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The Three Debts: A Look from the East

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Introduction

The pressures on fiscal consolidation have mounted dramatically in the wake of the Greek and then the 'contagion' crisis which followed it (across the so-called 'weakest links': Portugal, Spain, Italy, Ireland). It led to the setting-up of the 750 billion euro stabilisation package widely seen as a life-saving rescue operation of the euro-zone. In this commentary we want to examine whether the singular focus on fiscal adjustment which has now been given utmost urgency across the EU as a whole (i.e. not only the euro-zone) and also across Eastern European candidate countries and prospective candidate countries in the Western Balkans is justified.

In the following we shall first examine the development of the 'three debts' (public, private and foreign) and then address the problems of stability and growth in the euro area and in the transition economies, both those in the EU as well as those aspiring to membership.[1] We take a look at the emerging economies in the East (and South) of Europe, which were initially seen to have significant fiscal and public debt problems. We conclude that the key issue has been the development of private debt, both in the bubble period, and now after the bubble has burst, and thus the key policy remedy would have to be private debt consolidation especially when it goes together with high foreign debt. Public debt management and thus fiscal policy should be countercyclical in order to support private debt consolidation.

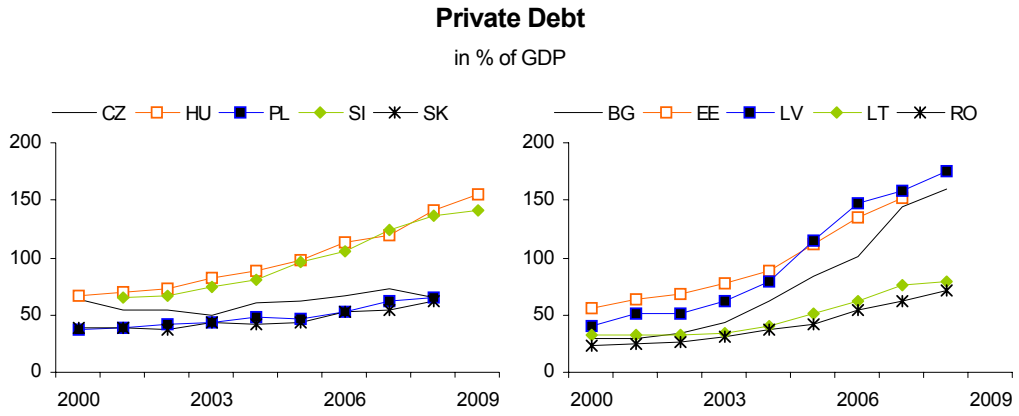
Private and other debts

It may be clarifying if the developments of debts in Emerging Europe, in the East and the South, are reviewed before discussing the developments in the euro member states because the debt dynamics, which is essentially the same, is perhaps easier to discern in the former countries. Figures 1-3 show the developments of external, private, and public debts for new member states (NMS) of the European Union (EU) and external and public debts for candidate countries (CMS) for membership in the EU in the Balkans. Invariably,

[1] Recent comments on some of the issues discussed here are to be found in de Grauwe (2010) on public and private debts, Cinzia and Gros (2010) on public and external debt sustainability, and Caballero (2010) on global private and public financing. See also wiiw and CEPS (2009).

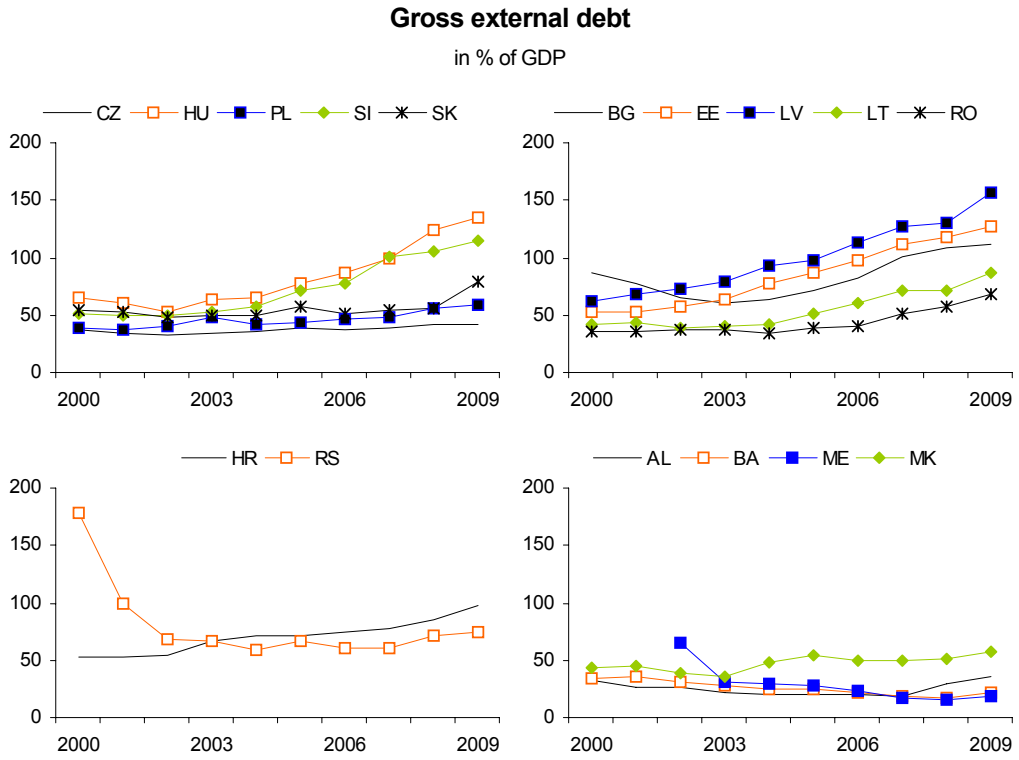
private debts grew faster than public debts and dragged along or were rather facilitated by foreign debts. Public debt is for the most part either stable or declining before the crisis (Hungary being the main exception).

