

VIVES

Briefings

2011
19 OKTOBER

The impact of Ageing and Financial Sector Support on the Sustainability of Belgian Public Finances

Bas van Aarle & Joep Konings

bas.vanaarle@uhasselt.be

[tel] +31 6-53560613

joep.konings@econ.kuleuven.be

Het Vlaams Instituut voor Economie en Samenleving, Vives, is een economisch onderzoekscentrum dat via fundamenteel en toegepast onderzoek wil bijdragen tot het maatschappelijk debat inzake de economische en maatschappelijke ontwikkeling van regio's, in het bijzonder van Vlaanderen. VIVES is als onderzoekscentrum wetenschappelijk en juridisch geïntegreerd binnen de K.U.Leuven. Vives werkt ook samen met research fellows uit andere universiteiten.

The Impact of Ageing and Financial Sector Support on the Sustainability of Belgian Public Finances

Bas van Aarle & Joep Konings

*In deze briefing analyseren we de houdbaarheid van de Belgische overheidsfinanciën aan de hand van een eenvoudig macro-economisch model. Dit laat ons toe de impact van een aantal schokken te analyseren. We beperken ons in deze briefing tot twee, nl. de impact van vergrijzing en de impact van het redden van banken en vergelijken dit met een 'baseline' scenario. We tonen telkens het effect van een 'optimistisch' scenario en vergelijken dit met een 'pessimistisch' scenario. De simulaties tonen aan dat kleine wijzigingen in de kosten van vergrijzing of de kosten van financiële 'bail out' aanleiding kunnen geven tot langdurige effecten op de overheidsfinanciën. Het is daarom belangrijk een begroting op te stellen gericht op **consolidatie**, gekoppeld aan **structurele maatregelen** zodat op middellange termijn er geen ontsporing zou optreden van de Belgische publieke financiën.*

Motivation

The collapse of Lehman Brothers and the global banking crisis and worldwide recession that emerged during the Fall of 2008, triggered a swift response of Central Banks and policy makers. Central Banks provided the required liquidity to restore confidence and governments throughout the world implemented fiscal stimuli in a coordinated fashion¹. Three years later, however, the banking crisis turned into a sovereign debt crisis for a number of (mostly) European countries. Apart from prominent cases like Greece, Portugal and Ireland, also Belgium has been a few times in the interest of financial markets, even if so far no downgrading has taken place. Two factors that often have been cited are the political uncertainty, associated with a two-year political stalemate surrounding the attempts to realise a broad institutional overhaul of the fiscal institutions, and a high debt level resulting from the recent fiscal deterioration in the aftermath of the global financial crises of 2008-2010. On the positive side, it is noted the economic slowdown affected Belgium –e.g witnessed in terms of unemployment effects- to a lesser extent than some other euro area countries and also short and medium term growth potential of the Belgian economy appears to be less affected than e.g. Greece by the debt problems.

Speculation in global markets about the Belgian case is not only evidenced by the evaluations from the rating agencies but also by a small but persistent risk premium on Belgian bonds relative to German bonds since 2009. Recently this spread has been increasing, although not in the same proportion as countries like Italy and Spain, which also have witnessed sharply increasing debt levels in the last few years.

This briefing is based on a recent VIVES discussion paper that analyzes Belgian fiscal sustainability. In particular, we focus here on describing the impact of two pressing challenges, the first concerns the budgetary costs of ageing, the second is the financial sector support, i.e. bailing out the banking sector and in particular the latest one, DEXIA. To this end, we use a stylized model of public finances, which allows us to assess the long run impact of changes in the macroeconomic environment.

