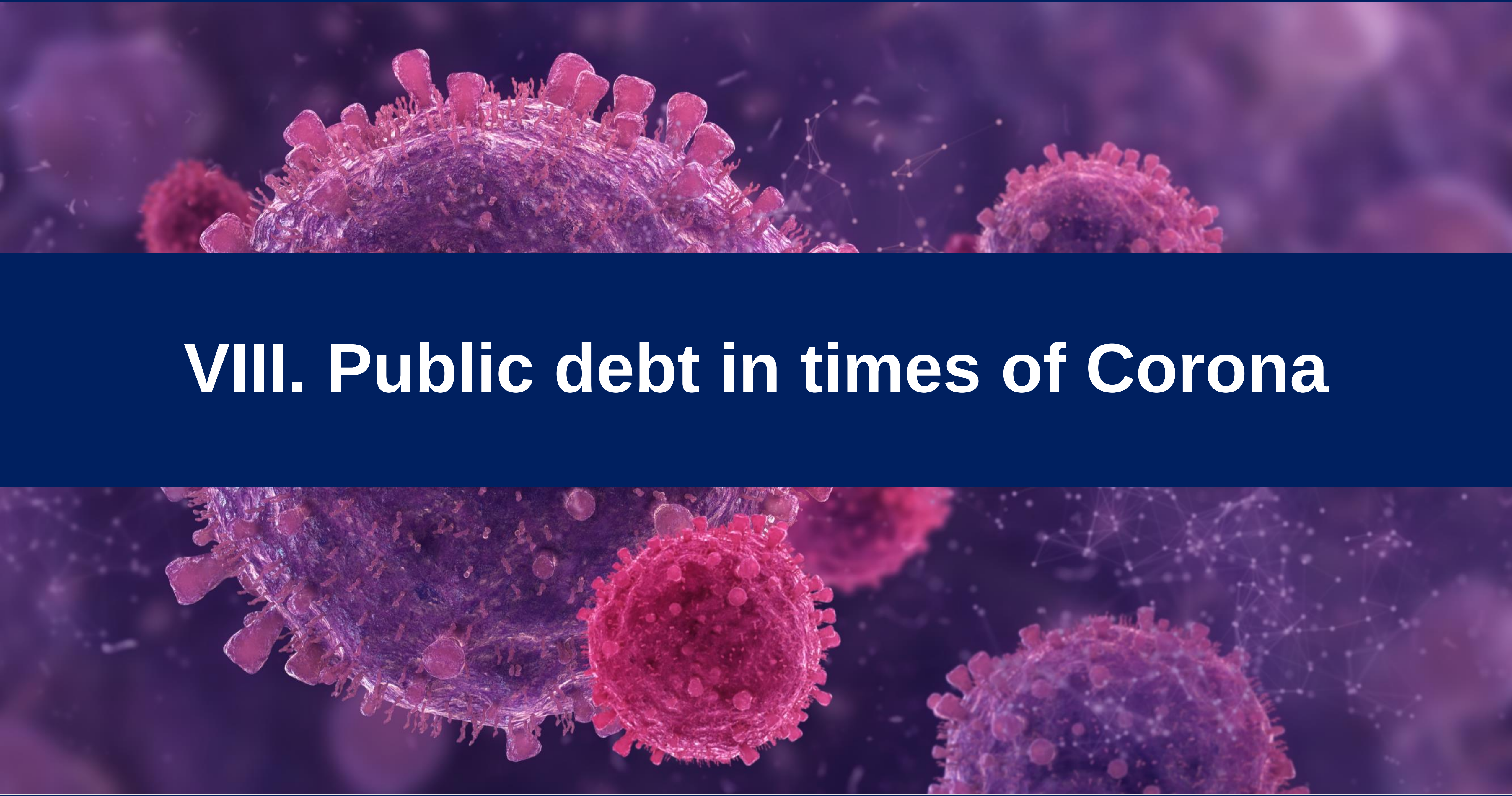
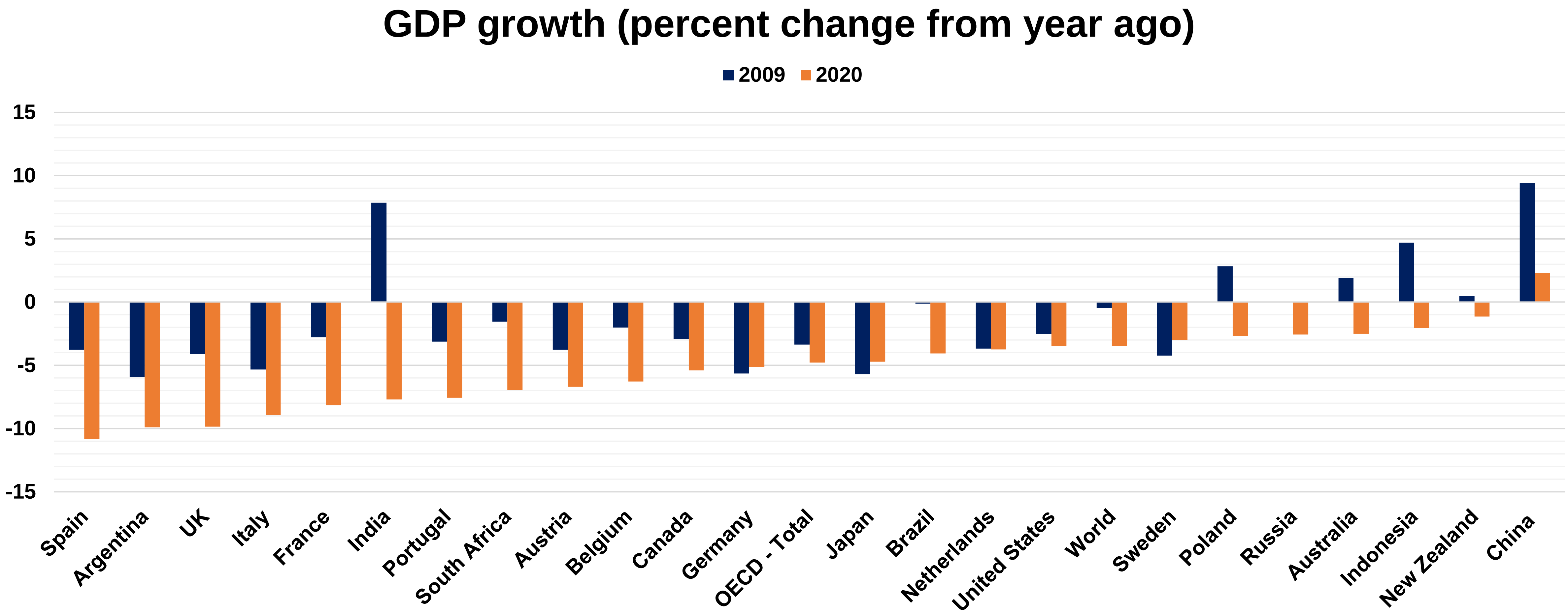
# European Macroeconomics

