

Sujet traité : Quelle crise de la dette? / What Debt Crisis?

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What Debt Crisis?

There has been general apprehension about the U.S. government’s fiscal condition – specifically, the dramatic increase in the budgetary deficit and public sector debt in recent decades, a trend that many are worried is unsustainable. Many fiscal critics often warn about the “day of reckoning” and argue that rising “fiscal risk premium” (FRP) will eventually wreak havoc on the U.S. bond market and the economy. The problem with this argument, however, is that no one has ever proven that this so-called FRP ever existed in the U.S.

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Where Is It?

Empirically, FRP does not seem to exist at all, at least in the developed world. To be precise: there is no correlation between the levels of the budget deficit and/or public debt on one side, and levels of bond yields on the other.

On the contrary, **Chart 1** shows that the levels of U.S. Treasury yields have, in fact, been negatively correlated with the U.S. government’s fiscal deficit and debt load since 2000: the bigger the deficit and debt, the lower the nominal and real interest rates.

For example, the U.S. fiscal deficit turned into surpluses under the Clinton administration between 1997 and 2002, while public sector debt, at around 55-60% of GDP, barely grew in the 1990s. However, 10-year Treasury yields were well above 6%, and real bond yields were over 4% at the end of 1999, both much higher than those in the 2000s and 2010s when the budget deficit and public debt grew exponentially.

Chart 1 Deficit, Debt And Interest Rates: Where Is FRP?

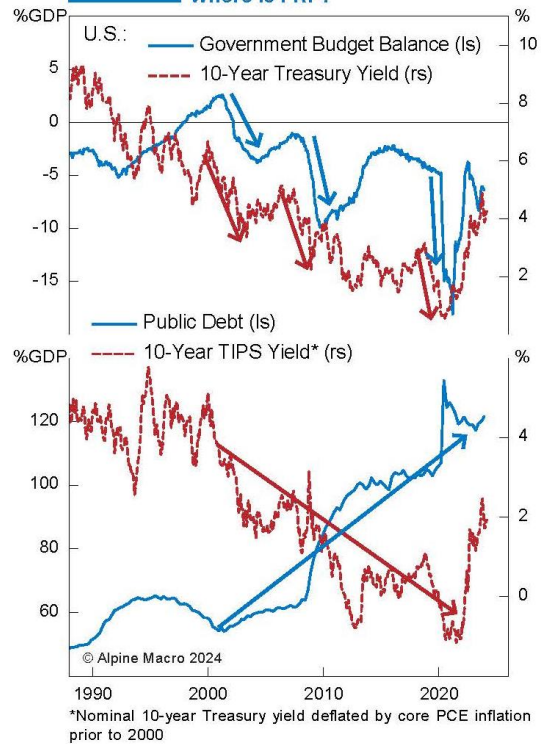
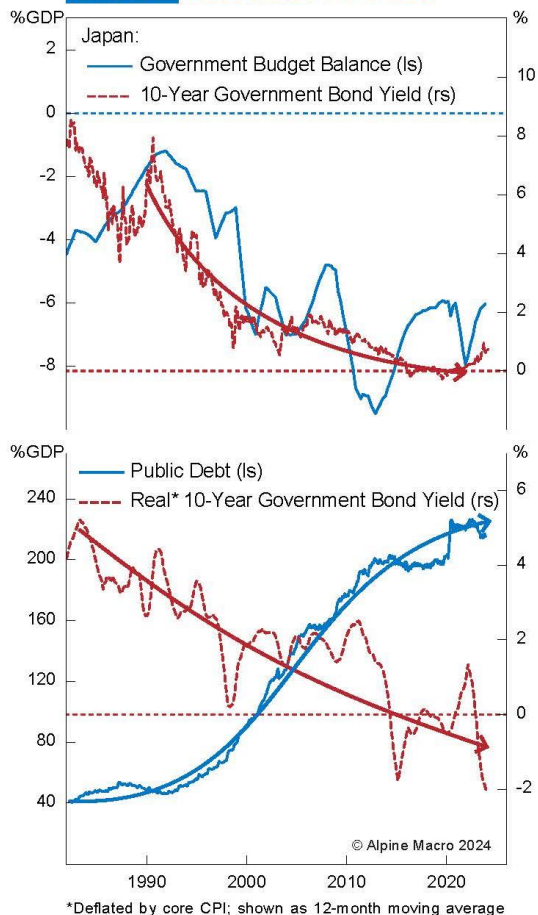
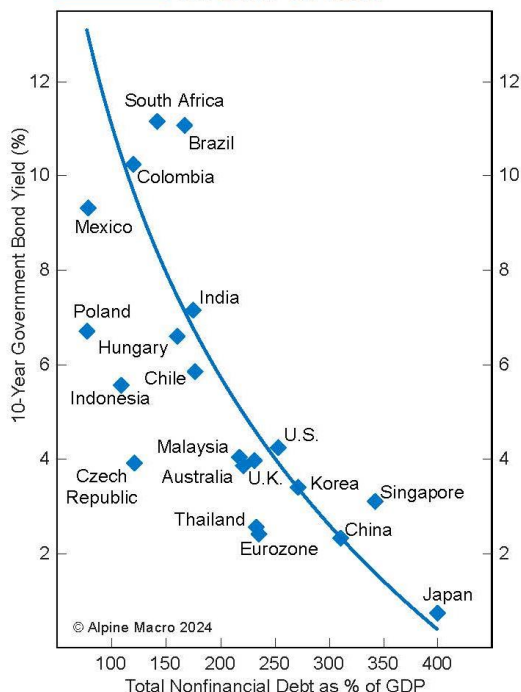


