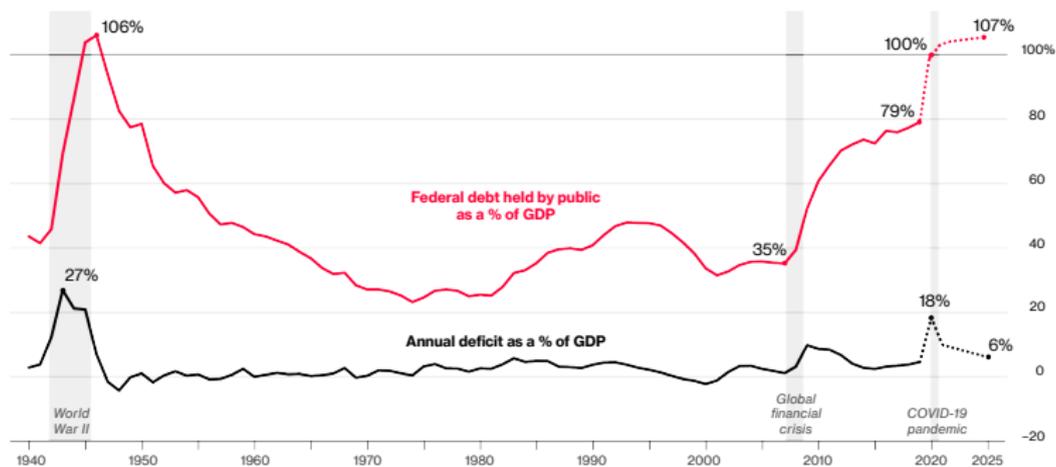# The Debt Capacity of a Government

By B. Dumas, P. Ehling and C. Yang
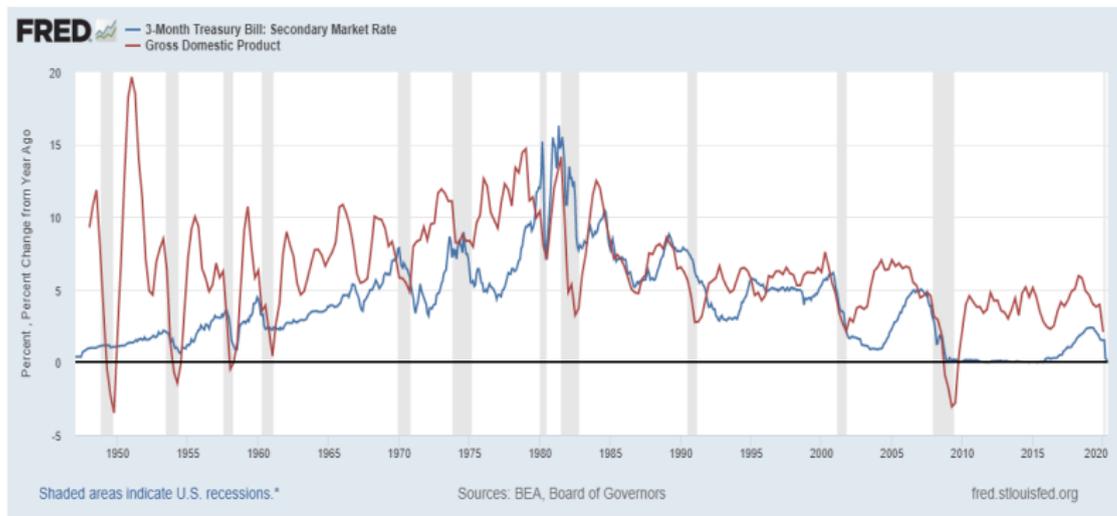
Discussion: Nicola Borri (LUISS)

Franco-German Fiscal Policy Seminar
November 10, 2021

How much can governments continue to borrow?

