Financial fall-out of macroeconomic policies and the implications for financial regulation

Group A

Most countries applied emergency fiscal stimulus to counteract the negative impact on the real economy of the financial crisis. In the presence of falling growth rates these policies generated rising sovereign debt to GDP ratios and pressure to reduce government expenditures raising the question of the degree of substitution between fiscal policies to provide stabilization of the financial sector and policies to provide stability of the real sector.

Outline

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Financial Crisis Overview

- Financial crisis brought with it negative economic growth, high unemployment and weak macroeconomic prospects.

- Bank collapses during the financial crisis generated great uncertainty, and greatly reduced the willingness of banks in most countries to provide loans.

- US and the UK were directly affected by the crisis
  - Exposure to home mortgage finance products and a sharp drop in house prices.

- Greece, Italy, Spain, Ireland and Portugal were affected by the crisis to service high public debt and limited by large budget deficits.

- This financial crisis quickly spread to emerging market and developing economies.

Fiscal Policies Contribution to Stability

- Fiscal policy can contribute to macroeconomic stability through three main channels.

1. Automatic reduction in government saving during downturns and increase during upturns, cushioning shocks to national expenditure (Blinder and Solow, 1974).
2. Fovernments changing public spending and tax instruments to offset business cycle fluctuations.
3. Structure of the tax and transfer system to maximize economic efficiency and market flexibility to enhance the resilience of the economy in the face of shocks.

Fiscal Policies Applied

- Specific modalities have differed across countries.
  - Some countries adopted broad-based schemes consisting of both guarantees and recapitalisation measures (Germany, Austria, Greece, Spain, France and the Netherlands).
  - Other countries did not announce a general scheme, but carried out *ad hoc* interventions to support or even nationalise individual financial institutions as a way to address specific banks' solvency threats (e.g. Belgium, the Netherlands, Luxembourg and Ireland).
  - Guarantees and recapitalisation measures some governments have adopted *sui generis* schemes consisting of asset purchase schemes, debt assumption/cancellation, temporary swap arrangements (e.g. Spain, the Netherlands and Italy) and blanket guarantees on all deposits and debts of both domestic banks and foreign subsidiaries (Ireland).

Fiscal Stimulus Measures

- Fiscal stimulus measures were announced in the aftermath of the global financial crisis in advanced economies broadly in terms of tax reduction and additional spending to stimulate economic growth.

- Asset relief measures should aim at the attainment of the following objectives:
  - (i) safeguarding financial stability and restoring the provision of credit to the private sector while limiting moral hazard;

  - (ii) ensuring that a level playing field within the single market is maintained to the maximum extent possible; and (iii) containing the impact of possible asset support measures on public finances.

Asset Relief Measures continued

- Large fiscal stimulus packages were implemented during crisis.

- As per Eurostat statistical norms, recapitalisations, loans and asset purchases increase government debt if the government has to borrow to finance these operations. Interest and dividend payments, as well as fees received for securities lent and guarantees provided, improve the government budget balance.

- There is considerable cross-country variation in the scale of crisis measures introduced.
  - For the average OECD country carrying out a positive stimulus package, their cumulated budget impact over the period 2008-10 amounts to more than 2½ per cent of GDP, with the United States having the largest fiscal package at about 5½ per cent of 2008 GDP. Fiscal cliff in U.S.

Fiscal Stimulus Packages - Examples

Country/Region	Stimulus Package	Amount	Size of GDP	
US	The Economic Stimulus Act of 2008	USD 152 billion	1.06% of 2008 GDP	US taxpayers and tax cuts for businesses
US	American Recovery and Reinvestment Act of 2009	USD 787 billion	5.57% of 2009 GDP	tax cuts and subsidies, for health, education and social security payments
US	Extra stimulus package for infrastructure 2010	USD 50 billion	0.34% of forecast 2010 GDP	Infrastructure
UK	UK Stimulus packages 2008–2009	GBP 31 billion	2.2% of 2009 GDP	Construction sector. The Creation of 100 000 jobs
EU	2008 European Union stimulus plan	EUR 200 billion	1.8% of EU 2008 GDP	Member states to enable them to increase unemployment benefits, support for households, reduce (VAT) and social security contributions for low-income households - provide loan and credit guarantees for companies.

