The turmoil that has roiled global financial markets this summer, emanating from China and other emerging economies, probably came as no surprise to those who heeded Nobel Prize-winning economist James Tobin about the ‘Achilles heel of capitalism.’

Back in 1989, Tobin identified excess leverage and credit growth as the points of acute vulnerability for the global economy and markets.

Our analysis shows that while the credit cycle operates more slowly than the standard business cycle, it produces infrequent but spectacular busts. This means that the ‘credit gap’ and debt service ratios can serve as valuable early warning indicators to these potentially costly events. Indeed, the warning lights of these indicators have been flashing for some time in emerging economies, notably China.

Business cycles are relatively well understood, with rhythms and regularities that repeat through history. Economic expansions typically see simultaneous growth in employment, income, sales and production that endures for several years. Such expansions are interspersed by short-lived recessions, as spending on capital and consumer durable goods collapses and unemployment rises. Such business cycle inflection points are critical factors in the evolution of asset prices. In particular, recessions are almost always characterised by rising defaults, faltering corporate earnings and declining equity prices.

However, overarching the business cycle is a harder-to-spot financial cycle, which reflects the changing appetite, for and provision of, credit. These fluctuations can amplify normal business cycles into more destructive boom and bust cycles, such as in 2008/2009. During periods of credit expansion, rising debt levels allow greater spending on capital and consumer goods and permit investment in a range of assets. During periods of credit contraction, households and corporations are forced to cut spending to make debt repayments and are incentivised to pay down debt. Those that cannot are pushed into bankruptcy, triggering chains of default. The credit cycle typically operates at a lower frequency to the standard business cycle and credit busts are typically much more severe than ‘normal’ recessions.

An increase in private credit to GDP is not necessarily a bad thing. Corporate credit facilitates investment; mortgage financing facilitates house purchases; trade finance facilitates exports. From
has been led by households in the US, UK and parts of Europe paying down mortgage debt. In emerging markets, the last five years have seen a massive increase in private sector debt, driven by the debt-fuelled housing and infrastructure boom in China.

We can assess the ‘credit gap’ through the deviation of credit/GDP from its recent trend. Spikes of more than 5% have tended to act as a clear early warning indicator of trouble ahead, as was the case in 1997 for emerging markets before the Asian financial crisis, and in 2007/2008 as a forerunner to the global financial crisis. More recently, the emerging market credit gap has been in the danger zone persistently since 2009. This does not necessarily suggest that a crash is around the corner, but highlights the increased fragility of a growth model built on debt accumulation.

A large credit gap, consistent with the recent explosive growth in debt, is another good indicator of an underlying chronic problem. Typically, it needs something with a detrimental impact on corporate and household cashflows, such as a ‘cash crunch,’ to transform into an acute crisis. Debt service ratios (DSRs), which measure the proportion of income devoted to meeting the claims of debtholders, form a second key warning indicator.

DSRs in major developed markets have trended down since 2009 as ultra-low official interest rates have fed into low effective interest rates for the private sector. Debt maturities have been termed out in response to market conditions, and the debt burden has steadily decreased. Across emerging markets, however, a much more concerning picture is apparent as relatively high inflation has kept interest rates fairly high and the explosion in debt outstanding has pushed DSRs to worrying levels. China has an uncomfortably large credit gap and high DSR today. Brazil and Turkey have both seen a worrying build-up in private sector credit over recent years and look vulnerable to a sudden increase in interest rates.

Downturns in the credit cycle typically generate recessions that are deeper and longer than those in normal business cycles, so it is sensible to closely monitor indicators of credit excesses and vulnerabilities. If excessive leverage and credit growth is the Achilles heel of capitalism, then currently investors in developed markets may feel comfortable in sandals. Those with large emerging market exposure are well advised to consider protective footwear. «

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Figure 1: EM vs. DM credit accumulation

Source: BIS, IMF, Macrobond & LGIM