THE HINDU Business Line

Opinion - Economy

Asia and the Western debt crisis

Advanced economies are likely to reduce their debt-to-GDP ratio, banking not just on growth, but inflation as well. However, for Asia the preferred option is faster growth in the US and Europe that will boost exports and keep their savings safe, says M. SHAHIDUL ISLAM.

According to the International Monetary Fund (IMF), sovereign debt in the advanced G-20 economies is set to reach or exceed 100 per cent of their GDP in the next few years. While emerging Asia, with the exception of India, has a low debt-to-GDP ratio, there is growing concern about the region's exposure to the sovereign debt crisis of major advanced economies.

ECONOMIC INTERDEPENDENCE

While most of the public debt in the advanced economies accumulated following the financial crisis, and is thus cyclical in nature, there is another dimension to the problem, namely, the structural fiscal deficit. As the baby boomers retire, the state of public finance in the US, Europe and Japan is likely to become even more vulnerable in order to finance their old-age pensions.

Some analysts fear that the debt crisis that originated in Greece, the birthplace of Western civilisation, could reach the last bastion of Western power, on the other side of the Atlantic, after crossing the channel to Britain.

Although the "decoupling theory" has gained some currency in recent years, the economic interdependence between advanced economies and developing Asia has not lessened.

There has been an increasing correlation between the G-7 and developing Asia's growth, particularly in the post-2000s. There is a strong linkage between their bond markets, portfolio investment, FDI flows, among others. The G-7 economies still consume over two-third of developing Asia's exports. The central bank of China alone holds nearly a quarter of the US' Treasury securities.

GROWTH AND DEBT MANAGEMENT

China has voiced its concern on several occasions that the US could stoke inflation and devalue the dollar to partly offset its debt. If Chinese concerns translate into reality, it could unduly punish Asian savers.

Theoretically, the debt-ridden economies can lower their debt-to-GDP ratios by banking on several mechanisms: GDP can grow fast enough to reduce the ratio, prices can be inflated enough to erode the real value of debt, fiscal tools can be employed to redeem some of the debt, austerity measures can be adopted by lagging credit growth behind GDP growth to reduce debt, and finally, the government can default on its debt obligations.

The relationship between debt and growth has attracted much attention, particularly following the recession of 2008-09. In an influential paper, Prof Carmen Reinhart of the University of Maryland and Prof Kenneth Rogoff of Harvard University demonstrated that across both advanced countries and emerging markets, high debt/GDP levels (90 per cent and above) are associated with notably lower growth outcomes. They also showed that, historically, periods of sharp deleveraging have followed periods of lower growth.

INFLATION TO CONTROL DEBT

Under the current circumstances, low to moderate growth in the advanced economies could repeal a fraction of the debt. This is very likely in the case of the US where economic recovery looks better than for its peers. Dr Martin Feldstein of Harvard University estimated that the US economy could grow at 1.9 per cent per annum in this decade. In Europe, debt and other economic problems are not unique. On the whole, as far as near-to-medium term economic growth is concerned, the continent's economic picture is not rosy. Japan's case is no different. If debt cannot be eroded significantly by GDP growth, then inflation is the most favoured tool.

What worried the US and Europe during and in the aftermath of the great recession is the spectre of deflation that halted Japan's progress for more than a decade. Like in the US, however, the fear of deflation in Europe has also subsided. Japan remains in the midst of deflation.

However, too low inflation for too long is blamed for the creation of recent asset bubbles and the global imbalances that eventually caused the great recession of 2008-09. Hence, though high inflation is not a clear policy preference, policymakers in the advanced economies do not want to import a Japan-style prolonged deflation either.

This means that a middle path, namely, moderate-level inflation and modest growth, could be a policy preference to reduce the debt. Debt reduction strategies in the post-war period (1946-2003) show that while real GDP growth reduced the debt-to-GDP ratio by 1.3 per cent on average, the effect of inflation on the ratio was 1.6 per cent.

Many influential economists in the US believe that a 4-6 per cent inflation for four years could reduce the debt-to-GDP ratio by 20 per cent — a scenario similar to what happened following World War II.

PROLONGED IMBALANCES

It appears that advanced economies are likely to reduce their debt-to-GDP ratio, banking on both GDP growth and inflation. However, the relative effects of these two variables will depend on their economic recovery. Clearly, for Asian savers the preferred option is a faster recovery in the advanced economies that will keep their savings safe.

The current sovereign debt crisis is one of the by-products of global imbalances. It is unlikely to unwind through a hard default by rich countries which have large current account deficits along with fiscal arrears. A soft default via inflation remains a danger but Asia and the West's ever-growing economic interdependence is likely to reduce the risk.

Instead, we might see prolonged financial and other economic imbalances or, at best, a slow adjustment between the two stakeholders in the years to come.

(The author is a research associate with the Institute of South Asian Studies at the National University of Singapore)