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EXECUTIVE SUMMARY

The fiscal challenges facing advanced economies are unprecedented, and bring to the fore questions about how to assess fiscal sustainability. Intertemporal solvency—the notion that governments *eventually* repay their debts—requires only that adjustments to bring debt dynamics back on track occur *at some point* in the future. Given the sovereign's right to tax and (not) spend, changes in these variables can always make the problem of insolvency disappear. But markets are not impressed by promises that are unsupported by countries' track record of adjustment (words unsupported by deeds), and so it is critical to examine this track record to see whether it is indeed consistent with satisfying the intertemporal constraint.

In this note, we reexamine the issue of debt sustainability in a large group of advanced economies. Our hypothesis is that, when debt is in a moderate range, its dynamics are sustainable in the sense that increases in debt elicit sufficient increases in primary fiscal balances to stabilize the debt-to-GDP ratio. At high debt levels, however, the dynamics may turn unstable, and the debt ratio may not converge to a finite level. Such a framework allows us to define a "debt limit" that is consistent with the country's historical track record of adjustment in the sense that, without an extraordinary fiscal effort, any debt increment beyond this limit would cause debt to increase without bound. It bears emphasizing that this debt limit is not an absolute and immutable barrier, but it does define a critical point above which the country's *historical* fiscal response to rising debt becomes insufficient to maintain debt sustainability. Nor should the limit be interpreted as being the optimal level of public debt. Indeed, since the limit delineates the point at which fiscal *solvency* is called into question—and the analysis abstracts entirely from liquidity/rollover risk—prudence dictates that countries target a debt level well below the limit. Given the country's normal pattern of adjustment, *fiscal space* is then simply the difference between the debt limit and current debt.

Applying our concepts to a sample of 23 advanced economies, we find a number of countries that have either very little or no additional fiscal space (again, based on their historical adjustment patterns). In particular, Greece, Italy, Japan, and Portugal appear to have the least fiscal space, with Iceland, Ireland, Spain, the United Kingdom, and the United States also constrained in their degree of fiscal maneuver, the more so owing to the run-up in public debt projected in coming years. An absence of fiscal space should not be taken to mean that some form of fiscal "crisis" is imminent, or even likely, but it does underscore the need for credible adjustment plans—and it is noteworthy therefore that a number of countries have already demonstrated the political willingness to undertake adjustment that departs markedly from their historical performance. By the same token, other countries in the sample that have more fiscal space may still need to undertake medium-term adjustment on account of future demographic pressures and the possible realization of contingent liabilities. In all countries, fiscal strategies must internalize both the need to support a still fragile recovery and the potential for financial stress prompted by concerns over sovereign risk—which underscores the criticality of firm commitment to credible strategies to lower fiscal deficits over time and, where funding pressures are present or seem imminent, supported by upfront measures.