Flash Economics

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What are the disadvantages of a very high level of public debt?

There is a debate among economists about the limit to the public debt ratio; for some, the examples of Japan and Italy show that this limit is high; for others, it is urgent to stabilise public debt ratios at a level that is not too high.

This raises the question of the disadvantages of very high levels of public debt.

These disadvantages may result from:

- Dependence on foreign investors if the savings rate is not high enough;
- Higher long-term interest rates if there is insufficient demand for public debt;
- The crowding out of business investment (business capital) and investment in housing, if external debt is limited;
- The high sensitivity of the economy to fluctuations in long-term real interest rates.

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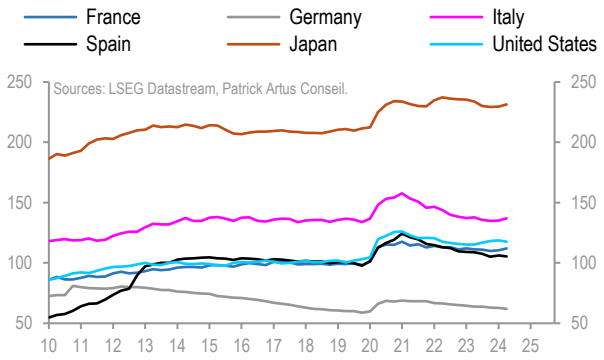
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Is public debt excessive?

In the 3rd quarter of 2024, France's public debt ratio was close to 114% of GDP.

This level of public debt is very high compared with that of Germany, similar to that of the United States and Spain, and lower than that of Italy or Japan (Chart 1).

Chart 1
Public debt (as % of nominal GDP)



Economists differ in their assessment of the desired, or desirable, level of public debt.

For some, OECD countries still have the possibility of increasing their public debt ratio without major inconvenience; for others, these countries urgently need to stabilise their public debt ratio.

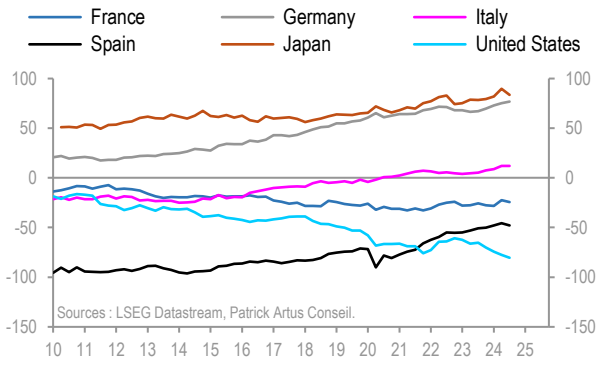
This prompts us to consider the possible drawbacks associated with a high public debt ratio.

High levels of public debt: what are the drawbacks?

1. Dependence on foreign investors

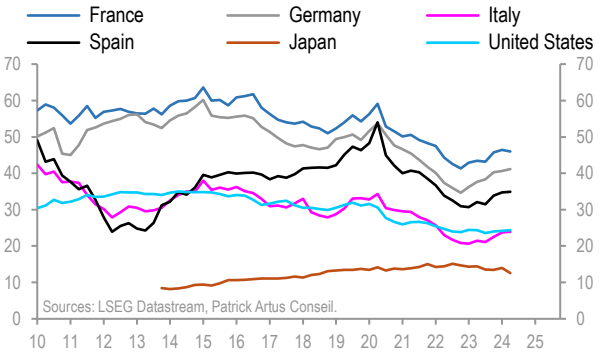
If the public debt ratio is high, and if the private sector savings rate is chronically too low, **a high level of external debt** may emerge (this is the case, for example, in the United States, Spain and, to a lesser extent, France, Chart 2).

Chart 2
Net foreign assets or liabilities (as % of nominal GDP)



This would lead to **a high proportion of non-residents holding public debt** (**Chart 3**), which would not be due to the scale of demand for the country's public securities but to the insufficiency of the country's savings in relation to its public debt.

Chart 3
Public debt held by non-residents (as a % of public debt)



Non-resident investors are likely to be less stable than domestic investors when it comes to holding public debt, which can lead to high variability in long-term interest rates.

2. Risk of a rise in long-term interest rates

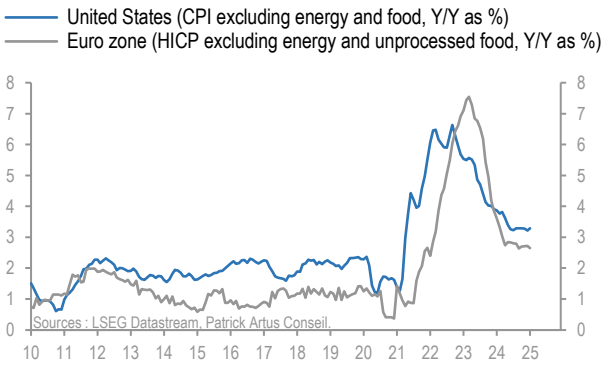
The long-term interest rate on government debt is the result of supply and demand for sovereign bonds. One can't just look at the public debt ratio, **one must look at the demand for government securities**.

