MUNI
ECON

Debt Management and Fiscal Rules

Public Finance 2

with documents from Petra Dvořáková

Content of the Lecture

- Basics of fiscal imbalance (revision)
- Debt management and its institutional models
- Debt statistics
- Fiscal rules – definition, development and division
- Maastricht fiscal rules

Fiscal Imbalance - definition

- Short-term fiscal imbalance occurs in a situation when budget revenues differ from budget expenditures in the certain period (budget year):
  - revenues > expenditures → surplus
  - revenues < expenditures → deficit
- Long-term fiscal imbalance = accumulation of public deficits + other liabilities of government → debt

Ways of Deficit Financing

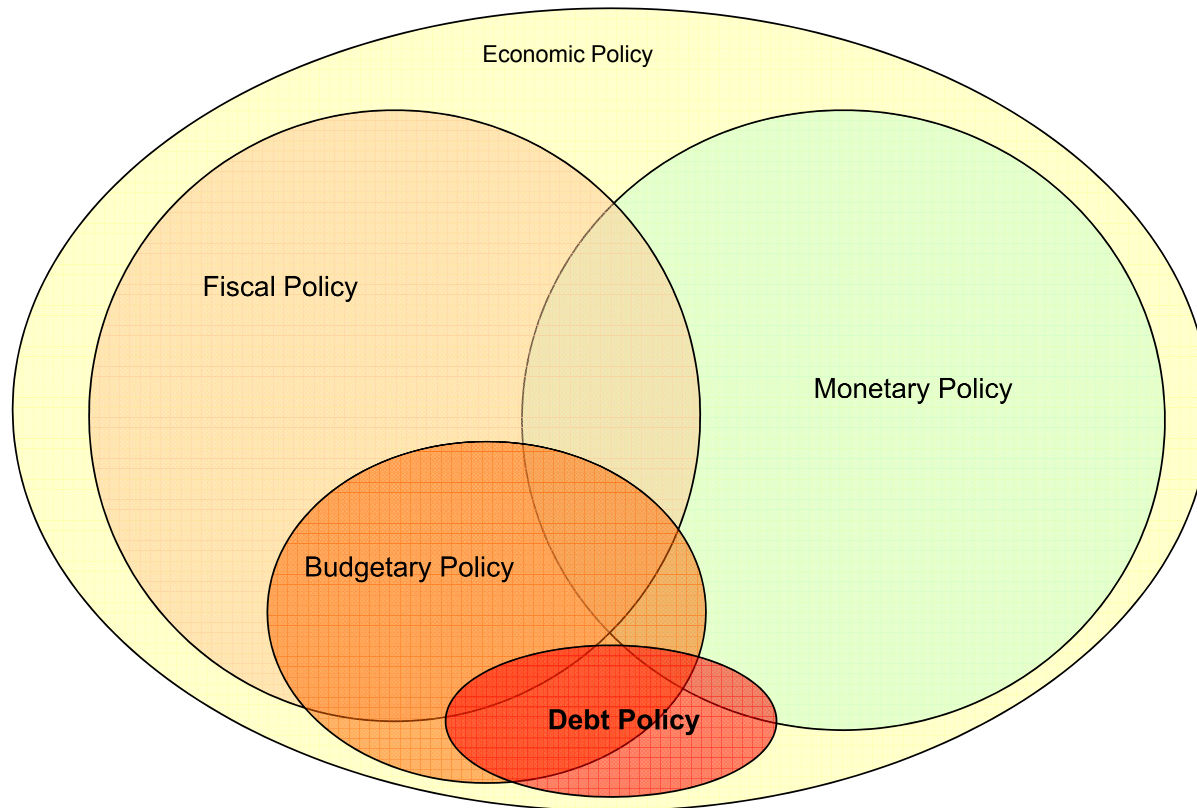
- changes in revenues (↑ taxes, sale of state property)
- changes in expenditures (cuts)
- issuing money – “debt monetization”
- debt financing (taking loans, issuing bonds)

Definition of Debt Management

„Debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and to meet any other debt management goals the government may have set, such as developing and maintaining an efficient market for government securities."

(IMF+WB. Guidelines for Public Debt Management, 2003.)

