1. Meeting the challenge of the global financial crisis in OECD nations: fiscal responses and future challenges

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> I confess to being continually amazed, and shocked, by the still evolving global financial crisis. If this crisis hasn't changed at least some of your views about how the world works, then I reckon you haven't been paying attention – or alternatively, your views are so tightly held as to be impervious to the arrival of new information. (Former Senior Treasury Official, David Gruen, 2009)

The global financial crisis of 2007–09 was the most serious crisis to rock global economies in more than 70 years. As it emerged and took shape, it confounded governments, financial institutions, markets and industries, academics and media commentators. Previous certainties and complacencies were abandoned amid a global loss of confidence and perceived regulatory failure. The speed of the crisis and its unexpected and calamitous twists and turns heightened the perception of a 'meltdown' scenario and excited fears of a 'perfect storm' (Patterson and Koller 2011). In a matter of months, the crisis swept around the globe, impacting on financial markets, economies and government budgets. The costs of this near implosion are still with us today and will affect future generations for years to come, even though the immediacy and lessons of the crisis seem to be fading, as governments deal with the 'new normal' of slow economic growth, constrained public budgets, persistent deficits and rising public debt. For these reasons the global financial crisis needs to be studied as a catalytic shock to our economic and financial systems, and to our government finances and the budgetary systems that ostensibly monitor changing conditions, provide order and discipline and some strategic direction in the face of competing demands and future challenges. The character of this shock to the system and the responses of policy and budget players are the main themes of this book, focusing on the impacts on public finances and consequences for the management of government budgets. In this introductory chapter we discuss the contributing causes of the pending global financial crisis, before arguing that the crisis represents a form of 'natural experiment' invoking an acute challenge to budgetary systems. We then outline a five-phase framework through which to study the impacts of the crisis and the responses it provoked, and signal our main research questions and methodology, following that with a brief overview of the book.

EARLY SIGNS OF A PENDING CRISIS

The earliest inkling of impending turbulence in international financial markets was first detected in the United States of America in the Northern summer of 2007 (Brunnermeier 2009; Greenlaw et al. 2008). Financial markets, prudential regulators and governments around the world began to watch with increasing trepidation as leading US financial institutions exhibited signs of acute stress and impending collapse. The initial indications of financial stress derived from the increasing provision of exotic and subprime mortgages from government-sponsored residential mortgage brokers stoking the urban real estate market. The mortgages provided by these firms to home-buyers were 'exotic' products in that the home loans required little personal assurance or equity injection into the purchased property (the so-called 'no-doc' loans requiring little documentation or creditworthiness checks) and were issued to credit-risk customers who borrowed amounts often greater than the collateral of the assets they were purchasing. Private firms such as Fannie Mae and Freddie Mac engaged in such risky lending practices under a 'lend freely' policy, and bundled them into packaged mortgage-backed securities which were then sold on and backed by guarantees even though they ultimately held insufficient capital backing to adequately cover these loans (Shiller 2008; Konings 2010; Patterson and Koller 2011). As mortgage brokers they sourced similar packaged securities from across the housing sector and also sold on these securities to various other financial institutions (in the 'shadow banking system') who purchased these packaged debts as assets, thus spreading the contagion. At this point, with many developed nations running overheated economies, no one apparently appreciated the risk to established financial institutions from the trading in dubious mortgage-backed securities; systemic contamination was not considered to be a likely occurrence.

The United States' residential mortgage system had functioned moderately well while property prices were escalating rapidly and investors continued to have an appetite for taking on increased levels of debt. The US, like other Organisation for Economic Co-operation and Development

(OECD) nations, had largely been following a series of procyclical economic policies before the crisis. The rationale for individual home-buyers entering the subprime mortgage market suggested that the proportion of equity to debt would gradually increase as the housing bubble inflated. But by late 2006 the US property bubble began to burst, house prices began falling steeply, and home-buyers faced negative amortization – owing much more than the houses were worth, or having 'negative equity' and being unable to make sufficient repayments to shrink their principal debt – resulting in more than 1 million property foreclosures or around 10 per cent of all mortgages. The vulnerability of the US housing market to a sudden fall in asset prices quickly manifested itself as a national housing crisis. As repossessions increased and families simply walked away from their homes, the various packaged securities (often transferred into futures or derivative instruments) appearing on or off the balance sheets of major financial institutions began to turn toxic. Crucially, the extended guarantees that had been underwritten for these loans simply meant that the financial risks were passed on, and borne by established institutions further up the highly interconnected international financial system.

Hence, by mid-2007 the phenomenon that came to be known as the 'global financial crisis' was well under way in the US. Once these mortgage firms and a cluster of merchant and investment banks began to feel the squeeze in late 2007 and early 2008, they began to face severe liquidity problems and require liquidity assistance (Shiller 2008; Konings 2010). In February, Freddie Mac, the Federal Home Loan Mortgage Corporation, announced that it would no longer buy the most risky subprime mortgages and mortgage-related securities. In March rumours started circulating about big losses arising in Bear Stearns hedge funds, requiring a liquidity rescue from the US Federal Reserve. By April, the New Century Financial Corporation (the second-largest subprime mortgage lender in the United States) had filed for bankruptcy. In May, the global UBS private banking firm closed its major hedge fund. At the same time, Cheyenne Capital announced significant losses on its subprime investments. The volatility in the housing finance market was confirmed when Standard & Poors downgraded its credit ratings on $7.3 billion of asset-backed securities, followed by Moody's similarly downgrading $5 billion worth of subprime mortgage bonds. Suddenly, the house of cards characterizing integrated global financial markets began to look decidedly unstable. Countrywide Financial Corp soon flagged its own difficulties; the American Home Mortgage Investment Corporation filed for bankruptcy protection, soon followed by the Sentinel Management Group, which managed a significant hedge fund.[1]

THE CRISIS DEEPENS

These seemingly isolated developments led to a wider lack of confidence and huge losses in international financial markets during the latter half of 2007 (Melvin and Taylor 2009; Taylor and Clarida 2011; Blinder 2013). Developments in the US were mirrored elsewhere: Australia's Absolute Capital froze withdrawals; Germany's IKB bank was the first European bank to acknowledge its exposure to the US subprime mortgage crisis; and the French bank BNP Paribas Securities suspended withdrawals for three funds in August 2007. In the UK, the Northern Rock Bank (formerly a building society) suffered its own liquidity crisis after a run on funds saw it nearly collapse; the bank sought liquidity assistance from the Bank of England in mid-September 2007 and after a few months was eventually nationalized and brought into full public ownership to ensure its very survival. In mid-December 2007, several central banks in countries such as the US, the UK, Canada and Switzerland announced plans for coordinated interventions, such as interest-rate reductions, along with other assistance measures (Borio 2008; Quaglia 2009). For instance, the US Federal Economic Stimulus Act was announced in February 2008 to avoid recession by providing tax rebates to lower and middle-income Americans, tax incentives to business, and increased limits for mortgage purchases to more than $150 billion by government-sponsored mortgage enterprises like Fannie Mae and Freddie Mac.

