EDITORIAL

THE STAIRWAY OF PUBLIC INDEBTEDNESS

For a large sample of developed economies, government debt as a percentage of GDP has been on a rising trend over the past 40 years. High public sector debt weakens the resilience of the economy to cope with interest rate and growth shocks. This calls for embarking, at some point in time, on a fiscal consolidation. Clearly, now is not the time. The economy is still recovering from the Covid-19 shock and the outlook remains highly uncertain. Nor is there any urgency, considering the very low interest rates. However, the absence of urgency in the near term should not make us forget about the necessity to act at a later stage. Otherwise, the resilience of the economy would weaken further. It would also represent a bet that in every downturn, central bank QE will come to the rescue.

For a large sample of developed economies, government debt as a percentage of GDP has been on a rising trend over the past 40 years.[1] Recessions cause an acceleration in this development due to the decline in GDP, the role of automatic stabilisers – whereby revenues decline and expenditures such as unemployment benefit payments increase - and discretionary measures to support growth. The decline in government indebtedness during an economic expansion tends to be slow and more limited. The Great Recession, which, after a short-lived recovery, was followed in many countries in the sample by a relapse in recession, had a profound impact, causing a big jump in indebtedness.

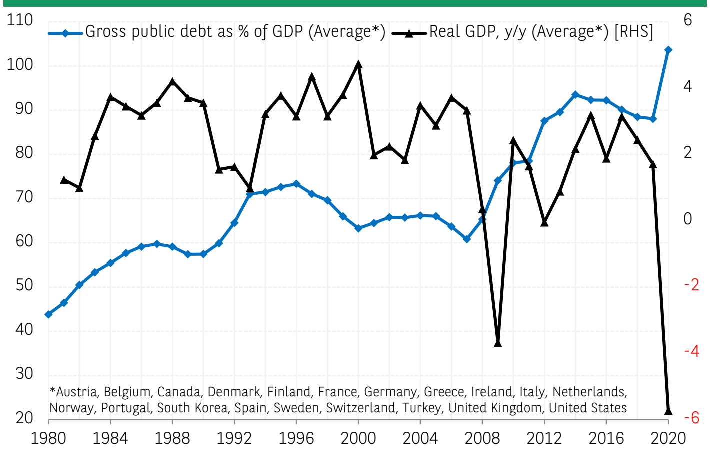
After a limited decline in the average debt ratio, this year will see another big increase due to the Covid-19 crisis. Uncertainty about the economic outlook remains very high and the IMF, in its latest Fiscal Monitor, argues that *"more needs to be done to address rising poverty, unemployment, and inequality and to foster the economic recovery."*[2] Assuming a healthy rebound in economic activity, the Fund expects the global public debt ratio to stabilise.

Low and stable interest rates play a key role in this respect. The health crisis has probably caused a further decline in the neutral rate of interest, monetary policy and quantitative easing keep bond yields under control and central bank forward guidance is unambiguous: accommodative policy will remain in place for a considerable time. It seems very likely that for several years to come, nominal GDP growth (g) should be higher than the average nominal interest rate on outstanding public debt (r). When g > r, stabilising the debt ratio shouldn't be that difficult, once activity has normalised, considering that it allows governments to run moderate primary deficits.

Of course, this would imply that the recession-induced jump in the public debt ratio becomes permanent, thereby extending the historical pattern of the debt stairway. In a recent speech, Banque de France's Governor François Villeroy de Galhau, warned this represents a tragedy on the horizon: *"we do not know if nor when the tragedy – a major confidence shock, for instance – may happen. But we know for sure that rising public debt is a growing risk hanging over us, and still more over our children and grandchildren."*[3] High and rising public sector debt is indeed a source of mounting risk. First, it increases the sensitivity of government finances should interest rates rise due to a tightening of monetary policy. Driving down the debt ratio is more challenging when starting from an elevated level given the extent of the effort which is needed to bring it back to acceptable proportions. As a consequence, investors will demand a risk premium, which pushes up the borrowing cost and complicates debt stabilisation[4].

