Tim Phillips [00:00:00]:
Today on VoxTalks Economics, COVID-19 and the war in Ukraine have challenged debt sustainability. Can our existing institutions meet that challenge?

Tim Phillips [00:00:18]:
Welcome to VoxTalks Economics from the Center for Economic Policy Research. My name is Tim Phillips. Every week we bring you the best new research in economics, so follow us wherever you get your podcasts. CEPR recently published its fifth annual report in the series on the Future of Banking. It discusses the consequences of the COVID-19 pandemic and the Russian war on Ukraine for the international economic and financial order. Today we're going to focus on one part of that report, the financial architecture needed to ensure sovereign debt sustainability. I recently caught up with Jeromin Zettelmeyer, director of Bruegel, the European think tank, who is the author of this part of the report, to discuss the impact of COVID, the war, and whether the existing framework and institutions for resolving debt crises can cope, and perhaps what might replace them. So, Jeromin, globally, debt levels are up, real interest rates up as well, growth down. I imagine this has a negative effect on fiscal sustainability.

Jeromin Zettelmeyer [00:01:26]:
So it does. And in the report we try to quantify in fact, roughly speaking, the order of magnitude is that the primary fiscal balance, that is, the difference between revenues and non-interest expenditures that countries need to run after this pandemic and war phase to stabilize their debts, is about 1% of GDP higher today than it was in late 2009. So this is the cumulative effect of the pandemic and the energy related shocks. For the most part, these higher fiscal pressures come from higher expected long term real interest rates. So they are up about one and a half percent compared to what was expected before the COVID shock. To a lesser extent, also to higher debt. The reason why I say to a lesser extent is because when this whole episode started, interest rates were really low. In fact, they were negative real interest rates in some countries. And so when interest rates are so low, then even a substantial increase in debt is not going to lead to a very high adjustment need. But interest rates have gone up, and this is what drives most of this additional pressure. And then there is the impact of growth that you mentioned. Now, at least according to IMF projections, which are used here. If you compare five year out growth projections in advanced countries before COVID and in October of last year or the spring of last year, there isn't much change in advanced countries. On average, some countries are in a better position, others are in a worse position, the EU in a slightly worse position. But long term growth prospects have indeed declined in the fast growing emerging markets, particularly in China. So some of that is a growth effect too, but for the most part it's an interest effect.

Tim Phillips [00:03:07]:
So looking at the effect of that in the EU to start with, are there countries that are going to have to make fiscal adjustments to manage their debt burden?

Jeromin Zettelmeyer [00:03:18]:

If the ambition is to maintain sustainable debt, then the answer is most definitely. If your ambition is on top of that to meet maximum deficit requirements, then depending on how ambitious you are on those deficit requirements, you may have to do stuff on top. The rough ballpark is that you would have to do a few points of fiscal adjustment in most of the high debt countries to get debts to stabilize, and then you will need to do a bit more to make it fall with high probability. Given where we are starting from, which are large deficits, that's going to require very substantial fiscal adjustment efforts in countries like Italy, Spain, Belgium, France. Where you end up depends on whether you impose rules that require meeting additional benchmarks, which was not the focus of our chapter, but is very much the focus of the ongoing fiscal governance reform in the EU.

Tim Phillips [00:04:17]:
Yes. Does debt sustainability situation in the EU mean that the efforts of the last decade since the stability and growth pact, does it mean that those efforts have failed?

