

Debt, growth & disappointment

Are industrialised economies are destined for below-trend growth?



Yes, according to the latest research. It seems that economic recovery will be drawn out and hard won for the indebted industrialised nations. The burden of debt repayment will weigh heavily on growth prospects as governments, corporations and consumers reduce their debt exposure (deleverage).

This prospect has profound implications for manufacturers, service providers and the wealth management industry. Company objectives, strategies and tactical manoeuvres will have to accommodate this vision of mature economies struggling to find rhythm over the next five years and beyond. For the US, UK and much of the EU, the medium-term future (and possibly longer) will be quite different to the experience of the last three decades.

The consequences are real and already happening

Low medium-term economic growth prospects would have consequences beyond the foregone increases in national income.

Prolonged low rates of growth would mean more recessions. With economies managing just 'stall speed', even minor shocks could reduce national output. With six recessions in the last twenty years, Japan's low growth trajectory provides a vivid example of this effect.

More frequent recessions would create more instability and less confidence on the part of consumers to spend and companies to invest, perpetuating the low growth prognosis. Shorter economic cycles would increase risk and lower expected returns to investment. And they would maintain the shortened 'risk-on/risk-off' investor cycle of capital flows which have so destabilised currencies and bond prices over the last three years.

Moreover, this instability could also undermine political and social structures. Low economic growth would necessitate more government intervention in the working of the economy. Fiscal and monetary policy levers would have more discretionary use, with all the risks that this would entail.

Consumers across the industrialised world have already recognised that their material well-being is being eroded. Lack of progress in living standards could add to political unrest and disillusionment with both political processes and market economics. More market regulation and intervention is a likely consequence.

The recent history

Relative to GDP, private and public sector debt has grown with inexorable force over the last three decades across the industrialised world.

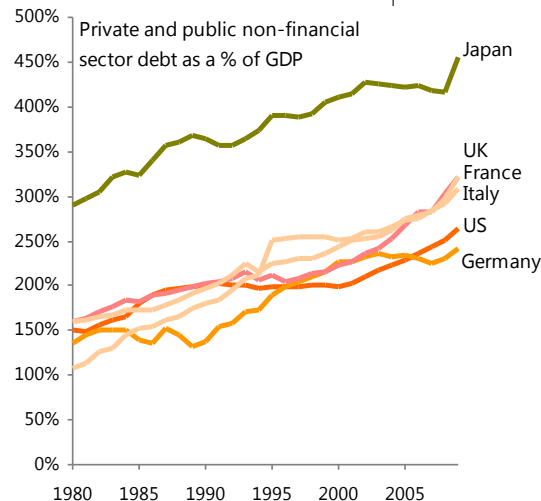
It seems that the vagaries of the economic cycle, changes in government, globalisation, the internet, the emergence of new economic superpowers and rising levels of financial literacy over this period have done little to arrest this trend.

Increased indebtedness, in absolute terms and relative to

the ability to repay, has been an integral feature of the modern industrialised western economy.

The composition of this debt varies widely across the industrialised economies. Government debt (as a proportion of all non-financial sector debt) is highest in Japan, Italy and Greece and the US. Corporate debt is particularly high in Scandinavia, Spain and Bel-

The Great Moderation probably made everyone more credit-worthy



gium while in Australia, the Netherlands and the UK, household debt is dominant.

The willing lenders

This relentless debt accumulation seems to have been driven by both institutional and market changes.

Global deregulation has progressively removed barriers to financial mobility. IT advances have also helped innovation in financial products. Tax treatment of debt - from mortgage interest relief to corporate debt issues - have also encouraged borrowing.

More stable macroeconomic conditions (at least until 2008) promoted borrowing. This Great Moderation - low inflation, lower unemployment and less uncertainty across the industrialised world - probably made everyone more credit-worthy. And low real interest rates since the mid-1990s have

The research

According to the latest research, debt, both public and private, will constrain economic growth over the medium term and possibly for as long as a decade.

