Insights
Macroeconomics

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The Tidal Wave of Global Debt
Causes and Consequences

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Global debt has surged at an unprecedented pace over the last four years, driven by aggressive deficit spending as governments scrambled to cushion the blow of the COVID-19 recession.

Servicing this debt is becoming increasingly burdensome. In the US, for example, federal debt alone has risen by more than 50% since 2020, and interest costs now consume nearly 20% of federal revenues. The US isn't alone. Across the globe, from Canada and the UK, to emerging markets, the concerns around fiscal sustainability are growing.

Our Focus on Fiscal papers examine the profound implications this fiscal backdrop will have on economies and investors in the years to come. Higher interest rates, persistent inflationary pressures, and lower growth are some of the key risks to track. Forthcoming articles will explore global macroeconomic trends as well as provide country-specific spotlights.

Global Debt Surges

The Covid pandemic unleashed a global tidal wave of fiscal expansion that helped blunt the extent and shorten the duration of the ensuing recession. While fiscal enlargement has also contributed to high inflation, the effects are generally seen as net positive. As crisis-era policies are retired, fiscal retrenchment then becomes a headwind to growth. While unpleasant, this is the lesser risk: better to pay the smaller cost up front to set public finances on a more sustainable course than delay corrective measures and threaten financial and price stability down the line. Fiscal policy choices carry great weight for financial markets given their increased impact on shaping long-term interest rates.

Taking Stock: How Did We Get Here?

By design and intent, economic policies have implications, yet some of these are unintentional and only recognized in hindsight. That is precisely why policies risk becoming excessive: there is no accurate real-time "stop" signal. As policymakers eventually internalize the lessons of past mistakes, they become so intent on avoiding them going forward that new ones are being made, often in the opposite direction. The (policy) pendulum swings.

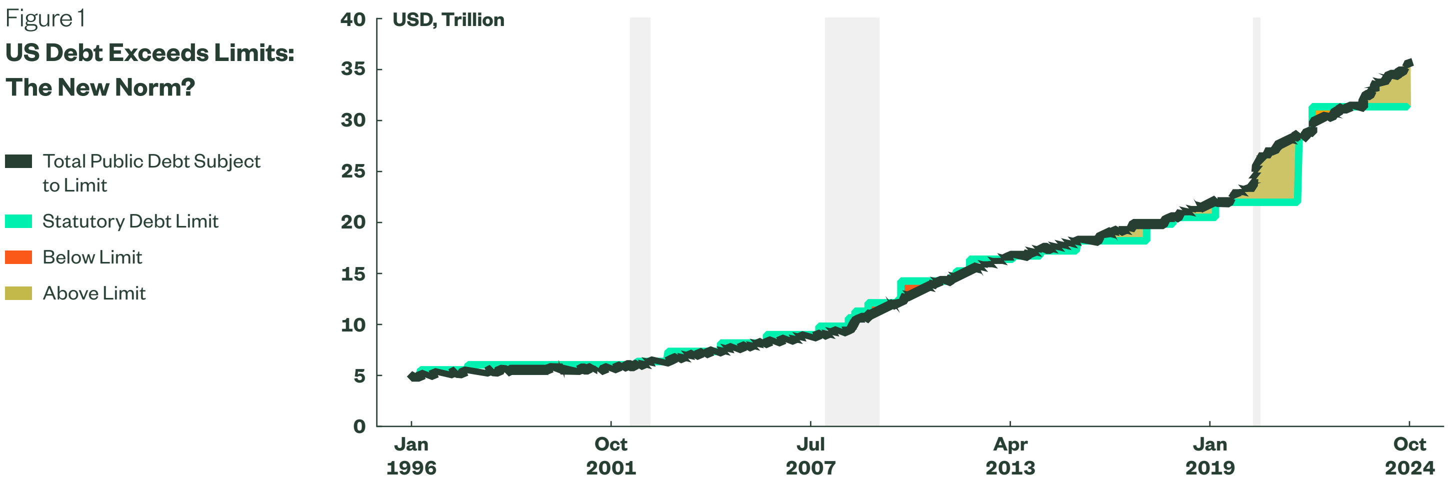
The current moment in time is no exception. In the United States, two big policy errors aggravated the Global Financial Crisis (GFC) — one preceding it, and one following it. Pre-crisis, the lending environment had become too lax, with loose credit standards and insufficient risk management. Post-crisis, the fiscal policy response was too timid in the wake of a forced, deep, and broad, private sector deleveraging process which was accompanied by sharply tighter lending standards. The initial post-GFC response was then followed by corrective fiscal retrenchment which was enforced too soon, well before the economy had regained a solid footing. By 2014, the US budget deficit narrowed to 2.8% of gross domestic product (GDP) and shrank further to 2.4% in 2015; these figures were below 2003–2005 levels and below what had been typical in the 1980s and the first half of the 1990s.[1] As a result, the immediate post-GFC recovery was unnecessarily protracted and slow.

