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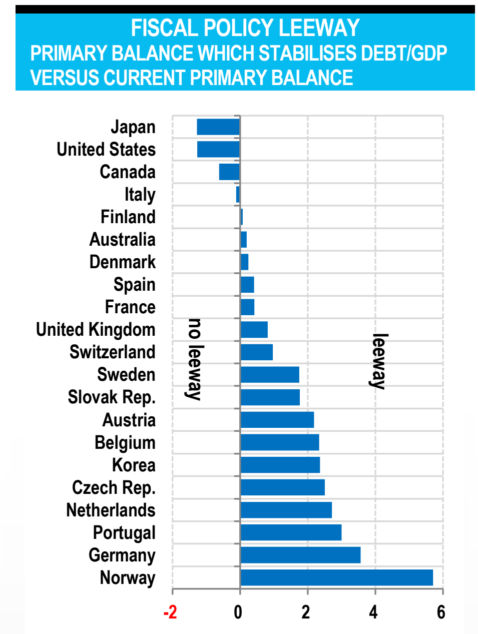
Growth, interest rates and government debt

■The relationships between government debt, economic growth and interest rates are complex and varied ■In general, a recession causes an increase in government debt and a decline in government borrowing costs ■A prolonged period of monetary accommodation during a cyclical upswing can cause the average nominal interest rate on government debt to drop below the rate of nominal GDP growth ■Depending on the level of the primary balance, such a situation can, under certain conditions, create leeway for fiscal expansion in order to support growth

The relationships between government debt, economic growth and interest rates are complex and varied. Recessions tend to cause a jump in government debt in absolute terms and as a percentage of GDP, but the ensuing monetary easing leads to a decline in government borrowing costs. Highly indebted countries however can suffer from investor distrust, which leads to a rise in the required risk premium and hence bond yields. A prolonged period of monetary accommodation during a cyclical upswing can cause the average nominal interest rate on government debt (r) to drop below the rate of nominal GDP growth (g). This is what has happened in recent years in a large number of countries. In a recent speech, former IMF chief economist Olivier Blanchard has elaborated on the policy leeway provided when r<g[1]. In that case, a country can afford to run a permanent primary deficit (which corresponds to the general government deficit excluding interest charges) and yet have a stable debt/GDP ratio. When r<g and the primary deficit is smaller than the critical level (i.e. the level at which the debt ratio is stable), it follows that the debt/GDP ratio will decline. In that case a country has leeway to conduct a fiscal expansion which would bring the primary balance to its critical level. Such a policy should boost growth in the short run. Faced with lacklustre private demand, this could make a considerable difference to growth: the fiscal multiplier could be big, although this also depends on the openness of the economy. It would also reduce the risk that low or negative growth has lasting adverse supply-side effects via a decline in capital formation. Fiscal expansion could also play a key role to complement monetary policy when it is constrained by very low interest rates.

Applying this thinking, a back of the envelope calculation[2] shows that in many countries, r is below g, which, taking into account the current primary balance, offers quite some leeway (chart). Of the bigger countries, Germany is in that position, whereas the UK and France only have limited leeway. Italy has none and, interestingly, the US primary deficit is already too high to stabilise the debt ratio. The argument can be made however that with r<g, the increase of the debt/GDP ratio would be very slow if the primary deficit would increase beyond its critical level. In addition, a low appetite for riskier assets (equities, corporate bonds, etc.) during a recession would mean that the borrowing requirement could be easily met without pushing yields higher. For countries which already have a high debt/GDP ratio, this argument may not hold and rising bond yields could limit the effectiveness of fiscal expansion[3].

FISCAL POLICY LEEWAY
PRIMARY BALANCE WHICH STABILISES DEBT/GDP VERSUS CURRENT PRIMARY BALANCE



Source: BNP Paribas calculations based on IMF data

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[1] Olivier Blanchard, Peterson Institute for International Economics and MIT, Public debt and low interest rates, American Economic Association Presidential Lecture, Jan. 2019.
[2] The calculations were based on data from tables A2, A7 and A23 of the statistical appendix of the IMF's Fiscal Monitor (April 2019). The difference between r and g corresponds to the IMF's projection of the interest rate–growth differential for the period 2019-24. In order to simplify the calculation, the primary balance which, given r and g, generates a stable debt/GDP ratio has been calculated based on the requirement of instantaneous stabilisation of the debt ratio
[3] This would be an illustration of the Lucas critique which states that economic relationships change when economic policy changes.

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