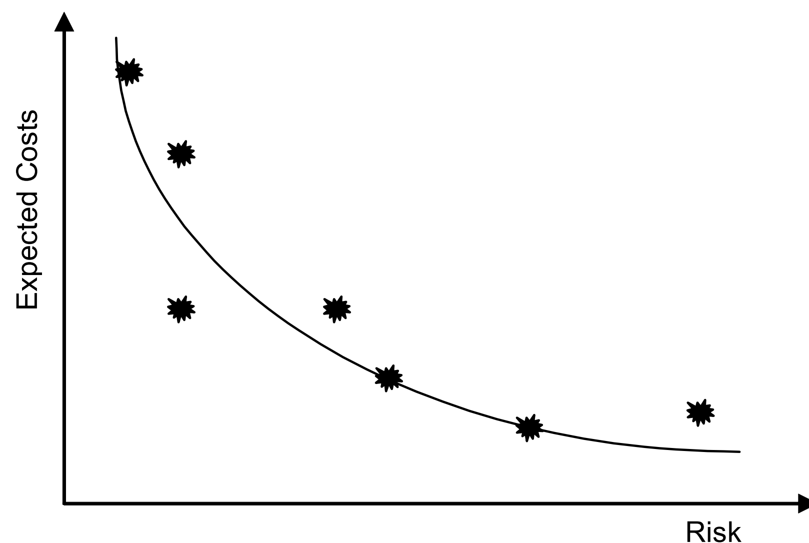
Debt Management within Economic Policy



Source: Author (Petra Dvořáková)

Targets of Debt Management

1. Coverage of the borrowing requirements and payment obligations of the government
2. Achievement of the lowest possible cost over the medium to long run
3. Considerate level of accepted risk
4. Development of the domestic debt market and its support



Source: ŠAROCH, S.; ANDRLE, M.; PAVELEK, P. Rehabilitujeme fiskální makroekonomickou stabilizaci? Politická ekonomie. 2003, Vol. 3, p. 386.

Scope of Debt Management

Main financial liabilities of the central government (both marketable and non-marketable debt)

Management of borrowings in both national and foreign currency

Summary of liquid financial assets and potential government liabilities (state guarantees)

→ concept **SALM** (mutual management of government assets and liabilities)

Structure of government debt simulation model

Source: RISBJERG, L; HOLMUND, A. Analytical Framework for Debt and Risk Management. In OECD. Advances in Risk Management of Government Debt. Paris, 2005, p. 54.

Institutional debt management models

1. debt management office within the organizational structure of the ministry of finance or the state treasury;
2. autonomous debt management unit within the organizational structure of the ministry of finance or the state treasury;
3. autonomous debt management agency;
4. unit within the “non-monetary” part of the central bank organizational structure

Examples of DM models (OECD)

1. Belgium, France, Italy, Canada, Poland, Czech Republic
2. New Zealand, Australia, Finland, Latvia
3. Ireland, Iceland, Germany, Sweden, Great Britain, Slovakia
4. Denmark, Cyprus

