

The slippery fiscal space

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I. Introduction

Ladies and gentlemen, I am pleased to be able to address you in the newly expanded premises of the BIS Representative Office for the Americas here in Mexico City. I thank everyone for their attendance and especially Governor Carstens for his persistent efforts in promoting cooperation among the region's central banks and for supporting the activities of our office.

As some of you may know, the Americas Office was opened in 2002. Since 2008, when the Consultative Council for the Americas (CCA) was created, the Office's activities have expanded considerably. The CCA is made up of Governors of the eight BIS shareholding central banks in the Americas region, from Argentina, Brazil, Canada, Chile, Colombia, Mexico, Peru and the United States. The CCA advises the BIS on its activities in the Americas region in areas of interest to central banks. BIS Americas Office staff, in close cooperation with their colleagues in Basel, also coordinate the cooperative CCA central bank activities in the areas of macroeconomic and monetary policy research, central bank market operations and financial stability.¹ I also want to thank Enrique Alberola and the Americas Office team for their excellent work.

Let me now turn to the substance of my presentation about what fiscal policy can do to boost growth. Nearly 10 years after the onset of the Great Financial Crisis (GFC), output growth and investment are still disappointing, and real wages have stagnated.

These developments seem to reflect more than just a cyclical downturn, and suggest the effects of structural factors and the complexities associated with a balance sheet recession. Productivity growth has slowed in most OECD economies, in most sectors and for both small and large firms. In the EU over the past decade (2006–15) growth in GDP per hour worked has been 0.8% year on year, down from 1.7% in the previous decade. The slowdown in the United States has been even more pronounced: from 2.4% to 1.0%. Productivity growth has also fallen in emerging market economies (EMEs), partly reflecting the transition from industrial to service economies. This drop is worrying, as productivity is the principal factor in sustainably improving standard of living.

The slowdown in the advances in productivity is associated with a shift of resources towards low productivity growth sectors in the boom phase of the financial cycle. Recent BIS research² shows that there is a close relationship between productivity developments and the financial cycle. In particular, the credit

¹ For more information, see www.bis.org/about/repoffice_americas.htm.

² See Borio et al (2015).

boom prior to the crisis undermined productivity growth because it caused resources to be reallocated towards more credit-intensive sectors with low productivity growth as the boom occurred; for example, temporarily bloating the real estate sector. The impact of the reallocation of resources on productivity growth was significant and persistent, continuing after the crisis when the financial cycle abruptly entered the bust phase.

Overall, there seems to be no quick and easy fix for slow economic growth. Monetary policy is not the long-term solution, and there is a growing consensus that it has probably reached its limits in sustaining economic growth. In Latin America, the room for monetary policy stimulus has in any case been limited because inflation has picked up significantly in recent years – even as growth has declined – and some central banks have had to tighten monetary policy to counter inflationary pressures.

Against this background, there are increasing calls to adopt expansionary fiscal policies. As the BIS has suggested, there is a need for more balanced policies, including fiscal policy, that put more emphasis on structural reforms and balance sheet cleansing. For most of the period since the GFC, there has been too much reliance on monetary policy to support growth. There is a risk that fiscal policy will be overburdened in a similar way, adding new imbalances instead of correcting them, and posing risks to macroeconomic and financial stability. For this reason, while fiscal policy can play a positive role in supporting growth, it would be a mistake to abandon fiscal prudence.

I will structure my remarks in three parts. First, I will discuss the margin available for fiscal stimulus. Some estimates suggest that there is ample fiscal space in a number of countries, but I will highlight some reasons why these estimates should be viewed with caution.

Second, I will note that policymakers should take into account the potential negative feedback between private and public debt. High levels of private debt imply that fiscal space may be much more limited and slippery than public debt levels alone suggest. That is, it is more difficult to change direction and bring debt back onto a downward path.

Finally, I will talk about sustainable fiscal policies that could support medium-term growth by supporting reforms that promote a better allocation of resources and productivity growth.

II. How much fiscal space is available?

What is the amount of available fiscal space to stimulate growth? Recent trends in public debt and fiscal adjustment offer a mixed picture.

On the one hand, after worsening sharply after the 2008–09 recession, fiscal positions measured by primary balances in most advanced economies have started to improve. Primary deficits, which reached unsustainable levels in the United States and Japan, have narrowed and real interest rates have fallen to well below the rates of economic growth. As a result, the growth in public debt has slowed. On the other hand, public debt has been on a rising trend in advanced economies for an extended period and is currently at a historical high in several countries. The expansion in public debt has generally coincided with a rise in social transfers, which are hard to scale back.

The fiscal situation of Latin America is apparently better due to much lower debt levels, but conditions are now more challenging because of the end of the commodity boom, the continued slowdown in growth and some tightening financing conditions. Primary balances have deteriorated significantly and debt has markedly increased since 2013.

