The Eleventh Dubrovnik Economic Conference

Organized by the Croatian National Bank

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Financial Stability during Convergence: Is Fiscal Policy the Right Regulator?

The case of EU Members in the Baltic Region and Central Europe

Hotel "Grand Villa Argentina",
Dubrovnik
June 29 - July 2, 2005

Draft version

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CROATIAN NATIONAL BANK

PRELIMINARY TEXT

11TH DUBROVNIK ECONOMIC CONFERENCE
29th June – 3rd July 2005

Financial Stability during Convergence: Is Fiscal Policy the Right Regulator?

The case of EU Members in the Baltic Region and Central Europe

Max Watson[(*)]

1. Introduction

The EU Member States in the Baltic region and central Europe face a steep convergence path to average EU income levels, and have financial sectors that are still developing strongly. These features are even more pronounced in most candidate countries. Does this setting of real and financial convergence carry special implications for fiscal policy? And, in particular, can or should it be used as a "regulator" to pre-empt or moderate financial instability?

Arguments that fiscal policy has a special role during convergence have been made in support of both wider and narrower deficits. Development needs, high returns to public investment, favourable potential growth, and frequently low levels of public debt have led some to suggest that Stability and Growth Pact constraints might be too tight (Buiter et al., and Sapir et al., 2003). Others have stressed that possibility of large private sector imbalances during credit-fuelled booms, and market risks in the run-up to euro adoption – thus calling for significant fiscal safety margins (IMF 2004). A further factor to bear in mind is that *de facto* euroization could seriously constrain monetary policy, due to balance sheet risks – thus placing heavier demands on fiscal policy in stabilizing the economy (Mishkin 2002).

Operationally, these issues translate into some difficult questions. Should fiscal policy "lean against the wind" during extended credit and asset price booms? Should it seek to substitute for the stabilizing role of other policies, if these are constrained? To what extent should medium-term fiscal plans build in headroom for the volatility of deficits or debt, including a crystallization of contingent liabilities following real or financial sector shocks? And behind these questions lies a somewhat wider one: how the main branches of macroeconomic and financial policy can best come together to address, transparently, financial stability risks.

To shed light on these issues this paper discusses, first, the role of fiscal policy in supporting economic catching-up – focusing on tax and expenditure reforms and their implications for deficits. Second, it considers some aspects of the convergence setting that are relevant to financial stability. Third, it discusses how monetary and supervisory policies influence financial stability, and their interaction with fiscal policy in this regard. Finally, it discusses the ways in which fiscal policy might act as a "regulator" of the economy in safeguarding stability, and explores how to improve potential trade-offs facing policy-makers.

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2. The role of fiscal policy in supporting real convergence

The structural features of fiscal policy clearly have an important role to play in supporting strong and sustained convergence.[1] It is worth focusing on these features first, including the question how they relate to consolidation challenges. This will help clarify how far there may be tensions or complementarities between the roles of fiscal policy in fostering growth and safeguarding stability.

To support catching-up, the public sector needs to commit adequate resources for priorities such as infrastructure investment, research and development needs, education and training. Pension reforms, which also entail upfront costs, can improve employment incentives and the profile of the public finances. These priorities have prompted the question whether growth would be enhanced by tolerating wider fiscal deficits (e.g., Buiter and Grafe (2002)). Indeed, the important medium-term contribution of pension reforms has led to their special treatment under the revised Stability and Growth Pact (Box 1).

Box 1. The 2005 Reform of the Stability and Growth Pact

The March 2005 reform of the Pact strengthens the role of economic considerations and the degree of country differentiation. Several aspects are particularly relevant in the convergence setting:

Medium-term budgetary objectives (MTO) will be differentiated according to countries' debt ratio and potential growth (and, later, fiscal sustainability). This is important for converging economies, which typically have high potential growth and, in many cases, relatively low debt ratios. Countries participating in ERM II or the euro area will have a MTO in a range between -1% of GDP for those with low debt and high potential growth, and balance or surplus for countries with high debt and low potential growth. Until this goal is achieved, they should pursue an annual adjustment of 0.5% of GDP, net of one-off and other temporary measures. In the period before ERM II entry, the MTO will be set at a level providing a safety margin with respect to the 3% of GDP deficit limit, ensuring rapid progress towards sustainability, and allowing room for budgetary manoeuvre, in particular taking into account the needs for public investment.

There will be a deeper and more differentiated assessment under the Excessive Deficit Procedure. The Commission and the Council will take into account a specified set of 'other relevant factors' when deciding on the existence of an excessive deficit and deadlines to correct it. These include developments in potential growth, but also considerations with respect to debt sustainability. They can be taken into account in all the steps of the procedure (except abrogation). The reformulation of the exceptionality clause of a 'severe economic downturn' is also relevant. An excess above 3% may be considered as exceptional so long as it remains 'close to the reference value' and 'temporary,' and results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential.

Assessments under the Excessive Deficit Procedure will give due consideration to systemic pension reforms – which are being introduced by many of the recently acceded Member States. Deficits above, but close to, 3 percent, which reflect introduction of a multi-pillar pension system that includes a mandatory, fully-funded pillar, will be considered carefully for the initial five years after introduction (or five years after 2004 for reforms introduced before 2005) in a declining manner over five years. This is potentially important for decisions on the euro adoption.

