

COMMENTS ON SESSION 4 THE LEGACY OF THE CRISIS AND THE EXIT STRATEGY

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I would like to begin by thanking Daniele Franco and Banca d'Italia for inviting me to this workshop and giving me an opportunity to discuss two excellent papers: "A Note on Optimal Fiscal Rule for Turkey" by Mehmet Yörükoğlu and "Optimal Fiscal Policy in the Post-crisis World" by Francesco Caprioli, Pietro Rizza and Pietro Tommasino.

As this session is devoted to the legacy of the crisis, let me begin with a few remarks on how the crisis has affected fiscal policies. Over the recent months we have witnessed a massive increase in public deficits, arising from the operation of automatic stabilisers, discretionary fiscal stimulus measures, government support to financial institutions, as well as a reversal of revenue windfalls arising from asset price bubbles. In addition, as potential output estimates have been revised downwards, structural fiscal positions were revealed to have been much worse than estimated before the crisis.

The effect of this widening of fiscal imbalances has been on the one hand prevention of an even deeper recession of uncertain magnitude. On the other hand, however, they have resulted in a huge build-up of public debt, amounting to around 30-40 per cent of GDP. As a result, debt ratios in developed countries are on average projected to exceed 100 per cent of GDP and continue rising. Sizeable structural deficits persist and debt dynamics are turning from a very favourable environment observed in recent years to an adverse mix of slower potential growth and, at least in the medium term, a likely increase in long-term interest rates.

In this environment, it may be useful to ask the question about the optimal or acceptable debt ratio – what should governments aim to do in the current context – simply stop the build-up of public debt or rather reduce it and if so then to what level.

The key consideration in this respect is an "acceptable" debt threshold, found in the empirical literature to be critical in terms of the impact of government policy on the economy. Beyond this threshold, estimated by some studies at around 90-100 per cent of GDP, risk premia may be expected to rise sharply, the behaviour of economic agents may change, as they become more Ricardian and economic growth suffers. These effects are reflected in the Caprioli, Rizza and Tommasino paper.

Other considerations have also been mentioned in the literature for thinking about the optimal or desired level of public debt. One is the idea of using deficit financing to finance only public investment, implying that the optimal level of public debt is a function of the desired stock of public capital.

Another important argument is that of intergenerational equity and demographics in general. The projected increase in old-age dependency ratios and the ensuing increases in ageing-related public expenditure pressures are an important argument for pre-funding, *i.e.* reducing debt ratios or even building up net asset positions today, so as to ease the burden falling on future generations.

The issue of the optimal/acceptable debt ratios is to some extent addressed by both of the papers I shall discuss, as they both address the issue of targeting an optimal or acceptable debt ratio and both do so using theoretical models. However, while the paper by Caprioli, Rizza and Tommasino focuses on the period after or during a crisis, the paper by Yörükoğlu discusses a fiscal

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rule to be employed in “normal” times. In addition, the frameworks of the two papers differ a lot, so I shall discuss them separately.

1 Comments on “Optimal Fiscal Policy in the Post-crisis World” by Francesco Caprioli, Pietro Rizza and Pietro Tommasino

The paper by Caprioli, Rizza and Tommasino describes an infinite horizon economy model, with an infinitely lived representative consumer and a benevolent fiscal authority which issues and services debt and imposes distortionary taxation. In the first stage, consumers are fully confident about government solvency, there is therefore no need to reduce the initial debt ratio. As a result, it is optimal to stabilise debt, keep the tax level smooth and thus facilitate consumption smoothing. In the second step, consumers’ fear of government default is introduced, although it is ungrounded, as the government has no intention of defaulting. In these circumstances, debt reduction becomes an optimal policy, so as to avoid an increase in risk premia.

The lack of possibility of default in the model is not quite intuitive, and the authors mention a possible extension in the form of introducing a strategic default.

