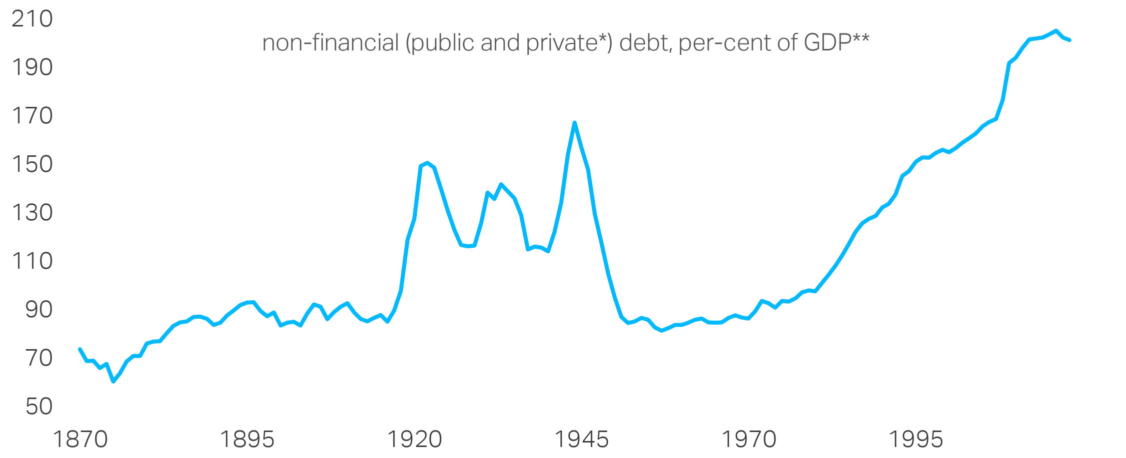
Macro Picture

DEBT TRAPPED

Dario Perkins

Global debt ratios have continued to rise over the past decade, as low interest rates kept the world growing in spite of secular economic weakness. After a brief market panic in 2018, the prospect of renewed central bank easing has supported sentiment and re-ignited the search for yield. But where is the balance sheet to 'reflate' global demand?

Chart 1: Unprecedented debt levels



Source: Macrohistory database, TS Lombard, *bank loans only, **simple average of G7 countries

LEVERAGED UP

Global debt ratios remain above the levels that triggered the subprime crash. China has been responsible for around half of this extra borrowing but debt has also grown rapidly in other parts of the world, particularly areas that avoided the crunch in 2008. This time, capital markets – not banks – have been the marginal lenders, bolstering the dollar's role in the global financial cycle.

DEBT SUSTAINABILITY

There is no magic number for what constitutes a sustainable debt ratio, especially as falling interest rates have kept debt servicing costs down. History suggests it is the pace of borrowing, not the overall level of debt, which can be dangerous. Capital markets do not carry the same systemic risks as over-leveraged banks, but they can still produce nasty periods of volatility.

CREDITABLE RESPONSE?

The prospect of new monetary stimulus has helped to stabilize global risk appetite in 2019. Central banks must now validate market expectations to keep financial conditions loose. While falling yields are bad news for banks, they could reignite the search for yield in capital markets, extending the cycle. But DM fiscal support might have to replace Chinese stimulus (eventually).

DEBT TRAPPED

It wasn't long ago everyone in this industry was worried about record global debt levels. Central banks were determined to normalize interest rates and when the 'overtightening' theme became the market consensus in late 2018, risk assets suffered a serious wobble. The dovish pivot from central banks has eased the threat of further short-term disasters, but the world's inability to live with even modestly tighter monetary policy has left many investors feeling uncomfortable. Worse, long-term interest rates have fallen to historic lows and record amounts of securities are trading with negative yields, so there is still a nagging feeling that something is profoundly wrong with the world (Ray Dalio blames a grim paradigm shift). Perhaps, as some commentators claim, we are genuinely stuck in a deflationary trap, overburdened by large, 'unsustainable' levels of debt. After all, despite a crisis of historical proportions in 2008 – a crisis inescapably linked to excessive credit and leverage – aggregate global borrowing has continued to rise. China is responsible for half of this extra debt, but many other parts of the world have also increased their leverage – particularly those sectors (e.g. US and EM corporates, DM auto finance) and countries (e.g. Hong Kong, Sweden, Canada, Australia) that avoided the worst of the subprime crisis.

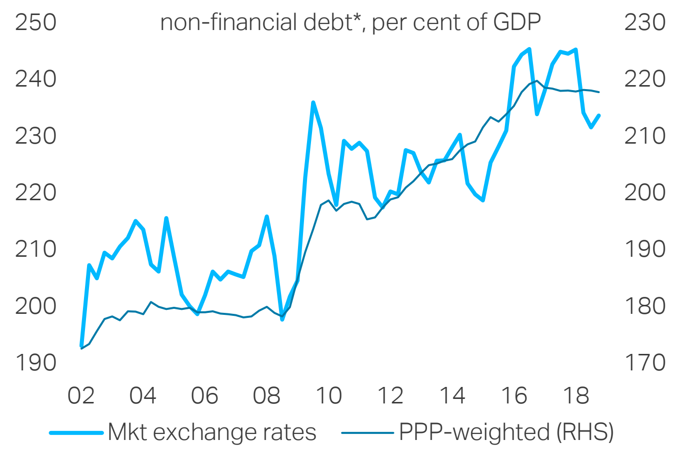
Are debt levels now too high? Unfortunately, there is no simple way to work out what constitutes a 'sustainable' amount of debt, especially as private credit ratios have trended higher for decades and vary widely across countries. Arguably the best approach is to look at debt servicing ratios, which still look manageable across most OECD countries. Obviously, this conclusion is dependent on interest rates staying low by historical standards. Growth and inflation rates have declined substantially since the 1980s, making it harder to 'inflate away' debt, but borrowing costs have dropped even faster – narrowing the infamous 'r-g' spread. Still, rather than focus on debt ratios, recent research suggests we should pay more attention to the pace of borrowing. Those countries that suffer most when financial bubbles burst tend to be those that have experienced the fastest growth in private borrowing, not the countries that have the highest aggregate amounts of debt. This is probably because the forces that drive speculative, riskier lending develop more quickly than the fundamentals that determine more sustainable increases in debt (such as lower equilibrium interest rates). If fast debt growth is the real threat to macro stability, it is easy to identify the main areas of vulnerability in the world today.

It is popular to blame policymakers for inflating a series of debt 'bubbles' to mask a secular deterioration in macro fundamentals. In the case of China, this is undoubtedly true. Yet it is not clear the authorities in other countries could have raised interest rates to sustainably higher levels, even if they had tried. Remember also that the relationship between interest rates and debt becomes rather circular – low borrowing costs encourage the accumulation of debt but also make the global financial system riskier, raising the demand for safe assets. Regardless of who is to blame, it is clear rising debt levels have supported global growth since 2008 and the question now is whether we have reached the limits of this expansion, or if the latest plunge in bond yields can reflate global activity and extend the cycle. The biggest problem is surely China, which still has the capacity for more debt, but the authorities are increasingly reluctant to use their balance sheet in this way. Banks in developed economies are also struggling, which suggests further rounds of monetary stimulus (especially negative yields) will not be helpful. But the lesson from the last decade is that we shouldn't underestimate the role of non-banks, particularly capital markets, to continue to fuel global credit creation. Either falling interest rates reignite the search for yield, or DM fiscal policy will take over – both mean debt will keep rising.

