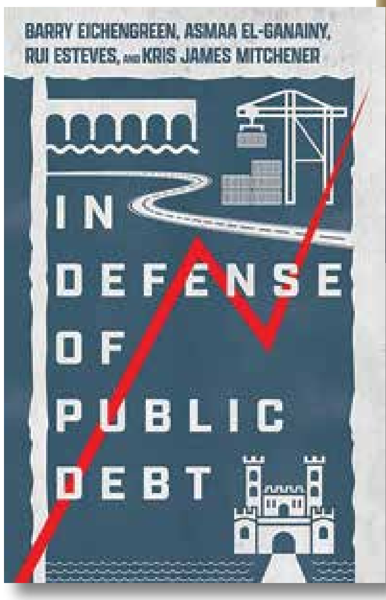
A Balanced, Nuanced Story *on* Debt

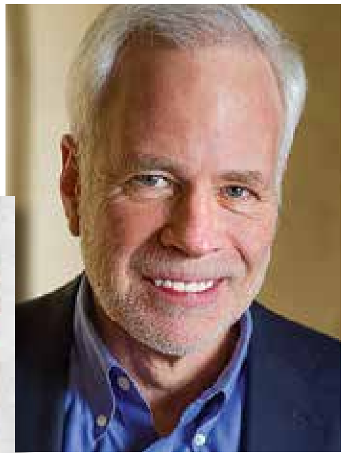
Long-time TIE *editorial advisory board member and contributor Barry Eichengreen talks to* TIE *Founder and Editor David Smick about his new book,* In Defense of Public Debt.

TIE: **Your new book, *In Defense of Public Debt,* is an extraordinarily well-timed addition to global discussion of sovereign debt. You effectively knock down the simplistic notions about balanced budgets and show how throughout history the gradual securitizing of loans and organizing of secondary markets for sovereign debt brought on the development of private financial markets, the management of global liquidity, and greater prosperity for the West.**

I kept wondering, though, how you feel about today's political hypocrisy associated with the accumulation of public debt in the United States, particularly in the last fifty years. When Republicans are in power, increases in the debt-to-GDP ratio are deemed by them to be acceptable, while Democrats bemoan a debt-ridden economy about to fall off a cliff. When Democrats run up the debt ratio, Republicans declare Armageddon is upon us. It's not surprising that public confidence in our policy leaders is at an all-time low. Did you and your associates have the same view of debt in the 1980s when defense spending and tax cuts sent deficits and debt ever higher?

Eichengreen: There certainly is a dollop of hypocrisy in the party in power regularly dismissing concerns about rising public debt and the party out of power warning that a debt apocalypse is upon us. But what is fundamentally going on, I think, is that the party in power has a strong vested interest in the tax cuts or spending programs that are being debt financed, while the other party opposes them. Republicans from Reagan through George W. Bush and Trump favored tax cuts for the





Barry Eichengreen

wealthy and corporate interests, and if these ended up being debt-financed, they were willing to look the other way. Democrats opposed those tax policies, so they were naturally critical of the resulting debt. Democratic presidents favor social spending even if it has to be debt-financed. Republicans oppose those spending policies, so they were naturally critical of the resulting debt. Of course, it would be better to have an honest discussion of those tax and spending priorities rather than to fixate on the impending debt Armageddon. If only….

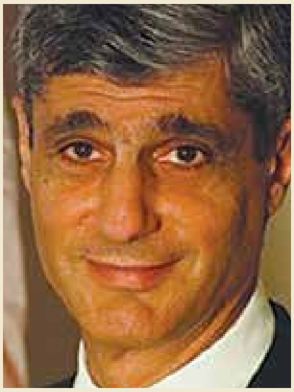
TIE: **Your book offers a fascinating history of public borrowing going back as far as two thousand years ago with Greek city-states such as Syracuse. But, you say, sovereign borrowing really took off in Europe starting in the second half of the millennium. Why Europe? Why wasn't the Roman Empire the heyday of public borrowing? Why not China?**

Eichengreen: You're really asking two different questions, David. Why not earlier? And why not elsewhere (why in Europe)? There were in fact some earlier instances of public borrowing. In the book we tell the story of borrowing by thirteen Greek city-states in the fourth century BCE, and observe that one can read about their eventual default on a marble slab now in the Fitzwilliam Museum in Cambridge. But the practice of issuing sovereign debt only "took off," as you put it, in the thirteenth and fourteenth centuries, when a constellation of prerequisites was in place. There were experienced bankers, starting with those of Tuscany, Genoa, and Venice, who could act collusively to enforce their claims. There was an ample pool of savings, accumulated through long-distance trade, to be invested in public debt. And there were nascent secondary markets on which that debt could be traded.