Chart 2 The Japanese Experience


A similar phenomenon is also evident in Japan. Since the 1990s, Japan's fiscal deficit has become progressively worse and its public sector debt has skyrocketed (**Chart 2**), but long-term JGB yields have consistently fallen and went negative for the most part between 2016 and 2021. Even today, Japan's 10-year government bond yields are still below 1%.

Chart 3 The Higher The Debt, The Lower The Rates


A cross-country comparison also reveals some interesting and highly counterintuitive results. **Chart 3** compares the levels of interest rates versus total indebtedness of 20 nations. The correlation is clearly negative, i.e., countries with low debt loads often end up with high interest rates, but those with heavy debt loads are associated with very low interest rates.

Granted, public sector debt is only a subset of gross national debt, but this chart clearly challenges the popular notion that a more heavily indebted economy should have a higher "risk premium" or interest rates than those with a lower debt load.

A Classical Fallacy

For a long time, a generally accepted fiscal doctrine has been that a sound fiscal policy should be characterized by a balanced budget and limited debt buildup. In other words, a sound fiscal policy should always ensure that the government lives within its means. Otherwise, its policy will be labeled as “proliferate” or “irresponsible”. Nevertheless, few have realized that this doctrine largely stems from classical economics with the gold standard as the prerequisite.

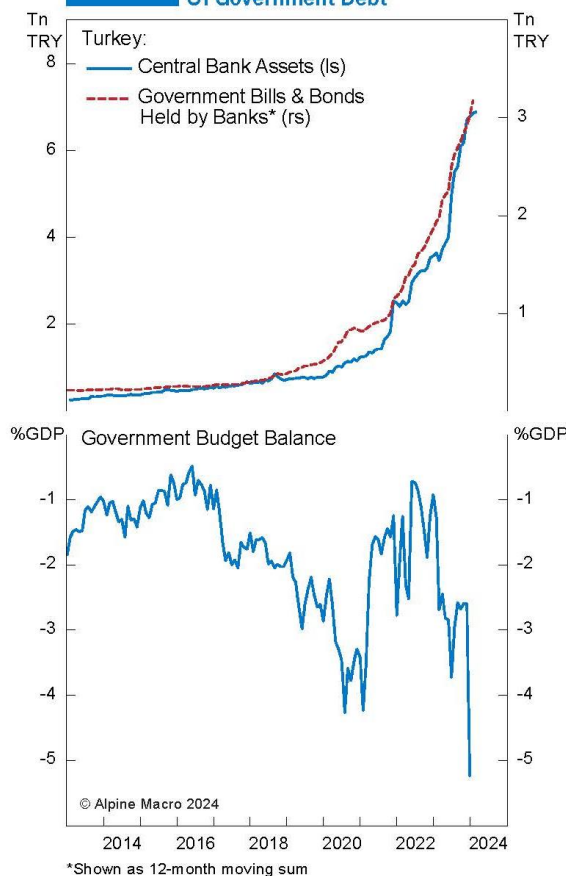
Under the gold standard, money creation was an endogenous process which imposed the same hard constraints on both public and private sector budgets. Under this system, a central bank did not have discretionary power to change the size of its balance sheet, which was bounded by the amount of gold reserves the central bank had.

