José Manuel González-Páramo: Fiscal policy and the financial crisis – the need for an effective exit strategy

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the CFS conference "The ECB and its Watchers XI", Frankfurt am Main, 4 September 2009.

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Introduction

The economic and financial landscape has changed dramatically since the last ECB Watchers Conference. Until a year ago, the front line in the fight against the financial market turmoil had been manned largely by central banks. Then, in the space of a month:

- Fannie Mae and Freddie Mac were taken into public ownership;
- Merrill Lynch was taken over by Bank of America;
- the Federal Reserve extended an extraordinary loan to AIG in return for a majority stake;
- and Lehman Brothers filed for bankruptcy.

The financial turmoil became a financial crisis. The US Treasury unveiled a proposal to buy up to 700 billion US dollars of illiquid mortgage-based assets. And on this side of the Atlantic, a wave of government interventions to stabilise the financial system and support the broader economy was set in motion.

The need for policy actions

In September 2008, money markets around the world had come to a standstill. Banks had stopped lending to each other. Central banks had become the main source of refinancing for the banking system. Given the situation, the top priority was to restore more orderly market conditions as soon as possible in order to limit the damage to the real economy. To this end, in addition to the unconventional measures taken by central banks, vast public funds have been made available to guarantee bank lending, to recapitalise troubled banks and to purchase impaired assets.

To what extent have these actions been successful? A useful measure of money market tensions is the spread between unsecured and secured money market rates. In the euro area, for the three-month maturity, this spread rose from below 10 basis points before the onset of the turmoil to 180 basis points at the height of the crisis in autumn 2008. Since then, it has declined to around 40 basis points. This is still an elevated level, but nonetheless indicates significant progress towards restoring stable money market conditions. And while credit conditions in the euro area have weakened significantly over the past 12 months, there has been no collapse in bank lending to the non-financial private sector.

Even so, economic activity has contracted more sharply than at any time since the Second World War. In the euro area, output contracted on a cumulated basis by more than 4% over the third quarter of 2008 and the first quarter of 2009, driven mainly by a sharp fall in investment and net exports. The latest data indicates a stabilisation in economic activity for the euro area as a whole in the second quarter of 2009. And most forecasters now expect a modest recovery in the course of 2010.

But if central banks and governments had not acted as they have done over the past year, the financial crisis would have been even more intense and the recession would have been deeper.

The fiscal costs of the crisis

As things stand now, the fiscal costs of the economic and financial crisis are expected to be considerable. In 2007, euro area general government borrowing amounted to around half a percent of GDP. In its Spring 2009 forecast, the European Commission projected that government borrowing in the euro area would rise to 5.3% of GDP this year and 6.5% next year. The euro area government debt ratio, which stood at 66% in 2007, is projected to rise to 84% in 2010. 13 out of 16 euro area governments are projected to breach the 3% of GDP deficit reference value of the Maastricht Treaty. And all are at risk of doing so next year.

These figures reflect the impact on public finances of the contraction in economic activity. They also reflect the costs of discretionary fiscal stimulus measures adopted in many countries. But the cost of providing public support to the financial sector is only reflected to a very limited extent in these projections.

According to information collected within the Eurosystem, the impact of public interventions on euro area government debt, as recorded in the national accounts this year, is likely to be something in the order of 3% of GDP. And the impact on the euro area government deficit is likely to be negligible. But the scale of government support to the financial sector is far greater than these figures suggest. According to the European Commission, as of the end of March 2009, the amount of funds made available under approved measures amounted to around 35% of euro area GDP. Of this amount, around 11% of GDP has already been turned into effective support, in terms of actual recapitalisations, asset purchases and so on.

The difference between the total amount of funds made available and the impact actually recorded in government deficit and debt statistics reflects the considerable uncertainty regarding the true fiscal costs of the bank rescue packages. Roughly speaking, in cases where governments actually issue debt to finance a loan or an asset purchase, there is an immediate impact on government debt in the official statistics. But no impact on the deficit will be recorded unless or until there is clear evidence that the interest on the loan or the price paid for the asset does not reflect market conditions.

In cases where a privately owned special entity is established to provide loans or purchase assets, there may be no immediate impact on the government accounts, even if the debt issued by this entity is backed by a government guarantee. Only if and when this guarantee is called will the corresponding amount be recorded as government spending. At the current juncture, it is impossible to assess the amount of the guarantees that will be called or what the final scale of the losses will be. As Eurostat put it, the cost of the public support to banks is a large cloud on the horizon, but at the moment we do not know how much it is going to rain!