It was against this backdrop that the 2017 tax cuts were delivered and modern monetary theory gained prominence. It also helped explain the no-holds-barred fiscal response to the pandemic. The US budget deficit surged from 4.6% in 2019 to 14.7% of GDP in 2020. In 2021, when the economy was already recovering, the budget deficit still stood at 12.1% of GDP.

Fiscal stimulus was arguably the biggest driver behind the swift rebound that followed the initial Covid shock. In the United States, following a 2.2% contraction in 2020, real GDP in 2021 surged 6.1%, with real household consumption up an impressive 8.8%. Trillions of dollars in government transfers pushed the personal savings rate to unprecedented levels and exacerbated the powerful inflationary effects of extreme supply chain disruptions. Fiscal action did not end there. The rationale changed over time, shifting from emergency pandemic support to supply chain management and industrial policy.

Irrespective of the rationale, the results have been dramatic: Since January 1, 2020, US public debt has swelled by 52% and the debt-to-GDP ratio has jumped from 105% to 120% (Figure 1). This surge has created large private sector surpluses at the cost of even larger public sector deficits.

Figure 1
US Debt Exceeds Limits: The New Norm?

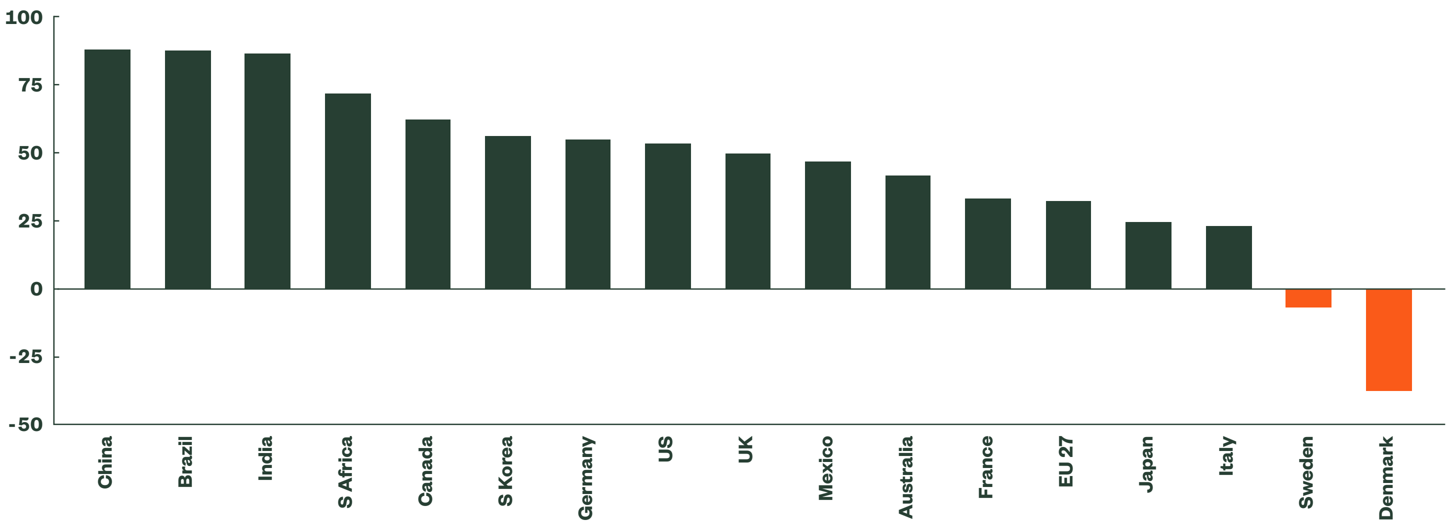


Source: Macrobond, State Street Global Advisors Economics, U.S. Treasury. Data as of September 30, 2024.

