Panel 1

# Becoming Slimmer: Why Europe Needs to Cut Debt and Reduce Leverage

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## Introduction

The ongoing crisis has focused attention on macroeconomic policy. Fiscal policy is especially controversial because of the widespread perception that 'austerity' is the main culprit for the ongoing recession in Europe. However, this perception is mistaken.

I will argue that the more important problem for Europe (and in particular the euro area) is how to deal with the existing overhang of private debt. Over five years have now passed since the onset of the financial crisis, which many thought was precipitated by 'Anglo Saxon' finance. The US economy is now visibly recovering from the crisis, but the euro area remains mired in recession. What is the reason for this divergence?

All credit booms create an overhang of debt. The recovery depends on the speed at which this overhang is eliminated. Unfortunately very little has changed in Europe during this period of over five years in terms of private debt. The increase in public debt has, on average, actually been better contained in Europe, than in the United States, but private debt, especially in the banking sector, has not been dealt with sufficiently.

Moreover, the corporate sector in Europe has a much lower capacity to finance investment from internal sources of funds. This implies that a recovery of investment in Europe will be much more difficult than in the United States as long as the banking sector remains weakened by excessive levels of leverage. This problem, not excessive austerity, is the reason why the cost of the crisis could be much larger in Europe than in the United States.

## Genesis of a crisis

The literature on financial crisis has demonstrated that almost all major crises are preceded by a combination of two phenomena: an increase in leverage (or credit expansion) and an unusual increase in asset prices.[1] These two alarm signals were observed not only in the United States, but in Europe as well. Yet, unfortunately, they were largely ignored on both sides of the Atlantic[2] and, contrary to a widespread perception, Europe accumulated more imbalances than the United States. Moreover, the higher reliance of the European corporate sector on external financing suggests that it will take longer for Europe to recover.

As the key problem for Europe is now its dysfunctional banking sector, it is instructive to look more closely at a macroeconomic indicator of credit expansion or leverage. Every boom is similar in that low standards of risk aversion (or a perception of a low risk, known as 'great moderation') invite financial institutions to increase credit and this happened on a large scale on both sides of the Atlantic. Excessive levels of leverage are an essential ingredient of most crises and the 'great financial crisis' constitutes no exception. Leverage is defined in financial markets as the ratio of debt to equity financing. A higher level of leverage generally indicates a lower capacity to absorb losses and hence greater fragility. In this respect there has been progress, as Europe's banks have increased their equity cushion (from extremely low levels). European

[1] See, for example, Adalid and Detken (2007) or Alessi and Detken (2009). According to Borio and Lowe (2002), a low inflation environment increases the likelihood that excess demand pressures show up in the form of credit growth and asset price bubbles, rather than in goods price inflation. If this is the case, inflation-targeting central banks with a 'myopic behavior' could contribute to financial instability (see de Grauwe 2009), and de Grauwe and Gros (2009).
[2] See de Grauwe and Gros (2009), and Carmassi Gros and Micossi (2013) on the reasons for this.

banks have thus marginally increased their ability to absorb losses.

But the new higher capital requirements have not yet been satisfied and do not take effect until 2018. Long transition periods are justified when real investment needs to be made. But this is not the case when one considers an increase in capital ratios for banks. On the contrary, the complicated and lengthy implementation timetables for Basle III, stretching in some cases over a decade, increase uncertainty and create time inconsistency (time is never ripe). This is the real problem today: the current shareholders own a valuable franchise, namely the bank at its present (low) level of capitalization, which ensures a high probability of government intervention in case the bank gets into difficulties. However, the present shareholders know that required capital levels will go up over time. Their incentive today is to restrict credit, rather than increase capital because that would dilute their own stakes. Sinn (2010) also analyses the incentives for owners of bank equity with limited liability.

But what about the likelihood of losses? This can be measured better in macroeconomic terms *via* the ratio of credit to GDP. Leverage defined this way increases when credit expands, but nominal GDP does not increase. This usually occurs when the perception of risk diminishes, making banks more inclined to extend credit to marginal borrowers. One key reason why this happened on a large scale prior to 2007 was that great moderation gave the widespread illusion that macroeconomic volatility had permanently been reduced because of central banks targeting inflation and keeping it at a low level.

