# telescope

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# Good debt, bad debt

Governments´ room for manoeuvre is limited by escalating debt.

VP BANK

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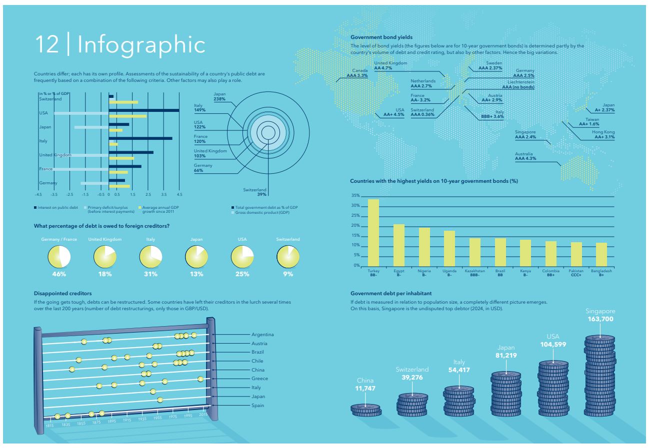


# Until enough is enough

**Dear Reader**

Lending money to a friend is something we are all happy to do. Once is easy. But if the friend keeps coming back for more and fobs us off with promises instead of cash, then what? Unless debts are honoured, lenders get wary.

Government debt is no exception. But political leaders do not stay in office forever. Having run up debts, they pass the buck to their successors. And so the problem passes from one generation to the next. Will the market eventually lose patience and greet a new bond issue with "Thanks, but no thanks"? That is hard to predict. But if it happens, it will hurt.

We at VP Bank are not in the business of scaremongering. If the USA can get its finances onto an even keel, the whole world will benefit. In this issue of Telescope we show how an assemblage of factors can make higher government debt tolerable (pages 3 and 10). We also fact-check various common assertions about debt (page 16), explain the points to watch when investing in debt markets and take a look at companies that can benefit from higher government spending (pages 20 and 21).

There is more. A portrait of a man who made waves on the US bond market half a century ago. And Switzerland's number one woman golfer, Chiara Tamburlini, tells us what her best ever investment was.

I hope that the following pages will give you plenty of "aha" moments.

**Dr Felix Brill**
Chief Investment Officer VP Bank

# Good debt, bad debt

Europe wants to increase capital spending but is deep in debt. The US is cutting taxes but hardly reducing its outlays. Debt is never a simple matter and certainly not a neutral one.

**Felix Brill**

Government debt hits the headlines at least once a year – when a country's parliament has to vote on the national budget. It is a time of haggling, confrontation, bluff and threats – until finally a decision is made. Does the budget involve a deficit? No problem, let's simply borrow more. The story tends to be the same whatever party is in power.

New debt is always okay – until things turn sour. It is hard to predict when that will happen. Rating agencies try to assess the risk. They examine borrowers' ability to service their debts, and they award ratings accordingly. In May of this year, the major rating agency Moody's downgraded the USA's credit rating. America had already lost its top rating with the other two major agencies. So it is no longer a triple-A nation. Just eleven countries now enjoy a top rating by all the "big three" agencies. Before the 2007–2008 financial crisis there were fifteen.

## Big minus

The financial market spotlight is now on the United States. Government after government has been pumping up debt. The shortfall is now around USD 2 trillion a year, equivalent to over 7% of gross domestic product (GDP). And things might get worse. Moody's warns that the figure could climb to 9% within a decade unless corrective measures (increased income or reduced spending) are taken.

President Donald Trump embarked on his second term with a promise to bring the deficit down. He appointed Tesla trillionaire Elon Musk as cost-cutting czar. The result of Musk's efforts has been chaos but little else. Thousands of government employees have lost their jobs, but the effect on the budget has been minimal. The monumental "One Big Beautiful Bill Act" to cut expenditure and taxes could now result in a further dramatic increase in borrowing, though opinion on that is divided. What is certain, however, is that the debt clock is ticking. As time passes, the price of new debt increases.

## Global phenomenon

The USA is not alone here. Government debt is on the rise worldwide, and so is corporate debt, though to a smaller extent (see page 22). Figures for the 38 member states of the Organisation for Economic Co-operation and Development (OECD) paint a clear picture. Government debt in these countries already averaged 100% of GDP in 2011, and by the end of 2024 the figure had climbed to 113%. During this period, which witnessed the euro crisis, the low interest phase and finally the global coronavirus pandemic, only 13 countries were able to reduce their debt burden. The expansion of debt was especially strong in Greece, Japan, Spain, Italy, Finland and Australia. And in the USA too. The world's most heavily indebted country is still Japan (see chart on page 4).

The growth of debt and its size in relation to GDP does not by itself mean a lot (see page 10). When assessing a country's debt profile, numerous other factors must also be taken into account. These include the level of interest rates, economic growth, the size of the deficit before interest payments, the proportion of foreign creditors, and the currency in which debts are denominated. Less tangible inputs are also important, notably confidence in the political process and trust in the currency. Were it not for this mix of factors, Japan would be in trouble.

This also explains why the USA has so far enjoyed a special status as a debtor. The dollar is the world's reserve currency. As long as investors around the world trust it and are willing to buy dollar-denominated investments or trade in dollars, the US government is less subject to the restraints that bind other countries. But this trust might now be jeopardy. The dollar has been in retreat since the start of President Trump's second term in January 2025, especially after the tariffs announcement at the start of April, which sparked a sell-off on the financial markets and downward pressure on the dollar. The stock markets recovered quickly, but the dollar did not. The Trump administration's provocative trade policy – and perhaps its fiscal policy too – threatens to undermine the USA's most important asset: worldwide confidence. If the dollar loses its shine, America's debt model starts to wobble. The consequences would be felt globally, including in investors' portfolios. History tells us that scaling down debt is neither easy nor without side-effects.

## Theory meets reality

Among economists, there are various schools of thought about government debt. Adherents of classical economics warn that government debt is harmful to the private sector. The state, as top borrower, sucks in capital that is therefore no longer available to private borrowers, who are crowded out. Hence classical economists believe that the government should exercise self-restraint and follow the logic of the markets (see Interview on page 8).

Keynesian economists see things differently. They regard government debt as a legitimate and essential tool of economic management. In an economic downturn, as happened during the coronavirus pandemic, the Keynesian approach dictates that the government should intervene to boost demand and limit unemployment. In good times, conversely, the emphasis should be on cost-cutting. In reality, however, such policy switches are easier said than done. Cost-cutting is politically unpopular, so "exceptional" laxity becomes the rule.

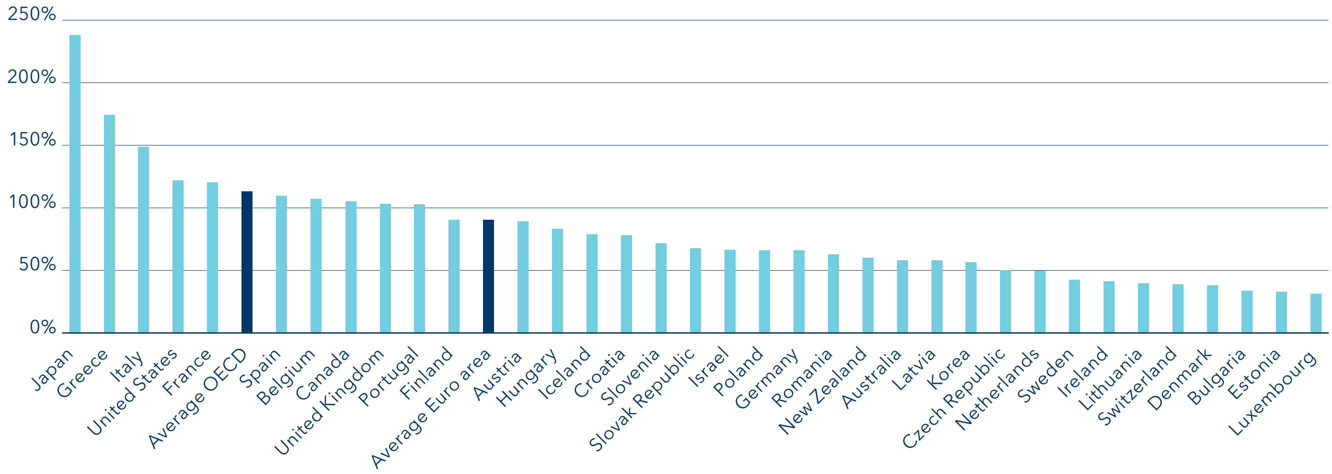
> // Exceptions become the rule. Spending cuts are politically unpopular. //

Modern Monetary Theory (MMT) goes even further. It declares that a country that has its own currency does not need to borrow like a private person, because it can meet its liabilities by simply printing money via its central bank (see page 17). The limit is not the level of debt but the rate of inflation. As long as prices remain stable, debt is not a problem. That sounds cosy. But critics regard it as a recipe for excess. What if confidence in the currency fades? This year's depreciation of the US dollar could serve as a warning here.

