Talking Points for Bank of Latvia’s conference “Quo Vadis Europe?”

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Preliminary. Not to be cited.

26 Oct 2015

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Intro Remarks:
Lessons from History on Public Debt Reduction

- We wouldn't be here if public debt was not regarded as "high" in much (but not all) of the EU

- Back to history: what is a "high" debt?

- Over the past 150-200 years, public debt to GDP (D/Y henceforth) fluctuated around 50% as a broad cross-country mean

- From this gauge, anything above 50%-60% would be "high"

- But too much diversity across country and periods
  ➔ Take such benchmarks with a pinch of salt

- In particular, D/Y's have risen steeply in some big recessions in the past…

- And fallen steeply during prolonged world growth (as in the 1950s and 1960s)

- Out of the 22 advanced countries with 150+ years or data, more than half experienced at least one episode in which D/Y > 100%

→ So bouts of high public debt not so uncommon in history

- And the vast majority did not end up in debt restructuring!

- 2012 issue of the IMF WEO zooms in on these episodes.

Some key take-ways of that historical analysis:

1) Deleveraging was ***on average*** very gradual – no more than 2 pp or so a year.

2) Deleveraging came from a combination of improvements in primary balance, looser monetary policy for prolonged periods, and GDP growth

- The weak link today in much (but again not all) the Eurozone is GDP growth (both real and nominal)

Is this because consolidation attempts went too far?

- Difficult to generalize, as country conditions have been so different
- But Kose et al. (VOX-EU, april 2013): a main difference this time was, on average, slower recovery in public spending (G) in advanced countries
- There may be a case for higher G in a handful of countries with greater fiscal space, particularly where infrastructure needs are greatest

- This seems to point to a lower pace of debt consolidation in these countries, but a clear long-term commitment to deleveraging

- And a tilting of spending towards public investment

- History again: financial crises were less traumatic systemically prior to WWI partly because more debt went into financing capital rather than current spending and transfers

- Now: share of public investment ("Ipub") in total gov. spending (G) has been falling for a while

  EU-12: 20% in 1970s

  17% in 1980s

  13% in 2007

  Ipub/Y from 5% in 1970s to less than 3%

→ So, fall not new due to crisis but long standing trend

→ Even if difficult to establish how much of that fall is to be expected or desired

Other reasons for being firm but very gradual on D/Y reduction

1) Evidence (even if still controversial) on higher fiscal multiplier when output gap is substantially negative

2) Taxation fatigue, Laffer curve considerations: fiscal revenues to GDP, T/Y, historically high in the EU, close to 50% and bulk of privatizations already done in many countries

3) Evidence that spreads tend to rise as growth slows (Catão and Mano, VOX-EU, Sept 2015)

4) Corporations still too leveraged → If there is migration from private debt to the public purse, what also matters is aggregate leverage.

Wrapping up:

- Case for public sector deleveraging to be firm but quite gradual, in general..
- Yet, mileage varies in different countries (more upfront adjustments warranted in some)
- Case for the composition of the adjustment be more (but not necessarily all) on the spending side without sacrificing public investment
- And for (structural) reforms to be put in place to help foster growth