A high level of leverage is an essential ingredient in any major financial crisis because it means that many agents have issued promises to pay a certain nominal amount, but do not necessarily have the 'expected' regular cash flow to honour these promises – see Minsky (2008) for the classical description of leverage schemes leading systems towards instability. Since regular cash flows will be proportional to GDP, macroeconomic leverage can be measured by relating the stock of credit to GDP. It is not possible to establish an absolute benchmark for leverage as different financial systems can support quite different ratios of credit to GDP. However, changes over time, and especially rapid increases in this ratio, constitute alarm signals that have been identified as reliable predictors of financial crises.

**Credit boom and bust: a transatlantic comparison**

The (by now) standard warning signals were certainly flashing in Europe before 2007/2008 as the ratio of debt to GDP increased.[3] From the start of EMU to the peak of the credit boom total debt (defined here as all claims fixed in nominal value) increased in the euro area from about 250 percent to over 330 percent of GDP, as shown in the last column of Table 1. Most of this increase came from the financial sector[4] whose leverage almost doubled from about 60 to 112 percent of GDP. Government debt actually declined slightly as a share of GDP (from 76 to 69 percent of GDP) and the increase in leverage of the other sectors (households and the non financial corporate sector) was much more moderate.

[3] We leave aside the question of why the build-up of the credit boom was ignored. Inflation targeting by central banks was probably one key reason. According to Borio and Lowe (2002) a low inflation environment increases the likelihood that excess demand pressures show up in the form of credit growth and asset price bubbles, rather than in goods price inflation. If this is the case, inflation-targeting central banks with a 'myopic behavior' could contribute to financial instability (see de Grauwe 2009) and de Grauwe and Gros (2009).

[4] Note: the financial sector in the EA is defined as MFIs, insurance corporations and pension funds and other financial intermediaries, including financial auxiliaries. MFIs debt is given by debt securities issued plus currency, but excludes deposits. Our data differ from those of the McKinsey Global Institute, which have been used in other publications. However, the McKinsey data appear to be too low to be plausible, as they give the total debt of the financial sector as only 40 percent of GDP for the United States.

**Table 1**

**Euro area leverage: debt as percentage of GDP**

| | Non-financial corporations | Financial sector | General government | Households | Total economy |
|---|---|---|---|---|---|
| 1999 | 63 | 64 | 76 | 45 | 248 |
| 2007 | 92 | 112 | 69 | 62 | 334 |
| 2012 | 99 | 128 | 102 | 65 | 394 |
| Change 1999–2007 | 29 | 48 | – 7 | 16 | 86 |
| Change 2007–2012 | 7 | 16 | 33 | 4 | 59 |

Source: Own calculations based on ECB data.

**Table 2**

**US leverage: debt as a percentage of GDP**

| | Non-financial corporations | Financial sector | General government | Households | Total economy |
|---|---|---|---|---|---|
| 1999 | 61 | 73 | 53 | 66 | 253 |
| 2007 | 76 | 113 | 56 | 96 | 341 |
| 2012 | 80 | 87 | 92 | 81 | 340 |
| Change 1999–2007 | 15 | 41 | 2 | 30 | 88 |
| Change 2007–2012 | 4 | – 26 | 36 | – 15 | – 1 |

Source: Own calculations based on data from the Federal Reserve.

Given that it is difficult to establish an absolute benchmark for leverage, a transatlantic comparison is useful here. The increase in overall leverage, measured by the debt-to-GDP ratio, in the United States (88 percentage points of GDP) was very similar to that of the euro area (86 percentage points of GDP), only its distribution over different sectors differed, as can be seen from a comparison of Tables 1 and 2.

Total economy-wide leverage was thus very similar across the Atlantic both at the start of the boom (around 250 percent of GDP in 1999) and at its peak (340 percent of GDP in 2007). 'Anglo Saxon finance' was initially the main culprit, but in reality the increase in leverage of the financial sector was somewhat smaller in the United States. One reason for this lower increase is that the much maligned securitization of sub-prime mortgages actually results in securities (so-called RMBS) that are more like equity than debt, whereas the covered bonds much preferred in Europe do not have that quality. This implies that if there is a problem with the underlying mortgages, the issuing bank is not threatened with bankruptcy (and the attendant disruption and cost).

The sectoral differences appear less important in retrospect. In the United States the contribution of households was somewhat larger than in the euro area, whereas that of the non-financial sectors was smaller. The sum of the increase in leverage resulting from these two sectors is the same across the Atlantic – they are just inversed in terms of relative importance.

