Debt Sustainability After the Pandemic: a Rift between the Advanced and Developing Economies?

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Purpose of the paper

- We estimate the fiscal space for developed and developing economies in the G20.
- For this we use an analytical framework that expands standard Debt Sustainable Analysis (DSA) to include the induced responses of growth, yields and fiscal policy to debt.
- We use this to detect whether a country's debt is on a sustainable path or not and highlight the differences between advanced and emerging economies.

Analytical framework

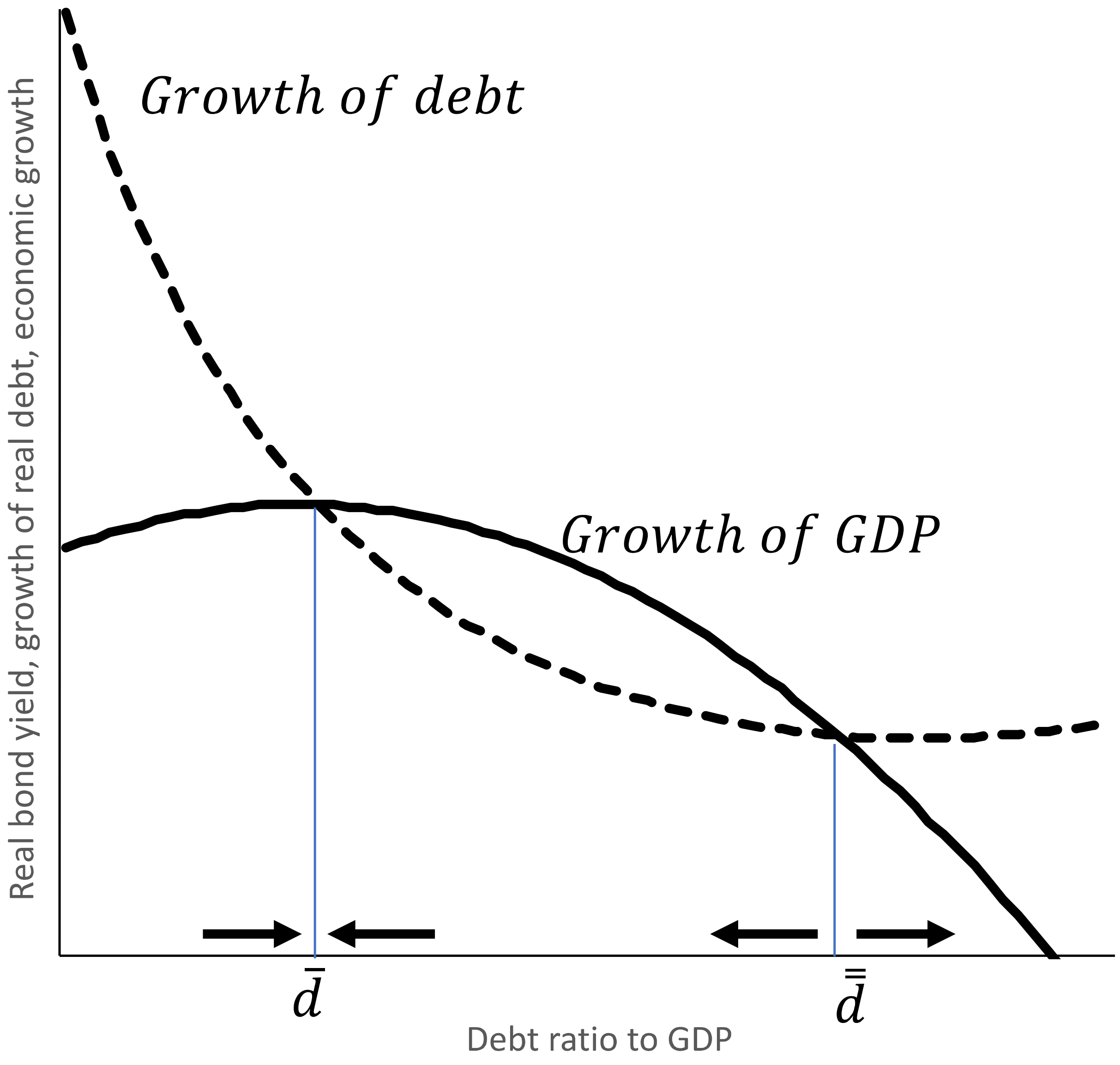
- ‘Public debt can be regarded as sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible such that the level of debt is consistent with an acceptably low rollover risk with preserving potential growth at a satisfactory level’. (IMF, 2020)

Analytical framework

1. Growth intially increases with public debt as part of financial development, but falls beyond a debt threshold. (Kassouri et al 2021)

2. Interest rate intially falls with debt, owing to liquidity premium; increases beyond a threshold due to solvency risk. (Pappas and Kostakis 2020)

