The Fiscal Crisis as an Opportunity for Structural Reforms

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Politicians, newspapers and commentators have a natural tendency to focus on the current problems. The word "crisis" is probably the most used word in the ongoing economic policy debate. While handling the current crisis is certainly a priority, a longer-term view is ultimately more important for the world economy. After all, a crisis in which a country's economy falls by 10 percent of GDP—a very large crisis, indeed—is half as important as a "lost decade" of growth, where an economy grows at 2 percent per year less than it could. Japan is one example of this. At the end of the 1980s, Japan was an envied example of an economy with fast growth, a potential challenge to the economic status quo and the dominance of the Western developed economies, and the economic powerhouse. Twenty years of the anemic growth has now made Japan a lackluster heavyweight slugging along.

Austerity Is Unavoidable

The massive fiscal expansion used to fight the crisis substantially increased the debt burden in the world economy, especially in the OECD countries. The level of debt in many developed countries exceeded the 90 percent debt-to-GDP ratio—the "red line" after which, according to Reinhart and Rogoff, a significant slowdown of growth is very likely.[1] This "red line" is even more important because it reduces the hopes of growing out of the debt problems. The mutually reinforcing high-debt/low-growth trap is a dangerous reality for developed economies that foreshadows a decade or more of lost growth.

Another dangerous sign is that the likely size of the debt problem of the main developed economies is significantly underestimated. The key problem is the value of the implicitly guaranteed off-balance-sheet liabilities. Consider as an example the United States. While the official estimates state that the U.S. debt is in the range of $15 trillion, the number is likely higher. For example, adding up the obligations of Fannie Mae and Freddie Mac and capitalizing the pension and health care obligations results in an astounding 600 percent of GDP or $100 trillion.[2] Certainly, this number is misleading. The $100 trillion amount does not have to be repaid all at once; it is being paid every year from the current budget. Still, the official estimates are to be adjusted upwards. For example, the official estimates do not take into account the potential bailout of the state budgets. As the states will surely face a debt crisis, the federal government will have to take its debt on the balance sheet. Robert Novy-Marx and Joshua Rauh estimate that this will increase the net liability of the U.S. federal budget by about $2 trillion.[3]

But even the official forecasts are not rosy in the long run. The Congressional Budget Office estimates the incremental costs related to the aging population (pension and healthcare expenses) to increase by 5 percent of GDP by 2035. Eichengreen et al. estimate that in Europe such costs will raise the fiscal expenditures by 2.7 percent of GDP by 2035.[4]

The sheer size of the debt problem is so large that the austerity measures are unavoidable—both in the U.S. and in Europe. Europe is already under the pressures of financial markets, but the U.S.—as suggested by the Standard and Poors' recent downgrade of the U.S. sovereign rating—is also going to face this challenge in the near future.

The Rich World's Fiscal Problems Matter for All

Many emerging market economies worry that fiscal problems in the developed countries will be dangerous for them as well. The argument is that the growth in the U.S., Europe and Japan will slow down and the emerging markets will be inevitably hurt. This is why correcting the current situation in the OECD economies is in the long-term interest of the developing countries. Even if (and we argue later that this is a big "if") fiscal consolidation in the developed world slows growth, such reform will still have tangible benefits for the developing markets. Three key reasons for this are as follows:

First, the developing world's "safety cushion" relies on the quality of the long-term financial instruments in the developed world.

The hard lessons of the previous crises and the fast growth led many emerging market economies in the last decade to accumulate a sizeable amount of reserves. These reserves are a crucial safety cushion for growth in the developed world. Much like how the deposit insurance for banks prevents panic and runs on banks, the accumulated reserves significantly decrease the probability of serious problems with the emerging markets. At the same time, the developed world possesses a unique export product—high quality long-term assets. These assets are difficult or impossible to replicate and are therefore essential to "park" the excess precautionary reserves of the emerging world. The decrease in the quality of the long-term assets—which is inevitable if the developed world does not resolve its structural issues—will lead to a significant de facto reduction of the ability of the emerging markets to shield themselves from serious crises.

