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Concerning the sustainability of public debt

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As a result of the COVID-19 pandemic, public debt will continue to break record highs, raising concerns with regard to its sustainability. Is there a "magic" number that defines the maximum amount of public debt a government can sustain? The answer is no: neither historical facts, nor economic theory point to a threshold above which public debt becomes unsustainable. If the gap between the interest rate paid by a government and the nominal growth rate of its economy plays a key role in the sustainability of public debt, the self-fulfilling prophecy effect among investors can lead to multiple equilibrium.

Due to the COVID-19 crisis, global public debt will rise to a historically unprecedented level this year, reaching 101.5% of the global GDP according to the IMF. Governments have rightly acted as emergency insurers by compensating as much as possible for the loss of corporate and household income linked to the sudden cessation of activity during lockdowns enforced to fight COVID-19. Measures to support households and businesses and to revitalize the economy, combined with the fall in tax revenue caused by the economic recession, have placed deficits and public debt on a sharp upward trajectory. This situation is raising concerns about the sustainability of public debt: could governments default on their debt?

Is public debt on an unsustainable path?

The notion of the sustainability of government debt is complex. Strictly speaking, public debt is unsustainable when a government becomes incapable of financing its public debt, including in introducing new taxes. But a more nuanced notion of unsustainability comes into play when a government is exposed to the risk of excessive or unrealistic fiscal adjustment, or even when public debt begins to endanger growth and economic stability.

Certain economists suggest that high levels of public debt weigh on economic growth. Carmen Reinhart and Kenneth Rogoff (2010)[1] have notably suggested that there is a level of public debt, variable depending on whether the government's debt is in its own currency or a foreign currency, above which problems of debt sustainability arise. This can lead the country into years of slow growth, whether because private agents anticipate a sharp increase in taxes and decide to reduce their investments or consumption in advance, or because markets doubt the government's ability to repay debt and require in consequence higher interest rates.

Reinhart and Rogoff suggest that this critical debt threshold is 90% of GDP for advanced economies and 60% for emerging economies with debt in foreign currency.

[1] Carmen M. Reinhart and Kenneth S. Rogoff (2010), « Growth in a time of debt », American Economic review, Vol. 100, n°2, May (pp. 573-78).

There are no absolute criteria for the sustainability of public debt

Reinhart and Rogoff's studies have proved controversial, in particular because they have served as scientific justification for budgetary austerity policies. Over the course of the past decade, many empirical studies have been carried out to determine whether there is, indeed, a threshold above which debt becomes economically risky. Today, if it is generally believed that, above a certain level, the growth of public debt can compromise growth prospects, the threshold of 90% of GDP is largely contested.

Neither historical facts, nor economic theory point to a figure, common to all countries and constant over time, **for the maximum amount of debt a country can sustain**.

Interest rate on debt, growth, and multiple equilibria

The economic literature considers that **the gap between the interest rate a government pays on its debt and the nominal growth rate of its economy plays a key role** in the trajectory of public debt.

When the interest rate is higher than the growth rate, the burden of debt increases due to a snowball effect: the weight of interest in the government's budget rises, driving expenses upward and widening the deficit. This, in turn, forces the government to continue to borrow and inflates the level of interest it owes. The government must then generate a primary surplus (excluding interest charges) to stabilise or reduce its debt ratio.

On the other hand, when the interest rate is lower than the growth rate, debt tends to shrink automatically. But this interest rate itself depends on a number of factors, including current levels of debt and deficit, social acceptance of a tax increase, and the government's capacity to collect savings. The latter, in turn, depends on several factors including the government's reputation for budgetary discipline, the acceptability of the policies carried out, and the economy's future growth trajectory, as well as those of inflation and deficit. The analysis of these factors and their trajectories leaves significant room for interpretation.

For this reason, **the perception of investors appears to be an essential variable in determining the sustainability of public debt**. Regardless of a country's fundamentals, its government can lose the trust of, and therefore access to, financial markets. The deterioration of market sentiment can tip governments from a good equilibrium (in which debt is deemed sustainable and risk premiums demanded by investors are low) to a bad equilibrium (in which debt is perceived as unsustainable, causing a rise in interest rates that may place debt on an unsustainable path). These self-fulfilling behaviours can lead to multiple equilibria; it follows that a high level of debt is sustainable as long as markets maintain confidence in the government, but becomes unsustainable as soon as this confidence is lost.

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