

The tree of debt must stop growing

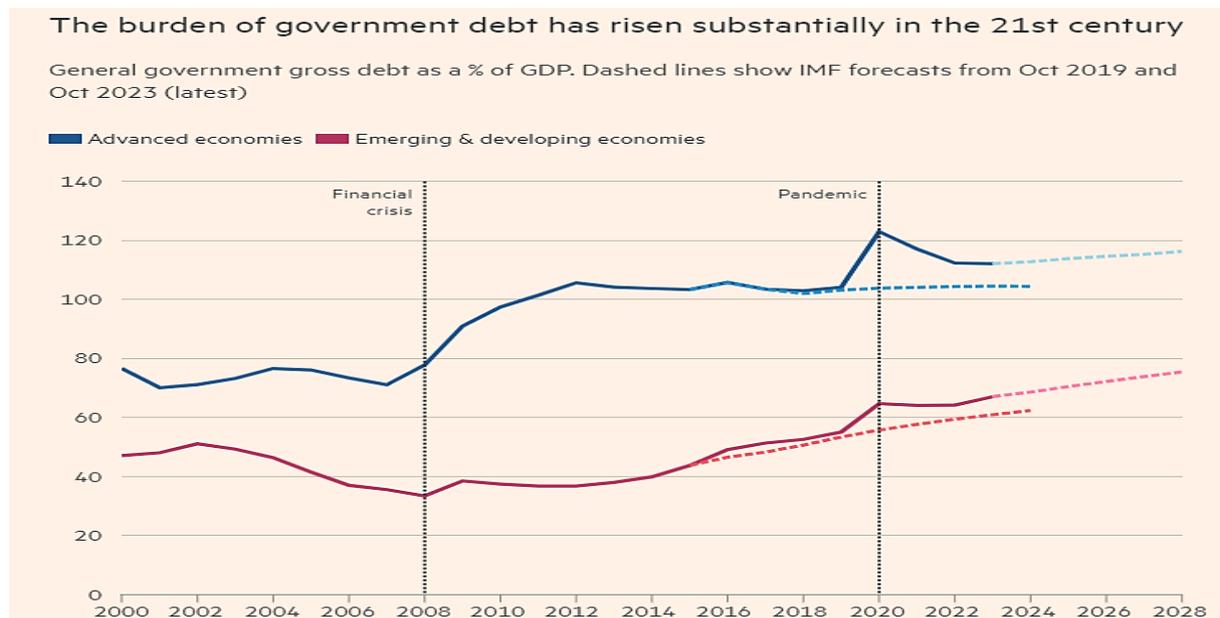
Since the era of ultra-low interest rates ended, large-scale government borrowing is looking more and more problematic

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“If something cannot go on forever, it will stop.” This is known as “Stein’s law”, after the late Herbert Stein, former chair of Richard Nixon’s Council of Economic Advisers. Stein published this in June 1989, in reference to US trade and budget deficits. They have still not stopped! But, as a German adage of similar import says, “trees don’t grow to the sky”. At some point the tree’s weight becomes unsupportable. This is also true of fiscal debt. Limits on debt exist for every economy, even one as mighty as that of the US.

In a recent blog on “The Fiscal and Financial Risks of a High-Debt, Slow-Growth World”, Tobias Adrian, Vitor Gaspar and Pierre-Olivier Gourinchas elucidate the dynamics of today’s global situation. Overall, they note, debt sustainability depends upon four elements: primary balances, economic growth, real interest rates and debt: “Higher primary balances — the excess of government revenues over expenditures, excluding interest payments — and growth help to achieve debt sustainability, whereas higher interest rates and debt levels make it more challenging.”

The global financial crisis that hit in 2007 and then the pandemic of 2020 and its aftermath caused huge jumps in ratios of public debt to GDP in high-income and emerging economies. By 2028, these are forecast to reach 120 and 80 per cent respectively. In the former case, these are the highest ratios since the second world war. In the latter case, these are the highest ever.



Debt dynamics were extremely favourable for a long time, partly due to ultra-low real rates of interest. But everything has now become more difficult. “Medium-term growth rates are”, argue the authors, “projected to continue declining on the back of mediocre productivity growth, weaker demographics, feeble investment and continued scarring from the pandemic.” Ageing directly raises public spending pressures, too. Moreover, even if, as seems likely, equilibrium short-term real interest rates — the so-called “natural rate” — fall back to low levels again, long-term real interest rates may not do so, partly because of recent jumps in the perception of risk. This “term-risk premium” has recently substantially risen.