This implies that a central bank would have limited resources, or money, to act as a potential buyer of last resort for government paper. Thus, there is a rising possibility of a sovereign government default, should the government in question ever run out of money.

Historically, there were indeed hundreds of sovereign defaults during the gold standard era, including the U.K.’s suspension of the gold standard during the Napoleonic Wars. The U.S. experienced two major sovereign defaults in the 19th and 20th centuries, as well.

The U.S. federal government suspended interest payments on federal debt in 1814 due to soaring war spending and lagging revenues, which severely

Chart 4 Turkey: *De Facto* Monetization Of Government Debt



strained public finances. In 1933, President Franklin Roosevelt took steps to suspend the gold standard to fight the Great Depression, leading to the cancellation of the gold clauses in federal bond contracts. This amounted to a *de facto* restructuring of debt.

Nevertheless, the fiat money system has fundamentally changed the rules of the game. With a printing press at its disposal, a central bank can

always act as a credible buyer of last resort of sovereign bonds: a central bank can, and has often, swapped government debt obligations with its own paper – also known as money, by simply expanding its balance sheet. This capability has largely eliminated the sovereign default risk, provided that the outstanding public debt is denominated in the local currency.

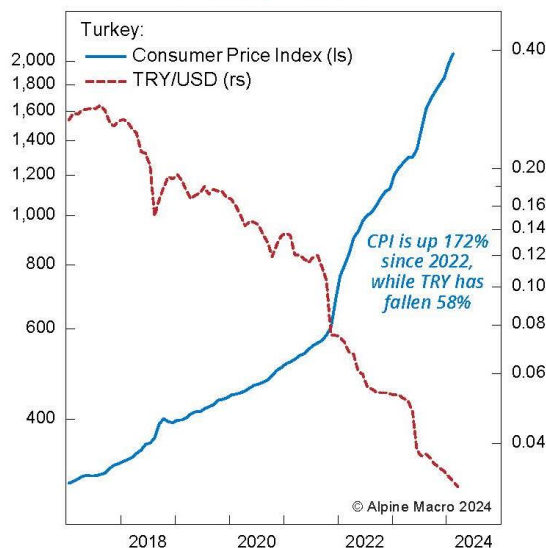
Of course, if a country has borrowed too much in foreign currency debt, it can still face the risk of a sovereign default because the central bank in question cannot print foreign currency. Here, the availability of foreign exchange reserves imposes the same constraints on the borrowing countries as the gold standard.

It is important to emphasize that although the central bank's capability to monetize debt can largely eliminate sovereign default risk, money printing does not generate any wealth. Debt monetization merely transforms the sovereign default risk into inflation and/or currency risk.

Simply put, although a country with a large and growing domestic debt load may never run into a sovereign default because of central bank monetization, it can fall into a trap of rising inflation and/or a falling currency if a persistent public sector deficit generates excess demand.

Turkey is a classic example of how country sovereign risk has been transformed into rising inflation and a falling currency. The country has run fiscal deficits since 2003, but the Turkish government decided to abandon fiscal austerity in 2018, while forcing the central bank to loosen the monetary taps.

