

Fiscal Policy: Reconciling Fiscal Sustainability and Growth



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Fiscal Monitor, September 2011 and January 2012 Update

World Economic and Financial Surveys

Fiscal Monitor

Addressing Fiscal Challenges to Reduce Economic Risks

SEP 11

INTERNATIONAL MONETARY FUND

Fiscal Monitor

UPDATE

Fiscal Affairs Department

As Downside Risks Rise, Fiscal Policy Has To Walk a Narrow Path

Deficits in many advanced economies fell significantly during 2011, and most plan substantial adjustment this year. Continued adjustment is necessary for medium-term debt sustainability, but should ideally occur at a pace that supports adequate growth in output and employment. Given the large adjustment already in train this year, governments should avoid responding to any unexpected downturn in growth by further tightening policies, and should instead allow the automatic stabilizers to operate, as long as financing is available and sustainability concerns permit. Countries with enough fiscal space, including some in the euro area, should reconsider the pace of near-term adjustment. At the same time, some countries—notably, the United States and Japan—need to clarify their medium-term debt-reduction strategies. Adjustment should be supported by the availability of adequate nonmarket financing when, as in the euro area, market confidence is slow to respond to reforms.

Fiscal deficits fell significantly in 2011 in many advanced economies...

In advanced economies, fiscal deficits fell in 2011 by about 1 percent of GDP overall, and by only slightly less after taking into account the narrowing output gap. The headline deficit fell by 2 percent of GDP in the euro area, and by a still sizable 1¼ percent of GDP in cyclically adjusted terms (Table 1). However, a large share of the improvement within the euro area is accounted for by Germany, where the cyclically adjusted deficit fell by 2¼ percent of GDP, reflecting an unusually strong response of revenues and employment to output. The cyclically adjusted balance also strengthened substantially in Spain, while France and Italy posted more modest improvements, as measures announced or approved in these countries will not take full effect until next year (see below). Cyclically adjusted deficits also fell substantially in Canada,

the United Kingdom and the United States, but rose marginally in Japan owing to reconstruction costs related to the natural disaster.

Among European program countries, headline deficits were larger than expected in Greece owing in part to a weaker economic outturn. Slippages in the implementation of revenue and spending measures and lower tax compliance suggest that the cyclically adjusted deficit exceeded expectations as well, notwithstanding an improvement of 3 percentage points of GDP relative to 2010. In Portugal, the fiscal target was met through a one-time partial transfer of banks' pension fund assets, implying that the underlying adjustment in 2011 was smaller than expected there, although still very sizable (4 percentage points of GDP in cyclically adjusted terms). In Ireland, headline fiscal outturns were on track, and the cyclically adjusted balance improved by 2 percent of GDP.



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Overview

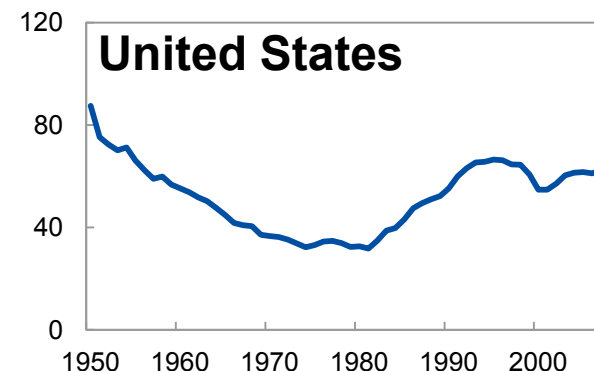
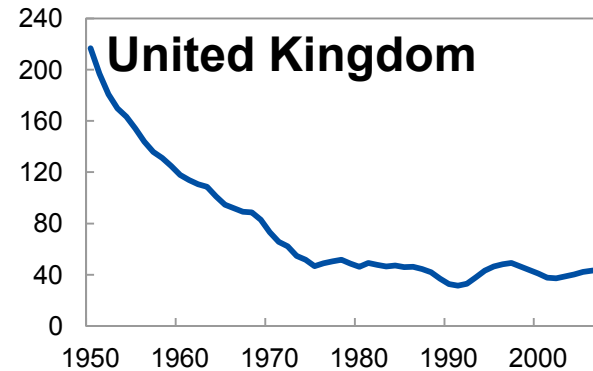
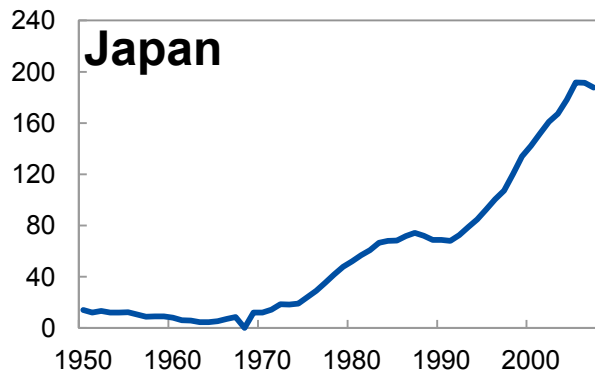
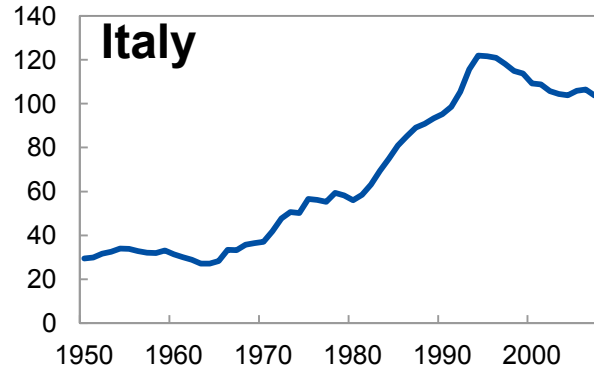
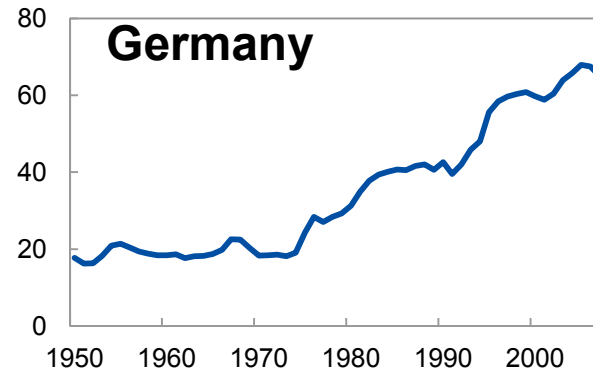
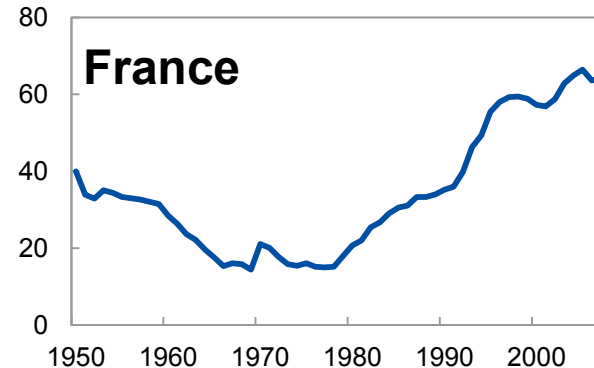
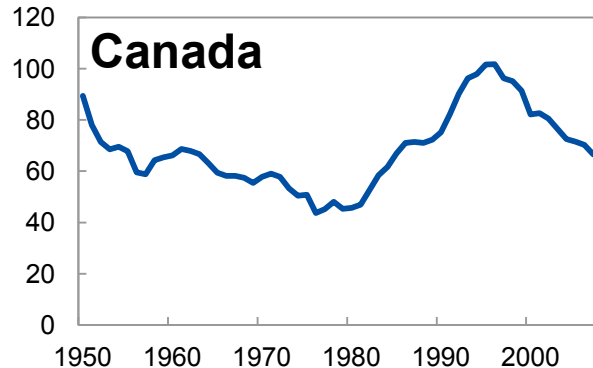
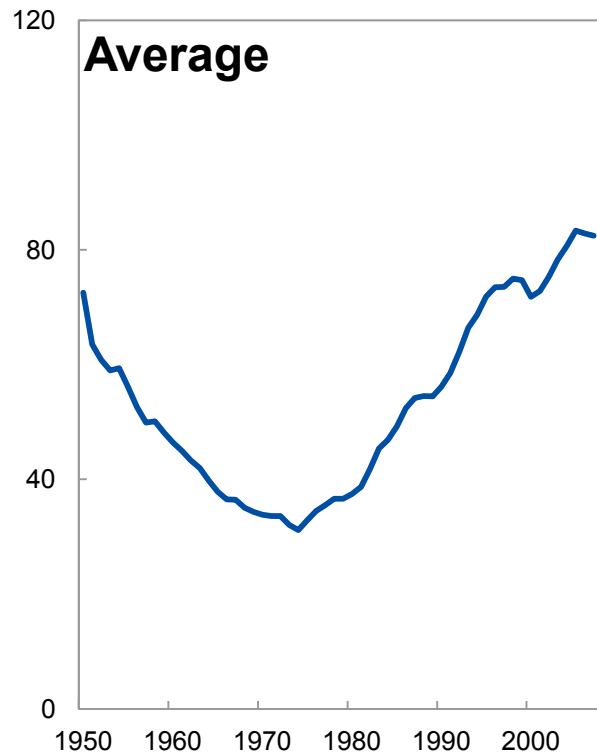
1. The state of the public finances before the 2008 crisis
2. The effect of the crisis on the fiscal accounts
3. The pace of fiscal adjustment
4. Policy conclusions



