How to implement stabilisation policies with high public debt? How to correct nominal divergence in Europe?

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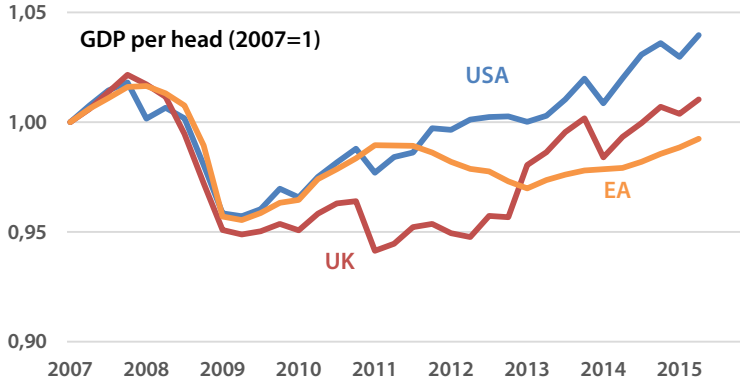
Problems ahead

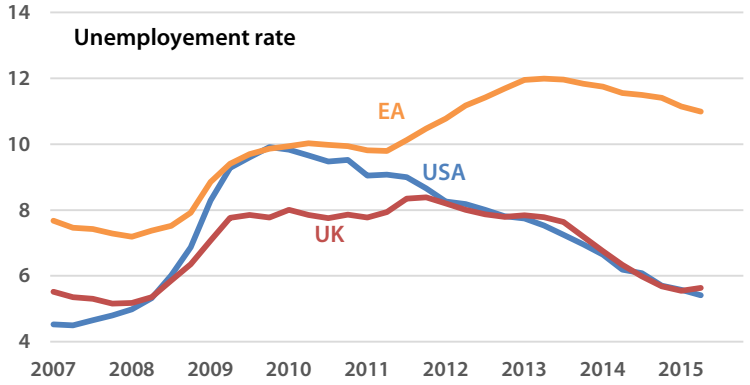
- **Challenges**
  - High debt – no so high when compared to UK or USA – but high enough in some EA countries
  - High unemployment
  - Risk of deflation/low inflation
  - External account imbalances inside the EA/no exchange ajustement possible

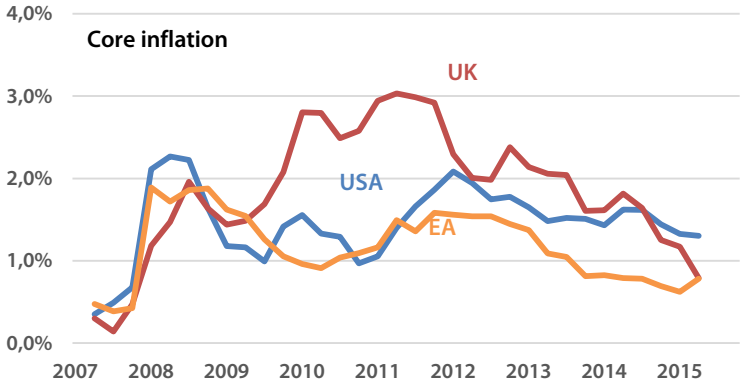
- **So how to stabilize with high debt and correct the nominal divergence ?**
  1. Consolidate and reduce debt while interest rates are low
     keep them low while consolidating
     backload as much as you can and low interest rates allow
  2. Keep political stability
     because high debts are frightful ; break up would add fear
  3. Avoid deflation
     because you need to keep real interest rates low (ZLB) and you need political stability
     think twice about structural reforms
  4. Enhance growth
  5. Coordinate as much you can nominal adjustment
     because it is deflationary

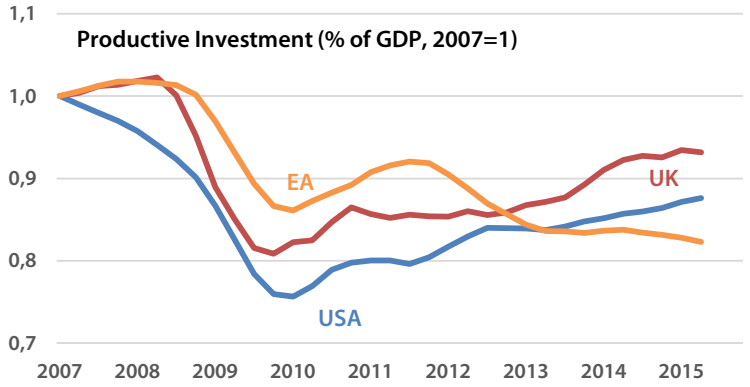
A too slow recovery: Euro area is lagging behind