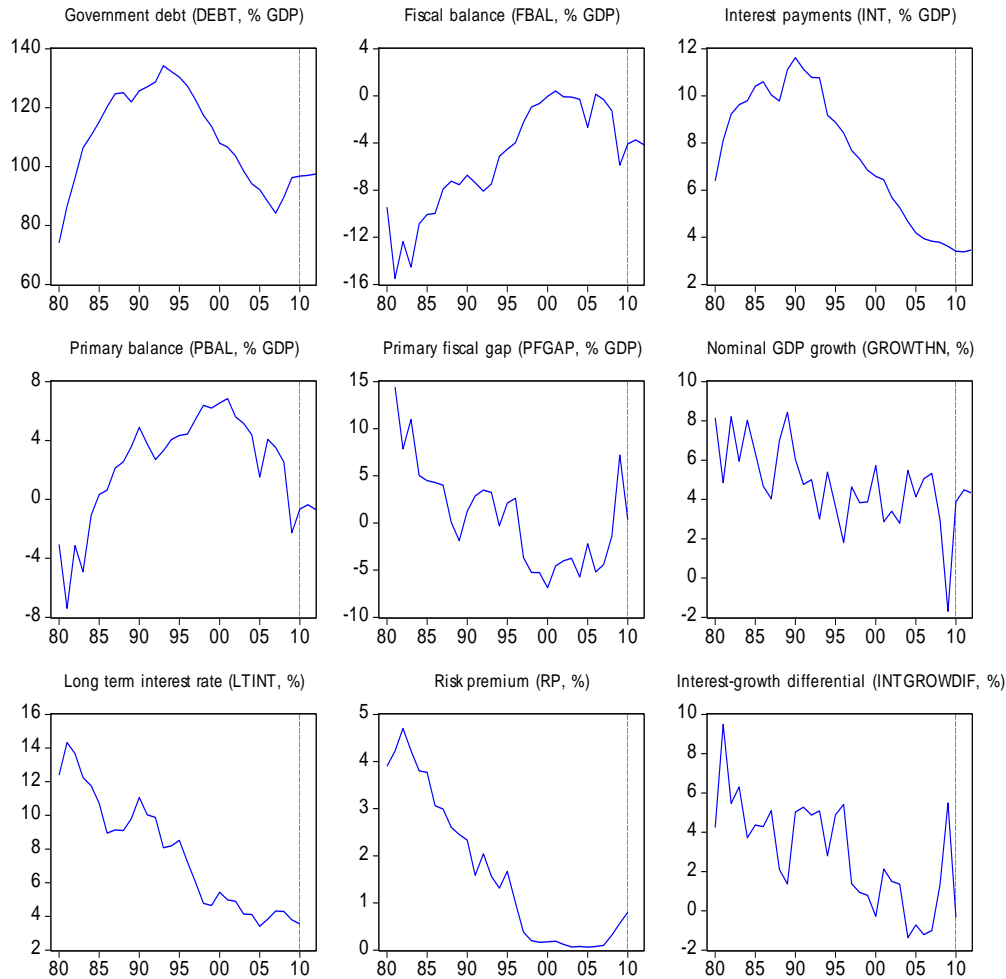
Background

In order to understand current public finances and challenges, it is useful to first scrutinize the main fiscal developments in the recent and more distinct past. Figure 1 summarizes the main budgetary and macroeconomic trends that are observed during the period from 1980 to 2010. All data are from the EU's AMECO database. The general picture on sustainability of Belgian public finances is relatively mixed: a rather high level of debt is still present despite the substantial fiscal restructuring during the period 1990-2005. The recent global economic and financial turmoil has also impacts on Belgium and a significant number of challenges and vulnerabilities remain. These are both on the growth front as on public finances themselves, think e.g. about the costs of ageing and possible losses from financial guarantees to the banking sector. Clearly it is very difficult to assess how sustainable public finances are currently and in the near and less near future. From Figure 1, it seems that at best there is a mixed picture of sustainability of public finances. In the first half of the sample public finances were clearly on an unsustainable path with exploding government debt, reaching almost 140% of GDP, negative fiscal balances and accumulating interest payments. This contrasts with the

¹ E.g. the European recovery program and the various G20 summits.

second half when fiscal consolidation reduced government debt and deficits significantly. Indeed, more formal tests (stationarity and cointegration tests) confirm mixed formal results of the sustainability of public finances in the past (for details we refer to the technical discussion paper). This makes it even more interesting to also assess the possible budgetary adjustment that Belgium is facing in the near and longer future.

Figure 1: Fiscal and macro-economic variables, Belgium, 1980-2012.



Note: Source: AMECO (Data for 2011-2012 concern projections)

Fiscal sustainability in Belgium: Simulating a number of scenarios for 2011-2030.