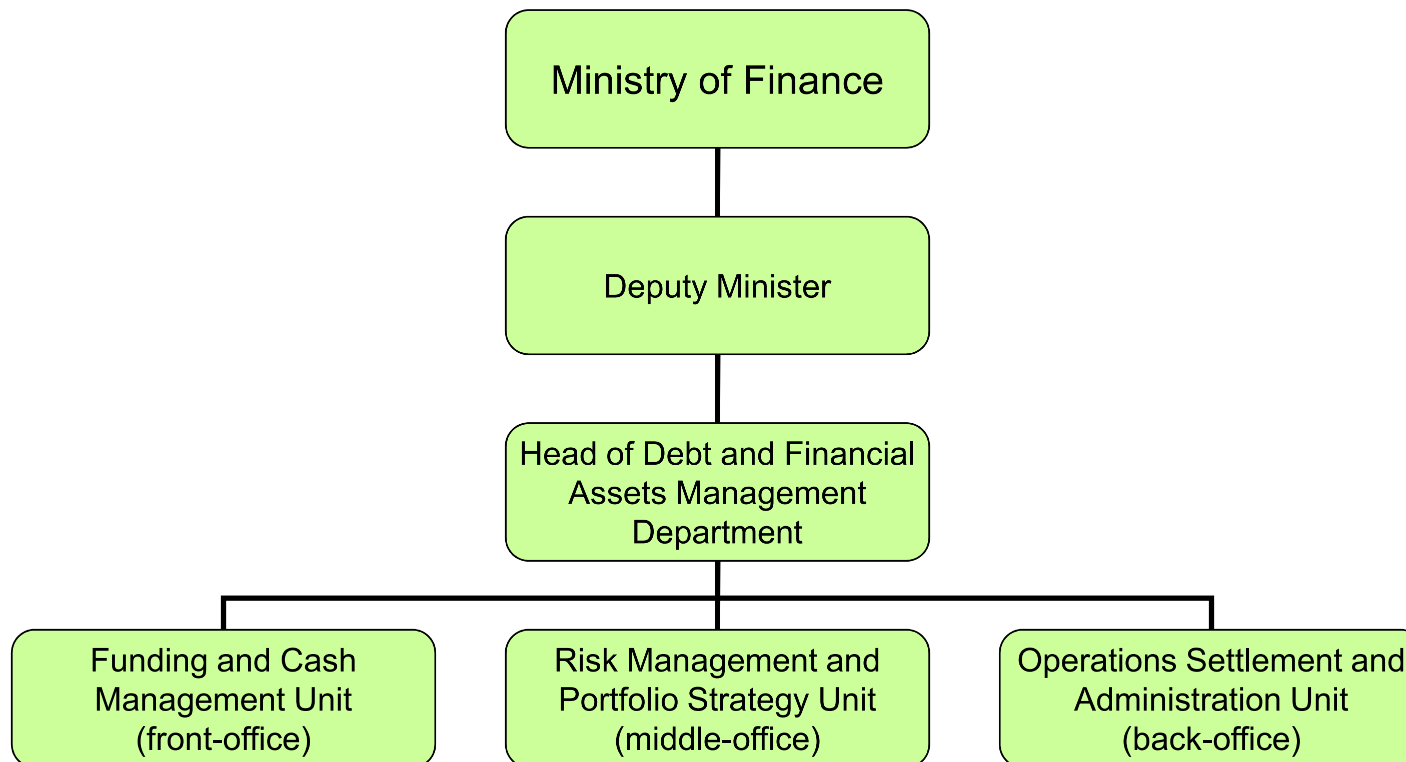
Transition Economies

- Generally they do not have sufficient control and responsibility mechanism needed for autonomous debt office
- High degree of dependency between debt management and economic policies

