A credit crash ahead?

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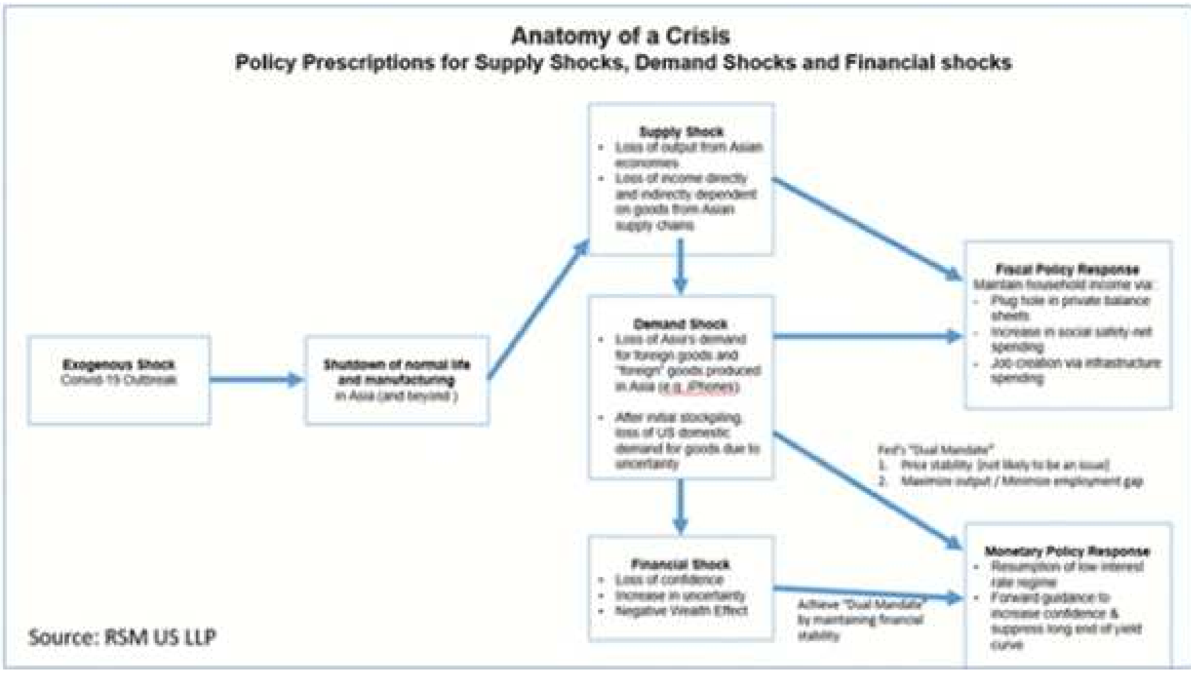
The pandemic global slump of 2020 is different from previous slumps in capitalism. The boom and slump cycle in capitalist production and investment is often triggered by a financial crash, either in the banking system (as in the Great Recession of 2008-9) or in the 'fictitious capital' world of stocks and bonds (as in 1929 or 2001). Of course, the underlying cause of regular and recurring slumps lies in the movements in the profitability of capital, as has been discussed *ad nauseam* in this blog. This is the 'ultimate' cause. But 'proximate' causes can differ. And they are not always 'financial' in origin. The first simultaneous international post-war global slump of 1974-5 was triggered by a sharp rise in oil prices following the Arab-Israeli war; and the double-dip recession of 1980-2 had similar origins. Again, the 1991-2 recession followed the 'Gulf War' of 1990.

The pandemic slump also has a different 'proximate' cause. In a sense, this unprecedented global slump, affecting 97% of the world's nations, kicked off because of an 'exogenous event' – the spread of a deadly virus. But, as has been argued by ecologists and in this blog, the rapacious drive for profits by capitalist companies in fossil fuel exploration, timber logging, mining and urban expansion without regard for nature, created the conditions for the emergence of a succession of pathogens deadly to the human body to which it lacked immunity. In that sense, the slump was not 'exogenous'.

