Sustainability of the Public and Private Global Debt Levels

Global Economies at the Crossroads: *Growing Together While Growing Apart?*
Event co-hosted by NABE and Sveriges Riksbank

José Luis Escrivá, Chair, Network of EU Independent Fiscal Institutions and AIReF
Stockholm, May 3th, 2019

1. Are we headed towards a new debt sustainability paradigm?
2. Europe is different
3. Underlying risks going ahead

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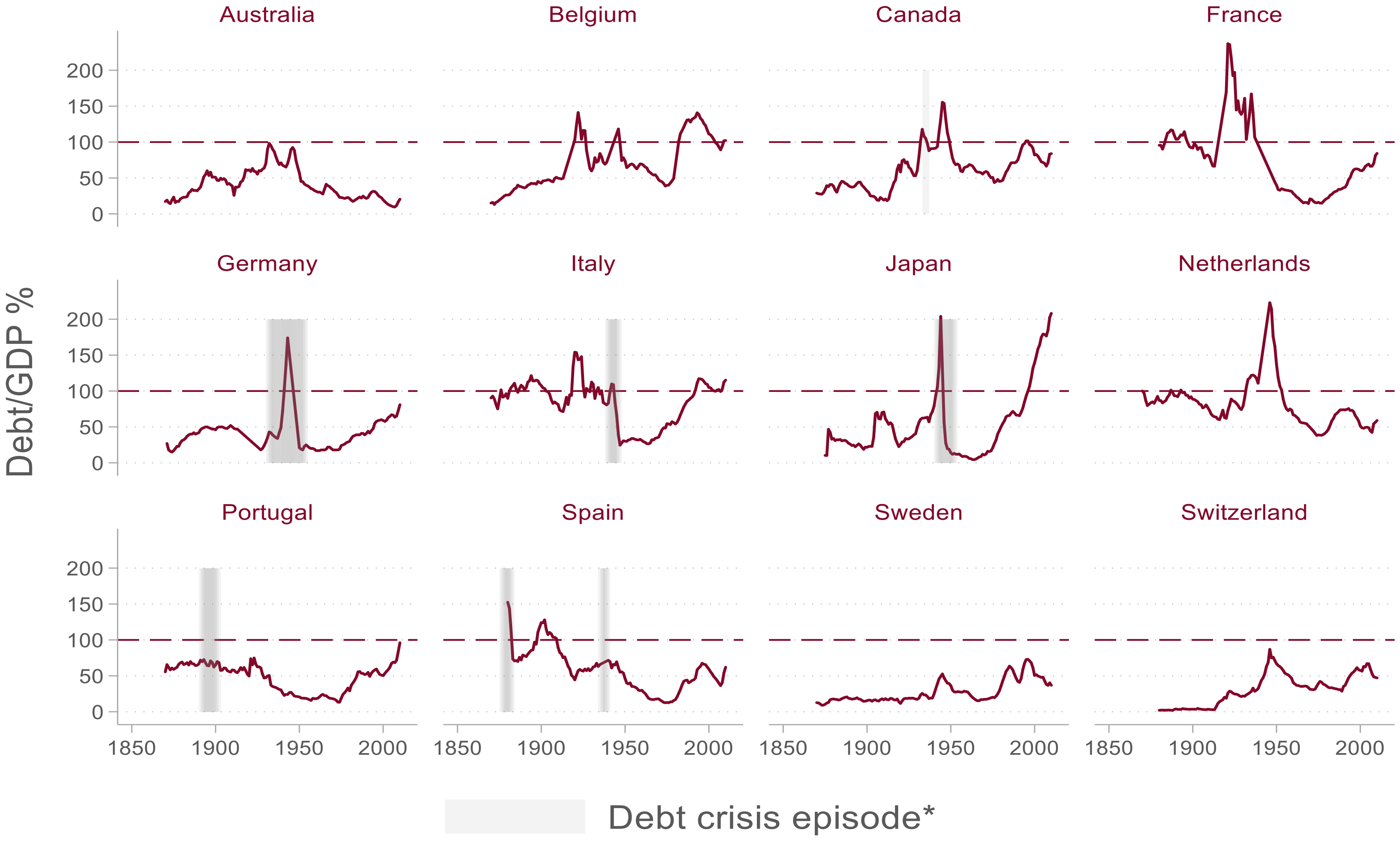
1.New paradigm

2.Europe is different

3.Risks ahead

Public debt levels have reached peace-time peak levels in many countries

Public debt and crisis episodes in European countries (in % GDP)



Source: Jordà-Schularick-Taylor Macrohistory database and *Reinhardt&Rogoff

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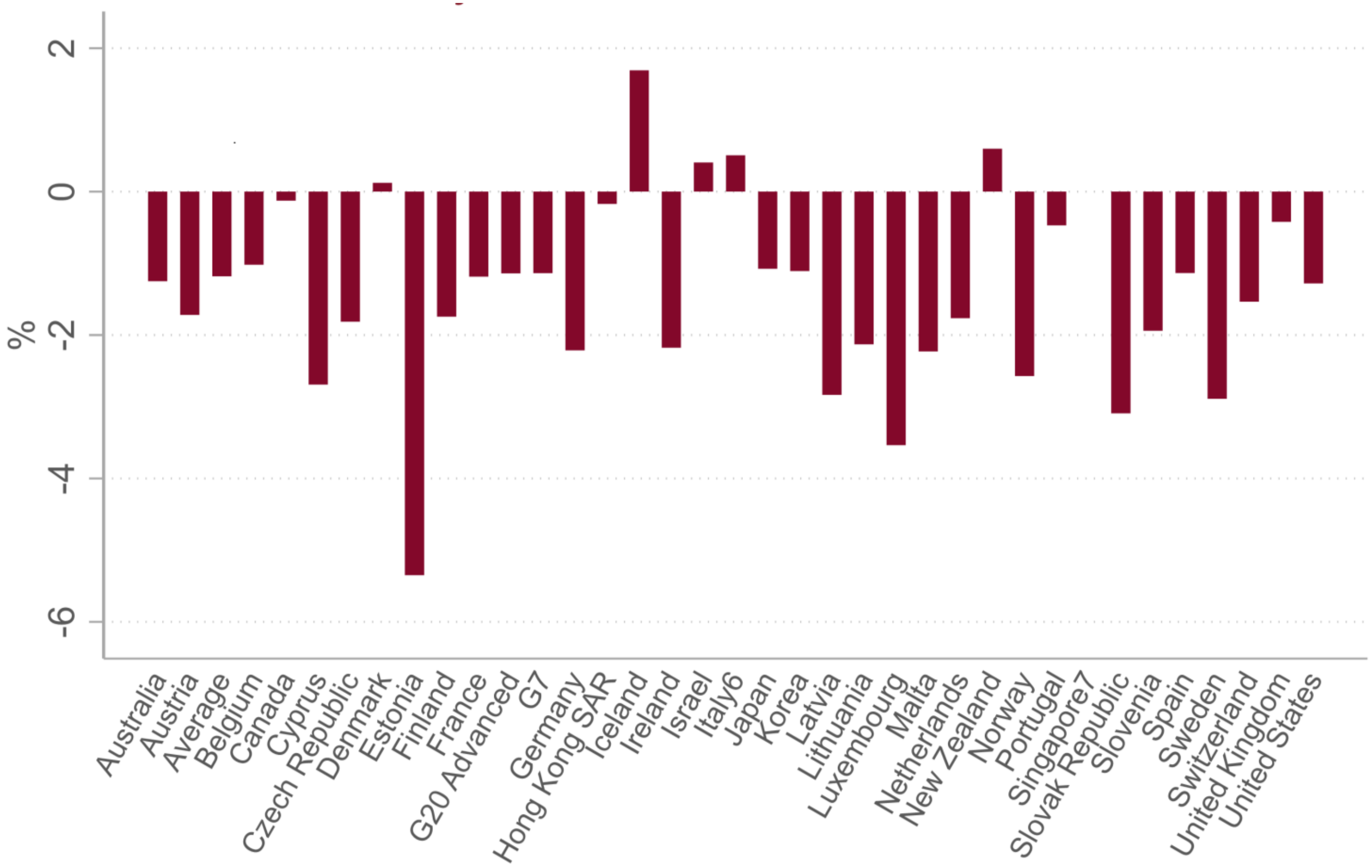
A question arises: do deficits matter in a low interest rate world?

