Who is Afraid of Fiscal Adjustment?

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Outline

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Objective & Rationale

Objective:

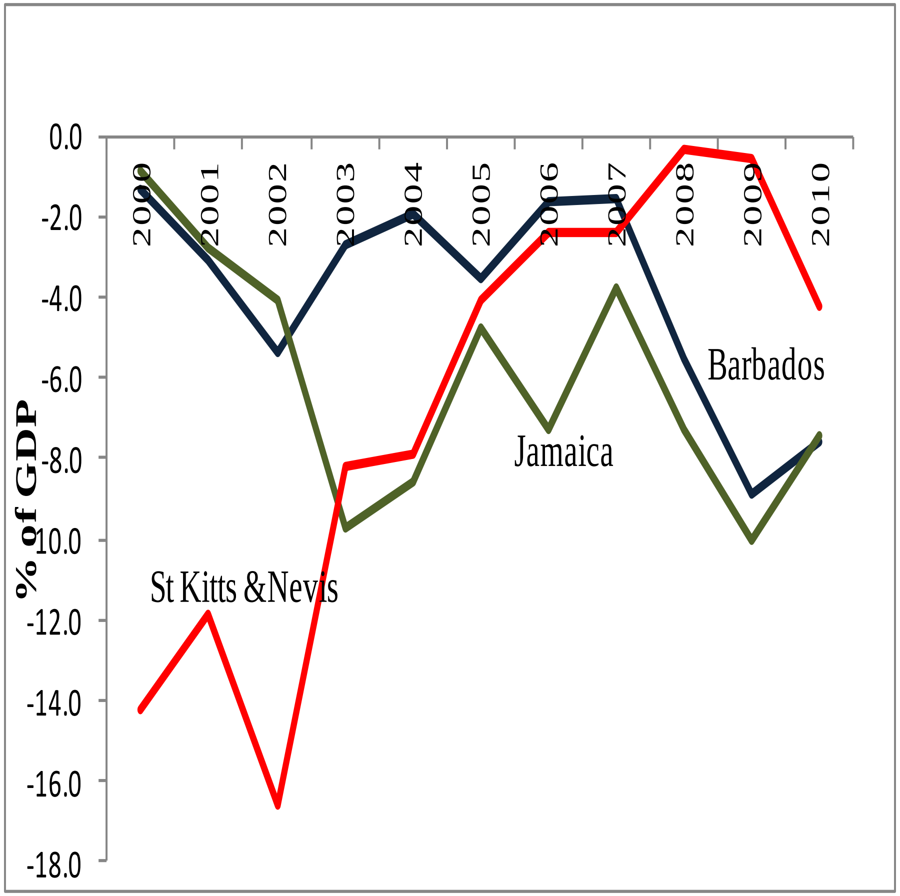
- **To critically assess fiscal sustainability in Barbados, Jamaica and St. Kitts and Nevis; countries with public debt that exceeded 100% of GDP at the end of 2010.**

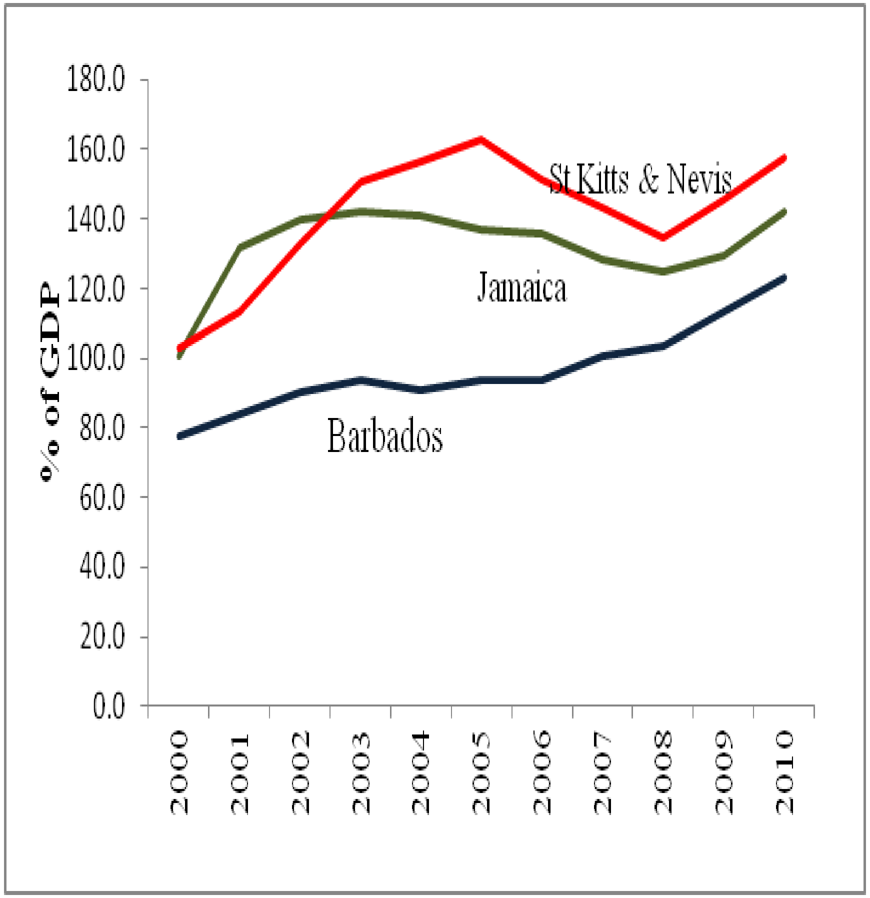
Rationale:

- Importance of fiscal and debt sustainability for growth and development.
- The large fiscal imbalances and high debt levels in the three countries suggest that fiscal adjustment will be required to anchor solvency expectations
- The need to explore the scale and composition of fiscal adjustments that policymakers may have to contemplate to put their fiscal deficit and debt on a sustainable path.

Research Problem

Acute Fiscal Challenges and High Indebtedness





Research Questions

1. What is the primary balance needed for a 25% point reduction in the debt ratio by 2015?
2. What is the fiscal adjustment required for a 25% point reduction in the debt ratio by 2015 given current fiscal policies?
3. What is the Primary Balance needed to stabilise the debt ratio at the 2010 level?
4. What is the value of the fiscal sustainability indicator?

Research Approach

The Accounting Approach:

- **Focuses on the debt-to-GDP ratio**
- **Assesses the mutual consistency of a number of fiscal sustainability indicators**
- **Implies that fiscal deficit is sustainable if it generates a constant debt-to-GDP ratio (the growth rate of real GDP must be larger than the real interest rate)**

Research Approach (Cont'd)

$$D_t = (1 + r_t)D_{t-1} - PS_t$$

$$\Delta d_t \equiv d_t - d_{t-1} = \frac{r_t - g_t}{1 + g_t} d_{t-1} - ps_t$$

$$ps^* = \frac{(r_t - g_t)}{(1 + g_t)} d_{t-1}$$

$$ps' = \frac{(\beta - 1)(\gamma - \beta^N)}{(1 - \beta^N)} d_t$$

$$ps' = \frac{(\beta - 1)(\gamma - \beta^N)}{(1 - \beta^N)} d_t$$

$$CI_t = (\beta - \gamma) = \left(\frac{1 + r_t}{1 + g_t} - \frac{ps_t - ps^*}{d_{t-1} - d^*}\right)$$

Research Approach (Cont'd)

- Fiscal sustainability analysis based on the respective country's fiscal outturn (debt ratio and primary balance-to-GDP ratio) at the end of 2010 and medium-term assumptions for real GDP growth and real interest rate.

- Scope of fiscal adjustment examined under three scenarios: (i) baseline, (ii) optimistic, and (iii) pessimistic.

Results: Baseline

Policy Questions on Medium-term Debt Sustainability Based on Fiscal Stance at Year-end 2010 and Medium-term Growth/Interest Rate Assumptions (Baseline Scenario) (% of GDP)			
	Barbados	Jamaica	St. Kitts and Nevis
What is the Fiscal Sustainability Indicator?	1.33	1.05	1.18
What is the primary balance needed for a 25% reduction in the debt ratio by 2015?	6.8%	6.7%	7.1%
What is the fiscal adjustment required for a 25% reduction in the debt ratio by 2015?	9.4%	2.3%	7.5%
What is the Primary Balance needed to stabilise the debt ratio at the 2010 level?	0.9%	-0.6%	-0.8%

