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New challenges for public debt in advanced economies Summary of the conference held in Strasbourg on 16-17 September 2010

Carine Bouthevillain, Gilles Dufrénot, Philippe Frouté, Laurent Paul
Business Conditions and Macroeconomic Forecasting Directorate
Public Finance Division

On 16-17 September 2010, the Banque de France's Directorate General Economics and International Relations and the Bureau d'économie théorique et appliquée *(BETA) of Strasbourg University jointly hosted a conference on the new challenges posed by public debt in the industrialised countries. The conference brought together a diverse public made up of economists from French and foreign universities, ESCB and other central banks and European and international institutions. The relevance of the topic in the context of the crisis and fiscal imbalances that the advanced economies are currently experiencing is undeniable.*

The conference highlighted three topics relating to fiscal consolidation that have been hotly debated in international bodies: at what horizon, at what pace and by what magnitude should the current fiscal imbalances be corrected, so as to restore market confidence and stimulate economic activity over the medium term? These questions, which are the common focus of the concerns of political decision-makers and researchers alike formed the backbone of the conference.

The issue of the risks linked to excessive public debt is universally recognised as a cause for concern. However, the effect on economic activity of containing debt dynamics is not neutral and different approaches are possible to achieve this objective. The discussions that took place at the conference made it possible to gauge the consequences of these different policy choices; while it is pretty clear that excessive public debt can weigh on medium-term growth, several presentations showed that the links between public debt and economic activity are complex.

Some of the research that was presented at the conference related to the impact of the consolidation methods used on economic activity. In particular, the impact of public debt on the behaviour of financial and real estate markets, as well as the links between public debt and sovereign risk were discussed. Lastly, the role of the institutions responsible for debt governance was addressed. The initiatives taken to encourage countries,
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following the example of Germany, to introduce fiscal rules at national level were touched on. In fact, the discussions showed that implementation of an urgent political and institutional response to the challenges constituted by the fiscal imbalances is vital.

All of these issues are at the heart of the concerns of central banks, which cannot ignore the fiscal sphere given its substantial impact on price levels and price stability.

Keywords: public debt, governance, financial markets, fiscal policy.

JEL codes: E62, E63, H6, H12.

On 16-17 September 2010, the Banque de France's Directorate General Economics and International Relations via its Public Finance Division and the *Bureau d'économie théorique et appliquée* (BETA) of Strasbourg University headed by Claude Diebolt jointly hosted a conference on the new challenges posed by public debt in the industrialised countries. The conference brought together a diverse public made up of economists from French and foreign universities, European System of Central Banks (ESCB) and other central banks, and European and international institutions. The relevance of the topic in the context of the crisis and fiscal imbalances that the advanced economies are currently experiencing is undeniable. The highly stimulating discussions and diversity of points of view expressed during the conference made it possible to identify the main macroeconomic challenges facing the advanced economies in relation to the soaring levels of public debt.[1]

The conference was opened by Jean-Alain Héraud, Dean of the Faculty of Economics and Management at Strasbourg University, who, along with Pierre Jaillet, Director General of Economics and International Relations at the Banque de France, expressed his satisfaction at the success of this first collaboration between the Bank and Strasbourg University. This joint enterprise is wholly in keeping with the Bank's desire to develop closer ties between research carried out in academia and that conducted within public institutions. Pierre Jaillet then set out the issues relating to public debt from a central bank's point of view. He highlighted three questions that have been hotly debated in international bodies, i.e. at what horizon, at what pace and by what magnitude should the current fiscal imbalances be corrected, so as to restore market confidence and stimulate economic activity over the medium term? These questions, which are the common focus of the concerns of both political decision-makers and researchers, were discussed throughout the conference, notably in the keynote speeches given by Michel Camdessus, former General Manager of the International Monetary Fund and Honorary Governor of the Banque de France, and Jean-Paul Pollin, Professor at Orleans University.

From left to right: Jean-Paul Pollin, Pierre Jaillet and Michel Camdessus.