As for why Europe, the explanation lies in the exceptional prevalence of war. After the collapse of the Carolingian Empire in 888 CE (you can see we go way back!), the continent was divided into literally hundreds of princely states. Where much of China is a great plain, Europe is divided by mountain ranges and river valleys that pose natural obstacles to the formation of large territorial states. Neighboring rulers couldn't resist the temptation to seize territory and resources when they could. They issued debt to raise armies. Others raised debt to defend themselves. The late great historical sociologist Charles Tilly put it nicely when he wrote of Europe that "War made the state, and the state made war." Our version is "War made state debt, and state debt made war."

I'm not entirely confident that the United States is immune from potential debt servicing problems.

TIE: **You make the compelling case that so much of the rise in public debt was associated with the need of Europe's monarchs to finance their wars. Meeting that need led eventually to other benefits, including the prosperity brought about by modernizing credit markets. But can a case be made that had wars been less easy to finance, a lot of useless bloodshed and suffering over the centuries would have been avoided? Over the last twenty years, the United States spent a trillion dollars in Afghanistan. Would that have happened if, instead of**



Former U.S. Treasury Secretary **Robert E. Rubin**

If President Clinton and Robert Rubin's low interest rates were responsible for U.S. productivity growth, then we should have seen crowding in—a big surge in private investment, in other words. It didn't happen.

—B. Eichengreen

increasing public debt (under both Republican and Democratic presidents), the American people each year faced an Afghan war surtax in their paychecks?

Eichengreen: I see where you're going, but it's a complicated counterfactual. Historically, sovereigns issued debt to raise militias and fight offensive wars, but they also issued it to build fortifications and take other steps to discourage potential invaders. On America in Afghanistan, there might have been less support for our adventure there had there been a clearer sense of the fiscal cost. But I doubt that any additional taxes would have been expressly labelled "Afghan war surtax."

TIE: **The book explains how the four decades leading up to World War I were "the heyday of overseas lending to sovereigns, railway companies, and other borrowers," with Great Britain the leading capital exporter. How did this scenario come about? Can you connect the dots between Britain's sovereign debt and its growing global economic power? And how does this relate to the global role of U.S. financial markets today? To what extent, if at all, does America's financial sector enhance America's global soft power?**

Eichengreen: Britain already had relatively sophisticated financial markets, including from 1694 a central bank to backstop the market and act as liquidity provider of last resort. It was the first industrial nation and for much of the nineteenth century the world's leading exporter. So it had international connections and a substantial pool of savings to invest abroad. It's quite remarkable, from a twenty-first century perspective, that this economy invested as much as half its savings abroad, year after year, for going on four decades leading up to World War I. There was also a political aspect. Much of this lending went to the Commonwealth and Empire, which were expected to pay back. That's why we write about "overseas lending" rather than "foreign lending."

But Britain wasn't alone. France, Germany, the Netherlands, Switzerland, and others were also consequential lenders. The market had very modern-looking infrastructure. There were investment banks with foreign branches, organized exchanges on which bonds could be traded, and bondholder committees to represent the creditors. There were steamships and submarine telegraph cables to convey information about foreign economic conditions and policies. There were even managed investment funds—the equivalent of modern mutual funds—to select portfolios of government bonds on behalf of Scottish housewives and other small investors.

Actually, France and Germany were more active than Britain in using financial markets and foreign lending as instruments of soft power. French governments encouraged investors to purchase Czarist bonds as a way of attempting to solidify the country's alliance with Russia, so that it could potentially oppose Germany on two fronts. German governments encouraged investors to purchase Ottoman bonds, like those of the Constantinople-to-Baghdad Railway, in an effort to outflank Russia to its south. Of course, what's interesting is that these efforts illustrate mainly the costs, not the benefits, of using financial markets as instruments of soft power. These investments turned out poorly compared to contemporaneous British investments. The only place you'll see a Czarist bond these days is at a flea market, where you can purchase it for decorative purposes.

