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The Fiscal Framework in the Eastern Caribbean Currency Union: Lessons from Comparisons with the Euro Area

Presentation at the *45th Annual Conference of Monetary Studies*, Bank of Jamaica, Kingston, October 2, 2013

Svend E. Hougaard Jensen

- Professor, Department of Economics, Copenhagen Business School, Denmark
- Research Fellow, Netspar, the Netherlands

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When Macro Imbalances Are More Than Just Fiscal Imbalances…

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Idea

- Recent developments have shown that an upsurge in public debt can happen just as easily from poor macroeconomic fundamentals as it can from fiscal irresponsibility *per se*.
- Therefore, policies directed exclusively at obtaining fiscal discipline may be too narrow.
- Instead, the appropriate policy response should allow for the particular circumstance underlying the fiscal problem.
- For example, members of a monetary union are likely to be especially vulnerable to "sudden stops" and banking crises, due to the absence of a lender of last resort.

Findings

- Using the Euro Area and the Eastern Caribbean Currency Union as case studies, we argue that a broad policy framework should comprise a rule for fiscal policy, financial regulation and a broader set of policies to improve competitiveness and economic growth.
- We stress the need to prevent a build-up of public and private debt, by introducing,
  - a coordinating mechanism to ensure that the borrowing done by either party is consistent with the overall macroeconomic strategy;
  - a resolution mechanism needed in case debt limits are breached;
  - policies directed at structural reforms, to stimulate growth and employment in the private sector.

