

National Research University Higher School of Economics

as a manuscript

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**PUBLIC FINANCE AND FISCAL POLICY
UNDER FINANCIAL REPRESSION**

PhD Dissertation Summary
for the purpose of obtaining academic degree
Doctor of Philosophy in Economics

Academic supervisor:
PhD in Economics
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JEL: E62, E63

Moscow – 2022

Motivation

In the XXI century, high levels of public debt have become norms rather than exceptions in many developed and developing countries. For example, the level of public debt in the United States has been on an upward trend since the mid-1970s, driven by increases in government spending (in particular, mandatory spending on social security and health insurance) and slower growth in government tax revenues (see e.g. (Yared, 2019)). At the same time, other developed and developing countries have also faced long-term growth in public debt relative to output, the main reason for which is non-prudential public financial management and failure to implement fiscal consolidation. Colossal levels of government debt to GDP can lead to long-term crises with huge costs.

The global financial crisis of 2007-2009 and the sovereign debt crisis of 2010-2012 identified the weaknesses of accumulated public debts. On the one hand, high levels of debt have limited the effectiveness of fiscal stimulus during crises. For example, the paper by (Obstfeld, 2013) indicates that governments should sustain moderate levels of public debt due to financial globalization. Under low levels of public debt, bailouts of the financial system are credible, thus making the fiscal policy more effective. At the same time, (Romer, Romer, 2018) finds empirical support for the importance of fiscal and monetary freedom, which is expressed in moderate levels of public debt and the policy interest rates above zero lower bound. Countries with fiscal and monetary freedom prior to crises had little costs, while other countries experienced dramatic declines in output. From a theoretical point of view, the paper (Battaglin, Coate, 2016) demonstrates the relationship between high levels of public debt and high unemployment, where debt is the main political barrier while fighting against unemployment. On the other hand, significant debt-to-GDP ratios can accelerate the rise in sovereign spreads during crises, which in turn can lead to several issues. For example, during the sovereign debt crisis, some peripheral European countries experienced borrowing problems as a result

of high spreads and low demand for sovereign debt. As noted, for example, by (Reinhart, Reinhart, Rogoff, 2015), financial repression has been extensively used as an alternative to fiscal consolidation to solve the problem.

In modern practice, financial repression is a set of regulatory measures in the forms of placement of public debt in captive domestic financial institutions and reducing the cost of servicing debt through inflation and/or low nominal interest rates. For the first time, the definition of financial repression was used by (McKinnon, 1973; Shaw, 1973), who demonstrated the negative relationship between the functioning of financial markets and long-term growth. The practice of financial repression goes back to the distant past. For example, economic historians consider the creation of the Bank of England as a way to finance a long-term war between England and France by placing sovereign debt on the institution's balance sheet (see, for example, (Calomiris, Haber, 2014)). At the same time, widespread use of measures of financial repression in the form of non-market placement of debt was observed during the Second World War. Then this accumulation followed by elimination of debt through inflation and low nominal incomes (see, for example (Chari et al. 2020)). Moreover, financial repression is not a phenomenon of the past. For example, many macroprudential policies that artificially increase demand for sovereign debt and keep low government debt yields can be considered as financial repression. Since financial repression is characterized by distorting effects on the financial sector, governments should account for the impact of these measures on public finance.

Brief literature review

Following (McKinnon, 1973; Shaw, 1973), several papers (Roubini, Sala-i-Martin, 1992; Demetriades, Luintel, 1997) show the negative impact of financial repression on economic growth and financial development in developing economies. Recent studies (Reinhart, 2012; Becker, Ivashina, 2018)

reflect the practice of financial repression in developed countries as well. This dissertation contributes to (i) the estimation of revenue from financial repression in general equilibrium models; (ii) the impact of financial repression on the effectiveness of fiscal stimulation (the magnitude of fiscal multipliers); and (iii) the impact of financial repression on the incentives of governments to default.

