Private and public sector deleveraging in the EU: what policy responses?

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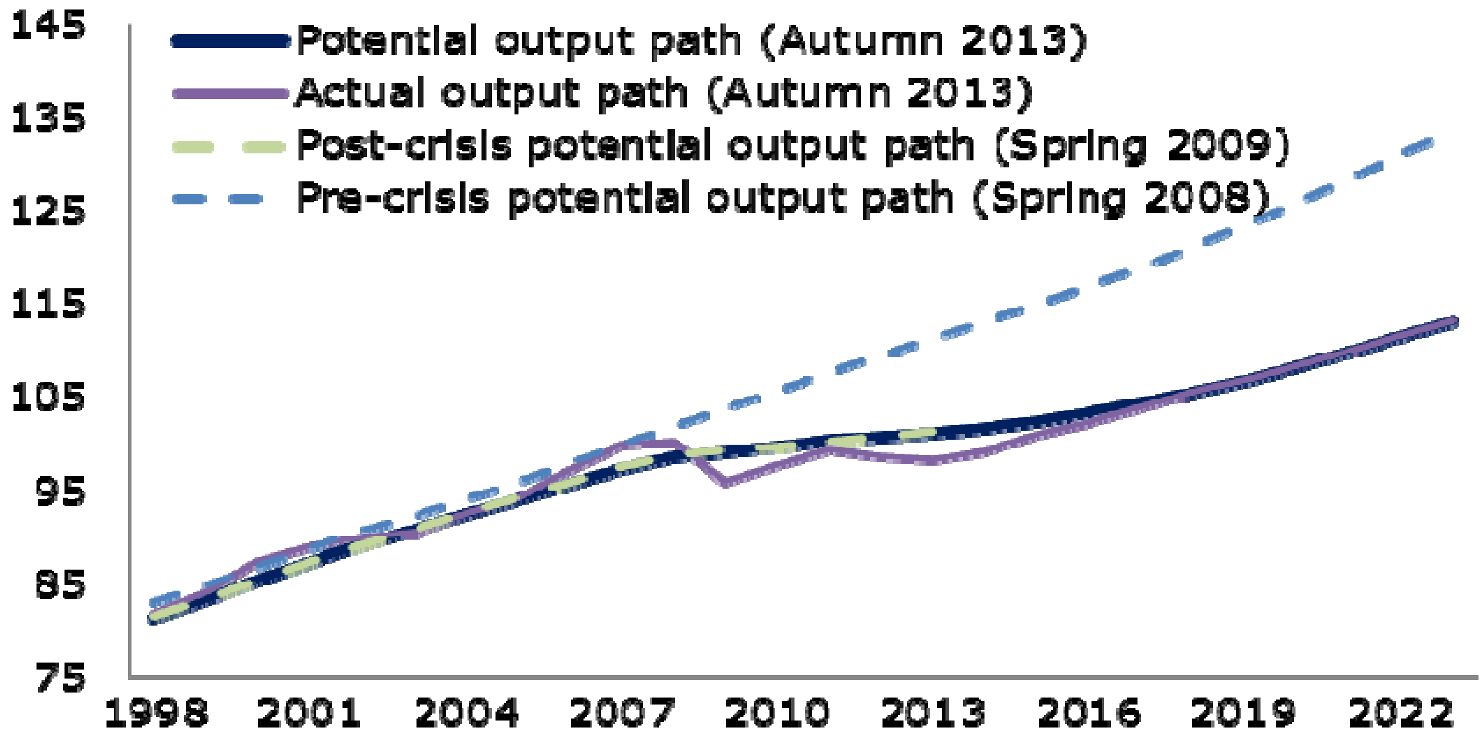
Euro area growth slowdown



