Financial Globalization, Inequality, and the Raising of Public Debt*

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Abstract

During the last three decades, the stock of government debt has increased in most developed countries. During the same period, we also observe a significant liberalization of international financial markets and an increase in income inequality in several industrialized countries. In this paper we propose a multicountry political economy model with incomplete markets and endogenous government borrowing and show that governments choose higher levels of public debt when financial markets become internationally integrated and inequality increases. We also conduct an empirical analysis using OECD data and find that the predictions of the theoretical model are supported by the empirical results.

Keywords: Government debt, financial integration, income inequality.

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1 Introduction

During the last three decades, we have observed an increase in the stock of public debt in most developed countries. As shown in the top panel of Figure 1, the stock of public debt in OECD countries has increased from around 30 percent of GDP in the early 1980s to about 50 percent in 2005. Similar increases are observed in the United States and Europe.

Historically, the dynamics of public debt have been closely connected to war financing and business cycle fluctuations, where budget deficits and surpluses are instrumental in minimizing the distortionary effects of taxation. The tax-smoothing theory developed by Barro (1979) provides a rationale for such dynamics. However, when we look at the upward trend in public debt that started in the early 1980s, it becomes difficult to rationalize this trend with the tax-smoothing argument since this period is characterized by relatively peaceful times and low macroeconomic volatility.

The last three decades have also been characterized by two additional trends: the international liberalization of financial markets and the increase in inequality in several industrialized countries. The second panel of Figure 1 plots the index of financial liberalization constructed by Abiad, Detragiache and Tressel (2008) for the group of OECD countries, United States and Europe. As can be seen from the panel, the world financial markets have become much less regulated starting in the early 1980s. A fact also confirmed by other indicators of international capital mobility as shown in Obstfeld and Taylor (2005). The second trend that took place during the last three decades is the increase in inequality. The last panel of Figure 1 plots the share of income earned by the top 1% of the population as reported by Atkinson, Piketty, and Saez (2011). The increase in inequality is not limited to the United States.

In this paper we propose a theory in which government borrowing responds positively to both financial liberalization and increased income inequality. We study a multicountry model where agents face uninsurable idiosyncratic risks and public debt is held by private agents to smooth consumption. To keep tractability, we assume that there are two types of agents: those who face idiosyncratic risks (entrepreneurs) and those who are less exposed to these risks (workers). Government policies are determined through the aggregation of agents' preferences based on probabilistic voting. The goal is to show how the choice of government debt changes when capital markets are liberalized and inequality increases.

Both agents have preferences for some public debt. Agents who face higher idiosyncratic risks (entrepreneurs) benefit from public debt because it

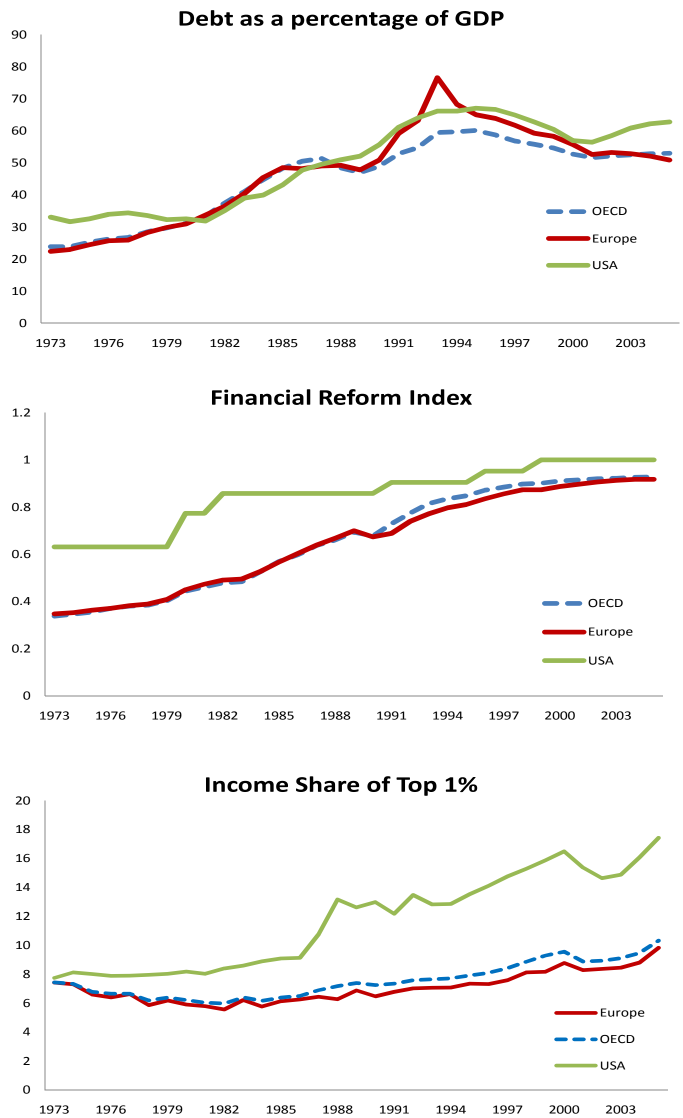


Figure 1: Public debt, financial liberalization, and inequality in advanced economies. Appendix A provides the definition of variables and the data sources.

provides an additional instrument to smooth consumption. This is the same reason why in Aiyagari and McGrattan (1998) and Shin (2006) public debt improves welfare. Agents who face lower risks (workers) can also benefit from government borrowing because the equilibrium interest rate is lower than the intertemporal discount rate. The benefits from public debt, however, fade away as the stock of debt increases. Once the debt has reached a certain level, further increases provide only small gains to entrepreneurs, since they already hold large amounts of risk-free assets. On the other hand, workers internalize the fact that raising the stock of debt increases its cost, which is given by the interest rate. Thus, once the debt has reached a certain level, workers do not support further increases; the internalization of the increasing cost of debt serves as a limit to its growth.

How does financial integration affect the government incentive to issue debt? The central mechanism is the elasticity of the interest rate to the supply of debt. In a globalized world, both the demand and supply of government debt come not only from domestic agents (investors and governments) but also from their foreign counterparts. Therefore, when governments do not coordinate their actions and act only on their citizens' interests, each individual country faces a lower elasticity of the interest rate to the supply of 'their own' government debt. Since the interest rate is less responsive to a country's debt, governments have more incentives to increase borrowing provided that workers have sufficient political influence. Thus, we have a mechanism through which capital liberalization increases government debt.

How does income inequality affect preferences for public debt? In our model, income inequality is associated with greater uninsurable risks. Since this increases the demand for safe assets and reduces the interest rate, the issuance of debt is beneficial for both entrepreneurs and workers. For entrepreneurs, it is beneficial because public bonds provide safe assets available for consumption smoothing. For workers, it is beneficial because the interest rate declines, and through the government debt, they can borrow cheaply.

The increase in income inequality induces higher government borrowing independently of the international regime of capital markets. However, with capital mobility, public debt could rise in all countries even if inequality increases only in a subset of countries. Thus, for the model to generate a worldwide increase in public debt, it is sufficient that inequality increases in a subset of countries, provided that they are financially integrated.

The organization of the paper is as follows. We first describe how the paper relates to various contributions in the literature. After the literature review, Section 2 describes the model and defines the equilibrium. Section 3 explores a simplified version of the model with only two periods, providing simple analytical intuition for the key results of the paper. Section 4 performs a quantitative analysis with the infinite horizon model. Section 5 conducts the empirical analysis and Section 6 concludes. All technical proofs are relegated to the Appendix.

1.1 Literature review

An influential theoretical literature studies the optimal choice of public debt over the business cycle with contributions by Barro (1979), Lucas and Stokey (1983), Aiyagari, Marcet, Sargent, and Seppala (2002), Angeletos (2002), Chari, Christiano, and Kehoe (1994), and Marcet and Scott (2009). We depart from the tax-smoothing mechanism because we abstract from aggregate fluctuations and distortionary taxation. Instead, we focus on the role of heterogeneity within a country that is assumed away in these papers.

The economic structure of our model is closer to models studied in Aiyagari and McGrattan (1998) and Shin (2006). In these papers the role of government debt is to partially complete the assets' market when agents are subject to uninsurable idiosyncratic risks. The government accumulates debt in order to crowd out private capital, which is inefficiently high due to precautionary savings. In our model, however, we abstract from capital accumulation. Therefore, the government choice to issue debt is independent of production efficiency considerations, but it is based on redistributive concerns. Because of this, our paper is also related to the literature on optimal redistributive policy in heterogeneous agent economies such as Krusell and Rios-Rull (1999), Golosov, Kocherlakota, and Tsyvinski (2003), Albanesi and Sleet (2006), Farhi and Werning (2008), and Corbae, D'Erasmo, and Kuruscu (2009).

The paper is also related to the literature on the political economy of debt initiated by Alesina and Tabellini (1990), Persson and Svensson (1989), and further developed by Song, Storesletten, and Zilibotti (2007), Battaglini and Coate (2008), Caballero and Yared (2008), Ilzetzki (2011), and Aguiar and Amador (2011). A common feature of these papers is the strategic use of public debt in economies where the interest rate is exogenous and governments with different preferences over public spending alternate in power. We abstract from political turnover and consider instead how the supply of government bonds endogenously affects interest rates and redistribution. The 'interest rate manipulation' channel is also present in Azzimonti, de Francisco, and Krusell (2008), but it relies on the existence of distortionary taxation, which we assume away here.

Another difference between our study and most of the papers proposed in the literature that study the optimal choice of public debt is that we consider an open economy environment. An exception is Chang (1990) who studies how the international liberalization of capital markets affects government borrowing in an economy with overlapping generations. Although the structure of this model is different from our model, the mechanism through which capital liberalization leads to higher government borrowing is similar. The analysis of Chang (1990), however, abstracts from risk and does not investigate how income inequality affects government borrowing. In addition, we perform a quantitative evaluation of the theory through the calibration of the model and test some of the results empirically using cross-country data. Kehoe (1989), Mendoza and Tesar (2005), and Quadrini (2005) also study equilibrium government policies with capital mobility, but in models without public debt or with public debt that is not chosen optimally. Cooper, Kempf, and Peled (2008) study the role of debt limits on governments within a federation. Our paper shows that even in the absence of the free rider problem present in fiscal federations, a country's participation in the international bond market can lead to higher sovereign debt.

The paper is also related to the recent literature that explores the importance of market incompleteness for international financial flows. Caballero, Farhi, and Gourinchas (2008), Mendoza, Quadrini, and Rios-Rull (2009), and Angeletos and Panousi (2010) have all emphasized the importance of cross-country heterogeneity in financial markets for global imbalances. Our study differs from these contributions in two dimensions. First, our focus is on public debt while the above contributions have focused on private debt. There is an important difference between public and private debt that is crucial for our results: while in private borrowing, atomistic agents do not internalize the impact that the issuance of debt has on the interest rate, governments do. As already mentioned, part of our results are driven by the fact that governments do not take the interest rate as given, as individual agents do. The second difference is that the goal of our study is to explain the global volumes of (public) debt, while the contributions mentioned above focus on net volumes. In these models financial liberalization leads to higher liabilities in one country but lower liabilities in others, with the difference defining the imbalance. The global volume of credit, however, does not change significantly. In contrast, in our model capital liberalization (and income inequality) generates an increase in the global stock of debt even if countries are symmetric and liberalization (and income inequality) does not generate international imbalances.

2 Theoretical environment and equilibrium

In this section we first describe the model. We then characterize the competitive equilibrium for given government policies. Finally, we define an equilibrium when public policies (debt) are chosen optimally by governments.

2.1 The model

Consider an economy composed of N symmetric countries indexed by $j \in \{1, ..., N\}$. Markets are incomplete in the sense that agents face uninsurable idiosyncratic risks, but some agents are more exposed to risk than others.

To model heterogeneous exposure to risk in a tractable manner, we assume that there are two types of agents: a measure Φ of workers and a measure 1 of entrepreneurs. Workers do not face any idiosyncratic uncertainty, while entrepreneurs are subject to investment risks. In modeling entrepreneurs, we adopt the approach proposed by Angeletos (2007), which allows for linear aggregation. We can then conduct the general equilibrium analysis by focusing only on a representative worker and a representative entrepreneur, without paying attention to the evolution of wealth distribution among entrepreneurs.

Although we focus on heterogeneity between workers and entrepreneurs and make the extreme assumption that workers do not face any risk, the model should be interpreted more generally as an environment in which some agents face more risk than others. Because of the different exposure to risk, preferences over government debt differ for workers and entrepreneurs. Thus, the public debt chosen by the government will depend on the relative political power (size) of these two groups.

Both types of agents maximize the expected lifetime utility

$$\mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \ln(c_t), \tag{1}$$

where c_t is consumption and $\beta = \tilde{\beta}\omega$. The discount factor results from the product of two terms: the intertemporal discount factor in preferences, $\tilde{\beta} \in (0, 1)$, and the survival probability, $\omega \in (0, 1]$. The reason to assume agents' mortality will be explained below. At that point, we will also specify how the wealth of exiting agents is redistributed to newborn agents. In each country j there is a unit supply of land, an international immobile asset traded at price $p_{j,t}$. Entrepreneurs are individual owners of private firms, each producing output with production function $F(z, k, l)$, where k is the input of land, l the input of labor supplied by workers, and z is an idiosyncratic productivity shock that is observed after the input of land. It is independently and identically distributed among agents and over time, and takes values in the set $\{z_1, ..., z_m\}$ with probabilities $\{\mu_1, ..., \mu_m\}$. This is the only source of risk in the model. The function $F(z, k, l)$ is strictly increasing in z, k, l and homogeneous of degree 1 in k and l (constant returns).

Entrepreneur i in country j hires workers in a competitive labor market at wage $w_{j,t}$, and the budget constraint of the entrepreneur is

$$c_{i,j,t}+p_{j,t}k_{i,j,t+1}+\frac{b_{i,j,t+1}}{R_{j,t}}=F(z_{i,j,t},k_{i,j,t},l_{i,j,t})-w_{j,t}l_{i,j,t}+p_{j,t}k_{i,j,t}+b_{i,j,t}, \quad (2)$$

where $b_{i,j,t}$ are the holding of riskless bonds with current unit price $1/R_{j,t}$.

