

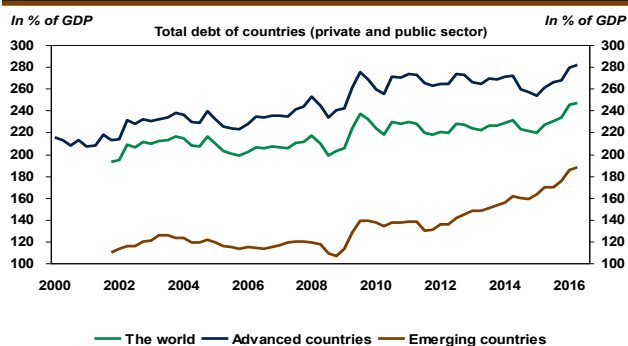
Will the next global crisis once again be tied to excessive debt?

Excessive household debt, especially in the United States, contributed to the financial crisis of 2008–2009. In other countries, government debt was the source of the economic difficulties and financial strains. Moreover, the economic recoveries that follow debt-related crises are usually much slower. The sectors that are overly indebted have to clean up their balance sheets before they can once again start to support economic growth. As 2017 begins, we could think that the deleveraging process is well on its way and that global economic growth now rests on a more solid footing. In light of available data, we have to conclude that this is not the case. While some countries have made noteworthy improvements, the debt issue is still a major problem on a global scale; it also represents a serious risk to future economic growth. This risk is even higher now that the recent uptrend in interest rates could put pressure on borrowers.

WORLDWIDE DEBT BREAKS NEW RECORDS

Based on the data compiled by the International Settlements Bank, the total debt of households, governments and non-financial businesses exceeded GDP by 215% globally in early 2008. This level fell slightly until early 2009, and then it rebounded to 230% within just a few months. After a few years of relative stability, global debt is edging closer to 250% of GDP (graph 1).

Graph 1 – Worldwide debt reaches new heights

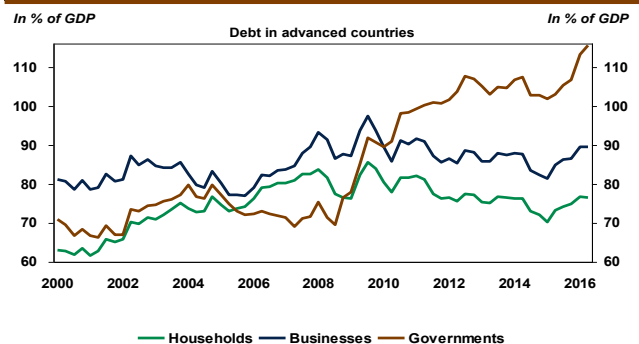


Sources: Bank for International Settlements and Desjardins, Economic Studies

Unsurprisingly, the advanced countries are the most heavily indebted, at about 280% of GDP on average. But the sharper uptrend in the emerging countries is also making them stand out. The most recent data point to an average debt level in these countries of about 190% of GDP.

In analyzing the data per borrower category, we see that debt in advanced countries has risen sharply—for governments—while household and business debt has fallen slightly on average since 2008 (graph 2). Governments have therefore more than offset the deleveraging of households and businesses in advanced countries. The situation was vastly different in emerging countries where business debt tipped the scales (graph 3 on page 2). Household debt also increased in these countries, but to a lesser extent than business debt.

Graph 2 – Advanced countries record sharp increase in public debt



Sources: Bank for International Settlements and Desjardins, Economic Studies

UNEVEN IMPROVEMENTS IN HOUSEHOLD DEBT

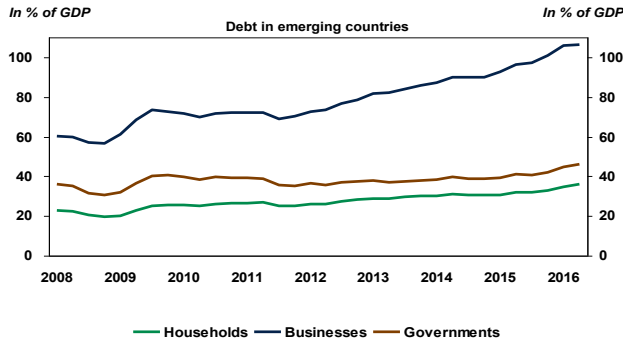
Before the financial crisis of 2008–2009, the debt level of U.S. households was almost 100% of GDP—it is now less than 80% of GDP. This downtrend was recorded in other

