

Box 8

FISCAL POLICIES AND FINANCIAL STABILITY: ANALYTICAL FRAMEWORK

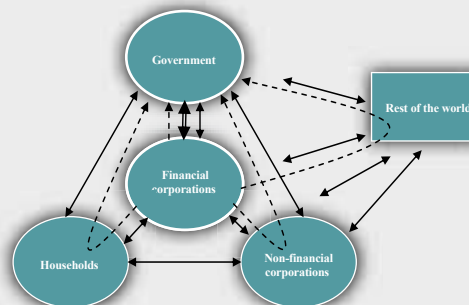
This box aims to provide an overview of economic and financial linkages between the government and financial sectors. Acknowledging that financial market stability may influence public finances, the box focuses on potential channels through which fiscal policies may support or represent a risk for financial stability. These linkages are wide-ranging and rather heterogeneous in nature; therefore, it may be useful to distinguish between several types of relationships (see the figure below).

First, governments and their fiscal policies may interact *directly* with the financial system as market participants when financing their fiscal deficits and managing debt. In this context, parameters like the amount and maturity of public debt held by financial institutions, (changes to) sovereign credit ratings, the proportion of government debt insured via the credit default swap markets and the share of intrabank lending covered by government securities as collateral might be taken into account when assessing the relationship between fiscal policies and financial stability. In addition, the government plays a key role as tax authority, thus affecting the behaviour of financial sector participants via tax structures.

Second, the *indirect* linkages between fiscal policies and the financial sector, via non-financial corporations or households, are extensive, and thus of high relevance. They may have even more important consequences for financial stability than direct links, also in view of the potential implications for a country's national balance sheet. Moreover, there may be cross-border contagion effects coming from, or having an impact on, the rest of the world. Such spillover effects are of

The relationship between fiscal policies and the financial system

- ⇒ Direct interaction between the government (including central, state and local governments and social security funds) and the financial sector (excluding the central bank):
 - government as a participant in the financial markets (borrower and investor);
 - government providing incentives via tax and expenditure structures; and
 - government intervening in the financial system and acting as government intervening in the financial system and acting as an owner of financial institutions.
- Direct and indirect standard economic and financial relations, including those relating to the government's macroeconomic role:
 - fiscal revenue and expenditures; and
 - fiscal policy stance and sustainability.
- - - → Feedback loops between the government sector and the financial system:
 - influence from financial sector performance on public finances – direct and indirect via other real economy sectors and via international spillovers/contagion.



particular importance in a monetary union such as the euro area. In principle, fiscal policies may represent a risk to financial stability if they pose a risk for the functioning of the real economy. By contrast, they contribute to financial stability as long as they support sound overall economic developments.

Third, the perception of financial system stability may be dependent on the financial strength of the government standing behind it, which is in turn influenced by the size of recognised and contingent government support already provided to the financial system. Therefore, fiscal and financial risks may not be fully separable. When assessing financial stability risks, the sustainability of public finances needs to be taken into account in order to assess the governments' ability to cut potential adverse feedback loops that could develop into a self-reinforcing downward spiral.

Finally, although contributing to financial stability has not gained much attention as a standard fiscal policy objective so far, appropriate fiscal policies may contribute to financial stability in several respects, which may include: (i) contributing to a high level of public and market confidence through a responsible and sustainable conduct of fiscal policy; (ii) creating fiscal room for manoeuvre in order to have a strong capacity for intervention in crisis times; (iii) providing sound incentives to financial institutions' owners and managers, as well as to the economy at large, in connection with tax and expenditure structures; and (iv) creating restrictive rules for providing financial assistance to financial institutions in order to limit "moral hazard" behaviour.

Overall, the various channels through which fiscal policies may support or pose risks to financial stability in the euro area merit a regular examination of the euro area fiscal position for financial stability assessments.