Flash Economics

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How can public debt levels be reduced?

Public debt ratios are very high in virtually all major OECD countries (the United States, the United Kingdom, France, Spain, Italy and Japan). The rise in public debt ratios today stems both from long-term interest rates exceeding nominal growth (in France, the United Kingdom and Italy) and from the presence of primary public deficits (excluding interest on debt) in the United States, the United Kingdom, France, Germany and Japan.

Past experience (for example in Spain) shows that fiscal austerity is not effective in reducing the public debt ratio, due to its negative impact on economic activity.

An effective strategy, employed by countries following the world wars, involves the central bank accepting high inflation without resorting to a restrictive monetary policy. The resulting very low real interest rates help to reduce the public debt ratio.

It is clear that, as long as central banks are focused on fighting inflation, there is no policy that can bring down public debt ratios.

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Why are public debt ratios rising?

Public debt ratios are very high in all the major OECD countries except Germany (**Charts 1A/B**). However, Germany's public debt ratio is set to rise as a result of increased investment in infrastructure and higher military spending.

Chart 1A
Public debt (as % of nominal GDP)

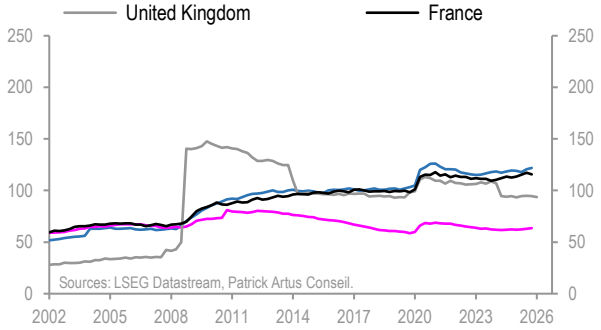
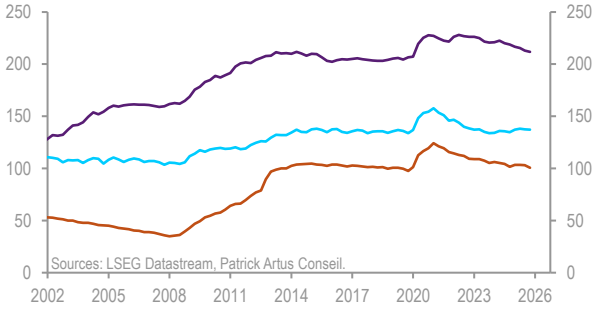


Chart 1B
Public debt (as % of nominal GDP)



Today, the rise in public debt ratios is due to two factors:

- **Long-term nominal interest rates** (**Charts 2A/B**) **exceeding nominal growth rates** (**Charts 3A/B**) in France, Italy and the United Kingdom;

Chart 2A
Interest rate on 10-year government bonds (as %)

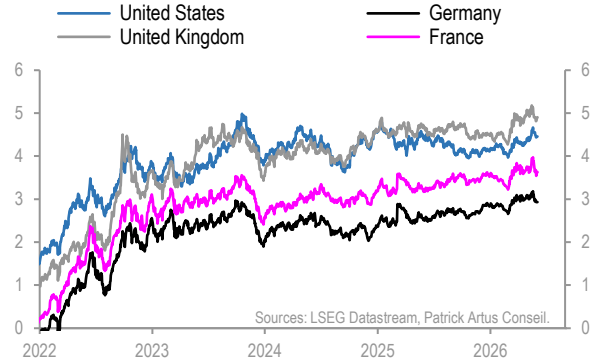


Chart 2B
Interest rate on 10-year government bonds (as %)

