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Strong in emerging Asia, the recovery is slow in spreading to the rest of the world

Spotlight
on Country Risk

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Economic Outlook

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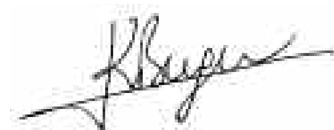
Editorial

Debt: every man for himself?

"On the macroeconomic level, we have entered a well-known phase that follows financial crises: one of debt deflation". These were the words used by the brilliant economist of financial crises, Michel Aglietta, speaking at the end of March 2010 to the Finance Committee of the French National Assembly, in describing what we could call the third phase of the crisis of 2009. After the financial and economic crisis itself, and then the technical rebound at the end of 2009, the start of 2010 opens the way to a long phase of 'return to the normal'. After having refamiliarised ourselves with Keynes, we now need to re-read Irving Fisher. What do we mean when we talk about 'debt deflation'? Simply that, in order to 'return to normal', the economic agents – companies, households and above all banking systems – need to be freed of debt for three reasons: first, because of the drop in their incomes, brought about by the crisis; second, because of the excessive levels of debt and bubbles created at the origin of the crisis; and third, because banks' balance sheets were severely unbalanced by the financial and real estate shocks once the bubbles had burst. In short, everyone is trying, all at the same time, to get rid of their excessive debt. It is for this reason, in order to prevent these deleveraging efforts from triggering a deflationary spiral, that governments had to take the reins and were forced to swell their own national debts. The problem is that the present equilibrium is so fragile that nobody very well knows exactly how we can return to normal. On the one hand, governments cannot get rid of their national debt immediately, because the phase of debt deflation in the private sector is only just starting and will undoubtedly last for several months. On the other, public debt is so high that there are doubts over governments' capacity ever to be able to repay it. We should remember, however, why states are seen as more certain than private companies to repay their debt: quite simply, because the state has the ability to raise taxes, and governments can choose to raise total taxation constantly. And without even touching their taxation rates, as the taxable total grows each year in line with wealth creation, governments enjoy revenue increases more or less precisely in line with underlying growth in the economy. So, roughly speaking, as long as the additional wealth produced each year (GDP growth) allows for the interest on government debt to be repaid, there is no danger. The danger arises if interest rates rise more sharply than a country's GDP growth: in this case, the debt inflates by itself, and the only means of stopping its growth is to increase taxation. The Maastricht Treaty sets out 'magic figures' for EU states: limiting their public deficit to 3% of GDP and national debt to 60% of GDP, debt is stabilised because additional GDP growth is supposed to cover the interest payments. The problem arises that Greece, Portugal and undoubtedly other countries are no longer within the Maastricht criteria. This has led the sovereign risk credit rating agencies to ask how these countries will return to a framework of stabilising their national debt. The mathematics have a cold logic: tax rates will have to go up in nearly all OECD countries – particularly in those countries where public deficit exceeds 3% of GDP – without, however, stopping the recovery, since firms, now in the midst of degearing, lack the capacity to refloat the economy. In short, there is very limited room for manoeuvre in formulating economic policy, and this will call for a great deal of cooperation, coordination, courage... and rational calculation!



Revised forecasts

GDP growth 2010

	Mar. 2009	Mar. 2010	Revision
World	1.5%	2.9%	1.5%
USA	0.7%	2.9%	2.1%
Canada	1.4%	2.7%	1.3%
Japan	0.2%	1.8%	1.7%
Euro zone	0.2%	0.7%	0.6%
Germany	0.6%	1.5%	0.9%
France	0.5%	1.0%	0.5%
Italy	-0.1%	0.5%	0.6%
Spain	-0.5%	-0.6%	-0.1%
Netherlands	0.6%	1.0%	0.4%
Belgium	0.4%	1.3%	0.8%
Austria	0.5%	1.4%	0.8%
Finland	1.4%	1.5%	0.1%
Greece	0.9%	-1.7%	-2.6%
Ireland	-0.1%	-1.1%	-1.0%
Portugal	0.3%	0.7%	0.3%
UK	0.0%	0.9%	0.9%
Sweden	1.1%	0.6%	-0.5%
Denmark	0.4%	1.0%	0.6%
Norway	2.0%	1.6%	-0.3%
Switzerland	1.0%	1.5%	0.5%
Central and Eastern Europe	7.8%	9.5%	1.7%
Russia	2.0%	3.0%	1.0%
Asia (excluding Japan)	1.3%	4.8%	3.5%
China	5.5%	7.5%	2.0%
India	5.1%	7.1%	2.0%
Latin America	1.5%	2.4%	0.9%
Brazil	0.9%	3.1%	2.2%
Middle East and Africa	3.9%	4.2%	0.3%

Sources: IHS Global Insight, Euler Hermes forecasts

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