



BANCA D'ITALIA
EUROSISTEMA

Comments on
“The liquidation of government debt”
by C. M. Reinhart and M. B. Sbrancia

Ignazio Visco
Bank of Italy

BIS Annual Conference
Lucerne, 23-24 June 2011

Outline

1. Main messages of the paper
2. Some general remarks
3. Some methodological issues
4. A focus on Italy
5. A comparison: Belgium and Canada
6. Conclusions



1. Main messages of the paper

- Financial repression in combination with inflation played an important role in reducing debts in many of the advanced countries in the period 1945-1980
- In fact, real ex-post interest rates in the advanced economies were negative in about half of the years of the financial repression era, compared to less than 15 percent of time since the early 1980s
- The annual “liquidation effect” – computed as the real (negative) interest rate times the stock of domestic debt outstanding – is found to be non-trivial for all countries
- To deal with the current debt overhang, financial repression policies may re-emerge in the form of prudential regulation...



2. Some general remarks

- Another interesting paper in quantitative financial history.
- Financial repression (with special result of liquidation effect) seen as a way to consolidate public debt – an “implicit tax”
- The project is challenging. Important to get good approximations of surprise inflation (horizons of “expected” price changes to match debt maturities, and perhaps direct measures of expected inflation)
- Financial repression rather difficult in open economies... And difficult to identify periods of low interest rates as periods of financial repression
- Most important, what happens when financial repression gives way to financial liberalization?



3. Some methodological issues

- Analysis focused on years of negative real interest rates. Should more emphasis be given to less conservative definitions of “liquidation years” (e.g., when real interest rates on government debt below a market real rate or real GDP growth)?
- Years may be different in the intensity of financial repression/liquidation effects or because they were still war years (e.g., 1945 for Italy)
- The share of liquidation years is defined independently from the size of the liquidation effect (table 4)
- The liquidation effect as a share of tax revenues does not appear to be always coherent with the liquidation effect as a share of GDP (table 6)



4. Focus on Italy (1)

- The analysis for Italy covers 1945-1970. Doubts on 1945. Debt after the war less than 100% of GDP (in UK around 250%). 1946-47 unexpected inflation main reason for reduction to less than 30%. Doubts about substantial financial repression afterwards as real rates relatively high, cyclical, with a single surprise (1951)
- But different sorts of prudential regulations were enacted in 1970s to early 1980s with significant liquidation effects and a relatively stable debt/GDP ratio. Afterwards the ratio rapidly increasing up to 1994; following reduction (primary surpluses cum privatizations) reversed by the effects of the current crisis ([Figure 1](#))
- The contribution of unexpected inflation especially significant in 1974-1982 ([Table 1](#))



4. Focus on Italy (2)

- The resulting negative interest rates significantly lowered the impact on debt of high primary deficits ([Figure 2](#))
- Between 1983 and 1990 a negative “liquidation effect” added to still positive primary deficits (2.8% of GDP on average) ; the financial repression-inflation tax was not replaced by some new tax or reduced expenditures and → the debt-to-GDP ratio grew by more than 30 pp
- In the following years exceptionally high real interest rates determined a further increase in the ratio (which reached its peak in 1994, at 122%), despite primary surpluses already started being recorded at the beginning of the decade



4. Focus on Italy (3)

- In the last decade relatively prudent fiscal policies and low real interest rates, kept the debt-to-GDP ratio under control and despite the global crisis, the Italian public debt did not exceed its mid-1990s level
- The contribution of real GDP growth has been limited over the entire sample period. With financial repression and unexpected inflation, the disconnect between nominal interest rates and inflation in the period 1970-82 was much stronger than in the following years ([Figure 3](#))
- In the last decade longer maturities and relatively low new financing needs have lowered the sensitivity of the average cost of debt to changes in interest rates, creating a new potential source of disconnection ([Figure 4](#))

