June 11, 2010

The Fiscal Situation in the Advanced Foreign Economies[1]

Introduction

As a result of the global financial crisis and recession, fiscal deficits in the advanced economies have ballooned, reflecting automatic stabilizers as well as discretionary economic stimulus and support for the financial sector. Government debt levels have risen commensurately. Although deficits should begin to narrow as the economic recovery progresses, addressing the legacy of high debt will require greater time and effort. Aging demographic profiles in many countries further amplify concerns about the sustainability of debt trajectories. These fears have been particularly acute for a number of European economies, as evident in recent financial market developments.

This memo reviews the fiscal situation in the advanced foreign economies (AFEs), beginning with a look at current budget imbalances, the plans to address these imbalances, and the likely effects of these measures on economic growth. We then analyze the sustainability of debt in the AFEs and assess whether policy responses to date have been sufficient to stave off further destabilizing outcomes. Finally, we offer recommendations as to how policymakers and the international financial community can work to preserve economic and financial stability in Europe. A companion note to the Committee, "The Macroeconomic Consequences of the European Debt Crisis," considers potential spillovers to the United States and the global economy more broadly should such efforts fail.[2]

For most advanced foreign economies, we find that current consolidation plans, if effectively implemented, will lead to sustainable outcomes. For a few countries, we are less sanguine. In particular, we are concerned about those euro-area economies currently under the most market stress – notably Greece, Portugal, Ireland, and Spain. These economies have all adopted ambitious fiscal consolidation plans, but achieving fiscal sustainability will require both strict commitment to the plans and a favorable macroeconomic environment. In Greece, and perhaps Portugal, the public debt burden may eventually prove unsustainable, but it is too soon to be certain. Policymakers in Europe should do more to reduce the risks of bad outcomes, including redoubling efforts to cut budgets in vulnerable countries, strengthening the institutional framework of the European Union, and bolstering the transparency and capital of the banking system. Moreover, to support aggregate European economic activity, countries with more fiscal space, such as Germany, should not pursue aggressive consolidation efforts.

[1] Beth Anne Wilson, Carlos Arteta, Jasper Hoek, Steven Kamin, Robert Martin, and Trevor Reeve of the Division of International Finance contributed to this report.
[2] Chris Erceg, Jesper Linde, and David Reifschneider, June 11, 2010.

The Fiscal Situation of the AFEs

Exhibit 1 presents a cross-country look at the fiscal positions of a range of advanced economies. The upper panel compares estimates of government debt and deficits as percent of GDP for 2009. As can be seen, Greece is a clear outlier, in terms of high deficit and debt ratios, sitting alone in the northeast corner of the graph. Next come Portugal, the United States, the United Kingdom, Spain, and Ireland, followed by Italy, Belgium, and France.[3] (Japan is literally off the charts with a debt-to-GDP ratio of about 200 percent in 2009.) Among the set of countries shown, several European countries, notably Greece, Portugal and, to a lesser extent, Spain, also ran sizable current account deficits last year (the middle panel). In terms of relative competitiveness, unit labor costs over the past decade have increased sharply for the euro-area countries that have high fiscal and current account deficits and high debt ratios (the bottom panel).

In light of these vulnerabilities, a number of countries have announced measures that should improve their fiscal balances. Most consolidation plans include actions to increase revenue through higher taxes and improved tax administration and to control expenditures, notably through cuts or freezes in public sector wages. Consistent with the Stability and Growth Pact, euro-area members intend to reduce their general government deficits from an average of 6.3 percent of GDP in 2009 to 3 percent between 2012 and 2014. In the United Kingdom, previous plans to reduce the fiscal deficit to 4 percent of GDP by the fiscal year 2014 are likely to be made more ambitious when the new government reveals its program in late June. Canada aims to return to fiscal surplus by 2015. Only Japan has yet to publish a specific consolidation plan, but this is likely to be a priority for the new prime minister.

