Debts That Cannot Be Paid Will Not Be

T SABRI ÖNCÜ

Total global debt has increased, growth has been slowing down since the onset of the global financial crisis in 2007 and has been rapidly decelerating after 2012. This may be a sign that the world has arrived at its debt carrying capacity or has even crossed it, meaning that capitalism is probably already insolvent.

With my June 2015 HT Parekh Finance Column article titled “When Will the Next Financial Crisis Start?” (Öncü 2015a) I initiated an investigation of the possibility of a new phase in the ongoing global financial crisis (GFC) that started in the summer of 2007. This article was retitled at the Policy Research in Macroeconomics website as “What Straw Will Break the Finance Sector’s Back?” when it was republished three days later (Öncü 2015b).

The next two articles in the series were my February 2016 article titled “Has the Crash of the Global Financial Markets Begun?” (Öncü 2016a) and November 2016 article titled “It’s the Private Debt, Stupid!” (Öncü 2016c).

The current article is the fourth in the series and its title is inspired by the latest first quarter (Q1) report of the Institute of International Finance (IIF), a respected tracker of global leverage statistics.

Time will tell whether this article will be the last in the series or not as financial markets have a way to put even the best forecasters to shame.

Total Global Debt

In this Q1 report, the IIF documented that the total global debt hit a new all-time high of $217 trillion or about 327% of the global economic output, that is, world gross domestic product (GDP). This is an alarming total debt to GDP ratio.

Furthermore, the report also indicated that while the financial sector debt issuance—although supplanted by money created by major central banks—has moderated in recent years, the total global debt of the non-financial sector has continued to grow and hit an all-time high of $160 trillion or about 242% of the world GDP as of the Q1 of 2017.

Recall that when the total global non-financial sector debt reached $152 trillion or about 225% of the world GDP at end of 2015, the International Monetary Fund (IMF) issued a stark warning to the world that the sheer size of the non-financial sector debt—comprising the general government, non-financial firms and households—could set the stage for an unprecedented private deleveraging process that could thwart the fragile economic recovery of the world, indicating the difficulty of resolving the “private debt overhang” problem in the current global environment of low nominal output growth. (Öncü 2016c)

Table 1 gives a summary of the total global debt at five-year intervals between 2002 and 2017, and shows that this ratio did not become alarming just in the Q1 of 2017. It has been alarming for at least a decade.

<table>
<thead>
<tr>
<th>Year</th>
<th>As Percentage of World GDP</th>
<th>Amount in Trillion Dollars</th>
<th>Percent Change over Five Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>246</td>
<td>86</td>
<td>–</td>
</tr>
<tr>
<td>2007</td>
<td>276</td>
<td>149</td>
<td>73.3</td>
</tr>
<tr>
<td>2012</td>
<td>305</td>
<td>205</td>
<td>27.3</td>
</tr>
<tr>
<td>2017</td>
<td>327</td>
<td>217</td>
<td>5.8</td>
</tr>
</tbody>
</table>

Is Capitalism Insolvent?

The IIF said in this report that rising debt “may create headwinds for long-term growth and eventually pose risks for financial stability.”

It is puzzling that the IIF is saying this only now. Is this not what has been happening since the onset of the GFC in the summer of 2007? Has global economic growth not been dismal since 2007 to this day or is a 10-year period not long-term enough?

Have we not experienced at least two major phases of the GFC, one originated in the United States (US) mortgage market in 2007 and then spread to the rest of the world, the other originated in Greece in 2010 and then spread through Europe with spillover effects in the rest of the world?

Table 1 also shows that although the total global debt has increased in the period steadily, growth has been slowing down since the onset of the GFC in 2007 and has been rapidly decelerating after 2012. This may be a sign that the world
has arrived at its debt carrying capacity or even crossed it, meaning that capital-
ism is insolvent already.

And, if this is the case, then a global
deleveraging accompanied by increasing
delinquencies and defaults will accelerate. Indeed, delinquencies and defaults
have been accelerating around the globe in recent years. As Indians and Italians
know quite well, their banks are already suffering from bad loans severely, and
India and Italy are not the only two
countries where this is happening.