But these initial embryonic interventions did not fully stem the tide. In February 2008, AIG and Credit Suisse announced significant write-downs (Borio 2008). In early March 2008, the Federal Reserve of New York supported a deal with JP Morgan Chase to take over at a significant discount the assets of Bear Stearns, a well-established mortgage bond underwriter in the US (Allen and Carletti 2010; Melvin and Taylor 2009). Fannie Mae and Freddie Mac continued to have problems into the summer of 2008, and shortly afterwards in September the US Federal Housing Finance Agency put Fannie Mae and Freddie Mac in government conservatorship. At around the same time, in July 2008, President George W. Bush signed into law the Housing and Economic Recovery Act, providing an additional $300 billion to the Federal Housing Agency to stabilize the subprime mortgage market.

Yet worse was still to come. In September, the Federal Reserve of New York bailed out one of the US's largest insurance firms, AIG (Ito 2009), and later that month another Wall Street institution and the country's fourth-largest investment bank, Lehman Brothers, declared bankruptcy after no buyers could be found. That same day, the Bank of America agreed to buy and absorb the investment banker and financial advising firm Merrill Lynch, in order to rescue it after it recorded a write-down of $8.4 billion in losses. While the Washington Mutual Bank went into receivership ten days later as a result of a massive $17 billion run of withdrawals in nine days, other banks teetered close to the brink of collapse. Many smaller banks and financial institutions suffered the same inevitable fate: being taken over by larger institutions prepared to contemplate mergers or acquisitions, or consigned to straight out bankruptcy (Ariff et al. 2012).

It was not long before governments worldwide faced pressures to act (Haugh et al. 2009). The first US rescue package had been legislated in early 2008 and the first bailout plan for commercial and investment banks was conceived in mid-2008. In October 2008 the US government passed the Emergency Economic Stabilization Act, which established the $700 billion Troubled Asset Relief Program (TARP). Soon, other big US entities, such as leading insurance and automobile companies, were seeking credit assistance (Nanto 2009; Rasmus 2010; Ito 2009), which would eventually amount to another $50 billion. European governments, such as the Belgian, French and Luxembourg governments, were forced to coordinate a €6.4 billion bailout package for the Dexia bank, while the Belgian, Dutch and Luxembourg governments were required to take equity stakes in Fortis, which also involved the BNP Paribas bank (Pauly 2009). Governments became the ultimate guarantors or 'lenders of last resort' as financial markets went into free-fall. Significant financial institutions domiciled in their national economies were suddenly deemed by policy-makers as 'too big to fail', and so deserving of various emergency rescue packages, the likes of which had not been seen in decades.

Volatility continued in financial markets into late 2008. By now the emerging financial crisis affecting the international financial system was gradually becoming regarded as the most serious economic calamity since the Great Depression (Krugman 2009; Stiglitz 2010; Hetzel 2012; Blinder 2013). In late 2008 and early 2009 even countries in Asia and Europe, with little exposure to the US mortgage-backed securities crisis, felt the effects in the real economy, with Japan's gross domestic product (GDP), for example, falling by a full 4 per cent (Glick and Spiegel 2009). Still there was no consensus among the leading economies as to the best remedy to respond to the malaise, or the best route for sustainability. There continued to be widespread concerns about the effectiveness of government interventions with respect to avoiding a deeper worldwide recession and encouraging sustained economic recovery.

Financial systems in most countries came under severe strain (Soros 2012). The turmoil in financial markets almost immediately infected the broader economy. Economic production fell, with some closures of firms, manufacturing plants and mines, unemployment began to rise to levels not seen in decades. The level of GDP fell in almost every developed nation, and only a few countries managed not to go into recession (for example, Australia, Singapore, Korea, as well as China among the developing nations) and some countries stayed in prolonged recession for years. Yet deeper cracks began to emerge in the welfare states of the European Union, especially (and ironically) in those more traditional economies of Southern Europe with internal structural problems, less-diversified economies and lower value manufacturing. As the euro crisis intensified, nations such as Greece, Spain, Portugal and Cyprus required extraordinary assistance during 2010–11 (Beblavy et al. 2011; van Overtveldt 2011; Hall 2011; Baldwin et al. 2010).

Various fiscal relief packages were devised by national governments in the developed economies, and in many developing nations such as China and Korea. In addition, a series of repeated emergency loans were provided internationally to countries unable to underwrite and sustain their financial markets of their own accord. These packages formed a concertina of initiatives, in some cases guided through coordinated efforts between sovereign nations, and in others taking the form of specific international injections to particularly badly affected economies. Many of these rescue packages required intense, high-stakes negotiations among the member states of the European Union (EU), and between international funds providers such as the International Monetary Fund (IMF) and World Bank (WB). But overall, despite pleas for international coordination, much of the response activity was nationally focused, staccatic and piecemeal (Blinder 2013). Nevertheless, by 2010–11, most of the panic about the crisis had largely subsided with the enormous outlays of governments and international institutions were managing to stabilize financial markets. But the much-promised economic recovery and a return to financial viability continued to remain elusive.

STUDYING THE GLOBAL FINANCIAL CRISIS

What would soon become known as the global financial crisis (GFC), a phenomenon that in all truthfulness was near-global but never totally, was initially seen as an insular local problem for US financial markets and domestic policy-makers to handle. After all, other world economies were then performing well; international economic growth rates were high; unemployment rates were low; real estate markets were booming; China and Asian economies were coming on stream with extraordinary growth rates and becoming significant forces in the global economy (Asian Development Bank 2009). Initially, some heads of government, treasurers and finance ministers stated publicly that the US subprime crisis affecting housing loans and unsecured credit markets would not impact on their economies, as they believed at the time that they were not themselves overly exposed. Some continental European leaders even speculated adversely that the crisis was exclusively an Anglo-American disease caused by too much greed and neo-liberalization of their financial sectors, especially from a misguided policy trajectory of allowing risky banking deregulation. For instance, the French President believed that the British and Americans had brought the crisis down upon their own heads; it was self-inflicted, and served as a wake-up call to these economies to restore confidence. However, this perception quickly changed as observers rapidly came to appreciate the integration of global financial markets, the extent of exposure of their own governments and economies around the world to these developments, and the increasing likelihood of a significant worldwide recession. This awareness led to growing alarm and heightened expectations of significant government interventions into financial markets and national economies, and the need for coordinated and concerted responses by international institutions and governments alike.

Not surprisingly, the havoc wreaked by the GFC has led many observers to chronicle its origins and unpredictable course (see Shiller 2008; Fender and Gyntelberg 2008; Carmassi et al. 2009; Allen and Carletti 2010; Taylor and Clarida 2011). These accounts trace the various antecedents to the crisis, its initial impacts and victims, the priorities and timing of government responses and interventions, and the mobilization and coordination of international bodies or forums such as the G7, G20 and the European Union. Some observers have attempted to gauge the effectiveness of these ameliorative policies and rescue programmes once implemented, and then the efficacy of the subsequent austerity measures designed to produce fiscal consolidation and restore balanced budgets (OECD 2009). There remains ongoing apprehension and an appreciation of the prospect that potential further crises may follow, bringing additional shocks to the global economic system. To date, most of these contributions of an economic bent have focused on the financial and macroeconomic interventions and, somewhat in parallel, there has been a resurgent of interest in the public management literature on expenditure cutbacks, spending reviews, austerity management, alternative service delivery and technological displacement strategies, and co-production – themes first emerging in the government debt crises of the 1970s and later the contracting-out philosophies of the 1990s (see Hood and Wright 1981; Salamon 2002; Pollitt and Bouckaert 2011).

