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The Fiscal Tools of Crisis Management – A Comparative Analysis

SUMMARY: The study provides an overview of three European countries' crisis management in response to external shocks in 2008. Following a short theoretical outline, the paper evaluates the key characteristics of adjustment measures, placing special emphasis on the vulnerability of countries. On the basis of the analysed crisis periods it concludes that fiscal stability in itself is insufficient. As the study argues, economic policymakers must not be narrow-minded and -- along with maintaining fiscal prudency -- they also have to closely observe the regulatory activities of the financial intermediary system and other economic indicators.

KEYWORDS: global crisis, vulnerability, crisis management, fiscal policy, economic policy
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Several European countries have fallen victim to the global crisis of 2008. In terms of size and scope, this was the gravest crisis since 1929 (since the *great depression*), one which shook the whole of the global financial system to its core. Following a brief theoretical overview, this study examines three cases from the European Union in detail: Latvia, Sweden and France.

The internal and external balance positions of these countries were vastly different, and their reactions to the crisis varied accordingly. They, however, draw attention to a number of relevant correlations. They help us understand the underlying threat of external imbalances to fiscal developments, and underscore why the emergence of a crisis in a given region cannot be viewed as an isolated phenomenon. They provide answers to questions like why it is important to have a responsible government approach to public finances, and how drastic changes in external environment impact economic developments. All in all, these questions are all aimed at a topic that is highly important for this study; namely, whether it suffices for economic policymakers to solely focus on fiscal discipline or whether the exact opposite is true, by focusing on this factor alone, are they playing a crucial role in the development of these crises?

THEORETICAL OVERVIEW

Before the global crisis, economic policy debates across the world focused on fiscal discipline. This was in part due to the fact that the ruling notion in academic circles was that the current account deficit only has significance if it can be traced back to a deficit of the government sector (*Lámfalussy*, 2008). As a result, attention was less focused on the 'world' beyond budget

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policy, and was aimed at solely on enforcing fiscal discipline to the greatest possible extent.

Wyplosz (2002) and *Debrun – Kumar* (2007) argue that similarly to institutions of monetary policy, an independent institution must also stand guard over fiscal policy. *Manasse* (2006) and *Kopits* (2007) traced the fact that budget deficit always increases before elections back to the propensity of government officials to spend funds. Others (*Milesi-Feretti*, 1997) saw the transparency of budgetary processes as a priority. At the same time, they emphasised that in the interest of ensuring fiscal discipline, reliable and transparent budget figures are required.[1]

In examining deficit reduction, *Alesina – Perotti* (1996) arrived at the conclusion that off-balance-sheet lines are key potential sources of threat. The shifting of certain budget items from the traditional balance sheet line to the 'gray area' could accomplish a result that is contrary to the long-term interests of the community. *Kopits – Craig* (1998) and *Daflon – Rossi* (1999) emphasised that government players are more prone to 'paint a nicer picture' of a country's budget situation than it actually is. In the 1990s, the application of creative accounting techniques became so widespread in European countries, that by the end of the decade it became exceedingly difficult to provide a realistic economic situational assessment using statistical reports. In relation to this fact, certain authors (*Koen – Noord*, 2005) pointed out that recourse to creative accounting is more likely near the threshold of fiscal regulations. Although in this particular field, the development and adoption of international accounting principles could bring a slight improvement (*Allan – Parry*, 2003), the underlying deficiencies of the accounting system can never be fully eliminated.

Blanchard (1990) and *Brunilla et al.* (1999) identified the incorrect interpretation of fiscal balance indicators as another aspect of hazards. From the cyclically adjusted balance, they derived that there are no precise and standard procedures for the structural assessment of the budget. No single method suitable to filter out the cyclical effect of the economy can generate a comprehensive, relevant figure. According to *Brandner et al.* (1998), the problem is that the perception of fiscal objectives varies across various time horizons. Moreover, demographic trends also exert multi-branch pressure on the budget. Firstly, ageing society, where the number of the population is dwindling, leads to a rise in pension expenditures: the number of pensioners per active age citizens is on the rise (*Burniaux et al.*, 2004; *Barabás*, 2007). The effect is similar in the case of healthcare expenditures: as society shifts towards the older generation, the strain on the healthcare provision system increases (*Gokhale – Kotlikoff*, 1998), as do tensions about the financing of various institutions.

However, only a handful of experts drew attention to the fact that tensions may still be generated between fiscal objectives and the continued pursuit of the 'correct' economic policy even if all these criticisms are taken into consideration.On this note, [2] *Uctum – Wickens* (1999) said that the sustainability of fiscal policy may not necessarily be guaranteed even if budget criteria are adhered to. *Balassone – Franco – Zotteri* (2004) added that if the authorities of the given country are overly focused on achieving a given macro-economic indicator, the optimal economic policy mix could become distorted: the excessive rigidity of economic policy could become a breeding ground for a subsequent crisis. Lámfalussy (2008) pointed out that private sector players may also play key roles in shaping the economic situation of a given country. Attention to risks tends to dampen over time: on the one hand, borrowers may overestimate the limits of their load-bearing capacity, and on the other, creditors may also build their future on

overly favourable expectations. Meanwhile, the structural weaknesses of supervisory authorities could also contribute to the mispricing of the various financial assets.

The next section of the study presents the unfolding of the global crisis and its impact on the economies of Latvia, Sweden and France, while taking the above observations into consideration. As far as the crisis management of the countries in question is concerned, the process is still ongoing in France and as such its macro-economic path is shrouded in greater uncertainty than that of the other two countries.

LATVIA

Within the European Union, Latvia was one of the economies most severely hit by the 2008 global crisis. In 2009, the country's growth stopped in its tracks, its public debt increased sharply and its seemingly well-functioning economic model became unviable in a matter of moments. Looking back, it is clear that the debt of the private sectors of the three Baltic states increased at an unsustainable rate prior to the deepening of the crisis. While at the end of 2004 the average debt-to-GDP ratio was 63.2 per cent, by the end of 2007 it jumped to 100.2 per cent, which is an increase of approximately 40 percentage points, and all the while these countries gave the impression to investors of being reliable debtors. International credit rating agencies also placed the countries in question into the priority category, unsuspectingly observing the dramatic changes in their financing positions. In order to begin to understand how this process led to the drastic deterioration of the macro-economic indicators of Baltic states, we should thoroughly analyse the chronology of events (IMF, 2006a; 2013a).