# VIII. Public debt in times of Corona

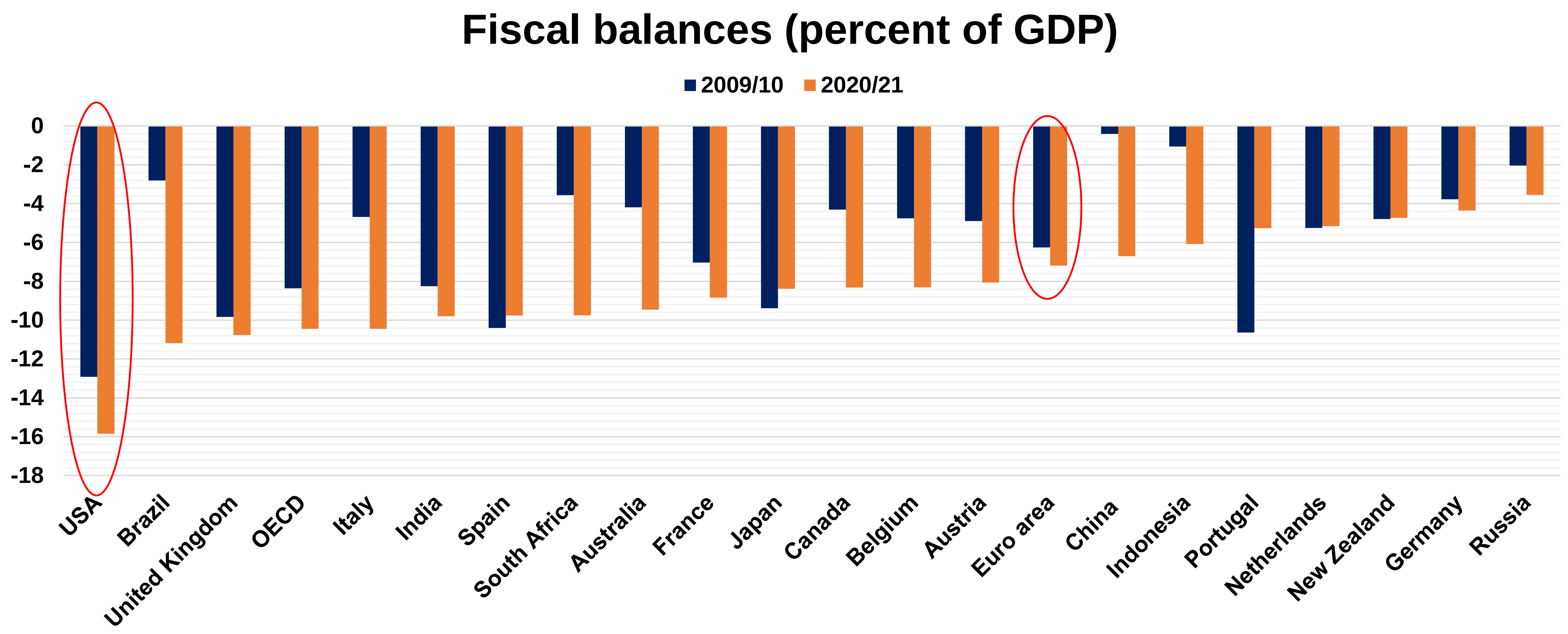


# The COVID pandemic: “A crisis like no other” (Gita Gopinath, IMF Chief Economist)



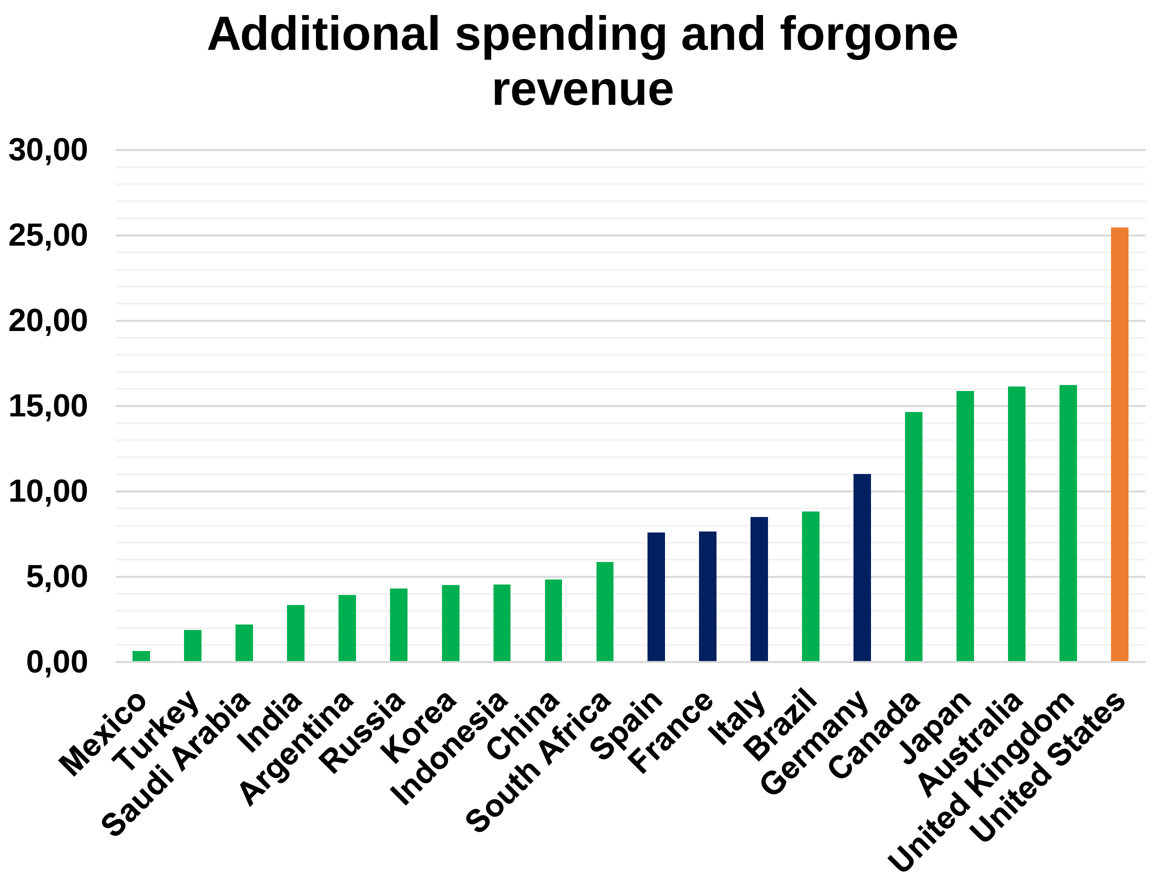

Source: OECD Economic Outlook

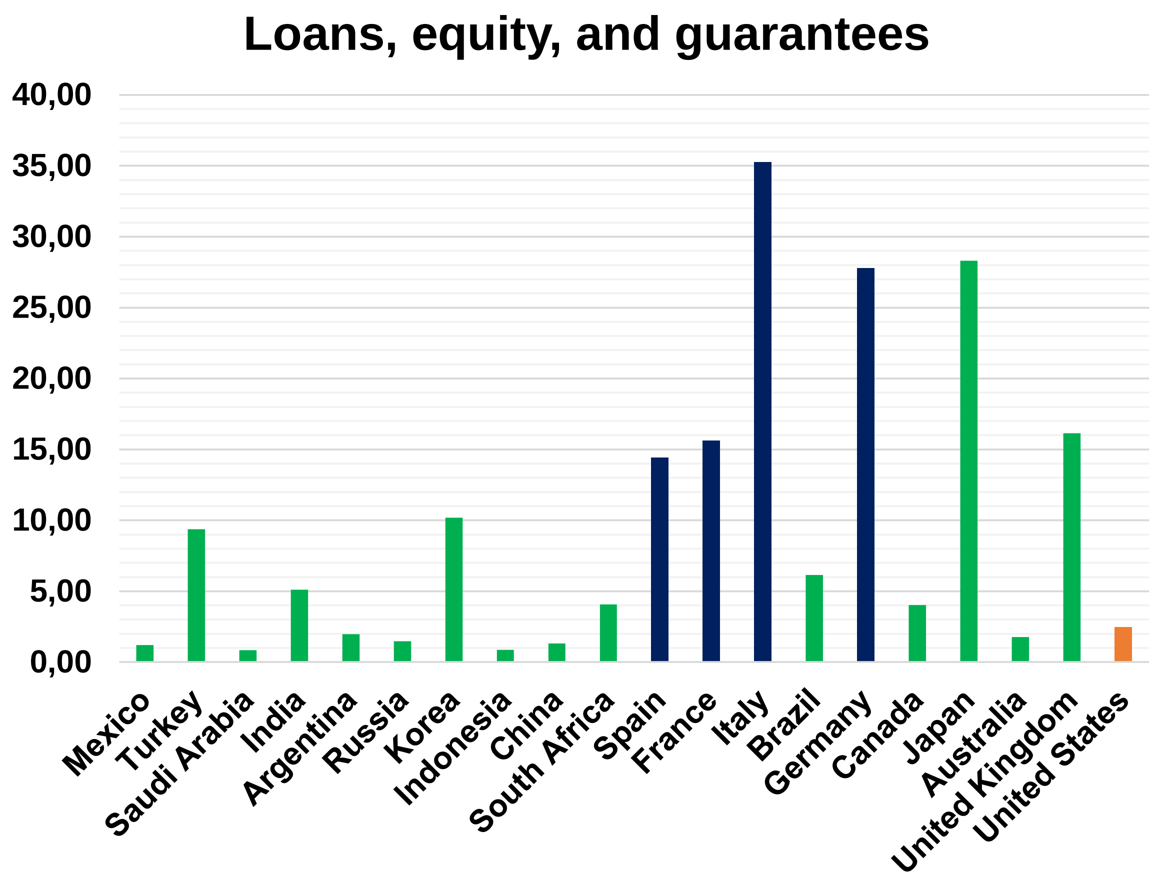
# Macroeconomic stabilization with very high deficits




Source: OECD Economic Outlook

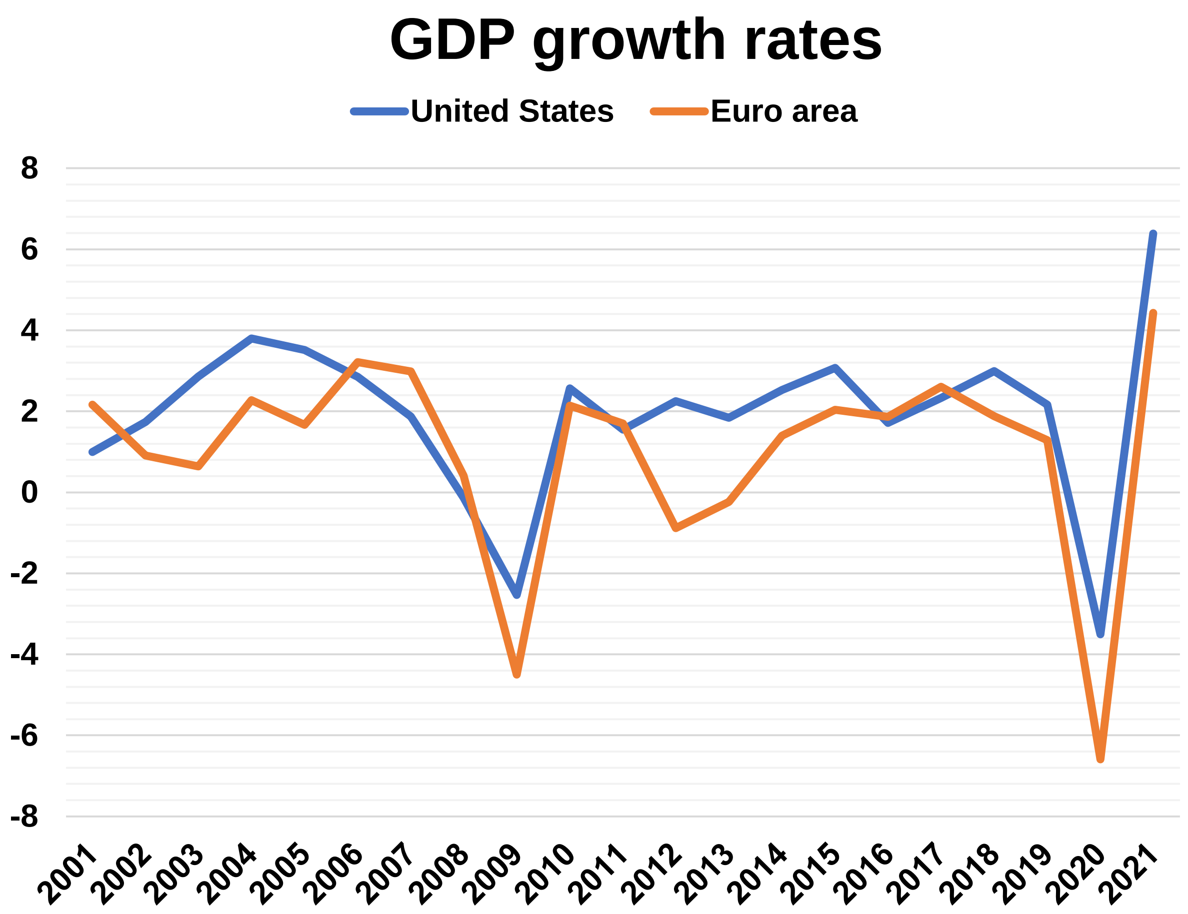
# Government Fiscal Support in Response to COVID-19 (2020-21 in Percent of 2020 GDP)

