Research on Money and Finance

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The Eurozone Debt Mountain: There are Debts and Debts

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1.Debt accumulation following the introduction of the euro

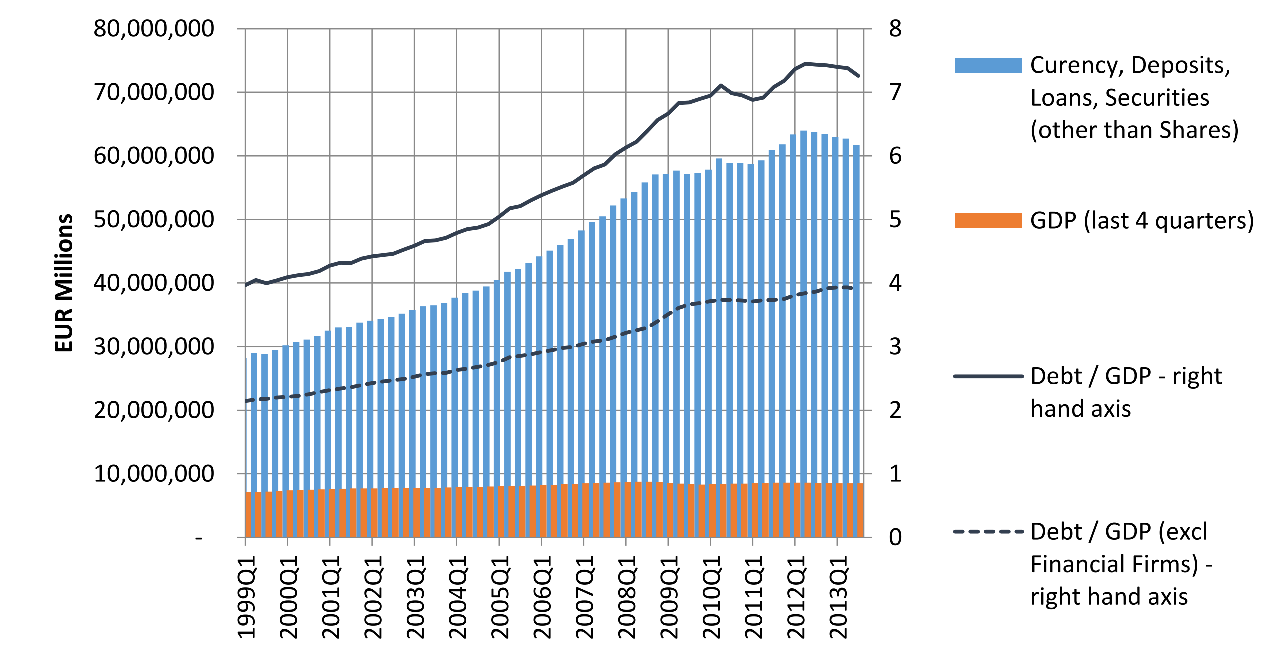
The Eurozone has a major problem of debt, both public and private. This has been widely acknowledged, sparking academic debate and informing policy, for example in the form of debt restructurings, banking union and the upcoming asset quality review (AQR); above all, Eurozone debt has provided cover for austerity. This Occasional Policy Paper considers the aggregate debt and shows that the majority is private; indeed the growth in aggregate debt before 2008 was dominated by the growth of private debt. In 2008 private credit creation juddered to a halt as confidence evaporated, and governments took up the slack – from which point public debt started growing rapidly.

In 2012 the ECB acted to calm financial markets - above all sovereign debt markets - and this potentially marks a second turning point as total debt started to fall. The fall has been led by the debt of financial firms, responding to the decline in liquidity provision by the ECB/Eurosystem. However, this type of decline of Eurozone debt is not necessarily a desirable way of dealing with it. The effects will not be benign in a debt dependent economy and, moreover, will do nothing to tackle the underlying conditions of debt accumulation, both public and private. The paper argues that the first step in tackling the Eurozone debt mountain would be for policy makers to appreciate the qualitative differences between the debts of different groups and the role each has played in aggregate debt accumulation. In short, although there is a debt mountain, there are debts and there are debts – policy must be different with regard to each.