Starting point

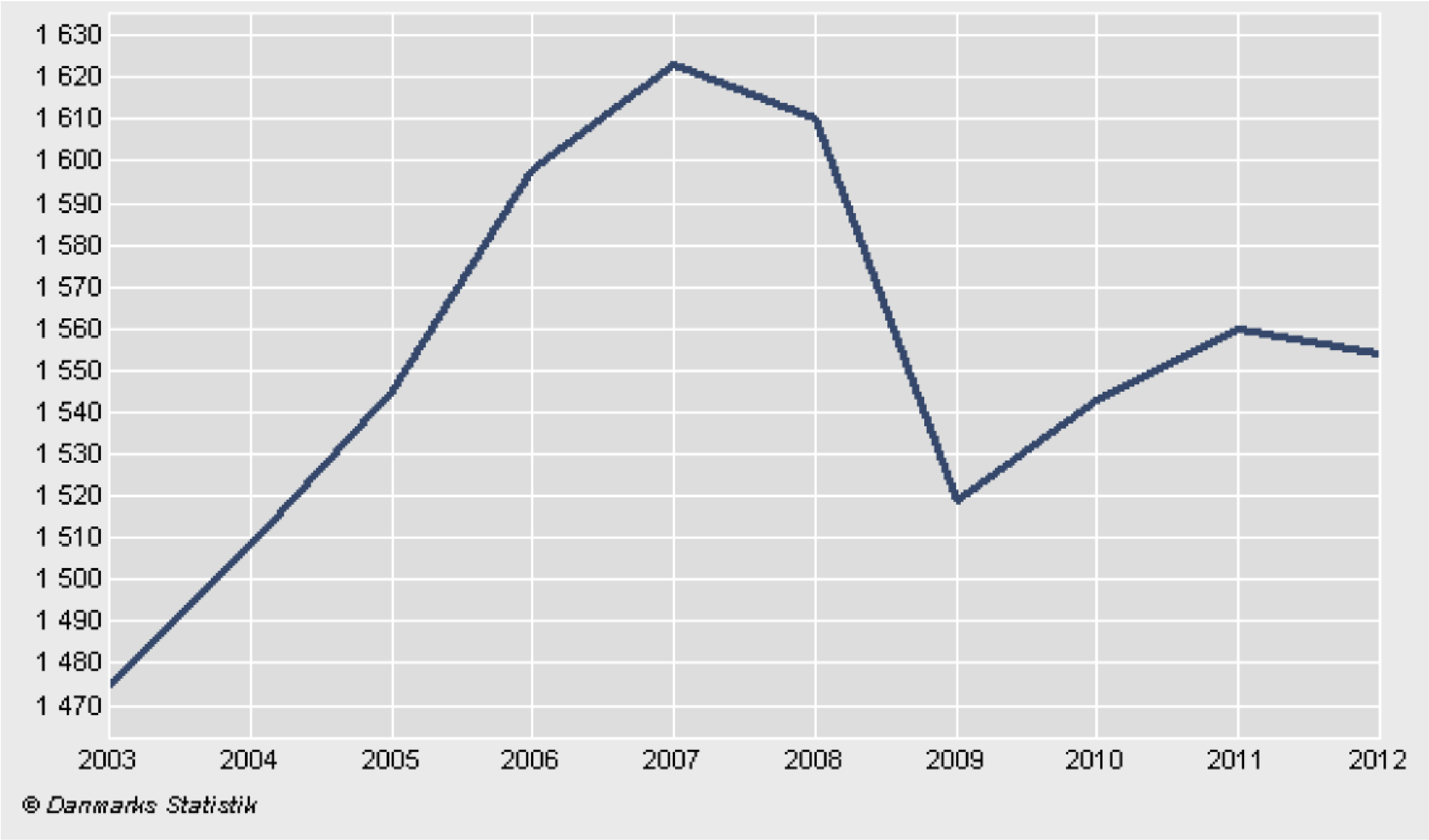
$$(S-I) + (T-G) = (X-M+p)$$

Public and Private Savings Gaps (% of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013*
General government net lending								
Denmark	5,0	4,8	3,3	-2,8	-2,7	-2,0	-4,4*	-2,8
Sweden	2,2	3,6	2,2	-1,0	-0,1	0,1	-0,4*	-0,8
Euro Area	-1,3	-0,7	-2,1	-6,3	-6,2	-4,1	-3,6	-2,9
Finland	4,1	5,3	4,3	-2,7	-2,8	-0,9	-1,7*	-2,0
Greece	-6,0	-6,8	-9,9	-15,6	-10,7	-9,4	-6,4	-4,6
Portugal	-3,7	-3,2	-3,7	-10,2	-9,8	-4,4	-4,9*	-5,5
Current account surplus								
Denmark	3,0	1,4	2,9	3,4	5,9	5,6	5,3	4,7
Sweden	8,3	9,1	9,0	6,7	6,9	7,0	7,1	6,0
Euro Area	0,5	0,4	-0,7	0,2	0,5	0,6	1,8	2,3
Finland	4,2	4,3	2,6	1,7	1,5	-1,6	-1,7	-1,7
Greece	-11,4	-14,6	-14,9	-11,2	-10,1	-9,9	-2,9	-0,3
Portugal	-10,7	-10,1	-12,6	-10,9	-10,6	-7,0	-1,5	0,1
Private savings-investment gap								
Denmark	-2,1	-3,4	-0,4	6,2	8,6	7,6	9,6*	7,5*
Sweden	6,1	5,5	6,9	7,7	6,9	6,9	7,5*	6,8*
Euro Area	1,9	1,1	1,5	6,7	6,7	4,7	5,5	5,4*
Finland	0,1	-1,1	-1,7	4,5	4,3	-0,7	0,7*	0,3*
Greece	-5,3	-7,8	-5,0	4,4	0,6	-0,5	3,5	4,3*
Portugal	-7,0	-6,9	-8,9	-0,6	-0,5	-2,8	2,8*	5,6*

* Estimates. Source: IMF, World Economic Outlook Database, April 2013

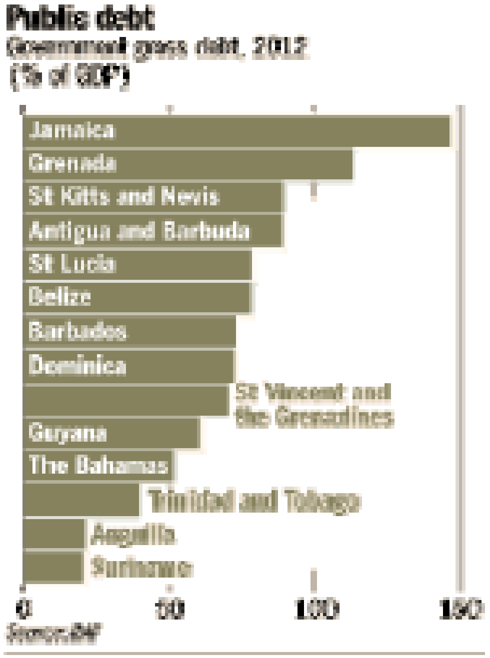
Real GDP, DK, 2003-2012, Billions of 2005 DKK