Some recent estimates suggest that several countries have ample fiscal space in the sense that they are still far away from their debt limit – that is, they have the room to raise their public debt without

causing market strains or provoking investors to question their creditworthiness.³ These estimates suggest that debt limits are over 150% of GDP in Germany, the United Kingdom and the United States and, given current debt levels of around 100% of GDP, would indicate that relatively large fiscal space exists in those countries. By contrast, the estimated fiscal response is insufficient to stabilise debt in Japan and Italy, suggesting a lack of fiscal space there.⁴

How much can we rely on these estimates? We should interpret them with caution for several reasons. First, even small changes to the parameters of the underlying model could alter debt limit estimates significantly (by up to 100% of GDP).

Second, estimated debt limits are largely based on extrapolation. Few countries have experienced debt levels anywhere near the estimated debt limits. It is possible that financial markets would react, raising risk premia *well before* those estimated limits are reached. Thus, while fiscal space may be estimated using an economic framework that suggests that debt is sustainable, in practice the effective fiscal space is determined by market perceptions and liquidity, which are uncertain and may shift abruptly. In addition, evidence suggests that market participants may evaluate EMEs' debts more severely.

Third, fiscal space estimates often ignore factors that may make it difficult to stabilise public debt. One is declining population growth and ageing, which – in the absence of corrective measures – will tend to reduce primary balances. In particular, estimates of fiscal space may not include implicit liabilities from ageing populations or contingent liabilities due to possible future financial crises. It is estimated that in a sample of 80 advanced and emerging market economies during 1990–2014, the average cost of realised contingent liabilities from financial crises was 6% of GDP and reached almost 60% in some cases.⁵ Another factor is the possibility that low long-term interest rates, which have improved the estimates of fiscal space in recent years, may reflect unsustainable bond market pricing amid unusually easy monetary conditions. For those reasons, the risk of a snapback and a sudden reduction of financing and fiscal space cannot be ruled out.⁶

III. The implications of private debt

While I have focused so far on public debt, private debt is also relevant for fiscal space. Banks and public sector balance sheets (and therefore fiscal policy) are potentially linked by adverse feedback loops. For example, a deleveraging and downturn in the financial sector can lower public revenues. The deterioration in the fiscal position can in turn impose significant risks for banks holding sovereign bonds, weakening bank balance sheets.

In line with this, sovereign and bank credit default swap (CDS) spreads tend to influence each other. Studies show that bank CDS spreads rise when sovereign CDS spreads rise, and vice versa. Moreover, CDS spreads and the feedback effects tend to be larger in countries with weaker fiscal positions, and where the share of domestic sovereign debt in bank assets is higher. The fact that sovereign and financial risks reinforce each other was illustrated by the recent euro area debt crisis and, closer to home, by the Mexican crises of the 1980s and of 1994.

³ See, for example, Ghosh et al (2013) and Zandi et al (2011). Debt limits are normally calculated based on (present discounted value) estimates of the maximum average primary fiscal surplus that a country can ultimately sustain. More concretely, a fiscal reaction function is fitted to the data in which the primary surplus responds to public debt, and the response of the fiscal authorities is allowed to diminish as debt increases. A recent method calculates such an average surplus on the basis of historical experience, while allowing for political and economic considerations that prevent persistent increases in fiscal surpluses.

⁴ See BIS (2016), Box V.B.

⁵ See Bova et al (2016).

⁶ See, for example, Feroli et al (2014).



In this context, some recent developments are grounds for concern. First, global debt levels (public and private non-financial debt) currently stand at about 250% of GDP. This is an all-time high, and two thirds are private sector debt. Estimates of fiscal space that ignore private sector debt may thus be significantly overstated. Furthermore, feedback loops between the public and financial sectors may be large during periods of stress, posing significant financial and macroeconomic stability risks.

Second, in some cases global debt levels remain high because of limited and insufficient reductions in private debt since the crisis. Before the GFC, a large proportion of the increase in total debt in advanced economies was due to rising private debt. Public sector debt has since grown rapidly in this group of countries, due to the loss of tax revenues and higher spending in response to the crisis-induced downturn and, in some cases, direct support to troubled financial institutions. Reductions in private debt are needed to improve macroeconomic and financial stability and lay a solid foundation for sustained growth, but adjustment has been uneven. There are signs of adjustment in the United States, the United Kingdom, Spain and a few other countries, but at the aggregate level private debt has continued to grow, particularly in EMEs.

IV. Growth-enhancing fiscal policies

Given the uncertainty about the available fiscal space, traditional fiscal measures, which simply aim at boosting aggregate demand, may be effective in the short run, but the beneficial effects are likely to be only temporary, while the costs may be more persistent. If fiscal space is utilised and reduced significantly, risk premia may rise and financial conditions for the private sector worsen, which could in turn lead to a decrease in private investment, and with it growth. Reduced fiscal space also means that policy has less room to stabilise the economy in a downturn or during situations of stress – and room for manoeuvre is necessary at times like the present, given the heightened and harder to forecast geopolitical risks. Furthermore, servicing a higher debt may eventually require higher distortionary taxes or less productive spending, depressing economic activity even further. Thus, conventional short-term stimulus, by raising public debt, may exacerbate the headwinds to medium- and long-run growth.⁷

If public debt rises, fiscal space and fiscal policy effectiveness may be reduced in the future. Hence, for fiscal policy to be effective, it needs to be designed so as to boost total factor productivity (TFP) and growth over longer-term horizons. In fact, measures that boost growth do not necessarily imply more taxes or debt. First, structural or long-run spending composition and taxes can be tweaked to sustain higher public investment or less distortionary taxes. Second, current taxes and transfers could be better directed and designed. Third, without compromising public services, public spending could be reduced by cutting wasteful spending and improving the efficiency of public administration. Obviously, the exact mix of those measures will depend on the specific circumstances of each country.

