# Perspectives

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## Can the debt mountain be conquered?

IHAG PRIVATBANK

# The thing about debt

**Dear investor**

A remarkable number of quotes are attributed to the American author Mark Twain. Among others, these include the observation that "prediction is difficult – particularly when it involves the future", and "October is one of the peculiarly dangerous months in which to speculate in stocks. The others being July, January, September, April, November, May, March, June, December, August, and February."

Equally humorous, but perhaps more profound, is another quote he is reputed to have penned: "From now onwards I will only spend what I can bring in, even if I have to borrow money as a result." And so the debt accumulation process begins.

All forms of debt have one thing in common: Whether designed to allow a purchase to be brought forward or to leverage the return on an investment, there is always an obligation for the debt to be settled, or at the very least interest payments must be made on an ongoing basis in order to use the money in question.

The world has never been so indebted as it is today. Various crises over the last decade and a half – from the financial crisis of 2008/09 to the more recent coronavirus assistance packages – have led to a relentless increase in both public and private debt burdens. This was initially a manageable problem, as long as there was sufficient economic growth or at least a sufficiently low interest rate environment (ideally even falling interest rates). If such a favourable constellation had persisted for a prolonged period, these debt problems could no doubt have been consigned to the history books.

So what does this mean for economic growth going forward? A combination of the record-high debt levels currently in place and the unprecedented speed of interest rate rises over the last 18 months may well induce a queasy feeling in some quarters. Precisely how are these debts supposed to be reduced with a deteriorating economic outlook? In such a scenario, might higher inflation actually be a useful tool for reducing the value of this debt in real terms?

These are the questions we intend to investigate in this issue of Perspectives. Debt plays a not unimportant role in economic development – but can simultaneously harbour a great deal of risk. The deliberately euphemistic (and heavily satirical) observation of the Austrian writer Ernst Ferstl – that debt should simply be viewed as "negative saving" – is a nice way of putting it, but obviously does not do justice to the complexity of this issue.

We wish you an enjoyable read.

Christoph Boner
Chief Investment Officer

# When debt rises faster than economic growth

The world has never been as indebted as it is now. At the end of 2020, the outstanding global debt mountain stood at USD 226 trillion – and it is safe to assume that the 300-trillion mark was passed in the summer of 2023. Accordingly, total outstanding debt is now likely to stand at more than 300% of global economic output. Hypothetically speaking, even if the world were to suddenly stop spending, we would still have to work for a full three years to pay off this debt.

There are a number of reasons for the rise in the size of this debt mountain. Private debts have risen as a result of various socio-demographic developments and a generally higher inclination to spend on the part of consumers. Government debt levels have surged in the wake of various crises – such as the financial crisis at the end of the first decade of the current millennium, and more recently the support packages rolled out to combat the Covid crisis, to name just a couple of significant examples. Corporate debt burdens have likewise increased sharply as companies look to strengthen their return on equity – as this metric can be increased through higher levels of debt.

