Flash Economics

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Is public debt being crowded out?

Traditionally, the crowding-out effect works as follows: if the fiscal deficit (or public debt) is too high, the real interest rate rises and private investment falls. However, it is worth asking whether the crowding-out effect is now working in reverse. Corporate financing needs are very large, particularly to fund investment in artificial intelligence; the expected return on this investment is very high. As a result, real interest rates are rising in order to balance saving and investment ex post, but it is governments, not companies, that are facing financing difficulties.

Indeed, swap spreads (the difference between swap rates and government bond yields of the same maturity) are currently declining, as are corporate CDS spreads, which indicates that companies' financing costs are rising less than those of governments. It is therefore governments, not companies, whose spending is being crowded out most and whose creditworthiness is deteriorating.

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The traditional crowding-out effect

In its traditional form, the crowding-out effect involves the following mechanisms:

- **the fiscal deficit and public debt reach high levels**; this is currently the case, particularly in the United States, France, the United Kingdom and Japan (**Charts 1A, 1B and 2**);

Chart 1A
Government surplus or deficit (% of GDP)

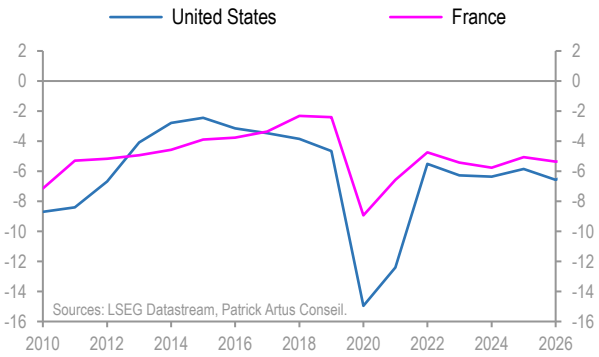


Chart 1B
Government surplus or deficit (% of GDP)

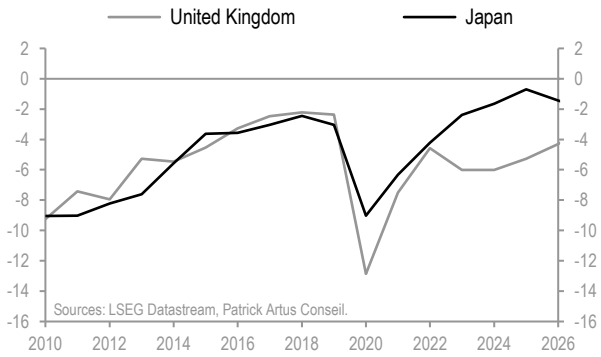
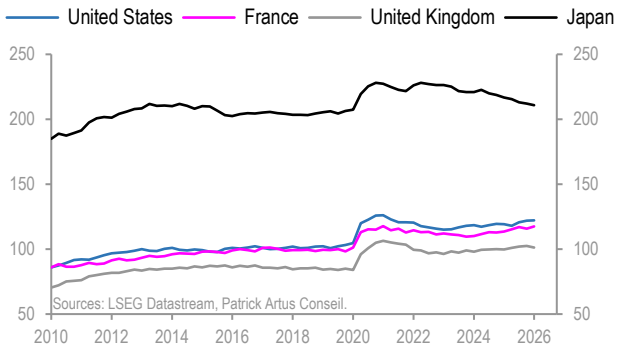


Chart 2
Public debt (% of GDP)



- as a result, **the long-term real interest rate** (which balances saving and investment) **rises**, since the fiscal deficit reduces the national saving rate (**Chart 3**);
- and this rise in the long-term real interest rate **reduces investment** (business and residential), which is currently observed only in France (**Chart 4**).

Chart 3
Real interest rate on 10-year government bonds (%)

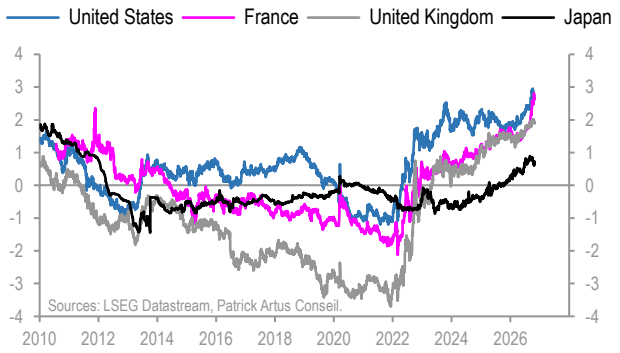
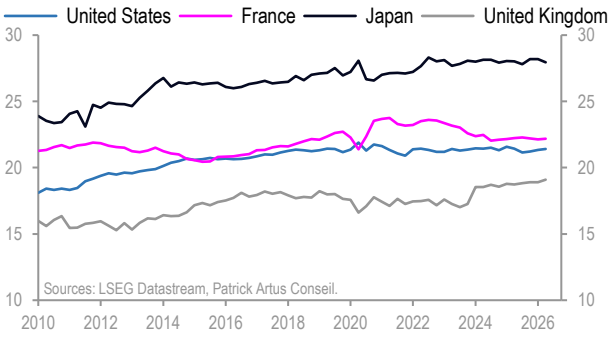


Chart 4
Investment by corporations, households and NPISHs
(% of GDP)



Note: NPISHs: non-profit institutions serving households. Corporations include public corporations.