1. LEVERAGED UP

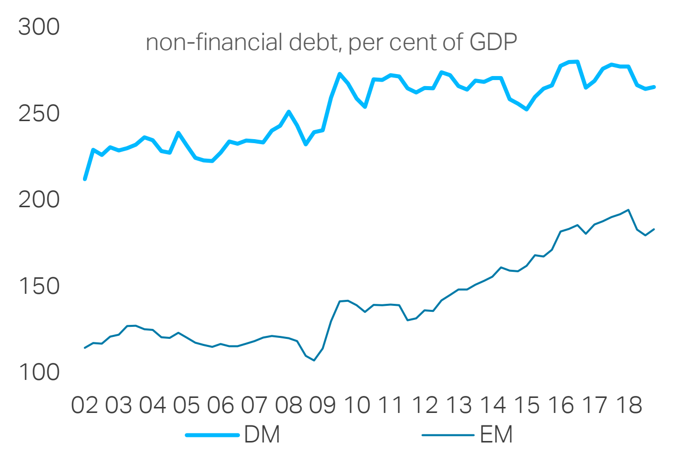
One way or another, most economists blamed the 2008 subprime crisis on over-indebtedness. Easy financial conditions and increasingly risky bank lending fuelled massive housing and credit bubbles, which ended with a spectacular collapse in asset prices and a global recession. While the United States was at the epicentre of the crisis, thanks to the way global banks had funded themselves using US asset-backed securities as collateral, the theme of 'too much debt' was a popular narrative in many other parts of the world. The consensus also blamed several aftershocks, including the euro crisis, China's ongoing structural slowdown and various periods of EM turbulence, on levels of debt that were 'too high'. So when politicians everywhere adopted austerity policies, they argued this was necessary to prevent their public finances 'turning into Greece'. There was also a popular cliché: "you can't cure at debt crisis with more debt".

Chart 2: Global debt ratios



Source: BIS, TS Lombard, *includes non-bank

Chart 3: DM versus EM debts



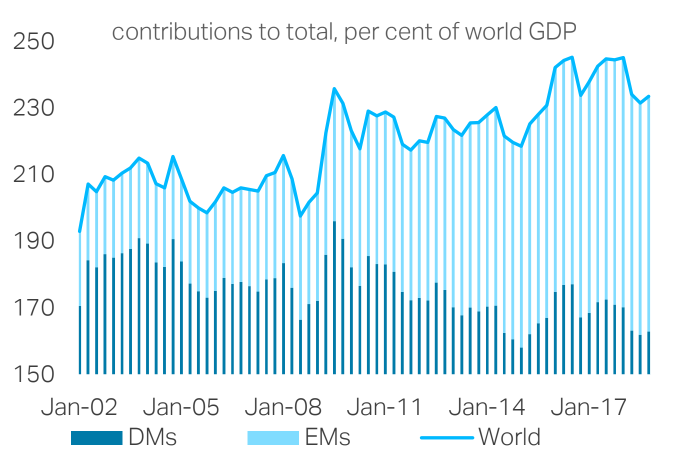
Source: BIS, TS Lombard

Yet, at the aggregate level, it appears the world has been trying to cure a debt problem by creating more debt. Global borrowing increased significantly in the decade following the financial crisis, hitting 245% of GDP in early 2018. Though it has come down a little since then, global debt ratios remain a source of anxiety for many investors. Last December, when stock markets plunged, many commentators again blamed excessive borrowing, particularly among US corporates. Remember the warnings about 'ticking time bombs' and the curse of 'fallen angels' in the bond market? While the period of panic didn't last, even today there is a widespread feeling that something is not right in the global financial system. With long-term interest rates plunging to their lowest levels in centuries and record amounts of securities trading with negative yields, it is tempting to think the world could be stuck in a deflationary debt trap.

Beyond the headlines

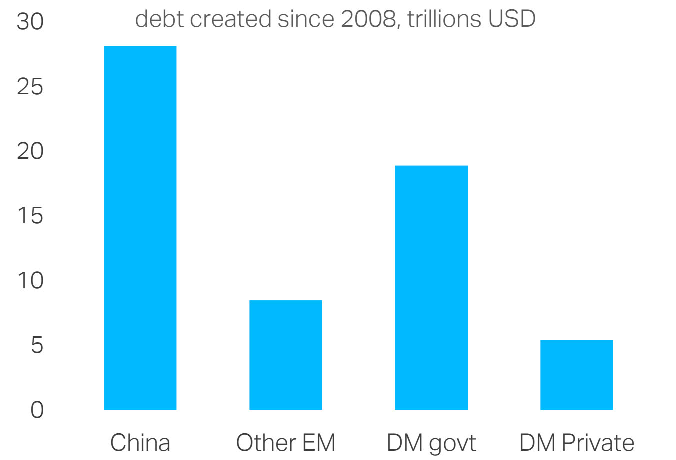
When we break down the increase in global debt since 2008 (Chart 5) we see that China accounts for almost half of this borrowing. According to BIS statistics, China has added around $30 trillion to global debt over 10 years, a truly remarkable statistic. Officially, Chinese corporations have done most of this borrowing, but the line between the state and the private sector is blurry in China. Much of this activity has involved state-owned banks lending to state-owned enterprises. This has important implications for financial stability, since – in contrast to what happened during the US subprime crisis – it is unlikely there will be a sudden 'margin call' in China. The Chinese state is not going to default on itself. To illustrate the point, the authorities have even started to manage the accumulation of debt more actively across their various balance sheets, curbing corporate liabilities but increasing public and household borrowing. There is no doubt the Chinese credit splurge has 'artificially' boosted global demand, allowing the authorities to meet overly ambitious GDP targets. But a 2008-style crisis isn't likely.

Chart 4: EMs the main driver



Source: BIS, TS Lombard

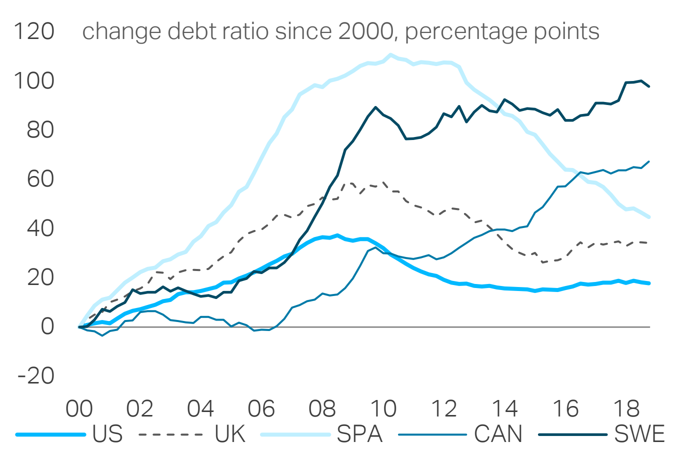
Chart 5: Debt growth since 2008



Source: BIS, TS Lombard

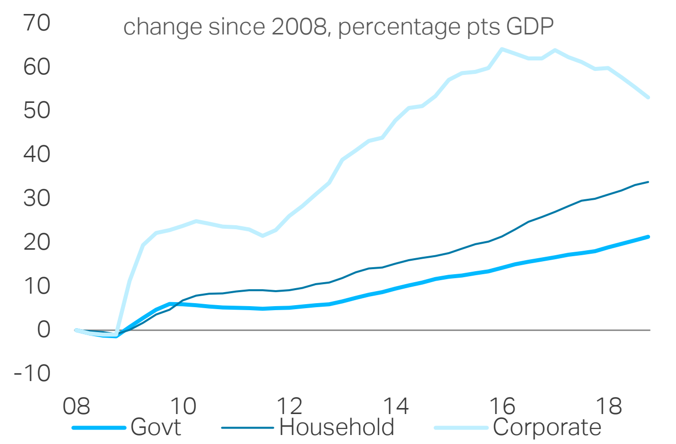
After the Chinese state, DM governments have been the second largest borrowers since the subprime crash. Media attention inevitably focused on the cost to taxpayers from various state bailouts, yet it was the impact of the wider economic downturn that forced governments to expand their balance sheets. Even a decade after the crash, most countries have continued to spend more than they receive in taxes (Trump's recent tax cuts made the situation worse).