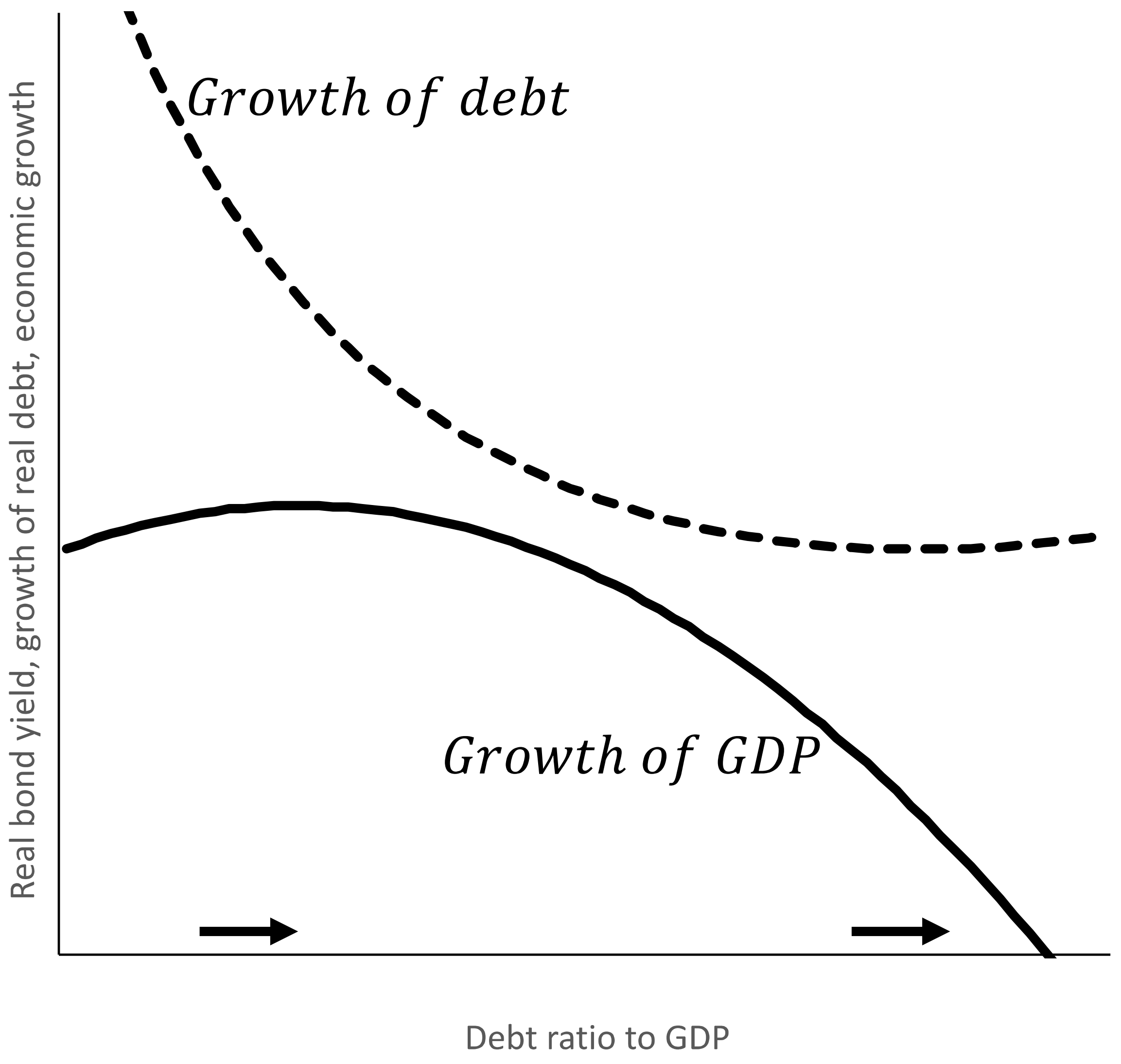
3. Fiscal consolidation response also non-linear, initially getting stronger with higher debt but then choked off by ‘consolidation fatigue’. (Ghosh et al 2013)



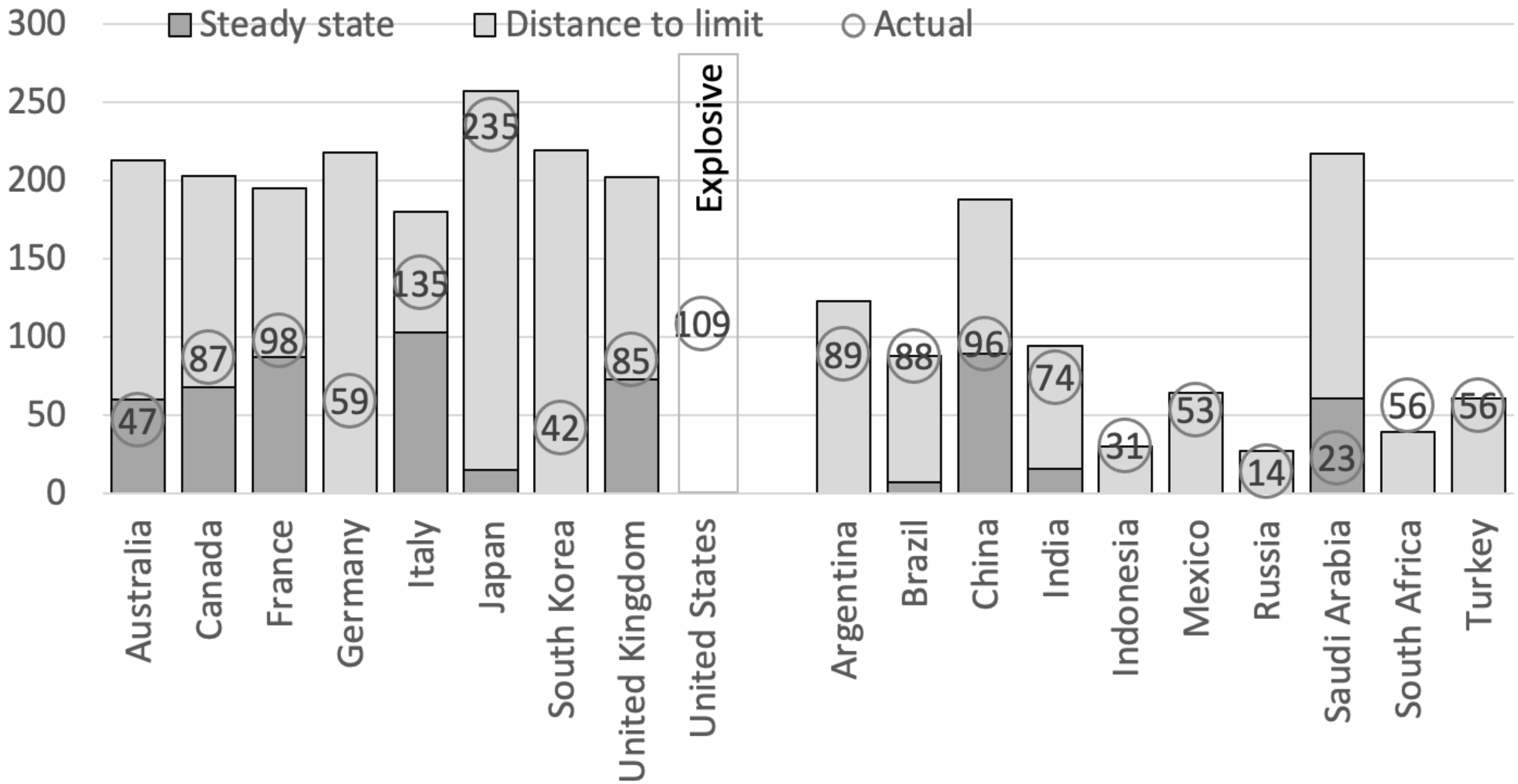
Analytical framework

Three possible debt sustainability situations distinguished:

