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### **Who's Afraid of the National Debt?**

The outlook for government finances in many advanced economies was already perilous due to the prospect of rising pension and health care costs, but the financial crisis made matters even worse. How to achieve a soft landing? The recently released IMF Fiscal Monitor quantifies the fiscal challenge and presents a broad outline of policies to achieve orderly adjustment, while enhancing economic efficiency (available at <http://www.imf.org/external/np/exr/key/fiscal.htm>).

During the past decades, concerns about the fiscal health of low income countries and emerging markets kept policymakers and investors on the edge, with periodic defaults and rescheduling of external debt, sometimes coinciding with disruptive currency and banking crises. It appears that the tables have turned though. Emerging economies as a group are now in much better fiscal shape than the advanced economies, with lower deficits, stronger growth, and declining debt ratios.

At this juncture, indeed, it is sovereign debt fears that imperil the advanced economies and reverberate through global financial markets. The drivers of debt dynamics can be illustrated by the following inconvenient truth: a country's debt trajectory depends on its current debt level and the expected primary deficits of the government, now and in the future. A higher real interest rate makes the debt less sustainable, while stronger economic growth works in the opposite direction. The foreign currency component of the debt becomes more costly to service if the exchange rate depreciates. Any pressure becomes more severe and acute if the country's debt has a relatively short maturity structure.

Before the global financial crisis, there were already doubts about debt sustainability in advanced economies. The key concern at that time was the expectation of higher primary deficits over the medium term, due to structural spending pressures associated with population aging and associated health care and pension costs.

In advanced G-20 economies, the crisis-related deterioration of fiscal balances further fueled the fire. The reasons for this include the operation of automatic stabilizers, the deterioration of the fiscal balance due to lower potential growth compared to pre-crisis trends, revenue losses from lower asset prices and financial profits, and higher interest spending. About three quarters of the 39 percentage point increase in the debt-to-GDP ratio in these countries reflects the combined operation of these factors. The good news here is that the bulk of the deficit increase should be reversed as the economy recovers; the bad news is that some of the revenue is gone forever (as potential output is permanently lower).

Unlike the general belief, fiscal stimulus and financial sector support play only a minor role in the debt evolution. While their contributions to debt dynamics were small, nonetheless, these were important in sustaining aggregate demand at the most critical juncture.

Although unsustainable for a while, it appears that markets and policymakers saw little urgency in fixing the debt situation. Greece's debt situation was a wake-up call for advanced economies. When Greece announced that its deficit was much higher than previously reported, its debt (already high) became less sustainable, leading investors to sell Greek bonds, in turn causing interest rates to rise, expectations for economic growth to decline, and the euro to depreciate, all making the debt path even more unattractive. In turn, sovereign credit problems could adversely affect the financial sector through losses on holdings of sovereign and, in some cases, corporate debt, further adding to the bearish sentiment.

The recognition to repair government balance sheets in many countries has now clearly settled in. The key issue is how to do this without undermining the global recovery. As fiscal room varies, fiscal responses need to be adapted to the individual circumstances of each country. Countries that are facing market pressures have no choice but to go ahead with forceful fiscal adjustment, even if this means slower growth. Structural reforms, as envisaged in the Lisbon Strategy, can support growth during this adjustment phase. The key reforms include making the labor market more dynamic, removing disincentives to work embedded in various public policies, enhancing wage bargaining flexibility, further liberalizing services sectors, and higher outlays on R&D.

Other advanced economies and emerging markets with high debt levels need to announce credible medium-term consolidation plans to convince markets and the public at large that future primary deficits will be lower even if the fiscal stance remains accommodative in the near term. The key word here is credible, and where applicable these plans require comprehensive reforms to pension and health systems, and other entitlement programs, as well as revenue measures, where base broadening and higher indirect taxes (VAT and excises) as well as taxing pollution more heavily are the preferred way to go.

As a general lesson, the crisis has also highlighted the importance of anchoring the annual budget in a credible and binding medium-term budget framework with greater independent scrutiny. Such a framework can be supported by numerical fiscal rules to guide policy and anchor expectations. The breadth, depth, and timeliness of fiscal reporting, including risks, could also be improved in many countries.

Prudent debt-management strategies are vital as well. As the yield curve usually slopes upward, borrowing at longer maturities is more costly, but also provides some insurance against sudden shifts in investor risk aversion. Greater reliance on borrowing in domestic currency provides protection from sudden swings in exchange rates. Countries will be able to take advantage of these strategies with a deeper financial system, particularly the pension and insurance industries as these are usually the key takers for longer-dated debt papers.

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