Chart 6: DM private debt ratios



Source: BIS, TS Lombard

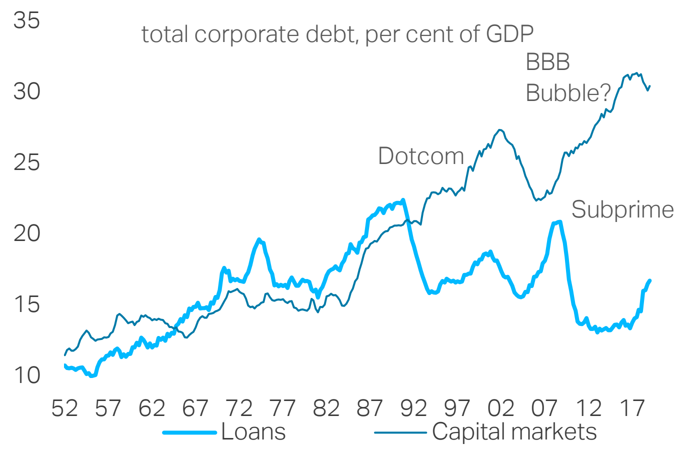
Chart 7: China managing its balance sheets



Source: BIS, TS Lombard

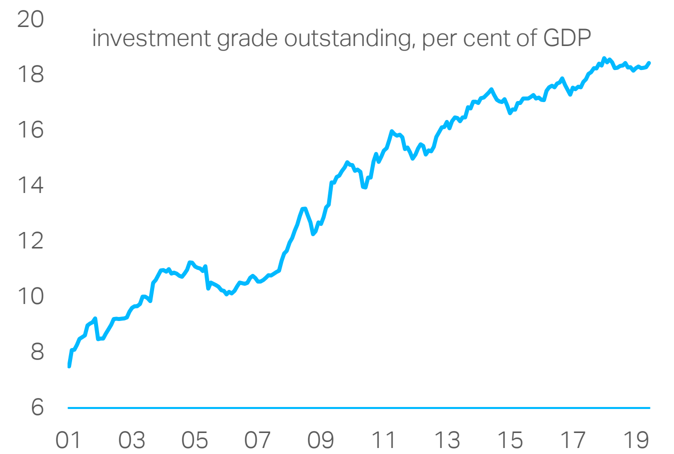
Does it matter that governments are borrowing on such a scale? Traditionally, economists worried about public-sector demand boosting interest rates and 'crowding out' private investment. Yet there is no sign this is happening. It is possible to construct a counterfactual in which borrowing costs would have been even lower without government deficits (see Larry Summers' latest) but it is difficult to come up with a plausible scenario in which the 'bond vigilantes' return, pushing DM governments into a solvency crisis. As far as the 'global debt is too high' narrative goes, we should probably restrict our attention to private borrowing. Since governments have the capacity to print money, their debts only really become problematic where they have borrowed in a foreign currency. This is an important issue for many EMs (see below) but it is not a problem for the Chinese state or most DM (non-EMU) governments.

Chart 8: US corporate debt surge



Source: Federal Reserve, TS Lombard

Chart 9: DM corporate bonds

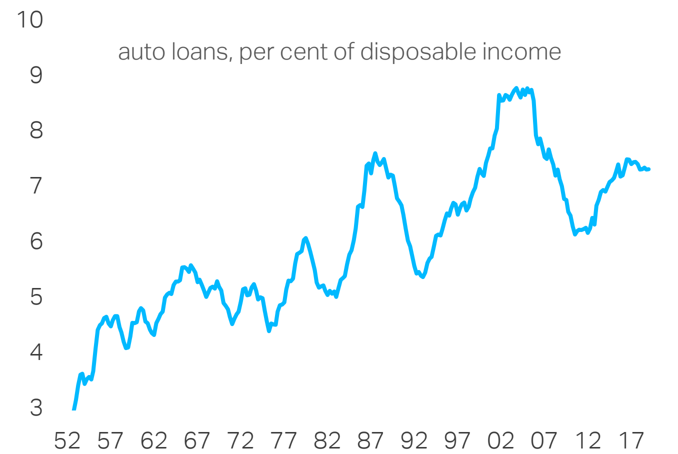


Source: Bloomberg, TS Lombard

Private borrowers

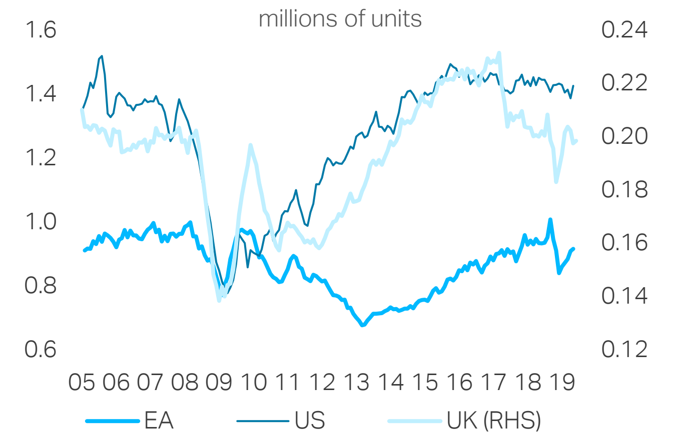
Private debt, whether by households or corporates, has historically provided a more serious threat to financial and macro stability. Here the picture since 2008 has been rather mixed. Those sectors and countries that provided the epicentre of the subprime crash – notably households in the United States, the UK and periphery Europe, have cut their borrowing substantially. Most banks have also reduced their leverage, either because their old business models failed, or because new regulations have curbed their activities. Yet many of the countries that escaped the worst of the 2008 crash have continued to run up private debts, sometimes at an alarming pace. Private debt ratios in Hong Kong, Canada, Australia, Sweden and France, plus many others, have risen rapidly over the past decade, even exceeding past crisis levels.

Chart 10: US auto debt



Source: Federal Reserve, TS Lombard

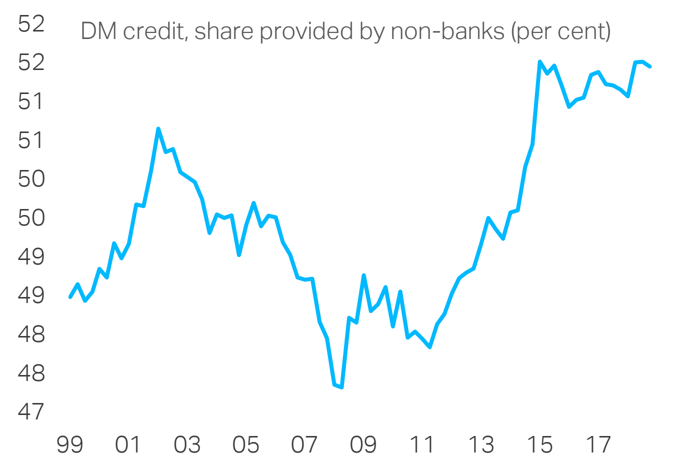
Chart 11: Auto sales running on fumes



Source: National sources, TS Lombard

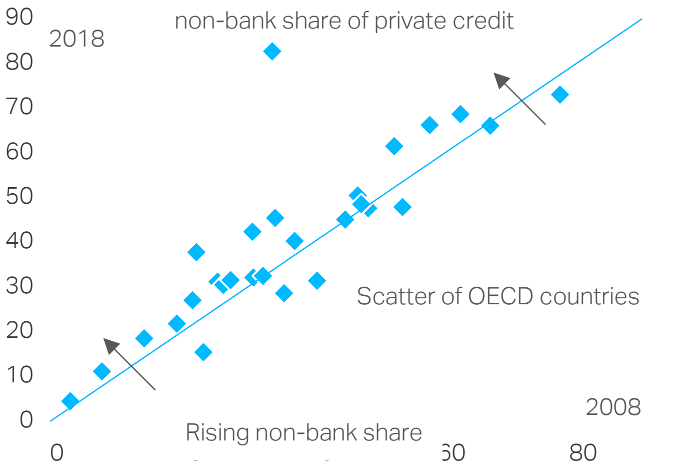
There have also been important increases in debt at the sectoral level. Many economies (DM and EM) have experienced a sharp rise in corporate leverage since 2008, including countries where household deleveraging prevented an overall rise in private borrowing. Even the consumer story is more complicated than it seems. Households in some countries have borrowed less to buy new homes, but they have taken on debt in other areas such as auto loans. The US and the UK, both countries that have reduced their household debt ratios since 2008, experienced a boom in car finance. In America, subprime borrowers (and securitization) were again at the centre of this story, which is why default rates picked up as soon as the Fed began raising interest rates. In the UK, the authorities have been more concerned about various leasing arrangements (such as PCP). While auto finance is not a threat to aggregate consumer balance sheets, it could still cause serious problems for the car industry. Global auto manufacturers have used easy credit to 'bring forward' demand, storing up future problems.

