

ECONOMIC VIEWPOINT



Business Debt Is It Really Better to Reduce It?

Business debt appears high in some countries. This can feed the fears surrounding future economic growth. Interest rate increases are still a possibility, and business profitability could fall due to the costs associated with debt. That being said, other indicators paint a brighter picture despite the high level of indebtedness. Moreover, it may be preferable to look at the problem of debt as a whole. Government contribution to total debt in advanced countries has outstripped that of businesses over the last 10 years.

Business Debt Is Beating Records

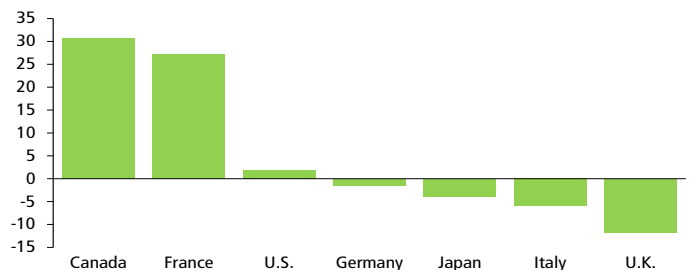
Debt of non-financial businesses has reached almost 74% of GDP in the United States, an all-time high for the country. Considering that high household debt in the United States was a major contributor to the Great Recession of 2008–2009, it may be tempting to think that excess business debt now threatens to create major turmoil.

Although U.S. businesses have never been so far in debt, they are not the worst offenders. Among the G7 countries, businesses in France, Canada, Japan, and the United Kingdom all posted higher average rates of indebtedness according to the data compiled by the Bank for International Settlements (BIS) (graph 1). However, the trend is not on the upswing everywhere, and business debt clearly rose less in the United States than in France or Canada over the last 10 years (graph 2).

GRAPH 2

Canada and France stand out for the rise in business debt over the last 10 years

Change in debt of non-financial corporations among the G7 countries over the last 10 years
In % of GDP



Sources: Bank for International Settlements and Desjardins, Economic Studies

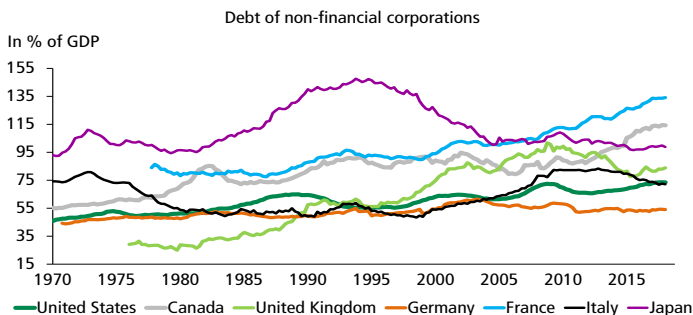
Higher debt ratios can be found outside the G7. In China, businesses are posting debt ratio exceeding 160% of GDP (graph 3 on page 2). Business debt in China rose by nearly 70% of GDP over a 10-year period. On average, business debt in the emerging countries grew faster than that in the advanced countries, but this is not necessarily cause for concern. As emerging countries continue to develop, some catching up is normal. Nonetheless, China does stand out. Given that many Chinese businesses are actually supported by the government, however, it probably makes more sense to combine business debt and government debt when comparing China with other countries, making China's situation more like the average of the advanced countries (graph 4 on page 2).

The Debt Burden Remains Contained

Large debts are not necessarily costly. The ratio of debt service compared with business revenues is a better indicator of this

GRAPH 1

U.S. businesses do not have the highest debt



Sources: Bank for International Settlements and Desjardins, Economic Studies

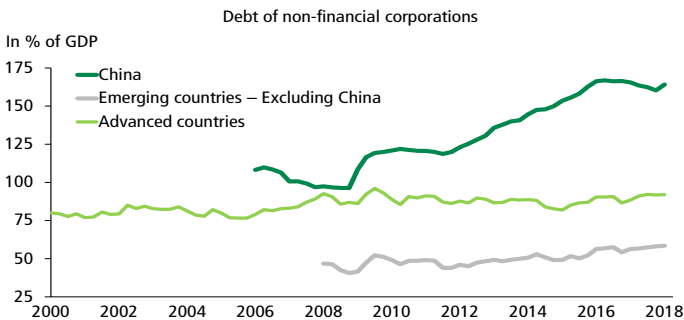
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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

