BANCO DE ESPAÑA
Eurosistema

“Bailing out the people? When private debt becomes public”

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Workshop on "Fiscal policy in an environment of high debt“

Brussels, 18 January 2018

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OVERVIEW

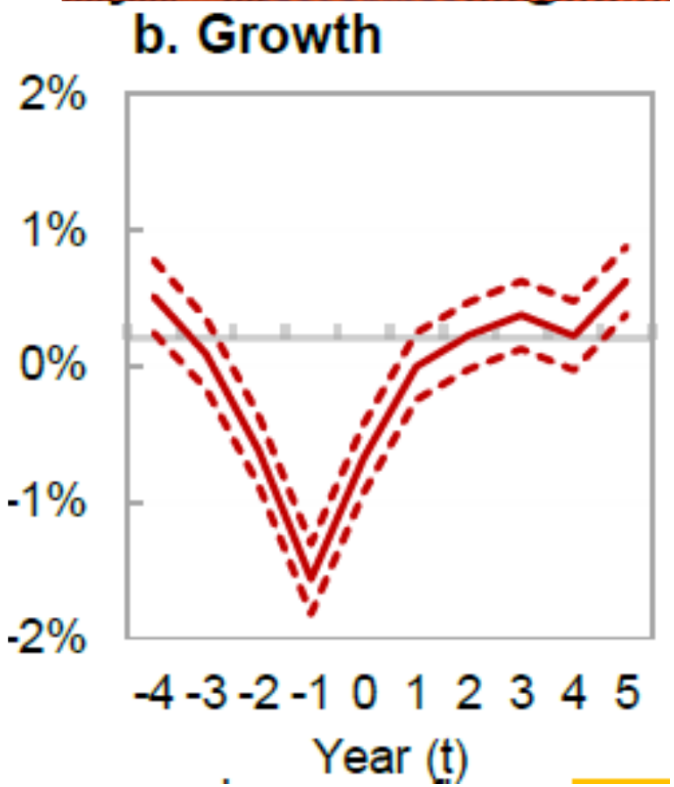
- The paper argues that **private deleveraging episodes trigger increases in public debt** (mutualization).
- The key mechanism is not so much explicit bail-outs but …
  - **The private deleveraging episode hinders economic growth and subsequent countercyclical fiscal policy increases the public debt ratio.**
- **Whether total debt ends up increasing or decreasing depends on the extent of the growth slowdown and the reaction of fiscal policy** during the deleveraging spell
  - **Total debt increases only in a slow growth and strong fiscal policy reaction scenario**
- Implications for monitoring public finance developments: **we should take into account these apparent implicit guarantees when analyzing public debt sustainability** (see Berti et al (2013) or Hernández de Cos et al (2014))

- **The topic is timely and the econometric analysis well-executed.**
- **The database is impressive and very useful.**

COMMENT #1: AN ALTERNATIVE INTERPRETATION

- The empirical evidence presented in the paper is not at odds with an alternative narrative in which **a negative growth shock is the trigger of the private deleveraging episode as well as of the surge in public debt**.

- Indeed, according to figure 9 in the paper**, a negative growth shock takes place the year before the deleveraging episode begins**…



- Suggestion: In order to enhance the validity of the paper's narrative, one nice exercise would be to **identify negative GDP shocks and estimate their effect on private deleveraging and public debt (i.e. switching Y and X**). The lack of significant effects in this exercise would be clear evidence in favor of the authors' hypothesis.

- Note that the IPWRA approach is not the panacea to alleviate this concern (see comment #2 below)

COMMENT #2: ON THE CAUSAL INTERPRETATION

- **The IPWRA approach only takes into account selection in observables**, which is essentially the same assumption that you use in OLS with controls. However, it fully ignores selection on unobservables for instance.
- Therefore, the crucial assumption is that conditional on the control variables having a deleveraging episode is completely random.
- This is important because **the list of variables that may simultaneously affect GDP growth and private/public debt is huge** (for instance, there is no control variable related to housing prices).
- Moreover, the authors emphasize the benefits of the IPWRA method to enhance causality but most results in the paper are based on OLS a la Gourinchas and Obstfeld (2012). Are all the findings based on OLS robust to the use of IPWRA?

- **Suggestion:** Given the importance of the control variables, **more discussion on the choice of observables to include in the conditioning set (the Xs) is warranted**. Include robustness checks.
- Moreover, for the sake of coherence, IPWRA should be the baseline method.