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

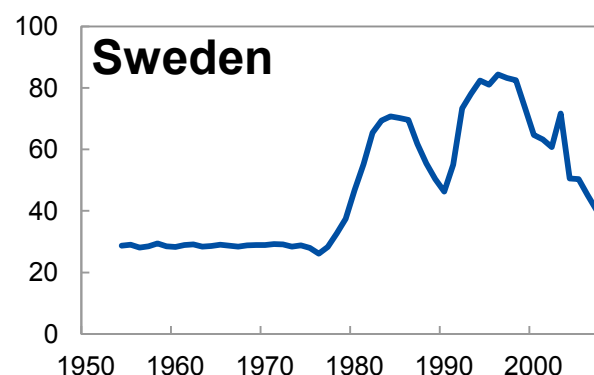
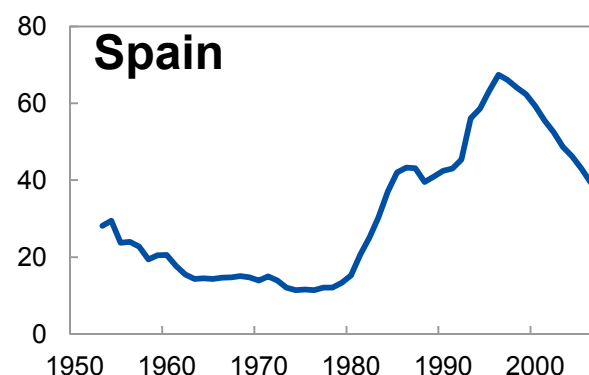
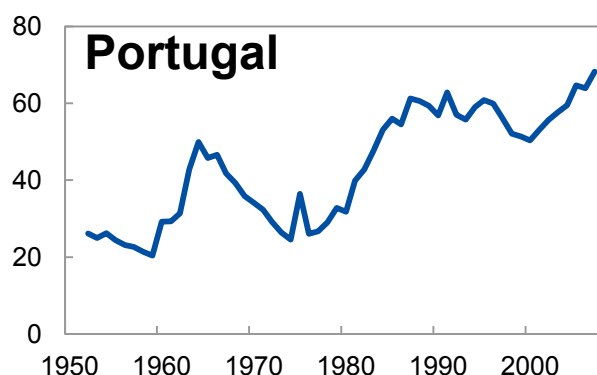
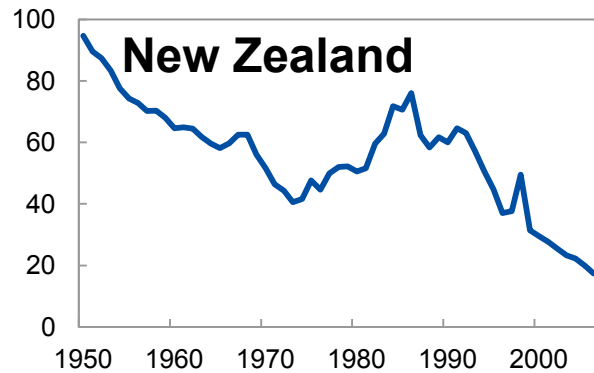
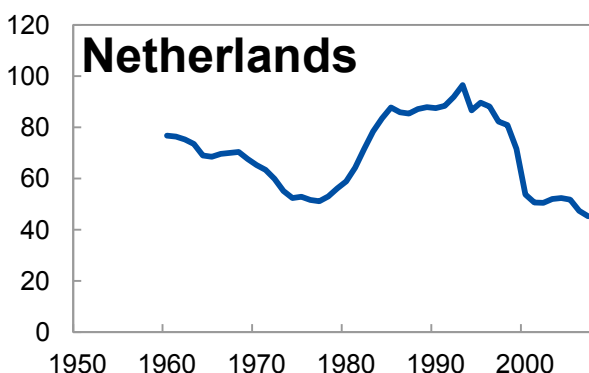
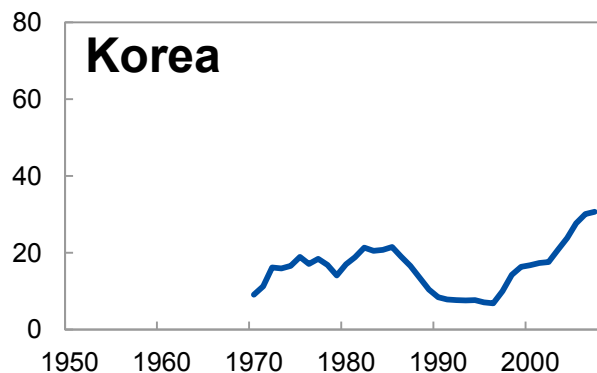
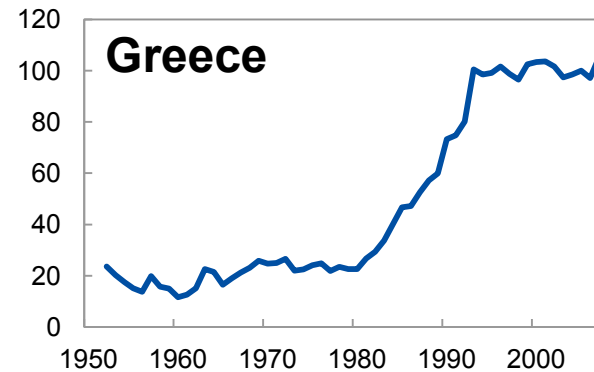
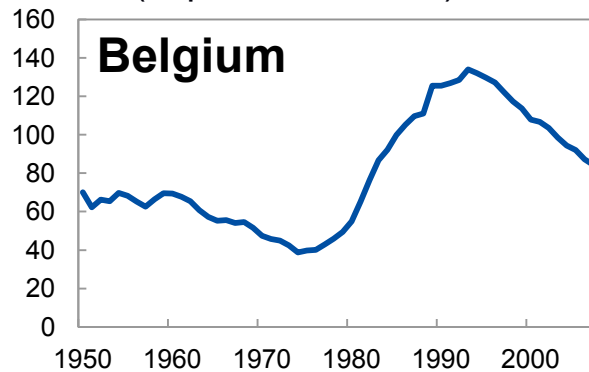
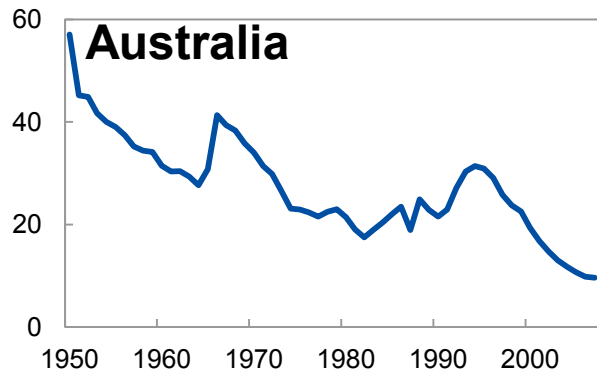
General Government Gross Debt in G-7 Economies, 1950-2007

(In percent of GDP)



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

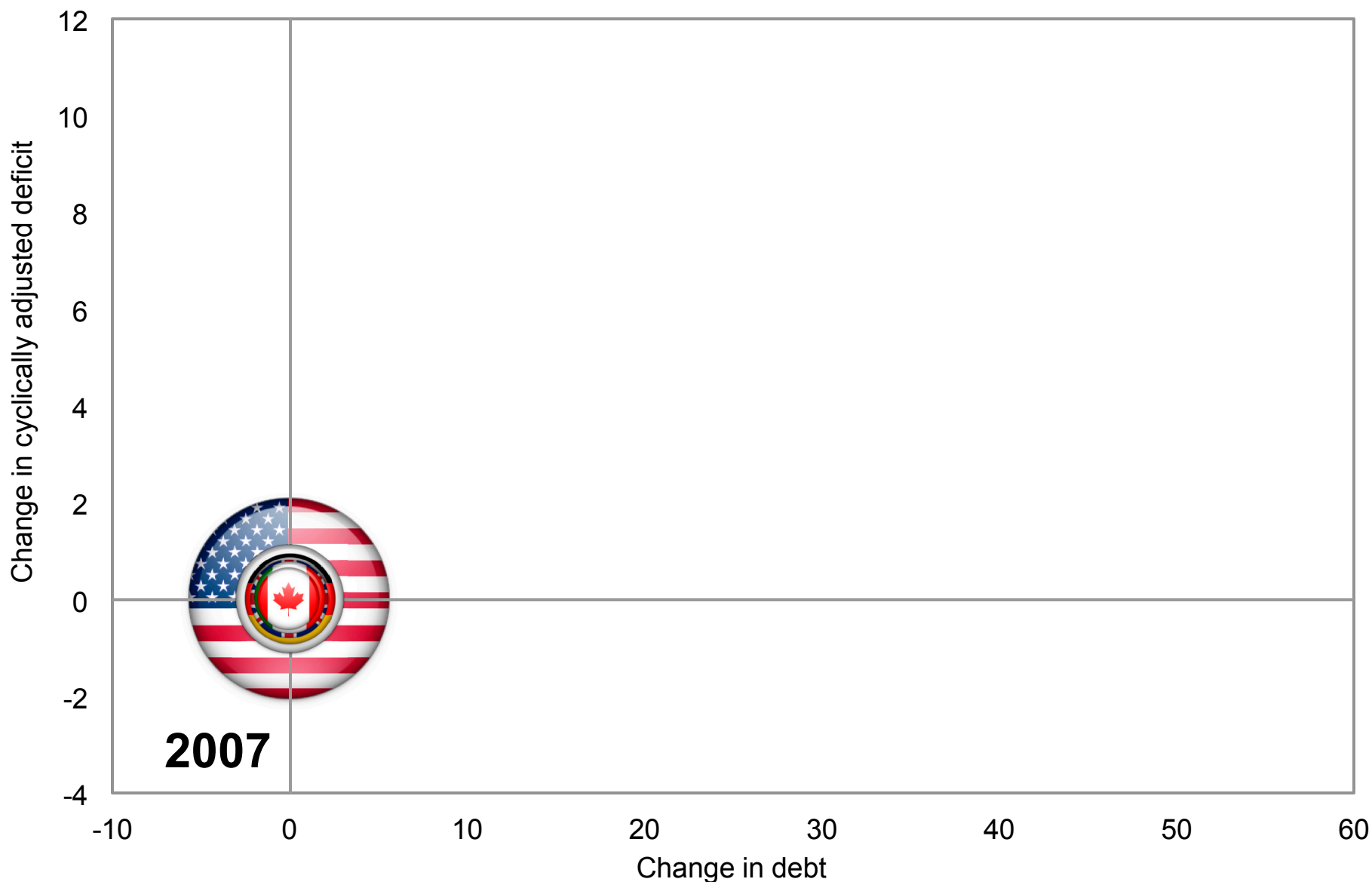
(In percent of GDP)



