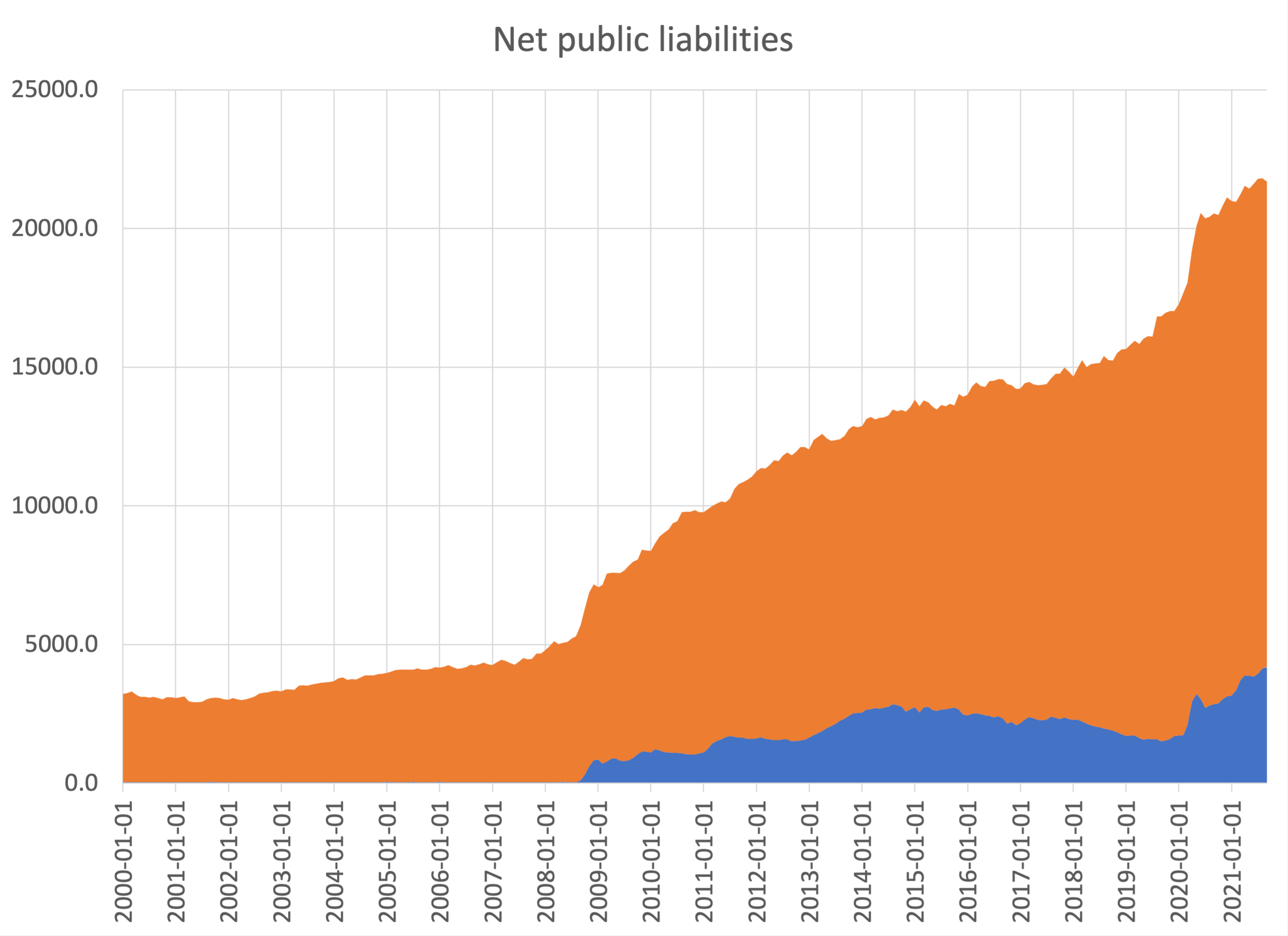
HIGH PUBLIC LEVERAGE AND FINANCIAL INSTABILITY

Ricardo Reis
LSE

10th of November, 2021
FRB Boston conference on "The Implications of High Leverage"