It seems that when debt obligations reach certain proportions, they weigh economies down like lead boots in a swamp. Debt repayments reduce incomes left for consumption and investment, while the high debt environment keeps long term borrowing costs high.

Moreover, the highly indebted economies' sluggish advances into recovery constrain the growth trajectories of their trading partners.

The Bank of International Settlements has provided some broad-based rules to suggest when debt levels can start to become dangerous.

Apparently, government debt starts to constrain economic growth when it reaches 85% of annual GDP. And for every additional 10% of GDP, trend growth falls by 0.1%-0.2%.

The threshold for corporate debt is around 90% of GDP, but the impact on economic growth is around half that of government debt. It seems that economies can withstand higher levels of corporate debt than government debt.

The relationship between household debt and economic growth proved inconsistent for the BIS economists. They found a threshold of 84%, but this estimate lacked statistical precision.

These results corroborate previous research by economists Carmen Reinhart and Kenneth Rogoff. They concluded that public debt starts to constrain economic growth when it reaches 90% of GDP. They observe that when debt passes this threshold, GDP growth falls by 1%. For emerging markets, this dampening effect is stronger, with growth likely to lose 1.5%-3.0%.

made it less costly to support ever higher levels of debt.

To a great extent, this debt taken on by the industrialised world has been funded by emerging economies. The high-growth, industrialising economies have been using the proceeds of their trade surpluses to create more demand for their products in the industrialised world.

This is the opposite of what might have been expected. The industrialised economies should have been saving to finance the retirement costs of their ageing populations. And the emerging economies should have been borrowing to finance investment and house building for their younger populations.

The common explanations for this are that savings rates have been higher in emerging economies where social insurance and pensions are less common. And, ironically, emerging economy governments have been considered less credit-worthy than their industrialised counterparts and so have tended to borrow less.

Governments across the industrialised world have accepted that lower levels of debt would be highly desirable. Many companies and individuals would agree. But unwinding the debts of the major economies will be very long term projects. After all,

The industrialised economies should have been saving to finance the retirement costs of their ageing populations

The UK's debt metrics are similar to France's and Italy's. When the eurozone's fate is resolved, the markets will turn their attention to the UK

the accumulation of these debts have been happening for decades.

Local circumstances

Simply equating high debt with low growth, as the research suggests, has the advantage of providing simple policy direction.

A number of commentators and politicians have adopted a mantra of 'reducing debt to unleash the economy' in defence of austerity programmes adopted across Europe and the US.

Yet the relationship between debt and economic growth is not so simple. The amount of debt any particular economy can carry without constraining growth probably depends on a range of factors.

Expected growth rates, economic structure, interest rate and inflation expectations, the debt maturity profile, the debt currency denomination(s), the country's credit history, government policy and credibility, global capital movement and changes in investor risk-aversion could all determine the tolerable debt level for any given economy.

These factors differ markedly across the industrialised world, suggesting that while the broad-based thresholds established by the researchers may offer rules of thumb, they may be misleading for any individual economy.

Current long term bond yields among the indebted European economies support this contention. The UK's overall debt levels are comparable to France and Italy's, and its budget deficit is actually higher. But France is paying a third more in interest for its long term debt compared to the UK, Italy three times as much.

The UK's low debt costs may be partly attributable to government deficit reduction ambitions. But the UK's control over monetary policy, the Bank of England's quantitative easing exercises, sterling's low euro and dollar rates and investor desire to move out of euro-denominated assets and into the (presently perceived) relative safety of UK gilts have also contributed to the UK's low borrowing costs.

Of course, this position could change. When the eurozone's fate is resolved, it seems likely that the markets will turn their attention to other indebted economies. It would then be the UK's turn to watch its debt interest increase.

Running out of steam

In the first weeks of 2012 investment banks, the IMF, the OECD, government departments, think-tanks and central banks across the world drastically reduced their economic growth forecasts for 2012 and 2013 for almost all the industrialised nations.

