Fiscal sustainability in Curacao

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Structure

- Conceptual discussion of fiscal sustainability
- Fiscal stance in the Netherlands Antilles up till now
- Preliminary findings sustainable debt ratio
- Concluding remarks

When is the fiscal stance unsustainable?

At the point that the government fails to comply with its intertemporal budget constraint.

> At that point in time the outstanding debt is not matched by the present value of the sum of expected future primary surpluses.

Observations:

- Gradual policy changes needed to yield that outcome are compatible with sustainability.
- If drastic policy adjustments are required, the situation is unsustainable.

When is the fiscal stance unsustainable? *continued*

The one period government budget constraint may be expressed as follows:

(1) $\Delta B_t = G_t - T_t + rB_{t-1}$ *

B_t stands for the stock of outstanding public debt,

G_t stands for the primary public expenditures, i.e. exclusive of interest on the outstanding public debt,

T_t stands for the public revenues,

r stands for the implicit interest rate on the outstanding public debt, assumed constant.

* no monetary financing

When is the fiscal stance unsustainable? ***continued***

The budget constraint may also be presented with the variables expressed in terms of a ratio to the Gross Domestic Product, Y_t, as follows:

$$\Delta b_t \equiv b_t - b_{t-1} = g_t - t_t + \frac{(1+r)}{(1+y)} b_{t-1} \approx \underbrace{g_t - t_t}_{A} + \underbrace{(r-y)b_{t-1}}_{B} \tag{2}$$

y is the economic growth rate.

→ the dynamics of the debt ratio is determined by two terms: A and B.

Term A is the opposite of the primary balance and represents net public borrowing.

Term B gives the relation between the economic growth rate and the implicit interest rate on the outstanding public debt.

When is the fiscal stance unsustainable? *continued*

A stable debt ratio, i.e. $\Delta b_t = 0$ requires:

(3) $$\Delta b_t = 0 \Rightarrow g_t - t_t + (r - y)b_{t-1} = 0 \Leftrightarrow t_t - g_t = (r - y)b_{t-1}$$

- If the interest rate exceeds the economic growth rate, a primary surplus is needed to keep the debt ratio constant.
- If the economic growth rate exceeds the interest rate, a primary deficit may be compatible with a stable debt ratio.

So sustainability may be ensured or restored through the primary balance and/or economic policy by influencing the interest rate and the economic growth rate.

When is the fiscal stance unsustainable? *continued*

After some transformations (…..) we get the government intertemporal budget constraint:

(4)
$$b_t \approx -E_t \sum_{j=0}^{\infty} \frac{t_{t+j} - g_{t+j}}{(1+r)^j} + E_t \lim_{j\to\infty} \frac{b_{t+j}}{(1+r)^j}$$

→ For the fiscal stance to be sustainable the expected limit term must be zero so that the sum of the present values of expected primary balances equals the amount of current outstanding debt at any point in time.

This reflects the no Ponzi-game condition; the government is forced to pay off its debt at some point in time.

Operationalizing

Let T_t be the real public revenues and G_t the real public expenditures (inclusive of interest). Then, if $T_t \sim I(1)$ and $G_t \sim I(1)$, a necessary and sufficient condition for sustainability is T_t and G_t to be cointegrated with cointegrating vector (1, 0, 1) in the following equation.

(5) $T_t = \delta_0 + \delta_1 * G_t + \varepsilon_t$

- If T_t and G_t are cointegrated and $\delta_o \leq 0$ and $\delta_1 \geq 1$ the fiscal stance is <u>also</u> sustainable.
- If T_t and G_t are cointegrated, but $\delta_1 < 1$ the fiscal stance may not be sustainable.

Assessment of fiscal sustainability is country specific

To assess the sustainability of the fiscal stance we need a baseline trajectory for public debt based on the assumptions underlying the macroeconomic framework.

Crucial:

- Realism of baseline scenario, especially growth and interest rate assumptions.
  - How does this compare to no policy change scenario and history?
- Coverage of fiscal data.
  - Off-budget public entities like SOEs (guarantees) and PPPs may pose risks,
  - Ageing related long term spending pressures (pension and health care) may have a sizeable impact on the fiscal stance.

Assessment of fiscal sustainability is country specific, *continued*

- Aside from the trend the level of the debt ratio is key
  - large primary surpluses are needed to service high public debt levels; such surpluses may be politically not sustainable.
  - high public debt levels exacerbate an economy's vulnerability to shocks.
  - high public debt levels are generally associated with higher borrowing requirements, and therefore expose a country to higher refinancing risks.

    Many countries use a ceiling of 60 percent of GDP as an anchor for fiscal policy.
- Vulnerabilities associated with the debt profile.
- The assessment's outcome may depend on whether a gross or net debt figures are considered.
  - Are you issuing debt to finance current expenditures or capital expenditures?

