

Debt, Debt Crises, Politics, and Currency Unions

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These are my own views

The Euro: manage it or leave it!

Gabriele d'Annunzio University, June 23

d'Annunzio and economics

The tenth Corporation
envisioned in the Charter of
Carnaro (Fiume, 1919) had
solved the economic problem:

“The tenth corporation is
reserved for the mysterious
forces of progress and
adventure. .. to the man of the
future, to the hoped-for
idealization of daily work, to the
liberation of the spirit of man
beyond the panting effort and
bloody sweat of today.



d'Annunzio and debts

- In 1909, creditors foreclosed 47 boxes of books and manuscripts
- Giovanni Pascoli offered to bail him out with a poem titled "La catastrofe"
- In 1910, d'Annunzio escapes to France in order to avoid paying its debts



Outline

- Debt and politics in tranquil times
- Debt and politics during crises
 - When defaults cannot be avoided
 - When defaults can be avoided
- The politics of the resolution of sovereign defaults

Debt and Politics in Tranquil Times

- Politics and deficit (debt) bias
 - Because of excessive optimism
 - Not enough savings in good times
 - Remember the official reason for Greenspan's support of tax cuts during the Bush administration
 - Because issuing debt allows to postpone difficult decisions
 - Because of strategic considerations
 - Why would Ronald Reagan run a large budget deficit?

Solutions

- Budgetary institutions
 - Smart budgetary rules
 - Transparency rules
 - Hierarchical rules
- Like motherhood and apple pie, these are great things...

...but they may not be enough

- The relationship between deficit and debt is not as tight as you may think
- Low debt is not enough

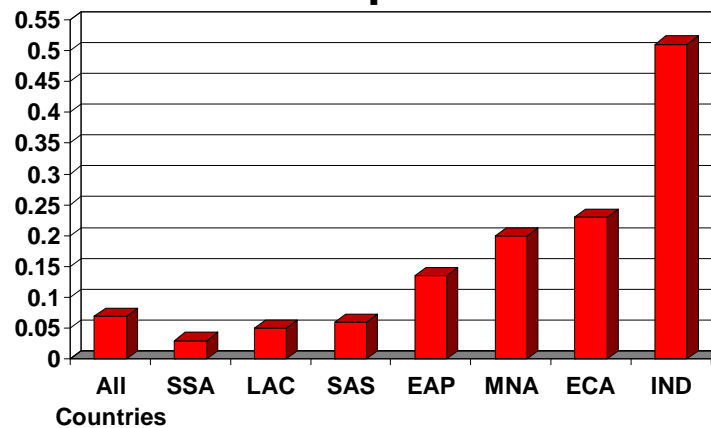
How Debt Grows?

- The economics 101 debt accumulation equation states that:
 - ***CHANGE IN DEBT = DEFICIT***
- Practitioners use:
 - ***CHANGE IN DEBT = DEFICIT+SF***
 - ***SF***=Stock-flow reconciliation, or the unexplained part of public debt
- The stock-flow reconciliation is often considered a residual entity of small importance
- Is it?

If we estimate: $\Delta D_{i,t} = \alpha_i + \beta d_{i,t} + \varepsilon_{i,t}$

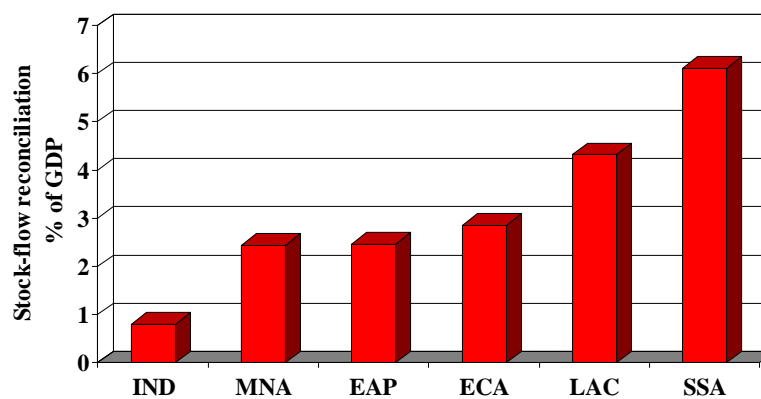
We expect: β and R^2 to be close to 1 and $\alpha = 0$

