

Vítor Constâncio: Remarks at the Symposium on Debt – economic, political and moral consequences

Remarks prepared by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 37th Symposium on Debt – Economic, Political and Moral Consequences in honour of Benjamin M. Friedman, organised by the Institut für bankhistorische Forschung e.V. jointly with the Deutsche Bundesbank and Goethe University/Research Center SAFE, Frankfurt am Main, 24 June 2015.

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It is indeed a great pleasure for me to participate in this homage to Professor Benjamin Friedman and I am grateful for having been invited by Professor Kotz to take part in this panel. Over the years, Ben Friedman has made important contributions to macroeconomics and monetary theory. From 1975 to 1990, he was an early critic of the use of partially endogenous variables like money or credit as intermediate targets in the design of monetary policy.¹ He consistently underlined the importance of credit but later resigned himself to the demise of the (demand for money) LM curve² and contributed recently to the extension of the modern canonical model to include a credit and bond market.³ He did not limit himself to mere technical work. His 2005 great book on “*The moral consequences of economic growth*”⁴ shows how, in the absence of continuous economic growth, political and social stability vanish and our democratic societies lose their moral compass. Ahead of the subject becoming so topical and urgent, he also underlined how inequality corrodes the social compact and affects the Hegelian ethics of the community (*Sittlichkeit*).

The same moral perspective underlies the BIS paper that Ben Friedman wrote last year about how to deal with debt: “A predictable pathology”.⁵ That paper is a sort of background to this panel but I am in no position to react to the moral, social and political issues that the paper raises when it reminds us that the “consequence of economic stagnation, together with the absence of widespread employment opportunities, is a turn away from liberal values toward xenophobic populism of either the right or the left”. Unfortunately, I cannot even provide a full answer to his policy view that “With European monetary policy already expansionary ... and since Europe as such has no fiscal policy, the urgent need today is for debt restructuring and relief for the fiscally weak European countries... In a similar way, in the United States today there is need for relief for under-water homeowners whom the bail-out of US lenders a half-decade ago largely neglected.” My own remarks today will be mostly of a more descriptive and technical nature and, in view of the time constraint, rather telegraphic.

It is consensual that the financial crisis that started in 2007 was a crisis of excessive debt, resulting from an excessive credit boom. It was a crisis just like the ones analysed for 17 advanced economies from 1870 to 2011 by Jordà, Schularick and Taylor (2014).⁶ The

¹ Friedman, B.M. (1975) “Targets, instruments and indicators of Monetary Policy” *Journal of Monetary Economics*, 1, October 1975; Friedman, B.M. (1990) “Targets and instruments of monetary policy” Chapter 22 of Benjamin Friedman and Frank Hahn, editors (1990) “*Handbook of Monetary Economics*” North-Holland.

² Friedman, B.M. (2003) “The LM Curve: a not-so-fond farewell”, *NBER Working Paper 10123*.

³ Friedman, B.M. (2013) “The simple analytics of monetary policy: a post-crisis approach”, *NBER Working Paper 18960*.

⁴ Friedman, B.M. (2005) “The moral consequences of economic growth” Alfred A. Knof, New York.

⁵ Friedman, B.M. (2014) “A predictable pathology” Keynote address at the Bank for International Settlements Conference on “Debt,” Lucerne, 26 June, 2014.

⁶ Jordà, O., M. Schularick, and A. Taylor (2014) “Sovereigns versus banks: Credit, crises and consequences” *Institute for Economic Thinking Working Paper No. 3* or *Federal Reserve Bank of San Francisco Working*

authors concluded: “On the one hand, we reaffirm the central role played by private sector borrowing behaviour for the build-up of financial fragility. In advanced economies, the idea that financial crises typically have their roots in fiscal problems which in turn take a toll on the banking sector is not supported by history as a general matter. ... On the other hand, our results also speak to the potential dangers of high public debt in some situations. While high levels of public debt make little difference in normal times, entering a financial crisis recession with an elevated level of public debt seems to exacerbate the effects of private sector deleveraging and is typically accompanied by a prolonged period of sub-par economic performance.” In another paper Taylor⁷ goes as far as saying that: “As symptoms of financial crises, external imbalances are a distraction and so are public debts”. Evidence points to the fact that only excessive credit growth permits a good prediction of financial crises.