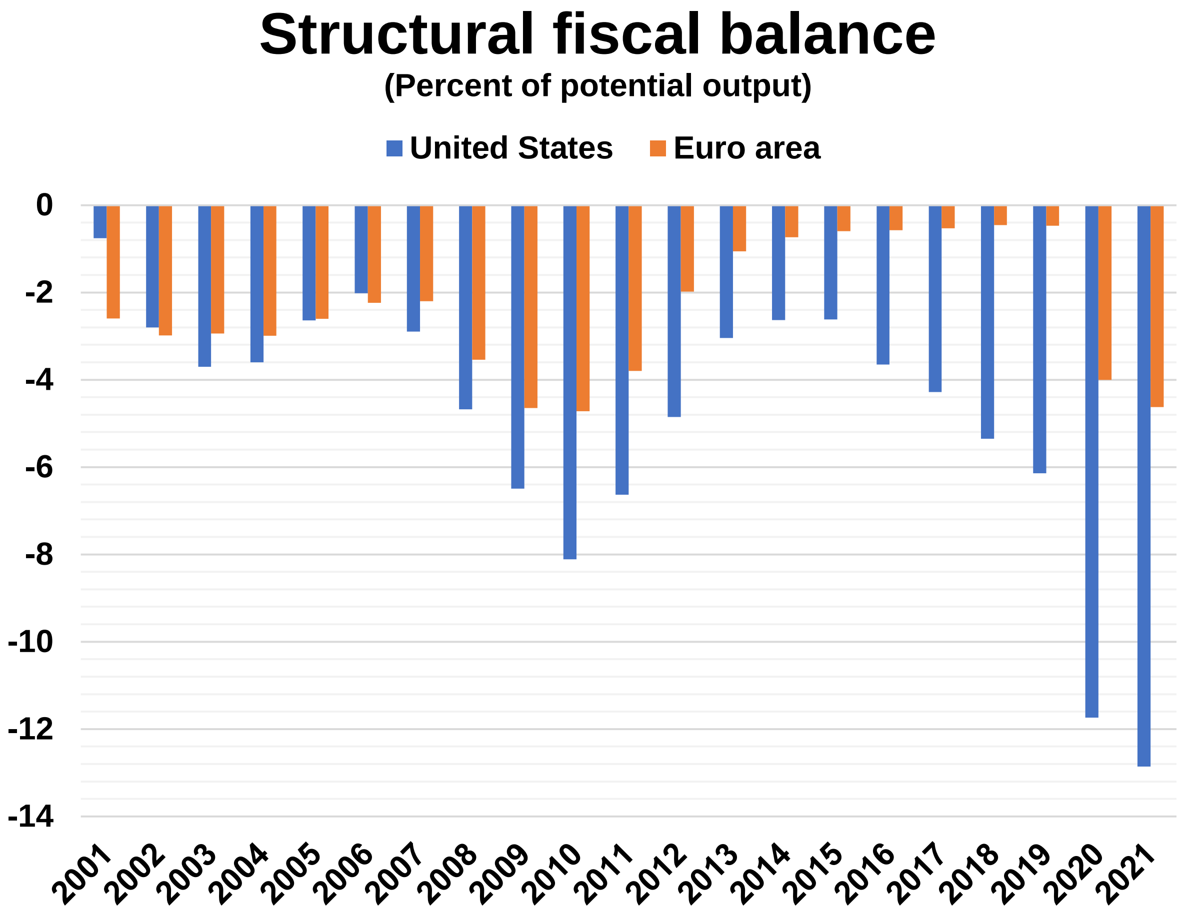



Source: IMF Fiscal Monitor, April 2021

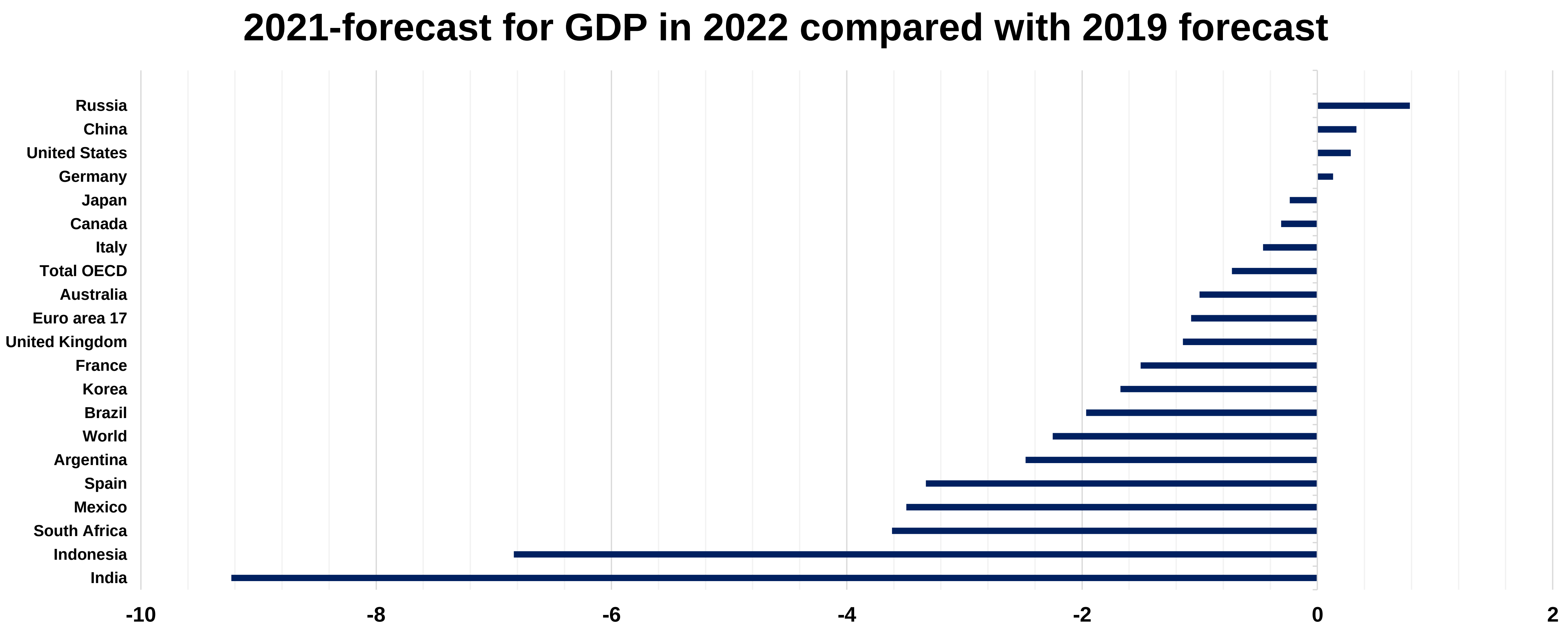
# US versus euro area: fiscal policy with stronger impulses and more stable US GDP growth