The more relevant differences between the United States and the euro area can be seen in the response to the crisis, as shown in Figure 1, which uses the data from the last rows of Tables 1 and 2. The two major differences are in the household sector and the financial sector. Households in the United States have been paring down their debt by over 10 percent of GDP. This was, of course, partially possible thanks to the 'no recourse' features of mortgages in many US states, which allow households to walk away from their mortgage debt when the value of the house falls below that of the mortgage balance still due.

But the key transatlantic difference lies in the financial sector, where leverage has fallen substantially in the United States (about 25 percent of GDP), but has increased in the euro area (by about 15 percent of GDP).[5] The stark difference in the financial sector is also the reason why overall leverage (see the last columns of Tables 1 and 2) has continued to increase strongly (by almost 60 percentage points of GDP) after 2007 in the euro area, whereas it has been constant in the United States (where the increase in government debt was counterbalanced by a fall in both the financial sector and households).

This continuing increase in economy-wide leverage is the key reason why the financial crisis is bound to linger longer in Europe – even abstracting from the specific 'euro' aspect, which has dominated the discussion and absorbed the attention of policymakers in Europe so far.

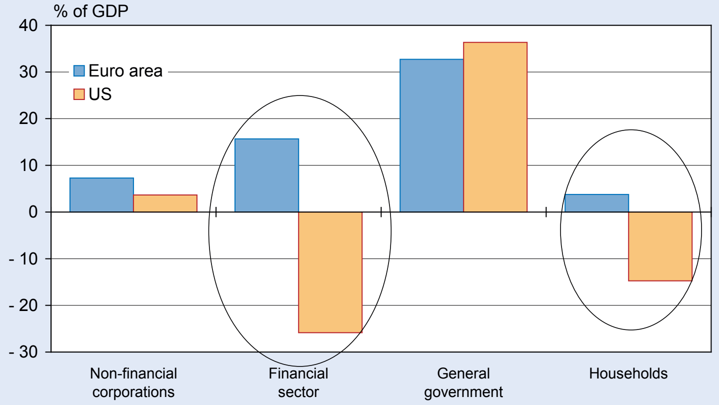
Two conclusions emerge immediately from this simple comparison:

- deleveraging the financial sector is possible as the example of the United States shows; and
- deleveraging has not even started in the euro area.

[5] The financial sector comprises in both cases of the central bank and this might affect the results as both central banks have increased their balance sheet considerably. However, as the increase in the balance sheets of both central banks has been of a comparable size, this aspect should not affect the comparison. Moreover, the ECB has lent large amounts to the banking sector (and it has been accorded de facto a preferred creditor status, thus making other debt less secure) whereas the Federal Reserve has been taking large amounts of deposits from the banking sector, which it has mostly invested in government guaranteed securities.

Figure 1

**Change in leverage by sector since the start of the crisis 2007–2012**




Source: See Tables 1 and 2.

**Why it matters: the importance of the financial sector to investment**

A financial system that needs to reduce leverage has a tendency to restrict the availability of credit. How important is this to the economy? This depends, of course, on the financing needs of the various sectors in the economy. European consumers traditionally have been large savers (with the exception of Spain). They do not need credit to maintain consumption.

However, the corporate sector is in a completely different situation. It typically needs access to external financing to maintain investment. Yet in this area the starting situation in the United States is once again more favourable. One key reason for this is that the US corporate sector has traditionally had a much smaller financing gap than the European one. Tables 1 and 2 above already showed that the increase in the non-financial corporate sector was smaller in the United States than in the euro area.

Figure 2 right shows that the US corporate sector is actually typically a net saver because its profits are usually larger than its expenditure on investment. This implies that the US corporate sector does not need to receive new credit (from banks or other sources) in order to maintain investment at least at the present level. There are naturally large differences within the US corporate sector, with some parts having a large cash flow surplus (e.g. the tech sector) and other parts (e.g. the automobile sector) suffering from a major deficit. However, the commercial paper market, which continues to function, can recycle the surplus funds of enterprises such as Microsoft to those firms needing funds.