First, quantitative estimates of revenue from financial repression indicate its significance to public finance. For example, the paper by (Giovannini, de Melo, 1993) estimates revenue from financial repression for 24 developing countries. The authors calculate budget revenues utilizing the volume of domestic public debt and the differential in the cost of servicing the public debt in the domestic and foreign markets. Several countries had positive revenues. In particular, the revenue from financial repression to the government budget was at least 2% of GDP for 7 countries. At the same time, (Reinhart, Sbrancia, 2015) demonstrate that low nominal public debt yields coupled with moderate inflation can actively reduce public debt alternatively generating revenue from financial repression. The authors estimate the revenue from financial repression for the U.S., which is 3.6% of GDP for the period 1945-1980. Despite significant explicit revenues from financial repression, it can implicitly reduce government revenues, negatively affecting traditional sources of revenue. For example, (Trabandt, Uhlig, 2011) demonstrates the interconnection of revenues from traditional proportional taxes using a neoclassical general equilibrium model. Since financial repression is an implicit proportional tax (see, for example, (Reinhart, 2012)), it can lead to a reduction in aggregate traditional government revenues. The paper by (Isakov, Pekarski, 2016) - which is the first chapter of the dissertation - estimates the revenue from financial repression in a modified general equilibrium model with elements of financial repression. Results demonstrate commensurate revenues from financial repression with the empirical findings. It also shows how fiscal repression affects revenues from traditional taxation of consumption and factor income.

Second, the literature analyzes the policy of financial repression as well as political and economic reasons for measures of financial repression. Governments might prefer financial repression over traditional taxation due to higher government revenues and/or higher welfare of domestic agents. For example, (Gupta, 2008) motivates the practice of repression through a theoretical model characterized by endogenous tax evasion. Since aggressive taxation can lead to intense tax evasion, the government can resort to financial repression to increase its revenues. At the same time, the paper by (Bai et al., 2001) provides a rationale for the practice of financial repression to increase the welfare of agents. Due to the uneven distribution of the tax burden, the government can increase the welfare of agents through uniform taxation of savings (financial repression). On the other hand, governments can restrict financial development to obtain cheap credit (see, for example, (Becerra et al., 2012; Calomiris, Haber, 2014)). Since less developed financial markets are characterized by higher capital returns for operating financial intermediaries, governments have higher bargaining power and thus can place public debt in these financial institutions.

Despite the broad analysis of financial repression, the literature has not considered the influence of financial repression on the effectiveness of fiscal stimulation (size of fiscal multipliers). Several studies show that the effectiveness of fiscal stimulus depends on several factors. For example, (Drautzburg, Uhlig, 2015) shows that the effectiveness of fiscal stimulus strongly depends on a channel of stimulation and the way government expenditures are financed. While financing government expenditures through labor income taxation, the magnitudes of the fiscal multipliers take the smallest values. At the same time, (Eggerston, 2010) demonstrates that financing fiscal stimulation through a proportional tax on labor has a positive effect on fiscal efficiency in a low interest rate environment. The effects of financial repression on the efficiency of fiscal stimulation are considered in (Isakov, Pekarski,

2017), which constitutes the basis for the second chapter of the dissertation. The study shows that financial repression insignificantly reduces the magnitude of fiscal multipliers in the short run, while financing fiscal stimulus through proportional labor taxation are the least efficient. Since the “labor wedge” (deviation of the marginal productivity of labor from the marginal rate of substitution between consumption and leisure) is an important component of optimal taxation (see, for example, (Chari, Kehoe, McGrattan, 2007)), fiscal stimulus through financial repression is characterized by the higher efficiency in the short run, which allows to smooth labor taxation in times of fiscal needs.

Third, several studies (see, for example, (Reinhart, Rogoff, 2009)) consider financial repression as an alternative to sovereign defaults. Using historical data, the authors point out that governments rarely resort to explicit defaults on domestic debt, using implicit forms of default in the form of deflation of public debt. In fact, sovereign defaults also occur in countries where governments resort to measures of financial repression. For example, (Sosa-Padilla, 2018) indicates that repressed banking systems are subject to sovereign risks. At the same time, the paper by (Borensztein, Panizza, 2008) demonstrates a causal relationship between sovereign and banking crises. The authors point out that sovereign defaults are most likely to lead to banking crises. Moreover, (Baskaya, Kalemli-Ozcan, 2016) show that sovereign defaults lead to a decline in private lending, using microdata and the 1999 Turkish earthquake as a natural experiment. The third chapter, which is based on (Isakov, 2021), demonstrates the relationship between sovereign and banking crises. The former relationship is observed in the above empirical works. Moreover, the third chapter looks at the effect of financial repression on the government's incentives to default. The most repressed financial system reduces the incentives of the benevolent policymakers to declare defaults since the latter can lead to banking crises.

