PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Chapter 6: Reducing Debt Short of Default

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Summary

- A clear and comprehensive survey of the topic
    - No notable omissions
    - Analysis seems correct
    - Would benefit from sharper conclusions
- Two broad comments
    - Currency denomination needs more emphasis
    - Some quibbles on the line between monetary policy and financial repression

Currency of Debt

- The issue of local currency versus foreign currency deserves a bigger role as an organizing principle in the chapter (and the book)
- Many conclusions (on crises, fiscal space, growth impacts) depend critically on currency denomination
- With FX debt, options are primarily fiscal consolidation or default
  - Micro policies to boost growth can be hard to find
  - Seigniorage scope is quite limited

Currency of Debt

- With local currency debt, the options are augmented by monetary policy and financial repression
- QE demonstrates that the entire interest burden of the government is under monetary control
  - Greek-style crises are not a concern with LC debt
- Hyperinflation is possible, but considerable debt reduction may occur before inflation rises that high

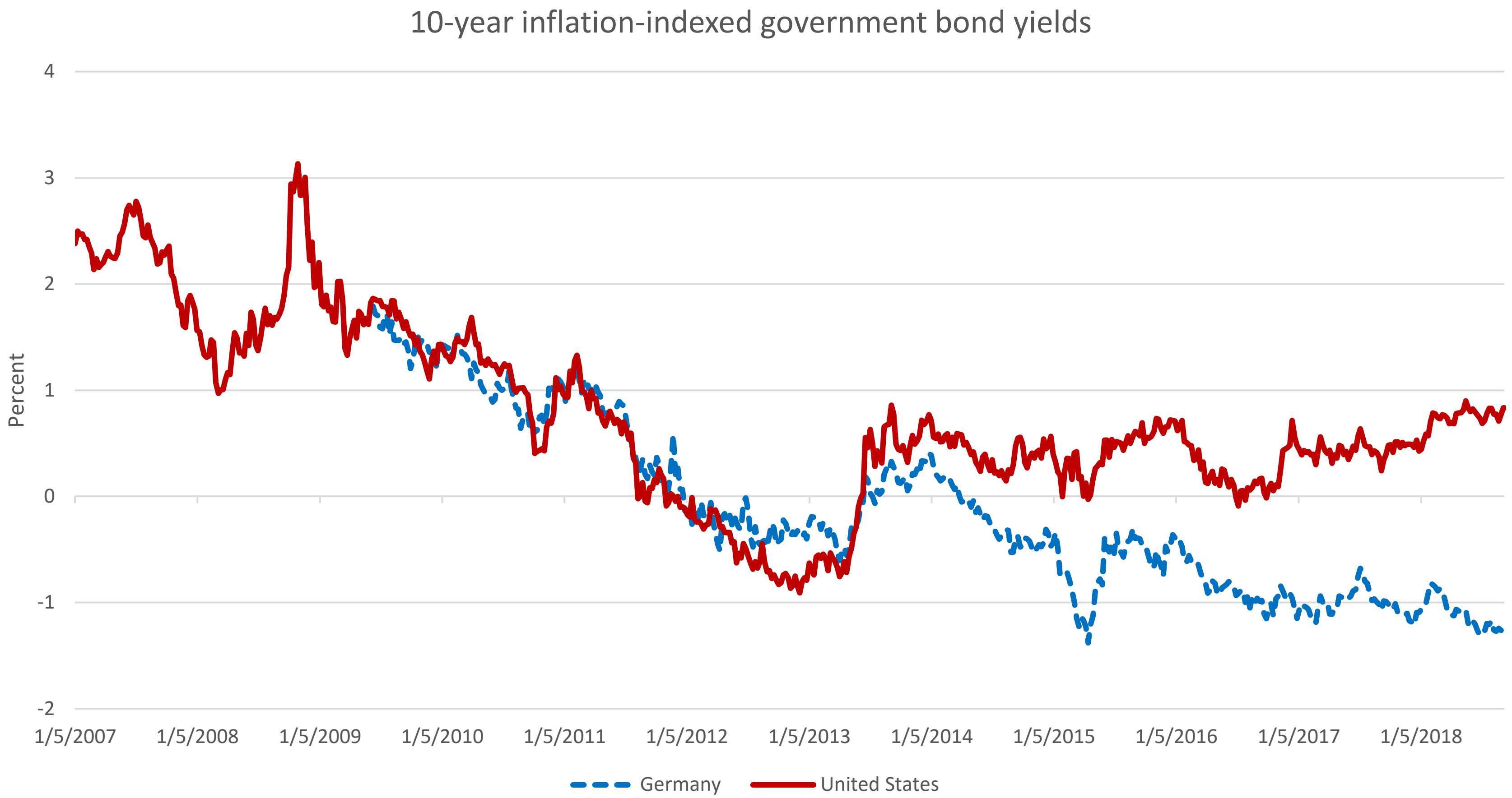
Monetary Policy and Financial Repression

- Substantive conclusions are fine
  - Figure 2 shows importance of keeping interest rate below growth rate
- Taxonomy is questionable
- Repression requires coercion
  - Binding reserve requirements or bond allocations
  - Binding deposit interest ceilings
  - Prohibitions on foreign investment
  - Not fixed bond yields if no one forced to buy
  - Not central bank purchases of long-term debt to hold down bond yields

Monetary Policy and Financial Repression

- Fisher effect implies that central banks cannot move real interest rates
  - Clearly violated for short-term rates
  - Also fails for long-term rates
- Moderate increases in inflation are possible without equal rises in nominal interest rates
  - Not limited to surprise in inflation
  - Greater scope to monetize debt
- With downward wage and price rigidity, it may be possible to reduce interest rates, grow faster, and reduce debt without more inflation, e.g. Japan

Monetary Policy and Real Bond Yields



Source: Bloomberg.