Frances Coppola writes: If you thought the world was reducing its debt pile - forget it:
I have been reading the Geneva 16 report.

The debt is still growing, but the world's GDP growth is slowing. Indeed as aggregate debt figures are usually quoted versus GDP, the two are connected. The debt pile grows faster as growth slows, simply because the denominator is falling.

The report looks at total debt/GDP - not just sovereign debt. This is refreshing: unrelenting media focus on sovereign debt as the principal problem misses the fact that in many countries the bigger burden is PRIVATE debt. However, it makes the figures even worse. Global debt, it seems, is a terrible problem.

None of this will come as a surprise to anyone, except perhaps the news that the world as a whole is actually accumulating debt rather than deleveraging. The deleveraging efforts by developed countries are being more than offset by the increasing debt of emerging markets, particularly China.

Who are the owners of all this debt?

There is a simple answer to this. Households and corporations own this debt. It is the savings of households and the uninvested profits of corporations. Since the financial crisis, developed-country governments also own some of this debt, via their central banks. And in emerging markets, where governments, corporations and households can be very closely related, exactly who owns the debt can be unclear.

The global debt glut described in this report, and the global saving glut described by Bernanke, are the same thing. The authors note that growth has been slowing in developed countries since 1980. Indeed it has - and during that time capital ownership and indebtedness have been increasing in tandem, as we might expect since they are opposite sides of the same coin. The report cites numerous analyses that show high debt levels - public AND private sector - tending to impede growth as resources that could have been turned to productive investment are spent on debt service. Secular stagnation is as much a consequence of over-indebtedness as it is of excess capital.

The owners of debt think they have saved prudently and accumulated safe financial assets to insure them against an uncertain future. They believe that their savings are PAST income, stored. Bonds and bank accounts are simply their own money in another form. How very dare anyone suggest that their hard-earned savings should be lost in order to relieve the debt burden on others? Let the profligate debtors sort out their own problems. Prudent savers must be protected from loss.

But debt assets are not stored past income. They are actually claims on the FUTURE income of other people. When you buy bonds, you are spending, not saving. Your money goes to someone else and you have no right to its return. In return, you receive a promise. In a simple vanilla bond, the promise has two parts:

- the promise that you will at some point in the future recover a nominal sum of money equal to the amount that you paid for the bond (note that this is not protected against inflation)
- the promise of a stream of coupon payments that may or may not include compensation for expected inflation

There are huge variations on this theme, but they all boil down to the same thing. You spend money in the present in return for a promise of more money in the future.

The price of the bond is the value of that promise, and it depends on the trustworthiness of the borrower. If the borrower is regarded as trustworthy, the price is high. But if the borrower is regarded as untrustworthy - say they have recently failed to honour a payment promise - the price is low.

Similarly, bank accounts are not "your money, stored". They are a loan to the bank. You give the bank your money in return for a promise of future income (interest payments), and possibly other services such as safe storage and payments. You don't have any right to return of that money: what you have is a promise that if you ask for it back, the bank will honour your request if it can.

Risk of loss due to default is a intrinsic part of lending. When you lend money - whether by buying bonds, putting money in a bank account, or lending directly to someone - you accept the risk that the borrower will fail either to make the promised payments or return your money. Your judgement of someone's creditworthiness governs the amount you will charge them for this risk: the interest rate on an unsecured loan to someone with a good credit history is typically far lower than on a loan to someone with a recent history of payment default. A good credit history is a very valuable intangible asset for a borrower. Destruction of trustworthiness as a result of default amounts to a serious loss of net worth.

You may insure against risk of default by demanding that the borrower pledge some of their assets as surety: this of course what pawnbrokers do, but it is also the foundation of all property lending and most lending in financial markets. A mortgage is a loan on which the lender has the right to seize an associated asset (property) in the event of default. A repurchase agreement (repo) is a loan on which the lender has the right to seize a certain amount of securities in the event of default. Since the financial crisis, secured lending has become far more widespread due to loss of trust. The world runs on pawnbroking.

The problem with this, of course, is that the assets pledged as surety may fall in value, as we saw in the subprime crisis. When this happens, the risk of default may or may not rise, but the risk of losses in the event of default rises. Suddenly the loan or the bond is not worth as much. And insurance policies such as CDS aren't foolproof either: insurers can go bankrupt if there are too many claims, as AIG and the monoline insurers discovered. Nor is deposit insurance wholly trustworthy: Iceland legally defaulted on deposit insurance obligations to overseas customers of its banks. There is no such thing as a completely safe debt asset.