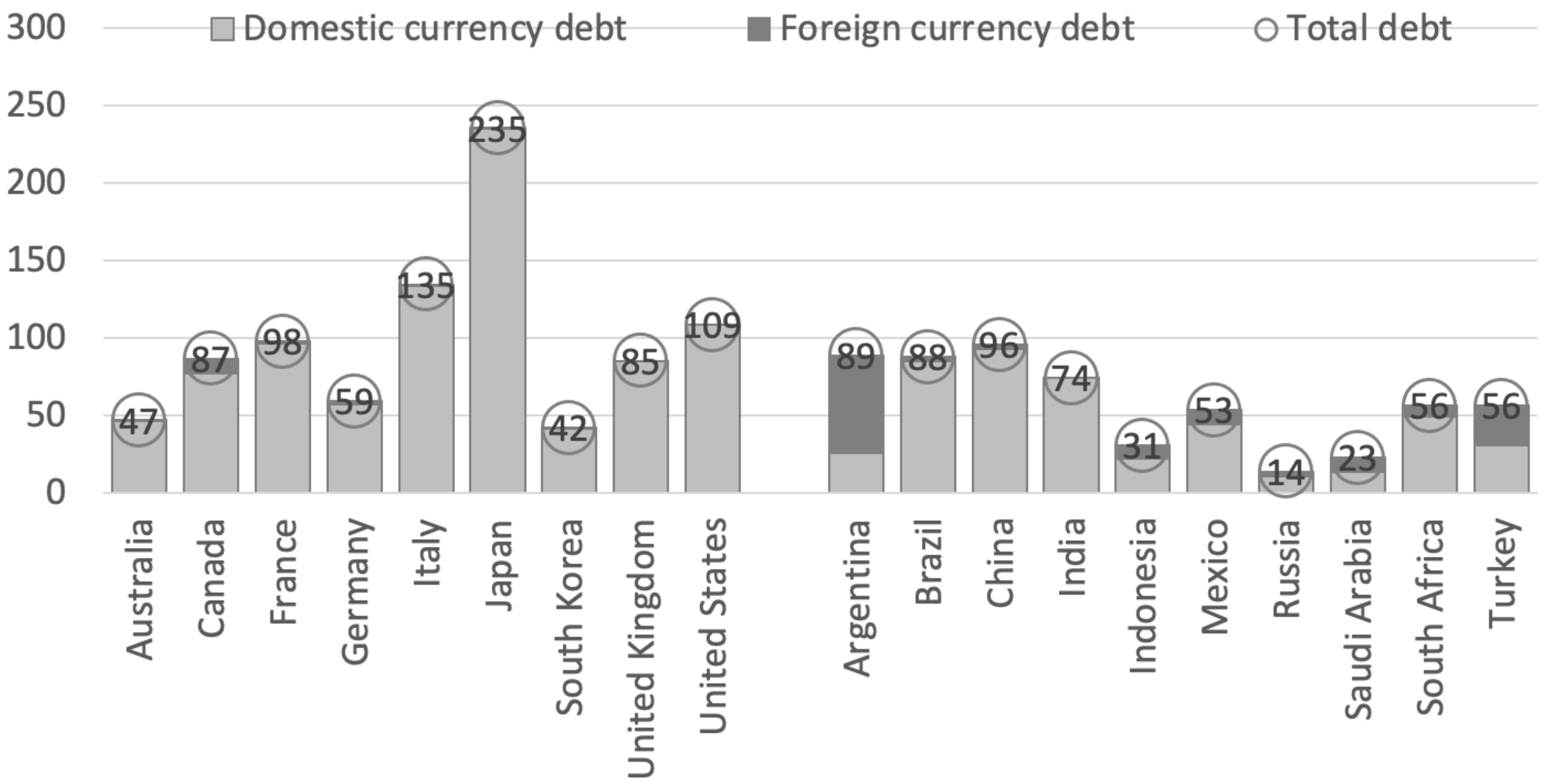
1. *Sustainable:* debt is smaller than the debt limit, falls toward steady state.
2. *Potentially sustainable*: debt exceeds the limit and grows exponentially, partial default can take it back below the limit.
3. *Explosive*: debt will always grow exponentially unless the primary deficit is permanetly cut.



