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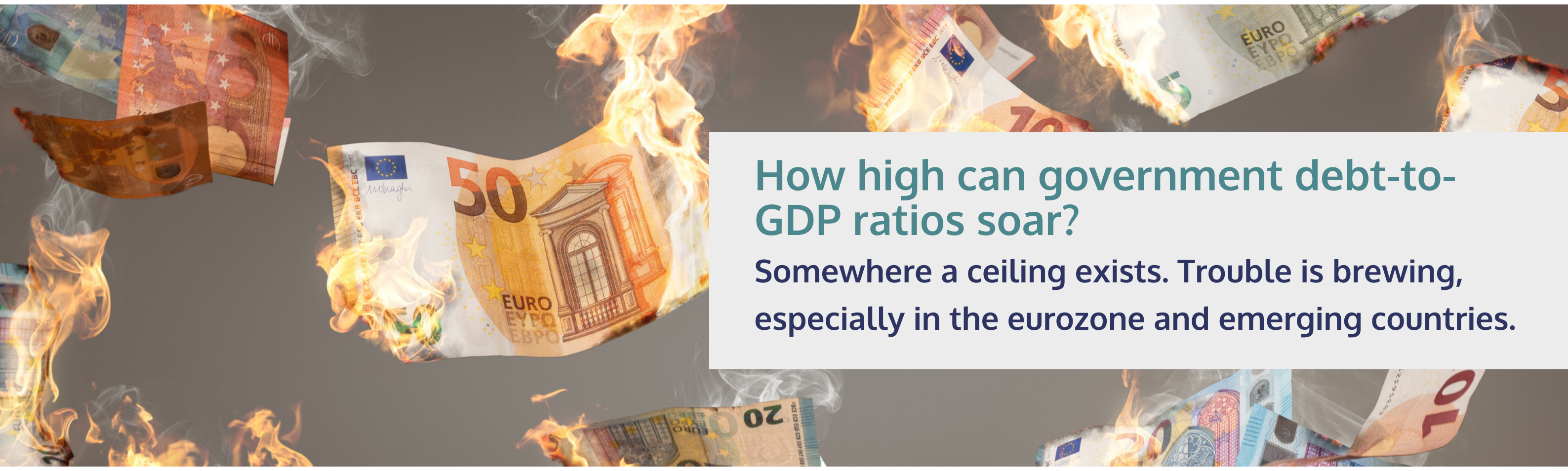
EXPERTS IN GLOBAL INVESTING



How high can government debt-to-GDP ratios soar?

Somewhere a ceiling exists. Trouble is brewing, especially in the eurozone and emerging countries.

The 'IMF crisis' is judged the worst event to have hit South Korea since the civil war of 1950-53. The rest of the world knows this financial upheaval as the 'Asia crisis' of 1997. The mismatch is because South Koreans, perhaps ungratefully, focus on the damage after the International Monetary Fund bailed out a country tormented by a currency-turned-banking crisis.[1]

The then-record IMF package of US$58 billion dollars was laced with conditions. One was austerity. As government support shrank, South Korea's economy shrivelled 5.1% in 1998 while the jobless rate sprang to 7.0% from 2.1% pre-crisis (1996).[2]

The contraction, however, was fleeting. South Korea's economy rebounded in 1999 (expanding 11.9%) and grew every year until the covid-19 pandemic struck in 2020. The jobless rate fell to 3.3% by 2002 and has been 3.something% ever since.

