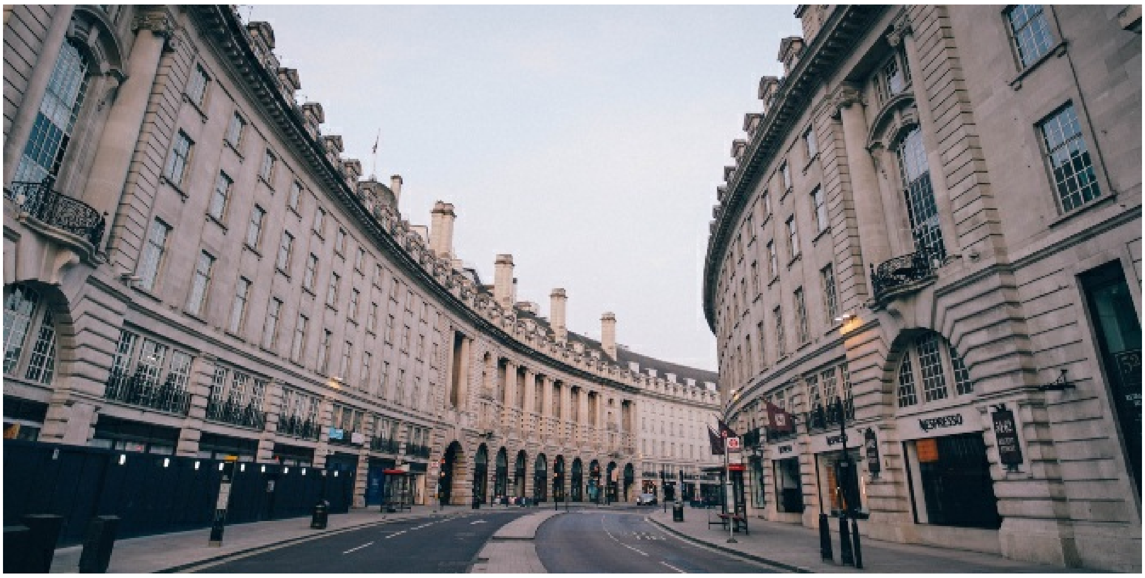
How to deal with higher debt levels and falling prices post-lockdown



In response to the economic fallout from the coronavirus lockdown, public debt has soared in many advanced economies. Against this backdrop, many argued that we should not fear rising debt because inflation is an unlikely scenario and because of current low interest rates. Yet, less attention has been given to the potential implications of higher levels of debt and falling prices.

Velocity (turnover of money) is going down for most major economies. This means that people and businesses are saving rather than spending. Consumers across advanced economies consider that the best strategy to withstand the next pandemic or the second wave of the coronavirus is to increase savings and to reduce household debt.

UK government bonds' negative interest rates provide additional information from markets in support of deflation rather than inflation in the medium term in accordance with the Fisher equation. Deflation increases the real value of debt, however. We know how highly leveraged businesses and households in many advanced economies are. The global outstanding stock of non-financial corporate bonds is a particular concern, as it stood at an all-time high of $13.5tn at the end of December. Over-indebtedness and deflation are two major factors that can lead to a depression, rather than a recession, through a "debt-deflationary spiral", first described by Irving Fisher in 1933.

With higher debt in real terms, consumers and corporations may struggle to stay afloat financially and may default on their debts, which will lead to a repeating cycle of consequences. Consumers who are defaulting will also reduce their spending, which will decrease prices further. Businesses that are making a loss will reduce their output and their employment of labour, sending additional negative ripple effects through the economy. Once the economy is trapped inside a debt-deflationary spiral, it is very hard to emerge from it. Confidence must be restored, which is an even harder task in the state we are in, given the psychological scars of the pandemic and lockdowns.

The conventional policy recommendation to address deflation would be quantitative easing (QE), which implies the continuation of "helicopter money" and other forms of government support programmes. Yet, as we know, the QE effect on growth recovery in the aftermath of the great recession was modest at best, if not controversial. This suggests that governments should also consider implementing policies that address structural problems. For instance, implementing debt restructuring programs could allow "bad" credit to wash out of the system, encouraging new innovative entrants instead of creating zombie firms and companies. Economic growth cannot be generated from a system that keeps running on bad operating capacity.

Debt restructuring does not mean that all employees would be fired, but rather that governments would not bail out investors. A new management team will replace the old one and employees will be rehired. An example of how this policy could work comes from Norway. Norwegian Air (Europe's third-largest low-cost airline) underwent a major refinancing with their creditors when they agreed to a large debt-for-equity swap under a huge haircut, which enabled the airline to access the state's support package. The Norwegian government had set a threshold of an equity ratio (a measure of leverage comparing equity to total assets) of 8% as requirement for its support.

The UK government is working on a bailout plan named "Project Birch", under which the state is expected to inject equity into "important businesses" currently drowning in debt. The project is expected to operate in a way that "any such support would be on terms that protect the taxpayer". Would it be more sensible to provide government-backed loans, or take stakes at those companies only if companies satisfy certain conditions? Liquidity does not solve solvency issues, and we should not repeat the mistakes of similar actions in the post-2008-09 recovery that significantly weakened the economy's ability to withstand the current health crisis.

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Notes:

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