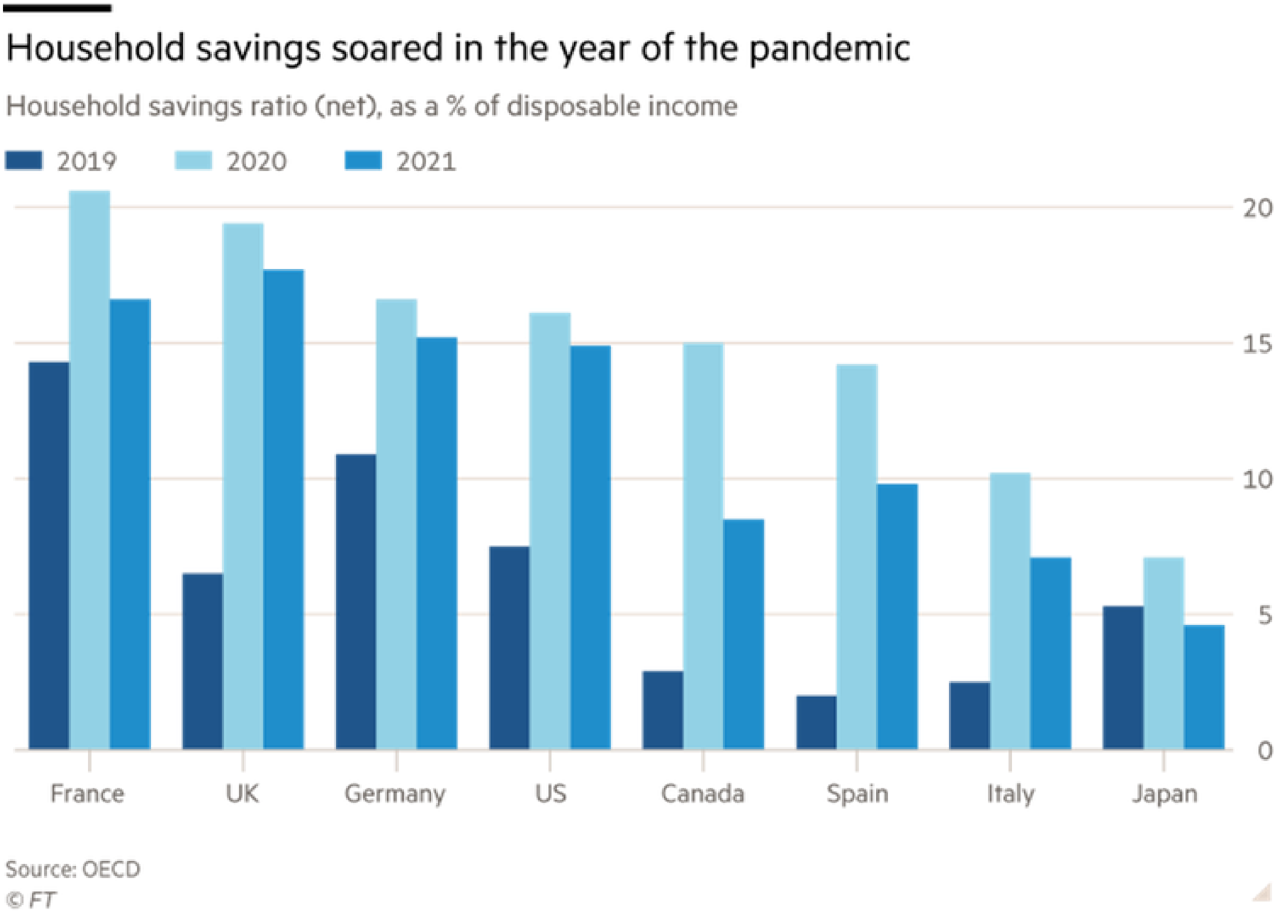
But the ensuing slump in world production, trade, investment and employment did not start with a financial or stock market crash, which then led to a collapse in investment, production and employment. It was the opposite. There was a collapse in production and trade, forced or imposed by pandemic lockdowns, which then led to a huge fall in incomes, spending and trade. So the slump kicked off with an 'exogenous shock', then the lockdowns led to a 'supply shock' and then a 'demand shock'.



But so far, there has not been a 'financial shock'. On the contrary, the stock and bond markets of the major countries are at record highs. The reason is clear. The response of the key national monetary institutions and governments was to inject trillions of money/credit into their economies to bolster up the banks, major companies and smaller ones; as well as pay checks for millions of unemployed and/or laid off workers. The size of this 'largesse', financed by the 'printing' of money by central banks, is unprecedented in the history of modern capitalism.

This has meant, contrary to the situation at the start of the Great Recession, the banks and major financial institutions are not close to meltdown at all. Bank balance sheets are stronger than before the pandemic. Financial profits are up. Bank deposits have rocketed as central banks increase commercial bank reserves and companies and households hoard cash; given that investment has stopped and households are spending less.

