

# **DOES EXCESSIVE SOVEREIGN DEBT REALLY HURT GROWTH?**

**Yeva Nersisyan and L. Randall Wray  
University of Missouri - Kansas city**

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# Deficit Hysteria

“Although fiscal consolidation may imply costs in terms of lower economic growth in the short run, the longer-run beneficial effects of fiscal consolidation are undisputed.” (*ECB, Monthly Bulletin, June, 2010*)

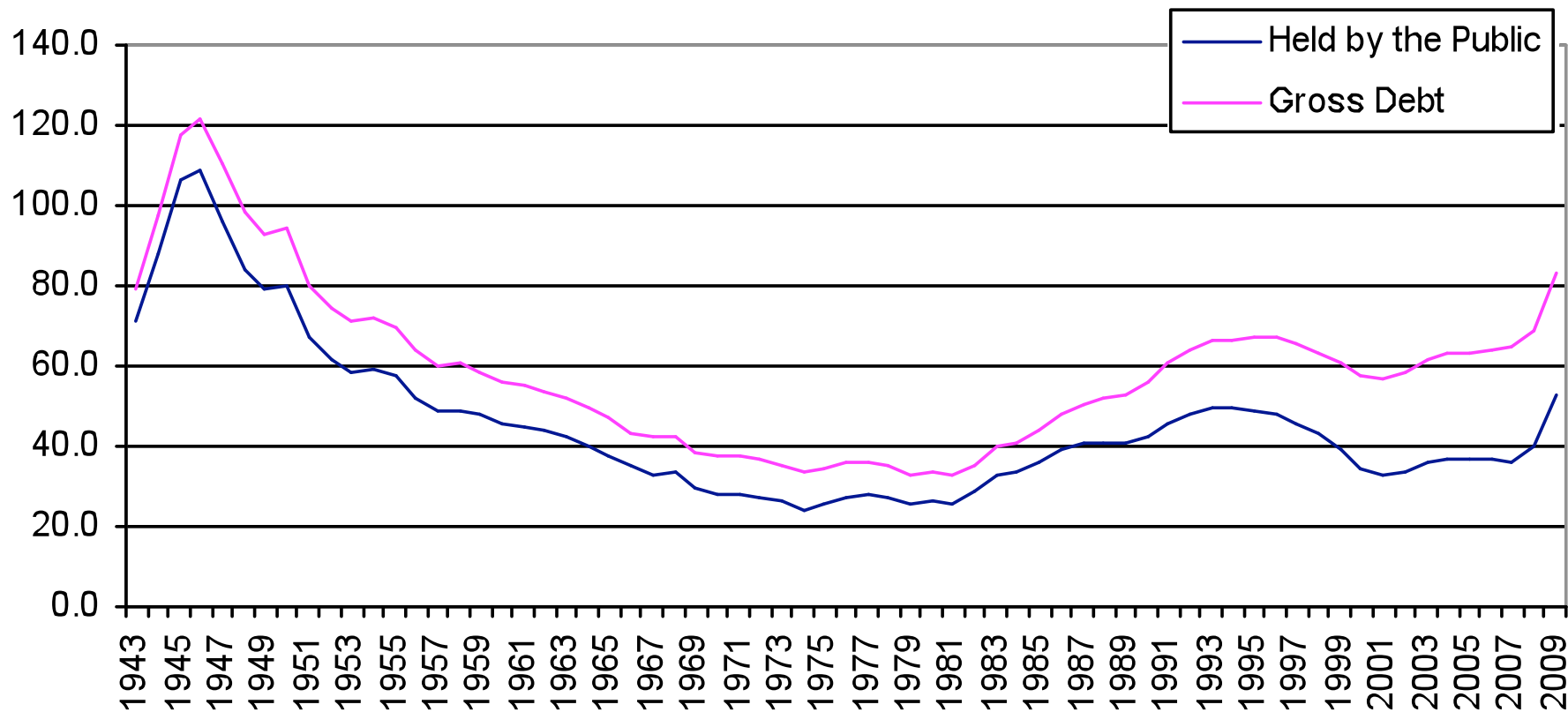
“Fiscal adjustment is key to high private investment and long-term growth. It may also be key, at least in some countries, to avoiding disorderly financial market conditions, which would have a more immediate impact on growth, through effects on confidence and lending.” (*Blanchard and Cottarelli, Ten Commandments for Fiscal Adjustment in Advanced Economies, IMF Direct, June 24, 2010*)