However, there has been insufficient consideration of the overall performance of national public finance systems, including in particular the robustness of government budgetary frameworks, as the global financial crisis took shape and governments ascertained the need for exceptional policy interventions. There appears to be scant attention paid to how well government budgetary systems were prepared both before and during the crisis, and whether different countries and their governments perceived that they were dealing with the same sets of challenges. In 'public finance systems' we include the fiscal strategies and outcomes evident at the national level but also increasingly integrated internationally the resilience of government budget systems, the core institutions and decision-makers within the national and international context, and the exceptionality of decision-making in crisis situations. At the national and international level, governments relied heavily on the advice and analysis of their core budget agencies, their traditional and non-traditional budgetary instruments and processes and, as the crisis deepened, a larger group of political and bureaucratic actors as well as financial experts outside government to make budget policy and response processes work (Schick 2009).

This book emerges out of an ongoing research collaboration which has reviewed the budget systems of several OECD countries and led to two earlier Edward Elgar collections: *Controlling Public Expenditure: The Changing Roles of Central Budget Agencies* (Wanna et al. 2003) and *The Reality of Budget Reform in OECD Nations: Trajectories and Consequences* (Wanna et al. 2010). The 2010 book reviewed and contrasted the budget reform experiences in ten countries over a number of decades. Drafted in 2008, those chapters could not have dealt with the global financial crisis (which was then only just emerging, its full magnitude unknown). Nevertheless, the timing of *The Reality of Budget Reform* was propitious, providing interesting snapshots of several OECD countries as the crisis was taking shape and impacting on their economies and budgetary positions. Following this, a core set of contributors agreed to a further collaboration dedicated to exploring the impact of the crisis on the budgetary systems of a similar group of OECD countries: Australia and New Zealand, Canada, Denmark and Sweden, Greece, Ireland, Japan, the Netherlands, Portugal, Spain and the United States. Many of these countries had contemporaneously boasted of their prowess in public financial management, and the resilience of their budgetary frameworks. Sufficient time has since elapsed that we can venture assessments of how governments and their budget systems responded to the challenge and have been changed in the aftermath.

Our present volume, thus, specifically explores the impact of the financial and economic crisis of 2007–09 on budgetary systems of a selection of OECD nations. It asks: how well prepared were these countries in the face of the emergency and how much was readiness a factor in their handling of the crisis? How did the global financial crisis, which initially originated in the US housing sector, manifest itself in different jurisdictions? Did it appear as an essentially similar global crisis with similar characteristics, or a different set of crises each with its own peculiar characteristics and dimensions? How resilient and adaptive were the budget systems of each country? How did governments use their budgetary and financial regulatory systems, what political and bureaucratic strategies were adopted, and what were the consequences? What seemed to be the major challenges confronting the budget systems of each country, and, in hindsight, what might we consider to be the successes and/or failures of fiscal or regulatory management? What appear to be longer-term budget trajectories and strategies for meeting targets, making tough decisions and balancing competing demands? Although the GFC did not hit each country at the same time or with the same degree of intensity, it did rock the foundations of the international financial system and inflict enormous public debt burdens onto national governments. It also provides an intriguing opportunity to examine how different OECD budgetary systems performed when confronted with such an intense magnitude of stress.

We have already provided some important context to the emergence, background and timing of the global financial crisis. But chronology itself provides no straightforward explanation. More relevant to the deeper analysis of the crisis and its impact on government finances is the development and application of a conceptual framework that has been used to situate our studies and guide the research efforts of contributors of the country case studies. The remainder of this introductory chapter introduces this conceptual framework. We identify the questions and approach that guide this study, as well as our hypotheses, and explain why we settled on the country case studies. Our concluding chapter at the end of this volume will draw together and evaluate the findings from across the chapters, before listing the ongoing fiscal challenges for governments and then identifying a forward-looking research agenda.

THE GLOBAL FINANCIAL CRISIS: A SERIOUS SHOCK AND NATURAL EXPERIMENT

Recounting the historical origins of the 2007–09 global financial crisis reminds us of what a significant shock it was for governments, markets, investors, economies and citizens around the world. Many market analysts and policy players suddenly had to grapple with enormous uncertainties. Economies that had been performing well and growing steadily were hit with catastrophic changes in fortune. There was much confusion,

Table 1.1 Timeline of key events in the global financial crisis, 2007–10

Date	Event	Comment
1999	Repeal of the Glass–Steagall Act in US allowed banks to operate large investment banking businesses	Beginning of the 'shadow banking system'
Mid 2007	'Exotic' subprime mortgage crisis emerges in US home loan markets	So-called 'lend freely' policies trigger first real signs of an overheated economy
7th August 2007	French bank freezes three hedge funds exposed to subprime mortgages, sparking global jump in interest rates	Beginning of the liquidity crisis in North America and Europe
September 2007	Internationally some banks agree to easing the liquidity crisis by lending cash against bank mortgage securities	First real inkling that systemic problems were emerging in global financial markets
14 September 2007	Northern Rock Bank (a former building society) rescued by the Bank of England after run on deposits, nationalized in February 2008	Increased nervousness in financial markets, but not yet seen as systemic international crisis
October 2007	Stock markets peaked	The tipping point in the overheated economies of the 2000s
Mid-December 2007	Major international banks announce coordinated market interventions	First signs of international concertation
February 2008	Freddie Mac announces it will no longer buy mortgage backed securities; US passes the Federal Economic Stimulus Act; the New Century Financial Corporation becomes the first major US bankruptcy of the GFC	Crisis in the 'shadow banking sector' begins to infect financial markets more generally
15 March 2008	US Federal Reserve rescues Bear Stearns and allows take-over by JP Morgan Chase	First major sign the global financial crisis is becoming serious
April–May 2008	Many financing firms exit the subprime mortgage market and close hedge funds	Beginning of panic as toxic debts cannot be accurately assessed
July 2008	US passes Housing and Economic Recovery Act	Attempts to stabilise the housing market

Table 1.1 (continued)

