A survey of international fiscal policy issues — current drivers and future challenges

Over the past decade the fiscal positions of many of Australia's major trading partners have changed markedly. This article examines recent fiscal developments in selected economies and the future challenges facing policymakers.

Introduction

Policy makers in many countries responded to the synchronised global downturn in 2001 by relaxing their fiscal stance. In Europe and the US, this followed a period of strong growth and fiscal consolidation. In Japan and emerging East Asia fiscal policy had already been loosened in response to previous downturns.

While a short-run loosening of fiscal policy in response to the downturn may have been appropriate, a period of fiscal consolidation is likely to be necessary in the coming years as many countries face medium-to-long term fiscal challenges.

For developed countries, ageing populations and medical technology are likely to increase pressures for additional government pension and health expenditures. The *Intergenerational Report (2002-03 Budget Paper No. 5)* outlined the longer-term fiscal pressures that Australia could face. The fiscal challenges facing many of the advanced economies are much greater than those facing Australia, particularly for Japan and the European economies.

The countries of emerging East Asia appear to have less pressing demographic constraints, but face other pressures. Public debt ratios have increased significantly in recent years and dealing with unresolved financial sector problems may involve further large costs for governments in the future.

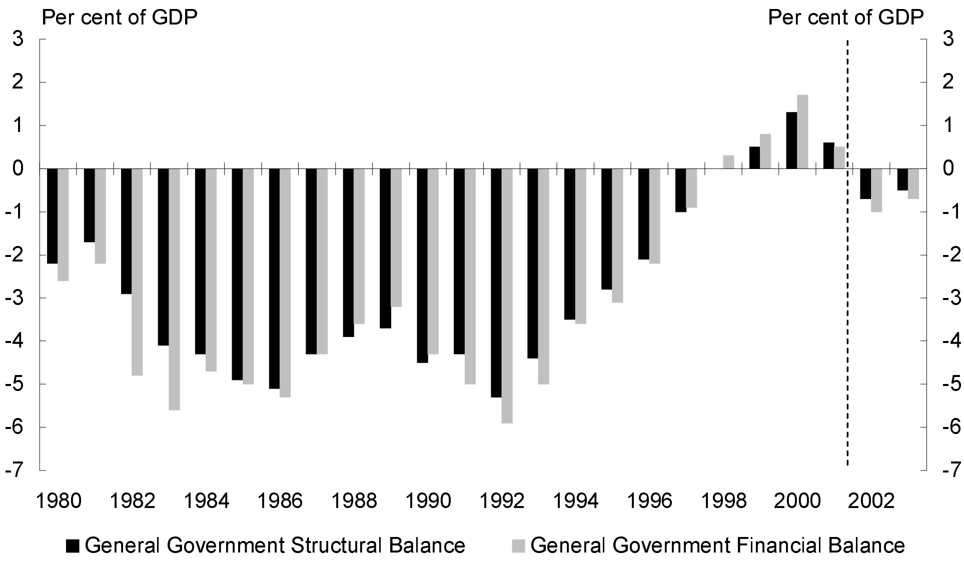
Current and prospective fiscal positions in other countries are relevant to Australia because of our trade and financial linkages with the rest of the world. If other countries fail to address their fiscal challenges Australia may be adversely affected through resultant impacts on world economic growth and capital markets, although we can advance our prospects in relative terms by maintaining a sound fiscal position ourselves.

Recent fiscal policy developments

The United States and Europe

The global economic slowdown in 2001 was associated with a decline in fiscal balances in the United States and the European Union. This brought to an end a period of substantial fiscal consolidation during the long expansion of the 1990s (Charts 1 and 2).

Chart 1: United States financial and structural balances



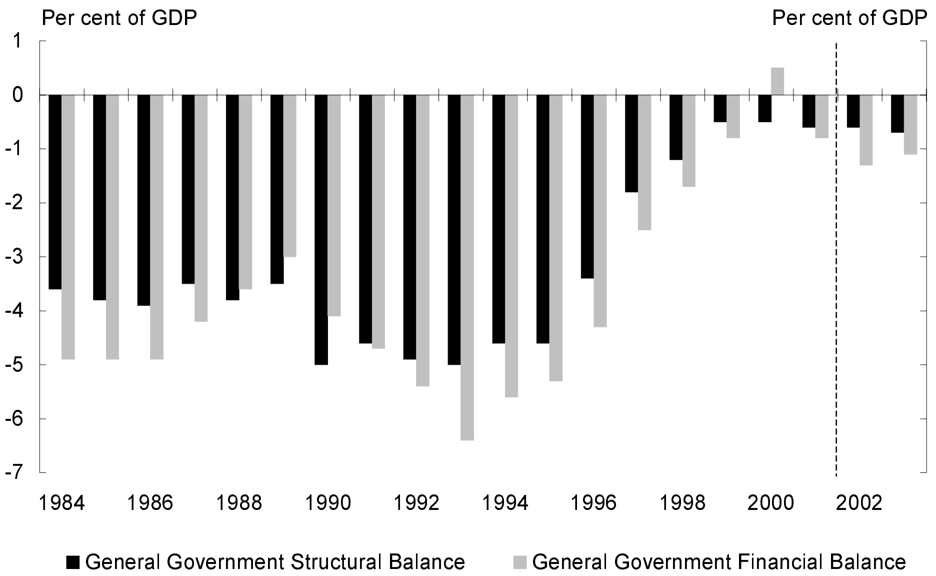
Source: OECD Economic Outlook 71.