According to the OECD, household savings rates have risen between 10-20% points during the pandemic. Household deposits at the banks have soared. Similarly, non-financial corporation cash holdings have increased as companies take out cheap or interest-free government-guaranteed loans, or larger companies issue yet more bonds, all encouraged and financed by government-sponsored programs. Taxes have also been deferred as companies go into lockdown or purdah, again building up yet more cash. Tax deferrals are equivalent to 13% of GDP in Italy and 5% of GDP in Japan, according to the OECD.



Indeed, the latest corporate profit figures (Q3 2020) in the US showed a sharp rise in profits, almost entirely due government loans and grants that have boosted cash flow along with a fall in sales and production taxes as companies stopped trading. Corporate profits increased $495 billion in the third quarter, in contrast to a decrease of $209 billion in the second quarter. The government statistical office explains *"Corporate profits and proprietors' income were in part bolstered by provisions from federal government pandemic response programs, such as the Paycheck Protection Program and tax credits for employee retention and paid sick leave, which provided financial support to businesses impacted by the pandemic in both the second and third quarters."* Around $1.5trn of US government grants and loans went into subsidising US companies during the pandemic. So corporate profits have been sustained by government intervention – at the cost of unprecedented levels of government budget deficits and rises in public sector debt.

The hope now is that as the vaccines are delivered and distributed during 2021 and the lockdowns are ended, the world economy will spring back and the build-up of household savings and corporate profits will be released, as 'pent up' demand flows back into the capitalist economy. Consumer spending will return, people will resume international travel and tourism and go to mass events; while companies will launch an investment binge.

The OECD is less sanguine about this scenario. It is concerned that much of the increase in personal savings is with the rich who tend to spend less as percentage of their incomes (because they just have too much!). The average household in the major economies (and also in the less developed capitalist economies) has not accumulated savings – on the contrary, they have raised their levels of debt during the pandemic. Moreover, with the likely ending of government pay checks and other support during 2021, the situation for the average household could well deteriorate. These inequalities also apply to the corporate sector. The OECD reckons that the bulk of government support in loans and grants has gone to the larger companies, particularly in the technology sector – a sector least hit by the slump.

So this is the likely place to look for the third leg of the pandemic slump – a credit crunch and financial crash when companies, particularly small to medium firms, go bust as government support evaporates, sales revenues remain weak and debt and wage costs rise.

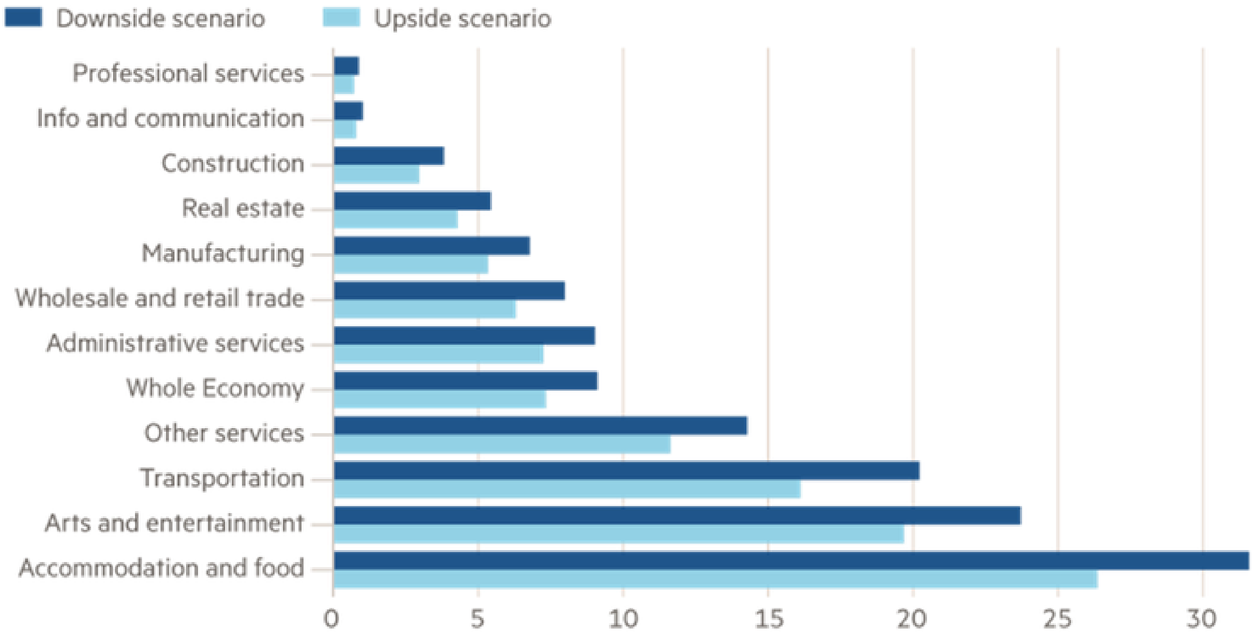
The Institute of International Finance (IIF) recently reported that the ratio of global debt to gross domestic product will rise from 320 per cent in 2019 to a record 365 per cent in 2020. The IIF concludes starkly: "*more debt, more trouble*". As Martin Wolf put it in the FT: "*Financial markets have ignored these warnings. Global equities have reached new highs and credit spreads have been narrowing, almost as if extreme debt is a good, not a bad, economic development.*"

