Fiscal Risks

Sources, Disclosure, and Management

Paolo Mauro

Fiscal Affairs Department

International Monetary Fund

Introduction

- Fiscal Risks: Deviations of fiscal outturns (deficits, debt/GDP) from expectations at the time of the budget or other fiscal forecasts.
- How large are fiscal risks for different groups of countries?
- What are the most important sources of risk?
- What can policy makers do about fiscal risks?

Motivation

- Pressure to reduce deficits can result in governments assuming off-budget risks, including through guarantees.
- Identification, disclosure and management of fiscal risks are mutually supporting activities.

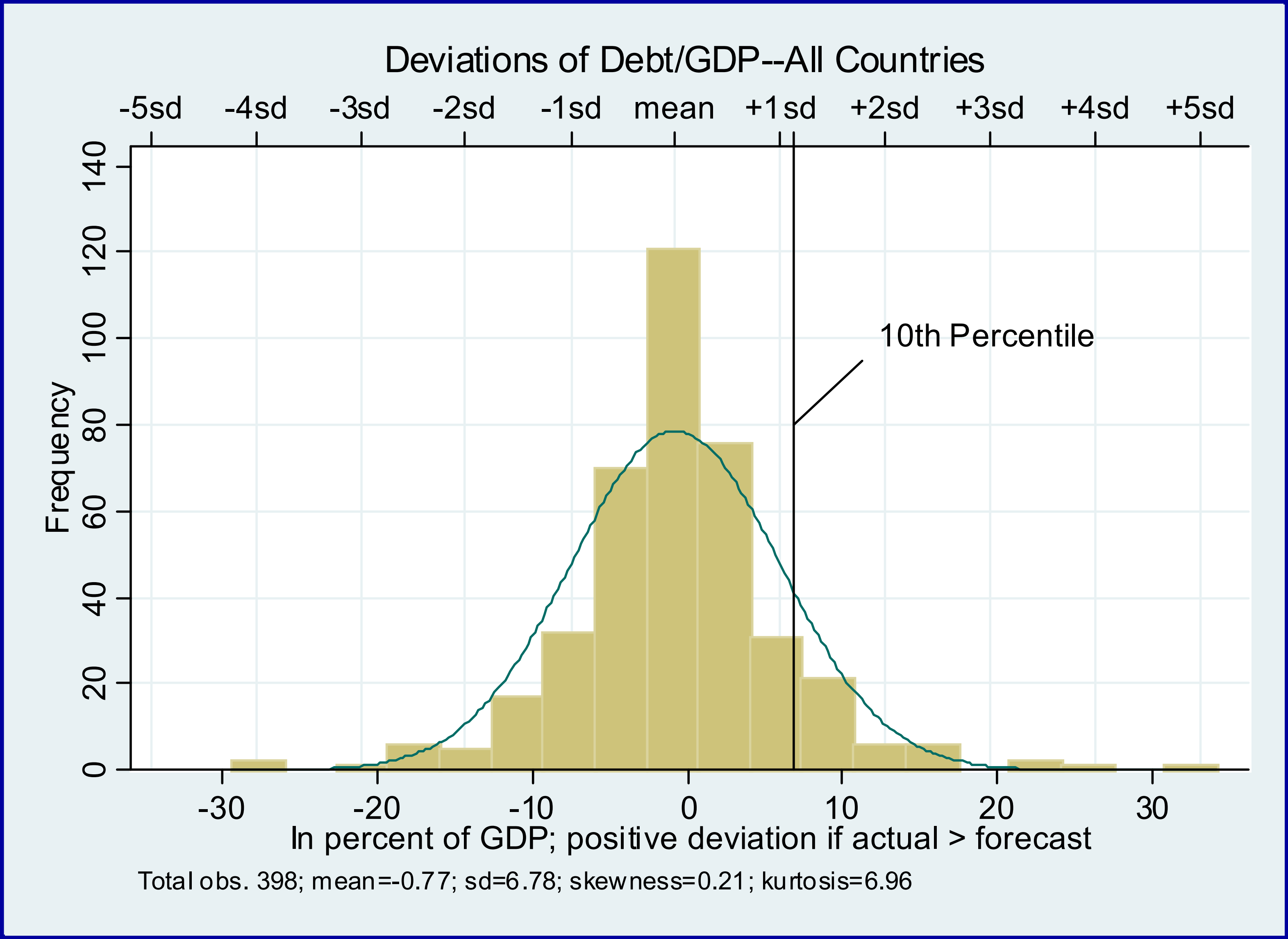
Context

- Increasing interest in fiscal risk disclosure and management: more and more countries are doing fiscal risk statements; request from APEC countries
- Presentation draws on paper recently discussed at the IMF's Executive Board.
- Represents extension of the IMF's ongoing work on transparency (revised Code and Manual on Fiscal Transparency).
- Preliminary Guidelines: not prescriptive; a tool for policymakers that will evolve with experience.
- More requests for advisory services in this area.