For quite some time, the growth of the Latvian economy seemed impressive, expanding by 7–12 per cent between 2000 and 2007. While foreign direct investment at the start of the decade was below USD 0.5 billion, it accelerated by the middle of the decade, rising to USD 1 billion and 1.4 billion by the end of 2006 and the end of 2007, respectively. This process was maintained by the simultaneous occurrence of a number of factors. The contribution of the financial sector to GDP rose above 4.5 per cent from 3 per cent, while the share of the real estate sector almost doubled, jumping to 11 per cent from 6 per cent. This boom also pulled the labour market along, with the number of people in employment increasing by approximately 100,000 between 2002 and2007. In other words, to any outside onlookers the country seemed to have a stable and prospering economy. It is worth reading an excerpt on the matter from the October 2006 report of the International Monetary Fund (2006, p. 3):

"Financial deepening, EU-funded spending, and real wage growth caused a surge in domestic demand that pushed the economy above capacity. GDP growth accelerated to 10¼ per cent in 2005, and the current account deficit and inflation remained elevated. … Recent drivers of demand are expected to persist in the near term, and growth will remain very strong, while the current account deficit will widen further and inflation will remain in excess of the Maastricht limit. Thereafter, a gradual unwinding of imbalances through a moderation of growth is likely. …"

Indeed, favourable growth figures were somewhat overshadowed by the fact that their achievement entailed an extremely high external financing requirement (net borrowing) *(see Table 1)*. Still, this had little significance in the eyes of many. Not even the most absorbed analysts would have suspected that the financing of such a small country would pose any problems. International institution pointed out increasingly often in their recommendations that the institutions supervising financial organisations required strengthening and that a sudden change in the international

Table 1

EXTERNAL FINANCING REQUIREMENT OF BALTIC STATES (AS A PERCENTAGE OF GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
Latvia	–3.4	–5.6	–5.2	–6.5	–10.6	–10.5	–19.6	–18.9
Lithuania	–5.9	–4.7	–4.7	–6.4	–6.8	–6.1	–8.9	–12.8
Estonia	–5	–6.9	–10.6	–12.3	–11.3	–8.0	–12.8	–13.8

Source: Eurostat

environment could cause grave problems, but the warnings were unheeded, and external debt continued to grow at an alarming rate.

The accumulation of debt was linked almost entirely to the private sector, and the state's financial management was prudent. Public debt moved within the range of 10–15 per cent of GDP, and government sector deficit remained below 3 per cent of GDP (i.e. stayed under the Maastricht deficit indicator) throughout the years under review. Moreover, the fiscal balance was achieved at low revenue and expenditure levels (in 2007, the government sector's expenditures amounted to 33.9 per cent of GDP, while its revenues came to 33.3 per cent of GDP), which supported the economy's competitiveness through the state's moderate crowding out effect.

For the most part, high-volume capital inflows affected the aforementioned real estate sector: as a result of drastically increasing credit demand, real estate prices between 2004 and 2007 rose by almost 260 per cent (Vandenbussche et al., 2012). Such a dizzying soaring of the construction industry should certainly be cause for alarm as a sudden and unregulated withdrawal of funds may launch a multitude of uncontrollable processes in the economy. After all this, it was clear that it was just a matter of time before confidence in the country ran out. It was only after the external shock of 2008 that creditors and investors became aware of the true situation and the unsustainability of these processes. The sudden change in market mood instantly directed attention to the country's weaknesses, primarily its external financing difficulties. The gravity of the situation was well illustrated by the country's 5-year CDS value reflecting its risk perception. In just under two months, this value jumped from 300 basis points at the beginning of September 2008 to nearly 900 basis points at the end of October *(see Table 2).*

At this point, the question was not how to prevent the crisis or minimise risks, but rather to draw up a scenario that would require the least amount of sacrifice possible. As a first step, the country turned to international institutions for assistance. In November 2008, the International Monetary Fund and the European Union provided a credit facility of USD 10.5 billion to the Latvian economy in order to reduce the external financing pressure. As a second step, as a prerequisite of borrowing, the country was required to take measures – despite the global crisis – to keep the budget deficit at a moderate level. As part of these measures, among other things, government officials ordered a 20 per cent pay cut for public servants; pension values were reduced by 10 per cent and administrative expenditures by 30 per cent, minimum wage was slashed by 25 per cent, while in addition to raising the value added tax rate, policymakers decided to introduce the real estate tax and property tax. Despite all deficit reduction measures, by the

Table 2

CDS BASIS POINTS OF THE LATVIAN ECONOMY, 2008

	August	September	October	November	December
1-year	114	146	307	916	899
3-year	195	242	511	873	862
5-year	265	330	708	860	833
10-year	295	358	730	791	804

Source: Bloomberg

end of 2009 – due to debts assumed from the banking sector – the budget deficit jumped to 9 per cent of GDP, while the debt-to-GDP ratio rose drastically from 18.6 to 36.4 per cent.

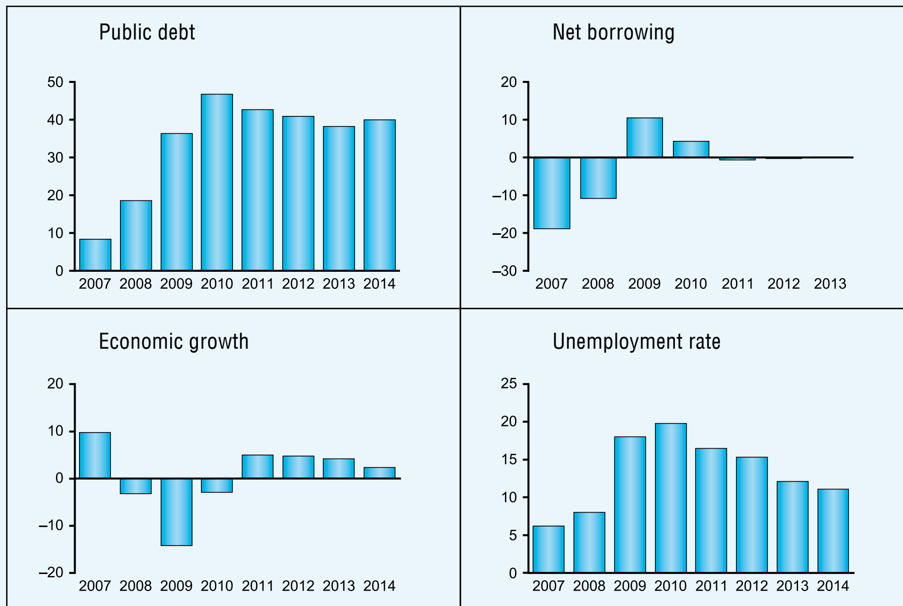
As a third step, officials of the Latvian government made a commitment to continue to uphold the fixed exchange rate regime. It was the commercial banks of Scandinavian countries (which provided large volumes of loan) that primarily argued against changing the exchange rate regime – which facilitated the inflow of capital –, viewed by many as an original sin. They argued that the devaluation of the exchange rate not only did not help the adjustment process, but it actually carried the risk of the emergence of a regional syndrome through the drastic rise in non-performing loans. The fourth step comprised the reinforcement of banking supervision. Taking into account that regulatory deficiencies played a crucial part in the development of the crisis, eliminating the weaknesses of supervisory bodies was an indispensable element of a successful relief effort.

