Debt burden in advanced economies now a global threat

By Eswar Prasad and Mengjie Ding

Our analysis paints a sobering picture of worsening public debt dynamics and a sharply rising debt burden in advanced economies. These rising debt levels combined with heightened concerns about fiscal solvency now constitute a major threat to global financial stability.

Recent events in Greece, Ireland, Portugal and other economies on the periphery of the eurozone show the risks of debt buildups that are not tackled. Bond investors can quickly turn against a vulnerable country with high debt levels, leaving the country little breathing room to balance its fiscal books and precipitating a crisis.

Overall, the worldwide picture of government debt is not pretty.

Data from the IMF’s latest Fiscal Monitor show that the level of aggregate net government debt in the world rose from $21,900bn in 2007 to an expected $34,400bn in 2011. IMF forecasts indicate the level will reach $48,100bn in 2016. The ratio of world net debt to world GDP rose from 42 per cent in 2007 to 57 per cent in 2011, and is expected to hit 58 per cent in 2016.

Over the past year, there has been a modest improvement in the forecasts for US debt levels relative to earlier forecasts thanks to stronger revenues and lower spending levels than expected. If the US recovery remains weak and employment growth stalls, some of this apparent improvement may be reversed. Japan’s debt ratio is expected to worsen as a result of tepid output growth and the reconstruction costs following the earthquake and tsunami. Lack of growth has also worsened the debt positions of peripheral European economies.

Advanced economies account for the bulk of the increase in global public debt since 2007, both in absolute levels and relative to GDP.

- Aggregate debt of advanced economies will increase from $18,100bn in 2007
to $29,500bn in 2011, and is expected to rise to $41,300bn in 2016. The corresponding numbers for emerging market economies are $3,800bn, $4,900bn and $6,700bn, respectively.

- The ratio of aggregate debt to aggregate GDP for advanced economies will rise from 46 per cent in 2007 to 70 per cent in 2011 and further to 80 per cent in 2016. The corresponding ratios for emerging market economies are 28 per cent, 26 per cent and 21 per cent, respectively.*

There is also a stark contrast between advanced economies and emerging market economies in their relative contributions to growth in world debt versus growth in world GDP. Emerging market economies contribute far more to growth in global GDP than to the growth in global public debt.

- In 2007, emerging market economies accounted for 25 per cent of world GDP and 17 per cent of world debt. By 2016, they are expected to produce 38 per cent of world output and account for just 14 per cent of world debt.
- Emerging market economies account for 9 per cent of the increase in global debt levels from 2007 to 2011 and are expected to account for 13 per cent of the increase from 2011 to 2016. By contrast, their contributions to increases in global GDP over these two periods are 66 per cent and 56 per cent, respectively.
- The US contributes 37 per cent of the increase in global debt from 2007 to 2011 and 40 per cent from 2011 to 2016. Its contributions to global GDP over those two periods are 8 per cent and 18 per cent, respectively.

Another way to understand the burden of public debt is to examine the level of debt per capita. Richer economies can of course afford more debt but this is still an instructive calculation as it highlights the growing gulf between advanced economies and emerging markets.

- The average per capita debt in advanced economies is $29,600 in 2011 and is expected to be $40,400 in 2016. The burden of debt for US citizens is $34,200 in 2011 and will rise to $49,100 by 2016. The debt burden for Japanese citizens will hit $85,000 in 2016, the highest level in the world.
- Average per capita debt for emerging markets is predicted to rise gradually to $1,500 in 2016, far lower than advanced economy levels. In 2016, the debt burden will be $800 for China and $1,300 for India.

There is an even sharper contrast between advanced economies and emerging
markets when we calculate the debt burden of the working-age population (ages 15-64).

- Among advanced economies, the average debt per working-age person will more than double from $27,600 in 2007 to $62,000 in 2016. Japan tops all countries and the US will move into the third spot by 2016. US debt per working-age person goes from $29,000 in 2007 to $73,300 in 2016. For Japan, it more than triples from $42,700 in 2007 to $140,300 in 2016.
- For emerging markets, average debt-per working-age person rises to $2,200 in 2016, a level far lower than that of the advanced economies. For China, this measure of the debt burden will be $1,100 in 2016.

The path to reducing vulnerable debt levels is not an easy one. Advanced economy governments need to strike a delicate balance between supporting weak recoveries while laying out a clear strategy for bringing down their deficit and debt levels once growth picks up.

In the US, this balancing act is complicated by the debt ceiling negotiations. US politicians are playing with fire if they feel that their brinksmanship will have no major repercussions. The debt ceiling negotiations are an opportunity for fundamental fiscal reforms rather than tinkering at the margin. If the government doesn’t rise to the challenge, the consequences could be dire—financial turmoil, a more sluggish recovery, and weaker long-term growth prospects.

Advanced economies need to learn the lessons of fiscal discipline that for so long they preached to the emerging markets.

Eswar Prasad is a professor at Cornell University and a senior fellow at the Brookings Institution. Mengjie Ding is a rising senior at the Massachusetts Institute of Technology and was an intern at the Brookings Institution.

* A note of caution on reported debt levels of emerging markets: in China, for instance, financial liabilities of provincial governments and contingent liabilities such as nonperforming assets held by the state-owned banking system imply a higher value of government debt obligations than suggested by official statistics.