PUBLIC DEBT: WHEN THE US SNEEZES THE WORLD CATCHES A COLD

According to the IMF's latest Fiscal Monitor, between 2023 and 2029, many advanced economies are projected to see an increase in their public sector debt to GDP ratio. The US ranks second in terms of increase of the public debt ratio (+ 11.7 percentage points of GDP). Administration and Congress will have no other option than to structurally reduce the budget deficit. However, the challenge will be huge given the unpopularity of tax increases, the difficulty of cutting expenditures and the major headwinds of rising interest charges and, in the medium run, slower GDP growth. Whether the US manages to bring its public finances under control also matters for the rest of the world, given the central role of the US Treasury market and the US dollar in the global financial system. Persistent high budget deficits could exert upward pressure on long-term interest rates in the US and abroad, thereby weighing on growth. It could also cause a depreciation of the dollar.

The IMF's latest Fiscal Monitor offers sobering reading. Between 2023 and 2029, many advanced economies are projected to see an increase in their public sector debt to GDP ratio (*chart 1*). Within the Eurozone, between 2023 and 2029, the largest increase in percentage points (pp) of GDP is expected in Slovakia[1] (14.6 pp), Estonia (11.6 pp), Belgium (11.1 pp) and Finland (10.5 pp). Italy (7.6 pp), Luxembourg (5.6 pp), the Netherlands (5.4 pp) and France (4.5 pp) are also projected to see a significant increase[2]. Clearly, the economic importance of such a development - including possible concerns about debt sustainability -, depends on the initial debt level. On the other hand, former crisis countries are expected to make huge progress in terms of debt reduction: Greece (-30 pp), Cyprus (-27.4 pp), Portugal (-22.1 pp), Ireland (-11.2 pp). Germany should also see a decline in its debt ratio (-6.6 pp).

Amongst the advanced economies, the US ranks second in terms of increase of the public debt ratio (+ 11.7 pp). This projection is based on the February 2024 Congressional Budget Office baseline, adjusted for IMF staff's policy and macroeconomic assumptions. Basically, the CBO supposes expenditures and revenues will evolve in line with what is scheduled under current law -typically until 2034- and thereafter grow in line with nominal GDP[3]. Under these assumptions, the CBO estimates that the public sector deficit would average 6.7% of GDP between 2024 and 2054 and reach 8.5 percent of GDP in 2054. Consequently, debt held by the public would reach 116% of GDP in 2034, 139% in 2044 and 166% in 2054. These numbers could trigger a reaction of incredulity. Given the scale of the deterioration of US public finances, fiscal policy will have to adjust by structurally reducing annual deficits, meaning that these debt ratios should never be reached.

However, the challenge will be huge. A structural reduction of the budget deficit would probably require a combination of both tax increases -which are politically unpopular- and spending cuts -equally unpopular and difficult. However, mandatory spending - 13.9 percent of GDP in 2024- is expected to rise steadily, driven by the cost of major health care programs on the back of rising health care costs per person and population ageing. Scaling these back will be a complicated effort.

GENERAL GOVERNMENT GROSS DEBT (IN % OF GDP)

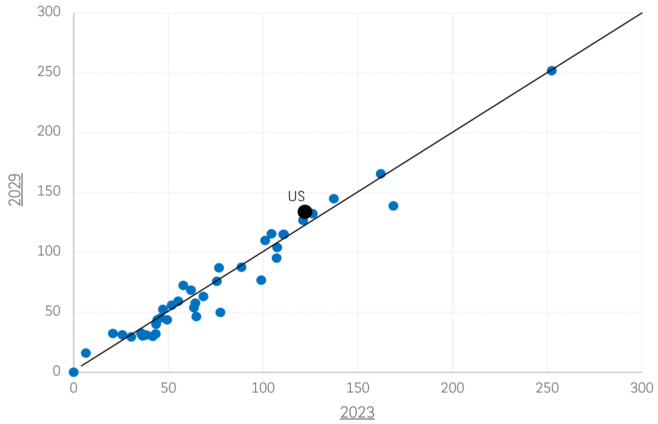

CHART 1

SOURCE: IMF, FISCAL MONITOR (APRIL 2024), BNP PARIBAS

The same also applies to discretionary spending, which represents a smaller share of GDP - 6.2 percent in 2024 - and "*includes most defense spending and spending for many nondefense activities, such as elementary and secondary education, housing assistance, international affairs, the administration of justice, and highway programs*." Finally, net interest charges are projected to more than double—from 3.1 percent of GDP in 2024 to 6.3 percent of GDP in 2054, driven by rising debt and the refinancing of the outstanding debt at a higher interest rate[4]. Moreover, the evolution of real GDP growth won't help either. It is expected to slow down from 2.0% between 2024-2034 to, on average, 1.6% thereafter due to slower growth of the labour force as well as labour productivity.

Whether the US manages to bring its public finances under control also matters for the rest of the world, given the central role of the US Treasury market and the US dollar in the global financial system.