The ***United States*** had moved back into fiscal surplus from 1998 after almost 30 years of budget deficits. This was due to a sustained period of exceptional economic growth, low interest rates, booming equity prices and a post-Cold War reduction in defence spending, which had fallen by around 3 per cent of GDP since the late 1980s.

Discretionary policy changes and the effects of the recession mean that the US is now expected to record deficits in 2002 and 2003. OECD estimates suggest that most of this fiscal easing has been structural: ie it is due to ongoing factors rather than a temporary effect of the downturn in the economic cycle.[1] Key factors have been the large income tax cuts legislated in June 2001 and the increase in defence and security-related spending following September 11.

The policy easing also has important longer-term effects. The Congressional Budget Office (CBO) estimates that the fiscal cost of discretionary policy changes enacted since January 2001 rises from 1.4 per cent of GDP in 2002 to 2.2 per cent of GDP in 2010. This reflects the rising cost of income tax cuts that are phased in over this period.[2] The CBO projects a return to steadily rising surpluses from 2004, but these are subject to uncertainties that increase further out in the projection period.

Chart 2: European Union financial and structural balances



Source: OECD Economic Outlook 71.

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1 *OECD Economic Outlook No. 71, June 2002.* Structural balance estimates by the IMF *(World Economic Outlook, April 2002)* are similar, except where noted otherwise.

2 *The Budget and Economic Outlook: Fiscal Years 2003-2012* (January 2002) and CBO testimony on the President's budget for 2003 (6 March 2002). A sunset clause in the legislation formally rescinds the tax cuts in 2010, as a device to limit the total 10-year cost, but political imperatives may ensure they are extended.

The ***European Union*** (EU) also returned briefly to surplus in 2000, although the OECD estimates that this was due to cyclical factors. The better performers have been the United Kingdom and many of the smaller economies. Germany, France and Italy are estimated to have remained in significant structural deficit. For the bulk of EU members, fiscal consolidation has been driven by the requirements for joining the European Monetary Union (EMU).[3] The Maastricht criteria required EMU members to reduce deficits below 3 per cent of GDP, while the later Stability and Growth Pact committed them to achieving near balance or surplus by 2004.

The OECD estimates suggest that the apparent fiscal easing in the EU in 2001 has been largely cyclical. Of the larger EU economies, only Germany and the UK appear to have had a significant structural easing in 2001, although in some economies there had been some earlier structural easing.

The recent economic slowdown highlighted some tensions in the EMU requirements. With monetary policy ceded to the European Central Bank, fiscal policy is the key instrument for national governments to manage demand to fit their own circumstances. Even a moderate economic slowdown has seen Germany and Portugal threaten to breach the 3 per cent deficit ceiling, and balance by 2004 may be unreachable for some countries. Managing the trade-off between short-term stabilisation needs and the long-term need to ensure fiscal sustainability will be a key challenge for the EMU, especially as structural rigidities continue to impede the Euro area's ability to adjust to cyclical pressures.

OECD estimates indicate that this downturn has been associated with relatively moderate structural deficits in the US and the EU, at around ½ to ¾ of a percentage point of GDP compared to peaks of over 5 per cent of GDP in the early 1990s. The IMF estimates a somewhat larger structural deficit in the US of just over 1 per cent of GDP.

Net general government debt to GDP ratios have fallen in recent years in both the US and the EU (see Chart 3), and have not increased in the current downturn, reflecting a combination of the small size of recent deficits and the relatively mild impact on activity. The net debt picture within Europe varies considerably, with the most progress on debt reduction occurring in the UK and the Scandinavian economies, and significantly less progress in Italy, Germany and France.

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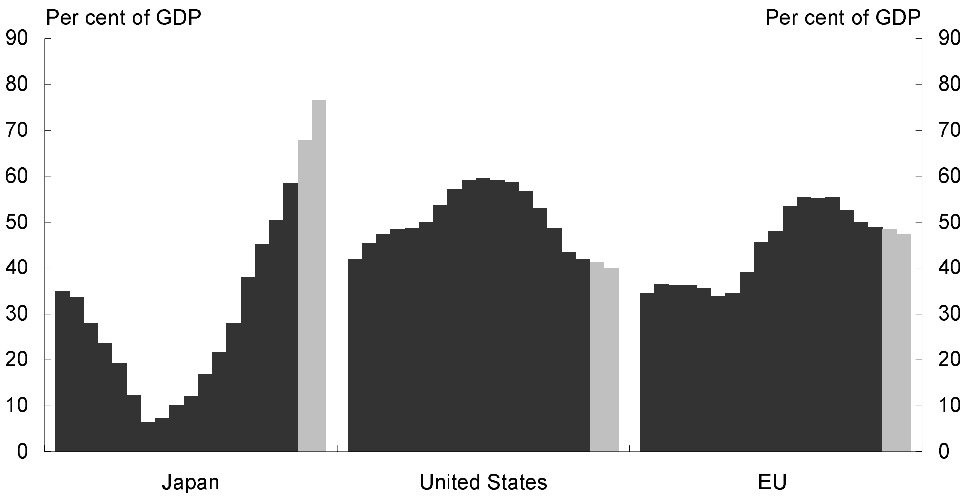
3 The EMU comprises 12 of the 15 EU members. The United Kingdom, Sweden and Denmark remain outside the EMU for the present.

