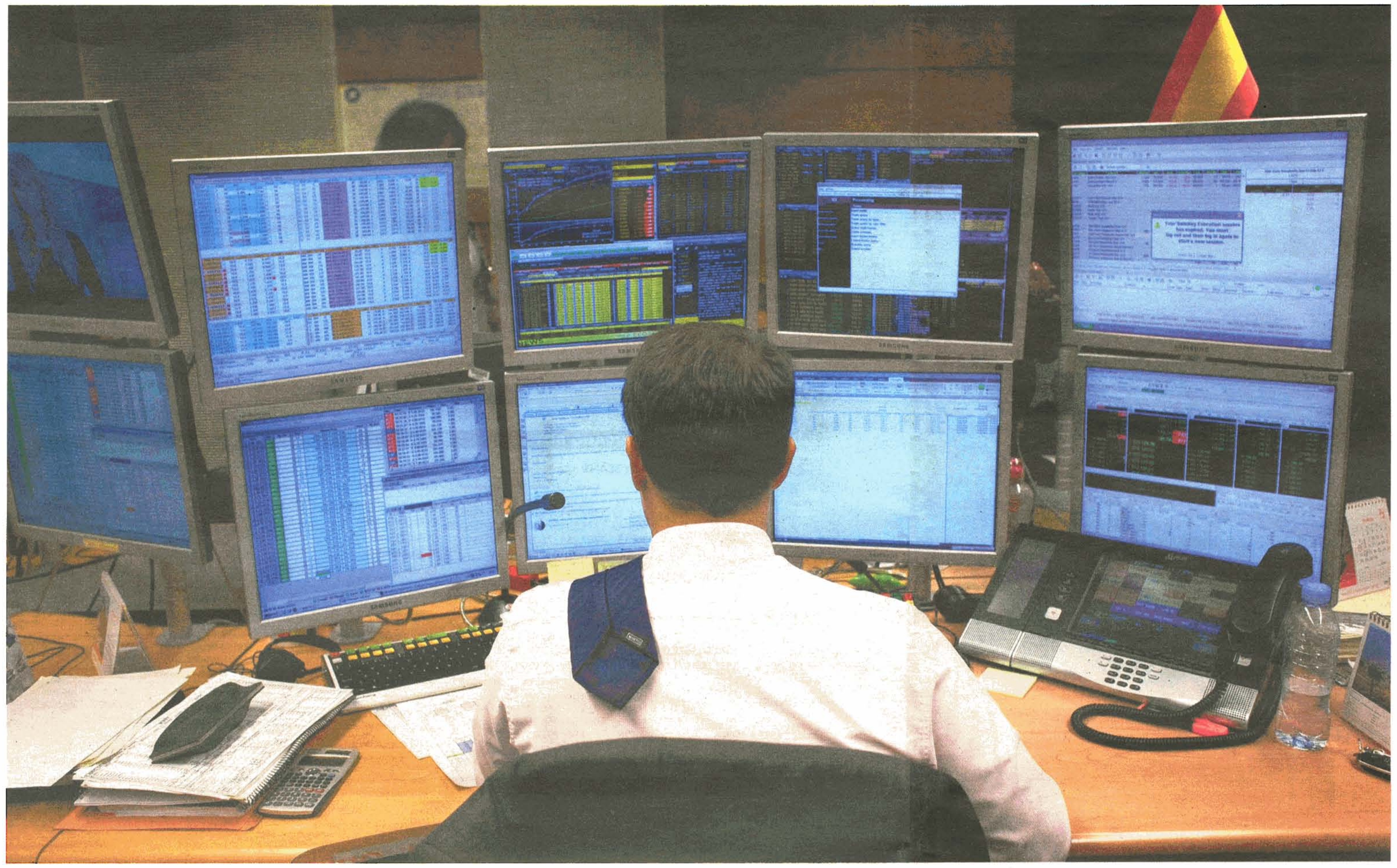
Publication: The Business Times, p 28-29
Date: 24-25 November 2012
Headline: The way out of the debt trap



IT'S IN THE DETAILS
At the end of September, Spain saw strong demand for the 10-year bonds, with investors bidding for nearly three times the amount on offer with an average yield of 5.66 per cent. PHOTO: REUTERS

The way out of the debt trap

One possible method is to leave debt levels (the principal) where they are, renewing debt when it is due, and focusing on an economic policy that diminishes the net interest burden. **By Joergen Oerstroem Moeller**

HOW to get out of the debt trap? The figures are terrifying. US sovereign debt is close to 100 per cent of gross domestic product (GDP) and apparently on an unstoppable trend irrespective of what happens at the fiscal cliff. The federal deficit was, for the fourth consecutive year, above US$1 trillion and is running at 7 per cent of GDP. The eurozone is doing somewhat better with debt/GDP at 87 per cent. Forecasts point to a gradual, albeit small, decline from 2013/14 and a fall in the zone's budget deficit from its current level of 3.3 per cent of GDP.

