The Motives to Borrow

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Sovereign Debt: A Guide for Economists and Practitioners

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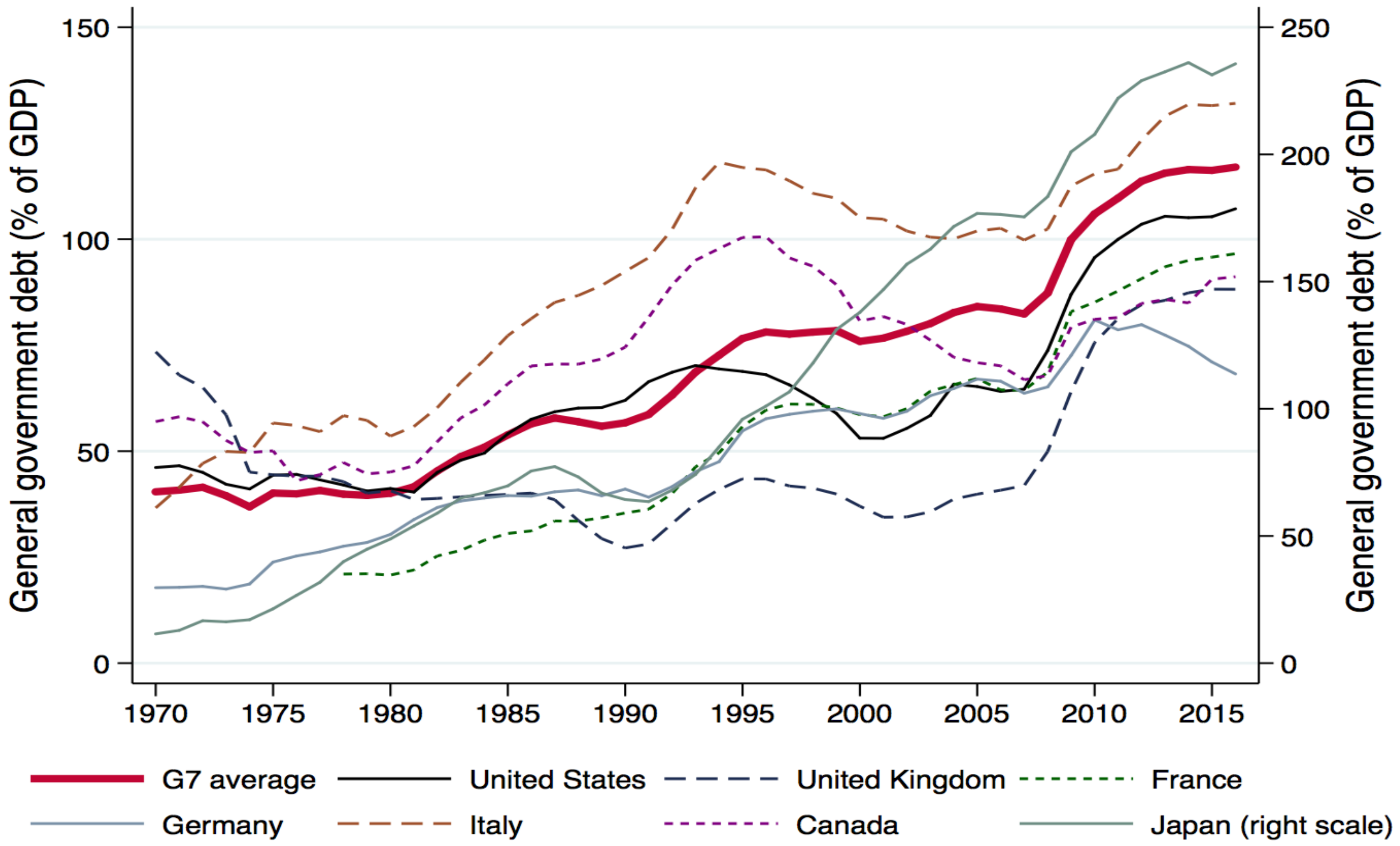
Outline

