HSBC Global Research

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The ticking debt time bomb

The global monetary risks stemming from fiscal excess

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Economics - Global

- Unprecedented peacetime increases in public debt…
- …are now more difficult to digest…
- …given the higher monetary costs of achieving price stability

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A central bank "subsidy" to government?

Following the end of the Global Financial Crisis, most economies in the developed world became hooked on ever-increasing amounts of government debt, associated with banking bailouts, COVID-19 support mechanisms and, following Russia's invasion of Ukraine, generous energy subsidies. Until recently, however, such debt increases offered no significant macroeconomic risk. With central banks setting interest rates at zero and delivering seemingly endless quantitative easing, debt service costs remained under control.

Price stability or debt stability?

With inflation now having replaced deflation as the major monetary challenge, fiscal stability may no longer be so easily achieved. Put simply, the level of real interest rates now required to keep inflation at bay may be too high for lasting government debt sustainability. Policymakers are left with a stark choice: either keep interest rates high enough to defeat inflation, in which case government debt rises too rapidly, or leave interest rates low enough to stabilise government debt, in which case inflationary overshoots will become increasingly common.

The exchange rate "barometer"

History suggests that the exchange rate can serve as a useful barometer to assess specific country risks. The US dollar tumbled in the early-1970s. Sterling collapsed in the middle of that decade. Today, Japan may be facing a similar threat: a continued yen decline may end up magnifying inflationary pressures in a situation where, rightly or wrongly, investors begin to wonder whether the Bank of Japan is able to raise rates far enough given likely consequences for debt service costs.

Fasten your seatbelts: financial turbulence ahead

The independence of central banks has camouflaged the historically important relationship between monetary and fiscal policy, particularly with regard to the pursuit of price stability. Yet the central banks themselves are – unintentionally – partly responsible for re-exposing that relationship, given that they dramatically lowered the costs to governments of ever-higher levels of debt. With government debt set to rise much further – reflecting soft growth and the mounting costs of, *inter alia*, population ageing, the green transition and heightened defence spending in an increasingly dangerous world – the risks of monetary and financial upheaval are rising rapidly.

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The ticking debt time bomb

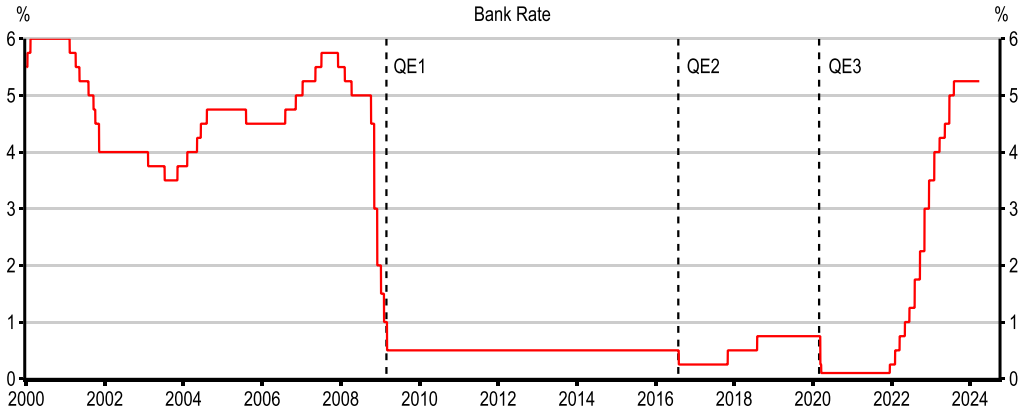
- The separation of monetary church from fiscal state is taken for granted
- Yet with government debt already high and set to rise much more rapidly, monetary risks are mounting
- Interest rate and currency shocks will become more frequent, and governments may tolerate sustained periods of "sticky" inflation

The unintended fiscal consequences of quantitative easing

Since the advent of inflation targeting and independent central banks, it has been generally assumed that achieving price stability is a job for monetary policy alone. It may now be time for a rethink. Fiscal policy may be just as important as monetary policy. To understand why, we first have to consider what might best be described as some of the unintended consequences of quantitative easing.

The adoption of quantitative easing was a response to policy rates falling closer and closer to the so-called "zero rate bound" in the aftermath of the 2008 Global Financial Crisis (or, in Japan's case, long before that crisis). Central banks couldn't admit they were running out of ammunition, so they had to find something other than rate cuts to stimulate the economy. Quantitative easing seemed to be the answer (chart 1).