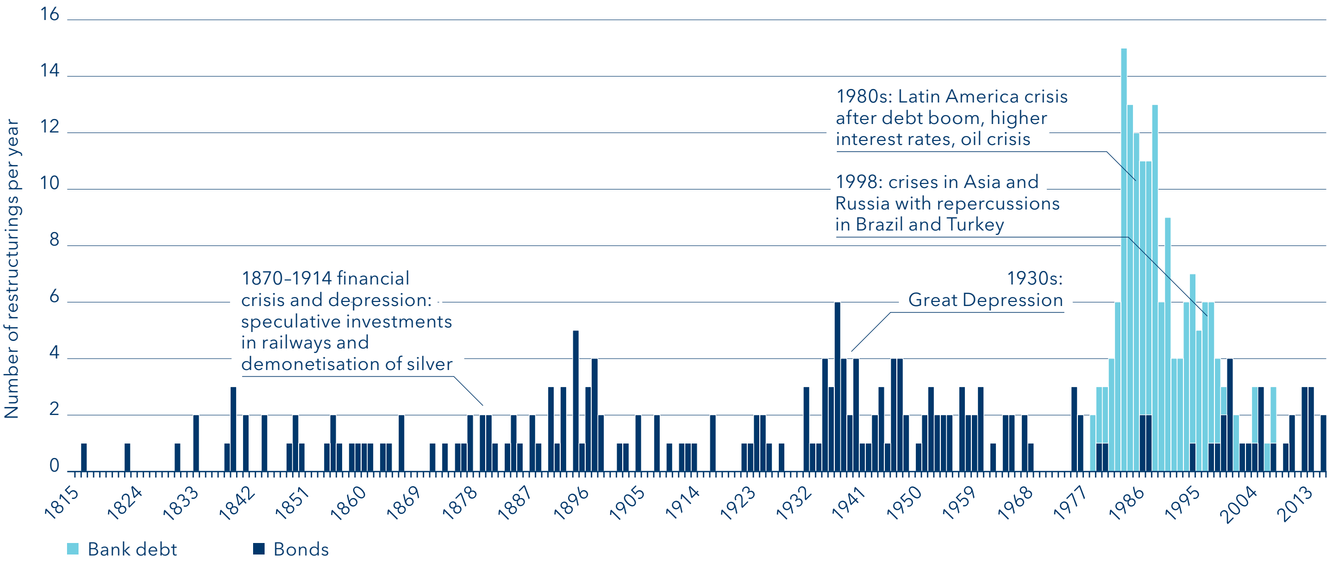
## What works? What harms?

Theory provides us with concepts and explains interrelationships. But what will the results be in practice? Take the multiplier effect, for example (see page 7). If a government ups its spending, the resultant capital investment and consumption can give a disproportionately large boost to growth. But not all forms of expenditure have the same impact. Subsidies that are not properly focussed lead nowhere. An ill-planned project can tie up a lot of people without creating corresponding benefit. Moreover, consumers will be inclined to hang on to a part of any increased income, because they know that ultimately they are the ones who will have to pay.

**Huge differences in government debt within the OECD (debt as % of GDP)**



**Sovereign debt restructurings with foreign private creditors, 1815–2016**




"Good debt" shapes the future. That is the standard point of view. Borrowing is used to build roads, bridges, communication networks, schools etc. and mitigate climate change. It generates a return, not just in hard cash, but in the form of resilience, education and competitiveness. It makes a country more resistant to crisis and helps it to open up new markets and iron out regional disparities. Not every investment makes sense, of course. Goal-setting, planning and control are essential. A properly thought-out infrastructure project can bring benefits lasting decades. An uncoordinated development programme can fizzle out within months. Good debt requires a sound political instinct and a nose for the likely return. Politicians face a major challenge here.

## Borrowing to finance the status quo

"Bad debt" often serves to maintain the status quo. Money is channelled into outdated structures or used to buy short-term industrial peace without confronting underlying problems. This is the politics of easy fixes instead of genuine change. At some point, however, the bill will have to be paid, and it will be higher than if action had been taken earlier.

Meanwhile, interest costs swallow up an ever larger chunk of the budget. Government debt service in the USA amounts to almost 5% of GDP annually, or 13% of government expenditure. France, by contrast, pays just under 2% of GDP despite a comparable level of debt. The figure for the whole of the OECD in 2024 was 2.3%. Paying so much for yesterday leaves less for tomorrow – and makes the borrower more vulnerable if interest rates rise.

Bad debt in an ageing society is especially risky. If a shrinking working-age population has to service growing debt, the room for manoeuvre in planning government expenditure is diminished. There comes a point at which promises of reform are pointless. Only cuts can help. Or simply going without.

## Bitter medicine

Spain, France, Venezuela, Mexico, Argentina. The list of sinful debtors is long. What these examples have in common is that governments did not borrow in order to modernise their economies but simply as a means of clinging to power (see chart above). The Greek experience provides a stark reminder. The euro crisis starting in 2010 showed how debt, false incentives and lax control can derail an economy. Greece's public debt rocketed to 239% of GDP. The upshot was debt rescheduling and enforced retrenchment. Pensions were cut, public services slashed and public assets sold off.

It was bitter medicine, and many Greek citizens paid a heavy price in the form of reduced living standards, lost jobs and disappointed hopes for the future. But it worked. Greece is back in the bond market. Debt fell to 174% of GDP in 2024. And the trend is downwards. The OECD is forecasting 165% for 2026, with economic growth continuing to accelerate while unemployment falls. Confidence has been restored. The process has been painful, but Greece's experience shows how mountainous debt can become a pernicious burden that defies painless solutions.

## Money available again for defence spending

There is no clear answer to the question as to what kind of debt is good and what is bad. But whenever a situation occurs that is generally regarded as exceptional, countries reach for exceptional measures. That is what happened during the coronavirus pandemic, the euro crisis and the financial crisis of 2007/08.

Europe is now seeing a resurgence of support for increased defence spending. Germany, for example, reacted to the Russian invasion of Ukraine in 2022 by setting up a EUR 100 billion special defence fund exempt from the statutory cap on government spending (the "debt brake"). Even more is in the pipeline. This year some adroit political footwork produced a plan to commit an estimated amount of around EUR 1 trillion for spending on defence and infrastructure.

The peace dividend following the end of the Cold War had led to a rundown of defence budgets. Military spending was politically unpopular, ethically controversial and a low priority in the fiscal process. But that has changed. Security policy is a frontline concern again. Arms deliveries, rearmament, higher expenditure for NATO – all this is no longer taboo, either socially or fiscally. Germany is not alone in striking out in this new direction. The EU is also setting up a special fund for new defence expenditure. Even so, Germany's experience shows how difficult the process of political prioritisation is. Pensions, education and health are still subject to the old rules. Costs are totted up, cuts proposed, priorities debated. The question is essentially a political one: Is external security worth more than social and fiscal resilience? Or is it simply an easier political option?

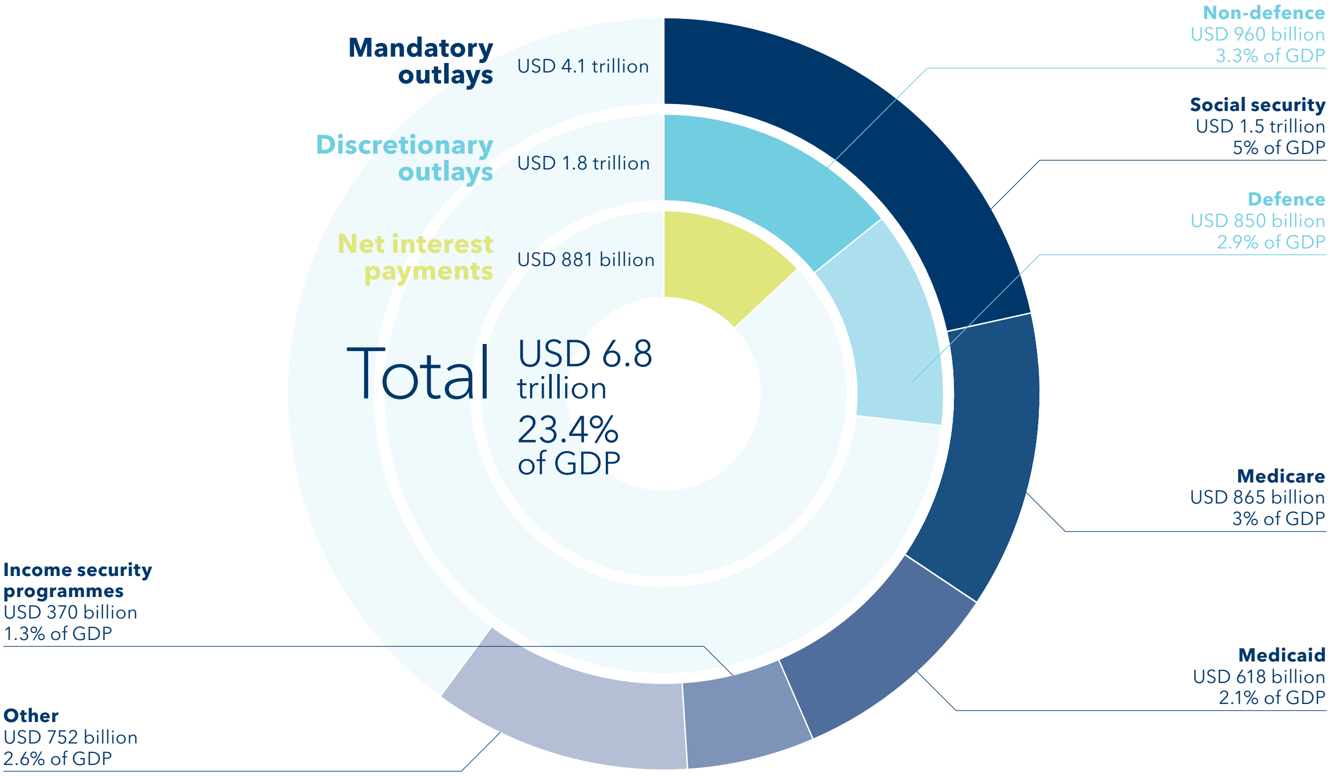
// Passing the buck: today´s debt was run up by predecessors and pre-predecessors. //

## Debt is never neutral

Government debt is not an arithmetical mistake. It stems from political decisions and the democratic process. The US experience shows where lack of fiscal discipline can lead. The Moody's downgrading merely set the seal on the financial reality. The buck is passed from one generation of politicians to the next. Today's US debts were run up by Trump's predecessors and pre-predecessors. And now Trump himself is doing the same.

History teaches that debt can be either useful or ruinous. The Greeks know this all too well. The USA and most industrialised nations now have a choice. The world is looking to Washington. But we should also look in the mirror and ask, "What future do we owe ourselves?"

**US federal budget in fiscal year 2024**



# The multiplier effect

**Thomas Gitzel**

Fiscal measures can boost the economy. Politicians know that very well. But how and by how much? That is where opinions differ.

Fiscal stimulus consists in cutting taxes and other government levies or raising public expenditure. Higher government spending has a direct positive arithmetical effect on gross domestic product. It also has an impact on the private sector. Government investment involves awarding contracts to companies, whose output is thereby increased. On the other hand, if taxes are cut, people have more spending power, resulting in a boost to private consumption. Thus the impact of both strategies is multiplied in the private sector of the economy.

