VIII. Public debt in times of Corona
The COVID pandemic: “A crisis like no other” (Gita Gopinath, IMF Chief Economist)

GDP growth (percent change from year ago)

Source: OECD Economic Outlook
Macroeconomic stabilization with very high deficits

Fiscal balances (percent of GDP)

Source: OECD Economic Outlook

Source: IMF Fiscal Monitor, April 2021
US versus euro area: fiscal policy with stronger impulses and more stable US GDP growth

GDP growth rates
- United States
- Euro area

Structural fiscal balance
- United States
- Euro area

Source: IMF, World Economic Outlook
The medium-term output loss GDP in 2022 compared to forecast in 2019

2021-forecast for GDP in 2022 compared with 2019 forecast

Source: OECD Economic Outlook
Debt levels have increased considerably Maastricht reference value out of reach for most countries

Source: IMF, World Economic Outlook
Central banks have purchased large amounts of assets and become key holders of government bonds

Central bank asset purchases since end-2019 (percent of GDP)

- General government bonds
- Private assets

Central bank holdings of government securities (in percent of total tradable government securities)

Source: OECD, Economic Outlook
The ECB has changed its approach
The (…) responsibility of the government (…) is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce. If total spending is allowed to go above this there will be inflation, and if it is allowed to go below this there will be unemployment.

(…)

any excess over money revenues, if it cannot be met out of money hoards must be met by printing new money.


Kenneth Rogoff: ”Modern Monetary Nonsense”

Larry Summers: “A recipe for disaster”

Paul Krugman: “There's much that's true, and there's much that's new, but what's true isn't new and what's new isn't true.”

Abba P. Lerner (1943):
Key insights from Modern Monetary Theory

- Large countries that are indebted in their own currency have **no financing restrictions**. They can always finance themselves directly or indirectly through the national central bank.

- The only **restriction is the availability of goods**, which must be taken into account if inflation is to be avoided.

- In the Corona crisis, public debt is only filling the holes in private balance sheets. Serious **deflation** is thus **avoided**.

- The problem for EMU memberstates, above all **Italy** is that it is not indebted in its own currency and cannot finance itself through its own central bank.
“But is the Fed really financing the budget deficit?”

“Not really. At a fundamental level, households are financing the deficit: the funds being borrowed by the government are coming out of the huge savings undertaken by families saving much of their income in an environment where much of their usual consumption hasn’t felt safe.

However, household financing of the deficit isn’t direct. Instead, it has taken the form of a sort of financial daisy chain. Families are stashing their savings in banks. Banks, in turn, have been accumulating reserves — that is, lending to the Fed, which these days pays interest on bank reserves. And the Fed has been buying government bonds.”

Source: https://www.nytimes.com/2021/05/21/opinion/money-federal-reserve-deficit.html
The mechanics of the monetary model

- **Banks purchase bonds from Treasury**
  - Treasury FED deposits increase
  - Banks' FED reserves decline
- **Treasury makes payments to private households (enabling saving).**
  - Household bank deposits increase
  - Treasury FED deposits decline
  - Banks' FED reserves increase
- **FED purchases bonds from banks**
  - Banks' FED reserves increase
- **In sum:** Household saving is the result of central bank financed government spending
MMT: The dose makes the poison

US: Disposable income
(Q1/2021: 21 % higher than Q1/2019)

- Transfers minus taxes and contributions to social security
- Other incomes (Capital incomes)
- Compensation of employees

Monetary growth
M3 (Euro area)  M2 (United States)

Source: FRED St. Louis
US inflation has picked up, but inflation expectations have remained stable

**Consumer price inflation**
- Euro area
- United States

**US inflation expectations**
- 5-year, 5 year Forward Inflation Expectation
- 10-year breakeven inflation rate

Source: FRED St. Louis
Fiscal policy after the pandemic
Revenues and expenditures shall *in principle be balanced* without revenue from credits.

In cases of natural catastrophes or *unusual emergency situations* beyond governmental control and substantially harmful to the state's financial capacity, *these credit limits may be exceeded* (...).

*Repayment* of the credits borrowed under the sixth sentence must be *accomplished within an appropriate period of time.*
The German experience after the Financial Crisis growing out of debt

Source: IMF, World Economic Outlook
Amortisation requires permanent budget surpluses of the Federal Government

- Repayment of COVID debt from 2020: one twentieth as of 2023
- Repayment of COVID debt from 2021/22: one seventeenth from 2026
  → Repayment of 2 billion euros from 2023, of 20.5 billion euros from 2026
  → Debt ratio of around 40% in 2042
Stability and growth pact will suffocate growth in the euro area

Six pack enacted in 2011:

“Member States with government debt ratios in excess of 60% of GDP should reduce this ratio in line with a numerical benchmark, which implies a decline of the amount by which their debt exceeds the threshold at a rate in the order of 1/20th per year over three years.”

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt ratio (2021)</th>
<th>Primary balance (2014-2019)</th>
<th>Y-i = +0.5</th>
<th>y-i= -0.5</th>
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The dangerous policy implications of flawed textbooks

Best of Mankiw No. 7: „Government budget deficits reduce the economy’s growth rate.“

Mankiw: “When the government reduces national saving by running a budget deficit, the interest rises, and investment falls.”

Implicit assumption: No public investment

Mankiw: “Higher investment means more rapid economic growth.”

Alternative view: If the government finances additional public investment by running a budget deficit, the interest rate rises and investment increases.
With the Stability and Growth Pact, the euro area risks falling behind China and the United States.
What about the risk of higher long-term interest rates?

Bank of Japan:

- The guideline for market operations specifies a short-term policy interest rate and a target level of a long-term interest rate.
- E.g., decision from 19 May 2021:
  - The **short-term policy interest rate**: The Bank will apply a negative interest rate of **minus 0.1 percent** to the Policy-Rate Balances in current accounts held by financial institutions at the Bank.
  - The **long-term interest rate**: The Bank will purchase a necessary amount of JGBs without setting an upper limit so that 10-year JGB yields will remain at **around zero percent**.
Summary

- Monetary and fiscal policy responded quickly and in a strong dose to the COVID pandemic
- This effectively halted the slump in the global economy
- This policy approach largely coincides with the concept of Modern Monetary Policy
- The major fiscal challenge are high fiscal debt levels in the post-crisis phase
- By imposing strict fiscal rules, Germany and the euro area run the risk of limiting their ability to successfully transform their economies.
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