R-Squared



Source: Campos, Jaimovich and Panizza (2006)

The Unexplained Part of Public Debt



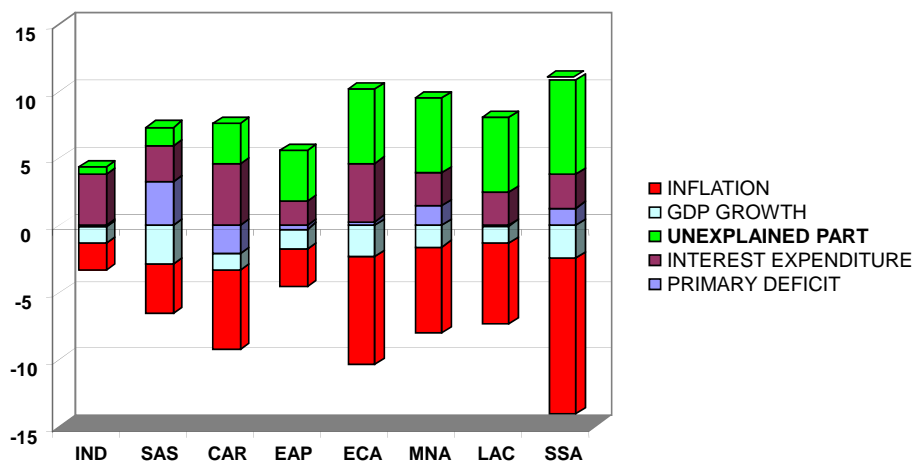
Source: Campos, Jaimovich and Panizza (2006)

The Unexplained Part of Public Debt

- The growth rate of the debt-to-GDP ratio is equal to:
 - Primary deficit/GDP + interest payments/GDP+
– GDP growth – inflation
 - The last two variables are multiplied by the debt-to-GDP ratio
- If you like math:

$$\Delta\left(\frac{D}{Y}\right) = \frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + i \frac{D_{t-1}}{Y_t} - (g + \pi) \frac{D_{t-1}}{Y_t} + \frac{SF_t}{Y_t}$$

The Unexplained Part of Public Debt



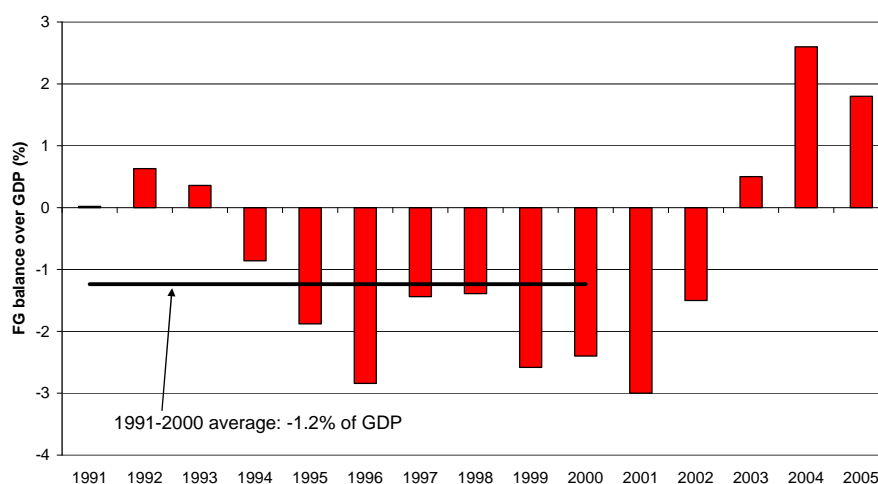
Source: Campos, Jaimovich and Panizza (2006)

