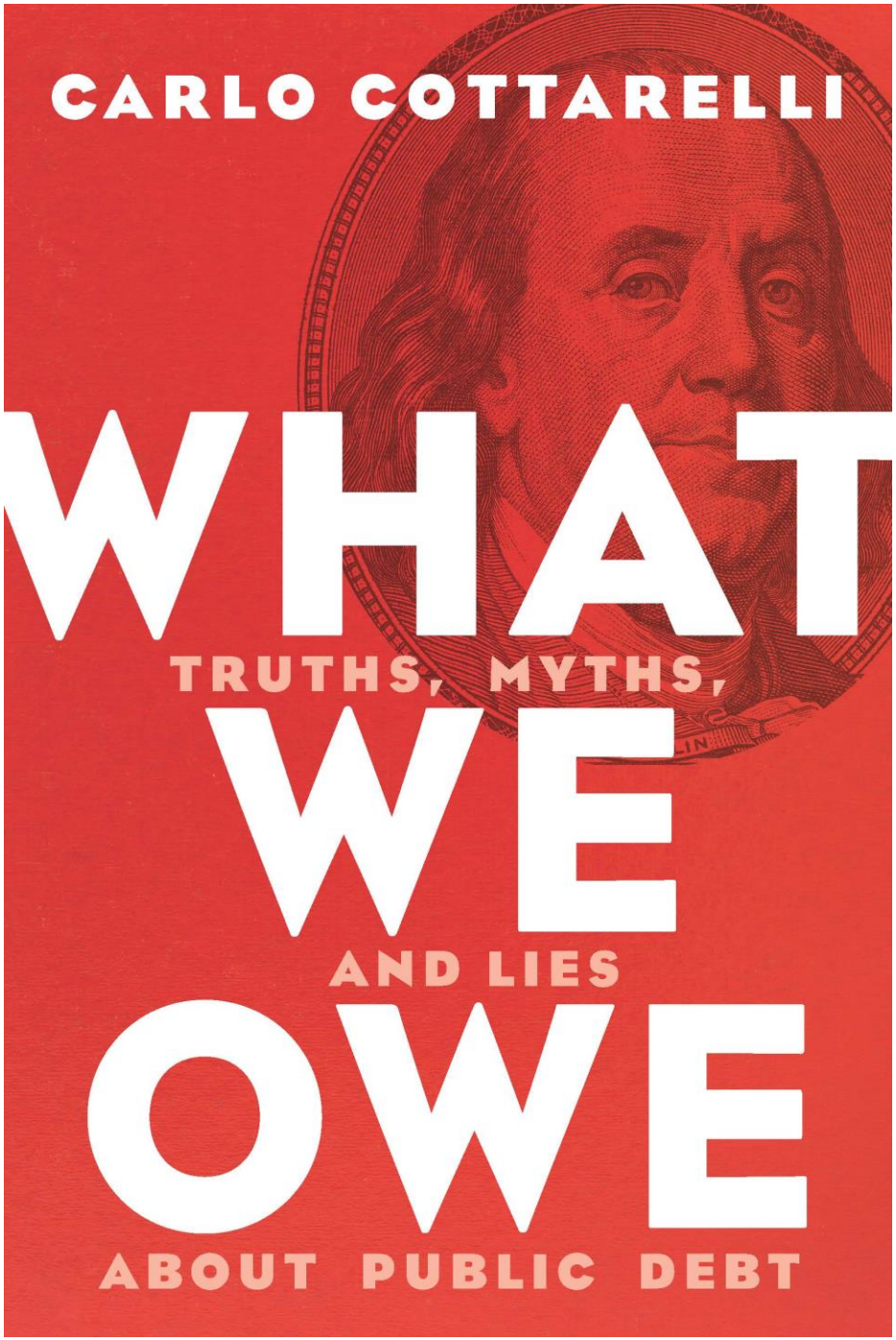
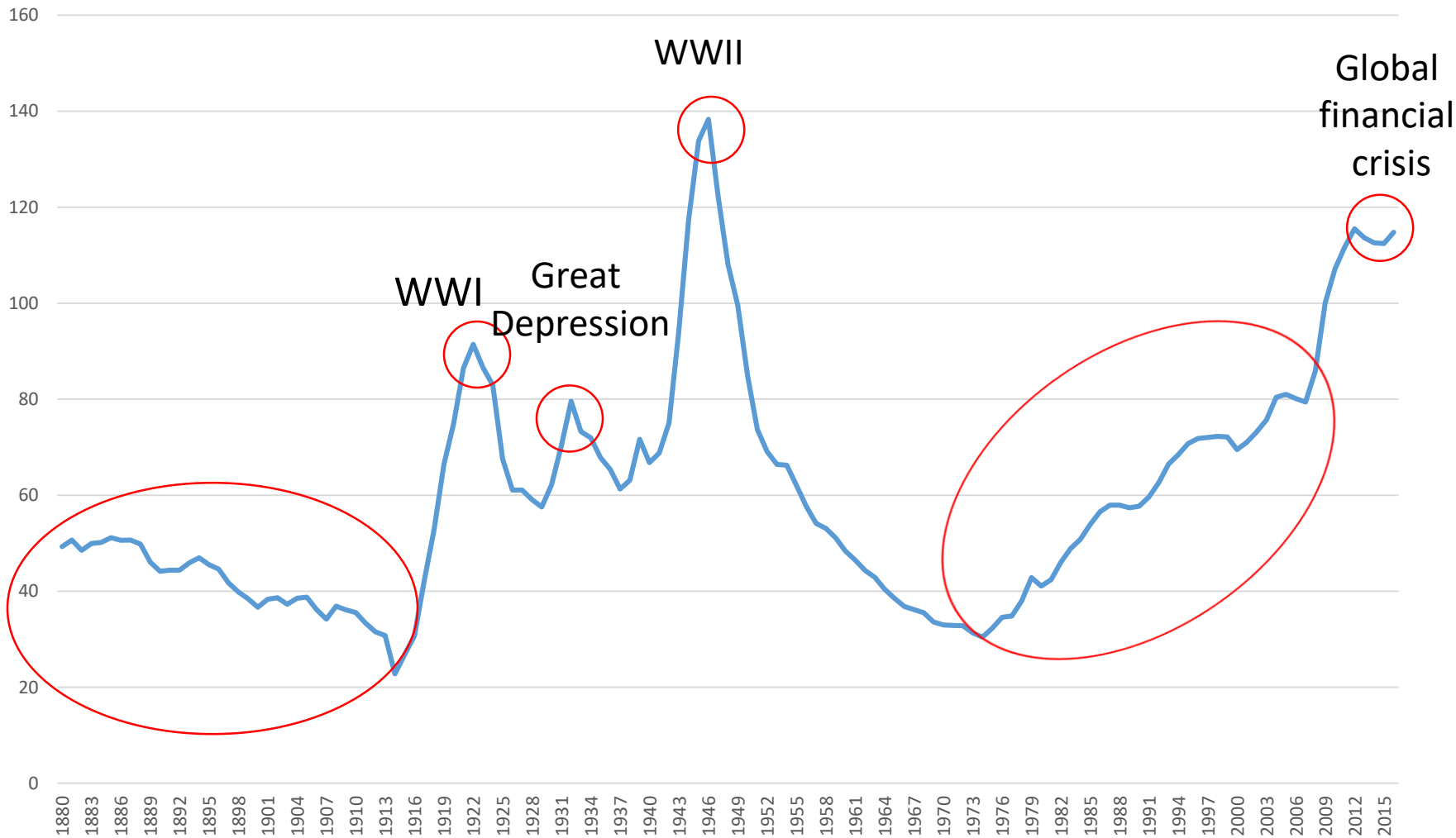
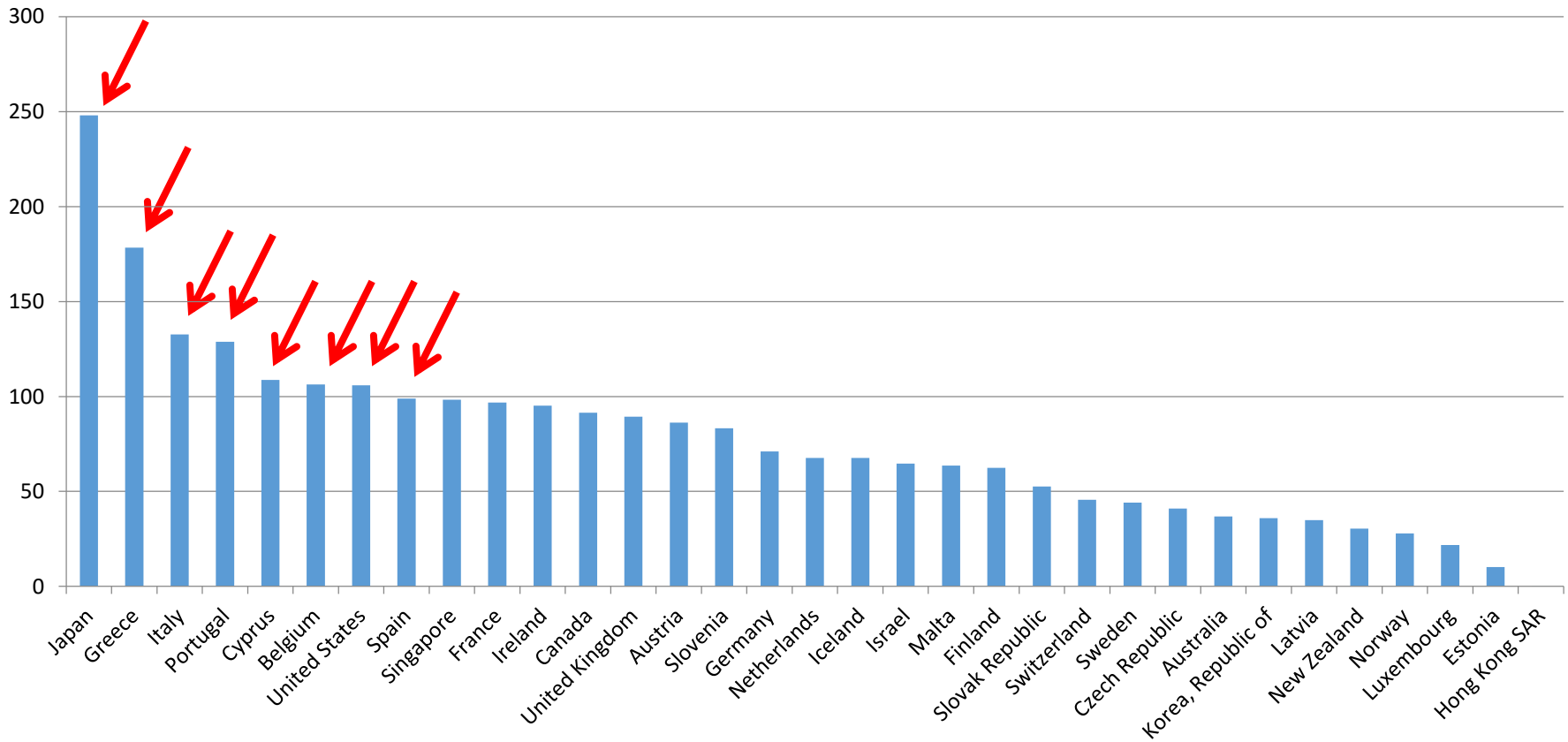