A Global Tidal Wave of Fiscal Expansion

The US was by no means alone in this fiscal experiment (Figure 2). UK public debt has risen by a similar magnitude; in South Korea, Canada, India, and Brazil, public debt levels have increased even more. At the other end of the spectrum, Japan and Italy have experienced only a moderate increase in debt, although that is largely due to constraints around pre-existing high debt levels. Elsewhere, some Nordic countries are bucking the trend with recent reductions in debt stocks outweighing the initial Covid rise.

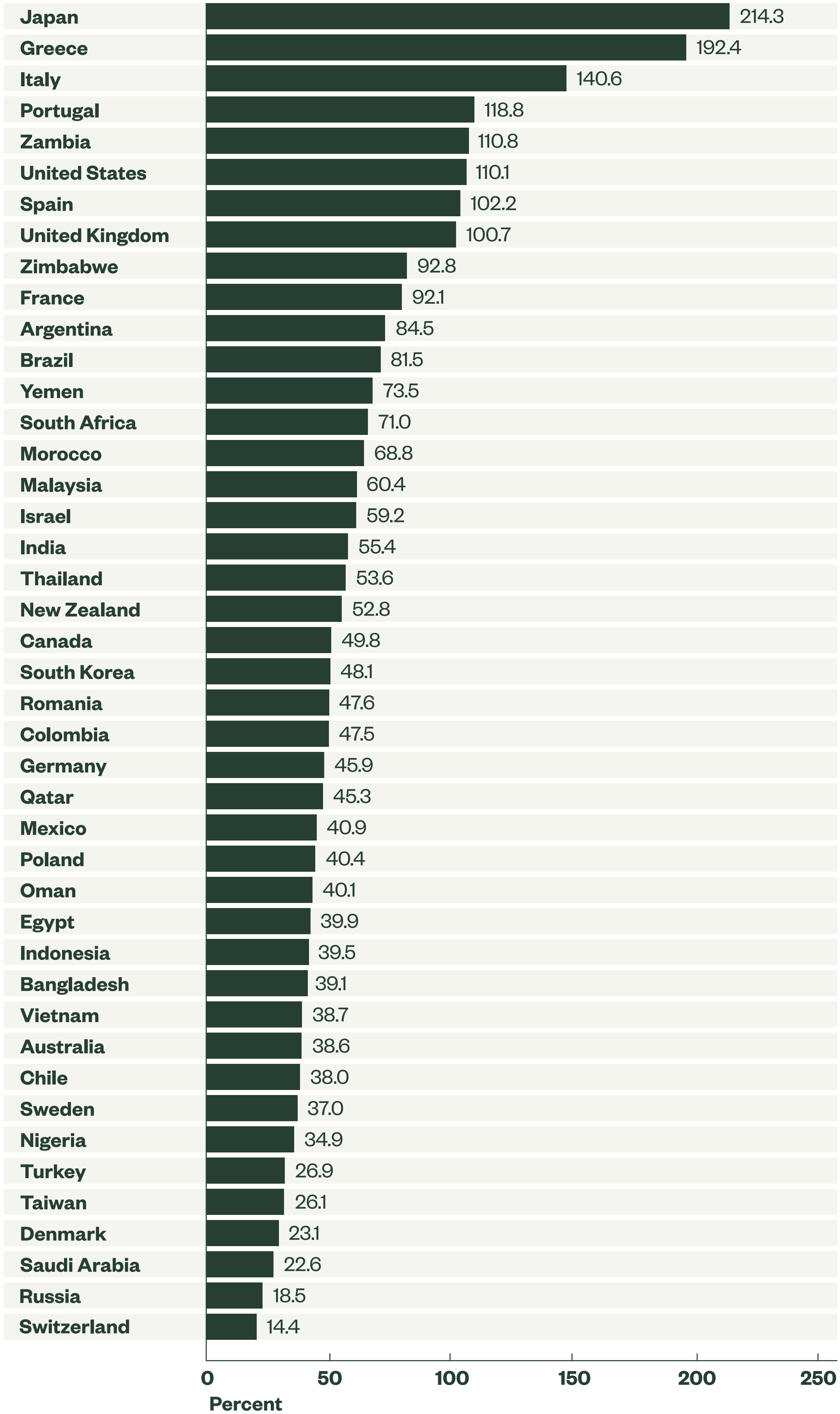
Figure 2
Comparative Change in Nominal Debt Levels Globally
(Since January 1, 2020)