The Unexplained Part of Public Debt

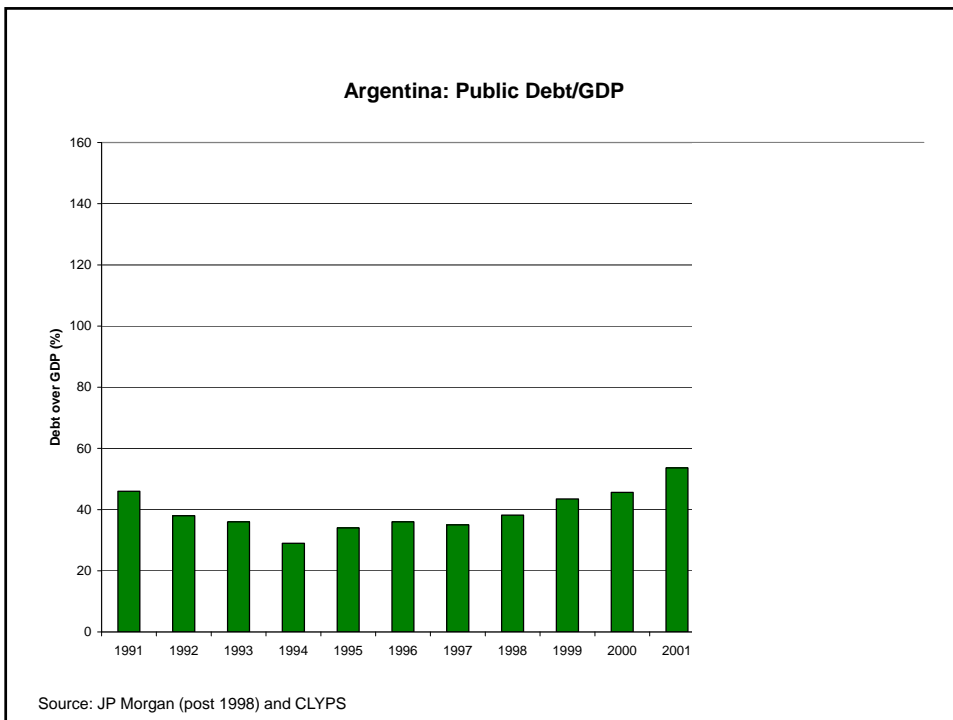
- What explains the “Unexplained” part of debt
 - **Skeletons**
 - Fiscal policy matters!
 - Transparent fiscal accounts are important
 - **Banking Crises**
 - **Balance Sheet Effects** due to debt composition
 - In the presence of foreign currency debt, currency devaluations lead to sudden debt explosions

Example: Argentina

Argentina: Federal Govt. Balance over GDP



Source: JP Morgan (post 1998) and ECLAC (pre 1998)



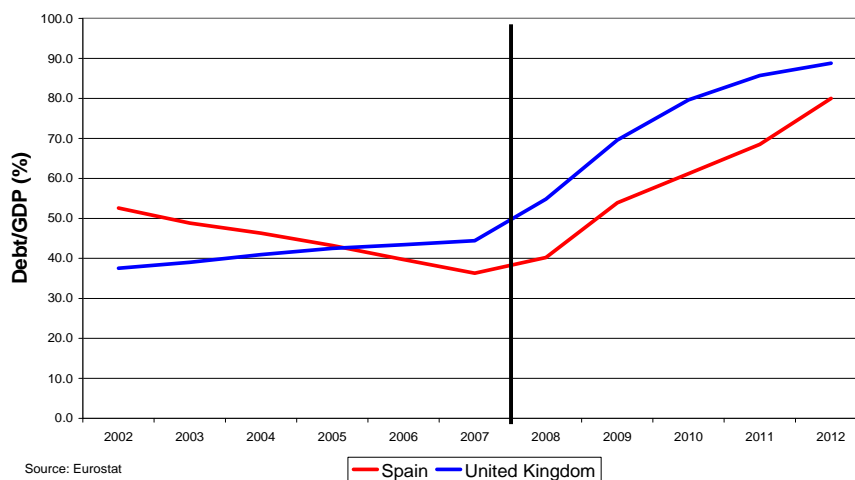
From:
It's Mostly Fiscal
to:
INAF
It's Not Always Fiscal

