INSTITUTE OF INTERNATIONAL FINANCE

IIF Weekly Insight
Game of Loans

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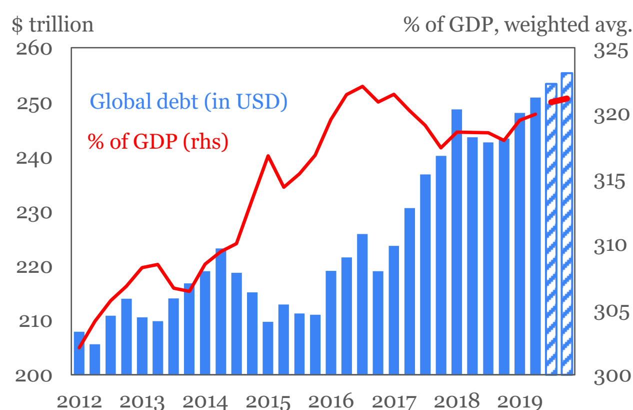
- Global debt has topped $250 trillion—320% of GDP; emerging market debt hits a new record of $71.4 trillion (220% of GDP).
- With limited room for further monetary easing, debt service costs will be an increasing constraint on fiscal policy.
- Climate change is driving significant reallocation in investor portfolios; high-debt countries will have a much harder time coming up with funding to address climate risks.
- USD hovering at record highs despite Fed rate cuts this year: persistent growth in demand for U.S. liquidity as dollar debt across EM and mature markets (ex-U.S.) hits record highs. Non-U.S. banks are increasingly reliant on USD funding.

Mind-boggling debt levels: Without question, rising debt levels have supported global growth since the 2008 financial crisis. However, there are increasing questions about the marginal utility of further borrowing—and a lot of concern that a continued ramp-up in debt could spark a fresh crisis. The global debt load has grown by a massive $78 trillion since 2008 and as of H1 2019 has topped $250 trillion (Chart 1). China alone accounts for 40% of this global debt increase as the country's non-financial corporates (notably SOEs) and households have cranked up their leverage. The U.S. is responsible for another fifth of the global debt buildup—largely a consequence of rapidly rising federal government debt. But the payoff has been modest: since 2008, the global economy has expanded by only $28 trillion, bringing global debt-to-GDP ratio to a record high of 320%. This clearly implies a declining growth-to-debt ratio—in other words, diminishing returns to debt. With no signs of slowing debt accumulation across major economies (notably U.S., China), we expect the global debt stock to exceed $255 trillion by year-end, or $193 trillion excluding the financial sector—see our latest Global Debt Monitor.

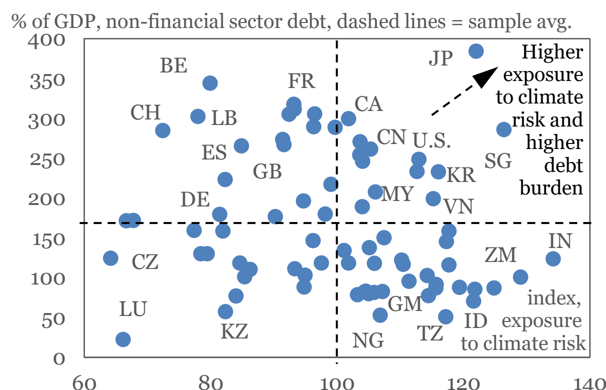
Accommodative central bank policies have been crucial in keeping a lid on borrowing costs across a range of mature and emerging markets. Indeed, low interest rates have helped keep debt service costs below historical peaks in many countries (despite rapidly rising debt), while also reducing the likelihood of severe refunding stress. However, this growing dependence on loose monetary policy has prompted widespread concern, including among central bankers. For instance, Fed Chair Powell has been increasingly vocal about U.S. public debt growth, reiterating in written testimony this week that, absent any meaningful reductions in the government's large and "unsustainable" budget deficits, increasing interest expense could become a bigger burden on taxpayers in the long term.

Chart 1: Global debt fast approaching $255 trillion



Source: Bloomberg, IIF

Chart 2: High debt burdens could curb efforts to address climate risk



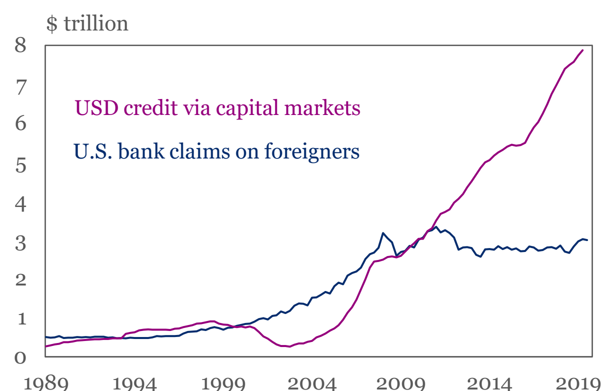
*Source: Bloomberg, IIF. * Bloomberg composite rating*