Sources: IMF, EU Commission, Reuters

Effectiveness of Fiscal Stimulus Measures

- Are fiscal stimulus measures effective ?
  - Many fiscal policy measures implemented in response to the financial crisis have had the intended effects on the real economy. There is considerable un- certainty surrounding the effects of fiscal policy.
  - In the ongoing debate on the effects of fiscal policy on the economy, the findings vary widely.
- Cross-country experience indicate that expenditures measures were found to be more effective in affecting growth based on fiscal multipliers. Within expenditure, the impact of capital expenditure appear to be more durable than the revenue expenditure.
- In order to make the FP more effective a coordinated response was called for through G-20 mechanism. This was partially adhered to by the member countries.
- Taxation measures are not that effective in stabilizing growth.

Fiscal Multipliers

- Covering the pre-crisis period, concludes that fiscal multipliers have been low in advanced economies, around 0.5 or less (Alesina and Ardagna, 2010; IMF, 2010b; Barro and Redlick, 2011, for example).

- Other studies, also based on data covering normal times, find evidence of larger multipliers, well above 1 (Romer and Romer, 2010, for example). However, in view of their reliance on data covering the pre-crisis period, these studies are unlikely to fully reflect the peculiarities of the current economic environment.

Fiscal Stimulus and Public Debt

- High debt-GDP ratio is inimical to growth. Fiscal support to stabilization should be short-term and has the characteristics of growth inducing element in the composition of expenditure.

- High sovereign debt (sum of internal and external) can breach the limit beyond which the perception about repayment of this debt becomes negative. The perception, as it works in financial markets, soon spreads to countries with sovereign debts still within the limit.

- Countries with independent currencies may be able to monetise their internal debt but for others and for external debt, the cost of borrowing rises.

- Sovereign debt contracts suffer from the common agency problem and hence perceptions have a tendency to become self-reinforcing. When financial markets are further allowed to bet on the riskiness of this debt, it becomes beneficial to fan the existing perception (positive or negative) and then to accelerate it instead of taking stock of what is really going on.

Bank Bail out by the Fiscal Stimulus and Their Impact on Debt

- During the crisis, debt increased much more than was thought possible, raising doubts about what level of debt could be regarded as "safe."
- Since 2008, macroeconomic and fiscal shocks have been much larger than previously anticipated, which has caused debt-to-GDP ratios to rise much faster than in prior downturns.
- On average, most of the surge in debt-to-GDP ratios has been due to a shortfall in revenues as a byproduct of sluggish growth in the aftermath of the financial crisis, rather than to direct fiscal costs from bailing out banks.
- However, in Ireland and Iceland, bank rescues drove an (unexpected) increase in the debt ratio of 41 and 43 percentage points of GDP, respectively. These two cases illustrate that even levels of debt well below what was considered prudent before the crisis may not be "safe" in the face of large potential contingent liabilities.

Effectiveness Measures

- US as well as European Union have some sort of automatic stabilizers to take care of cyclical down turn in growth. But they were in-adequate to sustain growth. As a result, additional spending was undertaken.

- EMEs like China and India introduced FP measures in the form of additional spending and lowering taxes. For instance the stimulus in India was around 1.8 per cent of GDP in 2008-09 and 2.4 per cent of GDP in 2009-10. China around US $ 200 billion.

- In the case of India the banking system was not directly impacted by the crisis.

Fiscal Policy Measures and Financial Stability

- In order to make these institutions resilient and be complaint with the BASEL III norms there was a capital infusion by the Government as per the capital requirements of these institutions in the ensuing years till 2018.
- Financial regulation necessary to ensure that the financial instability does not arise in the economy in the first place.
- The high incidence of sovereign debt, in this case, is an unfortunate fall-out of the government's efforts to restore stability in the financial markets.
- If there is financial instability in the economy, there is debt-income imbalance in the financial system. Only if the surplus generated in the real economy (as manifested in current account surplus, balanced budget and a savings cushion) matches this imbalance (or exceeds it) will the economy be able to successfully manage both the financial instability (which by now it is clear, has to be really localized) and the stability of the real economy.