Workers are endowed with $1/\Phi$ units of labor that they supply inelastically in the domestic market for the wage $w_{j,t}$. Labor is internationally immobile.[1] Workers also receive lump-sum transfers $T_{j,t}$ from the government. For simplicity we assume that workers do not hold assets or borrow. Therefore, workers' consumption is equal to

$$c^w_{j,t}=w_{j,t}\left(\frac{1}{\Phi}\right)+T_{j,t}. \quad (3)$$

The assumption that workers do not hold assets or borrow is without loss of generality. As we will see, the equilibrium interest rate is smaller than the intertemporal discount rate, that is, $R_{j,t}<1/\beta$. Since workers do not face any risk, they will not hold bonds in the long run. The inability to borrow can be rationalized by limited enforcement, leading to an upper bound in the amount of borrowing, which for simplicity we set to zero.

The government raises revenues by issuing one-period bonds. The proceeds are redistributed as lump-sum transfers to workers and used to pay outstanding debt. The government budget constraint is

$$\Phi\cdot T_{j,t}+B_{j,t}=\frac{B_{j,t+1}}{R_{j,t}}, \quad (4)$$

where $B_{j,t}$ are the bonds issued at time $t-1$ and due in period t, and $B_{j,t+1}$ are the new bonds issued at t. The assumption that the government makes lump-sum transfers only to workers is made for analytical tractability. If transfers were also paid to entrepreneurs, we would not be able to derive the aggregation result stated below.

2.2 Competitive equilibrium for given policies

We start characterizing the competitive equilibrium, taking as given government policies. This is the necessary first step to characterize the policies that governments will choose optimally, as we will do in the next section.

[1] The assumption that the individual labor supply is $1/\Phi$ is simply a normalization that keeps the ratio of total land over the aggregate supply of labor equal to 1.

We consider two trading arrangements. In the first arrangement, each country is under financial autarky, where riskless bonds cannot be traded in international markets. In the second arrangement, countries are financially integrated, so governments can sell bonds to (borrow from) domestic and foreign entrepreneurs.

The decision problem of workers is trivial because transfers are taken as given and the supply of labor is inelastic. They simply consume their income. The decision problem of entrepreneurs is more complex. Given the initial holdings of land and bonds, they choose labor input, consumption and asset holdings (land and bonds) that maximize their lifetime utility. These choices are functions of their individual states, which we denote by $s_{i,j,t} = (k_{i,j,t}, b_{i,j,t}, z_{i,j,t})$.

Definition 2.1 (Autarkic Equilibrium) *Given a sequence of government debt $\{B_{j,t+1}\}_{t=0}^{\infty}$, a competitive equilibrium without mobility of capital (autarky) is defined as a sequence of prices $\{w_{j,t}, p_{j,t}, R_{j,t}\}_{t=0}^{\infty}$, entrepreneurs' decisions $\{c_{i,j,t}(s_{i,j,t}), l_{i,j,t}(s_{i,j,t}), k_{i,j,t+1}(s_{i,j,t}), b_{i,j,t+1}(s_{i,j,t})\}_{t=0}^{\infty}$, consumption of workers $\{c_{j,t}^{w}\}_{t=0}^{\infty}$, and transfers $\{T_{j,t}\}_{t=0}^{\infty}$ for $j \in \{1, ..., N\}$ such that:*

i. Entrepreneurs' decisions maximize (1) subject to the budget constraint (2). Workers' consumption satisfies the budget constraint (3).

ii. Prices clear domestic markets for labor, $\int_i l_{i,j,t}(s_{i,j,t})di = 1$, for land, $\int_i k_{i,j,t+1}(s_{i,j,t})di = 1$, and for bonds, $\int_i b_{i,j,t+1}(s_{i,j,t})di = B_{j,t+1}$.

iii. Domestic bonds and transfers satisfy the government's budget (4).

The definition of a competitive equilibrium with integrated capital markets is similar. The only difference is that the bond market clears internationally instead of country by country, that is, $\sum_{j=1}^{N} \int_i b_{i,j,t+1}(s_{i,j,t})\mathrm{d}i = \sum_{j=1}^{N} B_{j,t+1}$, and interest rates are equalized across countries, that is, $R_{1,t} = R_{2,t} = ... = R_{N,t} \equiv R_t$.

We can now provide some characterization of the competitive equilibrium. The hiring decision of entrepreneurs is static, since it affects only current profits. Given productivity $z_{i,j,t}$ and land $k_{i,j,t}$, the marginal product of labor is equalized to the wage rate, that is, $F_l(z_{i,j,t}, k_{i,j,t}, l_{i,j,t}) = w_{j,t}$. Because the production function is homogeneous of degree 1, the demand of labor is linear in the input of land and can be expressed as $l_{i,j,t} = l(z_{i,j,t}, w_{j,t})k_{i,j,t}$. Using the linearity of the demand of labor together with the homogeneity property of the production function, the entrepreneurial profits are also linear in the input of land, that is,

$$F(z_{i,j,t}, k_{i,j,t}, l_{i,j,t}) - w_{j,t} l_{i,j,t} = A(z_{i,j,t}, w_{j,t}) k_{i,j,t}. \tag{5}$$

As in Angeletos (2007), the linearity of the profit function implies that the decision rules for consumption, land, and bonds are linear in wealth $a_{i,j,t} = A(z_{i,j,t}, w_{j,t})k_{i,j,t} + p_{j,t}k_{i,j,t} + b_{i,j,t}$.

Lemma 2.1 *Given the equilibrium prices, entrepreneur's policies are*

$$\begin{aligned} c_{i,j,t} &= (1-\beta)a_{i,j,t}, \\ k_{i,j,t+1} &= \frac{\beta\phi_{j,t}}{p_{j,t}} a_{i,j,t}, \\ b_{i,j,t+1} &= R_{j,t}\beta(1-\phi_{j,t})a_{i,j,t}, \end{aligned}$$

where $\phi_{j,t}$ satisfies $\mathbb{E}_t\left[\frac{R_{j,t}}{\left(\frac{A(z_{i,j,t+1}, w_{j,t+1}) + p_{j,t+1}}{p_{j,t}}\right)\phi_{j,t} + R_{j,t}(1-\phi_{j,t})}\right] = 1.$

Proof 2.1 *Appendix B.*

In the analysis that follows, we shall distinguish the stock of public debt issued by country j from the aggregate bonds held by the residents (entrepreneurs) of country j. The debt issued by country j government is denoted by $B_{j,t}$, and the aggregate bonds held by country j residents are denoted by $b_{j,t} = \int_i b_{i,j,t}$. In a closed economy $b_{j,t} = B_{j,t}$. In an open economy, however, the two quantities may differ, since government bonds can be acquired by both domestic and foreign investors.

Aggregating agents' decisions using Lemma 2.1 and imposing market clearing, we establish the following proposition, similar to Angeletos (2007).

Proposition 2.1 *Given the sequence of public debt $\{B_{1,t+1}, ..., B_{N,t+1}\}_{t=0}^{\infty}$, the equilibrium wage $\bar{w}$ is constant and equal across countries. The remaining prices and aggregate allocations are independent of the distribution of* *wealth among entrepreneurs and are equal to*

$$c^w_{j,t} = \bar{w}\left(\frac{1}{\Phi}\right) + \left(\frac{B_{j,t+1}}{R_{j,t}} - B_{j,t}\right)\left(\frac{1}{\Phi}\right), \tag{6}$$

$$\phi_{j,t} = \mathbb{E}\left[\frac{A(z_{i,j,t+1}) + p_{j,t+1}}{A(z_{i,j,t+1}) + p_{j,t+1} + b_{j,t+1}}\right], \tag{7}$$

$$p_{j,t} = \frac{\beta\phi_{j,t}(\bar{A} + b_{j,t})}{(1 - \beta\phi_{j,t})}, \tag{8}$$

$$R_{j,t} = \frac{(1 - \beta\phi_{j,t})b_{j,t+1}}{\beta(1 - \phi_{j,t})(\bar{A} + b_{j,t})}, \tag{9}$$

$$c^e_{j,t} = \left(\frac{1-\beta}{\beta}\right)\left(p_{j,t} + \frac{b_{j,t+1}}{R_{j,t}}\right), \tag{10}$$

where $A(z_{i,j,t}) \equiv A(z_{i,j,t}, \bar{w})$, $\bar{A} = \sum_\ell A(z_\ell)\mu_\ell$, *and* $c^e_{j,t} = \int_i c_{i,j,t}$.

Proof 2.1 *Appendix C.*

From the above expressions, we can verify that, if the sequence of government policies were identical in all countries, that is, $B_{1,t} = ... = B_{N,t}$, and independent of the capital regime, the autarkic equilibrium would coincide with the equilibrium with integrated capital markets. This is a consequence of the cross-country symmetry in technology and preferences. However, as we will see next, when policies are chosen endogenously by governments, the sequences of public debt and associated allocations differ in the two regimes.

2.2.1 Distribution of wealth

Since entrepreneurs face idiosyncratic shocks, the model generates a complex distribution of income and wealth. By virtue of the linearity of the production technology, we have seen that the model admits aggregation, which is a convenient property to characterize and solve for the model. However, an implication of this property is that the distributions of income and wealth are not stationary. Since individual wealth follows a random walk, the degree of inequality increases over time without bound even if we limit the analysis to a steady state with constant debt. This property becomes problematic if we want to compare the inequality generated by the model with the inequality observed in the data.

To have stationary distributions of income and wealth, we have assumed that agents survive with some probability $\omega < 1$ and they are replaced by the same number of newborn agents. The assets left by exiting entrepreneurs are redistributed equally (lump-sum) to the new born entrepreneurs. With this assumption, the distributions of income and wealth become stationary, that is, they converge to a steady state if the stocks of public debt are constant. Notice that workers have zero assets, so there is no wealth that needs to be redistributed among workers. Under these conditions, the aggregate properties of the competitive equilibrium are the same as those characterized in the previous sections.

2.3 Determination of government policies

We now turn to the derivation of the optimal government policies, which is the main goal and contribution of this paper. In particular, we study how governments choose the supply of bonds and how this choice is affected by the international capital market regime. We start analyzing the case without mobility of capital (financial autarky).

2.3.1 Politico-economic equilibrium with financial autarky

We focus on Markov-Perfect equilibria where government policies are functions of the stock of public debt. Since in an equilibrium with financial autarky government debt is always equal to the private ownership of bonds from entrepreneurs, that is, $b_{j,t} = B_{j,t}$, the only aggregate state variable is $B_{j,t}$. To simplify notations, we denote next period variables with a prime and drop the country index j.

Define $\mathcal{B}(B)$ the equilibrium policy rule governing the supply of bonds. Each government chooses the current period supply, B', under the assumption that future policies will be determined by the function $\mathcal{B}(B')$. In order to specify how the political process aggregates preferences for B', we have to derive agents' indirect utilities.

Imposing $b = B$ on equations (8) and (9), we can show that the price of land and the interest rate are only functions of current and next period debt. Therefore, they can be written as $p(B; B')$ and $R(B; B')$, respectively.

Now suppose that the government choice of debt in the current period is B' and, starting in the next period, the debt will be determined by the policy rule $B'' = \mathcal{B}(B')$. We then have the following proposition.

Proposition 2.2 *Given current policy B' and the policy rule $\mathcal{B}(B')$,* *i. The indirect utility of workers is*

$$-\left(\frac{1}{1-\beta}\right)\ln\Phi + W(B;B'), \tag{11}$$

where $W(B;B')$ is defined recursively as

$$W(B;B') = \ln\left(\bar{w} + \frac{B'}{R(B;B')} - B\right) + \beta W\Big(B';\mathcal{B}(B')\Big).$$

ii. The indirect utility of an entrepreneur with z and k is

$$\left(\frac{1}{1-\beta}\right)\ln k + V(B,z;B'), \tag{12}$$

where $V(B,z;B')$ is defined recursively as

$$\begin{aligned} V(B,z;B') \quad = \quad & \ln(1-\beta) + \left(\frac{1}{1-\beta}\right)\ln\Big(A(z)+B+p(B;B')\Big) + \\ & \left(\frac{\beta}{1-\beta}\right)\ln\left(\frac{\beta\phi(B')}{p(B;B')}\right) + \beta\mathbb{E}V\Big(B',z';\mathcal{B}(B')\Big). \end{aligned}$$

Proof 2.2 *Appendix D.*

We can see from equation (12) that entrepreneurs are heterogeneous in lifetime utility. The heterogeneity is fully summarized by the current stock of land k and productivity z. The variable k enters the indirect utility additively, and, therefore, it does not affect preferences over B'. The variable z, instead, does generate heterogeneous preferences over policies. However, since the distribution of z is exogenous and time invariant, the aggregation of preferences remains simple. Therefore, when the government aggregates entrepreneurs' preferences, the only *endogenous* variable that matters for the choice of the policy today is the current stock of outstanding debt B. Notice that this property would not hold if lump-sum transfers were also paid to entrepreneurs, complicating the characterization of the equilibrium.

An important implication of this property is that, since the aggregate stock of debt B is a sufficient statistic to characterize the optimal policy in a Markov equilibrium, it makes sense to assume that future policies are determined only by future aggregate debt. This justifies the assumption in Proposition 2.2 that future policies are determined by the function $\mathcal{B}(B')$.

We now briefly describe the political process. Government policies are implemented by representatives who are selected through democratic elections. Consider a political race between two opportunistic candidates who only care about gaining power and have commitment to some platforms. Under standard assumptions made in the probabilistic voting literature, political competition leads to convergence in policy proposals. As shown in Persson and Tabellini (2000), government policies maximize a weighted sum of agents' welfare. In our framework, the government's objective is a weighted sum of the welfare of workers and entrepreneurs alive in the current period. Thus, the optimization problem of the government is

$$\max_{B'}\left\{\Phi \cdot W(B;B') + \sum_{\ell=1}^{m} V(B, z_\ell; B')\mu_\ell\right\},$$

where $W(B;B')$ and $V(B,z_i;B')$ are defined in Proposition 2.2.

Because elections are held every period and candidates are identical, in the politico-economic equilibrium $B' = \mathcal{B}(B)$. The government behaves de-facto as a benevolent planner without commitment to future policies.[2]

2.3.2 Politico-economic equilibrium with financial integration

With capital mobility the relevant state space is augmented since the domestic supply and demand of government bonds are not necessarily equalized, that is, b_j may be different from B_j. Given the initial states and the prices, workers' consumption is affected only by the domestic supply of bonds B'_j while entrepreneurs' consumption depends on their holding of bonds b'_j (recall equations (6) and (10)). In addition, the interest rate is now determined by the worldwide market clearing condition $\sum_{j=1}^{N} b'_j = \sum_{j=1}^{N} B'_j$, implying that agents in one country need to form expectations about the foreign demand and supply of bonds. This creates a strategic interaction between the government policies of financially integrated countries.

