COMMENTS ON SESSION 4
THE LEGACY OF THE CRISIS AND THE EXIT STRATEGY

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I was fortunate enough to be asked to comment on three papers with which I have little reasons to disagree. These are very useful papers, and I enjoyed reading them. The downside of this is that I do not have too much to suggest about these papers. So, after commenting on some aspects of these papers, particularly the one on the effect of banking crises on public finances, I will provide some of my views regarding the challenges that countries are facing in terms of exiting the accumulation of public debt related to the crisis.

Comments on the papers "The Consequences of Banking Crises for Public Debt" by Davide Furceri and Aleksandra Zdzienicka, "Cyclical and Structural Components of Corporate Tax Revenues in Japan" by Junji Ueda, Daisuke Ishikawa and Tadashi Tsutsui and "Structural Aspects of the Japanese Budget" by Michio Saito

I will start from a comment on Davide's paper on the consequences of banking crises on public debt.

The paper is convincing in showing that banking crises have major implications for the fiscal accounts and that these implications depend on the specific features of the crises, such as its severity for output loss, the extent of discretionary actions, and, over the medium term, the quality of fiscal institutions. Other factors such as openness, size, degree of developments, are not important. All this is very intuitive, and, if anything, my only complaint is that these results are in a way too intuitive, or pretty obvious. There are some not obvious results, in particular, those relating the cost of the financial crises to the modalities of support – e.g., liquidity support would have a stronger impact than direct recapitalization – but these are the results that the authors themselves regard as to be taken with caution.

However, the paper does not focus on one important aspect, namely the potential interaction between banking crises and the exchange rate. Many banking crises are associated with large swings in exchange rates (for example, the banking crises in Asia in the 1990s, or Turkey in 2001). These exchange rate swings have huge implications for public debt ratios whenever public debt is denominated in foreign exchange. The effect of exchange rate corrections on public debt could be a persistent one if the exchange rate was initially overvalued and, following the crisis, stabilizes at a level closer to that determined by long-term fundamentals. The paper could have taken these factors into account.

Focusing on the recent crisis, what are the implications of the paper for the persistence of the shocks suffered by the fiscal accounts? The key message of Davide's paper is that the persistence of the shocks depends on their nature. Thus, it is important to look at the reasons why the debt-to-GDP ratio is rising as a result of the current crisis. I will focus on the advanced countries because this is where the major fiscal problems are.

The pie chart in Figure 1 breaks down the increase in general government gross debt in the advanced G-20 countries into its various components. Some of them reflect factors that have temporary effects on the deficit, others that have permanent effects on the deficits. But even those

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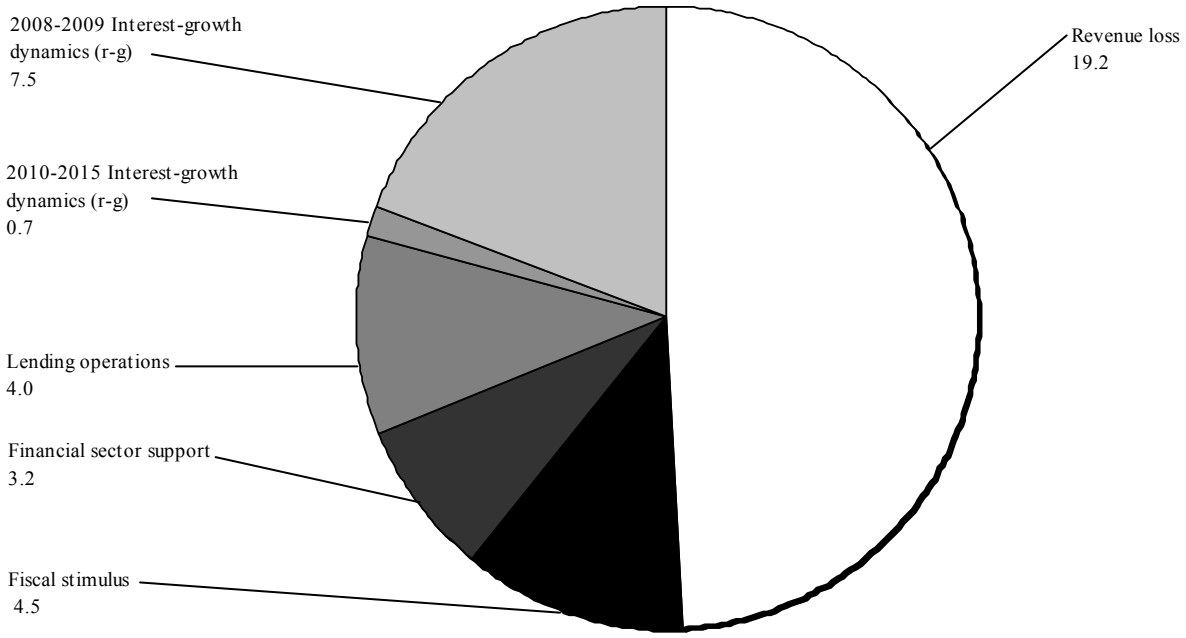
Figure 1

