



Government Debt Binge Ripples Worldwide

Advanced economies are now confronting higher borrowing costs as yields rise

BY SAM GOLDFARB AND PETER SANTILLI

Recent strains in the global bond market are demonstrating a key problem that confronted G-7 leaders at their meeting in Paris this week: how to manage a growing pile of government debt, accelerated by war and the pandemic.

Tumbling bond prices have pushed yields on government debt higher, lifting borrowing costs for governments, businesses and consumers alike. The main driver has been the war-fueled surge in energy prices, which has lifted inflation and spurred talk of possible interest-rate increases by central banks. But concerns about the fiscal outlook in Japan and the U.K. have also added to the bond-market selloff in recent days.

In the U.S., federal debt held by the public just climbed above 100% of the country's gross domestic product for the first time since the aftermath of World War II. Yet the country still has advantages that have blunted the impact of that milestone.

Here is a look at the current complex relationship between government finances and the bond market:

The global picture

Countries across the globe are dealing with aging populations and pressure to increase military spending. Taken together, the debt of advanced economies is growing as a percentage of their collective GDP, according to the International Monetary Fund.

Much of the increase is being driven by the U.S., and the overall trend masks significant differences between countries.

The U.S. advantage

Countries do the vast amount of their borrowing by issuing bonds to investors. As debt levels rise, some fear that the supply of bonds will outstrip demand, forcing governments to pay higher interest rates. That, in turn, could also push up borrowing costs for businesses and consumers, weighing on economic growth.

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The bond market, therefore, is the ultimate arbiter of a country's fiscal health. But it has its biases: Investors, governments and central banks have long preferred owning U.S. Treasuries over other government bonds. ^{-Note}

It helps that the bonds are backed by the world's richest, most-powerful country. It also helps that they are plentiful: Investors can easily buy and sell large amounts of Treasuries of any maturity—a confidence booster that has earned the market a reputation as the most liquid in the world.

Some \$263 trillion of U.S. Treasuries were bought and sold in 2023, almost nine times the amount of bonds that were outstanding at the end of the year, according to Sifma, a securities industry trade group.

Trading volume of German government bonds totaled roughly 7.1 trillion euros, just four times the size of the market, according to Germany's finance agency.

Calm at home

The U.S. government's borrowing advantage—sometimes called its "exorbitant privilege"—can be seen in the relatively small gap between the yields on its shorter-term debt and its longer-term debt.

Yields on all government debt are heavily influenced by what investors think short-term interest rates (set by central banks) will average over the life of a bond. Investors, though, typically demand higher yields to hold longer-term bonds, due to the risk that inflation and interest rates could surge unexpectedly in the future.

Worries about the future supply of bonds can also push those yields higher—making the gap between short and long-term yields a very rough gauge of investors' fiscal concerns.

Since the start of the Iran war, yields on both short and long-term bonds have climbed, as investors have shifted from expecting rate cuts to rate increases.

Over the past week, however, the gap between short and long-term yields has jumped in the U.K. and Japan, reflecting investors' anxiety about the political situations in those countries.

Such developments fit the historical pattern. Over time, it has become clear that "there's not a magical threshold" of government debt that will trigger higher borrowing costs, said Joe Davis, global chief economist at Vanguard. ^{-Note}

Rather, bond yields tend to jump when there is a major change in a country's tax and spending policies or a deterioration in its economic outlook. For the U.S. to experience a bond market revolt, doubts would likely have to emerge about both its fiscal and economic trajectory, Davis said. In addition, another bond market would likely have to emerge—perhaps out of a more unified Europe—that could rival the U.S. market in size and liquidity. ^{-Note}

Right now, "there is not a close second," he said.

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