Fiscal Limits & Nominal Debt

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Every economy has a fiscal limit:

- Point at which surpluses can no longer adjust to stabilize government debt
- Economic limits: Laffer curves, minimum size of government
- Political limits: electorate’s tolerance for taxes & demand for government services

I’ll use fiscal limits framework to discuss:

1. Sovereign debt problems in Europe
2. Difference between real & nominal debt
3. Implications for Europe going forward
The Fiscal Limit & Sustainability

- Delivers maximum expected present value of all future primary surpluses (or “cash flows”)
  - government debt derives its value from future surpluses
  - fiscal limit implies maximum sustainable debt-GDP ratio

- Fiscal limit
  1. uncertain: a probability distribution—not a point
  2. forward-looking: hinges on expected policies & their credibility
  3. depends on: private & government behavior; shocks hitting economy
  4. country-specific: no “one-size-fits-all” limit
What Happens at the Fiscal Limit?

- Default is ultimately a *political* decision
  - about a government’s *willingness*, rather than its *ability*, to honor debt
  - political decision yields “effective fiscal limit”: when debt exceeds this threshold, default occurs

- If debt is real, as debt approaches fiscal limit, probability rises that
  1. government defaults outright ⇒ raises risk premia
  2. debt-stabilizing policies occur ⇒ reduces risk premia

- In Europe we’ve seen some of each
Greece’s Fiscal Limit

- Quantifying Greece’s fiscal limit
  - use formal economic model
  - Greek debt is real: Greece cannot create euros
  - connect model to Greek data

- How do changes in economic conditions & policies shift fiscal limit and alter risk premia?

- Model fiscal consolidation as change in fiscal rules
  - permanently or temporarily
  - empirical work treats consolidations as sequences of realizations of policy “shocks”
  - hard to quantify expectations effects of consolidations
Fiscal limit computed using peak of labor Laffer curve, constant government purchases, current transfers regime, no seigniorage revenues

- Low (High) Productivity Can Reduce (Raise) Country’s Sustainable Debt Level
- Unstable (Stable) Growth in Transfers Can Reduce (Raise) Country’s Sustainable Debt Level
Fiscal Limit Implications

1. Focus on current debt *relative* to country’s willingness to support debt
   - statements like, “countries run into problems when debt exceeds $X\%$ of GDP” ignore fiscal limits
   - Sweden’s debt was risky at 70%; Belgium was risk-free at 100%

2. Risk premia can change with no change in current debt
   - shocks & policies—both fiscal & monetary—can shift fiscal limit
   - persistent changes in real interest rates change discounted surpluses & shift fiscal limit
   - emphasizes *future*, rather than current, policies
Nominal vs. Real Debt

- Real government debt different from nominal debt
  - real debt: a claim to “goods,” which government may not have available
  - nominal debt: a claim to “currency,” which government can always create... if it controls its currency

- Euro Area countries effectively issue real debt
  - creation of euros not controlled by individual members
  - if government cannot repay, default is only option

- Nominal debt permits other options: surprise changes in inflation & nominal interest rates
  - this may devalue outstanding debt but avoids default
Nominal vs. Real Debt

- Sims emphasizes surprise inflation as a fiscal cushion
  - surprise capital gains & losses on U.S. Treasuries equal $\pm 6\%$ of value of debt

- Surprising inflation revalues debt
  - less reliance on adjusting distorting taxes & spending

- Fiscal cushion is a component of optimal monetary & fiscal policies
  - makes outright default less likely
Surprise gains & losses to holders of U.S. government bonds, as share of GDP. Source: Sims (2013)
Recent research finds that with long-maturity nominal debt, can achieve *nearly equivalent welfare*. . .

- whether fiscal policy adjusts to stabilize debt or does not adjust

Inflation can be part of an optimal fiscal consolidation plan, but it’s not part of the European conversation.

Because Euro Area countries have no fiscal cushion through inflation, fiscal limits imply

- defaults, EU receiverships, loss of fiscal sovereignty
Some European Realities

1. There is a de facto fiscal union in place in Eurozone
   ▶ it is chaotic & uncertain
   ▶ it is run by unelected technocrats
   ▶ incidence of sovereign risks & defaults are difficult to trace

2. Let’s admit that some problems will never disappear
   ▶ free riders & moral hazard
   ▶ loss of fiscal sovereignty
   ▶ difficulty distinguishing between illiquid & insolvent sovereigns

3. Looming fiscal limits are ubiquitous
   ▶ unresolved fiscal stress from aging populations will hit all EZ nations
Policy Institutions Going Forward

- Create institutional arrangements that are robust to coming fiscal stress

- Important aspects of those arrangements...  
  1. country-specific fiscal rules to steer nations clear of fiscal limits  
  2. a limited form of explicit fiscal union  
  3. nominal Eurobonds to provide a fiscal cushion

- There will be substantial opposition to this  
  - but the status quo will produce an exaggerated version of the last several years