Comments on
"BOOSTING FISCAL SPACE: THE ROLES OF GDP-LINKED DEBT AND LONGER MATURITIES"
by J.I. Kim and J.D. Ostry

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The recent economic crises, and the consequent increases in public debt, have revived interest in understanding the implications of alternative debt management strategies. This paper revisits a long-standing proposal, and namely whether government should rely more extensively on securities like GDP-linked bonds (GLBs) or long-duration bonds (LDB). As is well known, through this type of securities governments could (at least partially) insure against economic shocks. The debt burden declines during bad (low growth) times, so that default episodes occur less frequently. In turn, the borrowing costs declines, and the debt limit increases.

The present study proposes a tractable and transparent framework to assess quantitatively to what extent issuing GLBs and LDB allow governments to gain "fiscal space", defined as the increase in the debt limit, relatively to a case where a governments only issue standard (one-period) bonds. The main message of the paper is that debt management policies could lead to sizable gains in "fiscal space", even though their actual magnitude varies substantially across different specifications ---the gains are above 120 percent of GDP in the baseline simulation with only one shock (Table 1), but in a range between 2 and 12 percent of GDP in the presence of multiple shocks (Table 6). This is certainly an important insight, as gaining "fiscal space" may actually be appealing to many countries, especially since the debt/GDP is growing rapidly as a consequence of the COVID-19 Pandemic crisis.

In what follows I will focus on two main points. The first one is about how we should interpret the gains in fiscal space. The second is about the potential drawbacks of issuing the proposed securities. Among the problems that have been pointed out in the past, and partly discussed in the paper, I will focus in particular on moral-hazard/incentives problems, which I believe require more extensive consideration.

Regarding the first point, when comparing alternative debt management options, one needs to compare benefits and costs. This paper quantifies the gains in "fiscal space", and discusses some possible costs. But how should the gains in fiscal space be compared with the potential costs? Clearly, increasing the debt limit say by 10 or 50% of GDP could be very attractive for countries which are currently very close to the debt limit, but less attractive for countries that are unlikely to reach the debt limit.

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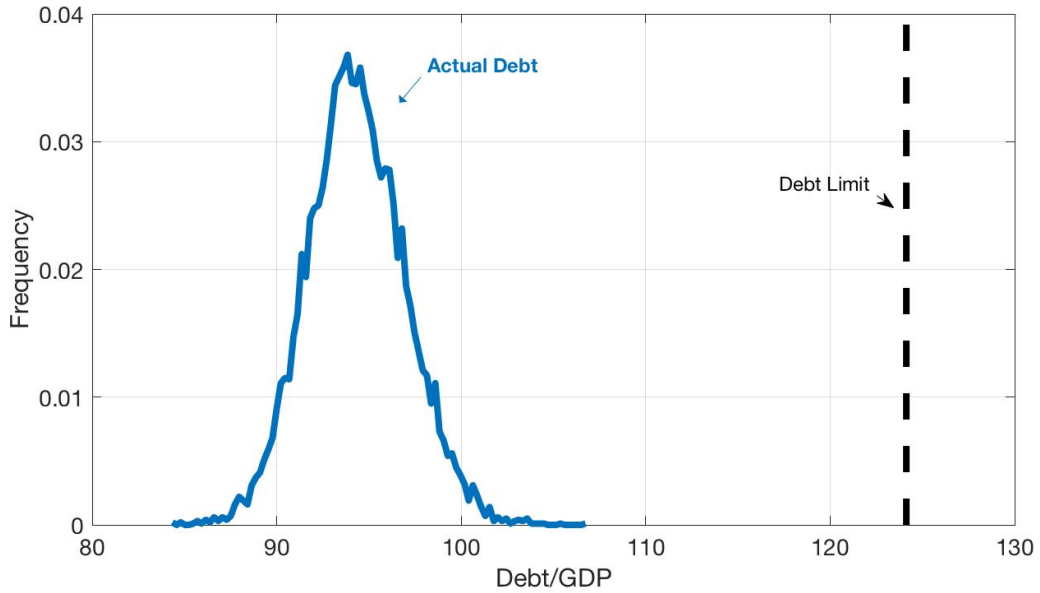
To provide a concrete example, Section V in the paper contains a very interesting application to a high-indebted country, where it is shown that issuing GLBs would lead to an increase in fiscal space of 90 percent of GDP. How important is to gain fiscal space for this country? To answer this question, the figure below illustrates the debt/GDP limit and the distribution of the debt/GDP, obtained from a simulation of 10.000 periods of the authors' calibrated model, assuming the country only issues standard bonds (STD), and follows the fiscal rule postulated in Figure 5. This exercise reveals that in this case even though the debt/GDP ration is relatively high (about 95% on average) it remains well below the debt limit. In fact, the (unconditional) probability of reaching the debt limits and thus default is less than 0.01 percent. Arguably, this implies that for this country there is little scope for further increasing fiscal space. The benefit is to avoid the costs of default, which is an extremely rare event. The cost is the risk/term premium, which would have to be paid every year. In this case, the government would buy fiscal space that it will rarely use. Obviously, countries facing a high probability of default, say because of higher initial debt, or high growth uncertainty, would be in the opposite situation, and issuing GLBs or LDB could be very attractive, even if it leads to a relative small increase in fiscal space. These considerations clarify that measuring the gains in "fiscal space" is not necessarily informative about the desirability of alternative debt management policies. Gains in fiscal space could be very large, but not very valuable. Or could be relatively small, but very precious.