Yet the crisis scarred South Koreans. Even though (at 10% of GDP in 1997) public borrowing provided no fuel for the upheaval, one legacy was a consensus that Seoul must not let gross government debt exceed 40% of output.[3]

No longer. The government of President Moon Jae-in in August announced a budget for 2022 that vowed to use fiscal stimulus to counter the damage of the pandemic and, more broadly, fight poverty and inequality. Government spending is forecast to expand 8.3% in 2022. Public debt is expected to climb to 50.2% of GDP by next year and reach 59% by 2025, from 36% of output when Moon took office in 2017.[4]

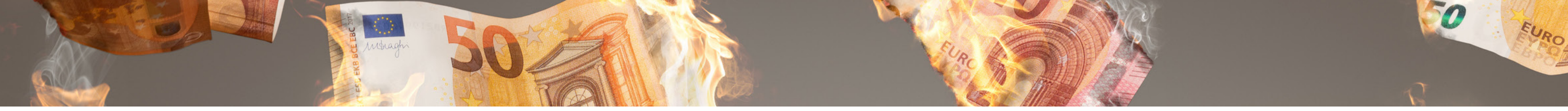
And why not let government borrowing rip? Does anyone care that government debt-to-GDP ratios (however imperfectly measured) are higher than seemed possible because interest rates are so low? US government debt is now at 103% of GDP.[5] Eurozone public debt is at a near-record 98.3% of output (where the record is 100.0%). France (114%), Greece (207%) Spain (123%), Italy (156%) and Portugal (135%) make a mockery of the suspended legal limit of 60%; even zero-deficit-by-law-pandemic-excepted Germany (70%) exceeds the legal ceiling.[6] While Australia's federal debt is only headed to 50% of GDP by 2025,[7] Japan's public debt stands at an astonishing 257% of GDP. Public debt in emerging markets extends to a record 64% of output. Brazil (91%), China (69%) and India (91%) exceed the average as do Latin American countries overall (73%). The IMF estimates 'general' government debt now reaches a record 99% of global output, from 83% in 2016.[8]

An overarching question, especially when governments are relying on fiscal policy to fight this pandemic and linked economic crisis, is: At what level might public debt become disruptive? A debt crisis would erupt if investors assessed any country were unable to meet its debt repayments. They would baulk at buying, even holding, its bonds. Bond yields would soar, adding to the debt burden, while the country's currency would plunge, which is damaging if debts are denominated in foreign currencies. History is replete with examples of when excessive debt triggered a crisis, from an inflationary economic collapse to endless stagnation ('Japanification'). The role excessive debt played in the fall of the Ottoman and British empires shows it comes with global political implications. So, too, does China's 'debt-trap diplomacy' (that echoes US meddling in Latin America) where Beijing gains sway over emerging countries by giving them loans they can't repay.

Governments have three standard ways to tackle their debt burdens. (A fourth would be asset sales, a fifth, conquest and a sixth, reparations.) The first conventional cure is to raise taxes and reduce spending. The UK in September became the first major country to raise taxes to cover covid-19 debt when it lifted payroll taxes.[9] More countries will follow. The handbrake here is that austerity is often politically fraught and can undermine economies so much it might backfire – such an outcome occurs if an economic contraction worsens debt ratios.

A second, and the most appealing, option is to ensure economies flourish in a way that erodes real debt burdens over time – this is how the winners reduced their bills after World War II. The formula is to ensure nominal output (GDP unadjusted for inflation) grows at a higher rate than the average interest rate on public debt – a historic norm.[10] A variation on this recipe is that debts will be manageable if inflation-adjusted interest repayments stay below 2% of GDP for the foreseeable future.[11]

Over the pandemic, these formulas were met because interest rates were around record lows partly due to central-bank asset purchases.[12] A repeat of the post-World War II drawdown – Washington's debt fell from a record 106.1% of GDP in 1946 to 23% of output in 1974[13] – will be hard because back then pent-up demand, low regulation, favourable demographics and free trade drove economies, huge multi-decade-long advantages that no longer prevail.



Still, within this option, governments can choose to allow some inflation and supress interest rates. The benefit of this approach is that rising nominal GDP growth offers governments tax windfalls via higher nominal business profits and by pushing individuals into higher tax brackets. Post-war governments practised 'financial repression' to prevent market forces setting the price of money. But capital controls, fixed-exchange rates, curbed bank lending and ceilings on interest rates would entail a U-turn from the liberalised bent of the past four decades. Low rates would only encourage companies and consumers to add to their record debt loads that come primed with risks too.

