Debt contributed mightly to the great recession of 2008-2009

The ‘great recession’ of 2008-2009 had many causes and most of them were similar to the factors that ended most previous business cycles. However, the massive buildup of debt over the prior 5 to 6 years contributed importantly to the length, breadth and depth of the 2008-2009 recession. Profligate borrowing mostly by households, careless, or worse disingenuous lending practices by commercial banks and non-bank financial institutions, lax Federal regulation of financial institutions’ practices, and imprudent investing by all types of financial institutions contributed to the massive debt buildup that financed excessive construction at extravagant prices.

The past recession

Some real economic measures had already turned down before December 2007, the NBER’s date for the peak of the 2001-2007 expansion. For example, durable goods orders began to decline in October of 2006, because manufacturers began to lose confidence in the sustainability of the expansion. Earlier, in the first quarter of 2006 residential housing prices peaked and instigated a protracted period of decline. They fell for 5 years and dropped 40% from their peak value. This tumultuous price decline of residential real estate initiated a tsunami of housing defaults that catapulted into a financial panic perhaps worse than anything seen since the great depression of the 1930’s. Homes that had been purchased with interest only mortgages and that were lent to subprime borrowers, quickly became worth much less than the principle amount of the mortgage.

These sub-prime mortgages were packaged into mortgage-backed securities (MBS) and collateralized debt obligations (CDO), and sold throughout the world to gullible professional investors in a low or non-existent regulatory environment. Sometimes, these MBSs and CDOs were
even given top ratings by the rating agencies! Professional investors also bought credit default swaps to protect their mortgage-related investments in the case of mortgage defaults, and they suddenly discovered that there wasn’t enough liquidity in this market to cover the amount of CDS that were sold.

The weight of uncollateralized debt and declining asset values had real economic implications. Perhaps the most critical was that it caused business and consumers to lose all confidence in the expansion and in the government’s ability to halt the decline. By the end of 2007, employment began to decline and with it nearly all other high frequency economic measures.

The financial and economic consequences of this era are now history.

The present: The US economy is expanding

Nearly all of the important high frequency economic data series are expanding significantly. Durable goods orders by manufacturers are increasing, as is payroll employment, which continues to adequately finance the growth in personal consumption expenditures. Moreover, business and consumer confidence surveys are at, or close to their business cycle peaks. Together these important measures of the US economy’s health continue to propel quarterly GDP growth rates substantially higher.

A most favorable development continues to unfold in the real estate market, which had been the source of trouble in the past recession. Unlike in the quarters before the start of the ‘great recession’ real property prices are appreciating significantly and as a result delinquency rates are plunging. Consequently, there is no evidence of a credit market disruption to the present business expansion.

The current debt situation in the US

There appears to be no substantial, or worrisome buildup in private credit creation in the non-financial sector of the US over the past few years. One of the broadest measures of excessive debt creation is total credit extended to the private non-financial sector. In the years leading up to the ‘great recession’, total credit creation extended to the private non-financial sector greatly exceeded the growth of GDP and eventually caused the collapse of the entire business expansion. Over the past several years total credit creation has expanded greatly.
Leverage ratios of non-financial companies are well below their rates during the heady credit fueled days of the past decade. As the following chart reveals, the credit market debt to equity ratio of non-financial companies is well below its menacing level in 2008. Similarly, asset levels have risen relative to total nonfinancial company debt. Consequently, the corporate sector seems to be relatively free from a threatening debt buildup.

Non Financial corporate leverage ratios

Another key debt variable that often foretells problems for the consumer sector is household debt service payments relative to disposable personal income. As seen in the accompanying chart, debt service payments relative to disposable income have been relatively stable over the past several years. Again, it is another debt measure that is signaling there is no imminent danger to the current US economy.

The broadest measure of household debt is also presently telegraphing a very benign debt situation. Total household debt relative to GDP has been declining since the debt crisis and this debt ratio is now stabilizing at a rate not seen since 2003.
Sovereign debt is the most worrisome debt market factor

Ironically, the most sinister debt problem in the US belongs to the US federal government. As the following chart reveals, the US commitment to enhance economic growth beyond its lethargic 2%, or less long run rate of growth has propelled the debt side of the economy into dangerous territory.

After decades of a relatively sovereign benign debt to GDP sovereign debt ratios fluctuating between 40% and 50%, the US government dealt with the credit market meltdown in the previous decade by supplying billions of dollars of funding to keep financial institutions afloat in the rising sea of bad debts. Their efforts were successful at restoring confidence in the financial system and promoting renewed economic growth, but the cost was essentially doubling the US sovereign debt to GDP ratio. See the following chart.

Now with debt levels aggravatingly high, the present US government has employed aggressive fiscal policy measures to boost GDP growth rates (and to fulfill political promises made during the Presidential election). Thus, these latest fiscal policies have begun to elevate the debt to GDP ratio beyond its sustainable rate.

