Flash Economics

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Is the increase in public debt levels dangerous?

Many countries are facing a sharp increase or already high levels of public debt (notably the United States, the United Kingdom, France, Italy, and Japan). Should we be concerned about this rise? This increase is indeed worrisome:

- If the rise in public debt leads to an increase in external debt, with the risk that non-residents may lose interest in the country's debt (whether public debt, corporate debt, or corporate equity);
- If the rise in public debt results in a reduced capacity for businesses to invest, as public debt crowds out private capital in investment portfolios—particularly in cases of financial repression;
- Even in the absence of an abrupt crisis, if the rise in public debt leads to an increase in long-term interest rates (the term premium), pushing them above the long-term growth rate.

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Public debt levels rising or already very high

We will illustrate our analysis by examining the situations in the **United States, the United Kingdom, France, Italy, and Japan**.

These countries are **either experiencing a rise in public debt levels** (United States, United Kingdom, France, Japan) **or already have very high levels of public debt** (Italy, and Japan, which exhibits both characteristics) (**Charts 1A/B**).

Chart 1A
Public debt (as % of nominal GDP)

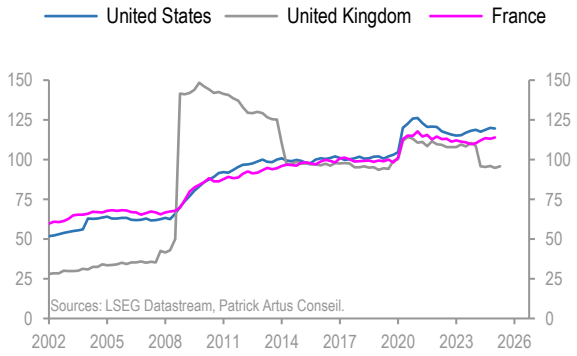
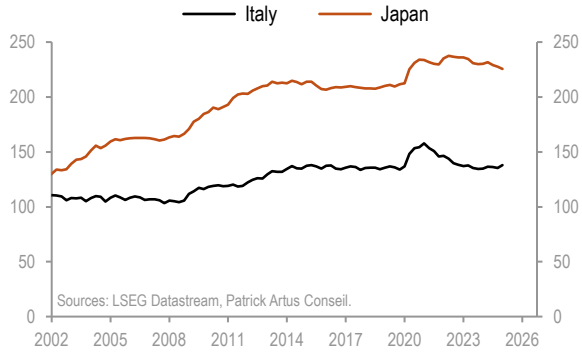


Chart 1B
Public debt (as % of nominal GDP)



There is considerable debate in financial markets regarding whether the current situation of high or rising public debt should be a cause for concern. Should we be worried about the evolution of public debt levels, and why?

First source of concern: twin deficits and twin debts

If public debt is high but primarily held by domestic investors, it is less risky than if it leads to a situation of **twin debts** (high public debt and high external debt), resulting from the **simultaneous accumulation of a fiscal deficit and a current account deficit**.

Charts 2A/B/C/D/E show the **public deficits and current account balances** of the United States, the United Kingdom, France, Italy, and Japan.

Charts 3A/B display **net external debt ratios**, which should be compared to the public debt ratios shown in **Charts 1a/b**.

Chart 2A
United States: public deficit and current account balance (as % of nominal GDP)

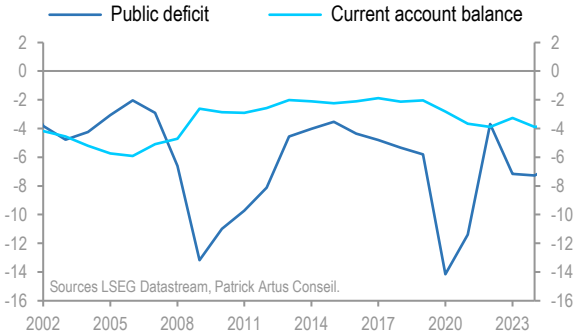


Chart 2B
United Kingdom: public deficit and current account balance (as % of nominal GDP)

