

# Challenges of Budgetary and Financial Crisis in Europe



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London School of Economics and Political Science  
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# Fiscal Monitor, September 2011

World Economic and Financial Surveys

## Fiscal Monitor

**Addressing Fiscal Challenges  
to Reduce Economic Risks**

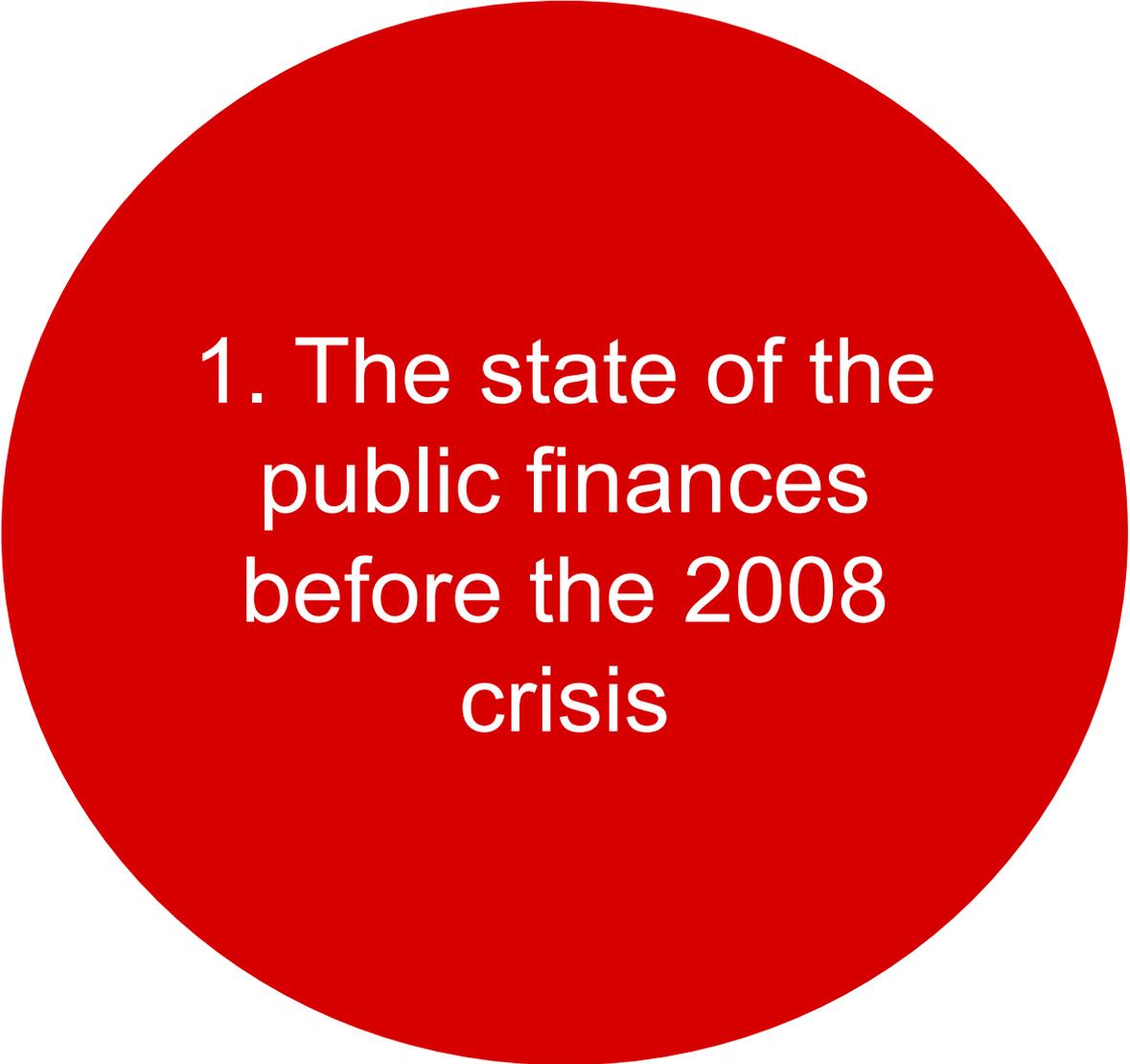


SEP **11**

I N T E R N A T I O N A L M O N E T A R Y F U N D

# Overview

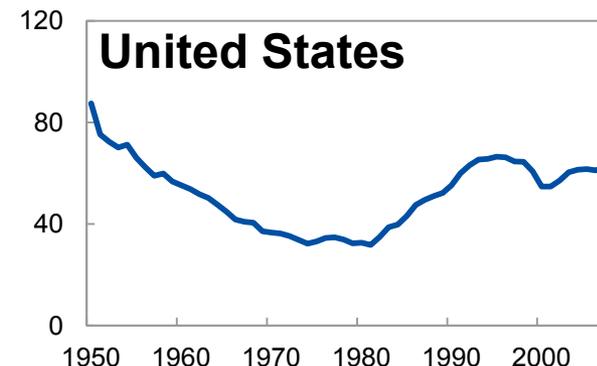
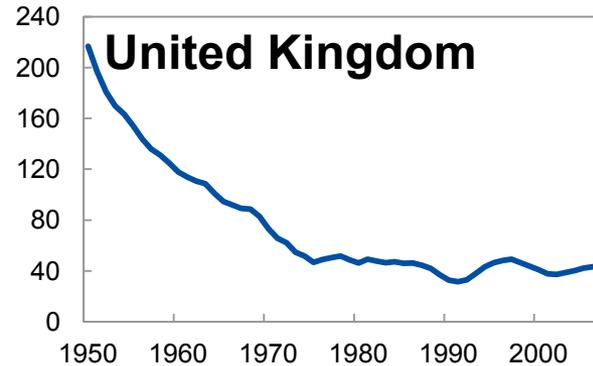
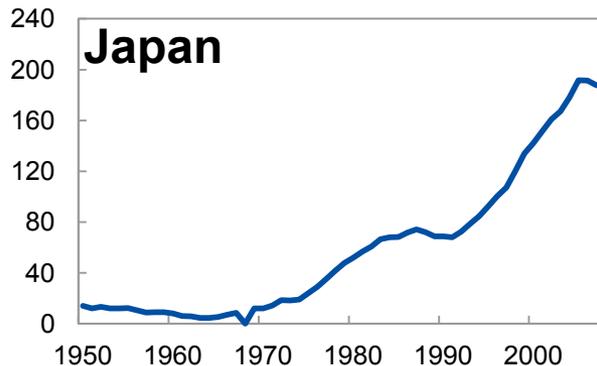
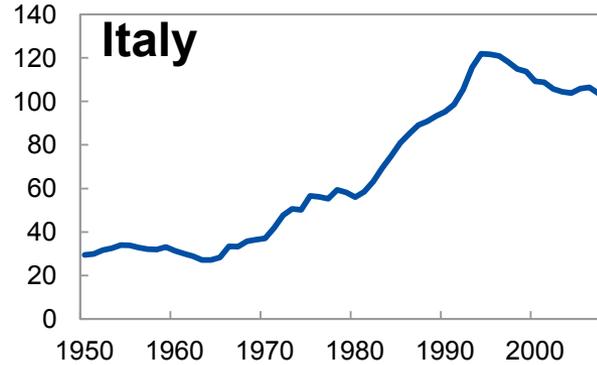
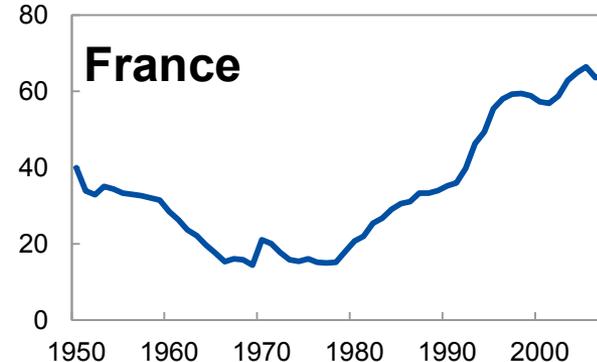
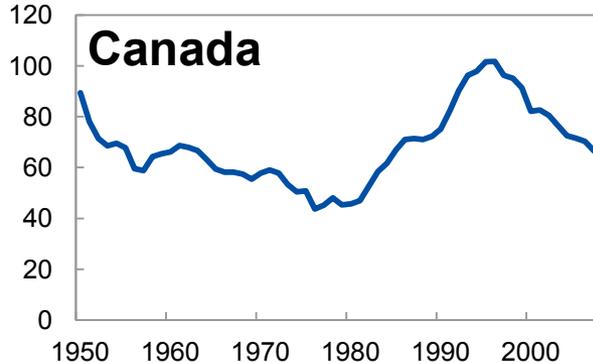
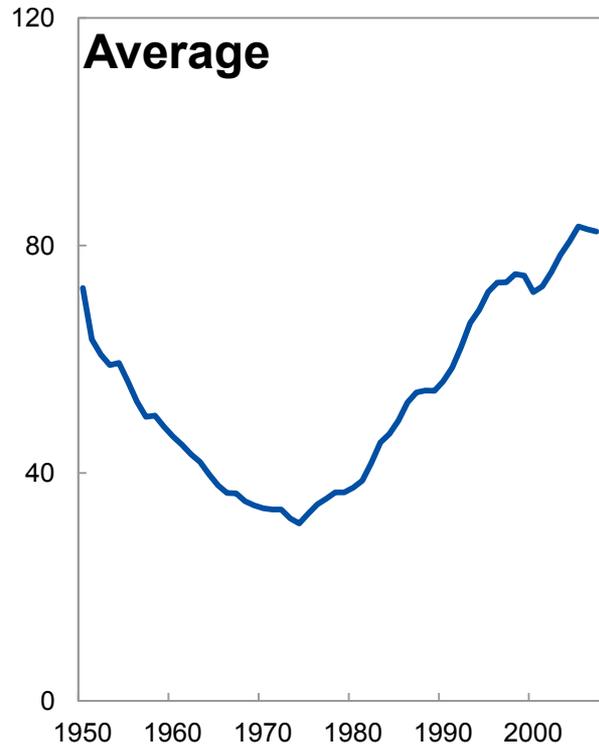
1. The state of the public finances before the 2008 crisis
2. The effect of the crisis on the fiscal accounts
3. The risks arising from the current situation
4. Policy conclusions



1. The state of the  
public finances  
before the 2008  
crisis

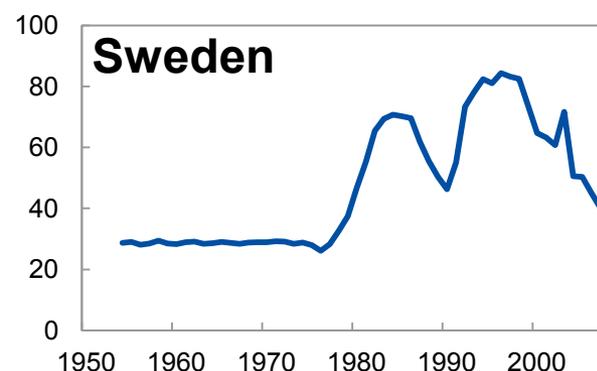
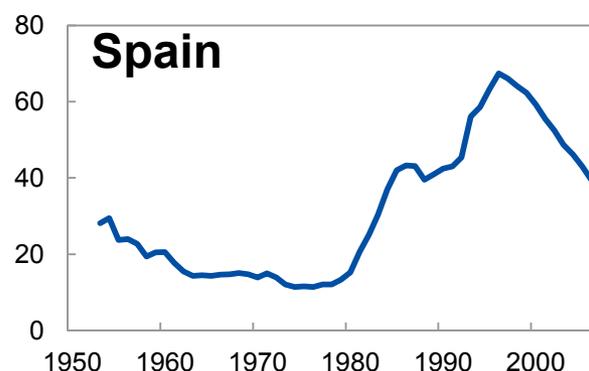
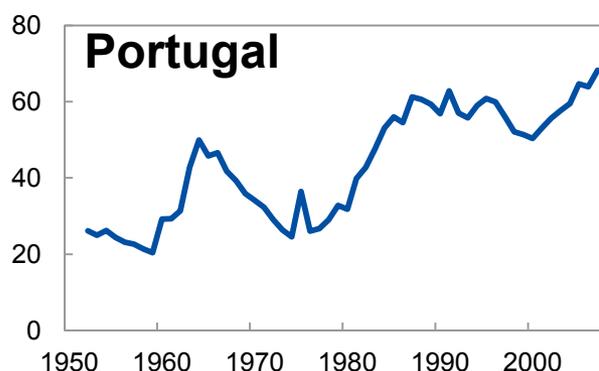
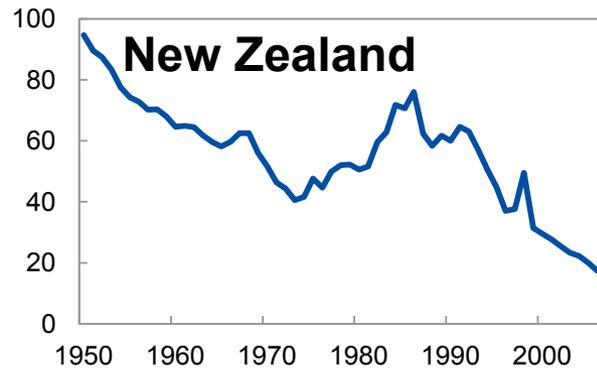
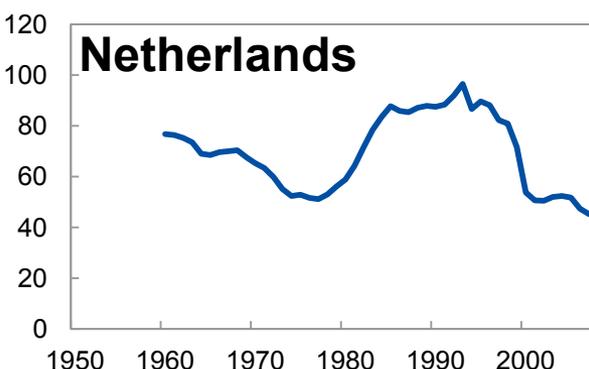
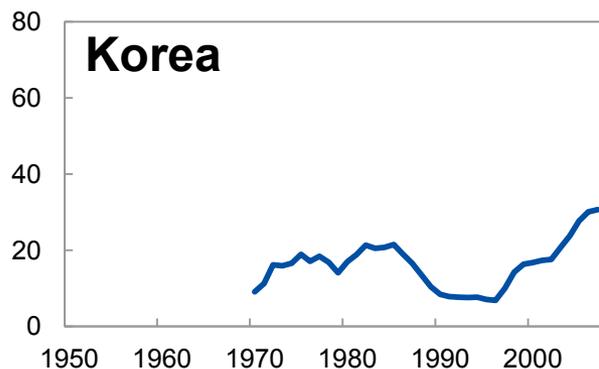
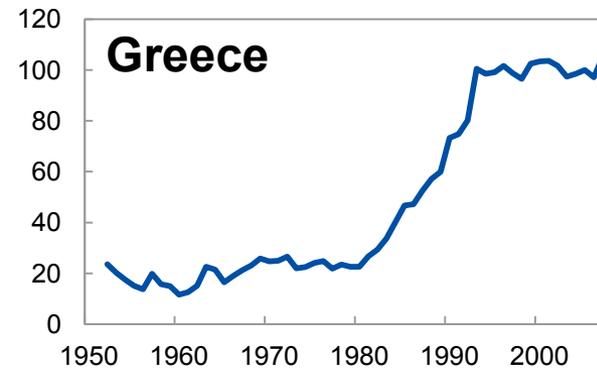
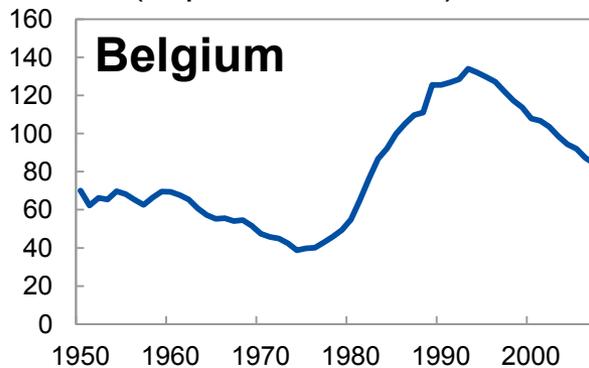
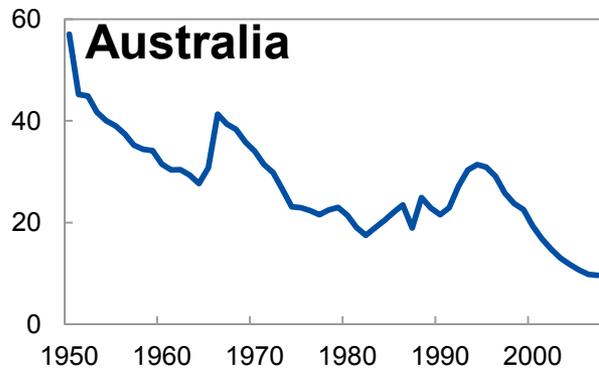
# General Government Gross Debt in G-7 Economies, 1950-2007

