WHAT WE OWE
TRUTHS, MYTHS, AND LIES ABOUT PUBLIC DEBT
Public debt-to-GDP ratio (in percent, 2015)
Holdings of public debt by residents
(in percent of total public debt, 2015)
Pension and healthcare entitlement debt\(^1\) (in percent of GDP)

Source: IMF Fiscal Monitor April 2016, Table A23

1 Net present value of increases in public spending for healthcare (red) and pension (blu) as projected by the IMF Fiscal Monitor for 2016-2050
Why is high public debt a problem?

1. Exposure to a roll over crisis

2. Lower long term growth
Exposure to a roll over crisis
Charles Ponzi
(Lugo di Romagna, 1882 – Rio de Janeiro 1949)
IMF Public debt sustainability thresholds

- Emerging economies: 70 percent of GDP
- Advanced economies: 85 percent of GDP (high risk)
- Advanced economies: 120 percent of GDP (unsustainable debt?)
Spread dell’Italia sulla Germania
(rendimento differenziale a 10 anni BTP-BUND)

Spread 10-years yields BTP-Bund

Source: Thomson Reuters Datastream
Surge in money base

1 In national currency
Lower long term GDP growth
Why does high public debt lower long-term growth?

1. Crowding out:

Olivier Blanchard, “Current and anticipated deficits, interest rates and economic activity” NBER WP n. 1265, 1984

“I have a long argued that paying down the national debt is beneficial for the economy: it keeps interest rate lower than they otherwise would be and frees savings to finance increases in the capital stock, thereby boosting productivity and real incomes.” Speech held by Alan Greenspan on April 27, 2001

2. Higher Taxes

David Ricardo
Annual average growth rate
(in percent, 1990-2015)

* Data for these countries are available since 1995
High public debt lowers potential growth


- Checherita, C. and P. Rother, 2010, —The impact of high and growing government debt on economic growth an empirical investigation for the euro area, IMF Working Paper No. 1237


Relationship between public debt level and GDP growth

How to lower public debt
Shortcuts

1. Printing money
2. Financial repression
3. Debt repudiation
4. Debt mutualization
5. Privatization
1. Printing money: what monetary policy can do to alleviate the effects of high public debt

- Printing money to temporarily finance the government if the demand for liquidity surges (current situation; see above)

- Stand ready to provide liquidity at times of market pressure (fighting self-fulfilling expectations). (See de Grauwe, Paul and Ji, Yuemei (2016) Flexibility versus stability: a difficult tradeoff in the Eurozone, Credit and Capital Markets)

- Risk ➔ Inflation
1. Printing money: Inflation as a solution to the public debt problem

- How much inflation?
- It depends on whether the Fisher effect holds
- If the FE holds, moderate inflation is not enough
- An inflation outburst (20-25 percent for 2 years would be needed)
- Costs: - inflation is a tax
  - inflation genie out of the bottle
  - the case of Turkey
- Altogether: not a great idea

Source: IMF Fiscal Monitor, April 2013
Should Euro Area countries leave the euro area?

Nobel Prize winners against the euro

Joseph Stiglitz
Paul Krugman
Amartya Sen
Milton Friedman
Christopher Pissarides
James Mirrlees
Real GDP per capita, 1980-2015
(index 1980 = 100)

Source: Eurostat
Nominal unit labor costs per person,
2000-2015
(index 2000 = 100)

Source: Eurostat
2. Financial repression

- Accidental financial repression?
  - surge in base money
  - tight bank regulation (equity requirements)
  - lower interest rates and low bank profits
  - will it last?

3. Debt repudiation

a. Reputational costs

b. Not alternative to austerity

c. High spillover effects

Italian public debt in euro

- Italy 2016 = 2219 billion
- Greece 2011 = 356 billion
4. Debt mutualization

❖ Pulling together public debt in the euro area (to replace the debt of individual states) would be nice but...

❖ ... it will not happen...

❖ ...because it does not happen even in monetary areas that achieved political union (federal states)
5. Privatization

Privatization may be good

❖ But there is not enough left to privatize

❖ Italy: optimistic estimates: 15 percent of GDP in 10 years (against a public debt of >130 percent of GDP and average privatization revenues of 0.25 of GDP in 2011-15).
The highway:

1. Structural reforms to boost growth

2. A moderate level of fiscal austerity
1. The effect of growth on the public debt-to-GDP ratio

![Graph showing the effect of growth on the public debt-to-GDP ratio. The baseline shows a steady decrease, with different lines indicating +1% growth and +1% (growth increase if revenues are not saved) scenarios, each showing a greater decrease over time.]
How can we boost growth?

- Pulling oneself up by one’s bootstraps (higher deficit)?
- Plain vanilla version does not work (temporary growth impact, permanent deficit impact, public debt may initially decline but then increases)
- Non plain vanilla stories (Left wing version):
  - Temporary increases in spending raises potential output permanently (lower hysteresis) (Romer, de Long, Summers)
  - Temporary increases in public spending boost not only real GDP but also the inflation for a while (IMF, the 3C approach)
  - Problematic assumptions: (i) interest rates do not rise; (ii) spending increases are reversed at the right time.
- Non plain vanilla stories (right wing version):
  - Reaganomics, Trumponomics: tax cuts raise potential growth
  - Problem: it does not work (public debt increased under Reagan)

➔ you need structural reforms to boost growth (but it takes time)
1. The effect of growth on the public debt-to-GDP ratio
2. A moderate level of fiscal austerity (the case of Italy)

What is needed? (March 2016 scenario)

1. Freezing of primary public spending in real terms at the 2016 level

2. Balancing the budget by 2019-20

3. Maintaining a balanced budget (in cyclically adjusted terms thereafter)
Primary spending, revenues and fiscal deficit

1 Based on the April 2016 medium-term fiscal plan (Documento di Economia e Finanza, Aprile 2016)
Public debt-to-GDP ratio (2007-45)
## Episodes of strong decline in public debt in advanced economies during the last 30 years

<table>
<thead>
<tr>
<th>Country</th>
<th>Initial public debt (in % of GDP)</th>
<th>Change of the Debt-to-GDP ratio</th>
<th>Period</th>
<th>Number of years of decline in the debt ratio</th>
<th>Annual average reduction (in % of GDP)</th>
<th>Average primary surplus</th>
<th>Average contribution of r-g and other (percentage points)</th>
<th>Average GDP growth rate</th>
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<tbody>
<tr>
<td>Ireland</td>
<td>94.6</td>
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<td>1991-01</td>
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<td>-5.9</td>
<td>4.5</td>
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<td>7.8</td>
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<td>Sweden</td>
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<td>-43.2</td>
<td>1998-08</td>
<td>10</td>
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<td>4.3</td>
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<td>3.0</td>
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<td>1996-08</td>
<td>12</td>
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<tr>
<td>Denmark</td>
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<td>1996-07</td>
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<td>Spain</td>
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<td>-0.5</td>
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</tr>
</tbody>
</table>
Can it be done with low growth?
(Primary surplus and growth in episodes of strong decline of public debt)
If the public debt ratio is declining, a high public debt ratio is less of a problem


THANK YOU FOR YOUR ATTENTION!