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Public Debt and Fiscal Consolidation

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Introduction

The recent global financial crisis necessitated the prompt and coordinated actions of monetary and fiscal institutions across countries to prevent the global economy from plunging into a wide-scale depression. Loose monetary policy became necessary to encourage economic activities. This was complemented by accommodative fiscal policies, implemented through various fiscal stimulus measures, to offset the slack in private sector demand. The crisis has reduced productive capacity and therefore tax revenues, and at the same time has caused government spending (and, as a consequence, government borrowings) to rise to record levels following the implementation of fiscal stimulus measures. This has raised concerns about the debt sustainability of countries, particularly those mired in soaring sovereign borrowings. Hence, several Eurozone governments, starting with Greece, experienced funding turmoil when investors doubted its repayment capability and demanded higher returns for lending money. The turmoil spread over to other members of the Eurozone such as in Ireland and Portugal. The European sovereign debt problem prompted the provision of official financial assistance to the affected countries from the IMF, European Commission and European central banks.

Meanwhile, emerging market economies (EMEs) recovered faster from the global financial crisis relative to developed countries, which enabled them to start the normalization process early. Liquidity-enhancing measures implemented during the crisis were unwound and policy rates were adjusted gradually in some EMEs to counter emerging inflationary pressures.

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A Closer Look at Public Debts

How are Public Debts Incurred

Public debts are incurred to finance the activities of the public sector either through the revenue streams generated from taxation, or through borrowing in the financial market. In the latter this could be through term loan facilities whereby a public institution borrows from financial institutions directly. The government could also borrow directly from the private sector through its regular auctions of government securities, or through issuance of other sovereign debt papers.

Public debts could be affected by economic variables. For example, inflation could reduce the value of debts as the government will have to repay the borrowed amount rather inexpensively when inflation increases, all else remaining equal. Likewise, monetary policy has a vital impact on public debts through the interest rate channel. When central banks decide to raise interest rates, the cost of debt offering will correspondingly increase. Expectations about interest rates also affect market valuation of existing public debts that, like other financial assets, are bought and sold in the financial market.

Classification of Public Debts

The public sector issues several types of debts as follows:

1. Type of public sector debt issuances. The national government (NG) issues debts to finance a portion of its operations, apart from revenues raised from tax collection. Local government units also have the power to borrow, as well as government-owned-and-controlled corporations and government financial institutions. The NG may opt to explicitly guarantee their

borrowings. Taken together, public sector debts are accounted in the consolidated public sector fiscal position (CPSFP), which refers to the net deficit or surplus calculated after summing-up the budget balances of all government entities.[2]

2. Maturity structure. Public sector entities could decide to borrow either short- or long-term, consistent with their borrowing guidelines and debt management thrust. The NG typically conducts its short-term borrowings through the issuance of Treasury bills (T-bills) that carry maturities of three months to one year. Long-term borrowings are financed by issuing longer-dated Treasury bonds, foreign-currency sovereign debt issuances and such other debentures.

3. Currency composition. Public sector debts can be contracted in local currency or in foreign currencies (which are collectively known as ROPs in market parlance).

4. Securitized public sector debts. The public sector may also securitize its future cash flow streams to finance current expenditures. For example, the government may issue "revenue bonds," which will be financed by revenues collected from specific user fees, such as highway tolls.[3]

Rationale of Public Borrowings

A successful fiscal adjustment is usually defined as the ability of a fiscal policy tightening today to achieve a lasting public debt reduction in the future.[4] Public debt arises when the expenditures of the public sector exceeds the revenues it generates. Public debt, per se, is not undesirable so long as the proceeds generated from this undertaking are used to spur economic development. One of the reasons for the existence of government is to provide public goods and services that offer little profit incentives but have significant social returns. The government will rely on its revenues – which are principally derived through taxation – to fund these socially responsive activities. The government's revenue streams from taxation and its activities may not coincide, and this mismatch may be financed by borrowing first in the financial market and then paying when the tax revenues collected are enough to cover the debts.

