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Policy Debate - Special Issue

"Policy Mix in the Eurozone facing Covid-19"

Public debts in times of coronavirus

Henri Sterdyniak

OFCE, Les Économistes Atterrés

The COVID-19 outbreak has strengthened two trends in recent monetary developments: the rise in public debts and the low level of interest rates. In all advanced economies, governments have implemented huge measures to support businesses and households. The resulting rise in public deficits was easily financed at very low interest rates in most countries. Will higher public debts be a problem in the future? Several proposals have been made to cancel or to monetize public debts. Are they realistic?

THE RISE IN FISCAL DEFICITS WAS FINANCED

The COVID-19 sanitary crisis led to a sharp rise in deficits and public debts in all advanced economies. According to the IMF (World Economic Outlook, 2020), the average output loss in advanced economies will be 8% in 2020, leaving a gap of 5.5% compared to the pre-crisis trend in 2021. Public deficits would increase on average by 7.6 percentage points of GDP in 2020 (public finances would bear 75% of the output fall in 2020), of which 2.4 percentage points would remain in 2021; the debt-to-GDP ratio would increase by 16 percentage points.

In modern monetary economies governments should always be able to finance their deficits. The Central Bank commits to refinance banks at a refinancing rate that it set. Banks commit to buy all bonds issued by the government, knowing that they can always place them at the Central Bank, if they fail to place them with public or other financial institutions. The

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Government has, in fact, an unlimited right to draw on the Central Bank, at a rate close to the refinancing rate.

Financial markets currently anticipate neither a strong economic recovery, nor the acceleration of inflation, nor generally sovereign default risks. Therefore, they expect interest rates to remain low. Thus, governments have been able in 2020 to issue short-term and long-term bonds at very low rates. Once again, the rise in public debts and deficits in times of economic depression, is accompanied by a fall and not by a rise in interest rates.

In the euro area, since the COVID-19 outbreak, most governments have been able to issue bonds at negative interest rates up to 10-year maturities. In 2020-21, the French government is expected to borrow around € 300 billion (net, excluding interest payments), at near zero interest rates from financial institutions. Hardly a “debt wall” which should be broken.

Conversely, the Italian sovereign risk premium has widened until 2 percentage points. Markets are not worried at all about the US public debt (despite Trump), the UK public debt (despite Brexit) or the Japanese one (which has reached 240% of GDP). Markets have fears about the Italian debt because it is not guaranteed by the ECB. They remember the Greek debt crisis in 2012: a crisis leading Italy to leave the Eurozone cannot be totally excluded, especially since markets may fear their own self-fulfilling prophecy. Once again, the health crisis shows that the Eurozone is a fragile building.

THE MAGIC SOLUTIONS

The health crisis has led public debt to increase while private agents overall have accumulated financial assets. The risk is that demand remain sluggish for a long time. Uncertainty will weigh on households' spending and on business investment. Support for activity will remain necessary. In this situation, how to manage public debts? Three innovative solutions have been proposed.

The first proposal consists in cancelling part of the public debts, to the expense of their holders. However, government bonds' holders are not the richest. The latter hold a variety of assets outside government bonds, either in real estate, in riskier, higher-yield financial instruments, or in they own company. Public debt owners are middle-class households (through life insurance, pension funds or investment funds assets). They have trusted the French government by buying bonds at very low rates without a risk premium: they are ready to buy bonds again. France is not bankrupt, it cannot seriously claim to be unable to service its debt. The government bonds holders would complain to French or international courts of justice and would win. Finally, raising the possibility of partial debt cancellation could frighten savers, cause interest rates to rise, and generate a debt crisis. Public debts would no longer be considered safe assets; this would require banks to tie up capital to hold it. Countries that have carried out such

operations would find it difficult to borrow again to finance the ecological transition.

Some suggest, more modestly, that the government issue perpetual bonds, solely requiring interest payments. George Soros suggests the EU should issue such bonds at a 0.5% interest rate¹. But why would financial institutions buy such bonds, which they would never be able to sell without a huge loss if interest rates rose? The EU would have to offer much higher rates or indexed rates, which would strongly reduce the attractiveness of the proposal.

The second would be to print money or to monetize public debt. But, what is money printing in 2020? The question is not: “Can the State give money to households and businesses in times of crisis”? As we have seen, the State can distribute any amount of money it wants², but this money is neither distributed nor held in the form of banknotes. So, there is no need to print any money, but there are also no additional resources at guaranteed zero interest rates.

