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# Global debt - Is history repeating itself?

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2018 started with the expectation that this time around the world economy really would be able to chalk up a second consecutive year of solid growth and successfully navigate through two of its main hazards: US monetary normalisation and China's slowdown. Three months on, the return of tensions to the financial markets and the threat of protectionism have been enough to dampen the positive effect of increased growth in the US as well as intensifying the risks threatening the strength of the recovery.

In order to determine how severe the economic effects of a possible shock from trade or financing might be, it is essential to first establish the conditions from which we start out, and one of the most important of these is the volume of debt. It would be ingenuous to ignore the importance of indebtedness in the current cycle, or to minimise the risks inherent in any increase in it. The IMF has once again warned of the dangers of transitioning into a tighter monetary environment with debt standing at 225% of world GDP. The parallels with the situation prior to the Great Recession are inescapable, and without wishing to be alarmist, we believe it is worth clarifying certain similarities and differences so as to anticipate possible sources of vulnerability.

Among the similarities we would highlight the signs of over-valuation in certain segments of the equity and credit markets, and the rise of leverage strategies (ETFs, CDOs, etc.) in an environment dominated by the search for yield in the allocation of capital. The result has been an increase in the debt of countries and economic agents with low credit ratings, especially vulnerable to a downturn in their income (low-income countries and small businesses). However, the differences compared with 2008 are significant too: they concern the distribution of debt and the tools available to the authorities to counter an economic downturn.

In 2008, the risk was concentrated in the private sectors (including banks) of the major developed economies. Today, their position is relatively healthy, at least in aggregate terms. For example, debt ratios of households in countries such as the US, the UK and Spain have returned to pre-crisis levels, and there are no discernible signs of overheating in the property market.

Thus, the alerts in the current phase come from two sides: the sharp increase in corporate debt in the emerging countries and the generalised deterioration in public debt ratios, with an ever higher percentage of countries breaching the thresholds that may compromise their sustainability. Narrowing down the risks, China emerges as the main centre of vulnerability in the emerging world, while in the developed world the US and certain countries of the euro zone stand out.

The challenge for China is to manage the reduction of its private sector debt without overly compromising economic growth. This is no easy task, and if we were to refer to historical experience we would conclude that it is highly unlikely to succeed. However, some of China's particular features (closed capital account, volume of reserves and institutional framework) may make it possible, more so now that the government has reaffirmed its commitment to healthier growth. Failure to manage this process would have a recessive and deflationary impact on the world economy, all the more intense in countries inked by trade to China's commodity cycle.

In the case of the US, the threat posed by the increase in its public debt lies not with doubts about its solvency, but with its impact in terms of how the Federal Reserve in particular, and also the private sector, will react. The combination of both reactions could lead to significant recessive effects at a global level: an accelerated rise in interest rates would seriously hamper servicing of dollar-denominated debt (very significant for emerging economies), while retrenchment in private spending in anticipation of a future public adjustment would affect debt repayment through lower incomes.

Regardless of which risk materialises and from where, the means to avoid its spreading are much less today than they were ten years ago. The risk of once again falling into a spiral of debt and deflation seems more real than that of seeing prices drift upwards out of control.

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