Sovereign – Bank Nexus

- Sovereign-bank feedback loop can emerge and amplify a sovereign debt crisis.
- A sovereign-bank feedback loop can initially stem from either a rise in sovereign yields diminishing the value of public debt held by domestic banks, raising concerns about banks' solvency when they hold large quantities of public debt, or from systemic banking sector problems, with the potential fiscal costs raising concerns about fiscal solvency .
- In such situations, a feedback loop emerges that is often fueled by increasing uncertainty regarding the solvency of both the government and the banks, leading investors to demand higher default risk premium and creating self-fulfilling crisis dynamics, as seen in the euro area crisis countries

Macro prudential Tools

- Macro prudential instruments are typically introduced with the objective of reducing systemic risk over time or across institutions and markets.
  - Variety of tools, including credit-related, liquidity-related, and capital-related measures to address such risks, and the choice of instruments often depends on countries' degree of economic and financial development, exchange rate regime, and vulnerability to certain shocks.
  - Countries often use these instruments in combination rather than singly, use them to complement other macroeconomic policies, and adjust them counter cyclically so that they act in much the same way as "automatic stabilizers."

- Policymakers face a menu of options in using macro prudential instruments. While no one size fits all, some approaches may have advantages.

Case Study- India
Fiscal Policy as an Instrument of Stabilization

- The fiscal policy measures were implemented in India in terms of reduction in tax rates as well as additional spending by the government.

- Additional spending undertaken was around 1.8 per cent of GDP and 2.4 per cent GDP, respectively in 2008-09 and 2009-10. The revenue loss due to tax reductions was about 0.2 per cent of GDP.

- Recapitalization of public sector banks constituted about 0.1 per cent of GDP in 2008-09 and 2009-10.

Case Study 2- Vietnam
Economy in crisis

- Vietnam's economy has been bogged down in difficulties since early 2008
- Many economic sectors are slowing down
- Causing production stagnancy
- Economic growth has slowed from 8.8% in 2007 to 6% in 2008
- The economy has been battered by a widening trade deficit and double-digit inflation.
- The government grapples with a large current-account deficit and weak banking and corporate sectors.

- The market's consumption power has declined since the start of the year. According to Nielson Global Online Consumer Survey, showing that Vietnam's confidence declined nine points to 97 points during last four months in 2008.

- The main causes were rigid monetary policies and public investment ineffectiveness

Measures Applied to combat the economic Slowdown and Cushion the Impact of the Global Financial Crisis

- Measures outlined by PM included:
  - Revising up stagnant domestic production and exports
  - Fuelling weakening consumption power
  - Applying flexible monetary and financial policies
  - Ensuring social security,
  - Care for the poor and speeding up administrative reforms

Actions Taken by Vietnamese Ministry of Finance & Central Bank

- Draw up proposals on tax cuts,
- Tax exemption
- Delay of tax levies for enterprises
- Further rate cuts and assistance
- Funds
- Banking restructuring
- Established Asset Management Company

Focus on State-funded Projects

- Facilitating important state-funded projects
- Disbursement of capital from gov bonds for medical and education sectors and housing for the poor
- Expanding productions and export markets of the state economic sector
  - Would help boost domestic demand

Corporate Income tax cut

- Bringing the corporate income tax down from 25% to 18%.
- Cutting corporate income tax by 30% for small & medium sized enterprises.
- Postponing the implementation of the personal income Tax Law.
- Reducing the basic interest rate from 11% in 2007 to 7% in 2013.

Case Study 3- Bahrain

- Bahrain, as in the rest of the world, the impact of the financial crisis was felt first through a withdrawal of liquidity, a situation that was reinforced by our currency peg to the US dollar.

- At the end of 2008 and the first half of 2009, our financial markets continued to function normally.

- In the final quarter of 2008 faced a situation in which our financial institutions were facing liquidity pressures, owing to the market reaction to the Lehman Brothers failure.
  - Central Bank instituted a new swap facility that permitted banks to exchange US dollar for Bahrain Dinar without a penalty fee.
  - Helped greatly to ease liquidity conditions in Bahrain's.

Measures Taken by the Government

- Financial resources for Bahrain and other GCC countries, in addition to the initial macro intervention policies taken by Bahraini government, help mitigate the impact of the current global financial crisis.

- Government of Bahrain did not consider it necessary to take some of the extraordinary measures, such as the recapitalization of banks and providing blanket guarantees, that had been adopted in other parts of the world.

- We needed to place two wholesale banks into Administration in the course of 2009, these events did not have a spill-over effect to the wider financial system.

Measures Taken- continued

- The domestic impact of the crisis has been limited in large part due to the fact that our real estate market had not experienced high levels of speculative activity.
- Since Bahraini banks are providers of credit throughout the MENA region, they have been affected by credit defaults elsewhere, and by problems in the real estate sector elsewhere in the region.
- Consulting with the local banks on measures to limit their exposure to the real estate sector.

Thank You