CAN FISCAL DISCIPLINE BE RECONCILED WITH FISCAL SOVEREIGNTY?

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1 Introduction

In times of acute fiscal stress, a government often feels pressured from abroad by international organizations, foreign governments, and especially investors. Often the initial response from political leaders, almost by reflex, is an expression of outrage at outside *diktat* to undertake an unpalatable budgetary correction.

Criticism of speculators, credit rating agencies, and the International Monetary Fund (IMF) has been a hallmark of recent crisis or near-crisis episodes. Ironically, when political leaders engage in this blame game – which usually plays well with domestic audiences – instead of focusing on the inevitable adjustment task, the country becomes even more dependent on foreign private and official financing of sovereign debt.

Loss of fiscal sovereignty is not new, though its manifestation has shifted significantly over the past century. Four very distinct historical examples may be worth noting: the Ottoman capitulations in the early 1900s; the mandate under the League of Nations loan to Hungary in 1924; the IMF stand-by arrangement with Indonesia in 1998; and more recently, the EU-IMF financial rescue operation for Greece. All four episodes illustrate dramatically how national pride suffered, as foreigners were seen to dictate the conduct of fiscal policy.

Although most public debt crises do not climax in such an outcome, the perils of eroding fiscal sovereignty should not be ignored by any government. This view was expressed rather convincingly by a former Swedish government official, reflecting on his country's crisis and subsequent fiscal consolidation in the first half of the 1990s:[1]

> *"A country with [public] deficit and debt problems is constantly monitored by the financial markets, by international organizations, by other countries…. Being closely monitored by the financial markets means that power shifts from the open chambers of the people's elected representatives to the closed rooms of the financial markets in London and New York…. Some people argue that it is undemocratic that markets have this power over elected representatives. This is a view I do not share. A country that each and every day has to borrow money, either to service the debt or to finance the deficit, is in the hands of its creditors".*

In fact, the high degree of capital mobility does not spare even the economically most powerful nations from dependence on the bond market.[2]

This paper reviews the pre-crisis trends in government financing which may explain the resilience or vulnerability of various countries when facing the repercussions of the recent global financial crisis. The crisis underscores the importance of the sovereign bond market and the need for anchoring expectations by signaling a credible fiscal adjustment. It is argued that this requires a rethink in fiscal policymaking especially by heavily indebted governments. The paper concludes

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1 See Henriksson (2007).

2 As expressed eloquently by James Carville, former U.S. President Clinton's chief political strategist: "I used to think that, if there is reincarnation, I wanted to come back as the president or the pope or a 0.400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody".

with implications with a view to adopting a permanent rules-based fiscal framework by these governments on the basis of internationally accepted good practices.

2 Pre-crisis trends

2.1 Patterns of sovereign financing

Well into the 20th century, government deficits were financed primarily by central banks and external creditors. However, with the advent of central bank independence and the decline in inflation, public debt was held increasingly by the domestic private sector. Italy provides a classic illustration of the evolution of financial innovations in the l970s and 1980s that led to commercial bank intermediation of private savings to meet sizable government borrowing needs in the form of securitized debt. As a result, an active domestic secondary market in government bonds became the main source of financing public sector deficits. Curiously, until recently, much like in Japan, Italy's private savings exhibited a "home bias" as the bulk of a staggering public debt stock, in excess of GDP, remains in the hands of residents. In other advanced economies, absent such a bias, sovereign paper has been held by both residents and non-residents, driven by cross-country financial arbitrage.

In developing economies, lacking access to private sector financing, government debt was monetized (often in the form of non-securitized loans) by the central bank. This was supplemented with general and project-related financing from external bilateral and multilateral official sources, as well as private banking sources. For the most part, foreign lending to local governments and state-owned enterprises, and even to private banks, was explicitly or implicitly viewed as government-guaranteed, which was confirmed in the event of a financial crisis.[3] In addition, eligible governments relied directly or indirectly (through central banks) on balance-of-payments financing from the IMF.

Since the 1990s, with the onset of external liberalization and financial integration, in an increasing number of developing economies, governments satisfied their financing needs with sovereign paper issued both at home and abroad. As they gained access to the secondary bond market, they became known as emerging-market economies.[4] Instead of tapping well-identified bank and official sources, sovereign bonds were issued to anonymous resident and non-resident holders, as in the case of advanced economies. This trend characterized private corporate borrowing as well, although often to a lesser extent than sovereign borrowing. Figure 1 illustrates the shift in the shares of gross debt financing (that is, excluding equity flows) from abroad. However, the rise in the proportion of bond to loan financing for governments has been far more pronounced than shown – especially if government bonds issued in domestic currency to residents were included.

The evolution of emerging markets was accompanied by a host of complex issues that distinguished them from the well-established markets prevailing in advanced economies. With increasing access to the secondary bond market, emerging-market economies became subject to scrutiny by credit rating agencies, which at the outset lacked sufficient information about this novel investment environment. More generally, the ebb and flow of capital movements often followed procyclically the busts and booms in the price of commodities, which for many countries constitute the most important collateral.