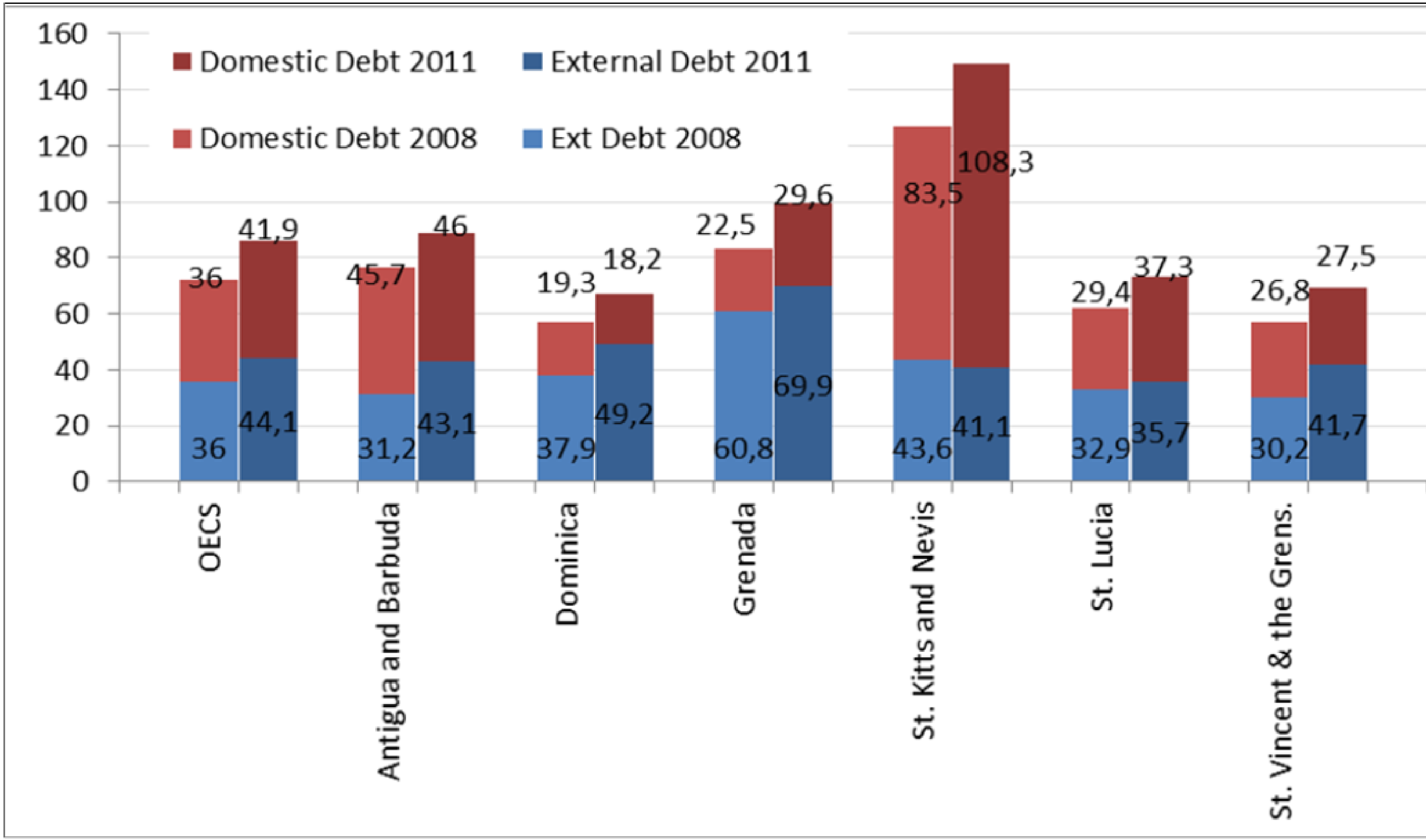
Public debt

	2006	2007	2008	2009	2010	2011	2012	2013
				(a) EA				
Finland	39,6	35,2	33,9	43,5	48,6	49,0	53,3*	56,9*
Germany	67,9	65,4	66,8	74,5	82,5	80,5	82,0	80,4*
France	64,1	64,2	68,2	79,2	82,3	86,0	90,3	92,7*
Greece	107,5	107,3	112,5	129,3	147,9	170,6	158,5	179,5*
Ireland	24,6	25,0	44,5	64,9	92,2	106,5	117,1	122,0*
Italy	106,3	103,3	106,1	116,4	119,3	120,8	127,0	130,6*
Portugal	63,7	68,3	71,6	83,1	93,2	108,0	123,0*	122,3*
Spain	39,7	36,3	40,2	53,9	61,3	69,1	84,1	91,8*
Euro area	68,6	66,4	70,3	80,0	85,6	88,1	92,9	95,0
				(b) ECCU				
Antigua and Barbuda	90,9	79,2	77,3	102,5	90,8	92,9	89,2	91,9*
Dominica	79,0	73,0	65,3	64,2	69,9	70,7	72,2*	73,6*
Grenada	93,4	89,5	84,4	97,7	104,3	109,0	112,6	116,1*
St. Kitts and Nevis	145,3	134,0	131,0	148,5	163,9	153,6	89,3	83,0*
St. Lucia	59,4	57,5	57,1	61,3	66,0	71,1	78,4	84,8*
St. Vincent and the Grenadines	63,8	55,6	57,3	64,6	66,2	67,8	70,2*	74,2*

