

More on Fiscal Balances, Financial Markets and Power

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Well before President Trump upended the rules of the international trade game with his tariff aggression, it was well-known most of all in global financial circles that the US had a special place with regard to cross-border capital flows. Obviously, the unique strength of the US derives from its position as the holder of the global reserve currency, but that is in effect a circular argument: it holds the global reserve currency because of its perceived strength. And that is not just about its size, or its wide and deep capital markets, or even its perceived “stability”. (In fact, when it was at its most unstable as an economy, during and just after the Global Financial Crisis, the US attracted even more capital from abroad because of investors’ “flight to safety”.) Rather, it is fundamentally about perceptions of relative power, which can be economic, or financial, or military, or more broadly geopolitical. Financial markets, which operate more on perceptions and expectations than any other markets, are particularly sensitive to this, even when they do not always get it right.

That is what explains the apparently peculiar response of capital markets and bond markets in particular to changes in fiscal stance across the US and other countries. Orthodox economists would have us believe that bond markets respond to fiscal deficit to GDP ratios and public debt to GDP ratios, such that higher ratios lead to adverse reactions that cause capital to flow out. As we have argued before (see <https://www.thehindubusinessline.com/opinion/columns/c-p-chandrasekhar/the-unbalanced-world-economy/article67628156.ece>), in practice the opposite has often been true, especially in the past decade. High income countries get away with fiscal deficit-to-GDP and public debt-to-GDP ratios that are significantly higher, sometimes several multiples higher, than those of middle and low income countries, yet bond markets punish the latter much more severely.

But a closer look at the data suggest that the pattern is complex and the cross-country analysis therefore needs to be more nuanced. It is important to separate the two most powerful players in the global economy, the US and China, and then look at the fiscal patterns and their implications for sovereign debt.

Figure 1 provides the total fiscal deficit to GDP ratios for countries grouped according to per capita income, with the US and China taken out of their respective groups and examined separately. (Data for all figures are from the IMF Fiscal Monitor, April 2025.) It is evident that since 2019, the US and China have both been much more fiscally “ambitious” (or profligate, depending on your viewpoint) than either other high income countries or other middle income countries. Indeed, the high income countries seem to be the most caught up by the doctrine of “austerity” after 2021, while low income country governments have also tightened their belts.

Figure 1.

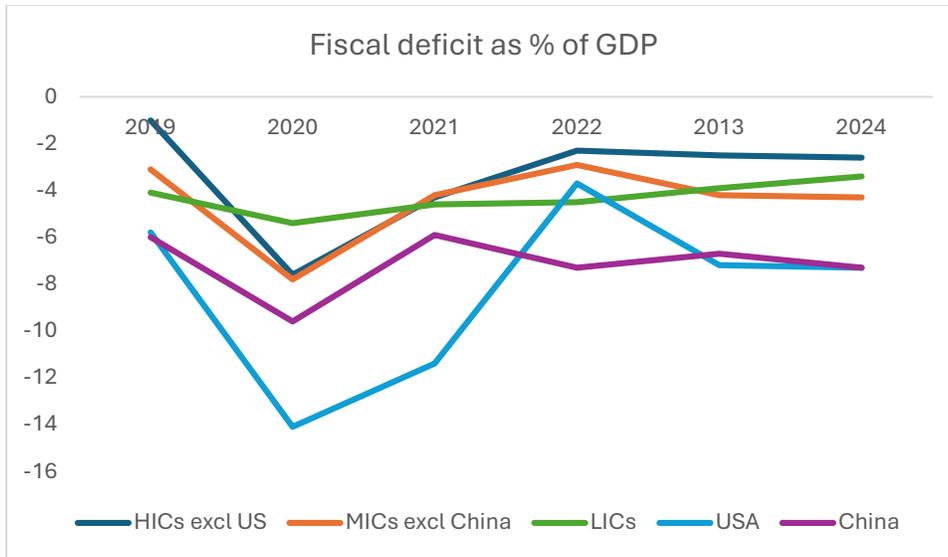
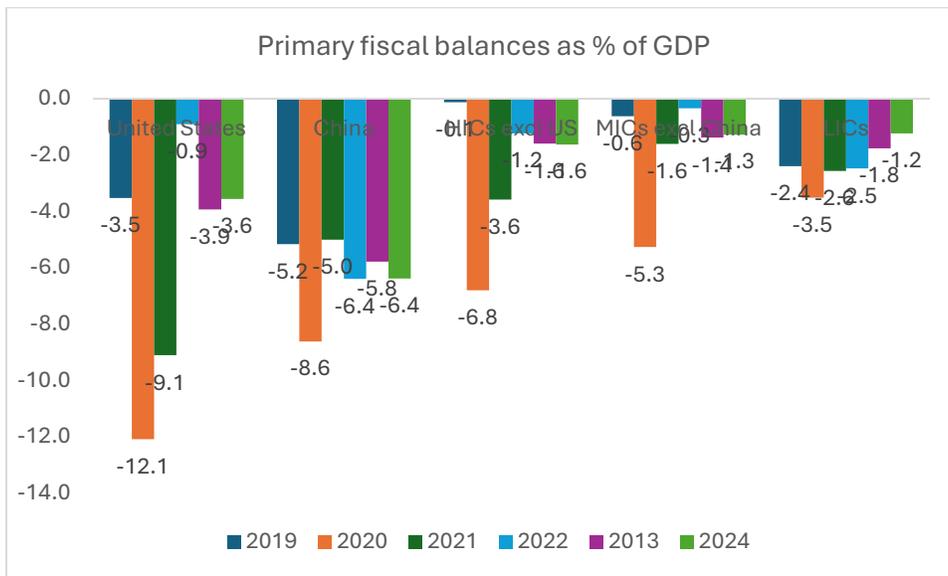