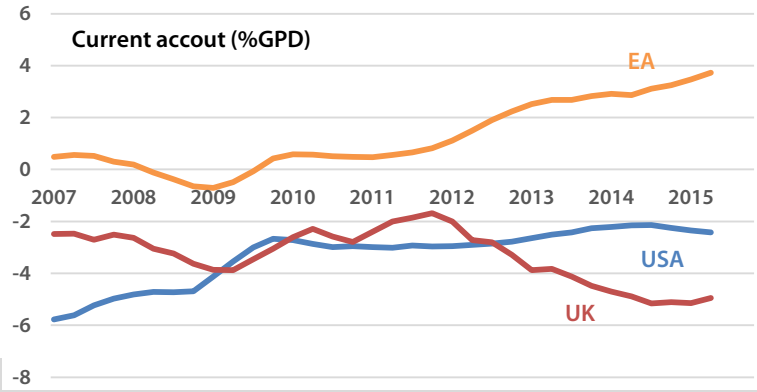
Figure 2. EA vs USA vs UK

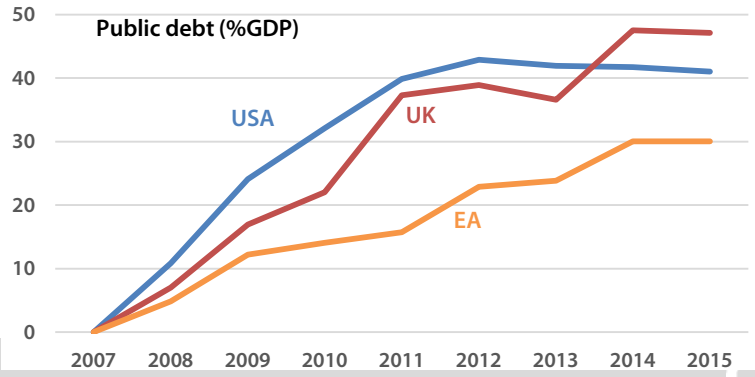












The road to 60%

Table 2. Is it possible to reach a 60% debt-to-GDP ratio? (baseline scenario except +/- 0.5 fiscal impulses depending on public debt gap *vis-à-vis* 60% target)