Jeromin Zettelmeyer [00:04:27]:
The stability and growth pact has had some impact in containing deficits, particularly through the so called excessive deficit procedure, which means that countries that have deficits of above 3% of GDP, which are not just temporary or minor, that they have to do a minimum amount of adjustment in a formal procedure, that's also viewed as kind of sending a bad signal. Right? So it's a bit of a reputational punishment. So not wanting to be in that situation has had an impact in that deficits have been lower than they might otherwise have been. So in that sense, it has had some effect. The procedure has not worked well in the sense that it was very often not implemented. Beyond this, worry about deficits bumping up to the 3%, and the lack of implementation, in my interpretation, has to do with two things. On the one hand, you have the point that's often emphasized that there are no real hard sticks to enforce the rules. But equally importantly, in my view, is the fact that the rules themselves were a bit arbitrary. They were not very tightly linked to debt sustainability, for example. They were tied to the 60% debt anchor of the European treaty and the 3% anchor, and then there were more or less arbitrary views on how fast countries should approach these anchors. When you have a system of rules that doesn't really seem to be very well justified on economic grounds, that doesn't seem to take your own economic situation into account very much, then countries are less likely to follow them. The big step forward that the European Commission proposed about a year and a half ago is to have a new system that is really very much founded in this idea of debt sustainability. So countries would have four to seven years to do adjustments from these kinds of debt levels, and then they should bring debt on a plausibly declining path that's robust against shocks and so forth. So that is the spirit of the new reform. But to finish answering your question, of course, the main reason why debt is high now is that also rules have been suspended since COVID and we have had two cataclysmic shocks. First the COVID shock and then the energy price shock that has increased them further, particularly the COVID shock. Right. So it was not mainly a failure of the rules, but the rules have contributed to this failure, hence prompting the desire for a reform.

Tim Phillips [00:06:59]:
Given the unsatisfactory nature of the rules as they stand, is there a consensus that the governance reforms are a good thing?

Jeromin Zettelmeyer [00:07:09]:
I think the consensus is that the governance reforms that, by the way, have just been agreed. Right. So we have just finished the so-called trilogue, which is the process of negotiation between the European Commission, the European Parliament and the European Council. If the so called co-legislators, the council and the parliament, do not fully agree, which is always the case. Right. So the commission writes a proposal, then there's a parliament version that gets passed, a council version. The council version was passed at the end of December, and now the parliament and the council have sorted out the differences and accepted a version of this new legislation, which is very close to what the council wanted. So we do have political agreement and it will be passed. The final legislative text will come out very soon. It will be passed still in this session of parliament, which, as you know, ends very soon. With European elections coming up in May, there is no consensus whether this is a great new system. I think that the consensus is that it's probably an improvement over the old one, but that's not a very high bar, because the old system, apart from its failings even before the pandemic, would have been practically inapplicable in the post pandemic period because it would have required unrealistic adjustment efforts from many countries without a sufficiently clear motivation. So it simply could not have been applied.

[Voiceover] [00:08:35]:
The climate crisis is already undermining the economy of many of the world's most indebted countries. In October 2022, Beatrice Weder Di Mauro and Ugo Panizza discussed the 25th Geneva report from CEPR, which investigated potential solutions for the joint problem of climate and debt.

Tim Phillips [00:09:06]:
In low income countries, we were worried at the start of the COVID crisis, very worried, and we covered this on Vox talk several times, that there may be widespread debt defaults. Has that occurred?

Jeromin Zettelmeyer [00:09:19]:
No. What has occurred is a trickle of defaults with some high profile cases, such as Zambia. And then we have had also some defaults and high profile restructuring attempts in some emerging market countries that are on the poorer side, and there, the most famous one was Sri Lanka. Some of these cases, the problem was magnified by COVID. So, for example, Sri Lanka suffered a very big tourism shock, which sort of pushed over the edge. For the most part, though, all these cases are about economic mismanagement and bad luck that had a cumulative effect. And then with COVID the situation became untenable because it was then much more difficult to refinance these debts in the market. And most of these countries have some combination of market debt and official debt. The reason why there wasn't a big explosion

of defaults. These countries initially were not hit as hard across the board by higher interest rates to the extent that they borrowed from the market, because there was this massively expansionary monetary policy by the advanced country's central bank. So particularly the Fed eased a lot in March of 2020, and it was only relatively late after the inflation, that interest rates jumped up and then, of course, eventually monetary policy turned around. So these countries initially got a break on market financing and they also got a break on official financing. So there was a very rapid IMF led response, giving relatively small credits to many countries. And then there was a thing called the Special Drawing Rights, SDR allocation, which was essentially free money given to all members of the IMF in the summer of 2022, if I remember correctly. There is a lingering problem that continues. Countries are edging towards the moment when there may be a larger group of countries that really cannot repay. And we've had this at least once, namely in the 1990s, when there was then, in the end, a decision by the rich countries to finance a large scale debt relief operation that involved both the write down of bilateral official debts, but also multilateral debts. So, to the IMF and the World Bank and development banks. So we're not yet at the point where this might become necessary, but we are getting closer. And, of course, the problem is that it is much more difficult to pull off this type of big group based restructuring like we did in the 90s. It was called the Highly Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative. So many people ask themselves, do we need a new one of those? The answer is, we may, but it's much harder to do. And of course, the reasons why it's harder to do is we are in a much more difficult geopolitical situation. China is a much, much bigger creditor than it was. And so to get that kind of consensus among the big creditor countries that there should be big time debt relief is really hard.

