

Enormous Debt: the Growth Outlook for Mature Economies¹

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We seem to be emerging from the Financial Tsunami that hit the world since the Lehman Brothers bankruptcy on 15 September 2008

Growth has resumed in the US with some promising signals of stronger growth lately, and the same is true in all advanced economies now including the UK which was the last major economy to come out of recession with its 0.01% growth in the last quarter of 09.

However, just as the early buds of new growth are causing some excitement, authorities and observers are beginning to focus also on the extremely high fiscal deficits and public debt this has created for advanced economies. And my assessment is that **time is quite ripe to focus on the debt**. And on what kind of adjustment the West will need to put in place before too long. And on what this will mean for growth in the coming years ...

But before we see some numbers on the debt it is useful to review the range of positive indicators that we have, on many fronts: growth, financial markets, market sentiment. After the extreme intensity and collective trauma of the Tsunami, the green shoots of exit from the recession have generated widespread enthusiasm. Billions in monetary and fiscal stimulus have worked their way into the system and continued improvement is widely expected.

Indeed, for each mature economy and regions of the world, the IMF's last full World Economic Outlook (WEO) published in October 2009 projected some-to-strong growth in 2010 (see Table 1)

¹ Delivered at the Conference on "The Global Financial Crisis and Recovery: a Regional Cooperation Perspective", organized by the The Hong Kong Committee for Pacific Cooperation and the HK Trade and Industry Department, 27 January 2010.

	2007	2008	2009	2010
World	5.2	3.0	- 1.1	3.1
Advanced Economies	2.7	0.6	- 3.4	1.3
US	2.1	0.4	- 2.7	1.5
Euro Area	2.7	0.7	- 4.2	0.3
UK	2.6	0.7	- 4.4	0.9
Japan	2.3	- 0.70	- 5.4	1.7
Other Advanced Asia	5.7	1.5	- 2.4	3.6
China	13.0	9.0	8.5	9.0

Source: IMF World Economic Outlook, October 2009

This was the positive outlook with which we closed last year, and was much more positive than the IMF's own forecasts for 2010 formulated last July. **These figures, however, have now been revised upwards by the IMF, and sharply so.** In an update to the WEO issued only yesterday, the growth numbers for 2010 are moved up significantly, for the World and for most advanced economies individually:

	As formulated in:			Inc. on Jul 09:	
	Jul 09	Oct 09	Jan 10	Oct 09	Jan 10
World	2.5	3.1	3.9	+ 0.6	+ 1.4
Advanced Economies	0.6	1.3	2.1	+ 0.7	+ 1.5
US	0.8	1.5	2.7	+ 0.7	+ 1.9
Euro Area	-0.3	0.3	1.0	+ 0.6	+ 1.3
UK	0.2	0.9	1.3	+ 0.7	+ 1.1
Japan	1.7	1.7	1.7	0.0	0.0
Other Advanced Asia	1.4	3.6	4.8	+ 2.2	+ 3.4
China	8.5	9.0	10.0	+ 0.5	+ 1.5

Source: IMF World Economic Outlook, Oct 09 and update 26/Jan/10
<http://www.imf.org/external/pubs/ft/survey/so/2010/NEW012610B.htm>

These revisions are extremely strong. Optimism reigns. Largely linked to this outlook on growth, **perceptions of risks to financial stability** have fallen significantly².

- Macroeconomic Risks: potential shocks from a possible reversal in the growth outlook. *Down*
- Emerging Market Risks: the usual source of risk in crises past. Portfolio flows to EMs are now recovering, particularly in Asia and also Latin America although Eastern Europe remains delicate. *Down*
- Overall market sentiment, *Up*.

With growth --and financial markets-- strongly on the upswing and financial stability seen as an issue that is gradually not an issue, confidence has become very strong among most market commentators. For example, Deloitte's Global Economic Outlook for the last quarter of 2009 concludes that, for the US, "financial indicators suggest a stronger than generally expected recovery. A steep yield curve, compressed risk spreads, and a rising stock market are all consistent with this view. The strength of that recovery will come from business investment, government spending, and exports to foreign consumers."

This is a good point to start departing from the generalized bullish sentiment prevailing a little too much at present. Indeed, **the yield curve is steep not because the future is confidently seen bright by the markets but because present i-rates are forced down by policy.**

The current optimism fails to internalize the fact that the positive numbers we are witnessing --and very positive they are-- flow directly from the unprecedented, massive intervention by governments all around the world, with extremely lax monetary policy that will not be sustainable too long, and in particular with the massive stimulus and deficits that we discuss further below. All observers agree this permissive fiscal policy will need to end one day, but also that it cannot end too soon. Self-propelling private growth must soon start to take over. Is this what we are witnessing? Let me look at some indicators.