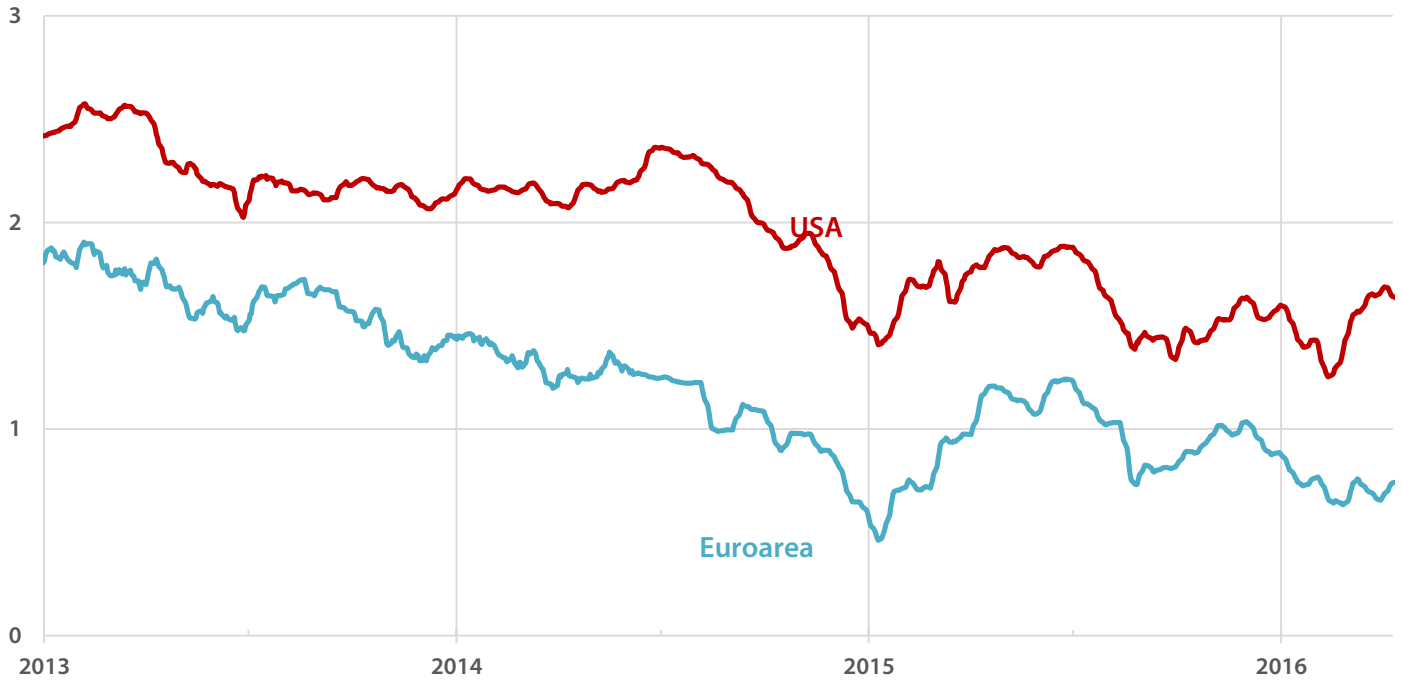
	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse	GDP growth rate (%)		Average output gap	Inflation rate (%)	
	(1) 2020	(2) 2035	(3) 2020	(4) 2035	(5) 2015-35	(6) 2016-20	(7) 2021-35	(8) 2016-35	(9) 2016-20	(10) 2021-35
DEU	60	59	-1.4	-2.0	3.1	1.6	1.0	0.4	2.1	2.1
FRA	97	60	-0.7	0.4	-4.0	1.4	1.5	-0.5	0.6	1.8
ITA	128	60	1.9	3.3	-1.9	0.6	0.3	-0.7	0.1	1.9
ESP	96	60	-0.3	0.2	-2.5	1.9	1.5	-0.3	0.6	1.9
NLD	63	60	-1.5	-1.9	0.4	1.9	1.2	0.2	1.6	2.1
BEL	99	60	-0.4	0.2	-1.7	1.7	1.5	0.0	0.7	2.0
PRT	106	60	0.1	1.1	0.8	2.2	1.0	0.0	1.4	2.1
IRL	76	60	-1.0	-1.5	3.4	3.0	1.8	0.7	2.3	2.2
GRC	206	152	1.3	5.2	-8.7	1.8	0.7	-3.6	-2.3	0.2
FIN	63	60	-1.7	-2.1	-0.5	2.1	1.6	-0.2	1.2	2.0
AUT	79	60	-1.0	-1.0	0.5	1.9	1.4	0.0	1.6	2.0
EA	88	61	-0.5	-0.3	-0.5	1.5	1.1	-0.2	1.1	1.9

Source: iAGS model.