*Estimates. Source: IMF, World Economic Outlook Database, April 2013


Public debt
Government gross debt, 2012
(% of GDP)
Jamaica
Grenada
St Kitts and Nevis
Antigua and Barbuda
St Lucia
Belize
Barbados
Dominica
St Vincent and the Grenadines
Guyana
The Bahamas
Trinidad and Tobago
Anguilla
Suriname
0
50
100
150

Composition of public debt on domestic and foreign creditors



Source: IMF, World Economic Outlook Database, April 2012

Illustration (1): Excessive private debt

- Households run into debt problems…
- This shows up as a banking crisis…
- The banks won't be stuck with the bill and pass it on to the government…
- This leads to an increase in sovereign debt…
- Debt burdened sovereigns pass on the bill to its citizens…
- Fiscal pain with higher taxes or spending cuts - and possibly seigniorage, bail-outs, defaults…

Illustration (2): External imbalance

- Suppose a CA deficit appears – for whatever reason
- Then either the government has to run a deficit, or private savings must fall relative to investment to restore equilibrium
- In a downturn, however, savings tend to rise and investment to fall
- So the most likely outcome is that the government deficit will rise

Illustration (3): Entering monetary union

- Suppose an economy enters an era of historically low interest rates, on joining a more disciplined currency zone
- Savings-investment gap turns negative
- This is not a fiscal problem if matched by a current account deficit, such as Portugal and Spain until 2008
- But if it fails to produce that external deficit, the there will be a financing stop and fiscal deficits have to increase to provide liquidity to the banks
- So excess private debt becomes public debt…
- The bottom line is that poor macroeconomic fundamentals and imbalances elsewhere in the economy can easily translate into a crisis in the banking sector and fiscal deficits, even if there has been no fiscal irresponsibility *per se*

Illustration (4): Sudden stops

- Demand for assets in ”problem countries” will collapse, especially in a currency union where individual countries are deprived of a lender of last resort
- Asset sales can be sent to low-risk countries without major transactions costs:
  - in the EA to Germany, Finland etc. in the north
  - In the ECCU to the US
- This leads to liquidity crisis and increased borrowing costs
- In principle, this could occur without “actively irresponsible” fiscal decisions…

Illustration (5): Portugal…

- Suppose investors fear default of the Portuguese government
  - They sell Portuguese government bonds and yields increase
  - Proceeds of these sales are used to invest in other eurozone assets
  - No foreign exchange market and floating exchange rate to stop this
  - The Portuguese money stock declines and the pool of liquidity for investing in Portuguese government bonds shrinks
  - No Portuguese central bank that can be forced to buy Portuguese government bonds
  - Liquidity crisis possible: Portuguese government cannot fund bond issues at reasonable interest rate
  - Can be forced to default
  - Investors know this and will be tempted to try…

General government net lending

	2006	2007	2008	2009	2010	2011	2012	2013
(a) EA								
Finland	4.1	5.3	4.3	-2.7	-2.8	-0.9	-1.7*	-2.0*
Germany	-1.6	0.2	-0.1	-3.1	-4.1	-0.8	0.2	-0.3*
France	-2.4	-2.7	-3.3	-7.6	-7.1	-5.2	-4.6*	-3.7*
Greece	-6.0	-6.8	-9.9	-15.6	-10.7	-9.4	-6.4	-4.6*
Ireland	2.9	0.1	-7.4	-13.9	-30.9	-13.4	-7.7	-7.5*
Italy	-3.4	-1.6	-2.7	-5.4	-4.3	-3.7	-3.0	-2.6*
Portugal	-3.7	-3.2	-3.7	-10.2	-9.8	-4.4	-4.9*	-5.5*
Spain	2.4	1.9	-4.5	-11.2	-9.7	-9.4	-10.3	-6.6*
Euro area	-1.3	-0.7	-2.1	-6.3	-6.2	-4.1	-3.6	-2.9
(b) ECCU								
Antigua and Barbuda	-8.8	-5.0	-5.7	-18.2	-0.2	-3.6	-1.2	-6.6*
Dominica	3.0	1.8	0.7	-0.3	-3.5	-4.5	-3.8*	-3.4*
Grenada	-5.6	-6.3	-4.1	-5.2	-3.1	-4.4	-4.7	-6.1*
St. Kitts and Nevis	-3.9	-3.5	-3.9	-2.9	-7.8	1.8	5.2	2.2*
St. Lucia	-5.9	-1.9	-0.9	-3.1	-4.8	-6.9	-11.9	-9.4*
St. Vincent and the Grenadines	-3.1	-3.1	-1.4	-3.2	-5.4	-3.6	-2.7*	-2.8*

