

Dealing with Fiscal Risks: OECD experiences

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What is fiscal risk?

- **Narrow definition**
 - exogenous factors affecting the fiscal projections
 - of uncertain incidence
 - beyond the direct control of government

- **Broader conception**

anything that can blow the public finances off course ...
... or make it harder to keep them on their chartered course ...
... potentially leading to hardship – or disaster – for citizens

Risks that are obvious



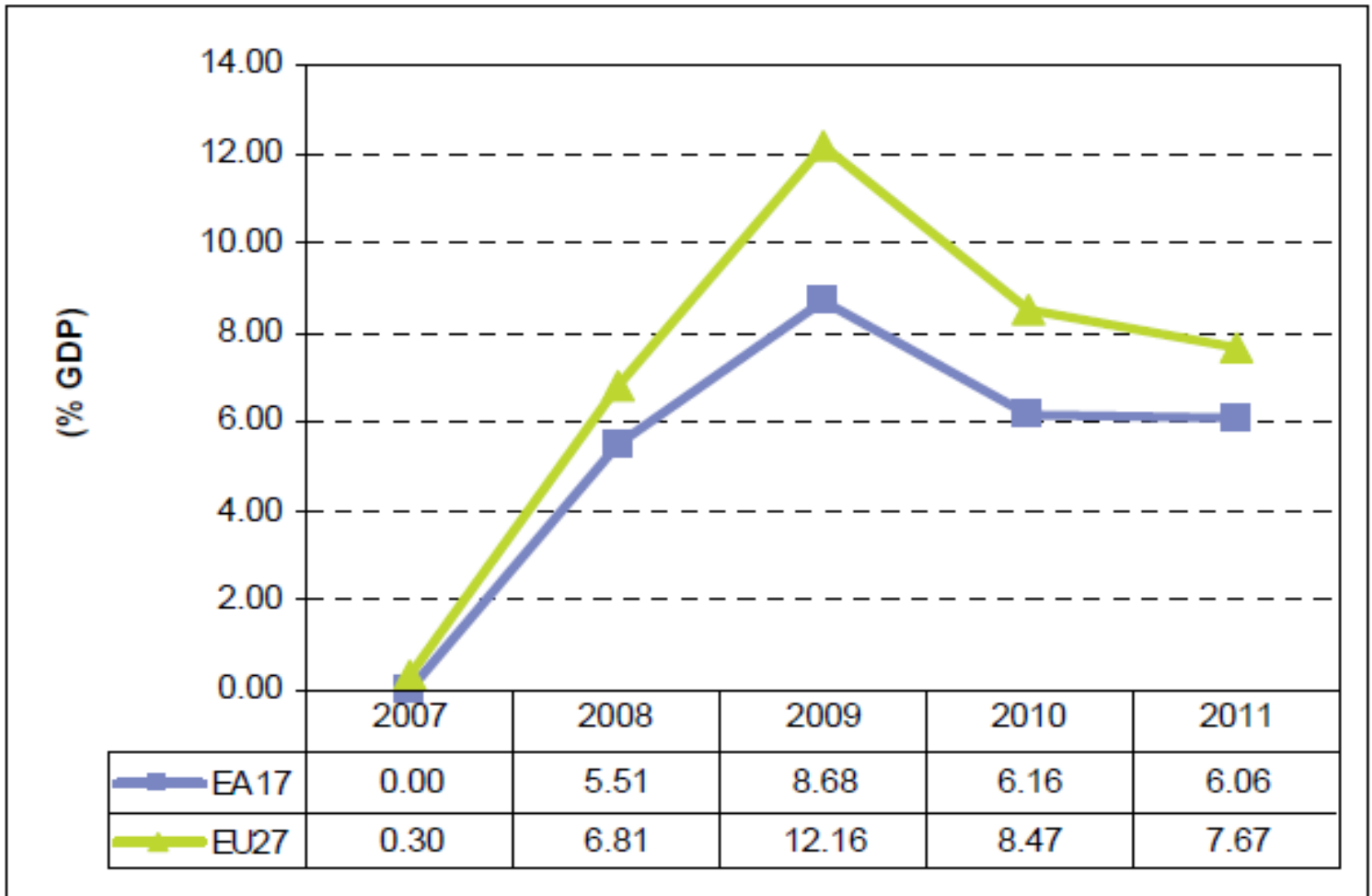
Risks that don't seem like risks



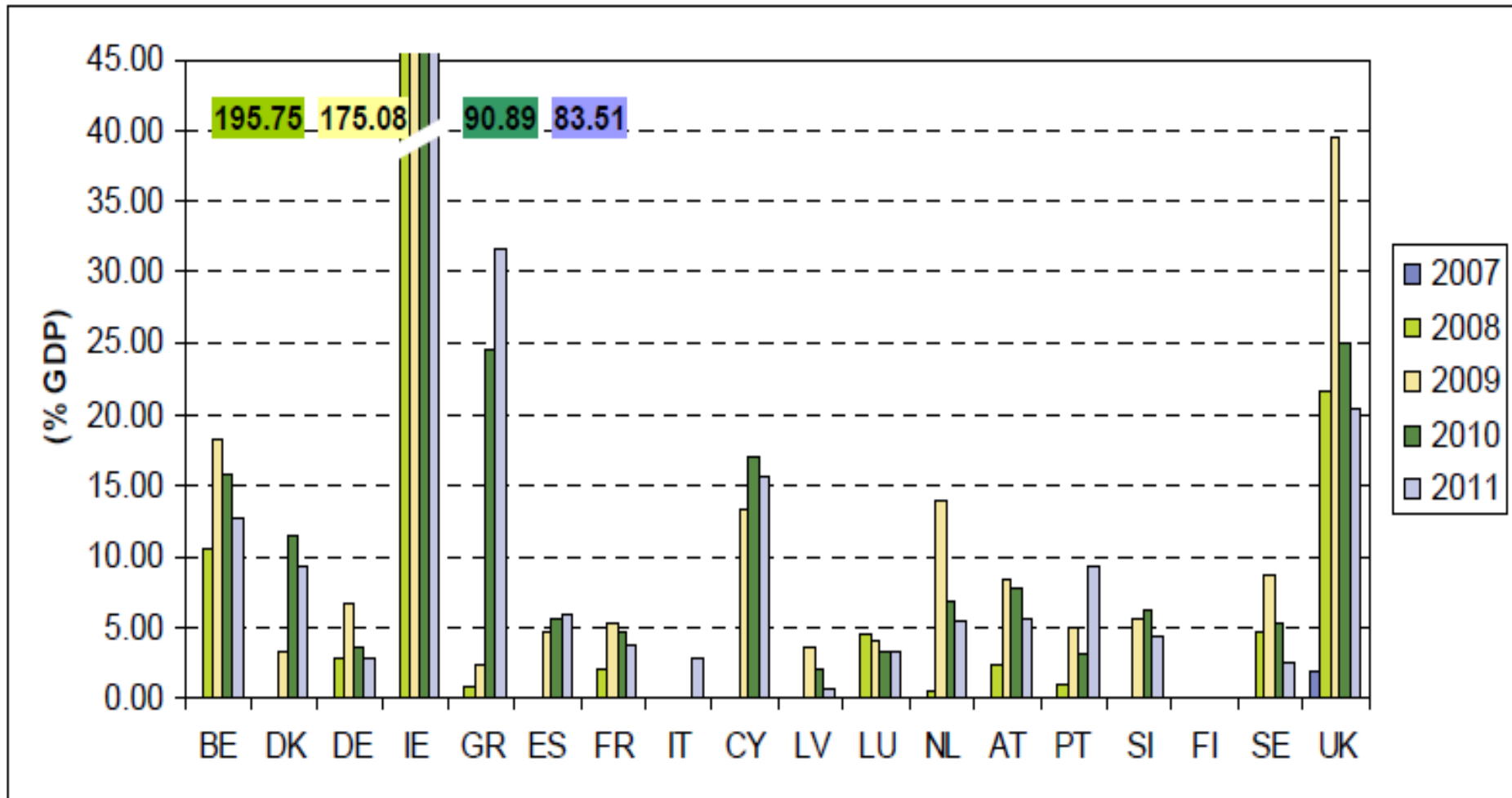
Risks that are invisible



Level of contingent liabilities in EU



Level of contingent liabilities, by EU country



A systematic categorisation of Fiscal Risk



Types of Fiscal Risk

Known Knowns

- Ageing, pensions
- Contractual commitments (e.g. PPPs)

Known Unknowns

- SOEs, financial sector
- Flooding, foot-and-mouth
- Business cycle

Unknown Unknowns

- ???
- Asteroid impact?
- Army deafness?

