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Perspectives on Global Debt
Part I: Aggregate Picture

This report brings together data on global debt trends from several sources along with various arguments on the implications of these trends. Debt is neither entirely dangerous nor entirely beneficial. When incurred to cushion cyclical downturns, it's largely beneficial so long as it's not overdone. Beyond this cyclical situation, the debt picture today is mainly benign, with historically low interest rates and low debt service burdens in most countries. Governments, households, and corporations have taken advantage of this favorable environment to issue debt for multiple purposes, both private and public.

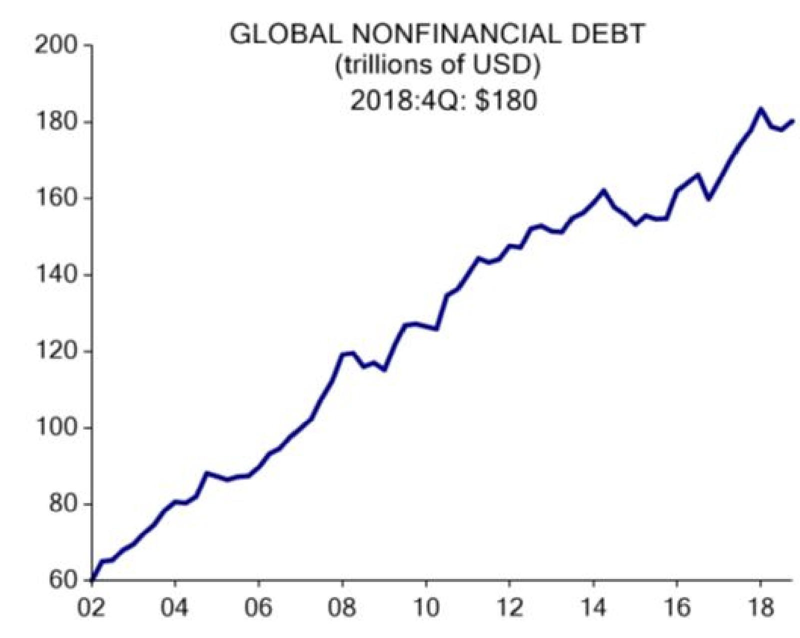
But if history is any guide, the large increases in debt relative to GDP will at some point lead to repayment/replacement problems of maturing debt; defaults will increase too. The exact timing of such a change in the financial environment cannot be predicted with any accuracy, nor can the precise trigger(s) for such a change be known in advance. But when the change comes, it is likely to happen rapidly and without much warning.

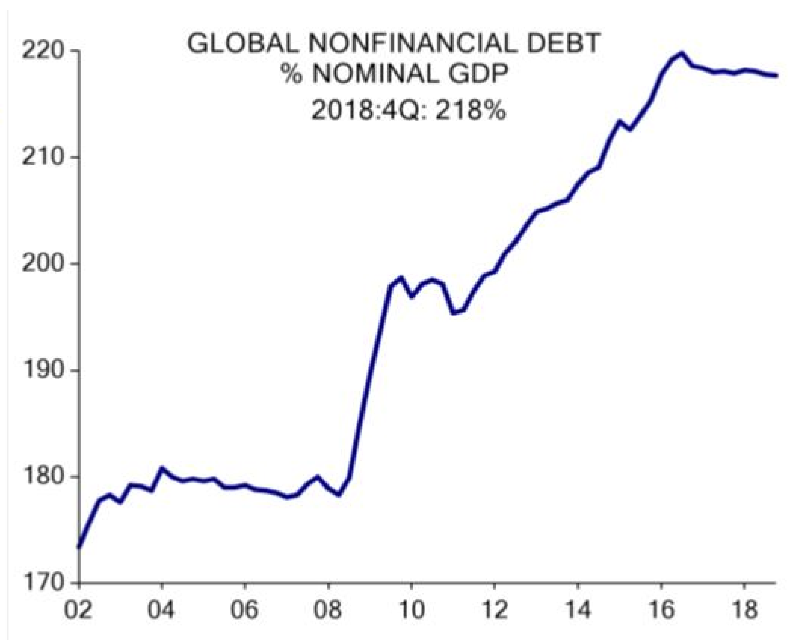
- Global Debt Has Tripled in 15 Years
- U.S. Nonfinancial Debt 250% Of GDP
- Debt Has Grown In Both DVs And EMs
- Composition Of Global Debt By Sector: Biggest Concerns Are In Corporate Sector.
- Debt In Foreign Currency Is Up Sharply And Is Always Very Risky
- Bond Yields Are Extremely Low
- DV Debt Service Ratios Are Low
- EM Debt Service Ratios Show A Mixed Picture
- Consequences Of Rapidly Rising Debt

Global Debt Has Tripled in 15 Years

Since 2002, global nonfinancial debt -- which comprises debt of govts, households, and nonfinancial corporations -- has tripled, from $60t to $180t. The increase has been much faster than global GDP, so debt % GDP has risen from 173% to 218%. A short interval of deleveraging in 2009-2010 in the aftermath of the Financial Crisis and Great Recession has given way to re-leveraging over the past eight years.

