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# External Imbalances and Fiscal Policy

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## Abstract

We analyse the role of fiscal policy both in the emergence and the unwinding of external imbalances. Furthermore, we probe whether there is a role for fiscal policy in the prevention of excessive external imbalances. Finally, we ask whether fiscal policy could in practice successfully fulfill such a role.

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# 1 Introduction

The goal of this paper is to consider the role of fiscal policy in the determination and resolution of external imbalances. Our primary focus is on individual member countries of the euro area, since these countries no longer have an independent monetary policy or an independent nominal exchange rate that may be deployed in order to target the external balance. In particular, we draw on the recent Irish experience in order to illustrate some of the arguments made in this paper.

We consider the inter-connections between fiscal policy and the external position from a number of angles. First, fiscal policy may be a contributory factor to the emergence of external imbalances. Second, regardless of the source of an external imbalance, fiscal policy may have a role to play in the external adjustment process. Third, fiscal policy may have a preventive role in guarding against the emergence of sub-optimal external imbalances that may be the result of underlying distortions in the economy. However, even if a *prima facie* case for such a preventive mechanism can be established, it is an open question as to whether fiscal policy could be effective in performing such a role.

In the rest of this paper, we consider each of these dimensions in turn. In Section 2, we review the role of fiscal policy as a source of external imbalances. We turn to the contribution of fiscal policy to external adjustment in Section 3. In Section 4, we consider whether fiscal policy should be deployed in order to prevent the emergence of excessive external imbalances. Next, in Section 5, we address whether it is feasible for fiscal policy to successfully take on such a role. Finally, some concluding remarks are offered in Section 6.

## 2 Fiscal Policy As a Source of External Imbalances

Fiscal policy may be a source of external imbalances through a number of channels. In the standard intertemporal model of the current account, a temporary increase in government spending generates a current account deficit, since households prefer to smooth private consumption rather than to make room for the surge in government absorption via a decline in private absorption (Sachs 1982, Obstfeld and Rogoff 1995). Such transitory shifts in public expenditure may be the result of a temporary surge in government consumption or government investment. A similar pattern holds in the baseline “new open economy macroeconomic” model (Obstfeld and Rogoff 1996). A temporary increase in government consumption boosts domestic demand, generating a current account deficit and real appreciation.

In contrast, a permanent increase in government consumption has no impact on the current account in the standard intertemporal model. Moreover, it generates a current account surplus in the baseline “new open economy macroeconomic” model, since the long-term budget constraint means that households downwardly adjust private consumption. However, the impact of permanent shifts in government spending more closely resemble the results for temporary shocks once frictions are introduced into the dynamics of private consumption, due to the role of habits in preferences or some related mechanism.

Corsetti and Muller (2006) consider the impact of persistent shocks to government spending in a multi-sector, multi-country model. Since government spending is mainly directed at domestically-produced goods, a positive fiscal shock drives up domestic prices and improves the terms of trade. For a persistent shock, the expected return on domestic capital improves since domestic output prices increase relative to the price of capital goods, due to the terms of trade improvement. Accordingly, the positive investment response means that a larger current account deficit occurs in a more open economy, due to the terms of trade channel.

Turning to the dynamics of public debt, there is no direct co-movement between the fiscal balance and the external balance under Ricardian Equivalence. However, if the conditions required for Ricardian Equivalence do not hold, an increase in public debt may be associated with an increase in external debt. For instance, Ganelli (2005) and Kumhof and Laxton (2009) provide models in which households have finite horizons, such that a debt-financed tax cut increases the wealth of currently-alive cohorts, boosting consumption and generating a current account deficit. Furthermore, Corsetti and Muller (2006) show that the addition of an investment channel reinforces the pass through from a fiscal deficit to an external deficit in the case of persistent deficits, especially for more open economies.

Kumhof and Laxton (2009) also show qualitatively-similar results apply in relation to a temporary increase in the fiscal deficit even in an infinite-horizon framework if some proportion of households are credit constrained. Under these conditions, a debt-financed tax cut boosts the current consumption of credit-constrained or hand-to-mouth consumers, leading to a current account deficit.<sup>1</sup>

Consistent with this pattern, the VAR evidence for an eleven-member panel of EMU countries provided by Benetrix and Lane (2009a) is that an increase in government spending is associated with an expansion in the relative size of the nontraded sector and a deterioration in the trade balance. These results are summarised in Figure 1, which also highlights that the impact varies across the different types of government spending. Similar results for the trade balance are also reported by Lane and Perotti (1998) and Beetsma et al (2008).