Today, however, crowding out falls more heavily on government financing needs

In the traditional crowding-out mechanism, it is private investment that is crowded out by the fiscal deficit and public debt.

Yet investment is currently very high owing to **the considerable investment needs related to artificial intelligence**, particularly in the United States (**Chart 5**), and **the expected return on this AI investment is particularly high**.

Consequently, **the interest-rate sensitivity of this investment is low**. If saving becomes insufficient ex ante to finance investment, the resulting rise in real interest rates reduces investment only marginally and mainly affects residential investment. The rise in interest rates needed to restore equilibrium is therefore correspondingly larger, and it **mainly weakens the financial position of governments**.

It is thus the financial soundness of governments that is adversely affected, not that of companies, whose profitability is very high, particularly in the United States (**Chart 6**).

Chart 5
United States: Private fixed investment
(chained 2017 USD billion)

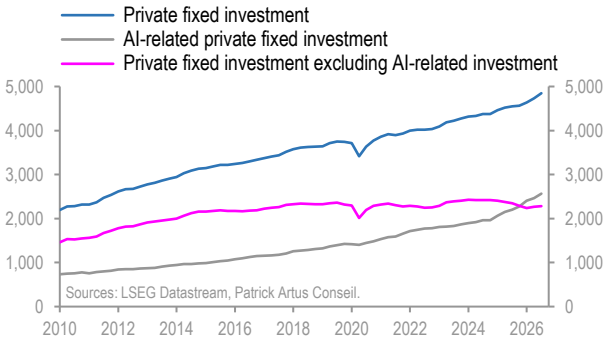
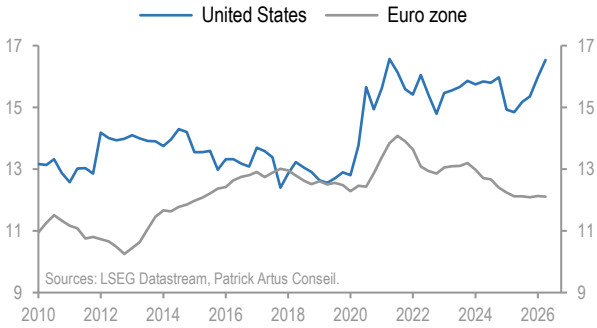


Chart 6
Profits after tax and interest of non-financial corporations
(% of GDP)



Corporate financing costs are rising less than those of governments

If corporate profitability is very high, particularly in the United States, and if governments' financial position worsens as interest rates rise, **the creditworthiness of governments should deteriorate relative to that of companies**. This is indeed the case, as shown by:

- **developments in credit spreads**: **Charts 7A and 7B** illustrate the case of Europe, where these spreads are very tight;
- **developments in swap spreads** (the difference between swap rates and government bond yields of the same maturity), which are very low by historical standards (**Chart 8**).

Chart 7A
European investment-grade corporate CDS spreads
(iTraxx Europe 10-year index; basis points)

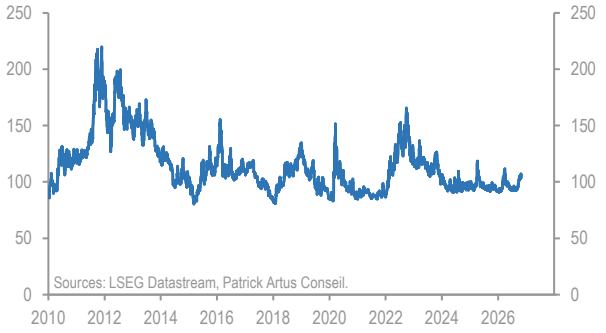


Chart 7B
European high-yield corporate CDS spreads
(iTraxx Crossover 10-year index; basis points)

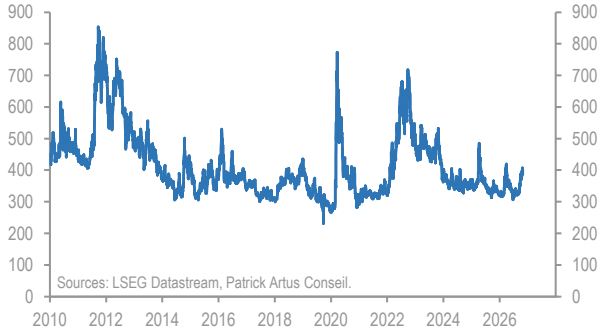
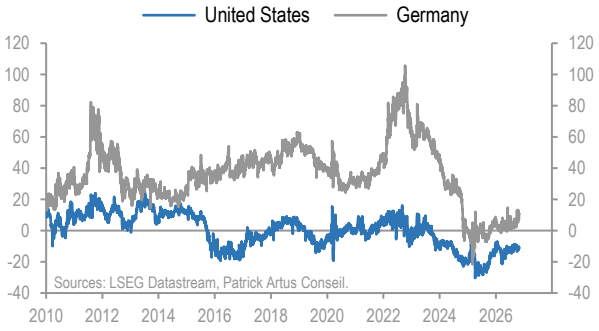


Chart 8
Spreads between 10-year swap rates and government
bond yields (basis points)



Conclusion: crowding out now mainly affects public debt

The shortfall of saving relative to investment is pushing up long-term real interest rates. This rise weakens the financial position of governments more than that of companies, whose profitability is very high. Crowding out is therefore taking place, affecting public debt more than private debt – the reverse of the mechanism usually described, whereby excessive fiscal deficits crowd out private investment.

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