Let us assume that the government gives 100 billion euros to precarious households who will spend it entirely³. This will have a multiplier effect on output if the economy is underemployed. Let us assume that the average households' savings rate on their current income is 0.7 and that the tax rate on production is 0.3. Then the Keynesian multiplier is 2, output will increase by 200 billion and therefore tax revenues by 60 billion. Ex post, the public deficit will increase by 40 billion, as will households' savings. The effect on the public deficit is much smaller than the initial shock. But these 40 billion will not be held in cash. For example, 20 billion will be held in bonds (through life insurance in particular) and 20 billion will be held in remunerated bank deposits. Banks have no reason a priori to increase lending to the private sector and will therefore be able to buy the 20 billion bonds issued by the government. Ex post, the public debt will necessarily be 40 billion higher in long-term or short-term bonds. Knowing how much of that 40 billion is monetary funding is a question that makes no sense.

With interest rates currently at 0, increasing public borrowing is not an issue. If interest rates rise in the future, interest payments will increase. However, interest rates will rise only in the event of strong economic growth and inflation, therefore with higher tax revenues and a relatively low interest rate corrected from growth. Consequently, the situation of public finances will not be necessarily difficult.

If the Central Bank buys 100 billion government bonds, directly or from banks, banks' refinancing decreases by 100 billion, which could encourage banks to increase lending. This implies that the amount of public bonds held by the central bank should not be too large, as it could reduce excessively banks' refinancing and could weaken the Central Bank's control on credit supply.

Some believe that Treaties should allow the Central Bank to directly finance States. But who would have the

initiative? The Central Bank - in which case it would be like today where the Central Bank guarantees that the government may issue as many bonds as they want and can buy back long-term debt - or governments - but at what interest rates and up to what limits? There is a difference between a situation where the Central Bank can decide to buy government bonds, directly or indirectly, to stabilize long-term interest rates and a situation where the Central Bank would be forced to finance a public expenditure programmed, without having a say on its amount. This could prevent the Central bank from controlling banks' refinancing or constrain it, on the contrary, to run a too restrictive refinancing policy.

The Central Bank is owned by the State, and gives its profits to the latter. When It buys public bonds, it earns interest payments on public debt, but loses interest payments on bank refinancing. Financing government at zero interest rates would amount to squeezing the Central Bank's profits (which in itself is of little importance since the Central Bank's profits are given back to the State, except that it would be contrary to the Central Bank's autonomy if the State could reduce its profit in a discretionary manner). It is therefore legitimate that the State pays a risk-free market rate for the public debt that the Central Bank holds.

Debt monetisation therefore means for the whole "State + Central Bank" financing borrowing at the refinancing rate, which should be compared to borrowing costs via bonds, at long-term, risk-free rates, which reflect market expectations on the evolution of short-term rates. Thus, when long-term interest rates are at zero as they currently are, the government may prefer to borrow via long-term bonds, rather than be financed at the money market rate, and thus be protected against the risk of higher interest rates. Conversely, the Central Bank may buy government bonds to lower long-term interest rates, which may be helpful if markets are worried about a rise in interest rates.

According to some economists, if the Central bank owns government securities forever, the State will not have to repay. Certainly, but this is true for all public debt, if it is guaranteed by the Central bank. At each period of time, the government is ensured to be able to refinance the maturing debt. The State is eternal: there will always be savers who want to hold safe financial assets. There will not be a D-day when the State has to repay the entire public debt. Each month, the government reimburses the maturing loans, but most of the institutions being reimbursed immediately buy government bonds again. The government only has to keep control of its debt; it must be able to lower it if government borrowing generates excessive demand in relation to production capacity.

The third solution would be to have the public debt born by the Central Bank. Some suggest that the Central Bank cancel the public bonds it already owns or that it holds them until the end of times at a nil interest rate, which is the same thing. In fact, this operation is purely internal to the "State + Central Bank" entity and would have no effect on other agents and so no macroeconomic impact. Let us assume that the Central

Bank cancels 400 billion of public debt it owns. Public debt falls by 400 billion, but the "Central Bank + State" debt remains unchanged. This would not give public finances an additional 400 billion room of manoeuvre both in terms of the short-term equilibrium and of debt sustainability⁴. With interest rates at zero today, interest payments do not matter. But if interest rates increased, the central bank would have to borrow from banks at the refinancing rates and its current account would be unbalanced. As the Central bank is owned by the State, the savings made by the government on interest payments on the cancelled debt would be offset by the loss of dividends from the Central bank and probably by the obligation to subsidize it. The Central Bank's independence would be weakened.