The first task in this respect is to establish the size and composition of aggregate Eurozone debt. Fig. 1 shows the remarkable increase of aggregate debt after the introduction of the euro.[1] Debt increased rapidly until the outbreak of the global crisis in 2008, the pace then slowed for three years before picking up again in mid-2011. Then in the summer of 2012 debt began fall. Total debt to GDP has almost doubled - growing from 4xGDP to over 7xGDP since 1999.

[1] Data is sourced from the financial balance sheet in the Euro area accounts found at the ECB's Statistical Data Warehouse (available here: http://sdw.ecb.europa.eu/) The Eurozone's total financial liabilities amounted to 102trillion Euros at the end of 2013-Q3. Included in figure 1 are the instruments Currency & Deposits, Loans and Securities other than shares; excluded are Financial Derivatives, Shares and Other Equity, Insurance Technical Reserves and Other Accounts payable.

Figure 1 Eurozone Debt and GDP

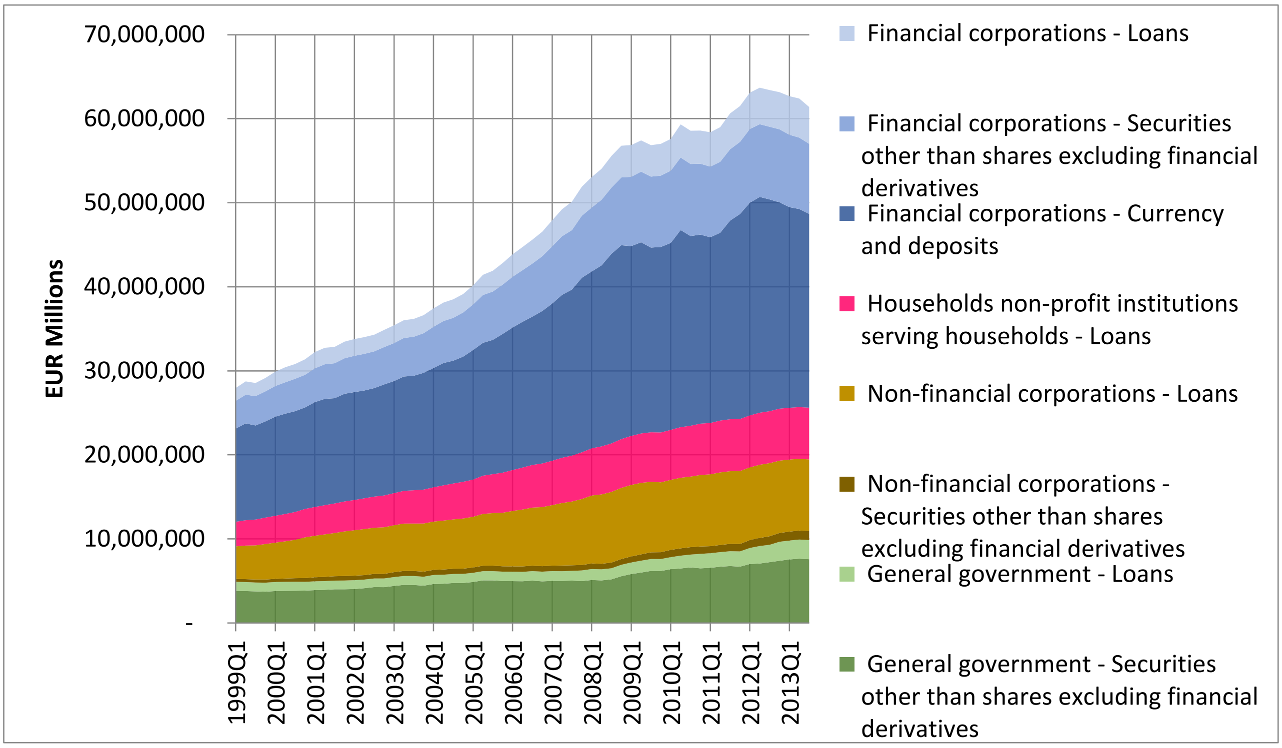