If the indicator of successful crisis management is whether a country is able to weather the storm of the crisis without sovereign default or announcing a unilateral repayment moratorium, then the Latvian crisis management effort can certainly be deemed successful. Such scenarios, however, are rather scarce – although not unprecedented – in the history of European economies. In order to draw material conclusions, therefore, we should focus on the deeper characteristics of the processes.

As far as the state of the economy is concerned, there has certainly been considerable improvement. As of 2009–2010, the structure of growth was made healthier, with processes pointing in the direction of sustainability *(see Figure 1)*. Two years after the 14.2 per cent downturn in 2009, the growth rate of the economy reached 5 per cent. In part, this reflects the considerable easing of money market tensions starting from the autumn of 2009; not even the tumble of the global economy in the summer of 2011 was able to steer the country off the growth path. At this point, it should be pointed out that having a coordinated international relief effort had special significance. In addition to providing substantial amounts of credit to the country, international institutions made certain that the most important commercial bank creditors of the country (Nordea Bank, SEB Bank, Swedbank) also made significant commitments: namely, they pledged that in the most severe phase of the crisis they would not withdraw funds from the country, or limit outflows to the minimum (*De Haas et al.,* 2012).[3] Stipulating this condition was in the vested interests of both the Latvian economy and the international institutions providing the loans; indeed, without this condition, the assistance would not have

Figure 1

LATVIA'S KEY MACRO-ECONOMIC INDICATORS, 2007–2014



Note: Public debt and net borrowing/net lending are expressed as a percentage of GDP; the unemployment rate indicates the percentage value of unemployed persons compared to the total number of the population between the ages of 15 and 74, while economic growth is also expressed as a percentage value. Net borrowing/net lending is the sum of the current account and the capital account.

Source: European Commission, Eurostat

been able to make a substantial impact. As a result, the banking sector did not hamper the efforts to ensure that economic players have sufficient time available to consolidate their positions.

At the same time, it is difficult to decide with certainty whether the crisis could have been managed more efficiently. Looking back, in October 2008 the Latvian economy was forced to face problems of such gravity that, in essence, led directly to the utilisation of the relief package. Although the country undertook to act in accordance with the express specifications of the IMF, the situation caused a severe headache for the international community. As the financial crisis deepened in 2008, there was a possibility that it would impact multiple countries concurrently, bringing about a 'domino-effect' in the region which could shake the Western banking system to the core. At the same time, this strong co-dependence allowed the negotiating parties to come to a consensus relatively easily. (Given the global crisis, the IMF was much more lenient than usual). However, it is impossible to say whether or not this was the optimal solution.

From a third aspect, the success of crisis management is strongly contested. This is to do with the tightness of the adjustment path. As the devaluation of domestic currency was out of the question for the Latvian economy due to its fixed exchange rate regime, the only

way to restore the imbalance of the budget was by reducing wages and social transfers substantially and by raising taxes. Of course, it may be debated how radical the adjustment process actually was and whether this could have been stretched out more over time. In the light of subsequent events, however, it was most definitely required. The officials of the Latvian government decided to take highly drastic measures, through which, in essence, they laid the groundwork for a grave problem. To escape unemployment and hardship, a significant portion of the population, about 200–250 thousand people left the country to go abroad. There is no evidence to support the assumption that this sacrifice could have been avoided with a different type of crisis management. No matter what kind of adjustment a given country opts for, international experience shows that in order to be successful, it should be 'front-loaded', i.e. able to restore the conditions for growth as soon as possible (CEMI, 2006; Lámfalussy, 2008).

In order to facilitate a disciplined fiscal policy, the Baltic state had its own system of fiscal regulations in place even before the external shock of 2008 (1994): the government imposed strict regulations on local governments and the revenue side of the central budget (EB, 2012). It set strong limits to the borrowing of local governments. The requirement concerning the central budget was meant to ensure the balance between the contributions paid and social expenditures. Later on, it was these fiscal regulations that were supplemented by less stringent Maastricht criteria.

Taking the highly prudent financial management of the Latvian budget into account, we can state that the problem did not arise from the operation of fiscal regulations. Only in a handful of cases can the point of origin of a crisis be traced back to the irresponsible financial management of the budget; more frequently, troubles stem from the dysfunctional operation of areas distant from the budget, although ultimately, this upsets the fiscal balance all the same. In this respect, the role of the state supervisory authority responsible for financial institutions should be noted as it is the task of this institution to assist the process of sober risk assessment through useful guidance and to prevent the emergence of various asset price bubbles. Getting back to the situation of the Baltic state: the domestic supervisory authority failed to draw the attention of economic players to the dangers of excessive risk taking and as such was unable to minimise the danger of a crisis forming. This deficiency was only corrected after the eruption of the crisis and it was only then that the powers of supervisory bodies were reinforced.

SWEDEN

In contrast with Latvian events, the Swedish economy weathered 2008–2009 with relative stability. The reason for this striking difference is that the external financing situation of the Northern country was wholly different prior to the crisis: By the end of 2007, it showed a 9.3 per cent surplus compared to GDP, while at this point the Latvian economy had already been operating with a permanently high financing requirement for some years. For the most part, the difference in financing positions is due to the net savings of the private sector: between 2004 and 2007, the net lending of the population and businesses ranged between 6and 9 per cent of GDP. Another prominent difference is that in the years in question, Sweden was characterised by capital export, while Latvia saw high-volume capital inflows.