Aside from the apparent time mismatch between government revenues and expenditures, the government may likewise resort to borrowing to finance relatively expensive but socially responsive programs which are essential to enhance the productive capacity of the country. For example, the government may opt to finance infrastructure projects such as the construction of farm-to-market roads to assist the farmers in efficiently transporting their products to their intended destination. Alternatively, it could embark on constructing public schools and health centers that could lift the human capital resources of the country.

The government also borrows to spur economic activities, particularly when the private sector activities are constrained by weak economic conditions. For example, the external shocks emanating from the recent global financial crisis necessitated the government to implement stimulus measures to counteract the slack in private sector activities.

There are instances that the government borrows not because it needs financing but to set benchmarks for borrowings undertaken by the private sector. In this case, the government's objective is more of local capital market deepening rather than financial affairs.

Borrowings by the public sector should likewise be managed by taking into consideration the overall fiscal position and thrust of the government. In instances when the proceeds from government borrowings are spent recklessly, government debts cease to contribute to economic development. In

[2] Government entities include the national government, the non-financial government corporations (usually includes only the 14 major GOCCs), government financial institutions, local government units, the social security institutions, the Oil Price Stabilization Fund, the Bangko Sentral ng Pilipinas, and the Central Bank-Board of Liquidators.
[3] Seater, John J., "Government Debts and Deficits, " The Concise Encyclopedia of Economics, http://www.econlib.org/library/Enc/GovernmentDebtandDeficits.html
[4] Toglhofer and Zagler, "The Impact of Different Fiscal Policy Regimes on Public Debt Dynamics," 2008

addition, excessive debts could fracture the macroeconomy. They could fan inflationary pressures (through higher government spending), leading to rising interest rates and lower investment, as investors will lose confidence in the government's ability to finance its borrowing spree. In this case, public debts become anti-developmental.

Public Debts and the Macroeconomy

Economists' views are divided on the impact of public debts on the macroeconomy. Proponents of the Ricardian equivalence argues that increased government borrowing may have no impact on consumer spending because consumers, by being rational, will expect tax cuts or higher spending that will lead to future tax increases to pay back the resulting increase in debts.[5] For example, in the first year, an economy chose to finance its expenditures of, say, ₱100 billion (assumed constant) through taxation. However, in the second year, it opted to finance the ₱100 billion expenditure by reducing taxation to ₱90 billion and issuing a ₱10 billion one-year T-bills (to compensate for the reduced taxation). The Ricardian equivalence posits that consumers will be indifferent to a tax cut as this will be temporary and will be offset by higher taxes to counter the increased expenditure requirements resulting from T-bills maturing in one year.

However, there are arguments against the Ricardian equivalence as follows:

1. Consumers may not be as rational as initially thought. Some consumers may not anticipate that tax cuts will lead to tax hikes in the future. Thus, tax rebates are usually included in fiscal stimulus packages during an economic downturn.

2. Tax cuts can boost growth and diminish borrowing requirements. Tax revenues fall in periods of slower economic growth, while government spending may increase through providing heightened social services such as higher spending on unemployment benefits. Some argue that decreasing taxes in periods of soft economic activity could encourage spending and heighten economic activity, which could improve the fiscal position and reduce the need for future borrowings to offset the tax cuts.

3. Public debts could pump-prime the economy without crowding-out the private sector. During periods of weaker economic activity and uncertain conditions, the private sector may choose to remain in the sidelines. The government's task, therefore, is to stimulate aggregate demand by spurring economic activity.

4. Pump priming activity could generate multiplier effect. The increase in output associated with pump-priming activity of the government could be higher relative to government spending.