We restrict attention to Nash equilibria where public borrowing decisions are made simultaneously and independently (i.e., there is no coordination among governments). The government of country j cares only about the welfare of its own citizens, and in choosing the optimal B'_j, it takes the

[2]Since there is no distortionary taxation, debt does not affect aggregate production. However, if the government finances transfers with distortionary taxes and the supply of labor is endogenous, taxes will affect the demand and supply of labor and hence production. In an earlier version of the model, we allowed for endogenous supply of labor and distortionary taxes. Since the effect of taxes on public debt was not quantitatively important, we decided to abstract from them to keep the model simple.

policies of other countries as given. Without loss of generality, we focus on the problem faced by an individual country, which we refer to as the *domestic* country. We will then denote the debt issued by the domestic country by B without subscript. Due to symmetry, the identity of other countries issuing debt is irrelevant from the standpoint of an individual country. Only the aggregate amount supplied by the rest of the world matters. The supply from the rest of the world will be denoted by $B^* = \sum_{j=1}^{N} B_j - B$. Using this notation, the problem solved by the government of the domestic country is

$$\max_{B'} \left\{ \Phi W\Big(b, B, B^*; B', B^{*'}\Big) + \sum_{\ell=1}^{m} V\Big(z_\ell, b, B, B^*; B', B^{*'}\Big)\mu_\ell \right\},$$

where the indirect utilities are derived in a similar fashion as in the autarky regime. The sufficient set of state variables are b, B, B^*. Once we know these three variables, we can derive the aggregate demand of debt from the rest of the world, b^*, using the worldwide market clearing condition $b+b^* = B+B^*$.

Symmetry also implies that, if we start with $b_j = b = B_j = B$ for all $j = \{1, ..., N\}$, then $b'_j = b' = \frac{B'+B^{*'}}{N} = \overline{B}'$, provided that the equilibrium is unique. The interest rate can then be derived from equation (9) as

$$R(\overline{B}; \overline{B}') = \frac{(1 - \beta\phi(\overline{B}'))\overline{B}'}{\beta(1-\phi)(\bar{A} + \overline{B})}. \tag{13}$$

At this point we can compare this equation with the corresponding equation for the interest rate in the autarky regime, which reads

$$R(B; B') = \frac{(1 - \beta\phi(B'))B'}{\beta(1-\phi)(\bar{A} + B)}. \tag{14}$$

The difference is that in autarky the interest rate is determined only by domestic debt, that is, B and B'. With mobility, the interest rate is a function of average worldwide debt, that is, $\overline{B} = \frac{B+B^*}{N}$ and $\overline{B}' = \frac{B'+B^{*'}}{N}$. Therefore, when the domestic government considers a change in B', the induced change in worldwide debt $\overline{B}' = \frac{B'+B^{*'}}{N}$ is smaller than in the autarky regime. This is because in the Nash game the level of debt issued by other governments $B^{*'}$ is taken as given. Thus, the change in the interest rate is smaller. Effectively, the worldwide interest rate is perceived by each individual government as being less elastic to its own supply of bonds. This changes the (individual) incentive to issue debt because the marginal increase in the repayment costs R is lower when $B^{*'}$ is taken as given.[3]

This channel, which has also been emphasized in Chang (1990), derives from the non atomistic nature of governments, and it is essential to differentiate public borrowing from private borrowing. In fact, private issuers do not internalize the impact of their choices on the equilibrium interest rate since each agent is too small to affect aggregate prices. Therefore, with only private issuers, the autarkic equilibrium would not be different from the equilibrium with capital mobility. In our framework, on the contrary, when governments issue debt, they fully internalize the effect of higher borrowing on the interest rate. Since the effect on the interest rate depends on the international capital market regime, the equilibrium debt differs in the economy with and without mobility of capital. As a result, the model predicts that financial integration affects the equilibrium outcome even if countries are homogeneous. This property differentiates our study from the recent literature on global imbalances where liberalization affects the equilibrium because countries are heterogeneous in some important dimension.[4]

Because of the complexity of the model, we are unable to derive a closed-form solution and characterize the equilibrium analytically. Instead, we will provide a numerical characterization. Before proceeding to the quantitative analysis, however, we will consider a simplified version of the model with only two periods where we can derive simple analytical intuitions.

3 Two-period model

Suppose that the economy lasts two periods. In the first period entrepreneurs start with the same stock of land, $k_{i,j,1} = 1$, and they do not face idiosyncratic shocks, that is, $z_{i,j,1} = \bar{z}$. We further assume that they do not hold bonds initially, that is, $b_{i,j,1} = 0$. The entrepreneurs' wealth, including current production is $a = \bar{A} + p$. They allocate their wealth between current consumption and next period savings in the form of bonds, b_2, and land, k_2. Output in period 2, however, is stochastic since it depends on the idiosyn-

[3] There is a second mechanism taken into account by governments. The issuance of bonds are beneficial for entrepreneurs because they can hold assets to insure their idiosyncratic risk. In a liberalized market, the impact of one country issuance, B', on the bonds held by domestic entrepreneurs, $b' = \frac{B'+B^{*'}}{N}$, is smaller. This second mechanism reduces the incentive of the government to issue debt (when it takes the debt issued by other countries as given). We will see that, as long as the size of workers Φ is sufficiently large, the interest rate effect dominates and government debt increases after liberalization.

[4] Examples are Fogli and Perri (2006), Caballero, Farhi, and Gourinchas (2008), Mendoza, Quadrini, and Rios-Rull (2009), and Angeletos and Panousi (2010).

cratic shock z_2. Entrepreneurial wealth in the second period is $A(z_2) + b_2$. Since this is the last period, land has no value after production.

We start characterizing the equilibrium with financial autarky. To simplify the notation, ignore time subscripts and let k and b denote the individual land and bonds purchased at time 1. Also, we use R and B, without subscript, to denote the gross interest rate and the bonds issued in period 1, and z denotes the idiosyncratic shock realized in period 2.

Workers receive constant wages $\bar{w}$ in both periods. In addition they receive transfers from the government. The total transfers paid in period 1 to all workers are equal to government borrowing B/R, and the transfers paid in period 2 are equal to the repayment of the debt, $-B$. Therefore, workers' consumption is $c_1^w = (\bar{w}+B/R)/\Phi$ in the current period and $c_2^w = (\bar{w}-B)/\Phi$ in the next period. The lifetime utility is

$$W(B) = \bar{W} + \ln\left(\bar{w} + \frac{B}{R}\right) + \beta \ln\Big(\bar{w} - B\Big), \tag{15}$$

where $\bar{W} = -(1+\beta)\ln\Phi$ is a constant.

Period 1 consumption for entrepreneurs is equal to $c_1 = a - b/R - pk$. Since entrepreneurs start with the same wealth a, they choose the same land and bond. Thus, $k = 1$ and $b = B$. Taking into account that $a = \bar{A} + p$ (since entrepreneurs start with one unit of land and zero bonds) consumption in period 1 is $c_1 = \bar{A} - B/R$. Next period consumption depends on the realization of the idiosyncratic shock and it is equal to $c_2 = A(z) + B$. Therefore, entrepreneurs' lifetime utility is

$$V(B) = \ln\left(\bar{A} - \frac{B}{R}\right) + \beta\mathbb{E}\ln\Big(A(z) + B\Big). \tag{16}$$

Apart from the effects that the issuance of debt has in the determination of prices R and p, equations (15) and (16) make clear that public debt redistributes consumption inter-temporally between workers and entrepreneurs. The following lemma establishes some properties of the lifetime utilities.

Lemma 3.1 *In the autarky equilibrium*

i. The indirect utility of workers (15) is strictly concave in B with a unique maximum in the interval $[0, \bar{w}]$.

ii. The indirect utility of entrepreneurs (16) is strictly increasing in B.

Proof 3.1 *Appendix E.*

Workers would like to borrow initially, since the interest rate is lower than the intertemporal discount rate. In fact, as B converges to zero, the interest rate converges to $R < 1/\beta$. However, as the government borrows more, it reaches a point in which workers' welfare starts to decrease. This happens for two reasons. First, keeping the interest rate fixed, the marginal utility of consumption in the next period becomes larger than the marginal utility of consumption in the current period. Second, as the government borrows more, the interest rate increases, raising the cost of borrowing. Entrepreneurs, on the other hand, always prefer higher debt because it increases the interest rate and, therefore, the return on their financial wealth (entrepreneurs are net holders of public debt).

Based on probabilistic voting, the debt is chosen to maximize the weighted sum of workers' and entrepreneurs' utilities, that is,

$$\max_{B} \Big\{ \Phi W(B) + V(B) \Big\}, \tag{17}$$

where the functions $W(B)$ and $V(B)$ are defined in (15) and (16).

Although we cannot establish the global concavity of the objective function, we know that there is an optimal level of debt that is interior to the interval $[0, \bar{w}]$.[5] Since the objective function is differentiable, its derivative must be zero at the optimal (interior) B. Differentiating (17) we obtain the first order condition

$$\Phi \cdot \left[\frac{\partial \left(\frac{B}{R}\right)}{\partial B} \left(\frac{1}{C_1^w} \right) - \beta \left(\frac{1}{C_2^w} \right) \right] = \left[\frac{\partial \left(\frac{B}{R}\right)}{\partial B} \left(\frac{1}{c_1^e} \right) - \beta \mathbb{E} \left(\frac{1}{c_2^e(z)} \right) \right], \tag{18}$$

where $C_t^w = c_t^w \Phi$ is the aggregate consumption of workers and $c_2^e(z)$ the consumption of entrepreneurs with realization z in the second period.

A marginal unit of debt issued by the government in period 1 transfers consumption from entrepreneurs (who save by buying bonds) to workers (who receive transfers financed by government borrowing). This affects the marginal utility of each agent in the first period. In period 2 the government pays back the debt by taxing workers (negative transfers). This reduces worker's consumption, C_2^w, and increases the consumption of entrepreneurs, c_2^e. As the size of workers Φ increases, the left-hand-side of (18) receives more weight, meaning that the effects on workers' welfare become more important in the decision of the government.

[5] This must be the case because the objective function is continuous and converges to minus infinity as B converges to $\bar{w}$.

Because the government is a monopolist in the supply of bonds, it takes into account that its debt affects the interest rate. Each dollar issued generates a current transfer to workers equal to

$$\frac{\partial\left(\frac{B}{R}\right)}{\partial B} = \frac{1}{R}\Big(1 - \epsilon(B)\Big),$$

where $\epsilon(B) = \frac{\partial R}{\partial B}\frac{B}{R}$ is the elasticity of the interest rate R to the supply of bonds. Clearly, higher values of the elasticity imply smaller transfers to workers. It is the internalization of the interest rate elasticity that differentiates public borrowing from private borrowing. With private borrowing, atomistic agents take the interest rate as given, and $\epsilon(B)$ would be zero in their individual optimality condition. In this case the perceived increase in consumption in period 1 from (private) borrowing would be $1/R$.

Figure 2 plots the welfare of workers and entrepreneurs in the domestic country, for a parameterized version of the model. The production function is specified as $F(z, k, l) = z^{\theta} k^{\theta} l^{1-\theta}$ and the values of the parameters are reported at the bottom of the figure. With this specification of the production function, the wage is $\bar{w} = (1-\theta)\bar{z}^{\theta}$ and $A(z) = \theta z/\bar{z}^{1-\theta}$.

The continuous lines, denoted by V^A and W^A, are for the autarky regime. The dashed lines are for the regime with capital mobility when there are N symmetric countries. We will come back to the case of capital mobility in the next section. The actual level of debt chosen by the government depends on the size of workers Φ. Although the indirect utility of workers $W(B)$ is strictly concave, the indirect utility of entrepreneurs $V(B)$ is not. As a result, the government's objective is not necessarily concave. We can establish concavity only for large values of Φ.

Proposition 3.1 *If $\Phi > \frac{(1+\beta)\bar{w}}{\bar{A}} + \beta$, the government's objective is strictly concave, and there is a unique maximum interior to the interval $[0, \bar{w}]$.*

Proof 3.1 *Appendix F.*

Two remarks are in order here. First, the condition on Φ is sufficient but not necessary. Second, even if the government objective is not strictly concave, the maximum is still interior, although we can not establish uniqueness. However, for the simple model considered here, we can always check concavity numerically as we do in Figure 3. This figure plots the government objective for different values of Φ and shows that the optimal level of B decreases with the relative population of workers.

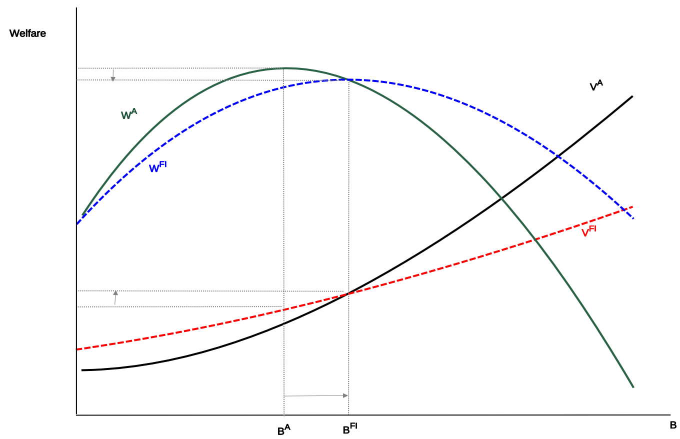


Figure 2: Indirect utilities with and without capital mobility for $B^* = B^{FI}$. The parameter values are $\beta = 0.95$, $\theta = 0.36$, $z \in \{1, 3\}$, $\text{Prob}(z) \in \{0.5, 0.5\}$.

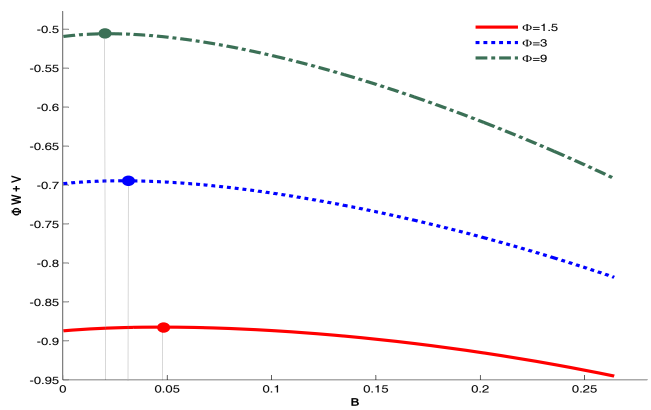


Figure 3: Government's objective function in autarky. The parameter values are $\beta = 0.95$, $\theta = 0.36$, $z \in \{1, 3\}$, $\text{Prob}(z) \in \{0.5, 0.5\}$.

