Rising Government Debt – Do we need to worry?

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Government debt levels have risen substantially on a global scale and most countries do not show any signs of a trend reversal in the foreseeable future. Fiscal policymakers face various challenges and oftentimes there is a lack of political will to cut overall spending and begin prioritizing expenditures. Many rely on the central bank's will and ability to stop another debt crisis should push come to shove. However, such a rescue would not come without cost and instead lead to increased inflation.

Debt ratios have risen considerably since the Financial Crisis ...

In many countries sovereign debt levels have shot up following the Global Financial Crisis in 2007. In the US, the debt-to-GDP ratio has almost doubled, rising from 65% to 122% [1]. Similarly, France saw its debt-to-GDP ratio rise from 65% to 111% (Title chart). As a consequence, the ratings agency S&P recently adjusted the country's credit rating downwards.

... and a trend reversal is not in sight, ...

In the upcoming years, a continuation of this almost universal upwards trend is likely. It seems, the consolidation of the fiscal budget is simply not a priority for policymakers everywhere. More than that, multiple countries such as France are even setting the stage for additional costly expenditure plans or tax reductions. In the current election campaign in France, none of the parties have even so much as mentioned plans to tackle the deficit.

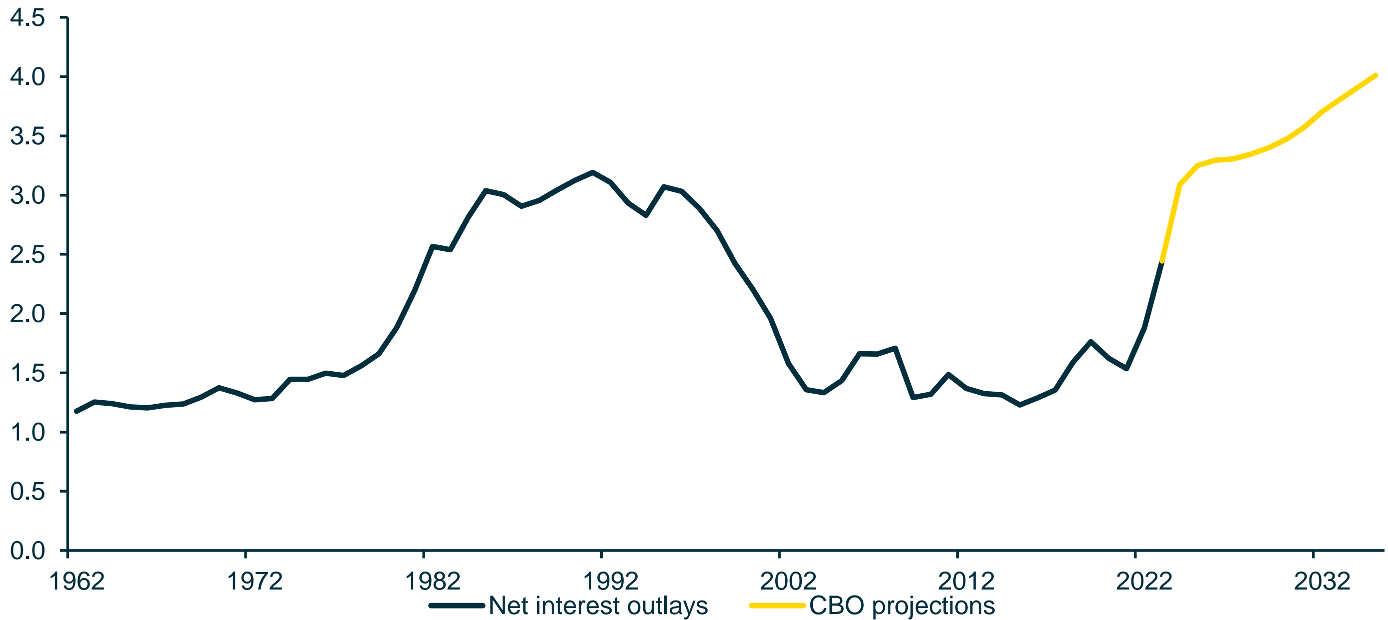
... also considering higher interest rates and less inflation

The lack of political awareness could be traced back to the benign borrowing environment during more than a decade of historically low interest rates. When credit is cheap, additional debt has no noticeable impact on the budget. In addition, high rates of inflation generated faster nominal GDP growth, in turn curbing the rise of the debt ratio.

