



The effects of financial crisis on fiscal positions



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ABSTRACT

The recent financial crisis was characterized by the sizeable fiscal cost of banking sector bail out operations and the significant automatic and discretionary fiscal policy response to shrinking output, which have put increased pressure on public finances in many industrialized countries. This paper tries to evaluate the impact of financial crisis episodes on debt developments. The findings indicate that severe financial crisis episodes increase the stock of debt by 2.7%–4.0% of GDP, on average in the 20 OECD countries examined. In countries with big financial sectors it ranges from 4.2%–5.3% of GDP and in countries with smaller financial sectors it is about 1.4%–1.7% of GDP. The primary balance and the cyclically adjusted fiscal policy stance ease by about 2.6% of GDP and 1.6% of potential GDP, respectively, in the event of a severe financial market crash. Expansionary fiscal interventions are more pronounced in countries with sizable financial sectors. I find significant evidence that a financial market collapse paves the way for a subsequent deterioration in debt ratios.

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1. Introduction

The recent financial market crisis was a quite unprecedented episode in terms of its severe and worldwide implications and because of the strong and coordinated global policy responses that followed it. These actions involved both discretionary demand boosting measures and monetary easing, as well as measures to restore financial stability in the banking sector, involving equity injections, subsidies, asset purchases, loan guarantees and other forms of assistance.

One of the major consequences of the recent financial crisis is its impact on government finances. Total support packages from governments and monetary authorities during the recent crisis have reached unprecedented levels, i.e., about 74% of GDP in the U.K., 73% of GDP in the U.S., and 18% of GDP in the euro area (Detragiache and Ho, 2010).

These actions coupled with the cyclical deterioration of fiscal positions have led to a substantial pick up in debt to GDP ratios in many OECD countries. According to the European Commission (2011) euro area debt stood at 66.2% of GDP in 2007 and is expected to reach 87.7% of GDP in 2011 and to increase further in 2012 to 88.5% of GDP. The United States, starting from a debt level of 62.3% of GDP in 2007, is expected to end up with a debt level of 102.4% of GDP in 2012 (European Commission, 2011). More recently the Organization of Economic Cooperation and Development (2011b) (henceforth OECD) projected that debt ratios will rise even further in 2012, reaching 97.2% in the euro area and 103.8% in the US.

Although the recent crisis and the response to it was unprecedented, it certainly implies that fiscal policy makers will put more of their attention on financial market developments and will try to avert analogous events in the future. Several of these actions, involving strengthening financial supervision and regulation, reforming international financial institutions to overcome the recent crisis and prevent future ones, creating the Financial Stability Board (FSB) to improve macro-prudential surveillance at the

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global level, and taking decisive and coordinated fiscal policy actions in order to restore confidence, growth and jobs etc. have already been agreed within the G20 context (G20, 2009a,b).

The links between the real economy, the financial sector and government activity need to be examined further. One of the issues arising, following the recent crisis, is to better understand the feedback loops between government activity and financial market developments. For example, unsound fiscal policies, by impacting negatively on market confidence, could represent a risk to economic and consequently financial stability. Government borrowing operations in financial markets and its tax decisions could also have repercussion for interest rates and asset price behavior, which could become a risk to financial market stability.¹ Financial instability can have significant implication for public finances, either directly or through its effects on economic activity.

Therefore, it is of real interest to better understand the fiscal policy implications of financial market developments and in particular of financial market crisis. This is likely to have significant implication on fiscal balances, to the extent that it requires an intervention from the government, involving some sort of bail out. Moreover, an ailing banking system will mean that financial intermediation breaks down and credit extended to the private sector is substantially reduced impacting negatively on economic activity. At the same time, as we have observed in the recent crisis, the monetary policy channel could become dysfunctional. Given banks' effort to reduce their activities and improve their balance sheets and capital base, lowering policy rates to kick-start economic activity is not automatically translated into increased lending to the private sector.