3.1 The effects of financial integration

We now consider the case in which the financial markets of N countries are integrated. As in the general model, we focus on Nash equilibria where governments choose the supply of bonds independently and simultaneously. When financial markets are integrated, entrepreneurs in one country can purchase domestic and foreign bonds.

Since countries are symmetric, the bonds acquired by entrepreneurs are equal to $b = \frac{B+B^*}{N}$. Thus, the indirect utility of domestic entrepreneurs is

$$V(B,B^*) = \ln\left(\bar{A} - \frac{B+B^*}{NR}\right) + \beta\mathbb{E}\ln\left(A(z) + \frac{B+B^*}{N}\right). \tag{19}$$

The properties of $V(B,B^*)$ are similar to the properties of the value function in autarky. Entrepreneurs still prefer higher levels of debt, since this increases the equilibrium interest rate, and therefore, the return on the risk-free bonds held to insure the idiosyncratic risk. Now, however, the elasticity of the interest rate to the issuance of domestic debt is lower.

The indirect utility of workers in country 1 can be written as

$$W(B,B^*) = \bar{W} + \ln\left(\bar{w} + \frac{B}{R}\right) + \beta\ln\left(\bar{w} - B\right), \tag{20}$$

which is very similar to (15). The only difference is that the interest rate R is now determined in the world market and is equal to

$$R = \left(\frac{B+B^*}{N}\right)\frac{(1+\beta(1-\phi))}{\beta(1-\phi)\bar{A}}, \tag{21}$$

where $\phi = \mathbb{E}\left(\frac{A(z)}{A(z)+(B+B^*)/N}\right)$.

The optimal level of debt B satisfies the first order condition

$$\Phi\cdot\left[\frac{\partial(\frac{B}{R})}{\partial B}\left(\frac{1}{C_1^w}\right) - \beta\left(\frac{1}{C_2^w}\right)\right] = \left[\frac{\partial\left(\frac{B+B^*}{NR}\right)}{\partial B}\left(\frac{1}{c_1^e}\right) - \beta\frac{\partial\left(\frac{B+B^*}{N}\right)}{\partial B}\mathbb{E}\left(\frac{1}{c_2^e(z)}\right)\right], \tag{22}$$

where $C_t^w = c_t^w\Phi$ is the aggregate consumption of workers and c_t^e is the consumption of entrepreneurs. This condition is necessary but not sufficient as in the autarky regime.

While the government still faces the trade-off between the benefits and costs of transferring consumption from entrepreneurs to workers in the first period, this expression differs from equation (18) in several respects. First, workers' transfers depend only on the domestic supply of government bonds B, while entrepreneurs' utility depends on both domestic and foreign bonds. Hence, an extra unit of B increases C_1^w by $\frac{\partial\left(\frac{B}{R}\right)}{\partial B}$ but decreases c_1^e by only $\frac{\partial\left(\frac{B+B^*}{NR}\right)}{\partial B} = \frac{1}{N}\frac{\partial\left(\frac{B}{R}\right)}{\partial B}$. This is because part of the extra bonds are absorbed by entrepreneurs in other countries. In the second period, the government repays B by taxing workers (with negative transfers), which reduces C_2^w in the same amount as before. The increase in c_2^e, however, is smaller than in the autarky case because the stock of domestic bonds held by domestic entrepreneurs is smaller.

There is another, less evident difference between equations (18) and (22): the effect of a unilateral change in B on the world-wide interest rate is now smaller. We can show that in a symmetric equilibrium $\frac{\partial R}{\partial B} = \frac{1}{N}\frac{\partial R}{\partial (B+B^*)}$. Imposing $B(N-1) = B^*$ in equation (22) and by re-arranging, we obtain

$$\Phi \cdot \left[\frac{1}{C_1^w}\frac{1}{R}\left(1 - \frac{\epsilon(B)}{N}\right) - \frac{\beta}{C_2^w}\right] = \frac{1}{N}\left[\frac{1}{c_1^e}\frac{1}{R}\Big(1 - \epsilon(B)\Big) - \mathbb{E}\left(\frac{\beta}{c_2^e(z)}\right)\right], \tag{23}$$

where $\epsilon(B)$ is the elasticity of the interest rate under autarky.

Relative to the autarky case, the cost of the transfers is smaller, since the perceived elasticity of the interest rate is $\epsilon(B)/N$. The costs and benefits for entrepreneurs are also different, since they are split between domestic and foreign residents. More specifically, the marginal effects on $V(B)$—the indirect utility of entrepreneurs—are reduced when the economy is financially integrated. Thus, whether financial integration leads to more or less public debt depends on the relative sizes of workers and entrepreneurs.

Proposition 3.2 *Suppose that $\Phi/(1+\Phi) \simeq 1$. Per-capita debt is strictly increasing in the number of countries N. As $N \to \infty$, there exists a unique symmetric equilibrium where debt is bounded and $\beta R < 1$. Financial integration generates welfare losses for workers and welfare gains for entrepreneurs.*

Proof 3.2 *Appendix G.*

When the size of entrepreneurs is small, the government objective is approximately equal to the utility of workers. Since the interest rate is less elastic to domestic debt B in an integrated world, workers would like the government to borrow more (see Figure 2). We would like to emphasize that the symmetric equilibrium is the only equilibrium, that is, it is not possible to have one country choosing a level of debt different from other countries. This is established in the proof of the proposition provided in the appendix.

Size heterogeneity: The effects of financial integration on the debt issued by the integrating countries depend on their relative size. To be more specific, suppose that the population and land endowment of the domestic country is a proportion α of the worldwide endowment. If $\alpha = 0.5$, we revert back to the symmetric case studied in the previous section ($N = 2$). The average worldwide debt is equal to $\overline{B} = \alpha B + (1-\alpha)B^*$, where B is the per-capita debt of the domestic country and B^* is the per-capita debt of the foreign country. In a closed economy, the two countries choose $B = B^*$. After liberalization, however, $B \neq B^*$.

Proposition 3.3 *Suppose that $\Phi/(1+\Phi) \simeq 1$. If $\alpha < 0.5$, in the regime with capital mobility, the domestic country issues more per-capita debt than the foreign country ($B > B^*$).*

Proof 3.3 *Appendix H.*

Since small countries face a larger world market relative to their own economy, they perceive the world interest rate as less sensitive to their own per-capita debt. As a result, they issue more debt. For this result to hold, however, the relative size of workers, which determines their political power, must be sufficiently high. Otherwise, the benefit of providing safe assets to entrepreneurs dominates the government objective, and since in an open economy these benefits are shared with foreign entrepreneurs.

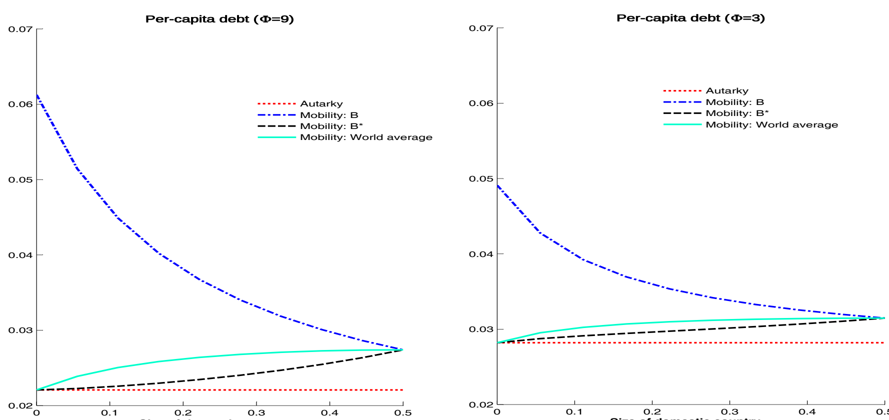


Figure 4: Country size and equilibrium government debt with capital mobility. The parameter values are $\beta = 0.95$, $\theta = 0.36$, $z \in \{1, 3\}$, $\text{Prob}(z) \in \{0.5, 0.5\}$.

Figure 4 plots the equilibrium debt for different sizes of the domestic economy. When $\alpha = 0$, the domestic country is a small open economy and the foreign country is effectively in autarky. Thus, the debt chosen by the foreign country does not change from the autarkic level. When $\alpha = 0.5$, we are back to the symmetric case, so both countries choose the same level of debt. For intermediate values of α, B is significantly larger than B^*.

3.2 The effects of raising income inequality

The fact that entrepreneurs face idiosyncratic investment risks implies that their incomes in period 2 are unequal. Furthermore, as we increase the volatility of the idiosyncratic shock z, income inequality increases. This is similar to Krueger and Perri (2006). The goal of this section is to analyze how the change in income inequality affects the choice of public debt.

Proposition 3.4 *Consider the autarky regime and suppose that* $\Phi/(1+\Phi) \simeq 1$*. If a mean preserving spread increase in the distribution of* z *raises the term* $(1-\epsilon(B))/(\bar{w}R(B)+B)$*, then* B *increases.*

Proof 3.4 *Appendix I.*

In general, an increase in the volatility of the idiosyncratic shock implies that entrepreneurs face higher risk. This strengthens the precautionary savings' motive, increasing the private demand for safe assets. Since the higher demand for bonds reduces the interest rate, workers would like to increase borrowing. The government, however, takes into account not only the level of the interest rate but also the elasticity of the interest rate to public debt. At the same time, the government also finds it optimal to increase public debt to provide safer assets to entrepreneurs. In general, we cannot establish unambiguously whether government debt increases in response to an increase in inequality. However, as long as the term $(1-\epsilon(B))/(\bar{w}R(B)+B)$ increases, the government will borrow more as we show in the proof of the proposition. The dependence of public debt from inequality is shown in Figure 5 which plots the equilibrium debt as a function of the volatility of the idiosyncratic shock in autarky.

Next, we show what happens to government borrowing in the regime with capital mobility when inequality increases only in one country. Figure 6 plots the stock of debt in both countries when the volatility of the idiosyncratic shock increases only in the domestic economy. Even if income inequality changes only in the domestic country, the stock of debt increases in both countries. This happens because the higher risk faced by domestic entrepreneurs increases their demand for bonds and reduces the world interest rate. If the government's weight assigned to workers (their relative size)

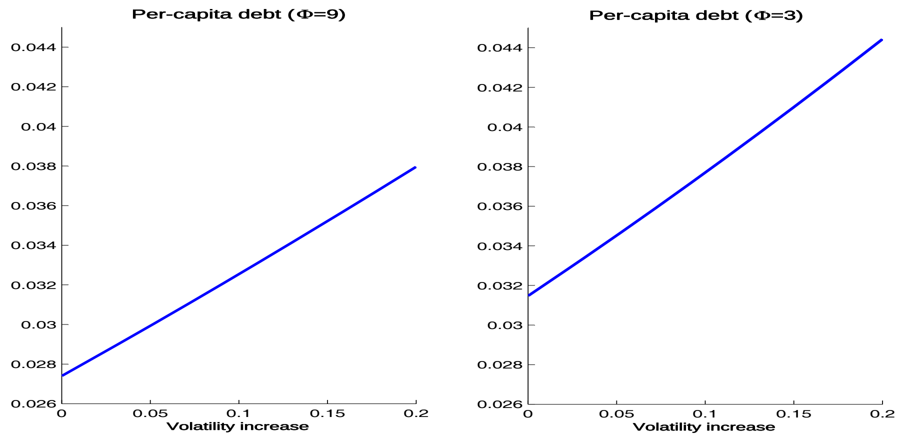


Figure 5: Inequality and government debt in autarky. The parameter values are $\beta = 0.95$, $\theta = 0.36$, $\text{Prob}(z) \in \{0.5, 0.5\}$. Starting from $z \in \{1, 3\}$, we change the two values of z by the volatility increase reported in the graph.

is sizable—as assumed in the numerical example—the lower interest rate makes public debt more attractive for the governments of both countries.

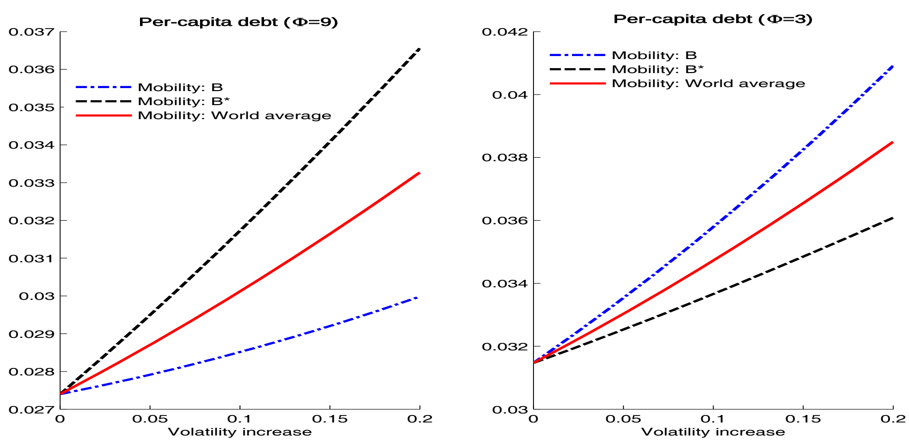


Figure 6: Inequality and government debt with capital mobility. The parameter values are $\beta = 0.95$, $\theta = 0.36$, $\text{Prob}(z) \in \{0.5, 0.5\}$. Starting from $z \in \{1, 3\}$ in both countries, we change the values of z only in the domestic country by the volatility increase reported in the graph.

Even though worldwide debt increases with a rise in domestic inequality, the response of each country's debt supply is asymmetric when inequality increases only in one country. In the left panel of Figure 6, we see that the foreign country can be more responsive to inequality than the domestic country (note that B^* is always above B). As the weight on entrepreneurs increases (i.e., as Φ goes down), the domestic country has even more incentives to increase debt because of the higher risk faced by domestic entrepreneurs. This is not beneficial for entrepreneurs in the foreign country because their risk does not change, but on their bonds they receive lower interests. Thus, the foreign government increases debt less to compensate for the higher debt issued by the domestic country. This is depicted in the right panel of Figure 6 where, in contrast to the case with larger Φ, the increase in foreign supply of bonds is smaller than the domestic supply (B^* lies below B).

