Fiscal Space: Why Does It Matter?

Prepared for the Workshop
Debt Sustainability: Current Practice and Future Perspective

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Three Questions

1 What is fiscal space? *Multidimensional concept.*

2 How has fiscal space evolved? *Deteriorated in EMDEs; deteriorated in some dimensions in OECD.*

3 What does narrower fiscal space mean for fiscal adjustment? *Less effective fiscal policy.*

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1

What is fiscal space? *Multidimensional concept.*

Fiscal Space:
What Is It?

- [Fiscal space is the] availability of budgetary resources for a specific purpose…without jeopardizing the sustainability of the government's financial position or the sustainability of the economy (Ley 2009; World Bank 2015).

- "Fiscal space is defined as the room for undertaking discretionary fiscal policy relative to existing plans without endangering market access and debt sustainability" (IMF 2016, IMF 2018).
- "…we seek to determine a "debt limit" beyond which fiscal solvency is in doubt. We … define fiscal space as the distance between the current debt level and this debt limit" (Ghosh et al. 2013).
- "… "fiscal space" - a measure of how much governments can borrow without losing market access or facing sustainability challenges" (Botev, Fournier and Mourougane 2016)

Dimensions of Fiscal Space :
Sustainability, Balance Sheet, Contingent Liabilities, Perception

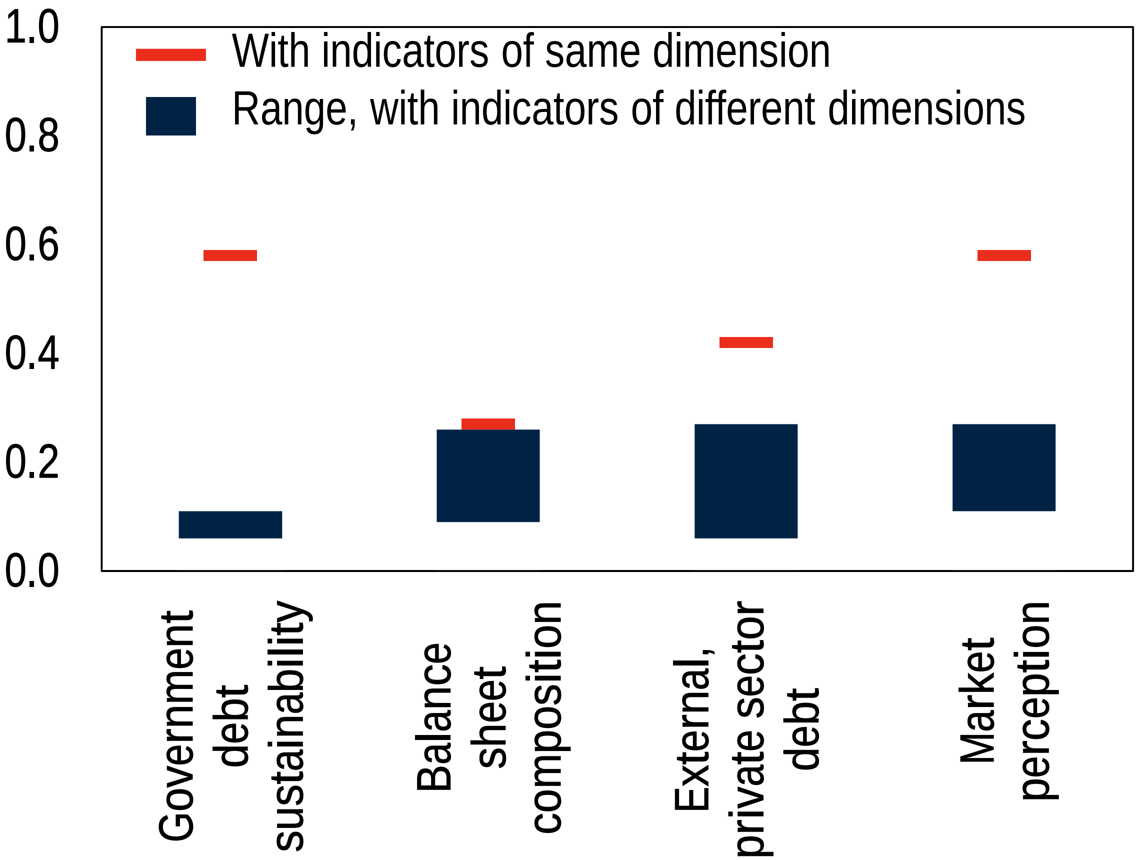
Dimension of Fiscal Space (28 indicators)	**Examples of indicators**
Government debt sustainability (12 indicators)	General government debt, fiscal balance, sustainability gaps
Government debt composition (6 indicators)	Shares of government debt held by nonresidents and in foreign currency, maturity of debt
Non-government debt (8 indicators)	External debt, short-term external debt, credit to the private sector
Market perceptions (2 indicators)	Sovereign CDS spreads, long-term sovereign debt ratings

Coverage: 41 advanced economies, 159 EMDEs for 1990-2017

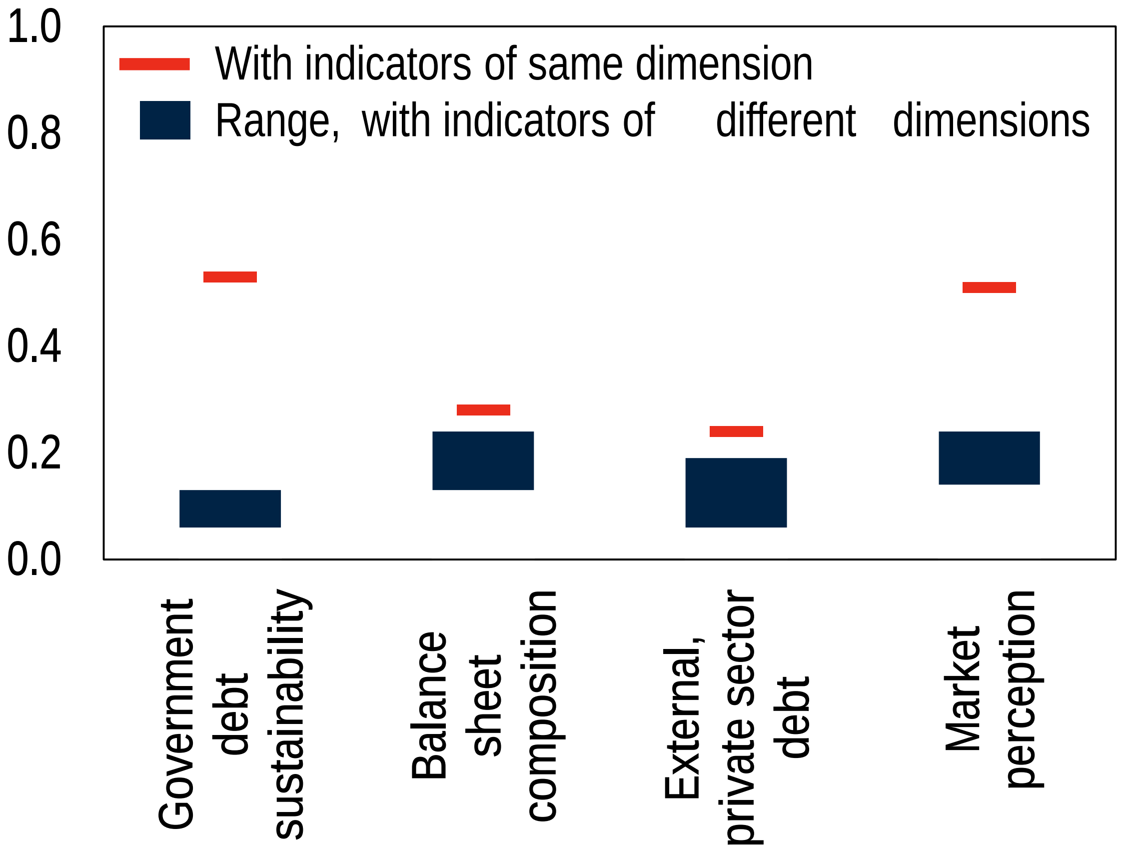
Source: Kose, Kurlat, Ohnsorge, and Sugawara (2017) “A Cross-Country Database of Fiscal Space.”
Data is available at http://www.worldbank.org/en/research/brief/fiscal-space