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

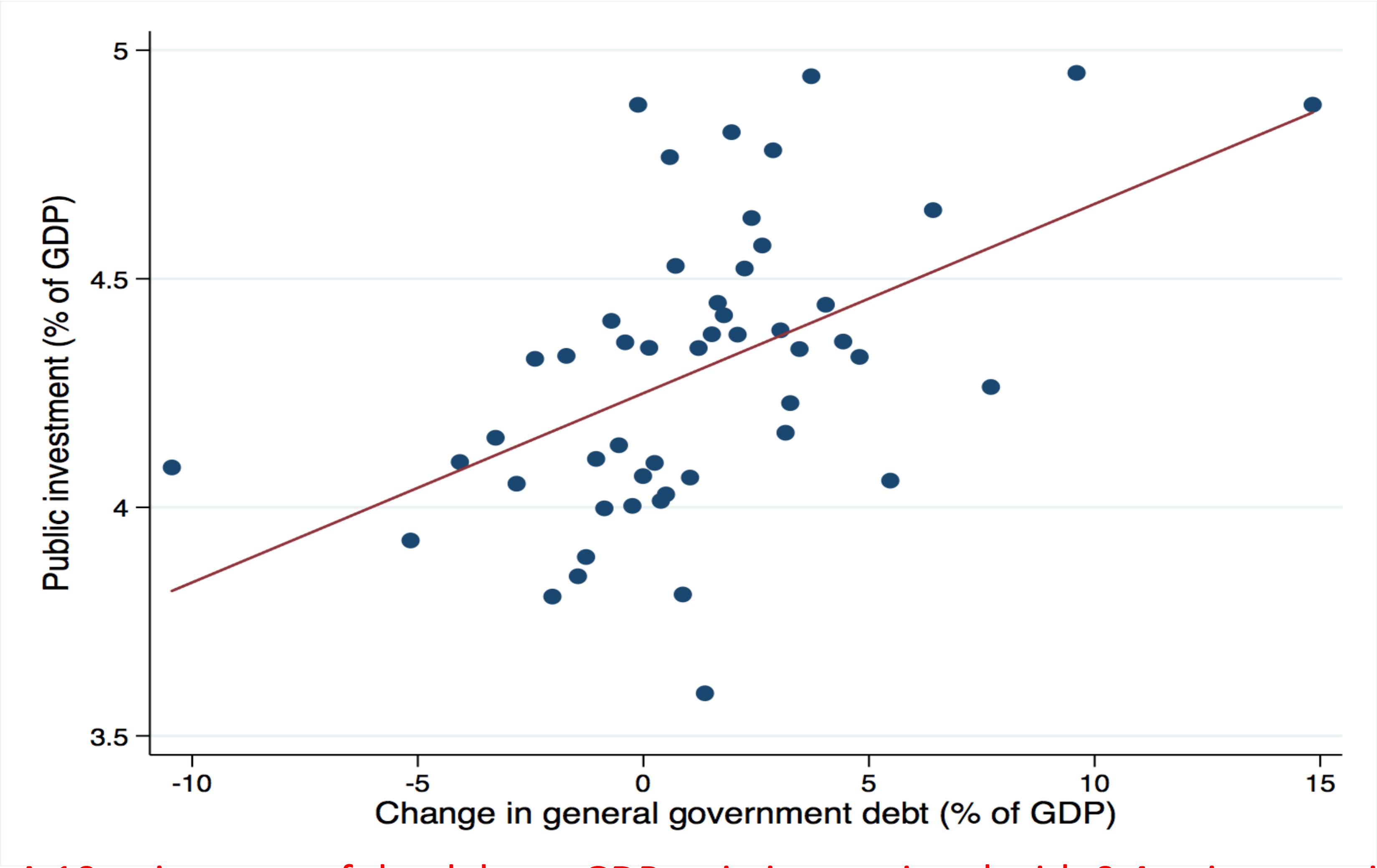
Good Reasons to Borrow

- 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?