Fiscal sustainability can not only be defined in terms of observed behaviour of fiscal deficits, debt, expenditures and revenues in the past, but also in terms of a forward-looking approach by considering alternative scenarios for the near future and beyond and assess their implications in term of budgetary sustainability. In this section, we analyse a number of

budgetary scenarios that could be relevant from the perspective of sustainability of Belgian public finances. Our analysis refers to the Belgian consolidated government and we refrain from a more detailed, decentralised analysis of the public finances of federal government and social security (s.c. entity I) and regional and local governments (s.c. entity II), notwithstanding the considerable number of important and interesting issues that can be raised in this respect.

Underlying our analysis is a small simulation model of public finances, which is explained in detail in the appendix. The intuition of the model is straightforward. In particular, we set out a number of standard relationships that describe well the dynamics of public finances. In our model the debt-to-GDP ratio results of the deficit to GDP ratio, the GDP growth rate and a stock-flow adjustment (i.e. a once and for all extra loan to e.g. bail out Dexia). We further specify a relationship in which primary government spending depends on interest expenditures, and expenditures that are related to ageing. We also assume that the nominal interest rate is defined as the sum of the real interest rate, (expected) inflation, and a risk premium. The risk premium in turn depends on the level of debt, which seems reasonable to do. With higher debt levels, public finances become more sensitive to interest rate changes due to their impact on interest burdens and thereby on the fiscal balance. In our simple simulation model there is also an additional non-linear mechanism that enters into force: with increasing debt also the risk premium start to increase, adding an additional interest burden.

The risk-premium-debt relation could reflect in a stylized way the possible credit-rating down-grading by rating agencies when debt increases and doubts arise if long-run fiscal sustainability is guaranteed. In fact, the rating agencies Standard and Poor's, Fitch and Moody's have repeatedly assessed a possible downgrading of Belgium in the last two years, referring to political uncertainty but also. Whether or not this would be justified, such downgradings would increase the risk-premium on Belgian debt and increase the borrowing costs.

We set out a baseline scenario for the period 2011-2030 and analyse the consequences for budgetary sustainability of 2 alternative scenarios. In the first scenario, we consider the effects of a financial sector bail-out. In the second scenario we consider the effects from ageing costs on public finances.

While the baseline scenario should not be considered necessarily as the most realistic scenario, we give it a number of features that could be a useful benchmark. We assume a real growth rate of 1.7%, an inflation rate of 2% and a real interest rate of 1.7%. These values are based on the historical averages during the period 1980-2010. Primary government expenditures and government revenues are set to 49% and 50% of GDP close to their 2009-2010 values- and implying a structural primary balance of 1%, close to the official Belgian objective of its Stability Program 2011-2014. In the period 2000-2007 Belgium managed generate a primary surpluses of the order of 1% and more, after 2007 the primary balance deteriorate to around -1%. Clearly, it is not certain that after the financial crisis and economic slowdown of 2008-2010 such a positive primary balance can be regained even if large priority to is given to improve the primary balance. Simulating the model with these baseline assumptions result in the adjustment of public finances shown in Figure 2 and 3 by blue lines. The baseline scenario yields a practically flat profile of public finances during the period 2010-2030: government debt decreases somewhat from its starting value of 97% of GDP to 91% by 2030 while the total deficit is practically constant at the 3% deficit target of the Maastricht Treaty. This results from a baseline where growth equals the interest rate so that debt dynamics are borderline stable, combined with a small primary surplus. A slightly negative primary fiscal balance gap indicates throughout the period public finances are sustainable. Clearly this baseline scenario implies sustainable public finances even if the fiscal consolidation can be hardly considered ambitious and not compatible

with the European Stability and Growth criteria to reach a 60% debt ratio. This baseline scenario is moreover vulnerable to a number of potential challenges as we will analyse in the following alternative scenarios.

