The Future of Public Debt: Prospects and Implications

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*Views expressed here are those of the author and do not necessarily reflect those of the BIS.

The problem

- Public debt is rising sharply in advanced countries
- Debt-to-GDP ratios of 100% is becoming common
- Should we care?
  - Post-WWII debts above 100% of GDP were common (examples: US 120%, UK 300%)
  - Japan has been living with high debt for years
  - The last industrial countries to default were some of the WWII losers

Things are not as they seem in advanced world

- Consolidation is difficult when
  - Interest rates are poised to increase
  - Growth rates are unlikely to rise
- The long run is much worse
  - Populations are aging
  - Unless policies change, debts will rise to 3+ times their current levels
- Problem needs to be addressed now

Outline

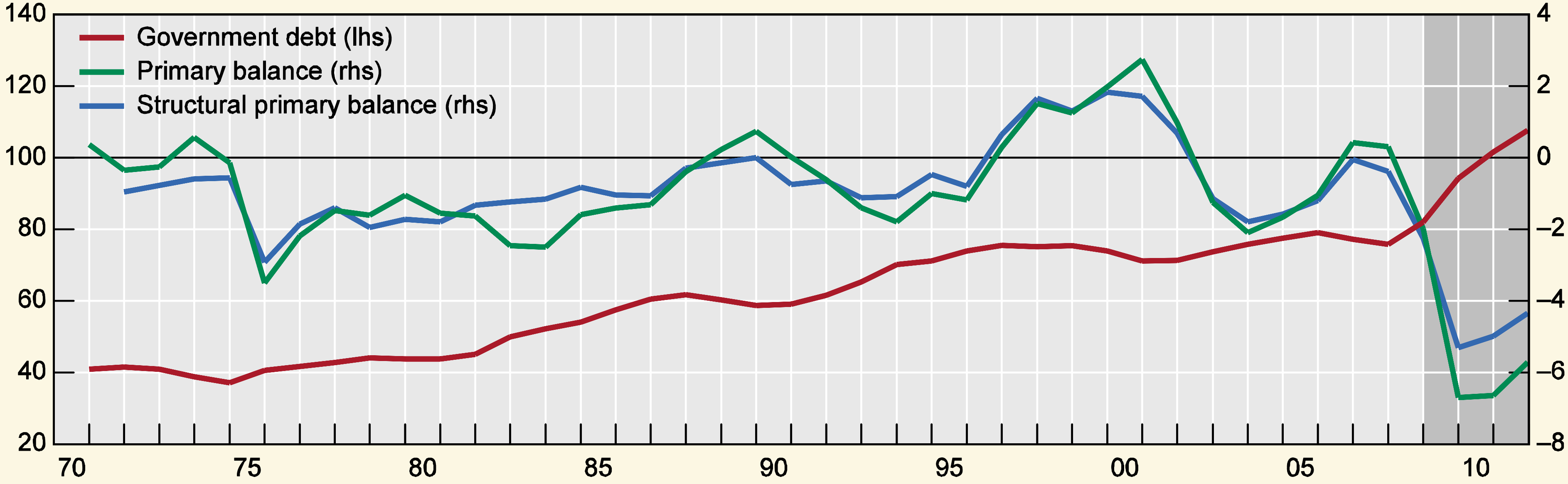
- Current situation
- The impossible future
- What are the risks of high sovereign debt?
- What can policymakers do?

Fiscal situation and prospects

	Fiscal balance			Structural balance			Government debt		
	As a percentage of GDP								
	2007	2010	2011	2007	2010	2011	2007	2010	2011
Austria	–0.5	–4.7	–4.6	–1.1	–3.1	–3.2	62	74	77
France	–2.7	–7.8	–6.9	–3.0	–5.7	–5.2	70	94	99
Germany	0.2	–5.4	–4.5	–0.4	–3.7	–3.1	65	81	84
Greece	–5.4	–8.1	–7.1	–5.8	–4.6	–2.4	104	129	139
Ireland	0.1	–11.7	–10.8	–1.3	–8.0	–8.3	28	83	92
Italy	–1.5	–5.2	–5.0	–2.2	–2.4	–2.8	112	132	135
Japan	–2.4	–7.6	–8.3	–3.0	–6.6	–7.6	167	199	205
Netherlands	0.2	–6.4	–5.4	–0.3	–4.4	–3.7	52	75	79
Portugal	–2.7	–7.4	–5.6	–2.6	–5.8	–4.3	71	95	99
Spain	1.9	–9.4	–7.0	1.6	–6.6	–4.6	42	73	78
United Kingdom	–2.7	–11.5	–10.3	–3.4	–8.6	–7.8	47	82	91
United States	–2.8	–10.7	–8.9	–3.1	–9.3	–8.0	62	90	95
Memo:									
Emerging Asia	*0.1*	*–3.1*	*–2.6*	…	…	…	*33*	*36*	…
Central Europe	*–2.2*	*–6.0*	*–5.0*	…	…	…	*45*	*55*	*59*
Latin America	*–0.5*	*–2.3*	*–1.9*	…	…	…	*39*	*40*	…