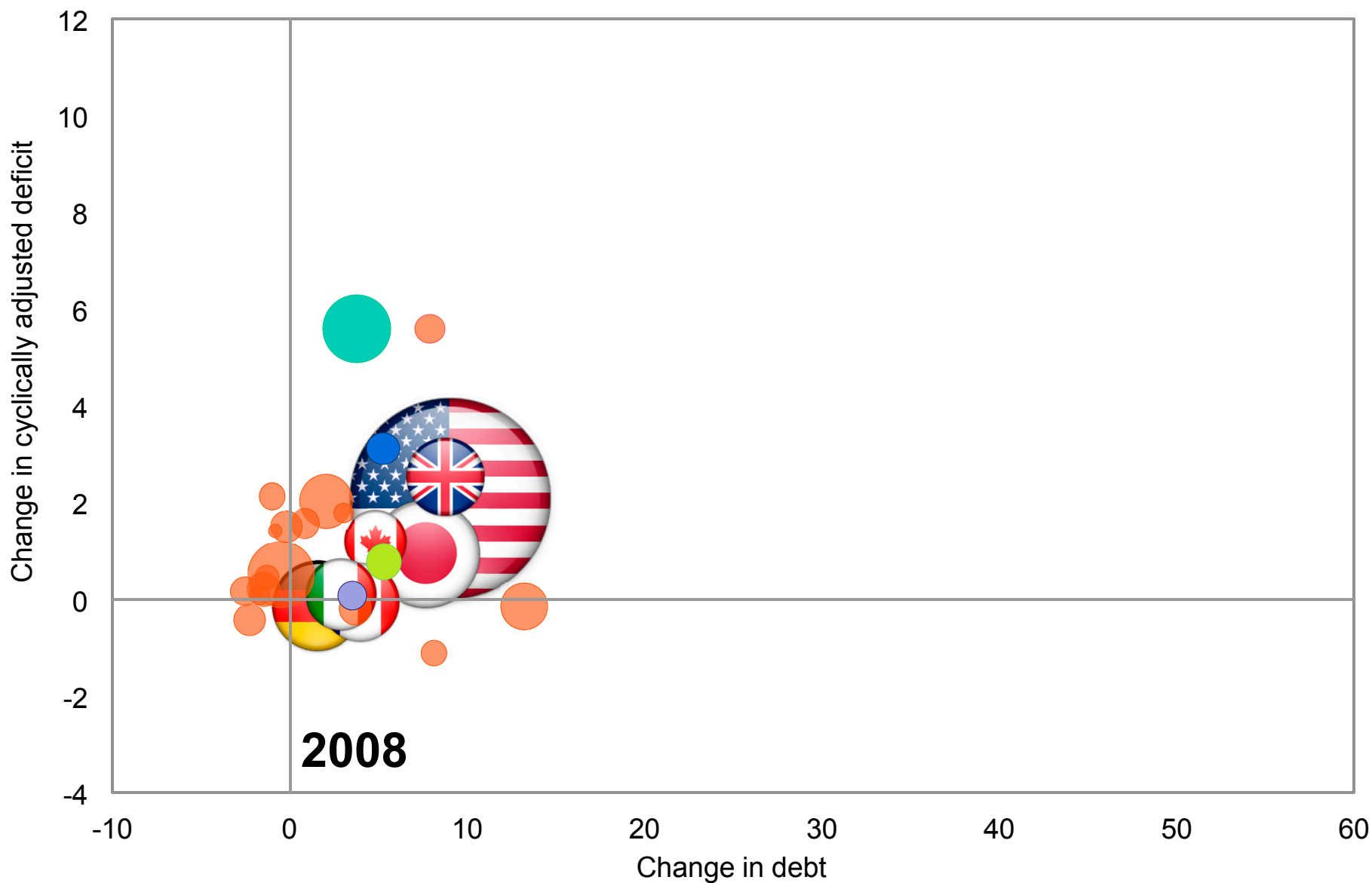


2. The effect of the crisis on the fiscal accounts

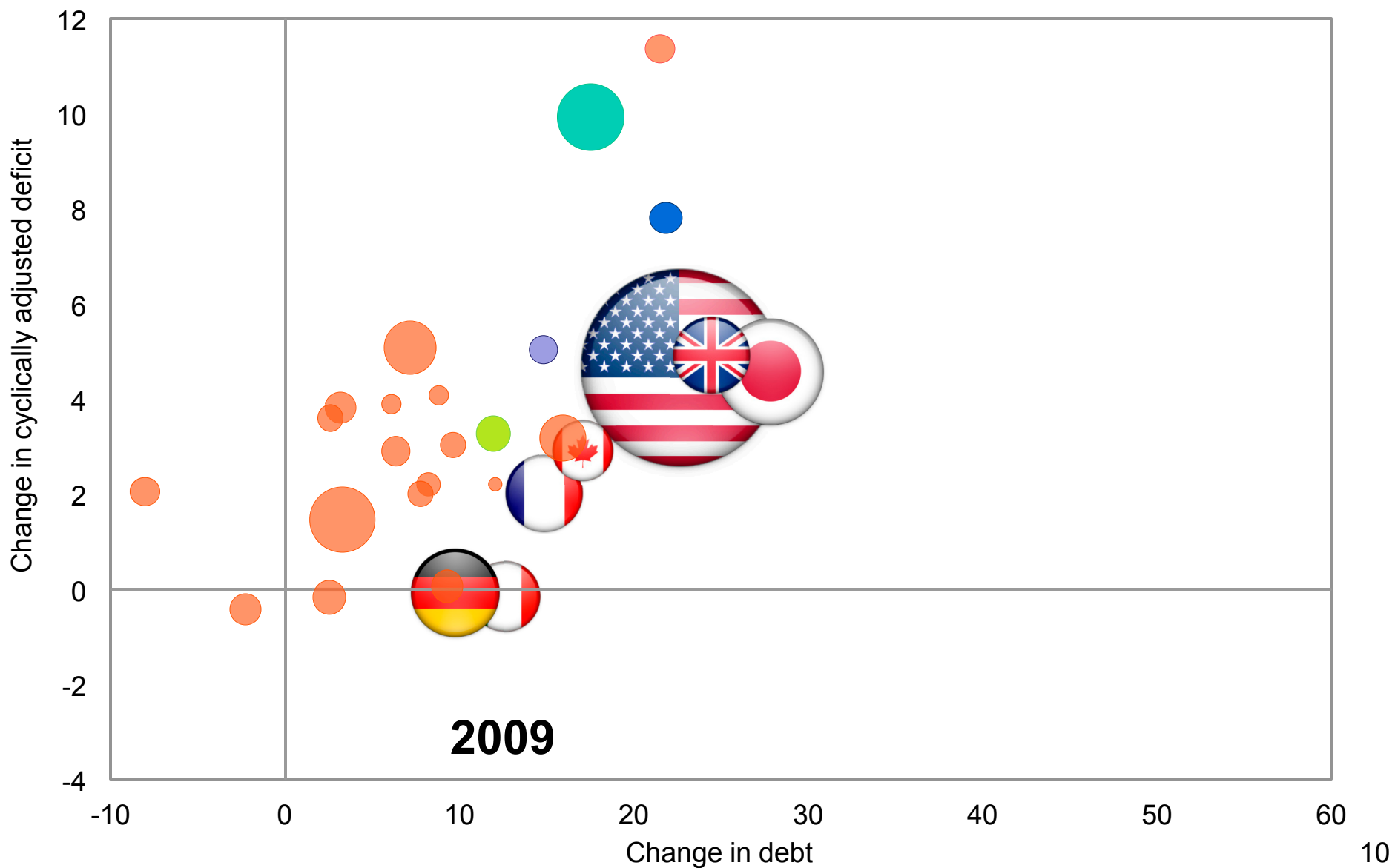
Advanced Economies: Change in General Government Debt and Cyclically Adjusted Deficit from 2007



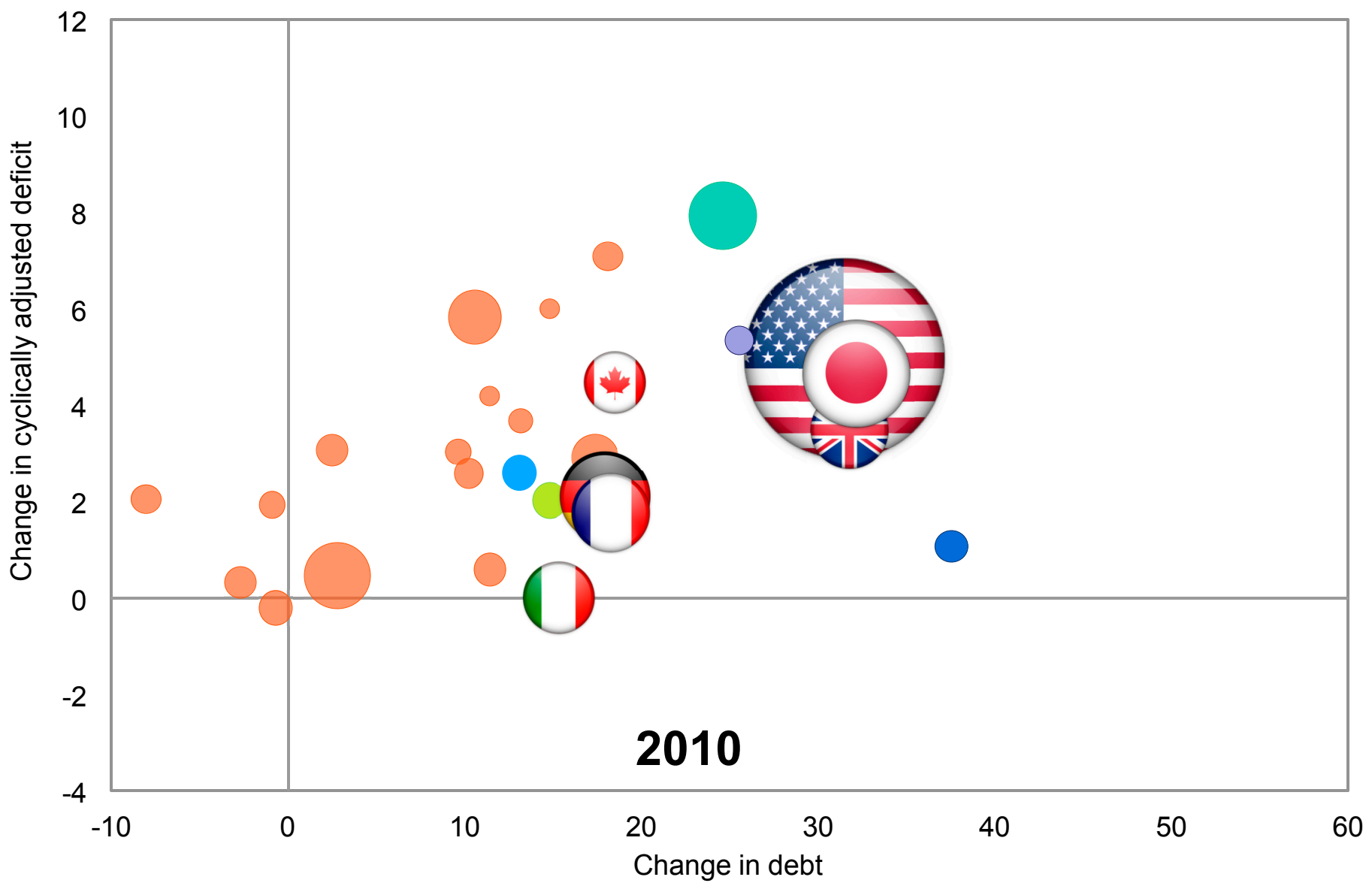
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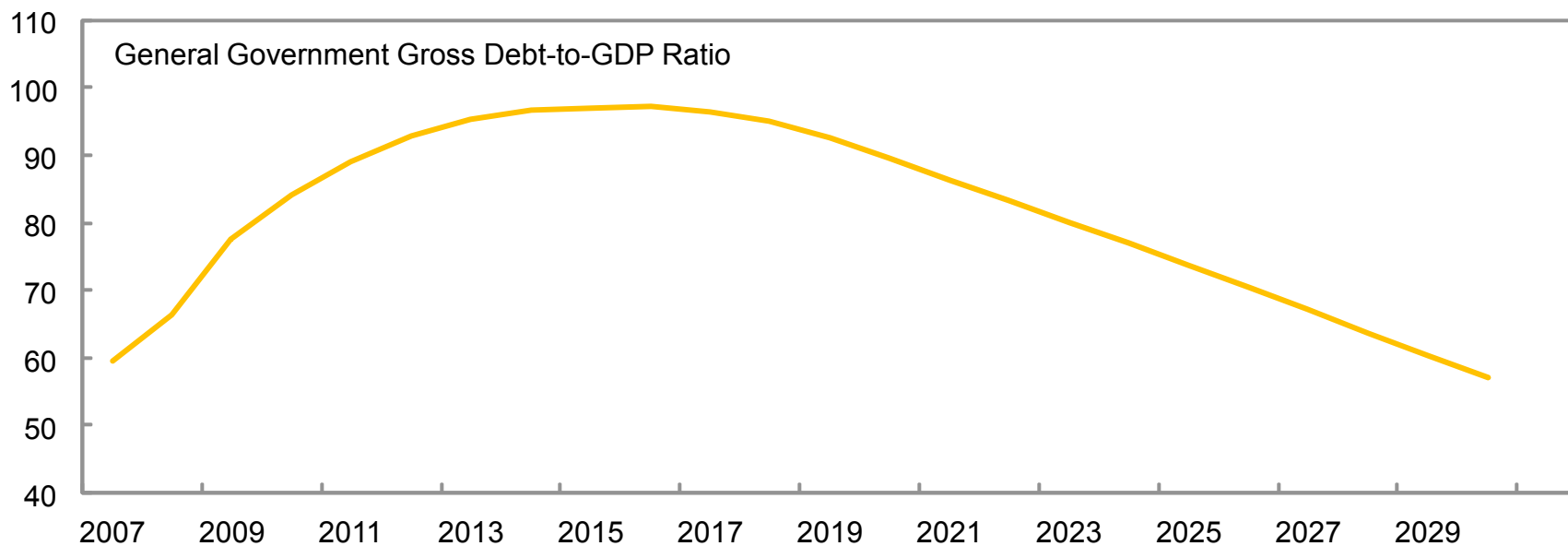
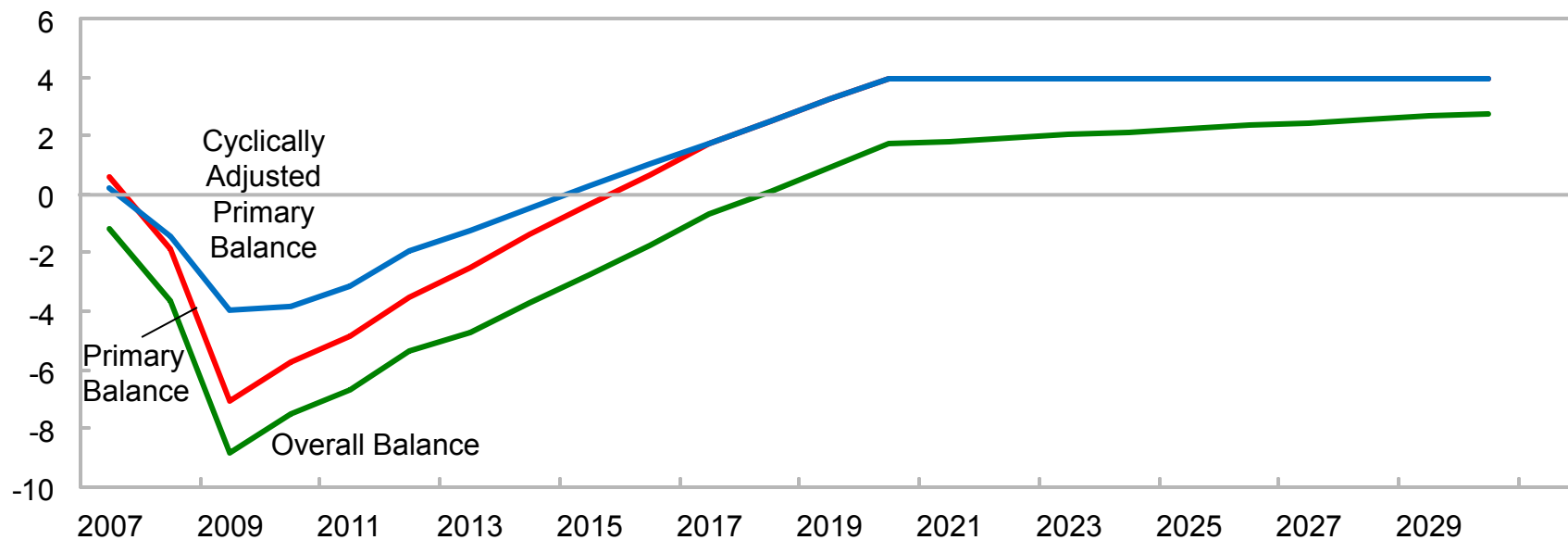
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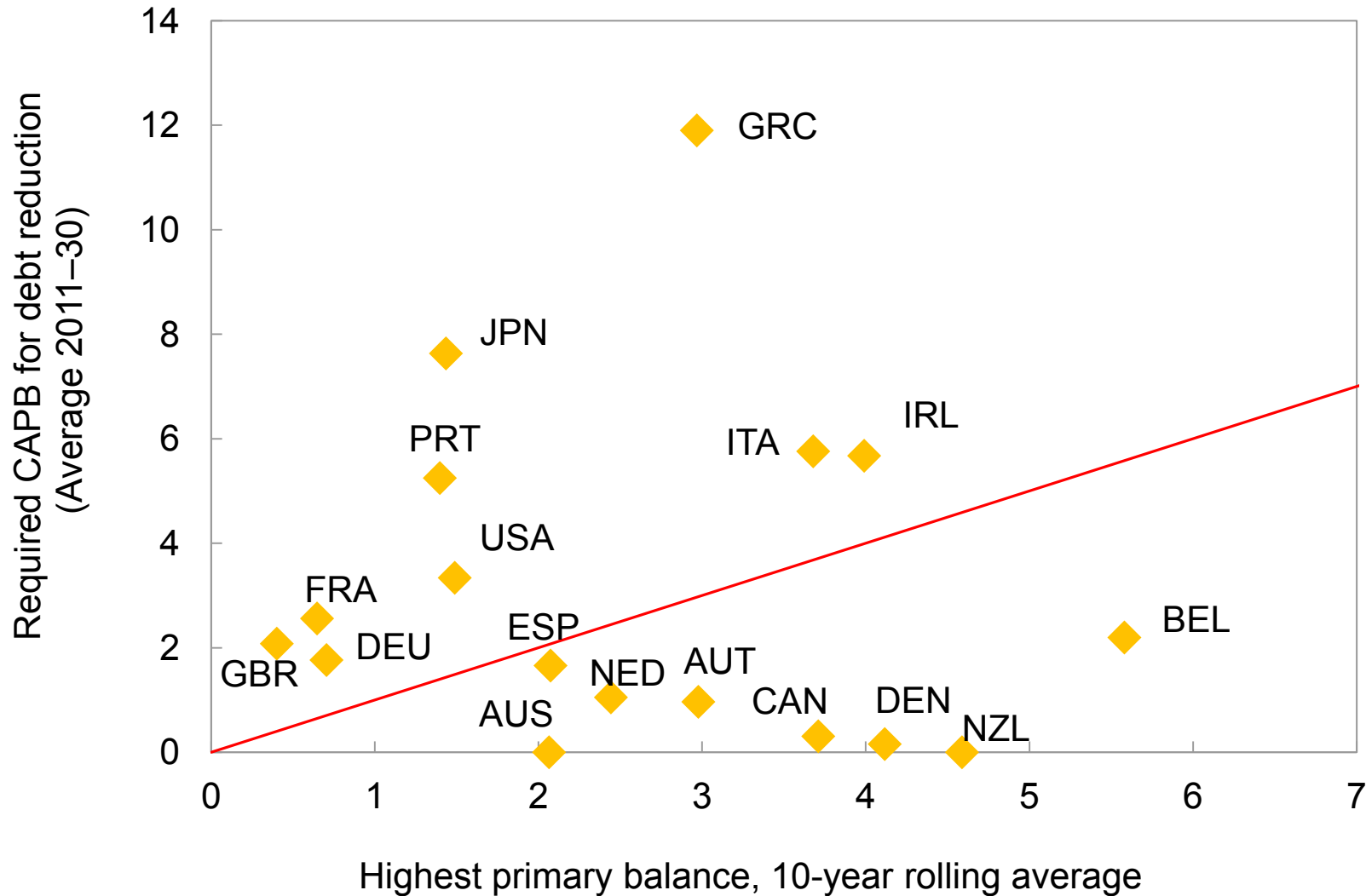


