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Crisis and consolidation

Is there a way back to fiscal rules?

For long decades, it had been a prevailing opinion in economic science that the state has to formulate its classical functions – such as stabilisation, allocation and redistribution – in a discretionary manner, i.e. conforming and reacting to the current circumstances. In the past decades, however, more and more developed and emerging economies chose the way of limiting the discretionary policy with rules. While prior to the early 1990s fiscal rules had been introduced only in some and decisively developed countries, in the last two decades – not irrespective of the waves of indebtedness of the 1970s–1980s and the start of monetary cooperations (especially the European Economic and Monetary Union) – an increasing number of states decided on applying fiscal policy rules. In 1990, only seven countries used national-level rules. Barely twenty years later, already some eighty states limited the scope for action of their respective fiscal policies in this manner (Kumar et al., 2009).

It is an undeniable fact that, by definition, an ad hoc economic policy is a more flexible or even more efficient means of stabilisation than rule-based policy, which requires commitment, and can only be considered as the second best solution (Barro and Gordon, 1983). Nevertheless, numerous countries were of the opinion that the additional benefit stemming from following the rules would be able to adequately compensate for the lost opportunities, which is reflected, inter alia, in the strengthening of long-term fiscal sustainability. The popularity of fiscal policy rules – similarly to the rules implemented in monetary policy, then to institutional independence – was primarily explained by the fact that their use allowed the control of the self-centered discretionary policy, which jeopardised social welfare. The introduction of the rules paved the way for depoliticising budget policy (Kopits, 2001).

The popularity of fiscal rules had proven to be unabated all the way until the economic crisis that erupted in the USA in the spring of 2008, and subsequently became global, gained ground. *The responses to the crisis*, which basically concentrated on artificial incentives to aggregate demand, especially on making money cheap and on the upswing in fiscal expenditures, *put rule-following economic policy in brackets in most countries* for quite some time. Almost without exception, the countries affected by the crisis started to refer to the various relief clauses or, if such did not exist, simply ignored the limits posed by the rules.

In our paper – which is based on the research results and findings in our recently published book entitled *Költségvetési pénzügyek* (*Fiscal finances*)[1] – we examine what *could have justi-*

fied the application of discretionary economic policy following the crisis and together with this the violation of fiscal policy rules that had previously been said to be successful, and *whether there is any return to rule-based economic policy*. First, the crisis is outlined in brief, then the practical side of crisis management is scrutinised, reviewing the reactions of the USA and the large decisive countries of the EU. Finally, the forms of actual use of fiscal policy tools are evaluated with the obvious intention to prove that there is a way back to fiscal discipline.

CONNECTION POINTS BETWEEN THE CRISIS AND PUBLIC FINANCES[2]

Prior to the crisis, a sizable real estate market boom and bubble evolved in the USA.[3] Owing to expectations regarding price increases, it was possible to encumber real estate with additional (*subprime*) mortgage borrowing. Demand for real estate of a speculative nature (not with an intention to live in, but to rent or sell at a higher price) increased substantially, which pulled real estate prices upwards, and increased the ratio of real estate intended to be sold in the short or medium term within the stock of real estate.[4] Mortgage loans were financed by financial institutions by issuing mortgage bonds, in the forms of various so-called mixed mutual fund shares and bonds, which then were typically included in the highest categories by rating agencies. However, these 'structured' debt bonds represented the AAA quality, which is considered risk free, to a lesser extent, and were typically included in the category of the so-called junk bonds. The 'packaged' securities, in turn, were bought up in good faith by numerous US and European financial institutions as well as investment and pension funds.

The international shock triggered by AIG and Merrill Lynch, which in September 2008 took refuge in chapter eleven, and by Lehman Brothers, which asked for protection in vain, entailed two important consequences. First, confidence among financial institutions was shaken, which froze the functioning of the interbank credit market for a short time, and contained it in the medium term as well. Second, it was also unclear what exactly would happen to the financial giants that got into a difficult situation. The financial institutions that went bankrupt were either to be liquidated (as it happened to Lehman Brothers), leaving large amounts of debts behind and risking a rippling bank panic; or the state would make up for the funds that disappeared in the bond market. An argument for liquidation would have been that banks with a bad capital structure would have disappeared from the markets in a relatively short time, and the money market would have rapidly punished and terminated the hidden defects of the banking system. However, two peculiarities of the banking sector had to be taken into account: (a) liquidation results in further panic in the market, and (b) non-financial enterprises cannot effect payments to one another, or cannot borrow from others' savings. Therefore, in terms of economic strategy, owing to the unforeseeable risks, bank consolidation and replenishing the banking sector with money in the USA became inevitable in the short term.

Following the developments outlined above, the economic crisis, which became global by the autumn of 2008, resulted in a shrinkage of the gross domestic product, or at least in a deceleration of its growth rate. The downward branch of the growth cycle started: employment declined, households lost a part of their income, which also resulted in a deterioration of their creditworthiness. The income loss and the deterioration in creditworthiness resulted in a considerable fall in the consumption of the private sector as well. This process was exacerbated by the fact that