Figure 1



Source: Eurostat and national statistics.

Figure 2

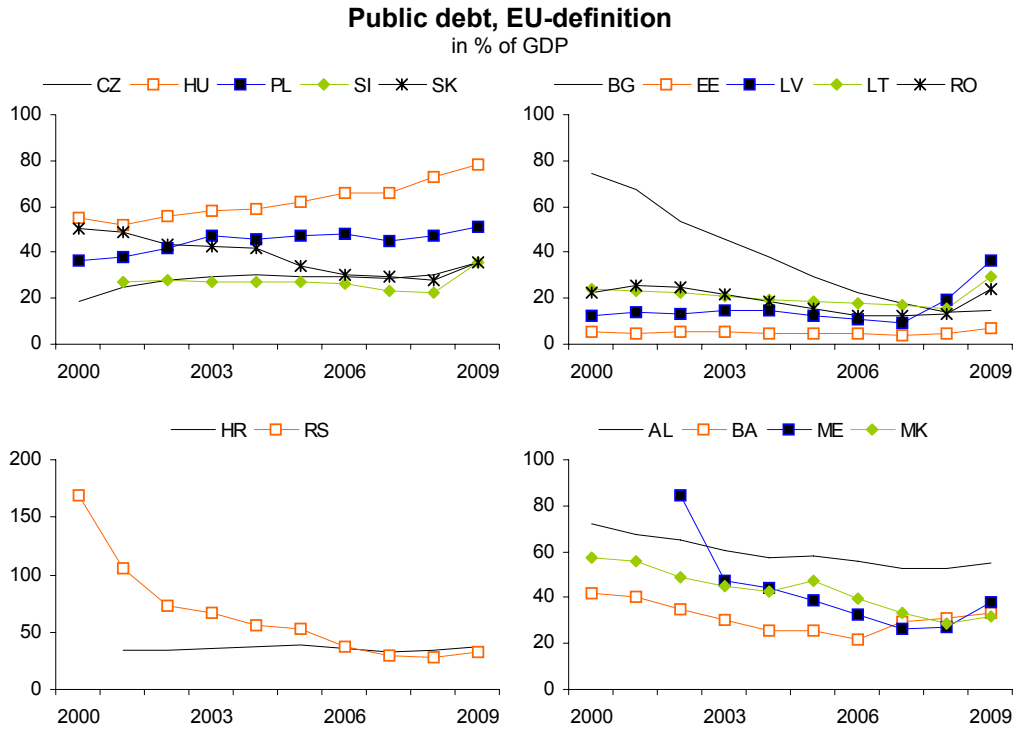


Source: Eurostat and national statistics.

Some of the Balkan countries, the CMS, have not had the time to experience strong increases in external debts due to slow growth of private debts and mostly falling public debt to GDP ratios. The main exceptions, however, are the two largest Balkan economies,

Serbia and Croatia. They exhibit the same tendency as the NMS, with the growth of foreign debt (precise data is not readily available, but development can be inferred) due mostly to increases in private debts. Public debts are also to a large extent financed by foreign creditors, but their contribution to the growth of foreign debts is not strong as the public debt to GDP ratio is either stagnant, in Croatia, or declining, in Serbia.

Figure 3



Note: BA; MK, ME, RS public debt acc. national definition.