My first point is thus to underline that, similarly to past crises episodes, the 2007 crisis is rooted in a private sector credit boom. Looking at figures at global level, between 2000 and 2007, private debt (measured as a percentage of GDP) increased whereas the public debt came down.⁸ In the euro area, private debt increased by 27% whereas public debt declined by 7.4%, from 1999 to 2007. In fact, in a number of countries public debt declined substantially: in Spain, it declined from 62% to 36% of GDP; in Ireland, over the same period, public debt fell from 47% to 25% of GDP. Despite the relatively high levels, public debt also declined in Italy, from 113% of GDP to 103% of GDP whereas it increased slightly in Greece. In the latter two countries, debt levels were indeed still far above the 60% stipulated in the Stability and Growth Pact.⁹ In all cases, private debt increased by large multiples of the public debt percentage increase over the period 1999 to 2007. Only after the crisis has the increase in public debt significantly accelerated.

The extraordinary increase in debt accompanied a strong financialization of the economy with an enormous surge of financial institutions’ total assets in relation to GDP. In the literature, these developments are explained by a period of general financial deregulation, the emergence of a world-wide “savings glut” and the need to offset inequality, as Rajan (2011)¹⁰ put it, by “letting them eat credit”. Two recent reports, one from McKinsey another published by CEPR¹¹ highlight how total global debt continued to expand, having increased by 40% (or by USD 57 trillion) since 2007 with the debt ratio to GDP growing from 269% to 286%. Among the 15 countries with highest total debt, 12 are from the EU, 9 of which within the euro area. In the ranking, the US comes 16th.¹²

The negative effects of excessive high levels of debt are quite well known and I will not dwell on them. One could therefore expect that deleveraging or the reduction of debt ratios would be uncontroversial and the way right forward. Things are however more complex, especially in the wake of a financial crisis when economic recoveries tend to be slower. Advanced economies are caught in a sort of dilemma: either to press for both private and public debt reduction thereby further slowing the pace of the recovery, helping it only with structural reforms on the supply side; or to try stimulate aggregate demand in the short term which

Paper Series 2013–37. See also Schularick, M. and A. Taylor, (2013) “Credit booms gone bust: monetary policy, leverage cycles and financial crises 1870–2008” *American Economic Review* 102 (2).

⁷ Taylor, A. (2012) “The great leveraging” presented at the BIS Annual Conference, Lucerne, 21–22 June 2012.

⁸ See McKinsey Global Institute (2015) “Debt and (not much) deleveraging”, February.

⁹ Constâncio, V. (2013) “The European crisis and the role of the financial system” speech at the Bank of Greece conference on “The crisis in the euro area” Athens, 23 May 2013.

¹⁰ Rajan, R. (2011) “Fault Lines: How Hidden Fractures Still Threaten the World Economy”, *Princeton University Press*.

¹¹ McKinsey Global Institute (2015) “Debt and (not much) deleveraging” and Buttiglione, L., P. Lane, L. Reichlin, and V. Reinhart, (2014) “Deleveraging, what deleveraging?” *Geneva Report No. 16*, CEPR Press.

¹² McKinsey Global Institute (2015) “Debt and (not much) deleveraging”, Exhibit 3, page 18.

implies, among other things, normalising credit and finance after the initial crunch. The dilemma is thus liquidation and restructuring versus stabilisation and compensating stimulus to aggregate demand. Reality is never so black and white and both strands have been partially pursued with the end result that deleveraging has hardly happened both in the case of households or corporates, let alone sovereigns, as I mentioned before. The pressure to restore growth and reduce unemployment has been understandably very strong in our societies. Countries with very high debt ratios were forced to take active measures of fiscal consolidation in order to regain regular access to financial markets.