5. A comparison: Belgium and Canada

- The pattern of the debt-to-GDP ratio has been similar in all three countries: the ratio reached its peak in the mid-1990s in all countries ([Figure 5](#))
- In Belgium – where the benefits of debt liquidation lasted only 3 years (from 1974 to 1976) – primary surpluses were run for a long period (from 1985 on) and allowed to compensate the effects of high interest rates with a debt/GDP reversal in the early 1990s ([Figure 6](#))
- Also in Canada the benefit from negative real interest rates lasted only 2 years (1974-75); the effects on the debt of primary surpluses (from 1986 on) mirrored those of a highly positive interest rate-growth differential, allowing a steady reduction in the debt-to-GDP ratio starting in 1997 ([Figure 7](#))



6. Conclusions (1)

- Financial repression helped the decumulation of public debt acting as an implicit tax (together with an inflation tax) but only when it was not followed by a deterioration of the primary balance (once the tax was removed)
- In the case of Italy the financial repression of the 1970s did not prevent high accumulation of public debt in the following decades
- Between 1970 and 1982 primary deficits in the order of 1.5% of GDP (instead of 4.5%) would have determined the same debt dynamics without any need of debt liquidation
- If a stricter fiscal discipline in the 1970s induced more prudent policies afterwards (with primary deficits on average lower than actual by 3% of GDP), the debt-to-GDP ratio would have now been about 40%



6. Conclusions (2)

- The main question is whether financial repression could be relied upon, even in the form of macro-prudential regulation, in the current juncture (no clear message is offered by the paper, but “prudential regulation is mentioned)
- I have substantial doubts. Indeed, financial repression appears neither desirable (it distorts choices and allocations and lowers the incentives for fiscal discipline) ... nor feasible (financial markets are more and more integrated and capital movements much freer than in the past; nominal interest rates are still at rather low levels)



6. Conclusions (3)

- No shortcuts for debt-reduction are available, as the main road for the reduction of government debts passes through:
 - strengthening economic growth
 - fiscal consolidation
 - debt restructuring
- And financial markets should be allowed to correctly price all the above options so to provide appropriate signals. Proper design of conditions for ex ante creditors' involvement in debt restructuring would help against the remark by the Delors Committee (1989), that “*the constraints imposed by market forces might either be too slow and weak or too sudden and disruptive*”



3. Focus on Italy (1)

Table 1 – Nominal interest rate and its determinants

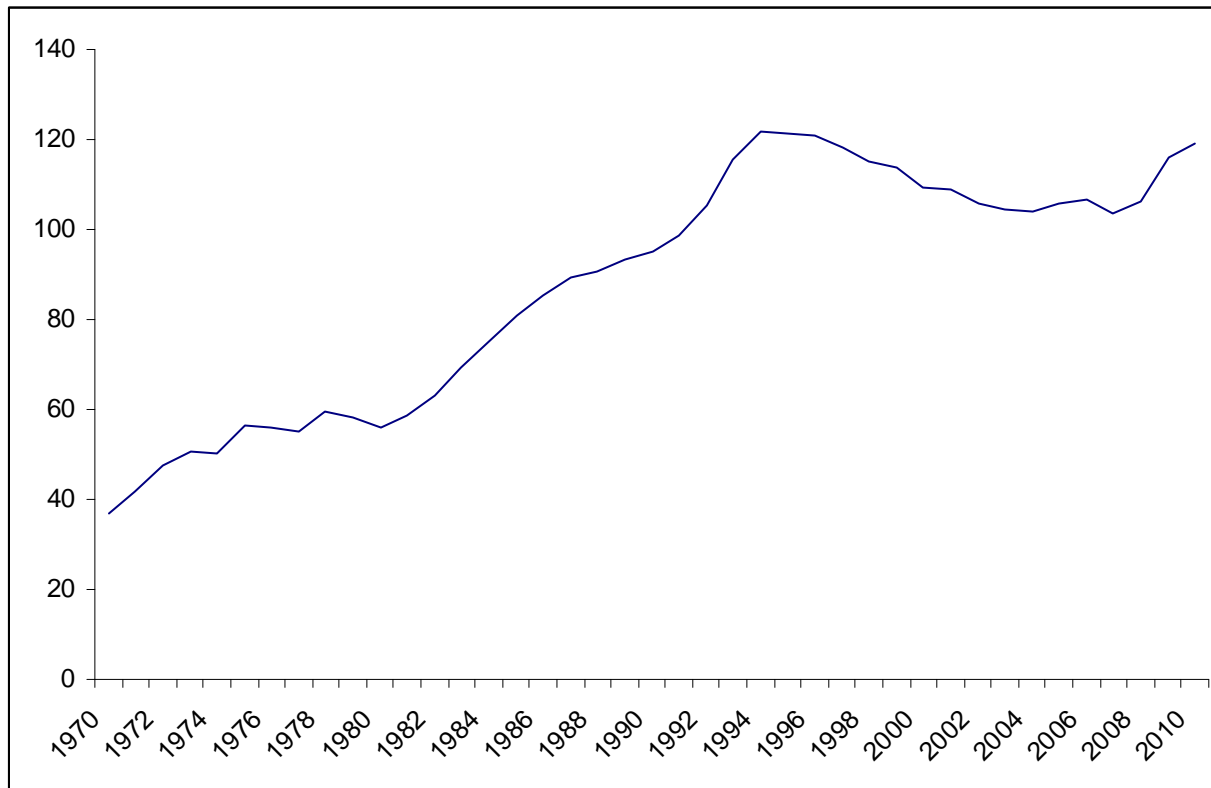
	Nominal interest rate	Inflation expectations	Unexpected inflation	Real <i>ex post</i> interest rate
1970-1982	8.3	11.7	3.5	-5.1
1983-1990	12.0	8.6	-1.3	4.4
1991-1999	10.0	4.4	-0.7	6.1
2000-2010	4.9	2.4	-0.2	2.7