# WHY BABIES CRY AT BIRTH...



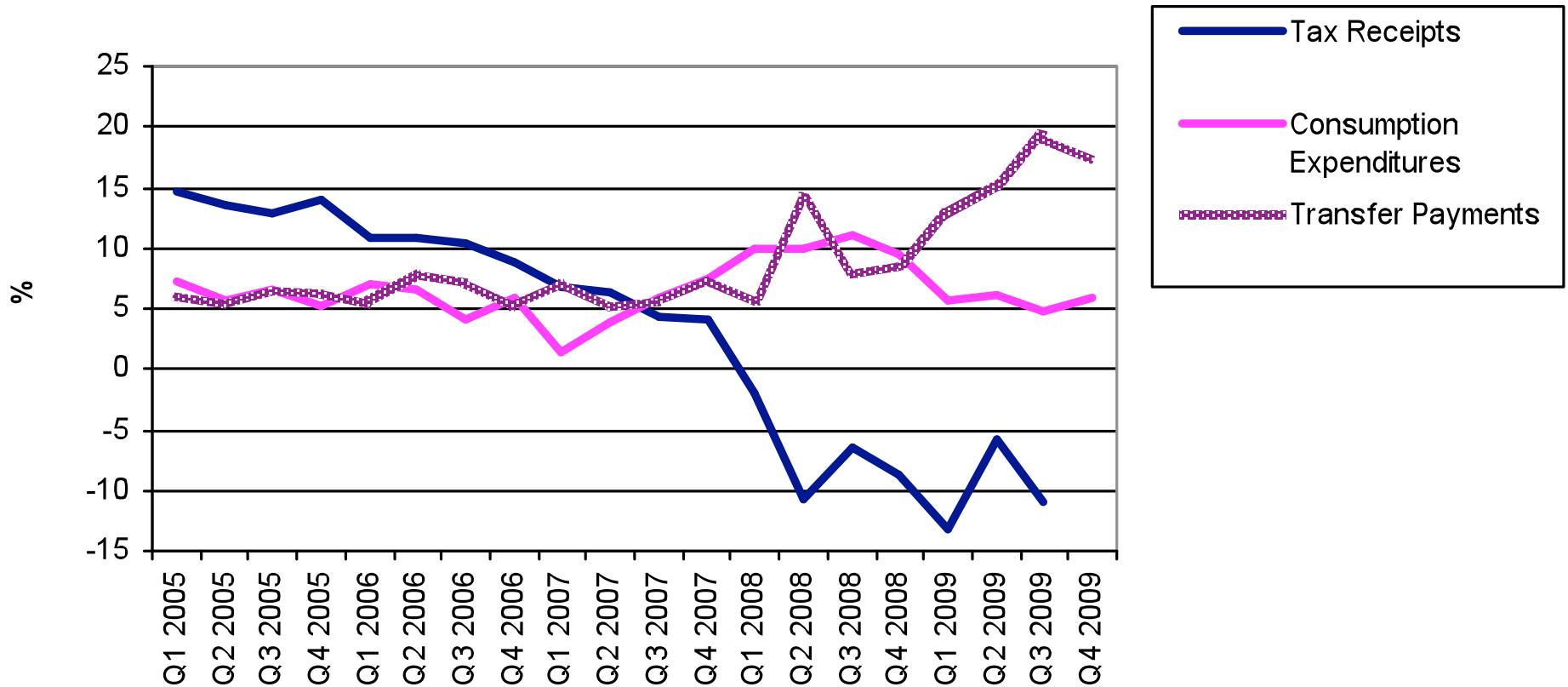
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## Federal Government Debt 1943-2009 (% of GDP)



Source: Economic Report of the President 2010 and authors' calculations

## Federal Government Tax Receipts, Consumption Expenditures and Transfer Payments (Growth Rate Relative to the Same Quarter of the Previous Year)