1.QE went hand-in-hand with a near-zero interest rate policy in the UK – and elsewhere



Source: Macrobond, HSBC

In truth, quantitative easing was a halfway house between standard rate cuts and the helicopter money described by, among others, Milton Friedman. The idea was to buy "second hand" government debt (and, particularly for the Federal Reserve, other forms of typically riskier private debt) with newly created electronic money. The benefits of this arrangement included (i) the potential for interest rates further out the yield curve to fall; (ii) the positive impact of those further declines on the value of riskier assets (such as equities and real estate); (iii) the likely boost to consumer demand linked to the resulting increase in financial wealth; and (iv) the

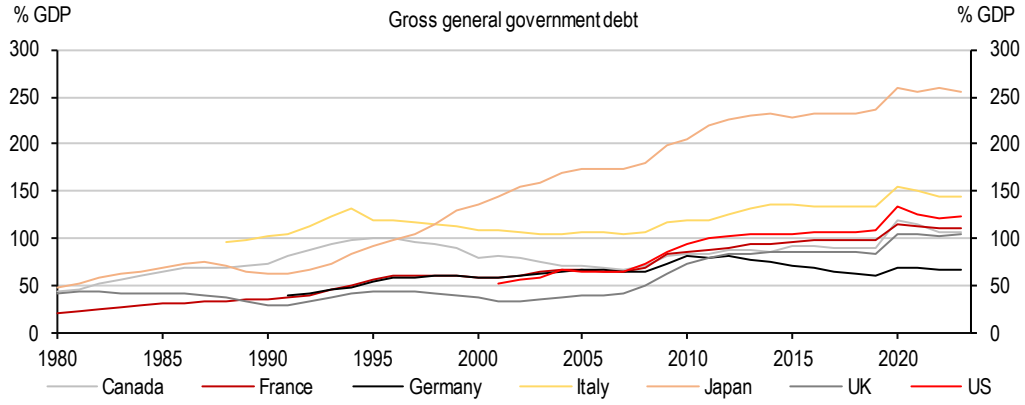
heightened ability of companies to raise funds via the capital markets even as commercial banks were left to nurse their post-Global Financial Crisis (GFC) wounds.

Unlike helicopter money, however, there was no intention to deliver a monetised tax cut (or a monetised increase in public spending). More specifically, the stimulus was aimed at boosting private sector activity directly, not via a money-funded increase in government borrowing. Central banks thus focused on the purchase of existing government debt, as opposed to newly-created government debt. Governments were supposed to stick to fiscal orthodoxy, even if central banks were becoming ever more experimental.

The end of fiscal orthodoxy?

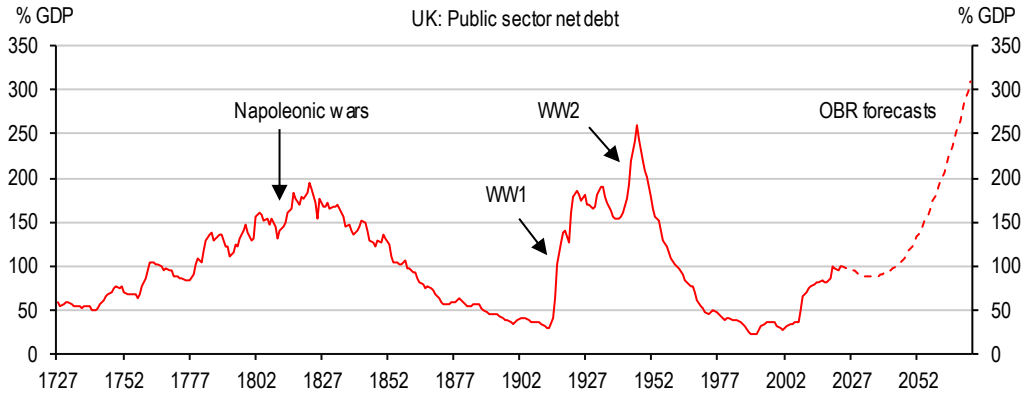
In hindsight, however, it's not at all obvious that orthodoxy prevailed. During what proved to be a sustained period of zero rates and QE, government debt soared. Chart 2 shows levels of government debt as a share of GDP across the G7 since 1980. Until the advent of the Global Financial Crisis, debt had been, mostly, low. Thereafter, it has risen at a rate of knots. In the UK's case, where there is a rich history going all the way back to the early 18th Century, it is safe to say that, in peacetime, such a sustained increase is without precedent. Yes, debt has risen rapidly in the past, but only for the purposes of financing warfare (chart 3: the 18th Century was associated with so many wars that there wasn't space on the chart to label them all).

2.Japanese government debt has risen enormously but some others are following suit



Source: IMF WEO

3. UK government debt has already risen rapidly and the Office for Budget Responsibility thinks there's a lot more to come



Source: OBR, BoE, HSBC

The standard defence for such huge increases in government debt is that major economies have faced an unprecedented series of negative shocks in a remarkably short space of time: the GFC itself cast a long shadow over economies but, even as that shadow was beginning to lift, debt rose further in response to, first, the COVID-19 pandemic and, shortly afterwards, the Ukraine-related surge in energy prices. What else could governments do?

The weakness in this argument, however, is that not all governments succumbed to fiscal profligacy. Germany's government debt is now lower as a share of GDP than it was in the immediate aftermath of the GFC (chart 2). Switzerland's is no higher than it was back then (chart 4). Yet both were as much affected by COVID-19 and higher energy prices as anybody else. Admittedly, both nations have, over many decades, revealed a preference for fiscal caution not shared elsewhere. Nevertheless, their monetary arrangements were no different to others'. They were offered the temptation of cheap money but, for the most part, they resisted (if only because they were constitutionally constrained: some fiscal rules are tougher than others).