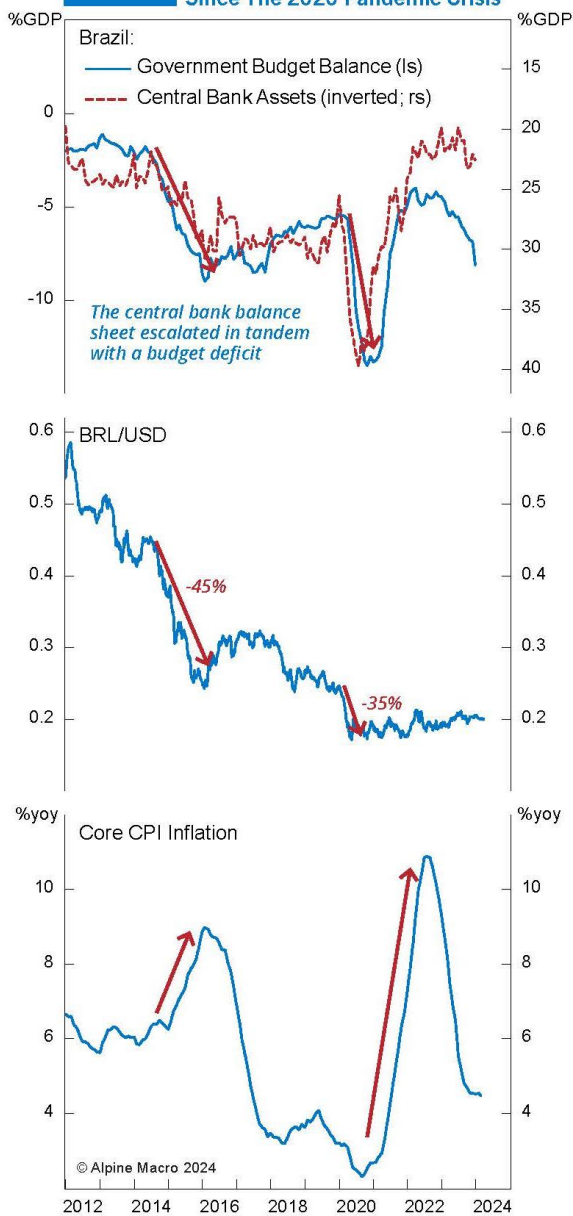
Chart 5 Turkey: Transforming Solvency Problem Into Inflation And Currency Problems



As a result, commercial banks' purchase of government bills and bonds has escalated, which has been underwritten by the central bank's expanding balance sheet (**Chart 4**). The consequence of this policy has been reacceleration in inflation and a plunging lira (**Chart 5**). By monetizing debt, the government and central bank have effectively transformed Turkey's potential solvency problem into inflation and currency problems.

A similar situation is also evident in Brazil where the previous government, under Jair Bolsonaro, blew a big hole in the federal budget by handing out a huge amount of subsidies during the Covid-19 crisis. This deficit was also monetized by the central bank and caused inflation to shoot up and the BRL to plunge (**Chart 6**).

Chart 6 The Brazilian Experience Since The 2020 Pandemic Crisis



Keynesian Framework: What Is A Sound Fiscal Policy?

What does a sound fiscal policy mean under today's fiat money system, and what role should a central bank play in macroprudential management?

According to the Keynesian framework, a sound fiscal policy should always be calibrated to offset any imbalances from the private sector. Specifically, if the private sector cannot balance out its savings versus its desired investment, the public sector must step in to make up the difference.

This means that, should the private sector save too much and invest too little, the government sector must do the opposite by running a budget deficit (dissaving) or the economy will contract and deflate; and *vice versa*. Therefore, a sound fiscal policy should never set "balancing the books" as its goal. Instead, countercyclicality should be the essence of a sound fiscal policy today.

By this criterion, most Western governments have done a decent job in times of financial or economic crises. Most G7 governments have run massive fiscal deficits during recessions, suggesting that surging public sector demand (or dissaving) at least partially offsets the sudden withdrawal in private spending. It is fair to say that fiscal policy has played a crucial role in reducing the depth and duration of economic recessions.