The finding that the increase in inequality in few countries may trigger an increase in government borrowing in other countries is important to reconcile the theory with the data. In fact, the increase in inequality observed since the early 1980s arose only in a few countries (see Atkinson, Piketty and Saez (2011)), while the cross-country increase in government debt was more general. The fact that in the 1980s capital markets were liberalized may explain why the increase in inequality in a few countries may have triggered the increase in government borrowing in other countries. Furthermore, this is more likely to happen if the increase in inequality took place in economically large countries like in the United States.

4 Quantitative analysis

In this section we solve the infinite horizon model numerically and provide a quantitative evaluation of the importance of financial liberalization and raising income inequality for public debt. To assess the importance of financial liberalization, we start from a steady state equilibrium without mobility of capital. We then compute the transition dynamics following financial integration. To assess the importance of raising income inequality, we start from a steady-state equilibrium with low-income inequality. We then compute the transition dynamics following the increase in inequality. The numerical procedure used to solve the model is based on the discretization of the state space (the stock of public debt in the two countries). For each grid point, we solve for the optimal debt chosen by the governments of the two countries.

4.1 Calibration

We choose variables observed in the early 1980s as the initial calibration targets. This is motivated by the view that the process of international financial liberalization started in the 1980s. The pre-1980s period can then be considered as closer to a regime of financial autarky. Also, as can be seen from Figure 1, the average income inequality in industrialized countries started to increase toward the end of the 1970s and early 1980s. This motivates our choice to calibrate the autarky version of the model to the early 1980s. In particular, we focus on two targets: a ratio of public debt over income of 30 percent and a share of income earned by the top 1 percent of the population equal to 6 percent. These are the approximate numbers reported in Figure 1 for the OECD countries at the beginning of the 1980s. We now describe in detail how the initial calibration targets can be used to pin down the parameters of the model.

A period in the model is one year, and the discount factor is set to $\beta = 0.95$. This results from an intertemporal discount rate of 3 percent and a survival probability $\omega = 0.98$, which implies an average life of 50 years.[6]

For the production function we would like to use a Cobb-Douglas specification, that is, $F(z, k, l) = z^{\theta} k^{\theta} l^{1-\theta}$. However, since z cannot be negative, the amount of idiosyncratic risk that can be generated with this specification is limited. For that reason we use the function $F(z, k, l) = k^{\theta} l^{1-\theta} + zk$, where $Ez = 0$. The analytical properties of the model with these two production functions are equivalent. However, since in the second specification z can take negative values, we can calibrate the distribution of z to generate any desired degree of idiosyncratic risk.[7] Notice that aggregate production is exactly the same in the two cases. Thus, the parameter θ represents the capital income share which we set to 0.2. This is lower than the typical number used in the literature because in our model there is no depreciation.

Productivity is uniformly distributed in the domain $[-\Delta, \Delta]$. The value of Δ is chosen so that the share of income earned by the top 1 percent is equal to 6 percent in the autarky steady state.[8] However, this also depends on Φ, which in turn is chosen to have a steady state of public debt over income of 30 percent in the autarky steady state. These are the approximate numbers for income concentration and public debt in the OECD countries at the

[6] In Section 2.2.1 we assumed that agents die with probability $1-\omega$ and that the assets of exiting entrepreneurs are redistributed equally to newborn entrepreneurs.

[7] In both cases, the profit function for an individual entrepreneur is linear in k. More specifically, in the first case $A(z) = \theta z$ while in the second $A(z) = \theta + z$. Therefore, if we define $\tilde{z}$ the productivity in the Cobb-Douglas case, the transformation $z = \theta(\tilde{z} - 1)$ makes the two profit functions identical. The shock z is similar to stochastic depreciation commonly used in asset price models, also with the purpose of generating higher risk.

[8] Entrepreneurial income is equal to $A(z_{it})k_{it} + b_{it} - b_{it}/R_t$, that is, profits plus the interest earned on bonds. The income of an individual worker is equal to $(w_t + T_t)/\Phi$, that is, the labor income plus the government transfer $T_t/\Phi = (B_{t+1}/R_t - B_t)/\Phi$.

beginning of the 1980s reported in Figure 1. Effectively, we have to choose Δ and Φ simultaneously, which require an iterative procedure. The resulting values are $\Delta = 0.91$ and $\Phi = 5.06$.

The calibrated value of Δ implies a significant amount of idiosyncratic risk. The standard deviation of entrepreneurial income is about 15% the value of land used in production, pk. If we think of entrepreneurs as owners of private businesses with risk coming from profits and capital gains, the 15% standard deviation is quite plausible. The calibrated value of Φ implies that the share of workers in the population is slightly above 80%.

4.2 Results

Figure 7 plots the transition dynamics for government debt induced by international capital market liberalization and increased income inequality. The increase in income inequality is generated by a higher volatility of the idiosyncratic risk, which changes from $\Delta = 0.91$ to $\Delta = 0.984$. As described above, $\Delta = 0.91$ was chosen to generate the 6% concentration of income at the top 1% in the autarky steady state. The new value is chosen to have a share of 9% for the top income earners in the steady state with capital mobility. As shown in Figure 1, this is the approximate number for the OECD countries toward the end of the sample. Since the 2000s are characterized by a significant degree of financial integration, we have targeted this number in the version of the model with capital mobility.

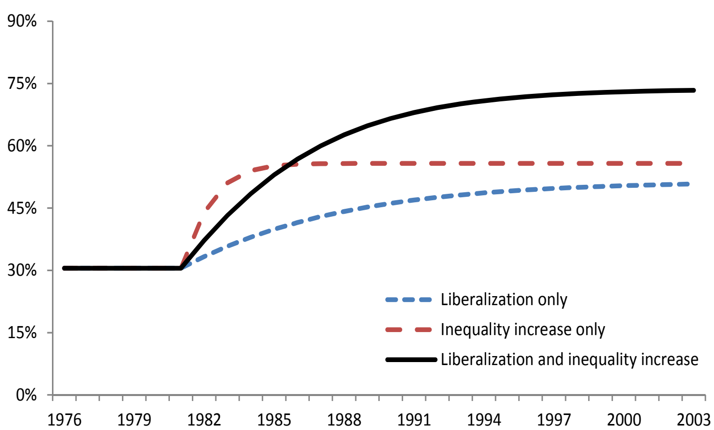


Figure 7: Dynamics of public debt in response to financial liberalization and increase in income inequality.

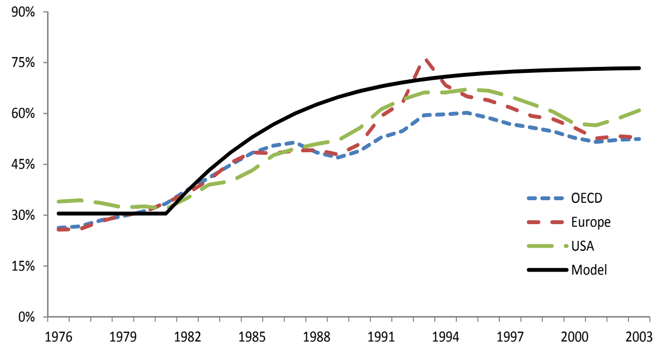
Before continuing, we would like to explain why we make the assumption that inequality increases in both countries even if in the data the increase is observed only in some countries (see Atkinson, Piketty, and Saez (2011)). Our choice is motivated by computational considerations. In order to compute the equilibrium with different cross-country levels of Δ, we need to add another state variable, which significantly increases the computational complexity of the equilibrium with capital mobility. However, this is not a major shortcoming because, as shown in Section 3 with the two-period model, the change in inequality in only one country also affects the debt chosen by the other country when financial markets are integrated. Thus, using the average change in inequality as the target for all countries provides a reasonable approximation to the response of public debt in all integrated economies when the change is asymmetric.

As can been seen in Figure 7, the increase in inequality (ignoring liberalization), increases long-term debt from 30% of income to about 55% of income. If we focus instead on capital liberalization alone (keeping inequality constant), long-term debt increases to 51% of income. When the two changes are considered together, long-term debt increases to 73%.

To compare the dynamics of the model to the empirical series, Figure 8 plots the data generated by the model (with both liberalization and increased risk) and the empirical data for the average of the OECD countries, Europe, and the United States. The figure also plots the response of the interest rate. The data sources and the construction of the interest rates are described in Appendix A. The dynamic path of public debt generated by the model (continuous line) resembles the dynamics observed in the data (dashed lines). The dynamics of the interest rates are also similar, particularly for Europe and OECD countries where we see hikes in the real rates in the first half of the 1980s, with subsequent decline later in the sample.

The initial jump in the interest rate generated by the model is necessary to make bonds attractive to entrepreneurs who need to absorb the additional bonds. The increase in the holding of bonds requires entrepreneurs to reduce current consumption in compensation for higher future consumption, which in turn requires higher interest rates. Since the government continues to increase the debt after the first period, the interest rate remains high. However, since the increase in government debt slows down over time, the interest rate declines gradually after the initial jump. In the long run, R is higher than in the autarky steady state, but the difference is small.

We would like to emphasize that the comparison of the dynamics of the interest rate generated by the model with the empirical series, is not meant to show that the empirical pattern can be fully explained by capital markets liberalization and increased income inequality. Of course, there are many *(a) Public debt*



(b) Interest rate

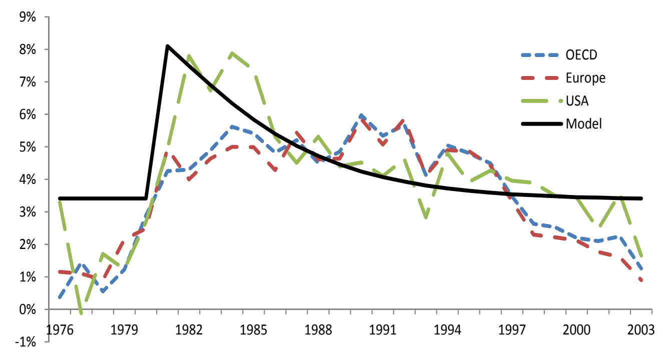


Figure 8: Dynamics of public debt and real interest rates in response to liberalization and increase in income inequality.

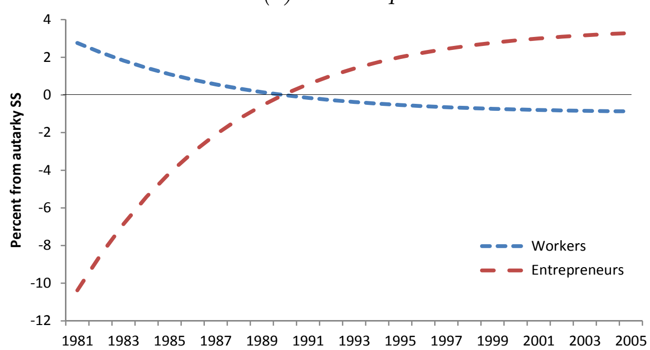
other factors that contributed to the dynamics of the interest rate, including the hikes observed in the early 1980s. Our goal is more limited. We only want to show that the response of the interest rate predicted by the model is not at odds with the general dynamics observed in the data.

4.3 Welfare implications of capital market liberalization

Government borrowing has only redistributional implications in this model. Since the labor supply is fixed and there is not capital accumulation, public debt does not affect production. However, through redistribution, government policies have welfare consequences for the two types of agents.

The top panel of Figure 9 plots the dynamics of consumption for workers and entrepreneurs in response to capital market liberalization. Entrepreneurial risk does no change in this simulation. As the government increases public debt after liberalization, the consumption of workers increases, while the consumption of entrepreneurs decreases. In the long run, workers' consumption stabilizes at a lower level than the consumption in the autarky steady state. This is because the higher debt implies higher payment of interests and, therefore, lower transfers to workers (which become negative in the long run). For entrepreneurs, we have the opposite dynamics, since aggregate production and consumption are constant.

(a) Consumption



(b) Welfare gains (consumption equivalent)

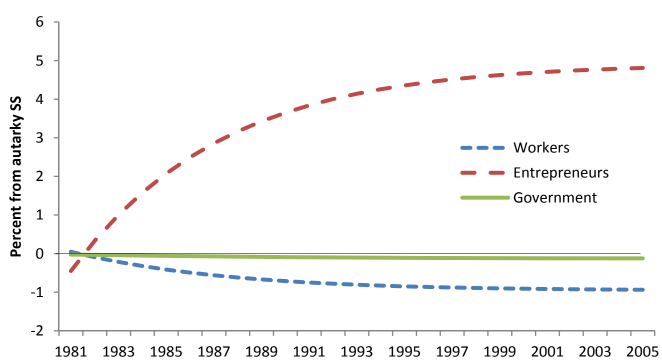


Figure 9: Transition dynamics of consumption and welfare.

The bottom panel of Figure 9 plots the welfare gains from liberalization, computed using the standard 'consumption equivalent' measure. This is the percentage increase in steady-state consumption that would leave the agent indifferent between staying in a regime without capital mobility or liberalizing capital markets. To evaluate the welfare consequences of liberalization we need to consider only the first point of the plotted lines. The other points simply show the continuation welfare at any point in time in the future.

Workers gain from liberalization while entrepreneurs incur losses. This is because, with the exception of the first few periods, the interest rate is lower than the intertemporal discount rate. Therefore, the anticipation of consumption through government borrowing is optimal for workers. For entrepreneurs, this implies a temporary reduction in consumption. Even if the issuance of government bonds allows them to have better insurance, this is not enough to compensate for the temporary reduction in consumption.

Next, we look at government's welfare, which is also computed by applying the 'consumption equivalent' measure to the government's objective (sum of workers and entrepreneurs' utilities weighted with $\Phi = 5.06$). Government's welfare declines in response to liberalization. This is a consequence of the noncooperative game played between the governments of the two countries leading to an inferior outcome.

Although the government welfare loss is very small, this finding raises the question of why countries liberalize their capital markets if this has negative consequences. Two remarks are in order. First, the model abstracts from many possible benefits we can think of associated with capital market liberalization.[9] Once these benefits are properly accounted for, they might compensate for the small welfare losses shown in Figure 9. Second, what induces a welfare loss is not liberalization per se but the fact that governments do not coordinate their policies in an environment with capital mobility. This may justify the introduction of statutory debt limits before the liberalization as in the case of the Maastricht treaty for European countries, assuming that these limits are de-facto enforceable.

5 Empirical analysis

The analysis conducted in the previous sections has shown that greater mobility of capital and higher inequality raises government borrowing. In this section we conduct a simple empirical investigation of this prediction using cross-country data for the OECD countries. The main objective is to check whether there are statistically significant links between indices of capital market liberalization, income inequality, and government borrowing.

