G-20 Priorities: Heavily Indebted Rich Countries

Sergei Guriev *Rector, New Economic School, Moscow*

RUSSIA

The agendas of the G-20 summits as well as those of other meetings of world leaders are dominated by issues that matter to the current state of the global economy, including fiscal stimulus, currency wars, global imbalances, capital requirements and bankers' bonuses. However, the summits pay much less attention to the issues related to long-term growth and development. Yet, these issues have been known for years and their importance has been building up slowly. The recent crisis has shown that discussion of some of these issues should not be postponed any further. The most important of them is the shaky fiscal position and the looming bankruptcy of pension systems in industrialized countries.

We have known for a while that we do not really have a solution to the problem of solvency of pension systems in the United States, Europe and most transition countries. We have also known that excessive government debt is a threat for long-term economic growth. There is no single answer to the question of what level of debt is dangerous and critical; it certainly depends on the country-specific characteristics. For most countries, a debt level of below 60 percent annual GDP is probably safe while a debt level of about 100 percent of GDP is threatening—and this is already a reality for many industrialized countries.

During the recent crisis, many countries implemented unprecedented fiscal stimulus packages and brought budget deficits and debts to levels that were previously described in the development economics literature as "debt overhang". These debt levels are already so high that they are going to slow down growth either through increasing interest rates crowding out investment, through higher taxes imposed by governments to reduce budget deficits or through high inflation. But if growth continues to be slow, many countries will not be able to grow out of their debt. Consequently if and when another global economic crisis happens, these countries will enter a recession with existing high debt levels. Even if these countries understand the urgent need for a sizeable fiscal stimulus, they may be unable to undertake it; markets will not lend to them at reasonable interest rates and high interest rates would only deepen the contraction. Therefore, such debt will eventually undermine the ability of country governments to handle another recession.

We have almost never witnessed this problem in recent decades. The debt overhang issue used to only be a problem for poor countries, particularly the heavily indebted poor countries. But there have been exceptions. For example, in the 1980s, the Soviet Union was a high middle-income country with a reasonably low debt burden. But just a few years of loose fiscal policy coupled with an adverse terms-of-trade shock (a drop in the oil price) removed the country from the map. The sharp decrease in global oil prices reduced government revenues and brought about a recession in the country. In order to spend their way out of recession, Soviet leaders borrowed at enormous speed, which resulted in a situation where nobody would lend to the Soviet Union anymore and the country went bankrupt.

Certainly, the U.S. and Europe are very different from the former Soviet Union. In particular, the U.S. dollar and euro are international reserve currencies that are hard to replace in any foreseeable future. During the recent crisis, global investors

ran to the dollar for safety even though the dollar rates hit the zero lower bound. Yet, if fiscal deficits are not cut, government debt will continue to increase and grow faster than GDP. This will make the frightening debt overhang scenario a reality and financing the huge public debt will eventually crowd out private investment and undermine long-term growth. And with debt levels so high, it is not clear how the U.S. and EU will be able to fight off the next recession.

Why is fiscal consolidation policy an issue of global governance? In principle, countries can and should cut their budgets on their own and they should have incentives to do so. However, there are substantial free-rider problems. First, because the debt overhang now concerns countries that issue reserve currencies, this also impacts other countries that hold international reserves. Second, there are substantial cross-border spillovers of fiscal consolidation. If one country cuts its budget deficit and reduces its borrowing in the market, interest rates fall. Therefore, capital may leave the country for a neighboring country with less responsible fiscal policies. In the latter country, as the capital inflows reduce interest rates, the government will be happier to keep running the budget deficit. Thus, mutual commitments and coordination are important.

The solution to the problem of fiscal deficit is straightforward—albeit difficult to implement. Rich countries should bring their deficits and debts down (e.g. to the Maastricht Criteria). As the Maastricht Treaty is hard to enforce within Europe —even with the recent proposals of peer review of budgets—it will also be virtually impossible to enforce within a loose club such as the G-20. But, in order to make sure that this is not dismissed and forgotten, it is important to keep bringing the issue of fiscal consolidation policy to the top of the G-20 agenda every time the group meets.