Letter n°80

A global public debt that is difficult to control. Awareness but without a crisis of mistrust.

"May our past pleasures increase our torments! / How hard it is to feel after so many delights, / The cruelties of fate!". La Fontaine in Cupid and Psyche.

Debt, for many states, has often been seen as an easy way out in the past 30 years, as La Fontaine would say "our past pleasures" was a means of spending and buying social peace without resorting to the unpopular measure of tax increases. The "cruelties of fate" mentioned by La Fontaine refers to the impact of the recent rise in interest rates, which has now become a debt cost capable of undermining the solvency of states and causing defaults.

Studying global debt involves assessing the evolution of debt volumes and monitoring costs.

After taking stock of global debt, we will analyze more specifically the evolution of debt in Western countries, the evolution of debt in China, and the problematic situation of many emerging countries.

In the background, we have the more or less sustainable nature of the increase in interest rates, resulting from current inflation, and the impact and risks on the solvency of states.

The worsening of public debt in the world:

What is the evolution of debt? What is the impact on the real economy, namely growth and credit? How can debt be stabilized? Is it possible to cancel a portion of this debt? These are the four questions being considered here.

The drift of global debt has not benefited growth and credit:

- How much is the debt getting worse?

According to the Institute of International Finance (IIF) or the IMF, global public debt represents 1x the world GDP, compared to around 30% of GDP in 1970. Among the most indebted countries, Japan's debt is 2.5x its GDP, Greece's debt is 2x, and Italy's debt is 1.5x its GDP.

While developed countries have the highest levels of debt on average, around 1.2x their GDP, they are not necessarily the riskiest countries as they often have substantial private savings and more liquid financial markets.

Today, the countries at risk of default are, as we will see, emerging countries.

During the recent period, the major cause of debt worsening has been the COVID-19 crisis, as economic activity temporarily came to a halt and governments provided numerous assistance measures.

The worsening of debt has led to the financialization of economies, inadvertently giving banks and finance an oversized role compared to real production and causing recurrent crises.

- What is the impact of debt on GDP growth and credit?

Despite this debt, there has been a decrease in the GDP growth rate of various economies in OECD countries. It was around 4% in the 1980s, but has since dropped to an average of 1.5%.

Despite low interest rates over the past two decades, the investment rate has decreased. There are three reasons for this:

The ongoing shift from industrial economies to less capital-intensive service-based economies.

The second reason, well described by ***Jacques de Larosière***, former managing director of the IMF from 1978 to 1987, is the idea that the low capital returns discourages investment and encourages the investment of savings in financial products.

Finally, low interest rates have allowed "zombie" companies, which are not competitive, to survive, thus maintaining excess capacity.

How to stabilize or reduce debt?

To stabilize debt ratios, governments must achieve primary surpluses, meaning that their revenues exceed their expenditures before interest payments on public debt.

To reduce their indebtedness, governments must strive to generate budget surpluses, where the revenues for the year exceed expenditures.

The prospects are bleak because states have only three means to reduce debt, and none of them can be approached with great optimism:

Increasing economic growth, and therefore revenues, is challenging in aging populations and a context of low productivity growth.

Increasing the tax burden is unpopular everywhere.

Reducing public spending, a classic neoliberal approach seen in the policies of Thatcher and Reagan in the early 1980s, could destabilize democracies and encourage the rise of populist governments.

Is the cancellation of part of the public debts conceivable?

The question is recurrent and resurfaces from time to time, but this solution should be dismissed. The political management of a debt cancellation would be delicate. Everyone would believe in the possibility of free and infinite money, demands would multiply and wage increases would keep inflation at a high level.

All things considered, occasional policies of repurchasing public debts held until maturity and reinvesting them in new debts would be preferred. This may be equivalent to debt cancellation but is more discreet.

To delve further into this point, one can refer to Letter 38, in which the Modern Monetary Theory (MMT) is presented, advocated by Stephanie Kelton in her book "The Deficit Myth".

The worsening of debt in Western countries:

First, let's analyze the drift of debt in the three main regions: the United States, Europe, and Japan. Then, let's question four debated issues: What is the impact of inflation on debt? What should we think of debt purchases by central banks? Should we doubt the independence of central banks? Is there a link between liquidity injections and the evolution of wealth inequalities?