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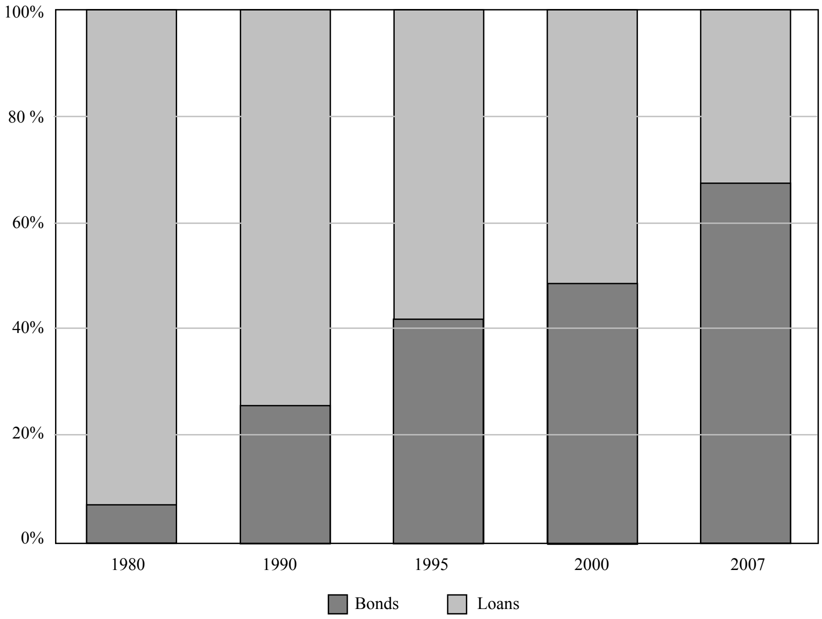
3 In this regard, the Chilean banking crisis, documented by Diaz Alejandro (1985), suggests a *déjà-vu* for much of the Asian crisis and the recent Irish crisis.

4 See Mussa and Richards (2000) on the pull factors and push factors that help explain the rise of emerging markets.

Figure 1

Emerging Markets: External Debt Financing



Source: International Monetary Fund.

Lured by the search for yield, coupled with understated risk, investors flocked to vulnerable emerging-market economies until halted by financial crises. Lack of sophistication and adequate information were reflected in correlated spreads among countries, notwithstanding prevailing cross-country differences. As a result, several debt crises were followed by contagion, including in distant countries. Occasionally, advanced economies were also exposed to shifts in investor sentiment, as shown by the European EMS crisis, in some cases due to underlying policy inconsistency.

Credit rating agencies were seen to discriminate between advanced and emerging-market economies; sovereign bonds were assigned more favorable ratings in the advanced economies even when their debt-GDP ratios were much higher. This was attributable mainly to the structure of the debt and various macroeconomic indicators.[5]

Nevertheless, over time, the differential treatment of emerging-market sovereign paper vanished to some extent, in spite of the massive Argentine default in 2001. The fear that this crisis would leave a lasting scar that, along with the proliferation of so-called collective action clauses (to induce bondholders into crisis-related debt restructuring negotiations), would inhibit capital flows to emerging markets, did not materialize. Apparently, such inhibiting factors were overwhelmed by abundant world liquidity during the Great Moderation.

2.2 *Role of international institutions*

Traditionally, the IMF played a key role as chief disciplinarian over macroeconomic policies, earlier in postwar Europe and later mainly developing countries. This role was exercised through two basic functions: surveillance of member government policies and support of adjustment programs associated with balance-of-payments financing. As the agent of major shareholder governments, the Fund prescribed fiscal, monetary and structural policy measures to correct severe external imbalances, which often reflected sizable fiscal deficits of a given member government. In turn, the government received financial and technical assistance, but more important, through the Fund's catalytic role, it gained leverage for much larger voluntary financing from private investors.

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[5] See Hausmann (2004).

The Fund supported programs in the context of not only stand-by arrangements over a relatively short time horizon, but also extended arrangements that included conditionality incorporating a variety of structural policy measures – often accompanied with policy-based lending from the World Bank – that entailed a longer implementation period. Adjustment programs became choreographed into almost a routine process, frequently involving official debt rescheduling in the Paris Club, and in some instances private debt rescheduling in the London Club, with the activation of the Fund arrangement and financing from official and private sources.

However, the Fund's role changed in tandem with the shift in the composition of financing from official and bank loans to bond issuance. From the second half of the 1990s, with the evolution of sovereign bond financing that could not be rescheduled or restructured (with haircuts) in an orderly fashion, it became increasingly difficult to rein in private lenders to support an adjustment program, as the robustness of Fund arrangements could be questioned by a large number of anonymous bondholders. Market support could no longer be taken for granted. Stand-by arrangements with Russia and Brazil became unraveled in 1998 and 1999, respectively, a few months after they were launched, as markets lost confidence in these governments' capacity to comply with fiscal policy conditionality. The Argentine sovereign default in 2001, in the midst of a Fund supported program, was spectacular in both scale and impact. The Fund's catalytic role was damaged[6] and resolution of the default remained pending, as many bondholders refused to agree to the terms offered by the authorities.

In a regional dimension, the European Union, through ECOFIN and the Commission, relied on the EU Stability and Growth Pact as a disciplinary means of prevention and dissuasion regarding fiscal misbehavior by member countries. Euro area members were required to submit for review multiyear stability programs and non-euro members convergence programs. Members whose fiscal performance was deemed inconsistent with the Pact (upon surpassing the budget deficit limit of 3 per cent of GDP without mitigating circumstances) were subject to the Excess Deficit Procedure. Although nominally liable to financial penalties upon non-compliance, violation by Germany and France was left unpunished, and in 2005 the Pact reinterpreted accordingly. In fact, oversight and peer review proved inadequate as a disciplining instrument and enforcement was lacking.

