Conference „Common Challenges in Asia and Europe“

Eltville 1/2 May 2014

Comments on

Dealing with high debt in an Era of low growth

by A. Abbas, B. Akitoby, J. Andritzky, H. Berger, T. Komatsuzaki and J. Tyson

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Main Points of Paper

Motivation:
- Steep increase in public debt ratios of advanced countries to very high levels
- What policies are needed for debt reduction?

Method:
- Empirical importance of different factors driving debt ratio
- Mechanics: Interdependence of different factors
- Look at successful debt reversal periods in past (no econometric analysis)

Results/Conclusions:
- Main drivers are primary balances and growth
- Task will be complicated by
  - Pressure on public finances (ageing, health care)
  - Low expected growth rates

Policy Advice:
- Fiscal policy:
  - Pace consolidation should take account of state of public finances, impact on economy, risk premium
  - Strengthen budget institutions
  - Growth friendly composition of adjustment
- Accommodative monetary policy
- Structural reforms to lift potential growth
- Privatisations (but limited impact), Inflation not advisable

Agree with policy advice and most results

Outline

A. Importance of Growth to debt reduction

1. Effect of lower growth on structural deficits?
2. Denominator effect of lower growth on debt ratio?
3. Empirical evidence?

B. Additional Points

How important is growth to debt reduction?

1) Effect of lower growth on structural deficits

Debt reduction complicated by

- **Increase in age-related spending**
- **Diminished outlook for growth**
  - Medium-term: deleveraging
  - Long-term: decline in labor force (growth)

  -> higher structural deficits (lower revenue, sluggish adjustment of expenditure)

- **Long-term: Decline in labor force might not lead to lower per capita growth**

  -> same increase of revenue per capita as in past

  -> not obvious why per capita spending (and therefore deficit) should increase
- **Medium-term: Deleveraging will reduce per capita growth, but:**
  - Expenditure might adjust rapidly
  - Offsetting effect once deleveraging is accomplished

  -> only low and temporary impact of growth on structural deficits?

How important is growth to debt reduction?

2) Denominator effect of lower growth on debt ratio

Focus on growth might be too narrow: Debt ratio driven by interest – growth differential