The current fiscal position, however, must be viewed in the context of the longer-term fiscal challenges discussed later in the paper. These challenges are particularly pressing for some of the major EU economies that have made least progress in reducing government debt ratios — while starting from a relatively weaker fiscal position than most other countries — as they now confront large and more imminent fiscal pressures from population ageing.

Chart 3: US, EU and Japan net general government debt 1985-2003



Source: OECD Economic Outlook 71 (EU excluding Ireland and Luxembourg).

East Asia

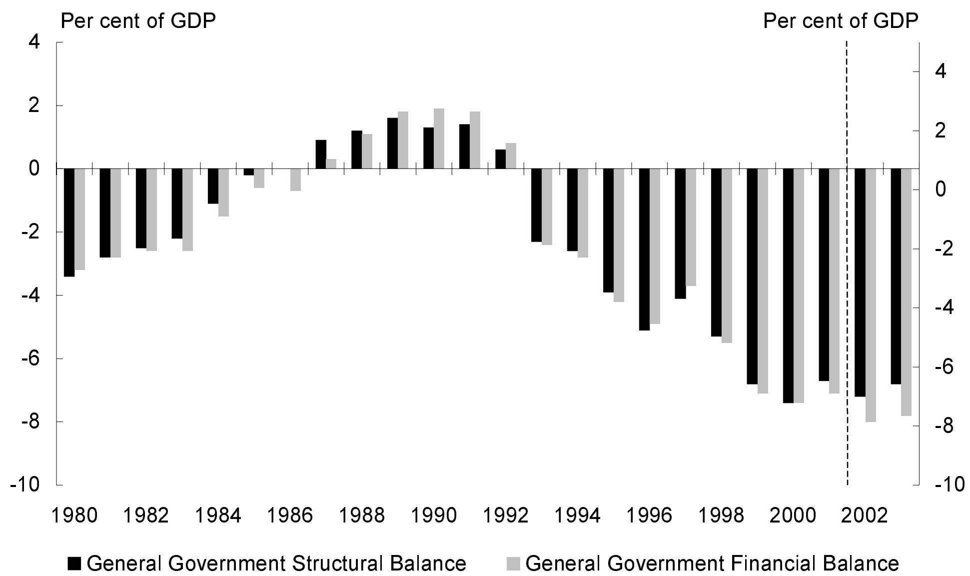
The US and EU experience over the past decade contrasts with that in East Asia, where a number of economies had strong track records of near-balance or surplus budgets until the latter part of the 1990s.

During the last decade, ***Japan*** has used a succession of fiscal stimulus packages to try to spend its way out of a prolonged economic stagnation.

This, and the poor performance of the economy, have led to increasingly large fiscal deficits as a share of GDP (Chart 4). The OECD estimates that current deficits are largely structural, as does the IMF.[4]

While it is widely accepted that Japan's economic growth has been constrained by deep-seated structural problems, it is an open question whether past growth might have been even lower without fiscal expansion. The Hashimoto Government's fiscal consolidation measures in 1997 were followed by recession. That said, it is likely that the effectiveness of fiscal policy has eroded since then. The need for future fiscal repair in Japan has become widely recognised, raising the likelihood that forward-looking households increase their own saving to meet future fiscal demands. Moreover, the perceived failure of past fiscal interventions suggests that confidence effects from new initiatives are likely to be very small.

Chart 4: Japan financial and structural balances



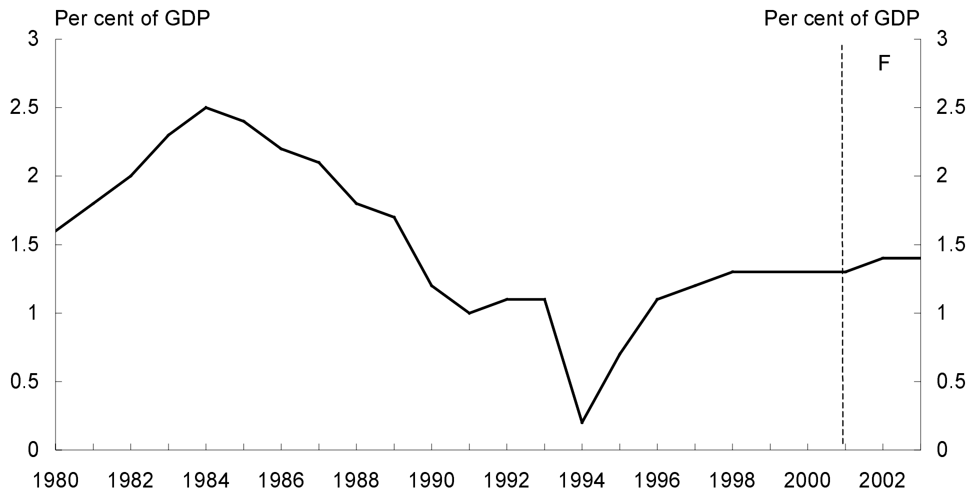
Source: OECD Economic Outlook 71.