Chart 12: Non-banking boom



Source: BIS, TS Lombard

Chart 13: Common theme across the OECD



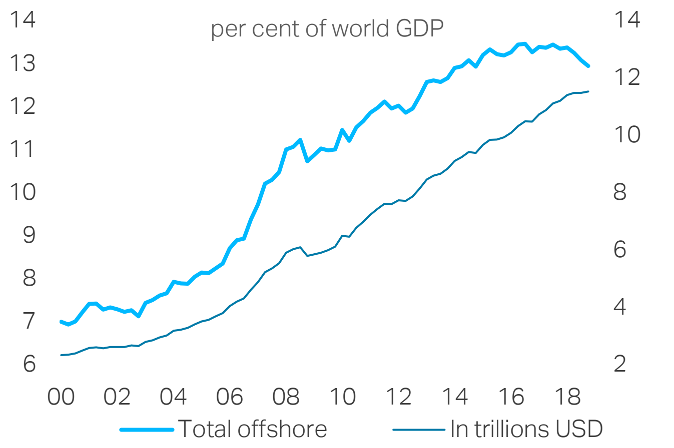
Source: BIS, TS Lombard

Rise of the non-banks (and the USD!)

The other big theme since 2008 is that capital markets have taken over from banks as the marginal source of credit provision (Chart 14). While banks have behaved rather cautiously, particularly compared to their behaviour in the early 2000s, capital markets have experienced a powerful search for yield. This created an insatiable demand for positive-yielding securities, particularly in the asset management industry, which is the main reason many DM and EM corporates have been able to issue large amounts of debt on remarkably generous terms. Companies at the weaker end of the rating scale have taken particular advantage of this search for yield, causing a surge in lower-investment-grade (BBB) and High Yield (HY) securities. BBB and HY yield debt now account for 60% of the outstanding stock of corporate debt, double their 2008 share. We've written about these trends before, describing them loosely as 'the Buyside Bubble'. While some clients object to this phrase, the term is intended to distinguish these developments from the subprime boom, which was all about banks (i.e. a 'Sellside Bubble').

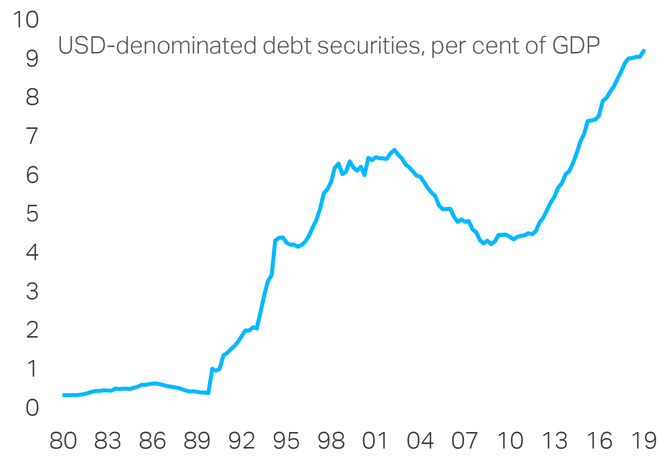
The other thing to bear in mind about the surge in capital-market lending over the past decade is that much of this debt has been denominated in US currency. This has strengthened the role of the dollar in the global financial cycle, which is why the currency has become such an important barometer of global market sentiment and risk appetite. When the value of the dollar rises, the balance sheets of USD borrowers deteriorate, which tightens financial conditions and restricts cross-border lending. In fact, EM borrowers were among the biggest 'beneficiaries' of the search for yield in global capital markets, raising their dollar exposure beyond the levels that caused a series of financial crises in the 1990s. This is also why periods of dollar strength and market turbulence now hit the emerging economies particularly hard.

Chart 14: Growing USD dominance



Source: BIS, TS Lombard

Chart 15: EM 'original sin'

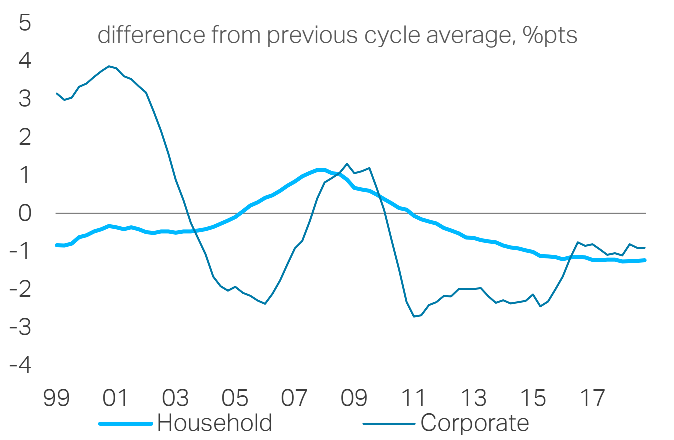


Source: BIS, TS Lombard

2. DEBT SUSTAINABILITY

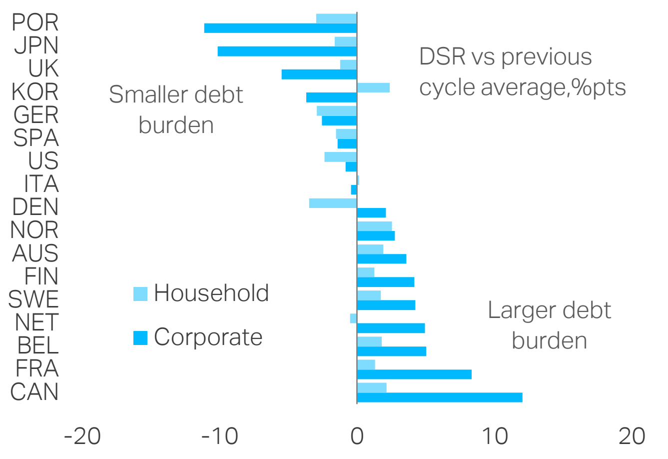
The further increase in borrowing since the subprime crisis raises obvious questions about what constitutes a 'sustainable' level of debt for the global economy, particularly if the world had reached dangerous levels in 2008. After all, 10 years ago there were already a number of commentators and market pundits who thought the world was facing a nasty 'balance sheet recession', which would require a long period of deleveraging and a lasting economic slump. So what should we make of the world's ability to generate even more debt since then? And how much more can the world borrow before solvency issues start to bite (assuming we haven't already reached that point)? These questions are particularly relevant now that policymakers are on the verge of introducing new monetary stimulus in an effort to revive global demand.

Chart 16: OECD debt servicing ratios



Source: BIS, TS Lombard

Chart 17: Debt servicing ratios

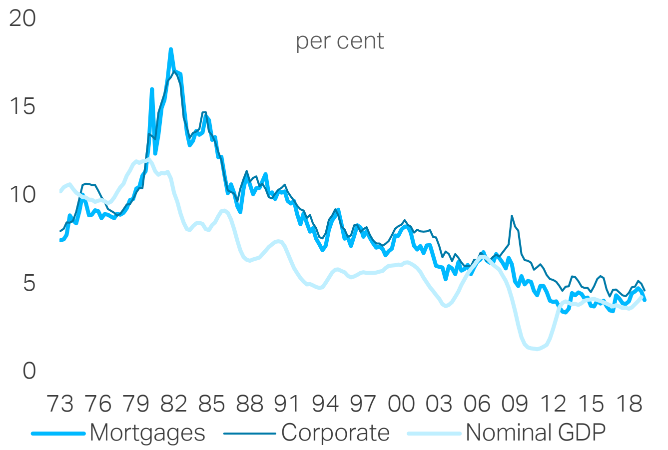


Source: BIS, TS Lombard

No magic level

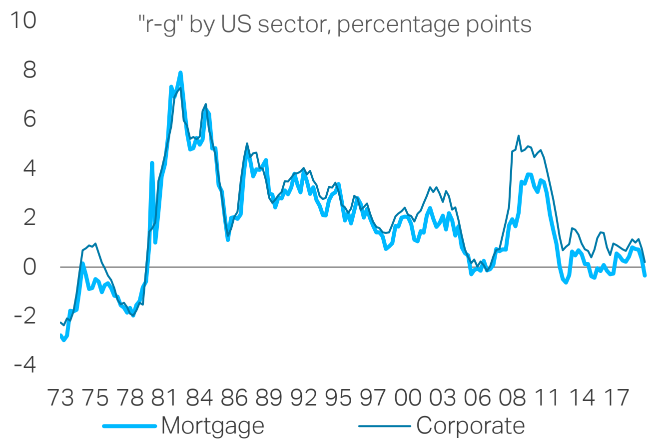
Global debt at 235% of GDP sounds high, but there is no simple guide to what constitutes a 'sustainable' level. Sustainability depends on a number of factors including the level of interest rates, net worth (i.e. the asset side of the balance sheet), future growth prospects, the characteristics of the lender (and the borrower), and even the currency of the loans. This is why we see such large variation in debt-to-GDP ratios, both over time and across countries. Perhaps the closest we can come to a single measure of debt sustainability is to monitor debt servicing ratios, the proportion of income required to meet interest repayments. The BIS publishes these data for a large number of developed economies, showing that despite the continued accumulation of debt across the advanced world, servicing costs for many countries remain below the peaks of previous economic cycles. This suggests there is no funding problem.