Second, capital flows to the emerging markets can be significantly curtailed if the uncertainty in the developed markets remains high.

A significant amount of economic research shows that an important determinant of the flow of capital to emerging markets is volatility in the world economy. When uncertainty is high, investors "fly to safety" and so capital flows out of the emerging markets. The "risk-off" mode of the world economy is significantly affecting the ability of emerging markets to finance their capital needs—which, in turn, is important for sustaining high growth rates. The current situation in the developed world is unsustainable in the long run. The ensuing uncertainty about the resolution of the current problems is detrimental for emerging markets—flight to safety reduces inflow of capital to emerging economies.

Third, failure to resolve the current economic crisis will doom the idea of global governance.

The world needs global governance, both in politics and in economics. But in order to build functioning global institutions, developing markets need the rich countries to have credibility. Rich countries still control the global institutions and will control the international organizations regardless of the resolution of the current crisis—by the very virtue of their large share in the global economy, and their technological and military power. Loss of credibility for the developed world will entail a loss of credibility for international institutions. Another related issue is that eurozone itself is a key experiment in multilateral governance. If it fails, it will be a major blow for building the institutions of global governance.

Fiscal Discipline Can Be Enforced

The failure of the Maastricht agreements to maintain fiscal discipline in the eurozone and the current turbulence in European markets have raised a new wave of skepticism in the ability to enforce limits on deficit and debt. By now, we know that domestic political institutions are not sufficient to impose fiscal discipline. Indeed, 2035 is too far away for cutting pensions and the promise of pensions. Therefore, it is not surprising that almost every eurozone country—and all large countries —now violates the Maastricht criteria on the debt-to-GDP ratio.

However, one should not interpret the recent events as a death sentence to fiscal discipline. On

the one hand, it is clear the unprecedented level of financial globalization has made almost all countries "systemically important". Therefore, many governments count on bailouts by international financial institutions. And for every politician or political party, such soft budget constraints always create a temptation to gain more political support through lower taxes or higher spending. In the longer run, however, this scenario leads to a dead end; eventually excessive borrowing will result in a default.

On the other hand, the current debt crisis is likely to build a consensus that the international community should change its approach to bailouts—very much like how the 2008 global economic crisis resulted in a serious rethinking on regulating the bailouts of "systemically important financial institutions". New approaches to enforcing fiscal discipline for sovereigns should benefit from the debates (and the resulting solutions) on imposing budget constraints on systemically important banks. The simplest approach is to use the framework of bank deposit insurance for redefining sovereign bailouts.[5] For example, the countries should agree on debt limits (e.g. 60 percent of GDP) and should only allow bailing out the debt that it is within these limits. The "junior" debt in excess of these limits can still be issued but should never be bailed out by international financial organizations. If such an agreement is publically announced, it will be relatively easy to enforce. Voters in one country will be very upset if its government uses their tax money to bail out another—clearly irresponsible—country and its equally irresponsible creditors. Indeed, if the country being bailed out violates its public promise to keep the debt within the limits, the aiding government will be unlikely to win a domestic debate on bailing out the other country's debt.

This will work as a global deposit insurance fund: for the "senior" debt (i.e. debt within the limits), there will be a promise of an international bailout; therefore the run on such debt is highly unlikely. For the "junior" debt, there will be no guarantee; hence, the junior debt will automatically become a high risk/high return asset—where runs and defaults will be possible but will not be considered as threatening to the global financial order, given that they will be almost expected.

Austerity as an Opportunity

There is debate and considerable uncertainty over whether austerity is necessarily detrimental for growth in the short run.[6] However, there is no doubt that responsible fiscal policy is certainly beneficial in the long run—especially if austerity is accompanied by structural reform. Rooting out inefficient subsidies, deregulating the business environment, introducing flexible labor markets, and most importantly radically reforming pension systems and health care will lay the foundations for long-term economic growth. Failure to implement structural reforms will certainly lead to a growth slowdown.