Also crucial in fostering growth are incentives and signals for the private sector. These influence investment and job creation. Subsidies and other transfers that distort resource allocation need to be phased out; marginal rates of tax and of benefit withdrawal must be employment-friendly; and the base of taxation frequently needs to be broadened so that tax

[1] On the support of fiscal policy for growth, see for example Kneller, Bleaney and Gemmell (1999, 2001) for an empirical analysis of OECD countries, and Romero de Avila and Strauch (2003) for an application to EU countries. European Commission (2004a) provides a literature survey.

and social security charges do not lay an unduly heavy burden on labour income. A careful targeting of benefits, moreover, can facilitate restructuring by easing adjustment strains. Such approaches can increase public savings even in the short run; so it would be wrong to equate growth-oriented reforms, mechanically, with wider deficits.

The impact of reforms on fiscal consolidation will, of course, vary importantly from country to country. Even among the eight EU Members in the Baltics and central Europe, levels and composition of expenditure, and structures of taxation, differ strikingly. Recent research suggests a number of relevant features (European Commission 2005). Despite a cut in taxes on capital and labour over the past decade, the total burden on labour often remains high compared with other countries of similar per-capita income. Meanwhile, levels of primary expenditure in central Europe (except Slovakia) are comparable to euro area members, despite substantially lower income levels (thus contrasting with the Baltic region). Collective consumption and employee costs are relatively high across these eight economies. Cash social transfers typically do not exceed the euro area level, but they show wide variations. Subsidies are sizable in some cases, but again vary considerably.

In terms of reform opportunities, it is worth highlighting three overall messages that emerge from this analysis, which also appear quite relevant to challenges facing candidate countries. (1) There is scope to enhance growth by restructuring existing fiscal programs, and this can help make room for new priority spending while still reducing deficits. (2) The scope varies markedly across countries, and appears greatest in cases where deficit and debt challenges are more pronounced. For example, the relatively high level of some expenditures, and their variation across countries, suggest *prima facie* further scope for rationalisation in central Europe. (3) Structural approaches are needed to achieve consolidation – including significant reforms to existing expenditure programmes and additional action to enhance tax bases. Convergence Programmes in these countries reflect a number of priorities for tax and expenditure reform along these lines – recent reforms in Slovakia being an example (Box 2).

Box 2. Slovakia: Structural Reform and Consolidation in the Public Finances

Since end-2002 Slovakia has implemented a comprehensive tax reform package and a broad array of structural expenditure reforms, while strengthening fiscal institutions. The deficit and expenditure ratio declined (to 3.3% of GDP and 38.5% of GDP in 2004, respectively), while growth accelerated (to 5½% in 2004). A tax reform package led to a considerable shift toward indirect taxation, simplified the system and increased transparency. It appears to have been broadly revenue-neutral. Key elements were: the introduction of a flat tax rate of 19% for both individual and corporate income taxation, coupled with the removal of tax exemptions; introduction of a unified VAT tax rate of 19%; increases of several excise taxes; and abolition of some less significant taxes (inheritance tax, gift tax) and amendments to some other smaller taxes (real estate tax, vehicle tax). In addition, health and social insurance contribution rates for employers and employees have been reduced, albeit to a still relatively high total level of some 48% of gross wages. Expenditure reforms focused in particular on the targeting and incentive aspects of social transfers – improving incentives while also enhancing fiscal sustainability. Key measures were: (1) Reform of pensions: changes in key parameters of the pay-as-you-go pillar and introduction of a sizeable funded pillar. (2) Other changes to benefits and social assistance, emphasising targeting and incentives. (3) Changes to healthcare (e.g. introduction of co-payments; introduction of individual insurance; streamlining of the health benefit package; better incentives and harder budget constraints for providers). On the institutional side, as part of a comprehensive management reform supported by the World Bank, all steps of the budget cycle were improved. In particular, the medium-term orientation has been strengthened and, together with the budget 2005, a detailed three-year budget framework (covering the years 2005 to 2007) was elaborated for the first time. The obligation to submit annual convergence programmes in the context of EU surveillance procedures was an additional catalyst for reforms.

In other words, policy-makers have some degrees of freedom in combining growth-oriented fiscal reforms with consolidation. In fostering strong and sustained growth, there can be strong complementarities even in the short run. Nonetheless, there can be political constraints on first-best policies; and no-one would deny that in practice trade-offs can exist at the margin between higher spending, reduced taxes and lower deficits. It is important to ask what are the financial stability risks, during convergence, against which lower deficits represent a form of insurance - and how far other policies can contribute to addressing those risks.

3. Financial stability challenges in the convergence setting

A number of factors suggest that policy-makers can potentially face important challenges in safeguarding financial stability during convergence – particularly where a rapid catch-up is under way in the domestic financial sector, and in an open capital account setting. The discussion below considers, first, evidence about the general potential for volatility in the economy and the public finances in these economies during convergence; and second, challenges arising specifically from capital flows and catch-up in the financial sector.

Experience with macroeconomic and fiscal volatility

A first set of arguments suggesting stability challenges for fiscal and other policies relates to past experience of volatility in converging economies (IMF 2003). In the East European setting, such arguments need to be evaluated with a particularly critical eye: the past decade-and-a-half saw the immense structural transformations of early transition, and it would not be reasonable to extrapolate such volatility into the future. Nonetheless, it is worth examining experience in the Baltic region and Central Europe from the late 1990s onward – a period when the initial transition shocks and transition recession were largely over. This may also be valuable for actual and potential EU candidate countries as they wrestle with similar issues.

Some research into volatility in these eight economies during 1997-2004 was conducted recently in DG ECFIN (European Commission, 2005). Four features emerge:

- Economic growth was on average higher in these economies than in the former EU-15, but stronger growth rates were typically associated with somewhat greater volatility of output. A significantly higher volatility of inflation was also noted.

