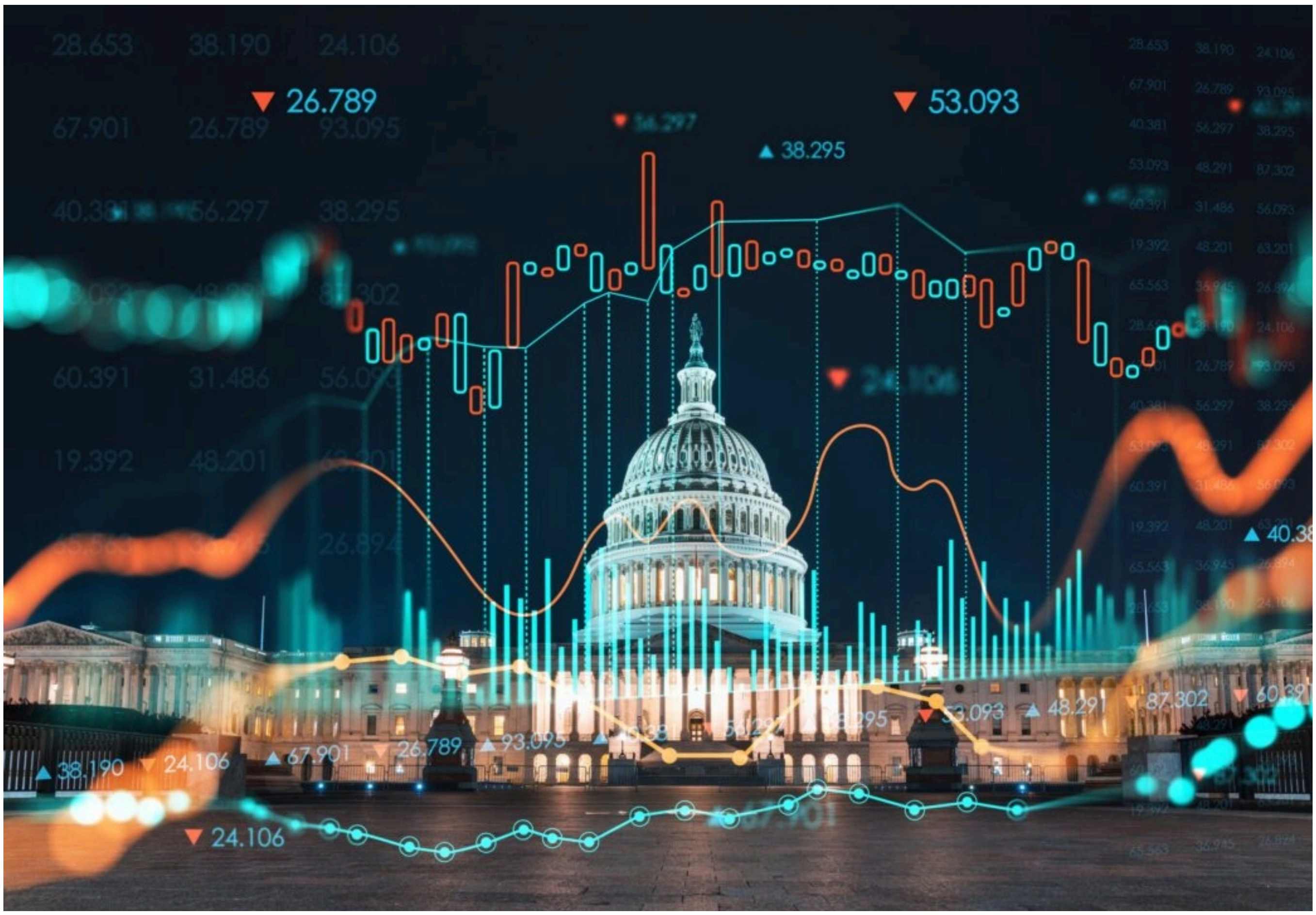
Government Spending Will Cause the Next Financial Crisis



VideoFlow/Shutterstock

By Daniel Lacalle
1/13/2025 Updated: 1/13/2025

Commentary

Crises are never caused by building excessive exposure to high-risk assets. Crises can only happen when investors, government bodies, and households accumulate risk in assets where most believe there is little to no risk.

The 2008 crisis did not occur due to subprime mortgages. Those were the tips of the iceberg. Moreover, Freddie Mac and Fannie Mae, state-owned entities, guaranteed a sizable portion of the subprime mortgage packages, which prompted numerous investors and banks to invest in them. Nobody can anticipate a crisis stemming from the potential decline in the Nvidia share price or the value of Bitcoin. In fact, if the 2008 crisis had been created by subprime mortgages, it would have been absorbed and offset in less than two weeks.

