SUERF THE EUROPEAN MONEY AND FINANCE FORUM

SUERF Policy Briefs
No 24, August 2020

The big debt surge

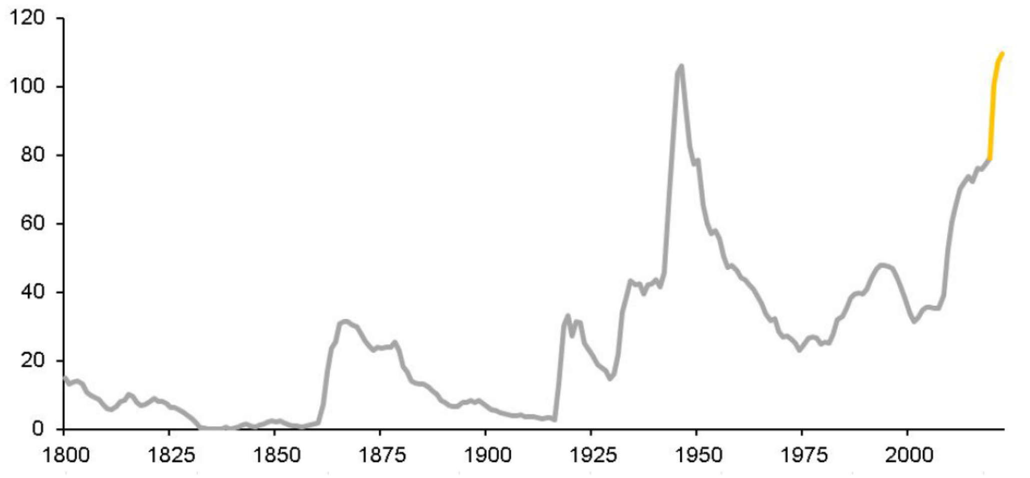
By Ralph Solveen

Commerzbank

Keywords: Corona, corporate debt, public debt, US, Euro area, China, Germany, monetary policy, fiscal dominance.

The corona crisis has resulted in a worldwide rise in debt. We analyse the liabilities of private households and businesses and find that only the latter have increased in the course of the corona crisis. This might be a burden for the recovery especially in the US and China. However, the bulk of the burden is borne by the state. This has consequences for monetary policy and asset prices.

US sovereign debt higher than at wartime
Federal debt held by the public, in percent of GDP, 2020 to 2022: Commerzbank forecast



Source: CBO, Commerzbank-Research

Will the rise in debt act as a brake on the economy?

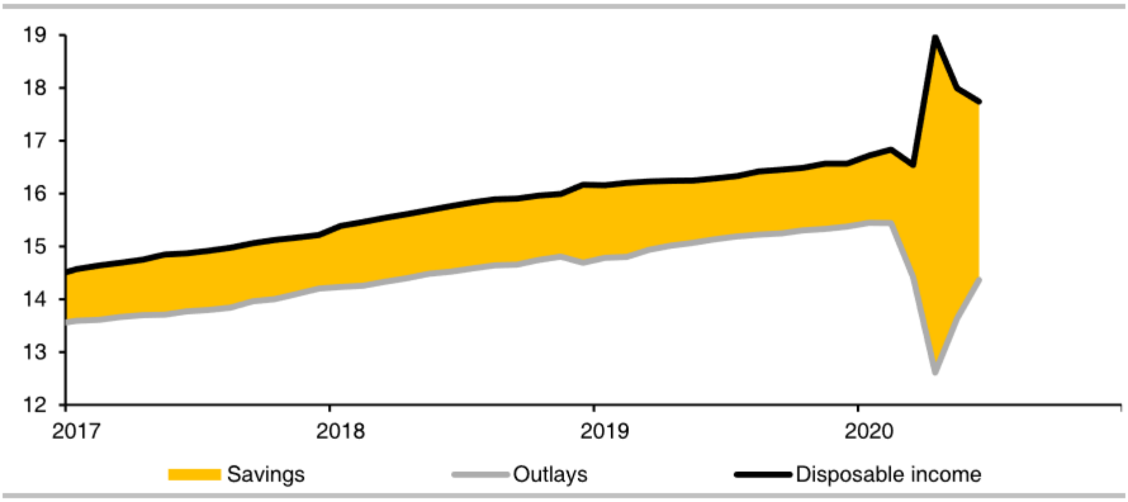
The corona crisis has caused the economy to collapse worldwide. In order to compensate for the resulting loss of income, many households and companies had to take on additional debt in order to be able to continue to cover their current expenses.