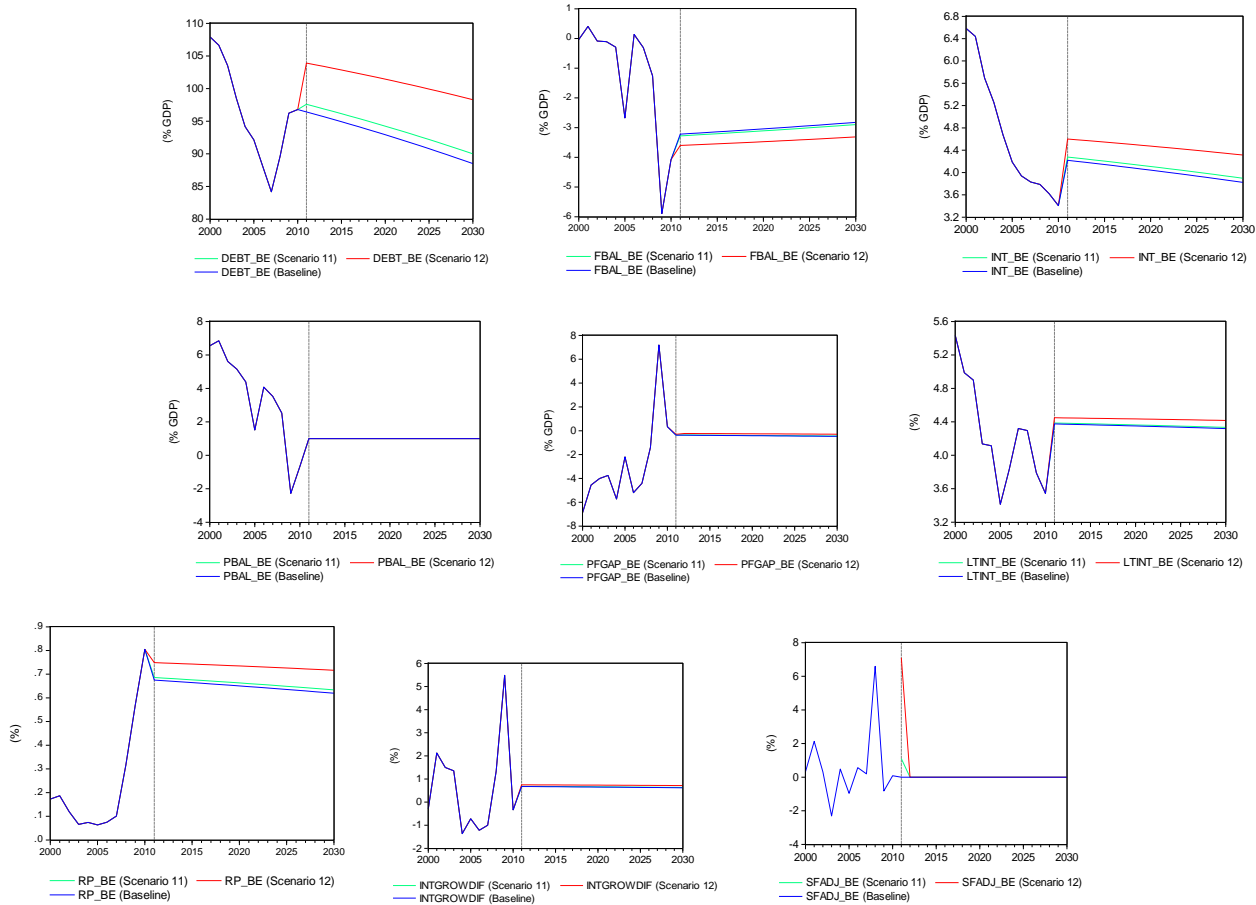
The impact of financial sector bail-outs: the example of Dexia

Directly in the aftermath of the Lehmann collapse and the resulting global financial turmoil, the Belgian government was forced in 2008 to carry out substantial support interventions to the Belgian system banks (Fortis, Dexia, ING and KBC) to stock up their capital. More recently in October 2011, renewed support was required to avoid a collapse of Dexia. Part of the bank was acquired by the state for an amount of 4bn euro. (In addition, a state guarantee of up to 54bn euro on bad loans was provided, clearly a much larger potential risk in the long-run). To finance this intervention, of course, additional borrowing by the government is needed. While gross government debt increases to the full amount of this operation -due to what is technically a stock-flow adjustment-, net debt of course would only increase to the extent that the participation would turn out to be loss-making, or in the worst case worthless when Dexia would still go bankrupt. In a very positive scenario, the bank would recover quickly and the State would as a sole proprietor now, benefit from considerable profits and valuation gains.

In Figure 2 we want to assess the budgetary impact of such an operation to safeguard the financial system. In Scenario 11 a one-time positive stock-flow of the size of 1.1% of GDP in 2011 is carried out that measures the budgetary impact of the support operation and acquiring of a part of Dexia. In Scenario 12 a much larger one-time positive stock-flow adjustment of 7.1% of GDP is carried out –reflecting a very negative scenario where not only the budgetary costs of acquiring Dexia are counted (1.1% of GDP as in Scenario 11) but also a cost of 6% of GDP that would be incurred if 40% of the loan guarantees provided by the Belgian State on bad loans -as part of the Dexia deal- would indeed be invoked (here assumed immediately in 2011, in practice this could also be (much) later, for the sake of the argument this assumption is not too crucial).

