Independent Economics

Can history teach us how to solve the government debt problem?

The standard tools in the box have already been used

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The world economy has experienced a series of shocks since the financial crisis of 2008. Covid-19 is the most recent. Fiscal policies and monetary policies have been used aggressively in order to alleviate the shocks. These policies, however, have come at a price.

Gross government debt has increased. In the US, general government gross debt is around 120% of GDP, in the UK around 100% (see Figures 1 & 2), and over 250% in Japan. The fiscal deficit is more than 6% of GDP in the US; over 4% in the UK; and over 5% in Japan.

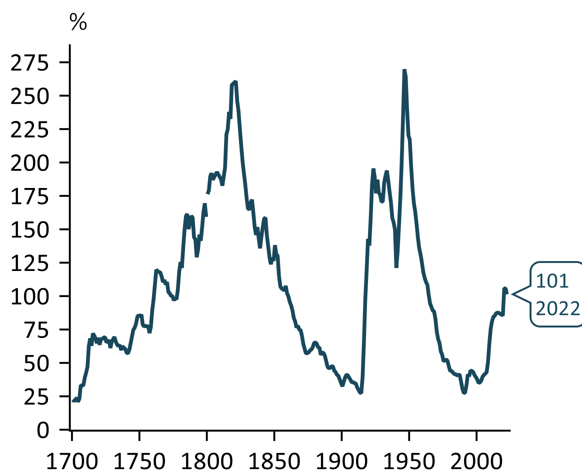
In the advanced economies, central banks have become the largest creditor in most OECD countries, holding more than 25% of outstanding government bonds.[1] With interest rates having risen, an increasing share of public expenditure is being spent on paying for the policies of the past, and slowly squeezing out other government spending, including on education, health, and defence.

How to manoeuvre back to a more normal situation? Is the problem solvable? If we look back in history,[2] we see that we have been there before. Government debt has been very high, and has come back to normal levels.[3]

There have been seven major ways that policymakers have used to 'solve' the debt problem.

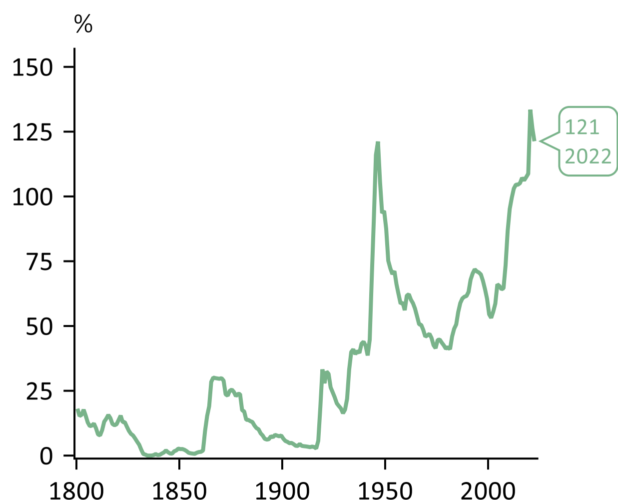
1. 'Marry a Medici'
2. Create inflation
3. Get help from a professional debt manager
4. Renege on the debt
5. Commercialise the debt, increase its redemption time, and transform some of it into equity
6. Spur economic growth
7. Falsify the statistics.

Figure 1: UK general government gross debt to GDP



Source: Bank of England before 1800; IMF from 1800

Figure 2: US general government gross debt to GDP



Source: IMF

Solution 1: Marry a Medici

Through history, large state debts came about because of wars, or when kings spent money lavishly. The debt problems were solved in various ways. During the Italian Renaissance, it helped to form an alliance with the Medici or Borgia families. Marie de' Medici was Queen of France as the second wife of King Henry IV of France, and Regent of the Kingdom of France officially during 1610–1614 and *de facto* until 1617.[4]

Marie de' Medici

Solution 2: Create inflation

Henry VIII (1491-1547) became King of England in 1509. Known for his many wives and being an extravagant spender, he paid for this partly by using the proceeds from the dissolution of the monasteries and converting the money that was formerly paid to Rome into royal revenue. This income, however, was not enough. Inflation solved the rest. The technique used was debasement of the coinage. When paper money became standard tender some centuries later, solving the debt problem by inflation became (technically) easier.