Object and subject of the research

Object: measures of financial repression expressed in the artificial placement of public debt with yields below market ones.

Subject: the dissertation is aimed at considering the following channels of influence of financial repression. The first chapter examines the impact of financial repression on consumption taxes, labor income taxes, and capital income taxes. The second chapter of the dissertation assesses the effectiveness of fiscal stimulus under financial repression. Finally, the concluding chapter studies the impact of financial repression on the incentives of governments to default; and it also explains the connection between sovereign and banking crises.

Objectives of the research

The main goal of the dissertation is to characterize the impact of financial repression on public finance, optimal fiscal policy, and incentives of governments to default. To achieve this goal, the following tasks have been solved:

- Incorporate financial repression into general equilibrium models: a neoclassical general equilibrium model, a general equilibrium model with nominal rigidities, and a model of an economy with a developed financial sector;
- Assess the impact of financial repression on public finances (total government revenues);
- Define optimal fiscal policy under financial repression;
- Assess the impact of financial repression on the effectiveness of fiscal stimulus;

- Assess liquidation effect of financial repression;¹
- Study the channel of influence of sovereign defaults on the coincidence with banking crises;
- Examine the impact of financial repression on the incentives of governments to sovereign defaults.

Methodology

The first chapter expands the model by (Cooley, Hansen, 1992), which takes into account the practice of financial repression. Financial repression is introduced into the model as a requirement to households to invest part of assets in government bonds. The model includes a household sector, a manufacturing sector, and a benevolent government. The government finances government expenditure through distortionary taxation and financial repression. The model is calibrated for the United States and the European Union, where main parameters are borrowed from the paper by (Trabandt, Uhlig, 2011). Parameters of financial repression - reflecting artificial demand for government bonds - are calibrated to match the average debt-to-GDP ratio for the 2008-2015 period.

In the second chapter, the impact of financial repression on fiscal stimulus is carried out using a general equilibrium model with nominal rigidities and fiscal policy. The model by (Christiano, Eichenbaum, Evans, 2005) is extended with proportional capital, labor, and consumption taxation. The model includes households, manufacturing firms, retailers, and the government. In addition, the second chapter divides households into Ricardian and Non-Ricardian households (Rule-of-Thumb Consumers). On the one hand, as the literature shows (see, for example, (Gali et al., 2007; Drautzburg, Uhlig, 2015)), this approach allows to adequately assess fiscal multipliers. On the other hand,

¹ The liquidation effect of financial repression is defined as a ratio of reduction in government debt service cost to output, where cost reduction is defined as the product of the differential between market yield and government bond yield, as well as stock level of public debt.

only Ricardian households are explicitly affected by financial repression i.e. only Ricardian households have access to financial markets. Financial repression is presented as the non-market placement of government debt. The model is calibrated for the US economy, in which the main parameters are borrowed from the relevant literature. Calibration of parameters characterizing financial repression is borrowed from the first chapter.

In the final chapter, I extend the sovereign debt model a la (Mendoza, Yue, 2012) with a financial sector (Gertler, Kiyotaki, 2010) taking into account the practice of financial repression. The model includes households, production, financial, and foreign sectors, and the government. Unlike the first two chapters, the third chapter explicitly introduces the financial sector. The financial sector is represented by a set of commercial banks required to hold government bonds as a share of their total assets. Following the work by (Gertler, Kiyotaki, 2015), I introduce self-fulfilling banking crises. Households' expectations of a possible default play a significant role in generating potential costs. In the event of a default, the government loses access to international financial markets as well as household confidence in the quality of banking assets, which could lead to banking crises. The model is calibrated for a set of peripheral European countries.

Main findings

- **Assessment of the impact of financial repression on budget revenues**

The first chapter provides qualitative and quantitative analyses of the impact of financial repression on traditional forms of government revenues within a model calibrated for the US and European Union (EU) economies. First, tougher financial repression in the form of low yields on sovereign debt and/or forced placement of public debt in the accounts of captive financial institutions leads to a decrease in labor tax revenues for all parameter values.