Macroeconomy kicks back: price expectations

- 5y5y inflation swap is a (popular) indicator of inflation expectations

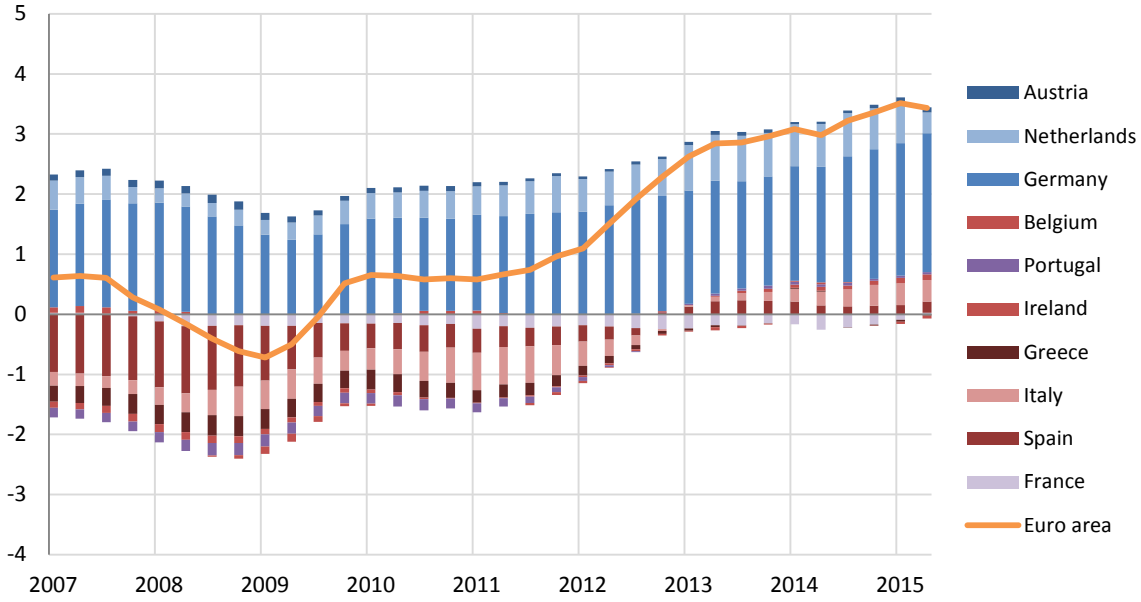
Figure 5. Inflation expectations



Inflation expectations are measured using 5 Years Forward 5 Years Swap. Source: Datastream

Internal and external rebalancing are fueling deflationary pressures

Figure 3. Current account in % of EA GDP



Upward shift of current account is a consequence of lower raw material prices, low internal deman and unconventional monetary policy. Source: national accounts, ECB, iAGS 2016 calculations. Current account is cumulated over 4 quarters.

Table 4: Nominal adjustment for value added prices (relative to Germany)

	2008	2009	2010	2011	2012	2013	2014
Germany	0	0	0	0	0	0	0
France	-21	-18	-18	-21	-22	-17	-21
Italy	-35	-29	-40	-38	-22	-13	-10
Spain	-63	-40	-37	-35	-25	-16	-20
Netherlands	-5	6	6	4	5	7	1
Belgium	-40	-36	-17	-37	-27	-25	-27
Portugal	-116	-106	-90	-56	-37	-18	-24
Ireland	-31	-34	-29	-31	-33	-22	-16
Finland	5	-1	-8	-34	-37	-33	-28
Austria	18	15	12	1	3	6	1

Some countries have improved significantly which may be a symptom of an inaccurate method or that things can improve trough others channels than simply wages adjustment.

Taking seriously the adjustments

Table 11. Correction of fiscal and external imbalances in the cooperative (symmetric price adjustment) case

	Public debt (*in % of GDP*)		Structural balance (*in % of GDP*)		Cumula-tive fiscal impulse	Average output gap	Inflation rate (*in %*)		Current account adjustment
	(1) 2020	(2) 2035	(3) 2020	(4) 2035	(5) 2015-35	(6) 2016-35	(7) 2016-20	(8) 2021-35	(9) 2015-35
DEU	58	60	-1.3	-2.5	3.8	0.5	2.5	2.8	-3.1
FRA	100	60	-0.8	1.5	-5.5	-0.8	0.3	1.2	2.0
ITA	127	60	1.7	3.2	-1.6	-0.6	0.2	2.0	-2.9
ESP	98	60	-0.2	0.8	-3.2	-0.4	0.2	1.4	-0.4
NLD	63	60	-2.0	-2.4	1.1	0.3	2.1	2.7	-2.7
BEL	102	60	0.3	0.9	-2.6	-0.1	0.2	1.3	3.7
PRT	109	60	0.7	1.7	0.1	0.0	0.8	1.5	-3.2
IRL	76	60	-1.0	-1.3	3.2	0.8	2.1	2.0	-0.9
GRC	221	245	1.0	2.5	-8.7	-3.6	-3.6	-1.6	9.8
FIN	67	60	-1.0	-1.3	-1.6	-0.5	0.2	1.2	3.0
AUT	76	60	-1.6	-1.7	1.5	0.2	2.4	2.8	-2.9
EA	**88**	**61**	**-0.5**	**-0.4**	**-0.6**	**-0.2**	**1.1**	**1.9**	**-1.0**

Note: The adjustment of current account is computed as the change in the current account between 2015 and 2035.
Source: iAGS model

Non symetric adjustments, no fiscal space usage

Table 12. Correction of fiscal and external imbalances in the non-cooperative (asymmetric price adjustment) case