Illustrative Scenarios for Primary Balance Adjustment and Debt, 2010-30



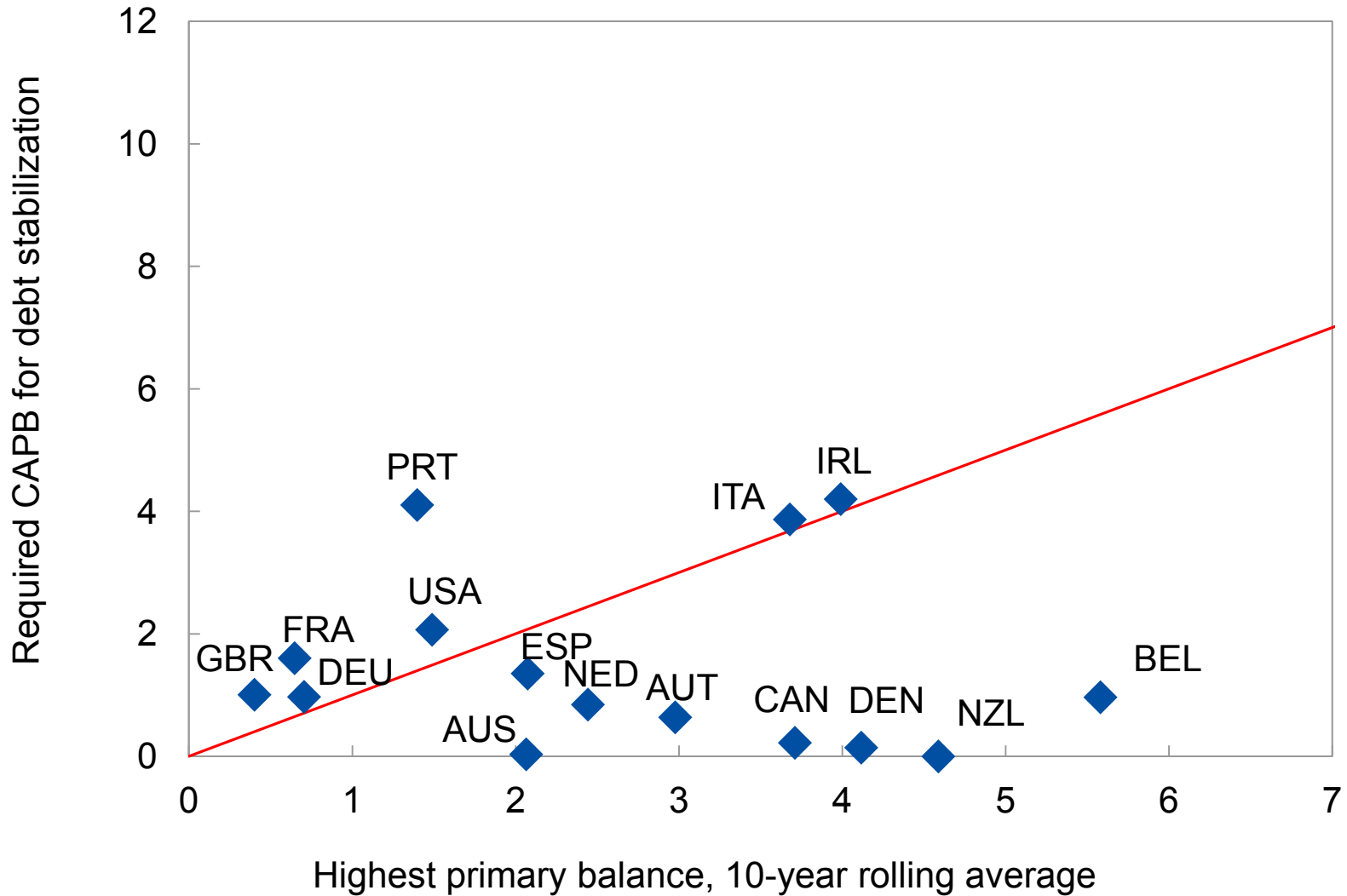
Cyclically Adjusted Primary Balance that Needs to Be Achieved to Reduce Debt Ratio

(In percent of GDP)