Second, fiscal repression in the form of an artificial expansion in the demand for sovereign debt could lead to higher consumption tax revenues coupled with a relatively high rate of return on debt. However, the combination of compulsory debt allocation with relatively low yields results in lower consumption tax revenues. Third, financial repression can lead to an increase in capital tax revenues by reducing aggregate capital and increasing the marginal productivity of capital. Fourth, financial repression can increase the total government revenues, however, financial repression produces a negative impact on the welfare of households at reasonable values of the rate of substitution between private and public goods.

At the same time, the first chapter provides a quantitative analysis for substitutability and complementarity of fiscal instruments and instruments of financial repression for the calibrated US and EU economies. First, financial repression in the form of low sovereign debt yields is a substitute for traditional taxes. At the same time, the quantitative results demonstrate a colossal marginal rate of substitution between financial repression in the form of a low interest rate and a tax on capital income. This result motivates the political economy reasons for the practice of financial repression. Second, for the US economy, repression in the form of non-market placement of sovereign debt is a substitute to traditional taxes, while for the EU economy this instrument has complementary properties to the same taxes.

- **Effectiveness of fiscal stimulus under financial repression**

The second chapter provides a quantitative analysis of the magnitude of fiscal multipliers and computes the liquidation effect of financial repression in a calibrated model of the US economy. First, the analysis shows a slight decline in the effectiveness of the fiscal stimulus in the short run. Since repression is additional distortionary taxation, more severe financial repression results in

lower fiscal multipliers. However, despite the distorting nature of financial repression, the values of the fiscal multipliers decrease insignificantly in the short run. Second, the numerical analysis demonstrates the huge liquidation effect of public debt. The low real interest rate of government bonds makes it possible to effectively liquidate government debt and keep it on a stable path. Third, unlike fiscal stimulus in a zero lower bound environment, financial repression in the form of low government bond yields declines fiscal multipliers due to implicit distortionary taxation.

- **Sovereign debt and banking crises**

The third chapter provides a qualitative and quantitative analysis of the impact of sovereign defaults on an economy characterized by financial repression. First, theoretical analysis helps to explain the coincidence of sovereign and banking crises. The announcement of a sovereign default leads to the loss of public confidence in sovereign debt, which, in turn, can create room for banking crises. Second, quantitative analysis demonstrates that sovereign defaults associated with banking crises lead to significant losses in output and household welfare. This result is explained by the redistribution of capital from the most productive agents (commercial banks) to the least productive agents (households) as a result of a banking crisis. Third, quantitative analysis indicates that the main parameters that significantly affect the cost of banking crises and the likelihood of their occurrence as a result of sovereign defaults are the significance of the banking sector and the degree of financial repression.

Contribution

The dissertation contributes to the literature on financial repression by demonstrating its impact on public finance and effectiveness of fiscal policy. Unlike the literature that estimates revenues from financial repression, this

study covers deeper aspects of public finance. The first chapter of the study – which is based on (Isakov, Pekarski, 2016) – is devoted to the analysis of the impact of financial repression on traditional government revenue in the context of general equilibrium model. In contrast to papers that study distorting taxation (see, for example, (Trabandt and Uhlig, 2011)), the first chapter introduces the practice of financial repression and analyzes its impact on traditional forms of government revenue. The first chapter contributes to the literature in the following dimension. One of the political and economic motivations for financial repression is temporary smoothing of distorting taxes.² Financial repression reduces excessive traditional taxation during times of fiscal needs by placing public debt in controlled financial institutions and reducing accumulated debt in the future. However, the above motive misses the interplay of financial repression and traditional distortionary taxation. The first chapter fills the gap. Aimed at reducing the service cost of public debt, financial repression potentially may reduce traditional government revenues from taxation of consumption and factor income.

As a form of distortionary taxation, financial repression potentially might reduce effectiveness of fiscal stimulation. The paper (Isakov, Pekarski, 2017) demonstrates that financial repression slightly reduces effectiveness of fiscal stimulation in the short run and has a significant negative impact in the long run. In contrast to the literature that evaluates effectiveness of fiscal stimulation (see, for example, (Drautzburg, Uhlig, 2015)), the second chapter allows to analyze effectiveness of fiscal stimulus by financing the public deficit with public debt placed in controlled financial institutions through financial repression. Previous studies miss this point by assuming governments finance deficits issuing government debt in free financial markets. The second chapter demonstrates that measures of financial repression in the form of non-market placement of public debt during times of fiscal needs can smooth out the costs

² See, for example, (Chari, Dovic, Kehoe, 2020).

of proportional taxation on labor. However, the benefit of tax smoothing comes at a significant cost losing effectiveness of fiscal stimulation in the long run.

