

McKinsey Global Institute

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Briefing note

Debt and deleveraging: The global credit bubble and its economic consequences

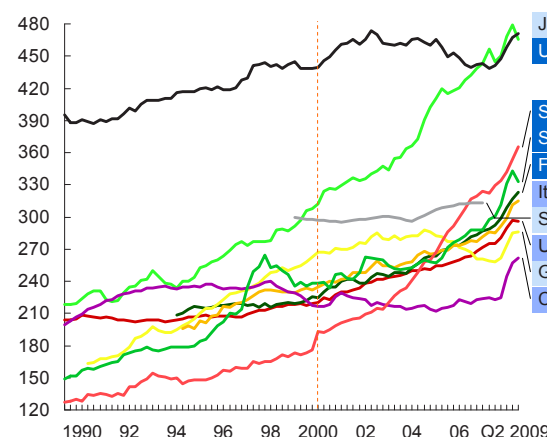
The recent bursting of the great global credit bubble has left a large burden of debt weighing on many households, businesses and governments, as well as on the broader prospects for economic recovery. In this report, we add new details to the picture of how leverage grew around the world before the current financial crisis, and how the process of reducing it could unfold.

While we cannot predict that deleveraging will occur, we know that it has followed every major financial crisis in the postwar period with only one exception—Japan, in which private sector deleveraging has been offset by a large and growing government debt. Today, deleveraging will be particularly challenging because several major economies are involved. The ratio of total debt to GDP grew rapidly after 2000 in most mature economies—and in some exceeded the level of the United States.

Exhibit 1

Debt grew in most mature economies

Domestic private and public sector debt¹ by country
% of GDP



	CAGR ² , %		Change, p.p.
	1990-00	2000-08	

Japan	1.2	0.5	19
UK ³	3.3	5.2	157
Spain	4.1	7.4	150
S. Korea	4.3	4.2	93
France	1.2	3.9	83
Italy	2.9	3.1	64
Switzerland	N/A	0.8	17
US	0.6	3.5	70
Germany	5.6	0.3	7
Canada	0.3	1.5	28

¹ "Debt" is defined as all credit market borrowing including loans and fixed-income securities.

² Compound annual growth rate.

³ Even after removing foreign lending by UK banks, UK debt/GDP remains higher than every country's except Japan.

SOURCE: Central banks; Haver Analytics; McKinsey Global Institute

What's new?

This McKinsey Global Institute research analyzes how debt and leverage evolved in each sector of ten mature economies and four emerging economies. We also analyzed 45 episodes since 1930 in which an economy deleveraged, or significantly reduced its total debt-to-GDP ratio.

Takeaways

Leverage levels are still very high in ten sectors of at least five major economies, and this is a global problem, not just a US one.

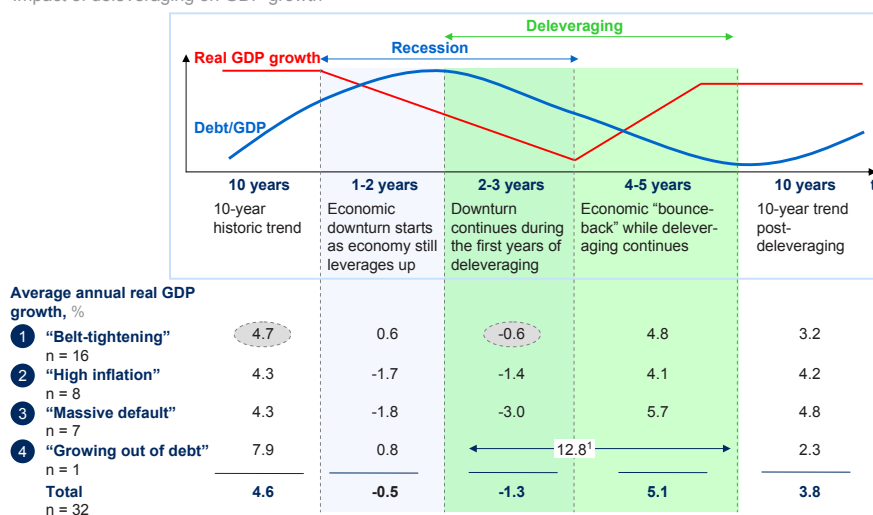
If history is a guide, we would expect many years of debt reduction in specific sectors of some of the world's largest economies, and this process will exert a significant drag on GDP growth.

