Rising Interest on Nations' Debts May Sap World Growth

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As governments worldwide try to spend their way out of recession, many countries are finding themselves in the same situation as embattled consumers: paying higher interest rates on their rapidly expanding debt.

Increased rates could translate into hundreds of billions of dollars more in government spending for countries like the United States, Britain and Germany.

Even a single percentage point increase could cost the Treasury an additional $50 billion annually over a few years — and, eventually, an additional $170 billion annually.

This could put unprecedented pressure on other government spending, including social programs and military spending, while also sapping economic growth by forcing up rates on debt held by companies, homeowners and consumers.

"It will be more expensive for everybody," said Olivier J. Blanchard, chief economist of the International Monetary Fund in Washington. "As government borrowing in the world increases, interest rates will go up. We're already starting to see it."

Since the end of 2008, the yield on the benchmark 10-year Treasury note has increased by one and a half percentage points, rising to 3.54 percent from 2 percent, the sharpest upward move in 15 years. Over the same period, the yield on German 10-year bonds has risen to 3.57 percent, from 2.93 percent. And British bond yields have increased to 3.78 percent, from 3.41 percent.

Concern over the long-term effect of greater debt prompted Ben S. Bernanke, the Federal Reserve chairman, to say in testimony before Congress on Wednesday, "Even as we take steps to address the recession and threats to financial stability, maintaining the confidence of the financial markets requires that we, as a nation, begin planning now for the restoration of fiscal balance."

For now, the cost of more debt is the price government is willing to pay to spend its way out of recession, hoping that a return to fiscal health will increase tax revenue and repay the debt.

But in the last three weeks, the pace of the increase in the 10-year Treasury note's yield has quickened, spurred by a Congressional Budget Office estimate that net government debt will rise to 65 percent of the gross domestic product at the end of fiscal 2010, from 41 percent at the end of fiscal 2008.

In 2009 and 2010, Washington will sell more than $5 trillion in new debt, according to Citigroup. A decade from now, according to the Congressional Budget office, Washington's outstanding debt could equal 82 percent of G.D.P., or just over $17 trillion.

Governments borrow money in part by getting investors to buy their bonds, which are essentially i.o.u.'s. To attract investors for all the new debt, governments will have to compete with stock and corporate bond markets for investors' money, hence the rising yields.

Although interest rates remain low by historical standards, the recent spike in rates comes at a critical juncture, threatening to damp the positive effects of new stimulus spending by governments around the world.

Under President Obama's 2010 budget, total interest payments by the federal government could rise to $806 billion in 2019, from $170 billion this year, according to the Congressional Budget Office. Much of that projected increase is a result of higher government borrowing, but the forecast also assumes that the average 10-year note yield will increase to 4.7 percent.

Some of the increase in rates earlier this year actually stems from rising confidence in an economic recovery and growing tolerance for risk, as investors abandon government bonds for higher-yielding but riskier corporate bonds and stocks.

Now the threat posed by the rise in government debt is getting increasing attention from investors and traders.

"It's a gigantic issue," said Kenneth Rogoff, a Harvard professor and the co-author of a forthcoming book, "This Time is Different: Eight Centuries of Financial Folly." "It leaves us very vulnerable to a global rise in interest rates that might be substantially beyond our control."

Mr. Rogoff estimates that if the budget office's debt estimate proves correct, every one percentage point increase in rates could eventually cost Washington an added $170 billion a year.

The long-term situation is particularly perilous, because the added interest costs will worsen what have become record deficits as Washington has rushed to bail out industries and stimulate the economy.

A year ago, under old budget and policy assumptions and before thefinancial crisis escalated, the Congressional Budget Office projected that outstanding federal debt would hit $5.3 trillion in 10 years.

“It’s an exaggeration of course, but it’s a little like what happened to the subprime borrowers,” Mr. Rogoff said. “People are just assuming the funding will always be there.”

These assumptions may not hold over time. Spending could be reduced, economic growth could be greater than predicted or interest rates could be affected by other factors.

In the meantime, Europe is also turning to the markets to replenish overstretched coffers. In 2009 and 2010, according to Citigroup, the 16-nation euro zone will sell nearly 1.6 trillion euros ($2.6 trillion) in new debt, while Britain plans to offer £490 billion ($799 billion) in new debt.

Britain’s debt sales might seem less alarming than the multitrillion-dollar offerings from the euro zone and the United States. But Mark D. Schofield, global head of interest rate strategy at Citigroup in London, said, “It’s a huge increase in percentage terms, and it dwarfs anything else.”

Standard & Poor’s caught some traders and investors off-guard last month when it warned that Britain’s sovereign debt was in danger of losing its AAA rating, lowering the outlook to negative from stable. It was the first time since Standard & Poor’s initiated coverage of British debt in 1978 that the country received a negative outlook.

Britain’s government debt now equals 55 percent of G.D.P., but Standard and Poor’s estimates it could approach 100 percent by 2013.

“It wasn’t just a message for the U.K., but they were the easiest of the G-7 to target,” said Mark Wall, chief euro-area economist atDeutsche Bank in London, referring to the seven largest industrial nations. “The global financial markets took this as a message as much for the U.S. as the U.K.”

While still worrisome, the short-term debt picture within the euro zone is better than that in either Britain or the United States, Mr. Schofield said.

Over the long term, however, he said that higher rates could compound Europe’s larger problem of prolonged economic weakness and slow its recovery from the current recession.

Even regions that are unlikely to issue substantial amounts of new debt — like South America and Eastern Europe — will be affected by rising rates as they refinance their existing debt.

Asian economies have the least to fear from the prospect of increased rates. “Asia is in much better shape with lower levels of debt and they can afford larger deficits without the market penalizing them,” Mr. Blanchard of the I.M.F. said. “China, for example, is in a very strong position to pay for its stimulus.”

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