The basic concept of the multiplier effect was contained in François Quesnay's "Tableau économique" published in 1758: higher government spending generates new jobs and increased income, resulting in additional consumption. In the 1930s, under the impact of the Great Depression, this idea was popularised by the British economist John Maynard Keynes, who argued that government action was essential for stimulating the economy in a time of recession.

But how big is this multiplier effect? Textbooks often point to models that claim to show that money spent by governments becomes multiplied four or five times in the private sector. If that were the case, government spending would be an extremely effective way of boosting economic activity. But this theoretical ratio is too high, because the models underestimate negative consequences. For example, increased public spending can result in higher interest rates, which put a brake on private investment. And consumers might decide that an expansion of government expenditure will lead to future tax increases and therefore not make full use of the extra income they receive.

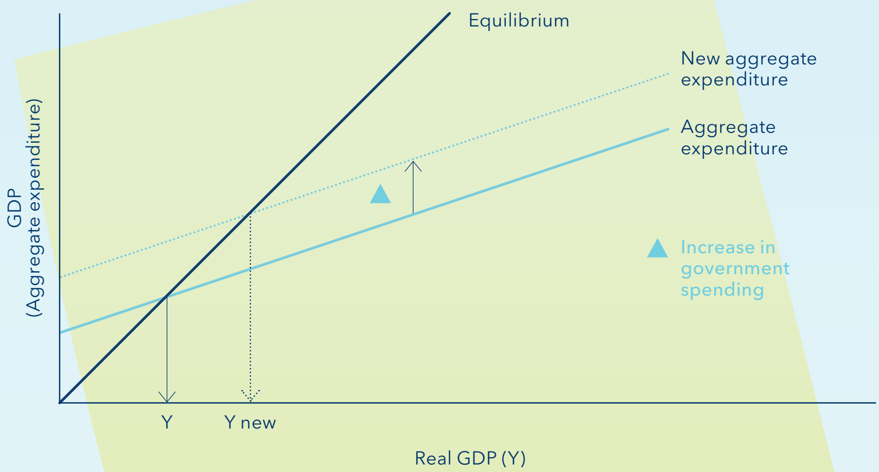
These secondary effects make the multiplier much smaller and can push it towards parity. In extreme cases the multiplier will sink below 1, meaning that public money is being invested badly.

There is widespread agreement among economists, however, that public investment is especially effective in this context. Road repairs and new road construction, for example, generate new orders for civil engineering companies, pushing up the general level of incomes and thereby boosting private consumption. Research suggests that public investment has a multiplier effect of between 1.3 and 1.8 and is especially effective at times when the economy is stalling.

Economists now have a concrete example to look at. The German government has set up a special fund worth EUR 500 billion for infrastructure projects. This is a clear case of public investment at a time of economic weakness.

The German Institute for Economic Research (DIW Berlin) has ventured to predict that this scheme will involve a multiplier of close to 2. The institute's calculations show that the fund's investments could boost economic performance by an average of more than two percent annually over the next ten years. It will be very interesting to see how things turn out.

**More benefits than costs**



# “A debt brake does not make financial policy superfluous“

Getting a grip on government debt is no easy matter. Professor of political economics Christoph Schaltegger explains what measures are helpful and how governments with big debt burdens can continue to invest.

**Interview: Clifford Padevit**

**Professor Schaltegger, are there good and bad debts?**
The usual answer is that debts incurred for consumption are bad, while those used for investment are good. But politicians always say that the expenditures they are advocating will produce a return and should therefore be regarded as investments. So that gets us nowhere in defining good and bad debts.

**What does an economist say?**
Government borrowing has the function of smoothing the tax burden over the economic cycle. It enables the government to avoid raising taxes during a recession or lowering them during a boom. Thus borrowing serves to bridge economic downturns – obviously a useful function. Governments are privileged to have this instrument at their disposal, and they make free use of it.

**That can be seen in the worldwide escalation of government debt. How risky is this?**
Very risky. Politicians, and perhaps people in general, tend to regard their present situation as special. An apparently unusual situation calls for exceptional measures. It’s always: “Yes, it’s important to keep the budget balanced over the long term, but today’s case is different.”

**How has that turned out in the past?**
In a book entitled “This Time Is Different” Carmen M. Reinhart and Kenneth S. Rogoff analyse debt cycles over the last 800 years. They show that the special pleading only works until excessive government borrowing, often coupled with mounting debt in the private sector (notably on real estate), finally leads to a crisis. The mixture of public debt, higher interest rates, high real estate borrowing and undercapitalised banks can result in huge financial turmoil.

**Even so, the debt burden continues to mount.**
This spring the International Monetary Fund warned governments to start consolidating their budgets. The dangers should not be ignored. When someone comes and says that this time is different, we should be on our guard. Many countries now want to redirect spending into defence, but they are already so deep in debt that such action is hardly practicable. In Germany this is leading to a circumvention of the "debt brake": the balanced budget rule that structural deficits should be strictly limited.

**What are the reasons for the debt explosion? Unusual events like the coronavirus pandemic and the financial crisis? Or is it due to structural trends such as the ageing population, climate change and rising welfare spending?**
All of the above. In a crisis we see a ratchet effect. Spending is increased, for reasons that make sense. But afterwards it is difficult to take away support that has been given to any particular interest group.

**And structural developments?**
They exacerbate pressures in the social insurance sector, above all in underfinanced and structurally unbalanced pension systems. Crises and structural developments overlap, both working in the same direction. The trend towards deficits is exacerbated by the ageing electorate. In Switzerland the average age of people who regularly vote is 57. So meddling with the pension system is not easy.

**At what level does public sector debt become critical?**
There isn't a threshold. The crucial point is that a government cannot afford to run a primary deficit, i.e. a deficit before interest payments, over the long term if the interest burden is equal to or greater than economic growth. There is a voluminous literature on threshold values. Research shows that markets price in a degree of risk intolerance if they feel that a particular level of borrowing involves a risk of default that is high or higher than in another country. Every country is different in this respect. Researchers are not unanimous, but there are indications that borrowing of around 90% of GDP is seen as negative for growth.

**What are successful ways of reducing borrowing and getting government finances onto an even keel?**
The debt problem arises mainly because the political process follows rules that ordinary citizens do not regard as right. Direct democracy, as we have in Switzerland, therefore tends to hold politicians back. The political process contains numerous helpful rules in this context, notably qualified majorities for spending decisions or a hierarchy in the cabinet to ensure that the person with financial responsibility is in a good position to enforce the guidelines. The principal way of achieving a comprehensive effect is a debt brake.

**There is now a lot of talk about the debt brake in connection with Germany's planned raising of spending on infrastructure and defence. How does such a mechanism help?**
A debt brake is designed to work as comprehensively as possible at the level of the overall budget, setting clear political boundaries in the budget process while also providing a means of checking afterwards whether the rules have been obeyed.

**Switzerland has an effective debt brake, whereas in Germany the mechanism has become discredited because it allegedly hinders investment. Does it?**
The situation in Switzerland is rather different than in Germany. Here there is no evidence that investment is disincentivised. Switzerland has special off-budget funds like Germany's, notably the National Roads Fund and the Railway Infrastructure Fund. These funds are financed outside the regular budget and involve strict earmarking. But they are not outside the debt brake and therefore do not confer special authority to borrow as in Germany.

**In both countries defence spending is now a major talking point.**
We Europeans have made hay with the peace dividend by keeping defence spending virtually stable in real terms. The additional money generated by economic growth has gone into social welfare. In Switzerland spending on defence and welfare was almost identical in 1990. Today the two are wide apart. That is the result of political decisions. Even so, the evidence does not suggest that Switzerland has an investment problem.

**Can debt brakes be copied?**
Such mechanisms have to accord with cultural and institutional realities. In Switzerland the debt brake is effective because it was introduced on the basis of a clear popular vote, and politicians stick with it for fear of being punished at the polls. In Germany it's more a constitutional matter. Both approaches can work.

**In Switzerland the amortisation of debts incurred during the coronavirus pandemic has been postponed till 2035. Is that not an admission that bringing down debt is very difficult?**
The lengthening of the amortisation period amounts to a further flexibilisation of the debt brake that was not originally intended. Strictly speaking, the rules were loosened when they became inconveniently tight. Even so, it is a considerable success that the general mechanism and its application to the budget are not being questioned. In Germany the rules were obeyed as long as they did not tie the government's hands. When they did, they were jettisoned.

**Is a debt brake flexible enough to tackle structural issues?**
That is not what the brake is for. Its function is to set a clear rule for the annual accounts and the budget. It is essentially a short-term instrument. This does not mean, however, that financial policy has no part to play in discussion about tax and spending plans for the next three or more years. That is where long-term issues regarding defence, ageing and infrastructure have to be addressed. A debt brake does not make financial policy superfluous.

## Profile

**Christoph Schaltegger**, 53 years old, is professor of political economics at the University of Lucerne and also teaches public finance at the University of St. Gallen, where he gained his post-doctoral lecture qualification in 2009. He is also Director of the Institute for Swiss Economic Policy. He studied economics at the University of Basle, where he obtained his doctorate. In 2024 he was a member of a five-person team of experts that produced cost-cutting proposals for the Swiss government. His research emphasis is on issues relating to public finance.

**Note:** The opinions expressed in this interview may differ from those of VP Bank.

# Why does higher debt not always mean higher interest?

The growth of debt in Japan and the USA has not yet led to higher bond yields. This reflects the abundance of savings.

**Bernd Hartmann**

Higher debt means higher interest rates. Really? That certainly looks true for personal and corporate borrowers. Lenders naturally want to be compensated for higher risk. But how far does it apply to governments?

Governments and big corporations borrow on the same bond market, competing for the same investors. In the case of non-public borrowers, creditworthiness plays an important role. A borrower's debt level is a central criterion for measuring creditworthiness, albeit not the only one. When assessing credit risk, investors look first and foremost at the ratings awarded by rating agencies. In principle, the lower the credit rating, the higher the interest rate.

