Dealing with debt in an era of low growth

Lunchtalk, 26 March 2013

At this event, IMF officials presented a paper providing theoretical and empirical evidence of successful consolidation efforts and their driving effects.

Helge Berger

- Automatic stabilizers and expansionary fiscal policy increased debt levels now reaching historic heights which are now aggravated by missing growth.
- **Empirical evidence for advanced economies looking at the main reasons for successful consolidation defined as reduction of debt-to-GDP ratio of at least 5% with an initial level above 50%:** 1. Growth; 2. Fiscal consolidation; 3. Export growth can be supportive; 4. Monetary policy can be supportive.
- The analysis showed that inflation and interest rates had rather limited effects on debt reduction. Nonetheless, the evidence shows that low interest rates and high growth provide the friendliest environment for successful debt reduction.
- Private indebtedness was not an explicit part of the analysis. Nonetheless, private deleveraging reducing demand and investment can aggravate the situation
- High debt countries had a potentially larger consolidation. However, probability of success was higher in less heavily indebted countries
- Conclusion: as economic growth is expected to be low, fiscal consolidation has to play a major role in the future.
- **Theory of consolidation**
    - Fiscal consolidation: Trade-off between credibility gain and negative multiplier effect.
        - Credibility effect: Improvement of debt sustainability lowers risk premiums and improves investment climate.
        - Multiplier effect: Size of multiplier effect depends on growth rate, external demand and other factors. In the short run, multiplier effects normally outweigh credibility effects temporarily increasing debt levels.
        - Guntram Wolff suggested that in the euro area credibility effects overweigh multipliers for program countries as stopping consolidation would imply loosing financial support and threaten the exit of the respective country. This would certainly decrease investment climate.

    - Front loaded or gradual consolidation?
        - Very high indebted countries which are credit constrained have no choice but to consolidate immediately.
        - Only front loaded consolidation can instantly increase credibility (if fiscal rules committing to long term consolidation are not credible)
        - Front loaded fiscal consolidation is politically more feasible. On the other hand structural reforms might be impeded by limited political capital.
        - Decision could be based on time varying multiplier effects: If multipliers are lower in the future, consolidation should be postponed.
- **The case of the euro area**
    - Positive story: exports can support consolidation. Exports figures of some crisis countries substantially improved.
    - Negative story: growth was essential part of debt reduction. Large growth rates are not forecasted.

S. Ali Abbas

- External demand effects might be significant considering a situation of simultaneity of consolidation (spillover effects).
- However, during the EMU accession there was simultaneous debt reductions in several EU countries.

Guntram Wolff

- Role of primary deficit: Italy had high primary surpluses. However, if this is not enough to decrease debt levels their options are limited.

Event notes by Nikolas Schoell