Permitting inflation is tricky. Officials might lose control of prices if they print too much money and 'debase the coinage' because that comes with economic and political problems.[14] Interest rates would rise if inflation were to accelerate in a durable way, which hampers economies and adds to repayment burdens. Governments would be tempted to pressure central banks not to raise rates, as US presidents Lyndon Johnson and Richard Nixon did to help pay for the Vietnam war. But that would demolish central-bank independence to fight inflation, perhaps the economic policy most responsible for recent prosperity.

The other option is to default (and any 'restructuring' is technically a default). When it comes to advanced countries, Japan's debt ratio shows countries with national currencies can rely on their central banks to stave off default for a long time. But, while no defaults in such advanced countries are imminent (now that a fight over the US debt ceiling has been settled for another 12 months), their governments can't boost debt forever. Pressure will mount for authorities to control debt ratios to stop ratings downgrades, perhaps even engage in accounting tricks. Central banks could do this by cancelling the government debt they have bought under quantitative-easing programs.[15] Treasury departments could print trillion-dollar coins.[16]

Eurozone governments with high debt ratios are more vulnerable to default because they lack their own currencies. Yet any default could bring down the European Monetary System. More crises around Greece, Italy and perhaps eventually France and Spain that threaten mayhem are likely, especially if bond yields rise after the European Central Bank stops its asset buying.

Emerging countries, which are inherently less stable economically and politically, are most likely to default. The candidates are many – the IMF in December estimated that 60% of low-income countries are at "high risk or already in debt distress" compared with 30% in 2015.[17] Emerging countries that have borrowed in foreign currency (a diminishing percentage) and ones that have borrowed from foreigners rather than locals are the most at risk.

For indebted advanced and emerging countries, a world of record government debt could soon enough be a realm of hard choices and one of sporadic crises. As the debt status quo appears unsustainable, any rise in US interest rates will signal trouble ahead.

To be clear, government debt proved its worth during the pandemic and there's nothing risky with it per se especially when governments borrow in local currency from locals. Sovereign bonds are a useful financial asset that institutions hold for regulatory reasons. Debt allows governments to spread the cost of capital goods across time. A desire to sell debt forces countries to be creditworthy. Debt is a Keynesian tool for managing the economy. The flaw here, however, is that few governments post budget surpluses and debt must be repaid sometime. As Japan shows, debt-to-GDP ratios can climb far higher than thought possible without any obvious damage to an economy. It's true too that few indebted governments are struggling to sell debt at low rates. But, at some point, rising debt would trigger steeper borrowing costs and puncture the complacency that public debts are manageable because interest rates are low.

History shows that public debt ushers in its nemesis; higher interest rates. That reckoning one indeterminant day likely means a harsher, poorer, perhaps crisis-prone future awaits.

THE LIKELY TROUBLE SPOTS

On November 30, Federal Reserve Chair Jerome Powell said the central bank's asset-buying program might end "a few months earlier" than its scheduled finish in mid-2022 and that it was "probably a good time to retire that word" [transitory] when describing faster inflation.[18] A report two weeks later showed US consumer prices rose 6.8% in the 12 months to November, the most since 1982. On January 5, by when the Fed had halved its pandemic asset buying to US$60 billion a month, minutes from the Fed's policy-setting meeting showed the central bank was thinking of raising the US cash rate "sooner or at a faster pace" than expected.[19] In Europe on January 7, a report showed eurozone inflation reached 5% in 2021. This fresh record high for the euro area flags the end of the European Central Bank's ultra-loose monetary policy that includes ample purchases of government debt.

If the ECB trims, even slashes, its bond purchases, the eurozone's indebted countries will have lost their 'lender of last resort', a term that describes the emergency role that governments can play in countries with bespoke currencies and central banks. By acting as a buyer of its own debt in the absence of other buyers, governments can ensure they won't default on their obligations – though they generally can't avoid an economic crisis as severe as if they had reneged on their repayments.

