November 2023

Why Government Debt Levels Matter

Since the Global Financial Crisis (GFC) in 2008, debt levels of governments, corporations, and individuals have been on the rise. The decade-plus period that followed the GFC was characterised by record-low interest rates, which meant that the risk of these rising debt levels was largely ignored. Now that interest rates have risen sharply to counteract inflation, we are starting to see concern growing.

In this commentary, we explore how we reached these levels of debt, the reasons why this poses a risk to the global economy, and how a country such as the United States (US) might go about reducing its debt levels over time.

What are Debt Levels Today?

We focus on government debt for this commentary. In simple terms, this refers to the total amount of money that a government owes. It increases when a government borrows money to finance its spending or to cover budget deficits. This debt is typically in the form of bonds or loans that the government must eventually repay, with interest, to the lenders or bondholders.

Table 1: Growth in Government Debt for Select Nations [1]

Year	US (in USD)	China (in USD)	South Africa (in USD)
2000	$5.7 trillion	(data not widely available)	$38.6 billion
2008	$10 trillion	$729 billion	$154 billion
2015	$18.2 trillion	$3.4 trillion	$146 billion
2022	$28.9 trillion	$8.1 trillion	$284 billion

While the table above shows the exponential growth of government debt in these nations, it is much more informative to look at the growth of this debt in the context of a country's economic output. The generally accepted measurement for this is a country's Gross Domestic Product (GDP), which is a measure of the total value of all goods and services produced within a country's borders in a specific period, usually a year. While absolute debt levels indicate how much a government owes, the Debt:GDP ratio considers this debt in relation to the country's economic size. Figure 1 demonstrates that the US is currently at its highest-ever Debt:GDP levels in the modern era, even higher than when the country was fighting in World War 2.

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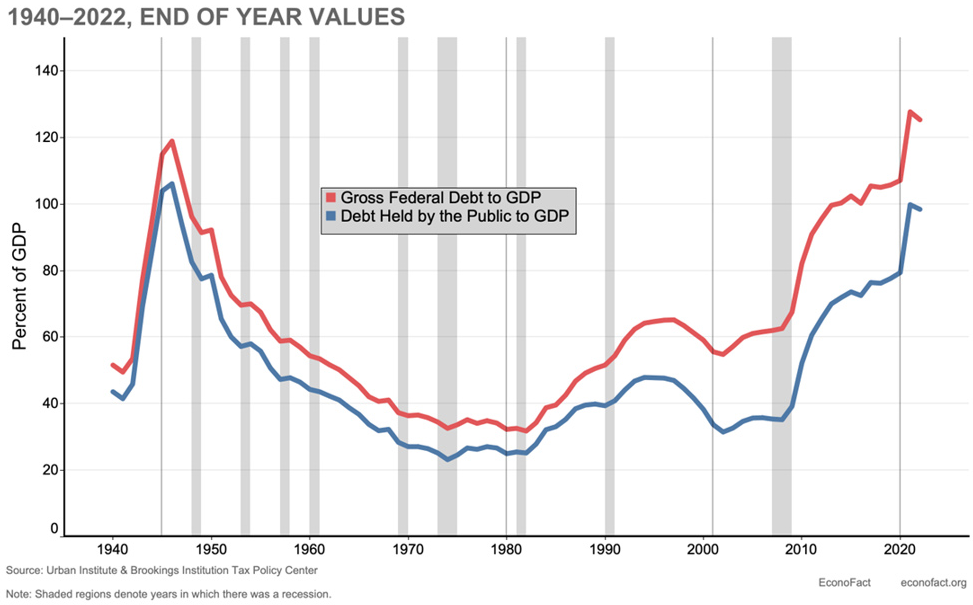
Figure 1: US Debt:GDP Through Time



So how did we get here?

If we use the United States as an example, we have seen their Debt:GDP levels almost double and their absolute debt levels almost triple since 2008. This growth has been significantly influenced by two key events: namely, the GFC in 2008 and the Covid crisis in 2020. Both of these events saw the US government stepping in to help both corporations and consumers from widespread economic collapse and to stabilise the economy.

While the exact government response to each crisis was slightly different, the main action they took was to 'print money', so to speak. This effectively means that they injected more money into the economy to keep it afloat. While they were effective in keeping the economy going, they funded this money printing by issuing more government debt.

The Issue with High Debt Levels

The question you are probably asking now is, *'So what? Why does it matter how much debt a government has?'* The answer is that higher Debt:GDP ratios are less of an issue when interest rates are close to 0%. At these levels the cost of paying interest on your debt is very low. This is what was experienced in the decade and a half after the GFC as interest rates were kept artificially low by global central banks. The issues start to become clearer as interest rates are forced higher, towards their long-term averages, which is exactly what we have seen over the past year and a half.

