

Impact of Fiscal Policy on Financial Stability

Mirna Dumičić

Belgrade, June 2016

The views expressed in this presentation are those of the author and do not necessarily reflect the views of the Croatian National Bank or the European Central Bank.

This work has been supported by the Croatian Science Foundation under project “Public Finance Sustainability on the path to the Monetary Union - PuFiSuMU” (IP-2016-06-4609).

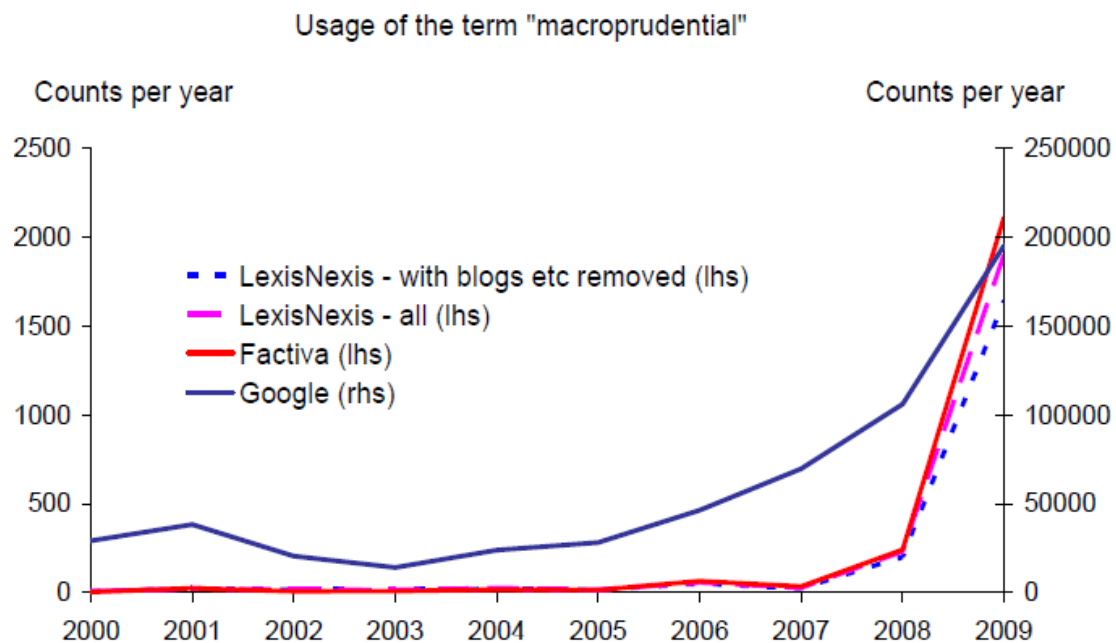
Introduction

- The recent global financial crisis - **significant fiscal, quasi fiscal and social costs** of financial instability
- From the macroprudential perspective - key prerequisite for more efficient system – to **understand the channels** through which different economic policies could affect **financial (in)stability**
- Fiscal policy – **huge macroprudential potential** - numerous interlinkages both with the financial system and the real economy.

New perception of goals of economic policies – pre-crisis period

- **Monetary policy** - maintaining low and stable inflation
- **Fiscal policy** – sustainable economic growth, higher employment, social goals
- **Financial market regulators** – microprudential approach, focus on stability of individual institutions

- **Macroprudential policy (MPP)** – “new” player in the field - financial stability (FS) – in practice used only in small number of countries