Fiscal Space:
Four Major Dimensions

Correlations of Indicators of Fiscal Space: All Countries
(Average correlation coefficients)



Correlations of Indicators of Fiscal Space: EMDEs
(Average correlation coefficients)



Source: Kose et al. (2017) “A Cross-Country Database of Fiscal Space.”
Note: Correlations coefficients between different indicators of fiscal space, average within each dimension (red lines) and range of averages across dimensions (blue bars). From Table 3 of Kose et al. (2017).

Three Questions

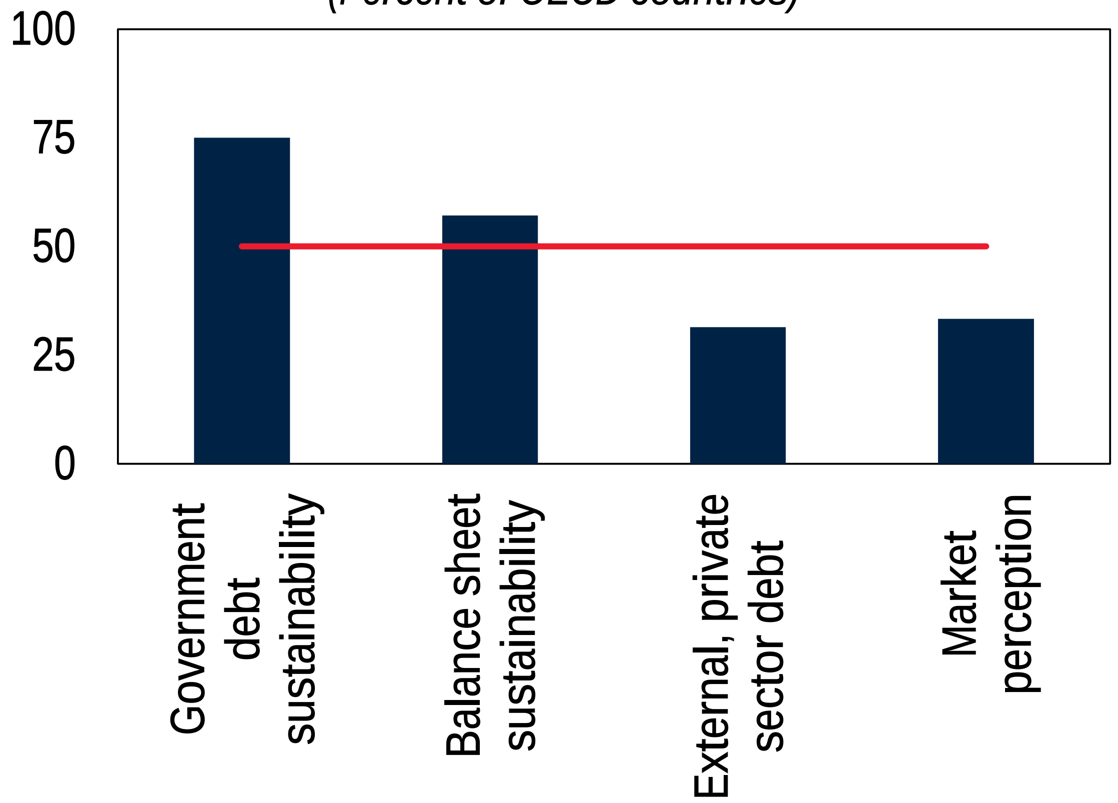
2

How has fiscal space evolved? *Deteriorated in EMDEs; deteriorated in some dimensions in OECD.*

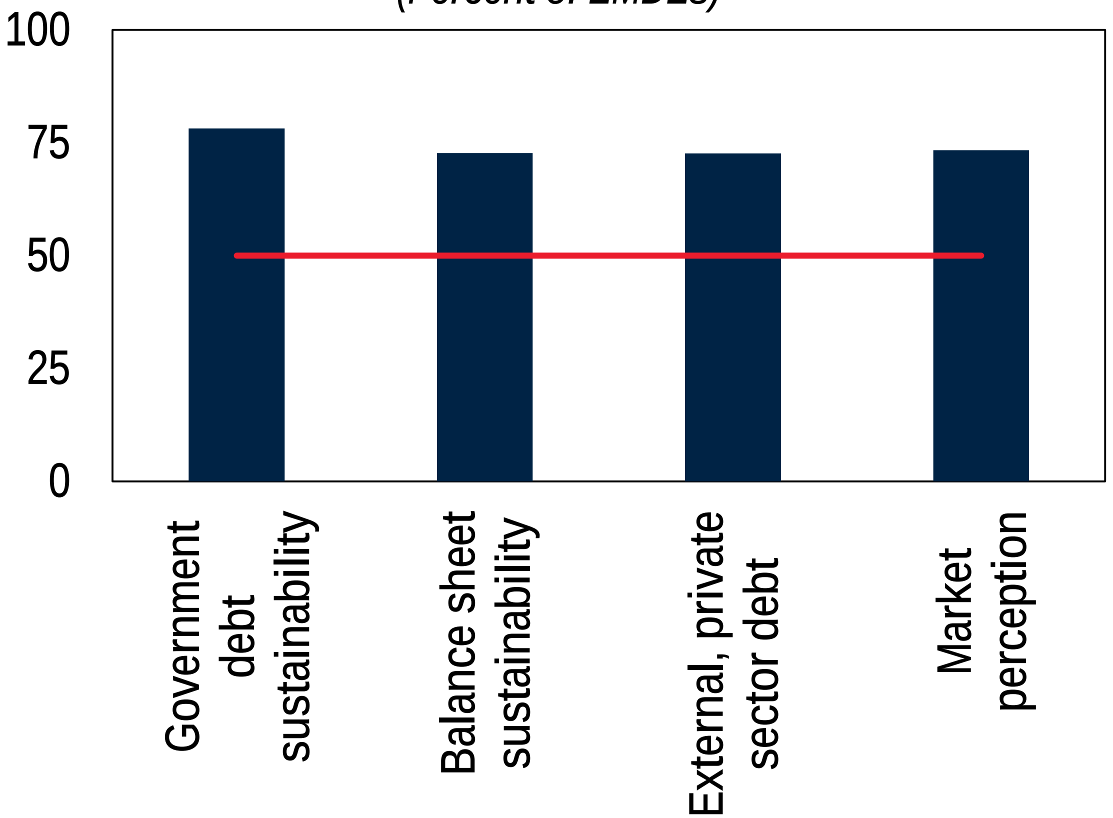
Fiscal Space:

Deterioration Since the Global Financial Crisis

OECD: Countries with Deteriorating Fiscal Indicators, 2007-2017
(Percent of OECD countries)



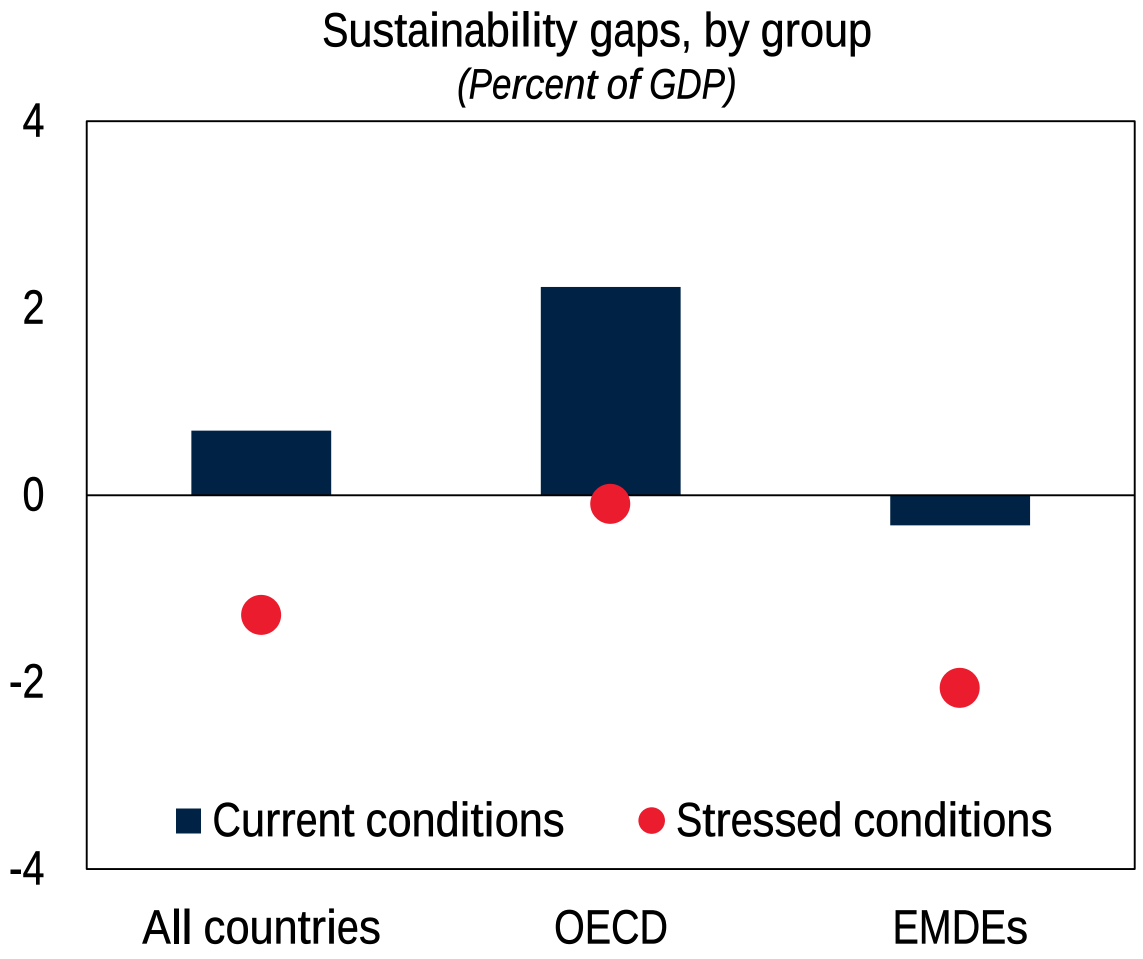
EMDEs: Countries with Deteriorating Fiscal Indicators, 2007-2017
(Percent of EMDEs)