2.3 Fiscal policy stance

Through the end of the past century, discretionary fiscal policy did not fulfill the role of macroeconomic stabilization. Largely because of political economy reasons, in both advanced and developing countries, the conduct of fiscal policy was more often pro-cyclical than not.[7] This was particularly the case in developing economies, where sharp commodity-led real output volatility was exacerbated by capital movements, and on top of that, by fiscal policy.[8]

However, during the decade of the Great Moderation, fiscal stance varied widely across countries. Several advanced governments, as well as some peripheral euro member governments, adopted an expansionary stance, which in certain cases was encouraged by speculative asset bubbles in financial markets and a largely accommodating monetary policy.

Fiscal policy in many emerging-market economies, especially in Asia and Latin America, reflected lessons learned during the financial crises in the previous decade. An upshot of the

6 See the assessment in International Monetary Fund (2004).

7 European Commission (2000) and Taylor (2000) provide evidence on pro-cylical policies in the European Union and the United States, respectively. Auerbach (2002) also found little evidence of effective countercyclical policy in the U.S.

8 See Kaminsky, Reinhart and Végh (2004).

learning process was that, with increased credibility, governments shed the so-called "original sin",[9] and were gradually able to shift to longer-term borrowing in domestic currency both at home and abroad, thus reducing vulnerability to possible shifts in investor sentiment.

In much of Asia, governments opted for a relatively prudent discretionary stance, underpinned by an aggressive export-oriented strategy that led to a massive accumulation of foreign exchange reserves and reduction in public sector indebtedness. Record-high household propensity to save and active official foreign-exchange intervention permitted maintenance of an undervalued exchange rate while containing inflationary pressures. The war chest of reserves provided ample protection against possible swings in market conditions.

In Latin America, something close to a paradigm shift in fiscal behavior had taken place. At least a half a dozen countries introduced fiscal policy rules at the national and subnational levels of government.[10] Perhaps most remarkable was the case of Brazil where newly promulgated fiscal responsibility law helped stave off a pending crisis in the run-up to the 2002 presidential elections; more important, it ushered in a change in the political culture toward fiscal discipline, unprecedented in the country's modern history. Eventually, the paradigm shift helped mitigate significantly the impact of the recent global crisis in the region.

In Europe, contrary to its anticipated disciplining benefits, the Pact failed to correct an ingrained deficit bias and debt bias in some member countries. In particular, several peripheral euro members incurred growing fiscal imbalances.[11] In a few cases, budget deficits were masked by asset bubbles and accompanied by private dissaving, as well as erosion in competitiveness, all resulting in large external imbalances.

Fiscal laxity in these countries was attributable in part to conflicting signals from EU institutions. The European Central Bank valued uniformly as collateral, in the highest category, sovereign bonds issued by all EU members, without regard to risk differentials due to differences in fiscal performance.[12] Also, as mentioned, the Excess Deficit Procedure was practically ignored, including by major members, without incurring penalties from ECOFIN. In these circumstances, the no-bailout provision prescribed by the Treaty remained untested and not really credible in the markets. Not surprisingly, assuming an implicit official guarantee, credit rating agencies awarded very favorable sovereign ratings for all euro members.

Although to a lesser extent, EU membership was also seen as some sort of guarantee for non-euro members that had just graduated from post-socialist transition. While some of the new members were intent in meeting the criteria for adopting the euro, including the deficit limit, others maintained an attitude of fiscal indulgence.[13] In these countries, much like in the peripheral euro area, market sentiment was numbed by the assumed implicit guarantee by EU institutions. In sum, investors, along with host governments, indulged in moral hazard under the umbrella of EU membership and the protection of a prudent monetary stance.

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9 Until the turn of the century, most of the borrowing by emerging-market governments was in the form of short-term foreign-currency-denominated paper, a practice called the "original sin" by Eichengreen and Hausmann (1999).

10 Argentina, Ecuador, and Venezuela chose a markedly expansionary path, insofar as permitted by the rise in commodity prices.

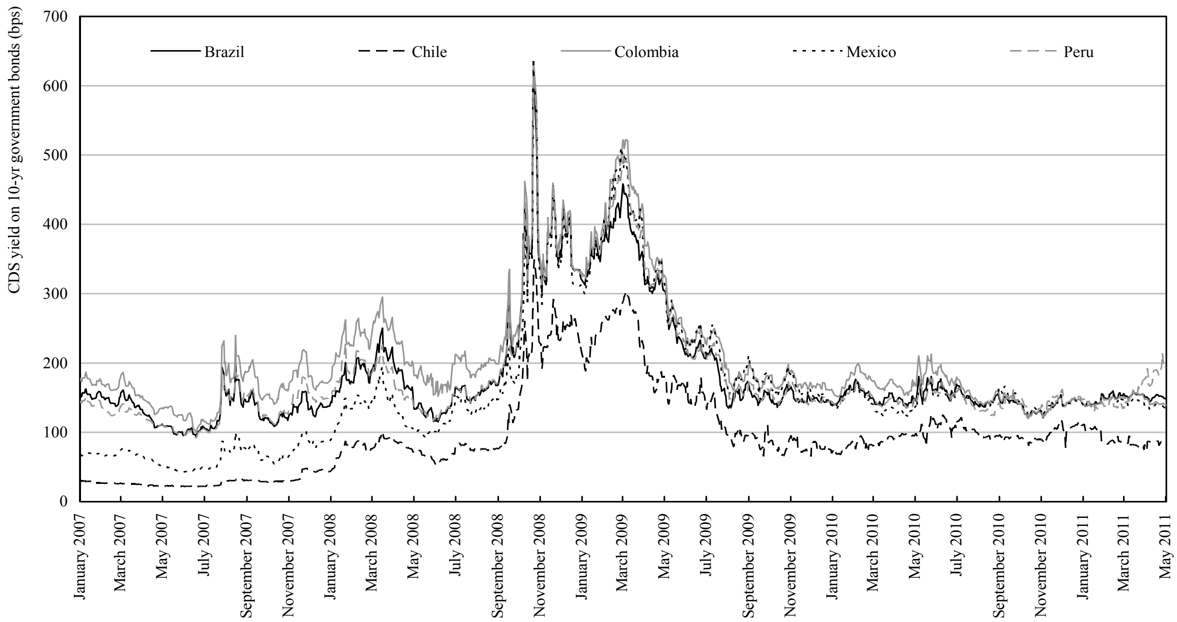
11 Prior to EU accession by former socialist economies, markets attributed a favorable impact to membership, as compared to Latin American economies that would not be able to reap such benefits – as revealed by cross-country differences in yields on sovereign paper, as shown by Kopits (2002).

