

From Here to Eternity: The Outlook for Fiscal Adjustment in Advanced Economies



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World Economic and Financial Surveys

Fiscal Monitor

Fiscal Adjustment in an Uncertain World



APR **13**

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

Main Questions

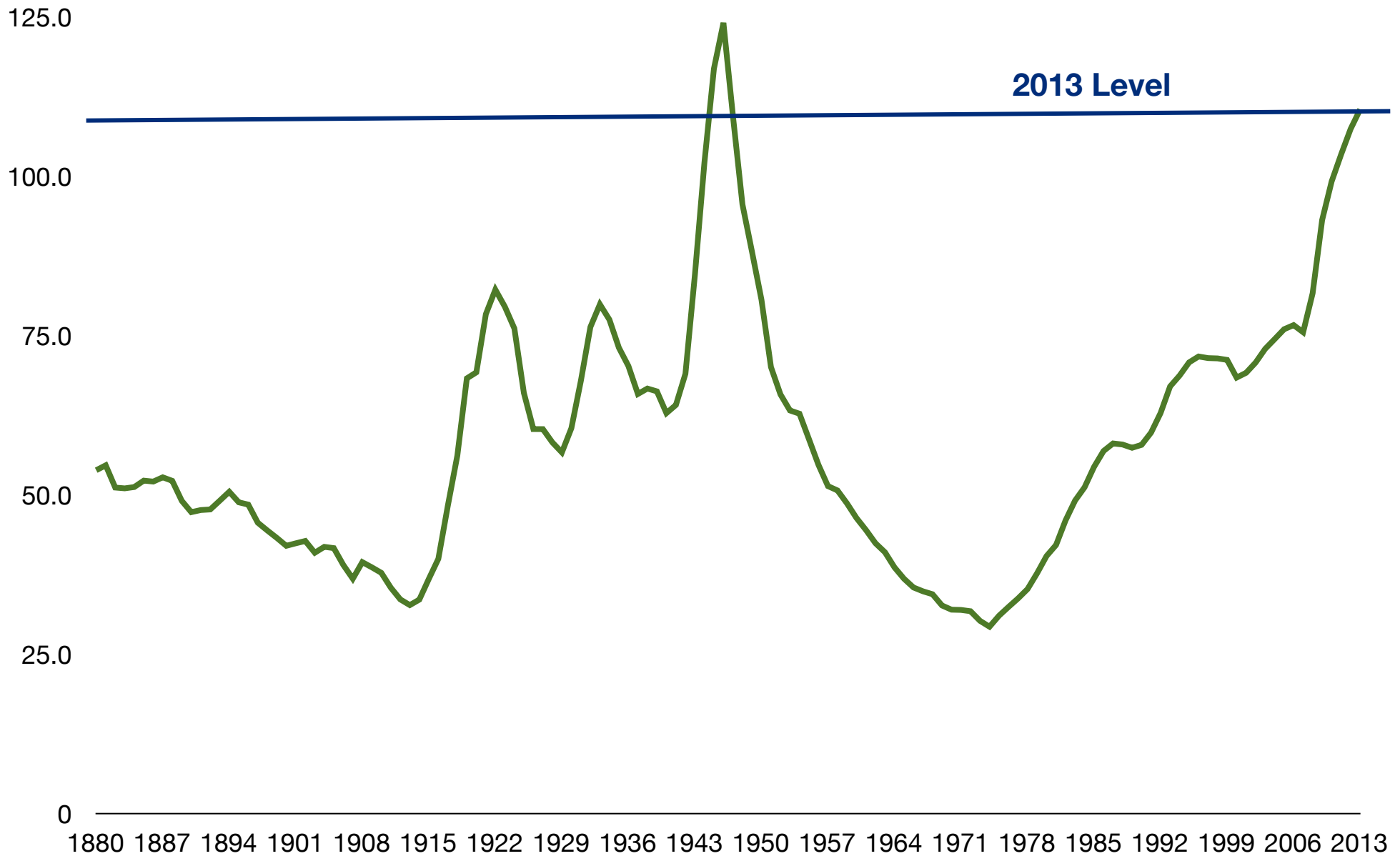
- How bad is the fiscal position in advanced economies?
- What are the risks arising from the poor state of the fiscal accounts?
- What is the appropriate strategy to address these fiscal challenges?
- Is the current fiscal adjustment strategy working?



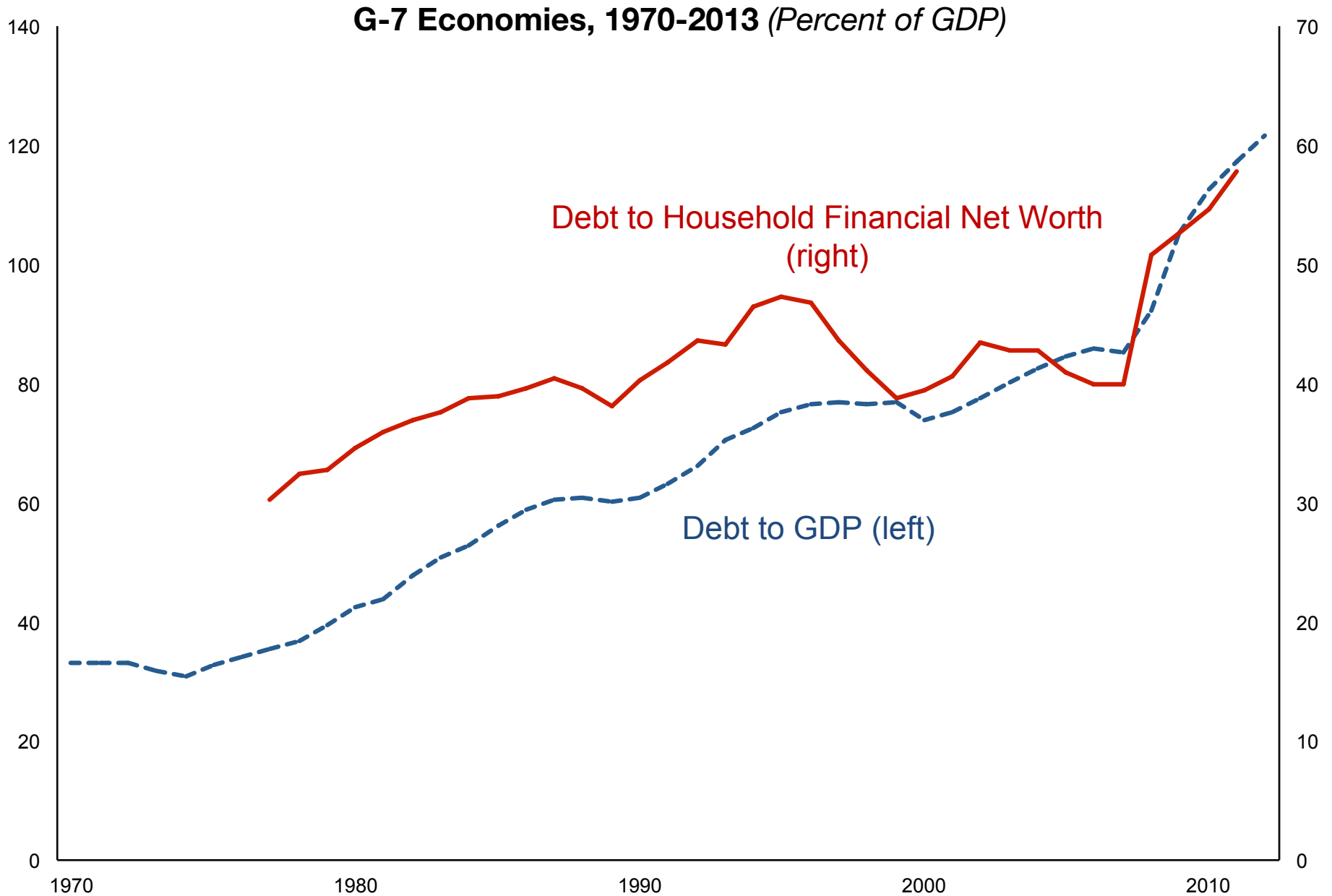
**How Bad is the Fiscal
Position in Advanced
Economies?**

General Government Gross Debt

Advanced Economies, 1880-2013 (Percent of GDP)

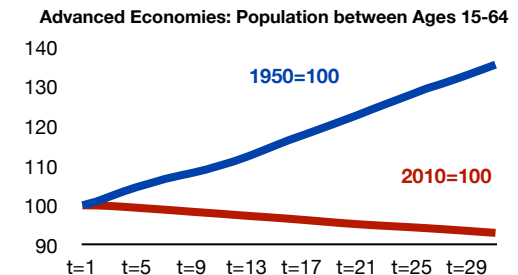
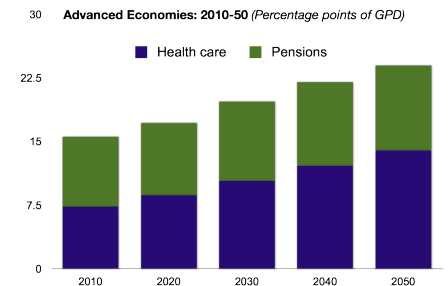


Gross Public Debt to Household Financial Net Worth

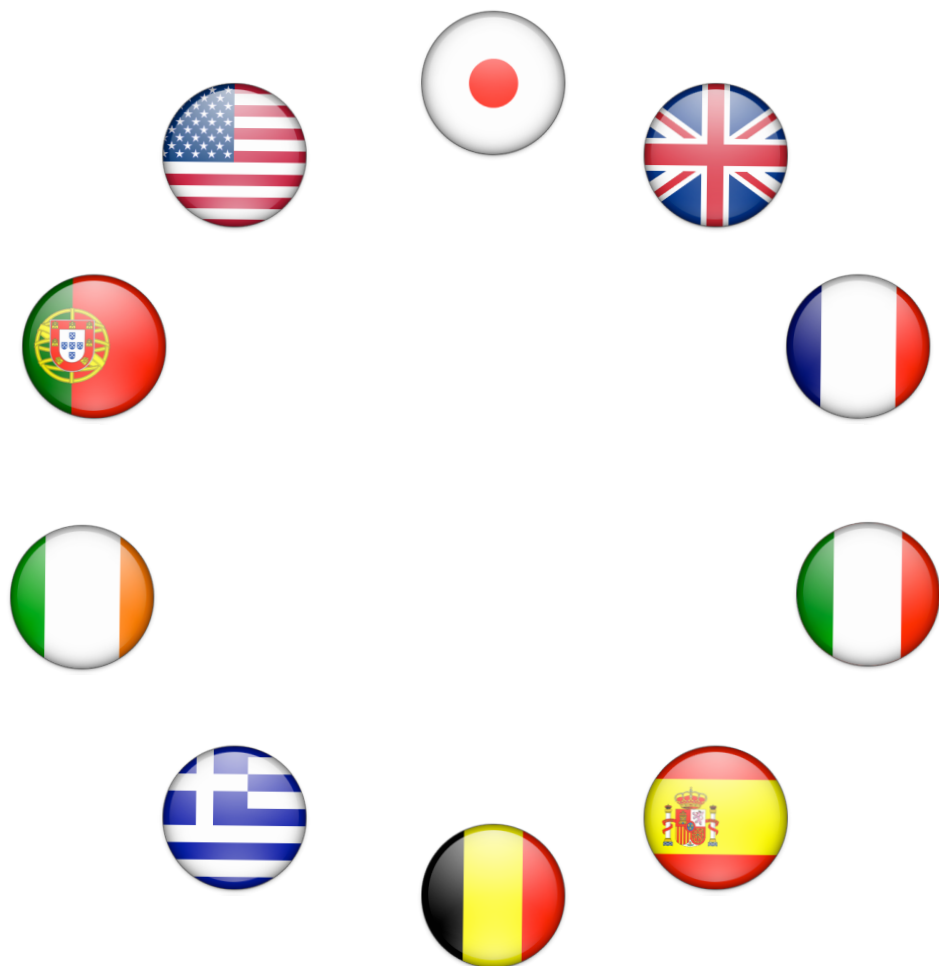


The Outlook is Worse than at the End of WW2 for Four Reasons

- Most of the fiscal adjustment then consisted of cuts in military spending
- Spending for pension and health care will be on the rise over the coming decades
- Growth prospects are not great
- Financial sector in most advanced economies was repressed



