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Debt sustainability in times of large uncertainties

We should stop relying on optimistic scenarios and accept that budget deficits will have to be eliminated. Not now, but once inflation has been tamed. A column by Charles Wyplosz.

CHARLES WYPLOSZ

«Future fiscal policies should not be driven by dogmas but by careful assessments of current and future conditions.»

For a while now, the prevailing way of thinking about public indebtedness has been Debt Sustainability Analysis (DSA). International institutions, national governments, private financial firms all use this instrument, which forecasts the evolution over coming years of the debt as a fraction of GDP. It looks like a simple accounting exercise to pass judgment on debt sustainability.

It is everything but that. The reason is that tracking the future debt ratio requires making forecasts on the evolution, year after year, of the interest rate, the GDP growth rate and the primary budget balance. And we need to look far into the future, a decade or possibly more, because a few years of large deficits –

as most countries recently underwent – do not mean that the debt has become unsustainable. It all depends on what will happen to the budget, but also to the interest rate and the growth rate over a long time.

About the author

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

Sustainability is about the future, which why DSA is about forecasts. But economic forecasting can be very unreliable, especially when we look far into the future. In the good old time of the Great Moderation, the exercise was not seen as outlandish. Using past trends, possibly with the help of sophisticated models, seemed like a reasonable bet, even though forecasting budget outcomes set by governments yet to be elected always was either perfectly arbitrary or wishful thinking.

This period has left us with two fashionable doctrines. The first one is that the equilibrium interest rate, which is defined as the rate at which inflation remains stable ceteris paribus, is low, possibly even negative. The second one – known as r-g – is that GDP growth (g) will remain higher than the interest rate (r), if not indefinitely, at least for a very long time. When this is the case, the reassuring implication is that public debts more than pay for themselves. Under reasonable scenarios about the future primary budget deficits, most public debt ratios are deemed sustainable, at least in the developed economies. Large occasional deficits are not a problem provided that they will not last for too long.

A guess and a deep mystery

How robust are these doctrines in the new world of recurrent crises? Start with economic growth over, say, the next decade. A key driver of growth, demography, says it will decline. Another driver, investment in productive capacities, is anyone's guess.

The third driver, productivity, is a deep mystery. We constantly hear about the IT and robotic revolutions, but the impact on productivity has yet to be detected. The developed economies are overwhelmingly producing services, where technological gains have historically been slow. Some economists argue that the scope for fast-rising productivity is now considerable. Others are skeptical.

Globalization has contributed to productivity gains through specialization in industry and this could now affect services as well. Yet, growth has not picked up speed in the past and there is now talk of deglobalization.

Next comes the future of interest rates. As they tackle inflation, central banks are raising interest rates. By now, they have given up on their initial forecasts whereby the inflation surge would be temporary, but how persistent will it be? The current message from central banks is that a modest interest rate increase to, say, 3%, will quickly tame inflation.

Meanwhile, with inflation rates running at 5% or more, (nominal) GDP growth remains above the (nominal) interest rate, even if there is a modest recession. This optimistic scenario assumes that the equilibrium real interest rate is structurally very low, so that we will eventually go back to low interest rates and debt sustainability is not under threat.

Many unexpected shocks

But just imagine that inflation is persistent. In the pre-Great Moderation times, taming inflation required durably driving the interest rate well above the inflation rate, which often led to a slowdown, if not a recession. Under this pessimistic scenario, public debts increase fast and can become unstable unless the budgets are promptly brought to surpluses.

Unfortunately, we know surprisingly little about the equilibrium real interest rate. Its empirical estimation is subject to much imprecision and the justifications for ultra-low equilibrium interest rate have changed over time. It started with the saving glut hypothesis, the idea that world savings had risen while investment spending had declined.

True, China had become a big saver, but that was true a decade or so ago, not anymore. Then high savings were explained by population aging, a very fragile link which is subject to numerous debates. Then the story was about investment having become cheaper due to technological progress. In the end, the popularity of this view may rest on its ability to explain that inflation has been so stubbornly low since 2008 and until now because central banks simply could not lower their policy rates enough.

This is circumstantial evidence, at best. A fair conclusion is that the current and future levels of the equilibrium interest rate remain as mysterious as the likely evolution of economic growth.

Under these conditions, any policy that relies on DSA is not just fragile, it stands to be misleading. This would not be new, however. Since 2008, growth rates have generally exceeded interest rates, so that debt ratios should have declined. In many countries, they did not, simply because the budget deficits were kept too large.

One reason is that governments had to deal with many unexpected shocks. Sure, but this is precisely why DSAs cannot be trusted. Another reason could be that, presented with optimistic scenarios, governments concluded that they could keep runing budget deficits without being bothered by debt sustainability considerations.

Rising deficits

Once inflation is brought back under control, debt sustainability is bound to emerge as the next major policy concern. Starting already with historically large public debts, we face an unusual combination of economic challenges that all call for larger budget deficits. The pandemic and the invasion of Ukraine stand to justify more public spending on health and defense. Inequality has risen to prominence and is likely to be dealt with through more transfers and, perhaps lower taxes.

And then climate change is raising the challenge to a new level. Climate policies, both mitigation and adaptation, involve substantial new spending, including transfers to less well-off at home and the poorer countries that pollute little but face dire consequences that they are not able to cope with. To make matter worse, these policies all stand to dent growth, which will take us further away from the reassuring situation where it exceeds the interest rate.

DSA forecasts are hopeless, but the DSA logic is undeniable. We should stop relying on optimistic scenarios and accept that budget deficits will have to be eliminated. Not now, but once inflation has been tamed. Not brutally, but gradually and persistently, barring another shock. Like monetary policies in their glorious years, future fiscal policies should not be driven by dogmas but by careful assessments of current and future conditions.