12 See Buiter and Siebert (2006).

13 In the pre-accession period, there was a marked contrast between the fiscal discipline in the Baltic countries and the fiscal indulgence in Central Europe. Eventually Slovakia and Slovenia joined the Baltics and gained entry in the euro area; see Berger, Kopits and Székely (2007).

Figure 2

Latin America: Sovereign Default Risk



Source: Reuters.

3 Consequences of the financial crisis

3.1 Immediate repercussions

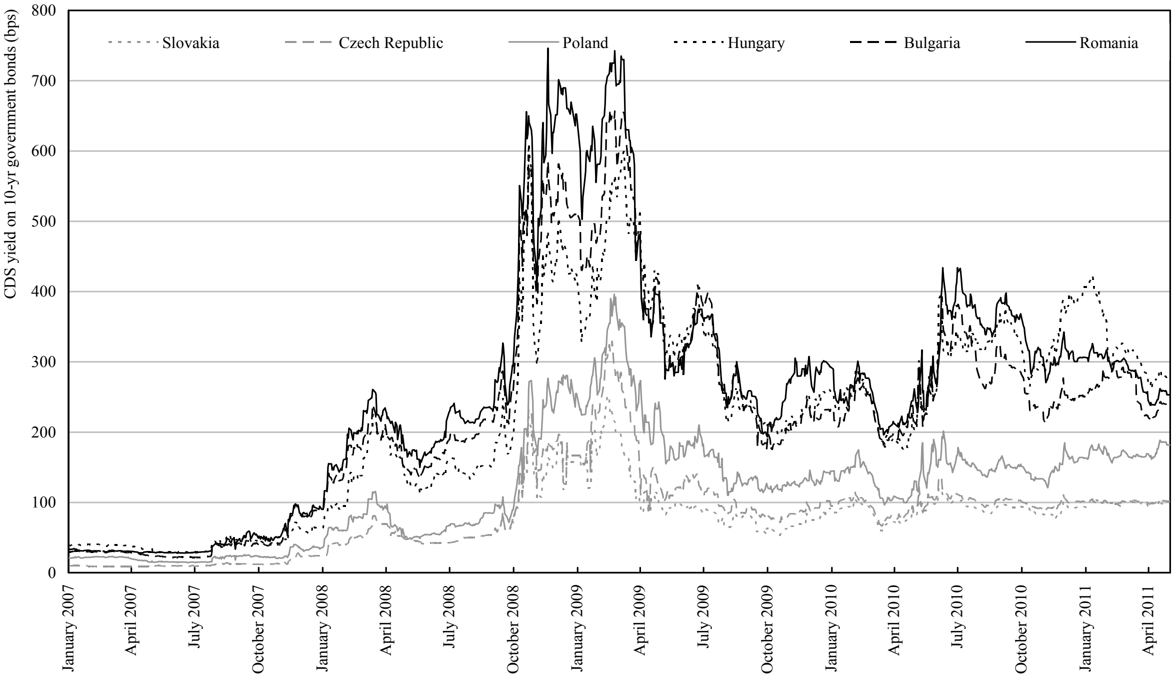
Despite some initial spikes in spreads on sovereign bonds and on their derivatives (measured by CDS spreads), markets were relatively calm until the collapse of Lehman Brothers in October 2008. Thereafter, vulnerable new non-euro EU members, led by Hungary, that suffered a sudden stop in capital markets, applied for IMF-EU financial assistance. In mid-2009, markets were spooked and reacted adversely to the revelation by the newly elected Greek government of a much larger than earlier estimated budget deficit. Ireland was next in suffering a loss of market confidence, following a banking crisis that imposed a significant burden on public finances. In the course of 2010, the governments of Greece, Ireland and Portugal had practically lost access to private financing and secured large-scale IMF-EU assistance. It is noteworthy that, unlike in previous crisis episodes, in Latin America, none of the "usual suspects" from the past made recourse to IMF financial assistance.

By and large, the earlier distinction between advanced and emerging-market economies had practically disappeared. Figures 2, 3 and 4 depict the sovereign default risk during the crisis (as measured by CDS yields). Whereas in Latin America, and Central and Eastern Europe, the default risk had been somewhat rversed, in the peripheral euro area it has kept soaring.

As it became evident that the no-bailout provision in the Maastricht Treaty was being interpreted in a rather fitful manner by the EU authorities, credit rating agencies reacted with sharp downgrades and jolts in risk premium on these countries' bonds. The IMF-EU rescue operations could only be maintained with augmented commitments of official resources and stricter conditionality, in response to market dissatisfaction with the initial terms of the packages. The markets demonstrated yet again their dominant disciplining role, as compared with the Fund and the European Commission.

