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Coping with Post-Covid Sovereign Debt Levels in the Euro Area

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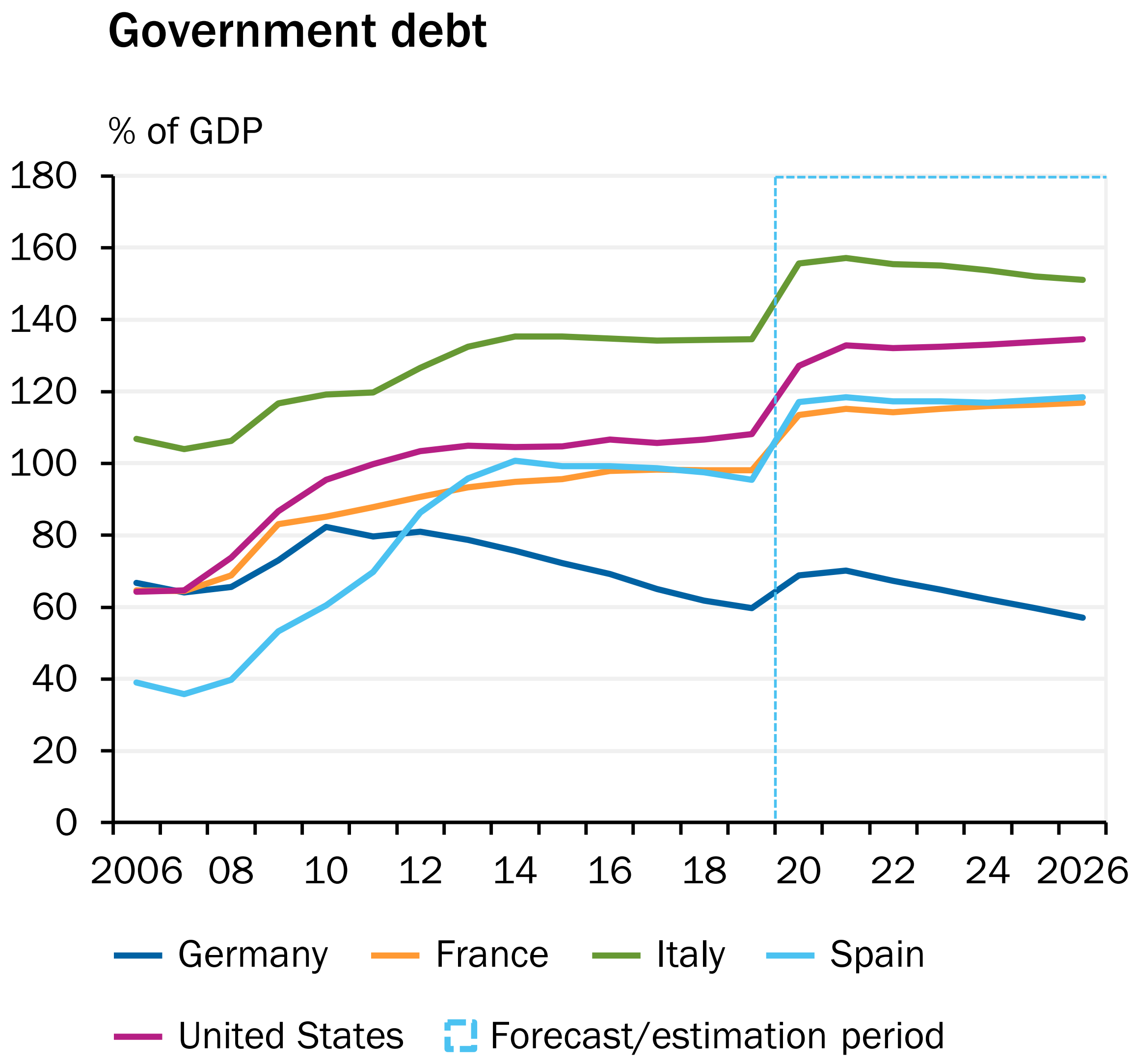
Three issues

I. Government debt and consolidation
II. Fiscal and monetary policy interaction
III. Risks of fiscal dominance and ECB strategy