The budgetary effects of this intervention are not negligible, especially in the extended Dexia bail-out variant. In addition to the initial stock-flow adjustment that puts public debt on a higher level, the financial market interventions affects public finances through their effects on interest payments, including an effect on the risk premium, and thereby deteriorating fiscal balance and debt. This case makes clear that even a one-time fiscal intervention, in the form here of a one-time injection in the form of financial sector support, may have longer-term fiscal consequences, through debt accumulation, interest costs –including risk-premium effects. The effects increase when the ‘recovery rate’ of these support interventions declines. These simulations do not take other secondary effects into account. For instance, potential downgrading by the credit agencies of Belgium as a result of such bail outs are not considered here, but it is clear that the impact on public finances would deteriorate further.

Figure 2: Budgetary effects of an (extended) Dexia bail-out



Note: Baseline scenario Belgian public finances 2011-2030 (blue lines), 1.1% of GDP budgetary costs of financial sector/Dexia bail-out (Scenario 5, green lines) vs 7.1% budgetary costs of financial sector/extended Dexia bail-out (Scenario 6, red lines).²

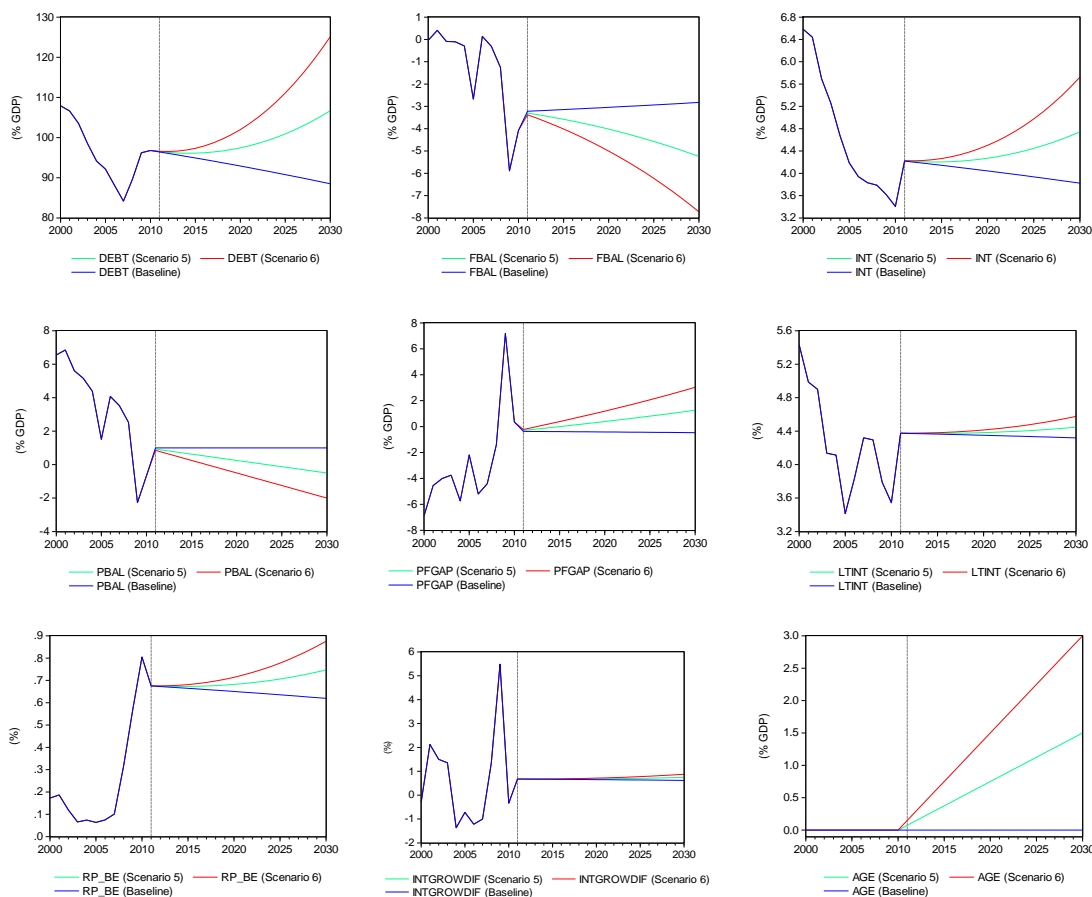
The impact of ageing

Estimates from e.g. the OECD suggest that a country like Belgium may face ageing costs in the order of 0.1% each year during the period 2010-2030 and even beyond. Taken together this implies a significant cumulative costs from ageing in the order of 3% of GDP. In the baseline and other scenarios so far we ignored these additional budgetary costs –or maybe better, we assumed implicitly that these costs were matched by equivalent reductions in other non-ageing related budgetary expenditures.³ Scenario 5 and 6 introduces extra government spending relating to ageing: Scenario 5 considers relatively contained budgetary costs from ageing, 0.075% cumulative each year during the period 2011-2030, Scenario 6 assumes substantial budgetary costs, 0.15% cumulative each year during the period 2011-2030.

² In the figures the following abbreviations are used DEBT: debt to GDP ratio, FBAL: fiscal balance to GDP ratio, PBAL: primary fiscal balance to GDP ratio, GEX: government spending to GDP ratio, INT: interest payments to GDP ratio, LTINT: long-term interest rate on government bonds, RP: risk premium on government bonds, INTGROWDIF: interest rate-growth rate differential, PFGAP: primary fiscal balance gap to GDP ratio, AGE: ageing costs variable, SFADJ: stock-flow adjustment.

³ This scenario is also considered by the High Council of Finance (2009). Standard and Poor's (2010) use a value of 0.3% for the annual ageing costs. This assumption leads to a rather dramatic deterioration of Belgian fiscal variables and seems a bit unrealistic.

Figure 3: Budgetary costs of ageing



Notes