Souce: OECD (Latest data – Economic Outlook May 2010)

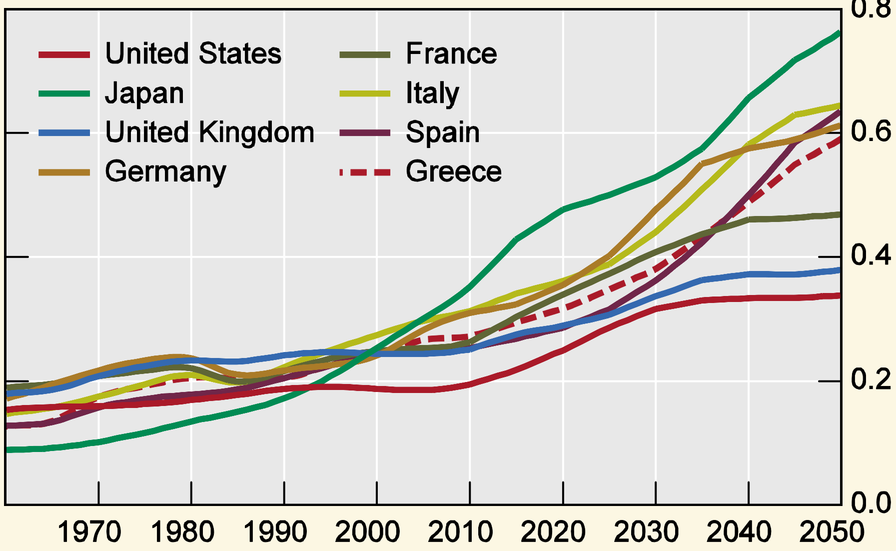
Government gross public debt and primary fiscal balance in industrial economies



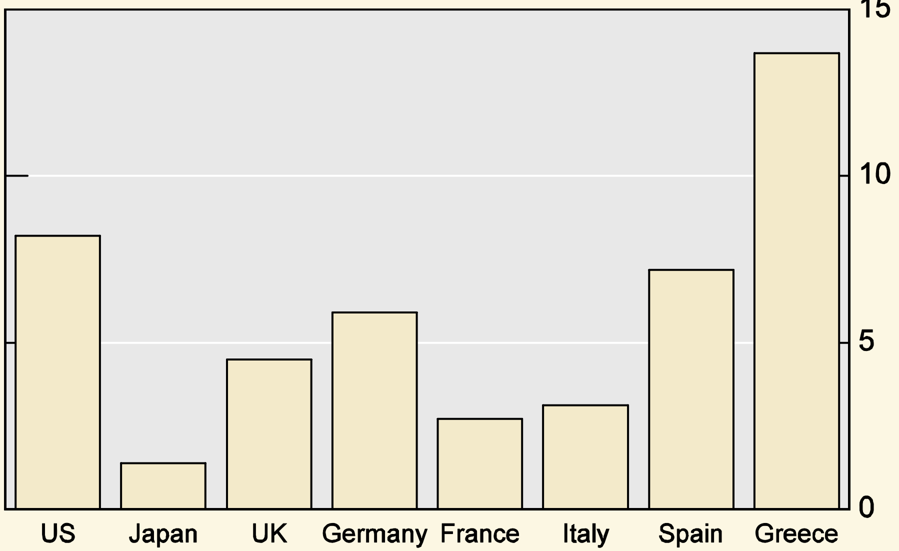
Source: OECD (November 2009 Economic Outlook).

Projected population structure and age-related spending

Old-age population
(ratio to working age population)



Estimated increase in age-related government expenditure from 2011 to 2050



Sources: IMF, *World Economic Outlook*, April 2007; UN Secretariat; European Commission; Congressional Budget Office; authors' calculations.

