

Debt Relief

For Europe, the time is drawing near.

BY KENNETH ROGOFF

Eurozone leaders continue to debate how best to reinvigorate economic growth, with French and Italian leaders now arguing that the eurozone's rigid "fiscal compact" should be loosened. Meanwhile, the leaders of the eurozone's northern member countries continue to push for more serious implementation of structural reform.

Ideally, both sides will get their way, but it is difficult to see an endgame that does not involve significant debt restructuring or rescheduling. The inability of Europe's politicians to contemplate this scenario is placing a huge burden on the European Central Bank.

Although there are many explanations for the eurozone's lagging recovery, it is clear that the overhang of both public and private debt looms large. The gross debts of households and financial institutions are higher today as a share of national income than they were before the financial crisis. Nonfinancial corporate debt has fallen only slightly. And government debt, of course, has risen sharply, owing to bank bailouts and a sharp, recession-fueled decline in tax revenues.

Yes, Europe is also wrestling with an aging population. Southern eurozone countries such as Italy and Spain have suffered from rising competition with China in textiles and light manufacturing industries. But just as the pre-crisis credit boom masked underlying structural problems, post-crisis credit constraints have greatly amplified the downturn.

True, German growth owes much to the country's willingness a decade ago to engage in painful economic reforms, especially of

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labor-market rules. Today, Germany appears to have full employment and above-trend growth. German leaders believe, with some justification, that if France and Italy were to adopt similar reforms, the changes would work wonders for their economies' long-term growth.

Yet what of Portugal, Ireland, and (especially) Spain, all of which have taken significant steps toward reform since the crisis? All are still experiencing double-digit unemployment rates amid moribund growth, and, as the last International Monetary Fund Fiscal Monitor made abundantly clear, all still suffer from significant debt problems.

Debt overhang traps countries in a vicious circle. Exceptionally high public and private debts constrain a country's options and are indisputably associated with slower growth, which in turn makes it difficult to escape a debt trap. Last spring's campaign against anyone who dared to worry about the long-run effects of high debt largely ignored the substantial academic literature, just as a remarkably similar recent challenge to Thomas Piketty's research on inequality took no account of a larger body of evidence.

It is true that not all debt is created equal, and there is a strong case for adding more of it if the purpose is to finance highly productive infrastructure investments. Europe greatly lags many Asian countries in its efforts to expand the reach of broadband. Outside the Nordic countries, electricity networks are thoroughly balkanized, and major efforts are needed to integrate them.

Raising debt for the purposes of significantly increasing or ensuring long-run growth makes sense, especially in an environment of low real interest rates. A similar argument can be made for expenditures aimed at improving education, for example to improve Europe's underfunded universities.

Beyond growth-enhancing investment, however, the case for greater stimulus becomes more nuanced. Brad Delong and Larry Summers have argued that in a repressed economy, short-term increases in borrowing can pay for themselves, even if the expenditures do not

directly increase long-run potential. By contrast, Alberto Alesina and Silvia Ardagna argue that in an economy with a large and inefficient government, debt-stabilization measures directed at reducing the size of government can actually be expansionary.

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I admit to being an outsider to this debate. (The word "austerity" does not appear once in my 2009 book with Carmen Reinhart on the history of financial crises.) My general sense, however, is that both views are extreme. In general, neither pure austerity nor crude Keynesian stimulus can help countries escape high-debt traps. Throughout history, other measures, including debt rescheduling, inflation, and various forms of wealth taxation (such as financial repression) have typically played a significant role.

It is hard to see how European countries can indefinitely avoid recourse to the full debt toolkit, especially to repair the fragile economies of the eurozone's periphery. The ECB's expansive "whatever it takes" guarantee may indeed be enough to help finance greater short-term stimulus than is currently being allowed, but the ECB's guarantee will not solve long-run sustainability problems.

Indeed, the ECB will soon have to confront the fact that structural reforms and fiscal austerity fall far short of being a complete solution to Europe's debt problems. In October and November, the ECB will announce the results of its bank stress tests. Because many banks hold a large volume of eurozone government debt, the results will depend very much on how the ECB assesses sovereign risk.

If the ECB grossly understates the risks, its credibility as a regulator will be badly tarnished. If it is more forthright about the risks, there is a chance that some periphery countries might have difficulty plugging the holes, and will require help from the north. One hopes that the ECB will be forthright. It is high time for a conversation on debt relief for the entire eurozone periphery. ◆

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