Long-Term Fiscal Sustainability in Major Economies

Alan J. Auerbach
University of California, Berkeley

Worsening Fiscal Positions

- Based on debt-GDP ratios, situation has worsened in recent years in several countries and is projected to get worse as world economy recovers slowly

General Government Net Debt-GDP Ratios

	2007	2010	2013	2016
Australia	-7.3	5.5	7.6	5.3
Austria	39.8	49.8	51.5	50.9
Belgium	73.3	81.5	83.9	86.5
Canada	22.9	32.2	36.3	33.0
Denmark	-3.8	0.9	8.1	6.0
Finland	-72.6	-56.8	-45.6	-36.6
France	54.1	74.6	80.6	77.0
Germany	50.1	53.8	53.9	52.6
Greece	105.1	142.0	157.0	145.5
Ireland	12.2	69.4	110.3	103.5
Italy	87.3	99.6	100.2	98.9
Japan	81.5	117.5	142.4	163.9
Netherlands	21.6	27.5	33.5	34.1
New Zealand	-5.7	4.6	14.7	11.7
Norway	-142.5	-156.4	-170.5	-186.0
Portugal	58.1	79.1	93.3	102.3
Spain	26.5	48.8	58.5	64.6
Sweden	-17.1	-14.6	-13.7	-16.3
United Kingdom	38.2	69.4	79.5	73.5
United States	42.6	64.8	79.3	85.7

Worsening Fiscal Positions

- Based on Debt-GDP ratios, situation has worsened in recent years in several countries and is projected to get worse as world economy recovers
- The problem is not limited to high-profile countries facing current crises
  - It is also prominent in the G-7 countries, for example

General Government Net Debt-GDP Ratios

	2007	2010	2013	2016
Australia	-7.3	5.5	7.6	5.3
Austria	39.8	49.8	51.5	50.9
Belgium	73.3	81.5	83.9	86.5
Canada	22.9	32.2	36.3	33.0
Denmark	-3.8	0.9	8.1	6.0
Finland	-72.6	-56.8	-45.6	-36.6
France	54.1	74.6	80.6	77.0
Germany	50.1	53.8	53.9	52.6
Greece	105.1	142.0	157.0	145.5
Ireland	12.2	69.4	110.3	103.5
Italy	87.3	99.6	100.2	98.9
Japan	81.5	117.5	142.4	163.9
Netherlands	21.6	27.5	33.5	34.1
New Zealand	-5.7	4.6	14.7	11.7
Norway	-142.5	-156.4	-170.5	-186.0
Portugal	58.1	79.1	93.3	102.3
Spain	26.5	48.8	58.5	64.6
Sweden	-17.1	-14.6	-13.7	-16.3
United Kingdom	38.2	69.4	79.5	73.5
United States	42.6	64.8	79.3	85.7

How Should We Measure Sustainability?

- Debt-GDP ratios are an inadequate measure
  - Short-term trajectories differ
  - Long-term trajectories not taken into account
  - Access to capital markets may vary, even for given projections
    - Countries vary in their abilities to absorb debt internally
    - Credibility of government responses may differ