[\(Back\)](#)



4. Focus on Italy (1)

Fig. 1 – Debt-to-GDP ratio

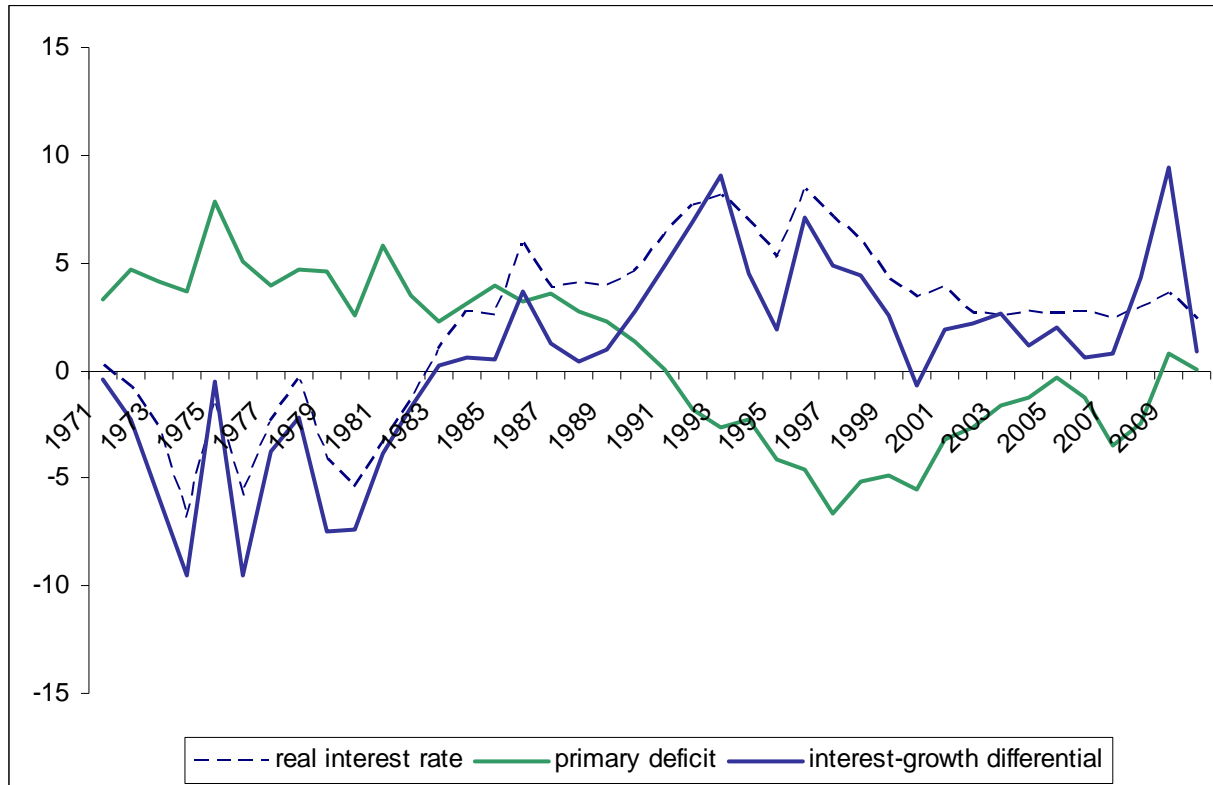


[\(Back\)](#)



