The Motives to Borrow

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Sovereign Debt: A Guide for Economists and Practitioners
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The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management
Outline

- Good reasons
- Bad reasons
- Debt, growth, and investment
- Case study: Italy
Good Reasons to Borrow

- Tax smoothing (Gallatin, 1807; Barro, 1979)
- Keynesian stabilization

  - But why debt accumulation?
    - Political incentives can lead to excessive optimism in good times
    - Excessive pessimism during bad times may make the problem worse instead of compensating (Fatás, 2018)

- Asset management and government debt as safe asset (Singapore and Chile)
- Dynamic inefficiency
Debt in G7 countries. Good Reasons to Borrow?
A 10pp increase of the debt-to-GDP ratio is associated with 0.4pp increase in the ratio of public investment over GDP
Bad Reasons to Borrow

- Political failures
  - Political budget cycles
  - Intergenerational transfers
  - Strategic manipulation
  - Common pool
    - From big government to excessive debt accumulation

- Controlling overborrowing
  - Electoral systems
  - Fiscal rules
  - Budget institutions
But when is it too much?

- Even without “bad” reasons to borrow we can end up with a lot of debt
  - Tax smoothing means that basically any exceptionally high spending can be debt financed.
  - Asset management means that if the financial or social return is higher than the interest rate then it is ok to issue debt.

- So where to draw the line?
  - Only when debt sustainability is at risk?
    - Discussed in another chapter
  - What are the other costs of issuing debt?
Public Debt, Investment, and Growth

- Large literature showing a negative correlation between debt and growth (Reinhart and Rogoff, 2010, Cecchetti et al., 2010, Baum et al., 2013, Woo and Kumar, 2015)
  - Assessing causality is more difficult
- Firm-level data provide some evidence of a negative link from public debt to corporate investment (Huang et al., 2017, 2018)
  - Tension between identification and ability to capture the total effect of debt
- Evidence on non-linearities and threshold effects is mixed
  - Cross-country heterogeneity
Debt and Growth in AEs

![Graph showing the relationship between annual real GDP growth and general government debt as a percentage of GDP. The graph displays a negative correlation, with data points scattered around a declining trend line.](image-url)
Debt and Growth in AEs
How debt grows? The case of Italy

I Fiscal policy out of control
II Fiscal policy out of control & money financing
III CB independence with large deficits
IV Primary surplus & lower real rates
V Crisis

5-year moving average Data from Mauro et al. & IMF WEO
How debt grows? Primary Balance in Italy

Missed opportunity

Data from Mauro et al. & IMF WEO
Composition of Public Expenditure in Italy

Data from Mauro et al. & IMF WEO

5-year moving average

Data from Mauro et al. & IMF WEO
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