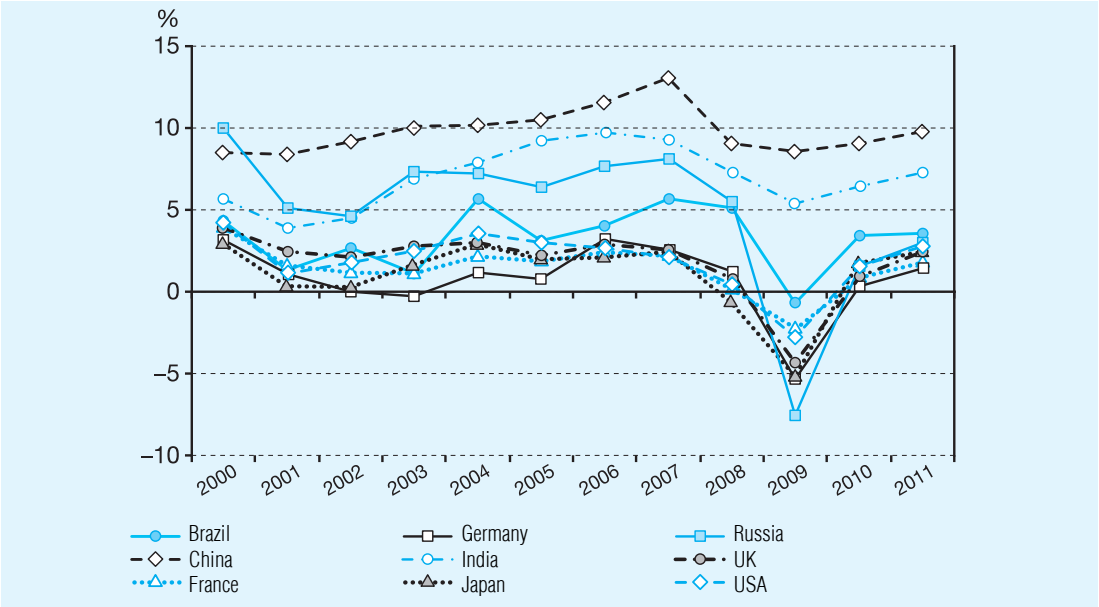
the household sector, seeing the protracted nature of the crisis, was not only unable to spend its lost income, but it even increased (more precisely: it had to increase) its reserves (savings) compared to the previous years in order to finance living in the medium term and to mitigate the risks of indebtedness. For the corporate sector all this meant a fall in demand for products/services, triggering and strengthening a decline in employment. At the same time, the declining demand also entailed a considerable fall in prices, not only in the markets of energy inputs, but also in the markets of finished products, consumer durables, food and real estate. Following from the demand/supply correlations of the commodity market, the declining prices – depending on the extent of price elasticity – encouraged enterprises that produced the supply to cut their output. And this can be done by using fewer employees as well. *Therefore, the global economy was compelled to face a shrinkage spiral in which the reduction of consumption and the termination of jobs could become mutually reinforcing developments, which was exacerbated by the danger of deflation. Chart 1* depicts the changes in economic performance in the 2000s.

As the US economy, which absorbs around one fifth of the world trade as imports, was the first to be affected by the slowdown/shrinkage, the fall in demand made its impact felt in other parts of the world as well through trade relations within a relatively short time. As a result, in the last quarter of 2008 world trade already fell by 6 per cent compared to the last quarter of the previous year (WTO, 2009). As the growth of Europe and of the developing and emerging economies is also of a strongly export-oriented nature, the shrinking of the demand in the US market imposed a significant burden on the economies of these countries as well.[5]

Thus the US financial crisis of 2007 already led to a crack in the global loan market and to

Chart 1

ECONOMIC GROWTH IN MAJOR ECONOMIES OF THE WORLD, 2000–2011



Note: change in GDP, per cent. The year 2009–2011 values are based on forecasts.
Source: IMF (2009a)

the shrinking of the real economy by 2009. Distrust prevailed in global credit markets, financing the public debt in certain countries posed significant challenges, as a result of risk aversion investors were fleeing from the market of lower-volume currencies, which resulted in considerable depreciation and monetary crisis. Partly as a result of the real estate market shock and partly as a consequence of the depreciation of national currencies, the ratio of non-performing household loans also increased. Governments were compelled to apply expansive solutions to stimulate the economy in a creative manner, first of all to prevent the financial sector from collapsing.

The Fed already reached the zero interest rate level in the last quarter of 2008. The objective was to supply the economy with cheap money and discourage the saving of income to an extent that would result in a recovery in domestic consumption. Besides the zero interest rate level, *the only active tool* that remained in the hands of economic policy makers *was the fiscal adjustment channel*.[6] Banks were saved using budgetary sources and public investment was increased significantly in order to offset the fall in household consumption.[7]

Damages occurred from a money market standpoint as well. *A substantial stock of bad debts evolved; moreover, through the transmissions of securitisation it also deteriorated the bond market, and the holdings of investment funds also suffered a serious loss in value through the bond market.* The US federal government had to rescue banks. Some banks were compelled to merge. Between September 2008 and February 2009 the interbank credit market froze, i.e. in view of bankruptcies of banks, commercial banks did not dare to lend to one another either. As a result, bank transactions of non-financial corporations also became partly impossible. This solvency trap, in turn, affected inter-company trade as well.

Some of those who analyse the 2008–2009 crisis compare it to the Great Depression in 1929–1933. One of the clearest similarities between the two crises is that fiscal expansion was the main tool of crisis management 75 years ago as well. This form of government incentives also played a role in the 2008–2009 crisis. However, it must be emphasised that the current global crisis – contrary to the Great Depression in the USA in the thirties – occurred as the aggregate of several known institutional and fundamental problems of money-market, general government, monetary policy, supervisory and sectoral nature, which had always been neglected by influential political decision-makers before 2007. The 2007–2008 US mortgage market crisis – as it turned out later – rather served as a focal point only, which subsequently partly buried under itself the financial systems as well, and resulted in a decline in real economy.

CRISIS MANAGEMENT IN PRACTICE

By 2009 and 2010, the global economic crisis that occurred in 2008 significantly overwrote the budget policy trend intended to be followed originally in the developed and emerging economies. Earlier efforts to attain fiscal equilibrium were relegated to the background, and stimulation of the economy became the main objective in the short term. International organisations (including the International Monetary Fund and the European Union as well) practically accepted the barely limited expansion, although emphasised that they consider it justified only temporarily.[8] However, the method of crisis management was not the same at all in the influential centres of the world. While the USA stood up for the stimulation of aggregate demand with monetary and fiscal means, Europe strived to redraw the financial architecture.