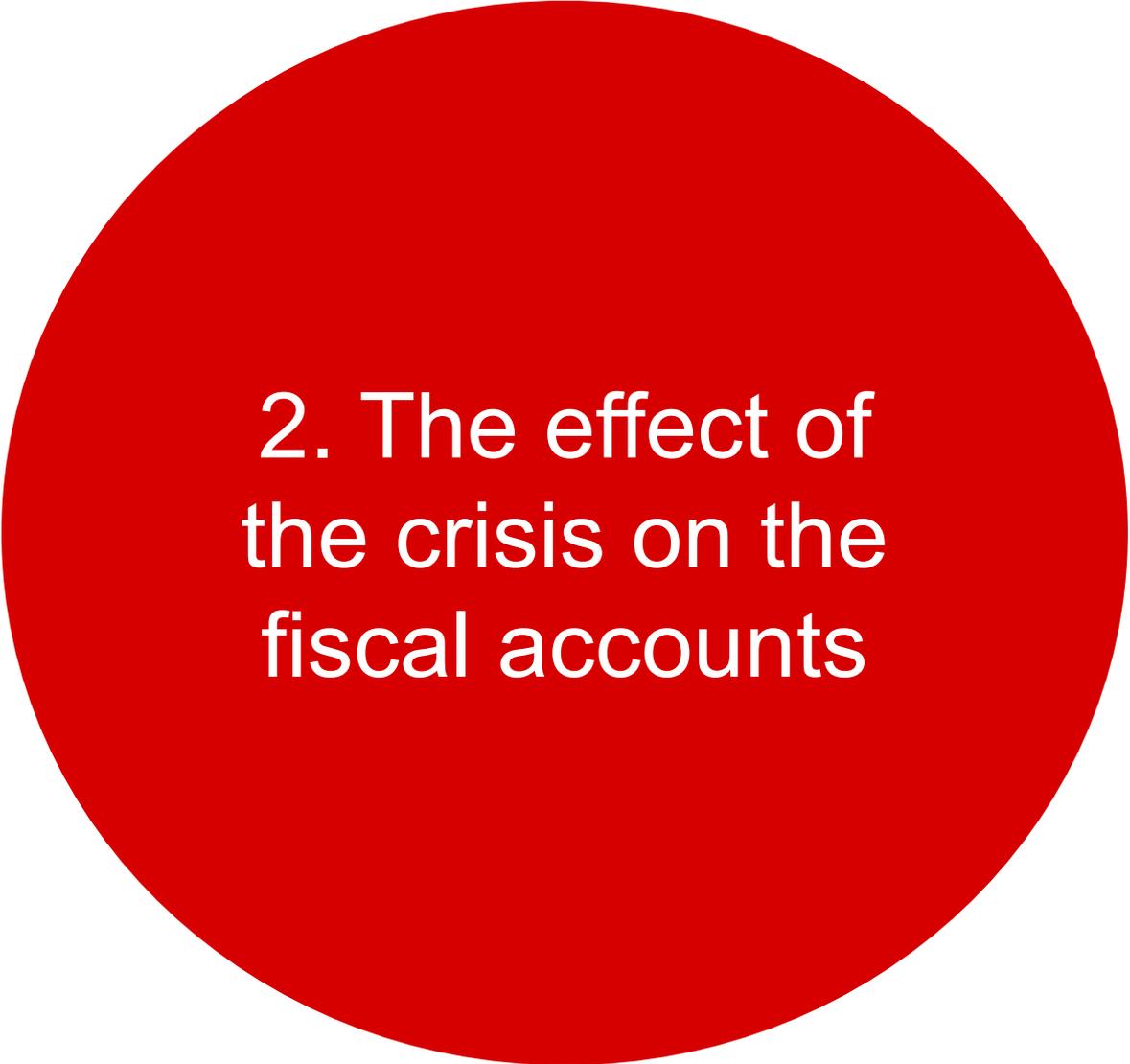
(In percent of GDP)



# General Government Gross Debt in Selected Advanced Economies, 1950-2007

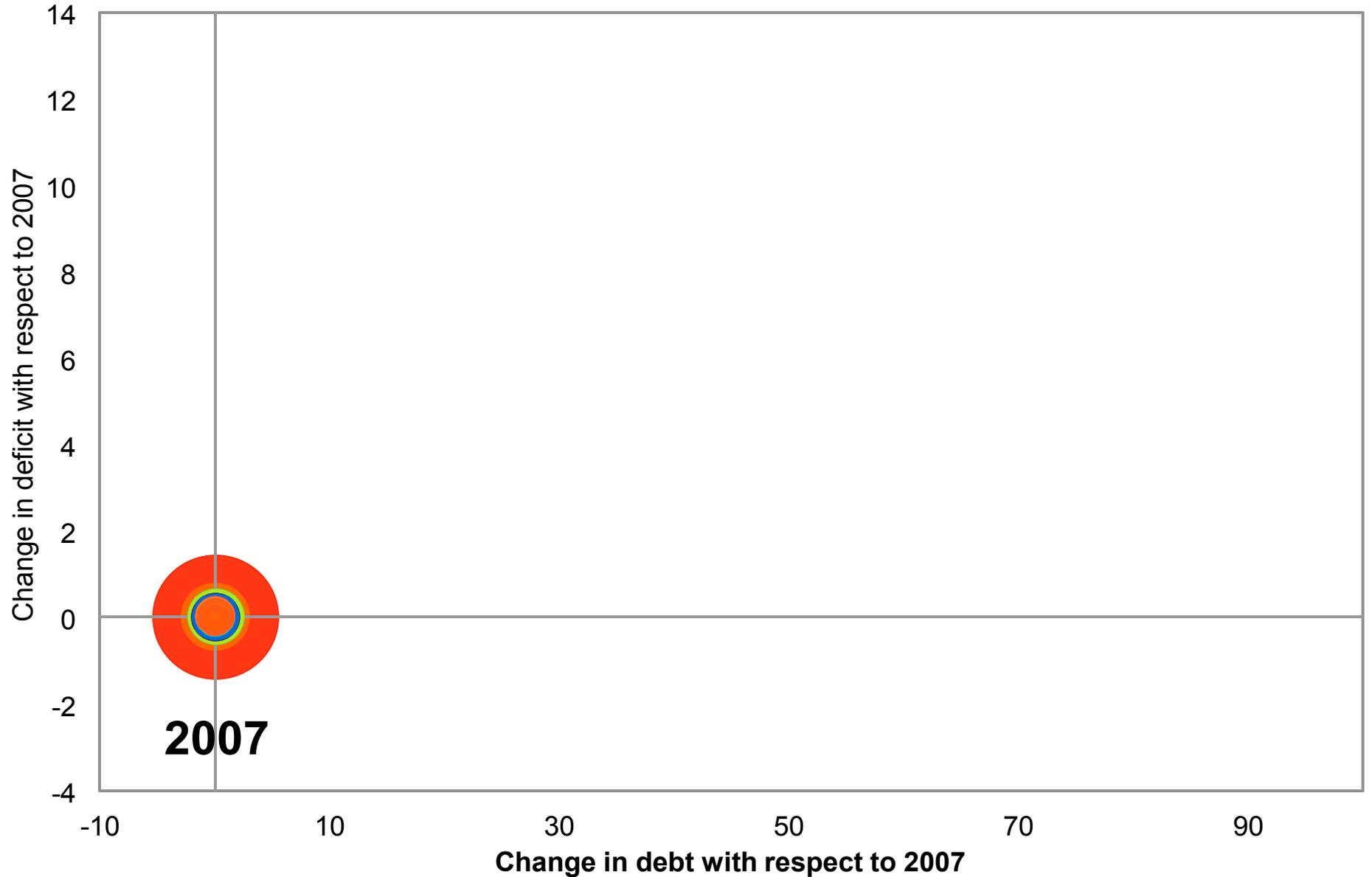
(In percent of GDP)