CARLO COTTARELLI
WHAT
TRUTHS, MYTHS,
WE
AND LIES
OWE
ABOUT PUBLIC DEBT

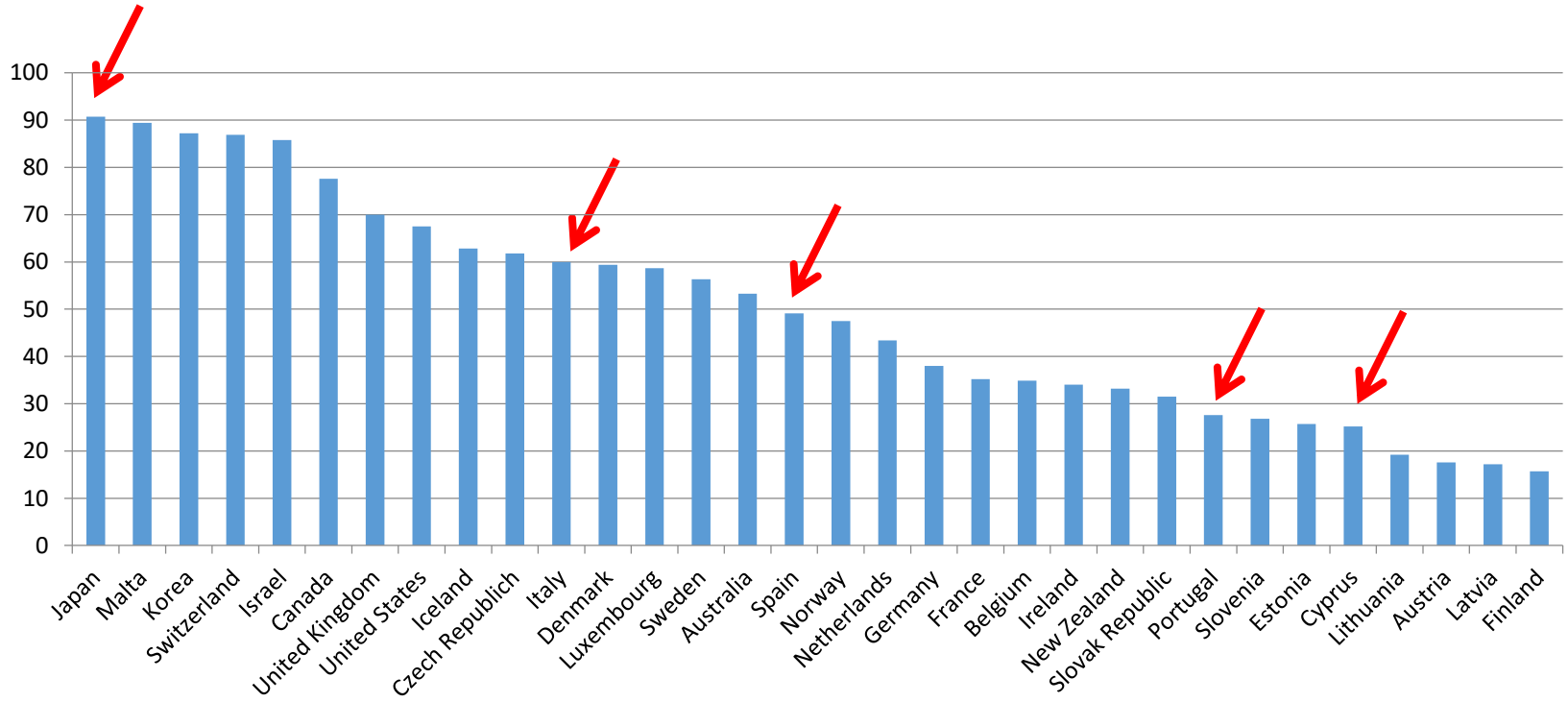
Advanced Economies:
Public Debt-to-GDP Ratio, 1880-2016



