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Excessive debt build-up and risk of a global debt crisis

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The investor psychology goes like this. If entities with surplus money are confident that entities with deficits will repay their debts, financial transactions will take place and debts will be easier to refinance and roll-over. But if something shatters this very confidence, then transactions stop and hopes of refinance are lost. And it takes only one card to pull down the whole house and infuse chaos. This is the crux of the rising global debt in the current environment.

The Global Financial crisis left many countries in turmoil. Economic growth slowed, unemployment rose, confidence in business decreased and economic output took a severe hit. To fuel growth and spur investments, interest rates were lowered, and since then, utilization of debt as a major vehicle of fueling economic growth has continued to work wonders – till 2018, increase in debt was 50% from a decade ago[i]. Going by recent numbers, world's debt-to-GDP ratio is on its way to reaching peak levels of 322%. In absolute terms, the number has crossed $250 trillion and that turns out to be $32,500 of debt for every human being on earth.[ii] However, in recent times, global growth hasn't really supported the cost to-be-incurred for this increasing debt which has gradually resulted into stretched asset valuations. But the financial world has resorted to solving this problem by its own root cause – More debt. The increase in borrowing from different sectors is a bit skewed and calls for a mention. Government borrowing has accounted for almost 43% of increase in the past decade led by mature markets mainly for reasons such as financing bailouts, stimulus programs, assistances during crisis, etc. Another 41% increase has been accounted by non-financial corporate debt.[iii] Delving in the same numbers, it is interesting to note that this wave of debt accumulation is quite different from earlier ones; it has seen different sectors raking up more and more as compared to just one sector being at the forefront of debt accumulation as seen in the earlier three waves.[iv] What drives this change is deepening of financial ecosystem and better access to capital markets. Since 1960's, In the aftermath of the global financial crisis, commercial bank lending turned subdued and hence, the corporate bond market has witnessed a three-fold expansion at the global level led by a rapid growth in emerging markets. As of 2018, bonds formed 19% of global non-financial corporate debt, up from 10% in 2007. Global non-financial corporate bonds outstanding have increased 2.7 times over the past decade reaching a value of $11.7 trillion.[v] In China, bond issuance jumped from $33 billion in 2007 to $357 billion in 2017.[vi] Emerging market economies have also seen an increase in external debt – 2018 saw external debt reach 26% of GDP on average as compared to just around 15% in 2010.[vii] While we can attribute a variety of reasons for rising debt in different countries, one reason that draws a common thread across the world is an environment of prolonged low interest rates. With short term growth prospects not being really robust, the latter will be here to stay in the near future. Once the credit cycle turns and interest rates rise, whether the bond issuances stays robust or not will be interesting to see. For now, we have several of examples from the last century that tell us the ruckus that debts create if they cross a certain limit – Latin American Debt crisis of 1997, Greek government-debt crisis of 2010's. So, are there signs around the world that signal to us something unusual going on in this space which may lead to the next blowup?

As an aftereffect of low interest rates, insurance companies, pension funds and other institutional investors with set return targets have been compelled to invest in riskier and less liquid assets. As a result, the percentage of non-investment grade i.e. high-yield or junk bonds has increased. In US, almost 40% of all non-financial corporate bonds come under the latter category, up from 31% in 2000. In India, companies sold $3.7 billion in high yield bonds in the past year which was an increase of 187% from 2018.[viii] In the first 11 months of 2019, China's default rate among private issuer of bonds climbed to a record 4.9%. In India, the cases of IL & FS, DHFL, etc. tell about the worsening atmosphere of financial system. In the earlier released RBI's bi-annual Financial Stability report in December 2019, it predicted an increase of 60 basis points in GNPA ratio in Sep '20 from Sep '19.[ix] The risk of contagion is invariably high in the financial ecosystem. Drawing an analogy from the recent NBFC crisis of India, one firm's actions wrecked the entire financial industry eventually affecting the overall economy and this is a unique trait in the financial industry – When Jet Airways shut shop, it didn't have any contagion effect; instead other firms like IndiGo and SpiceJet actually reported a better business performance. The rise of external debt has increased current account deficits a huge margin – in 2018, 55% of emerging market economies had weaker current account balances than in 2010.[x] Integration of these economies into the global financial ecosystem have a potential to lead to huge contagion effect should a distress be witnessed in any one region. Recent happenings around the globe such as US and China fighting over trade issues, uncertainty around Brexit, suffering economies in the Eurozone, stress in some emerging market economies, crisis in the Middle East, etc. too have increased concerns about repaying capabilities of entities including several sovereign governments. The idea that governments can always print their own money and repay back any amount of debt is truly possible but it doesn't come without disastrous consequences such as hyperinflation. And that in itself will bring many more issues to the existing debt market. In fact, rating agency Moody's cut its global sovereign outlook for 2020 to 'negative' from 'stable' saying disruptive and unpredictable world politics would slow growth and increase risk of economic or financial shocks.[xi] The International Monetary Fund has identified 32 countries which are at high risk of unsustainable debt.[xii] Financial vulnerabilities have increased not only for sovereign debt but also for corporate debt. And it's seemingly looking a grim picture for now. This again makes us go back to the thin thread that connects the whole financial ecosystem – sentiments. As earlier mentioned, even a small crack somewhere in those sentiments can shake the whole world and lead to the collapse of the entire financial ecosystem.

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