

# SOS on corporate debt blowout

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By Elisa Barwick

You can add yet another warning to the accumulated list—including the Bank of England, the IMF, former US Federal Reserve Chair Janet Yellen and many leading regulators, bankers and financial experts—cautioning that the corporate debt bubble is overdue for collapse. The latest is from the Organisation for Economic Cooperation and Development (OECD), whose 25 February report titled “Corporate Bond Markets in a Time of Unconventional Monetary Policy” highlights the “elevated risks and vulnerabilities” that have resulted from the easy-money policies deployed since the 2008 global financial crisis (GFC) to keep the financial system afloat.

Corporations “have dramatically increased their borrowing in the form of corporate bonds”, bringing the total debt at stake to nearly \$13 trillion,<sup>1</sup> double the amount outstanding before the GFC, the report states. Bonds of the lowest investment grade (BBB) account for 54 per cent of the total debt. The report warns that if there is a collapse on the scale of 2008, \$500 billion of corporate bonds would be downgraded to sub-investment level, meaning that many investment funds including insurance companies, pension funds and mutual funds would be forced to offload them. Investors “will have a hard time finding potential buyers” in such a collapsing market, the OECD said.

The report points to “unconventional” monetary policies such as quantitative easing (QE) as a major contributor to the corporate bond boom, warning that “the future direction of monetary policy will continue to affect the dynamics on corporate bond markets”. All of this is compounded by slowing global economic growth, which creates difficulties for debt servicing, leading to higher default rates.

Still, under these circumstances, \$4 trillion of corporate debt must be paid back or refinanced over the next three years. And appetite for new investment is declining, as indicated by the reduction in net issue of corporate bonds by 41 per cent in 2018 compared to 2017, while the net issue of non-investment grade (a.k.a. “high yield” or “junk”) bonds turned negative for the first time since 2008, meaning more matured than were issued.

Of the \$13 trillion total global corporate debt, advanced nations owe \$10.2 trillion (up 70 per cent since the GFC), and emerging markets carry the other \$2.8 trillion. New bond issues increased steeply in the developing world, led by China. The OECD reported that whilst the USA is still the largest issuer of corporate bonds, China “moved from a negligible level of issuance prior to the 2008 crisis to a record issuance” in 2016, which then fell back somewhat in the following years.

Ambrose Evans-Pritchard pointed out in the 25 February London Telegraph that a significant amount of this emerging market debt is denominated in US dollars, “a spill-over legacy from the QE era when dollar funding was cheap, abundant, and irresistible”. The \$12 trillion-or-so ocean of US currency “has yet to be fully tested”, he warned.

## Rescue?

In an earlier article, “It may already be too late to avert global recession, with dire consequences for Europe”, Evans-Pritchard complained that China is not doing enough to keep the world out of recession, or at least its actions are not having as dramatic an effect as post-GFC. Since the start of the year US growth has halved, approaching “stall speed”, and in December retail sales dropped 1.2 per cent, the biggest monthly fall in nine years. Europe is “chronically incapable of generating its own internal demand growth”, meaning that “If the US rolls over before China stabilises, the eurozone risks a terminal crisis”. In addition, French Economy and Finance Minister Bruno Le Maire has warned that Italy, which is now technically in recession, could trigger a Europe-wide crisis. The Eurozone “is not sufficiently armed to face a new economic or financial crisis”, he had warned last October.

While he called China the “wild card” on corporate debt in his 25 February article, Evans-Pritchard mooted that “it is becoming clear that the Communist leadership either cannot or will not engineer another break-neck credit boom to revive an economy slipping into structural stagnation.” It would seem, to financial commentators, China can’t do anything right—it is either increasing stimulus (debt) too much, or not enough.

Despite having achieved something of a reputation as a miracle-worker with its economic development over the last few decades, China cannot continue to uplift the world alone. It has worked to recruit other nations, therefore, to its development perspective. On 22 February, speaking at a study session of the Communist Party of China Political Bureau, President Xi Jinping elaborated on the type of economic thinking with which China shifted the world economy following the GFC. Xi stressed that within China’s financial and structural reform it is important to identify and strengthen the financial services that serve the real economy and the people’s livelihood. “The economy is the body, finance is the blood, and the two are symbiotic”, Xi said. “We must deepen our understanding of the nature and laws of finance, base ourselves on China’s reality, and step out along the road of financial development with Chinese characteristics.” Following the GFC the Chinese had studied the causes of the crisis, concluding that the separation of finance from the real economy was a major factor.

At a meeting of the State Council on 20 February, Chinese Premier Li Keqiang stated that China has acted to increase the flow of credit into the real economy by cutting the Reserve Ratio Requirement held by China's banks, but it was not about to engage in "big flood irrigation".

Without a dramatic reorientation to the productive economy, as China has demonstrated, nothing will save the rest of the world.

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