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Pressure or prudence? Tales of market pressure and fiscal adjustment

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We study whether multiyear fiscal adjustment plans in 17 OECD countries during 1980–2011 have been associated with market pressure. We find that only a fraction of the consolidations occurred under market pressure, suggesting that market pressure is important but not the main element associated with consolidation plans. Many adjustments under market pressure were also clustered around external shocks, and entailed larger median fiscal adjustments than other multiyear consolidations. In contrast, we find that virtually all multiyear consolidations aimed at reducing budget deficits occurred with initially weak macro-fiscal fundamentals.

1. Introduction

This paper presents historical evidence on the association between market pressure and discretionary decisions to undertake multiyear fiscal consolidations. Many of the largest advanced economies may need to pursue sizable fiscal adjustments over the medium term to rebuild fiscal buffers following the global financial crisis.[1] However, historically low borrowing rates and highly accommodative monetary policies have raised concerns that policy makers lack strong market-based incentives to pursue sustained consolidations. We explore this issue by assessing if multiyear fiscal

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[1] See *IMF Fiscal Monitor: Fiscal Adjustment in an Uncertain World (April 2013)*: (http://www.imf.org/external/pubs/ft/fm/2013/01/fmindex.htm).

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consolidations in 17 OECD countries during the last 30 years have been associated with market pressure. We also consider the association between weak underlying macro-fiscal fundamentals with planned multiyear consolidations.

We identify multiyear fiscal adjustments based on a dataset of planned consolidations. Focusing on intended fiscal adjustments enables us to assess the potential link between market pressure and discretionary changes in fiscal policy. We measure market pressure based on changes in government short- and long-term interest rates, exchange rates and credit ratings. We also consider macroeconomic and fiscal fundamentals preceding and during the first year of a multiyear fiscal adjustment. Based on this approach, we find that 20 percent of planned multiyear consolidations in OECD countries during 1980–2011 occurred under market pressure, whereas virtually all episodes were associated with initially weak fundamentals, such as high debt, adverse debt dynamics or below trend growth. These results suggest that market pressure is important but not the main feature of multiyear fiscal consolidations.

We proceed as follows: Section II presents a brief literature review. Section III discusses the methodology used to (i) identify fiscal consolidation episodes, and (ii) identify and measure market pressure. Section IV presents the main results on the relative importance of market pressure compared to other key macro-fiscal fundamentals and their association with multiyear fiscal consolidation plans. Section V provides regression analysis to support the facts presented in Section IV. In Section VI we discuss policy implications, and Section VII concludes.

2. Literature review

The large literature on the analysis of episodes of fiscal consolidations can be divided into two main strands. One strand has focused on the conditions that lead countries to begin a consolidation; the other strand has focused on the macroeconomic and financial consequences of fiscal consolidations.[2] Our paper falls into the first strand of analysis. This paper differs from the previous literature in two main aspects. First, we use a novel dataset constructed by Devries et al. (2011) which allows us to identify discretionary multiyear fiscal consolidations based on policy actions rather than policy outcomes. Second, this is the first paper to analyze how the emergence of market pressure is associated with the likelihood of beginning a discretionary fiscal consolidation. Our question and results do not directly contribute to the literature analyzing determinants of successful consolidations.[3] The literature has identified several factors that lead countries to initiate a fiscal consolidation.[4] The consensus among those studies is that consolidations are more likely to start when initial fiscal conditions are weak and governments are stronger and newly elected. Molnar (2012) finds that conditions like the initial size of the budget deficit, newly elected governments or governments with a larger majority are factors that tend to increase the likelihood of a consolidation. Similarly, Guichard et al. (2007) finds that consolidations are more likely after an election year or when the cyclically adjusted primary balance (CAPB) is weak.

While previous studies have relied on statistical methods to identify episodes of fiscal consolidation based on changes in the CAPB, in this paper we identify a discretionary consolidation episode using an alternative approach based on intended or “action-based” plans. We use the dataset constructed by Devries et al. (2011) who follow the narrative approach originally developed by Romer and Romer (2009) to document episodes of discretionary fiscal policy changes in 17 OECD countries during 1973–2009 based on a reading of official documents and reports. This identification approach represents an alternative way to identify and measure discretionary changes in fiscal policy.

On the relation between fiscal policy and financial markets behavior, Ardagna (2009) finds that long-term government interest rates decrease when fiscal positions improve, and increase around periods of budget deterioration. Stock market prices also tend to surge around times of substantial

[2] See Alesina and Perotti (1995), Alesina and Ardagna (1998, 2009). See Guajardo et al. (2014) for more recent evidence on the macroeconomic effects of fiscal consolidations and its relation to the previous literature.

[3] See Kumar et al. (2007) for a review of the literature on the determinants of successful consolidations.

[4] See Molnar (2012) for a thorough literature review on the factors that affect the start of consolidations.