Ádám Török*

Fiscal policy in the service of sustainable growth

The post-2008 international investment climate is quite unfavourable to fiscal policy disturbances and growing budget deficits, much more so than in pre-crisis times. Growing investor sensitivity may make external financing of budget deficit and government debt quite difficult, but the growth perspectives of the national economy may also largely suffer. Rules-based fiscal policy models are increasingly considered helpful in preventing such disturbances, and this beneficial effect is usually enhanced by the existence of an independent office of fiscal policy analysis and monitoring. As of this day, four member countries of the EU maintain such an institution, including Hungary. Their positive experience has encouraged other countries (as the UK for example) to seriously consider the creation of such an institution.

Amid severe repercussions of the crisis observed since 2008 in terms of increasing deficits and indebtedness, the sustainability of fiscal policy has come into focus across most of the global economy.[1] This rather serious global problem has approached dramatic levels in certain regions and countries.[2] The international press has often voiced concerns about a number of euro area Member States – primarily those in Southern Europe –, that they merely delayed sovereign default and ultimately, they would have to face it 5–10 years down the road–. Indeed, it is unlikely that these countries can permanently forestall the increase in their public debt, which is already above the critical 90 per cent of GDP.[3]

In the first decade of the new millennium, the Hungarian economy has struggled with increasing public debt levels nearly continuously. In 2010 the Hungarian national debt-to-GDP ratio stands at 83 per cent compared to a ratio of approximately 50 per cent recorded at the beginning of the decade. Not only is it much higher than the 60 per cent Maastricht criterion, but it is also approaching the critical ratio and, based on international experience, once that threshold is exceeded chances of a sustainable decline in public debt diminish.

In general, false alarms about national bankruptcy or a similar financial disaster largely restrict the room for manoeuvre of a reasonable and sustainable fiscal policy and deteriorate its international reputation. In this respect, caution is warranted also because the concept of

* The original version of this article was delivered as a plenary presentation at the annual Itinerant Conference of the Hungarian Economic Association on 30 September 2010 in Szeged. The author owes a debt of thanks to György Kopits, László Jankovics and Zoltán Jakab M.; however, the article does not necessary reflect the position of the Fiscal Council in all topics covered by it.

sovereign default has a broader interpretation in the technical literature than in the traditional sense and today, in addition to direct insolvency, it also implies the rising of government bond risk premia above a pre-defined critical threshold (Pescatori – Amadou, 2007). However, we should bear in mind that averting the out-of-control soaring of public debt and ultimately, the sovereign debt crisis, remains a key principle of sustainable fiscal policy. A debt crisis (or even an excessive public debt level) could have severe repercussions not only in terms of finances but also in terms of growth.

According to an OECD study (Furceri – Zdzienicka, 2010) analysing the experience of 159 countries and summarising the lessons of the period of 1970–2006, one year after the outbreak of a debt crisis growth losses may reach 3–5 per cent of GDP, and may even rise to 6–12 of GDP in 8 years' time. The debt crisis is expected to generate an additional 0.7–0.8 percentage point GDP drop in countries where public debt-to-GDP already exceeds the 90 per cent threshold defined as especially critical by *Reinhardt* and *Rogoff*.

According to another source, debt crises and sovereign default should be avoided in consideration of the various costs involved which, although often unpredictable, are invariably substantial (Borensztein – Panizza, 2009). These costs include reputational costs (in other words, the consequences of deteriorating international confidence in the specific country), international trade exclusion costs, increased operating costs to the domestic economy and political costs to the government.

The need to prevent debt crises has come to the foreground not only because of the financial damages involved. The consequences of the crisis seriously jeopardize the economic growth in the countries concerned in the government, corporate and private sectors alike. After a debt crisis, amid a steep decline in income, savings and consumption domestic capital supply may be considerably curtailed by the outflow of private funds. Consequently, in addition to developing prevention plans against a debt crisis as well as a systematical protection strategy – one that is taken seriously enough even before the alarm bells start ringing –, the conditions for a sustainable budget and hence, long-term economic growth must be ensured continuously, without regulatory or substantive compromises.