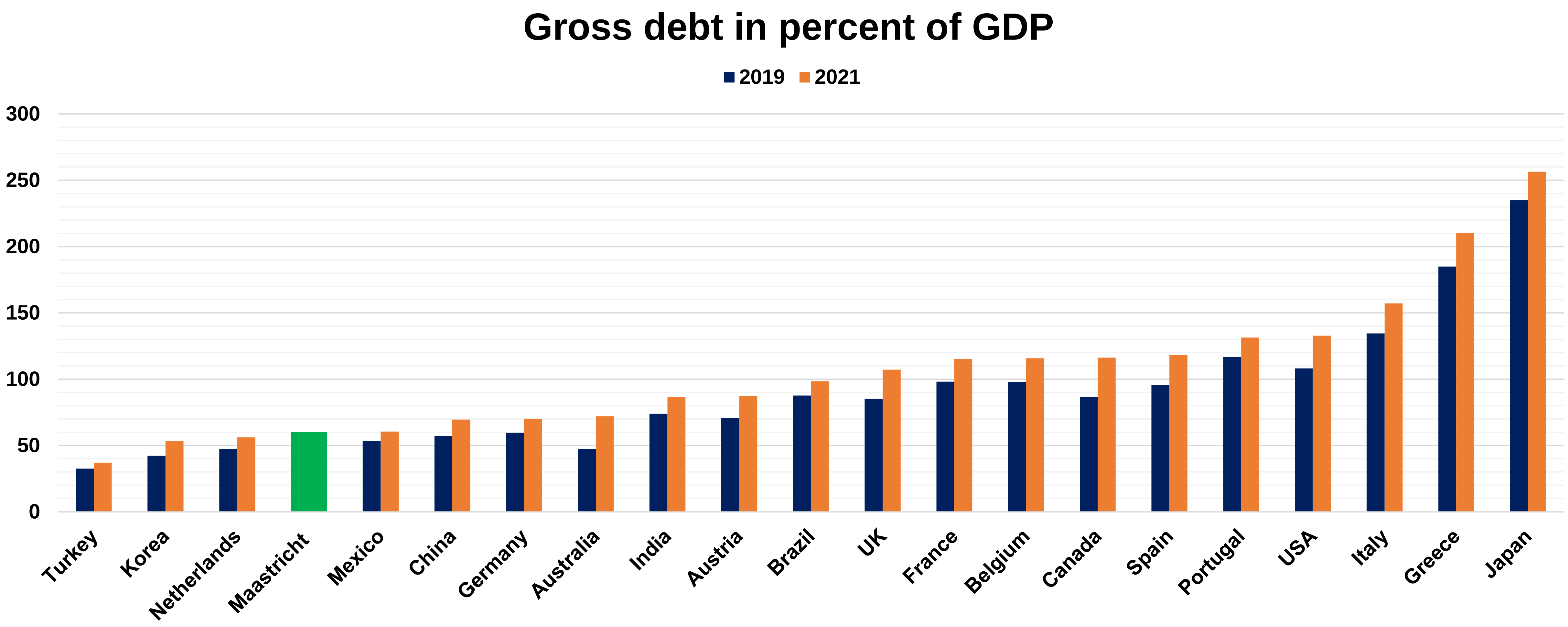

Source: IMF, World Economic Outlook

# The medium-term output loss GDP in 2022 compared to forecast in 2019



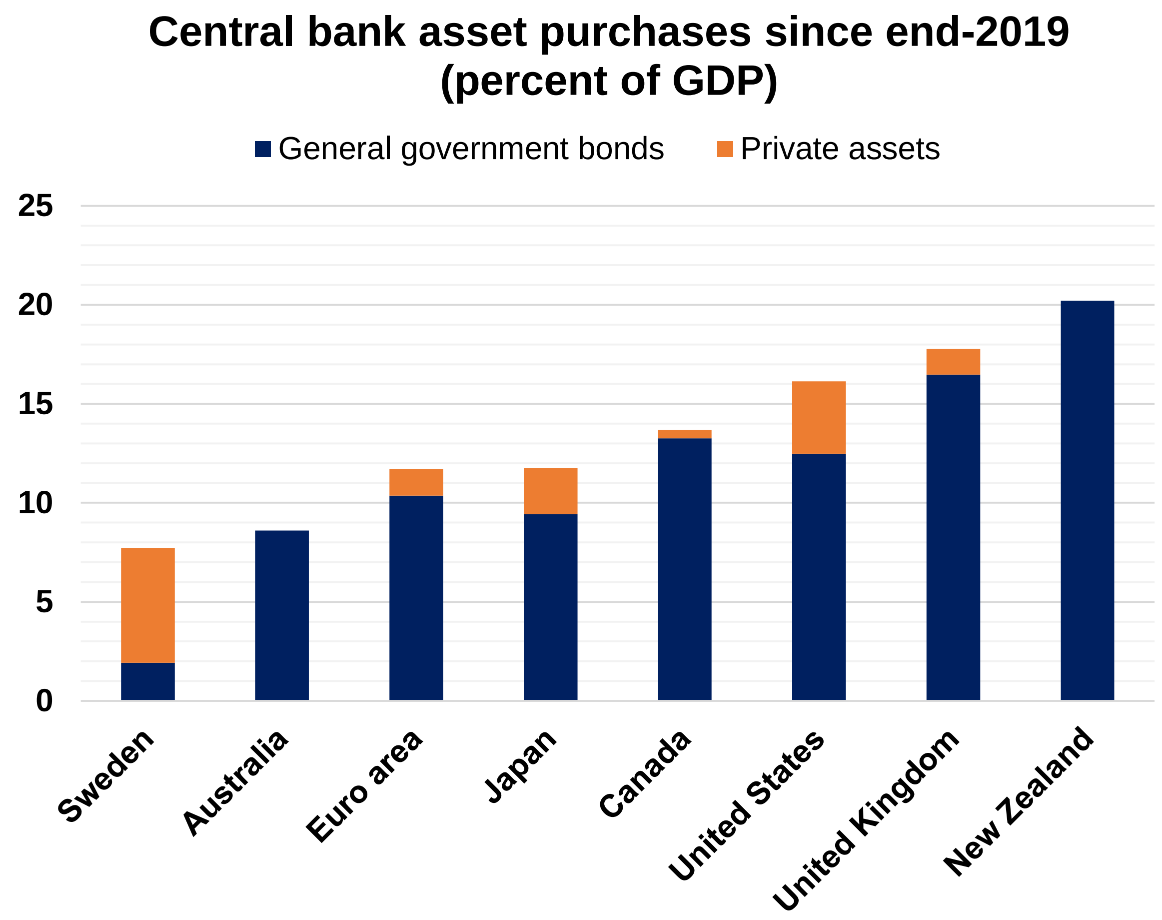

Source: OECD Economic Outlook

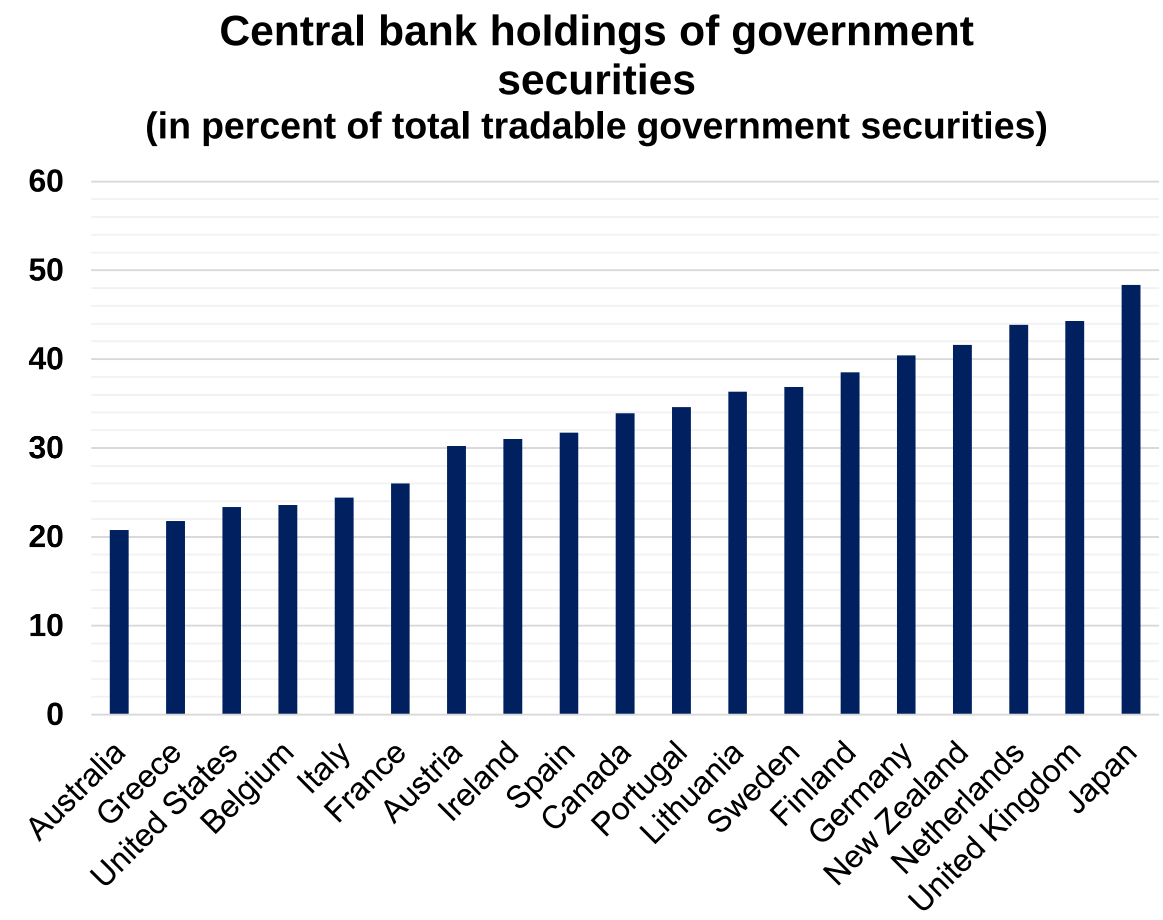
# Debt levels have increased considerably Maastricht reference value out of reach for most countries




Source: IMF, World Economic Outlook

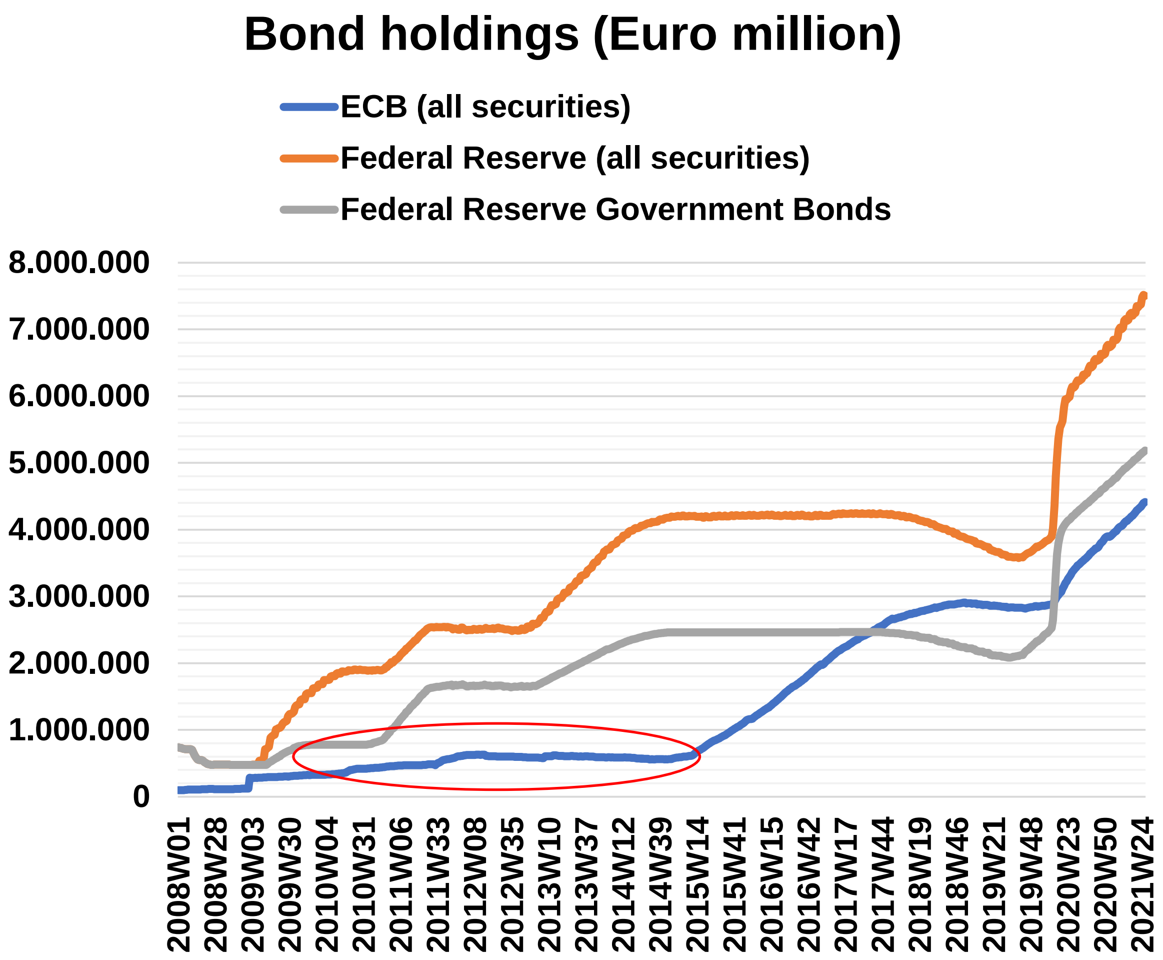
# Central banks have purchased large amounts of assets and become key holders of government bonds

