How would a new crisis affect Latvia's government debt?

The debt rule established by the Fiscal Discipline Law[1] limits general government debt[2] to 60% of GDP[3], which corresponds to the limit established in the Maastricht Treaty. Currently, after a sharp increase during the crisis, in recent years government debt has stabilised and hovered at 38%-40% of GDP. The Council believes that the persistence of deficit spending needs to be addressed and carefully considered to allow bringing the debt levels down more rapidly. Fiscal rules were introduced to limit the growth of the budget deficit, which is the main cause of the increase in government debt.

Among the aims of FDL is the promotion of countercyclical fiscal policy. This means that the government should run surpluses when the economy is growing fast, and allow deficits only when the economy performs below its potential. In the last 20 years, the government of Latvia has consistently practiced deficit spending, even during periods of fast economic growth[4].

An often cited paper by Reinhart and Rogoff[5] has posited that government debt above 90% of GDP has a negative effect on growth, but this claim has also been contested. Various other debt thresholds[6] have been proposed in academic literature, and a linear relationship between debt and growth has not been clearly observed. However, a rising debt trajectory has been shown to have a negative effect on long-term growth prospects[7]. Growth is hampered by debt servicing costs, rising interest rates attached to higher debt levels, as well as borrowing opportunities and increased costs to the private sector.

Both the level and growth rate of government debt should be sustainable, so that the debt can be serviced even as the economy enters into unfavourable period of the cycle – a crisis.[8] Assessments of sustainable debt levels should be context-specific**.** There is no universally applicable debt threshold or a context-independent sustainable level of government debt. For this reason, the Council suggests focusing on issues specific to Latvia and adopting specific long-term targets for the level of government debt, taking into account the potential impact of the economic cycle.

Since the late 1980s, a new approach to debt management has emerged[9]. The move towards improving the quality of government debt management is underpinned by the recognition that rising debt servicing costs will put a strain on budget expenditure. Furthermore, in conjunction with prudent macroeconomic and fiscal policies, debt management based on clear objectives is a prerequisite for absorbing and containing financial shocks.

The most recent global financial crisis led to increased levels of public debt. According to Ostry, Ghosh and Espinoza[10], the average level of government debt rose by almost 27 percentage points during the period between 2007 and 2012. This is the largest increase in average government debt levels since World War II. In the European Union, debt levels rose by 26 percentage points. The effect of the financial crises and its aftermath was even more pronounced in Latvia, and its debt level rose by 33 percentage points (Table 1).

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[1] Hereafter - FDL

[2] Hereafter - government debt

[3] Chapter 1, Section 14 of the Fiscal Discipline Law, which corresponds to the limit established by the Maastricht Treaty.

[4] For more information see Rutkaste, U. *Fiskālās disciplīnas nozīme Latvijā un eiro zonā*, available at: https://www.makroekonomika.lv/latvijai-jatiecas-uz-bezdeficita-budzetu-jau-2017-gada, accessed on 4 December 2015.

[5] Reinhart, C. M. and Rogoff, K. S. *Growth in a Time of Debt*, NBER Working Paper No. 15639, available at: http://www.nber.org/papers/w15639, accessed on 08.12.2015.

[6] Debt threshold refers to a debt level above which economic growth is hampered.

[7] Chudik, A., Mohaddes, K., Pesaran, M. H. and Raissi, M. *Is There a Debt-threshold Effect on Output Growth?,* available at: https://www.imf.org/external/pubs/cat/longres.aspx?sk=43260.0, accessed on 08.12.2015.

[8] See *Revised Guidelines for Public Debt Management*, International Monetary Fund & the World Bank, March 2014, available at https://www.imf.org/external/np/pp/eng/2014/040114.pdf, accessed on 4 December 2015.

[9] Wheeler, G. *Sound Practice in Government Debt Management,* pieejams: http://elibrary.worldbank.org/doi/abs/10.1596/0-8213-5073-0, skatīts 08.12.2015.