COMMENT #3: ON THE ROLE OF FISCAL POLICY

- According to the results, **under a growthless deleveraging episode strong government support seems to increase total debt** while growth remains much lower than in tranquil times (Fig. 12).
- Figure 10 shows that is **discretionary fiscal policy**, not automatic stabilisers or stock flow adjustments (which are positive on average suggesting sale of assets?), **the responsible of the increase in public debt**. Is this evidence of non-keynesian effects?
- Not really: **episodes of strong government support may well be those in which GDP growth is lower** among the growthless episodes

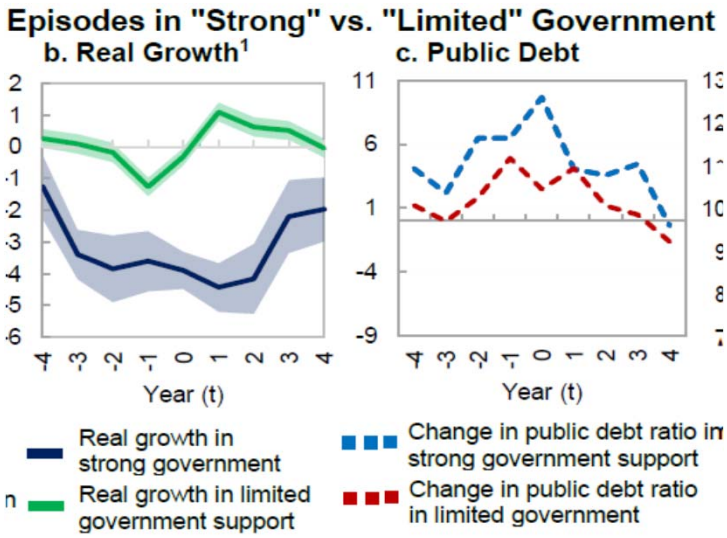
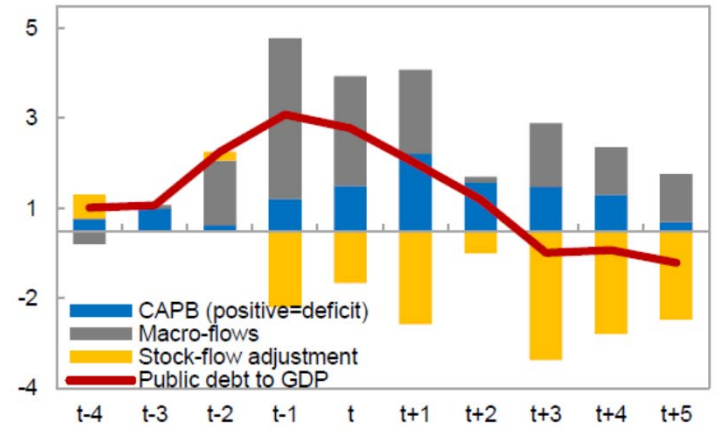


Figure 10. Sources of Change in Public Debt during Private Deleveraging (Percent of GDP)



- Suggestion: One possibility is to explore the role of fiscal policy by **splitting the sample according to the exogenous fiscal expansions and consolidations** compiled in DeVries et al (2011).

COMMENT #4: ON THE ROLE OF MONETARY POLICY

- A discussion on the potential role of monetary policy during deleveraging episodes is somehow missing from the draft.

- **The monetary policy reaction (regime) can be a key conditioning factor of the success of the private deleveraging process and its impact on the economy and of the ability of fiscal policy to react** and accumulate debt without spurring a market reaction (experience of the current crisis, particularly in Europe).

- **Suggestion:** It would be informative to conduct an additional exercise **splitting the sample according to the monetary policy stance**. This would allow the authors to explore the differences in the evolution of growth and public debt after the deleveraging episode depending on the monetary policy stance.

COMMENT #5: ON THE SIZE OF THE EPISODE (OR THE INITIAL LEVEL OF DEBT)

- The deleveraging definition **does not take into account the size of the deleveraging process** (**or the initial level of debt**) and thus episodes are treated symmetrically regardless of their size.

- However, **the dispersion in size (initial level) across episodes is substantial** (table 1). Therefore, the estimates in the paper can be interpreted as the effects of the "average deleveraging episode".

Table 1: Average Features of Private Deleveraging Epis

	World	
	Mean	(Std. dev.)
Length (years)	3.4	(1.7)
Size (drop from peak to through, % of GDP)	-11.8	(24.3)
Rate (size/length)	-3.2	(4.8)
Distance between episodes (years)	8.0	(7.1)

- The concern is that it may well be that large and small episodes differ in their effects. Indeed, **the possible correlation between growth and the size of the episode implies that the growthless results (increases in total debt) may well be due to the size of the episode** rather than to its growthless nature.

- Suggestion: One possible solution is to **include interaction terms in equation (1) along the lines of Gourinchas and Obstfeld (2012) with episode-size dummies** (initial level of debt) in order to assess whether the estimated effects, especially the increase in total debt, depend on the size of the episode (or the initial level of debt).