François Dupuis
Vice-President and Chief Economist

Hendrix Vachon
Senior Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

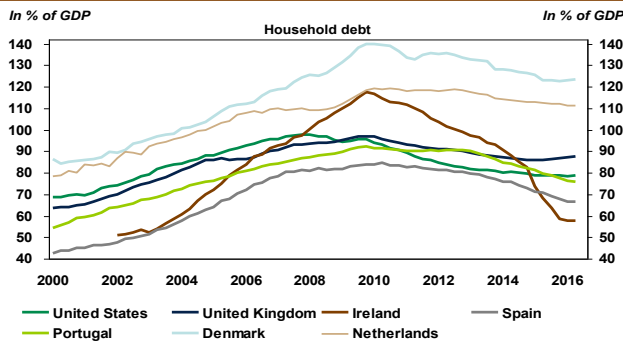
Graph 3 – Business debt dominates in emerging countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

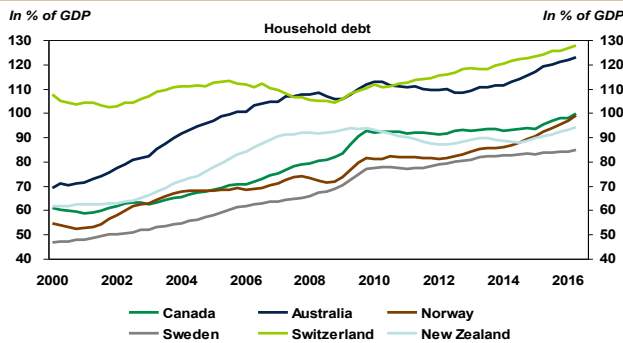
advanced countries (graph 4), while in some cases the complete opposite has occurred (graph 5).

Graph 4 – Household debt rates have fallen in several advanced countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

Graph 5 – While rising in other advanced countries, household debt is nearing or exceeding 100% of GDP



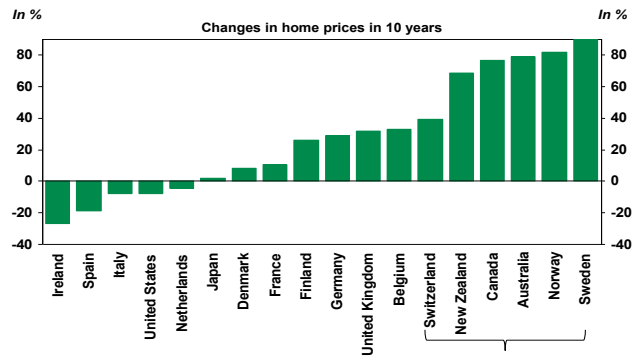
Sources: Bank for International Settlements and Desjardins, Economic Studies

The debt level of households in Canada, Norway and New Zealand is reaching levels seen in the United States before the 2008–2009 crisis. The levels are even higher in Australia and Switzerland, with no reversal in sight. Households in

Denmark and the Netherlands also show high debt levels, but the trend has been falling for the last few years.

The divergences in household debt levels seem in line with changes in home prices (graph 6). This is not all countries that have suffered a price correction in the last 10 years. Household debt could also have been boosted by a healthier economic situation in some countries and where the impact of low interest rates was more effective in stimulating credit.

Graph 6 – Home prices rising faster in countries where household debt is up

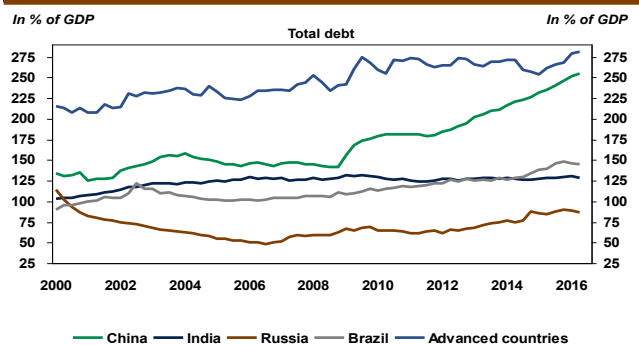


Sources: Bank for International Settlements and Desjardins, Economic Studies

CHINA CATCHING UP TO ADVANCED COUNTRIES

A closer look at the details of the debt uptrend in emerging countries shows that China is a major growth vector in this area. China's total debt is 255% of GDP—much higher than the other major emerging countries and close to the average of advanced countries (graph 7). This level of debt is similar to that in the United States (254.7% of GDP), but it still trails the level of debt in the euro zone (271.2%).