The literature that analyses sovereign debt problems does not consider the government's ability to forcefully place of public debt in controlled financial institutions. At the same time, one of the important issues in this literature is the coincidence of sovereign and banking crises. The third chapter fills the gap by extending the standard sovereign debt model with a financially repressed banking sector. In contrast to the literature (Gertler, Kiyotaki, 2015), the third chapter focuses on the problem of sovereign default risk, allowing to explain the relationship between sovereign and banking crises. The paper (Mendoza, Yue, 2021) contributes to the micro-foundation of the sovereign default cost through loss of access by firms to international intermediate goods used as means of production. The third chapter also contributes to the micro-justification of the sovereign default cost; however, cost takes the form of banking crises. The last chapter is also closely related to the papers (Sosa-Padilla, 2018; Chari, DAVIS, Kehoe, 2020) that demonstrate negative impact of sovereign defaults on real economic activity through reduction in lending by banking sector. In contrast to these papers, the third chapter illustrates the loss of access to credit by the real sector due to banking crises. First, the third chapter demonstrates that sovereign defaults can negatively affect the balance sheet of the banking system and, therefore, might lead to massive outflow of deposits. Second, the chapter shows that financial repression is one of the ways to manage the expectations of national agents by increasing public debt on the balance sheet of the national banking system, thereby increasing the potential costs of default in the future. For the first time, these questions are studied in this dissertation.

Theoretical significance of the research

The dissertation demonstrates the significance of the influence and importance of financial repression measures on public finances. First, financial

repression as an instrument of fiscal policy can create significant government revenue as well as stabilize the public debt. Despite this, financial repression also affects other sources of budget revenues. Second, financial repression can smooth out more distortionary proportional labor taxes over time, while stimulating government expenditure by placing government debt in captive domestic financial institutions. Third, while financial repression has a crowding-out effect on private investment, it can reduce the risk of strategic defaults. Thus, financial repression can be the optimal choice during periods of fiscal stress and massive capital outflows.

Practical significance of the research

From a practical point of view, the results can be useful for an optimal fiscal and monetary policy. The practice of various measures of financial pressure in different countries to one degree or another affects public policy through general equilibrium effects. Thus, for example, when building a general equilibrium model, central banks, ministries of finance, and other institutions involved in the production of macroeconomic forecasts may want to take into account the practice of financial repression in the corresponding economy.

Publications of the results

Based on the results of the dissertation research, publications were prepared in Russian peer-reviewed scientific journals:

1. Isakov K.S., Pekarski S.E. Assessment of the impact of financial repression on budget revenues // *Economic Policy* (in Russian). 2016. Vol. 11. No. 5. P. 28-49.
2. Isakov K.S., Pekarski S.E. Effectiveness of fiscal stimulus under financial repression // *Journal of Economic Theory* (in Russian). 2017. No. 4. P. 59-68.

3. Isakov K.S. Sovereign defaults and banking crises // Journal of Economic Theory (in Russian). 2021. Vol. 18. No. 1. P. 29-47.

The main provisions and results were presented by the author at the following international scientific conferences:

- XVII April International Academic Conference on Economic and Social Development, Moscow (Russia), April 2016
- XX International Conference on Macroeconomic Analysis and Finance, Crete (Greece), May 2016
- XVIII April International Academic Conference on Economic and Social Development, Moscow (Russia), April 2017
- Second World Congress on Comparative Economics, Saint-Petersburg (Russia), June 2017
- XVIII International Economic Association World Congress, Mexico (Mexico), June 2017.
- I International Laboratory for Macroeconomic Analysis (ILMA) workshop, Frontiers of Macroeconomic Research, Moscow, Russia, October 2018.
- II International Laboratory for Macroeconomic Analysis (ILMA) workshop, Frontiers of Macroeconomic Research: Public Debt, Private Debt and Financial Repression, Moscow, Russia, June 2019.

Moreover, the chapters of the dissertation were presented at internal scientific events:

- III Russian Economic Congress, Moscow (Russia), December 2016
- Scientific Seminar of the International Laboratory for Macroeconomic Analysis NRU HSE, June 2020.

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