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Opinion Article

Debt risks in global financial crises

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DESCRIPTION

The rise in debt is most noticeable in industrialised nations, where public debt has risen from roughly 70% of GDP in 2007 to 124 percent of GDP in 2020. In the same time period, private debt increased at a slower rate, rising from 164 to 178 percent of GDP. Public debt currently makes up about 40% of total global debt, the largest proportion since the mid-1960s. The two big economic crises that governments have faced—first the global financial crisis, and subsequently the COVID-19 pandemic—are substantially to blame for the surge in public debt since 2007.

Debt dynamics, on the other hand, vary greatly between countries. In 2020, advanced economies and China contributed for nearly all of the $28 trillion debt increase. Low interest rates, central bank activities (including substantial purchases of government debt), and well-developed financial markets allowed these countries to grow public and private debt during the epidemic. Most emerging economies, on the other hand, are on the other side of the finance gap, with restricted access to capital and frequently higher borrowing rates.

As COVID-19 grew in size, fiscal imbalances in advanced economies grew as countries suffered revenue declines due to the crisis and undertook sweeping austerity measures. In 2020, public debt increased by 19 percentage points of GDP, similar to the growth observed during the global financial crisis in 2008 and 2009. Private debt, on the other hand, increased by 14 percentage points of GDP in 2020, about twice as much as it did during the global financial crisis, highlighting the two crises' distinct natures. Governments and central banks supported private sector borrowing during the outbreak to help save lives and livelihoods. During the global financial crisis, the objective was to limit the harm caused by the private sector's excessive leverage.

Emerging markets and low-income developing countries had substantially tighter funding limitations, albeit there were significant differences across countries. China was responsible for 26% of the global debt increase. Emerging markets (excluding China) and low-income nations each contributed roughly $1–$1.2 trillion to the global debt increase, owing to increasing public debt.

Nonetheless, due to the huge drop in nominal GDP in 2020, both emerging markets and low-income nations are confronting high debt ratios. In developing markets, public debt hit new highs, while in low-income nations; it reached new highs not seen since the early 2000s, when many people benefited from debt relief programmes

A delicate balancing act

The massive debt rise was justified by the necessity to safeguard people's lives, keep their employment, and avert a wave of bankruptcies. The social and economic repercussions of governments failing to act would have been disastrous. However, when finance circumstances tighten, however, debt accumulation exacerbates vulnerabilities. In most situations, high debt levels limit governments' ability to assist recovery and the private sector's ability to invest in the medium term. In a situation of high debt and increasing inflation, finding the correct combination of fiscal and monetary policy is critical. During the worst of the epidemic, fiscal and monetary policy thankfully complimented one other. Interest rates have been pushed lower by central banks, particularly in industrialised economies.

The focus of monetary policy has shifted to growing inflation and inflation expectations. In certain circumstances, an increase in inflation and nominal GDP can assist lower debt ratios, although this is unlikely to result in a considerable reduction in debt. Borrowing costs grow as central banks boost interest rates to combat persistently rising inflation. Many developing market policy rates have already risen and are anticipated to climb higher. Central banks in industrialised nations are likewise preparing to cease their huge purchases of government debt and other assets, but how they do so will have ramifications for economic recovery and fiscal policy.

Fiscal policy will need to change when interest rates increase, especially in nations with larger debt vulnerabilities. Fiscal support, as history has shown, becomes less effective when interest rates rise, implying that increased spending (or lower taxes) would have less of an influence on economic activity and employment.

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