Nonetheless, tailwinds for the public finance situation are losing their force. Inflation has cooled down while higher interest rates are weighing heavily on the budgets. The direct consequences of outsized sovereign debt volumes become visible when considering the large sums of interest rate payments governments are due to pay out to their lenders. For example, in fiscal 2024, the US federal government's interest payments as a percentage of GDP are expected to amount to 3.1%. This represents a doubling compared to the early 21st century. In the coming years, this ratio is set to rise to 4%.

Chart 1 - US debt burden is rising

US federal government net interest outlays in % of GDP, fiscal years. CBO projections after 2023



Source: CBO, Commerzbank Research

Rich countries don't go bust...

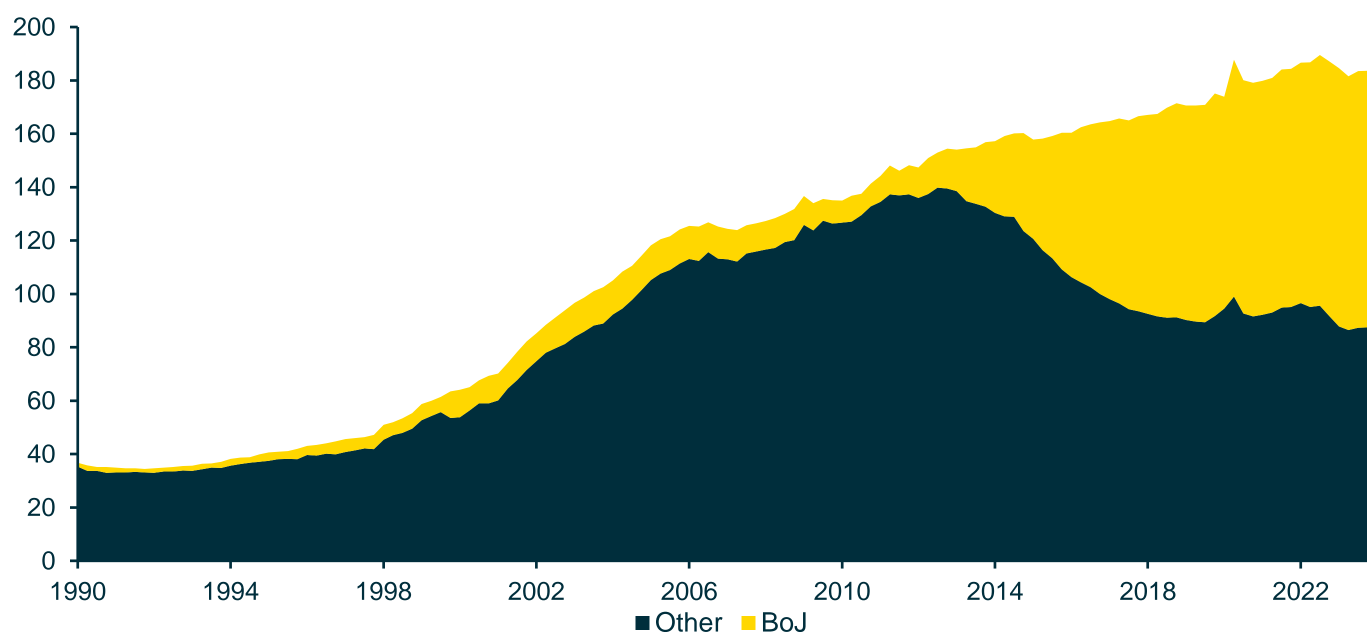
Despite the rapid and steady rise in debt-to-GDP ratios across the globe, at first glance, another debt crisis shaking up advanced economies seems unlikely. Their key advantage over developing economies is the ability to issue debt denominated in domestic currency. Should deficits reach critical levels causing credit lines to dry up, the domestic central bank can step in and purchase the newly issued bonds themselves [2].