Average projected interest-growth differential for developed economies (2019-2022)



Source: IMF, Fiscal Monitor, October 2018

Modern Monetary Theory advocates for an inflationary, instead of a budgetary constraint

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Shift of focus from sustainability to fiscal space (e,g. IMF)

MMT public debt not only doesn't matter: the more the better! (public debt is a public good)

Recent mainstream sources:
"Low interest rates imply that public debt may have small fiscal and welfare costs. You can use it, if you use it wisely"
(Blanchard's 2019 AEA Presidential Lecture)

Episodes of g>r: not so rare in developed countries

Source: Jordà-Schularick-Taylor Macrohistory database

Switching from a Budget to an Inflation Constraint has important policy implications…

Monetary policy

- If r<g for a extended period of time even debts of 100% GDP are not a problem. New normal. What's the actual fiscal space?
- Even without inflation, too low interest rates may give rise to misallocation of resources and create bubbles
- And what about if there is an unexpected bout of inflation

Fiscal dominance

- Increasing pressure for a bigger role for fiscal policy
- It would imply subsidiary role for CBs: particularly doggy in EMU with no equivalent European institution to the ECB on the fiscal policy side able to take the lead in managing euro-area business cycle

Risk of overburdening fiscal policy

- Dealing with inequality and the menace of populism
- Public debt increase associated to ageing is a done deal

Switching from a Budget to an Inflation Constraint might not be a good idea in the multiple equilibria-prone EMU. The two main set of factors behind the previous debt crisis may still be looming

DOMESTIC POLICIES INCONSISTENT WITH A SINGLE CURRENCY	COORDINATION FAILURE
▪ Lack of discipline in the absence of exchange rate and monetary policy ▪ Insufficient real convergence ▪ Competitiveness losses and free riders out of the EU fiscal rules	▪ Design and governance problems ▪ Non cooperative behaviors and renationalization of decisions in response to the crisis ▪ Lack of common tools to face the crisis

AIReF

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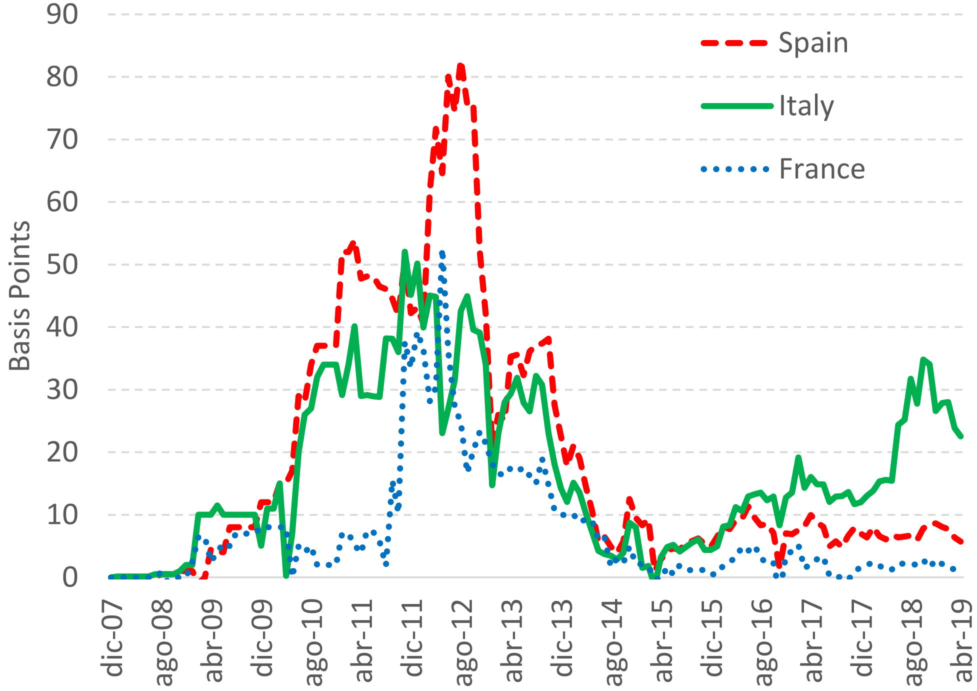
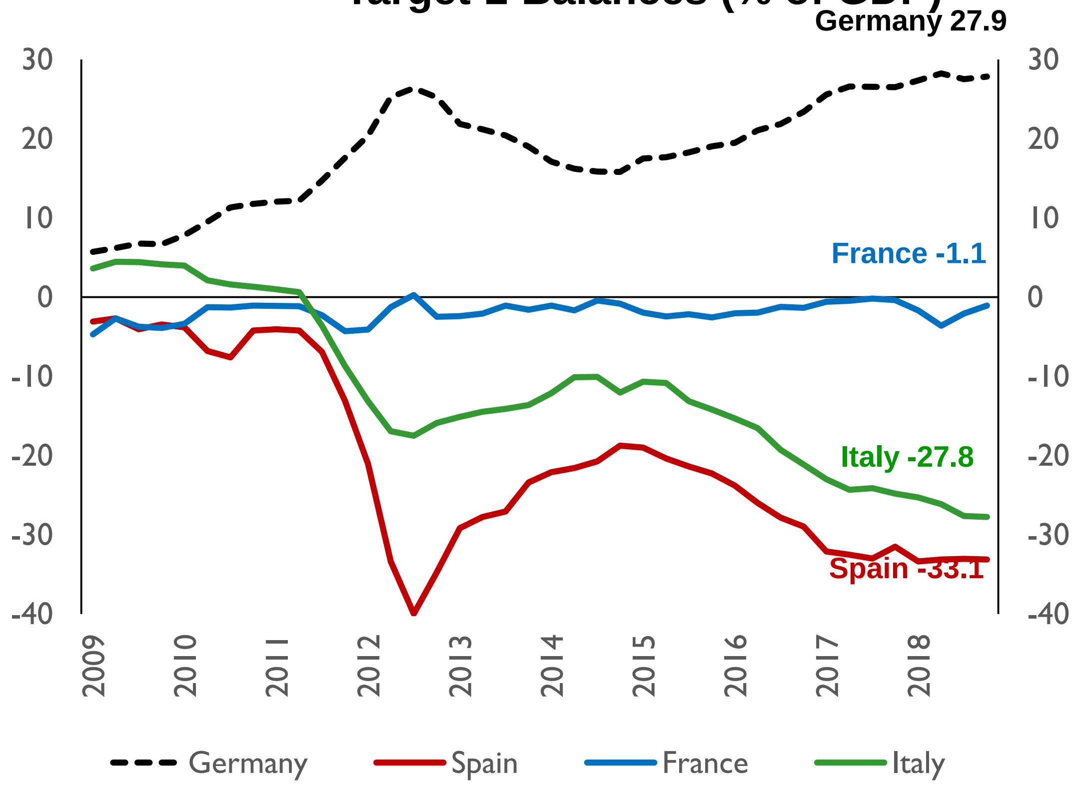
Weaknesses still matter in Europe
1. Trust by markets not granted