Source: Macrobond, State Street Global Advisors Economics, Office for National Statistics (ONS), U.S. Treasury, Ministry of Finance (MOF), Bank of Italy, Banco Central do Brasil (BCB), Ministry of Economy and Finance (MOEF), Canadian Department of Finance, Banco de Mexico (BANXICO), Romanian Ministry of Finance, Central Bank of Denmark (Danmarks Nationalbank), Eurostat, Finnish Treasury, South African Reserve Bank (SARB), Riksgalden, German Ministry of Finance, Agence France Trésor, Austrian Department of the Treasury. Data as of September 30, 2024.

The change in nominal debt levels only tells half the story, however. Debt accumulation must be assessed against economic growth over time and is typically captured in the debt-to-GDP ratio (Figure 3). Rapid growth from a low base (as in South Korea) is far less troublesome than modest growth from a high base (such as Italy). Through this lens, the US looks worse than many other developed market peers. In fact, it looks worse than many emerging market economies!

Figure 3
A Comparison of Central Government Debt Levels



Source: Macrobond, State Street Global Advisors Economics, International Monetary Fund. Data as of October 1, 2024.

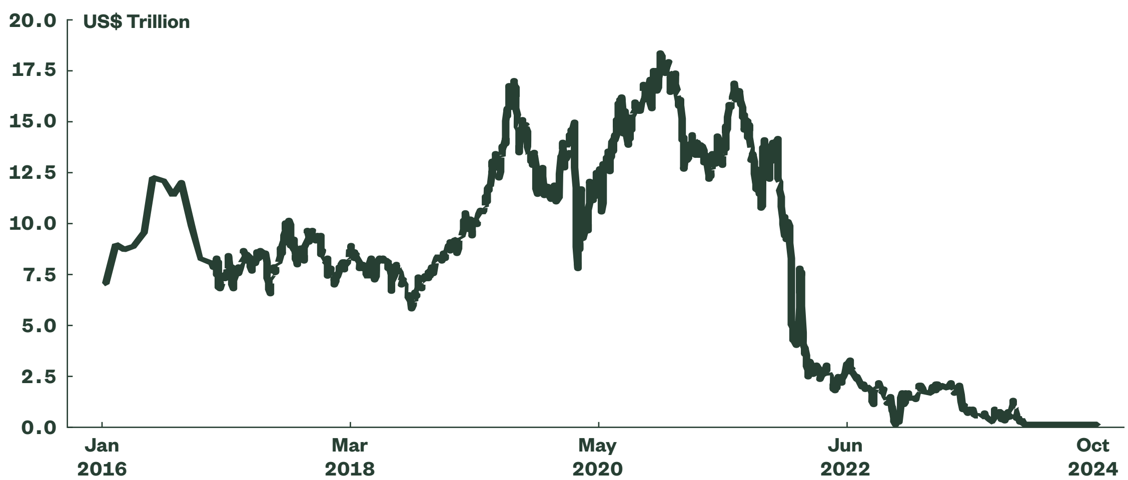
Where Do Governments and Investors Go From Here?

The fiscal boost was welcome, but it cannot be sustained. Figure 3 illustrates the range of fiscal space across economies. A growing number of countries require corrective measures to lower fiscal deficits and slow the accumulation of debt. Unsurprisingly, the fiscal trajectory has taken a more central role in elections around the globe, including in France, the UK, Japan, and the United States.

The debt surge of the past few years has already caused sharp increases in global debt service costs. Debt mechanics imply that this trend will continue as the initial Covid stimulus occurred during extremely low (and even negative) interest rates — refinancing costs will thus increase even if rates come down a little from current levels. For example, US net interest expenses as a share of government revenues is due to exceed 20% and its 1980s peaks. With Japanese interest rates also on the rise, negative yielding bonds — whose global combined value exceeded $17 trillion at the 2020 peak — are no longer a feature of the market (Figure 4).