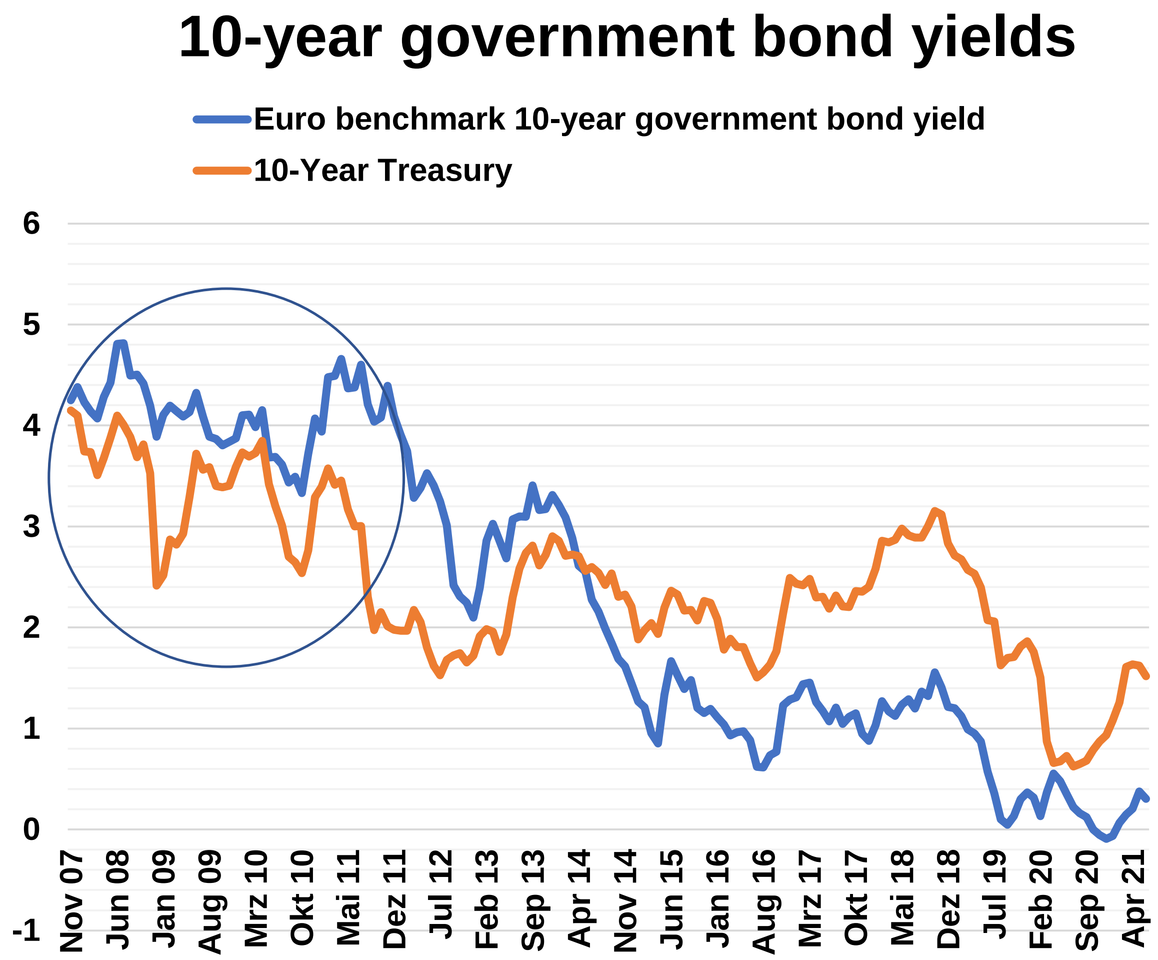



Source: OECD, Economic Outlook

# The ECB has changed ist approach




Source: ECB SDW

# What is Modern Monetary Theory

**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):

“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”

(Abba P Lerner, Functional Finance and the Federal Debt, Social Research, Vol. 10, No. 1, pp. 38-51)

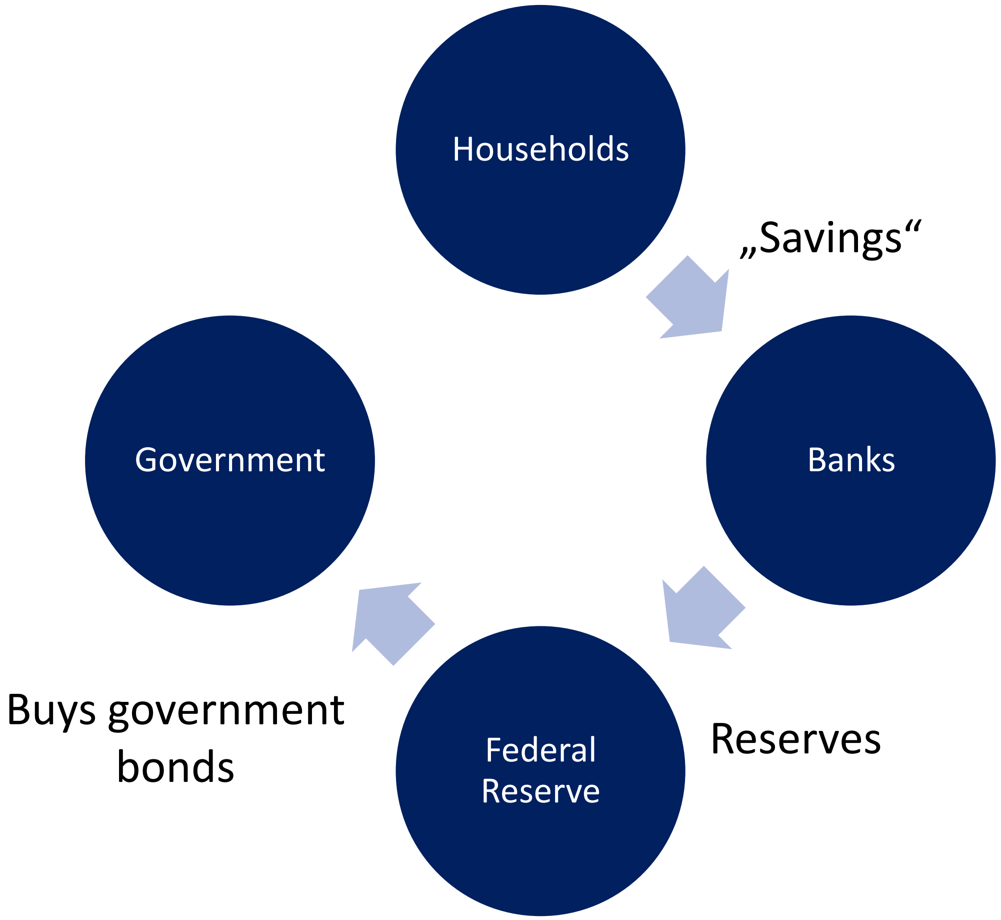
# Key insights from Modern Monetary Theory

- 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.

# How a Keynesian falls into the trap of the classics

## Paul Krugman (NYT, 21 May 2021)

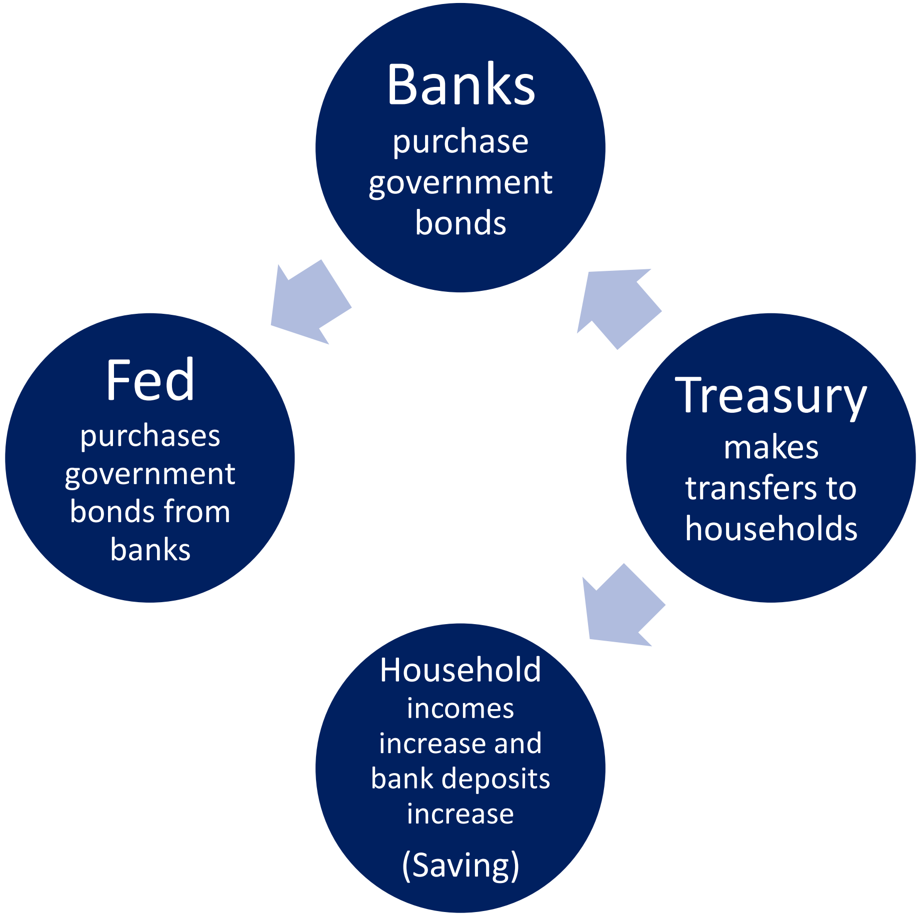
- “But is the Fed really financing the budget deficit?”
- “Not really. At a fundamental level, households are financing the deficit: the funds being borrowed by the government are coming out of the huge savings undertaken by families saving much of their income in an environment where much of their usual 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