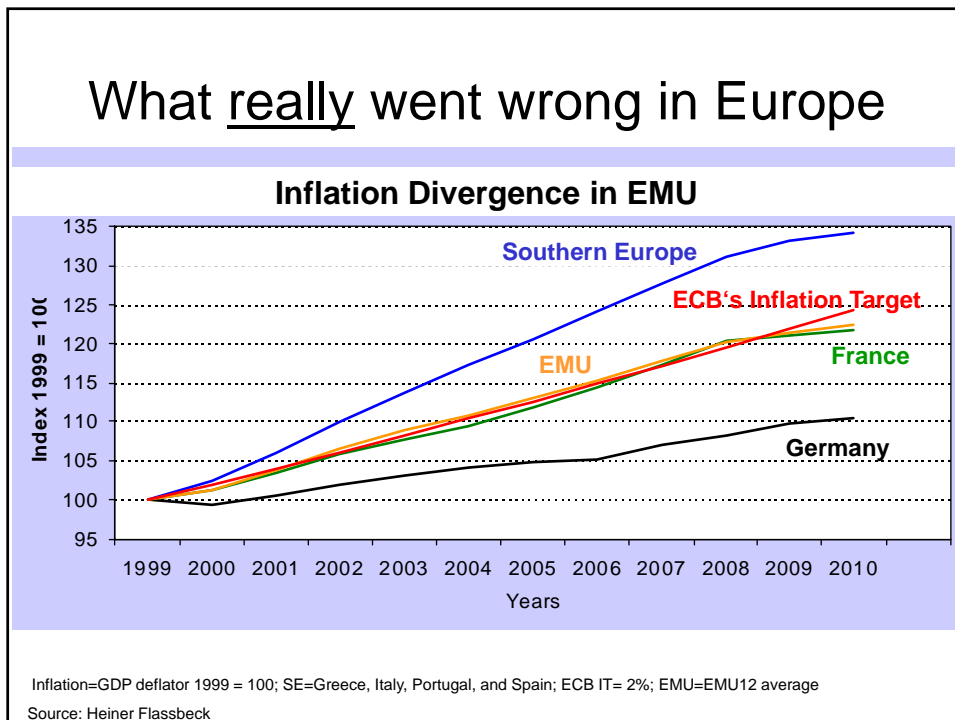
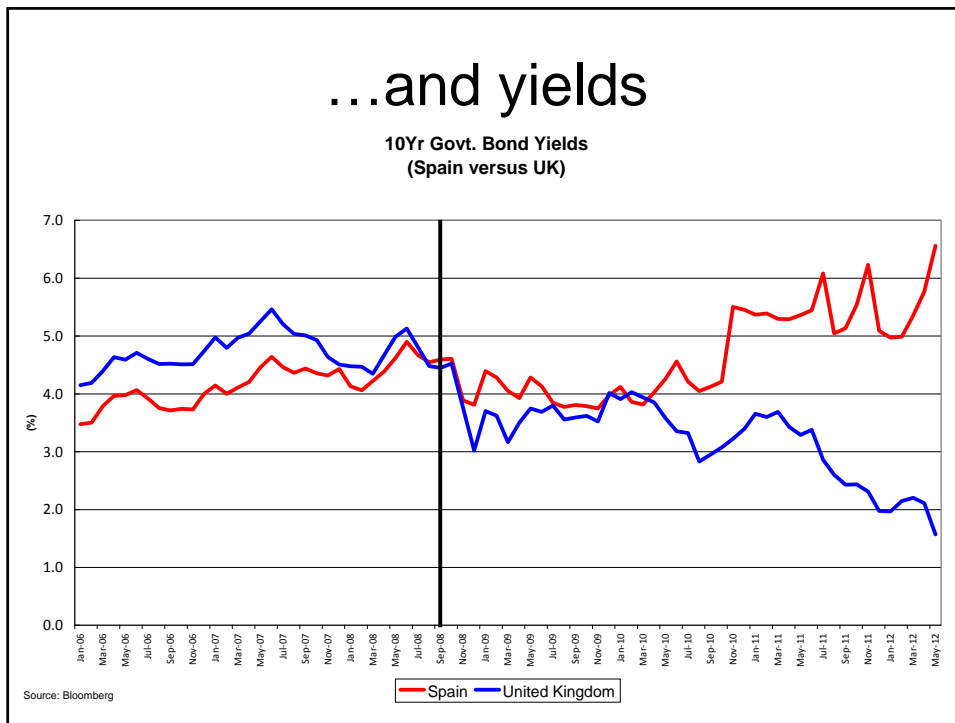
... but they may not be enough

