

## Developed economies' debt weighs down recovery

Global economic update: June 2010

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The global economy generally looks to be on the mend, but sovereign (country) debt continues to threaten the fragile recovery.

Since the downturn in late 2008 and early 2009, an increasing number of countries are now registering positive quarterly growth along with a notable recovery in international trade and global industrial production.

### Banks reluctant to lend

Despite more encouraging growth figures, recovery is not uniform and conditions for sustained growth remain fragile. Credit conditions remain tight, and many major financial institutions are continuing to limit their lending.

### Governments cut back on spending

In May, the European sovereign debt crisis threatened to tip the global economy back towards recession. However, a 750 billion-euro rescue package from the EU (European Union) and IMF (International Monetary Fund) for debt-burdened governments stabilised the situation, at least in the short-term. High-deficit countries including Greece, Spain and Portugal will be forced to make massive deficit cuts. Less stringent deficit cuts in the better-off nations such as Germany and France will most likely also follow. Tighter fiscal policies could restrict growth in many European economies.

### Fragile euro threatens Central and Eastern Europe

The debt crisis could put pressure on EU members in Central and Eastern Europe as well as on Central European countries such as Poland and the Czech Republic whose economies are closely linked to the performance of the euro. Delays in adopting the euro in these countries will put further pressure on their economies.

### Government debt rising substantially

Concerns over government fiscal balances are not confined to Europe. The average gross general government debt-to-GDP (gross domestic product) ratio for advanced economies is projected to rise from almost 91% of GDP at the end of 2009 to 110% of GDP in 2015. Among the G7<sup>1</sup> countries, the government debt-to-GDP ratio is expected to rise to higher levels than those that followed the Second World War.

Japan remains the world's most indebted government with a debt-to-GDP ratio of 227.1% in 2010. Greece is in second place at 133.2%, Iceland third at 119.9%, Italy fourth at 118.6%, and Belgium fifth at 100.1%. The only developed country that has managed its finances prudently is Australia.

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<sup>1</sup>Canada, France, Germany, Italy, Japan, United Kingdom, United States

Government finances in Australia are in excellent shape with government debt-to-GDP at only 19.8%, having only recently moved into a fiscal deficit.

### Governments living beyond their means

The increase in government debt is probably most noticeable in the United Kingdom and the United States, but there have also been large increases in other countries such as Japan and most of the advanced European economies. It is fairly common for advanced countries to blame the increase in debt on a fall-off in tax revenue, especially during the Great Recession. However, the data tells a different story.

For example, in the UK the ratio of government revenue to GDP was 37.9% in 2000, while in 2009 it had fallen modestly to 36.4%. That is hardly enough of a decline to explain the huge increase in debt and the current fiscal deficit. In contrast, the UK's government expenditure rose from an acceptably high 30.2% of GDP in 2000 to a massive 42.9% of GDP in 2009. Just like consumers, governments in some advanced economies have been living beyond their means for many years, partly in an effort to retain power.

### Emerging economies are better managed

In contrast, the debt-to-GDP ratios in emerging economies are projected to start declining gradually from 38.0% in 2010 to an estimated 34.2% in 2015 due to sustained economic growth and relatively low interest rates. The same trend applies to low-income countries, which include many African economies.

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