Borrowed time

Economist Insights

One of the many paradoxes thrown up by the world of ultra-low interest rates is the disinclination to borrow. Why would borrowers, corporate and household alike, not choose to avail themselves of what would seem to be cheap money? Maybe, the effect of low rates has actually proved to be counterintuitive and just maybe, the effect of an interest rate hike will prove just as unexpected.

Joshua McCallum
Head of Fixed Income Economics
UBS Asset Management
joshua.mccallum@ubs.com

The wonderful thing about debt is it allows you to take money from someone you know quite well but have never met: your future self. You get the money today, but it is your future self who pays it back. The hope is that this future self is richer than your current self, so won't mind lending you the money. And if interest rates are low, all the better - might as well borrow more from your future self. The temptation for a government is even greater: borrowing today means that a completely different future politician has to find a way to pay it back. And that politician may even be from a different party. Corporate CEOs are no different: leveraging up for share buybacks boosts my share options today, and it is someone else's problem to pay it back.

So you would think that ultra-low interest rates should have resulted in a huge boost to credit. Well, that's what the central banks hoped for. But it hasn't worked out that way. If you are close to retirement you know that your future self is not going to be richer than you. The role is reversed: you need to give money to your future self (by saving). So the role of interest rates is reversed as well: with low rates you need to save even more money to give your future self the same amount of cash. With ageing populations there are more and more people who need to think this way.

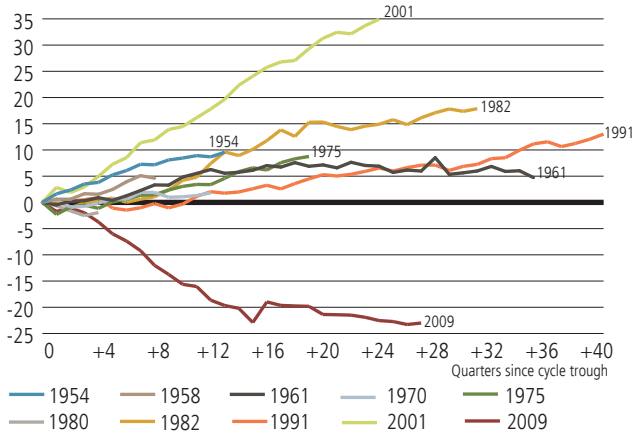
And what if you also realised that you got a bit carried away and borrowed too much from your future self? In a fit of irrational exuberance you borrowed too much money (to invest in housing in the mid-2000s perhaps) and then the financial crisis hit. Your debt is too high even after the interest rate dropped, so you need to get that debt down. Suddenly the price of debt (the interest rate) becomes less important than the quantity.

This economic cycle is unique in that it is the first modern expansion in which households have reduced, rather than increased, debt relative to disposable income (chart 1a). This has essentially been an unwind of the 2001 debt binge. Initially corporates reacted the same way (chart 1b), but that was short lived and they are back to their old, pre-financial crisis habits.

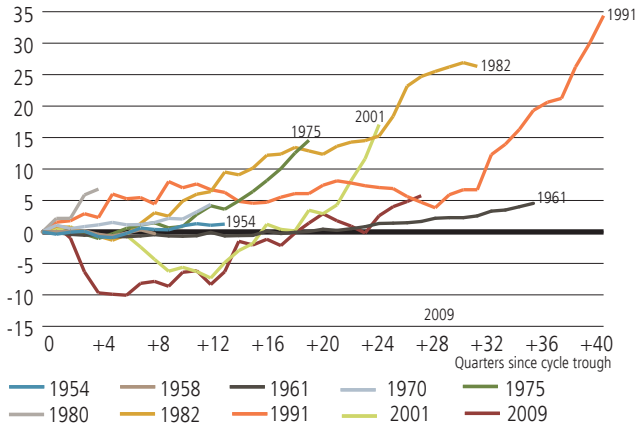
Chart 1: Nine times bitten, once shy

Change in financial liability ratios from trough of cycle (t=0) to peak of cycle or most recent data (quarterly), %

a. Households (relative to disposable income)



b. Non-financial corporates (relative to gross value added)



Source: BEA, Federal Reserve, NBER, UBS Asset Management

Despite the resumption of borrowing by non-financial corporates, the dissaving by households is outweighing this move. Overall, the private sector is still deleveraging at an unprecedented pace (chart 2a). The only other substantial and sustained episode of private sector deleveraging was in the 1990s, but the scale was less and that ended with a very rapid period of debt accumulation (mostly from corporates during the tech bubble).