4. The Swiss have been fiscally conservative even as others have not

Source: IMF WEO

Others, however, arguably did give in to temptation (or, to be kind, discovered in hindsight that their fiscal positions were far weaker than anticipated thanks to the impact on revenues of continuously lacklustre growth). True, central banks were not directly in the business of funding increases in government borrowing. Yet, to the extent that governments knew that central banks were, in effect, underpinning bond markets via guarantees of very low yields (thanks to persistently low inflation and, on occasion, outright deflation), the risks associated with running up ever larger amounts of government debt appeared to be minimal[1]. Gone were the "crowding out" dangers of the 1970s and 1980s, when additional government borrowing threated to raise interest rates and limit private sector investment: central banks had, in effect, removed that danger by guaranteeing low yields across all maturities over an indefinite future. The bond market vigilantes had been sent packing. Meanwhile, currency markets were mostly becalmed because, given the increasingly international nature of the deflationary challenge, policymakers were "all in this together": no one country faced more currency risk than any other, at least as a consequence of monetary stimulus.

[1] Different rules applied in the Eurozone, where individual nations did not have direct access to a printing press and, until Mario Draghi promised to do "whatever it takes" in 2012, faced serious sovereign risk dangers

The tension between varying monetary objectives

This view was fine while it lasted. Put simply, monetary policies designed to defeat deflation had a useful side effect: they also lowered the costs of government finance at a time when fiscal stimulus itself potentially offered a useful shot in the arm for otherwise somnolent economies. Yet, as inflationary pressures returned in 2021 and onwards, a potential tension arose*: monetary policies necessary for the delivery of price stability were potentially inconsistent with those required to deliver fiscal (and thus financial) stability*.

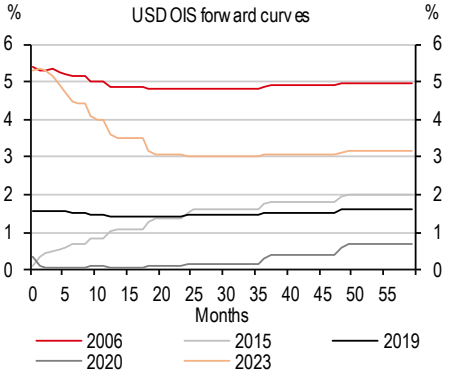
To understand why, it's worth considering some basic fiscal arithmetic. A country's budget deficit (or surplus) can be divided into two parts: the so-called "primary" deficit (or surplus) and, separately, interest payments on existing government debt. Other things equal, the higher the level of government debt – in effect, the totality of all deficits accrued historically – the greater is the interest paid given the prevailing level of interest rates.

At the same time, the pace of economic growth and the rate of inflation will have an impact on both the size of any primary deficit and the debt/GDP ratio. Other things equal, higher growth and higher inflation will boost tax revenues relative to expenditures and, as such, reduce the level of primary borrowing in any one year (one reason why recessions tend to be associated with large budget deficits while booms deliver either smaller deficits or, occasionally, outright surpluses). Meanwhile, the faster is the growth rate of nominal GDP, the lower will be the ratio of debt to GDP, thanks to a larger denominator than might otherwise have been the case.

There is, of course, a major complication. The level of interest rates is – loosely - related to the pace of economic growth and the rate of inflation: in other words, stronger growth may lift revenues (thanks to higher tax receipts) and reduce spending (thanks to lower unemployment benefits) but may also, to a degree, raise nominal interest rates and thus boost debt interest payments. What matters in these circumstances is the level of debt, the proportion of that debt which is linked to short-term interest rates (and thus more sensitive to immediate rollover risk) and the degree to which interest rates rise relative to any acceleration in either growth or inflation. It is, ultimately, an empirical matter.

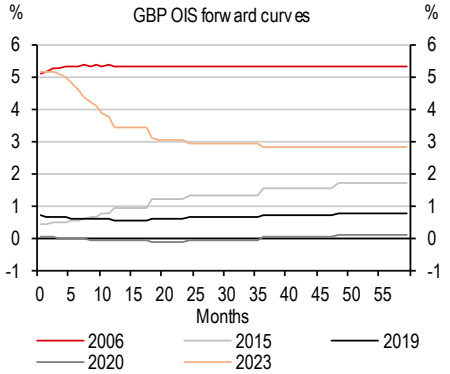
Seen in this light, recent developments have not been encouraging for fiscal stability. Interest rates across the yield curve are dramatically higher than they once were. Charts 5 and 6 show yield curves for, respectively, the US and UK at the end of 2006 (pre-GFC), end-2015 (post-GFC), end-2019 (pre-COVID-19), end-2020 (peak- COVID-19) and end-2023 (post- COVID-19). The perceived "Japanification" of the western developed world has come to an abrupt end: central banks are now engaged in a fight against inflation rather than deflation and, in both nominal and real terms, borrowing costs are a lot higher than they once were across all maturities (see chart 7). One way to interpret this outcome is that the level of interest rates required to deliver price stability is now much higher than it was, another way of saying that the earlier deflationary mind-set has been replaced by an inflationary mind-set. That holds true even if market expectations of interest rate cuts later in 2024 prove to be correct.