Date	Event	Comment
September 2008	Federal Reserve forced to bailout insurance firm AIG, which is taken over by the government	Many governments become forced into nationalization of financial institutions to prop them up in the crisis
7 September 2008	US government seizes control over mortgage lenders Fannie Mae and Freddie Mac	Suddenly the GFC is getting very serious
15 September 2008	US investment bank Lehman Brothers files for bankruptcy after rescue negotiations fail; Bank of America agrees to buy Merrill Lynch to rescue it; collapse in stock markets and housing prices	Lehman was allowed to fail; but had reverse effect on other governments and their big banks; the mantra went around the globe that the banks were 'too big to fail'
September–October 2008	Icelandic banking collapse occurs, two banks into receivership and one nationalized, most foreign assets liquidated	Stark sign of the fragility of European money markets exacerbated by runs on deposits and inabilities to refinance debt
October 2008	The overnight TED spread rate reaches 4.65% for interbank lending; following Ireland, many nations provide banking guarantees; the US Congress provides $700 billion in financial underwriting to industries (TARP) and announced stimulus package of $800 billion	The most intense phase of the financial crisis, causing governments to become guarantors of their national financial systems
Late 2008–early 2009	Many nations commit to expansionary stimulus packages (China 6.9%, Spain 6.7%, US 5.5%, New Zealand 3.7% Sweden 3%, Japan 2.3% of GDP)	G20 and finance minister summits coordinate government responses averaging around 2% of GDP in 2008–09
2009	Greece records Europe's largest budget deficit at 15.2% of GDP	A number of smaller economies begin to destabilize the intended recovery phase (including Greece, Ireland, Cypress, Portugal and even Spain)

Table 1.1 (continued)

Date	Event	Comment
April–May 2010	Greek bond crisis – government bonds downgraded to junk status, and emergency €110 billion bailout provided by EU and IMF	Significant threat to the Euro single currency and possibility of exits from the eurozone as economies get out of kilter
Mid-2010	The 16 Eurozone countries agree to bailout funds of €440 billion for banks issued as loans to national governments; public debt in Greece and Italy reach 150% GDP with Japan 200% GDP	By mid-2008 Europe's combined public debt equalled 80% of the continent's GDP
November 2010	Ireland's budget deficit reached over 32% of GDP, and receives first EU bailout of €85 billion; US deficit still 11% GDP	Ireland's bailout would be followed by similar emergency loans to Greece and Portugal in 2011

bewilderment and insecurity. Many policy-makers believed that the imperatives sending markets into freefall were beyond their control, and perhaps for a while even beyond their comprehension. The GFC became the most serious shock since the 1930s Great Depression (Krugman 2009; Rudd 2009; Hetzel 2012; Blinder 2013).

Much has been written about the role of governments in stabilizing markets and financial institutions, and in seeking to buffer economies with often massive fiscal and monetary policy interventions. However, much less attention has been focused on the performance of government budget authorities and processes in dealing with the GFC. Little has been written about the responsiveness, resilience and adaptability of government budget systems. Like all crises, the GFC effectively put institutional 'patients' on the table, revealing much about policy, politics, and public administrative and budgetary systems, and, increasingly, the development of budget policy in the context of international institutions.

The international reach and pace of the GFC meant that it impacted upon the budget systems of the OECD and other countries almost simultaneously, so that in hindsight it can be considered a 'natural experiment' of sorts, recognizing that, as we note below in more detail, it manifested itself differently across jurisdictions depending on the fiscal and economic health of different countries. This is a rare opportunity to explore how the budget systems of different countries responded to an acute challenge: the GFC in its various forms can be cast as an independent variable, with the dependent variables being the response of budget systems, which might involve different levels of government, including state, regional and local governments as well as supra-governments such as the European Union and international institutions. Important intermediary variables include fiscal and economic health, regulatory system, bureaucratic readiness, political decisiveness and engagement, and institutional capability.

The American budget analyst Allen Schick has argued that the 'global financial crisis and the extraordinary governmental and international responses give rise to fundamental questions that go to the core of budgeting as the authoritative process for allocating public money' (Schick 2009: 2). In analysing these developments, Schick made a useful distinction between the nature of the fiscal stimuli (and/or bailout packages) hastily arranged by governments and how the crisis affected the core machinery and conduct of budgeting. He volunteered a number of important observations about how budgetary routines can meet crisis situations:

> budgeting is fundamentally altered, if only temporarily, by pressures that overwhelm established policies and practices. Emergencies 'stress test' the entrenched routines that regulate budgeting in normal times. Business-as-usual budgeting is a stabilizer of government policy and a routinizer of public management that thrives when underlying political and fiscal conditions are stable. When they are not, budget makers may have difficulty managing the frenzied, largely unstructured and improvisational rush for decisions, and effective power may migrate from those who run the process to those who manage the crisis. In some circumstances, budgeting might be shunted aside, its main role confined to tallying the fiscal impacts of decisions taken elsewhere . . . A persuasive case can be made for adopting extraordinary measures to cope with immediate or long-term crisis. Arguably, the modulated cadences of budgeting – small adjustments made according to fixed procedures and schedules – should not be allowed to block forthright action. When crisis strikes, political leaders feel impelled to act, even if doing so temporarily bypasses or disables the budget process. (Schick 2009: 2)

With this in mind, Schick identified how 'crisis budgeting' differed from normal budgeting. He cited four main differences:

- new procedures and 'shortcuts' were instituted to deal with the 'maze of budget procedures';
- the power to make budgetary decisions gravitated away from the normal budgetary guardians to political leaders, with decision-making becoming centralized and top-down, and at the same time marginalizing 'those who stand in the way';

- many decisions were essentially non-incremental, involving significant departures from previous thresholds; and,
- even though the potential for political and bureaucratic conflict increased dramatically in the crisis, the centralization of power and the urgent need to make decisions served to dampen bureaucratic conflict (Schick 2009: 8–9).

In a later piece, Schick (2010) offered some equally interesting conjectures about the nature of post-crisis budgeting, arguing that in terms of process and aggregates there should be a return to pre-crisis routines and incrementalism, but with some important caveats. Consider two of his predictions or observations concerning national governments in advanced economies. He suggested that:

> The crisis passes, normalcy returns, and budgeting reverts to pre-set routines, stable roles, and predictable outcomes. This has generally been the pattern in the past; it may well prevail when the current crisis is over. Recent distress may spur some governments to strengthen or add a multiyear perspective to their budget work, or to bolster their capacity to analyze the interface between the budget and the economy. Undoubtedly, budgeting will continue to exhibit the restless tinkering with rules, procedures, informational requirements, and other features of the process that has characterized reform for the past half a century. But in most regards, there will not be overwhelming pressure to remake budgeting . . .
>
> In at least four ways, however, the current crisis may significantly impact budget practice. First, the crisis will leave many countries with elevated public debt levels, in some cases far above widely accepted norms such as the 60 percent ratio to GDP specified in EU's Stability and Growth Pact (SGP). Second, national governments will pay greater attention to questions of fiscal sustainability, which will induce them to expand time horizons beyond the medium term to cross-generational issues. Third, governments will seek new means to assess fiscal risk and integrate risk estimates into the budget and other financial statements. Finally, the crisis and its aftermath will spur governments to coordinate some budget rules and policies. (Schick 2010: 10)

Despite his general prediction about a return to budgetary incrementalism and rule-tinkering in the wake of the GFC shocks, Schick had earlier acknowledged the possibility that some governments may retain the extraordinary powers gained as a result of crisis. He noted that 'abnormal policies or instruments contrived to cope with crisis might be deployed to very different ends years later. For example, extra budgetary accounts introduced to inject money into the economy might become precedents for non-crisis ploys when the government of the day wants to evade budget controls' (Schick 2009: 2).

