Norman T L Chan: Global deleveraging – the right track

Speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Hong Kong Economic Summit 2013, Hong Kong, 10 December 2012.

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At this very same forum last year, I put forward my view that excessive leveraging, or over-borrowing, in major industrialised countries was the root cause of both the global financial crisis and the more recent sovereign debt crisis plaguing Europe. Today, I'd like to expound my view on this very important issue.

As you may recall, I pointed out that during the period between mid-1950s and early 1980s, the total debts of households, businesses other than financial institutions and the government in major industrialised countries remained relatively stable at about 150% of GDP. However this ratio kept increasing after the 1980s, reaching an alarming 320% even after the outbreak of the global financial crisis.

As we all know, it is wonderful to have a credit line to meet our funding needs. We can use it to pay hefty tuition fees for our children studying abroad. We can use it to meet emergency needs, such as footing medical bills for a family member suddenly fallen ill. But more often than not, people borrow to fulfil their desire to consume, or to finance their property and equity purchases. In the case of companies, loans may be crucial to their business expansion plan, which would hopefully increase sales. On the government level, borrowings would really be handy when it wants to keep up public expenditure and to enhance welfare payments, healthcare and the military. This would not only improve the standard of living and employment, but also help boost national power and speed up economic growth.

The list of wonders that borrowed money can bring goes on, but we almost forget there is a catch, that is, debts must be repaid somehow some day; and the higher the interest rates, the more we will have to pay back over time. For individual borrowers, except for those with a handsome pay rise, they can only hope to pay off earlier debts by reducing consumption in the days ahead. Well-run enterprises should have no problem servicing their debt if their business expansion financed by loans does indeed enhance their productivity and competitiveness. Likewise, heavily indebted governments will be able to service their debts only when they have sustained economic growth and rising tax revenues. In other words, the ability to repay debt hinges on increased productivity and improved income, or otherwise, reduced future spending and increased savings.

But despite the substantial GDP growth in major industrialised countries in the past 30 years, debts in these countries have piled up concurrently at an even more alarming rate. Advanced economies from across Europe and the US to Japan have all sought to boost economic prosperity, standard of living and employment with ever more borrowings and increased consumption and public spending. To me, this seemingly euphoric approach to growth was in fact driving their countries into a "debt abyss". That was clearly unsustainable. Indeed it presented great risks to global financial and economic stability. For too long a time, the "deep abyss" – a danger masked by financial innovation and market failure – has gone largely unnoticed. In a convoluted twist of logic, some even commended debt-for-prosperity as being one of modern finance's greatest contributions to the well-being of mankind.

Then the crisis hit in 2008. Only then did the millennia-old wisdom of "Don't Spend Beyond Your Means" suddenly dawn on the folks. Meanwhile, as the financial markets acted to correct their excessive tolerance for over-borrowing by households, businesses and governments, market failure began to be rectified. I explained last year how excessive leveraging became the root cause of the global financial crisis and the turmoil that followed, and the only solution was to deleverage or cut debt. Deleveraging is an extremely difficult and painful process, resulting in job losses, pay cuts, bankruptcies, and reduced public services and social welfare. The standard of living stalls if not declines. My view is that for all the suffering and pain necessitated by the process, this is the only way to put global finance and growth on its right track. There is no alternative cure, unfortunately.

My theory of excessive leveraging being the main culprit of the financial crisis may not be shared by everyone. But make no mistake – deleveraging is now a cold and hard fact of reality in many advanced countries. Let's look more closely at the sectors involved:

(1) Households: Take the US as an example. We all know that the Americans are quite used to spending on credit. But we should note in particular that the growth in US household debts, which doubled between 2000 and 2007, had been driven mainly by more and more people looking to buy a house on mortgage. This trend has in turn caused house prices to double in a short period unseen before. Looking further back, the ratio of average debt to after-tax income of the US households had remained at 80% in the past 50 years. But it shot up to a peak of 130% in end-2007 and has been on a downward trend following the burst of the US property bubble, falling to the current level of 109%. Forced to cut debt but with rather subdued pay rises, many US households have no choice but to lessen their spending. It is still uncertain whether this process of deleveraging, i.e. increased savings and decreased spending combined, will continue. But the one thing we are certain about is that this will be a major factor affecting consumer demand in the US. Over in Europe, many countries are similarly beset with huge debts. Despite the prevailing low interest rates, efforts to cut debt have to be kept up, which can restrain consumption and impede short-term growth.