Cyclically Adjusted Primary Balance that Needs to Be Achieved to Stabilize Debt

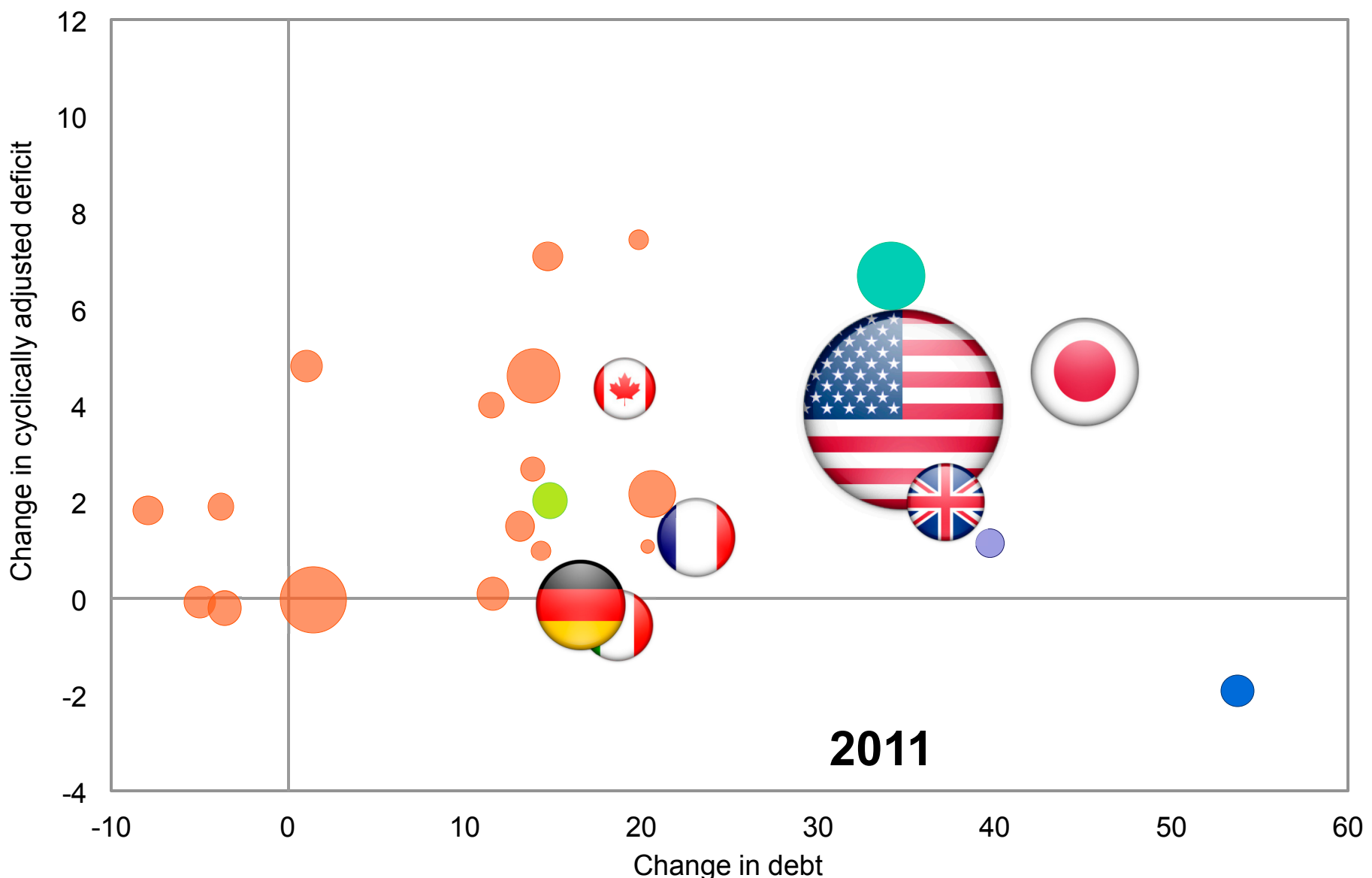
(In percent of GDP)



