CAPITAL ECONOMICS

GLOBAL ECONOMICS UPDATE

The fiscal implications of the rise in bond yields

- **Perceptions matter at least as much as actual policies in determining fiscal stability. Accordingly, the surge in bond yields over the past month poses the greatest risk to those countries where the government's commitment to fiscal rectitude over the medium term is in question.**
- **The rise in bond yields will obviously push up governments' debt interest costs.** This comes against a backdrop of QE effectively shortening the average maturity of government debt and increasing the speed with which higher interest rates are reflected in debt interest costs (given that long-term government debt has essentially been replaced by central bank reserves carrying a floating interest rate).
- **As an illustration of the magnitudes involved, estimates from the US's CBO and UK's OBR suggest that each 1%-pt rise in short- and long- term interest rates will raise government borrowing in 2024 in both countries by the equivalent of 0.5% of GDP.** The impact on annual borrowing rises as more debt matures; by 2027, for example, it reaches 0.7%-0.8% of GDP.
- **The key question is whether this rise in interest costs threatens the fundamental sustainability of government debt.** Debt sustainability is a woolly term, but it is generally taken to mean that the debt to GDP ratio is on a stable (or downward) path, which in turn will generally mean that financial markets remain willing to lend to governments at a low premium. **Whether the recent rise in bond yields compromises this sustainability depends on whether this rise persists and what is driving it.**
- If we are right in thinking that policy rates will be cut more quickly and sharply than markets expect – and that markets have got a bit carried away with the "higher for longer" narrative – then yields should reverse some of their recent increase. (See here.)
- **However, not all of the rise is likely to be reversed, not least because financial markets now seem to think that the equilibrium level of real interest rates has risen and/or will rise further.** To the extent that this reflects higher expectations for economic growth, this does not matter for the debt outlook, as it increases both the "r" and the "g" in the interest-growth differential that is key to debt dynamics. (For more detail, see here.) But markets might also think that a change in the balance of desired savings and investment has increased real interest rates by more than it has raised potential GDP growth, leading to a less favourable differential. (We will be exploring the implications of higher equilibrium interest rates for public sector debt sustainability in an upcoming longer piece of work.)
- **A further reason to worry is that the most recent rise in yields seems to have been driven more by higher term premia than by policy rate expectations.** (See here.) This rise could be for all sorts of reasons, from a more volatile inflation outlook to a reduction in EM appetite for DM assets. **But rising fiscal concerns could also be to blame, particularly in the US.** Although the risk of outright default is low for those developed economies that issue debt in their own currency and can print their own money, that still leaves the possibility of "default" by other means, including by financial repression or inflation.
- **It might seem puzzling that markets have chosen now to get concerned; after all, the CBO's projections have for years shown the US debt ratio to be on a long-term upward trajectory. But a couple of factors could have ignited fiscal worries.** The first is the possible shift in view about equilibrium interest rates. The second is that fiscal deficits in many countries are still so high, even with economies remaining resilient and pandemic-related effects having largely washed out. In fact, Italy recently revised *up* its budget deficit forecasts. And primary deficits are set to remain relatively high for now (see here). In the US, in particular, where the primary deficit this year is projected to be equivalent to about 5.5% of GDP, there is little prospect of any meaningful tightening in fiscal policy soon. (See here.)
- **If it is true that markets are getting nervous about governments' fiscal positions, then there is the risk of falling into a downward spiral.** Markets worry about government debt, which raises term premia and

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interest rates, which makes the debt situation even worse and makes markets even more concerned. **Perceptions are as important as reality here.** We have pointed out before that there can be "multiple equilibria"; a given level of debt can be both sustainable (if markets remain relaxed and risk premia and yields remain low) and unsustainable (if markets get concerned and interest rates rise). (See here.)

- Indeed, most fiscal crises over the past five years or so have been caused by a belief in markets that the government in question has lost, or is losing, fiscal credibility. This has not always been the result of a change in actual policy, so much as a belief that the government's commitment to fiscal rectitude has waned. **The crisis that followed in the wake of Liz Truss's disastrous "Mini-Budget" in the UK last year is a good example of this.**
- We don't think that a fiscal crisis is imminent either in the US or anywhere else. **Nonetheless, financial markets seem to be indicating they have a limited tolerance for fiscal profligacy** – a stark contrast with the years before the pandemic when the low level of interest rates was almost viewed as giving governments the green light to borrow as much as they wanted.
- **On the face of it, the US would seem to be at high risk of losing financial market confidence.** Chart 1 shows the primary budget balance of G7 economies on the vertical axis and the difference between interest rates and nominal GDP growth on the horizontal axis. (We have calculated the latter using the average of 5-year bond yields this month and our estimate of potential nominal GDP growth currently.) Countries that sit furthest towards the bottom right of the chart have the shakiest fiscal dynamics, with the US seemingly in a relatively poor position.
- **However, countries face significantly different room for manoeuvre depending on their political and institutional constraints.** The US benefits from issuing debt in the world's reserve currency, while a high domestic savings rate has allowed Japan to sustain a much larger public debt ratio than other advanced countries. In contrast, being part of a monetary union without full fiscal union puts more of a straightjacket on euro-zone governments.
- **Accordingly, it is France, the UK and Italy** (see here) **that are arguably in the most vulnerable positions.** On the basis of the current r-g differential, all are running primary deficits that are incompatible with keeping debt to GDP ratios stable. (See Chart 2.) That is likely to remain the case even if bond yields fall back somewhat as we expect. All of these countries plan to reduce their deficits over the next few years. **So, if a fiscal crisis is to develop in any of these countries soon, it is most likely to be because markets sense a weakening in these commitments.**

Chart 1: Debt Dynamics for G7 Countries

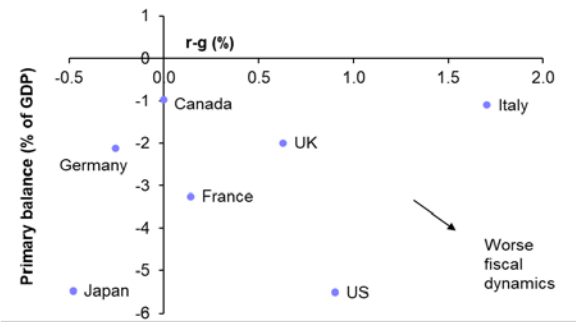
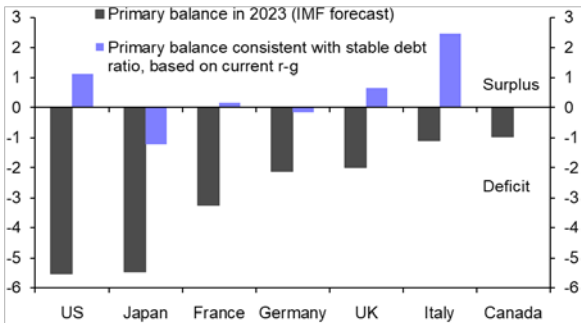


Chart 2: Government Primary Balance (% of GDP)



Sources: Refinitiv, IMF, OBR, CBO, Capital Economics

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