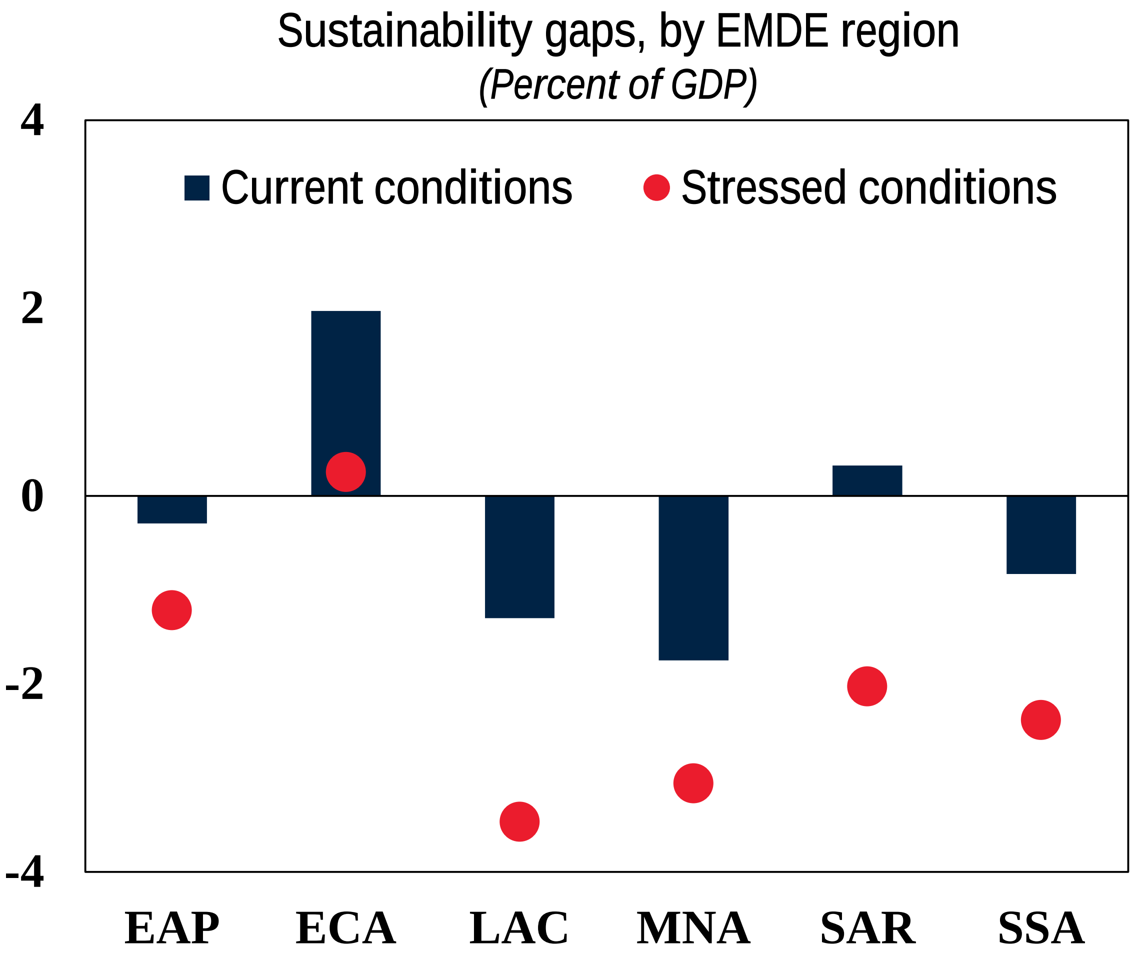


Source: Kose et al. (2017) "A Cross-Country Database of Fiscal Space."
Note: Share of 36 OECD countries (left panel) or 159 EMDEs (right panel) in which half or more of the 12 fiscal sustainability indicators, half or more of the 6 balance sheet indicators, half or more of the 8 contingent liabilities indicators, and at least one of the two perceptions indicators are worse in 2017 than in 2007. Missing data was substituted with the earliest or latest available data in the window 2007-2017. Red line denotes 50 percent.

Sustainability Gaps:

May Deteriorate Sharply When Conditions Tighten



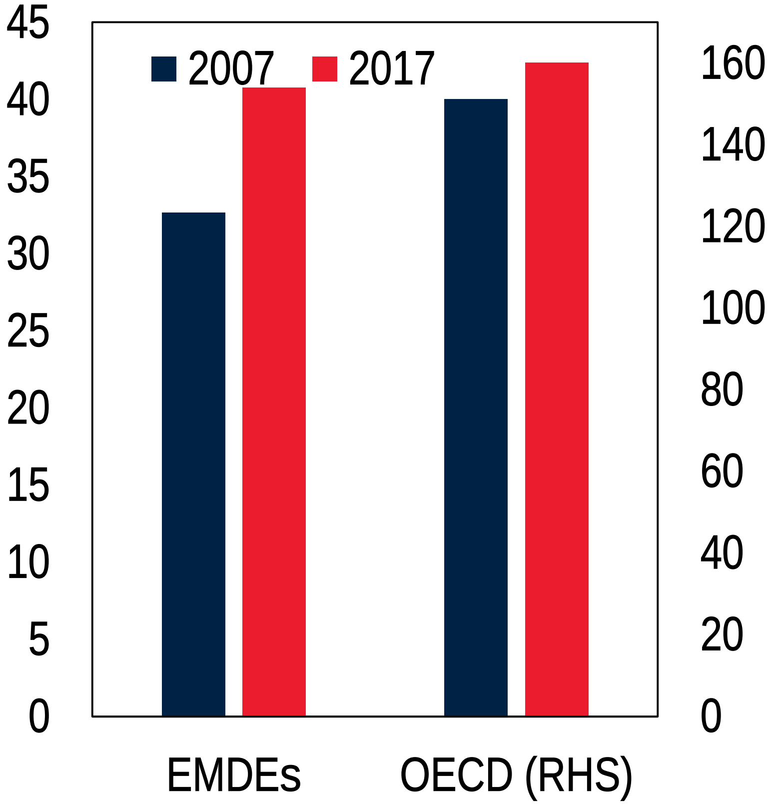


Source: Kose et al. (2017).

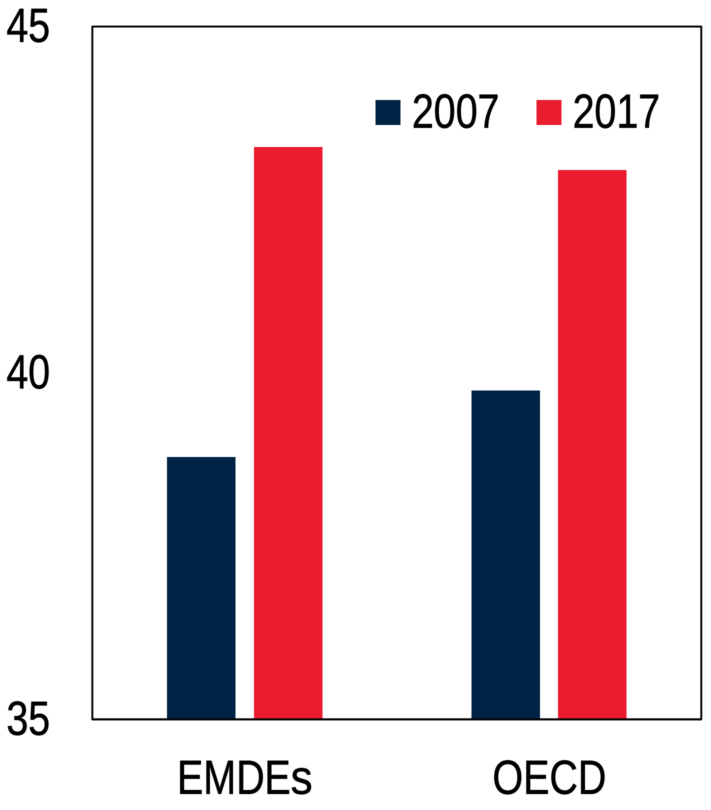
Note: Unweighted average of latest data (for 2017) by country group. A sustainability gap is defined as the difference between the actual fiscal balance and the debt-stabilizing balance that captures cumulative impact of sustained fiscal balance on debt stocks. A sustainability gap under "current conditions" is based on contemporaneous growth and interest rates. Under "stressed conditions" it is assumed that output growth is 1 percentage point lower and the interest rate is 1 percentage point higher in computing a debt-stabilizing balance. Left Panel. Based on 107 countries (36 OECD economies and 72 EMDEs). Right Panel. Based on 10 countries, 14 countries, 20 countries, 8 countries, 5 countries, and 15 countries in East Asia and Pacific (EAP), Europe and Central Asia (ECA), Latin America and the Caribbean (LAC), Middle East and North Africa (MNA), South Asia (SAR), and Sub-Saharan Africa (SSA), respectively.

Balance Sheets, Contingent Liabilities, Ratings:
Some Deterioration over Past Decade