1 *A large selection of the articles presented at the conference will be published in a special issue of the* Revue économique *at the end of 2011.*

Jean-Paul Pollin set out the main difficulties stemming from the ongoing crisis in rising to the challenge of simultaneously reducing government deficits and restoring dynamic economic growth. The main difficulty in resolving this dilemma is two-fold: on the one hand, it relates to the precise assessment of the impact of the crisis on potential growth and on the other, the measurement of the effect of fiscal policy on economic activity through, for example, the estimation of fiscal multipliers. These assessments determine the trade-off arrived at between an overly rapid exit from stimulus measures, which could depress growth, and exiting too late, which would be harmful for the sustainability of public finances. Jean-Paul Pollin also recalled that these discussions should not obscure the structural reforms that need to be implemented in order to correct over the medium term the macroeconomic imbalances that existed prior to the crisis. Lastly, he spoke about the creation of a new institutional framework to regulate public finances and coordinate economic policies, this issue being the subject of Michel Camdessus' address.

Michel Camdessus' address focused on presenting the objectives and conclusions of the working group on the constitutional rule on balancing France's public finances, which he chaired and which submitted its report to the French President on 21 June 2010. Michel Camdessus started by highlighting the shortcomings in the French institutional system, which in the past have made it possible, notwithstanding sometimes binding rules on government spending, to disregard the commitments made by decision-makers at European level. At a time when the crisis has increased the need for credibility on the part of national fiscal authorities, it seems that the best way of achieving this, as shown by Germany's example, is to enshrine a framework law in the Constitution providing for a return to balanced public finances. The latter's trajectory and the correction of intermediate errors must be enshrined in the annual budgets and the multi-year programmes that contain our European commitments regarding general government across the board. The aim of this system is to reinforce the credibility of these commitments by submitting them to Parliament for annual approval.

The issue of risks linked to excessive public debt is not a new one. Antoine Parent,[2] Professor at Nancy II University, provided a historical perspective based on a critical commentary of Reinhart and Rogoff's work *This Time is Different: Eight Centuries of Financial Folly*. He showed that the questions being addressed at the moment, and particularly at this conference, are little different from those that were being asked at the end of the nineteenth century. For example, following the crisis of the British bank Barings in 1890, Crédit Lyonnais developed its own

2 The conference ended with a roundtable chaired by Olivier De Bandt (Banque de France) that brought together Daniele Franco (Banca d'Italia), Helmut Herres (Bundesfinanzministerium), Arnaud Marès (Morgan Stanley), Philippe Moutot (ECB) and Antoine Parent (BETA, Strasbourg University). The main elements of their contributions are included in the different sections of this summary.

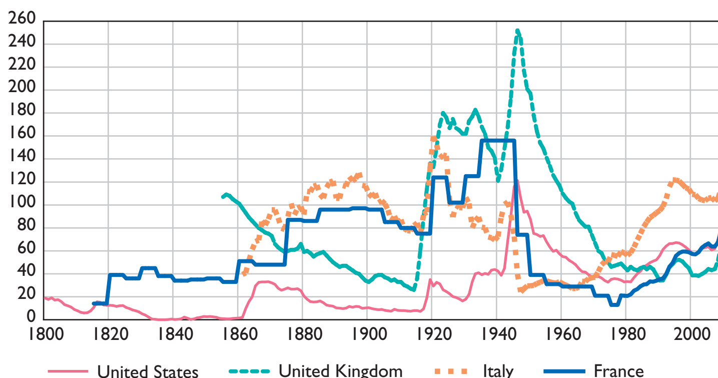
assessment of sovereign insolvency risk and conducted studies aimed at identifying warning thresholds above which countries' fiscal positions were deemed to be critical. However, the particular context prevailing in each era substantially affects the responses provided to the crisis at hand.

Thus, while the questions raised are not new, as was recalled by Olivier de Bandt, Director for Business Conditions and Macroeconomic Forecasting at the Banque de France, they have come to the fore again due to the levels of public debt currently observed in most developed countries. Indeed, the build-up of fiscal imbalances over the past 30 years has led to the highest public debt ratios ever seen in peacetime (see Chart 1). This trend has been exacerbated by the crisis due to the combined effect of automatic stabilisers, fiscal stimulus packages and the measures taken to support the banking sector.

However, Olivier de Bandt pointed out that, even more than the levels observed, it is the debt dynamics that are worrying. Indeed, in most advanced economies the accumulation of debt is self-perpetuating (the "snowball effect"). Recent simulations carried out by the European Commission show that, in the absence of corrective measures taken by governments, the euro area's debt and that of the EU-27 could rise to 140% of GDP by 2020, compared with around 80% of GDP currently. Only strict application of stability programmes and keeping public deficits at sustainable levels subsequently would make it possible to stabilise the euro area's debt ratio at its current level. It is crucial for governments to announce and embark on a process of credible fiscal consolidation and to stick to it over the long term.