By the middle of the decade, the country's competitive advantage increased mainly due to successful structural reforms (IMF, 2008a; 2013b). The labour market measures taken, the improvement of the fiscal balance and

the general European economic boom created a favourable economic climate. Between 2001 and 2006, the Swedish krona appreciated against the euro by 14 per cent. From the summer of 2004, this allowed the two-week base rate of the Swedish central bank to sink below that of the European Central Bank and the Fed. There was one alarming development: the exposure of Swedish commercial banks to Baltic states was too high. In September 2007, 31 per cent of the external liabilities of debtor states was towards Swedish credit institutions. Of the largest commercial banks, 20 per cent and 5.2 per cent of the total asset value of Svedbank and SEB Bank was affected, respectively.[4] Other risks impacting the economy remained moderate: this was in part because of money market supervision, and in part due to the cautious policy of the government, something that can be explained by events that had happened 15 years earlier.

In 1992–1993, Scandinavian countries experienced the gravest financial crisis in the post-WWII period (Blanchard et al., 2008). The crisis broke out in Norway, with the effects rippling on to all other Northern countries. The large-scale liberalisation of financial markets, inappropriately functioning money market supervision and the fixed exchange rate regime led to the overheating of the economy through excessive borrowing. The business environment was the first to deteriorate drastically, followed by a rise in the state's outstanding debt. At the end of 1990, the total public debt of Norway, Finland and Sweden amounted to USD 224.6 billion. By the end of 1993, this figure nearly tripled, rocketing to USD 676.6 billion. Behind the accumulated debt was state assistance provided to commercial banks: by way of an asset management company, the budget assumed a significant volume of the debt of defaulting debtors.

The financial crisis also had a significant impact on the real economy. The unemployment rate rose in all three countries. Finland saw the sharpest increase from 3.2 to 16.4 per cent, but unemployment also rose considerably in Sweden from 1.7 to above 9 per cent. During this same period, as a result of forced adjustment, the deficit of the current account dropped from USD 9.3 billion to USD 1.8 billion. The excessive risk-taking of the banking sector, therefore, led to prolonged grave consequences, and at the same time forced the countries in question to review and rethink their supervisory and economic policy. As a result, Northern countries shifted towards a smaller state size, the expenditure side of the budget dropped by some 9 per cent on average, and they also managed to permanently reduce the budget deficit. The situation of the Swedish economy was unique in the respect that compared to the other two Northern countries, as of 1993 it was forced to reduce its redistribution rate from a very high level *(see Table 3)*. Moreover, it was forced to do so amid a series of fiscal adjustment measures taken in response to the deteriorating positions of the budget and the real economy, with the austerity measures primarily affecting general community services and social expenditures *(see Table 4)*. By the end of the decade, pursuing a disciplined budget policy, the Swedish government was able to reduce the redistribution rate – which was in excess of 70 per cent of GDP – to 57.3 per cent. This meant that in 1998, budget revenues exceeded expenditures.

Although there are a number of similarities between the Scandinavian crisis of the early 1990s and the global crisis of 2008, the difference in respect of the situation of the economy was still striking. The 3–4 per cent growth preceding the 2008 external shock was accompanied by relatively low inflation: a budget surplus of 2–3 per cent of GDP and net lending in excess of 6 per cent of GDP. As a result, the global crisis materialised in the economy

Table 3

BUDGET INDICATORS OF SWEDEN (AS A PERCENTAGE OF GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Expenditure	61.0	64.5	70.3	71.0	68.1	63.5	61.4	59.2	57.3
Revenue	64.9	64.8	61.3	59.6	59.0	56.5	58.3	57.7	58.1
Balance	3.9	0.3	–9.0	–11.4	–9.1	–7.0	–3.1	–1.5	0.8

Source: Eurostat. International Monetary Fund

Table 4

SWEDISH BUDGET EXPENDITURES BROKEN DOWN BY MAIN EXPENDITURE TYPES (AS A PERCENTAGE OF GDP)

	1995	2000	2005	2010	2013
General community services	11.0	9.7	7.8	7.4	7.8
Defence	2.4	2.2	1.7	1.5	1.5
Public order and public safety	1.4	1.2	1.3	1.4	1.4
Economic expenditures	5.6	3.6	4.2	4.4	4.3
Environmental protection	0.2	0.2	0.4	0.3	0.3
Housing subsidies	2.7	0.9	0.8	0.7	0.7
Healthcare	6.1	5.9	6.5	6.8	7.0
Entertainment. culture. religion	1.8	1.0	1.0	1.1	1.1
Education	7.0	6.5	6.7	6.5	6.6
Social expenditures	25.6	22.3	22.5	21.9	22.6

Note: Official data on the functional distribution of budget expenditures have been available since 1995.

Source: Eurostat

in a much more indirect form: through the foreign trade channel, the financial channel and through the country's financing.

Sweden was deeply integrated into the European economic environment. Compared to total exports, the share of the European Union was at around 65 per cent, while in the case of import products this ratio was 55 per cent. Approximately 60 per cent of export revenues was from the export of industries especially sensitive to the economic environment such as machinery and transport equipment as well as processed products, and as a result, the country was unable to remain unscathed in the 2008–2009 period. The destructive impact of the crisis, however, was not perceived exclusively in the most severe phase, the early spring of 2009, but actually had long-lasting consequences. For instance, between 2008 and 2013, the decline of export performance came close to 9 per cent, while the drop in imports was above 4.5 per cent. In addition, this drop in foreign trade turnover occurred parallel to large-scale fluctuation, rendering the adjustment very difficult for economic participants.

Prior to the outbreak of the crisis, Scandinavian commercial banks provided a high vol-

ume of loans to the Baltic states which, however, slipped into a deep crisis immediately after the emergence of the global crisis (De Haas et al., 2012). (Of the USD 106.3 billion external liability of Latvia, Lithuania and Estonia at the end of 2009, USD 78.2 billion was to Sweden). As a condition of providing bridging finance to the countries affected, creditors stipulated that the fixed exchange rate regime had to be maintained. This allowed them to prevent distressed countries from carrying out the necessary adjustment by way of devaluing their own currency, but at the same time, they took on the risk of destabilising their country.

The third channel through which the Swedish economy was affected by the global crisis was the modification of financing opportunities. It is a general view that during external shocks, the risk perception of various countries branches out. While countries with sound economic foundations experience increased capital inflows (so-called safe haven), economies with grave structural problems have hardly any or no access to external funds. The Swedish economy belonged to the group of moderate risk countries. As a result, between 2007 and 2010, the Swedish krona appreciated against the euro by 2.5 per cent. The fact that government borrowing was carried out with lower yields had to do with this process, and as a result, the interest expenditures of the budget went into a nosedive dropping from 1.7 per cent at the end of 2008 to 1 per cent by the end of 2010. Such positive effects, however, were still a long way from offsetting the negative waves generated by the crisis.