However, it is worth considering, whether a forced default would not be more likely to occur in reality. Based on evidence gathered mainly in emerging market economies, sovereign default literature suggests that defaults carry high economic and political costs and that these reputational costs are actually higher if the default is strategic. In addition, the consumers’ perception of default risk in the model depends only on the debt level, while it could be broadened to include other factors, such as political factors, fiscal institutions or size of government. A potential solution to both issues could be the introduction of a fiscal limit *à la* Bi and Leeper (2010) in the form of a dynamic Laffer curve. One could also consider modelling default as a political decision conditional on the fiscal limit.

Let me now move to the policy conclusions of the paper. In the first stage, when there is full trust in government solvency, after a crisis leading to a build-up of public debt, the debt ratio is stabilised at the resulting level, without any debt reduction. This would imply debt ratcheting, with each subsequent crisis or downturn. In the second stage, once consumers begin to fear a default, following a build-up of public debt, the debt ratio needs to be reduced, but the question is to what level. Authors note, that after 20 periods, the debt-to-GDP ratio is equal to about 100 per cent of GDP in the case of a fully credible government, while it is equal to 35 per cent in the other scenario. However, the rationale behind the 35 per cent of GDP debt ratio is not given in the paper. It is also worth considering, whether debt should be reduced to the critical level, beyond which consumers begin fearing default or rather even further, so as to ensure a safety margin when the next crisis hits.

2 Comments on “A Note on Optimal Fiscal Rule for Turkey” by Mehmet Yörükoğlu

Let me now turn to the Mehmet Yörükoğlu paper on the optimal fiscal rule for Turkey. In looking for such a fiscal rule, the paper addresses a dynamic fiscal loss minimization problem, aiming to minimise deviations of both spending and debt from optimal levels. As noted in the paper, as well as in literature dealing with fiscal rules more generally, one of the desirable features of a fiscal rule is simplicity. In this respect, the rule proposed in the paper may be considered simple in a model setting, but not necessarily for politicians to apply and for the general public to monitor compliance.

A key aspect of the paper is the dual objective of the rule, which is to stabilise the spending and debt ratios. The relative importance of the two objectives is denoted by α_g and α_b , which are called political preference parameters in the paper. However, the targeted stability of the two ratios will have different macroeconomic implications and as such, their relative importance may be more than simply an issue of political preference. The case for a relatively stable expenditure ratio appears to be strong. Expenditure volatility has been found in empirical studies to be harmful for economic growth. One reason for this may be, that a relatively stable expenditure ratio is a key ingredient for the successful operation of automatic stabilisers on the revenue side. Meanwhile, adjusting the spending ratio to debt fluctuations implies a strongly procyclical fiscal policy. For example, if the debt ratio increases in a downturn, the rule would call for a procyclical cut in public expenditure. In fact, even maintaining a stable ratio of public expenditure to nominal GDP would result in a procyclical policy, with spending rising faster in upturns. An option could be to target a stable ratio of spending to potential GDP, provided that the underlying fiscal position is sound, although using an unobserved variable as a policy target entails another set of problems.

Meanwhile, maintaining a stable debt ratio has different effects. Fluctuations of the debt ratio over the economic cycle are a natural and desirable consequence of the operation of automatic stabilisers, as well as timely discretionary anti-cyclical policy, provided that such is carried out. If a government were to try to minimise these fluctuations, this would again imply a pro-cyclical policy. More generally, changes of the debt ratio by themselves do not have negative effects, provided that fiscal policy remains sustainable. In this respect, keeping debt below the critical debt threshold referred to earlier, is likely more relevant for policymaking than maintaining a stable debt ratio.

The paper could generally reflect more on the cyclical impact of fiscal policy and take this impact into account when discussing the design of an optimal fiscal rule. The author applies the fiscal rule to historical output growth figures, but does not address the issue of the impact of fiscal policy on the growth path. Even if output stabilisation was not to be explicitly featured as a target of the rule, it could be useful to evaluate the rules considered from the viewpoint of the impact of resulting fiscal policy on output.