4 This may, to some degree, be a product of OECD and IMF structural balance estimation techniques, which are based on estimates of how far the economy is away from its long-term trend. A long period of stagnant growth will pull down the trend estimate, and hence the estimated output gap, even though the economy may have substantial spare capacity.

A combination of fiscal easing and little or no growth in nominal GDP has seen the government debt to GDP ratio in Japan rise sharply in recent years (see Chart 3). Net debt is currently around 60 per cent of GDP but when social security assets are excluded it exceeds 110 per cent of GDP. Prime Minister Koizumi has set reform of government finances as one of his key goals and has limited new bond issuances to 30 trillion yen (6 per cent of current GDP) per year, but on all plausible growth paths this would still entail further increases in the debt/GDP ratio.

Despite ballooning debt levels, servicing costs have remained stable over the last few years (see Chart 5). Debt is almost entirely yen-denominated and domestically held. Japan has a large pool of private savings, and Japanese residents have been willing to hold increased government debt without demanding higher interest rates. Using the official CPI, real interest rates on Japanese long-term bonds remain slightly below US rates. The Japanese government has also been able to roll over debt at lower interest rates: the weighted average interest rate on outstanding government debt is 2¾ per cent but new 10-year bonds now pay less than 1½ per cent. Nonetheless, if present trends continue, one would expect to see risk premiums on government bond rates increase at some point (everything else unchanged). This would raise debt interest costs as a share of GDP.

Chart 5: Japan net debt interest payments

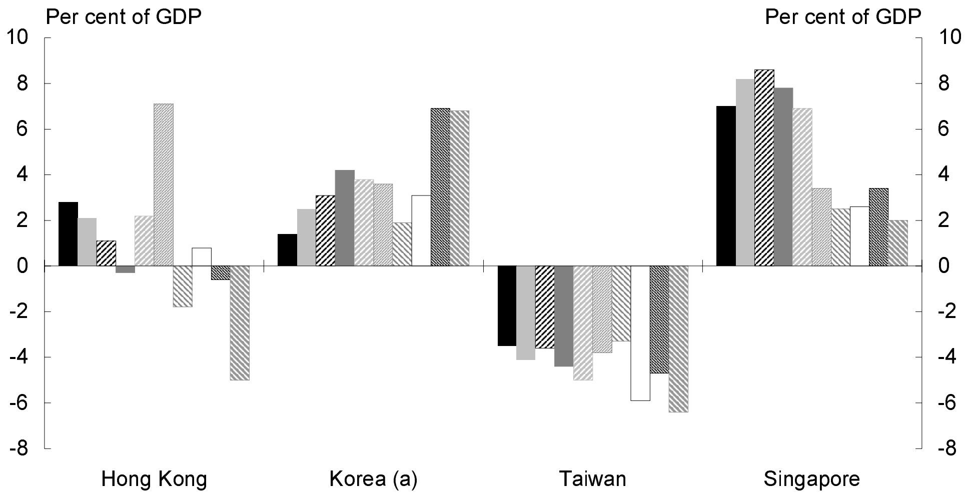


Source: OECD Economic Outlook 71.

Up until 1997, most of the economies in ***emerging East Asia*** had run surplus budgets for a number of years. These economies relaxed their fiscal policy stance following the Asian crisis of 1997-98. The global slowdown in 2001 prompted further fiscal easing (See Charts 6 and 7).[5] These easings reflected automatic stabiliser effects, fiscal stimulus packages and measures to recapitalise the financial sector in some countries.

As a result of an easier fiscal stance and the assumption of financial sector liabilities, public debt to GDP ratios in many East Asian countries have risen sharply over the last five years (see Chart 8). A large proportion of this is external debt, mainly denominated in foreign currencies. The situation varies considerably across the region, with governments in Singapore, Hong Kong and Korea maintaining strong net financial asset positions. But a key medium-term challenge for policy makers in some economies — particularly Indonesia, the Philippines and, to a lesser extent, Thailand — is to reduce vulnerability to external shocks through reductions in debt ratios.

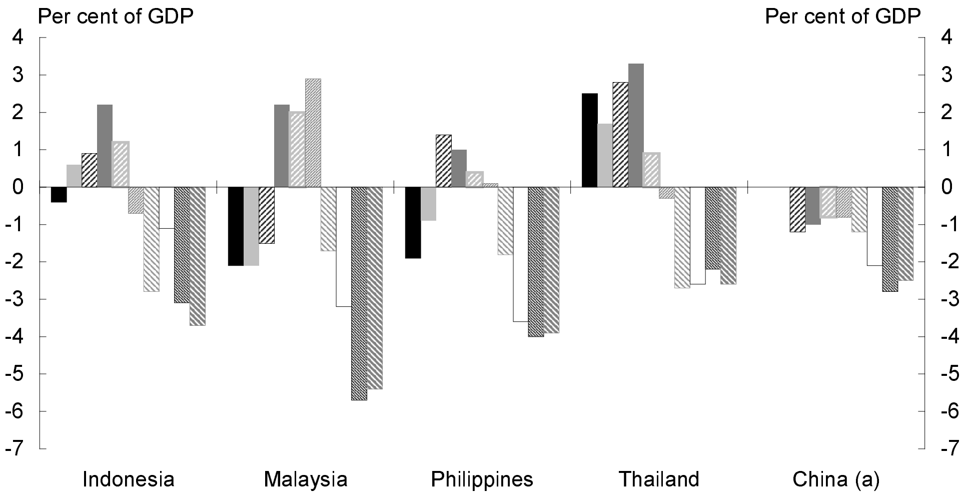
Chart 6: Newly industrialised economies fiscal balance, 1992-2001



Source: Economist Intelligence Unit, OECD (2002).
(a) Data for Korea is for general government only.