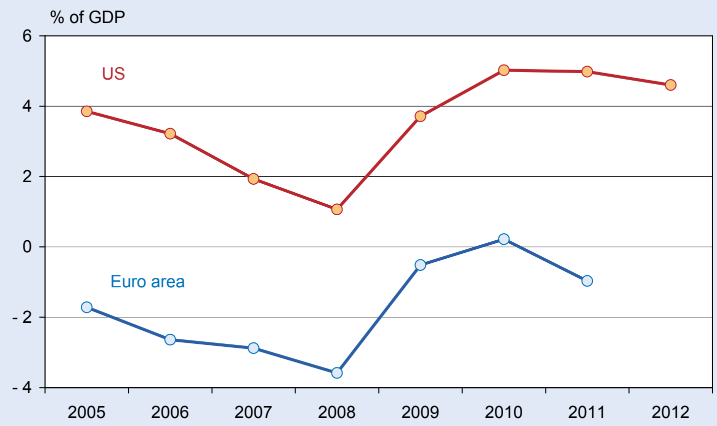
The situation of the European corporate sector is quite different. It can finance only part of all investment from internal sources as its savings rate has remained negative for a long time. This implies that the corporate sector in the euro area needs a continuing flow of new credit just in order to maintain investment at its present level. Europe thus faces the unpleasant combination of having a stronger need for deleveraging in the financial sector and a corporate sector that is more dependent on external finance than that of the United States.

**Can debt be serviced in Europe?**

The euro area therefore has a double handicap (at least compared to the United States): leverage is higher and the corporate sector is more dependent on additional credit. A third drawback is that servicing debt (i.e. claims fixed in nominal terms) is more difficult in Europe for the simple reason that the difference between the growth rate of nominal GDP and the interest rate is less favourable (and has

Figure 2

**Non financial corporations net savings**




Source: Eurostat; ECB; US Federal Reserve.

worsened since the start of the crisis). Table 3 shows the difference between the growth rate of (nominal) GDP and the (nominal) interest rate actually paid by governments and non-financial corporations.

Panel (a) of Table 3 looks at government debt, which usually sets the benchmark for all other interest rates and for which a transatlantic comparison is possible. This table shows that, even before the crisis started, this difference was already negative for the euro area average, indicating that interest was accumulating at a faster pace than the capacity to service the debt due to growth (this implies that 'Ponzi units' in the parlance of Minsky (2009) would already have had a difficult life). After the crisis the difference worsened by about one full percentage point (to minus 2.1 percent). By contrast, for the United States the difference was slightly positive during the boom and has remained positive even after 2008, indicating that it remains much easier to service nominal debt in the United States than in the euro area.

There are, of course, vast differences across the euro area in terms of this key indicator of debt sustainability. This indicator has improved considerably in Germany (which had one of the worst growth – interest rate differentials during its slow growth period prior to 2005), but deteriorated very sharply in the euro area's periphery, as shown in the lower part of Table 3. Most member countries are either much worse (the periphery) or much better (most of the core) than the euro area average.

Looking at the cost of medium-term loans to non-financial corporations confirms this picture: for the euro area average the interest rate – growth rate differential was actually close to zero during the boom, but worsened after the crisis (by almost two points). A stark difference again emerges between Germany (no change) and countries like Italy and Spain, where the interest rate now exceeds the growth rate by almost 4 percentage points. The deterioration was particularly stark for Spain (over 7 percentage points) given that, during the boom, Spanish interest rates had been lower than the euro area average and the growth rate (of nominal GDP) had been much higher. Both elements have now turned around. It is also interesting to note that the interest rate – growth rate differential for Germany before 2008 was not that different from that of Spain today.

**Table 3**

**Can debt be serviced with growth? The interest rate growth differential**

*Panel (a): Government debt*

| | Boom (until 2008) | Bust (since 2008) | Change |
|---|---|---|---|
| Euro area | – 1.1 | – 2.1 | – 1.1 |
| US | 0.4 | 0.2 | – 0.1 |
| Germany | – 2.7 | – 1.2 | 1.5 |
| Spain | 2.0 | – 3.3 | – 5.4 |
| Italy | – 1.4 | – 3.7 | – 2.3 |

Source: Own calculations based on Eurostat data.

*Panel (b): Cost of financing for the non-financial sector*

| | Boom (until 2008) | Bust (since 2008) | Change |
|---|---|---|---|
| Euro area | – 0.3 | – 2.7 | – 2.4 |
| Germany | – 2.1 | – 2.1 | 0.0 |
| Spain | 3.6 | – 3.9 | – 7.5 |
| Italy | – 0.7 | – 3.6 | – 2.8 |

Source: Own calculations based on ECB data for new business of medium term loans to non-financial corporations.

## Conclusions

Getting the European economy to grow again requires a radical overhaul of its financial sector. The financial sector was already too highly leveraged at the start of the crisis in the euro area, but, in contrast to the United States, this has not improved since then. On the contrary, leverage has even increased strongly as debt continues to increase, both in the financial and government sectors. Given this parallel increase in debt, one should not be surprised by the 'diabolic loop', which could, at times, be observed between these two sectors. Moreover, servicing debt is becoming more difficult in the euro area as the difference between interest rates and growth rates grew even more unfavourable with the start of the crisis.

