Accuracy

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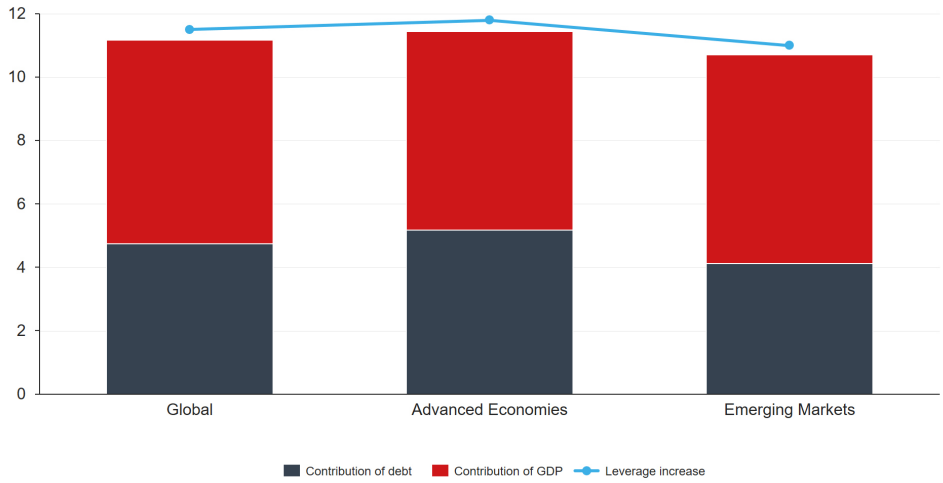
Economic brief: what the figures tell us

THE LEGACY OF DEBT

In this edition of the Economic Brief, we will examine some of the factors behind the increase in corporate leverage. We look at how corporate debt can amplify the effects of a financial shock and go on to investigate what the price may be for the current high levels of debt.

Breakdown of increase in debt/GDP ratio from Q4 2019 to Q3 2020 (percentage points)



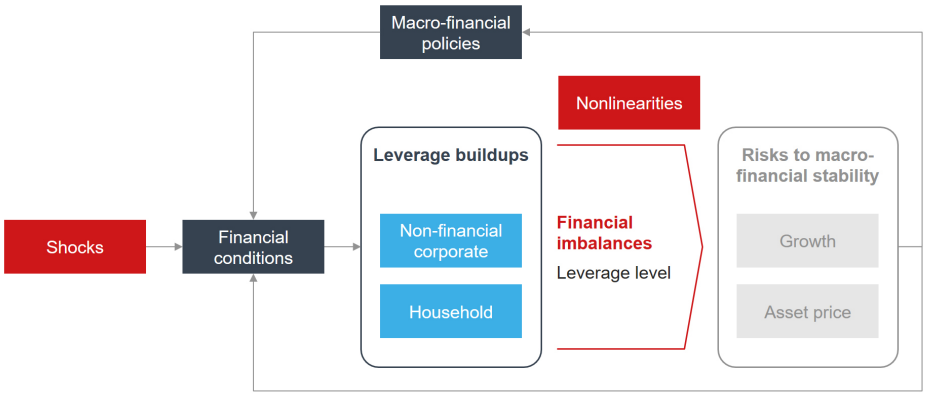
Note: Leverage is measured as the ratio of aggregate debt to aggregate GDP across different country groups. Non-financial corporate debt figures are non-consolidated.

Source: IMF

Corporate leverage in the non-financial sector reached historically high levels following the Great Recession from 2007 to 2009, thanks to eased financial conditions. This was exacerbated by the onset of the COVID-19 crisis, with leverage increasing even further. Analysing the ratio of corporate debt to gross domestic product (GDP) is a good indicator of corporate leverage for the non-financial sector. The graph opposite shows how this ratio developed from Q4 2019 to Q3 2020 for non-financial corporations. We can clearly identify the global increase of 11.5 points in debt as a percentage of GDP, but we can delve deeper to discover that approximately 4.7 points of this increase derived from greater debt; the remainder derived from the fall in GDP.

This high level of corporate leverage should be of some concern to policymakers across the world. Indeed, in the past, high leverage in the non-financial sector has often come before an economic downturn. It is important to remember that there is a close relationship between general financial conditions, leverage and macro-financial stability. The diagram opposite demonstrates just this. The current loose financial conditions (e.g. low interest rates) facilitate a rise in leverage, as non-financial companies avail themselves of cheap debt.

Leverage as an amplifier of shocks



Note: 'Nonlinearities' indicates that the impact of financial conditions on macro-financial stability may be amplified in the presence of elevated financial vulnerabilities, such as a high level of leverage.

Source: IMF

This rise in leverage can lead to financial imbalances, which can ultimately generate risks to macro-financial stability, such as overvalued assets and subsequently weaker growth. Policymakers must manage these risks by implementing policies that will have an impact on financial conditions and leverage, for example, regulating debt-to-equity ratios, thus feeding into the system again. The resulting high levels of leverage leave corporate entities more susceptible to financial shocks.

Of course, this is not the only negative consequence associated with high levels of debt. IMF studies have shown that higher build-ups in leverage tend to be followed by more subdued economic activity over the following three years in both advanced and emerging market economies. Policymakers must consider this trade-off in their calculations: to what extent will supporting economic activity now sacrifice economic growth in the future?

The unprecedented level of governmental assistance to support economic activity has been entirely justified in light of the economic context in place since the onset of the COVID-19 pandemic. However, we are already seeing the effects of such support in economies across the world as corporate debt levels rise to historical highs. Whilst favourable conditions have facilitated access to debt, thereby helping corporate entities to continue their operations despite precarious outlooks, we must remember that nothing comes for free; the price to pay will be lower economic growth in the future.