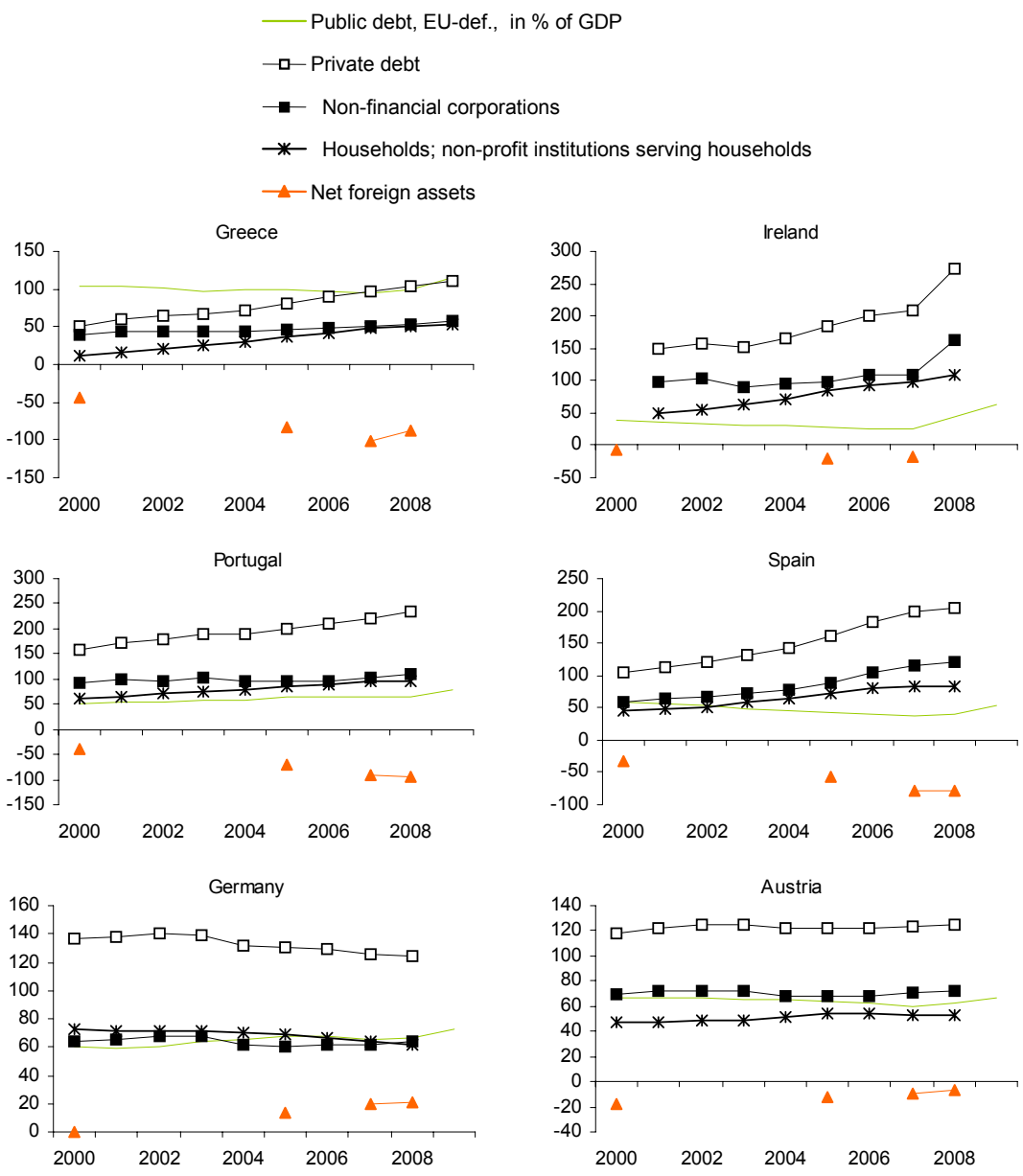
Source: Eurostat and national statistics.

Similar developments characterize the euro member states that are mostly in the news as fiscal delinquents, i.e. Greece, Spain, Portugal, and Ireland. In Figure 4 their public and private debts as well as net foreign assets are displayed. In addition, Austria and Germany are added for comparison.

Clearly, private debt growth has been the main driving force in the four countries since the introduction of the euro. In that, it is the household debt that is growing the fastest (in Spain corporate debt was also growing). By contrast, there were no significant changes in the various debt ratios in Austria and Germany throughout the period (in the latter there is a fall in private sector debt to GDP ratio). Their private and public debt developments are also quite similar to those in the Czech Republic, Poland, and Slovakia (check figures 1 and 2) though foreign debts in these three countries are significant and net foreign asset positions (not shown here) are strongly negative.

Figure 4

Public and private debt in % of GDP



Source: Eurostat, European Commission.

Much of the debts in Greece, Spain, and Portugal are foreign owned (see Cabral, 2010), and the growth of their external debts was mostly driven by private debt increases prior to the crisis, as was the case of NMS and CMS too. Figure 4 records net foreign asset developments: clearly, the levels in Greece, Spain and Portugal are quite high. Ireland is different with relatively low negative net foreign assets; in contrast Germany's net foreign asset position has become significantly positive. Overall then, it was the growth of private debts that had pushed the growth in external debts, though significant part of the public debt is also owned to foreign creditors.

