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The director of the Fiscal Affairs department of the International Monetary Fund spoke on Monday to the BC community.

Cottarelli discusses fiscal accounts

By Andrew Skaras
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"The fiscal accounts of many advanced economies are now in the worst shape ever," Carlo Cottarelli said. "In 2008, the IMF was calling for an expansionary fiscal policy for the first time ever. The recession was not an ordinary recession—[it] turned into a demand recession. The monetary lever was not working. We called for a fiscal expansion when others had not recognized the full impact of the crisis."

At Boston College on Monday as a part of the International Economic Policy and Political Economy Seminar, Cottarelli came to speak about the situation of public finances in advanced economies. He has served as a director of the Fiscal Affairs department of the IMF since 2008, which gives advice on public finance to approximately 100 different economies and publishes the *Fiscal Monitor,* a bulletin that tracks the progress of national fiscal adjustments around the world.

Cottarelli began by explaining how many advanced economies came to be in the situation where they needed significant fiscal restructuring. He traced it back to a surge in public debt in the 1970s that continued into the crisis that began in 2007. Looking at both the gross debt and the deficits, he showed that both increased further through the crisis, especially the structural deficit.

"At the end of this year, the gross debt [of the U.S.] is expected to exceed 110 percent of GDP, near the historic high at the end of the Second World War," Cottarelli said. "However, four factors suggest that the fiscal account is worse than it was at the end of the Second World War."

The first factor that Cottarelli talked about was the type of fiscal cuts that were employed—military cuts—and how they were easy to implement. Moving to demographic concerns, he explained how there were not pressures on pension and health care systems, due to the relatively young population. He then discussed higher labor force growth rate in the 1950s. Lastly, he described how the financial sectors of most advanced economies were repressed in the post-war period and how that facilitated the financing of government paper.

Turning to the present situation, Cottarelli grouped the 25 most advanced economies into three groups. The first included those with declining or stable debt, most of which had a surplus before the crisis. Examples of these countries were Switzerland and Sweden. The second group included countries with small increases in debt at low levels. None of these countries currently have a net debt-to-GDP ration above 60 percent. The third group, which included the U.S., was made up of countries with a debt-to-GDP ratio of over 90 percent. Cottarelli stressed that these 10 countries represent 70 percent of the advanced economies' GDP and 43 percent of the world GDP.

"How difficult will it be for these countries to bring [their] fiscal accounts under control?" Cottarelli asked. "This depends on two things. First of all, what do we mean by 'bringing public finances under control?' Second, it depends on the assumptions of the interest rate-growth differential."

Focusing on the first question, Cottarelli talked about bringing down the debt-to-GDP ratio. One of the goals that he described was bringing down public debt to 60-70 percent of GDP by 2030 by some combination of lowering spending and increasing taxes tailored to each country. He then explained a graph that showed the different situations of the different "Group 3" countries and how much fiscal adjustment they needed to achieve the necessary budget surplus to meet the goal.

"Many countries will have to swim against the tide because they will have to implement fiscal adjustment at a period when demographic and other forces will lead to an increase in spending for pensions and health care," Cottarelli said. "The United States is the second largest in entitlement spending. Given the magnitude of the adjustments, one could wonder if there are short cuts."

The two potential shortcuts that Cottarelli discussed were increasing inflation and debt restructuring. Regarding inflation, he described two ways that inflation helps. The first was seigniorage, the amount of money that the government would gain simply by printing more money. Cottarelli said, however, that this was not large in advanced economies. The second was the decrease in the value of public debt in circulation. Although Cottarelli admitted that this would have a larger impact than seigniorage, he also thought that it would be difficult to control and that it would not do enough to solve the fiscal problems.

"How about debt restructuring or, in plain English, not paying your bondholders?" Cottarelli asked next. "This is not a cost-free option. After default, when a country goes back to the market, it will have to pay a higher risk premium. We should not forget that default is a tax on the bondholder and therefore has the same deflationary effects on the economy as any tax. I think that the cost of debt restructuring is quite high."

Cottarelli then turned to two requirements for governments to navigate their fiscal adjustments succesfully. The first was structural reforms to raise potential growth.

"[Structural reforms] are important because it affects the debt-to-GDP ratio," he said. "Also, it is easier to run large primary surpluses when an economy is growing a lot. If there is an increase of growth per year, it will lower the debt-to-GDP ratio."

The second requirement was that countries implement a strategy to keep interest rates under control. Cottarelli described four aspects of this requirement. The first was a "medium term fiscal adjustment plan." The second was determining the appropriate pace of fiscal adjustment, which depended on the market circumstances facing each country, as well as the amount of fiscal adjustment necessary.

The third was defining the appropriate balance between increased taxation and decreased spending for each country. He noted that it would be better in the long term for European countries to cut spending, while the U.S. and Japan had room for raising taxes. The fourth aspect of the strategy was relaxed monetary policy.

"In several advanced economies, the fiscal accounts are in really bad shapes," Cottarelli concluded. "It will take decades to lower [them] to sustainable levels. It is not impossible, but there are not good shortcuts." ■