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Guest Post: Eswar Prasad and Mengjie Ding examine the worrying trajectory of government debt

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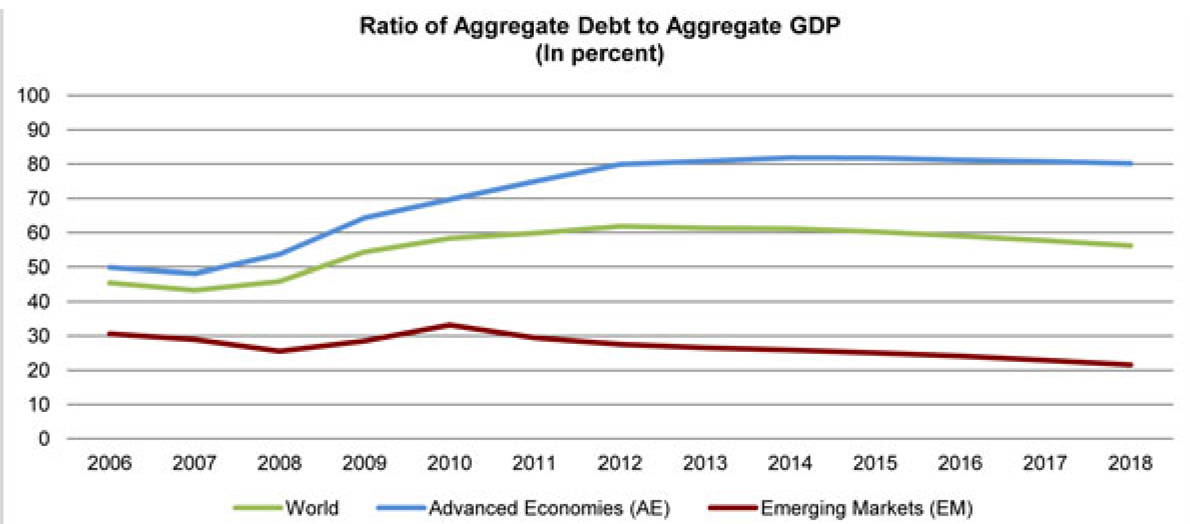
By Eswar Prasad and Mengjie Ding

As the fifth anniversary of the collapse of Lehman Brothers draws near and the debate about fiscal austerity continues to rage, it is time to take stock of the trajectory of debt levels in the key advanced and emerging market economies (AEs and EMs). The overall picture of government debt around the world is not a pretty one (interactive data here).

Data from the IMF's latest Fiscal Monitor show that the level of aggregate net government debt in the world is expected to rise from $26tn in 2008 to $42tn in 2013. The ratio of world net debt to world GDP, a more relevant indicator of sustainable debt levels, shows a corresponding increase from 46 per cent in 2008 to 61 per cent in 2013.



This ratio depends not just on debt dynamics but also on economic growth. The US recovery, although slow and tenuous, is firming up despite the fiscal drag from the ill-timed expenditure cuts resulting from the budget sequester. Short-term forecasts for US debt levels now look better relative to earlier forecasts. The lack of economic growth continues to hamper debt reduction in other advanced economies, especially Europe and Japan. Advanced economies account for the bulk of the increase in global public debt since the financial crisis, both in absolute levels and relative to GDP.

• Aggregate debt of AEs is expected to increase from $22 trillion in 2008 to $36 trillion in 2013. The corresponding numbers for EMs are $4 trillion and $7 trillion, respectively.

• The ratio of aggregate debt to aggregate GDP for AEs goes from 54 percent in 2008 to 81 percent in 2013. The corresponding ratios for EMs are 26 percent and 27 percent, respectively. There is a stark contrast between the two groups of economies in their relative contributions to growth in world debt versus growth in world GDP. EMs contribute far more to growth in global GDP than to the growth in global public debt.

