The relationship between debt and growth

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The unprecedented growth in credit over the last ten years has left the world with a severe debt problem, but it is exactly this debt that fuels economic growth

Until the recent global financial crisis, the world economy was adding an estimated 150 million new consumers of credit each year. Credit societies have become a growing challenge in the globalised world. Consumer debt from the use of credit cards and installment purchases has led to delinquencies and defaults in both developed and emerging economies.

Debt reduction means less spending

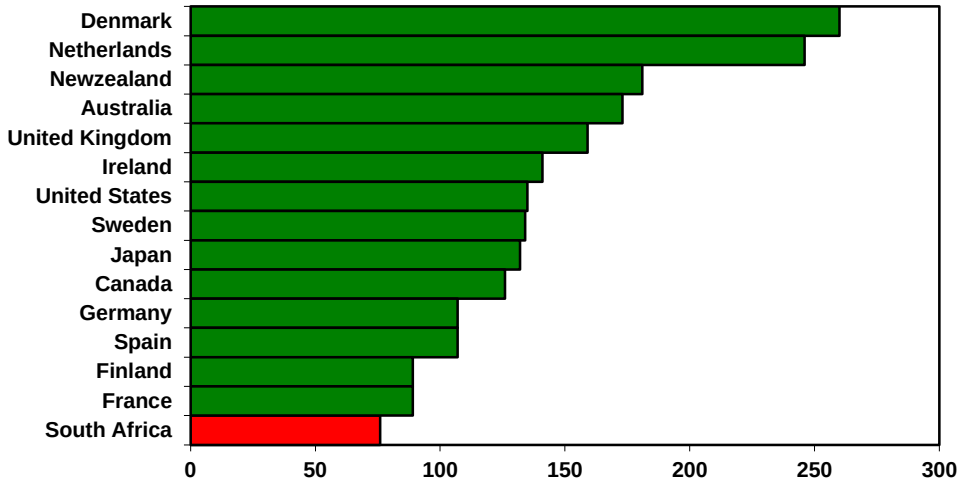
During the latter part of 2008, consumers started to reduce their debt levels and there could be more debt reductions to follow, which will reduce the consumer's ability to spend. With households experiencing a reduction in wealth, an upsurge in consumer spending some time soon seems rather slim.

Debt drives economic expansion

While some view debt for anything other than investments as detrimental to the economy, others advocate that debt is beneficial to the economy. They argue that consumer debt is a way of increasing domestic production because if credit is easily available, the increased demand for consumer goods should cause an increase in overall domestic production, which will assist to fuel economic expansion.

Interestingly, the more developed economies have fared less well in avoiding the debt trap.

Household debt as a percentage of disposable income



Source: OECD and SA Reserve Bank

How South Africa fares

In contrast South Africa's household debt totaled R1 185 billion at the end of 2009 and most of the debt is in the form of mortgages (R753 billion). The remaining debt is for items such as car finance, overdrafts, personal loans, student loans, credit cards etc.

Correspondingly, household net wealth (assets less liabilities) was R5 221 billion at the end of 2009. If durable consumer goods are included, household wealth rises to R5 618 billion. Interestingly, the net worth (value minus debt) of residential property is a healthy R840 million.

Is the net wealth good or bad? Firstly, SA's household net wealth is on the rise and has increased noticeably over the past year, helped by a rise in both financial asset values (equities on the stock market) and house prices. Importantly, there is a positive relationship between increases in household wealth and increased consumer activity. Secondly, using the international convention of comparing net wealth to income, SA's net wealth is 366% of disposable income. This is well above the recent low of 316% in Q1 2009 and above SA's long-term average of 337%. Using the US as an unfair comparison, their net wealth is currently equivalent to 472% of disposable income (although it has previously spiked to over 600%, when they created the Hi-Tech bubble and more recently, the residential property bubble). Overall, SA net wealth can be considered reasonable in the context of emerging markets.

Savers will recover faster

The economic crisis exposed imbalances in the world's economies. When the inflated values of property-based assets peaked and then collapsed, global financial institutions suffered huge losses and indebted consumers were forced to deleverage (pay off debt). Consumers increased savings, paid off debts and stopped spending unnecessarily.

Countries that borrowed heavily to finance excessive consumer spending could therefore experience slower consumer spending growth as households struggle to repay debt, repair their balance sheets and accumulate wealth for future retirement and other needs.

The impact on China

The economic growth of these over-indebted countries will probably be driven by exports, business investment and government spending rather than consumer spending. However, those countries whose growth was fuelled by exporting to borrowing countries will no longer be able to depend on such markets. Consumers will not be able to sustain China's export sector as it did in the past. Consequently, countries such as China will shift away from export-oriented growth toward growth driven by consumer spending.

For those global companies that sell goods and services to consumers (such as those in retailing, consumer products, hospitality and even retail financial services) the next decade will entail a very different business environment than that of the past decade. Not only will the growth of consumer spending shift geographically, the nature of consumer spending will shift as well.

Please consult your financial adviser should you require advice of a financial nature and/or intermediary services.