

Queue up for a fiscal exit strategy

Governments around the globe have successfully averted another great depression by providing support to their economies of an unprecedented size and scope. But in the process their balance sheets have deteriorated, their liabilities have expanded and buyers of their debt face increasing risks of future losses. To keep the bond vigilantes at bay, politicians now need to have a convincing plan for ensuring the sustainability of public finances.

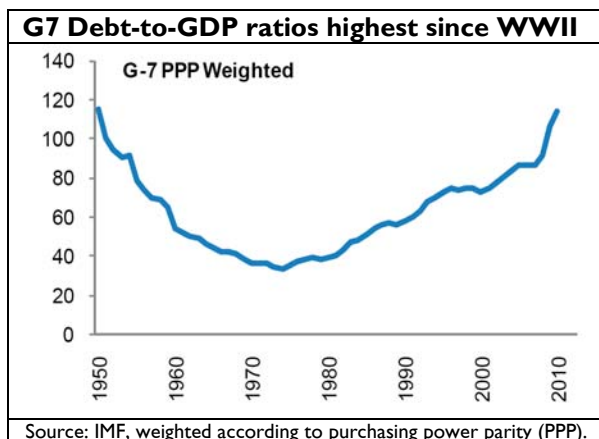
The global economic crisis has resulted in the greatest deterioration of government accounts since World War II. It is too early to exit from crisis-response policies just yet, with prospects for the global economy remaining uncertain despite some evidence of improvement. However, failure to articulate a strategy for moving budgets and balance sheets to a sustainable position would destabilise expectations, raise borrowing costs, and weaken the effect of the fiscal and monetary support now being provided.

More than a vigorous response is required

The challenge is daunting, particularly for advanced economies. Nevertheless, historical precedents do exist for overcoming it, as we will explore in a future Daily Theme. Letting fiscal stimulus measures expire will not be sufficient – ambitious policies are needed. A large and sustained improvement in primary structural balances will be necessary in many advanced economies. In many cases restoring fiscal sustainability will require more than vigorously addressing pre-existing long-run challenges in health and pensions. It will also mean undertaking reforms to reduce other spending and increase tax revenue as a share of output.

Unless tough measures are put in place, the ratio of gross government debt to GDP of advanced economies will rise from 73% in 2007 to around

110% in 2014. By 2014, this ratio will be close to or exceed 85% in all of the G7 major industrialised economies, except Canada. The scale of the problem is unprecedented in peacetime, with G7 government debt as high as it was in the immediate aftermath of World War II. Major government debt increases also occurred in the wake of the 1930s Great Depression, but from lower starting levels. Moreover, while demographic trends were favourable in the 1930s, they are unfavourable now. Fiscal pressures from an ageing population will add significantly to the fiscal challenge of advanced economies.



The fiscal problem will improve only in part as the global economy recovers, given the weak state of structural balances even before the credit crisis. In some countries there has been an underlying increase in spending unrelated to the crisis. Loss of revenue, for example from a steep decline in potential output and from lower tax payments from the financial sector, is expected to be long lasting. The fiscal outlook is significantly stronger for emerging economies, with debt ratios projected to return to pre-crisis levels by 2012. This better outlook reflects more favourable structural balance between government revenue and expenditures during the crisis and smaller output losses.

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Beware of complacency

At best, higher deficits and debt will put upward pressure on interest rates, weakening growth prospects. At worst, the weaker fiscal outlook in advanced economies will lead to concerns that debt will be “inflated away,” a risk that we will also address in a coming Daily Theme, or that default is inevitable. If so, investors would balk at buying debt with longer maturities, demand higher yields and could, ultimately, trigger refinancing crises. A fiscal crisis would be at least as severe as a crisis rooted in the private sector, because no entity would be available to bail out the public sector of a major economy.

At present, financial markets do not seem to be overly concerned about the weaker fiscal outlook, but this should not be an excuse for complacency either on the part of investors or policy makers. While financial markets have started to differentiate between sovereign bond markets, they have not yet reacted forcefully to the fiscal challenges of high-debt advanced economies. This may reflect short-sightedness. As recent experience has shown, markets often react late and suddenly in the face of a persistent disequilibrium.

A more favourable interpretation could be that the increased supply of private savings and/or expectations that policy makers will eventually embark on credible fiscal adjustment are behind the muted reaction. In any event, clarifying the fiscal adjustment strategy would reduce the likelihood of a sudden deterioration in market sentiment leading to sharply higher bond yields and/or weaker currencies.

As former US President Bill Clinton’s political advisor James Carville observed, after a nasty reaction in the bond markets to concerns about a rising budget deficit: “if there was reincarnation... I would like to come back as the bond market. You can intimidate everybody.”

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