Figure: Debt/GDP in a Highly Indebted Country



Regarding the second point, an aspect deserving further consideration is the incentives / moral-hazard problem. As is well known, providing more insurance may worsen incentives, and induce countries to accumulate excessive debt, or to delay indefinitely growth-enhancing reforms. It is often claimed that the moral-hazard problem is not a very relevant problem, especially for advanced countries. One argument is that governments are responsible and voters reward economic performance. Another argument is that one can mitigate moral-hazard problems imposing certain contractual conditions (e.g. retaining some "skin in the game", triggers, etc.). I do not find these arguments particularly compelling. Regarding the first argument, several studies in the political economy literature have shown that political economy factors, like older population, rising political polarization, and rising political uncertainty, are among the most important drivers of the high debt accumulation observed in the past decades [see e.g. Yared (2019)]. A common theme in these theories is the time-inconsistency of government policies. Current governments want to be *fiscally irresponsible*, hoping that future governments will be *responsible*. But if all governments were responsible, they would not accumulate high levels of debt. Regarding the second argument, it is not clear that enforcing contractual conditions to prevent moral-hazard problems should be easier than enforcing fiscal rules, or to enforce re-payments of standard bonds. But if countries were not accumulating high-level debt, and/or if it were possible to enforce fiscal rules, there would be little scope to increase fiscal space to start with. For this reason, the trade-off between insurance and incentives should be adequately taken into account, and quantified when thinking about alternative debt management strategies. This paper contains a useful exercise in that direction, and considers for instance a case where an increase in fiscal space may lead to a permanent decline in the growth rate of the economy. A natural question arises in this context, independently of what are the specific gains in fiscal space (which the authors show to be sizeable): under which circumstances should a government prefer a permanent reduction in its growth prospects to increase its fiscal space?

The trade-off between insurance vs. incentives motives has been analyzed extensively in the literature about the optimal debt maturity structure [see e.g. Arellano and Ramanarayanan (2012) and Aguiar et. al. (2019)]. Issuing long-term bonds provides insurance against economic shocks, but it exacerbates the commitment problem, so that governments have the incentives to accumulate excessive deficits ex-post. These incentives are anticipated by rational investors ex-ante, and reflected into higher borrowing costs. A typical prediction in this literature is that governments prioritize reducing the borrowing costs to getting insurance, and prefer short-term over long-term issuances, especially for emerging countries during crises, a feature that seems consistent with the empirical evidence [see e.g. Broner at. al. (2013)]. This suggests that the insurance motive might not be the key driver of the debt maturity structure.

To conclude, this paper argues that changing debt management practices may lead to substantial gains in fiscal space. This is a useful insight, with direct practical implications. However, understanding whether gaining fiscal space is actually desirable, when taking into account the associated costs, remains a largely open question.

References

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