4

Comment on Charles Wyplosz and José María Fanelli[1]

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One of the first lessons that was drawn from the Mexican crisis and re-confirmed in the subsequent crises has been that an open capital account imposes severe constraints on macroeconomic policy. Countries that want to get full benefit from the access to external capital, especially emerging market developing countries, have to run macroeconomic policies that can meet the demands of international capital markets.

José María Fanelli refers in his paper to the Fund's agreeing on targets with Argentina that were very hard for Argentina to achieve. I think that is true, but this reflects the understanding of the authorities that those were the targets that the markets required, and if there is an error to be attributed to the Fund, it is that it went along with the authorities in their belief that they could implement those policies. It is not clear to me that there was a less demanding set of policies that could have achieved the objective of satisfying the international capital markets. But given the difficulties that countries have had in running policies that meet the demands of the markets, especially in the area of fiscal policy, it is understandable that Charles Wyplosz looks for better mechanisms for delivering the sort of fiscal policy the markets need.

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[1] The paper by José Maria Fanelli has been included in a separate volume, Jan Joost Teunissen and Age Akkerman (eds.), *The Crisis That Was Not Prevented: Lessons for Argentina, the IMF, and Globalisation*, FONDAD, The Hague, 2003, pp. 32-67.

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Given the relative success of a technocratic approach to monetary policy in recent years, Wyplosz suggests that fiscal policy can be run along the same sort of lines. Clearly the approach is intriguing, but there are a number of problems which, at the very least, need further analysis. But, as Charles said at the end of his presentation, perhaps this is no more outrageous a proposal than the proposal to have monetary policy run by a Monetary Policy Committee seemed to be when it was initially suggested.

I want to address some of the issues I see with putting fiscal policy in the hands of a Fiscal Policy Committee. I will complement this with some discussion of the work the Fund is doing on debt sustainability, which is very relevant here, since the target of Wyplosz' proposed Fiscal Policy Committee would be ensuring debt sustainability for the country and running fiscal policy in line with that main objective.

Fiscal Policy is a Political Issue

The essence of Wyplosz' proposal is that a Fiscal Policy Committee (FPC) set an obligatory fiscal deficit target aimed at achieving and maintaining debt sustainability. The first problem with the proposal is that, while the Fiscal Policy Committee can set the target for the fiscal deficit, it doesn't control the instruments that will achieve that target. The target is achieved through the sum of the taxing and spending decisions of the government as approved by parliament. This is in contrast with the position of a monetary policy committee, which actually wields the instruments that are applied to meet its targets. In order to deal with this problem, Wyplosz proposes that the Fiscal Policy Committee be backed up by legal restraints on what the government and the legislature can do. The government would be compelled to deliver a budget in which it can spend what it likes and can tax as much as it wants, as long as it comes up with the deficit that was proposed by the Fiscal Policy Committee.

However, these decisions to tax and to spend are the most hotly contested areas of politics – they are what politics is all about. It is very hard to see how the struggles on the trade-offs between spending and taxing decisions will not rebound on the Fiscal Policy Committee itself. When things get tough, the pressures on a Monetary Policy Committee can be very severe, as they are in Poland at the moment. I would see the pressure on a Fiscal Policy Committee being even more severe when the economic conditions were difficult or when the political struggle was intense.

Wyplosz' proposal also assumes that an effective legislative straitjacket can be devised to constrain this mechanism. We have seen fiscal responsibility legislation in a number of countries. Wyplosz mentioned a few examples like the Stability and Growth Pact in Europe, some of the longer-term fiscal legislation in the United Kingdom and the United States. There is also a lot of recent experience in Latin America with fiscal responsibility legislation which is actually not very encouraging. The problem is obviously that, when you pass a law, you can unpass the same law very easily – the time-inconsistency problem. To remedy this, you can make it an organic law, as Ecuador is trying to do at the moment, which will be much more difficult to overturn. But these legislative straitjackets are very hard to implement. It is possible that as popular acceptance of the proposal increased, the legitimacy of such constraints would become stronger, but I do see considerable difficulties for this approach in Latin America, given the current problems with fiscal responsibility legislation.

