



What can history teach us
about the sovereign debt
crisis?

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Yes, countries can default...

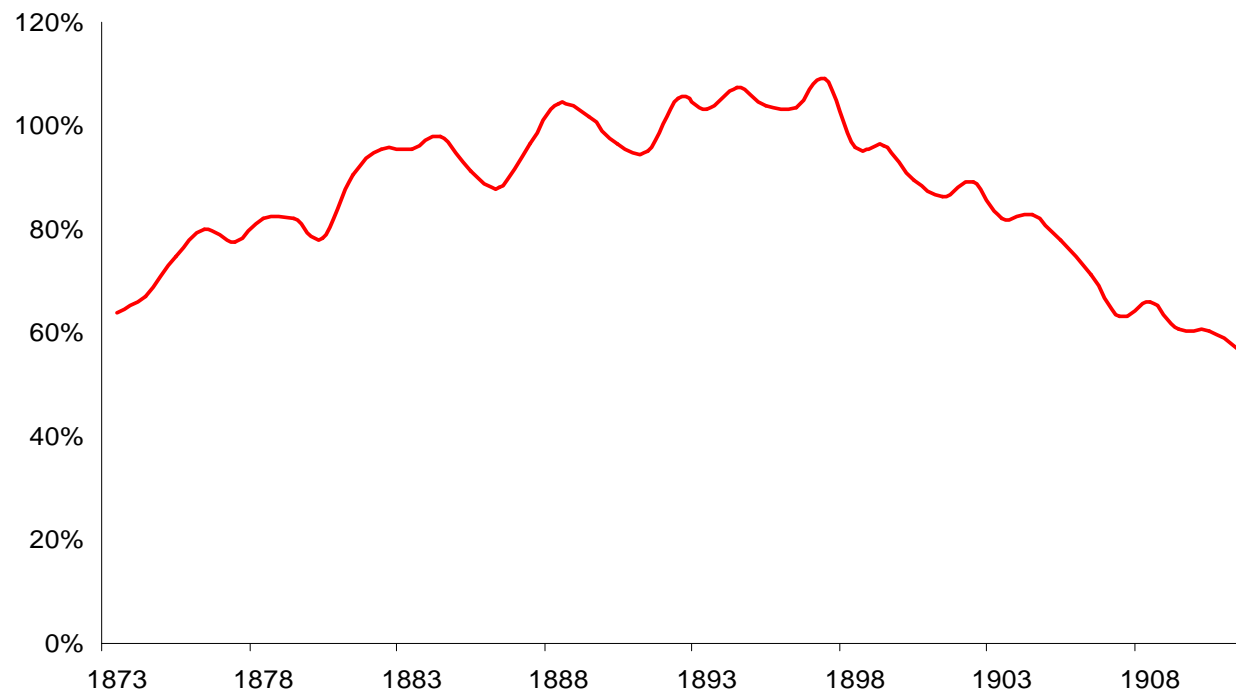
- The markets have woken up to the fact that the public debts of developed countries are not risk free.
- The last great round of European defaults was after the World War II – mostly via hyperinflation.
 - See the cover illustration – Hungary 1946 – the world’s greatest hyperinflation – prices doubled every 13 hours at the peak.
- But, although colourful, this is not the most appropriate precedent for current situation
 - the fiscal problems of war-torn countries result from the destruction of their economies.
 - inflation is the invariable outcome.
- Nor are developing country defaults particularly relevant
 - the amounts involved have not been enough to derail the global economy.
- Need to look for precedents of developed countries borrowing to excess in peacetime.

Happy endings in the late 19th century

- After 1870 Europe enjoyed continuous peace until 1914
- But there were two countries where public debts rose to over 100% of GDP: France and Italy
- In both countries deficits were more or less continuous
- In France public debt rose from 80% of GDP in 1871 to 105% in 1900
- In Italy debt rose from 70% of GDP in 1867 to 110% in 1897
- But in neither case did this lead to a sovereign debt crisis
 - In France, borrowing costs fell from 5.5% in 1871 to 2.9% in 1900
 - In Italy, there was a remarkable turnaround after 1897

Happy endings ?