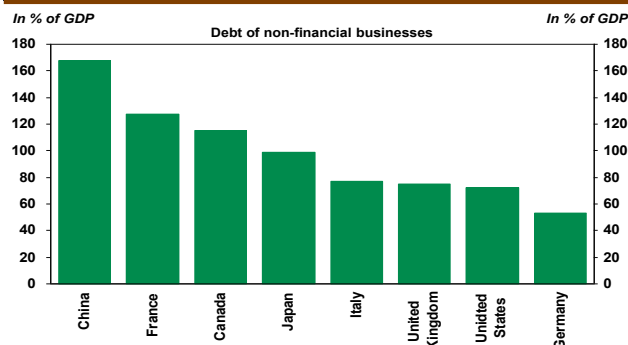
Graph 7 – China driving average debt higher in emerging countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

As is the case with several emerging countries, China's growing debt is primarily fuelled by the private sector, especially businesses. On this score, China has significantly past the G7 countries (graph 8 on page 3). If we add

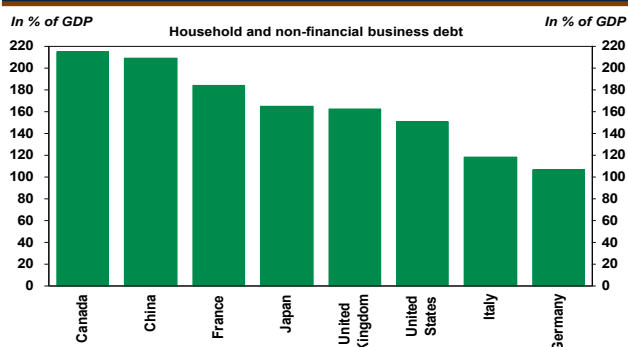
Graph 8 – Business debt in China exceeds levels in G7 countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

household debt to the mix, Canada is just slightly ahead of China—Canada tops of the list of private sector debt among the G7 countries (graph 9).

Graph 9 – Canada tops G7 countries in total private sector debt



Sources: Bank for International Settlements and Desjardins, Economic Studies

A WORRISOME SNAPSHOT

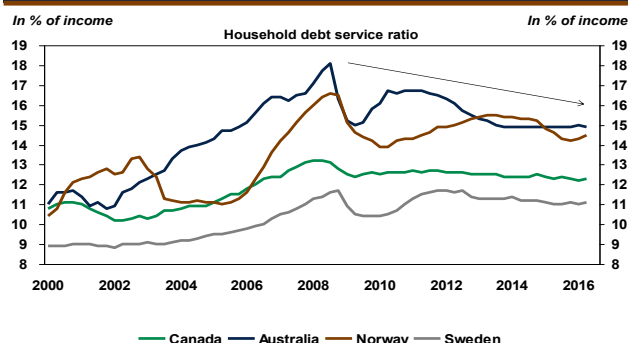
In short, the debt problem has not really been tackled in recent years, it has merely been displaced. Improvements in household balance sheets in the United States and in other advanced countries have been offset by increasing government debt. Private debt has also risen significantly elsewhere around the world, meaning that today other countries are grappling with the risks tied to over-indebtedness, which is once again threatening to destabilize the global economy and the financial markets.

There are no clear debt thresholds that define the tipping point when households, businesses or governments are going to experience financial difficulties and hurt the economy. Still, the European Commission deems that private sector debt becomes problematic when it exceeds 160% of GDP¹. The threshold for governments is 60% of GDP. That said, several countries have had debt levels beyond these

thresholds for several years without necessarily triggering a financial or economic crisis.