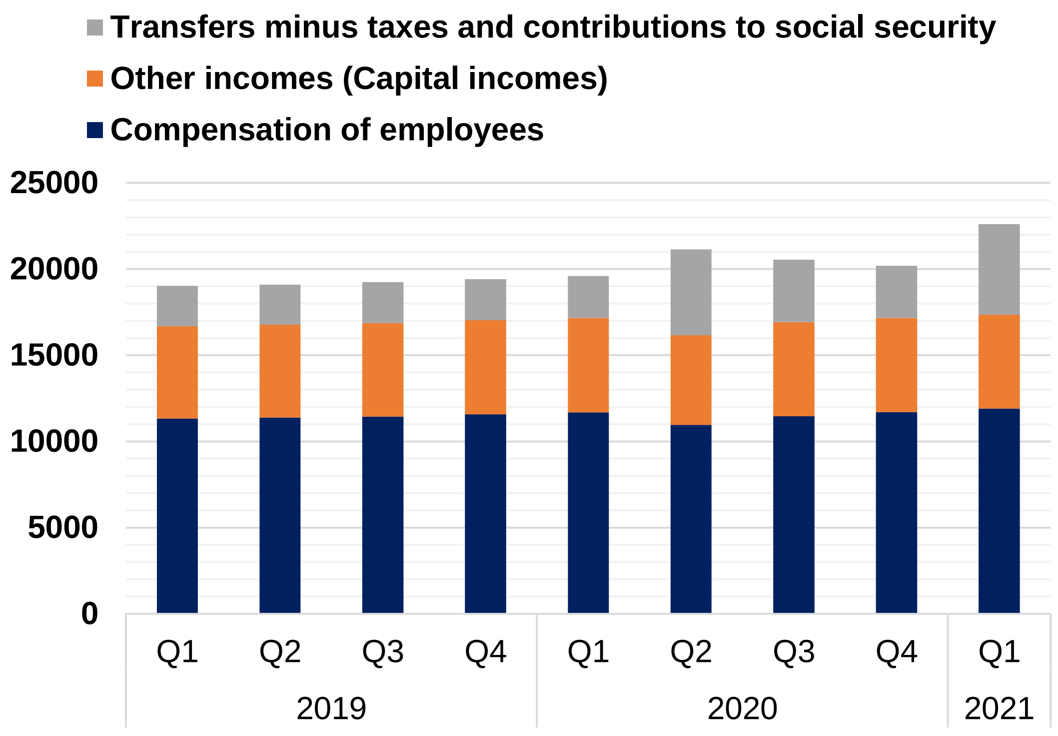
- Banks purchase bonds from Treasury
  - Treasury FED deposits increase
  - Banks‘ FED reserves decline
- Treasury makes payments to private households (enabling saving).
  - Household bank deposits increase
  - Treasury FED deposits decline
  - Banks‘ FED reserves increase
- FED purchases bonds from banks
  - Banks‘ FED reserves increase
- In sum: Household saving is the result of central bank financed government spendig