The only asset that can really create a crisis is the part of banks' balance sheets that is considered "no risk" and, as such, requires no capital to finance their holdings: government bonds. When the price of sovereign bonds swiftly declines, the banks' balance sheet rapidly shrinks. Even if central banks conduct quantitative easing, the spillover effect on other assets leads to the abrupt destruction of the money base and lending.

The collapse in the price of the allegedly safest asset, government bonds, comes when investors must sell their existing holdings and fail to purchase the new supply issued by the states. Persistent inflation consumes the real returns of previously purchased bonds, leading to the emergence of evident solvency problems.

In summary, a financial crisis serves as evidence of the state's insolvency. When the lowest-risk asset abruptly loses value, the entire asset base of commercial banks dissolves and falls faster than the ability to issue shares or bank bonds. In fact, banks are unable to increase capital or add debt due to the declining demand for sovereign bonds, as banks are perceived as a leveraged bet on government debt.

Banks do not cause financial crises. What creates a crisis is regulation, which always considers lending to governments a "no-risk," "no capital required" investment even when solvency ratios are poor.

Because the currency and government debt are inextricably linked, the financial crisis first manifests in the currency, which loses its purchasing power and leads to elevated inflation, and then in sovereign bonds.

Keynesianism and the MMT fallacy have driven global public debt to record levels. Furthermore, the burden of unfunded liabilities is even larger than the trillions of dollars of government debt issued. The United States' unfunded liabilities exceed 600 percent of GDP, according to the Financial Report of the United States Government, February 2024. In the European Union, according to Eurostat, France and Germany each accumulate unfunded liabilities that exceed 350 percent of GDP.

According to Claudio Borio of the Bank for International Settlements, a government debt glut may cause a bond market correction that could spill over into other assets. Reuters reports that large government budget deficits suggest that sovereign debt could rise by a third by 2028 to approach $130 trillion, according to the Institute of International Finance (IIF) financial services trade group.

Keynesians always say that public debt does not matter because the government can issue all it needs and has unlimited taxation power. It is simply false.

Governments cannot issue all the debt they need to finance their deficit spending. They have three clear limits:

The economic limit: Rising public deficits and debt cease to function as purported tools to stimulate economic growth, instead becoming a hindrance to productivity and economic development. Despite this completely false theory, most governments continue to portray themselves as engines of growth. Today, this is more evident than ever before. In the United States, every new dollar of debt brings less than 60 cents of nominal GDP growth. In France, the situation is particularly alarming, as a 6 percent GDP deficit results in a stagnant economy.

The fiscal limit: Rising taxes generate lower-than-expected receipts, and debt continues to rise. Keynesianism believes in government as an engine of growth when it is a burden that does not create wealth and only consumes what has been created by the private sector. When taxes become confiscatory, tax receipts fail to rise, and debt soars regardless.

The inflationary limit: more currency printing and government spending creates persistent annualised inflation, making citizens poorer and the real economy weaker.

In most developed nations, the three limits have been clearly exceeded, but it seems that no government is willing to reduce its spending, and without spending cuts, there is no debt reduction.

Irresponsible governments, forgetting that their role is to administer scarce resources rather than create debt, will trigger the next crisis. Countries like Brazil and India are seeing their currencies plummet due to concerns about the sustainability of public finances and the risk of borrowing more while inflation remains high. The euro has plummeted due to the combination of France's fiscal woes and bureaucrats' demands for Germany to increase its deficit spending.

As always, the next crisis will be attributed to the final drop that causes the dam to collapse, but it will also be caused—as always—by government debt. Politicians' lack of concern stems from the fact that taxpayers, families, and businesses will bear the brunt of all the adverse consequences. When the debt crisis arises, Keynesians and astute politicians will argue that the solution demands increased public spending and debt. You and I will pay.

From Mises.org

Views expressed in this article are opinions of the author and do not necessarily reflect the views of The Epoch Times.

Daniel Lacalle

Author

Daniel Lacalle, Ph.D., is chief economist at hedge fund Tressis and author of the bestselling books “Freedom or Equality” (2020), “Escape from the Central Bank Trap” (2017), “The Energy World Is Flat” (2015), and “Life in the Financial Markets.”

WEBSITE

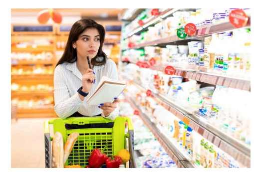
Author’s Selected Articles

The $100 Trillion Global Debt Bomb and Financial Shock Risk

Dec 20, 2024

No Central Bank Wants to Stop Price Inflation

Oct 27, 2024



Money and Rates Signal Long-Term Bullish Markets

Sep 10, 2024

Markets Need More Than a Rate Cut to Go Back to Bullish Mode

Aug 14, 2024