JEL Classification Numbers:
E43, F21, F32, F36

Summary of
WP/95/30

"World Public Debt and Real Interest Rates" by Robert Ford and Douglas Laxton

Aside from perhaps unemployment or inflation, no other recent macroeconomic policy issue has attracted as much attention as government deficits. Robert Barro and others have demonstrated that the long-term effects of government debt on real interest rates will depend on the extent to which consumers view government debt as wealth. If consumers are connected to all future generations and can borrow against their future income streams, changes in government debt will not crowd out private consumption and investment because consumers adjust their savings to offset the effects of government deficits on their future tax liabilities. This invariance proposition is referred to as Ricardian equivalence, although David Ricardo himself did not believe that the economic consequences of deficits were unimportant. Although there exists considerable empirical evidence that rejects the notion that consumers offset completely the effects of government deficits, there is a paucity of direct empirical evidence that higher levels of government debt will result in higher real interest rates. Indeed, a significant body of empirical research, for example, that by Robert Barro and Paul Evans, has concluded that government deficits and government debt have not had any significant effects on interest rates.

This paper estimates the effects of aggregate fiscal developments in the industrial world on real interest rates in nine industrial countries with liberalized capital markets. The results imply that the increase in OECD-wide government debt since the late 1970s was responsible for the rise in real interest rates in all of these countries. The fact that increases in government debt in any one country will increase real interest rates in other countries suggests that some countries with high levels of government debt may be imposing significant negative externalities on other countries. The results of this paper have two implications for policy. First, they suggest that policymakers should care as much about debt targets as they do about deficit targets. Second, since debt reduction in one country provides long-term benefits for the world economy, there may be an important role for coordination of fiscal policies across countries.

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