• In 2008, EMs accounted for 28 percent of world GDP and 15 percent of world debt. By 2018, EMs are expected to produce 41 percent of world output and account for 16 percent of world debt.

Figure 3: Global Distribution of GDP

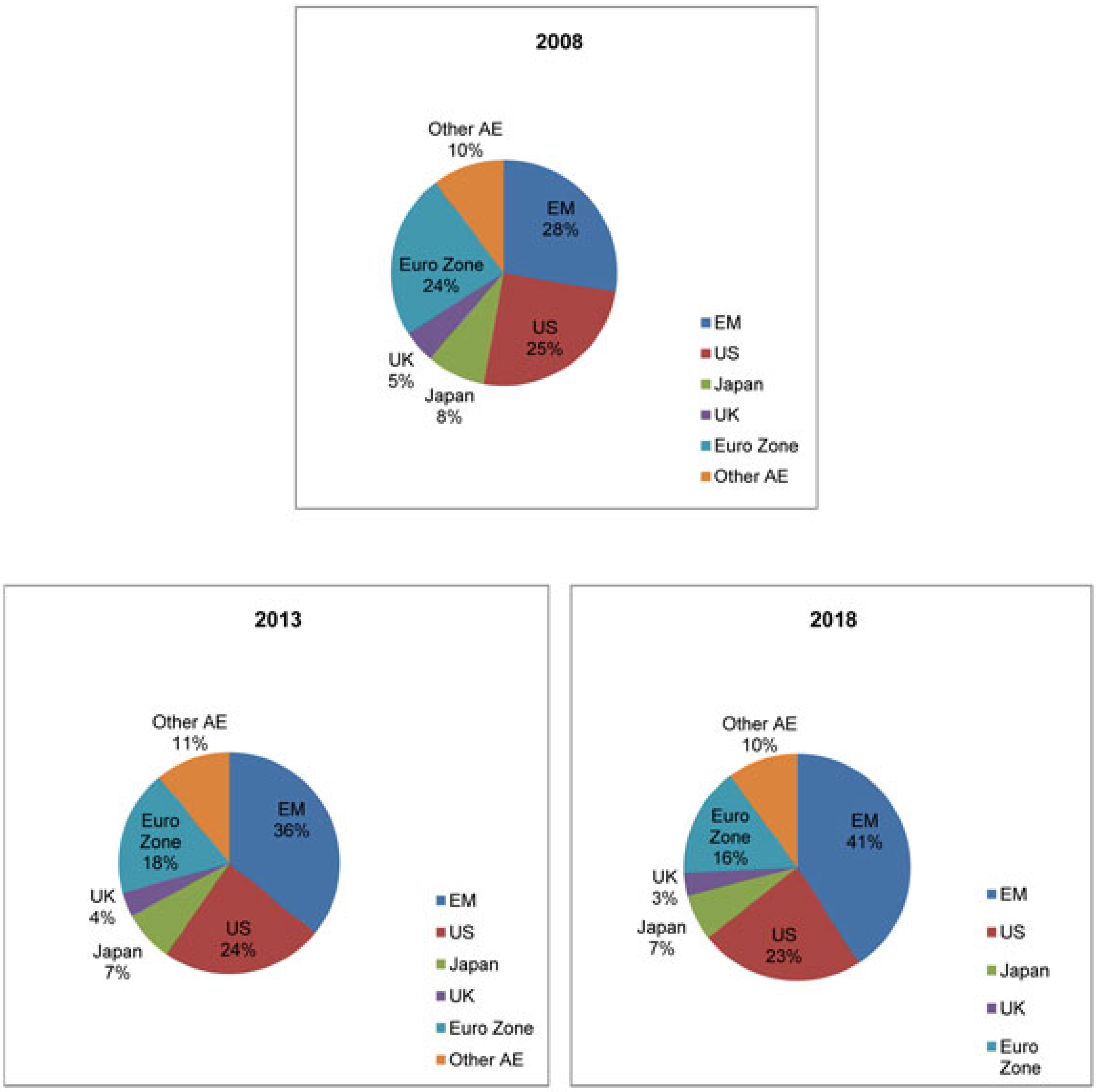
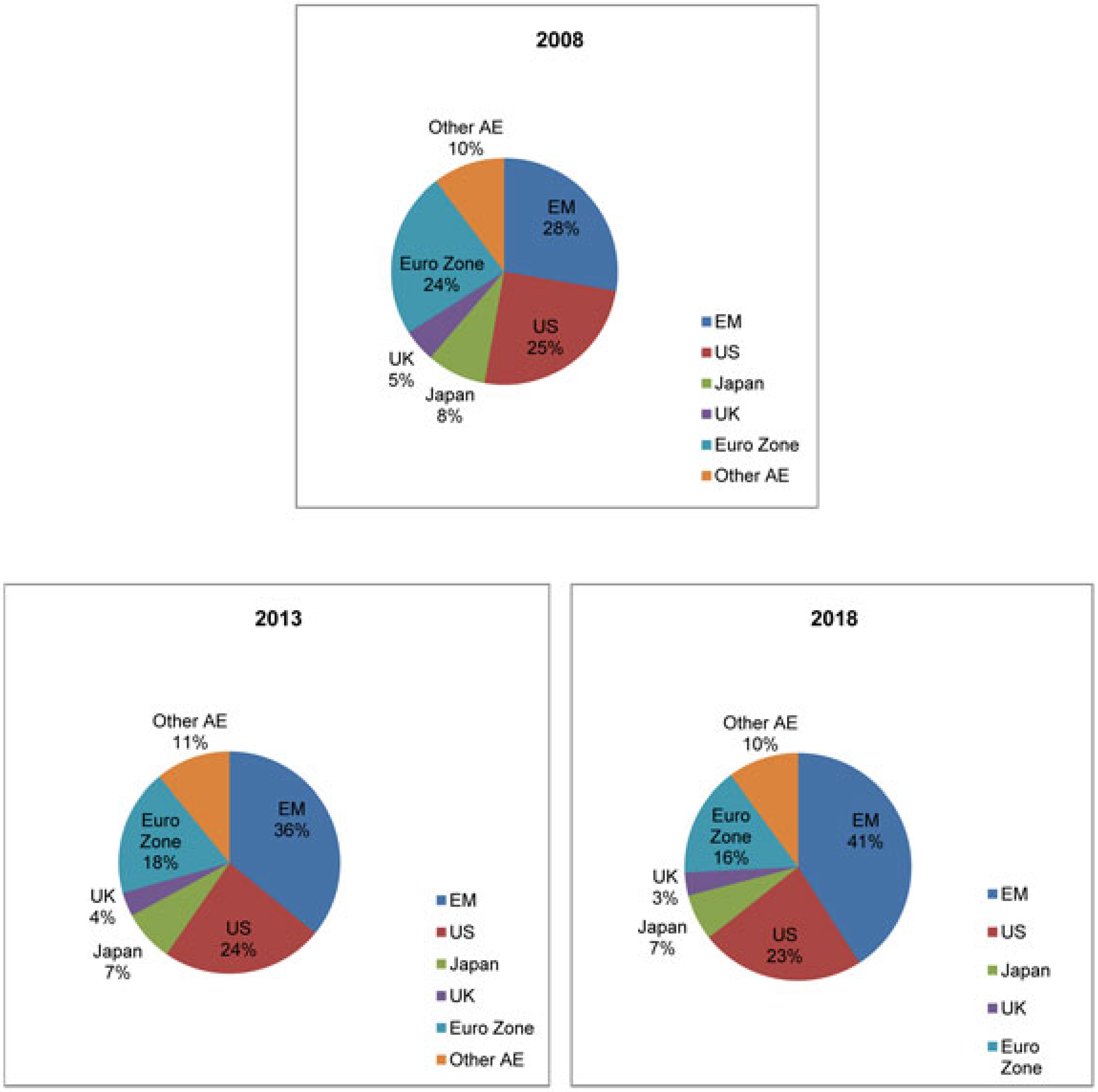


Figure 3: Global Distribution of GDP



• EMs account for 16 percent of the increase in global debt levels from 2008 to 2013 and are expected to account for roughly the same share from 2013 to 2018. Their contributions to increases in global GDP over these two periods are much larger–76 percent and 57 percent, respectively.