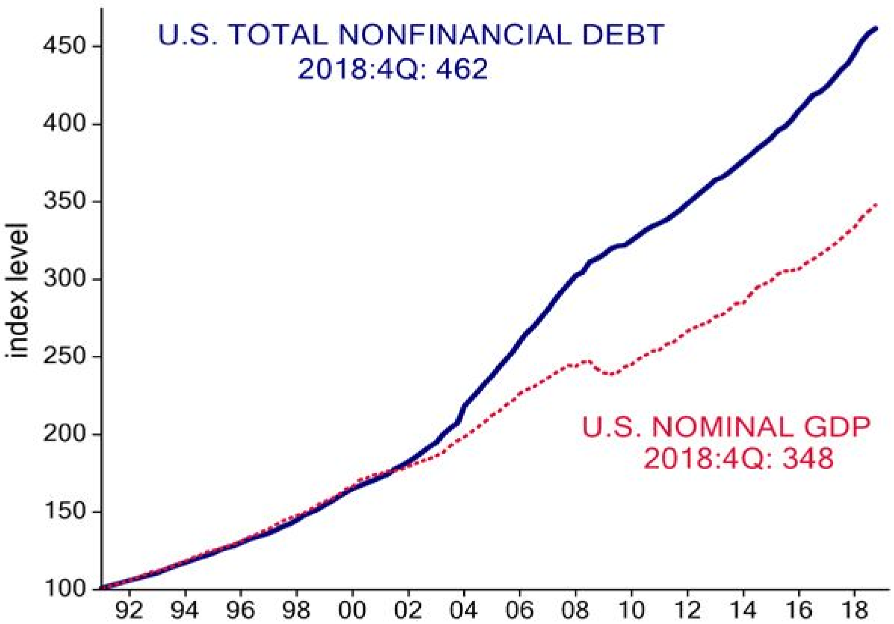
Right now debt is easy to issue and service. But at some point in the future, this rapid increase is likely to create problems via asset bubbles and/or inability to refinance/service the debt.

