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Remarks by Paul Inderbinen, SIF

Credibility, Fiscal Institutions and Rules

[Introductory remarks]

I would like to make some brief points on fiscal policy. I will do so from a Swiss perspective – specifically, I will focus on fiscal rules, and their role in promoting credibility and growth. I will also put this into the context of monetary policy.

First, on monetary policy. Currency reform and establishment of monetary authority are by their very nature closely linked to the establishment of nationhood. Indeed, tomorrow's celebration of the twentieth anniversary of the introduction of the Kyrgyz som has provided the backdrop to this conference.

Looking at the region more broadly, challenges certainly remain in the monetary domain. But inroads have been made. While annual inflation rates in the CIS averaged close to 40 percent in the decade from the mid-nineties to 2004, they are now expected to be well within the single-digit range in the Caucasus and Central Asian region in the years immediately ahead. Also, countries in the region have made progress in establishing central bank independence, in ensuring the convertibility of transactions on their current and capital accounts, and in maintaining unified exchange rates.

Fiscal policy is just as closely linked to nationhood as is monetary policy. National fiscal policy is among <u>the</u> manifestations of sovereignty and political entity.

Looking again at the CCA, progress towards sustainable fiscal positions continues to be mixed. Countries have made limited progress in creating dependable, non-hydrocarbon revenue bases; they continue to rely heavily on remittances; they have since the 2009 global crisis become more dependent on external assistance; and their budgets continue to be exposed to contingent liabilities stemming from state-owned enterprises and weaknesses in their banking systems. As a rule, fiscal planning remains weak.

This state of affairs puts into question macroeconomic stability. By representing a continuous possibility of fiscal dominance, it also threatens to undermine the hard-won achievements that have been made on the monetary side.

This is where the importance of strengthening fiscal institutions comes in. The institutional underpinnings of fiscal policy can be re-enforced in many ways. One possibility is an expenditure rule, or what Switzerland has chosen to term a «debt-brake» rule: The debt brake introduced at the central government level in Switzerland some twelve years ago entails a set of simple but binding rules. It stipulates that central government must at all times maintain the balance of revenue and expenditure: the upper-bound of expenditure appropriated in the budget has to be based on expected revenue, taking economic developments into account. The rule thus essentially implies a balanced budget over the economic cycle. Critically, it includes a sanctioning mechanism, in that total expenditure exceeding the ceiling has to be compensated in subsequent years. Also, if taxes were to be reduced, so would expenditure. Equally important, the debt-brake rule includes an escape clause, under which additional expenditure can be made in exceptional circumstances – such as a severe downturn, or substantial strain in the banking system.

Balancing the budget over the cycle does not imply impotence of fiscal policy for macroeconomic ends. It allows automatic stabilizers to work. But beyond this, it strictly limits the discretion of government and parliament in what is an inherently political process -- that of determining a public expenditure envelope, and securing sufficient streams of revenue.

By all accounts, experience under our fiscal rule has been positive: Swiss gross <u>central</u> government debt plateaued upon introduction of the «debt brake» at the beginning of the previous decade. Since 2005, <u>general</u> government debt has fallen by around 16 basis points, and is now well under 40 percent of GDP. It goes without telling that this compares favorably with average figures for the major advanced economies. The debt ratio should continue to fall, dropping to 33 percent – slightly more than a third of the EU average.

One of the most telling experiences under the debt-brake rule is that the fiscal consolidation it implied did not have an adverse impact on growth. In fact, Switzerland's GDP grew by an average of close to two percent, compared to slightly over one percent in the decade preceding the rule. This may not seem like a stellar performance, particularly compared to less mature economies. But what is more important than the magnitude is the direction. Consolidation did not cause growth to collapse; quite the contrary.

One explanation for the positive effect of consolidation on growth performance is that much of the previous uncertainty surrounding the macro policy mix was removed. Going further, the credibility provided to the fiscal authority, and the confidence thus generated in the consolidated balance sheet of the government, allowed the Swiss authorities to take unprecedented measures in the course of the financial crisis in 2008, when one of the G-SIBs was recapitalized with public funds, and its impaired assets were transferred to the Swiss National Bank.

<u>To conclude</u>: Well-designed and binding fiscal rules limit discretion and thus impart credibility to a countries' fiscal authorities. The consolidation that fiscal rules imply need not lead to slower growth, certainly not in the medium term. Since a lack of fiscal credibility in the CAA can ultimately undermine progress in assuring monetary stability, developing fiscal rules would clearly be an important mile stone for the CAA on the road ahead.