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Comment on Albrecht Ritschl: Sustainability of High Public Debt: What the Historical Record Shows

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Ever since the 1970s public debt in most OECD countries has risen rapidly. Presently, a number of European countries have debt to GDP ratios surpassing 100 percent. The Swedish public debt roughly follows this pattern as shown in Figure 1 in Mats Persson's study in this issue. Swedish gross central government debt to GDP was fairly stable from 1860 until World War II. It rose from around 20 percent to a peak of 50 percent in the period 1940–46. It then fell back to a low of around 20 percent in the mid-1960s. A sharp rise began at the end of the 1970s, peaking in the mid-1980s, followed by a fall in the second half of the 1980s. The ratio rose rapidly to a level of between 80 and 90 percent of GDP by the mid-1990s. Now the ratio seems to be declining again.

How should this remarkable appearance of high public debt in peacetime be explained? This is a crucial question to answer. Can the history of public debt prior to the 1970s give us any clues?

Albrecht Ritschl surveys the history of high public debt in three countries in the twentieth century, Great Britain, France and Germany, in search of an answer. He demonstrates that high public debt prior to the 1970s was due to the financing of World War I and II. The outcome of the two world wars determined the extent and character of debt retirement. Great Britain and France honored their debts after some initial problems whereas Germany defaulted and actually emerged from World War II with no debt.

Ritschl's basic conclusion is that the debt experience of the two periods, i.e., the accumulation and retirement of public debt, does not

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give us much guidance in interpreting the debt behavior of governments after the 1970s. I firmly agree with him on this point. He hints in his conclusions "that the debt record of the last few decades may be the result of a regime change whose nature is not yet fully understood".

Let me develop this suggestion somewhat, as I am convinced that a change of stabilization policy regime or monetary regime took place in the early 1970s following the breakdown of the Bretton Woods system in Sweden as well as in other countries. Although I focus on Sweden, I believe that the Swedish case has a lot in common with the experience of several OECD countries in recent decades.

The Bretton Woods system placed a strong restriction on Swedish fiscal and monetary policies as it represented a fixed exchange rate system. After it broke down, exchange rates became more flexible. This allowed for a switch to a Keynesian regime characterized by monetary and fiscal accommodation as a policy response when Sweden was the target of negative chocks such as OPEC I and II and the depression of the early 1990s.

Monetary accommodation took the form of a series of devaluations (1976, 1977, 1981 and 1982) and a sharp depreciation following the move from a fixed to a flexible exchange rate for the Swedish currency in November 1992. Fiscal accommodation came about through government support to contracting industries and regions as well as unemployed labor. Since tax revenues were insufficient, rising public expenditures were financed by borrowing. This led eventually to high public debt.

This interpretation explains why the Swedish government did not allow public debt to rise during the depressions of the 1920s and 1930s. In the interwar period, a balanced budget was still the norm of stabilization policy. This budget rule was ignored after the full-fledged acceptance of a Keynesian approach to policy formulation in the 1970s and 1980s.

To sum up, I would explain the post-1970 pattern of high public debt as the outcome of a change in the monetary regime due to the acceptance of a Keynesian view when Sweden was hit by a number of negative shocks. Consequently, the wartime experience of public debt prior to the 1970s belongs to a different monetary regime. Basically, it represents the "traditional" way of financing war efforts, i.e., by borrowing from the public or from the central bank.[1]

[1] This is seen from the Swedish experience of public finances during the wars in the 18th and 19th centuries as well, as examined by Fregert and Jonung (1996).

What will happen in the future to the currently high public debt in Europe? We do not have – as Ritschl points out – much historical evidence to guide us on this point. My guess is that as long as the Keynesian view predominates, there will be no major attempts to reduce the volume of public debt. Such attempts will prove politically unpopular and costly. Rather, I suspect that when a new negative shock occurs, the debt ratio will again be allowed to rise.

Policymakers are presently not disciplined by budget norms and fixed exchange rates as was the case prior to the 1970s. Rather, they are disciplined primarily by the response of financial markets, i.e., by movements in interest rates on government debt. As long as the level of interest rates appears politically acceptable, there are weak incentives to reduce the volume of debt. The incentive to default will not be high either. The reason is simple; any government in debt is dependent on access to capital markets to finance its future expected debt. A default will cut off this source of finance, which is too high a price to pay under peacetime conditions. I thus predict a future with continuing high public debt.

References

Fregert, K. and Jonung, L. (1996), Inflation and Switches between Specie and Paper Standards in Sweden 1668–1931. A Public Finance Interpretation, forthcoming in *Scottish Journal of Political Economy.*