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Keynote Address

“Public Debt Reduction in Uncertain Times – With a View to Europe –”

By

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We live in uncertain times both economically - growth remains weak, especially in the fundamentals - and in the policy response and from the point of view of governance, both nationally and globally.

Public debt remains a source of fragility for many countries. Private debt also, in some countries. Putting debt/GDP over a declining path remains imperative to reduce fragility.

While this topic has been subject to scrutiny for quite a long time I will consider some additional longer term determinants of debt dynamics that have gained relevance recently and relate them to broad uncertainty.

What drives debt dynamics? Let me start from two recent contributions, among the many that look at the determinants of debt dynamics and provide policy implications.

Bernardini, Cottarelli *et al.*(2019), investigate thirty episodes of public debt reduction in advanced economies since the Second World War. The paper demonstrates that four main approaches succeeded in lowering the debt ratio. First, after the end of WWII, high and unexpected inflation eroded a large share of public debt. Second, during the Bretton Woods era, a mix of financial repression, high economic growth and moderate inflation helped reducing public debt.

Third, since the 1980s, several advanced economies followed "orthodox" fiscal adjustments, namely improving their primary balance by reducing expenditure and/or raising taxes. The fourth approach (debt restructuring) was implemented only in one case: Greece in 2011-12. However debt restructuring remains an option on the table, including in the Eurozone.

One key findings by Bernardini, Cottarelli *et al.* (2019)is that debt reduction has never been achieved by relaxing fiscal policy (cutting taxes or increasing expenditure), hoping that this would set in motion a growth process sufficiently strong to lower the debt ratio (the so-called "denominator approach" which has recently become fashionable in some countries,

including Italy). All in all, the empirical evidence of the last 70 years suggests that running a sufficiently large primary surplus is the only viable option to reduce public debt ratio, particularly in countries that are part of the euro area.

While interesting the contribution by Bernardini, Cottarelli et al does not take into account the impact of the “r-g” factor (the difference between the interest rate and the nominal rate of growth) in a changing global environment. My point is that both the primary surplus and the r-g factor contribute to debt dynamics and should be taken into account.

Blanchard (2019) in a much discussed paper takes a different view. He looks at conditions under which high debt can be sustainable given appropriate values of “r-g”, while neglecting the role of primary surplus. He finds that rising debt can be sustainable if the rate of interest is lower than the rate of growth. Otherwise, as we know, the size of the primary surplus must be such as to offset the negative consequence of an interest rate higher than the growth rate.

Blanchard draws some implications that point to space for debt to grow so as to improve welfare. However this possibly additional fiscal space requires the condition for negative “r-g” to hold. (Blanchard also excludes that he is in favour of unconstrained debt growth).

Critics of Blanchard (e.g Wyplosz) note that: “r-g” is not always negative; it can be highly volatile; the primary surplus cannot be ignored; the evolution of “r-g” can impact on fiscal discipline and hence on the primary surplus itself.

Currently “r-g” is negative for most countries (with the notable exception of Italy), however this should not be considered the norm. Especially if long term determinants of “r” and “g” (in addition to the factors that prevail in the short medium term) come into play. What impacts on “r-g” on the longer term beyond cyclical conditions (which lead to “r-g” to be

larger in downturns)? The list includes demographics, the global saving glut, the debt level itself (which, if high impacts directly on “r-g” by raising it).

Let’s concentrate on more long term, and structural factors. They represent additional determinants of “r-g”. I would argue that these factors may be such as to offset (partially) the positive contribution of “r-g” to debt reduction and eventually turn it into a debt increasing factor.

It follows that in uncertain times such as the one we are currently in, other things equal, conditions for debt sustainability are harder to achieve because of adverse pressure on the variables that bear on debt dynamics, the growth rate and the interest rate.

These forces originate from structural factors generated by the state of global policy uncertainty itself related to weak global economic governance and the forces underlying weak potential growth including secular stagnation.

Governance

Over the last few years global governance has been under increasing pressure. Pressure has impacted on several policy domains, notably trade and security. In addition, policy uncertainty has increased. The Economic Policy Uncertainty (EPU) index has gone up in tandem with events such as the Eurozone crisis in 2009, it has gone down with the initial solution of the Eurozone crisis during 2011-15, increased with the Brexit vote in 2015, increased with the migration crisis during 2015-17 and increased with the US-China trade war.

Policy uncertainty reflects, among other factors, changing conditions in global governance. Over the past few years, increasing fragmentation and conflicts have replaced a more coordinated approach to global governance that had prevailed in the recent past. Taking into account evidence of the relationship between policy uncertainty and risk (Johannidis C.

and Kook K., 2018) as well as policy uncertainty and growth, other things equal, higher uncertainty about global governance translates in an increase in the interest rate and lower growth. A more conflictual approach to governance implies, other things equal, that adjustment of imbalances is more costly and disorderly with negative consequences on growth and risk perception. The current state of global relations suggest that conflicts and weak governance are on the rise and will persist. Other things equal the degree of risk should increase, leading to (possible) higher interest rate.