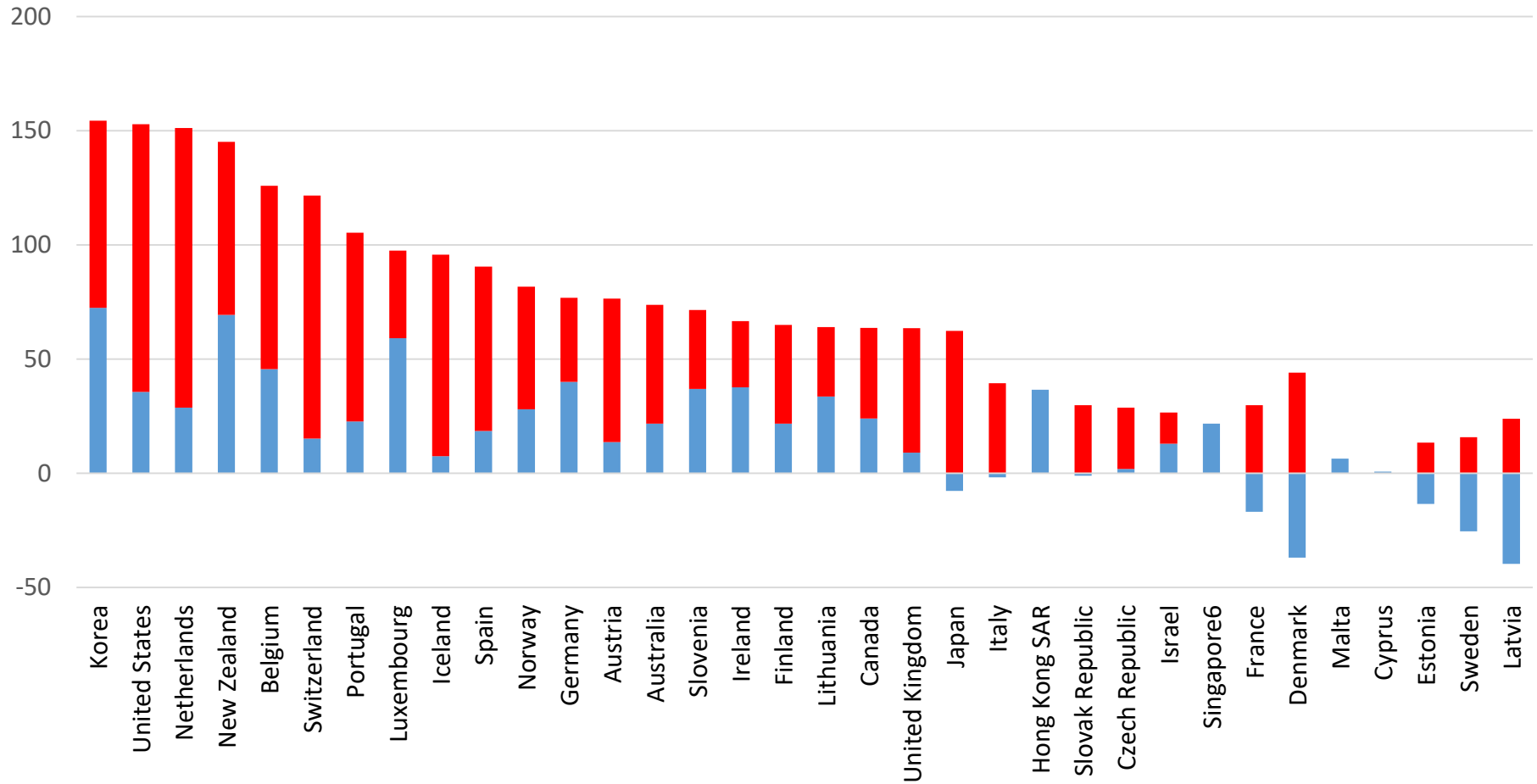
Public debt-to-GDP ratio
(in percent, 2015)



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

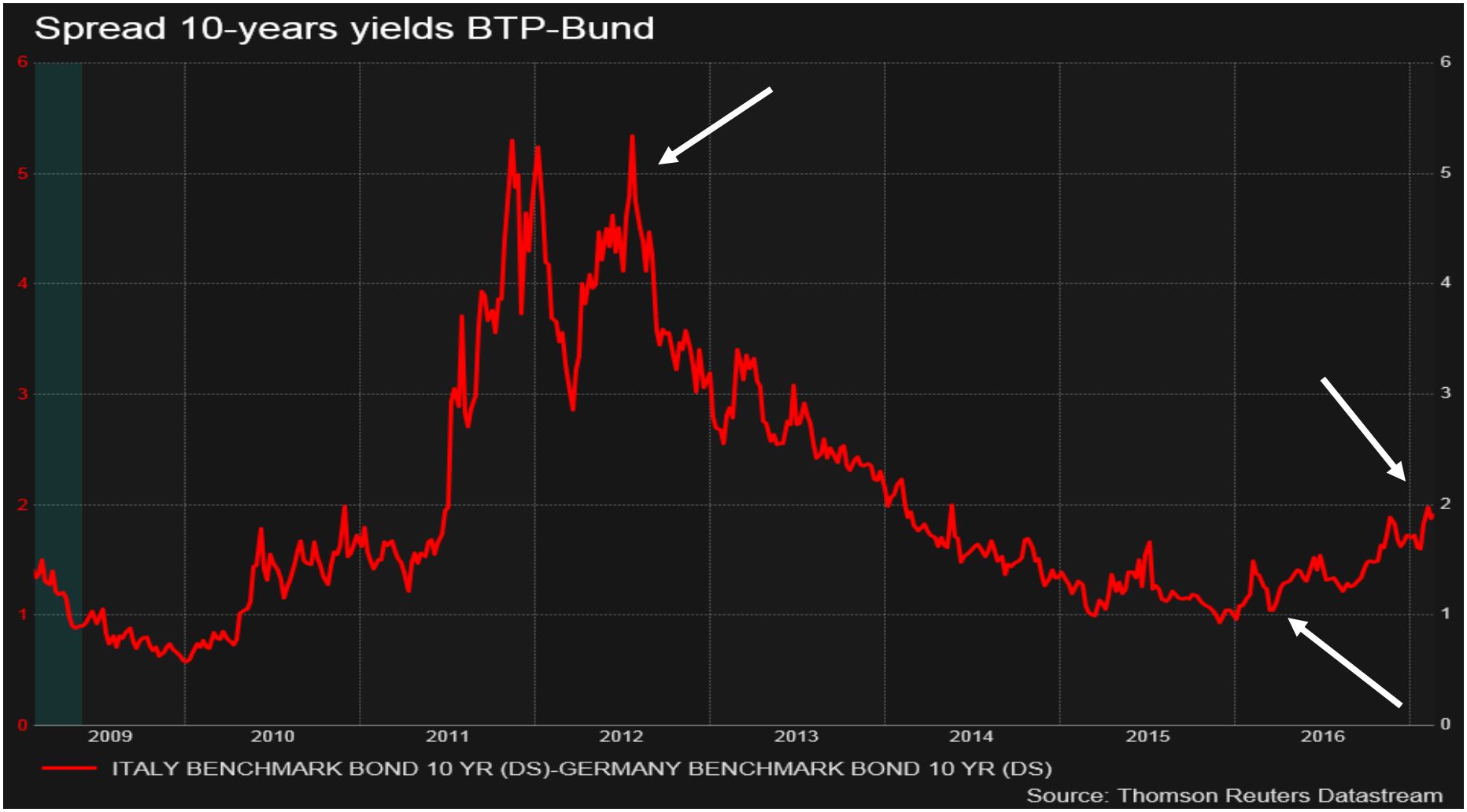
Charles Ponzi

(Lugo di Romagna, 1882 – Rio de Janeiro 1949)

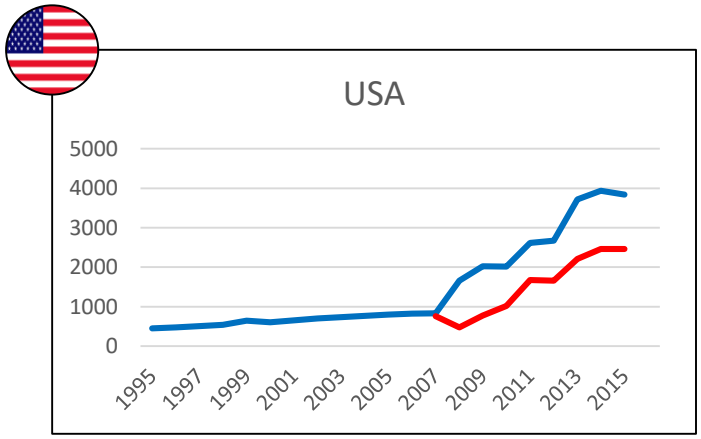
IMF Public debt sustainability thresholds

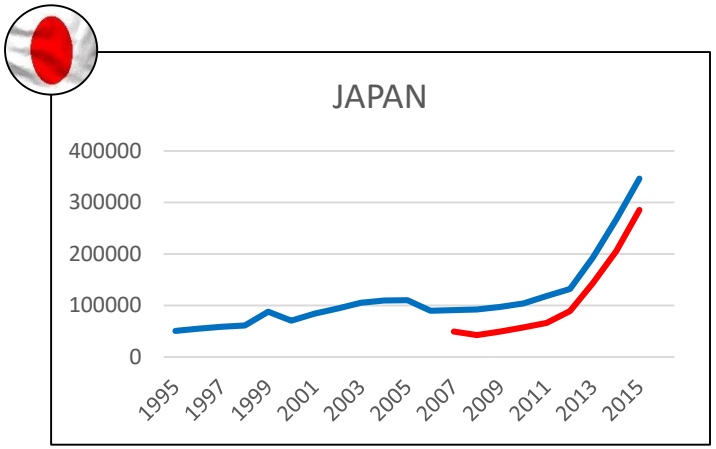
- Emerging economies: 70 percent of GDP
- Advanced economies: 85 percent of GDP (high risk)
- Advanced economies: 120 percent of GDP (unsustainable debt?)

