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We will need to think outside of the box

Governments realize that debts are not harmless. They will be stuck between contradictory necessities: spend more without raising revenues and keep public debts in check. A column by Charles Wyplosz.

CHARLES WYPLOSZ

«My list of potential instruments could include debt restructuring, financial repression, temporary increase in taxation of windfall capital gains and of upper middle incomes and above, in-depth cuts in some public spending programs.»



Barely three years ago, we were looking forward to forgetting about the global financial crisis legacy. Soon, the whole world would resume a new Great Moderation. What a difference these three years have made! We had the

unwelcome visits of the Coronavirus and of Putin's warmongering, obviously impossible to foresee. Now, even if these nightmares dissipate, there are many challenging developments that can be foreseen and should be taken care of. It will not be easy.

After the massive increases in public debts of the last decade, it would seem natural to expect determined efforts to bring them down. This is not going to happen. The demands for public

spending have increased dramatically. Decades of negligence or denial imply that limiting climate change has finally become a matter of urgency, a pretty costly one. The political landscape seems to limit the scope for a regularly rising carbon tax, the efficient and budget-neutral tool. Instead, governments are starting to download large-scale programs, which are as costly as they are likely to be inefficient. Next, the Covid-19 pandemic has revealed that, even in countries where they are adequate in normal times, the health systems cannot face rare disasters.

The pandemic has also shed light on some limits of globalization. Low-tech masks are produced miles away where labor is cheap, as is economically rational. The same applies to medicines and vaccines. Then, distribution lines break down when these products, and many others, become urgently needed. Governments will want to repatriate some of these production facilities and keep them available, even when they are not needed. The need to build excess capacity extends to hospitals, hospital doctors and nurses. More generally, the current bottlenecks in global supply chains of intermediate products are likely to encourage more local production. Then, on top of the rise of China's military might, the Russian invasion of Ukraine will be followed by larger military budgets, and the search for strategic independence in several goods, ranging from energy to hardware and to food. Finally, the demographic transition will add to the needs for public goods while revenues decline.

Moving away from globalization comes at a cost

Inasmuch as globalization is the outcome of efficient exploitation of comparative advantage, moving away will not be cheap. It requires government interventions in the form of subsidies and tariffs or other protectionist measures. It will cut growth. It will result in income redistribution, which may elicit other government interventions. How will we pay for all that? Taxes are in

About the author

Charles Wyplosz is Professor for International Economics at the Graduate Institute in Geneva.

the toolkit, but they are politically difficult to implement, especially in times of rising populism. From Biden to Macron and other well-intended political leaders, we have seen how even timid tax reforms can get bogged down. The unavoidable conclusion is that budget deficits are not about to be rolled down.

The currently prevailing view is that it is not a problem. The neutral real interest rate is believed to be very low, possibly even negative, and to stay that way for decades to come. In this world, public debts more than pay for themselves. Could that be wishful thinking? A decade of QEs has indeed led to very low interest rates. Somewhat miraculously, during that period, inflation has remained low, usually below the policy targets. It is fair to assert that we do not fully understand why. Are Phillips curves really flat, pegged to highly stable inflation expectations? Have workers been cowed by the competitive pressure of globalization? Is it a lasting consequence of the global financial crisis and ensuing regulation? Already, this view has taken a hit. During much of 2021, the central banks have declared the inflation surge as temporary. Most have now recognized that they were deeply mistaken, under the influence of their models that do not resemble the world, by far. These models do not just ignore pandemics and lockdowns, they also include rock-bottom neutral interest rates. Which flaws matter?

Central banks under pressure

As central banks now embark on interest rate increases and QT, governments will discover that debts are not a harmless convenience. They will be stuck between two contradictory necessities: spend more without raising matching their revenues and keep public debts in check. Sustained solid growth might resolve the contradiction but I will hold my breath on it. There will be talks about how inflation helps in such a situation, but we know that the gain comes before the pain. Central banks will have to resist pressure coming from governments and financial markets. They may well ignore the governments since they are (reasonably) independent, but what about the financial markets? The last time when they intended to ignore the markets' pleas, in 2008, they finally gave in and protected the markets from further turmoil.

The situation in the emerging market and developing countries is a further source of concern. Many of them have also increased their public debts before and during the pandemic. Their precise indebtedness is not always well-known because they have received substantial loans from China, apparently under the condition that the relevant information be kept confidential. Like in the

developed countries, borrowing has been painless due to low interest rates, but the situation is bound to deteriorate when these rates increase. A wave of debt crises is a distinct possibility.

This is a long list of threats. It is disquieting to realize that the proper response to each of them is difficult to work out. Compulsory additional spending requires additional tax revenues. The overall tax burden is already heavy in some countries (the average is 46% of GDP in the euro area, 48% in Germany and 52% in France), which limits the desirability and acceptability of increases that might need to reach a few percentage points of GDP. Most central banks will not allow inflation to settle at rates much above 2%. As they engage in QT, they will drain the abundant market liquidity that made deficit financing easy in recent years.

Even more crises may erupt

The picture can be made darker too. We just lived through four crises, the global financial crisis, the euro area debt crisis, the pandemic and now the Russian invasion of Ukraine. Each of them has left a heavy legacy, including large private debts. More crises may erupt, as unforeseeable as the previous ones and, anyway, we already face climate change. We will need to think outside of the box.

My list of potential instruments could include debt restructuring, financial repression, temporary increase in taxation of windfall capital gains and of upper middle incomes and above, in-depth cuts in some public spending programs, privatization of some public services, higher retirement age. None is politically appealing, and some are economically painful.