

# The Unintended Consequences of the Stability and Growth Pact

Η ΕΛΛΑΔΑ ΣΤΗΝ ΟΝΕ

*Thomas Moutos (AUEB & CESifo)*

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## Private Saving, Government Saving, and the “Twin Deficits”

- Private saving is the part of disposable income that remains after consumption spending, i.e. it is equal to  $PS=Y-T-C$  (T denotes **net** taxes, i.e. after subtracting government transfers.)
- Government saving is similarly defined as  $GS=T-G$ , with G denoting government purchases of goods and services (i.e. excluding transfer payments)
- National saving is the sum of PS and GS,  $NS=PS+GS=Y-C-G$
- Since  $Y=C+I+G+CAB$ , subtracting T and C from both sides, we can re-write the national income identity as

$$(PS-I) + (T-G) = CAB, \text{ or,}$$

Private Sector Balance + Government Budget Balances = CAB  
(the CAB is what the country lends to or borrows from abroad)

Note: This is an identity – not a theory.

# “Twin Deficits”

- To turn this identity into the *twin deficits hypothesis* you need to assume that changes in the government budget balance are (i) exogenously determined and (ii) do not affect the private sector balance.
- Neither of these assumptions seems to hold.

European Union (percentage of GNP)						
Year	CA	$S^P$	$I$	$G - T$		
1995	0.6	25.9	19.9	-5.4		
1996	1.0	24.6	19.3	-4.3		
1997	1.5	23.4	19.4	-2.5		
1998	1.0	22.6	20.0	-1.6		
1999	0.2	21.8	20.8	-0.8		

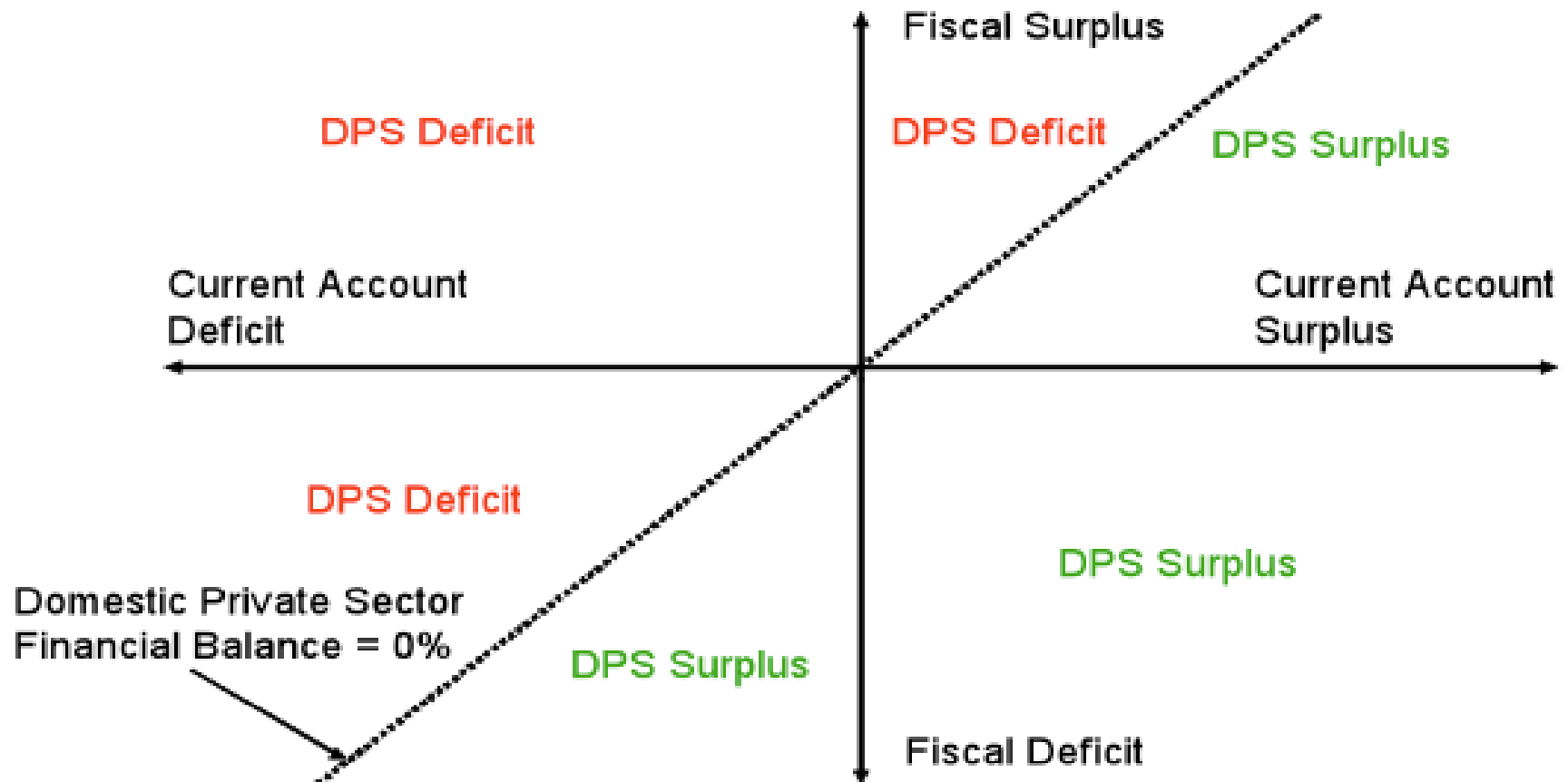
- In the data above, the private sector adjusted to the change in the government’s budget balance.