But how great is this effect? How much has the indebtedness of private households and companies increased? This is very important for the outlook, as in the past a sharp rise in debt has often proved to be a brake on growth and could therefore weaken the current recovery.

Private households: With government support ...

This is unlikely to be the case for private households, though. Many have lost their jobs or had to reduce their working hours. However, the state has largely compensated for these income losses. In Germany, for example, gross monthly earnings paid by employers in the second quarter were only around 2% lower than a year ago. But adding in unemployment and short-time working benefits, the net figure for all employees is likely to have been higher than a year ago. In spite of the often larger losses among the self-employed, disposable incomes are therefore unlikely to have declined at all. In the US – the corresponding figures are already available – disposable incomes have actually risen substantially despite the subsequent loss of 22 million jobs (Chart 1).

Chart 1 - US households saved much more
Private households, monthly figures, in trillion USD



Source: Global Insight, Commerzbank-Research

... forced to save more

At the same time, the restrictions adopted to combat the coronavirus have made it considerably more difficult for private households to spend their income. As a result, the savings ratio in the US has jumped up sharply due to higher incomes and much lower spending. In April US households saved more than one-third of their income, whereas their savings rate is normally well below 10%. In the euro area the movement may not have been so extreme. But here, too, consumer spending is likely to have fallen much more sharply in the second quarter than government-supported disposable income.

Against this backdrop, it comes as no surprise that household debt has fallen slightly in the US and that in the euro area the growth of bank loans to households has slowed or even decreased in some countries. An adverse effect on the economy caused by higher debt is therefore unlikely. On the contrary, the pent-up income could even temporarily give an additional boost to consumption, as the recent good retail trade figures for Germany and the euro zone suggest.

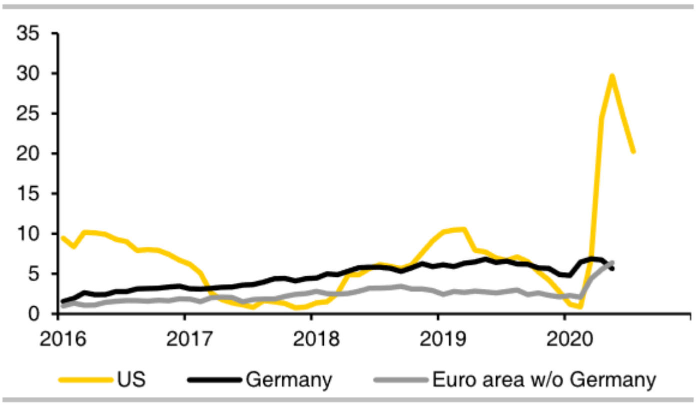
The limiting factor for overall private consumption is more likely to be the virus itself, which will probably prevent some activities for some time to come. Moreover, it remains to be seen what will happen after the government aid measures expire.

Corporate debt on the rise ...

The situation is different for companies. Many of them had to take on additional debt in order to bridge the massive loss of sales:

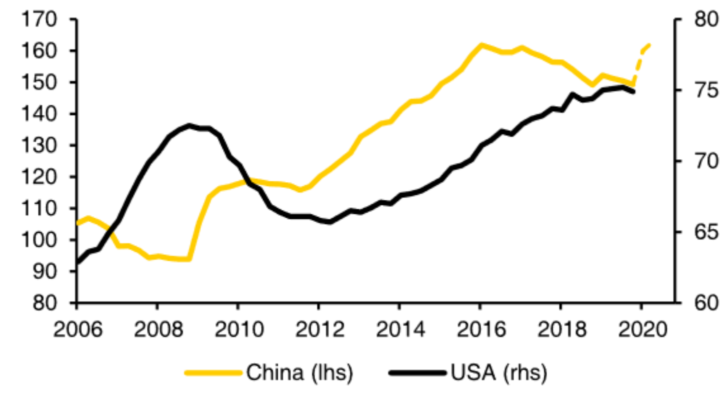
- The strongest increase in loans was in the US (Chart 2). Moreover, the volume of new bonds issued by non-financial companies almost tripled. Since mid-May, however, loans have been declining again in absolute terms; around one-third of the additional loans issued since mid-March have already been redeemed. Issuance activity also seems to have slowed.
- In the euro area, bank loans – as well as new corporate bond issues – also rose more strongly between March and May than previously. There are noticeable differences between the individual countries. In Germany, for example, loans rose somewhat more strongly only in March and April. Even the very extensive programmes for loan guarantees (especially via the Reconstruction Loan Corporation, or KfW) have so far been used only to a small extent. In most other euro countries – especially in France and Italy – the growth in loans has increased noticeably, but not nearly as much as in the US.
- In China, too, according to estimates by the state-run CASS (Chinese Academy of Social Sciences), non-financial corporate debt in relation to GDP has risen again (Chart 3). While in the first quarter this was primarily an arithmetic effect – the slump in GDP reduced the denominator and therefore caused the ratio to rise – in the second quarter, when GDP rose again significantly, debt actually increased noticeably. The downward trend of the past three years has thus come to an end for the time being.

Chart 2 - Loans to firms are rising faster ...
Bank loans to non-financial firms (US: C&I loans), change on year in percent



Source: ECB, Global Insight, Commerzbank Research

Chart 3 - ... as in China
Debt of non-financial corporates, in percent of GDP, China: 2020Q1 and Q2 estimated based on CASS figures



Source: BIS, CASS, Commerzbank-Research

... negative fallout on economy in China and the US

This means that the recovery in the US could actually be slowed in the coming months by the fact that companies primarily want to reduce their (unintended) additional debt and therefore postpone investment. This effect could be intensified by the fact that the debt of US companies has already risen in recent years (Chart 3) and some companies are now looking at this higher debt with different eyes in view of the less favourable and, in particular, uncertain outlook. However, this is unlikely to pose a threat to the continuation of the recovery.

In China, too, the economy is likely to be slowed down by efforts to reduce higher corporate debt levels. After all, the government and the central bank have long been pursuing the goal of curbing corporate debt, which had risen sharply in the past. There are already first signs: in July, significantly fewer new loans were granted than a year ago.

This effect should be less noticeable in the euro zone. After all, the most recent increase was very limited, and in the years before the crisis the corporate debt ratio tended to decline.

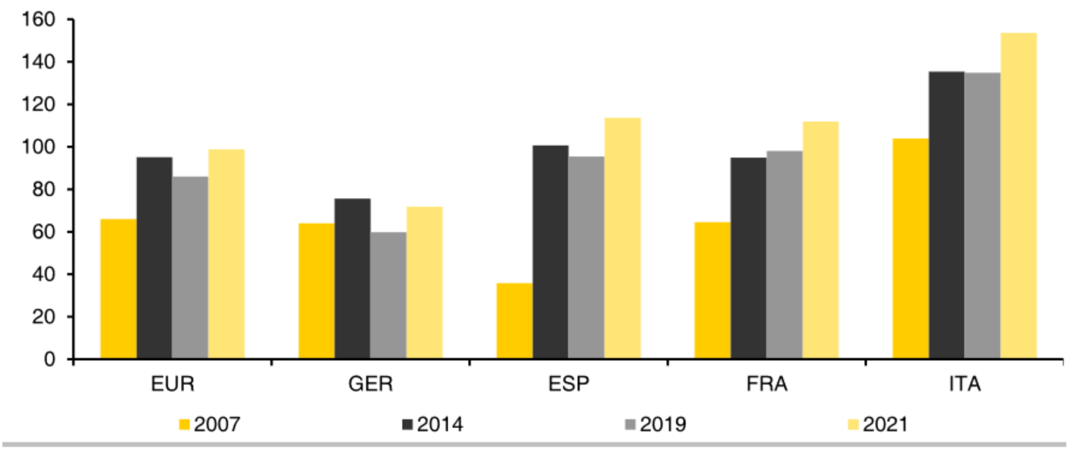
The government carries most of the burden ...