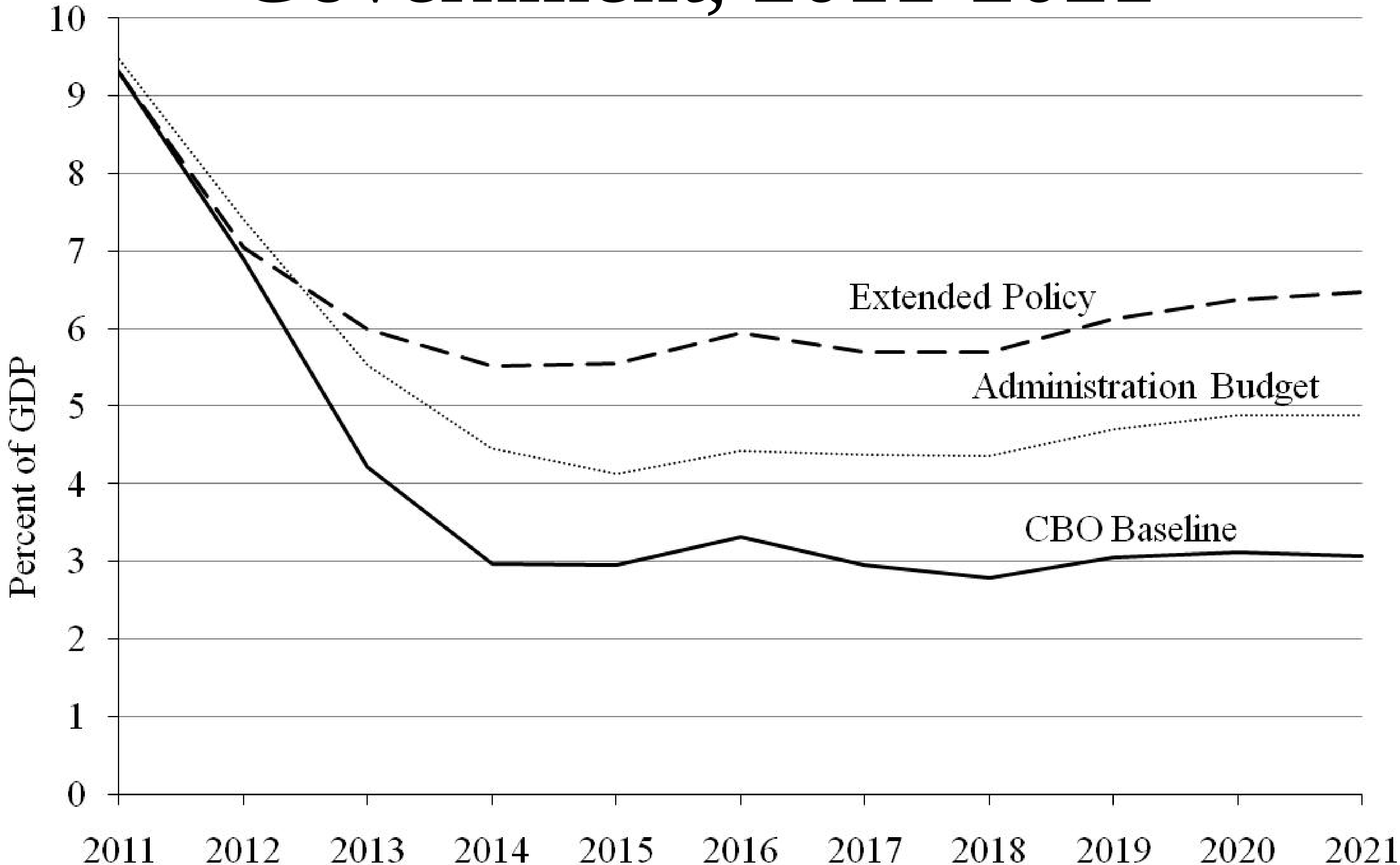
Outline

- U.S. case study
- Fiscal imbalances around the world
- Factors contributing to risks
- Fiscal rules and the path forward