Schick's influential work presented to the OECD's senior budgetary officials' network was informed by the experiences of a diverse set of

OECD countries. It provided a synoptic overview of changes and identified interesting issues and possibilities for leaders and officials in all of those jurisdictions to consider. However, it does not provide a theory of how different countries might react to the same crisis, controlling for fiscal health, the quality of budget systems, and the willingness of political leaders to address rapidly evolving challenges. Moreover, it does not explicitly account for the fact that the GFC manifested itself in different ways in different countries, emerging variously as a financial crisis, budget crisis, economic crisis, regulatory crisis, political crisis – and in different combinations. Building on the seminal insights of Schick, this book seeks to take a closer look at the experience of different OECD jurisdictions.

MEETING THE GFC CHALLENGE: TRAJECTORIES AND RESPONSES OF BUDGETARY SYSTEMS

The GFC was a significant and unexpected challenge to economies and governments around the world. However, not only did the GFC manifest itself differently in every jurisdiction, but also governments were in unique political, economic and governance circumstances when responding to it. Moreover, the scope of the challenge internationally meant that, in contrast to our previous volumes in this series, we needed to expand our focus from core budget institutions and the processes and the aggregates they normally seek to control and influence, to consider a larger circle of actors, instruments and processes. This section sets out the framework and definitions we utilized to facilitate gathering and analysing our data, making comparisons, and drawing lessons.

Adopting a Five-Phase Framework for Analysis

The concentrated and widespread nature of the GFC provides a focal point for the framework guiding this book. Initially we devised a heuristic 'financial crisis response cycle' or response/reaction trajectory through which many nations appeared to have progressed at varying speeds and levels. Figure 1.1 indicates the various stages of recognition and response depicted in the cycle, beginning with denial, disbelief or nervousness, and going through analysis, scenarios, responses, institutional reforms, and eventually to planned fiscal consolidation and a return to surplus.

We then refined this cycle to better enable us to analyse the crisis and the budgetary responses. Accordingly, we adopted a five-phase framework which considers both the trajectory of the crisis in terms of a chronological response sequence as well as the specific conditions affecting separate

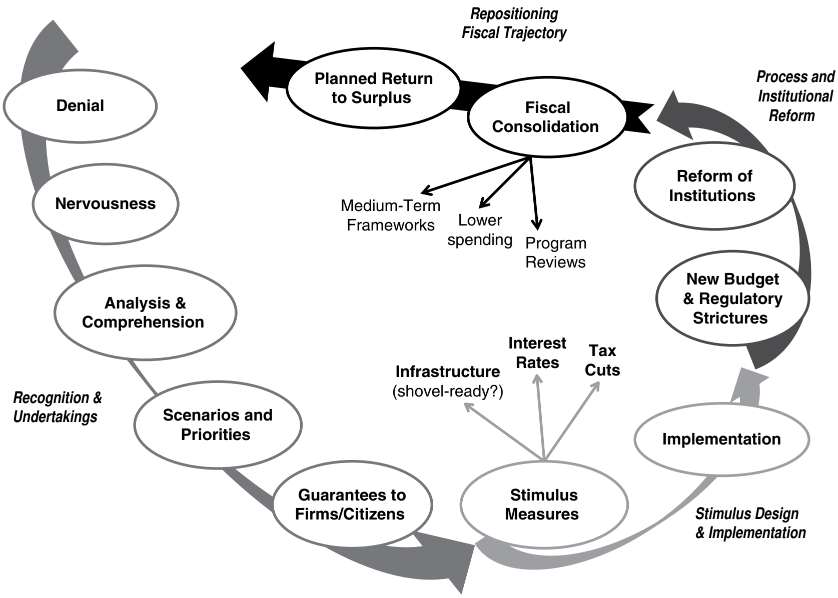

Figure 1.1 The financial crisis response cycle

countries. According to this framework, countries went into the crisis with differing degrees of readiness and potential resilience, which varied along a scale of low to high. The nature of the global crisis within each country often varied in its primary characteristics and local framing, perhaps appearing as a financial collapse, or as a budgetary crisis, or an economic downturn. The initial responses to the crisis also varied between nations (and governments), from slow and indecisive to fast and decisive. Countries went to different lengths to chart and plan for the medium-term and longer-term consequences of the crisis, ranging from tentative considerations to firm plans. Finally, the degree to which national budgetary systems could future-proof their countries against subsequent significant challenges that may appear on the horizon was evidence of future resilience. We consider each of these sequential phases in further detail below.

Readiness of budget institutions and governments

Each government began from a different starting point when confronted with the GFC. One aspect of readiness concerned the capacity and competence of budget institutions and related processes in governments, including their ability to anticipate such challenges, to identify strategies, and to engage political masters and international colleagues. Another aspect involved the fiscal health of governments, the extent of public debt, and whether jurisdictions were in deficit situations or had surpluses. Greater indebtedness restricted room for manoeuvre. A third aspect concerned the state of governance: whether political leaders had a majority or minority government, and a willingness to take charge in difficult circumstances and work with officials and other levels of governance. Finally, our previous research reported in *The Reality of Budget Reform* (Wanna et al. 2010) identified not only general directions for reform across several jurisdictions, but also the degree of variation of take-up of reform initiatives and the extent to which they were insinuated into bureaucratic and political routines. Taken together, these factors combined to shape the overall readiness and resilience of jurisdictions to deal with a largely unanticipated shock.

What crisis? Which crisis?

In 1974 the rock band Supertramp released a well-known album entitled *Crisis? What Crisis?* With the GFC there was no doubt about the emergence of a globalizing crisis, but what is now often not well understood was that many OECD countries experienced very different crises, sometimes reflected in different nomenclatures to describe them (Figure 1.2). Some countries had a combination of a financial crisis, with imminent or possible failure of financial institutions; a budget crisis (in the sense of not

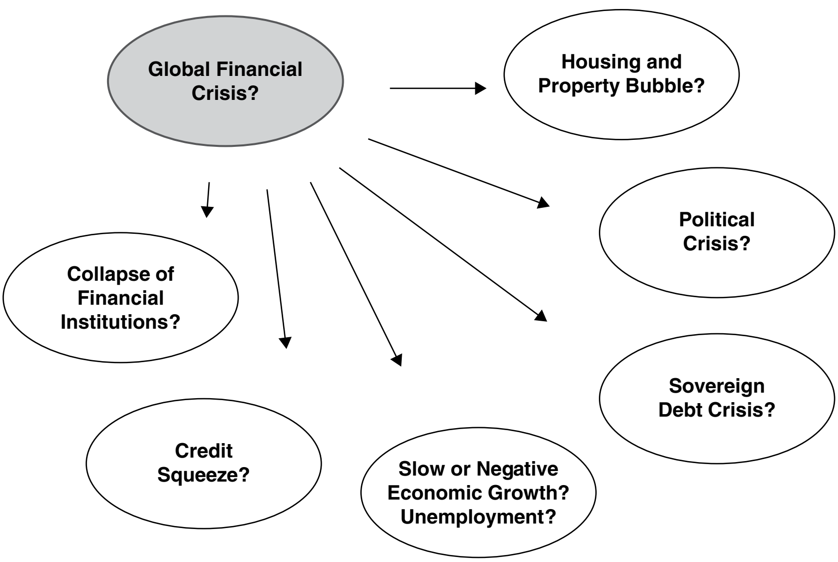

Figure 1.2 *Crisis? What crisis?*

meeting surplus/deficit or debt targets), and rapidly declining performance in the real economy, such as declining purchasing, employment, trade, and so on. Some countries did not experience meltdowns in the financial sector, perhaps due to strong regulatory regimes or less leveraged institutions, and instead were primarily worried about budget issues and a pending recession, and thus focused on more aggressive economic stimulus programmes. In order to assess how well governments and budget officials performed in response to the GFC, it is important to understand what the nature of the crisis was in each jurisdiction, in part because the deeper and wider the crisis, the more political and bureaucratic actors may be required in developing a response.