Public Debt and Public Investment in AEs



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**

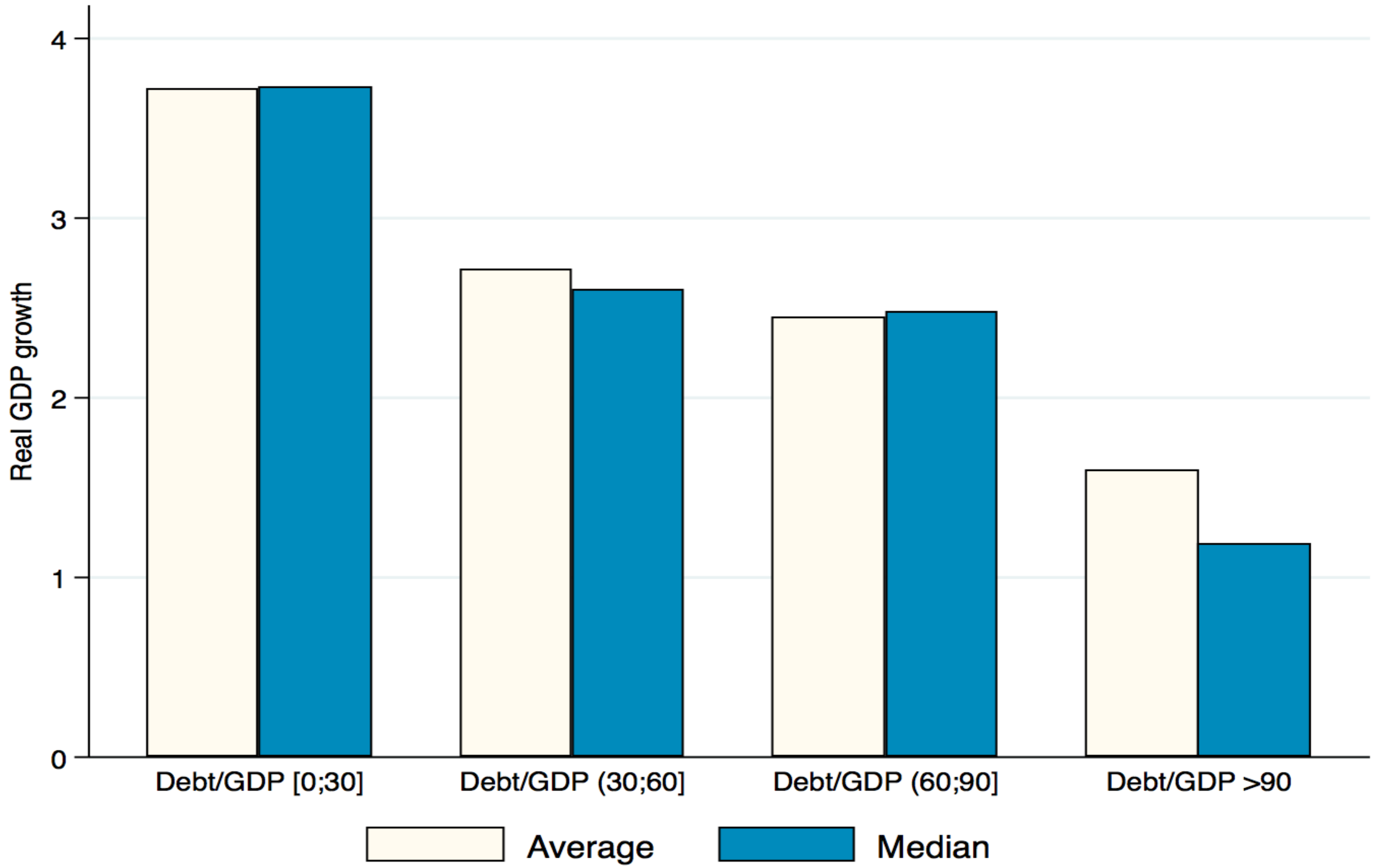
But when is it too much?

- 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?