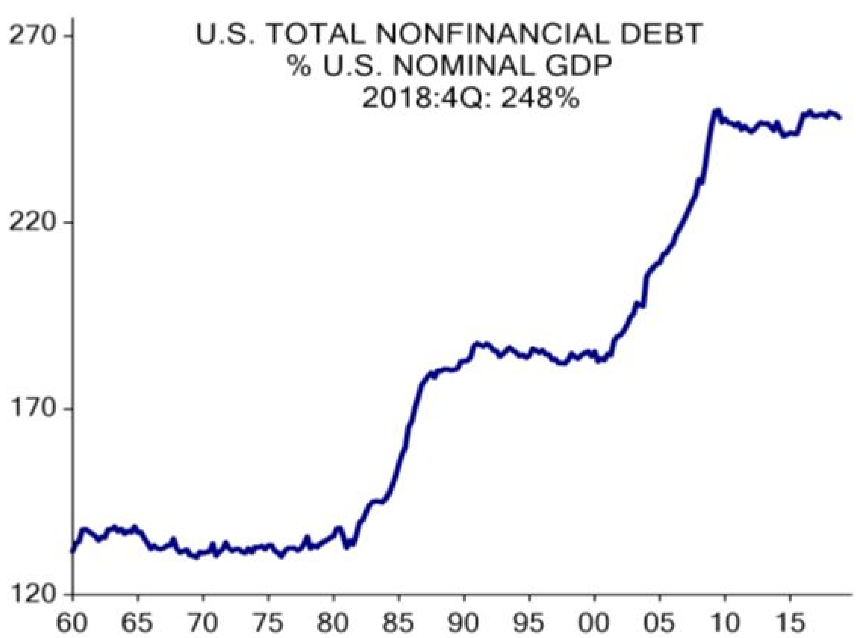




Source: BIS

U.S. Nonfinancial Debt 250% Of GDP



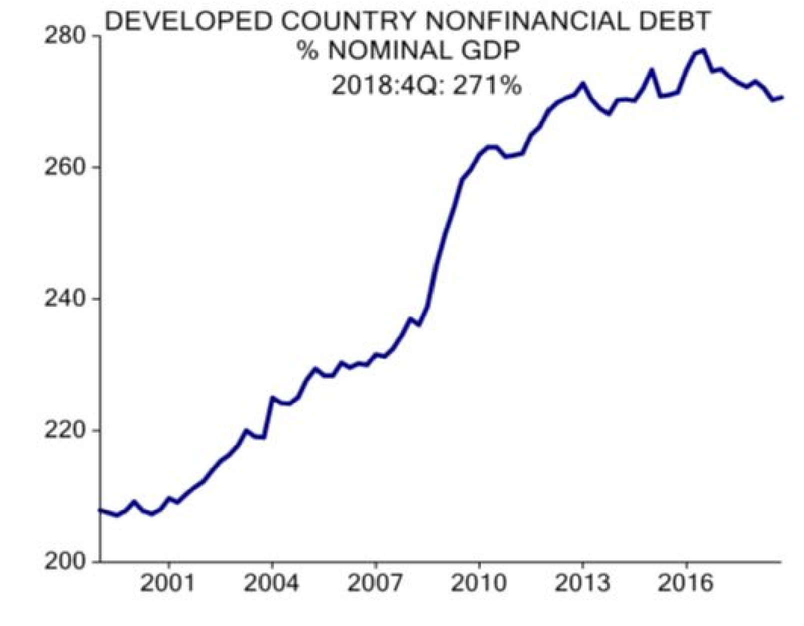


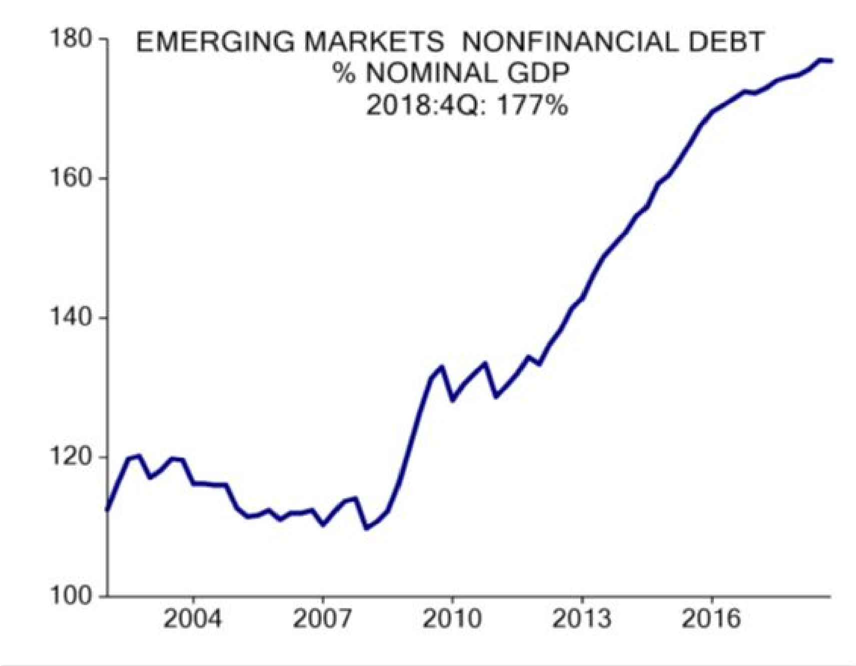
Source: Financial Accounts of the U.S.

The global debt data from BIS are only available back to 2001. To obtain a longer perspective, data from the Financial Accounts of the United States can be used. Over the period since 1990, nonfinancial US debt has rise by +362% (or +13% per year). Debt has advanced much faster than GDP, which rose +248% (or +9% per year). So debt has increased much more than what would be necessary to finance GDP.

An even longer perspective on the relationship between debt and GDP reveals that the ratio of the two was relatively constant from 1960 through 1980 (at about 135%), then rose sharply from 1980 to 1990. Another plateau prevailed through 2003 (at about 185%), followed by a further sharp acceleration that occurred over 2003-2010. Then during 2010-2018, the ratio again flattened out, this time at close to 250%.

