A False Sense *of* Global Security?

Follow the debt to the next financial crisis.

By Desmond Lachman

In the 1976 movie *All the President's Men, Washington Post* reporters Bob Woodward and Carl Bernstein were advised to follow the money if they wanted to find the real source of the Watergate cover-up. One has to wonder whether something similar might not be said about the next global financial crisis. If one wants to determine the next such crisis, one might be well advised to follow the debt, since normally, the primary source of financial and economic crises is over-indebtedness in the economy.

Following the debt today should dispel any complacency about the world economic outlook. According to a recent McKinsey study, in the seven years since the bursting of a global credit bubble that resulted in the worst world financial crisis since the Great Depression, overall global debt has increased by around US$60 trillion, or by some 17 percentage points of global GDP. As a result, rather than reducing indebtedness, today practically all of the world's major economies have higher levels of overall borrowing relative to GDP than they did in 2007.

Of particular concern has to be the over-indebtedness in key regions of the global economy. Among the more vulnerable of these regions is the formerly rapidly growing emerging market economies, which went on a borrowing binge in the up phase of the international commodity price cycle. These economies now account for around 40 percent of world GDP and until very recently were the major engine of global economic growth. Since 2008, corporate indebtedness of the emerging market economies has more than doubled to around US$23 trillion. This makes that debt market approximately the same size as the U.S. high-yield

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debt market, which underlines its potential to destabilize global financial markets.

More troubling yet, as the Bank for International Settlements keeps reminding us, is the fact that over the past seven years, these emerging market corporations have increased their U.S. dollar-denominated indebtedness by over US$3.25 trillion. This makes the emerging market economies particularly vulnerable to crises, especially at a time when their currencies have plummeted and they are being hit hard by a major international commodity price bust. It also does not help matters that a number of key emerging market countries such as Brazil and Russia are in the grips of very deep economic recessions.

It also has to be of major concern that non-financial enterprises in China, the world's second-largest economy, have gone on a borrowing spree of epic proportions. It is estimated that over the past seven years, the debt of these enterprises increased by a staggering 90 percent of China's GDP. This rate of credit expansion is very much more rapid than the private sector credit expansion which preceded the bursting of the Japanese credit bubble in the late 1980s or that which occurred before the bursting of the U.S. housing bubble in 2006. This has to raise concerns about an eventual credit market bust in China, since historically it is difficult to find countries that have escaped such credit market busts even with credit bubbles on a much smaller scale than that in China.

It also is hardly comforting that sovereign debt-to-GDP ratios in the European economic periphery, and in key European countries such as Italy, remain at troublingly high levels. This is all the more the case considering the fact that European politics now appears to be fragmenting and that European banks continue to hold a disproportionate amount of their countries' sovereign debt on their balance sheets. In this

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Corporate indebtedness of the emerging market economies has more than doubled.

China Credit Bust?

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—*D. Lachman*

Shanghai skyline.

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context, it might be recalled that Italy's banking system is already on a shaky footing, while its sovereign debt market, at more than US$2 trillion in size, is the world's third-largest government bond market.

High levels of global indebtedness might not be a matter of major concern in the context of a rapidly growing world economy and of one that is not beset by major economic risks. However, today's global economy is anything but rapidly growing, especially outside the United States. More troubling yet, it would seem that rarely before has the global economy been confronted with such a confluence of major risks in so many different segments.

The United States, the world's largest economy, could be headed for a period of political uncertainty ahead of its November 2016 elections that could undermine global investor confidence. In the run-up to those elections, one has to be struck by the electorate's disdain for traditional politics and by the vitriolic anti-free trade rhetoric in the primary election campaigns.

China, the world's second-largest economy, is currently struggling to reorient its economy away from an investment- and export-led model that is expected to put the country on a lower economic growth path. At the same time, the country is having to cope with a very large credit overhang and it is being challenged by a capital outflow problem of epic proportions. This has to raise questions as to whether China might be forced to depreciate its currency, which, at a time when other central banks are trying to weaken their currencies, could have the potential to set off a real currency war.

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Japan, the world's third-largest economy, is stalling yet again and is slipping back into deflation at a time that credibility in Abenomics is rapidly dwindling. It is hardly reassuring that Japan's public debt-to-GDP ratio continues to ratchet up from already disturbingly very high levels. This is especially the case at a time when the country continues to run a large budget deficit and when its population is rapidly aging.

Italy's banking system is already on a shaky footing.

Meanwhile, the United Kingdom, the world's fifth-largest economy, is scheduled to have a closely fought referendum on June 23 on continued European membership at the same time that it has close to a record external current account deficit. As Bank of England Governor Mark Carney keeps reminding us, that deficit makes the United Kingdom uncomfortably dependent on the kindness of strangers to finance it. A "yes" vote in that referendum would see the United Kingdom well on the way to leaving the European Union, which would almost certainly trigger a sterling crisis. It would also likely lead to a second independence vote in Scotland, which would prefer to remain in Europe and which could pave the way for the dissolution of the United Kingdom in its present form.

And Brazil, by far the largest Latin American economy, is in the grips of a political and economic crisis that could put the country well on the path to defaulting on its debt. It has to be disturbing that over the past two years, Brazil's public debt-to-GDP ratio has risen from 50 percent to around 67 percent. It also has to be of concern that the country's budget deficit has now blown out to more than 10 percent of GDP and that the country is experiencing its worst economic recession since the 1930s. It would seem to be only a matter of time before the country's banking system is hit by a spike in non-performing loans that will require the government to bail it out.

With global debt at such a high level and with so many risks currently confronting the global economy, one has to hope that world economic policymakers are not lulled into a false sense of security by the present calm in global financial markets. Rather, one would hope that they do not succumb to the temptation to engage in a premature normalization of interest rates. One must also hope that those countries that do have the room to engage in fiscal stimulus use that room wisely to help put the world economic recovery on a sounder footing. ◆