Chart 18: US borrowing costs versus GDP



Source: Datastream, TS Lombard

Chart 19: Sectoral r-g proxies



Source: Datastream, TS Lombard

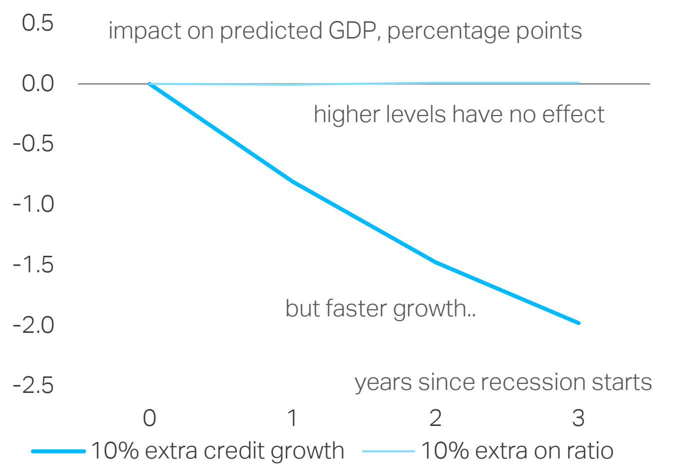
Still, it is just not the current burden of servicing debt that matters, but also how these costs are likely to evolve in the future. When assessing debt sustainability for the public sector, it is standard practice to compare bond yields to nominal GDP growth (“r-g”). If interest rates are below nominal growth rates, the share of income spent on debt servicing will decline over time. In theory, we should be able to make similar calculations for the private sector, though relatively few economists have tried to do this (we only know of Josh Mason’s estimates for US households). Calculating ‘r-g’ for the private sector is more difficult than running the calculation for governments because there is no single interest rate and sectoral incomes do not necessarily grow in line with GDP. Ideally we need an estimate of the average cost of servicing the stock of debt, rather than market-based interest rates (which provide the marginal cost). Still, with these caveats in mind, we can approximate ‘r-g’ for the private sector by comparing mortgage rates and corporate yields with nominal GDP growth. Chart 18 shows what has happened in the US. Though nominal GDP has slowed since the 1980s, making it harder to ‘inflate away’ debt, interest rates have fallen even faster – bolstering debt sustainability.

Growth matters more than ‘levels’

Low interest rates mean the world can cope with a higher level of debt, certainly compared with the situation in the 1980s, but even compared to what seemed possible a decade ago. Yet the world still suffers regular financial panics and periodic banking crises, which illustrate the dangers of leverage. How do we distinguish between sustainable increases in debt and more speculative/dangerous periods of borrowing? Recent research suggests we should pay special attention to the pace or borrowing, rather than its absolute level. When debt is growing rapidly it is more likely to be dangerous from a systemic macro point of view. This was certainly the case when the subprime bubble burst, as it hit those countries that had experienced the fastest borrowing particularly hard, not those countries that went into the crash with higher debt ratios.

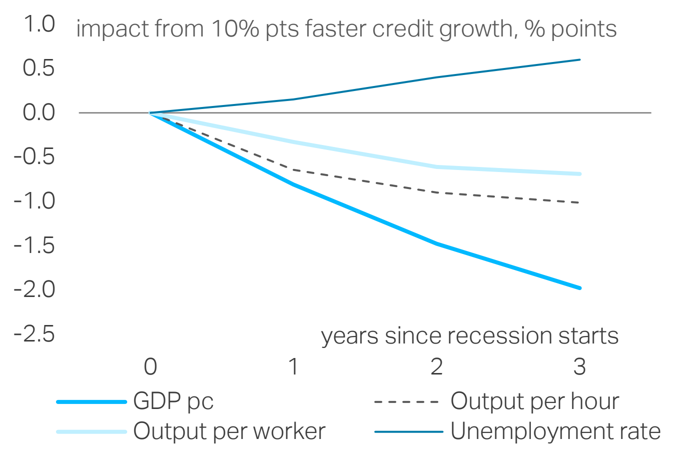
A recent Bank of England study, which looked at the experience of 26 advanced economies over 50 years, suggests this lesson also applies more generally. Growth matters more than levels (Charts 20 and 21). Other research supports this conclusion (see here and here).

Chart 20: Credit booms and recessions



Source: Bank of England

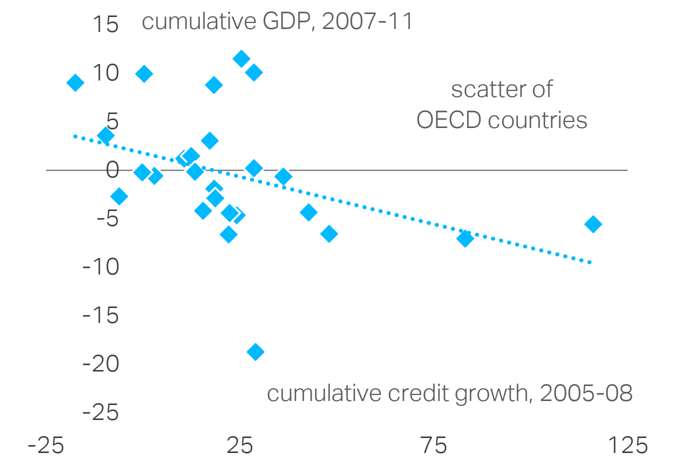
Chart 21: Impact of credit booms



Source: Bank of England

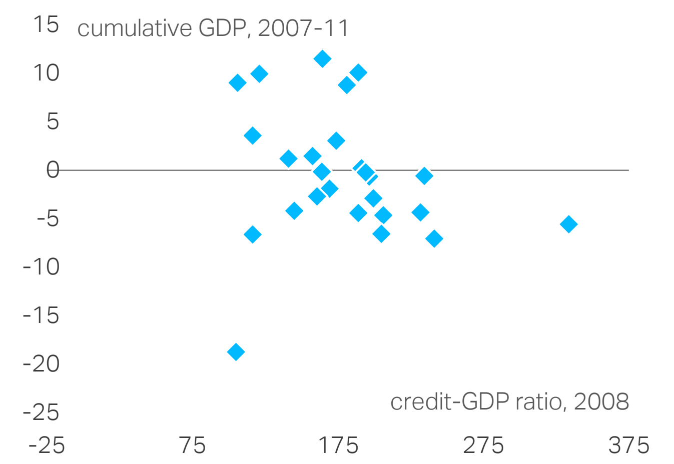
We don't need sophisticated econometric analysis to show that growth rates are more important than absolute debt ratios – simple scatter plots will do. Charts 22 and 23 show faster credit growth before 2008 was strongly correlated with subsequent economic performance, but there is no obvious link between average credit ratios and per capita growth. It is also interesting to extend the timeframe to look at what happens once the immediate downturn is over.

Chart 22: Faster credit, worse recessions



Source: TS Lombard, BIS

Chart 23: But credit ratios didn't matter?

