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# Economist Insights

## *Sense and sustainability*

The focus for countries has always been on the level of their debt, but in fact sustainability depends far more on the interest burden from that debt. The interest rate is like the growth rate of the stock of past debt, so a country with a high enough GDP growth rate can effectively outgrow its stock of debt. While many countries have become less sustainable as debt has risen in recent years, for some the overall burden of their debt has remained unchanged or even fallen. Nonetheless, as debt rises, countries become more exposed to a change in interest rates, particularly since many countries have been issuing shorter-dated debt to capture lower borrowing costs.

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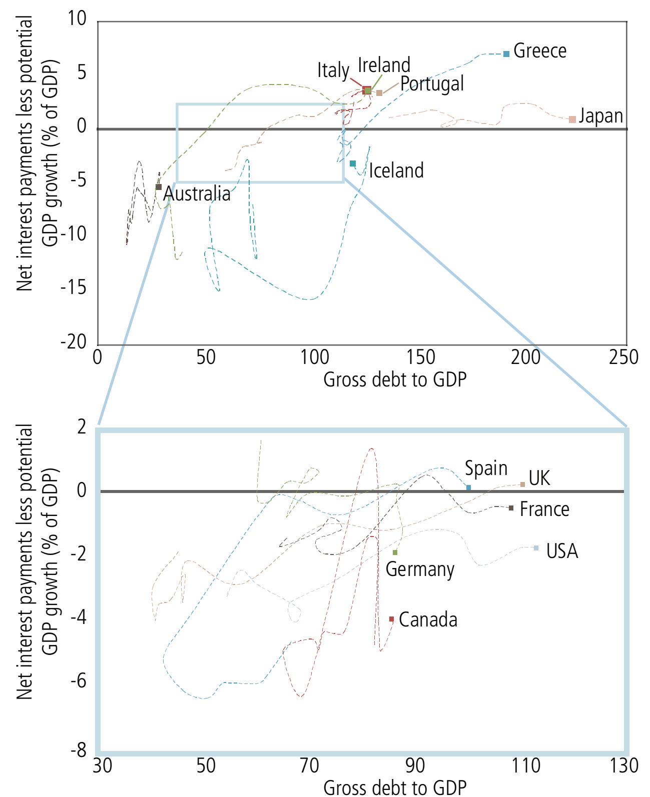
Everyone knows that many countries have too much debt, so everyone worries about countries that have lots of debt. But debt in itself is not really the problem. After all, if you had lots of debt but did not have to pay any interest, or if nobody ever asked for the principal back, then that debt would not really be much of a concern to you. It is the burden that the debt imposes that is the real problem. A country that has debt of 100% of GDP but only pays 3% of GDP in interest payments each year has much less of a problem than a country with the same debt that pays 7% of GDP in interest.

Even then, the affordability of those interest payments will depend upon the economy's growth rate. If a country has net interest of 3% of GDP, but nominal GDP is growing at 3% per year, then the country is effectively outgrowing its interest burden. In approximate terms, interest payments are adding 3 percentage points to the ratio of debt to GDP per year. But then economic growth is effectively reducing that ratio by about 3 percentage points per year (there is more GDP to spread those interest payments over). Debt will therefore only be growing if the country is running a deficit on the rest of the budget (known as the primary balance).

One simple measure of sustainability is therefore the difference between interest payments and trend growth. When interest payments are higher than trend growth, debt will be rising unless the country balances it out by running a primary surplus. When interest payments are lower than trend growth, debt will actually fall unless the country chooses to run a primary deficit instead. Comparing this measure of sustainability to debt levels can go a long way to explaining why some countries have low borrowing costs despite high debt levels (see chart).

**Sustainability snail trails**

Net interest payments less potential GDP growth, compared to gross debt to GDP ratio (%). Data shows 2005-2013 (OECD forecast), square marker denotes 2013 and line denotes path from 2005




Source: OECD Economic Outlook, November 2012

Two trends are immediately obvious. Firstly, both debt and this measure of sustainability have worsened on average across the board. Secondly, and more surprising, is that for many countries debt has risen without a worsening in the sustainability. In particular, the UK, France, US and Canada all have higher debt than in the past, but interest payments are still broadly in line with or less than trend nominal GDP growth. In other words, the problem for these countries is their primary deficit, not their existing debt burden.

Even Spain, which is the focus of so much concern, has interest payments that are only marginally above trend growth. Of course, someone could argue that the estimate of trend growth from the OECD may be too high – in which case Spain becomes far less sustainable. Nonetheless, compared to Greece or Portugal, Spain looks positively steady. Italy actually looks worse than Spain on these metrics, but take into account that Italy has a primary surplus while Spain has a primary deficit and you can see why the market sees Spain as riskier.

Partially this trend is due to the effects of monetary policy in the UK, US and Canada where the negative effects from weaker growth have been offset by lower interest rates on the newly issued debt. Conversely, France has benefited from both monetary policy and its status as a safe haven within the Eurozone.

An important factor which is not explicitly accounted for in this simple measure of sustainability is the link between the interest rate and the average maturity of the public debt. If a country's stock of outstanding debt has a short average maturity then it will need to roll over a large portion of its debt each year. If interest rates rise, then the new debt will have a higher interest burden and interest costs will rise relative to GDP, therefore the debt will become more unsustainable. If, on the other hand, a country has a very long average maturity of debt then an increase in borrowing costs will have less effect on sustainability.

With all the uncertainty about the future of Europe, investors are less willing to lend to riskier governments for long periods of time. Many sovereigns have therefore been forced to reduce the average maturity of the debt that they issue to avoid punitive borrowing costs. However, accumulating too much short-term debt increases "roll over risk" – the risk that interest rates rise in the meantime and as debt matures the country must refinance at a higher borrowing cost. Issuing longer-dated debt provides a government with far more certainty about its financing costs.

The longest average debt maturity of any country of significant size is that of the UK, which is particularly useful for the UK because it really needs that extra certainty. On Wednesday, the UK government will be announcing the new budget deficit and Chancellor George Osborne has already hinted that the targets will need to be pushed back again. This means more austerity for even longer.

The UK's fiscal consolidation has been based on reducing both the primary deficit and reducing interest payments. The government has been reducing the primary surplus through austerity measures while the Bank of England has been reducing the interest payments on the UK debt through quantitative easing. This coordination of fiscal and monetary policy may be the most effective approach to fiscal consolidation, but it is not always the best outcome for economic growth.

High levels of debt and slow growth are not in themselves a trigger for a financial crisis. Japan is living evidence that you can go for a long time with both high debt and slow growth yet still pay very low interest rates. The burden of the debt matters more to sustainability than the level of debt, but only if interest rates stay the same. Common sense still tells us that high levels of debt are still going to be less sustainable.

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