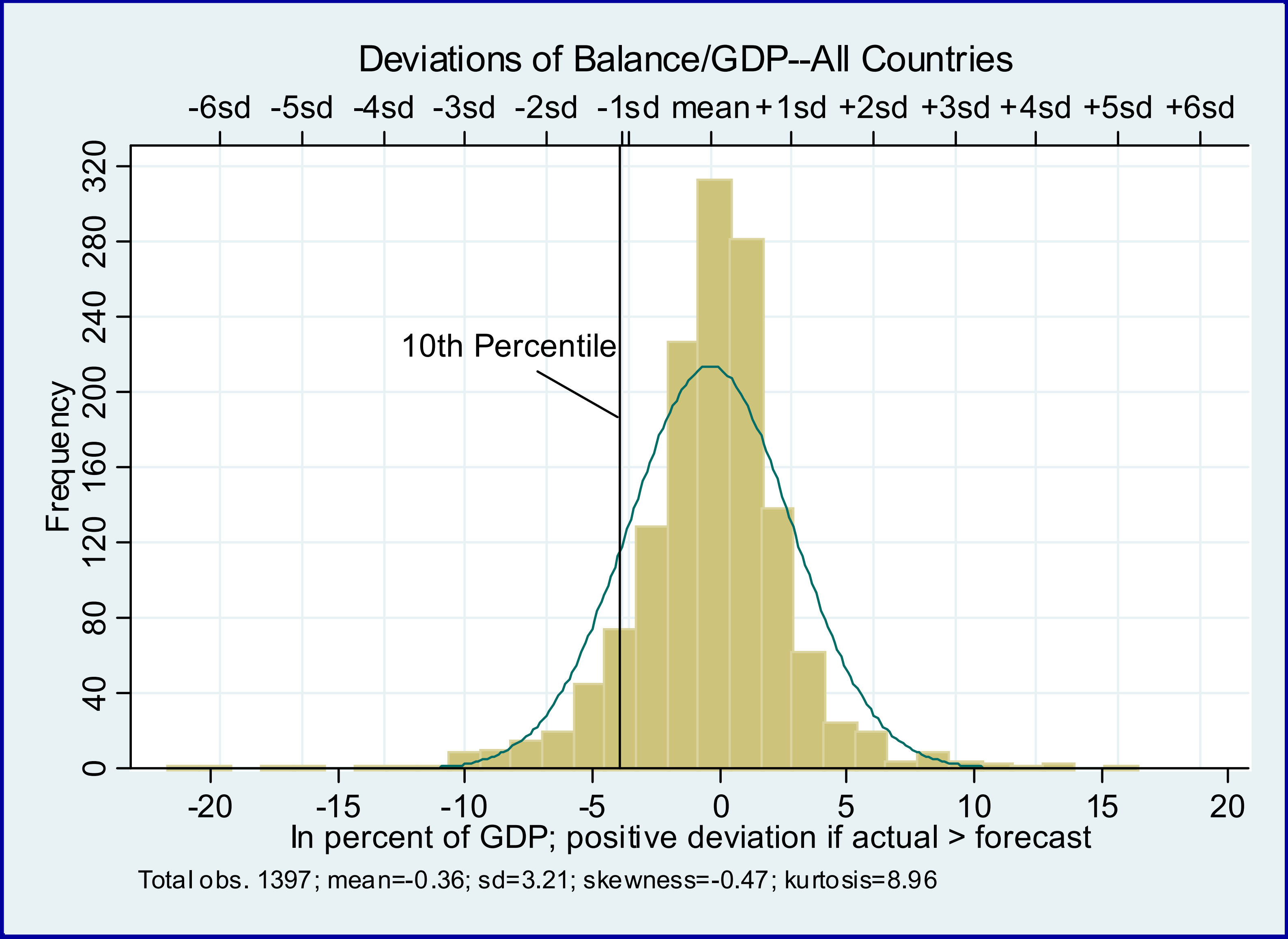
Outline of Presentation

- How large are fiscal risks?
- What are the main sources?
- Identification, Disclosure and