Source: Jiang et al. (2021)

Possibly a lot if no fiscal cost $r < g$ (Blanchard, 2019)

FRED — 3-Month Treasury Bill: Secondary Market Rate
— Gross Domestic Product

Shaded areas indicate U.S. recessions.* Sources: BEA, Board of Governors fred.stlouisfed.org

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.
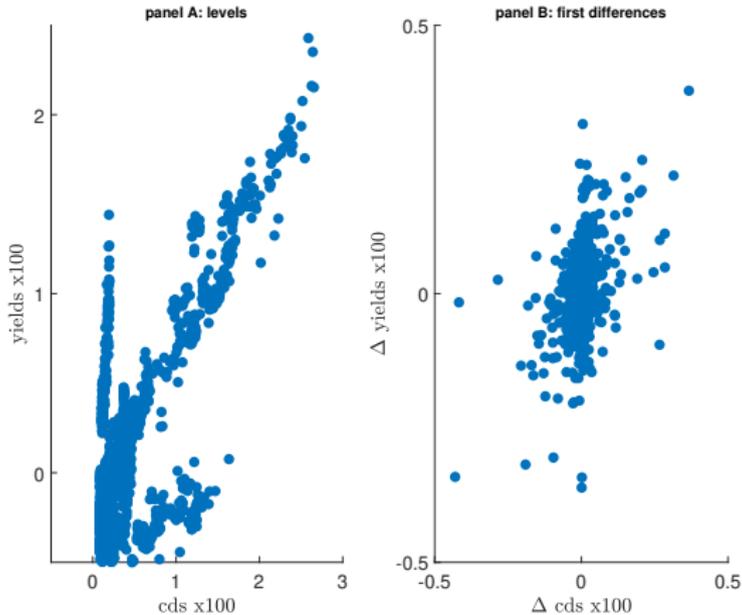
This paper (II/II)

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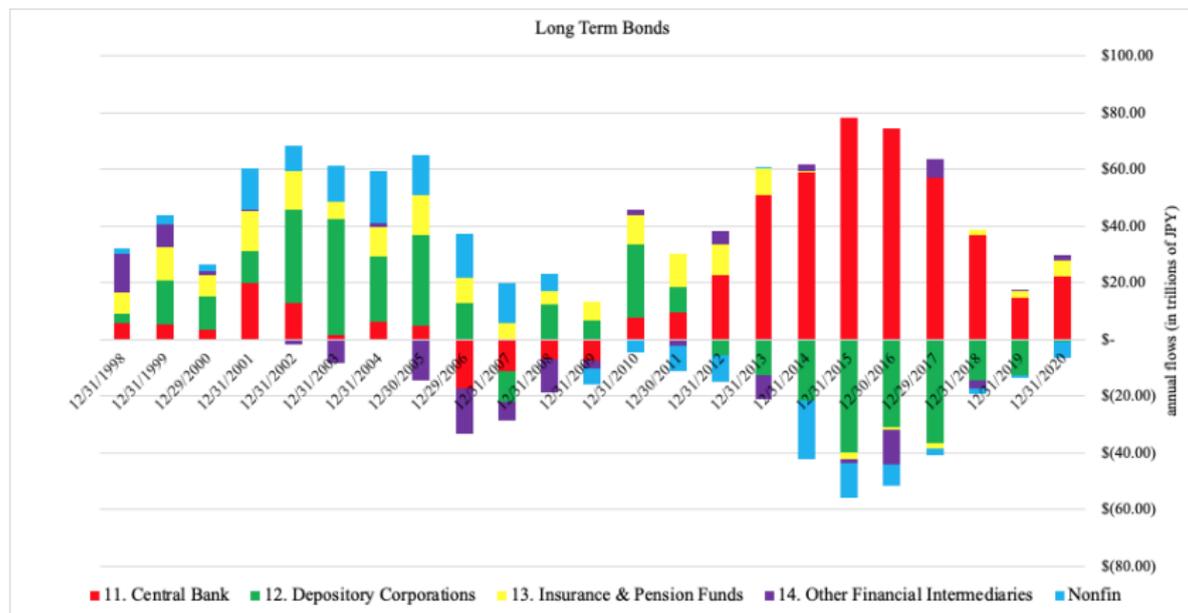 - nominal debt and inflation
  - debt and growth

