ENSURING GROWTH AND FINANCIAL STABILITY IN EUROPE WITH OVER PUBLIC INDEBTEDNESS AND THE RESURGENCE OF INFLATION

Note written by Didier Cahen & Jacques de Larosière

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. In the current environment characterised by the return of inflation, the continuation of a monetary policy of very low interest rates in the euro area 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 peacetime, even before the Covid crisis. According to statistics issued by the IIF, global debt reached a record high of 360% of GDP in June 2021, 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 euro area 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 has disincentivised fiscal discipline.

In Europe, the fiscal rules of the Stability and Growth Pact have not been obeyed by many large economies of the EU (France, Italy, Spain..., [1]) which has contributed to their over-indebtedness.

Furthermore, in the EU, the rules of the Stability and Growth Pact have, most of the time, not been respected by many large economies of the EU (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 a 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 stabilise their public debt at respectively 60% and 48% of their GDP in 2019, to be in line with 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.

Debt differences in the Eurozone have widened during the past two years, not converged (*see below*). The volume of French debt increased by 400 billion between March 2020 and September 2021, while those of Germany and Italy increased by 343 and 273 billion euros (ECB data). Sooner or later speculators will decide that such debt levels are unsustainable and drive Eurozone debt spreads much wider. Hence the need to establish disciplined and monitored medium-term debt reduction policies that convince international financial markets, or else a new Eurozone crisis is inevitable.

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 $16trillion 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.

1. In 2019, 16 of the EU members (including Germany and the Netherlands) had a public debt/GDP ratio below.

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-normalising 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 central banks) has increased by 13.50% per year, which is 4 times faster than nominal growth in the real economy. Between December 2007 and January 2020, M0 in the euro area increased by 13.6% per year on average[2], which is 5.4 times faster than nominal GDP growth. These figures show that the excess of liquidity has not been passed on the real economy.

The growth of M3 has also continuously exceeded real GDP growth both in the US and in the eurozone during the past decade. This gap has produced an excess quantity of money in the economies compared to effective economic growth. This excess money has not led to higher prices of goods and services until 2021 but has fuelled the rise in real estate and financial asset prices.

Furthermore, lasting ultra-loose monetary conditions are reducing economic dynamism. Lasting low interest rates do not foster by themselves, more productive investment. The facts are undisputable: non-residential tangible investment in advanced economies has significantly declined over the past ten years of zero interest rates (from 14.4% in 2000 to 11.5% in 2019 of GDP), according to IMF calculations. The rise in intangible investment[3] over the same period was less than the decline in tangible non-residential investment.

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[4] called the 'liquidity trap', investors play safe by placing savings in very short-term instruments rather than deploying them on longer term, where low interest rates bring them inadequate returns for higher risks.

Thus, the liquid share of financial assets held by households and non-financial corporations increased from 10.2% in 2007 to 19.4% in 2019 in Germany and from 5.3% in 2007 to 7.4% in 2019 in France. The increase was also important in Spain and Italy over the same period of time (respectively +7.7 percentage points and +5.9 percentage points). Following the Covid-19 crisis, the figure reached 20.6% in Germany as of June 2021, 8.4% in France, 23.1% in Spain and 23.5% in Italy.

'Too low for too long' policies have also fuelled 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 incentivise 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 eventually trigger 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[5].

Lasting loose monetary policies have significantly increased wealth inequalities

The social significance of persistent low interest rates should not be underplayed. Did they help reduce societal inequalities? In fact, the opposite is true; they tend to make societal disequilibria worse because the beneficiaries have been those who have the income and capital to profit from inflated financial and asset markets. Not poor people.

---

2. Quarterly data.

3. Non-residential intangible investments that include patent, brand, trademark, copyright or software, have stagnated or increased slightly over the past two decades, reflecting the digitalisation of advanced economies. In AEs, it has increased from 4.3% of GDP in 2000 to 5% in 2019. But this dynamic did not compensate for the decline of total non-residential investment, that went from 19% of GDP in 2000 to 16.5% in 2019.

4. 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.

5. See the Eurofi Monetary Scoreboard – February 2022.

A report issued by the McKinsey Global Institute[6], notes that globally, net worth has tripled since 2000; but the increase mainly reflects valuation gains in real assets — especially real estate — rather than investment in productive assets that drive our economies. Rising asset prices and two decades of relatively low interest rates have helped expand the world's "balance sheet" to high levels, far outpacing underlying economic growth and raising questions over whether this can endure. Moreover, "asset values are now nearly 50 per cent higher than the long-run average relative to income", the report continues. "Not only is the sustainability of the expanded balance sheet in question; so too is its desirability, given some of the drivers and potential consequences of the expansion. For example, is it healthy for the economy that high house prices rather than investment in productive assets are the engine of growth, and that wealth is mostly built from price increases on existing wealth?".