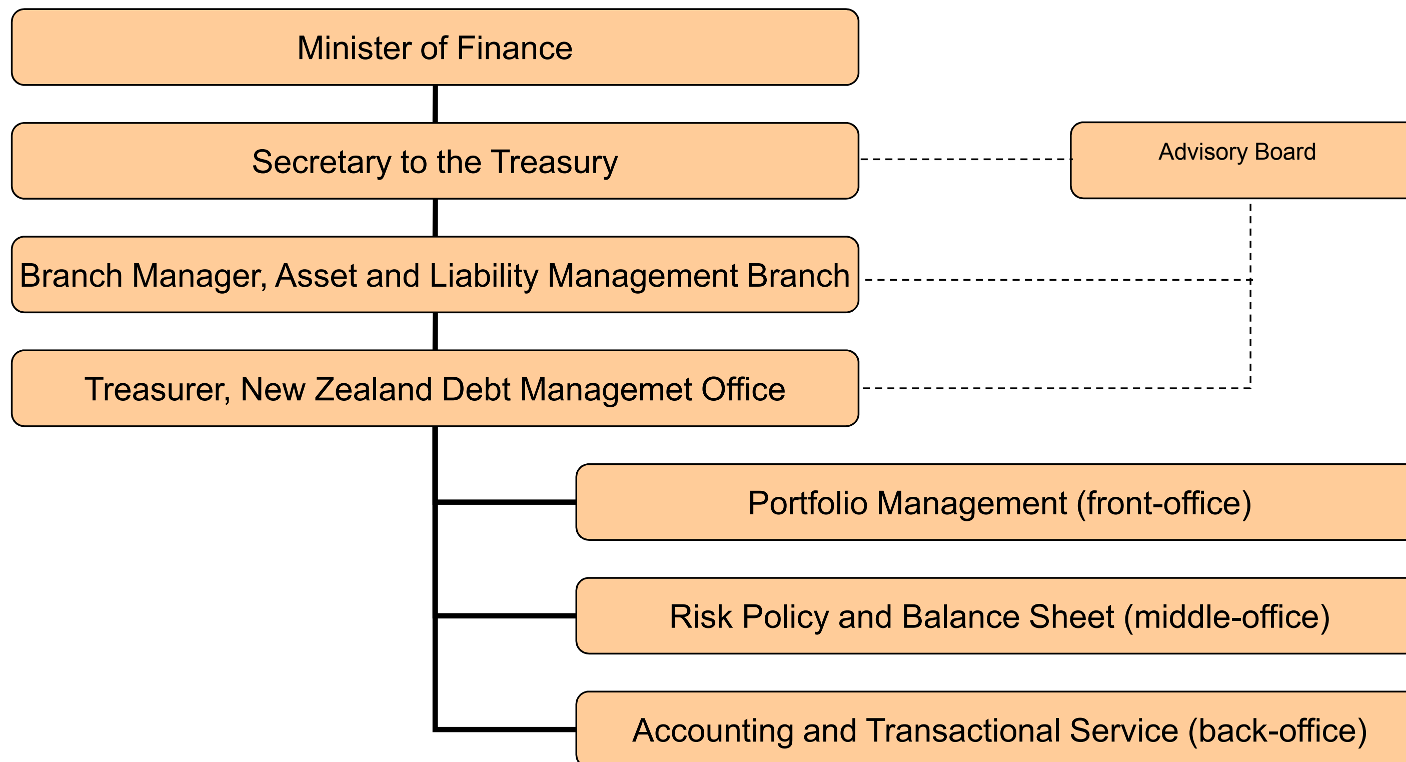
  ↓

- unit within the structure of ministry of finance, but problem with employing experts

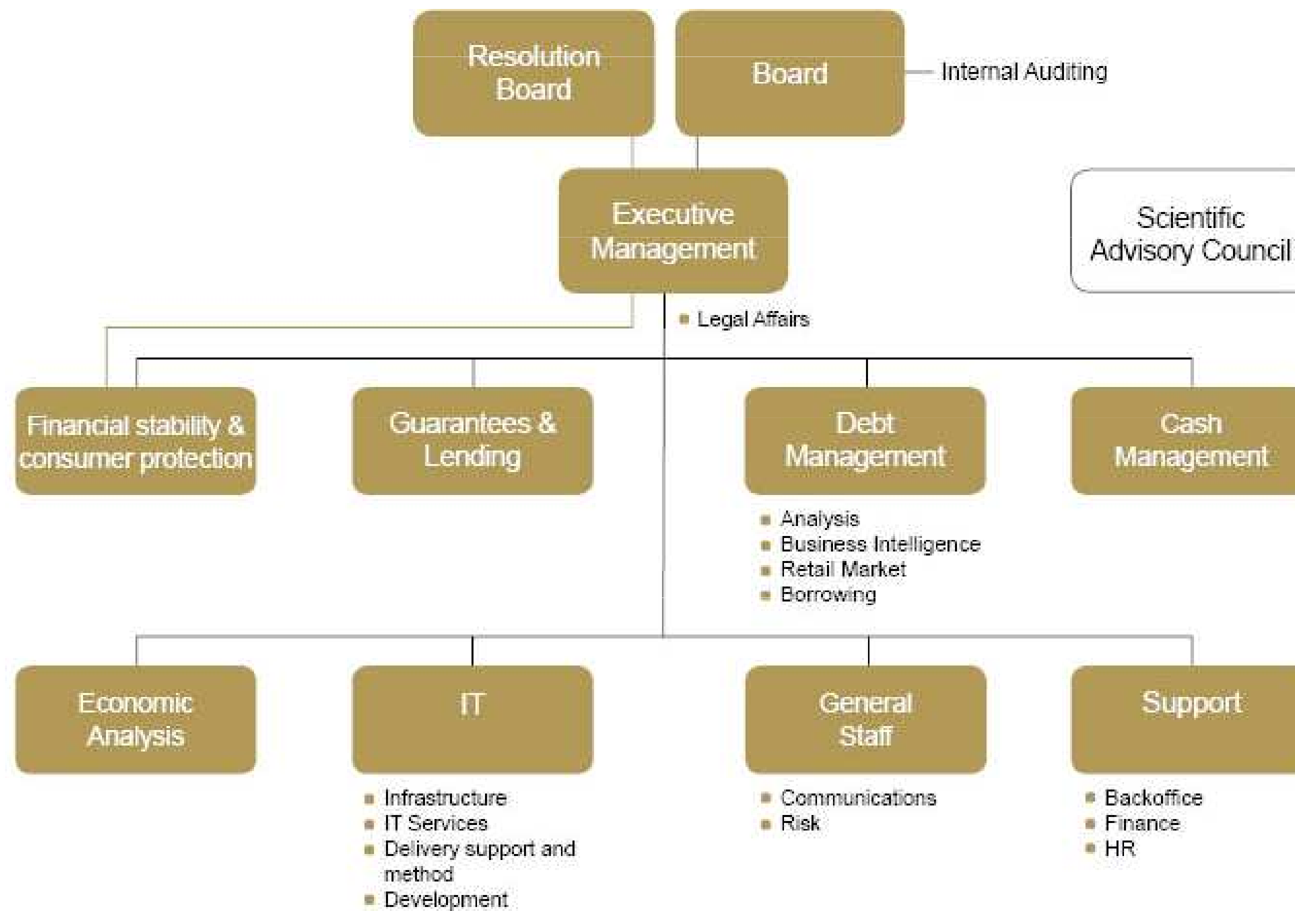
Organizational structure of debt management in the Czech Republic (model 1)



