2 June 2023

ECONOMIC UPDATE

The global debt mountain got a little bit smaller

Key Points

- **The global debt to GDP ratio has declined in recent years, mostly due to high inflation;**
- **That ratio declined in most OECD countries, although it has risen in some;**
- **Total debt to GDP in Australia is very low by OECD standards but the household debt ratio is high;**
- **Most countries have at least one sector of the economy with high debt.**

The current Debt Ceiling debate in the US is a reminder of the problems a country can have if it has too much debt. Once a quarter an international industry banking association (the International Institute of Finance, or IIF) publishes data on global debt. Knowing how much debt is outstanding and who owes how what debt to whom is important to understanding potential economic and financial vulnerabilities.

There are limitations on focussing on the amount of debt outstanding:

- It is not the size of debt that matters but the ability of the borrower to repay debt. That is why the main benchmark used for sustainability is debt relative to the size of incomes (or in the case of countries, debt to GDP);
- Even then a simple debt to GDP ratio can be misleading as high-income countries are able to service a higher debt ratio than low-income earners;
- The other key variable for debt servicing is interest payments (and is why a ratio of interest payments to income is used). The ratio will be influenced by the amount of debt outstanding, the size of borrowers' income and the level of interest rates;
- Another important question is whether debt is used to fund consumption or investment. Investment spending (hopefully) will lead to higher future income making it easier to repay debt.
- This leads to another important benchmark of debt relative to assets (and the quality of those assets);
- Focussing upon total debt outstanding for an economy might disguise trends within sectors of the economy. The IIF details the debt outstanding for the four sectors of the economy (households, firms, governments and financials) relative to the total size of the country GDP; While that is a reasonable ratio to use for government comparisons (as governments can tax the wider economy) it is a little misleading otherwise as other sectors are only able to fund debt from their own sector income;
- The IIF details financial sector indebtedness, defined as loan and bond financing from financial markets. The measure chosen by the IIF excludes deposits which is another form of debt albeit one that is highly regulated.

Despite these limitations, examining debt to GDP ratios at an aggregate level provides a useful first screen for where potential economic or financial vulnerabilities to debt could reside.

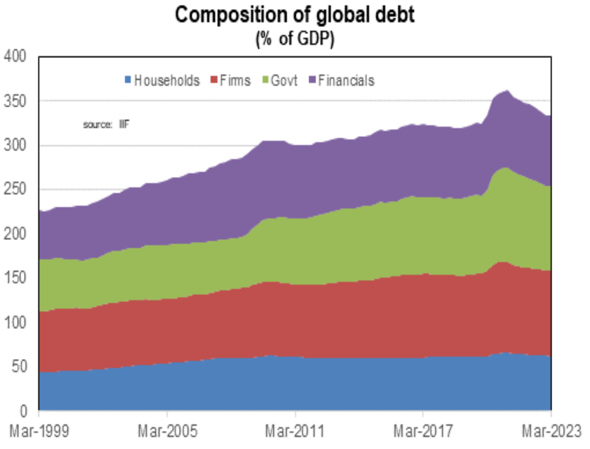
A slightly smaller debt mountain

The global debt to GDP ratio has decreased over the past couple of years. That has mostly reflected the sizeable rise in global GDP as a result of higher inflation. Actual debt has risen, most notably for governments and businesses. The rise in government debt reflected the use of fiscal policy to protect household and business incomes through the pandemic (and more recently through the sharp rise in the cost of living). The big rise in business debt was driven by the need to fund higher inventories, to boost capacity to meet the strong increase in demand through COVID as well as to overcome supply-chain problems.