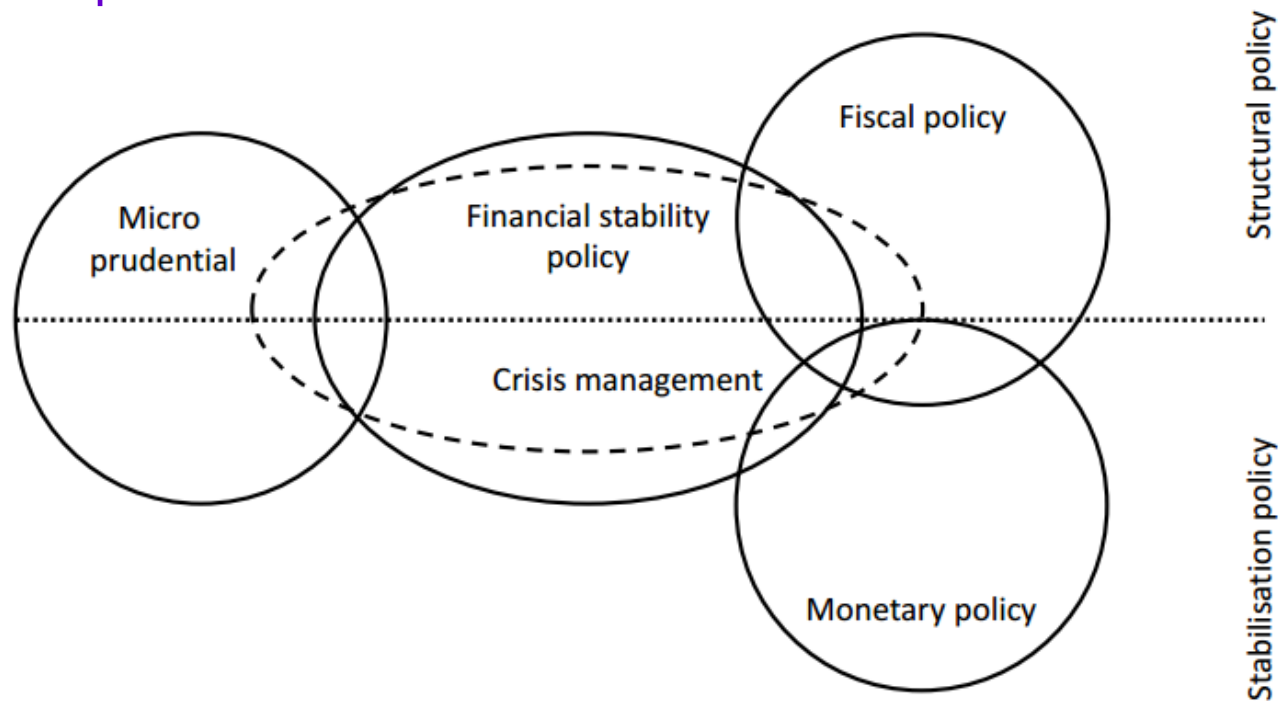


New perception of goals of economic policies – post-crisis period

- New views on roles of different economic policies
 - The use of unconventional measures and instruments became conventional
 - MPP – recognized as a potential tool for preventing future crisis episodes
 - Development of its theoretical and institutional framework, instruments, calibration
 - But – many unknowns about its interaction with other policies
- Blanchard, Dell'Ariceia and Mauro (2013) – two potential directions:
 - Return to “classical” monetary policy, limited use of MPP and FP
 - Extended goals and instruments of monetary policy, active role of MPP and FP

Condition sine qua non – coordination between different economic policies

- Although **FS** is the main goal of MPP – it should be the result of **coordinated activities** of all economic policies – each of them can have MP character
- Precondition – understanding of main **channels of influence of individual policies on FS**



Channels of impact of fiscal policy on FS

– Public debt

- **PD** sustainability – precondition for maintaining FS
 - depends on various factors: nominal value, term and currency structure, domestic / foreign, type of creditors, current market and economic conditions, budget structure, political stability, stability of domestic financial sector etc.
 - high level of PD decreases the **countercyclical capacity of FP**
 - directly reduces systemic risks and increases the resilience of economy to potential shock - **compatible with building capital and liquidity buffers on the system level**
- Irresponsible FP – increases the need for MPP and simultaneously reduces its manoeuvring space
 - could result with deterioration of liquidity, but also of solvency of financial institutions - threat for the FS of the whole system (Praet, 2011)
 - Affect the quality of balance sheet of the private sector as well

Channels of impact of fiscal policy on FS – Country risk premium

- One of the most important determinants of the **government borrowing costs**
- Determined by:
 - Market sentiment - dynamics
 - Macroeconomic fundamentals - level
 - Most important **fiscal indicators** – public debt and budget balance (realized and expected)
- Due to their low risk and high liquidity - government securities are benchmark for assessing the prices of other assets (Das et al., 2010)
 - **private sector funding costs** therefore also largely depend on the government's fiscal performance

Channels of impact of fiscal policy on FS – **Tax policy**

- Should be adjusted to **economic and financial cycles**
- Tax **treatment of different types of financing (debt vs. equity) and investment** – potential shock amplifier
- **Tax reliefs** - strong potential influence on systemic risks (affects different prices)
 - Common example of procyclical tax policy – tax reliefs for interest rates on housing loans in the boom stage of the cycle – significant impact on house prices and demand, credit activity

Channels of impact of fiscal policy on FS

- fiscal strategy during capital flow bonanzas

- Fiscal policy - many tools to mitigate imbalances occurring in the periods of strong capital inflows
- But, in such situations – FP is usually procyclical and undisciplined (Reinhart and Reinhart, 2008)
 - government expenditures increase
 - acts in a destabilizing manner assuming that these flows will be continuous.
 - becomes another source of potential vulnerabilities,
 - additional pressure on monetary and macroprudential policies and reduces their maneuvering space (Watson, 2010).

Channels of impact of fiscal policy on FS

– time horizons

Different time horizons – additional limiting factor in harmonizing economic policies

- Within the countercyclical approach - policies should adjust to the financial and economic cycles – create **buffers** in the **boom** stages and use them to **moderate** the **downturns**
- Objective constrain of FP - **election cycles**
 - discourage activities with show results in the long run
 - increase probability of **procyclical FP**

▪

Fiscal costs of financial instability

Significant impact on the level of **social welfare**

- **rescuing** financial institution
- **protection** of deponents and creditors of financial institutions
- **subsidies** to the corporate sector or households

● Fiscal costs of crisis episodes according to the literature:

- Hoggarth, Reis and Saporta (2002): could reach **22% of GDP**.
- Laeven and Valencia (2012)
 - in extreme scenarios - > **55% of GDP**
 - total sample of the countries - **2% - 57% of GDP**
- IMF (2015) - around **7% of GDP**

Fiscal policy framework and financial stability in the EU

- Recent global financial crisis - **set of institutional and regulatory changes**
 - prevention of crisis episodes
 - enabling timely identification of potential imbalances in the EU
- Most important - **framework for ensuring sustainable fiscal policy** - The Treaty on Stability, Coordination and Governance in the EMU (2012)
- **Stability and Growth Pact**
 - not efficient enough for mitigating the systemic fiscal risks,
 - nor for enabling countercyclical action when the crisis struck
- The new mechanism for ensuring prudent fiscal policy - **Six-pack** - defines the excessive deficit procedure and sets the rules for lowering public debt (Brkić and Šabić, 2014)

Conclusion

- **Macroprudential approach** – should be built in the core of every (economic) policy
- **Fiscal policy** – should be perceived as one of the key elements of the overall **financial stability**
- Cechetti (2011) - suggestions for strengthening the FP framework:
 - focusing on **long term goals**,
 - better **communication** with public,
 - increased **transparency** (particularly related to government expenditures)
 - more prudent budget policy which would create buffers against shocks



Thank you!

MP approach...

- Prevention
- Sophisticated monitoring system and timely reactions
- Buffers
- Openness to unconventional methods



...always pays off 😊