When the ECB reduces, even ends, its asset buying, global bond investors are likely to reprice eurozone sovereign debts according to a country's theoretical ability to repay. 'Lo spread' as the Italians dub the premium on Italian government debt over German bunds, to cite just one example, could well rise to troubling levels. The euro's lack of a supportive fiscal, banking and political union could inevitably lead to more debt crises and bailouts aka those of the 2010s that cast doubt on the single currency's viability.

Whatever is happening in the eurozone, emerging markets are likely to more threatened by what the Fed does to global interest rates and what that might mean for the value of the US dollar. A worry is that in 2019 the IMF and World Bank assessed the world's emerging countries were already "at high risk of or already in debt distress" at the end of 2019.[20] Now average gross government debt in emerging markets is up by almost 10 percentage points since 2019 (with large variations around that average).[21]

Emerging countries were vulnerable to a financial crisis pre-pandemic because many turned (once again) to borrowing after the global financial crisis. The debts of the 111 low- and middle-income countries more than doubled from US$600 billion in 2008 to US$1.3 trillion by 2018. Over the 10 years, interest plus principal repayments jumped from US$47 billion to US $117 billion.[22] Some worried that the sporadic debt holidays of 2020 – a reneging on debt repayments – could undermine trust in emerging countries and boost risk premiums on their bonds.

But, even if continued, they are unlikely to be enough to prevent more developing countries defaulting – Zambia in November 2020 became the first country to default post covid-19.[23]

The worry is that emerging countries are inherently riskier investments. They typically have unstable political systems and poor institutions, ones that lack capable and trustworthy bureaucracies. Governments struggle to raise adequate tax revenues, which is why they turn to borrowing. Public finances are often murky. Rule of law is sporadic. The judiciary lacks independence. The media is hobbled. Many rulers have usurped power or have gamed the democratic process to cement their rule. Their subjects identify more with tribal, religious, ethnic or cultural groups than with countries created by colonial powers that lack national unity. The poor institutions, murky politics and tribal allegiances allow corruption to thrive.

Economic risks include that emerging countries often rely on a few primary exports. They are thus vulnerable to a drop in the prices of the commodities that earn their foreign exchange. Many are net food importers and their local produce is vulnerable to harsh weather (climate change). While emerging governments these days borrow more in local currency, they are still reliant to a large extent on foreign investors buying their bonds. Default risks are heightened if the investments are short term, thereby requiring constant debt renewal at inauspicious times.

It's true that emerging countries, which typically posted higher growth rates than advanced ones, have taken steps to boost their financial stability that averted financial catastrophes at the start of the pandemic. They have built up foreign reserves in recent times to protect their currency regimes. Their central banks are prepared to engage in unconventional steps such as quantitative easing to protect government debt. In March and April last year, for instance, central banks of 14 emerging countries including those of India, Indonesia and Mexico announced bond-buying programs.[24] But many emerging countries have been hard hit by covid-19 in terms of deaths and lost income, especially from absent tourists.

Policymakers are aware emerging countries are at risk, especially that their debts tie their fate to rich world monetary policies.[25] Yet the world lacks a global rules-based system for managing such default shocks, something the policymakers at the IMF and UN have investigated without solving.[26]

If a government defaults now, only the parties involved sort out an agreement under New York or English law that may involve write-offs, loan extensions, grace periods and rate reductions, even if the negotiations are supervised by the IMF, which is conflicted if it's a creditor.

Such an ad-hoc system (compared with US court-overseen corporate or municipal defaults) favours developed over emerging countries and rarely resets a country's financial position onto a sustainable path.

The typical result is a country doomed to sporadic crises and economic devastation. Greece's torment of the 2010s, when it underwent three bailouts, serves as a prime example of how a country becomes an investor pariah. Argentina's nine defaults since 1827 offers another.[27] But not industrialised and OECD-belonging South Korea, even if the people there still wince at the acronym, IMF.