Corsetti and Muller (2006) provide evidence on fiscal expenditure shocks for a four-country sample (US, UK, Australia and Canada). These authors find that an increase in public spending leads to an external deficit for the UK and Canada but the results are

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<sup>1</sup>These authors also show that the impact of a permanent increase in public debt differs across the two approaches. In the finite-horizon model, the long-run stock of net external liabilities increases. In contrast, the savings of non-constrained households fully offsets reduced government savings in the long-run in the infinite-horizon model.

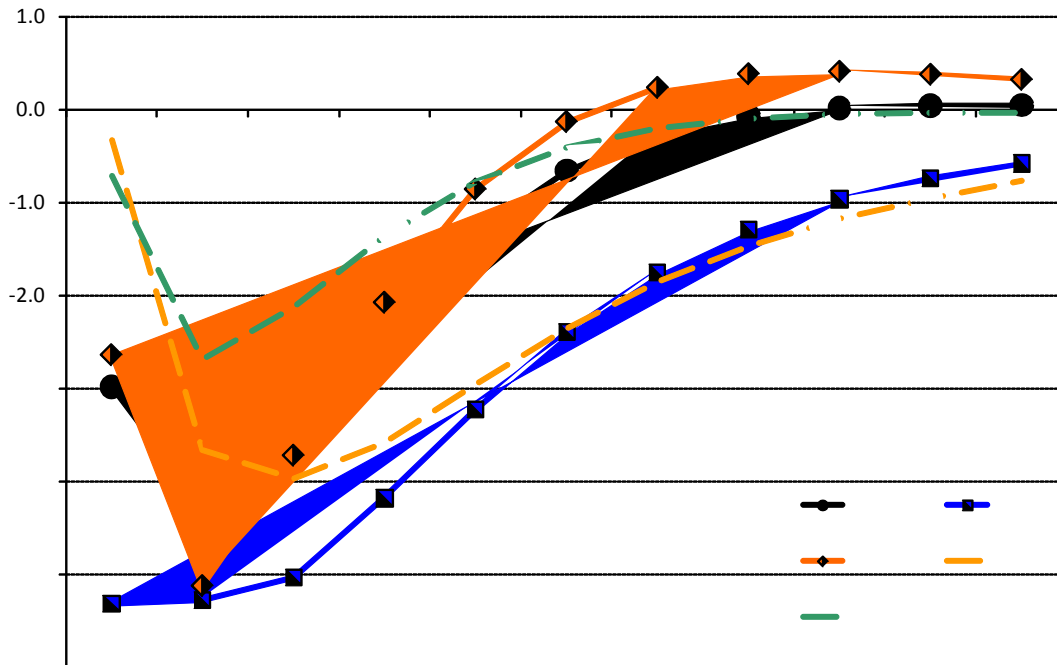


Figure 1: Government Spending and the Trade Balance. Note: Response of trade balance to a 1 percent of GDP shock to different types of government spending. GEXP: total government absorption; GINV: public investment; GC: government consumption; WGC: wage government consumption; NWGC: non-wage government consumption. Source: Adapted from Benetrix and Lane (2009c).

not significant for the US and Canada. As is discussed by Benetrix and Lane (2009a), the latter finding can be explained by the data pattern by which fiscal expansions in these countries tend to occur during periods of currency weakness. (These four countries all have floating exchange rate regimes.)

In relation to the connection between public debt and the net foreign asset position is provided by Lane and Milesi-Ferretti (2002). These authors model the long-run evolution of the net foreign asset position as a function of relative output per capita, relative demographic profiles and relative levels of public debt. For a panel of advanced economies, there is a significant association between public debt and the net external debt but the pass through is limited at around 0.11. In contrast, the pass through is much stronger for a panel of developing countries with a coefficient of about 0.66. The more powerful effect in the latter group is in line with theories that emphasise the role of credit constraints in explaining deviations from the Ricardian Equivalence benchmark, in view of the more limited level of financial development in the less-advanced economies.

Corsetti and Muller (2006) provide evidence on shocks to the fiscal deficit for a four-country sample (US, UK, Australia and Canada). Consistent with the results for the impact of expenditure shocks, there is evidence of pass through from the fiscal deficit to the external deficit for the UK and Canada but no significant pattern for the US and Canada. As indicated above, it is difficult to properly capture the impact of fiscal policy on the external account for these countries, due to the regularity that these countries experience currency depreciation during the same periods that fiscal policy is in expansionary mode.