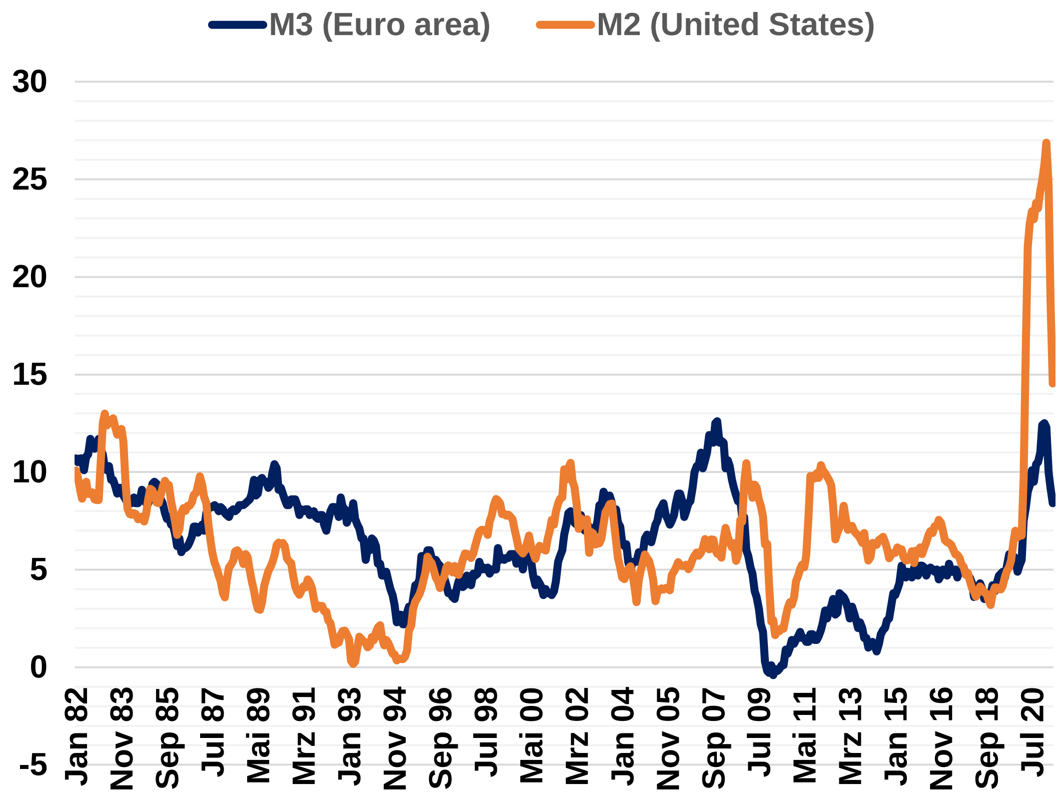
# MMT: The dose makes the poison

## US: Disposable income

**(Q1/2021: 21 % higher than Q1/2019)**

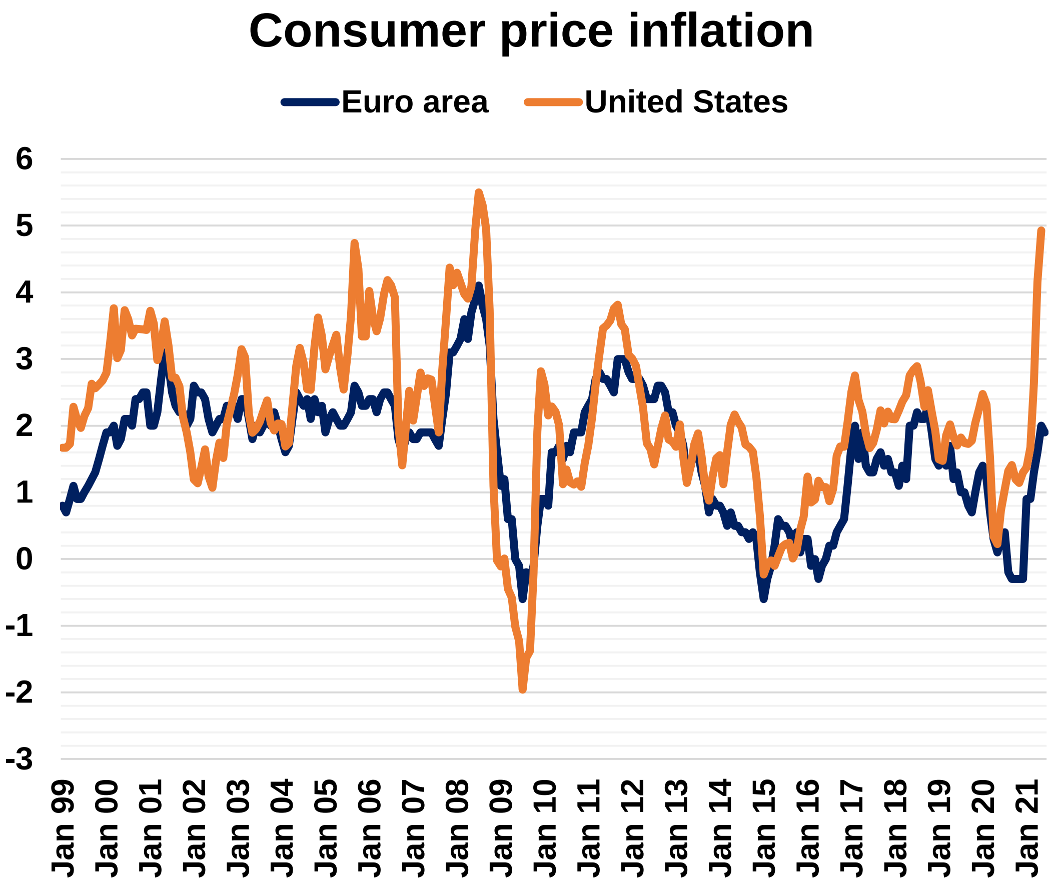


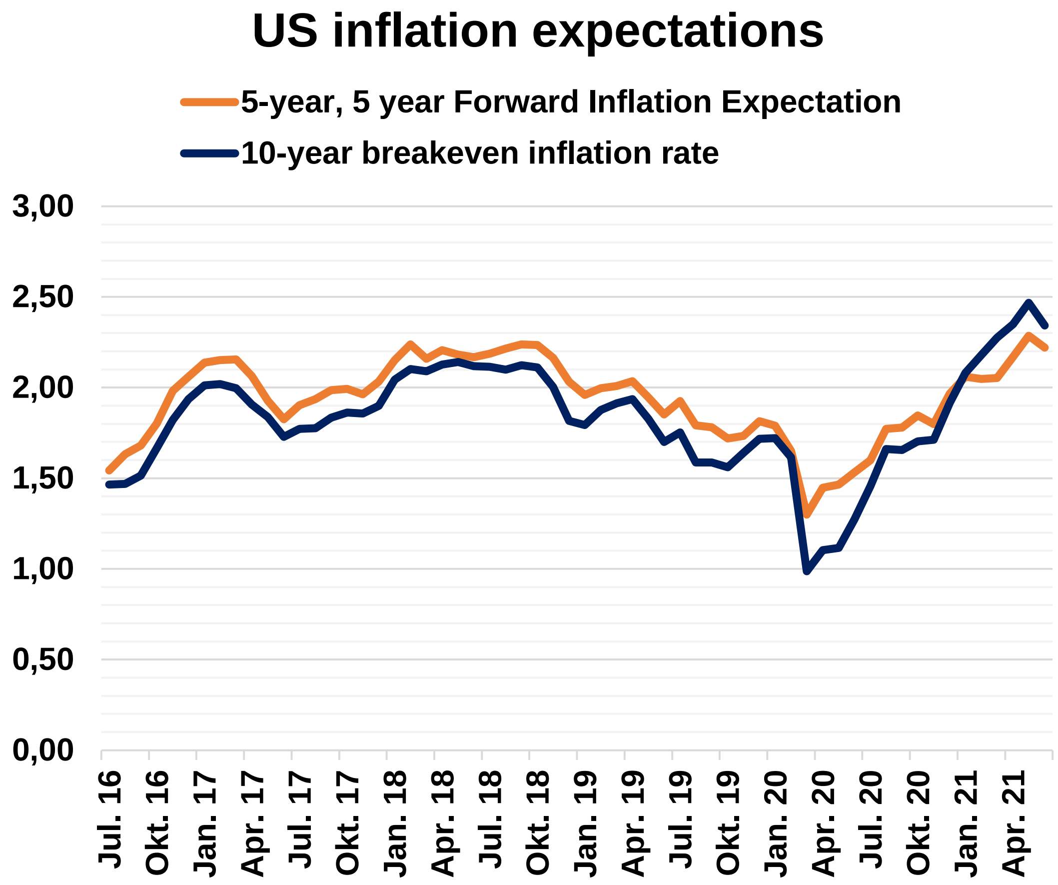

## Monetary growth




Source: FRED St. Louis

# US inflation has picked up, but inflation expectations have remained stable




Source: FRED St. Louis

# Fiscal policy after the pandemic

# The German debt brake

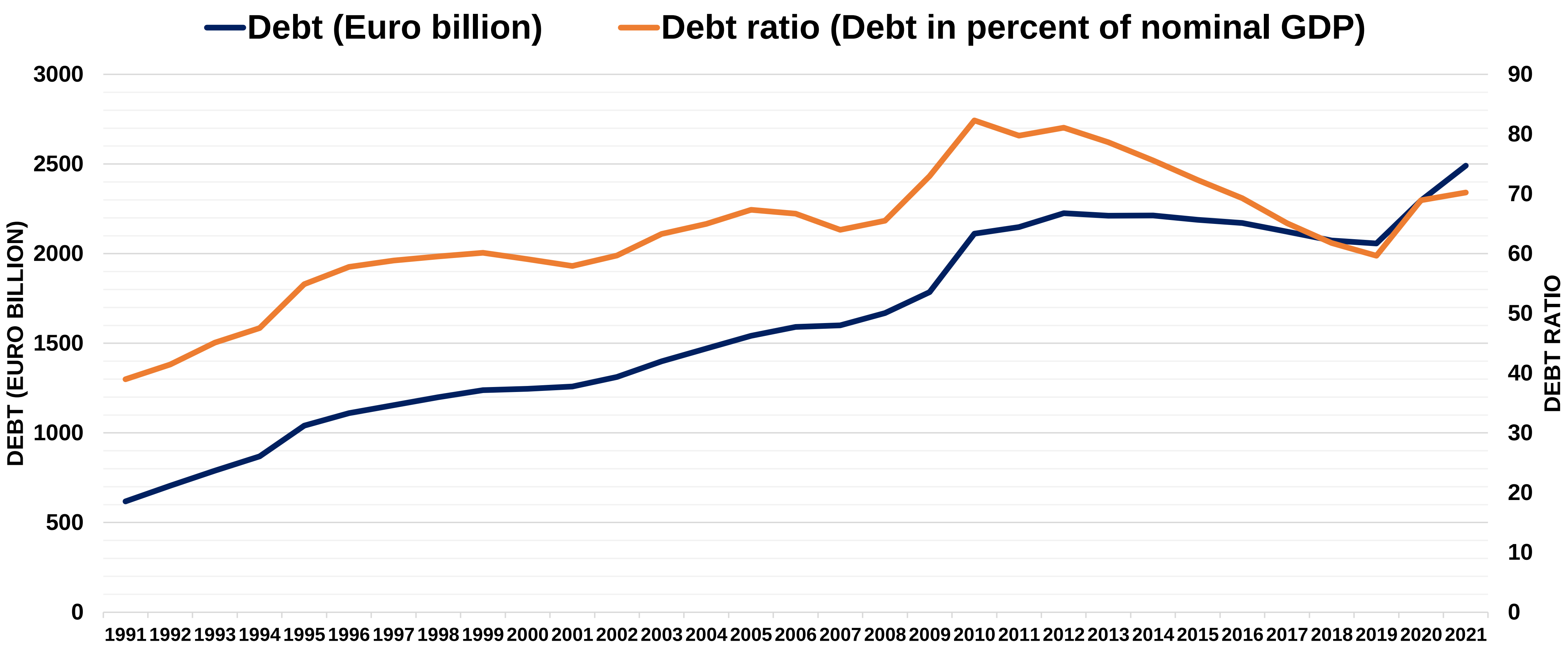
## Article 115 Basic Law

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



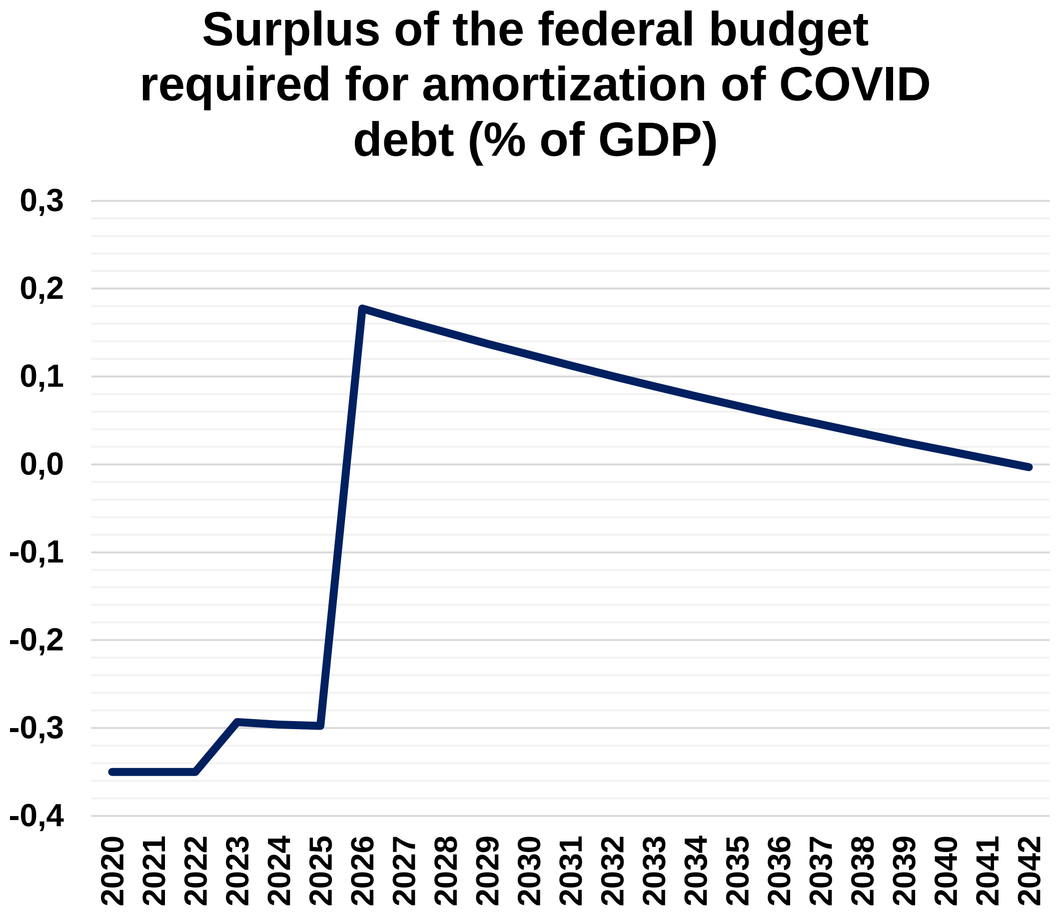

Source: IMF, World Economic Outlook

# 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

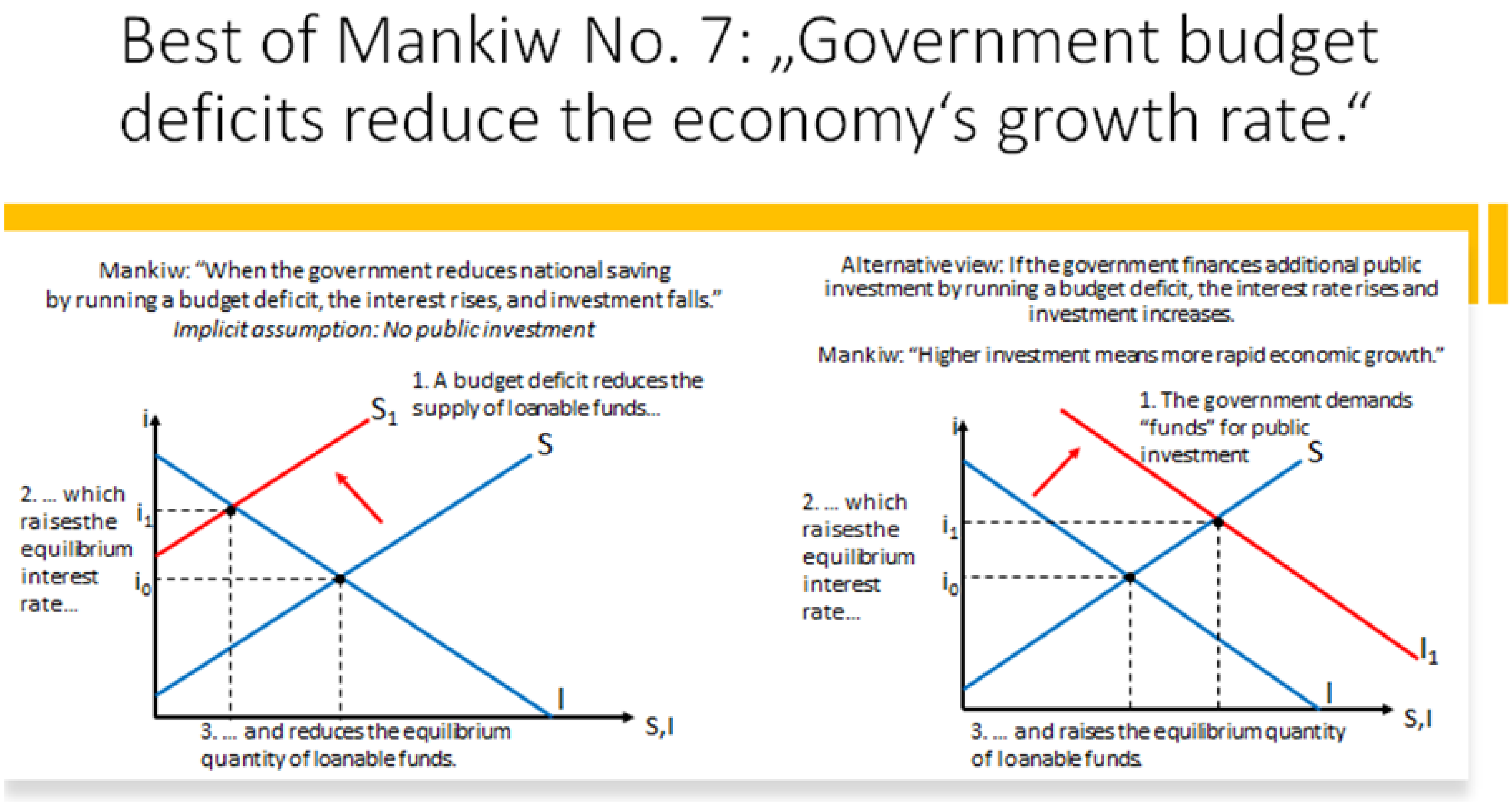