Figure 3

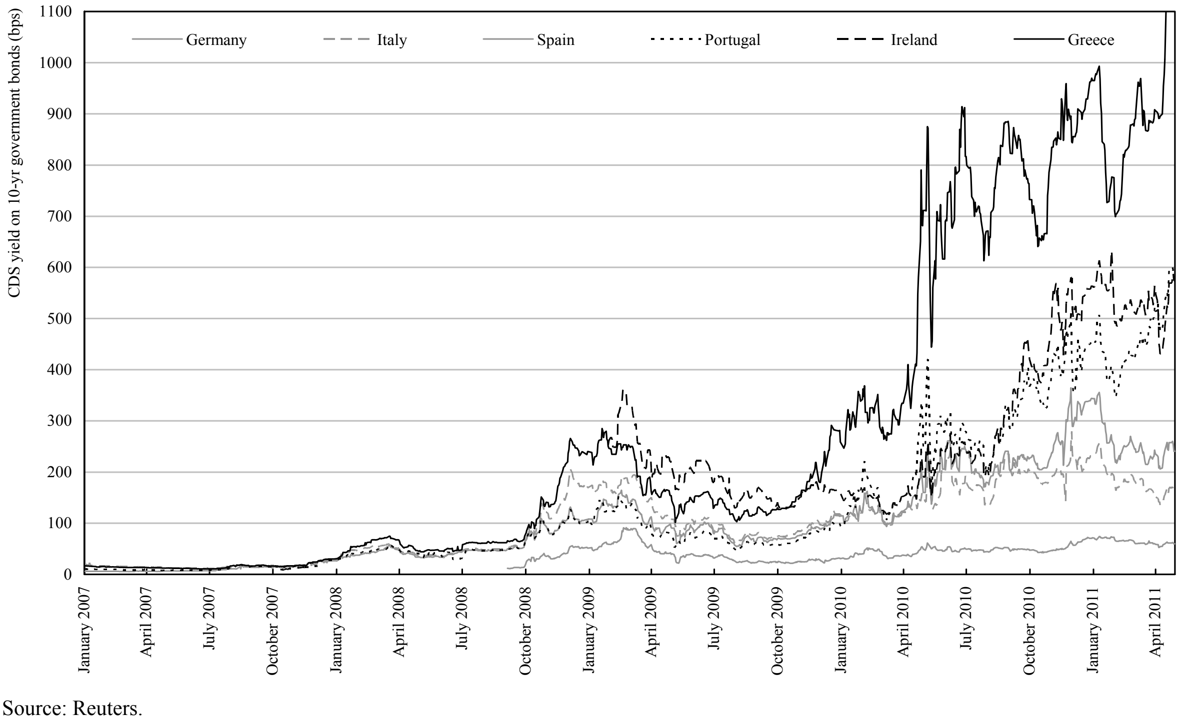
Central and Eastern Europe: Sovereign Default Risk



Source: Reuters.

Figure 4

Peripheral Euro Area: Sovereign Default Risk



Source: Reuters.

3.2 Need for anchoring expectations

Capital account crises – whether precipitated by weaknesses in an overleveraged banking sector, a currency misalignment, revelation of a worsening budgetary position, or some outside event – that are rooted in a public debt sustainability problem require commitment to a bold fiscal correction. As the capital outflow (or sudden stop) is induced in the first place by perceptions of fiscal vulnerability, strong policy signaling through an unequivocal pledge to phasing in structural measures over the medium term is far more convincing than immediate one-off measures, likely to be reversed in the future. In other words, legislative enactment of a public pension reform – even though implementation is scheduled to be phased in over several years – is far more valued by financial markets than a wage freeze that is bound to be temporary.[14] The goal should be to anchor fiscal expectations over a medium-term horizon, much like for monetary policy the base interest rate is set with the objective of anchoring inflation expectations in the near term.[15]

An effective approach to anchor expectations consists of adopting a permanent rules-based fiscal framework, which represents a commitment technology analogous to an inflation targeting framework for monetary policy practiced in more than two dozen countries. In essence, such a fiscal framework can help anticipate imbalances much before the markets or credit rating agencies – notorious for their lagged response to a deterioration or an improvement in fiscal performance – do, and thus provide useful feedback and alert policymakers at an early stage.

Key elements of the fiscal framework are (numerical) policy rules, procedural rules, transparency norms, and an independent monitoring authority. Not all these elements are present to a uniform extent in a fiscal framework: in some countries (New Zealand) an independent monitoring institution is obviated by high standards of accountability and transparency; or in others, instead of a statutory constraint on fiscal performance, the government sets a fiscal target for its term in office (United Kingdom) subject to surveillance by an independent authority. Indeed, for the most part, a fiscal framework is to be designed taking into account the country's political culture and legal traditions. Contrary to earlier belief, a supranational framework, such as the EU Stability and Growth Pact, can serve merely as an envelope for national fiscal rules, but cannot be a substitute for them. This is, incidentally, the approach being formalized in the EU draft directive on national budgetary frameworks.[16]

Therefore, to be convincing, a rules-based fiscal framework should be home-grown rather than imported (often reluctantly) from an international institution. Inasmuch as possible, it should also be home-owned, that is, based on a broad consensus among political parties. Well-designed policy rules and independent watchdogs, supported by broad-based political ownership, are key ingredients for the success of such a framework in the Netherlands or Sweden in Europe, and in Brazil or Chile in Latin America.