G-20 Advanced Economies: Increase in Public Debt, 2008-15
(total increase: 39.1 percentage points of GDP; 2009 PPP weighted GDP)



Source: IMF staff estimates based on the April 2010 WEO.

that have temporary effects on the deficit have a permanent effect on debt ratios. Let us consider these factors one by one.

Fiscal stimulus: this includes measures undertaken specifically with the goal of alleviating the crisis. The effect is small and is temporary on the deficit (as most of these measures were temporary or easily reversible), but their effect on the stock of debt is permanent unless not only they are allowed to expire but are offset with a (temporary) fiscal tightening.

The effect of the operations in direct support of the financial sector on the debt could, in part, at least, be temporary: assets have been typically accumulated against these operations, and they could be sold over time. Part of the support, however, will result in permanent losses, whose effect is permanent. In any case, this item is rather small, compared with the overall increase in public debt.

About 10 percent in the overall increase in public debt relates to lending operations introduced during the crisis to alleviate the credit crunch that was affecting some nonfinancial sectors (e.g., lending to students by the U.S. government). If these loans are repaid overtime, and new lending is taken over by the private financial sector as the latter recovers, the effect on gross debt will be temporary.

However, the largest item, explaining about half of the increase, reflects the huge revenue losses arising from the crisis, the loss in output (with respect to the pre-crisis potential, as well as lower payments from the financial sector and higher asset prices, to the extent pre-crisis revenues

from these sources were above equilibrium). With respect to these losses, one important element of uncertainty relates to the extent to which the crisis led to a permanent drop in potential output levels. If it did, the flow loss will not be fully recovered. But in any case the stock loss would not be recovered.

Finally, the increase in the debt ratio is also partly due to the direct effect of the decline in the denominator of the ratio (output), or, more precisely, to the extent to which this drop was not affected by a drop in interest rates (it is the differential between interest rates and growth that drives the output-to-GDP ratio). As we are observing the increase in the debt ratio between 2007 and 2015 – a year by when the output gap is expected to be closed – this effect could be expected to be permanent (as it already reflects the recovery of output arising from the closing of the output gap). However, to the extent that the recovery of potential output is currently underestimated in the fiscal projections underlying the figure, the case could be made that GDP in the period ahead could rise faster than projected, which would lead to a lower increase in the debt ratio (or a decline following 2015). Whether this will happen or not – even assuming that the decline in potential output is indeed overestimated – depends on the reaction of interest rates to the higher output growth. If interest rates are also higher, there will not be any benefit in terms of the dynamics of the debt ratio.

Altogether, we can safely conclude that a large part of the shock to public debt is definitely of a permanent nature and will require policy actions to reverse it.