

## The Global Debt Dilemma

It should not come as a surprise to investors to hear that the global economy is in a state of heightened debt levels, exacerbated in part by the effects of the Covid-19 pandemic over the last two years. Evergrande, the Chinese property company that has dominated news headlines for several months, is indebted to the degree of \$300bn while the market capitalisation of the company is valued at only \$5bn. The debt crisis, however, stretches far beyond individual companies, or even individual economies, and is now truly a global phenomenon.



### An Insurmountable Debt Mountain

Currently global debt, as measured by the Institute of International Finance (IIF), totals a gargantuan \$296 trillion. For most of us, numbers of this magnitude are simply too large to comprehend. However, to attempt to put that figure into perspective, a stack of 300 trillion \$1 bills would reach to the moon and back over 40 times! If one were to assess the underlying breakdown of this debt figure, it may not come as a surprise to read that the largest contributor is that of government/sovereign debt, measuring just over \$86tn globally. This is followed by non-financial corporate debt at \$85tn, financial sector debt at \$69tn, and lastly by household borrowing at an inordinate \$55tn.

In order to understand global debt on a relative basis one must measure total global debt against total global GDP, that is the total amount of money in the global financial system. Based on the latest debt figure, total global debt is currently 353% of total global GDP. In other words, there is over three times more debt in the world than there is money with which to fund it. What is encouraging, though, is that this figure has actually declined slightly over the last quarter due to the strong economic rebound enjoyed by global markets. We are, however, still up from our pre-pandemic level of 333%, due primarily to the extensively loose monetary policy adopted by central banks to quell the effects of the pandemic. Indeed, the Fed has only this month announced its plans to dial back its \$120bn monthly bond-buying program that has been in place for the last 18 months,

and only by a relatively small \$15bn. Moving forward, the servicing of this global debt should be of primary concern for policymakers, particularly now that the global economy is entering into a rising interest rate environment. Market consensus in the United States, which has enjoyed extremely low interest rates for several years, is for two rate hikes to take place in the next year, both of which will provide headwinds to servicing their debt burden.

At these exorbitant levels the obvious question is why aren't investors panicking, or at the very least taking more notice? The answer to this question is twofold. Firstly, interest rates have been at extremely accommodative levels for a sustained period of time. Many developed central banks, in fact, still maintain negative real rates on debt. This phenomenon has the effect of benefitting those that borrow money while disadvantaging those who choose to save their money. This has encouraged corporations and households to increase their levels of borrowing, or at the very least to spend their money rather than have it lose value in the bank as it earns a negative rate. Secondly, and this is particularly evident with government debt, there is no fixed point in the future when their outstanding debt needs to be paid. As a result, governments and central banks have been able to extend the duration of their debt and prolong the period over which the debt is paid.



### The US Debt Ceiling

As discussed above, most countries in the world run their economies with some form of a budget deficit; the large differentiator being the relative degree to which they stretch that deficit. The US is no different, and as a result is forced to borrow large sums of money each year in order to meet its obligations. In order to contain

these debt levels the US government makes use of a debt ceiling, in theory limiting the total debt it is allowed to accumulate on its balance sheet as it goes about fulfilling its financial obligations. This is in no way a new concept, and was first introduced in 1917 as part of the Second Liberty Bond Act.

It is probably also unsurprising that since its introduction over a hundred years ago, the ceiling has consistently been revised upwards over time, thereby allowing the US government to take on more debt. It is important to note that lifting the debt ceiling doesn't necessarily allow the government to take part in any new spending, instead it gives the US government a margin of breathing room to finance its existing obligations. The current ceiling is set at just over the \$28tn mark, with the latest US debt reading at \$28.8tn. As such, debates surrounding necessity of the Debt Ceiling, and the potential for another upward revision, are gaining momentum in the offshore market. Treasury Secretary

Janet Yellen has made it clear that she would support legislation to abolish the debt ceiling altogether. In a recent statement, Yellen asserted "I believe when Congress legislates expenditures and puts in place tax policy that determines taxes, those are the crucial decisions Congress is making. And if to finance those spending and tax decisions it is necessary to issue additional debt, I believe it is very destructive to put the president and myself, as Treasury secretary, in a situation where we might be unable to pay the bills that result from those past decisions."



## Dealing with the Debt

In order to curtail the current debt trajectory it is evident that drastic measures are required by policymaker across the global economies. Generally, there are four potential paths legislators can take in such scenarios:

- The first option is to significantly increase inflation to erode the value of the debt. High inflation can be referred to as a "soft default" on current government debt levels as the real value of the debt asset is repriced under the new inflation expectations. A drawback of this scenario, however, is that it assumes the debt is held in a country's local currency. If the debt is held in a foreign currency, an increase in inflation will reduce the relative value of the currency and could instead amplify the country's debt burden.
- The second option is to keep interest rates low, or at least below inflation, to mitigate the compounding effects of the debt burden over time. A low interest rate environment, however, has the inborn disadvantage of reducing the returns of savings and fixed income investments. Furthermore, a low interest rate scenario is unlikely given that the global economy is entering into a rising-interest rate environment.

- A third alternative is that of debt forgiveness, whereby the lending country writes off the debt obligation and essentially sets the borrowing country free from any commitment. Such events, while uncommon, have occurred at points in history in order to avoid an outright political or social explosion. These outcomes, however, are generally packaged with many clauses and conditions, but may become necessary to avert social disaster.
- The fourth and final path policymakers can take is that of mass defaults and financial crises, much like that of the international debt crisis of 1982.

Before one falls into despair we would do well to remember that there is a final scenario which involves consistently and significantly increasing GDP growth over time while reducing the levels of debt taken on. This will effectively reduce the debt to GDP ratio of a country whilst simultaneously bolstering growth. Whilst history has proven this outcome to be unlikely, it should be the commanding objective for all policymakers going forward if we are to avoid a very-present debt crisis.

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