USA

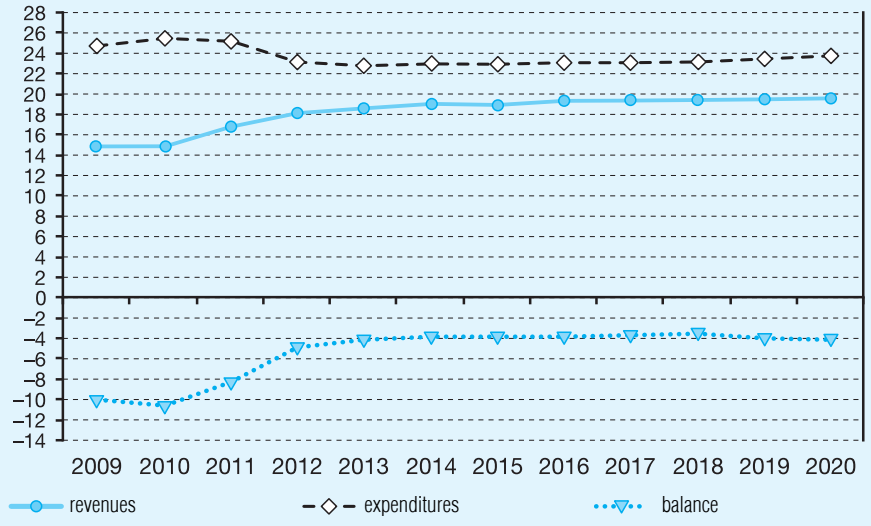
Since 2008 the US central bank – and budget policy as well – *have been trying to offset the economic downturn in an anti-cyclical manner*, stimulating aggregate demand in various ways. It must be emphasised, however, that the US economic policy between 2000 and 2007 was strongly pro-cyclical, because in the period of economic growth (i.e. between 2003 and 2007) it was heated artificially (as well) by the state with the tax reduction programme and the increasing of military expenditures.[9]

The Fed, which plays the role of the US central bank, set the central bank base rate to zero already in December 2008. Therefore, economic policy makers of the USA *could only use the means of public finances for further incentives*. In 2009, the deficit of the federal budget amounted to 9.9 per cent of the gross domestic product, which – considering the very low redistribution rate (24.7 per cent of GDP) – means that 40 per cent of public expenditures in 2009 was covered by government bonds issues. The deficit of unprecedented magnitude was the result of a two-directional process. First, expenditures as a proportion of GDP increased from 20 per cent, which had been typical of the previous years, to 24.7 per cent. Second, public tax revenues declined from 18 per cent to 14.8 per cent.

The question arises: *How is the USA able to finance this extraordinary degree of deficit and indebtedness?* The answer is complex. First, the US budget – as a result of, inter alia, the zero central bank base rate – can obtain funds from international money markets extremely cheaply. The yield on two-year government bonds remained continuously below one per cent during the crisis, but that on the five-year ones did not reach two per cent either. Second, despite or precisely because of the crisis, high demand evolved in the market of US government bonds, as financial investors

Chart 2

SCHEDULE TO RESTORE EQUILIBRIUM.
LONG-TERM BUDGET PLANS OF THE WHITE HOUSE IN 2010



Note: data as a percentage of GDP

Source: Office of Management and Budget, White House, U.S. Government Printing Office

consider these instruments the least risky. The underlying explanation is that the crisis undermined primarily the risk-seeking sentiment of previous years, thus resulting in a withdrawal of funds from those typically emerging markets that by now have become extremely vulnerable, which was not independent of the withdrawal.

The US government engaged in expenditure expansion in order to restore money market confidence and protect jobs, hoping that it would be able to return the US economy to the growth path as soon as possible. In 2008, an 8.1 per cent unemployment rate (equalling some 5.1 million people) was recorded in the USA, while the unemployment rate reached 10.2 per cent (6.4 million people) in 2009. Such a high value was last recorded in the USA in 1983. (U.S. Bureau of Labor Statistics, U.S. Department of Labor).[10] Therefore, one of the main objectives of the economic incentive programme became to keep four million jobs. The government tried to achieve this aim mainly through construction, by launching infrastructural investment, and by rescuing automobile manufacturers from bankruptcy.

Beyond the bank rescue packages, *the deficit increasing programme of the USA cannot simply be considered as rehashing the traditional Keynesian economy stimulating policy, but – to some extent – as a change in conception and shifting of accent* in the US market economy. Thus the new emphases fell on the extension of health care, the wider scope of public financing in education, the enhancement of the spreading of clean, environment-friendly sources of energy as well as on raising the tax of those with higher incomes. Therefore, the success of crisis management in the USA mostly depends on how the social and environmental sustainability pillars can be reinforced within total consumption.[11]

Nevertheless, the economic incentive plans for 2009–2010 follow the so-called Keynesian economic policy almost as it is written in the textbooks, according to which the loss of market demand has to be offset by increasing public consumption and investment as well as by adding to households' income through tax reductions. However, crisis management in the United States also reveals one of the weaknesses and the source of the vulnerability of the development of the country: *the momentum of the economy is maintained by the consumers of its own, internal market*. This has been in the background of dynamic economic growth. Consequently, the limits of the incentive programme are clear-cut. *Neither the bank consolidation, nor the rescue of the automotive industry – in themselves – are able to rev up the US economy, as all this is only sufficient to keep alive those enterprises that otherwise went bankrupt (or are very close to bankruptcy).*

The reason why infrastructural investments increase the performance of the economy over the long term is not that they come into being, but that they create an opportunity for the spreading of cost-effective or higher-capacity economic solutions. In the near term, however, precisely a fall in production can be observed. Consequently, no need for capacity expansion is shown. *Accordingly, the crisis management package of the USA is based on the requirement that the economy should be able to survive the temporary crisis with a relatively small loss.* Therefore, the key to success, inter alia, is for money market confidence to be restored as soon as possible. This may ensure continuous money supply and credit supply (i.e. liquidity) as well, and banks will also extend loans to one another with (more) confidence. Only if this process gets underway could there be a chance that the government's investment projects will result in additional demand and that the private sector will create new capacities and jobs. The produced additional income, in turn, may spill over as purchase orders or household consumption to other sectors as well.[12] (See Chart 2)