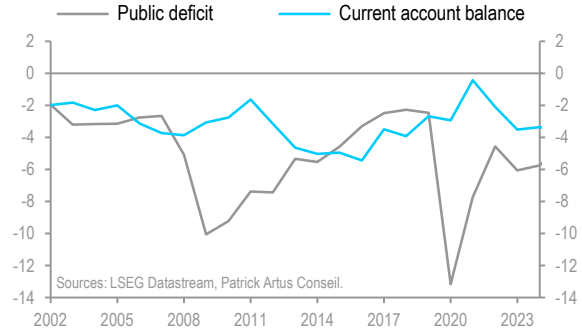


Chart 2C
France: public deficit and current account balance
(as % of nominal GDP)

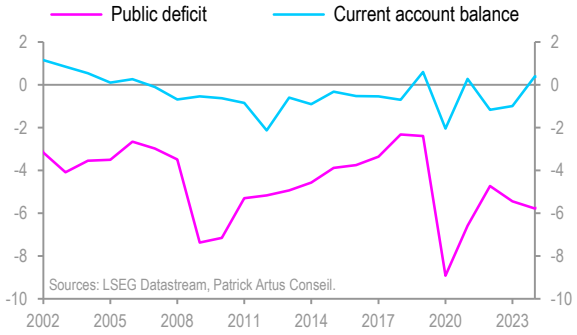


Chart 2D
Italy: public deficit and current account balance
(as % of nominal GDP)

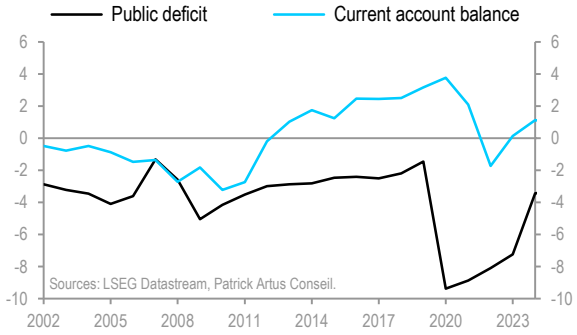


Chart 2E
Japan: public deficit and current account balance
(as % of nominal GDP)

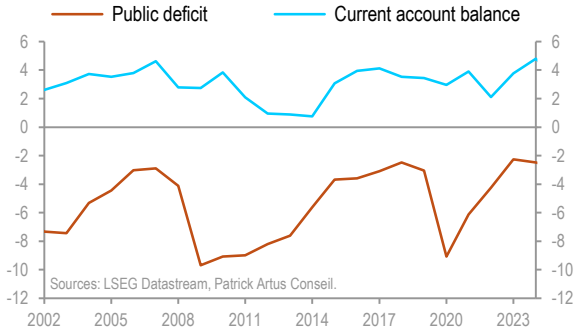


Chart 3A
Net foreign assets or liabilities (as % of nominal GDP)

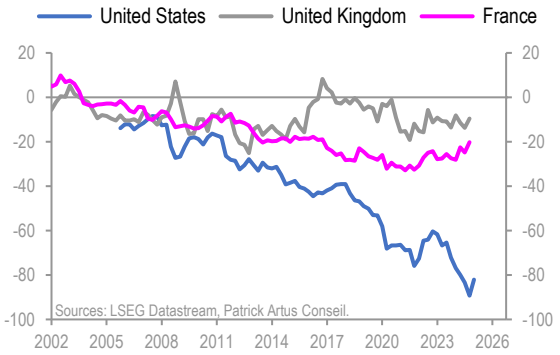
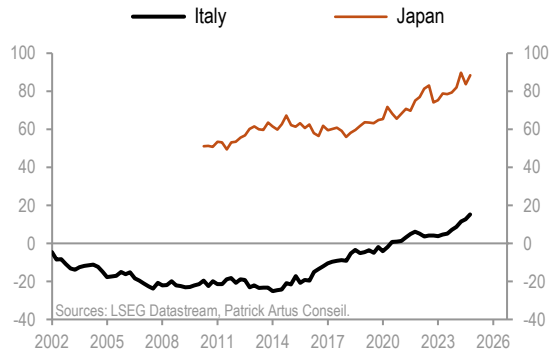