*Estimates. Source: IMF, World Economic Outlook Database, April 2013

Current account balance

	2006	2007	2008	2009	2010	2011	2012	2013
(a) EA								
Finland	4.2	4.3	2.6	1.7	1.5	-1.6	-1.7	-1.7*
Germany	6.2	7.4	6.2	6.0	6.2	6.2	7.0	6.0*
France	-0. 6	-1.0	-1.7	-1.3	-1.6	-1.9	-2.4	-1.3*
Greece	-11.4	-14.6	-14.9	-11.2	-10.1	-9.9	-2.9	-0.3*
Ireland	-3.5	-5.4	-5.7	-2.3	1.1	1.1	4.9*	3.4*
Italy	-1.5	-1.3	-2.8	-2.0	-3.5	-3.1	-0.5	0.3*
Portugal	-10.7	-10.1	-12.6	-10.9	-10.6	-7.0	-1.5	0.1*
Spain	-9.0	-10.0	-9.6	-4.8	-4.5	-3.7	-1.1	1.1*
EA	0.5	0.4	-0.7	0.2	0.5	0.6	1.8	2.3
(b) ECCU								
Antigua/ Barbuda	-26.3	-30.0	-25.9	-19.4	-14.7	-10.8	-12.8*	-13.1*
Dominica	-13.0	-21.1	-27.5	-21.2	-16.2	-12.8	-13.4*	-13.8*
Grenada	-29.6	-27.7	-25.3	-23.6	-24.1	-23.3*	-22.9*	-23.4*
St. Kitts/ Nevis	-14.1	-18.2	-27.6	-27.4	-22.4	-15.6	-13.5*	-15.9*
St. Lucia	-30.6	-30.6	-29.2	-11.7	-16.9	-20.1	-19.1*	-18.2*
St.Vincent/ Grenadines	-19.5	-28.0	-33.1	-29.3	-30.6	-28.8	-27.8*	-26.8*

* Estimates. Source: IMF, World Economic Outlook Database, April 2013

Private savings-investment gap

	2006	2007	2008	2009	2010	2011	2012	2013
			(c) EA					
Finland	0. 1	-1.1	-1.7	4.5	4.3	-0.7	0.7*	0.3*
Germany	7.9	7.2	6.3	9.0	10.4	7.0	6.8	6.4*
France	1.8	1.7	1.6	6.2	5.5	3.2	2.3*	2.4*
Greece	-5.3	-7.8	-5.0	4.4	0.6	-0.5	3.5	4.3*
Ireland	-6.4	-5.4	1.7	11.6	32.0	14.5	12.7	10.9*
Italy	1.9	0.3	-0.2	3.4	0.8	0.6	2.5	2.9*
Portugal	-7.0	-6.9	-8.9	-0.6	-0.5	-2.8	2.8*	5.6*
Spain	-11.3	-11.9	-5.1	6.4	5.2	5.7	9.2	7.7*
EA	1.9	1.1	1.5	6.7	6.7	4.7	5.5	5.4
			(d) ECCU					
Antigua/ Barbuda	-17.5	-24.9	-20.1	-1.1	-14.5	-7.2	-11.5*	-6.5*
Dominica	-16.0	-22. 9	-28.2	-20.9	-12.7	-8.4	-9.6*	-10.4*
Grenada	-23.9	-21.4	-21.2	-18.4	-20.9	-18.9*	-18.3*	-17.3*
St. Kitts/ Nevis	-10.2	-14.6	-23.7	-24.5	-14.6	-17.4	-18.7*	-18.2*
St. Lucia	-24.6	-28.7	-28.3	-8.6	-12.1	-13.2	-7.2*	-8.8*
St.Vincent/ Grenadines	-16.5	-24.9	-31.8	-26.0	-25.2	-25.1	-25.1*	-24.0*

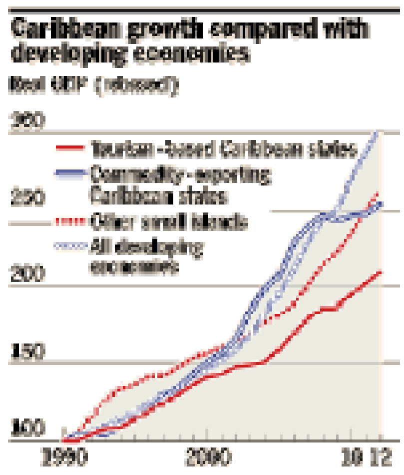
* Estimates. Source: IMF, World Economic Outlook Database, April 2012

ECCU: fiscal imbalances the main risk?