(2) Corporates: Corporates have always sought to increase profits by using loans to increase investment and expand operations. When the economy continues to boom, revving up demand, increased leveraging looks like an enterprising approach to increase profits. But once circumstances shift, companies building up a mirage of prosperity after years of reliance on loans will suddenly find themselves mired in massive debts. This is what we have witnessed across the major industrialised countries. Though the debt levels of businesses differ from country to country – with those in Spain, the UK and France among the highest, it is obvious that they all have no alternative but to reduce debt when demand has ceased to grow rapidly as before. Those that are not healthy enough financially might even have to go bankrupt.

(3) Banks: When we talk about deleveraging or cutting debt, we must also look at the role played by banks in the process. Of course, banks are not the sole provider of credit. Capital markets and the shadow banking sector are indeed among the other sources contributing to the rapid expansion of credit in the past two decades. However, the banking sector is beyond doubt the key player leading the major industrialised countries deeper and deeper into the debt abyss. When the global financial crisis finally hit in 2008, many large international banks fell into complete disarray, sending governments to their rescue with huge amounts of public funds. After this, the Group of Twenty (G20) decided to reform the banking system. A series of regulatory measures are introduced by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision, aiming to strengthen the quality and quantity of capital requirements for banks. Basel III will take effect in January 2013, and a more stringent Liquidity Coverage Ratio and Leverage Ratio will be put in place. Besides, the FSB has requested additional capital requirements and more stringent regulatory oversight on global systemically important banks. To address moral hazard in banks which are considered "too big to fail", they are required to establish a so-called "living will" and recovery and resolution plan. I do not intend to go into details about these measures. But I would like to point out that from now on banks will require more capital and more liquid assets for their financial intermediation activities, and that this is going to reduce their credit-creating ability.

This will inevitably drive up the cost of borrowing for individuals, companies and governments alike, thereby adding impetus to the process of deleveraging and debt reduction in the major industrialised countries.

(4) Government: It is now apparent that many major industrialised countries have over-borrowed. The problem has been exacerbated by the global financial crisis in 2008. Following a prolonged period of incubation by market failure, the European debt crisis was finally precipitated by Ireland and Greece. The crisis has since remained unresolved, and has even spread to core countries like Spain and Italy. Other countries of the European Union, including the UK and France, are faring not much better, though the markets have been more accommodative of their plight so far. The whole Europe is in fact mired in the "debt abyss". For all the hard efforts by the European Central Bank (ECB) to minimise the risk of a total euro collapse, President of the ECB, Mr Mario Draghi, once said that these were merely attempts to buy time, so that the euro zone countries could implement fiscal and structural reforms. Hopefully the markets would be convinced that these reforms would help those countries reduce government debt and regain competitiveness.

As regards fiscal reforms, the EU agreed on and signed the Fiscal Compact in March 2012. If implemented, the European countries concerned will have to pursue rigorous deficit reduction plans and lower their total sovereign debt to GDP ratio to 60% or below within years. Take Italy as an example. It will have to keep on reducing its government debt by an amount equal to 3% of GDP annually for the next twenty years so as to reduce its current debt-to-GDP ratio of 120% to the target of 60%. This shows how formidable and painful it will be for the European countries to re-establish fiscal discipline. The short to medium term economic outlook for Europe is hardly optimistic. What I would like to point out here is that implementation of the Fiscal Compact will lead to significant deleveraging by the various European governments.

Although the US may fare better than Europe, its economy is heading towards the "fiscal cliff". Similar to Europe, it is also necessary for the US to make significant cut in expenditures in the medium to long term in order to regain fiscal balance and discipline. The situation in Japan is even more worrying. Public debt in Japan has now exceeded 200% of GDP, excluding civil service pension and other contingent liabilities. Currently, the market is not concerned about Japan's repayment ability as it is believed that the Japanese government will continue to address the ever-increasing deficits by maintaining an exceptionally low interest rate environment. However, it is worth noting that the market was treating the European countries in the same way until recently. Once market sentiment changes, the situation can take a sharp turn and it would be very difficult to arrest a deteriorating trend.

In addition to the pain brought about by deleveraging, I would also like to talk about the different forms of "quantitative easing" implemented by the various central banks. Why did these economies implement "quantitative easing"? If we agree that the root cause of the global financial crisis is excessive leveraging, then the only solution would be deleveraging. However, in reality, the process of deleveraging is just too painful. "Quantitative easing" is able to provide the much desired relief for everyone, be it a household in negative equity that has overstretched itself, an over-expanded enterprise or a government faced with social unrest as a result of the stringent measures it is forced to implement. Yet, quantitative easing is the exact opposite of deleveraging. Quantitative easing aims at: 1. reducing the interest burden of highly leveraged individuals, enterprises and governments, and 2. propping asset prices, lessening the negative wealth effect or even trying to create positive wealth effect, enhancing people's confidence so that they will be more willing to spend, and increasing employment.