Chart 1 Public debt-to-GDP ratio 1800-2009

(as a %)

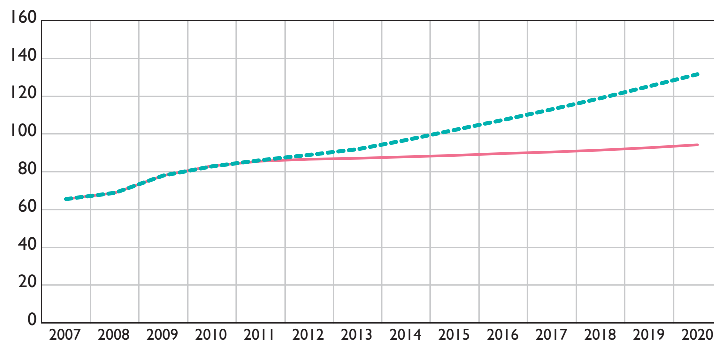


Source: Banque de France.

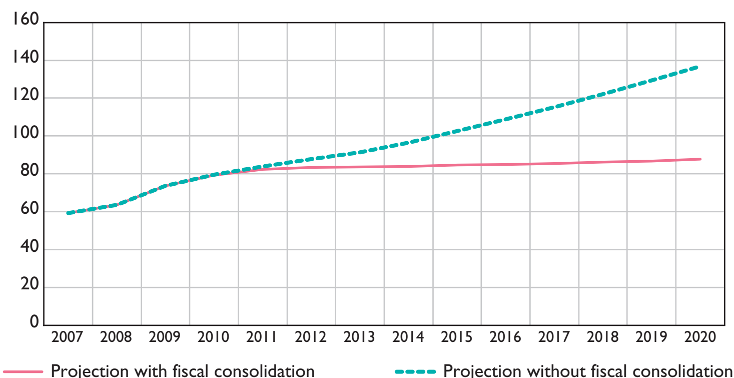
Chart 2 Medium-term projections of the public debt-to-GDP ratio in the European Union and euro area

(as a % of GDP)

A – Euro area



B – EU-27



Projection with fiscal consolidation — Projection without fiscal consolidation

Source: European Commission.

However, the effect on economic activity of containing debt dynamics is not neutral. Different means can be used to achieve this. The discussions at the conference made it possible to gauge the consequences that stem from these choices. Indeed, while it is pretty clear that excessive public debt can weigh on medium-term growth, much research has shown the complexity of the links between public debt and economic activity. Jacques Le Cacheux, Director of the research department at the Observatoire français des conjonctures économiques (OFCE) and Professor at the University of Pau and Pays de l'Adour, presented the latest developments in the structure of the multi-region general equilibrium model INGENU.[3] This type of complex model is designed to analyse numerous fundamental economic issues, including that of persistently high levels of public debt, but proves to be tricky to use on account of the extreme sensitivity of the results to the many parameters that it requires.

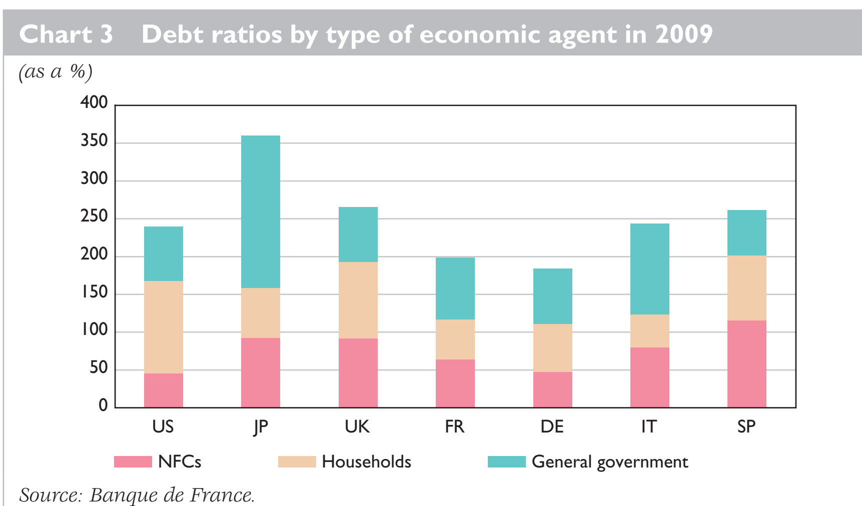
3 *Jacques Le Cacheux: "Long-term sustainability of public debts: a global perspective".*

Once finalised, it should make it possible to address the issue of debt at the global level taking account of economic and financial interactions and the long-term demographic outlook.

