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Into the valley of debt

Sep 25th 2003

From The Economist print edition

Budget finances in emerging economies are in worse shape than in the developed world

INTERNATIONAL organisations such as the IMF and the OECD are constantly lecturing rich-country governments about their hefty debt burdens. Yet governments in many emerging economies have been even more profligate. In most developed economies, with the notable exception of Japan, public debt has fallen as a percentage of GDP since the mid-1990s. In emerging economies, however, the average debt ratio has risen sharply and now exceeds that in the richer economies.



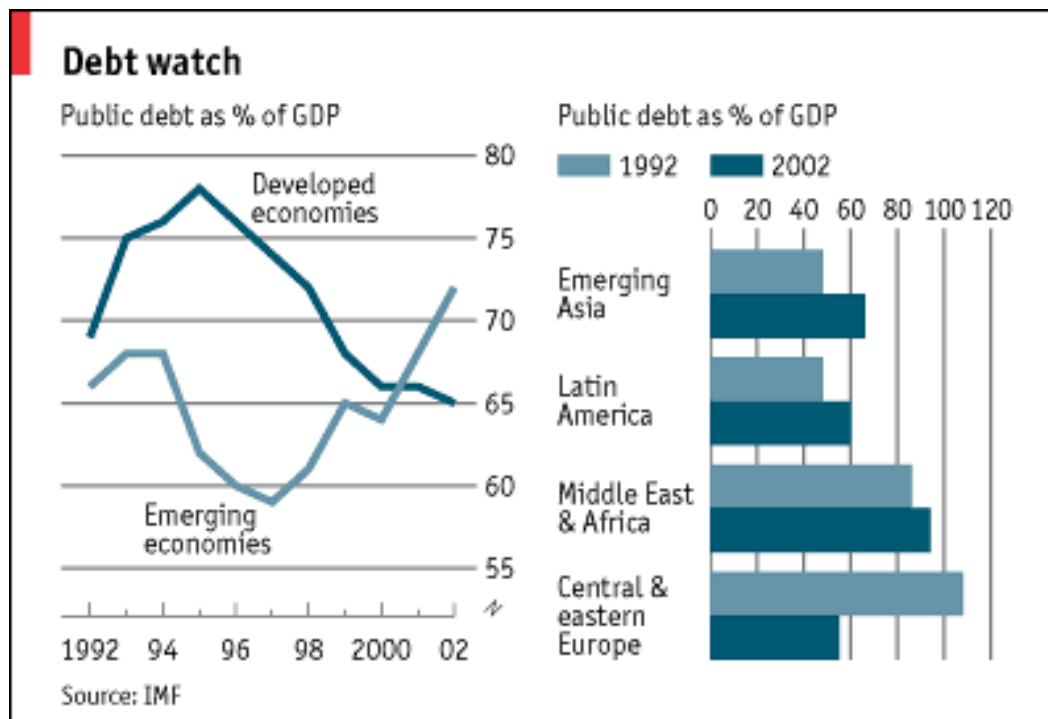
There are some good reasons for a government to borrow. If the money is used to finance better infrastructure, education or health, it can boost a country's growth rate. On the other hand, excessive public debt can push up interest rates, crowd out private investment or limit the scope for a fiscal stimulus when an economy stumbles. Worst of all, it can lead to default.

A study* in the IMF'S latest *World Economic Outlook* considers whether emerging-market governments have borrowed too much. Public debt in emerging economies amounted to an average of 71% of GDP at the end of 2002, compared with an average of 65% of GDP in developed economies (see chart). Asia and Latin America have seen the sharpest increases in debt ratios over the past decade. In the Middle East and Africa, the average ratio has increased less markedly, but is over 90%. Debt ratios have fallen in central and eastern Europe.

No rich country has defaulted on its public debt since the second world war, but defaults have been far from rare in emerging economies. This has led many economists to argue that, because of their poor credit history, the level of sustainable public debt in emerging economies is lower than in rich economies. Indeed, in over half of all sovereign debt

defaults in the past 30 years, public debt was less than 60% of GDP—the ceiling for government debt in the euro area set by the Maastricht treaty.

There are some striking differences in the structure of budget finances in emerging and developed economies. The first is that government revenue amounts to an average of only 27% of GDP in emerging economies (compared with 44% in rich economies) as a result of inefficient tax systems and bigger black economies. This means that debts loom much larger in relation to tax revenues. Revenues are also more variable in emerging economies because of their bigger economic ups and downs. Another difference is that interest payments are almost twice as high as a share of GDP as in rich countries. They are also more volatile, because in poor countries foreign-currency and short-term debt make up a larger share of the total.



The IMF's study uses three different methods to assess whether emerging economies' public debt is sustainable. One popular gauge is the future path of debt to GDP if governments hold their primary budget balances (ie, excluding interest payments) at existing levels. Worryingly, most emerging economies' current budget positions imply ever-rising debt ratios. Another approach focuses on the relationship between debt and changes in the primary budget balance. Emerging-market governments tend, on average, to do much less than those in rich countries to increase their primary surpluses when their debt ratios rise. The authors suggest that because rich-country governments behave as if they have a stronger commitment to keeping their debts under control, they can allow budget deficits to widen in a recession without alarming lenders. But because lenders often doubt the ability of many emerging economies to adjust their budgets to maintain debt sustainability, they quickly get jumpy when deficits widen. This can force governments to slash spending in a downturn, worsening economic weakness.

As a third test, the IMF asks whether a government's debt exceeds the present discounted value of its expected future primary surpluses (based on the average of recent years). If so, the debt is likely to be unsustainable. Using this rule, the study suggests that the sustainable public-debt ratio for a typical emerging economy is only about 25% of GDP, compared with 75% in developed economies. That is well below the current average debt ratio. A weak revenue base, plus an inability to control spending during economic upswings, means that emerging-market economies can generally only sustain lower public-debt ratios than rich economies. They need to run bigger budget surpluses to put their finances on an even keel.

The inevitability of debt and taxes

How can governments slim their debt? The IMF looks at 26 cases during the past three decades in which emerging economies' debt has declined significantly. Of these, 19 involved default, which limited governments' subsequent ability to borrow and thus cramped growth. In the other seven cases, debt ratios were reduced by fiscal restraint. For instance, Chile cut its public debt from 54% of GDP in 1990 to 21% at the end of last year by cutting spending, broadening its tax base and clamping down on tax avoidance, and through privatisation. The rewards have been huge: Chile enjoys lower interest rates than other Latin American countries, and its uninterrupted access to capital markets has helped to support economic activity through downturns.

However, the IMF finds that most of the recent increase in emerging-market government debt has been due not to bigger primary budget deficits, but to large swings in exchange rates and interest rates. Emerging economies need to reduce their reliance on foreign-currency and short-term debt to make interest payments less volatile. Another interesting idea suggested by the IMF economists is that governments could issue bonds on which the interest payments would be linked to a country's growth rate: the faster the rate of growth, the higher would be the interest rate paid in any year. If growth slowed, interest payments would fall, providing a useful cushion in times of economic stress. It is an idea well worth further consideration.

* "Public Debt in Emerging Markets: Is it Too High?": available on the internet at www.imf.org/external/pubs/ft/weo/2003/02/pdf/chapter3.pdf