More generally, I wonder whether these proposals are based on a 'technocratic fallacy'. Just leave economic policy to the economists and let the politicians squabble about something else. While this has become conventional wisdom for monetary policy, I am not convinced that in the longer run it will remain so. More fundamentally, the problem of governance in large parts of the world is to produce a mature political system that internalises the need to make trade-offs and social choices within a given envelope. But I doubt that establishing a Fiscal Policy Committee will help in producing a mature political system in which there is a general understanding of the need to make societal choices within a resource envelope. Discussions on the stance of fiscal policy are political decisions, not purely technocratic ones. But perhaps the Wyplosz proposal is part of the spadework for creating such mature political systems.

Debt Sustainability and Fiscal Policy

This brings me to the work we have been doing in the Fund on sustainability. We have realised the importance of getting a better handle on this concept. The Fund should not lend to a country whose debt is unsustainable, without action being taken to make it sustainable. The discussion of sovereign bankruptcy presumes that a judgment can be made as to what debt structure is sustainable and what unsustainable. A paper on this was discussed recently by the Executive Board and is available on the web.[2] In this paper we look at two aspects of sustainability: the external sustainability of a country's debt, and fiscal sustainability. I shall concentrate on the latter since it fits well with Wyplosz' chapter.

A government's debt is sustainable if the debt dynamics are expected to remain under control, without the need for a major adjustment in policies at some point in the future. The chances of the debt dynamics staying under control are the result of factors both under the control of the authorities and any Fiscal Policy Committee and those beyond their control. They will depend on the stance of fiscal policy, growth and interest rate expectations, shocks hitting the economy, developments in world and partner country goods and financial markets, etc. There is uncertainty about many of these factors. Thus a country's debt and fiscal policy may be sustainable in some states of the world and not in others. At any time one could in principle make the judgment that there is such-and-such a probability of the debt being sustainable. In the Fund, we are planning to be much more explicit about the elements that enter into a judgment on sustainability and the chances of worse outcomes than the baseline projection. But ultimately all we can do at the technical, staff level is to put the elements forward on which the difficult – political – decisions have to be made.

The Fiscal Policy Committee will also have to make these judgments – but the scope for disagreement is going to be large. Not only on the probabilities of distant events, but also on how risky a policy to run, or how fast to converge on a given target. Should the country run a fiscal policy where the chance of a crisis is 1 in 5, or should policy be directed to reducing the chance of a crisis to 1 in 20 or 1 in 100? These are political, not technical, decisions.

One possibility might be to put these elements into the contract of the Fiscal Policy Committee, in the same way that the inflation target

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[2] International Monetary Fund, *Assessing Sustainability*, May 29, 2002. http://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf

is put into the contract of the governor of the Bank of New Zealand or the Monetary Policy Committee of the Bank of England. But it is quite different to set as a target 'keep inflation below 2 percent', which is clearly defined and manageable than a target in the form, 'keep the risk of the debt becoming unsustainable to 1 in 5'. The next year, if there is a crisis, the Committee could argue that it did a fine job, but this one was just the one year in five. It is hard to specify without a lot more further thought what the precise targets of the Fiscal Policy Committee would be.

There is some discussion of what is a safe debt stock in José María Fanelli's paper. At the Fund we have been looking to see whether there are key thresholds for determining sustainable debt, for example, as used in the HIPC Initiative. And, quite frankly, we have not got very far. We did discover that the probability of a default in an emerging market rose quite sharply when the fiscal debt to GDP ratio went above 40 percent. Below 40 percent, *grosso modo*, the chance of a crisis in the following year is 2 or 3 percent; above 40 percent debt ratio, the chance of a crisis rises to about 20 percent.

Even so, it is not clear what the operational conclusion is. If the Fund were to be very strict with a country whose debt ratio went beyond 40 percent, refusing to lend unless it restructured, in four out of five cases, the country would actually have been sustainable at that level and the restructuring would have been unnecessary. So, these debt sustainability concepts are quite hard to apply to fiscal policy.

The one clear message I got out of the papers by Fanelli and Wyplosz is the importance of low debt ratios well below 40 percent. Only such low ratios give the country room for counter-cyclical fiscal policy, as well as a margin to cope with shocks.

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