In spite of all this, the Swedish economy managed to retain its stability during the crisis. Even in 2009, the most critical of the crisis years, the debt-to-GDP ratio did not increase substantially, rising from 36.8 to 43.9 per cent between 2008 and 2014, i.e. up 7.1 percentage points only *(see Figure 2)*. The primary reason for this is that even though economic growth sank into negative territory, the accumulation of debt was dampened by the low budget deficit. The fiscal system of rules introduced at the beginning of the 1990s played a significant positive role in this process: it was in part this which contributed to establishing budgetary discipline and for keeping public debt at a moderate level (the rate of the latter was still above 70 per cent of GDP in 1996, but only 38 per cent of GDP at the end of 2007).

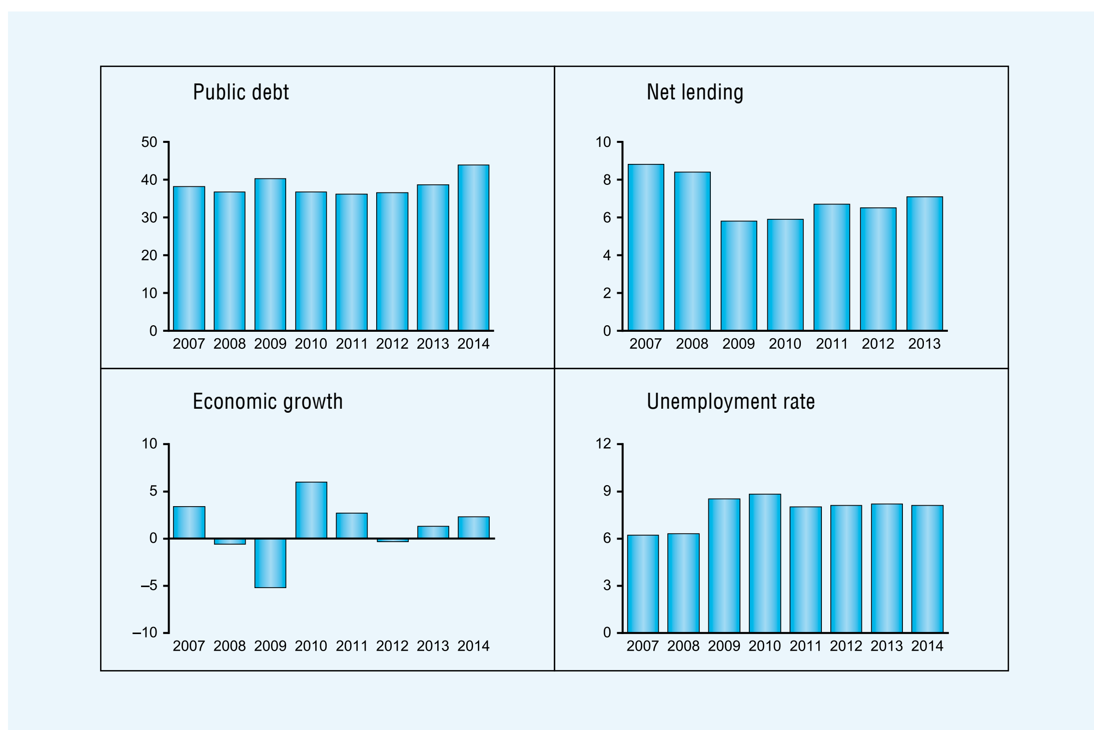
The Parliament passed the expenditure ceiling rule (*State Budget Act)* in question in 1996 – at this point, certain elements of fiscal regulations had already been in force for years; therefore, decision-makers already had relevant experience (EC, 2012). Compared to the Maastricht criteria, the criteria set out for the budget deficit and redistribution by the state were considerably stricter: tight limitations were set both for central budget expenditures and local government financial management. For instance, a surplus of 2 per cent of GDP was targeted for the budget as a whole.

The fiscal rule entered into full force in 2000. In spite of the above, there was a justified fear that budgetary discipline – as it usually does – would grow more lax over time; therefore, the setting up of a new institution also became part of the fiscal framework in 2007. The fiscal council assessed whether central government expenditures and balance goals were in harmony with the criterion of balanced growth, and also provided opinion on whether the level of employment was in line with the cyclical movement of the economy. In the years preceding the crisis, the Swedish authorities increasingly moved towards a rule-based fiscal policy which, as a result of high government commitment, allowed for the gradual reduction of external debts.

Besides the public sector, the private sector also became more cautious. As the irresponsible lending practices of the financial

Figure 2

SWEDEN'S KEY MACRO-ECONOMIC INDICATORS, 2007–2014



Note: Public debt and net borrowing/net lending are expressed as a percentage of GDP; the unemployment rate indicates the percentage value of unemployed persons compared to the total number of the population between the ages of 15 and 74, while economic growth is also expressed as a percentage value. Net borrowing/net lending is the sum of the current balance of payments and the capital balance.

Source: European Commission, Eurostat

sector prior to the Scandinavian crisis of 1991–1992 played a major role in the escalation of the situation, commercial banks, once again, played a key role during the time of the 2008 external shock. Events, however, took a very different turn. In the years before the crisis, credit institutions were not faced with domestic credit demand of such magnitude that would have threatened the healthy functioning of the economy. Domestic lending was characterised by only moderate debt accumulation: thanks to their well-functioning risk alert mechanism, players of the financial intermediary system were capable of adjusting to the macro-economic conditions that had changed radically in the autumn of 2008. In addition, in 2010 the money market supervisory authority imposed further limits on mortgage lending, and by raising bank equity requirements, it reduced the risks threatening the financial system.

The outstanding liabilities of Baltic states towards Swedish commercial banks, however, pointed to a grave situation down the line. In the early stages of the crisis, the maturing high-volume debts of the affected commercial banks threatened that the Swedish state may have to intervene in the interest of the uninterrupted operation of the domestic banking system, which in turn would have depleted the accumulated reserves. In addition, the economies of the debtor countries went into

freefall at the end of 2008 which, through bank interlinkages, carried the risk of regional contagion. The first favourable signs surfaced at the beginning of 2010: the economies of affected countries appeared to be stabilising, Estonia's downturn dropped to 2.7 per cent; while that of Latvia and Lithuania fell by 5.3 and 1.9 per cent, respectively. By this time, the rising of the yield curve has also reached its peak, and in July 2010 long-term interest rates (the 10-year yield level) dropped below 10 per cent in all three Baltic states.

