What are the likely long-run economic and financial consequences of our presently very high debt levels?

And what are the policy options for dealing with these elevated debt levels?

Begin with some **facts**.

IIF has just published its estimates of global debt ($228 trillion) to GDP in 2020Q1. This rose to 331%. For AMEs was 392% and for EMEs 230%. The increase between 2019Q4 and 2020Q1 was "the largest quarterly surge on record" and has been accelerating since March under the influence of the pandemic.

This is not a new trend. The global debt ratio is 50 percentage points higher than in 2008, with most off the increase occurring in EMEs, especially China (335% of GDP). Looking back further, to the early 1980s (when interest rates began to decline after the Volcker shock) the total debt ratio has increased abut 2 ½ times, while the ratio of government debt has almost tripled. The ratio of government debt to GDP is about at the level it was at the end of WW2.

Moreover, the quality of that debt has also been decreasing: ie the expected losses have been increasing. $11 trillion of debt has been issued in dollars by issuers who do not earn dollars. The quality of corporate debt, as measured by ratings agencies, has been falling for ages and especially over the last decade. Moreover, the pandemic has led to a massive increase in corporate borrowing by companies just above investment grade.

What are the **reasons** for this build up of debt?

A more superficial answer is to blame an excessive reliance in AMEs on monetary policy for macroeconomic stimulus, whenever stimulus seemed required. This policy began with the Greenspan put of 1987 and was repeated in 1990, 1997, 2001 and 2008 and now 2020. Policy rates were lowered, inducing increased demand for **private** sector credit. Then financial deregulation allowed an equivalent increase in credit supply. As this remedy was used repeatedly, the stock of debt rose cumulatively. Against a backdrop of low global inflation, arising from positive supply side shocks, monetary policy was never tightened as much in upturns as it was eased in downturns, ands interest rates (both real and nominal) ratcheted downwards.

These trends were repeated in the EMEs as well. Monetary easing in the AMEs (and “risk-on” flows) should have pushed up the exchange rates of EMEs. However, for various reasons (“fear of floating”) they refused to let this happen and responded with FX intervention and monetary easing. In this way, they imported all the debt and imbalance problems of the AMEs. Whereas the EMEs were “part of the solution” in 2008, they are now “part of the problem”.

Similarly, automatic stabilizers (and sometimes discretionary action) led to fiscal deficits expanding in downturns, but there was never an equivalent tightening in upturns. Thus, **government** debt ratios also ratcheted upwards. We are now at a point where the room for manoeuvre of both monetary and fiscal policy can be being questioned.

A more profound answer would delve into the question of why monetary policy has been conducted in the way it has been. I would point out two basic analytical errors. First, the failure to understand how the “headwinds of debt” eventually make monetary policy ineffective in stimulating aggregate demand. Second, the failure to recognize the importance of supply side shocks in influencing inflation. In particular, demographic trends and globalisation led to excessively stimulative monetary policy throughout the “Great Moderation”, and to the credit bust that followed. This latter point is especially important because those disinflationary trends are now going into reverse.

What are the likely **consequences** of continuing on the current policy path?

High private sector debt will raise precautionary saving and reduce investment. Aggregate demand therefore seems likely to stay weak for an extended period. With aggregate demand restrained, the consensus seems to be that disinflationary pressures might be expected to continue, but this again ignores supply side considerations. Potential growth will be affected (“scarring”) by the pandemic as resources have to be shifted from declining to ascending industries. Resource misallocations, associated with easy availability of credit in the past, will work in the same direction. Finally, Goodhart and argue convincingly in a new book that rising dependency ratios globally will soon begin to reduce supply while increasing demand. Whether the balance between weak demand and weak supply leads to disinflation or inflation, real growth is likely to be muted for an extended period.

This will likely lead to both monetary and fiscal policies “doubling down” on continued stimulus. While it is being increasingly recognized that monetary policy is “pushing on a string’, and could even be having harmful effects, there seems to be no appetite (either within central banks or elsewhere) to begin to tighten up. As for fiscal stimulus, most large countries seem far from having lost market access, and there are also theoretical (MMT) and practical reasons (the experience of Japan) for believing that further increases in government debt ratios are not likely to cause problems. Moreover, it is not impossible that fiscal stimulus might stimulate both rising private sector demand and even inflation. If interest rates also could be held down (financial repression as after WW2), then the overhang of debt (both private and public) might slowly disappear.