Chart 3B
Net foreign assets or liabilities (as % of nominal GDP)



We observe this situation of **twin deficits** (public deficit and current account deficit) in the **United States and the United Kingdom**, and of **twin debts** (public debt and external debt) in the **United States**.

The risk is that investment in the country's debt or other assets (notably equities) becomes less attractive, leading non-residents to reduce their holdings of the country's debt (or other assets). This could trigger both **a balance of payments crisis** (due to insufficient foreign demand for domestic assets) and **a public debt crisis** (due to insufficient demand for government bonds).

Second source of concern: crowding out of corporate investment

If public debt levels are high, investors (institutional investors, households) may prefer to hold government bonds rather than assets (corporate debt, equities) that finance business investment. If **public debt is substituted for private debt or equities in portfolios, public debt will crowd out private investment**. Where do we observe weak corporate investment rates associated with high levels of public debt (**Charts 4A/B**)?

Chart 4A
Real private non-residential gross fixed capital formation (as % of real GDP)

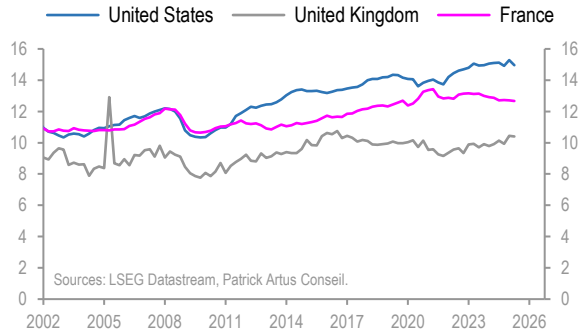
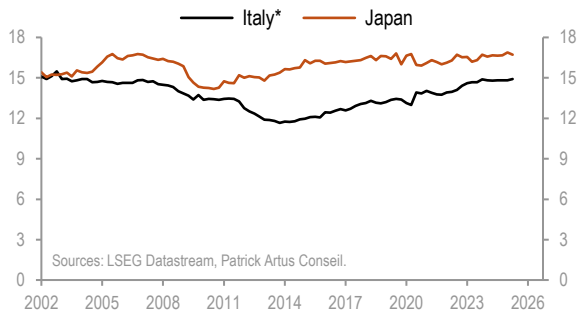


Chart 4B
Real private non-residential gross fixed capital formation (as % of real GDP)



* Italy: private non-residential and government fixed capital formation

We observe **weak corporate investment rates** in the United Kingdom, France, and Italy.

This situation is particularly likely to arise in the presence of **financial repression** — that is, policies that channel savings toward government debt instruments through favorable tax treatment or prudential regulations for insurers or banks that incentivize holding government bonds.

Third source of concern: even without a sharp crisis, rising long-term interest rates

Even in the absence of a sudden crisis (such as a rejection of government bond holdings), a high or persistently rising level of public debt can create a dangerous situation through an **increase in long-term interest rates** (a rise in the risk premium added to the interest rate when the supply of public debt is high—in other words, an increase in the term premium). It is well established that when **the long-term interest rate exceeds the long-term nominal growth rate**, the dynamics of public debt become unstable, and the country must generate a fiscal surplus to stabilize its debt ratio

Charts 5A/B/C/D/E compare the long-term real interest rate (calculated as the difference between the 10-year nominal interest rate and the 10-year inflation swap rate) with **real GDP growth** for the United States, the United Kingdom, France, Italy, and Japan.