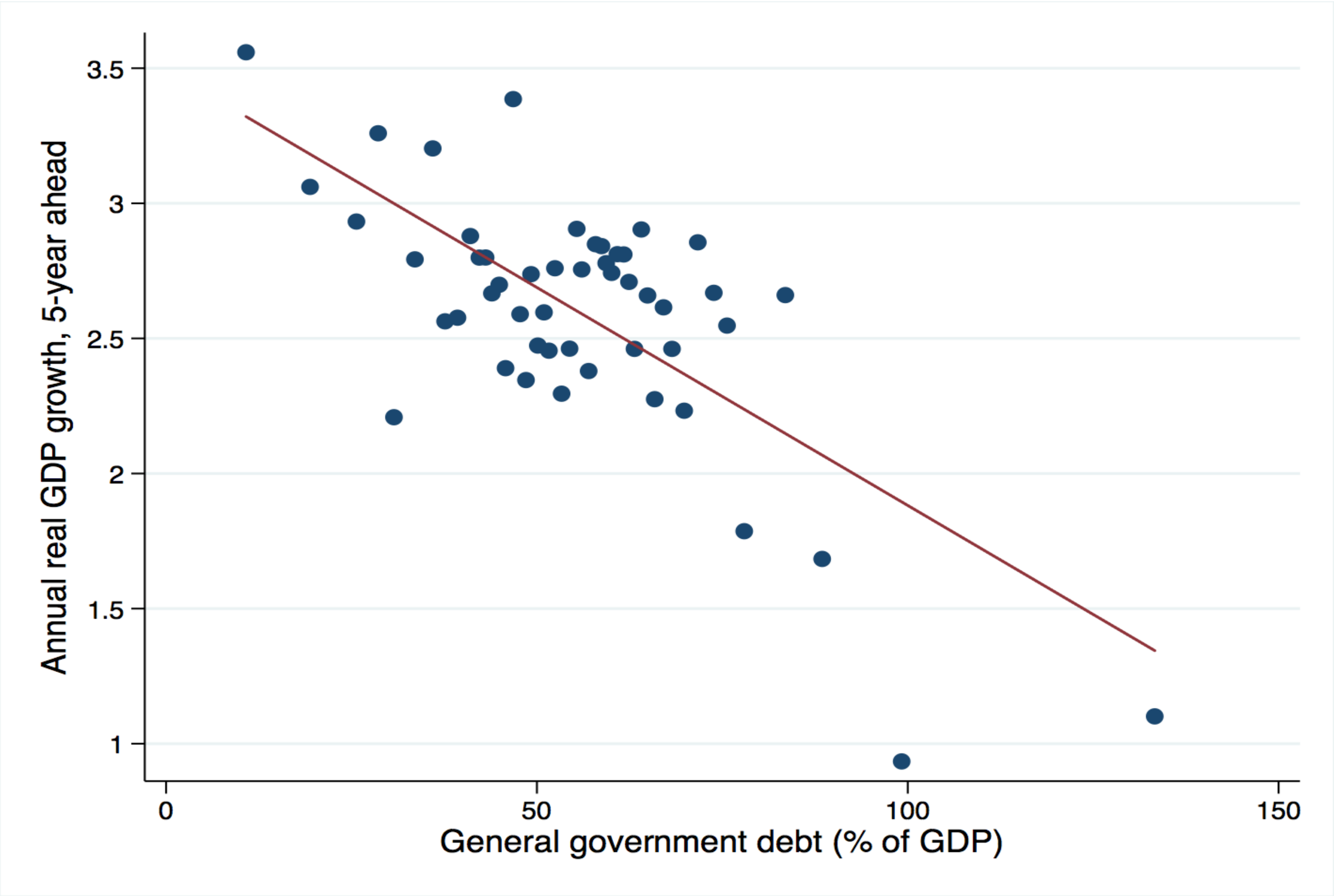
Public Debt, Investment, and Growth

- **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**