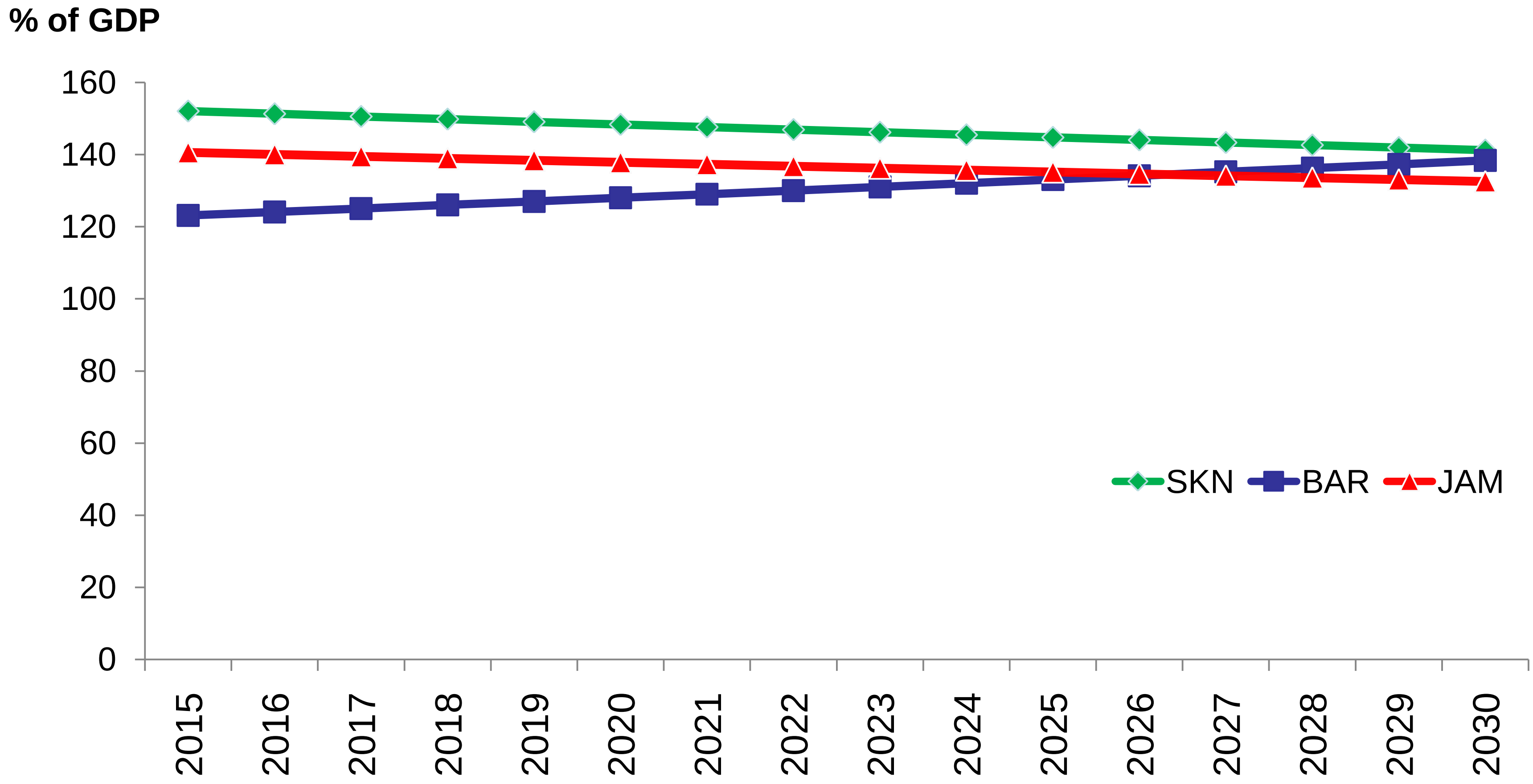
Results: Optimistic

Policy Questions on Medium-term Debt Sustainability Based on Fiscal Stance at Year-end 2010 and Medium-term Growth/Interest Rate Assumptions (Optimistic Scenario) (% of GDP)			
	Barbados	Jamaica	St. Kitts and Nevis
What is the Fiscal Sustainability Indicator?	1.24	1.01	1.15
What is the primary balance needed for a 25% reduction in the debt ratio by 2015?	5.93%	5.55%	5.76%
What is the fiscal adjustment required for a 25% reduction in the debt ratio by 2015?	8.53%	1.15%	6.16%
What is the primary balance needed to stabilise the debt ratio at the 2010 level?	-0.2%	-1.95%	-2.3%

Results: Pessimistic

Policy Questions on Medium-term Debt Sustainability Based on Fiscal Stance at Year-end 2010 and Medium-term Growth/Interest Rate Assumptions (Pessimistic Scenario) (% of GDP)			
	Barbados	Jamaica	St Kitts & Nevis
What is the Fiscal Sustainability Indicator?	1.42	1.08	1.24
What is the primary balance needed for a 25% reduction in the debt ratio by 2015?	7.82%	7.95%	8.76%
What is the fiscal adjustment required for a 25% reduction in the debt ratio by 2015?	10.42%	3.55%	9.16%
What is the primary balance needed to stabilise the debt ratio at the 2010 level?	2.1%	0.99%	0.77%

Debt Projections



Policy Implications

1. Growth-sensitive fiscal adjustment to anchor solvency expectations.
2. Policies should be designed and implemented in a manner that strike the right balance between the need to support economic growth and the need to restore fiscal and debt sustainability.
3. Well thought out debt reduction strategies will also be crucial.

The End