ECONOMICS

PUBLIC DEBT: IS THE NEXT CRISIS LOOMING?

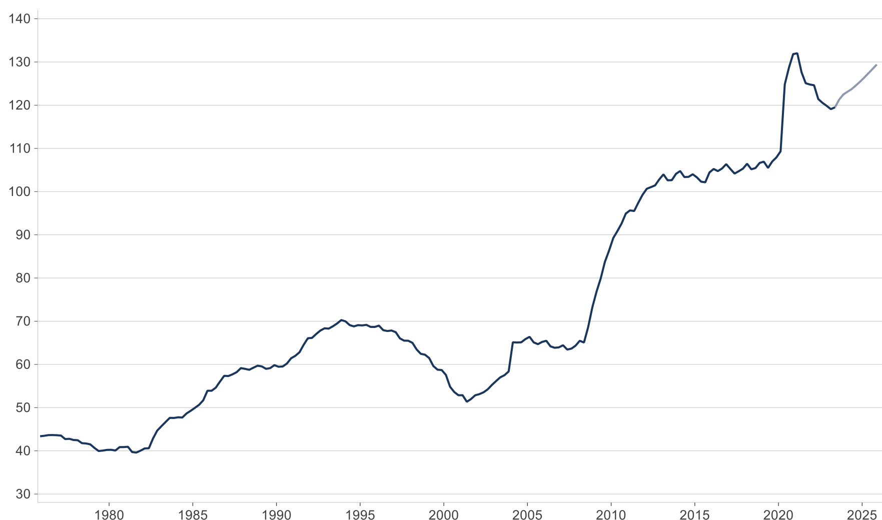
Dr. Jörn Quitzau, 14 May 2024

Debt sustainability has a lot to do with trust. There are early warning indicators for sovereign debt crises that can indicate an incipient loss of confidence. However, fiscal and monetary policy measures can override the early warning indicators by postponing the financial policy problems into the future. It is therefore difficult to predict the onset of a debt crisis. This applies in particular to the highly indebted USA.

How long can countries afford to take on debt? The answer is simple: as long as the lenders have confidence in the state's ability to repay. There is just one catch to this simple answer - no one knows when lenders will lose confidence. When confidence on the financial markets collapses, things can happen very quickly. A country that was just considered creditworthy can suddenly find itself in a debt crisis.

After the global financial crisis of 2008/09, the debt sustainability of countries was closely scrutinized. Financial markets were concerned about the sharp rise in government debt: Will countries still be able to service their debt fully on time? After initially being extremely nervous, the situation gradually eased as the central banks purchased parts of the government bonds, loosened their monetary policy and thus reduced the interest burden on governments. In many cases, however, the lower interest rates were not used to reduce debt and restructure public finances. Instead, many countries took advantage of the favorable financing conditions to take on even more debt. There was a veritable debt surge during the pandemic in particular. The debt ratios of many countries even rose above the levels seen during the financial crisis.

Fig. 1 US public debt as % of gross domestic product



Source: Macrobond. From 2024 OECD forecast

As interest rates were initially still low, many observers did not see debt as a major problem. On the contrary: as borrowing could solve many acute problems in the short term and the high public debt hardly seemed to have any negative side effects, some economists, market players and politicians declared borrowing to be a virtue. According to the so-called Modern Monetary Theory (MMT), countries with their own central bank can issue virtually unlimited amounts of money because the money needed could be provided by the central bank. Before this point of view became acceptable, however, the great inflationary surge came and put the danger of expansive monetary policy and high government debt back into perspective. High inflation also led to a rise in interest rates: in the US, interest rates on ten-year treasuries temporarily fell below 1% during the pandemic. Since then, interest rates have risen sharply, even reaching 5% at times.

Fig. 2 Yields on ten-year government bonds

Source: Macrobond

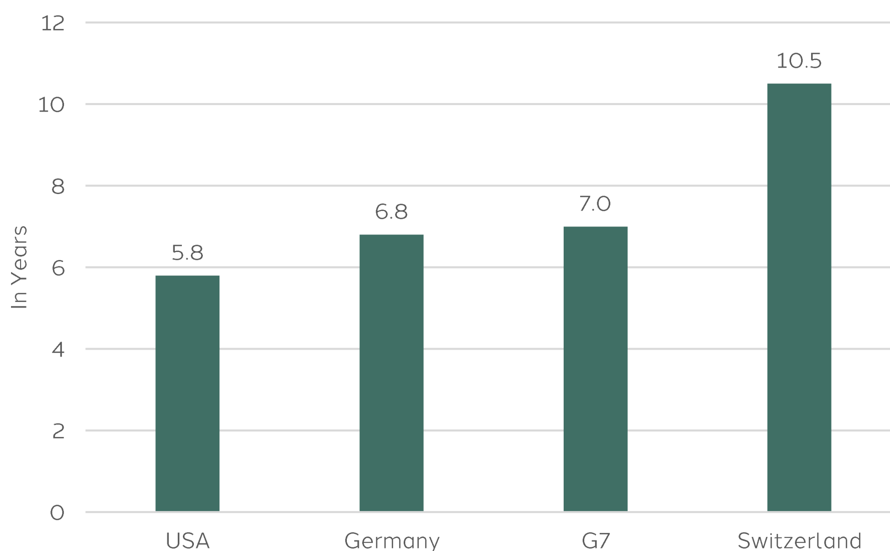
In its “Global Debt Report 2024”, the OECD pointed out that 40% of global public debt will mature in the next three years and require refinancing. The now higher interest rates will then impact these debts to be refinanced and increase the financing burden for finance ministers. How quickly the higher interest rates are reflected in public budgets depends on the maturity structure of the respective country's government debt. The shorter the remaining term of the outstanding government bonds, the faster the increased interest rates will be a burden, as the government bonds have to be refinanced at the end of their term at the now higher interest rate. Swiss government debt has a relatively long average remaining term of 10.5 years. This means that Switzerland is comparatively well protected against rising interest rates. The US, on the other hand, is much more vulnerable with an average residual term of 5.8 years (Chart 3).