² See IMF Global Financial Stability Report, October 2010

1 THE STATE OF DEMAND

Is the private sector beginning to grow on its own feet now, beyond the stimulus provided by governments?

A - EXCESS CAPACITY

This negative role of excess capacity for the recovery from the Tsunami has been stressed by Professor Justin LIN, the Chinese Chief Economist of the World Bank. He states, "the main challenge of the global crisis has turned from solving the problems in the financial sector to tackling those in the real sector, specifically the issue of the large excess capacity to produce output" ("Beyond Keynesianism: The Necessity of a Globally Coordinated Solution", Agriculture, Summer 2009 Issue).

In an upswing, excess capacity can be a factor for competitiveness and growth: firms can expand on a low-cost basis. But when the problem is a collapse of aggregate demand, excess capacity can be a powerful contributor to deflationary pressure. The capacity utilization rate in U.S. industry fell to 69% in March 2009, its lowest level since records began in 1967; to 60% in Japan; and to 50% in some developing countries. Also in March, the US headline CPI had its first fall (of 0.4%) since 1955. Capacity utilization rates continue not to improve in both the US and Europe. See table 3.

Table 3							
US Capacity Utilization (all industry) 1972 to end-2009							
Average 72-08	Dec 08	Jul 09	Aug 09	Sep 09	Oct 09	Nov 09	Dec 09
80.9	72.7	69.2	70.2	70.8	71.0	71.5	72.0

Source: Federal Reserve Statistical Base: Industrial Production and Capacity Utilization, 15 Jan 2010

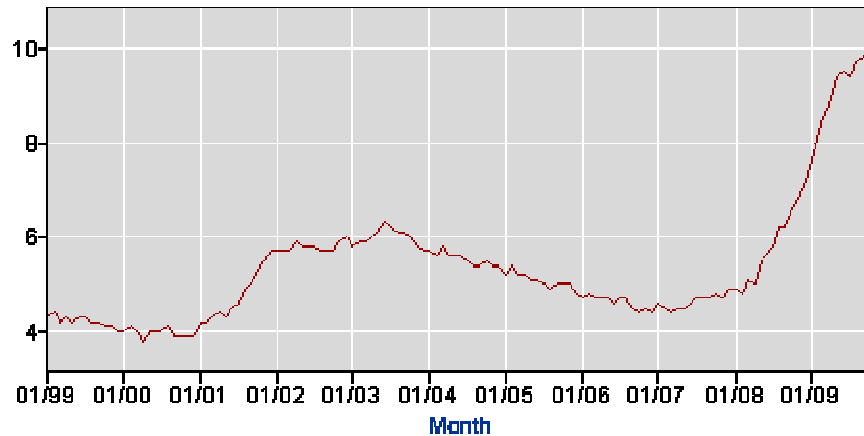
<http://www.federalreserve.gov/releases/G17/Current/default.htm>

B - UNEMPLOYMENT

Alongside excess capacity, further demand depression comes from the counterpart phenomenon on the labour side. Unemployment in the US and in much of the industrial world has grown enormously with the crisis and continues to grow: see Figure 1. This again is a major contributor to the depression of demand.

Figure 1

US Unemployment Rate, Jan 99 - Dec 09
(Source: US Bureau of Labor Statistics)



Source: US Bureau of Labor Statistics,
<http://data.bls.gov/PDQ/servlet/SurveyOutputServlet>

C - OTHER INDICATORS OF DEMAND

We can look at:

- New Orders for manufactured goods: 21% lower in 2009 compared to 2008; 11% lower in Oct 09 compared to Oct 08 at the worst of the Tsunami; lower in Oct 09 than in Sep 09;
- New orders for Durable Goods: again lower at end-09 than at end-08 and continuing to fall;
- Housing starts: about the same in Dec 09 as they were in Dec 08 at the worst of the Tsunami, and 4% below the Nov 09 rate, all seasonally adjusted.
- New house sales: lower in Nov 09 than they were in Oct 09, and 9% lower than in Oct 08 at the worst of the Tsunami.

We must conclude that growth in the private sector is still lagging, the pick-up of demand is patchy at best.

Let us consider a second line of hope for the recovery to develop its own momentum independently of government support: the state of credit markets.

2 BANK LENDING

Is bank lending ready to resume, and to contribute to support and generate the missing demand? The answer is *no*: not yet. Bank lending in the major advanced economies has been falling since the outset of the financial crisis and continues to fall unabated. The worst rate of continuing deterioration in lending at present is taking place in the Eurozone.