Paper money inflation reached a peak during the Weimar republic in Germany in 1922 and 1923. Zimbabwe has in this century perhaps overtaken that record.

100 Trillion Mark Bill

Solution 3: Get help from a professional debt manager

William III was the King of England, Ireland, and Scotland from 1689 until his death in 1702. He ran into debt problems. The Bank of England was created in 1694. A royal charter allowed the bank to operate as a joint-stock bank with limited liability. William III thus got a professional agent to help him manage his debt. The Bank of England was successful in this respect.

Bank of England

Solution 4: Renege on the debt (default)

In 1716, John Law created a Banque Générale in France. Law also set up and directed the Mississippi Company, funded by the Banque Royale. It ended in a chaotic collapse and default for the bank. During the French revolution similar bank collapses occurred. Default "solves" the debt problem, but comes with a caveat. People remember that they were fooled, and hesitate to lend to the government. Michael D. Bordo and Eugene N. White illustrate this point in *A Tale of Two Currencies: British and French Finance During the Napoleonic Wars*. [5]

> *"The record of British and French finance during the Napoleonic wars presents the striking picture of a financially strong nation abandoning the gold standard, borrowing heavily, and generating inflation, while a financially weaker country followed more "orthodox" policies. This paradoxical behaviour is explained by Britain's strong credibility that allowed more flexible policies, while France's poor reputation forced reliance on taxation."*

John Law

Solution 5: Commercialise debt, increase the redemption time, and turn some of the debt into equity

The Treaty of Kiel signed on 14 January 1814 ended the hostilities between the parties in the ongoing Napoleonic Wars, where the United Kingdom and Sweden were part of the anti-French camp while Denmark–Norway was allied to France. Denmark ceded Norway to Sweden. While the Swedish army was busy on the continent, Norway declared its independence, adopted a constitution, and elected its own king. When the Swedish army had finished its business on the continent, they went north with the intent to implement what was promised in the Treaty of Kiel. After a short war, Norway had to accept the 'realpolitik', and entered a personal union with Sweden. Norway had to share its part of the Danish-Norwegian state debt.

In 1822, Norway ran into financial problems. The Swedish king offered to help, but the Norwegian political authorities knew that, if they accepted his offer, they would yield power to him. There are always strings attached. Instead, they sought help from the bankers in London. The Rothschilds would not help, and lobbied the other bankers to do likewise, because the Norwegian constitution at that time included a paragraph on not letting any Jews into the country.

Joseph Hambro

Joseph Hambro was born in 1780 in Copenhagen, Denmark. The Norwegian government was more successful with merchant and banker C. J. Hambro & Son in Copenhagen. They decided to help the Norwegians out. The Danish king accepted a reduction in the debt (*"better to get the cash in hand than owning an uncertain debt").* The Hambro bank took over the rest of the debt, increasing the redemption time span and commercializing the debt. The Norwegian government, who had borrowed money in 1818 from the Benecke brothers in Berlin at

record high interest (the loan was called the *"loan of thieves"*) had, since the chaotic year of 1814, always made sure that the government budget was in surplus. So, state finances were run in an orthodox rigid way.

Only ten years after the birth of this young nation, Norway (*"Who are they, a new and unknown state"*)[6] could borrow money on the international capital markets at rates similar to Denmark (the old well-known nation) and marginally above the rates of the United Kingdom.

The moral of the story: keep state finances in order, honour your debt and make it liquid, and increase the redemption time.

After World War I Germany had, according to the Versailles treaty, to pay war reparations. During the 1920s Germany had difficulties in fulfilling its obligations. The Dawes Plan of 1924 alleviated the problems for some time. The plan contained some of the same elements used by the Norwegian authorities 100 years earlier. The problems with the German war reparations resurfaced in 1929. The Young committee was set up and discussed the commercialisation, and Germany's capacity to pay.