Public Debt Sustainability

Public borrowings – like any other debt – carry costs, particularly the interest expense of the funds borrowed. The debt servicing burden – i.e., principal plus interest, which are spread throughout the life of the debt – could comprise a significant chunk of the annual government budget. Debt management should, therefore, ensure that public debt programs are not bunched-up (by spreading the maturity profile to avoid illiquidity) nor excessive (by possibly setting a debt ceiling to avoid insolvency). When countries are unable to service their debt obligations, a credit event or default occurs. Countries rarely default on domestic currency debt since they have the option of printing more money.

Countries facing a liquidity shortage may need assistance from multilateral institutions to counter the temporary liquidity squeeze. Meanwhile, highly indebted countries may need to implement strong, credible, and arguably unpopular fiscal consolidation.

Multilateral institutions, such as the IMF, as well as credit rating agencies and private sector institutions, do regard the fiscal sector, in general, and public debt conditions, in particular, as important indicators in gauging the country's economic and political situation.

[5] Economics.Help, "Ricardian Equivalence," http://www.economicshelp.org/blog/economics/ricardian-equivalence/

Metrics are often employed to determine the country's debt sustainability in terms of its liquidity and solvency positions with respect to its public sector debt accumulation.

Foncerrada (2005) reiterated the IMF and World Bank's stance that debt sustainability should be assessed on the basis of indicators of the debt stock or debt service relative to various measures of repayment capacity.[6] The most commonly used is public debt-to-GDP ratio to measure the financial leverage of an economy. Other indicators include ratios of foreign debt-to-exports or international reserves, public debt to revenue and revenue to GDP.

Another set of indicators focuses on the country's ability to service its short-term obligations, and are used to gauge the country's liquidity conditions. These include ratios such as debt service to GDP, foreign debt service to exports and government debt service to current fiscal revenue. Other indicators are also being used to determine how the debt burden ratios would change in the absence of repayments or new disbursements (e.g., by getting the average interest rate on outstanding debt scaled to the growth rate of nominal GDP).[7]

Debt sustainability is a major issue, particularly for countries facing higher public debts, such as what most advanced economies are currently experiencing. These countries are vulnerable to rollover risks as maturing debt obligations could become more expensive to refinance considering that investors will demand significant premium to compensate for the greater risks that they will be assuming. The punitive action of the market through higher borrowing costs will make it more difficult for these countries to service their obligations, creating a vicious cycle of debt trap. This could be aggravated when governments planning to undertake unpopular measures that will increase revenues and/or reduce public expenditures face political backlash that render them not politically feasible.

For advanced economies where monetary authorities embarked on massive bond buying programs to help prop up the domestic economy, the management of sovereign debts could affect monetary and financial stability. They could also undermine a central bank's credibility as large-scale buying activities of government bonds could be perceived as providing support for the government's financing needs, which could give rise to the risk of perceived threat to its independence.

Fiscal Consolidation

Fiscal Consolidation in Advanced Economies

Alberto Alesina and Roberto Perotti (1995) find that, among other things, consolidation policies are most successful when they entail a reduction of government expenditures.[8] There are two possible reasons for this. First, spending-based consolidations are usually more persistent, as they are often combined with structural reforms. Second, spending cuts tend to be less damaging for growth than tax increases mainly because spending-based adjustments are typically accompanied by monetary easing while tax-based ones often see monetary tightening. Goldman Sachs (2011) further argued that in the US, with the Fed funds rate close to zero, both spending and tax-based consolidations are likely to hinder economic growth. Nonetheless, spending-based adjustments might still be preferable, particularly if properly enforced. Thus, the best that the US Federal Reserve Bank can do is to keep monetary policy on hold to cushion the growth drag from fiscal consolidation—independently of whether it comes through adjustments in spending, revenue-generation or both.[9] It may be noted that the US needs a very large fiscal consolidation, with Goldman Sachs projecting a primary (ex-interest) deficit of 7.7 percent of GDP for 2011. Failure by US policy makers to reach consensus on medium-term fiscal consolidation might lead to a disorderly USD decline and loss of confidence amongst

