FISCAL RULE STRETCHING DURING FINANCIAL MARKET STRESS AND CRISIS

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ELECTIONS AND FISCAL POLICY

Considerable research has examined how [FILL IN]

FISCAL ACCOUNTING IN EUROPE

STABILITY & GROWTH PACT

Stability and Growth Pact (SGP) sets deficit and debt levels.

- Before eurozone debt crisis, focus was on 3% deficit limit

Created an enforceable European government finance accounting regime, with **common rules** (European System of Accounts) and a **common accounting monitoring institution–Eurostat**.

Nonetheless member states have **first mover advantage**.

Debt and deficit figures are **first published by member states**. They have first crack at **classifying** a policy with seemingly ambiguous budgetary effects.

Eurostat only **scrutinises and revises published figures post hoc**.

It is difficult within the European accounting regime to simply fabricate the government's fiscal position.

However …

FISCAL RULE STRETCHING

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- **voters don't really care** about revisions...

- governments have strong incentives to **rule stretch**.

Fiscal rule stretching: if the fiscal implications of a policy are potentially ambiguous, then a decision is made to minimise its debt and/or debt implications

ACCOUNTING POLICY RESPONSES TO FINANCIAL CRISES

HYPOTHESES

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- H_2: Debt revisions will be greater for years when there are endogenous elections.
- H_3: The effects predicted by H_1 and H_2 will be stronger when a country also has high financial market stress.

EMPIRICS: SETUP

Dependent variable: cumulative revisions made by **Eurostat** to government debt and deficit statistics (% of GDP) over the 3 years from initial publication. Revisions occur bi-annually (April & October).

Revisions to data for 2003-2013.

Cumulative **debt** revisions: $[-1.1, 12.7]$

Cumulative **deficit** revisions: $[-4.5, 1.1]$

Unit of analysis: Eurostat revision for a given year.

- There are typically 7 observations per publication year. The first in October of the publication year + twice a year for the subsequent 3.

Note: Changes due to GDP revisions are **not included**.

RIGHT-HAND SIDE

- Years to election (Gandrud 2015)
- No election, Predetermined Election, Endogenous Election (Hallerberg and Wehner)
- FinStress (Gandrud & Hallerberg, in development)

Previously, most research on financial crisis used either Reinhart & Rogoff (2010) or Laeven & Valencia (2012). But,

- binary, no indication of intensity,
- created post hoc, not real-time. Policy-makers might perceive something different in real-time.

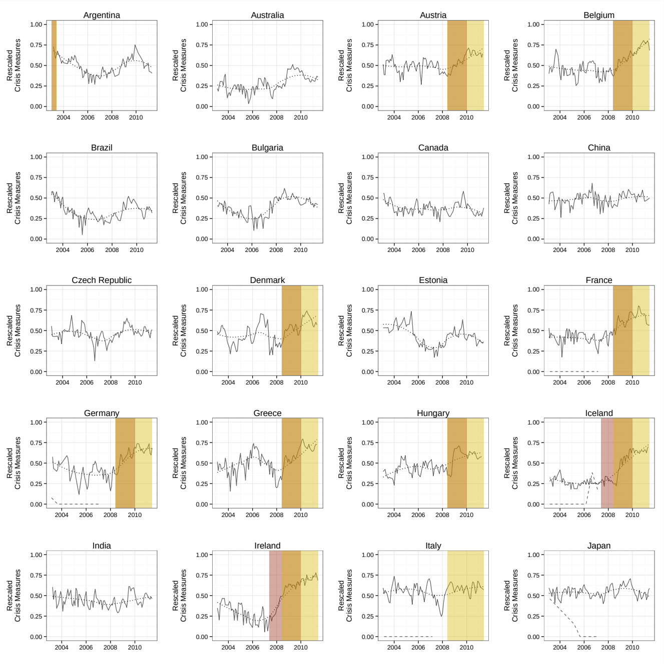
Kernel Principal Component Analysis of $> 12,000$ Economist Intelligence Unit **monthly** country reports on financial markets.