Fiscal stance in the Netherlands Antilles

The former Netherlands Antilles implemented several structural reforms intended to restore fiscal balance and foster economic growth. Evidence based research shows the contrary:

- No evidence of fiscal sustainability;
- A regime shift might have occurred in the Central government's budget dynamics during the fiscal consolidation program, specifically in 1999, yet not sufficient to guarantee fiscal sustainability.

As a consequence:

- the economy lagged behind trading partners and other Caribbean economies;
- budget deficits persisted.

Debt relief and restructuring

Constitutional changes in 2010 along with a public debt relief and restructuring program:

- the public debt of the former Netherlands Antilles was partially paid off by the Netherlands. This occurred for the outstanding stock of public debt in excess of an agreed threshold.
- Curacao kept each a share of the public debt up to that threshold.
- finally, this public debt was restructured as well.

Outcome of debt relief and restructuring

Prior to debt relief and restructuring		**After debt relief**		**After debt relief and restructuring**	
Public debt	Interest burden	Public debt	Interest burden	Public debt	Interest burden
3.563 million	232 million	1.647 million	74 million	1.667 million	49 million

Despite the significant debt reduction and interest savings, challenges faced:

- consolidation measures in the social security system needed,
- downsizing of the public apparatus needed,
- budget dynamics: expenditures growing much faster than the revenues.

Conditions

This agreement was conditioned to the introduction of a new set of fiscal rules and the setup of an external independent supervisory body to monitor the compliance to these fiscal rules.

New set of fiscal rules:

- A multi-annual golden rule: current public expenditures not to exceed current public revenues and borrowing is allowed only to finance public capital expenditures.
- Ceiling for the interest burden: not to exceed 5% of the average public revenues in the preceding three years.

Objective: contain the growth of public debt and assure sustainable public finances.

Baseline scenario for the assessment of debt sustainability in Curaçao

Set of assumptions: budget dynamics contained in the draft Budget 2017

inflation rate of 1.5%

→ First preliminary findings: in a no public debt scenario fiscal sustainability is preserved if the real growth rate averages at least 0.8%.

This means that the current budget dynamics can only be preserved if economic growth averages at least 0.8%.

→ This represents a critical growth threshold.

Compliance to the fiscal rules for different growth and interest scenarios

- Set of assumptions: budget dynamics contained in the draft Budget 2017
  inflation rate of 1.5%
- Simulations are performed using respective economic growth scenarios of: 0.85% and 1.0%.
- Simulations are performed using the following respective interest rate scenarios of: 7%, 5%, 4%, 2.69% and 1%.

Preliminary findings sustainable debt ratio

Economic growth rate	Interest rate				
	7.00%	5.00%	4.00%	2.69%	1.00%
0.85%	26%	36%	36%	43%	58%
1.00%	42%	64%	81%	≥100%	≥100%

→ The higher the growth rate and the lower the interest rate, the higher the sustainable debt ratio is, as expected.

Next question: debt ratio ceiling more binding than the existing fiscal rules?

Economic growth rate		Interest rate 7.00%	5.00%	4.00%	2.69%	1.00%
0.85%	Sustainable debt ratio	3	3	2	2	2
	Interest rule	2	2	3	3	3
	Balanced current account	1	1	1	1	1
1.00%	Sustainable debt ratio	3	3	3	3	2
	Interest rule	2	2	2	2	3
	Balanced current account	1	1	1	1	1

1 is more binding than 2, 2 is more binding than 3.

→ The simulations show that the current account balance rule is the more binding rule the lower the interest rate and the lower the growth rate.

→ The debt ceiling rule is the less binding the higher the growth rate.

Next question: debt ratio ceiling more binding than the existing fiscal rules? *Continued*

→ In the current circumstances, where the interest rate is very low, a debt ceiling rule becomes more binding but the current account balance rule is still the stricter and consequently more binding.

Concluding remarks

→ Fiscal sustainability is important, because it determines the need for future discretionary and drastic policy actions.

→ The sensibility analysis shows that compliance to the fiscal rules is highly dependent on economic growth.

→ The simulations yielded the preliminary conclusion that a debt ceiling is not necessarily more binding than the existing fiscal rules.

→ The simulations yielded the preliminary conclusion that the current budget dynamics are sustainable only if the economy grows at least 0.8%.

Concluding remarks, *continued*

- → From 1979 up to 2015 the economy grew on average less than the critical average minimum of 0.8%.
  - → Risk of fiscal unsustainability and non-compliance with the fiscal rules.
- → For the past decades, economic growth was constrained by the unsustainable situation of the fiscal stance. The debt relief and restructuring as well as the fiscal consolidation undertaken have removed this obstacle to growth.
- → No debt ceiling rule is generally applicable. We need one, but more urgently economic growth is necessary to ensure compliance to any debt ceiling rule.
- → The authorities should continue to implement the necessary reforms to increase the growth potential of the economy.