SYNOPSIS

Ending Over-Lending explores how the Debt to Cash Flow ratio ("Debt/CF") can be applied to a nation as a monitor of its fiscal health. Debt/CF ratios are powerful statistics used in corporate financial analysis. As academic studies have shown, the Debt/CF ratio is an effective predictor of corporate loan covenant violations and bankruptcy.

Simplistically, the Debt/CF ratio measures the number of years of savings (known as cash flow) required to retire an entity's outstanding debt. The higher the ratio, the more 'levered' the entity. Ending Over-Lending examines the merits of this tool in measuring the indebtedness of nations, the ongoing debt-carrying capacity of nations, and the early warning signals to avert financial crises of nations.

This paper arose in part from observation of limitations in current popular debt statistics. The commonly available % Government Deficit / GDP and % Government Debt/GDP only account for government debt, while ignoring Household, Corporate and Banking sector debt. Additionally, the debt-to-GDP contrast is likely more the result of historical data availability than deliberate choice. GDP measures the total output of a nation and as such is akin to its aggregate revenue. In financial analysis, debts are normally compared to another accounting measure--cash flow--which more directly affects an entity's ability to source and service debt.

A nation's cash flow is measured by its Gross Savings and calculated by adding a capital consumption allowance (i.e. a depreciation equivalent) to the more commonly reported Net Savings. Total Country Debt is the sum of Household, Corporate, Banking, and Government debt. The Debt/CF statistic for a nation can therefore be measured as Total Country Debt / Gross Savings.

Ending Over-Lending starts by explaining how the Debt/CF ratio is calculated. The paper then explores Debt/CF ratios for individual corporations, industry groups, banks and households. This data is examined historically to estimate appropriate levels of debt and assess the consequences of over-leverage. Next, the paper provides a sample calculation of a Debt/CF ratio for a nation. Debt/CF ratios and statistical trends for 20 countries are then examined. Finally, the 20 nations are grouped into 4 categories of leverage—Inefficient, Optimum, Warning, and Calamity—according to a Four Zone Framework proposed by the author.

Based on the research, Ending Over-Lending characterizes the Debt/CF ratio as a simple, reliable, predictive metric that should be considered in assessing the financial health of a nation.