

Debt sustainability and a sustainable COVID recovery

Overcoming the dilemma between debt and environmental sustainability in the discussions over a post Covid-19 recovery package

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Key points:

- Recovery and support packages must avoid institutionalising moral hazard and creating zombie companies and windfall profits that blur the boundaries between market and state.
- Support for financial markets must avoid socialising risk and undermining financial markets' ability to allocate resources effectively.
- Recovery measures must be tied to green and social conditions that promote sustainable activities and fund the transition away from unsustainable activities.
- Stability and Growth Pact rules must be relaxed for well-specified and targeted sustainability-oriented investments coordinated at EU level.
- High levels of public debt must be managed pragmatically, without artificial constraints on potential monetary solutions.

Introduction

2020 will be remembered in economic history as the year when the debate around public finance evolved from the sustainability of public deficits and debt to the sustainability of the world. In 2019, the debate about investing to build a sustainable economy was still taking place between the proponents of budgetary orthodoxy pleading for investments, regardless of their colour, to be made within the limits of balanced public budgets. In 2021, the debate will no longer be about balanced budgets but about the destination and the conditions of public investment and of public support to the economy. 2020 was an inflection point.

When it came to supporting collapsing economies in the face of the Covid-19 crisis, governments and central banks provided an unprecedented level of fiscal and monetary support to their economies and to financial markets. At the moment of writing this note, the process is continuing in the European Union with the discussion of a “Recovery Instrument to support the recovery in the aftermath of the Covid-19 pandemic”. In the process, yesterday’s partisans of balanced public budgets became, almost overnight, the partisans of public budget deficits targeted at supporting the economy in its entirety, regardless of the economic or the environmental sustainability of the activities or the companies supported. The objective became to go back to normal, normality being understood as the economy as it ran before Covid-19 struck.

However, this remarkable shift in priorities raises five fundamental issues that must be considered if policy-makers want to ensure that they are providing support to the general economy for the right reasons and with the desired consequences.

Absent a clear answer to these questions, the massive allocation of public money to private actors could be misguided or, even worse, take the world on an irremediable path to an unsustainable future. In this bleak scenario, the support provided to the economy to recover from the Covid-19 induced crisis would contribute to building, or rebuilding, a world leading to even worse consequences than the pandemic’s.

1 The institutionalisation of moral hazard: towards a hybrid economic system?

The rationale for the massive support of the economy unleashed by governments throughout the world in the wake of the Covid-19 crisis was to put the economy as a whole on a lifeline to ensure society would continue functioning.

The rationale for the post-crisis recovery packages currently discussed in many jurisdictions, in particular in the EU, is to provide the stimulus deemed necessary to go back to the economic situation that prevailed before the Covid-19 crisis triggered a substantial contraction of the world economy.

Looking at their economic consequences, the various recovery and support packages face a triple challenge:

- ◇ Avoiding that they become a lifeline for so-called zombie companies and businesses that would not have prospered or even survived in normal circumstances without the injection of public money.
- ◇ Avoiding windfall profits for the owners of companies. It has been reported, for instance, that companies of significant size owned by private equity funds sitting on billions of dollars or euros of “dry powder” are benefitting from massive cash injections coming out of public coffers despite the fact that they would have the means of supporting themselves.
- ◇ Avoiding that public money be injected into businesses without any conditions either in the form of a limitation of pay-outs to private parties (dividends, share buy-backs, bonuses...), or strong and binding commitments regarding employment, or equity participation or other means to gain upside potential for the public institutions providing the support.

If the recovery plans on the table do not address this triple challenge, policy-makers run the risk of creating a hybrid economic system that will be neither a market nor a state-run economy. Such a scenario would have enormous consequences on the ability of the economy to operate in an efficient way given the lack of coherence of such a system.

At the heart of market economies is the Schumpeterian creative destruction process, an expression summarizing a Darwinian logic where the best companies adapt and win the economic game to the detriment of the less competitive, thereby creating a general momentum supposed to bring economic prosperity. Recovery packages supporting the economy in its entirety would go effectively against this logic, as they would be unable to distinguish between successful and ailing businesses. By going down this road, policy-makers would be inventing, perhaps without being conscious of it, a hybrid economic system that lacks the discipline of a market economy and the control of a state-run economy. Such a system would suffer from a fundamental internal incoherence, as the risk takers (public budgets) would not benefit from the risks they are taking, and as private interests would end up being in the enviable position of having nothing to lose. Such an institutionalisation of moral hazard, asymmetrical sharing of risks and gains, and wrong incentives would inevitably damage the economy and undermine trust in both markets and the state.

2 When financial markets themselves have become too-big-to-fail

Since the long reign (1987–2006) of Alan Greenspan at the head of the US Federal Reserve, central bankers have taken the habit of supporting financial markets through interest rate cuts and liquidity injections. Dubbed at the time the “Greenspan put”, this unwritten mandate comes on top of their traditional price and financial stability mandates and, despite its lack of official existence, it has now become the norm. The magnitude of the support provided to financial markets by all major central banks since the outburst of the Covid-19 crisis is the latest testimony to this situation.

