REALTIME ECONOMICS

If markets are right about long real rates, public debt ratios will increase for some time. We must make sure that they do not explode.

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November 6, 2023 10:30 AM

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Across advanced economies, the celebrated (r - g), i.e., the difference between the interest rate and the growth rate, appears to have durably changed sign or, at a minimum, to have gone from a substantially negative number to a number closer to zero.

It is fair to say that, while economists expected the short end of the yield curve to reflect the higher rates needed to win the fight against inflation, the sharply steeper long end of the yield curve in the last few months has come as a surprise. I shall freely admit that I did not predict it. (Neither did options markets, which, until recently, put a zero probability on long rates being what they are today.)

Even after the fact, it is still not clear what is behind this increase in long rates: Increases in the term premium, and if so why? Unusually large flow supply and low flow demand due to quantitative tightening? A decrease in the proportion of price-insensitive bond buyers? Stronger sustained household demand? Higher expected potential growth due to generative AI? We do not really know.

Thus, it is not unreasonable to conclude that some of the factors underlying the recent increase are transitory and that long real rates will come down. Most of the factors that economists concluded had contributed to the long pre-COVID decline do not appear to

have turned around dramatically. But the fact is that long rates are high today, and ministers of finance must finance their budgets at those rates and cannot bet the house on such a decrease.

When (r - g) is equal to zero, the dynamics of the ratio of public debt to GDP become straightforward: If the government runs a primary deficit, the debt ratio increases. If it runs a surplus, it decreases. At this juncture, nearly all advanced economies are running primary deficits, many of them in the range of 2 to 4 percent. Thus, once current debt has been refinanced and the average interest on debt reflects the higher long rates, absent changes in policy, debt ratios will increase.

Put another way, stabilizing the debt ratio implies reducing primary deficits to zero. For both economic and political reasons, there is no way governments can do this quickly. A drastic, immediate consolidation would most likely be catastrophic, both economically in triggering a recession, and politically, by increasing the share of votes going to populist parties.

So, how fast can advanced-economy governments realistically consolidate? Some earlier policy measures, put in place to protect firms and households against COVID disruptions, and, more recently, large increases in the price of energy, can indeed be terminated. While this will help, it will, however, not be enough to close the deficits. More needs to be done.

The strong turn to fiscal austerity, which took place from 2010 to 2014 in Europe and is widely seen today as having been too quick, impeding the European recovery, should serve as a cautionary tale. Add to this the additional spending needed to reinforce defense and increase public green spending. It is clear that the adjustment must be steady but equally clear that it has to be slow. Starting from a 3 percent primary deficit, absent happy surprises, it may well take close to a decade to reach balance, and thus stabilize debt.

A small detour in the argument and a potential conundrum: A fiscal consolidation faces two challenges. First, the need to cut popular programs, or increase unpopular taxes. Second, the risk of a sustained contraction in aggregate demand, generating higher unemployment. The second can in principle be alleviated, if not offset, by more accommodative monetary policy. But this in turn suggests lower interest rates in the

future as the fiscal contraction takes place. One may wonder whether this is consistent with the current beliefs of investors of high interest rates in the future. In other words, one may wonder if the current higher long r does not contain the seeds of a lower r in the future.

Going back to the main argument: Achieving the required path of sustained fiscal consolidation will not be easy. For investors to believe in it and not ask for a higher spread, there has to be a credible plan, with specific measures either on the spending or the tax side to achieve it. But, even under such a scenario, the debt ratio will increase so long as primary deficits have not been eliminated.

Such an increase is inevitable (unless long interest rates decrease again, in which case we return to a world where debt stabilization allows for some primary deficits, and the adjustment can slow down or stop all together). It is not good, but it is not catastrophic. I have argued elsewhere that the evidence suggests that advanced economies can sustain a higher debt ratio, so long as it is not exploding.

What must indeed be avoided at all costs is debt explosion, which would occur if primary deficits just did not go away. Thus, putting the previous arguments together, the right plan is a credible plan of steady primary deficit reduction, but accepting the fact that the debt ratio will increase for some time, and stabilize at a higher level.

Turning to the European Union, and the current discussion of how to reform fiscal rules, this argument implies that, while the rules must enforce debt sustainability, any further requirement that the debt ratio actually decreases over some limited horizon is likely infeasible in a number of countries. If such a rule is introduced, it will either be breached, at the cost of credibility of the new rules, or lead to catastrophic economic and political outcomes, not to mention a likely squeeze on badly needed public green investment.

Turning to the United States, where the primary deficit is around 4 percent and (r - g) looks positive at this point, the challenge is even stronger. And, given the current budget process dysfunction, one must worry that the adjustment will not take place any time soon. Thus, the debt ratio is likely to increase for quite some time. We have to hope that it will not eventually explode.