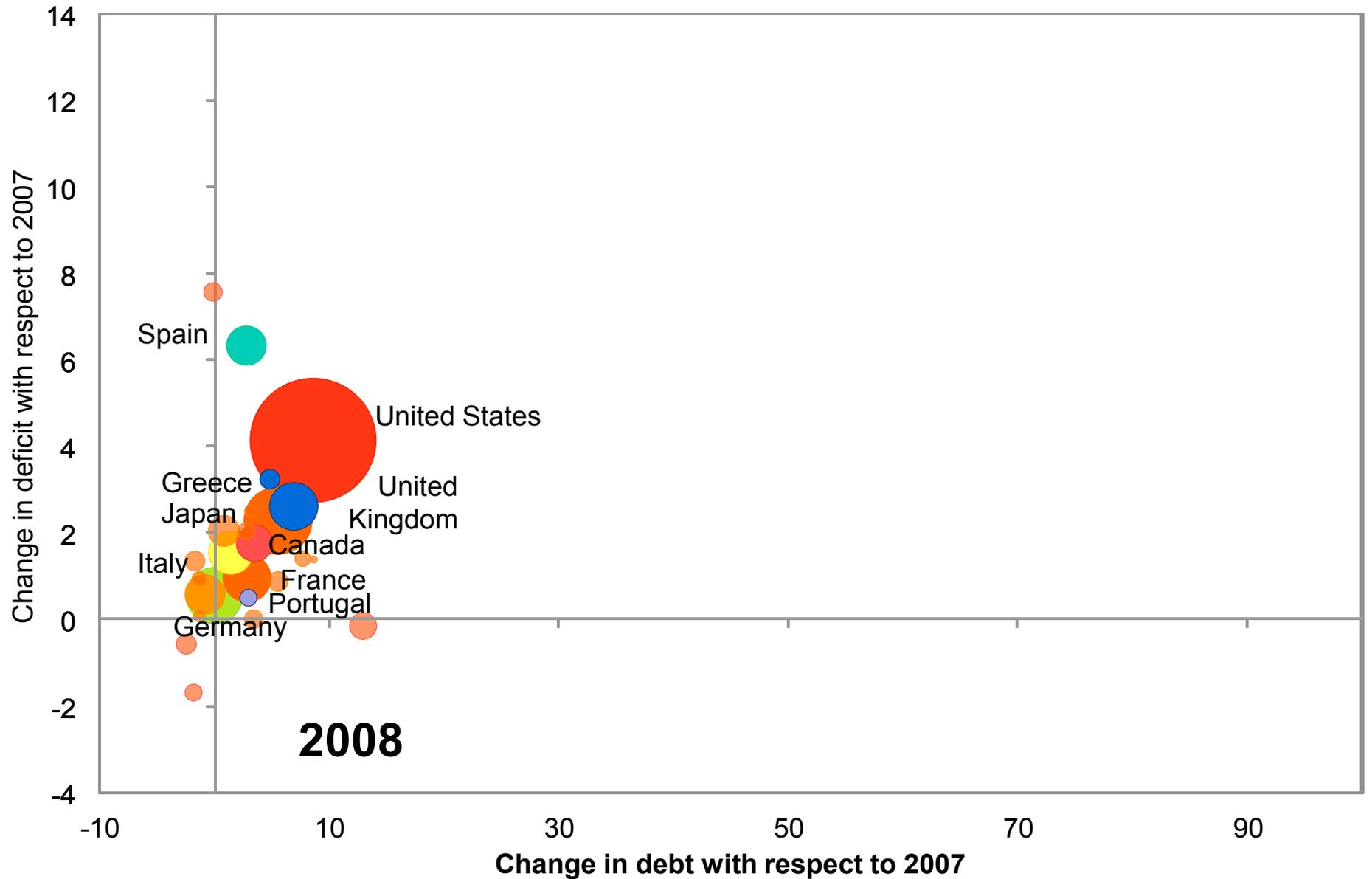


## 2. The effect of the crisis on the fiscal accounts

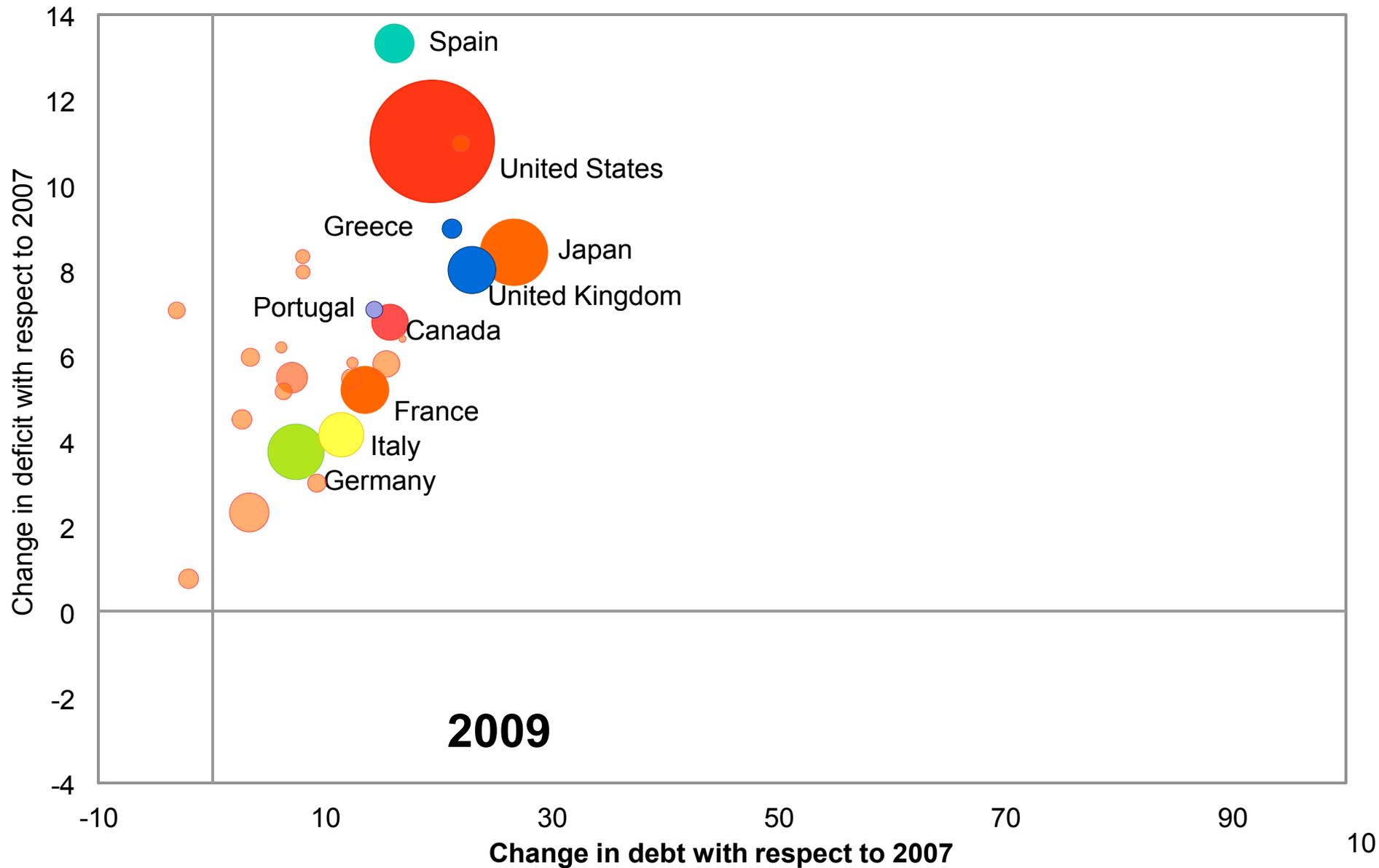
# Change in General Government Debt and Deficit: Advanced Economies



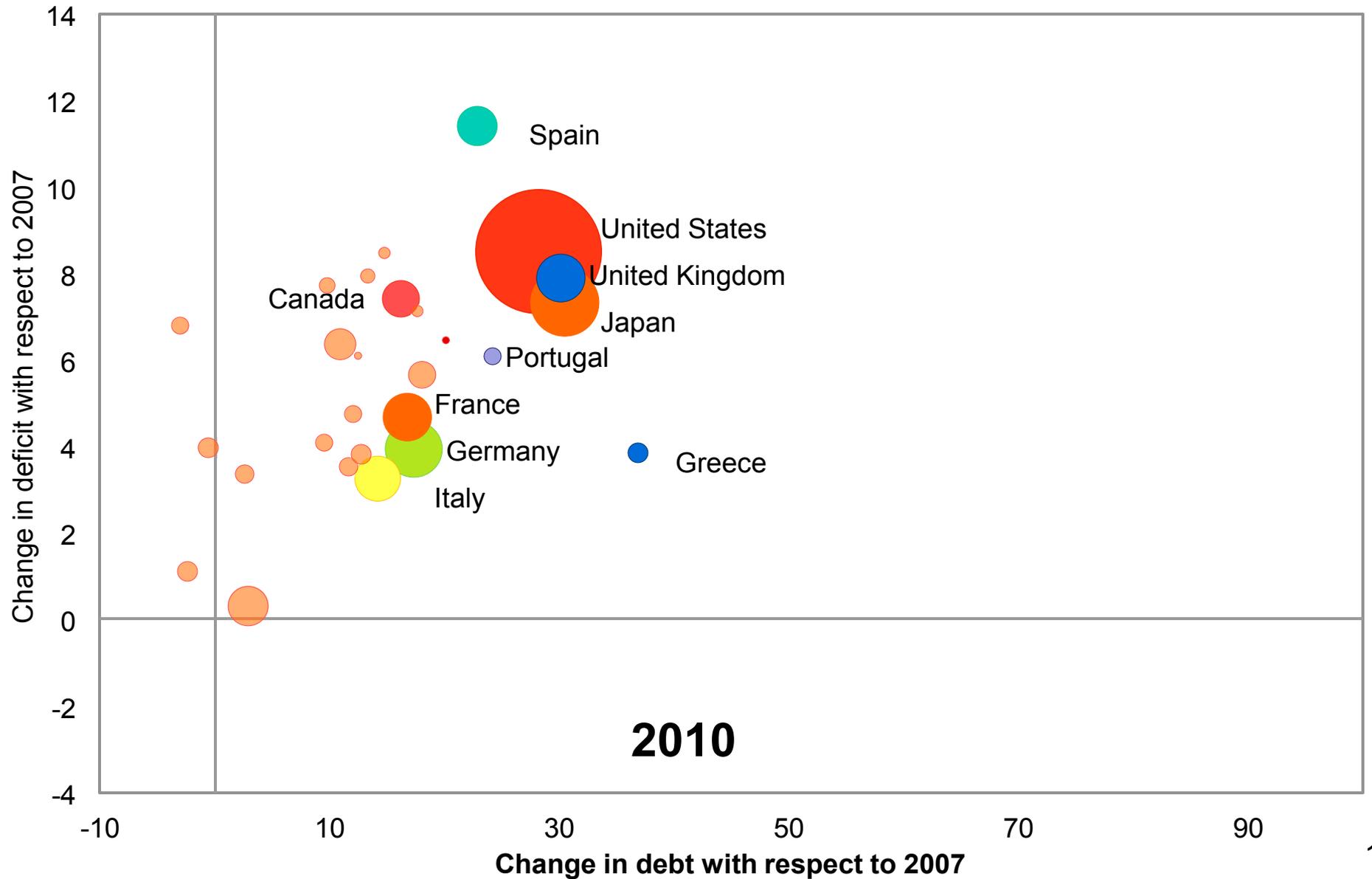
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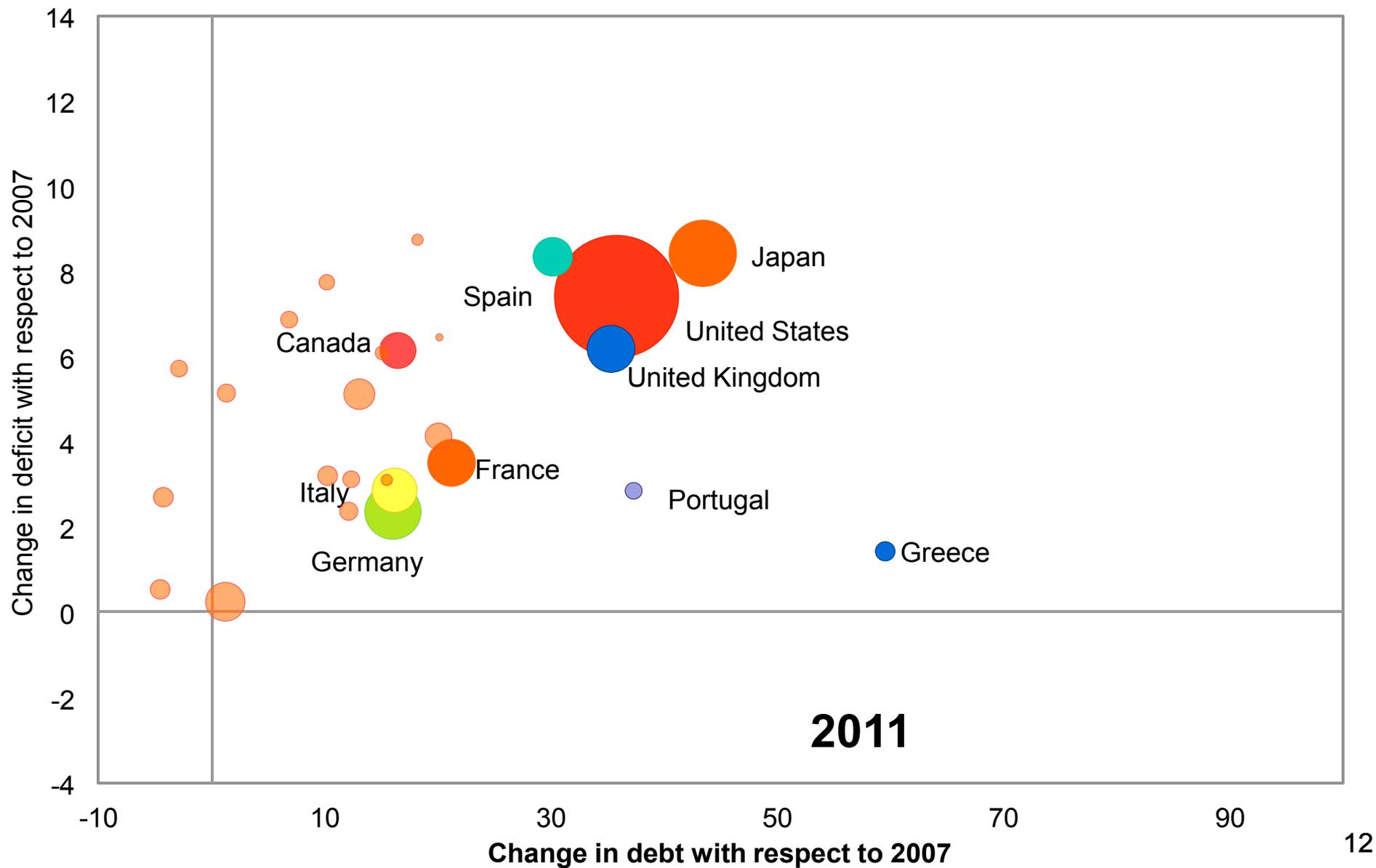
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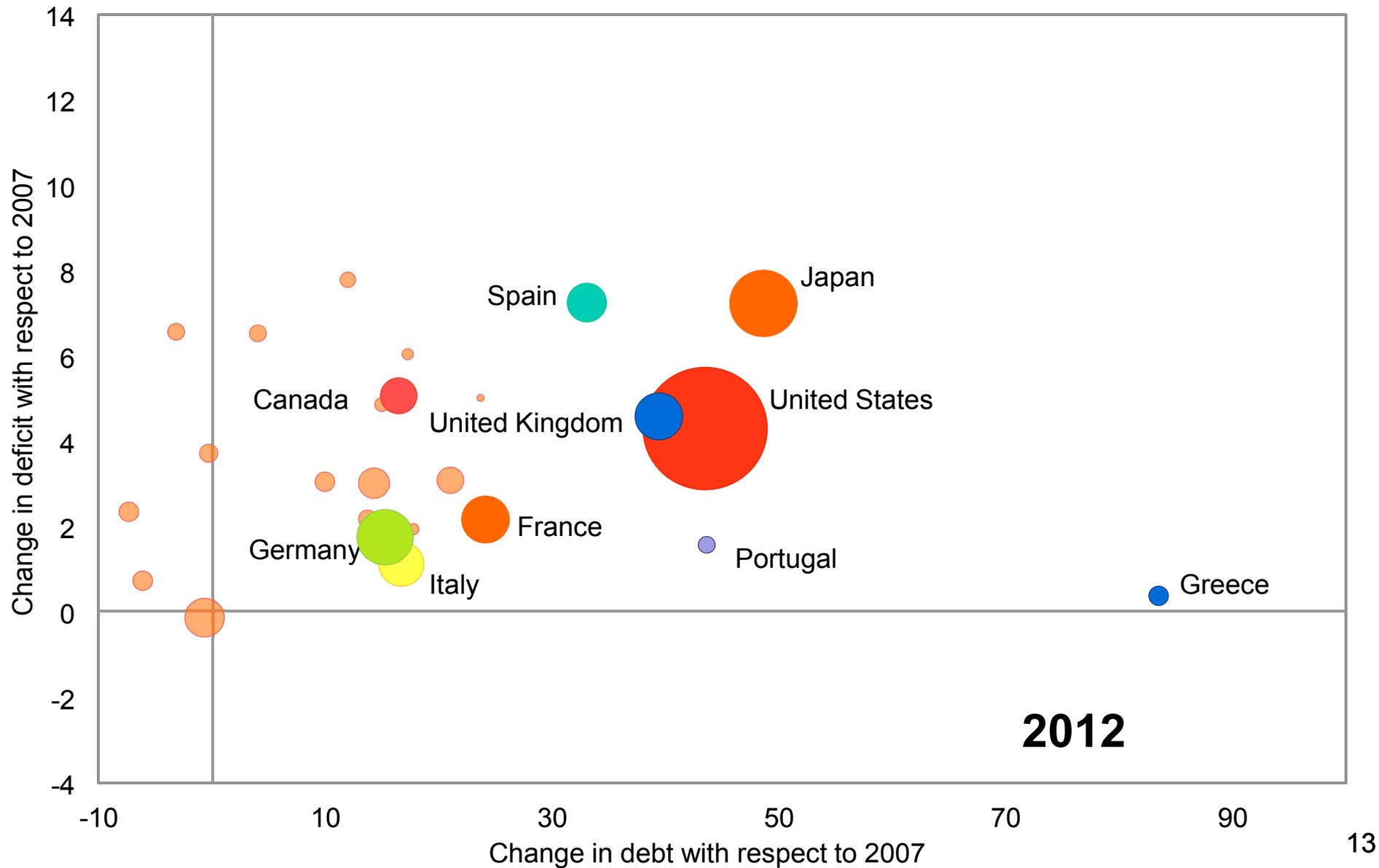
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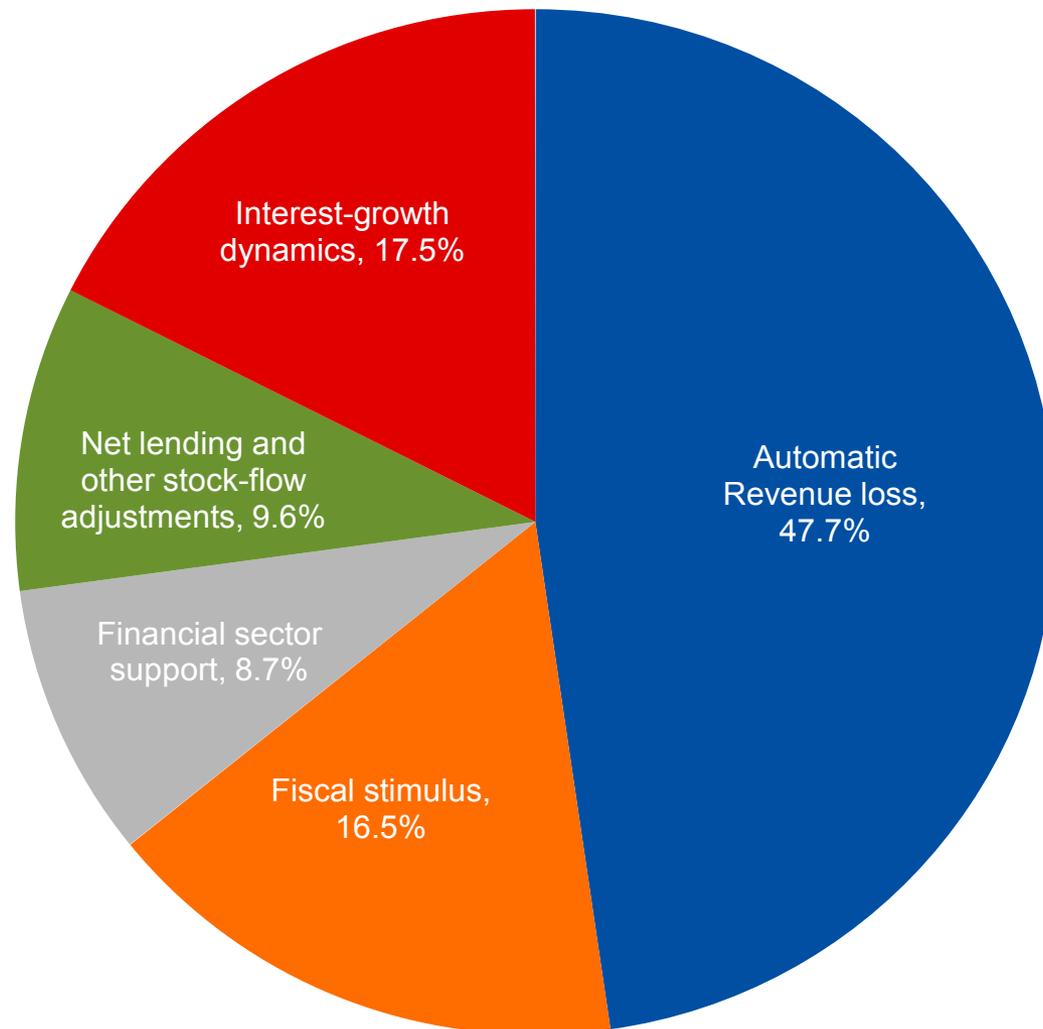