4. Focus on Italy (1)

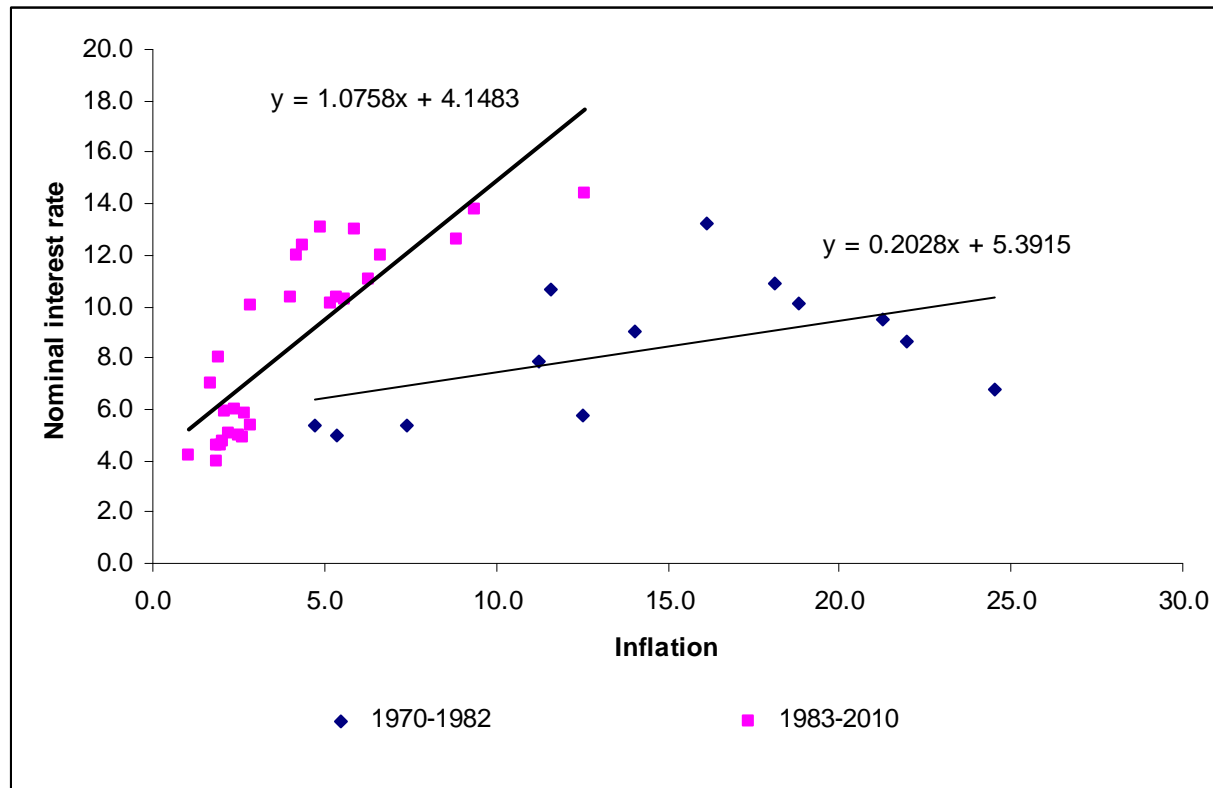
Fig. 2 - Components of the change in the debt-to-GDP ratio



[\(Back\)](#)