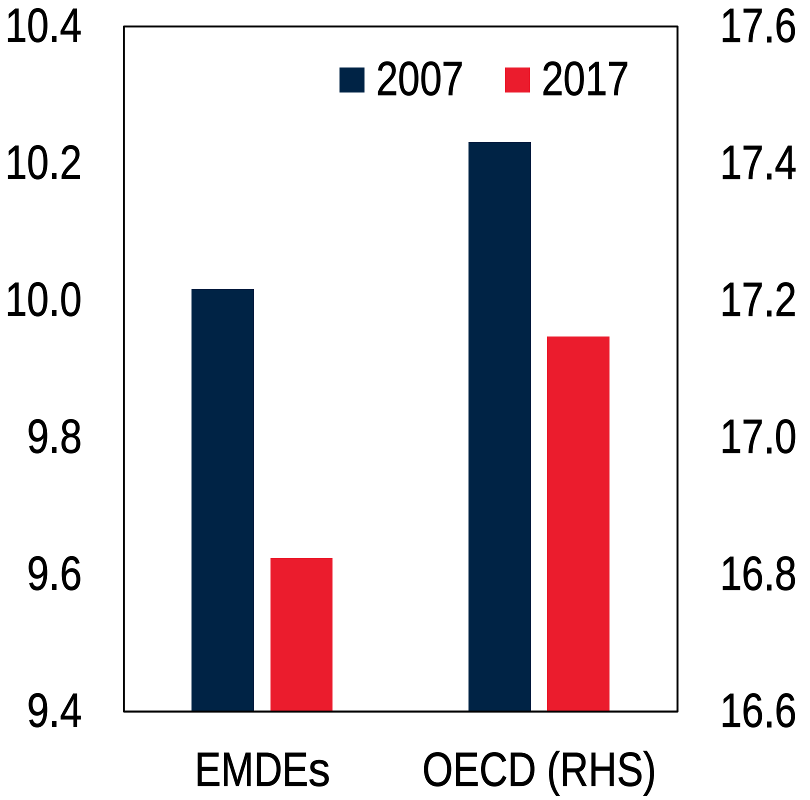
Credit to the private sector
(Percent of GDP)



Government debt held by non-residents
(Percent of government debt)



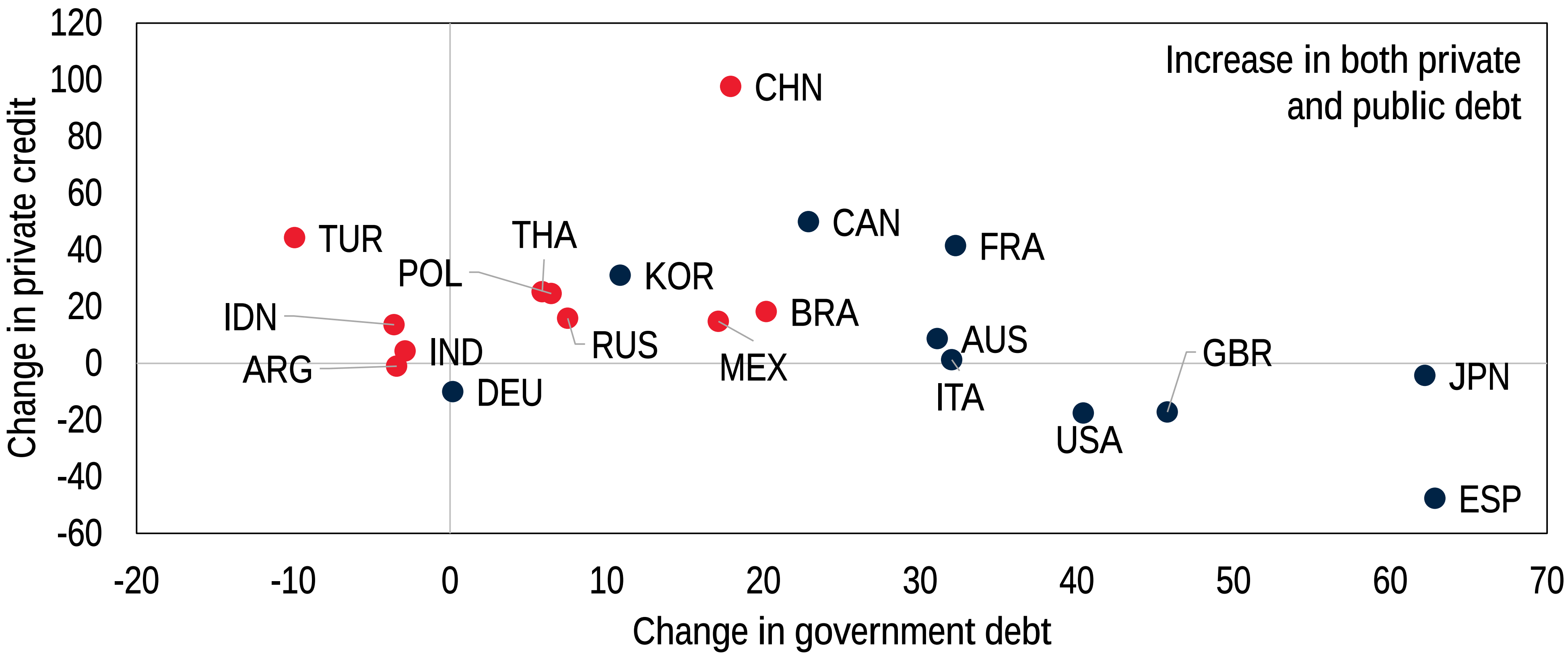
Long-term sovereign debt ratings
(Index, 1–21 [best])



Source: Kose et al. (2017).
Left Panel. Unweighted average of domestic credit to the non-financial private sector provided by commercial banks and, if data are available, by other financial corporations. Based on 123 EMDEs and 34 OECD countries (excluding Latvia and Lithuania). Center Panel. Unweighted average of the share of government debt held by nonresidents as estimated by Arslanalp and Tuda (2014), for 33 EMDEs and 33 OECD countries. To ensure a broader coverage, EMDE data starts from 2009 (and for the 24 EMDEs with available data in 2007-2009 the share was broadly stable). Right Panel. Unweighted averages of foreign-currency long-term sovereign debt ratings by Moody's, Standard & Poor's, and Fitch Ratings. Each rating is first converted to a numerical scale ranging from 1 to 21 (higher index = better rating). The scores below 12 are the non-investment grades. Based on 89 EMDEs and 36 OECD countries.

Diminishing Fiscal Space:
Different Dimensions Amplify Each Other

Change in government debt and credit to the private sector, 2007-17
(Percentage points of GDP)



Sources: International Monetary Fund, World Bank.
Note: Change in government debt in percentage points of GDP between 2007 and 2017 and change in credit to the private sector in percentage points of GDP between 2007 and 2017. Blue dots indicate advanced economies.