The ECB's **Euro Area Bank Lending Survey** noted in January³ that the "further decline in the net tightening of credit standards, although at a slower pace than in previous quarters. The decline in net tightening was stronger for mortgages than for consumer credit or for loans to non-financial corporations (NFCs). All in all, a turning-point in the tightening trend observed since the second half of 2007 is now closer, but has not yet been reached" and "The net demand for consumer credit continued to decline (-10% in the fourth quarter of 2009 compared with -9% in the third quarter and -26% in the second). This is at odds with banks' expectation that net demand for loans would reach zero in the last quarter of 2009."

While not as bad as in the Eurozone, the state of bank lending in the US too is not good:

Table 4								
US Total Consumer Credit: Annualized Growth Rates								
2006	2007	2008	2009					
			Q1	Q2	Q3	Sep	Oct	Nov
4.1	5.6	1.6	-3.5	-4.8	-3.3	-4.3	-2.0	-8.5

Source: Federal Reserve Statistical Release: Consumer Credit, 8 Jan 2010.

<http://www.federalreserve.gov/releases/g19/current/g19.htm>

A major factor for the continuing weakness in bank lending is the continuing deterioration of important asset classes. Strangely, many observers seem to assume or believe that Residential real estate markets may be stabilizing. What has stabilized is the overall financial position of the banks thanks to the support received and some

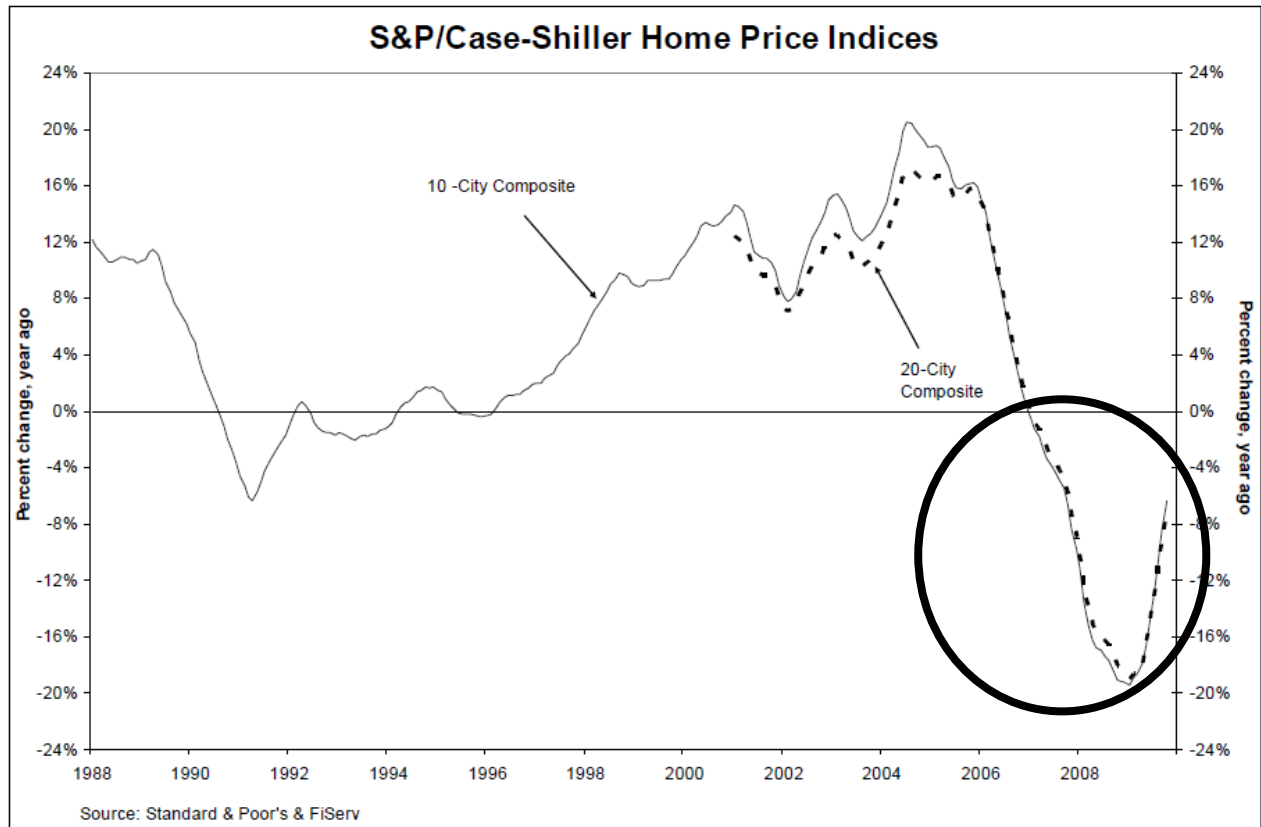
³ European Central Bank, **Euro Area Bank Lending Survey**, 10 January 2010,

http://www.ecb.europa.eu/stats/pdf/blssurvey_201001.pdf?e658b818266020659d3e8aa4f946f064

new dynamics in some sub-markets. But the reality of home mortgages is different:

1. Home prices continue and will continue to fall for at least some time on both sides of the Atlantic
2. Loan Delinquencies are rising in both the US and in Europe, and in the latter will increase further with unemployment.

Figure 2



Caution: this figure does not show the level of the price indices but their **rate of change**: figures below zero mean that prices are **falling** – and that is where the graph fully lies at present, with prices falling still for time to come.

With prices continuing to fall, the rate of home mortgage delinquencies⁴ is rising and very fast, currently standing at nearly 10% of all mortgage loans (US Mortgage Bankers Association for latest data; Fed data below).

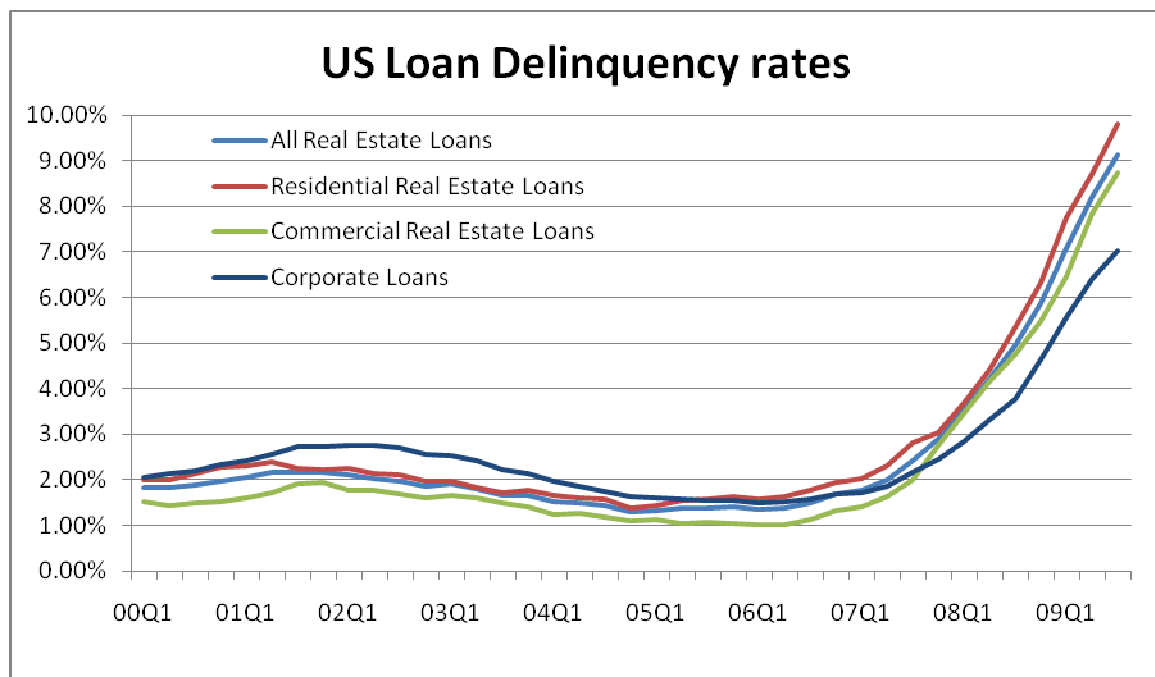
⁴ Defined as the payments to serve the loan in question being **two months late** or worse.

But worse than this is the fact that **the commercial real estate market is now also in a progressively worsening situation in both the US and in Europe**, and this is a market was initially less affected than other sectors.

In addition, **corporate loan delinquencies** are now also high and rising in the US and are likely to rise in Europe with the weak economy. This in turn may have a significant effect on European banks, 75% of whose loans are to SMEs which are likelier to default.

Unemployment, vacancies, falling prices and tight lending are generating increased delinquencies and distressed sales in the US while pressure is severe in several European countries.