Unfortunately, however, it is proving almost impossible to cut debt in Europe. Part of the problem is that bankruptcy costs are very high in Europe. This is an important consideration for households. In the United States a household can emerge from personal bankruptcy in a matter of weeks or months (with little social stigma attached). In Europe, by contrast, personal bankruptcy proceedings usually last several years (in Germany a household has to show 'good behaviour' for six years before being discharged of its remaining obligations).

An even more important aspect, however, is that bank debt has been considered sacrosanct to date – or at least it was until the case of Cyprus emerged in early 2013. The ongoing debate on the rules for bank resolution and the bailing in of bank creditors is thus crucial to allowing Europe to deal with its debt overhang in the financial sector.

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## Panel

The panel's first speaker, **Axel Weber,** Chairman of the Board of Directors at UBS, offered an outsider's perspective on the euro crisis from Switzerland. In his opinion, the crisis has revealed major flaws in the construction of the euro, which can only be corrected with courageous political decisions and bold reforms. Weber advocated a well-thought out, sequenced approach to reform and argued that stabilizing the financial and banking sector should be a clear priority as Europe needs an orderly and appropriate flow of credit to enable its economy to expand.

With its intervention the ECB has opted for short-fixes, but general expectations of how much central banks can achieve are too high, warned Mr Weber. The powers of central banks are limited, especially when interest rates are already close to 0 percent. In other words, warned Mr Weber, central banks certainly cannot be expected to fix structural problems. They have merely created a breathing space that needs to be used wisely by policy-makers, he added, while expressing fears that this may not be the case.

So what should be done, asked Mr Weber? He identified recapitalizing banks as the key to stabilizing the financial system and restoring credit flows as a crucial precondition for sustaining economic activity. Bigger capital buffers are needed by banks (in Switzerland these buffers are 19 percent) to better withstand their adversaries in the market. While the instruments used to achieve this are widely known, recapitalisation can be harder to achieve when a sovereign is under pressure, acknowledged Mr Weber. So if more capital for banks is the answer, how can it be raised, he asked? In view of the difficulty of raising capital on today's market, most banks have opted to deleverage their balance sheets. Yet if banks deleverage and reduce risk-rated assets, they cannot at the same time grant new credit to stimulate the economy.

In his closing remarks, Mr Weber insisted that: *"A global diversification of banks has never been as useful as it is now"* in terms of offering banks protection from problems in the eurozone. *"In terms of where the eurozone needs to go, […]"* he added, *"There need to be structural forms, but […] once a country has lost market access and banks don't lend to that country any more or buy its assets, there is no alternative to austerity because, having lost market access, the only thing* *you can do is de-lever".* Mr Weber ended by calling for greater fiscal harmonization across Europe, but stressed that this should be an evolutionary process which must be preceded by further integration and convergence on a European level in terms of effective retirement ages, tax rates and labour market regulations.

For **John Evans,** General Secretary of the Trade Union Advisory Committee at the OECD, the immediate issue is the short-term relaunch of growth, and not just the long-term perspective. This short-term boost could be achieved *via* major programmes to increase infrastructure investment, which would, in turn, create more jobs. The populations of crisis-stricken countries like Greece cannot accept any more austerity, cautioned Evans. Instead they need to be given renewed confidence in the future *via* investment in on-the-job training. Evans also cited a more equal distribution of income increases as the key to a broad-based recovery.

**Andrius Kubilius,** MP and former Prime Minister of Lithuania, on the other hand, was far more positive about austerity. In his experience austerity works and can bring real growth. Nicknamed the "Crisis Prime Minister" for his terms in office in 1999–2000 and his election in October 2008, one month after the Lehman Brothers collapse, Mr Kubilius spent 4 years managing economic crisis. In 2009 Lithuanian economy went into very deep recession during which the country's GDP fell by 15 percent while its deficit grew by 14 percent. Instead of appealing for IMF assistance in 2009, Lithuania opted for internal devaluation.

By 2012 the results were impressive with GDP growth up to – 3.5 percent, the deficit at ~ 3 percent GDP and public debt at 40 percent of GDP. In addition to instant cuts in public wages and pension benefits, internal devaluation in Lithuania reduced labour costs by 15 percent, enabling the economy to regain competitiveness. Exports started to recover by annual 30 percent growth, reaching levels that far exceeded the pre-crisis figures. These results were achieved thanks to the political will to implement effective austerity measures *via* internal devaluation, explained Mr Kubilius. Austerity was built on a national consensus between the government and its social partners like the major labour unions, business and pension associations. Indeed, in Mr Kubilius' view, crisis is the best time to reform and slim down public sector.