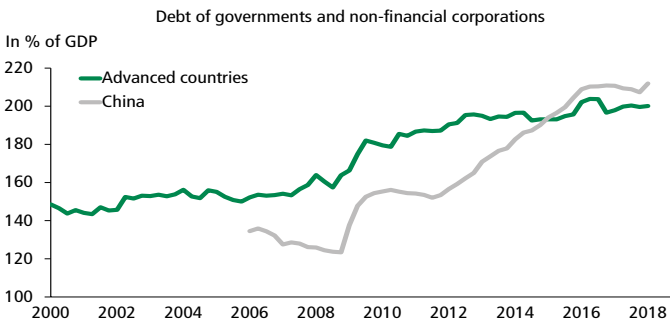
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GRAPH 3
Chinese business debt far exceeds the average in emerging and advanced countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

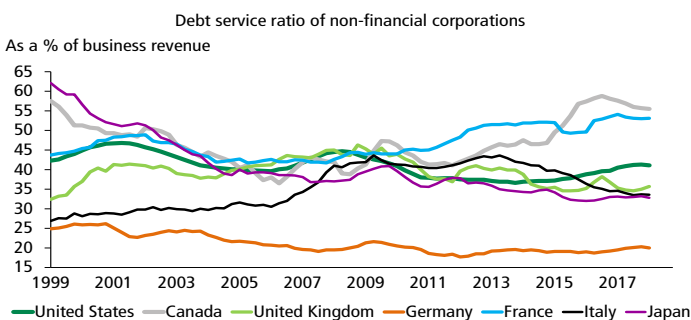
GRAPH 4
The accumulated rate of government and business indebtedness in China is closer to that of advanced countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

(graph 5). Canada's ratio is currently the highest among all the G7 countries. Yet, it is not an all-time record for Canadian businesses, as interest rates remain low. Interest rates are even lower in the Eurozone, which allows French businesses to have a lower debt service ratio than Canada's despite the higher rate of indebtedness. The United States ranks third among the G7 countries. The U.S. business debt service ratio remains lower

GRAPH 5
Business debt service ratio in G7 countries

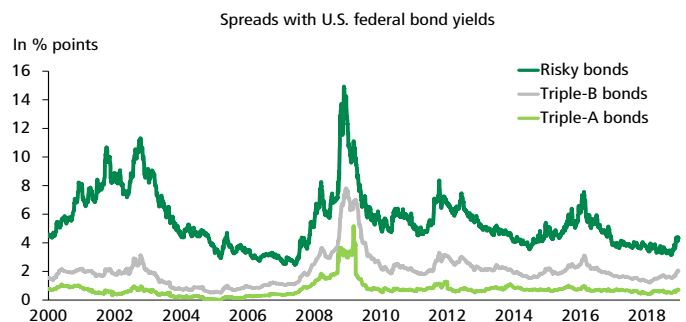


Sources: Bank for International Settlements and Desjardins, Economic Studies

than its previous cyclical peak in 2008. No comparable data is available for the debt service ratio of Chinese businesses.

The monetary policy normalization process threatens to push the debt burden higher. However, the central banks are not signalling a swift and significant rise in interest rates. It remains to be seen how the other factors that affect interest rate levels, such as risk premiums, evolve. Currently, they are very low, but they could also climb in the coming years (graph 6), thereby magnifying the impact of monetary tightening. There is some concern that the same thing could happen with term premiums.

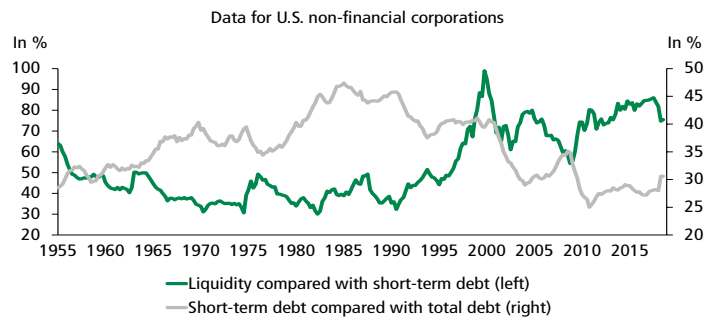
GRAPH 6
Interest rate spreads have begun to widen—ever so slightly—for riskier assets



Sources: Datastream and Desjardins, Economic Studies

Even if interest rates climb quickly due to the combined impact of key rates, risk premiums and term premiums, this would not automatically affect corporate costs, at least not entirely. Businesses appear to have profited from low, long-term interest rates to extend the maturity date of their debts. For example, the burden of short-term debt to total debt in the United States is only about 30% (graph 7). Moreover, businesses seem to have enough liquidity to absorb a large portion of this part of the debt, which is more sensitive to interest rate changes.