Emerging and developing countries with unsound economic and financial policies are usually more at risk of falling into debt crises. Currently, however, even the major economies can no longer be safe.

Some of the world's largest economies have piled up huge mountains of debt. Japan is the lone leader with a debt ratio of around 255% of gross domestic product (GDP). With a debt ratio of around 125% and continued deficit spending, the US is no longer beyond reproach either. The question arises: How long will the financial market players be willing to finance the high debt?

As mentioned at the beginning, the time for this cannot be calculated precisely. It is a question of trust. But there are early warning signs. These include the interest that a country has to pay on loans it has taken out. The higher the estimated risk of default, the higher the lenders' interest demands. In other words, risk premiums rise, meaning that higher interest rates can be an indicator of unsound public finances. The premiums for credit default swaps (CDS) provide a similar indication. The same applies here: The greater the risk that a country will be unable to repay its debts, the higher the insurance premiums. However, neither indicator is reliable because central banks and governments can intervene in the markets and postpone emerging risks into the future.

Fig. 3 Average term to maturity in years



Source: IMF

When a central bank announces its willingness to buy up government bonds in an emergency – as former ECB President Mario Draghi once did with his "Whatever it takes" speech – the markets relax. The market players no longer need to fear that they will not be able to find buyers for the bonds of financially troubled states – after all, the central bank is ready to act as a buyer in an emergency. However, this distorts or eliminates the risk signals. This is fine if the central bank intervenes to counteract an irrational market panic. However, if the markets rightly have doubts about a state's ability to repay and therefore demand higher risk premiums, intervention by the central bank is not appropriate. It is crucial to distinguish between legitimate concerns and irrational market panic. In practice, this is not easy. The ECB might have to make this decision when it activates its Transmission Protection Instrument (TPI), newly created in 2022, to protect highly indebted countries from an excessive rise in interest rates.

Rating agencies also attempt to assess the repayment capacity of countries and issue corresponding credit ratings. The global financial crisis has shown that even the professionals at rating agencies can be wrong in their risk assessment. They underestimated the risks for too long and therefore failed to fulfill their early warning function.

In addition to such mistakes, there is another problem inherent in the system: rating agencies assess whether a country will meet its obligations on time and in full. The repayment of a loan taken out is assessed in nominal, not real terms. This means that the rating agencies only assess the probability that a country will repay the loan amount in full at the agreed time. If this amount has been partially devalued by inflation in the meantime, this does not play a role for the rating agencies.

Moreover, the ratings only indicate relative, but not absolute, probabilities of default. In the specific case of the USA, it should be noted that a US default would not be an isolated event. If the world's largest economy and the most important international financial market player were to suffer a sovereign default, this would have massive consequences for the international financial markets. Other countries would be drawn into the downward spiral. The USA is "too big to fail" and "too interconnected to fail". If the rating agencies downgrade the USA, it would be logical for them to downgrade all other countries affected by potential contagion effects as well.

The overall conclusion is that the early indicators for a debt crisis in the US are unlikely to have any impact. Should the USA one day get into serious financial difficulties, the sentiment on the financial markets is likely to change relatively quickly. The past has shown that so-called multiple equilibria are possible on the financial markets. This means that the same economic data can lead to different market results. How concerned market participants are about a certain level of debt and how high the resulting interest rates are, depends to a large extent on the confidence of the paricipants, which in turn is influenced by the dominant narratives on the market. In this respect, it is important to keep a close eye on US financial policy and form an own opinion on debt sustainability.

For the time being, however, confidence in the US does not appear to have been particularly dented, because when the world experiences crises, international investors continue to seek the US dollar as a safe haven. And should there be a loss of confidence or even a buyers' strike, the US Federal Reserve would be forced to step in again and buy up government bonds in order to push down interest rates and reassure market paticipants. This would not be a sound and sustainable financial and monetary policy approach, as it would once again increase the risk of inflation. However, inflation can reduce the burden of government debt. And in case of doubt, the USA will likely opt to inflate away its national debt rather than risk an international financial crisis.

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