Italian public debt as % of GDP 1870-1910



But the belle époque was different

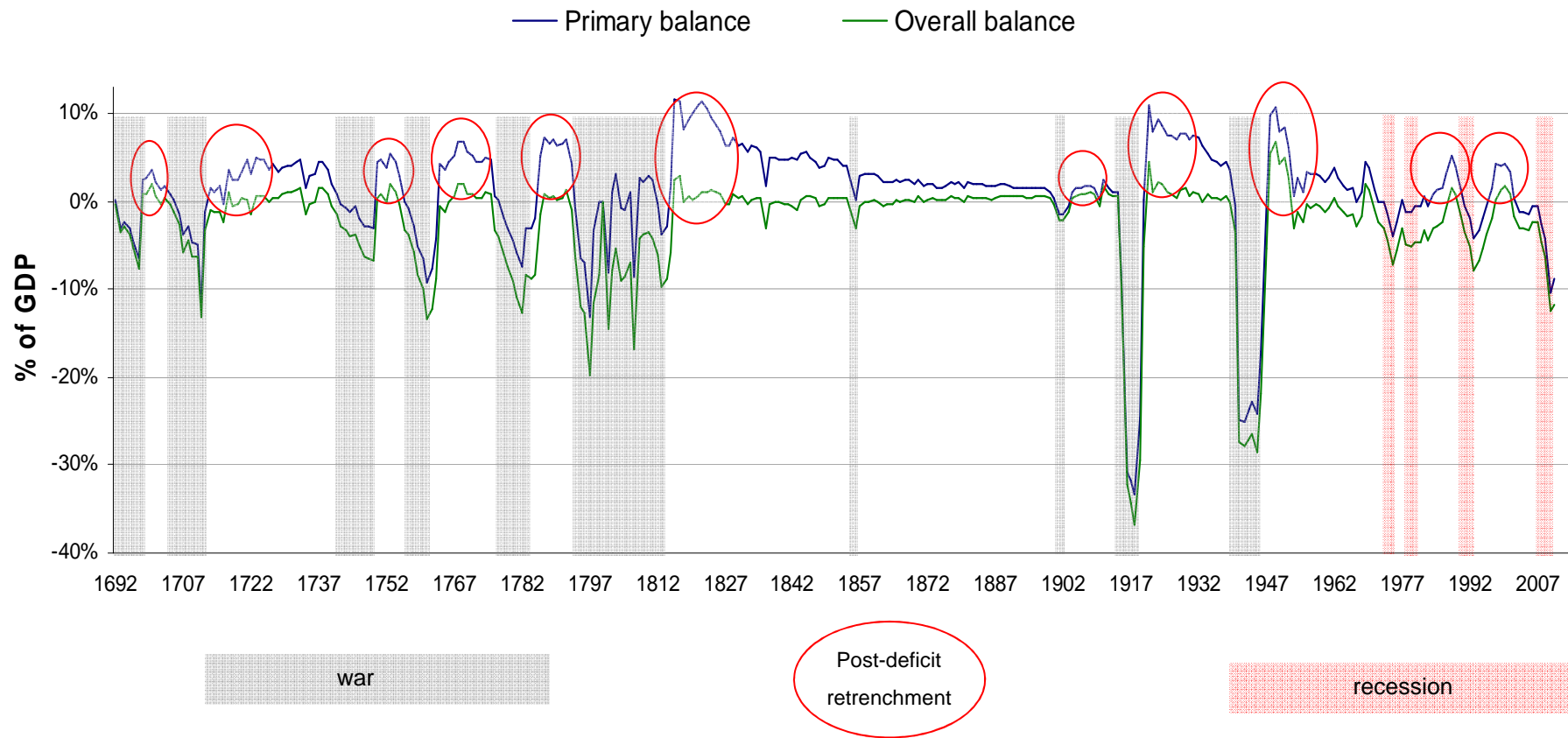
- It was not a generalised crisis. The world's two biggest economies had low and falling public debts
 - GB under 30% of GDP by 1900
 - USA under 10% of GDP
- Much borrowing was for public railways which produced income
- Price level effects:
 - 1873-1895 prices fell c. 20% - increasing relative debt levels
 - 1896-1913 prices rose c. 15% - reversing the effect
- Deficits were tiny compared to now
 - Italy had average deficit of 1.2% of GDP from 1867-1897, and ran a continuous primary budget surplus
 - After 1897 a modest fiscal tightening led to a budget surplus