Figure 4
Negative Yielding Bonds Now Fade

Bloomberg Barclays Global Aggregate Negative Yielding Debt Market Value USD

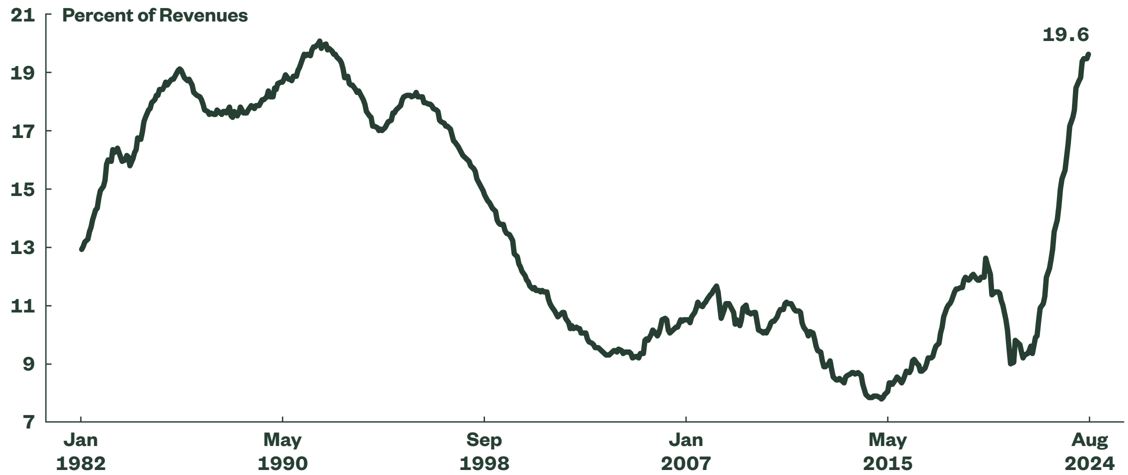


Source: Macrobond, State Street Global Advisors Economics. Data as of October 7, 2024.

The process of fiscal reversion has already begun. Tax increases are on the docket in both France and the UK (dedicated Focus on Fiscal articles to follow). The outcome of the US general elections will affect US fiscal policy, but eventually some form of revenue increasing measures will be necessary even if there are no current policy proposals which are serious about deficit reduction. This is especially true because US deficits are increasingly driven by mandatory spending and interest expenses (Figures 5 and 6), leaving limited space to maneuver on the spending side.