Source: Bureau of Economic Analysis and Authors' Calculations; Tax Receipts Data Unavailable for 2009 Q4

# Two main problems with government deficits and debt

- Sustainability issue
  - Relations among interest rates and economic growth
  - Excessive Deficit-to-GDP and Debt-to-GDP ratios
  - Inflation tax
- Growth issue
  - Crowding out effect
  - Ricardian equivalences
  - Inefficient use of resources by governments

# This Time is Different – Reinhart and Rogoff

- Used by a number of commentators to argue that U.S. deficit and debt are unsustainable and to draw parallels with Greece
- WSJ called it “one of the most important economics books of 2009”
- Empirical evidence of the relations among debt, financial crises, inflation, currency crashes and sovereign defaults
  - Claim to cover eight centuries and sixty-six countries
  - Identify 250 sovereign external defaults and 70 defaults on domestic public debt
  - “Serial default” is the norm through history and around the globe -- with almost no “default virgins”

# Growth in Time of Debt

- Developed and Developing Countries:
  - Beyond a debt/GDP ratio of 90% growth suffers with median long term growth falling by 1% point and average growth falling by more.
- Developing Countries:
  - Growth falls by 2% point when the ratio of externally held government debt to GDP hits 60%.
  - Growth becomes negative at a ratio beyond 90%.

# Misgivings

- Exchange rates, monetary regimes and institutions vary significantly over the covered period
  - e.g. last time the U.S. defaulted was in 1933 when it was on a gold standard and had a very small government (6% of GDP)
- Classify debt as domestic and foreign based on the ownership of the security not the currency of denomination
  - Although there is some recognition of the importance of the currency of denomination, the data is not categorized on this basis

# Misgivings

- Use average and median Debt/GDP values across different countries and time periods to draw conclusions about debt and growth in general
- Average growth rates higher at mid-range levels of debt (60-90% of GDP) than at low levels of debt (30-60% of GDP)
- Growth rates didn't deteriorate for some of the countries in their sample at levels of debt over 90% - no explanation
- Not enough observations
  - only 2.3% of observations for the U.S. were for debt/GDP above 90% (3 of these were for 1945, 1946 and 1947)

# Misgivings

- Explanation in terms of the Ricardian Equivalences
  - Correlation doesn't mean causation
  - US debt held by the public increased from 36% of GDP in 2006 to about 52% of GDP by 2009 largely due to automatic stabilizers
- Add together public and private external debts
  - If it's denominated in domestic currency the only thing that matters is private debt
  - If it's denominated in foreign currency then external debt can be dangerous even at low levels of debt since it depends on the ability to earn foreign currency