The rise of public liabilities and the Fed



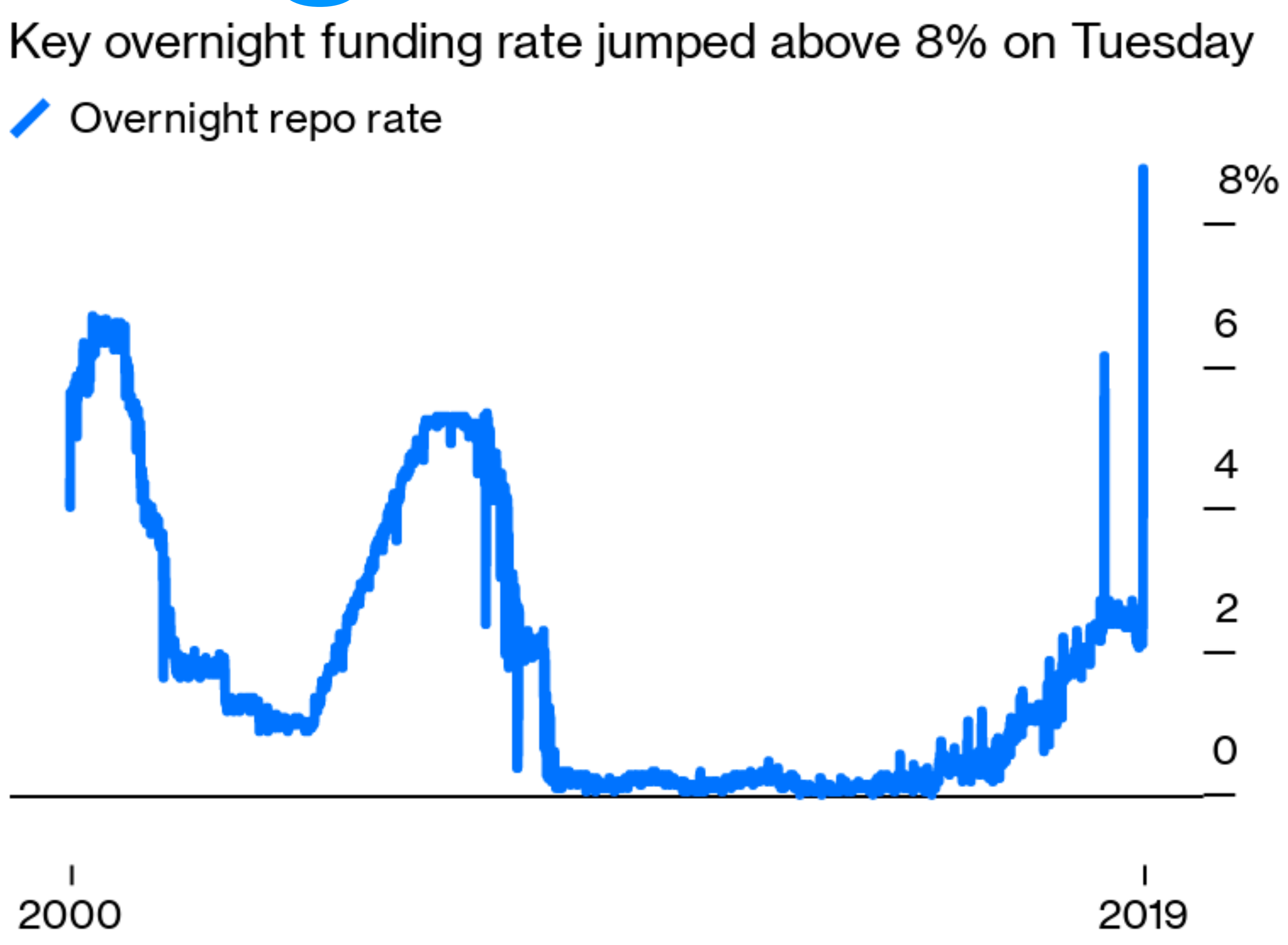
Historically:

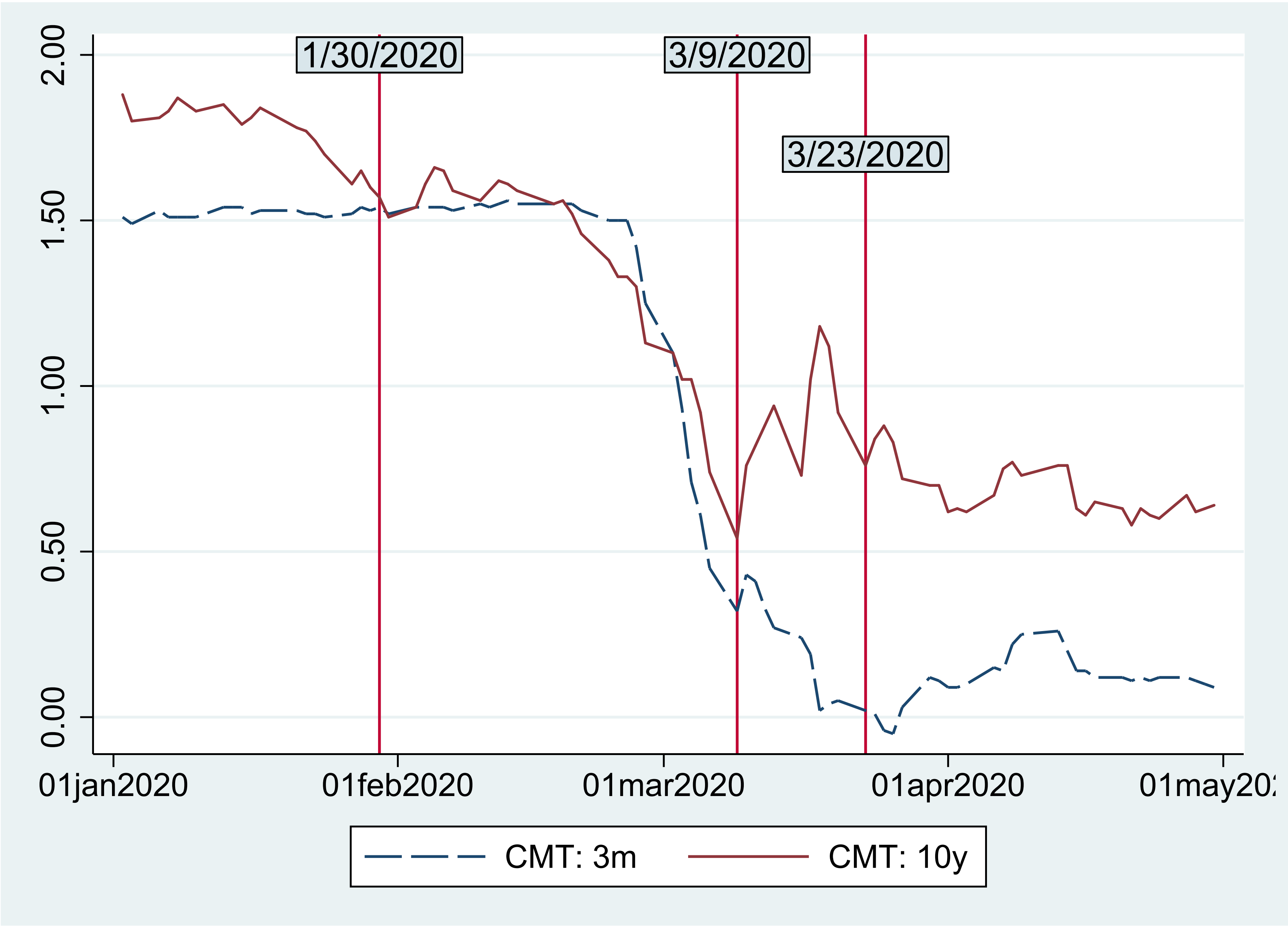
- after World War I: surpluses, but internationalization of the USD, Fed's active role in trade credit

- after World War II: active ceiling on long-term interest rates, rise in inflation in 1940s

- Internationally: CBs very active participants in public debt market

Satiating the demand for liquidity





Surprising need for liquidity:
(i) September 2019
(ii) March 2021
(iii) "Establish a new Federal Reserve standing repo facility… providing funding against U.S. Treasury securities" Task Force on Financial Stability (June, 2021)

New regime: unwinding on active asset holdings, elastic on lending programs.

Central bank digital currency and the elasticity of bank deposits

Public debt and financial instability

Table 1: Deficits versus Changes in the Debt-GDP Ratio

Period: From	To	With interest Deficit (1)	Primary Deficit (2)	Interest Charge (3)	Nominal Growth Effect (4)	Real Growth Effect (5)	Inflation Effect (6)	Change in Debt/GDP (7)
1792	**2003**	**1.2%**	**0.3%**	**0.9%**	**1.3%**	**0.8%**	**0.5%**	**0.0%**
1792	1868	0.4%	-0.1%	0.5%	0.6%	0.5%	0.1%	-0.1%
1869	2003	1.7%	0.5%	1.2%	1.7%	1.0%	0.7%	0.0%
1792	1914	0.1%	-0.4%	0.5%	0.5%	0.5%	0.0%	-0.3%
1915	2003	2.8%	1.2%	1.6%	2.4%	1.2%	1.2%	0.4%

r g

$$b_0 = -\int_0^{\infty} e^{-\bar{m}_t t} s_t dt + \int_0^{\infty} e^{-\bar{m}_t t}(m_t - r_t) b_t dt.$$