Figure 3



Source: US Federal Reserve Board. <http://www.federalreserve.gov/releases/chargeoff/>

Indeed, **the IMF's latest GFSR expects loan write-downs and provisions to rise for several years**, in turn putting pressure on banks' balance sheets. This panorama will continue to heavily limit banks' ability to lend, to clients weak or strong, in turn handicapping a serious resumption of credit for recovery.

Taking stock of where we are, I have argued:

- That the private sector in Advanced Economies is not growing broadly nor is it in a condition to lead the resumption of growth at present; and,
- That the state of retail credit markets is also not back to normal.

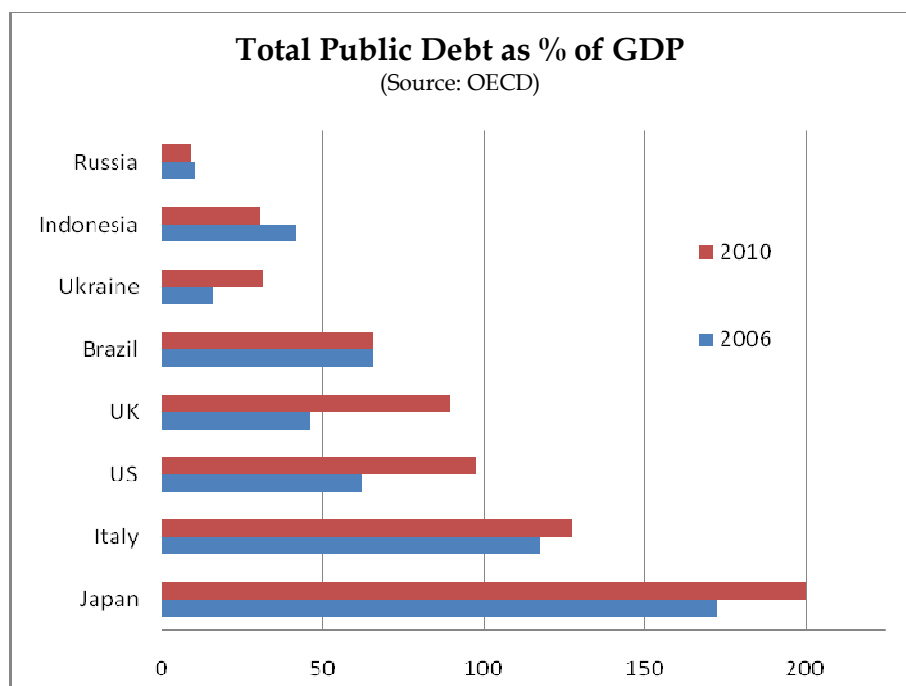
The growth we see is entirely the fortunate consequence of the billions of dollars that have been provided and continue to be provided by the US government and those of the major European countries and Japan through their decisive stimulus support and massively permissive fiscal and monetary policies. Present growth stems from that support. The maintenance and reinforcement of this largesse throughout most of the Advanced Economies. The question is, can their governments afford to continue delivering as required? Will markets allow them?

3 - ENORMOUS DEBTS

The current levels of debt in the US and several major economies and the way their debt jumped with the Tsunami are **staggering**.

Consider the US and the UK, alongside the two most indebted Advanced Economies (AEs) and a few Emerging Market (EM) countries for comparison (see Figure 4):

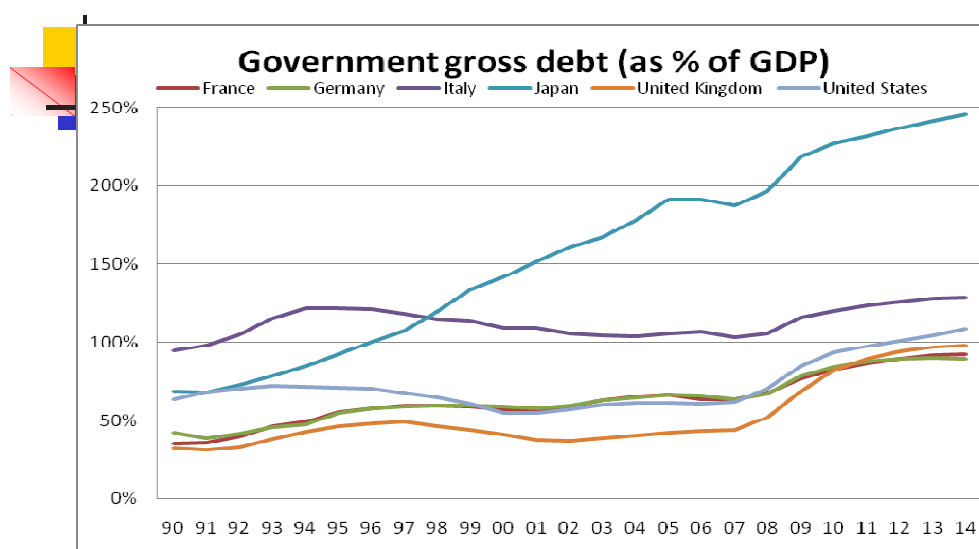
Figure 4



The 2010 expected levels of debt of all four AEs in the figure are much higher than those of their four Ems shown, and have increased massively over the recent few years unlike those of most of the EMs shown.

