REDUCING DEBT, SHORT OF DEFAULT

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Sovereign debt: a guide for economists and practitioners
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A word of warning

Organising framework

- Government debt to GDP ratios are historically quite high
- Some governments may wish to reduce them if they exceed the optimal level or to meet legislative limits
- Debt dynamics equation:

$$\Delta d_t = \frac{1}{1+g_t}\left(\frac{i_t - \pi_t}{1+\pi_t} - g_t\right) d_{t-1} - pb_t + sfa_t$$

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Fiscal consolidation

- Accounts for between 25% (LICs since 2000) and 85% (AEs since 1970) of a typical large reduction in debt to GDP
- Size
  - Sustained primary surplus of 4% GDP are unusual
  - Consolidation may also reduce GDP
- Timing
  - Better to focus adjustment in years when multipliers are low
  - But postponing adjustment may raise doubts over credibility
- Composition
  - No consensus on the tax/spending measures which minimise ST output cost
  - Can be used as an opportunity to improve efficiency of taxation and spending
  - Spending cuts more likely to last if they are targeted
  - Promises of tax hikes more likely to be kept than promises of spending cuts

Growth policies

- Are there free lunches?
  - More likely for LDCs and EMEs
  - Opportunity to overcome collective action problems
  - Need to reduce debt may tip balance towards policies which boost growth but have some welfare-reducing impacts
- Policies
  - TFP-boosting policies give largest scope for gains (e.g. reforms to product, labour and financial markets and trade liberalisation)
  - Reforms to increase human capital (e.g. pro-work welfare systems, education)
  - Pro-investment policies (e.g. tax policy, public infrastructure)
- Prioritisation
  - Focus on policies with largest growth impacts (e.g. based on “growth diagnostics”)
  - Consider direct impact on public finances
  - Plan packages which minimise number of losers

Monetary policy

- Seigniorage
  - Tax on money holdings
  - Absent financial repression, seigniorage rarely generates more than 2-3% GDP per year, even with very high inflation
  - Wide range of estimates of seigniorage-maximising rate of inflation (all high)
- Inflating away
  - Tax on domestic currency debt holders
  - Can be achieved at lower inflation cost under certain conditions
  - E.g. US debt could fall by 20% of GDP over 10 years with inflation averaging 7%
  - Longer debt maturity reduces inflation required for a given reduction
- Costs of inflation
  - Distorted prices
  - Money holdings too low
  - Reduction in financial intermediation
  - Political costs

Financial repression

- Definition and examples
  - Policies which introduce financial frictions and keep government borrowing costs artificially low
  - E.g. ceilings on interest rates, portfolio requirements, capital controls, moral suasion
- Post-WWII repression
  - Evidence of large contribution to debt reduction; large incidence of negative real interest rates
  - UK: restrictions on private sector security issuance and moral suasion on insurers to fund debt
  - Japan: Regulation of interest rates on government debt
  - Growth rates very high during period of repression
- Repression today
  - Central bank purchases of government debt
  - Regulation (e.g. zero risk weight on sovereign debt)

Conclusion

- Most large reductions rely on a combination of these four options
- Consolidation often plays a very important role, despite its unpopularity
- Growth policies are attractive but difficult
- Monetary policy can always contribute, but high inflation is costly
- Repression has been effective in the past and evidence on the macroeconomic costs is limited