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ABSTRACT

A key objective of fiscal policy is to maintain the sustainability of public finances and avoid crises. Remarkably, only a few studies provide empirical analysis on fiscal crises. This paper presents a new database of fiscal crises covering different country groups, including low-income developing countries (LIDCs) that have been mostly overlooked in the past. We also shed some light on policies and economic dynamics around crises. Surprisingly, advanced economies face greater turbulence, with half of them experiencing economic contractions during fiscal crises. Fiscal policy is usually procyclical around fiscal crises and the decline in economic growth is magnified if accompanied by a financial crisis.

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1. Introduction

We fear fiscal crises, but do not know much about them. The term, coined by O'Connor (1973), came to prominence in the wake of the oil crisis and the breakdown of the Bretton Woods system to denote a “structural gap” between public revenues and expenditures when growth plummeted, and unemployment and inflation surged. Yet, fiscal crises may be triggered by other imbalances in the economy or exogenous shocks.¹ In the aftermath of the global economic and financial crisis of the late 2000s, there is greater interest in how to avoid fiscal crises, including via well-designed fiscal adjustments (Mauro, 2011). However, there is relatively limited empirical research about fiscal crises, especially when compared to financial crises. What is the frequency and duration of the episodes? How disruptive are they? Do they have a persistent impact on economic growth? These are some of the questions that need answers to better understand and prevent periods of heightened fiscal distress, which can be accompanied by large and abrupt declines in growth (Fig. 1.1).

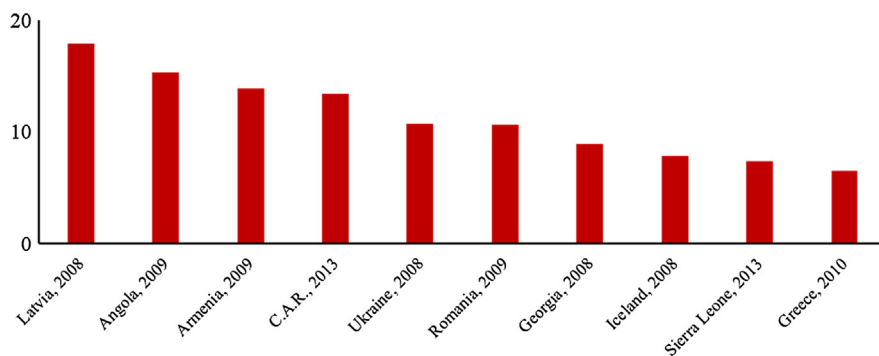
There is no common definition of fiscal crises, with the literature mostly focusing on sovereign debt crises triggered by external default episodes (e.g., Detragiache and Spilimbergo, 2001; Chakrabarti and Zeaiter, 2014). While sovereign defaults are an important part of the story, they do not capture all periods of fiscal crises. Over time, the definition has been extended to cover large-scale official financing (e.g., Manasse et al., 2003) and, to a very limited degree, domestic public debt defaults, including via higher inflation (e.g., Reinhart and Rogoff, 2009, 2011b; Gourinchas and Obstfeld, 2012). There has also been some work on identifying the cost of sovereign defaults (Trebesch and Zabel, 2017), providing only a partial view of the impacts of fiscal crises.

[☆] The views expressed in this paper are those of the authors and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

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¹ For example, a financial crisis may put the budget under pressure either directly due to a need to bail out banks (e.g., Ireland in 2010) or via a sharp economic deterioration and subsequent fall in tax revenues.



Source: Authors' own calculations, based on IMF data.

Note: difference in simple averages of real GDP p.c. growth rate of the three years preceding a crisis and the three years after the onset of the crisis.

Fig. 1.1. Ten of the Worst Crises Since 2005. (decline in the real GDP p.c. growth rate, percentage points).

This paper contributes to the literature by improving the identification of fiscal crises. We build a new database of fiscal crises by taking a comprehensive definition that includes the different types or triggers. We look at periods of extreme fiscal distress, when large fiscal imbalances led to the adoption of extreme measures (e.g., debt default and monetization of the deficit), partly building on the work by Baldacci et al. (2011).² Our approach also allows for an improved measurement of the duration of fiscal crises, a key challenge in the literature (Reinhart and Rogoff, 2011a). Another contribution of our paper is to extend the analysis of fiscal crises to developing countries for the first time, as far as we know. These countries experience a larger frequency of crises with unique patterns. We expand the country coverage to 188 countries, over 1970–2015, more than double the size of the sample relative to many other studies.

Our new database allows to shed light on the patterns of fiscal crises and their economic impact across different country groups and crisis identification triggers. We analyze the relationship between crises and key macroeconomic variables. First, we assess the behavior of fiscal variables and ask how fiscal policy and public debt behave around the crisis period. Second, we confirm that fiscal crises are associated with severe deterioration in economic activity and higher likelihood of being in a recession. Third, we also analyze the twin deficits (fiscal and external) hypothesis—that is, do fiscal and external current account deficits tend to move together? Finally, we assess whether fiscal crises have a persistent effect on output and public debt using impulse response functions (IRFs).

Given that different crises can interact, we also study the interaction of fiscal crises with banking and currency crises. In particular, we are interested in understanding the impact on economic growth and public debt. Our analysis provides support, in line with findings by Romer and Romer (2018), that periods of twin crises (fiscal-financial) are characterized by a deeper decline in growth than stand-alone crises at least for some country groups.

2. Theoretical considerations

We use the term fiscal crisis to describe a period of heightened budgetary distress, resulting in the sovereign taking exceptional measures. In normal times, a government collects revenues and borrows to fund its expenditures. A country may experience fiscal distress, when large imbalances emerge between inflows and outflows. These imbalances may lead to a fiscal crisis if the country is not able to sufficiently adjust its fiscal position. As Bordo and Meissner (2016) note, the canonical fiscal crisis is a debt crisis, when the government is unable to service the interest and or principle as scheduled. More concretely, this can be thought of as a disruption in the normal debt dynamics:

$$d_t = d_{t-1} * (r_t - g_t) / (1 + g_t) - p_t + SF_t$$

where the debt-to-GDP ratio d_t depends on the initial stock of debt in $t-1$, effective interest rate r_t , nominal GDP growth rate g_t , the primary balance-to-GDP ratio p_t , and a residual reflecting stock-flow adjustments SF_t . (capturing e.g., exchange rate movements or materialization of contingent liabilities).

It is important to note, however, that fiscal crises may not necessarily be associated with debt defaults. The literature focuses mainly on (external) credit events, either via outright default, repudiation, or the restructuring of public debts. However, it is also acknowledged that fiscal crises can be associated with other forms of expropriation, including domestic arrears and high inflation that erodes the value of some types of debt (Reinhart and Rogoff, 2011a). In addition, countries that face severe financial conditions may opt to ask for official creditors assistance (e.g. IMF) instead of defaulting (Manasse et al., 2003).

A fiscal crisis can happen for several reasons. As the debt equation shows, there may be several factors driving a country to unsustainable fiscal positions, including policies or economic shocks. First, the buildup of large budgetary imbalances may

² Baldacci et al. (2011) compile a set of criteria to identify fiscal crises over 1970–2010. Bruns and Poghosyan (2018) extend the dataset through 2015. These papers focus on assessing the likelihood of entering a crisis, and do not study the crisis period itself. Also, their sample is limited to advanced and emerging markets.

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