- Households in many advanced economies increased their borrowing substantially after 2000, particularly through home mortgages. Rising home prices meant that the ratio of household debt to assets appeared stable in the years before the crisis. But household debt compared with disposable income increased significantly, which should have raised a red warning flag years before the crisis hit. The nonfinancial business sector in most countries entered the crisis with lower leverage, measured as the ratio of debt over book equity, than in 2000. The exceptions were the commercial real estate sector and companies bought through leveraged buyouts. Government debt was flat or even declining in most countries.
- Within the financial sector, aggregate bank leverage increased modestly relative to historic levels in most countries. Only in specific pockets of the financial sector—such as US broker dealers and certain European banks—did leverage increase substantially before the crisis. We also find that some banks had a marked deterioration in the quality of their capital, as they substituted hybrid forms of capital for common equity.
- Aggregate measures of leverage in an economy, such as the ratio of total debt to GDP, are not by themselves a reliable guide to the sustainability of debt. To gauge the likelihood of deleveraging, one needs to take a more granular view of individual sectors. As a first attempt, we assessed the sustainability of debt in different sectors of 14 countries based on factors such as the growth of leverage, debt servicing capacity, and the borrowers' vulnerability to income shocks.
- Our analysis suggests that ten sectors in five countries have a high likelihood of deleveraging. In eight of the ten, the high leverage levels are linked to real estate: they are the household sectors of the UK, the US, Spain, Canada, South Korea, and the commercial real estate sectors of Spain, the UK, and the US. The remaining two are portions of Spain's financial and non-real estate corporate sectors. In the emerging markets of Brazil, China, India, and Russia, leverage in the private sector is far below that of developed economies due to conservative borrowing practices.
- With the exception of the financial sector, the deleveraging process has barely begun. Total debt-to-GDP ratios have fallen only slightly in just a few countries, including the United States, the United Kingdom, and South Korea. However, by the second quarter of 2009, the banking system had deleveraged to the point at which capital levels were at or above the average levels of the 15 years preceding the crisis. Whether more capital is needed in addition to what banks have now accumulated remains unknown. And given the possibility of economy-wide deleveraging going forward, any such measures to boost capital requirements should be phased in very cautiously over time to minimize the reduction of credit provision.

Exhibit 2

Real GDP growth is significantly slower in the first 2-3 years of deleveraging

Impact of deleveraging on GDP growth



¹ Deleveraging driven by off-trend growth is not linked to a recession.

SOURCE: IMF; McKinsey Global Institute analysis

- *Since 1930, we have found 45 episodes of significant economy-wide deleveraging, of which 32 followed a financial crisis.* These 32 episodes were accompanied by declining GDP in the initial years and lasted an average of six to seven years. The ratio of total debt to GDP declined by 25 percent (the median). Several features of the crisis today, including its global nature and the large projected increases in government debt, could delay the start of deleveraging and result in a longer period of debt reduction than in the past.
- *History shows that policy makers can enable healthy deleveraging by supporting GDP growth through multiple channels.* However, they will also need to carefully consider when to wind down various stimulus programs. Providing support for too long could cause inflation or undesirable levels of government debt, but withdrawing it too soon could stifle the recovery.
- *Our analysis shows that the right tools could have identified the unsustainable buildup of leverage in pockets of several economies in the years leading up to the crisis.* Policy makers should work to develop a more robust system for tracking leverage at a granular level across countries and over time. These data could be used as inputs to banks' own risk models as well as macroprudential regulation. Our analysis also supports current efforts to improve the quality of bank capital, and for central banks to track leverage as a proxy for asset bubbles.
- *Policy makers should revisit the numerous incentives for borrowing, especially in real estate markets.* This includes tax breaks for mortgages, subsidies and other programs to encourage home ownership. Residential and commercial mortgages played a primary role in the build up of leverage before the current crisis, and real estate has played a major role in many past financial crises.
- *Coping with pockets of deleveraging is also a challenge for business executives.* They may have to adapt to an environment in which credit is tighter and more costly, altering the viability of some business models and changing the attractiveness of different types of investments. Today, the household sectors of several countries have a high likelihood of deleveraging. If this happens, consumption growth will likely be slower than the precrisis trend and spending patterns will shift. We have already seen a shift in consumer spending toward value-oriented goods, and this new pattern may persist while households repair their balance sheets.

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