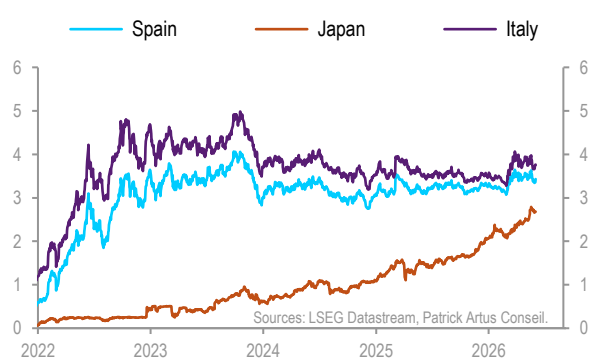


Chart 3A
GDP growth (Y/Y as %)

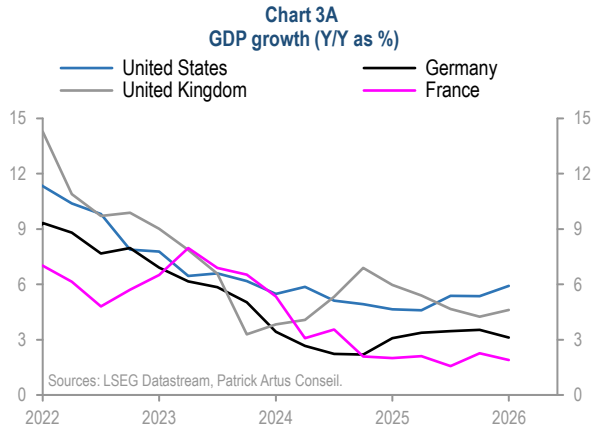
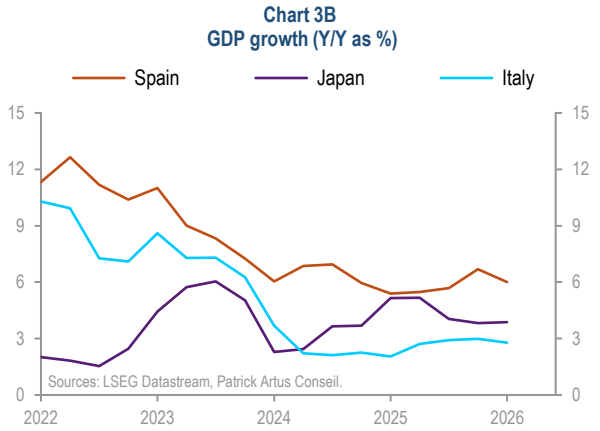


Chart 3B
GDP growth (Y/Y as %)



- **The existence of a primary public deficit** (excluding interest on public debt) in the United States, the United Kingdom, Germany, France and Japan (**Charts 4A/B**).

Chart 4A
Primary fiscal surplus or deficit (as % of nominal GDP)

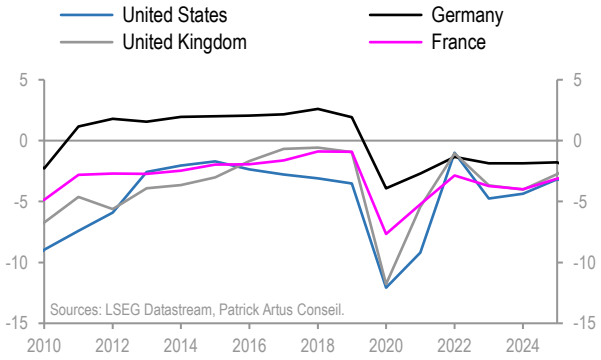
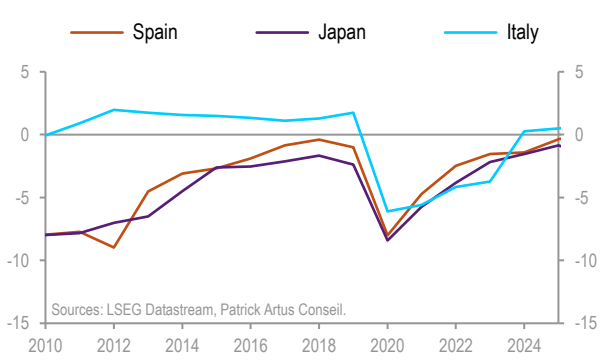


Chart 4B
Primary fiscal surplus or deficit (as % of nominal GDP)



The question will therefore arise in all major OECD countries as to what **policies should be implemented to stabilise or even reduce public debt ratios**.