Large states of the EU

The US financial crisis that had unfolded in the middle of 2007 reached the European states as well by the autumn of 2008, and even the largest economies of the single European market faced deflation and economic downturn. Most of the EU Member States, including the largest ones, were compelled to give up their equilibrium targets undertaken in their respective stability and convergence programmes and to introduce economic incentive packages to offset the shrinkage in consumption, the decline in production and the number of jobs as well as the collapse of key sectors. As it is shown by the estimate of the European Commission's Directorate General Economy and Finance *(see Table 1)*, 2007 and 2008 were the years of slowdown, while 2009 was the year of shrinkage for the EU. Only slow recovery can be expected in 2010 and 2011 as well, and in 2011 the Community will only reach the pre-2007 output level. As a result of the growth trend diverted by the crisis in the medium term as well, employment will also deteriorate indefinitely (in the medium term). *Accordingly, the stimulation of the economy financed from the indebtedness of the general government may only attain partial results, and in the 2009–2011 period will be unable to neutralise the loss in output.*

As it is shown by the cyclically adjusted and structural values in *Table 2*, the stimulation of the economy that offset the crisis swung out the EU, and within that the euro area, from the state of budgetary equilibrium in the medium term as well. As a result, 2010 and the following years are expected to be spent with the challenges of managing the increasing public debt and terminating the large discretionary expenditure items.

The recovery of the 'large Member States' that represent the driving force and internal

Table 1

MAIN AGGREGATE MACROECONOMIC INDICATORS OF THE EU AND THE EURO AREA

(%)

	2006		2007		2008		2009*		2010*		2011*	
	EU	euro area	EU	euro area	EU	euro area	EU	euro area	EU	euro area	EU	euro area
Changes in GDP	3.2	3	2.9	2.8	0.8	0.6	–4.1	–4	0.7	0.7	1.6	1.5
Changes in private consumption	2.2	2	2.1	1.7	0.8	0.4	–1.7	–1	0.2	0.2	1.2	1
Changes in public consumption	2	2.1	1.9	2.3	2.2	2	2	2	1	1.1	0.6	1
Changes in total investment	6.2	5.5	5.9	4.8	–0.3	–0.4	–11.4	–10.7	–2	–1.9	2.5	2.1
Changes in employment	1.5	1.4	1.7	1.7	0.9	0.6	–2.3	–2.3	–1.2	–1.3	0.3	0
Unemployment	8.2	8.3	7.1	7.5	7	7.5	9.1	9.5	10.3	10.7	10.2	10.9
Inflation	2.3	2.2	2.4	2.1	3.7	3.3	1	0	1.3	1.1	1.6	1.5
Balance of the budget (as a percentage of GDP)	–1.4	–1.3	–0.8	–0.6	–2.3	–2	–6.9	–6.4	–7.5	–6.9	–6.9	–6.5
Public debt (as a percentage of GDP)	61.3	68.3	58.7	66	61.5	69.3	73	78.2	79.3	84	83.7	88.2
Balance of current account (as a percentage of GDP)	–1.2	–0.1	–1.1	0.1	–2	–1.1	–1.7	–1	–1.5	–0.8	–1.3	–0.7

Note: *end-2009 estimate and forecast

Source: EC (2009a)

Table 2

CHANGES IN BUDGET BALANCE INDICATORS IN THE EU AND THE EURO AREA

(%)

	2008		2009*		2010*		2011*	
	EU	euro area	EU	euro area	EU	euro area	EU	euro area
Total revenue	44.6	44.8	43.4	44	43.2	43.7	43.2	43.7
Total expenditure	46.8	46.8	50.4	50.4	50.6	50.5	50.1	50.2
Balance of the budget	–2.2	–2	–7	–6.4	–7.4	–6.8	–6.9	–6.5
Interest payment obligation	2.7	3	2.8	3	3	3.2	3.2	3.4
Primary balance	0.5	1	–4.2	–3.4	–4.4	–3.6	–3.7	–3.1
Cyclically adjusted balance of the budget	–3.2	–2.9	–5.5	–5	–6	–5.5	–5.7	–5.3
Cyclically adjusted primary balance	–0.5	0.1	–2.7	–2	–3	–2.2	–2.5	–1.9
Structural balance	–3.1	–2.8	–5.4	–4.9	–5.9	–5.3	–5.7	–5.3

Note: *end-2009 estimate and forecast. Data as a percentage of GDP

Source: EC (2009a)

Table 3

COMPARISON OF DISCRETIONARY ECONOMIC STIMULATION PACKAGES OF EU MEMBER STATES

	Budgetary package total (EUR billion)		Expenditures (EUR billion)		Budgetary package total (as a percentage of GDP)		Expenditures (as a percentage of GDP)	
	2009	2010	2009	2010	2009	2010	2009	2010
Austria	4.9	4.6	1.4	1	1.71	1.63	0.48	0.36
Belgium	1.3	1.2	0.9	0.8	0.36	0.33	0.27	0.24
Germany	25.9	48.4	18	13.6	1.44	1.93	0.72	0.54
Greece	0	0	0	0	0	0	0	0
Spain	26.8	14.7	12.1	0	2.44	1.34	1.1	0
Finland	2.4	2.4	0.4	0.4	1.25	1.25	0.23	0.23
France	17	4	16.3	4	0.87	0.2	0.83	0.2
Ireland	0	0	0	0	0	0	0	0
Italy	–0.3	–0.8	3.1	0.2	–0.02	–0.05	0.19	0.01
Netherlands	3.1	2.9	0.2	0	0.53	0.49	0.03	0
Portugal	1	0.3	0.9	0.3	0.6	0.18	0.54	0.18
EU-11	92	77.6	53.2	20.4	1.01	0.85	0.58	0.22

Source: Cwik and Wielander (2009)

market of the EU (Germany, Great Britain, France and Italy) is an especially important element of the recuperation of the single European market from the shock caused by the crisis. In view of their relatively homogeneous economic and economic policy structures, nearly the same solutions cropped up in the management of the crisis as well. As a result of previous years' similar economic policies, which strived for budgetary equilibrium and price stability, these four countries have had to cope with similar problems. In each country under review, deflationary processes began in the fourth quarter of 2008 and in the first quarter of 2009, and there was a danger of the start of a deflationary spiral, i.e. that the declining

prices would result in a further shrinkage of production instead of an expansion in consumption. The deflationary spiral could have further reduced the number of jobs and the wage bill paid, which, in turn, would have further deteriorated consumption demand. *All four governments attempted to break this deflationary vicious circle* with tax reductions, income supports and public investment. In addition, *the rehabilitation of two driving force sectors had to be carried out everywhere at the same time.* In the automotive industry, primarily the non-competitiveness problems of past decades strengthened as a result of the fall in demand in the global market (not only in Europe, but in the USA as well), while the banking sector succeeded in 'conjuring away' several hundred billion euros at a European level during the financial crisis, through US mortgage bonds as well as with the increase in default risk of loans to households in East and Central East Europe. (*Table 3* provides information on the estimated magnitude of stimulating the economy.)

