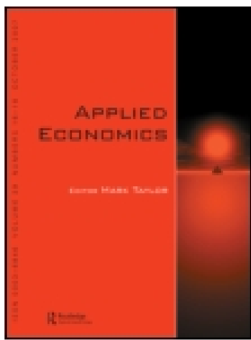

Applied Economics

ISSN: 0003-6846 (Print) 1466-4283 (Online) Journal homepage: https://www.tandfonline.com/loi/raec20

Comment on '"A toolkit to assessing fiscal vulnerabilities and risks in advanced economies" by Andrea Schaechter, C. Emre Alper, Elif Arbatli, Carlos Caceres, Giovanni Callegari, Marc Gerard, Jiri Jonas, Tidiane Kinda, Anna Shabunina and Anke Weber'

Peter Claeys

To cite this article: Peter Claeys (2014) Comment on '"A toolkit to assessing fiscal vulnerabilities and risks in advanced economies" by Andrea Schaechter, C. Emre Alper, Elif Arbatli, Carlos Caceres, Giovanni Callegari, Marc Gerard, Jiri Jonas, Tidiane Kinda, Anna Shabunina and Anke Weber', Applied Economics, 46:6, 661-662, DOI: 10.1080/00036846.2013.861960

To link to this article: https://doi.org/10.1080/00036846.2013.861960

Published online: 20 Dec 2013.

Submit your article to this journal

Article views: 102

View related articles

View Crossmark data

Full Terms & Conditions of access and use can be found at
https://www.tandfonline.com/action/journalInformation?journalCode=raec20

Applied Economics, 2014
Vol. 46, No. 6, 661–662, http://dx.doi.org/10.1080/00036846.2013.861960

Comment

Comment on '"A toolkit to assessing fiscal vulnerabilities and risks in advanced economies" by Andrea Schaechter, C. Emre Alper, Elif Arbatli, Carlos Caceres, Giovanni Callegari, Marc Gerard, Jiri Jonas, Tidiane Kinda, Anna Shabunina and Anke Weber'

Peter Claeys

Facultat d'Economia, Grup AQR-IREA, Universitat de Barcelona, E-08034 Barcelona, Spain
E-mail: peter.claeys@ub.edu

Budget sustainability means a government is deemed able to pledge its future taxing capacity to return outstanding public debt. An assessment of fiscal trouble must therefore be forward-looking, and consider future economic and political conditions. Econometric exercises relying on past events are thus limited in indicating how the future path of fiscal policy may look like. An evaluation of the range of possible threats to fiscal positions must necessarily rely on a battery of tests that mix accounting measures and market indicators, and subject these to different macroeconomic scenarios.

The team of authors of this article presents a toolkit for assessing fiscal vulnerabilities that is to be used for the joint IMF-Financial Stability Board (FSB) Early Warning Exercise for macroeconomic surveillance. The main value added of this article is to join six tools that recognize also the new threats to fiscal sustainability that have become apparent with the Financial Crisis. Risks to fiscal sustainability are indeed all related, and a joint analysis allows for a consistent assessment of fiscal vulnerabilities in the short, medium and long term. The Financial Crisis has revealed that short-term risks have increased due to the increased integration of sovereign bond markets, and the consequences for stress dependence across markets and borders.

This toolkit will certainly become a standard in future judgements of fiscal trouble in developed economies. In its use, I would first forewarn of not acting in an overly alarmist way to its early warnings. This caveat may look odd as we live in an era of fiscal constraints, but I argue we ought not to downplay the role of stability in economic and policy institutions. I further discuss some refinements to the econometric techniques so as to distinguish the downside risks to fiscal vulnerability in integrated bond markets.

The toolkit is meant for sending early warnings, but they may also be useful to convince policy-makers to take warnings seriously, and implement cautious stabilizing policies in response. A concern is that the signals sent by these indicators may not be very perceptible, and therefore ignored. Many indicators do not show very surprising findings: countries with bad starting positions (high debt) are likely to be more vulnerable on different criteria. By the time of the next crisis, this warning may easily be overlooked. This problem is exacerbated by our incapacity, as economists, of acknowledging structural change. It is inevitable that we tend to use old frameworks to explain

© 2013 Taylor & Francis

new events. We tend to focus on past crises, but we do not know what elements will become important in the next crisis. Of course, the toolkit cannot warn us of the unknown, but the framework should be flexible enough to account for additional variables, perhaps in the financial sector.

Taking warnings seriously does not imply we should intervene after every new warning, but remind ourselves of basic economics principles. Discretion has become regarded as optimal to respond to the extraordinary circumstances of the Financial Crisis. But the abuse of discretion in the 1970s taught us that rules-based policy guarantees stability in the longer term. Building long-term institutions for economic stability is still the best way to avoid future crises. As Jean Monnet stated: *Nothing is possible without men and women, but nothing is lasting without institutions*. Since crises are an inherent consequence of distortions that build up in the economy, economists should concentrate more on designing resilient policies. There is a small literature suggesting that policy should be cautious and keep away from downside risks.

The instruments of the toolkit might be made more robust by further developing the econometric techniques behind the six tools. These refinements may incorporate techniques to model the downside risks to fiscal vulnerability in integrated bond markets.

First, short-term liquidity problems have quickly degenerated into long-term solvency problems for a couple of Eurozone countries. Most of the literature is still examining on what factors this degeneration depends. The speed and magnitude with which the subprime crisis in the US spread to the global banking system and then sovereign bond markets has come as a surprise to many. Was it spillover across borders, spillover to other asset markets (banks), policy failure, rating agencies, etc.? Financial integration magnifies initially small risks into more widespread fiscal problems. When we observe that even relatively small financial trouble can quickly spread across markets, fiscal positions can be undermined by market movements abroad. Financial developments are not exogenous anymore. A benchmark asset does not exist anymore as investors in US Treasury bonds or German bonds prefer a subdued rate for a safe haven asset. The spillover analysis based on the computational model is a first step in this direction. A full treatment of all bilateral market linkages would be a worthwhile extension.

Second, early warning indicators should flash when downside risks become too large. Many of the econometric tools in the article are symmetric, while nonlinear behaviour is potentially a big danger, even for sovereign bond markets. Recent events show that sudden breakdowns of markets are possible.

Third, another lesson from the Crisis is political risk. Policy-makers in developed economies have been captured by a weak financial sector to give in to bail-out pressures, and have shown little ability to coordinate policy across borders. This political confusion matters for perspectives of sovereign debt positions.

Fourth, the aftermath of the Financial Crisis is bound to be characterized by low economic growth. If policy does not react firmly, a prolonged crisis may result in a lost decade. The output effects of a delayed recovery are large, and potential growth is unlikely going to resume its former path. Scenario testing should therefore probably be more pessimistic.

Finally, the toolkit should be tested with real-time data. Early warnings are most useful in crisis moments when economic conditions change. The indicator should be robust to such changes, or run the risk of not sending the right signal at the right time. The tools should therefore be applied to some historical events – the Great Depression, Japan – to check their usefulness *a posteriori*. These counterfactuals may serve to calibrate better the indicator. It is also a check on economists' success or failure in warning for unsustainable positions. Few economists dared to warn that the US, Ireland or Spain were following unsound policies in 2005. While correct in retrospect, these warnings were considered as a false alarm as most believed 'our times are different'.