Time to Revisit Government Debt?
By Eduardo Cortes, CIO
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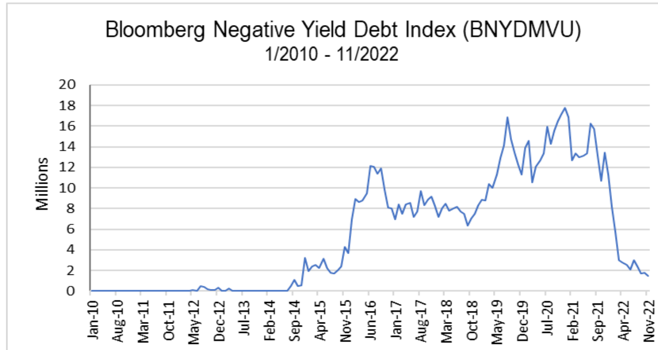
On January 5, 2023, Bloomberg ran an article entitled "World Says Goodbye to Negative-Yielding Debt as BOJ Shift Bites." The referenced BOJ shift is a change in that country's central bank's yield curve management policy which widened the range of the yields the bank would control along the curve. The last government security with a negative yield was a short-term Japanese government bond that lost its distinction on January 4. This news should be excellent for the world financial system as negative rates are highly distortionary and not reflective of a logical marketplace for the efficient allocation of resources. Toward the end of 2020, about $18.4 trillion of global government debt had negative yields (see graph). At that size, negative-yielding debt represented 27% of the debt in Bloomberg's Global Aggregate Index and a staggering 51% of Bloomberg's Global Treasury Index, which includes government bonds of developed markets and a few large, investment grade rated emerging economies, like China.

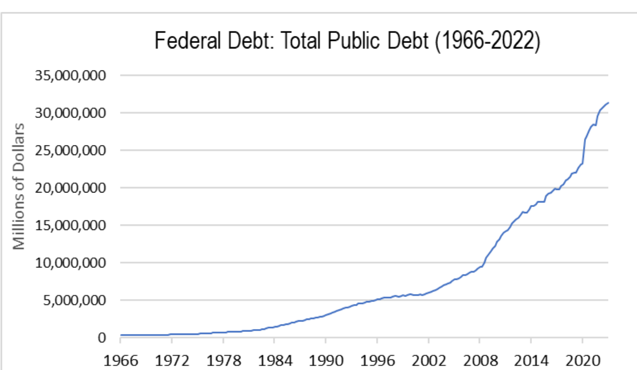


Source: Bloomberg

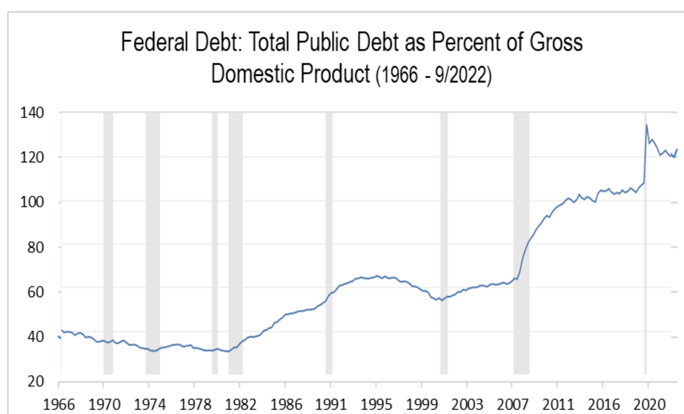
What is the problem with low or negative yields? For too long, many of the world's leading central banks subsidized their interest rate markets by keeping policy rates low and purchasing government bonds via quantitative easing. There are economists and academics who argue some economies, including the U.S. as controller of the reserve currency, can issue "unlimited" amounts of debt supported by their monetary authorities. The argument relies on the concept that the government, as an economic actor, has the role of managing development through its borrowing and monetary policy decisions. However, the logic of negative yields suggests countries or regions can live successfully in deflationary environments, a combination that does not have much supportive evidence in the annals of economic development. Furthermore, it appears the world is now facing the consequences of these flawed profligate policy decisions.

U.S. Finances

Over the last fifteen years U.S. government debt exploded from $9.2 trillion to over $31 trillion, about 8.5% growth per annum. At the end of 2007, before the financial crisis, debt to GDP was about 62% compared to over 122% now. During those years, nominal GDP grew from $14.3 trillion to $25.7 trillion, nearly 4% annually. In 2007, the effective interest rate from the federal outlay was 2.6% while in 2022 it was only 1.5%. These more recent debt costs were meaningfully below the 5.5% cost in 1990 and likely the result of the Fed's aggressive intervention.



Source: St. Louis Federal Reserve (fred.stlouisfed.org)



Source: St. Louis Federal Reserve (fred.stlouisfed.org)

It is interesting to observe that during one of the largest historical expansions of government debt, the country paid a lower rate of interest. That can be attributed to the Fed's role as a buyer of that debt, nominally due to the need to support the economy. Theories proposing the unlimited creation of money suffer from several fatal flaws, which the world is now confronting with potentially dire consequences.