Debt Has Grown In Both DVs And EMs



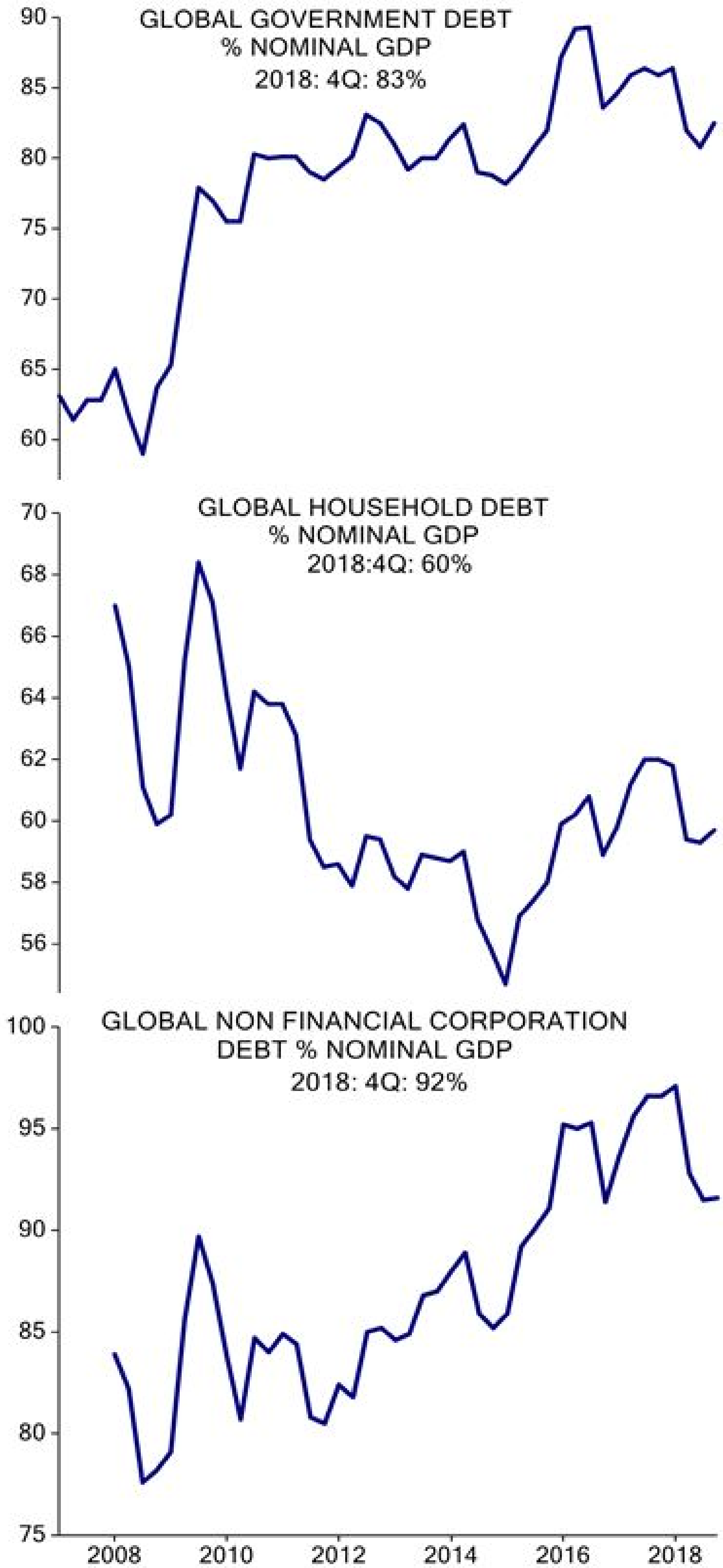


Source: BIS

Debt has risen relative to GDP in both Developed and Emerging Market economies over the past 20 or so years. But there are some important differences between them:

- Debt % GDP is much higher in DVs than in EMs.
- But since about 2010, the debt ratio in EMs has risen much faster in than in DVs.

Composition Of Global Debt By Sector: Biggest Concerns Are In Corporate Sector.