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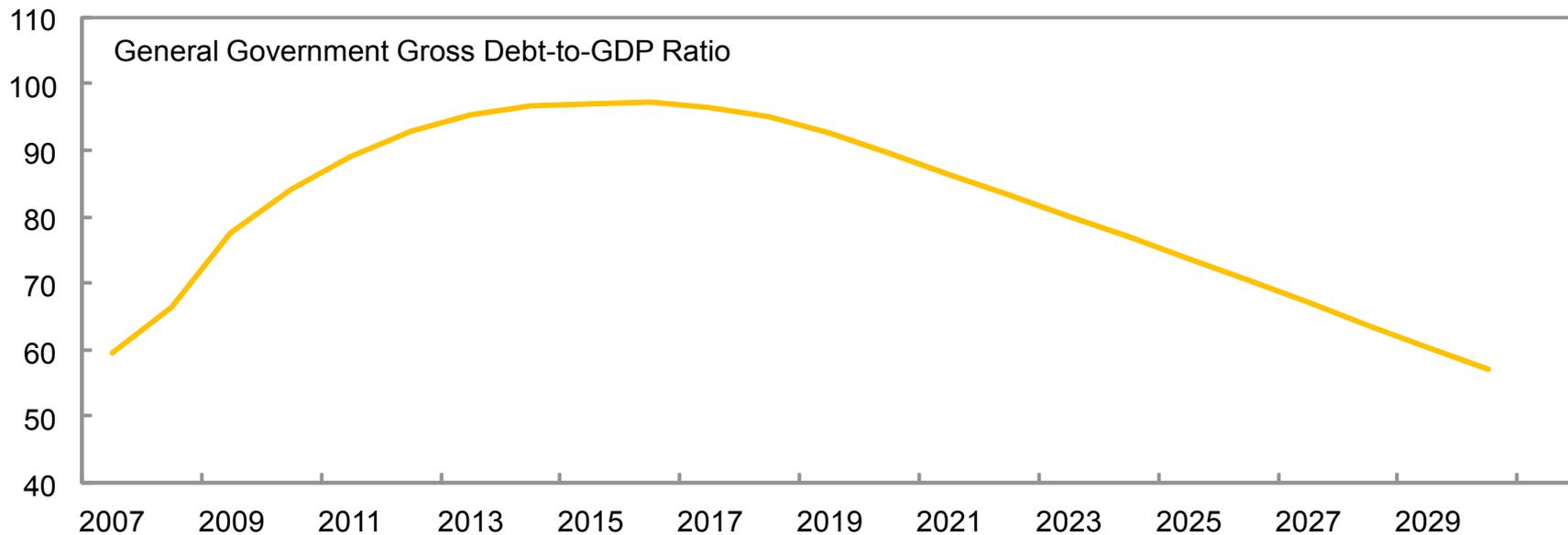
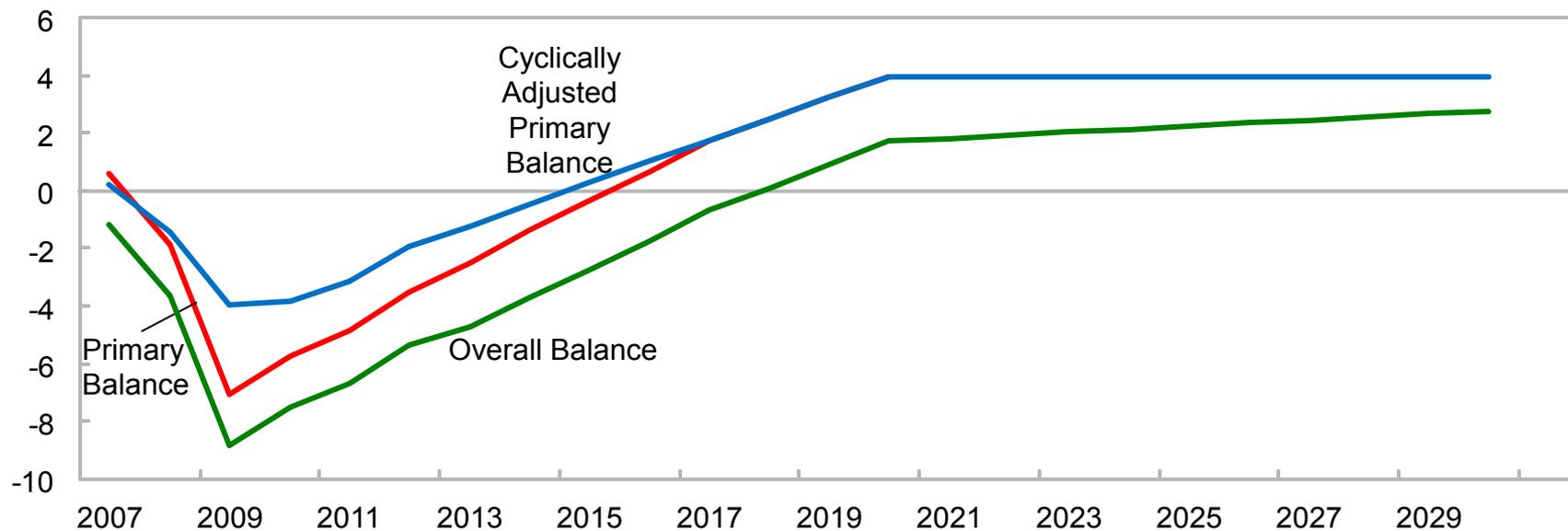


# G-20 Advanced Economies: Increase in General Government Debt, 2008–15

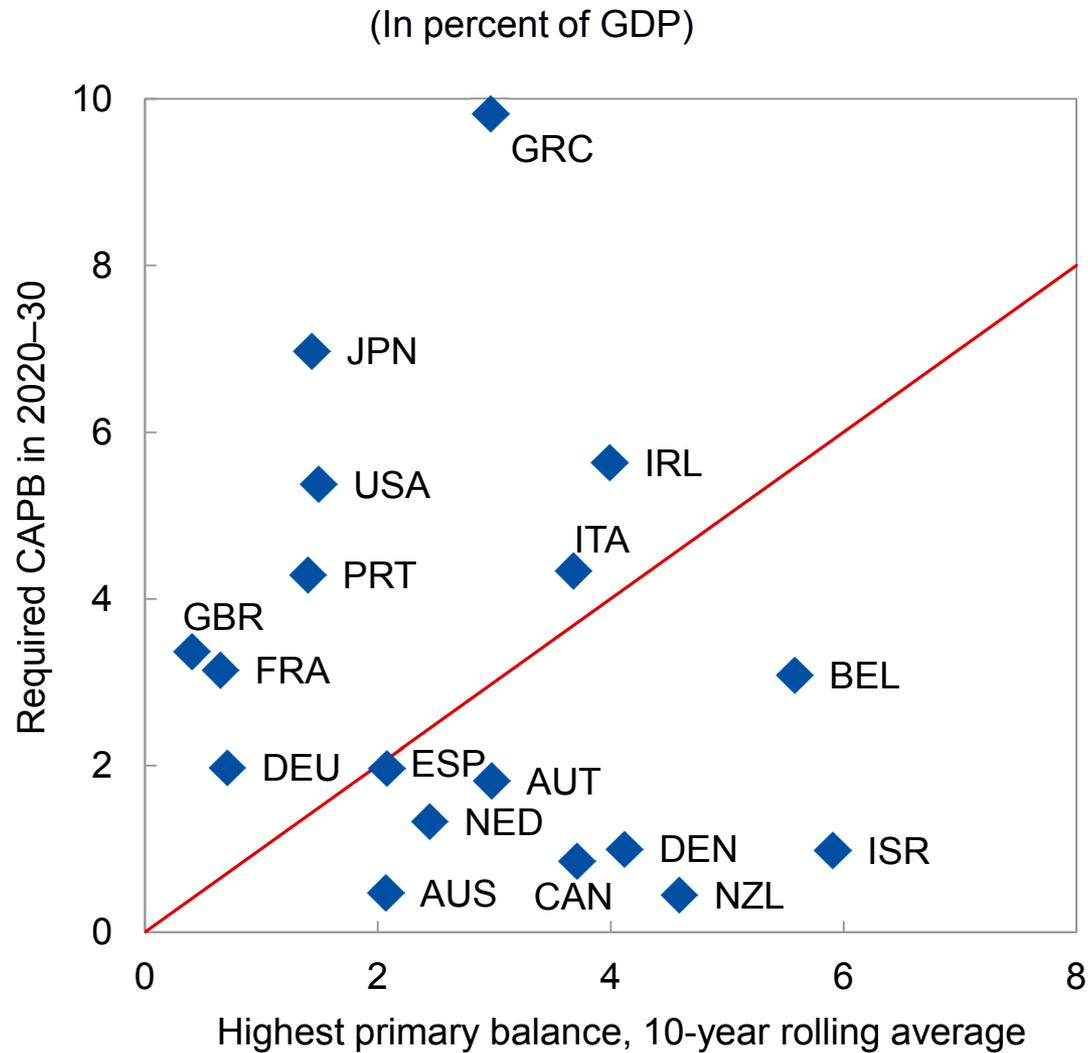
*(Total increase: 38.6 percentage points of GDP)*