- The relationship between deficit and debt is not as tight as you may think
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 - Example: UK versus Spain
 - (with thanks to Paul De Grauwe)

Debt ...

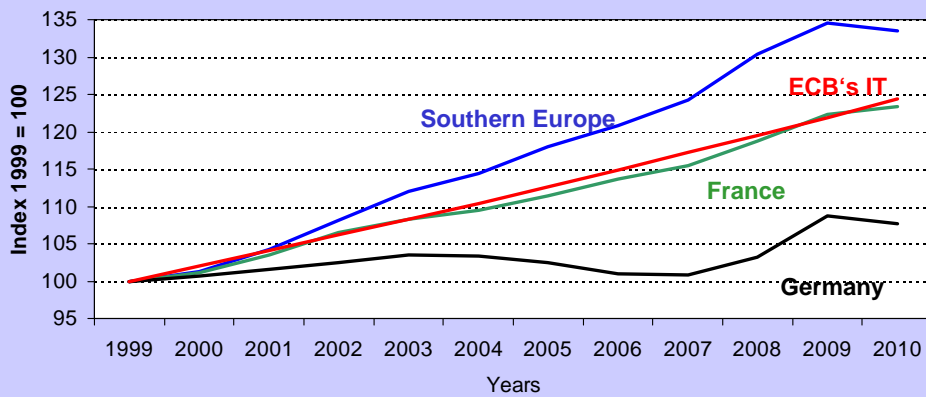
Total Gross Public Debt/GDP
(Spain versus UK)





What really went wrong in Europe

Unit Labor Costs



Source: Heiner Flassbeck

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The politics of sovereign default

- Policymakers (domestic and international) have strong incentives to gamble for redemption and delay the moment of reckoning
 - Borensztein and Panizza (2009), Levy Yeyati and Panizza (2010)
 - *The problem historically has not been that countries have been too eager to renege on their financial obligations, but often too reluctant.*
 - Memo prepared by the Central Banks of England and Canada (Source: Bluestein, 2005, p 102)
- And this is bad because it prolongs the economic crisis and reduces recovery value
 - For both economic and political reasons
- Everybody is worse off

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The politics of crisis packages

- Packages often come with:
 - Requests for fiscal consolidation
 - Not “too much” money
 - Interest rates which are above the opportunity cost of funds
- Does this approach make sense from an economic point of view?
- I will argue that it does not

Fiscal consolidation

- Rationale (1)
 - They need to put their house in order
- But...
 - Was the crisis caused by fiscal misbehavior?
 - We saw that in many cases, fiscal policy was not the problem