COMMENT #6: ON FINANCIAL CRISES

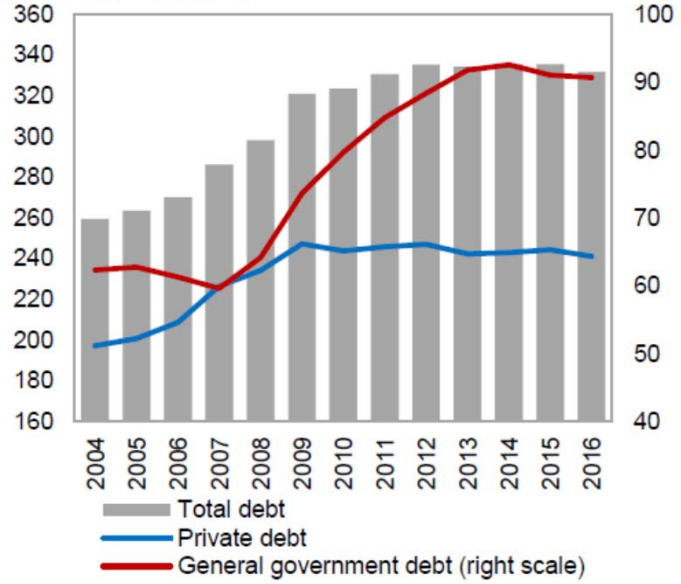
- It is striking that the consequences of private deleveraging episodes are more or less the same regardless of the presence of financial crises, as one may expect that **the presence of a financial crisis would amplify the main channels emphasized in the paper**. This result somehow casts doubt on the “This time is different” hypothesis…
- This result may be related to the previous comment on the size of the deleveraging episode:
  - It seems reasonable that financial crises are associated to larger deleveraging episodes, which are expected to have larger effects on economic activity and thus on public debt.
- Given the discretization of deleveraging episodes, this possiblity is completely concealed in the current analysis.

- **Suggestion:** Explore the relationship between financial crises and the size of deleveraging episodes. If it is positive, include interaction terms in equation (1) along the lines in comment #5.

COMMENT #7: LOOKING AHEAD

- After the global financial crisis many economies were left with both a high stock of private and public debt.
- A key challenge for many AEs is **how to consolidate public finances in high private-debt environment with deleveraging pressures**.
- **The new dataset provided in the paper is highly valuable to shed light on some key questions:**

Figure 1. Advanced Economies: Gross Debt
(Percent of GDP)



- How likely is this?

The available empirical evidence shows that a high growth scenario (as the current one) is associated to a lower probability of private deleveraging (Table A.4.1 of the current paper, for example) as well as a lower probability of public sector deleveraging or fiscal consolidation (Hernández de Cos and Moral-Benito 2013).

- What are the economic implications of a simultaneous reduction in public and private debt?

- What are the policy implications in that environment?

THE EFFECTS OF FISCAL CONSOLIDATIONS ON PRIVATE DELEVERAGING DYNAMICS

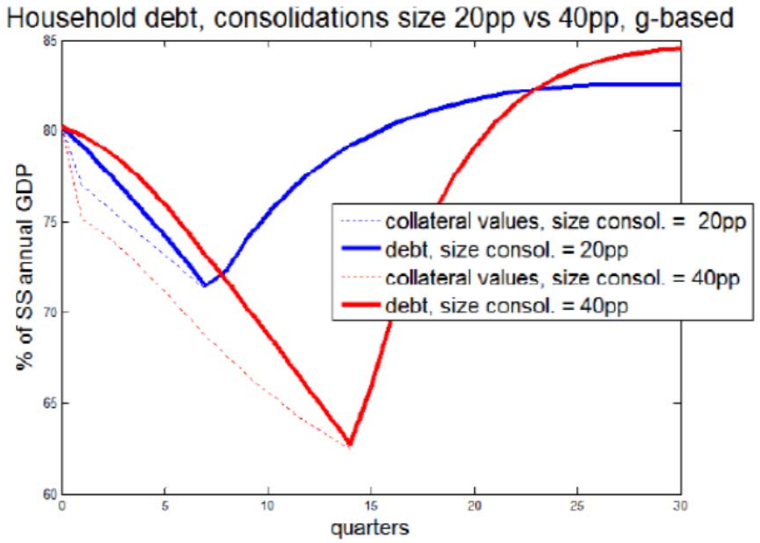
- Some recent research at Banco de España (see Andrés et al 2016) analyzes jointly fiscal consolidations and private deleveraging in a model with financial and real frictions:

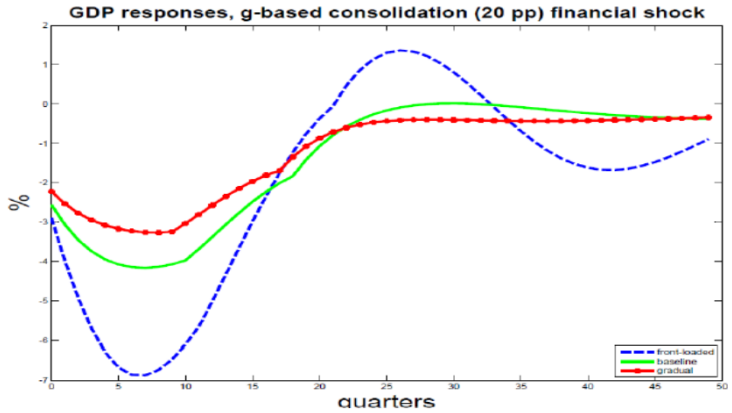
➢ **Fiscal consolidations** depress NFCs' and households' net worth (lower income, asset prices, etc.) and **make deleveraging longer, deeper and costlier**

➢ **Timing of fiscal consolidations matters**: frontloading is likely to worsen private deleveraging dynamics, by exerting a sharp and persistent drop in debtors' net worth, but CREDIBILTY is essential

➢ **Composition of fiscal consolidation matters**:

- Taxes on assets penalize the recovery of net worth and collateral values
- In the ZLB, aggressive govn't expenditure contractions are strongly deflationary, raising real interest rates and the debt burden (Fisher effect)

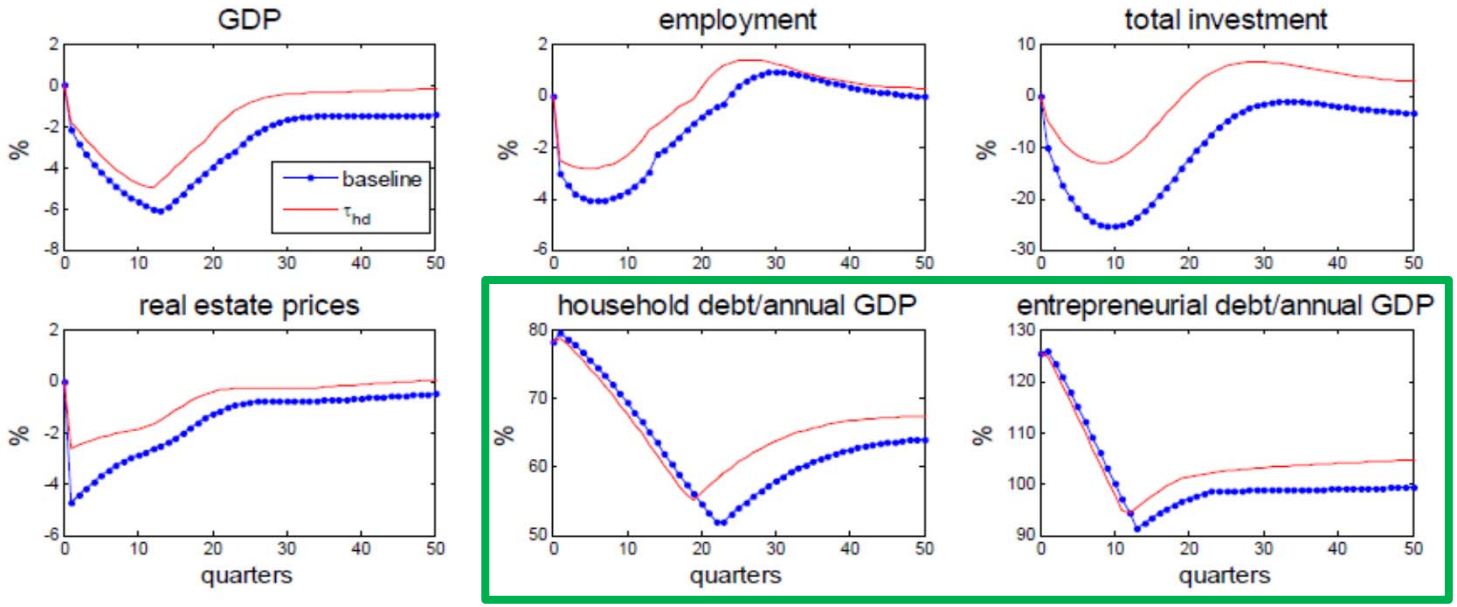




STRUCTURAL REFORMS IN A HIGH PUBLIC & PRIVATE DEBT ENVIRONMENT

- **Some structural reforms** (e.g. higher competition in product markets) have also the virtue to **facilitate private deleveraging** by incentivizing investment….

Responses after a financial shock with and without an investment-friendly structural reform



Source: Andrés et al (2017)

- …**and to reduce the distortions caused by a fiscal consolidation** by enlarging tax-bases (Gerali, Notarpietro and Pisani, 2015).