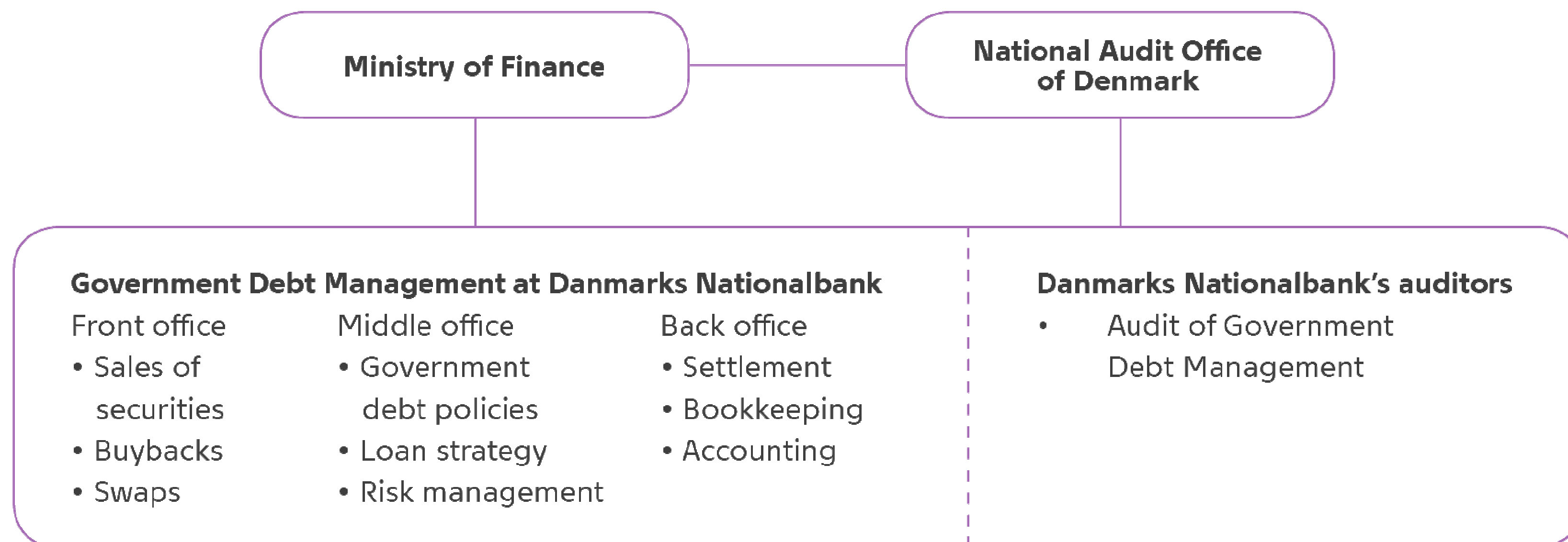
Organizational structure of debt management in New Zealand – New Zealand Debt Management Office (model 2)