Chart 5A
United Kingdom: Real interest rate on 10-year government bonds and real GDP



Chart 5B
United States: Real interest rate on 10-year government bonds and real GDP

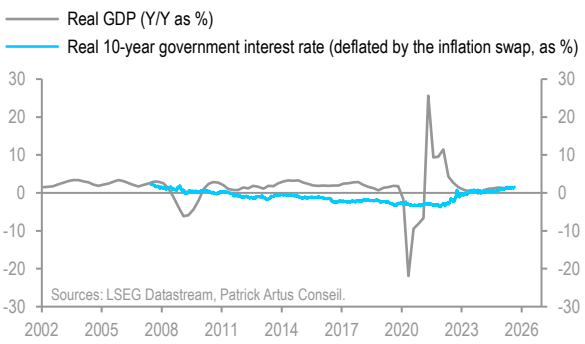


Chart 5C
France: Real interest rate on 10-year government bonds and real GDP

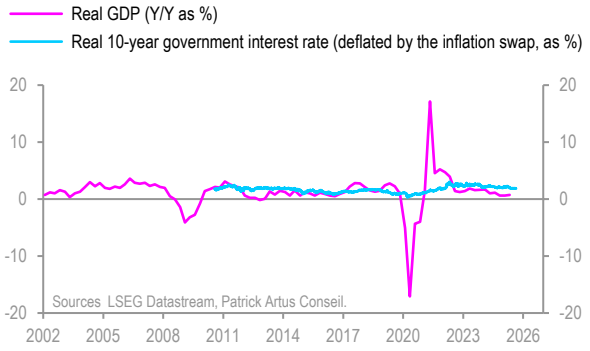


Chart 5D
Italy: Real interest rate on 10-year government bonds and real GDP

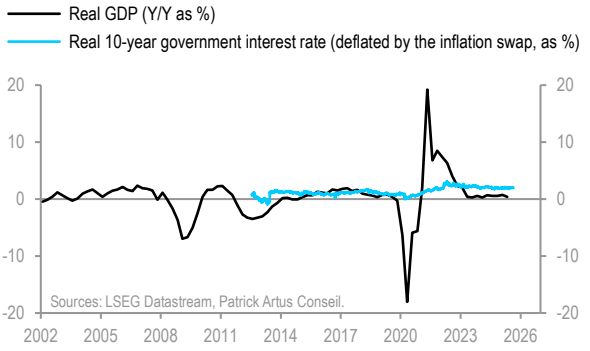
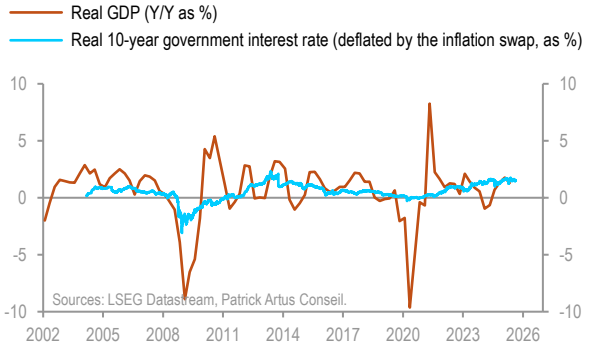


Chart 5E
Japan: Real interest rate on 10-year government bonds and real GDP



We observe that, in the recent period, **the long-term real interest rate exceeds long-term real GDP growth in France and Italy**.

Summary: in which countries should public debt not be a concern?

We have seen that a high or persistently rising public debt level should be a cause for concern:

- If it leads to increasing or high external debt (as is the case in the United States and the United Kingdom);
- If it crowds out corporate investment (as seen in the United Kingdom, France, and Italy);
- If it results in long-term interest rates exceeding long-term growth (currently the case in France and Italy).

Among the five countries we have analyzed (United States, United Kingdom, France, Italy, Japan), **the only one where none of these dangerous consequences of high public debt are present is Japan.**

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