So we need examples of high deficits as well as high debt

- Best examples are in / after wars
 - Often ignored because assumed that circumstances are too different
 - But there are many similarities – and the differences themselves are revealing
- Look at experience of winners whose economies were not destroyed
- USA in World War II
 - Economy grew by 7.7% per year
 - Ran deficits of 25% of GDP
 - Debt increased to 130% of GDP
- UK has even longer history
 - Budgets published continuously since 1692
 - Many wars, and therefore:
many periods of deficits and retrenchment

Three centuries of spending and retrenching

UK budget surplus / deficit 1692 - 2010

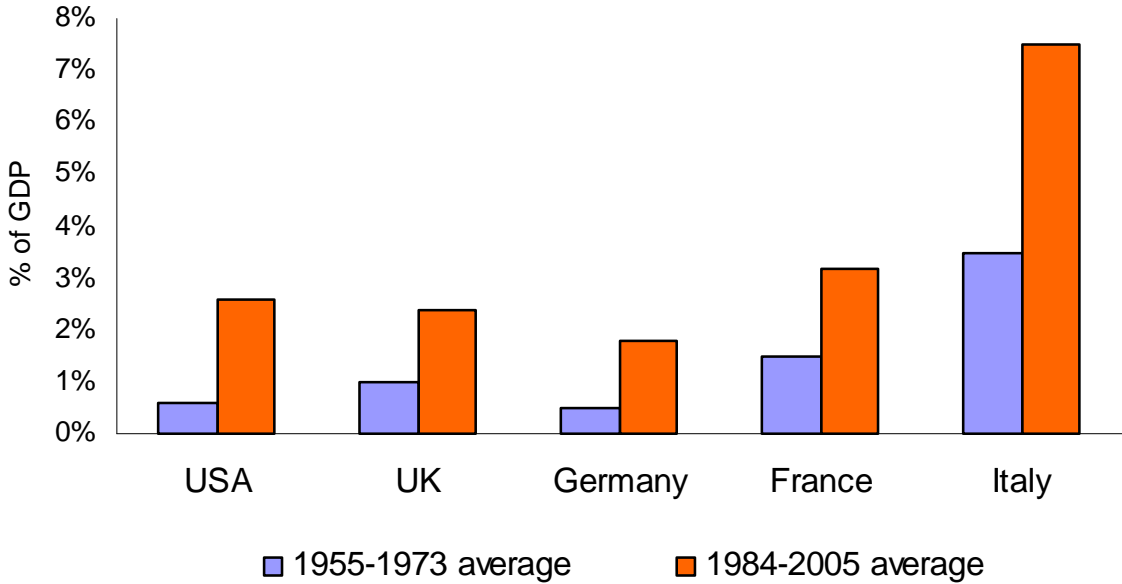


Lessons from British history

- Periods of high deficit were followed by periods of surplus – especially primary surplus
 - This is probably essential for countries that wish to maintain their long-term credibility
- This was true even after World War II
 - The Atlee government ran a surplus even while it introduced the welfare state
 - The recessionary deficits of the 1970s and early 1990s were also followed by surpluses
- There is a visible downward trend after World War II
 - The ‘Keynesian’ era (1940s-1970s) had far lower deficits than the ‘post-Keynesian’ era (1980s-2000s)
 - seems counterintuitive...
 - But it is true in all western economies ([see following chart](#)) - why ?
 - The welfare state was cheap to establish in the 1940s
 - Now the chickens are coming home to roost ?
- Most important:
Post-war retrenchments have been extremely rapid
 - Invariably accomplished within two years

Chickens coming home to roost ?