Management—Benefits and Broad Principles.
- Guidelines

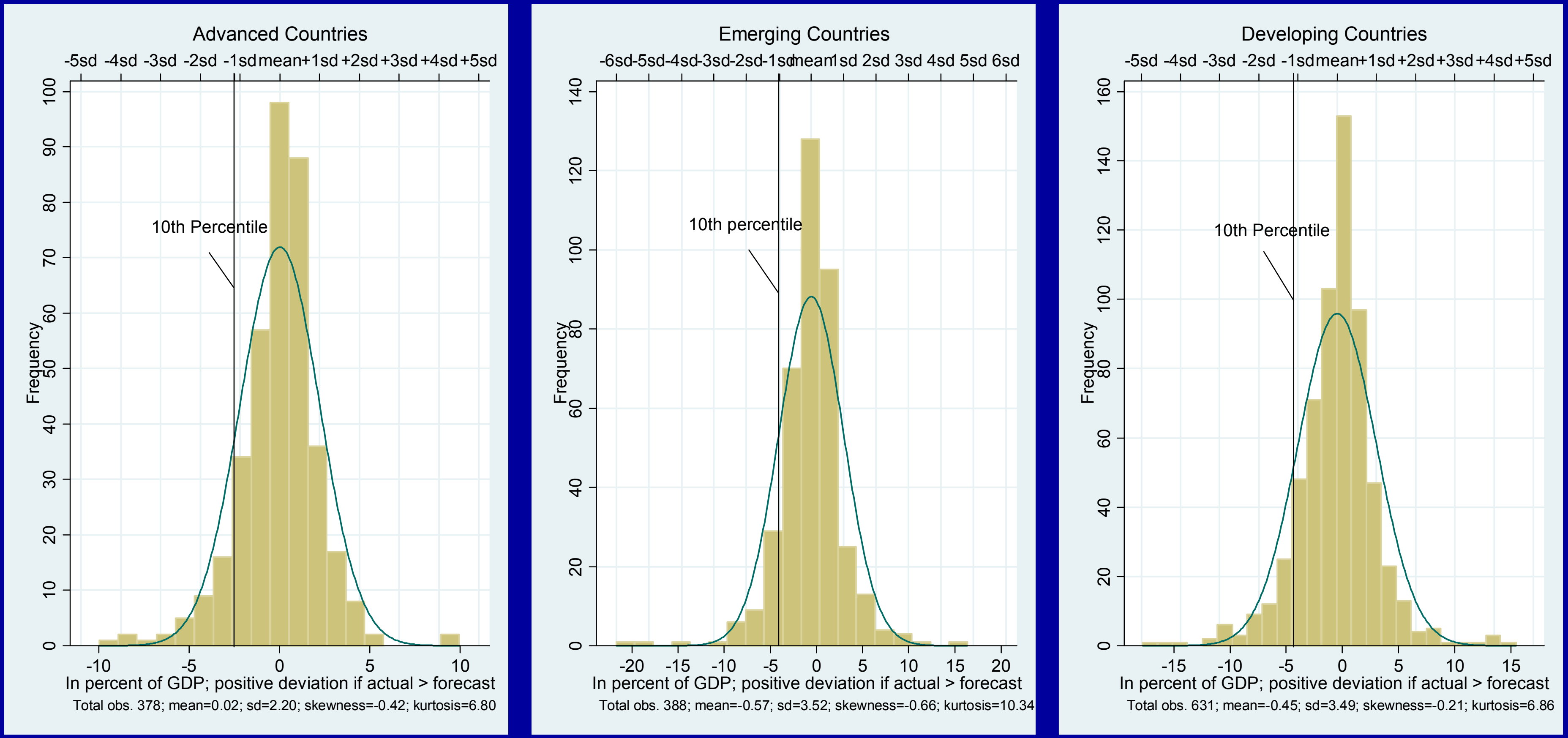
How Large Are Fiscal Risks?
Surprise Deviations in Debt/GDP