[9] In addition to the efficiency gains from higher competition, Kehoe (1989) shows that capital mobility may be a deterrent to excessive capital taxes when governments cannot commit to future policies and they face a well-known time-inconsistency problem associated with capital taxation. Quadrini (2005) shows that through this mechanism, capital mobility could generate sizable welfare gains in the absence of coordination.

To do so we regress the growth rate of real government debt on two main variables: (i) an index that captures the change in capital mobility, and (ii) changes in the share of income earned by the top 1% of the population. We estimate the following fixed effect regression equation:

$$\begin{aligned}\mathrm{dDEBT}_{j,t} \quad = \quad & \alpha_D \cdot \mathrm{DEBT}_{j,t-1} + \alpha_G \cdot \mathrm{dGDP}_{j,t-1} + \alpha_M \cdot \mathrm{dMOB}_t \\ & + \alpha_I \cdot dINEQ_t + \alpha_X \cdot X_{j,t} + u_{j,t}.\end{aligned}$$

- $\mathrm{dDEBT}_{j,t}$: Log-change in real public debt of country j in year t.
- $\mathrm{DEBT}_{j,t-1}$: Ratio of public debt to the GDP of country j in year $t-1$.
- $\mathrm{dGDP}_{j,t}$: Log-change in the GDP of country j in year t.
- dMOB_t: Change in the index of capital mobility in year t or $t-1$.
- dINEQ_t: Log-change in top 1% of income shares in year t.
- $X_{j,t}$: Set of control variables for country j.
- $u_{j,t}$: Residuals containing country and year fixed effects.

A few remarks are in order. First, we relate the *change* in public debt to the *change* in the liberalization index, instead of the *level* of the index. This better captures the dynamics predicted by the model. In fact, in the long run, there is no relation between the degree of capital mobility and the change in debt, since the stock of debt converges to the steady state.

The second remark pertains to the construction of the index of financial liberalization. This index is not country-specific as can be noticed from the absence of the country subscript j. Instead, we construct the index as the average of country-specific indices for all countries included in the sample, weighted by their size (measured by total GDP). The motivation for adopting this measure of capital liberalization can be explained as follows.

Indicators of financial liberalization refer to the private sector, not the public sector. Thus, the fact that one country has very strict international capital controls does not mean that the government is restrained from borrowing abroad. What is relevant for the government ability to borrow abroad is the openness of other countries. Therefore, to determine the easiness with which the government can sell its debt to foreign (private) investors, we have to look at the capital controls imposed by other countries. This is done by computing an average index for all countries included in the sample.[10]

[10] Another way of showing the irrelevance of the country's own indicator is with the following example. Suppose that country A liberalizes its capital markets, allowing free international mobility of capital. However, all other countries maintain strict controls. Obviously, the government of country A does not have access to the foreign market even if it had liberalized its own market.

A related issue is whether in computing the weighted average of the liberalization index we should exclude the country of reference. For example, to evaluate the importance of capital mobility for the U.S. public debt, we should perhaps average the indices of the OECD countries excluding the U.S. We have chosen not to do so for the following reason. Although the liberalization of other countries is what defines the foreign market for government bonds, the domestic liberalization can still affect domestic issuance through an indirect channel. However, we also tried the alternative index and the results (not reported) are robust.

Regarding the data for the liberalization variable, we use two indices, both based on de-jure measures. The first is the liberalization index constructed by Abiad, Detragiache, and Tressel (2008). The results based on this index are reported in Table 1. The second index uses the capital account openness indicator constructed by Chinn and Ito (2008), with results reported in Table 2. Income inequality is proxied by the share of income earned by the top 1% of the population, compiled by Atkinson, Piketty, and Saez (2011). The data sources are described in the tables.

We estimate the regression equation on a sample that includes 22 OECD countries. The selection of countries in the first set of regressions is based on data availability for government debt and financial index, which restrict the sample to 26 countries. From this selected group, we exclude four countries: Hungary, Poland, Mexico, and Turkey. The first two countries are excluded since the available data start in the 1990s, when they became market oriented economies. Mexico and Turkey are excluded because they were at a lower stage of economic development compared to the other countries in the sample and they experienced various degrees of market turbulence during the sample period. For robustness, however, we also repeated the estimations for the whole sample with 26 countries, and the results are consistent with those obtained with the restricted sample, including 22 countries. The results for the extended sample are available upon request from the authors.

We start by analyzing the effects of financial integration on debt accumulation, but initially excluding inequality dINEQ_t. By doing so we can use a larger sample since the inequality variable is unavailable for Austria, Belgium, Switzerland, Germany, Greece, and Korea. The sample size consists of 677 observations. In the simplest specification, we also abstract from any controls $X_{j,t}$. In the second specification we include a dummy for the countries that joined the European Monetary System. Since the membership was conditional on fulfilling certain requirements in terms of public debt (Maastricht Treaty), it is possible that the government debt of certain European countries has been affected by joining the EMU.

As can be seen in the first two columns of Tables 1 and 2, the coefficient on the financial index is positive and highly significant, meaning that the change in capital market integration is positively correlated with the change in public debt. Although we do not claim that this proves causation, there is a strong conditional correlation between these two variables. As far as the EMU dummy is concerned, the coefficient is negative, consistent with the view that EMU countries were forced to adjust their public finances before becoming full members.

Next, we add the interaction term between the financial index and the size of the country, measured by real GDP. The motivation to include this term is dictated by the theory. We have seen in Section 3 that the effect of capital liberalization is stronger for smaller countries. Since small countries have a lower ability to affect the world interest rate, their governments have a higher incentive to borrow once they have access to the world financial market. The third column of Tables 1 and 2 show that the coefficient on the interaction term between the financial index and the country size is negative, as expected from the theory, and statistically significant in some cases.

The fourth specification adds a demographic variable. This is the *Old Dependency Ratio* between the population in the age group 65 and higher and the population in the age group 15-64. Although our model abstracts from demographic considerations, there is a widespread belief that aging in industrialized countries is an important force for the rising public debt. This is because the political weight shifts toward older generations that may prefer higher debt. As can be seen from the fourth column of Tables 1 and 2, the coefficient associated with the change in this variable is positive. However, the inclusion of the old dependency ratio does not affect the sign and significance of the financial index, confirming the importance of capital market liberalization for government borrowing.

The final specification introduces income inequality. With the inclusion of the inequality index we lose some observations, since the index is not available for all countries. As a result, the sample shrinks to 435 observations. The coefficient is positive and statistically significant, indicating that raising income inequality is associated with higher borrowing.

As far as the other variables are concerned, we find that the lagged stock of debt is negatively correlated with its change. This is what we expect if the debt tends to converge to a long-term level. The change in GDP is meant to capture business cycle effects, and it has the expected negative sign: when the economy does well, government revenues increase and automatic expenditures decline so that government debt increases less.

Table 1: Country fixed-effect regression. The dependent variable is real public debt growth. The financial index is based on Abiad, Detragiache, and Tressel (2008).

	(1)	(2)	(3)	(4)	(5)
Lag debt to GDP ratio	-0.149^{***}	-0.146^{***}	-0.149^{***}	-0.170^{***}	-0.162^{***}
	(0.0374)	(0.0375)	(0.0378)	(0.0383)	(0.0253)
Lag real GDP growth	-1.235^{***}	-1.210^{**}	-1.216^{***}	-1.159^{**}	-1.381^{**}
	(0.433)	(0.430)	(0.429)	(0.413)	(0.571)
Lag change in financial index	0.688^{**}	0.697^{**}	0.966^{***}	1.180^{***}	1.555^{***}
	(0.269)	(0.270)	(0.281)	(0.278)	(0.331)
Lag EMU dummy		-0.0478^{**}	-0.0474^{**}	-0.0521^{**}	-0.084^{***}
		(0.0189)	(0.0190)	(0.0185)	(0.0259)
Size × Lag change in FI			-6.136	-6.602^{*}	-7.883^{*}
			(3.818)	(3.554)	(3.932)
Change in dependency ratio				0.0695^{**}	0.0636^{**}
				(0.0256)	(0.0223)
Log change in inequality					0.128^{**}
					(0.0536)
Observations	677	677	677	677	435
R-squared	0.130	0.132	0.137	0.150	0.199
Number of countries	22	22	22	22	16

Notes: The variable *Financial Index* (FI) is constructed using the liberalization index of Abiad, Detragiache, and Tressel (2008). We compute the financial index for a year as a weighted average of all the country indexes where weights are given by their relative GDP shares. The ratio of debt to GDP is from Reinhart and Rogoff (2011), and real GDP and population data are from the World Development Indicators (World Bank). Real debt is constructed by multiplying the ratio of debt to GDP by real GDP. Size is the lagged logarithm of real GDP. The EMU dummy is equal to 1 in the year the country joined the European Monetary Union and 0 otherwise. The old dependency ratio is the population 65 and above divided by the population in the age group 15-64. Inequality index is measured by the top 1% income share calculated by Atkinson, Piketty, and Saez (2011). The sample period is 1973-2005 and includes the following countries for specifications (1) to (4): Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Korea, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Austria, Belgium, Germany, Greece, and Korea are excluded in specification (5) due to data availability. Robust standard errors are in parenthesis.

* Significant at 10%. ** Significant at 5%. *** Significant at 1%.

6 Conclusion

The stock of public debt has increased in most advanced economies during the last 30 years, a period also characterized by extensive liberalization of international capital markets and a sustained increase in income inequality. In this paper we study a multicountry politico-economic model where the

Table 2: Country fixed-effect regression. The dependent variable is real public debt growth. The financial index is based on Chinn and Ito (2008).

	(1)	(2)	(3)	(4)	(5)
Lag debt to GDP ratio	-0.150^{***}	-0.147^{***}	-0.148^{***}	-0.166^{***}	-0.157^{***}
	(0.0366)	(0.0366)	(0.0368)	(0.0380)	(0.0267)
Lag real GDP growth	-1.262^{***}	-1.235^{***}	-1.230^{***}	-1.189^{***}	-1.400^{**}
	(0.428)	(0.425)	(0.423)	(0.410)	(0.585)
Change in financial index	0.113^{**}	0.116^{**}	0.177^{***}	0.205^{***}	0.253^{***}
	(0.0539)	(0.0539)	(0.0575)	(0.0630)	(0.0606)
Lag EMU dummy		-0.0485^{**}	-0.0487^{**}	-0.0528^{**}	-0.0854^{***}
		(0.0189)	(0.0192)	(0.0187)	(0.0264)
Size × Change in fin index			-1.375^{**}	-1.428^{**}	-1.437^{**}
			(0.728)	(0.680)	(0.617)
Change in dependency ratio				0.0594^{**}	0.0535^{**}
				(0.0259)	(0.0250)
Change in top 1% share					0.106^{*}
					(0.0599)
Observations	677	677	677	677	435
R-squared	0.130	0.132	0.137	0.150	0.199
Number of countries	22	22	22	22	16

Notes: The variable *Financial Index* is constructed using the capital account openness index of Chinn and Ito (2008). For the other variables, see notes in Table 1

incentives of governments to borrow increase both when financial markets become internationally integrated and when inequality rises. We propose this mechanism as one of the possible explanations for the growing stocks of government debt observed in most of the advanced economies since the early 1980s. We have also conducted a cross-country empirical analysis using OECD data, and the results are consistent with the theoretical predictions.

Although we have focused on government debt, it is natural to ask whether public debt is simply a substitute for private debt. Since the issuance of government debt could be Pareto improving relative to an economy where governments' budgets have to be balanced in every period, it is natural to ask whether the welfare gains can also be achieved with private debt once we allow workers to borrow from entrepreneurs. Although under certain conditions the economy with public debt can be replicated by an economy with private debt—a point also made by Kocherlakota (2007)—there are two potential limitations.

First, in our economy the competitive equilibrium with private debt is different from the equilibrium with public debt. As emphasized throughout the paper, governments internalize the effect of issuing bonds on interest rates while individual agents take prices as given when they choose their bond holdings. This implies that, if workers were allowed to borrow, the equilibrium private debt would be very different from the debt chosen by the government. Therefore, from the point of view of a positive analysis—that is, explaining the actual level of borrowing that would arise in equilibrium—the consideration of public debt is not a substitute for private debt. Of course, we can consider an environment in which the government intervenes with policies insuring that private agents choose the same amount of debt as the one chosen by the government (see Yared (2011) for an example in which public debt can serve as a substitute for private credit if private borrowing is limited). However, in absence of these policies, the equilibrium with private borrowing will be different from the equilibrium with public borrowing.[11]

The second limitation to the application of the equivalence result is that private agents may face tighter constraints than governments. In our framework private debt arises if workers are allowed to borrow. But in the presence of limited enforcement of private contracts, workers may not be able to borrow or their borrowing capacity may be limited. If governments have higher credit capacity than workers, then the economy with public debt will not be equivalent to the economy with private debt since the latter will have zero or insufficient private debt.

The final remark relates to the relevance of the analysis conducted in this paper for understanding the recent difficulties in sovereign borrowing. If debt crises are more likely to arise when the stock of public debt is higher, then the growth in government borrowing induced by capital markets liberalization and increased income inequality may contribute to trigger a sovereign debt crisis. An extension that explicitly studies the possibility of default on sovereign debt is, however, left for future research.

[11]In particular, if we allow workers to borrow privately, the equilibrium debt will grow until it reaches some borrowing limit. Without a limit the debt will converge to infinity. On the other hand, the debt chosen endogenously by the government is bounded even in absence of a very tight borrowing limit. This is an important feature of our model where the imposition of a borrowing limit for the government may not be necessary other than, of course, the imposition of some transversality condition.

A Data appendix for Figure 1 and Figure 8

Variables and Sources

1) *Debt/GDP Ratio* is total (domestic plus external) gross central government debt over GDP, from Reinhart and Rogoff (2011). The sample period is 1973-2005.

2) *Financial Liberalization Index* is from Abiad, Detragiache, and Tressel (2008). The sample period is 1973-2005.

3) *Income Share of Top 1%* is from Alvaredo, Atkinson, Piketty, and Saez (2011).

4) *Deflator, p*, is the GDP deflator from Kaminsky, Reinhart, and Végh (2004). The sample period is 1970-2003.

5) *Inflation,* π, is computed as $\pi_t = p_t/p_{t-1} - 1$.

