OVER PUBLIC INDEBTEDNESS: WHAT WAY FORWARD?

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Even before the Covid crisis, global debt was at an all-peacetime record due to over accommodative monetary policies in advanced countries over the past 20 years. The debt situation has been worsening with the Covid crisis. The continuation of a monetary policy of very low interest rates would intensify its negative consequences on growth, employment and financial stability. The increase in public debt and unlimited money creation are a dangerous spiral for our economies. Increasing public spending and debt in over-indebted European economies inevitably leads to economic underperformance and to the questioning of the existence of the euro. Thinking that monetary creation can solve the problems arising from excessive debt is an illusion. Structural issues can only be resolved by structural policies: it is economic growth that eventually solves indebtedness issues.

Even before the Covid crisis, global debt was at an all-peacetime record due to over accommodative monetary policies in advanced countries over the past 20 years

Global debt has reached record high levels. The continuation of very low interest rates during the past two decades has pushed many countries to implement active fiscal policies and economics agents to borrow more. This has driven global debt to records in peace time, even before the Covid crisis. According to statistics issued by the IIF, global debt reached a record high of 335% of GDP at the end of March 2020, up from 320% in 2019 and 200% in 2011. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within five years (2015-2020).

The very accommodative monetary policy in the EU over the last 20 years explains to a large extent this public debt overhang. In fact, with lasting interest rates at ultra-low levels, debt service costs are at post war troughs. The debt burden has never felt so light. Thus, governments are under no pressure to reduce their debts. Negative interest rates encourage them to borrow more and disincentivized fiscal discipline.

In Europe, except for very few countries, the fiscal rules of the Stability and Growth Pact have not been obeyed, which has also contributed to the over indebtedness of some EU countries

Furthermore, in the EU, the rules of the Stability and Growth Pact have, most of the time, not been respected by most of the Member States (e.g France, Spain, Italy, Belgium) since their implementation in 2002. In those countries, gross public debt has continued to rise since the EU sovereign debt crisis (2011-2012). Such dynamic is due to the accumulation of yearly large public deficits. Indeed, between 2014 and 2019, their average public deficit amounted to 3.2% of GDP (France), 2.3% (Italy) and 3.9% (Spain). Moreover, France, Italy and Spain entered the crisis with debt-to-GDP close or above 100%.

By contrast, Germany and the Netherlands entered the Covid crisis with healthy public finances, ensuring an average surplus of 1.2% and 0.04% of their GDP over the same period. Such fiscal efforts over 2014-2019 allowed them to gradually reduce and stabilize their public debt at respectively 60% and 48% of their GDP in 2019, to be in line with the EU fiscal rules.

The debt situation has been worsening with the Covid crisis

Following the Covid crisis, monetary and fiscal policies have been more active than before, widely contributing to the shock absorption. Central Banks substantially eased the monetary policy stance over the course of 2020 to counter the negative impact of the Covid-19 pandemic on economies.

According to the IMF, between March 2020 and July 2021 global Central Banks have increased their balance sheets by a combined $7.5 trillion and governments have spent $16 trillion providing fiscal support amid the pandemic. Public deficits are the highest they have been since World War II and Central Banks have provided more liquidity in the past year than in the past 10 years combined.

Can such persistent accommodating monetary and fiscal policies continue in Europe in particular?

The Annual Economic Report of the BIS (June 2021) states that “no well-functioning economy should operate with real interest rates that remain negative for too long: capital is misallocated and growth impaired” and adds that once the Covid pandemic is left behind and the economy has recovered, policy makers need to rebuild safety margins for both monetary and fiscal policy. “An economy that operates with thin safety margins is vulnerable to both unexpected events and future recessions which inevitably come. These margins have been narrowing over time. Rebuilding them means re-normalizing policy”.