the growth of deficits during the 'post-Keynesian' era



* The periods chosen represent only times of maximum growth and prosperity: They deliberately exclude the immediate post-war period, the oil-crisis era, and the current credit crisis

This leads to the question of 'exit' strategies

- There has been much focus by Keynesians on the 1938 recession
 - a result of premature tightening coming out of the Depression ?
- But almost no one has bothered to look at the 'mother of all exit strategies' :
 - the aftermath of World Wars I and II
- Shared characteristics, wartime and now
 - Strong fiscal and monetary stimulus led to wartime economic growth in the UK and USA (unlike in the war torn economies of continental Europe)
 - Large increase in size of state - especially increase in state employees (mobilisation)
 - Unsustainable fiscal policy and economy - need to retrench and rebalance
- Distinct post-war characteristics
 - No question of gradual unwinding – avg 26% of GDP fiscal tightening over 2 years (!)
 - No question about whether by tax increases or spending cuts
 - all accomplished by spending cuts
 - mostly by laying off government employees (demobilisation)

Exit strategies – after World Wars I and II



Lessons from the world wars

- Extreme fiscal swing in each case
Budget in surplus (not just reduced deficit) within two years
- Immediate price surge after wars – result of ending price controls

But three different monetary reactions:

1. USA post-WWI: tighten, but leave prices at 1919 level
 2. UK post-WWI: tighten, but try to reduce prices to pre-war levels
 3. USA and UK post-WWII: leave monetary policy loose notwithstanding inflation
- Economic outcomes
 - All show post-war recession, but followed by strong growth – except UK post-WWI
 - USA post-WWI shows short-term surge in unemployment following monetary tightening, but otherwise low unemployment
 - UK post-WWI was a disaster for GDP and unemployment

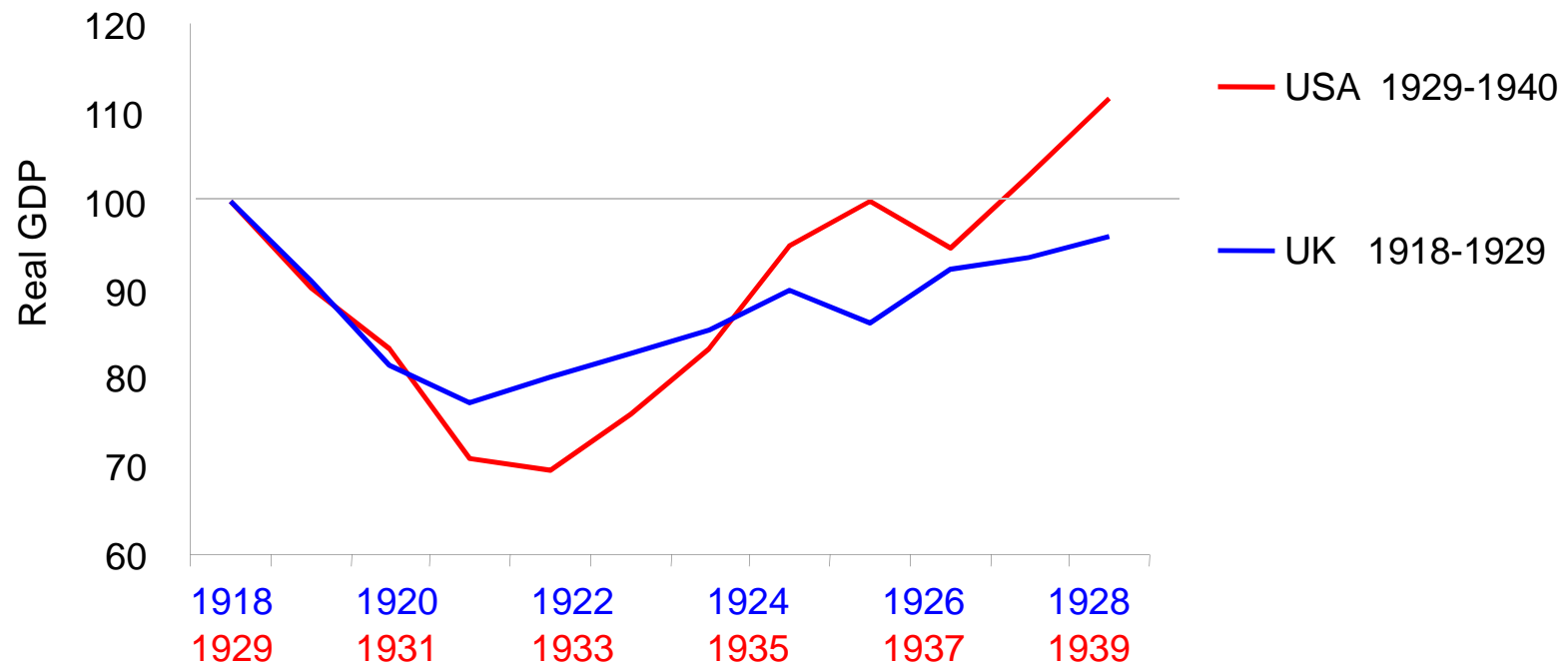
Lessons from the world wars....(contd)