	Public debt (*in % of GDP*)		Structural balance (*in % of GDP*)		Cumulative fiscal impulse	Average output gap	Inflation rate (*in %*)		Current account adjustment
	(1) 2020	(2) 2035	(3) 2020	(4) 2035	(5) 2015-35	(6) 2016-35	(7) 2016-20	(8) 2021-35	(9) 2015-35
DEU	54	12	1.1	2.1	0.4	0.4	1.9	2.2	-1.9
FRA	102	65	-0.8	4.8	-10.0	-1.5	-0.2	0.0	5.4
ITA	131	60	2.2	4.2	-2.8	-0.8	-0.3	1.3	-1.8
ESP	100	60	-0.1	1.4	-3.7	-0.4	-0.1	0.8	-0.1
NLD	61	41	-0.8	-0.3	-0.2	0.4	1.5	2.3	-1.9
BEL	102	60	0.5	1.3	-2.6	0.1	-0.2	0.8	3.9
PRT	112	54	1.3	2.8	-0.8	0.0	0.1	1.0	-2.9
IRL	74	13	1.4	3.3	0.0	0.7	1.5	1.5	0.5
GRC	224	245	1.1	3.4	-8.7	-3.2	-4.0	-1.9	9.5
FIN	67	60	-1.1	-1.2	-1.3	-0.2	-0.1	0.7	3.5
AUT	77	46	-0.7	0.0	0.4	0.2	1.7	2.3	-2.5
EA	88	42	0.5	2.4	-2.9	-0.4	0.6	1.2	0.4

Note: The adjustment of current account is computed as the change in the current account between 2015 and 2035.
Source: iAGS model

Non cooperative asymetric adjustment and euro appreciation

Table 13. Correction of fiscal and external imbalances in the non-cooperative case and with appreciation of the euro (up to 1.3)

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse	Average output gap	Inflation rate (%)		Current account adjustment
	(1) 2020	(2) 2035	(3) 2020	(4) 2035	(5) 2015-35	(6) 2016-35	(7) 2016-20	(8) 2021-35	(9) 2035-15
DEU	56	14	1.2	2.0	0.4	0.3	1.4	2.3	-3.1
FRA	105	70	-0.6	4.5	-10.0	-1.7	-0.5	0.0	5.0
ITA	138	63	2.2	8.5	-9.3	-2.1	-0.8	0.4	0.9
ESP	102	58	0.0	1.9	-4.5	-0.7	-0.5	0.7	-0.7
NLD	63	35	-0.7	0.1	-0.2	0.5	0.8	2.6	-3.8
BEL	103	60	0.0	0.9	-1.7	0.3	-0.8	1.1	2.4
PRT	112	48	1.6	3.1	-0.8	0.0	-0.1	1.0	-3.0
IRL	78	12	1.5	3.4	0.0	0.8	0.3	1.8	-2.0
GRC	229	242	1.1	3.8	-8.7	-3.2	-4.3	-1.9	8.3
FIN	67	60	-1.2	-1.4	-0.9	-0.1	-0.5	0.9	1.6
AUT	77	40	-0.5	0.4	0.4	0.3	1.3	2.5	-3.9
EA	91	42	0.6	2.9	-3.8	-0.6	0.1	1.2	0.0

Note: The adjustment of current account is computed as the change in the current account between 2015 and 2035.
Source: iAGS model

As a conclusion:

- **Market discipline and Monetray union are not stable**
  - Free circulation of savings; no exchange rate risk; bank union lead to market discipline a the first euro (instead of marginal market discipline)
  - Long term fiscal discipline should replace market discipline
  - Resolution of public debt is necessary but should be reserved to extraordinary situations
- **Mixing fiscal consolidation and demand management is possible**
  - Juncker plan 1.0 is not going to do it ; Do you believe in 2.0 ?
  - We need much more than a marginal cut in risk free rate
- **in iAGS 2015 we proposed**
  - A carbon price shock, boosting investment and depreciating (brown) capital
  - With low rates, financing is not an issue, with political credibility, uncertainty is not an issue
  - The problem is loosers (brown capital owner, locked in households)
  - Compensation of the former coul dbe financed trough public debt
  - Public debt is not the problem (debt is low, rates are low, climate change is coming, no debt on a +4°C planet is not a gift to future generations), the problem is fiscal discipline and fiscal trust
  - Fiscal discipline reciprocal trust (enforced by something ?) is necessary to backload or to invest, ther is no other option. Helicopter money is unjustified and looks appealing just because public debt is a tabou.