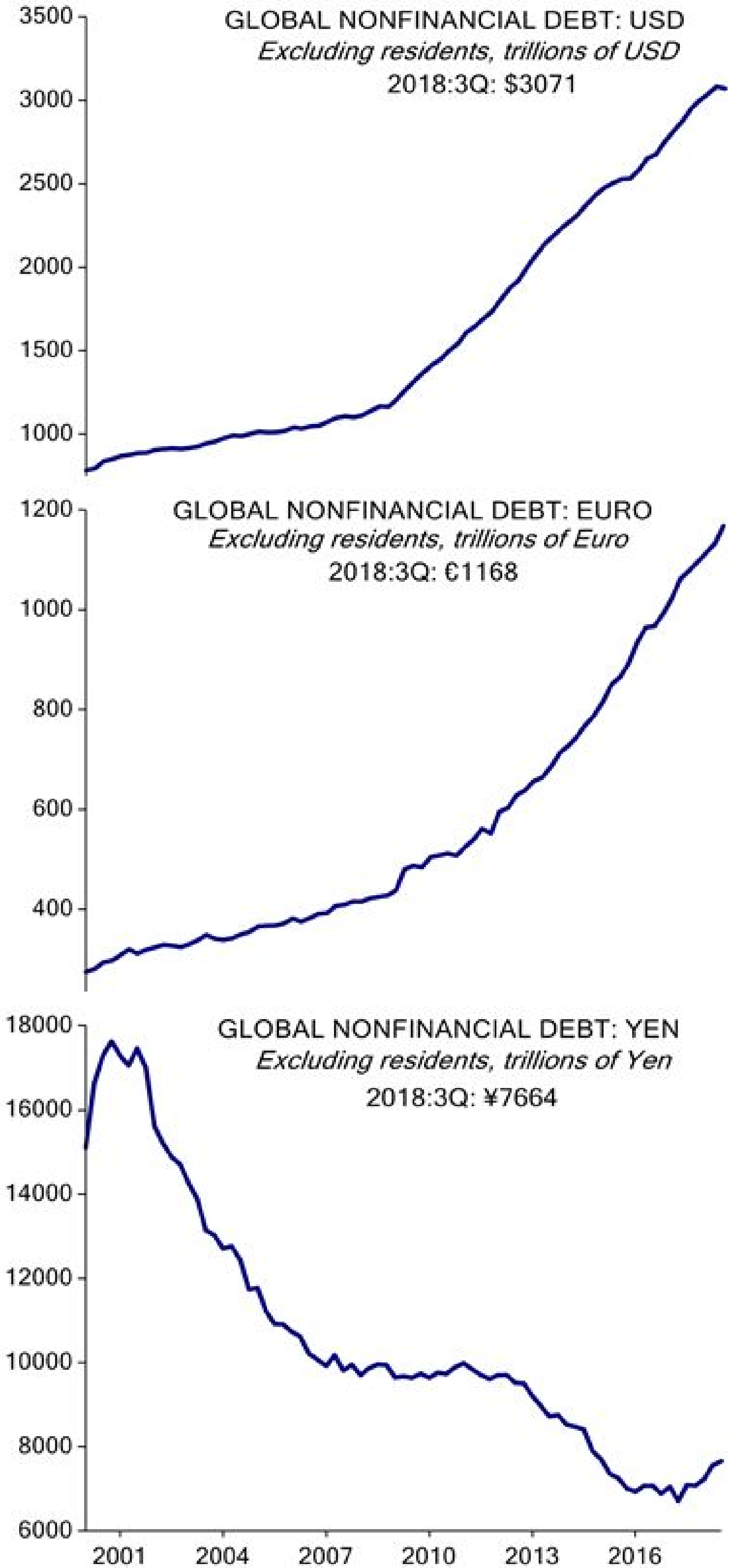
Source: BIS

The three major components of global debt have traced out quite different patterns over the past decade: govt debt % GDP rose sharply during the global recession (especially in 2009), but since 2011 has fluctuated with little net change.

Household debt % GDP declined sharply in the aftermath of the global recession, reaching a low in 2014-2015; since then there has been an upturn, yet the current level is below that of a decade ago.

Nonfinancial corporate debt % GDP has been in a rising trend over the past decade, pushed up by the financing of M&A activity and low interest rates. This is likely the sector with the greatest risks (see comments by Powell and Reinhart on pages 10-11).

Debt In Foreign Currency Is Up Sharply And Is Always Very Risky



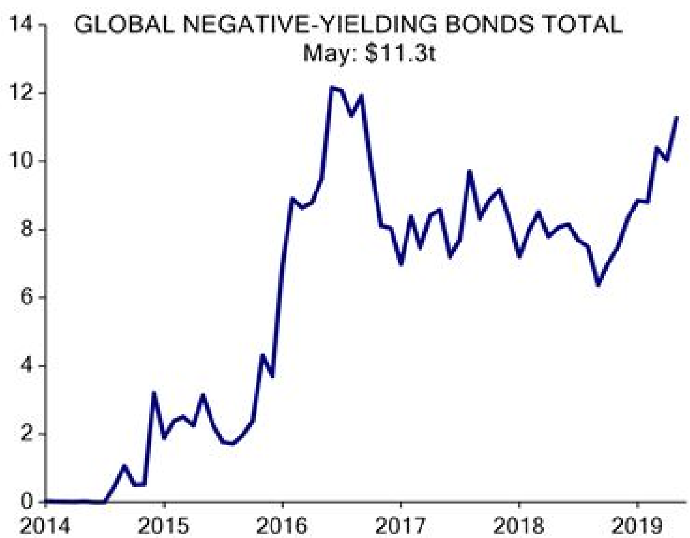
Source: BIS

Debt issued in a foreign currency can cause major problems when -- as often turns out to be the case -- it has to be repaid or refinanced after the currency in the borrowing country has depreciated (see comment by Dalio on page 11).

Most of the foreign currency debt is in dollars, and it has quadrupled since 2000. Euro denominated debt has also grown rapidly.

However, the amount of yen denominated foreign currency debt has declined sharply.

