EconoFact Chats: A Brief History of Public Debt

Barry Eichengreen, University of California Berkeley

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Michael Klein:

I'm Michael Klein, executive editor of a EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At a EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

About one block east of New York's Times Square, there is a national debt clock that shows minute by minute an estimated value of the government's outstanding financial obligations. In October 2022, this clock showed a national debt of over $31 trillion, representing more than $90,000 per citizen. The purpose of this is clearly to rebuke, rather than to applaud government debt. But is there an upside to government spending more than its tax revenues? How much should we worry about government debt of this magnitude? Does history offer any guide? To answer these questions, I am very pleased to welcome to EconoFact Chats Professor Barry Eichengreen. Barry is Distinguished Professor of Economics and Professor of Political Science at the University of California Berkeley, and is one of the country's preeminent economic historians. He co-authored the 2021 book In Defense of Public Debt. Barry also served as senior policy advisor at the International Monetary Fund from 1997 to 1998. Barry, welcome to a EconoFact Chats.

Barry Eichengreen:

Good to be with you, Michael.

Michael Klein:

Barry, I really enjoyed In Defense of Public Debt. The book takes a very long view, beginning with a discussion of government spending and taxing back in the Greek city-states and the Roman Republic, and over 200 pages coming to the present day. But at the very beginning of the introduction, you cite remarks made by Senator Rand Paul in December 2020 castigating the increase in government debt during the COVID Pandemic. Why did you begin this book that looks back thousands of years with a speech from about two years ago?

Barry Eichengreen:

So I started with that speech for two reasons. Number one, I wanted an extreme irrational expression of opposition to all government borrowing, and Senator Paul's speech qualified. And secondly, he made that speech on December 21st, 2020, in the throes of the COVID-19 pandemic, when almost everybody understood that it was essential for government to transfer funds to households so they could pay the rent and put food on the table, transfer funds to companies so they could meet payroll, and stay in business. Government didn't have enough tax revenues to finance those exceptional expenditures. I thought it was patently obvious that in an existential crisis like COVID circa 2020, the case for incurring public debt was clear.

Michael Klein:

That's a little bit like saying in 1943, we've run out of money. Let's stop fighting World War II.

Barry Eichengreen:

We make the case in the book that there are a variety of existential crises for states, from wars to natural disasters to pandemics, so your point is right on.

Michael Klein:

So we think of government spending today as providing for the national defense, building infrastructure, creating a safety net. And you point out that historically, government debt also helped foster financial markets, and through, this economic development. How did that happen?

Barry Eichengreen:

The first step was that when residents of a state purchased the government, government's or the sovereign's debt, they might find that their circumstances changed. So they wanted cash to meet some other need, and they wanted to sell their government bonds, securities to somebody else That prompted the development of what we now call secondary markets, which provided more liquidity to buyers and sellers of public debt, and more liquidity for other financial transactions as well.

Secondly, public debt is a relatively safe asset. We're going to come back to that I bet and talk about that qualifier relatively, but safe assets can be posted as collateral when a firm or an individual needed to borrow more money on those secondary markets or from a bank; they could offer government bonds as collateral, as security. So we find these spillovers from public debt to private debt markets in emerging economies today. A prominent development of the last 20 years is that governments have become able to issue their own bonds, denominated in the domestic currency, and slowly now their corporations are beginning to follow.

Michael Klein:

So basically government debt jump-started financial markets because there weren't large corporations that could issue bonds or stocks or anything like that. And that helped financial markets develop, correct?

Barry Eichengreen:

That's right. So one story about why Europe was the first part of the world to experience an industrial revolution is that it experienced a financial revolution prior to that. And one explanation for the financial revolution is that Europe was the public debt pioneer, the first part of the world where sovereigns, states began to issue public debt.

Michael Klein:

So you use the word relatively a minute ago, and another important theme is why do governments repay their debt? If you're an absolute ruler like a monarch, you could just repudiate the debt, and nobody's going to take the king to court. So what's the answer to that?

Barry Eichengreen:

Right. So the king is the highest earthly power, the sovereign, if you will. Sovereigns had a variety of motives for repaying what they borrowed. They understood the repeated game aspect of sovereign borrowing and repaying. They understood the importance of reputation, of cultivating a reputation for being a responsible borrower and paying back what they borrowed, because the bankers with whom they dealt, early sovereign debt was underwritten and extended mainly by Italian bankers, actually to the kings of England and the kings of Spain. And those bankers wouldn't lend again unless they were repaid.

