Why we should expect low growth amid debt

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As government debt levels explode in the aftermath of the financial crisis, there is growing uncertainty about how quickly to exit from today's extraordinary fiscal stimulus. Our research on the long history of financial crises suggests that choices are not easy, no matter how much one wants to believe the present illusion of normalcy in markets. Unless this time is different - which so far has not been the case - yesterday's financial crisis could easily morph into tomorrow's government debt crisis.

In previous cycles, international banking crises have often led to a wave of sovereign defaults a few years later. The dynamic is hardly surprising, since public debt soars after a financial crisis, rising by an average of over 80 per cent within three years. Public debt burdens soar owing to bail-outs, fiscal stimulus and the collapse in tax revenues. Not every banking crisis ends in default, but whenever there is a huge international wave of crises as we have just seen, some governments choose this route.

We do not anticipate outright defaults in the largest crisis-hit countries, certainly nothing like the dramatic de facto defaults of the 1930s when the US and Britain abandoned the gold standard. Monetary institutions are more stable (assuming the US Congress leaves them that way). Fundamentally, the size of the shock is less. But debt burdens are racing to thresholds of (roughly) 90 per cent of gross domestic product and above. That level has historically been associated with notably lower growth.

While the exact mechanism is not certain, we presume that at some point, interest rate premia react to unchecked deficits, forcing governments to tighten fiscal policy. Higher taxes have an especially deleterious effect on growth. We suspect that growth also slows as governments turn to financial repression to place debts at sub-market interest rates.

Fortunately, many emerging markets are in better fiscal shape than advanced countries, particularly with regard to external debt. While many advanced countries took on massive increases in external debt during the run-up to the crisis, many emerging markets were busy deleveraging. Unfortunately, this is not the case in emerging Europe, where external debt burdens average over 100 per cent of GDP; external (again including public plus private) debt levels in troubled Greece and Ireland are even higher. Will the typical wave of post-financial crisis defaults follow in the next few years? That depends on many factors.

One factor that is different is the huge expansion of the International Monetary Fund initiated last April. IMF programmes can mitigate outright panics and will help those countries that genuinely make an effort to adjust. For some countries, however, debt burdens will prove politically intractable even after IMF loans. They will eventually require restructuring. Indeed, the IMF mustensure that it does not simply enable countries to dig deeper holes that lead to more destructive defaults, as occurred in Argentina in 2001. Having imposed very lax conditions in response to the financial crisis, the IMF now faces its own difficult exit strategy. How this unfolds will affect the timing of defaults, though debt downgrades and interest rate spikes have already started to unfold.

Another big unknown is the future path of world real interest rates, which have been trending downwards for many years. The lower these rates are, the higher the debt levels countries can sustain without facing market discipline. One common mistake is for governments to "play the yield curve" - as debts soar, shifting to cheaper short-term debt to economise on interestcosts. Unfortunately, a government with massive short-term debts to roll over is ill-positioned to adjust if rates spike or market confidence fades.

Given these risks of higher government debt, how quickly should governments exit from fiscal stimulus? This is not an easy task, especially given weak employment, which is again quite characteristic of the post-second world war financial crises suffered by the Nordic countries, Japan, Spain and many emerging markets. Given the likelihood of continued weak consumption growth in the US and Europe, rapid withdrawal of stimulus could easily tilt the economy back into recession. Yet, the sooner politicians reconcile themselves to accepting adjustment, the lower the risks of truly paralysing debt problems down the road. Although most governments still enjoy strong access to financial markets at very low interest rates, market discipline can comewithout warning. Countries that have not laid the groundworkfor adjustment will regret it.

Markets are already adjusting to the financial regulation that must follow in the wake of unprecedented taxpayer largesse. Soon they will also wake up to the fiscal tsunami that is following. Governments who have convinced themselves that they have done things so much better than their predecessors had better wake up first. This time is not different.

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