The Debt Capacity of a Government

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Discussion: Nicola Borri (LUISS)

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How much can governments continue to borrow?

The U.S. federal government is the largest borrower in the world. The outstanding debt held by the public was $17.67 trillion at the end of 2019, a doubling from 35% of GDP before the Great Recession to 79% of GDP in 2019. Further deteriorated during the Covid crisis.

Can the U.S. government continue to borrow trillions more? Or should it reduce the deficit to avoid a debt market crash?

Source: Jiang et al. (2021)
Possibly a lot if no fiscal cost $r < g$ (Blanchard, 2019)
Very relevant policy implications

- If we borrow too little, and true debt limit high, then waste of fiscal space and lower growth.

- If we borrow too much, interest rates might ↑ unexpectedly and a crisis could occur (i.e., sovereign defaults, high inflation, etc.).
This paper (I/II)

- OLG economy, no uncertainty.
- Price of debt can be positive without being supported by future budget surpluses (rational bubble).
- Dynamics of debt function of the dynamics of the primary budget deficit.
- Identify debt capacity as maximum debt level above which it would necessarily explode.
This paper (II/II)

▶ $r < g$ matters, but also the amount of outstanding debt.
▶ Study policy-relevant settings:
  ▶ nominal debt and inflation
  ▶ debt and growth
My comments

1. Evidence of a rational bubble?

2. The role of the CB balance sheets.

3. International demand for safe assets and multiple equilibria.
Bond yields and default premia in the EZ

Yields appear to respond to the increase in default premium, especially so for riskier countries.
Who is buying (long-term) government bonds?

BoJ only buyer of government bonds since 2013 (source: @HannoLustig).
Central bank holdings in other countries ↑↑

Source: @RobinBrooksIIIF
Debt crises are like bank runs (I/II)

Source: Farhi+Maggiori (QJE 2017)
Debt crises are like bank runs (I/II)

- When is a government more likely to choose a high debt level (and risk a crisis)?
  - the world demand for safe assets is high,
  - the crisis is perceived to be a low probability event
Conclusions

- Great paper!
- Very hot and relevant topic.
- I would love to see a version of the paper with uncertainty.
Thank you!