How Large Are Fiscal Risks?
Surprise Deviations in Balance/GDP



Surprise Deviations in Balance/GDP

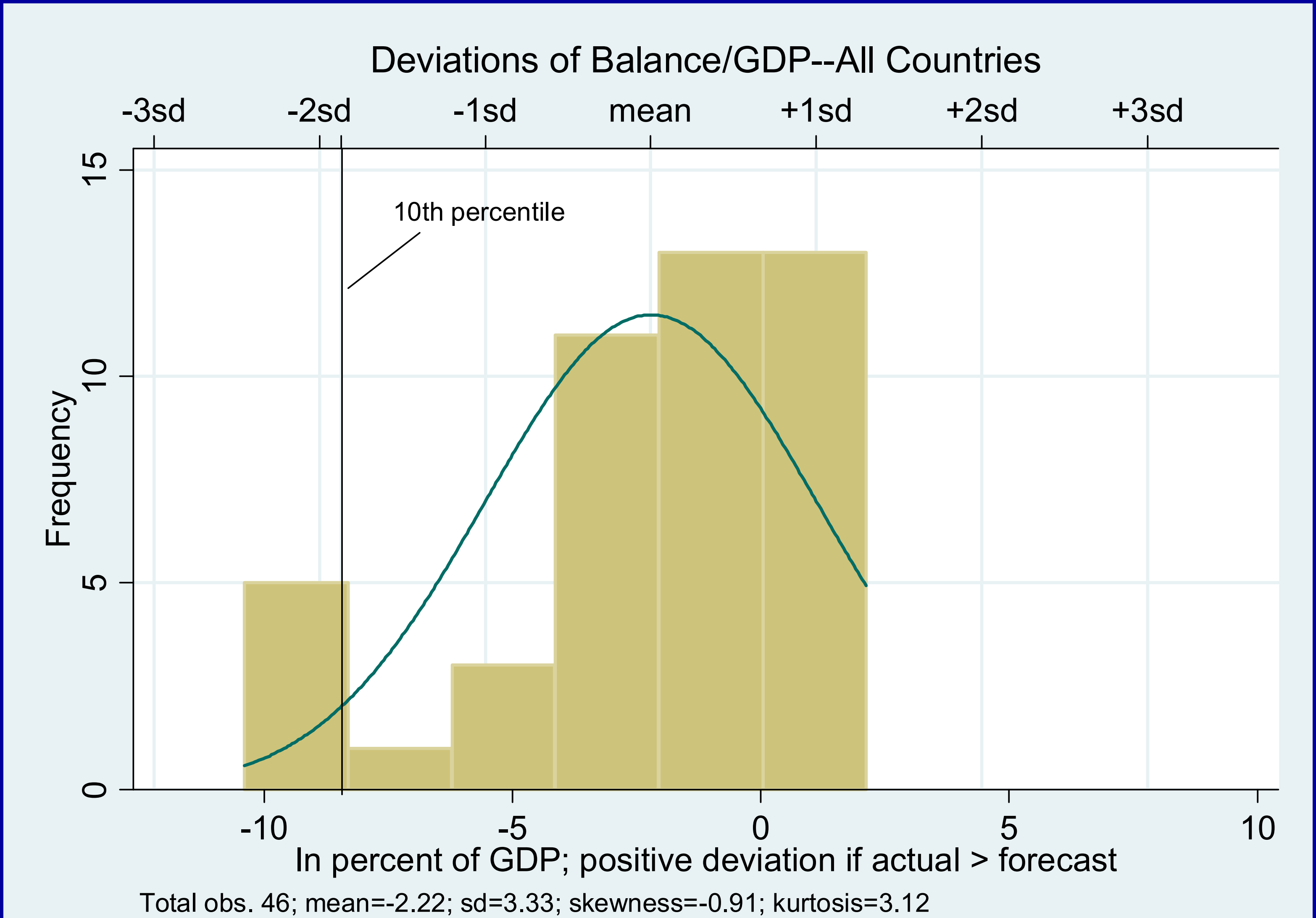


Sources of Fiscal Risk

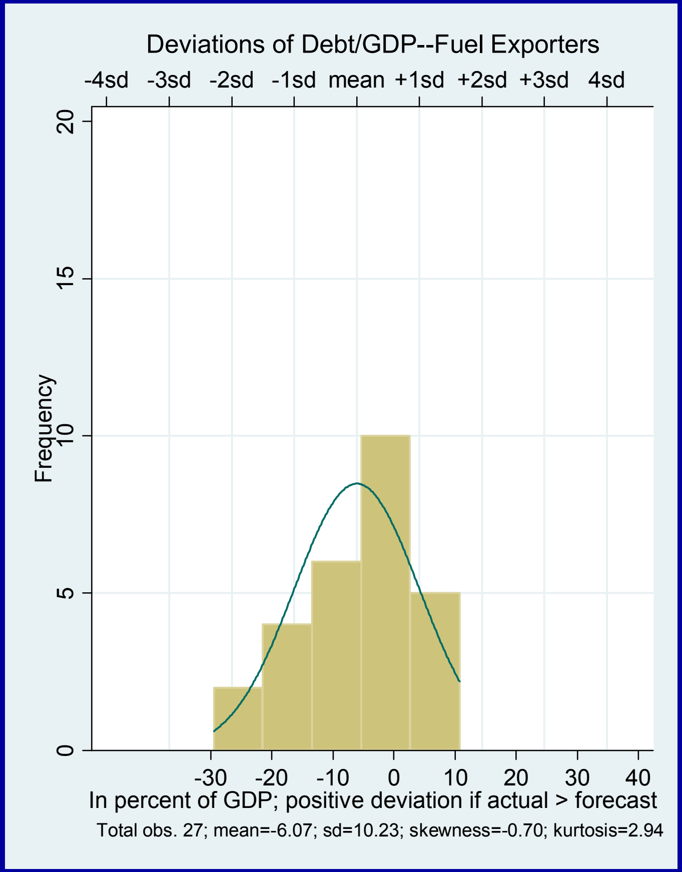
- Macroeconomic shocks: growth, commodity prices, interest rates, and exchange rates.
- Contingent liabilities: obligations triggered by uncertain events.
  – Explicit: those defined by law or contract, e.g., debt guarantees, PPPs, legal claims against the government.
  – Implicit: expected obligations for the government, e.g., natural disasters; bailouts of banks or public sector entities assumptions of debts.....
- Desirable policy response depends on whether shocks are temporary or permanent; and their degree of correlation.