Fiscal consolidation

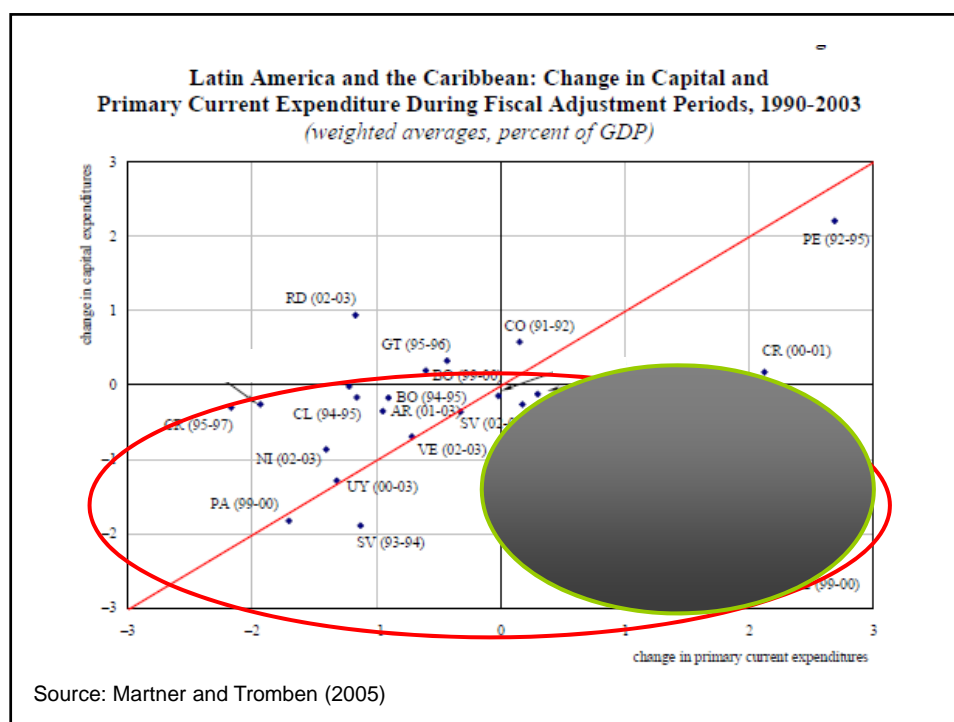
- Standard answer:
 - Yes, but now the debt is high and things have changed!
 - Think about the math:

$$\Delta d = -ps + (i-g)d$$

- Assume LT growth 2% and LT interest rate 3%. Then, if debt increases by 50% of GDP, **ps** needs to increase by 0.5% of GDP
- Also, multiple equilibria (high i and low i)
 - Should "bailouts" have punitive interest rates?
- More on this in a minute

Fiscal consolidation

- Moreover
 - Even when the source of the problem was fiscal misbehavior, sustainable fiscal policy is a long-term concept
 - Short-term restrictive policies may be counterproductive because
 - They may worsen the crisis
 - They may be reversed as soon as the situation improves and the country no longer needs international assistance
 - Success requires addressing the political distortions that led to the unsustainable long-term policy stance



...and this may be bad for growth,
and for the fiscal adjustment

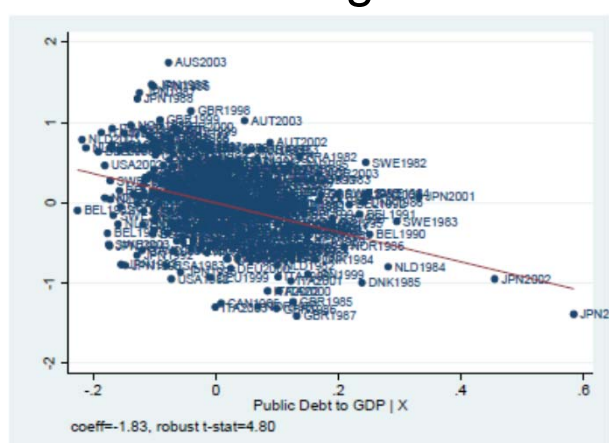
When growth-promoting spending is cut so much that the present value of future government revenues falls by more than the immediate improvement in the cash deficit, fiscal adjustment becomes like walking up the down escalator.

(Easterly, Irwin, Serven, 2008)

Fiscal consolidation

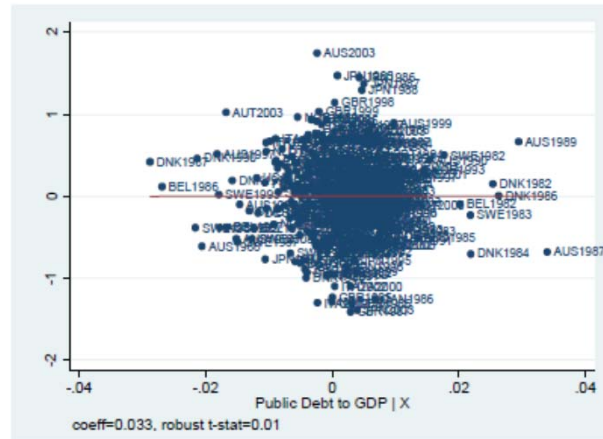
- Rationale (2)
 - High public debt is bad for growth
- But...
 - No evidence on the causal effect of public debt on growth