- Accounting rules imply that the private sector as a whole can only spend less than it earns if some other sector spends more than it earns.
- Usually the spendthrift sector has tended to be the government.
- Pursuing fiscal retrenchment in order to reduce government debt default risk will merely raise the odds of private sector debt defaults. Cash flow will be taken from households and firms attempting to rebuild their net saving positions, and private debt servicing will falter.
- The only way to avoid this outcome is if the nations undertaking fiscal retrenchment improve their trade balances.
- Pursuing “internal devaluation” is meant to do exactly this.
- However, there is no guarantee that trade balance improvements will be large enough to overcome the fiscal contraction, i.e. a less-open economy will have a hard task achieving this.
- If many countries engage in internal devaluation concurrently the likelihood of success decreases.

A schematic way to represent the different combinations of sectoral balances; Japan has been for many years in the bottom-right quadrant; Ireland and Spain were in the years preceding the crisis in the top left...

## 3 Sector Financial Balances Map

Domestic Private Sector Financial Balance = Current Account Balance – Fiscal Balance



the adjustment of private savings to government savings was not unidirectional across countries and across periods (i.e. contrast Greece with Spain)... but some caution is needed in the interpretation of the last period due to the bailouts of the banking sector

	Total Savings				Private Savings				Government Savings			
	95	96-00	01-08	09-14	95	96-00	01-08	09-14	95	96-00	01-08	09-14
ES	21.2	22.1	22.4	19.8	23.2	20.9	18.0	24.5	-2.0	1.2	4.4	-4.7
<b>GR</b>	<b>20.0</b>	<b>19.0</b>	<b>13.3</b>	<b>7.2</b>	<b>26.1</b>	<b>20.4</b>	<b>16.1</b>	<b>13.1</b>	<b>-6.1</b>	<b>-1.4</b>	<b>-2.8</b>	<b>-5.9</b>
IE	21.6	24.1	23.7	18.8	21.8	19.5	19.9	25.0	-0.2	4.6	3.8	-6.2
IT	21.7	21.2	20.3	17.7	25.5	21.4	20.0	18.8	-3.8	-0.2	0.3	-1.1
PT	20.9	19.7	14.6	13.1	22.6	19.2	16.1	18.2	-1.7	0.5	-1.5	-5.0

the narrowing of the current account deficit in Greece was based on an investment collapse (mainly in residential investment) -not a rise in saving – with private saving collapsing by as much as the rise in public saving...

	Total Investment		Corporate Investment		Residential Investment		Public Investment	
	2008	2014	2008	2014	2008	2014	2008	2014
ES	29.2	18.9	14.2	12.8	10.4	4.1	4.6	2.0
<b>GR</b>	<b>23.7</b>	<b>11.5</b>	<b>10.7</b>	<b>6.7</b>	<b>8.1</b>	<b>1.0</b>	<b>4.9</b>	<b>3.8</b>
IE	24.2	16.4	10.7	12.1	8.3	2.4	5.2	1.9
IT	21.2	16.8	12.4	10.0	5.8	4.6	3.0	2.2
PT	22.8	14.6	14.4	10.2	4.7	2.4	3.7	2.0

	Total Savings		Private Savings		Government Savings	
	2008	2014	2008	2014	2008	2014
ES	20.4	20.1	19.8	23.8	0.6	-3.7
<b>GR</b>	<b>8.2</b>	<b>8.4</b>	<b>14.6</b>	<b>8.4</b>	<b>-6.4</b>	<b>0.0</b>
IE	18.4	24.8	19.9	28.6	-1.5	-3.8
IT	18.9	18.5	18.1	18.9	0.8	-0.4
PT	11.0	15.4	12.3	18.4	-1.3	-3.0

## **the causality between the government's budget and the current account balance may not be running from the former to the latter...**

- Greece provides a good example of how some governments of euro-area countries have been aided by (or, have intentionally used) the absence of any constraints of the Stability and Growth Pact (SGP) on credit creation, and current account deficits to create a semblance of fiscal rectitude both before and after their countries' accession to the eurozone.
- Output composition effects affect revenue collections by changing the weight of tax-intensive sectors in the economy : a higher reliance on imports leads to higher indirect tax collections (e.g. VAT), whereas a higher reliance on exports, which are VAT exempt, limits tax collections.



- For reasons related to the financial liberalization laws enacted in Greece in 1994, international borrowing (mediated through the domestic banking sector) became easier and households started being able to borrow far more in order to finance purchases of consumer durables (and at lower real interest rates as well).
- This unprecedented (for Greece) credit expansion, led to a huge deterioration in the current account balance - from a surplus of 1.3% of GDP in 1994, to a deficit of 12.0% in 2000.
- At the same time, government revenue doubled during the same period. This was partly a result of the huge rise in imports – from 24.9 % of GDP in 1994, to 38.4% in 2000. The current account deficit widened further to 16.3% of GDP in 2008, before “declining” to 11.7% in 2010 (now financed almost entirely by official inflows).
- The ratio of government revenue to GDP increased from 34.8% in 1994, to 40.1% in 2000.

- The reason is that imports which suddenly become possible through (international) borrowing need not fully displace spending on domestically produced goods (they may even increase it!), and create a revenue boon for the government. For example, car imports in Greece generate immediate tax revenue (VAT, luxury taxes, etc). They also allow for increases in domestic value added (e.g. services related to sales, advertising, and repairs of automobiles), thus allowing for second-round increases in income tax revenue
- As a result, due to capital inflows, higher current account deficits can be associated with smaller budget deficits (for as long as foreigners are willing to provide the funding). (This provides another channel (alternative to the Ricardian hypothesis) which can explain why the evidence in favour of the twin deficits hypothesis is inconclusive.) More importantly, it suggests that non-benevolent governments may “achieve” a strict adherence to the SGP limits on budget deficits, for some years, by running huge current account deficits. (The “Cobra Effect”)