GRAPH 7
The burden of short-term debt is low, and businesses have access to a lot of liquidity

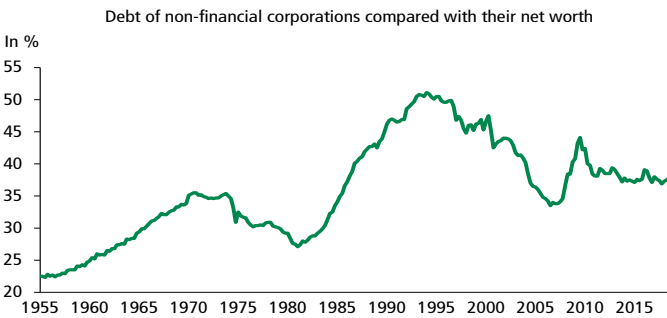


Sources: Federal Reserve, Datastream and Desjardins, Economic Studies

Let's Not Forget about the Flip Side of Debt

Any analysis of business debt also has to consider the value of assets. In the United States, the business debt-to-net-worth ratio is still far below the peak reached in the early 1990s (graph 8).

GRAPH 8
Debt as a percentage of corporate net worth in the United States is far from its previous high



Sources: Federal Reserve, Datastream and Desjardins, Economic Studies

Debt can also be a good thing for the economy. More debt normally means more business investment in things such as additional production capacity or new technologies. Yet, too much investment is not necessarily desirable, as it can cause problems when profitability drops, especially if the demand to consume the goods and services produced fails to keep up. In France, high business debt seems to have gone hand-in-hand with an increase in investment (graph 9). The same situation was noted in other countries, including in the United States.

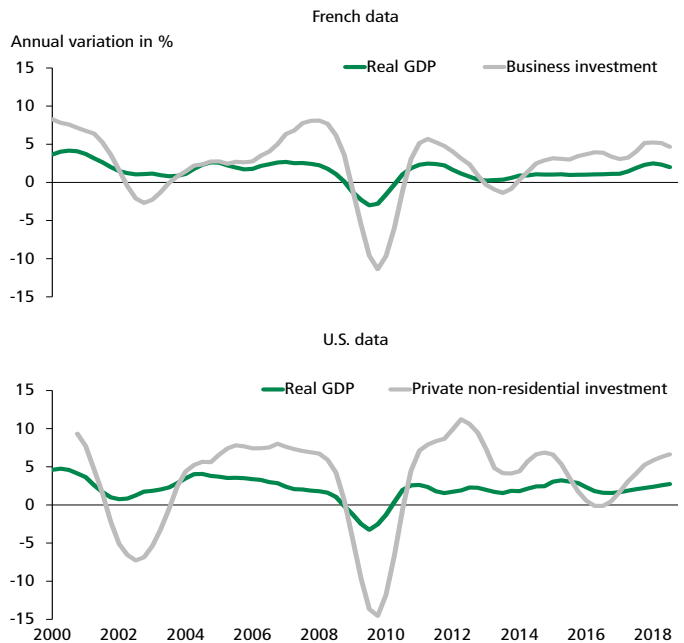
However, it is likely that a part of the business debt was used to finance numerous mergers and acquisitions, which do not necessarily affect economic growth. The issuing of debt can also be used to finance share buybacks, another transaction that does not directly affect the economy. Nevertheless, the money investors receive for redeeming their shares can be reallocated to other uses that can contribute positively to the economy.

Finally, not all industries have upped their debt levels. The high demand for natural resources and energy, in particular, has stimulated investment in the oil and mining sectors for several years now. The result is clearly visible in Canada, where the oil and mining sectors are piling up liabilities worth 10 times their operating income. This ratio has hardly budged in the other sectors (graph 10).