The most vulnerable euro-area countries have announced particularly substantial fiscal consolidations. As shown in exhibit 2, the projected fiscal adjustment is, in some cases, enormous. Not surprisingly, the largest fiscal effort will take place in Greece, where the improvement in the primary balance (which excludes interest payments) is slated to be 14½ percent of GDP from 2009 to 2014, when the primary surplus is projected to reach 6 percent. Spain, Ireland, and Portugal also have proposed major adjustments to their primary balances, ranging from about 8 to 10 percent of GDP over the next four to five years. Italy's consolidation effort is the smallest, reflecting its limited fiscal stimulus in response to the global financial crisis, which led to a relatively modest fiscal deficit of 5 percent of GDP last year.

To place these efforts into historical context, the bottom half of the exhibit shows data for the largest fiscal consolidations in advanced economies over the past two decades.[4] If completed as projected, the adjustments in Greece, Spain, and Portugal would rank in the top ten – the Greek adjustment being particularly notable. These announced consolidation efforts for the vulnerable euro-area countries will be particularly challenging, given that they are set to occur simultaneously and in less than half the average time of the earlier examples. As importantly,

[3] The debt figure for the United States includes federal, state, and local government debt. Federal debt amounted to 55 percent of GDP in 2009; state and local debt added an additional 17 percent of GDP.
[4] The episodes were identified in the November 2009 IMF Fiscal Monitor in terms of cyclically adjusted primary balances. In the table, we show unadjusted primary balances in order to compare with the current consolidation efforts shown in the top of the table.

the macroeconomic environment is far less favorable, with nominal GDP growth in each country expected to be far weaker than in the historical experience, particularly for Greece.

The sizable consolidation efforts across the AFEs will undoubtedly weigh on the pace of economic recovery. Staff estimates of the effect on real GDP growth of fiscal stimulus and consolidation plans between 2009 and 2012 for the major advanced foreign economies are shown in exhibit 3. We expect the fiscal impulse to be a slight drag on average AFE real growth this year before subtracting close to 1 percentage point of GDP next year and just a bit less than that in 2012. This impact is not evenly distributed across economies. In Japan, fiscal policy will impose little drag on growth through 2012. In contrast, fiscal consolidation in the United Kingdom will subtract more than 1¼ percentage points from GDP growth this year and nearly 1 percentage point in 2011 and 2012. We expect that fiscal policy in the euro area will be almost neutral for GDP growth in 2010, reflecting still-simulative policies in Germany, but subtract a bit over 1 percentage point on average over the next two years. This average masks a much more significant drag coming from the consolidation efforts of the most vulnerable euro-area economies. Importantly, from 2010 to 2012, the drag on Greek growth averages 2½ percentage points and, for Spain, the figure is close to 2 percentage points.

These ongoing fiscal efforts are not without their downside. Such sizable fiscal consolidation measures could run a risk of pushing the countries back into recession, which would likely shift deficit and debt ratios still higher. However, if the fiscally vulnerable countries do not pursue sizable fiscal measures, market confidence in these economies will suffer, leading to financial distress, as the recent pressures in Greece show. While we recognize the costs of consolidation, in our view, they are more than outweighed by the risks associated with insufficient action.

Debt Sustainability

Although the planned fiscal consolidation efforts of many countries are quite sizable, it remains an open question whether they will be sufficient to stabilize the debt-to-GDP ratio under plausible assumptions about economic and financial market conditions. To address this question, we project debt-to-GDP ratios for the AFEs under two sets of assumptions: (1) official projections from country finance ministries, the European Commission or, in the case of Greece, the IMF, which include the latest fiscal austerity measures announced by the authorities in each country, and (2) staff forecasts for the AFEs.

Key assumptions underlying these projections are nominal GDP growth, changes in the primary balance, and the interest rate at which new debt will be issued (which, together with the maturity profile of the debt, determines the average interest rate on the debt stock).[5] In most (though not all) countries, staff forecasts for these variables are somewhat more pessimistic than official-sector projections, reflecting our assessment that some of the fiscal austerity plans are implausibly ambitious, particularly given the low growth embedded in both official and staff forecasts.

[5] For details on the methodology used see the companion memo to the Committee, "The Long-Term Outlook for U.S. Fiscal Policy," by Eric Engen, Glenn Follette, and David López-Salido (June 11, 2010).

