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Near-Record Sovereign Debt: Cyclical Savior and Potential Risks

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Near-Record Sovereign Debt: Cyclical Savior and Potential-Residual Risks

Global sovereign debt has soared in the past fifteen years, rising from 63% of GDP in 2007 to 103% in the middle of this year[1]. In this report we discuss the following: (i) Why we believe the most recent buildup in sovereign debt was warranted. (ii) The principal macroeconomic risks related to current public debt levels and how they have evolved vis-à-vis their private-debt counterparts. (iii) We respond to four questions concerning the preeminent-macroeconomic risks associated with the near-record sovereign debt levels. (iv) Lastly, we discuss whether life insurers could be the new shadow banks, a latent risk and possible "unknown unknown" of which investors should be aware.

The four macroeconomic questions / issues that we address are following:

- **Effect of Increases in Sovereign Debt on Inflation and Inflation Expectations?**
- **Effect of Sovereign Debt Levels on Growth Rates?**
- **Effect of Interest Rates on Sovereign Debt Sustainability?**
- **Risks Related to China's and Other EM Debt Burdens?**

Turning first to why we believe investors and the world at large have reaped considerable benefits from the recent surge in global sovereign debt. Extraordinary fiscal stimulus has played a pivotal role in facilitating the global economy's exit from the Great Financial Crisis (GFC) in 2009 and its emergence in 2020 with consumers and businesses in relatively strong financial positions from the brief, albeit severe, pandemic recession. The unprecedented rise in global sovereign debt over the past fifteen years undoubtedly embodied some less-than-optimal programs and excesses. But its invaluable contribution to restoring the global economy to health at two very worrisome points in time overshadows these shortcomings.

Much has changed since 2007 when the subprime mortgage meltdown -- the canary in the coal mine for the GFC -- surfaced. Household debt is in a relatively sound position currently. In the decade following the GFC consumers rebuilt their balance sheets, and they accumulated record savings during the pandemic recession. Legislators and regulators around the world have tightened policies and appear to be moving toward an enhanced macroprudential framework to foster continuing stability. Global bank capital has increased significantly, and US banks are now required to take stress tests regularly.

Business debt is high currently but cash on corporate balance sheets is also elevated and there are few signs of stress. Moreover, a recent comprehensive empirical study -- which covered a hundred-plus- year period and seventeen advanced countries -- found that the world's bankruptcy and reorganization process is

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[1] Sovereign debt statistics quoted in this report are from the May and September 2022 reports of the Institute of International Statistics which were published in recent JPM reports

efficient. Growth in corporate credit has not affected the likelihood or severity of a subsequent recession[2].

Against this background, public debt levels at the present time are giving rise to some significant macroeconomic questions. One principal concern, at least for the advanced economies, relates to the possible collateral damage such as accelerating inflation and/or slowing growth that might stem from near-record sovereign debt levels. The situation is more nuanced for China where the distinctions between public and private debt are ambiguous and for EMs at large where the possibility of outright default is material in some cases.

Turning now to our four pressing questions / issues related to the potential macroeconomic-risks associated with near-record sovereign debt levels:

Effects of Recent Stimulus on Inflation and Inflation Expectations

A key insight of Keynesian economics which helped the world exit the great depression of the 1930s and has been taught in macroeconomics classes for the past seventy-five years is that fiscal stimulus when applied judiciously in an economy that is operating below capacity will not generate inflation. The post GFC experience was exactly in line with the textbook model. Inflation remained contained[3], despite a 14%-point jump in the global debt-to-GDP ratio between the spring of 2008 and the summer of 2009.

At first glance the substantial global fiscal stimulus --18%-points of GDP between year-end 2019 and 1Q 2021 -- employed to combat the pandemic recession and the subsequent inflationary surge that we're currently experiencing may not appear to conform to the textbook model. However, when we take account of the supply-related distortions that surfaced as the global economy emerged from the pandemic recession — severe demand-supply imbalances, commodity shocks, bottlenecks, and supply- chain breaches — it is difficult to ascribe much of latest inflationary surge to fiscal excesses. Some prominent economists, however, such as Larry Summers contend that one possible exception is the nearly $2 trillion stimulus package that was passed in the US in March 2021 when the economy was well on the road to recovery.[4]

Policymakers and investors also must be concerned about the possible effects on the inflation expectations of fiscal policies that raise demand above supply. Markets are forward-looking and expectations can respond instantly and violently to perceived significant changes such as the so-called "mini budget" recently proposed in the UK by the Truss Administration. Following the 23 September announcement of a budget perceived to embed sweeping- unfunded tax cuts: UK bond yields surged, the sterling depreciated to its lowest level since 1985[5], and the Bank of England had to intervene to stabilize markets.