Austerity measures are failing to reduce public debt ratios

We can take **the example of Spain** from 2010 onwards.

In 2010, the Spanish government announced cuts to public spending, reductions in civil servants' salaries, a freeze on pensions and an increase in VAT. In 2011, it decided to raise the retirement age and implemented further budget cuts. In 2013, the Spanish government continued its policy of reducing public spending and increasing the tax burden.

What are the observable effects of this austerity policy?

- **Public spending falls sharply** (**Chart 5**);
- **The tax burden rises sharply (Chart 6)**;
- **The public deficit** only begins to fall from 2013 (**Chart 7**);

Chart 5
Spain: Public spending (as % of nominal GDP)

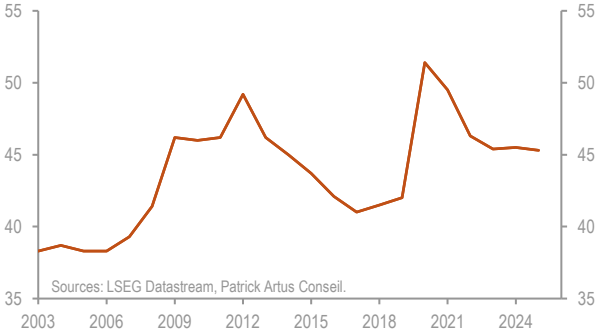
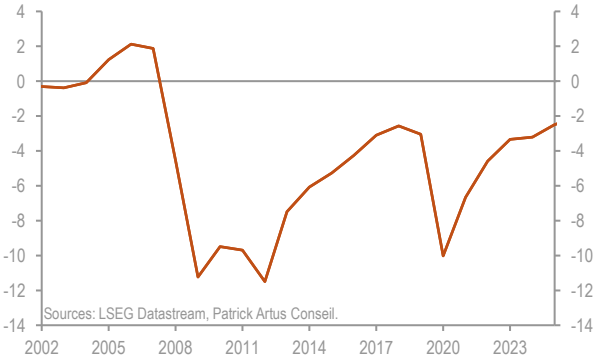


Chart 6
Tax burden (as % of nominal GDP)



Chart 7
Spain: Fiscal deficit (as % of nominal GDP)

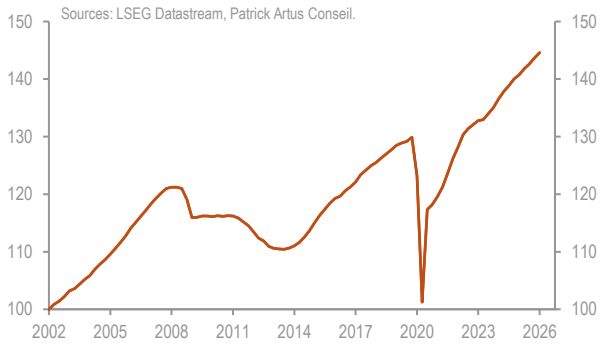


- **GDP growth** was flat in 2010 and negative from 2011 to 2013 (**Chart 8A**); it was not until 2017 that Spain returned to its 2008 level of real GDP (**Chart 8B**);

Chart 8A
Spain: Real GDP growth (Y/Y as %)



Chart 8B
Spain: Real GDP (2002Q1 = 100)



- **Finally, the public debt-to-GDP ratio** rose sharply between 2010 and 2013, only stabilising at around 100% of GDP between 2013 and 2019 (**Chart 9**).