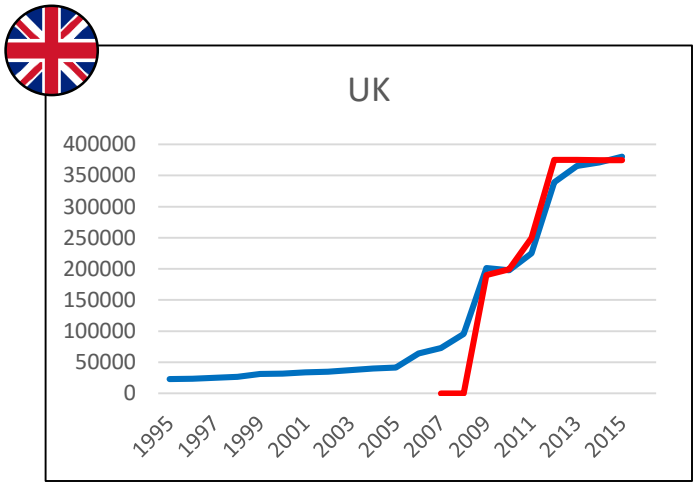
Spread dell'Italia sulla Germania
(rendimento differenziale a 10 anni BTP-BUND)

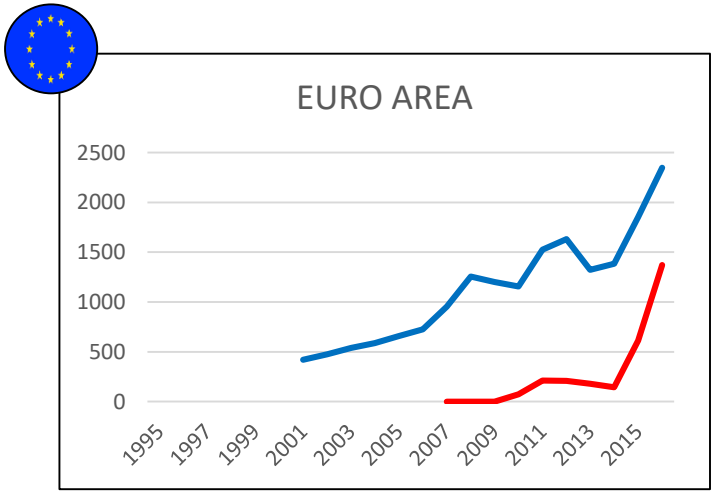


Surge in money base[1]









Monetary base — Central Bank's credit to government

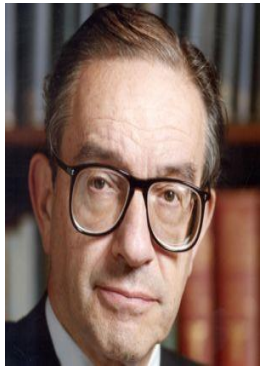
1 In national currency

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

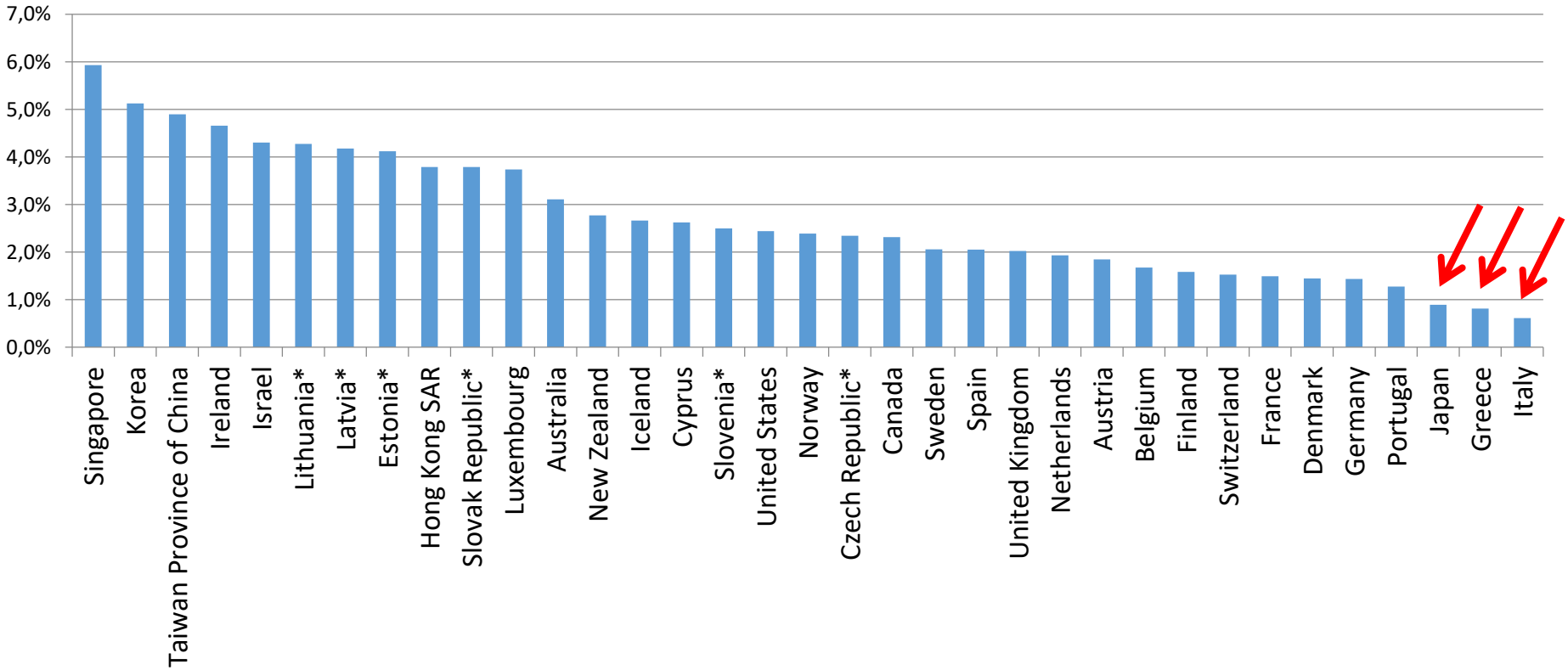


"I have a long argued that paying down the national debt is beneficial for the economy: it keeps interest rate lower than they otherwise would be and frees savings to finance increases in the capital stock, thereby boosting productivity and real incomes." Speech held by Alan Greenspan on April 27, 2001

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

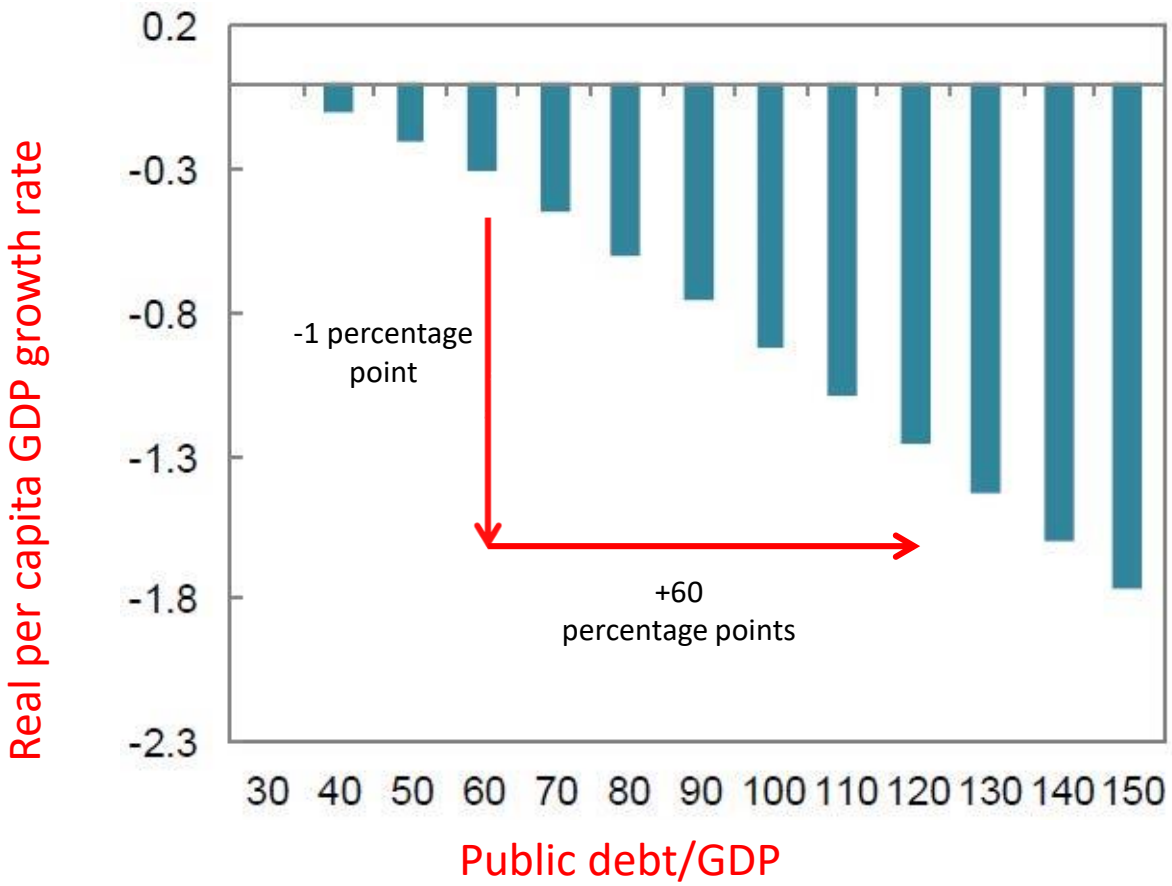
- Kumar, M., and J. Woo, 2010, ―Public Debt and Growth,‖ IMF Working Paper No. 10/174.