Further evidence concerning the impact of fiscal policy on the current account is provided by Feyrer and Shambaugh (2009). These authors identify fiscal shocks in the United States by reference to the narrative approach developed by Romer and Romer (2008). Their estimate is that 50 percent of an unexpected tax cut is passed through to an increase in the US current account deficit.



### **3 Fiscal Policy and External Adjustment**

Regardless of the source of the external imbalance, fiscal policy may have a role to play in facilitating external adjustment. In this section, we first address the role of fiscal policy in contributing to shifts in the real exchange rate and the trade balance. Next, we turn to the role of the fiscal authority in restructuring the international balance sheet in the event of crisis conditions.

#### **3.1 Fiscal Policy, the Real Exchange Rate and the Trade Balance**

In order to combine external adjustment with the maintenance of full employment, an economy must re-allocate labour from the nontraded sector to the traded sector. In related fashion, the expansion of the traded sector is facilitated by depreciation of the real exchange rate, which improves the competitiveness of export-orientated and import-competing firms and improves the relative profitability of the traded sector relative to the nontraded sector.

For a member of a monetary union, real depreciation cannot be achieved via the traditional route of engineering a nominal devaluation. In the absence of this mechanism, the main macroeconomic policy instrument available is fiscal policy. To the extent that government spending is concentrated on nontraded goods, a contraction in public expenditure may be associated with a decline in the relative price of nontradables and a real depreciation. As an example, government wage consumption is a major component in public spending: the government is a major employer and a decline in its demand for labour relieves pressure on the domestic labour market. In turn, this increases the supply of labour to the traded sector and puts downward pressure on wage levels. A similar mechanism applies to government purchases of consumption and investment goods from the domestic private sector.

In this regard, it is noteworthy that the empirical evidence indicates a robust relation between government spending and the real exchange rate. At medium- and long-term

horizons, the cointegration analysis of Ricci et al (2008) and Galstyan and Lane (2009a, 2009b) shows that a sustained decline in government consumption (relative to trading partners) is associated with real depreciation.<sup>2</sup> A similar result is obtained in annual data by Lane and Perotti (2003). Furthermore, the evidence for Europe from VAR analyses is that a discretionary negative shock to government spending is associated with real depreciation (Beetsma et al 2008, Benetrix and Lane 2009a, 2009b).<sup>3</sup> <sup>4</sup> Benetrix and Lane (2009a, 2009b) shows that the impact of government spending on the real exchange rate varies across different expenditure categories, such that the composition of spending matters in assessing the sensitivity of the real exchange rate to a fiscal shock. Finally, Benetrix and Lane (2009b, 2009c) shows that the impact of government spending on the real exchange rate varies across different expenditure categories, such that the composition of spending matters in assessing the sensitivity of the real exchange rate to a fiscal shock. Figure 2 summarises the Benetrix-Lane results for the EMU11 sample in terms of the dynamic response of the real exchange rate to a 1 percent of GDP shock to government spending. As is clear from Figure 1, the sensitivity of the real exchange rate varies across different types of government spending.

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<sup>2</sup>Galstyan and Lane (2009a, 2009b) also consider the long-run relation between public investment and the real exchange rate. Since a higher stock of public capital may affect productivity in the traded and nontraded sectors, its impact on the real exchange rate is ambiguous. In the data, there is little robust evidence of a strong link between public investment and the real exchange rate.

<sup>3</sup>Beetsma et al (2008) consider an EU14 sample, whereas Benetrix and Lane (2009a) provide evidence for an EMU11 group (the founding members of EMU, with the exception of Luxembourg) and Benetrix and Lane (2009b) report results from a country study for Ireland.

<sup>4</sup>It is striking that some studies (Monacelli and Perotti 2009, Ravn et al 2009) find the opposite pattern (a decline in government spending being associated with real appreciation) for a sample consisting of the United States, United Kingdom, Canada and Australia. However, Benetrix and Lane (2009b) argue that likely reflects a data pattern for this group of floating-currency countries by which the same type of economic news that induces a government to engage in fiscal expansion also leads to a sell off in the currency market.