Chart 9
Spain: Public debt (as % of nominal GDP)



We can therefore see **that fiscal austerity, by severely weakening economic activity, fails to reduce the public debt ratio**.

Inflation tolerated by central banks does succeed in reducing the public debt ratio

If the central bank tolerates high inflation without reacting, without raising interest rates, this results in the emergence of significantly **negative long-term real interest rates**, **which bring down the public debt ratio**. This trend in the public debt ratio was observed after both world wars, for example in the **United States and the United Kingdom** (**Charts 10A/B, 11**).

Chart 10A
United States: Inflation and 10-year government bond yields

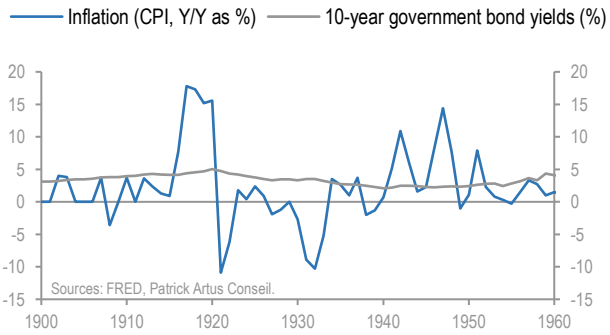


Chart 10B
United Kingdom: Inflation and 10-year government bond yields

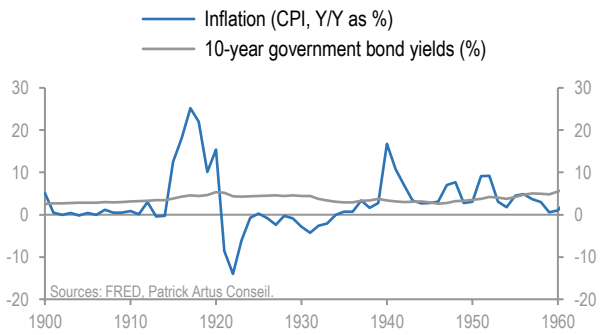
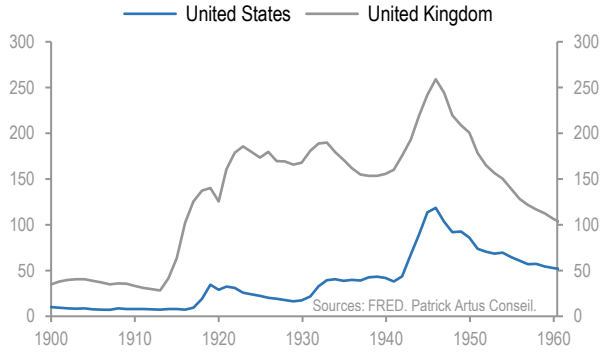


Chart 11
Public debt (as % of nominal GDP)



In the **United States**, we see:
- Negative long-term real interest rates from 1916 to 1920 and from 1941 to 1948;
- A fall in the public debt ratio from 35% to 24% of GDP between 1919 and 1924, and from 118% to 71% of GDP between 1946 and 1952.

In the **United Kingdom**, we see:

- Negative long-term real interest rates from 1915 to 1920 and from 1940 to 1950;
- A fall in the public debt ratio from 259% to 165% of GDP between 1947 and 1952.

Summary: as long as central banks have a strict inflation target, the public debt ratio cannot fall

We have seen that fiscal discipline does not lead to a reduction in the public debt ratio because of its negative impact on economic activity. We have also seen that following the two world wars, public debt ratios fell significantly, as inflation was not passed on to nominal interest rates.

Today, central banks practice inflation targeting and therefore combat inflation by shifting to a restrictive monetary policy. As long as central banks continue to behave in this way, it will therefore be impossible to bring public debt ratios back down.

Central banks would therefore need to agree not to respond to inflation by raising short-term interest rates, and indeed to prevent inflation from pushing up long-term interest rates through a policy of public debt purchases.

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