Public debts developments, on the other hand, had – before the crisis – for the most part little to do with increased debt ratios in all these countries, except for Hungary and Greece. In the aftermath of the crisis, it is the private debt deleveraging that is putting pressure on fiscal balances. This conforms to the historical record of private and public debt dynamics as reported and analysed in Reinhart and Rogoff (2010).

Three problems

In a range of below average income economies in Europe there were apparently private and foreign debt bubbles before the crisis with possibly unsustainable public debt growth in some of these countries after the crisis. How was the development of these bubbles possible?

A bubble can develop if the growth rate in the value of the underlying asset or in the expected income stream is higher than the rate of return on the security drawn on that asset – i.e. the bubble thrives on the Ponzi game type of 'snowball effect', as it is called in public finance (higher growth rate of nominal GDP than the nominal interest rate on the public debt; for succinct discussion of bubbles see Brunnermeier, 2009). In the case of *public debt*, if the interest rate on the debt is below the growth rate of GDP, debt to GDP ratio will tend to decline from any level if primary fiscal deficit (in % of GDP) is brought down to below the difference between the interest rate on the public debt and the growth rate of GDP. In that case, any level of public debt to GDP ratio may look sustainable. Similarly, the *foreign debt* to GDP ratio will tend to decline from any level if the current account deficit (in % of GDP) is brought down to less than the difference between the higher growth rate of GDP and the lower interest rate on the foreign debt. Finally, *private debt* is sustainable as long as the interest rate is low enough to be more than covered by the growth rate of (expected) incomes or of the value of the underlying securities, which can justify explosive private debt increases which look sustainable.

When will these conditions for bubbles be satisfied? The example of the 'snowball effect' in the public finances of EU member states may make it easier to see the answer. Figures 4-6 show the growth of GDP and the interest rate on public debt, and the consequent development of public debt to GDP ratios, in the NMS, the three EU candidate countries, CMS, the three South European member states and Ireland, and in Austria and Germany (again for comparison).

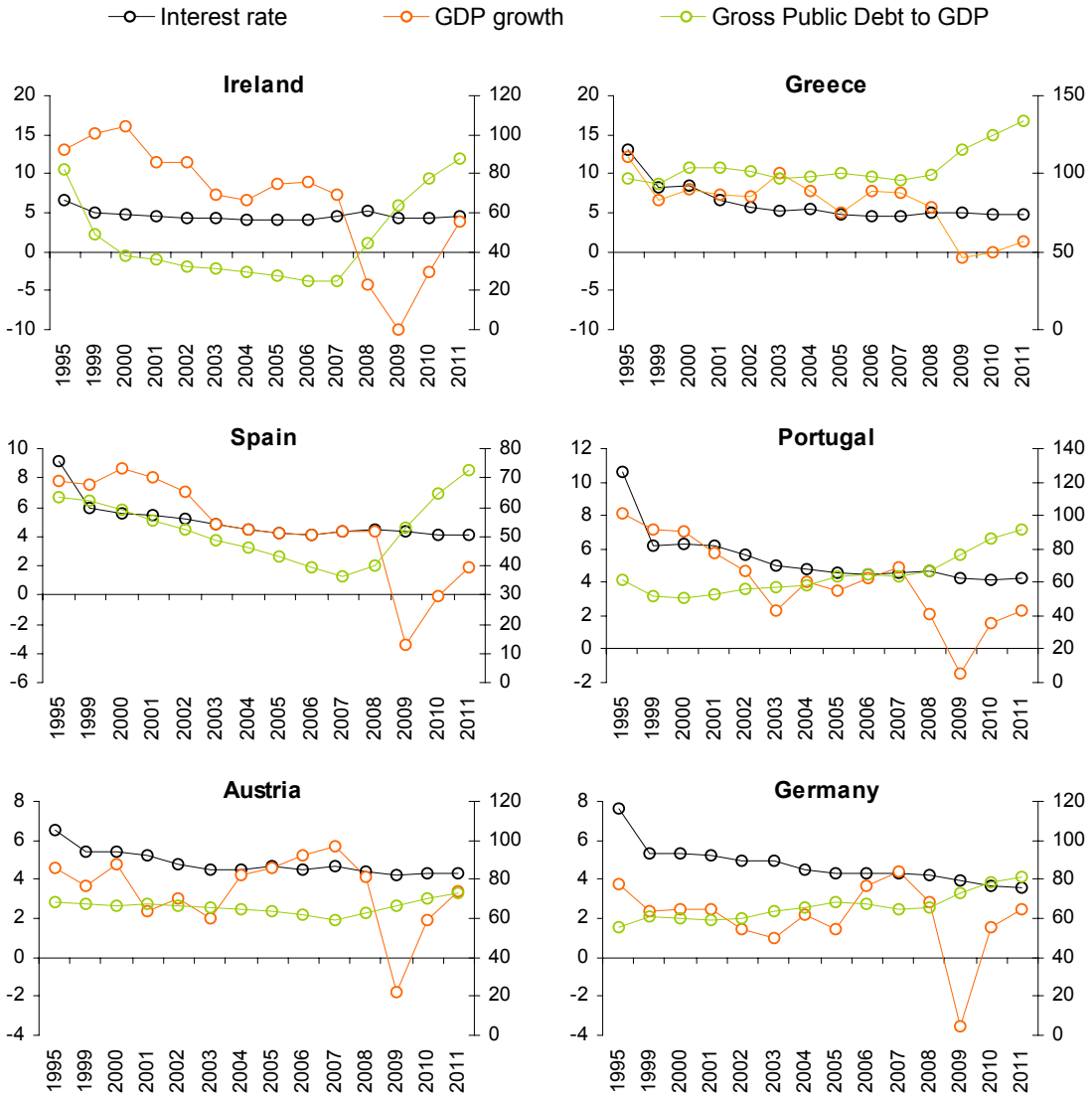
What can be seen from these graphs is that countries like Ireland, Greece, Spain and Portugal as well as the NMS and the CMS have as a rule had to pay an interest rate on their public debt that is below, and at times well below, the growth rates of their GDPs. Most of them ran fiscal deficits that kept the public debt to GDP ratio stable, while some