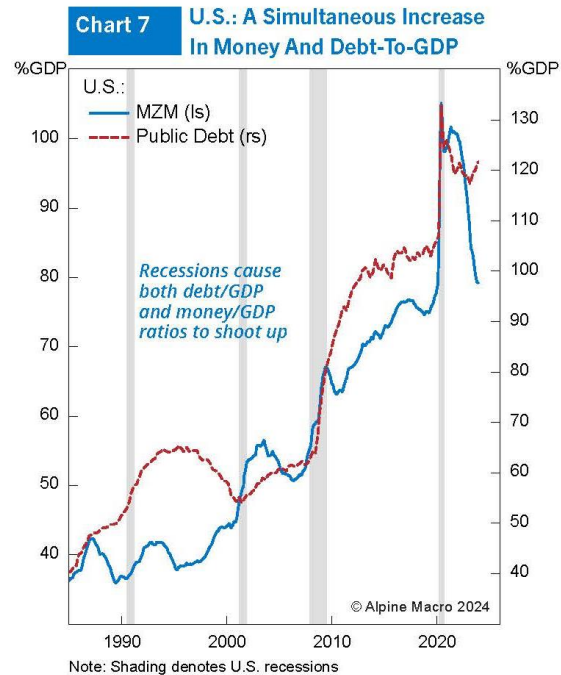
Nevertheless, it is also true that politicians always love expansionary fiscal policy, while trying to avoid fiscal austerity which is painful. In our view, the Biden administration's fiscal expansion in 2023 was misguided because the U.S. economy was already in a recovery boom and did not need any fiscal boost.

In short, bad fiscal policy is one that disregards underlying economic conditions. Adding fiscal dissaving (deficit) at a time when private sector demand is already strong or excessive can only fan the inflation flame. By the same token, pushing for fiscal austerity in a weak economy is also a bad decision that risks price deflation. The U.K. pursued disastrous fiscal austerity in the 1920s, leading to the cursed deflation and massive social unrest. The Japanese government's repeated efforts to tighten fiscal policy in the 1990s and 2000s only deepened the economy's deflation problem.

How about monetary policy? Under normal circumstances, a central bank has no role to play in government policy. Only under extraordinary circumstances should a central bank come into play. For example, central bank intervention becomes necessary if sovereign debt markets are in turmoil or failing, only if under these rare moments, the central bank is the only institution that can put a quick end to a debt crisis.

This is vividly demonstrated by how the European Central Bank's "whatever it takes" statement ended the eurozone debt crisis quickly in 2010. Similarly, it was the Bank of England's announcement of £65 billion in purchases of long-dated Gilts that put an end to the 2022 Gilt turmoil, also called the "Liz Truss Crisis".

Finally, it is worth emphasizing that central bank QE programs in the past decade were independent monetary decisions that were not aimed at helping out government fiscal conditions. In the 2010s when most Western economies were swamped in



excess savings that drove interest rates to zero, the only logical way for central banks to stimulate was *via* QE.

Where Is The Limit?

With the public debt/GDP ratio having escalated quickly in most high-income economies, investors are naturally worried about the potential consequences of this persistent buildup. "Fiscal time bomb" and "financial ruin" are words often used to describe the situation.

In our view, "*Where is the limit?*" is a rather silly question. With the credit quality of sovereign government paper being the same as that of central bank paper and both papers being

interchangeable, to ask where the limit is for government debt accumulation is identical to asking where the limit is for money supply for the same economy.