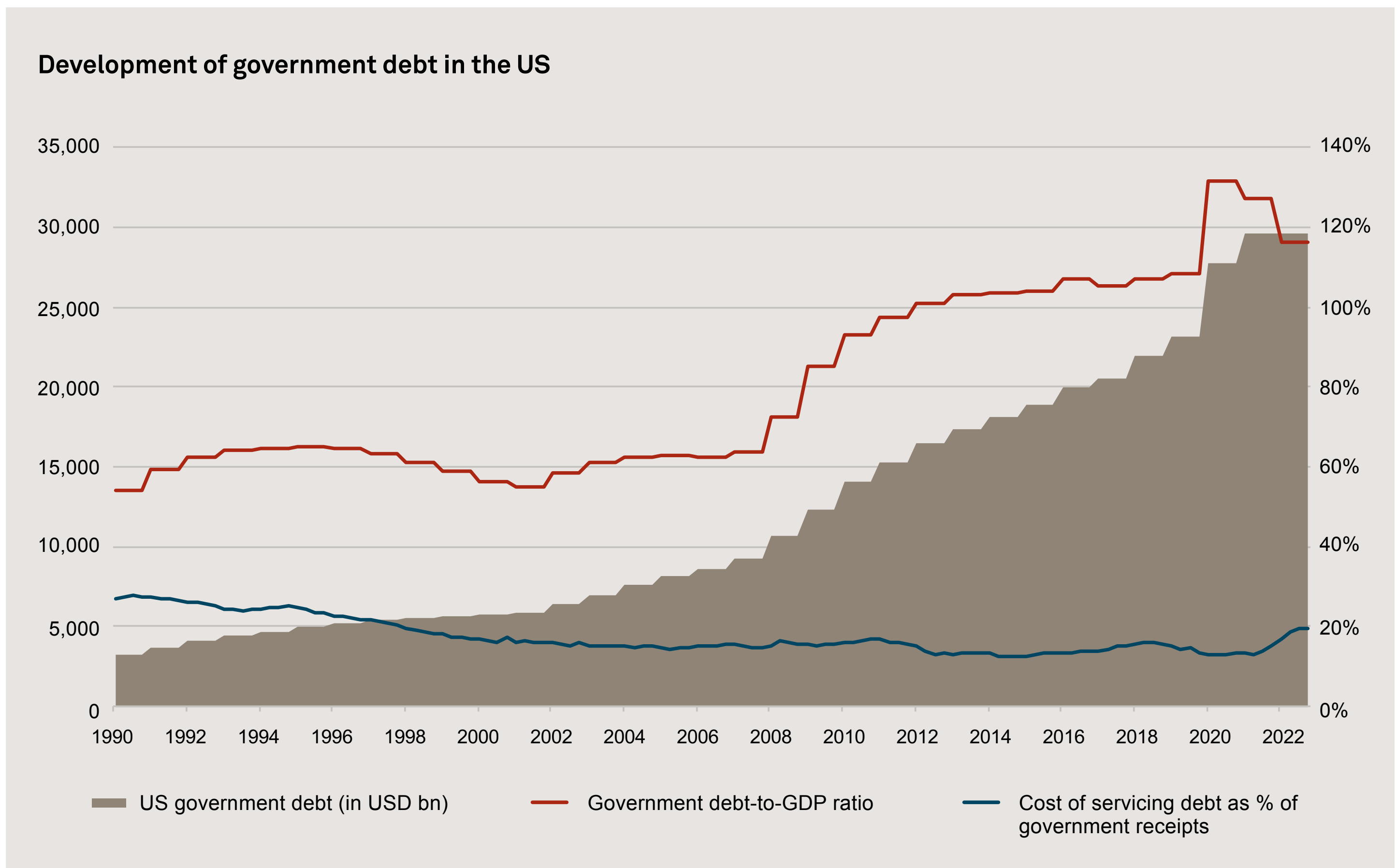
But a common factor to all of these developments is that they were greatly facilitated by the persistent fall in interest rates over the last 40 years. A rising debt mountain in itself does not pose a problem as long as growth in

economic output is at least as strong – but unfortunately this has not been the case in recent decades. In 1983, at the start of this phase of declining interest rates, global debt amounted to slightly more than 100% of global economic output. Over the last 40 years, therefore, the global debt mountain has risen at three times the rate of the global economy.

In the US, economic output has increased by some 291% (or just under 5% annually) over the last 30 years – but the growth in US debt works out at more than 700% over the same period. In other words, with debt growth having exceeded economic growth by around two percentage points annually, US debt as a proportion of economic output surged from below 60% to more than 130% at one point.

Economic growth and falling interest rates make increases in debt manageable to a certain extent. However, both developments could now have reached a crossroads.

As the global economy becomes increasingly mature, the incremental growth of aggregate economic output necessarily wanes for technical reasons. Leaps in technology – such as the invention of the steam engine in the 18th century or the proliferation of the internet at the end of the 20th century – can trigger macroeconomic growth surges, but setbacks such as the destruction of capital stock in global wars can equally lead to growth. Whether – and to what extent – the much-discussed current theme of artificial intelligence can unleash a new growth spurt remains unclear.



But at the same time, the trend of ever-lower interest rates may now have been halted for quite some time. The ongoing support provided to economic growth in recent years by the injection of ever greater levels of liquidity – particularly through interest rate cuts – was only possible thanks to a combination of technological progress, the increased exploitation of comparative cost advantages on the back of globalisation, and persistently falling energy prices. Too many of these phenomena have been stopped in their tracks in recent months to enable monetary policy to remain expansionary against a background of rising rates of inflation.

Reverting to the example of the US, the interest rate burden as a proportion of government income was languishing at a historic low of 12% as recently as March 2022, but has shot up to more than 20% in recent months. Put another way, one dollar in every five of national income is now spent on servicing US debt – and note that this means purely paying off the interest, rather than making any inroads into capital repayment.

With lower growth and higher interest rates, debt mountains are becoming a problem that just won't go away. Both developments necessarily lead to reduction in debt, either because refinancing is more expensive, or in a more direct way through the default of the borrower. But equally, both of these phenomena lead to a slump in asset values, which has historically tended to result in a financial crisis and recession. In other words, the spiral of credit financing can also embark on a downward trajectory.

300%

**The global debt mountain is currently more than three times global economic output, and therefore twice as high as in 1983 – which marked the start of the era of falling interest rates.**

USD 32,989 bn

**The current size of the US government debt mountain, equivalent to more than 120% of US economic output. The equivalent figure for Switzerland is just under 28%.**

# Not pain-free but possible – orderly, long-term deleveraging

Although an economic slowdown will always result in increased calls for more accommodating monetary policy, central banks currently have no leeway to cut interest rates. As a result of various inflation-stoking developments – from demographic shifts and the partial restructuring of the economy away from fossil fuels to increased spending on security – interest rates will remain high for the foreseeable future. This will maintain the pressure that high indebtedness is already exerting on asset values and economic growth.