A Potentially Riskier Debt

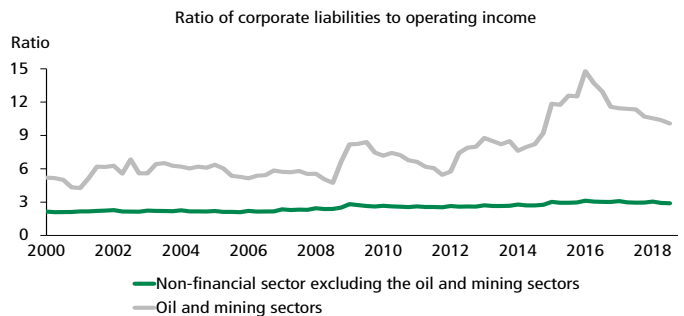
Concentrating debt in some sectors may prove to be problematic if they take a hit. With this in mind, the trouble Canadian oil producers are having to sell their output is a serious risk. The cut in output the Alberta government wanted seems to have already caused prices to rise however, which should help the industry (graph 11 on page 4). All the same, the situation still merits close monitoring.

GRAPH 9
Business debt is good for the economy if it finances more investment



Sources: Datastream and Desjardins, Economic Studies

GRAPH 10
The debt load in Canada appears to be a bigger problem in the oil and mining sectors

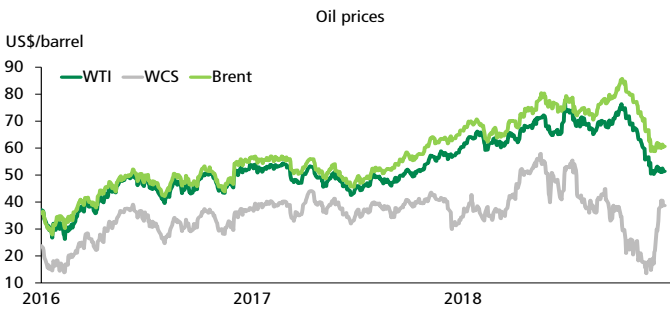


Sources: Bank for International Settlements and Desjardins, Economic Studies

Alarm bells began ringing in the fall because of the type of the business debt in the advanced countries, especially in the United States and Europe. The BIS published analyzes on the rise in the number of zombie companies and the increase in the number of leveraged loans.¹ Zombie companies are businesses that haven't had generate enough revenue for servicing their debt over an extended period of time. There are six times as many of them today as there were some 30 years ago. The long

¹ *BIS Quarterly Review – International banking and financial market developments*, September 2018 : Ryan BANERJEE and Boris HOFMANN, *The rise of zombie firms: causes and consequences*, p. 67-78; Tirupam GOEL, *The rise of leveraged loans: a risky resurgence?*, p. 10-11.

GRAPH 11
The spread between Canadian and U.S. oil prices reached nearly US\$40 in November



WTI: West Texas Intermediate; WCS: Western Canadian Select
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

downward trend of interest rates may have contributed to their rapid growth, however, an increase in interest rates in the coming years could force many of them to close up shop. That being said, the economy could benefit from fewer zombie companies in the longer term. They are less productive and a huge drain on major financial resources that could be put to better use.

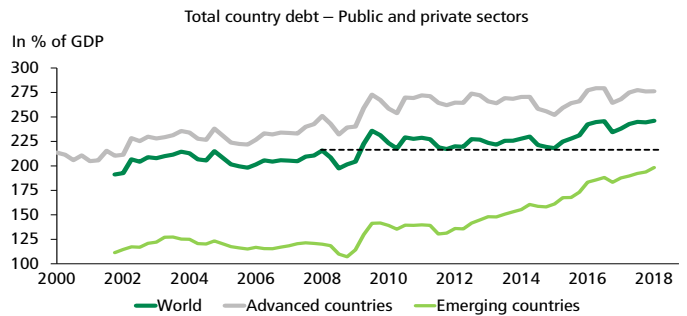
As for leveraged loans, they can be grouped into various categories, including collateralized loan obligations (CLOs) and covenant-lite loans, which offer lenders fewer protections. Leveraged loans are generally granted to businesses already saddled with a lot of debt or a poor credit file, thereby making the loans riskier. Once again, higher interest rates could impact this market, especially as variable interest rates are often used. Moreover, increased risk aversion among investors could put the brakes on the demand for these financial assets. A sudden drop in demand would make it harder for some businesses to refinance their debt. Yet, this kind of situation would probably be temporary, especially if it were to penalize the economy, with the central banks likely returning to easing mode. The central banks also have access to tools that can affect credit spreads and help corporate financing.