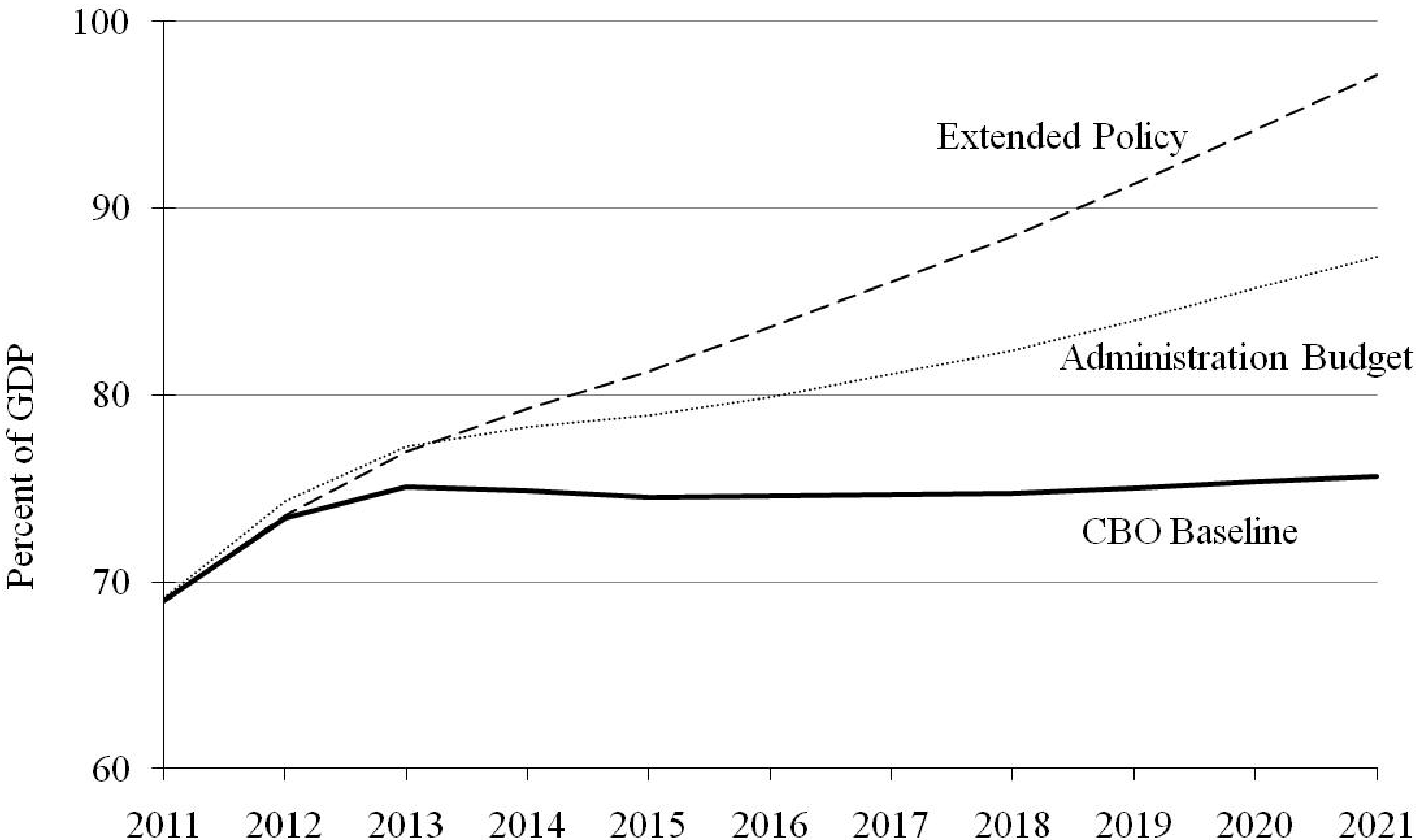
The U.S. Fiscal Situation

- Useful to distinguish between short run and longer run
- Short run dominated by recovery from recession
- But possible interpretations of “current policy” leave considerable ambiguity as to path