It is useful to look at the development of debt levels in leading AEs over the last twenty years (figure 8). Again with the exceptions of Italy (always high debt) and Japan (a terrible loss of control throughout this period), the other AEs had fairly stable debt levels broadly around the 50% mark all along this period - until 2007/08 when a quantum leap begins to happen.

Figure 5



Source: OECD

9

How high is a level of debt of, say, 80 or 100%? For reference:

- Advanced Countries' median debt before the crisis was around 60%;
- The EU's condition for new members' accession has been to first come under 60% at most.
- Traditional IMF advice has usually taken 40-50% as the threshold level beyond which caution is required;

Yet, both the US and the UK are approaching 100% - and rising. Can such debt be managed? Is this a "price to pay" to see off the Tsunami?

Perhaps the rise in debt was inevitable. The stimulus itself has been but a fraction of

the total increase in debt, whose bulk has come from revenue losses and expenditure increases arising from the crisis. But the relevant question is not who is to blame or how did this happen. The question we need to ask: what does this situation mean – and require?

True, Japan and Italy have long had debt/DGP ratios in excess of 100%. But they also have had for many years the lowest rates of growth among advanced economies, a parallel that should not be ignored.

In the US, UK and most others, these levels of debt had never been seen in peace time. **How can such debt be rolled back?**

A key question: the huge increase in debt that we saw they all had, is it a one-off impact from the Tsunami (stimuli plus effects), which they can now proceed to roll back? Answer: NO. Look at the levels of the public deficit.

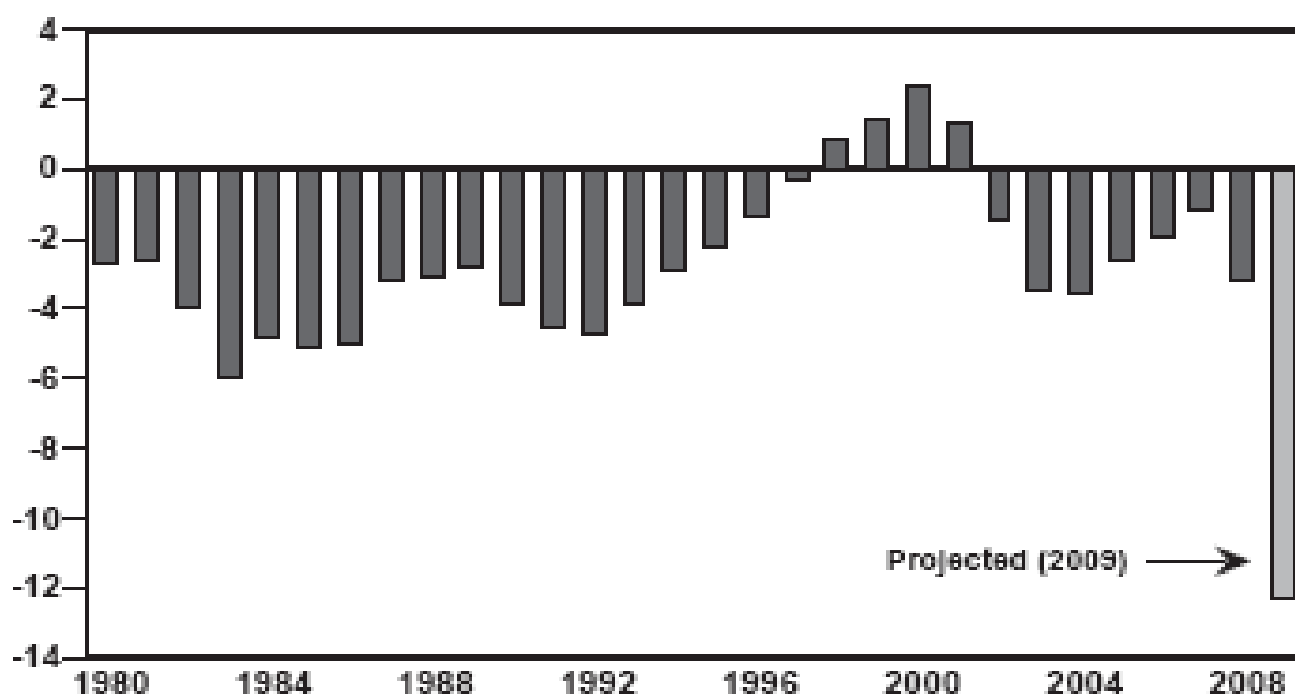
United States	12.5%
United Kingdom	11.6%
Japan	10.5%
France	8.3%
China	3.9%
Brazil	3.8%

