

Making the case for sovereign GDP-linked bonds

Robert Shiller | Yale University | 21 March 2018

The time has come for national governments around the world to start issuing their debt in a new form, linked to their countries' resources. GDP-linked bonds – with coupons and principal that rise and fall in proportion to the issuing country's GDP – promise to solve many fundamental problems that governments face when their countries' economies falter. And, once GDP-linked bonds are issued by a variety of countries, investors will be attracted by the prospect of high returns when some of these countries do very well.

This new debt instrument is especially exciting because of its monumental size. Although issues may start out small, they will be very important from the outset. The capitalised value of total global GDP is worth far more than the world's stock markets, and could be valued today in the quadrillions of US dollars.

Now, an authoritative, open-source, online handbook just published by the Centre for Economic Policy Research – *Sovereign GDP-Linked Bonds: Rationale and Design* – explains how governments can do this. I co-edited the book with Jonathan D. Ostry of the International Monetary Fund, and James Benford and Mark Joy of the Bank of England. The book draws on work commissioned by the recent Chinese and German presidencies of the G20, with the collaboration of 20 leading economists, lawyers, and investors. Its publication carries endorsements from Andy Haldane, Executive Director of Financial Stability of the Bank of England, and Maurice Obstfeld, Economic Counselor and Research Director at the International Monetary Fund.

I have been advocating something like GDP-linked bonds for 25 years. In my 1993 book *Macro Markets*, I described the world's GDP as the "mother of all markets" and emphasised a form of debt that I called "perpetual claims". But, I did not work out a real plan of implementation and advocacy. *Sovereign GDP-Linked Bonds* does just that.

The basic idea is simple enough. Governments issue GDP-linked bonds to raise funds, just as corporations issue shares. By issuing such bonds, governments pledge to pay in proportion to the resources they have, measured by their countries' GDP. The price-to-GDP ratio of GDP-linked bonds is essentially analogous to the price-to-earnings ratio of corporate shares. The difference is that GDP is an order of magnitude larger than corporate profits represented by the stock market.

As *Sovereign GDP-Linked Bonds* argues, the issuance of GDP-linked bonds will create "fiscal space" – a cushion for exigencies – for some countries. When government debt payments are fixed in currency terms, as they typically are today, countries get into trouble. In a financial crisis, they become over-leveraged, unable to borrow more, and forced to take drastic action that may impede recovery from the crisis. Taxpayers, rather than willing investors, are forced to become the final bearers of risk.

Issuing GDP-linked bonds is akin to buying insurance against economic distress. The crises that erupted in countries like Ireland and Greece a decade ago would not have been so severe had their debt been GDP-linked. And the same is true today. Investors around the world will continue to accept the risk, given the unlimited upside to investing in entire economies. And, they can achieve the *ne plus ultra* of diversification by holding GDP-linked bonds from around the world.

One may wonder why countries have hardly ever issued GDP-linked securities. The reason is straightforward – financial innovation is difficult. Financial inventions are as complex as engineering inventions, and many details must be worked out to make things work well. We have almost no examples of successful GDP-linked bonds for the same reason we did not see laptop computers until the late 1980s. It takes time and energy to innovate.

The new book takes on the design problem, describing a term sheet for the debt. The answers sometimes focus on seemingly small but important questions. For example, how will the market deal with governments' subsequent revisions of their announced GDP statistics? What will happen if the government somehow fails to produce a GDP number on time? What is the seniority ranking of GDP-linked bonds relative to other sovereign debt? How should collective-action clauses be written, and should they extend to the sovereign's conventional debt? Should GDP-linked bonds be issued in the national currency or in a reserve currency?

Some worry that governments could manipulate their GDP statistics so that they will have less to pay. But that is unlikely, because lower GDP would be taken as a sign of the government's failure. As *Sovereign GDP-Linked Bonds* points out, inflation-indexed debt is even more vulnerable to government cheating, because the monetary incentive for the government is to underreport inflation, which is in line with keeping up appearances. And yet inflation-indexed debt has not been plagued by dishonesty.

The global economy is improving, but the aftermath of the financial crisis has left behind a mountain of government debt, leaving governments less able to rely on fiscal policy to respond to any new crisis. It is important to begin establishing GDP-linked debt now, along the lines described in the new book, so that the biggest risks can be managed and policymakers can focus on maintaining economic stability.

Debt instruments similar to GDP-linked bonds have been tried, but only when it is already too late, as an emergency component of a post-default restructuring process. Now, countries that are not in crisis have a chance to try the real thing. The biggest step forward will come when advanced countries issue GDP-linked bonds in relatively normal times. That will set the example the rest of the world has been waiting for.

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