5. Borrowing costs are not back to where they were pre-GFC…



Source: Bloomberg Note: OIS curves are taken on the 31 December for each year

6…but they're a lot higher than at any other point post-GFC



Source: Bloomberg Note: OIS curves are taken from 31 December for each year

7. US 10-year real yields back to pre-GFC levels

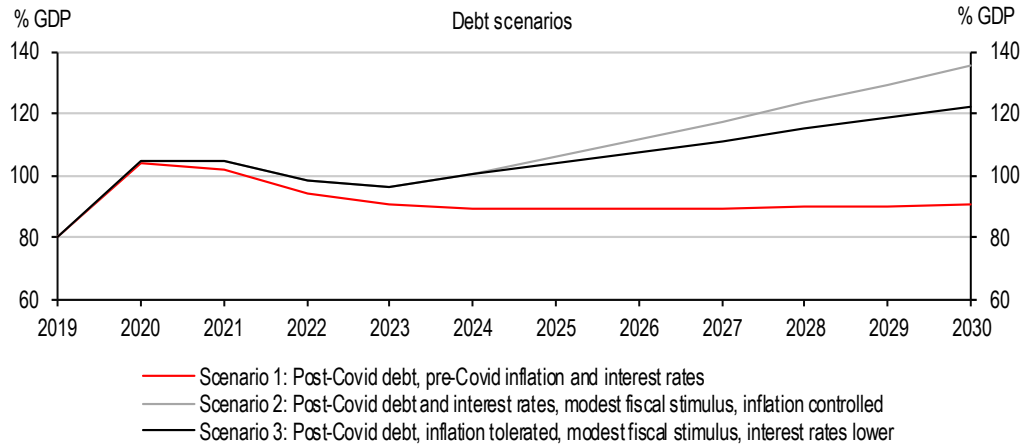
Source: FRED, Federal Reserve Bank of Cleveland, using an estimate of the expected rate of inflation over the next 30 years along with the inflation risk premium, the real risk premium, and the real interest rate

Growth-wise, the US is stronger than it was pre-COVID-19 but both the UK and the Eurozone remain fragile. For the most part, the trade-off between growth and inflation appears to have worsened, pointing to a persistently disappointing supply-side response, whether because of the effects of near-shoring, the enthusiasm for "national resilience", an increase in sickness among those of working age (an apparently lasting legacy of COVID-19 in some countries), the emergence of populism and nationalism across numerous nations or, more prosaically, a sense that central banks have lost some of their "invincibility" (and, as such, that they may need higher real interest rates for an extended period to regain credibility)[2]. The overall implication is that the achievement of price stability may require more monetary "heavy lifting" than was true before the onset of the COVID-19 pandemic, even more so given the excess money created during the pandemic, much of which is still sloshing around the economic system.

As such, a situation may emerge in which the level of interest rates required for price stability may be at variance with the level required for fiscal stability. Chart 8 shows a theoretical demonstration of the problem, which ultimately stems from a combination of three things: a higher stock of debt; a lower real growth rate and a higher nominal interest rate (the last required because of stickier inflation, in turn a reflection of persistent supply-side "scarring" and diminished central bank credibility). The chart offers three scenarios, focused on a fictitious economy closely approximating to the UK. Scenario 1 is, in effect, a pre-pandemic story with post-pandemic levels of debt, in which both inflation and interest rates return to historically low levels. Scenario 2 is a post-pandemic story in which the costs of delivering price stability are seen both in a worsening split between growth and inflation and in the form of higher interest rates, both nominal and real: put simply, the debt/GDP ratio rises much more rapidly, not helped by a politically expedient if economically short-sighted near-term loosening of fiscal policy (central banks may be able to rise above the temptations of the electoral cycle but many democratically-elected governments do not). Scenario 3 allows for the covert tolerance of higher inflation: there is no return to the 2% target of old, in part because nominal interest rates are never quite high enough. Debt, however, doesn't rise as quickly as in scenario 2, at least as a share of nominal GDP. Put simply, tolerating higher inflation can bring with it some near-term fiscal benefits.

[2] Paul Volcker, the then-Chairman of the Federal Reserve, defeated US inflation in the 1980s partly by delivering positive real policy rates after the negative rates witnessed under the watch of Arthur F Burns in the inflationary 1970s

8. Interest rates and inflation matter for government debt sustainability: a "fictitious UK" example



Source: HSBC calculations, based on IMF WEO data

There is, thus, a potential inconsistency between monetary arrangements designed to deliver price stability and monetary arrangements that, in the short-term at least, might help stabilise a government's debt position. In that sense, inflation (if not fully anticipated) acts as a tax, both on cash savers and on the incomes of those who find themselves in higher tax bands (assuming those bands are not fully indexed). Monetary policy can, at times, be hijacked by fiscal policy. And, as we shall see, one of the more useful barometers of such hijacking in an international context is typically the exchange rate.

Past, present and future

Inconsistencies between inflationary and fiscal objectives have plagued nations over hundreds of years. In the modern era, we habitually think of such problems being associated primarily with emerging economies which lack fiscal "space" owing to poor systems of tax collection, overly generous levels of public spending via attempts to curry favour with vulnerable voters, weak balance of payments positions and, at times, kleptocratic leaderships that run off with the money. Yet such habits can only take us so far. The developed world has also encountered problems associated with a growing inconsistency between monetary and fiscal objectives, typically because achieving good outcomes for growth and inflation simultaneously has proved to be tricky, to say the least. Three examples, one of which is potentially playing out in front of us now, should suffice to demonstrate the general point.