# Illustrative Scenarios for Primary Balance Adjustment and Debt, 2010-30



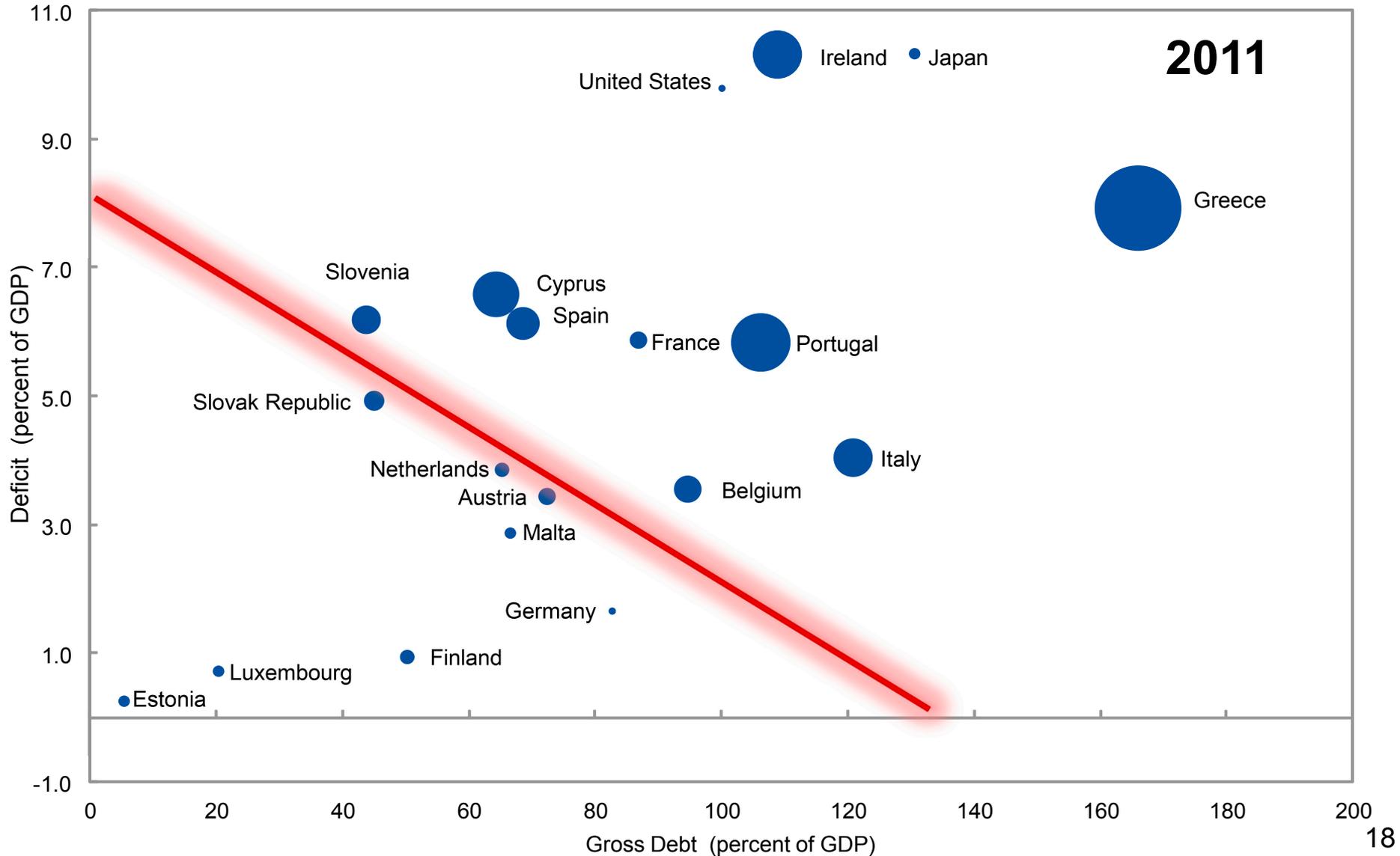
# Cyclically Adjusted Primary Balance that Needs to Be Maintained in 2020–30 to Achieve Debt Target by 2030





3. The risks  
arising from the  
current situation

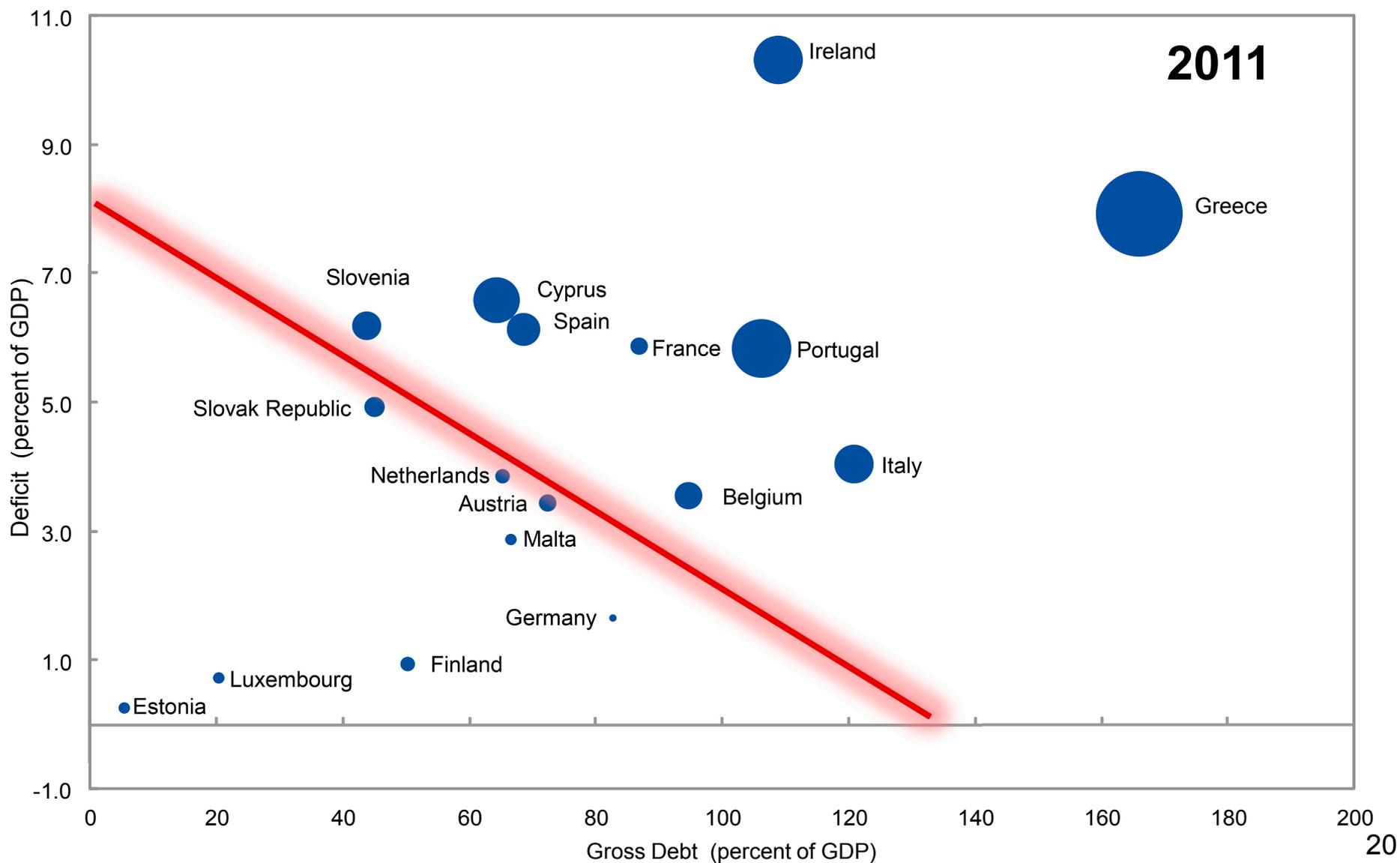
# General Government Deficit vs. Debt in Euro Area Countries, 2011



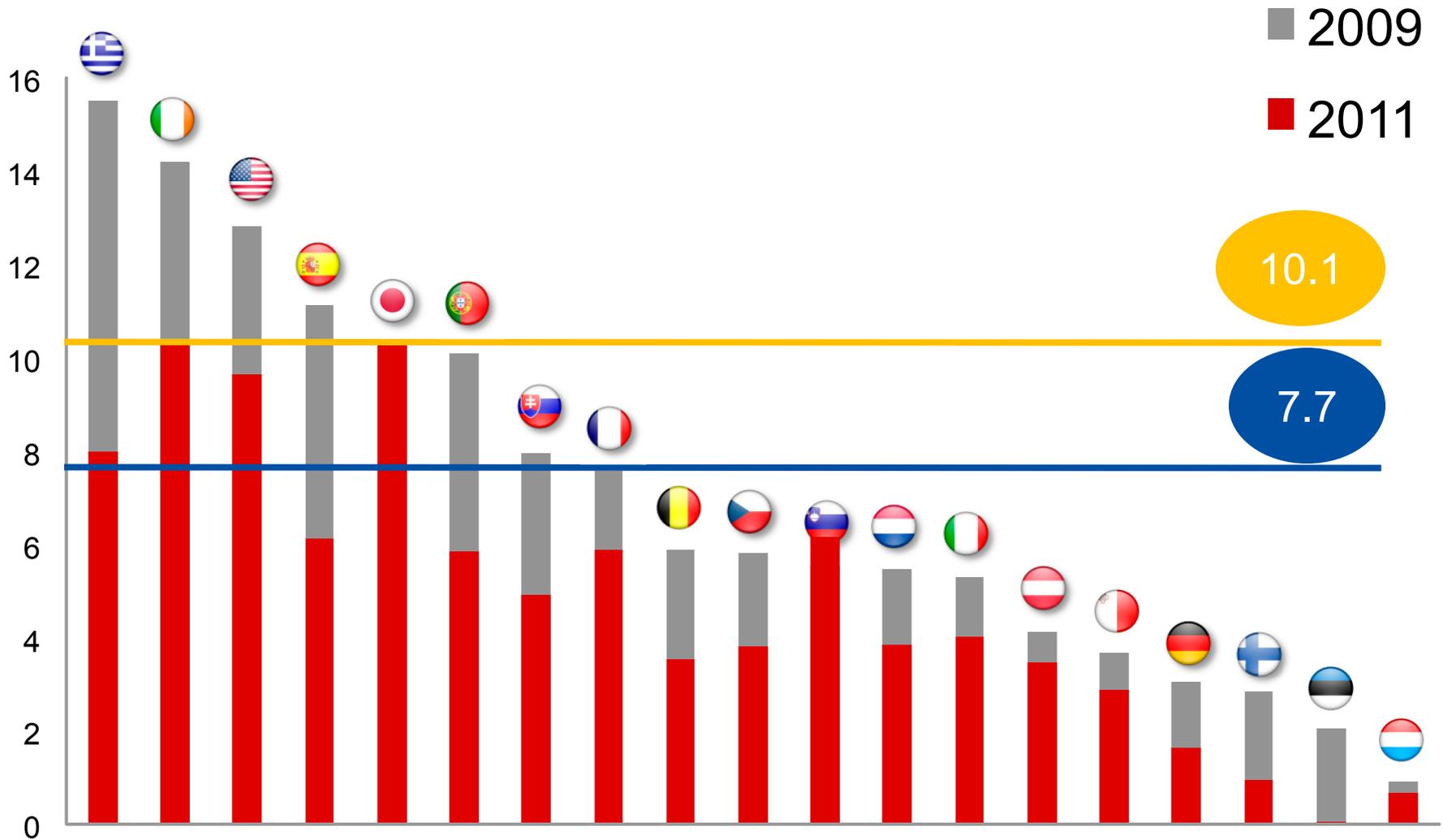
# Why Euro Area Countries Are Different from US and Japan?