Some suggest to use helicopter money to provide a certain amount of money to each household⁵. But the Central Bank's role is not to run fiscal policy, but to run monetary policy, and therefore to control credit and to guarantee banks and public debts. A bank lends; it does not pay benefits. In the euro zone, each member state has already taken measures to support its economy as well as possible, it would be a waste to add a transfer to all, the richest as well as the poorest, to pay money to civil servants or to retirees who did not see their incomes fall ; assistance needs differ for countries with or without a minimum income and a satisfying unemployment insurance system.

Let's go back to our example. Let us assume that the Central Bank paid 100 billion to precarious households. Ex post, the Central Bank will run a deficit of 100 billion; the government will be able to cut its deficit and debt by 60 billion, but the central bank will see its refinancing to banks cut by 100 billion. On the whole, for the "Central Bank + State" entities," the evolution of net debt will be the same as for a State-financed operation, money supply will be the same, nothing will be changed for private agents, but the financing will be ensured by banks' refinancing and not by bonds.

For the economists who propose to transfer the public debt to the Central Bank, being the ultimate source of liquidity, the Central Bank's balance sheet can be unbalanced without problem. But this reasoning applies

1 <https://www.project-syndicate.org/commentary/finance-european-union-recovery-with-perpetual-bonds-by-george-soros-2020-04>

2 Which allows one to say, according one's mood that the Modern Monetary Theory is right, or that it knocks on an open door.

3 To make the reasoning simpler, we assumed that this is a closed economy.

4 Contrary to what believes Laurence Scialom (2020) : <http://tnova.fr/notes/des-annulations-de-dette-publique-par-la-bce-lancons-le-debat> and Gaël Giraud (2020) https://www.lepoint.fr/postillon/gael-giraud-cette-crise-est-une-epreuve-de-verite-pour-les-collapsologues-romantiques-25-04-2020-2372847_3961.php

5 As Aurore Lalucq and Jézabel Couppey-Soubeyran (2020): <https://www.nouvelobs.com/economie/20200330.OBS26781/tribune-la-monnaie-helicoptere-ou-le-desastre.html>

similarly to the State, whose public debt, guaranteed by the central bank, can also grow without limit. The equivalence between public debt and possibly a Central Bank debt is macroeconomic and financial. To assess the fiscal stimulus, one must account for government and Central bank's deficits. This is where some economists suggest creative accounting. They think that financial markets and European Authorities may be fooled, that they will look at the fall in public debt and not at the stability in the total "public + Central Bank" debt. This is an illusion. If governments tried to cancel part of their debt in their Central bank's balance sheet, financial markets and international institutions would quickly take this into account to assess debt sustainability.

There is no magic monetary creation that could allow unlimited funding at nil interest rates of universal income, guaranteed full-employment, ecological transition, and now the health crisis. As concerns the equilibrium of goods and services markets, an increase in public expenditure must be financed by taxes in full employment periods. Its increase is necessary in times of unemployment; it must be financed by deficit, i.e. by borrowing. The delicate point is to draw the line between these two situations.

WHAT TO DO WITH PUBLIC DEBT?

Public debt is necessary. It satisfies households' and financial markets' wish to hold a safe financial asset. It is legitimate that it finances public investments. Fiscal deficits should increase in times of weak activity, once interest rates have been cut to their minimum. Public debt is only excessive when it induc-

es excessively high interest rates and inflation rates. Obviously, this is not currently the case. The recent increase in public debt corresponds partly to households' involuntary savings resulting from the impossibility to buy goods and services in the lockdown. It would be counterproductive to reduce this savings through taxes, while demand needs to be sustained. It would be socially unjustifiable.

In the short term, the priority is for activity to resume; public debt should be cut only by lower excess savings and by inflation; above all, European authorities should not reintroduce the 60% of GDP limit for public debt, 3% of GDP limit for the deficit and the objective of medium-term public balance in equilibrium. The ECB should guarantee public debts while the European budget should support the countries most affected by the pandemic. In the medium term, public investments and ecological transition financing should be facilitated by the development of a public financial system offering safe financial investments, at low rates, off-markets, and protected from inflation. In the longer term, public debt reduction will be facilitated by a tax on high wealth, by the fight against tax competition and optimization, and above all by the reduction of income inequalities induced by neo-liberalism.



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