In almost all countries the main burden of the crisis is being borne by the state. Extensive aid programmes, together with the "normal" effect of a weak economy on public finances via tax shortfalls and additional welfare spending, are causing deficits to rise sharply:

- In the US the budget gap in this fiscal year, which ends on 30 September, is likely to amount to just under 20% of GDP, which would be a new post-war record. The debt ratio – i.e. government debt in relation to GDP – will also exceed the level at the end of World War II by 2021, when another double-digit deficit ratio is expected (see front page chart). However, this is not solely due to the reaction to the corona crisis. Rather, the US debt ratio had risen by a similar amount during the financial crisis, and in the following years it continued to trend upwards despite a significantly growing economy.
- The situation is similar in most euro area countries. They, too, have not been able to reduce debt ratios, which increased significantly in the wake of the financial crisis and the subsequent sovereign debt crisis. Of the larger countries, only Germany's debt ratio last year was at a level similar to that before the financial

crisis (Chart 4). For this reason, the budget deficits of the euro countries this year may well be only about half as high on average as in the US. But this is sufficient to make the already precarious situation of public finances in many countries even worse.

Chart 4 - Euro area – public debt continues to rise
Public debt in percent of GDP, 2020/21 forecast of the EU Commission



Source: Ameco, Commerzbank-Research

... which further narrows the leeway for monetary policy

This would only slow down the economic recovery if governments tried to reduce their debt to pre-crisis levels as quickly as possible. But this is unlikely. In the euro zone, for example, the Stability and Growth Pact, which is intended to prevent excessive public debt and deficits, was suspended in spring, and is unlikely to be reactivated in the foreseeable future. Moreover, the crisis should give additional tailwind to the advocates of a "strong" state, who had already been given a boost by the previous crises. For this reason, although deficits will decline again in the coming years as the economy recovers and the aid programmes come to an end, the debt ratio is unlikely to fall sustainably, in fact it is more likely to continue to rise.

Even if this means that the current high level of debt is unlikely to hamper the economic recovery, it will have a noticeable effect in the long run. For as debt rises, the pressure on monetary policy to ensure low interest rates and thus make this burden easier to bear is also increasing. Just how far this can go is shown by the post-war period, when the Fed set an interest rate ceiling for government bonds. This time the measures may not be quite so obvious. But the high level of debt will provide the doves at the Fed and the ECB with further arguments to keep interest rates at an extremely low level for as long as possible, especially as the consensus among economists is increasingly moving towards the conclusion that there is no danger of inflation. In this way, therefore, the Corona crisis will make a significant contribution to keeping interest rates low and sustaining asset price inflation.

About the author

Dr. Ralph Solveen *is Deputy Head of Economic Research at Commerzbank AG, where he has been working since 1999. Before joining Commerzbank he held positions as Research Assistant at the German Business Cycle Research Department of Kiel Institute for World Economics (IfW) and at AXA Colonia. Dr. Solveen was educated at the universities of Bonn and California at Berkeley.*

SUERF THE EUROPEAN MONEY AND FINANCE FORUM

SUERF is a network association of central bankers and regulators, academics, and practitioners in the financial sector. The focus of the association is on the analysis, discussion and understanding of financial markets and institutions, the monetary economy, the conduct of regulation, supervision and monetary policy.

SUERF's events and publications provide a unique European network for the analysis and discussion of these and related issues.

SUERF Policy Briefs (SPBs) serve to promote SUERF Members' economic views and research findings as well as economic policy-oriented analyses. They address topical issues and propose solutions to current economic and financial challenges. SPBs serve to increase the international visibility of SUERF Members' analyses and research.

The views expressed are those of the author(s) and not necessarily those of the institution(s) the author(s) is/are affiliated with.

SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at