Surging Fiscal Deficits Should Not Unleash Bond Market Chaos

Strong institutional infrastructures should keep inflation at bay.

June 2020

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After a short hiatus, debate over whether rising fiscal deficits will lead to a calamitous sell-off in sovereign bond markets has resumed.

In one corner there are the "bond vigilantes," who contend that a sell-off in sovereign bonds is imminent. They believe this for two main reasons: first, because they feel simple supply/demand laws dictate that the price of government bonds must fall precipitously for duration risk to clear and second, because they think that fears over default risk will prompt bond investors to demand a much higher risk premium to finance profligate governments.

In the other (extreme) corner, there are the advocates of Modern Monetary Theory (MMT), who argue that central banks can simply print money to fund government fiscal deficits in order to keep the economy operating at full capacity.

Which, if either, is right?

Fiscal Expansions Need Not Cause Bond Market Disruption

Let's first look at the bond vigilantes' arguments. In any closed economic system (and the world is a closed economic system), by definition, one person must be willing to borrow for another person to be able to save. Accordingly, the net savings of the private sector must equal the net dissavings of the public sector. When economic uncertainty rises (as it does when the world is hit by a pandemic), nobody wants to invest (i.e., borrow) because they are too uncertain about the future. Rather, everyone wants to save so that they can withstand what might be coming. In response, supply/demand dynamics cause interest rates to fall to reduce the attractiveness of savings and bring forward investments.

The enormous fiscal deficits of today are simply evidence of the public sector stepping in to recycle the private sector savings—in other words, the public sector dissaving to facilitate private sector savings. This is the essence of countercyclical fiscal policy and explains why countercyclical fiscal expansions can be financed without disruptions to the bond markets. So, given the current backdrop, I am not convinced by the argument that the

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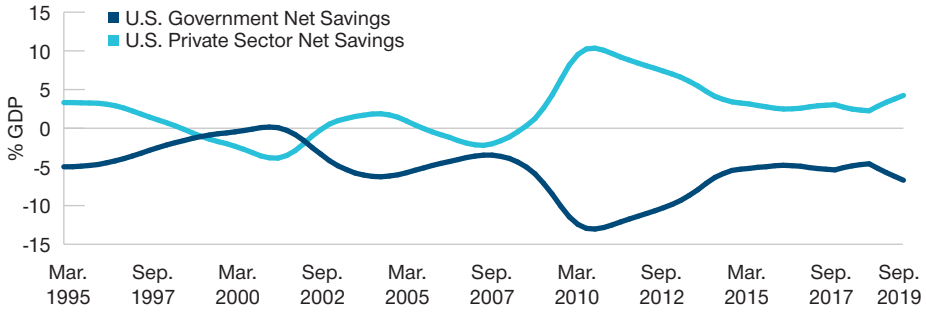
Private Sector Savings Must Equal Public Sector Dissavings

U.S. public and private debt, March 1995 to September 2019



As of September 31, 2019.
Source: U.S. Federal Reserve.

law of supply and demand will trigger a disruptive adjustment in the market for government debt.

Emerging Markets at Greater Risk Than Core Economies

Now let's turn to the bond vigilantes' second argument—that fears over government bond defaults will drive yields higher. As the official sector debt stock surges, investors must evaluate whether they believe that the debt stock is sustainable. Has U.S. government debt, for example, reached the level at which it is unsustainable? Let's run a thought experiment: What would be the interest burden on the U.S. government if it decided to increase the debt stock by 100% of gross domestic product (GDP)? If we assume that the average tenor of the debt is 10 years, at today's interest rate, the interest rate burden would amount to roughly 1.3% of GDP per annum (the total U.S. government debt would become 206% of GDP). Consequently, if the primary fiscal balance was zero, an average nominal growth rate in the United States of more than 1.3% would put the debt-to-GDP ratio on a downward trajectory. I believe nominal growth in the U.S., on average over the next 10 years, is likely to exceed 1.3% in nominal terms, so I am not overly concerned about the bond vigilantes' second argument either.

But what if interest rates rose? An increase in interest rates would be a sign of accelerating investment activity and/or consumption. Amid rising activity, the U.S. government would be able to bring about a fiscal consolidation. As a fiscal consolidation increases savings in the economy, it puts a cap on the rise in interest rates. In this manner, the interaction between the fiscal budget, aggregate savings, and the level of interest rates would likely keep U.S. debt on a sustainable trajectory.

This does not mean that any country could run an enormous fiscal deficit. The U.S. and other countries in the core of the financial system typically have credible institutional frameworks and political processes, mitigating the risk of inflation and currency instability. Most emerging economies have much weaker institutional infrastructures, which cause investors to fret that investments in government bonds might be undermined by a surge in inflation or, worse, by a failure to pay. Consequently, when times are tough, the private sector in emerging markets tends to move its savings into the core of the financial system. As a result, governments in emerging markets find their ability to run fiscal deficits constrained by the need to retain private sector savings in the domestic economy.

> ...quantitative easing in emerging markets carry higher risks than quantitative easing in the core economies.

MMT Undermines the Foundation of Stable Bond Markets

What about the argument from the MMT advocates that governments can just direct the central bank to print the money they need to finance their fiscal deficits? This argument presupposes that investors are willing to hold the money that the central bank prints. In turn, investors are willing to hold local currency only when they believe that the purchasing value of the money will not be eroded by bursts of inflation, or a currency devaluation. However, by letting politicians determine the pace of money printing, MMT would most likely reintroduce electoral spending cycles that lead to economic overheating, bursts of inflation, and financial instability—undermining the very institutional infrastructure that is supposed to reassure investors that government bonds are a safe investment.

This line of reasoning does not imply that investors flee at the first sign of money printing. However, it does suggest that the financial stability risks associated with money printing are higher in countries with a less mature and weaker institutional infrastructure. In other words, quantitative easing in emerging markets carries higher risks than quantitative easing in the core economies.

Second Virus Wave and U.S.-China Relations Pose a Bigger Threat

Overall, then, I think that the argument that surging fiscal deficits will lead to a major sell-off in developed sovereign bond markets can be put to one side for now. At the same time, the argument that central banks can simply print money to fund unlimited fiscal deficits is also flawed. For now, however, the most important point is that the monetary and fiscal policies put in place over the past few months have provided a strong tailwind for the global economy as it begins to open up again—and that the main threat to this is not inflation, but the teetering U.S.-China relationship and the prospect of a second wave of the coronavirus.

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ID0003371 (06/2020)
202006-1207021