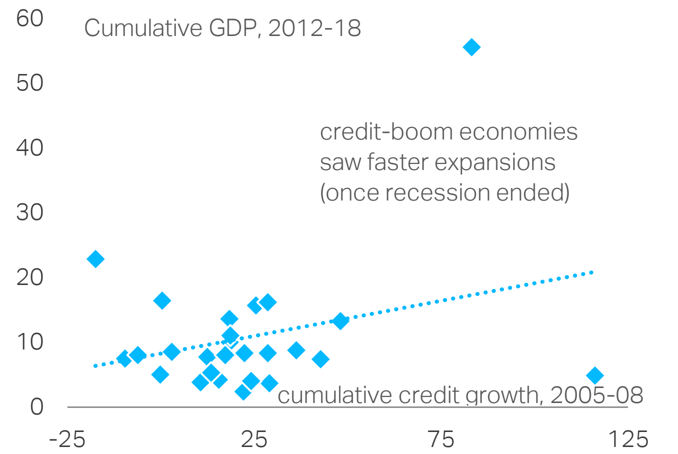


Source: TS Lombard, BIS

Can we find evidence of a lasting 'balance sheet recession'? Here the story is more nuanced. While countries that experienced the fastest credit growth in the run-up to the subprime crash have not underperformed in a relative sense (Chart 24) – i.e. relative to countries that didn't experience rapid credit growth – they have certainly performed worse compared to their own pre-2008 trends (Chart 25). This suggests credit booms artificially boost GDP and cause worst immediate recessions, but the impact on relative economic performance disappears quite quickly. To illustrate, the US and Spain suffered nasty recessions after the subprime crash but –

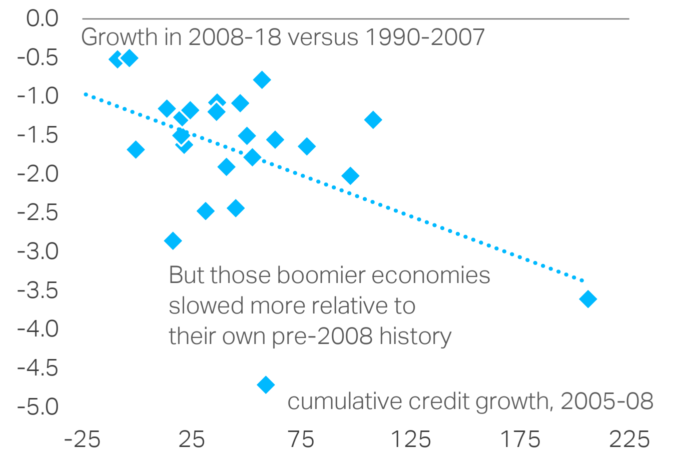
since then – both have performed well compared to other developed economies (even if they couldn't match their own pre-recession performance). 'Japanization' doesn't seem inevitable.

Chart 24: Relative decline soon wore off



Source: TS Lombard, BIS

Chart 25: But booms inflated pre-crisis GDP



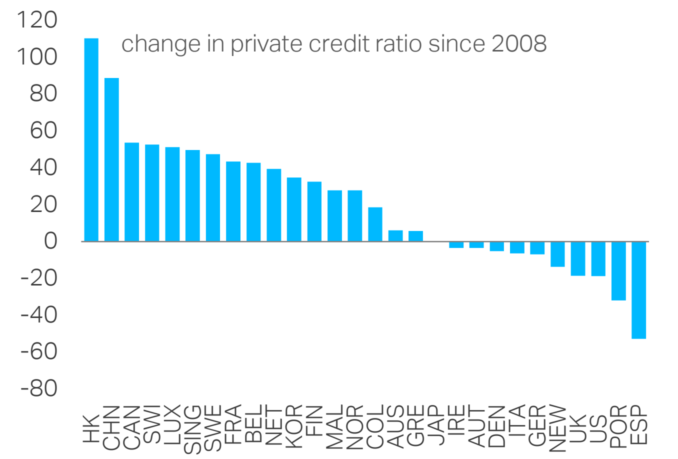
Source: TS Lombard, BIS

Danger areas

If it is the pace of borrowing that matters, not overall credit ratios, those countries that have experienced the fastest debt growth are surely now the global economy's main areas of vulnerability. On this basis, we should be watching developments in China, Hong Kong, Canada, Switzerland, Singapore, Sweden, France and Korea closely. But extending the analysis to the sectoral level, private corporations in a number of countries could also be in trouble – especially the United States. Of course, this doesn't mean there will be another 2008-style crash. Since capital markets have driven much of the recent expansion in credit, the systemic consequences should be less severe. The subprime crash was particularly deadly because the world's largest banks had leveraged themselves up to record levels using toxic collateral. When the value of these securities plunged, it triggered a nasty spiral of falling asset sales and forced deleveraging. If the 'Buyside Bubble' bursts, it would not have the same devastating macro consequences – though we would still expect a large decline in asset prices and a probably a recession.

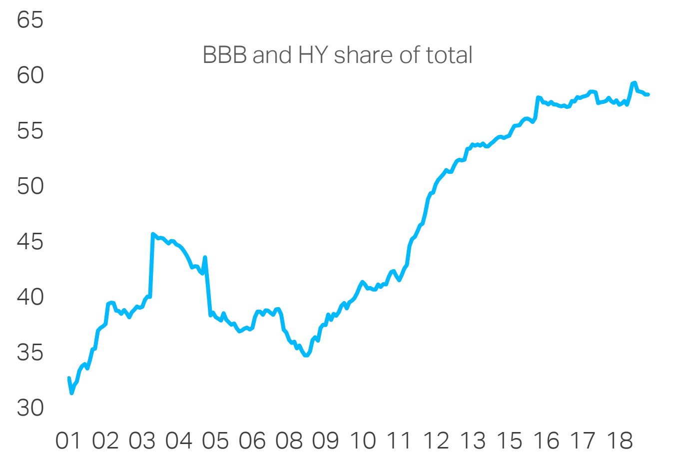
While it is always tempting to look for potential debt crises, most investors are now much less worried about a systemic financial crash that they were in 2018. The recent dovish pivot from central banks has clearly helped – far from 'overtightening' policy, which was the consensus worry 12 months ago, global policymakers are poised to add fresh stimulus. The important question now is whether this latest round of monetary easing will be sufficient to lift global demand and reflate the world economy. And this means global debt levels are still relevant. If rising leverage has supported global growth over the past decade, which seems true, how much longer can these trends continue? The New Mediocre has produced dismal growth rates even with record amounts of borrowing – imagine what it would look like if credit stopped growing.