United States:

Rising expenses, often driven by Democrats, and decreasing revenues, often driven by Republicans, are the two reasons for American debt in recent decades. Public spending has increased from 32% of GDP in 1980 to 40% in 2019 before the Covid pandemic, and there have been tax cuts in the meantime.

Public debt as a percentage of GDP more than doubled between 2000 and 2019, but the debt service remained at 2% of GDP. Since then, public debt has increased from 100% of GDP in 2019 to 125% in 2020, but without a significant impact on the debt service because the average maturity of the debt is long.

The government has recently reached an agreement to raise the current debt ceiling of $31.4 trillion. However, this agreement on the debt ceiling only provides for a maximum of $1.3 trillion in savings over 10 years, likely much less in reality, a trivial amount compared to the $80 trillion to be spent by the federal government over the next decade. By 2025, the debt ceiling will have been raised again.

Concurrently with this worsening debt situation facilitated by the financialization of the economy, but not unrelated, the profit rates of American companies have increased from 11% of GDP in 1980 to record levels, reaching around 15%.

Europe: contrasting situations.

Public debt in Europe increased from 0.77 times GDP in 2019 to 90% in 2020. However, the situation varies greatly between Northern and Southern European countries. The former, temporarily faced with an increase in debt, have made efforts to reduce it. The latter, on the other hand, are struggling much more.

Between 2012 and the end of 2019, Germany managed to reduce its public debt-to-GDP ratio from 80% to 61%. During the same period, Italy's debt slightly increased to 135% of GDP.

Such a difference has allowed Germany to spend much more during the COVID crisis to stimulate its economy and avoid recession. Currently, Germany is planning to further reduce its debt.

In less than a year, ECB rates have increased by 3.75%. However, due to the long maturity of state debt, the debt service has only slightly increased so far. In France, it has risen from 1.4% to 1.9% of GDP, and in Italy, from 3.4% to 4.4%. However, the upward trend is not yet over.

Japan: a world record.

Public debt represents 2.5 times GDP. The central bank holds half of it, and its balance sheet is also 1.3 times GDP. These figures are unparalleled elsewhere in the world.

The originality of this Japanese public debt is its holding at more than 90% by the Japanese themselves.

The specificity of Japanese monetary policy is the setting of a ceiling on 10-year debt, ranging from 0-0.10% for several years to 0.5% currently, with a possible change in the future.

A change initiated by the new president of the Bank of Japan could have an impact on global markets because Japanese savings invested worldwide are substantial, and any repatriation, even partial, would push long-term interest rates higher.

The impact of inflation on debt: two opposing aspects.

On the positive side, the inflation of the past two years has led to a decrease in debt ratios because nominal growth, which includes both real growth and inflation, exceeds the average interest rate on the debt. VAT revenues follow inflation, income tax revenues benefit from the non-adjustment of tax brackets in a context of wage inflation, and corporate tax revenues reflect the pricing power of many companies. These phenomena are expected to persist to some extent and explain the slight decrease in European debt to 84% of GDP.

On the negative side, inflation, particularly the initiation of a price-wage spiral in a low unemployment rate environment, prompts central banks to maintain interest rates at elevated levels, risking a recession and a contraction in public revenues.

This is the idea advocated by ***Larry Summers*** of a price-wage spiral that could persist in the United States as long as the unemployment rate does not reach 5% (currently 3.7%), as there are nearly two job openings for every unemployed person.

What to think of the debt purchases made by central banks?

By seeking to ensure the fiscal solvency of governments, central banks are deviating from their historical mission, which is the pursuit of price stability and, in the case of the Fed, the pursuit of full employment.

Logically, the first consequence of a deterioration in debt ratios should be an increase in risk premiums and, therefore, an increase in interest rates.

However, between 2007 and 2020, the opposite was observed: a decrease in the cost of debt, and there were even several years of negative interest rates.

One reason for this is the liquidity injections by central banks, which involve the purchase of debt by central banks, as evidenced by the growth of their balance sheets. Since 2020, the ECB's balance sheet has increased from €3 trillion to €6 trillion, and the Fed's balance sheet has increased from $4 trillion to $8.5 trillion.

As a result of these acquisitions, major central banks now hold $14 trillion, which represents a quarter of the outstanding public debt.