Analyses of debt burdens in the past highlight limited inflation as the magical stick hollowing out purchasing power, reducing the share of GDP needed to honour outstanding debt. Countries trying manfully to pay back the debt by austerity and low inflation – as the eurozone is doing now – have rarely been successful.

Burden of adjustment

This may be true, and if it is, the omens for both the US and the eurozone – as well as Britain and Japan – do not look promising. The public has grown used to low inflation over the last 25 years and do not seem ready to surrender that privilege, least of all the creditors knowing that it would shift the burden of adjustment to them.

So what to do? The answer may be that these analyses speak the truth, but not the whole truth.

Debt does not go away. It has to be repaid – eventually, but not necessarily now or within a short time span. The alternative to start paying back here and now is to leave debt levels (the principal) where they are, renewing debt when it is due, and focusing on an economic policy that diminishes the net interest burden. Japan has done so over the last 20 years. Italy too. Admittedly, neither of these two countries can flag a good growth rate, but nor have they suffered some kind of cataclysm.

First, the debt level must be under control to instil confidence among households and private investors to encourage them to spend without fear of further tax increases. John Maynard Keynes is often invoked in this debate. What he said was that if private demand falters, the public should step in to bridge the demand gap to maintain aggregate demand. But this policy only works if private demand does not react negatively to public policy as it may when debt levels and public deficits go up.

Second, low interest rates to reduce the net interest burden, and low inflation should be the main objective of monetary policy. In past crises, countries may have relied on inflation to reduce the pay-back burden, but as the interest rates followed the price level upwards, the real interest rate was kept steady and the net interest burden did not fall.

What we see now in the US, Japan, and the eurozone is a monetary policy pursuing low interest rates by pumping money into the system. Many observers have predicted inflation, but they are wrong. There is no demand pressure, so consumer prices have been steady and it is unlikely that this trend will be reversed. Liquidity goes into commodities, property, and stocks and not to the market for goods and services.

The net interest burden for even the heavily indebted countries will not be insurmountable. If we assume – not unreasonably – that for the eurozone including weak countries real trend growth will be 1.5 per cent per annum and inflation 2.5 per cent, nominal GDP growth comes to 4 per cent. Recent debt auctions for Italy and Spain show that the yield is falling. At the end of October, Italy sold eightbillion euros (S$12.6 billion) of six-month T-bills at an average yield of 1.347 per cent. At the end of September, Spain saw strong demand for the 10-year bonds, with investors bidding for nearly three times the amount on offer with an average yield of 5.66 per cent. Investors bid for three-year bonds, with an average yield of 3.85 per cent.

The current net interest burden on government budgets compared to GDP is, for France, 2.6 per cent; Italy, 4.8 per cent; and Spain, 3 per cent. For the US, the corresponding figure is 1.5 per cent. These figures may, however, not give a correct picture of the burden on government budgets as public budgets among the eurozone countries are double the size of the US federal budget, generally speaking. The tax burden thus amounts to almost the same among the heavily indebted eurozone countries and the US. Forecasts point to a rising burden in the US and a smaller burden for the eurozone countries.

Blessing in disguise

The next step is to figure out where to find the tax revenue to finance net interest payments without stopping the recovery. The answer is: Institutional investors. For the eurozone, institutional investors account for 40 per cent and in some cases almost 50 per cent of public debt-holders. A shift in the tax system to increase taxes on remunerations from bonds held by these investors would in reality mean that you give with one hand and take back with the other one.

The losses would in due course be borne by retirees, but as the Europeans try to make people stay longer in the labour market, this may be a blessing in disguise encouraging people to work longer to get the same pension.

This model would clearly work for the eurozone – even for countries such as Italy and Spain. For the US, it is not certain. Forecasts signal continued rising debt/GDP ratio. A higher share of public debt is held by foreigners (50 per cent of treasury bonds) compared to 31.5 per cent for the eurozone (Italy and Spain at or below 40 per cent). Institutional investors do not account for much more than 15-20 per cent of treasury bonds with the Federal Reserve and foreigners taking about 75 per cent.

As for any prescription to get out of the blind alley, there are weaknesses. It would require adroit economic and, in particular, monetary policy to balance nominal growth, nominal interest rates, and the size of debt/GDP. Creditors might unexpectedly ask to get their money back, but as this would ground the global economy including their own, it is unlikely that they will do so.

Debtor countries will not find room to do much else than servicing the debt – but do they have any freedom of action now? The alternatives – starting to pay back or inflation – are worse, so the way outlined above may be what we are going to see either because policymakers choose it or by default.

✎ **The writer is a visiting senior research fellow, Institute of Southeast Asian Studies, Singapore and an adjunct professor at Singapore Management University & Copenhagen Business School**