The first meeting of the BIS 1930

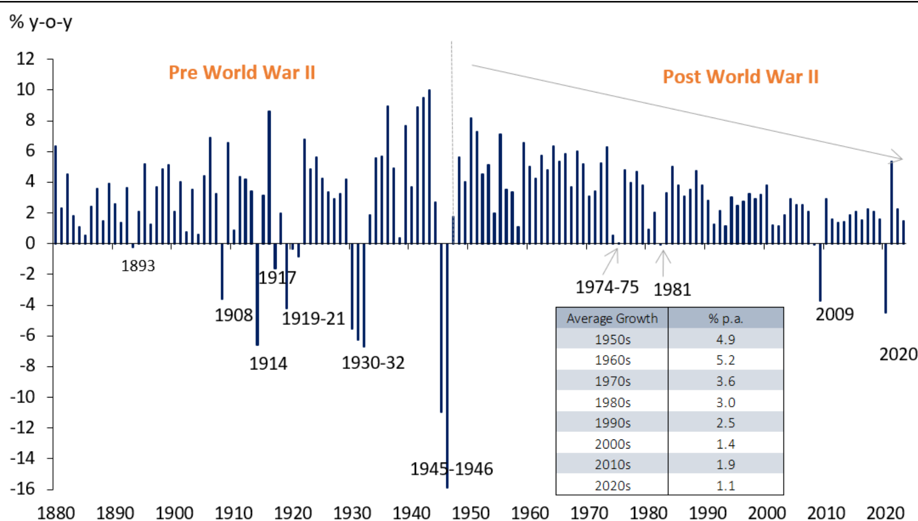
The Young committee resulted in the creation of the Bank for International Settlements (BIS) in 1930. The BIS became the intermediary.

The main elements for solving the problems of the German war reparations were again: scale down the debt, and increase the redemption time. But this time a new element was added – turn some of the debt into equity. Swapping bonds for equity meant that creditors got their money back if the German economy thrived. Germany took their debt and equity obligations seriously. Even as late as 12 April 1945 the Reichsbank paid 1 525.6 kg of fine gold as interest payments to the BIS![7]

Solution 6: Economic growth

Many countries came out of World War II with heavy state debt. However, in the first decades after the war, GDP growth was strong. If growth is strong, it does not take many years before the debt as a share of GDP is

Figure 3: G7 growth rates by decade



Average Growth	% p.a.
1950s	4.9
1960s	5.2
1970s	3.6
1980s	3.0
1990s	2.5
2000s	1.4
2010s	1.9
2020s	1.1

Source: IMF, Maddison, OECD

reduced. The problem with this solution is that economic growth is not something the politicians can decide. Economic growth comes as a result of many decisions in the public and private sector.

Solution 7: Falsification of statistics

The international capital markets rely on national statistics in order to assess the terms the state debt should pay. There have been several examples of fudging the numbers. The Bank of France issued false balance sheets during the 1920s.[8] This episode of accounting manipulation marked a turning point in French monetary policy. It destroyed the credibility of governmental monetary intentions, and was the beginning of the second franc crisis.

Greece falsified its statistics in order to fulfil the criteria for joining the euro on 1 January 2001. The falsification continued in order to avoid the EU Excessive Deficit Procedure.[9] In 2009, it became obvious that the political authorities in Greece had "*leaned on*" the Greek Statistical Office. Since then, the EU has required that the statistical offices of the member states be independent of the political authorities.

Falsification, as long as it works, makes the debt problem look better, and reduces the risk premium on government borrowing. When the charade is disclosed, however, there is normally a risk premium penalty. Interest rates on new government borrowing increase dramatically.

What can we learn from history?