The new strategy for the fiscal policy of the European Union – the outlines of which were only emerging, albeit with a strong direction, at the end of October 2010 – is intended to introduce the principle of sustainability in this area as well, and to stand up against the former indulgent and wasteful – yet, inefficient – fiscal policy stance, the so-called 'fiscal alcoholism' (Kopits, 2006). The heretofore disclosed elements of the strategy claim that transparency, accountability and enhanced responsibility are required in fiscal policy, for strict compliance with these principles can largely contribute to regaining and retaining the confidence of international investors over the long term. These are also the fundamental pre-requisites of maintaining long-term financial stability within the euro area, the importance of which was particularly underpinned by the Greek debt crisis in the spring of 2010.

Following the political transition, Hungary had politically-driven, regular, four-year fiscal cycles until 2006. This meant that election years invariably saw soaring budget deficits with a corresponding increase in public debt. Similar cycles could be observed in other transitional countries as well, such as the Czech Republic and Poland. However, the swings of the cycles were less wild in those countries and public debt did not escalate to excessive levels. In some EU Member States of the region, such as Slovenia, Slovakia and the Baltic States, the elimination of fiscal political

cycles and the fundamental transformation of the system of public finances have become an organic part of the reform process (Kopits, 2009). However, there were significant differences. For example, instead of adopting major reform measures, Slovenia preferred a pragmatic approach; the Baltic states, in turn, relied on a so-called external anchor while they enjoyed the benefit of not having a debt burden inherited from before 1990.[4]

As a result of poor fiscal policy decisions and the cyclicity pointed out above, Hungarian public debt as a percentage of GDP has been growing continuously for the past 8–9 years, and in 2010 the debt-to-GDP ratio significantly exceeds the values recorded in all the other new EU Member States.[5] *(See Chart 1)*

The international credit market has become more sensitive since the outbreak of the Greek crisis at the beginning of 2010. A number of euro area Member States (Spain, Portugal and Ireland beside Greece) have been put on credit watch already. Investor confidence in new EU Member States – including Hungary – has notably deteriorated.

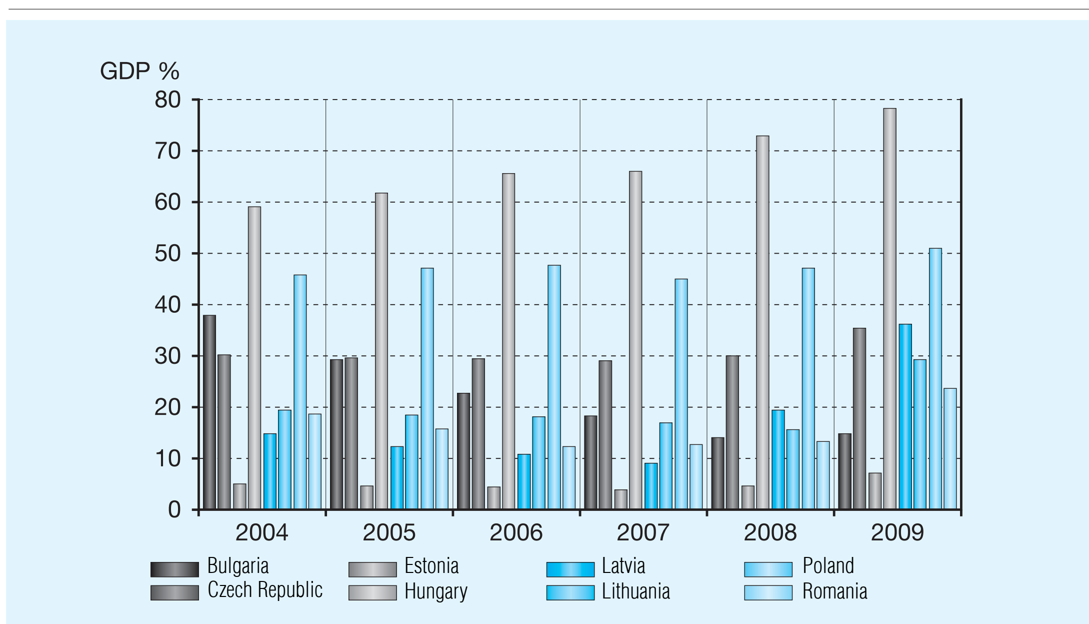
The wild swings observed in investor confidence demonstrates how jittery the market is. Until the first round of the parliamentary elections in 2010, the risk premium on Hungarian government securities has gradually declined. However, the investment appetite of non-residents was temporarily reduced by the impact of a number of unexpected political statements (the so-called 'communication surprises') and by the renewal of budget transparency problems following the episode in 2009 (such as a lack of comparability of some annual data and the removal of the loss relief of state-owned companies from the budget).