Nevertheless, this policy response has certain risks attached to it, particularly if the hoped for recovery fails to materialize. While there are some grounds for optimism that post-crisis regulatory reforms will ensure continued stability in the financial sector, a renewed bout of instability cannot be ruled out. This could arise in financial markets (a collapse of equity prices in the US?) or debt related disruptions in in some part of the “shadow banking system” which has recently been growing rapidly. Perhaps most importantly, the business models of many financial institutions (not least pension funds, life insurance companies and even banks) is not viable given the current level of interest rates. The associated “search for yield” raises still further dangers, including still more resource misallocations.

Another danger of “doubling down” on both monetary and fiscal stimulus, is that it leads to fears of fiscal dominance and self-fulfilling fears of inflation. In that case, keeping control over interest rates, particularly at the long end might prove impossible. Indeed, belated attempts to tighten monetary policy in response might actually increase fears of fiscal dominance as higher rates lead to higher debt service requirements. Sargent and Wallace have presented the theory of how these processes work, and Bernholz has given many historical examples. While in the end the real burden of the debt disappears, the costs of high inflation (and associated political problems) makes this cure worse than the disease.

The risks associated with fiscal dominance can be reduced if the government finances itself at very long durations at low rates. Note in this regard that QE effectively replaces long term financing with the shortest form of financing there is - overnight liabilities of the central bank. Promises by governments to anchor longer term fiscal discipline in target debt (or debt service) ratios would be helpful, as would explicit discussion of the fiscal measures that might lead to such an outcome.

What other **policy alternatives** could reduce the debt overhang?

Near term fiscal austerity, without other sources of demand, will not work to reduce government debt. The Keynesian “paradox of thrift” applies and becomes even more destructive if many countries are doing this at the same time and if private sector debt levels are high to begin with.

Faster real growth would also reduce the burden of debt service. Structural reforms to increase the potential growth rate of the economy would be welcomed. However, “green” considerations imply they must also reduce the energy component of faster growth as well as the carbon intensity of that input. This will not be easy. Moreover, increased supply potential will not result in more growth if there is no aggregate demand to activate that supply.

This provides the main reason for restructuring private sector debt. There is a presumption that those given debt relief will raise demand more than those providing relief will reduce it. Of course, this might not be the case if private sector creditors reduce the supply of new credits, or if the credit worthiness of governments (the bank/sovereign nexus) is called into question. Note that the “debt jubilees” of ancient times generally came at the expenses of a royal elite who could carry on as before. It is a different thing today if, for example, pension funds would be hard hit. If pensions decline, or corporations cut investment to top up plans, then the final effect on spending has to be judged on a net basis.

In any event, there are many impediments to restructuring **private sector** debt. Creditors will resist agreeing to take a haircut, even if doing so would give them a larger return than not doing so. Considerations of fairness, moral hazard and even moral dimensions will be invoked. WP1 at the OECD , the Group of Thirty, the IMF and others have all noted inadequacies in laws and administrative procedures to restructure non-financial debt in an orderly way. As for the financial sector, they have many incentives to “extend and pretend”, not least that it hides their own exposure to insolvency. As for insolvency procedures for financial institutions, “too big to fail” and “too big to save” remain important constraints on the timely restructuring of the financial sector.

Similarly, there are many impediments to the orderly restructuring of **public sector** debt. Politicians will delay as long as possible to push the problem off to their successors. The public sector/bank nexus could imply a government restructuring would actually force restructuring of the financial system, with (by definition) no government support in the wings. As well, at the moment there is no generally accepted set of criteria to determine the need for a sovereign restructuring. Indeed , there are no international treaties to force action, or even to prevent other bodies (as in the recent Greek case) from extending still more credit to a sovereign whose debt load is clearly unsustainable.

The bottom line can be simply stated. There are palliative procedures to deal with today’s debt overhang problem, but they face many obstacles. The best bet is that, after a disinflationary interlude, we face a significantly more inflationary future.