Source: IMF Fiscal Monitor, November 2009: The State of Public Finances Cross-Country
<http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf>

These numbers must be seen against an **advanced countries' average deficit of 1.9% in 2007**, before the Tsunami.

Evolution over time, and expectation for years ahead? The US surplus/deficit timeline in the last 30 years is illustrative—of wher the US needs to be and where it is (figure 6):

FIGURE 6
US Surplus and deficit ratios to GDP, 1989-2009



SOURCE: US Office of Management and Budget, "A New Era of Responsibility", p. 14, <http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf>

This 12% deficit far from coming to grips with the level of debt seen in figure 4 continues to increase it rapidly. At some point the US government needs to stop the drain and bring under control the deficit and gradually the debt. The question is when, how fast. **Table 6** provides some estimates by the IMF. We notice how, for example, the public deficit is projected to remain at extremely high levels for the full half-decade ahead, declining to only -6.7% by 2014, while the debt continues to increase unabated, reaching an enormous 108.2% of GDP in that year. **What is most remarkable about these figures is that they already embody a significant amount of fiscal tightening relative to policies currently in place:** namely the non-renewal of temporary fiscal measures such as the fiscal stimulus or the expiration of Bush Administration tax cuts in the US.

Table 6					
Fiscal Balances and Public Debt (in % of GDP)					
		2007	2009	2010	2014
Advanced G20	Public Deficit *	-1.9	-9.7	-8.7	-5.3
	Public Debt **	62.0	75.1	80.2	85.9
US	Public Deficit	-2.8	-12.5	-10.0	-6.7
	Public Debt	61.9	84.8	93.6	108.2
Emerging G20	Public Deficit	0.3	-5.1	-4.1	-1.3
	Public Debt	37.4	38.9	39.6	36.2

* Overall fiscal balance / ** General Government Debt

Source: The State of Public Finances Cross-Country Fiscal Monitor: November 2009, IMF Staff Position Note, P. 35. <http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf>

The problem with such high levels of debt as this table shows for 2014, is not only the fiscal impact on government and on the economy –the high service payments such debt requires, which higher taxes or other expenditure foregone must cover, but **the impact that the high debt has on on interest rates hence growth**: as debt increases markets require more pay to buy the debt. The IMF estimates that **the projected increase of some 40% on current trends in advanced-country sovereign debt will push interest rates up by a full 2%**. And again, even this assumes NO renewal of fiscal stimulus beyond 2010

As debt grows, the more it does the harder it is to cut it back: because interest costs per dollar of debt, and more debt dollars to service, sucking resources that might otherwise go into retiring principal. **As a result, if instead of accepting to live with the very high debt shown in Table 6, Advanced Countries want to cut their gross debt back to 60% (the pre-crisis median) by 2030, the IMF estimates they will (on average) need an 8% increase in taxes (or expenditure cuts) additional to the elimination of temporary measures already assumed in the table, sustained for over ten years.**

4 WHAT ARE THE OPTIONS?

Not many. In simple terms, and through well considered decisions or as a result infinitely complex social and political processes that will turn around these issues for years to come, governments and societies can essentially:

1. **Leave the debt where it is**, or where it will be after the Tsunami. But we just saw that this will have an long term impact on interest rates through debt markets, on fiscal service costs, and hence on growth. This is *Japan's model of recent decades*. Governments' first choice will be to stay away from this scenario, and working backwards, as debt continues to grow as present deficit levels continue, the ghost of this scenario will increasingly and very soon create enormous pressures for fiscal correction.

Alternatively,

2. **Resort to inflation to devalue that debt**. This was often the de facto choice of developing countries running into debt impasses in the past. But the fear of inflation is deeply ingrained into the economic credo of major political actors in most countries around the world and this is a most unlikely choice by any government or political system today.