Source: ECB

The rapid increase of debt during this period is broadly a reflection of the financialisation of the Eurozone economy, and more specifically a result of the lowering of interest rates across the common currency area, which has facilitated cross-country flows of loanable capital as well as the expansion of domestic credit by the financial system. To be more precise, the euro has led to increased borrowing by peripheral countries from the core as well as to domestic expansion of lending as banks took advantage of the new conditions in the unified money market.[2] The break-down of the aggregate debt is of considerable importance in this respect:

[2] See RMF's Eurozone Reports available at http://www.researchonmoneyandfinance.org/ also collected as a book, Lapavitsas et al, 2012, *Crisis in the Eurozone*, London: Verso

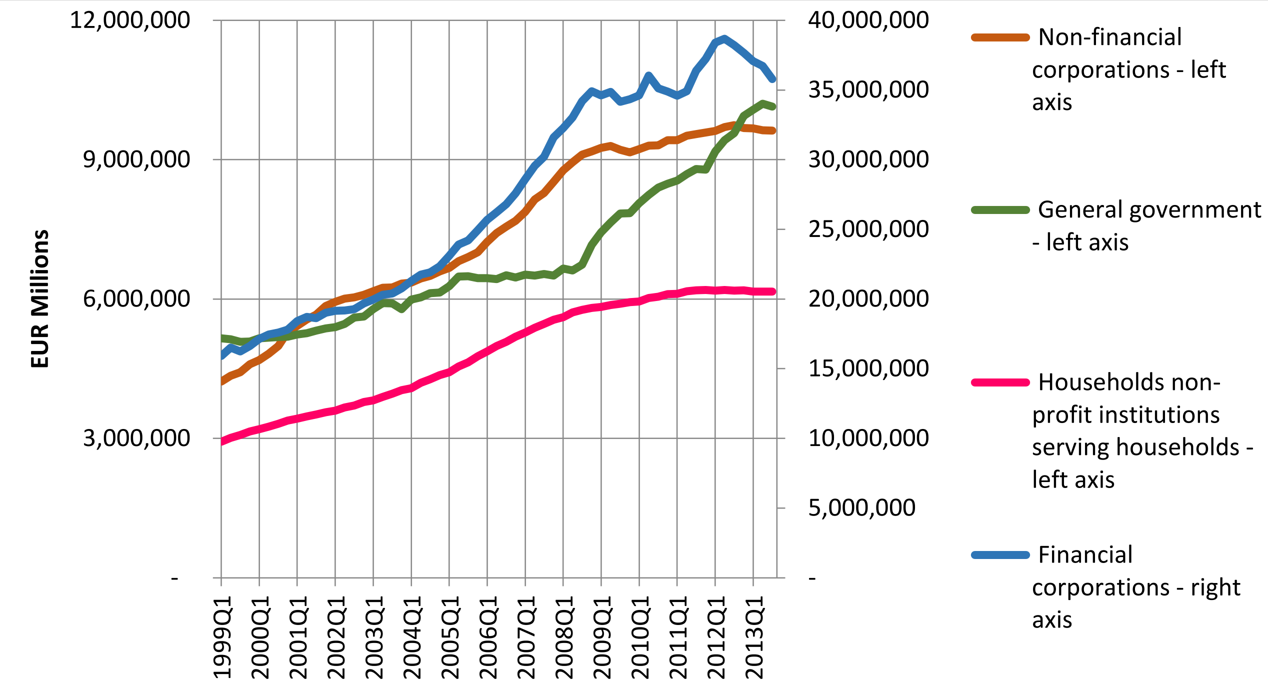
Figure 2 Government, Household, Non-Financial Corporation and Financial Corporation - Debt Composition.