(e.g. Spain and Ireland) ran at times smaller deficits or even surpluses that led to declines in public debt to GDP ratios (especially dramatic in pre-crisis Ireland and Bulgaria).

Figure 4

Public debt, growth and interest rates (euro countries)

Implicit interest rate and nominal GDP growth rate (left scale); gross public debt/GDP (right scale)



Source: Eurostat, European Commission, DG: ECFIN, Spring 2010.

By comparison, Austrian interest rate on public debt was above the growth rate of its GDP, so primary surpluses were needed to keep the debt to GDP ratio stable. The same is true of Germany and most other more developed EU and euro member states (not shown here). The German case is especially important because it strongly influences the monetary policy of the European Central Bank (ECB). Indeed, 'the great moderation', i.e. the European level monetary policy which seems mostly based on the German growth and

inflation record, makes it possible for other, less-developed, EU member states, and even the CMS, to enjoy low interest rates and thus have ready access to financing for the three debts discussed here. Hence the relevance of the 'snowball effect' for below average income European economies is based on the fact that their expected GDP (and corporate and household income) growth rates are higher than in the more mature, higher income economies which, given their much higher weights in the EU economy as a whole, dominate ECB monetary policy and hence interest rates – in 'normal times' across the Eurozone, including of those countries which are tightly linked financially (and in monetary policy) to that zone.

Figure 5

Public debt, growth and interest rates (NMS)

Implicit interest rate and nominal GDP growth rate (left scale); gross public debt/GDP (right scale)