Redenomination risks: Ajusted Quanto CDS



Target-2 Balances (% of GDP)



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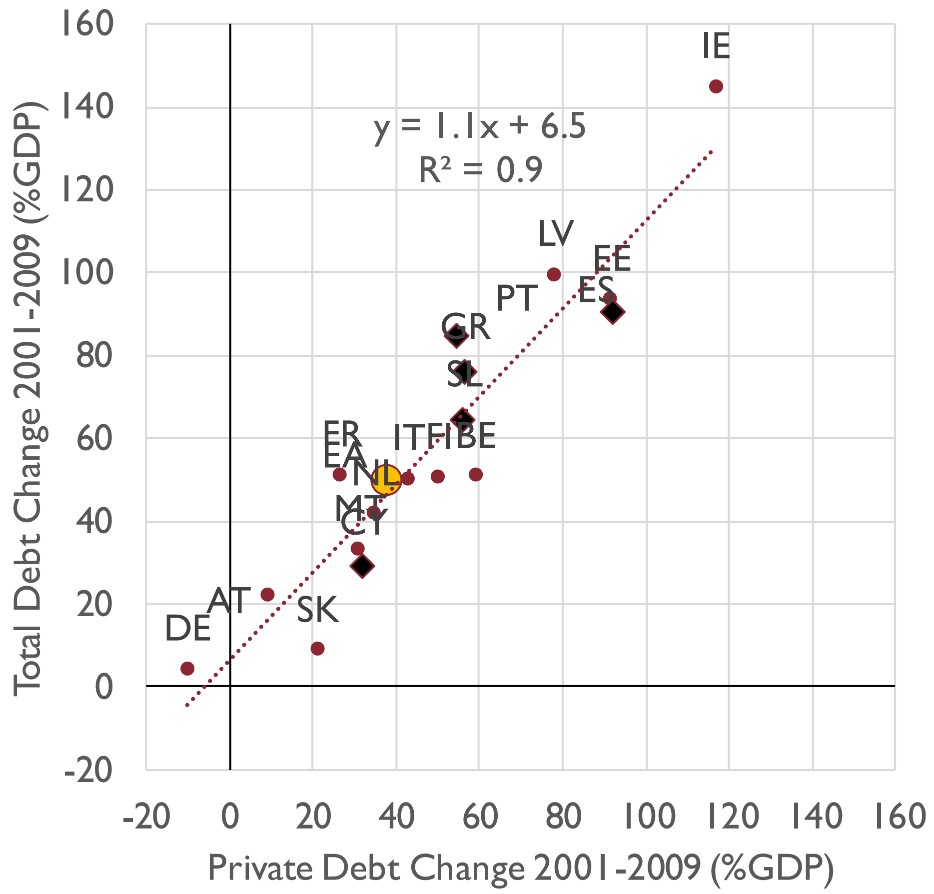
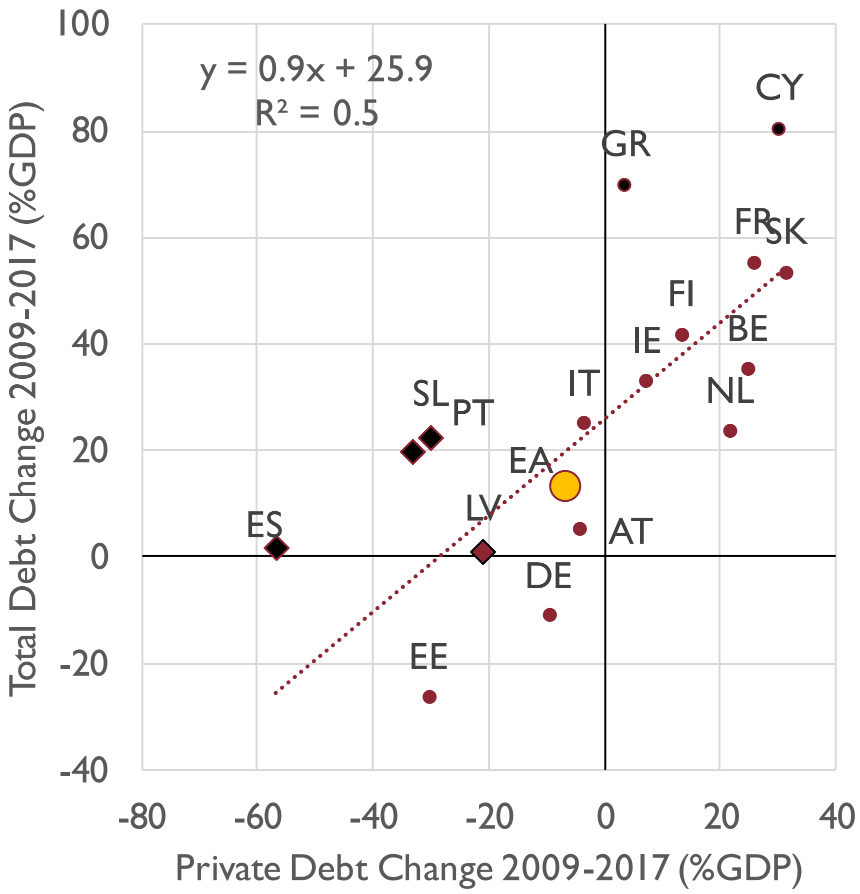
Weaknesses still matter in Europe
2. The recent private deleveraging process was mostly channeled by an increase in public indebtedness but crowding-out effects cannot be excluded