Although the aggregate impact of this process was positive overall, the tensions caused by the global crisis were eased only in part. As the May 2013 report of the International Monetary Fund reveals, fears concerning growth grew stronger as the European debt crisis stretched on: the economy decelerates in line with the key trading partners, and the government can only partly offset the difficulties arising from the deterioration of the external environment (2013b, p. 1). The same fear can be perceived in relation to the over-heating of the economy. Housing loans are increasing in number in spite of the tightening of lending conditions; meanwhile, starting from 2008–2009, the unemployment rate rose to 8–9 per cent (a relatively high level compared to previous years), with an undoubtedly negative impact on loan repayments.

Finally, seemingly unrelated to the economy, there are two things that give cause for concern regarding crisis management. Firstly, the street demonstrations that began in May 2013. These demonstrations scare away capital investments or at the very least, confound foreign investors. Secondly, the fact that in September 2014, the country's political stability came under considerable pressure. The far-right formation Sverigedemokraterna (Swedish Democrats) grew stronger at the parliamentary elections at the expense of moderate parties, which instilled considerable doubt in outside observers. Both series of events carry grave political-economic policy dangers as far as the future is concerned.

FRANCE

The crisis that deepened in the Eastern part of Europe in October 2008 inexorably pointed out that liquidity difficulties and structural weaknesses do not go unpunished. Over time, however, the question that moved increasingly to the forefront was which region would fall victim to the crisis next. Following Central and Eastern European economies, the crisis spread to the Southern countries before reaching Western European states. By that time, the progress of the crisis was relatively well known, but its consequences varied from country to country. Looking back, in the case of the French economy only small signs pointed to the possible emergence of future troubles (IMF, 2008b; 2013c). Although before the crisis the country maintained an extensive welfare state with a high redistribution and centralisation rate, at the end of the 1990s and in the 2000s, the French economy was characterised by low inflation, external balance, relatively low budget deficit and moderate growth. As a result, public debt did not increase drastically either, rising only 10 percentage points between 2001 and 2008, edging close to 68 per cent of GDP. The question is how the crisis unfolded in the face of the apparent stability of the country.

As the July 2010 report of the IMF clearly pointed out, one of the primary reasons of the crisis was the emergence of unfavourable labour market developments: the 35-hour work-week introduced at the beginning of 2000, the high level of minimum wages, the high rate of public dues on wages and the early retirement scheme. The relaxed labour regulation improved employee sentiment only in

the short run, while over the long term, it had grave consequences in respect of the country's competitiveness. The aforementioned report also showed that total labour cost (wages and public dues) increased considerably in the business sector from the beginning of the decade. While the value of this indicator increased by 30.3 per cent in France between 2000 and 2008, it only rose by 5.6 per cent in Germany in the same period.

These processes also affected capital movements. On the one hand, the rise in the price of labour shifted the attention of investors to capital-intensive industries, and on the other hand, the economic rationality of certain investments was called into question. In the context of an uncertain investment environment, investors tend to have higher yield expectations than they would under normal circumstances, for fears for profitability. Despite this factor, the investment rate rose to 24.1 per cent compared to 21.8 per cent in pre-crisis years.

The most striking phenomenon observed in connection with the financial intermediary system was the marked increase in the domestic and international exposure of French commercial banks. In a liberalised world, this would not have been perceived as a dangerous process, but at the time of the 2008 external shock it raised a few serious questions. According to the June 2008 BIS report, the three countries with the largest shares in loans outstanding in the European Union were Great Britain with 24 per cent, Germany with 13 per cent and France with 9 per cent. Between 2003 and 2007, the annual credit expansion rate of French commercial banks exceeded 24 per cent in Portugal and Spain, 34 per cent in Italy and 38 per cent in Greece. The situation was exacerbated by the fact that nearly three quarters of bank loans were short-term (with maturities of less than a year) at the end of 2007 *(see Table 5)*. As a result, the events of the crisis that occurred in the Southern part of Europe at the end of 2008 and in the early spring of 2009 had an extremely harsh effect on the French economy. In other words, the oversized financial sector raised the country's vulnerability to external shocks significantly.

The unparalleled growth of international lending also led to distorted capital allocation: financing low-yield investments turned into a practice. Besides protracted and pronounced

Table 5

THE CONSOLIDATED INTERNATIONAL LOANS OF FRENCH COMMERCIAL BANKS BROKEN DOWN BY MATURITY AND SECTOR (PERCENTAGE DISTRIBUTION)

	2003	2005	2007
By maturity			
Loans maturing within one year	59	65	74
Loans maturing within 1–2 years	10	6	5
Loans maturing over 2 years	31	29	21
By sector			
Banks		61	70
State		17	11
Private sector	29	22	19

Source: BIS

credit growth, this phenomenon carried the added risk of economic players becoming overly complacent and that the expectations would deviate significantly from the fundamentals of the real economy, which would lead to the build-up of excessive capacities. Increased rates of leverage contributed significantly to the over-heating of the economies of Southern European countries.

Therefore, the weaknesses of the French economy and the unrelated global events both played a role in the unfolding of the crisis. Although the relative importance of these two factors changed from time to time, the options at the disposal of domestic policy-makers were most importantly limited by the fact that French government officials preferred a protracted approach to crisis management instead of quick adjustment. The decision-makers of the country failed to perceive the full depth of the external shock in 2008; within the government and even the economic community, the debate over dwindling funds versus excessive government reaction took precedence at the time. The latter position was reinforced by the fact that carrying out structural reforms within the French economy has been traditionally difficult due to trade union resistance, which meant that the risk of social instability was rather high. Moreover, the room for manoeuvre for French President *Nicolas Sarkozy* (Union for a Popular Movement, UMP) was further reduced by the campaign promises made to certain groups during the 2006–2007 electoral campaign.

From February 2009, risk premiums went up drastically in the money markets of developing countries, exerting mounting pressure on French government officials. Finally, by the summer of 2010 it became clear that the countercyclical budgetary policy launched to counteract the crisis could not be continued further: public debt rose at a rate that made the adjustment unavoidable (up 16 per cent in the span of a year between 2008 and 2009). The expenditures of the budget rose to 56.8 per cent of GDP by the end of 2009 compared to 53 per cent in 2008. While revenues of the budget did not change at such an exorbitant rate during the same period, with revenues dropping from 49.8 per cent of GDP to 49.6 per cent, central budget deficit increased significantly (by 7.2 per cent).

