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

<table>
<thead>
<tr>
<th>Country</th>
<th>Fiscal balance</th>
<th>Structural balance</th>
<th>Government debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>−0.5</td>
<td>−4.7</td>
<td>−4.6</td>
</tr>
<tr>
<td>France</td>
<td>−2.7</td>
<td>−7.8</td>
<td>−6.9</td>
</tr>
<tr>
<td>Germany</td>
<td>0.2</td>
<td>−5.4</td>
<td>−4.5</td>
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<tr>
<td>Greece</td>
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<tr>
<td>Ireland</td>
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<tr>
<td>Italy</td>
<td>−1.5</td>
<td>−5.2</td>
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<td>−2.4</td>
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<td><strong>Memo:</strong></td>
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<td></td>
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<td>Emerging Asia</td>
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Source: OECD (Latest data – Economic Outlook May 2010)
Government gross public debt and primary fiscal balance in industrial economies

Source: OECD (November 2009 Economic Outlook).
Old-age population (ratio to working age population)

Projected population structure and age-related spending

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

Austria

France

Germany

Greece

Ireland

Italy
Public debt projections (cont.)

- Japan
- Netherlands
- Portugal
- Spain
- United Kingdom
- United States
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

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<th>Country</th>
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<th>Over 10 years</th>
<th>Over 20 years</th>
<th>Memo: Primary balance in 2011 (forecast)</th>
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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

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