The fiscal exit strategy

Faced with the prospect of large deficits in the coming years and uncertainty regarding the final costs of bank rescue packages, the priority for fiscal policy must be to set out a clear and credible plan for restoring order to the public finances over the medium term. Just as central banks are mulling their exit strategy from non-standard monetary policy measures, governments need to develop their exit strategy too.

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In this respect, the first hurdle to overcome is to be honest and transparent about the scale of the problem. As I already mentioned, much of the support given by governments to the banking sector will not be reflected, for the time being, in the government accounts. But this does not mean it can be overlooked. Eurostat has announced that it intends to establish a supplementary reporting table to collect data on guarantees, liquidity support measures, and the operations of special purpose entities relating to the financial crisis. This reporting must be taken seriously. Public authorities cannot call on banks to be more transparent about the scale of their liabilities, if they exploit statistical conventions themselves to keep debt off of their balance sheets.

Beyond this, there is a risk that the increase in government borrowing during the crisis is viewed as being purely the consequence of the operation of the automatic stabilisers and fiscal stimulus packages. Cyclical effects should cancel out over time. Stimulus measures are supposed to be largely temporary. So once the crisis is over and the stimulus measures unwind, we should be more or less back where we started.

This is wishful thinking. The sharp contraction in economic activity brings with it a permanent output loss. This is reflected in significant downward revisions to estimates of potential output and potential output growth. These revisions imply a reassessment of the spending that governments can afford given a lower structural level of tax receipts. The European Commission's estimate is that the "cyclical component" of the euro area government deficit will amount to about 1.4% of GDP this year and 1.9% next year. This is less than one third of the overall projected deficit!

Assuming that fiscal stimulus measures can be easily unwound may also prove a little optimistic. Even if a tax cut or a subsidy is announced as temporary, this does not mean that cancelling it will be less unpopular. And even when stimulus measures are unwound, the resulting impact on the deficit will be limited. Even net of stimulus measures, the projected structural deficit for the euro area would still be almost 4% of GDP in 2010 according to the European Commission.

The most reasonable assumption is that, for the most part, the sizeable government deficits that are likely to build up this year and next will not be self-correcting. Instead, they will need to be corrected through policy actions.

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The challenge for fiscal policy at this juncture is to appropriately calibrate the timing and speed of this adjustment. In this respect, we should not forget that fiscal policies in EMU do not operate in a vacuum. Governments are bound by their obligations under the Treaty and the Stability and Growth Pact. All the more so now, as monetary authorities consider their exit strategy from the crisis, it is essential that fiscal policies are conducted within a predictable, medium-term oriented framework.

The Treaty and the Stability and Growth Pact provide for a degree of flexibility under the current, special circumstances. The European Commission has expressed its view that Member States incurring excessive deficits due to the crisis should be allowed to implement corrective action in a time frame consistent with the recovery of the economy. But this should not lead to corrective action being unduly delayed. Fiscal adjustment needs to start with and not later than the economic recovery. And when more normal economic conditions return, consolidation efforts will need to be substantial.

Just how substantial these efforts need to be can be illustrated by way of a simple, numerical example. Let us assume that the current projections of the European Commission until 2010 turn out to be correct. Let us assume that from 2011 onwards annual output growth is equal to 2¼ percent. This might be considered a generous assumption. And let us also assume that government revenues keep pace with economic activity so that the revenue ratio is unchanged. Under such assumptions, a complete freeze on government spending would reduce the euro area government deficit by around 1% of GDP each year, bringing it close to balance no sooner than 2016. A more timely fiscal adjustment would require the adoption of corrective measures already in 2010, absolute spending cuts in real terms or additional tax increases.

Concluding remarks

To conclude, the scale of the challenge for fiscal policy is considerable. Over the past 12 months, governments, like central banks, have taken unprecedented action to restore stability to the financial system and to tackle the largest recession in post-war history. This action was largely justified. But most governments will come out of this crisis with the highest debt levels, as a proportion of GDP, ever to have been experienced in modern history. And this at a time, lest we forget, when the fiscal burden associated with population ageing looms ever larger over the horizon. If confidence in future stability is to be ensured, now is the time to set out an effective fiscal exit strategy.