Can we emerge from our current debt trap?

Governments around the globe have incurred staggering levels of debt in order to deal with the COVID-19 crisis over the past year. Professors Jordi Gual and Pedro Videla look at how we might dig ourselves out from under it.

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The United States, Europe, China, Japan... The world's largest economies have increased their public debt burdens by an average of 25% over the past year. To fight the COVID-19 crisis, China has borrowed up to 50% of its GDP and the United States has become as indebted as it was back in World War II.

Professors Jordi Gual and Pedro Videla, speaking to IESE alumni in an online session, offered a stark portrait of global public-sector debt. "We have never seen anything like this in a peacetime era," Videla said. "We are facing humongous debt."

Even before the pandemic hit, public-sector debt had been on the rise in many developed countries. In order to smooth out the ups and downs of economic cycles, governments have generally been spending more than they brought in since sometime around the 1980s -- a situation that spiked during the Global Financial Crisis of 2007-08.

But this 40-year-long debt spree culminated in COVID-19. When the pandemic hit, governments began more debt-financed spending to fight the illness and keep their economies afloat -- at the same time as their growth rates plummeted. That has sent debt levels through the ceiling -- they now average 120% of GDP in developed countries.

So, will the post-vaccination growth surge that many countries are hoping for be enough to revert the situation? "The higher the level of debt that you have, the harder it is to think that you'll be able to get out of debt with growth," said Gual, who recently rejoined the IESE Economics Department after serving as chairman of the Spanish financial services group CaixaBank.

Adding a fresh layer of concern is the fact that the main buyers of the debt over the past year are the world's central banks, effectively increasing the money supply and keeping interest rates unusually low and even negative. Borrowing is essentially free in most advanced economies.

Lessons from the past, tools for the future

Gual looked at some of the tools and policies that have been used in the past to manage debt, including: economic growth; primary budget surplus; moderate inflation; financial repression (government policy that caps interest rates); restructuring and default; or a combination of a number of them.

Even if those tools have been used in the past, Gual noted, it's unclear whether they will be used in the present or future. Super-charged growth is difficult in countries with large debts to service. Creating budget surpluses may require disciplined austerity, which tends to be highly unpopular socially and politically -- and may also undermine growth. Domestic inflation wouldn't help countries with portions of their debt in foreign currencies (as is the case for economies in the Eurozone), and inflation behavior has confounded economists for 20 years. And financial repression is tough in countries with full capital mobility.

Restructuring and default can't be ruled out -- though it's hardly the recipe for long-term economic health. "This sounds a bit surprising but it happened in the past, it happened in Greece, and it may happen in the future," said Gual.

That means any solution will likely involve a battery of measures -- plus, almost inevitably, higher taxes, both Videla and Gual said. But regardless of the complexity of the task, governments must make reducing the debt one of their priorities going forward.

What's next (and what's not)

Europe doesn't currently have the resources to end its run of unusually low interest rates. Only the United States has that capacity, but it is unlikely that it would raise rates, because it would shake up the markets, making investors nervous.

Regarding the theory that countries with their own currencies can issue as much money as they need to pay off their debts, with inflation as the only limit, Gual dismisses that idea as absurd.

And regarding inflation fears, there hasn't been a meaningful bout of inflation in advanced economies over the last 20 years, probably due to downward pressures from globalization and technological advances. However, both IESE professors note that previous crises saw money injected into the banking system, not into the public's wallets. In the United States, President Biden's recent COVID-19 relief measures have already reached citizens directly. It remains to be seen if that fiscal stimulus will translate into rising product prices, as we have seen rising asset prices in the markets there. Monitoring the risk of bubbles is important, Gual and Videla warned, because bubbles could damage the economy in the long term.

In Spain, a tax hike looks inevitable, although it will weigh on the national economy, which is plagued with low productivity. Gual noted the importance of designing taxes efficiently to avoid unwanted distortions.

Regardless of the complexity of the task at hand, governments must reduce debt and lift themselves out of the debt trap. As Gual concluded: there is no other choice.