Yves Mersch: Challenges of excessive indebtedness

Keynote lecture by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the Euro Finance Week, Frankfurt am Main, 15 November 2011.

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Ladies and Gentlemen,

It is my pleasure and privilege to contribute to the Euro Finance Week. This conference has a long tradition of bringing together experts in finance, economics and politics. In recent years it has become a distinguished forum to discuss ways to get out of the financial crisis we are still facing.

The global rise in debt levels

The financial crisis weighs heavy on the global economy for more than four years. It erupted in August 2007with the epicentre at the US subprime mortgages markets and deteriorated dramatically in September 2008 when the US investment bank Lehman Brothers collapsed. And it triggered the sovereign debt crisis in the euro area in spring 2010 that has not been resolved until today.

The debt crisis has deeper roots. And indebtedness has not been only a feature of the financial industry and public finances. According to figures of the Bank of International Settlement (BIS) the aggregate gross financial liabilities of industrial country governments, households and non-financial corporations (represented by 18 countries) have grown from about 165% of gross domestic product (GDP) in 1980 to a record 320% of GDP by 2010.

By contrast, most emerging market (EME) countries have been doing better. BIS data since the mid-1990s suggest that EME debt levels have remained relatively modest and stable. Their debt stands now at about 110% of GDP on average, i.e. – a little more than one third of that in advanced countries.

The indebtedness of industrial countries is not only high. It is still rising. The average debt levels of industrial countries have risen to reach 320% of GDP by 2010, starting from a modest level of 165% of GDP in 1980. This is an annual average increase of more than 5 percentage points.

Both private and public sector debt levels have risen dramatically. Adjusted for inflation, corporate debt has risen by three times, government debt by 4½ times and household debt by six times.

This dramatic rise is widespread across advanced countries. Total non-financial sector debt now exceeds 450% of GDP in Japan, 350% in Belgium, Portugal and Spain, and 300% in two thirds of the countries. But also other major industrial countries have also experienced a substantial increase in their debt ratios. Household and non-financial corporate indebtedness in the United Kingdom began to rise rapidly in the early 2000s. In Germany and France, the aggregate debt ratio started to increase rapidly beginning in the mid-1990s, led by the growing indebtedness of both the government and the private sector.

These high levels of indebtedness imply serious risks. Borrowers' ability to service their debt becomes progressively more difficult due to the sensitivity to decreases in income and increases in interest rates. For any external event, the likelihood of default rises together with the level of debt. Even for a mild shock, highly indebted borrowers may suddenly no longer be regarded as creditworthy.

Highly indebted governments may be constrained both in their scope for engaging in traditional countercyclical stabilisation policies and in their role as lenders of last resort during an economic or financial crisis.

Moreover, growth might be hampered by excessive debt levels. Following the empirical findings of Kenneth Rogoff and Carmen Reinhart, who concentrated on the impacts of public debt on growth, recent BIS research also looked at corporate and household debt. The main finding is that there is a threshold of about 85% of GDP beyond which an additional 10 percentage points of debt reduces average per-capita growth by 13–14 basis points.

What has caused this trend of accelerated borrowing? The main reasons were the liberalisation of credit markets since the late 1970s and the introduction of (complex) financial innovations which made it easier to borrow.

In several countries the accumulation of debt was financed by property investment, which could be used as collateral for even more borrowing.

Moreover, since the mid-1980s until the current crisis, the economic environment has been more stable, a period that has been coined the Great Moderation. Lower unemployment and inflation rates and less uncertainty made investors more optimistic. Borrowers borrowed more and lenders lent more – while inflation remained low.

In addition financial innovation stabilized the credit supply. This allowed risks to move away from the banking system. General economic stability was improved, risk primea compressed, and future income prospects were boosted.

On the political level a persistent deficit bias in fiscal policy has been en vogue which additionally pushed debt levels upwards. The lack of fiscal discipline was accompanied by households' and firms' behaviour that did not properly discount a higher future tax liability in their spending decisions but instead increased their own liabilities.