[6] Foncerrada, Luis, "Public debt sustainability. Notes on debt sustainability, development of a domestic government securities market and financial risks," 2005

[7] Wikipedia, http://en.wikipedia.org/wiki/External_debt

[8] Toglhofer and Zagler, "The Impact of Different Fiscal Policy Regimes on Public Debt Dynamics," 2008

[9] Goldman Sachs, "Fiscal Adjustment without Fed Easing: A Tall Order," 14 May 2011

holders of US Treasuries.[10] Thus, on 5 August 2011, Standard and Poor's decided to cut the long-term sovereign rating of the US to AA+ (with negative outlook), the first time a credit rating agency has done so.

The Eurozone faces a similar pressing need for fiscal consolidation, given the lingering European sovereign debt turmoil. Some have speculated that it is just a matter of time before Greece will default on its existing obligations. Sovereign debt woes have spilled over across Eurozone countries, threatening to engulf bigger countries like Spain and Italy. This prompted the European Central Bank to reverse the sell-off of Spanish and Italian bonds.The Eurozone episode highlights not only the dark side of borrowing beyond one's means but also the limited policy toolkit of countries to address elevated fiscal imbalances under a unified monetary system. Given these concerns, the European Union summit recently agreed to strengthen further the fiscal framework for the Eurozone. The amendments to the existing rules and regulations focused on: (1) economic governance, which is meant to prevent any country ever again from coming close to a fiscally unsustainable position; and (2) new crisis mechanism, which comes into play once a country faces imminent funding problems.[11] While these initiatives aim to enforce closer fiscal policy coordination, they do not fully address the issue of solvency that has arisen as a consequence of the debt crisis. The European Financial Stabilization Facility (EFSF), established in May 2010 with guarantee commitments of EUR440 billion aims to preserve the financial stability of Europe's monetary union by providing temporary financial assistance to euro area member states in difficulty.[12] It became fully operational on 4 August 2010 and to date has issued three bonds to fund loans to Ireland and Portugal. Since it was originally set up, the EFSF has been amended twice to extend its scope and expand its size. While the amendments have been agreed, they remain to be ratified by the national procedures of the euro area member states.[13] However, these reform measures, together with the stricter enforcement of the debt rules, could reduce solvency risk but will not eliminate it.[14]

These fiscal policy constraints among advanced economies have become a major concern among investors. Implementing fiscal consolidation could lead to negative shocks that could shake, if not wipe out, the modest economic gains achieved so far. Pacific Investment Management Co. (PIMCO) argued that sovereign creditworthiness will continue to diverge, with the deterioration in advanced countries contrasting with the continued improvement in the emerging world. This scenario could foster heightened financial repression and higher inflation.[15]

Fiscal Consolidation in EMEs

EMEs have emerged from the recent global financial crisis relatively less scathed than advanced economies. In fact, bright economic growth prospects and favorable interest rate differentials have encouraged heightened capital inflows. These, together with rising international commodity and food prices, have raised concerns about the buildup of inflationary pressures, which could lead to a tighter fiscal policy stance.

Fiscal Consolidation in the Philippines

In the Philippines, the current administration has made fiscal sustainability the cornerstone of its governance agenda. Efforts are being undertaken by the government to improve tax collection. It may be noted that the national government's (NG) revenue collection scaled to GDP has been stable, rising by 14.2 percent in 2010, which is slightly lower than the previous year's 14.6 percent growth. The tax effort (tax collection to GDP ratio) was unchanged at 12.8 percent in 2010 and 2009, but comparably lower than the ratio in 2008 of 14.2 percent. It is in this light that the

[10] HSBC, "Asia's Bond Market," May 2011
[11] Goldman Sachs, "A More Stable Eurozone after the Comprehensive Package," 8 April 2011
[12] A new permanent crisis mechanism, the European Stability Mechanism (ESM), will be set up in the euro area as of mid-2013 following the expiry of the existing EFSF. The ESM will complement the new framework for reinforced economic surveillance in the EU. This new framework, which includes in particular a stronger focus on debt sustainability and more effective enforcement measures, focuses on prevention and will substantially reduce the probability of a crisis emerging in the future.