I'm not a fan of Modern Monetary Theory, so I still believe there are limits.

I definitely think that America's financial sector, and specifically the international role of the dollar, is a source of geopolitical leverage. We see this in foreign governments' complaints about U.S. efforts to weaponize the dollar. We see it when the Taliban is unable to get its hands on the Afghan government's dollar balances in the United States. We see it in the ongoing efforts of Russia, China, and other countries to develop ways of bypassing U.S. financial markets. The very great difficulty they seem to be experiencing in developing those alternatives may be the most impressive testimony of all of the extent of that geopolitical leverage.

***TIE:* You effectively detail the Netherlands' successful efforts to mass-market debt. How did the provinces of the Dutch Republic issue rising amounts of new debt from 1618 to 1648, yet interest rates declined? You say the Netherlands' early success at modernizing public finances, however, "gave way, ultimately, to failure." Why? And why, in the case of sovereign debt, isn't history more linear?**

Eichengreen: The Dutch story is partly about sophisticated institutional arrangements and partly about politics. The Netherlands was a kind of creditor republic. The provincial delegates who sat in the States-General, the body that oversaw the finances of the government, were also the principal debt holders. The States-General had a subcommittee tasked with presenting a report of common expenses annually. It appointed a treasurer to keep the books. The chief executive of the Estates of Holland was for many years an investor and mathematician, Johan de Witt, who wrote a tome on debt management (*The Worth of Life Annuities Compared to Redemption Bonds*). All this made the Dutch provinces the only territorial states that could borrow at interest rates as low as 3 percent.

So why didn't it last? Because the decentralized structure of the system gave rise to free riding. Every Dutch province collected its own taxes (mainly on goods landed at its ports) and transferred a portion to the central government for the common defense. They had a natural tendency to under-tax, under-report, and under-transfer. And as building armies and navies became more expensive in the eighteenth century, the Dutch, so resource-constrained, fell behind the British and even the French. My Berkeley colleague Jan de Vries writes of the Dutch Republic's "undisguisable military impotence" in this period. It's tempting to say that Holland's eighteenth-century experience illustrates the dangers of economic and monetary union without fiscal union. European Commission, take heed!

I don't find the fact that the history of sovereign debt is nonlinear surprising, because history in general is nonlinear.

***TIE:* You also make an interesting case that "democratization" played a key role in expanding public debt. Can you flesh that out a bit further?**

Eichengreen: It starts with the development of checks and balances on arbitrary action—such as arbitrary default—by the sovereign. Barry Weingast and Douglass North wrote a famous article more than thirty years ago arguing that the Glorious Revolution of 1688, which increased the power of Parliament, where creditors sat, explains the long decline of borrowing costs in eighteenth-century England. The story actually is more complicated than they let on: the decline starts earlier, and there's no sharp break around 1688. Still, their's is an important insight.

I'm not worried about the technological and economic dynamism of the United States, which is as strong as ever. But I am worried about political polarization, tribalism, and denialism.

The Dutch case, which we were just discussing, is another interesting one. In the seventeenth century, there were government "revenue offices" to market bonds to retail investors in every important Dutch city. So not only the wealthy investors who sat in the States-General but the members of the middle class to whom they answered pushed for responsible government spending and prudent borrowing. And those responsible policies in turn made members of the public more willing to hold public debt.

***TIE:* I really appreciated the book's nuance with regard to debt's less-certain connection to interest rate changes. You ask: "When is a debt sustainable?" The answer, you point out, lies in part in the relationship between the interest rate and the rate of economic growth. You argue: "If the economy grows faster, then government revenues will grow faster, and if revenues rise faster than interest payments, the debt will become easier to service."**

Full disclosure: I am an admirer of the folks who ran the Clinton economy. The former president will be remembered for inappropriate behavior in the Oval Office. But history will also record extraordinary rises in productivity, blockbuster growth, budget surpluses, and declining interest rates during his tenure. His tax increases were modest compared to the Republican protests at the time. The Clinton team argued that their superior fiscal

Continued on page 78

Continued from page 33

management helped give financial markets increased confidence in the future. So investment in innovation and thus enhanced productivity took off. I remember French central banker Jean-Claude Trichet telling me at the time that the Clinton productivity growth increases for him and his European colleagues were nothing less than "mind-blowing." What about the Clinton years? How does the Bill Clinton example square with your thesis connecting rising public debt in many cases to greater prosperity?