For the near but uncertain future, global financial markets will accept this profligate borrowing by the US. There are too few alternative currencies presently available for global central banks to hold in reserve to back their own currency and money supply. However, aggravating the present pernicious trade war with China will quicken the pace and resolve of all countries to discover alternative sources of reserves for global currencies. Then, as demand for Treasuries erodes, interest rates will increase, stymieing economic activity in the US and forcing the US government to adopt stricter and unpopular restrictive fiscal policy measures just when economic growth is slowing.
Sovereign debt in the EU is soaring, too

In Europe the monetary policy response to the ‘great recession’ was very late and came after a very destructive fiscal policy of ‘austerity’. Presently the sovereign debt constraint has been stretched. There are now 5 major members of the EU with debt to GDP ratios at or above 100%. Keep in mind the fiscal debt ratio target established at the Maastricht meeting was 60%. The EU has permitted, or worse, neglected to enforce their debt target. The fiscal slide is no longer confined to Greece and Italy, but it has spread to Spain and France. Now they all have joined the 100% debt ratio club, which will make future enforcement of the Maastricht fiscal agreement even more difficult politically, if not impossible to achieve.

Fiscal austerity was not the answer to the EU economic drought in the past decade; it probably prolonged the agonizingly slow recovery period. Now with political cohesion within the EU breaking down rising debt ratios will only create deeper political fractures within this immense economic block. Widespread public frustration over immigration, globalization, and the inescapable backlash from technological change are bitterly confronting political cohesion within the EU. This becomes the EU’s biggest challenge, rather than attempting to boost the recent meager growth of the EU economy.

With debt ratios across the EU already well in excess of their target, the degrees of freedom policy makers have to address low growth are severely limited. The recent depreciation of the Euro is a baleful manifestation of the world’s perception of the EU policy makers’ ability to solve their political and economic problems.

In contrast, private lending to non-financial institutions within the EU has either stabilized at relatively high levels, or modestly declined within the past two years. Arresting the growth in private bank debt indicates that the relatively slow pace of economic growth within the EU has not needed the extreme financing that characterized the years immediately after the great recession.

Assuming fiscal policy initiatives are constrained, it places nearly all the burden for stimulating EU economic growth on the European Central Bank. The ECB will have to continue its support of the sovereign debt market and maintain a very low policy rate. Their low rate policy commitment is in direct contrast to the actions taken by other
central banks, which have already begun to raise their policy rates. This bodes poorly for the Euro.

One positive development is lending by Chinese government and commercial banks to non-bank financial entities has decreased significantly, while loans to non-financial companies has increased in the past two years. However, the amount of loans made directly to non-financial companies remains tiny in comparison to loans made to non-bank financial institutions. Consequently, the shadow banking loan market continues to persist in China and is supported by both the commercial banking system and the national government. Such gross financing remains outside the scope of normal regulation and thus fosters inefficient uses of federal and commercial bank funding.

Debt growth in China soaring

The debt situation in China is becoming threatening, as commercial bank loans to non-bank financial companies are soaring well ahead of all other type of loans. This funding of non-bank financial institutions provides funds for these institutions to lend to third parties. This non-bank lending is generally outside of normal central bank regulation.

Conclusion: private debt is not the issue this time

Despite the constant stream of worrisome rhetoric about the current status of global trade disruptions, the destruction of international agreements, and the political disarray in most western governments, there are few, if any, signs of economic trouble as there were in the build up to the
‘great recession’. For example, there are no telltale signs from the private debt markets that would spark ominous forecasts of immanent economic collapse as there were before the onset of the ‘great recession’.

Private sector debt to GDP ratios are stable, residential mortgage delinquency rates are declining, the ratio of household debt service to disposable income is stable as is total household debt to GDP. Debt to equity ratios of non-financial companies are also well below their past peaks. All were harbingers of menacing things ahead for the economy in 2007. Even in the EU where GDP growth has been unevenly sluggish private credit market signals have been pleasantly benign. Private credit creation growth has slowed as have loans made by commercial banks to all sectors of the EU economy.

The only significant debt problem in the economically developed world resides with sovereign entities. Sovereign debt to GDP ratios have been rising across the EU and in the US. Most major western economies have sovereign debt ratios near, or in excess of 100% of GDP, and are at unacceptable and unsustainable high levels. While they are not signaling an immediate crisis, they represent unfathomable danger to public policymakers in economies whose rates of economic growth are collapsing. They accentuate the limited scope for aggressive fiscal policy that will be needed to bolster future declining rates of economic growth.

The debt situation in China is less transparent, but equally severe. Lending by government and commercial banks to non-bank financial institutions has grown significantly in the past several years. Since this rapid credit expansion is arguably beyond the traditional regulatory scope of the government, its use and misuse pose a serious problem for the second biggest economy in the world and therefore for total global growth.

Private debt may not be the catalyst that ignites the next recession but mounting sovereign debt will seriously limit the actions of future governments to stimulate the economy.

For more information, please contact camri@nus.edu.sg
KEY INDICATORS TABLE (AS OF 31 OCTOBER 2018)

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Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)

**S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

**FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

**NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

**HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

**STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

**EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

**YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

**CMCI**: Constant Maturity Commodity Index (CMCIP)

**Oil**: West Texas Intermediate prices, $ per barrel (CLK1)

**3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)

**10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)

**10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)

**10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

**10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)

**US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

**EU PMI**: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)

**JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

**CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAIOY)

**LC**: Local Currency

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