# INAF

## It's Not Always Fiscal

**Ugo Panizza**
**UNCTAD**

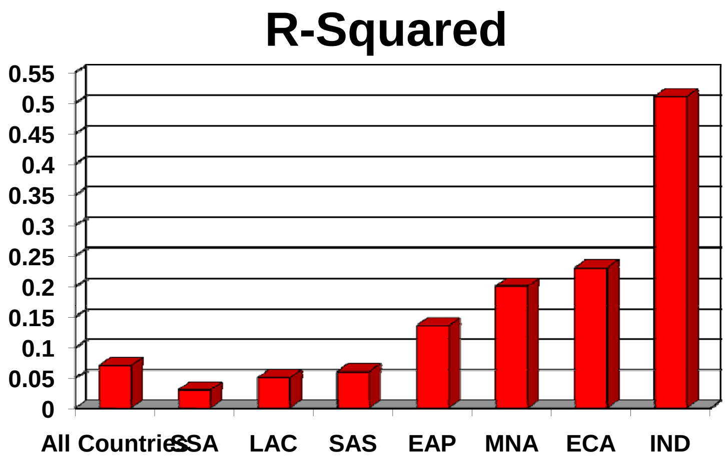
These are my own views

## How Debt Grows?

- The economics 101 debt accumulation equation states that:
  - ***CHANGE IN DEBT = DEFICIT***
- Practitioners use:
  - ***CHANGE IN DEBT = DEFICIT+SF***
  - ***SF***=Stock-flow reconciliation, or the <u>unexplained part</u> of public debt
- The stock-flow reconciliation is often considered a residual entity of small importance
- Is it?

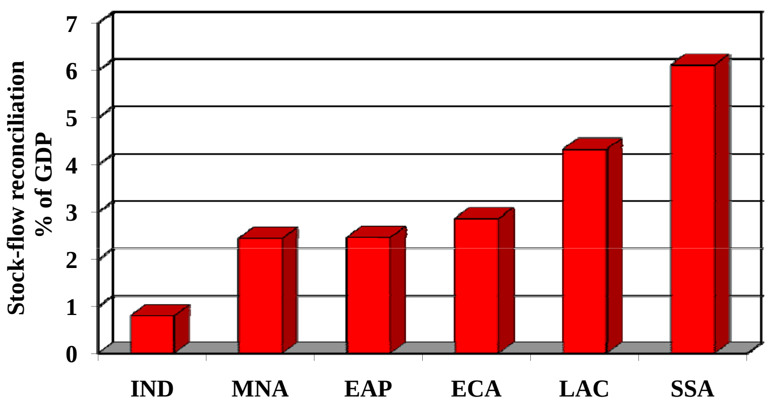
## If we estimate: $\Delta D_{i,t} = \alpha_i + \beta d_{i,t} + \varepsilon_{i,t}$

We expect: $\beta$ and **$R^2$** to be close to 1 and **$\alpha$ = 0**




Source: Campos, Jaimovich and Panizza (2006)

## The Unexplained Part of Public Debt



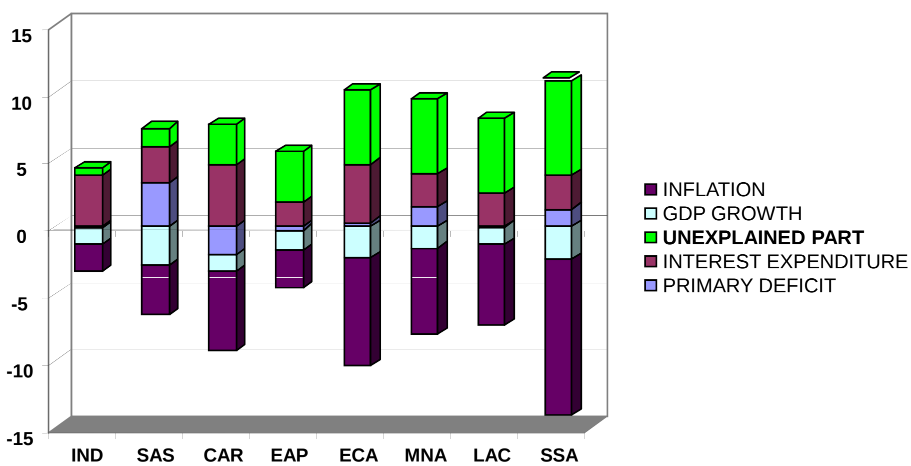

Source: Campos, Jaimovich and Panizza (2006)