Nevertheless, the world's savings are largely held in the form of the world's debt, and people like to believe that their savings are safe. Because too high a debt burden increases the likelihood of default, many people - including the authors of the Geneva 16 report - think that governments should reduce sovereign debt. There are four principal ways of doing this:

- by running persistent budget surpluses.
- by reducing the real value of the debt through inflation
- by reducing the debt/GDP ratio through higher growth.
- by outright confiscation of savings (financial repression)

The authors dismiss the third of these as there is no evidence that higher growth can eliminate a persistent debt overhang. Historically, they note, the second (inflation) has most frequently been used to reduce post-war sovereign debt burdens, often in combination with the fourth (financial repression). The first is the preferred choice of governments such as Germany and the UK, but in practice running sustained budget surpluses is extraordinarily difficult to do and arguably pointless if the private sector is also highly indebted.

For a government to run a persistent budget surplus requires that it takes in tax more than it spends. In the absence of a trade surplus, this means extracting money from the domestic private sector, which understandably does not want to give it up.* Running a sustained budget surplus when there is a trade deficit amounts to financial repression. But even if there is a trade surplus, a government surplus means lower saving for the private sector than it might desire. The Geneva 16 report points to substantial debt overhangs in the private sector. When the private sector is highly indebted, saving can take the form of paying off debt. If the government runs a surplus, therefore, it impedes deleveraging in the private sector, and may even force some sectors (typically the poor) to increase debt. Reducing the sovereign debt not only reduces saving in the private sector, it comes at the price of continued and possibly rising indebtedness. The report rightly notes that transferring debt from the private to the public sector, as the US has done, isn't deleveraging. But transferring it back again isn't deleveraging either. And as transferring it back again is likely only to be possible with extensive sovereign guarantees (the UK's Help to Buy, for example), whose debt is it really, anyway?

Reports such as this, that look on debt as a problem and ignore the associated savings, fail to address the real issue. The fact is that households, corporations and governments like to have savings and are terrified of loss. Writing down the debt in which people invest their savings means that people must lose their savings. THIS is the real "shock, horror". This is what people fear when they worry about a catastrophic debt default. This is what the world went to great lengths to prevent in 2008. The problem is not the debt, it is the savings.

If we really wish to reduce the global debt pile, we must either accept that the households, corporations and governments that currently own that debt must take losses,

or find alternative investment vehicles. The problem, of course, is that potential replacements are either illiquid (property), risky (equities) or volatile (commodities).

I don't think that trying to find substitutes among existing asset classes in any way solves the problem of "too much debt". Debt is dysfunctional. It places debtors in a one-down position in relation to creditors and creates moral hazard for both - creditors because they can claim their due even at the price of severe hardship for the other, and debtors because they believe creditors will balk at enforcing the terms of the contract. This dilemma is centuries old: in The Merchant of Venice, Shylock's "pound of flesh" was his rightful due when Antonio defaulted on his loan, but enforcing that right would have killed Antonio and made Shylock a murderer. Shakespeare rightly lampooned such a destructive relationship, but four hundred years later nothing has fundamentally changed: we might not murder defaulters, but we certainly make their lives extremely difficult. We need a fundamentally different way of viewing the investments that households, corporations and governments make.

I think the world is inching its way towards a model that replaces most debt with equity. We have already seen debt for equity swaps in distressed banks. Perhaps we need debt for equity swaps for sovereigns, too. Why not replace USTs with shares in USA Inc.? Let's stop calling it "sovereign debt". It's share capital. It's our collective investment in our own futures.**

Debt for equity swaps are also possible for households that have both assets and debt - an over-mortgaged homeowner, for example. Though I wouldn't want to take this too far. Someone whose net worth is less than their debts cannot offer a debt for equity swap. They are insolvent, and their debt needs to be written off, not restructured. We do not want to see a return of debt peonage. But there are other shared-equity models that could replace current debt-based ones: imagine, for example, well-off elderly sponsoring the tertiary education of young people and mentoring them during their studies and in the early part of their careers. Or, for that matter, young people investing in the care of the elderly in return for a share in their housing wealth.

Clearly there are limits to the equity-savings model: there would still be a role for some debt, and some losses will have to be accepted. But equity is (pardon the pun) a far more equitable investment than debt, since issuers and investors are equally responsible for the success of the investment. Yes, an equity investment is ostensibly higher risk than lending: but haven't we yet learned that the safety of debt is an illusion?