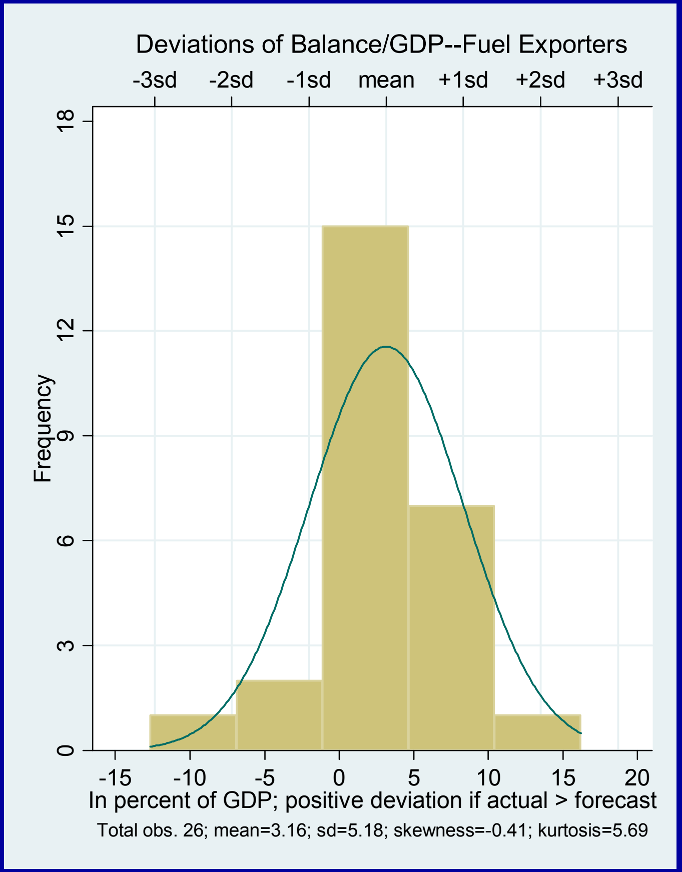
Currency Crises

(depreciation by at least 25 p.p. and at least 10 p.p. greater than the previous year)



Oil Exporters: Years of Oil Price increase





Results: Sources of Fiscal Risks

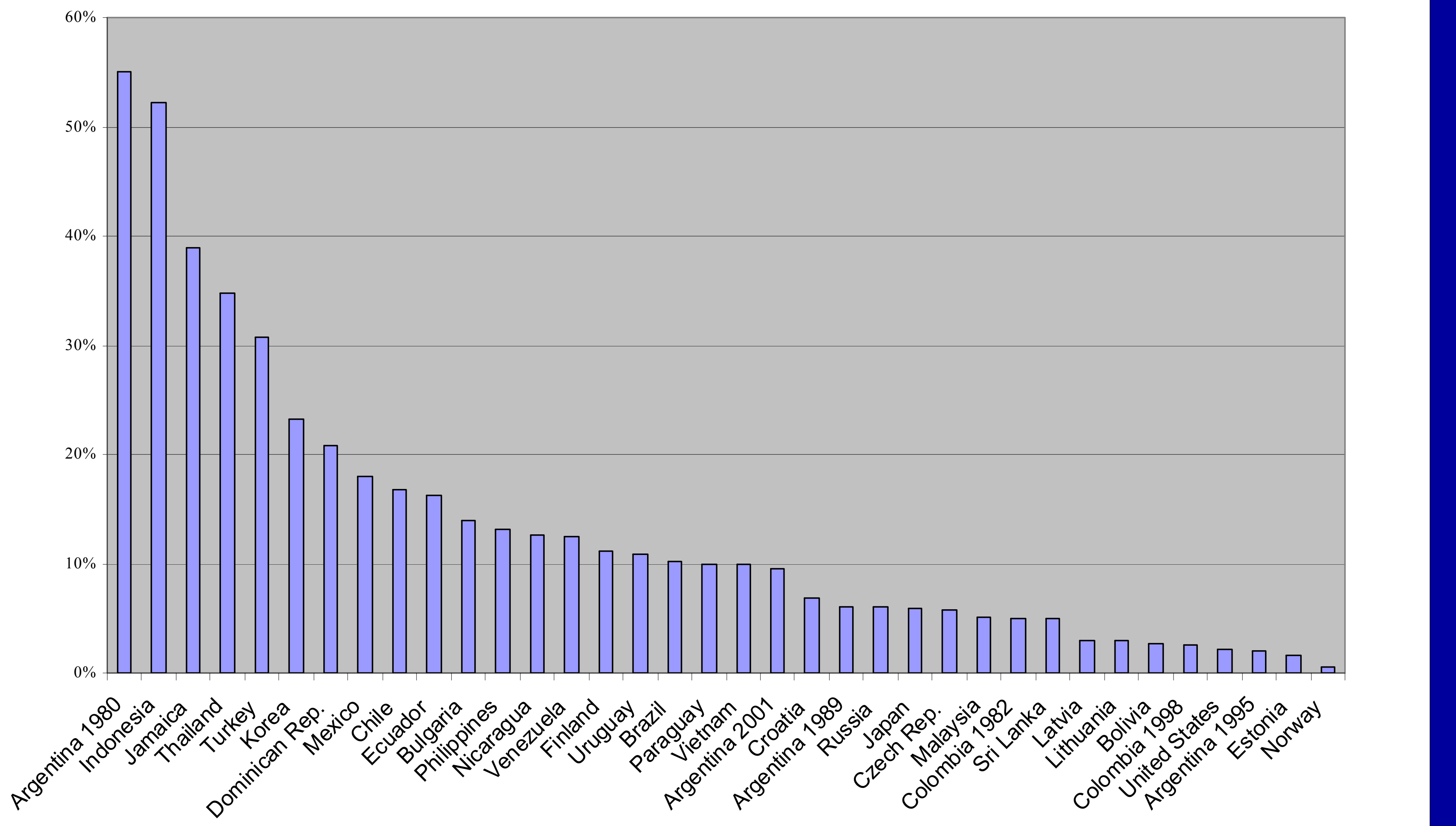
- Really big, immediate, unexpected increases in debt/GDP: banking crises; exchange rate crises (especially when large share of debt is denominated in foreign currency); assumptions of debts.
- More common/fiscal risks to the deficit: economic growth slowdowns, adverse terms of trade changes.