- First look at the data suggests:
  - By far the biggest imbalances are in the current account
  - Then in the savings-investment financing gap
  - Private financing therefore covers the larger part of the external deficits but not by enough
- This leads to accumulation of public debt
  - The ECCU countries are thus open to big risk from sudden financing stops or capital reversals
- We are primarily concerned here with sudden deteriorations in the savings-investment gap itself, and the sudden improvements which reflect a drop in investment…

Causality?

- Stable patterns in ECCU, except:
  - Private investment-savings gap in 2008-09
  - The current account balance in 2008-10
  - Government net lending in 2009-11
- Lagged effect with respect to fiscal gap may tell something about causality:
  - Imbalances start with private sector external payments which are not fully financed by capital inflows from abroad
  - In fact, those inflows tend to dry up before the external deficits fall
  - This throws the problem into fiscal deficits and public debt


Caribbean growth compared with developing economies
Real GDP (rebased)
300
250
200
150
100
Tourism-based Caribbean states
Commodity-exporting Caribbean states
Other small islands
All developing economies
1990
2000
10 12

EA – ECCU comparison

- The ECCUs biggest problem is current account deficits
- The EAs largest problem is fiscal deficits, augmented by external imbalances in Greece, Portugal (and Germany!) before 2012
- The EA deficits have been worse (4-5% of GDP) than those in the ECCU (3-4% of GDP)
- Current account imbalances in the ECCU are four to five times larger (about 15 to 30 % of GDP) than those in the EA (less than 2% of GDP, and mostly in surplus)
- The upshot is that ECCUs main problem is a private sector one in the first instance, and official policy should be adapted to deal with that…

Re-orientation of policy response

- Not to say that fiscal deficit and debt reductions would **not** be an important component of policy and structural reform.
- But the private sector imbalances are considerably larger and evidently feed through to induce increased fiscal deficits and public debt.
- Policies should therefore be directed at increasing savings, growth or employment.
- Improving the balance of trade and net investment incomes or remittances would have the biggest impact on improving economic performance, on reducing the risk of periodic financial crises, *as well as* reducing the pressures on fiscal budgets and escalating public debt.

Re-orientation of policy response

- These figures make the differences between what might otherwise appear to be a common excess debt problem in the ECCU and EA clear:
- To account for those differences, the policy prescriptions need to be different.
- In that regard, it is in important to note that the savings-investment gaps have all turned positive since 2008 in the EA which, with improving trade balances,
- Means the EA has shifted private sector deficits onto the public budget. In the ECCU, there are no such changes in the sign of the private savings-investment gaps or the size of the external deficits.
- <u>Their imbalances remain in the private sector</u>.

Re-orientation of policy response

- Europe is now at a point where consolidation policies could operate on the public sector.
- This calls for a distinction between fiscal consolidations and restructuring - now that growth and private sector balances are returning to normal…
- The premature use of austerity policies which had probably delayed that return to a “business as usual” equilibrium in the EA.
- In the ECCU, by contrast, the need is for policies explicitly directed at restructuring the private sector.

Intertemporal assignment of fiscal and monetary policy

- Fiscal policy should focus on long-term targets, such as pensions, public service, research and education etc., subject to controlled debt development
- Monetary policy focuses on short-term targets, such as price stability (i.e., no change for the ECB), knowing what the role of fiscal policy is. That is, fiscal leadership…
- Intertemporal assignment combined with debt targeting would lead to better coordination of monetary and fiscal policy
- No need for direct negotiations between ECB and fiscal authorities, and no need for new institutions…

Debt targets

- Restrictions on fiscal policy should focus on potential imbalances, and not on the size of the public sector or the composition of revenues/expenditures…
- Fiscal policy not taken out of the hands of elected politicians with a public mandate.
- Debt targets implies a degree of persistence, moves more slowly than deficits…
- Focuses directly on the primary concern: unsustainable public finances…
- Gives policymakers a greater incentive to save at the top of a cycle and remain within target in the future…

Debt targets in practice

- EA-wide monetary fund (ESM) to cope with short-term shocks
- Set-up for each government, with target value and upper boundary
- Space between target and upper boundary divided into sub-ranges
- Debt targets might differ across countries, but space between target and upper boundary should be common
- Monitored by Fiscal Policy Commission (FPC)

Debt targets in practice

Numerical characteristics

- Debt *target*:
  - 45% of GDP
- Debt *ceiling*:
  - 60% of GDP
- Debt *sub-ranges*:
  - 45-50; 50-55; 55-60

Governance in practice

- 45-50: ”green”
  - no intervention
- 50-55: ”yellow”
  - FPC watch list, any assistance based on conditionality, oversight
- 55-60: ”red”
  - public warnings, any assistance, loans or bail-out guarantees would become strictly conditional on recommendations being implemented
- > 60:
  - very tough!!