Initial response to the crisis

In retrospect, the GFC might appear to have been an inevitable phenomenon, but it took most corporate and government leaders by surprise, and during the early stages of the crisis some jurisdictions remained in denial or apprehension. Some imagined it was not their problem and so little action was warranted or commissioned. Even when the crisis was recognized, political leaders and budget officials did not size it up accurately and tended to rely on patterned responses appropriate for other challenges. In some cases this was due to insufficient urgency, or perhaps ideological blinkers, about whether and how to respond, and in turn this affected whether a full set of options were considered in a timely fashion. More generally, political and budget decision-making processes may have been under stress, requiring short-circuiting or adaptation in order to support political and bureaucratic decision-making, as well as the implementation and monitoring of decisions and policies. Initial responses were sometimes complicated by the governing context, with political engagement conditioned by whether the government was in a majority or minority position, prior policy positions, and the extent to which, if at all, fiscal and other responses required approval or alignment with regional governments and international organizations. All of these factors influenced how quickly governments were able to assess and respond to the crisis; a particularly important matter when many remedies for stabilization and stimulus are time-sensitive.

Setting a new course

Stabilizing crisis situations is not necessarily the same as charting a medium- to longer-term course for restoring fiscal, economic and financial health. Stimulus and bailout programmes cannot last forever, and governments need to chart ways back to recovery. In some jurisdictions this might require re-regulating the financial sector and rationalizing the mix and content of government programmes, and fundamentally reforming the budget system. Countries in poor financial straits before the crisis, which may have received emergency support from other governments and international organizations once the crisis was felt, may in turn have to reschedule debt arrangements and make further structural adjustments. Although incumbent governments, regardless of their strength, may have had to deal with the crisis as it unfolded, they subsequently had to deal with the political consequences of difficult decisions made, and identify and defend the often unpalatable policies required for the longer term. In some jurisdictions governments became weakened or were removed from office in the aftermath of the GFC, while in other jurisdictions sitting governments attempted to galvanize and strengthen their position.

Readiness for subsequent challenges

Regardless of the strategic directions set by governments coming out of the GFC, there remained no shortage of possible challenges that might compromise recovery and a return to financial and economic health. Many countries experienced continuing economic and fiscal challenges, nursing fragile recoveries and jurisdictions with precarious finances, with non-trivial risks for regional governments and global markets. In addition, some countries also encountered subsequent crises of entirely different kinds: natural disasters, wars and even political disintegration. These lingering factors had significant consequences for the restoration of public finances, economic stability, and trust in governments and other elites. Another way to think about this is to compare how resilient governments and budget systems were in the face of the GFC, and how resilient do we think that different jurisdictions will be in the face of subsequent and sometimes different challenges?

Figure 1.3 indicates this five-phase framework and provides illustrative examples to show possible variations between three different countries. It shows the range of different trajectories and patterns in response to the GFC. Some jurisdictions might have entered into the GFC with strong fiscal positions and budget systems, and emerged relatively strong, notwithstanding the crisis. Others might have started with weak fiscal positions and budget systems, and were severely compromised by the crisis. Still others might have used the crisis to galvanize political support and budget systems as part of a longer-term process of change.

Figure 1.3 can be used to explain how a particular country was moving into the GFC in relatively good shape, but was confronted with a crisis involving financial, budgetary and economic dimensions and, having responded with adequate political and bureaucratic decision-making, then emerged reasonably well prepared for handling future challenges.

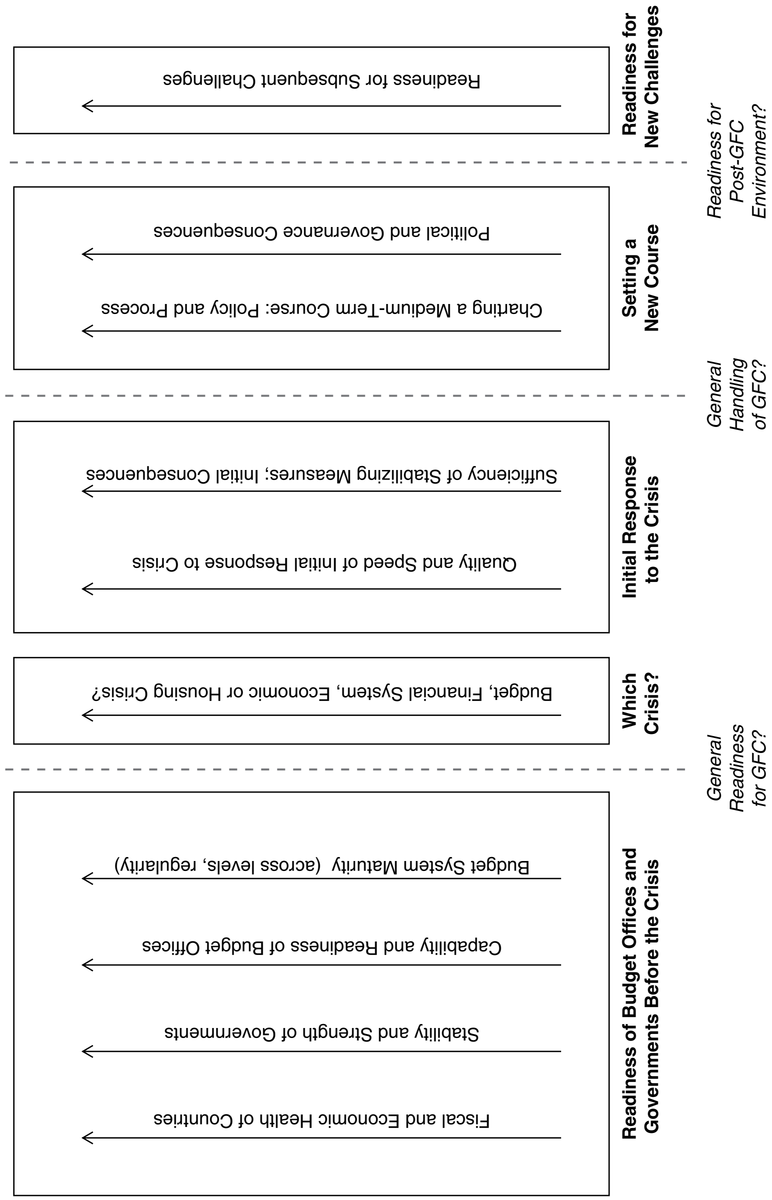

Figure 1.3 Phases and variables affecting GFC country responses

By contrast, another country could have started with poor readiness and repertoires, adopted a slow initial response followed by very tentative medium-term planning and, as a consequence, remains poorly situated to deal with future challenges. Some of our case studies were in a middling state of readiness but, perhaps because of good political and bureaucratic leadership, acted in a decisive manner, and emerged from the crisis in relatively good shape with a robust plan and systems.