... as shown by Japan

A popular example of this practice is Japan. Japan's sovereign debt level is far above 200% of GDP. The Bank of Japan purchased about half of the outstanding issued debt. Meanwhile, the volume of bonds purchased by the market has even declined relative to GDP (Chart 2).

Chart 2 - Japan: With a little help from your friend

Japanese Government Bonds (JGBs), held by BoJ and other investors, quarterly data in % of GDP



Source: BoJ, S&P Global, Commerzbank Research

But is this example really representative?

In view of the country's macroeconomic developments, Japan is an absolute exception amongst the world's wealthy nations. Since 2000, i.e. roughly when the BoJ started their bond purchasing program, average inflation has been a mere 0.3%. Within the same time frame, US prices grew at 2.6% p.a. on average, and in the eurozone at 2.1%. Many indicators point to Japan being a special case. Therefore, it would be unwise to expect other countries being able to follow this example.

"Lender of last resort": this is not what we had in mind

The reinsurance central banks provide to their domestic government is intended to prevent any acute crisis in government financing (here, the UK case of 2022 provides a warning; see box). However, this only works as an emergency strategy until the respective government has regained control over its budget, thereby regaining the trust of its lenders.

The prerequisite for long term viability of sovereign debt levels is that debt growth does not continuously outpace output growth. After all, GDP serves as the tax base, with which governments interest and principle payments ultimately need to be financed. A persistent disproportionate increase in government debt will ultimately cause the share of the budget being allocated to debt financing to rise significantly. As a consequence, other important expenditures are crowded-out. Over time, this can raise doubts about the government's ability and willingness to prioritize debt service over social services or defense spending in the long term. Rising doubts in term cause market interest rates to increase considerably as the risk premium grows.

If the central bank is determined to facilitate permanent debt ratio growth, even far beyond the levels sustained by Japan, it would have to continuously increase its balance sheet relative to GDP. This way, it would put more and more money in circulation. The willingness of firms and households to hold liquidity is not without its limits. Instead, in the long run, liquidity holdings grow roughly proportional to GDP. As a result, households will try to reduce their money holdings by purchasing consumption goods as expansionary monetary policy grows their stack of cash. If cash holdings grow faster than total output, inflation follows. In addition, we could expect capital flight, in turn raising inflationary pressures as the currency depreciates. From the central bank's perspective, these simultaneous developments would generate a conflict in their policy objectives: price stability and government financing. In the extreme case, this could make the currency worthless. However, it is more likely that inflation far beyond 2% or 3%, would prompt a political reaction. The Covid-19 crisis showed how badly the average consumer suffers from surging inflation – and that this leads has political consequences, as can currently be observed in the US for example. Despite persistent full employment, sentiments about economic performance are at rock-bottom, which is likely to be caused by the high inflation rates of recent years.

Budget consolidation is unlikely in the near future, ...

The obvious path towards consolidation of public finances would be expenditure cuts and/or tax increases.However, this is unlikely for the near future. Instead, the tendency towards rising expenditures is unbroken, specifically due to higher costs of pension schemes and the health care sector as western societies age. In addition, most governments are determined to raise their defense spending as a reaction to Russia's invasion of Ukraine. Another costly objective is the green transformation to combat the climate crisis. At the same time, there is no willingness to cut expenditures elsewhere.

... but there is no viable alternative

However, there are hardly any real alternatives to such prioritization and thus the consolidation of public finances. It is often argued that higher government spending and investment stimulates economic growth. This way, government revenues rise. Also, the denominator of the debt ratio grows faster than its numerator reducing the ratio overall. Unfortunately, dynamics in demographics speak strongly against a substantial positive effect on output growth as labor supply shortages render the additional capital less productive. The remaining possibility is a significant increase in productivity. Yet, this presumably requires serious deregulation, which may not be politically feasible.

Furthermore, higher inflation only benefits the borrower at first glance, as the real value of debt is eroded. Lenders know this, and, as a consequence, only provide credit against higher interest rates. As high rates of inflation are typically very volatile, an increase in the risk premium is also highly likely. Therefore, higher inflation is only a short-term solution at best, or would have to rise continuously in the long-run.