Deficit Projections, U.S. Federal Government, 2011-2021



Debt Projections, 2011-2021



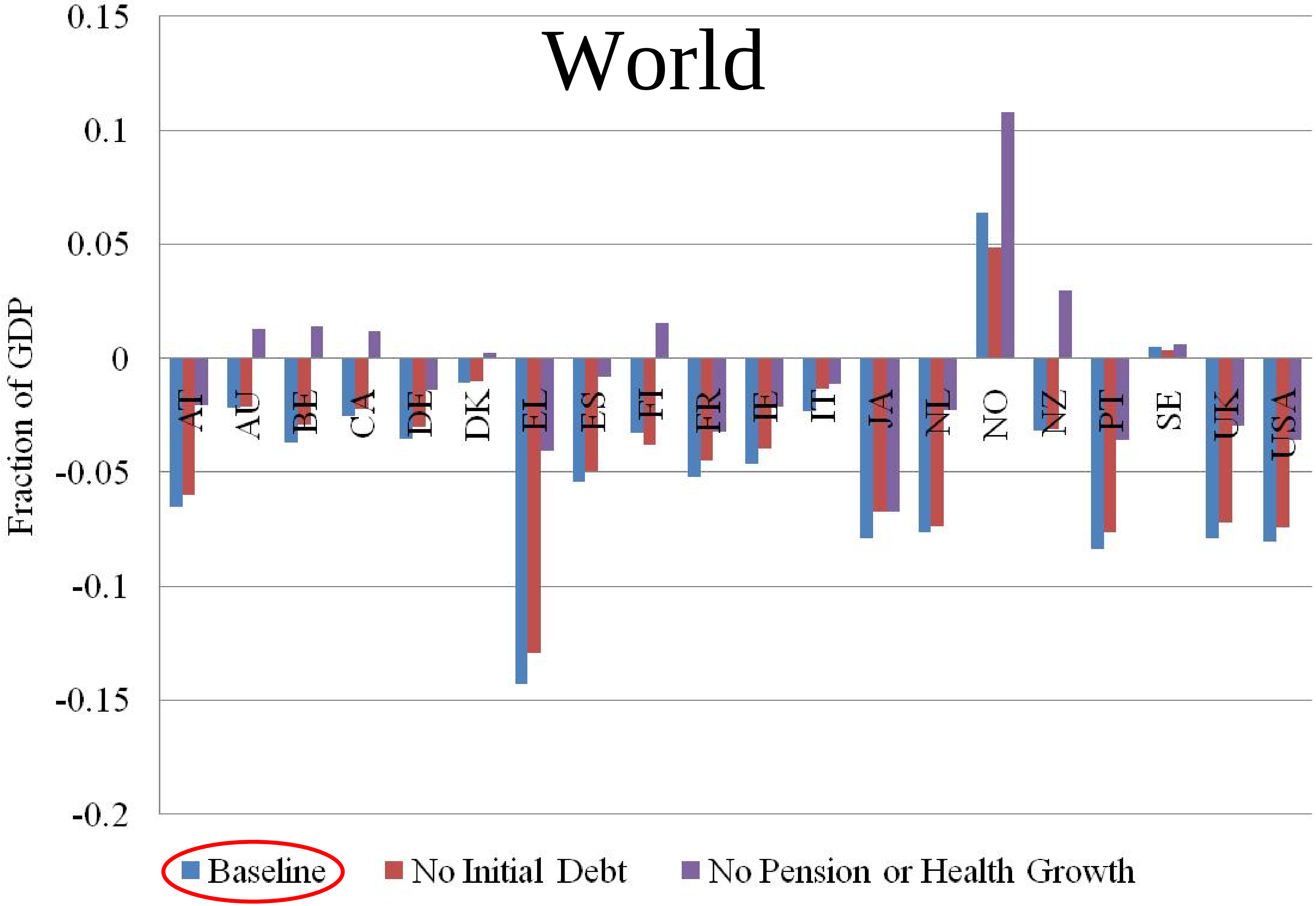
Fiscal Sustainability

- How to summarize necessary adjustments?
- Calculate fiscal gaps to determine how much need to add to primary surplus annually to maintain debt-GDP ratio for next 50 years
- For US, range is 3 to 7 percent of GDP, based on projected growth and interest rates
  - Worse if interest or growth rates respond negatively to debt accumulation