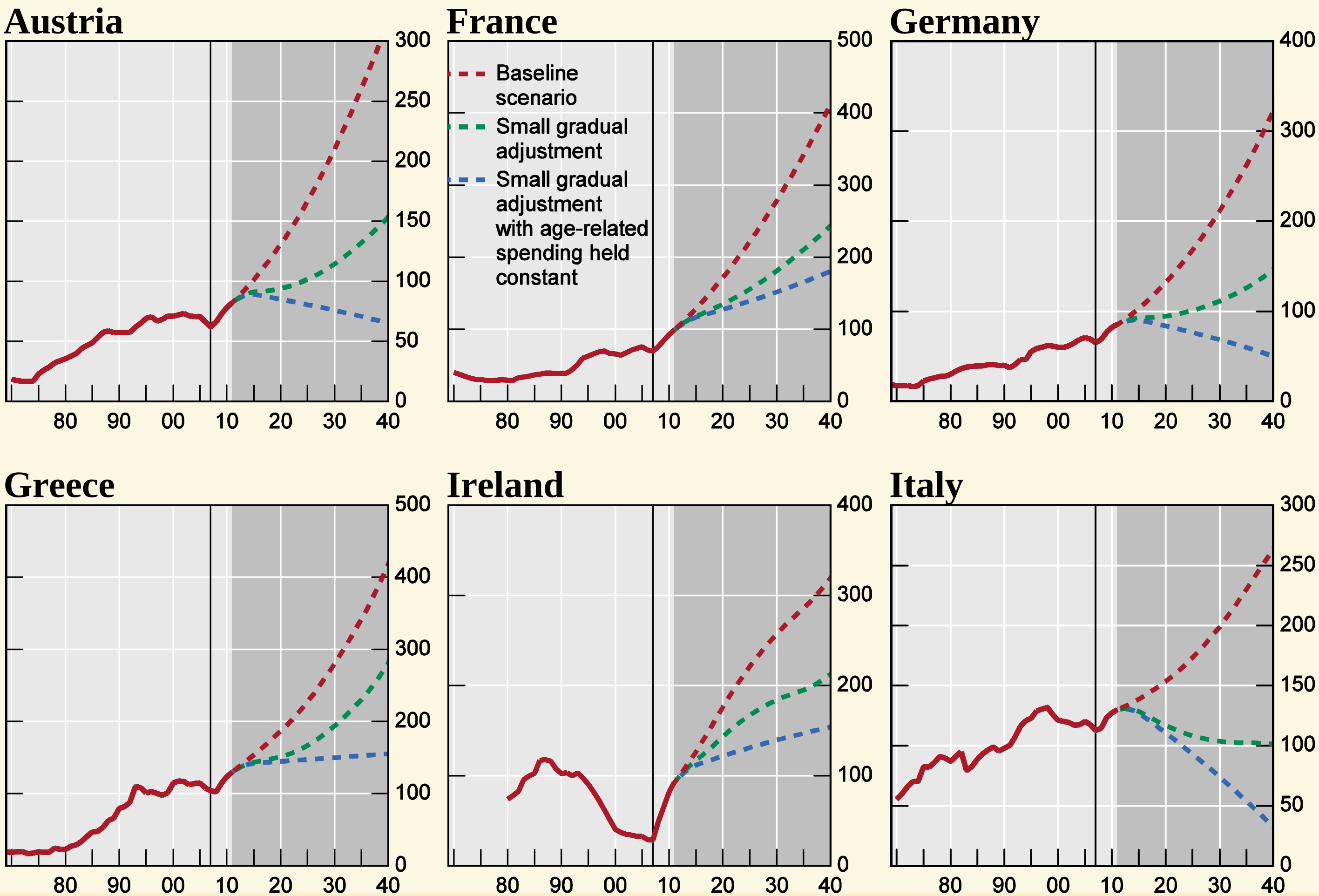
Long-term fiscal imbalances in industrial economies

- Age-related spending is rising rapidly
- Short-term policy focus may be misleading and disastrous
- Concerns about fiscal sustainability & intergeneration equity: present value of unfunded commitments should be reflected