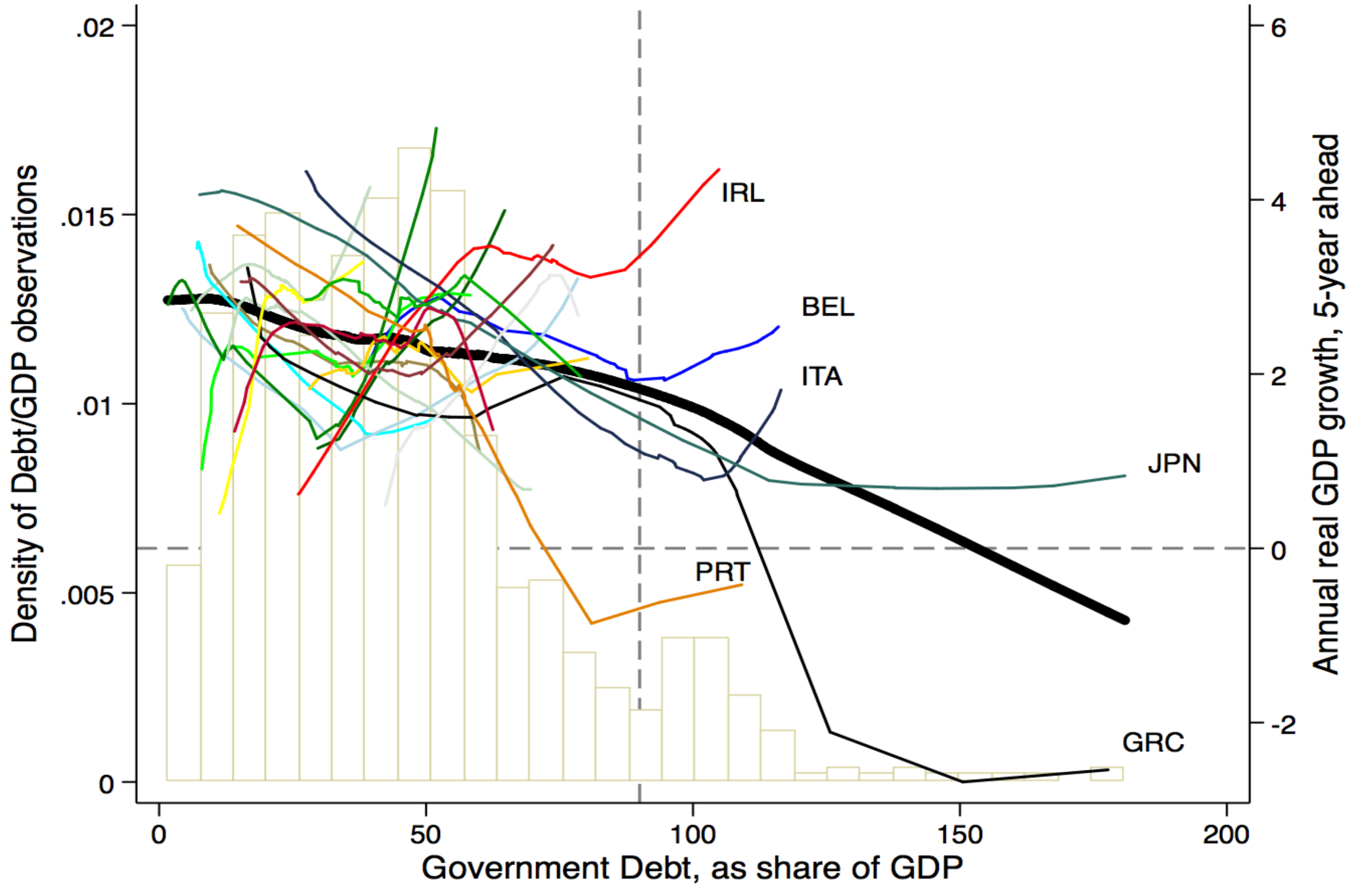
Debt and Growth in AEs



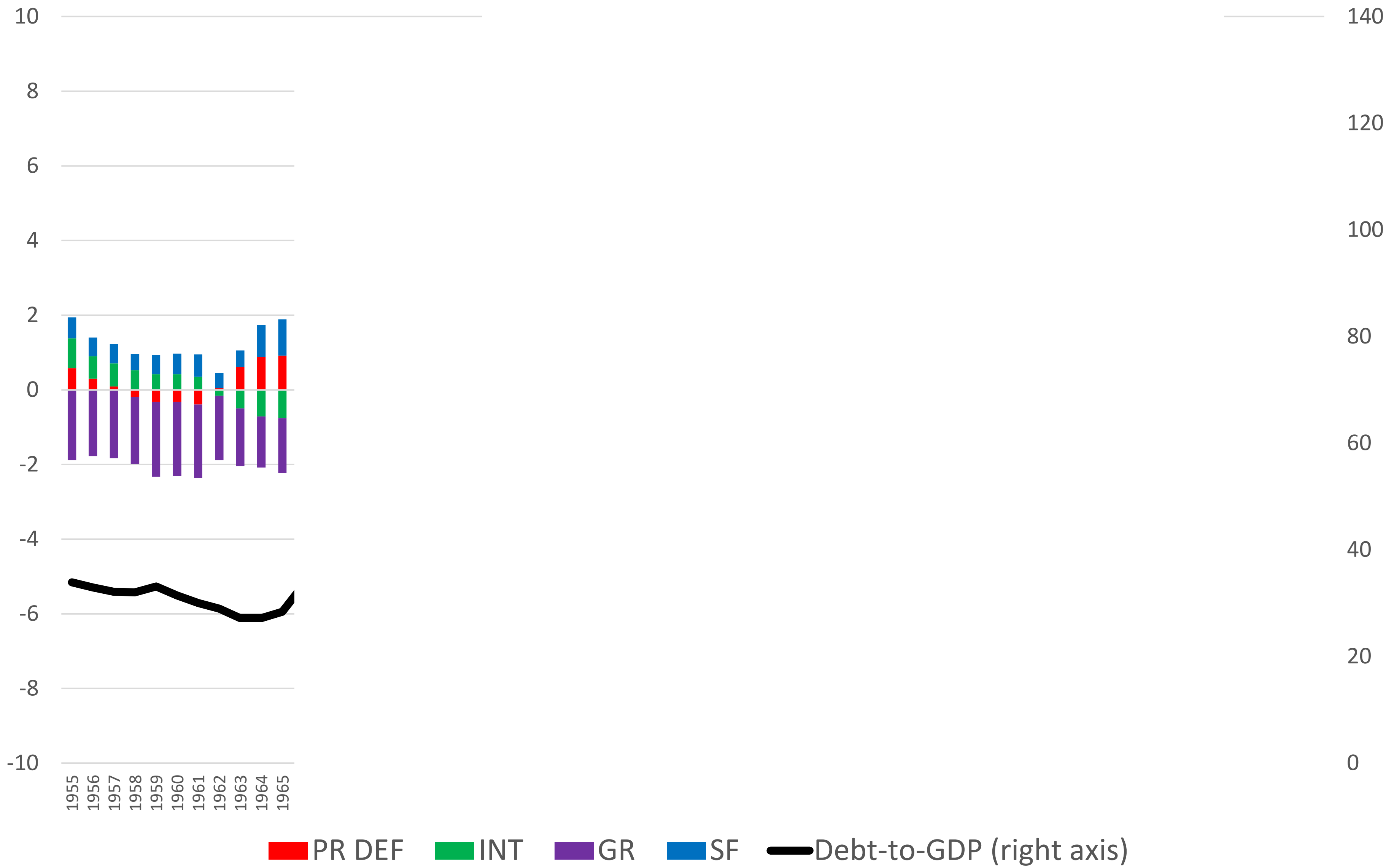
Debt and Growth in AEs