The correlation between public debt and growth



Source: Panizza and Presbitero (2012)

The causal effect of public debt on growth



Source: Panizza and Presbitero (2012)

Interest rates above opportunity cost and not “too much” money

- Rationale (1)
 - Need to protect our own taxpayers
- But...
 - The smaller the size of the package and the higher the interest rate, the less likely the success of the package
 - (higher risk for the taxpayer)

Interest rates above opportunity cost and not “too much” money

- Rationale (2)
 - Avoid moral hazard
- But...
 - Do you really believe that politicians are so farsighted?
 - Bagehot was right for banking crises, but he may be wrong for sovereign debt crises
 - Moral hazard is often overstated (Meltzer *versus* Krugman)

Why do we observe actions that go against economic logic?

- Wrong economic model
 - Some countries and economists still live in the shadow of the Treasury view
- Politics
 - In this case, not politics in the crisis country, but politics in the “strong” countries
 - Electors want a pound of flesh

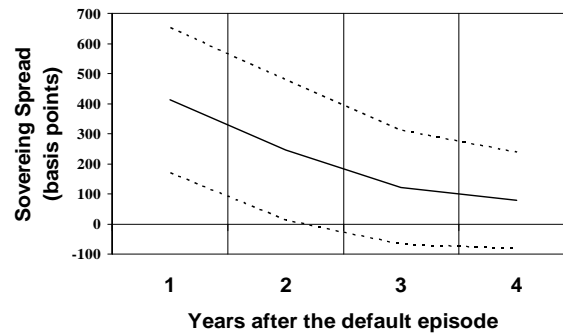
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Problems with the current non-system for the resolution of sovereign debt crises

- Debt renegotiations take too long, their outcome is uncertain and, in general, they do not restore debt sustainability
- Creditors' coordination and the holdout problem
- Lack of private interim financing
- Overborrowing caused by debt dilution
- Delayed defaults

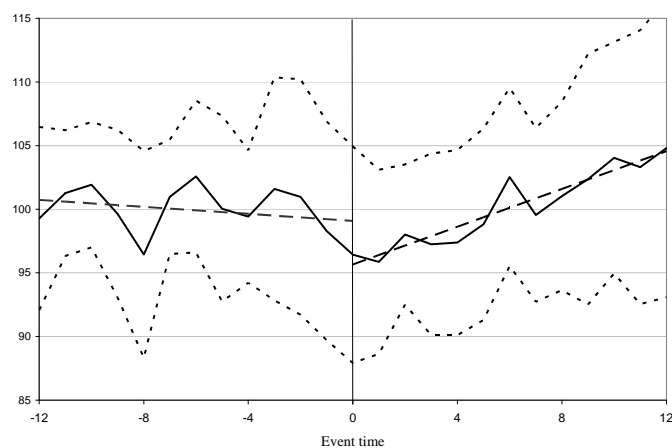
The costs of defaults are hard to find: Reputation



- 3 years after the resolution of a default episode, there is no statistically significant difference between the spreads paid by defaulters and non defaulters
- We find similar results if we look at access
- Global factors (risk aversion and US interest rate) appear to be more important than default history

Source: Borensztein and Panizza (2009)

The costs of defaults are hard to find: GDP growth



Source: Levy Yeyati and Panizza (2010)

Why delayed defaults?

- Two possible stories
- Bad politicians
 - Defaults have a political cost and politicians have an incentive to gamble for redemption
- Good politicians

Why delayed defaults?

- Good politicians
 - Strategic defaults have large reputational costs but unavoidable defaults are excused
 - (Theory: Grossman & Van Huyck, 1988; Evidence on the costs of default: Borensztein and Panizza, 2009)
 - Countries use self-flagellation to signal that the default is unavoidable
 - This is inefficient
 - A structured mechanism could “certify” unavoidable defaults, avoid unnecessary suffering and, by increasing recovery values, reduce borrowing costs
 - A possible answer to Dooley’s dilemma

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