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[2] "Zombies at Large?" Corporate Debt Overhang and the Macroeconomy", Oscar Jorda et al, FRB of NY, December 2020

[3] Current survey and market data indicate that long run inflation expectations, albeit up from recent lows, are still relatively contained. U of M's September consumer survey: one-year ahead inflation expectations 4.6% and five-year ahead 2.8%. Early October 5-year / 5-year forward market-based inflation expectations: US 2.22%, Germany 2.05%

[4] "How Did They Get Inflation So Wrong?", James Surowiecki, The Atlantic, June 2022

[5] Initial Assessment of New Sweeping UK Stimulus Plans, Parth Purohit, SECOR, September 2022

Markets were seemingly accepting of the recent episodes of counter-cyclical fiscal stimulus[6]. But the announcement of significant permanent tax cuts -- not accompanied by a credible plan to fund them or an independent budget review -- generated considerable market turmoil. Although Mrs. Truss has resigned and her policies are largely being reversed, the markets sudden and dramatic responses to the announcement of far-reaching policies that were deemed to be inflationary highlight the importance of expectations.

Effects of Sovereign Debt Levels on Growth Rates

The net effects on near-term growth of the recent buildup in sovereign debt incurred by the major advanced countries to exit the pandemic recession appear to be positive, albeit probably small in aggregate. Increased digitalization and other work-related improvements that have been implemented in response to the pandemic appear to be giving a lift to productivity[7]. At the same time, however, with interest rates rising from historic lows, increases in debt servicing costs[8] may largely offset the benefits of higher productivity growth.

For advanced countries that can issue debt in their own currencies the risk outright default is not a particularly relevant issue. But assessing the impact on longer-term growth is relevant, albeit difficult. Carmen Reinhart and Ken Rogoff in a popular 2009 book presented their empirical research which indicated that when advanced countries penetrate a 90% debt-to-GDP threshold their median growth rate declines by 1%. Unfortunately, shortcomings in Reinhart and Rogoff's analysis -- which include the omission of interest rates – that were uncovered by prominent academics call into question the applicability of their conclusions, particularly for the current period[9].

Accurately measuring the long-term effects of an increase in debt on growth requires assessing the merits of the programs that the debt funds. Will they enhance or restrain future growth? How will future interest rates affect debt-servicing costs? Funding projects such as an interstate highway system, a break-through vaccine, or creating a transformative educational environment can reap benefits that surpass their costs by a wide margin. However, funding pork barrel or even worthwhile projects with debt rather than increasing taxes or offsetting reductions in other expenditures can transfer

[6] Debt financed increases in government spending will increase aggregate demand, but so long as aggregate demand does not exceed supply inflation should remain contained

[7] "Productivity Pullback Signal vs Noise", Spencer Hill et al, Goldman Sachs, September 2022.GS economists estimate that working from home and increased digitalization across a breadth of industries helped US productivity increase at a 1.6% pace since 2019, up from a 1% pre-pandemic rate.

[8] Budget and Economic Outlook, Congressional Budget Office, May 2022. CBO's latest estimates assume US debt costs will only rise from 1.4% of GDP in 2022 to 1.6% in 2024. Key assumptions: weighted average maturity 5.5 years, 3-month rate rises from 0.6% to 2.1%, 10-year rate rises from 2.1% to 3.0%. "Extra Policy Tightening…", Jennifer McKeown, Capital Economics, September 2022. CE economists' current terminal rate assumptions: 5% for UK, 4% - 4.75% for US, and 3% for Euro area.

[9] This Time Is Different: Eight Centuries of Financial Folly, Carmen Reinhart and Kenneth Rogoff, 2009. Prominent scholars including Bradford DeLong, Larry Summers and Paul Krugman have criticized the book for excluding key variables such as interest rates and basing their conclusions on correlation rather than causation. Technical errors were also uncovered by researchers at the University of Massachusetts. "Risks of Debt: The Real Flaw in Reinhart-Rogoff?", J. Bradford DeLong, Project Syndicate, April 2013.

the burden of servicing the increased debt to future generations and slow growth. In fact, debt servicing costs are likely to become a more pressing issue as interest rates rise from their historic lows.