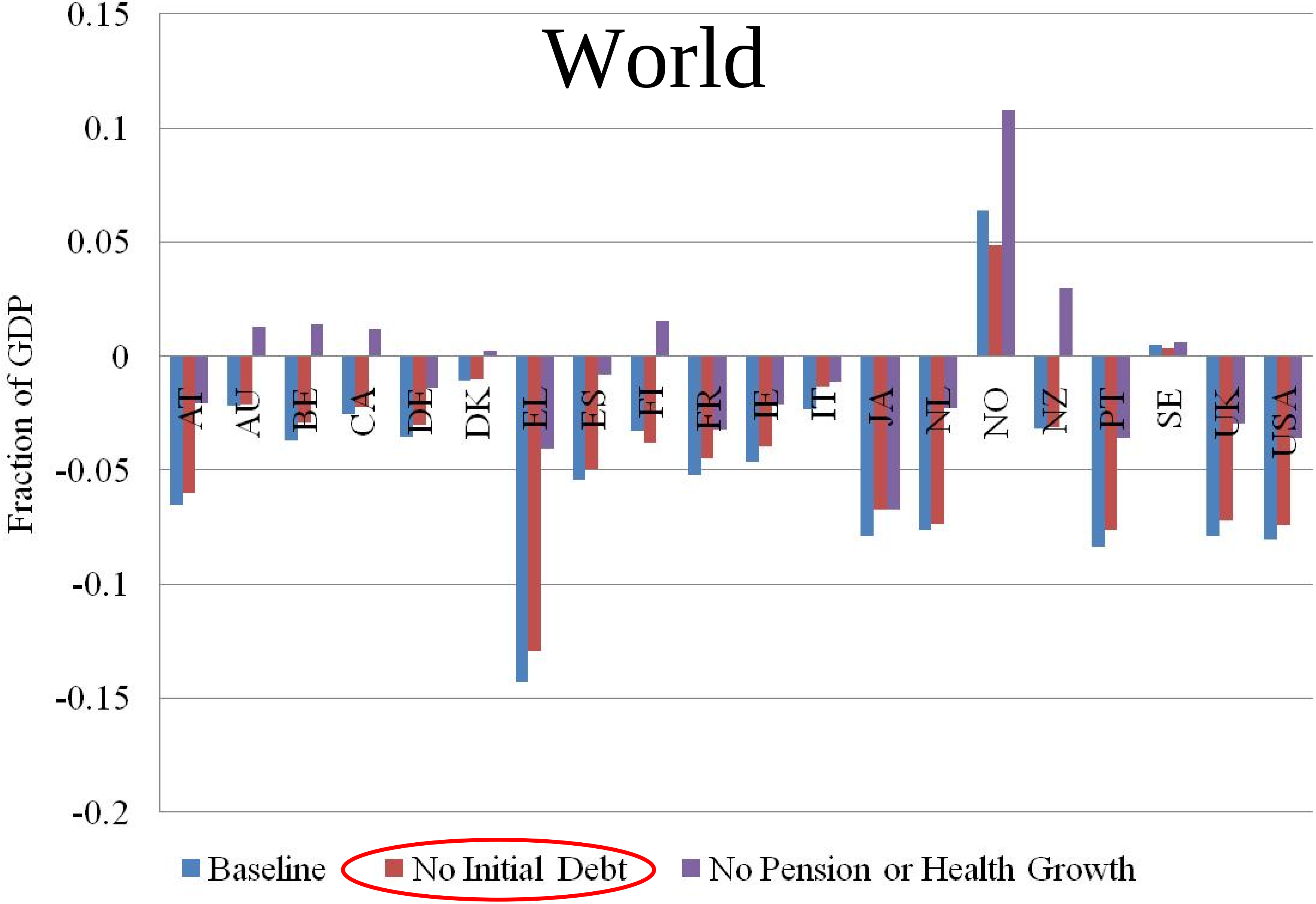
Considering Policy Options

- Existing national debt is small relative to future deficits; given their nature, inflation is largely irrelevant
- Even with large existing net debt ($9.8 trillion), implicit liabilities are much larger, and either implicitly or explicitly indexed
  – Social security: $17.9 trillion
  – Medicare: nearly $40 trillion (or more)