At the same time, the similarities also allowed the leading countries of Europe to jointly tackle international challenges that affected all four of them unfavourably, including, for example, offshore taxation or the 'Buy American' protectionist policy. It is another matter that the leaders of the four states criticised one another as well because of their protectionist measures. This criticism was primarily aimed at France and Italy, where – in exchange for government subsidies – automotive manufacturers ensure the maintenance of capacities and even the domestic implementation of capacity expansion planned to be done abroad. As far as the joint action is concerned, it mainly took the form of protesting against US protectionism and – on the initiative of former British Prime Minister *Gordon Brown* – a strict review of incomes flowing into tax havens. There was no community-level harmonisation in the areas of the bank rescue[13] or the stimulation of manufacturing, the reduction of taxes[14] or expenditures that facilitate consumption. Thus, eventually, *no community-level crisis management aiming at the growth, reinforced with synergies, of the single market took shape*. Although it is true that at the banks consolidated from the German, French, Italian, Austrian etc. budgets primarily the non-performing loans in eastern Member States were reorganised, but instead of an attitude of stimulating the overall growth of the single market, Member States clearly strived to provide domestic incentives and keep jobs within their own respective countries. A good example of this is that the French automotive job creation deprived Slovenia, where labour is cheaper, of capacities. Although French jobs were saved this way, but only with a worse relative wage cost, resulting in a deterioration in the aggregate efficiency of the EU. The French government announced it only at the end of January 2010 that France and Germany were preparing a joint strategy for recovering from the crisis, which would harmonise the relevant EU policies in institutional and regulatory issues, namely in terms of improving the financial regulation and the reform of the international financial administration, and not in fiscal issues.

However, already when the crisis erupted, there was an important difference in the scope for fiscal action to stimulate the economy, and it was the magnitude of public debt. For example, at the end of 2008, the public debt to GDP ratio stood at 44 per cent in Great Britain (compared to 68 per cent in 2009). The relevant figures are 66 and 76 per cent for France, 76 per cent for Germany in both years, while Italy recorded 104 per cent and 114.6 per cent, respectively (IMF, 2009b and EC, 2009a). *The magnitude of indebtedness that had developed by then determined the magnitude and cost of the issuance of government securities allowed by the expenditure increasing and revenue reducing*

measures. However, this is influenced by the debt stock considered acceptable in individual Member States. The Italian government only received an international (IMF) warning, while the actors of British economic and political life already call the attention of the government to the hazards of the debt stock that is above 45 per cent. Accordingly, the crisis resulted in a strange convergence of the wrong direction: contrary to the value limit declared in the Stability and Growth Pact, Member States' public debt levels converge to 100 per cent of GDP or even to a value exceeding that in the period between 2009 and 2011. This 'convergence' is strengthened by the fact that the countries whose debt level had been lower at the outset of the crisis allowed themselves typically higher deficits.

Nevertheless, in connection with economic incentives it can be established that the large countries of the EU were basically cautious and self-controlled. The total volume of expenditures was also far below the amounts spent by the Bush and Obama Administrations on stimulating the economy and rescuing the banks. It was the Toronto Summit of the G20 when the *difference of opinion between the USA and the EU on whether fiscal incentives or the management of the public debt risk is a better way to avoid/mitigate the W-shape crisis* was sharply displayed. The clear position of the USA was that where public debt is at a sustainable level, and the government securities of the country concerned can be sold at a relatively low price in the market (the USA, Japan, Great Britain and Germany are considered to be countries like this), states should continue to apply fiscal incentives, and the EU, the IMF and other financial organisations as lenders of last resort should 'generously' allocate credit facilities. Nevertheless, politicians of the leading economies of the Union – perhaps precisely because of the financing and sustainability limits of public finances and the public debt – did not (and do not) consider fiscal easing to be the (only) solution to overcome the crisis. In their opinion, the solution is rather the improvement of the institutional regulation and supervision of the international monetary system, aiming at the restoration of confidence in the interbank loan market.

One of the greatest risks of further fiscal stimulus may be that it continues to strengthen the contagious nature of debt crises, deepens the already existing sustainability problems, and at the same time puts off the solution.[15] Of course, theoretically it is conceivable that market participants' confidence can be preserved in spite of further fiscal stimulus as well, in the event that it is announced together with a credible and long-term programme that creates equilibrium. However, the first decade of the euro area has proven that countries tendentiously deviate in a negative direction from their convergence and stability programmes aimed at fiscal equilibrium and sustainability. Moreover, the low central bank base rates and the generosity of international lenders of last resort (including the EU itself) most probably elicit the effect that the cheaper and higher credit lines give false information to decision-makers, indicating that the position of the general governments concerned can substantially be improved. This in turn ultimately strengthens moral hazard.[16]

FISCAL CONSOLIDATION FOLLOWING THE CRISIS

In connection with the economics of crisis and recovery, *Csaba (2010, p.10)* – quoting *Lámfalussy*'s (2000) book analysing financial crises – concludes that individual downturns 'are of different natures and mechanisms. It means that they cannot adequately be treated with the cycle theory, which is popular in theoretical model creation as well, because the recurrent and

repetitive phenomena are not of the same, but of different natures.' Consequently, comparing the current crisis to the Great Depression of 1929–1933 may also lead to misconclusions, if only because the then crisis management was much less coordinated and more against the market than the current one. The energy crises of the 1970s cannot be compared with the one in 2008 either. Namely, the former ones made it expressly clear that Keynesian tools are unable to treat structural distortions. The only effect of the expansion of aggregate demand is stagflation. In the case of the currency crises between 1997–1999, in turn, 'a new model of financial crisis came into being […], where the 'fundamentals', i.e. the fundamental growth and equilibrium indicators of the national economy, do not play a decisive role at all any longer' (Csaba, 2010, p. 11).