The continuation of a monetary policy of very low interest rates would intensify its negative consequences on growth, employment and financial stability

It is simplistic to believe that monetary financing and low interest rates will fundamentally take care of debt

problems. As we have learned over the last years' experience, abundant liquidity and low rates do not result in higher productive investment but in liquidity hoarding. Since 2008, M0 in major advanced countries (i.e., banknotes in circulation and bank reserves held at the central banks) has increased by 13,50% per year, which is 4 times faster than nominal growth in the real economy. In the euro area, during the same period, M3 that includes bank deposits (and therefore reflects the transformation function of the banking sector), grew much more moderately (3,50% per year), showing that central money creation had not seeped into the economy. These figures show that the excess of liquidity has not been passed on the real economy.

Furthermore, lasting ultra-loose monetary conditions are reducing economic dynamism. The facts are undisputable: non-residential productive investment in advanced economies has significantly declined over the past ten years of zero interest rates (from 14,4% in 2000 to 12% in 2018 of global GDP). Indeed, interest rates that remain at zero for an indefinite period discourage investors from investing in risky projects and instead move into yielding and speculative assets. Household savings have shifted to liquid and non-risky assets, as investments no longer yield any return, in Europe in particular. In addition, low or negative interest rates induce a fatalistic mindset that lowers, not raises, propensity to invest. Under what John Maynard Keynes[1] called the 'liquidity trap', investors play safe by placing savings in very short-term instruments rather than deploying them longer term, where low interest rates bring them inadequate returns for higher risks.

'Too low for too long' policies have also fueled the survival of weak firms, increasing a misallocation of capital. Indeed, such prolonged monetary policy easing contributes to consolidate zombie firms (over indebted and uncompetitive) that are only surviving because of the interest rate subsidy provided to them by monetary policy and incentivize companies to take on cheap debt rather than invest in long term projects.

The pursuit of such a loose monetary policy – "as if nothing had changed" – would be likely to trigger eventually a financial crisis with all its negative economic and social consequences. Indeed, the persistence of very low interest rates has led to overleverage and search for yield which has fueled asset bubbles and contributed to a weak profitability of the EU banking and life insurance sectors[2].

The increase in public debt and unlimited money creation are a dangerous spiral for our economies. Increasing public spending and debt in over-indebted European economies inevitably leads to economic underperformance and to the questioning of the existence of the euro

Large deficits and high levels of debt and deficit have not been conducive to growth, especially in Europe. Indeed, the most indebted countries, (e.g France, Italy, Spain) have achieved the lowest growth performance of the eurozone since 2013[3]. The most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020. Likewise, the most indebted EU Members have experienced close to double-digit level of unemployment rate since 2007, as Spain (14,5% in 2019), Italy (9,9%) and France (8,5%). Despite their significant deficit, the three countries are among those with the highest share of long-term and young unemployment rate.

By contrast, the EU countries that have best managed their public finances after the Global financial Crisis and the EU Sovereign crisis (e.g. Germany, Netherlands, Austria) are those that have suffered the least from the Covid-19 shock. At 4,2% of GDP (Germany) and 4,3% (the Netherlands), their 2020 public deficit has remained mainly below the Eurozone average of 7,2%. Those countries also record among the lowest unemployment rate within the euro area, with 3.2% for the Netherlands and 5.9% Germany as of June 2021[4].

As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate.

The economic consequences of the current Covid-19 crisis are worsening the situation. They are increasing the heterogeneity of fiscal performance across euro area member states. The aggregate government debt-to-GDP ratio rose by around 15% in 2020, reaching respectively 95% and 102% in the EU/EA. Italian, Spanish and French public debts are going to jump by more than 20% of GDP in 2020 to reach respectively 160% (Italy), 120% (Spain) and 116% of GDP in 2020 (France). Several factors drive these divergences: the relative size and economic importance of contact-intensive sectors and the differences in fiscal space available. These differences might impact confidence, investments, and growth prospects.