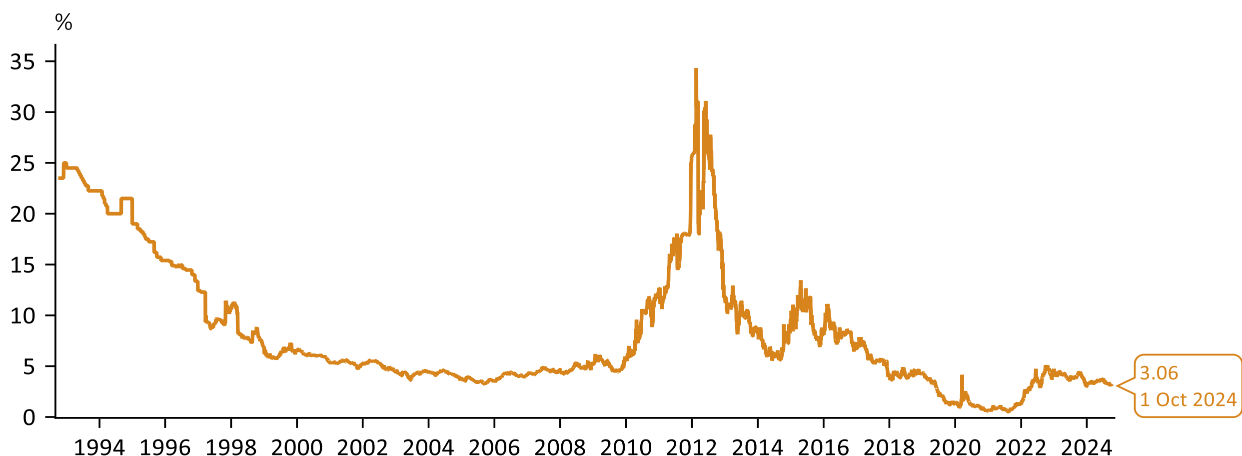
The examples above illustrate ways in which the debt problem has been addressed through history. Some of the solutions are not advisable, such as falsification of statistics, and default. Marrying a Medici is perhaps no longer an option. To create inflation is not advisable either. Economic growth solved the problem after World War II, and policies to stimulate growth are worth a try, but the task is uphill. For every decade after World War II, average GDP growth has decreased by around a percentage point. (see Figure 3). Present forecasts for the OECD economies do not foresee a strong pick up of growth.

The solutions of the past that worked, such as commercialised debt, long maturity, and debt for equity are instruments already in place: today's debt generally has already a long maturity, and it is commercialised. There is no magic solution hidden in the toolbox.

Inflation could of course always solve *part* of the problem. However, the political authorities have granted the central banks independence with a mandate to keep inflation low and stable, usually around or below 2 per cent. As the world economy turns back to normal, interest rates too are tending to normalise. The cost of servicing government debt is increasing: and the political costs for governments are also rising.

Perhaps some political authorities will try to put pressure on the central banks not to increase interest rates? Perhaps some will come to consider that the independence that they granted the central banks is something they consider taking back.■

Figure 4: Greek 10-year treasury bond yields



Source: Eurostat

Endnotes

[1] See https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2024/03/Aligning-sovereign-bond-markets-with-the-net-zero-transition_the-role-of-central-banks.pdf, especially Figure 2.4.

[2] Detail on the telling Information in these historical episodes draws widely not only on the author's own knowledge, particularly of Scandinavian/Nordic experiences, acquired over the years, together with the specific sources cited below, but also on *Wikipedia* and a range of sources therein.

[3] https://www.historyandpolicy.org/policy-papers/papers/covid-19-and-the-uk-national-debt-in-historical-context

[4] The Borgias became prominent in political affairs in the 15th and 16th centuries, producing two popes: Pope Callixtus III during 1455–1458, and Pope Alexander VI, during 1492–1503.

[5] "A Tale of Two Currencies: British and French Finance During the Napoleonic Wars" by Michael D. Bordo and Eugene N. White. The Journal of Economic History, Vol. 51, No. 2 (June., 1991), pp. 303-316 (14 pages).

[6] William Watts, 1834. *Norway: Who are they, a new and unknown state*. James Cochrane and Co.

[7] Gianni Toniolo: "Central Bank Cooperation at the Bank for International Settlements, 1930-1973", Footnote 2008 to pp pages 246-249

[8] Blancheton, B. (2012). The false balance sheets of the Bank of France and the origins of the Franc crisis, 1924–26. *Accounting History Review*, *22*(1), 1–22. https://doi.org/10.1080/21552851.2012.653134

[9] This is an action launched by the European Commission against any European Union Member State that exceeds the budgetary deficit ceiling imposed by the EU's Stability and Growth Pact legislation. Member States in the euro area must demonstrate sound public finances. There are two criteria: (1) the budget deficit must not exceed 3 % of gross domestic product (GDP) and (2) public debt must not exceed 60 % of GDP.