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Comment on Silverio Foresi, Alessandro Penati and George Pennacchi: Reducing the Cost of Government Debt: The Italian Experience and the Role of Indexed Bonds

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Foresi, Penati and Pennacchi's paper is a very useful summary of the Italian experience of national debt policy. The authors have done an excellent job in explaining to outsiders some important aspects of this policy, and in providing a very sensible evaluation of it. I find very little to disagree with in their analysis. Since Sweden has rapidly accumulated a large public debt and Swedish interest rates have increased to levels comparable to Italy's, the Italian experience should be given serious consideration in evaluating and improving Swedish debt policy. In my comments I focus on some implications of the authors' analysis for Sweden.

The authors examine the role of indexed debt in considerable detail. They show that the ex post borrowing cost has been lower for Italian indexed bonds than for other kinds of debt instruments. They show that the inflation risk premium may be sizeable and lead to considerably lower borrowing costs for indexed debt, but they also note that estimates of inflation risk premia are very uncertain. The low relative ex post borrowing cost for indexed debt in the Italian case is probably due to an anticipated fall in Italian inflation during the maturity of the bond examined, from 1983 to 1993. An unanticipated fall in inflation means that realized inflation is less than previously expected inflation. This is the case, for instance, in a situation when the monetary policy regime has shifted towards achieving low inflation, but the credibility of that policy among investors has not yet been established. I focus on that situation, since I believe it is especially relevant in the Swedish case. I also believe that the

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Swedish National Debt Office (NDO) has made serious mistakes in its debt policy, possibly because of a misunderstanding of the appropriate debt policy when the credibility of a new low-inflation monetary policy has not yet been established.

During past decade, Swedish monetary policy has been, first implicitly, and later more explicitly, directed towards achieving and maintaining low inflation. After the devaluation in October 1982, a fixed exchange rate was maintained as an intermediate monetary policy target for 10 years. With free capital mobility, a fixed exchange rate forces monetary policy to focus exclusively on maintaining a level of the short interest rate that keeps the currency flow essentially in balance, otherwise the exchange rate will drift away from its central parity. Then fiscal policy has to take on the responsibility of stabilizing inflation at a level that does not lead to a misalignment of the real exchange rate, since such misalignment may induce a speculative attack on the exchange rate. Swedish fiscal policy failed miserably in this responsibility; the Swedish economy was allowed to overheat severely towards the end of the 1980s, the ensuing inflation eroded competitiveness, the deepest recession since the Great Depression and an unprecedented budget deficit followed, and the krona was subject to overwhelming speculative attacks in the fall of 1992. After the krona was floated in November 1992, monetary policy switched in January 1993 to an explicit inflation target of 2 percent per year, with a tolerance band of plus/minus 1 percentage point, to be achieved and maintained from 1995 onwards.

This new explicit inflation target was initially far from credible. Inflation expectations measured by surveys remained several percentage points above the inflation target. Long nominal bond interest rates have remained high, especially during 1994, when they reached 10–12 percent. The NDO has continued to issue large amounts of long nominal bonds at such high rates, and has also started to issue small amounts of long indexed bonds at real rates between 5 and 5.5 percent. The break-even long-term inflation rate at which nominal and real bonds pay the same real return is then around 5–6 percent per year. Thus, if average inflation over the next 10 years ends up being lower than 5–6 percent per year, ex post it will be cheaper to issue indexed debt. Put differently, the NDO seems to have had inflation expectations for the next 10 years of 5–6 percent per year or higher, in order to make such issuing policy consistent with its announced goal of minimizing the cost of borrowing.

Inflation expectations of 5–6 percent or higher, per year, for the next

10 years appear highly exaggerated. The average inflation in Europe is about 3 percent per year, and several countries in Europe and the rest of the world have increased their commitment towards low inflation, for instance by institutional reforms that have reinforced low inflation as the goal of monetary policy and given central banks more independence in achieving and maintaining that goal. The Maastricht Treaty ensures that the monetary policy of the European Central Bank, if it comes into existence, will be firmly focused on low inflation. After the krona was floated Swedish inflation reached 5 percent per year, but during the last two years it has mostly fluctuated between 2.5 and 3 percent per year. One would have to expect Sweden to deviate very strongly from the forceful trends in the rest of the world in order to believe in an average 10-year inflation rate of 5–6 percent per year or higher.

In a situation when monetary policy has switched to a low inflation regime, it is common that inflation expectations lag behind, and that it takes time before the regime's credibility has been established. Meanwhile, nominal interest rates, long and short, and ex post real rates on nominal debt, will remain high. Eventually, if credibility is established, inflation expectations and long nominal rates will fall. The rational debt policy in such a situation is, obviously, to issue more indexed debt and less nominal debt, and to the extent that nominal debt is issued, to issue short-term debt rather than long-term debt. It may even be wise to buy back already issued long nominal debt and swap it for short debt. Issuing indexed debt and shortening the maturity of the nominal debt is rational both as a way to lower the expected real cost of borrowing when market inflation expectations are deemed excessive, but also as a hedge against more volatile inflation expectations and long nominal rates, that is, as a way to reduce the variance of the real cost of borrowing. As detailed in Mats Persson's paper in this volume, during this period the NDO has done the opposite, and *increased* the average time to maturity and the duration of the domestic currency debt.

The NDO's policy may also have prolonged the period of high inflation expectations and high long nominal rates, since its debt policy may directly influence inflation expectations. Issuing long-term nominal debt at very high nominal rates increases the cost of a low-inflation policy, and increases the incentive for the government and the parliament to put pressure on the Riksbank to allow more inflation. That in turn may maintain inflation expectations at a high level, and hence further increase the cost of borrowing. The considerable inflation incentives created by

Swedish fiscal and debt policy are detailed in Persson, Persson and Svensson (1995).

Recently, inflation expectations measured by surveys have nevertheless decreased rapidly towards 3 percent per year for the next 5 years, and long nominal rates have fallen considerably. The lucky or wise investor who bought a Swedish 16-year bond at 11 percent from the NDO has made a handsome capital gain and the NDO will probably end up paying an average real rate of return on that bond for those 16 years, at the taxpayer's expense, of more than 8 percent per year, 2.5–3 percent above the real rate on indexed bonds.

Reference

Persson, M., T. Persson and L.E.O. Svensson (1995), Kan man inflatera bort budgetunderskottet? (Can the Budget Deficit be Inflated Away?), in: L. Calmfors *et al.*, Ekonomisk politik: En vänbok till Assar Lindbeck (Economic Policy: Festschrift in Honor of Assar Lindbeck), (SNS Förlag, Stockholm) 251–287.