One of the potential negative effects of high debt, which has been overly discussed, concerns the relation between debt and economic growth. High debt levels, initially seen as quite negative by Rogoff and Reinhart (2010) and Cecchetti et al. (2012),¹³ setting a threshold around 90% of GDP, subsequent research pointed to the ambiguity of results and the impossibility of defining any thresholds. Two-way causality, endogeneity and the effect of omitted variables, plagued the econometrics of the issue. In October 2012 the IMF concluded that “there are many factors that matter for a country’s growth and debt performance. Moreover, there is no single threshold for debt ratios that can delineate the “bad” from the “good”.¹⁴

In an IMF Staff Discussion Note published this month¹⁵ it is concluded that “Where countries retain ample fiscal space, governments should not pursue policies aimed at paying down the debt, instead allowing the debt ratio to decline through growth and “opportunistic” revenues, living with the debt otherwise.” The rationale is that the deadweight loss of high debt is a sunk cost and the option value of reducing it as a risk management measure would be lower than the economic costs of the specific policies aimed at actively reducing the debt ratio now. The authors use the concept they have developed of fiscal space (distance to debt limit) as the difference between the present debt ratio and the country specific debt limit that is consistent with the country’s historical track record beyond which the debt would increase without bound. The study finds fiscal space for European countries such as Spain (115 percentage points), Ireland (105 percentage points), Portugal (59 percentage points), while Italy and Greece stand at zero.

Historically, there are several cases of successful reduction of public debt ratios. The possible drivers of such reductions are well known: accumulation of primary surplus, real growth, nominal interest rates and degree of financial repression, inflation and, finally, debt restructuring or rescheduling.

In the IMF’s WEO of October 2012, the analysis of concrete episodes of debt ratio reductions drew three main conclusions. First, that to be successful in reducing debt ratios, tighter fiscal policy usually has to be accompanied by accommodative monetary policy. The UK case, from 1918 to 1933, failed because both fiscal and monetary policy stances were too tight. This was also the case of Japan, from 1997 to 2012, when monetary policy tried but could not become sufficiently expansionary. The second lesson is that international growth helped several successful cases. This was particularly true of Belgium, between 1992 and 2002 and of Canada, between 1995 and 2005. The third lesson is that success depends on taking structural fiscal measures and creating an appropriate institutional framework. The

¹³ Reinhart, C. M. and K. Rogoff, (2010) “Growth in a time of debt” *American Economic Review* 100(2) 573–78; Cecchetti, S., M. Mohanty, and F. Zampoli, (2012) “Achieving growth amid fiscal imbalances: the real effects of debt” Jackson Hole Kansas FED Symposium; see also Panizza, U. and A. Presbitero, (2013) “Public debt and economic growth in advanced economies: a survey” *Money & Finance Research Group Working Paper No. 78*.

¹⁴ IMF (2012) “The good, the bad, and the ugly: 100 years of dealing with public debt overhangs”, Chapter 3 of the October *World Economic Outlook*.

¹⁵ Ostry, J., A.R. Ghosh, and R. Espinoza, (2015) “When should public debt be reduced?” *IMF Staff Discussion Note* 15/10, June.

impressive case of the US, between 1946 and 1961, benefited from high real growth, very accommodative low nominal interest rates with inflation engineering periods of negative real rates.

In all successful cases, positive primary surplus played an important role. The cases of Belgium, with a 5.4% primary surplus during 10 years, or Denmark with 5.3% during 26 years are impressive. However, Eichengreen and Panizza (2014)¹⁶, after examining 54 countries from 1974 to 2013, show that from 185 episodes of positive primary surplus, only 12 were above 4% (and from which only 4 were above 5%). Duration of the episodes was also not very long, leading the authors to conclude that “large primary surpluses for extended periods are possible, but they are the exception” in successfully reducing debt ratios.

Undoubtedly, the euro area needs to find ways to normalise debt ratios in several member countries. Right now, after the setback of the double dip in 2012, the strategy is based on appropriate primary surplus, accommodative monetary policy to normalise inflation levels, and economic growth resulting from monetary stimulus and structural reforms. Many shocks and surprises may emerge during the implementation and so, many academics doubt that the strategy can be fully successful and therefore other measures may have to be considered as a complement.¹⁷ The future will tell and, following Voltaire, I will not insult the future by trying to predict it.

Thank you for your attention.

¹⁶ Eichengreen, B. and Panizza, U. (2014) “A surplus of ambition: can Europe rely on large primary surpluses to solve its debt problem” *NBER Working Paper 20316*.

¹⁷ For the latest academic effort to make challenging suggestions and for the references to several other proposals, see Corsetti, G, L. Feld, P. Lane, L. Reichlin, D. Vayanos and B. Weder di Mauro, (2015) “A new start for the Eurozone: dealing with debt” The European Council of Economic Experts, CEPR.