In our opinion, the increased sovereign debt over the past fifteen years is more likely to restrain than enhance growth over the next decade and perhaps beyond. Given that the bulk of the recent stimulus was designed to shore up deteriorating economies rather than to fund productivity-enhancing programs, we believe that the negative impact on future debt service costs is likely to exceed any positive impacts on growth.

Effect of Interest Rates on Debt Sustainability

The impact of interest rates on debt sustainability is an important complement to the foregoing discussion of the impact of debt levels on growth and a topical issue. In fact, prominent academics including Olivier Blanchard, Larry Summers and Jason Furman have recently indicated that low interest rates could be providing an opportune time to issue sovereign debt. Blanchard in an article published in a prestigious economic journal in 2019[10] noted that when: "…safe interest rates are expected to remain below growth rates for a long time… the issuance of debt without a subsequent increase in taxes — may well be feasible". When interest rates are below nominal GPD growth rates relative debt burdens will decline over time. Summers and Furman in a 2020 paper argued that with real debt service costs below 1%, issuing public debt could be attractive[11].

Much has changed, however, since these articles were published. With the current yield on 10-year Treasuries above 4% and considerable uncertainty about future rates, the case for rates remaining low for longer is less compelling than four years ago. Some of the key points that Blanchard made in a follow-up 2022 article appear to be particularly relevant for our current discussion[12]. We agree with his contention that debt service-to-GDP ratios would be a better measure of debt sustainability than the widely used debt-to-GDP ratios. Measuring a government's ability to cover its current debt service costs, however, is only a first step. The outlook for a country's future growth and interest rates should also be considered to assess debt safety.

As we transition from a low-rate-for-longer environment to a higher rate and less certain one, it might be helpful to look briefly at the high implicit and explicit costs borne respectively by Japan and Greece, the two countries with the highest debt-to-GDP ratios. Japan's government debt-to-GDP ratio of ~235% is the highest among some 130 countries monitored by the Institute of International Statistics and more than double the OECD average. With the yield on 10-year JGBs currently at an ultra-low 0.25%, it might appear that Japan's outsized sovereign-debt level is a virtual free lunch. However, when we consider who owns these JBGs, it is readily apparent that the government and domestic investors are bearing the lion's share of the costs. The Bank of Japan owns over 40% of the outstanding JBGs and spends trillions of yen to maintain a ceiling on Japan's borrowing costs, while the domestic financial institutions and

[10] "Public Debt and Low Interest Rates", Olivier Blanchard, American Economic Review, April 2019.

[11] "A Reconsideration of Fiscal Policy in an Era of Low Interest Rates", Jason Furman & Lawrence Summers, Hutchins Center & Peterson Institute, December 2020.

[12] "Deciding When Debt Becomes Unsafe", Olivier Blanchard, Peterson Institute—Finance and Development, March 2022.

investors who own much of the balance of the JBGs are earning below-market yields on their investments.

Greece's current debt-to-GDP ratio of 175% is the second highest in the world. In contrast with Japan, the considerable costs of Greece's debt excesses -- at least in hindsight -- are readily apparent. After adopting the euro in 2001, Greece's large deficits fell under the market's radar screen until the government belatedly disclosed that its deficit (which reached 15.6% in 2011) was far higher than anyone realized. This news set off a virtual earthquake for Greece's economy, its populace, and its creditors. The yield on Greece's government bonds surged to nearly 30%, EU-IMF bailouts followed, unemployment reached a 27% rate, wages and pensions fell, and debt write downs were necessary. Greece's economy is currently stable and slowly recovering but its populace has suffered a great deal due to their government's debt excesses[13].

Risks Related to China's and Other EM Debt Burdens

China's government debt-to-GDP of ~75% significantly understates its potential liability and the challenges facing its policymakers as they work to reduce the country's huge property debt burdens. Due to demographics and overbuilding the property sector -- which accounts for ~25% of GDP -- is currently experiencing considerable weakness[14]. Three points related to China's property sector should be highlighted in our discussion of the country's debt burdens[15].

One, the government explicitly guarantees the deposits at domestic banks, the principal source of capital for mortgages and developers. Thus, China's private and public sector property debts are virtually synonymous. Two, China's government and consumers appear to be in solid financial positions currently. The government has a strong balance sheet and controls the land supply for the property sector. Consumers have saving rates > 40% and put high down payments on their property purchases.

Three, China needs to reduce dependance on its property sector. This reorientation is expected to result in further developer defaults and to be a major headwind for China's economy for years to come. Repositioning investment from property to a less congested and more productive sector or sectors will take time and growth is likely to slow in the interim. In our opinion, the most likely scenario calls for China avoiding a debt crisis and a systemic recession as it navigates the transition.