Christine Lagarde was criticized when she declared in March 2020 that she was “not here to close spreads” (in other words for having ignored that her mandate involved also supporting financial markets). Interestingly, she changed her stance radically in the following days and led one of the biggest interventions ever of the European Central Bank to support financial markets. The “Greenspan put” and its subsequent “Bernanke put”, “Yellen put”, “Powel put”, “Draghi put” or “Lagarde put” have become over the years part of the financial stability mandate of central banks. The reason for this situation is simple to understand: the entire financial system has become so dependent on financial market prices that significantly lower prices would put the entire system at risk. There is a strong argument for thinking that central banks’ interventions and the generalised lowering of interest rates are the cause of the bloated financial markets and financial asset prices we are witnessing today. However, regardless of the validity of this point, it has to be recognised that things being what they are today the solvency of banks and insurance companies is a direct function of financial market asset prices.

Financial markets have become “too-big-to-be-let-down”, a financial markets equivalent of the banking “too-big-to-fail”, and this has a number of consequences similar to the consequences of the support of the economy by public budgets.

Financial markets are meant to be a mechanism for allocating capital to private and to public issuers at a price reflecting the risk of the entities and enterprises raising capital. However, a system where financial markets have become too-big-to-fail has the consequence of socialising market risk, and in particular credit risk. In turn, this phenomenon has the consequence of distorting the capital allocation process as financial markets lose their ability to price the real risk of issuing entities.

When financial markets operate on moral hazard, they do not allocate capital at a price reflecting the economic fundamentals of issuers, and they do not differentiate sufficiently between issuers of different quality. This gives rise to the possibility of questioning their very purpose. Is the system giving the right incentive to investors if the risk and the profit potentials are unevenly distributed? Does the concept of market discipline still mean something in such an environment? How can we build a prosperous economy on a market mechanism where prices of financial assets are disconnected from their fundamental value contrary to what financial markets are meant to do?

3 Supporting unsustainable activities will feed disruption risk

The Covid-19 crisis has shown the fragility of manmade economic systems and their dependence on the sustainability of the world.

This crisis has demonstrated that the biggest risk borne by human economies is the risk of disruption, i.e. the risk that confronted with the environmental consequences and geostrategic upheavals that an unsustainable world will bring, there is no plausible scenario under which the world economy as we know it will continue to function. This assertion is particularly relevant, if not exclusively, in the cases of climate change and loss of biodiversity. For instance, in all likelihood, global warming will trigger a prolonged depression, which will threaten economic and financial structures. The CEO of Axa famously said in 2015 that a world at + 4° C could not be insured. Meanwhile, he described disruption risk, i.e. a world with a collapsing economic activity, as the economy as we know it today would be dramatically curtailed without property and casualty insurance.

Providing support to environmentally unsustainable businesses via recovery packages would lock-in an unsustainable global economic model, which would lead inevitably, and in a relatively short time span, to the disruption of human economies and societies. We are working on a very short time horizon. On current trends, the planet's carbon budget will be exhausted in 10 to 15 years, and we cannot afford to “re-launch” the unsustainable economy that we are currently running (as a reminder, the IPCC has shown that current economic activity leads the world on a global warming path of between + 3.7 ° C and + 4.8° C before the end of the century). Bringing an undifferentiated support to the economy would be a mistake of historical dimension, and it would be akin to committing suicide. Recovery packages must therefore support only sustainable economic activities. From a practical standpoint, distinguishing between sustainable and unsustainable activities is within reach in the EU given the work already done to develop and start adopting a taxonomy of sustainable activities.

Finally, yet most importantly, public money will need to be spent on the necessary scale to support people working today in, or dependent on, unsustainable businesses. The money not spent on supporting unsustainable businesses should be spent on supporting the people whose lives depend on those businesses, making sure that they receive the support to train to work in new sustainable activities and, more generally, that they benefit from sufficient revenues to live a decent life. This objective of a “just transition” is the condition for a politically, socially and ethically acceptable evolution towards a sustainable economy. As such, committing “whatever it takes” to this question is the best possible use of public money. If central banks have a policy of doing “whatever it takes” to save financial markets, policy-makers can and must do “whatever it takes” to avoid leaving people on the side of the road.

4 The impossibility of debt sustainability in an unsustainable world

EU and EU member state leaders face a dilemma between following today the rules of the Stability and Growth Pact (SGP), typically the budget deficit limit at 3% of GDP and the debt-to-GDP ratio limit at 60%, and investing to build a sustainable world.

By following SGP rules, EU member states are supposed to remain within the limits of a so-called sustainable level of debt, i.e. a level where the debt can be serviced and reimbursed under plausible economic scenarios.

But EU member states face a most significant dilemma: if they do not invest massively today in the infrastructures and the transformation of the economy necessary to build a sustainable future, they will be continuing to support an environmentally unsustainable economy, which will feed tomorrow's disruption of the economy. The Covid-19 crisis showed without ambiguity that when the economy is disrupted, public debt explodes as a result of governments' support to economic activity. Moreover, the ability of sovereign issuers to service their debt in a depressed economic environment is greatly reduced, if anything because of lower tax receipts.