Organizational structure of debt management in Sweden – Swedish National Debt Office (model 3)



Organizational structure of debt management in Denmark (model 4)



Risks Management

Risks	Instruments/Indicators
Refinancing Risk	- share of short-term debt - share of medium-term debt - average time to maturity - the maturity profile
Interest Rate Risk	- average time to re-fixing - interest re-fixing within 1 year - Cost-at-Risk
Currency risk	- net foreign-currency exposure of the debt

Other types of risks connected with debt portfolio:

- liquidity risk
- counterpart risk
- credit risk
- operative risk

Conclusions

Debt management is an important instrument of fiscal policy, its usage can help optimize size and structure of the government debt.

Stable legal environment, sufficiently developed domestic financial market and access on foreign financial markets are essential conditions of the successful debt management

Proper setting of relationships between the debt management actors, responsibilities, reporting and supervisory structures, as well as specification of the government balance extent and adjusting of the strategic targets are more important than an institutional model.

Fiscal Rules – Why?

Reason – growth of deficits and debts in advanced countries

Effort of governments to achieve a long-term sustainability of public finance

Target – to eliminate risk of excessive political activity by setting control and directive mechanism

Mutual characteristic of the rules - to secure credibility of the country and to reduce active interference of the state

Definition of Fiscal Rule

„Fiscal policy rule is a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof.“

(Kopits, Symansky, 1998)

Evolution of Fiscal Policy Rules

1. mid-19th century – the golden rule applied on current budget balance
   - e.g. most states in the U.S., several cantons in Switzerland
2. After WWII – balanced-budget rules; based on the golden rule + rules limiting the financing of budget deficit from central banks
   - e.g. Germany, Italy, Japan, Belgium, Netherlands, Sweden
3. From 1994 (implementation of NZ Fiscal Responsibility Act) – variety of rules: balanced-budget obligations, debt limits, expenditure limits + transparency standards
   - Escape clauses in the event of unforeseen exogenous shocks
   - Rules imposed on each government level, not only central

Pros x Cons of Fiscal Rules

Political reason for fiscal rule imposing – framework for politics and restriction of their impact on economic cycle
Restriction of principal-agent problem:
Fiscal illusion
Voting cycle
Asymmetric allocation of expenditure and benefit of government programs
Distribution conflict
Niskanen egoist bureaucrat

Stabilization of public finance with help of restriction of political influence and lobby
Acquirement of investors' credibility

destruction of traditional functions of fiscal policy
increase of bureaucracy and government expenditure
indirect expenditure → e.g. creative accounting
„invisible hands of foreign investors“
problem of „black passenger“ in area with common monetary policy – indebted country could escape higher cost (higher interest rate) → international moral hazard

„Design“ of Fiscal Rules

1. **well-designed rule** (target value, institutional scope, escape clauses)
2. **transparency** (state accounting, specific information in reports, assuring of report integrity)
3. **adequacy**
4. **consistency** (with other targets of economic policies, but also consistency in time)
5. **simplicity** (set by a law, understandable to public)
6. **flexibility** (mainly according to exogenous shocks; escape clauses – exceptions from fulfilling a rule)
7. **enforceability** (existence of a special independent institution for supervision; sanctions in case of breaking the rule – reputation, law, financial)
8. **efficiency** (support by economic and political steps)

Types of fiscal rules according to the side of the budget

- **Expenditure rules**
  - Restriction of selected types of expenditure
  - Limit on total expenditure
- **Revenue rules**
  - Restriction of deficit or debt refinancing by increasing taxes
  - Prohibition of government deficit financing by central bank
- **Balance rules**
  - Balanced budget in a certain period
  - Maximum level of deficit (to GDP, to total expenditure)
  - Total balance x current balance
  - Deficit only when financed from a special fund
- **Debt rule**
  - It usually supplements balance rule

Conclusion to the fiscal rules

- No rule should be overrated; the situation is usually more or less dependent on the political atmosphere and economic situation of the country
- In the CR: medium-term expenditure frameworks, Maastricht fiscal criteria (SGP)

Maastricht fiscal rules (EU)