- 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


- Cecchetti, S. G., M. S. Mohanty and F. Zampolli, 2011, ―The Real Effects of Debt,‖ BIS Working Paper No. 352.


- Reinhart, C. and K. Rogoff, 2010, ―Growth in a Time of Debt,‖ NBER Working Paper No. 15639.


Relationship between public debt level and GDP growth



Source: Kumar M., Woo J., Public Debt and Growth, IMF Working Paper, 2010

How to lower public debt

Shortcuts

1. Printing money
2. Financial repression
3. Debt repudiation
4. Debt mutualization
5. Privatiziation

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)

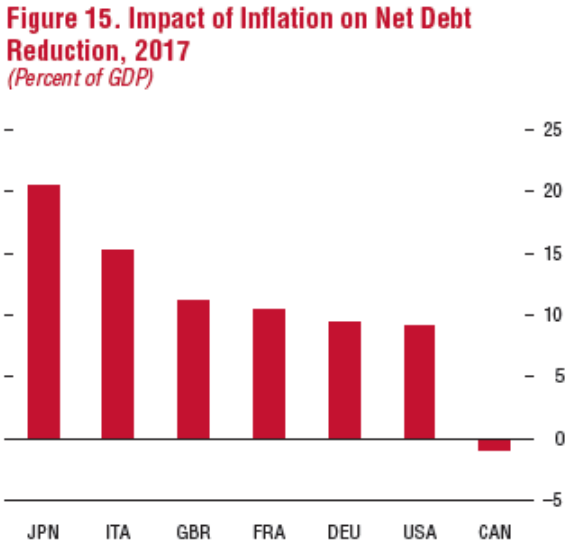
- Risk → Inflation

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

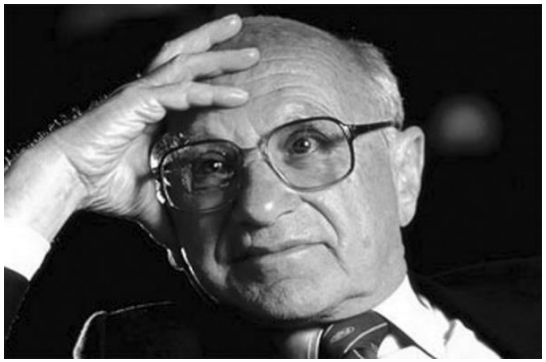
Should Euro Area countries leave the euro area?

Nobel Prize winners against the euro

Joseph Stiglitz

Paul Krugman

Amartya Sen

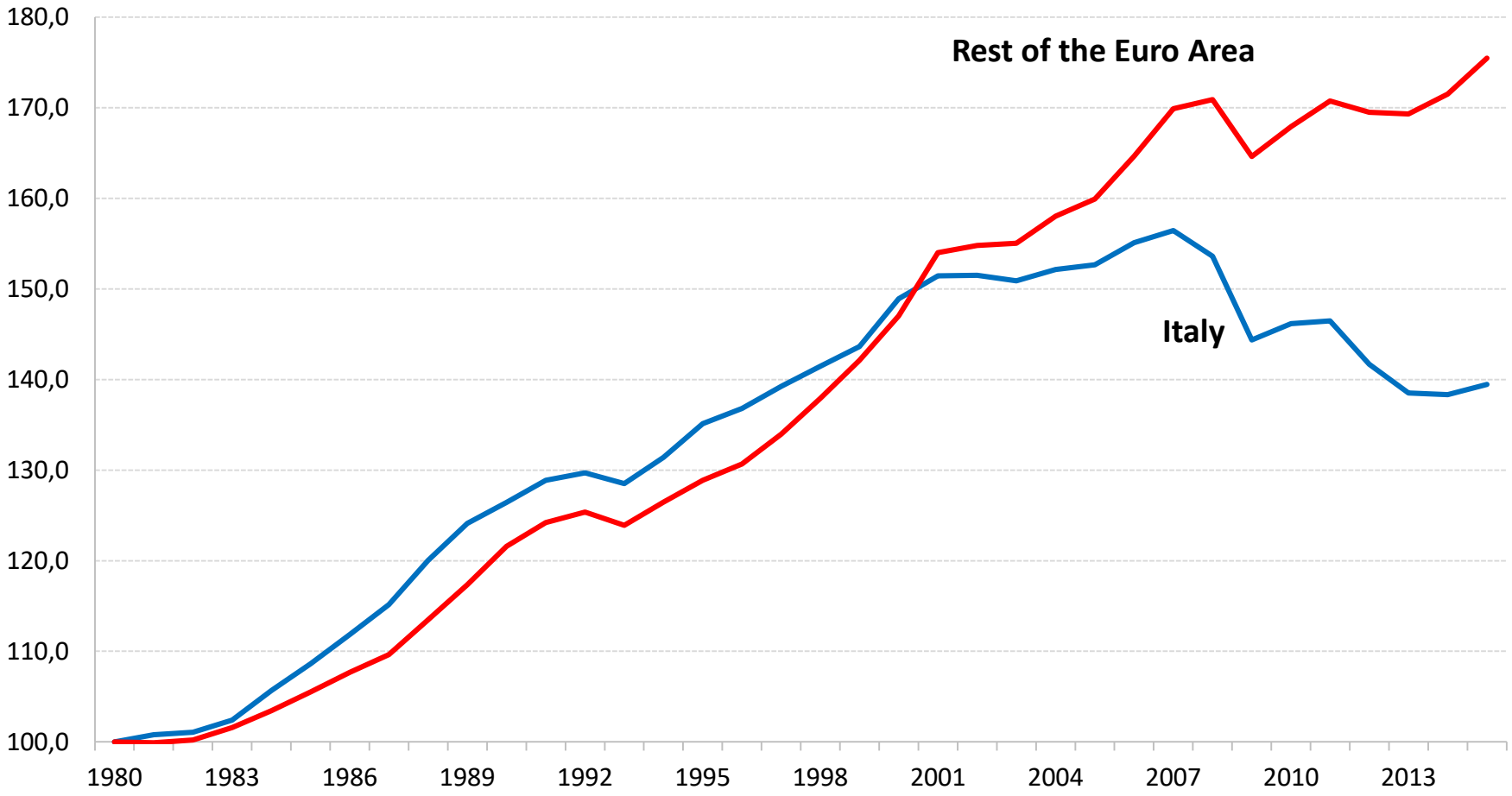


Milton Friedman

Christopher Pissarides

James Mirrlees

Real GDP per capita, 1980-2015
(index 1980 = 100)