Several scenarios have been prepared for how the current crisis will subside. The illusion of the so-called *V-shape crisis* was fed by the production expansion that started at the end of 2009. According to this approach, the worst of the crisis is over for the world economy, and a renewal of economic growth is only a matter of time. By contrast, in the opinion of those who forecast a so-called *W-shape crisis*, the upswing perceived from the second half of 2009 will be followed by another downturn, and an increase in economic performance is expected only after that, extending the crisis by up to two to three more years. Of the pessimists, *Krugman* (2009) compared the economic stimulus programme of the US general government to the unsuccessful practice of Japan in the 1990s. Although the Asian government rescued the banks then, it did not deal with the consolidation of the bad debt stock. Consequently, in view of the risk of further insolvencies, mistrust consolidated in the interbank credit market, and the Japanese financial supervisory authority started to rate bad debts as 'defaulting' only a decade later, from 2001 on (Callen and Mühleisen, 2003). Since then, this phenomenon is called *L-shape crisis*, which means the protraction of a period without significant growth and with persistently high unemployment.

In terms of the actual, quantitative effects of fiscal policy there is high uncertainty in international literature. Namely, the problem is not only what econometric method is used for calculating the effects, but rather what the theoretical model or framework in which we try to interpret the effects is. *Those who argue for fiscal activism expect discretionary fiscal stimulus of their governments based on the Keynesian multiplier effect.* The multiplier effect, in turn, relies on the simple assumption that – assuming sticky prices – an increase in government expenditures results in a growth in national income (ideally not only to the extent by which the government increased its expenditures additionally). The effect can be derived from the well-known income equation and the Keynesian consumption function.[17]

If total expenditures grow as a result of additional government purchases, in a Keynesian model it adds to income, and increases the consumption of the private sector, which again adds to total expenditure etc. Inter alia, the traditional Keynesian model assumes that private consumption depends on disposable income, and is not affected by the individual's path of life or future events and changes. It assumes that individuals are not far-sighted, rational persons, i.e. they do not take account of the future effects of additional spending in the present (for example that one day the government may be compelled to introduce tightening measures etc.). Moreover, in times of crises the Keynesian models also often assume that the crowding out effect does not succeed, as the central bank keeps the base rate low in order to supply the market with an adequate amount of liquidity.

However, many questions may be raised with regard to the reality of the Keynesian mul-

tiplier effect. *Do the zero base rate of the central bank and the inherent abundance of liquidity mean at the same time that enterprises are willing to implement additional investment? Are banks willing to lend to credit applicants and to one another? Do the investments that are implemented add to employment (or on the contrary: it is substituted with capital, for example to avoid the problem of downsizing in the time of a future crisis)?*

Keeping the central bank base rate at zero level may be a realistic assumption in a large country that has a relatively autonomous monetary policy, but it is not realistic in a small, open economy that cannot independently decide on the level of the interest rate, as it is determined by the willingness to finance of international money markets. Initial conditions may also prove important: if a state pursued an expansionary policy prior to the crisis as well, then during the crisis – especially if it also means a confidence crisis – it may easily realise that it is compelled to conduct a procyclical policy, as it happened, inter alia, first in Hungary, then in Greece as well.

However, over the long term the zero level of the reference interest rate cannot be guaranteed even in large, relatively closed economies. If individuals and corporations are far-sighted and pursue an optimising behaviour, they will take account of the future consequences of the current stimulation of demand, which is reflected in the magnitude of interest rates as well. Players in the private sector price all this already in the present (for example, in the form of positive long-term interest rates). As it is unreasonable to suppose that a company would not perform a cost/benefit analysis of the planned project (calculation of net present value) prior to the implementation of an investment, this behaviour should be true for all rational players, even in times of crises. And if individuals and corporations expect tightening in the future, they may now increase their savings, at present, and thus the multiplier effect of the additional government spending may even dramatically subside. The weaker the liquidity constraints are in the economy, the stronger this effect is. Accordingly, in an economy, the lower the ratio of those who decide on their consumption on the basis of disposable income, the higher the probability of the postponement of consumption and thus of a decline in the multiplier is.

Relatively numerous studies have attempted to quantify the size of the fiscal multiplier. In their review of the relevant literature, *Hemming et al.* (2002) concluded that although the value of the multiplier is typically positive (at least in the short term), it is relatively low. The common denominator of the studies is that the fiscal multiplier of the USA was measured to be significantly higher than that of European states. Upon examining the large countries of the EU, *Roeger* and *Veld* (2002), for example, found that – assuming monetary policy support – the value of the fiscal multiplier fluctuates around one in the near term, and is zero over the long term. *Blanchard* and *Perotti* (2002) calculated a value around one in the USA over the short term, but the cumulative effect already amounted to 2–3 per cent of GDP. The quantifying attempt of *Robert Barro*, a prominent representative of the new classical macroeconomics, seems to contradict this (Barro, 2008). Barro clearly professes that the only real effect of additional government expenditures is the rearrangement of income, i.e. the periodic value of private investment declines in line with the increase in government expenditures, and thus the GDP itself remains unchanged. According to his calculations, a multiplier larger than one was not attained in the USA even during the Second World War: in 1943–1944, at an annual level, the US government spent 540 billion dollars (44 per cent of GDP) on military expenditures (calculated at year 1996 prices), while real GDP increased by only 430 billion dollars. Accordingly, the value

of the multiplier was 0.8 (430/540). For normal times, Barro calculated a multiplier of zero.