1. The end of Bretton Woods and the Nixon "shock".

For two decades from the late-1940s onwards, much of the world economy was tied to a hybrid dollar/gold standard under the Bretton Woods system of fixed but adjustable exchange rates. The US dollar itself was supposedly "as good as gold". The system's success depended on the US providing a monetary anchor for other nations. Other currencies could adjust in value against the dollar, the equivalent of planetary orbits adjusting around a "fixed" sun. The dollar, however, was supposedly immovable in value, at least vis-á-vis gold. The implication was that the American authorities had to "behave themselves" in terms of both monetary and fiscal policy.

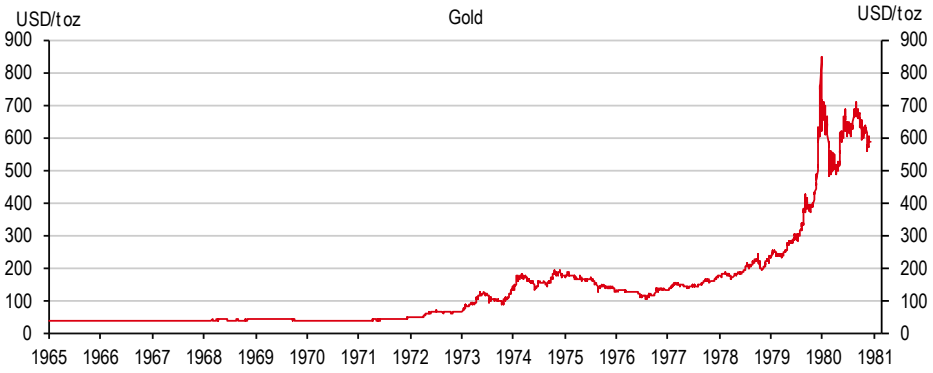
Yet this approach depended on the dollar itself retaining its credibility. As the 1960s progressed, however, the dollar's situation became increasingly precarious. Lyndon B Johnson's Great Society commitments contributed to ever-more rapid US economic growth. As a consequence, the labour market tightened, leading both to diminishing productivity growth and accelerating wage growth. All the while the US was funding a costly war in Vietnam. The result was a sustained rise in inflation, a widening of America's balance of payments deficit and increasing downward pressure on the US dollar (see table 9 and chart 10). President de Gaulle's decision in 1965 to sell French US dollar foreign exchange reserves in favour of gold only added to the greenback's problems (de Gaulle rightly feared that, eventually, the Americans would be forced to pull the plug on the dollar's pivotal role in the global financial system, even if he wrongly called for a return to a gold standard that Keynes in the mid-1920s had poetically labelled a "barbarous relic").

9. How things looked for the US economy back in the day

Year	GDP (%yr)	Inflation (PCE % yr)	Unemployment rate (%)	Wages (% yr)	Output per hour (% yr)	Unit Labour Costs (% yr)	10Y bond yield (%)	BoP current account ($bn)
1965	6.4	1.4	4.5	4.2	3.1	0.2	4.3	5.4
1966	6.5	2.5	3.8	3.5	3.6	2.3	4.9	3.0
1967	2.5	2.5	3.8	2.8	1.7	4.0	5.1	2.6
1968	4.8	3.9	3.6	5.4	3.4	4.3	5.6	0.6
1969	3.1	4.5	3.5	6.1	0.2	6.6	6.7	0.4
1970	0.2	4.7	4.9	4.2	1.5	5.6	7.4	2.3
1971	3.4	4.2	5.9	6.2	4.0	2.3	6.2	-1.4
1972	5.3	3.4	5.6	7.7	3.3	3.1	6.2	-5.8
1973	5.8	5.4	4.9	6.2	3.1	4.9	6.9	7.1
1974	-0.6	10.4	5.6	5.6	-1.6	11.6	7.6	2.0
1975	-0.2	8.4	8.5	5.6	2.8	7.1	8.0	18.1

Source: Economic Report of the President, various editions, HSBC

10. All that glitters is sometimes gold…or at least it was in the 1970s



Source: Macrobond

One way around this would have been for the US to have tightened both monetary and fiscal policy to nip the rise in inflation in the bud. That, however, did not happen. Instead, following the 1971 "Nixon shock", the dollar floated (or sank, depending on one's point of view) while Washington imposed an across-the-board tariff on imports from near enough everywhere together with a domestic prices policy. In effect, the US attempted to limit inflation via domestic wage and price controls even as imported prices rose thanks to a falling currency and punitive tariffs.

The imposition of such economic straitjackets rarely succeeds, particularly when, outside of wartime, people are unwilling to tolerate ongoing limitations on their civil liberties. The US economy was simply growing too quickly. A sustained tightening of monetary and fiscal policy was needed to keep a lid on inflation and prevent the balance of payments from spiralling out of control. Instead, in a bid to maintain domestic economic vigour, the exchange rate was allowed to fall in the forlorn hope that the US could radically improve its competitive position vis-á-vis the rest of the world. As John Connally, the combative US Treasury Secretary, said at the time, "The dollar is our currency, but it's your problem".