4. Focus on Italy (3)

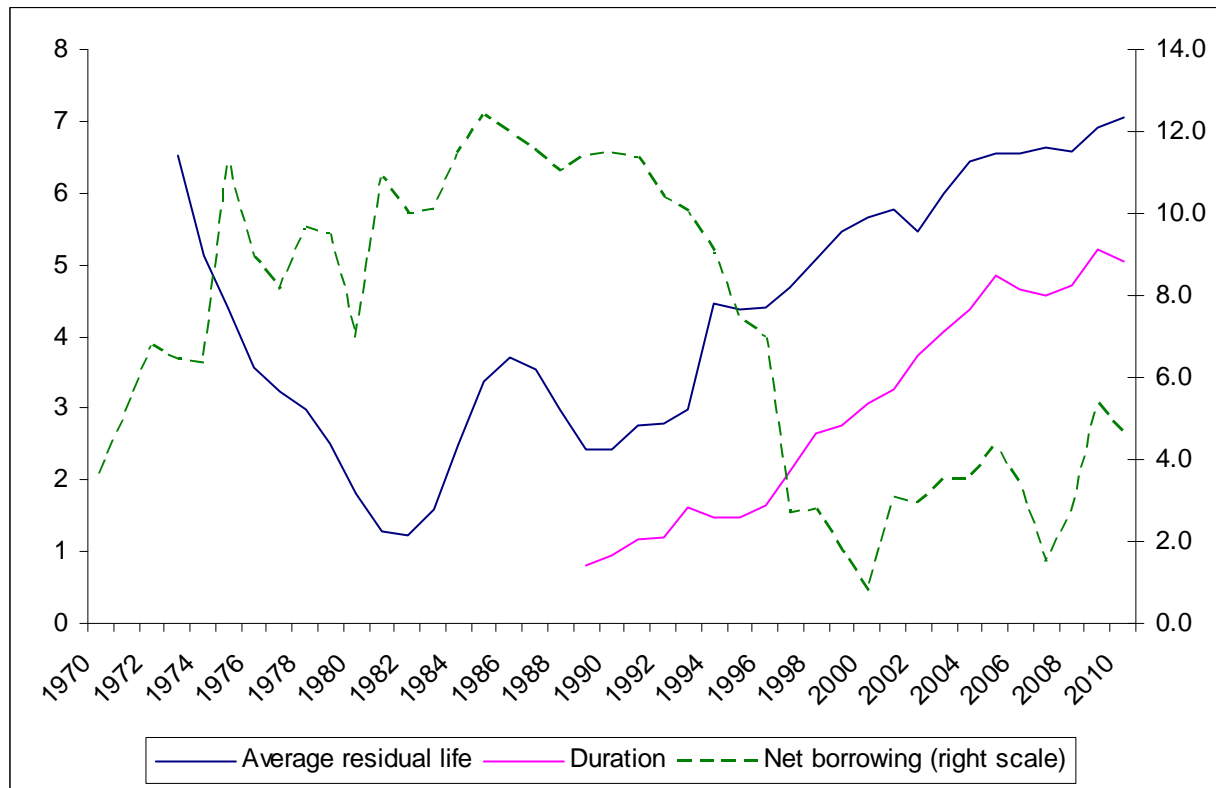
Fig. 3 – The relationship between nominal interest rates and inflation



[\(Back\)](#)