Debt and Growth in AEs



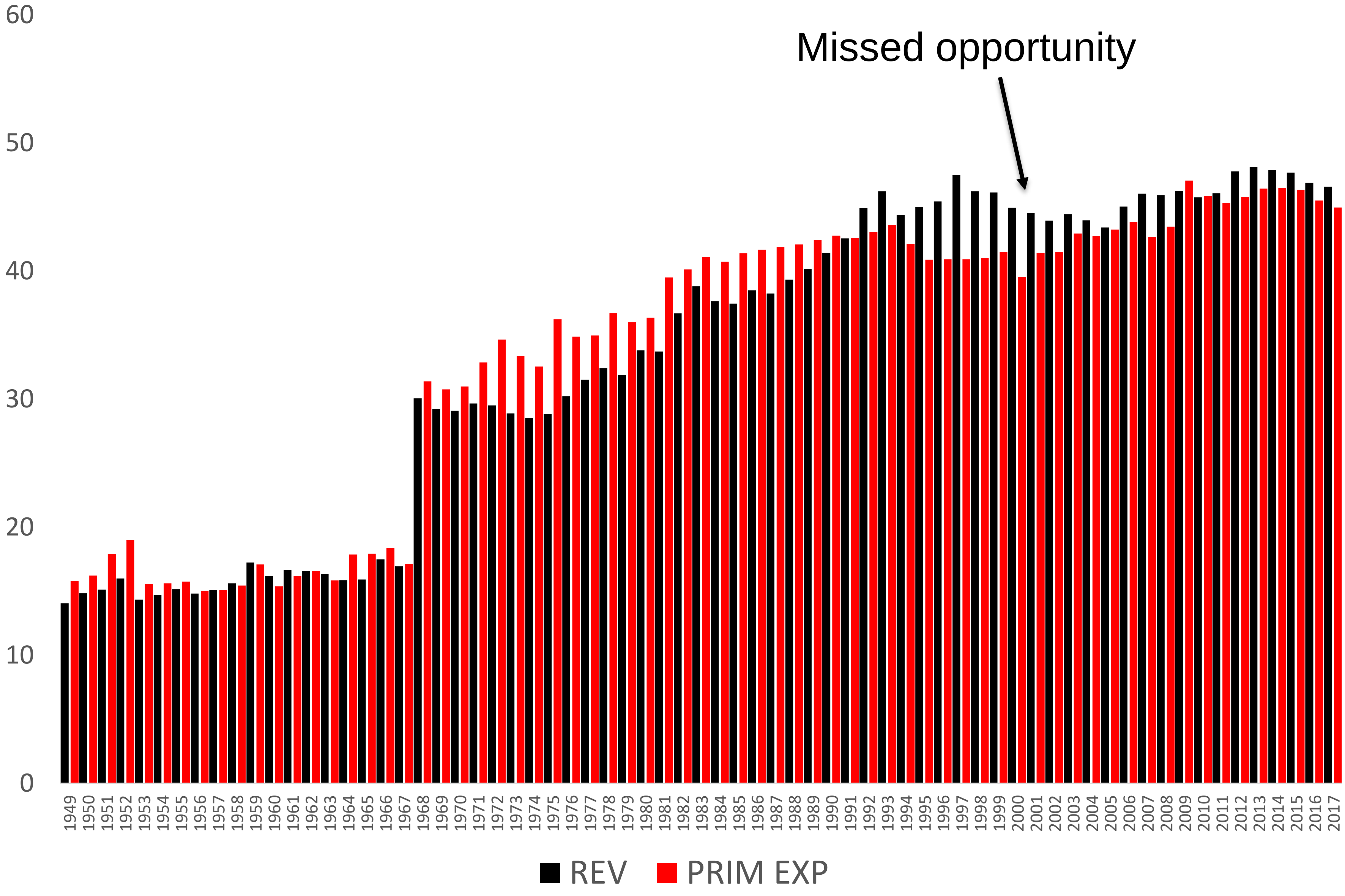
How debt grows? The case of Italy



5-year moving average