Between April and September 2010, the CDS[6] spread on Hungarian government securities – a measure of investors' confidence or, more precisely, their perception of a country's risk – increased to nearly 380 basis points from

Chart 1

GROSS NATIONAL DEBT AS A PERCENTAGE OF GDP

(Maastricht indicator)



Source: Fiscal Council Secretariat

around 200 basis points, while it remained consistently below 200 basis points for Czech, Polish and Slovakian government papers. *Chart 2* indicates particularly nervous swings in the Hungarian CDS spread from January 2009. In the first decade of the 2000s, up until the beginning of 2008, the spread did not rise above 50 basis points in Hungary; however, in the ominous atmosphere of October 2008 it soared to 600 basis points. It declined subsequently before starting to exhibit nervous fluctuations again in the summer of 2010.

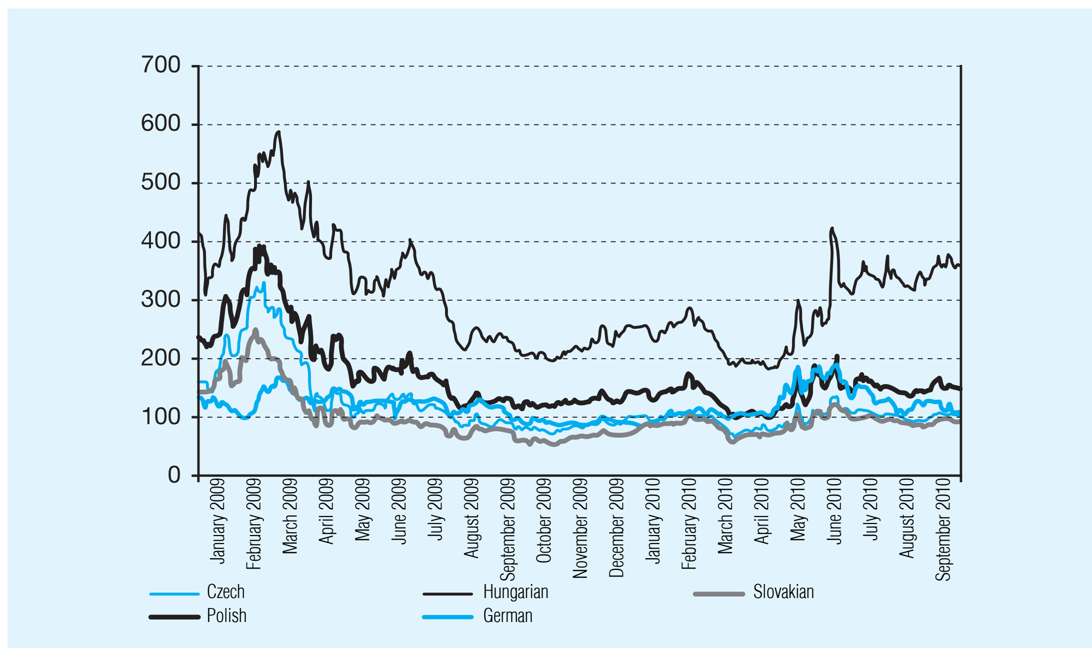
It was not only the international markets that became more sensitive to the fiscal balance issues of specific countries, but also the institutions responsible for fiscal matters across the European Union and worldwide. Accordingly, in Brussels preparations for the reform of the contents of the Stability and Growth Pact were put on the agenda. This reform would not modify the so-called Maastricht criteria as such, but it would establish conditions for their more stringent and permanent control and accountability. According to the new approach, dual control (legality and substance) would be introduced over the fiscal policies of the EU Member States.[7]

In practice, this would translate into the general application of the so-called rules-based fiscal policy models in Europe. A rules-based fiscal policy limits the annual deficit level or the public debt level for a pre-defined, usually longer-term period, primarily based on the recognition that in parliamentary democracies there is continuous pressure on economic policy-makers to increase budget expenditures and slash revenues (more specifically, taxes). This recognition is associated primarily with the representatives of the *public choice* theory (Vass, 2006, pp. 61–62).