## Not clear-cut

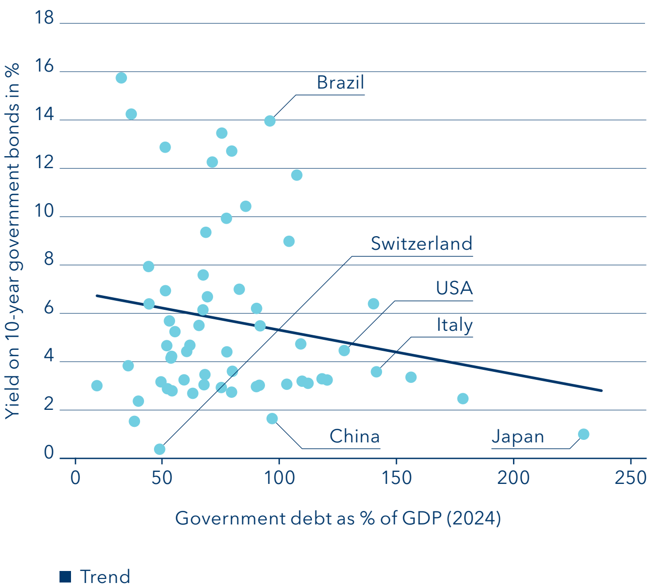
In the case of government borrowers too, a look at the level of indebtedness is a first step in assessing creditworthiness. But the relationship between debt level and interest rates is less clear-cut than in the corporate sector. In fact, the picture is counterintuitive: the higher a country's debt, the lower the interest rate paid (see trend line in chart).

The USA is a prime example. Total US public debt as a percentage of GDP sank to around 32% in the 1970s, its lowest level since World War II. Since then it has moved up and up, with especially steep growth in recent years. The figure now stands at over 120%. But the yield on 10-year Treasuries has fallen steeply in both nominal and real (inflation-adjusted) terms from almost 16% nominal in 1981 to around 0.5% in 2020 (see chart on page 11). The USA is certainly not unique in this respect. Japan's public debt as a percentage of GDP has climbed almost fivefold since the 1990s to currently 238%, but Japanese government bond yields over the last ten years have been mostly close to zero. In China, meanwhile, public debt has more than doubled over the last ten years while yields have fallen by half. Why, in all these cases, have yields fallen despite growing debt?

## Various factors at work

Short-term interest rates in a particular currency are controlled by the country's central bank, whereas long-term rates are determined by the bond market. The primary inputs for bond investors are macroeconomic data such as the economy's long-term growth potential and long-term inflation expectations. Political and economic stability are also factored in. If stability is under threat, the markets can react very nervously. When British Prime Minister Liz Truss presented her tax-cutting plans in September 2022, the yield on 10-year UK gilts doubled within a month, because the market knew that the tax

**Counterintuitive: national debt levels and bond yields**



cuts would have had to be financed by new borrowing. The market revolted, and the plans were ditched. Truss resigned after only 45 days in office. There were echoes of this in America recently. The announcement of swingeing punitive tariffs at the start of April sparked a jump in yields on US Treasury bonds, and President Trump thereupon postponed the tariffs for 90 days.

Such political squalls are fairly uncommon. Expectations for the industrialised nations are normally firmly anchored and change only slowly. The US potential growth rate as calculated by the Congressional Budget Office has ranged between 1.4% and 2.5% over the last 20 years. Given the setbacks triggered by the financial crisis and the coronavirus pandemic, that can be regarded as very stable. Not only the growth outlook but also inflation and the market's inflation expectations are close to the levels seen 20 years ago.

## Ignorant bond market?

Against this very stable background and despite the expansion of debt, the level of interest rates for fixed-interest securities has not risen. Why? The bond market is regarded as extremely efficient. As in any market, prices (i.e. yields) are determined by supply and demand. Public discussion tends to focus on supply, which has expanded significantly as a result of the growth of debt.

Less attention is paid to the demand side. Demand for bonds depends on the savings rate, because savings are invested in the financial markets. But the decisive factor is the relationship between savings and capital investment, i.e. real estate purchases and corporate spending on new plant and inventories. If the private sector saves more than it invests, the result is excess savings, leading to higher demand for bonds and hence falling yields. How much is saved and invested also depends on the economic cycle. In a recession, the private sector tends to save more and invest less, resulting in lower overall demand in the economy. Governments then often step in to stimulate demand and mitigate the recessionary effects, thereby causing an enlargement of the public deficit. If that happens, the government deficit and private sector savings both increase.

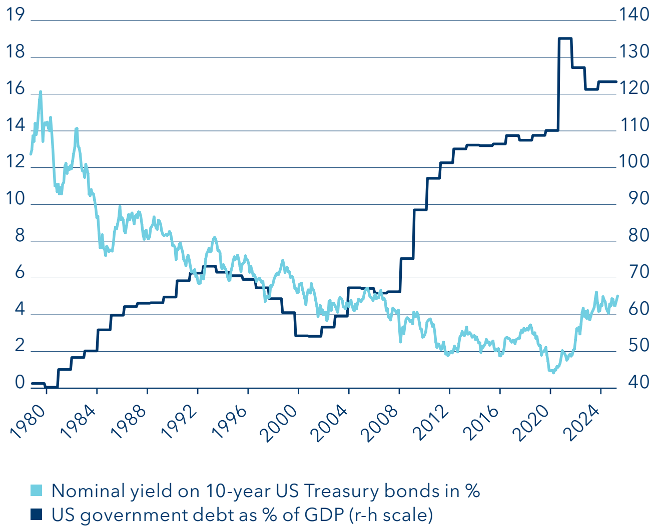
But a high savings rate can also become a durable phenomenon. In Japan excess savings in relation to GDP have risen since the 1990s and stayed stuck at a high level. A similar trend has been seen in the eurozone over the last twenty years and recently in China. These three economies are all characterised by a subdued level of capital investment in the private sector. And they have another thing in common: although their governments are running a budget deficit, the combined total of the public-sector deficit and private investment has been lower than the available savings. Things are very different in the USA. Here the propensity to save is low and willingness to invest high. Despite solid growth rates, the government has not been economising. On the contrary, fiscal policy has been expansionary, meaning that the USA needs foreign capital to finance its deficit.

## Global equilibration

A mismatch between savings and investment is evened out by flows of capital in or out of the country. Japan and China, for example, are America's largest foreign creditors. Even so, bond markets are dominated by domestic investors. Alongside an understandable preference for investing locally, investors are deterred from investing abroad by fear of currency fluctuations. But even within the eurozone there is a strong inclination to invest domestically. In Italy, for example, 69% of government debt is held by Italians. All in all, interest rates play an important role in the process of balancing global demand and supply in the bond markets.

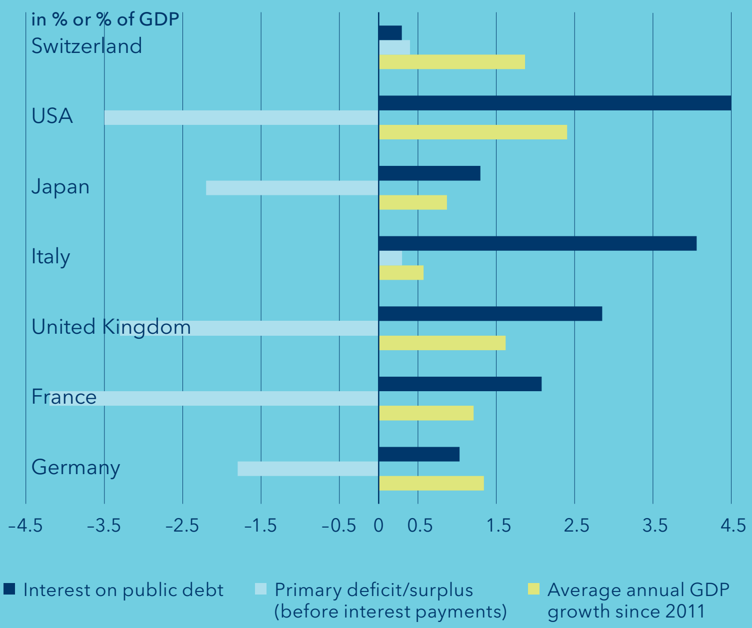
Thus the level of bond yields is not a reliable guide to a country's creditworthiness. Market yields are more determined by the relation of savings to investment, especially if the markets' macroeconomic expectations are stable.

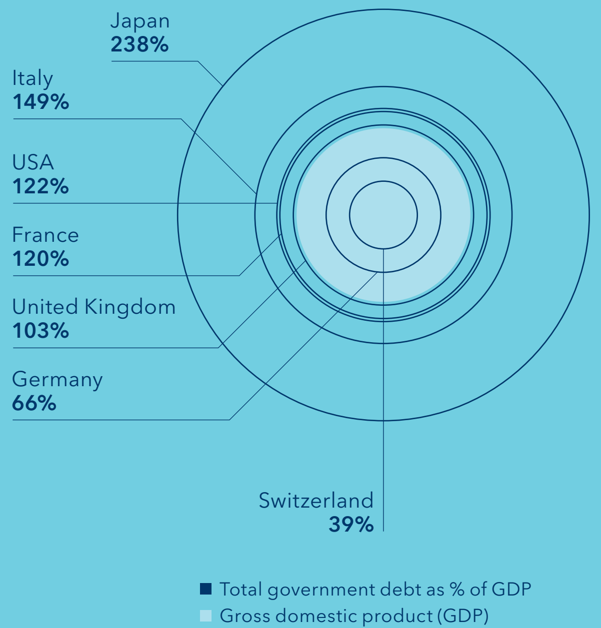
**Yields largely shrug off rising debt**



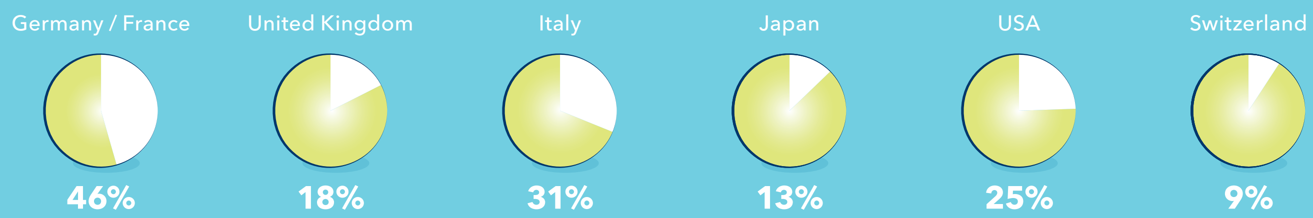
# Governments in debt

Countries differ; each has its own profile. Assessments of the sustainability of a country's public debt are frequently based on a combination of the following criteria. Other factors may also play a role.