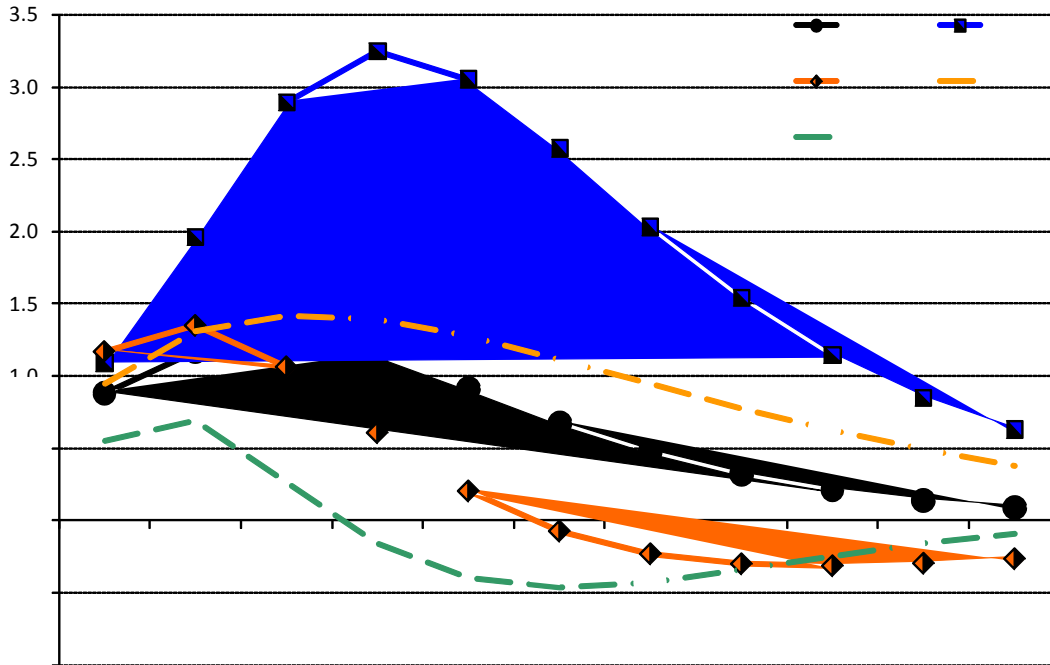


Figure 2: Government Spending and the Real Exchange Rate. Note: Response of real exchange rate to a 1 percent of GDP shock to different types of government spending. GEXP: total government absorption; GINV: public investment; GC: government consumption; WGC: wage government consumption; NWGC: non-wage government consumption. Source: Adapted from Benetrix and Lane (2009a).

Taken together, these studies are suggestive that shifts in the level of government spending can contribute to the external adjustment process by influencing the path for the real exchange rate. Consistent with this pattern, the VAR evidence for Europe provided by Benetrix and Lane (2009c) is that a relative decline in government spending is associated with a relative contraction in the size of the nontraded sector and an improvement in the trade balance. Figure 2 provides a summary of the results from Benetrix and Lane (2009c) in terms of the dynamic response of the trade balance to a 1 percent of GDP shock to government spending. As with Figure 1, the impact varies across the different spending categories. Similar results for the trade balance are also reported by Lane and Perotti (1998) and Beetsma et al (2008).

Turning to the financing of the fiscal position, the evidence in the previous section was that, all else being equal, an improvement in the fiscal balance should be associated with a partial improvement in the external balance. Accordingly, a government may also facilitate external adjustment via an improvement in the fiscal balance.

However, the conditions under which an improvement in net exports is required are also often associated with a slump in domestic demand. Under such circumstances, policymakers face a conflict between the pursuit of external competitiveness and the maintenance of domestic demand through fiscal expansion.

In addition to the macroeconomic dimensions of fiscal policy, there may also be a role for specific microeconomic interventions in aiding external adjustment. For instance, a reduction in employment taxes contributes to real depreciation by lowering the cost of domestic labour (Calmfors 2003). A further type of microeconomic intervention is to alter the timing of consumption decisions through subsidies to saving schemes, which mimics the impact of a shift in the interest rate.<sup>5</sup> While such interventions may be hard to

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<sup>5</sup>While Ireland introduced the Special Savings Incentive Account (SSIA) scheme in 2001 to cool down the booming economy, the design of these scheme was not targeted at cyclical stabilisation. Most important, its fixed five-year horizon meant that the withdrawal of the subsidy in 2006/2007 was independent of the



implement in relation to minor imbalances, these may be worth pursuing in tackling larger-scale deficits.

### **3.2 The Public Balance Sheet and the International Balance Sheet**

In the event of an external adjustment problem that is coupled with a financial crisis, the public balance sheet may be transformed by rescue operations that act to transfer assets and liabilities from the private sector to the government or to increase the contingent liabilities of the government through the provision of guarantees and insurance to private entities. This may be the result of a publicly-financed restructuring of the balance sheets of the banking system, the corporate sector and/or the household sector. In some cases, the costs of such bailouts may feed directly into the fiscal balance; in others, the main costs may remain “off balance sheet.” Under either scenario, the impact on the public balance sheet may affect funding costs for the government and affect choices over public spending and taxation.