The results of this exercise are presented in exhibit 4, which shows official projections of debt-to-GDP ratios (the solid lines) and the staff projections (the dashed lines).[6] With the exception of Canada, where the debt ratio falls noticeably, the level of debt as a percent of GDP remains elevated relative to recent history. For most countries, however, debt-to-GDP ratios stabilize under both official-sector and staff projections, suggesting that current fiscal consolidation plans are likely sustainable. We emphasize, however, that for some countries a stable projected debt-to-GDP ratio, while meeting the definition of fiscal sustainability, may prove difficult to maintain. High debt ratios mean high annual funding needs and debt-service burdens which lead annual fiscal balances to be sensitive to changes in interest rates. Moreover, higher debt ratios will probably increase vulnerability to swings in market sentiment. Finally, high debt levels may reduce the ability of governments to respond to future downturns with the same alacrity and force with which they addressed the recent crisis, placing a higher burden on monetary policy and potentially reducing the overall ability of policy to smooth output going forward.

For most of the economies shown, there is little substantive difference between staff and official forecasts, and in the cases of Japan and the United Kingdom, the staff forecast is somewhat more optimistic than the official projection.[7] For Spain, Portugal, and especially Greece, however, the staff forecasts are substantially worse than the official projections (which, themselves, are not all that promising). Although the staff view is slightly more pessimistic than the official baseline in terms of nominal growth, the primary difference lies in the timing and extent of fiscal consolidation assumed in the official forecast, which the staff considers to be quite optimistic.

Under the staff forecast, the Greek outlook is bleak. Debt reaches 165 percent of GDP by 2020. In this scenario, we assume that Greece pays a 350 basis point premium over German rates on any newly issued debt starting in 2012, when the country is scheduled to return to financial markets for funding, implying that interest payments exceed 12 percent of GDP by the end of the projection period (exhibit 5).[8] Accordingly, despite our continued assumption of substantial fiscal consolidation (12 percentage points of primary balance adjustment, compared with 14½ percentage points in the official projection), the total fiscal deficit never falls below 6 percent of GDP, violating the Maastricht criterion of 3 percent by a substantial margin. To sustain this path and not default will require significant and long-term sacrifices on the part of the Greek populace. It will also require a high tolerance and strong appetite for Greek debt from domestic and international investors. Alternatively, it will require the willingness of the other euro-area governments, and, possibly the IMF, to lend to Greece over an extended period, as well as that of the European Central Bank (ECB) to continue to provide significant liquidity to the financial sector.

[6] The sources for the official forecasts vary. For the euro-area economies, near-term forecasts, typically through 2013, are taken from Stability and Growth Pact (SGP) submissions. These data are supplemented with information from country-level announcements of fiscal consolidation not yet incorporated in the SGP. For the United Kingdom and Canada, the projections through 2015 are based on data from the most recent budget reports. The Japanese projections are based on forecasts from the OECD. In all cases, beyond the last forecast period, we gradually bring the forecasts for output growth and inflation in line with long-term projections from the OECD.
[7] For the United Kingdom, this difference reflects incoming data showing less public sector net borrowing than in the March Budget and faster assumed consolidation going forward. For Japan, the difference reflects our more favorable interest rate assumptions.
[8] We assume that the EU Financial Stabilization Mechanism, the potential for IMF funding, and ECB liquidity support provide sufficient backstop that rates do not move higher, although that remains a prominent risk. If spreads were 100 basis points lower than in our baseline, the Greek debt-to-GDP ratio would eventually stabilize, but near 155 percent, still implying very large interest payments each year.

The staff outlook for Portugal, while better than that for Greece, is also grim. Despite more than 7 percentage points of primary balance adjustment, the actual deficit remains above 5 percent of GDP and interest payments exceed 6 percent of GDP by 2020. The interest spread over German yields is assumed to be 250 basis points from 2010 on. The debt-to-GDP ratio exceeds 100 percent and continues to rise at the end of the projection.