[10] Ostry, J. D. Ghosh, A. R. And Espinoza, R. *When Should Public Debt be Reduced?*, available at: https://www.imf.org/external/pubs/cat/longres.aspx?sk=42931, accessed on 08.12.2015.

	2007	2008	2009	2010	2011	2012	Increase in debt 2007 - 2012
EU 28	57.8	61.0	73.0	78.4	81.0	83.8	26.0
Estonia	3.7	4.5	7.0	6.6	5.9	9.5	5.8
Latvia	8.4	18.7	36.6	47.5	42.8	41.4	33.0
Lithuania	15.9	14.6	29.0	36.2	37.2	39.8	23.9

Table 1. Government debt as % of GDP. Data source: Eurostat.

Low debt level is essential to allow a country to weather another crisis – a downturn in the business cycle, disruption in the financial system, geopolitical shocks or a combination of the above. Countries with the capacity to borrow and service their debts will have better access to new loans in the case of a crisis. This, however, depends on the opinion of the lenders regarding the borrower's ability to repay the borrowed funds, including interest and charges representing the lenders income. This ability depends heavily on institutional strength and the capacity of financial management, as well as the burden of previously accumulated debts.

The case of Latvia: 2008-2010 crisis and future prospects

Our analysis attempts to determine how much GDP decline Latvia can afford, while still being able to comply with the 60% government debt-to-GDP criterion, as specified in the FDL and the Maastricht Treaty. Calculations are based on the assumption that the potential impact of GDP decline on government debt will be proportional to the most recent financial crisis (2008)[11]. We should stress that the following is based on rough estimates and a more in-depth analysis is required for a definite statement regarding the issues outlined above. Our work merely attempts to draw attention to several important questions that should be considered in the context of government debt.

First, if we look at the historical interaction between the nominal GDP and government debt as a percentage of GDP, we can observe that **nominal GDP decline was directly reflected as an increase in government debt during the 2008 – 2010 crisis** (Charts 1 and 2). From 2007 to 2010, the debt-to-GDP ratio increased by 39.1 percentage points – from 8.4% of GDP in 2008 to 47.5% of GDP in 2010. We can conclude that during an economic downturn the gap between government expenditure and government revenue widens, resulting in larger budget deficits and, consequently, increasing government debt. However, during years of positive GDP growth, government debt does not decrease substantially, which is not in accordance with the principles of countercyclical fiscal policy. This is primarily due to the government's practice of deficit spending.

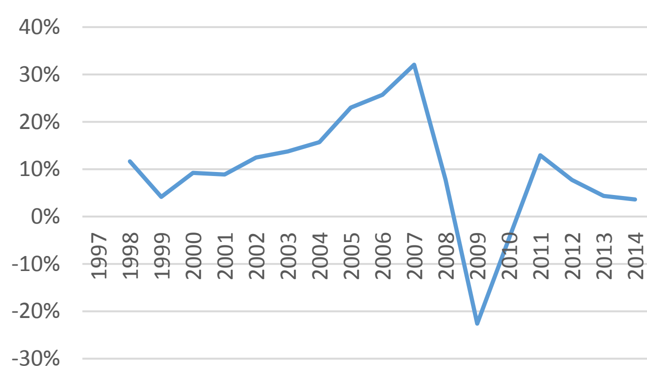

Chart 1. Nominal GDP growth rate in Latvia. Data source: CSB.

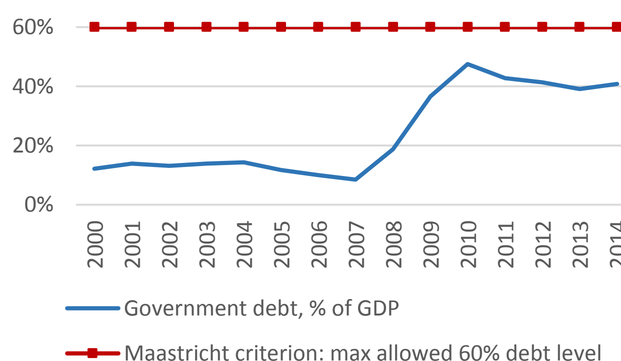

Chart 2. Government debt as % of GDP in Latvia. Data source: CSB.