As has been reported before, even before this pandemic corporate debt was at record highs, whether measured against annual GDP, or perhaps more relevant for potential bankruptcy, against the net worth of company assets.

The OECD reckons that if corporate profits were to fall sharply in 2021 as governments withdraw financial support, many companies could become *"distressed"*.

The hit on previously viable businesses is expected to be dramatic

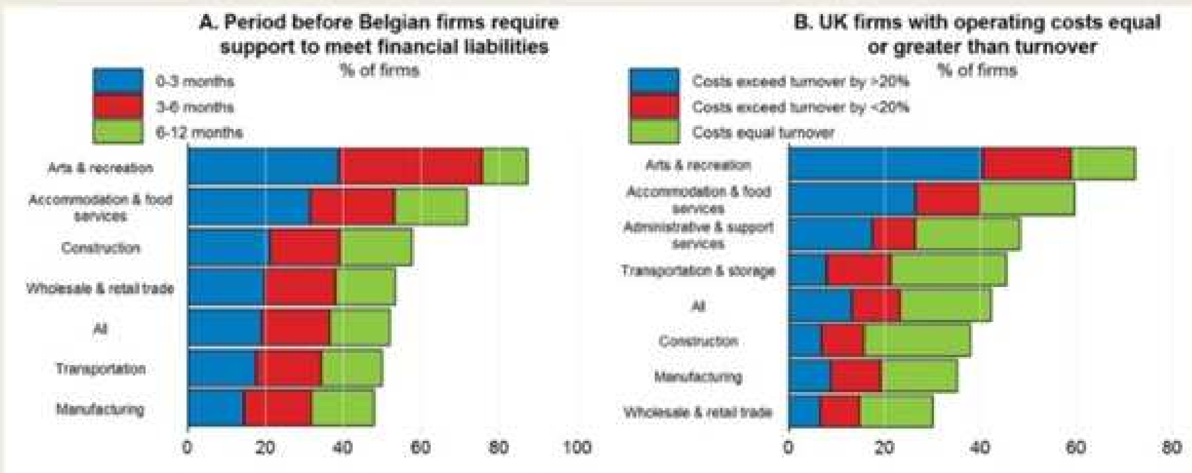
% of otherwise viable companies becoming distressed*, by sector



Sample is over 800,000 companies in 14 European countries
*Companies whose net equity is predicted to be negative a year after the implementation of containment measures. Sample excludes those that would have been distressed in normal times (negative profits and book value of equity in 2018)
Source: OECD

Already, the number of so-called 'zombie companies', those which are not making enough profits to cover the interest on their outstanding debts, has risen significantly. The OECD notes that one-fifth of firms in Belgium, for example, could not meet their financial liabilities for more than three months without taking out more debt or getting an equity injection. That ratio was much higher in certain sectors like accommodation, events and leisure.

Figure 1.5. There are signs of financial fragilities in some service sectors



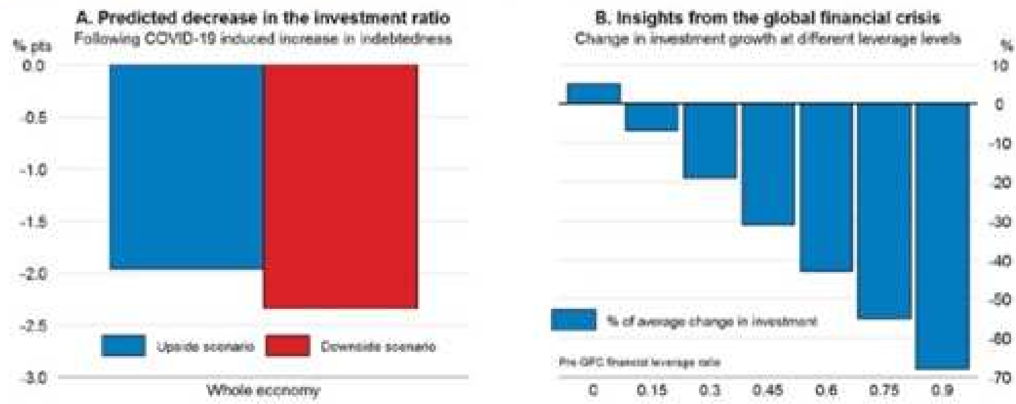
Note: Data in Panel A are responses in September to the question "How long can you still meet your current financial obligations without having to rely on additional equity or credit?", weighted by the number of responding firms. Data in Panel B are responses weighted by turnover to the question "In the last two weeks, how did your business's turnover compare to its operating costs?", and refer to the period September 21 to October 4. Firms replying not sure are excluded from the calculations.
Source: National Bank of Belgium; Office for National Statistics; and OECD calculations.