Unacknowledgeable Knowns?

- Fiscal bias – political, electoral, administrative
- Financial, housing bubbles

The four strategies for handling Fiscal Risk

“Identify and Enumerate”

- Full transparency
- Prompt a sense of urgency and action

“Manage and mitigate”

- Specific policy interventions
- Pick off risks one-by-one




Rules and institutions

- Make it harder to ignore the risks
 - Increase political, reputational costs of inaction

“Brace yourself”

- Accept the inevitable...
... and prepare for it

“Identify and enumerate”

- A conditioning strategy
- Theory: transparency → attention → policy response
 - Annual Statement of Fiscal Risks
 - Long-term sustainability report
 - Scenario analysis, sensitivity testing, fan charts
-  **FINLAND** – *Overview of Government Risks and Liabilities* – every April (since 2015) – categorisation and rating of risks – details on long-term sustainability and financial sector
-  **LATVIA** – detailed, highly structured *Fiscal Risks Statement* with Medium-term fiscal framework – in principle, links to “fiscal safety reserve”
-  **GERMANY** – separate *Long-term sustainability report*

“Identify and enumerate”

- Positive: if it is used a way of structuring analysis and action
- Challenge: applies to the “known” category: can all risks be identified, quantified?
 - Measurement approaches – estimates, sensitivity / stress scenarios, “stochastic” approaches – can alienate policy-makers
- Risk: the report can be seen as a compliance exercise, an end in itself – **“So what?” “What next?”**
 - e.g. hard to frame a “long-term” report in a way that prompts “near-term” policy messages

“Manage and mitigate”

- A direct strategy
- Policy interventions to understand, contain and reduce risks, collectively or one by one

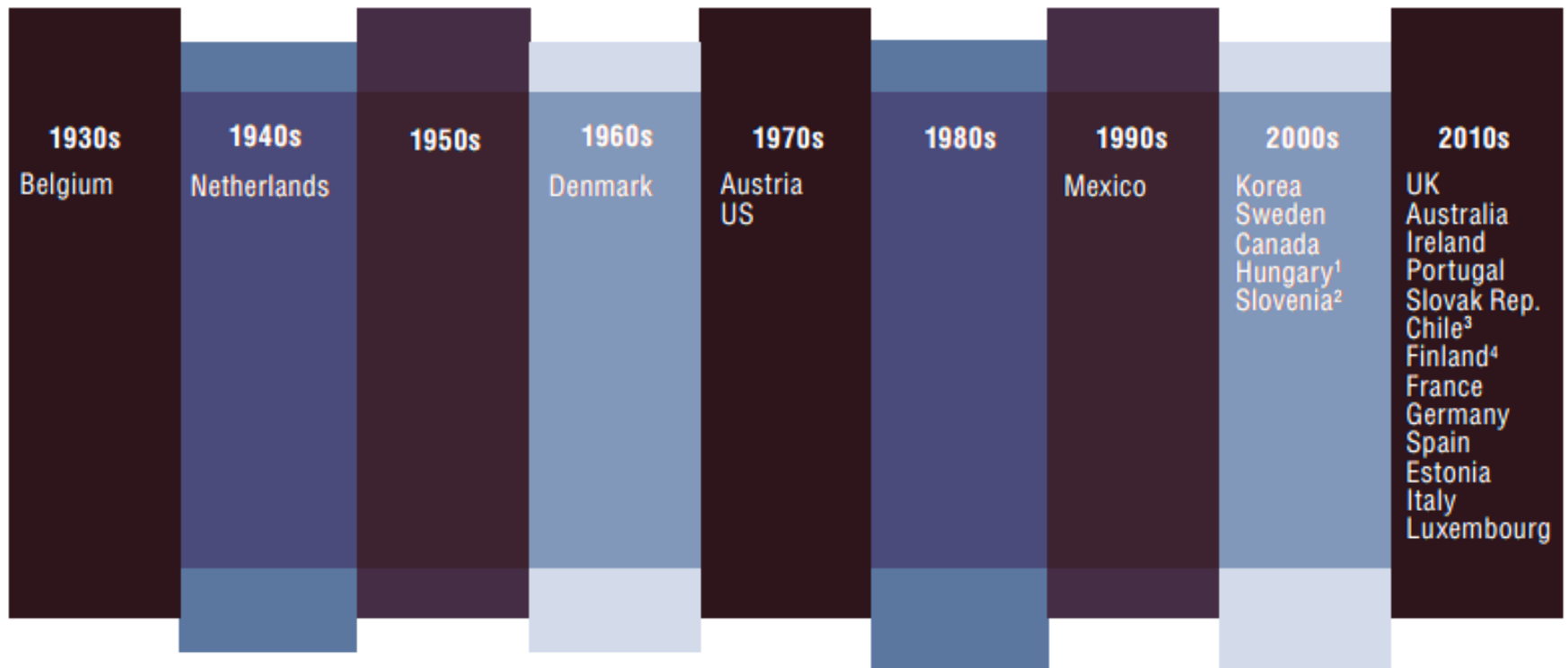
- **NEW ZEALAND: Crown Asset & Liability Management (CALM)**
 - Comprehensive Balance Sheet (GAAP); fiscal balance sheet linked to Treasury’s Fiscal Strategy Model
 - Risk analysis based on *Sustainability / Resilience* and *Risk tolerance*
 - Understand risk contribution of various Agencies