1. It is OK to cut government deficits sharply as long as monetary policy remains easy.
 - It is true that there was a recession after the world wars, but the amount of fiscal tightening was far more extreme than currently proposed
 - Even Greece is only tightening by 12% of GDP over 4 years, not 26% of GDP over 2 years.
 - Most other countries are tightening by less than 2% of GDP per year

2. Do NOT attempt an 'internal devaluation' like the UK after WWI
(and like the Eurozone is prescribing for Greece, and other uncompetitive member states)
 - The UK deliberately reduced prices and wages to return to the pre-war gold parity
 - As a result it underwent a depression in the 1920s that was almost as extreme as the US in the 1930s – and lasted considerably longer.

A tale of two Great Depressions

(but at least the US depression was not deliberately engineered)



Is this a fair comparison ?

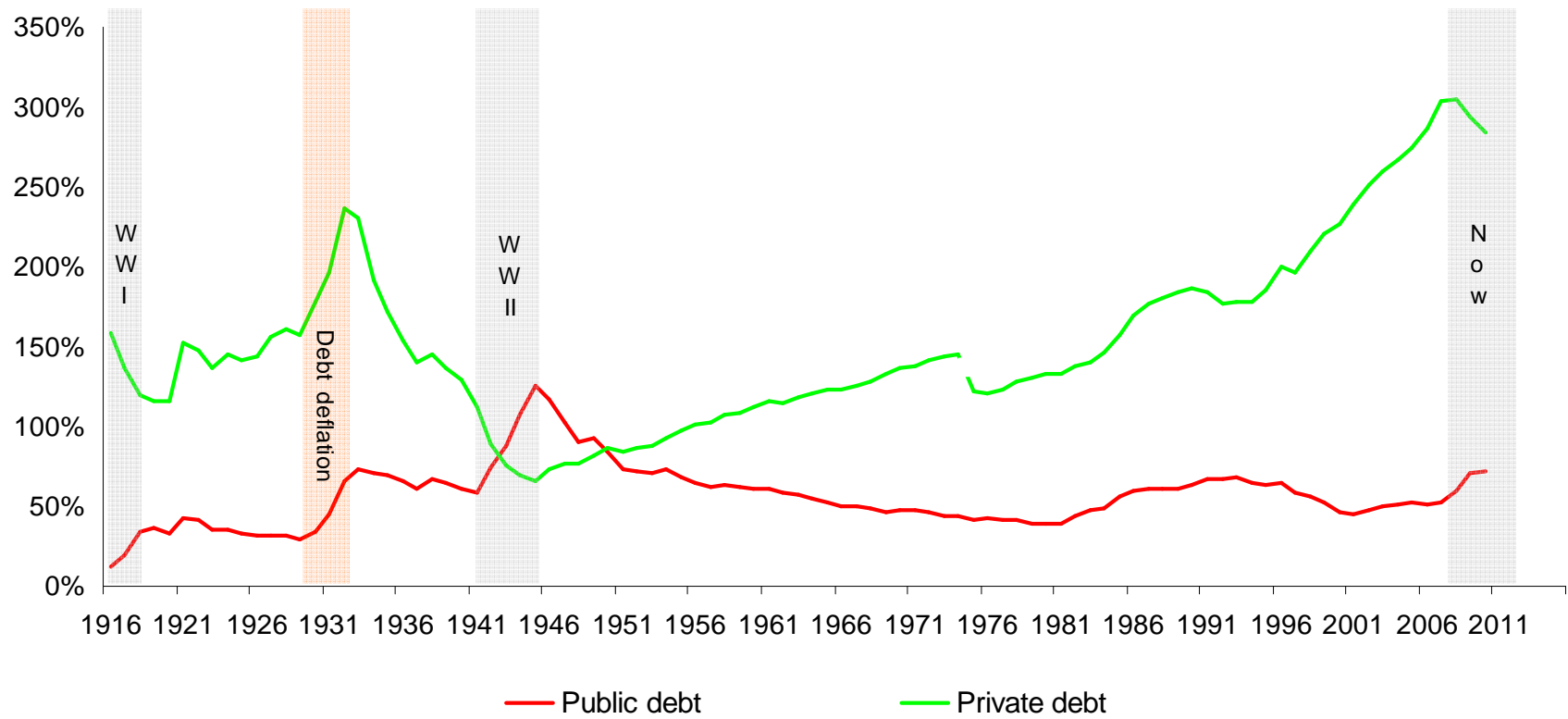
- Economically, yes...
 - Artificially stimulated economy and an unsustainable deficit
 - Unbalanced economy – needs structural adjustment
 - Then - need to produce washing machines, not tanks
 - Now - need to rely less on financial services and housing
 - The Allies represented c. 50% of world GDP in 1945 – so, like now, a world-wide problem, with no hope of easing adjustment by exporting to a ‘consumer of last resort’
- Psychologically, no...
 - There were no vested interests in maintaining the war economy
 - Many had private sector jobs to return to
 - No one argued for keeping up public spending to avoid the difficulties of demobilization
 - Nowadays, by contrast, there are huge vested interests in maintaining the welfare state
- The issue is therefore political, not economic

