Insights from past large and prolonged sovereign debt reductions in OECD countries

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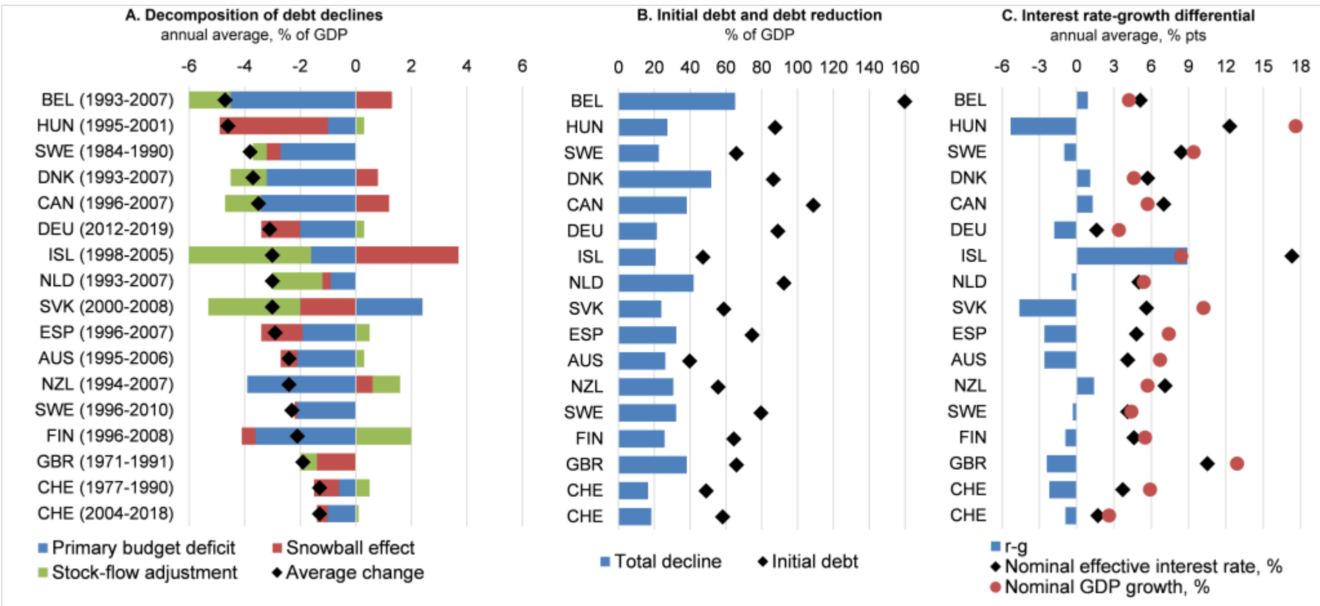
Due to the COVID-19 crisis, sovereign debt in relation to GDP has increased massively, reaching the highest levels in several decades in many countries. Current low interest rates reduce concerns about debt sustainability, but high debt makes public finances vulnerable to negative shocks. Thus, governments will have to balance the need to minimise the risk of fiscal stress and the need to satisfy growing demands on public finances.

In this context, in our recent paper Constraints and demands on public finances: Considerations of resilient fiscal policy (Rawdanowicz et al., 2021), we analyse 17 episodes of large and prolonged sovereign debt reductions in OECD countries since the 1970s. We find that such debt reductions were achieved primarily by increasing budget surpluses, supported by a context of strong nominal GDP growth (on average 7%). Debt reduction episodes were initiated in response to rising debt and interest payments, sometimes resulting from economic crises. It is noteworthy that in some cases debt reduction episodes were accompanied by revamping fiscal frameworks.

There are many examples of large and prolonged debt reductions

We identify 17 episodes that involved persistent reductions in gross debt (spanning at least five years, but allowing for temporary debt reversals) of at least 15% of GDP, in contrast to a traditional focus in the literature on fiscal consolidations which are measured by changes in budget balances – e.g. (Molnár, 2012) (Figure 1). Most of the episodes started in the 1990s and ended before the global financial crisis. On average across the episodes, debt was reduced by just over 30% of GDP over 11 years, but the size and duration varied across the episodes (Figure 1, Panel A). In many episodes, initial debt was no higher than 80% of GDP and, in most cases, the debt-to-GDP ratio was reduced by less than half (Figure 1, Panel B).

Figure 1. Episodes of large and prolonged sovereign debt reductions: main statistics



