	First deposit	Repeated recommendation and new extension of deadline	Repeated recommendation and new extension of deadline	Extended initial deadline
t+5	First deposit converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline	Repeated recommendation and new extension of deadline
t+6		First deposit is converted into fine	Second deposit	First deposit	Repeated notice and further extension of deadline
t+7			First deposit converted into fine	Second deposit	First deposit
t+8				First deposit converted into fine	Second deposit
t+9					First deposit converted into fine

Note: The table has been constructed under the assumption that a deficit above three per cent of GDP is identified the year after its occurrence. Later identification would lengthen the period before fines should be imposed according to the new rules.

Discussion on Greece

- Financial aid?
  - *no-bail-out clause*
  - financial aid if problems due to events outside the control of the country
- Moral hazard
  - incentives for the country
  - **more a question of the signalling system in financial markets**
- Mechanism for joint eurozone/IMF financial aid
  - much is unclear
  - potentially problematic

EMF as a complement/substitute for IMF?

- Risk of political tensions within Europé
- Risk-based fees as with bank guarantees?
- Need to sharpen European fiscal rules
  - earlier problems of legitimacy
  - too tough sanctions to start with
  - pecuniary or non-pecuniary sanctions: loss of voting rights on certain issues
- National fiscal policy councils with the task of monitoring public finances

Table 8 The size of deposits/fines

Deficit (per cent of GDP)	Deposit/fine (per cent of GDP)	
	Year 1	Subsequent years
3-4	0.3	0.1
4-5	0.4	0.2
5-6	0.5	0.3
6-7	0.5	0.4
7-	0.5	0.5

Conclusions

- Difficult situation in many countries
- There may be no good solutions because of earlier ”sins”
- Stable public finances in Sweden
  - but we will be affected by high interest rates in the world economy and if the upswing is dampened
- Policy mix in other countries: fiscal restraint and continued easy monetary policy?
- Reverse assignment in Sweden: monetary tightening and continued expansionary fiscal policy?
- The problems in the eurozone illustrate problems with a common currency
  - earlier overheating and the Walters critique
  - difficult to achieve real depreciations now (lowering of the relative cost position to improve international competitiveness)