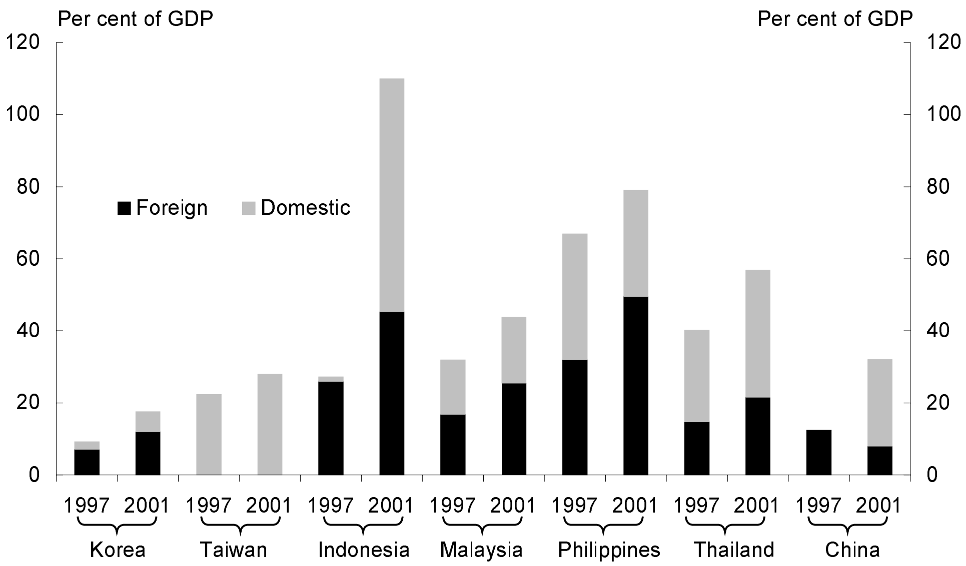
5 Data for the general government sector, which is the standard fiscal measure for OECD economies, are not available for non-OECD Asian economies. In making cross-country comparisons it should be noted that public sector figures include government business enterprises, which are not normally considered in the context of fiscal policy. In addition, public debt data for Asian economies is generally only available on a gross basis, which does not take account of offsetting holdings of financial assets.

Chart 7: Other regional economies fiscal balance, 1992-2001[(a)]



Source: Economist Intelligence Unit.
(a) Data for China is from 1994 onwards.

Chart 8: Emerging East Asia gross public debt[(a)]



Source: CEIC, www.economist.com, ADB (2002), OECD, Lehmann Brothers (2001).
(a) Hong Kong and Singapore have negative public debt from large accumulated surpluses; historical data for the Chinese gross public debt is unavailable; and Korean data is for general government only.

Medium-to-long term fiscal pressures

As noted earlier, current fiscal balance and government debt positions around the world need to be seen in the light of fiscal pressures likely to arise in the medium-to-long term.

This section focuses on two readily identifiable sources of fiscal pressure: the long-term impact of population ageing (in conjunction with rising health care costs) and the contingent liabilities associated with unresolved financial sector problems in East Asia. While the future size of these pressures is uncertain, the underlying factors can be identified. Other sources of fiscal pressure will depend on future developments and changes in voter preferences that are more difficult to clearly identify at this stage — for instance, pressures for higher defence / security-related spending or environmental spending.

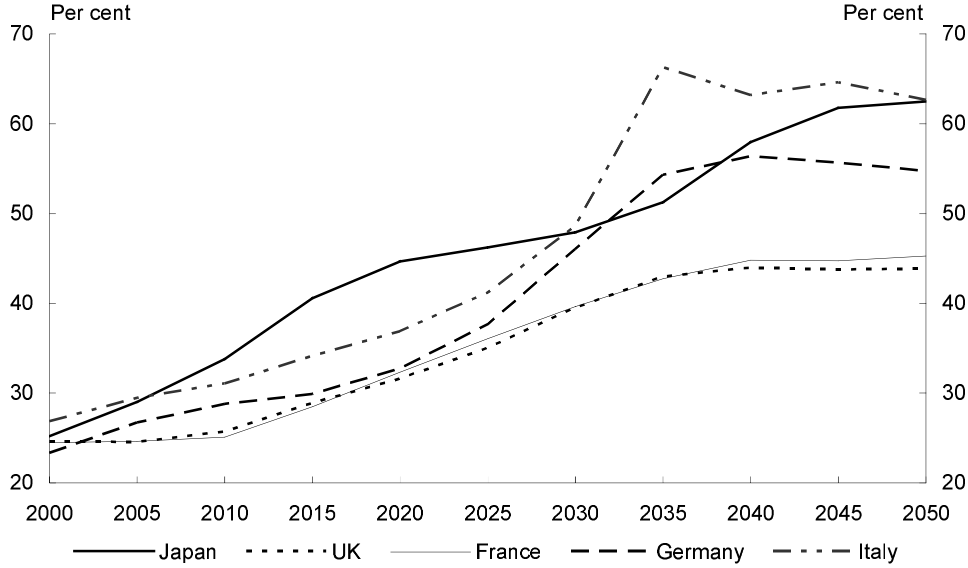
Fiscal pressures may also arise from international tax competition. In the East Asian region, for instance, perceptions of China's rise and its relative attractiveness as an investment destination may create pressure for lower tax rates among ASEAN members seeking foreign direct investment.