1 Slovakia also has the biggest debt ratio increase of all advanced economies.
2 In the Eurozone, this is expected to be the case for Belgium, Estonia, Finland, France, Italy, Luxembourg, Malta, the Netherlands and Slovakia. On the other hand, Croatia, Cyprus, Germany, Greece, Ireland, Latvia, Lithuania, Portugal, Slovenia and Spain should see a decline in their debt ratio whereas in Austria it should remain stable. Depending on the country, these projections are based on the latest budget, medium-term plans, IMF staff assumptions and, for EU countries, the stability programme.
3 For a more detailed explanation of the assumptions, see Congressional Budget Office, The Long-Term Budget Outlook: 2024 to 2054, March 2024.
4 This doubling of interest charges occurs even though the CBO's interest rates assumptions are not aggressive. It assumes a nominal (real) 10-year Treasury yield in a range between 4.1% and 4.3% (1.8% - 2.1% in real terms) between 2024 and 2050.

Persistent high budget deficits could exert upward pressure on Treasury yields. The IMF has calculated that a temporary 1 percentage point increase in the US primary deficit -the budget balance excluding interest charges- is associated with a rise in the term premium of about 11 basis points in the quarters that follow[5]. One should assume that a permanent increase in the primary deficit would have a lasting impact on bond yields, thereby influencing financing conditions of the private sector as well. This would probably weigh on longer-term GDP growth and would complicate matters in terms of debt/GDP dynamics[6].

In addition, there would be spillover effects to other advanced economies as well as to emerging and developing economies. According to the IMF, "*a 1 percentage point spike in US rates is associated with a rise in long-term nominal interest rates that peaks at 90 basis points in other advanced economies, with a persistent impact over many months*"[7].

For emerging market economies, the impact is even bigger, with a peak increase in long-term interest rates of 100 basis points. Interestingly, the IMF also finds an adverse impact on long-term interest rates abroad of US fiscal policy uncertainty, such as the debt ceiling and government shutdown 'cliff-hangers' that have become more frequent in recent years.

Finally, absence of progress in terms of public finances could end up weighing on the appetite of foreign investors to buy US Treasuries and US assets more generally. This would weaken the dollar and could put upward pressure on inflation and interest rates in the US, thereby complicating the budgetary consolidation effort. To conclude, for domestic as well as international reasons, it's important to put the objective of healthy public finances high on the political agenda.

William De Vijlder

GENERAL GOVERNMENT GROSS DEBT (IN % OF GDP)

	2023	2029	change (2029 minus 2023)
Andorra	36.4	30.3	-6.1
Australia	49.4	43.8	-5.6
Austria	75.5	76.0	0.4
Belgium	104.5	115.6	11.1
Canada	107.1	95.4	-11.8
Croatia	63.5	54.0	-9.5
Cyprus	77.4	50.0	-27.4
Czech Republic	44.2	43.9	-0.3
Denmark	30.4	29.6	-0.8
Estonia	20.7	32.4	11.6
Finland	76.7	87.2	10.4
France	110.6	115.2	4.5
Germany	64.3	57.7	-6.6
Greece	168.8	138.8	-30.0
Hong Kong SAR	6.5	16.1	9.6
Iceland	64.8	46.5	-18.3
Ireland	43.3	32.1	-11.2
Israel	61.9	68.5	6.5
Italy	137.3	144.9	7.6
Japan	252.4	251.7	-0.6
Korea	55.2	59.4	4.2
Latvia	43.5	40.2	-3.3
Lithuania	35.6	32.7	-2.9
Luxembourg	25.7	31.3	5.6
Malta	51.8	55.9	4.2
Netherlands	47.2	52.6	5.4
New Zealand	45.9	45.4	-0.5
Norway	41.8	30.0	-11.8
Portugal	99.0	76.9	-22.1
Singapore	162.1	165.6	3.5
Slovak Republic	57.9	72.4	14.6
Slovenia	68.5	63.4	-5.1
Spain	107.5	104.2	-3.3
Sweden	35.9	31.4	-4.5
Switzerland	38.3	31.1	-7.2
United Kingdom	101.1	110.1	9.0
United States	122.1	133.9	11.7

TABLE 1 SOURCE: IMF, FISCAL MONITOR (APRIL 2024), BNP PARIBAS

5 Source: IMF, Fiscal Monitor, April 2024. To the extent that a higher primary deficit would not influence the expected path for the Federal Reserve's policy rate, the increase in the term premium would correspond to the increase in Treasury yields.
6 This refers to the well-known debate about r-g with r = average interest rate on the stock of public debt and g = nominal GDP growth.
7 *Our own calculations show an economically significant but more limited impact as far as German Bund yields are concerned. See: US versus the eurozone: inflation divergence causes monetary desynchronization and lowers bond market correlation*, BNP Paribas, Ecoweek, 22 April 2024.