- The links between nominal GDP growth on the one hand, and trends in public revenue and expenditure, on the other, were somewhat weaker than in the former EU-15. Expenditure and revenue shares varied more. This was particularly so in the Baltic States, but there the impact on primary balances was muted. In the four largest central European economies, primary expenditure was fairly variable, and in some cases triggered instability in primary balances. Contingent liabilities (such as public guarantees) remain significant in some cases.

- Forward-looking stress-tests show a widely varying impact of potential shocks on the public debt, partly as a result of very different current levels of debt. The four largest central European economies show the more troublesome responses to such stress-tests (e.g., relative to the SGP’s 60% of GDP ceiling) – notably shocks to the primary balance, and in several cases currency depreciation. This is consistent with findings in IMF Article IV staff reports.

- Fiscal balances show on average a somewhat lower sensitivity to business cycles than in the former EU-15. This reflects the lower progressivity of income taxes and their lower share in total revenues; less generous unemployment insurance; and labour market variables that are less responsive over the cycle, though there are some reservations on econometric robustness. Clearly, however, sensitivity varies substantially across countries.

On balance, therefore, experience in these eight economies since the late 1990s lends some support to the volatility hypothesis. The past is not necessarily a reliable guide for the future in this respect; but policy-makers may need to allow somewhat greater headroom for risks, other things being equal, when developing medium-term fiscal plans.

Financial sector dynamics and economic imbalances.

Past macroeconomic and fiscal volatility are important reference points, but they are not the only reason to anticipate financial stability challenge for fiscal policy in the period ahead. External capital flows and rapid financial development are potentially even more important. Why would one worry about these issues particularly in a convergence setting, and to a greater extent than in the past decade? The interaction of two aspects of financial market dynamics is potentially relevant: current account financing via debt-creating capital inflows; and, in the period ahead, a rapid catch-up in levels of credit to the private sector.[2]

The first concern is with the financing of the *external current account*. One would expect the economy to be drawing substantially on foreign savings during catching up, given low capital-labour ratios and potentially high rates of return. But – as Lipschitz, Lane and Mourmouras (2002) have pointed out – this can be too much of a good thing: capital flows may become “master” rather than “servant.” Such flows can drive domestic interest rates down to levels lower than desirable for domestic monetary management. To the extent this results in externally-driven boom-bust cycles, such flows can be destabilizing.

In practice, various layers of risk premia may moderate inflows, helping to keep them to a manageable level. But risk premia undergo substantial shifts over time, for reasons that are only partly associated with domestic policies. As liquidity fluctuates in international capital markets risk appetites may undergo cycles of feast and famine – even abstracting from specific events such as the Russian crisis. At present, risk premia in international markets are historically very low (IMF 2005). Converging economies may depend strongly on capital inflows, and thus be vulnerable to capital account shocks. To the extent they borrow in foreign currencies, balance sheet effects can heighten the impact of exchange market swings on the real economy and the public accounts. And the limited diversification of domestic financial markets, which tends to focus external borrowing in the banking system, could leave them somewhat more prone to contagion through such channels as common lenders.

The underlying issue, which ultimately influences ongoing access to capital markets, is the sustainability of the external current account, not the headline deficit number. This calls for careful analysis of the financing structure, domestic counterparts, and policy context of current account deficits, as well as balance sheet exposures and reserve adequacy. Estonia’s ability to finance large current account deficits, for example, has had much to do with a strongly rules-based policy environment. Conversely, episodes such as the capital account volatility in Hungary in early 2003, or sizeable swings in Polish interest rates and exchange rates in recent years, illustrate the risks if there are problems of policy mix and internal policy co-ordination. The potential for financial instability from this source is clearly of considerable importance in setting out medium-term fiscal frameworks.

But the potential concern about financial sector dynamics during convergence is not just an external current account question. Levels of *domestic credit to the private sector* in Eastern

[2] Issues relating to ERM II and euro adoption are discussed in section 4 below.

Europe are likely to continue to rise sharply over the coming decade, from levels that are currently low (even relative to GDP). This can substantially support real convergence through investment financing and consumption smoothing. But it could also be associated with exaggerated cycles in credit, asset prices and the real exchange rate. It is difficult to screen credit effectively at times of rapid expansion in lending. Moreover, inherent market imperfections, including swings in risk premia, could lead to a misallocation of resources. Indeed, a feature of recent models of credit cycles is that possible "boom-bust" dynamics are largely endogenous. Investors' attitudes towards risk behave pro-cyclically, supporting the build-up of imbalances and then aggravating the correction (Borio et al, 2001). This must be a point of particular concern in the convergence setting, which places a relatively heavy burden on risk premia in balancing saving and investment flows at levels that are financially sustainable over the medium term. Supervision, meanwhile, is still gaining effectiveness.

So there are both external and domestic questions about the *behaviour of risk premia* during convergence; and, in an open capital account context, cycles in these two sets of premia will inevitably be interlinked. Two scenarios for convergence may help illustrate the interplay of these factors as they affect financial stability during convergence:

- In a benign scenario, productive investment and consumption-smoothing on an equilibrium path are reflected in external current account deficits that are sizable but sustainable. These deficits may be financed to a substantial degree by foreign direct investment, which can also help to improve levels of productivity. Strong legal and institutional frameworks support efficient financial intermediation. Well-aligned risk premia help to keep credit growth, and thus also the counterparts to the external current account deficit, on a sustainable path.