In relation to the external position, the assumption of foreign liabilities by the government typically reduces the expected losses to foreign creditors on distressed debt.<sup>6</sup> The long-term horizon of the government means that it may be better able to withstand short-term declines in the market value of assets, although at the cost of increased direct risk to the taxpayer if the ultimate return on these assets fail to meet expectations.

If external liabilities are mainly denominated in foreign currency, the government takes on substantial currency risk if it acquires foreign liabilities from the private sector. In particular, the existence of substantial foreign-currency debt complicates the external adjustment process. In a cyclical state of the economy, a cyclically-focused scheme would have specified a subsidy schedule that was conditioned on cyclical indicators.

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<sup>6</sup>In some cases, the government may also acquire foreign assets. Examples include the nationalisation of a bank with international operations and the establishment of an asset management agency that acquires non-performing (domestic and foreign) loans from the domestic banking system.

justment process. On the one side, currency depreciation may be helpful in improving the trade balance; on the other side, currency depreciation has an adverse balance sheet effect due to increased domestic-currency value of foreign-currency liabilities (see, amongst others, Lane and Milesi-Ferretti 2005 and Lane and Shambaugh 2010). This trade off has plagued exchange rate policies during emerging market crises in recent decades and is now high on the policy agenda for highly-indebted countries in Central and Eastern Europe.

However, this currency risk is largely absent for members of the euro area. In particular, much of the foreign debt issued in recent years is denominated in euro and held by residents in other member countries of the euro area. Accordingly, crisis dynamics are fundamentally different between member countries and those outside the euro area, especially in relation to crises that are centred in the banking system.

In particular, a member of the euro area is less exposed to the risk of a liquidity run. In the case of a country with substantial foreign-currency liabilities and only limited foreign-currency reserves, its banking system is vulnerable to the withdrawal of foreign-currency financing by private sector investors. In contrast, banks (with sufficient eligible collateral) in the euro area that encounter such problems are able to turn to the ESCB under the rules of its liquidity operations. As a result, the role of the national fiscal authority is to concentrate on ensuring the solvency of domestic banks [through direct and indirect re-capitalisation programmes], which in turn enables the banks to obtain liquidity from the ESCB.

## 4 Preventive Fiscal Policy

In this section, we first outline the factors that may justify a preventive role for fiscal policy in correcting the distortions associated with excessive external imbalances. We then consider a broader array of policy interventions that may also be employed to this end. In particular, we examine the stabilisation of the external account from the perspective macro-

prudential risk management, plus the potential role of social partnership in mitigating the wage and price rigidities that are an important source of the risks associated with excessive external imbalances.

## **4.1 The Case for a Preventive Role for Fiscal Policy**

Summers (1988) interpreted the small average size of current account balances as evidence in favour of a “maintained external balance” hypothesis by which national governments proactively seek to avoid large external imbalances. In relation to surplus positions, Summers argued that private-sector agents failed to internalise the full social return on additions to the domestic capital stock and the adverse terms of trade impact of an excessive level of net exports. On the deficit side, large net capital inflows squeeze the domestic traded sector and capacity losses in exporting are difficult to reverse.

In similar vein, Blanchard (2007a) argues that a variety of distortions may justify policy interventions in response to the incipient emergence of current account imbalances. First, rigidities in nominal wages and prices may mean that there is excessive volatility in employment in response to swings in the level of domestic demand. Second, financial constraints mean that a contraction in tradables output during a period of high domestic expenditure may not be easily reversed once the economy needs to make the transition towards greater net exports. Third, high net inflows may increase the risk of a sudden stop and the attendant risk of financial distress.

In this study, Blanchard shows how the timing of government spending on nontradables and tradables may be optimally manipulated to limit the distortions induced by current account imbalances. However, an important message from his analysis is that the fiscal intervention may not necessarily alter the scale of the current account position - rather, the policy focus should be on mitigating the associated distortions. For instance, if there is a temporary surge in domestic consumption, rigidities in prices and wages may lead to an

excessive increase in employment in the nontraded sector: this can be offset by a reduction in government spending on nontradables, even if this intervention has no impact on the current account deficit.

Indeed, Blanchard shows that in some cases the optimal fiscal response may actually result in a larger current account deficit. Under conditions in which financial constraints mean that it is damaging to tolerate a contraction in traded-sector output, the optimal policy to a temporary increase in domestic consumption is to reduce government purchases of nontradables and increase government purchases of tradables. This stems the contraction of the tradables sector but does lead to an enlarged current account deficit.

