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Debt ratios in many advanced countries are at historically high levels. In his research, Martin Wolf points out three ways in which high debt can adversely affect our economies: a risk of fiscal stagnation; a risk that debt levels rise even more once interest rates go up; and the idea that monetary policy can become less effective at controlling inflation due to self-fulfilling beliefs of financial dominance.

Fiscal Stagnation: High government debt tends to be accompanied by low productivity growth. One reason may be that, to stabilise their debt, governments need to take costly measures that hamper the growth process, such as taxing firms' investment. As Martin Wolf shows in joint work with Luca Fornaro, this can induce a negative feedback loop: as growth falls, the debt-to-GDP ratio rises even more, forcing the government into even costlier measures to stabilise the debt. This can imply that, once debt-to-GDP is high enough, the country can become trapped in an equilibrium with high debt and low growth, from which it is very hard to escape.

Debt and interest rates: Martin Wolf and Leopold Zessner show that high-debt and low-debt countries respond very differently to rises in interest rates. When interest rates go up, low-debt countries respond by reducing their debt, because borrowing is more expensive. In contrast, high-debt countries respond by borrowing more. Intuitively, the interest expense on the debt is much higher for high-debt than for low-debt countries. As interest rates rise, this mechanically forces high-debt countries into more debt. This channel makes heterogeneity in debt levels self-reinforcing. For example, once the ECB raises rates, Italian debt levels may rise, but German debt levels may fall, adding to the already-large cross-country heterogeneity in the euro area.

Self-fulfilling financial dominance: High levels of private sector (e.g. bank) debt breed the possibility of a financial crisis, especially when interest rates go up. This makes central banks reluctant to raise interest rates after inflationary shocks, so-called financial dominance. Martin Wolf and Leopold Zessner argue that financial dominance can lead to self-fulfilling beliefs. When the private sector expects low interest rates going forward, leverage stays high, and financial dominance stays strong. The central bank responds by keeping interest rates low, validating the beliefs by the private sector. High debt may thus erode the ability of central banks to control inflation, by giving rise to self-fulfilling beliefs of financial dominance.

Martin Wolf is an Assistant Professor for Monetary Economics at the University of St Gallen. He has studied the impact of globalisation, automation, and financial crises on our economies, among other topics. He has recently been awarded an SNSF Starting Grant over CHF 1.1 million, on the topic "Debt, Growth, and the Macroeconomy: A Unified Perspective".