When kings borrowed from their residents, they understood that the goodwill of those residents could be at stake. And especially with the advent of political checks and balances with the creation of republican

assembly in the low countries with the glorious revolution in England, they understood that there could be very serious blow back, if you will, from residents, from other domestic stakeholders if they defaulted on their debts. If you were Canada or Australia and you had borrowed from British banks and British households, defaulting on them was, in effect, defaulting on your kith and kin. You were all part of the commonwealth and empire. And finally, there was always the threat of gunboat diplomacy.

Michael Klein:

So that's how government debt helped foster the development of financial markets. And you also write about how government spending and taxation contributed to state building. For example, Alexander Hamilton had the Federal Government assume the debts of the states after the American Revolution. What are the ways that historically government debt helped serve this purpose of state building?

Barry Eichengreen:

Well, government debt issued in a crisis enabled states to carry out their core functions, to defend their borders, to defend their populations, to deal with a public health emergency. One can think of other examples. A government which falls down on its core functions doesn't long retain legitimacy in the eyes of the public. And conversely, if the government is effectively carrying out its duties, especially in times of crisis, it will garner more respect and support from the citizenry.

Michael Klein:

So I had this interesting conversation on a previous EconoFact Chats with Roger Lowenstein about the role of finance during the Civil War, and how the Union's ability to access financing and the South's relative inability to do so was one of the features that turned the war. So I guess that's a way in which state building or the preservation of a state depended upon financial markets.

Barry Eichengreen:

That is right. And we have a chapter in the book on that Civil War episode. The difference between the North and the South in terms of their ability to issue bonds in order to prosecute the war was really dramatic. The South was basically unable to do so. And there are some amusing, colorful stories about the Confederacy's attempt to issue bonds in Paris.

Michael Klein:

Where they tried to back them with cotton, right?

Barry Eichengreen:

They tried to back them with cotton that the creditors, the lenders, could only take delivery of in the South, much of which was being occupied or invaded by Northern troops.

Michael Klein:

I guess it was a threadbare excuse. So sticking with the 19th century in America, there's a saying that's attributed to Mark Twain that history does not repeat, but it rhymes. And this might be especially true with respect to government debt crises, going back to your use of the word relatively before. Walter Wriston, the Chairman of Citibank in the 1970s, said that countries don't go bankrupt. But if he had a better sense of economic history, he might not have made that statement, right?

Barry Eichengreen:

Right, well, I can think of a substantial list of mis-statements that might have been averted by a better knowledge of history, but that 1970s episode is a really interesting one. This is when money center banks like Citibank located mainly in New York, were lending hand over fist, recycling petrodollars -- deposits they received from Middle Eastern oil exporters -- to all manner of Latin American borrowers, Eastern European countries as well, despite the fact that they had these very different economic systems whose prospects were at best uncertain. So that raises the question of what these bankers thought they were doing.

They were, I think, more broadly ignorant of their earlier history. None of them had lived through earlier debt crises like the widespread defaults of the 1930s. Come the 1970s, all those earlier guys had retired and there was a new generation of MBAs at work at places like Citibank who were ignorant of that earlier history. So I make it my life's purpose to try to inform students and others about this history. But it is striking that my efforts, not withstanding, we see these repeated cycles of hand over fist lending, followed by the development of problems, followed by defaults, followed by a period of quiescent international financial markets, after which the boom starts up again, as if nobody can remember what happened before.

Michael Klein:

So of course, there's a famous book by Rogoff and Reinhart, This Time Is Different, which was meant to be an ironic title that, in fact, these times weren't different. So it's interesting then you were serving as a senior policy advisor at the International Monetary Fund in the late 1990s, a time of the Asian debt crisis, and not long after the debt crisis in Mexico and the prospect of a crisis in Argentina. What lessons from history did you find particularly helpful, Barry, when you were working at the IMF?

