Comments on “Public Debt through the Ages”

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Conference: Sovereign Debt: A guide for Economists and Practitioners

Excellent, stimulating paper

- Provides a historical survey on the origins of sovereign debt
- Then moves to the study of sovereign debt dynamics, focusing on the behavior of debt-to-gdp ratios
- Offers a number of case studies enabling the decomposition of debt/GDP dynamics, using formula by Escolano (2010) (Fiscal Effort, Endogenous Debt Dynamic/Financial Repression, and an adjustment variable).
- Offers me the opportunity to revisit questions which have long fascinated me (Flandreau, Le Cacheux and Zumer 1998).

Delivers many insights

Table 3. Decomposition of Large Debt Increases in Select G-20 Advanced Economies during the Great Depression and the Great Recession

(Contribution to debt increase, percent as share of total)

	Primary balance	Interest-growth differential	Stock-flow adjustment
Great Depression (1928-33)	-9	108	1
Great Recession (2007-13)	67	25	8

1. Debt sustainability

- Discussion is conducted by looking purely at the dynamics of the debt/GDP ratio (increase or decrease), without reference to targets.
- Back in the 1990s, in the context of the adoption of the euro, criteria were produced which distilled “stability” in terms of ratios: Debt/GDP (<60%) and deficit (<3%)
- They were criticized back then on the grounds that the numbers were arbitrary
- But maybe it’s even more serious: Maybe Debt/GDP is not even a relevant concept
- My own research on historical data has convinced me of the limitations of the approach.

- Consider the following case: 2 countries with same GDP of 100 USD both issue perpetual debts for a nominal amount of 100 USD; suppose that the government revenue is 30 USD
  - Country 1 has a good reputation and issues at 5%
  - Country 2 has a bad reputation and issues at 10%

	Country 1	Country 2
Debt/GDP	100%	100%
Debt Service/Government Revenue	16%	33%

- Capacity to pay is not the same as Debt/GDP ratio.

2. Targeting

- Debt burden: $B = \dfrac{Interest\ Service}{Tax\ Revenues}$

  - Interest service is influenced by:
    - Borrowing
    - Interest rates and Reputation (determines interest rate)
    - Exchange rate (determines burden of external debt)
  - Tax revenues are influenced by:
    - Growth rate
    - Fiscal pressure
    - Inflation rate
- Not just primary deficit versus interest/growth relation
- Endogenous/ Exogenous

3. Regimes

- Different periods may admit different regimes (different levels of taxation etc.)
- Role of the geopolitical framework: Pax Britannica:
  - Britain starts the 19th century with a huge debt
  - Needs to reduce it so as to consolidate debt and uphold its imperial position (”Gladstonian finance”)
  - Efforts to repay debts motivated by this logic –“Empire on a shoe-string”
- Likewise, 19th century practice of imposing indemnities on the defeated may have served the purpose of preventing arms race
  - E.g. first indemnity imposed to the French after Napoleonic wars may have served the purpose of rebalancing the debt outlook of the two rival powers
- Today?