Spain appears in better shape. Although government debt reaches 75 percent of GDP in 2013, it declines thereafter in the staff forecast. Because of the relatively low overall debt burden, interest payments remain below 3½ percent of GDP and the total deficit falls below the Maastricht criterion in 2016, reaching a modest 2 percent of GDP by 2020.

Ireland's position is similar to Spain's, although it starts with slightly higher deficit and debt levels. Despite similar adjustment in the primary balance, Ireland's debt peaks at nearly 95 percent of GDP, interest payments rise to over 4 percent of GDP by 2011, and the total deficit remains just above the Maastricht criterion by 2020. Reflecting their somewhat better fiscal positions, Spanish and Irish sovereign rates are assumed to be 150 basis points above German rates in the staff forecast.

We should note that there is considerable uncertainty surrounding our best guesses for growth, interest rates, and fiscal balances. However, the qualitative results, including the relative rankings of the countries in terms of debt sustainability, are reasonably robust to variations in our assumptions. We should also keep in mind that Greece and Portugal together represent only 5 percent of euro-area GDP, and the euro-area economy as a whole should be able to absorb a restructuring of either country's sovereign debt if market conditions remain otherwise stable.

Necessary Policy Steps

As the above discussion highlights, the current fiscal situation in a number of European countries, especially Greece and Portugal, looks precarious. For these countries, achieving fiscal sustainability will require both strict commitment to fiscal consolidation plans and benign economic and financial outcomes. Should efforts fail and countries be forced to restructure debt in the near term, risks to financial and economic stability in the euro area and beyond are high. As is discussed in detail in the companion paper "The Macroeconomic Consequences of the European Debt Crisis," spillovers of financial turmoil through credit and equity markets, exposure of banks and other institutions, exchange rates, and trade could result in substantially weaker economic growth in the United States and throughout the world. Greece and Portugal alone account for less than 5 percent of euro-area GDP, but with the global economic recovery still in an early phase and vulnerabilities in financial markets and institutions remaining acute, it is essential to buy time to allow policymakers and institutions to take steps to limit risks. Some of the necessary steps should be taken by national fiscal authorities:

- Vulnerable countries, such as Portugal, should intensify consolidation efforts, striving to make painful, up-front budget cuts that convince markets of their seriousness.
- Consolidation plans should support long-run growth by including productivity-enhancing structural reforms that improve flexibility and efficiency or by changes to the tax structure that reduce economic distortions.
- To guard against the widespread recession and deflation that could result from synchronized budget cutting, economies with stronger fiscal positions (particularly

Germany) should strive to support demand in the region, including through more measured withdrawal of fiscal stimulus.

Stabilization efforts by individual European countries should be complemented by appropriate monetary and fiscal policy actions at the Europe-wide level:

- In the face of the sizable drag resulting from fiscal consolidation efforts, as well as the still-fragile condition of financial markets, the ECB should maintain its highly simulative policy stance and provide ample financial sector liquidity.
- Leaders should also act to strengthen the institutional framework within the euro area and European Union, including improving the surveillance of members' policies and developing joint decision-making approaches to address fiscal and other stresses.
- European governments and leaders should seek to follow a more disciplined and coherent communication strategy than has been the case recently, when apparently inconsistent and variable communications undercut market sentiment.

Finally, Europe's financial system needs to be bolstered to allow it to better weather the types of shocks that have been buffeting markets as of late:

- Efforts should be undertaken by European banks to strengthen their balance sheets and then improve capital positions, as necessary.
- More progress should be made to strengthen liquidity positions and address the structural dollar funding needs that continue to be a source of strain for European institutions.
- Improving the transparency of financial reporting is critical to ensuring that, in the event of adverse outcomes, an indiscriminate run on all European institutions is avoided. Along these lines, European authorities should consider a formal stress testing exercise to provide clear information on the financial condition of their major banks.

However, in some cases, even the best efforts of policymakers may not be enough to put fiscal positions on a sustainable path. The macroeconomic environment may turn out to be worse than expected. New shocks, such as the collapse of a major banking institution, may derail fiscal consolidation plans. And, political and social will may be insufficient to bring such programs to successful completion, given that buy-in from both the vulnerable euro-area countries and the more stable core countries is far from universal. Given these risks, European policymakers must also start thinking seriously, if they have not already, about "Plan B" options such as an orderly debt restructuring in the event that the government debt of one or more countries proves unsustainable.

