

Government debt is both unsustainable *and* desirable

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There is no doubt that government debt and deficits are unsustainable. The US, the UK and other industrialised countries now have budget deficits of more than 10% of GDP. With such deficits, government debts are exploding rapidly. Simple extrapolations into the future lead to the conclusion that these debt and deficit levels are unsustainable and that they will have to be reversed to avoid insolvency.

The fact that government debts and deficits are unsustainable, however, does not imply that they are undesirable today. There is no contradiction in the statement that government debt is both unsustainable and desirable. Why is that?

The stark increase in government debt today is a natural consequence of the unsustainable debt explosion in the private sector during the last ten years. Consumers in the US and in a number of European countries, and financial institutions in both the US and Europe accumulated vast amounts of private debt. With the bursting of the bubble, consumers and financial institutions started a painful process of reducing their debt levels. This process of 'deleveraging' is necessary to kick-start the economy again. At the same time, it is only possible if governments are willing to increase their debt levels.

The fundamental insight that private debt levels can decline only if government debt is allowed to increase follows from a 'feedback loop' mechanism, first uncovered long ago by Irving Fisher and John Maynard Keynes. Once the private sector has accumulated excessive debt and everyone suddenly wants to reduce their debt levels at the same time, this will not work. The reason is that they all want to reduce their debt burdens through either asset sales or increased savings or both. But asset sales lower asset prices, thus increasing the solvency problems for the private sector. The private sector will fall into another virtuous circle if it chooses to deleverage through higher savings, as higher savings leads to lower consumption, lower production and less income to save from. In other words: The attempts of the private sector to reduce debt levels and to increase savings can only be successful if governments do the reverse, i.e. if they dissave, or issue more government debt.

Governments in the US, the UK and some European countries have understood this mechanism and have done what governments have to do to unwind the private sector's excessive debt

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levels. But now we increasingly hear that this is irresponsible and that governments should quickly bring down their debts and deficits.

I think this is mistaken. Private debt levels are still unsustainably high. If governments were to respond to these calls and started a fiscal retrenchment today, private debt would not decline further and therefore would remain unsustainable. This would be highly undesirable as it would continue to drag down the economy. In an attempt to reduce debt levels, downward pressure on asset prices would be exerted again, and consumers would continue to try to save more but without succeeding in doing so.

In fact, such a fiscal retrenchment today would in no way guarantee that governments would be able to reduce their debt levels. Deflationary forces would continue to reduce government revenues, creating budgetary problems that would equally become unsustainable.

There is no way out. The uncomfortable truth is that in order for private debt levels to become sustainable again, government debt must temporarily become unsustainable. How long will we have to live with this uncomfortable truth? Until the private sector is willing to stop saving more and until it starts to accumulate new debt. This will occur when the economy turns around again.

Government debt and deficits are necessary today to allow the private sector to unwind its debt, which in turn is necessary to stabilise the economy. The latter incidentally is also necessary to keep government finances on a sound footing.

Unfortunately, this is not the view of the rating agencies that have been downgrading government debt in continental European countries and now threaten to do the same in the UK and the US. They watch in horror as the public debt increases and wave a red flag. All they will achieve is to make it more difficult for governments to assist the private sector in unwinding its debt.

We learn from this that it matters to think systemically and to see the inevitable linkages between public and private debt. Such a systemic thinking allows us to resolve the apparent paradox that the government debt and deficits today are both unsustainable and desirable.