Analyzing Debt as a Whole

Business debt may be high in some countries, but the picture isn't so dark according to our own analysis. However, it does fit into the overall debt problem globally, which is serious. Accumulated government, household and business debt has not gone down since the last Great Recession; it currently sits at just under 250% of GDP (graph 12). In the advanced countries, the total debt burden exceeds 275% of GDP.

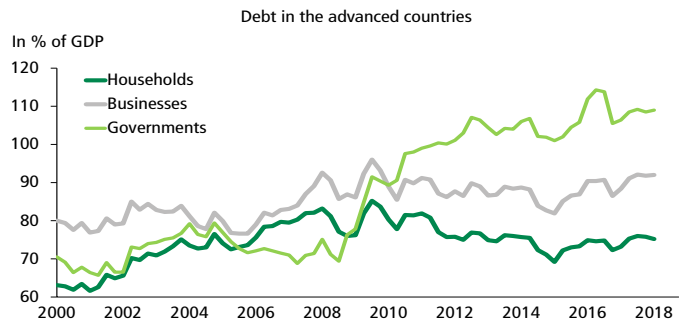
If we look closer, we can see that it is primarily government debt that has contributed to the rise in total debt over the last 10 years in advanced countries (graph 13). During the Great Recession of 2008–2009, many governments responded to the slowdown in demand by introducing major stimulus plans. This is one of the reasons why their debt soared. Next, governments had to continue to provide some support, especially in countries where

GRAPH 12
Total debt is higher than that before the Great Recession of 2008–2009



Sources: Bank for International Settlements and Desjardins, Economic Studies

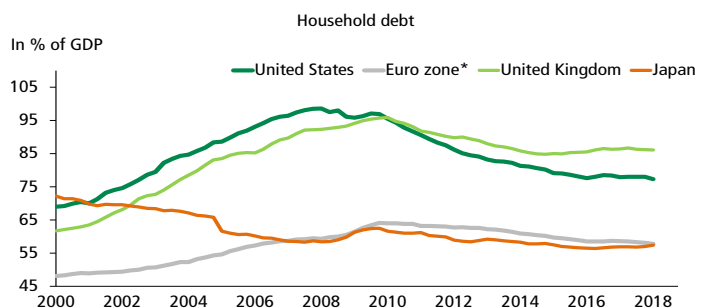
GRAPH 13
Public debt is the portion of total debt that grew the most in the advanced countries



Sources: Bank for International Settlements and Desjardins, Economic Studies

households had reduced their debt load and, as a result, their contribution to economic growth. This was certainly the case in the United States specifically, and in the euro zone in general (graph 14). Against this backdrop, a return of business investment and an increase in business debt to allow governments to ease off the gas pedal a little was almost desirable. It would not have been better if household debt were to climb again and create

GRAPH 14
Households in the major economies have reduced their debt load



* Main declines were in Spain, Portugal, Ireland, Germany and Holland.
Sources: Bank for International Settlements and Desjardins, Economic Studies

the same imbalances that were at the heart of the 2008–2009 recession.

It's Not Easy to Reduce the Total Debt Burden, Especially If You're Targeting Business Debt

Lower total debt would probably reduce the threat of economic and financial instability in the medium and long terms. Yet, this seems to be hard to do without causing economic growth to decline too much. It's a fine balance, and the central banks must proceed gradually with their monetary tightening, which has a more impact on the economy because of the high level of indebtedness.

One way to help reduce the debt burden would be to have higher potential economic growth. In this way, the debt would be amortized on a more rapidly growing economy. For this kind of scenario to work, however, businesses would likely need to invest more for productivity to increase. Productivity is one of the cornerstones of potential economic growth, along with the size of the pool of workers and their level of skill. What you wouldn't want in this situation is for businesses to reduce their debt. Moreover, acquiring more assets and increasing net worth will improve financial strength of businesses.

On the other hand, this should not lead to underestimating the risks and focusing excessively on certain types of financial assets, such as leveraged loans. There could also be a problem with concentrating debt in only a few sectors. Furthermore, there would be no advantage to increasing the number of zombie companies. In a perfect world, financial resources are allocated efficiently to many businesses, but not to those that cannot generate enough revenue over a long period of time. Good businesses succeed in generating value by using their debt.

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