Calculations to assess the effects of the economic policy expansion were made in connection with the year 2008–2009 crisis as well. However, the results are not unequivocal in this case either. Barack Obama's advisor, *Christina Romer* and her colleague, *Jared Bernstein* (2009) found in their study, which was one of those that elicited most criticism, that a one per cent increase in government spending results in a 1.6 per cent growth in national income (i.e. the multiplier effect exists). At the same time, *Cogan et al.* (2009) as well as *Cwik* and *Wieland* (2009) criticised the method and finding of Romer and Bernstein, as – in their opinion – Romer and Bernstein made their calculations on the basis of the traditional Keynesian model, and thus were unable to properly model the fact that individuals and corporations change their behaviour if they perceive a change in economic policy. If we assumed what co-authors Romer and Bernstein assume, i.e. that expenditures grow permanently, and no adjustment is expected in the future (moreover, the Fed would not change its zero interest rate policy either), sooner or later the economy would inevitably face a crowding out effect and hyperinflation. Considering that individuals and corporations are far-sighted, and that the present expansion in expenditures will be replaced by tightening in the future, Cogan et al. (2009) measured a much lower multiplier for the USA: a mere 0.6. The findings of Cwik and Wieland (2009), in turn, were similar with regard to European states: the fiscal multiplier remained below one in this case as well. Both studies warn of the dangers of the crowding out (rising real interest rates) and negative wealth effects (increasing tax burden in the future) of the fiscal expansion implemented in 2009 and 2010: the impact of government incentive packages leads to a shrinkage of the consumption and willingness to invest of the private sector even in the short term (and even more strongly in the medium and long term).[18]

The low-value multiplier is also rendered probable by the fact that the crisis affected precisely the financial sector most (including the mortgage markets as well), which would be able to facilitate the multiplier effect in practice as well. *Clarida* (2009), among others, also pointed out that in the last fifty years the private sector's (including households and corporations) borrowing requirement had never fallen as dramatically as in the time of the current crisis. The dramatic depreciation of shares and housing markets meant the loss of wealth of households as well, which makes the increase in consumption impossible, or at least difficult. For the year 2008, the author estimated households' net loss of wealth to be ten trillion dollars, which especially affected older generations, who are now compelled to re-accumulate savings even more strongly.

Corsetti et al. (2009) go even further beyond the new-Keynesian models described above,[19] and take into account whether the government chooses the raising of taxes or the reduction of expenditures upon returning to the equilibrium-oriented policy.[20] The model of the authors of the IMF is original also because earlier estimates typically expected tax increases in the future, and assumed that the expenditure side would remain unchanged (i.e. an increase in expenditure in the short term meant a growth in the magnitude of redistribution in the medium term). However, in the authors' opinion, this assumption is not realistic for several reasons, as an adjustment implemented only with a tax increase is not a viable assumption, especially in small, open economies. Another novelty of the model is that such a temporary rise and subsequent definite decline in public spending project a moderation in expectations regarding future short-term real interest rates. This, in turn, may have a mitigating effect on long-term real interests already at present, which induces a process

in a direction contrary to the crowding out effect, strengthening consumption and investment.[21]

One of the important conclusions of the study of the IMF staff is that fiscal stimulus can truly be successful if governments credibly commit themselves to the subsequent rearrangement already upon launching the stimulation, i.e. the current increase in expenditures will be followed by their decline in the medium term. One of the relevant elements may be the return to fiscal policy rules and fixing the probable time of this return now, also determining the expected fiscal policy and the magnitudes of balances of the transition period.

The strengthening of the importance of planning and foresight is essential, inter alia, because the current short-term decisions that are deemed to be necessary (and have an expansionary effect) have long-term consequences as well. Therefore, political decision-makers and voters have to see what concrete sustainability risks are entailed by fiscal policy (discretionary) decisions adopted at present. Through the strengthening of future-orientation, planning also makes those long-term objectives and priorities (such as the management of an ageing society or of labour market inflexibility) clearly determinable, the remedying of which cannot be ignored by any responsible government.

The rules are supposed to ensure medium-term sustainability, but the crisis required immediate, short-term intervention, thus the short-term attitude became prevalent in the states concerned, which, in turn – in our opinion – repealed fiscal policy rules only temporarily. The after-effect of the crisis is that debt settlement will be required in almost all countries to stabilise the debt at a sustainable level. Consequently, *the application of fiscal rules and institutional limits will be necessary in a*(n even) *wider scope.* Of course, this also follows from the anti-cyclical Keynesian economic philosophy, which is often referred to in the crisis, as expansion may be justified in lean years, but containing overheatedness is the desirable economic policy in a period of growth. The significance of fiscal rules may strengthen especially in those countries where the fiscal structure has not been built on automatic stabilisers earlier either. Consequently, it was the discretionary solutions that added to the debt stock in the crisis as well.[22] As a result of the effect of the discretionary fiscal policy that destroys sustainability, the credibility of public finances fades away rapidly. Therefore, in countries like that it is expedient to introduce fiscal rules with a short deadline to be able to control the process of indebtedness and to make public debt renewable this way as well.

Notes

[1] István Benczes - Gábor Kutasi (2010): Költségvetési pénzügyek, Akadémiai Kiadó, Budapest. The researches of István Benczes and Gábor Kutasi are supported by the Bolyai János scholarship of the Hungarian Academy of Sciences and the Corvinus TÁMOP (Social Renewal Operational Programme) Project, respectively.

[2] Within the framework of this paper we cannot undertake a deep and systematic analysis of the crisis as a whole. There are several relevant studies available in Hungarian; see, in particular: Csaba (2010), Győrffy (2009), Király et al. (2008), Kutasi (2010), Magas (2009) and Szakolczai (2009).

[3] For details see: Király et al. (2008)

[4] This is what Minsky's financial crisis theory calls the stage of pre-crisis euphoria, when, motivated by the upturn in prices, many engage themselves in speculative real estate or securities business in the expectation of high returns (Minsky, 2008). On the basis of Minsky's financial crisis theory, Losoncz (2008) deduces the global economic crisis of 2008–2009

starting from the early 2000s. Accordingly, the fundamental shift resulting in the crisis is the reduction of/decline in interest rates that started at a global level in 2001. Low interest rates did not stimulate investment, as there were significant unutilised capacities, but resulted in the indebtedness of households, which, inter alia, led to a dynamic increase in real estate market prices until 2007.