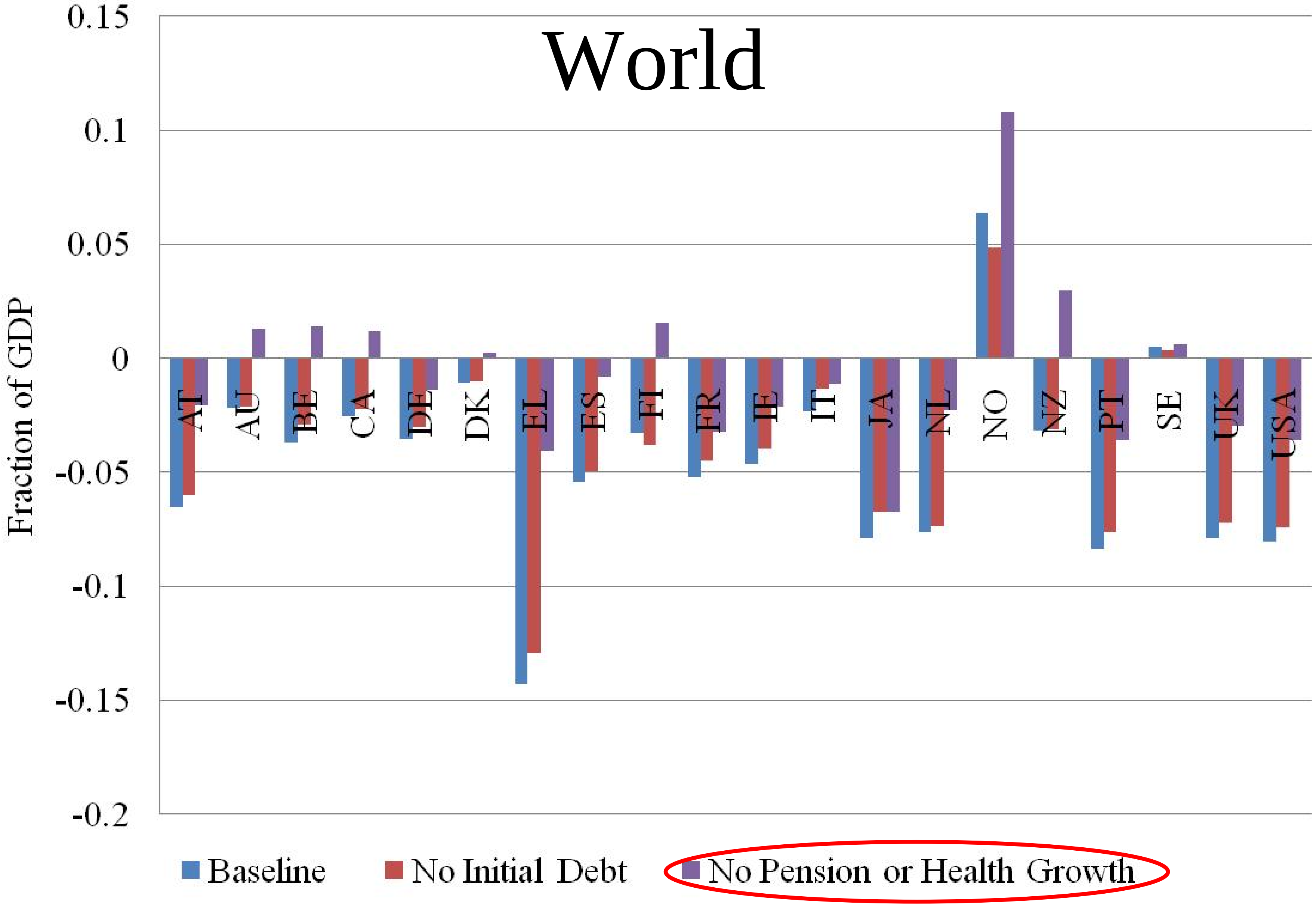
Fiscal Imbalances around the World



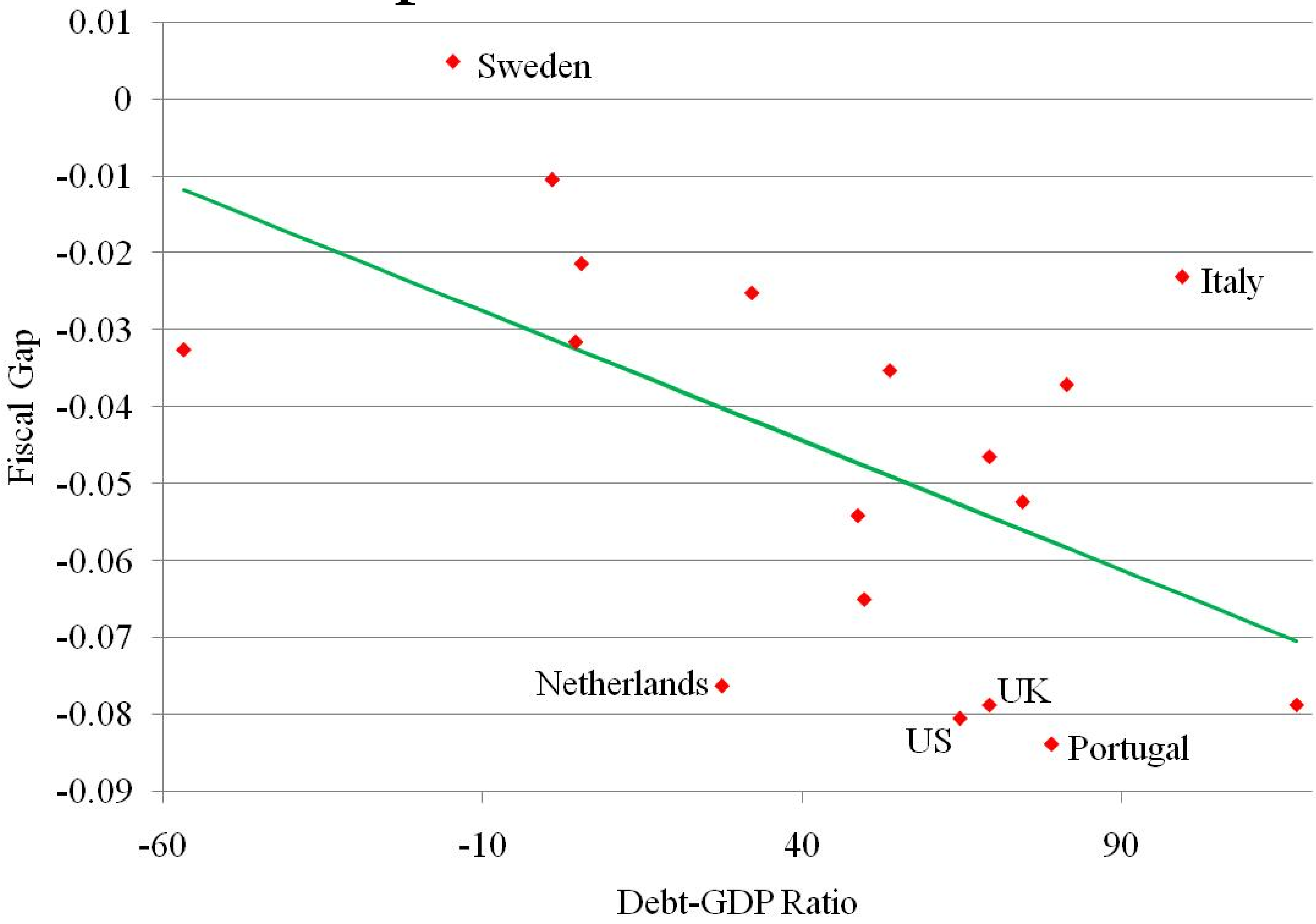
Fiscal Imbalances around the World