1. Past and future fiscal trends

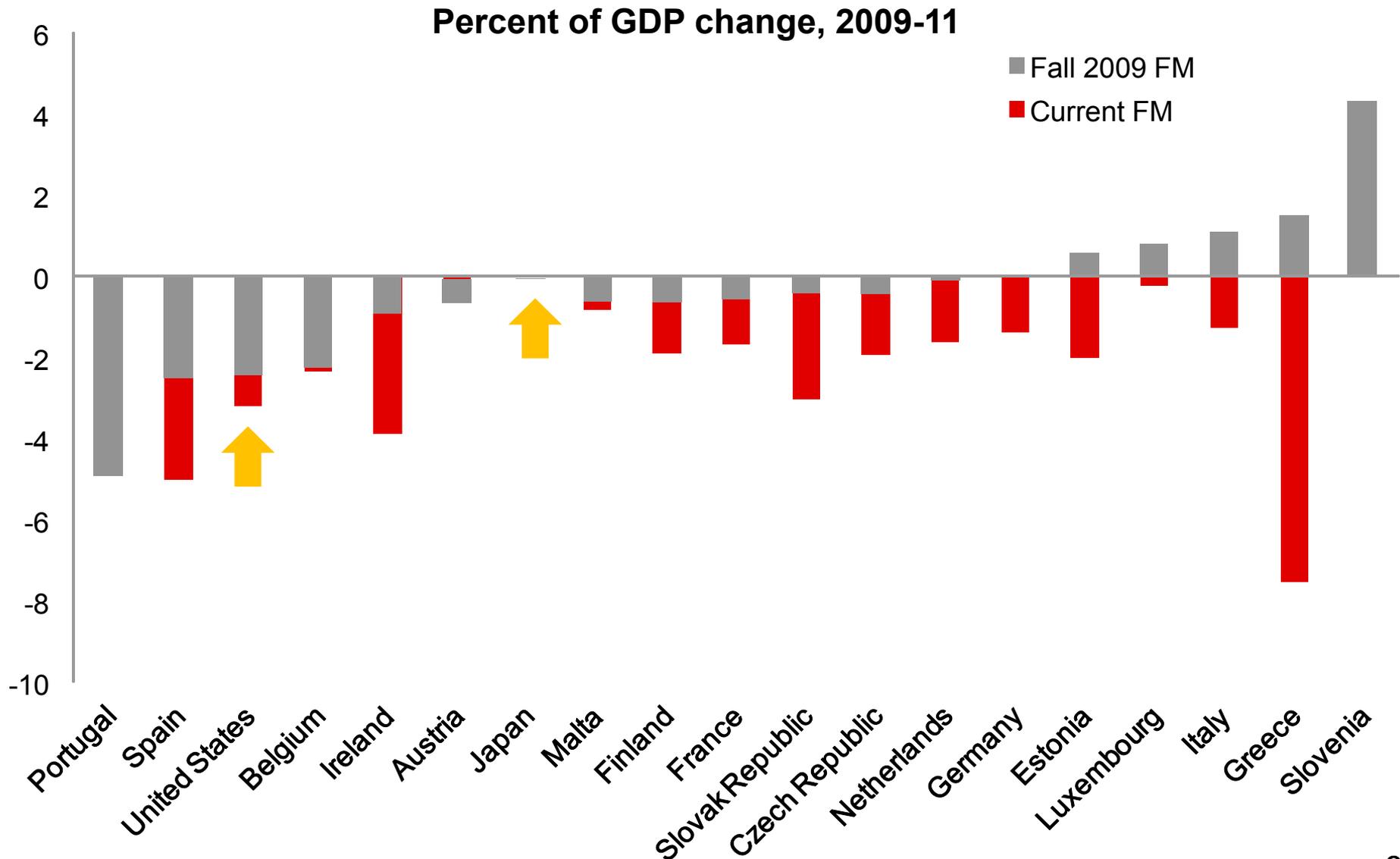
# General Government Deficit vs. Debt in Euro Area Countries, 2011



# General Government Deficit, in percent of GDP



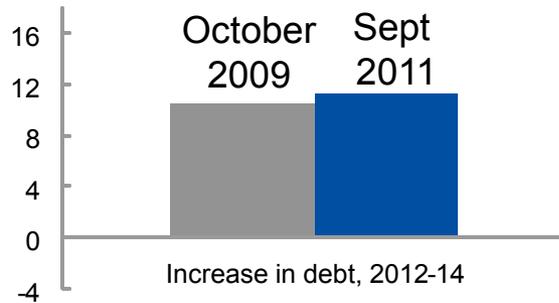
# Change in the Deficit in the Euro Area, US and Japan



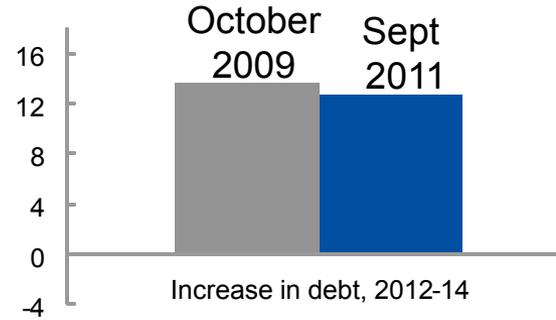
# Fiscal Outlook: Increase in General Government Debt during 2012-14

(Change in percent of GDP)

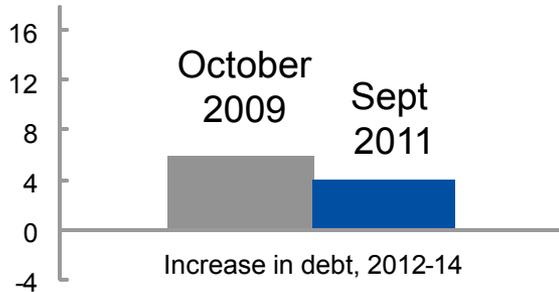
## United States



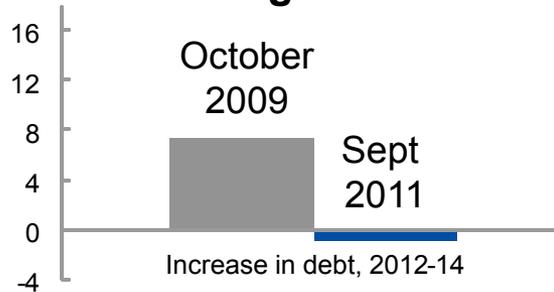
## Japan



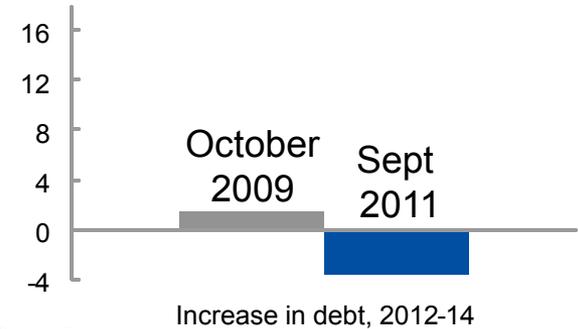
## France



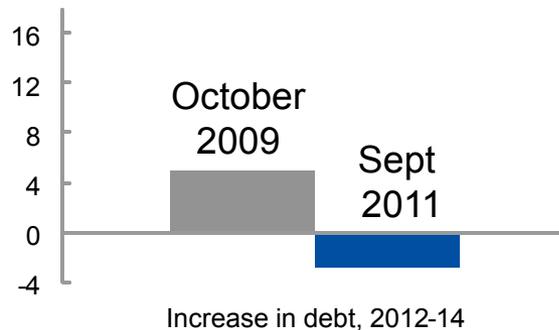
## Belgium



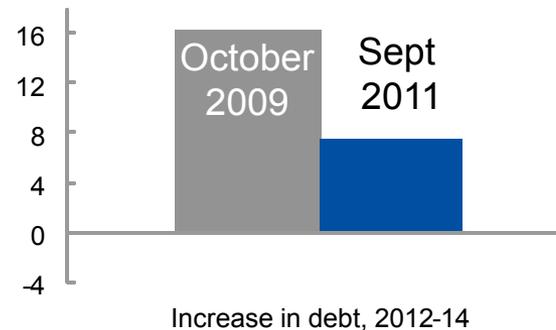
## Germany



## Italy



## Spain

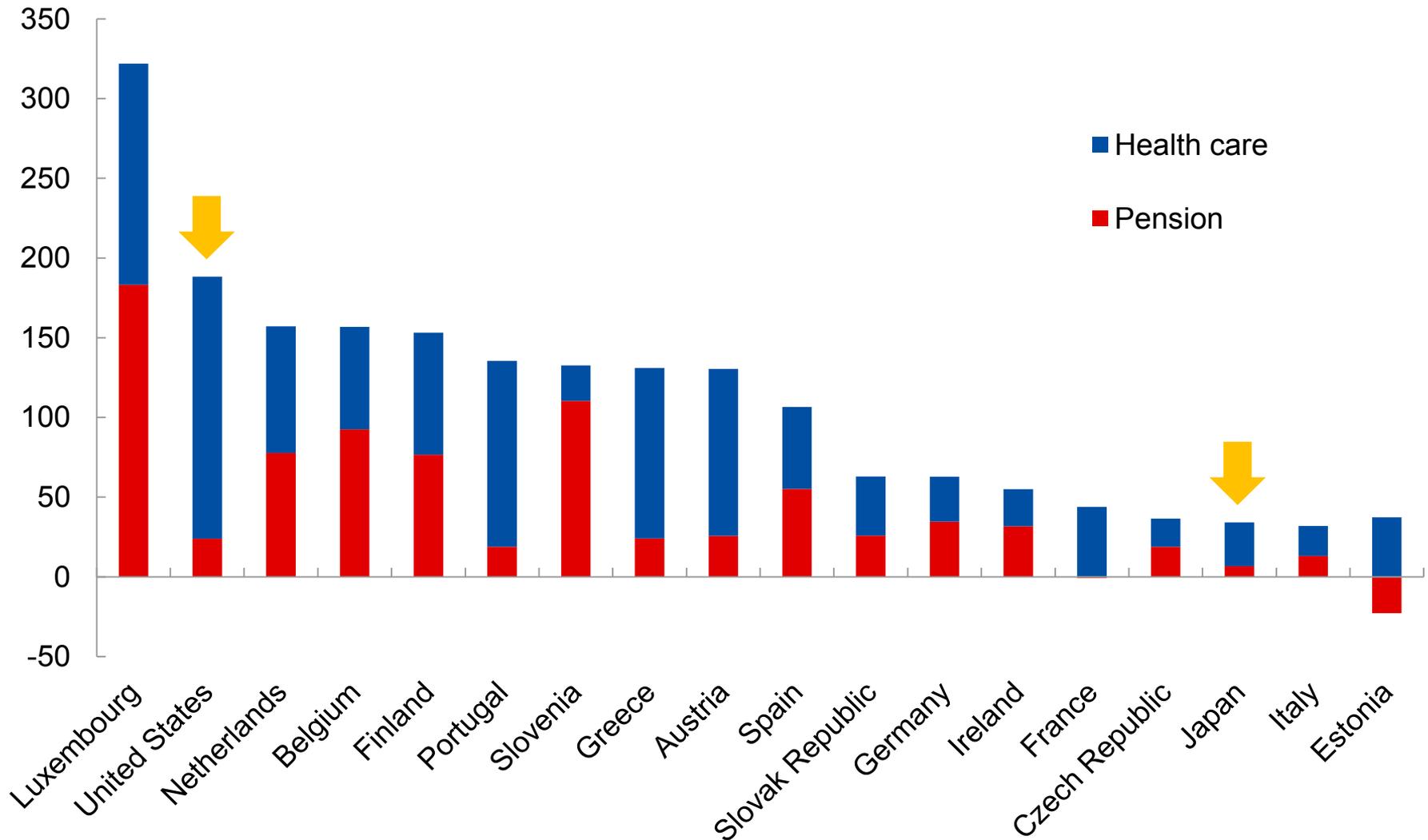


# Why Euro Area Countries Are Different from US and Japan?

1. Past and future fiscal trends
2. Long-term pressures on spending for health care and pensions

# NPV of Pension and Health care Spending Change 2010–50

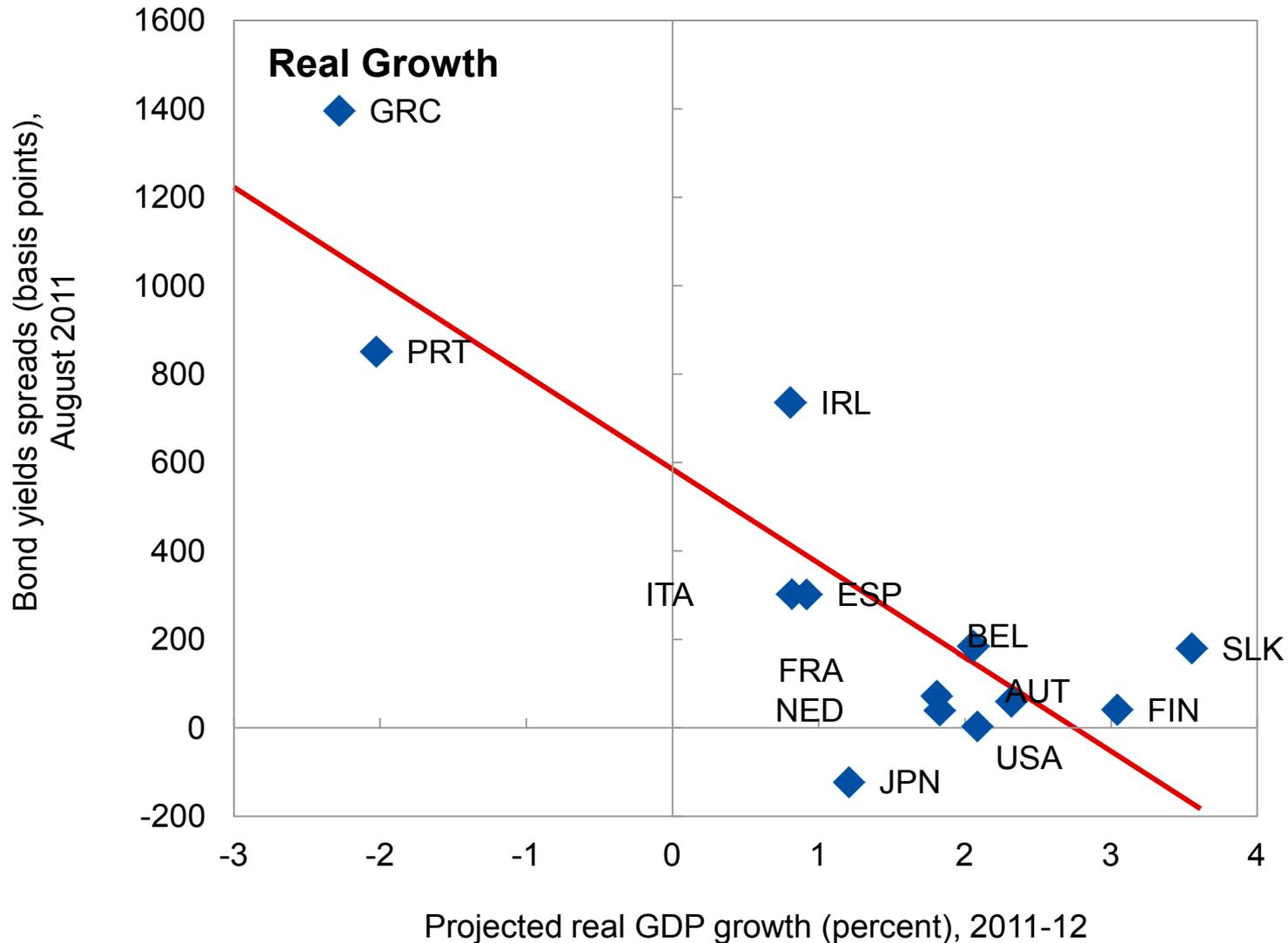
(Change in percent of GDP)