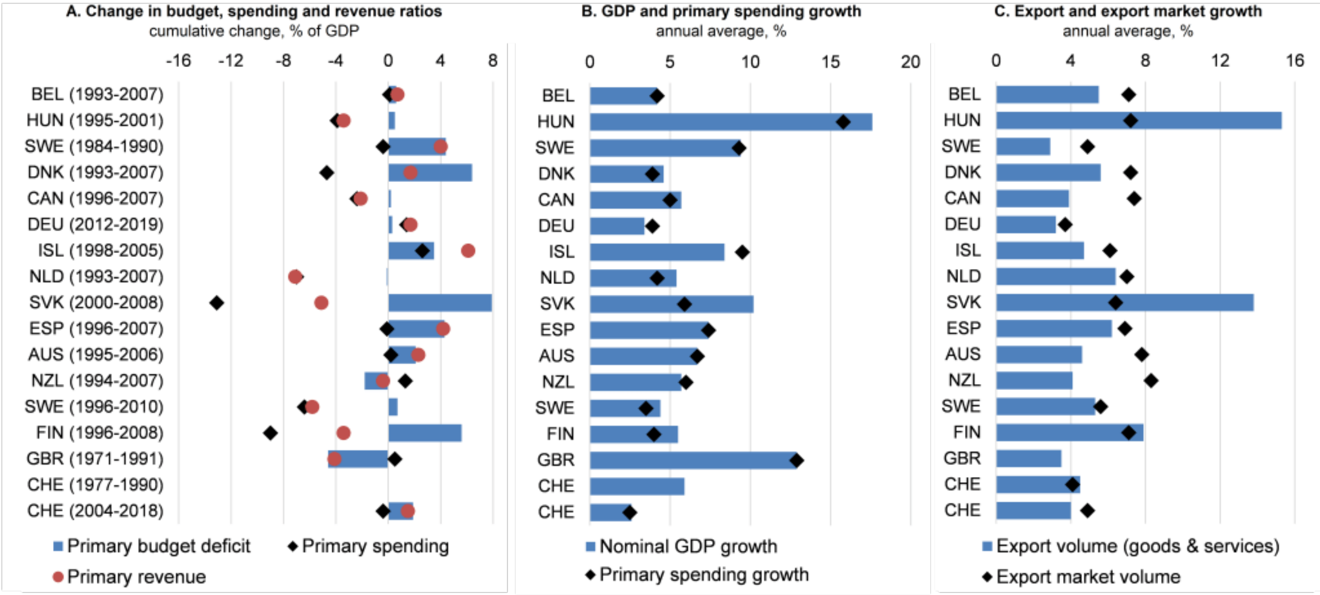
Note: Episodes selected based on data availability in the OECD Economic Outlook database. The snowball effect captures the product of lagged gross debt and the interest rate-growth differential (see Annex B of Rawdanowicz et al. (2021) for explanations on the debt dynamics decomposition).
Source: OECD Economic Outlook database; and authors' calculations.

High budget surpluses and strong GDP growth were instrumental in lowering debt

Most of the debt reductions took place in an environment of high nominal GDP growth (on average 7% across countries and years; Figure 1, Panel C), in particular in Hungary and the United Kingdom. The notable exceptions are Germany and Switzerland (2004-2018), where nominal growth was modest but still *r-g* was negative and the budget surpluses were high. In line with this, in most cases, the primary budget balance-to-GDP ratio improved as primary revenue increased by more or declined by less than primary spending (Figure 2, Panel A). In addition, average growth in nominal primary expenditure was not higher than average nominal GDP growth (Figure 2, Panel B). In some countries (e.g. Finland and Canada), the debt reduction episode also coincided with a substantial depreciation of the domestic currency, helping export growth (Figure 2, Panel C).

Decomposing the annual average changes in debt (see details in Annex B of Rawdanowicz et al. 2021) shows that in most of the episodes a high primary budget surplus reduced debt – on average by 2% of GDP per annum, but in some cases by more than 3% of GDP (Figure 1, Panel A). In two thirds of the episodes, higher growth than interest rates lowered the debt-to-GDP ratio (Figure 1, Panel C), with a total contribution of the snowball effect to the debt reduction (i.e. a combined effect of the interest rate growth differential and the lagged level of gross debt) on average close to 1% of GDP per year. A few countries benefited also from favourable stock flow adjustments (i.e. all changes in the debt ratio that are not explained by the budget balance and the snowball effect, like sale or purchase of financial assets). This was particularly the case in Iceland and the Slovak Republic due to very large interest earnings and a sizeable reduction in the ratio of government financial assets to GDP, respectively.

Figure 2. Episodes of large and prolonged sovereign debt reductions: additional statistics



Note: Episodes selected based on data availability in the OECD Economic Outlook database. Export market is calculated as a weighted average of trading partners' import volumes.
Source: OECD Economic Outlook database; and authors' calculations.

While the economic and political context triggering debt reductions varied across countries, there were a few common themes

Growing fiscal pressures. In several episodes, debt reductions were initiated following prolonged and large debt accumulations. Falling interest rates and subsequently government interest payments helped the debt reductions in the 1990s. In some countries, at the beginning of debt reductions, interest payments amounted to at least 5% of GDP and in Belgium and Canada around 10% of GDP, crowding out other spending.

Fiscal rules and frameworks encouraged actions to reduce debt. In several EU countries, the requirement to fulfil the Maastricht fiscal criteria (budget deficit no higher than 3% of GDP and government debt below 60% of GDP) ahead of adoption of the euro contributed to public debt reductions. In Canada, to help deal with large budget deficits of provincial and federal governments in the early-1990s, many provinces voluntarily adopted fiscal rules. The Federal government introduced the Spending Control Act between 1992 and 1995 and since then has generally used non-legislated fiscal targets, helping to achieve high budget surpluses in the subsequent years. In New Zealand, fiscal discipline was accompanied by the introduction of a new budgetary framework (the 1994 Fiscal Responsibility Act), building on responsible fiscal management principles. The Act also enforced greater transparency about the fiscal situation and fiscal policies.

Negative economic shocks. In a few countries, severe economic crises required fiscal adjustments, thereby securing popular support for adjustment. For instance, in Finland the deep recession following a financial crisis in the early 1990s prompted the government to implement large cuts in government spending (including social benefits, public sector wages, subsidies, investment, and transfers to sub-central governments), with the aim to restore confidence in financial markets and to achieve a non-inflationary recovery. The impact of these measures on debt reduction was strengthened by the move to a floating exchange rate that led to a sharp depreciation of the local currency. In Sweden, the severe banking and economic crises in the early 1990s led the government to implement several structural reforms covering governance of the public finances, tax reforms, liberalisation of the economy, reforming the welfare state (pensions especially), and promoting an export-oriented growth model. However, we should acknowledge that for these countries, favourable global economic conditions boosted exports, contributing to the resumption of economic growth and debt reduction.

References

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