He was only half right. The US dollar collapsed in value against gold through the 1970s, and inflation took off. In effect, attempts to reconcile a weakening balance of payments position with an overly ambitious path for domestic economic growth could only be sustained through a monetary expansion which, in effect, allowed inflation to accelerate. As it turned, out, this was very good news for government debt sustainability – largely because real interest rates were mostly negative throughout the whole period, allowing the ratio of government debt to GDP to drift lower throughout the decade. It was also, however, terrible news for the broader economy.

2. The UK's "growth at all costs" strategy of the 1970s

When the rest of the world is reacting to an inflationary shock and a single country tries to head off in a different direction, the currency often initially takes the strain. In the mid-1970s, this now familiar mechanism was still rather novel. Under Bretton Woods, after all, currency adjustments were few and far between. It was scarcely imaginable, therefore, that sterling could collapse in the way it did. Yet between the end of Bretton Woods in 1971 and October 1976, sterling fell from USD2.40 to USD1.60 and by an even greater amount against the Deutsche Mark.

The British view at the time – eerily familiar to observers today – was that the early-1970s rise in inflation was a product more of bad luck than of bad judgement. After all, hadn't oil prices quadrupled in late-1973, implying a huge spike in input costs that was bound to raise inflationary pressures temporarily? All true, of course, but not, as it turned out, the whole truth. Inflation was already bubbling away long before OPEC's actions in 1973. The oil shock, meanwhile, was regarded by the UK authorities as more a demand than a supply shock (the same view, interestingly, was taken by many western policymakers when initially evaluating the impact of the COVID-19 pandemic). As a result, monetary policy was left relatively loose and fiscal policy was mostly supportive: large budgetary surpluses in the late-1960s shrank in the early-1970s before turning into deficits in 1975 and thereafter.

Despite this apparent fiscal laxity, however, the ratio of government debt to GDP fell for most of the period, a reflection of rapid inflation-driven increases in nominal GDP and persistently negative real interest rates. It appeared, therefore, that nothing was seriously amiss.

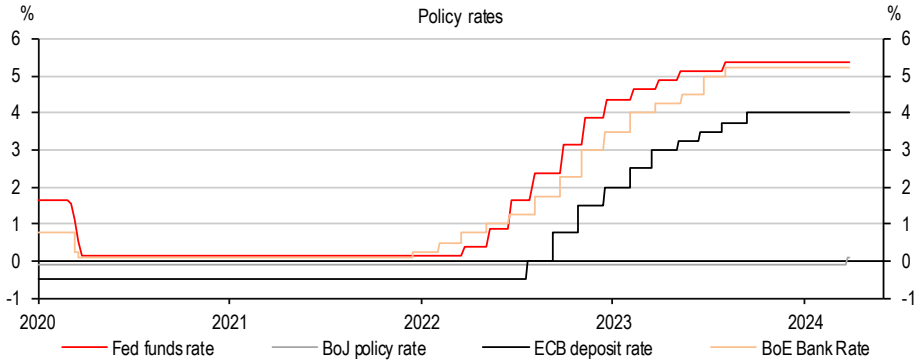
The currency markets suggested otherwise. If other countries were intent on bringing inflation to heel and the UK was not, the most obvious outcome was a collapse in sterling's value on the foreign exchanges, which is exactly what happened. This only served, however, to magnify the UK's burgeoning inflation problem which, in turn, led to even more sterling weakness. In 1976, the government of the day was forced to call in the IMF. Denis Healey, the then Chancellor of the Exchequer, had struggled to bring the UK's fiscal position under any kind of control, thanks in part to a totally divided Cabinet. The markets knew it. The IMF's involvement imposed much-needed discipline from afar. Sterling soared and, for a while, inflation went into retreat (had the fiscal position remained incontinent, no amount of monetary tightening would likely have restored credibility in the eyes of foreign creditors.)

3. Going it alone in the modern era: the strange case of Japan

On 19 March 2024, there was, it seemed, a momentous change in Japanese monetary policy. After decades of quantitative easing and various forms of yield curve control, the Bank of Japan finally decided to raise interest rates.

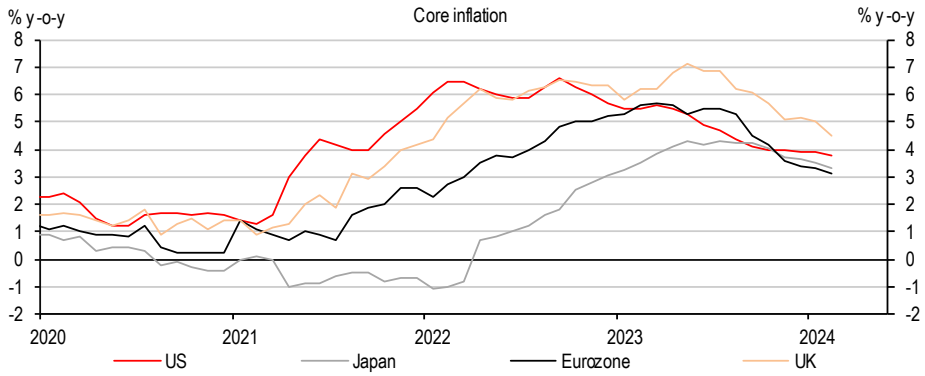
Relative to Japan's own history, this was a big deal. Relative to what other central banks had done, Japan's actions were, frankly, small fry. Chart 11 shows policy rates for major economies since 2020, taking into account both the initial laxity and the aggressive tightening thereafter. The striking feature of this comparison is Japan's position: even though its own inflation rate has risen, the degree of monetary response has been tiny compared with its industrial peers.