Dual control over the fiscal policies of the Member States could be put in place by assigning independent national institutions to play this role alongside the European

Chart 2

10-YEAR CDS SPREADS



Forrás: Reuters/Datastream

Commission, or even a separate agency established by the Commission for this purpose. The co-operation between the national fiscal regulatory systems and an EU-level independent monitoring system would be able to issue an alert, jointly and truly credibly, if the gross national debt of a specific Member State exceeded 60 per cent of the gross domestic product or if the rising of the ratio pointed to unsustainability. Contrary to current practice, legal or financial sanctions could follow the collapse of the budget balance.

In most of the Member States (in 15 countries so far), such institutional reforms have already begun, or have been firmly put on the agenda. The first step is generally aimed at the adoption or maintenance of tighter fiscal regulations. The example of Poland should be highlighted, where the rising of public debt above a certain threshold (55 per cent of GDP) is tantamount to breaching the constitutional limit. Elsewhere – in Germany, for instance –, while the rules are not as strict in the formal sense, fixed fiscal regulations ensure the long-term predictability of the deficit and debt paths.

In other countries the objective is to establish an independent supervisory institution for the fiscal policy. An independent institution is a stronger instrument for ensuring the sustainability of the fiscal policy, because it can determine the practical directions of fiscal policy and budget planning without being influenced by the government. In addition, it can demonstrate to the public that fiscal policy can be influenced by external constraints stronger than potential political commitments (Benczes – Kutasi, 2010, pp. 157–159). This could ensure such an independent institutional anchor for fiscal policy, which may even assume a part of the government's professional (but not political) responsibility towards the society for unpopular fiscal policy decisions.[8]

Such institutions are already in place in four Member States (Belgium, Holland, Sweden and Hungary), albeit with different competences and responsibilities for the time being. Since February 2009 this institution in Hungary has been the independent Fiscal Council. The British and Romanian governments have been studying the Hungarian experiences[9] with a view to establishing a similar institution.

Professional arguments for the rules-based Hungarian fiscal policy stress that the yields on Hungarian government securities are not only sensitive to market and macroeconomic facts, but also to communication. As such, a communication surprise or mishap may translate into fact or serious market information. Thus they can strongly influence the market perception and risk premium of Hungarian government securities – in other words, the debt service commitment –, even if macroeconomic facts would not otherwise warrant concerns or anxiety.

Hungarian fiscal performance and achievement of transparency have recently been in the focus of increased international attention by the EU authorities, the international markets and credit rating agencies. Carefully planned communication, transparency and the clear direction towards sustainability may have a favourable impact on the mood and decisions of international investors. It could improve credibility if the Hungarian financial government complied with the 'paygo', i.e. the mandatory consideration rule, from as early as 2010 and the real debt rule applicable to the long-term balance from 2012.

The first serious test is the 2011 budget and the implementation of the mid-term fiscal strategy. Not only the pre-defined deficit target (of 3% or less by 2011) will be monitored in Hungary, but also compliance with the requirements that are necessary in order to put real debt on a declining path and improve the long-term investor perception of the country. This would put an end to the detrimental self-fuelling processes which increased the public

debt of Hungary from the beginning of the new millennium without boosting economic growth. By doing so, they further deteriorated the criteria system of debt repayment.

Indeed, a vicious circle has developed. Between 2001 and 2010, Hungarian economic leaders could not even use the excuse cited frequently abroad for the increasing level of debt, namely, that debt increased year after year to increase the growth potential of the economy and forestall a crisis. It is a deterring textbook example when, instead of laying down foundations for the future, a country uses expensive external borrowing to cover its current needs, thereby imposing further limitations on its own growth potential. This government stance is especially typical in countries with an ageing population. In those countries decision-makers are under a stronger social pressure to change the re-distribution of the budget in favour of the older age groups (Kopits, 2009, p. 73). This is an absolutely understandable ambition from a social and a political perspective. However, if the budget redistribution improves the welfare position of the older age groups without offsetting it by reduced financing for other expenditures, efforts to reduce public debt will be inhibited.

The chance of breaking out from the 'vicious circle', and create an 'angelic circle' is in the hands of the government. However, in these efforts it is important to consider the independent analyses and proposals that were prepared with a few to furthering the sustainability and transparency of fiscal policy. The Hungarian experience has proved (and serves as an example for a number of countries including the United Kingdom and Romania) that fiscal policy could become more controllable and predictable if, in addition to stricter regulations, an independent public monitoring institution was put in place (one that closely follows the fiscal processes and issues a warning as soon as the first signs of risk materialise).