Bond Yields Are Extremely Low

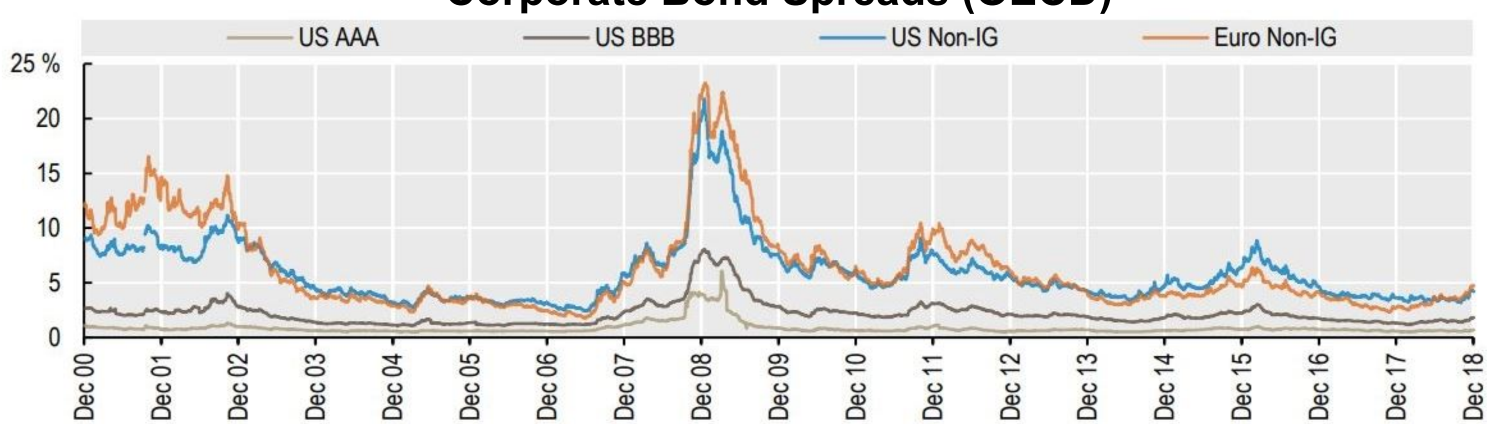


Sovereign and corporate bond yields are at or near historical lows, making debt financing very attractive. Low inflation, accommodative monetary policies, and the search by investors for higher yields are mainly responsible. Partly in response to low yields, equity valuations have increased.

10-year US treasuries currently yield just 2.13% (and the 30 year is 2.62%) while the 10-year yields in Germany and Japan are negative. Around the world, there are $11.3t of debt instruments with negative yields.

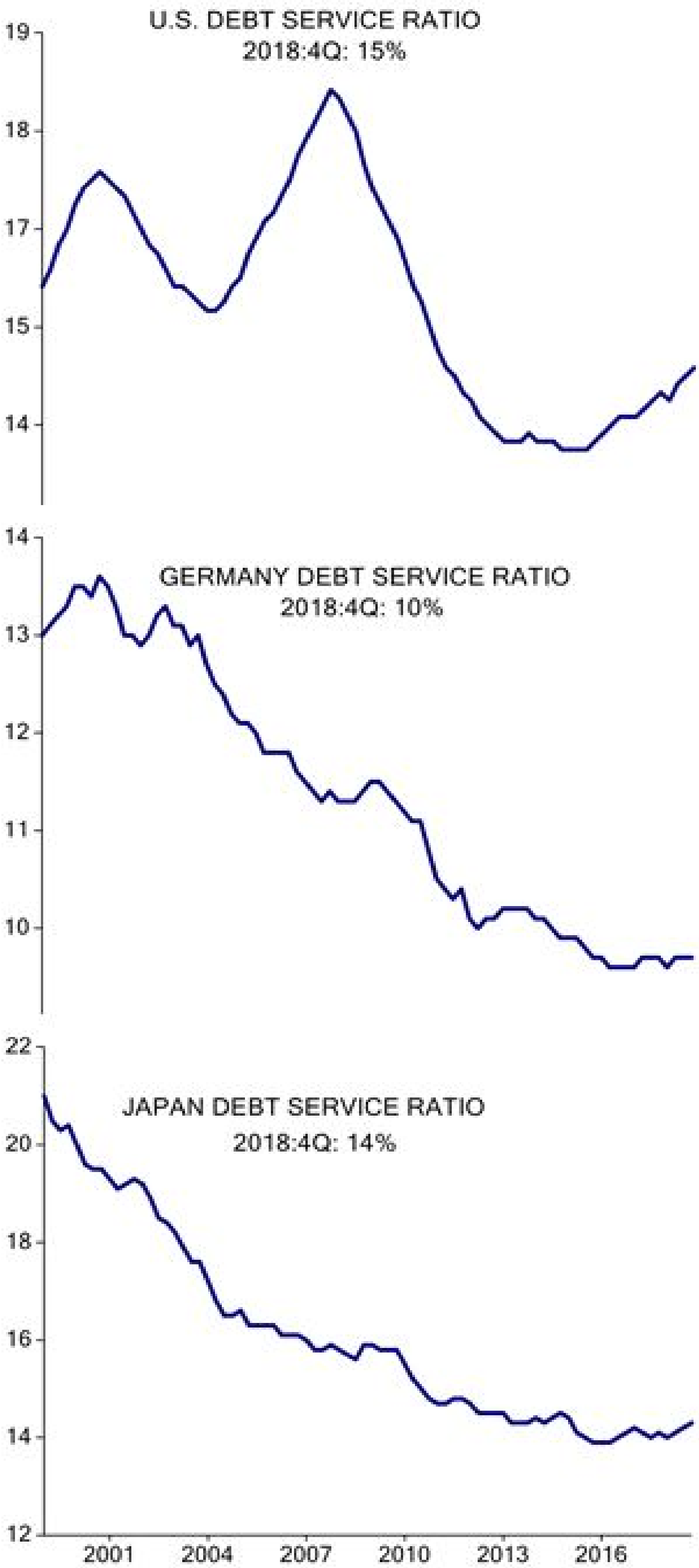
In the corporate sector, the spreads with government bonds are extremely narrow.