In the space of just a few months, the consensus among economic opinion formers transformed from wary optimism to cautious pessimism. Expectations were drawn back to reflect the outcomes predicted by the research.

The collapsing recoveries of the once mighty economies of Europe and north America have alarmed and confounded policy-makers, industrialists and economists.

This latter group is still scratching around for plausible explanations for the crawling growth shown by so much of the western world. After the event, some are pointing to debt as the leading contributory factor.

This will profoundly affect the strategies of companies selling into the industrialised economies. Manufacturers and service providers will need to build more flexibility into their strat-

egies to allow for the effects of sustained, below-trend economic growth constraining their markets and intensifying competition.

Investors face a maze of cryptic decision-making as the financial landscape around the industrialised economies' low growth prospects reforms with new dimensions of risk.

And policy-makers of the indebted nations will revisit their fiscal and monetary plans on an uncomfortably frequent basis as solvency issues persist.

No silver bullet

The range of attitudes, approaches and methods of dealing with debt proposed by the political classes of the industrialised nations suggests that no consensus has emerged yet of the best way to reduce debt.

The US government has a ceiling for government debt while the UK government has

Investors face a maze of cryptic decision making as the financial landscape reforms with new dimensions of risk

adopted an austerity programme to reduce its excess of spending over revenues. In both economies, public debt is still expected to continue to rise over the next few years.

Matters are different in the eurozone. The stressed peripheral members are required to pursue punishing austerity programmes in order to persuade lenders (bond markets and bail-out sponsors) that they are worth further loans.

Even core members like France and Belgium are facing close examination of their credit-worthiness as past borrowing catches up on them.

While a consensus on how best to deal with debt is probably some time away, there is mounting evidence that attitudes to debt will have to change profoundly, if they haven't already.

The credit supply industry has tightened lending criteria

Debt - it really isn't all bad

The role of debt in economic cycle theory has been neglected by theorists and researchers. In the past, the emphasis has generally been on the real economy with prices, wages and exchange rates as the (often costly) monetary adjustment over the cycle.

But since the credit crunch economists has been developing financial stability policy theory in the hope of enabling policy-makers to more effectively manage systemic risk in their monetary systems. The early results call for drastic reductions in debt.

But debt isn't all bad. It performs valuable functions for the economy. With debt, households can smooth out their consumption when incomes are volatile. And companies can acquire equipment for production and can weather volatile sales.

Governments can smooth out tax revenues over irregular spending programmes, even across generations. And government debt can provide liquidity to ease private sector credit conditions, as it is doing in Europe and the US. Managed adequately, debt facilitates growth and constrains volatility in the economy.

Nonetheless, debt is brought forward spending. It is spending made in the present from future income, income that has yet to be earned. Debt is spending other people's money. And debt almost always has to be repaid.

Of course, when debt levels pass certain thresholds they can have the dire consequences. Credit-worthiness can be lost after the mildest of shocks. Collapsing domestic demand, default, sliding asset prices, under-investment, high unemployment and even sustained deflation can follow.

across the world out of necessity. New regulatory requirements compel them to repair balance sheets and further regulatory change, especially in Europe, will hope to prevent a return to the lending activity prior to the credit crunch in 2008.

But more generally, attitudes to borrowing may have been changed with some permanence.

Changing attitudes

A range of national economies have suffered humiliating credit downgrades. Their governments have accepted that debt reduction will be a painfully slow process over decades rather than years.

The current bond market trauma is likely to live for generations in the minds of politicians who have been powerless in preventing investors from judging and (in some cases) condemning the integrity of their fiscal management.

Consumers are likely to be re-thinking their own attitudes to

Governments have accepted that debt reduction will be over decades rather than years

Businesses will be tempted to postpone investment and recruitment decisions when ROI seems so low

debt, too. Property price collapses across Europe have left households with negative equity while interest rates on unsecured debt have advanced for the less credit-worthy.

Millions of European households are discovering that tighter lending criteria are denying them the funds for borrowing that were within easy reach a few years ago.

