Article

Financial markets

The periphery is leveraged. How can it deleverage?

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Judit Montoriol-Garriga
Oriol Aspachs

After getting into too much debt over more than a decade, the private sector of the periphery countries has started the arduous but vital process of deleveraging. Arduous because it limits the capacity for economic growth precisely when this is needed most. But vital because, in order to dispel doubts regarding the solvency of the private sector and, ultimately, the public sector, indebtedness must return to unquestionably sustainable levels. As of today, and in spite of the fact that pressure on the periphery countries has fallen, the progress made in private sector deleveraging in the periphery is still incipient.

To analyse this process, it is useful to break down the dynamics of private sector debt into that of households and that of corporations. On the one hand, households take out a larger proportion of long-term debt and their capacity to repay is determined by trends in employment income and also income from financial and non-financial assets. On the other hand, corporations tend to issue more short-term debt so that, when there are refinancing difficulties, their leverage tends to fall more quickly. The mechanisms used by households and corporations to declare default on their debts are also different. While companies can file for bankruptcy, it is more difficult for households to do so and there is limited debt relief in general.

Let us therefore start by looking at household debt. The first thing to point out is that it did not rise evenly throughout all countries in the periphery. In fact, Italy's household debt always remained below the average level for the euro area. In Greece, however, although this only accounted for 10% of GDP in 2000, it saw the biggest increase among periphery countries, specifically 64 percentage points, reaching 74% of GDP by 2Q 2012. Nevertheless, it is particularly in Ireland but also in Spain and Portugal where household debt reached the highest levels. In these three countries, the deleveraging process has already begun but it is progressing quite slowly. In Ireland, the correction since the peak has been 17 percentage points, while in Spain and Portugal it has only fallen by 7 and 4 percentage points respectively. In these three countries, on average, the current level of household debt is still 27 percentage points higher than the figures for the euro area as a whole.

To a great extent, this slow progress is due to the current macroeconomic conditions. Historically, the ratio between household debt and nominal income (an indicator of the capacity to repay) has fallen, especially because of the rise in nominal income, due particularly to inflation. Specifically, the contribution of inflation to this ratio's correction to pre-boom levels has historically been 70%.(1) The contribution of the rise in income in real terms has also been, historically, approximately 25%. In this episode, however, inflation is remaining at a very low level so that, added to poor trends in real household income, it limits their deleveraging capacity. In fact, since 2010 gross household income has fallen by 3.4% in Spain and 1.8% in Portugal. In Ireland the trend in income has also been more favourable over the last two years which, added to the greater reduction in debt in absolute terms, has made a somewhat larger adjustment possible. In any case, given that the ECB looks very unlikely to relax its current inflation target and that the economic recovery is expected to be slow in all periphery countries, household deleveraging will probably take longer than usual. It is important to note that, historically, this has lasted between 5 and 10 years according to IMF estimates.

Similarly, the deleveraging of non-financial corporations is also progressing slowly. Ireland and Portugal are the countries whose companies are most in debt (205% and 164% of GDP in 1Q 2013) and where debt has yet to stop growing. Corporate debt grew the most in Spain between 2000 and 2010, by 83 percentage points no less, but since then this is where it has fallen the most (15 percentage points). In 1Q 2013 it still accounted for 129% of GDP. Italy and Greece, for their part, did not start from an excessively high level of corporate debt and neither did this increase too much during the boom years. They therefore have a less pressing need to deleverage.

How much should corporate debt be reduced in order to be sustainable? According to the IMF, episodes of high growth in corporate indebtedness are generally followed by deleveraging processes in which approximately two thirds of the increase in debt is subsequently reduced. Applying this percentage, Spanish firms should reduce their debt by a further 41 percentage points, a similar reduction to the one pending for Ireland and Portugal. In any case, the great heterogeneity within the business fabric of each country means that not all corporations need to go down the deleveraging path. For example, firms more open to the foreign sector, in general, can continue to get into debt in order to finance profitable investment projects, as shown by the large number of corporate bonds issued by certain companies in periphery countries. On the other hand, there are some companies, such as Spanish or Irish construction firms, that have accumulated large amounts of debt which they must now reduce. Moreover, unlike households, companies have more options to clean up their balance sheets by selling off assets or using other mechanisms such as debt-to-equity swaps, out-of-court restructuring or through Asset Management Companies. These strategies are aimed at reducing corporate debt in order to make these firms viable and thereby avoid liquidation.

As is well-known, the liquidation value of assets is usually different from their book value or the value they have if production continues, so winding up a company entails significant costs. These costs are even higher when a large proportion of the debt is external, as this can damage reputation and spread to other viable firms.

Given that the correction in the level of debt, both for households and corporations, has been quite limited so far, the financial burden of this debt has remained at levels that are still relatively high. And these levels would be even higher if it weren't for the lifeline provided by the low interest rate policy of the ECB. In the medium term, as the improvement in the economy consolidates corporate earnings, household income grows once again and financial fragmentation diminishes, the debt burden should become more bearable. But, once this time comes, the ECB will face a tough dilemma: with deleveraging progressing slowly in the periphery countries, an interest rate hike could be very necessary for some countries but very harmful for others. Striking the right balance will not be an easy task.

Oriol Aspachs Bracons and Judit Montoriol-Garriga

European Unit, Research Department, "la Caixa"

(1) See (2013) «Indebtedness and deleveraging in the euro area», IMF, Euro Area Policies: Selected Issues Paper.

Judit Montoriol-Garriga
Oriol Aspachs