It is for the above reason that since the onset of the crisis, a number of countries, mainly in Europe, have introduced their own fiscal rules or independent agencies or both – but all consistent with the Pact.[17] Following a politically-polarized debate, in late 2008, Hungary enacted the fiscal responsibility law that incorporates a set of fiscal rules and a fiscal council charged with surveillance of fiscal management and compliance with the rules. Slovenia, Romania, and the United Kingdom have followed suit, while Australia, Ireland, and Portugal are about to establish

[14] See Kopits (2004).

[15] See, for example, the comparison between monetary and fiscal policies in the U.S. by Leeper (2010).

[16] Both the Van Rompuy Task Force report (2010) and the Council of the European Union (2011) draft directive outline the basic requirements of a comprehensive national fiscal framework for member states. Regrettably, unlike the report, the draft directive excludes any reference to the desirability of establishing independent fiscal institutions, as part of the national frameworks.

[17] See Kopits (2010a).

independent fiscal institutions. Interestingly, in the United States, with the oldest fiscal monitoring institution (the Congressional Budget Office) in place, there are legislative initiatives to introduce fiscal policy rules (a balanced-budget requirement and an expenditure limit) as well.

3.3 An illustration

Contrasting recent episodes that illustrate the influence of policy signaling on market expectations can be found in Hungary and the United Kingdom. Although both countries' recent experience can be viewed as comparable, they provide no more than stylized facts for this purpose – leaving aside a myriad of other features that differentiate them. Features in common include the concurrent general election, held April 2010, of a center-right government, succeeding a center-left government notorious for fiscal indulgence over an extended period.

In the United Kingdom, shortly after assuming power, the new coalition government set an ambitious balanced-budget target (named the fiscal mandate) for the end of its term. In addition, the government established an interim Office for Budget Responsibility (OBR) that was succeeded by a permanent OBR. The OBR is charged primarily with monitoring fulfillment of the mandate, preparation of macro-fiscal forecasts (a task taken over from the Treasury) and analysis of debt sustainability. These steps were followed by a number of tangible measures such as pruning welfare entitlements and raising the value-added tax rate. In all, these measures were designed to meet the mandate.

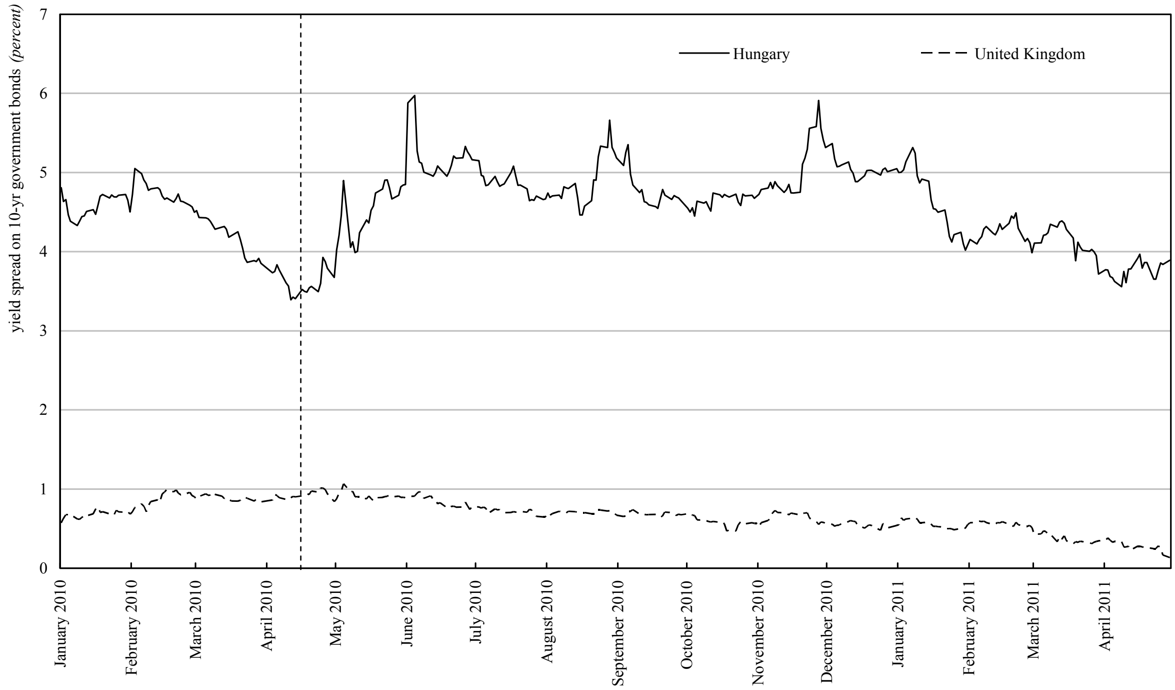
In Hungary, the new government, in command of a two-thirds parliamentary majority, inherited a rules-based fiscal framework which it chose to ignore. Instead of continuing with the Fund- EU supported adjustment program, it communicated a set of mixed signals to the market as to its willingness to contain the sharp rise in indebtedness. The government dismantled several modest structural measures and imposed distortionary asset taxes on selected activities, which were followed by amalgamation of defined-contribution government-mandated private pension funds into the traditional defined-benefit pay-as-you-go system. None of these measures contributed to reducing the structural budget deficit. Further, the government weakened significantly institutional checks-and-balances in the oversight of fiscal policy (including as regards the constitutional court and the state audit office). In particular, by the end of the year, it abolished the staff of the Fiscal Council and de facto eliminated the Council's independent monitoring role.

