

What is the Deficit Endgame?

by *Kenneth Rogoff*

REYKJAVIK – No one yet has any real idea about when the global financial crisis will end, but one thing is certain: government budget deficits are headed into the stratosphere. Investors in the coming years will need to be persuaded to hold mountains of new debt.

Although governments may try to cram public debt down the throats of local savers (by using, for example, their rising influence over banks to force them to hold a disproportionate quantity of government paper), they will eventually find themselves having to pay much higher interest rates as well. Within a couple years, interest rates on long-term US Treasury notes could easily rise 3-4%, with interest rates on other governments' paper rising as much, or more.

Interest rates will rise to compensate investors both for having to accept a larger share of government bonds in their portfolio and for an increasing risk that governments will be tempted to inflate away the value of their debts, or even default.

In research that Carmen Reinhart and I have done on the history of financial crises, we find that public debt typically doubles, even adjusting for inflation, in the three years following a crisis. Many nations, large and small, are now well on the way to meeting this projection.

China's government has clearly indicated that it will use any means necessary to backstop growth in the face of a free fall in exports. The Chinese have \$2 trillion in hard currency reserves to back up their promise. President Barack Obama's new budget calls for a stunning \$1.75 trillion deficit in the United States, a multiple of the previous record. Even those countries that are not actively engaged in a fiscal orgy are seeing their surpluses collapse and their deficits soar, mainly in the face of falling tax revenues.

Indeed, few governments have submitted remotely realistic budget projections, typically relying on overly rosy economic scenarios. Unfortunately, in 2009, the global economy will not be a bed of roses. Income in the US and euro-area both appear to have declined at an annualized rate of roughly 6% in the fourth quarter of 2008; Japan's GDP fell at perhaps twice that rate.

China's claim that its GDP *grew* at a 6% rate, during the end of last year, is suspect. Exports have collapsed throughout Asia, including Korea, Japan, and Singapore. Arguably India, and to a lesser extent Brazil, have been holding out a bit better. But few emerging markets have reached a stage at which they can withstand a sustained collapse in the developed economies, much less serve as substitute engines of global growth.

With the credit crisis still making it difficult for many small and medium-size businesses to obtain even the minimal level of financing necessary to maintain inventories and conduct trade, global GDP is on a precipice in 2009. There is a real possibility that global growth will register its first contraction since World War II.

In all likelihood, a slew of countries will see output declines of 4-5% in 2009, with some having true depression level drops, of 10% or more. Worse yet, unless financial systems spring back, growth could disappoint for years to come, especially in "ground zero" countries such as the United States, Britain, Ireland and Spain. US long-term growth could be particularly dismal, as the Obama administration steers the country toward more European levels of welfare assistance and income redistribution,

Countries with European-style growth rates could handle debt obligations of 60% of GDP when interest rates

were low. But, with debts in many countries rising to 80% or 90% of GDP, and with today's low interest rates clearly a temporary phenomenon, trouble is brewing. Many of the countries that are piling on massive quantities of debt to bail out their banks have only tepid medium term growth prospects, raising real questions of solvency and sustainability

Italy, for example with a debt-to-income ratio already exceeding 100%, has been able to manage so far thanks to falling global rates. But as debts mount, and global interest rates rise, investors will become rightly nervous about the risk of debt restructuring. Other countries, such as Ireland, Britain, and the US, started with a much stronger fiscal position, but may not be much better off when the smoke clears.

Exchange rates are another wild card. Asian central banks are still nervously clinging to the dollar. But with the US printing debt and money like it is going out of style, it would appear the euro is set to appreciate against the dollar two or three years down the road, if the euro is still around, that is.

As debt mounts and the recession lingers, we are surely going to see a number of governments trying to lighten their load through financial repression, higher inflation, partial default, or a combinations of all three. Unfortunately, the endgame to the great recession of the 2000's will not be a pretty picture.

Kenneth Rogoff is Professor of Economics and Public Policy at Harvard University, and was formerly chief economist at the IMF.

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