Chart 26: Private credit divergences



Source: BIS, TS Lombard

Chart 27: Lower-grade corporate boom

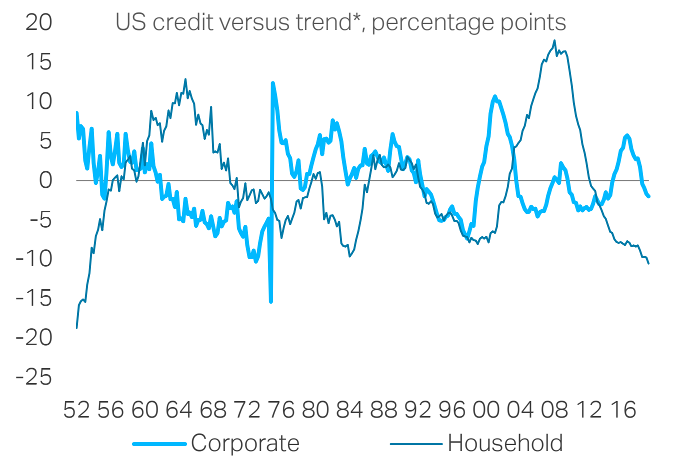


Source: Bloomberg, TS Lombard estimates

3. CREDITABLE RECOVERY

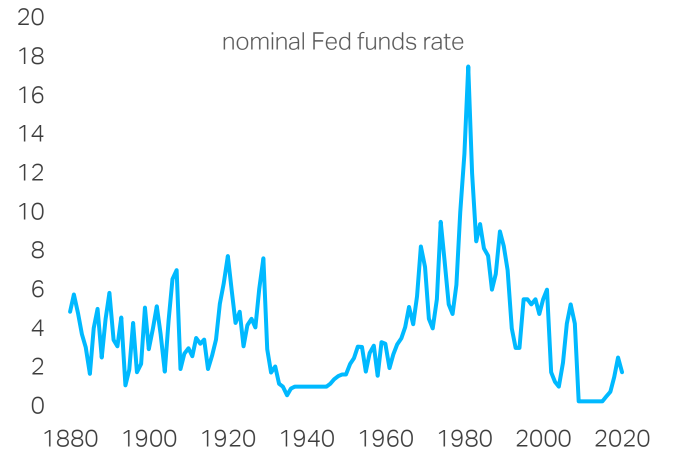
Critics accuse policymakers of masking a secular economic slowdown by inflating a series of bubbles. The Federal Reserve usually bears the brunt of this criticism. Savings and loans – LTCM – Dotcom – Subprime – corporate debt. The US authorities responded to each financial crisis by reducing interest rates to new lows, inflating new bubbles and causing bigger problems down the line. But perhaps this interpretation is too simplistic. If interest rates have declined for secular reasons, then any attempt to try to force yields higher by tightening monetary policy surely wouldn't have worked. In fact, those central banks that actively tried to raise interest rates usually ended up reversing those policies. Whether we want to call this 'secular stagnation' or not, it is clear that the world is now stuck in a high-debt/low-interest-rate equilibrium[1].

Chart 28: Forever blowing bubbles



Source: Federal Reserve, TS Lombard, *HP filter

Chart 29: Every crash brings lower rates

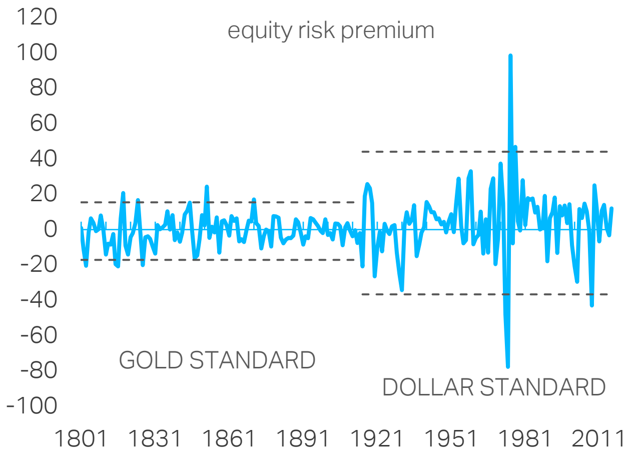


Source: Macrohistory database, Bloomberg

[1] One of our favourite recent pieces of analysis, by Gertjan Vlieghe at the Bank of England, shows how the modern 'financialized' system is much riskier than the one that preceded it (the Gold Standard), which has permanently raised the demand for safe assets (reducing equilibrium interest rates) – Charts 30 and 31. Others agree (see e.g. here).

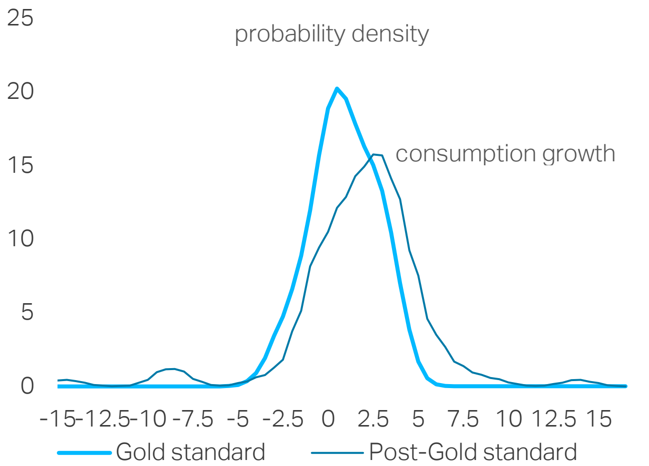
Regardless of who is to 'blame' for this high-debt equilibrium, the important issue now is about incremental growth rates. Unless there is a sudden secular revival (e.g. a productivity boom) or a "credit-less recovery" (one of those increasingly rare economic expansions that doesn't involve rising debt ratios), you have to wonder where the balance sheet to extend this global cycle will come from. As we saw in Section 1, much of the debt growth since 2008 came from three main sources: (i) China, (ii) countries/sectors that avoided the 2008 crunch and (iii) capital markets (i.e. the Buyside Bubble). Can these areas continue to support credit creation and global activity?

Chart 30: World is more unstable



Source: Bank of England

Chart 31: Tail risks happen more often



Source: Bank of England

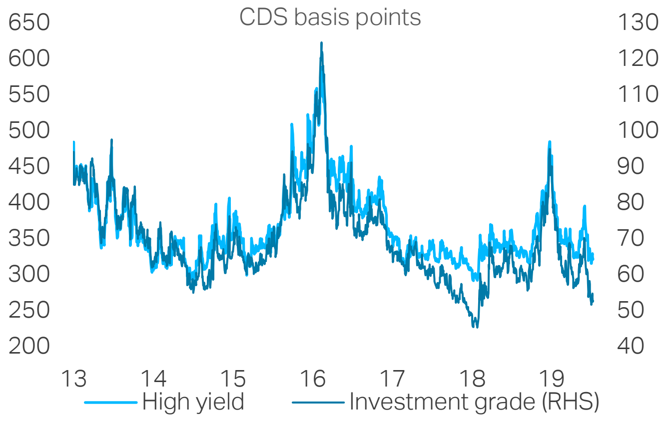
What will China do?

China surely comes closest to using a credit boom to 'artificially' inflate GDP, so what happens with Chinese policy could have a powerful bearing on the prospects for a global recovery. Most investors are assuming another large credit splurge, repeating China's stop-go policy cycle. Officials have certainly stepped up their stimulus efforts in 2019, using domestic bond markets to finance new rounds of infrastructure spending. But they also show a genuine reluctance to repeat the errors they have made over the past decade. China's authorities realize that another large increase in debt would compound their existing macro imbalances and exaggerate their existing financial fragilities. Even without a subprime-style crash, they risk a Japanese-style slump. This is why our China policy analysts think the authorities will continue to provide stimulus in the short term, but only on a scale sufficient to stabilize the domestic economy – not on the scale needed to reflate the rest of the world. And if the trade war with the US escalates again, the authorities might resort to RMB devaluation instead.

DM monetary easy

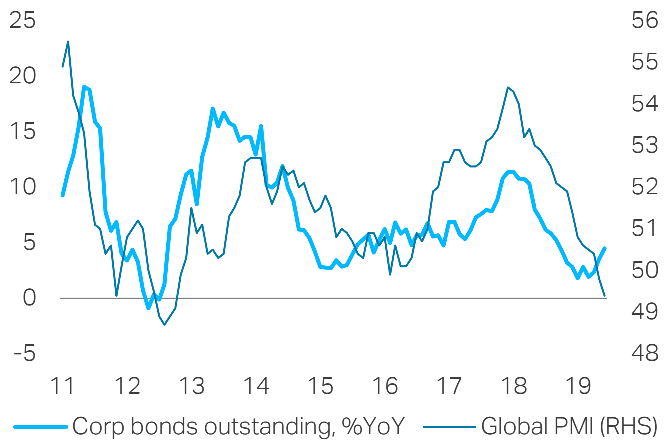
If the Chinese are no longer willing to stimulate their economy with debt, there will be even more pressure on Western central banks to boost global demand. The Federal Reserve has already signalled its willingness to cut interest rates and we expect the ECB to announce a package of measures in the autumn, including deeper negative interest rates and a new QE programme. But what will another round of monetary stimulus achieve? In fact, the prospect of fresh stimulus has already eased global financial conditions significantly. This was particularly important at the start of the year, when central-bank dovishness broke what was becoming a dangerous feedback loop between deteriorating credit markets, falling asset prices and weaker macroeconomic data. It is important to remember that the non-recessionary data we seen today is conditional on the easing in financial conditions that has already happened. If central banks failed to validate market expectations, by not easing policy this summer, they could trigger a significant deterioration in sentiment and perhaps a new period of turbulence.

Chart 32: Search for yield is back



Source: Bloomberg

Chart 33: Can CBs restart bond issuance?