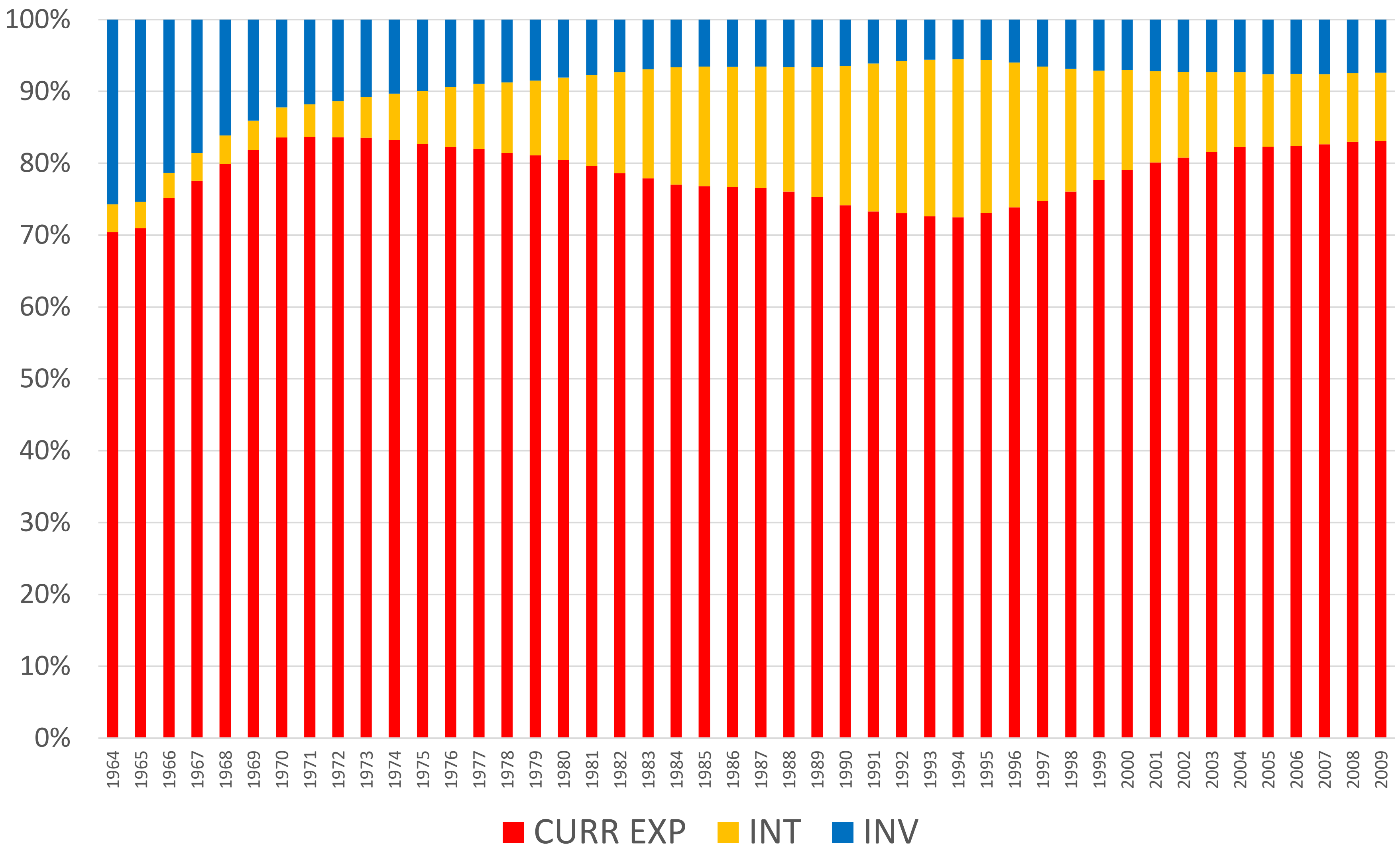
Data from Mauro et al. & IMF WEO

How debt grows? Primary Balance in Italy



Data from Mauro et al. & IMF WEO

Composition of Public Expenditure in Italy



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