Last but not least, tax incentives distorted financing choices. Preferential tax treatment of interest expenses may have played a major role in boosting corporate borrowing to finance ever larger mergers and acquisitions as well as leveraged buy-outs. Likewise, generous tax deductions for mortgage interest payments, combined with public policy intervention to boost home ownership, may have contributed to a sharp growth in household debt in some countries.

Global economic challenges

To tackle the threat of a debt trap three main approaches are generally discussed: fiscal consolidation to reduce the public fraction of debt, economic growth to increase the affordability of given liabilities, and inflation to lower the debt burden in real terms.

Fiscal consolidation decreases the vulnerability of public finance. And public finance is the water mouth of debt from all sectors in an economy in times of crisis. Regardless of whether private debt has been socialized or the problem was from the beginning in public finances itself, the outcome was a drastic increase in the public debt burden. Even John Maynard Keynes was aware of the limits of public expenditure based on borrowing has to its limits. After the Great Depression, Keynes acknowledged: "Just as it was advisable for the government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy." To bring public finances in order is of additional importance in mature economies where the demographic challenge kicks already in and might challenge the sustainability of established pension systems.

Growth should be stimulated. To this goal, structural reforms can strengthen confidence, market dynamics and job creation. Higher competitiveness will increase the flexibility of the economy and lift the longer-term growth potential. In particular, rigidities on labour market should be removed to increase wage flexibility. Structural reforms to increase competition in product markets, particularly in services and the privatisation of services currently provided by the public sector might further accelerate growth. To improve supply side conditions will also help to dampen the negative short term impacts on aggregate demand that kick it when the necessary fiscal consolidation measures are implemented.

Inflation, by contrast, is not a feasible option. This statement might not come as a surprise from a central banker. But there are sound reasons behind:

1. Accelerated inflation would raise the risks of even higher future inflation and greater output volatility. Uncontrollable wage-price spirals would be likely.
2. It would reduce incentives for governments to lower their public debt levels.
3. Financial markets would probably not buy the story of, for instance, a temporary modest increase in the inflation target. Rather they would add an inflation risk premium when public debt is rolled over. Real refinancing costs of governments could become even higher once the genie of higher inflation rates was out of the bottle.
4. It is a myth that accelerated inflation can be a substitute for economic adjustment. Remember that the necessary disinflation policies of the late 1970 and early 1980 came along with high costs including severe recessions and sharp increases in unemployment.

The case of the euro area

Although elevated debt levels are a common feature of advanced economies the euro area has been at the epicentre of the current public debt crisis since spring 2010.

Strangely enough, on a consolidated base public finances in the euro are in a more favourable position than for example in the US. The euro area as a whole will run a budget deficit of about 4.5% of GDP this year. The International Monetary Fund (IMF) expects a US budget shortfall of about 10 percent of GDP this year.

According to the Commission's spring forecast, the euro area deficit ratio is projected to decline to 3.5% of GDP by 2012. By comparison, in the US and Japan fiscal deficits are expected to be at 8.6% and 9.8%, respectively, in 2012.

On the other side of the channel, the UK expects for this fiscal year to meet its deficit target of 7.9% of GDP, down from 9.3% of GDP in the previous one ending in April 2011. The budget forecasts however are based on the assumption that the economy will grow 1.7% in 2011 – a euphemistic view compared to private sector economists' recent forecasts of 1.0 to 1.3%.

According to the IMF the aggregate public debt-to-GDP for the euro area stands at 87 percent. Figures for the UK are similar. For the US the debt-to-GDP ratio in 2011 is expected to be 100 percent. In Japan public debt-to-GDP exceeds 200 percent.

Under market scrutiny

Still, it is the euro area that is under particular market scrutiny. Market judgement can sometimes deviate from economic fundamentals. Even wealthy states with sound economic fundamentals are in trouble to refinance themselves at reasonable conditions. Comparing for instance Britain and Spain based on debts, deficits and inflation, Britain should be the riskier credit. But British bonds yield around 2.3% while Spain's yield around 5.5%.

Moreover, market sentiments can deteriorate dramatically within days – although economic fundamentals might not have changed. In mid October Italian one year bonds yielded around 3.5%. Last week they yielded around 7%.