But while the degree of indebtedness indicated above may already be a cause for concern, the actual debt situation is even more serious due to a number of factors:

**Shadow banks**

Against a backdrop of increasing bank regulation, a not insignificant proportion of credit lending has now migrated to other areas – such as private equity companies, lending platforms, and hedge funds. With interest rates rising, significant value losses can be expected here that will for the most part not be apparent in official debt statistics.

**Credit card debt**

Despite higher interest rates, credit card debt has climbed to new record levels. One explanation for this is a high degree of job security, which is in turn feeding a record-low savings rate. With interest rates of more than 20% on credit card debt, the modern consumer – a key pillar of macroeconomic demand – has at the same time become highly vulnerable.

**Real estate**

In the world of property, revaluations of commercially used properties are now widespread. When the financing of such properties relies heavily on debt capital, interest rates are rising, and vacancy rates are high, lower yields and therefore lower valuations are the inevitable result.

On the positive side, while this constellation clearly harbours risks in some respects, it should be noted that the structure of real estate debt is essentially much healthier than it was at the time of the financial crisis of 2008. Specifically, debt is in many cases of a longer-term nature and staggered, hence the pressure of higher interest rates only unfolds over time and is less likely to lead directly to defaults. Where individual debt is concerned, greater affordability is also likely due to persistently tighter labour markets, just as the development of corporate profitability facilitates an orderly response to higher debt interest levels. By contrast, the reduction of what are in some cases eye-watering government debt mountains can be expected to trigger painful developments – whether through tax increases that withdraw resources from the economy or through cuts to public services.

Having said all this, it does appear to be the case that the global debt situation can be resolved in an orderly way, for all that this process will not be pain-free. No other credible pathway to a sustainable economic footing exists, as the more radical alternatives do not bear thinking about.

Debt enables money to be channelled to where it is needed.

**Christoph Boner**
**Chief Investment Officer**

**What is debt?**
In the financial sense, debt is a transfer of money between economic subjects over time. For example, debts may be created to bring forward the possibility of consumer spending or for investment purposes. In order to use this borrowed money, the debtor has to pay interest, and the debt is usually paid back either in staggered instalments over the term of the loan as a whole, or in one single amount at the end of the term. The best-known form of debt in the financial system is a bond, a financial product used by both governments and companies to borrow money from investors. The most common forms of individual debt are mortgages, car leases, and outstanding credit card debt.

**Why can it make sense to take on debt?**
Debt allows for the temporary transfer of money from economic subjects who currently have no need of the money in question to those that do. It gives the recipient the immediate opportunity to make a purchase or an investment. Debt is an efficient tool in the system of capital allocation in an economy.

**What are the risks?**
Interest has to be paid for at least the period in which the borrowed money is used; a debt will often be only for a fixed period, and the capital sum must be repaid – either over time or at the end of the term. The rate of interest can be fixed right from the start or coupled to the prevailing level of interest rates by a specific mechanism. The risks involved include not just potential rises in interest rates, but also a possible inability – or indeed refusal – on the part of the debtor to settle their debts, which can then result in bankruptcy.

**How is the rate of interest determined?**
The rate of interest payable on a debt is typically determined by three factors. First of all, a basic rate of interest is payable based on an arbitrage system, whereby this depends on the prevailing level of interest rates in the currency in which the debt is denominated. Secondly, a time premium is payable – in other words, it is generally the case that the longer the money is borrowed for, the higher the rate of interest payable. Thirdly, a “risk premium” is applied to compensate the creditor for the risk of the borrower defaulting. The greater the default risk, the higher this risk premium will be.

**Why is debt needed?**
Like any other financial resources, borrowed money can be used for consumer spending or investment purposes. In the case of consumer spending, debt allows the borrower to bring forward a purchase in exchange for payment of interest. When the debt is used for investment purposes, the aim is to at least cover the debt interest with income from the corresponding investments, and thereby achieve a higher return on capital through higher income. This leverage works both ways, however. If the income earned on the investments does not suffice to cover the debt interest, the debtor's capital will take the corresponding hit.

**How are debt levels brought down?**
In addition to the orderly repayment of debt through the settlement of interest payments and repayment of the capital amount, debt can also be eliminated through the default of the borrower or reduced by the effects of inflation – as long as the debt amount is not index-linked. In the former scenario the creditor suffers a loss, which may then trigger further defaults. In the second scenario, a transfer of value from the creditor to the borrower takes place. In both these cases, the reduction of debt goes hand in hand with a loss in prosperity, with the additional potential to trigger a chain reaction in the form of further defaults.

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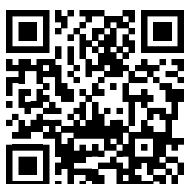

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