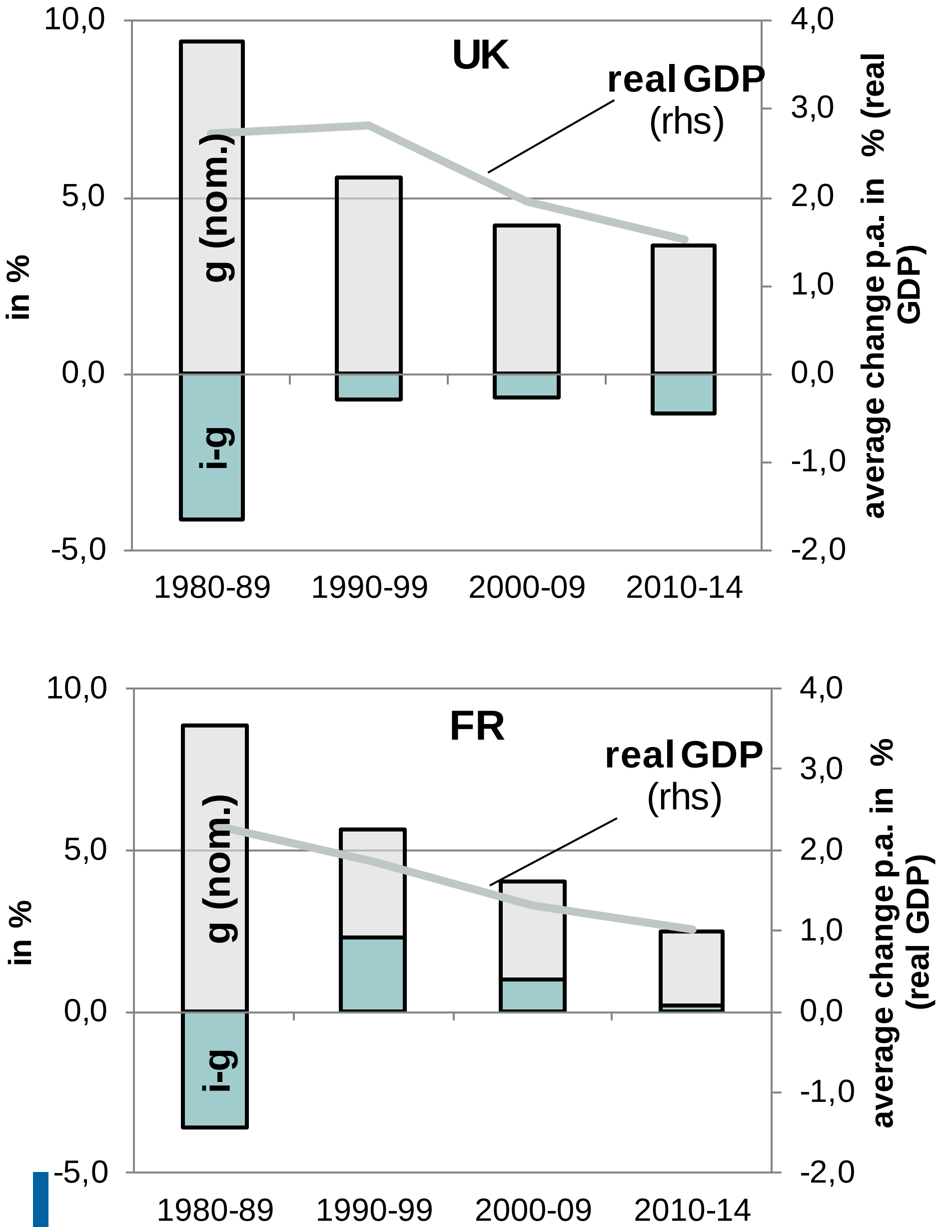
$$\Delta d = p_t \frac{\boldsymbol{i - g}}{1 + g} d_{t-1}$$

How will interest rates develop in future? Will interest – growth differential increase with lower growth?

- **Long-term? Next slide**
- **Medium-term projections in table 1 too pessimistic?**
  - EC winter 2014 forecast points to much lower differential 2014/15 even for low growth countries subject to market pressure

Projected interest growth differential			
	IMF(2013-18)	EC 2014	EC 2015
ES	2.7	2.1	1.2
IT	2.9	2.2	1.4
Pt	2.5	1.7	1.0

How important is growth to debt reduction?



Source: WEO database, own calculations

Long-term? Look at past

- Incomplete database
- Real GDP growth decreased
- Picture of i-g in 80s distorted: highly negative in both countries in 80s due to lagged effect of disinflation on i
- Since 1990 i-g stable (UK) or even decreasing (FR)

-> Debt reduction as easy/even easier despite lower growth?

-> Further empirical/theoretical investigation of interaction of i and g?

How important is growth to debt reduction?

3) Evidence:

Debt reduction spells more frequent during periods with higher growth (figure 2)

- **Might simply capture impact of cycle**
  - Averaging over four years not enough to capture full cycle
  - In boom higher growth, lower deficits and denominator effect of high growth on debt ratio
- **Impact of lower potential growth?**

Fiscal effort more likely to be successful when growth is stronger (figure 4)

- **Might simply reflect denominator effect of higher growth?**

Additional points

Tradeoff between multiplier effect and credibility

– Urgency of restoring market credibility <-> high multiplier (output gap, openness, simultaneity of fiscal effort abroad)

– Simultaneous deleveraging of other sectors?

– High multipliers alone no reason to slow down consolidation, but possible effects on potential growth (hysteresis <-> Schumpeterian creative distruction)

Use of different datasets and definitions

Paper focuses on primary balance

– For high debt countries higher primary surplus necessary to stabilize debt ratio

– In policy debate overall balance more prominent

– Should i and g both fall, primary balance might be unaffected, but overall balance will drop. If fiscal policy is loosened to take advantage of lower interest payments debt dynamics will be adversly affected.

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