- However, expectations may become overly "exuberant," leading to excessive credit expansion, destabilizing inflows, a misallocation of credit and asset price bubbles. Firms and households may take on unhedged foreign currency debt. At the macroeconomic level, unproductive investment and over-consumption could drive the current account deficit into unsustainable territory, while external financing could become more short-term. At some point, this cycle would reverse, possibly resulting in exchange market turbulence. Depending in part on the scale of unhedged balance sheet exposures, it could lead to a serious loss of output. Under fixed exchange rates, this cycle would play out through relative prices, with the output – and fiscal – consequences depending in part on the strength of the banking sector and the flexibility of real sector markets.

Credit and asset price booms are often triggered by genuinely positive changes in the economy, such as favourable shocks to productivity; and such positive shocks are inherent in successful convergence. Moreover, there are features of convergence that make it particularly hard to disentangle healthy financial growth from a potentially unstable boom. In particular, a strong *equilibrium rise* may be underway in the stock of credit, asset prices, and (for productivity reasons) the real effective exchange rate – and in this context it may be especially difficult to distinguish trends that are potentially de-stabilizing.

So there are difficult issues of analysis for policy-makers during convergence. This is where central bank financial stability reports hold important potential (and it is notable that all of the central European economies now have such reports). One of their major contributions can be to focus on balance sheet vulnerabilities, and on linkages between economic sectors. Sector linkages and complementarities matter greatly: in general, because financial stability is a property of the system not of its parts; and specifically, in the present context, because market linkages have important implications for the extent of risks to output when financial shocks impact the system – risks against which prudent policies are a form of insurance.

In sum, financial market dynamics need to be monitored carefully as a potential source of instability during convergence. The reasons for this should be distinguished from the traditional issues in the literature of financial liberalization and sequencing – because economies in the Baltic region and central Europe, and indeed candidate economies, are already highly liberalized. During convergence as such, the discussion above suggests six elements that could come together to increase, to some degree, risks of financial instability: the critical role of domestic and external risk premia; difficulties in screening credit quality during periods of rapid financial expansion; potential dependency on external bank borrowing, which is closely related to low diversification in the domestic financial system; the attractions of borrowing in foreign currency; the fact that experience is still being gained in supervising the financial system; and analytical challenges in distinguishing signs of instability at a time of rapid real and financial convergence.

Financial market dynamics – and potential financial stability concerns – may thus be very important aspects of the setting for fiscal policy during convergence. Moreover, the analytical difficulties in distinguishing between healthy and destabilizing trends, and in timing any discretionary adjustment of polices, place a special value on policy approaches that can, ex ante, pre-empt possible market stress.

4. Policy assignments – and the impact of monetary and supervisory frameworks

Economic catching-up holds risks as well as opportunities, but one cannot argue to keep every policy as tight as possible. There are opportunity costs to be considered – not to mention potential moral hazards if policy-makers seek to insure against every risk. So it is important to ask if there are ways to design or co-ordinate policies in ways that can improve the trade-offs for stable growth. In this respect one cannot assess the contribution of fiscal policy in isolation from other elements in the policy system – or from the wider question how policies can be transparently assigned to help safeguard financial stability.

Policy assignments and financial stability

There is no well-developed consensus on the role, in safeguarding financial stability, of the main branches of macroeconomic and financial policy – monetary, fiscal or supervisory policies.[3] Of course, the long-run objectives of all these policies are strongly congruent with financial stability – whether one thinks of price stability; public debt sustainability and the role of fiscal stabilizers; or the integrity of individual financial institutions and the payments system. But policy goals and intermediate targets do not conventionally include such variables as credit growth, asset prices, non-financial sector leverage, the external current account or the real exchange rate. In Tinbergen terms – "one instrument/one goal" – financial stability could be viewed as a policy orphan.

One response to this could be to dismiss the philosophy of "one instrument/one goal" as too narrow. But there would be costs to such a cavalier dismissal. With open capital accounts and liberalized markets policy-makers need to pay great attention to the way they influence expectations. An attractive recent characterisation by Bank of England Governor Mervyn King stresses the extent to which monetary policy can derive powerful leverage by

[3] It is an implicit or even an explicit mandate of central banks, but they have no instrument to address it (Oosterloo).

anticipating the way that other players on the field expect the policy-maker to act.[4] Where expectations are a fulcrum for stability, instruments may need to be adjusted less frequently, or less sharply. This also helps circumvent the difficulty in knowing when, and to what extent, discretionary adjustment might be warranted.

How, then, can we take financial stability into account in the short run, while holding to transparent policy rules? Here are three general suggestions. Their relevance is not limited to the convergence setting, but they may be particularly relevant here; and they may help clarify, in particular, the role that fiscal policy can be called upon to play:

- **Co-ordination of policy goals is fundamental**. The value of a balanced fiscal-monetary policy mix is an obvious example of this: among other considerations, it can play a key role in reducing risks of destabilizing short-term inflows. There are additional, perhaps less obvious, questions about co-ordination. How far is co-ordination at issue when monetary policy may be impeded by *de facto* euroization; when tax authorities may rule out cyclical buffers in loan loss provisions; or when well-diversified international banks could nonetheless have, in host countries, large sector exposures through systemically important establishments? These potential aspects of coordination deserve deeper study. More broadly, the output costs of financial stress will depend in part on policy frameworks outside the main scope of this paper, including those for governance, insolvency and labour markets.