1| Complex links between fiscal policy and economic activity

Most of the participants noted that their work on public debt was conducted within the wider perspective of overall imbalances. Indeed, public debt is only one component of total debt, which also reached record levels before the crisis. For some countries (Spain, the United States), this high level of indebtedness of domestic agents has its counterpart in growing external debt (twin deficits).

Chart 3 Debt ratios by type of economic agent in 2009



Source: Banque de France.

1|1 Is there a level of public debt that should not be exceeded?

Alexandru Minea, Professor at the University of the Auvergne, showed that the links between public debt and economic growth are not linear.[4] With the same level of public debt, several different levels of growth may be reached. The situation that actually comes about will ultimately depend on private sector expectations. As long as the debt is deemed sustainable, short-term Keynesian effects (an increase in consumption) will have a positive impact on growth. Conversely, in the event of a turnaround in private sector expectations, long-term non-Keynesian effects (an increase

4 *Alexandru Minea and Patrick Villieu: "Persistent deficits, growth and indeterminacy".*

in savings) predominate due to the expected rise in taxes and social security contributions to finance the debt. This research thus points to the existence of a debt threshold at which the turnaround occurs, although it does not seek to measure it.

Cristina Checherita, economist in the Fiscal Policies Division of the European Central Bank, addressed this issue from an empirical perspective.[5] Her work highlights the existence of a turning point beyond which debt has a negative impact on growth. In line with Reinhart and Rogoff's findings, Cristina Checherita estimated this turning point at around 90%-100% of GDP, levels that have already been reached or are expected to be reached by several countries, notably in the euro area. This result underscores the need for urgent fiscal consolidation in the countries concerned.

Francesco Caprioli, economist at the Banca d'Italia, showed however that, even if a government takes all the necessary measures to reduce its debt after a period in which it has risen sharply, bringing it down to pre-crisis levels should not be an objective in itself.[6] The sustainable level for public debt may be higher than pre-crisis levels. This finding stems from the nature of private sector expectations vis-à-vis public debt default risk. If expectations are not rational but rather adaptive (agents learn from experience) then sustainability levels for public debt will depend on the country's past debt record.

1|2 The economic impact of public debt is not neutral

Some of the research presented at the conference concerned the impact on economic activity of the means of consolidation used.

Several participants also underscored the fact that public debt developments may have different effects depending on the markets concerned. Luca Agnello, economist at the Banque de France, thus showed that although, overall, an unexpected deterioration in public finances has a negative impact on the prices of financial and real estate assets, the speed with which shocks are propagated and their persistence can differ greatly.[7] Financial markets react almost instantaneously to shocks and absorb them rapidly, whereas real estate markets react later and the effect of shocks is persistent.

Roland Winkler, economist at the Goethe Institute in Frankfurt, presented the conclusions of a study seeking to determine the best exit strategy for the euro area taking account of the effects of the influx of sovereign bonds

5 *Cristina Checherita and Philipp Rother: "The impact of high and growing government debt in economic growth: an empirical investigation of the Euro area".*
6 *Francesco Caprioli, Pietro Rizza and Pietro Tommasino: "Optimal fiscal policy when agents fear government default".*
7 *Lucas Agnello and Ricardo Sousa: "Fiscal policy and asset prices".*

on financial markets.[8] The conclusions are that consolidation should be rapid (shock therapy), based mainly on spending cuts and higher taxes on consumption. In the current situation, the author therefore recommends simultaneous fiscal consolidation in the euro area countries, which would be offset by a single monetary policy that could remain accommodating at the start of the process.

On the role of monetary policy in the context of a fiscal crisis, Antoine Parent presented an analysis based on the lessons of the past.[9] This study highlights the existence of a liquidity trap in 1928-29 in the United States. The authors wonder whether in that situation expansive monetary policy would have made it possible to avoid the Great Depression, and answer in the negative. They conclude that an appropriate way of managing the crisis would have been to exit the liquidity trap by raising interest rates so as to break expectations leading to the formation of bubbles on asset markets.

