With debt levels exploding, central bankers are in a Catch-22. We're heading for trouble

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Sybarite is a term that first appeared around 1600 and means "person devoted to pleasure." In fact, Sybaris was an ancient Greek town inhabited by citizens who loved nice things.

Why am I referring to this unusual and little-known term? It is because I believe we live in an era when we demand instant gratification. We want everything now – cannot wait to have it tomorrow. No one these days wants to live within their means.

This has led to a North American economy that is hard to explain by typical economic models. We have an economy that is performing better than expected while at the same time debt levels are going through the roof. People have forgotten how to live without credit and debt, falling victim to an addiction that helps to sustain what is perceived to be a normal life. That includes racking up debt to help pay for everything from buying meme stocks on margin to overpriced vacations.

Consider that in the fourth quarter of 2023, household debt in the United States rose by US$212-billion to US$17.5-trillion, as consumers used credit to bolster their spending. In Canada, credit card debt reached a new high of $113.4-billion in the third quarter of 2023, an increase of 16 per cent from last year, according to Equifax Canada.

Recent economic data show that economic growth in Canada and the U.S. are exceeding expectations. The widely expected recession was highly exaggerated, to paraphrase Mark Twain. This is primarily because consumers in both countries continue to spend at a rate that is faster than expected. Employment growth and rising wages have contributed to it, but I believe it is more than that. It is a cosmic change of attitudes toward spending and borrowing.

At the same time, inflationary pressures are still an issue – not only in Canada and the U.S., but in most OECD countries – in the face of robust wage gains. In Canada, for example, average hourly wages rose 0.6 per cent in December and rose 5.3 per cent from a year ago. The figures are similar in the U.S.

What are central bankers going to do? Will they cut interest rates or not? The decision is becoming more difficult by the day.

They are in a Catch-22 situation.

If central banks start cutting interest rates to avoid economic and financial risks even though inflation continues to run hotter than 2 per cent, they risk reigniting more serious inflation. They may also not be able to convince the markets that they know what they are doing, as they are all relying on standard economic models that have not worked as well as expected.

If they are seen abandoning the inflation mandate to support the financial system, it may lead to financial markets and the economy weakening too quickly to bail out, given the amount of debt outstanding. Their credibility will be hurt.

In the long run, inflation is going to be higher than in the past. Globalization has come to an end. Wages are going up, and union power has returned. Taxes are going up, too. Nearshoring is in fashion, global trade is on the decline, cheap Chinese labour is over and productivity is down. And AI will not be the panacea everyone is expecting it to be. These are not good signs for inflation to cool.

And these shifts are not driven by cyclical effects, they are secular. Central banks cannot contain inflation beyond the business cyclical effect on it. They can try to contain inflation by causing a recession, but they will only combat cyclical inflation. It will have no impact on the long-run inflationary pressures built into the system. They may thus choose to live with higher inflation, which the markets will not like.

Alternatively, they can be stubborn enough to try to bring inflation back to their 2 per cent target by aggressively raising interest rates further. This may cause a recession, which given the large amounts of debt – not only at the government level but also at the personal level – will cause severe pain.

In the U.S., for example, the federal government has added US$20-trillion in debt since 2009. In the previous 15 years they added US$5-trillion in debt. Federal debt outstanding stands at US$33-trillion. Debt service charges currently stand at 14 per cent of revenues. Interest on debt outstanding was US$949-billion in 2022 – the sixth largest government expense for 2022.

In Canada, the federal government will spend $46.5-billion on debt service charges this year, much more than it will spend on child-care benefits. These numbers are unsustainable and can cause tremendous pressure on government finances and social upheaval. A recession will decrease revenues and increase debt service charges to an unsustainable level.

No matter which option central bankers choose, the outcome would be the same: a bursting of the bubble in equities and in consumption and borrowing. There will also be higher secular inflation and interest rates.

As a society, if we do not change our ways and our attitudes toward savings and investments, as well as borrowing and spending, we're heading for trouble.

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