Even the IMF voiced some concern that the processes could become unmanageable if the French authorities were unable to turn the direction of the country's economic policy around. The July 2010 report of the IMF (pp. 3–6, 2010) points out that even though the recession affecting the country might have been less severe than elsewhere in Western Europe, it was mainly related to the country's relatively low exposure to international trade and its generous social safety net. At the same time, they expressed deep concern over the alarming increase in public debt during the period of financial turbulence and the continuously deteriorating quality of the assets held by the financial sector.

Two external circumstances also played a role in the commencement of the consolidation process. Southern European countries faced mounting pressures; the Portuguese state had to come up with USD 45 billion to ensure financeability, while Spain and Italy needed to raise USD 340 and 525 billion to do the same. This explicitly had a negative impact on the French economy. Secondly, from the autumn of 2009, global money markets were characterised by relatively high liquidity. As a result, countries suffering from imbalances and high external debt had sufficient time to start the structural change.

However, the adjustment efforts of countries affected by the structural change were only partly successful, and the French economy was no exception. The primary reason for this is that they were too late in facing up

to the true risk of procrastinating policy. In this respect, it may be considered a mitigating factor that there was excessive optimism in professional circles at the time. The launch of the Fed's (*Federal Reserve Board*) quantitative easing in December 2008, the continuous cuts of European and US base rates and the robust 4 per cent growth of the German economy (2010) were signs that led the countries concerned to believe that the growth trends of past times would return once again. Another contributing factor was the change in the domestic economy. In the spring of 2011, the growth of the French economy faltered, and in 2012 Q2 it actually decelerated in real terms. Key sectors, such as tourism, real estate investments and bank lending – which, under normal circumstances, are drivers of the economy – deteriorated.

The consolidation process, however, was not interrupted even in the face of these ominous circumstances. Although stabilisation efforts proved to be insufficient compared to the previously outlined scenarios *(see Table 6 and Figure 3)*, this reflected, besides weakening commitment, a number of successive crisis periods. The capacity of the French economy for debt service largely depends on how consistently it is able to implement the structural reforms underlying budgetary discipline. These measures were aimed primarily at reducing the state's redistributive role. Under such circumstances, the deficit reduction was accompanied by a very lax monetary policy: first the US monetary authority, then central banks across the world lowered base rates and provided an abundant supply of money.

In addition, the external financing position also made the economy vulnerable to external shocks, mainly because of the over-spending of the public sector. Despite all this, the officials of the French government did not strive to create a comprehensive fiscal rule (EB, 2012). The main budgetary requirements – i.e. the deficit-free financial management of local governments (1983; 1987), the expenditure ceiling imposed in healthcare (1997) and the limiting of state expenditures (2004; 2011) – implied more lenient expectations than the Maastricht deficit criterion.

As was the case during past crises, at the turn of 2012–2013 the most important question of French crisis management was how to put the country on a sustainable, high growth path. The concurrence of a number of factors plays a role in recovery. The first factor is the

Table 6

THE REVENUE AND EXPENDITURE SIDE OF FRANCE'S BUDGET BALANCE: ACTUAL FIGURES VS. HYPOTHETICAL SCENARIOS. 2010–2014 (AS A PERCENTAGE OF GDP)

	Revenues					Expenditures				
	2010	2011	2012	2013	2014	2010	2011	2012	2013	2014
Actual	49.5	50.7	51.8	52.8	53.2	56.6	55.9	56.7	57.1	57.2
First scenario*		50.8	51.5	52.1	52.2		55.9	55.8	55.1	54.2
Second scenario**	47.6	48.6	49.1	49.8		55.8	54.6	53.7	52.8	

*Assumption: based on the Stability Programme submitted in 2012.

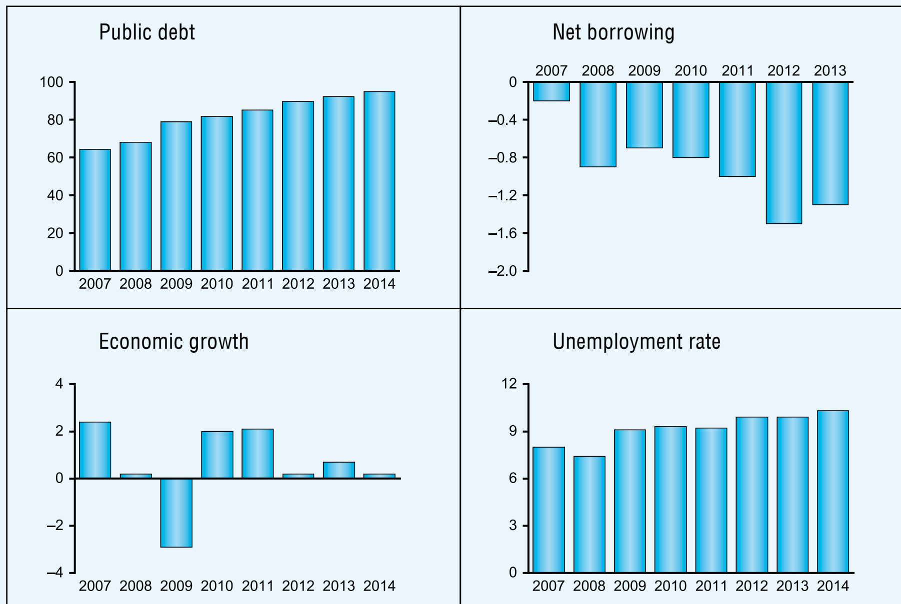
**Assumption: based on the Stability Programme submitted in 2010.

Methodology note: budget figures in 2010–2013 based on ESA 95. and in 2014 based on ESA 2010.

Source: European Commission

Figure 3

FRANCE'S KEY MACRO-ECONOMIC INDICATORS, 2007–2014



Note: Public debt and net borrowing/net lending are expressed as a percentage of GDP; the unemployment rate indicates the percentage value of unemployed persons compared to the total number of the population between the ages of 15 and 74, while economic growth is also expressed as a percentage value. Net borrowing/net lending is the sum of the current account and the capital account.