However, if the main distortionary impact of a current account deficit relates to the enhanced risk of a sudden stop, the optimal fiscal policy indeed involves a reduction in the current account deficit. In contrast, the more direct policy targets in the other cases relate to employment stabilisation and balanced sectoral growth rates.

In terms of fiscal strategy, the discussion in Sections 2 and 3 indicates that the government can target the current account balance via a number of instruments. First, a government that wishes to narrow a current account deficit could run a more positive fiscal balance. Second, even at an unchanged fiscal balance, a reduction in government absorption can improve the external balance. Third, even at an unchanged budget balance, tilting the schedule for particular types of taxes can mimic a real depreciation and improve the external position.

## **4.2 Macro-Prudential Risk Management and the External Account**

In addition, taking a wider policy perspective, a primary instrument for tackling some of the risks associated with excessive capital inflows is the macro-prudential regulation of the financial sector. Since the banking system is in many cases the main intermediary of



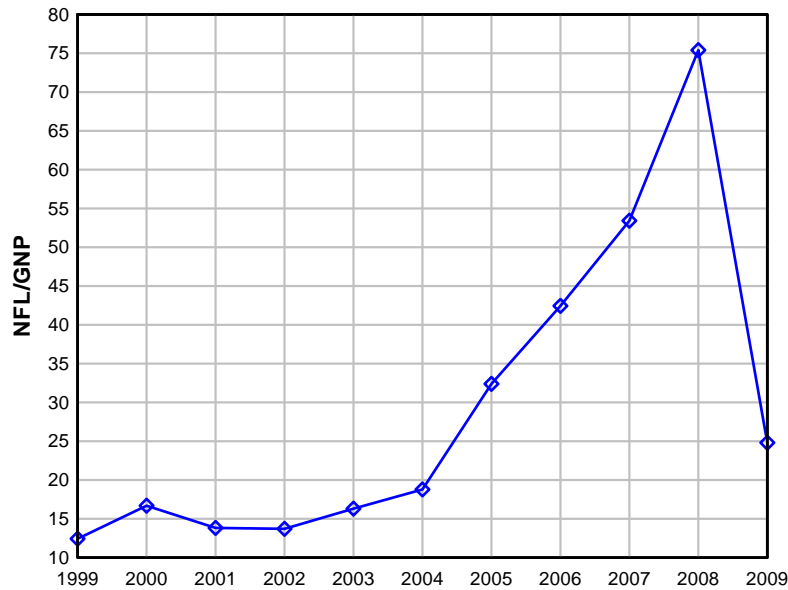


Figure 3: Net Foreign Liabilities of Irish Credit Institutions as a Ratio to GNP. Note: Credit Institutions are . Source: Adapted from Honohan (2009), based on data in Table C3 of Quarterly Bulletin from Central Bank of Ireland.

foreign capital flows, a regulatory regime that successfully manages macro-prudential risk should address concerns about the vulnerabilities embedded in the international balance sheet.

A basic risk is that an external deficit may fuel a domestic credit boom and thereby raise the probability of a banking crisis. To illustrate this point, Figure 3 (adapted from Honohan 2009a) shows the net foreign liability position of Irish credit institutions over 1999-2009. While this risk can be mitigated by suitable regulatory interventions by the domestic monetary authority to guard against excessive credit growth, the enhanced risk of a banking crisis may justify running a offsetting fiscal surplus. In many ways, such a precautionary fiscal surplus is analogous to the accumulation of foreign-exchange reserves for a country with its own currency as a guard against financial and currency instability.

One option is to simply run a larger fiscal surplus and pay down the level of gross

government debt in the event of large capital inflows. However, there is a risk that the occurrence of a financial crisis may also compromise a government's ability to borrow. Accordingly, an alternative approach is to divert the extra net revenues into a dedicated fund that would be invested in liquid assets. In turn, such liquidity may prove useful in dealing with the fallout from a banking crisis and/or reduce the risk of a crisis by providing assurance to investors.

Along these lines, Lane (1998a) advocated the establishment of a rainy-day fund upon Ireland's entry into EMU in order to provide some pre-funding in the event of a subsequent banking crisis. Recent proposals to tax bank profits in order to accumulate an insurance fund are similar in terms of objectives. In the Irish case, no such rainy-day fund was established. However, the National Pensions Reserve Fund (NPRF) was established in 2001 in order to accumulate assets with the goal of pre-funding the long-term increase in ageing-related public spending after 2025.<sup>7</sup> Although its mandate was to invest commercially on a global basis, a substantial proportion of its net value was recently re-directed towards the re-capitalisation of the two main Irish banks. In this way, the NPRF was re-deployed as a rainy-day fund, despite its stated long-term mission.