Although the above policy shift had no immediate impact on macro-fiscal trends, the adopted measures influenced market expectations regarding the medium- to long-term fiscal outlook. Markets reacted promptly to the contrasting policy signals in the two countries, as reflected in the risk premium on sovereign paper (Figure 5). In the UK, sovereign interest rate spreads declined on all maturities. By contrast, in Hungary, following a pre-electoral decline, in anticipation of the change in government which was expected to break with past behavior, the spread bounced back sharply to its level at the beginning of the year, while credit ratings fell to just one notch above junk bond status. Only by early 2011 did the CDS spread on Hungarian sovereign paper began to decline again, after the government announced some structural measures intended to avert a further downgrade to junk status. After a lost decade (reminiscent of Latin America's lost decade of the 90s), Hungary experienced yet an additional lost year under the new government. The disparity in the movement of market confidence between the two countries was reflected even more sharply in the CDS spreads on government bonds (Figure 6).[18]

[18] Although more volatile (as they are generated in a thin market for derivatives), CDS spreads provide a more useful gauge for default risk, than plain sovereign spreads which include currency risk as well.

Figure 5

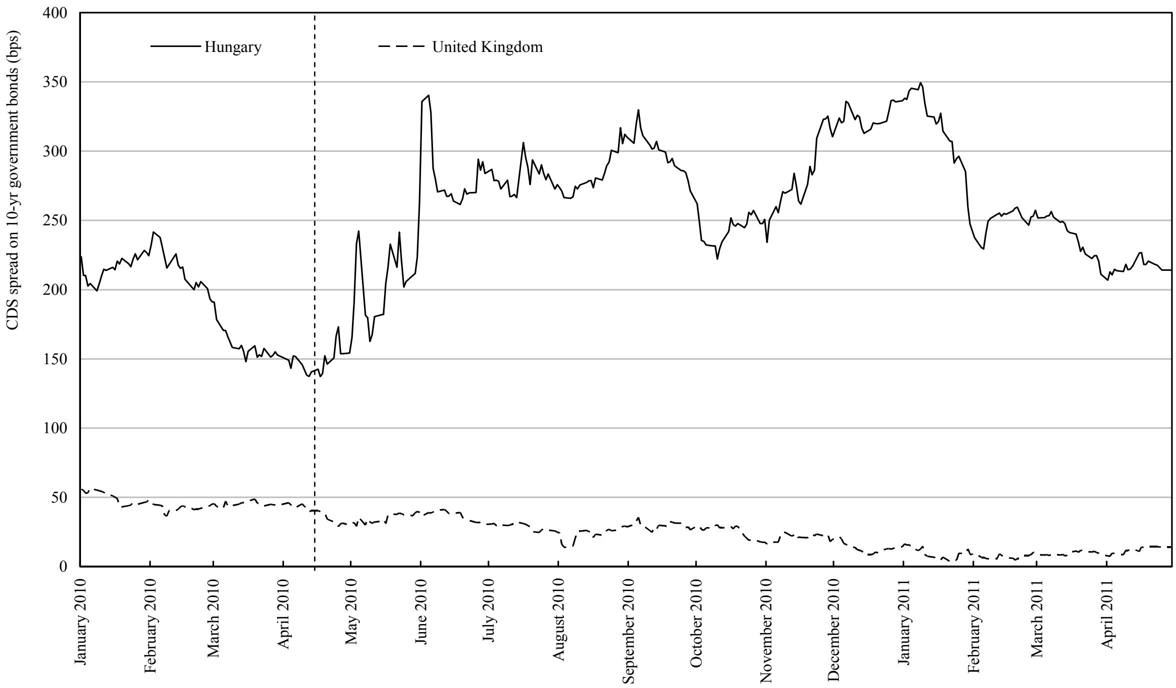
Hungary and United Kingdom: Sovereign Risk Premium



Source: Reuters.

Figure 6

Hungary and United Kingdom: Sovereign Default Risk Premium



Source: Reuters.

4 Progress toward good practices

Over the years, considerable experience has been gathered in both advanced and emerging-market economies in the design and operational aspects of rules-based fiscal frameworks. The accumulated experience provides useful input for deriving internationally accepted good practices, which contribute to regaining or strengthening a country's fiscal sovereignty in the marketplace. Let us focus on key elements of the framework: fiscal policy rules, transparency standards, and independent fiscal authorities.

There are eight criteria that have been widely accepted and applied to ascertain the quality of a fiscal policy rule.[19] These good practices consist of: (a) clarity in the definition of (numerical) performance indicators, time frame and institutional coverage; (b) transparency, especially as regards public sector accounts and forecasts; (c) adequacy of the rules to achieve the objective at hand; (d) consistency among the rules, and with respect to other policies; (e) operational simplicity, for widespread understanding of the mechanics of the rule; (f) flexibility in accommodating economic cycles and shocks; (g) enforceability in practice; and (h) efficiency in application. Admittedly, there is no fiscal rule that can meet all criteria in an equally high degree, as there are tradeoffs among some of them. For example, a simple rule (e.g., annual balanced-budget rule) may be too rigid and prevents operation of automatic stabilizers.

The need for transparency in government operations is universal, with very few exceptions where asymmetric information is warranted in the public interest. These three kinds of exceptions: strategic, for national defense and security; tactical, for preventing the use of insider information on anticipated economic policy decisions (e.g., prospective interest rate action by the central bank) for profit; and as a civil right, for protection of privacy. The importance of transparency is enhanced when the government is subject to certain constraints, including targets or limits in the context of fiscal rules. More generally, there are three broad areas where good practices are necessary: (a) institutions, (b) public accounts, and (c) indicators and forecasts.[20] Institutional transparency implies broad coverage of the public sector and delineation of responsibilities, clarity in budget process, financing, regulation, and tax treatment. Transparency in public accounts involves statistical coverage, recording basis, recognition and valuation conventions, and data classification. Transparency includes reliable analytical indicators, short- and medium-term forecasts, and long-term quantitative scenarios, including realistic underlying macroeconomic assumptions.