Exhibit 1

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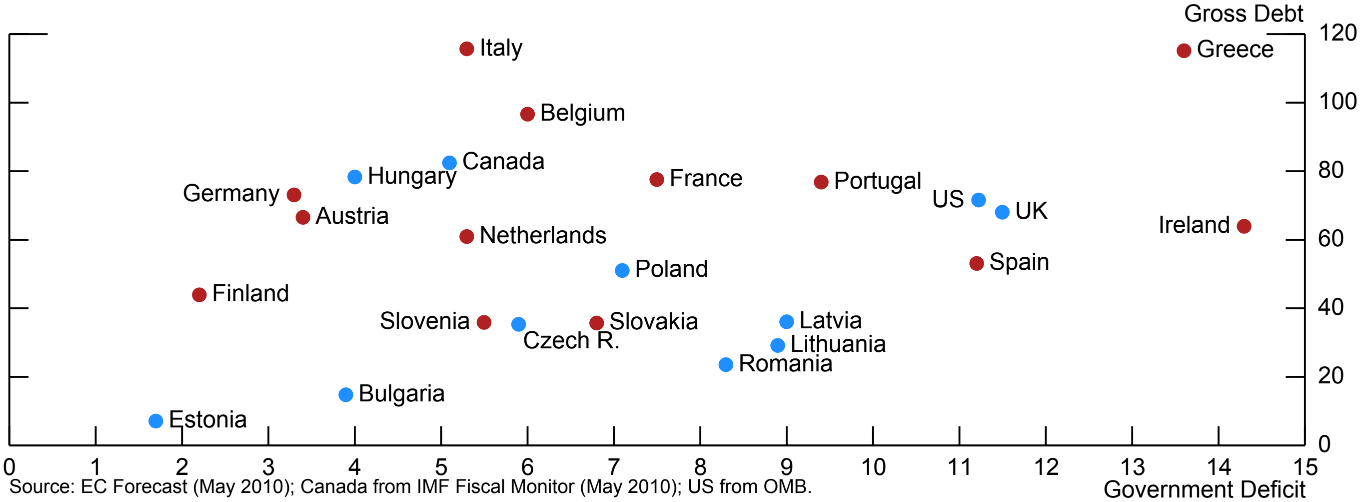
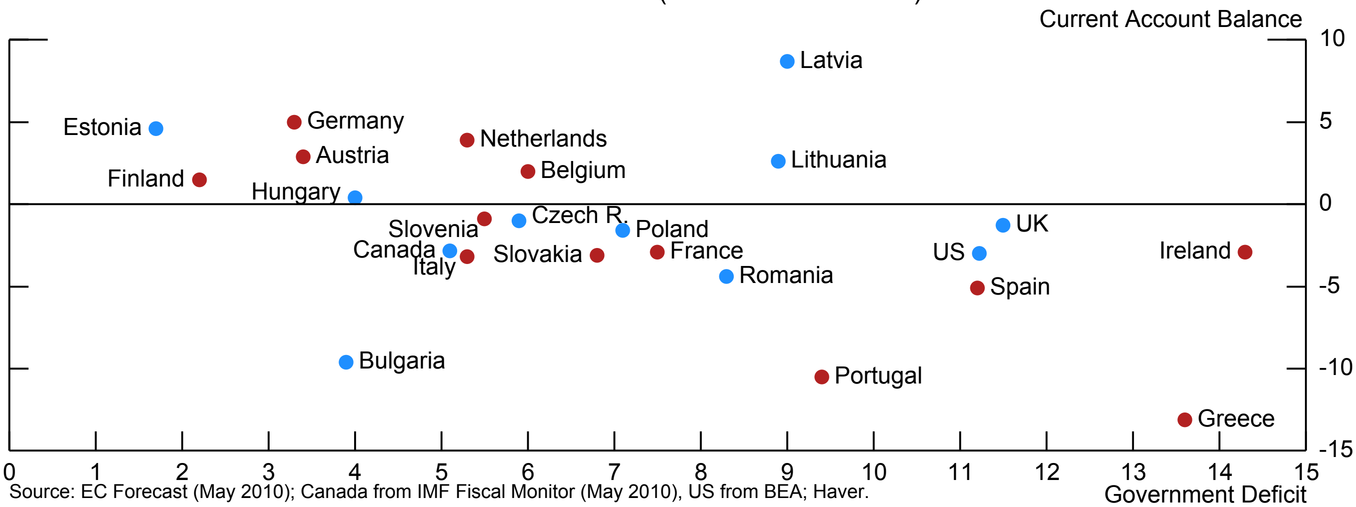
Comparative Fiscal Positions Across the Advanced Economies