However, financial regulation on its own is not sufficient, since corporations, the government and households may also accrue external liabilities through other channels. Indeed, over-regulation of the domestic financial sector increases the incentives to directly tap sources of foreign capital, via overseas banks, the international bond market and the issue of equity-type liabilities to foreign investors.

In relation to the feasibility of targeting the external account, the persistent nature of current account positions (at least in recent years) means that timing lags do not provide a prohibitive objection. A basic problem is in identifying the episodes in which policy intervention may be warranted, since it is unlikely that a simple rules-based approach can

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<sup>7</sup>In addition to initial funding from the proceeds of the privatisation of the national telecoms operator, the government allocates one percent of GNP each year to the NPRF.

properly differentiate between “desirable” and “undesirable” levels of net capital inflows.

To this end, the current generation of models of equilibrium current account balances and equilibrium real exchange rates provide only a very broad and imprecise guide to the sustainability of a given external balance.<sup>8</sup> However, the main risks are associated with large external deficits and it may be possible to establish threshold indicators, such that fiscal policy responds in a non-linear fashion to the emergence of deficits that enter a “danger zone.”

### **4.3 Fiscal Policy and Social Partnership**

Finally, another policy task is to improve the adaptability of the domestic economy in coping with shifts in net capital flows. In particular, structural policies that can mitigate nominal and real rigidities can enable external adjustment to occur in a smoother fashion. Such policies are especially important for member countries of the euro area, since real devaluation may typically require periods of nominal declines in wages and prices. Improving the capacity for downward wage and price flexibility is especially challenging in view of the substantial real rigidities that underly resistance to nominal reductions.

One specific real rigidity relates to the non-coordination of wage setting in a decentralised economy. With staggered and non-coordinated wage setting, it is difficult to implement in a clean way the type of discrete real devaluation that can be accomplished by a nominal depreciation outside a monetary union. Accordingly, institutions that promote a coordinated approach to wage determination may be especially useful for members of a monetary union, since coordination allows the economy-wide level of wages to adjust to macroeconomic shocks (see, amongst many others, Blanchard 2007a).

Ireland has such a coordination mechanism, through its system of social partnership. Under social partnership, national agreements are negotiated between the government,

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<sup>8</sup>The state of the art is represented by Ricci et al (2008).

unions and employer federations. During the post-1987 fiscal adjustment and economic recovery, this mechanism facilitated wage moderation that was in part delivered in exchange for a more favourable tax treatment of labour income. During the Celtic Tiger boom years, it may even be argued that wage moderation was excessive for the reasons outlined by Blanchard (2007a). In particular, it may have been better to stem the very strong employment expansion that ran until 2007, although the expansion during the latter years was in part attributable to other policy failures such as inadequate credit regulation and a pro-cyclical fiscal position.

In relation to the current adjustment process in Ireland, the evidence is mixed concerning the role of social partnership. The scale of the macroeconomic shock has led to a pragmatic approach by unions in accepting nominal wage reductions in firms that are struggling for survival. Moreover, there was little substantial opposition to the cancellation of scheduled wage increases under the national agreement and substantial pay reductions in the public sector, via the introduction of a pension levy that averages 7.5 percent across state employees and the nominal pay reductions that were implemented in January 2010.

However, at the time of writing, it seems that the level of union opposition to further nominal pay reductions has grown stronger. A primary concern is that the union movement do not appear to share in the common analysis that a real devaluation needs to be engineered in order to allow Ireland to move onto a sustainable growth path that is not overly-dependent on domestic sources of demand.

Rather, the stated fears centre on the risk of a “deflationary spiral” that will only serve to deepen the current recession. A further complicating factor is that the high level of household nominal debt means that nominal pay reductions may trigger adverse financial accelerator effects in the household sector. If such resistance takes hold, there is a substantial risk that Ireland may suffer economic stagnation if real wage adjustment is delayed. In this regard, as is analysed by Blanchard (2007b), the experience of Portugal over the last decade offers a cautionary tale.



## 5 Effectiveness of Fiscal Policy

In order for fiscal policy to be helpful in external adjustment or as a preventive measure to forestall unsustainable imbalances, it must be the case that fiscal policy can be effectively deployed. In this regard, there are several concerns.