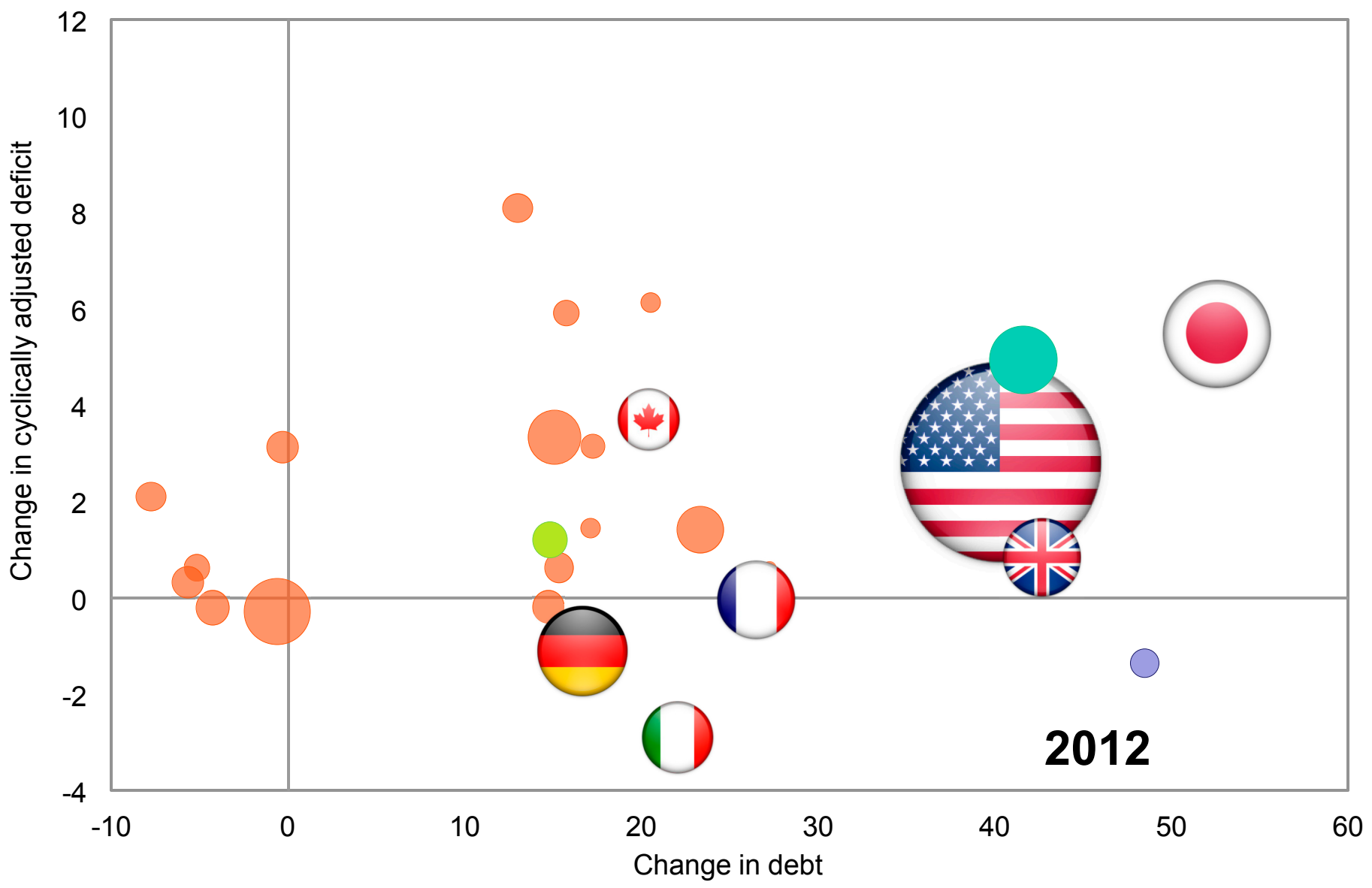


3. The pace of fiscal adjustment

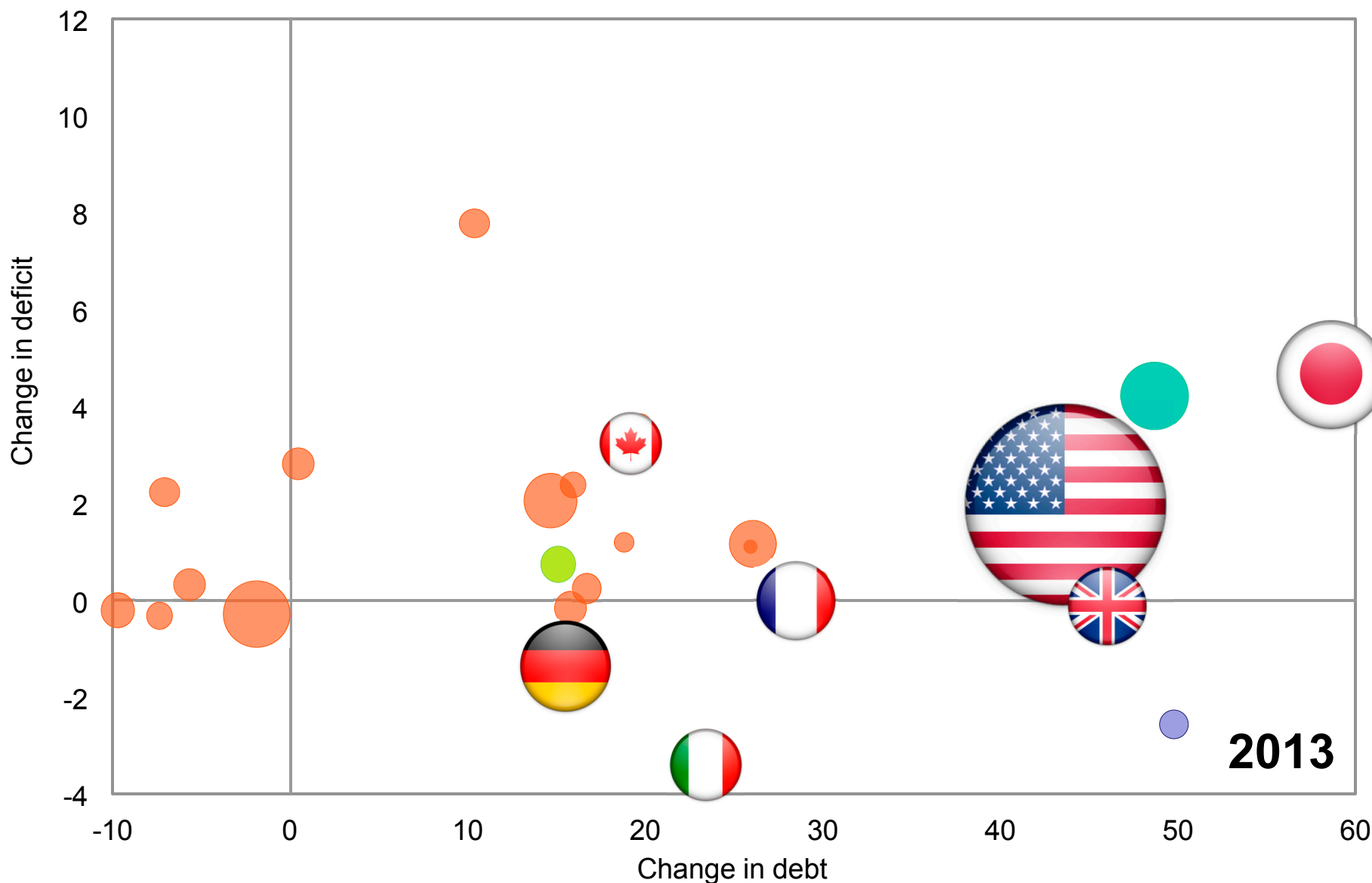
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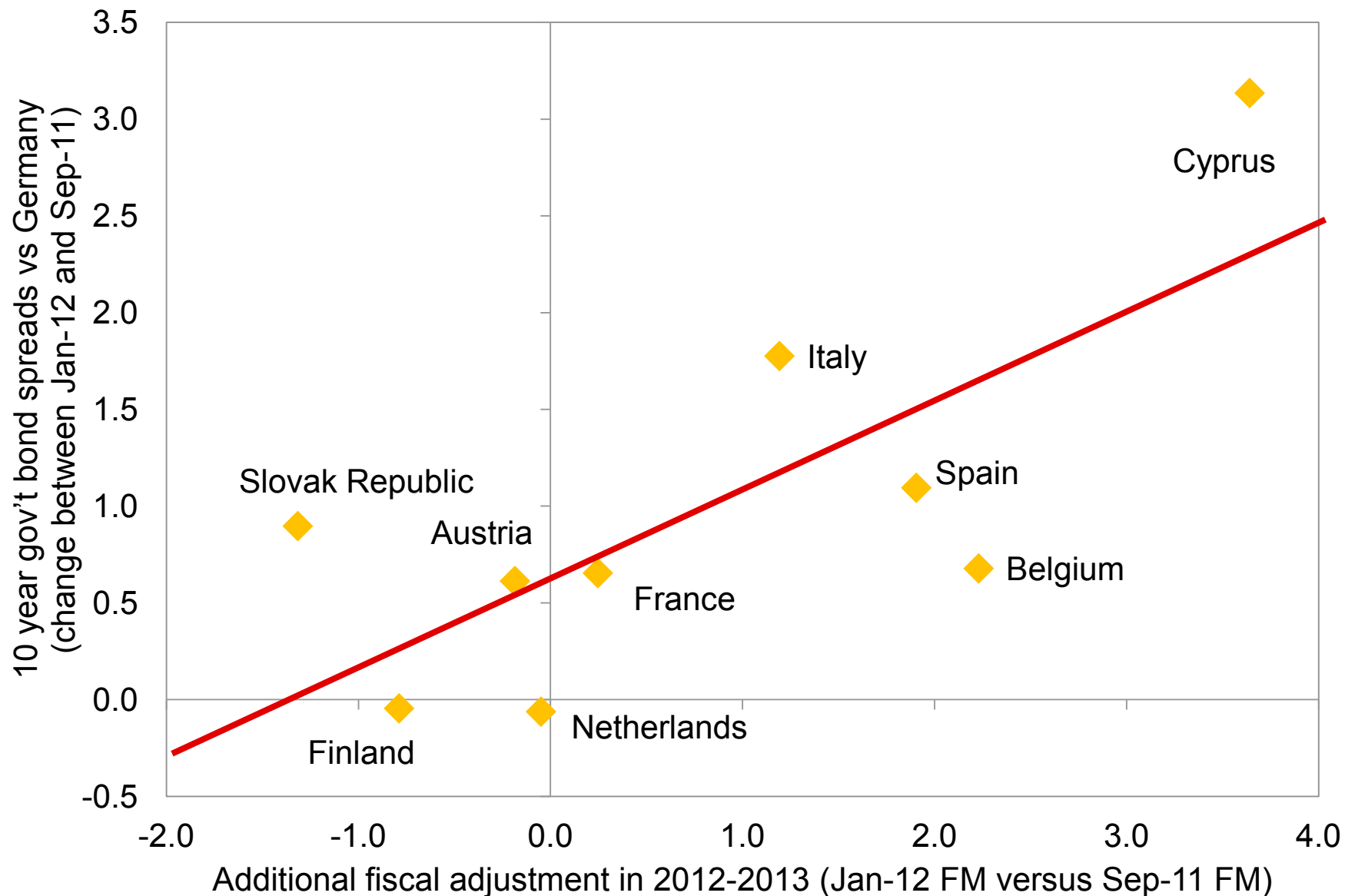
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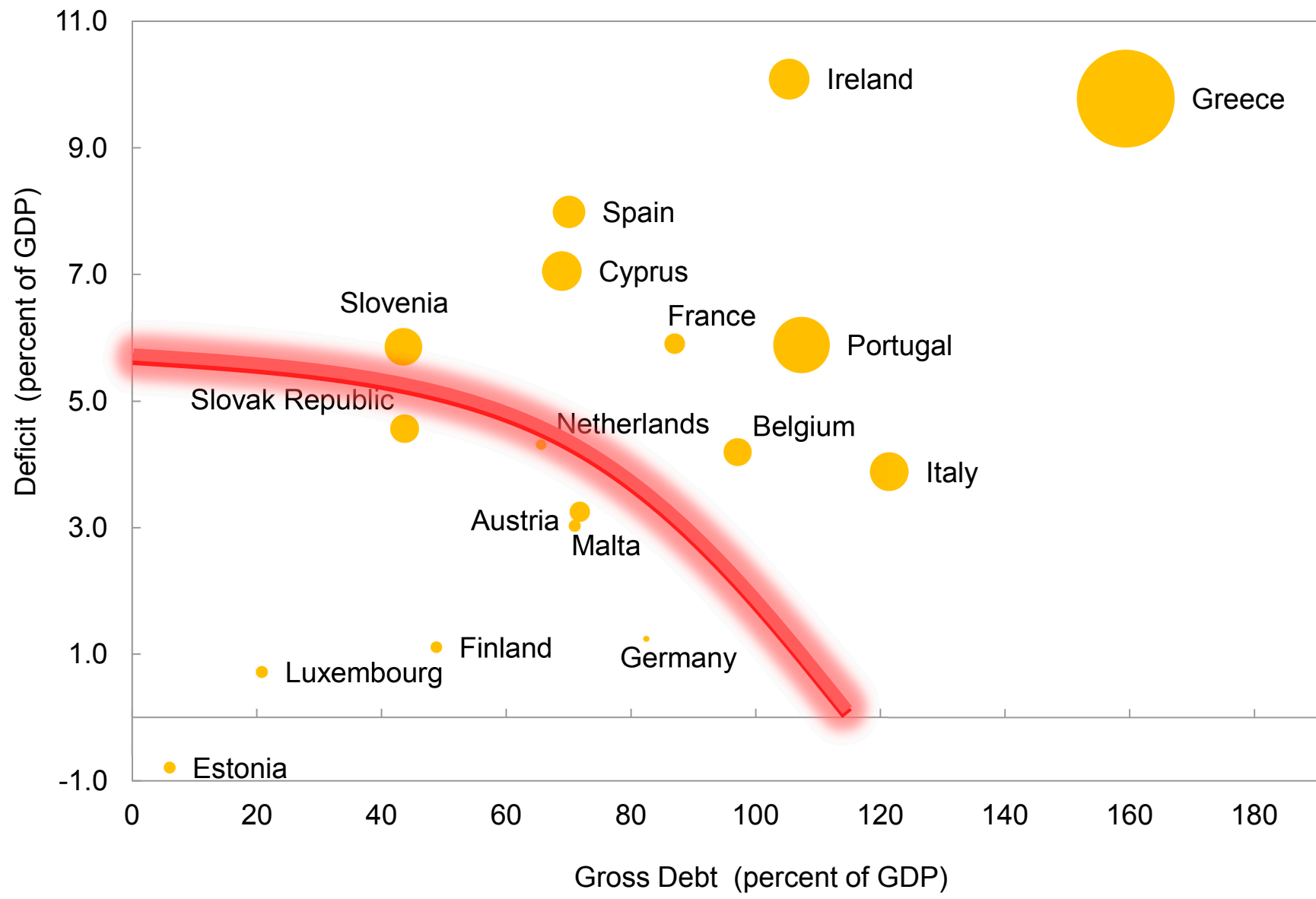
Additional Fiscal Adjustment and Increase in Sovereign Spreads



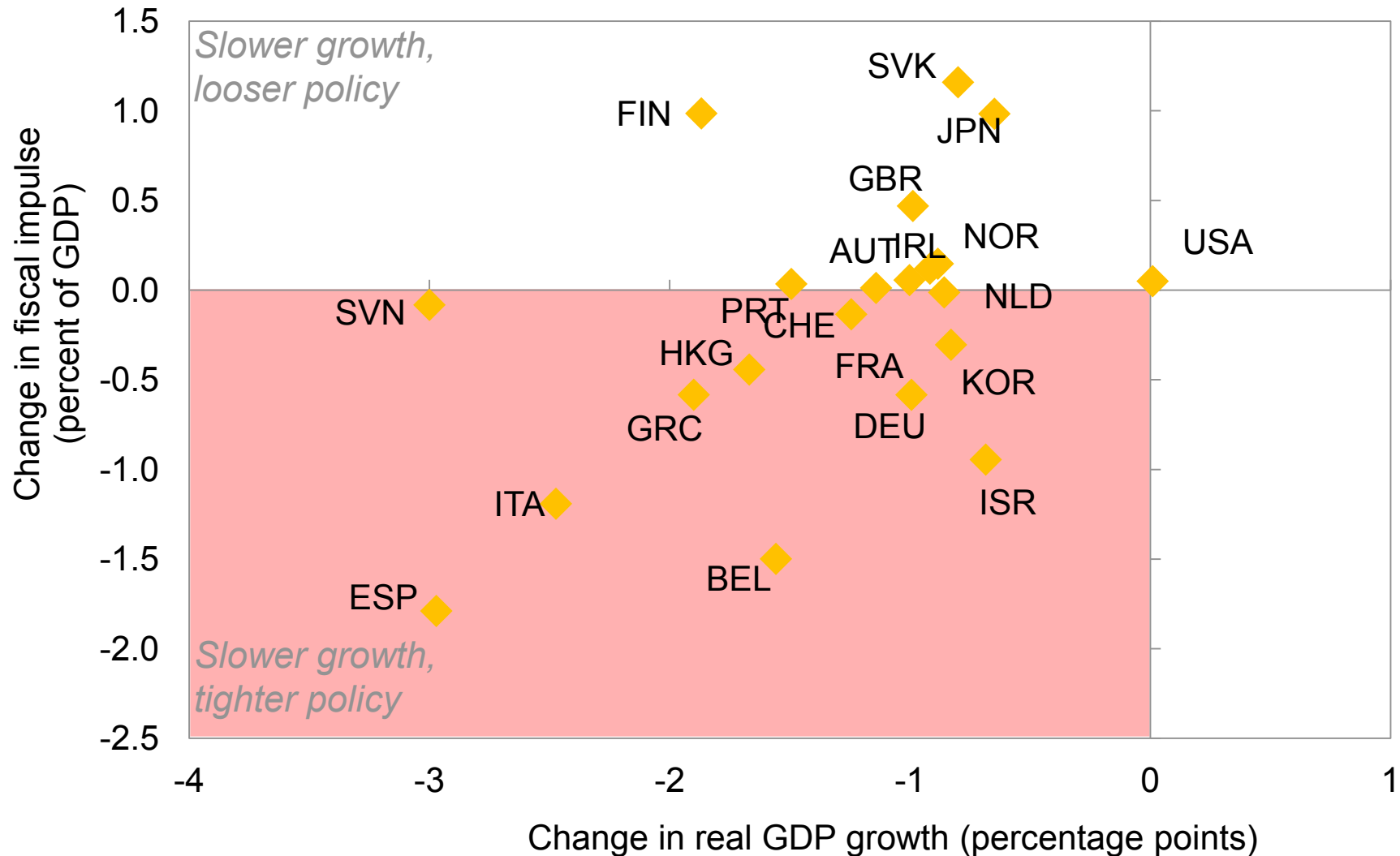
Two Misinterpretations

- Fiscal fundamentals do not matter
- Fiscal adjustment is the only thing that matters