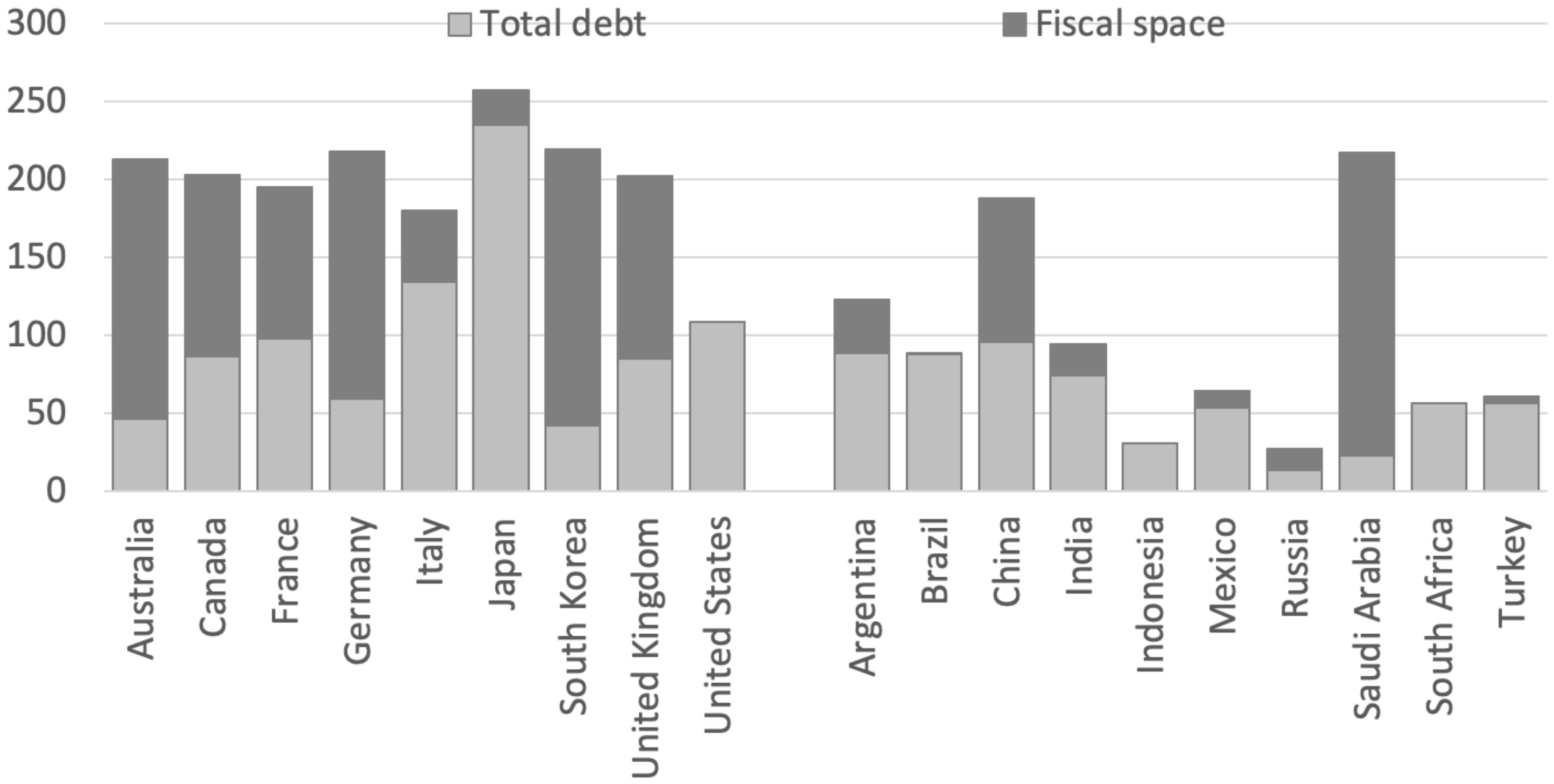
Situation in 2019
Public debt, % of GDP



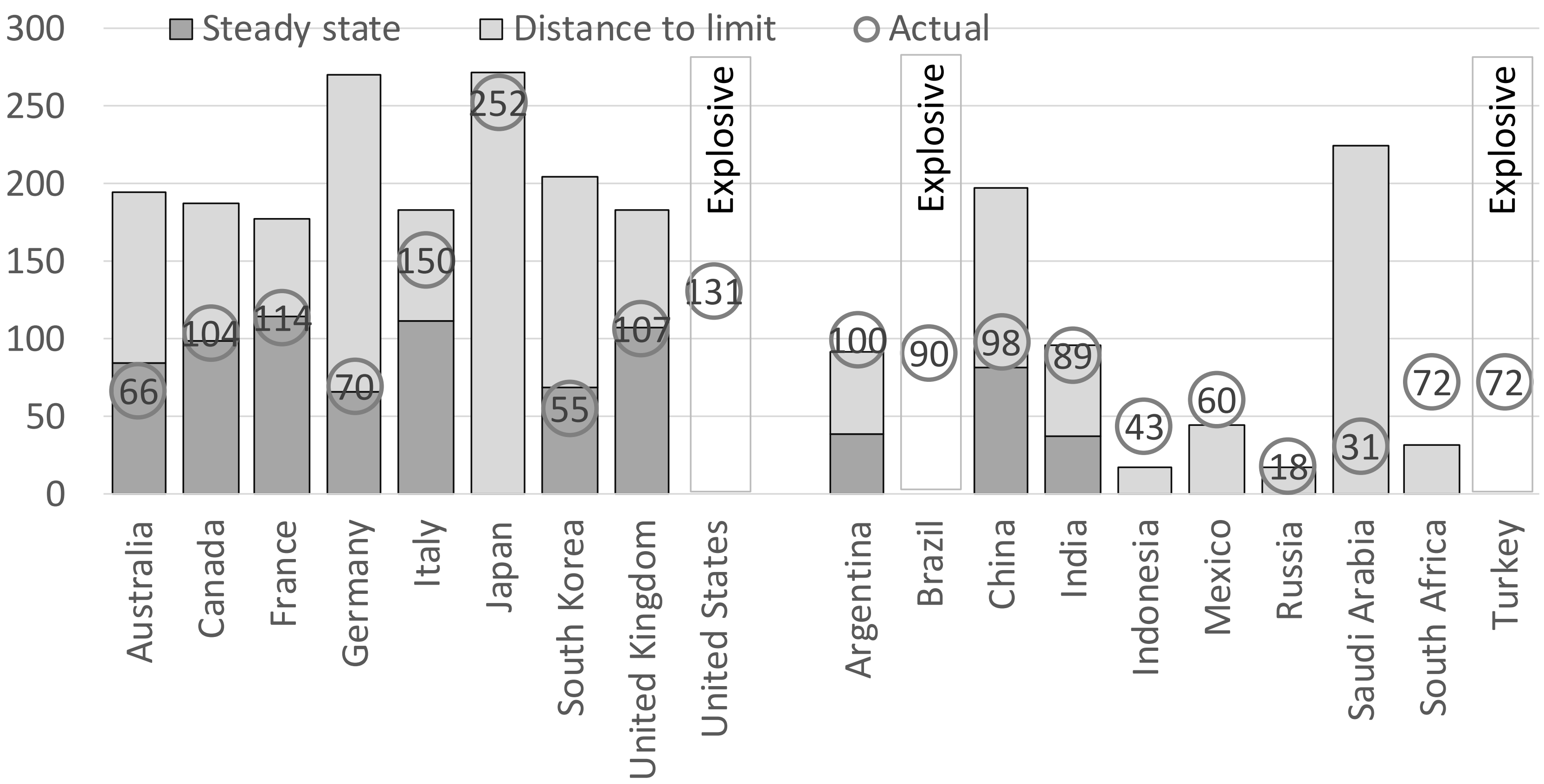
Situation in 2019
Home versus foreign currency public debt, % of GDP