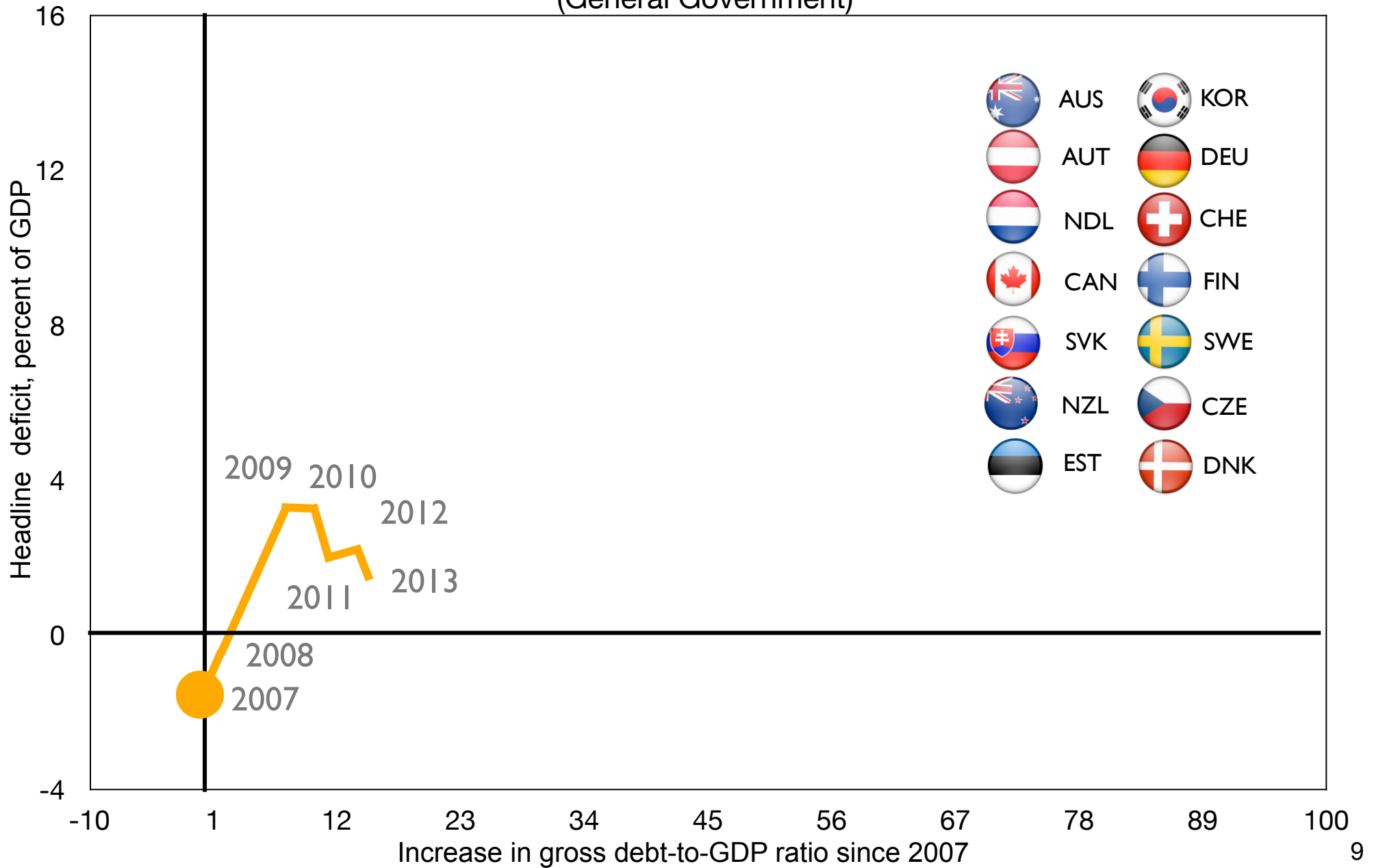
Large Advanced Economies Where Public Debt-to-GDP Ratio Exceeds 90 Percent and Is Still Rising



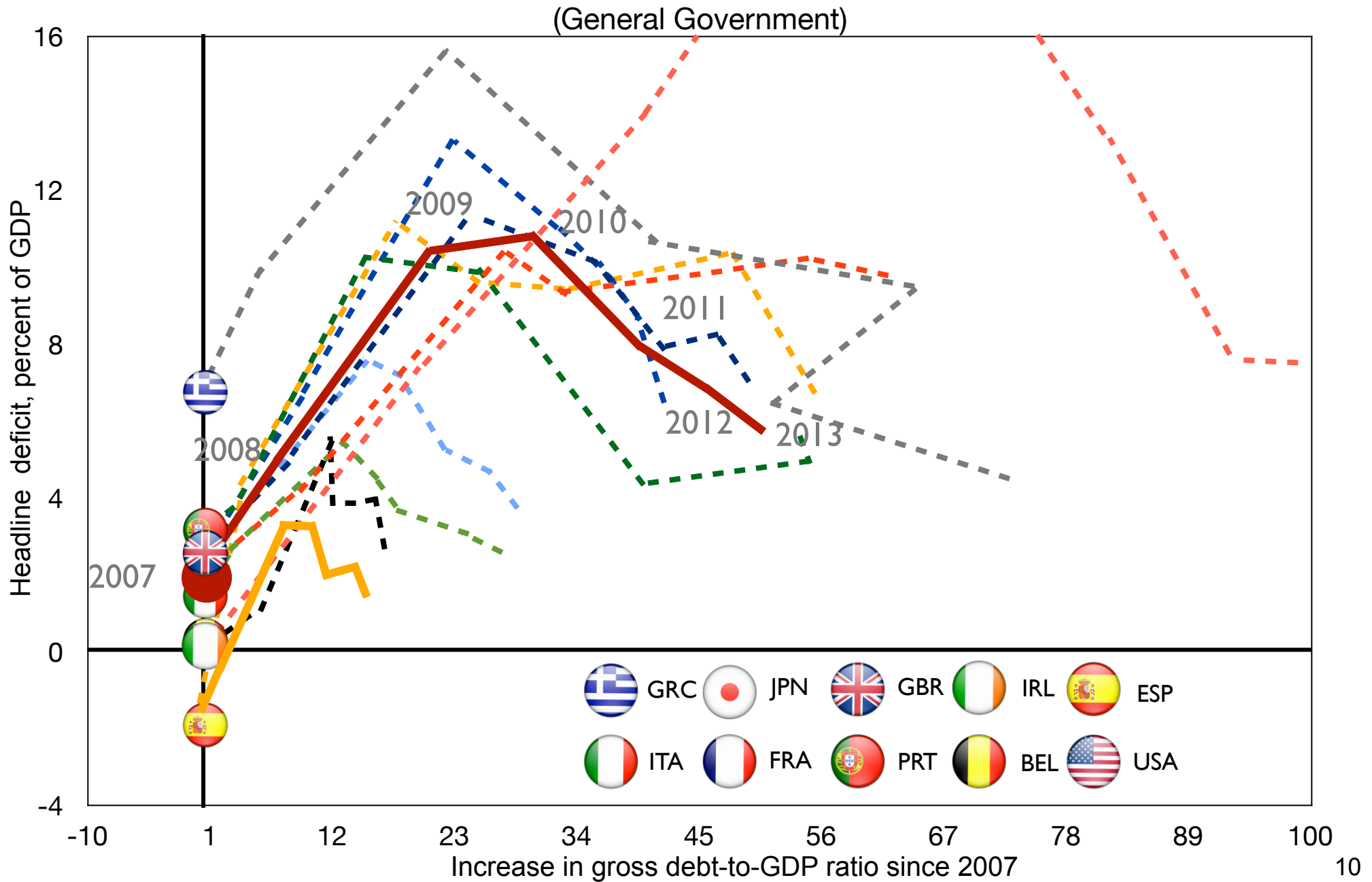
**40
percent of
world GDP**

Public Debt and Deficit Since 2007

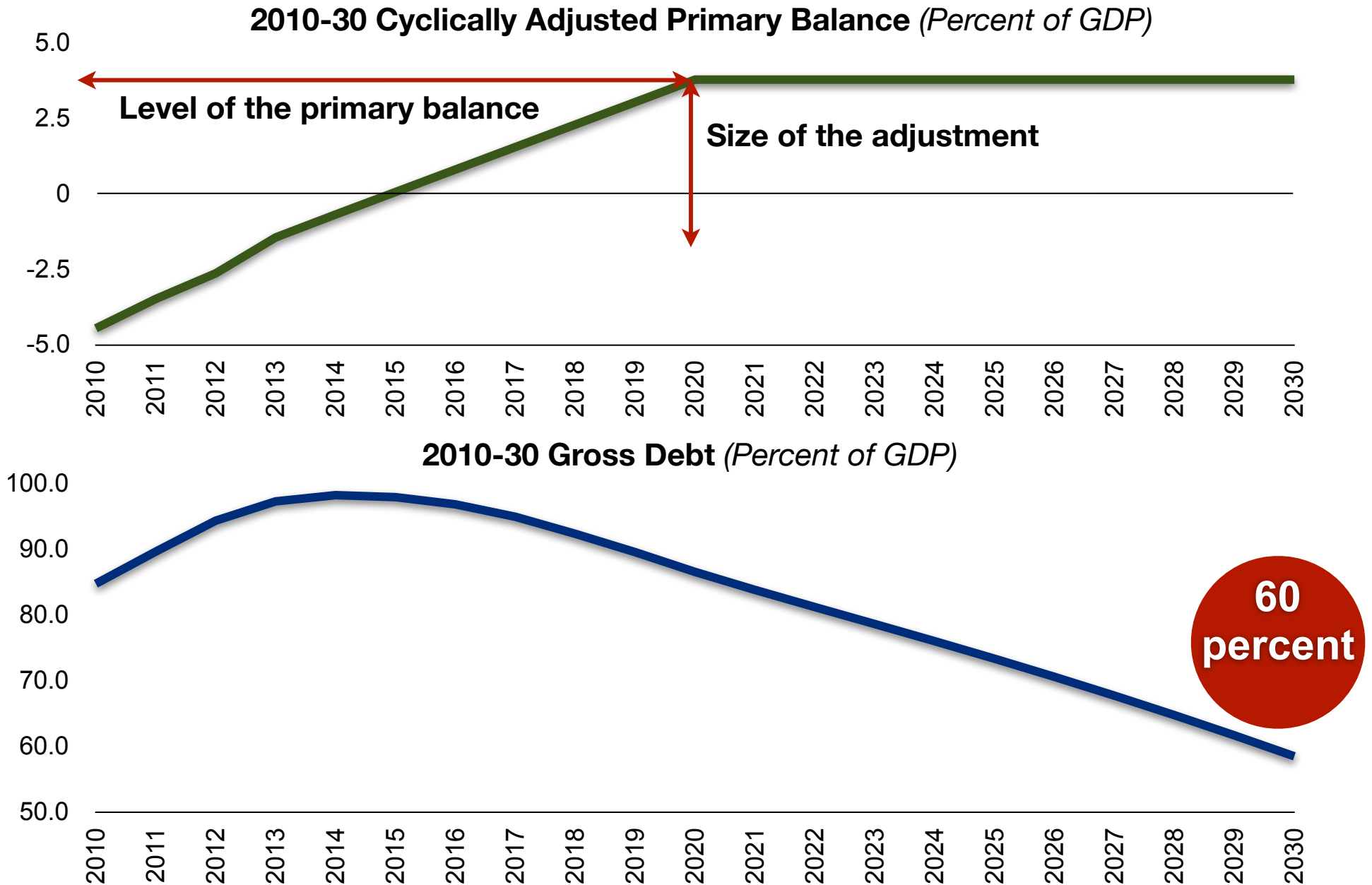
(General Government)



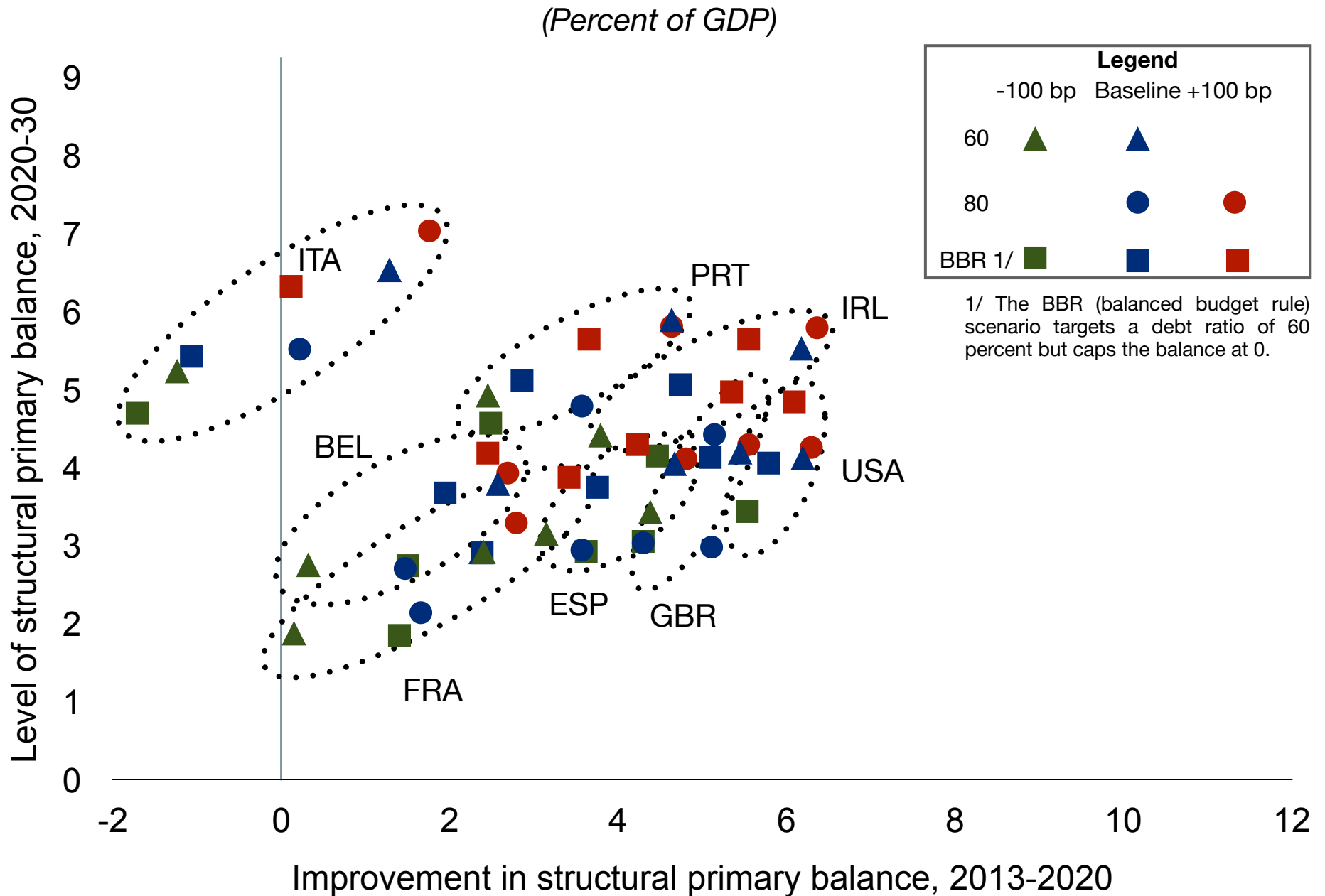
Public Debt and Deficit Since 2007



Focus of Long-term FM Scenarios: Degree of Fiscal Tightening Needed to Lower Public Debt to 60-80 percent by 2030

