Session on
Debt Traps, Public and Private

Comments on presentations

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Need for a theoretical approach different from the mainstream one, in which:

it is explicitly acknowledged that the price system is not capable, by itself, to induce the full employment of available resources (even under price & wage flexibility)

demand is conceived as a fundamental determinant of the levels of activity (including investment)

In such conceptual framework:

fiscal policy, deficit spending, public debt are no longer ‘taboo’

they are tools to be used to hit the target of higher levels of output and employment

even money creation by the Central Bank is to be considered as a possible way of financing deficit spending (Turner, Keen)

Sustainability of public debt:

no theoretically clear-cut notion, often simplistically reduced to stability of the debt ratio, even independently from its magnitude

which kind of debt safer than public debt?

(power of raising taxes, and in principle of seigniorage, of the debtor)

Perhaps less agreement on whether:

availability of (cheap enough) finance *per se* capable to stimulate economic activity

My view:

- mere availability of credit not sufficient to increase borrowing and spending (consistently with endogenous money?)

- no general efficacy of lower interest rates in increasing demand and output

As to the second point, apart from empirical findings, very good reasons on theoretical grounds:

general inverse relation between investment and interest rate undermined by criticism of neoclassical capital theory (hence, of NT tout court)

no general validity of the mainstream presupposition that capital intensity of productive methods would move inversely with the ‘price of capital’ (interest rate) however, low interest rates on public debt (Central Bank’s action needed) helps to prevent or limit undesired distributive effects in case the need arises for primary budget surpluses (i.e,. interest on public debt financed by taxes)

Once acknowledged that public expenditure affects positively aggregate demand and therefore output, flow and stock identities (closed economy for simplicity)

$$S_p = I_p + D$$

$$W_p = K_p + B$$

[S_p = private savings, I_p = private investment, D = public deficit, W_p = private wealth, K_p = real private capital, B = public debt (owned by private sector)]

imply causal relation in which S_p and W_p increase by the same amount of, respectively, D and B, through:

the higher level of income, hence of private savings, determined by additional deficit spending

i.e., deficit spending allows for the realization of incomes and savings which otherwise *would not come into existence*

This perspective entails destroying some myths, or ideological preconceptions, erected against public deficits and debt.

One of them is, as pointed out by professor Schularick, that public debt would be used to finance socially wasteful projects, as opposed to the socially efficient use of private debt

Other purely ideological statements, in contrast even with sheer accountancy:

public debt is the debt of the nation (false even for debt hold by foreigners, since compensated by more foreign assets) – acknowledged even by an anti-debt author like Ricardo

public debt is a burden on future generations (false, future *generations* will inherit the wealth consisting of public bonds)

A recent proof of the ideological fog commonly surrounding public debt, coming from authoritative source:

EUROPEAN CENTRAL BANK
EUROSYSTEM

Statistics Paper Series

Celestino Girón, Marta Rodríguez-Vives

Leverage interactions:
a national accounts approach

No 19 / January 2017

the authors discover, and even illustrate with numerical examples, that

> Although the design of the Macroeconomic Imbalance Procedure (MIP – see footnote 2) in the European context[4] is a step in the right direction for preventing and correcting macroeconomic imbalances, the focus is – as in the research on leverage mentioned above – based on deflated debt only. Furthermore, no attention is paid in the MIP context to possible interactions of indicators and, in particular, between the debts of the various sectors. This scenario resembles the situation before 2008, when the analytical focus was on the measurement of general government debt, ignoring its possible relation to mounting private debt, which was seen as irrelevant in a sort of Lawson doctrine bias (according to the "Lawson doctrine", current account deficits due to private sector behaviour are not a concern and should not be subject to public intervention – see Corden (1977)).[5]
>
> The underlying line of reasoning throughout this paper is that mainstream debt analysis, focusing on GDP ratios, overlooks the asset dimension of debt and fails to capture a basic economic relationship and its implications: that every liability of an agent is also the asset of another agent in the economy.[6] We believe that this aspect is becoming more central to understanding the dynamics of debt and its macroeconomic implications.

Efficacy of deficit spending often denied by appealing to the so-called ‘Ricardian Equivalence’:

in the face of deficit spending, private agents would correspondingly raise their present propensity to save in the expectation of the higher future taxes the State will charge on them or their descendants, in accordance with its ‘intertemporal budget constraint’ (= zero present value of future public debt)

as I claim elsewhere, lacking rationality of the behavior of private agents on which this argument (originally put forward by Barro) is based

State’s intertemporal budget constraint: only applies as counterpart of alleged unwillingness of the private sector of holding assets indefinitely

for the assets consisting of public bonds, the private sector would thus absurdly prefer having part of their wealth cancelled out by taxes rather than keep it indefinitely

Lack of rationality entailed in RE: undermines what is viewed to be its main strength, the alleged character of logical necessity

On the other hand, data like those provided by Costantini and by Schularick in their papers, showing that households are indebted even when old, conflict with the basic premise of Barro’s argument: diffused interest of living generations for the wealth to be transmitted to descendants.

Being questionable on both theoretical and empirical grounds, a mostly ideological character is what seems to remain of RE

Ideological bias of many arguments against deficit spending (and more generally State intervention)

Relation with Costantini's reference to *ad hoc* economic conceptions, providing theoretical support to policies by which dominant groups maintain and even increase their power and control over working classes

thus, reduction of public expenditure and privatizations accompanied by policies favoring household indebtedness

in this way, sustaining aggregate demand (possibly, though indirectly, even in the investment component, minor disagreement on that with the analogy Costantini makes with Ricardo's 'fire in the warehouse')

while, my addition, substituting household debt for contractual or 'social' wages (i.e welfare and public services) increases the economic and social costs of being fired, hence weakens the power of labourers in the bargaining with 'masters' (Adam Smith) for working conditions

A few observations on professor Pesaran’s presentation

as in fact the authors are ready to admit, “a significant negative long-run relationship between rising debt-to-GDP and economic growth” might reflect causal link in which low growth of income is the cause, rather than the effect, of rising debt ratio

indeed, that causal direction is the one more consistent with the conceptual framework I referred to above

in particular, thresholds of the ratio of public debt to GDP can be envisaged in relation to the effects of fiscal policies on that ratio

higher debt/gdp ratios would react ‘perversely’ (from orthodox standpoint) to restrictive fiscal policies, since the larger the debt relative to gdp, the larger the proportional reduction of the gdp compared with that of the stock of debt, produced by given cuts in public expenditure flows

Anyone who has struggled with poverty knows how extraordinarily expensive it is to be poor.

—James Baldwin

REAWAKENING