Long-Term Fiscal Sustainability in Major Economies

Alan J. Auerbach
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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

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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
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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
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
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Fiscal Imbalances around the World

The chart shows the fraction of GDP for various countries under different scenarios:
- Baseline
- No Initial Debt
- No Pension or Health Growth

Countries include AT, AU, BE, CA, DE, DK, EL, ES, FI, FR, IE, IT, JA, NL, NO, NZ, PT, SE, UK, USA.
Further Issues

• What if current interest and growth rates are used?
Further Issues

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• 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