2009 General Government Debt & Deficits (as a Percent of GDP)



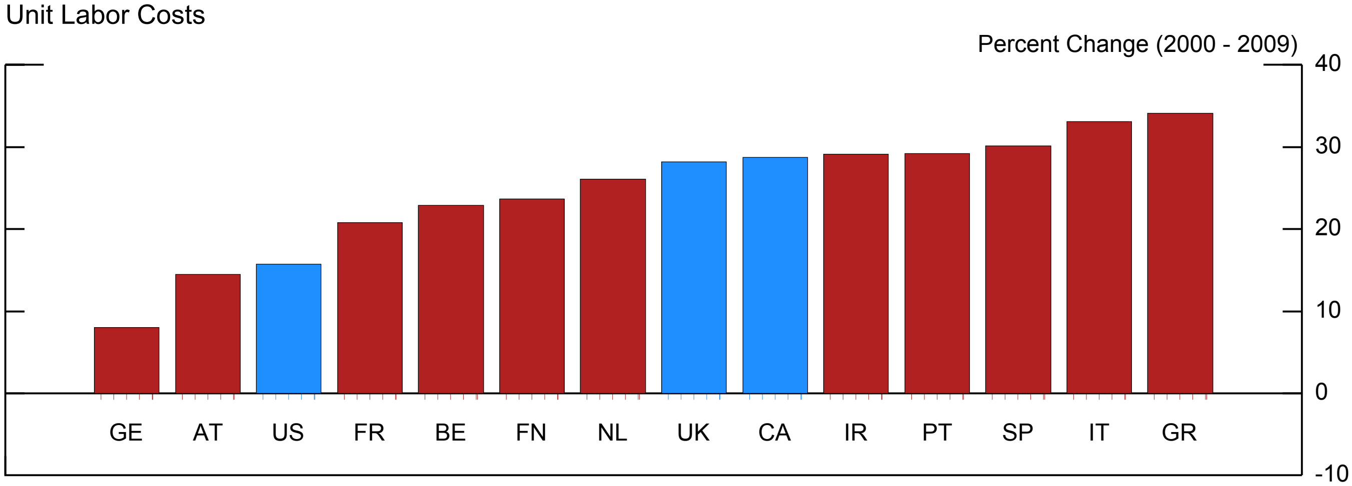
Source: EC Forecast (May 2010); Canada from IMF Fiscal Monitor (May 2010); US from OMB.

2009 Current Account & General Government Deficits (as a Percent of GDP)



Source: EC Forecast (May 2010); Canada from IMF Fiscal Monitor (May 2010), US from BEA; Haver.

Unit Labor Costs



Source: European Commission AMECO database.

Note: Red dots and bars denote euro-area countries; blue dots and bars denote all others.