• The US accounts for 42 percent of the increase in global debt and 17 percent of the increase in global GDP from 2008 to 2013. It is expected to make similar contributions to global debt and GDP, respectively, over the next five years.

Figure 4: Contributions to Changes in World Net Government Debt

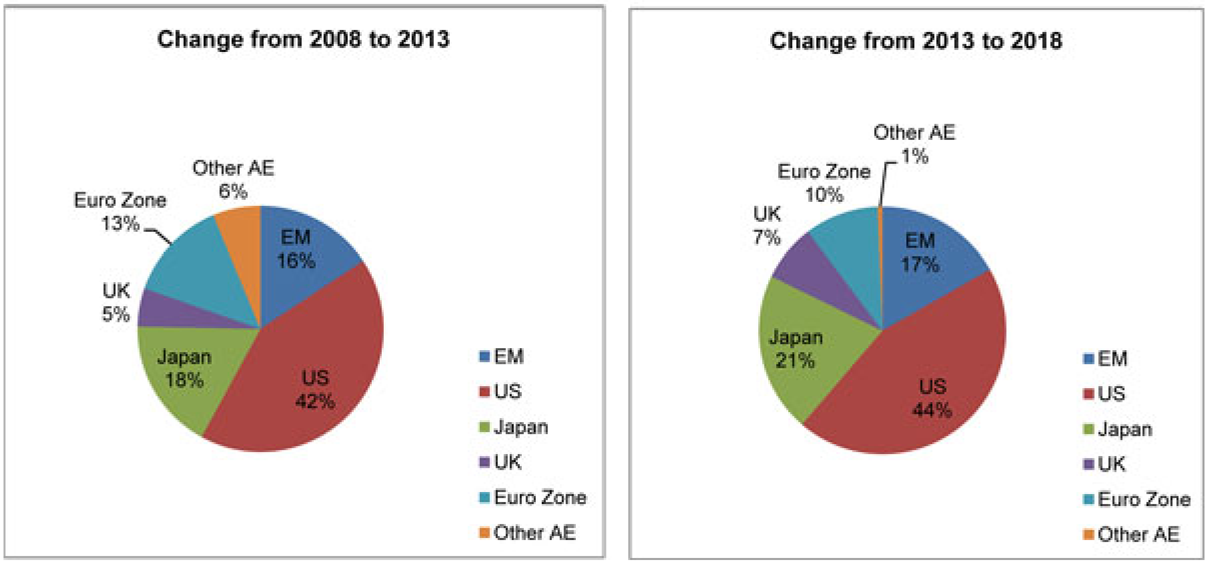
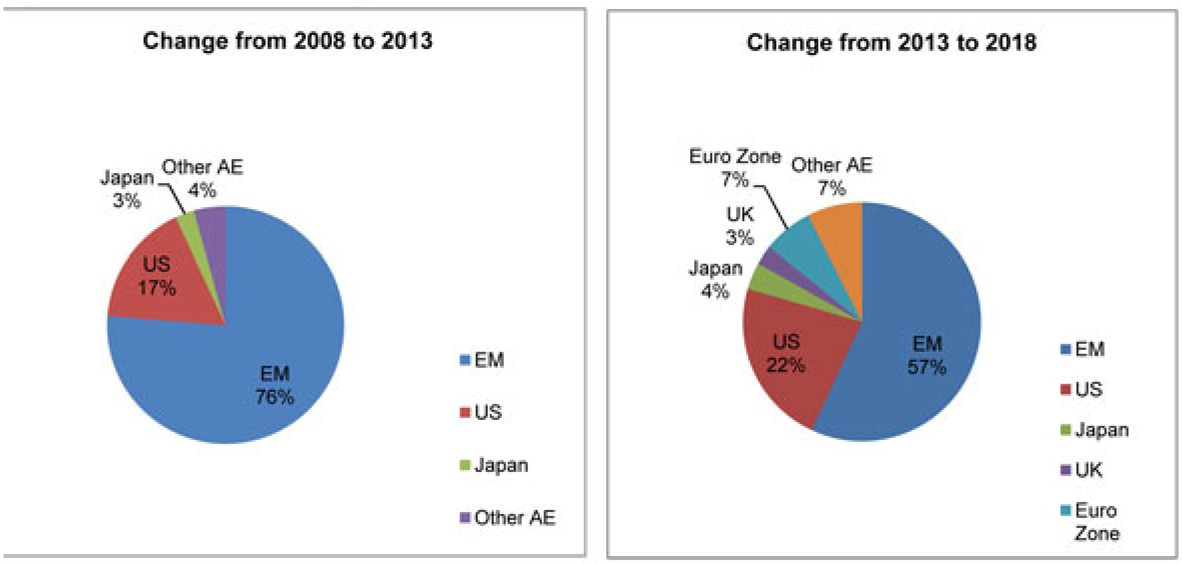