Fiscal Costs of Banking Crises

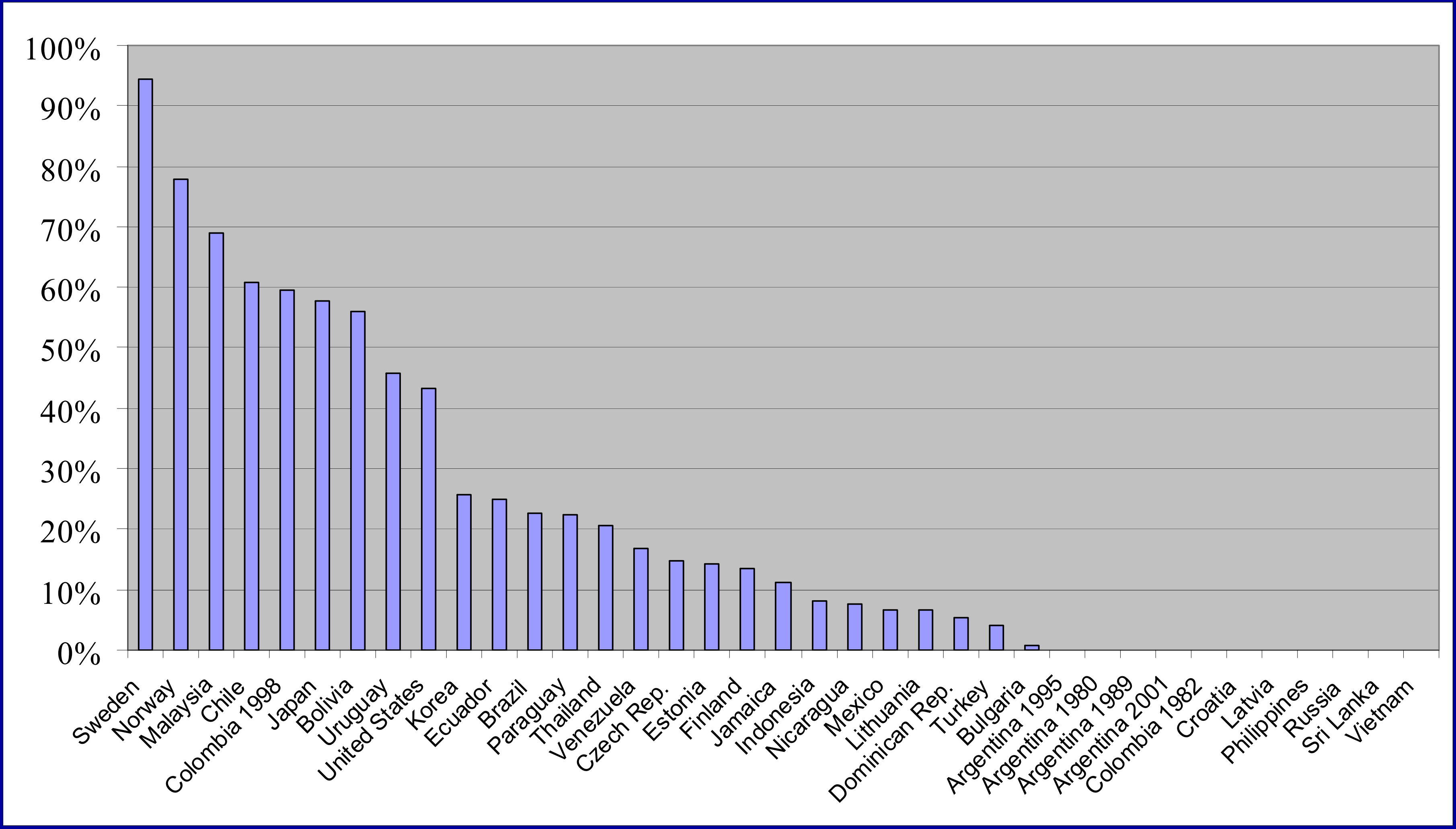
Gross costs vs. Net costs

Recovery rates: fiscal risks on the asset side

Banking Crises: Net Fiscal Costs
(in percent of GDP)



Banking Crises: Recovery rate
(recovery as a share of gross fiscal costs)



Benefits of Disclosure

- Identification, disclosure and management of fiscal risks are mutually supporting activities.
- Disclosure imposes discipline to identify and manage fiscal risks.
- Disclosure may reduce long-run borrowing costs
- The public often knows the risks are there

Management of Fiscal Risks: Key Principles

- Sound macroeconomic and public financial management policies
- Risk sharing with other parties
- A clear legal and administrative framework that guides the allocation of roles and responsibilities in risk management
  - Centralized vs. Decentralized depends on country circumstances

Guidelines for Fiscal Risk Disclosure and Management

- Fiscal risks to which the government is exposed should be identified and disclosed so as to facilitate an effective fiscal policy.
- Fiscal risks should be mitigated in a cost-effective manner.
- There should be a clear legal and administrative framework to regulate overall fiscal management and the government’s exposure to fiscal risks.
- Fiscal risks should be systematically incorporated in fiscal analysis and the budget process.

Guidelines: Identification and Disclosure

- Availability of information: compilation and monitoring of all risks—importance, probability, and where possible, quantification.
- Legislative/accounting framework for disclosure of risks, with presumption of publication; exceptions based on clear criteria (materiality, moral hazard, prejudice national interest).
- Full presentation of risks in budget documentation, possibly in statement of fiscal risks.

Guidelines: Legal and Administrative Framework

- Clear allocation of responsibilities between central government and rest of the public sector on use of public funds.
- Fiscal risk management may be facilitated by a central government unit that can monitor and control overall risk and consider interactions.