The Focus on Fiscal Policies and Budgetary Systems

Our previous book, *The Reality of Reform*, explicitly focused on expenditure budgets and budget institutions, and reform issues pertaining to them. The GFC, however, presented challenges to governments of considerable scope, demanding action and authorities broader than typical expenditure budgeting repertoires, involving fiscal and monetary policy interventions as well as significant stimulus and buy-out packages and, for many jurisdictions, dealing with financial sector regulators and international institutions. Central budget agencies now found themselves on a broader field of play, engaging with a larger set of actors and pressures.

Crises often reveal many of the latent and often taken-for-granted features of institutions and processes in which we are interested as researchers. With the GFC, a fast-moving crisis required the compression of decision-making and the involvement of many actors in order to achieve timely policy responses. This served to highlight the important aspects in the relationships between budgetary institutions, budgetary processes and governmental decision-making: the role of prime ministers in working with finance ministers; the involvement of international institutions and networks; linkages between fiscal and tax policy and other parts of national expenditure budgets; and the political consequences of budgetary and economic decisions.

In this context, we have chosen to focus our research at the level of budgetary systems, which goes beyond central budget agencies and expenditure management processes to include the larger set of actors, instruments and processes involved – typically on a rolling basis over the planning cycle – in ensuring a sound budget and financial management system for countries, including actors involved with financial regulation, prudential oversight and fiscal policy. This broad interpretation also includes the state of public finances and financial management, and indicators of the soundness of the financial and monetary system (including accumulated results such as the size of deficits, the amount of debt, bank failures, and so on).

This volume provides an opportunity to see how well budgetary systems and their various actors advised and assisted governments in the face of a far-reaching crisis with the pressing need to stabilize and provide resilience for larger governance systems and society. Taking this broader perspective does not mean we need to relinquish our focus on budget actors, processes and policy; rather, the nature of the GFC requires us to investigate how they performed under great stress. We need to consider how budgetary systems performed with an expanded array of actors and pressures in a highly compressed time period, and to consider the consequences from a budgetary perspective.

RESEARCH QUESTIONS AND METHODOLOGY

Our study is guided by several broad research questions, many of which condition our subsequent questions. This section outlines these research questions along with some of our initial expectations, and then reviews the methodology and guidance given to the authors conducting the country case studies.

Research Questions

Our major research questions (and initial expectations) were as follows.

Were governments ready for and even proactive about the GFC?
Here we were curious about two related matters. First, we wanted to learn about how strong the economic, public finance and budget fundamentals were for each government jurisdiction. Our expectation was that countries with less debt and deficits to manage would find it easier to respond to the GFC, and that countries with tighter regulatory systems for financial institutions would have a more circumscribed crisis to address (fiscal and economic), no matter how daunting. Second, we wanted to learn about whether governments (and budget institutions in particular) possessed robust forecasting and early warning systems, and whether they had imagined the possibility of crises or shocks of the magnitude of the GFC. Again, our expectation was that, to the extent that budgetary systems were prepared to handle crisis situations, they would be better prepared to advise governments and implement their chosen policy responses.

If governments were reactive, were they overwhelmed or resilient?
It is not unusual for governments and their budgetary systems to encounter surprises, but we were interested in how quickly the gravity of the situation,

with its particular character in each jurisdiction, was recognized not only by the budgetary people but also by political leaders. We were interested in learning about the nature of the political decision-making process: was there immediate consensus on what to do? If not, how did sufficient consensus emerge for action? We were also interested in learning about how budget offices, political leaders and other actors interacted. We were also very interested in how governments relied on or modified existing budget repertoires to deal with the financial crisis. Our expectations were that, to the extent that governments and their budget offices were working with good budget repertoires, were well led and had good rapport with political leadership, governments would be better able to assess the situation and develop more timely and concerted responses; particularly important when interventions in the economy and the financial sector had to be adroitly timed and delivered to maximize their effect.

What was the role of international agencies and higher orders of government?

For national governments with precarious debt, deficit and economic circumstances before the crisis, as well as those enmeshed in multilateral contexts (for example, the eurozone and the European Union), there were potential constraints on how quickly these governments could move to address the GFC. In some cases, international agencies, networks and higher governments could have served to stimulate and even demand action and coordinated responses. With these possibilities in mind, we were interested in whether and how international agencies and other governments influenced the strategies of national governments and their budget offices. We would expect that, to the extent that relationships and strategies were already worked out, national governments would be more responsive and better supported in addressing the crisis. We also expected that countries with less bureaucratic capacity and political will would be induced or coerced into action by international agencies and higher levels of government.

What was the nature and mix of government interventions?

As the crisis presented itself differently in each jurisdiction, this suggested that we had to pay close attention to the match of the policy response packages and the challenge in each country. Moreover, the key issue of the timing of the adopted packages was important, with respect not only to speed of adoption but also to how quickly different instruments promised to have an impact on the economy and financial sectors. We would expect that the policy mix would differ significantly depending on the perceived nature of the national crisis. If interventions were slow to be adopted and to take effect, then we would expect that perceptions of the quality of government performance would decline and there would be increased difficulty in charting exit strategies for rebalancing budgets over the longer term.

What were the results and the exit strategy?
Once governments adopted their respective stabilization, bailout and stimulus packages, they typically had increased their deficit and debt obligations, sometimes significantly so. An important question, therefore, concerned the costs and effectiveness of the interventions, and the impact they had not only on the economy and the national budget, but also on the fortunes of sitting governments. Over the medium to longer term, governments needed to address how they proposed to bring budgets into balance, continue nurturing their economies and re-regulate financial institutions or develop better budget repertoires, if necessary. We would expect that, to the extent governments adopted earlier and more concerted responses to the GFC, they would be more likely to have a credible strategy for consolidating public finances, and to be more successful with respect to popularity and re-election. We also expected that such governments would be better positioned to deal with subsequent economic and financial shocks, or other crises affecting their jurisdictions.

In the final chapter of this book we will reflect back and consider whether the findings from the country case study chapters support our hypotheses and expectations, or whether more complicated or even counter-intuitive dynamics were at play.

Methodology

Our methodology was as follows. To answer the specific research questions and still allow the research team to investigate individual country differences against the five phases of the crisis response cycle, we chose to feature individual country-based case studies with the intention of compiling our comparative analysis by relying on a similar framework of analysis and research questions (and sharing these insights at a colloquium). While each case is written up separately, they all employ the response cycle framework and pursue the common research questions. We then return to a more traditional comparative assessment in the conclusion, tracing our main findings, and commenting on the robustness of the analytical framework.