Tim Phillips [00:12:19]:
For the last 70 years, these crises have been resolved by that informal grouping, the Paris Club. China's not part of the Paris Club, is it? Is this way of resolving crises still valid?

Jeromin Zettelmeyer [00:12:34]:
The Paris Club continues to be an influential body, while its members, and these are most European countries, plus the non European advanced countries that would be typically also members of the Organization for Economic Cooperation and Development. The United States, of course, is a member. Japan is a member. Russia used to be a member. I'm not sure whether they left or their membership is dormant at this point. Even though the debts that are owed to individual countries in these groups are much smaller than to China collectively, it's still about in the same order of magnitude, right? So the Paris Club is a creditor of roughly the same size as China and some of the new creditors, like India, Saudi Arabia. It is an institution that has figured out a reasonable process for achieving debt relief. If you want to have orderly debt relief, there's a case for copying the technology of the Paris Club. And for that reason, China, after COVID this was in late 2020, agreed to join a framework for debt restructuring that was based on the G20, where of course, China is a member, as is India and South Africa and Brazil. And this so called G20 common framework for debt restructuring beyond the DSSI. The DSSI was this debt service suspension initiative that was a temporary relief measure during COVID. This framework is essentially copied on Paris Club rules. So the Paris Club secretariat also serves as a

secretariat for the common framework. And most restructurings that have been attempted under the common framework, which includes this case of Zambia, have France, the country that runs the Paris Club on a day to day basis, as a co chair. So in a way, the Paris club has extended itself in the common framework, and China has been willing to cooperate with that framework to some degree. But it's been a very slow process because, first of all, China has a lot of money at stake. And second, having by far more money at stake that any individual Paris club member, it is reluctant to automatically play by the Paris club rules. And the most important rule in the Paris Club is that the assessment of debt sustainability and how much debt relief a country needs is pretty much delegated to the International Monetary Fund. And of course, the International Monetary Fund is run mostly by the western world. Right? So the problem of the governance of this institution is that China doesn't have a very big weight on it, a far smaller weight than corresponds to its economic size and its footprint in geopolitics and the world economy. And so China is reluctant to simply delegate these assessments when it knows that these assessments ultimately lead to China footing most of the bill.

Tim Phillips [00:15:17]:
Will the elements of debt restructuring packages have to change?

Jeromin Zettelmeyer [00:15:23]:
There are some things about debt restructuring that are new. The really new one, of course, is how to deal with climate change. So the methodologies that are used to decide whether countries can pay or not have to take into account both the future impact and costs of climate change on growth and ability to repay. But they also should take into account the fact that countries can do things through adaptation measures that make them more resilient and as a result, improve their ability to repay creditors. And this is all new ground, because the traditional thinking behind debt restructuring is that most of the payments problems of a debtor country can be resolved through macroeconomic reforms. Bringing down inflation, cutting the deficit, making sure that countries don't overspend, which usually is a matter of something you can do within one and three years. You bring in the IMF, you impose some conditionality, there's a set of macroeconomic projections conditional on making all these reforms. And then creditors look at this and say, okay, well, if you are going to do all that, and after that, we're more likely to get repaid. In return, we're going to lower our debts to a feasible level that then post reform can be repaid. Now, the fact that we have these longer term uncertainties related to climate change probably should change the modus operandi of debt restructurings to include some conditionality that worries about these longer term effects. This is indeed new ground.

Tim Phillips [00:17:04]:
This report is partly the result of a discussion amongst your academic peers. Is there agreement amongst them about what the future holds and what the policy responses should be?

