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## ***Ten trillion dollars of US corporate debt set off alarm bells***

Alarm bells are starting to be rung over the increase in corporate debt in the US and other major economies, fuelled by the policies of major central banks in supplying ultra-cheap money to financial markets.

The *Washington Post* published an article on Saturday noting that US corporate debt had reached almost \$10 trillion, an amount equivalent to 47 percent of gross domestic product. It warned that 10 years after the global financial crisis the debt surge “threatens to unleash fresh financial turmoil.”

The newspaper commented that the danger was not “immediate,” but cited regulators and investors who said the borrowing “could send financial markets plunging when the next recession hits.”

This year, the “weakest firms” had accounted for most of the debt growth. It was being used, not to finance investment in plant and equipment, but rather for “financial risk-taking such as investor payouts and deal making.”

One of the most significant features of the debt binge is the purchase by companies of their own stock in order to boost share market valuations. According to Federal Reserve data, US companies have spent more than \$4 trillion since 2009 for this purpose, much of it in the past five years.

The quality of the debt is deteriorating, with a rapid rise in lower grade corporate bonds, rated just above junk status. Investors now hold \$4 trillion of such bonds, including \$2.5 trillion issued by US firms, according to the Standard and Poor’s rating agency.

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The article cited comments by Emre Tiftik of the Institute of International Finance, a major finance industry association, who warned: “We are sitting on the top of an unexploded bomb and we don’t really know what will trigger the explosion.”

The rise in corporate debt was highlighted by the International Monetary Fund in its *Global Financial Stability Report* issued in October, in which it said that “corporate debt vulnerabilities” were “significantly elevated” in a number of countries. The fear is that these “vulnerabilities” could set off a crisis if there is a downturn in the global economy.

“In a material economic slowdown half as severe as the global financial crisis, corporate-debt-at-risk (debt owed by firms that are unable to cover their interest expenses with their earnings) could rise to \$19 trillion--or nearly 40 percent of total corporate debt in major economies--above crisis levels,” the IMF said.

The IMF said very low interest rates, which have seen the amount of bonds with negative yields rise to \$15 trillion, were “prompting investors to search for yield and take on riskier and more illiquid assets to generate targeted returns.”

Despite the warnings of the dangers, money is continuing to pour into the financing of riskier assets because of the low interest rate regime of the world’s central banks. According to one fund manager cited by the *Washington Post*, companies were doing the “rational thing,” and that “if you tell them they can borrow cheap and borrow long, they will take advantage of it.”

This is because there is big money to be made. In an article published last week on the warning signs flashing in the US debt market, the *Financial Times* noted that an index of junk-rated debt run by Ice Data Services has returned almost 12 percent this year as “bullish fund managers look lower down the credit spectrum in pursuit of income.”

The present situation brings to mind the infamous comments by the former head of Citigroup, Chuck Prince. Asked in July 2007, on the eve of the financial crisis, about the group’s continued commitment to leveraged buyout deals, even as danger signs were emerging, he replied, “As long as the music is playing, you’ve got to get up and dance.”

An article published in the *Financial Times* last week by the senior investment manager at Pictet Asset Management, Galia Velimukhametova, pointed to the rise of “zombie” companies in the major economies. These are firms whose interest costs are in excess of their annual earnings and which are kept alive only because of the low interest rate regime.

“Bank of America Merrill Lynch estimates that there are 548 of these zombies in the OECD club of mostly rich nations against a peak of 626 during the crash,” she wrote, noting that there are five times more zombies today than in the late 1990s, when interest rates were significantly higher.

Velimukhametova pointed to the worsening situation in the quality of corporate debt extending over the past two decades. In the 1990s, the median corporate debt rating from S&P Global was solidly investment grade. Now it is just above junk status. There had been a sharp deterioration in Europe.

“As recently as 2011,” she wrote, “virtually all European corporate loans were issued with solid covenants--the minimum financial thresholds that help ensure a company will be able to meet its obligations. Now more than 80 percent of debt sold by the largest companies is classed as ‘covenant lite,’ offering negligible protection to creditors.”

The US Federal Reserve has also become concerned about the rise in corporate debt and its implications for the stability of the financial system. According to the minutes of its rate setting committee at the end of October, “several officials” warned that “imbalances” in corporate debt had grown during the current phase of economic expansion.

They also raised concerns that “deteriorating credit quality could lead to sharp increases in risk spreads in corporate bond markets,” and this could “amplify the effects of an adverse shock to the economy.”

The *Washington Post* was more direct. Citing investors and money managers, it said that if the “junk market were to be sufficiently disrupted, companies could be forced to default on their debts.” It added, “That would likely force massive layoffs and sharp reductions in business investment, turning the financial market’s headache into a punishing economic ill.”

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