Weak growth

The global financial crisis has significantly impacted on the potential growth rate. Beyond the crisis growth also suffers from symptoms of secular stagnation. There is a broad debate on the symptoms and the causes of secular stagnation. The divide has put supply and demand factors on two different sides. As is often the case when looking at long term factors both supply and demand factors play a role. Let me elaborate briefly a major symptom of secular stagnation is low or declining investment. Weak investment reacts to the weak tone of expected demand, low expected profits, and reflects debt accumulation, which has implications for higher perceived fragility. Low profitability in turn points to lack of reforms that (should) enhance profitability. So, structural reforms impact on investment through improved profitability (hence structural reforms impact on expectations).

The opposite causation also holds. Investment is the vehicle through which reforms change behaviour and change the economy. For instance reforms which encourage innovation and environment production of friendly goods and services. So lack of structural reforms is both a cause and a consequence of secular stagnation.

Finally, expectations that “r-g” will remain negative over the long term could impact in the propensity to reduce the primary surplus, leading to a lower surplus and more debt other things equal.

Putting together all these factors the implication is that debt sustainability has become more, not less, difficult to achieve because, other things equal, of a higher value of “r-g” reflecting both weaker governance and weaker long term growth.

Policy Implications and Governance

The implications are straightforward. There is a need to improve global governance, lower systemic risk, and raise long term growth. Revert the trends to higher confrontation and declining growth. How can this be achieved? Policy should at the same time decrease global risk and raise global growth: two targets that mutually reinforce each other (in both directions).

What are the challenges for global economic governance? As mentioned global governance is under severe stress. Global governance has changed dramatically after the outbreak of the global financial crisis, shifting the focus from the G7 to the G20. Recognizing the raising role of large emerging economies. The G20 agenda has extended over a very broad range of issues, including “strong, sustainable, balanced and inclusive growth”. However it is hard to say that global governance has succeeded in achieving risk reduction. The opposite holds as we look at the state of international relations today.

Over the recent past attempts to strengthen global cooperation and multilateralism seem to be replaced by increasing bilateralism and ‘sovereignism’ (i.e. the view that nation states should prevail over multilateral agreements).

The global hegemon, the US, has been increasingly inward oriented, looking at national interests and contributing less to global public goods such as stability and open markets. In other words, there is a lack of hegemonic stability as the largest power prefers bilateral relations (both positive and negative) to multilateral cooperation. And other key countries have similar attitudes. Therefore governance needs to deal with increasing fragmentation.

Because of the absence of a global hegemon, the provision of public goods by global governance would require fundamental changes, which are unlikely in the short to medium term. Conditions for systemic risk to be minimized are not at hand. Without hegemony international cooperation (in an international oligopoly), it is much more difficult, requiring key players' willingness to reciprocate, adjust preferences and adopt a long term perspective. Europe could play a much more effective role from this point of view. The new EU Commission could be instrumental in this respect.

What about global growth?

Long-term growth is the result of the interaction of different drivers and policies: macroeconomic, monetary and fiscal, microeconomic, structural, and financial. The way such policies interact is matter of continuous research and analysis (OECD analysis has always been at the frontier of such analysis). What we can safely say is that one dimension policies are less effective, if at all, in sustaining long term growth. One needs an integrated approach by which policies mutually support each other. In what follows I concentrate on the role played by structural reforms. However this should not be seen as saying that only supply side measures matter.

Indeed (as mentioned), conditions for structural reforms to succeed in terms of raising growth require demand and supply interaction as well as a long term horizon.

Well known features of the structural reforms process include: 1) Understanding that the initial impact of structural reforms could bear short term costs in terms of income and/or employment. Such costs could be mitigated by more favourable cyclical conditions. 2) Structural reforms can also improve confidence and expectations about the long term, with benefits both on growth and on risk perception (so they improve r-g). 3) Structural reforms require significant political capital to be implemented and such a political capital seems to be in short supply. Both reform fatigue and discontent with the prevailing economic system

are on the rise in Europe and elsewhere (OECD, Going for Growth 2018). "New" options (populism and "sovereign nationalism") are on the rise. Dismantling reforms rather than strengthening the reform agenda, favouring state led rather than market based policy recipes, and focusing on national rather than European solutions seems to be the rising political bet. (This in part has been mitigated by European Parliament elections but the challenge is still alive and kicking).

So, the issue arises of what are the incentives for structural reform. Political incentives are weak.

Reasons for this include the fact that the traditional "structural reform cycle" is long and difficult to complete, thus generating reform fatigue. Another one is that increasing reform fatigue is associated with decreasing support for Europe and the European project.

