COMMENTS ON SESSION I: ASSESSING PUBLIC LIABILITIES

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Let me start by expressing my profound gratitude to Mr. Daniele Franco and all the staff at Banca d'Italia for inviting me to this Public Debt workshop. I believe that their sincerity and integrity are the very pillars of this workshop, which continues to attract experts in the field of public finance and policymakers from around the world.

Assessing public liabilities is where we must begin. We start by defining the nature of public debt, and how we should measure it, before proceeding to the issues of sustainability and implications for existing policy. But it quickly becomes apparent that assessing public liabilities is not as easy as it seems. Significant differences exist between countries regarding data availability and recognition of public liabilities.

Despite these difficulties, all the papers in this session have produced interesting results based on the unique conditions of each country and region. Though differences obviously exist, two common themes that emerged in the papers focused on debt sustainability and, more broadly, fiscal soundness. Especially worth mentioning is that four out of six papers focused on Latin America, indicating increasing concern on public debt sustainability in that region, where people have started to ask whether warning signs are again cropping up. The other two papers focused on Europe, and some mechanisms related to the improvement of fiscal balance there.

It thus makes sense to divide my comments – one set for Latin America, and the other for Europe.

1. Latin America: fresh warning signs?

Latin American countries have undergone several crises during the period from the mid-Nineties to 2002. Mexico in 1995, Brazil in 1999, and Argentina in 2001 stand out as examples of currency crises that brought about fears of government defaults. Although those events were primarily currency crises, they also forced us to reconsider the sustainability of public liabilities.

One obvious feature of Latin American public debt is that it is often exposed to external risks. Public debt is sometimes denominated in foreign currency or borrowings from abroad. In these cases, public debt sustainability depends on the exchange rate conditions. As Martner and Tromben demonstrated in their paper,

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external factors have sometimes played a large part in the increase of public debt. Assessing public debt, therefore, leads to the issues of exchange rates and policies on capital markets.

Public debt in Latin America seems to be on rise again. As laid out in the paper by James Alexander Daniel *et al.* in this session, the "increase in debt has more than reversed the decline that took place in the first half of the Nineties" in emerging market economies. In these circumstances, researchers and policymakers will become more responsible for assessing public liabilities than they were in the past. To determine whether Latin American countries are showing warning signs again, the authors have given us a major contribution toward the search for better ways of assessing public liabilities.

Generally speaking, theoretical frameworks to examine sustainability are already in place. The authors have made use of these frameworks and applied them according to their objectives. Some of them challenge conventional methods of evaluating debt. Others propose different viewpoints.

I will first summarize the main points of the papers, and then comment on each paper.

- Many Latin American countries are not producing a primary surplus sufficient enough to keep public debt sustainable;
- Hidden liabilities will have certain additional impacts on public debt;
- External factors contribute to public debt accumulation;
- Enhancing growth and strengthening domestic macroeconomic conditions are important; at a minimum, remedies should be in place before debt dynamics develop.

Daniel *et al.*'s paper gives a comprehensive analysis on the recent development of public debt in emerging market economies, and investigates whether public debt is sustainable from four perspectives: 1) debt stabilizing primary balance, 2) fiscal policy reaction function, 3) overborrowing, and 4) uncertainty of revenue. The results are disturbing. First, Latin American countries have run short of primary surplus compared to the debt stabilizing level. Second, fiscal policy has been unresponsive: the improvement of the output gap does not increase primary surplus as much as it does in developed countries. Third, many countries overborrow. And fourth, revenue volatility reduces the maximum level of sustainable debt.

The paper is content-rich, but I'd like to comment on one point in particular: the importance of growth. The authors studied large public debt reduction experiences for the period 1970-2002. Surprisingly, 19 out of 27 examples were associated with debt default. The remaining seven cases were backed by strong real GDP growth averaging 8.5 per cent. Debt default is apparently not the best solution, whereas expenditure cuts may offset the recovery momentum, which in turn limits the extent to which fiscal balance improves. Therefore, the story tells us how economic growth plays a key role in public debt reduction. Bringing down public

debt to a sustainable level is not a task for the public sector only. Instead, achieving sustainability is closely related to private sector competitiveness. In this regard, I tend to see public debt as an outcome of the existing policy more than just a cause of concern.

Clavijo's paper emphasizes the distinction between gross and net and that between implicit and explicit public debt. He also calculates the debt tolerance level in Colombia and other Latin American countries. The broader definition of debt is intended to analyze hidden liabilities in Colombia like intra-government debt, public guarantees and pension liabilities, which are usually neglected but which might become significant risks regarding public debt sustainability. The paper concludes that in Colombia debt level increases by 10 percent of GDP, including intra-government debt, and that debt stabilizing primary surplus is required to deliver an additional 1 percent of GDP, when including contingent liabilities.

What differentiates this paper from the others is that it dares to include the impact of contingent liabilities into the public debt assessment. Although it is usually difficult to quantify the risk of contingent liabilities, we are obviously paying more attention to contingent liabilities than we did in the past, as a source of risk in public debt. In this context, the intention of this paper should be appreciated.