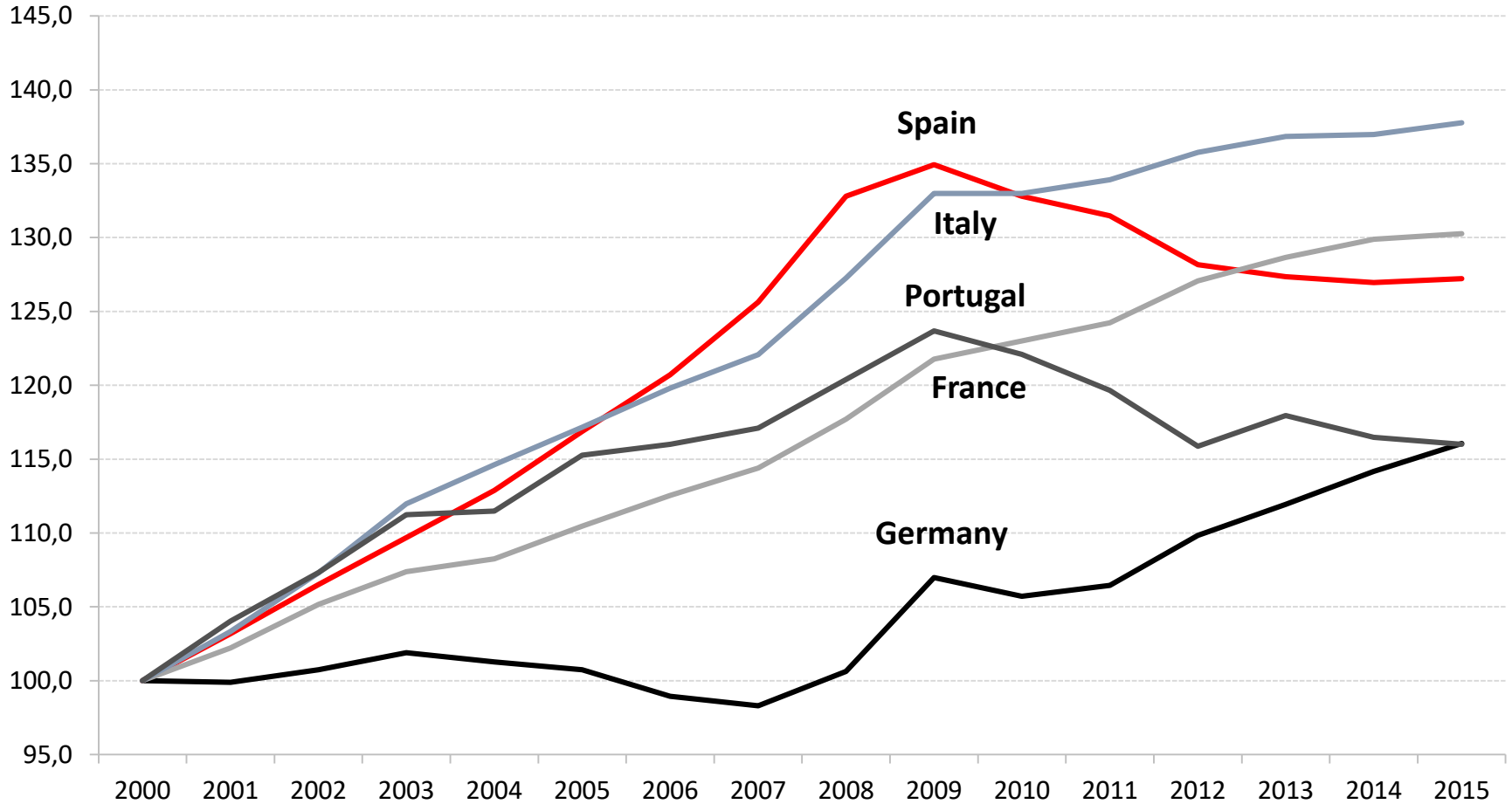


Source: Eurostat

Nominal unit labor costs per person,

2000-2015

(index 2000 = 100)



Source: Eurostat

2. Financial repression

Reinhart, C. M., M. B. Sbrancia, The liquidation of government debt, IMF Working Paper 16893M

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

3. Debt repudiation

a. Reputational costs

- Borensztein, E., and U. Panizza, The Costs of Sovereign Default, IMF Staff Papers 2009, 56 (4): 683–741.
- Cruces, J. J., C. Trebesch, Sovereign Defaults: The Price of Haircuts American Economic Journal: Macroeconomics 2013, 5(3): 85–117

b. Not alternative to austerity

c. High spillover effects

Italian public debt in euro

Italy 2016 = 2219 billion

Grecee 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

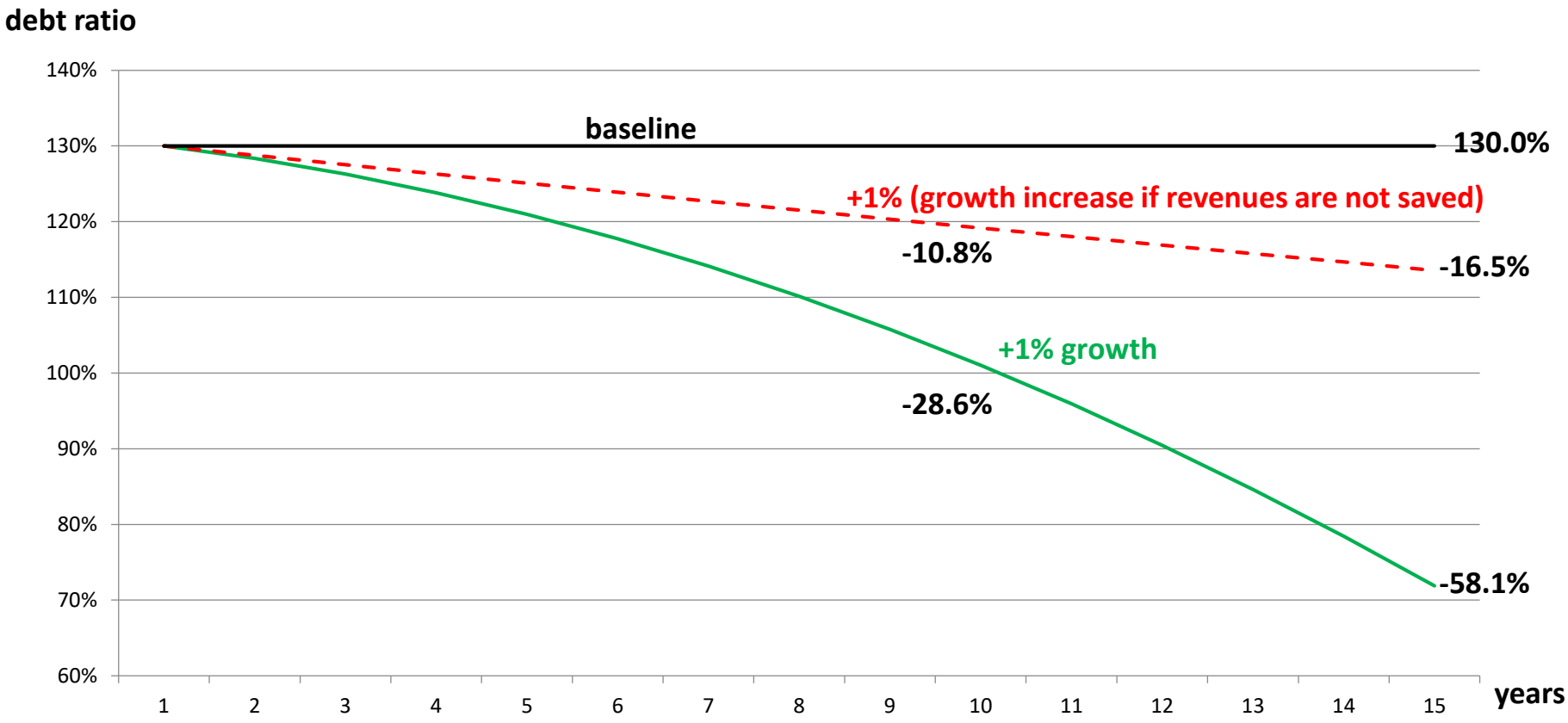
- Italy: optimistic estimates: 15 percent of GDP in 10 years (against a public debt of >130 percent of GDP and average privatization revenues of 0.25 of GDP in 2011-15).