Main differences to other countries

Although financial markets might temporarily be irrationally pessimistic there is no room for complacency and the challenges must still be addressed. In order to do so, it seems reasonable to recall what makes the euro area different from other currency areas.

The euro area is an alliance of sovereign countries without a central government or budget. Most of the relevant political decisions – including public finance – are taken by national governments. In this constellation member states share a common monetary policy and lack the instrument of the nominal exchange rate to react to internal or external imbalances.

In this institutional environment there has always been a risk embedded: moral hazard could arise when fiscal profligacy of one single member state can be compensated on average by the sound economic behaviour and stable public finances of the majority of the other countries. Such an incentive structure is flawed in so far as it can lead to unsustainable fiscal policies of individual member states which in turn would generate negative spill over effects to the monetary union as a whole and make financial markets to paint other members states with the same brush.

With hindsight, the original attempt to substitute a single government by rules, market and peer pressure has not been sufficient. Although the no-bail-out clause and the Stability and Growth Pact (SGP) were installed to exclude free rider incentives and to ensure the alignment of national fiscal policies, imbalances have emerged and the current crisis has not been prevented.

Particularly, there was a lack of political will to commit to sustained stability-oriented fiscal policy. The weak commitment was evident when the Stability and Growth Pact was watered down under the pressure of France and Germany in 2003.

Moreover, a crisis was not included in the scenarios to be prepared for. No crisis resolution mechanism for the euro area was foreseen.

Political and institutional challenges

Crises always must be seen as opportunities. As the Swiss writer Max Frisch once said: “A crisis is a productive time. It just has to be cleansed of the taint of a catastrophe.”

All advanced economies have to take swift, decisive and credible action to tackle the challenges that go along with the global debt crisis. This clearly includes the euro area. Having discussed the feasible options to overcome the debt challenge and the particularities of the euro area it is important that the consolidation of national budgets and the strengthening of the growth potential have to be put in place in a more coordinated way.

Important decisions have already been taken. In late September the European Parliament approved new legislation to tackle the shortcomings in the existing economic governance framework for co-ordinating fiscal and structural policies. The so-called “Six Pack” is a step in the right direction as the Stability and Growth Pact will be strengthened; imbalances and competitiveness will be monitored at an earlier stage.

In addition to the “Six-pack” the Heads of State or government of the euro area agreed in March 2011 on a “Euro Plus Pact” with the aim to strengthen policy coordination in the areas of competitiveness and convergence. A set of common indicators will be used to monitor the progress of labour-market reforms, reforms to wage-setting arrangements and reforms addressing the sustainability of pension, health care and social benefit systems.

Regarding the most urgent current challenges the Heads of State and Government of the euro area agreed on 26 October on a set of measures to restore confidence and address the current tensions in financial markets. These include a significant leveraging of the European Financial Stability Facility (EFSF) resources which shall increase the fund’s ability to extend loans, finance bank recapitalisations and conduct bond purchases in the primary and secondary markets. The crisis mechanism based in Luxembourg had been set up to help countries with stressed liquidity positions. This support should allow them to return to a sustainable level of debt and regain competitiveness as soon as possible.

As stated earlier, accelerated inflation is not a feasible option. Therefore, monetary policy in the euro area must remain focussed on delivering price stability. By doing so, the ECB can also best contribute to financial stability, by including a firm anchoring of inflation expectations and supplying the financial system with the necessary liquidity. Monetary policy, however, cannot replace governments which have to live up to their own responsibilities.

But challenges remain beyond today's institutional framework to safeguard the own life of a currency union within a common market to further proceed. In the medium to long run, we will need an institution that is solely responsible for the euro zone. A single monetary policy needs support from sound public finances and closer economic policy coordination with an agreed framework for national budgetary policies. This could be monitored ideally by an independent body be it a European Commissioner with special authority or a finance minister (not necessarily with a huge budget), as it has been suggested by former ECB President Jean-Claude Trichet. But in any case, the institutional vacuum that currently exists must be filled in the long term.

Ladies and gentlemen, thank you for your attention.