In other words, today's SGP debt and deficit rules, which are meant to make the level of public debt sustainable, are preparing an environmentally unsustainable world that will make tomorrow's sovereign debt unsustainable. We are not only witnessing a "short-term debt sustainability vs. environmental sustainability" dilemma but, as a consequence, also a "short-term debt sustainability vs. medium-to-long-term debt sustainability" dilemma: paradoxically, the SGP rules meant to make the debt of EU member states sustainable prepare the ground for this debt to become unsustainable in the future.

In this context, the only solution to avoid a situation where prevailing public budget rules lead to an environmentally unsustainable world and, subsequently, to a future unsustainable level of sovereign debt, is to relax the rules for well-specified and targeted sustainability-oriented investments.

We live in a world where public deficits and debt are due to rise regardless of the policy decisions made. Whether the policies adopted consist of investing in a sustainable future or not, public deficits and debt will be on the rise but, in the latter case, we will have built an unsustainable world and the impossibility of public issuers to service their debt will be caused by the economic disruption that will happen as a consequence of lack of action.

5 What options through a wall of public debt?

We are facing a situation where public debt will grow regardless of the choices made by policy-makers: if SGP rules are followed, the EU will build an unsustainable future that will lead to a future dramatic increase of public debt; if SGP rules are not followed, public debt will rise mechanically in the short term. This situation leaves open the question of the policy options open to manage this increasing amount of debt.

Technically, there are five possible ways of reducing public debt:

1. Increase taxes
2. Decrease public expenditures (austerity)
3. Cancel the debt
4. Create / accept inflation
5. Allow central banks to finance public deficits

The first two solutions would effectively see public authorities take back with the left hand what the right hand gave during the Covid-19 crisis to support people and businesses. In other words, if solution 1 or 2 (or a combination of the two) were used, the public support provided during the current crisis would have consisted only of a cash advance to be reimbursed, as opposed to a lasting support. These first two solutions would defy the very purpose of the actions taken by governments in reaction to the crisis. Moreover, they would be politically and, as far as the reduction of public expenditures is concerned, ethically unacceptable, as they would come down to making the very people who were most exposed to the pandemic because of their social and professional situation pay for the most privileged.

High and unsustainable levels of public debt are a characteristic of countries emerging from a war. From a public budget standpoint, the situation created by the Covid-19 crisis is similar to war, as it is one of those times when the stakes are so high that governments decide to spend without limits in order to save the essential or achieve what is perceived as an objective superior to budgetary rules. However, this leaves open the question of the repayment of the debt. If the public debt raised in the wake of the Covid-19 crisis cannot be paid back, as we hinted above by ruling out solutions 1 and 2, it will have to be written-off. There are several ways of doing this.

Between the general write-off of sovereign debt, allowing inflation to creep in to erase its value, and organising the direct financing of public deficits by central banks, the latter solution is without doubt the softer. Importantly, given the general deflationary trends encountered in advanced economies, and given the drop in aggregate demand resulting from the Covid-19 crisis (which reinforces deflationary trends), the direct financing of budget deficits by central banks would have a limited and perfectly manageable inflationary effect.

We have been living for several years in a deflationary environment that, mechanically, reinforces the weight of debtors' liabilities and is the worst enemy of the investment effort we need to make to build a sustainable future. We should therefore see a possible dose of inflation as part of the solution. It would undoubtedly have far more pros than cons in a context where today's central bankers are, in any case, equipped and able to control inflation if it were to show signs of getting out of control.

Conclusion

With the world on a path to a + 4° global warming, pleading for public budget orthodoxy to the detriment of investing in a sustainable world is tantamount to not seeing what is at stake. The Covid-19 crisis has shown the fragility of our economic system and its dependence on sustainability factors. Political leaders should show that they have understood the lesson.

If we want to avoid the disruption of the world of tomorrow, we need to invest sustainably today, which in turn requires that we understand that money is a human creation following conventions invented by humans. When it comes to money, governments and private individuals are not in comparable situations, as the former are rules makers and the latter are rule takers. This understanding is essential to get out of the “sustainability of debt vs. sustainability of the world” dilemma.

As the financing of public deficits by the European Central Bank is not permitted under existing rules, a situation where the currently discussed European Recovery Fund would make grants, as opposed to loans, to EU member states is an obvious technical solution. Given the inevitability of an increasing level of public debt regardless of the scenarios and of the policy choices made, this is not the time to dream about so-called budget orthodoxy but the right moment to think about practical and pragmatic solutions that can make our world liveable tomorrow.

Lastly, running a coherent economic system is a prerequisite to investing for a sustainable future. On that front, there are reasons to be worried by the institutionalisation of moral hazard we are witnessing today. Without appropriate conditionality, the massive injection of public money to support the economy in its entirety, and the ensuing emergence of a hybrid economic system looking like a market economy on the upside and a state-run economy on the downside, does not bode well for our ability to build a sustainable world. This point needs to be considered closely by policy-makers before they make their decisions.

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