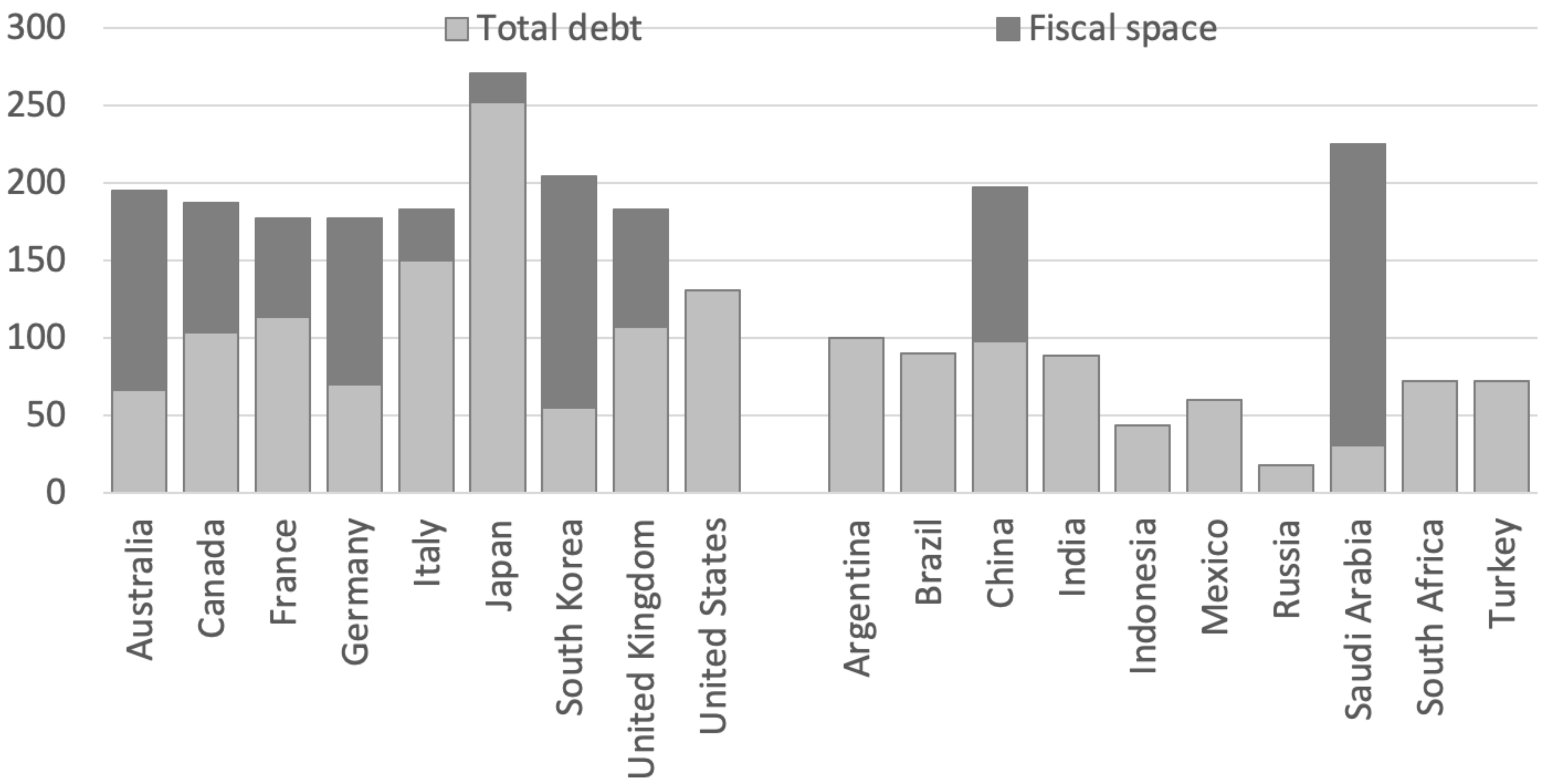
Situation in 2019
Public debt and fiscal space, % of GDP



