The Challenge of Fiscal Consolidation

A semi-Slovenian view on a much larger issue

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Structure

- Banking problems and Slovenian public finances - size of the burden and a need of decoupling
- Fiscal rule - an instrument of fiscal consolidation and bank decoupling
- Fiscal rule and the dynamics of fiscal consolidation in Slovenia
- Methodological problems in EC fiscal supervisory framework

Banks and public finances in Slovenia

Past and present

- To date roughly 8.5 bill.€ (almost 25% GDP) fiscal costs with interventions in the financial sector
- Expected:
  - Banks the only source of external financing to corporate sector
  - Banks had 16 bill.€ of liabilities to foreign institutions (mostly banks), down to 8 bill. € by Feb 2013. 2 bill.€ provided by the ECB.
  - Explosion of bad loans
- Efficiency of the use of funds low - buying time instead of restructuring

Banks and public finances in Slovenia

Decoupling in the future?

- Unlikely if Slovenia does not develop the capital market as the second pillar of external financing provision
- The plan is to raise funding for seizing troubled financial institutions from private sources
- Not really clear how ex-ante? Who will actually pay the cost?
- The industry will oppose efficient ex-post cost sharing solutions.
- Heavy political influence will still be there and so will moral hazard
- Changes in regulatory framework will be insufficient
- Tighter fiscal rule provide a stronger anchor

The fiscal pact and the fiscal rule and bank decoupling

- In the future such interventions in the financial system will be possible only under the exceptions provision approved by 2/3 majority
- Moreover, the deviation can be only temporary, hence not leading to significant increases in debt
- Negative side: 2/3 majority reduces responsiveness
- Positive side: The government forced to think about efficiency

The fiscal rule and fiscal consolidation

- Slovenia is the only troubled EA country with negative trend in credit spreads in 2013
- Consolidation regardless of the fiscal rule
- Fiscal rule adds a badly needed layer of credibility
- According the spring 2013 estimates of the CABB by the EC, the structural balance needs to be cut by 2.7% of GDP
- Compared to fiscal adjustment in 2012 (roughly 2% of GDP) this is manageable

The fiscal rule and fiscal consolidation

The issue of softer transition

- The spring 2012 estimates by the EC showed a required 2.1% consolidation
- The difference of 0.6 p.p. is due to deteriorated economic outlook and the way the EC methodology takes it into account
- Can be smeared beyond 2015
  - Slovenia is in a prolonged and deep recession
  - Most of the 0.6 p.p. is an artefact of official methodology of computing trend output and does not reflect discretionary fiscal measures

EU fiscal stability framework and growth-friendly consolidation

- Current methodology of estimating the CABB induces procyclicality to fiscal policy
- Compared to a DSGE-based approach leads to systematic bias in signalling discretionary measures
- Combined with weak government under the pressure of markets, can lead to increases in taxes
- Tax multipliers are large (see Mertens and Ravn in the last issue of AER), undermining the initial objective of growth-friendly consolidations
- Clearly a need to reconsider the methodological underpinnings of the EU fiscal supervisory framework