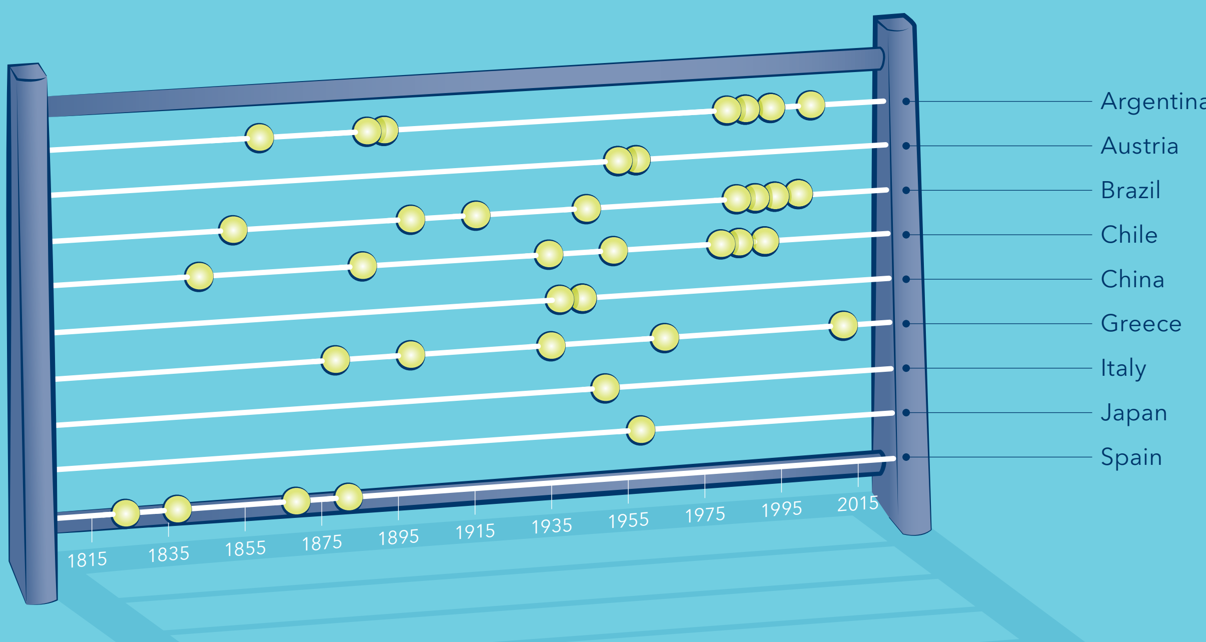




## What percentage of debt is owed to foreign creditors?



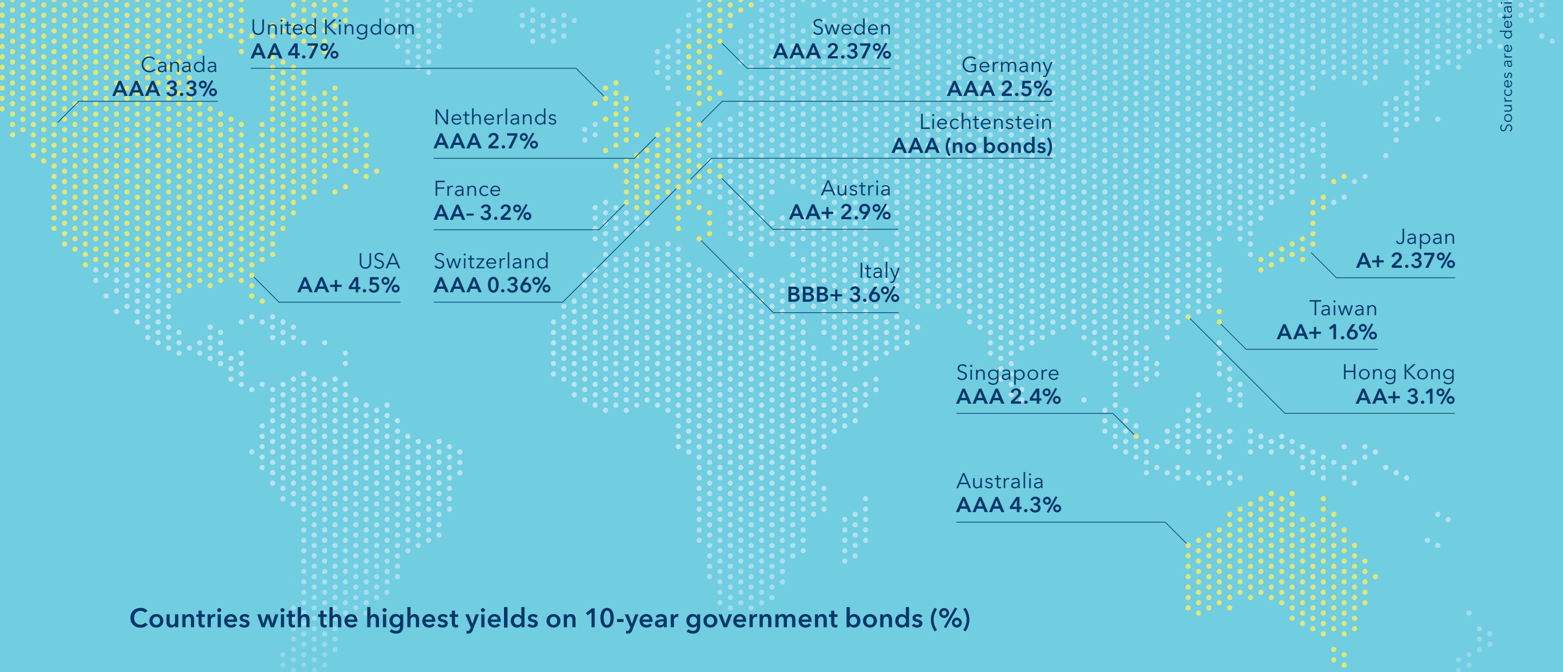

## Disappointed creditors

If the going gets tough, debts can be restructured. Some countries have left their creditors in the lurch several times over the last 200 years (number of debt restructurings, only those in GBP/USD).



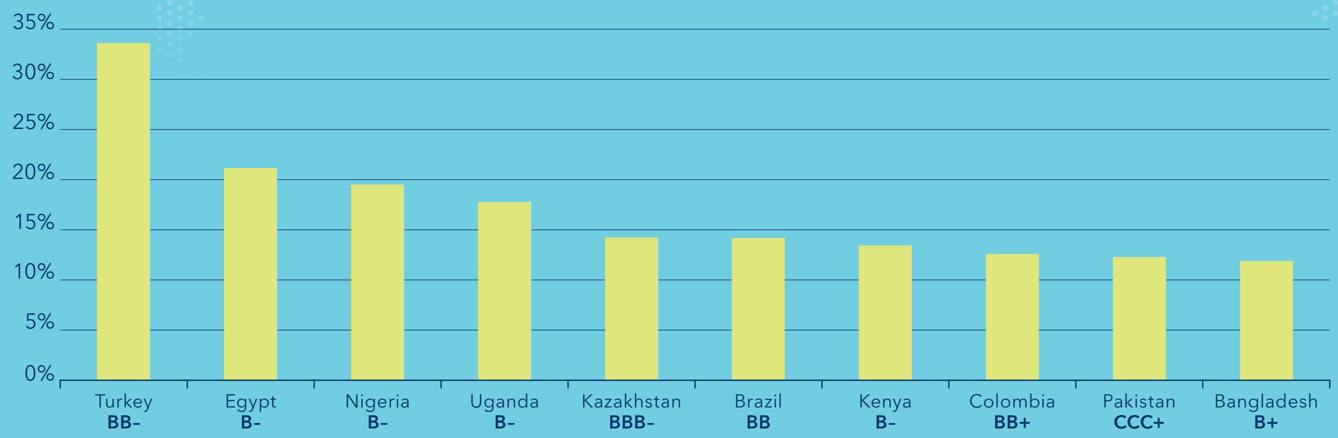
## Government bond yields

The level of bond yields (the figures below are for 10-year government bonds) is determined partly by the country's volume of debt and credit rating, but also by other factors. Hence the big variations.