- **Secondary characteristics of policies matter a great deal for financial stability.** Each branch of macroeconomic and financial policy has secondary characteristics that are directly relevant to financial stability. Take, for example, the concern about an excessive build-up of unhedged foreign currency borrowing – the "original sin." Each branch of policy can influence such behaviour through secondary characteristics. Prudential stress-tests that incorporate indirect exposure through credit risk on unhedged clients will tend in the same direction. Credible fiscal policy, by favouring lower real interest rates, can reduce incentives for such borrowing; and the currency denomination of public borrowing affects directly the economy's exposure to exchange rates. Under inflation targeting, a genuinely variable exchange rate will discourage such borrowing; and indeed the choice of monetary and exchange regime pre-determines strongly the scope of such secondary characteristics – as discussed further below. Such secondary aspects of policy involve no threat to transparency.

- **There can be a need to safeguard the tractability of policy goals – avoiding a stance now that could box-in policy seriously over a longer time horizon.** This is an important, though debatable, issue in terms of transparency. Take the example of a liquidity build-up that is feeding through to credit and asset price increases. At some point that liquidity may affect consumer price inflation beyond the central bank's target period; but, by then, raising interest rates might trigger balance sheet stresses and lead to deflation. In other words, the policy assigned to address inflation may no longer be able to address it successfully – at least within the central bank's implicit loss function. Is there a *tractability* case for pre-emptive action that would be consistent with the Tinbergen framework? Again, there are applications in fiscal policy – notably the case for tightening in "good times" to preserve flexibility later.

None of this is to deny that policy-makers may at times have to react decisively to extreme events without being able to fit their actions perfectly under transparently designed regimes. But two points are worth underscoring. First, monetary and prudential policies contribute strongly to stability over the medium and long run by pursuing transparently their primary

[4] Which Governor King entitled the *Maradona theory* of monetary policy, after the technique of the Argentine footballer – who was able to proceed in a straight line because others expected him to change course – during the 1986 World Cup Quarter-Final (Mais Lecture, 17 May, 2005).

goals. Second, there are aspects of these policies that, without jeopardizing transparency, can contribute a great deal to financial stability in the short run – including through effective policy co-ordination, intelligent design features and, plausibly, attention to future constraints.

The choice of monetary and exchange regime

When policy-makers select the monetary and exchange regime of the economy they are, of course, primarily choosing a nominal anchor for inflation. But through their choice they also affect the other dimensions of policy discussed above. In particular, such choices may widen or narrow the degrees of freedom for influencing financial stability through secondary aspects of policy; may change the transmission channels of financial shocks; and may increase or reduce the penalties for poor policy co-ordination – thus influencing profoundly the environment for fiscal policy.

For EU Member States and candidate countries in Eastern Europe, this is an important issue. They have chosen widely differing monetary regimes in the past, but at some points in the future are all destined to move through ERM II to euro adoption. Three examples help to highlight the risk characteristics of monetary frameworks, and related fiscal challenges:

- Under ***inflation targeting***, a monetary policy tuned to domestic developments can help contain credit growth and dampen swings in private sector activity to the extent these are threatening the attainment – or tractability – of inflation over the central bank's time horizon. Financial stresses, meanwhile, may well crystallize in the exchange market – and this can facilitate adjustment in the real economy (notably, in real wages). But if easy fiscal policy results in high domestic currency interest rates, and if the exchange rate is in practice somewhat rigid, these factors can encourage unhedged borrowing among firms and households, giving rise to potentially serious balance sheet risks. While the stabilizing role of monetary policy can ease the task of fiscal policy, unhedged exposure can increase adjustment costs and the burden on the public finances in a crisis.
- ***Exchange rate targeting regimes such as ERM II*** highlight the importance of a sound fiscal policy. They also place special demands on the policy mix to help ensure that the exchange rate for euro adoption reflects economic fundamentals. Tight money and an easy fiscal policy, for example, could result in an overly appreciated exchange rate. Credibility also falls under a market spotlight; and the scope for contagion across countries underscores that this is potentially a matter of common concern. Where countries remain in ERM II for an extended period, unhedged borrowing could build up quite steeply, increasing the output costs of any exchange rate stress.
- Under ***the euro and wholly credible pegs***, there is no latitude to use interest rates to address asymmetric upswings in the domestic economy, or to cushion the impact on output of negative shocks. Meanwhile, external adjustment plays out through relative price changes. Problems associated with exchange markets are eliminated, but external adjustment can be a slow process if real sector markets are rigid – also raising challenges for fiscal policy.

Such features of the monetary setting thus affect significantly the extent and the timing of challenges that fiscal policy may face. Changes in monetary regime are important – including notably the shift toward ERM II and the euro. At a deep level, this transition can be taken to signal a growing maturity in monetary transmission channels and decisive progress in nominal convergence – factors that clearly are favourable to stability. However, reduced degrees of monetary freedom have implications for the challenges to fiscal policy. Fiscal trade-offs may need to pay greater heed to stabilization issues. If fiscal policy is not yet well placed to engineer room for manoeuvre – for example, adequate safety margins in terms of the Maastricht criteria or policy mix requirements – then policy-makers will need to weigh this carefully before shifting to a more constraining monetary regime.

In these respects, it is crucial to distinguish between EU Treaty requirements and the principles of prudent fiscal management – which will normally take account of financial market risks to the convergence path and the desirability of keeping stabilizers available at all times. It is prudent management that suggests minimizing risks of a last minute market disturbance (for example, following a shock to the public finances) during the approach to euro adoption; and also that adequate room for stabilizers within the SGP limits be built in at the time when Member States become members of the euro area. These considerations may imply a more ambitious consolidation path in the approach to ERM II and euro adoption than implied by a mechanical observance of the Maastricht reference value. In these respects, the monetary regime gives special importance to policy co-ordination, affecting fiscal trade-offs.