Debt targets in practice

When public debt-GDP ratio > 60%

- All bail-out guarantees suspended
- Any further debt issued would be priced according to market forces with an explicit no bail-out provision attached.
- Any further European or IMF support would only be offered if the national government accepted the “assistance” of EC officials in running government spending and taxation until the 60% limit or better was regained; i.e. the national government would be placed in administration.

Financing…

- EC own funds (contributions from EA governments)
- Levy amounting to 0.25% of GDP for each percentage point that any deficit had exceeded the 3% limit in the period in which public debt was in one of the upper two excessive debt ranges
- Might be lifted in quarters with negative growth…

Management

- Conditions agreed and made public to all before start of regime…
- Progress of participating governments assessed and discussed in public by the FPC
- Real sanction is that the possibility of any loan, bail-out or other assistance is strictly conditional - and known to be so…

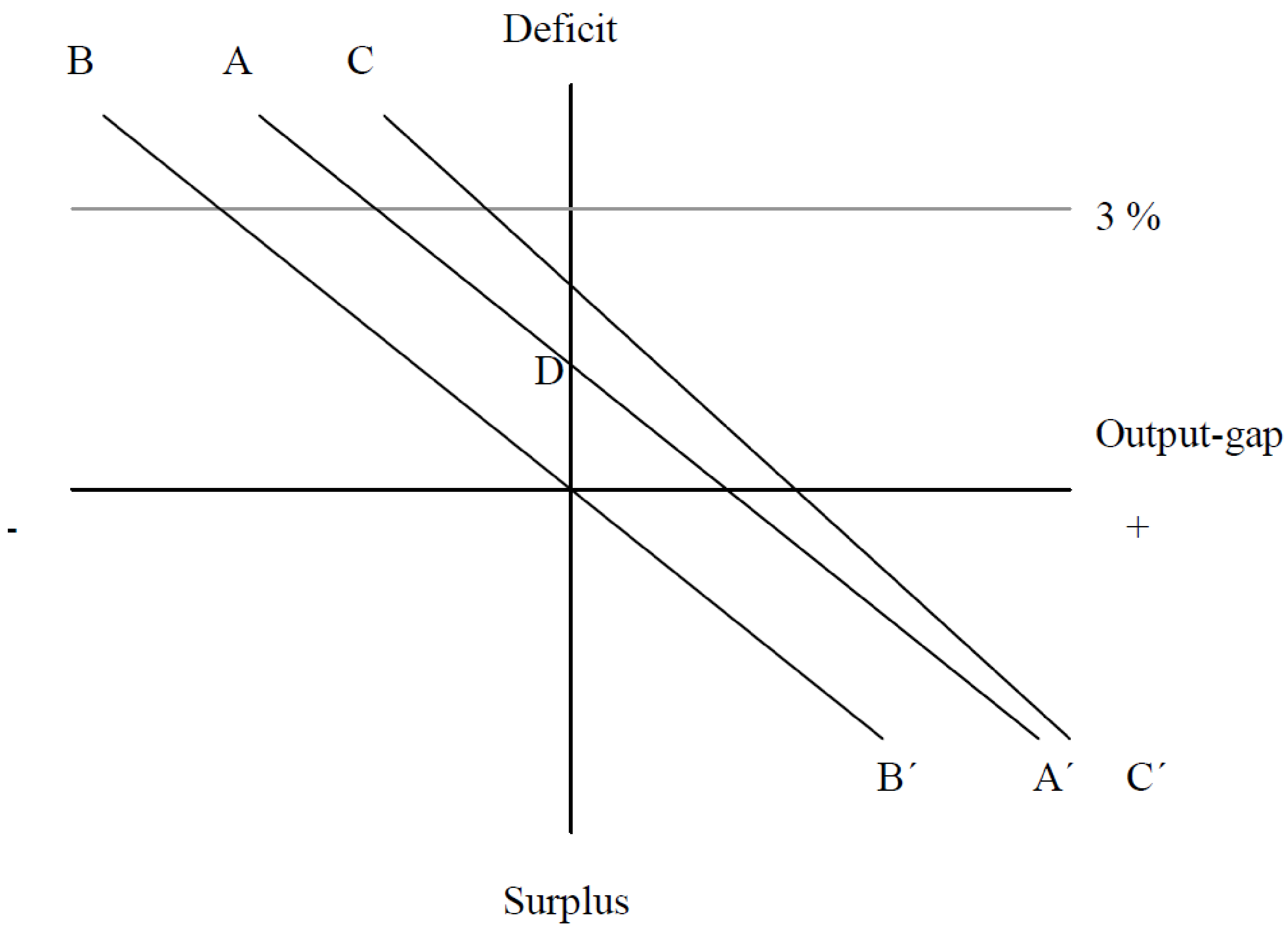
Management

- Breaches come with two zones of warning:
- Should act as a break on imprudent debt expansions and guard against the dilemma of moral hazard
- Penalities not so much fines but political backlash and escalating borrowing costs…