11. Others moved, the BoJ scarcely budged



Source: Macrobond

12. Japanese core inflation was lower but now as high as elsewhere



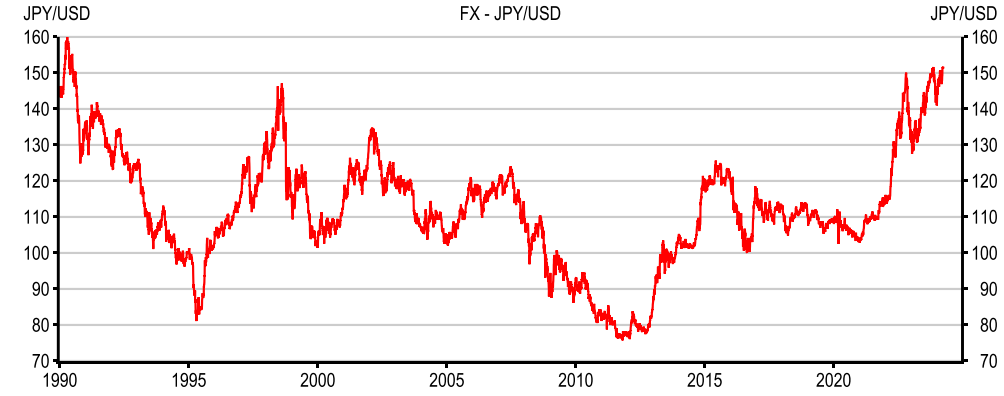
Source: Macrobond

The easy explanation for this difference comes from Japan's previous history. For a nation having suffered from deflation for around three decades, it might seem odd to tighten monetary policy at the first sign of inflation (and, indeed, the BoJ would describe its latest move not as a "tightening" but, instead, merely an exit from negative rates). After all, economists have argued for years that Japan needed a sustained period of above target inflation to break the deflationary psychology of old.

Yet it is difficult to make such choices in a vacuum. Consider the following three key points:

- First, since the global tightening of monetary policy, the Japanese yen has tumbled in value, precisely the kind of problem that plagued other countries when they chose to head down a different monetary path to everyone else. Shortly after the global financial crisis, a US dollar was sufficient to acquire JPY80. After the March 2024 Japanese rate increase, a US dollar was worth JPY152.

13. The Japanese yen is at its weakest point in over thirty years



Source: Macrobond

- Second, the fall in the exchange rate may lead to much higher inflation than initially anticipated. In effect, Japan is importing the world's inflationary woes (or, put another way, others are exporting their inflationary woes to Japan). Might it be that markets are too sanguine about Japan's inflation outlook?
- Third, dealing with the return of inflation might require real interest rates to rise to levels not consistent with longer term fiscal stability. It's easy enough to allow government debt to rise seemingly without limit when interest rates are at, or below, zero and the central bank is buying up huge amounts of government bonds in a bid to impose yield curve control. It's a totally different matter trying to manage that same debt when the cost of borrowing worldwide is rising: if interest rates domestically don't follow the global trend, the danger is that the currency goes into freefall, leading to ever-mounting inflationary problems.

A new impossible trinity?

A well-established maxim in economics is the so-called "impossible trinity". It is simply not possible simultaneously to fix both the inflation rate and the exchange rate in the absence of exchange or capital controls. This means that a country has either to allow its exchange rate to float (the US or the UK, for example), to lose direct control of its inflation rate (countries in the Eurozone), or to impose capital and exchange controls (China, to a limited extent, and emerging nations over the years).

In a world of high government debt, taken on board during a sustained period of zero or negative interest rates alongside continuous QE, a new version of the impossible trinity may

have arisen. In this guise, it simply isn't possible to set interest rates at levels that will stabilise both government finances and the inflation rate in a world in which inflation generally threatens to be too high rather than too low. Attempts to bring inflation to heel – involving elevated real interest rates – will simply lead to an excessive increase in government debt. Attempts to stabilise government debt – involving depressed or even negative real interest rates – will simply allow inflation to accelerate. Attempts to raise taxes or cut public spending, meanwhile, may simply not be possible if political "space" for such policies has run out.

The situation is made still worse if one country chooses to stabilise government debt via lower interest rates while others focus on the defeat of inflation via higher interest rates. The resulting interest rate differential is likely to trigger major currency weakness for the "debt-stabilising" nation, in turn leading to a further inflationary acceleration. In this situation, foreign creditors will increasingly recognise they are "on the hook" for a nation's fiscal profligacy, discovering that what they might gain in local currency terms could be partially lost via currency deprecation.