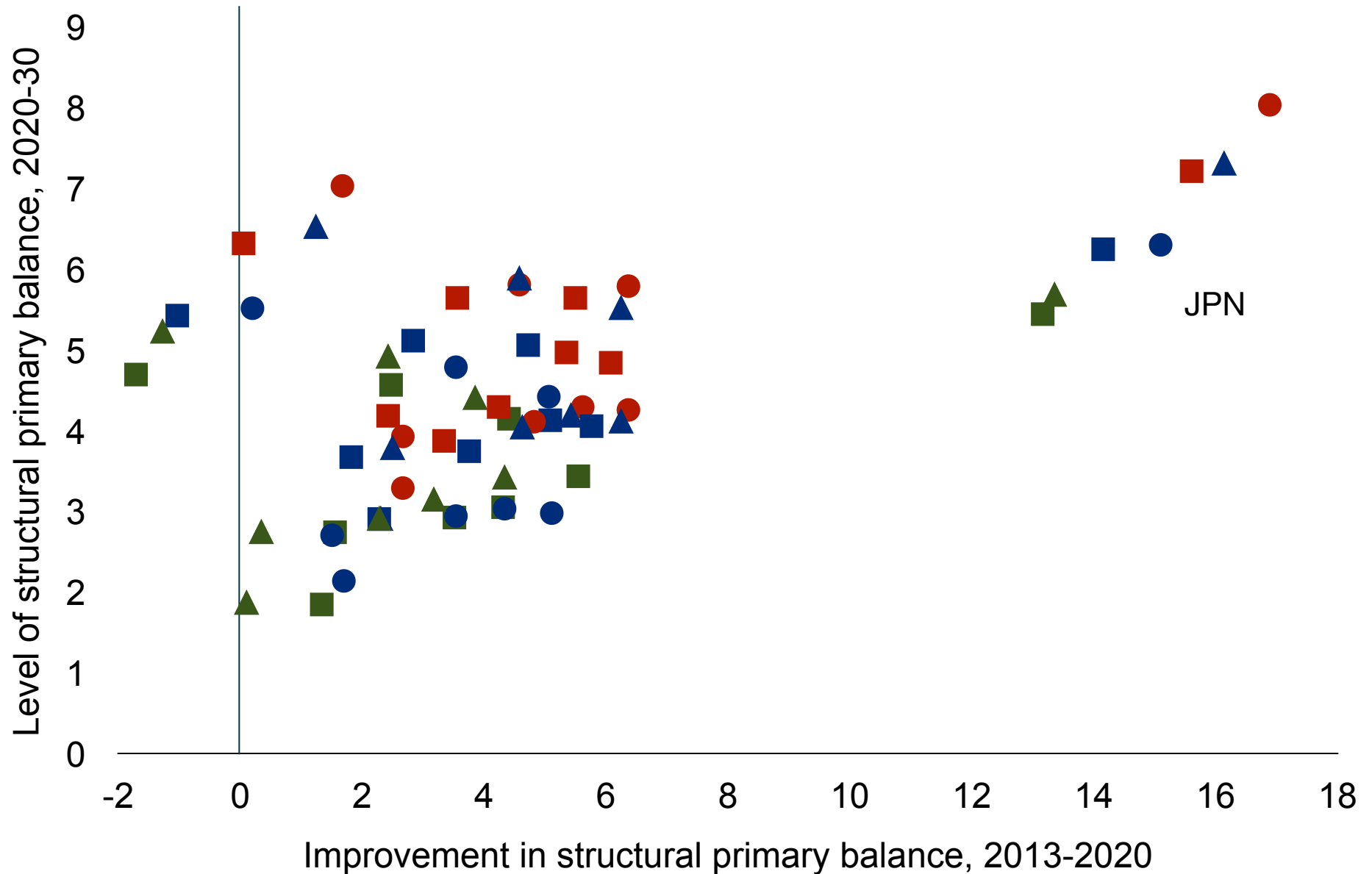



Illustrative Long-term Adjustment Scenarios



Illustrative Long-term Adjustment Scenarios

(Percent of GDP)





**What Are the Risks
Arising from the Poor
State of the Fiscal
Accounts?**

Two Reasons for Concern About High Public Debt

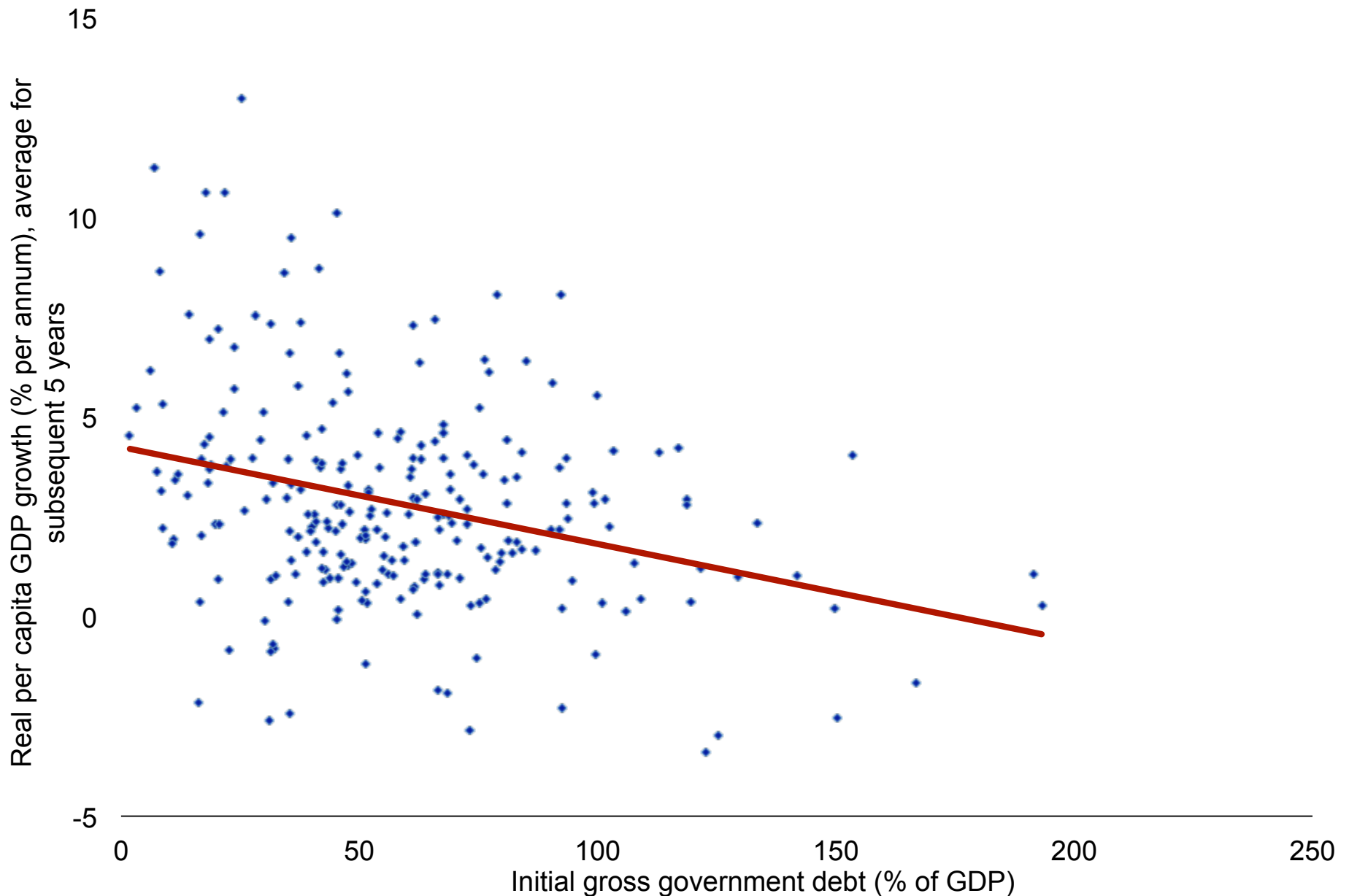
Effect of high public debt on long-term economic growth

High public debt raises risk of fiscal crises

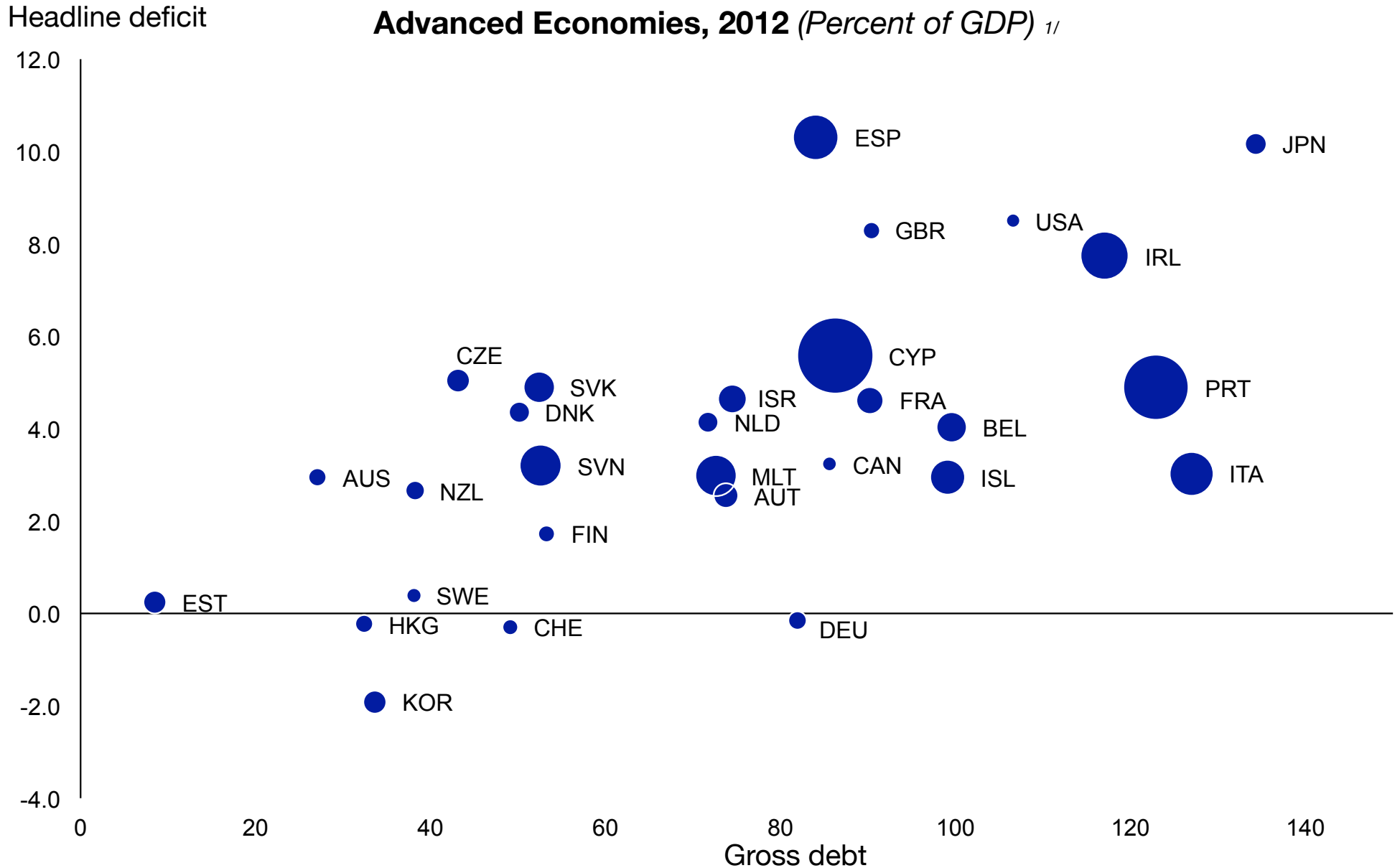
Empirical Literature on Debt and Growth

- Kumar and Woo (2010) in 46 AEs and EMEs for 1970-2007
- Kumar and Woo (2013) in 79 AEs, EMEs and LICs for 1970-2008
- Checherita and Rother (2010) in 12 Euro economies for 1970-2008
- Ceccetti et al. (2011) in 18 OECD countries for 1980-2005
- Balassone et al. (2011) for Italy for 1861-2010
- Ursua and Wilson (2012) in AEs and EMEs for 1950-2010
- Baum et al. (2013) in 12 Euro economies for 1990-2010
- Afonso and Jalles (2013) in 155 AEs, EMEs and LICs for 1970-2008
- Panizza and Presbiterio (2012) in 17 countries for 1980-2005