The concept of a 'sustainable' Debt:GDP ratio was popularised by two Harvard economics professors, Reinhart and Rogoff, in their paper 'Growth in a Time of Debt' [2]. They determined that when a country's government debt exceeds a certain threshold relative to GDP (approximately 90% for most developed market nations), it tends to have a more pronounced negative impact on economic growth. Above these levels, countries are forced to allocate too much of their annual spending on debt repayments instead of using this capital on initiatives to stimulate growth. As individuals, we can all empathise with this scenario, as higher interest rates and repayments on home loans or car refinancing tend to crowd out other areas of spending in our budgets.

Interest on government debt is typically paid semi-annually or annually based upon the interest rate which was set at the point that debt was issued. Given that interest rates were retained at levels close to 0%, as discussed earlier, this meant that the US government could issue more debt without materially increasing the interest expense they needed to pay. The problem they are facing today is that they need to re-issue their debt as it matures, now at materially higher interest rates. The result is a rapidly rising interest

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expense item on their income statement. This scenario has already driven the 2022 US government interest expense as a percentage of GDP to its highest level since the early 2000s. This is expected to increase further in the years ahead with Table 2 demonstrating the amount of US government debt reaching maturity in the next 3 years.

Table 2: US Government Debt Maturity Profile

Maturity Year	Outstanding (Billion USD)	% of Outstanding Government Debt
2024	$7,394	28%
2025	$2,965	11%
2026	$2,224	9%

If this trend continues, then the ability for the US to grow its economy will be constrained and it could find itself in a debt trap: as they try to repay what they owe, the interest keeps growing, making it tough to clear the debt. This cycle may then require them to borrow more to cover the interest costs on the existing debt.

As an aside, sustainable Debt:GDP ratios are not equal across all nations. Various factors unique to each country, such as economic growth rates, productivity, demographics, governance, and the ability to raise government revenue, can influence their capacity to handle debt. A country such as South Africa would have a sustainable Debt:GDP level closer to 60%.

Exploring Solutions for Debt Reduction

How would a country like the US go about reducing their debt burden? There are four primary options available:

1. Increased Taxation

The first option is to increase government revenues via increased taxation. The increase to government revenues would result in a budget surplus which means they can pay down their outstanding debt more quickly. This is likely to be the least popular option among the general population for obvious reasons. Besides being detrimental to public sentiment and potentially reducing the chance that a sitting president is re-elected, increased taxation can result in a negative impact on economic growth for a country. Corporations and individuals are forced to spend more on taxes and less on other goods and services. There is an argument that some of the largest companies in the US don't pay their fair share of taxes and this may provide an opportunity to increase government revenue.

2. Accelerate Economic Growth

The second option is to accelerate economic growth in a country to offset the rising debt burden. If the economy expands and the absolute debt levels remain constant, then the Debt:GDP ratio falls towards more sustainable levels. Growth also results in higher tax revenue which will allow them to pay down debt as discussed above. While this option is probably the most pleasing for corporations and individuals, it is also the most difficult to achieve for a country facing rising interest expense costs. These rising interest costs constrain the flexibility of a government to implement policies promoting faster economic growth.

3. Higher Inflation

When a country has a significant amount of debt, they must make regular interest payments on that debt. For most government debt, this interest payment is set at the point the debt is issued. This means that the Dollar amount of the interest payment is unchanged year on year. If inflation is at a higher but sustainable level, the nominal value of the debt (and associated interest payments) remains the same, but in real terms (adjusted for inflation), the debt becomes less burdensome. This method carries the risk that inflation moves to unsustainably high levels, where a country will be forced to raise interest rates to constrain it once again

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(as we have seen over the last 2 years), thereby restarting the cycle of higher interest rates on the government's debt.

4. Default on Your Debt

The fourth, and most extreme, option is to default on your debt obligations. This option results in a lack of credibility and higher future debt financing costs, similar to defaulting on a car loan as an individual. Lenders would demand a higher future rate of interest to compensate them for the risk of potential future defaults.

One of the biggest fallacies in global investment markets is the belief that only emerging markets like Argentina and Turkey default on their government debt. The US government has effectively defaulted four times before. The two most recent instances were in 1968, when the US government refused to redeem its silver certificate paper Dollars for silver Dollar, and in 1971, when the US ended the Bretton Woods system by refusing to redeem dollars held by foreign governments for gold.

This commentary highlights that government debt levels indeed matter. Allowing government debt levels to become unsustainable can potentially lead to lower growth rates or even into a debt trap scenario. In a world where government (and other) debt are at elevated levels, we remain cautious about the impact this could have on economic growth.