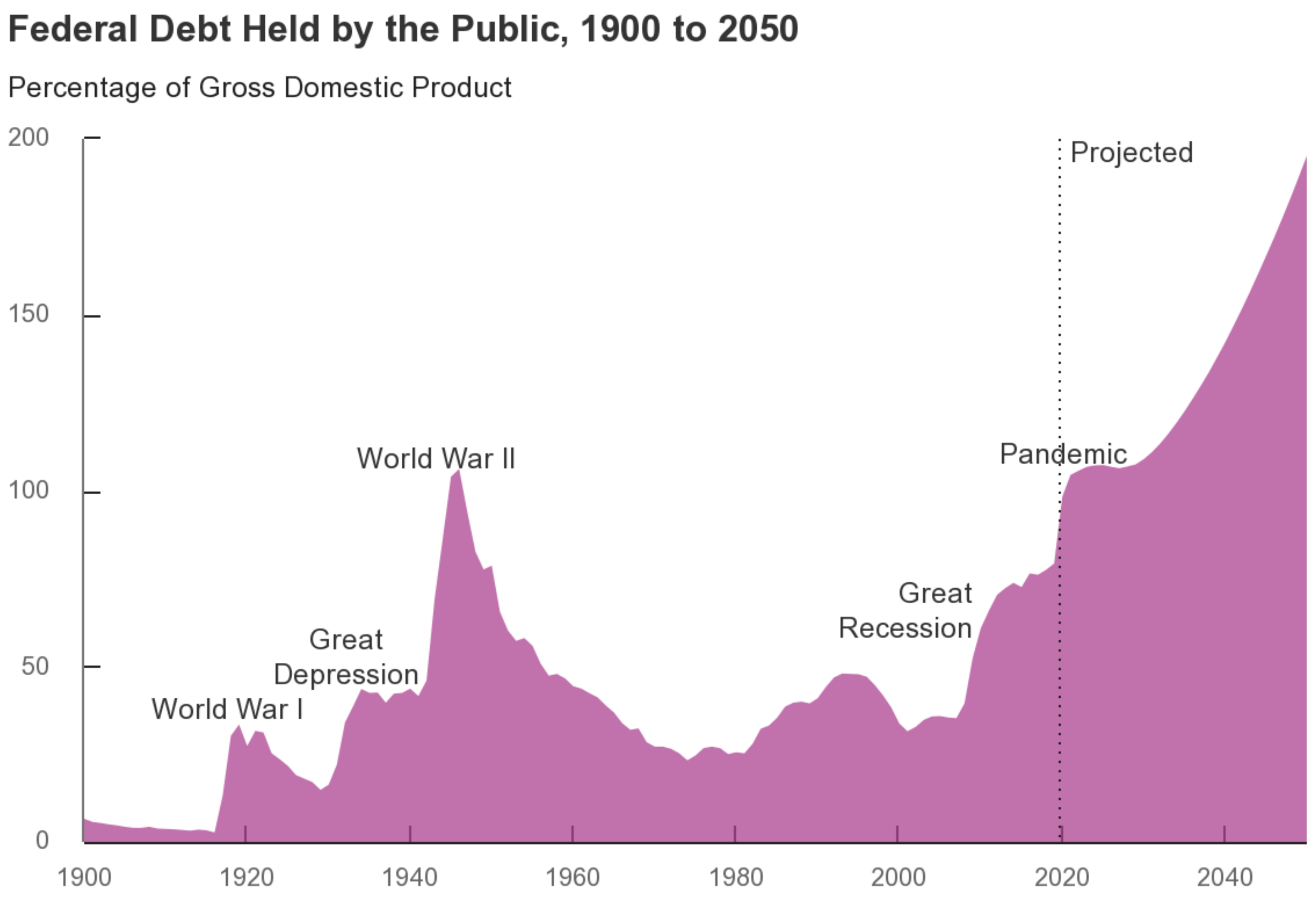
Government debt rises substantially due to corona crisis