Source: ECB

Two things are apparent from Fig. 2. First, the overwhelming bulk of the increase has come from private debt, and the largest component of that is clearly the debt of financial corporations. Second, public debt began to rise rapidly after 2008 and by 2013 it became larger than annual GDP – if there is a problem of public debt, it is a result of the Eurozone crisis. These points are even clearer in Fig. 3:

Figure 3 Government, Household, Non-Financial Corporation and Financial Corporation – Debt trajectory.



Source: ECB

For all four categories of debt the third quarter of 2008 certainly marked an important moment: after the default of Lehman Brothers private debt creation slowed to a halt and public debt creation grew rapidly. Considering the data more closely, it begins to appear that the summer of 2012, marked by ECB intervention, might also have been an important turning point. Financial debt rose particularly rapidly in 2004-8; it was broadly stable from 2009 to early 2011; rapid growth then resumed lasting until the summer of 2012; it then began to fall, and that decline began before the other forms of debt reached their own turning points. Non-financial corporation and household debt rose rapidly until 2008 and then became broadly flat, and in 2013 may also be beginning to decline. Public debt rose slowly until 2008, and hardly at all between 2005-2008; it then increased rapidly after the crisis began. In 2013 it potentially showed the first signs of stabilising. It is again clear that rise of public debt in the Eurozone is a result, not a cause, of the crisis.

It is plausible to surmise that during the first decade of the euro vast amounts of financial debt were created thus facilitating growth of non-financial private debt; the boost given to Eurozone GDP by this expansion of debt was ever smaller. When bank confidence evaporated in 2008 the debt machine staggered to a halt, and governments were forced to intervene to prevent depression. Since 2012, however, banks appear to be deleveraging, which will surely have a recessionary impact and, on its own, will do nothing to change the underlying relations of the financialised Eurozone.

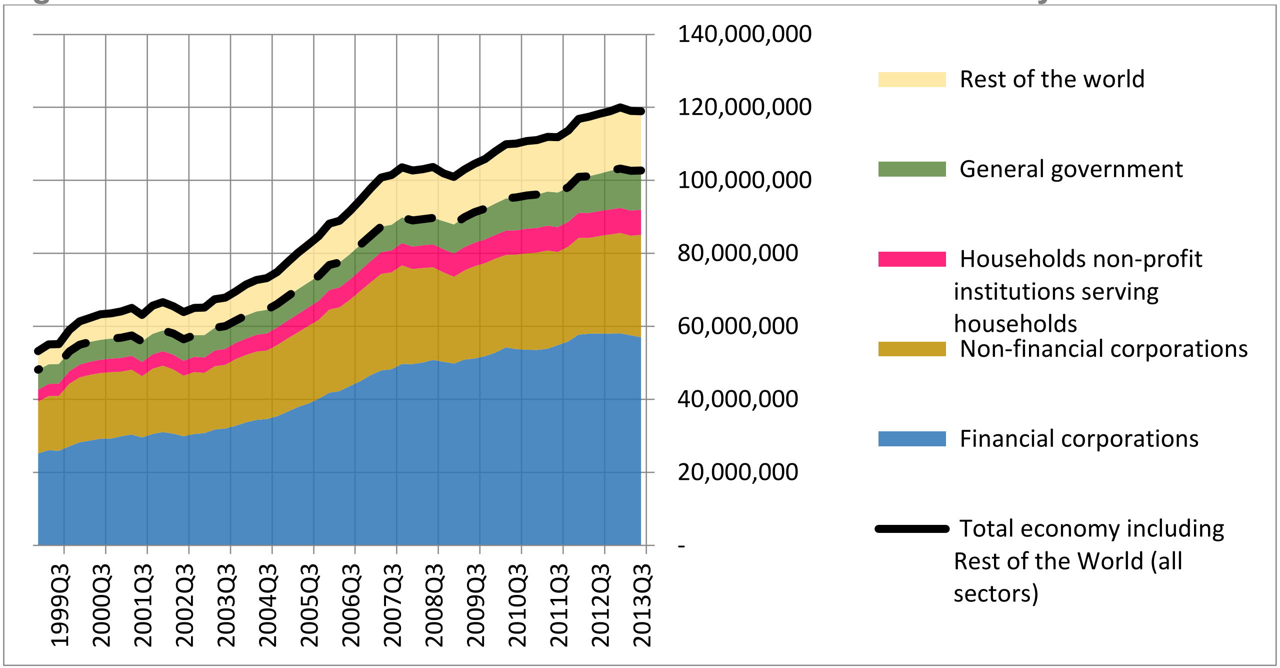
The point is underlined by examining the fuller financial balance sheet at the net positions of the 4 categories of debt.