Initial Government Debt and Growth of Real GDP Per Capita Over the Following Five-Year Period

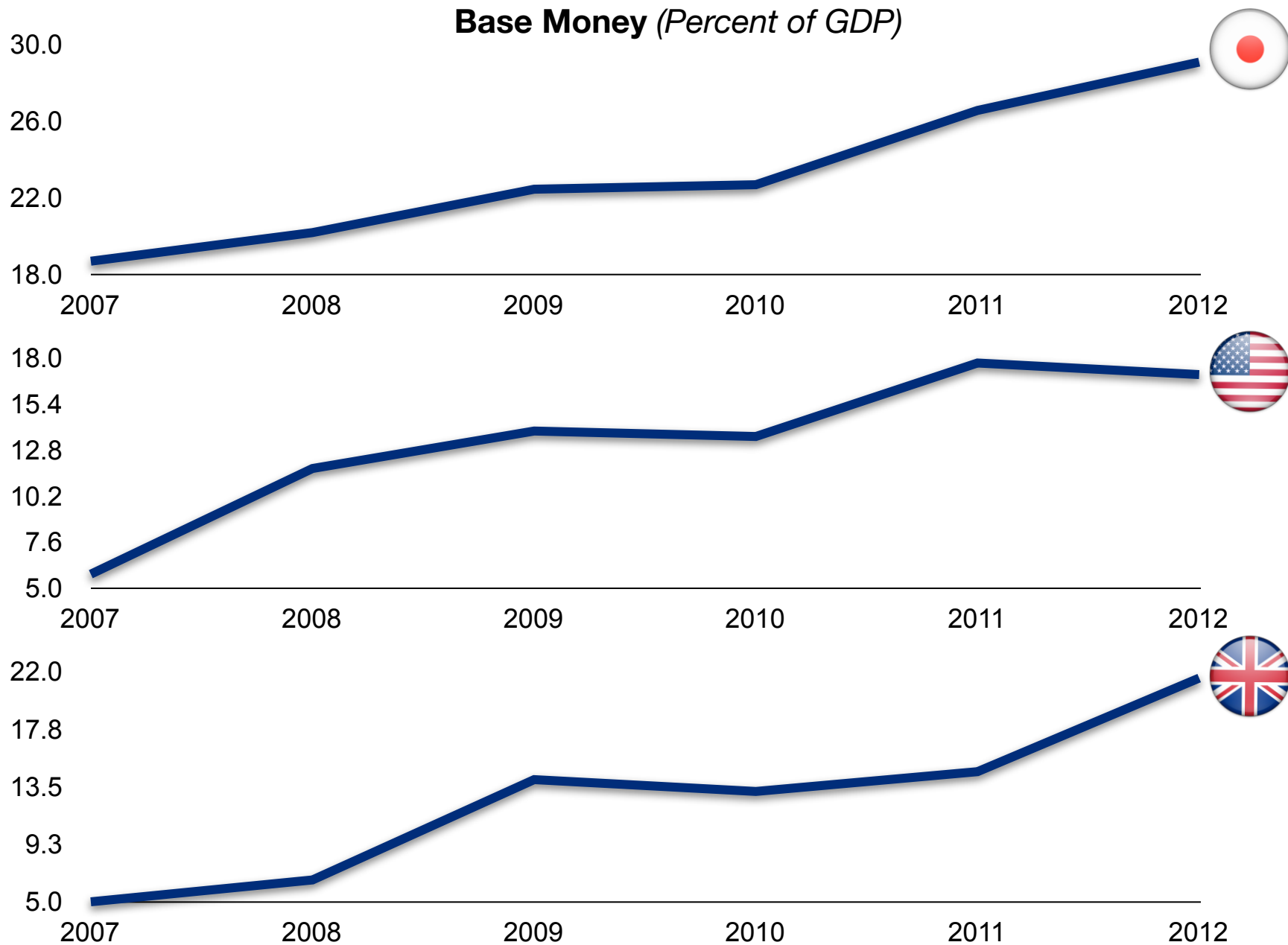


Public Debt, Deficits and CDS Spreads



^{1/} Balloon size based on 2012 average CDS spread.

Monetization of Public Debt



A large, solid red circle is centered on a white background. Inside the circle, the text "What is the Appropriate Strategy to Address these Fiscal Challenges?" is written in a bold, white, sans-serif font, arranged in four lines.

**What is the Appropriate
Strategy to Address these
Fiscal Challenges?**

The Austerity Debate



Ten Commandments for Fiscal Adjustment in Advanced Economies

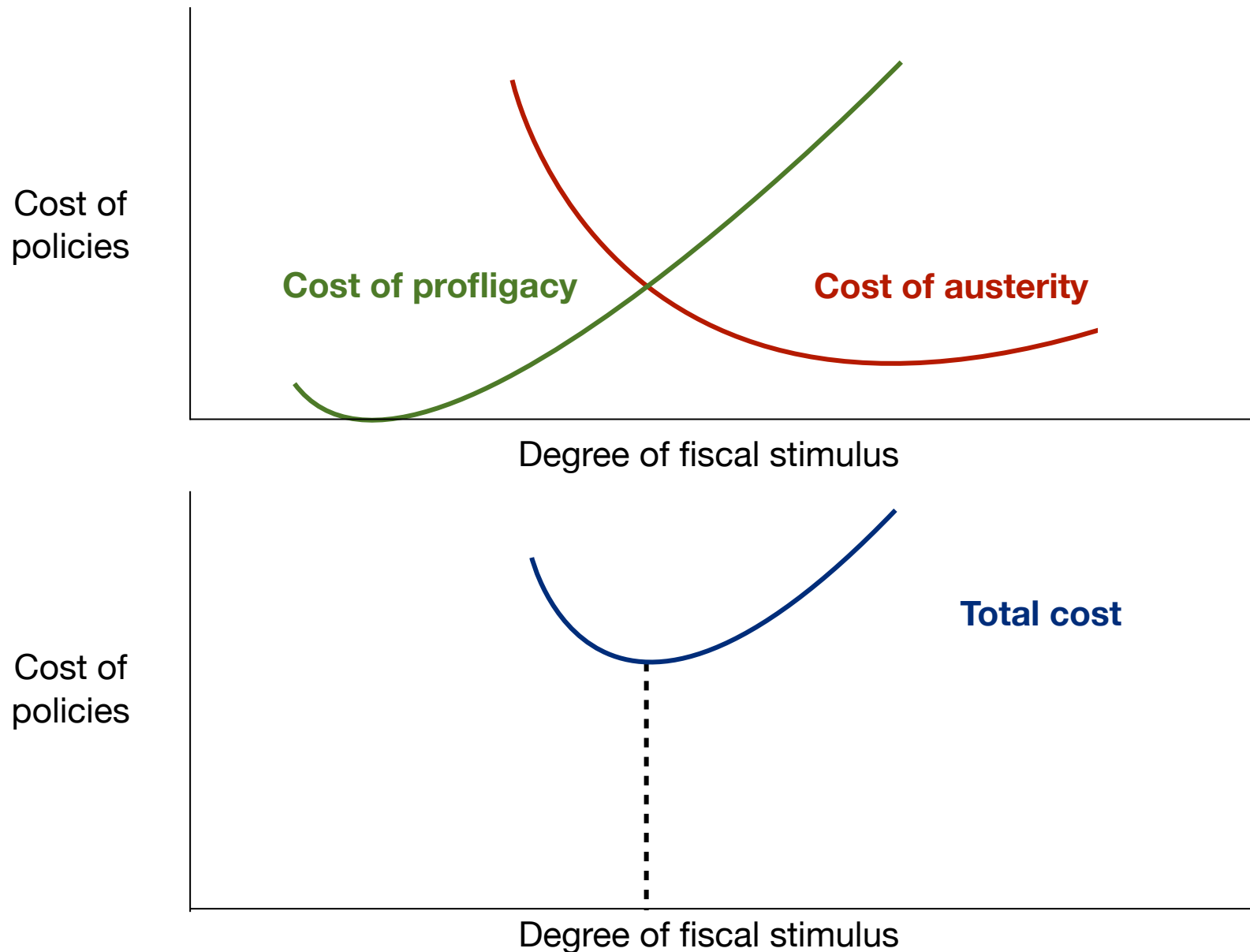
Olivier Blanchard and Carlo Cottarelli

June 24, 2010

Recommended Fiscal Adjustment Strategy

- For countries that are not subject to market pressure, fiscal adjustment should proceed at a moderate pace, within a MT adjustment plan
- These MT plans should be defined in cyclically adjusted terms so as to allow automatic stabilizers to operate
- Countries under market pressure should proceed more rapidly, but also for these there is a speed limit
- This fiscal strategy should be supported by relaxed monetary conditions, and structural reforms to boost trend growth

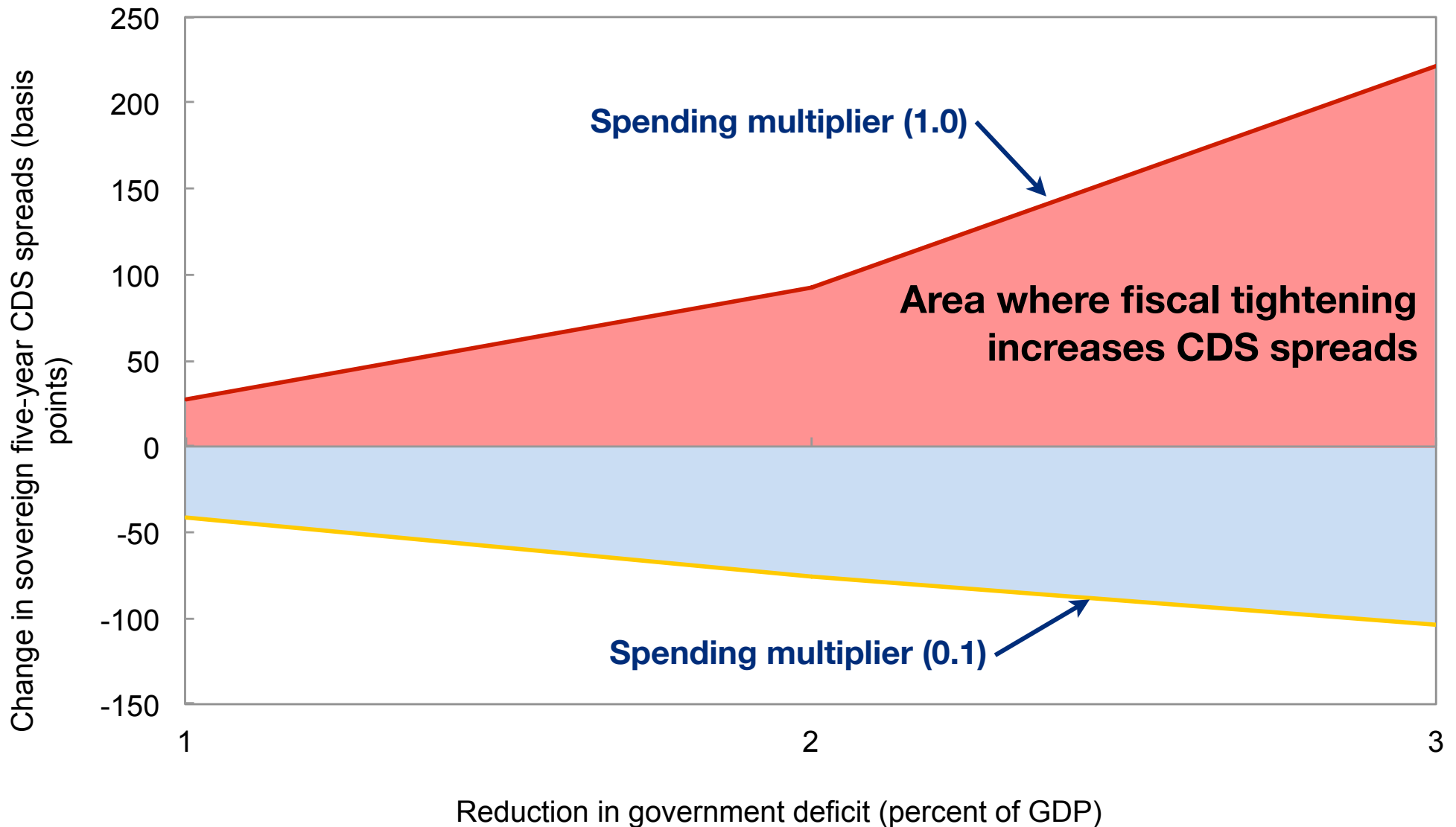
Nonlinearities of Fiscal Austerity and Profligacy