Supervision, governance, and real sector flexibility

The primary goals of supervisory policies in the financial sector, which address the health of institutions and payments systems, are clearly very supportive of longer run financial stability. Prudential frameworks can also contribute importantly in the short run, particularly where supervisors internalize systemic risks in evaluating institutions' credit and market exposures. Concerns about stability during convergence arise in part from capital market imperfections and risk assessment problems (for example, under-pricing indirect exposure to currency risks, or the perception of implicit guarantees on funding). Several supervisory approaches – such as stress-tests for compound shocks, or for indirect exchange exposure – can help address potential systemic risks. So can close and active co-operation between home and host supervisors of systemically important foreign establishments.

In addition, it is important to bear in mind the influence on financial stability of governance standards and of real sector frameworks. Regarding the former, a range of official policies and private codes of conduct relating to governance in the non-financial sector affect the efficient and stable functioning of non-financial corporations. This is a question that deserves heightened attention in light of structural shifts underway in the distribution of risk in the economy: there is a tendency in all economies for financial institutions to lay off on clients financial risks that formerly they themselves bore. Regarding flexible real sector markets, these are clearly crucial in reducing the potential costs to growth when the economy needs to adjust to real or financial shocks. They are thus a key element influencing the extent of output risks against which prudent fiscal policy is a form of insurance.

5. Fiscal policy and financial stability: is it a suitable "regulator"?

As a general proposition, no-one would challenge the benefits of a credible fiscal policy in ensuring that convergence is sustained without financial or real sector stress; that investment is fostered by favourable risk perceptions in the private sector; or that, to achieve this, fiscal policy should assure public debt sustainability and the free operation of automatic stabilizers. But when policy-makers turn to more operational propositions, this consensus can break down quickly. Four such issues are discussed below: the implications of contingent liabilities and population ageing; of credit booms and wide private sector imbalances; of possible complementarities or trade-offs in supporting stability and growth; and of the scope to improve potential trade-offs for policy – e.g., through strengthening fiscal institutions.

Sustainability, contingencies, and ageing

For public debt sustainability, the most fundamental requirement is to target a primary balance that assures satisfactory debt dynamics in terms of a debt ratio that declines rapidly to – or remains below – the Treaty value of 60 percent of GDP. Discussion earlier in this chapter highlighted risks to the public debt that could arise from volatility in key real and financial variables. Among these is the possibility that future stresses during the expansion and transformation of the real and financial sectors could add to contingent liabilities. In all economies it is prudent to allow headroom for shocks to the debt ratio. This is particularly important in the larger economies of central Europe – given present debt ratios, the extent of future economic and financial transformation, the relatively high stock of contingent liabilities, and the sensitivity of debt levels to shocks originating in the real and financial economy. The extent of headroom below the 60% debt ratio that is prudent on these grounds is an issue to be evaluated on a case-by-case basis.

The long run sustainability of the public finances also embraces broader issues, some of which cannot be assessed in isolation from strategies for structural reform. A key issue in this respect is population ageing – and this is an area in which the underlying demographic situation and prospects of converging economies in the EU happens to be unfavourable. Experience so far in the Baltic region and central Europe supports the view that policy-makers are opting for a growth-friendly strategy, based mainly on structural reforms rather than a higher primary surplus. This approach relies on microeconomic reforms to the public finances – such as entitlement adjustments – to contain risks of instability, and is potentially much more favourable to growth than raising taxes to improve the debt trajectory (or cutting priority spending). But in some cases further far-reaching action is still needed. More generally, credible progress will need to be kept up in implementing reforms, and flanking measures are typically needed in the labour market.

Stabilizers and credit cycles

The stabilizing influence of fiscal policy also operates through the role of the public sector saving-investment balance in dampening economic fluctuations – including by ensuring a sound macroeconomic policy mix. The core requirement in this regard, common to all EU Member States, is to create sufficient room for manoeuvre for the free play of automatic stabilizers over the business cycle without endangering policy credibility or SGP limits.

A more difficult issue, during catching up, is how fiscal policy should respond to strong cycles in private sector activity, lasting much longer than typical business cycles and frequently associated with rapid credit growth. These could give rise to sizable external imbalances, with the counterparts being some mix of household consumption and private investment. This has been illustrated in the Baltic states, where large external current account deficits have been wholly or partly driven by the private saving-investment imbalance, associated with strong credit growth.

Ultimately, the impact of such cycles on sustainable growth will depend on the sound allocation of resources and prudent appraisal of risks in the private sector. Nonetheless, the public sector balance can play an important role in moderating such cycles and assuring resilience during downturns. This was illustrated in the varying experience of earlier converging economies in the EU. Spain, for example, engineered a move to balance in the public accounts during its period of rapid real and financial convergence. Portugal did not take similar advantage of "good times" – and then had to implement fiscal consolidation when private sector activity was weak. The impact of the fiscal balance in moderating such private sector cycles will depend, of course, on factors such as the size of the public sector.

This role of fiscal policy in dampening longer cycles during convergence depends on policy-makers avoiding pro-cyclicality by correctly analyzing elements in fiscal performance that are permanent as against those that are transient. This is relevant not only as regards the potential growth rate but – as recent literature has highlighted – concerning the performance of revenues relative to GDP during a strong private sector boom, especially where asset prices are rising strongly (Jaeger and Schuknecht 2004). Fiscal receipts are frequently swollen by factors that reflect the ongoing credit and asset price boom: capital gains levies, securities transactions taxes, etc. The impact on revenues of booms related specifically to asset prices has been estimated at levels of perhaps 1 percent of GDP. During such periods it could be prudent to aim for a higher nominal surplus (or lower deficit) on this account.

