Good Debt *vs.* Bad Debt

By Otmar Issing and Ludger Schuknecht

Barry Eichengreen and his co-authors show that debt can have two sides.

High and rising public debt used to be seen as a true "bad" for countries: for their economies threatened by devaluation and crisis, their governments which were seen as latently weak and unstable, and for their people who had to feel apologetic for coming from such poorly managed places.

Today, the situation could not be more different. Countries have effortlessly financed momentous deficits and accumulated new record debt levels with hardly a blip in financial markets. Public debt in the G-7 countries stands at 140 percent of GDP, the same level as after World War II, and the financing costs are at record low interest rates. Germany and a few other countries even get paid for debt issued as far as ten years ahead.

Add to that all the possibilities to do good things with more debt: improve our health and education system for a more resilient and future-ready society; build better infrastructure; improve income distribution towards a less divided society; finance decarbonization and thus prevent climate change; and promote our soft and hard power to face growing geopolitical challenges.

More debt will thus make individual countries and the world economically, financially, and socially richer, and debt can be much higher than previously thought. Adherents to Modern Monetary Theory go even further and want to use the money printing press of central banks.

This is where Barry Eichengreen and his co-authors come in and provide an invaluable account of historical episodes where public debt played a positive

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Otmar Issing is President of the Center for Financial Studies at Goethe University Frankfurt, and founding Member of the Executive Board of European Central Bank. Ludger Schuknecht formerly served as Deputy Secretary-General of the Organisation for Economic Co-operation and Development, and G20 Deputy and Chief Economist for Germany's Federal Ministry of Finance.

and a negative role. Debt helped build nations, boost prosperity, and win wars. And debt ruined countries, toppled regimes, and humiliated and divided their people. Debt was by itself an innovation and helped innovate and develop finance, the lubricant of our economies. And most importantly, perhaps, good debt and successful nations helped propagate the institutional frameworks that made them successful and debt better.

The separation between "good" and " bad" debt is an *ex post* assessment. *Ex ante,* governments always claim that their budget deficits will create good debt. Will we look forward to a future where this distinction will become obsolete and all new debt will be good? Have we found the new "land of milk and honey" where everything will be fine if we spend more on the right things while debt finances itself? Is "this time different," to paraphrase economists Carmen M. Reinhart and Kenneth S. Rogoff? Or is there still reason to be cautious despite zero-interest rates?

Looking at the financing side of debt first, most people do indeed assume that financing costs remain ultra-low for the next decade at least. This is embedded in market expectations and in long-term economic projections. According to the European Commission, negative real interest rates will contribute to bringing down the real value of public debt by about 1–2 percent of GDP per year over the next decade in the European Union. It could even be more if the interest rate stays low and inflation is higher.

But how realistic is this? Inflation is expected to stay low according to most projections but at the moment it is not. And there are important factors that could lead to structurally higher inflation to come. This includes the labor supply, wage pressure, and the adverse savings effect of an aging population. Supply bottlenecks, re-nationalization of production, and carbon pricing will work in the same direction. The huge money overhang accumulated over the past two decades may unwind and further interact with inflation and financing costs. Is this something to worry about soon? Probably not, but over time likely yes. This judgement should affect strategic thinking about public finances and public debt quite soon.

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Equilibrium real interest rates may rise again over time. Population aging will move many people from high-savings to low-savings cohorts. Climate change and decarbonization will require huge investments into mitigation and adaptation. This may strongly alter our global savings investment balance over the course of the next decade. Of course, inflation and equilibrium real interest rates are highly uncertain, but it is imprudent to assume that things will simply stay the same while they have been constantly changing in the past.

Even if equilibrium rates stay low, the risk appetite—and with it, risk spreads—may change. This risk is not equal across countries. Where debt levels are higher and debt dynamics stronger, the risk of higher spreads and sudden stops in debt financing rises. Since the global financial crisis, we know that this does not just affect emerging economies. It becomes a more obvious risk when central banks plan to exit from the quantitative easing mode. Some countries are more obvious candidates than others and feature very high debt and deficits. Even the dollar or the euro may not be safe bets against rising mistrust by investors.

