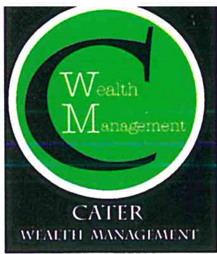

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Greg Cater Sr. and Greg Cater Jr.

Government Debt, Deficits and Interest Rates

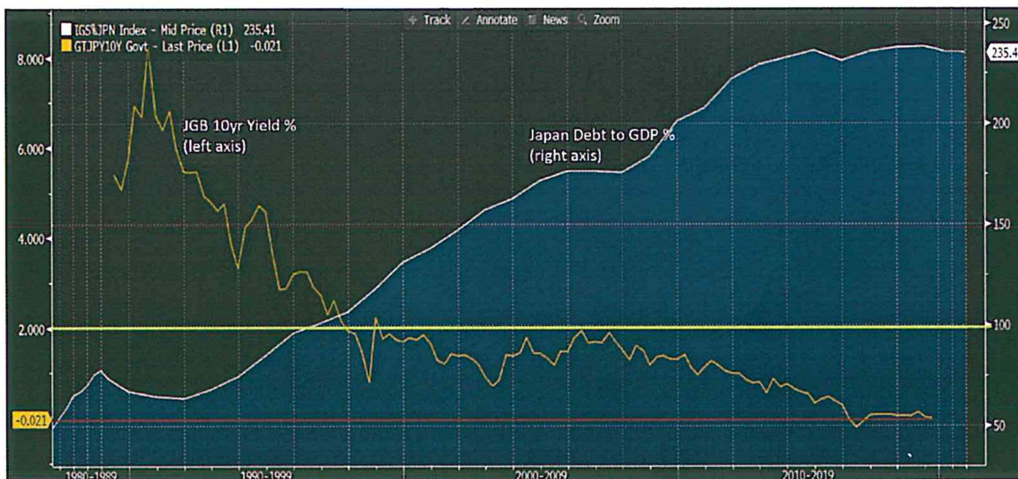
4/10/19

Many people believe large government budget deficits lead to high government debt and high interest rates. Many people are wrong. The record shows (for both The U.S. and Japan) the exact opposite. Let's look at Japan first:

After many years of budget deficits Japan enjoyed five years of budget surpluses starting in 1988.[1] Japan's 10-year government bond yield ended 1988 at 4.5%. Two years later it reached a high of 8% before falling over the next three decades to 0%![2] During the same three decades Japan's debt-to-GDP grew from 50% to 235%, posting budget deficits every year.[1] Over the last 30 years, budget surpluses and low government debt led to higher interest rates while budget deficits and high government debt led to lower interest rates. As of today, Japan's 10-year government bond yields less than 0%.[2]

Japan Government Debt % to GDP vs 10 Year Yields

As debt has risen, Japanese 10yr yields have remained below 2% for 20 years



Source: Bloomberg

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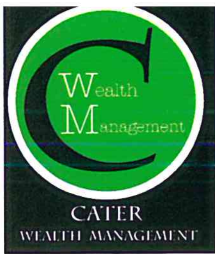

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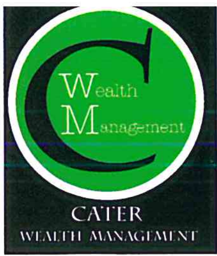
Now let's look at the U.S.

From 1965 through 1980 the U.S. reduced its debt-to-GDP ratio from 40% to 30%.[2] During this 15-year period, the U.S. 10-year government bond yield rose from less than 5% to over 15%. From 1980 through today (over 40 years) the U.S. debt-to-GDP has risen from 30% to over 100% while the U.S. ten-year bond as fallen to 2.50%.[2]

US Government Debt vs 10 Year Treasury Yields

Source: Bloomberg

The history is clear, and it is not a secret. Given the record why do so many people believe that large government budget deficits lead to high government debt and high interest rates? Increasing government debt must be financed. The consensus, while wrong, is that Investors will demand higher and higher rates as more and more bonds are sold. Eventually the government may not be able to sell any bonds at all. The next obvious step is debasement of the currency and of course hyperinflation.



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So why do large government deficits and high government debt lead to low interest rates? The answer lies in the simplest economic principal of all:

Supply vs. Demand

Supply vs. Demand of what?

Money

Before we get to supply vs. demand we need to define "money". A country's money represents its full faith and credit. In the U.S. we have 3 things that represent a full faith and credit obligation:

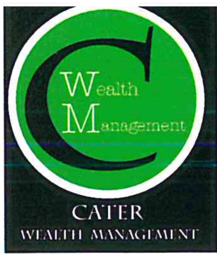
1) Currency in your pocket.
2) Publicly traded U.S. Government debt.
3) Commercial bank excess reserves deposited at the Federal Reserve.

Number 1 is obvious. Number 3 represents the money in your bank account and is a full faith guarantee because it is convertible on demand into number 1. Number 2 is a little harder to explain. We know it's a full faith guarantee but why is it "money"? A government bond is nothing more than a futures contract promising the delivery of a dollar at a future date. It may not be money right now (although it can be spent now through the repo market) but it will be money eventually.

Large government deficits and debt lead to more and more government bonds. More government bonds outstanding increases the money supply. Supply and demand suggests an increase in the supply of something, cetera paribus, causes its price to fall. According to Merriam- Webster, the price of money is:

"The net rate of interest paid for borrowed money"

So there's the answer. More government debt means more bonds. More bonds mean more money. Increasing the supply of money makes money cheaper. The price of money is the interest rate charged to borrow it. Therefore, more government debt causes interest rates to go down.



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Works Cited

1. https://www.imf.org
2. Bloomberg Terminal