An alternative option would be the reinforcement of financial repression. This expression refers to the effort to reduce the government's interest burden. This way, in the past, real losses were practically imposed on investors via interest rate caps. This practice helped countries like the US to reduce their debt burden after World War II. Today, investors are pushed towards sovereign debt financing by means of regulatory standards requiring them to hold treasury securities either directly or indirectly via favorable risk weighting. Nevertheless, due to practically free capital markets in western states, such measures are probably not sufficient to finance, let alone curb the dramatic rise in debt ratios.

It's politics, stupid!

In the upcoming years, we expect higher inflation compared to the years before Covid-19. At the same time, governments may attempt to reduce their interest burden by means of financial repression. This may restrain the rise in debt volumes in the short-term. However, in the long-term, a debt crisis can only be averted if there is a genuine political will to conduct painful but necessary course corrections. In most countries, there are no signs of such an intention. Apparently, the situation must worsen before it can improve.

On a positive note, individual states showed signs that this willingness does exist deep down. For it to rise to the surface, both political awareness and pressure from the public are critical. This way the case in early 1990 in the US, for example. The deficit was the front and center political topic. As a consequence, the Clinton Administration implemented tax raises and curbed expenditure growth. The combination with the New Economy Boom, which boosted the tax base, made this consolidation effort so successful, that some even feared for the market to tun out of Treasuries. More recent success stories are Germany and Switzerland. Both countries imposed an effective debt break (even though the necessity of such a break has become a topic of controversy in Germany).

The current political landscape does not show signs of consolidation efforts in the near-future. As a result, deficits will remain high and the debt ratio will continue to rise in the medium-run. Politicians will attempt to further delay the inevitable course correction. Some countries may test how far they can go until their debt ratio reaches a critical point [3].

> ## Box: A warning from the UK – bond market turmoil
>
> Even the expectation that the central bank will intervene in an emergency does not rule out a financial crisis. This was demonstrated at the beginning of September 2022 when Liz Truss became British Prime Minister. During the election campaign within the party, she had promised significant tax cuts to boost the economy. As one of the new government's first measures, Finance Minister Kwasi Kwarteng announced tax cuts that would lead to annual revenue losses of around 45 billion pounds (2% of gross domestic product). In return, new debt was to be taken on. Unlike usual, no assessment of the measures was presented at the same time by the independent Office for Budget Responsibility.
> The pound depreciated significantly on the markets - falling to a historic low against the dollar - and yields on British government bonds shot up. The ten-year yield rose from 3% to 4.5% within two weeks. In order to calm the markets, the Bank of England announced on September 28 that it would purchase bonds worth £65 billion and suspended planned bond sales as part of

> the planned reduction of its balance sheet. On October 10, it announced additional purchases of inflation-linked bonds, as this relatively narrow market had come under particular pressure. However, yields only fell noticeably after the Chancellor of the Exchequer was sacked on October 14 and his successor Jeremy Hunt buried most of the plans on October 17. Three days later, Prime Minister Truss resigned. (back to text)

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[1] For better comparability, we use the general government debt ratios published by the IMF. For the US, the markets normally focus on the US federal government debt held by the public (including the Fed). This ratio amounted to 97% of GDP at the end of 2023. (back to text).

[2] The sovereign debt crisis in the eurozone in 2012 was also due to the fact that the markets were initially unsure whether the ECB would step in to assist Greece as lender of last resort. In this sense, Greece did not have its "own" central bank and suffered an emerging market crisis, so to speak. Once ECB President Draghi had dispelled the doubts by guaranteeing sufficient measures, the debt crisis was over. (back to text)

[3] IIt is not possible to say with sufficient certainty where this critical point lies. In the literature, the condition is mentioned that the present value of the expected future budget surpluses must be at least as high as the current debt level. The markets must therefore assume that the state will be able to repay the debt at some point. However, this theoretically coherent concept encounters difficulties in practical application. The result is heavily influenced by the discount factor when calculating the present value. And budget surpluses in the more distant future depend heavily on the assumptions regarding growth and inflation in the economy concerned. We therefore refrain from providing an estimate. (back to text)

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In accordance with ESMA MAR requirements this report was completed 5/7/2024 07:41 CEST and disseminated 5/7/2024 07:41 CEST.

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