Corporate Bond Spreads (OECD)



Source: FRED, Federal Reserve Bank of St. Louis. Based on the indices ICE BofAML US Corporate AAA, ICE BofAML US Corporate BBB, ICE BofAML US High Yield Master II, ICE BofAML Euro High Yield.

DV Debt Service Ratios Are Low

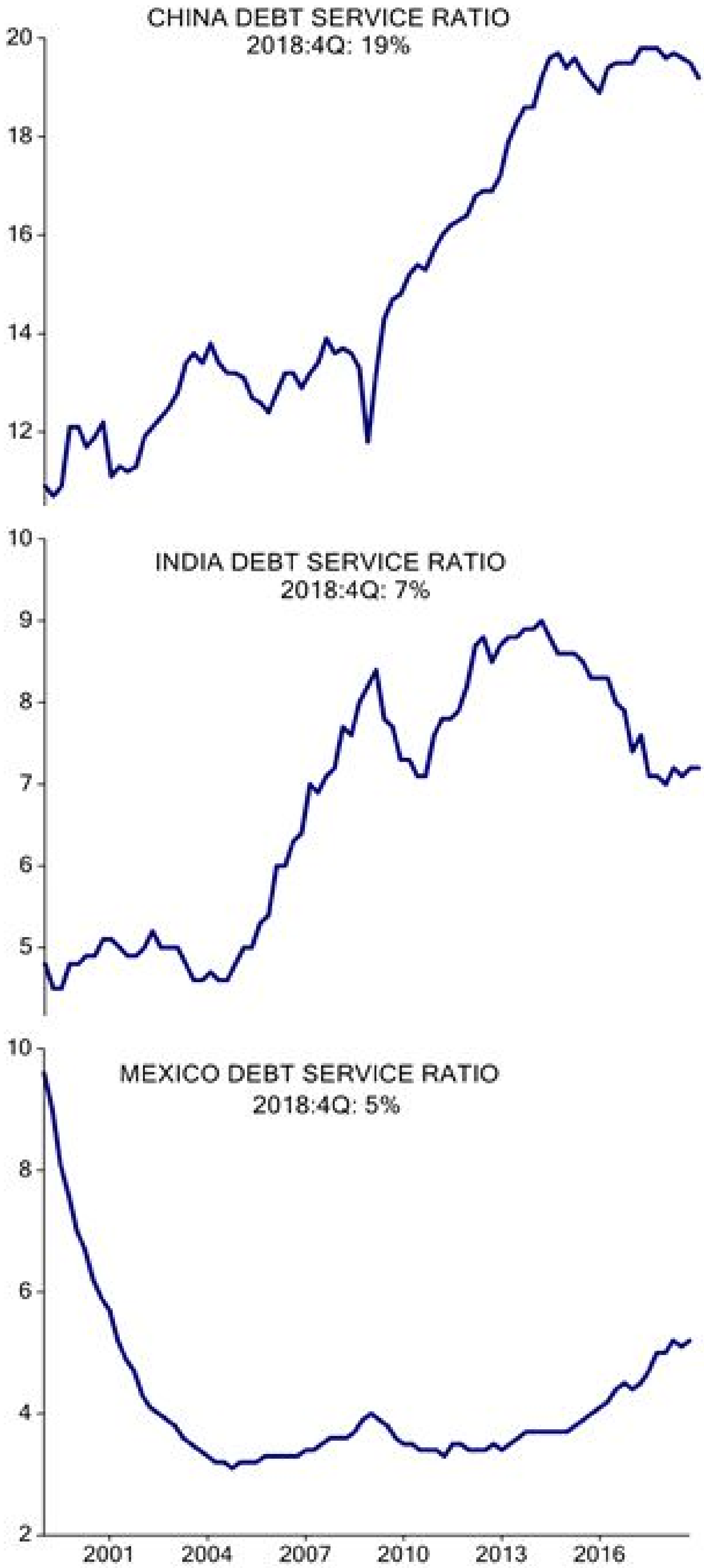


Source: BIS

The debt service ratio (DSR) is interest payments plus amortizations as a percent of income. These ratios for the private nonfinancial sector (nonfinancial corporations and households) are shown in these charts. No aggregate figures are available for the DV sector, so we look at major countries.