Baseline scenario Belgian public finances 2011-2030 (blue lines), 0.075% annual increase in ageing costs (Scenario 5, green lines) vs 0.15% annual increase in ageing costs (Scenario 6, red lines).

Over time the costs associated with ageing are clearly eating into the public finances: increasing government spending, deficits and debt result in particular towards the second halve of the period. Without being accompanied by fiscal consolidation, ageing, in other words can markedly deteriorate the fiscal situation.

Conclusions

Small permanent –or even temporary- changes in crucial factors to the deficit –interest rate (including risk premium assessments in international bond markets), economic growth, budgetary costs of ageing or costs of safeguarding the financial system e.g- can have significant influence on the course of public finance. Belgium is clearly finding itself on a crossroad currently: embarking upon a path of fiscal consolidation vs a status quo or fiscal slippage that would turn out to be harmful in the longer term. The political indecisiveness is a major risk that no clear vision and strategy emerges on budgetary adjustment in the near and longer term. Taken together with a high initial debt level, this constitutes risks in terms of budgetary sustainability in the longer run.

We have tuned in on just two factors that may affect fiscal sustainability to point out the precarious situation Belgian public finances is in. In particular, we simulated the impact of a change in interest rates and the impact of ageing. A first result is the importance of the interest for the dynamics of the fiscal variables in the longer run: a small reduction in interest rate delivers important gains in limiting/preventing the “debt snowball” we still observe quite significantly in the baseline scenario. Given that interest rates are only very indirectly under control of policymakers, fiscal prudence requires to be very cautious regarding projections on interest rates, and considering the possibility that interest rates could get higher than projected, given the financial unstable markets and credit rating risks that Belgium is facing.

Ageing costs constitute another clear risk to the medium and long-run sustainability of public finance. To the extent that politicians would underestimate the budgetary costs of ageing, there remains a serious threat to fiscal sustainability in Belgium.

Finally, one-time financial sector support measures –while potentially necessary to keep floating a financial system in turbulence- are not likely to be budgetary neutral and risk to generate longer term budgetary effects through their effects on interest burden and risk premia, as bond markets may perceive a larger risk.

The message of this briefing is clear. The challenge is twofold: First, the Belgian government must come up with a credible budget that shows substantial consolidation efforts, second, these consolidation efforts should be compatible with structural reforms that provide an answer to challenges such as ageing, competitiveness of the economy and growth. If this is not achieved, the risks of unsustainable public finances are quite pervasive.