USA, Italy, Spain, France
Germany

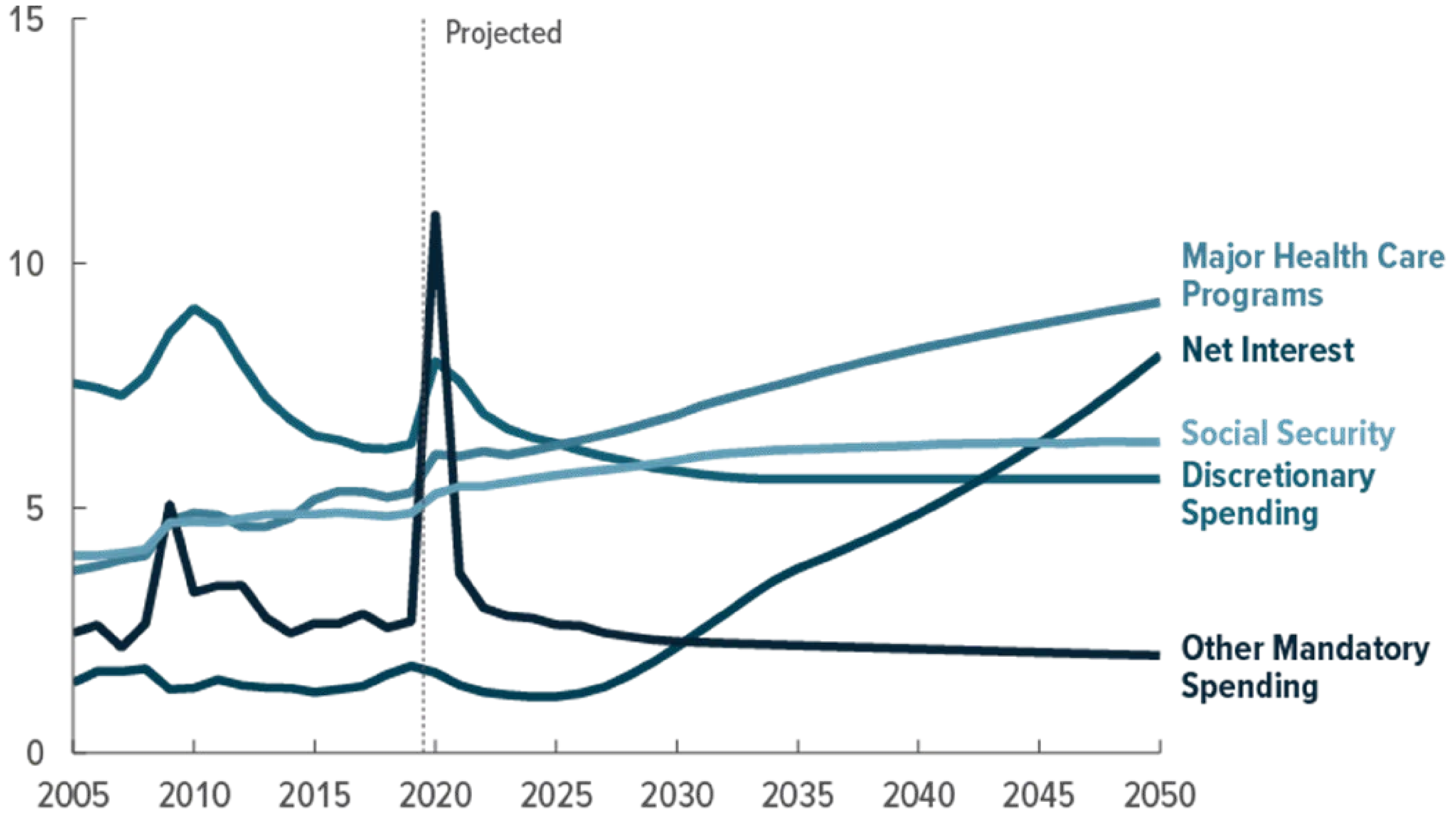
- 10 to 20% rise in debt to GDP ratio due to corona crisis.
- IMF WEO (April 2021) forecasts a plateau till 2026 or a slow decline.

Long-term outlook by U.S. Congressional Budget Office



- Uncontrolled increase after the plateau

U.S. CBO: Uncontrolled rise due to net interest



- Interest costs rise from about 2027 onwards
- And health care costs

Debt sustainability monitor (Feb 2021): Outlook till 2031

	DE	FR	IT	ES
Baseline	57.1	119.9	155.8	140.6
Higher interest rate (+1pp)	61.5	127.3	166.3	149.1
Lower GDP growth (-0.5pp)	60.3	125.9	164.2	147.3
Lower structural primary balance	59.2	123.9	156.3	142.4

Gross government debt in % of GDP in **2031**. Source: European Commission

- Deterministic projections
- Effects of higher interest rates, lower growth, lower primary balances
- Stochastic simulations of macro shocks show 10/90 Percentile ranges of 15 to 30% till 2026.

Fiscal strategy

- Borrow in crises when tax income falls. Sustain government expenditures incl transfers and provide liquidity support for households and companies.
- Fiscal rules serve to create such fiscal space for crises by ensuring consolidation in recovery and high growth periods.
- Consolidation strategy:
  - Expenditure-based consolidation is more growth friendly.
  - Aim for growing out of debt by letting government expenditure increase more slowly than economic activity.
  - At least avoid raising tax rates on labor and capital income, change mix to improve incentives for investment.

  - Related research: Alesina and Ardagna (2012), Alesina, Favero and Giavazzi (2012), Cogan, Taylor, Wieland and Wolters (2013) among others.