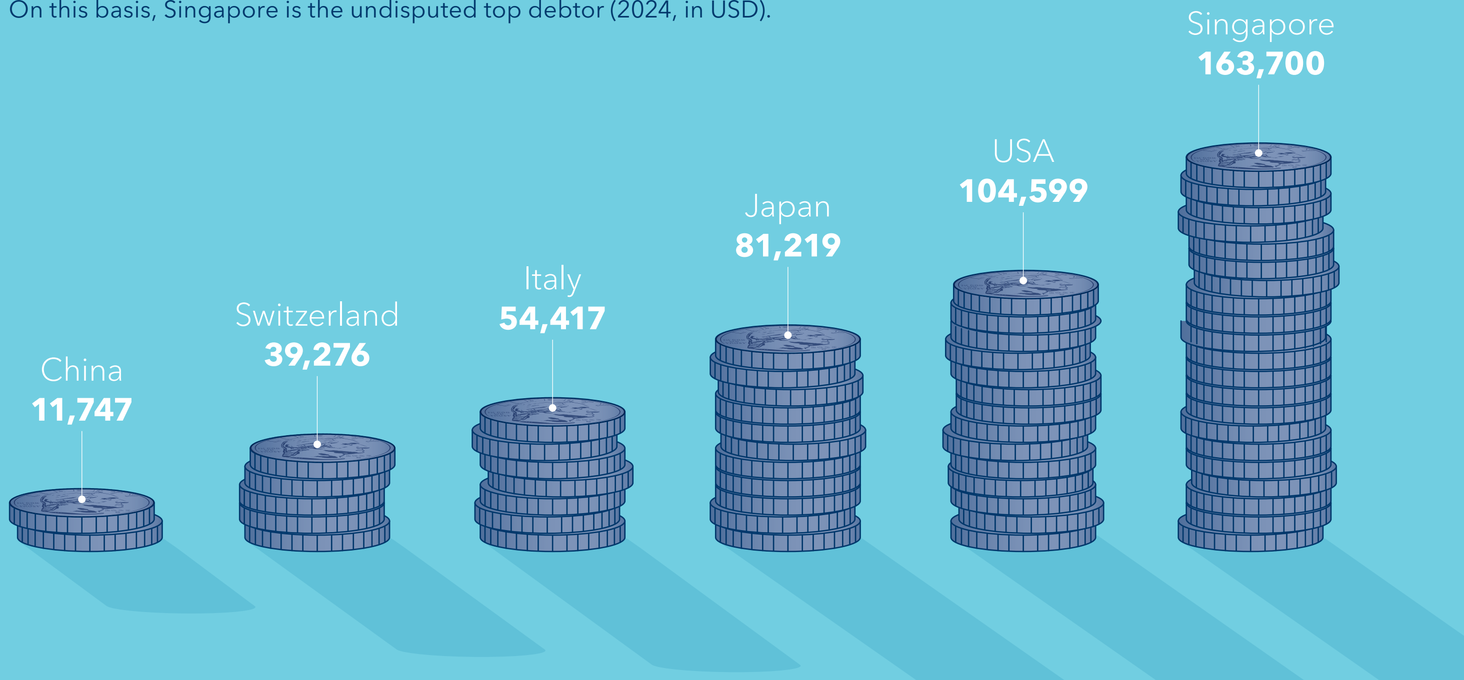

Sources are detailed on page 24

## Countries with the highest yields on 10-year government bonds (%)




## Government debt per inhabitant

If debt is measured in relation to population size, a completely different picture emerges. On this basis, Singapore is the undisputed top debtor (2024, in USD).



# “Talking helps a lot“

She won the Order of Merit of the Ladies European Tour in her first year as a professional. Swiss golfer Chiara Tamburlini has now set her sights even higher.

**Clifford Padevit**

// On the putting green I count to ten to calm myself. //

Win a day’s golf with Chiara Tamburlini!

More on page 23.

Winning three tournaments in her first Ladies European Tour season and capturing the 2024 Rookie of the Year award were certainly star accomplishments. But people tend to forget how long the 25-year-old had to work for this success.

The story started in the Niederbüren Golf Club in the Swiss canton of St. Gallen, which she joined when she was eight years old. At the age of twelve she was already outplaying her parents, and at fourteen she decided to enrol in a sports-oriented high school in southern Switzerland, where the curriculum includes training for up-and-coming athletes. "At that time I had no intention of going professional," says Tamburlini, "but without that step I wouldn't be where I am now." That is why she regards the switch to the sports school as one of her two best investments (see below). She joined the programme in its inaugural year alongside several other golfers.

After that she moved to the USA, where a grant from the University of Mississippi gave her the opportunity to play in the college team that won the US college championship in 2021. In late 2023 she joined the professional tour in Europe.

That's when the hard work really began. Golf has become a much more athletic sport over the last 15 years. "When I'm on the driving range, all the women are athletes," says Tamburlini. She also spends a lot of time in gyms, training her whole body for flexibility, balance, coordination and stability. "We use every muscle in our body." Her regime also includes weight training, which helped lengthen her driving distance by 30–40 metres when she was in the States. Given her relatively small body size (1.59 m tall), this improvement required a big input of strength and technique. She now drives an average of about 240 metres.

Her training takes up four to five hours a day, the same as an 18-hole round in a tournament. Fitness is important, but so is mentality. "You can't try to stay focussed for five hours, or you'd go mad. You have to be able to switch on and off." If something goes wrong, it is important to stay relaxed and concentrate on the next shot.

Tamburlini demonstrated this in masterly fashion in the 2024 French Open. After 16 holes in the last round she was one stroke behind the leaders and knew she needed a birdie at the 17th hole if she was to have any chance of victory. "I was really nervous, almost more than in the playoff afterwards." But she did it, and went on to win the playoff and the tournament. "When you are nervous, you often tighten up and move too fast," she says. If she feels that happening on the putting green, she counts to ten. "To distract myself. The body knows how to make the shot." She also has another way of keeping her cool. "It does me good to chat with other players." If she doesn't talk, she might start to brood. "Sometimes I have to give myself a nudge. Even a short conversation can loosen me up." The atmosphere among the women golfers is good. They know each other, sometimes share lodgings during the tournament or eat together.

It would be wrong to think that a professional female golfer is automatically free of financial worries. The total purse for a female tournament is generally in the region of EUR 300,000 to EUR 450,000, of which the winner receives about 15%. That is way below what the men get. Merely to pay the cost of flights and accommodation plus trainers and coaches, a player needs a good number of top placings – and sponsors.

It is not in Tamburlini's nature, however, to complain about the low prize money. She prefers to set herself new objectives: to make the cut in a major tournament and get into the top 20, win a card for the US tour, qualify for the Olympics and play in the Solheim Cup for Europe against the USA. Any player who starts their professional career so successfully is bound to set their sights higher. Chiara Tamburlini has what it takes.

## My best investment

"There are two: the decision to move to the sports high school in a distant part of Switzerland at the age of 14, and then the move to a college in the USA."

## My worst investment

"When I was eighteen I wanted to make my fingernails really beautiful, so I bought an expensive manicure set. But it turned out I was allergic to the nail polish."

# Five notions about public debt – Do they stand up?

There are many misunderstandings about government debt. We fact-check five frequently made assertions.

**Thomas Gitzel**

## "Debt is not a problem. Inflation will take care of it."

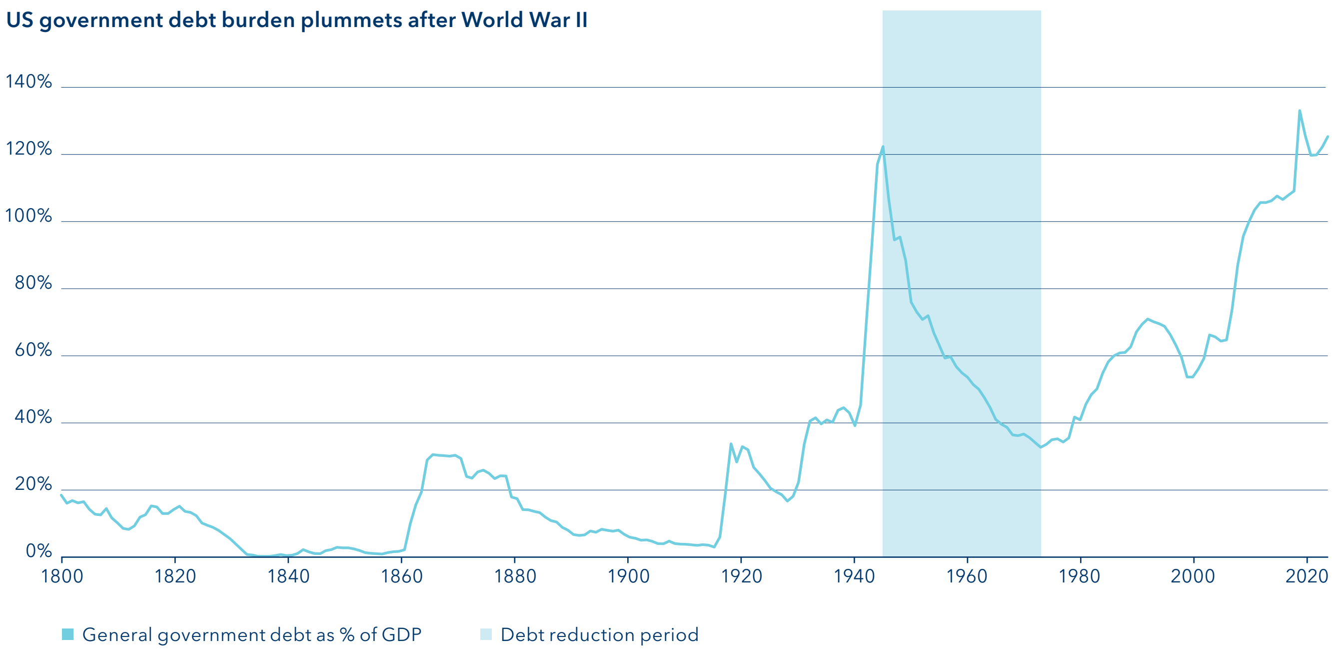
It's true: debt can indeed be "inflated away". In Europe, this phenomenon is often associated with periods of hyperinflation. But that is not necessarily the case, as the example of post-war America shows. A period of slightly elevated inflation combined with relatively low interest rates saw US debt levels crumble. Total public sector debt in the USA at the end of World War II amounted to 121% of gross domestic product (GDP). By the mid-1970s it had fallen to 32%, though it has bounced back since (see chart below).

A term often used in this connection is "financial repression". The process is repressive because it victimises investors, notably institutional investors like insurance companies and pension funds, which are forced by more or less gentle regulatory measures to buy domestic government bonds. The nominal interest rate on these bonds is kept below the rate of inflation either by connivance between the government and the central bank or by direct intervention in the market, perhaps even involving legislative controls.

The background: after World War II the USA was the only major industrialised country whose productive capacity had not been decimated by war. America was therefore able to supply other countries, notably Europe, with all sorts of goods, resulting in an enormous trade surplus. But such a surplus is always reflected in a deficit on the capital account. In other words, capital was flowing out of the USA. The outflow was predominantly in the form of military and development aid and loans in connection with the Marshall Plan for Europe's reconstruction.

The problem was that this outflow of capital posed a threat to the Bretton Woods system of fixed exchange

**US government debt burden plummets after World War II**



rates. The USA therefore introduced an interest equalisation tax, i.e. a withholding tax on foreign interest earnings. This meant that foreign investments became relatively less attractive, which incentivised Americans to buy domestic bonds. The resultant increased demand for domestic debt securities pushed yields below the rate of inflation. With real interest rates in negative territory, the government was economising on interest payments at savers' expense. This eventually caused debt as a percentage of GDP to fall. The oil price shocks of the 1970s and 1980s were likewise accompanied by negative real interest rates, pushing debt levels down sharply. Thus "inflating debt away" is certainly possible. But savers suffer.

