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Economics Group

Special Commentary

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Do Advanced Economies Have a Corporate Debt Problem?

Executive Summary

In the third installment of our four-part series on financial leverage in advanced economies, we turn our attention to leverage in the non-financial corporate (NFC) sectors. Overall, there has been little change on balance in corporate leverage in most advanced economies since the onset of the Great Recession eight years ago. The exceptions to this rule are Canada and the Eurozone, where debt-to-GDP ratios in their respective NFC sectors have risen about 20 percentage points since 2007 and currently exceed 100 percent. Much of the increase in corporate leverage in the Eurozone has occurred in France.

We are not saying that debt-servicing problems in the NFC sectors in Canada and France are imminent. Neither the Bank of Canada (BoC) nor the European Central Bank (ECB) are about to hike rates, certainly not in an aggressive fashion. Consequently, debt-servicing costs on short-term corporate debt in both economies are not likely to lurch higher due to rising interest rates. That said, the NFC sectors in Canada and France could become increasingly stressed if corporate leverage rises further, especially once interest rates in those economies start to rise.

Do Canadian and French Businesses Have a Debt Problem?

As we pointed out in the introductory report in this series, debt-to-GDP ratios in the NFC sector in Australia, Japan, the United Kingdom and the United States either remained essentially constant or declined between 2007 and 2015.[1] In Canada, however, the ratio rose nearly 20 percentage points over that period and currently exceeds 100 percent. The NFC debt ratio in the Eurozone crept up from about 95 percent prior to the Great Recession to 105 percent today, and much of this increase reflects a build-up in corporate debt in France. In this report we drill down deeper into corporate leverage in Canada and France to analyze whether these two economies could experience debt-servicing problems in their respective NFC sector in the foreseeable future.

Canada: Debt-Servicing Costs Have Tracked Increase in Leverage

Let us start with Canada. As shown in Figure 1, the debt-service ratio (DSR) of the Canadian NFC sector has risen over the past few years and currently stands near a two-decade high.[2] This trend increase in the DSR has occurred as the debt-to-GDP ratio of the corporate sector has risen from 95 percent in 2011 to nearly 110 percent today. Our econometric analysis shows that a 10 percentage point rise in the corporate debt-to-GDP ratio in Canada is associated with an increase in the DSR of nearly 6 percentage points, everything else equal.

The debt-service ratio in Canada has risen noticeably in recent years.

[1] See "Rising Financial Leverage in Advanced Economies" (December 17, 2015). Our second report, which is entitled "Are Australian & Canadian Households Over-Levered?" (January 5, 2016), examined financial leverage among households in Australia and Canada. Both reports are available upon request.

[2] A debt-service ratio shows the percentage of income that an individual, business or public entity must use to make interest and amortization payments on their existing stock of debt.

Figure 1

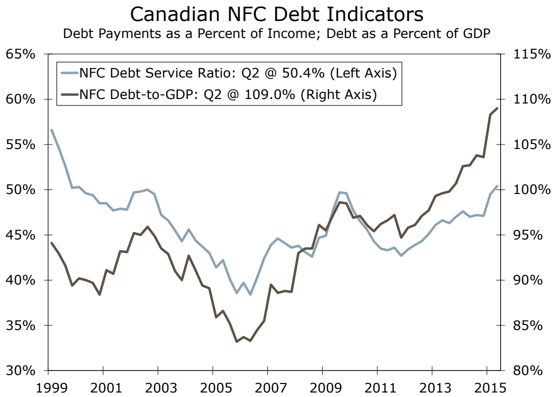
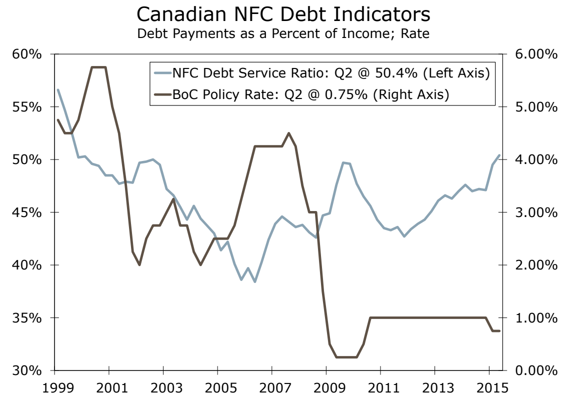


Figure 2



Source: Bank for International Settlements, Bloomberg LP and Wells Fargo Securities, LLC

Of course, everything else may not be equal. That is, changes in interest rates could affect the DSR. Figure 2 plots the Bank of Canada's (BoC) main policy rate, which in large part determines the level of short-term lending rates in Canada, and the DSR of the Canadian NFC sector. Casual examination reveals that the two variables have a low degree of correlation on a quarter-by-quarter basis, which is confirmed by formal analysis.[3] That said, the trend decline in Canadian interest rates over the past two decades undoubtedly has restrained the overall rise in the DSR in the face of rising financial leverage in the corporate sector that was shown in Figure 1.