2.Types of debt and varieties of social relations

Debt appears to be a uniform economic category - a contractual obligation to repay a certain amount of monetary value, often with covenants attached. However there also differences in the role that different debts play and, further, formal uniformity hides great qualitative differences which shape the economic and social impact of debt. The four types of debt shown in Figs. 2 and 3, and further explored below via the full financial balance sheet of the Eurozone, are a useful point of departure in analysing qualitative differences among varieties of debt.

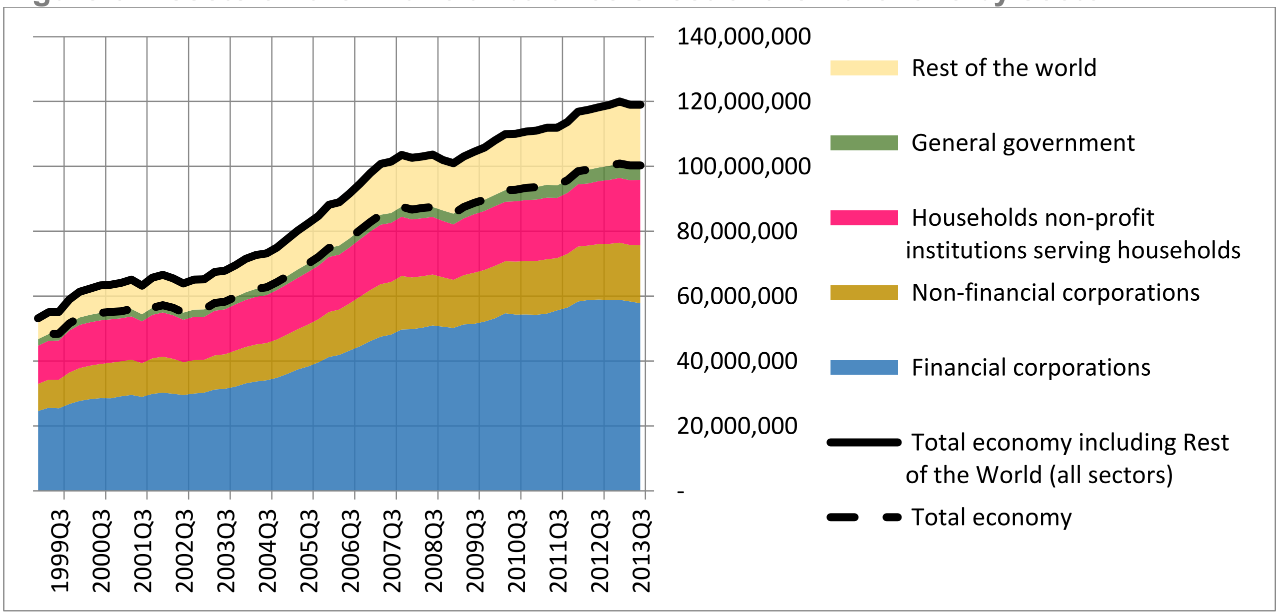
Figures 5 and 6 show the full financial liabilities and assets of each sector in euros, while Figures 7 and 8 show the net position of each sector in euros and as a multiple of GDP. All 4 sectors on this view have large financial assets and liabilities, but the most prominent is naturally the financial system. On a net basis however the picture is different: non-financial firms and governments are net borrowers (governments in particular have very small financial assets), households and the rest of the world (not shown) are net lenders, while the financial system has almost no net financial balance. Note that the net lending borrowing position of the sectors has also grown as a multiple of GDP over the period – more debt has been required for each euro of output. Note also again the dramatic change in the trajectory of government borrowing in 2008. While much more could be said about these positions within the Eurozone, not least the condition of households, examining these balances points the way to an exploration of the qualitative differences between the four types of debt.