Rising perceptions of risk have raised expected long-term real interest rates

US Treasury bond market (%)



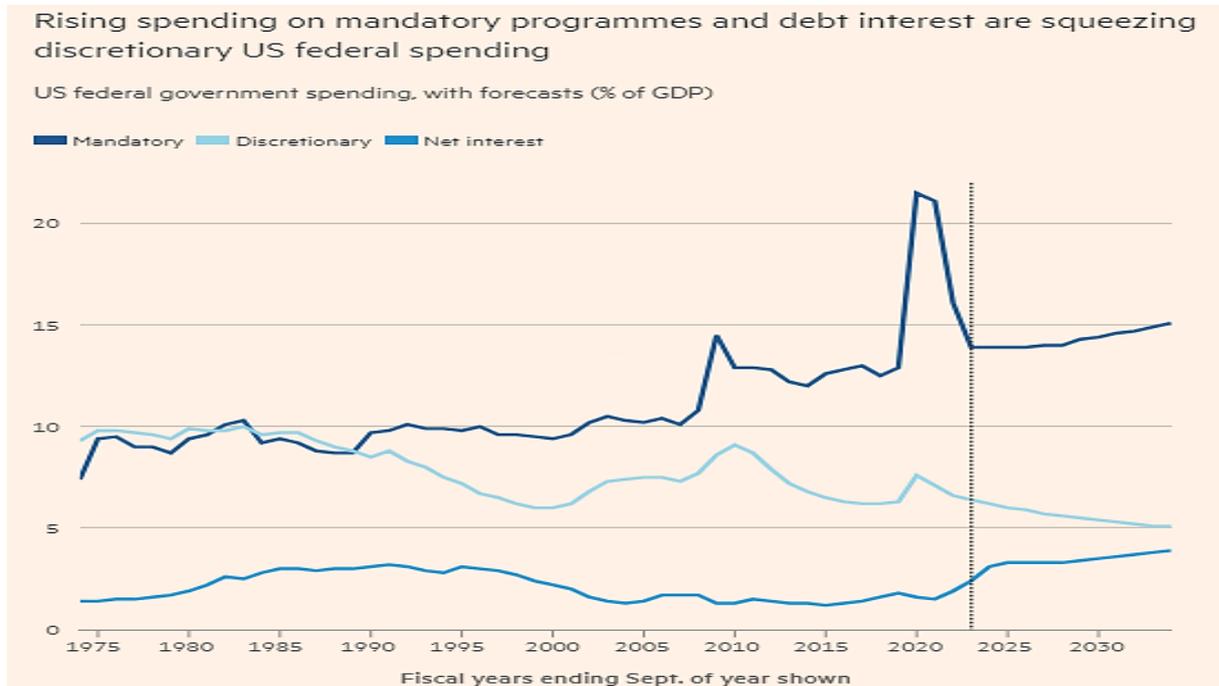
Thus, long-term real interest rates might remain high persistently, partly because of perceptions of inflation risk, partly because of quantitative tightening and partly because the fiscal deficits of many countries are expected to remain large. All this threatens to create a vicious circle in which high perceptions of risk raise interest rates above likely growth rates, thereby making fiscal positions less sustainable and keeping risk premia high. Elevated fiscal debt also worsens the threat of a “bank-sovereign nexus”, in which weak banks cause concern about the ability of sovereigns to rescue them and vice versa.

Forecasts of future economic growth have become significantly gloomier in the 21st century