- **NETHERLANDS: Mitigation and clarification strategies**
 - “insurance” payments to government from SOEs for guarantees
 - Credible repudiation of risk in other cases

“Rules and institutions”

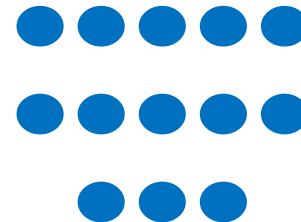
- A behavioural strategy
- Fiscal rules (expenditure caps, debt brake, surplus target)
- New institutions: fiscal councils, IFIs
- ... or new roles for old institutions (national auditors)

Growth of IFIs in OECD countries



Different types of fiscal rule in OECD countries

Euro area / European Compact



Clear Domestic Rule



Commonwealth model



National model



Hybrid model



“Rules and institutions”

- Positive: can help address pro-cyclical bias – an extra tool (weapon?) for those advocating fiscal rectitude
 - Ireland’s case: findings of “Wright Report”, link to role of IFAC
 - EU response: “belt and braces”
- Challenges:
 - Legitimacy issues if rules / institutions are seen to be imposed from outside
 - new institutions must build credibility; a new entrant in the national “ecosystem”
- Unresolved question:
 - Can rules, institutions make us more “virtuous” than we really are? Useful in “bad times”, just an irritant in “good times”?
 - Note SGP history