Figure 5. Liabilities on the financial balance sheet of the Eurozone by sector



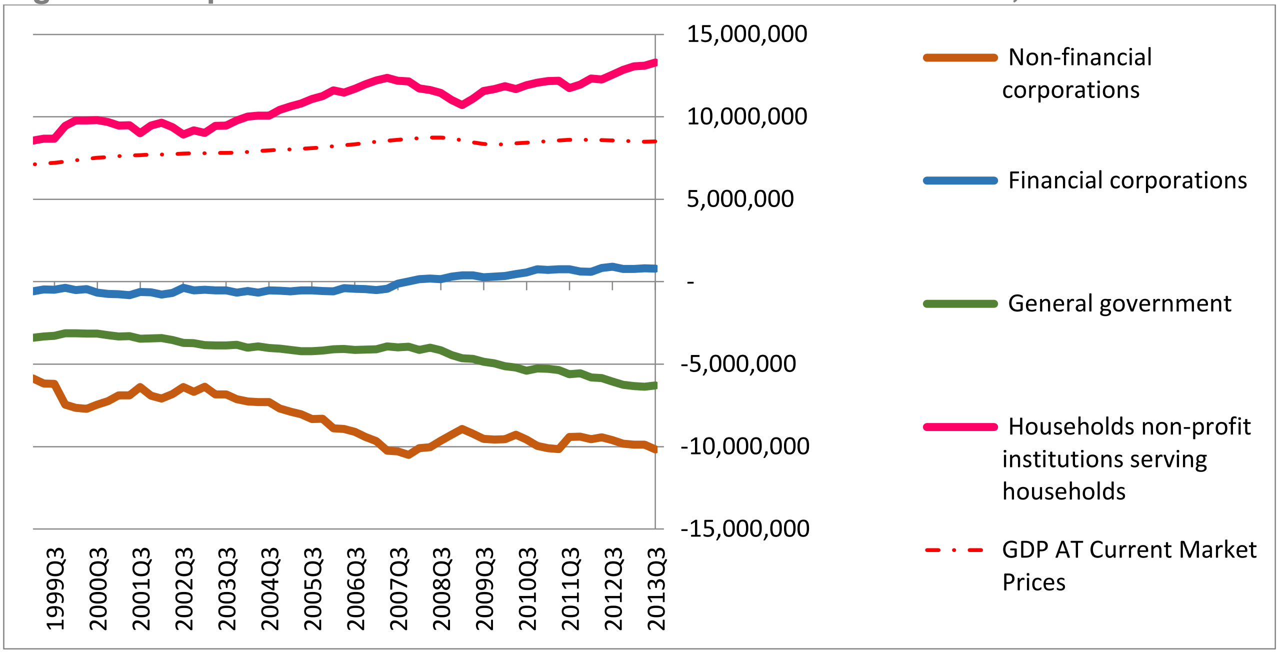
Source:ECB

Figure 6. Assets on the financial balance sheet of the Eurozone by sector



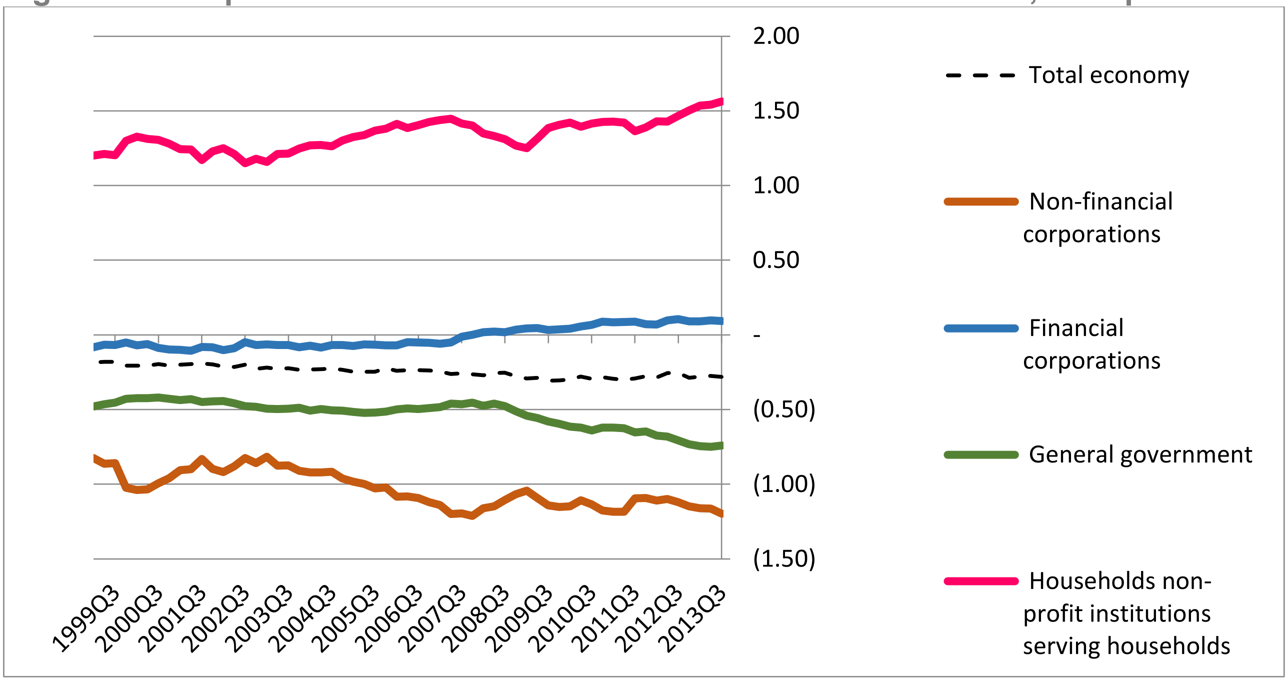
Source: ECB

Figure 7. Net position of each sector in the financial balance sheet; EUR Millions



Source: ECB

Figure 8 – Net position of each sector in the financial balance sheet; multiple of GDP



Source: ECB

In this light, non-financial corporation debt can be thought of as the typical debt of Economics textbooks, i.e., debt incurred by an enterprise which subsequently deploys the funds in a productive project, thus generating the returns out of which the debt is repaid. Clearly, the category also includes debt that does not directly produce its own returns out of a fresh flow value, e.g., debt incurred by real estate corporations, but the broad characterisation is useful.

Non-financial corporation debt is backed by well-defined bankruptcy laws which, together with limited liability, are part of the standard framework of a contemporary capitalist economy. Enterprises regularly go bankrupt, their assets are divided among claimants, and capitalist accumulation can subsequently recommence or continue. There are, of course, issues of moral hazard in repeated borrowing, but the legal and institutional room for a productive borrower to fail is a recognised feature of a normally functioning capitalist economy.

Household debt is incurred by households to support normal life, and mostly includes mortgage debt. Unsecured, consumption-related debt is a relatively small part of household debt, though some mortgage debt might in practice be related to consumption. The important point is that household debt is typically not directly related to a productive project that generates its own returns. Household debt is repaid out of household income, mostly earned through labour.

Household debt is also subject to bankruptcy legislation and the lender could seek recourse in the assets of the household. However, reflecting the non-commercial aspect of such debt, the legal and institutional framework of bankruptcy differs greatly among countries. Depending on history and social practice, household debt could even pass down the generations as well as having very different legal consequences for the person who has actually incurred it. There is an aspect of moral opprobrium attached to household debt, which varies considerably among different countries.

Consider now the components of Eurozone debt that lie at the core of the so-called ‘doom loop’ of state and banks, namely debts of financial firms and of governments.