The current unprecedented private sector deleveraging has been matched by the largest government re-leveraging in modern history (chart 2b). Some of this was no doubt involuntary because of lower tax receipts, but some was voluntary, such as the 2009 fiscal stimulus. Whether fully intentional or not, the policy direction was clear: public leveraging would offset private sector deleveraging. And in fact, taken together the two balance out (chart 2c).

Taken together, the recent cycle looks more like the usual cycles with no overall change in leverage. The unique cycles are the expansions of the 1980s and 2000s. These were the years of the twin deficits: a large government deficit and a large current account deficit.

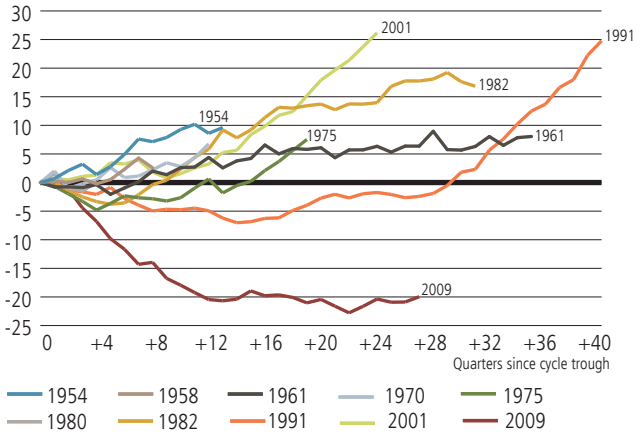
As much as the public-private offset describes the story in the three years after the crisis, in the subsequent four years the leverage trajectories for both the private and the public sector stabilised. From here there are two ways that growth can accelerate: either productivity itself rises, or we get a boost to demand from an increase in leverage (see Indebted, 13 May 2013). This is clearly what happened in the last three expansions, but what is the likelihood of that happening again?

First, households have to believe that their future selves will be richer - so wages have to rise. Second, the balance must shift between those who are targeting a retirement income (the savers) or are deleveraging and those who are keen to borrow. That depends not just on the interest rate but also on what is holding back those cash-constrained borrowers. If it is the availability of borrowing, the interest rate may be less important. But higher interest rates may make banks more willing to extend credit. So perhaps, paradoxically, the effect of interest rate hikes may not be as clear cut as we have been taught.

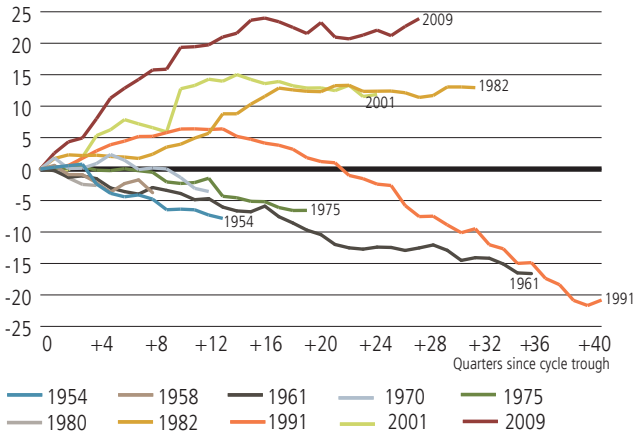
Chart 2: Public-private partnerships

Change in financial liabilities relative to GDP, from trough of cycle (t=0) to peak of cycle or most recent data (quarterly), %

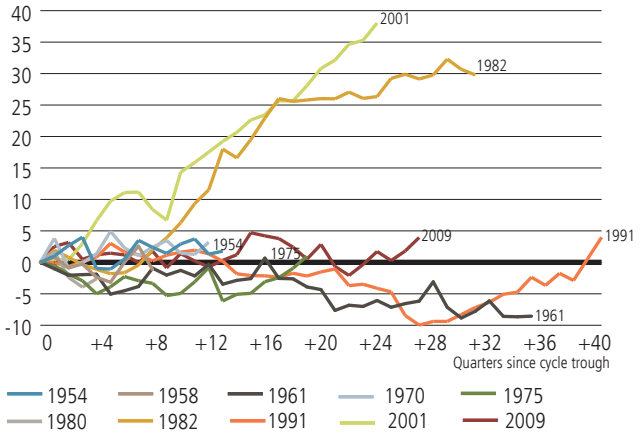
a. Private sector (household and corporate)



b. Government (Federal plus State & local)



c. Total private and government nonfinancial debt



Source: BEA, Federal Reserve, NBER, UBS Asset Management