A balance-sheet approach to fiscal policy

By Kemal Derviş
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Everyone is talking about debt, citing huge nominal figures that strongly affect public-policy debates worldwide. But all debt is *not* created equal.

For starters, when it comes to public debt, there is a big difference between the gross and net figures. While Japan's gross public debt, for example, is a massive 246% of GDP, the net figure, accounting for intra-government debts, is 127% of GDP.

Moreover, what should really matter about a country's public-debt burden is the expected annual cost of servicing it. As Daniel Gros recently pointed out, debt that can be rolled over indefinitely at zero interest rates is no debt at all. This is an extreme example; but the closer a fixed interest rate gets to zero, and the longer the maturity becomes, the lower the burden of the stock of debt.

Although Greece's public debt amounts to about 175% of GDP, low interest rates – which are fixed for a large proportion of it – and long maturities mean that it may be more manageable than it seems. Greece's ratio of public-debt service to GDP is similar to that of Portugal, or even Italy. Indeed, that is why the latest deal with Greece, which entails even more bailout funds, could work, as long as the country is accorded the debt reprofiling that it needs to reverse the decline of its GDP, reduces its primary surpluses, and pursues balance-sheet-strengthening reforms.

Such considerations underscore why it is a mistake to focus only on annual budgets, without adequate regard for the long-term balance-sheet implications of how borrowed money is used. This narrow, short-term focus differs from the approach taken for publicly traded companies, for which the strength of the balance sheet and the economy's potential are emphasized, alongside annual income statements.

Imagine, for example, that Germany borrows at a 1% fixed real interest rate with a ten-year maturity and invests the proceeds in repairing domestic transport infrastructure. These investments bring a modest real financial rate of return of 4% through fees, tolls, and, in the longer run, tax revenues (stemming from an increase in GDP). Such investments would directly strengthen Germany's public-sector balance sheet. This does not even take into account social returns, accrued through reduced traffic congestion and cleaner air.

Beyond infrastructure, spending to improve education – specifically to ensure that the next generation receives the skills they need to contribute to the twenty-first-century economy – would also result in faster GDP growth. And it, too, would likely yield significant social returns.

For governments with access to today's extremely low – and often negative – real interest rates, it may seem like a no-brainer to borrow and invest more in projects with long-term benefits. Doing so would strengthen their balance sheets, crowd in the private sector, and generate employment. But balance-sheet calculations are rarely at the center of political debate.

To be sure, some progress is being made toward bringing longer-term considerations into annual budget rules. Bodies like the European Commission increasingly distinguish between the structural and cyclical components of a budget deficit, and thus consider potential output, which increases with investment, in their calculations. But this is only a small step in the right direction.

For a long-term balance-sheet approach to gain traction, politicians will have to drop the ideological biases that are distorting fiscal policy. Proponents of austerity currently use nominal debt figures to scare voters, even in countries with record-low interest rates and large private-sector profits that are not being channeled toward investment. To counter their arguments, opinion-makers should emphasize the expected long-term returns on incremental public investment, not with ideological arguments, but with concrete examples from various sectors in the recent past that have had reasonably good rate of returns.

Of course, as the economist Charles Wyplosz has explained, debt sustainability analysis is inherently uncertain. But some needs can reasonably be anticipated. Amid massive unmet demand for new climate-compatible infrastructure and for workers with modern skillsets, any semi-competent government should be able to demonstrate the likelihood of significant real returns on incremental investment.

In many countries, one could realistically expect a 4% average return on at least one percentage point of GDP worth of incremental investment. If the marginal real interest rate is 1%, an increase in public investment would actually *reduce* future indebtedness. Of course, it is possible for too large of an increase to put pressure on real interest rates, thereby crowding out potential private investment. If there is significant exchange-rate risk, such as in non-reserve currency countries, that, too, should be taken into account.

Current fiscal-policy debates should not focus on simplistic headline numbers. To strengthen public accounts, both conservatives and progressives should start promoting a long-term balance-sheet-oriented approach to policymaking, ensuring that the debates are based on relevant data. Otherwise, the wrong policies – and, with them, anemic GDP growth and sluggish job creation – will continue to prevail.

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