Structural reforms require a complex and long cycle to be completed and this implies that they carry a very high cost in terms of political capital. Reforms have to be introduced by the government and approved by parliament; they have to be translated into administrative procedures, which have to be implemented, often by several government institutions, both national and local; they have to deliver visible outcomes, and such outcomes have to be perceived by citizens (and voters) as generated by the reform process. This may require quite a substantial communication effort by the government. In addition, while outcomes of reforms are typically widespread and delayed, costs of reforms are usually upfront and concentrated in smaller (and more vocal) groups. Finally, evidence suggests that benefits of reforms are stronger and more visible when the macroeconomic cycle is on the upswing.

Two implications, among the many, follow. First, governments introducing reforms should, in general, be prepared to wait several years to see some returns for the investment of their political capital. And this may run against political "short termism" in governments. Second, governments may want to activate compensation mechanism for the losers to broaden their

consensus base. In such a case, the reforms may bear (additional) budget costs for the government.

Considerations about the Eurozone

In Europe structural reforms can and should be implemented at the national and the EU level. Political support is needed both for national reform policies and for EU level policies. One example: the interaction between product market liberalization at the national level and at the EU level (single market) would bring additional benefits with respect to case of policies implemented in isolation. There are political economy implications in this case too. In some cases EU policies can be more attractive for citizens insofar as they are perceived as dealing with inequality (examples include competition policy as a way of confronting monopoly power of big internet giants, tax policy as an instrument for redistribution). In other cases in the current more Eurosceptic environment EU level policies are seen as mechanism that weaken national sovereignty, and hence they tend to be resisted. A possible misalignment between economic and political reforms priorities may emerge as economically crucial reforms might be much harder to introduce.

How do the above considerations bear on debt sustainability? In the Eurozone all countries except Italy display negative “r-g”, debt over GDP is declining and growth is relatively sustained. However optimism is out of place. A new recession could be looming given significant weakness in Germany and the UK, while Italy remains in stagnation. Monetary policy has stretched to the limits although the European Central Bank (ECB) suggests that limits could be stretched further. If symptoms of secular stagnation have to be taken seriously, the single monetary policy should be integrated by fiscal and structural policy. Structural reforms can improve the effectiveness of monetary policy, for example by increasing the response of labour and product markets to the monetary stance (Masuch, K *et al.,* 2018)

In short, in a monetary union the interaction between fiscal policy and structural policy is even more relevant. However, it is also important to look at country specificities so that individual countries adopt the appropriate policies taking into account the Europe wide framework. This has implications for fiscal policies. A proactive fiscal policy in the Eurozone has several dimensions. At the national level, prominence should be given to debt reduction. Hence, as long as the interest rate is larger than the nominal growth rate a primary surplus is needed. But also growth enhancing measures would strengthen debt reduction.

At the same time a reconsideration of the stability and growth pact should be initiated so as to strengthen incentives for public and private investment. A growth oriented flexibility should be introduced. An appropriate division of labour between countries is needed. Coordination among national policies should be improved by softening asymmetry in adjustment and improving the policy allocation. To clarify, countries with no fiscal space should concentrate on structural reforms, while striving to recreate fiscal space, but countries with fiscal space should use it while maintaining an appropriate primary surplus.

Steps towards a common fiscal capacity should be accelerated, including by the introduction of a European safe asset. The proposals to reform the EU budget carry some progress in dealing with convergence and adjustment, and hence growth. As one driver of stagnation in Europe is the dynamics of geography and cumulative effects, periphery suffers most. Secular stagnation is more evident in peripheral countries. So more long term convergence carries more growth. However, there is no progress in the stabilization function and the cyclical impact of downturn on reforms is not being dealt with at the EU level. The unemployment insurance mechanism is one example of an EU wide stabilization function which could have positive structural implications.

Irrespective of the “r-g” value structural policy should be implemented by all countries. Structural reforms at the national level should be integrated by EU level policies including by completing the Single market.

Conclusions

Deep and sometimes neglected causes are behind debt accumulation in addition to the ones we are used to take into consideration. Debt to GDP dynamics must be under the control of policy authorities, not vice versa. Control is not (only) a short term issue. It is also a long term issue.

Challenges in the long term include increasing potential growth and reducing systemic risk contributing to a smaller, if not negative “r-g”. This requires strategy and vision, and stronger international cooperation. Any single year budget must be plugged into a multiyear perspective to enhance credibility and allow the benefits of reforms to work through the economy. Fundamentals must be such that debt goes in the right direction. Growth must go up interest must go down. However action at the country level is only one condition for long term sustainability. The other is a stable and well managed international system. What is needed is a new framework for international cooperation and governance. A stronger and more resilient G20. At the EU level much progress can be made by integrating better monetary fiscal and structural policies at the level of single member state and at the EU level.

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