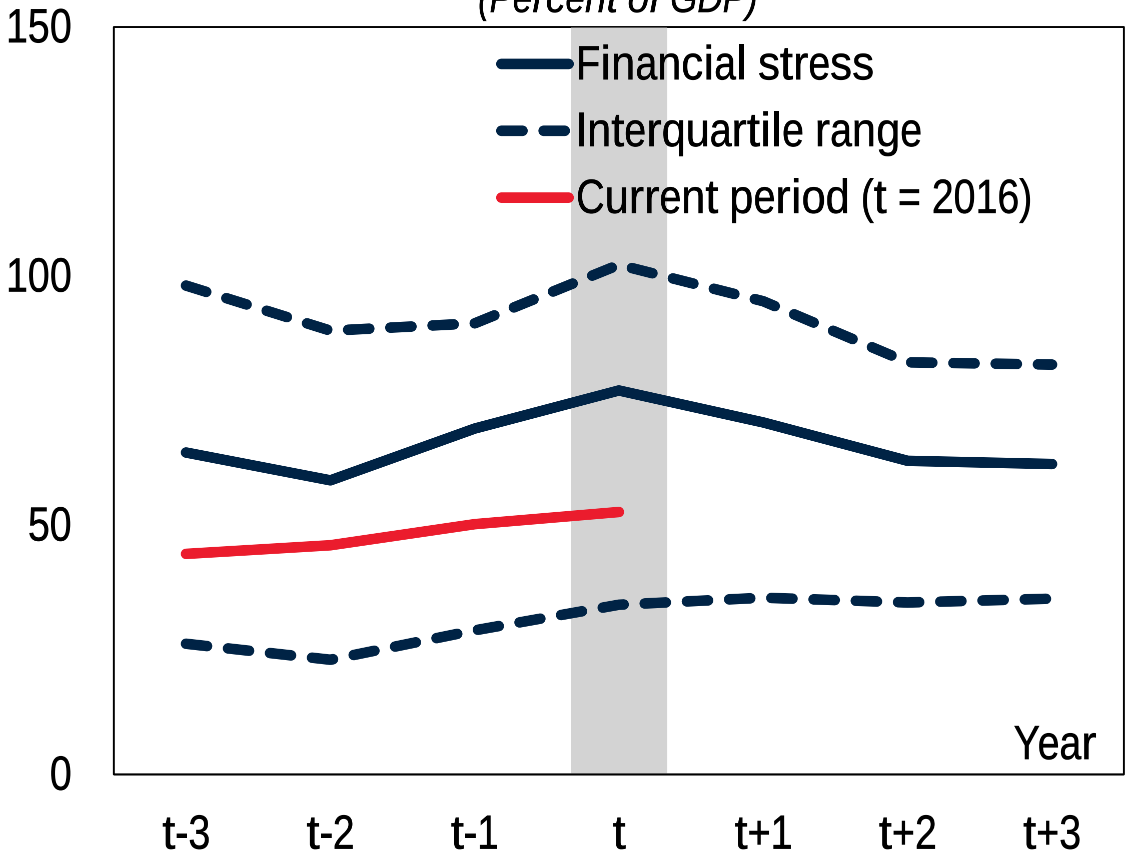
Three Questions

3

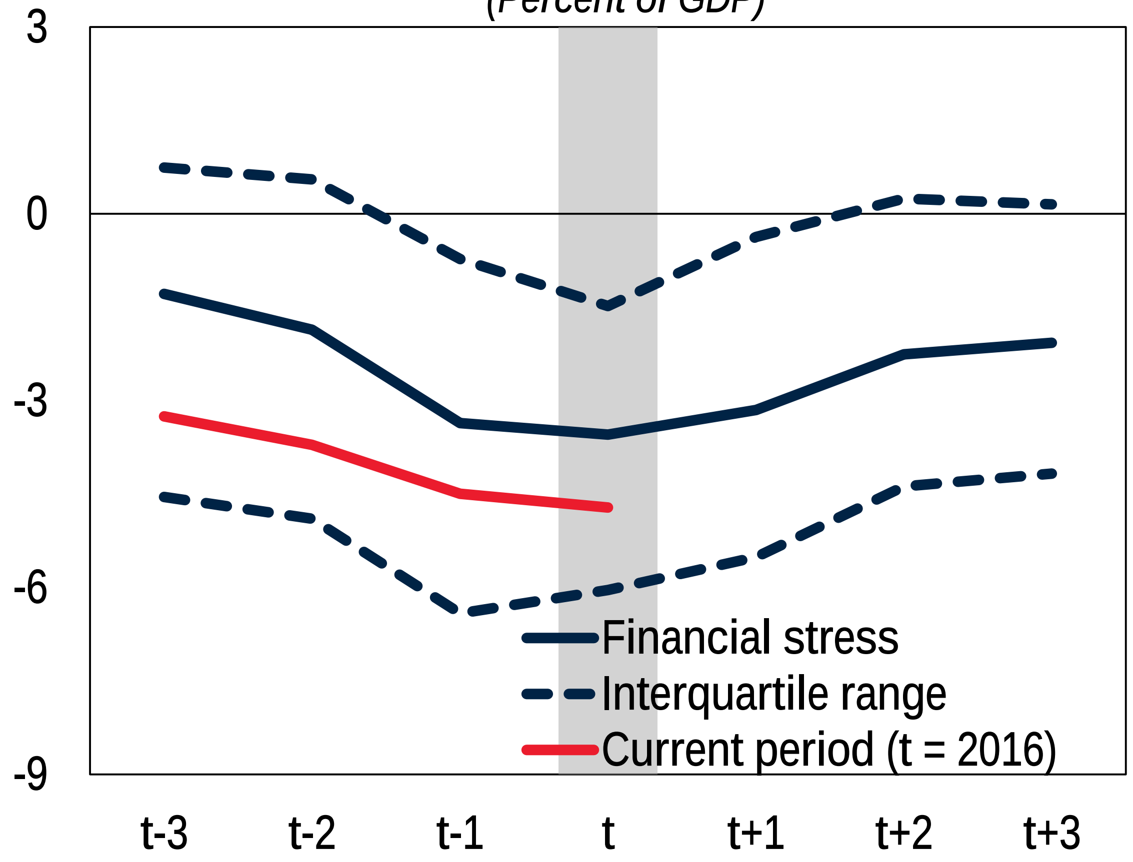
What does narrower fiscal space mean for fiscal adjustment? *Less effective fiscal policy.*

EMDE Government Debt and Deficits in Historical Context:
Somewhat Weaker Now than on the Eve of Previous Financial Crises

Government debt
(Percent of GDP)



Fiscal balance
(Percent of GDP)

