The dynamics of private deleveraging in the core and periphery of the euro area

The euro area is going through a tough time. The latest institutional advances made at a European level are helping to ease financial tensions but this is merely a first step towards economic recovery. Activity is unlikely to get back up to cruising speed without the support of the financial sector and, at present, that does not seem likely.

Certainly, the deleveraging currently being undergone by the euro area's private sector is not helping either. It's also surprising that this deleveraging is widespread throughout all countries although they have highly disparate levels of debt. For example, Germany's debt as a percentage of its GDP is 128 percentage points lower than that of Portugal, and, despite of this, Germany reduced its debt more than Portugal between 2010 and 2012. It seems reasonable to believe that only those countries with excessively high debt should undertake a path of moderation, while it would be highly beneficial for those countries with an underused credit capacity at least not to deleverage further.

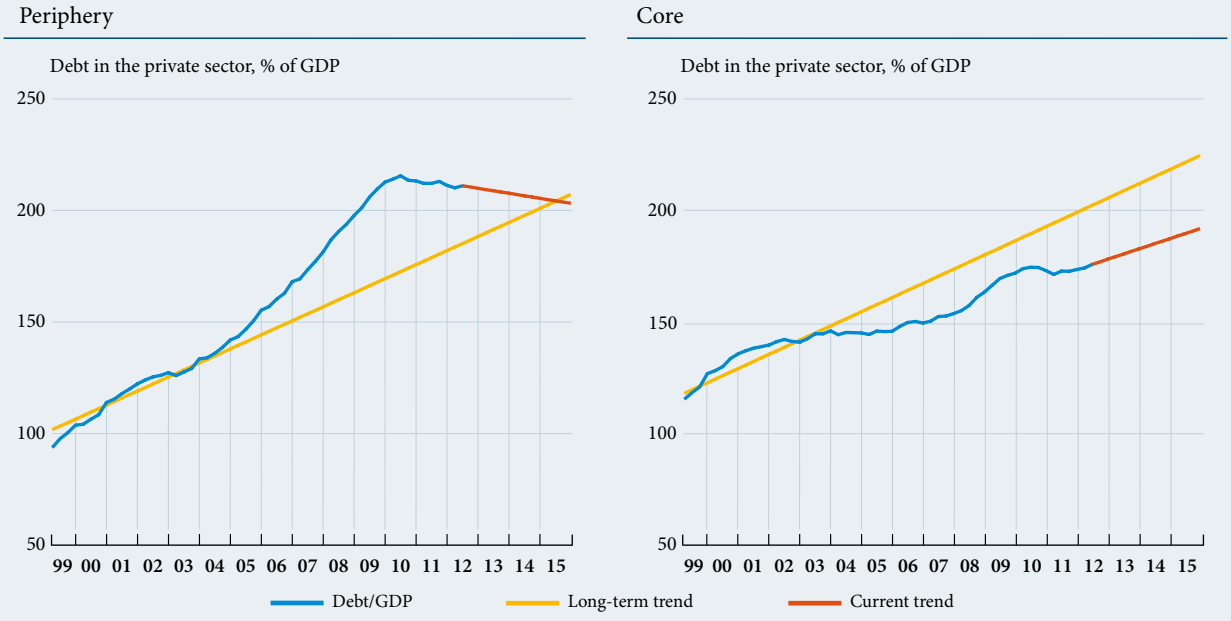
In order to assess to what extent there is enough margin to implement policies to boost credit in some countries and the need to contain credit in others, it is essential, firstly, to determine the potential level of debt for each country. To do so, we have broken down the leverage ratio into three components in order to separate the component that reflects the underlying trend from other components that also affect the level of indebtedness.[1]

The first component is the country factor, reflecting differences in leverage due to the structural factors of each economy, such as savings and consumption habits or the extent that companies finance themselves. The second factor measures the impact of interest rates on indebtedness and, in particular, how moderating the cost of financing can increase debt capacity. Lastly, and most importantly for our purpose, is the component that reflects the underlying trend in debt. After discounting the effect of country and interest rates, this component shows the long-term trend for debt capacity. This trend is generally positive as the sustainable level of debt tends to increase over time due to factors such as technological advances that improve risk management or macroeconomic factors such as greater price stability.

The graph below shows the debt of firms and households of the core and periphery of the euro area[2] in relation to the underlying trend. Here it can be seen that, although the level of private debt was higher in the core countries in 1999, the evolution has been highly disparate since 2005. While the indebtedness of core countries increased below their potential, in the periphery there was significant growth in debt, very much above the sustainable level in the long term, reflecting the abundant liquidity in the years prior to the crisis that led to a credit boom and the appearance of real estate bubbles. The indebtedness of the periphery continued to rise even after the global financial crisis of 2008. In the second quarter of 2010, the ratio for this group of countries peaked at 216% of GDP, 43 percentage points above its sustainable level.