Long-term debt reduces the sensitivity of debt service to changes in short-term interest rates.

It appears that the structure of corporate debt in Canada helps to reduce the sensitivity of the DSR in the NFC sector to quarterly changes in the BoC's main policy rate. Specifically, long-term bonds account for roughly one-quarter of the outstanding debt of the NFC sector. In addition, the commercial mortgages that businesses owe probably have some degree of interest rate fixity as well. This also would reduce the sensitivity of the DSR to changes in the BoC policy rate. We estimate that roughly 40 percent of Canadian corporate debt is fixed rate, which would not be sensitive to changes in the BoC's main policy rate.

In our view, the BoC is in no hurry to raise rates. Indeed, we believe that the BoC will be on hold throughout 2016 and any tightening that transpires next year will occur at a very gradual pace. Therefore, changes in interest rates likely will not play a significant role in affecting the DSR in the Canadian NFC sector in the foreseeable future.

The NFC sector in Canada could become increasingly stressed.

Rather, the DSR in the near term will be driven primarily by changes in financial leverage in the corporate sector. In that regard, growth in business credit has slowed recently and is currently rising at a year-over-year rate of roughly 6 percent (Figure 3). However, nominal GDP growth in Canada has essentially stalled in recent quarters, which means that the debt-to-GDP ratio of the corporate sector will continue to rise, at least in the near term. The DSR of the NFC sector currently stands at 50 percent, and it could eventually exceed its two-decade high of 56 percent if corporate leverage continues to increase. Like the household sector in Canada that we discussed in our previous report, the NFC sector in that country could become increasingly stressed if corporate leverage rises further.

[3] **The correlation coefficient between the two variables is only 0.11.**

Figure 3

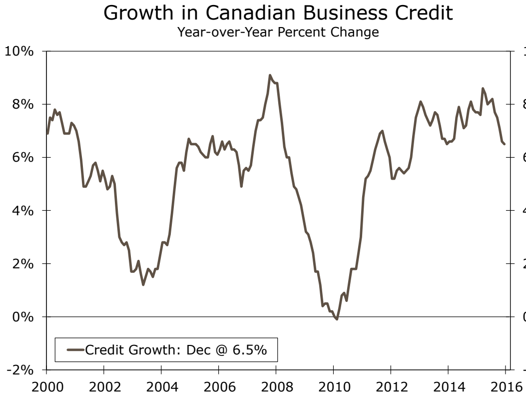
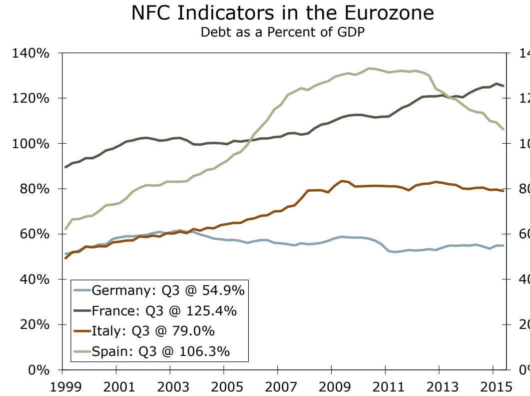


Figure 4



Source: Bank of Canada, Bank for International Settlements and Wells Fargo Securities, LLC

France: An Outlier Among Eurozone Economies

As noted in our first report and re-iterated above, the NFC debt ratio in the overall Eurozone has crept up over the past decade or so. As shown in Figure 4, however, not every country in the euro area has experienced an increase in corporate leverage. Debt-to-GDP ratios of the NFC sectors in Germany and Italy have been more or less flat over the past decade while the corporate sector in Spain has de-levered since the end of the global financial crisis. In contrast, the debt ratio of the French corporate sector has increased about 20 percentage points since 2007 and currently exceeds 125 percent.