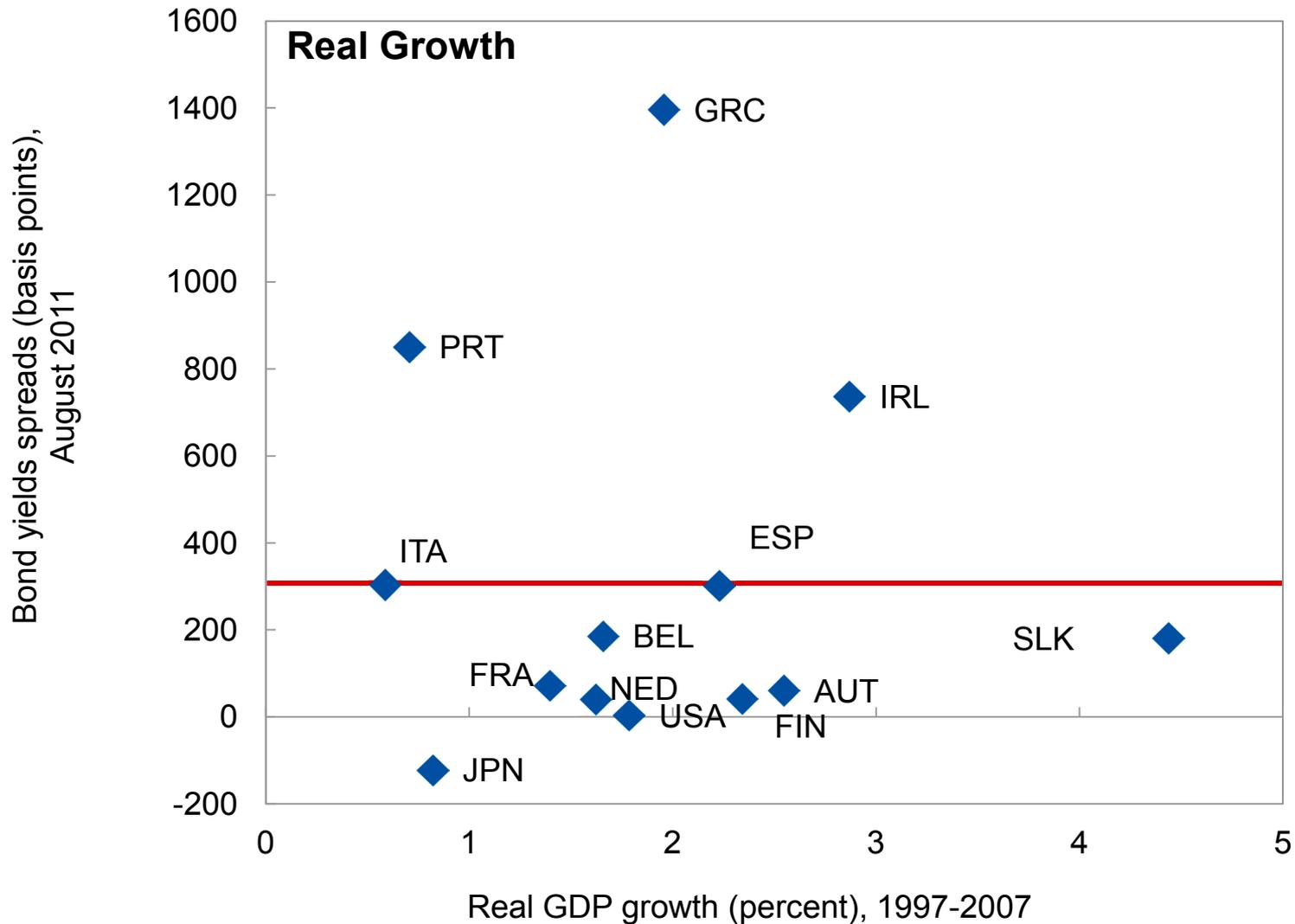
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1. Past and future fiscal trends
2. Long-term pressures on spending for health care and pensions
3. Banks
4. Growth

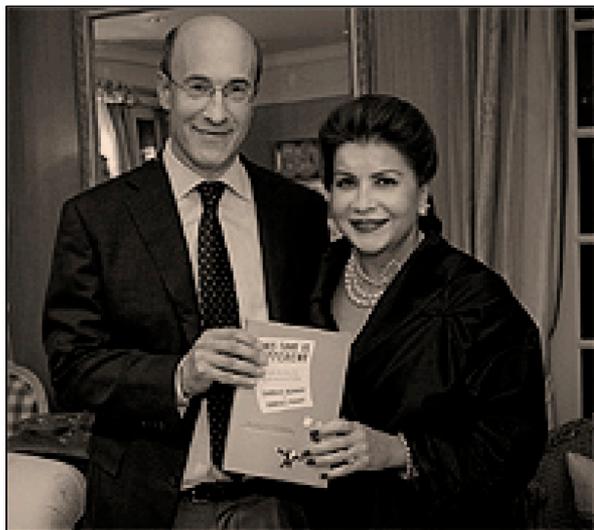
# Sovereign Bond Yield Spreads and Projected Real GDP Growth



# Sovereign Bond Yield Spreads and Real GDP Growth



# High Public Debt is Bad for Growth



Rogoff and  
Reinhart:  
“This Time is  
Different: Eight  
Centuries of  
Financial Folly”  
(2009)



Kumar and  
Woo:  
“Public Debt  
and Growth”  
(2010)



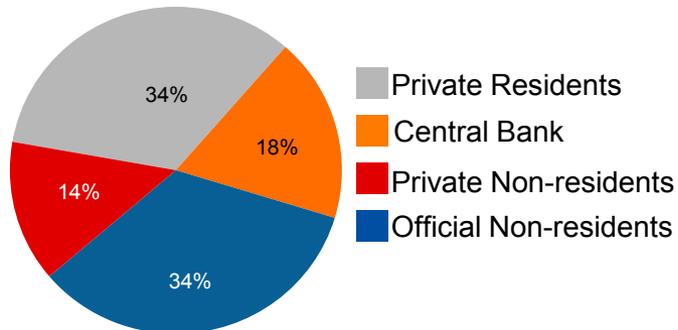
Steven  
Cecchetti:  
“The Real  
Effects of Debt”  
(2011)

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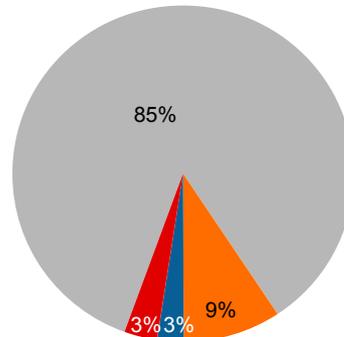
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5. Sources of financing

# Sources of Financing: Holders of Public Debt

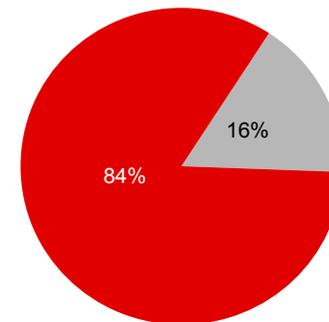
**United States** Treasury Securities



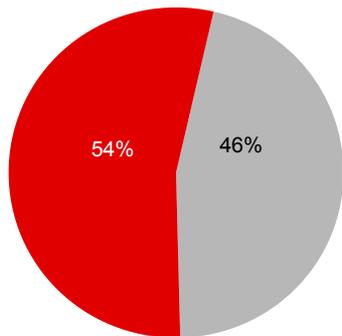
**Japan** Central Government Bonds



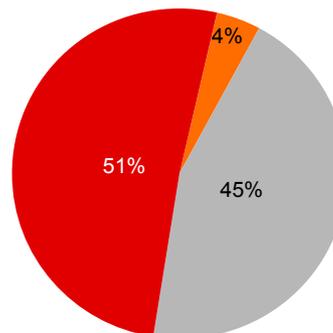
**Ireland** Central Government Bonds



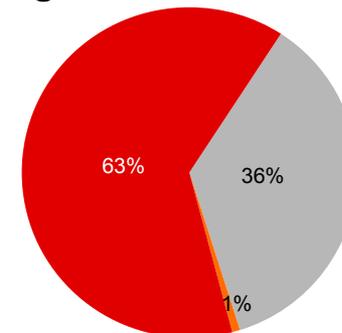
**France** Central Government Securities