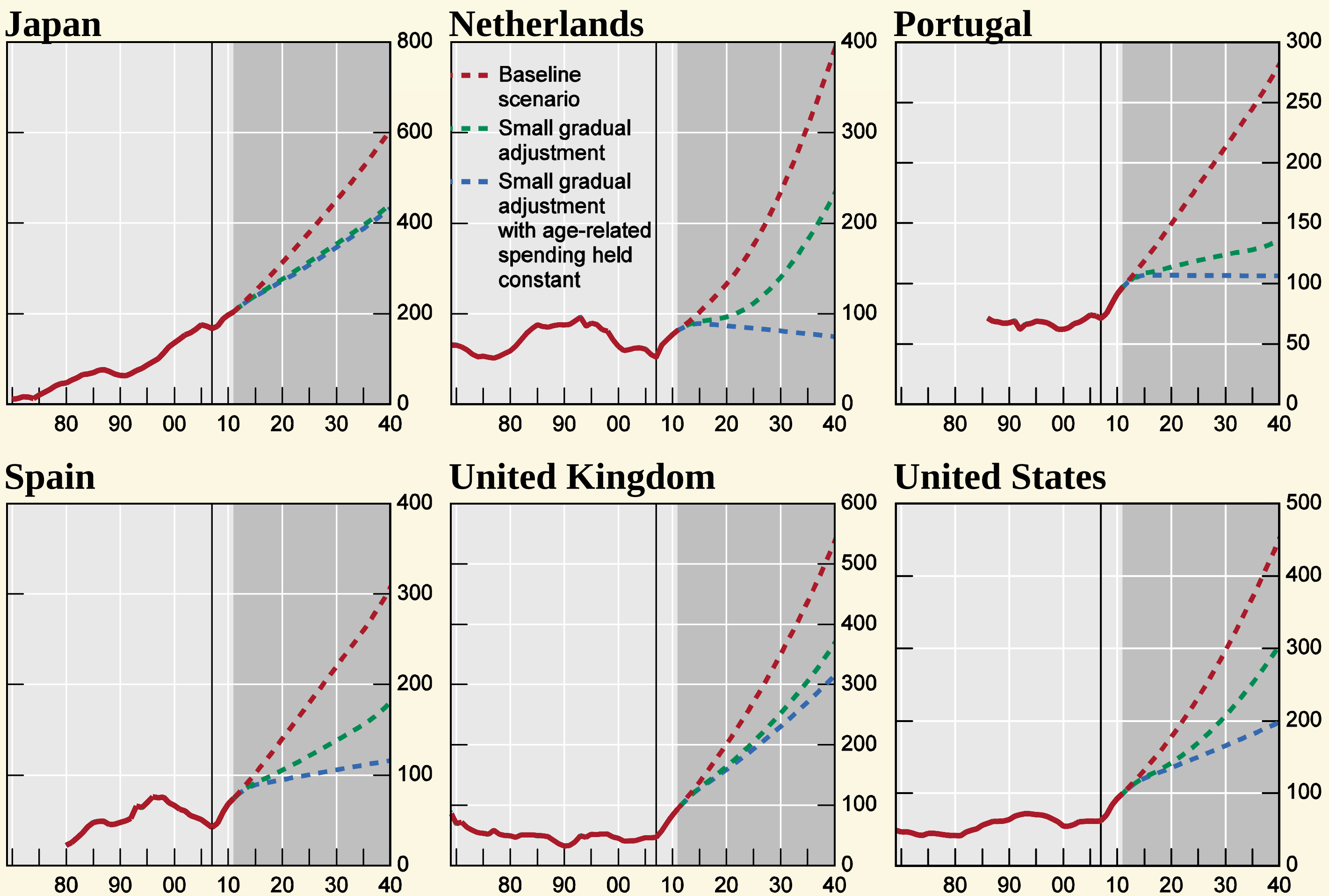
Debt-to-GDP Projections

- 30 years and 12 countries
- Baseline:
  - Revenue and non-age related expenditure constant as a share of GDP at the 2011 level
  - Real interest rate at 1998-2007 average
  - Potential growth for OECD post-crisis level
- Gradual adjustment:
  - Primary deficit improves 1pp of GDP per yr for 5 yrs
- Gradual adjustment
  + freezing age-related spending to GDP at 2011 level