Fiscal Imbalances around the World



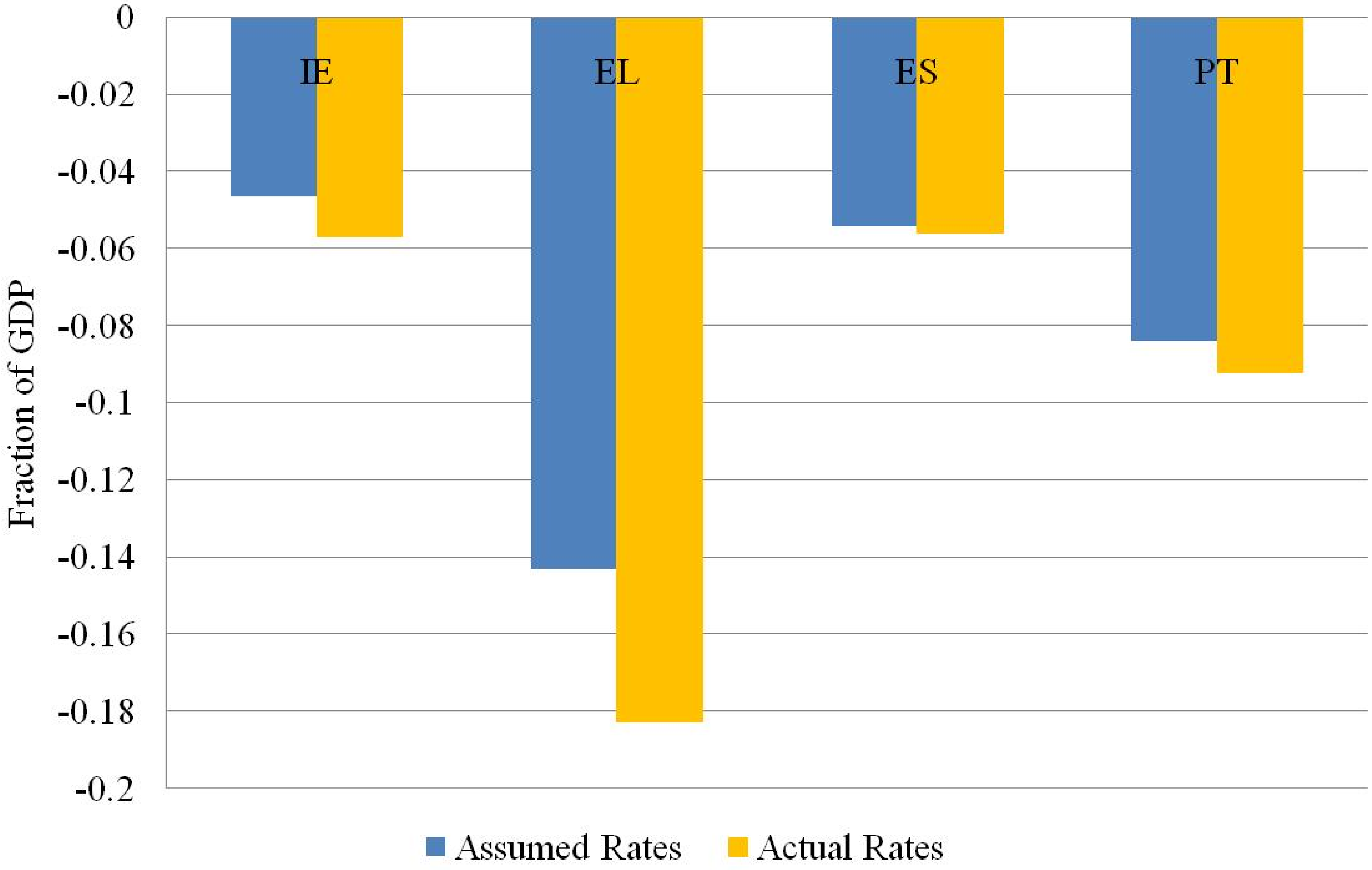
Fiscal Gaps and Debt-GDP Ratios



Further Issues

- What if current interest and growth rates are used?