Eichengreen: I agree that it's unfair that there should be a new mini-series ("A Vast Conspiracy," streaming on FX) about Clinton's deplorable behavior in the Oval Office, but no mini-series on the Clinton administration's admirable fiscal management. (I'm waiting for someone to option my book and commission a screenplay.) The success with which the Clinton administration closed the deficit and slowed the rise in debt looks even more remarkable now, twenty-five years later, than it did then. You'll recall handwringing toward the end of the Clinton years that we might face serious financial difficulties because the stock of Treasury securities was about to be extinguished. Well, George W. Bush fixed that problem.

In the book, we look carefully at whether Trichet was right. And the answer is no. If Clinton and Robert Rubin's low interest rates were responsible for U.S. productivity growth, then we should have seen crowding in—a big surge in private investment, in other words. It didn't happen. The more important factor in the acceleration in productivity growth starting around 1995 was the New Economy: earlier advances in digital technology (what we then called the "IT revolution") finally showing up in the productivity statistics.

TIE: **I appreciated that while the book makes the case for sovereign debt, it is not a cheerleading pamphlet. You point out that there were instances when the process "went spectacularly awry." Give us a sense of how the bondholders and borrowers at times were poorly served. Of course, the system also evolved, through diversification, in a way that led to more efficient debt management. How does this process of debt management fit into what you refer to as "the cycle of debt"?**

Eichengreen: Much of the literature on public debt focuses on debt crises and defaults, the financial equivalent of airplane crashes. Our goal was not to deny these problems but to tell a more balanced story—to also recount the role of public debt in meeting emergencies, not only wars but natural disasters, financial crises, and pandemics. We started well before Covid-19, which unfortunately gave us additional material. But we don't neglect the "spectacularly awry" cases, where debt was issued to build railways from no place to nowhere. We talk about the "Transoceanic Ship Railway" that was supposed to transport fully loaded cargo ships across the Honduran Isthmus in the 1870s. The tale will sound familiar to those who have been following the story of the Afristar railway in Kenya, built with Chinese Belt and Road funds.

Diversification is of course one way investors protect themselves against losses on bad loans. But it works better in some circumstances than others. I started out studying debt defaults in the 1930s, when two-thirds of foreign dollar bonds lapsed into default. In those circumstances, diversification bought you little.

TIE: **The connection between a rising public debt-to-GDP ratio and real interest rates seems one of the great paradoxes of our time. Free-market theorists have long argued that public debt would "crowd out" private investment and lead to higher real interest rates. Of course, over the last fifty years the United States and indeed the world have transitioned from an era of capital shortage to an era of massive excess global liquidity. At the same time, with the Federal Reserve's quantitative easing, the ten-year Treasury bond no longer serves as a market signal. Plus, the Covid scare globally has caused a flight of capital into U.S. fixed income assets, given America's higher vaccination rates and perceived greater economic resilience. So the "crowding out" theory seems less than relevant, at least in the short term.**

Still, are you worried about a Japan scenario? Elsewhere in this issue, we asked a distinguished body of experts whether the American economy and financial system today are at risk of becoming "Japanized." There are, of course, differences in the two economies, including demographics and general approach to entrepreneurship and innovation. But the Japan example since the early 1990s is striking. After the bursting of a real estate bubble, Japanese infrastructure spending exploded. Public debt as a percentage of GDP soared to unheard-of peacetime levels. Real interest rates plummeted. But Japan still entered an economically mediocre period known as its "lost decades."

Are you one hundred percent convinced that the United States today with its exploding public debt is entirely immune to repeating the Japan experience?

Eichengreen: First, I view Japan's heavy public debt load as mainly a consequence of its slow growth, not a cause. Second, there are multiple reasons why U.S. interest rates and debt-service costs remain low: high global savings rates (the "global savings glut"), limited investment demand for funds due to the shift from physical to digital platforms, quantitative easing, and demand for U.S. Treasuries as a safe asset. Third, even if the dollar grows weaker and more volatile, that doesn't necessarily eliminate the safe-asset characteristics of U.S. Treasuries in a dollar-centric world; it didn't eliminate them in the 1970s. Fourth, I'm highly skeptical that cryptocurrencies provide a viable alternative to U.S. Treasuries as a safe asset or to the dollar as a vehicle for international payments. But fifth, I'm not entirely confident that the United States is immune from potential debt servicing problems. Something could change—China could become more of a normal consumer-driven economy, and global savings rates could decline—causing real interest rates to go up. That's why we devote the last chapter of the book to what the United States should do to prepare for this possibility.