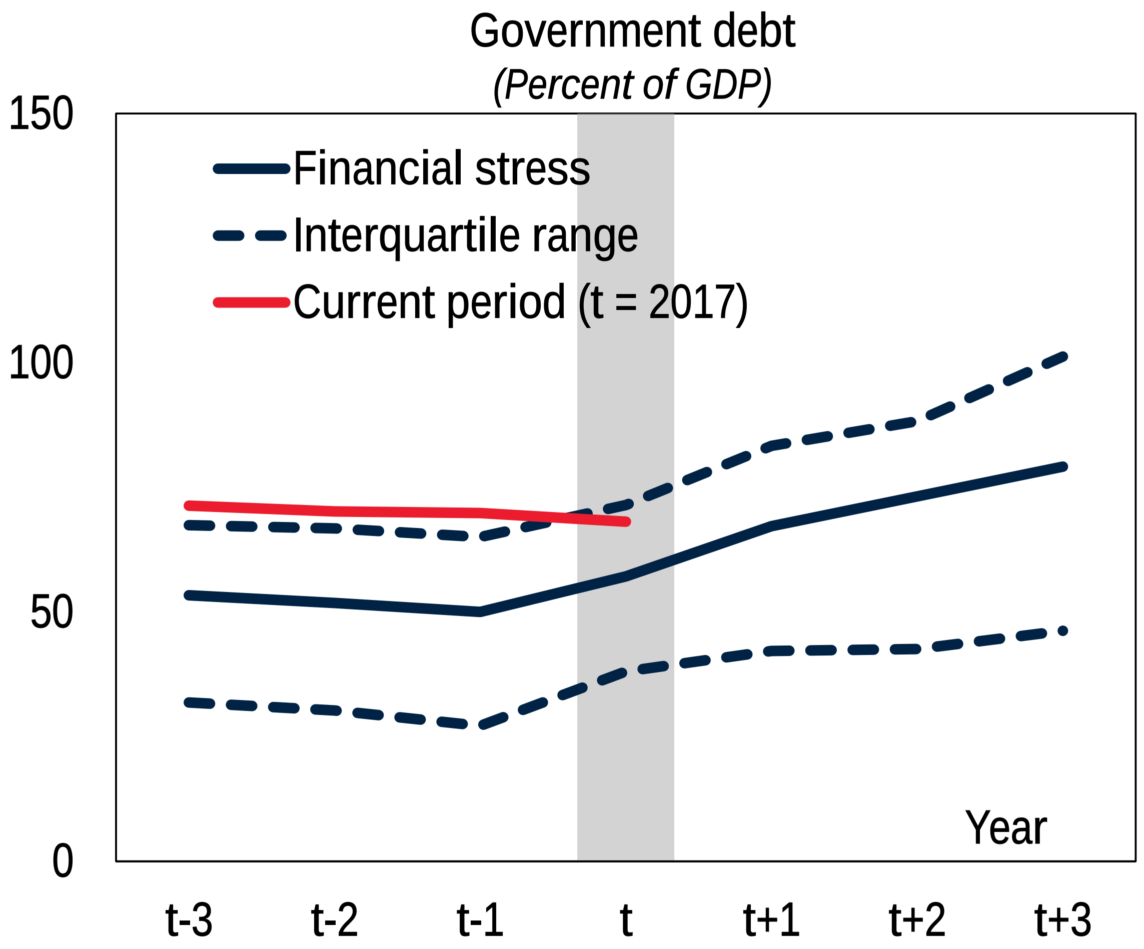


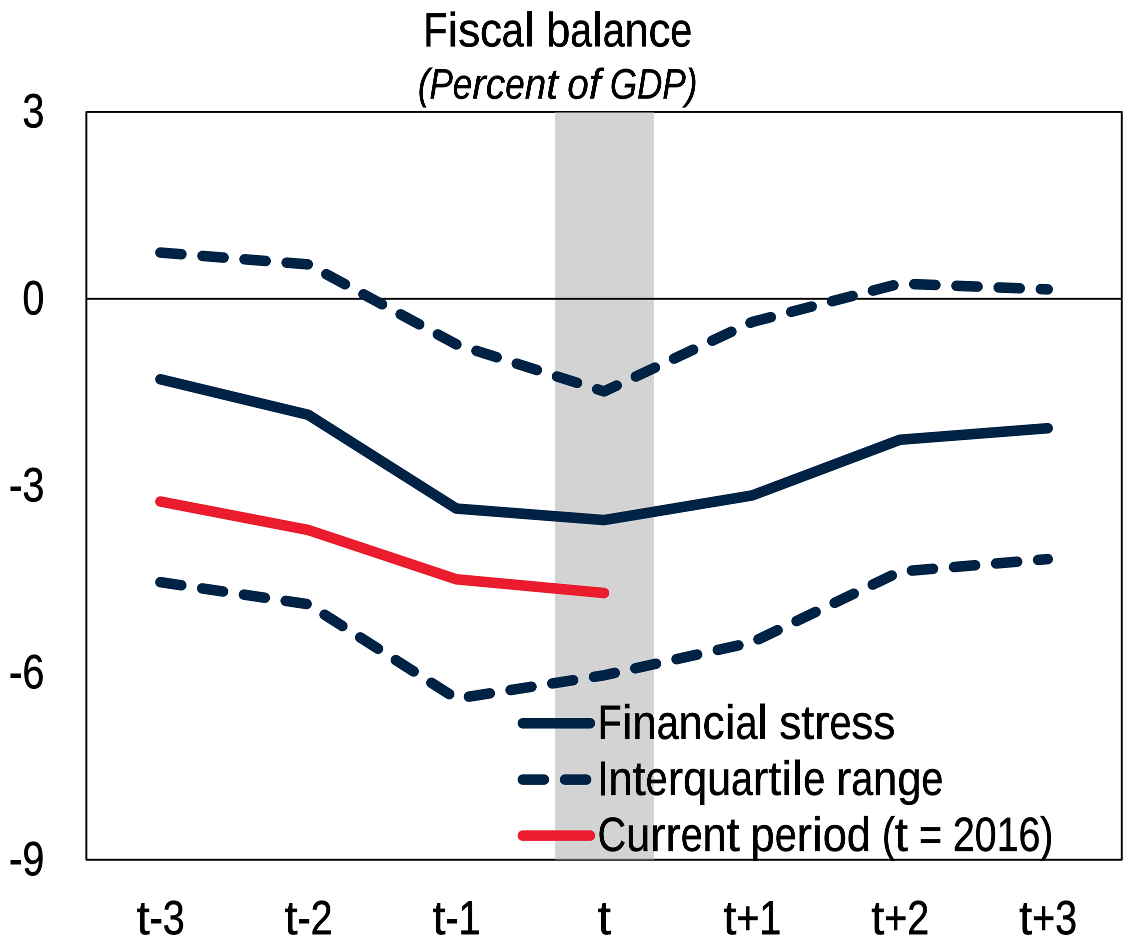
Sources: International Monetary Fund, World Bank.

Note: Unweighted averages. The dashed blue lines show interquartile ranges. Financial crises include all three types of crises: banking, currency, and debt crises. The red line is shown for reference and based on all EMDEs, although it is not a crisis episode. Crisis episodes are taken from Gourinchas and Obstfeld (2012) and Laeven and Valencia (2013). In any country, when consecutive crises are identified within the next five years, the one associated with the lowest real GDP growth is used. Left Panel. Government debt refers to liabilities that require payments of interest and principal by governments and includes, for example, debt liabilities in the form of currency and deposits, debt securities, and loans. It is for general government, and therefore, all transactions among government entities are consolidated.

OECD Government Debt and Deficits in Historical Context:

Weaker Now than on the Eve of Previous Financial Crises





Sources: International Monetary Fund, World Bank.

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Why Does Fiscal Space Matter for Fiscal Policy?

