

Zooming In

Zooming In on the DM debt sustainability and its implications for investors

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Neha

Hi everyone! Welcome to the latest episode of our CIO Zooming In series, where we discuss burning market and investor questions. Today's topic of discussion is the unprecedented growth of government debt in the developed world. We'll be discussing the implications of this ever ballooning fiscal deficit on growth, rates and central banks' policies, and also how it impacts various asset classes. To discuss all this and to compare the broad macro picture of Emerging Markets (EM) versus Developed Markets (DM), today, I'm joined by James Pomeroy, who is a senior global economist at HSBC's Global Investment Research division. James, welcome and thanks for joining us today.

James

Thanks for having me, Neha.

Neha

So James, as we all know, developed markets are mature economies with ageing populations and slower growth trajectories. Consequently, they have been really dependent on immigration thus far to keep their economies going. But, with rising 'economic nationalism' and closed border policies, how do you see their growth getting impacted now? And what are the repercussions of this new reality on public spending commitments like health, defence and pensions?

James

Thanks, Neha. So, as you can see in this chart, actually quite how bad the demographic situation is for a lot of developed economies. We've gone from a situation of having plenty of workers for every person of retirement age, to quite a different situation in recent years, and that trajectory continues to get even more challenging as time goes on. And that directly hurts growth because you have a smaller share of the population who are working and spending more, and that really does hold back growth. But I think the real challenge here is going to come through on the fiscal side. I think governments across the developed world are facing quite a challenge here, partly, given the interest commitments that are now there because of high levels of debt that have been built up in recent years, but also we've got growing commitments to spend more on defence. And you add on top of that the challenges that directly come from these ageing populations. So, that is greater commitments to spend on pensions, greater commitments to spend on healthcare, social care, all of these areas of spending that are very correlated with ageing. The fiscal dynamics start to look really, really quite troubling. And the problem we have is that if we look across the developed world, there's an unwillingness, politically, to make the very, very hard decisions that would tackle this. And because that involves very hard decisions like raising retirement ages or cutting back pension payment amounts, or thinking about how we fund healthcare in some economies. And when you're looking at all of that, they're not vote winners, and the governments are not doing that. And what that means is the fiscal challenges are still there. It makes it very, very hard to find the money to fund tax cuts or to fund capital investments to the degree that we need. And so global growth, or at least in the developed world, stays much, much weaker than it could be because of these fiscal challenges that are there.

Neha

Now let's address the elephant in the room. And that is the contentious topic of central banks' independence, especially in the US. As we all know, US national debt recently topped \$38 trillion. And there are no meaningful signs of any reversal quite yet. So the question is, James, do these rising debt levels put any pressure on central banks' decision-making process to lower rates?

James

It's a great question, and it's a really important point at the moment, given the ongoing discussions in markets. If we look across the developed world and the high levels of debt that are out there, clearly that means the interest payments today are quite high for a lot of governments. Now, governments would like lower interest rates as a result. But wouldn't we all. Wouldn't most households or businesses across the world would love lower interest rates. It helps to cut costs. It could help to lift growth. It could be a really, really good thing. But we don't think that's necessarily a reason why central banks cut rates. What I think is potentially more likely is that weakness in growth that we've just talked about, that comes from these high levels of debt, means that central banks might find that the only real stimulus that can be given to economies comes from monetary policy, given the fiscal levers just aren't there. So if there's a need to get growth going, it's much, much harder to get that from the fiscal side. So it's more likely that monetary policy has to play a role. But there're also a number of other considerations here. And they come through from these ageing populations that have supply side consequences as well. You could have fewer workers. That could mean higher wages. It could mean higher inflation. The lack of investment in the economy could create some bottlenecks. That means higher inflation too. So these high levels of debt could impact central banks in a number of different ways. Typically, it means that interest rates might be lower than otherwise. And it could well be the case, if growth is lower. But if some of these supply side challenges appear, then you could see central banks be a little bit more nervous. So this debt situation is going to keep central banks across the world, particularly in the US, very much on their toes for the foreseeable future.

Neha

Now, let's delve into the broadening macro divergence between emerging markets and their developed market counterparts. Whilst emerging markets have higher growth rates, lower debt levels and younger populations in general, developed markets are ageing, their growth trajectory is slowing and they have higher deficits. Developed markets' sovereign ratings are being downgraded, whereas emerging market sovereign ratings are going up. So, James, what are the broad socio-economic implications of this broadening EM-DM divergence in your view?

James

It's a really, really important point, and it's one that I continually think about as a global economist, that the world's shape is changing quite quickly. And I think over the course of the next ten years, we're going to spend a lot more of our time thinking about what's happening in those emerging markets as a result. Because whilst those developed economies have got those challenges that we've been discussing, these emerging market economies have got that really powerful combination of younger population, the right type of ageing as people move from being in their 20s and 30s into their 30s and 40s, that's good for growth. That means more consumers, more workers, more output. And also what we're seeing is these income gains happening in these economies are helping to lift more and more consumers into the realms of being middle class consumers. And that means, as you can see in this chart, we think that over the course of the next ten or so years, we're going to see a continued increase in the importance of these emerging market economies as global end-consumers. Not just as important parts of global trade and global investment, but in end-demand. And that's important because it means that the economies or the businesses that are most exposed to those consumers of the future will do well. And that's going to help to continue that tilt of global growth in the years to come.

Neha

Finally, can the US bring its debt burden and its interest costs down any time soon? If so, how?

James

Thanks, Neha. There is an enormous amount of problems with high levels of debt. We've discussed some of them already, particularly around those higher interest costs that it creates. And so governments across the developed world, including the US, want to try and get these debt levels down. And you've got two ways you can get this under control. Firstly, we can be much more fiscally conservative. That requires tax rises that no one wants to see or spending cuts that no one wants to see. So, if you're unwilling or unable to do that, you need faster growth. And faster growth is hard to come by without those triggers, although support could come from supportive fiscal policy. So there's a need for those technological advances we're seeing at the moment, like Artificial Intelligence or other technological advances to lift productivity growth. And whilst we're optimistic here, we don't think the magnitude of lift you're going to get is going to be enough. So, yes! Growth might, in certain areas, get a bit of a lift from AI and so forth, we do think still you're going to need governments to think seriously about either raising taxes or cutting spending. It's just that those decisions are going to be really, really tough because it requires making choices around retirement ages, pensions, and healthcare spending, all of which are incredibly unpopular.

Neha

Here are the implications of higher fiscal deficit for various asset classes, currencies and multi-asset portfolios. Firstly, US dollar's dominance as the world's reserve currency may come under pressure due to possible de-dollarisation over the long run. This necessitates a focus on currency diversification for long term investors. Secondly, gold is emerging as a viable hedge against dollar debasement concerns. Persistent central bank buying shows a clear reserve manager move out of Treasuries into gold. Thirdly, the debt landscape has flipped. Whilst governments piled on debt, corporates have deleveraged over the last decade. Consequently, high quality investment grade bonds offer better value than Treasuries. Finally, individuals need to hedge their portfolios against longer term government debt sustainability concerns. They can do this by allocating to hard assets like gold and infrastructure. These assets provide investors protection against any growth, inflation and currency debasement risks in the long run. Thank you, James, for sharing your razor sharp insights on debt sustainability today.