Some are concerned, and over the past year, there have been some attempts to reduce the balance sheets of these central banks, primarily in the United States and Europe. This is known as "Quantitative tightening," and it involves the central bank reducing its bond portfolio and/or not replacing maturing government bonds held in its portfolio. The consequence is an increase in interest rates and latent losses on bank portfolios invested in bonds, which acts as a brake on credit.

The Fed, for example, reduced its balance sheet for a few months, but this policy was one of the causes of difficulties faced by some US banks in March.

Immediately, to prevent a chain reaction crisis, the central bank injected liquidity again, nullifying months of balance sheet reduction. Given the magnitude of unsecured deposits, which amounted to nearly $9 trillion in 2022, the Fed did not want to take the risk of a systemic crisis similar to the Savings and Loan crisis in the late 1980s, which resulted in the collapse of 1,500 out of 14,000 banks.

What about the independence of central banks?

Independence is often enshrined in the statutes of these institutions, but government pressures can sometimes be strong.

In Turkey, President Erdoğan, eager to lower interest rates, has changed the head of the central bank several times. In Brazil, Mr. Lula continuously urged the central bank to lower interest rates. Two years ago, in India, Narendra Modi revoked the president of the central bank...

Apart from these pressures, central banks, sensitive to debt levels, often anticipate the expectations of the executive branch, delay interest rate hikes, and keep the solvency of states in mind.

During the COVID crisis, we saw central banks financing budget deficits by purchasing all or part of the issued debt.

Moreover, it is hard to imagine central banks going too far down this path.

As we anticipate a further deterioration of public debt ratios worldwide, it will be difficult to avoid an expansion of central bank balance sheets, as their aim is to mitigate the increasing cost of debt.

Furthermore, the distortions observed in bond markets in recent years, the low remuneration of bond risks, the abundance of liquidity in the markets, and bond bubbles are likely to reappear. These factors must be considered in bond investment policies.

What are the implications of injections on inequality?

Undoubtedly, there is a link between liquidity injections and the appreciation of stock markets and real estate prices. Wealth holders are clearly favored by expansionary monetary policies.

The deteriorating situation in China and the restructuring needs of many emerging countries:

The deteriorating financial situation in China:

Public debt was at 56% of GDP in 2018 and is projected to reach 82% this year. In addition to this, there is the debt of provinces and local governments.

Furthermore, in addition to the official debt of local governments, there is also the hidden debt of local governments that is not consolidated in the public accounts, known as the "Local government financing vehicles" (LGFV). The IMF estimates this debt to be around €9.2 trillion, and according to the institution, this amount is expected to double by 2027, representing approximately the equivalent of China's GDP.

We are already witnessing the inability of certain provinces or cities to meet their obligations. For example, the poor province of Guizhou is unable to repay a debt exceeding €160 billion.

In addition to these public debts, a portion of corporate debts, which amount to 1.5 times the GDP, could be added, as many of these companies are state-owned. To understand China's current difficulties, we cannot overlook household debt, which stood at 60% of GDP in 2021 before the real estate crisis.

The difficulties of many emerging countries:

Esther Duflo, the 2019 Nobel laureate in economics, demonstrated in her excellent book "Good Economics for Hard Times" that between 1980 and 2016, the poorest 50% of the world's population enjoyed faster income growth than the middle classes in Europe and the United States. In the same vein, the United Nations has observed that the proportion of people living on less than $1.9 a day was halved between 1990 and 2019.

However, this trend has now come to an end. Emerging countries are the first victims of the rise in interest rates observed over the past two years, as it is of a much greater magnitude than that seen in developed countries, and their average public debt has reached 70%.

Moreover, many countries have suffered from capital outflows and currency depreciation against the dollar, leading to an increase in their debt servicing costs and heightened inflationary pressures.

Many of these countries are experiencing a contraction in their resources and, therefore, a diminished budgetary capacity.

According to the ***World Bank***, $810 billion in debt in some 60 countries is expected to undergo restructuring, with 14 countries being in a situation of over indebtedness, where debt repayments exceed 20% of their budgetary revenues. Overall, the growth of emerging countries, excluding China, is projected to slow down from 4.1% to 2.9% between 2022 and 2023.

