Ksenia Yudaeva: National debt – vice or virtue?

Statement by Ms Ksenia Yudaeva, Deputy Governor of the Bank of Russia, at the Gaidar Forum 2016 “Russian and the world – looking to the future”, panel discussion “National debt – vice or virtue?”, Moscow, 13 January 2016.

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Before starting the discussion I would like to say a few words about ***the current market situation***. Following the 2008–2009 crisis, ***bursts of volatility*** can occasionally be observed in global markets. ***The reasons are different***: debt crisis in the peripheral eurozone countries, changes in the US Fed’s policy, changes in the structure and strategies of the oil market players or, as in the past six months, the situation in the Chinese market. Anyway the bursts of volatility relate to the adjustment of global imbalances, which have been piling up for years, and they are inevitable to a certain extent. This is a part on the new reality we are living in. ***Given the situation, the Bank of Russia’s main task is to stabilise the Russian economy amid external shocks,*** create conditions for its quick adaptation to the new environment while retaining high price stability, and macroeconomic and financial stability in general, and henceforth ***maintain basic conditions for economic growth***.

If we turn to ***the situation in the Russian markets***, we can see that recently it has been ***rather stable*** despite global volatility. There are no problems with liquidity and other risks to financial stability. Risks related to the corporate debt burden are under control. The Bank of Russia is monitoring financial stability, promptly and regularly adjusts its macroeconomic forecasts and its policy. ***The central bank is prepared to use all available instruments to stabilise the situation in case of need***.

However, in order to maintain macroeconomic stability we need not only a balanced policy pursued by the central bank, but also ***the appropriate fiscal policy***, including the government debt management policy.

The national debt in national currency is a basic financial instrument for any country of the world. It plays a leading part in the financial markets, is actively used by central banks in their monetary policies, as well as in banking and financial regulation. This is the role of a ***risk-free liquid asset***, as we conditionally call it. The rates on other riskier assets are usually calculated with due account of the risk premium to government debt. As distinct from short-term interest rates regulated by central banks, ***long-term rates in the economy depend on inflation expectations and expectations with regard to government finance sustainability***.

The ‘risk-free’ is a key word describing the relationship between the financial system and the government debt. The latter may perform all these functions only if ***the state budget is balanced in the medium and long terms*** and the government may honour its obligations without resorting to defaults and the printing press. Budget discipline impacts the central bank’s ability to function as an economic and financial stabiliser amid economic shocks.

You may find ***a lot of examples*** in the Russian and international history. ***The Russian policy between the end of the 19th century and the start of the First World War*** serves as a model of how the balanced fiscal policy allowed the government to preserve national currency stability, refrain from increasing taxes, and stabilise debt in per cent of GDP at the levels acceptable to the market. At that time a sustainable economic growth persisted despite the lost war with Japan and the revolutionary upheavals. (Vice versa, uncontrolled budget deficit growth and in effect the breakdown of government finance during the First World War led to an economic collapse and triggered the 1917 revolution.)

Let’s turn to more ***contemporary examples***. The development of the so-called emerging markets, i.e. the financial markets of developing countries, started following the state budgets’ stabilisation and inflation reduction. Market uncertainty about fiscal stability may cause shocks in the financial and FX markets. Both ***the situation in Brazil in recent months and the Russian crisis of 1998*** can serve as an example. Moreover, market concerns over the consistency of the Bank of Russia's policy and our adherence to announced goals, which we felt in 2014 and to a lesser extent in 2015, were also linked to the budget. All ***the theories of the ruble exchange rate pegged to a certain ruble price of oil originated from considerations of budget balance*** and concerns that the central bank would intentionally generate inflation to finance budget liabilities. That is ***the Bank of Russia was suspected of being ready to give up inflation targeting for the sake of budget replenishment***. It took us many months to persuade the market of the opposite.

Does Russia have a ***potential to build up government debt***? Yes, it does, in theory, since our country may boast one of the lowest levels of government debt. Consequently, the development of the government debt market could be conducive to the development of the financial system as a whole. Anyway I would proceed from the conservative assessments of the maximum possible debt burden on the Russian economy, which does not pose a threat to macroeconomic stability, say, no more than 25–30% of GDP. Anyway examples from the Russian history show that the real interest rates the Russian budget has to pay, should the government debt exceed 35–40%, became exorbitant and accelerated the debt spiral. Among the negative outcome of government debt growth I may also call the ousting of corporate and private borrowers by the state. By the way, ***the maximum permissible debt burden is higher in the countries witnessing persistently low inflation and persistently low inflation expectations***. The long-term real interest rates in these countries are lower, which means that debt burden limits are higher. This is another manifestation of interdependence between fiscal and monetary policies: ***the more successful the central bank is in terms of securing sustainable price stability, the larger is the room for manoeuvre used by the Government*** to build up budget deficit and government debt to pursue a countercyclical policy.

Actually, there is ***no choice whether the government debt is good or bad***. Any medicine can be fatal, or at least toxic, if overdosed. The same is true of the government debt: it can easily turn out from a basis for the financial system development to its grave digger. This is one of the reasons which cannot help being taken into account in shaping fiscal policy.

While assessing ***the size of potential development of the Russian debt market***, one cannot help taking into account several material risk factors. The first one is various ***off-balance-sheet budget liabilities, explicit and implicit ones***. The case of Vnesheconombank shows that they may be rather significant. Therefore, ***balancing federal budget alone without accounting for debt accumulation by the regions is insufficient.*** Such factor as population aging and the need to finance the growing costs of pension provision in the next five to ten years cannot be ruled out either. The second factor is ***high uncertainty in the global commodity markets, first of all, the oil market***. This is another argument in favour of using conservative scenarios. Finally, there is uncertainty with regard to the duration of the period of low oil prices. But ***the total amount of the macroeconomically stable debt burden is, unfortunately, an absolute value not depending on the period, during which the debt is being accumulated***. The lack of clear fiscal strategy in the future can destabilise the markets already now.

Whether the government debt is good or bad, as I have already mentioned, is a sham question to a certain extent. Another sham question is a ***choice between the financial stability and economic growth***. Both the central bank and the Ministry of Finance are being quite often criticised for focusing monetary and fiscal policies respectively on the problem of financial stability to the detriment of economic growth. In actual fact, economic growth is impossible without financial stability. While a stable budget is the basis of financial stability. It is possible to stake money, including government one, at the microlevel, at the level of small specific projects. To take risks at the macrolevel means to endanger economic growth and social stability.

An important question is ***how to finance the deficit: through reserves or through debt?*** Strictly speaking, both options lead to growth in net debt (net of reserves) and consequently to debt burden accumulation. That is why this choice is also ***a sham one to a large extent***. Nevertheless, since the commodity market risks are high, we believe that today the priority should be given to debt financing and ***keeping reserves for more complicated scenarios***, when the access to debt financing is even more difficult. Moreover, no doubt that the available reserves serve as an insurance from the market point of view and make the access to debt financing somewhat easier.

In conclusion I would like to say a few words about how ***to reach the path of strong economic growth*** amid tough monetary and fiscal policies and prudent build-up of government debt. The matter is ***the structure of budget expenditure***, rather than its volume, and ***the use of structural reform potential***. The external conditions push the economy towards structural changes and balanced structural reforms may accelerate this process and make it less painful. ***The emphasis should be put on those industries, which turned out to be competitive in the current situation without government support.*** Only they could become an efficient engine of development amid new reality. As it often happens, the best way to help businesses in the current conditions is not to interfere. The deficit resources of government support should be concentrated on assistance to the most vulnerable population groups, as well as on the development of infrastructure and human capital.