We also have to consider the environment in which each country is evolving to assess the sustainability of debt. For example, the emerging countries, which are more inclined to turn to foreign capital for their financing needs, may see investors flee and financial tensions rise at the first sign of over-indebtedness. In contrast, Japan relies very little on foreign capital, which helps it support public debt that exceeds 230% of GDP. The level of interest rates is also important—the lower the interest rates, as has been the case for many years now, the easier it is to support higher debt. Households in Canada, Australia, Norway and Sweden are a prime example of this—the debt service ratios have fallen despite the increased debt carried by these households (graph 10).

Graph 10 – The household debt service ratio has fallen, even in countries where debt has increased



Sources: Bank for International Settlements and Desjardins, Economic Studies

GREATER EXPOSURE TO ADVERSE SHOCKS

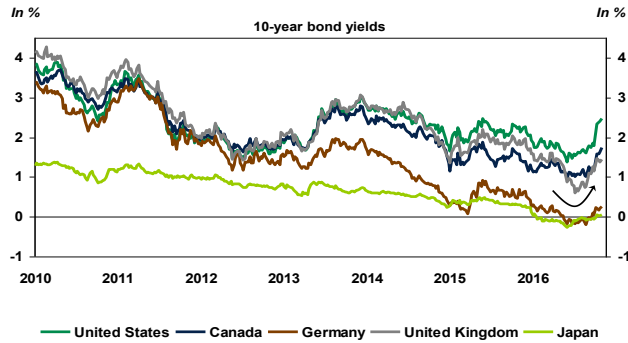
Given that low interest rates help support high debt levels, the recent recovery in interest rates around the world could be a concern (graph 11 on page 4). Many borrowers could find themselves under pressure if this recovery were to grow in scope. High debt levels alone may not trigger a financial crisis and a recession, but they certainly make the economy more sensitive to adverse shocks.

Other than interest rates, a shock could also stem from declining home prices or incomes. The potential rise in protectionism in the United States could also trigger a new

¹ Another threshold of 133% is now used, but the accounting method used for the private sector differs from the method applied by the Bank for International Settlements. The threshold of 160% had been proposed in 2011 as a comparable method.

European Commission, *Scoreboard for the surveillance of macroeconomic imbalances: Envisaged initial design*, Brussels, 2011.
http://ec.europa.eu/economy_finance/economic_governance/documents/swp_scoreboard_08_11_2011_en.pdf

Graph 11 – Bond yields have increased recently



Sources: Datastream and Desjardins, Economic Studies

global slowdown, which the high levels of debt would only heighten further.

During the 2008–2009 crisis, several governments had responded to the slowdown in demand by launching major stimulus programs—one of the reasons behind the run-up in government debt. If a new crisis were to occur today, several governments would not have the same flexibility to increase spending. Acknowledging this powerlessness would also threaten several central banks, and expose the global economy to a sharper contraction. Few central banks currently have significant leeway to lower their key interest rates. Resorting to mass asset purchase policies could still be considered, but the flexibility to do so would be curbed, notwithstanding that stimulating the economy by encouraging credit is more difficult to do when debt is already very high. At best, the central banks could try to buy some time by keeping interest rates low, including long-term rates. On another note, monetary financing—also known as helicopter money—could be more seriously considered, especially if the risk of deflation were to rise. High debt and deflation do not make good bedfellows.

DEBT HAS TO DECLINE, SOONER OR LATER

That indebtedness has continued to rise in the past few years is disheartening. It exposes the global economy to an increased risk of a wide-scale recession in the event of a shock. Genuine debt reduction seems the only long-term solution. In the ideal scenario, this reduction would take place very gradually to minimize the potential negative impacts on economic growth.

Keeping interest rates at low levels could pave the way for this scenario to take shape, but it could also push debt levels even higher at the same time. The actions taken by central banks must be accompanied by other measures designed to limit debt and stimulate growth.

The low pace of growth has not helped improve the debt-to-GDP ratios in recent years. What could prove beneficial is introducing structural measures or support for productive investment to raise the potential for economic growth. The gains would also have to be distributed equally across the population so that everyone would benefit from additional flexibility to reduce his or her debt.

Hendrix Vachon
Senior Economist