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World debt bomb is ticking, new IMF debt database shows

by **John Kehoe**

Is the world sitting on a debt time bomb?

A new global debt database launched by the International Monetary Fund here in Washington last week shows combined public and private debt has ballooned to at least $US164 trillion ($218 trillion).

Adding in a broader range of debt instruments, including financial sector debt, world debt is at a record high of $US243 trillion, or about 320 per cent of GDP.

Disturbingly, that excludes trillions of dollars of unfunded pensions that governments owe.

A decade of artificially low interest rates since the global financial crisis has encouraged governments, corporations and households to binge on cheap borrowing.

The sharp rise in credit is ironic given that over-leveraged American consumers and banks were a root cause of the 2008 financial crisis. Memories appear to be in short supply. Global deleveraging barely happened.

Tim Adams, president of the Institute of International Finance (IIF), recites an Ernest Hemingway quote to underline the perils of unsustainable debt.

"How did you go bankrupt?"

"Two ways. Gradually, then suddenly."

Incredibly, global debt levels across all sectors rose by $US21 trillion last year – accounting for more than 80 per cent of the total increase since 2012, according to the IIF.

Vulnerable to downturn

Among policymakers, there is a lively debate under way about how much debt is too much.

"What's big? How do you know?" asks Kenneth Rogoff, one of the world's premier scholars on debt.

"Debt-to-equity has not changed so much," he points out.

Rogoff says Australia's relatively low public debt – net federal debt is below 20 per cent of GDP – is "impressive".

But he says he doesn't want to "curse" Australia as the "poster child". Rogoff is also mindful that Australia's high house prices and household debt leave the local economy vulnerable to a downturn in debt-plagued China.

As a capital-importing country that relies on foreigners lending to Australia, a pristine sovereign balance sheet is crucial – especially when it is the backstop for banks that are dependent on the housing market not blowing up.

Rogoff's advice, especially to governments, is to keep a "good credit card" for an unforseen future crisis such as a cyber war, military conflict, pandemic or financial panic.

Major drivers

Internationally, the big drivers of the jump in debt over the past decade have been China, the US government and corporations around the world.

The IIF calculates global debt has jumped $US70 trillion over the past decade.

As well as ultra-low interest rates, tax distortions have incentivised companies and individuals to leverage up. The deductibility of interest means equity and debt investments are not treated equally.

The big risk for the indebted is a sharper-than-expected rise in interest rates.

US inflation is finally showing signs of firming. The 10-year US Treasury yield last week touched 3.1 per cent, the highest rate since July 2011.

The Treasury curve is a global benchmark for borrowing costs.

The big Republican fiscal stimulus worth 2 percentage points of GDP is hitting a US economy that is already around full-employment with a jobless rate below 4 per cent.

An obvious risk is the US Federal Reserve and bond markets are forced to ratchet up interest rates more aggressively than expected.

The consequences would be felt around the indebted world.

Security threat

US federal debt is projected to hit 100 per cent of GDP within a decade, with no plan to arrest it. National Intelligence Director Daniel Coats this year called rising debt a national security threat.

"This situation is unsustainable, as I think we all know, and represents a dire threat to our economic and national security."

The US enjoys the "exorbitant privilege" of having its debts denominated in the world's reserve currency, the US dollar.

There is no imminent threat to the greenback's supremacy, though if US debt continues to spiral out of control the dollar's role as a reserve currency may eventually be called into question.

One mitigating factor in analysing debt levels may be the distribution of debt. The Reserve Bank of Australia has emphasised that the surge in the debt-to-income ratio to about a world-leading 190 per cent, has been mostly driven by higher-income households. This is the opposite of what occurred in the US before the 2008 subprime housing crisis when poor people were sold loans they couldn't afford.

Today, the bottom 50 per cent of US households have negative net worth, whereas the top 10 per cent of US households own 75 per cent of net worth, the IIF calculates.

Moreover, the highly indebted US corporate sector is partly protected by huge cash piles belonging to companies such as Apple and Microsoft.

The IIF says most of the assets are concentrated in large companies. Medium and small firms have a lot of debt and not much cash on hand.

These non-large firms also have low interest coverage ratios, leaving them vulnerable to higher interest rates or a slowing economy.

For many, leveraging up and riding the asset prices booms over the past decade has delivered fabulous returns.

But the bills will ultimately need to be paid for the debt largesse.

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