Social Protection
& Public Finance Management

Course on social protection and PFM

Session 7- Macroeconomic policies and debt

This project is funded by the European Union

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The process of policy development

Process

1. Inventory of existing social protection schemes and data
2. Identifying and estimating coverage gaps
3. Costing analysis and projections of financing needs
4. Conducting fiscal space analysis
5. Poverty impact assessment
6. Policy recommendations

How to

- Social dialogue
- Capacity building

Tools

- ABND/SPOTT
- SSI (Social Security Inquiry)
- RAP costing tool
- ILO/HEALTH
- ILO/PENSIONS
- Handbook on fiscal space
- Poverty impact assessment tool

Expected results

- Create confidence and support a national consensus through social dialogue.
- Shared understanding of the national SP system configuration at the country level
- Policy options and costs of extending social protection coverage
- Policy and Financing gaps identification
- Quantification and feasibility analysis of different options to create fiscal space
- Measure impact on poverty ~~linked to~~ of different SP policies
- Strategies for extending social protection (informal sector, women, rural, specific populations)

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Eight financing options that countries should analyse and discuss in national dialogues:

1. Expansion of coverage of social security and contributory revenue;
2. Increase of tax revenue;
3. Elimination illicit financial flows;
4. Increase efficiency of public expenditure and reallocation to social protection prioritary areas;
5. Use of exceding fiscal and foreign exchange reserves;
6. **Debt or restructuration of debt;**
7. **Adoption of a more flexible macroeconomic frame;**
8. Increase of ODA and other forms of foreign aid.

[Fiscal space for social protection. A handbook for assessing financing options]

What is debt? Assets and liabilities

The key definition is net asset position: the remainder when government-owned assets are added up and then government liabilities are substracted.

Revenues and expenditures are, fundamentally, changes in the net asset position.

The example of privatization accounting may help clarify:

A country has a State Owned Enterprise valued at 5pc of GDP. It has debt of 55pc of GDP. It then privatizes the SOE and uses the money received to reduce its debt to 50pc of GDP. Is this revenue? No. If we assume the country has assets valued at 80pc of GDP, its initial net asset position was 80-55=25pc of GDP. After privatization of the SOE, the new asset position is simply 75-50=25pc of GDP. Hence, there were no revenues (or expenditures, for that matter).

You may have the reasonable question: if privatization is not booked as revenue, why is it a frequent policy prescription? If a country has to pay very high interest rates on its liabilities and receives low returns on its assets, reducing liabilities through asset sales may yield an improvement in the fiscal deficit.

Debt service: cash flow issues

Debt service is worrisome in two aspects, the most obvious one is that a country was loaned the principal but has to repay both the principal and the interest.

It would be infeasible for countries to find the resources to repay the debt in full each time, so typically what is done is a debt «roll-over». Many lenders do not desire to recover the principal at the maturity date, so they find it convenient to lend again the same principal amount and continue receiving interest payments.

This is true if the ability to repay of the country remains credible. When a country loses credibility, then the maturities of large amounts of debt become very concerning.

It is common for a single large debt emission maturity to be 0.5pc of GDP or more, and the cumulative yearly debt service to exceed 10pc of GDP. If there are repayment concerns, then the Ministry of Finance or Treasury has to be able to collect this amount in cash to allay the concerns of creditors.

Debt service: cash flow issues

As debt service includes principal it can become very large relative to national income. Even if interest payments are not high, a debt structure that is frontloaded in the short-term can create roll-over issues, but it is not easy for developing countries to persuade investors to buy longer term maturities.

Debt stock worries tend to be overstated and self-fulfilling prophecies

Most clear example, the 2010 Reinhart-Rogoff paper that had critical errors and was used as a basis for justifying austerity measures, starting from 60% of debt to GDP ratios and especially after 90% of debt to GDP ratios.

As Paul Krugman wrote in 2013:

«What the Reinhart-Rogoff affair shows is the extent to which austerity has been sold on false pretenses. For three years, the turn to austerity has been presented not as a choice but as a necessity. Economic research, austerity advocates insisted, showed that terrible things happen once debt exceeds 90 percent of G.D.P. But "economic research" showed no such thing; a couple of economists made that assertion, while many others disagreed. Policy makers abandoned the unemployed and turned to austerity because they wanted to, not because they had to»

The role of Credit Rating Agencies

Credit Rating Agencies or CRAs, are critical players in the debt market, especially for large institutional investors such as banks and pension funds that are heavily regulated. In the past, investment regulations often «hardwired» the need for CRA ratings as a criteria for making an investment.

For example, many pension funds are not allowed to invest below a certain rating. If a country is downgraded below this threshold rating, investors stop buying its debt, and its interest rates can increase significantly (e.g. go from 5.5% to 7%).