This increase in the French corporate debt ratio helped to push the DSR of the NFC sector from a low of 41 percent in Q4 2007 to 53 percent in late 2014, the highest ratio in at least 15 years (Figure 5). In the past few quarters, however, two developments have contributed to some modest reduction in the French corporate DSR. First, nominal GDP growth in France has picked up somewhat.[4] Stronger income growth by the French corporate sector helps to reduce its DSR, everything else equal. Second, efforts by the European Central Bank (ECB) to reduce borrowing costs are helping to ease debt-servicing costs in France, at least at the margin. As shown in Figure 6, the composite borrowing indicator, which measures interest rates charged on new bank loans across the maturity spectrum, has declined about 50 bps or so in France since mid-2014.

Figure 5

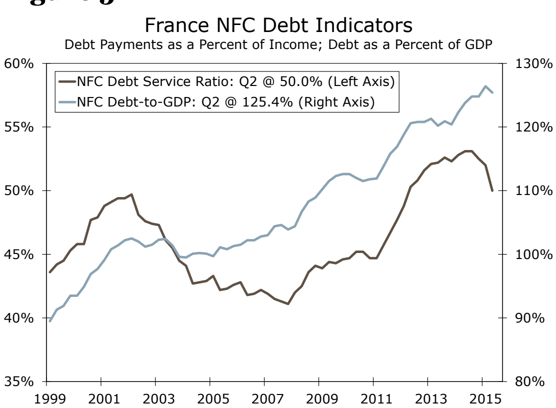
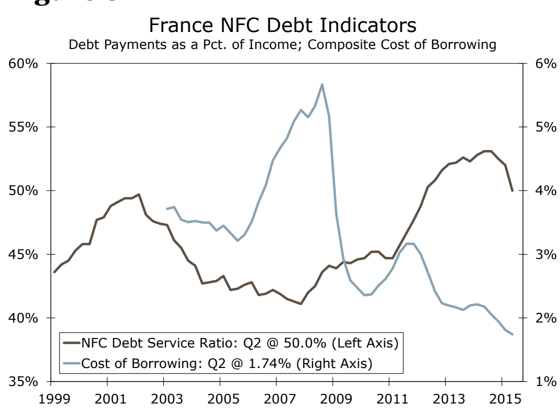


Figure 6



Source: Bank for International Settlements, European Central Bank and Wells Fargo Securities, LLC

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[4] **Nominal GDP growth in France was essentially flat on a year-ago basis in mid-2014, but it strengthened to 2.5 percent by the end of last year.**

There probably is a limit to how far the corporate DSR in France can recede, at least in the near term.

There probably is a limit to how far the corporate DSR in France can recede, at least in the near term. First, muted inflation means that nominal income growth in France likely will not strengthen significantly in the near term, which would constrain the increase in the denominator of the DSR. Second, 70 percent of French corporate debt is long-term in nature, which gives it low sensitivity to changes in short-term interest rates. Third, there is a limit to how much lower the ECB can push corporate borrowing rates. Although the ECB can charge negative interest rates on the excess reserves that European banks hold at the central bank, commercial banks will not take their lending rates into negative territory.

The evolution of the corporate DSR in France going forward will be determined largely by corporate borrowing behavior in that country. In that regard, loan growth in the French NFC sector has picked up recently and currently is running above 4 percent on a year-over-year basis. Stronger loan growth will help to support overall economic growth, but it will do little to bring about a significant reduction in the corporate debt-to-GDP ratio. In other words, leverage and the DSR in the French corporate sector likely will remain elevated for the foreseeable future.

Conclusion

In general, there has been little change on balance in corporate leverage in most advanced economies since the onset of the Great Recession eight years ago. The exceptions to this rule are Canada and France, where debt-to-GDP ratios in their respective NFC sectors have risen about 20 percentage points since 2007 and currently exceed 100 percent. Although the low level of interest rates in both countries has constrained the rise in debt-servicing costs, DSR's of the corporate sectors in both Canada and France have risen to their highest levels in years.

We are not saying that debt-servicing problems in the NFC sectors in Canada and France are imminent. Neither the ECB nor the BoC are about to hike rates, certainly not in an aggressive fashion. Consequently, debt-servicing costs on short-term corporate debt in both economies are not likely to lurch higher due to rising interest rates. That said, the NFC sectors in Canada and France could become increasingly stressed if corporate leverage rises further, especially once interest rates in those economies start to rise. Stay tuned.

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