Independent fiscal institutions – to be distinguished from state audit offices – are fewer and of relatively recent vintage. Yet, at least on a tentative basis, experience accumulated so far can be useful for formulating a commonly accepted set of good practices.[21] Admittedly, such an institution must be judged within their country-specific context. Nonetheless, six characteristics can be identified as being critical for the effectiveness of an independent fiscal institution: (a) home-grown and home-owned design and operations; (b) independence, non-partisanship, technical competence, and accountability to the legislature; (c) support by a technical support staff, with unlimited access to timely information from the government; (d) remit consisting of assessment of fiscal stance and debt sustainability – including monitoring of compliance with rules or targets – through real-time estimation of the budgetary effects of legislative proposals (while precluding policymaking functions); (d) immediate start-up of operations, in line with the terms of reference; and

[19] The criteria formulated in Kopits and Symansky (1998) were discussed and approved by the IMF Executive Board. For applications, for example, to the UK Code of Fiscal Stability, see Kell (2001), the EU Stability and Growth Pact, see Buti and Giudice (2002), and the German Debt Rule, see Kopits (2010b).

[20] These good practices, in Kopits and Craig (1998), were discussed and approved by the IMF Executive Board, provide the basis of the IMF Code on Fiscal Transparency.

[21] See Kopits (2011).

(e) effective means of communication to the public, ensuring the highest possible level of transparency.

5 Summary and implications

Over the past decades, with domestic financial liberalization and opening up of the external capital account, financial markets became highly integrated. At the same time, monetary dominance was on the rise, especially in the advanced economies. As a result, governments shifted the financing of budget deficits from the banking sector to the bond market. For developing economies, access to the secondary bond market offered a new source of financing, displacing non-securitized official and bank credits.

Since the second half of the nineties, parallel to the advent of sovereign bond markets, the IMF gradually gave way to financial markets in its disciplining role. Within Europe, the EU Stability and Growth Pact has not yet succeeded in developing a disciplining role over the EU members' fiscal policy, notwithstanding the mandate under the Maastricht Treaty. The shift toward increased financial market power became even more pronounced under the effect of the recent global financial crisis.

Fiscal behavior differed markedly across countries prior to the global financial crisis. Having learned the lessons of past crises, a few EU member countries both outside and inside the euro area and most Latin American countries maintained a prudent fiscal stance, within a rules-based framework. Meanwhile, a number of Asian countries had accumulated massive foreign exchange reserves for protection.

By contrast, some EU members (both inside and outside the euro area) opted for a risky expansionary stance, under the moral-hazard cover of EU membership. In addition to a weakened financial sector, fiscal indulgence had made some of these countries vulnerable to the fallout from the financial crisis. Markets reacted swiftly, with yields on sovereign paper and CDS spreads jumping to record levels. Differences between advanced and emerging-market economies became blurred.

In the face of a surge in public indebtedness and mounting pressures from markets and international institutions in the post-crisis period, efforts are under way in various countries to free themselves from these pressures by establishing a rules-based fiscal framework, inspired by some successful examples. Signaling commitment through such framework can be especially useful in anchoring fiscal expectations, much like a monetary framework is intended to anchor inflation expectations.

Recent policy developments in Hungary and the United Kingdom illustrate the importance of influencing fiscal expectations through policy signaling. Both countries have characteristics in common, including a change from a center-left to a center-right government that inherited a heavy fiscal burden and low credibility. However, each government chose a significantly different fiscal path. While the UK government adopted a frontloaded fiscal adjustment and installed an independent fiscal watchdog, the Hungarian counterpart introduced stopgap measures and disbanded the fiscal council. Not surprisingly, the sovereign risk premium declined in the UK and rose significantly in Hungary.

Several major implications follow from the above discussion. First, ironically, governments with a trail of fiscal profligacy are usually the least independent from market forces. Moreover, international financial organizations, notably the IMF or EU institutions, can extend financial or technical assistance, but cannot confer credibility on the recipient government. Credibility must be earned by every government through its own efforts.

Second, conversely, a government with a proven track record of self-discipline can enjoy fiscal sovereignty in the face of market pressures. In the event, creditors allow sufficient latitude for an active discretionary fiscal stimulus to counteract a recession – as shown recently in a few advanced economies as well as some emerging-market economies.

Third, the most effective way of signaling commitment to self-discipline, and thus to create fiscal space, consists of adopting a permanent rules-based fiscal framework. The framework should be preferably home-grown and home-owned rather than imported from (or seen as imposed by) a supranational authority or international organization. In sum, adherence to the framework should help anchor fiscal expectations among investors.

Fourth, a comprehensive fiscal framework consists of well-designed fiscal rules, a high degree of transparency in the public sector, and an independent watchdog charged with real-time monitoring of public finances, including compliance with the rules. Experience accumulated so far in various advanced and emerging-market economies with such a framework serves as the basis for deriving internationally accepted good practices in this area.

And fifth, by itself, adoption of a rules-based framework is not a magic wand. To be effective in restoring market confidence, the framework must be accompanied by phased-in implementation of policy measures that improve the structural budget balance and fiscal sustainability, possibly in the context of a coherent reform strategy.

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