

## **The debt issue : risk of financial instability and of a lost of trust in money.**

*Olivier Klein was invited by Euro 50 Group, Saturday 12 December, to debate the debt issue in the Euro Zone. Hereafter his speech.*

" First, I am very grateful to Euro 50 for this invitation to debate the issue of debt in the Europe.

As we all agree, budgetary and monetary policies are vital to limit the damage brought about by the pandemic. And everything which has been undertaken had to be. We also know that lowering our guard too hastily would be a serious mistake.

But given the substantial debt resulting from the crisis, should we be concerned about what could happen when the situation returns to normal ? Do not we have to worry about debt ?

The failure to repay public debt to private creditors would have considerable consequences for both the economy and society, impacting household savings and pensions. This is definitely not a correct option. Even supposing now that the law allowed us not to repay the debt to the central bank alone, we would be playing a zero-sum game because the Governments are the shareholders of Central Banks,

We maybe could figure out that the additional debt resulting from the pandemic could be financed on a near-perpetual basis by the central bank at a rate close to zero. But, could we imagine that this possibility could be extended to future increases of public debt?

Then, how does one avoid succumbing to the idea of magic money ? And that, ultimately, since we have found the financial resources for what previously appeared impossible to finance. Under these conditions, there would be no reason for not continuing in this manner.

But a policy of endless quantitative easing would not work and should be rejected. Allowing the state to spend limitlessly, and private agents to amass debt indefinitely with no constraints, would have substantial consequences on the financial instability, thus triggered. With the economy returning to more normal growth, maintaining too low interest rates for too long would be tantamount to encouraging and even engendering financial cycles. This would create even larger speculative bubbles and their inevitable bursts. These well-known phenomena give rise to major crises. This point is crucial. In my humble opinion, we maybe have not sufficiently focused on it up to now. For the last decades, in case of too low interest rates for too long, and/or strong increases in Base Money, we do experience inflation in financial assets and real estate or assets and not inflation of goods and services. In my view, because of globalisation and technological revolution which do not allow salaries and prices to go up. Lastly, in the long term, people could end up turning their back on sovereign currencies altogether. The lack of payment constraints, that is to say of monetary constraints, could lead to a crisis in our trust in money, as the monetary system is essentially a system of debt payments conferring consistency to trade. And it is vital to economic efficiency.

The entire system is based on that trust. Trust, essentially, is the ability to rely on someone's word, or on a signed contract. In this case, contracts for debts and receivables, which underpin the entire system, must be respected. Trust in banks themselves is also crucial. The same applies to trust in central banks. The trust in Central Banks is indeed crucial, because they are in charge of monetary regulation, that is to say in charge of regulating the growth rate of money, the linchpin that holds everything together.

If central banks were to issue too much central banks money for too long and with no limits, a major crisis could arise, similar to the collapse of the "assignat" during the French Revolution for example. Beyond an undetermined threshold, there is a risk that the national or regional currency will be rejected. This would result in the disintegration of the system of debts and receivables, and, in turn, the potential disintegration of our entire society. This trust must be protected, otherwise people may flee to a foreign currency. And even if all the central banks were to do the same thing at the same time, people could potentially take refuge in gold or physical assets such as real estate. The day could even come when one takes refuge in a cryptocurrency issued by a GAFAM having become more solvent than states themselves.

Money is an institution and must be managed as such. It must be founded on trust and rules. Trust and rules are indeed the alpha and omega of sound institutions. By rules, I mean here the repayment of debt, that is to say monetary constraints again. As companies and governments debts are generally repaid by the issuance of new loans, the monetary constraint rests therefore on the obligation to maintain a sustainable debt trajectory. Keeping interest rates extremely low will not suffice alone to ensure this requisite sustainability, first as there are no assurances over the long term that interest rates will never go up again. But also, because incomes can structurally lower or contract during a recession, even in a context of extremely low interest rates.

It is thus possible to suspend monetary constraints temporarily, as it is the case today, but not on a lasting basis. In essence, the set of measures introduced temporarily lifts the monetary constraint from the various economic players, businesses and households, as well as states. Monetary constraint applies in normal periods as it is vital to the efficient functioning of the economy. The sole businesses that are likely to survive in the medium and long term are those that do not make losses in an uninterrupted fashion. Otherwise, economic efficiency would not be possible and no Schumpeterian growth permitted. The same applies to households, which cannot spend more than they earn on a lasting basis.

The legitimacy of central banks thus relies on their capacity of staying above private and state interests. That is to say by guarding against fiscal dominance and financial market dominance, as well. At the end of the day, the duty of central banks, then, is to defend the general interest and safeguard their credibility. Failing this, they will be powerless to make valid use of monetary policy in the event of a further need for expansionary monetary policy. And defending the general interest and safeguarding their credibility is also for the good of the economy and its effectiveness. And for the good of social order itself.

Thank you."

*Olivier Klein*

CEO of BRED and Professor of Financial Macroeconomics and of Monetary Policy at HEC Business School