Demographic pressures

A major source of fiscal pressure in the longer term, especially in developed economies, will arise from population ageing as a consequence of long-term factors including declining fertility rates, the ageing of the baby-boom generation, and longer life expectancies. While all economies are expected to experience population ageing to some degree, there are substantial differences between groups of economies. Charts 9 to 11 show World Bank projections for aged dependency ratios — the ratios of retirees (aged 65 and over) to workers (aged 15 to 64) — out to 2050.

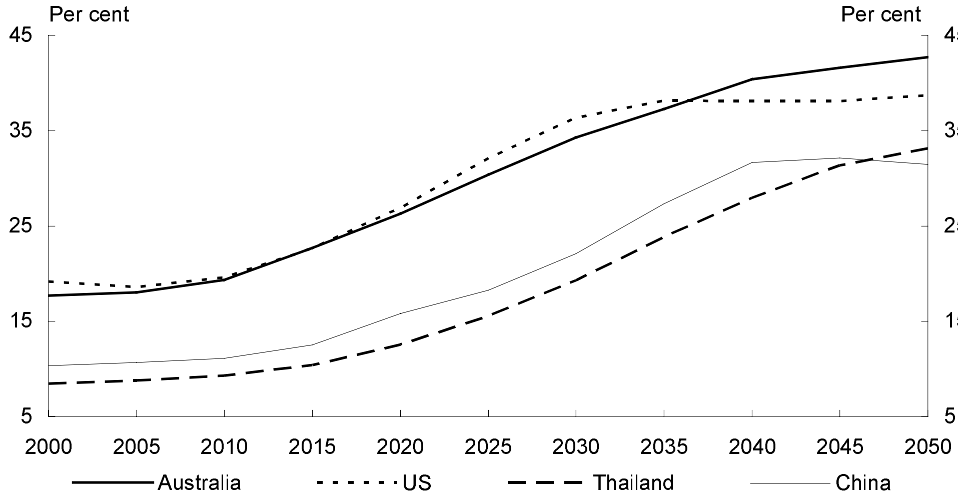
Japan, Italy and Germany appear to face the largest challenges from increasing aged dependency ratios. Not only are the projected increases larger in these countries, but they are already starting to occur. Ratios in other economies do not increase significantly until the next decade. Ratios for emerging East Asian economies are projected to remain at lower *levels* than the developed economies, although the *increase* in the ratio for most is similar to that for the US, the UK and France.

Chart 9: Ratio of retirees to workers (high)



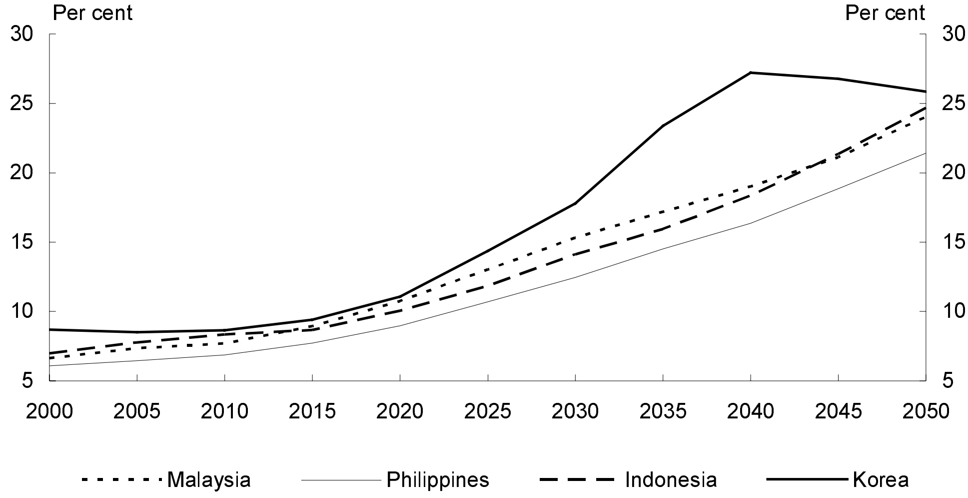
Source: World Bank.

Chart 10: Ratio of retirees to workers (medium)



Source: World Bank.

Chart 11: Ratio of retirees to workers (low)



Source: World Bank.

How these projected demographic trends might translate into fiscal pressures will depend on a range of factors, including the structure of spending programmes, future productivity growth and changes in labour force participation.