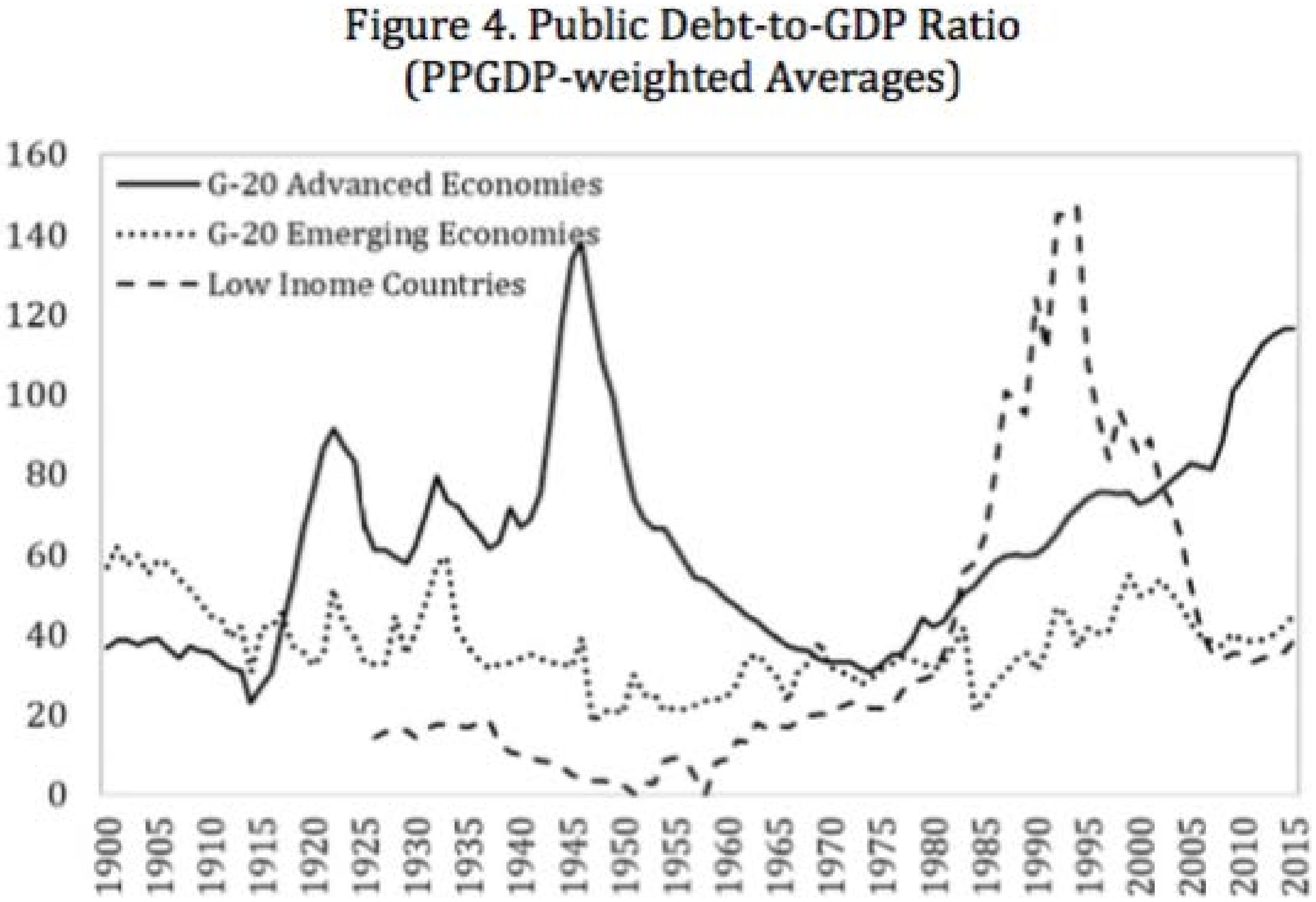
4. Cycles

- Monetary policy and debt dynamics:
  - Accommodating monetary policy may help debt accumulation by lowering interest rates:
  - Expansionary monetary policy can wipe out debt
- Gold Standard:
  - Unexpected inflation (1895-1913) made debts much more sustainable (inflation that was not priced in interest rates when debt was issued). This enabled more borrowing, and facilitated growth.
- Post WWII:
  - Financial repression wiped out the large debts contracted during the war and after

Today:

- Recently: massive government debt increase issued at very low interest rates (arguably because of unconventional monetary policy and the like):
- A debt increase at a low interest rate is much more sustainable than a similar movement at high interest rate: Global monetary policy matters
- Impact of tapering on debt burdens?

5. Public Goods



- One way to think of the record of sovereign debt:
  - The sovereign has off balance-sheet liabilities
  - i.e. claims, that materialize under difficult circumstances
- Four episodes:
  - Geopolitical Security=>
    - WWI (1914-18);
    - WWII (1939-1945)
  - Social security=>
    - “lower productivity growth, expanding welfare states and higher interest rates” (1970-2006)
  - Financial Security=>
    - Global Financial Crisis (2007-2013)
- Problem of funding of public goods: distributional issues

Conclusion

- A lot of the action regarding public debts is not taking place in the debt/GDP spreadsheet
- Look instead at the interface between the market and the government books
- Integrate the politics: Role of regimes, role of distributional conflict, integrates role of monetary policy, etc.