[13] Credit Suisse, EFSF (R)evoltion, 16 August 2011
[14] HSBC, European Economics Quarterly, 29 March 2011
[15] http://www.pimco.com/EN/Insights/Pages/Secular-Outlook-Navigating-the-Multi-Speed-World.aspx

government has implemented measures to improve the government's tax collection such as the Run Against the Tax Evaders (RATE), Run After the Smugglers (RATS) and Revenue Integrity Protection Service (RIPS). Moreover, measures to rationalize the government's fiscal incentive programs are underway to minimize their negative impact on the government's revenues.

In addition, the government has embarked on a pro-active debt management strategy which aims to reduce the debt stock and debt service payments and lengthen the maturity profile where feasible through debt swaps and exchanges. Debts with longer duration enable the government to finance urgent programs necessary for economic development such that when these debts mature, the country could easily repay them on the back of the economy's improved capacity.

The stock of NG's total outstanding debt as a percent of GDP has been on a declining trend. The ratio was 55.4 percent in 2010 compared to previous year's 57.3 percent. In April 2011, the NG debt-to-GDP ratio declined further to 51.2 percent against last year's 53.9 percent. The NG targets a debt-to-GDP ratio of 55 percent for this year. The share of foreign-currency denominated obligations has shrunk to 43.8 percent in 2010 against 50.7 percent share in 2010. This was a result of the NG's thrust to borrow in domestic currency to mitigate foreign exchange risk inherent in international borrowing transactions. For example, following the successful launch of the first-ever global peso bonds last September 2010 that raised US$1 billion, the NG issued anew US$1.25 billion of global peso bonds in January 2011.

In an effort to lengthen the government's external debt maturity profile, the government has instituted bond exchange transactions for both its domestic and foreign debt securities. In September 2010, it entered into a US$3-billion debt exchange, which involved the issuance of dollar-denominated global bonds due 2021 or an additional tranche of bonds due 2034 in exchange for existing bonds due 2011, 2013, 2014, 2015, January 2016, October 2016, and 2017. It also offered holders of bonds due January 2019, June 2019, September 2024, October 2024, 2025, 2030, and 2031 the chance to replace their holdings with a fresh tranche of bonds due 2034. For domestic borrowings, the NG has been periodically launching bond exchange programs over the years. In December 2010, the Bureau of the Treasury swapped around ₱200 billion of existing bonds for new 10- and 25-year bonds.

On the expenditure side, disciplined use of public resources resulted in a government expenditure-to-GDP ratio of 7.1 percent in 2010 from double-digit rates recorded in the previous three years. The government expressed its commitment to efficient fiscal expenditure program through the following reforms:[16]

- Zero-based budgeting: across-the-board review of all budgets to cut waste;
- Focused targeting of social programs ensuring that funds are channeled appropriately;
- Advancing the Pay-Go legislation: A law that requires all new expenditure and revenue-eroding legislation to be matched with revenue-increasing measures; and
- Tighter implementation of procurement laws that will allow greater scrutiny of all public procurement to cut waste.

Concluding Remarks

Notwithstanding the varied fiscal conditions across countries, it is paramount that fiscal policy remains relevant and supportive of long-term economic progress. This can be achieved through the efficient management of public sector debts to minimize the medium- and long-term expected costs of funding the government's activities. The dynamics in incurring public debt should include a debt management strategy that will take into account not only the reasons for borrowing but likewise the sustainability of incurring debts. Finer details inherent in debt transactions should be addressed, including issues about diversifying potential creditors,

[16] Philippine Economic Briefing, "Daylight in the Philippines: Accelerating Progress," 23 March 2011

currencies, debt instruments and duration. Accountability and transparency of debt borrowings should be a foremost consideration.

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