Correlation between private and public debt change in 2001-2009 and 2009-2017

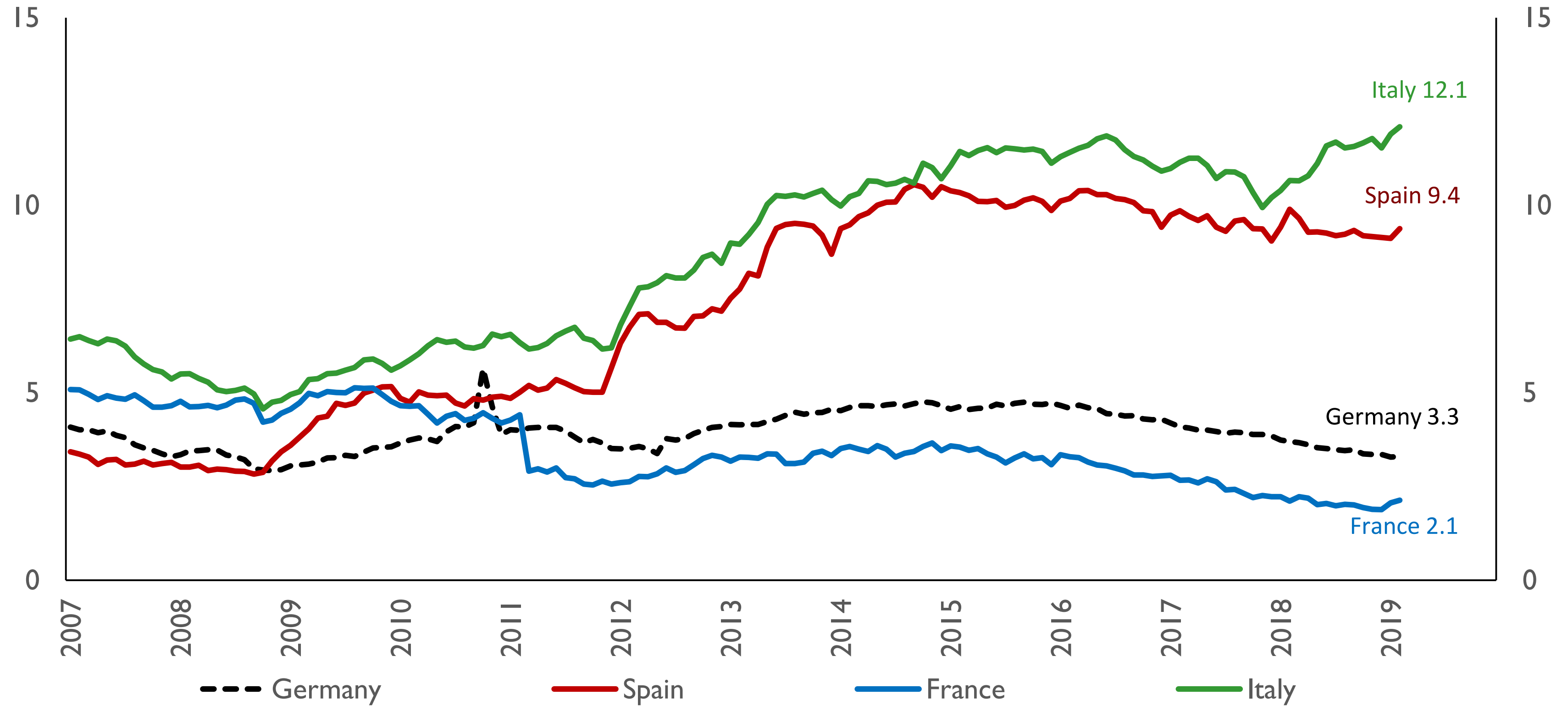




Weaknesses still matter in Europe

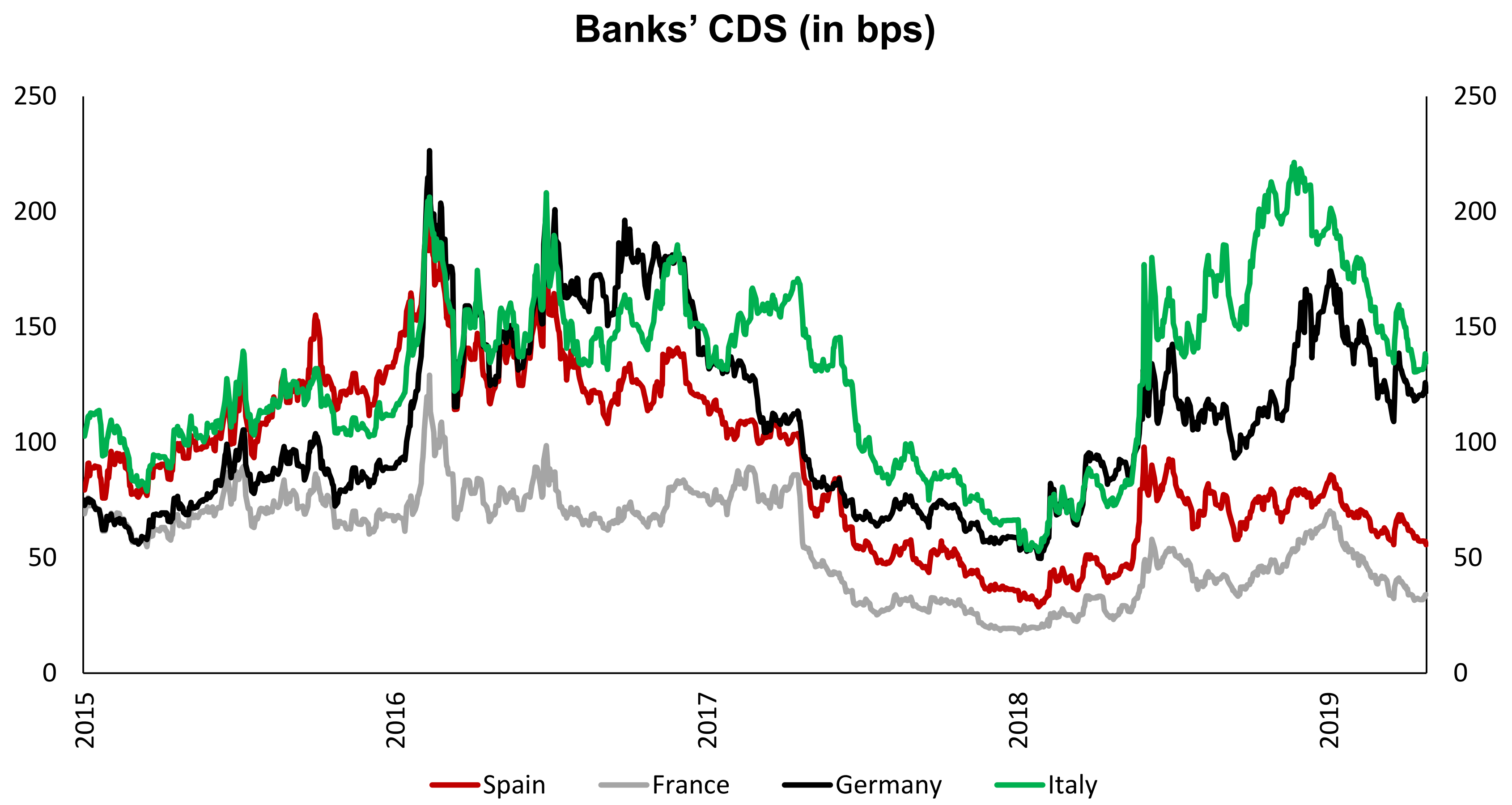
3. Banks public debt holdings are diverging, with Italy and Spain well above pre-crisis levels…

Bank's sovereign Debt Holdings (% of Total Assests)



- QE policies have been channeled to crisis countries.
- The transfer risk from sovereign to the banking sector is large in IT and ES.