And falling real incomes are combining with rising unemployment (itself a side-effect of below trend growth) to remind consumers across the continent (if they need reminding) that these are chastened times.

Consumers in the US seem to be sharing the experience.

The price must be paid

It does seem that the burden of debt repayment will limit economic growth for the highly indebted economies over the next five years and for probably longer.

Net lending to consumers and businesses in the debt-stricken economies will be lower for

some time as banks rebuild their balance sheets.

There may also be some crowding out in capital markets as governments are forced to roll over debt at higher borrowing costs, bidding up effective market interest rates in the process.

Businesses will be tempted to postpone investment and recruitment decisions as expected returns on investment seem low and higher future tax obligations seem likely.

For their part, consumers are likely to raise savings rates in anticipation of less social security provision and a greater likelihood of job-loss or real income cuts.

Most of the indebted economies have embarked on austerity programmes, sacrificing short term economic growth in order to persuade investors that they will not default on their debt. The hope is that (expected) debt repayment will raise confidence levels and stimulate economic activity and growth.

This has all happened before

The main participants in the second world war all ran up massive public debts. The UK's national debt was 216% of GDP in 1945, far higher than the current 64.2%).

Yet by 1955 this debt was down to 138% of GDP. Over the same period the US government cut its debt by 50% of GDP. Inflation played a very large part in this.

British savers tucked away money in local banks who then bought government bonds at yields some way below inflation.

The government duly repaid this debt which had lost real value. Savers suffered a real loss on their money while the government enjoyed a corresponding gain. But governments cannot do this today. The Bretton Woods agreement on exchange

rates and capital controls effectively forced banks to invest in safe assets like government bonds. Regulated lending rate limits also constrained bond yields, effectively subsidising default risk.

Now governments must compete for funds at globally competitive rates. The UK government hopes its debt/GDP ratio will stabilise by 2015.

So far, this strategy has had mixed results. The UK economy failed to expand over 2010 and 2011 while several eurozone members have seen their economies contract and their borrowing costs increase substantially.

Rather ominously, Reinhart and Rogoff concluded their research by noting that "*seldom do countries simply 'grow' their way out of deep debt burden*", suggesting that debt restructuring (with some element of default) with substantial currency revaluation are usually in the mix.

Less luck than last time

Hopefully, some of the structural impediments to growth in Europe will be removed over

That way, investors will have reason to believe that eurozone members will not run up debts again

the next year. And the eurozone will be forced (sooner rather than later) into some fiscal co-ordination agreement. That way, investors will have reason to believe that eurozone members will not be tempted to allow unsustainable debts to be run up again.

Meanwhile, the US government will work towards budgetary constraint measures to make the debt ceiling a reality.

And corrections to current improbable exchange rates (an artificially weak renminbi, an over-valued yen and an over-valued euro) will help to rebalance the rates of economic growth across the main trading blocs.

Over the longer term the industrialised economies will have to find those new sources of economic growth in higher added value services, building on the exporting success in finance, business services and entertainment industries.

Equally, the rapidly expanding middle classes in the emerging economies will provide enormous export opportunities for the industrialised economies and help redress the current trade imbalances. This will involve diverting trade surplus resources away from credit-hungry Europe and the US and toward these increasingly affluent consumers in Asia and south America. ©

Foresight First

Foresight First is an independent economics analysis and forecasting agency.

Foresight First exists to improve our clients' decision-making. We do this by anticipating change from the economic, market and consumer environments so that our clients can maximise longer term value for stake holders.

Our work starts and ends with our clients' objectives. Our business is based on our capacity to improve our clients' profitability. Our services include written reports, presentations, mathematical and statistical analysis and telephone support.

While most clients are based in the UK, Foresight First also provides regular economic analysis and forecasts for the economies of Russia, Australia and selected economies in eastern Europe, South America and the Far East.

Founded in 1996, Foresight First works with organisations in the private, public and not-for-profit sectors.

www.foresightfirst.co.uk
enquiries@foresightfirst.co.uk
+44 (0)208644 8350