Because of Household and Investor Concerns

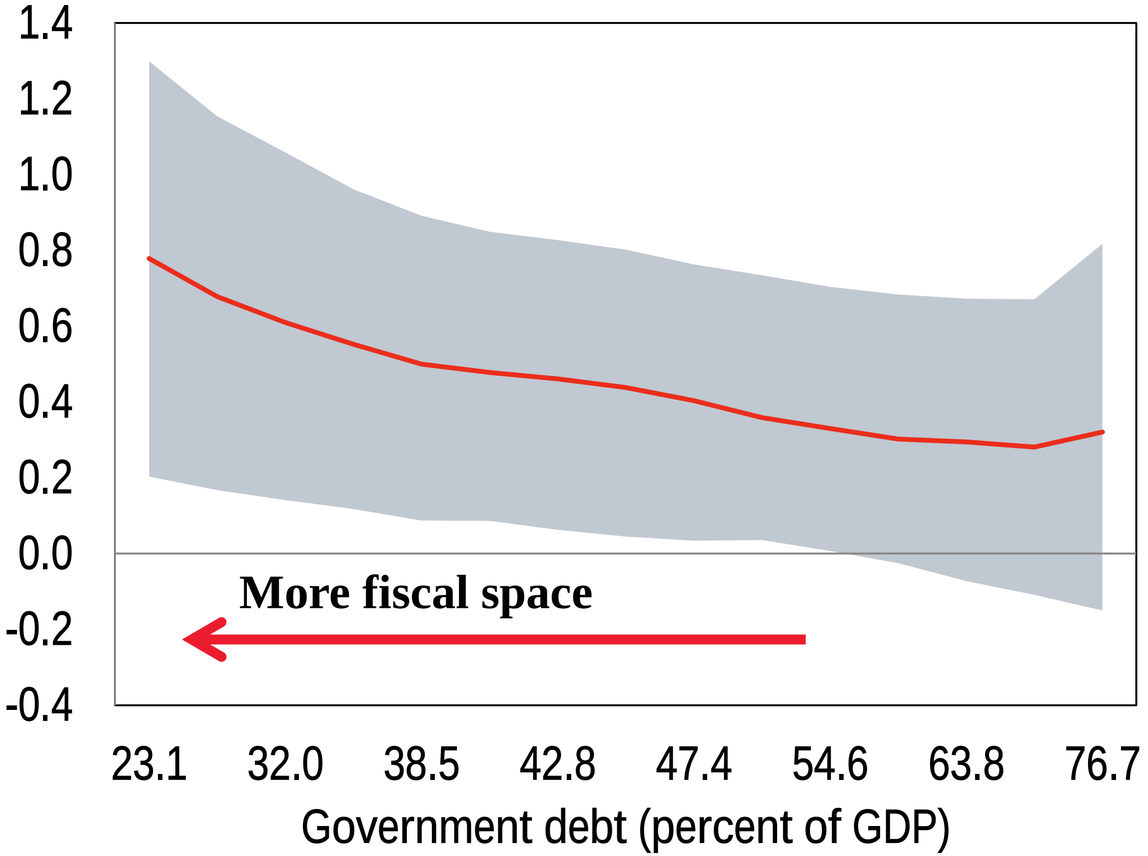
- *Ricardian channel:* When a government with little fiscal space implements stimulus, households anticipate tax hikes sooner. They save pre-emptively. This dampens private consumption (Perotti 1999).

- *Interest rate channel:* When a government with little fiscal space implements stimulus, investors become concerned about sovereign credit risk and raise their risk premia. This raises economy-wide borrowing cost and dampens private investment (Corsetti et al. 2012).

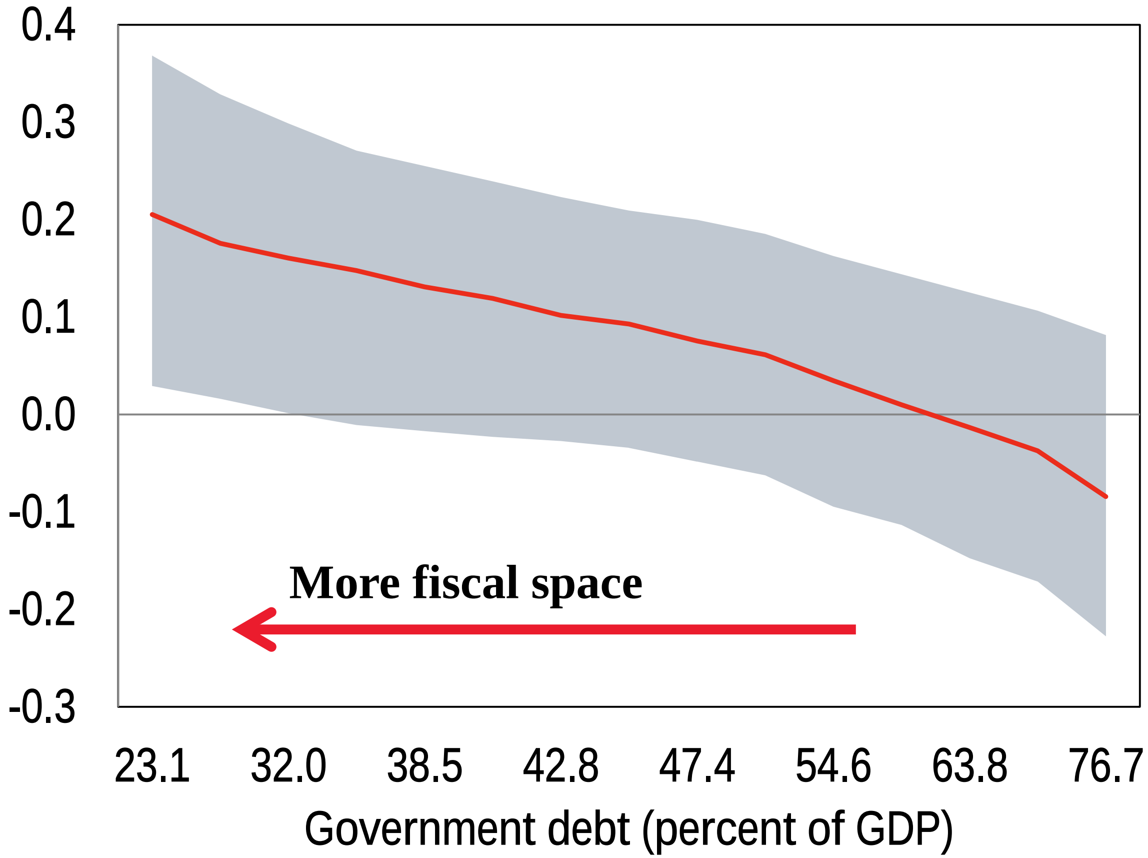
This results in lower fiscal multipliers.

Fiscal Multipliers and Fiscal Space:
Larger Fiscal Multipliers When Fiscal Space is Wider

Fiscal multiplier: On impact
(Change in GDP per unit of government spending)



Fiscal multiplier: After two years
(Cumulative change in GDP per unit of government spending)



Source: Huidrom et al. (2016).
Note: The graphs show the conditional fiscal multipliers for different levels of fiscal position at select horizons. These are based on estimates from the IPVAR model of Huidrom et al. (2016) for 19 advanced economies and 34 EMDEs, where model coefficients are conditioned only on fiscal position. Government debt as a percentage of GDP is the measure of fiscal position and the values shown on the x-axis correspond to the 15th to 85th percentiles from the sample. Fiscal position is strong (weak) when government debt is low (high). Solid lines represent the median, and dotted bands are the 16-84 percent confidence bands.

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Selected Publications by the Development Prospects Group

Kose, Kurlat, Ohnsorge and Sugawara (2017). "A Cross-Country Database of Fiscal Space." World Bank Working Paper 8157.

Huidrom, Kose, Lim and Ohnsorge (2016). "Do Fiscal Multipliers Depend on Fiscal Positions?" CEPR Discussion Paper DP11346.

Huidrom, Kose, Lim and Ohnsorge (2017). "Why Do Fiscal Multipliers Depend on Fiscal Positions?" Mimeo.

January 2015 *Global Economic Prospect* Report: Having Fiscal Space and Using It.

June 2017 *Global Economic Prospect* Report: A Fragile Recovery.

Thank you!

Questions & Comments

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www.worldbank.org/en/research/brief/fiscal-space