If and when financing conditions change, it may be too late to do something about very high debt. Experience shows that debt ratios are fast-moving on the way up but very slow-moving on the way down. Debt in G-7 countries went up by over 50 percent of GDP on average between 2007 and 2020. But it mostly takes ten to fifteen years to bring debt down by half that much. Hence, if your debt is at 120 percent or 150 percent of GDP in 2021, you need to start soon if you want to be ready for financial headwinds in 2030.

Some argue that there is more time because higher interest rates will take years to feed through to higher government financing costs. That is true to some extent, but

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perhaps less than we think. The average maturity of public debt was about fifteen years in the United Kingdom, and between five and one-half and seven years in the United States, Italy, or Spain in 2020–2021. But this does not take into account the effect of quantitative easing, which effectively turns long-term debt into short-term debt as regards market risk. Based on current central bank asset holdings, the effective maturity of public debt is about one-quarter shorter.

Turning to the spending side, the distinction between "good" and "bad" debt depends very much on what the money is used for. Well-designed spending on high-return infrastructure and citizens' skills and adaptiveness is indeed likely to enhance the innovativeness and growth potential of an economy and, thereby, its debt carrying capacity today.

But again, how likely is that to happen? Eichengreen and his co-authors provide some examples in both directions. When looking at the situation in today's advanced countries, however, some healthy skepticism is warranted. Public spending increased hugely in many countries over recent decades while investment and education spending broadly stagnated or declined. The European Fiscal Board's 2020 report, for example, shows that an expansionary expenditure stance during the pre-Covid recovery was hardly used at all to raise public investment. The additional spending over past decades raised social spending which even crowded out other items. Yet, this has not really appeased our societies, and social divisions seem greater today than before the expansion of the welfare state.

Looking forward, for example at Europe's Next Generation EU spending program, much of it is designated for public investment. However, money is fungible and the programs often choose to finance pre-existing rather than new commitments. This is no surprise, as it takes years to prepare good investment projects and financing is hardly ever the problem in Europe or elsewhere. The impediments are structural and mainly relate to complicated and lengthy bureaucratic procedures. Private sector involvement for the management and financing of public infrastructure could be a better option for professionalizing the management and depoliticizing the financing of infrastructure in many countries.

Looking forward, it is in fact unclear what the returns of additional spending will be. They may partly even be negative if they lead to more "white elephants," or poorly targeted programs that reduce rather than increase the incentives to work and innovate. What will happen in our societies when the expectation of more money that is "up for grabs" raises rather than appeases distributional conflicts further and distracts from the prioritization of core challenges, such as climate change and geopolitics?

This brings us to the core difference between good and bad debt. Spending and debt are only as good as their underlying governance and institutions. Soft budget constraints do not lead to better spending. They rather allow governments to avoid prioritization and proper controls, and finance less productive pet projects and programs. Moreover, many countries do not have proper mechanisms to ensure expenditure prioritization, project and program management, and outcome monitoring. However, it is outcomes that matter for the debt-carrying capacity of an economy.

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Turning back to the initial question of good versus bad debt: The quality of what we get for more future debt is highly uncertain and so is the prospect of repayment if debt rises further. Who in all honesty does not bear doubts whether all G-7 countries will use additional debt-financed spending for investment? Who does not wonder whether all G-7 countries will continue servicing and paying for their debt in the very long term, given population aging and other challenges, without the "helping hand" of a major debt-reducing event?

Institutional settings, including fiscal rules, budgetary institutions, and other incentives for policymakers and populations, will determine whether current record debt levels and projected debt increases will have a happy or an unhappy ending. For debt to be "good," the debt level and debt dynamics need to be sustainable and the quality of spending needs to be high. And for that to happen, we need to change course in good times. Revisiting our institutions and institutional shortcomings towards reaching safer debt levels and better spending should be the focus of our discussion on fiscal policy. Focusing on whether to spend the marginal additional fiscal space that an exceptional monetary policy environment temporarily created is a distraction and increases the risk of "good" debt turning "bad." ◆