Should we worry about high household and corporate debt?

By Catherine L. Mann, OECD Chief Economist and Head of the Economics Department, and Filippo Gori, Economist, Macroeconomic Policy Division, OECD Economics Department

Household and corporate debt in many advanced and emerging market economies is high in the wake of the financial crisis and following a decade of low global interest rates. Should we be worried by these developments?

The forthcoming OECD Economic Outlook special chapter on "Resilience in a Time of High Debt" looks at how high debt-to-GDP ratios can increase vulnerability in the short run. While higher indebtedness does not necessarily imply that problems are just around the corner, it does increase vulnerability to shocks and the on-going deterioration of credit quality, changes in the structure of corporate financing, increased forex risk and buoyant asset price dynamics raise concerns.

The impact of high debt on the sustainability of growth in the medium term is often overlooked. While finance is needed to support economic activity and innovation, it can increase risks, lower growth, and raise inequality in the longer term.

The assessment highlights some key features of the post-crisis expansion of private sector debt for risk:

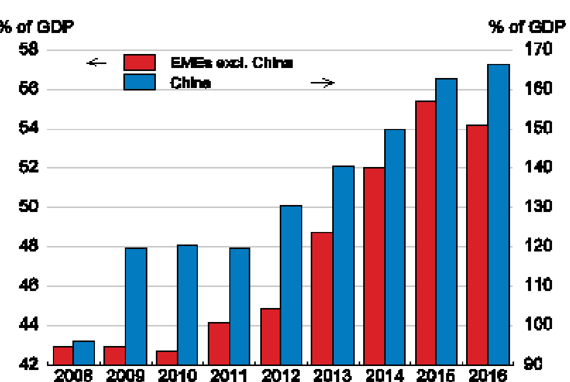
- There has been a significant shift in corporate finance towards bonds and a substantial decrease in credit quality, including a surge in issuance of non-investment grade bonds, weaker covenants and low bond ratings (Çelik et al., 2015). While deepening of bond markets can be positive, this points to higher credit risk and rollover risk.
- There has been a substantial expansion of international

bond markets and foreign-currency borrowing. This helps to share risk and improves access for countries with limited domestic financial markets. However, it increases the risk of international spillovers. The rise in foreign-currency denominated bond issuance – much of which via foreign subsidiaries – exposes borrowers more to exchange rate risk.

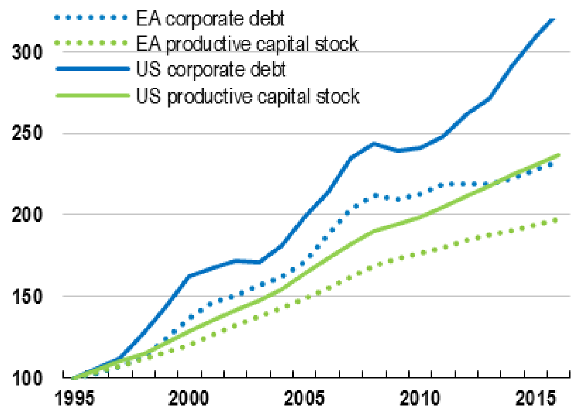
- On the asset side, more credit risk now lies with bond holders. They also face interest rate risks and the low level of coupon rates and rising maturity means that there are now record levels of duration risk, implying that bond values are very sensitive interest rate changes.
- Household debt ratios are closely linked to house prices and the credit cycle in mortgages: some OECD countries that have experienced the strongest increases in household debt since the crisis have also the steepest rise in house prices. The housing cycle is an important risk factor as excessive house price developments are predictive signals of future recessions (Caldera Sánchez, et al., 2017). A number of advanced economies have experienced worrying increases in house prices in recent years, while household debt as a share of income in some Asian countries is reaching levels typically seen in advanced economies.

Figure 1

A. Corporates in EMEs accumulated significant debt



B. The expansion of corporate debt has far outpaced investment



The efficiency of capital allocation is critical to ensure that corporate debt is sustainable and does weigh on medium-term growth. However, weak investment since the crisis raises concerns that debt is not being used to finance long-term productive capacity. Over-indebted firms tend to lose business dynamism, failing to keep up with the required investment to remain competitive, and become "zombie" firms, not only impairing their own prospects but also reducing performance by competing firms (Adalet McGowan et al., 2017).

An integrated policy approach is needed to enhance the financial resilience of economies to shocks and minimise the risks of sub-par growth in the medium term, balancing risks and the growth impacts. This needs to draw on a familiar menu of policy tools including an appropriate balance of macroeconomic policies and use of macroprudential instruments.

However, the approach needs to go beyond cyclical fixes and address underlying structural features of the economy and policy that can lead to too much corporate and household debt. For corporate finance, a sounder and healthier financial system would reduce the tax bias towards debt, deepen equity markets and improve the design of insolvency regimes. For housing markets, removing tax and other subsidies for housing and making housing supply more fluid would enhance the resilience of household debt.

Download Presentation

References:

Adalet McGowan, M., D. Andrews and V. Millot (2017a), "Insolvency regimes, zombie firms and capital reallocation", *OECD Economics Department Working Papers*, No. 1399, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/5a16beda-en

Çelik, S., G. Demirtaş and M. Isaksson (2015), "Corporate Bonds, Bondholders and Corporate Governance", *OECD Corporate Governance Working Papers*, No. 16, OECD Publishing, Paris.
DOI: http://dx.doi.org/10.1787/5js69lj4hvnw-en

Caldera Sánchez, A., et al. (2016), "Strengthening economic resilience: Insights from the post-1970 record of severe recessions and financial crises", *OECD Economic Policy Papers*, No. 20, OECD Publishing, Paris.

OECD (2017), *OECD Economic Outlook, Volume 2017 Issue 2*, OECD Publishing, Paris.