**Developing Country Debt**

According to the earlier mentioned IIF
report, while advanced economies con-
tinued to deleverage and reduced their
total debt by over $2 trillion in the past
year, developing countries increased their
total debt by $3 trillion, bringing their
total debt stock to $66 trillion. This is
equivalent to 218% of their combined
GDP, five percentage points above that
percentage in the q1 of 2016.

China alone borrowed $2 trillion of this $3 trillion and brought her total debt
stock to $33 trillion with the country’s
total debt to GDP now surpassing 300%.
More importantly, slightly more than
two-thirds of China’s total debt owed by
her non-financial private sector, and her
non-financial corporate sector owed
slightly more than 75% of this non-finan-
cial private sector debt, with the rest
belonging to households.

Furthermore, the IIF reported that the
emerging market countries increased their
hard currency-denominated debt by $200 billion in the past year and,
despite the recent dollar strength, 70% of this has been in dollars. The total
hard-currency denominated debt of the
emerging market countries was slightly
above $6.5 trillion at the end of 2016.

The IIF also reported that emerging
markets had over $1.9 trillion of bonds and
loans falling due before the end of 2018
with the biggest redemptions to be made
by China, Russia, Korea and Turkey, and
added that the rollover risk was high.

**Meanwhile the Equities**

Recall from my February 2016 article
(Öncü 2016a) that Bloomberg data
showed that the world equity markets
made their highest peak at $73.1 trillion
on 14 June 2015 and from there gradually crashed to $58.7 trillion by 31 Janu-
ary 2016.¹ Bloomberg data show that
global stocks had continued to struggle
until 23 June 2016—that is, until Brexit
(Öncü 2016b)—after which they started to recover.

The recovery gained speed about
a month after the election of Donald
Trump as the President of the US and has
been impressive after his inauguration
on 20 January 2017. The world equity mar-
tkets gained $4.8 trillion in the q1 of 2017—
the largest quarterly gain since 2012—
and closed the quarter at $71.6 trillion.

Although the performance of the
advanced economy equity markets had
walked in tandem with the global equi-
ties (as expected since they dominate the
global equity markets), the perform-
ance of the emerging market economy
equity markets has been phenomenal.
Since the turn of the year, emerging
market economy equity markets have
outperformed advanced economy equity
markets by at least 5%, returning more
than 15% in the first half of 2017.

Given the dire signs of a fast-
approaching global recession and possi-
ably the third phase of the GFC, offering
an explanation for why any of these
have happened is beyond me. I will not
claim that the third phase of the GFC or a
global recession will start shortly, but I
would not mind taking credit if one of
them happens.

And, if one of them happens, the other
will follow.

Let this be my prophecy.

**Janet Yellen’s Prophecy**

In comments at the British Academy in
London on 27 June 2017, US Federal
Reserve Chair Janet Yellen prophecised
that the US financial system was much
safer and sounder, and that a crisis like
the one in 2008 was unlikely “in our
lifetime.”

She prophecised this only 19 days
after the House of Representatives of the
US passed the Financial Creating Hope
and Opportunity for Investors, Con-
sumers and Entrepreneurs (CHOICE) Act. If
this act becomes law, it will replace much
of the Dodd–Frank Act passed by
the Obama administration in 2010 as a
response to the GFC. Despite the ques-
tionable success of the Dodd–Frank Act,
the CHOICE Act will remove most of the
safety valves the Dodd–Frank Act
attempted to put in place.

Furthermore, Yellen prophecised this
only about a week before the Office of
the Comptroller of the Currency of the
US published its q1 of 2017 derivatives
report. This report showed that the top-
25 us holding companies with derivatives
had a total derivatives exposure of $2.42
trillion whereas the said amount was
$160.2 trillion one quarter before the start
of the GFC in 2007 and $194.3 trillion
one quarter before the Lehman collapse
which made the crisis global in 2008.

Since no one debates the crucial role
the derivatives played at the onset of the
GFC, I can safely say that the situation is
worse than it was in either 2007 or 2008.

There are a multitude of other trou-
bles from around the globe that I cannot
list because of the shortage of space, but
let me respond to Yellen’s prophecy as
follows:

Debts that cannot be paid will not be.

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¹ Bloomberg World Exchange Market Capitalisa-
tion in US dollars—WCAUWRLD—Index,
weekly data.

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