Australian Government Debt following Two World Wars and Six Economic Downturns

Monique Champion[1], Stephen Elias[2], Peter Ireland[3], Aditya Khanna[4], David Lancaster[5]

1,2,3,5 Macroeconomic Analysis and Policy Division, Macroeconomic Group, The Treasury, Langton Crescent, Parkes ACT 2600.
4 Contributed to this research while in Macroeconomic Analysis and Policy Division, Macroeconomic Group, The Treasury, Langton Crescent, Parkes ACT 2600.

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Abstract

In response to the outbreak of COVID-19, the Australian Government provided an unprecedented level of economic and health support. This helped to cushion the impact on the economy and put in place the conditions for a strong rebound. However, it also resulted in a sharp increase in Commonwealth Government debt, to be at its highest level as a share of GDP since the Second World War. To achieve a sustainable debt path over time, the government will need to reduce debt to GDP over time, thereby rebuilding fiscal space to respond to future economic downturns.

There is ongoing debate about the appropriate pace of debt reduction and how it can be achieved. This paper contributes to this discussion by drawing lessons from previous debt cycles in Australia since Federation. Our approach is analogous to that used by Hall and Sargent (2011, 2020) in the United States and builds upon the work of Di Marco, Pirie and Au-Yeung (2009) in Australia. We use the law of motion for debt to GDP to decompose its changes into the contributions of the primary budget balance, real interest rates, real GDP growth and inflation.

The paper introduces and draws on a novel Australian dataset of fiscal aggregates, which was constructed in part from historical budget documents back to 1912. This dataset includes Commonwealth debt to GDP, the primary budget balance, interest payments, economic growth and inflation. Unlike previous research, we make a concerted effort to adjust for the effect on Commonwealth debt of borrowing on behalf of state and territory governments, which was a feature of budgets up until the early 1990s. The paper analyses the historical data alongside economic narratives in the periods of interest, including the changing focus and roles of fiscal and monetary policy at the time.

The paper focuses on two key research questions. How quickly has Australia reduced Commonwealth gross debt to GDP following recessions and wars to maintain a sustainable debt path over time? How has this debt reduction been achieved?

Since Federation, Australia has experienced eight major cycles in gross Commonwealth debt to GDP, sparked by two world wars and six economic downturns. On average, economic downturns prior to the global financial crisis (GFC) resulted in Commonwealth gross debt to GDP increasing by 8–17 percentage points over 4–6 years. The increase following the GFC was unusually large; debt to GDP increased by 24 percentage points over a decade or so. The First and Second World Wars saw much larger increases in debt to GDP.

Between these episodes, gross debt to GDP has been successfully reduced, thereby keeping debt on sustainable debt path over time. While gross debt to GDP has tended to increase quickly following wars and recessions, reductions in debt to GDP have tended to be achieved gradually. Gross debt to GDP typically declined by 1–3 percentage points per year on average over 6–10 years, although the period of debt reduction following the Second World War was much longer.

Reductions in gross debt to GDP have tended to involve primary budget surpluses. In episodes prior to the 1990s, GDP growth was also higher than interest rates on average, contributing to declines in gross debt as a share of GDP. Inflation has generally played a relatively modest role in debt reductions. An

exception was the decade following the Second World War; the removal of price controls contributed to strong nominal GDP growth over this period.

The primary budget surpluses in the 1990s and 2000s were unusually large, supported by elevated commodity prices. These surpluses enabled gross debt to GDP to be reduced in an environment of relatively high interest rates. Asset sales during this period also contributed to the reduction in debt to GDP.

Our historical analysis allows us to draw some lessons for fiscal policy in the period ahead. Economic forecasters are predicting a period of relatively low interest rates to persist, notwithstanding expected increases in rates in coming years. At the same time, economic growth is expected to remain solid. In this environment, Commonwealth gross debt to GDP may be able to be reduced even in the presence of modest budget deficits.

Key Words

Fiscal policy, budget, debt, economic history

JEL Classification: H6, E6