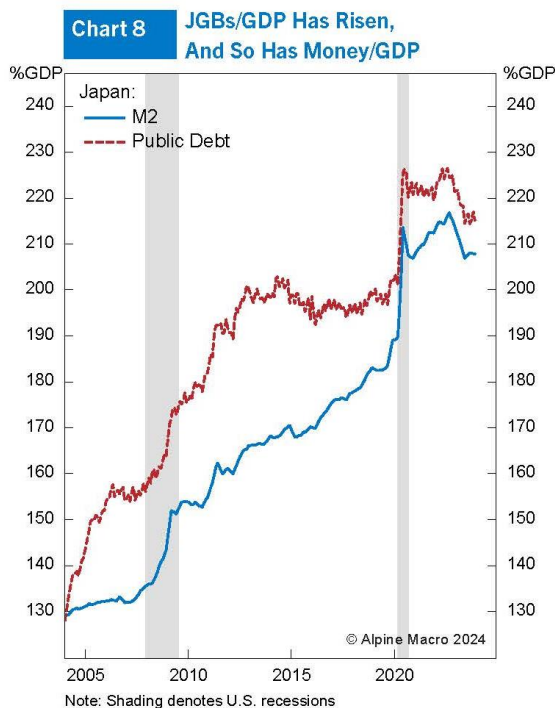
While most people understand and accept that money supply should always grow along with the underlying economy, they steadily reject the same phenomenon when it comes to government debt. In the end, money and government debt are the same thing. The only differences are that they have different maturities and holders of government paper are paid interest.

At a macro level, M2/GDP always rises or falls along with changing money velocity, which is simply a function of interest rates, while the fluctuations in the public debt/GDP ratio simply mirror how the government responds to the rise and fall in private sector imbalances. More often than not, excess savings rise and interest rates fall during recessions, which are the key reasons why debt and money tend to escalate during these periods (Chart 7).

Should excess savings become a chronic problem for the underlying economy, both money and debt will rise faster than the underlying economy, period. Chart 8 shows how Japan's public sector debt/GDP ratio has mimicked the explosive growth in M2/GDP. Neither seems to have a natural limit.

Conclusions

- In the fiat money system, there is no such thing as fiscal risk premium leading to higher rates of interest. Interest rates are largely determined by the supply of, and demand for, underlying savings.



- With the central bank acting as a credible buyer of last resort for government paper, any turmoil or crisis in the government bond market can be clamped down quickly by central bank intervention. However, high inflation or a falling currency could be the two limiting factors for such an intervention.
- The rise and fall in public debt/GDP of reasonably disciplined countries simply mirrors the shifting savings-investment imbalances in the private sector, while the rise and fall in the money stock-to-GDP ratio is largely reflective of secular trends in money velocity which in turn is a function of interest rates. Neither has an inherent or natural limit.

Housekeeping

- We are closing our long Brazilian equity (ETF: EWZ) and 10-year sovereign bond positions. Brazilian President Lula has made a series of statements highlighting his left-leaning and pro-interventionist ideology and this has spooked financial markets. We are also concerned about the rapid deterioration in Brazil's budget deficit. To control risk, we are closing our long positions in Brazilian assets.
- Buy Gold (ETF: GLD).

Chen Zhao

Chief Global Strategist

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Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long Nikkei 225 Unhedged	05/08/2023	28,950	38,000	-	-	35.0%
Long 10-Year German Bunds/Short 10-Year JGBs	08/07/2023	2.6%/0.62%	-	-	-	4.3%
Short USD/BRL ¹	10/23/2023	5.01	5.25	28/03/2024	5.01	4.4%
Long TLT	11/27/2023	91.30	92	-	-	4.9%
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	45	-	-	6.2%
Long Latin American Equities (ETF: ILF)	12/04/2023	27.78	25	-	-	5.5%
Long Brazilian 10-Year Govt Bonds Unhedged ²	12/04/2023	10.96%	-	28/03/2024	11.00%	1.8%
Long Brazilian Equities (ETF: EWZ) ³	12/04/2023	33.66	31	28/03/2024	32.24	-0.2%
Long Russell 2000 (ETF: IWM)	01/08/2024	196.73	185	-	-	7.2%
Long Chinese Equities (ETF: MCHI)	03/04/2024	38.91	Rolling -8%	-	-	2.1%
Long Gold (ETF: GLD) ⁴	04/01/2024	-	-	-	-	-
Long S&P 500 Energy (ETF: XLE)	03/25/2024	93.26	-	-	-	1.2%

Note: P&L is calculated using daily closing prices.

¹ We are closing our Short USD/BRL trade with a profit of 4.4%.

² We are closing our Long Brazilian 10-Year Govt Bonds trade with a profit of 1.8%.

³ We are closing our EWZ trade at a loss of 0.2%.

⁴ We are buying GLD outright.