# The Unexplained Part of Public Debt

- The growth rate of the debt-to-GDP ratio is equal to:
  - Primary deficit/GDP + interest payments/GDP+ – GDP growth – inflation
    - The last two variables are multiplied by the debt-to-GDP ratio
- If you like math:

$$\Delta\left(\frac{D}{Y}\right)=\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+i\frac{D_{t-1}}{Y_t}-(g+\pi)\frac{D_{t-1}}{Y_t}+\frac{SF_t}{Y_t}$$

# The Unexplained Part of Public Debt




Source: Campos, Jaimovich and Panizza (2006)

## The Unexplained Part of Public Debt

- What explains the "Unexplained" part of debt
  - Skeletons
    - Fiscal policy matters!
    - Transparent fiscal accounts are important
  - Banking Crises
  - Balance Sheet Effects due to debt composition

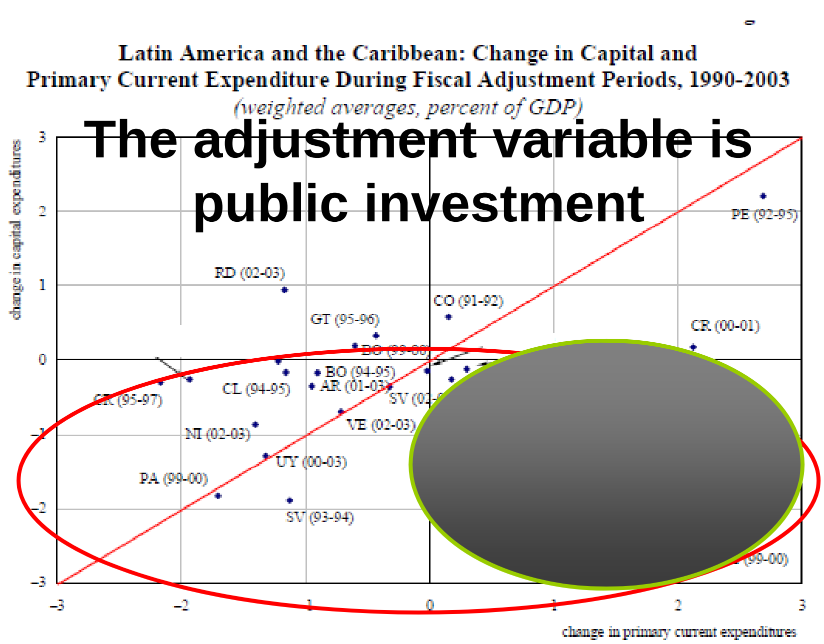
## The Unexplained Part of Public Debt

- There are also things that we can explain but may not have anything to do with fiscal policy
  - Output collapses
  - Sudden jumps in borrowing costs
  - Natural disasters

# Why am I talking about this stuff?

- Because the instinctive response to a debt crisis is (almost) always: we need a fiscal adjustment
- This does not make much sense if the debt crisis is not
- In fac
- Not o e long-run:
  - Rec oss (Cerra and
  - The ent (Ea nd Tromben, 200

# The adjustment variable is public investment




Source: Martner and Tromben (2005)

## …and this is very bad for growth, and for the fiscal adjustment

*When growth-promoting spending is cut so much that the present value of future government revenues falls by more than the immediate improvement in the cash deficit, fiscal adjustment* ***becomes like walking up the down escalator.***

(Easterly, Irwin, Serven, 2008)

## What can the multilaterals do?

- Prevent debt explosions:
  - Policy advice aimed at promoting responsible borrowing
    - Strengthen fiscal institutions
  - Policy advice aimed at avoiding disasters in the banking sector
    - It is mostly about preventing lending booms (Borio, Reinhart, Rogoff)
  - Promote the use of contingent debt instruments
    - Also in your own lending
    - For LICs, forget DSF and move to ex-post grants
    - ALM

## What can the multilaterals do?

- After debt explosions:
  - – **Don’t** ask for fiscal contractions if fiscal profligacy was not the problem
    - If a fiscal contractions is needed, don’t frontload it (Blanchard and Cottarelli, 2010)

## What can the multilaterals do?

- After debt explosions:
  - – **Don’t** lend at punitive interest rates
    - Bagehot was right for banking crises, but he might be wrong for sovereign debt crises
      - – Moral hazard is often overstated (Meltzer *versus* Krugman)

## What can the multilaterals do?

- After debt explosions:
  - Think about fiscal targets that protect investment (Blanchard and Giavazzi, 2004, Buiter, 198?)
    - Also think about the quality of public investment (Pritchett, 2000, Dabla-Norris et al., 2011,)

## What can the multilaterals do?

- After debt explosions:
  - Should the MDBs abandon budget support and do more project financing?
  - Are PPP projects a good idea?
    - They look fishy to me, but they transform easy-to-divert investment expenditure into hard-to-change current expenditure

# INAF

## It's Not Always Fiscal

**Ugo Panizza**
**UNCTAD**

These are my own views