Furthermore, if we look at government revenue and expenditure separately to trace the behaviour of these two indicators throughout the business cycle, we see that **during an economic decline budget revenue tends to fall more substantially than budget expenditure** (Chart 3). Moreover, the budget revenue to GDP ratio is quite stable throughout the business cycle (close to its trend), while budget expenditure to GDP increases during years of crisis (Chart 4). This is known as the automatic stabiliser effect[12].

[11] The crisis, which began in 2008, had both – cyclical economic downturn and bank failures having a significant impact on fiscal policy.
[12] See https://en.wikipedia.org/wiki/Automatic_stabilizer, accessed on 10.12.2015.

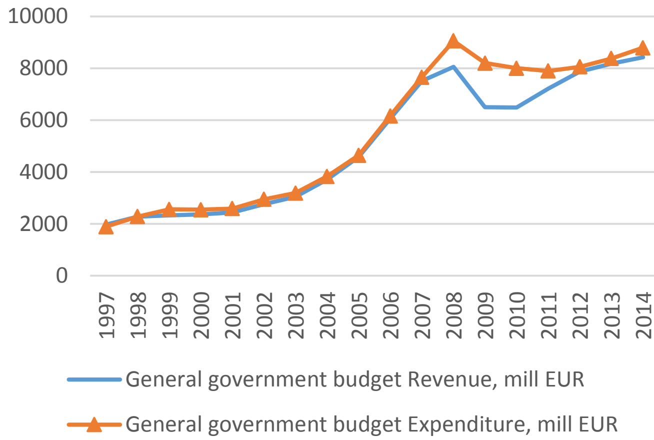

Chart 3. General government budget revenues and expenditure, million EUR. Data source: CSB.

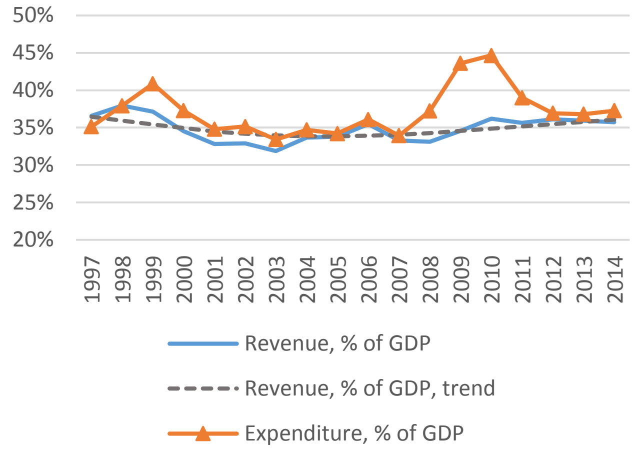

Chart 4. General government budget revenues and expenditure, % of GDP. Data source: CSB, Councils' calculation.

However, **the central question concerns the maximum permissible GDP decline for Latvia to remain in compliance with the 60% debt-to-GDP criterion**. Our calculations are based on the assumption that the impact of GDP decline on government debt will be proportional to the most recent financial crisis (2008-2010). Based on the historical observations described above, it is assumed that the forecasted budget revenue-to-GDP ratio equals its trend (Chart 5), while the forecasted budget expenditure-to-GDP ratio is assumed to increase during years of GDP decline, similar to the 2008-2010 economic crisis (Chart 6).

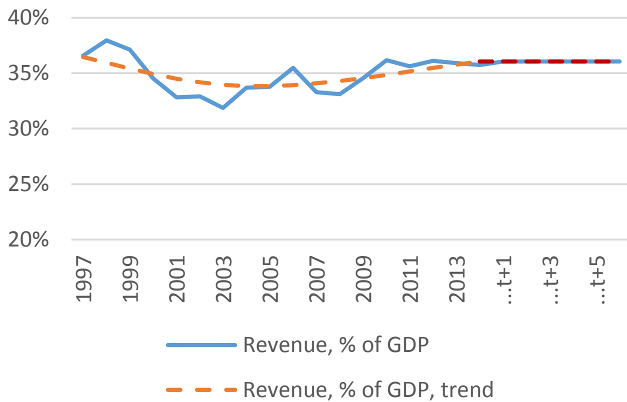

Chart 5. Government revenues, % of GDP: historical, trend, assumption. Data source: CSB, Councils' calculation.