6) *Expected Inflation,* π^e, is computed as the fitted values from the regression

$$\pi_t = \alpha_0 + \alpha_1\pi_{t-1} + \alpha_2\pi_{t-2} + \alpha_3\pi_{t-3} + \alpha_4\pi_{t-4} + \epsilon_t.$$

7) *Nominal Interest Rate, i*, is the long-term (10 years) interest rates on government bonds from OECD Statistics. Generally the yield is calculated at the pre-tax level and before deductions for brokerage costs and commissions and is derived from the relationship between the present market value of the bond and at maturity, also taking into account interest payments paid through to maturity.

8) *Real Interest Rate, r*, is computed as $r_t = (1 + i_t)/(1 + \pi^e_{t+1}) - 1$, where i is the nominal interest rate and π^e is expected inflation.

Countries

OECD: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Korea, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. *EUROPE*: Austria, Belgium, Bulgaria, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Netherlands, Norway, Poland, Portugal, Russia, Spain, Sweden, Switzerland, Turkey, and United Kingdom.

B Proof of Lemma 2.1

Guess that $k_{i,j,t+1}$ and $b_{i,j,t+1}$ are linear in wealth $a_{i,j,t}$: $k_{i,j,t+1} = \frac{\eta\phi_{j,t}}{p_{j,t}} a_{i,j,t}$ and $b_{i,j,t+1} = R_{j,t}\eta(1 - \phi_{j,t})a_{i,j,t}$, where η is an unknown constant. Thus, consumption follows $c_{i,j,t} = (1 - \eta)a_{i,j,t}$ and $a_{i,j,t+1}$ satisfies

$$a_{i,j,t+1} = \eta \left[\left(\frac{A(z_{i,j,t+1}, w_{j,t+1}) + p_{j,t+1}}{p_{j,t}} \right) \phi_{j,t} + R_{j,t}(1 - \phi_{j,t}) \right] a_{i,j,t}.$$

The first order conditions with respect to land and bond holdings become

$$\frac{\eta}{1-\eta} = \beta\mathbb{E}\left\{\frac{\frac{A(z_{i,j,t+1},w_{j,t+1})+p_{j,t+1}}{p_{j,t}}}{(1-\eta)\left[\left(\frac{A(z_{i,j,t+1},w_{j,t+1})+p_{j,t+1}}{p_{j,t}}\right)\phi_{j,t}+R_{j,t}(1-\phi_{j,t})\right]}\right\}, \quad (24)$$

$$\frac{\eta}{1-\eta} = \beta\mathbb{E}\left\{\frac{R_{j,t}}{(1-\eta)\left[\left(\frac{A(z_{i,j,t+1},w_{j,t+1})+p_{j,t+1}}{p_{j,t}}\right)\phi_{j,t}+R_{j,t}(1-\phi_{j,t})\right]}\right\}. \quad (25)$$

Multiply the two conditions by $\phi_{j,t}$ and $1-\phi_{j,t}$, respectively, and add them to get

$$\frac{\eta}{1-\eta} = \beta\mathbb{E}\left(\frac{1}{1-\eta}\right).$$

Hence, $\eta=\beta$ verifies the guess and the first optimality condition becomes

$$\mathbb{E}\left[\frac{R_{j,t}}{\left(\frac{A(z_{i,j,t+1},w_{j,t+1})+p_{j,t+1}}{p_{j,t}}\right)\phi_{j,t}+R_{j,t}(1-\phi_{j,t})}\right]=1. \quad (26)$$

Q.E.D.

C Proof of Proposition 2.1

We first show that the wage rate does not depend on the distribution and it is constant. The optimality condition for the input of labor is $F_l(z_{i,j,t},k_{i,j,t},l_{i,j,t}) = w_{j,t}$. Because the production function is homogeneous of degree 1, the demand of labor is linear in land, that is, $l_{i,j,t} = l(z_{i,j,t},w_{j,t})k_{i,j,t}$. If we integrate over all i and average over z, we obtain the aggregate demand of labor

$$\int_i \sum_\ell l(z_\ell,w_{j,t})k_{i,j,t}\mu_\ell = \sum_\ell l(z_\ell,w_{j,t})\mu_\ell \int_i k_{i,j,t},$$

where the expression on the right-hand-side uses the law of large numbers. Since in equilibrium the demand of labor must be equal to the supply, which is 1, and total land is also 1, the above condition can be rewritten as $1=\sum_\ell l(z_\ell,w_{j,t})\mu_\ell$. This defines implicitly the wage which does depend on endogenous variables. Therefore, the wage is constant. Since the distribution of z is the same across countries, the wage rate must also be equal across countries, that is, $w_{j,t}=\bar{w}$.

Equation (6) follows from replacing the government's budget constraint (4) into the worker's budget constraint (equation (3)). Equation (7) is obtained from equation (24) after replacing $R_{j,t}(1-\phi_{j,t}) = \phi_{j,t}b_{j,t+1}/p_{j,t}$. This expression is derived from Lemma 2.1. To obtain equation (8), combine aggregate assets holdings $\bar{a}_{j,t} = \sum_\ell A(z_\ell,\bar{w})\mu_\ell + p_{j,t} + b_{j,t}$ with the aggregated choice of land, $p_{j,t}\bar{k} = \beta\phi_{j,t}\bar{a}_{j,t}$. Taking into account that the wage is $\bar{w}$, $\bar{k}=1$, and defining $\sum_\ell A(z_\ell,\bar{w})\mu_\ell = \bar{A}$, we obtain equation (8).

To derive equation (9), consider the aggregate entrepreneurs' budget constraint $c^e_{j,t} + \frac{b_{j,t+1}}{R_{j,t}} = \bar{A} + b_{j,t}$. We can now use the aggregate policy $c^e_{j,t} = (1-\beta)\bar{a}_{j,t}$ to eliminate consumption and use equation (8) to eliminate $p_{j,t}$ and solve for $R_{j,t}$.

To derive equation (10), aggregate consumption across entrepreneurs $c^e_{j,t} = (1-\beta)\bar{a}_{j,t}$ and use their (aggregate) budget constraint $\bar{a}_{j,t} = c^e_{j,t} + p_{j,t} + b_{j,t+1}/R_{j,t}$ to eliminate $\bar{a}_{j,t}$. *Q.E.D.*

D Proof of Proposition 2.2

Write the worker's value function recursively as $\tilde{W}(B;B') = \ln(c^w) + \beta\tilde{W}(B';\mathcal{B}(B'))$, where $c^w = \bar{w}\frac{1}{\Phi} + T$. Use the government's budget constraint (4) to substitute away transfers in the workers' budget constraint. This yields $c^w = \bar{w}/\Phi + [B'/R(B;B') - B]/\Phi$. Replacing this expression into $\tilde{W}(B;B')$ we obtain

$$\tilde{W}(B;B') = -\ln\Phi + \ln\left(\bar{w} + \frac{B'}{R(B;B')} - B\right) + \beta\tilde{W}(B';\mathcal{B}(B')). \tag{27}$$

Define $W(B;B') = \tilde{W}(B;B') + \left(\frac{1}{1-\beta}\right)\ln\Phi$. Thus, the value for the worker is

$$\tilde{W}(B;B') = -\left(\frac{1}{1-\beta}\right)\ln\Phi + W(B;B'), \tag{28}$$

which is equivalent to (11). To derive a recursive expression for $W(B;B')$, we use (28) to eliminate $\tilde{W}(B;B')$ (current and next period) in equation (27), and obtain

$$W(B;B') = \ln\left(\bar{w} + \frac{B'}{R(B;B')} - B\right) + \beta W(B';\mathcal{B}(B')).$$

From Lemma 2.1 (and omitting i,j indexes) we have,

$$\begin{aligned} c &= (1-\beta)a, \\ k' &= \left(\frac{\beta\phi(B)}{p(B,B')}\right)a, \\ b' &= R(B,B')\beta(1-\phi(B))a. \end{aligned}$$

The indirect utility of an entrepreneur can be written recursively as

$$\tilde{V}(k,b,z,B;B') = \ln(c) + \beta\mathbb{E}\tilde{V}(k',b',z',B';\mathcal{B}(B')).$$

Substitute consumption $(1-\beta)a$ and use the definition of current wealth, $a = A(z)k + pk + b$ to obtain

$$\begin{aligned} \tilde{V}(k,b,z,B;B') &= \ln(1-\beta) + \ln(k) + \ln\left(A(z) + p(B,B') + \frac{b}{k}\right) + \\ &\qquad \beta\mathbb{E}\tilde{V}\Big(k',b',z',B';\mathcal{B}(B')\Big), \end{aligned}$$

which depends on b/k. Use equilibrium conditions to show that the ratio satisfies $b/k = b/\bar{k} = B/\bar{k} = B$.

Subtract $\frac{1}{1-\beta}\ln(k)$ on both sides of the Bellman's equation. Then add and subtract $\frac{\beta}{1-\beta}\mathbb{E}\ln(k')$ in the right-hand side to obtain

$$\begin{aligned} V(B,z;B') &= \ln(1-\beta) + \ln\left[A(z) + p(B;B') + B\right] + \frac{\beta}{1-\beta}\ln\left(\frac{k'}{k}\right) + \\ &\qquad \beta\mathbb{E}V\Big(B', z'; \mathcal{B}(B')\Big). \end{aligned} \tag{29}$$

Define the 'normalized' value function as

$$V(B,z;B') = \tilde{V}(k,d,z,B;B') - \frac{1}{1-\beta}\ln(k).$$

Impose the equilibrium condition $b/k = B$ in expression $a = [A(z) + p(B,B') + b/k]k$ to get

$$\frac{k'}{k} = \frac{\beta p(B,B')}{\phi(B')}\Big(A(z) + p(B,B') + B\Big),$$

which is independent of individual state variables other than z. Substitute this into equation (29) and re-arrange to derive equation (12). *Q.E.D.*

E Proof of Lemma 3.1

Follow the steps in the proof of Proposition 2.1 (see section D) to derive

$$\frac{B}{R} = \frac{\beta\bar{A}(1-\phi(B))}{1+\beta(1-\phi(B))} > 0, \tag{30}$$

where $\phi(B)$ satisfies

$$\phi(B) = \mathbb{E}\left(\frac{A(z)}{A(z)+B}\right) < 1. \tag{31}$$

i. Let B^A satisfy the FOC $\frac{\partial W(B)}{\partial B} = 0$, with

$$\frac{\partial W(B)}{\partial B} = \frac{1}{C_1^w}\frac{\partial(B/R)}{\partial B} - \beta\frac{1}{C_2^w},$$

where $C_1^w = \bar{w} + B/R$ and $C_2^w = \bar{w} - B$ are aggregate workers' consumption. Since $\frac{\partial W(B)}{\partial B} > 0|_{B=0}$ and $\frac{\partial W(B)}{\partial B} \to -\infty$ as $B \to \bar{w}$, then $B^A \in [0,\bar{w}]$. Uniqueness follows from the fact that $W(B)$ is strictly concave in this interval. Differentiating equation (15) yields

$$\frac{\partial^2 W(B)}{\partial B^2} = -\frac{1}{(C_1^w)^2}\left[\frac{\partial(B/R)}{\partial B}\right]^2 + \frac{1}{C_1^w}\frac{\partial^2(B/R)}{\partial B^2} - \frac{\beta}{(C_2^w)^2}. \tag{32}$$

Since

$$\frac{\partial^2\phi(B)}{\partial B^2} = 2\mathbb{E}\left[\frac{A(z)}{(A(z)+B)^3}\right] > 0, \tag{33}$$

we have that

$$\frac{\partial^2(B/R)}{\partial B^2} = -\frac{\beta\bar{A}}{(1+\beta[1-\phi(B)])^3}\left[\frac{\partial^2\phi(B)}{\partial B^2}(1+\beta[1-\phi(B)]) + 2\beta\left(\frac{\partial\phi(B)}{\partial B}\right)^2\right] < 0,$$

establishing concavity.

ii. Replace equation (30) into the representative entrepreneur's consumption and obtain $c_1^e = \frac{\bar{A}}{1+\beta[1-\phi(B)]}$. Then, differentiate the resulting indirect utility

$$\frac{\partial V(B)}{\partial B} = \frac{\beta}{1+\beta(1-\phi(B))}\frac{\partial\phi(B)}{\partial B} + \beta\mathbb{E}\left(\frac{1}{A(z)+B}\right).$$

Substitute

$$\frac{\partial\phi(B)}{\partial B} = -\mathbb{E}\left[\frac{A(z)}{(A(z)+B)^2}\right] \tag{34}$$

in the expression above and collect terms to show

$$\frac{\partial V(B)}{\partial B} = \beta\mathbb{E}\left[\frac{B+\beta[1-\phi(B)]\,(A(z)+B)}{(A(z)+B)^2\,(1+\beta[1-\phi(B)])}\right] > 0.$$

Q.E.D.

F Proof of Proposition 3.1

Suppose that $\Phi > \frac{(1+\beta)\bar{w}}{\bar{A}} + \beta$, and let the government's objective be defined by

$$G(B) \equiv \Phi W(B) + V(B)$$

where $W(B)$ and $V(B)$ are given by equations (15) and (16). To prove concavity, differentiate $G(B)$ twice, where $\frac{\partial^2 W(B)}{\partial B^2}$ is defined in equation (32) and

$$\frac{\partial^2 V(B)}{\partial B^2} = -\frac{1}{(c_1^e)^2}\left[\frac{\partial(B/R)}{\partial B}\right]^2 - \frac{1}{c_1^e}\frac{\partial^2(B/R)}{\partial B^2} - \beta\mathbb{E}\frac{1}{(c_2^e)^2}.$$

After some manipulations, we can show that

$$\begin{aligned}\frac{\partial^2 G(B)}{\partial B^2} &= -\left[\frac{\partial(B/R)}{\partial B}\right]^2\left[\frac{\Phi}{(C_1^w)^2} + \frac{1}{(c_1^e)^2}\right] - \beta\left[\frac{\Phi}{(C_2^w)^2} + \mathbb{E}\frac{1}{(c_2^e)^2}\right] \\ &+ \frac{\partial^2(B/R)}{\partial B^2}\left[\frac{\Phi}{C_1^w} - \frac{1}{c_1^e}\right].\end{aligned}$$

The first row is negative for all B. Hence, a sufficient condition for $\frac{\partial^2 G(B)}{\partial B^2} < 0$ is that the second row is non positive. We established that $\frac{\partial^2 (B/R)}{\partial B^2} < 0$ in Section E (Part *i.*). In addition, we need that

$$\frac{\Phi}{C_1^w} - \frac{1}{c_1^e} \quad = \quad \frac{\Phi c_1^e - C_1^w}{C_1^w c_1^e} > 0,$$

since $c_1^e = \frac{\bar{A}}{1+\beta[1-\phi(B)]}$ and $C_1^w = \bar{w} + B/R$. Substituting for R we get that

$$\begin{aligned} c_1^e - C_1^w/\Phi \quad &= \quad \frac{1}{1+\beta(1-\phi(B))}\left[\bar{A} - \frac{1}{\Phi}\left([1+\beta(1-\phi(B))]\bar{w} + \beta\bar{A}(1-\phi(B))\right)\right] \\ &\geq \quad \frac{1}{\Phi}\frac{1}{1+\beta(1-\phi(B)}[\bar{A}(\Phi-\beta) - \bar{w}(1+\beta)]. \end{aligned}$$

Since $0 \leq \phi(B) \leq 1$, the denominator of the above equation is positive. Moreover, the assumption that $\Phi > \frac{(1+\beta)\bar{w}}{\bar{A}} + \beta$ is a sufficient condition for the numerator of the above equation to be positive as well. This establishes concavity.