However, quantitative easing is not a panacea. In the past three years, quantitative easing had limited stimulating effect on the real economy. There are several reasons. First, household deleveraging has reduced households' propensity to consume, particularly for the lower income households. Secondly, with interest rate close to zero in the US, and the cost of current consumption already very low relative to future consumption, further interest rate cuts would have little effect in stimulating households to bring forward future consumption. Thirdly, regulatory reform and economic uncertainty are restraining banks' ability and incentive to lend. And we must not forget there is a price to pay for implementing quantitative easing, the interest income of depositors, including investment funds and retirees, is greatly reduced. Asset markets supported by an artificially low interest rate environment rather than economic fundamentals will skew resources allocation in society from expanding the productive sectors to pursuit of asset price appreciation. Such a shift will easily lead to investment mismatch, thereby eroding medium to long term productivity growth as well as growth potential of the economy. In addition, the more sizable and prolonged quantitative easing becomes, the more difficult and riskier will be the exit plan. Central banks should realise that there is not much they can do. In order to solve the structural imbalances built up in the past two decades, we must get to the bottom of the problem.

Ladies and Gentlemen, up until 2008, the industrialised countries and various emerging economies had been enjoying a golden period of development which lasted for two to three decades. Income levels and living standards continued to rise. Some academics call this a period of "Great Moderation". However, no one is sure why life during this period was so easy. Some say that this is due to technological and financial innovation of modern society, the so-called "paradigm shift". We should now be awakened to the reality that this golden period was probably underpinned by little more than excessive debts, and is in fact unsustainable.

If the major industrialised countries will have to undergo deleveraging in the foreseeable future, how will the global economy evolve? I think it is highly probable that the following situations will emerge:

(1) The more a country is indebted, the more deleveraging it has to undergo. It is inevitable that economic growth and employment will be weak and the living standards in some places where the problem is more serious may even deteriorate.

(2) Some advanced and many emerging economies do not need to bear the pain of deleveraging due to their low level of debt. However, as other advanced economies have to undergo deleveraging, it will not be possible to go back to the "good old days" with everybody enjoying a prosperous economic development. Countries around the world will have to strive to enhance their productivity and competitiveness so as to capture a bigger share in the international trade arena where growth has slowed down. More importantly, major emerging economies, such as China, India, Brazil and Russia, would have to try their best to expand domestic demand and carry out reforms to improve productivity, so as to reduce their reliance on exports to the advanced economies and to achieve slower, yet more balanced and sustainable economic growth.

Another question we would like to ask is: what will the global asset market be heading? I wish I have a crystal ball. All I can do is to make some assumptions and analyse different possibilities.

(1) The first possibility builds on the assumption that the process of global deleveraging is not affected by quantitative easing. Under these circumstances, if asset price inflation is driven by excessive leveraging, in theory, asset prices might drop first in search for a new equilibrium, and then stabilise at that point. Subsequently, asset prices will resume rising alongside economic recovery and a rebound in people's income.

(2) The second possibility is that quantitative easing produces the desired results. Asset prices go up, stimulating consumption, and employment improves significantly as a result. This buys time for the relevant authorities to carry out reforms to enhance productivity so that, ultimately, asset price increases will be supported by economic

fundamentals. This is, of course, a very desirable scenario as global economy will return to its normal growth path. I surely hope that this will be what eventually happens.

(3) What bothers me however is the third possibility, under which the process of deleveraging is disrupted by quantitative easing, leading to sharp increases in asset prices in the first place. Yet, since such increases are not supported by economic fundamentals, any increase in wealth will be seen as transient. As a result, households are unwilling to increase spending and in the end, the real economy fails to rebound. If inflationary pressure builds up alongside asset price increases, central banks may consider exiting the market and raise interest rates. When economic performance, inflation or monetary policy falls short of market expectation, asset prices might drop sharply and remain volatile.

I am not sure which of these three scenarios will happen or whether a fourth scenario will emerge, as the current situation is something we have never experienced before. However, what I am certain is that since the outlook for macro economic and financial environment is very uncertain, it is highly possible that we will continue to see large fund inflows and outflows as well as sharp fluctuations in the financial markets. Therefore, I would like to take this opportunity to ask everyone to stay alert to the risks ahead and be aware that the current environment is highly abnormal and uncertain. We should all take precautionary measures and get to the bottom of the problem, learn from others' experiences and avoid overstretching ourselves. Otherwise, we may find ourselves being trapped in the debt abyss with no way out.

Thank you.