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

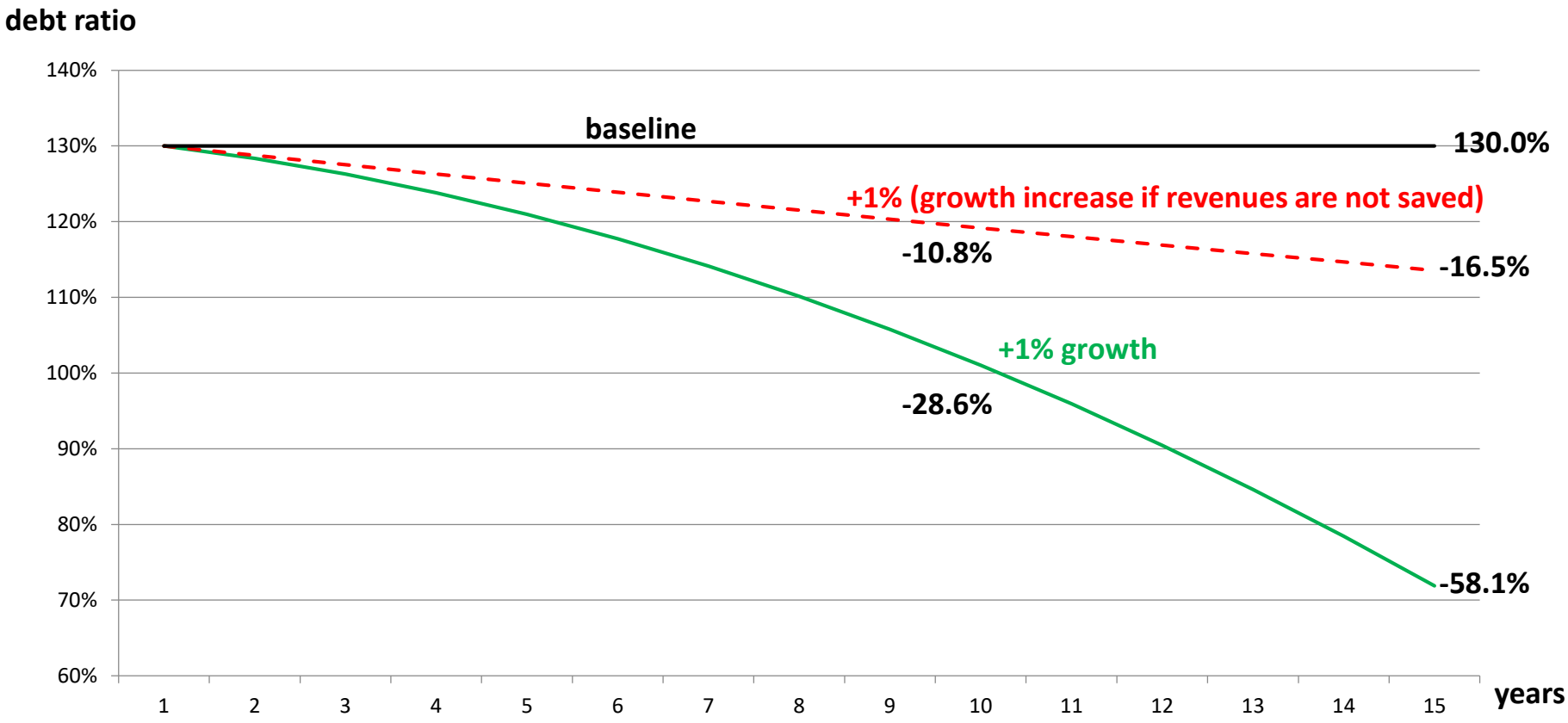


How can we boost growth?

- 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)

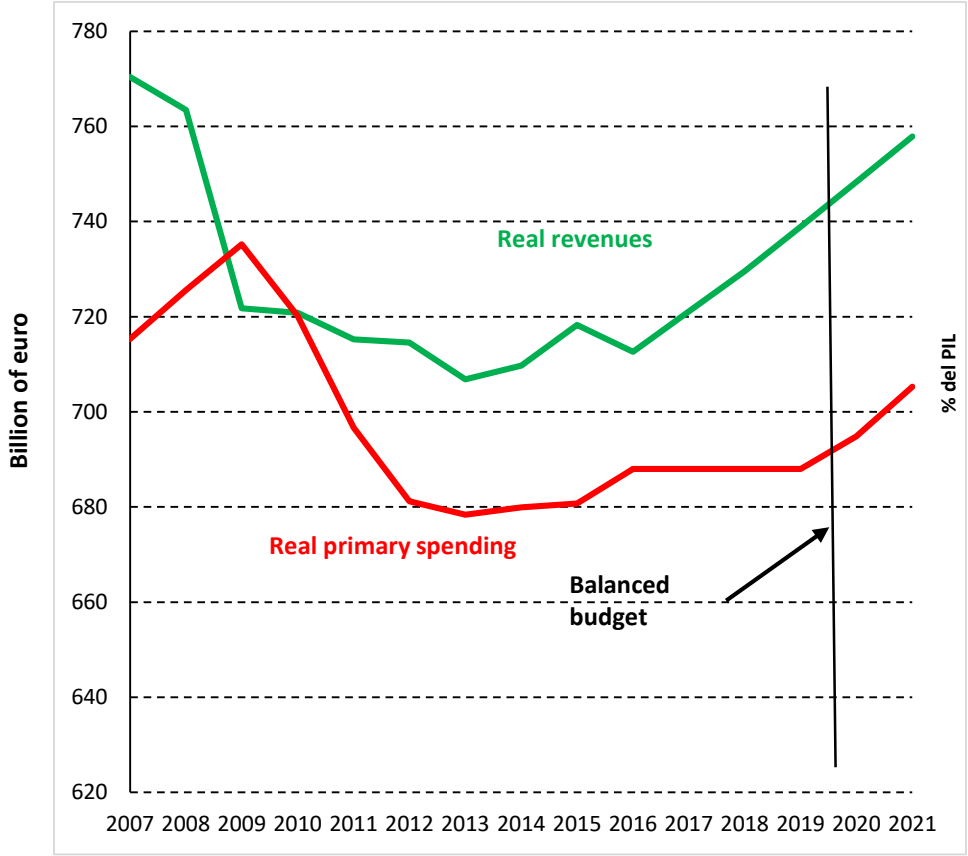
What is needed? (March 2016 scenario)

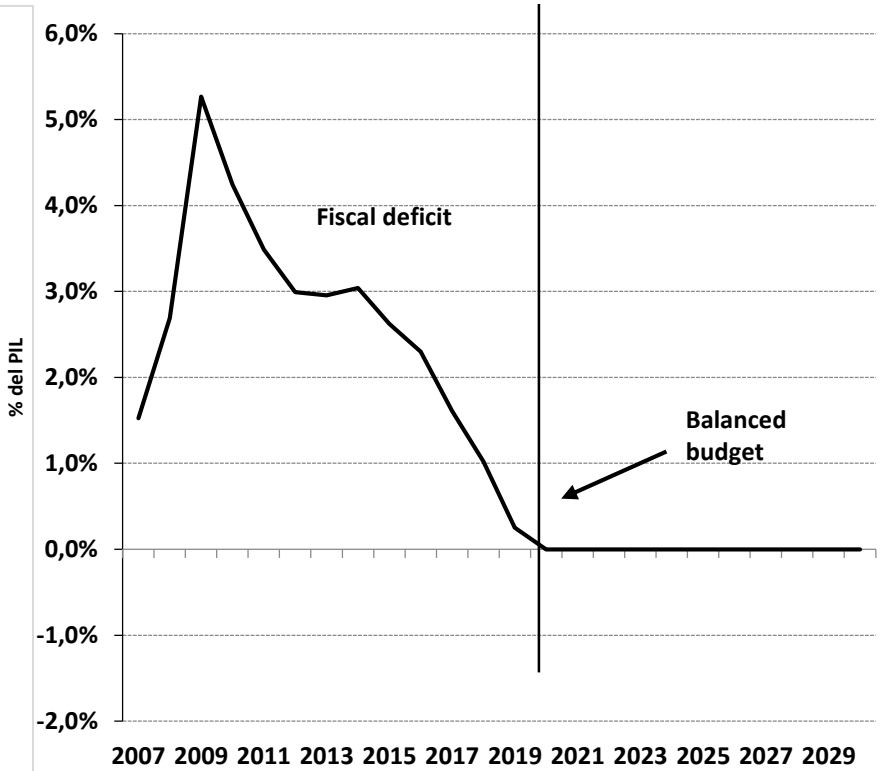
1. Freezing of primary public spending in real terms at the 2016 level