CRAs have a difficult job: sovereign defaults are not frequent, so even if CRAs are very knowledgeable about the country's fiscal situation, estimating the likelihood of a default is not straighforward and biases in rules of thumb can acquire outsize importance. This is why the Reinhart-Rogoff error was so important.

CRAs also make it much harder to even discuss the need to restructure or renegotiate debt since this may trigger downgrades.

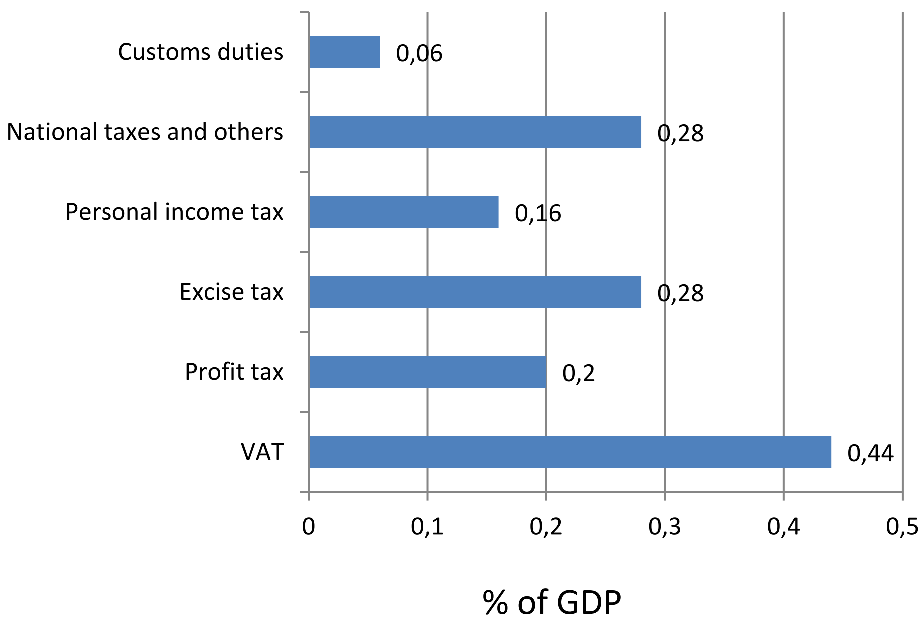
Can something be done about debt?

- Better management can make surprisingly large impact. Consider a country with 50% of debt to GDP that changes its debt management to make it more liquid and attractive to investors, reducing its average interest rate by a percentage point from 7% to 6%. This, over time, yields 0.5pc of GDP in additional fiscal space.
- Some countries have very low debt, e.g. below 30% of GDP. In most cases, these country could have higher debt loads to invest more on their people and improve future economic outcomes, besides the immediate benefits to the population.
- Creditor co-responsibility and odious debt discussions could be more prominent in international discussions.
- Role of financial regulations and credit rating agencies is currently under review.

The Albania example

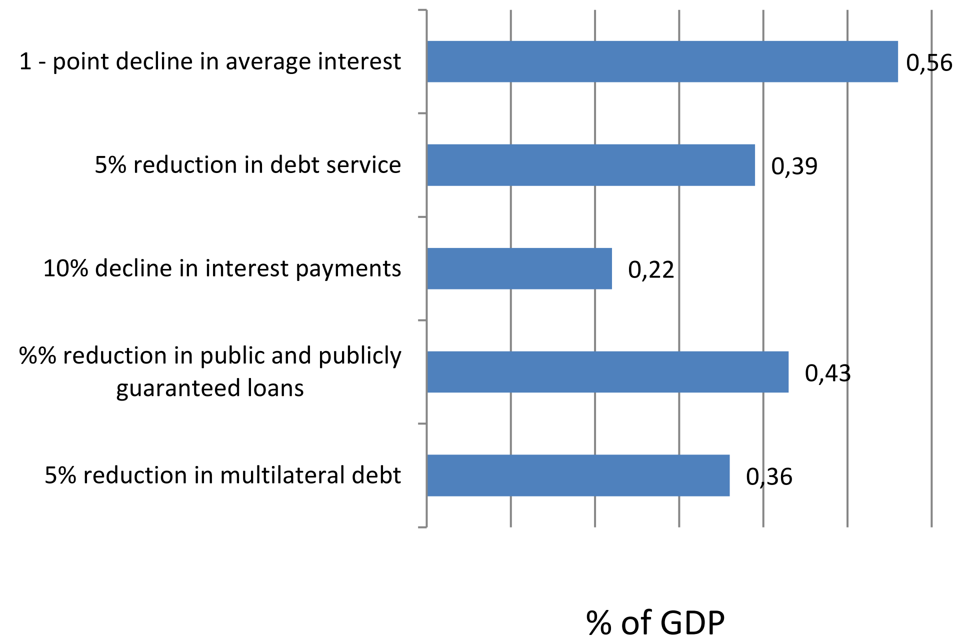
Taxation

Estimated additional resources from increasing tax rates by 1 percentage point



Debt restructuring

Estimated additional resources from debt related policy targets



Macroeconomic policies: standard theory

Since Keynes (1936), the analysis of macroeconomic policies revolves around the concept of potential output, a level of production at which all economic factors are fully employed in productive uses (labor, capital, land).