Barry Eichengreen:

So I was not surprised that the crisis began to spill from country to country, that we saw a contagion of financial crises and incipient debt defaults, because there are plenty of examples of that kind of contagion in history, in Europe in 1931, across the Atlantic in 1873. One could go on, but I think for many people, one of the surprising aspects of 1997 was the contagion that what started in Thailand didn't stay in Thailand, but spread through much of East Asia. The other thing that didn't surprise me was that resolving these problems took quite a long time because history similarly shows that resolving debt crises and debt defaults is messy and time consuming. And alas, that's a lesson that we are relearning today when scores of low income countries are suffering from debt problems, and we're only making very slow progress at working them out.

Michael Klein:

So you mentioned the 1930s, I want to put a plugin for your book, Golden Fetters, which I just think is a tremendous book, talking about that episode and the role of the gold standard at that time. Barry, are there ways in which the crises get resolved over the last few decades, that are similar to what happened historically? And in what ways were these resolutions similar? In what ways were they different?

Barry Eichengreen:

We have seen the decline of gunboat diplomacy. We have seen some weakening of sovereign immunity. So historically, a government that borrows abroad can only be sued by foreign creditors in its own courts, and a borrowing government won't permit such a suit to go forward. So there's more litigation now over sovereign defaults. So if you've been following the Argentine saga, Argentina has been in and out of default multiple times in recent decades. A lot of the drama revolves around disputed court cases in New York and elsewhere that introduce a new element of uncertainty and another dimension to the messy process of resolving defaults. But I think the historical constant is that governments borrow from dispersed creditors. There are many lenders; investment banks, mutual funds, hedge funds, individuals,

and getting them to agree on a resolution to the problem -- sovereign debt restructuring, is like herding cats. And that, unfortunately, remains the case.

Michael Klein:

What about less dramatic decreases in the debt burden? Not a crisis, but just an effort to reduce the debt burden? Your Berkeley colleague, Maury Obstfeld and I have an EconoFact memo on the reduction of government debt after World War II from over 100% of GDP in the United States right after the war to 50% within 10 years, and then less than 25% within 30 years. Does history offer any lessons on the reduction of debt of this type that are applicable today?

Barry Eichengreen:

Yeah, so we look at a number of these so-called debt consolidation episodes in the book where there are a variety of different ways that governments can and have worked down their debt ratios. So here I'm talking about debt relative to GDP. How much debt you have is important only relative to the size of the economy. So it's the debt to GDP ratio that you should focus on, and you can work that down by running budget surpluses, and retiring existing debt. You can work it down by growing the denominator of the debt to GDP ratio, growing the economy.

You can work it down through inflation as we in the United States have done this year, so long as the interest rate remains below the inflation rate, which as we know now can't be taken for granted, and might not be the case going forward. What we argue strongly in the book about [inaudible] post World War II period is that it wasn't all inflation, but it was a combination of a modest dose of inflation, regulations that kept interest rates down, but importantly, economic growth, which grew the denominator of the debt to GDP ratio, and in some countries persistent budget deficits as well.

We conclude in the book by asking what are we going to have to do to bring this debt burden back down in the future, which we should do in order that we have the capacity to meet the next emergency. And we conclude it will have to be done through a combination of approaches; budget, balance, successfully growing the economy and maybe a little bit of inflation, or at least avoiding deflation.

Michael Klein:

So following up in that and going back to where we started, Barry, I'd like to go back to Senator Paul and the debt clock just outside of Times Square. Using a historical lens, how would you balance current concerns about today's level of public debt and what would you say as in the title of your book, In Defense of Public Debt?

Barry Eichengreen:

The defense is that public debt is a valuable, even an essential policy instrument for governments confronting a crisis, be it a war, a natural disaster, a public health emergency. We learned that from COVID 19. We learned that in a sense from the global financial crisis of 2008-2009, when there was a danger of financial and economic collapse, and governments borrowed to finance programs to fend off that collapse. But the kernel of wisdom in Senator Paul's remarks is that once the emergency is over, you want to undergo a process of debt consolidation so that you can restore that ability to borrow in the future. We've done a great job at borrowing to meet emergencies. We haven't done such a great job of restoring that capacity once the emergency passes.

Michael Klein:

Barry, the historical lens is so useful for reviewing the current situation, and I congratulate you again on this wonderful book, In Defense of Public Debt. And thank you very much for joining me today on EconoFact Chats.

Barry Eichengreen:

Thank you, Michael. It's been fun.

Michael Klein:

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