## "Europe still has a debt problem."

Europe, or rather the countries in the eurozone, certainly have a debt problem, as do many other currency areas. But unlike the European sovereign debt crisis that buffeted the markets in 2011 and 2012, the situation now is not acute. By buying up government bonds and instituting emergency liquidity programmes, the European Central Bank (ECB) has erected a new protective shield. Added to that is the creation of the European Stability Mechanism (ESM), which can provide over-indebted eurozone countries with useful support.

Particularly hard hit by the debt crisis was Greece. Its creditors, notably the International Monetary Fund (IMF) and the ESM, imposed conditions that put the country's economy through the wringer. But a harsh reform programme turned Greece into a success story. Its growth rate is now among the highest in the eurozone. Greek unemployment has fallen from almost 30% in 2013 to less than 10% now. And its budget deficit is among the lowest in Europe.

Serious problems now beset France, the second largest eurozone economy. Since 2020 France has been running budget deficits that far exceed the criteria of the EU's Stability and Growth Pact (Maastricht rules). In 2024 France had a shortfall of just over 6% of GDP, with debt amounting to 120% of GDP. This forces France to offer a higher interest rate on its sovereign bonds than Spain and only slightly less than Greece.

Italy has a higher level of debt, but unlike France it runs a positive primary surplus, meaning that income is sufficient to finance core activities. Even so, France's fiscal predicament has not yet led to stress on the financial markets, despite the difficult political situation after the 2024 parliamentary election. The ECB programmes available for use in emergencies have proved strong enough to keep the markets calm.

## "Central banks can buy up unlimited quantities of government bonds, so government borrowing presents no problem."

The public sector can borrow directly from banks. This is often what happens at the local level. When a village or urban authority wants to borrow, it will usually do so through a bank if it can. This is like a private person applying for a bank loan. Higher level public bodies, e.g. Swiss cantons or the federal government, meet their borrowing needs mainly by issuing bonds. These public sector debt securities are traded on the financial markets. Anyone can buy them, including central banks. If central banks are willing to buy, governments have no problem selling their bonds, i.e. no problem borrowing.

During the coronavirus pandemic, major central banks around the globe became lavish buyers of government bonds. This amounted to what is known as "quantitative easing". Central bank action enabled governments to raise finance more cheaply while also serving to combat the deflation dangers arising from the short-term damper on economic activity due to coronavirus lockdown measures.

If a central bank buys government bonds it is effectively printing new money. The money supply is increased and interest rates pushed down. In this sense it is true that the government has no problem borrowing the money it needs. The trouble is that the newly printed money exacerbates the danger of inflation. We saw this in 2021, when an expanded money supply coincided with a shortage of goods and high demand (encouraged by governments' generous coronavirus aid programmes). Inflation in the USA and the eurozone soared to around 10% for a while. This meant a huge loss of purchasing power for private households and resultant voter disaffection, leading to a transformation of the political landscape in several countries. So it is certainly not true that government borrowing financed by central banks involves no costs.

## "High government debt is bad for the currency."

Not necessarily. High government debt does not mean that a currency cannot appreciate – at least in the short and medium term.

The best example of this is Japan, which has been piling up government debt for decades and now has a public-sector debt level equivalent to 238% of GDP. That has not stopped the yen from rising strongly over long periods, for example after the 2008–2011 financial crisis and then again between 2015 and 2021. Only when inflation climbed due to the impact of the coronavirus pandemic did the yen start to depreciate. The US dollar can also be cited as an example. Generous coronavirus support by the federal authorities led to a massive increase in government debt, but the dollar appreciated strongly.

Over the long term, however, the record shows that currencies of countries that pursue a stability-oriented fiscal policy, e.g. Switzerland, get stronger. The Swiss franc has been on an uptrend for over half a century now, albeit with occasional periods of weakness.

The fact is that financial integrity produces a strong currency, whereas countries with high government debt tend to experience higher inflation over the long term, which eventually pushes their currencies down. In a special category are countries with high debt denominated in foreign currency, as is often the case with emerging nations. Additional borrowing by such countries in the form of government bonds denominated in dollars or euros not infrequently leads to rapid depreciation of the currency. Investors are especially likely to get cold feet if the country's foreign currency liabilities exceed its foreign exchange reserves, because that puts a question mark over ability to repay. Investors then often withdraw their money, thereby accelerating the currency's fall. The result is a vicious circle, with currency depreciation making it even more difficult to service the country's foreign currency debt. Default is not infrequently the result (see infographic on page 12).

"The credit ratings awarded by rating agencies show how risky a particular government's bonds are."

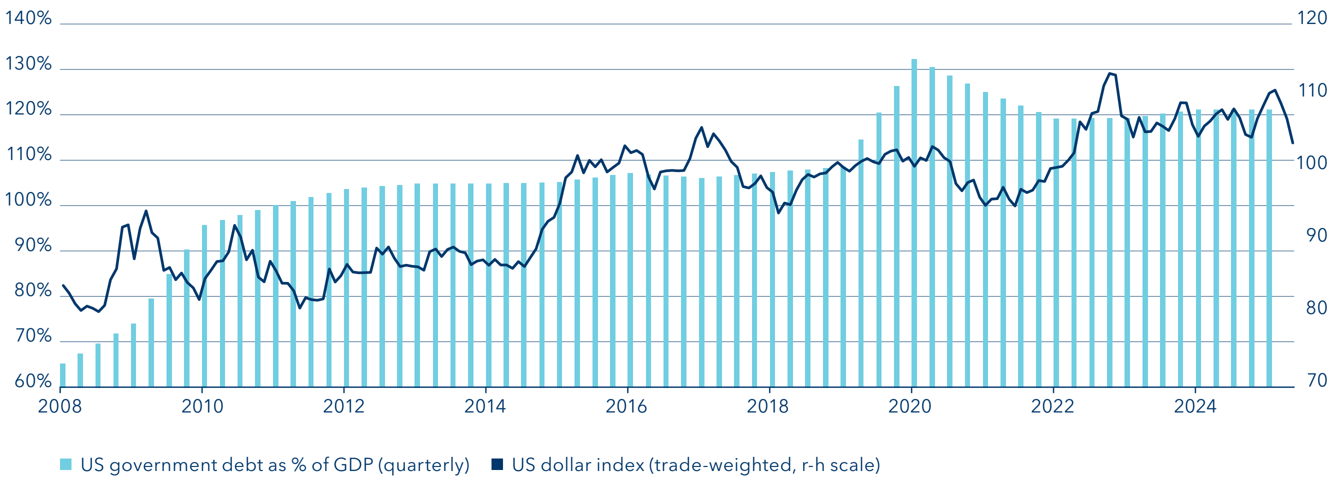
Rating agencies use various criteria to measure a country's creditworthiness. The resulting country rating is intended to show how high the risk of default is. The best-known rating agencies are Moody's, S&P and Fitch.

The agencies' judgements are based on an analysis of current economic data such as growth and inflation plus the country's financial and political situation and conditions in its corporate sector. The agencies keep their cards close to their chest; the details of how they arrive at their scores are a company secret. The ratings produced by the agencies, such as the top AAA ratings for Switzerland or Germany, provide a useful starting point in judging a country's creditworthiness.

The trouble is that economic and political conditions can change very rapidly, and rating agencies are usually slow to react. The financial markets are much faster off the mark, responding to negative economic news within seconds. Thus credit default swaps (CDSs), which are a form of traded default insurance for creditors, provide an implicit country rating. Or, to put it another way, the market prices of these swaps can be used to calculate a rating that is bang up to date.

It can be shown empirically that credit scores calculated on the basis of the prices of credit default swaps are a good early indicator of rating revisions by the agencies. The rating agencies do not have a monopoly of knowledge here. It is market prices that show how risky a government bond is.

**No contradiction: climbing government debt and a rising US dollar**



# Junk bond king

Michael Milken helped financially questionable companies to access the capital markets. He pushed the boundaries and ended up in prison.

**Clifford Padevit**

His glory days were around half a century ago, but investment banker Michael Milken is still famous – and notorious. That's quite an achievement, even for someone who took the US financial services industry by storm in the 1970s and 1980s.

Milken started his career as a trader in bonds issued by companies that were struggling. Institutional investors wanted nothing to do with such securities, so after a careful analysis of the companies' balance sheets he was able to acquire these bonds for a fraction of their face value. In this way he made huge profits for his employer, the Wall Street investment bank Drexel Burnham Lambert, which he had joined after leaving university. In 1978 the company recognised his merit by granting his unusual wish to move the bank's high-yield bond operation to Los Angeles.

In those days the corporate bond market was dominated by insurance companies and pension funds, which naturally preferred safe "investment grade" paper. When making a purchase they looked primarily at the issuer's credit rating. But Milken preferred to work with fund managers who put the stress on performance rather that "conformance", as he once put it. He set about creating a network that linked low-rated money-hungry companies to venturesome investors, arguing that these high-yield bonds – dismissed by competitors as "junk bonds" – would generate higher returns.

Above all, he said, investors should ignore the rating agencies, because these were looking in the rear mirror and not paying enough attention to cash flow.

Once a year Milken organised a high-yield bond conference graced by the presence of celebrities like Frank Sinatra. These conferences were decried by opponents as "predator balls", because Milken's new business model increasingly involved using high-yield bonds to finance corporate takeovers, including hostile ones. In 1989 Milken was involved in the leveraged buyout of the RJR Nabisco conglomerate by the private equity house KKR.

In 1978 the US high-yield bond market had a volume of USD 1 billion. By 1986 it had swollen to USD 125 billion, and the Los Angeles Times reckoned there were more issuers in the high-yield sector than in the investment grade market. Milken and Drexel Burnham Lambert were earning big time. By 1985 Milken was reckoned to be worth between USD 500 million and USD 1 billion, making him one of the 100 richest people in America. He was one of his bank's top shareholders, and his 1986 bonus was put at USD 100 million (USD 292 million in today's money).

Wall Street competitors looked askance at these enormous profits. Before long the US Securities and Exchange Commission (SEC) also started to take an interest. There was a growing question mark over Milken's precise role in these transactions. He knew the buyers and the sellers, acted as the dominant market maker and was a partner in the investment bank.