Financial corporation debt is an intermediary form of debt incurred by financial institutions in the course of their normal operations. Financial institutions are highly-leveraged enterprises that borrow heavily to make loans themselves – as the analysis of the Eurozone’s debt mountain above show clearly. Financial corporation debt, therefore, is typically debt that is used to create other debt, often to non-financial enterprises and households – its growth in the Eurozone lies at the heart of the debt mountain. Its repayment is based on the returns that other debts are expected to create, or on the incomes attached to the borrowers of other debts. In these respects it is the most precarious among the four forms of debt listed here.

Financial corporation debt, although still typically incurred by private capitalist businesses, has a different status from other private corporation debts. In implicit recognition of its intermediary character, the bankruptcy of the borrower is in practice confronted with a different set of criteria. There is a widely held assumption that financial corporation failure would have major knock-on effects on other economic agents and is, therefore, frequently evaded through public subsidy, although it remains a formal possibility. The result is, first, major problems of moral hazard, particularly among the largest financial borrowers; even the IMF has come to recognise the implicit subsidy gained by 'too big to fail' banks, estimating it to be worth tens, if not hundreds of billions of US dollars.[3] Second, especially in the event of bank failure there is a systematic transfer of public resources to the private financial system – bank bailouts being among the largest mechanisms by which private debt induced public debt growth – as was shown above. Protecting the debt of financial institutions has become one of the most intractable problems of contemporary financialised capitalism.

Finally public debt is typically incurred by the institutions of state and therefore has a directly social character. It is debt that supports the activities of the public sector and is ultimately repaid out of tax income. It follows immediately that public debt represents a set of claims on current and future national output; it also represents a mix of domestic and foreign claimants on national output.

Public debt, especially foreign public debt, has the weakest legal and institutional backing among the various forms of debt, even though the global markets in which public securities are traded can be enormous. There are no uniform internationally recognised mechanisms of default with clear legal implications and enforcement procedures. Indeed, the very concept of 'bankruptcy' makes little sense in view of public debt as a national obligation that conveys claims on national output. Domestically, a state could always pay its debts in

[3] For example see the Global Financial Stability Report April 2014, available here: http://www.imf.org/External/Pubs/FT/GFSR/2014/01/pdf/c3.pdf

its own currency – at the risk of boosting inflation; it could also change the law and default. Internationally, there are very few states that could pay in their own currency, the main exception being the USA. International default for other states, however, is a disorganised and unpredictable process. Given that public debt is a set of claims on national output, it is apparent that default involves abrupt resource transfers among different sections of the population (classes) as well as between domestic and foreign claimants. For this reason, changes in the valuation and repayment of public debt are well-established mechanisms of sudden enrichment (and impoverishment) in capitalist economies. Finally, for the same reason, command over public debt can be a powerful lever over public policy; public bondholders have emerged as a powerful sectoral interest within and across countries in recent years.

Summing up, analysis in this Occasional Policy Paper has shown that the Eurozone became increasingly indebted - with a huge growth in private debt - from its formation until 2008. When the crisis struck, public debt took up the slack in a debt-dependent economy and government debt grew rapidly. In confronting the problem of Eurozone debt, therefore, it is important to take into account the similarities but also the differences among the various types of debt. The debts of financial firms - intermediary in nature and used to generate other debts - actually led the growth in other private debt, though for an ever smaller return in output. The growth of this precarious financial debt, highly dependent on confidence among borrower and lender, came to a staggering halt in 2008 as banks stopped lending to each other and to other firms. Governments were forced to intervene as the debt-dependent economy threatened to fall into depression, and government debt duly rose affording to its holders an increased share of national output and an increased say in the formation of government policy. Deleveraging led by the ECB and the financial system, as appears to be underway, will bring recessionary pressures but will not fundamentally alter the situation. Crudely put, financial firms have not been constrained and governments will still be forced to bail them out. If policy makers wish to deal with the Eurozone's debt mountain they will need to go further and address the fundamental social relations embedded in different types of debt