[5] At the same time – as George Soros pointed out – the crisis destroyed economic growth prospects to various extents. Thus the crisis did not simply result in a decline in income, but also in a significant realignment, primarily in favour of emerging economies, such as China, India and the Far East in particular and, to a lesser extent, Latin America (Soros, 2008).

[6] For details on the effect mechanism of the zero interest rate and an analysis of the practice between 2007–2009 see Kutasi (2010)

[7] Mainly in Europe, banks did not have to be saved from bankruptcy at a national level, but rescue packages had to be separated in the countries where parent banks are registered, owing to the hazard of bankruptcy of German, Austrian and Italian banks' Central and East European affiliate banks (Baldacci et al., 2009, p. 3).

[8] cf. Freedman et al. (2009)

[9] In 2000, the Bush Administration started with a considerable tax reduction, while the war in Iraq cost the USA more than 3,000 billion dollars. According to the calculations of Bilmes and Stiglitz (2006), the management of the financial crisis of 2008–2009 amounted to at least another 800 billion dollars on the general government side. This compares to the total annual US income of 14,300 billion dollars.

[10] In 2008 and 2009, the annual number of jobs lost amounted to several hundreds of thousands in almost all sectors of the US industry. Only the health sector showed an increasing trend. Obviously, the US government used the extension of health services as well to offset the downturn. However, even this way they were able to make up for only 10 per cent of the jobs lost (600 thousand jobs within a year). Moreover, this is not fully compatible with construction, the financial sector and manufacturing production, which are the main producers of unemployment. However, in connection with the doubling of unemployment one must also see that its magnitude has become so drastic not only because of the temporary reduction of capacities that have turned redundant in view of the crisis. Under the pretext of the crisis many US companies – mainly in the financial and advisory sector, as well as the marketing and sales divisions – strived to get rid of a significant portion of the workforce. Therefore, it is not sure that employment will automatically expand with the easing of the crisis. And if many of the dismissed employees will not be needed in the same activity or sector, that already projects the protracted continuance of structural unemployment.

[11] US President Barack Obama recommended high-volume public spending aiming at the maintenance of consumption as an adequate means of recovery from the crisis to European leaders as well. As it will be demonstrated later, European states only partly took his advice, which among other things may be explained by the fact that these countries are unable to raise funds as cheaply from the money markets as the USA can.

[12] An expansion of disposable income through the reduction of the taxation on personal income may also be able to mitigate (or perhaps stop) the slowdown in the economy only if it directly covers the consumption of American products, and not the purchase of imported ones.

[13] Banking sectors of countries became heavily affected by the collapse of the mortgage bond market and the shortage of money supply resulting from the distrust that developed in the interbank credit market. The crisis management packages in the autumn of 2008 mainly served the purposes of banks' recapitalisation and the purchase of bad securities. Germany spent 250–300 billion euros on interbank credit guarantee, and appropriated 150 billion euros to bank rescue, most of which was used to save Hypo Real Estate and NSH Nordbank. The magnitude of the problem was much smaller in France; 10.5 billion euros were spent on bank rescue, financing mostly the loan losses of the financial institution Société Générale. IMF (2009f)

[14] In the field of tax reduction, France got rid of the local business tax, while other countries took comprehensive measures with regard to the tax burden on personal and corporate incomes as well as to the value added tax (VAT). Only France did not consider a reduction of the VAT at all, primarily referring to the lowering of the VAT in Great Britain, which had not resulted in the expected upturn in consumption in the British economy. In all probability, it is justified to treat the reduction of VAT

with reservations, as consumer credit becomes more expensive and households' willingness to save increases in a recession period, thus making households considerably insensitive from this aspect to the declines in gross prices.

[15] See all this formalised as well by Benczes and Kutasi (2010).

[16] A development of the Greek debt crisis is that in three years the IMF and the EU support the general government by approximately 50 per cent of the Greek GDP in order to avoid bankruptcy. In exchange for the rescue, the Greek government undertook to restore the equilibrium in the medium term (pursuant to the Greek stability programme, the planned deficit should sink below the Maastricht 3 per cent by 2012). However, the experience of debt crises is that bridging loans are unable to terminate the debt management problems, as the unchanged general government structure reproduces the problems continuously (Reinhart and Rogoff, 2009). According to the estimate of the DG ECFIN, with the nearly 134 per cent public debt to GDP ratio in 2011 it is simply unbelievable that Greece will be able to repay its debt in line with the original schedule (determined upon the issue of government bonds). The Greek CDS value on 4 May 2010 amounted to 689 basis points. Taking only this as a basis, irrespective of the structural reforms and the fiscal consolidation, around one tenth of the Greek aggregate income should be spent only on interest payment in the next years. Therefore, there is always a heavy political burden on the current Greek government, whose behaviour was strongly characterised by bad planning and deliberately deceptive and misleading data supply earlier as well. The credibility of the commitments of the Greek government is low, forecasting further bankruptcy problems.

[17] Namely: $Y = C(Y_d) + I(r) + G + (X–M)$, where Y is the national income, $C(Y_d)$ is private consumption, $I(r)$ is the investment of the private sector, G is the value of government purchases, and $(X–M)$ is the balance of foreign trade

[18] The authors of the European Commission (see Ratto et al., 2009) also came to a similar conclusion despite assuming in their model that one third of the actors in the private sector face liquidity constraints.

[19] The new-Keynesian model means sticky prices as well as rational and far-sighted individuals and corporations.

[20] The model consists of five equations: household maximisation function, equation of the budget line, corporate optimisation function, fiscal expenditure function (deviation from the debt objective) and interest rate function.

[21] Actually, this is a case when a mechanism that is very similar to the non-Keynesian effects prevails.

[22] However, where automatic stabilisers work (in Sweden, for example), as the crisis comes to an end, medium-term developments in revenues and expenditures restore the balance even without any special consolidation.

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