Jeromin Zettelmeyer [00:17:16]:
Mainstream economists, there's a fair amount of consensus about what are good policies, what are bad policies. That doesn't mean that they have the right answers. Right. So the problems

are evolving, the problems are too big, and there are just many things which we don't know how to do. There is also, of course, a challenge from a more inward looking, more nationalist tradition of economic thinking, as represented, for example, by Donald Trump and the United States. That has also been seeping into mainstream economics. You can detect some elements of that nationalism, for example, in the Inflation Reduction Act of the Biden administration, which is deliberately discriminatory against countries like China, Russia, Iran, North Korea. But it's implicitly also discriminatory against countries that the US doesn't have explicitly a free trade agreement with. This caused some discomfort among the Europeans that viewed themselves as close allies. So there is a question among economists and policymakers to what extent we are going back to a world where one country's growth and employment is viewed as being in competition with another country's growth and employment. And this is exacerbated by the need to do something about climate change and the worry that could be quite costly. This was a form of thinking which was standard. It was the standard paradigm among economists until the late 18th century. And then basically this was busted by Adam Smith, who pointed out that protectionism harms countries, not just collectively, but even individually, and that one country's prosperity is positively associated to another country's prosperity. What made the big difference in the last few years is the rise of China. And China was not adhering to this consensus, but very aggressively subsidized its own industries to gain bigger market share, and ostensibly has been doing relatively well with this approach, even though if you look closer behind the surface, that's actually not necessarily true, because it comes at very big costs for China. Very high debt levels, low productivity growth. It's mostly a brute force approach that cannot necessarily be sustained. But now we have this big rival that seems to play outside the rules. And then the question is, do they know something or are they doing something right that we forgot over the last few hundred years. So there's a little bit of this soul searching going on. There's some attempts going on to maybe reconcile more interventionism with our current ideas about openness, integration and collaboration. That is leading to debates even within the mainstream camp. But for the most part, we still think about the world in common ways. But that doesn't mean we have the right answers.

Tim Phillips [00:20:03]:
Half the planet's going to be voting in a national election this year. Do the results of those elections mean that potentially all the policies that we've been discussing, they might change?

Jeromin Zettelmeyer [00:20:15]:
Yes. To name the most obvious examples, is a rather high probability that Donald Trump might return to the presidency in the US. There is a smaller probability that the far right and the far left might make significant gains in the elections to the European Parliament. Now, you don't really think of the European Parliament normally as being the big geopolitical threat or player that you think of like a US president. But in the EU context it is very important because parliament is one of the two co legislators and has been a very important fighter for European integration and for more European commonalities. For the most part, the parliament has been progressive in the sense that it has advocated looking beyond our national squabbles, working together more. And you know that in the council, the fact that Poland and Hungary have taken anti integration views

has created some major problems. For example, on aid to Ukraine as we all know. These problems have never been there on the side of the parliament. So now imagine a situation where decision making and the parliament is no longer automatically pro EU cooperation, but may become a force of Euro skepticism that will make it extremely difficult to pass laws because parliament is a veto player. It is still the case that we will probably see a pretty solid center that can pass legislation and then with big parts of the political spectrum that are opposed, but that will probably not be more than 25 or 30%. What is at least as worrying as the election itself is the political and social phenomenon that's behind it. Why is it that these political forces are so strong, even though we believe that they have a very destructive impact on societies and policies? That's a problem for us that are part of the mainstream and apparently are not convincing enough.

Tim Phillips [00:22:40]:
The report is called The International Economic and Financial Order After The Pandemic and War. The authors are Giancarlo Corsetti, Barry Eichengreen, Xavier Vives and Jeromin Zettelmeyer. It is the fifth report in the future of banking series and a free download from cepr.org. We've discussed the debt part of the report today, but it focuses on two other major components of the international financial order, the macroeconomic outlook and the changes needed in the economic policy model, and also the the implications for the international monetary system and the stance of the dollar.

[Voiceover] [00:23:27]:
This has been a VoxTalk from the Centre for Economic Policy Research next week: How are banks coping with the same legacy of pandemic and war?