Governments around the world are actively trying to get their debt levels under control following a long period of excessive debt issuance through the GFC and Covid. It is crucial for global growth and asset markets that this reduction in debt is navigated with due diligence and care. It is something we continue to monitor very closely.

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[1] Defined as External Debt, Gross External Debt Position, General Government, Current Prices, USD
[2] Reinhart, C. M. & Rogoff, K. S. (2010) 'Growth in a Time of Debt'.

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REDFIN WEALTH

INVESTMENT - RETIREMENT - FINANCIAL PLANNERS

November 2023

MARKET REPORT

30 November 2023

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	2.2%	7.1%	4.7%	14.3%	12.4%	8.9%	17.1%	14.3%
FTSE/JSE SA Listed Property	ZAR	1.6%	0.2%	1.4%	16.2%	-1.8%	2.1%	27.3%	21.4%
SA All Bond Index (ALBI)	ZAR	4.0%	8.1%	8.8%	7.8%	8.1%	7.9%	8.4%	8.1%
SA Cash Index (SteFI)	ZAR	2.1%	7.3%	7.9%	5.5%	5.9%	6.4%	0.5%	0.4%
Balanced Benchmark	ZAR	2.3%	10.5%	8.9%	12.1%	11.2%	9.3%	11.8%	9.8%
SA Inflation (1 month lag)	ZAR	1.8%	5.6%	5.9%	6.2%	5.1%	5.2%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	1.7%	18.6%	13.6%	7.6%	10.5%	8.9%	18.6%	14.9%
Emerging Markets Equity (Datastream EM)	USD	1.2%	6.1%	4.6%	-3.7%	2.7%	2.5%	19.2%	17.2%
Global Property	USD	1.0%	1.9%	-1.3%	0.7%	2.3%	2.0%	19.5%	14.3%
Global Bonds (Barclays Global Bond Index)	USD	0.8%	1.5%	2.0%	-6.4%	-0.7%	-0.1%	7.3%	6.0%
Global Cash	USD	1.3%	4.7%	5.0%	2.1%	1.9%	1.4%	0.5%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	2.2%	7.1%	4.7%	14.3%	12.4%	8.9%	17.1%	14.3%
Global Equity (Datastream World)	ZAR	1.8%	32.0%	26.6%	15.1%	17.7%	15.9%	16.4%	15.6%
Emerging Markets Equity (Datastream EM)	ZAR	1.2%	18.1%	16.7%	3.1%	9.4%	9.1%	14.0%	13.5%
Global Property	ZAR	1.1%	13.5%	10.1%	7.7%	8.9%	5.3%	18.1%	14.9%
SA All Bond Index (ALBI)	ZAR	4.0%	8.1%	8.8%	7.8%	8.1%	7.9%	8.4%	8.1%
Global Bonds (Barclays Global Bond Index)	ZAR	0.8%	13.0%	13.8%	0.2%	5.7%	6.3%	14.1%	13.9%
COMMODITIES									
Gold (US Dollars)	USD	4.8%	12.2%	16.1%	4.9%	10.8%	5.0%	14.5%	13.7%
Gold (Rands)	ZAR	4.9%	25.9%	29.4%	12.2%	18.0%	11.7%	18.4%	17.2%
CURRENCIES									
Rand / Dollar	ZAR	0.1%	-10.8%	-11.1%	-6.9%	-6.3%	-6.4%	14.8%	14.9%
Rand / GBP Pound	ZAR	0.4%	-15.6%	-17.5%	-4.9%	-6.1%	-3.6%	12.8%	14.4%
Rand / Euro	ZAR	-0.4%	-12.5%	-17.4%	-3.6%	-5.5%	-4.0%	12.3%	13.1%

Spot Rates		30-Nov-23	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	19.0	18.8	17.0	13.9	10.2	6.4
Rand/GBP	Rand	24.0	23.0	20.3	17.7	16.7	11.0
Rand/EUR	Rand	20.7	19.9	17.5	15.7	13.8	7.7
RATES							
Libor 6m $	US$	5.8	5.9	5.2	2.9	0.3	1.3
Repo Rate	Rand	8.25	8.25	7.00	6.75	5.00	8.50
Prime	Rand	11.75	11.75	10.50	10.25	8.50	13.50
All Bond Index Yield	Rand	10.3	10.8	11.6	9.6	8.4	9.7
COMMODITIES							
Gold ($/oz)	US$	2,037.8	1,856.8	1,751.9	1,219.2	1,253.4	398.0
Platinum	US$	937.0	923.0	1,025.0	805.0	1,376.0	765.0
Oil (Brent Crude) $	US$	80.7	95.4	85.4	58.7	111.2	28.7
INFLATION							
SA Inflation	%	5.9	4.8	7.4	5.1	5.4	9.4

data provided by FE Analytics