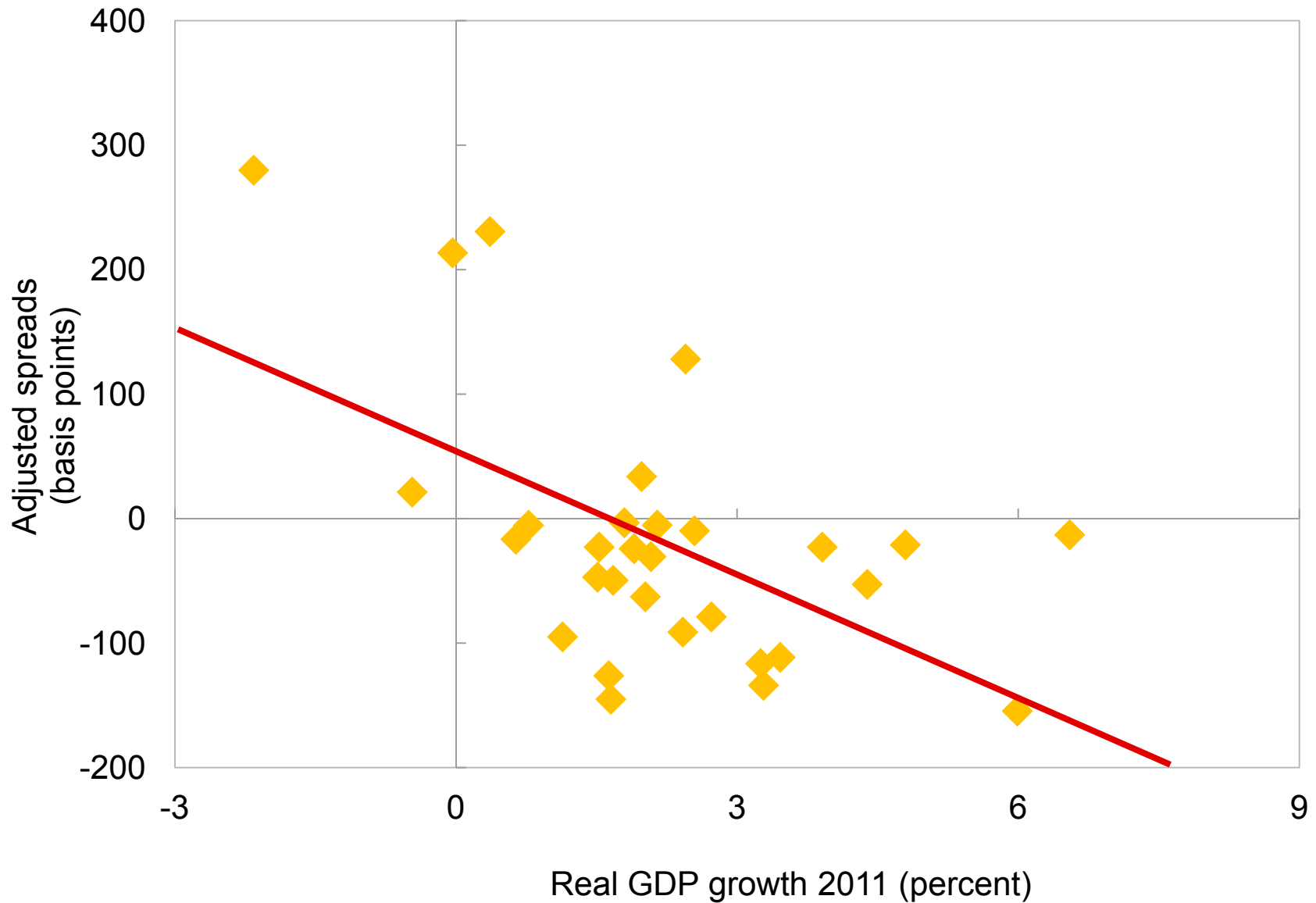
Fiscal Fundamentals Matter, 2011



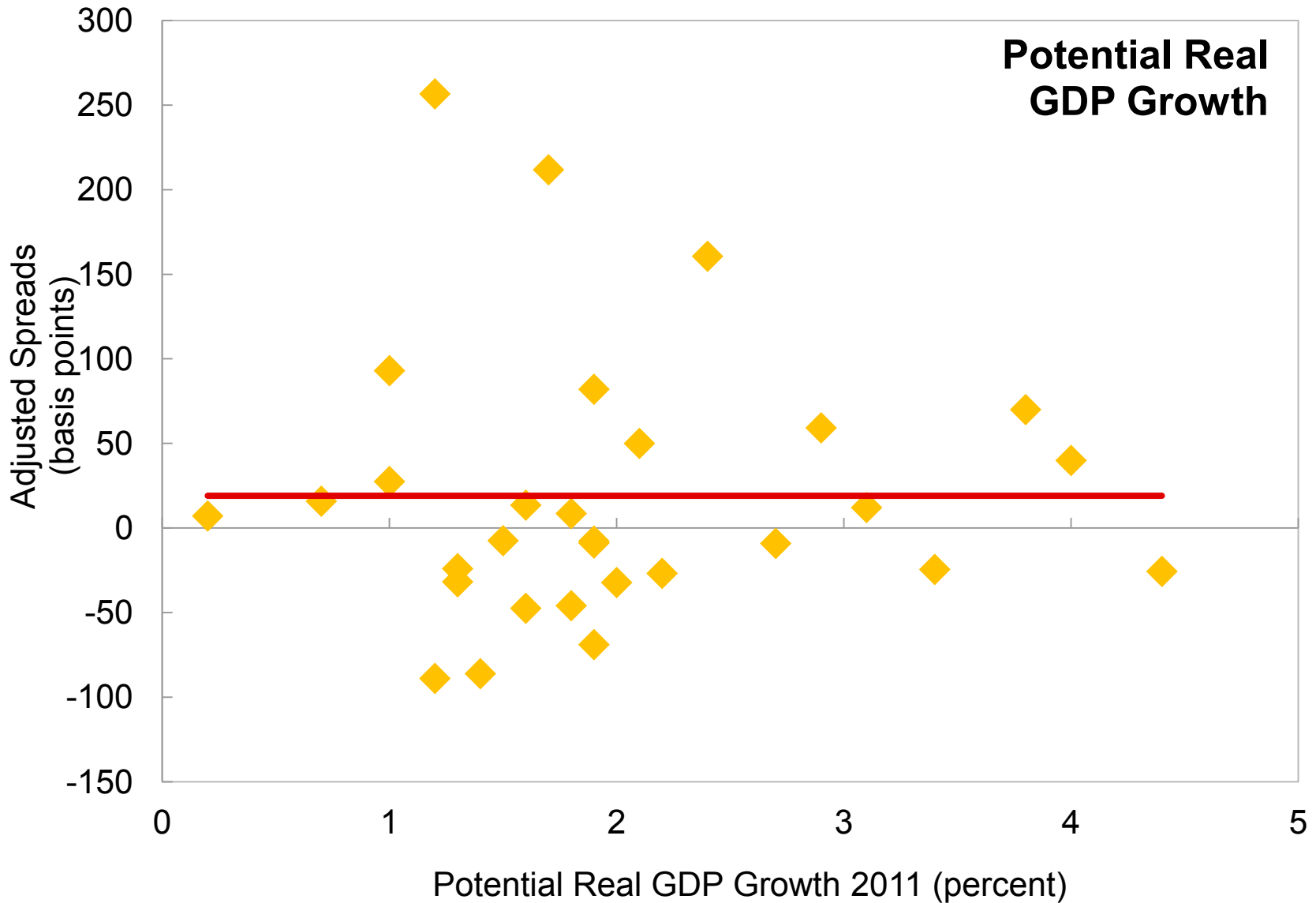
Advanced Economies: Change in Fiscal Impulse and Real GDP Growth, 2012



Real GDP Growth and Adjusted Spreads



Potential Real GDP Growth and Adjusted Spreads



“...we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls in line with consumers’ rising concerns about job security and disposable income, eroding national tax revenues”

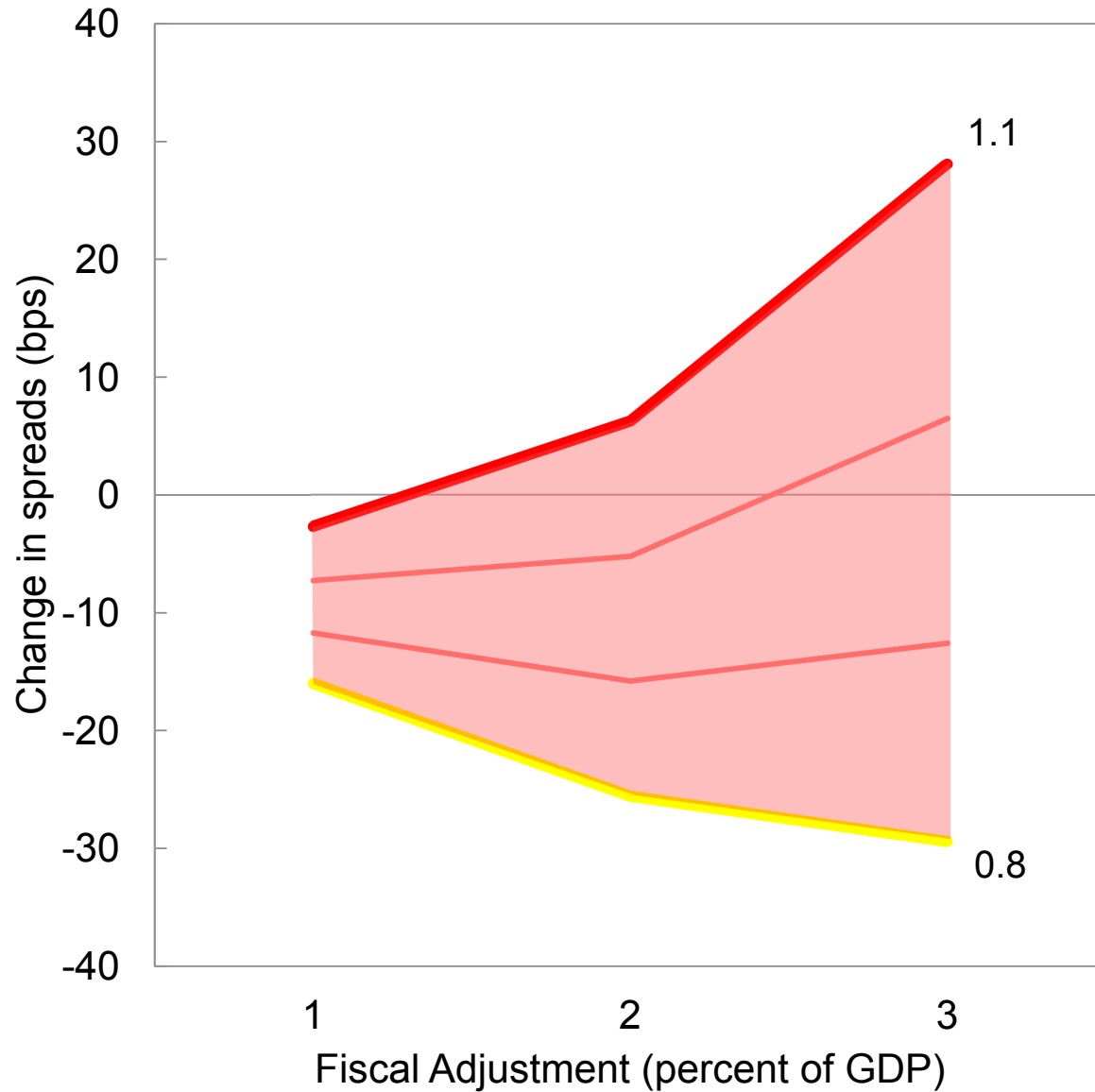
Determinants of Spreads, Cross Section Analysis, 2011

VARIABLES	(1)	(2)	(3)	(4)	(5)
Gross debt to GDP 2011	0.0159** (2.697)	0.0137** (2.643)	0.0149*** (3.957)	0.0149*** (4.063)	0.0150*** (4.122)
Primary balance to GDP 2011 for Euro Area	-0.206*** (-3.708)	-0.202*** (-3.325)	-0.188*** (-3.288)	-0.186*** (-3.661)	-0.191*** (-3.821)
Real GDP Growth 2011	-0.212*** (-3.260)	-0.190** (-2.711)	-0.207*** (-3.361)	-0.209*** (-3.501)	-0.200*** (-3.684)
Real GDP Growth Squared 2011	0.00843 (0.493)	0.0176 (1.617)	0.0192* (1.727)	0.0198* (1.934)	0.0198* (1.897)
Debt held by a country's central bank or by foreign central banks to GDP	-0.0262 (-1.473)	-0.0244 (-1.430)	-0.0285* (-2.020)	-0.0279* (-1.986)	-0.0321*** (-2.800)
Inflation Rate 2011	0.294** (2.593)	0.311*** (2.939)	0.324*** (3.610)	0.322*** (3.731)	0.304*** (3.835)
NPV of health spending in percent of GDP 2010	-0.00244 (-0.883)	-0.00149 (-0.579)	-0.00157 (-0.614)	-0.00168 (-0.658)	
NPV of pension spending in percent of GDP 2010	-0.000412 (-0.0985)	2.68e-05 (0.00651)	-0.000390 (-0.104)		
Primary balance to GDP 2014 for Euro Area	0.0721 (0.706)	0.0516 (0.488)			
Potential output growth, average 2011-2016	0.247 (1.171)				
Constant	2.704*** (4.075)	3.089*** (5.514)	3.061*** (5.866)	3.054*** (5.968)	2.984*** (6.301)
Observations	31	31	31	31	31
R-squared	0.784	0.767	0.765	0.765	0.763