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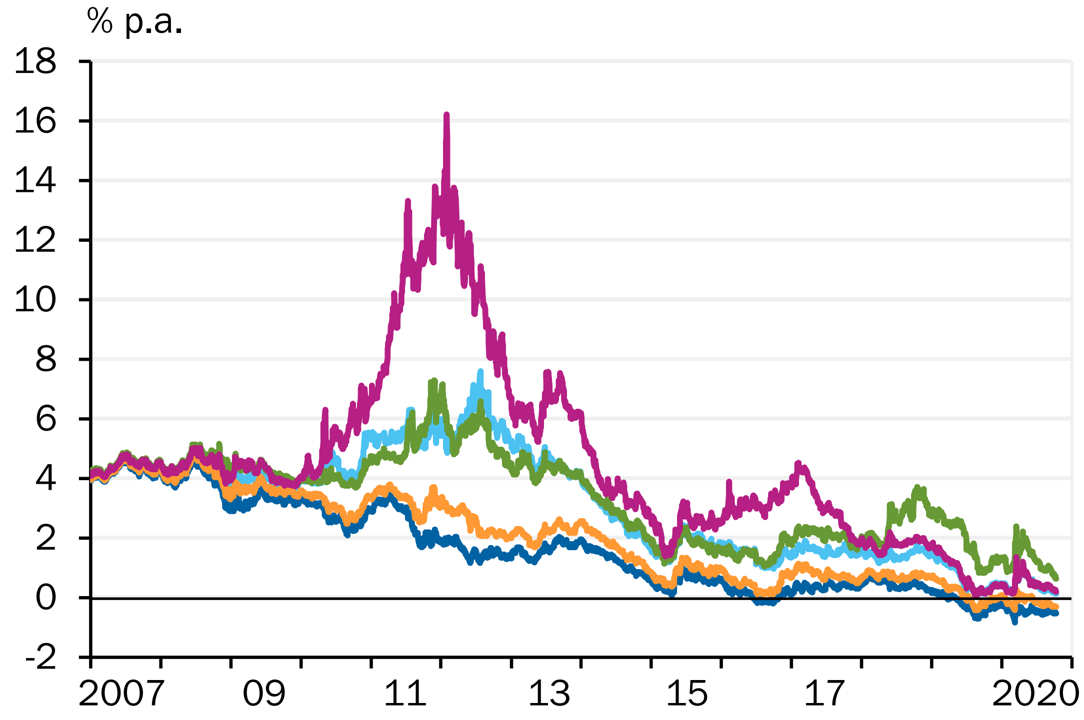
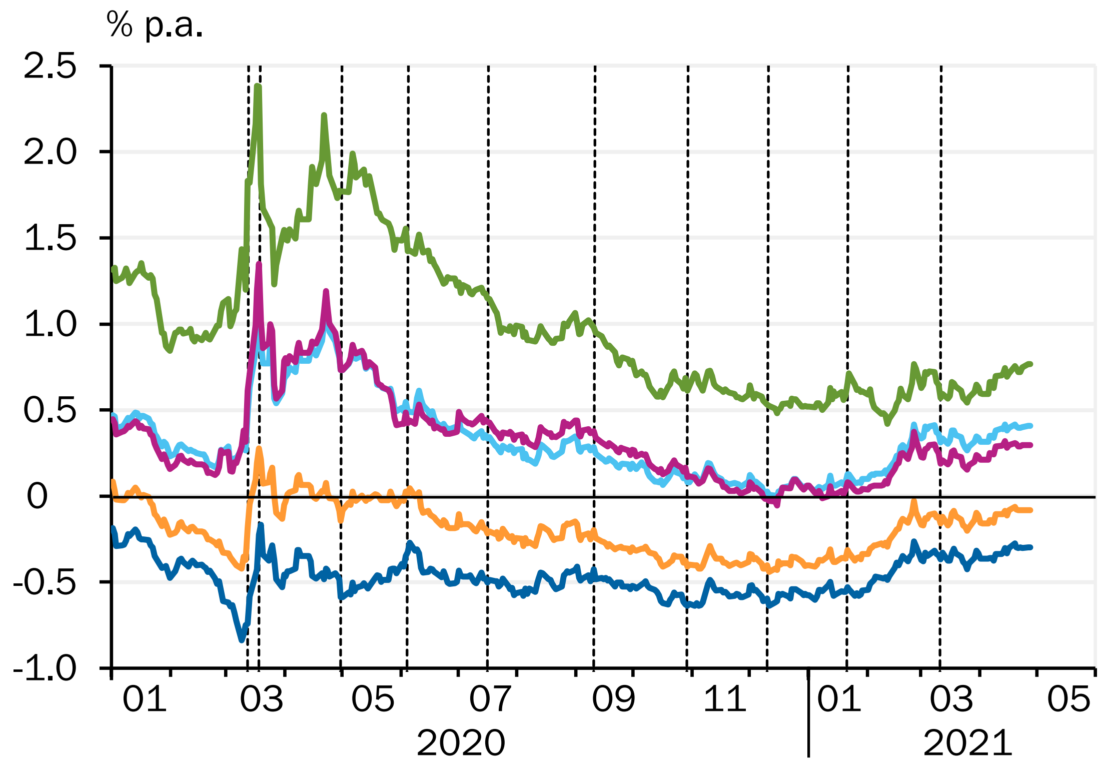
II. Fiscal and monetary policy interaction