## Six pack enacted in 2011:

"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."

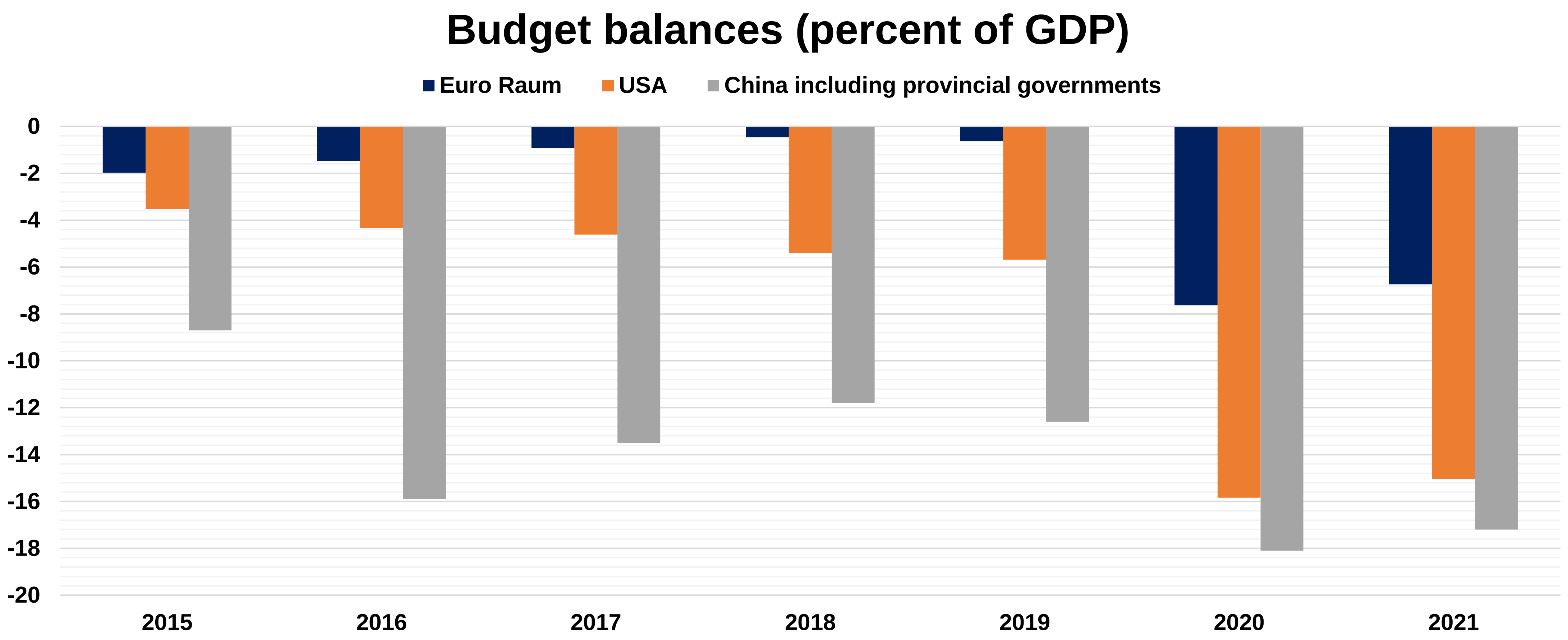
**Required primary balances to achieve the debt target**

| Country | Debt ratio (2021) | Primary balance (2014-2019) | Y-i = +0.5 | y-i= -0,5 |
|---|---|---|---|---|
| Belgium | 117,1 | 0,3 | 1,9 | 2,9 |
| France | 118,6 | -1,5 | 1,9 | 2,9 |
| Portugal | 130,0 | 0,9 | 1,9 | 2,9 |
| Spain | 121,3 | -1,5 | 1,9 | 2,9 |
| Italy | 158,3 | 1,4 | 2,9 | 4,2 |

# The dangerous policy implications of flawed textbooks



# With the Stability and Growth Pact, the euro area risks falling behind China and the United States

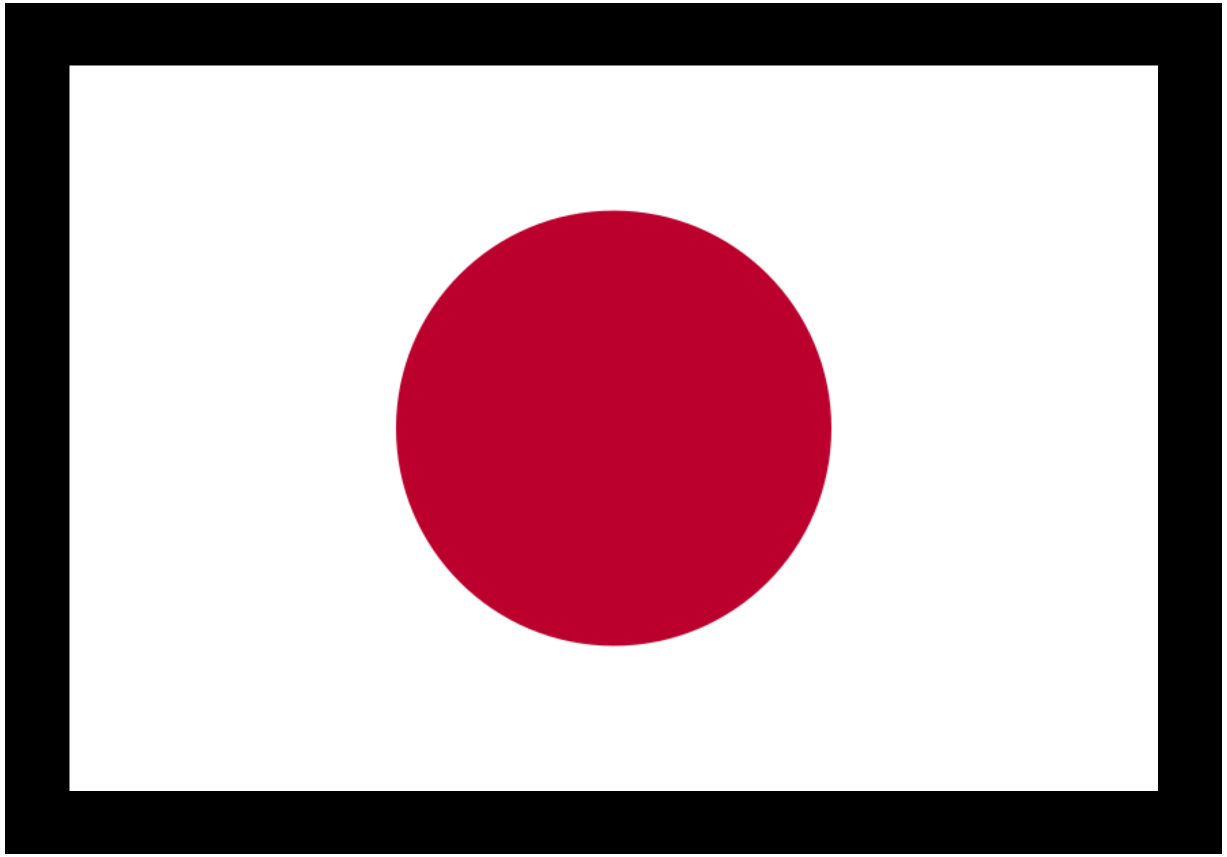



Source: IMF, World Economic Outlook

# 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.