Low interest rates make debt service quite low at this time. While the US ratio has moved up some, it is still well below the average since 1999. The same ratios for Germany and Japan are close to their all time lows. These data add to the evidence that debt financing is currently easy/appealing.

EM Debt Service Ratios Show A Mixed Picture



Source: BIS

Debt service ratios (DSR) for the private nonfinancial sectors of EMs (interest plus amortizations as a percent of income) are not as consistently low as they are for DVs.

In China, the DSR has risen from a little more than 10% in 1999 to 19% in 2018:4Q. In India, the ratio increased from close to 5% in 1999 to a high of 9% in 2014 but has since receded to 7%. In Mexico the DSR dropped from over 9% in 1999 to 3.5% in 2004 but has since moved up to 5%. For India and Mexico these ratios suggest financial strength in their private sectors.

Consequences Of Rapidly Rising Debt

There can be both positive and negative consequences when debt and govt deficits increase. Many of the citations below reference US debt, and some are mainly focused on government debt, but the applicability is probably much broader.

Positives:

- When recessions hit, govt deficits rise due to automatic stabilizers and fiscal stimulus.
- Advocates of Modern Monetary Theory believe that increased borrowing is positive as long as inflation is low and borrowing occurs in local currency.
- Several distinguished economists, while not endorsing MMT, contend the US should borrow more in order to build social capital, especially in light of currently low interest rates:
    - Lawrence Summers and Jason Furman argue that more debt financing should be used to fund important social projects: *"Long-term structural declines in interest rates mean that policymakers should reconsider the traditional fiscal approach that has often wrong-headedly limited worthwhile investments in such areas as education, health care, and infrastructure… Politicians and policymakers should focus on urgent social problems, not deficits."*
    - Olivier Blanchard makes a similar argument: *"The levels of debt we have in the US are not catastrophic. We can clearly afford more debt if there is a good reason to do it. There is no reason to panic."* His argument is that when the interest rate on government borrowing is below the growth rate of the economy, financing debt should be sustainable.

Negatives:

The existing economic structure leads to creation of excessive debt and credit. Eventually, the excesses lead to financial crises:

- Adair Turner makes the argument this way: *"The fundamental problem is that modern financial systems left to themselves inevitably create debt in excessive quantities, in particular debt that does not fund new capital investment but rather the purchase of already existing assets, above all real estate. It is that debt creation which drives booms and financial busts."*
- Excessive corporate debt growth is a concern cited by the Fed: Chair Powell sees the current situation with corporate debt this way: *"…(A)s of now, business debt does not present the kind of elevated risks to the stability of the financial system that would lead to broad harm to households and businesses should conditions deteriorate. At the same time, the level of debt certainly could stress borrowers if the economy weakens."*

Consequences of Rapidly Rising Debt

Contd

- Carmen Rinehart notes a specific vulnerability in Collateralized Loan Obligations: *"New issuance activity has shifted to the CLO market, where the amounts of these debt contracts outstanding have soared, hitting new peaks on almost daily basis. These collateralized loan obligations share many similarities with the now notorious mortgage-backed securities of the pre-subprime-crisis era."*

- Ray Dalio emphasizes the problem of debt in a foreign currency: *"Managing debt crises is all about spreading out the pain of the bad debts, and this can almost always be done well if one's debts are in one's own currency. The biggest risks are typically not from the debts themselves, but from the failure of policy makers to do the right things due to lack of knowledge and/or lack of authority. If a nation's debts are in a foreign currency, much more difficult choices have to be made to handle the situation well -- and, in any case, the consequences will be more painful."*

- Alice Rivlin noted US economic management deficiencies: *"Eventually there will be a wake-up call on the growth of U.S. debt. It might be inflation, it might be a crisis of confidence in our government that really convinces people that this country is not managing itself."* And responding to the question: Is there a debt tipping point? *"We don't know. But we shouldn't take too many chances."*

<u>When Will the Negatives Overrun the Positives?</u>

While there is no way to predict when a shift will occur, the history of financial crises suggests it will happen at some point. This warning from Rudiger Dornbusch is worth remembering: *"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."*

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