First, if fiscal policy is to be effective as a stabilisation instrument, the long-term fiscal position must be clearly sustainable. Otherwise, interventions that raise the fiscal deficit may lead to concerns among investors and taxpayers, with an attendant increase in funding risk and the size of the risk premium. However, in some cases, the correct fiscal policy from a stabilisation perspective may also improve fiscal sustainability. In particular, as was argued in Section 3, the adjustment process may be facilitated in a country that is running an external deficit by a reduction in government consumption, which should also improve the underlying fiscal position.

Second, an important potential limitation is whether fiscal interventions can be timed correctly. While the scale and duration of the current crisis has provided conditions under which discretionary fiscal interventions have been viable in many countries, there is a long-standing concern that the cumbersome and time-consuming nature of the fiscal process means that it is difficult to effectively deploy fiscal policy for stabilisation purposes.

Third, various political distortions may act against a stabilising role for fiscal policy. There is considerable evidence that the discretionary component of fiscal policy is procyclical in many countries (see, amongst others, Lane 1998a, 2003 and Alesina et al 2008). If fiscal policy is not stabilising vis-a-vis the domestic business cycle, it may be similarly difficult to implement fiscal measures that seek to “lean against the wind” vis-a-vis the external account. Moreover, Benetrix and Lane (2009d) show that membership of EMU has not improved the cyclical profile of fiscal policy: the member countries of the euro area have not improved the cyclical conduct of fiscal policy in recognition of the increased importance of fiscal policy as a stabilisation tool inside a monetary union.

This pattern raises doubts about whether fiscal policy could indeed be employed to “lean against the wind” in relation to the direction of net capital flows. Furthermore, there is a non-trivial risk of a de-stabilising fiscal response, since inward capital flows may generate a windfall in tax revenues due to upward pressure on domestic asset prices and an increased level of transactions in domestic asset markets. If the political system fails to save these windfall revenues, an increase in government spending or a reduction in taxes may further amplify the shock to the domestic economy. The importance of asset prices and wealth shocks for tax revenues has been documented for a panel of countries by Eschenbach and Schuknecht (2004). In the Irish case, Addison-Smyth and McQuinn (2009) calculate a substantial tax windfall from the 2002-2007 housing boom in Ireland that was fuelled by capital inflows.

Fourth, stabilisation of the external account may not receive a large weight in the objective function of policymakers. There are many competing pressures on the allocation of fiscal resources and the determination of overall spending and taxation levels, such that it may be difficult to push fiscal policy in the direction required for external stabilisation.

Taken together, these considerations reinforce the importance of a well-designed institutional framework for the conduct of fiscal policy. In addition to the importance of long-term fiscal sustainability, the assessment of the appropriate fiscal stance from a macroeconomic perspective may usefully involve input from independent experts, while still recognising the primacy of political accountability in making ultimate fiscal decisions. For instance, Calmfors (2003) recommends the establishment of an independent fiscal council that can play this role. While the literature on independent fiscal councils has largely focused on cyclical stabilisation, such a council could also assess the appropriate fiscal stance in guarding against risks that may be embedded in the external position.

## 6 Conclusions

This paper has covered four main dimensions of the relation between fiscal policy and the external position. First, we have reviewed the ways in which fiscal shocks and fiscal imbalances may be a contributory source to the emergence and persistence of external imbalances. Second, regardless of the original source of the imbalance, we have argued that fiscal policy may be deployed as an instrument that can support the external adjustment process. Third, we have assessed whether there may be a potential role for fiscal policy in the prevention of excessive external imbalances. Finally, we have considered whether fiscal policy can effectively fulfill its potential as a stabilising force for the external account.

The analysis in this paper indicates that fiscal policy is indeed an important potential source of external imbalances. Moreover, fiscal policy interventions can be helpful in facilitating the external adjustment process. This is especially important for member countries of a monetary union, since fiscal policy can help to engineer the type of shifts in the real exchange rate that can be accomplished via nominal currency movements for countries outside a monetary union.

Finally, in view of the havoc associated with disruptive types of adjustment episodes, there is a substantial *prima facie* case in favour of deploying fiscal policy to mitigate the distortions associated with excessive external imbalances. While this poses an array of logistical and institutional difficulties, the risk of a disruptive adjustment scenario means that intervention at least in response to large and persistent imbalances may be justified. Accordingly, it is highly desirable that further research be conducted on the optimal design of an implementable fiscal policy (plus related ancillary policies) that can reduce the costs from excessive external imbalances.

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