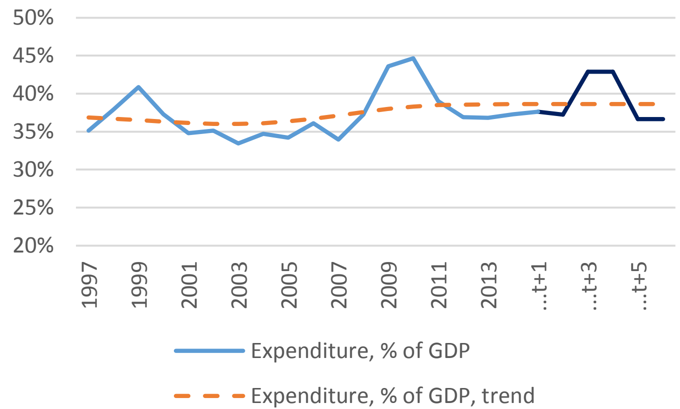

Chart 6. Government expenditure, % of GDP: historical, trend, assumption. Data source: CSB, Councils' calculation.

Based on the assumptions outlined above, our calculations indicate that, if deficit spending persists during years of positive growth**, Latvia can afford an annual 5.4% decline in nominal GDP for two consecutive years** (Chart 7 and 8).

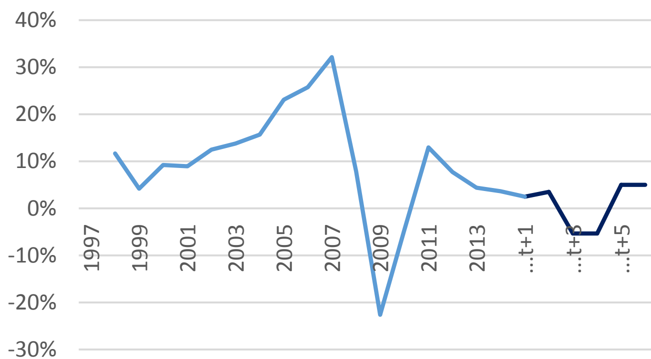

Chart 7. Nominal GDP growth rate / permissible future decline in GDP. Data source: CSB, Councils' calculation.

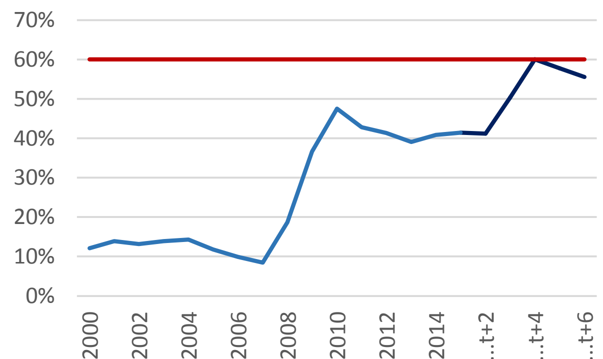

Chart 8. Government debt, % of GDP, and maximum permissible 60% debt to GDP ratio. Data source: CSB, Councils' calculation.

Conclusions and implications

- In accordance with the principles of countercyclical fiscal policy, deficit spending is only permissible when the economy is performing below its potential.
- High levels of government debt limit the flexibility of budget policy and can hamper economic growth.
- The most recent financial crisis caused a significant increase in levels of government debt.
- During an economic decline, budget revenue tends to fall more substantially than budget expenditure.
- If a period of economic decline lasts for 2 years and deficit spending persists during years of positive growth, Latvia can afford a 5.4% annual decline in nominal GDP to remain in compliance with the 60% debt-to-GDP criterion.
- Fiscal rules and policy should limit the level of government debt in line with long-term objectives.