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A global debt time bomb is ticking

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Ballooning debt in emerging markets and the oil and gas sector presents a growing threat to global financial stability.

The ASX's Elmer Funke-Kupper nailed it in the PwC survey of global chief executives tabled at Davos this week when he said the world was burdened with $US200 trillion of debt that could not be paid back.

That number probably comes from a McKinsey study nearly a year ago which provided a snapshot of global debt in mid-2014, so it may well understate the problem.

McKinsey found that between the financial crisis in 2007-08 and mid-2014 global debt had increased by $US57 trillion, for an annual compound growth rate of 5.3 per cent, taking total debt as a percentage of global GDP to 286 per cent — 17 percentage points higher than it was during the onset of the financial crisis. It's probably higher today.

It's not just the build-up in global debt that is disconcerting, but where the flows of debt — fuelled and encouraged by the ultra-cheap credit created by central bank monetary policies since the crisis — have gone.

A lot of that increased in debt flowed into emerging markets in search of positive returns and into exposures to the commodities boom the phenomenal (until relatively recently) growth in China generated. China, where total debt (about $US25 trillion) as a percentage of GDP has risen from about 160 per cent in 2008 to more than 240 per cent last year, accounts for about half the debt in the developing world.

The devaluations of emerging market and developing economy currencies, including China's, and the dramatic collapse in commodity prices are now amplifying the problem by increasing local currency interest costs and principal repayments even as economic growth rates in those economies are slowing and inflows of new capital are drying up.

The Institute of Institutional Finance said earlier this month that foreign investors in emerging market securities made net withdrawals for six consecutive months in the second half of last year and that the level of portfolio flows to emerging markets were at their lowest levels since 2008.

Foreign banks have lent about $US3.6 trillion to companies in those markets, according to the institute, and foreign investors hold about a quarter of their local debt. Ratings agencies have said default rates in emerging markets last year reached their highest levels since 2004.

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Perversely, a lot of that destabilising build-up in emerging market debt has come from the still-fragile eurozone banking system, which already has more than $US1 trillion of non-performing loans.

The potential for an emerging market financial crisis could represent the catalyst for another, very severe, European banking crisis.

Where growth in China and the other developing economies supported the weak global growth post-crisis, they now represent a significant and growing new threat to global financial stability and economic growth at a moment where central banks have virtually exhausted their monetary ammunition and where the build-up of government debt globally reduces fiscal policy options.

Within the global debt picture there are some hot spots, most notably in commodities and particularly oil and gas. The extent and rate of the plunge in commodity prices has been gut-wrenching and will inevitably see a tidal wave of corporate defaults and lender and investor losses.

The Bank for International Settlements last year cited a substantial increase in the debt borne by the oil sector in recent years as a source of increased solvency and liquidity risk, as well as the growth in US dollar-denominated funding by producers in emerging markets.

Within the $US1.4 trillion US junk bond markets, the energy sector has about $US200bn of debt securities trading below par, while credit analysts are predicting that more than $US70bn of investment grade energy securities could be reclassified as junk over the next few months.

High-yield energy-related bond default rates are rising sharply and will presumably accelerate as oil price hedges, some of which locked in oil prices of up to $US80 a barrel, fall away. The ratings have estimated that several hundred billions of dollars of debt is at risk of default unless energy prices rebound, which now appears most unlikely in the near term.

While US banks (which are now well-capitalised) have revealed increasing provisions against energy-related loans, much of the risk and much of the likely losses will have been widely distributed via exchange-traded funds, hedge funds and other forms of asset management.

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Nevertheless, the stresses that are apparent, and the scale of the latent losses within the US energy sector is indicative of the destructive forces within both the energy sector and the wider commodities sector as historically low prices and high debt levels intersect.

The rising stress in energy and commodity-related debt markets, however, is a symptom of the larger global debt problem, not its cause.

There’s simply way too much global debt in the context of anaemic global growth, much of which was channelled into emerging market economies and, to get an indirect but leveraged exposure to the post-crisis growth in China and the economies that feed off it, commodities.

Funke-Kupper didn’t see any obvious or painless way for the world to deal with the excess debt levels, although his comment that the debt would never be paid back implies large-scale write-offs and debt forgiveness — and losses.

An obvious question raised by the turmoil in global markets in this first part of the year and the increased investor fear is whether or not the US Federal Reserve Board will blink and freeze, or even reverse its planned gradual increase in US official rates.

The former chief economist of the Bank for International Settlements and chairman of the OECD’s Economic and Development Review Committee William White was asked about the Fed’s dilemma by London’s Telegraph newspaper this week.

Saying that the global financial system was dangerously unstable and facing an “avalanche” of bankruptcies, White said the world was in a debt trap.

“Things are so bad there is no right answer. If they raise rates it will be nasty. If they don’t raise rates it just makes matters worse,” he is reported to have said.

The world’s central bankers, led by the Fed, created (and indeed encouraged) the problem they now confront with their extraordinary and unconventional monetary policies that coerced the explosion of debt — a massive debt bubble — by forcing investors to chase ever-riskier yield by making credit ultra-cheap and retaining those settings throughout the post-crisis period.

They did defer the day of real reckoning from the bubble in securitised debt that ignited the 2008 crisis for more than eight

years, but in the process have created what is arguably an even bigger, more insidious and more threatening problem, with a greatly diminished ability to respond to it.