Costs of Fiscal Tightening are Now High

- Fiscal multipliers are particularly large now reflecting downward inflexibility of nominal interest rates, the difficulty banks have in extending credit, the large share of households that are credit rationed, and in a recession, cuts in demand will affect output rather than prices.
- The cost of an output loss is larger when the economy is already growing slowly
- Higher than usual hysteresis effect

Fiscal Adjustment and CDS Spreads with Alternative Fiscal Multipliers



Three Issues on the Costs of Fiscal Profligacy

A perfect commitment technology does not exist

We tend to underestimate the cost of fiscal crises before they occur

The risk of turmoil on the government paper market is not the same for all countries but “black swan” events do occur

Three Issues on the Costs of Fiscal Profligacy

A perfect commitment technology does not exist

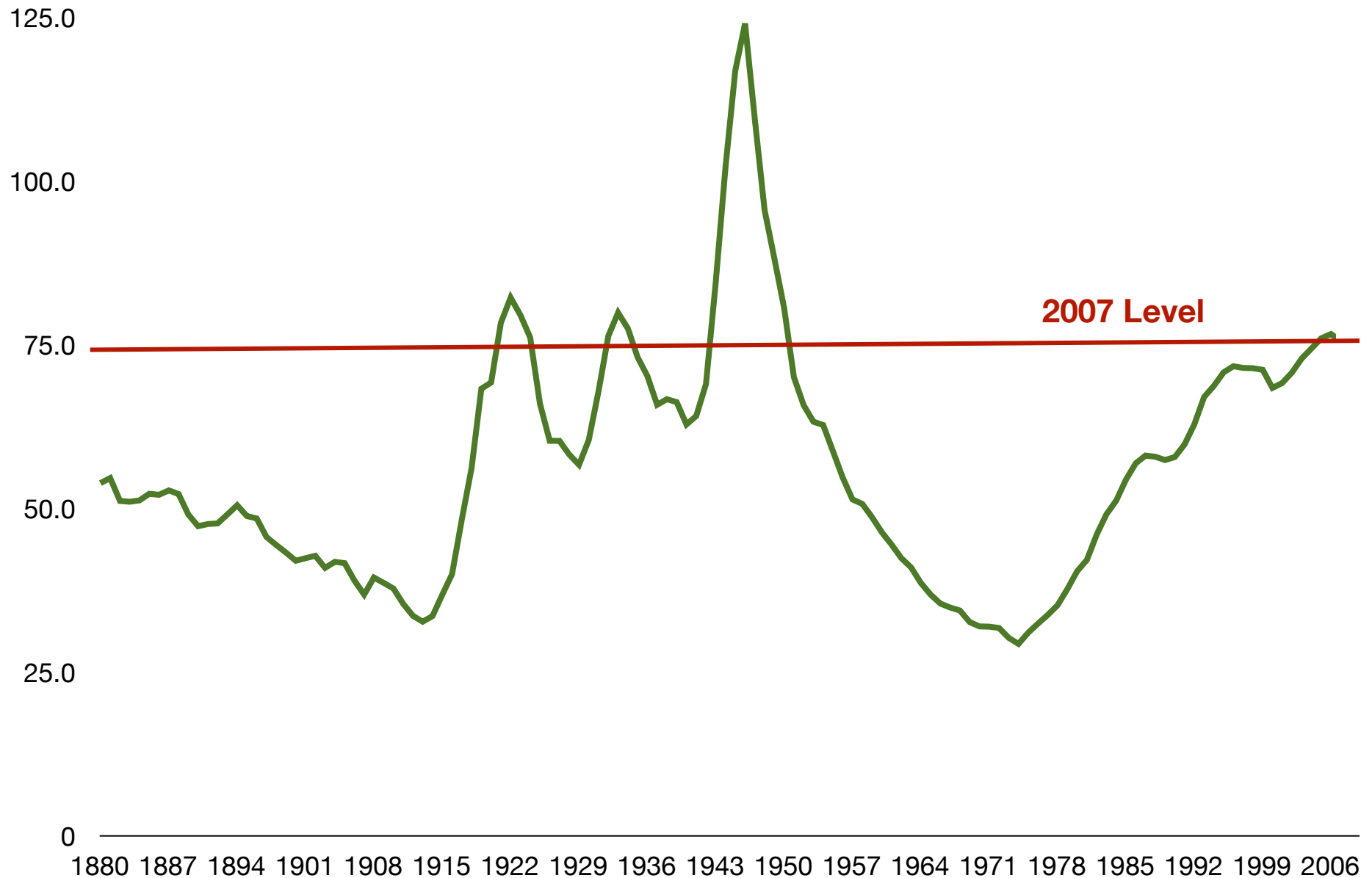
In the past, advanced economies did not use their good times to lower public debt

Fiscal twist already danced in 2008-09

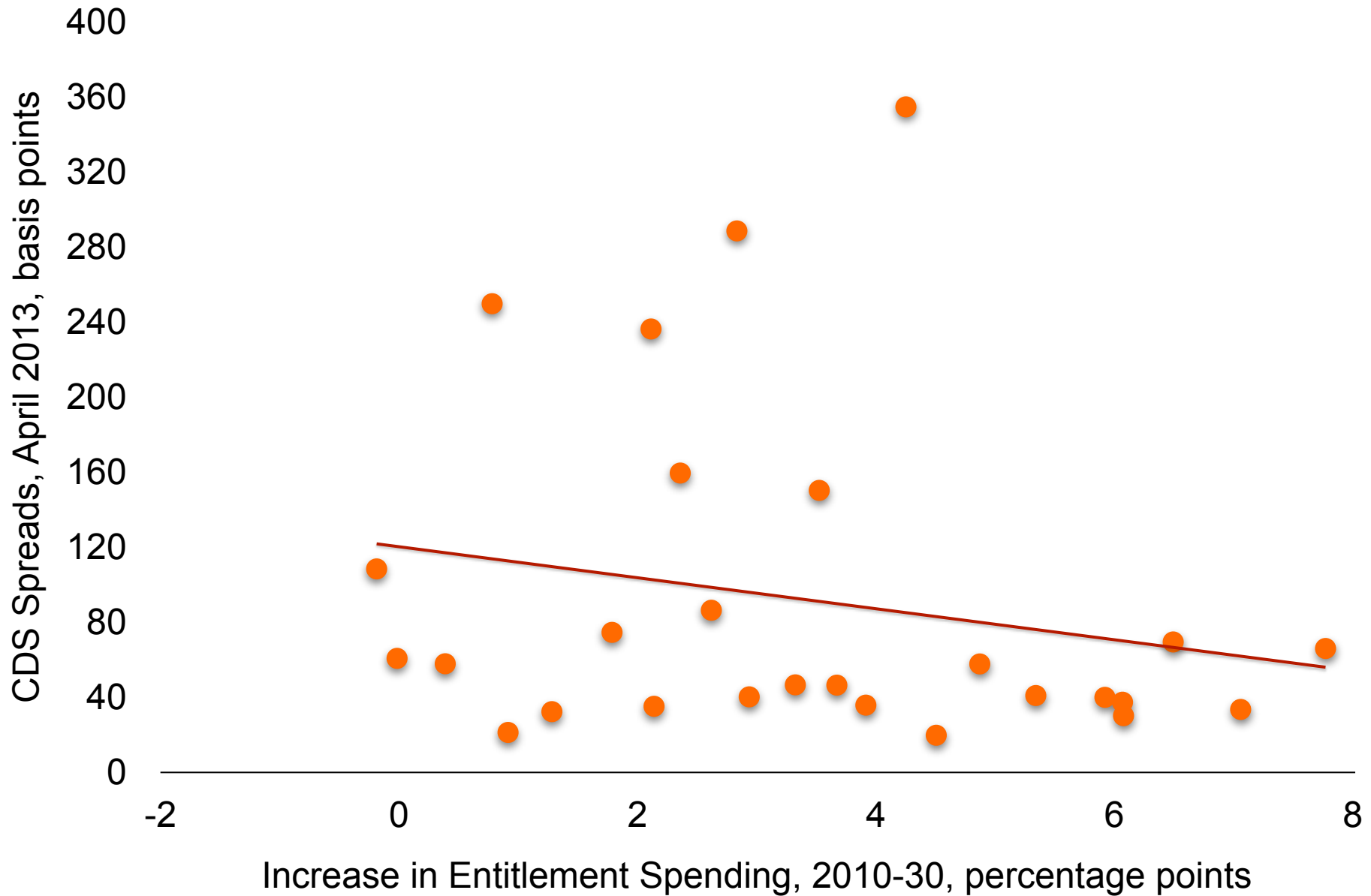
Gaining credibility by implementing entitlement reform is not so easy

General Government Gross Debt

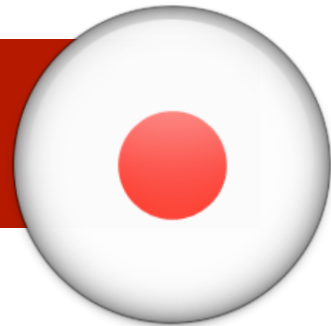
Advanced Economies, 1880-2013 (Percent of GDP)



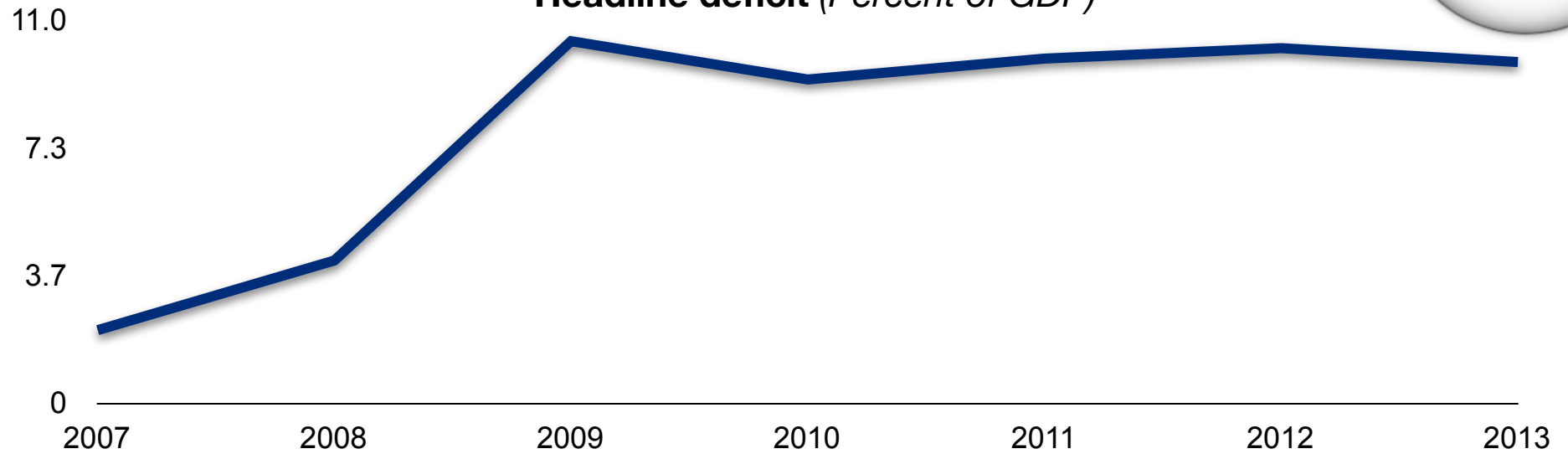
CDS Spreads and Entitlement Spending



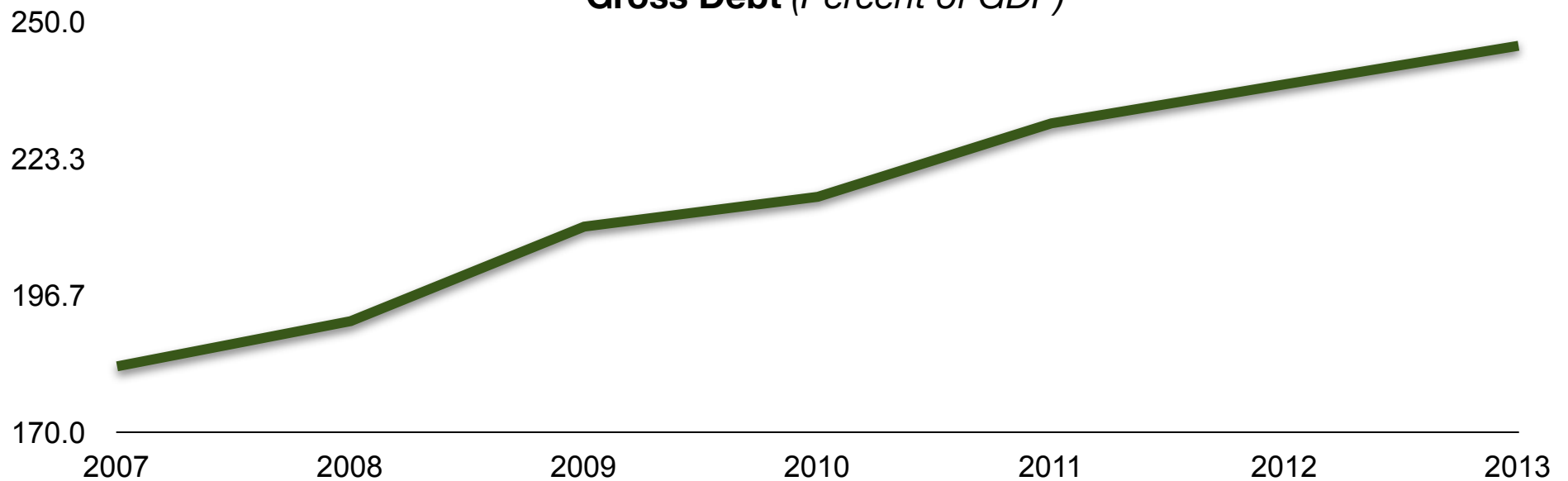
Japan: General Government Deficit and Debt



