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The Dreaded Four Ds

Markets and economic conversations around the world have been dominated by the dreaded four Ds: the risk of a "double-dip", deflation, or default. In its latest World Economic Outlook (WEO)publication (available at http://www.imf.org/external/pubs/ft/weo/2010/02/index.htm) and a Staff Position Note (available at http://www.imf.org/external/ns/cs.aspx?id=236) the IMF puts these fears in perspective and generally concludes that the risks of the four Ds are manageable, without being sanguine about remaining challenges to the outlook. Yet another D plays a central role in the arguments: the deficit.

Regarding the possibility of a "double-dip" to growth, in its latest WEO the IMF notes that the global recovery is proceeding broadly as expected, but in an unbalanced manner: sluggish in advanced countries, but much stronger in emerging and developing countries. The world economy is forecast to grow by 4.8 percent in 2010 before falling back to 4.2 percent next year, but a sharper global slowdown is unlikely. Indeed, the analysis suggests that risks for a sharp global slowdown, including a double dip in advanced economies, over the coming year still appear low. Such a scenario would entail two percent or less global real GDP growth over the coming year, comprising zero percent growth in the advanced economies and about four percent growth in the emerging and developing economies. According to the WEO, the probability of global growth falling below 2 percent is less than 5 percent.

Although a double-dip therefore appears unlikely, the risks to the forecast are mainly to the downside and a sustained, healthy recovery rests on two critical rebalancing acts: internal rebalancing, from public to private sectors in advanced economies, and external rebalancing, from surplus to deficit countries. For the advanced economies, repair and reform of the financial sector needs to accelerate to allow a resumption of healthy credit growth. In addition, fiscal adjustment needs to start in earnest in 2011. Specific plans to cut future budget deficits are urgently needed to create new room for fiscal policy maneuver in the face of still volatile sovereign debt markets and to help achieve sustainable fiscal positions before the end of the decade. This task is now more pressing than it was six months ago. For external balancing, strong international cooperation is essential, with agreement on the degree of burden sharing among advanced countries and emerging markets as well as a practical enforcement mechanism.

Although concerns about the potential for future high inflation in advanced economies have been lingering in the background, as evidenced for example in record gold prices, under present circumstances, deflation is the more pertinent risk. The reason is that risks to activity are clearly to the downside as noted above: households remain saddled with appreciable debt; the financial system remains vulnerable; and expectations could gradually catch up with—the much more benign—actual inflation, putting further downward pressure on prices and wages.

Judging by the IMF staff's deflation risk indicator, deflation risks have recently risen again to a high level, although they remain below the peaks reached one year ago. How households behave will crucially depend on how policymakers roll back large public deficits. Mistakes could cause a long period of deflation or low inflation and disappointing economic growth.

Regarding default, the state of the public finances has worsened substantially in the main advanced economies as a result of the 2008–09 global financial crisis. For some "peripheral" European countries, market participants and some commentators occasionally seem to believe that default (some form of debt restructuring) will sooner or later inevitably occur. Concerns about fiscal solvency in those countries have been reflected in financial market pressures, large default risk premiums on sovereign bonds, and downgrades by rating agencies. In general, volatility remains high and every auction of government paper—especially in Europe, including in the largest countries—is closely monitored to discern possible triggers of abrupt market reactions.

The main arguments put forward by these market commentators point to the size of the required fiscal adjustment and continued market concerns reflected in government bond spreads. Instead, after analyzing the top ten advanced economies ranked by needed fiscal adjustment (France, Greece, Ireland, Italy, Japan, Netherlands, Portugal, Spain, United Kingdom, and United States) a recent IMF Staff Position Note concludes that defaults in these economies are unnecessary, undesirable, and unlikely.

This stark conclusion centers around the fact that the challenge stems mainly from the advanced economies' large primary deficits, not from a high average interest rate on debt. Default would do little to reduce the deficit and would still require major fiscal adjustment. In contrast, the economies that defaulted in recent decades did so primarily as a result of high debt servicing costs, often in the context of major external shocks.

Indeed, although large, the fiscal adjustment required is historically not unprecedented and, even with a restructuring, a defaulting country still needs to run a primary surplus (as it will be shut out from borrowing for a while). In the past, the problem of defaulters had been the high interest burden, which is not the case for advanced economies today as the maturity of government debt is relatively long. In addition, the share of nonindexed, domestic currency debt is higher in advanced economies compared to emerging market defaulters of the past and a significant share of the debt is held by domestic residents and banks (making default unattractive from a political-economy perspective as well). For today's advanced economies, real interest rates are generally lower as well and the projected interest-growth differential is smaller too, implying less adverse debt dynamics going forward. Furthermore, emerging economy defaulters were hit by major increases in the debt ratio as a result of their currencies' nominal depreciations associated with their crises. In contrast, in euro area countries, a real depreciation would have to be attained through internal deflation, which would be less abrupt and imply a smaller increase in the debt-to-GDP ratio. Finally, although fiscal adjustment is detrimental to growth, the effects of a hypothetical debt restructuring on some sectors of the economy (in particular the banking system) would be even more severe.

More importantly, a restructuring would be no substitute for, and would probably end up as a distraction from, the fiscal and structural reforms that are truly necessary for a durable increase in economic growth.

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