

Editor's Letter

Testing Debt Limits

FOR YEARS, policymakers have treated government debt like an elastic band that could be stretched without ever snapping. They stretched during the global financial crisis and again during the COVID-19 pandemic. Today, with public debt exceeding annual economic output in several major advanced economies, the question is: How much stretch is left for the next crisis?

Mounting debt is causing concern across the world, and with good reason, as we explore in this issue. Debt levels in several advanced economies are the highest ever reached in peacetime, driving up borrowing costs for governments and consumers alike. Rising debt and high interest rates present policymakers with difficult choices: Raise taxes, cut spending on essential services and benefits, stoke inflation—or delay the reckoning by borrowing even more and praying markets won't impose too high a premium.

All this is making the trade-offs inherent in fiscal policy increasingly tough to manage, write the IMF's Era Dabla-Norris and Rodrigo Valdes. As societies age and economies slow, pension and health care costs are rising faster than tax receipts. In many of the advanced and emerging parts of the world, these costs are borne by a shrinking workforce.

How did debt reach such dizzying levels? Considering the United States, Alan Auerbach points to growing political polarization, which blocks the bipartisan consensus required for unpopular but needed steps, like tax increases or spending cuts. In a similar vein, Alan Blinder laments the clash between economists, with their focus on efficiency, and politicians, who can't see beyond the next elections. Politicians and economists must learn to speak each other's language, he says.

Excess saving—by the rich in advanced economies and by China overall—is fueling debts and deficits to sustain economic growth, Atif Mian says. But this “indebted demand” growth model is inherently fragile, he writes.

Fixing public finances will be difficult but not impossible, write Zsolt Darvas and Jeromin Zettelmeyer. They estimate the size of the adjustment needed in advanced European economies, including France and Germany, and conclude that well-calibrated steps, such as reforms to enhance economic growth and entrench fiscal discipline, can put debt on a sustainable path without sacrificing



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investment for the future. Greece, Ireland, and Portugal all faced severe fiscal crises 15 years ago—and are now paragons of discipline, they note.

Those are positive examples. And yet today's fraught geopolitics heightens the risk of supply disruptions that threaten stagflation and ultimately put more pressure on government finances, write Giancarlo Corsetti and Leonardo Melosi. Focusing on the relationship between fiscal and monetary authorities, they advance the provocative view that sustainable adjustment will likely require pragmatic tolerance of periods of above-target inflation.

While that may not appeal, neither do the alternatives. There are few elegant, easy, or politically attractive ways to reduce debt. At the same time, “fixing public finances is not about indiscriminate austerity,” write Dabla-Norris and Valdes. History shows that people are more likely to accept painful reforms if they believe the burden is shared fairly. In that spirit, they suggest measures to make government finances more transparent, which would in turn build public trust and bridge gaps between what's politically possible and technically feasible.

Daunting as all this is, hope can be found in innovation—the next wave of technological advances could revive global growth and shrink debt burdens. Still, we cannot wait for that day to begin managing debt wisely. Discipline is urgently required. The alternative, as our contributors show, is a growing risk of economic turmoil and erosion of faith in government. **F&D**

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