Weaknesses still matter in Europe
4. And there are still dark spots in the banking sector…



Source: Reuters Datastream.

- CDS of German (and Italian) Banks above 100 bps
- However, significant positive differentiation in other financial systems such as Spain in recent months

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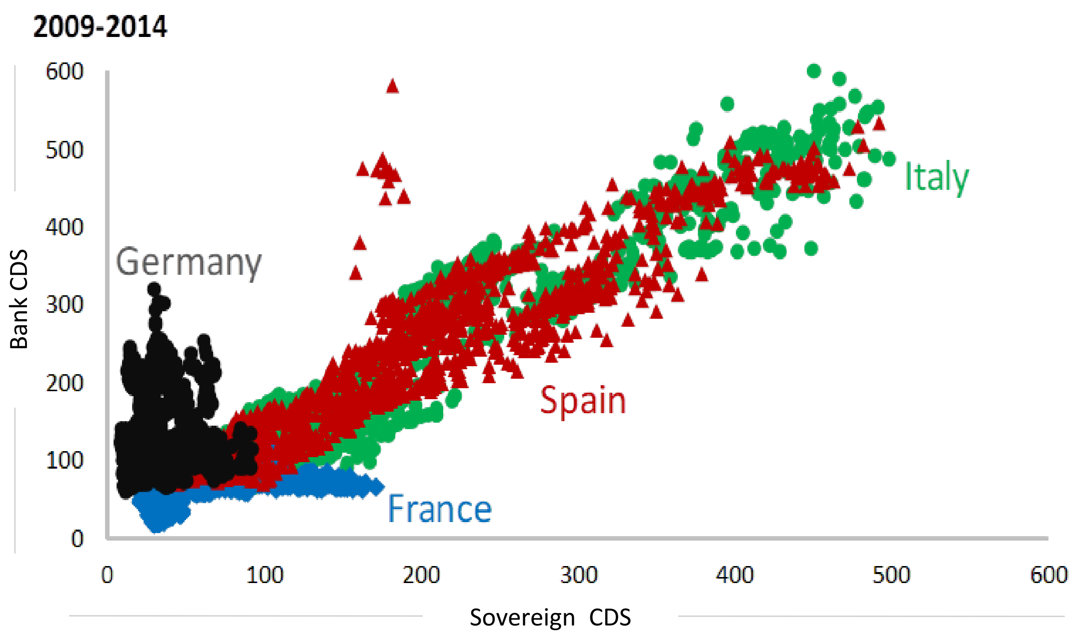
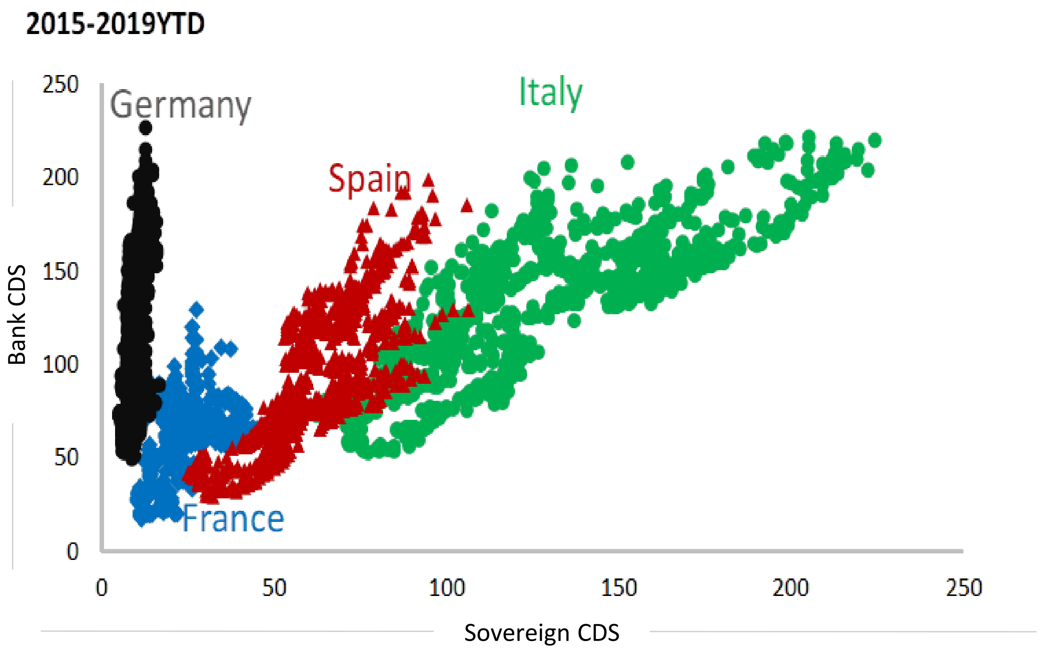
Weaknesses still matter in Europe
5. The European Sovereign-Banks feedback loop is still very strong