Weak demand for government bonds can be the result of **rising inflation expectations**, which reduce the expected real yield on bonds, or **of doubts about the sustainability of government debt**.

In the recent period, for example, we have seen:

- An upward revision of expected inflation, in the United States but also in the euro zone, which results from the observation that underlying inflation is no longer falling: (**Chart 4**).

Chart 4
Core inflation (as %)



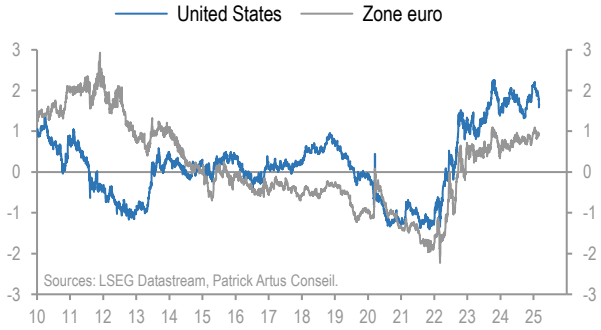
- Growing concern about the sustainability of France's debt (Chart 5).

Chart 5
France: Yield spread on country's 10-year government bonds against Germany (as % point)



The negative effects of the rise in long-term interest rates appear if it leads to a rise in long-term real interest rates, which is the case (Chart 6). **Higher real long-term interest rates slow down investment** (by companies, in housing) and make it more difficult to stabilise the public debt ratio.

Chart 6
Real interest rate on 10-year government bonds (deflated by 10-year inflation swap, as %)



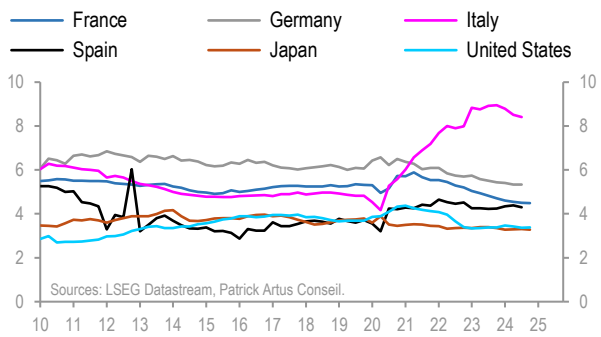
3. Risk of crowding out private investment

If a country has a limited capacity to borrow abroad (which is not currently the case in the United States, but is the case in European countries), **its stock of savings is divided between public debt and the stock of capital in the private sector**. If its public debt ratio rises, necessarily, if it cannot borrow more from the rest of the world, the capital stock of companies or the capital stock of housing is corrected downwards.

This effect of crowding out private investment can be observed:

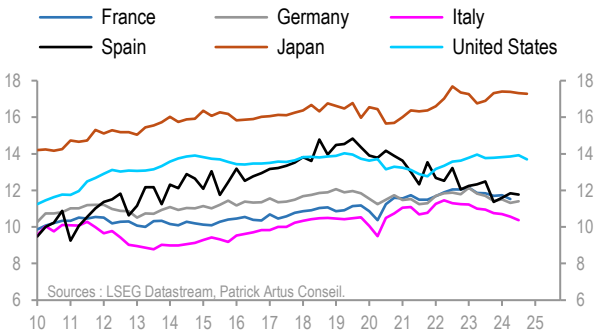
- Since 2020, everywhere except Italy, as far as investment in housing is concerned (Chart 7);

Chart 7
Household housing investment (in volume terms, as % of real GDP)



- Since 2022, in all euro zone countries, in terms of business investment (Chart 8).

Chart 8
Investment of corporations
(in value terms, as % of nominal GDP)



4. High sensitivity of the economy to fluctuations in real long-term interest rates

If the public debt ratio is high, fluctuations in long-term real interest rates (see Chart 6 above) have a greater effect on the sustainability of public debt.

If the public debt ratio is high, the same increase in the real long-term interest rate implies a greater increase in the primary budget surplus which ensures the stability of the public debt ratio.

Fiscal policy must therefore react more aggressively to changes in long-term real interest rates if the public debt ratio is high.

Summary: we have to recognise that a high level of public debt has its drawbacks

Particularly when the need for public investment is great (which is the case today with the energy transition, the digital transition and the increase in military spending in Europe), it can be tempting to allow the public debt ratio to rise.

But it should be remembered that a high level of public debt has negative consequences:

- Dependence on foreign investors if it leads to a high level of foreign debt ;
- Higher long-term real interest rates if there is insufficient demand for government securities;
- Crowding out of business investment and investment in housing if the country's external debt is limited;
- High sensitivity to changes in long-term real interest rates, especially as regards the need to generate a primary budget surplus sufficient to stabilise the public debt ratio.

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