More generally, of course, where growth is well above its medium-term trend, this is also an opportunity to accelerate fiscal consolidation toward medium-term goals. And where there is a risk of downside shocks – such as shake-out costs in the real or financial sector after a protracted boom, or risks of a loss of access to international capital markets – it could also be prudent to allow for these in setting medium-term goals.

Risks, safety margins and fiscal institutions

A number of factors differentiate the converging economies from other EU Member States. Most obvious, on the favourable side, is the potential for higher output growth, which will enhance debt-carrying capacity; and the fact that, in some cases, these Member States enjoy a much lower initial public debt ratio. On the more cautionary side, the discussion above suggests four risks that need to be factored in when developing medium-term fiscal plans:

- possible risks of economic and financial volatility affecting debt dynamics and output stability, especially in those cases where structural transformations and financial catching-up are still underway;
- risks, during rapid convergence, of over-estimating potential growth and, particularly, the durability of revenues associated with credit and asset price booms, again especially in cases of rapid growth in credit toward equilibrium levels;
- the possibility that sizable current account deficits could trigger a rise in risk premia that threaten capital market access; and
- the need to pay close regard to issues of credibility, safety margins, and policy mix in the run-up to euro adoption.

There are drawbacks in discretionary adjustments to fiscal policy to respond to such market risks at the time they emerge. In particular, ad hoc cuts in spending may fall heavily on investment, and time-lags mean that the withdrawal may be mistimed.

The uncertainties and costs of discretionary action underscore the case for prudent medium-term goals; but they also prompt the question what are complementary routes to help preserve stability. One obvious option is to exploit is the stabilizing role of strong fiscal institutions. In this respect, a key challenge for fiscal authorities is to establish credibility in sticking with budgetary plans and fulfilling commitments. A common source of slippage is the failure of spending ministers and local authorities to internalize the social costs of their demands, the so-called "common pool problem."

Fiscal institutions can be designed in ways that help limit this source of expenditure bias (for a fuller discussion, see European Commission 2005, forthcoming). One such approach is to delegate formation, monitoring and implementation of the budget to a single policy body – for instance, a finance minister with a leading role in the budgetary process (the "delegation approach"). Fragmentation of the process can also be limited by increased co-ordination among spending ministers and levels of government, possibly through formalised rules and procedures (the "commitment approach"). Most of the recently acceded Member States seem to have embarked on reforms in their fiscal institutions in line with this approach (Yaoutlinen 2004).

Most of these countries, in recent years, also introduced multi-year budgetary frameworks to better internalize the medium-term consequences of decisions on spending programmes in the formation of the budget and to improve ex-post monitoring. Many had already moved to better integrate the activities of extra-budgetary funds in the budget process and to increase the co-ordination of spending decisions across levels of government (Gleich (2003), Yaoutlinen (2004)).

In spite of this progress, there is still room to strengthen fiscal governance in these cases. First, the introduction of agreed provisions how to use better-than-expected budgetary outcomes in "good times" will be helpful to avoid loosening the stance of fiscal policy during periods of strong growth. Second, future reforms could contribute to reduce the high share of so-called "mandatory expenditures" in some countries – i.e., those that to be changed require additional legislation on top of the budget law, thus improving the ability of budgets to react to shocks. Third, strengthened practices in evaluating expenditure (e.g., via cost-benefit analysis techniques in project selection, periodic reviews of programmes, establishment of output-oriented indicators of government actions) could contribute to increase the effectiveness of government expenditure and achieve cost savings.

In additional to strengthening institutions, a further approach may help improve potential trade-offs for fiscal policy: microeconomic aspects of policy that influence economic stability. One key priority in this regard is to avoid creating distortions that could amplify boom-bust cycles in the private sector (such as untargeted mortgage subsidy programmes, and interest rate deductibility schemes). A further example is the currency denomination and maturity of public borrowing, which influences the exposure of the entire economy to, respectively, exchange and interest rate risk.

Such institutional and microeconomic priorities need to be pursued over a medium-term time horizon. Nonetheless, they can offer important routes to strengthen the stabilizing quality of fiscal policy for any given level of deficit and public debt. They thus can improve importantly the potential trade-offs or complementarities between stability and growth that face policy-makers during the convergence process.

Complementarities or trade-offs in supporting financial stability

The discussion in section 2 of this paper underscored that growth oriented reforms vary significantly in their impact on fiscal deficits – with some such reforms enhancing public savings even in the short run. Thus, when assessing trade-offs or complementarities, a key consideration is the wide variety of countries' economic and fiscal circumstances. The eight

EU Members in central Europe and the Baltics again suggest some contrasts that may also be valuable in thinking about challenges facing the candidate countries:

- A number of countries in central Europe face significant challenges in keeping public debt ratios within prudent bounds. In these economies too, it is plausible that the elasticity of fiscal balances to output is close to that in the former EU-15, albeit perhaps somewhat less. Larger fiscal deficits in some cases also pose policy co-ordination challenges that could affect the exchange market. Output costs of exchange rate variability have proved a concern. Seen from a stability perspective, these factors suggest significant challenges ahead in ensuring that fiscal policy contributes fully to economic stability. On the other hand, these economies may also have greater scope for a restructuring of existing programmes that is itself growth enhancing.
- Stability risks show a different profile in the Baltic states. Deficit and debt levels are on average far lower. The scope required for automatic stabilizers may be less, and the stabilizing impact of fiscal policy is limited by the size of the public sector. Current constraints on policy result mainly from the need to continue to underpin the credibility of currency board-style exchange regimes; to provide assurance to financial markets that wide external current account deficits do not have their source in any misallocation in the public sector; and to avoid fiscal amplification of trends toward real appreciation.