- > 180 countries
- 2003–2011

creating ...

FinStress: continuous [0, 1] indicator of real-time perceived credit provision stress.

Here, we use country-year means.


Argentina
Australia
Austria
Belgium
Brazil
Bulgaria
Canada
China
Czech Republic
Denmark
Estonia
France
Germany
Greece
Hungary
Iceland
India
Ireland
Italy
Japan
Rescaled Crisis Measures
1.00
0.75
0.50
0.25
0.00
2004
2006
2008
2010

Why credit provision, not financial markets more broadly?

In general, **politicians care** about financial market stress to the extent that it **hits credit provision to the real economy**.

Hypothesise that election variables have a **larger impact** on revisions during **high financial market stress**.

so

Focus on **interactions** between election variables and FinStress.

Also:

- Years since publication
- Eurozone membership
- Exchange rate (vs. USD)
- Absolute gross debt & deficit levels (2015 vintage)
- Country-varying intercepts

empirics: (preliminary) results

Figure: Marginal Effect of Election Timing (years to election) at Various Levels of Financial Market Stress on **Debt** Revisions

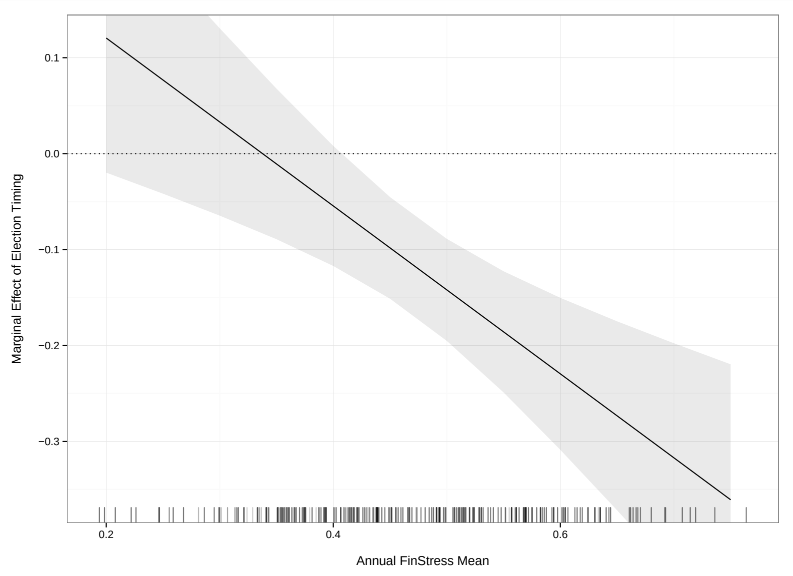


Figure: Marginal Effect of an Endogenous Election at Various Levels of Financial Market Stress on **Debt** Revisions

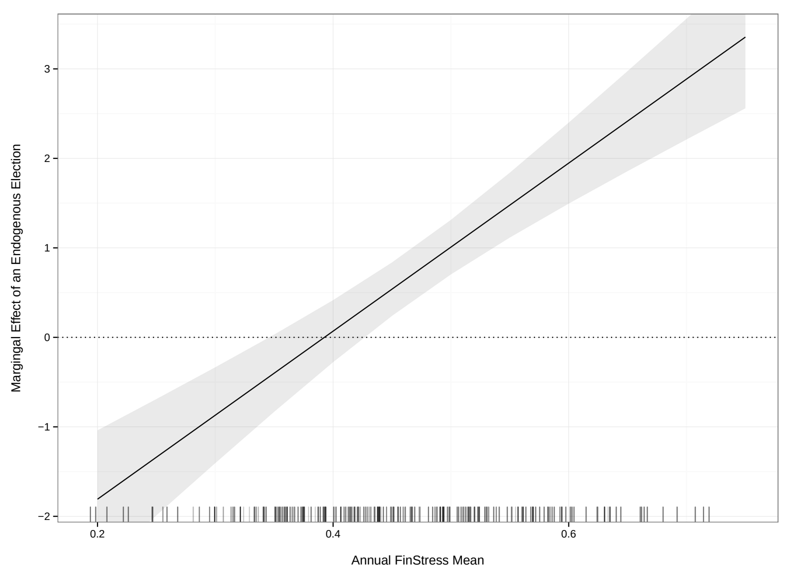


Figure: Predicted **Debt** Revisions in Four Years After Publication for Years with Different Election Types/Non-election Years