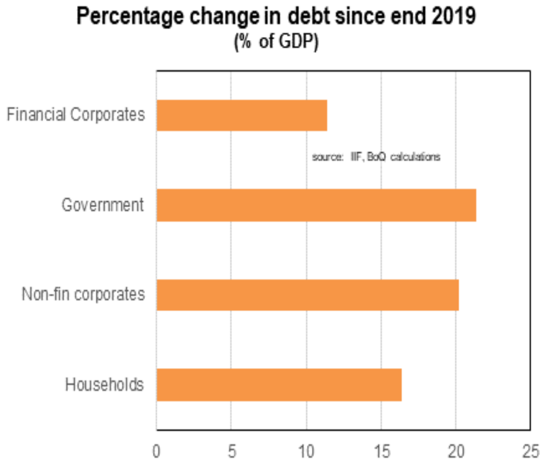
Movements in debt to GDP ratios since end 2019 have been mixed across OECD countries. While there was a modest rise in some countries (such as the US and France), there was substantial decline in others (Ireland, Norway, the Netherlands). The decline in the debt ratio in Australia (of a bit under 20%) was broadly in line with the (unweighted) average that occurred across the OECD over that time.

A key determinant of the movement in debt ratios for some countries was how they were impacted by high commodity prices. A number of energy exporters (such as Norway, Australia and Canada) received a significant boost from higher energy prices, helping their debt ratio to decline. By contrast debt ratios rose in some energy importers (such as France and Japan).

The global debt ratio has declined over the past couple of years mainly due to higher inflation.



The biggest rise in global debt in recent years has been for governments and firms.

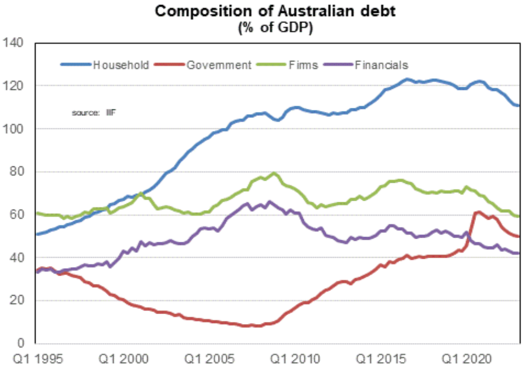


The debt ratio in Australia is at its lowest level in 9 years'

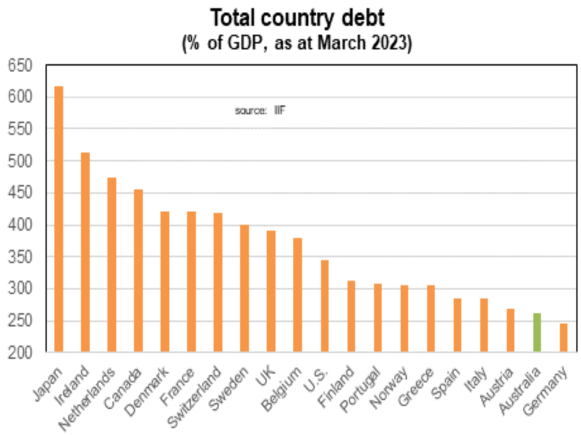
In Australia, the total debt to GDP ratio has declined to its lowest level in around 9 years. The ratio declined in each of the four segments of the economy. The ratio for the Australian financial sector is near twenty-year lows, and twenty-five-year lows for the corporate sector. The decline in the household debt ratio unwinds the rise that took place between 2012-18. The fall in the Government debt ratio only partially offsets the increase that occurred due to the budget deficits to fight COVID.

The total debt to GDP ratio in Australia is at its lowest level since 2014.

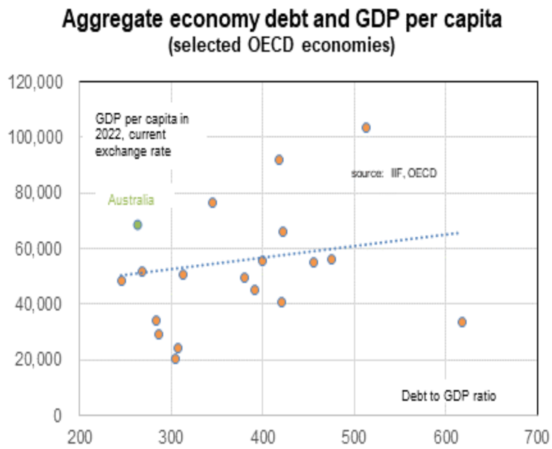
The debt ratio declined across all segments of the economy.