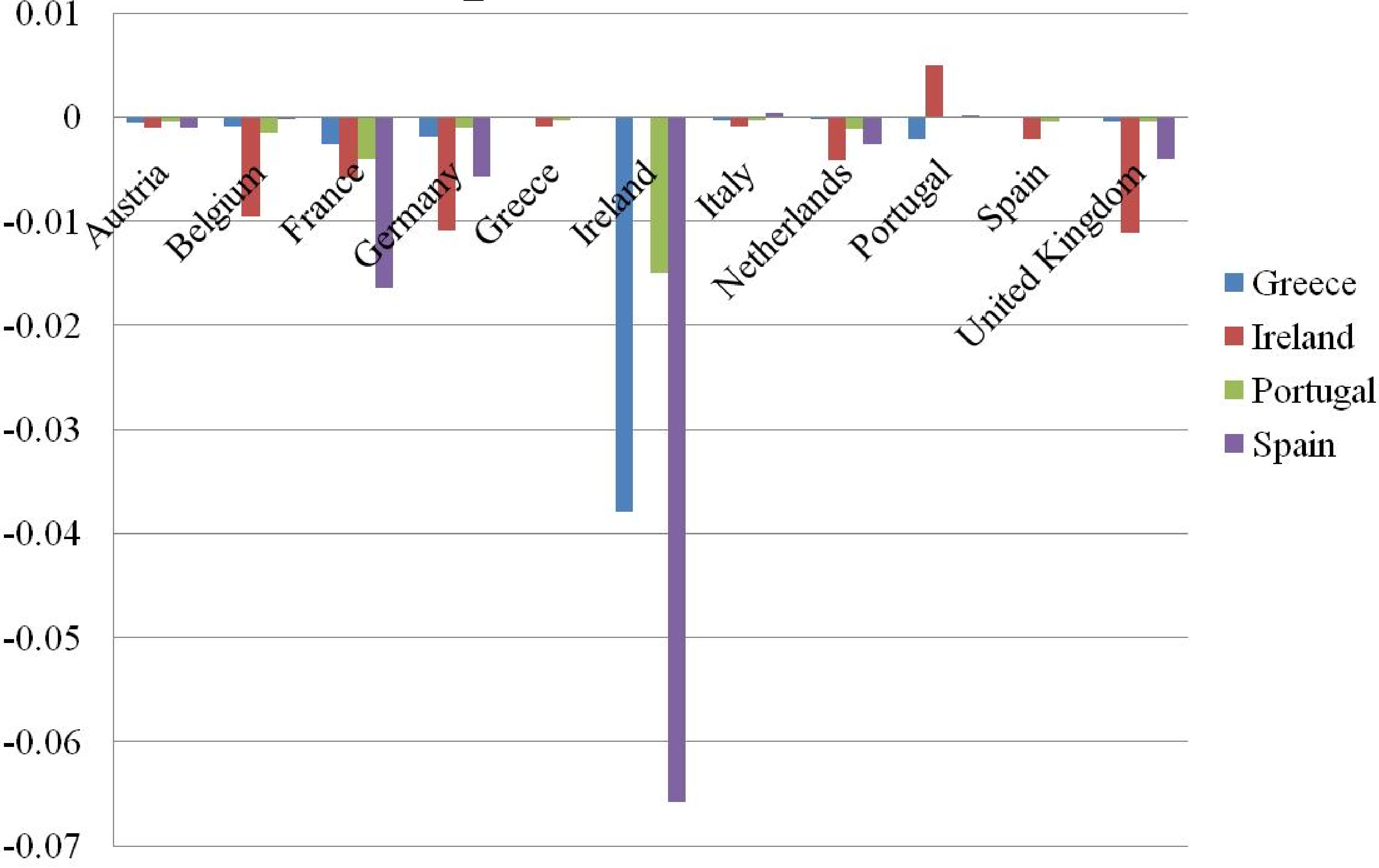
Fiscal Gaps and Assumed Rates



Further Issues

- What if current interest and growth rates are used?
- What about contagion and cross-border exposure?
  - Lots of cross-border exposure, which makes this a serious issue; but…

Change in Claims Relative to GDP, Sept. - Dec. 2010



What Determines Risk?

- Hard to tell precisely, but regressions explaining CDS spreads and Eurozone yield differentials (relative to Germany) indicate that fiscal variables matter, particularly surplus-GDP ratio, and that external exposure exacerbates risk

The Path Forward

- Can fiscal rules help?
  - Performance to date not promising
  - Even harder to implement and enforce given central importance of implicit liabilities

The Path Forward

- Fiscal councils may be more promising
  - Use own projections and judgment
  - Can utilize more varied measures that would be hard to incorporate in rules
  - An important auditing function, to inform policy makers and voters as well as markets
  - Not realistic to view them as having power to set fiscal aggregates; analogy to monetary policy is limited

The Path Forward

- Given the nature of looming gaps (implicit liabilities, age-based programs), need to modify and expand common wisdom in designing adjustment plans
  – Longer adjustments may be needed
  – Important to consider generational consequences of particular ways of reducing deficits
  – “Taxes” and “Spending” particularly not well defined categories