1. Government balance – it should not exceed **3 %** GDP
2. Gross government debt – it should not exceed **60 %** GDP

Stability and Growth Pact (SGP)

Outlined in 1997 (EC, Council of Ministers)

It clarifies arrangements from the Maastricht Treaty concerning "dissuasive arm" (excessive deficit procedure) and "preventive arm"

Requirements on the EU countries to have balanced or surplus budgets in a medium run

EU countries have to submit their budget data to the EC (Convergence x Stability Programs)

2.1. General government fiscal balance as a percentage of GDP, 2007, 2019 and 2020

◇ 2007 ■ 2019 ● 2020

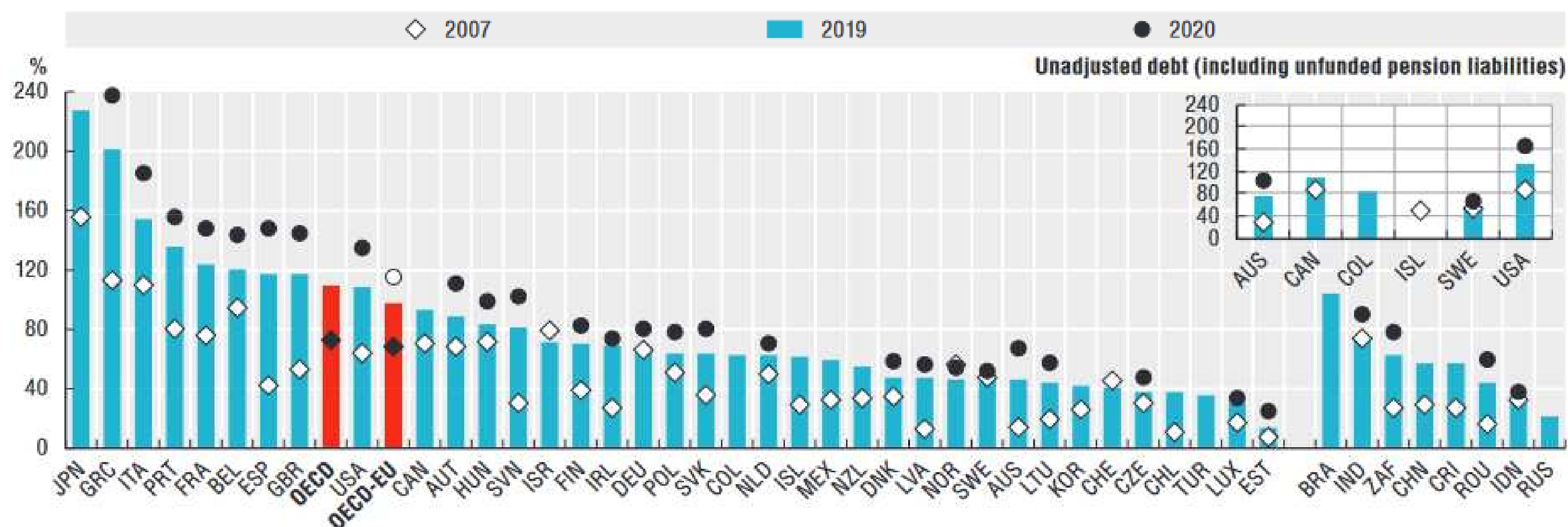
%
20
15
10
5
0
-5
-10
-15

USA AUS TUR MEX COL ISR **OECD** FRA ESP CHL GBR JPN HUN BEL ITA ISL SVK FIN POL **OECD-EU** LVA NZL EST PRT CZE SVN LTU IRL CAN SWE AUT KOR GRC CHE DEU NLD LUX DNK NOR IND CHN BRA ZAF ROU CRI IDN RUS

Source: *OECD National Accounts Statistics* (database). Data for China and India are from *the IMF Economic Outlook* (April 2021).

Source: OECD: Government at Glance, 2021

2.8. General government gross debt as a percentage of GDP, 2007, 2019 and 2020



Source: *OECD National Accounts Statistics* (database); *Eurostat Government Finance Statistics* (database). Data for the OECD key partners (apart from Brazil) and for Costa Rica are from the *IMF Economic Outlook* (April 2021).

Source: OECD: Government at Glance, 2021

– Q & A

MUNI
ECON