Interest rates remain very low, partly due to monetary policy

10 year sovereign yields



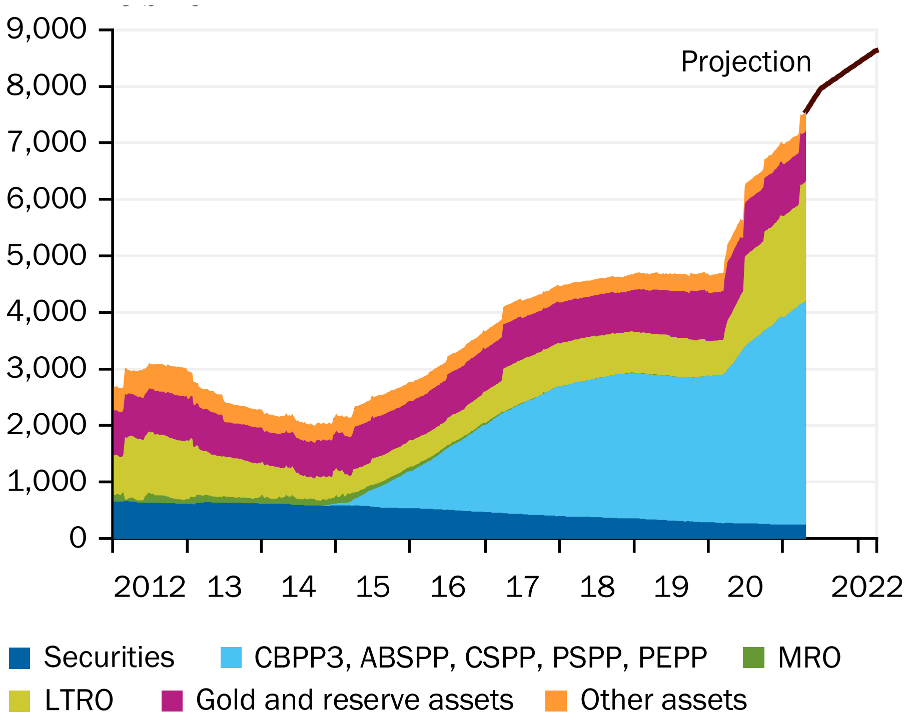


---- Monetary policy meeting of the Governing Council of the ECB

Spain Portugal Italy France Germany

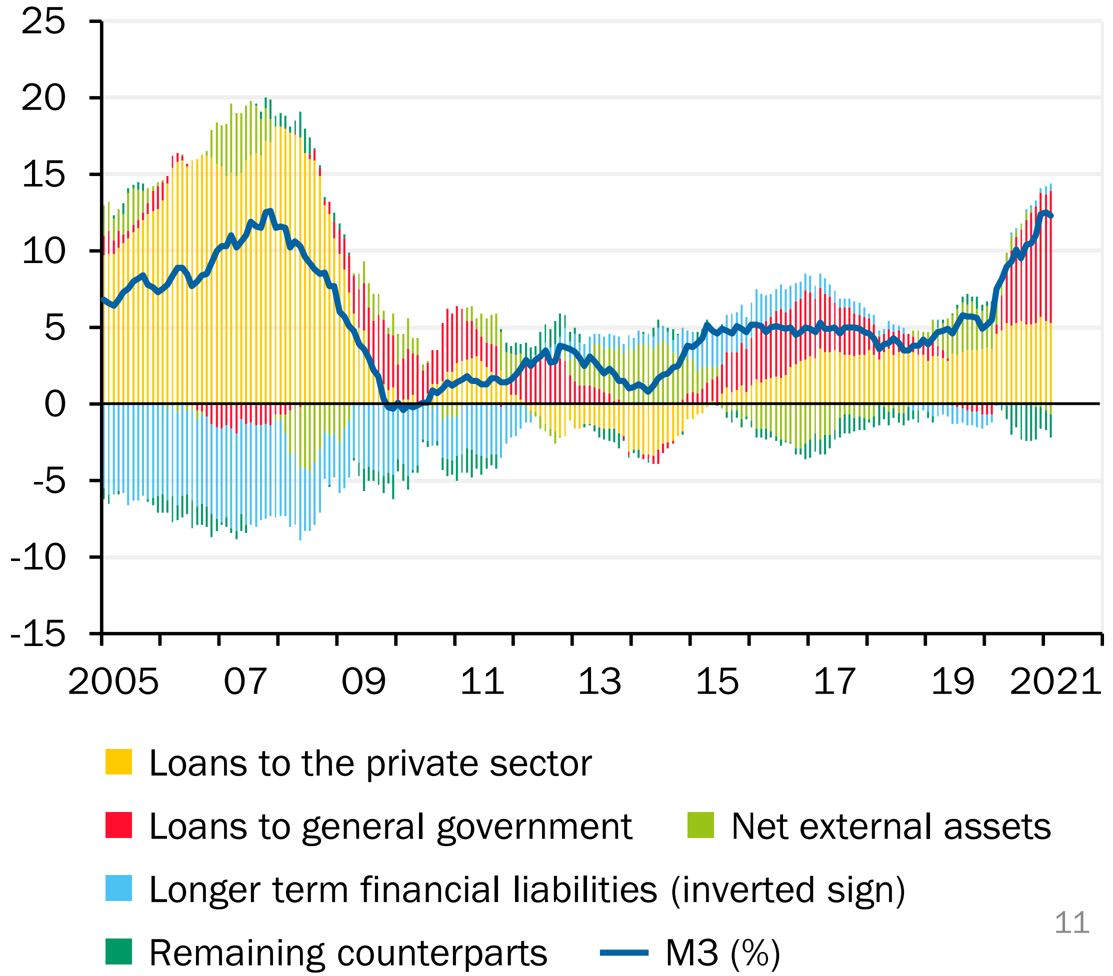
ECB expands balance sheet, broad money growth rises quickly