- Integration with overall fiscal management is facilitated by location within MoF.
- Line ministries and agencies to have clearly specified responsibilities for managing their risk exposure.
- Responsibility for taking on risks should be separate from that of estimating their potential fiscal costs.

Guidelines: Incorporating Fiscal Risks in Fiscal Policy and Budget Process

- Risk analysis should be incorporated in the macroeconomic policy framework with fiscal targets allowing for the possibility that some risks may materialize
  - The government’s exposure to fiscal risks should be incorporated in fiscal sustainability analysis.
  - A limited annual centralized contingency appropriation should be considered.

Guidelines: The case of Guarantees

- Decisions over guarantees and other contingent liabilities should be integrated with the annual budget cycle so that proposals are considered alongside competing instruments.
- A framework should be in place to require parliamentary approval of guarantees.
- An annual budget appropriation could be included to cover expected calls on guarantees (general, category, or specific).

Guidelines: detail on the Case of Guarantees

- **Why important?**
  - Guarantees prevalent during current financial turmoil
  - Guarantees often hide true fiscal costs
  - Guarantees are seen as less expensive that actual cash payout
- **Options to mitigate fiscal risks from guarantees**
  - Budget appropriations for expected cash cost of payouts to meet calls on guarantees
  - Alternatively, appropriate the full expected NPV cost
  - A fee-based guarantees fund to meet the cost of calls on guarantees
  - Annual quantitative limit on guarantees

Lessons for Policy Makers

- Identify your risks, coordinate information, and analyze risks in a comprehensive framework.
- Sources can be macro shocks (exchange rates, interest rates,...), contingent liabilities (implicit—e.g. natural disasters, banking system) or explicit (guarantees, PPPs).
- Disclose and manage risks (more and more countries are doing fiscal risk statements).
- Consider how guidelines apply to country-specific circumstances, and provide feedback on guidelines.