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**

<table>
<thead>
<tr>
<th></th>
<th>Primary balance</th>
<th>Interest-growth differential</th>
<th>Stock-flow adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Great Depression</strong></td>
<td>-9</td>
<td>108</td>
<td>1</td>
</tr>
<tr>
<td>(1928-33)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Great Recession</strong></td>
<td>67</td>
<td>25</td>
<td>8</td>
</tr>
<tr>
<td>(2007-13)</td>
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</table>
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%

<table>
<thead>
<tr>
<th></th>
<th>Country 1</th>
<th>Country 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt/GDP</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Debt Service/Government Revenue</td>
<td>16%</td>
<td>33%</td>
</tr>
</tbody>
</table>

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

• Debt burden: \( B = \frac{\text{Interest Service}}{\text{Tax Revenues}} \)

  • 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

Figure 4. Public Debt-to-GDP Ratio (PPGDP-weighted Averages)
• 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.