Options for public debt management

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Sovereign debt overhang

Source: Ameco database
Decomposing the big picture

increase of sovereign debt

\[ \Delta d = -s + \left( \frac{r - \gamma}{1 + \gamma} \right) \cdot d + sf - \Delta h \]

- fiscal consolidation
- growth in relation to debt servicing
- inflation

All variables are ratios to GDP:
- \( s \): primary surplus
- \( r \): real effective interest rate
  corresponding to the already-accumulated debt
- \( \gamma \): the growth rate of real GDP
- \( \Delta d \): the change in the public debt
- \( sf \): the stock-flow adjustments
- \( \Delta h \): the change of the monetary base

fiscal consolidation
growth in relation to debt servicing
A hypothetical economy:
- with sovereign debt at the level of 100% of GDP ($d=1$),
- anticipated real growth 2% ($\gamma=0.02$; this is definitely optimistic for the short term), and,
- a real effective interest rate 3% ($r=0.03$),
- must have as a long-term target primary surpluses of 1% as a share of GDP ($s=0.01$) to avoid any further increase of sovereign debt (without any change in the monetary base causing inflation).
The financial aspect of sovereign debt

- Sovereign debt is a financial asset.
- Financial markets *price* these securities, quantifying the anticipated results of future fiscal policies.
- Every quantification is also a representation of economic/social/political events.
- (Small) Countries with weak currencies have very little room to resist market supervision/disciplining and develop independent fiscal and social policies.
- (Big) Countries or monetary unions with strong currencies have the power to interfere with market supervision, that’s why they translate the moral hazard into a political issue.
The limitations

1. Deflationary fiscal adjustment cannot reduce a high sovereign debt.
2. Persistent primary surpluses and/or privatizations are self-defeating strategies; historical evidence shows that it is very hard to sustain for a long time.
3. Future growth prospects are not so optimistic.
4. Dilemma: unorthodox/unconventional solutions of public debt management or prolonged austerity and retreat of the welfare state.
5. In the wake of 2008 global financial crisis, unconventional monetary policies became standard and seem to be permanent (quasi-debt management; negative policy rates).
Central bank balance sheets

Bank of England

Source: BIS calculations
Central bank balance sheets

Federal Reserve

Per cent

Bn of national currency


Total assets to GDP (lhs)

Source: BIS calculations
Central bank balance sheets

Eurosysten

Source: BIS calculations
Moment 1: The ECB acquires and capitalizes in the form of zero-coupon bonds: (i) debt maturing in the years 2016–2020 and (ii) all interest payments of the same period (approximately this amounts to 55% of outstanding debt for an average country). In other words, the debt burden will be suspended for five years.

Moment 2: Each Eurozone country agrees to buy back from the ECB the zero-coupon bonds when their values will have been reduced to 20% of GDP, jointly accepting a (nominal) discounting rate of 1%.
1. **No debt forgiveness; no direct fiscal transfers** and **no additional tax burden** for any EA economy.

2. **Capital gains** and **seigniorage profits** but also **sterilization costs**.

3. The overall cost of the program is lower than the ordinary actions of the ECB.

4. A rising number of mainstream economists and advisors have started talking about the elephant in the room: central banks (ECB); good timing for a proposal like this one.
An illustration

Figure 1 ECB Annual Estimated Losses in our Basic Scenario in Billion Euros (Losses with Positive Sign)

Eurosystem²

Per cent

Bn of national currency

- ECB losses without including seigniorage and capital gains
- ECB losses without including capital gains
- ECB losses


Currency in circulation³
Deposit facility
Reserve balance⁴
Other liabilities
Scenario 0: austerity

Scenario 1: capitalization of debt maturing within the next five years and related interest payments

Scenario 2: capitalization of debt maturing within the next five years and all interest payments
Scenario 0: austerity

Scenario 1: capitalization of debt maturing within the next five years and related interest payments

Scenario 2: capitalization of debt maturing within the next five years and all interest payments
Conclusion


• During the turbulent 1920s, governments had to intervene to support a failing international order. They thus established policy mechanisms, which could potentially be used for different aims under proper democratic control.

• The policy responses to the crisis have shown the firepower of central banks. Perhaps it is time to start the debate of how we could utilize them for wider economic and social aims.

Karl Polanyi, 1886–1964
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