Headline deficit (*Percent of GDP*)

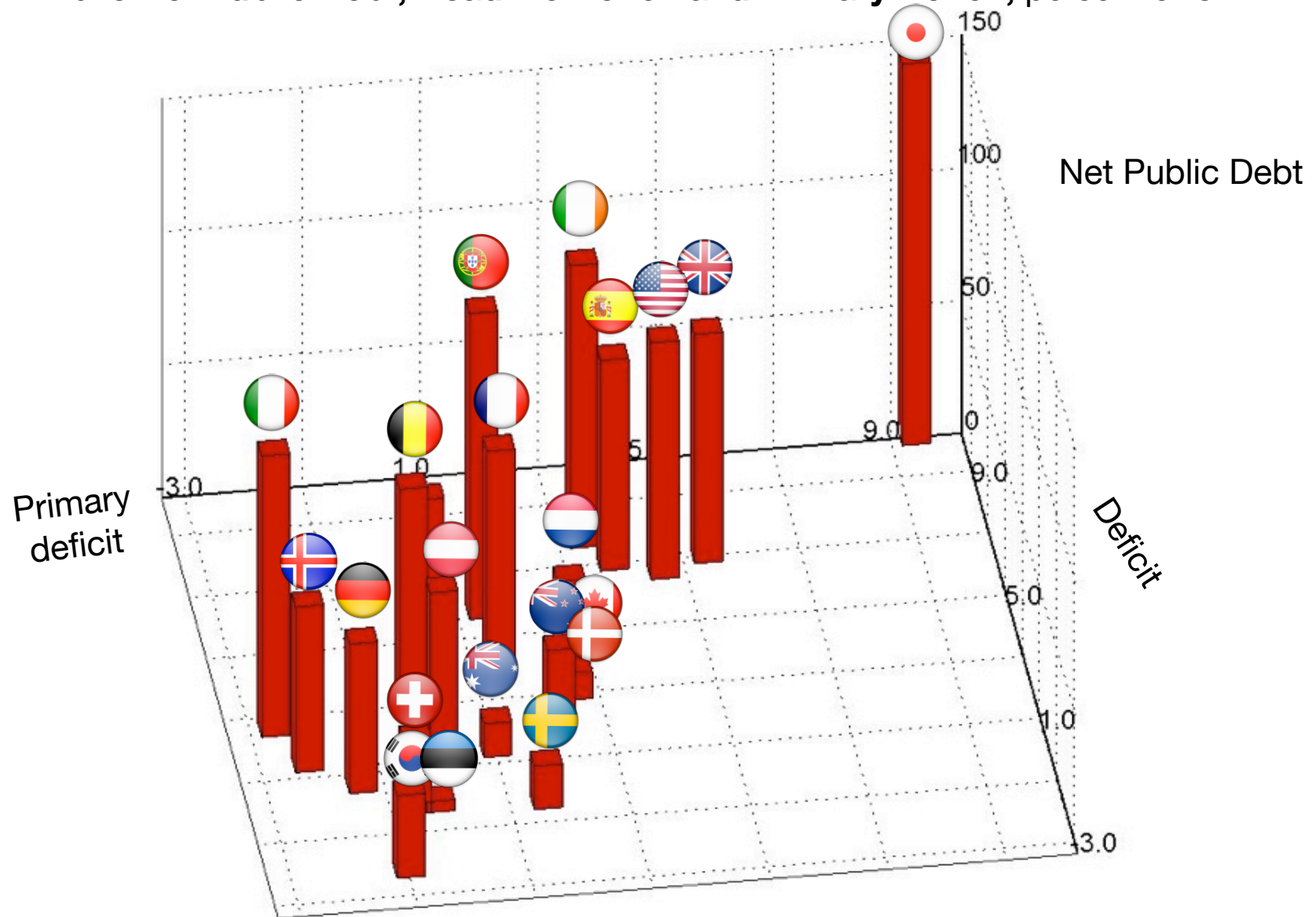


Gross Debt (*Percent of GDP*)



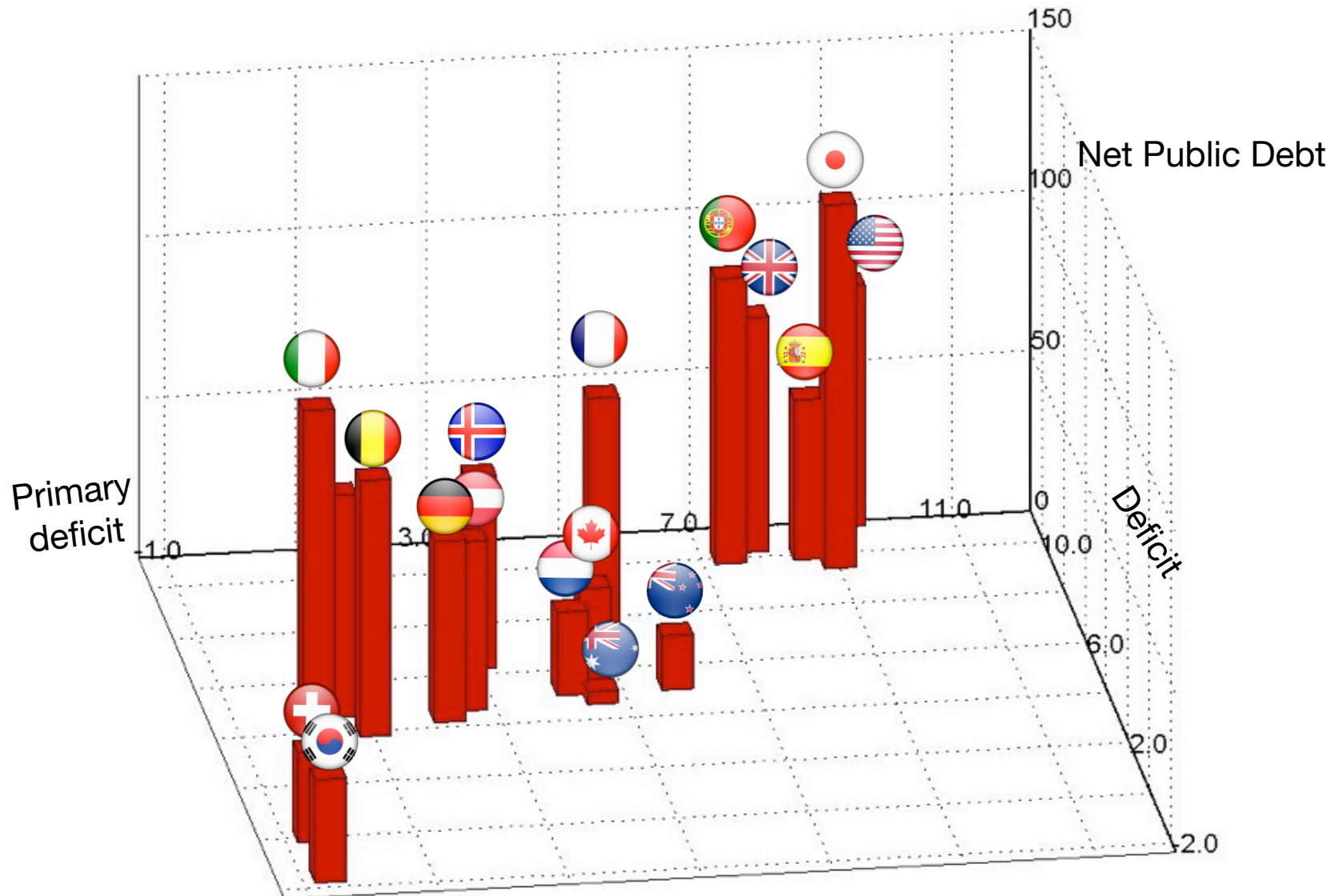
Advanced Economies

2013 Net Public Debt, Headline Deficit and Primary Deficit, percent of GDP



Advanced Economies

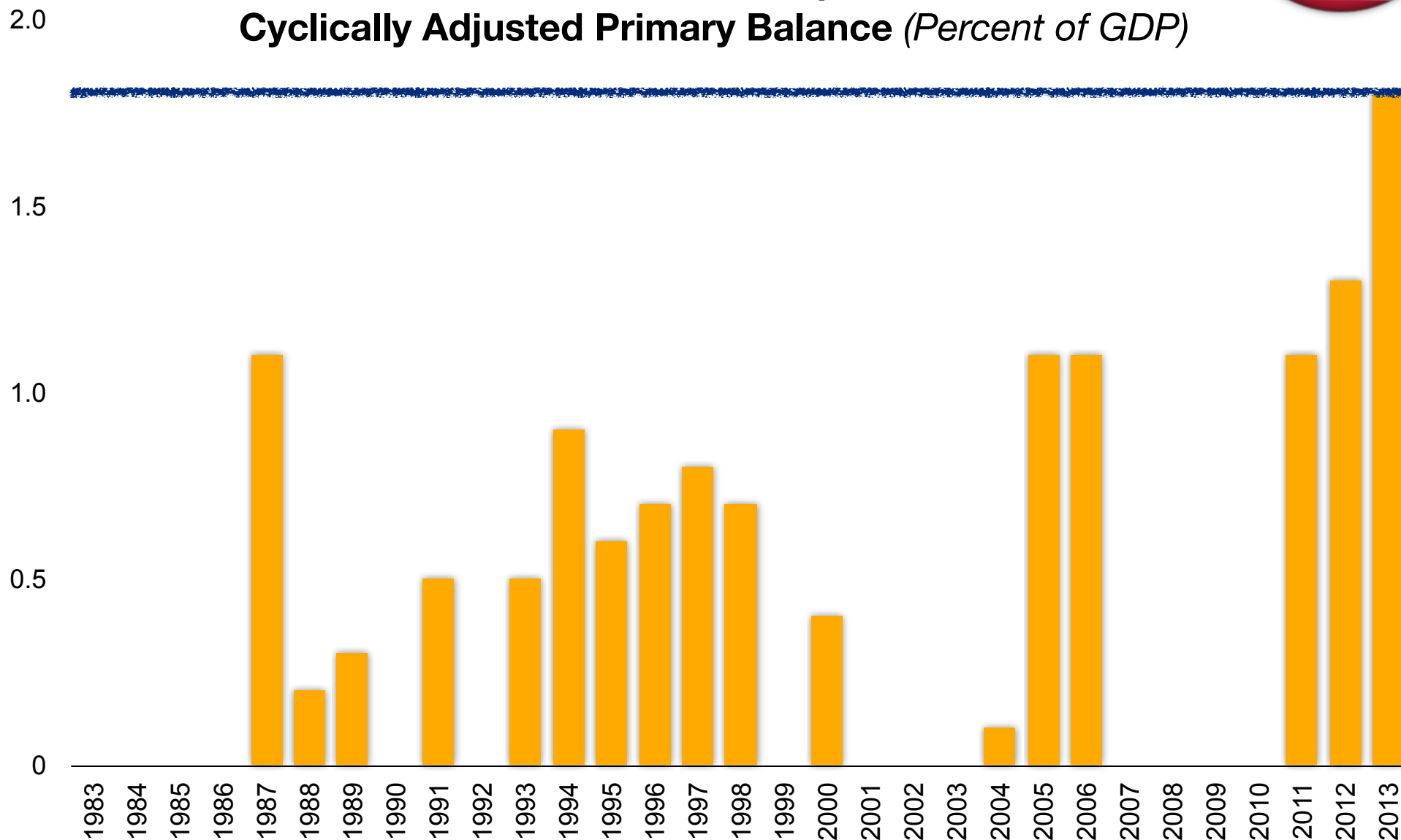
2010 Net Public Debt, Headline Deficit and Primary Deficit, percent of GDP