At the same time, the paper provides us with the seeds for future discussions to make similar analyses internationally more comparable. For example, 1) what should we include in gross and implicit debt definition and how should they be evaluated in cross-country analysis? And 2) how should we treat accounting matters such as the choice of accrual or cash basis in pension liabilities?

Martner and Tromben's paper examines the problems behind the public debt accumulation in Latin America in the past five years. Their focus is on how exogenous factors have contributed much to debt accumulation, especially for countries with access to international capital markets. As seen in Argentina and Uruguay, currency devaluation has played a large part in the increase of public debt stock, while interest rates have also proven to act more or less negatively on the accumulation of debt in other countries. The important implication from the analysis is that we can never separate the public debt problem from other policy areas, especially currency stability, price stability, and access to capital market in developing countries.

I would also like to add a related comment. In the paper, it is stated that "original sin is not a problem in itself; it is more of a symptom, signalling the presence of weak institutions or rule of Law." In many countries, when a government is serious about strengthening its domestic macroeconomic conditions, *i.e.*, improving economic efficiency, growth prospects and institutional credibility, it is also likely to raise the expectations of international investors as well, which in turn will work favorably toward long term debt sustainability. Therefore, resorting to fiscal policy may not be the only solution: a package of policies may sometimes work.

Rial and Vicente's paper provides more support to my view. It gives a thorough analysis on the Uruguayan experience and concludes that "only a sustainable primary balance adjustment could change former debt dynamics and assure long-term sustainability." The primary balance reflects the growth of GDP. Therefore, the paper assures that efforts to improve internal economic conditions ultimately help to improve debt sustainability, especially when debt dynamics are unavoidable.

This paper also presents some long-term simulations, in which Uruguayan net public debt never falls under 60 per cent of GDP by 2015, after reaching up to 80 per cent in 2003. Upward pressure dies hard for a long period. Once the latent risks materialize and the debt level jumps upward, containing the debt to previous levels is quite difficult. Although some reservations are called for in interpreting the results, since there is a range pertaining to long-term simulations, the case is a good example of showing how difficult it is to manage public debt sustainably.

2. Europe: on improving the fiscal balance

Fiscal conditions in European countries as a whole are viewed as being good compared to the emerging market economies. EU countries have reduced their public debt under the Maastricht Treaty, while the other European countries are also showing relatively good signs, as opposed to the early Nineties, partly because of the favorable economic environment.

Although the pressure to adjust the debt level for these countries is not too high, many issues remain to be studied. One of the two papers here deals with the fiscal operations that occurred in the run-up to Maastricht, while the other explains a unique treatment carried out by the Norwegian government. The topics are different, but both deal with fiscal soundness.

Milesi-Ferretti and Moriyama provide a very interesting view on the public debt of EU countries during the pre-Maastricht period. Their approach is simple: by focusing on the "net worth" effect of a government's balance sheet, they distinguish debt reduction with asset reduction from that with a net worth increase, *i.e.*, no change in assets. The paper is successful in showing that in the period 1992-97, debt reduction in these countries is associated with asset reduction, providing the evidence of fiscal operations; more specifically, the authors call them "nonstructural fiscal measures" and "creative accounting." They also point out that the "evolution of gross public debt provides only limited information on changes in the government's intertemporal position."

What is interesting about this paper is their compounded eyes: they focus on both assets and liabilities. Debt figures sometimes do not tell much about how they are produced. Even though the debt figures incorporate the fiscal operations, we cannot easily detect them on the other side of the balance sheet without specific analysis. Moreover, I agree with the idea that it is important to focus on net worth

rather than on gross debt if our concern is on the intertemporal budgetary position. Gross debt does not represent future tax burden.

Nevertheless, there are at least two reservations in the application of this method: 1) the asset price estimation problem, and 2) the interpretation of net worth. For the first point, let's take the example of an asset price bubble. Should we regard the fiscal burden to be permanently eased in the face of a temporary increase in asset prices? Since asset prices are extremely volatile, it is not easy to judge whether it is permanent or temporary. Net worth, therefore, entails the effect of asset price fluctuations that have essentially nothing to do with fiscal policy. In this context, for the second point, we should be careful in understanding what net worth really explains; the interpretation may depend on the macroeconomic asset price conditions specific to the period concerned.

Gjersem's paper introduced Norway's unique scheme of a "petroleum fund", which acts mainly as a buffer to short-term fluctuations in the Norwegian government's oil revenues, which has been, Gjersem argues, successfully managed. I would like to summarize three important properties of the fund: 1) returns on the fund are used to finance non-oil budget deficits; 2) the portfolio of the fund is diversified into equities and bonds; and 3) independent performance reviews are conducted by the experts from outside the external expertise. In my view, although they are unique, the three properties can be applied inherently to any country's budget account. We sometimes observe the same kind of special account treatment to support the general government budget balance.

My question arises from the first property. Under regulation, the fund is only allowed to invest abroad so as not to undermine the position of the fiscal budget. But doesn't it have the same consequence as domestic investment, since the fund is designed to finance the overall budget deficit? The government may, for example, be tempted to invest heavily in domestic infrastructure; it still can depend on the fund as a source of finance to make up for the deficit caused by the domestic investment. In such a case, the fund becomes a loophole: even if the fund is allowed to invest only abroad, it is ultimately used for domestic investment.