The surging Nikkei 225 provides a recent – and pertinent – example. In the five years to the end of February 2024, the Japanese stock market offered a total return in local currency of 101.5%, marginally ahead of the 98.3% return on the S&P500 over the same period. In US dollar terms, however, the Nikkei's return was a mere 48.8%: not disastrous, but disappointing compared with what was available elsewhere and a direct result of the yen's ongoing weakness.

The hope must be that inflation will fall elsewhere by a degree sufficient to allow the international interest rate differential to narrow, thereby reducing the currency risk for those most fiscally exposed to higher real interest rates globally. That, however, is not much more than a gamble. Even if, for example, the Federal Reserve and other central banks do cut policy rates later in 2024, differentials are likely to remain wide, and therefore the risk of large currency adjustments will remain.

Moreover, even if interest rates do fall, there may be no easy return to the levels prevailing before the onset of the COVID-19 pandemic[3]. With debt levels much higher than they once were and with inflationary risks more apparent than seemed plausible in, say, 2019, government debt service costs threaten to be permanently higher than they once were. That, in turn, creates a serious headwind for future economic development. There are, after all, only so many ways of bringing a potential government debt spiral back under control: some are, at the time of writing, more politically digestible than others:

1. **Raise taxes.** But with economies already weak and tax burdens high, there are political limitations.
2. **Cut public spending.** Easier said than done when governments are confronted with the costs of population ageing (pensions, healthcare and social care), a green transition and a rising defence bill in an increasingly dangerous world.
3. **Boost productivity.** The "holy grail" of policymakers but few have successfully managed to deliver on their promises (although some might argue that the US has done so post-COVID-19 – time will tell). Recent technological changes may have done more to redistribute income and wealth away from labour and towards capital than to lift living standards more generally.
4. **Default.** Rarely chosen, and typically an act of desperation that only serves to reduce access to international capital markets over extended periods of time (think, say, of Argentina over the decades).

[3] See King, S., *To cut or not to cut: the dangers of premature easing*, HSBC Research, 12 January 2024

5. **Impose financial repression.** Such policies allow governments to jump to the front of the "credit queue", which simply means that others are denied access to credit even if they have worthwhile investment plans. In other words, the risk is that, other things equal, growth is lowered over the long term.
6. **Accept a higher inflation rate.** Such actions may eventually risk hyperinflation but, in truth, higher inflation, if not fully anticipated, will redistribute wealth in an economy from creditors to debtors. As governments are now heavily indebted and, indirectly, control the printing presses, their incentive to create inflation is, to say the least, substantial.

The key point, ultimately, is that, in the absence of decent economic growth – and there has been little to write home about in the last two decades – government debt that has already risen a long way is in danger of rising inexorably further. While Japan has demonstrated that such large increases need not lead to a funding crisis – bond yields have been at rock bottom throughout its deflationary malaise – that may not hold in a world in which inflation, not deflation, is the bigger threat. Put simply, the higher real interest rates have to be in order to quell inflation, the bigger the danger of an unsustainable increase in government debt (at the time of writing, no one was seriously forecasting a sustained increase in interest rates but, then again, no one was forecasting a sustained further decline in the yen's value on the foreign exchanges).

Some final historical lessons

For students of previous hyperinflationary episodes (and, for that matter, sustained inflationary episodes) none of this should come as a major surprise. Interwar hyperinflations were brought to an end not just through monetary tightening but also via a commitment never to fund budget deficits via the printing press (typically, this required draconian tax increases and spending cuts to put the fiscal numbers on a sustainable non-inflationary path). The disinflations of the 1980s were, in many cases, helped by conservative fiscal policies, of which the UK's Medium Term Financial Strategy was an obvious example. In most such cases, the link between inflationary success and fiscal stability was explicitly recognised.

Admittedly, there is one huge exception, namely the US in the first half of the 1980s, a period during which real interest rates were incredibly high and the budget deficit incredibly large. Back then, however, tight US monetary policy probably did more to deflate the rest of the world than the US itself. After all, Paul Volcker's anti-inflationary policies helped trigger the Latin American debt crisis. What is true for the world's dominant international currency is not, however, necessarily true for everyone else. As John Connally didn't quite say, "it's our monetary policy, but it's your problem".

Still, the US experience during that period demonstrates that (i) defeating inflation generally requires positive real interest rates and (ii) positive real interest rates are not good for fiscal stability. Given how far government debt has risen since the early 1980s, those observations have never been more relevant. Admittedly, it's possible that a productivity miracle could bail us out but, so far, there has been scant evidence of one (even in the US, where productivity growth has recently been stronger, debt dynamics remain poor). Instead, current fiscal arrangements alongside sluggish real economic growth point to substantial further increases in government debt as a share of nominal GDP in coming decades, a view shared by both the Congressional Budget Office and the Office for Budget Responsibility. The monetary risks associated with such fiscal incontinence are only likely to build in the years ahead. As such, it may be time for us to fasten our macroeconomic and financial seatbelts: there is turbulence ahead, whether in the form of currency collapses, bond yield spikes or equity market sell-offs.

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