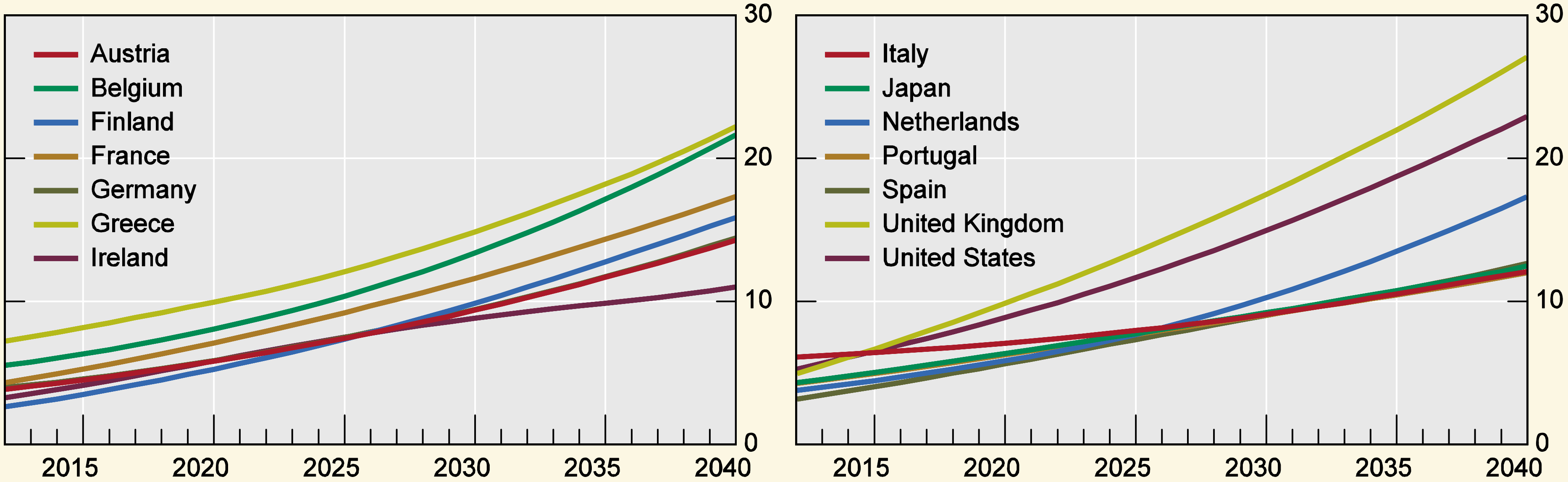
Public debt projections



Public debt projections (cont.)



Projected interest payments as a fraction of GDP



Source: OECD, authors' projections.

Average primary balance required to stabilise the public debt/GDP ratio at the 2007 level

In percentage points of GDP

	Over 5 years	Over 10 years	Over 20 years	*Memo: Primary balance in 2011 (forecast)*
Austria	5.1	3.0	2.0	*–2.9*
France	7.3	4.3	2.8	*–5.1*
Germany	5.5	3.5	2.4	*–2.0*
Greece	5.4	2.8	1.5	*–5.3*
Ireland	11.8	5.4	2.2	*–9.2*
Italy	5.1	3.4	2.5	*0.0*
Japan	10.1	6.4	4.5	*–8.0*
Netherlands	6.7	3.7	2.3	*–3.4*
Portugal	5.7	3.1	1.8	*–4.4*
Spain	6.1	2.9	1.3	*–6.6*
United Kingdom	10.6	5.8	3.5	*–9.0*
United States	8.1	4.3	2.4	*–7.1*

Sources: OECD; authors' calculations.

Challenges to policymakers

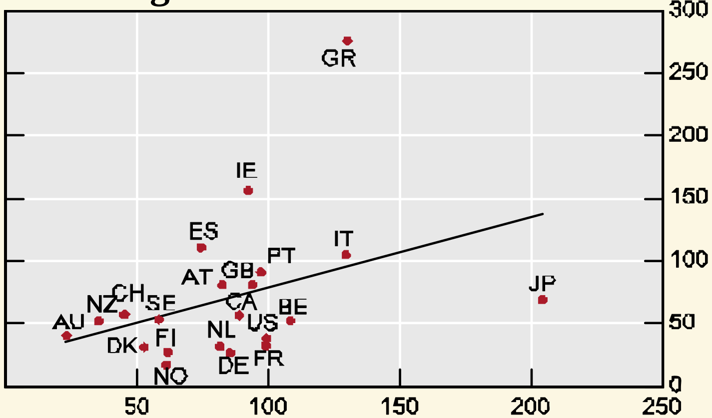
- Sovereign risk premia and CDS
- Debt and fiscal policy: growth
- Debt and monetary policy: inflation