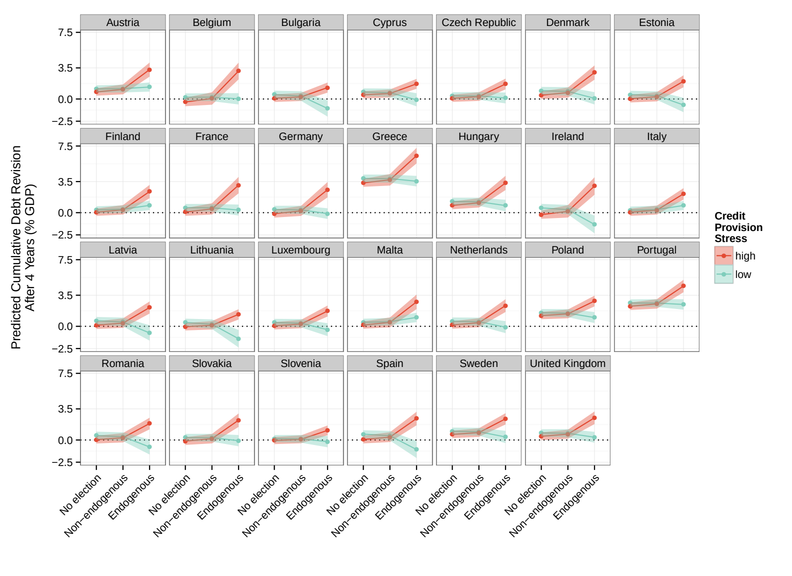
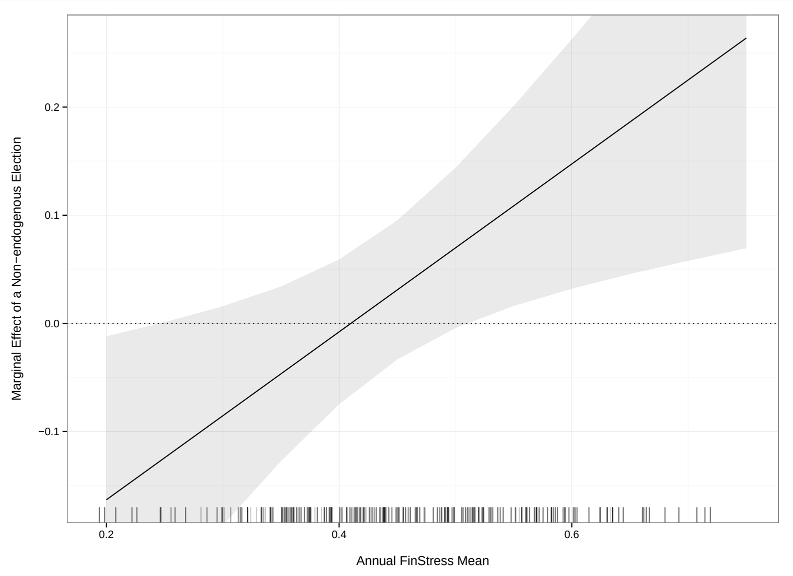


Figure: Marginal Effect of a Non-Endogenous Election at Various Levels of Financial Market Stress on **Deficit** Revisions



CONCLUSION/STILL TO DO

TO-DO: EMPIRICAL

Omitted variables?:

- independence of national accounting agency.
- SGP enforcement actions (not just eurozone membership)
- Others?

Model choice: normal linear regression with many 0s?

TO-DO: THEORETICAL

- Understand interaction between scheduled elections and FinStress.