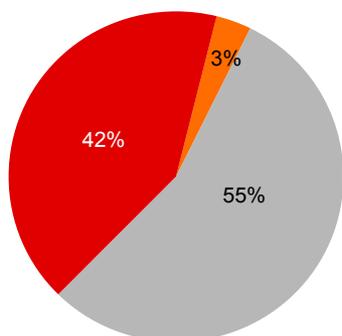
**Italy** General Government Securities



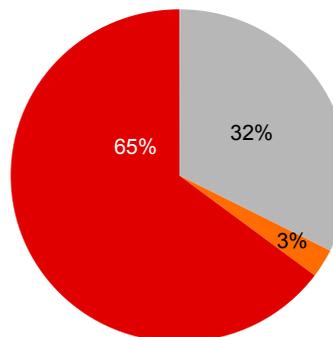
**Portugal** General Government Debt



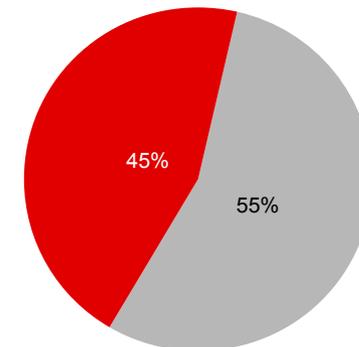
**Belgium** Gross Government Debt



**Greece** Central Government Marketable Debt

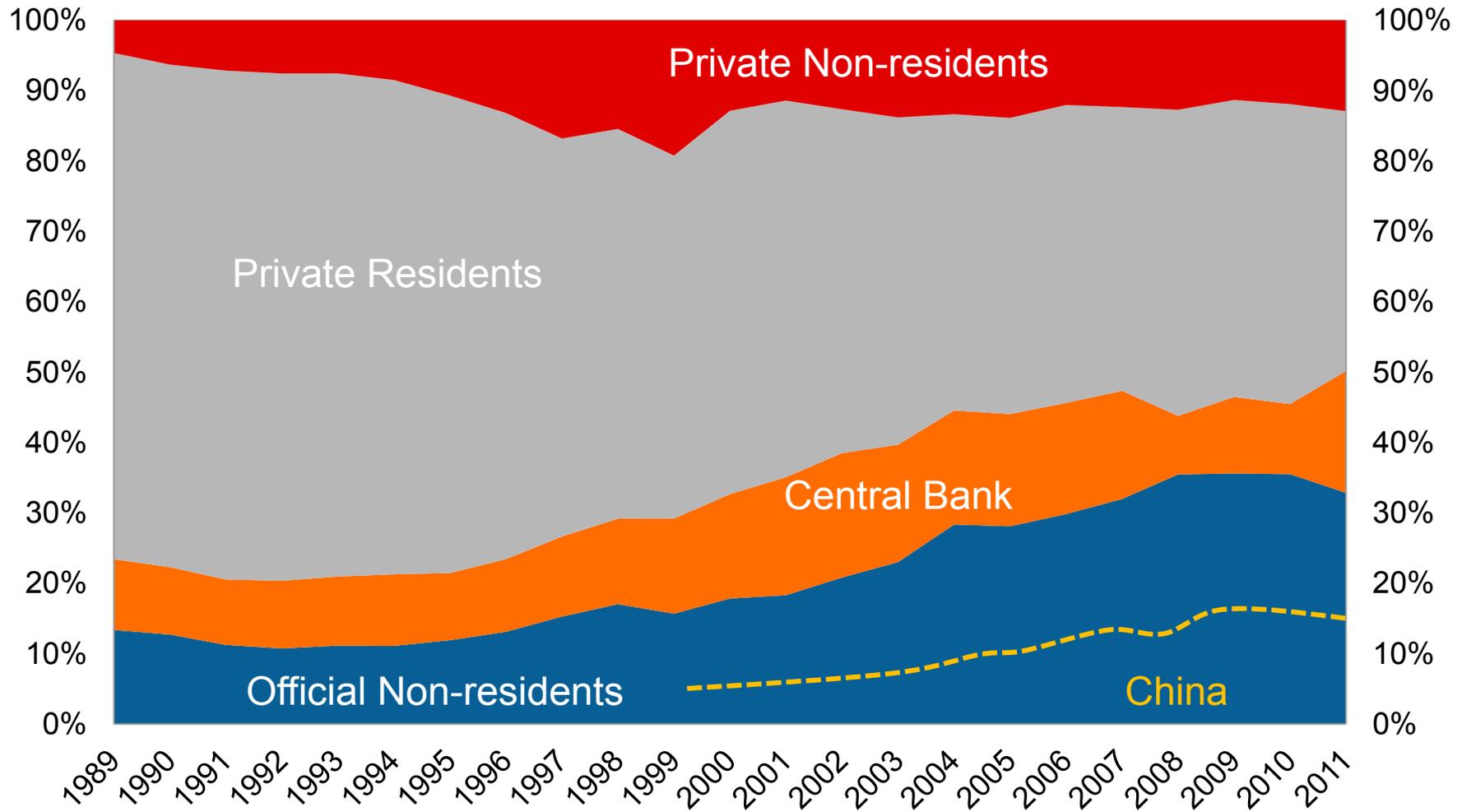


**Spain** Central Government Securities

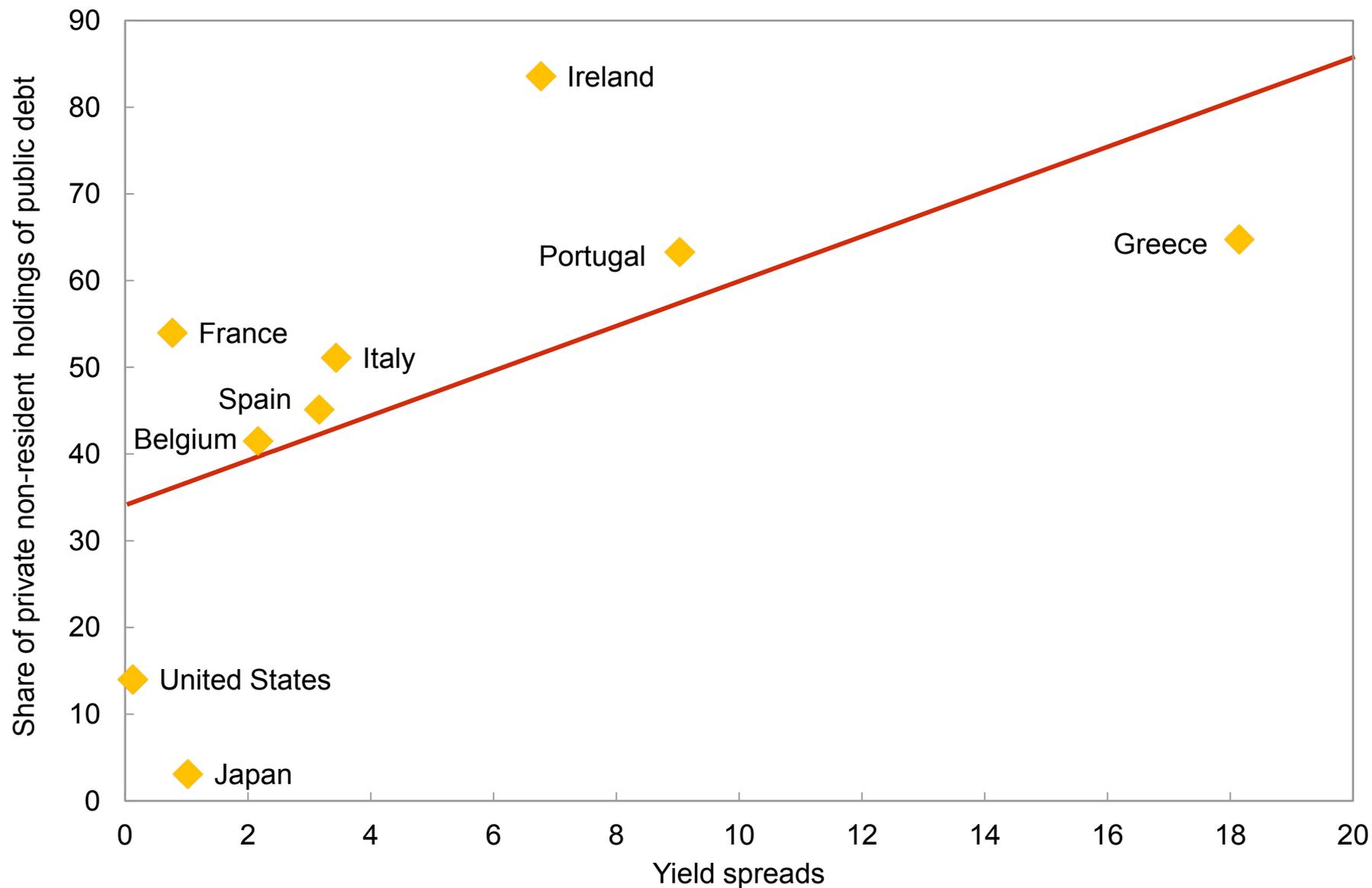


Note: For Ireland, France, Italy, Portugal, Greece and Spain: Private non-resident, includes ECB.

# United States: Ownership of Treasury Securities



# Private Non-residents Holders of Debt vs. Yield Spreads



# Determinants of Spreads, Cross Section Analysis, 2011

VARIABLES	(1)	(2)	(3)	(4)	(5)
Gross debt to GDP 2011	0.0165*** (3.089)	0.0191*** (5.683)	0.0170*** (4.930)	0.0170*** (5.026)	0.0175*** (5.390)
Primary balance to GDP 2011 for Euro Area	-0.210*** (-3.728)	-0.185*** (-3.273)	-0.185*** (-3.195)	-0.189*** (-3.432)	-0.177*** (-3.606)
Debt held by a country's central bank or by foreign central banks to GDP	-0.0287* (-1.744)	-0.0380** (-2.747)	-0.0398** (-2.633)	-0.0424*** (-3.531)	-0.0419*** (-3.681)
Inflation rate 2011	0.309** (2.729)	0.343*** (3.329)	0.395*** (4.623)	0.384*** (5.122)	0.382*** (5.024)
Real GDP Growth 2011	-0.195** (-2.632)	-0.221*** (-3.580)	-0.163** (-2.626)	-0.159*** (-2.822)	-0.153** (-2.671)
NPV of pension spending in percent of GDP 2010	-0.000967 (-0.225)	-0.00203 (-0.478)	-0.00233 (-0.615)	-0.00262 (-0.699)	
NPV of health spending in percent of GDP 2010	-0.00238 (-0.870)	-0.00245 (-0.880)	-0.00100 (-0.373)		
Primary balance to GDP 2014 for Euro Area	0.0948 (0.856)				
Potential output growth, average 2011-2016	0.287* (1.724)	0.290* (1.765)			
Constant	2.589*** (4.604)	2.506*** (4.982)	2.872*** (6.011)	2.845*** (6.418)	2.712*** (5.949)
Observations	31	31	31	31	31
R-squared	0.781	0.776	0.748	0.747	0.741

Robust t-statistics in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

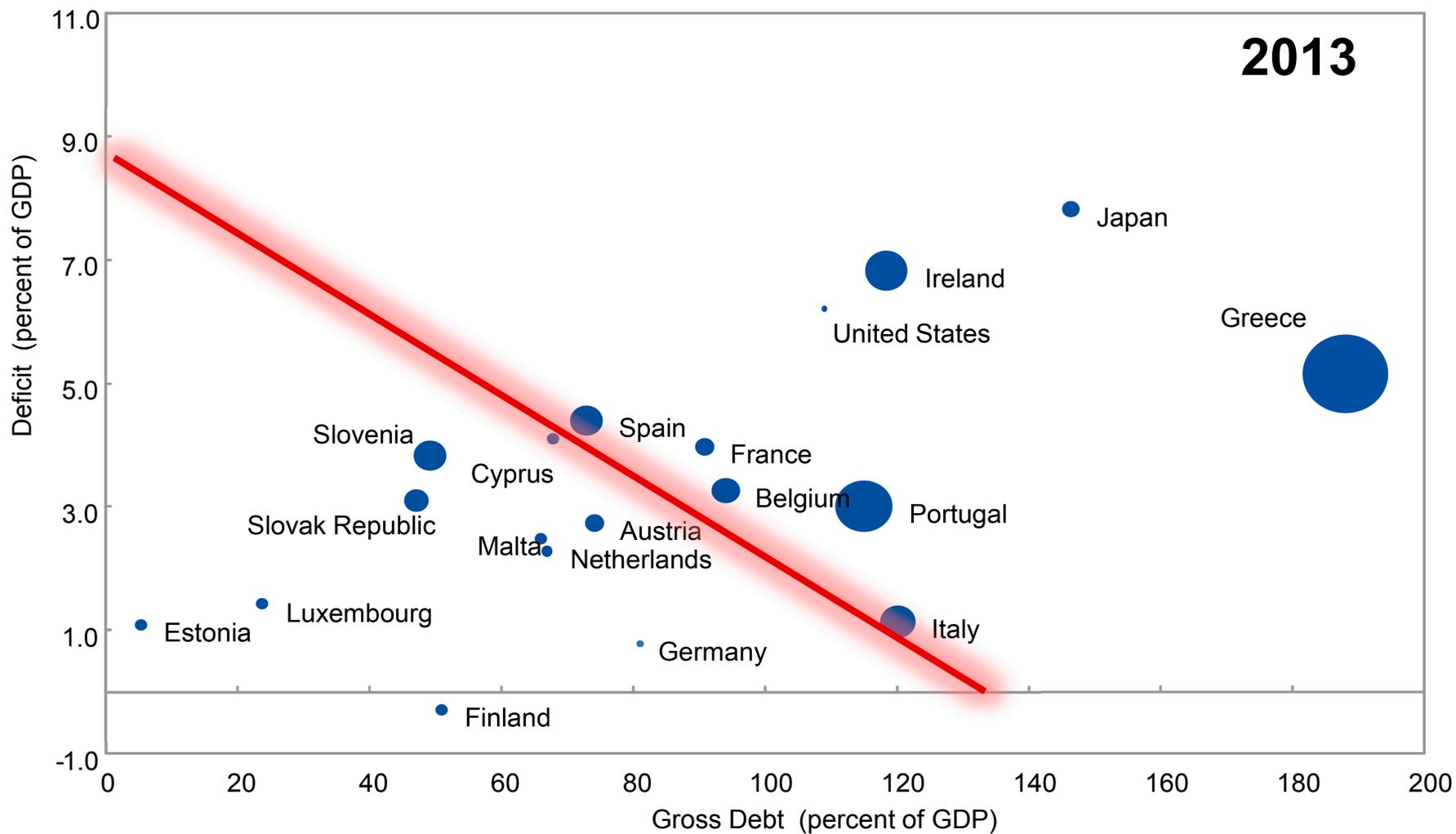


## 4. Policy conclusions

# Policy Conclusions

1. United States and Japan need a clear plan
2. Europe needs:
  1. Adjustment in fiscal fundamentals

# General Government Deficit vs. Debt in Euro Area Countries, 2013

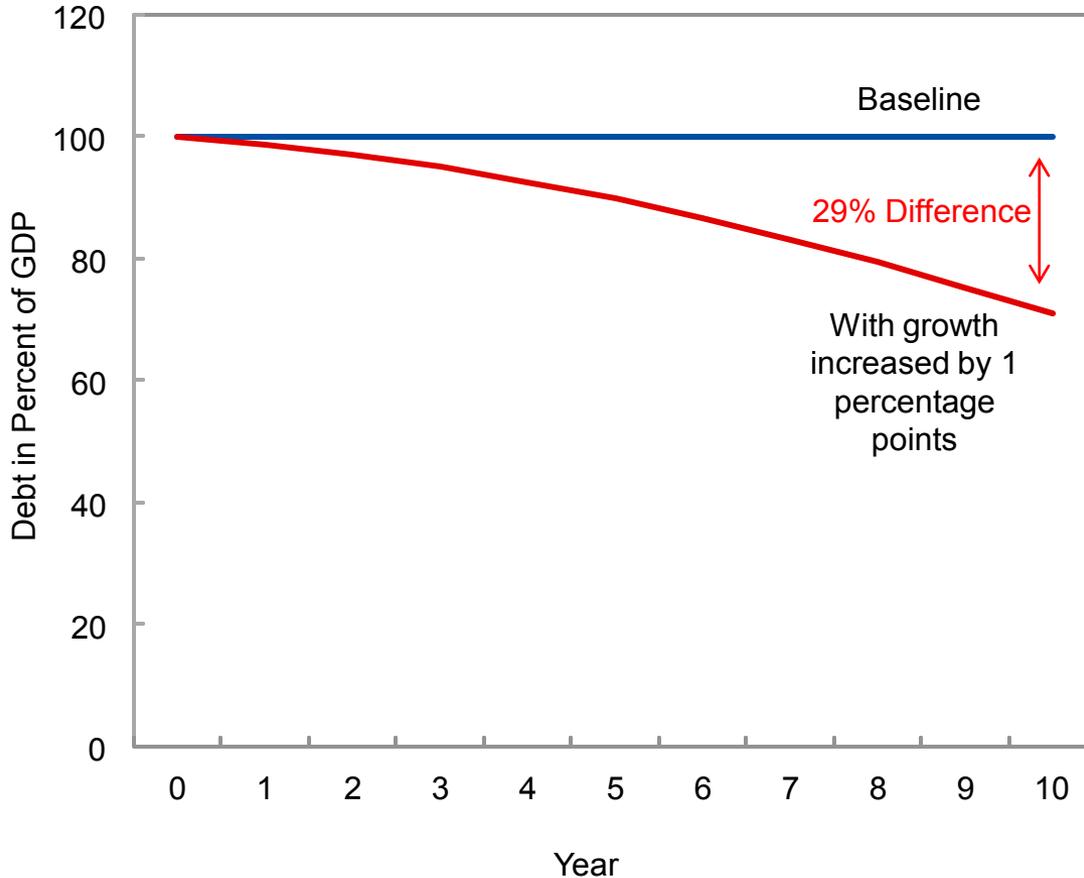


# Policy Conclusions

1. United States and Japan need a clear plan
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  2. Reforms to boost potential growth

# The Role of Growth Lowering Debt Ratios

Role of Growth in Debt Reduction



- Initial debt ratio at 100%
- Increase the growth rate for 10 years by 1 p.p.
- Spending constant in per capita terms, assuming a 40% tax ratio
- Would lower public debt by 29% of GDP

# Policy Conclusions

1. United States and Japan need a clear plan
2. Europe needs:
  1. Adjustment in fiscal fundamentals
  2. Reforms to boost potential growth
  3. Banking
  4. Financing for countries that are adjusting

**Thank You!**