Very dangerous strategies the two above. Most likely:

3. **Fiscal retrenchment**. It is increasingly evident to many, and one hopes particularly to major political leaders, that it is fundamental to bring their runaway public deficits and debt positions as much under control as they can in the coming years and beyond. The probable future UK government has committed itself to this line. Growing voices in US politics too are arguing this case. There is indeed a chorus of support not to tighten fiscal policies "too soon" lest the world economy may run into a double dip - a suggestion that seems to imply (or *hope*) that self-sustaining private growth is around the corner. But wherever we may be by the end of the year, a consensus is forming that no later than early 2011 fiscal correction must start.

The question then is, how much will that correction need to be? Where will the economies the industrial West be by then, and what will the tightening do to growth at that point? We saw in Table 6 that even after the removal of all stimulus and temporary fiscal measures in the US, in the absence of further measures the US

deficit will only fall to between 10% and just under 7% over the next five years – about twice as much than historical highs – and with the public debt continue to rise fast. Avoiding further growth in debt requires major adjustment: just to stabilize the debt at the post-crisis level requires an adjustment of 4.5% - sustained.

The result in my view is that a very significant fiscal tightening will be inevitable in the US and other major Advanced Economies – to contain debt at still unprecedented high levels. The impact of these on growth is impossible to model or predict. But the big impact the stimulus and the expansionary fiscal policy had on allowing the West to increase (resume) growth, might be a guide as to what its reversal may signify.

Major countries have historically used their deficits countercyclically to generate growth in recessions. Movements perhaps in the range of up to 3-4% maximum have been the instrument. The medium-term outlook we now face is to see major Advanced Economies being forced to hike-up fiscal positions as if to “cool off” their economies, with adjustments bigger than those 3-4% ranges and sustained for more than the trough of a business cycle – and precisely at a time when there is nothing in the economy to be cooled off.

5 BRIEF NOTE ON CHINA

I have not much mentioned China and emerging markets generally. Very briefly:

Both Asia (exc. Japan) and Latin America suffered immensely in their respective financial crises in the 1980s and 1990s, and came out of them the wiser, with stronger policy frameworks and a sharp correction in their fundamentals.

Threatened by the enormity of the financial crisis and its chilling effect on its export markets, the PRC responded from end-08 with an enormous RMB4 trillion fiscal stimulus package for 2009-10 –representing a 12%-13% of GDP, amply larger than the stimuli introduced by the major Advanced Economies, such as the US with 2.5% (the stimulus alone) or Japan and Germany with 4%.⁵

⁵ Asian Development Bank, **Impact and Policy Responses People’s Republic of China**, Jan 2010.
<http://www.adb.org/Documents/events/2010/Global-Economic-Financial-Crisis/report-4.pdf>

Nevertheless China came into this international crisis and has a very strong fiscal position, with a manageable fiscal deficit and debt positions despite the huge size of its stimulus (see **Table 7**). China's financial system too is in a very strong shape in macro and sectoral terms, with enormous reserves and a strong and growing financial sector and industry.

Table 7					
China's Debt and Deficit Position					
	2005	2006	2007	2008	2009
General government gross debt	17.8	16.5	20.2	17.7	21.0
General government balance	-1.4	-0.7	0.9	-0.3	-4.3

Source: IMF Executive Board: 2009 Article IV Consultation with the People's Republic of China
<http://www.imf.org/external/np/sec/pn/2009/pn0987.htm>

Nevertheless, China's impressive current growth may come under pressure, on two counts:

First, its growth last year was largely driven by its own investment in infrastructure, again stimulus-based. Much of this infrastructure should be very valuable to support development and the economy on all fronts - domestic markets, regional distribution, efficiency overall. But the infrastructure created is not a final market.

And second, this growth has also been supported by the less-bad-than-feared performance of Western markets and their demand for Chinese products. But this growth as was the central theme of this paper may ne be energetic on a sustainable basis in future.

The way ahead must increasingly lie in the much discussed restructuring and development of consumption markets in China. Two years ago this concept was relevant for the medium and long terms, as a matter of development strategy for the future. With the Tsunami and the grim growth prospects of the West, China's

decisive development of its consumption markets suddenly becomes a matter of the greatest urgency and priority. All the signals are that this is very much what is already taking place—including for example recent reports that Hubei and other inner provinces have lately overtaken the coastal provinces in terms of rates of growth. A great deal is happening and a great deal is needed, now, if China is to sustain its rates of growth in a continuing bleak economic world environment.

A related priority must be the development of Asia as a major consumption market for each other. Much mutual trade and investment in the past have been primarily aimed at gaining efficiency as integrated links in the production chain for world export markets. But with incomes growing throughout the region and, again, with demand elsewhere faltering, the opportunity is there, now, for every effort to be made to tap each other and collaborate as mutual final markets.