Let B^A satisfy $\frac{\partial G(B)}{\partial B} = 0$. From Lemma 3.1, $V(B)$ is increasing in $B \; \forall B \in [0, \bar{w}]$ and $\frac{\partial W(B)}{\partial B}|_{B=0} > 0 \Rightarrow \frac{\partial G(B)}{\partial B}|_{B=0} > 0$. Additionally, $\frac{\partial V(B)}{\partial B}$ is finite at $\bar{w}$ and $\frac{\partial W(B)}{\partial B} \to -\infty$ as $B \to \bar{w}$, so $\frac{\partial G(B)}{\partial B} \to -\infty$. Hence $B^* \in [0, \bar{w}]$. Because $G(B)$ is strictly concave, B^A must be unique. *Q.E.D.*

G Proof of Proposition 3.2

To show that debt is increasing in N, set $\Phi/(1+\Phi) = 1$ in equation (23) to obtain

$$G(B, N) \equiv \Phi\left[\frac{\partial(B/R)}{\partial B}\left(\frac{1}{C_1^w}\right) - \beta\left(\frac{1}{C_2^w}\right)\right] = 0,$$

where

$$\frac{\partial(B/R)}{\partial B} = \frac{1}{R}\left(1 - \frac{B}{R}\frac{\partial R}{\partial \bar{B}}\frac{1}{N}\right) \equiv \gamma \text{ and}$$

$$\frac{\partial R}{\partial \bar{B}} = R\left[\frac{1}{\bar{B}} + \frac{\partial \phi}{\partial \bar{B}}\frac{1}{[1+\beta(1-\phi)](1-\phi)}\right]. \tag{35}$$

Claim G.1: The interest rate is increasing in $\bar{B}$, $\frac{\partial R}{\partial \bar{B}} > 0$.

Proof: Re-write eq. (35) as

$$\begin{aligned} \frac{\partial R}{\partial \bar{B}} &= \frac{R}{\bar{B}[1+\beta(1-\phi)](1-\phi)}\left[[1+\beta(1-\phi)](1-\phi) + \bar{B}\frac{\partial \phi}{\partial \bar{B}}\right] \\ &> \frac{R}{\bar{B}[1+\beta(1-\phi)](1-\phi)}\left[1 - \phi + \bar{B}\frac{\partial \phi}{\partial \bar{B}}\right] = 0 \end{aligned}$$

The inequality follows from $\beta(1-\phi) < 1$. Replace eqs. (31) and (34) in the bracketed term to show the equality. *Q.E.D.*

Claim G.2: *(i.)* $\partial G(B,N)/\partial B < 0$ and *(ii.)* $\partial G(B,N)/\partial N > 0$

Proof:

(i.) We can show that

$$\frac{\partial G(B,N)}{\partial B} = \Phi\left[\frac{\partial\gamma}{\partial\bar{B}}\frac{1}{C_1^w} - \gamma^2\frac{\Phi}{(C_1^w)^2} - \beta\frac{\Phi}{(C_2^w)^2}\right]. \tag{36}$$

where

$$\frac{\partial\gamma}{\partial\bar{B}} = -\left(1-\frac{B}{N\bar{B}}\right)\frac{2}{NR^2}\frac{\partial R}{\partial\bar{B}} - \frac{B}{N\bar{B}}\frac{\beta\bar{A}}{(1+\beta(1-\phi))^2}\left[\frac{\partial^2\phi}{\partial\bar{B}^2} + \frac{2\beta\left(\frac{\partial\phi}{\partial\bar{B}}\right)^2}{1+\beta(1-\phi)}\right].$$

Since $\frac{\partial^2\phi}{\partial\bar{B}^2} > 0$ from eq. (33) and $\frac{\partial R}{\partial\bar{B}} > 0$ from Claim G.1, then $\frac{\partial\gamma}{\partial\bar{B}} < 0$. Because all terms in equation (36) are negative, the result follows.

(ii.) We can show that

$$\frac{\partial G(B,N)}{\partial N} = \Phi\left[\frac{\partial\gamma}{\partial N}\frac{1}{C_1^w} - \gamma\frac{\Phi}{(C_1^w)^2}\frac{\partial(B/R)}{\partial N}\right].$$

The first term is positive. Noting that since $\bar{B} = B$ then $\frac{\partial\bar{B}}{\partial N} = \frac{\bar{B}-B}{N^2} = 0$, and performing some algebraic manipulations, we obtain

$$\frac{\partial\gamma}{\partial N} = \frac{B}{R^2N^2}\frac{\partial R}{\partial\bar{B}} > 0$$

from Claim G.1. The second term is zero, since

$$\frac{\partial(B/R)}{\partial N} = -\left[\frac{1-\phi}{\bar{B}} + \frac{1}{[1+\beta(1-\phi)]}\frac{\partial\phi}{\partial\bar{B}}\right]\frac{B\beta\bar{A}}{[1-\beta(1-\phi)]\bar{B}}\frac{\partial\bar{B}}{\partial N}$$

and $\frac{\partial\bar{B}}{\partial N} = 0$. *Q.E.D.*

Using Claim G.2 and the implicit function theorem, we conclude that domestic debt B is increasing in N

$$\frac{\partial B}{\partial N} = -\frac{\partial G(B,N)/\partial N}{\partial G(B,N)/\partial B} > 0.$$

For the limiting case, let $N \to \infty$ in equation (23). Substituting C_1^w and C_2^w and rearranging, we obtain

$$\beta R = 1 - \frac{1+\beta}{\bar{w}}B. \tag{37}$$

This equation determines country 1's supply of debt given R. In equilibrium, $B_1 = B_2 = ...B_N = \bar{B} = b$ where the per-capita demand for debt $\bar{B}$ satisfies equation (21). The financially integrated equilibrium levels of b and R are thus determined by equations (21) and (37).

Existence and uniqueness follow from: (i) the LHS of equation (37) is decreasing in $\bar{B}$ and equals 1 at the origin, and (ii) the RHS of equation (37) is increasing in $\bar{B}$ (since $R_{\bar{B}} > 0$) and has an intercept at $\left[\mathbb{E}\left(\frac{\bar{z}}{z}\right)\right]^{-1} < 1$. Denote the intersection point by B^{FI}. From (i) and (ii) it also follows that B^{FI} is bounded and $\beta R < 1$ when $\bar{B} = B^{FI}$.

Under autarky, equation (37) is instead

$$\beta R = 1 - \frac{1+\beta}{\bar{w}}\bar{B} - \epsilon(\bar{B})\left(1 - \frac{\bar{B}}{\bar{w}}\right). \tag{38}$$

The LHS is the same as before. The RHS is also equal to 1 at the origin because $\epsilon(0) = 0$. Since $\epsilon(\bar{B}) > 0$ and $\bar{w} - b = C_2^w > 0$ when $\bar{B} > 0$, the new term in the RHS is positive. Hence, the intersection of the two curves in equation (38) occurs at $B^A < B^{FI}$, since the RHS is steeper.

Since debt is larger and V is increasing in $\bar{B}$, $V(B^A) < V(B^{FI})$. Since W is concave in $\bar{B}$ and $W(\bar{B})$ is decreasing when $\bar{B} > B^A$, then $W(B^A) > W(B^{FI})$.

What is left to prove is that the equilibrium must be symmetric. This can be shown starting from the first order condition of the government

$$\Phi \cdot \left[\frac{1 - \frac{\epsilon(\overline{B})B}{N\overline{B}}}{C_1^w} - \frac{\beta R}{C_2^w}\right] = \left(\frac{1}{N}\right) \cdot \left[\frac{1-\epsilon(\overline{B})}{c_1^e} - \mathbb{E}_t\left(\frac{\beta R}{c_2^e}\right)\right], \tag{39}$$

which must be satisfied for all countries.

An equilibrium is characterized by a worldwide debt $\overline{B}$. Given $\overline{B}$, the elasticity ϵ and the interest rate R are determined. Also notice that the right-hand side of (39) is the same for all countries, since entrepreneurs choose to hold the same stock of bond in all countries. The left-hand side could differ since governments could choose different B. However, since the left-hand side is strictly decreasing in B (keeping $\overline{B}$ constant), the fact that the right-hand side is the same for all countries implies that B must be the same for all countries. Otherwise, the first order condition (39) will not hold for all countries. Notice that this result applies for any value of Φ, not only for the limiting case $\Phi/(1+\Phi) = 1$. *Q.E.D.*

H Proof of Proposition 3.3

Setting $\Phi/(1+\Phi) = 1$, the first order conditions for the domestic and foreign country become

$$1 - \frac{\alpha B}{\overline{B}}\epsilon(\overline{B}) = \beta R(\overline{B})\left(\frac{C_1^w}{C_2^w}\right) \tag{40}$$

$$1 - \frac{(1-\alpha)B^*}{\overline{B}}\epsilon(\overline{B}) = \beta R(\overline{B})\left(\frac{C_1^{w*}}{C_2^{w*}}\right), \tag{41}$$

where we have made it explicit that the interest rate elasticity, $\epsilon(\overline{B})$, and the interest rate, $R(\overline{B})$, are functions of the average worldwide debt $\overline{B} = \alpha B + (1-\alpha)B^*$.

An equilibrium will be characterized by B and B^* (and $\overline{B}$) that satisfy conditions (40) and (41). We want to show that in an integrated economy $B > B^*$ if $\alpha < 1/2$, that is, the per-capita debt of the large country is lower than the per-capita debt of the small country.

Subtracting (41) to (40) and substituting $(1-\alpha)B^* = \overline{B} - \alpha B$ we get

$$\left(1 - \frac{2\alpha B}{\overline{B}}\right)\epsilon(\overline{B}) = \beta R(\overline{B})\left(\frac{C_1^w}{C_2^w} - \frac{C_1^w *}{C_2^w *}\right) \tag{42}$$

For a given $\overline{B}$ that characterizes the equilibrium, the left-hand-side term is decreasing in B. Since $\overline{B}$ is the equilibrium worldwide debt taken as given in this exercise, an increase in B must be associated to a decline in B^*. Therefore, it is the ratio B/B^* that matters. The right-hand-side term, instead, is increasing in B. To see this, we can define aggregate workers' consumption using the budget constraints as

$$C_1^w \;=\; \bar{w} + \frac{B}{R(\overline{B})}, \qquad C_2^w \;=\; \bar{w} - B \tag{43}$$

$$C_1^{w*} \;=\; \bar{w} + \frac{B^*}{R(\overline{B})}, \qquad C_2^{w*} \;=\; \bar{w} - B^* \tag{44}$$

From these equations it is clear that C_1^w/C_2^w is increasing in B and C_1^{w*}/C_2^{w*} is increasing in B^*. Since an increase in B must be associated with a decline in B^*, then C_1^{w*}/C_2^{w*} is decreasing in B. Thus, the right-hand side of equation (42) must be increasing in B.

So far, we have established that the LHS of equation (42) is decreasing and the RHS is increasing in B. Next, we observe that, if $\alpha < 1/2$, then the LHS is positive when $B = B^*$. The RHS, instead, is zero. Therefore, to equalize the LHS (which is decreasing in B) to the RHS (which is increasing in B) we have to increase B (which must be associated with a decrease in B^*). Therefore, if $\alpha < 1/2$, $B > B^*$.

Finally, since in the autarky equilibrium both countries had the same debt, the growth in debt following financial liberalization is bigger for the small country. Notice that this does not exclude the possibility of negative growth. *Q.E.D.*

I Proof of Proposition 3.4

Let $\Phi/(1+\Phi) = 1$, then the autarky equilibrium satisfies the government's first order condition

$$\frac{1-\epsilon(B)}{R(B)C_1^w} = \frac{\beta}{C_2^w},$$

where we made it explicit that the interest elasticity ϵ and the interest rate R are functions of debt B. Since $C_1^w = \bar{w} + B/R(B)$ and $C_2^w = \bar{w} - B$, the first order condition can be rewritten as

$$\frac{1-\epsilon(B)}{\bar{w}R(B)+B} = \frac{\beta}{\bar{w}-B}. \tag{45}$$

The right-hand side of (45) is clearly increasing in B. We now show that the left-hand side is decreasing B. First let's rewrite the left-hand side as

$$\frac{1-\epsilon(B)}{\bar{w}R(B)+B} = \left(\frac{1-\epsilon(B)}{R(B)}\right)\cdot\left(\frac{1}{\bar{w}+B/R(B)}\right), \tag{46}$$

which is the product of two terms. We want to show that both terms are decreasing in B. Let's start with the first term which is equal to

$$\frac{1-\epsilon(B)}{R(B)} = -\frac{\beta\phi'(B)\bar{A}}{[1+\beta(1-\phi(B))]^2}.$$

Since $\phi(B) = \mathbb{E}[A(z)/(A(z)+B)]$ and $-\phi'(B) = \mathbb{E}[A(z)/(A(z)+B)^2]$ are both decreasing in B, then the first term in (46) is also decreasing in B. The second term in (46) depends negatively on $B/R(B) = \beta(1-\phi(B)\bar{A}/[1+\beta(1-\phi(B))]$. As we have already observed, $\phi(B) = \mathbb{E}A(z)/(A(z)+B)$ depends negatively on B and, therefore, $B/R(B)$ increases in B. Thus, the second term in (46) decreases with B. This proves that (46) is decreasing in B.

To summarize, we have shown that the left-hand side of the first order condition (45) decreases with B, while the right-hand side increases with B. Therefore, if an increase in the mean preserving spread of z raises the term $(1-\epsilon(B))/[\bar{w}R(B)+B]$, which is the left-hand side of condition (45), to re-establish equality B has to rise.

Q.E.D.

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