Keynes' main concern was to explain the need to use countercyclical macro policies whenever output fell below the potential and resources were underused (e.g. labor unemployment), mainly through more government expenditure to compensate reduced private consumption in aggregate demand.

On the other hand, this model suggests the reduction of government expenditures or a more stringent monetary policy (higher interest rates) if effective output exceeds potential output and prices are increasing (inflationary pressures).

Macroeconomic policies in high-debt context

Applying the keynesian recipe is harder in high-debt context for several reasons:

1. Most obviously, high debt stock levels mean high debt service expenditures and this restricts the non-debt government expenditure space. In other words, if the macro situation calls for higher government expenditures and deficit spending, this is more difficult if the government already has high deficits.
2. In a high debt context, central banks may suffer from fiscal dominance and their ability to control inflation and set interest rates is constrained by the needs of financing the government or financially repress creditors (if possible).
3. High debt may affect inflation expectations and this changes the effects of a given set of policies. For example, if a Central Bank is aiming for 3% inflation, when inflation expectations are 3%, the CB policies are neutral, but if high debt raises inflation expectations to 5%, then the CB policies are now contractionary.

Macroeconomic policies: IFI mandates

The IMF's mandate. "The IMF promotes monetary cooperation and provides policy advice and capacity development support to preserve global macroeconomic and financial stability and help countries build and maintain strong economies. The IMF also provides short- and medium-term loans and helps countries design policy programs to solve balance of payments problems when sufficient financing cannot be obtained to meet net international payments obligations."

Macroeconomic policies: the typical rigidities

In fiscal policy, most common rigidity is having some static fiscal deficit rule (law or norm-based) that can imply current expenditure restrictions even if they would be good for growth.

In monetary policy, a common rigidity is having some inflation rule, where the Central Bank raises interest rates as soon as inflation exceeds a threshold, with very little regard to output and employment effects.

Hence, concrete measures to increase fiscal space through more acommodating macroeconomic policies will be concentrated in:

1. Increasing the overall level of expenditures if it is unusually low for the country development level and regional comparable economies.
2. If fiscal deficits are constrained by legal rules or are low relative to historical standards, the country may free up fiscal space by allowing a higher fiscal deficit.
3. If inflation is very low, e.g. 1-2% per year for a long time, it may be a sign that monetary policies are contractionary and could be eased to attain higher levels of growth.

Economic Growth and Debt, the “r vs g” debate

When discussing debt payments, the nominal interest rate is often described with an «i». However, we are concerned about the cost of paying debt in real production and assets, so typically this is adjusted by inflation to obtain the real interest rate «r».

GDP growth per year is often denominated by the letter «g».

If we are worried about the Debt to GDP ratio, this ratio will grow in two ways: whenever the debt stock is increasing due to fiscal deficits and whenever r is larger than g, because debt service is growing faster than GDP. One of the easiest ways to reduce Debt-to-GDP, then, is the reverse: if GDP grows faster than r, then eventually the debt will disappear.

Indeed, the Reinhart-Rogoff argument can be reversed: it is not only that high debt causes slow growth, it is as likely that slow growth can change high debt. Therefore a more accommodating macro policy that encourages higher growth can also reduce the debt-to-gdp ratio.

$$\frac{Debt}{\uparrow GDP} = \text{Debt to GDP ratio}\downarrow$$

The limits of partial initiatives such as DSSI

The Debt Service Suspension Initiative (DSSI) was a good initiative, but it has its limits. It does not forgive debt stock, so it has no long-term reduction. In theory, a country that was enabled to delay official debt payments, may concentrate its resources in paying private creditors and recovering from the COVID shock, but, as in the World Bank reading,

“In some countries, the authorities see modest benefits of DSSI owing to the composition of their debt (they have no or limited exposure to official bilateral creditors). Some countries have indicated concerns that application for DSSI participation might send a negative signal about their creditworthiness.”

The lesson is that there are no good substitutes for developing credibility and institution building. Unless they find a way to self-finance, policymakers have to convince creditors that their policies and priorities will enable the country to have sufficient capacity to repay. Unfortunately, creditors and regulations have biases that may discourage the financing of important policies such as Social Protection and this must be counteracted by evidence-based advocacy and, eventually, by improvements in the financial regulations themselves.

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Thank you

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