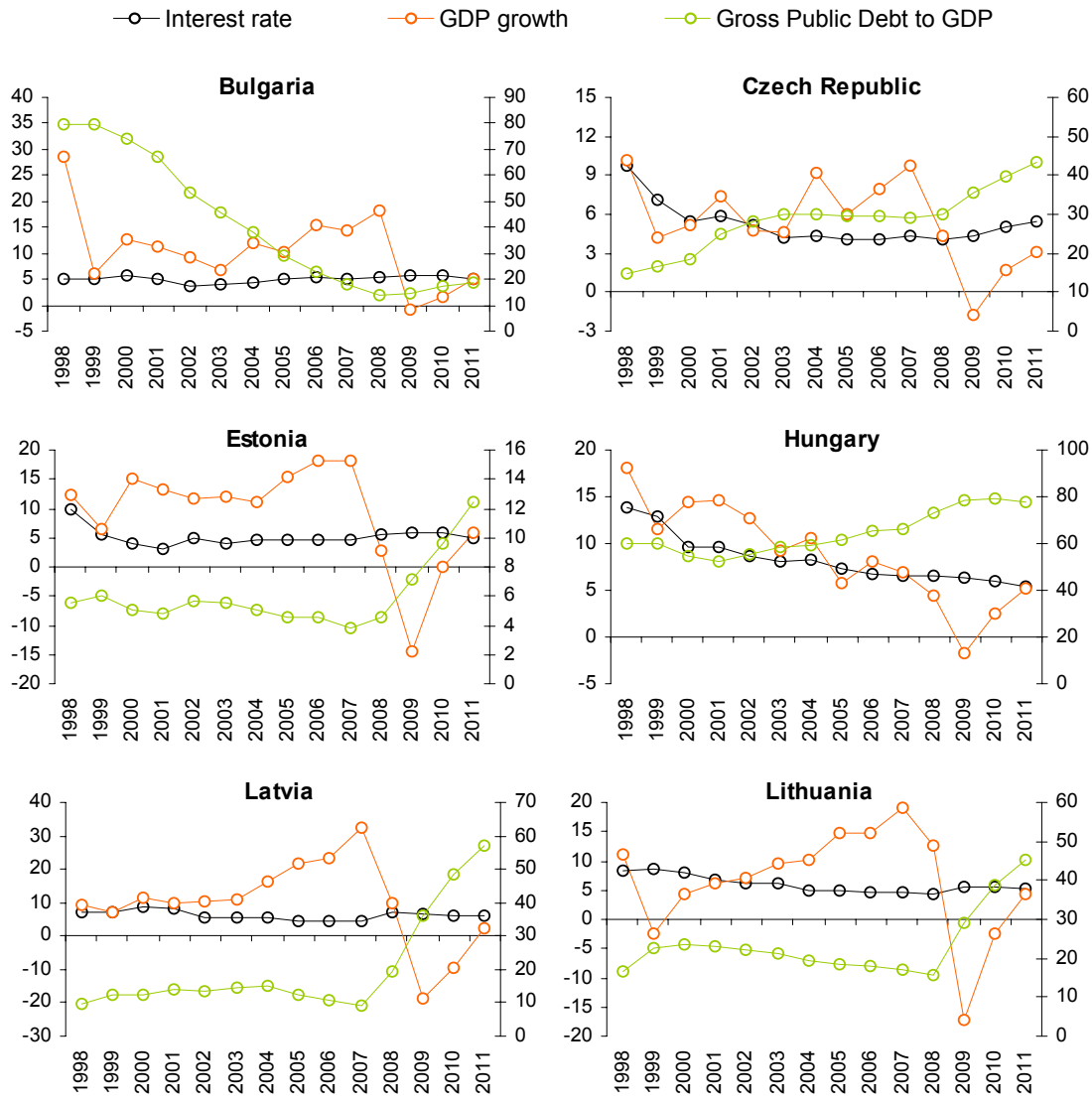
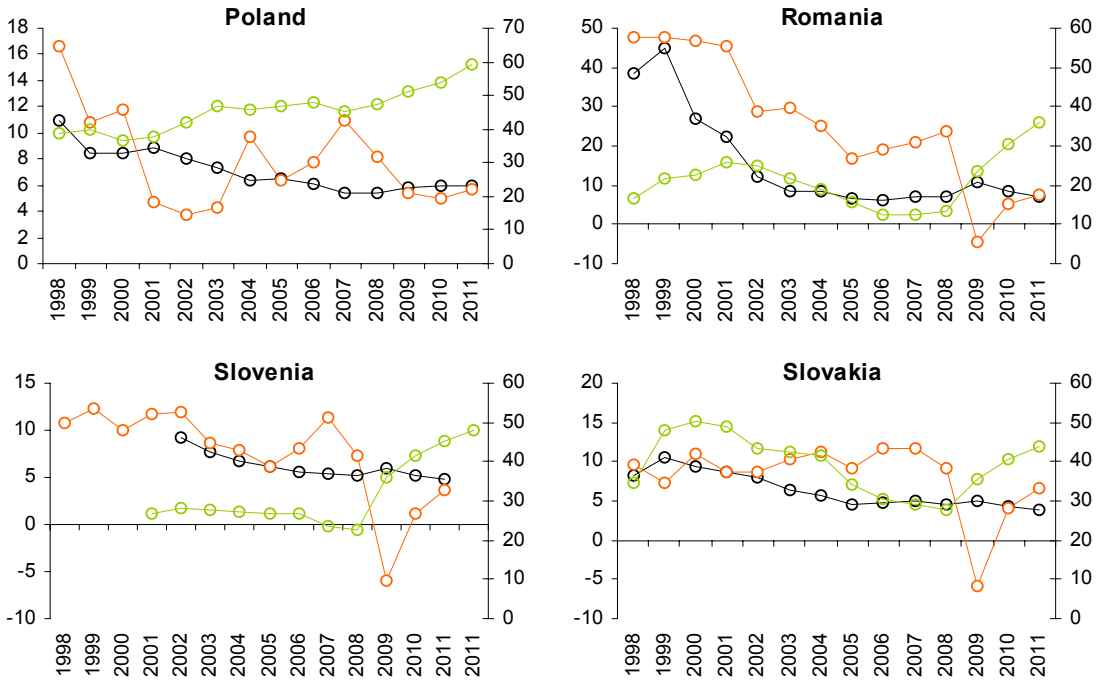