By Michael Collins, Investment Specialist

[1] See 'The 1997-98 Korean financial crisis: causes, policy response and lessons.' Speech by Kim Kihwan, Chair of the Seoul Finance Forum, International Advisor to Goldman Sachs and Chair of the Korea National Committee for the Pacific Economic Cooperation Council, at the High-Level Seminar on Crisis Prevention in Emerging Markets organised by the IMF and the government of Singapore. 2006. imf.org/external/np/seminars/eng/2006/cpem/pdf/kihwan.pdf

[2] IMF figures for Korea's economy from the World Economic Outlook Database. October 2021. The IMF's definition of gross debt consists of all liabilities that require payment or payments of interest to a creditor at some future point.

[3] IMF estimates, the fairest international comparison, even if lagged, place Korean general government at just above 40% since 2015 and score it at a peak of 42% of GDP in 2019.

[4] Reuters. 'South Korea drafts aggressive spending plan for 2022, taking government debt to 50% of GDP.' 31 August 2021. reuters.com/world/asia-pacific/skorea-drafts-aggressive-spending-plan-2022-taking-debt-50-gdp-2021-08-31/

[5] Congressional Budget Office. 'An update to the budget and economic outlook: 2021 to 2031.' 1 July 2021. cbo.gov/publication/57218. Within 10 years, half Washington's forecasted budget deficit is expected to go on debt repayments. See Congressional Budget Office. Presentation. 'An overview of the 2021 long-term budget outlook.' 20 May 2021. cbo.gov/publication/57189

[6] Figures as at 30 June 2021, where the eurozone debt record was set on 31 March 2021. Eurostat release. 'Government debt down to 98.3% of GDP in euro area.' 22 October 2021. ec.europa.eu/eurostat/documents/2995521/11563335/2-22102021-AP-EN.pdf/4bc91cb6-b073-d8c8-349d-18aa2bcd2b91

[7] Parliament of Australia. Budget review 2021-22. 'Commonwealth debt.' Net debt is projected to reach 41% of output by 2025. aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/BudgetReview202122/CommonwealthDebt

[8] IMF 'Fiscal monitor.' October 2021. See Table 1.2 'General government debt, 2016-26.' Chapter 1. Page 9. Record for emerging markets can be confirmed from the World Economic Outlook Database. October 2021 (op cit). imf.org/en/Publications/FM/Issues/2021/10/13/fiscal-monitor-october-2021

[9] BBC. 'Boris Johnson outlines new 1.25% health and social care tax to pay for reforms.' 7 September 2021. bbc.com/news/uk-politics-58476632

[10] See Olivier Blanchard. 'Public debt and low interest rates.' Working paper 19-4. February 2019. piie.com/publications/working-papers/public-debt-and-low-interest-rates. He responds to criticism of the paper here: 'Why critics of a more relaxed attitude on public debt are wrong.' 15 July 2019. piie.com/blogs/realtime-economic-issues-watch/why-critics-more-relaxed-attitude-public-debt-are-wrong

[11] See Jason Furman and Lawrence Summers. 'A reconsideration of fiscal policy in the era of low interest rates.' Discussion draft. 30 November 2020. brookings.edu/wp-content/uploads/2020/11/furman-summers-fiscal-reconsideration-discussion-draft.pdf

[12] IMF. 'Fiscal monitor.' October 2021. Chapter 2. 'Strengthening the credibility of public finances.' Page 17. imf.org/en/Publications/FM/Issues/2021/10/13/fiscal-monitor-october-2021

[13] Congressional Budget Office. 'Federal debt: A primer.' See 'Data underlying figures.' 12 March 2020.

[14] Higher prices impede economies through 'menu' or mark-up costs, the 'shoe leather' cost as shoppers search for lower prices, relative price distortions and tax distortions against savings income and 'bracket creep' on wages. Inflation redistributes wealth from creditors to debtors, from people of fixed incomes to those on flexible (indexed) incomes, from consumers to producers. Profiteers tend to flourish along with populists.