Robust t-statistics in parentheses

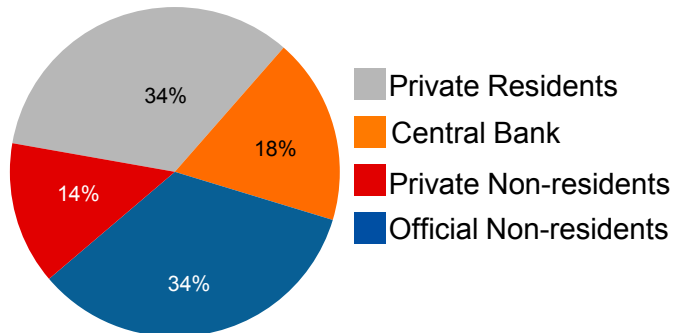
*** p<0.01, ** p<0.05, * p<0.1

Fiscal Adjustment and Change in Spreads

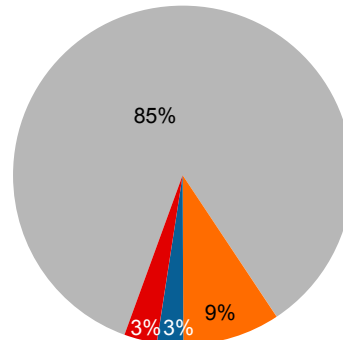


Sources of Financing: Holders of Public Debt

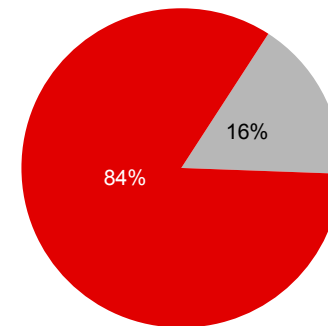
United States Treasury Securities



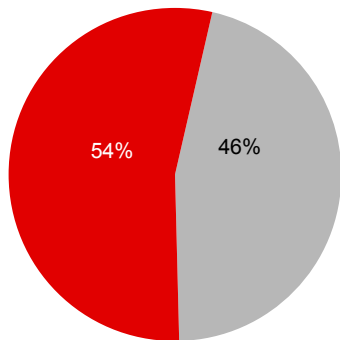
Japan Central Government Bonds



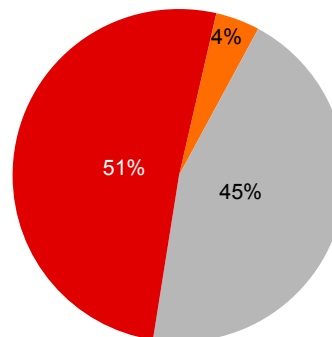
Ireland Central Government Bonds



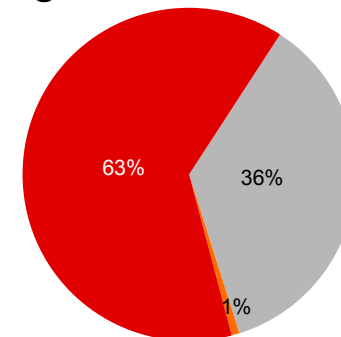
France Central Government Securities



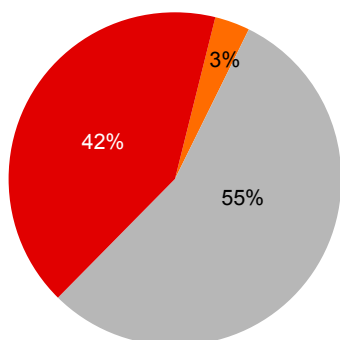
Italy General Government Securities



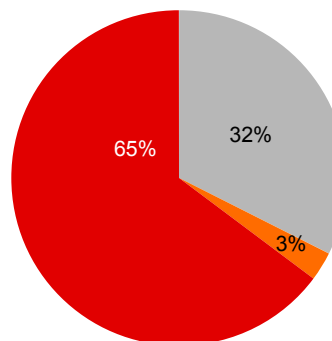
Portugal General Government Debt



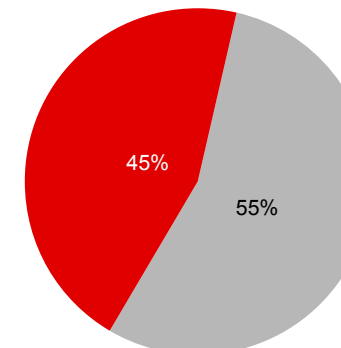
Belgium Gross Government Debt



Greece Central Government Marketable Debt

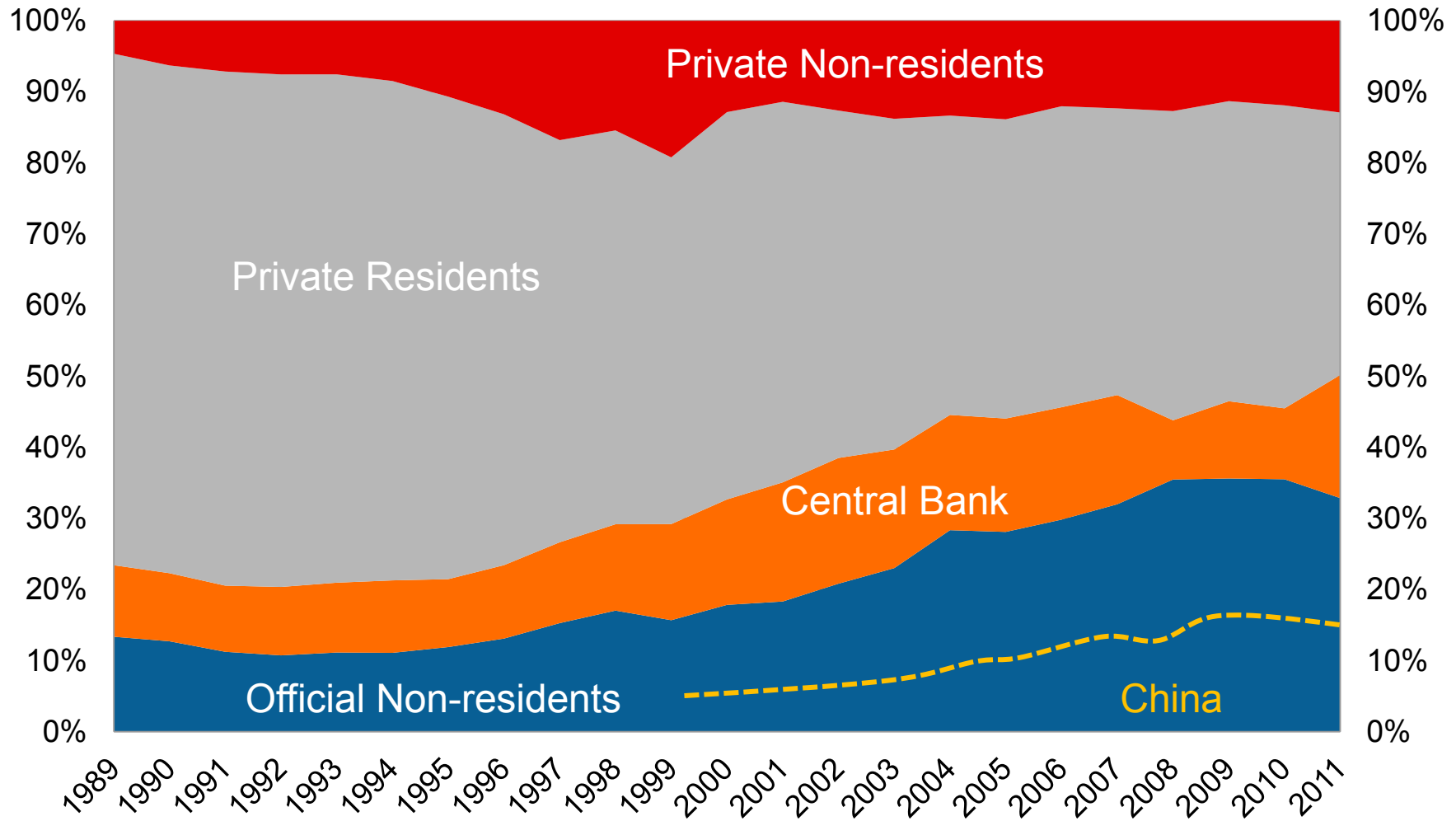


Spain Central Government Securities



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

United States: Ownership of Treasury Securities





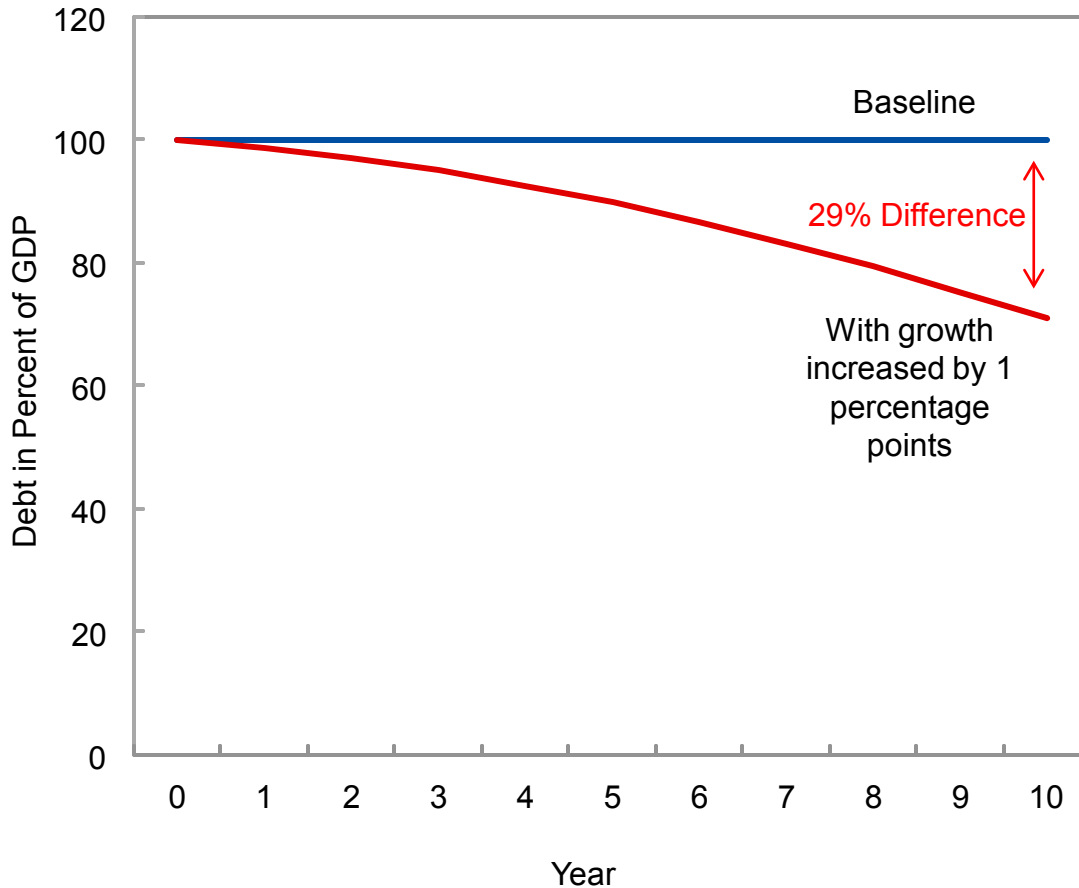
4. Policy conclusions

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. Availability of financing for countries that are adjusting

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

Thank You!