Figure 2.

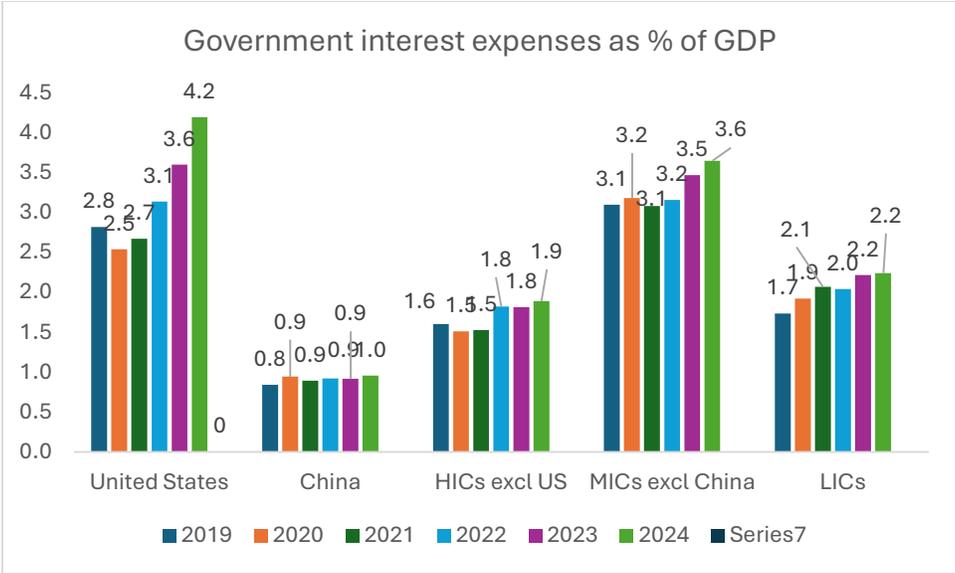


The primary fiscal balances shown in Figure 2 make this point even more emphatically. While the US increase in primary deficit in 2020 was by far the largest in both absolute terms and as share of its GDP, China's was also significant, and much more than for all other country groups. And China's primary deficit has remained high in subsequent years, even higher than the US.

Figure 3 plots the government interest expenses, which are obviously determined by both the legacy public debt and interest rates. Here the pattern is reversed, at least for China. The US shows the highest interest burden as share of GDP, but followed closely by middle income countries other than China. The substantial increase in the US interest burden in 2023 and 2024 also reflect the rising interest rates that were imposed as a response to the inflation. Yet both the US and China (which, like the US, has its public debt held in its own currency the RenMinBi) have the benefit

of lower interest rates compared to other countries, especially low and middle income countries that face higher spreads on their sovereign bonds. This is why middle income countries (other than China) as a group also have high interest expenses in terms of GDP. Low income countries generally have even higher spreads on their sovereign bonds, but that concern and the fear of capital flight have forced them to reign in their spending to such an extent that their public debt to GDP ratios are very low. Despite that, many of them face external debt crises.

Figure 3.



The costs of borrowing are further complicated by the difference between the bond coupon rate and the yield. The coupon rate of a sovereign bond is the fixed, annual interest rate paid on the bond's face value. The nominal yield, by contrast, is the market interest rate reflecting the bond's current price, which can rise or fall depending on demand for the bond. Yields will rise when the price of the bond falls. In this regard, the recent pattern of yields of the US Treasury Bills is of interest. They have clearly fluctuated over time the 10-year bond nominal yield reached a historic high of nearly 16 per cent in September 1981, but have been coming down continuously since then. By 2020 the yield was at a historic low of only 0.6 per cent, because of the US Federal Reserve's policy of lower interest rates and even more monetary easing. Since then it has been rising, and in the past year has been in the range of 3.8 to 4.6 per cent.

Figure 4.