Debt = PV (primary surplus) + Debt-revenue term

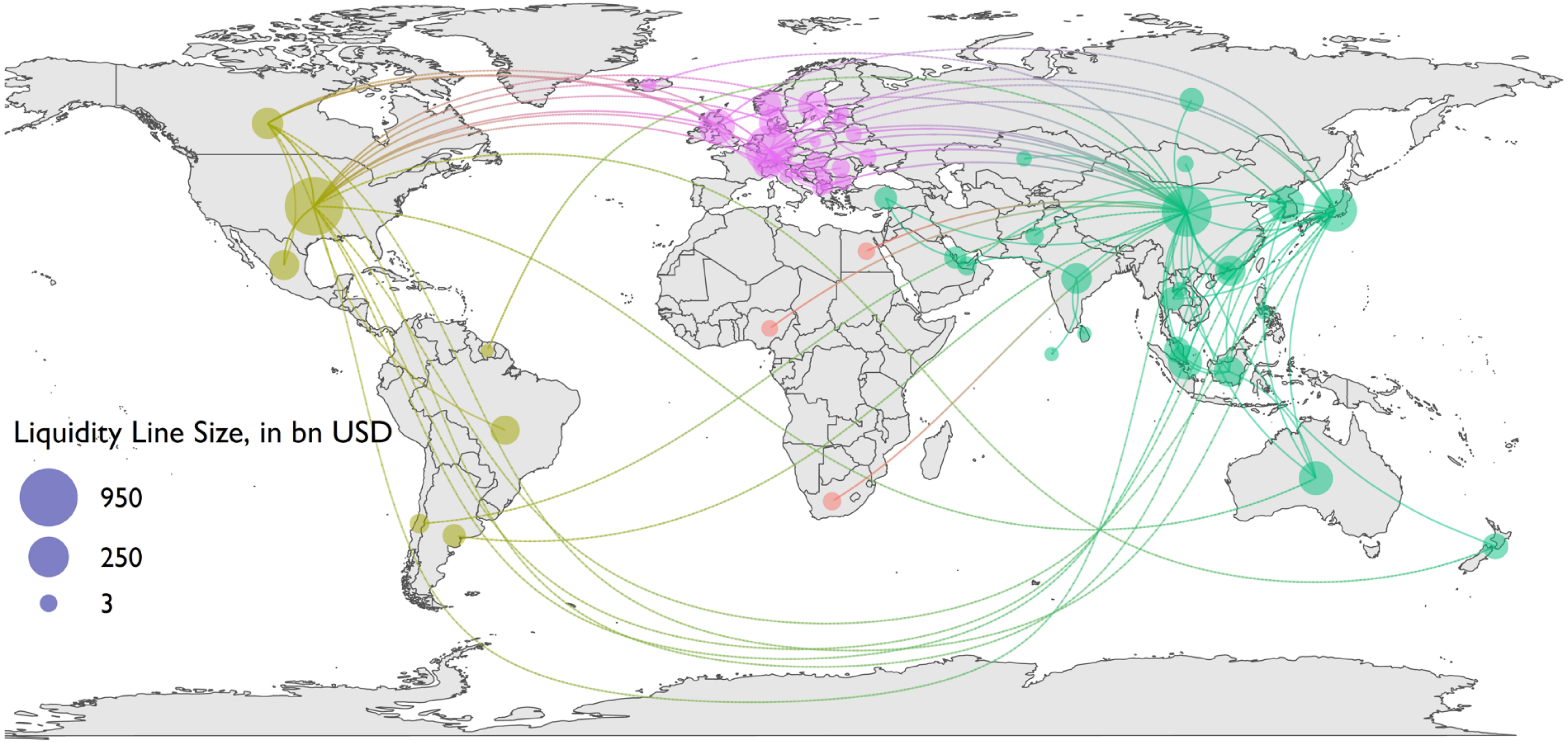
What makes government debt special in offering lower return?

Public bonds are ubiquitous in the plumbing of financial markets. Debt has been sustained by "debt revenues"

Fiscal footprint of CB policy
(i) duration and interest rates
(ii) safety and fear of inflation
(iii) roll-over and deposits
(iv) foreigners and safe haven

Unpleasant financial stability (macro prudential) arithmetics

The emerging global central bank



International coverage of network of liquidity lines is already vast. Stabilizing force over global flows.

Sources of instability:

- willingness to be world lender of last resort

- the ability to continue to distinguish banks from sovereigns

- the central role of the ECB and geopolitics