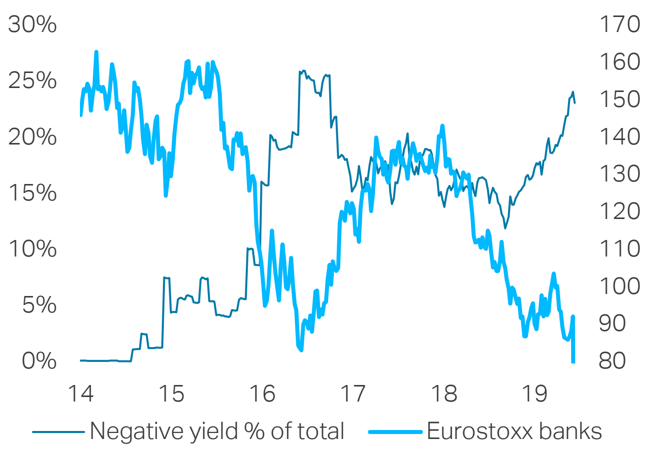


Source: Bloomberg, TS Lombard

Curse of negative rates

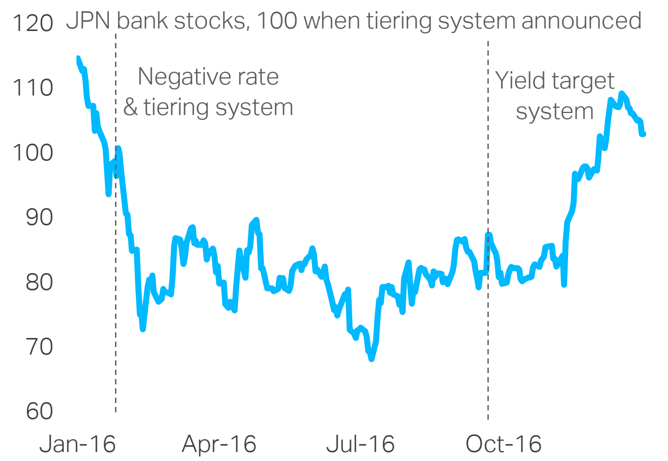
Even if central banks do enough to prevent a recession, can we expect the latest decline in yields to stimulate credit and boost demand? When it comes to the traditional 'bank lending channel', this is unlikely. Bank stocks have not reacted well to the plunge in interest rates, particularly in areas where yields are negative. This problem is most acute in Europe, where speculation the ECB will soon reduce its deposit rate further below zero isn't helping. Remember, central banks typically charge negative interest rates on excess reserves, which means they act like a tax on banks. Since banks – in aggregate – cannot reduce their excess reserves, or pass on the cost to their depositors (who could be highly sensitive to negative deposit rates) any further decline in interest rates will surely just erode the profitability of the sector.

Chart 34: Banks hate negative yields



Source: Bloomberg

Chart 35: When the BoJ announced 'tiering'



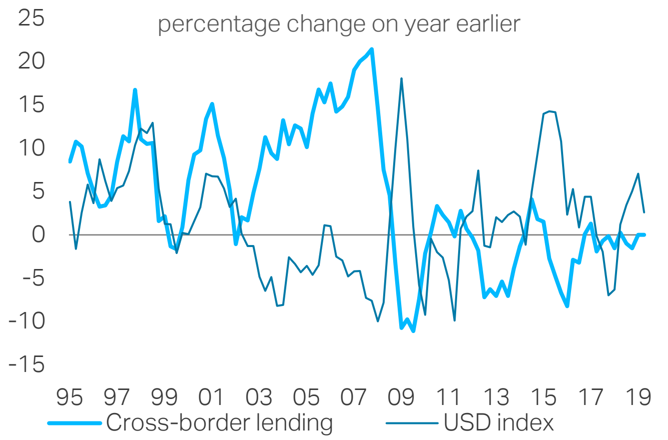
Source: Bloomberg

The ECB could try to limit the impact on banks by introducing a 'tiering' system – i.e. by excluding some existing deposits from the charge – but the Bank of Japan's 2016 experience with such a framework wasn't encouraging. Bank stocks plunged 30% after the BoJ announced its tiering system – on fears this would allow the BoJ to cut interest rates substantially further – and only recovered after officials switched to a yield-targeting QE framework instead.

Stimulus hinges on non-banks (and the USD)

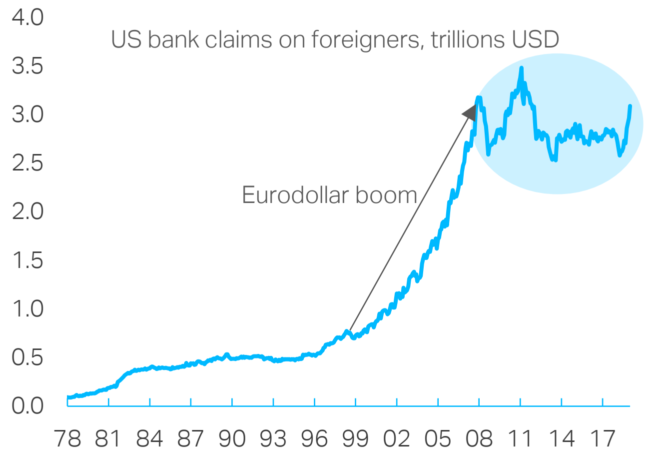
While banks are unlikely to boost their lending in response to lower interest rates, there should be a more favourable impact on capital markets. Credit spreads have already narrowed and there has been a modest revival in global bond issuance (Chart 33). This is surely central banks' best hope for reviving credit creation and extending the economic cycle – especially if China is no longer willing to 'fund' the global expansion. Interestingly, even the ECB is now paying more attention to non-bank lending, adjusting its rationale for further stimulus. ECB analysis shows that while negative deposit rates have failed to stimulate traditional bank lending in the way the authorities had hoped, they provided a powerful incentive for banks to bid up asset prices. ECB staff highlight a 'hot potato' effect where individual banks try to reduce their excess reserves by purchasing debt securities. This strengthens the search for yield and boosts credit supply.

Chart 36: Dollar and credit creation



Source: BIS, Bloomberg

Chart 37: Structural dollar shortage



Source: US Treasury

At the global level, a weaker dollar would also be helpful to stimulating capital-market lending, particularly for those EM borrowers who have a currency mismatch on their balance sheets. As we explained in Section 1, there is now a clear link between the trade-weighted value of the dollar, global risk sentiment and cross-border lending. Yet despite the prospect of Fed interest rates cuts, the USD has been remarkably range-bound in 2019, which suggests engineering a weaker currency will not be easy, particularly if there is a structural dollar shortage. The dollar also has relative growth differentials on its side given the US economy has remained resilient to weakness in the rest of the world, while there is no let-up to Europe's slump.

On balance, we think another round of DM monetary easing, combined with modest Chinese stimulus, will be sufficient to produce a gradual improvement in global demand by the end of the year. But global growth rates are unlikely to match the 2017-18 expansion, let alone threaten to break the world out of the New Mediocre. And if central banks are unable to sufficiently reflate the global economy, it is surely only a matter of time before the fiscal authorities take over. By becoming the marginal source of global demand, China has demonstrated the power of using government balance sheets, especially during a time of secular weakness. There is a growing consensus that Western government must eventually do the same. The only question is one of timing – will they do this while the world economy is still growing, or will they wait for a recession before agreeing a more forceful response. Either way, investors should probably get used to 'record' levels of global debt – because they are probably going to keep rising…

Bottom line

Global debt levels remain close to record levels, having risen further since the subprime crisis. Does this matter? Since debt servicing is manageable, the brief answer is 'no'. Yet the world economy is clearly now in a high-debt/low-interest-rate environment, which means bond yields are unlikely to revert to their pre-2008 levels anytime soon. And history shows that while the there is no 'magic level' for debt sustainability, rapid credit expansions can bring serious trouble – which exposes a number of areas of vulnerability in the global economy. There is also a question about where the incremental growth is going to come from now that China is reluctant to use its balance sheets to reflate global demand and the international banking system is struggling with thin margins and negative yields. Central banks' success in extending the cycle could depend on their ability to revive the search for yield and ease the global dollar shortage.

The Macro Picture will take a summer break and return on 22 August.

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