United States: Largest Fiscal Tightening in the Last 30 Years



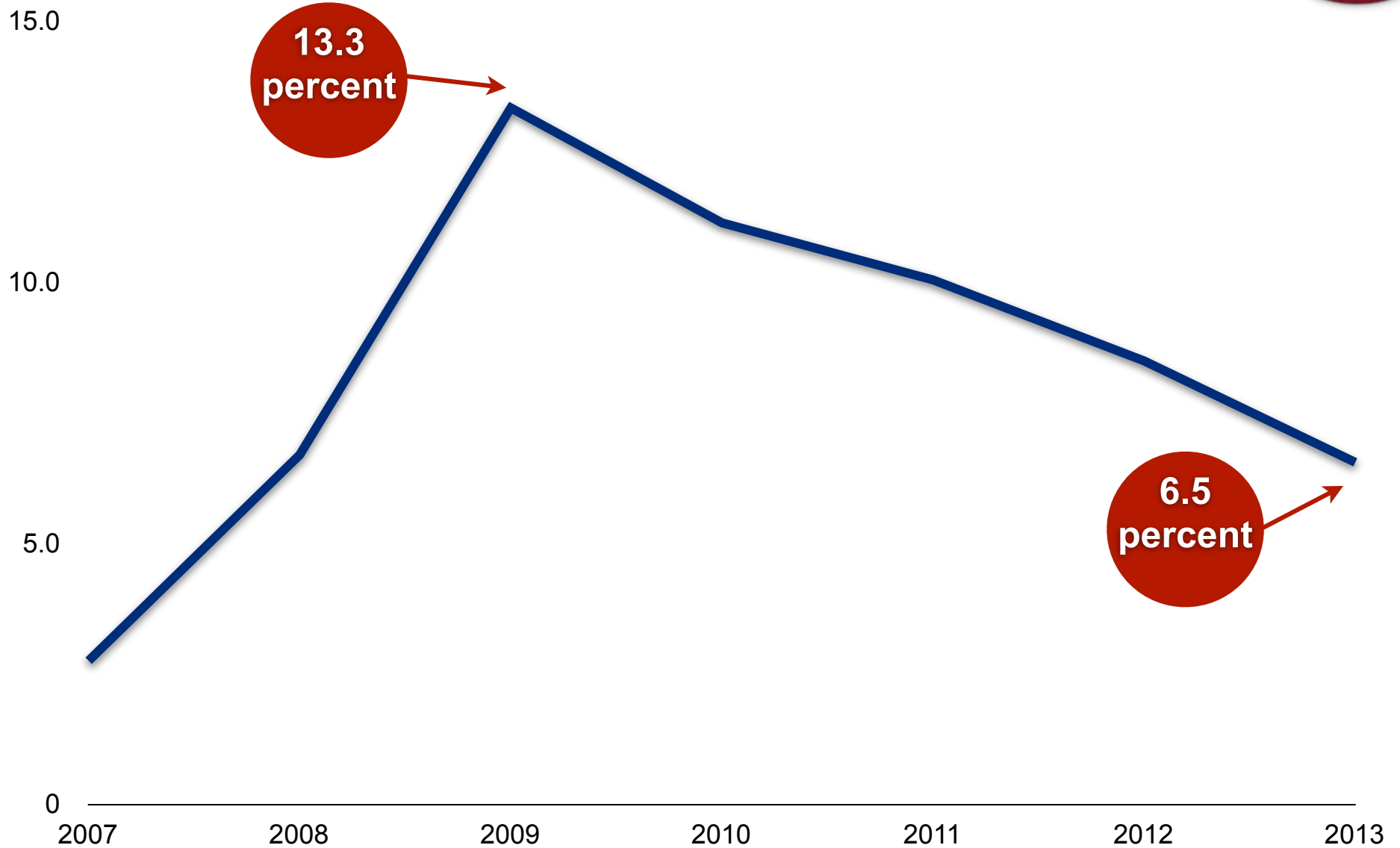
**General Government, Improvement in
Cyclically Adjusted Primary Balance (*Percent of GDP*)**



United States: General Government Deficit

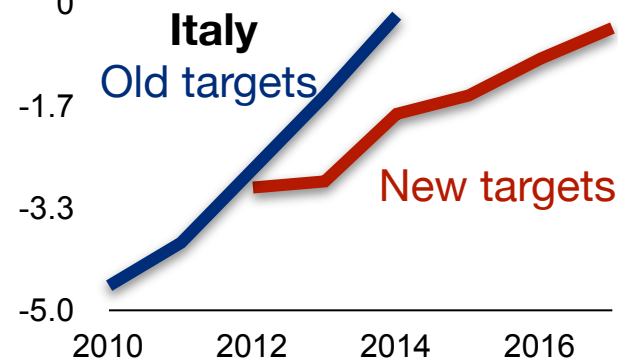
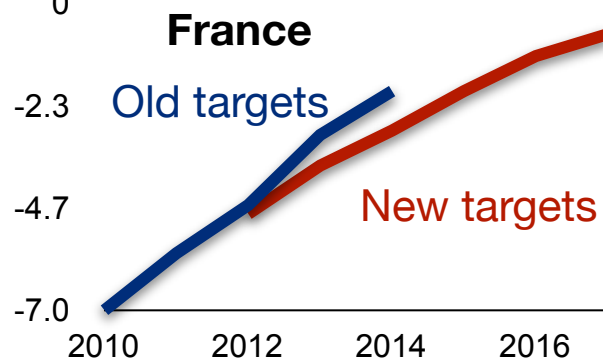
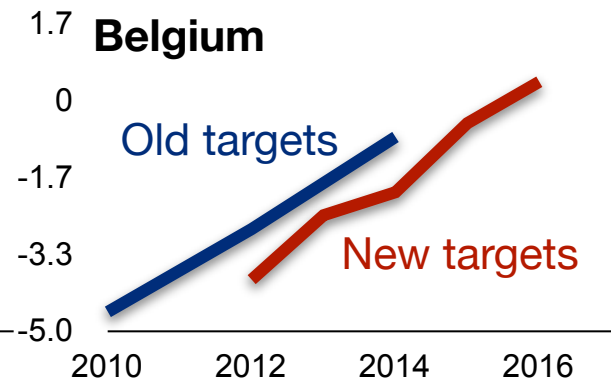
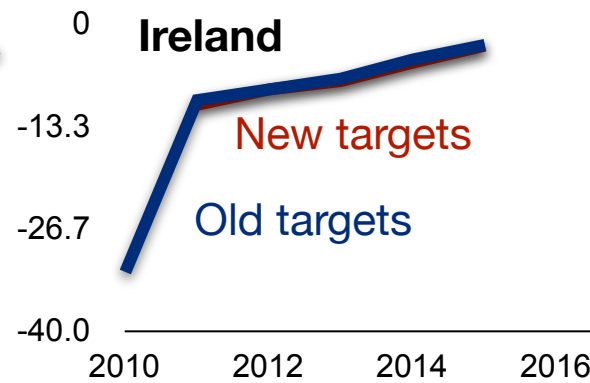
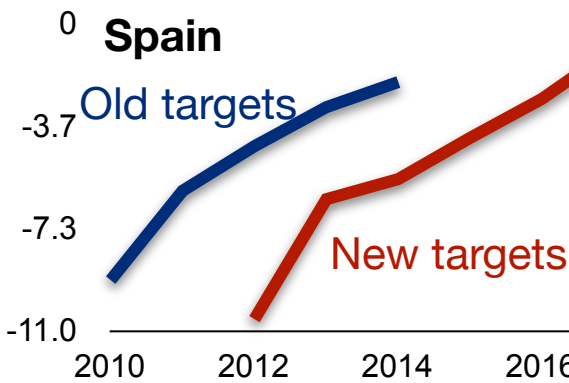
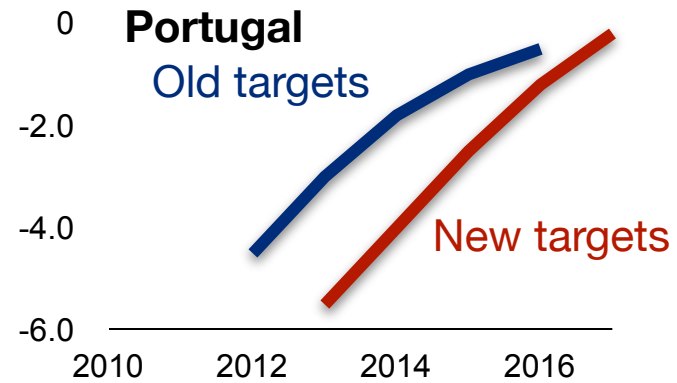
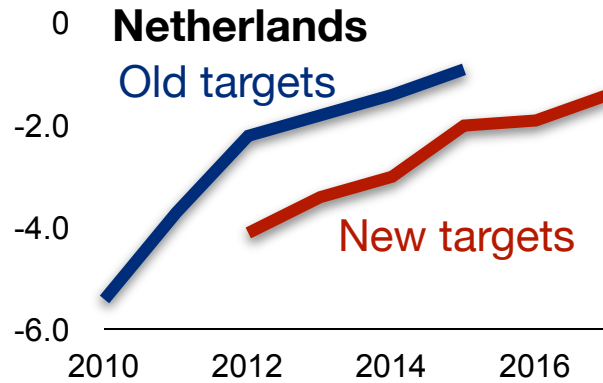


Headline deficit (*Percent of GDP*)



Stability Programs: 2011 and 2013

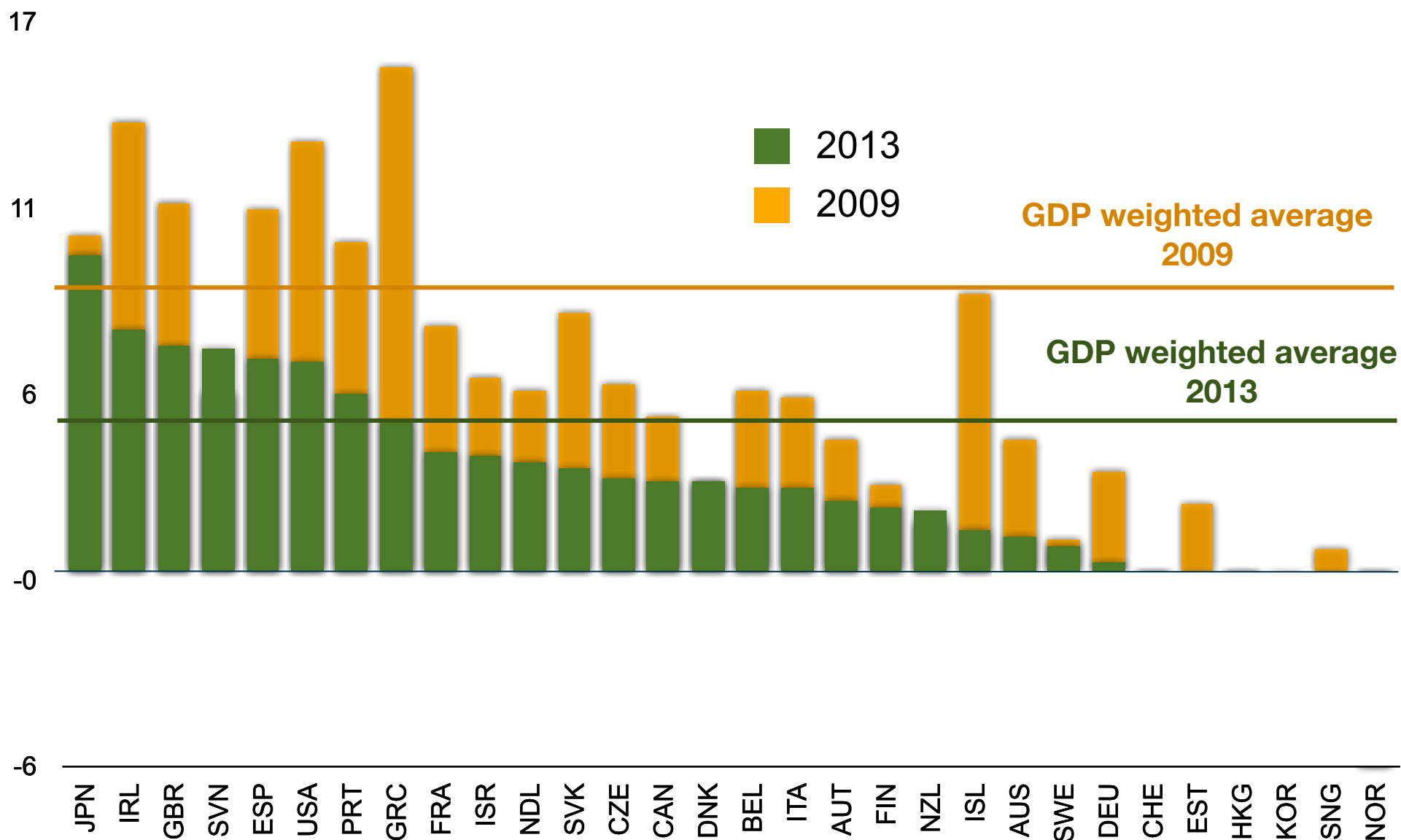
General Government Headline Balance Targets (Percent of GDP)