A fly in the ointment...

- However, there is one aspect of post-war adjustment not yet considered.
- The cause of current problems is not war, but a private sector debt bubble
- The reason that post-war adjustment was not hard was because private sector demand was suppressed during the war
- Public debt grew and private debt shrank in a process of 'debt substitution'
- This process was reversed after the war
- Debt substitution is positive – what has to be avoided is 'debt deflation', when falling prices raises the value of all debt, as in the early 1930s

Debt substitution vs debt deflation

US public and private debt 1915-2010



Questions of timing

- Fortunately, so far the present crisis has seen debt substitution, not debt deflation
 - except in countries attempting internal devaluations, such as Ireland and Latvia
- However, the process is starting from an unprecedented level of private debt
- Ideally, perhaps, the process should run further before an exit, as in World War II
- But is there time ?

The 'Greek' problem

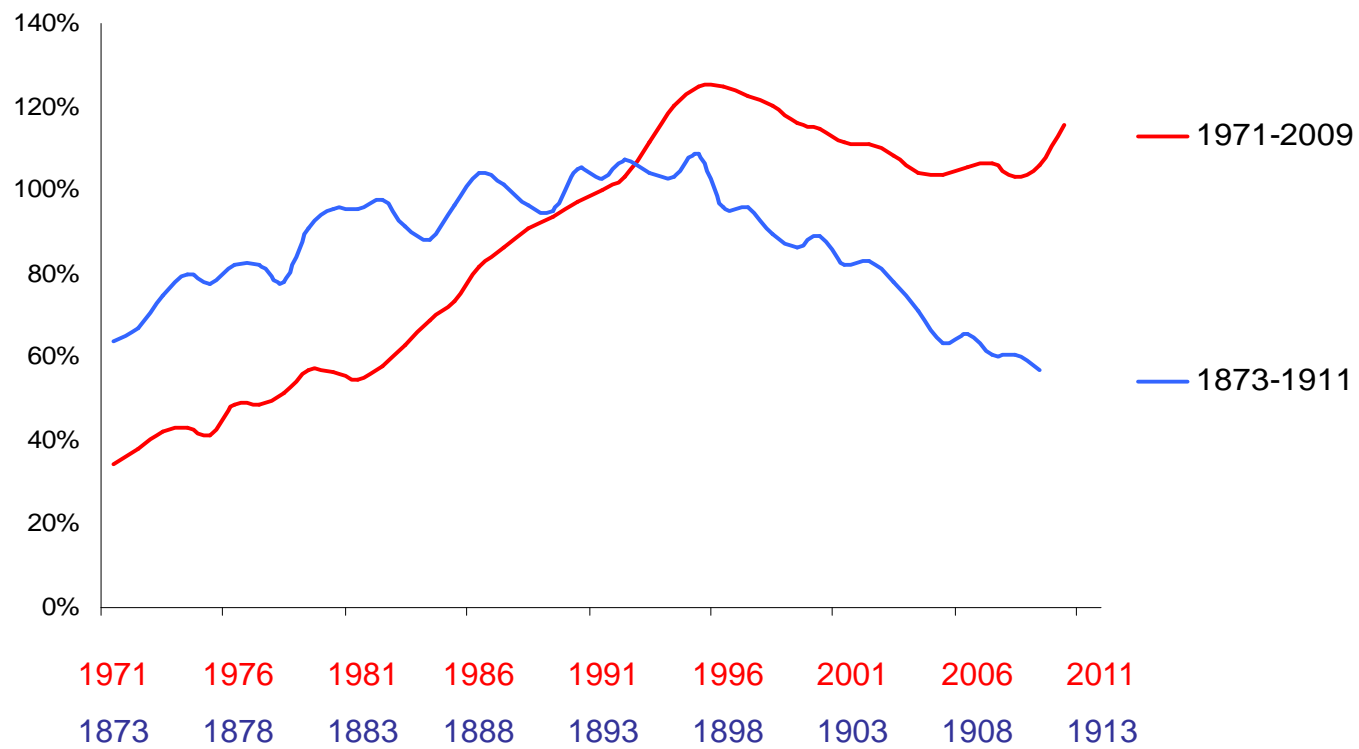
- What happens if the market calls 'time out' before a country wishes to exit ?
- Generally only the case if a country depends on foreign finance
 - Japan shows that a country can run a deficit almost indefinitely if it is self-financing
- In the World Wars, the US was entirely self-financing
- Britain was not, but could borrow from allies (USA and the empire)
- 1942: Keynesian economist Alvin Hansen wrote in *Fortune*
“We shall come out of the war debt free. We have no external debt, only an internal one.”