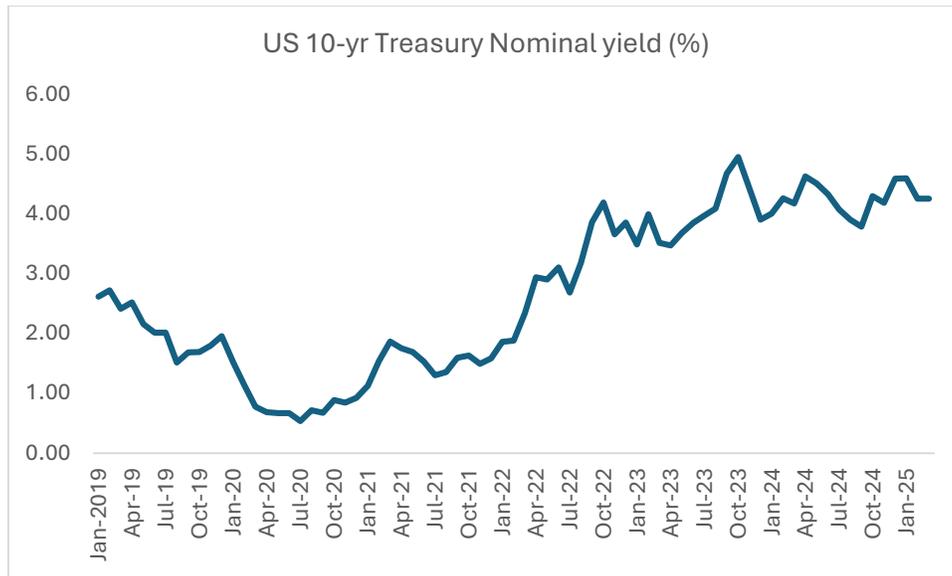
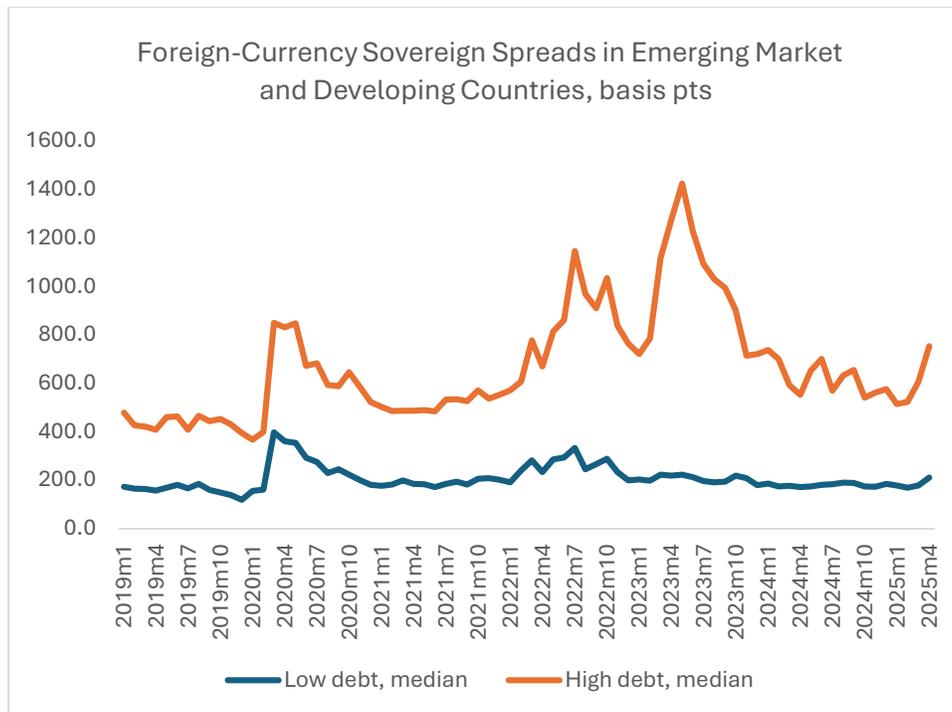


Figure 5.



More significant for the rest of the world is the further cost imposed on their sovereign borrowing by the spread over the US Fed rate, reflecting financial investor perceptions of “risk”. That such risk has little to do with actual fiscal or economic performance, and everything to do with relative power that result in currency hierarchies, is evident in the recent trends of such spreads, as shown in Figure 5. The low and middle income countries (LMICs) (here referred to as emerging market and developing countries) have experienced varying trends depending on whether they are seen to

be highly indebted or only moderately indebted. But note that even the “high debt” countries have public debt to GDP ratios that are much smaller than those of the US and other rich countries. Their problem rather is the foreign currency component of public debt, which becomes difficult to service whenever a foreign exchange constraint emerges, increasingly for reasons beyond their control.

The median increase in the spread over the US Fed rate for LMICs rose dramatically up to the middle of 2023, to as high as 14 percentage points above the US Fed rate. They have come down since, but still remain extremely high, at more than 7.5 percentage points. Such high borrowing costs are obviously unviable, especially for poor countries struggling to meet the most basic social and developmental objectives in an ever more hostile international environment.

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