With the support of these factors the Hungarian economy could step onto a truly sustainable growth path sooner. The sustainability of the budget and hence, growth, is a necessary requirement for increasing the inflow of external capital investment as well. In any case, it will contribute significantly to reducing the risk premium on Hungarian government papers and thereby easing the interest and debt burden.

Notes

[1] According to certain sources, the issue of fiscal sustainability has been in the focus of attention of economic research since the beginning of the 1980s (e.g., Vass, 2006). Without an intention to argue with this statement we should note that it was in 2007-2008 that the issue grew to become a crucial problem of national economic policies. However, the interpretation of the concept has been extended since then, and today it also covers the adequate economic growth rate and the growth rate and value of the real interest rate (Benczes – Kutasi, 2010, pp. 72–73).

[2] See, for example, Reinhart – Rogoff (2010), Furceri – Zdzienicka (2010)

[3] For this see Reinhart – Rogoff (2010)

[4] The Latvian debt crisis warns that the fiscal political reforms of the Baltic States did not succeed everywhere. The world took notice of the Latvian crisis in June 2009, when Latvia failed to sell any of the treasury bills offered for sale at the auction following the issuance of government securities worth USD 100 million.

[5] The situation of Hungary should only be compared to EU Member States which are at a similar stage in development. In Japan and Italy, for example, the public debt-to-GDP ratio is around 200% and 120%, respectively. However, these countries are much less exposed to foreign creditors because, for the time being, they have sufficient domestic savings to ensure the sustainable financing of their public

deficits. In addition, these two economies are far more advanced than the Hungarian economy, which could be viewed by external creditors as a stronger guarantee.

[6] Credit Default Swap, in other words, the probability of the government's default on the loans it has taken (practically a guarantee indicator).

[7] However, as of early November 2010 it is still unclear whether the European Union will adopt the more stringent and consistent 'Northern' (German, Dutch, Scandinavian), or the more permissive 'Southern' (French, Italian, Spanish) principles to serve as a basis for the control of fiscal policies and the sanctions for non-compliance with national fiscal targets.

[8] As János Kornai pointed out, the independent supervisory institutions of fiscal policy cannot participate in political decisions; however, they are certainly entitled to criticise them on the strength of their own professional criteria (Kornai, 2010).

[9] For more details see Kopits – Romhányi, 2010

Literature

Benczes I. – Kutasi G. (2010): Költségvetési pénzügyek *(Fiscal finances)*, *Akadémiai Kiadó, Budapest. p. 358*

Borensztein, E. – Panizza, U. (2009): The Costs of Sovereign Default, *IMF Staff Papers 56, pp. 683–741, November,) | doi:10.1057/imfsp.2009.21*

Furceri, D. – Zdzienicka, A. (2010): How Costly Are Debt Crises? *OECD Economic Department Working Paper, p. 37 Available for download: papers.ssrn.com/sol3/.../SSRN_ID1653855_code367824.pdf*

Kopits Gy. – Romhányi B. (2010): Lessons from the start of the Fiscal Council, *Közgazdasági Szemle, year LVII, July–August, pp. 573–590*

Kopits, Gy. (2006): The Sickest Men of Europe, *The Wall Street Journal Europe, September 21, p. 13*

Kopits, Gy. (2009): Political Economy of Fiscal Reform in Central and Eastern Europe, *Competitio, year VIII, volume 1, pp. 1–10*

Kornai, J. (2010): Where is the line between independent economic analysis and active policy making? The example of the independent fiscal councils, *Acta Oeconomica*, *Volume 60/3, pp. 249–254*

Pescatori, A. – Amadou, N. R. Sy. (2007): Are Debt Crises Adequately Defined? *IMF Staff Papers 54, pp. 306–337, 1 June | doi:10.1057/palgrave.imfsp.9450010*

Reinhardt, C. M. – Rogoff, K. S. (2010): From Financial Crash to Debt Crisis, *National Bureau of Economic Research Working Paper 15795, March, http://www.nber.org./papers/w15795. p. 48*

Vass K. (2006): A few words on fiscal policies, restricted by regulations, *Competitio, year V, Volume 1, March, pp. 59–79*