Source: European Commission, Eurostat

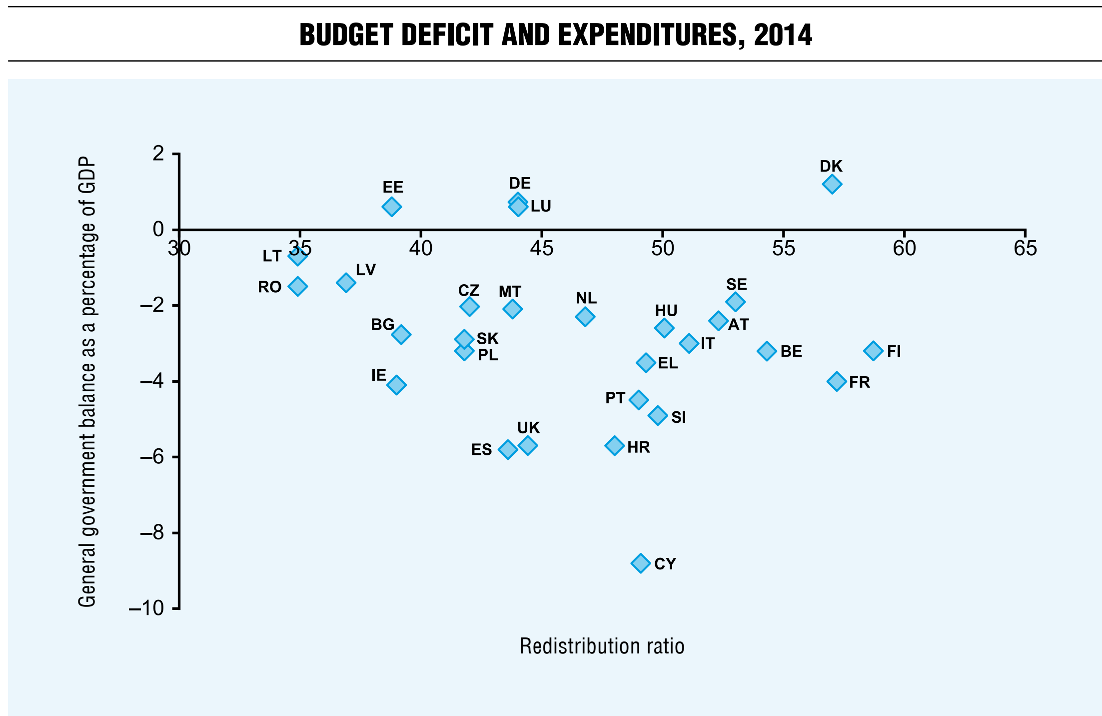
extent to which the demand generated by the Asian region is able to boost European – in particular, French – exports. The relatively low growth rate in the region exacerbates the situation of the countries that have close economic and trade relationships with it. The second factor is the magnitude of the write-offs to which French commercial banks will be forced owing to their various toxic assets. The actual value of the risks in their domestic and international portfolio can only be guessed. The final question concerns the competitiveness-improving measures the French authorities can make while maintaining the existing strict fiscal policy.

Although the structure of the budget adjustment is highly objectionable, the intervention by the state undoubtedly reduced the deficit of the government sector. In international comparison, the state's role in redistribution remains excessively high *(see Figure 4)*. It is striking that the state size of Northern countries (Denmark, Finland) is only marginally larger, and that Central-Eastern European countries with relatively high growth rates have substantially lower redistribution rates. If the reduction of the budget deficit is not combined with a persistent curtailment of the state's redistributive role, the risks threatening the French economy cannot be priced in, which could lead to grave consequences.

The process in question was accompanied

Figure 4

BUDGET DEFICIT AND EXPENDITURES, 2014



Source: European Commission, Eurostat

by a favourable phenomenon: compared to the first phase of the crisis, the unemployment rate did not change drastically, increasing from 8–9 per cent to only 10–11 per cent. In other words, social cohesion was not beyond repair.

At the same time, the Greek events that started at the beginning of 2015 may shake capital markets, and the exit of Greece from the euro area appears to be a realistic threat. Even if the disaster scenario does not materialise, the uncertainty of investors could still hinder the budding European growth trend, which in turn would greatly impact the French economy and most importantly, the domestic fiscal adjustment path may not progress according to the best scenario.

Nevertheless, the majority of economists feel that French economic governance is repaying a decades-old debt. Serous measures have been taken regarding the reform of the economy's structural foundations, with such topics placed repeatedly on the agenda as the abolishing of the 35-hour work-week. This increased confidence is supported by favourable capital movements, the yield levels in the government securities market and real economy processes. However, for the outside observer the country's performance falls short of expectations without a doubt, which only partly reflects the prolonged crisis management method favoured by the French authorities.

SUMMARY

This study examined crisis management in the light of fiscal policy. Before the global crisis, economic policy debates across the world focused on fiscal discipline. It appeared that 'large' crises could have been avoided with a conservative budget policy, and the ruling

notion was that the current account deficit only had significance if it could be traced back to the deficit of the government sector (Lámfalussy, 2008). The examples of the three affected countries clearly show the intensity with which previously underestimated risks can bubble to the surface. Of the narrowly or broadly interpreted lessons, the following merit repeated mention:

❶ Only in a handful of cases can the point of origin of a crisis be traced back to irresponsible fiscal management. More frequently, troubles stem from the dysfunctional operation of areas distant from the budget; however, ultimately this upsets the fiscal balance in any case. It is the role of financial supervisory authorities to assist the process of sober risk assessment through useful guidance and to prevent the creation of various asset price bubbles.

❷ The drastic deterioration of the external financing position is not necessarily accompanied by the instability of the budget, and the over-heating of the economy could in fact facilitate a high volume of tax revenues. The causal chain, however, also works the other way around. In case of an external shock, the state may find itself in a very difficult position not only because of the unsecured debts of economic players, but also due to the real economy effects, and this plays an important role in losing fiscal discipline.

❸ Similarly, the sharp rise in the financial sector's exposure to other countries may lead to grave problems and could increase the vulnerability of the domestic economy. In order to avoid this, the harmonisation of the activities of national financial authorities is required. If more than one country is in trouble, the options of the economic policy also become highly limited due to the more severe impact of the crisis (Blanchard – Leigh, 2013).

❹ Excessive fear of crises may force decision-makers to overreact. The economy does not need to be protected from smaller recessions as intervention into market processes could lead to a loss of 'realistic pricing' among market players. The over-treatment of small crises may lead to a global crisis (Rostowski, 2010).

Notes

[1] Von-Hagen (1992) proved empirically that the weight of officials responsible state finances within the government (such as the Finance Minister) also has outstanding significance in respect of budgetary discipline.

[2] Lámfalussy (2008) considered the conduct of correct economic policy as responsible fiscal and conservative monetary policy.

[3] Under the so-called Vienna Initiative, Western European commercial banks pledged to maintain exposures to support their distressed subsidiaries in Central and Eastern European countries.

[4] The exposure of the two Swedish commercial banks was distributed unevenly among the three Baltic states, with primarily the Estonian financial sector accumulating considerable debt.

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