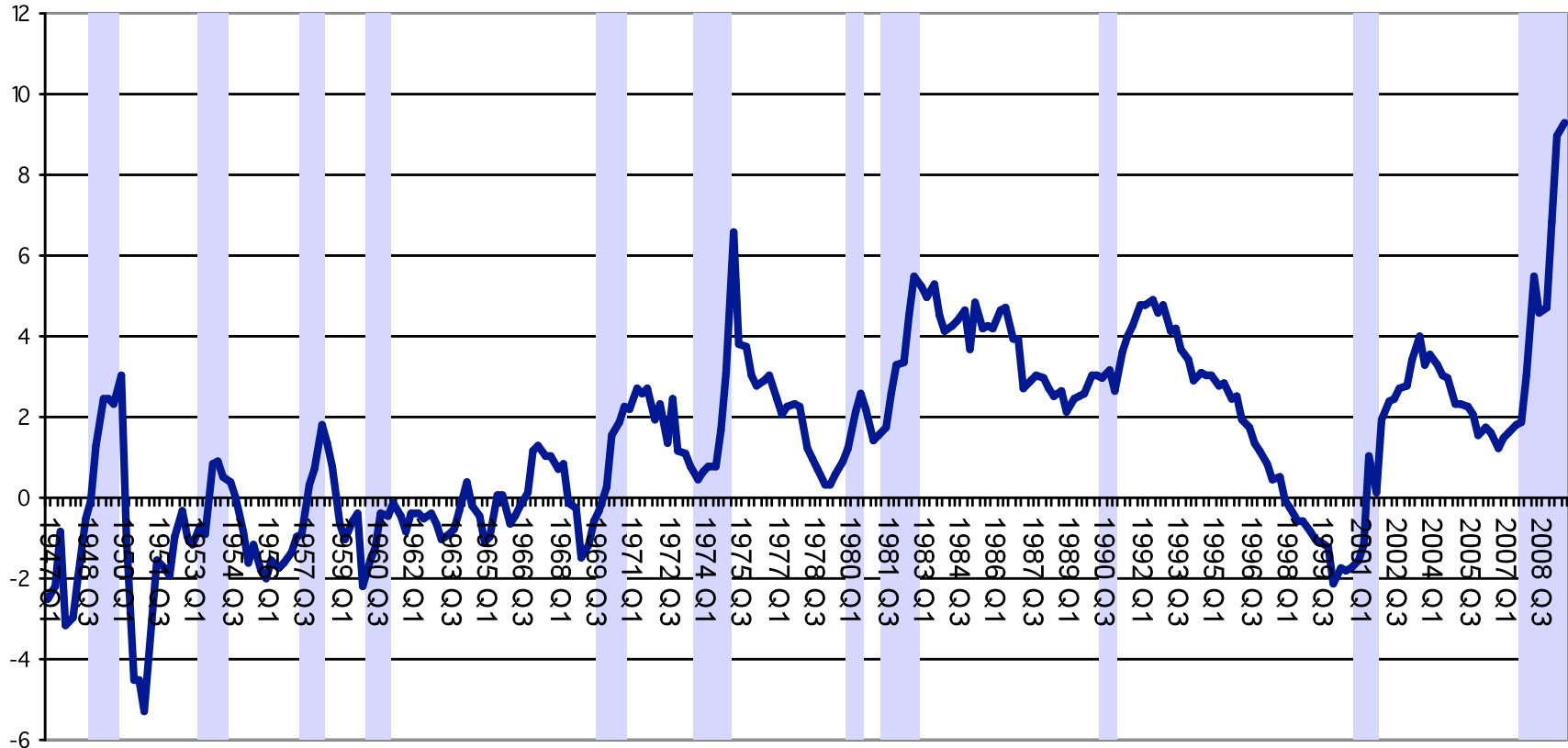
# Debt is Debt...or Is It?

- Important distinction is the currency of denomination not ownership
  - Why do countries convert foreign currency liabilities into domestic currency during crisis?
  - Case of Japan
  - Divide countries *not* into developed and developing but sovereign and non-sovereign
- When a country pegs its currency to another currency/ metal it is constrained in its ability to spend
  - Extreme case – Eurozone - loss of currency sovereignty
- Reinhart-Rogoff results *may* be applicable to foreign-currency denominated debt or to a country like Greece or Germany but not to the U.S. or any other sovereign currency issuing country

# Deficits and Debt

- Government deficit mirrors what goes on in the non-government sector
  - If the non-government sector wants to net save the government balance automatically goes into deficit
- The Rogoff-Reinhart classification exposes their misunderstanding of what government “debt” is
  - An interest paying liability of the government and an asset for the private sector
- Bonds are merely a “savings” account at the Fed and hence it’s not important whether there are takers for the debt