[15] See Mark Dowding. 'BlueBay CIO: It's time to think about debt cancellation.' 4 January 2021. ft.com/content/dffca01a-173a-4d68-bc68-9af9045e712e

[16] See ABC News (US). 'Is minting a $1 trillion platinum coin the answer to the debt limit crisis?' 8 October 2021. abcnews.go.com/Politics/minting-trillion-platinum-coin-answer-debt-limit-crisis/story

[17] IMF Blog. 'The G20 common framework for debt treatments must be stepped up.' 2 December 2021. blogs.imf.org/2021/12/02/the-g20-common-framework-for-debt-treatments-must-be-stepped-up/

[18] Bloomberg News. 'Powell weighs earlier end to bond tapering amid hot inflation.' 30 November 2021. bloomberg.com/news/articles/2021-11-30/powell-says-appopriate-to-weigh-earlier-end-to-bond-buy-tapering?sref=ORbm2mFs

[19] Federal Reserve. 'Minutes of the Federal Open Market Committee. 14 to 15 December 2021.' 5 January 2022. federalreserve.gov/monetarypolicy/fomcminutes20211215.htm

[20] International Development Association, IMF. 'The evolution of public debt vulnerabilities in lower income countries.' 2 January 2020. Page 2. documents1.worldbank.org/curated/en/695971579921244762/pdf/The-Evolution-of-Public-Debt-Vulnerabilities-in-Lower-Income-Economies.pdf

[21] IMFBlog. 'Emerging economies must prepare for Fed policy tightening.' 10 January 2022. blogs.imf.org/2022/01/10/emerging-economies-must-prepare-for-fed-policy-tightening/

[22] Centre for Economic Policy Research. 'Averting catastrophic debt crises in developing country extraordinary challenges calls for extraordinary measures.' CEPR Policy Insight No 104. July 2020. cepr.org/active/publications/policy_insights/viewpi.php?pino=104

[23] Geopolitical Monitor. 'Zambia becomes first post-covid debt default.' 17 November 2020. geopoliticalmonitor.com/zambia-becomes-first-post-covid-debt-default/. Most sovereign bond contracts do not include automatic force majeure protection that allows contracts to be broken due to unforeseen circumstances such as a pandemic.

[24] Adam Tooze. 'Shutdown. How covid shook the world's economy.' Allen Lane. 2021. Page 164.

[25] To reduce the risk, many partial solutions are offered to avoid steep defaults. US economist Joseph Stiglitz, for instance, argues for mechanisms such as 'voluntary sovereign-debt buybacks' that proved effective in Latin America in the 1990s and during the Greek crises of the 2010s. "They have the advantage of avoiding the harsh terms that typically come with debt swaps," Stiglitz argues. A buyback program under IMF oversight would aim to reduce debt burdens by securing significant discounts on the face value of sovereign bonds and by minimising exposure to risky private creditors, Stiglitz says. Such programs could advance health, climate and other goals by requiring that beneficiary governments spend the money that otherwise would have gone to debt service on creating public goods. See Centre for Economic Policy Research. Op cit.

[26] See IMFBlog. 'Time is ripe for innovation in the world of sovereign debt restructuring.' 19 November 2020. blogs.imf.org/2020/11/19/time-is-ripe-for-innovation-in-the-world-of-sovereign-debt-restructuring/. See also United Nations. 'The commission of experts of the president of the UN General Assembly on reforms of the international monetary and financial system.' 2009. un.org/en/ga/president/63/pdf/calendar/20090325-economiccrisis-commission.pdf

[27] Bloomberg. 'One country, nine defaults: Argentina is caught in a vicious cycle.' 11 September 2019. bloomberg.com/news/photo-essays/2019-09-11/one-country-eight-defaults-the-argentine-debacles

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