Exhibit 2: Comparison of Large Fiscal Adjustments in the Advanced Foreign Economies

Country (end year)	Total Primary Balance Adjustment (% of GDP)	Length (years)	Primary Balance (at end year)	Real GDP Growth (average over period)	Inflation (average over period)	Nominal GDP Growth (average over period)
Announced Adjustments*:						
Greece (2014)	14.5	5	6.0	-0.3	0.9	0.6
Spain (2013)	9.7	4	0.1	1.9	1.2	3.0
Ireland (2014)	8.6	5	-1.0	3.0	1.0	4.0
Portugal (2013)	7.7	4	1.3	1.2	1.7	2.8
Italy (2012)	3.2	3	2.7	1.7	1.8	3.5
Average	**8.7**	**4.2**	**1.8**	**1.5**	**1.3**	**2.8**
Historical Adjustments**:						
Denmark (1986)	16.7	4	9.5	3.9	5.4	9.3
Finland (2000)	16.5	7	7.8	4.5	1.3	5.8
Sweden (2000)	15.8	7	5.9	3.5	1.0	4.5
Belgium (1998)	11.9	15	6.0	2.3	2.6	4.9
United Kingdom (2000)	11.6	7	6.0	3.5	1.8	5.3
Canada (1999)	11.3	14	5.9	2.8	2.8	5.6
Sweden (1987)	10.3	7	5.1	2.2	7.6	9.9
Japan (1990)	8.4	12	3.3	4.6	2.7	7.2
Ireland (1989)	8.2	11	3.9	3.1	9.7	12.8
Greece (1995)	7.5	6	1.8	1.0	15.0	16.0
Italy (1993)	6.5	8	2.1	2.1	5.6	7.7
Average	**11.3**	**8.9**	**5.2**	**3.1**	**5.0**	**8.1**

Note: End year for consolidation effort in parentheses.

* Source: Stability Growth Program, IMF Standby Arrangement for Greece. Forecasts from IMF WEO April 2010.

** Source: OECD Outlook (December 2009) and IMF Fiscal Monitor (November 2009)

Exhibit 3: Fiscal Impulse from Policy

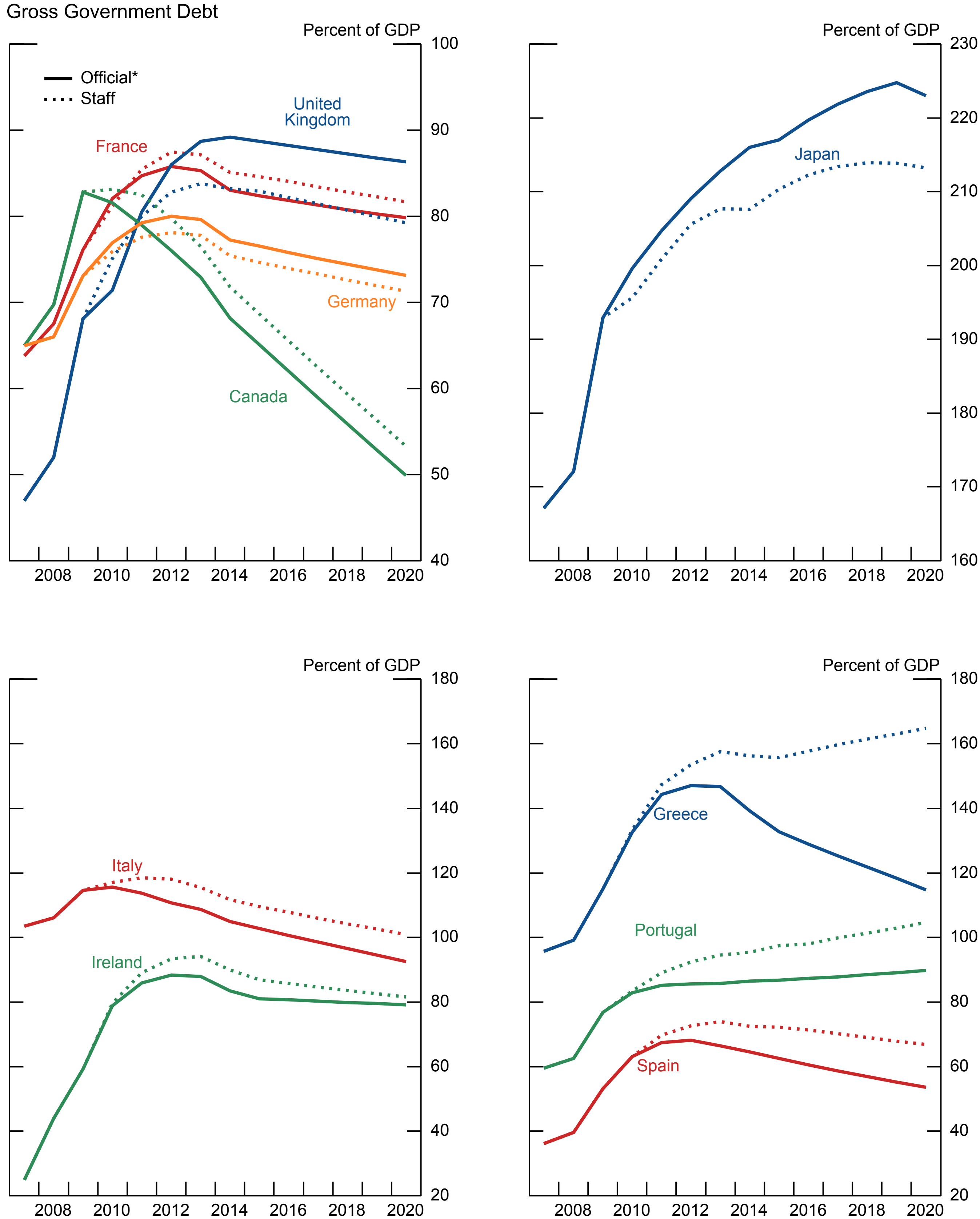
	Fiscal impact on GDP growth* Percentage Point Contribution (Q4/Q4)			
	2009	**2010**	**2011**	**2012**
Total**	**1.1**	**-0.2**	**-0.9**	**-0.7**
Canada	1.4	0.1	-0.6	-0.5
Japan	1.5	0.4	-0.1	-0.1
United Kingdom	0.7	-1.4	-0.9	-0.9
Euro Area	1.0	-0.2	-1.2	-0.9
of which				
Germany	1.3	0.8	-0.9	-0.6
France	1.2	-0.8	-1.0	-1.4
Italy	0.2	-0.4	-0.8	-1.0
Spain	1.6	-1.7	-2.0	-1.8
Greece	2.9	-4.5	-1.5	-1.5
Portugal	1.1	-1.5	-1.4	-0.8
Ireland	0.6	-2.8	-1.0	-0.7

