Viewpoints
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How to Handle the Sovereign Debt Explosion

By Mohamed El-Erian

Every once in a while, the world is faced with a major economic development that is ill-understood at first and dismissed as of limited relevance, and which then catches governments, companies and households unawares.

We have seen a few examples of this over the past 10 years. They include the emergence of China as a main influence on growth, prices, employment and wealth dynamics around the world. I would also include the dramatic over-extension, and subsequent spectacular collapse, of housing and shadow banks in the finance-driven economies of the US and UK.

Today, we should all be paying attention to a new theme: the simultaneous and significant deterioration in the public finances of many advanced economies. At present this is being viewed primarily – and excessively – through the narrow prism of Greece. Down the road, it will be recognised for what it is: a significant regime shift in advanced economies with consequential and long-lasting effects. To stay ahead of the process, we should keep the following six points in mind.

First, at the most basic level, what we are experiencing is best characterised as the latest in a series of disruptions to balance sheets. In 2008–2009, governments had to step in to counter the simultaneous implosion in housing, finance and consumption. The world now has to deal with the consequences of how this was done.

US sovereign indebtedness has surged by a previously unthinkable 20 percentage points of gross domestic product in less than two years. Even under a favourable growth scenario, the debt-to-GDP ratio is projected to continue to increase over the next 10 years from its much higher base.

Many metrics speak to the generalised nature of the disruption to public finances. My favourite comes from Willem Buiter, Citi's chief economist. More than 40% of global GDP now resides in jurisdictions (overwhelmingly in the advanced economies) running fiscal deficits of 10% of GDP or more. For much of the past 30 years, this fluctuated in the 0%–5% range and was dominated by emerging economies.

Second, the shock to public finances is undermining the analytical relevance of conventional classifications. Consider the old notion of a big divide between advanced and emerging economies. A growing number of the former now have significantly poorer economic and financial prospects, and greater vulnerabilities, than a growing number of the latter.

Third, the issue is not whether governments in advanced economies will adjust; they will. The operational questions relate to the nature of the adjustment (orderly versus disorderly), timing and collateral impact.

Governments naturally aspire to overcome bad debt dynamics through the orderly (and relatively painless) combination of growth and a willingness on the part of the private sector to maintain and extend holdings of government debt. Such an outcome, however, faces considerable headwinds in a world of unusually high unemployment, muted growth dynamics, persistently large deficits and regulatory uncertainty.

Countries will thus be forced to make difficult decisions relating to higher taxation and lower spending. If these do not materialise on a timely basis, the universe of likely outcomes will expand to include inflating out of excessive debt and, in the extreme, default and confiscation.

Fourth, governments can impose solutions on other sectors in the domestic economy. They do so by pre-empting and diverting resources. This is particularly relevant when there is limited scope for the cross-border migration of activities, which is the case today given the generalised nature of the public finance shock.

Fifth, the international dimension will complicate the internal fiscal adjustment facing advanced economies. The effectiveness of any fiscal consolidation is not only a function of a government's willingness and ability to implement measures over the medium term. It is also influenced by what other countries decide to do.

These five points all support the view that the shock to balance sheets is highly relevant to a wide range of sectors and markets. Yet for now, the inclination is to dismiss the shock as isolated, temporary and reversible.

This leads to the sixth and final point. We should expect (rather than be surprised by) damaging recognition lags in both the public and private sectors. Playbooks are not readily available when it comes to new systemic themes. This leads many to revert to backward-looking analytical models, the thrust of which is essentially to assume away the relevance of the new systemic phenomena.

There is a further complication. Timely recognition is necessary but not sufficient. It must be followed by the correct response. Here, history suggests that it is not easy for companies and governments to overcome the tyranny of backward-looking internal commitments.

Where does all this leave us? Our sense is that the importance of the shock to public finances in advanced economies is not yet sufficiently appreciated and understood. Yet, with time, it will prove to be highly consequential. The sooner this is recognised, the greater the probability of being able to stay ahead of the disruptions rather than be hurt by them.

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Mohamed El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO at the end of 2007 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, *When Markets Collide,* was a New York Times and Wall Street Journal bestseller, won the Financial Times/Goldman Sachs 2008 Business Book of the Year and was named a book of the year by The Economist. Dr. El-Erian has served on several boards and committees, including the US Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

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