However, as the fourth speaker **Georg Milbrandt**, Former Minister-President of the Free State of Saxony pointed out, *"If you are going to cut off a leg you need to do it fast, not inch by inch".* Although Mr Milbrandt agreed with Hans-Werner Sinn that devaluation is required in the South, he doubted whether the flexibility or political will exists in the periphery to take the harsh, swift measures required to achieve devaluation internally. He also highlighted the problems created by the flawed design of the euro, but argued that the solution does not lie in a transfer of funds. For if wealth were to be transferred to Europe's poor, noted Mr Milbrandt, it should be sent East to Poland and the Baltics, not South to Greece. In his view the solution consists of real economic adaptation i.e. in reducing wages and savings or *via* an exit, which should not be treated as a taboo. To believe that the stabilization of the bank sector alone will resolve Europe's present crisis is an illusion in Mr Milbrandt's view. He cited deleveraging and the injection of more equity into the system as essential components of the long-term solution, along with not just more, but better regulation.

Opening the discussion up to the floor, **John Peet,** panel chairman and Europe Editor at *The Economist*, raised the issue of the US' reputation for treating its banks more aggressively than Europe, where individual states protect their banks and have not been tough enough. In response, Mr Weber noted that US banks were all recapitalized immediately with TARP etc. after the crisis, but said it was a myth that US banks are better capitalized than their European counterparts. He attributed the difference in capitalization levels to the different accounting standards adopted by banks on either side of the Atlantic. He also pointed out that many US banks are not yet fully compliant with Basel III whereas their EU counterparts are. US banks, explained Mr Weber, have not yet consolidated their off-balance sheet engagements as EU banks have, which constitutes a major difference. The real debate, in Mr Weber's view, centres on the question of whether non-national money should be used as a backstop for national banks. That pillar of banking union is a long way off, he noted.

Mr Peet subsequently touched on the issue of convergence by citing the general consensus that countries need to adjust to become more like Germany in terms of their legal retirement age, for example. If all EU countries become more like Germany, however, they will all run a large current account surplus, he noted. To counter the potentially negative effects of such convergence, Mr Weber suggested funding for common features of the social welfare system at an EU level, with nations opting for idiosyncratic elements (such as a lower retirement age) being obliged to fund the latter themselves. In his opinion, this would make the price of being different to the EU average transparent and would open up a national debate over it. Mr Weber believes that if their citizens can see the cost of being different, some countries may reconsider this option.

A question from the floor raised the issue of whether a deeper microeconomic debate with a focus on innovation and entrepreneurship would not be more appropriate than a debate of macroeconomic instruments to manage the crisis? Mr Weber agreed with this point and described the whole debate in Europe as too inward looking, especially in terms of redistribution mechanisms for the proceeds of growth. Germany or Europe cannot afford to become less competitive, or other global emerging markets will steal Europe's market share, warned Mr Weber. Europe cannot sort out these issues internally. It should focus on being part of a global growth story, he added, and not on redistributing wealth within the continent. His views were echoed by Georg Milbrandt.

Raising another question from the floor, **Mats Hellström**, Former Ambassador of the Kingdom of Sweden, cited Mr Costas Simitis, former Prime Minister of Greece, who noted several years ago at the Summit, that the crisis was a matter of Southern European productivity, and not just Greek productivity. It is now generally recognised that all of Southern Europe has lost productivity and cannot compete with emerging economies. The key industry policy question, according to Mr Hellström, is how to revive competitive force and productivity in industry in Europe? He argued that EU funding should be devoted to innovation and services to help countries in emerging markets in Southern Europe to compete with Asia. Mr Gros, however, disagreed. *"The question of Southern Europe is not whether these countries are productive, but whether their consumption adjusts to their productivity or not".* In Mr Gros' view the central question is whether a country accepts the need to live within its means. In Germany a current account surplus has accumulated in recent years because Germans stopped consuming, not because the country was highly productive or competitive.

Mr Peet brought the panel discussion to a close by asking Mr Kubilius why Lithuania is still keen to join the 'EU disaster club'? *"Europe has always gone from crisis to crisis and has got stronger and more competitive",* responded Mr Kubilius, affirming Lithuania's continued optimism about the European project.