1. Only for a small number of countries, the projected public debt ratio at the end of 2020 is not significantly different from that in 1980: Denmark, Ireland and Sweden. The data for 2020 are an estimate.
2. Source: IMF, Fiscal Monitor, October 2020.
3. *Central banks' response to the "tragedy on the horizon"*, Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the SUERF –Online Conference, 14 October 2020.
4. Cinzia Alcidi and Daniel Gros emphasize that a marginal increase in debt ends up causing a sizeable increase in interest charges because eventually debt will need to be refinanced at more expensive terms.They refer to the rule of the thumb of the IMF *"that the risk premium increases by 4 basis points for every percentage of the debt GDP ratio above 60%."* The authors mention that according to the European Commission, this increase is 3 basis points. Source: *Public Debt and the Risk Premium: A Dangerous Doom Loop*, EconPol Europe Opinion, 2019, vol. 2.

GROSS PUBLIC DEBT AND REAL GDP



SOURCE: OXFORD ECONOMICS, BNP PARIBAS

> The absence of urgency in the near term should not make us forget about the necessity of a fiscal consolidation when circumstances are more favourable. Doing nothing would weaken the resilience of the economy to shocks. It would also represent a bet that in every downturn, central bank QE will come to the rescue.

At the current juncture, this risk looks remote because the ECB's quantitative easing – in particular the Pandemic Emergency Purchase Programme - has been instrumental in lowering sovereign spreads. When the net purchases of these programmes eventually come to a halt, this is expected to cause a repricing of risk and lead to somewhat wider sovereign spreads. Second, because of the impact on borrowing costs, it reduces the possibility to stimulate growth using fiscal policy, unless the central bank would again start a QE programme and buy government paper. Third, the sensitivity of government finances to a recession increases: a contraction of GDP causes a bigger increase in the debt ratio in terms of percentage points of GDP.

All these reasons call for embarking, at some point in time, on fiscal consolidation, i.e. to reduce year after year the cyclically adjusted primary deficit or even increase the surplus. The more difficult question is when to start? Clearly, now is not the time. The economic outlook remains highly uncertain due to the pandemic and even when a vaccine will have been found and deployed, most economies will continue to operate below potential for quite some time.

A contractionary fiscal policy when the output gap is negative would neutralise to a large degree the efforts of central banks in pushing up inflation by means of an accommodative monetary policy. On the other hand, fiscal consolidation when the output gap is positive would reduce the required extent of monetary tightening to keep inflation under control. Although the interaction with monetary policy is relevant to consider when deciding on the timing of a fiscal consolidation, the overriding concern should be whether the economy can withstand the fiscal policy tightening.

Government expenditure cuts or tax increases have a direct impact on final demand and income but they also increase uncertainty about future income and profits. A priori, one would expect the sensitivity to be higher when growth is subdued than when the activity is booming. Empirical research shows that this sensitivity – also known as the fiscal multiplier – fluctuates over time and is higher during recessions and lower during expansions. This calls for 'backloading' the fiscal consolidation effort and waiting for a more robust growth environment. Hysteresis effects – whereby a cyclical increase in unemployment ends up becoming permanent- strengthen the case for postponing the budgetary adjustment 'until the time is ripe'.[5]

The current low rate environment, in conjunction with QE, also means there is no urgency to act. As explained before, when $g > r$, the debt ratio declines 'automatically', unless the primary deficit would be too high to start with. However, the absence of urgency in the near term should not make us forget about the necessity to act at a later stage, when circumstances are more favourable. Doing nothing would weaken the resilience of the economy to cope with interest rate and growth shocks. It would also represent a bet that in every downturn, central bank QE will come to the rescue.

William De Vijlder

5. This point is analysed in an excellent paper from the IMF: *How delaying fiscal consolidation affects the present value of GDP*, working paper 15/52, March 2015