* Staff forecasts and estimates.

** Total weighted by 2009 nominal GDP in U.S. dollars.

Exhibit 4

Sovereign Debt Projections



* Official projections based on forecasts from European Commission, OECD, IMF, Country Treasury Departments, and staff estimates.

Exhibit 5: Interest Payments as a Percent of GDP Using Staff Forecasts*

	Greece	Portugal	Spain	Ireland	Italy	Germany	France	United Kingdom	Canada	Japan
2009	4.9	2.9	2.2	2.5	3.8	2.6	2.5	2.8	2.7	1.9
2010	5.8	3.7	2.7	3.5	4.0	2.6	2.7	3.1	3.1	2.0
2011	6.4	4.2	3.1	4.0	4.3	2.7	2.9	3.3	3.1	2.0
2012	7.3	4.5	3.3	4.2	4.4	2.8	3.1	3.4	3.0	2.2
2013	7.8	4.8	3.4	4.3	4.4	2.8	3.1	3.4	2.9	2.3
2014	8.1	5.0	3.5	4.2	4.4	2.8	3.1	3.4	2.7	2.4
2015	8.4	5.2	3.5	4.2	4.3	2.8	3.1	3.4	2.6	2.6
2016	10.3	5.4	3.5	4.1	4.3	2.8	3.1	3.4	2.5	2.9
2017	11.3	5.6	3.5	4.1	4.3	2.8	3.1	3.3	2.3	3.1
2018	11.8	5.8	3.4	4.1	4.3	2.8	3.1	3.3	2.2	3.4
2019	12.1	6.0	3.4	4.0	4.2	2.7	3.1	3.3	2.1	3.6
2020	12.3	6.2	3.4	4.0	4.2	2.7	3.1	3.2	2.0	3.9

* Interest payments are calculated as the average interest rate on the stock of debt times all outstanding marketable debt.
Official estimates of interest payments differ for some countries.