- What would Hansen think now ?
 - USA **not** self-financing – (and **not** borrowing from an ally)
 - \$3.8 tn foreign held debt – over 50% of non-agency debt

The 'Italian' problem

- Even if the markets do not call 'time out,' consider Italy
- After 1970, Italy went on a borrowing spree more extreme than in the late 19th century.
- After 1993 the country started to retrench, but at a slower pace than after 1897
- The result is that the country ran out of time to get its fiscal house in order before the current crisis struck and found itself with no fiscal room for manoeuvre.

Not so happy endings ?

Italian public debt as % of GDP 1910 vs 2010



Conclusion

- The present UK budget deficit is unprecedented in peacetime, and is as large as wartime deficits before the 20th century.
- If the country is to preserve its long-term credit standing, it will have to move over a number of years to period of primary budget surplus.
- Acting rapidly is necessary to avoid not only the problem of near-term market loss of confidence, but also the longer-term problem of inadequate fiscal recovery before the next crisis.
- The history of the post-war retrenchments suggests that it is possible to cut the deficit faster than imagined as long as monetary policy is left easy.
- The unprecedented level of private sector debt suggests that the economic trade-offs may be even harder than after the wars. However, this problem exists regardless of the fiscal strategy taken.

James Macdonald is the author of
A Free Nation Deep in Debt: The Financial Roots of Democracy