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CONCLUDING SESSION

I – Indebtedness : a worldwide phenomenon

Over the last forty years the public debt of advanced countries has increased massively in real terms without alarm bells ringing :

- From 1970 to 2010 public debt has jumped from 20 to 100% of GDP. An increase by a factor of five in real terms.
- But the banking loans to the private sector to households and non-financial enterprises) have also exploded :

For all the advanced countries private debt has gone up from 60% of GDP in 1970 to 170% in 2010[1].

II – Eventually, this accumulation of debt in the public as well as in the private sector, has been at the root of the 2007-2008 financial crisis.

Easy borrowing – at low interest rates - :

- Encouraged States to run large deficits and to turn a blind eye to fiscal reforms ;

[1] *From 1980 to 2007 the global financial assets increased from 14 trillion $ to 206 trillion $ (from 120% to 365% of world GDP).*

- Allowed the private sector to overextend its position while pushing upwards asset prices. Therefore when the – excessive - real estate prices started to fall, the borrowers saw the value of their houses dwindle and their solvency diminish. Financial institutions were hit :

  - Their assets were getting problematic ;
  - The “extraction of capital” by banks became impossible ;
  - And wholesale financial markets dried up.

III – Now, the world economy faces a serious challenge.

- Many States see their fiscal position strained by the overhang of public debt (around 90 to 100% of GDP).

Therefore they have become highly dependent – in terms of their fiscal sustainability – on the pursuit of the 0 interest rate policy that large Central Banks have carried out though QE and loose policies. Low interest rates for too long tend to weaken incentives to reform.

One of the main difficulties for the ECB today is to start “normalizing” its policy. Indeed an increase in interest rates can raise very serious problems for a number of overindebted States.

However, after a “bust”, a deleveraging process is inevitable.

- The debt solvency of the private sector is somewhat healthier because of the increase in corporate profitability. But the magnitude of non-performing loans in some European countries shows that several categories of private sector borrowers are still under strain.

However, as financial repression through 0 interest rates is not a lasting solution because of the instability that is creates in the balance sheets of a number of

financial institutions (insurance companies, pension funds …), and because of the need to restore some interest rate margin for the next recession, one has to face the eventuality of a gradual normalization of monetary policy.

IV – Can such normalization take place without some form of public debt restructuring ?

EU Countries like Greece and Cyprus have already been the object of debt restructurings.

But the issue is wider and could concern others.

If inflation doesn’t pick up, the long term prospect of public debt sustainability looks weak in a number of countries. Let us not forget that, in the past, several States (from 1900 to now) have provided, on the whole, negative returns on their bonds (France, Italy, Japan) because they resorted to inflation. This process seems less likely nowadays for structural reasons.

We should also observe that the size of Central Banks balance sheets is anything but normal (10 trillion $ added since the crisis to the largest Central banks : an unprecedented record).

In fact, aggressive money printing has been a response to huge debt burden.

So how can one envisage the “Great Unwinding” ?

I personally believe that :

- Keynesian margins of maneuver have evaporated ; there is no more room for fiscal and monetary stimulus ;

- The return to some fiscal solvency is a must. Deficit spending, at one point, cannot work anymore and, in fact, jeopardizes future growth. So, fiscal retrenchment or at least stabilization is inevitable ;

- Such fiscal action would be all the more painful and difficult if interest rates were to rise (according to the Domar theorem if interest rates on public debt are higher than nominal GDP growth, indebtedness increases indefinitely).

In “extreme cases” of insolvency (if the political and social acceptance of adequate primary surpluses were too weak), market based forms of restructuring could be envisaged :

- Debt renegociation through collective action clauses ;
- Conversion of present bonds into perpetual instruments could also be envisaged which would solve the repayment problem ;
- Those negociations could take the form of Brady type instruments (with exchanges of present bonds against discounted but secured instruments) ;
- The European Stability Mechanism (ESM) could help – as a “European IMF” – in financing the adjustment programs that would be needed to gradually help member countries to ensure the transition towards debt sustainability.
- The ESM could also be used in the event of a liquidity crisis (this would be better than resorting to a monetary instrument).

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