

**COMMENTS ON SESSION 1
THE INTERACTION OF FISCAL POLICY
AND MACROECONOMIC IMBALANCES**

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In this note I discuss three of the papers that were presented in this session: “Indebtedness, Deleveraging Dynamics and Macroeconomic Adjustment” by Carlos Cuerdo, Inês Drumond, Julia Lendvai, Peter Pontuch and Rafal Raciborski; “Fiscal Policy Interactions and Imbalances in a Monetary Union” by Ida Hjortsø; and “Empirical Analysis of Current Account Adjustments at Fixed Exchange Rates” by Jean J. Le Pavec. All three papers share a common feature: they deal with countries that try to live beyond their means. Such policies may work for a while but eventually lead to a costly adjustment. In Cuerdo *et al.* the realization of these adjustments is in the form of deleveraging, Hjortsø’s work focuses on welfare loss due to current account imbalances and inflation, and Le Pavec’s on current account adjustments in countries that try to maintain an exchange rate peg. All three papers are pretty much in the building stage of their analysis and do not, therefore, suggest clear short-term policy implications or recommendations. In the discussion below I try to highlight the main contributions of these papers, and to suggest where the analysis can be expanded or modified to better answer the core questions.

1 Comments on “Indebtedness, Deleveraging Dynamics and Macroeconomic Adjustment” by Carlos Cuerdo, Inês Drumond, Julia Lendvai, Peter Pontuch and Rafal Raciborski

The paper provides intensive data work on households’ and non-financial corporations’ debt in the EU. They cluster countries according to various leverage criteria and then use the QUEST model to analyze potential macro effects of deleveraging and their sensitivity to various country and process characteristics. The paper does not relate debt data to macro variables.

Despite its broad data coverage the paper does miss on some potentially useful elements of the analysis. Key among those is that the cluster analysis would have been more insightful if clusters were mutually exclusive and based on more variables. The paper could also benefit from creating a direct link between its first and second parts. Additionally, the deleveraging simulations can be enriched by information from the cluster analysis, e.g. by comparing deleveraging of typical countries from Cluster A to typical ones from cluster B. If such clusters were both mutually exclusive and framed around meaningful economic concepts, the discussion of deleveraging would have become much more relevant to policy.

While the paper does not lend its analysis directly to policy, some policy implications do emerge from the analysis. Most importantly, it highlights the point that to be able to offset private deleveraging fiscal policy should be more counter-cyclical (including in financial cycles) during boom periods, particularly in small countries in a monetary union. This indicates a sort of Ricardian behavior by governments in the face of private leveraging that requires higher public savings when the private sector accumulates debt. If such a policy does not take place when balance sheets expand, tackling the consequences when things turn bad may be too late. This question may gain relevance as unified bank supervision is adopted in the Eurozone, because it implies that, in some countries, government bonds may not be accepted as a riskless asset even for

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their domestic banks. This context of a unified risk assessment stresses the question whether government rating should also account for private debt in the country?

2 Comments on “Fiscal Policy Interactions and Imbalances in a Monetary Union” by Ida Hjortsø

Hjortsø’s paper highlights potential benefits of fiscal coordination in a monetary union. While bringing out some interesting insights, the results depend to a large extent on the assumed parameters. In particular, they depend on whether imports complement or substitute local goods. In practice, the magnitude of the home bias in consumption is known to depend on the size of the economy, meaning that the results are limited to larger countries. Beyond that issue, the paper points out, as commonly found in the literature, that coordination in a benevolent policy setting environment is beneficial. However, the “real world” policy question is often how to create such cooperation and whether it is possible, rather than whether it may be beneficial.

To enhance the paper’s contribution, the author may wish to focus on issues that are more at the core of current policy discussions. In particular, it may be useful to highlight questions related to the relative size of the discussed countries. Looking at small vs. large economies may be particularly important because the monetary authorities are likely to pay attention to the weighted average of the countries and in that case their contribution to mitigating shocks in small members of the union may not be significant. It is likely that a fiscal coordination authority would do the same thing and hence leave the smaller economies without macro stabilization instruments. In that sense the model seems to be more about Germany-France than Germany-Portugal/Greece, for example. Beyond that, it should be recognized that fiscal policy is not just about macro consequences and smoothing but also about preferences and national tastes. In terms of policy implications, the paper makes a case for coordination but ignores the trade-offs that are in the heart of the decision of small “different” countries whether to give up fiscal independence in favor of coordination. Indeed, more elaborate modeling may indicate that Pareto improving redistribution is a valid option but, even then, realizing it is not trivial. In this respect such an analysis may also have implications as to whether a full monetary union is sustainable.

To expand the current discussion the paper may take advantage of some elements included in the Cuerpo *et al.* paper. This may be done by picking up some of the insights regarding the role of fiscal policy in smaller countries in a monetary union and reflecting the policy trade-offs that arise from their model. Furthermore, utilizing estimated coefficients from the macro model would help in setting up a more empirically founded baseline case for the analysis.

3 Comments on “Empirical Analysis of Current Account Adjustments at Fixed Exchange Rates” by Jean J. Le Pavec

Le Pavec’s paper’s key policy question is what can Eurozone countries that face current account deficits learn from the experience of other countries? Specifically he examines how to adjust while maintaining a peg. Based on extensive data work he looks at current account adjustment episodes across the world and provides a detailed description of “success stories”. He finds 38 successful episodes and studies them carefully in order to classify them based on their different characteristics. However, many of these episodes are not relevant to the question because they represent on/off issues such as wars, changes in global commodity prices, political crises and weather changes. All these may result in temporary current account deficits, but these fade away as the transitory shock dissipates. The analysis is more interesting with respect to other types of adjustments. Forced adjustments, dictated by the markets, are fast but may be socially costly. In

contrast, planned and paced reforms are effective and less costly, but found to be very rare in the data.

The main caveat in the paper is that it does not really answer the question it poses. To present the data in a way that is more relevant to the question the author should examine all the cases that required an adjustment, rather than only successful adjustments, and identify policies that sustained the peg. As is, the paper may be positively highlighting strategies that failed in most cases (ended in continuing deficits or abandoning the peg), simply because they are common and succeeded in some cases. Moreover, the main recommendation emerging from the analysis is to “allow more time” for adjustments when they have to be implemented. Unfortunately, such a recommendation is based on the assumption that the time inconsistency problem can be overcome. The author should bring more evidence that it is realistic in nowadays Eurozone. Other difficulties in the analysis stem from the comparison of the results of “autonomous adjustments” with other types. Such a comparison is not “fair” because, by definition, the initial conditions are different, so without an appropriate control for the initial conditions it is not legitimate. In addition, the discussion would benefit from an analysis of what differentiates countries that avoided a current account problem altogether from those that had to find a way to step out of one.

To help the paper provide a more direct contribution to the studied question and the relevant analytical and policy discussions, the most important change would be to compare countries that failed to sustain the peg with successful ones; this may identify what strategies are effective. To do that the author could look at strategies across all countries (not just successful ones) rather than at countries across strategies, as done in the current version. This analysis will be greatly enhanced by using multi-variate econometrics, preferably with methods that would handle selection endogeneity with respect to whether the exchange rate and the financial pressure are exogenous. Further contribution to the analysis, as well as to shortening the paper, may come from focusing on relevant cases. As noted above, many of the included episodes reflect temporary shocks in developing countries that seem less relevant to the main question. Finally, since the author identifies many potential benefits in “planned and paced” adjustments it may be worthwhile to discuss why they are so rare, and whether they are rarer in countries with a peg.

