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Analysis of today
Assessment of tomorrow

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Long-Term Bond Yields Show the Limits of Government Debt

The recent surge in long-term bond yields proves that market participants are losing confidence in sovereign issuers as the solvency of governments in developed economies weakens.

Years of excessive spending and uncontrolled debt have led to an unsustainable fiscal situation, and the excuse of higher taxes does not work anymore.

Raising taxes is not a tool to reduce debt but an excuse to continue increasing spending and indebtedness.

In recent months, we have seen a gradual decline in global demand for sovereign bonds in developed economies, particularly Japan, the U.S., European Union member states, and the United Kingdom.

Market participants do not perceive these bonds as low-risk reserve assets. The latest auction of Japanese bonds yielded the lowest demand from investors since 1987, according to Bloomberg, and 30-year yields soared to record highs.

Warning signs

The warning signs have been clear for years. Central banks such as the ECB and the Federal Reserve have published large losses for three consecutive years, as their debt holdings lost value.

Furthermore, many global central banks are abandoning sovereign debt as a reserve asset and purchasing record amounts of gold.

> Doubts about the sustainability of public finances are now widespread

However, governments worldwide are ignoring this critical sequence of challenges, and they continue to expand spending and accumulate debt.

Doubts about the sustainability of public finances are now widespread. Market participants do not see how these governments can control their public finances when spending is never reduced, even after extraordinary events like Covid.

Global governments have abandoned their role as administrators of scarce resources to become spending machines that constantly resort to tax hikes to try to disguise their fiscal problems.

Stages of government insolvency and currency destruction

We can highlight three distinct but interconnected stages of government insolvency and currency destruction: surpassing the fiscal limit, breaching the economic limit, and finally, crossing the inflationary limit.

The fiscal limit represents the maximum debt-to-GDP ratio a government can sustain before the market loses confidence in its ability to stabilise finances through traditional adjustments.

As governments constantly increase spending and borrowing, they erode their fiscal space, and deficits become the norm in growth and recession periods.

Advanced economies have exceeded these fiscal thresholds under the belief that nothing would happen if central banks monetised some of the debt and global investors continued to purchase sovereign bonds.

However, demand is declining, sovereign bonds have proven to be a reserve asset, and central banks are abandoning developed economies' sovereign debt as a stability factor for their local currencies.

> "Fiscal fatigue" leads to a weakening of the government's primary balance

Once the fiscal limit is breached, the risk of unsustainable debt dynamics rises, interest rates may spike even with dovish central bank policies, and policymakers may find themselves unable or unwilling to make the necessary fiscal adjustments.

This phenomenon is called "fiscal fatigue" by the Economic Policy Innovation Centre and leads to a weakening of the government's primary balance when it is most required.

Breaching the economic limit leads the economy to stagnation. High levels of government debt crowd out private investment, increase the burden on the private economy, and families and businesses reduce investments.

Bloated government spending reduces the effectiveness of fiscal stimulus, constraining future policy options. Economic stagnation leads to severe consequences, such as weakening real wage growth despite low official unemployment rates, a decline in productivity growth, loss of competitiveness, and increasing social discontent.

Weak growth leads to higher spending and higher debt, which in turn suppresses productive growth even more.

Crossing the inflationary limit

The final stage occurs when governments, having exhausted fiscal and economic room, cross the inflationary limit.

Inflation is like a de facto slow-motion default; it is the manifestation of the erosion of the purchasing power of the currency that the governments issue.

Persistent deficit spending and high debt levels undermine the credibility of monetary policy, especially when central banks prioritise supporting government debt over controlling inflationary pressures.

Persistent deficit spending and high debt levels undermine the credibility of monetary policy - Daniel Lacalle

When inflation remains above central bank targets, the real value of long-term government bonds erodes, making them less attractive as reserve assets for both domestic and foreign investors. Furthermore, long-term government bonds stop working as a reserve asset for emerging markets’ central banks.

It is not a coincidence that bond yields soar, currencies lose purchasing power and inflation remains persistent. These three elements are part of the same problem: Current fiat money is government debt, and when its solvency is questioned, inflation becomes persistent, while citizens’ deposit savings and real wages gradually evaporate.

As bonds lose their appeal as safe-haven assets, central banks find it harder to maintain price stability without triggering losses on their own balance sheets, creating the current devil’s choice: support insolvent states and create inflation or stop inflation and weaken government debt.

This creates a feedback loop: higher inflation reduces bond values, which in turn undermines financial stability and further erodes confidence in government finances.

Returning to a prudent fiscal policy

When bond markets react with volatility and higher yields, governments launch an external enemy campaign to blame investors, speculators and foreign nations.

However, volatility is a rational response to deteriorating fiscal fundamentals, economic stagnation, and inflationary pressures. Investors are simply demanding greater compensation for the risks they now face.

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The only solution is to reduce bloated political spending and return to a prudent fiscal policy.

Rather than blaming market volatility, policymakers must confront the real causes: unsustainable spending, persistent deficits, and the crowding out of the private sector.

Without credible action to restore fiscal discipline and promote growth, the cycle of rising debt, stagnation, and inflation will continue.

It's time for governments to understand that soaring long bond yields are symptoms of the loss of credibility and weakening solvency of issuers and their insane spending and indebtedness policies.