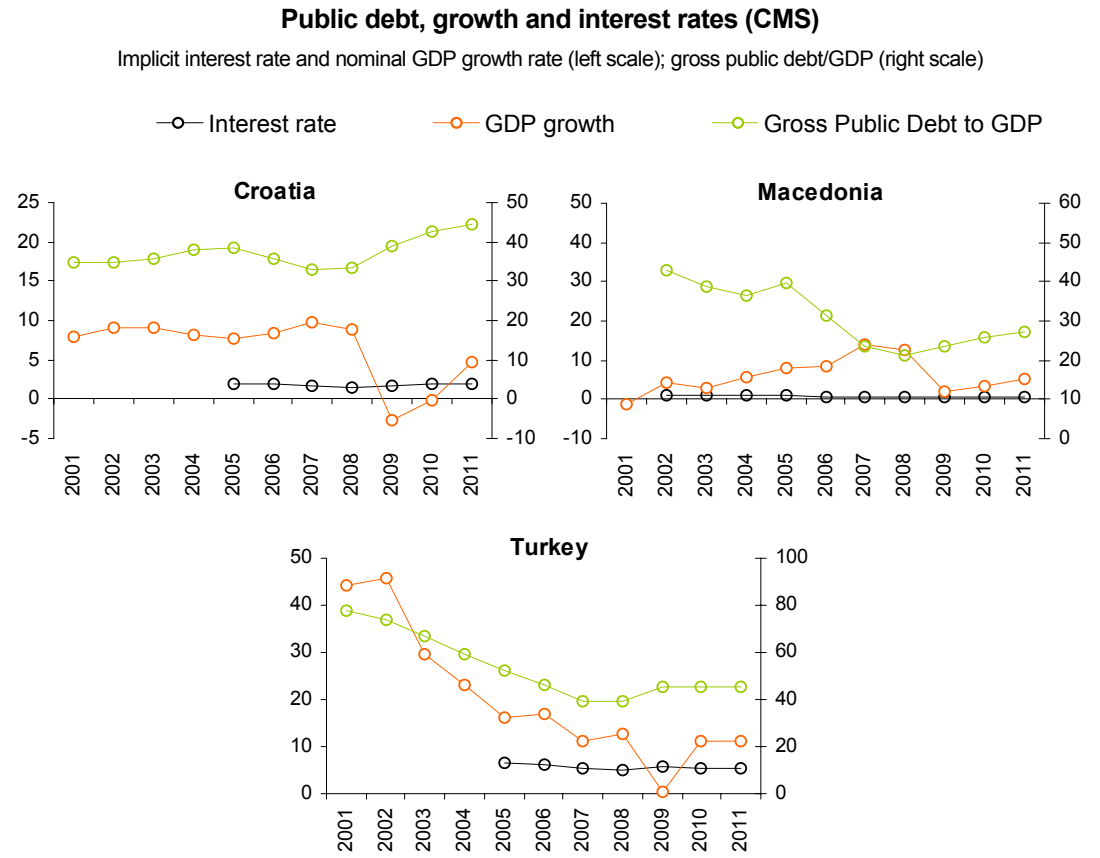
Figure 5 continued

Figure 5 (continued)



Source: Eurostat, European Commission, DG: ECFIN, Spring 2010.

Figure 6



Source: Eurostat, European Commission, DG: ECFIN, Spring 2010 and national statistics.

The same situation is reflected in the developments of foreign debts: as these were mostly driven by the steady growth of private debt, the same condition needed to be present in the financial markets too. This was clearly the case as can be seen from the steady increase of the private debt to GDP ratio. To the extent that incomes and the value of assets grew *pari pasu* with the GDP, growth of private debt looked sustainable as it could be refinanced at any time with the ratio declining to zero in infinity. Except of course if growth slowed down or the interest rate shot up.

Given the important role that foreign debts play in facilitating the rise of private debts, let us consider shortly the role of exchange rates: in the case that a country had a flexible exchange rate, the concern with current account sustainability would have pushed for monetary policy that would have put a cap on borrowing abroad. In other words, exchange rate risk played an equilibrating role in the case of most NMS with flexible exchange rates. As a consequence, their private debt growth was constrained by the narrowing of the current account. In contrast, in most fast growing euro member states and in NMS (Slovenia since 2006, Slovakia since 2008) and CMS with currency boards and fixed exchange rates (and even countries with heavily managed floats like Serbia and even Albania), current account deficits tended to widen as private borrowing faced no exchange rate risk. Thus, private and foreign debts increase seemingly without any constraints.

Once the bubble bursts, i.e. the interest rate shoots up, private and foreign debts have to be repaid and recession sets in, the growth rate goes well below the interest rate on all debts. In addition, fiscal deficit increases as it takes over some of the private obligations and the public debt to GDP ratio goes straight up also due to the declining revenues and the lower GDP. So, the countries are left with three problems:

(i) How to increase exports to pay for foreign debts?

(ii) How to increase savings to pay for private debts?

(iii) How to finance increasing costs of public debts?