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the Union European is not a state and that negative externalities - stemming from questionable national policies - should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination. Some may think that fiscal discipline

1. Keynes was in favour of low interest rates, but he specified not too low interest rates. Indeed, when they are too low, they deter savers from investing in long-term bonds and encourage them to either keep their savings in liquid forms, which they are doing, or in assets remunerated only because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of no growth emanating from zero interest rates for a long time, are turning away from productive investment in favour of things like share buybacks and speculative opportunities. A European study from the prior year that showed over the last 10 years a massive and spectacular increase.
2. See the Eurofi Monetary Scoreboard – September 2021.
3. See the Eurofi Macroeconomic scoreboard – September 2021.
4. According to Moody's Analytics.

is no more indispensable because of the persistence of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

Furthermore, if this fiscal drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them. If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

Thinking that monetary creation can solve the problems arising from excessive debt is an illusion

Since March 2020, Central Banks have been carrying a primary role in public debt monetization, as they purchase a large share of new public debt issuances[5]. In sight of the massive debt purchases, Central Banks de facto, have become the agents of fiscal policies. This “fiscal dominance” that is presently taking place puts in question the independence of Central Banks and is a major disincentive for governments to engage in the structural reforms.

Moreover, the idea that States can compensate for everything by exposing their balance sheets is unfortunately a fantasy. Indeed, it is not because budget deficits are monetised that they disappear. Despite the QE and its possible magnitude, the budget constraint remains. Analysts and rating agencies continue to examine ratios and make judgments about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of an issuer’s “signature” and a key factor in the decision to buy securities by private investors, especially non-residents. As they are very sensitive to the rating, they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgments voiced by the markets actually do not matter, because the Central Bank will always be there to buy, is doubly inaccurate: the Central Bank will not always be able to buy everything, as we shall see below, and the quality of a State’s signature is an essential element of confidence that must be preserved at all costs for the country’s future.

The continuation of the monetisation of an increasing share of public debt stock and new issues would eventually promote financial instabilities and lead to a loss of confidence in the currency. The ECB cannot absorb all public debt forever. If some national Central Banks are theoretically free to monetise the entirety of their States’ public debt, the same cannot be said of the ECB, which is governed by an international treaty that prohibits the monetisation of public debt. Similarly, the idea that Central Banks purchasing public securities could cancel their assets in order to reduce their States’ debt to zero is, in the European case, legally impossible. The subsidy to the States that would be implied by the cancellation of public debts is not compatible with the Maastricht Treaty, which prohibits the monetary financing of Treasuries.

We cannot pretend that money creation can exempt our societies indefinitely from having to face the question: “who will pay?” Do we seriously believe that unlimited issuance of sovereign securities will never come up against a fundamental questioning of the markets as to the solvency of States?

It is economic growth that eventually solves indebtedness issues

Adequate remuneration of risk, implementation of structural, supply side-oriented reforms and sustainable fiscal policies are essential to promote a return to healthy growth in overindebted countries.

The world should move gradually and cautiously towards monetary normalization, in order to avoid cliff effect. Preparing for European interest rates to return to more normal levels would also be the first step to a more productive post-pandemic period of higher growth and investment. A key condition will be ample cooperation between the monetary authorities in the leading countries, in line with standard practice not just in the 1980s and 1990s but also during the 2008 crisis.

Fostering a sustainable path to stronger growth is essential. Raising long term potential growth is of the essence to solve the indebtedness issue. This requires structural reforms and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries in particular has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything: only domestic structural reforms can resolve structural issues and increase productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

In over indebted countries, governments must take corrective actions to ensure a path to primary fiscal balances and reduce unproductive and inefficient public spending. In Europe, reforming the Stability and Growth Pact is an urgent necessity[6]. It would be rational to propose that each member country should outline a specific path for reducing its public debt which would take account of specific local parameters.

5. Refer to the Eurofi Monetary Scoreboard: 72.8% of French debt issuances have been bought by the ECB in 2020. The figure reaches 90% in Germany, 78.9% in Spain, 84.1% in Austria, 112.4% in Italy, 113.9% in the Netherlands.

6. Larosière.J, “A framework for a successor to the Stability and Growth Pact” – June 2021 (available in the Eurofi Regulatory Update - September 2021)