You'll recall handwringing toward the end of the Clinton years that we might face serious financial difficulties because the stock of Treasury securities was about to be extinguished.

TIE: **What about the connection, or lack thereof, between rising public debt loads and inflation rates? You correctly point out that the additional debt to confront the 2008 global financial crisis "did not automatically lead to inflation, high interest rates, and fiscal crisis." Of course, an extraordinarily generous monetary policy played a key role in the rescue effort. Recently, though, the U.S. inflation rate has jumped and the debate is whether such price rises are sustainable. In the end, doesn't this all come down to a bet? If the theory is wrong, and over the long term inflation and interest rates are indeed affected by the Fed's coming to terms with rising public debt loads, won't the little guy be the loser? I love it when central bank economists say they prefer to deal with core inflation—that is, the inflation rate less food and energy costs. So by today's measurements of inflation, if you don't eat, drive a car, or care about someday being able to own a home, inflation is benign. What inflation problem?**

Or put another way, if the amount of public debt as a percentage of GDP has little bearing on the level of interest rates or inflation, why not have even higher public debt

loads? Why not raise public debt to 200 percent of GDP? Why not 500 percent? Why any limits at all?

Eichengreen: I'm not a fan of Modern Monetary Theory, so I still believe there are limits. I believe that the government has a budget constraint—only that it's not the same as the household budget constraint. Exactly when and how that constraint binds depends on the path of real interest rates and real growth rates, where the latter too is affected by fiscal policy.

The next three sentences are of course subject to change. But as you and I speak, the inflation rate has been rising but interest rates on U.S. government debt have not. That means that U.S. public debt is becoming more easily sustainable, not less. Inflation is raising the denominator of the debt-to-GDP ratio, in other words, rendering that debt less worrisome for the moment.

TIE: **Tell me I'm wrong, but to me public debt management in the hands of either political party seems like a giant wager where, if things go wrong, the only losers will be working-class families. The top one percent, loaded with real estate and other assets, in relative terms will do just fine. Given how little we seem to agree on about what causes inflation, about how interest rates perform, and about how an economy increases productivity, shouldn't our policymakers be a bit more humble and less cavalier when it comes to public debt? After all, the Federal Reserve has more than three hundred Ph.D. economists on staff. Yet their econometric models are said to be consistently wrong. Some say embarrassingly so. Even the smartest get it wrong. Consistently. So is humility today in short supply?**

Eichengreen: Humility is in chronic short supply, not least among us economists. The fact is that we don't know whether interest rates will stay at their current low levels, and if so for how long, or whether and when they'll shoot up. (I'm not predicting.) But we should be preparing and should have plans in place for dealing with this last possibility.

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This is very different, though, from saying that uncertainty about the future should have deterred us from issuing $800 billion-plus worth of debt during the global financial crisis, or however many trillions we've issued during the pandemic. Debt is an important instrument of public policy in an emergency, and the global financial crisis and Covid-19 were all-hands-on-deck emergencies.

Nor do I think we were too lax in paring back debt issuance following the global financial crisis. The lesson of that experience was the danger of premature austerity, as we show in the book. But the time may come when austerity is in order. And our political system has shown little appetite or capacity to pursue it. We talk in the book about why (political polarization is part of the answer). I only wish we had solutions.

TIE: **Finally, the book's ending brings to mind this question given the rise of the Delta and other variants in this new post-Covid era—not to mention the never-ending battle of political polarization and the decline of American prestige in the world for a host of reasons. Are America's best days over? Would we be lucky to fall into a Japan-like scenario? Or is the premise of my question entirely too pessimistic?**

Eichengreen: I'm not worried about the technological and economic dynamism of the United States, which is as strong as ever. But I am worried about political polarization, tribalism, and denialism. The question is whether that technological and economic dynamism can survive these social and political problems, and whether we can get our collective hands around the latter. ◆