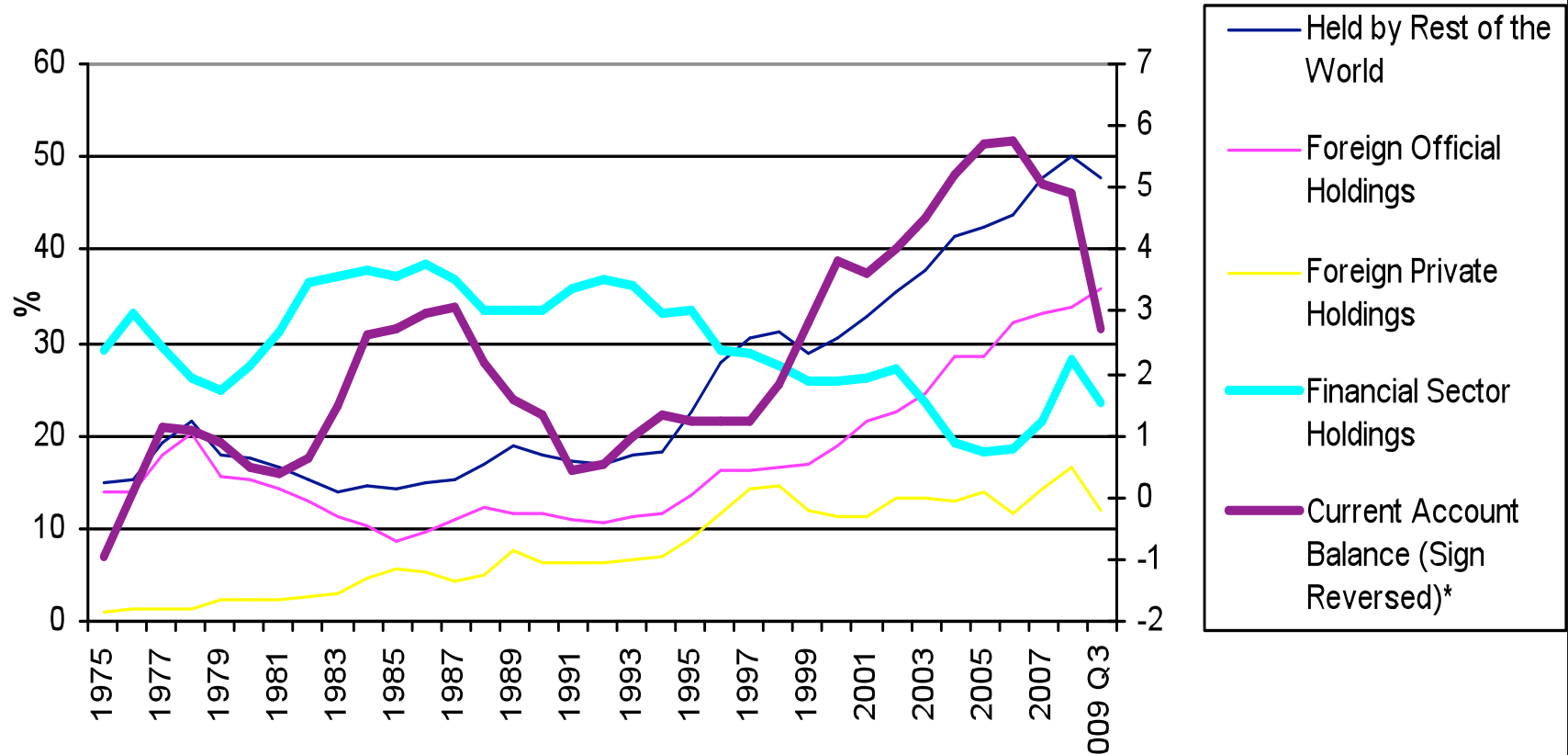
## Federal Government Deficit/Surplus (% of GDP) and Recessions