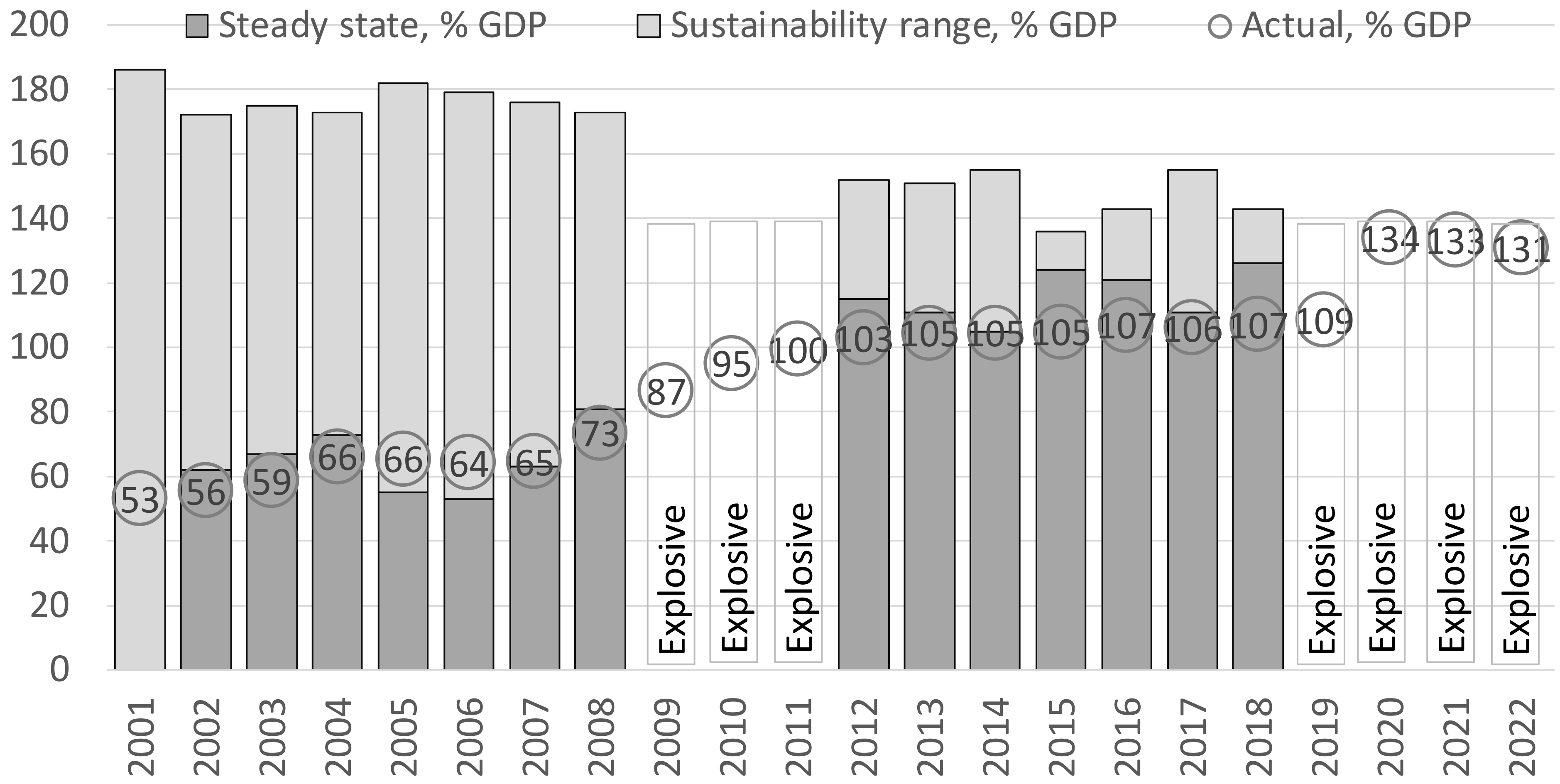
Situation in 2022
Public debt, % of GDP



Situation in 2022
Public debt and fiscal space, % of GDP

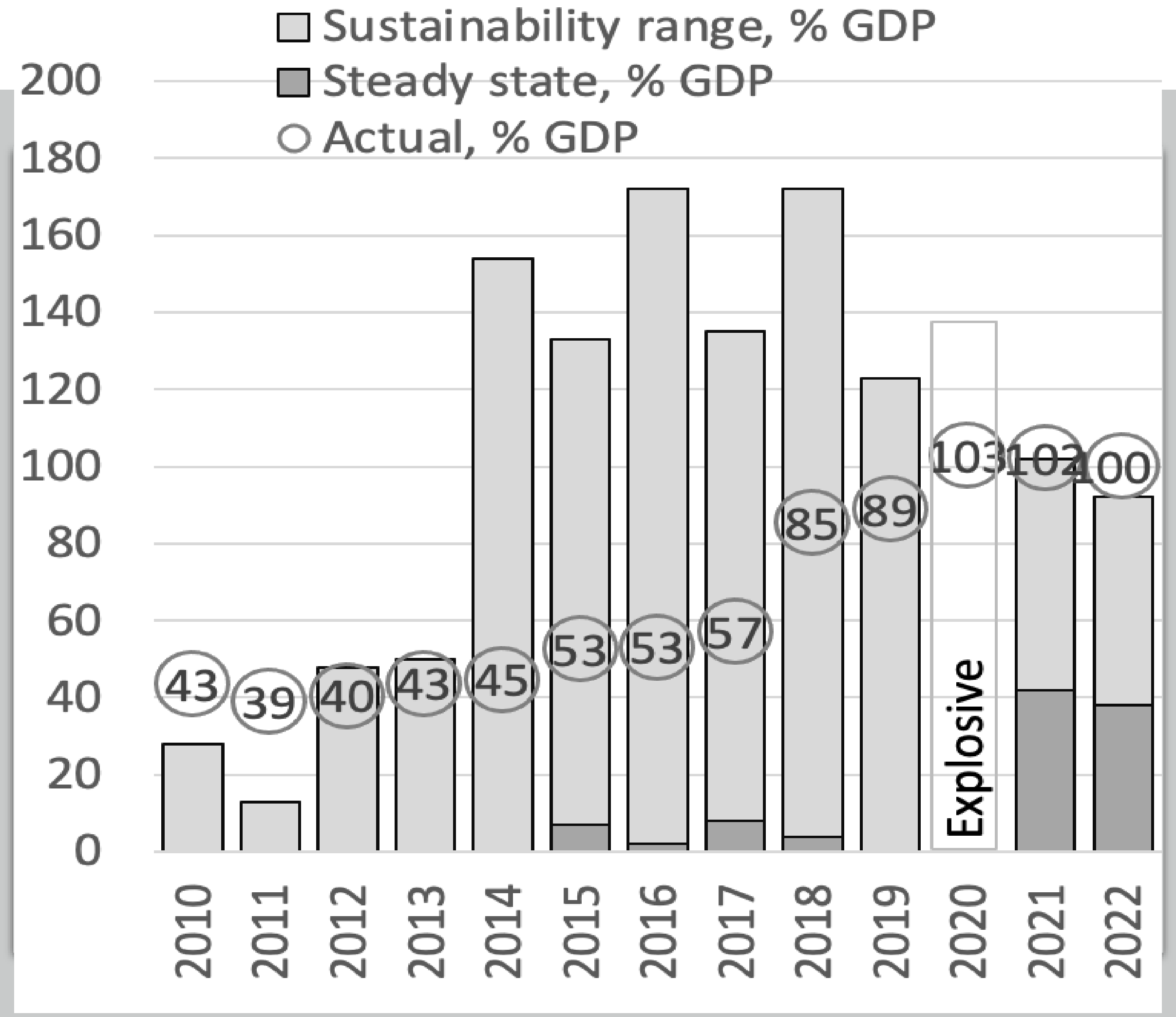


Situation in the United States
Public debt and fiscal space, % of GDP

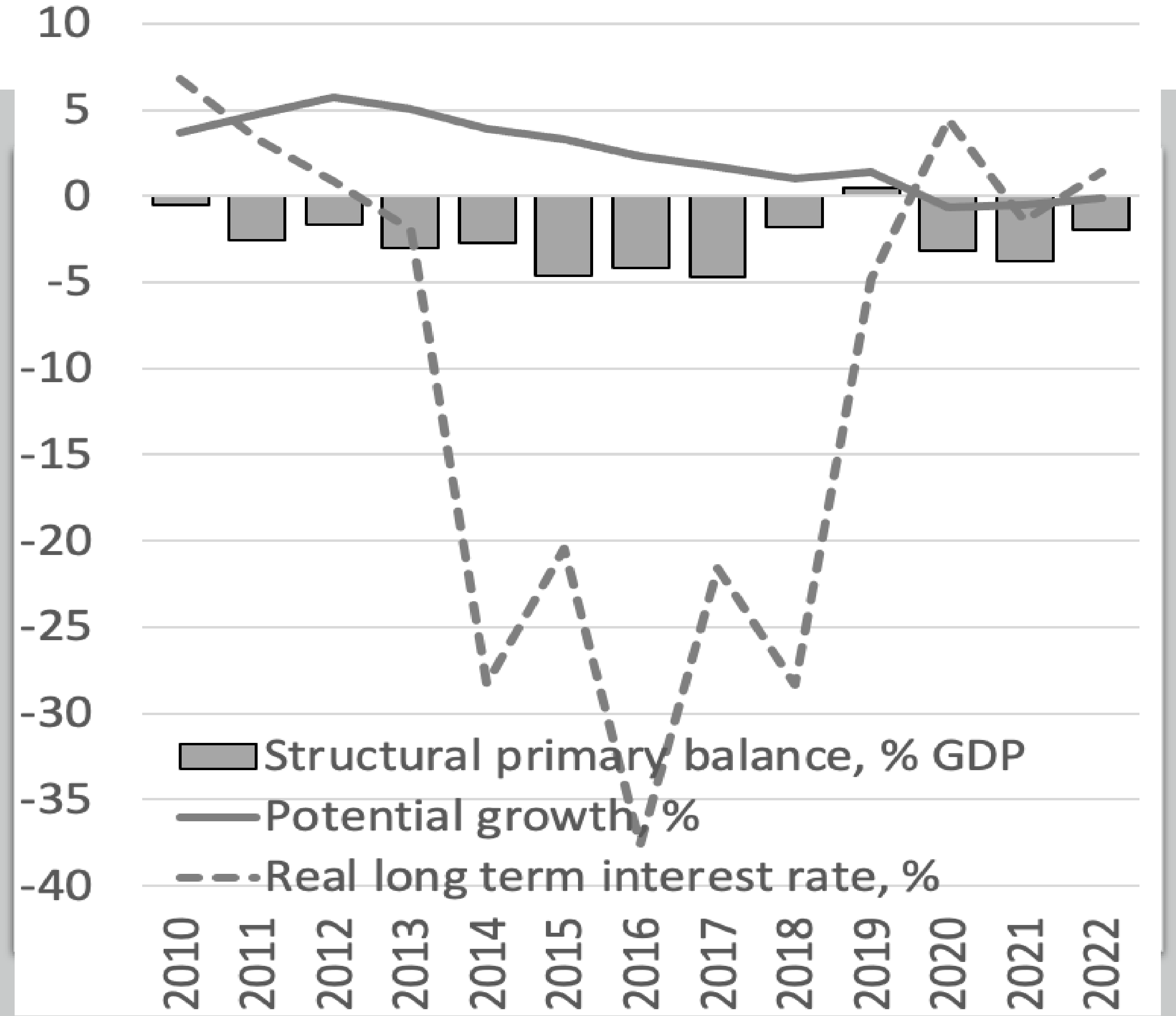


Situation in Argentina

Public debt

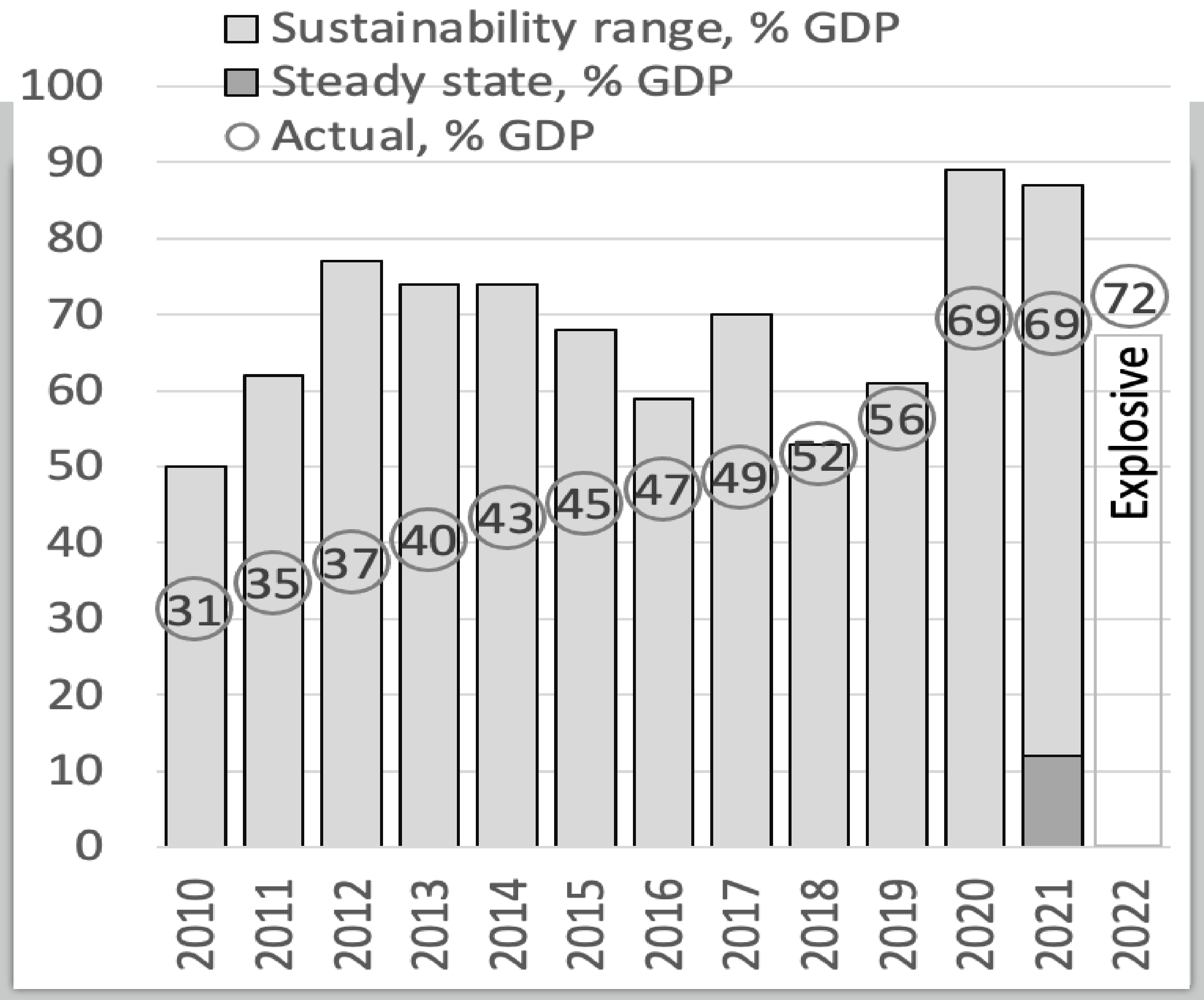


Primary balance, potential growth, real interest rate

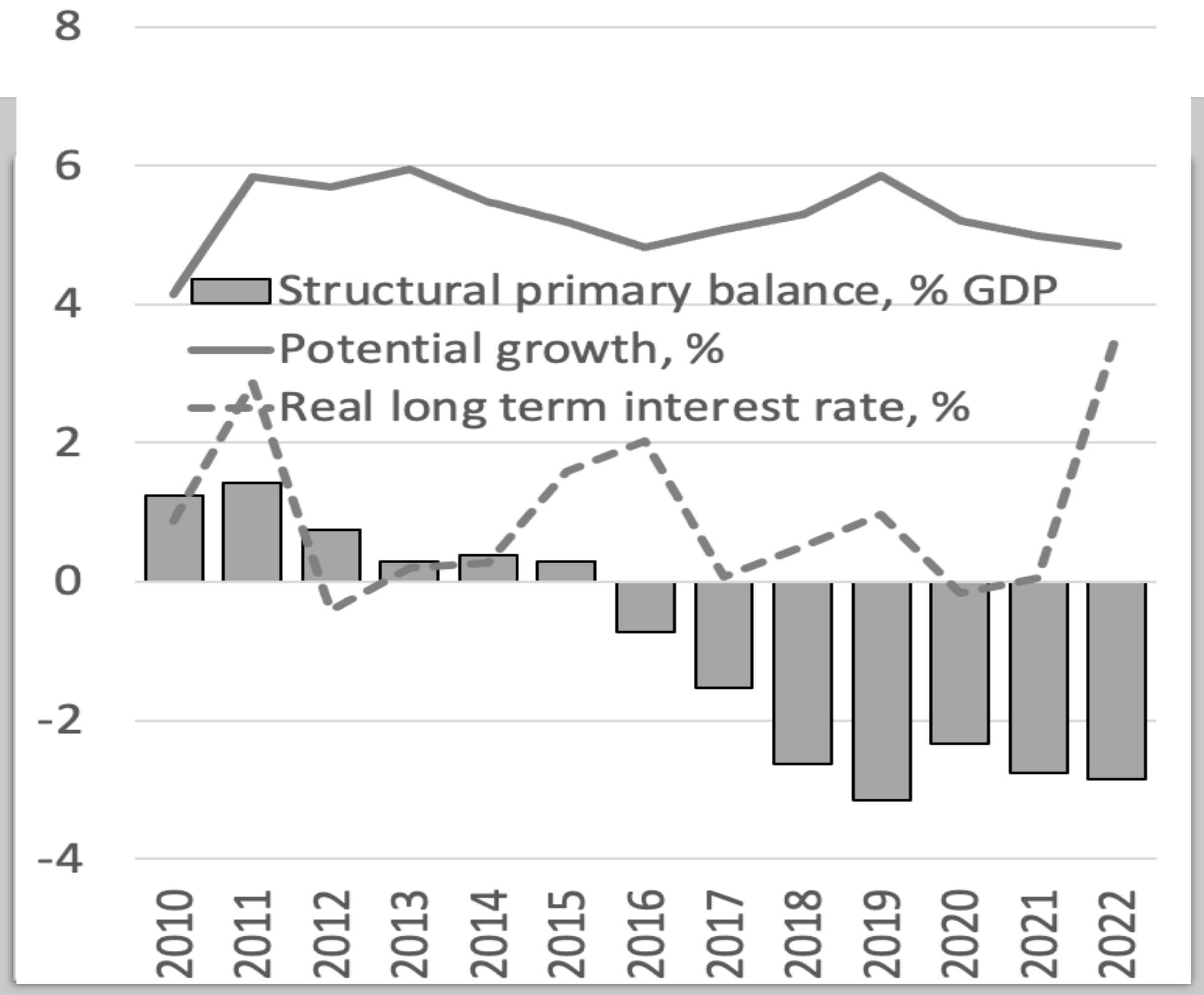


Situation in Turkey

Public debt



Primary balance, potential growth, real interest rate



Dual trilemma

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Free flow of capital

Domestic currency debt

Fixed exchange rate

Independent monetary policy

Fixed exchange rate

Independent fiscal policy

What the dual trilemma tells us?

Advanced economies:

- if free flow of capital and floating exchange rate
- thus, independent monetary policy
- if debt issued in domestic currency
- thus, independent fiscal policy

Developing economies:

- if free flow of capital and fixed exchange rate
- thus, monetary policy cannot be independent
- if debt issued in foreign currency
- thus, fiscal policy cannot be independent

A rift between advanced and developing economies ?

Advanced economies:

- Independent monetary policy
- Independent fiscal policy
- domestic currency debt
- exchange rate risk on the lender's balance sheet

wider fiscal space

Developing economies:

- multiple choices, but fixed exchange rate the default option
  - monetary policy cannot be independent
- exchange rate risk on the borrower's balance sheet
  - debt issued in foreign currency
    - fiscal policy cannot be independent
  - debt issued in domestic currency
    - higher risk premium

narrower fiscal space

Conclusion

- For the advanced economies, the fiscal space constraint is not binding
- Developing economies have limited fiscal space and it is binding
- Advanced and developing economies face entirely different conditions concerning the possibility to conduct independent fiscal and monetary policies to address major shocks.
  - Developing economies have limited instruments to expand their fiscal space at the time of shocks especially when they are already close to the limit of debt sustainability.