The OECD Working Paper *'Fiscal Implications of Ageing: Projections of Age-Related Spending'* compiles projections by OECD economies of age-related spending to 2050.[6] Age-related spending for the average country is projected to rise by around 6 to 7 percentage points of GDP between 2000 and 2050. Part of this fiscal pressure is a result of cost pressures from advances in medical technologies, rather than ageing *per se*. All else equal, the projected spending increase would increase the net debt ratio in the average country by almost 100 per cent of GDP by 2050 if no offsetting action were taken.

These projections could be on the low side, as some of the European economies did not provide projections for categories other than aged pensions. Some faster ageing economies that have already taken steps to make their pension systems sustainable have relatively moderate projected growth in spending. Japan has a projected increase in total age-related spending of 3 per cent of GDP, while Italy projects a peak increase in aged pension spending of

6 *Fiscal Implications of Ageing: Projections of Age-Related Spending*, Economics Department Working Paper No. 305. Age-related spending includes aged pensions, 'early retirement' benefits, health and aged care, education and child / family benefits.

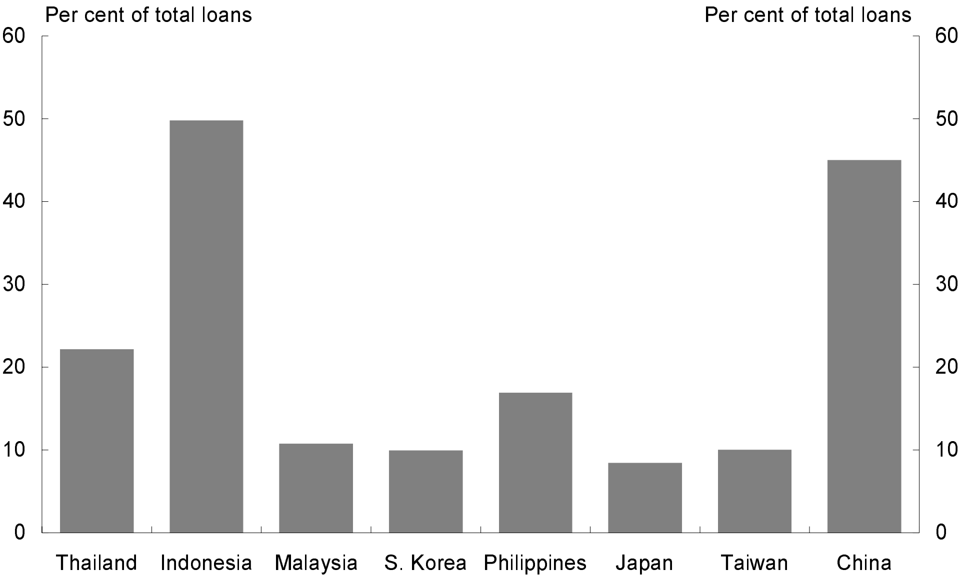
1.7 per cent of GDP. On the other hand, Korea projects an increase in total age-related spending of more than 8 per cent of GDP.

In ‘current policy’ terms, the direct fiscal implications of population ageing may be less in the less advanced East Asian economies than in the OECD economies. These economies typically have limited government-provided safety nets, relying instead on high private savings and family networks to support those unable to work. This approach has been assisted by relatively young populations and a long period of strong economic growth up until the 1997 crisis. But demands on governments may increase as countries develop, particularly as populations age and if business cycle fluctuations become more prevalent. The Asian crisis experience has already prompted an increased focus on social safety nets in the region.

Financial sector problems in East Asia

In the medium term, resolution of remaining problems in the financial sector represents a potentially large area of future increased liabilities for East Asian economies (see Chart 12). The Japanese government, for example, has set aside 15 trillion yen (3 per cent of GDP) to be injected into the banks if the financial system is faced with a systemic crisis. The emergence of fresh bad loans may mean that greater sums of public money will be required to restore the financial system to health. Life insurance companies in Japan also face potential large losses. As the chart suggests, potential problems may be even larger in some other East Asian economies.

Chart 12: Non-performing loans (including AMCs[a])



Source: ARIC, Philippines Central Bank, IMF

(a) Asset management corporations set up to manage the work-out and disposal of non-performing loans.

Conclusions

Fiscal challenges for other economies

Most of the economies surveyed in the article face important medium-to-long term fiscal challenges, although the nature and size of the challenges varies. Addressing these challenges may require not only fiscal consolidation *per se*, but also structural reforms to increase productivity growth, reduce structural unemployment, promote labour force participation and private provision for retirement, and improve the efficiency of government spending programmes.

The greatest and most pressing challenges arise in ***Japan***. Japanese policy makers face a particularly difficult combination of high and rising government debt, a rapidly ageing population and large unresolved problems in the financial sector. Critically, this is occurring against the background of a decade-long economic stagnation that shows no clear sign of ending. Dealing with the fiscal challenges will be exceedingly difficult unless Japan is able to address its structural economic problems and restart vigorous economic growth.

Many ***European economies*** also face testing longer-term fiscal challenges from future population ageing. Italy already has very high net government debt of over 90 per cent of GDP. Others, such as Germany and France, have more moderate net debt levels (just over 40 per cent of GDP), but made little progress in reducing debt ratios during the last expansion and still have significant structural deficits. Europe's challenge is also made more difficult by structural inefficiencies that limit its future growth potential.