Australia has a very low debt ratio by OECD standards.



Higher income countries can afford to borrow more.



Most countries have at least one high debt sector

By peer country standards the debt to GDP ratio in Australia is very low. Interestingly, the aggregate debt ratios of some countries that have had debt problems over the past decade (such as Greece, Spain, Italy and Portugal) are low while countries that to date have had few debt problems in recent times (such as Canada) have a debt ratio that is relatively high.

One factor behind the relatively low debt level in Greece, et al is those countries have relatively low incomes. This would place a natural restraint (and perhaps desire) on how much the private sector can borrow. By contrast, the governments in those countries were able to borrow more reflecting their ability to tax the entire economy as well as their status as typically the highest credit rating entity in the economy.

Japan's aggregate debt ratio is substantially higher than other OECD economies and at face value suggests a looming substantial problem. Maybe in time it will be. But the extremely low interest rates that has been a feature of Japan over the past couple of decades (as well as substantial Bank of Japan purchases of government debt) has meant that debt has been able to be serviced with few problems. The test will be how Japanese borrowers cope if interest rates move substantially higher.

But as demonstrated by the experience of Greece, Italy, Spain and Portugal last decade it is not the total debt in an economy that is the critical problem but debts in a particular sector of the economy. For most economies there is at least one sector that has high debt (Germany and New Zealand are the exceptions). In Australia's case, households are the high debt sector (defined as having debt above 100% of GDP). In the case of Greece, Italy, Spain (and the US) it is the Government sector. In some countries (Canada, Japan and Switzerland) they have three sectors that have debt above 100% of GDP.

Composition of country debt as at March 2023
(% of GDP)

Country	Household debt	Business debt	Govt debt	Financial debt
Australia	111	59	50	42
Austria	48	95	76	49
Belgium	60	134	106	80
Canada	101	113	87	155
Denmark	88	129	36	169
Finland	63	101	61	88
France	64	160	108	89
Germany	54	73	61	57
Greece	44	52	197	12
Ireland	25	143	38	307
Italy	41	63	135	46
Japan	65	119	239	194
Netherlands	92	143	47	193
New Zealand	93	69	46	-
Norway	76	114	42	74
Portugal	61	90	109	47
Spain	51	89	106	39
Sweden	86	176	32	106
Switzerland	127	147	32	112
US	73	78	116	78
UK	82	66	85	159

Source: IIF

The Government debt ratios of Spain and the US is a reminder of the limitations of just looking at one ratio. The debt ratio of the US is currently at a higher level than when Spain faced a financial crisis over a decade ago. One reason that concerns about the level of Spanish Government debt has settled down is that there is currently more macroeconomic support than there was a decade ago (lower interest rates, supportive fiscal policy, stronger economic growth, European Central Bank bond buying).

There have been few signs of financial market concerns about the current level of US Government debt (there has been about debt ceiling negotiations but that is at least as much as about domestic US politics). That lack of concern about the amount of government debt has reflected the pre-eminent position of the US economy and financial system.

The size of US Government debt (relative to GDP) has increased substantially over the past fifteen years. Debt servicing has not been a problem reflecting the very low interest rates that prevailed until recently (and Federal

Reserve bond purchases). But interest rates are now higher. US Government debt is projected to increase further. And the Federal Reserve is reducing the amount of US Government debt it owns. US politicians appear in no rush to find a solution. On its current trajectory the size of US Government debt at some point could become a significant issue. When that point arrives though is hard to determine.

We really do live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland

BOQ | 255 George Street Sydney NSW 2000

Twitter: @petermunckton

events, or results or otherwise, is disclaimed. BOQ does not undertake to update any forward-looking statements contained in this document, subject to disclosure requirements applicable to it.

Liability

The Bank does not accept any liability for any loss or damage arising out of any error or omission in the information provided or arising out of the use of all or any part of this presentation.

"NOTICE (You must not remove this notice from this email)