A World Awash in Debts

Joseph E. Gagnon discusses his new study projecting debt levels over 25 years by the United States, Europe, Japan, and emerging markets—and the threat they pose to growth and stability.

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Steve Weisman: The huge overhang of debts in the United States poses a problem for the U.S. economy. But Joseph Gagnon and Marc Hinterschweiger have done a new study of how that problem affects the whole world and whether all these debt crises pose an even greater problem. This is Steve Weisman at The Peterson Institute for International Economics with Joe Gagnon to discuss his new study. Thank you, Joe.

Joseph Gagnon: Thanks, Steve. Good to be here as always.

Steve Weisman: Tell us the main findings of this series of studies of the long–term prospects for mounting debts in mainly the advanced countries of the world.

Joseph Gagnon: That's correct. What this study does is try to look at debt around the world. I think it's the first study that I'm aware of that tries to extrapolate government debts for the whole world. And as you said, what we found is that in the advanced economies--especially the United States and Japan but to some extent in Europe--we see big problems in the future going forward with debt -- less so for the emerging markets.

Steve Weisman: Why less so for the emerging markets?

Joseph Gagnon: The emerging markets didn't seem to have been hit so bad by this financial crisis. They didn't have such big drops in their economies. They bounced back quicker. They didn't have as big fiscal stimulus packages. Their debts actually have declined on balance over the past 10 years, mostly because they're growing so fast. They're growing so fast that their economies are outgrowing their debts. Just to step back, everything is expressed as debt relative to GDP or debt relative to national income, which is one way to think about it.

Steve Weisman: What are the ratios that the United States is approaching on debt to GDP in the coming few years and then down the road? Your projections I think go up to 2035.

Joseph Gagnon: Yes, we go 25 years.

Steve Weisman: How do they grow if no policy changes are enacted?

Joseph Gagnon: For the United States: if we recover and stimulus is allowed to expire but no additional actions are taken, we see net debt for all governments in the United States, including states and locals, rising from about 67 percent of GDP last year to something around 70 percent in five years and around 90 percent in ten years. And then going forward, over 200 percent by 2035. So the real pick up happens between 10 and 25 years out.

Steve Weisman: As a companion to your study, the institute is publishing a new study by Carmen Reinhart and Kenneth Rogoff, suggesting that 90 percent is like a flashing red light.

Joseph Gagnon: We don't take a stand. We don't have a strong view on that. We have assumed the debt is harmful no matter along the way.

Steve Weisman: I didn't mean to ask you about another study. But I think you say that when the 90 percent debt-to-GDP ratio is reached in a decade, that's the time when you start to worry about the ability to finance it, or about its effect on growth or other problems that might arise.

Joseph Gagnon: We don't see any magic threshold. We do look roughly at certain ranges, but without any sort of magic number. We have seen countries around 200 percent of GDP debts in the past, but those were in extraordinary circumstances after the end of a war, in which the debt was expected to fall dramatically going forward. And so we don't think a 200 percent GDP deficit is sustainable without a crisis.

Steve Weisman: You mean, debt.

Joseph Gagnon: Debt, right. We then look at, well, what is sustainable? And we see that Italy and Belgium sustained 100 percent of GDP debts for a long time without a crisis. So, we think 100 percent GDP would be sustainable. But if markets thought that we were at 100 percent and only going up, that would be very different from if we're at 100 percent and flat or even falling.

Steve Weisman: You do see it going up without other changes.

Joseph Gagnon: We do see it going up. You can't really say that there's a magic number in terms of how the market will react because we just don't know how the market will react. And it all depends on what the market thinks the political system will do. So when we use numbers like 100 percent of GDP that's not meant to indicate that that's a magic line.

Steve Weisman: Still you advocate policy adjustments to address the deficits and the debt. You don't specify them, of course, but you say some actions need to be taken. But you also say that this consolidation shouldn't occur immediately. What's the logic of that?

Joseph Gagnon: We think it's very important that the recovery be firmly established. It's still in the early stages. It's been very weak, extraordinarily weak. The last thing we need right now is to kill the recovery. So we don't want budget cuts this year or even next year.

Steve Weisman: Or tax increases presumably?

