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Dependence on credit to boost demand imperils the world economy—we must correct the underlying imbalances

Nature requires balance—between predator and prey in the jungle, between the push and pull of planets in orbit, and so on. The economic system is no different; it requires long-term balance between what people earn and what they spend. Loss of this balance has led to a massive debt supercycle that threatens the global economy. Breaking that cycle is one of the most pressing challenges of the 21st century.

The debt supercycle is the product of an ever-increasing buildup of borrowing by consumers and governments. For example, total debt was about 140 percent of GDP between 1960 and 1980 in the United States, but has since more than doubled—to 300 percent of GDP. The same trend holds true globally. In fact, not even the Great Recession of 2008—which in many ways was a result of the excesses of borrowing—could put a dent in debt's relentless upward march. It would be a mistake to think that 2008 reflected merely some unfortunate policy misstep. The buildup in debt that led to the 2008 crisis stemmed from deep structural imbalances in the economy. Those imbalances persist, as do the dangers associated with them.

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Behind the imbalances

There are two main forces behind the rise of imbalances that have generated the debt supercycle: the saving glut of the rich and the global saving glut. The saving glut of the rich is a consequence of rising inequality. The share of disposable income going to the very rich (top 1 percent) has been steadily rising since 1980. Since the rich also tend to save a much higher fraction of their disposable income, rising inequality has led to a large surplus of savings accumulated by the very rich. The global saving glut is driven by a group of countries, including China, that essentially mimic the saving glut of the rich phenomenon. These countries have been earning a larger share of global income and also save at a much higher rate through various government institutions, such as central banks and sovereign wealth funds. The combined consequence of these two imbalances is a rise in financial surpluses, which have financed the global debt supercycle.

The financial sector plays an important intermediation role: it takes financial surpluses from rich individuals and countries and lends them to various segments of the economy. A well-functioning financial sector would channel the financial surpluses toward productive investments, such as building and maintaining infrastructure and developing technology. Any debt resulting from such productive lending would naturally be sustainable, because returns from investment would pay it off. Unfortunately, a key feature of the debt supercycle is its failure to finance productive investment. For example, even though total debt as a share of GDP has more than doubled, real investment as a share of GDP has remained stagnant, or even fallen over the past four decades.

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Instead of financing investment, the debt supercycle has mostly financed unproductive consumption by households and governments. Whether debt finances consumption or investment does not pose a problem in the short term, because both contribute toward aggregate demand in the same way. However, debt-financed consumption, or “indebted demand,” has different implications in the long run when indebted consumers repay their lenders. Borrowers can repay their debt only by cutting consumption, which puts a drag on aggregate demand, since savers are less inclined to spend the paid-back funds on consumption.

Pushing rates down

Indebted demand thus pulls down aggregate demand in the long run. The economy attempts to compensate for this downward pressure by pushing interest rates down as well. Lower rates help ease the debt-service burden for borrowers and push aggregate demand back up. Consequently, the rise of the debt supercycle is associated with a persistent fall in long-term interest rates as well. For example, the 10-year US real interest rate has declined from about 7 percent in the early 1980s to zero or even negative values in recent years. One unfortunate implication of the fall in long-term rates is that asset valuations tend to rise, which further worsens inequality.

In short, rising imbalances traceable to the very rich and certain countries have generated a global debt supercycle that largely finances unproductive indebted demand. This significant characteristic of the debt supercycle pushes long-term interest rates down, which only further exacerbates rising wealth inequality. An equally troubling aspect of the debt supercycle is that real investment has not gone up despite the large decline in interest rates and abundant financial surpluses. Debt supercycles reflect problems on the demand side, with rising inequality and the saving glut of the rich, and problems on the supply side, with a highly restrictive investment response despite extremely low interest rates and abundant financing.

World economy’s vulnerabilities

What dangers does the debt supercycle pose to the world economy? An economy that relies on a constant supply of new debt to generate demand is always susceptible to disruptions in financial markets, which can trigger serious slowdowns. This is what happened in 2008 with household debt. Since then, the economy has relied more on government debt to generate demand. Governments in advanced economies can often borrow at a rate lower than their rate of growth, which makes it easier for them to sustain the debt supercycle and keep the economy afloat. But dependence on continuous government borrowing is politically risky because it relies on continued financial market stability. Recent rate hikes in many countries demonstrate that this reliance cannot be taken for granted.

Ultimately the economy needs to find a way to rebalance and reverse the debt supercycle. This calls for structural changes so that growth is more equitable, which would naturally reduce the scope for imbalances. There is also a natural role for tax policy to rebalance the economy. For example, taxing wealth beyond a certain threshold can promote more spending by the very wealthy. This in turn would reduce the saving glut of the rich that finances the unproductive debt cycle. Finally, supply-side reforms, such as removing restrictions on new construction, promoting competition, and boosting public investment, can help expand investment opportunities so that debt can fund productive investment rather than unproductive indebted demand.

Governments around the world have been responding to the ills of the debt supercycle with traditional fiscal and monetary tools. However, as is well known, these tools are designed only to address temporary cyclical problems, not structural problems such as long-term imbalances. For example, looser monetary policy may help boost demand in the short term by enabling borrowers to borrow a little more. But ultimately such indebted demand will pull the economy back down again. We have at best been kicking the proverbial can down the road, and at worst further impeding eventual resolution of the debt supercycle.