The challenges for fiscal policy over the next few years, moreover, will not be static. As countries, at different times in the future, enter ERM II and adopt the euro, the evolving monetary setting will modify fiscal challenges. Six of the recently acceded Member States now participate in ERM II, but these do not include the four larger economies in central Europe which currently have flexible exchange rates. For those four countries, policy mix and credibility risks may come more strongly to the fore in the run-up to the euro. This could occur in an environment of rising levels of euro-denominated liabilities, and hence of balance sheet risks. Moreover, contagion within the group could be an issue. Once they have adopted the euro, some of these economies may still face challenges to ensure scope for automatic stabilizers and to keep the public debt on a credibly sustainable path.

In the Baltic states, by contrast, stability concerns may ease somewhat after euro adoption: the issue of hard-peg credibility will disappear, and debt and automatic stabilizer profiles will remain undemanding. The potential challenge will lie more in the issue how policy should respond to the scale and composition of private sector imbalances. A key will be to ensure that potential growth and revenue performance are assessed prudently. The outlook for public debt and potential growth may allow somewhat less constrained fiscal balance positions within the framework of the reformed SGP. However, in the process of transition it would be crucial to avoid a fiscal stimulus at cyclically inappropriate times.

A stylized analysis along these lines is thus somewhat encouraging from a policy perspective. Taking into account differing profiles across countries, it is plausible that complementarities exist, even in the short run, between accelerated tax and expenditure reforms and decisive progress with consolidation where this is needed.

If such a conclusion were borne out by in-depth country assessments, it would be very important: there is no escaping the urgency, particularly in certain cases in central Europe, of improving substantially both the prospects for growth and the outlook for the fiscal balance. The convergence programmes prepared by EU Member States, and Pre-Accession Economic Programmes developed by candidate countries, offer vehicles to explore such issues.

6. Some tentative conclusions

"Is fiscal policy the right regulator?" Well, it depends on the kind of function one understands by the term "regulator." Fiscal policy is not well equipped for active, discretionary adjustments of a fine-tuning type. But if, by "regulator," one means a policy framework that can help to forestall financial instability in a strategic and pre-emptive manner, then by all means the public finances are a key element in the policy armoury.

The key features of fiscal policy in this regard are to assure public debt sustainability and the free operation of automatic stabilizers. However, there are other dimensions of policy that also matter greatly. In the discussion above several of these were stressed, including a sound macroeconomic policy mix, prudent consolidation in "good times," and careful attention to microeconomic features of fiscal design. These elements can enhance the stabilizing role of fiscal policy and also improve short-term trade-offs between support for stability and for growth. In these respects, six broad considerations could be helpful in guiding fiscal policy.

First, it will be important to assure scope for growth-supportive expenditure priorities, while exploiting the scope to achieve fiscal savings by reforming existing programmes – an approach evidenced in various ways in recent Convergence Programmes.

Second, medium-term fiscal plans need to assure public debt sustainability, keeping in mind the possibility of future shocks to the economy and the public finances, including the scope for contingent liabilities to crystallize. Most of the economies in the EU face major demographic challenges. The converging economies typically are moving to address these through growth-oriented approaches based on structural reform of pension systems – though action is still needed in some cases, and supportive labour market reforms are also crucial.

Third, countries with developing financial sectors may face extended periods of rapid credit expansion and wide private sector imbalances. It is important not to overestimate underlying trends in potential growth or in revenues: an unintentionally pro-cyclical stance could run external risks, and limit the scope for fiscal flexibility during a subsequent slowdown. This contribution of fiscal policy is, of course, a complement to the role of strong supervisory policies – not a substitute.

Fourth, monetary and exchange regimes influence the way that risks for policy crystallize. In the run-up to euro adoption there are special demands on market credibility and the macroeconomic policy mix. Where domestic currencies are retained for an extended period, fiscal tensions and high domestic interest rates could contribute to a build-up of risks through unhedged foreign currency borrowing by the private sector. Under the euro, exchange rate risks disappear, but external adjustment challenges do not: sound fiscal policy in "good times" can increase flexibility at times of setbacks to growth. Again, fiscal policy cannot substitute for functions of monetary policy, but it needs to take adequately into account the key features of the monetary environment.

Fifth, there are questions how to address possible market tensions during convergence – including the risk of a loss of access to international capital markets, or of market pressures in the run-up to euro adoption. Responding to shocks and emerging risks through discretionary fiscal adjustment has costs, such as the risk that budgetary cuts fall on investment. This argues for setting prudent medium-term goals, with adequate safety margins. But it also highlights the case for strengthening fiscal institutions – thus improving the underlying trade-offs for policy – and for designing carefully such microeconomic dimensions of policy as the public debt management strategy and tax deduction regimes affecting real estate.

Finally, the situation in the public finances differs widely across countries. Encouragingly, those economies which face the tougher fiscal deficit and debt challenges may also have the greater scope to meet these through structural fiscal reforms that are themselves growth-enhancing. Effective fiscal strategies need to be developed on a case-by-case basis. EU Member States' Convergence and Stability Programmes, and the pre-Accession Economic Programmes of candidate countries, will continue to assure a key vehicle for this. And the Commission assessments of programmes will provide the basis for ongoing policy dialogues.

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