His downfall was precipitated by damaging statements made by a Wall Street arbitrageur in an SEC hearing. Finally, in 1990, Milken pleaded guilty to six counts of securities and tax violations and was sentenced to 10 years in prison and a USD 200 million fine. He was also banned from any involvement in the securities industry for life. His sentence was later reduced, but he was alleged to have flouted the ban. Under a plea deal he completed a period of community service, and in 2020 he was pardoned by Donald Trump.

After the end of his financial career, Milken became a generous philanthropist, with the emphasis on cancer research. The Milken Institute's 28th Global Conference, in which influential contributors meet to discuss the economic situation and problems such as climate change, was held in May. Milken, who will be 79 years old this July, intends to stay in the thick of things.

# Investing in debt

Government debt securities are a central component of a broad investment portfolio. We explain the role of debt securities in portfolio investment and also look at companies that benefit from higher state spending.

**Clifford Padevit and Jérôme Mäser (equity highlights)**

When constructing a balanced investment portfolio, the question is not whether debt securities (bonds etc.) should be included but rather what percentage of the portfolio they should account for. In a mixed portfolio, in which money is distributed across various asset classes, debt securities will always have a place.

“We carry out an annual review to establish the optimal strategic weightings of the various asset classes,” explains Dennis Huber, Head of VP Bank's Investment Management Department, which looks after clients' investment portfolios on a fiduciary basis. Using a combination of mathematics and experience, weightings are set in accordance with the portfolio's risk profile. The target bond weighting for a balanced portfolio in Swiss francs, for example, is currently 33%, while for US dollars or euros it is 35%.

Debt securities stabilise the portfolio. Firstly, price fluctuations in the bond market are smaller on average than in the equity sector. If these two asset classes are combined, the portfolio's value will therefore fluctuate less over time. Exceptions do occur, of course, albeit rarely. In 2022, which was an unusually bad year for investors, the equity and bond markets nosedived simultaneously. The cause was a surprisingly sharp uptick in inflation coupled with a rise in interest rates, which was uncomfortable for fixed-interest securities. Secondly, government bonds play a special role in this context, because their prices follow those of equities only to a small extent or even move in the opposite direction. It should be remembered, however, that positive or negative correlations between two asset classes are not immutable but change over time.

The debt securities position in a portfolio does not consist only of government bonds. It also includes various other segments, notably quasi-government bonds, corporate bonds and emerging market bonds. The portfolio's reference currency determines which currency area will be most strongly represented. Each market has its own characteristics, for example size. This can affect the liquidity of the bonds involved. The US dollar bond market is the largest, followed by the euro segment. The Swiss franc bond market is relatively small.

Selection is also based on the bond issuer's creditworthiness, as reflected in the ratings calculated by credit rating agencies. The problem is that ratings can vary from agency to agency. “We always take the lowest rating,” says Huber, i.e. the most conservative assessment of the risk involved. For corporate bonds other selection criteria are also applied, reflecting the great variations in the nature of such securities. High-yield corporate bonds, for example, carry a heightened risk of default. “The fact that we invest collectively in a wide range of bonds means that we can mitigate our exposure to debtor-specific risks.”

When managing positions in debt securities, the focus is always on risk. “In the case of equities, analysts look at a company's profit potential. With bonds, the issuer risk is at the forefront of attention,” says Huber.

## Security in prime position

The German company **Rheinmetall** is one of Europe's largest armaments manufacturers. Its success therefore depends heavily on military spending by individual countries. After years of inadequate defence spending within NATO, member states will have to cough up significantly more in the years to come. Rheinmetall's broad range of vehicles, weapons and munitions and its local partnership arrangements should enable the company to profit strongly from rising defence spending.

## Feeding the power socket

The Swiss electricity supplier **BKW** specialises in sustainable energy sources such as wind, water and solar. The company offers integrated all-in solutions for energy, buildings and infrastructure in Europe. As demand for energy grows, government programmes are needed that will expand and interconnect Europe's electricity networks. Added to that, regulatory incentives and ambitious climate objectives are driving demand for innovative energy solutions.

## Architect of the future

The business model of the US company **MasTec** includes supporting government departments in carrying out infrastructure projects. Alongside activities in the fields of communication and fossil fuels, the company is also engaged in the renewable energy sector. As the second largest US provider of specialist infrastructure services, MasTec benefits from government programmes centred on the modernisation of infrastructure in the fields of energy, communication and supply.

## Digitalised government

The IT services provider **Netcompany** generates almost two-thirds of its sales through contracts with the public sector. With the takeover of Intrasoft, this Danish company has established itself as a key player in the digitalisation of national and EU-wide public bodies. Alongside individual solutions, the company also provides standardised products for customs authorities, tax offices and social welfare institutions.

### Government debt as a driver of equities?

If a government finances economic measures by running a deficit or initiating new borrowing, the resultant expenditures (depending on how they are organised) can stimulate the economy and therefore boost the equity markets. The prime beneficiaries are companies for which government contracts are a major source of income. Such businesses are mostly active in the infrastructure and defence sectors. However, if the government's measures turn out to be ineffective, risk-related credit costs will be pushed up, with a negative impact on the capital investment climate for the whole economy.

# Shaky corporate finances

## The global expansion of debt is not only a government matter. Risks have also increased in the corporate sector.

**Clifford Padevit**

Debt is on the rise globally. The chief drivers of rising indebtedness are public sector borrowers, whom creditors generally regard as trustworthy. Governments have now overtaken non-financial corporations as the largest borrower group, as shown by the Global Debt Monitor of the International Institute of Finance (IIF), a global association of the financial industry (see chart).

But the corporate sector has also increased its borrowing, albeit to a smaller extent. Globally, non-financial corporations are USD 93.9 trillion in the red. This figure has roughly doubled since the financial crisis starting in 2007 and is now equivalent to 91% of world GDP. That sounds a lot, but it should be noted that this global figure obscures important regional differences. For example, Chinese non-financial companies now have debts amounting to 142% of China's GDP, about twice as high as the comparative figure for the United States and substantially higher than in the eurozone (105%).

### Shareholders love credit

Credit is a wonderful thing – as long as you can afford it. Corporate borrowing is part of the basic toolbox of any financial officer. Credit can be obtained in various ways: from a bank, from private investors or from the bond market. Borrowed money is commonly used for capital investment, notably outlays for new buildings or machinery. This is useful as long as the company sticks to the golden rule that long-term assets should be financed with long-term capital.

Debt is attractive to shareholders because borrowing pushes up the return on equity, always provided that the return on capital employed is higher than the interest rate paid. And there is also a tax advantage: interest payments on borrowings are tax-deductible.

But corporate borrowers should not overdo it. Lenders keep a close eye on companies' debt situation. Equity analysts, too, scrutinise balance sheet quality and examine how well a company is able to carry its debts, e.g. by measuring net borrowing in relation to earnings before interest, taxes, depreciation and amortisation (EBITDA).

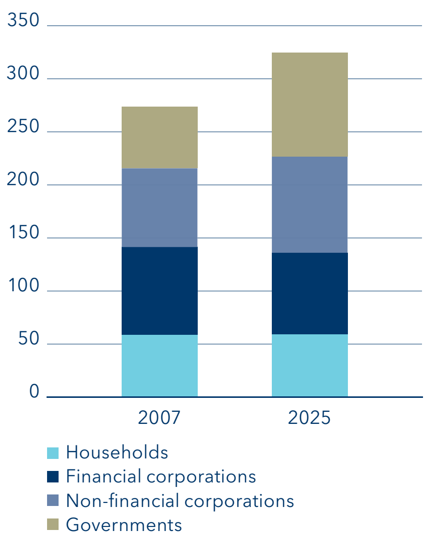
### Tarnished balance sheet quality

The crucial criteria for lenders are the quality of a company's balance sheet and its ability to honour its debts. It appears, however, that there has been an overall decline in corporate borrower quality. According to the Organisation for Economic Co-operation and Development (OECD), a half of all bond issues by non-financial corporate borrowers since 2014 have had a credit rating of BBB, the lowest score for investment grade bonds. That points to shakier balance sheets in the corporate world. So it is no surprise that bond issuance declined rapidly when interest rates started to rise worldwide from 2022 onwards.

Higher interest rates put a strain on borrowers, as the situation in the US corporate sector shows. The median interest coverage ratio in the US investment grade corporate bond index has fallen back to its 2020 level, when earnings were squeezed by the COVID-19 recession.

Globally, it is therefore advisable to keep a close watch on trends in public and corporate debt. Rising interest rates on long-term debt have not yet taken hold everywhere. And there is a growing risk that US trade policy could dent companies' profit calculations. Investors should be on their guard – even if the debt market still looks relaxed at present.

**Debt burden rising (worldwide as % of GDP)**



# VP Bank Swiss Ladies Open 2025

## A top international event that brings the world's best women golfers to Switzerland.

**Tamara Spiegel**

Dateline September for women golfers! The Ladies European Tour (LET) comes to Switzerland. To Holzhäusern in the Canton of Zug, to be precise. The VP Bank Swiss Ladies Open 2025 will be held on September 11–13. Since its inception in 2020 this tournament has become a highlight of the international golfing calendar, attracting crowds of spectators every year.

VP Bank, as co-initiator and naming partner of the tournament, is among the leading promoters of women's golf in Switzerland. Our long-term commitment ensures the tournament's continuation and further development. The VP Bank Swiss Ladies Open not only provides a platform for women golf professionals but also offers spectators unforgettable golfing experiences.

### Win a day's golf with Chiara Tamburlini

A highlight of this year's tournament is a raffle to win an exclusive day's play with Switzerland's top woman golfer Chiara Tamburlini (see page 14). The winner will spend a day on a golf course with Chiara this autumn, including a professional warm-up and technical instruction under Chiara's guidance. The day will be rounded off with a cosy aperitif and culinary titbits.

Take part in the raffle and come to the VP Bank Swiss Ladies Open on September 12. Then you will have a chance of winning an unforgettable day with Switzerland's Number 1 lady golfer.

**Win a golf day with me.**

Scan now:

vpbank.com/tamburlini

Chiara Tamburlini is Switzerland's current number 1 lady golfer. In 2024 she was top winner in the Ladies European Tour (LET) and was declared Rookie of the Year.

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