4. Focus on Italy (3)

Fig. 4 – Maturity structure of the debt and new financing needs

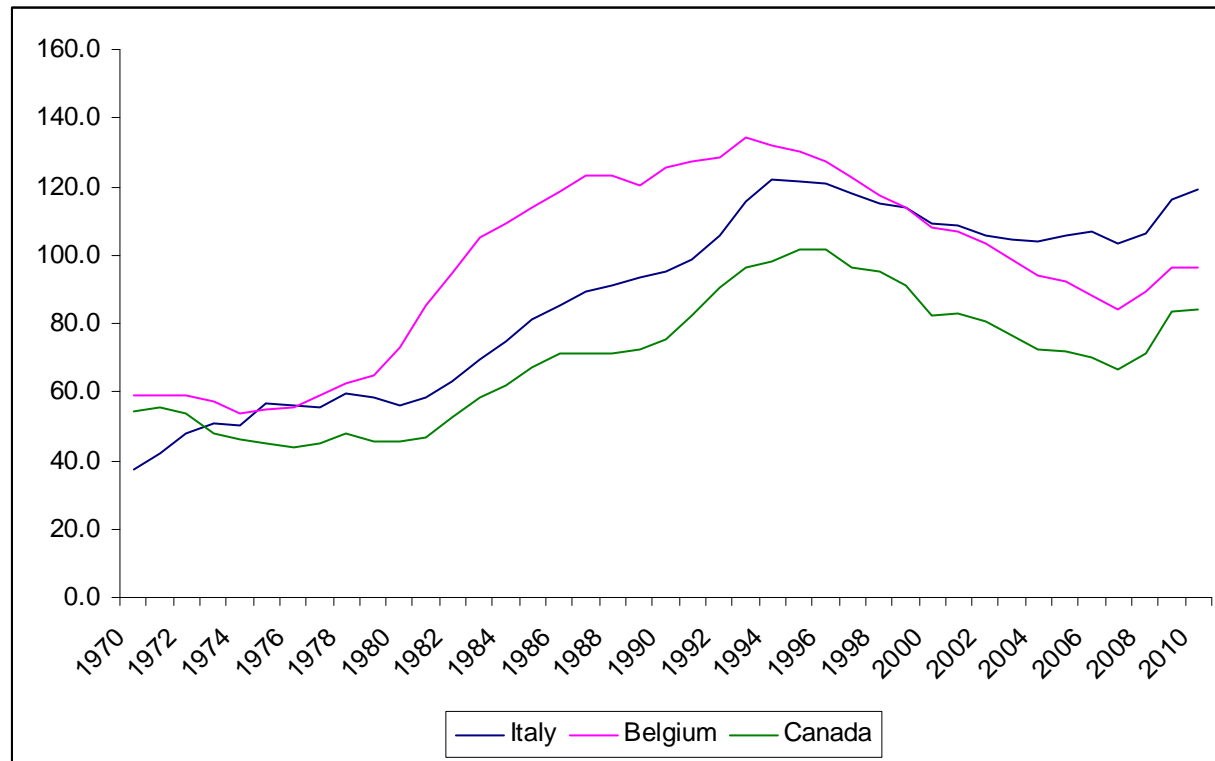


[\(Back\)](#)