Banks' vs Sovereign CDS (in bps) 2009-2014 ytd

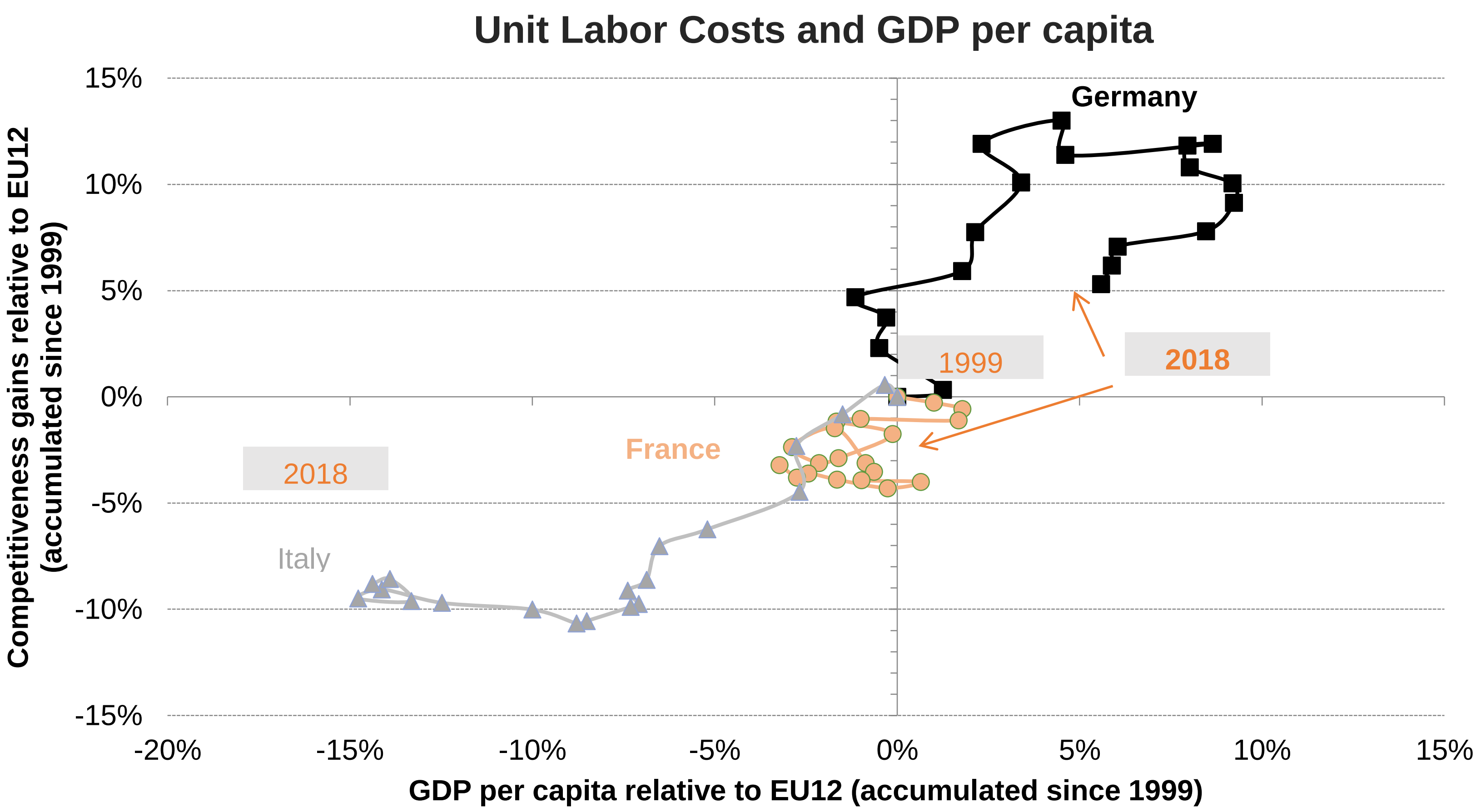


Banks' vs Sovereign CDS (in bps) 2015-2019 ytd



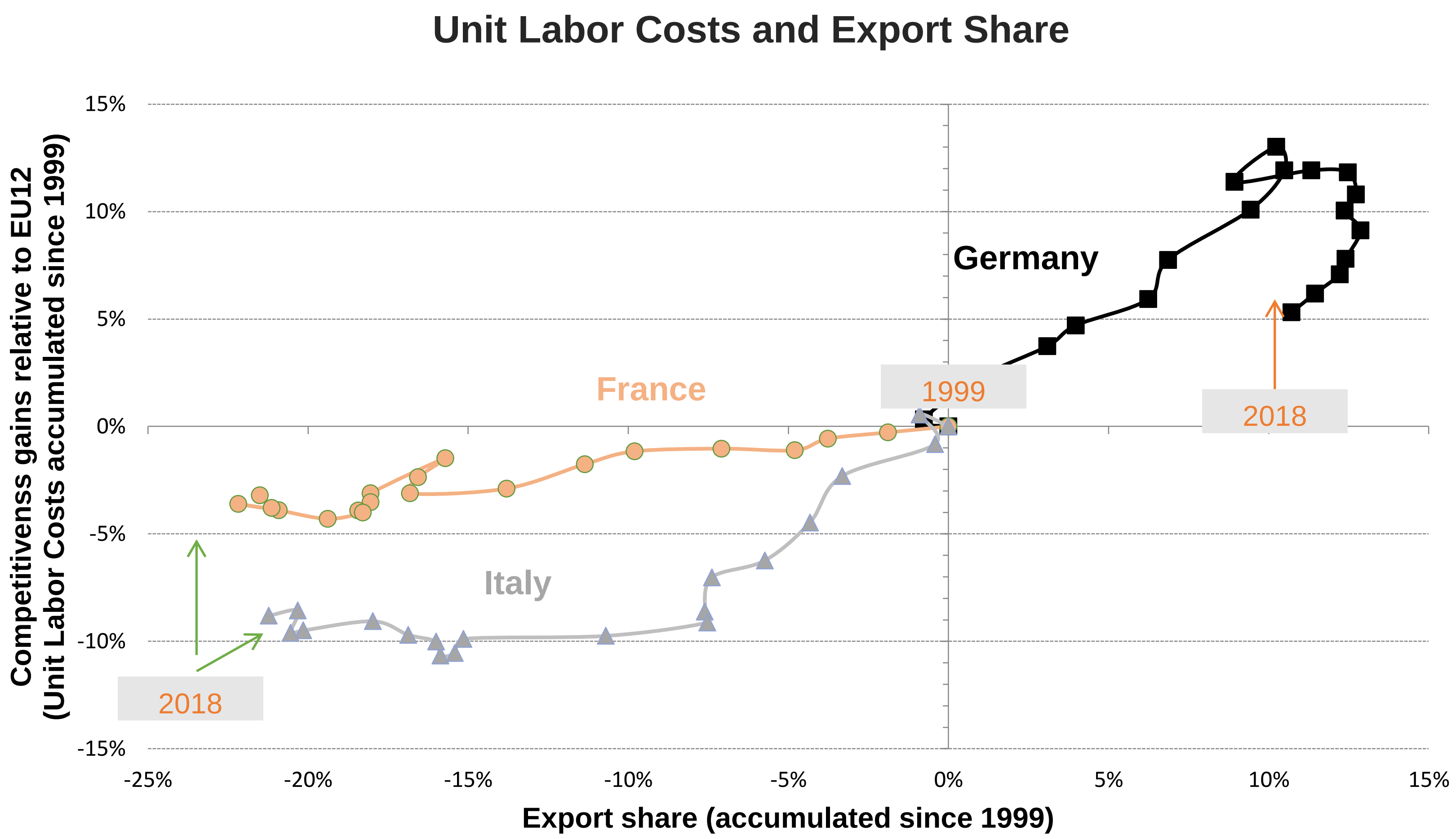
- Is Germany really the US of EMU?
- Markets have not been convinced by recent institutional reforms in the Euro Area architecture

Looking ahead, there are structural weaknesses within main Euro Area countries



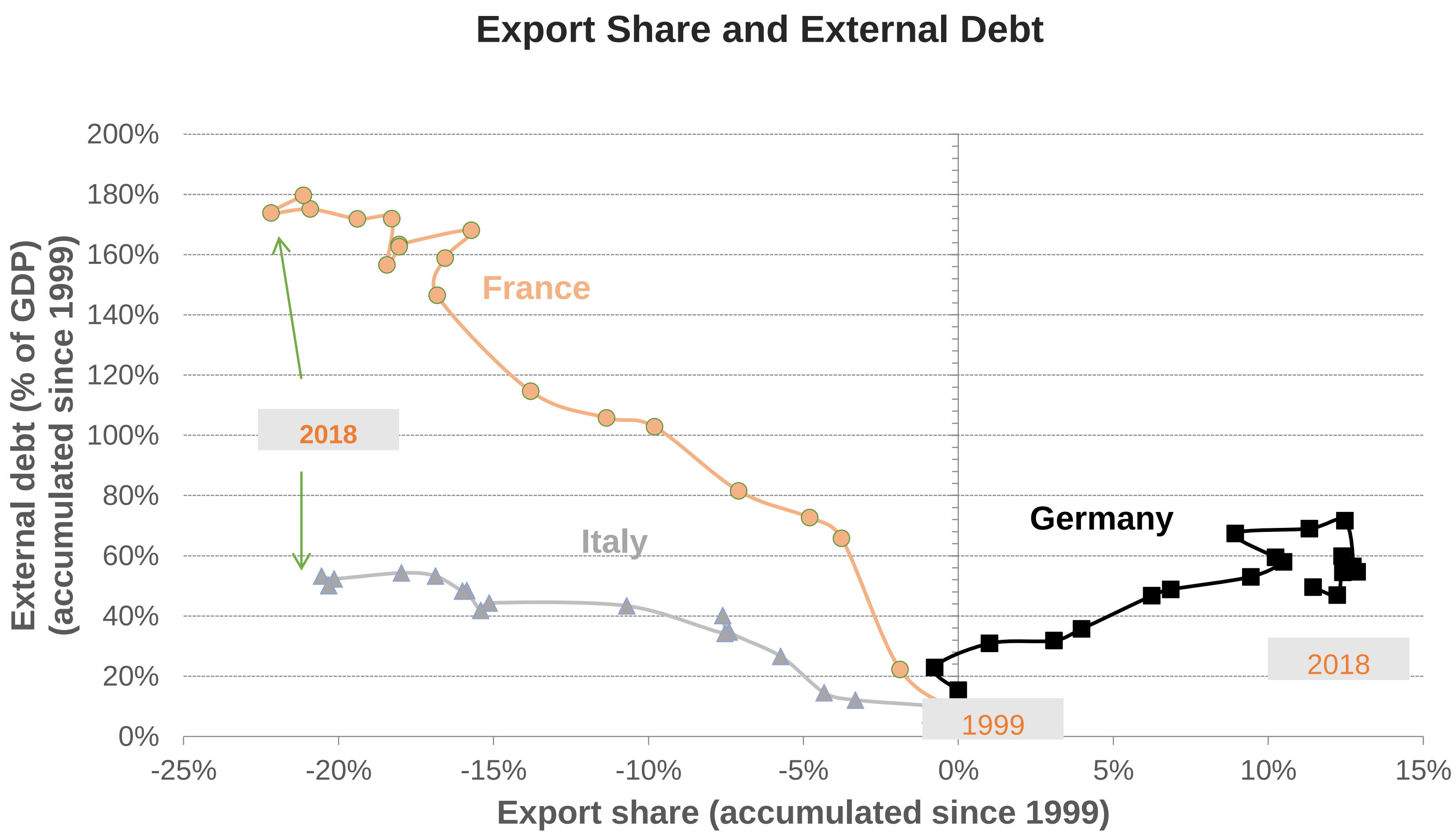
- Competitiveness divergence between Germany and Italy increases welfare gap

Looking ahead, there are structural weaknesses within main Euro Area countries



- Competitiveness decreases in France comparable to Italy’s, but without similar losses of welfare because…

Looking ahead, there are structural weaknesses within main Euro Area countries



- …France has compensated its external balance deterioration with strong external indebtedness