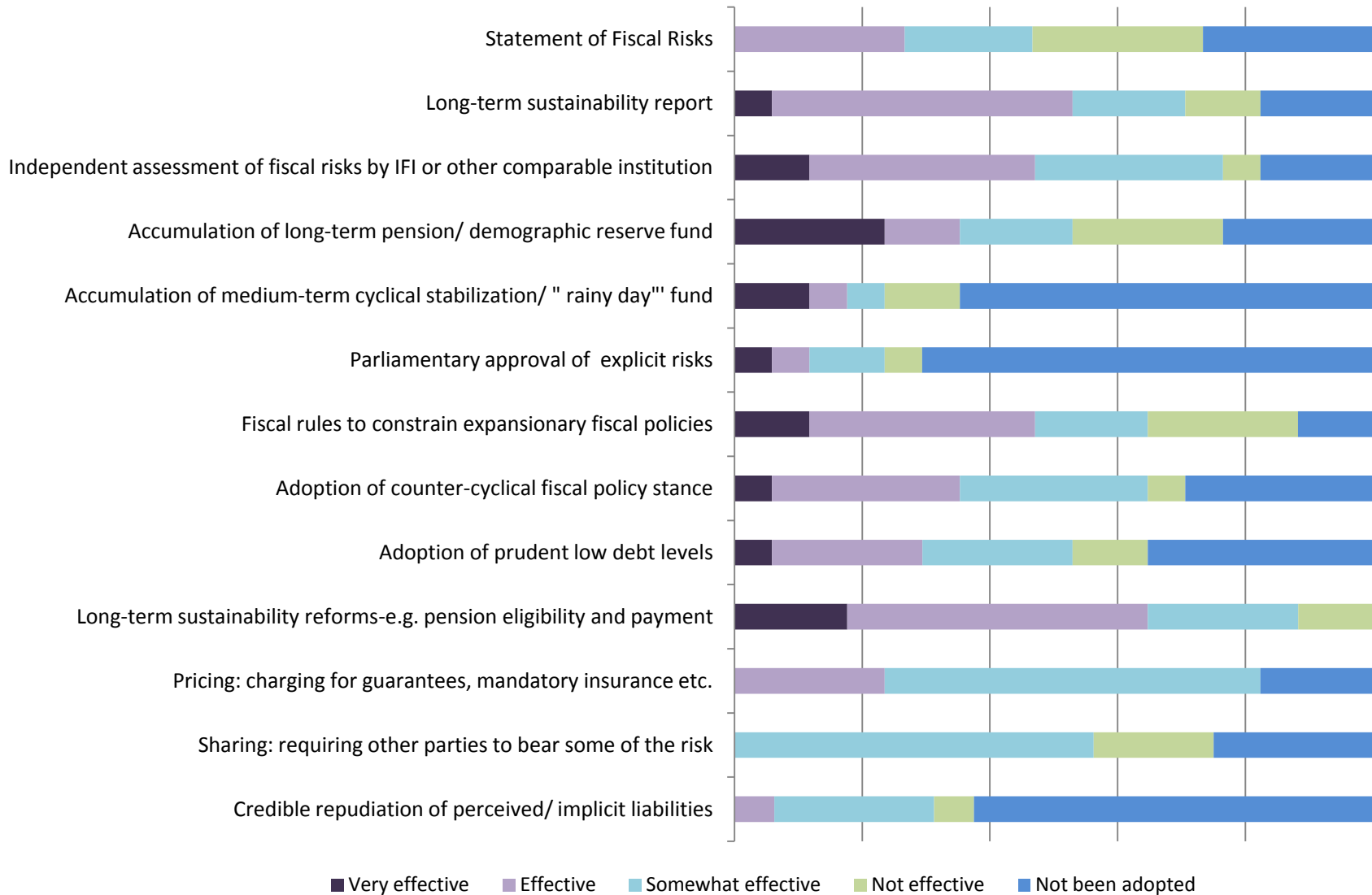
“Brace yourself”

- A stoical strategy - building up fiscal buffers
 - Prudent, counter-cyclical fiscal strategy
 - Prominent surplus target, low debt level
 - Funding strategies
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- **SWEDEN** – 1% surplus rule (introduced after their 1990s crisis)
 - **USA** – *Rainy day funds* used in individual States for stabilisation over the cycle – a more relevant tool also for sovereign states?
 - **TURKEY** – *Turkish Catastrophe Insurance Pool (TCIP)* funded by mandatory insurance for earthquakes etc
 - **IRELAND** – *Long-term Pension Reserve Fund* – 1% of GNP annually...

“Brace yourself”

- Positive: only way to tackle the “unknowns”
- Challenge: takes time, discipline and political capital to build up a fiscal surplus, or reserve funds
 - Recent example of Sweden
- Risk: the more sizeable the fiscal buffer, the more tempting it looks...

There is a perceived value in the various strategies



Summing up – towards an ideal hybrid strategy?

- Annual Fiscal Risk / Fiscal Resilience Report
 - Including stress scenarios
- Identify what can be managed, and manage it
 - E.g. mandatory insurance; construction of flood defences
- Simple, easily-understood fiscal rules
 - Do the current rules pass this test?
- Clearly mandated national fiscal institutions
 - “watchtowers” rather than “watchdogs”
- Rainy day / longer-term Funds can be useful, if they can be “taken off the table” for budgetary purposes