All in all, fiscal intervention will be required to restore confidence in the stability of the banking and financial system (given the public good character of financial stability) and to sustain economic activity, as was indeed the case in the recent crisis. However, this should be done in a manner that punishes unsound practices in the financial and banking system, i.e., reducing the risk of moral hazard, while also trying to contain the fiscal consequences of the rescue.

Given the important inter-linkages between financial markets and fiscal policy, the present paper builds on recent work by the European Commission (2009b), Furceri and Zdzienicka (2010, 2011) and Reinhart and Rogoff (2009, 2011) to investigate the impact of financial market crises on fiscal positions in 20 OECD countries in the period 1990–2010. In addition, the paper investigates whether the size of the financial sector is an important determinant of the impact effect that financial crisis have on fiscal positions, and on whether the magnitude of the fiscal intervention in the event of financial crisis differs depending the size of the financial sector. The findings of the paper provide an indication of what fiscal costs the OECD countries examined will, on average, have to bear, and how likely it is that they will have to bear these costs following a severe financial market crash. However, the quantitative estimate of the fiscal costs is indicative, and it could be significantly different depending on starting positions and other vulnerabilities faced by individual OECD countries. Nevertheless, their fiscal positions should be sound enough to cope with and absorb, at a minimum, these average fiscal cost effects.

Employing different modeling techniques (Pooled OLS, instrumental variable fixed effects, one-step system GMM estimator, logit and logit fixed effects analysis), and using data for 20 OECD countries over the period 1990–2010, I find significant econometric evidence that fiscal positions deteriorate during financial crisis. Severe financial crisis episodes, like the recent financial crises, increase the stock of debt by an average of 2.7% to 4.0% of GDP in the 20 OECD countries under examination. The effect is much more pronounced in countries with big financial sectors, i.e., it ranges from 4.2% to 5.3% of GDP, while in countries with smaller financial sectors it ranges between 1.4% to 1.7% of GDP.

Both the primary balance and the fiscal policy stance (the cyclically adjusted primary balance) indicate that fiscal policy remains intentionally expansionary when financial markets collapse; i.e., they are both reduced, the first one by about 2.6% of GDP and the second by about 1.6% of potential GDP. In some cases fiscal policy remains expansionary in the subsequent year of the financial crisis, contributing to deficit bias and the buildup of fiscal imbalances. Fiscal interventions in the event of a severe financial crisis are more pronounced in countries with big financial sector, i.e., the cyclically adjusted balance as a per cent of potential GDP and the primary balance as a per cent of GDP ease by about 2.5%–2.6% and 3.6%–3.8%, respectively. In countries where the financial sector has smaller size, the fiscal expansion (in times of financial crisis) of the cyclically adjusted primary balance as a per cent of potential GDP and the primary balance and a per cent of GDP ranges from 0.8% to 2.2%, respectively.

I also find significant positive association between financial market crashes and subsequent deteriorations in debt ratios. This is the case both when I examine only the debt ratio and when I combine it with sovereign debt financing problems, e.g., increasing nominal long term interest rates.

The rest of the paper is organized as follows: Section 2 overviews recent experience and previous studies that deal with the fiscal policy implications of financial crisis. Section 3 presents the empirical methodology, data information and findings. Finally, Section 4 summarizes the main findings and concludes.

2. Financial crises and implications for fiscal policy: recent experience and previous studies

The recent economic crisis was driven and exacerbated by the financial market turmoil, which has led to falling asset prices and a large number of bank defaults. These developments have induced governments around the globe to take decisive action in terms of sustaining economic activity and preventing the meltdown of the financial sector. These actions had direct and indirect fiscal costs. Direct fiscal costs are those involving permanent decreases in government's net worth as a result of the financial system rescue packages (e.g., capital injections, purchases of toxic assets, subsidies, pay out to depositors, payments of called upon guarantees etc.). These interventions lead to higher public debt, which either shows up as an increase in stock flow or

¹ IMF (2009) discusses links between tax policy issues, excessive leveraging and the development of asset price bubbles.

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