Figure 5: Contributions to Changes in World GDP



•The level of debt per capita helps gauge the burden of public debt, although it is less of a burden if much of this debt is owed to a country's own citizens. Moreover, richer economies can afford more debt. Still, this is an instructive calculation that highlights the growing gulf between AEs and EMs.

• The average per capita debt in AEs is $35,300 in 2013 and expected to be $41,500 in 2018. The burden of debt for U.S. citizens is $45,600 in 2013 and is set to rise to $55,100 by 2018. The debt burden for Japanese citizens could hit $73,200 in 2018, the highest level in the world.

• Among the peripheral European economies, the debt burden in 2013 ranges from $23,800 in Spain and Portugal to much higher levels in Italy ($36,000), Greece ($38,100), and Ireland ($51,200).

• Average per capita debt for EMs should rise gradually to $1,700 in 2018, far lower than AE levels. In 2018, the debt burden will be $1,400 for China and $1,100 for India. There is an even sharper contrast between AEs and EMs when we calculate the debt burden of the working-age population (ages 15-64).

• Among AEs, average debt per working-age person is expected to rise to $64,600 by 2018. Japan tops all countries and the U.S. will move into the second spot by then. US debt per working-age person goes from $37,700 in 2008 to $85,300 in 2018. For Japan, it more than doubles from $56,100 in 2008 to $123,100 in 2018.

• For EMs, average debt-per working-age person rises to $2,500 in 2018. For China, this measure of the debt burden will be $1,700 in 2018. Our analysis paints a sobering picture of worsening public debt dynamics and a sharply rising debt burden in the advanced economies. This rising burden will increase debt servicing costs, reducing room for productivity-enhancing government expenditures on education, health, and infrastructure. It will also raise social tensions if the result is a combination of low growth, high unemployment, and increasingly threadbare social safety nets.

Many advanced economies are getting policies backward by emphasising short-term fiscal tightening that is cutting the legs out from under already weak recoveries while not tackling more fundamental longer-term fiscal sustainability issues. With little progress on much-needed structural reforms, this has put the burden of sustaining recoveries squarely on monetary policy. This combination of policies does not bode well for sustainable growth. Rather than relying on monetary policy and short-term fiscal austerity, advanced economies would do better to articulate a clear path to long-term deficit and debt reduction, coupled with deep-rooted reforms to improve the working of labour, product, and financial markets.

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