The silver lining of the current crisis is that it creates an opportunity to implement big ideas, which would be politically infeasible during a time of the relative prosperity and slow decline. One example is overhauling the tax system by moving to consumption taxes. Economists have long argued that in order to avoid distortions, taxes should be imposed on what people maximize—hence a consumption tax is optimal in the static sense. In the dynamic sense, it is even more important as it provides additional incentives for saving, which lowers the cost of capital for investment and growth.

Another crucial reform agenda item is pension systems. This will have important implications for the financial system and growth. As the young generation will have to save for retirement, there will be an inflow of savings—again, providing long-term funds to companies and fueling growth. This of course will only work in countries with developed financial markets. But the financial market is already virtually global so savers everywhere will have access to good financial services. This will also increase incentives to develop financial systems in other countries.

Russia Faces the Same Problems

On the surface, it seems that Russia is doing much better than U.S., Europe and Japan. The country has more than half a trillion dollars in foreign exchange reserves, low debt (10 percent of GDP) and a deficit which is close to zero. But Russia is facing a daunting long-term fiscal issue and more broadly a long-term growth problem. The fiscal situation only looks rosy while oil prices are high. In 2007, Russia's national budget would have been balanced if oil prices were at $55 per barrel. Now the balance can only be achieved at $125 per barrel. The non-oil deficit is now above 10 percent of GDP. Russia's pension system is not sustainable. It is true that Russia can borrow, but the need to borrow will be the highest when the oil prices fall as a result of a global slowdown or recession. Consequently, markets will not want to lend to a country like Russia if this is the case.

Therefore, Russia also has the need for both fiscal restructuring and structural reforms in the economy. The good news is that the reform agenda is clear and inefficiencies are many—so there is a huge potential for accelerating growth. The bad news is that the reforms are not necessarily in the interest of the current political elite. This of course is not unique to Russia. As Bueno de Mesquita et al. put in their seminal book, *The Logic of Political Survival*, good policy is not necessarily good politics.[7] In order to improve its competitiveness and accelerate economic growth, Russia needs to build modern institutions of private property rights and rule of law, fight corruption and protect competition. However, the political elites rely on interest groups that control state-owned companies, including many state-owned monopolies. And fiscal expenditures—even if they are not sustainable —are politically important as they help to finance the support base of the regime. This is why as long as oil prices are high, Russian elites will most likely hold off on fiscal restructuring, privatization and structural reforms.

Conclusion

The world has come to a line where fiscal restructuring in the developed countries is unavoidable. The challenge now is to make sure this fiscal adjustment is accompanied by structural reforms. It is also important to draw lessons on rethinking future sovereign bailouts by international organizations—in order to reduce incentives for irresponsible borrowing in the future. The sovereign debt crisis offers an opportunity for such rethinking and it will be in the interest of both developed and developing countries. The fiscal problems of the developed countries hurt emerging markets in several ways: the emerging markets suffer from global economic instability, from an inability to find reliable instruments for investing their sovereign wealth, and from weak credibility of the international institutions led by the developed countries.

Russia has a special role in this context. As long as oil prices remain high, Russia looks like other emerging markets with responsible fiscal policy, low debt and a sovereign wealth fund. However, once oil prices come down, Russia will face all the challenges that the developed countries are facing today: fiscal problems and the urgent need for structural reforms. Therefore, like the developed countries, Russia can and should use fiscal restructuring to build the key foundations for the long-term economic growth.

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Endnotes

[1] Reinhart and Rogoff (2010).
[2] According to Bill Gross from the asset manager PIMCO. See Cox (2011).
[3] Novy-Marx and Rauh (2010).
[4] Eichengreen et al. (2011).
[5] Along the lines of Wyplosz (2011).
[6] See, for example, Trichet (2010), Alesina and Ardagna (2010), and IMF (2010).
[7] Bueno de Mesquita et al. (2003).