



Belt tightening lies ahead for major developed economies

Many of the world's major economies, weighed down by very high levels of debt, are likely to experience a lengthy and painful period of slower growth as they work it off. Although less common, some countries have in the past resorted to default or high inflation as alternative ways of reducing debt burdens. Neither is bond friendly. Nor would either of these extremes be currency friendly for the UK, whose debt is 34% foreign-owned. Other countries facing this deleveraging process include the US, France, Germany, Canada, Spain, and South Korea.

Episodes of debt reduction following financial crises can be split into four broad types: 1) belt tightening, in which credit growth lags behind GDP growth for many years; 2) massive default; 3) high inflation; or 4) growing out of debt through very rapid real GDP growth caused by a war effort, a "peace dividend" following war or an oil boom.

Belt-tightening has historically been the most common way of deleveraging, accounting for half of all episodes. During belt tightening most countries experienced some growth in lending, but the pace was far below the pre-crisis rate and slower than nominal (non-inflation-adjusted) GDP growth. In a handful of severe cases the stock of nominal debt actually fell. Examples of this type of debt reduction include the US economy during the Depression years of 1933-37, Finland and other Scandinavian countries in the 1990s and South Korea and Malaysia after the Asian financial crisis in 1997.

The difficulty during a belt tightening is that higher household savings and lower businesses investment will reduce GDP, unless it is supported by another factor. Many countries have offset those dampening effects by increasing net exports, as was the case in Scandinavia in the 1990s and in Asia after 1997. But

net exports are not the only mechanism for increasing GDP growth. Productivity growth is another way, as in the US experience in 1933-37. Increasing the labour supply is still another way, and this can be done by boosting the labour force participation rate, deferring retirement or through immigration.

If today's heavily indebted economies follow the belt-tightening path, history suggests they will experience six to eight years of deleveraging that will bring the ratio of debt to GDP down by around 25%. Worryingly, several features of the current crisis, including its global nature and the large projected increases in government debt, could delay the start of the process of reducing leverage and result in a longer period of debt reduction than in the past. In past episodes, a significant increase in net exports often helped support GDP growth during deleveraging. But it is unlikely that today's long list of highly leveraged major economies could all simultaneously increase their net exports. Moreover, projected increases in government debt may offset reductions in household and commercial real-estate borrowing.

There is therefore a risk that a large swathe of the developed world may remain highly leveraged for a prolonged period, creating a fragile and potentially unstable economic outlook over the next five to ten years. As debt is paid down, these countries may go through many years in which GDP growth is slower than it otherwise would have been.

Painlessly growing out of debt through a period of rapid economic expansion is very rare. The most common alternatives to belt tightening are high inflation and debt default, which have both occurred in about a quarter of the deleveraging episodes following financial crises. High inflation cuts the ratio of debt to GDP by increasing nominal

GDP growth. This pattern, which occurred in Chile from 1984 to 1991 and in Spain from 1976 to 1980, typically reflects the absence of a strong and independent central bank. Hence market concerns that the use of quantitative easing and bank bailouts in the US and UK have blurred the dividing line between central banks and treasuries. Massive defaults have typically been followed by currency crises, as in Argentina in 2002-08 and Mexico in 1982-92.

These alternative ways of relieving debt burdens are feared by bond holders and currency markets. So, it is understandable that there is a positive correlation between debt ratios and the yields demanded by bond investors. Currencies are particularly vulnerable to large debt build-ups when a high proportion of that debt is held by foreign investors. Among the highly leveraged major economies only Japan (93%), South Korea (90%) and Canada (86%) have debt which is predominately domestically owned. Japan has been able to sustain high levels of government debt because it can draw on a large pool of domestic savings. Countries like the UK, with high levels of debt and foreign ownership, are vulnerable to souring investor sentiment that could drive up interest rates and quash a fragile economic recovery.

	Whole Economy Debt (% GDP)	Foreign Ownership (%)
Russia	71	--
India	129	--
Brazil	142	--
China	159	--
Canada	245	14
Germany	274	50
US	290	21
Italy	298	35
France	308	56
Switzerland	313	55
South Korea	331	10
Spain	342	29
UK	380	34
Japan	459	7

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