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.
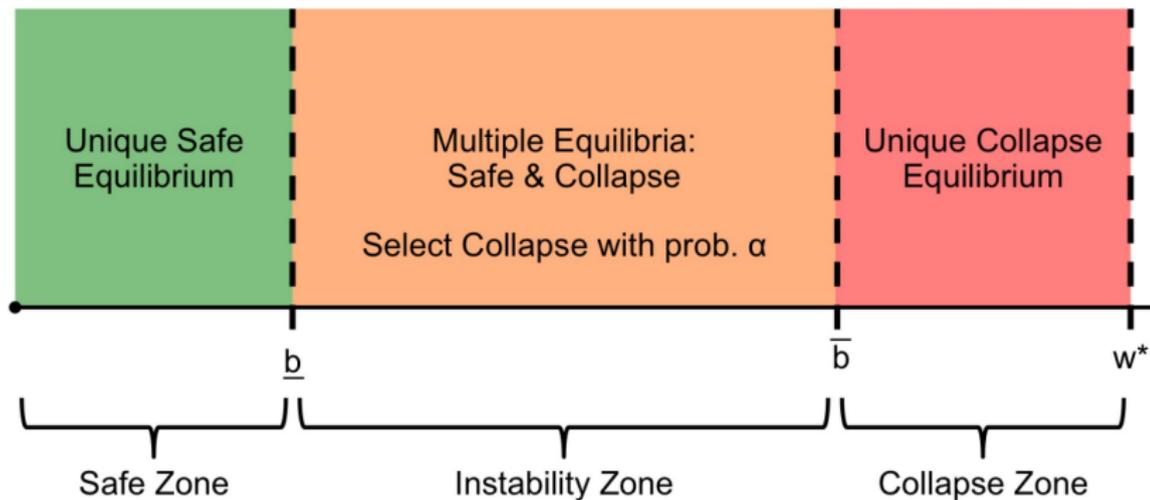
Who is buying (long-term) government bonds?

Long Term Bonds

Legend: 11. Central Bank | 12. Depository Corporations | 13. Insurance & Pension Funds | 14. Other Financial Intermediaries | Nonfin

BoJ only buyer of government bonds since 2013 (source: @HannoLustig).

Central bank holdings in other countries ↑↑

Central bank holdings of government bonds, in % GDP (last data point: Q3 2021)

Legend: CA, GB, JP, US, DE, SP, IT, AU
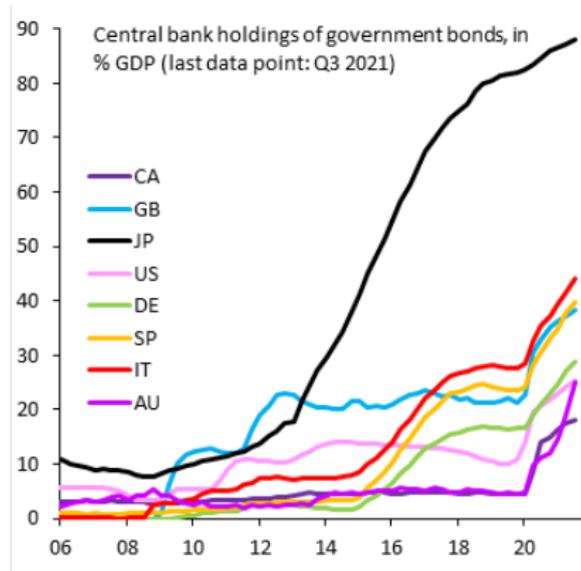
Source: @RobinBrooksIIF

Debt crises are like bank runs (I/II)

Source: Farhi+Maggiori (QJE 2017)

- 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!