Coming back to the recent period, Philippe Moutot, Deputy Director-General of Economic Research and Director of Monetary Policy at the European Central Bank (ECB), analysed the coordination of economic policies in the last recession. In his view, Europe did not suffer from the absence of an integrated European economic government. On the contrary, the current European structure made possible the implementation of an appropriate policy mix: on the one hand, monetary policy was conducted by the independent central bank and, on the other, national governments, under the impetus of the European Commission, coordinated their national actions. Indeed, unlike the management of the 1929 crisis in the United States, the monetary policy conducted by the ECB during the recent crisis, notably the implementation of non-standard measures, made it possible to successfully tackle the liquidity crisis with the attendant dangers of a liquidity trap linked to zero-bound interest rates. However, the sovereign debt crisis experienced by some euro area countries has shown the need to reconsider the links between fiscal policy and other economic policies.

2| Public debt and financial markets

If public debt can have effects on economic activity, it can also have a significant impact on the behaviour of financial markets and vice versa. This second aspect was the subject of a special session during the conference.

8 *Ignazio Angeloni, Ester Faia and Roland Winkler: "Exit Strategies".*
9 *Claude Diebolt, Antoine Parent and Jamel Trabelsi: "Revisiting the 1929 Crisis: Was the Fed Pre-Keynesian? New Lessons from the Past".*

2|1 Financial markets have an impact on the cost of public debt and sovereign default risk

The self-perpetuating build-up of debt stems from an extremely large stock of initial debt but also from the differential between interest rates and the growth rate of the economy. The interest rate determines the cost of debt and includes a fundamental component, i.e. the risk premium that is set by financial markets. Andreas Schabert, economist at Dortmund University and Amsterdam University, presented the findings of a study aimed at investigating the impact of risk premia on public debt using the assumption that a government is obliged to repay its debt as early as possible.[10] The author shows that risk premia dynamics result from investors' expectations regarding the probability of a government defaulting. These expectations are based on an assessment of the sustainability of the debt and governments' credibility in committing themselves not to default. These expectations are largely founded on an assessment of the future interest rate burden and of the resources governments have to cope with it. The authors show that negative spirals can occur. For example, in order to guard against default risk, investors raise risk premia, which increases the interest rate burden and therefore reduces the debt's sustainability, thus precipitating a default.

Peter Wierts, economist at the Nederlandsche Bank, presented the findings of an empirical study of the interactions between the public debt management policies conducted by countries – in France this role is played by the Agence France Trésor (AFT) – and macroeconomic variables.[11] The authors estimated a reaction function describing public debt management behaviour in response to variables such as the yield curve, monetary policy, and the liquidity and size of money and debt markets. They show that the behaviour of debt managers affects financial stability in euro area countries. Public debt managers tend to focus on minimising the cost of debt by reacting strongly to changes in the slope of the yield curve. In so doing, they increasingly make use of hedging instruments such as interest rate swaps. However, these swaps do not provide protection against all types of risk: while they hedge against interest rate risk, they do not hedge against the risks linked to refinancing operations. They can therefore generate counterparty risk and may ultimately reduce the transparency of the overall risk profile.

10 Falko Juessen, Ludger Linnemann and Andreas Schabert: "Understanding default risk premia on public debt".
11 Lex Hoogduin, Bahar Öztürk and Peter Wierts: "Public Debt Managers' Behaviour: Interactions with Macro Policies".

2|2 Financial markets are involved in assessing sovereign risk

Pedro Gomes, economist at the London School of Economics, presented an empirical analysis of the links between public debt and sovereign ratings.[12] The authors sought to reconstitute the sovereign debt ratings attributed by the main rating agencies (Moody's, Fitchratings and Standard & Poor's) with the aid of the main economic variables such as per capita GDP, GDP growth, inflation, external debt and unemployment. The authors show that in the industrialised countries there are large disparities in the correlation between fiscal imbalances and agencies' sovereign risk ratings. Some countries appear to enjoy a higher rating than their economic indicators might suggest (e.g. the United States, Italy and France) while others appear to be "under-rated" compared with the state of their fundamentals (Greece, Ireland and Portugal).

Philippe Frouté, economist at the Banque de France, presented the findings of a study devoted to the impact of expectations regarding macroeconomic fundamentals on the dynamics of sovereign spreads.[13] The authors suggest that this impact is greater following the adoption of a regulatory framework that modifies the rules governing financial stability. They draw on the example of the implementation of the Basel II accords to explain the existence of a structural break in 2005 in the correlation between European countries' sovereign spreads and expectations regarding developments in fiscal and current account deficits and inflation. The authors also show that this effect can be obscured if another large shock occurs. Indeed, the financial shock caused by the crisis has overshadowed the information relating to Basel II and led to an underestimation of the effect of the institutional changes on the impact of expectations regarding macroeconomic fundamentals on spreads. However, the authors show that the crisis also augmented the explanatory power of expectations regarding economic fundamentals vis-à-vis sovereign spread dynamics.