Countries were selected to cover a representative range of the advanced OECD nations: large and small, Old and New World, European and Asian, those with federal systems of government (or with regionally devolved subnational governments) versus centralized unitary ones. In total 12 nations were selected. Ideally, we sought to select countries with different 'going in' positions: that is to say, we grouped potential cases into three groupings according to whether their economies, public finances and budgetary systems were strong and robust; or had reasonably strong economies but also underlying weaknesses in their government finances and budgetary systems; or had relatively weak fiscal monitoring and underperforming budgetary systems. Accordingly four countries with strong economies and budgetary frameworks were selected (Australia, Canada, New Zealand and Sweden). Four countries 'going in' with underlying weaknesses in their budgetary or regulatory systems were Denmark, Japan, the Netherlands and the United States. Finally, four countries with significant weaknesses in their fiscal position, budgetary frameworks, and often in their pre-crisis economies, were Greece, Ireland, Portugal and Spain. Our various case study chapters each address the respective 'going in' position of the countries, and in the conclusion of this book we return again to these relative 'going in' positions as a crucial part of the explanation of resilience.

In two chapters of the volume relatively similar cases have been coupled: Australia and New Zealand (Chapter 4), and Denmark and Sweden (Chapter 7). The rationale here was that these pairings share many common features (community values, political cultures and institutions), and had relatively strong budgetary positions and comparable economic performances. However, while their 'going in' situations were readily comparable, their assessments and responses sometimes varied markedly, suggesting that similar problems were dealt with in different ways due to the interaction of contextual factors in relatively similar political and economic jurisdictions. Again, as in previous comparative volumes we have been engaged in, we tried to pair academic scholars with expert practitioners; often the chapters are written by these complementary teams, and, if not, practitioners were actively involved in the analysis but were unable to be named as a chapter author.

We were insistent that authors should actively interrogate the analytical framework and the applicability of the research questions, and not 'force' their countries into the proposed framework mechanically or unquestioningly. This also provided a set of independent tests of the utility and robustness of the framework. We advised contributors that if the framework did not fit or suit their circumstances we certainly did not want the framework getting in the way of the analysis, and that they should craft a persuasive narrative of what transpired. Our fall-back position was that a good story capturing the jurisdictional responses was preferable to a sterile imposition of the framework. Comfortingly, each author found value and merit in the structure of the analytical framework, because it was not overly prescriptive or too distortive and allowed for considerable national variability over the five phases. In many cases, contributors were conscious that there were many country-specific variables and intricacies to cover in their chapters, and because of space limitations they were forced to be concise and condense what in many ways was a complicated journey through the crisis.

OVERVIEW OF THE VOLUME

The volume proceeds with the two North American cases. In Chapter 2, Paul Posner and Denise Fantone recount how 'crisis budgeting' played out in the US with major fiscal injections initiated by the President and approved by Congress but little institutional post-crisis institutional reform and an inevitable descent into fiscal gridlock at the federal level. This is followed in Chapter 3 by David Good and Evert Lindquist's assessment of the Canadian responses, which they argue were clouded by indecision and a slowness to respond, due to the political convictions of the Harper government. John Wanna (Chapter 4) then traces Australian and New Zealand government responses, which were timely (but differed greatly in the magnitude of the fiscal stimuli used), and led both nations to promise an early return to surplus, although in Australia this was more problematic. In Chapter 5, Masahiro Horie traces the shifting sands of Japanese politics and documents the cascading Japanese fiscal injections, paid for through domestic bonds, but which proved less efficacious than expected, and left Japan with one of the world's largest public debt ratios.

Seven European countries are discussed in the next six chapters. In Chapter 6, Jouke de Vries and Tom Degen show how the Dutch government became embroiled in the crisis, and was then forced to nationalize banks and abandon its standard budgetary practices. They argue that while the Dutch government thought its economy and finances would rebound in the post-crisis context, the subsequent European crises and euro bailouts meant that the nature of budgetary politics became less national in scope and more shaped by intense international negotiation. Lotte Jensen and Sysser Davidsen (Chapter 7) compare the responses from two Scandinavian exemplars of tight budgetary management; both adopted 'lite' responses and made relatively few changes to their budgetary systems as a result of the crisis. Sweden was hardly affected by the crisis, largely because the drop in GDP did not translate onto the government's balance sheet; whereas Denmark found itself trapped in the crisis and looked to European budget rules to help recover and address its internal political problems. The Spanish, by contrast, were significantly impacted by the GFC, creating incredible internal dislocation, unemployment and political turmoil (including exacerbating tensions between national and autonomous regional governments). But as Eduardo Zapico-Goňi argues in Chapter 8, Spain did not maximize its opportunities to revive its economic credentials, and only slowly managed to stabilize its fiscal position through austerity measures and cutbacks. Paulo Pereira and Lara Wemans describe in Chapter 9 how Portugal became the third European power to require an international bailout, after decades of fiscal mismanagement and ballooning overseas debt. Portuguese governments were slow to react to the crisis, which flared into a full-blown economic crisis, leading to a collapse of revenues and increased spending pressures. A similar story is presented by Michael Arghyrou in Chapter 10, who charts the ever-deepening economic depression that affected Greece from 2009 onwards, leading to a drop in GDP of almost 25 per cent after 2007 and eventually 25 per cent unemployment by 2012–13. The collapse of public finances and the downgrading of Greek bonds into junk status led to a series of emergency loans from European institutions and much talk of Greece exiting the eurozone. Meanwhile, Richard Boyle and Michael Mulreany (Chapter 11) account for the helter-skelter ride that Ireland took from being the rich 'Celtic Tiger' to a poor, 'basket-case' economy. They detail the painful austerity measures and belt-tightening in areas of social provision that were forced on Irish society, with the gradual prospect of some return to prosperity detectable but still some way off.

Finally, we return to our five-phase framework in the concluding Chapter 12, summarizing and commenting on how each country fared across the various stages of the crisis. Key findings that stand out from this comparative assessment of budgetary resilience include: the importance of preparedness and foresight; the determination to act and adjust policy settings quickly; the need for strategic thinking from politicians and senior economic and budgetary officials; an ability to implement domestic policy decisions; and the embrace of a viable exit strategy to restore sound finances in the medium to longer term. Fiscal consolidation has been a difficult road to follow, and not as easy to achieve as many of our country cases imagined when they first began to pull out of the crisis. We also address various significant ongoing fiscal and economic challenges that governments face today and into the future, including: lower revenue streams from their constituencies; tighter fiscal policy settings and budgetary disciplines; the difficulties of addressing continuing structural problems in domestic economies and the need for policies to avoid housing bubbles recurring; the need for achievable debt reduction strategies and the lingering problems of loan defaults and write-offs of GFC bailout measures; and long-term social problems in developed economies associated with ageing, demographic changes and escalating entitlement provision, as well as ways to re-engage with the pool of long-term unemployed created as a painful reminder of the crisis.

NOTE

1. For detailed accounts of developments, see Borio (2008: Annex 1), Federal Reserve Bank of St Louis (2011) and Hetzel (2012).

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