Redirecting and widening the policy mix

The policy approach currently adopted across Europe resembles the preferred model of the IMF in the past: decrease public spending or increase tax revenues or both. That is because in the canonical IMF model (the Polak model) the only policy instrument that is at hand is the decrease of public credit demand, which means fiscal consolidation, i.e. lower public spending or higher taxes or both. Other policy instruments are assumed not to be available on short notice.

For this policy to work, there has to exist a causal connection between fiscal consolidation, current account improvements, and private deleveraging (problems i and ii above). However, the channels through which this causality would work are far from clear because

of weak association with the changes in relative prices – exchange rates, interest rates and wages. The strategy seems to be to cut public sector wages, relieve the pressure on the interest rates, and achieve real exchange rate depreciation. Then, increases in both private and public savings, overall deleveraging, is possible to the extent that the current account improves, which also supports foreign debt repayments. The major risk is that recession or stagnation will push up the debt to GDP ratio and the needed relative price adjustments may not occur. In other words, that policy mix risks a currency crisis and debt defaults. Because of that, these pro-cyclical fiscal policies should be avoided if that is at all possible (the need to pursue countercyclical fiscal policies is still the main policy stance of the IMF in the current circumstances; see IMF 2010).

In general, given that there are three problems and thus three policy targets, the Tinbergen rule requires the use of three instruments for the policy mix to have the chance to correct all three problems. To address short-term crisis management, the three instruments would normally be:

(i) exchange rate correction in order to address the external balance,

(ii) debt restructuring to support private debt deleveraging and avoid prolonged debt overhang, and

(iii) a low enough interest rate to avoid unsustainable developments of public debts or an outright default.

These three instruments interact with each other so the sequencing and the actual mix are important. The overall aim would be to engineer a macroeconomic stabilization and adjustment with as small a cost to growth as possible. Given that high foreign and private debts are the main underlying cause of the risks to stability, those should be primarily addressed in most programmes of stabilisation.

Given the weight of foreign debts in most of these countries, the appropriate policy is to aim to correct the exchange rate where this is possible in order to support improvements in the current account and boost private savings. Given that a lot of foreign debt is held by the private sector, increased costs for debt service will require higher public borrowing, and that might lead to higher fiscal deficits and to growth of public debt. However, once the current account improves through growth of exports and interest rates decline due to decreased private sector refinancing requirements (the result of debt restructuring), fiscal consolidation becomes easier. This is the way countries have grown out of crisis in a number of previous instances (e.g. in the case of the Asian crisis in the late 1990s). This strategy may not be possible if additional public borrowing is not available to some countries because of increased risk. This is where the support from the multilaterals (IMF and the World Bank) and the EU and the ECB should come in. If a household cannot borrow privately, and cannot borrow through its own fiscal centre, it should be able to

borrow via a supranational association like the EU or through a multilateral agency. That additional borrowing could then be subject to usual debt sustainability criteria.

However, for countries in the euro area or those with currency boards or fixed exchange rates that they cannot give up on, the policy that addresses the key causality has to be private debt restructuring with higher fiscal costs and real exchange rate correction. Fiscal costs can be shared – through a guarantee scheme, a stabilization fund as discussed in the EU now – but real exchange rate adjustment will have to be addressed by additional policy instruments (e.g. incomes policy and – for the longer-term - industrial policy). This will have further fiscal consequences that will probably require additional borrowing rather than either decreased spending or tax hikes.

In both settings (fixed and flexible exchange rate settings) debt restructuring has to be a major component to attain debt sustainability and to return to catching-up growth trajectories in emerging Europe, both of which are of great longer-term interest for creditors (both private and public ones) in the more advanced economies. The major risk to not doing that is a prolonged debt deflation or the Japanese type of prolonged banking crisis (on that see e.g. Kobayashi, 2008 and Posen, 2010).

Furthermore, a widening of the set of policy instruments to be used to aim towards longer-run current account sustainability of catching-up economies to avoid heavily distorting real exchange rate developments must also be an essential feature in the policy toolbox. Policy instruments and policy reforms at both national and EU are relevant here: national and EU-level reforms of financial market regulation to contain credit bubbles and avoid credit misallocations, more flexible exchange rate arrangements, and – as already mentioned – forward-looking incomes policy and industrial policy arrangements (for the latter see Rodrik, 2009).

Conclusion

The current debt mess has mostly been caused by the private debt bubble that has led to increases in foreign debts and has been supported in part by pro-cyclical fiscal policies. That has led to misalignment in relative prices, primarily in the real exchange rate. Thus, that relative price needs to be corrected and fiscal consolidation bears only a weak and tenuous causal link with it. Preferably, nominal exchange rate adjustment should be used where available in many cases jointly with private debt restructuring and with appropriate fiscal support. The latter two instruments are essential in the case where exchange rate policy is not available together with a range of shorter- and longer-run instruments which aim to contain credit bubbles which have often been the source of misaligned real exchange rate developments together with other policies targeting competitiveness in the integrated market environment of the extended European economy.

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