Concerns about debt risks for EM economies at large are bifurcated currently. Some large countries such as Brazil, Mexico, South Africa, Indonesia, and Malaysia appear to be well positioned. They have instituted reforms including floating currencies, large reserves, inflation targets, and most of their debt is in local currency[16]. At the same time, however, IMF economists warn that about 60% of low-income countries are now in or at risk of distress due to

[13] "The Greek Debt Crisis – No Easy Way Out", Peterson Institute, 2020

[14] Property sales were down 23% y/y in the first seven months of this year. Evergrande's default has curtailed financing for other developers. Twenty-six listed developers have defaulted or sought concessions (CEIC, Wind, UBS)

[15]: "Could the Property Downtown Be China's Minsky Movement?", Tao Wang et al, UBS, September 2022. Principal source for three points cited and the data referenced in the above footnote(12).

[16] "Is an EM Debt Crisis Coming?", Simon Weaver, Morgan Stanley, August 2022

rising rates and sharp increases in energy and food prices[17].

Possible "Unknown Unknown"

As seasoned investors who have lived through many financial crises including the GFC we are well aware of the following: (i) Failure of regulators to stay abreast of financial innovations can pave the way for a financial crisis. (ii) Significant reforms aimed at increasing bank capital and assuring that liquidity will be maintained in future periods of stress can materially reduce the risk of financial crises. (iii) Astute investors are aware that unknown unknowns -- though generally rare -- are possible and should not be dismissed out of hand.

Against this background, we should reiterate that we believe our base-case outlook for public and private debt discussed in this opinion piece is well supported and represents the most-likely-future scenario. With higher interest rates, debt servicing costs will increase, and private debt default rates may edge up as the growth slows. But with the global growth expected to approximate 2.5% in 2023 versus ~3% in 2022, the expected growth headwinds will be seemingly modest, manageable, and not likely to become systemic risks.

With respect to an "unknown unknown," we should note that shadow banking can come in many different forms including UK pensions' uses of repos for LDI funds, China's property debt markets, and perhaps US life insurers — a topic that has been referenced in a recent SSRN[18] paper. The authors note that US life insurers and their private equity partners are deploying insurance liabilities to enter the corporate loan market that has been largely vacated by commercial banks in the aftermath of the GFC. In a worst-case scenario such as the 2007-09 global recession, widespread defaults, or downgrades -- particularly for CLOs (collateralized loan obligations) exposures – could force life insurers to assume significant balance sheet losses and they could be vulnerable to a liquidity crisis.

The aforementioned-potential vulnerability of US life insurers should be closely monitored. However, the important differences between the current and the pre-GFC macroeconomic backdrop should also be considered. In this regard, we believe that the heathier financial position of the private sector[19] in particular --- which could mitigate the economic weakness in face of new shocks -- calls for monitoring rather than precipitous action at this time.

Final Thoughts

The rapid rise in global sovereign debt to unprecedented levels in recent years is providing much food for thought. It has helped the world exit two severe world recessions. Now as interest rates rise from their historic lows servicing costs will edge up and provide another potential headwind for the global economy. However, apart from low-income countries that may require international assistance, sovereign debt burdens appear manageable currently and

[17] "Dangerous Global Debt Burden Requires Decisive Cooperation", Vitor Gaspar et al, IMF, April 2022

[18] "Are Life Insurers the New Shadow Banks?", Nathan Foley-Fisher et al, SSRN, June 2021.

[19] "US: Private Sector Finance Still Healthy", Spencer Hill, Goldman Sachs, October 2022. GS economists note that GDP statistics indicate a balanced financial account currently, compared to deficits of 2% to 4% preceding the '01 – '02 and '07 – '09 recessions. Household current surplus is 2.2% of GDP and nonfinancial corporate sector surplus is 0.6% of GDP

their discernible effects on inflation and growth appear limited.

Our two principal takeaways for policymakers and investors are: One, the macroeconomic backdrop should be considered in assessing the future safety of sovereign debt. Much of the rapid buildup in recent years took place when many of the world's major economies were operating below potential and interest rates were at historically low levels. Similar fiscal stimulus in a more typical macroeconomic environment might not produce a benign outcome. Two, simple rules-of-thumb such as debt-to-GDP ratios for evaluating sovereign debt risk leave a lot to be desired. To assess sovereign-debt safety appropriately, a country's ability to access capital for servicing its debt in different economic environments should be considered.

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