The ***United States*** is in a better position than most of the other major advanced economies, although its net debt ratio is also above 40 per cent. Prospective population ageing is more moderate than in Japan and Europe. The US made more fiscal progress during the 1990s, and its more efficient economy gives it more scope to grow its way out of problems.

That said, there has been a large ongoing structural loosening of US fiscal policy over the past year. Some factors that assisted fiscal consolidation in the 1990s, such as the equity price boom and falling defence spending, are unlikely to be present in the coming decade. A key challenge for the US in these circumstances will be to maintain a political consensus in favour of fiscal discipline, and avoid a repetition of the fiscal problems that developed in the 1980s.

Emerging East Asian economies also face a medium-term fiscal consolidation task to address the deterioration in their fiscal positions over the past five years. Government debt burdens may be further increased by future costs associated with unresolved financial sector problems. The size of the task varies across the region, with less advanced economies such as Indonesia and the Philippines facing the biggest challenges.

Longer-term demographic pressures appear to be less of a challenge for most of these economies, although demands for age-related government spending may rise over time as they further develop. Emerging East Asia has a credible fiscal record and most economies have high potential growth rates, supported by the prospect of continuing growth in their working age populations. If policies conducive to stable growth are pursued then the challenge should be manageable.

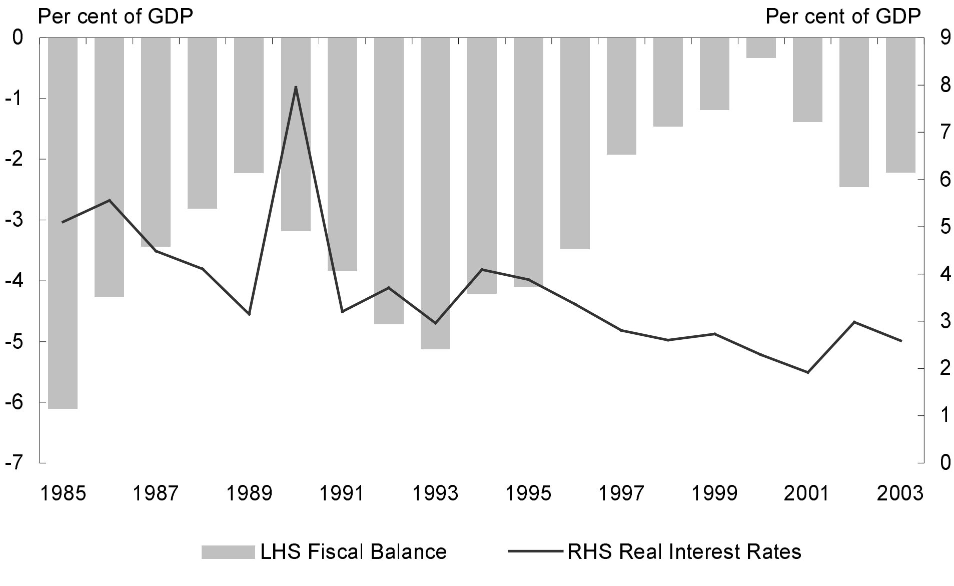
Potential implications for Australia

The consequential risk for Australia is that world economic growth will be adversely affected if there is a substantial worldwide increase in government debt ratios over time. Fiscal easing during the recent economic downturns may have helped support growth in our trading partners, but failure to consolidate as the cycle picks up would adversely affect growth in the medium-to-long term.

Rising government debt ratios would likely mean higher real interest rates. Recent Treasury research (see separate article in this edition of the Roundup) indicates that the Australia-US real interest rate differential is positively related to both the level of government debt in Australia and the budget balance. Risk premiums would increase for those countries with greater debt accumulation, but world interest rates would also tend to rise, barring an offsetting increase in private saving. External growth may also be affected by spending pressures putting upward pressure on tax burdens. High debt ratios could also limit scope to continue to use fiscal policy to moderate economic downturns. Unsustainable debt levels may ultimately help trigger an economic crisis if investors lose confidence in a country's ability to service its debt.

In a highly integrated global financial market, fiscal pressures on global interest rates would ultimately affect Australian interest rates, even if our risk premium remains low. In contrast, fiscal consolidation in most advanced economies has been among the factors putting downward pressure on world interest rates over the past decade (see Chart 13).

Chart 13: G7 fiscal balances and real interest rates(a)



Source: OECD Economic Outlook 71.
(a) GDP(PPP)-weighted average of 10 year bond yields deflated by CPI.

Australia's international linkages mean that it cannot entirely escape being affected if fiscal problems emerge in the rest of the world. Nonetheless, it will enhance its relative growth prospects and attractiveness to international investors if it is better able than other economies to limit government debt and spending growth. This would help maintain a low risk premium on interest rates and a competitive tax burden.

Given the potential for adverse impacts on Australia, it is in our interests to participate in constructive dialogue on medium-to-long term fiscal issues in the regional and multilateral forums to which we belong. Irrespective of what other countries do, Australia's best response is to maintain a sound fiscal position itself. As noted in the recent *Intergenerational Report*, the fact that Australia currently has very low government debt, and faces relatively moderate long-term fiscal pressure compared with other OECD countries, indicates that it is well placed to achieve this. Nevertheless, the fiscal pressures projected in the Report are significant, and early action to address these pressures will be important.