(1) Specifically, we have applied the methodology described in Oriol Aspachs-Bracons, Sandra Jódar-Rosell and Jordi Gual «Deleveraging Outlook for Spain», Documento de economía de "la Caixa" no. 23, December 2011.
(2) Due to data availability, 9 of the 17 euro area countries have been analyzed. The core is made up of Finland, France, Germany and Belgium and the periphery by Greece, Ireland, Italy, Portugal and Spain. The criterion for assigning countries to one group or another is based on their respective current account surplus or deficit.

IN SPITE OF THE ADJUSTMENT CARRIED OUT IN THE PERIPHERY, THERE'S STILL SOME WAY TO GO



NOTE: **Core:** Finland, France, Germany and Belgium. **Periphery:** Greece, Ireland, Italy, Portugal and Spain.
SOURCES: European Central Bank and own calculations.

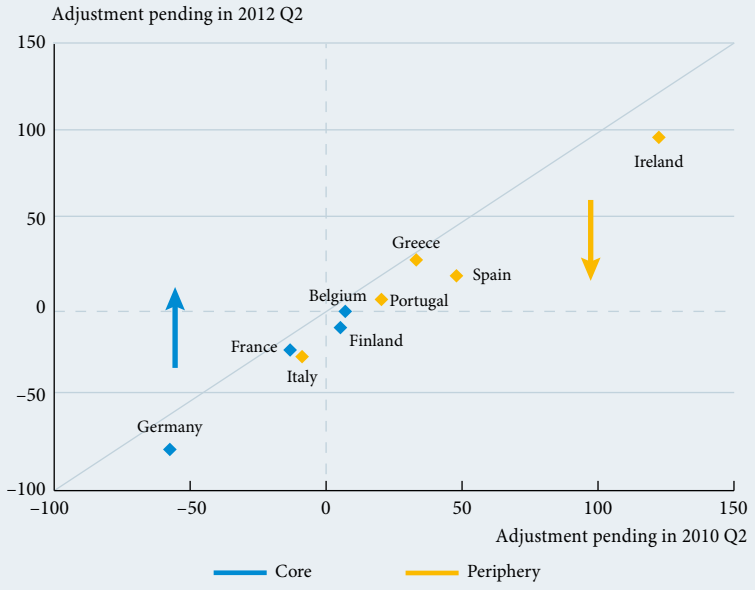
From this point onwards, the euro area's sovereign debt crisis meant that it was vital for firms and households to adjust their balance sheets, triggering a slow, far-reaching deleveraging process in the private sector. According to the latest data available, for the second quarter of 2012, the average ratio for periphery countries is 211% of GDP, 26 percentage points above the long-term trend. Although some adjustment has occurred, this is still not enough. This highlights how hard it is to reduce the debt to GDP ratio at a time of economic recession and low inflation, given that the leverage ratio is adjusted purely via the numerator; i.e. by reducing credit to the private sector.

Notwithstanding this adjustment in the periphery, there are big differences between countries, as can be seen in the graph below. On the one hand we can see countries such as Spain and especially Ireland, which had to adjust extensively in 2010 and have made considerable progress in reducing their debt. In other words, those countries that had deviated most from their long-term trend are the ones that have corrected their debt the most over the last 2 years, although they still have a lot of adjustment to make. Portugal, however, didn't have to adjust that much as it hadn't accumulated too much debt during the boom and has also followed the correct path over the last 2 years, so its pending adjustment is already quite small. At the other end of the spectrum we find Greece, which has not been able to adjust at all due to the recession getting worse. Lastly, Italy completes the periphery group although, in this respect, it's in a similar situation to the core countries.

Assuming adjustment continues at the same rate as between 2010 and 2012, the periphery countries as a whole could achieve sustainable debt levels within two years. Nonetheless, the pace of adjustment will largely be determined by the ability of these countries to return to economic growth. In this respect, the least traumatic way

GREATER DEBT IN THE CORE COULD HELP DELEVERAGING IN THE PERIPHERY

Adjustment pending in 2010 Q2 and 2012 Q2 (*)



NOTE: (*) Adjustment pending is the difference between the debt ratio and long-term trend as a percentage of GDP.
SOURCES: European Central Bank and own calculations.

to complete the deleveraging process is via sustained economic recovery; i.e. by increasing the denominator. A reduction in the leverage ratio might therefore go hand-in-hand with credit returning to the real economy.

For their part, the countries of the core of the euro area have a leverage level that is far below their potential. Moreover, in the last two years they have also carried out deleveraging, thereby widening the gap between their level of debt and debt capacity. In the second quarter of 2012, the average leverage of these core countries was 176% of GDP, 35 percentage points below the periphery average. Of particular note is Germany's low leverage level, which was further reduced from 125% to 120% between 2010 and 2012.

Certainly, the euro area is going through a tough time. But not all countries are facing the same difficulties. It's true that some must make an effort to reduce their debt precisely at a time when they most need a boost from credit to encourage economic growth. But it's also true that other countries still have a lot of margin in credit capacity terms which they should exploit, albeit without going overboard. Using this capacity would benefit both these countries and the euro area as a whole. Such measures are necessary and urgent to revive Europe's economy and ease the adjustment process in the periphery.

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