A key assumption is that resources, including labor, are plentiful and available. The pandemic (along with government policy) created a deficit of labor that also interrupted the flow of goods and services. The Fed's relentless creation of money in the face of resource dislocations fueled an inflationary spiral that forced the central bank to violently alter course in 2022. The Russia/Ukraine war then ruptured another unreliable assumption of monetary expansion proponents, the existence of rational actors in the marketplace for products.

Perhaps the biggest flaw associated with the money creation concept, also termed "Modern Monetary Theory (MMT)," is that it assumes policy makers both know how to manage development, and they make choices based on the future wellbeing of their citizens. The most glaring debunking of this assumption can be summarized in three often repeated words at the end of 2021 and early 2022, "inflation is transitory!"

As we write this commentary, the Federal Government is again embroiled in a political tussle over the debt ceiling. From its frequent mention in the press, one would think this subject comes up annually. In reality, the ceiling has existed in statutes since 1917, and has frequently been subject to maneuvering and machinations. Ultimately, the U.S. cannot default on its debt so regardless of the politics, the Treasury finds a way to pay. During the last five years, the ceiling was raised five times, three "de facto" (raised after a suspension) and two by congress ahead of a suspension or government closure. It seems obvious the government must raise the ceiling and, like an unstoppable force, more debt begets more debt.

A logical question is can it stop? There is a size at which debt can become unsustainable, especially if the government runs perennial budget deficits and inflation is elevated. Taking 2022 as an example, inflation was 6.4%, interest rates rose along the curve causing the government additional interest expense of about 3.0% on new issuance, and the federal government ran a deficit of around 5.4% of GDP. These figures can be considered to have occurred in an exceptional year, although social security and cost of living adjustments (COLA) for government programs will increase by 8.7% in 2023. Adjusting to "normalize" conditions, and assuming the Fed succeeds in its effort to reduce inflation to its target of 2.0%, interest costs can be estimated to be about 3.5% on the debt. The federal deficit can be expected to decline to 3.0% of GDP as additional programs get watered down in a divided congress. With debt exceeding 100% of GDP, this means debt will grow annually by at least 6.5%, an amount that in most years far exceeds the rate of GDP growth. This implies that without additional taxes, which are contractionary, or meaningful expenditure reductions, debt would grow out of control.

Non-U.S. Finances

After the 2008 financial crisis, Europe and Japan held the bulk of the negative yielding debt. Sluggish economies and particular local market characteristics enabled monetary authorities to set policy rates below zero and, with the help of quantitative easing, have government bonds trade at negative yields in the open market. Japan has been cited by MMT advocates as an example of a high debt, active monetary policy, and low inflation country that provides supportive evidence for the theory. Unfortunately, the country's paltry growth rate over many years does not deliver an equally ringing endorsement. The country has the highest debt to GDP amongst developed nations at well over 200%, a characteristic that unquestionably dampens its ability to grow.

In the Euro Area, debt to GDP is close to 100% with meaningful differences among countries. Perennial deficit countries like Greece and Italy manage ratios well above 100% and find themselves permanently at the mercy of the Euro Area for support. It is amusing to observe the failure of the Euro Area's formation agreement that sought budgetary deficit containment at low and manageable levels for every member. Many countries' inability (or deliberate disregard) to meet their commitments forced the remaining members, via communal organizations like the European Central Bank, to bail them out. Like the U.S. with the debt ceiling, a flawed premise must be perpetuated to avoid a globally destabilizing breakdown.

In emerging economies, the concept of unlimited debt and money creation has been demonstrated to be a repeated abject failure. Defaults and inflation abound amongst countries that indebt themselves and/or pursue monetary expansion. Once again, advocates of debt and money creation are forced to impose conditionality on the characteristics of economies that pursue this approach to growth and development. This implies the high debt, high money creation theory of economic management applies only to some, and certainly not to those with the biggest need of development. Conditionality becomes a very challenging limitation in the formulation of economic policy.

The Covid-19 pandemic had enormous repercussions well beyond its impact on health and social mores. The explosion of government debt and money creation to address the virus occurred at a time when the world was still vulnerable from recent economic crises. Inflation's resurgence and the damage to financial markets in 2022 provide a glaring warning against ignoring the limits of government intervention in free markets. Ultimately, distortions lead to unintended consequences and the outcome of flawed policy may be harder to recover from than the problem that was originally being addressed. With massive amounts of debt, the world's governments have lost policy flexibility making it imperative that decision-makers begin to address their debt levels. For the U.S., the assumption that buyers will always exist for its mountain of debt might be challenged sooner than expected.

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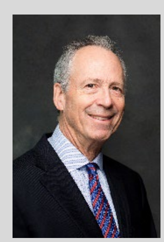

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