FT.com
FINANCIAL TIMES

Deleveraging out of the debt mire will be an unsavoury task

By Gillian Tett
Published: January 15 2010 02:00 | Last updated: January 15 2010 02:00

Which country experienced the biggest jump in debt, relative to gross domestic product, over the past decade?

A year ago, as the world reeled from the subprime mortgage crisis, most investors might have said America. And these days, countries such as Iceland, Dubai or Greece tend to spring to mind, in connection with deadly debt burdens.

However, if McKinsey consultants are to be believed, the real leverage giant - at least among the big western economies - is actually the UK. After crunching the data, McKinsey estimates that the gross level of British private and public debt is now 449 per cent of GDP - up from 350 per cent at the start of the decade.

And even excluding the liabilities of foreign banks based in the UK, the ratio still runs at 380 per cent - higher than any country except Japan (closely followed by Spain where debt has also spiralled dramatically, according to a McKinsey report issued today.*)

That is sobering stuff, particularly for UK voters. However, it also raises a much bigger point. In the middle of the last decade, it was often frustratingly difficult to get any data on leverage levels, since it was an issue on which precious few policymakers focused. That was partly due to misplaced faith that financial innovation had made debt less dangerous than before. But finance officials and bank supervisors also tended to focus on pretty narrow ways of measuring leverage, that tracked, say, hedge fund debt (a popular obsession, in the wake of the collapse of Long-Term Capital Management fund).

And since those narrow definitions of leverage looked benign, there was little concern about overall debt levels - or debate about whether deleveraging might be needed.

Now, of course, the world is radically different. But, as McKinsey points out, there is still surprisingly little known about the actual mechanics of "deleveraging", compared with, say, all that research that has been conducted on financial crises. And so it has tried to plug this gap by both plotting the recent pattern of global leverage levels - and then setting it in a wider historical context, to show how deleveraging has (or has not) occurred before.

Like any compendium of statistics, some of the numbers are controversial. Some economists, for example, may complain that the gross number for UK debt looks excessively crude, since it does not take account of assets or cross-holdings. UK voters are not usually liable for, say, the debt held by British industrial groups.

Nevertheless, some of the patterns in the report are fascinating - and valuable - precisely because they have often been ignored. Contrary to popular perception, for example, McKinsey points out that, by historical standards, most of the financial world was *not* crazily leveraged in the past decade. Instead, the crazy debt increase was focused on a small group of brokers, and global banks.

Moreover, alongside the (limited) rise in broker borrowing in the past decade, there was also a far more startling increase in "real economy" debt, particularly in the household and real estate sector. Since the crisis started, this "real economy" debt has declined a tiny bit, while financial sector leverage has fallen considerably. But since public debt has spiralled, gross leverage levels for most large nations have not fallen. And that, in turn, has a crucial implication: namely that, insofar as deleveraging is inevitable, much of it is still to come. From a historical perspective, this challenge is not entirely unprecedented. The UK and US have, after all, slashed vast debt burdens before during the last two centuries, and McKinsey has identified four dozen smaller deleveraging episodes around the world since 1950.

But while governments have sometimes softened this task before by creating rapid growth, often due to exports (via devaluation), or a peace dividend (after a war), those routes do not offer an easy escape this time. Growth, in other words, could be tough to achieve. So that leaves three unpalatable options, McKinsey suggests: outright default, inflation or belt-tightening.

McKinsey's best guess - or hope - is that belt-tightening will predominate, and it consequently forecasts a grim climate of austerity for the next decade. It may be right. But to my mind, at least, it remains a very open bet whether western voters will accept austerity without a backlash; personally, I would thus put a higher emphasis on the other options too.

Either way, the real moral is that the task now facing the western governments is monumental. It is a pity that groups such as McKinsey were not producing these leverage charts three years ago. If so, the politicians might now not be in quite such a pickle, even - or especially - in the UK.

* *Debt and Deleveraging; The Global Credit Bubble and its Economic Consequences; McKinsey Global Institute; January 2010* .

gillian.tett@ft.com