ECB balance sheet expands quickly
(bln Euro)

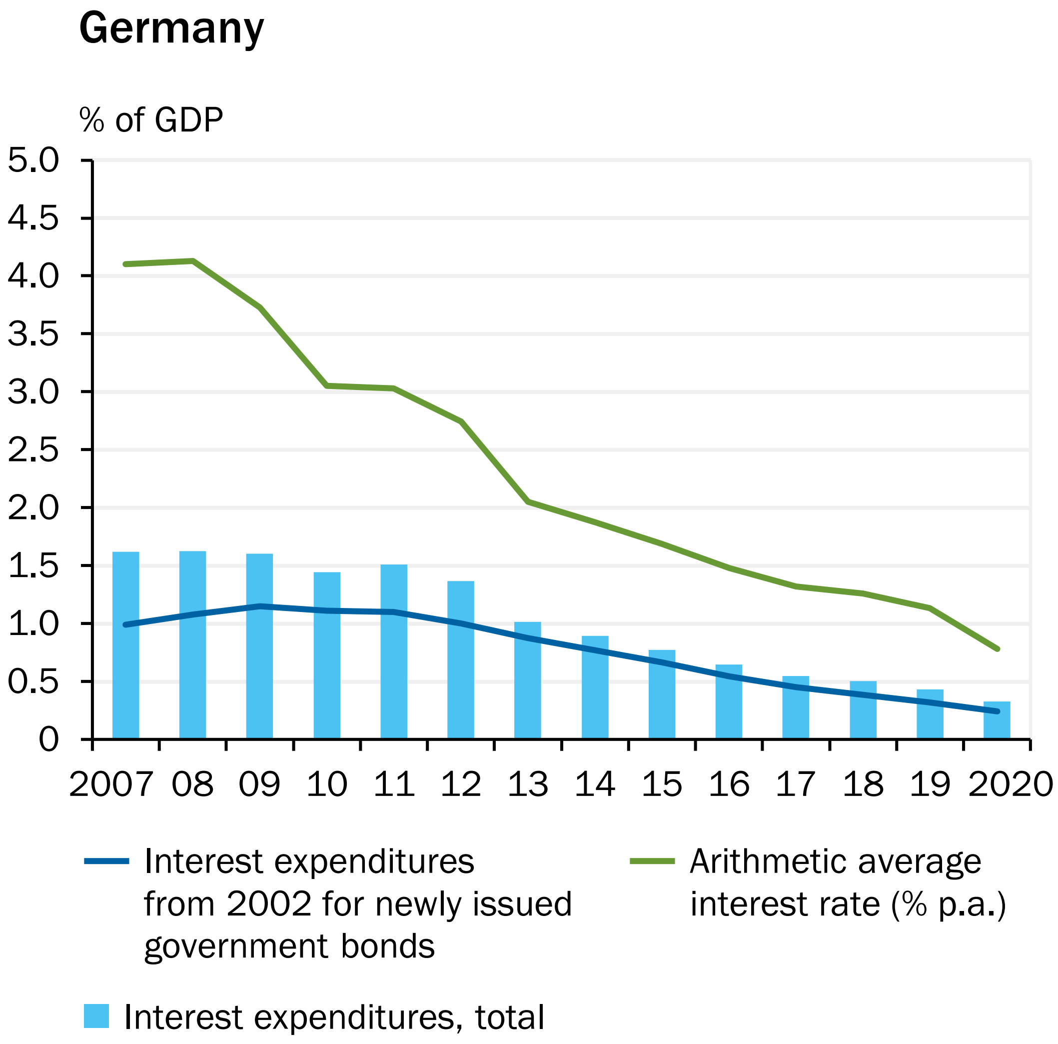


PEPP alone = 15,5% of euro area GDP in 2019
Roughly 8,4% of GDP purchased.