2. Balancing the budget by 2019-20

3. Maintaining a balanced budget (in cyclically adjusted terms thereafter)

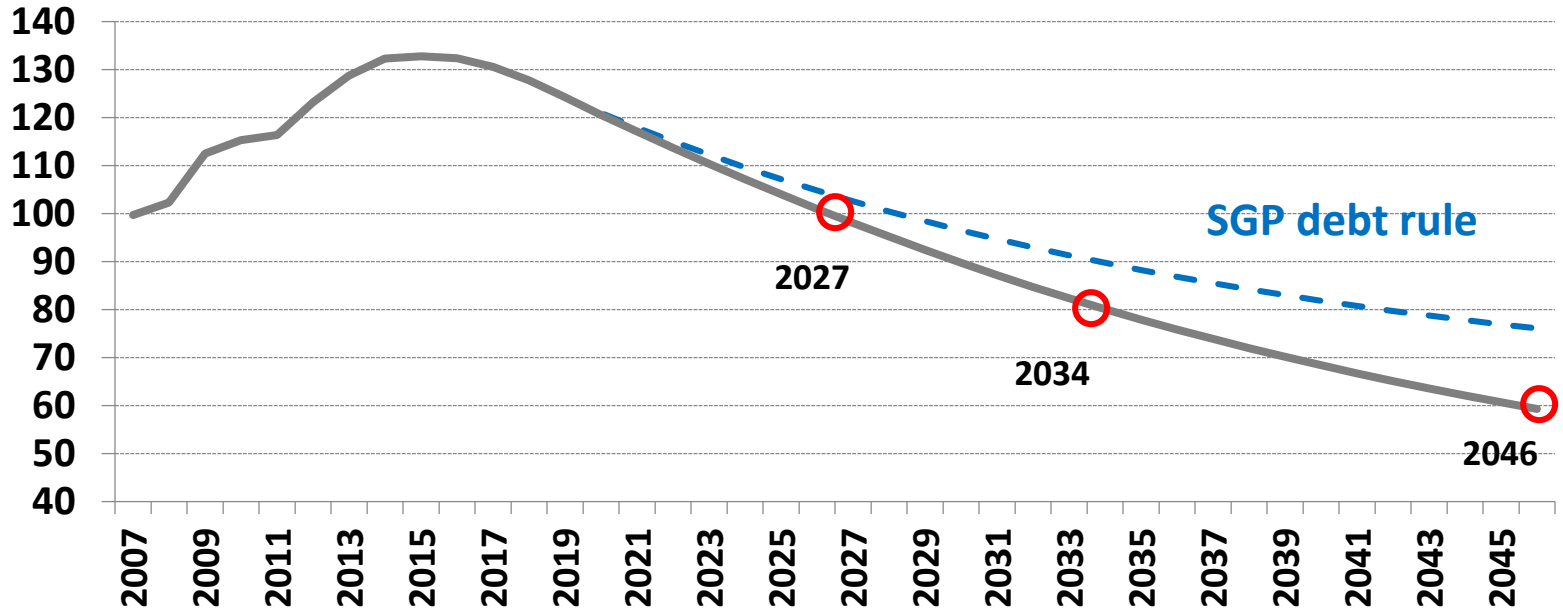
Primary spending, revenues and fiscal deficit[1]





1 Based on the April 2016 medium-term fiscal plan (Documento di Economia e Finanza, Aprile 2016)

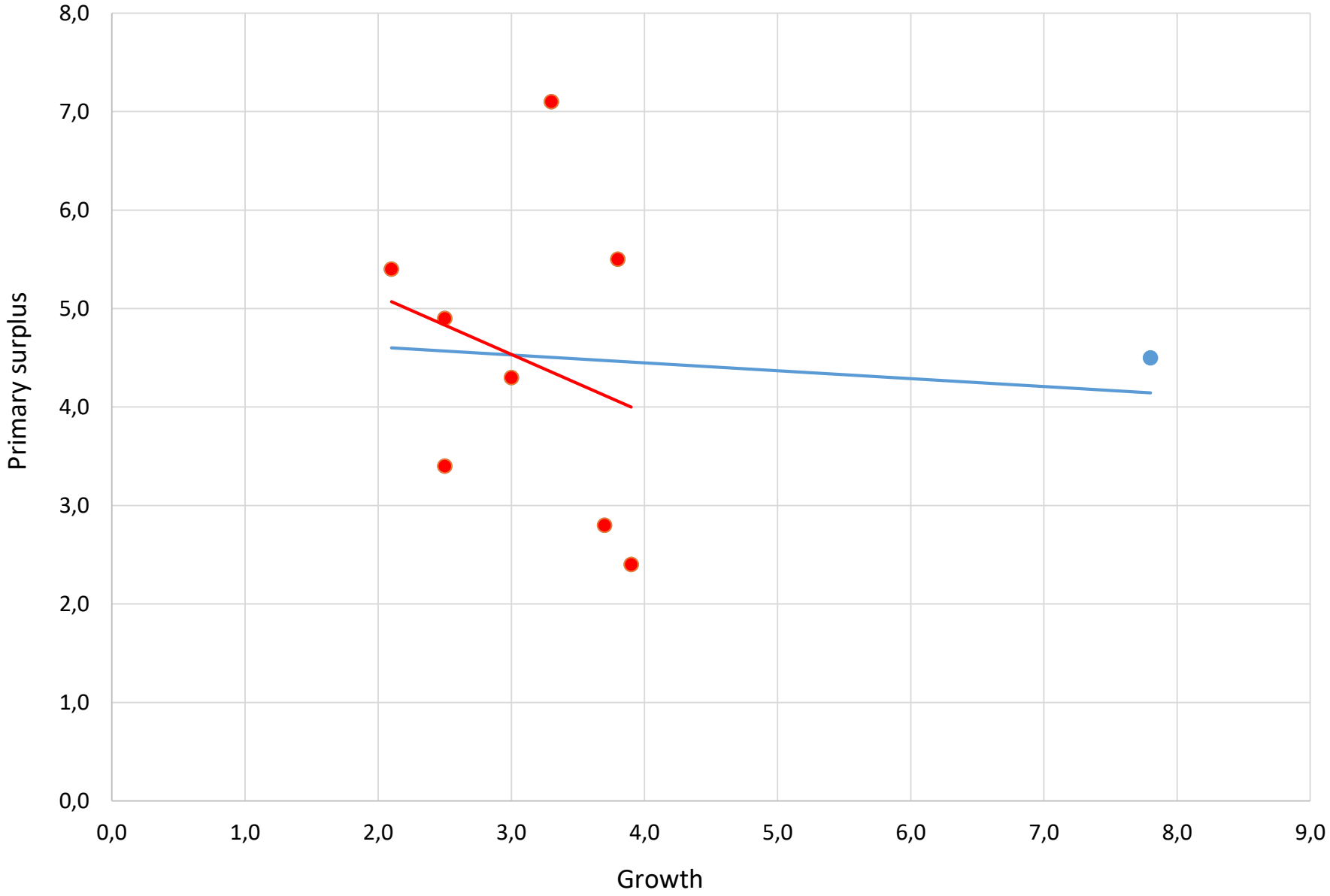
Public debt-to-GDP ratio (2007-45)



Episodes of strong decline in public debt in advanced economies during the last 30 years

	Initial public debt (in % of GDP)	Change of the Detb-to-GDP ratio	Period	Number of years of decline in the debt ratio	Annual average reduction (in % of GDP)	Average primary surplus	Average contribution of r-g and other (percentage points)	Average GDP growth rate
Ireland	94.6	-59.1	1991-01	10	-5.9	4.5	-1.4	7.8
Sweden	82.0	-43.2	1998-08	10	-4.3	4.3	--	3.0
Finland	57.7	-23.8	1996-08	12	-2.0	5.5	3.5	3.8
Denmark	69.2	-42.1	1996-07	11	-3.8	5.4	1.6	2.1
Belgium	134.1	-50.1	1993-07	14	-3.6	4.9	1.3	2.5
Canada	101.7	-35.2	1996-07	11	-3.2	7.1	3.9	3.3
Netherlands	78.5	-27.8	1993-01	8	-3.5	2.8	-0.7	3.7
New Zealand	76.0	-44.0	1987-01	14	-3.1	3.4	0.3	2.5
Spain	67.5	-31.2	1996-07	11	-2.9	2.4	-0.5	3.9

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

- Bassanetti A., Cottarelli, C. and Presbitero, A. F. (2016), Lost and Found: Market Access and Public Debt Dynamics, Mimeo, presented at the Sovereign Debt Restructuring Workshop (CIGI and University of Glasgow, 29-30 September 2016).

- Pescatori, A., D. Sandri, J. Simon, Debt and Growth: Is There a Magic Threshold?, ||IMF Working Paper No. 1434

THANK YOU FOR YOUR ATTENTION!