Figure 5

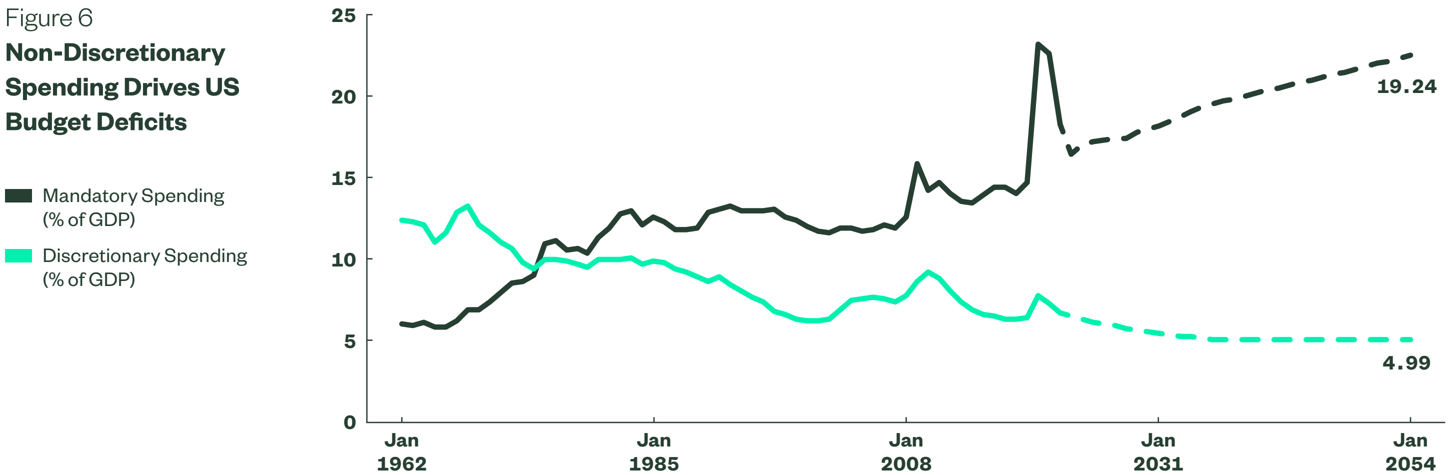
US Government Interest Costs Swell



Source: Macrobond, State Street Global Advisors Economics, U.S. Treasury. Data as of October 1, 2024.

Figure 6

Non-Discretionary Spending Drives US Budget Deficits



Source: Macrobond, State Street Global Advisors Economics, Congressional Budget Office. Data as of October 7, 2024.

Impact on Economies

The bottom line is that fiscal policy is set to become a mild drag on economic performance over the medium term across many economies.

China is a *near-term* exception to this rule, with emphasis on the near term. Amid a newfound near-term commitment to support the ailing economy, Chinese policymakers are widely expected to follow up on recent monetary policy stimulus (see our analysis here) with meaningful fiscal stimulus. Not all fiscal stimulus is created equal, however. As a simple rule of thumb, bigger is not necessarily better.

Looking to Europe, the eurozone presents a special challenge, both due to the divergent debt sustainability picture across countries as well as the constraints of fiscal rules on fiscal policy efficacy (see our analysis here). In light of the damage to its international competitiveness following the Ukraine invasion, Europe needs more forceful — yet targeted — fiscal policy deployment to directly address these challenges.

Currencies, i.e., exchange rates, are a preeminent mechanism through which markets assess countries' fiscal and debt sustainability pathways. A powerful recent reminder was the mini crisis that surrounded the budgetary proposals in the UK by the then prime minister Liz Truss. Yet, in a world where "everyone is doing it," investors' ability to differentiate is somewhat blunted.

The Price of This Debt

Aside from the "macro" price of all this debt — upcoming fiscal retrenchment, risk of crowding out of private investments, etc. — investors are also grappling with the question of what should be the *literal* price for all this debt. All things being equal, such a massive increase in debt supply would seem to imply a need for higher yields to clear the market. Our State Street colleagues have recently modeled a +95 basis points (bps) impact on US long-term yields due to rising supply (Who will buy the oncoming surge of Treasuries? And at what price?).

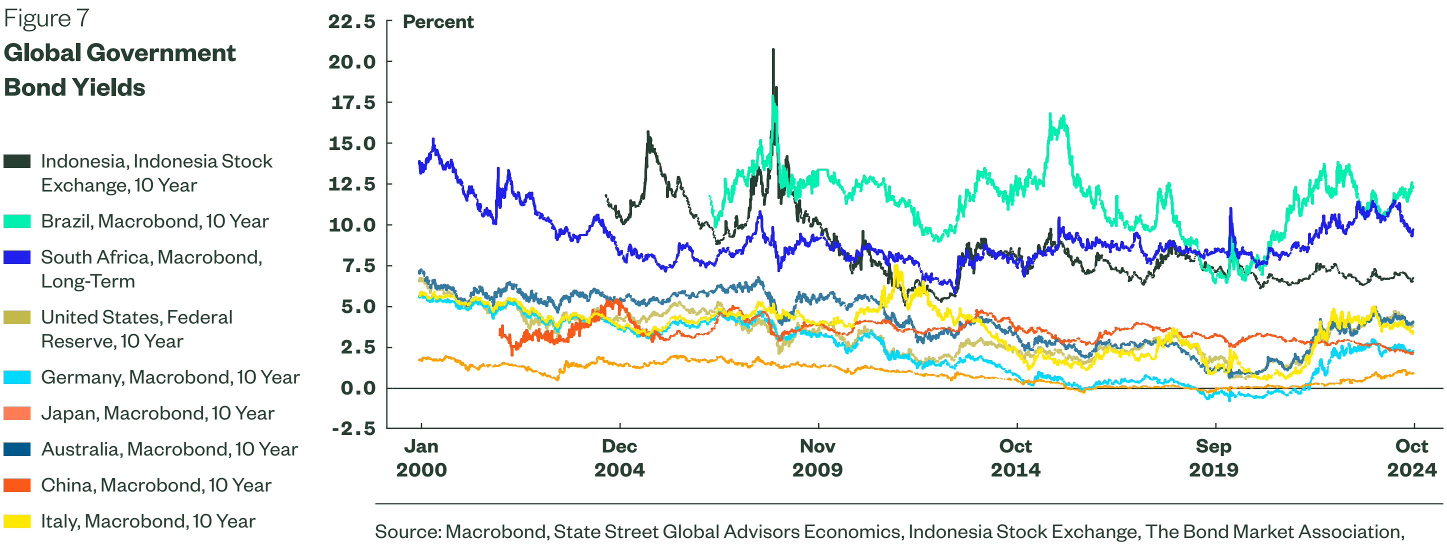
Broadly, fiscal deficits are problematic when they exceed nominal GDP growth as this raises the debt ratio. In the US, household and corporate balance sheets are strong and could absorb a higher tax burden. However, higher taxes are not a politically popular prescription. Absent corrective steps to lower the deficit, the steady increase in supply will require increased participation from the domestic buyer base since foreign demand has not kept pace with issuance in recent years. It is possible that these buyers would demand higher yields, raising the pressure to engage in fiscal consolidation.