Sovereign risk premia

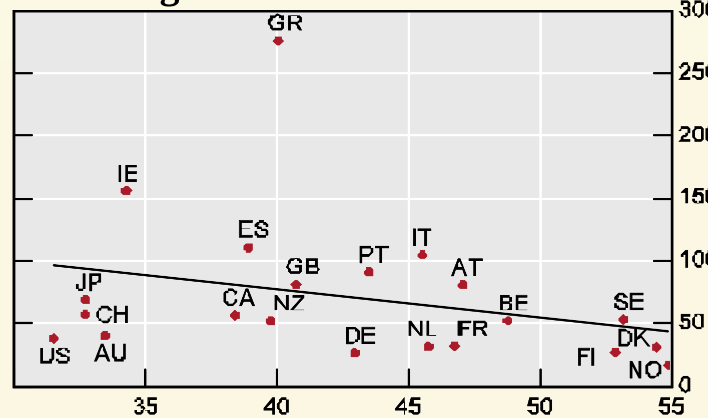
- Higher debt increases the possibility unstable dynamics
- So, higher debt means a bigger risk premium
- We plot CDS spreads against
  - Debt to GDP
  - Government revenue to GDP
  - Share of short-term debt
  - Incremental debt to private saving

Sovereign CDS spreads and fiscal indicators

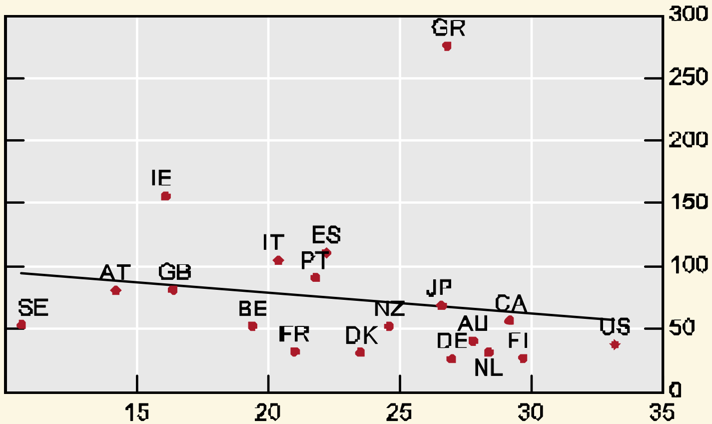
General government debt/GDP



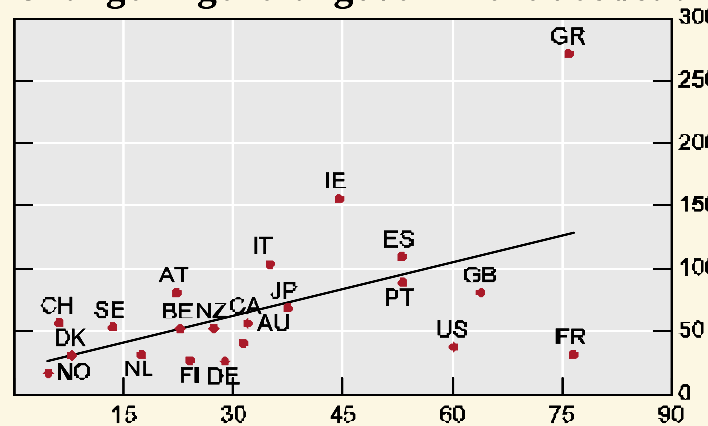
General government revenue/GDP



Share of short term debt



Change in general government debt/savings



Sources: IMF; OECD; JPMorgan Chase; Markit.

Debt and fiscal policy

- Higher taxes create greater distortions
- Higher debt can mean higher real interest rates
- Reduced effectiveness in responding to shocks
- All of this can lower the long-run growth path

Debt and monetary policy

- Inflation expectations
  - Temptation to inflate away debt
  - Unwillingness of public to refinance debt
- Evidence
  - Inflation linked to fiscal variables in EMEs
  - No or little evidence in industrial countries…

    … but risks may begin to weigh on current decisions
- Forecast uncertainty

Fiscal consolidation

- Most industrial countries need to improve both short- and long-term fiscal sustainability
- Delaying adjustment is very risky in some countries
- Tackle future age-related spending
  - to buttress investors' confidence everywhere
  - to improve flexibility in G3
- Past experience offers hope

Addressing long-term fiscal imbalances

- Boost overall productivity
  - Cut unproductive expenses
  - Overhaul of the tax system
  - Product and labour market reforms
- Increase the relative size of working population
  - Selective immigration
  - Participation rates
  - Retirement age

Summing up:

- Public debt numbers
  - depend on current deficits (look bad)
  - ignore age-related expenditure (look really bad)
- Significant real and financial risks
- Action is needed now