Fiscal Policy Council (FPC)

- Need for an independent FPC to have responsibility for:
  - reviewing the fiscal outlook for the EA governments,
  - reviewing the revenues likely to be available,
  - estimating the current structural positions, and
  - estimating the likely consequences of current spending plans, including those implied by changing demography and pension costs.

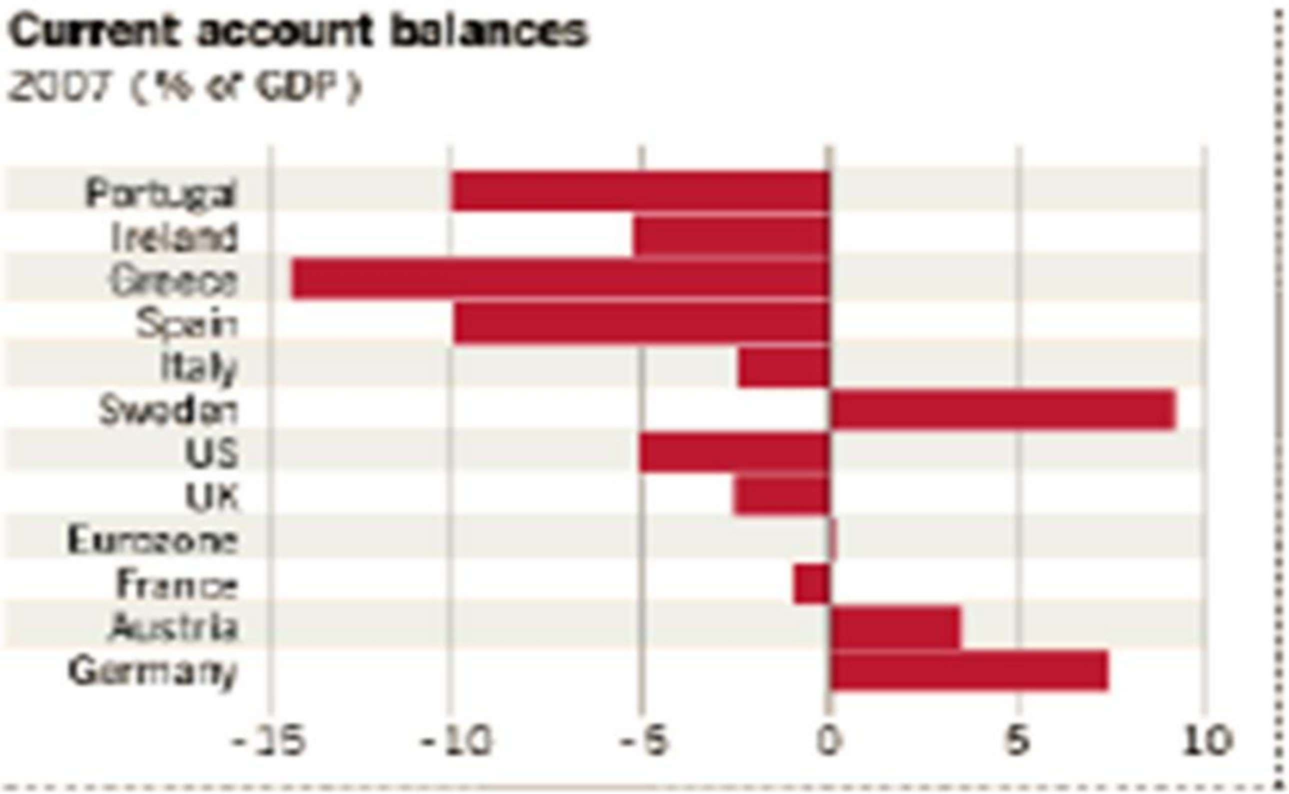
Link between fiscal policy and structural reform



Structural reforms

- Previously, discussions about the need for structural reforms in the EA have focussed on major countries like Germany and France
- Still relevant, but, as the next slides show, southern EA countries have systematically had external deficits. If this goes on, they become an EA ghetto and we get a ”Mezzogiorno problem”…

The current account



Net foreign assets