The only alternative would be a productivity miracle that lifts nominal growth well above annual deficits, thus bringing about an organic decline in debt ratios. While technological innovation means this is possible, engineering such an outcome is not within the purview of policymakers.[2]

Factors Constraining Yields

Even after a sharp rise since 2022, yields have really only returned to levels that prevailed a decade or so ago. Is this simply a story of an incomplete correction, and are further increases inevitable over the long term?

Figure 7
Global Government Bond Yields



Source: Macrobond, State Street Global Advisors Economics, Indonesia Stock Exchange, The Bond Market Association, U.S Treasury. Data as of October 1, 2024. Past performance is not a reliable indicator of future performance.

Some of the long-term forces pushing yields down persist. Deteriorating global demographics could slow growth ahead, which by necessity, constrains real yields. In a low-growth world, there are limited economic investments that are feasible at high interest rates. Hence, while rising supply may exert upward pressure on yields, all else being equal, slower growth will exert downward pressure on yields by reducing private sector demand for debt. In essence, this is an argument of diminished "crowding out" effects in a low-growth environment.

Demographics also affect yield by way of investment demand and portfolio preferences. An aging investor population would (again, all things equal) speak to a growing preference for, and rising allocation to, fixed income instruments. In practice, higher supply could be met with higher demand.

Lastly, the acute focus on inflation fighting has led most central banks to meaningfully reduce balance sheets, curtailing bond holdings. This should not be seen as precluding a return to quantitative easing. If bond yields were to spike unexpectedly, it is highly likely that quantitative tightening (QT) would once again give way to quantitative easing (QE).

The Bottom Line

Depending on the fiscal pathway taken in the future, the implications for investors could be starkly different. In scenarios where fiscal consolidation brings about a hit to short-term growth, risk assets might experience some serious underperformance in the short-term, although not necessarily beyond. In contrast, if public debt ratios level off due to rising productivity, risk assets could continue to deliver positive real returns, albeit at the cost of negative real returns for bond holders. The same would hold true if fiscal repression were enacted to manage rising debt yields.

Endnotes

1 Macrobond, U.S. Treasury. Data as of September 30, 2024.

2 There is also a technical element to higher debt levels. All else being equal, rising debt-to-GDP levels would imply that greater level of reserves would be required to clear the market for treasuries while simultaneously preventing crowding out of private investments. A repeat of 2019-esque repo/SOFR spike is unlikely, as the net effect would be rising liquidity in the system. As the Federal Reserve lowers interest rates, meeting the increased supply should become more manageable; albeit at the risk of re-accelerating inflation.

About State Street Global Advisors

For over four decades, State Street Global Advisors has served the world's governments, institutions, and financial advisors. With a rigorous, risk-aware approach built on research, analysis, and market-tested experience, and as pioneers in index and ETF investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager* with US $4.73 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.