Climate change to add to global debt burden: Investors are increasingly attentive to climate-related risks, amid growing awareness that climate change is happening faster than previously anticipated—with unnerving consequences. Climate risk is pervasive: over one-third of cross-border investment portfolios held by investors in G20 countries are exposed to climate-stressed regions (prompting widespread initiatives to measure and assess climate risk). Moreover, growing demand for a "just transition" to a low-carbon economy is weighing on investors' ability and willingness to fund large carbon exporters: for instance, Norges Bank aims to shift 1% of its AUM to renewables by 2022. Investors could well look to reduce exposure to climate-vulnerable countries and sectors, which will ultimately mean higher borrowing costs: case in point, Sweden's central bank has reduced its exposure to Australian and Canadian bonds due to climate-related risks. As highlighted in our latest Global Debt Monitor, rising borrowing costs are a growing source of concern for high-debt countries that also have high exposure to climate risk (e.g. Japan, Singapore, Korea and even the U.S.). Tackling climate change could be even more challenging and costly for some high-debt EM and low-income countries that may struggle to source international and domestic capital without sustained "easy money" (Chart 2).

Strong demand makes it difficult to engineer a weaker U.S. dollar: Despite a series of Fed rate cuts this year and lingering worries over large U.S. twin deficits, the strength of the USD has been remarkable, as it hovers near all-time highs (on a trade-weighted basis). One of the important drivers of dollar appreciation has been strong overseas demand for USD funding in capital markets (Chart 3). Rising demand for the greenback has been particularly notable in emerging markets, where USD-denominated debt has increased from $2.8 trillion in 2009 to over $6.1 trillion in mid-2019 (Chart 4). By sector, the biggest contributors to this demand have been EM non-financial corporates (USD debt has more than doubled since 2009, to $2.9 trillion) and the EM financial sector (USD debt up by $1.4 trillion to $2.3 trillion). In contrast, the buildup in USD debt by EM governments has been relatively limited, at just $0.4 trillion over the past decade—in part reflecting the development of local currency government bond markets.

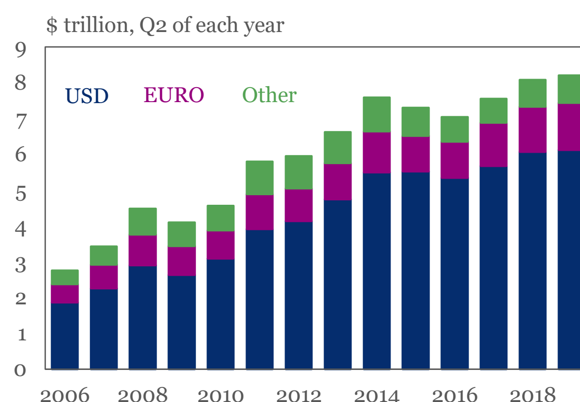
Furthermore, foreign demand for USD liquidity has not been limited to EMs. According to BIS estimates, USD debt incurred by non-bank borrowers in mature markets (ex-U.S.) has grown by 80% since 2009 to a new record of over $8 trillion in Q2 2019. The USD liabilities of non-U.S. banks have risen steadily since the crisis—albeit at a slower pace than in the pre-crisis boom years (Chart 5). Japanese, Chinese and Canadian banks account for most of the increase—these liabilities have risen from below $10 trillion in 2009 to over $13.5 trillion at present.

Chart 3: Capital markets—not banks--are the single most important source of USD funding for foreign borrowers



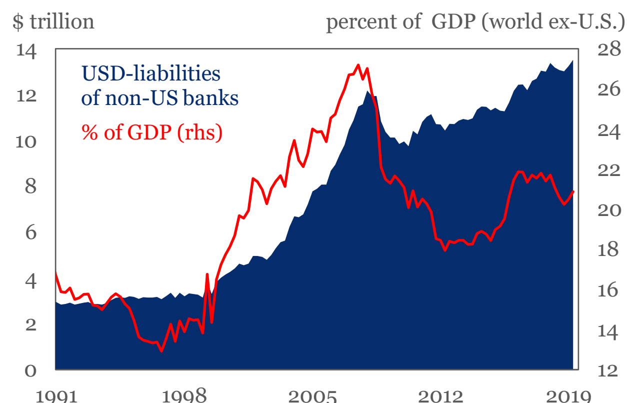
Source: US Treasury, BIS, IIF

Chart 4: EM FX debt at record highs



Source: Bloomberg, IIF

Chart 5: Non-U.S. banks have rising USD liabilities



Source: BIS, IIF

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