Global debt: will the fourth wave of debt turn into a tsunami?

Only a couple of months before the “Great Lockdown”, the World Bank published fundamental research into the so-called “waves of debt”, or periods of development of the global economy and financial markets when debt obligations show a steady and consistent growth for all categories of borrowers: sovereign and corporate debtors, households and international and national development institutions, primarily multilateral development banks (MDBs).

According to the authors of the research, there have been four such waves over the last fifty years. The last wave started to emerge immediately after the end of the 2008-2009 global financial crisis (GFC). However, this one is the most powerful in terms of scale and the number of affected borrowers and lenders. The latter have noticeably expanded through the rapid development of the shadow banking sector, which, at the suggestion of the Financial Stability Board (FSB), was renamed market-based finance as an alternative to bank lending. The explosive growth in new loans, which heavily indebted sovereigns are now using to cope with the coronavirus crisis as part of fiscal stimulation measures, clearly threatens to bring about a “debt tsunami” with all the attendant costs for development and global financial stability.

New realities for the financial sector

This forecast is not just another “horror story”. The three previous waves of debt invariably ended with large currency and/or banking crises, often both. Like a real tsunami, which is the result of a specific natural phenomenon – an earthquake – stress in international credit relations leads to a stage of the crisis (local, regional or global) caused by a specific trigger. In 1982, this trigger was the default by oil-producing Mexico of its sovereign debt, which grew into the Latin American debt crisis. This first paralysed the US banking sector followed by the international monetary and financial system. The June 1982 edition of Institutional Investor had

a memorable cover that depicted a Mexican cowboy in a huge sombrero kicking the planet into the abyss, as if it were a football (the illustrator played on the fact that the football world cup was being held in Mexico at the time).

There were other triggers after this: the bankruptcy of corporate borrowers in Asia in the late 1990s and Greece's default that turned into financial problems for governments in Southern, Central and Eastern Europe. At the current stage in the growth of the fourth wave of debt, this mission seems to have fallen to the coronavirus, or rather the consequences, risks and challenges generated in the global economy, including as a result of the unprecedented scale of fiscal and other measures taken by the authorities to cope with quite unexpected problems.

The inevitability of a global economic recession today has become reality, although, even in late 2019, most forecasts pointed to accelerated global GDP growth, rather than a slowdown, let alone a fall in production in absolute terms. However, first the slowdown in the Chinese economy, which led to a fall in demand and consumption of goods such as oil, coal, ferrous and non-ferrous metals, the suspension of production of dozens of intermediate products included in global production chains, and then the biggest shock experienced by the oil market took their toll. The effects of the pandemic, reinforced by lockdown measures, mean that we can only expect a return to economic growth in 2021, and only provided that the health situation has significantly improved.

However, recovery rates are unlikely to keep up with the growth in the debt burden of sovereign and corporate borrowers. The fall in revenue owing to an objective decrease in the tax base and the provision of numerous tax benefits, the sharp decline in or even absence of corporate profits all threaten the prospects for repayment as well as for servicing the accumulated debt. It is true that the monetary policies of the central banks mean that the conditions for refinancing current debt payments are still favourable for those debtors who have retained access to the debt market. However, for obvious reasons, this will not lead to a reduction in the absolute size of debt obligations. The prospects for growth of the economic potential of debtors for generating financial flows required to meet accumulated debt obligations also look doubtful, as money received from new borrowings is only rarely used to finance the production of goods and services. In

the next couple of years, the whole economy, as well as all industries within certain economies, will experience major difficulties.

Therefore, particular attention should be paid to the financial sector, where two “stress zones” have already formed. On the one hand, there is the hard-to-manage sovereign debt of a large group of countries and of the corporate sector of developed economies and several emerging economies, in particular China. For the last ten (!) years, the G20 has declared every year that it is necessary to “ensure that debt as a share of GDP is on a sustainable path” and has given numerous recommendations on this subject to developing countries. What is actually happening will be described in later sections of this article.

The other side of this “financial medal” is the ability of pension funds, insurance companies and other investors and lenders, which are dominated by different types of monetary funds, to meet their obligations to their many clients. There are two reasons: historically low yields from financial assets held by institutional investors, including sovereign bonds from developed economies, as well as the prospect that a significant part of the financial assets may be impaired as a result of the very probable default of sovereign and corporate borrowers from emerging markets and developing nations.

(to be continued)