Joseph Gagnon: Yes, or spending cuts or tax increases: not a good idea now. But what is a good idea now is to make concrete plans, legislative steps that are credible and hard to unwind, for gradual cuts that build in over time to address this problem. And that actually has benefits because it gives everyone more confidence about the future, which can really help.

It may forestall further increases in interest rates. And there may be many components to the ultimate solution to the problem. You know, given the length of time it may take to negotiate all this, starting sooner is definitely better.

Steve Weisman: My problem -- it's not that I disagree with you--is why would anyone be impressed if Congress this year enacted tax or spending changes to take effect two years from now. Why would any markets be impressed that that wouldn't be rescinded in two years?

Joseph Gagnon: I think we're actually fortunate in the United States, compared to a parliamentary system in that, well, actually markets are somewhat impressed. If Congress agrees -- and typically to get the agreement you need something like 60 votes in the Senate, and you have to get both bodies to agree -- then you have to get the President to agree. And so you get three different parties all to agree--one of which needs a supermajority nowadays to agree--on some course of action, it is very difficult to overturn that in the United States system.

And unlike a simple parliamentary system where only a 51 percent majority is needed and there's no second branch of government, that kind of thing isn't credible. In the United States it is credible. It's not perfectly credible. It's conceivable a future President and Congress could agree to rescind it, but it takes an unusual combination of events to do that. And that's why I think we actually can be credible in the U.S.

Steve Weisman: One other interesting and perhaps even surprising conclusion in your study is that the debt situation in Europe is perhaps less dire compared to the American one. That would seem to contradict a lot of the talk that you hear. Tell me a little bit about that.

Joseph Gagnon: Yes, and honestly that was perhaps the most surprising thing to me in this study, the reason being that we think that aging is more rapid in Europe than in the U.S. And that Japan stands out as the worst case is no surprise to anyone.

Steve Weisman: Japan is worse even than the United States?

Joseph Gagnon: Even than the United States. But the fact that Europe is better is a little surprising. And I think it reflects two things: one is a real thing, which is that they really have taken some serious measures to address their deficits concretely and legislated and already taken hold.

Steve Weisman: And your study took those into account?

Joseph Weisman: Yes. We rely on the IMF's judgment on this, but it's their latest judgment as of January of this year. [The study] includes most of anything that was legislated last year in Europe. There are still future things going on that the IMF had to make a judgment about. But the forces in Europe seem to be stronger pushing towards fiscal consolidation. Some of it has already happened. The French and the Spanish and the Greeks have actually legislated long, future changes in their retirement plans, which have actually happened. So that kind of thing, you know, seemed to matter.

The other thing is that we're relying on the judgment of the OECD and the IMF, two international institutions, as to how the systems that differ across country will interact with aging. And they have actually come up with an assessment that the situation is somewhat less dire in Europe even though the aging is stronger. And I don't fully understand the basis of that.

Steve Weisman: It could be the health care costs of dealing with an aging population.

Joseph Gagnon: Indeed it is. The health care is generally not forecasted to rise as much in Europe as I would have expected given the aging in Europe, and I don't fully understand that. I know that some of the work in Europe I think has actually blithely ignored the cost effects of technology. But I think the OECD and the IMF, having a multi country perspective, haven't ignored that. But I'm not sure why they are so optimistic. I actually don't know the answer.

Steve Weisman: This idea that debts are mounting all over the world in the developed world and somehow if nothing is done, there's going to be a crisis because there aren't enough savings in the world to support the financing of that debt. And we're talking 25 years down the road. But we're also talking about economic theory. Some economic theories suggest that they're always going to be savings. Would you explain that a little bit to me?

Joseph Gagnon: We tend to think that the market will work this out. If government demands more peoples' savings, interest rates will go up. If interest rates go up that means that some people will save more, and there'll be more savings supplied. It also means that other people, businesses, and people who are home buyers will borrow less to build houses or to build factories and stuff. And that means the economy will be, you know, somewhat poorer as a result.

The whole system equilibrates through higher interest rates and in some sense, we're poorer and we also save more. It's a question of how high interest rates have to go to get that result. And at what point do people rebel against the high interest rates or taxes required to service the debt. And then you get a fiscal crisis.

Steve Weisman: Well, congratulations on your study, Joe, which contributed a lot of information to this debate.

Joseph Gagnon: You're welcome.