First World Debt Crisis?

If the 1980s were the decade of the third world debt crisis, could the current decade be described by future economic historians, as the decade of the first world sovereign debt crisis? Quite possible, of course, as witness the problems in some euro zone countries (Greece, Ireland, Portugal? Spain?). And, across the Atlantic, the situation does not look much better if the late 2010 "deal" between the Democratic President and the Republican leadership is an indication. The Republicans won the mid-term election with a hawkish stance on the budget deficit. The first thing they did on winning it was to get a continuation, for the next two years, of a tax-cut for the rich which would cost something like $ 850 bn; in return, the Democrats got what they were after, namely a continuation of unemployment benefits beyond the existing time limit, necessitated by the continued near double digit unemployment. It is not left for us, poor third world commentators to understand the ways of the Americans to cut budget deficits! – or, indeed, the ways of the financial market which charges a higher credit spread on German sovereign debt as compared to U.S. sovereign debt ("too big to fail"?)! Or is this phenomenon merely another manifestation of the U.S.-centric biases of the financial market? To be sure, there would be analysts who would give me an extremely plausible rationale for the lower U.S. spreads. The fact is that the U.S. public debt and fiscal adjustment are a major challenge for policymakers. The dilemmas are manifest in the way the high profile debt reduction panel appointed by President Obama failed to agree on recommendations.

Historically, there have been two ways of solving a sovereign debt problem – fast growth or debasement of the currency (i.e. high inflation). Neither seems to be on the cards as far as most first world countries are concerned. And, in the U.S., the debt problem extends not only to states like California, but a very large number of municipalities – the aggregate outstanding municipal debt is estimated at $ 2 trillion, and yield spreads have been widening as investors perceive a greater credit risk. Another debt bomb which could explode in a not-so-robust economic recovery is the commercial real estate sector.

Turning to the prospects of global inflation, there are signs that it could pick up. Bond yields in the U.S. have gone up to some extent, although the headline inflation number is still pretty benign. This is not surprising – the index looks at the past while, at least in theory, markets are supposed to factor expectations about the future in current prices. The fact is that commodity prices have increased sharply since mid-2010 – precious metals, base metals, agricultural commodities (FAO's food price index is up 50% over the last 2 years), etc. – and, more recently, the price of crude oil. There are, perhaps, two different drivers of the flare up in commodity prices – rising demand in emerging markets, who continue to grow much faster than the first world; and the emergence of commodities as a new “asset class”. This would surely exacerbate cyclicality.

Product inflation may also pick up. One of the reasons for the relatively benign inflation over the last couple of decades in much of the first world has been Chinese prices. And, this could be in for a change. Two different factors will put upward pressure on Chinese product prices: sharp increases in wages and a gradual appreciation of the yuan in nominal terms. In theory, this should help reduce global imbalances. In my view, this is unlikely as the major deficit Anglo-Saxon economies have progressively de-industrialised themselves. (To be sure, these developments may help other emerging markets' competitiveness). Overall, however, inflation in the first world is unlikely to go to levels that would make any significant impact on debt as a percentage of nominal GDP. Macroeconomic policy makers have learnt much more about bringing inflation down, than pushing it up – witness the experience of Japan.

What about the growth outlook? The U.S. stock market is back to the pre-Lehman collapse levels. There are other indications as well that economic growth could pick up in 2011, but unemployment seems to be an increasingly intractable problem. I have seen analysts suggesting that GDP growth of 2.5% is needed merely to keep the unemployment level stable. The big question is what happens to economic recovery when the monetary and fiscal stimuli get withdrawn. The picture is not much rosier in Europe, with Germany an exception. But, the problems of some of the euro zone countries would continue to hobble the European recovery. Increasingly, the Chinese central bank is becoming the lender of last resort for many European governments. And, it remains by far the largest holder of U.S. sovereign debt.

The big worry for the global picture remains the possibility of tensions over exchange rates (particularly of the Chinese yuan) and political pressures for trade protectionist measures. In times of difficulties, it is always tempting to blame the nasty, crafty foreigner for one's own woes.

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