5. A comparison: Belgium and Canada

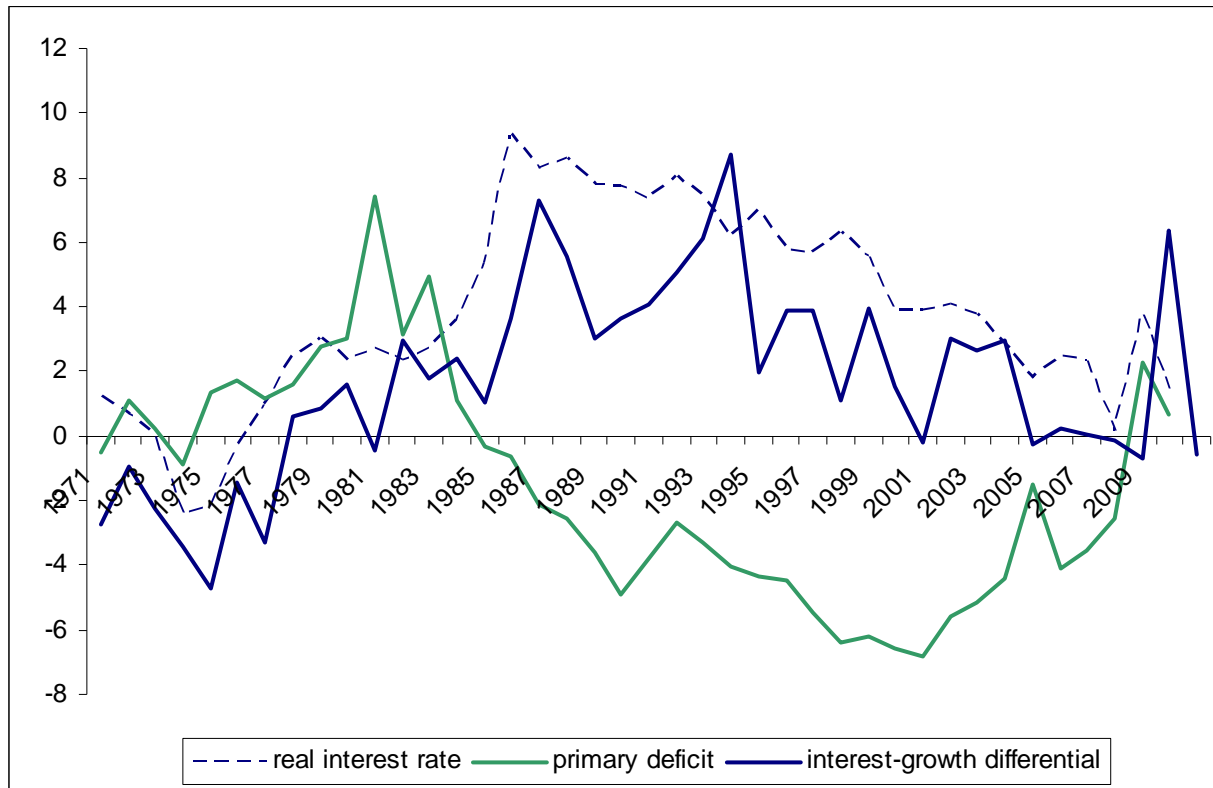
Fig. 5 – Debt-to-GDP ratio



[\(Back\)](#)

5. A comparison: Belgium

Fig. 6 – Components of the change in the debt-to-GDP ratio

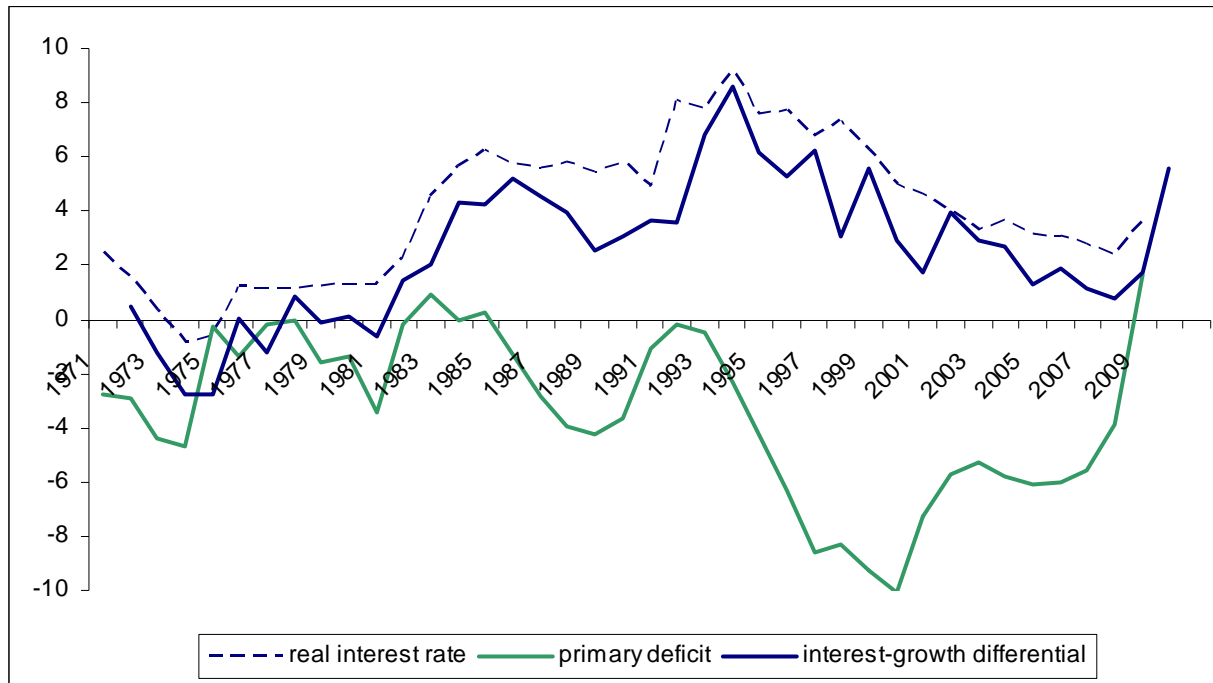


[\(Back\)](#)



5. A comparison: Canada

Fig. 7 – Components of the change in the debt-to-GDP ratio



[\(Back\)](#)