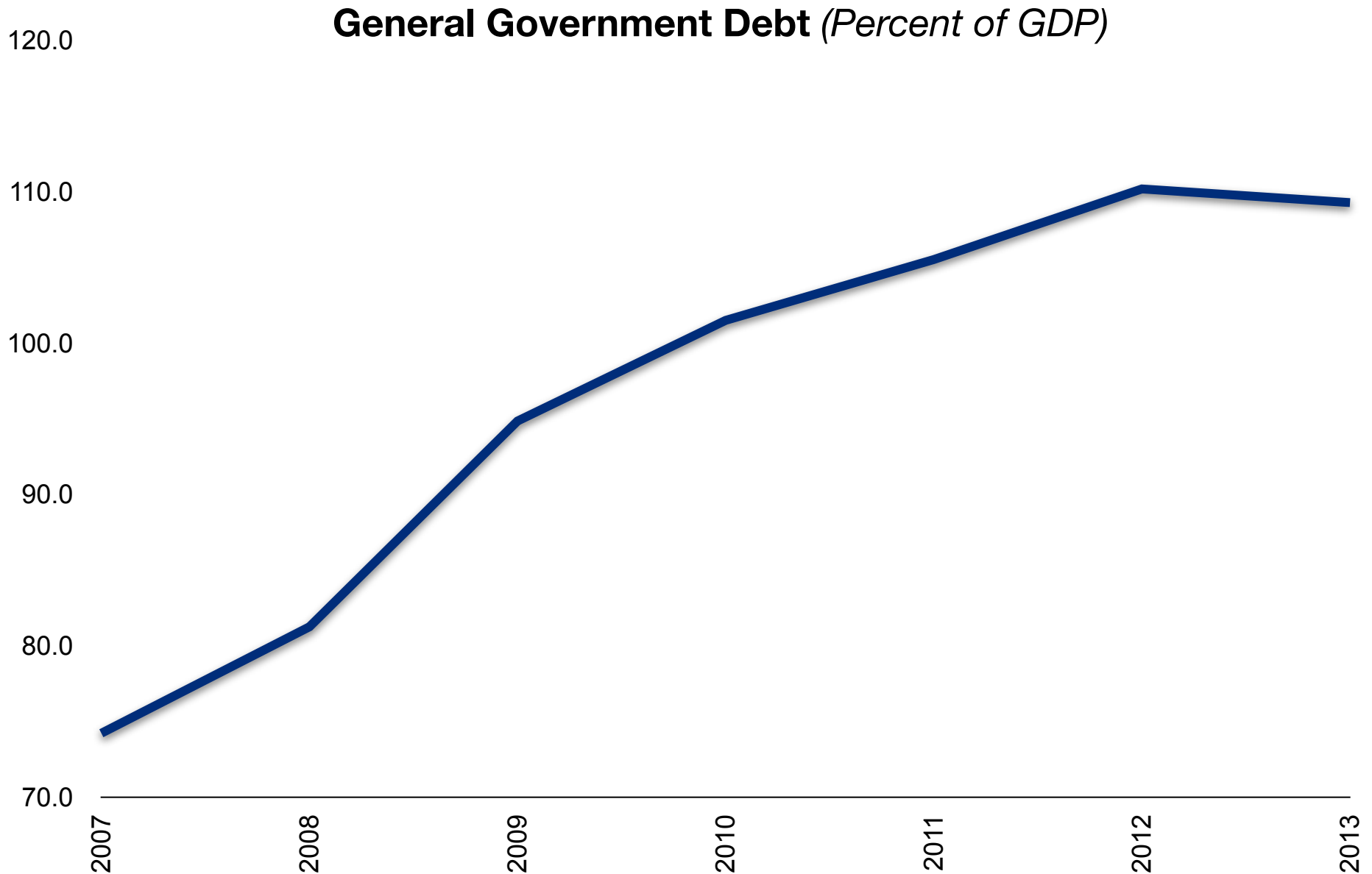
**Is This Strategy of
Steady Fiscal
Adjustment Working and
is it Realistic to
Continue it in the
Future?**

Advanced Economies: Average Deficit Will Be Half of What It Was in 2009

2009 and 2013, General Government Deficit (Percent of GDP)

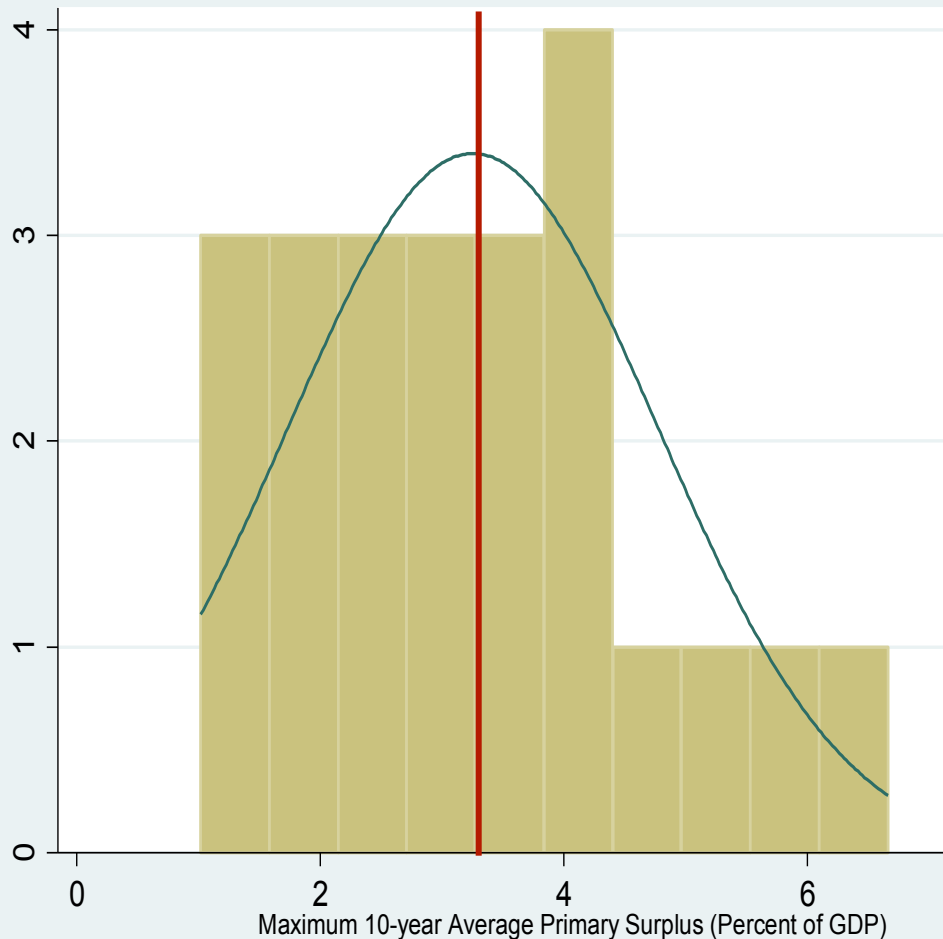


Advanced Economies: In 2013, Average Public Debt Will Stop Rising

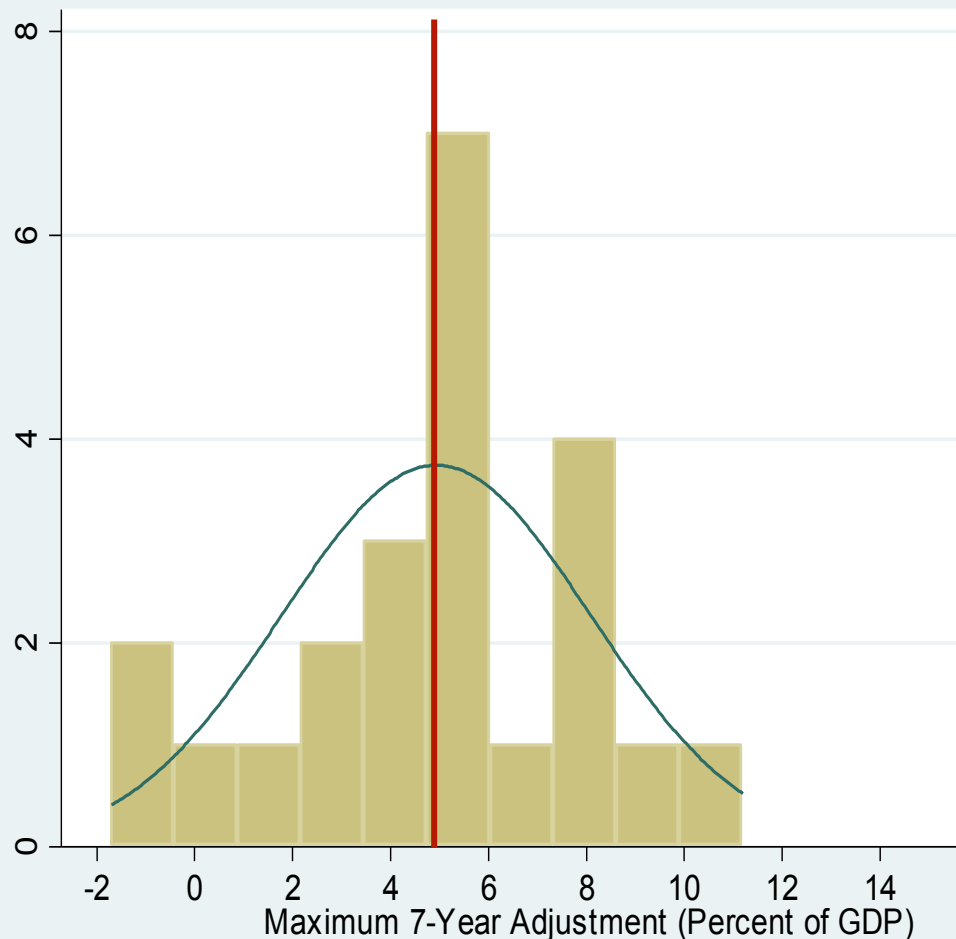


23 Advanced Economies: Historical Evidence on Primary Balances, 1950-2011 (New FAD Database)

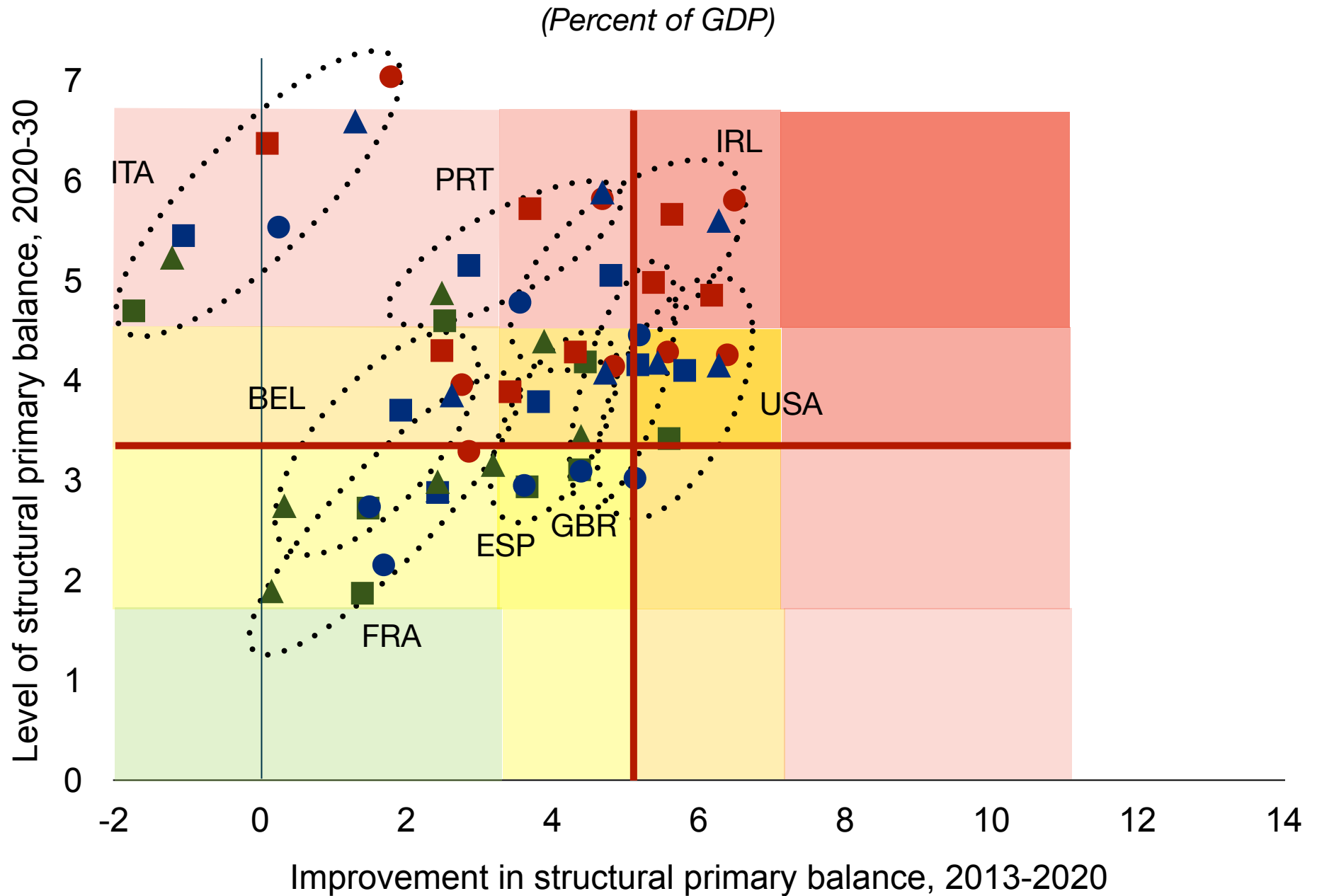
Maximum Primary Surplus



Maximum Improvement in Primary Surplus



Illustrative Long-term Adjustment Scenarios



Thank you!

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