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[7]. 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, the 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 3.5% Germany as of June 2021[8].

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 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 percentage points between 2019 and 2021, reaching respectively 92.1% and 100% in the EU/EA in 2021, according to forecasts from the European Commission. Italian and Spanish debts have jumped by more than 20 percentage points between 2019 and 2021 to reach respectively 154.4% and 120.6% in 2021. In France, it increased by 17 pp, to reach 114.6% of GDP in 2021.
By contrast, the public debt-to-GDP prudently increased during the same period by 9 percentage points in the Netherlands and 12.5 percentage points Germany respectively to 57.5% and 71.4%.

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 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 monetisation of public debt is not consistent with the functioning of our monetary union.

What we need is more long-term investment to cope with the challenges of reduced labour and the green and digital transition. This will not be achieved with more distribution through budgets or more money creation. It will only be possible if structural — supply side oriented — reforms as well as a normal remuneration of risky investments are made possible. This combination requires a reining in of excessive current public expenditure (i.e. fiscal normalisation), alongside a qualitative shift towards reasonable public investment.

If we continue to live on the illusion that fiscal stimulus can "replace" monetary stimulus, we will have two negative results:

- Fiscal dominance because fiscal stimulus cannot co-exist with high rates;
- A financial crisis because excessive leverage always leads to it.

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.

6. McKinsey Global Institute, "The rise and rise of the global balance sheet", November 2021.

7. See the Eurofi Macroeconomic scoreboard – February 2022.

8. According to Moody's Analytics Economic Indicators (can be found at https://www.economy.com/indicators).

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 monetisation, as they purchase a large share of new public debt issuances[9]. In sight of the massive debt purchases, central banks have de facto 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 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?

If inflation is not quickly addressed by central banks, economies, notably in Europe, may soon face the risk of stagflation.

Moreover, inflation has been rising in many countries for several months. Bottlenecks and energy prices have played a role. However, the current inflation spike is driven by structural factors and could last longer than expected[10], which would endanger the economic rebound.

In a recent paper[11], Mervin King noted that money has disappeared from modern models of inflation and explained that it would be a mistake to pretend that money has nothing to do with inflation and to believe that monetary stimulus is an appropriate response to all economic problems. When monetary policy is too tight, it slows aggregate demand. When monetary policy is too loose, it damages aggregate supply. The current period of high inflation has been coinciding with a substantial increase in the quantity of money emanating from aggressive central banks' interventions since March 2020.

This coincidence may be reviving the monetarist view, considering "inflation as always and everywhere a monetary phenomenon" in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. In other words, the amount of 'excess money' resulting from a mix of highly expansionary fiscal and monetary policies may have led inflation to be a monetary phenomenon. If this is true, the inertia of central banks in withdrawing extraordinary policy would be the proximate cause of surging prices.

Central banks are behind the inflation curve. In such a context, Federal Reserve Chairman Jerome Powell has announced an accelerated ending to the Fed's quantitative easing through massive government bond purchases. This delivers an urgent message worldwide. If central banks fail to act now, the economic rebound could be running into severe problems. Inflation will lower real revenues — prompting distorting wage demands, from income-pressed workers — with negative consequences not only for consumption, but also for saving and investment (inflation is lowering the earnings of companies).

Therefore, central banks need to move more quickly; they should pursue without compromise their primary objective of monetary stability, especially without taking governments' funding costs into consideration as well as the kind of addiction and dominance of markets.

It is economic growth that eventually solves indebtedness issues.

A monetary union does not by itself create economic convergence. The eurozone is a currency area comprising heterogeneous countries (their productivity levels,

9. Refer to the Eurofi Monetary Scoreboard: 64% of French debt issuances have been bought by the Eurosystem in 2020. The figure reaches 79.8% in Germany, 70.1% in Spain, 74.5% in Austria, 101.3% in Italy, 98.5% in the Netherlands.

10. See, J. de Larosière, D. Cahen and E. Krief, Eurofi Monetary Scoreboard, February 2022.

11. M. King, "Monetary policy is a world of radical uncertainty", Institute of International Monetary, research annual public lecture, 23 November, 2021.

their productive specialisation, the level of fiscal deficits and indebtedness, the level of labour force skills are different) with a low level of federalism. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States[12].

Monetary policy can erase spread differentials in the euro area but cannot relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect the persistent doubts of investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

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 normalisation, 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[13]. Only productivity enhancing, and productive investment can create sustainable increases in productivity, neither negative rates, nor QE.

12. See J. de Larosière, D. Cahen & E. Krief, Eurofi Economic Scoreboard, February 2022.

13. J. de Larosière & D. Cahen, “Reforming the Stability and Growth Pact” – February 2022 (available in the Eurofi Regulatory Update – February 2022).