The OECD concludes that *"financial stability concerns are likely to re-emerge"*, as the rapid build-up in public sector and corporate sector debt could soon lead to *"solvency concerns in a large number of companies."* Corporate defaults on bonds of weaker companies could well double in 2021, says the OECD, particularly in *"hard-hit sectors like airlines, hotels and the auto industry."* Bankruptcies in small and medium size companies in the retail, leisure and commercial property sectors are particularly likely.

This scenario is even more so in the so-called emerging economies. Indeed, even in China, where the economy at large is making the fastest recovery globally, a range of companies with heavy debts are starting to default on their bond payments, putting the government into a quandary. Should it save these companies (some of which are local government-owned state enterprises) or should it let them go bust, in order to reduce the overall debt burden on the economy? This won't lead to a major financial crash or a collapse in the Chinese recovery because the government has massive reserves and can draw on the huge household savings of the Chinese people, mainly deposited in the state-owned banks – unlike in other major economies. But the troubles of a range of Chinese over-indebted companies is a harbinger of what could be a 'debt tsunami' in many corporate sectors elsewhere during 2021.

Much depends on whether the corporate sector can stand on its own feet in 2021 as government subsidies disappear. Even if interest costs on existing debt stay low, if corporate profits do not rise but instead take a dive in 2021, then the OECD reckons that upwards of 30% of companies globally could be 'distressed' and face bankruptcy. And at the very least, companies will not raise their investments, but sit on their hands. The OECD reckons that there is a risk of a 'debt overhang' which would cut business investment growth by 2% points compared to the long-term average before the pandemic.

Figure 2.11. High financial leverage decreases investment



Note: Panel A shows the predicted decrease in the investment-to-fixed assets ratios under the hypothetical increase in the debt-to-total asset ratios shown in Figure 2.9 (Panel A) for the median firm. Estimates on the correlation between debt and investment ratios are based on column (7) of Table A.3 in OECD (2020b). Panel B shows the predicted percentage growth in the change in the ratio of investment to fixed assets following a one-standard deviation increase in the (post- minus pre-GFC) change in financial leverage, at different pre-crisis indebtedness levels. To interpret the size of the effect, the vertical-axis is scaled by the absolute value of the mean of the change in the investment ratio, hence obtaining the effect of a one standard deviation increase in the explanatory variable of interest on the average value of the dependent variable. Estimates are based on specification 2 of Table A.4 in OECD (2020b).
Source: OECD calculations based on Orbis® data.

So even if there is no debt tsunami and a financial crash caused by a wave of corporate bankruptcies, the recovery in most capitalist economies is likely to be very weak. The OECD in its latest forecast for the world economy talks about a *"brighter future"* in 2021 as the COVID vaccines are distributed. But its forecast still expects most economies in the world will not recover the output losses suffered in 2020. By end 2021, only a few economies will have experienced some real GDP growth over the two years since end-2019.

The leading economy on that measure will be China – up nearly 10%; followed by South Korea and Indonesia. The rise in GDP in these countries delivers an *average* rise in world GDP over the two years. ButChina will contribute one-third of that real GDP growth up to end 2021. The G7 advanced capitalist economies will have had no real GDP growth at all (the US) or will have contracted by anything between 3-5% by end 2021 (Europe and Japan), with the UK performing the worst at -6.4%. And large G20 economies like India and Brazil will have had significant declines.

The OECD expects a 'gradual but uneven recovery'. And that assumes the best possible news on the COVID vaccine impact. Even then, while the world economy GDP is expected to return to its pre-pandemic level by end 2021, it will still not catch up with where world GDP would have reached without the pandemic slump (leaving about a 6% of GDP gap). The 'reverse square root' trajectory of the Long Depression looks set to continue.