Debt restructuring or relief appears to be necessary in some cases, but it faces resistance from China. As a temporary measure during the COVID crisis, the IMF canceled debt service payments for the 25 poorest countries for several months and provided emergency assistance to the most vulnerable nations, but it was not sufficient.

China's reluctance to relieve the debts of defaulting countries:

As a major creditor of countries in financial difficulty, China wants to change the rules so that the IMF and World Bank give up their preferred creditor status and also write off a portion of their claims. However, the

World Bank refuses to do so out of fear of having its credit rating downgraded and thus being unable to lend at low interest rates. An agreement has nevertheless been reached regarding the debt treatment of Ghana. China had lent $2 billion and has agreed to incur losses in exchange for the World Bank providing concessional loans.

It remains to be seen what concessions China will accept with countries like Zambia, another country in default, as Chinese banks hold over a third of the country's external debt. Between 2000 and 2020, China is estimated to have lent $160 billion to African countries.

Difficulties in Africa:

In Africa, between 2010 and 2020, debt has significantly increased, reaching 56% of GDP in sub-Saharan countries at a time of economic slowdown.

40% of this debt is denominated in foreign currencies, and the burden has been exacerbated by the appreciation of the US dollar in recent years.

Since spring 2022, no country has been able to issue bonds in international markets. This is due to concerns about repayment capacity, high interest rates, and the level of existing debt.

On average, debt servicing in these countries accounts for over 15% of public revenues, a percentage not seen since 1999.

Conclusion:

"To express despair is to overcome it" said ***Albert Camus,*** but unfortunately, that is not the case today. While highlighting the high levels of public debt is an issue, the current increase in financial costs on this debt poses a problem of a different magnitude.

From this Letter 80, six key points can be emphasised:

- ***The low interest rates in recent years have had five causes that are probably obsolete today***: low inflation; liquidity injections; the abundance of savings surpluses in oil-exporting countries ($1300 billion according to the IMF), China (with a savings rate close to 40% of GDP expected to decrease with the desired transition to a consumer society) and Germany; the lower capital intensity of our post-industrial societies; the ageing of the population.

  Of these five causes, the first three have disappeared, at least temporarily. The fourth is thwarted by the costs of investment in transition, rearmament and relocation. Only the fifth, the most uncertain in its effects on rates, remains, because ageing certainly means a lower propensity to consume, but it is also a smaller working population, a low structural unemployment rate and therefore upward pressure on wages.

- ***Debt is a matter of concern, long masked by low interest rates but, now more problematic***: for example, in Europe, inflation averaged 0.9% per year between 2010 and 2019, but it is now at 6.1% with a slow downward trend for the "core" component. In other words, interest rates, which were once negative at -0.5%, are now at 3.25% and are expected to continue increasing.

- ***The increase in debt servicing costs*** is gradual as governments have taken advantage of low rates to extend the average maturity of their loans. However, it is bound to continue and undermine the budgetary solvency of certain states.

- ***Central banks will want to ensure success in the fight against inflation before initiating a rate cut,*** because in aging countries, with a growing weight of elderly voters, there is little tolerance for inflation that could erode the purchasing power of retirees and affect the bond portfolios of pension funds.

- ***As a consequence of these interest rate hikes, there is a slide towards recession*** for some countries or low growth for the majority of others, thus a decrease in budget revenues, another source of concern for solvency.

- ***Beyond public debt, there are private debts of businesses and households,*** posing an additional risk in some countries. According to the Institute of International Finance (IIF), the total of public and private debts worldwide amounted to 3.6 times global GDP, or $305 trillion, as of the first quarter of 2023. The financial costs associated with this total debt, according to The Economist, amount to $13 trillion, and they are inevitably set to increase. However, not everything relates to public debts, and private debts of businesses and households may be addressed in a separate Letter.

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Bruno Desgardins

Bruno Desgardins
CIO
Switzerland

SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@singalliance.com

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@singalliance.com

SingAlliance (Hong Kong) Ltd
Unit 904-907, 9/F Dah Sing Financial Centre
248 Queen's Road East
Wanchai, Hong Kong
T: +852 2639 3659
E: info.hongkong@singalliance.com

SingAlliance Pte Ltd
(DIFC Representative Office)
The Gate, Level 13 East, Office 10, DIFC
PO Box 121208 Dubai, UAE
T: +971 (0) 4 401 9158
E: info.dubai@singalliance.com

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