Why Worry About Rising Debt?

By Vicky Pryce

There are numerous concerns about whether the recent rapid acceleration in inflation in recent months will put a break to the bounce-back of the world economy in 2022. In the UK the Bank of England just revised its forecast for this year to 3.75%, a sharp cut from the 5% they expected in the autumn[i]. Not only are workers being affected by a cost of living crisis, mainly as a result of higher world energy costs, but higher interest rates will also act as a dampener to growth. However there is extra dimension that will hang over any recovery, possibly limiting its growth – namely the level of accumulated debt, both public and private during the pandemic which may well prove even more of a challenge than the disruption caused by what is now the highest rate of inflation in 30 years.

The global stock of debt rose by some $28trillion to some $230trillion in 2020 according to IMF calculations as governments across the world borrowed to fund the needs of their health services and also to mitigate the recessionary forces of the pandemic[ii]. Private sector debt also rose. This was the second big leap in debt levels in just over a decade when the world was struggling to deal with the 2008/9 financial crisis and its aftermath.

State borrowing has risen to levels as a per cent of GDP that would have been considered completely unacceptable before. Remember the Maastricht treaty stipulated a public sector debt to GDP ratio of no more than 60% . And the traditional IMF mantra had been that anything above 90% debt to GDP level was unsustainable. In that view, the high growth required to service that high a debt was unlikely to be forthcoming -and even it materialised in the short term, certainly couldn't be guaranteed to stay at a high rate for any length of time. And the capital markets would take fright anyway, making any extra borrowing difficult to come by and hastening default.

Well- that has so far been averted and analysts and policymakers are busy re-estimating what are sustainable levels of debt. But the truth is that the stock of public debt will have risen further in 2021 . And this is despite a return to growth, a slowdown in stimulus measures and higher tax receipts as economies started to recover. Lowering debt levels isn't proving easy- either for developed or developing countries. The demands of the health service have remained significant and many economies have needed continued support during their gradual return to normality. This year may see a sharp fall in public sector deficits as a percent of GDP but public debt levels , which in 2020 accounted for 40% of total debt will rise further. And this has concerned the IMF sufficiently for it to be now urging highly-indebted eurozone countries for example to come up with "credible" plans to improve their fiscal positions.

Indeed a paper by the European Central Bank (ECB) in the middle of the pandemic was arguing that although increasing public debt was justified, once the crisis is over, high debt levels could become a source of vulnerability[iii] as countries with high level of debt will inevitably be less equipped to deal with any future crises.

Is the mood of markets changing?

The markets have been prepared to fund debt to GDP levels of some 250% for Japan, just under 200% for Greece, and just below 100% for Europe as a whole [iv] as the debt has until now been secured in the minds of investors against future GDP growth. If that future looks less certain, the markets will turn. Indeed investors are already starting to expect higher yields for committing to continuing to buy bonds- and those central banks that can- i.e. the US and the UK, are in any case already slowing down their quantitative easing(QE) programmes and plan to soon start reducing their overgrown balance sheets. For emerging markets foreign currency denominated debt will start to be more expensive to service. And though inflation may reduce the real value of debt and also bring in bigger nominal tax revenues, outgoings also tend to rise in line , both for current and capital expenditure. Moreover the value of any debt financed in the form bonds which are indexed to inflation also rises.

But the level of private debt accounts for the remainder 60% of the overall global debt stock. Whereas during the financial crisis the focus was on deleveraging and reducing credit availability, during the pandemic the emphasis has been on extending credit and keeping companies afloat, even if some of it was misdirected and, as the UK is discovering, subject to fraud[v]. The result was a 14% rise else in global private debt in 2020 as a whole, which as the IMF estimates was twice the rate during the financial crisis. In the UK even pre Covid crisis private debt had tripled its ratio to GDP over the last 40 years[vi]. And in the ten years to end of 2020, the first year of the pandemic, the market for private debt had increased four times[vii].

We have seen the issues in China with its overindebted property sector and where corporate debt is at some 160% of GDP[viii]. Looking ahead global interest rate increases will bite in many countries. And there are concerns that in highly indebted countries the private sector will be crowded out.

The worry is that the recent turbulence in stock markets reacting to more hawkish central bank pronouncements and downgrades of growth forecasts, may well start affecting the mood in the corporate bond market too. We have already seen investors in the US moving to protect themselves against the likelihood of companies defaulting on their debts[ix]. The question is how will it also reflect on the UK where the outlook is additionally clouded by Brexit concerns as the Public Accounts Committee's report highlighted last week[x].

Vicky Pryce is Chief Economic Adviser and board member at CEBR. she is also a Visiting Professor at BCU and at King's College , London

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[i] https://news.sky.com/story/bank-of-england-raises-interest-rate-to-0-5-12531683

[ii] New Blog: Global Debt Reaches a Record $226 Trillion (govdelivery.com)

[iii] https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2450~e008f3b9ae.en.pdf

[iv] https://worldpopulationreview.com/countries/countries-by-national-debt

[v] https://www.theguardian.com/politics/2022/jan/29/how-the-uk-government-lost-49bn-to-covid-loan

[vi] http://speri.dept.shef.ac.uk/2021/07/07/understanding-britains-private-debt-epidemic/

[vii] https://www.spglobal.com/en/research-insights/featured/private-debt

[viii] https://www.marketwatch.com/story/chinas-slowing-growth-and-massive-debt-threatens-stock-and-bond-investors-worldwide-11634587800

[ix] https://www.ft.com/content/cf1d717a-f3c1-489e-b3ac-c4db2124536d

[x] https://abcnews.go.com/Business/wireStory/watchdog-brexit-brought-cost-red-tape-uk-firms-82769264