Euro Area M3 growth up due to public loans
(growth contributions in perc.points)

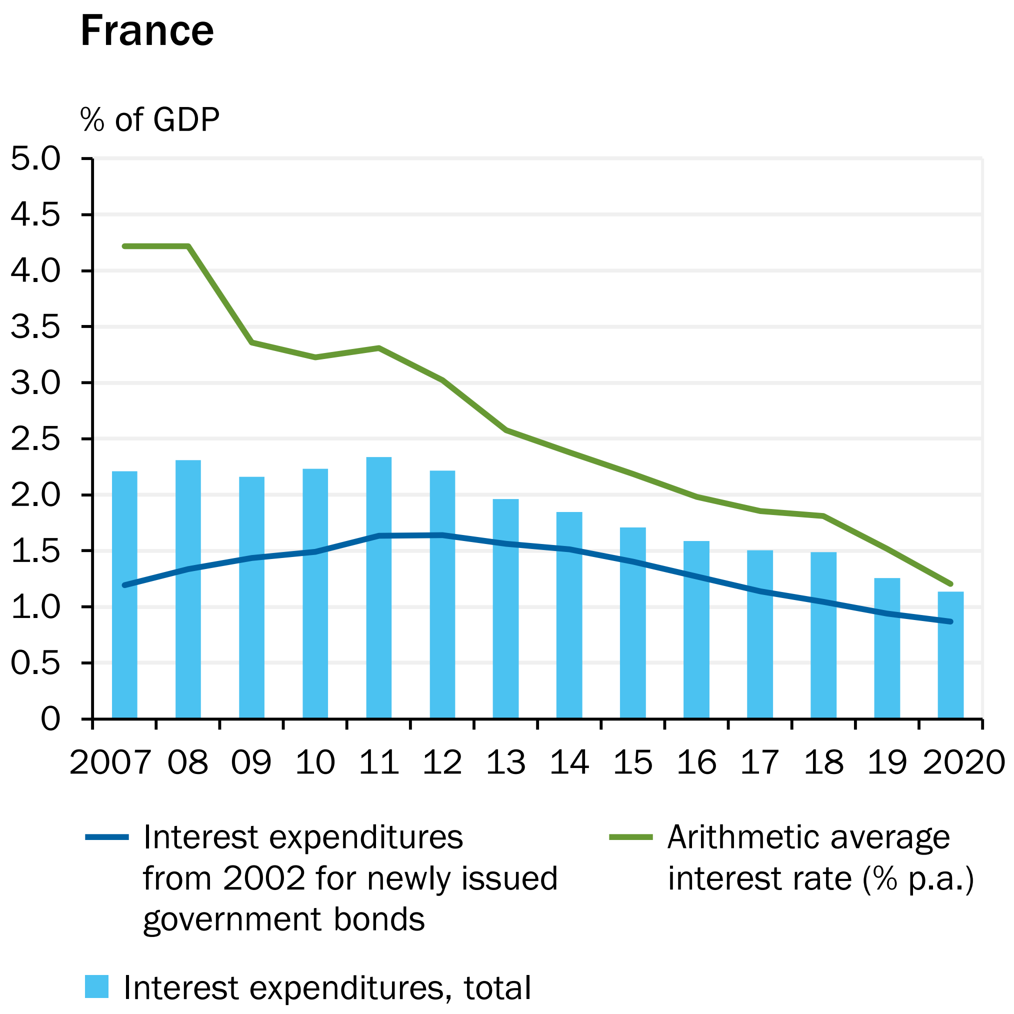


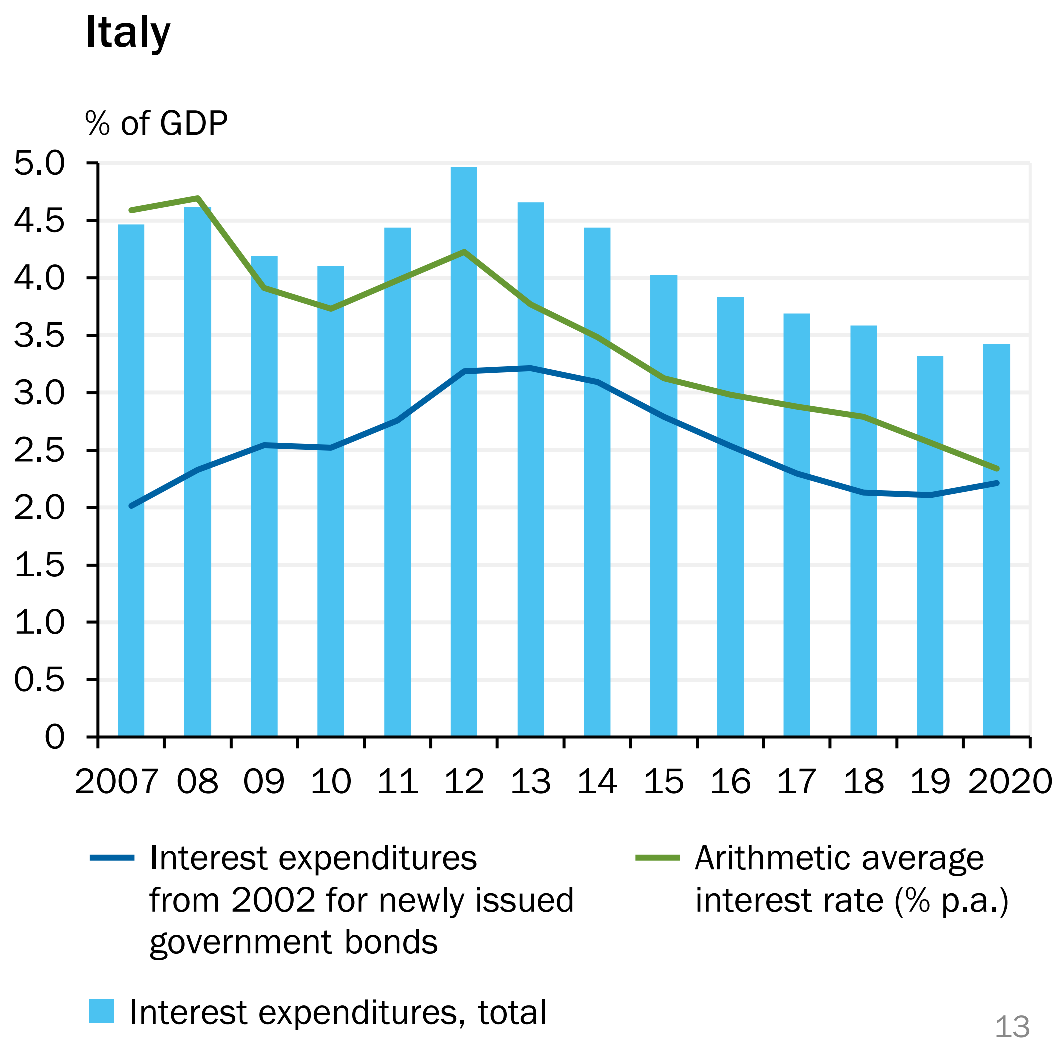
Governments' interest expenditures have already declined substantially in past years



- Blue Line: Based on issue volumes from 2002 calculated using the method of Boeing-Reicher and Boysen-Hogrefe (2017) [in % of GDP].
- Green Line: Interest payments of the central state from period t divided by 0.5*(debt level in t + debt level in t–1) [in % p.a.].
- Blue Bars: Total of interest expenses to be paid by the central state [in % of GDP].

Governments‘ interest expenditures have declined substantially in past years (central state budget)





II. Risks of fiscal dominance and ECB strategy

The government‘s intertemporal budget constraint and fiscal sustainability

- If there is outstanding government debt, the government must run a primary surplus in present value terms. No-Ponzi-Game condition.
- Discounted sum of future tax income needs to exceed discounted some of future government expenditure sufficiently to cover initially outstanding debt.
- Depends on expectations about how real interest rates, economic growth, governments‘ tax and expenditure policies hang together.
- Also depends on expectations of monetary policy and inflation, in particular seigniorage income generated by central bank money provision.

➔ **If** the fiscal authority (is expected to) adjust taxes or expenditures in order to satisfy intertemporal budget constraint, **only then** the central bank is free to use monetary policy to ensure price stability. **Monetary dominance**.

Fiscal dominance and the fiscal theory of the price level

Fiscal dominance:

- The fiscal authority decides taxes and expenditures without regard for the intertemporal government budget constraint.
- The central bank provides sufficient seigniorage for the budget constraint to be satifisfied. Inflation is determined by fiscal/seigniorage considerations.

Fiscal theory of the price level:

- Intertemporal budget constraint is treated as an equilibrium condition. It does not hold for any price level.
- The price level adjusts s.t. the government‘s budget constraint is satisfied.

Empirical indications for fiscal dominance

- Monetary policy does not tighten (sufficiently) in response to an increase in inflation or inflation expectations.
  - Taylor principle in (New-)Keynesian economics requires central bank rates to respond more than one-for-one to inflation or inflation expectations.

- Fiscal deficits do not respond sufficiently to increase in government debt s.t. debt-ratio is stabilized
  - Fiscal reaction functions, Bohn-style regressions, S1-S2 indicator of EU Commission.

How can the euro area avoid fiscal dominance?

ECB

- Pursue a strategy for exiting from quantitative easing and negative rates as economy recovers and inflation rises.
  - Need to communicate normalization strategy in order to influence expectations.
  - Priority for price stability helps. Also, better to avoid breaking self-imposed limits on purchases.

EU and member states

- Reactivate fiscal rules as economy recovers and pursue a growth-friendly fiscal consolidation strategy together with structural reforms improving productivity and competitiveness.
  - Use the recovery package effectively.
  - Communicate credible plans.
  - Don‘t call for monetary solutions to your fiscal problems.