Source: Bureau of Economic Analysis and National Bureau of Economic Research

Note: The Sign of the Deficit/Surplus is Reversed

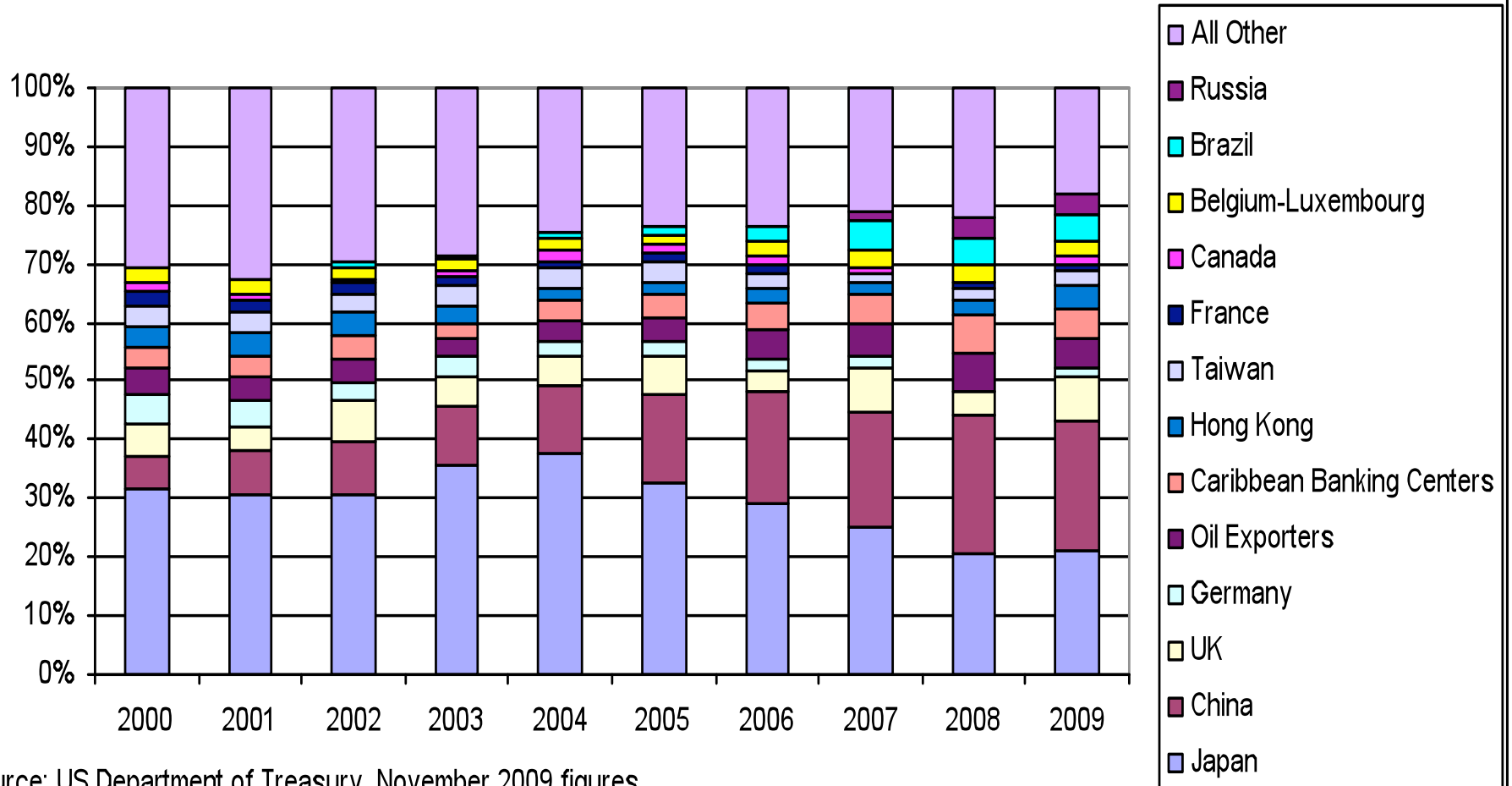
## Treasury Security Holdings (% of Total Outstanding)



Source: US Flow of Funds Accounts (for Treasury Holdings) and Bureau of Economic Analysis (for Current Account data)

\*Current account data is as of the end of 2009; treasury holdings data is as of 2009 Q3

## Foreign Holdings of US Treasuries (% of total held by Foreign Countries)



Source: US Department of Treasury, November 2009 figures

Note: For some years the holdings of the selected countries have been insignificant, so they are included in the category "All Other"

# Conclusions

- Reinhart and Rogoff research is not useful for expanding our knowledge about crises or effects of government debt and deficits
- In their book we can't find any defaults on domestic currency denominated debt with a floating currency
  - Even though they claim to have identified 70
  - Inflation is not default
- No mention of J.K. Galbraith or Minsky
- All we know after reading the book is “Yes, there have a lot of crises throughout history”

# Functional Finance vs. Myth and Magic

- With nearly 10% unemployment (and a more broad measure of labor underutilization at 17%) the public debate is focused on the false problems
- Government deficit should be a means not an end in and of itself (to achieve high employment, to stabilize private balance sheets, etc.)
  - Fiscal sustainability should be defined in terms of employment and not some arbitrary number
- There are no magic numbers applicable to all countries or different monetary regimes in different times

Sovereign governments are never financially constrained