The Perils of Mounting Debt Burdens and How to Avoid Them

Debt has surged across the member nations of the OECD since the mid-1990s. On average, the combined financial liabilities of the public and private sector have increased by almost two-thirds since the early 1990s and have gone beyond 1000 percent of GDP during the past decade. Governments need to set policies to minimize the problems such high debt levels can create.

Growing debt burdens hinder the ability of households and enterprises to smooth consumption and investment while reducing governments’ ability to cushion adverse shocks when the economy stumbles. High debt levels also create vulnerabilities which amplify and transmit macroeconomic and asset price shocks.

New OECD research shows the likelihood of a sharp economic downturn increases when debt levels in the private sector rise above trend. That is particularly marked for households. When household debt hovers near its trend, there is around a 10 percent probability that the economy will enter a recession within the year.

When household debt rises by 10 percent of GDP above trend levels, there is a 40 percent probability of the economy entering a recession the following year. Moreover, recessions tend to be sharper and more protracted when debt is high.

During recessions, debt typically migrates from the private sector to the government sector. During periods of swift growth, debt often builds up rapidly in the private sector. When the economy enters recession, the private-sector debt build up slows or reverses.

Government debt typically rises during recessions, as spending on unemployment benefits goes up and government revenues decline. Government debt is also driven by discretionary action to cushion the economic downturn. When government debt levels are already high, the scope for cushioning the shock is constrained, and will often induce a cut-back of government spending.

Three types of policies can help protect the economy from the adverse consequences of high debt levels. The first concerns prudential regulation. By enhancing the resilience of the financial sector, sound micro-prudential regulation can help dampen shocks and short-circuit the transmission of debt-induced problems across sectors.

Associated macro-prudential policies can help further, by making targeted policy changes to prevent debt levels rising precipitously. For example, when there is a fear that a housing market bubble is encouraging households to take on ever larger loans, imposing maximum loan-to-value ratios on lenders offers one way to contain the build-up of credit bubbles.

A second set of policies concerns procedures to reduce debt levels. Debt writedowns can hasten deleveraging and spur a more vigorous recovery from a high-debt recession. Writedowns can also take into account the social costs of disorderly bankruptcy and the consequences for both lenders and borrowers.

Following innovations by Denmark, a number of countries have recently introduced court-based systems that address excessive household debt levels. In the corporate sector, formal requirements to maintain otherwise viable businesses appear to have less effect than whether institutional structures exist to prevent the uncoordinated liquidation of distressed companies.

A final set of policies covers the monetary and fiscal spheres. Inappropriate macroeconomic policy settings can fuel high debt levels and limit the ability to react to shocks. Unduly lax monetary policy can encourage the private sector to take on more debt than would otherwise be the case.

Seen in this light, as the recovery from the crisis takes hold, monetary policy should guard against maintaining interest rates at too low levels and consider the implications for financial sector stability. Fiscal policy must ensure governments have the ability to smooth large shocks. Institutional frameworks, such as fiscal rules and fiscal councils, can help maintain appropriate fiscal policy in both good and bad times.

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