Arnaud Marès, economist at Morgan Stanley, advanced the idea that the financial markets are indeed at the root of the crisis, not because the system failed, but through their response to the growing problems of sustainability that they perceived. The sharp widening of spreads on sovereign bonds can be interpreted both as a sanction directed at governments that are lax in their conduct of fiscal policy and as an incentive to countries in difficulty to implement corrective policies. In this sense, the accusation directed at financial markets that they exacerbated the difficulties of some countries is, in his opinion, misplaced. This point of view however sparked debate. Indeed, one of the justifications for the introduction of fiscal rules is that it makes medium-term fiscal action credible in the face

12 Antonio Afonso and Pedro Gomes: "Do fiscal imbalances deteriorate sovereign debt ratings?"
13 Olivier Damette, Gilles Dufrénot and Philippe Frouté: "Are the forecasted macroeconomic variables informative of the changes observed in the euro area sovereign spreads?".

of markets that can tend to overreact to the announcement of economic indicators. For the proponents of this latter view, therefore, it is necessary to design an effective institutional framework and to reinforce market discipline in order to enable fiscal policies to follow a sustainable path conducive to growth.

3| The role of debt governance institutions

3|1 Fiscal rules

Daniele Franco, Director of the Department of Structural Economic Analysis at the Banca d'Italia, presented an overview of fiscal rules in Europe. He recalled the economic principles that guided the design of fiscal rules for EMU: correction of externalities linked to deficits and public debt, "no bail-out", and countering moral hazard and free-riding. It is easier to comply with these different objectives when they are part of a supranational framework. Daniele Franco judges that, while the crisis has underscored the need to reform the fiscal surveillance framework, a radical overhaul of the rules is not called for. He rather recommends incremental reform that would address the shortcomings revealed by the crisis. For example, better account should be taken of the complex links between macroeconomic variables and fiscal policies. The standard indicators have shown their limitations. In this respect, the case of Spain is very illustrative. Although the country has been hard hit by the crisis, just a few months before its onset some analysts were praising its development model. At the time, few observers paid attention to the chronic external deficits or to private agents' high rate of indebtedness. This being the case, an increasingly large proportion of the Spanish economy saw its vulnerability to interest rates and dependence on the buoyancy of one particular sector of activity grow. Like the European Commission and the ECB, Daniele Franco recommends the following changes to the Stability and Growth Pact (SGP): enhancing surveillance, strengthening sanctions and increasing the role of the debt criterion in the assessment of national fiscal policies. The ECB goes even further in recommending the creation of an independent fiscal policy watchdog. Both of these institutions also encourage national governments to implement fiscal rules at national level.

In this context, the introduction of a constitutional fiscal rule in Germany was cited as an example. This rule was presented by Helmut Herres, Director of Fiscal Policy in the German Federal Ministry of Finance. It consists of the introduction of a deficit limit set in cyclically-adjusted

terms (0.35% for the Bund by 2016 and 0% for the Länder by 2020) and a control account aimed at limiting slippage with respect to the target. The aim of the rule is to make fiscal policy symmetrical throughout the business cycle. It thus makes it possible to steer medium-term fiscal policy in a way that is consistent with the objectives of the SGP.

3|2 Towards a European debt agency?

Pavel Diev, economist at the Banque de France, set out the idea of the creation of a European debt agency.[14] This body would provide several benefits: a reduction in the cost of raising funds through the creation of a more liquid government bond market, a fall in the default risk perceived by markets, greater ease of refinancing and the fiscal discipline role played by financial markets. But the creation of such an agency raises numerous issues: how can the risks of free-riding within the euro area be guarded against? And what about the supervision and harmonisation of national regulations?

The conference showed, on the one hand, the growing interest of economic research in the issue of excessive public debt and, on the other hand, the convergence of the participants' concerns, whether they be researchers, market practitioners, macroeconomists or financial experts. The discussions showed that all of them advocate implementation of an urgent political and institutional response to the challenges posed by fiscal imbalances. While there was near unanimous agreement on the main thrust of these responses, divergent but also complementary points of view were expressed as to the exact means to be used. These issues are at the heart of the concerns of central banks, which cannot ignore the fiscal sphere given its significant impact on price levels and price stability.

14 Laurent Daniel, Pavel Diev: "What Prospects for a European Debt Agency?"