IMF forecasts for GDP growth in five years' time, %

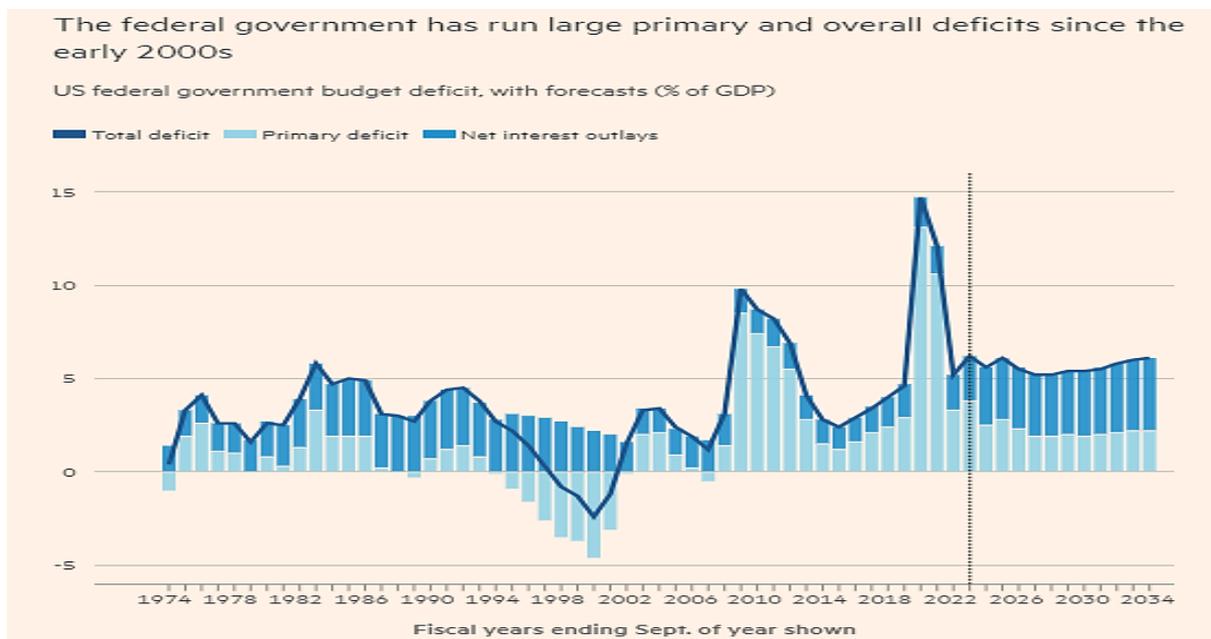


Arguably, the situation of the US is the most significant of all. In The Budget and Economic Outlook: 2024 to 2034, the non-partisan Congressional Budget Office notes that “debt held by the public rises each year in relation to the size of the economy, reaching 116 per cent of GDP in 2034 — an amount greater than at any point in the nation’s history. From 2024 to 2034, increases in mandatory spending and interest costs outpace declines in discretionary spending and growth in revenues and the economy, driving up debt. That trend persists, pushing federal debt to 172 per cent of GDP in 2054.”

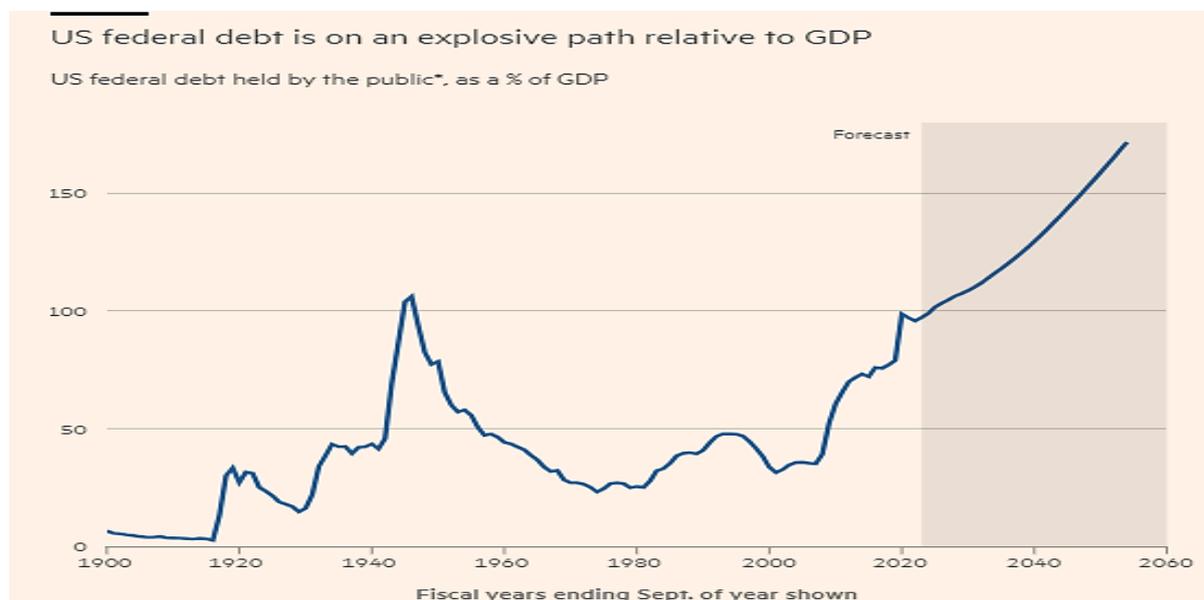


Only a brave economist could insist that this can continue forever. At some point, surely, Stein’s law would bite: investor resistance to further rises in debt would jump and then monetisation, inflation, financial repression and a global monetary mess would ensue.

Here are three relevant facts for the US: first, by 2034, mandatory federal spending is forecast to reach 15.1 per cent of GDP against total federal revenue of a mere 17.9 per cent; second, federal revenue was just 73 per cent of outlays in 2023; and, third, the primary balance has been in consistent deficit since the early 2000s. All this shows how immensely difficult it will be to bring overall deficits under control.



Crucially, politics are strongly against it. Since Ronald Reagan, the Republicans have become indifferent to balancing the budget. Their aim, instead, is lower taxes. Bill Clinton and Barack Obama made serious attempts at fiscal prudence. But this allowed George W Bush and Donald Trump to slash taxes. Democrats have now decided that scorched earth is a better strategy. Thus, both parties will happily run huge deficits — and let the future take care of itself. How long can this go on? Not forever. As the late Rudiger Dornbusch warned: “In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.”



Some economists seem to believe that the demand for a sovereign's money is infinite: so long as there is some slack in the economy, the government can keep printing. But flight from a sovereign's money can easily occur before then. Others argue that if the borrowing goes into profitable investment, it will pay for itself. What borrowing is used for does matter. But the link between illiquid assets and debt service capacity is imperfect.

Prudent sovereigns, even mighty ones able to borrow in their own currencies, cannot get away with an explosive path for fiscal debt forever. The IMF blog argues that "first and foremost, countries should start to gradually and credibly rebuild fiscal buffers and ensure the long-term sustainability of their sovereign debt". All this is wise. But the fiscal squeeze will also demand increased spending elsewhere, some of it abroad. The best approach would be to start soon, adjust slowly and co-ordinate globally. What are the chances of anything so sensible? Close to zero, alas