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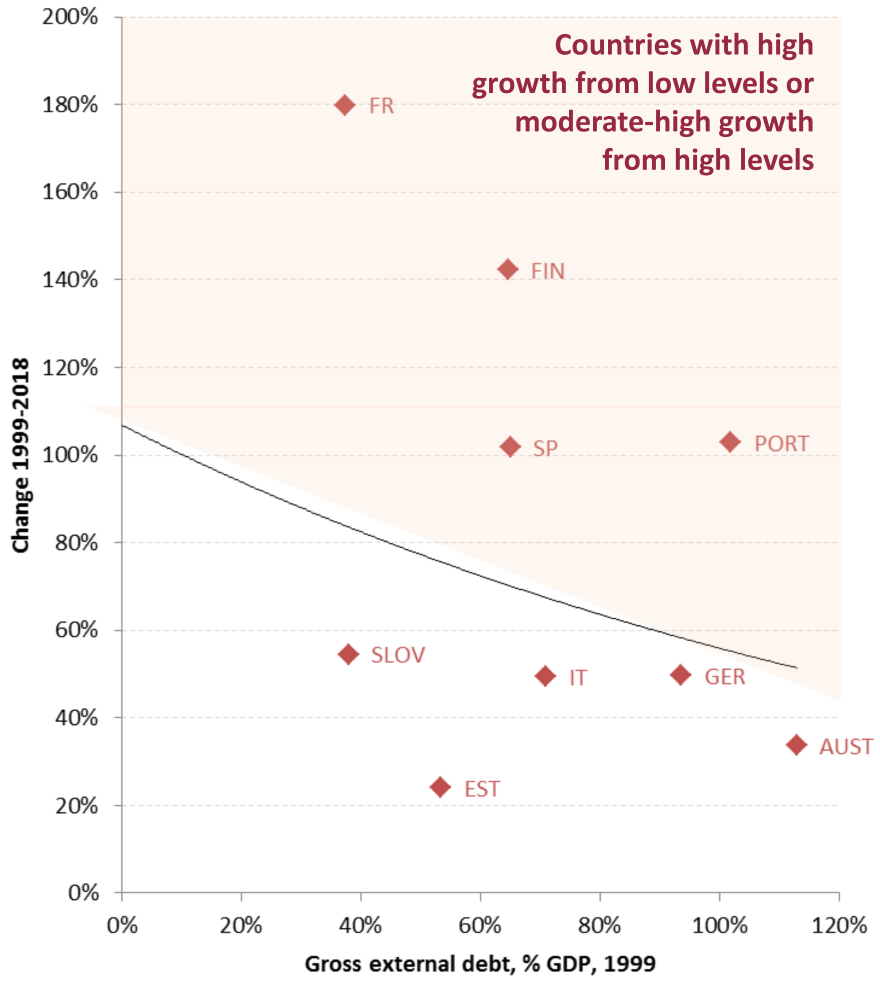
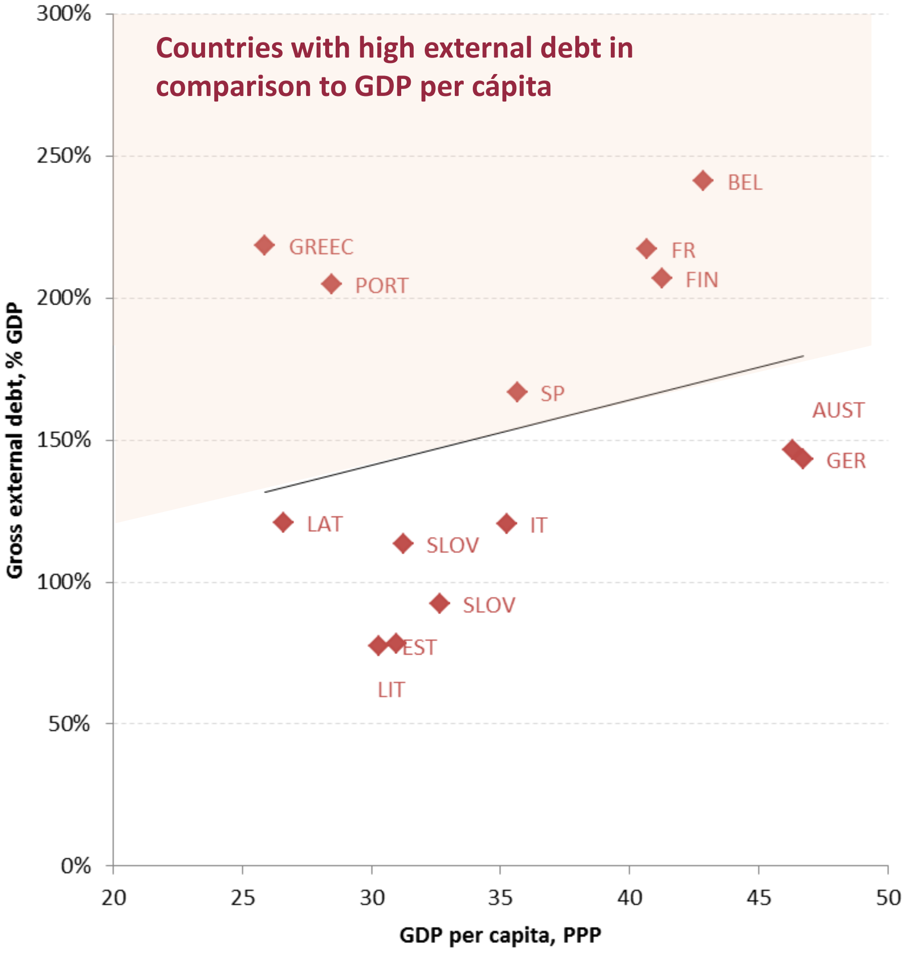
External Debt: stock and change since 1999



External Debt and GDP per capita in euro area countries, 2018



- Some countries shows a significant increase in external debt since the launch of the euro area and show as today a significant level of external debt in comparison to its GDP per cápita

Source: ECB and IMF
Cyprus, Ireland , Malta , Luxemburg and Netherlands are being removed from the sample for being special cases (off-shore centers for corporates or financial centers)

Conclusions

- Calls for a benign neglect approach to the cost of public debt in the current low interest rate environment are particularly misplaced when examined from a euro area perspective.

- The euro area remains prone to multiple equilibria whereby debt dynamics can change very rapidly and emerging markets-type balance of payment crises cannot be ruled out.

- Markets are still pricing in significant sovereign-banks risks feedback loops questioning the strength of the new architecture of the banking union.

- The two main set of factors behind the previous debt crisis (domestic policies inconsistent with the single currency and coordination failure) may still be looming