In this context, three types of fiscal measures could help: infrastructure spending, well designed tax incentives and human capital investment.

Turning first to *infrastructure spending*, in some countries infrastructure is ageing fast and needs to be upgraded, and new facilities are needed to ease bottlenecks. More and better infrastructure could

⁷ Following a contribution by Reinhart and Rogoff (2010), several empirical studies have found a negative link between public debt and trend growth, including Cecchetti et al (2011). See Table IV.A in BIS (2013). Addressing some of the criticisms to this earlier literature, Chudik et al (2016) find a significant negative effect for countries with debt over 50–60% of GDP provided debt is on an upward trajectory. Their findings are robust to feedback effects from growth to debt. Jordà et al (2016) show that the level of public debt amplifies the costs of a financial crisis. The higher the public debt at the onset of the crisis, the deeper the recession and the slower the recovery. High public debt is also likely to reduce the effectiveness of fiscal policy. Ilzetzki et al (2013) show that if public debt is sufficiently high, short-run fiscal multipliers can be small or even negative.

increase productivity levels and lead to complementary private investments.⁸ Unfortunately, in advanced economies, public investment has fallen from around 4% of GDP in 1980 to 3% in 2014.⁹ There is even more scope for infrastructure investment in EMEs, given their low physical infrastructure per person when compared with advanced economies: in the case of power generation capacity, this relationship is one fifth.

As for *tax incentives for investment*, empirical research suggests that lowering corporate taxes or tax breaks for research and development could increase productivity¹⁰ if, for example, those taxes increase investment in high-productivity sectors. Lowering taxes could also increase the efficiency of resource allocation and the incentives to become an entrepreneur by improving the expected post-tax return.

With respect to *human capital investment*, empirical studies confirm the importance of investment in health and education, especially in less developed economies. This investment could be directed not only through higher spending in education, but also through tax credits or deductions for education expenses.¹¹

Increasing spending and cutting taxes to boost growth supposes the adoption of other compensatory measures to limit or stop budget expansion. For example, it could be necessary to reduce other costs or shift the tax burden towards indirect and property taxes, which usually dent growth less. At the same time, efforts should be made to widen the tax base, to fight tax evasion and to improve the efficiency of public services. Furthermore, it would be necessary to curb the expected increase in public spending coming from population ageing.

Fiscal policy, if appropriately targeted in the medium and long term and combined with reforms, can thus help meet the need for productivity-enhancing public and private investments. Such reforms can facilitate the reallocation of resources to more productive sectors. Furthermore, fiscal policy, used in tandem with structural reforms, could cushion the possible short-term contractionary impact of certain reforms.

V. Conclusion

How far can fiscal policy support growth? Let me summarise my views.

As the result of disappointing growth in many countries, there are renewed calls for a more active fiscal policy. However, estimates of the margin for fiscal stimulus based on the calculation of fiscal space are very sensitive to assumptions and subject to uncertainty, and therefore could overestimate true fiscal space. In particular, adverse shifts in market sentiment are hard to predict and could in practice sharply reduce fiscal space. Furthermore, large stocks of private debt can interact with public debt in ways that can reduce fiscal space and threaten macroeconomic and financial stability.

Fiscal space is uncertain and slippery in the sense that it is difficult to put public debt back onto a downward path, particularly when financial markets change their assessments and tighten requirements for sustainability. Thus it would be prudent not to interpret current estimates of fiscal space (and associated debt limits) as boundaries that can be safely tested. Hitting these boundaries can be extremely costly. Even short of default, episodes of severe market stress can have large and persistent effects on the real economy. Furthermore, the higher risk premia, higher taxes and restricted room for policy manoeuvre that

⁸ More generally, appropriately targeted public investments, for example in network industries in the EU, could encourage private investment. See OECD (2015).

⁹ See IMF (2014).

¹⁰ See Pombo and Galindo (2011) and Vartia (2008).

¹¹ See, for example, IMF (2015).



may accompany higher levels of public debt might constitute a further drag on medium- and long-term growth.

Uncertainty about fiscal space, or its absence, does not preclude the use of fiscal measures to boost growth. While the effects of conventional fiscal stimulus may be temporary, fiscal measures can seek to support and strengthen structural reforms that can boost productivity growth in the medium term. This combination of fiscal measures and reforms can also reduce the risk of overburdening fiscal policy in much the same way that monetary policy has been overburdened since the GFC.

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