Conference “The crisis in the Euro-Area”

Discussion on

“How the crisis evolved: EMU, Fiscal Policy and Sovereign Debt” by Mike Wickens

Discussant: Dimitris Sideris
Bank of Greece

23 May 2013

Structure of the work

It first gives a view on the problems of the single monetary policy pursued on a group of heterogeneous economies with different inflation rates, in the years before the eurozone crisis

Then it provides two measures to evaluate the fiscal stance of an economy :

(I) an index of fiscal sustainability

(II) a credit rating measure

The Fiscal Sustainability Index (FSI)

The Fiscal sustainability index essentially measures in period t, the ratio of the desired level of the discounted debt-GDP ratio in period t+n, to its forecast value. (The discount rate is given by: nominal bonds yield – inflation rate – GDP growth rate)

So, if:

FSI(n)=1 the forecast debt-GDP ratio for period t+n is on target

FSI(n)>1 the forecast debt-GDP ratio for period t+n is above target

FSI(n)<1 the forecast debt-GDP ratio for period t+n is below target (fiscal policy too loose)

Advantages:

Existing indicators of fiscal stance are backward looking, not time varying, use forecasts based on *ad hoc* assumptions

FSI is forward looking, time varying, model based.

The credit rating methodology (estimation of the probability to default)

The methodology estimates the probability that the forecasted debt-GDP ratio will exceed a threshold (the maximum debt-GDP ratio that an economy can sustain) over a specific time horizon.

Advantages:

The transparency of the methodologies and the timing of downgrades of the Credit Rating Agencies have been questioned.

The proposed methodology is simple, transparent, and purely data-driven.

Technical comment, interpretation of empirical evidence

Technical comment

- In the estimations the discount rate (bond yield – inflation – GDP growth) is implicitly considered exogenous (and is not forecasted using the VAR model). Isn’t there an endogeneity issue? (GDP growth and the bond yield are affected by the debt-GDP ratio).

The empirical evidence

- FSI is estimated for one period ahead $n=1$ (justified by statistical criteria). Does the picture change for $n>1$?
- The idea we get from the FSI graphs is that the government misses the debt-GDP target (desired discounted debt-GDP ratio) , because of loose fiscal policy. Would it be that in some periods the target is missed due to lower than desired GDP growth?

  e.g. The graph of FSI for the EU economies indicate deterioration of the fiscal stance of all European economies for the post -2007 years. Could it be that the debt-GDP ratios worsened due to the low (or even negative for some countries) GDP growth rates -partly caused by austerity measures? Could they also reflect spill-over effects in the EU?
- Implications for near future: Now that the fiscal policies are monitored heavily by authorities and the markets, a deterioration of FSI would not imply lower than expected GDP growth rates?
- The FSI for Greece is relatively high (around unity) in the years 1998-2006, evidence which implies sustainability. Yet, the FL (fiscal limit) credit rating measure declines during these years indicating high probability to default.

Thank you for your attention