Potential output growth has been on declining trend for decades

- Slowdown TFP growth,
- population growth

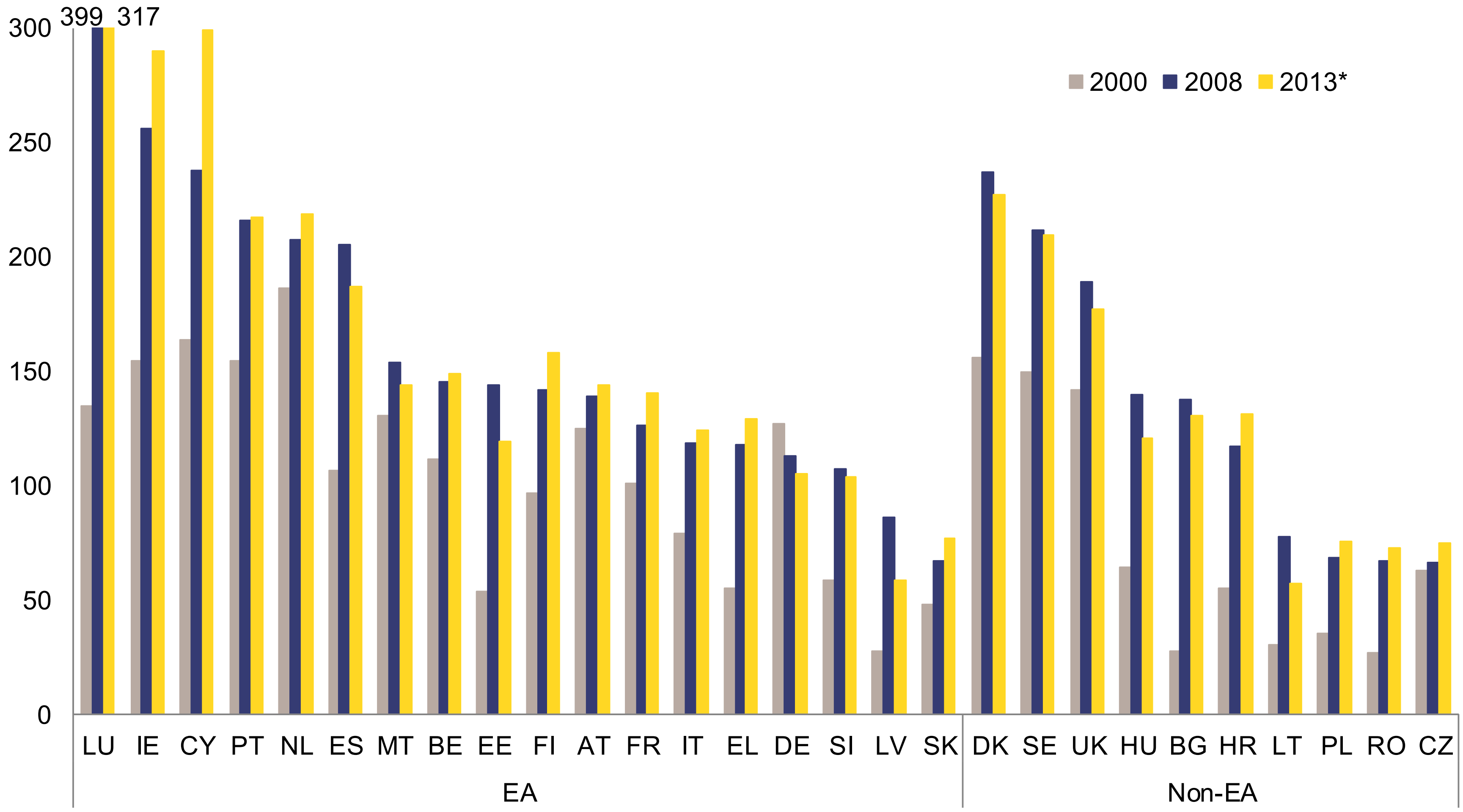
Source: European Commission, 2013.

Demand slowdown

- High debt build-up pre-crisis (households, firms, public sector)
- Need to adjust debt levels to sustainable levels → demand slowdown
  - Debt-deflation spiral (real debt ↑)
  - Zero lower bound: real interest rate ↑

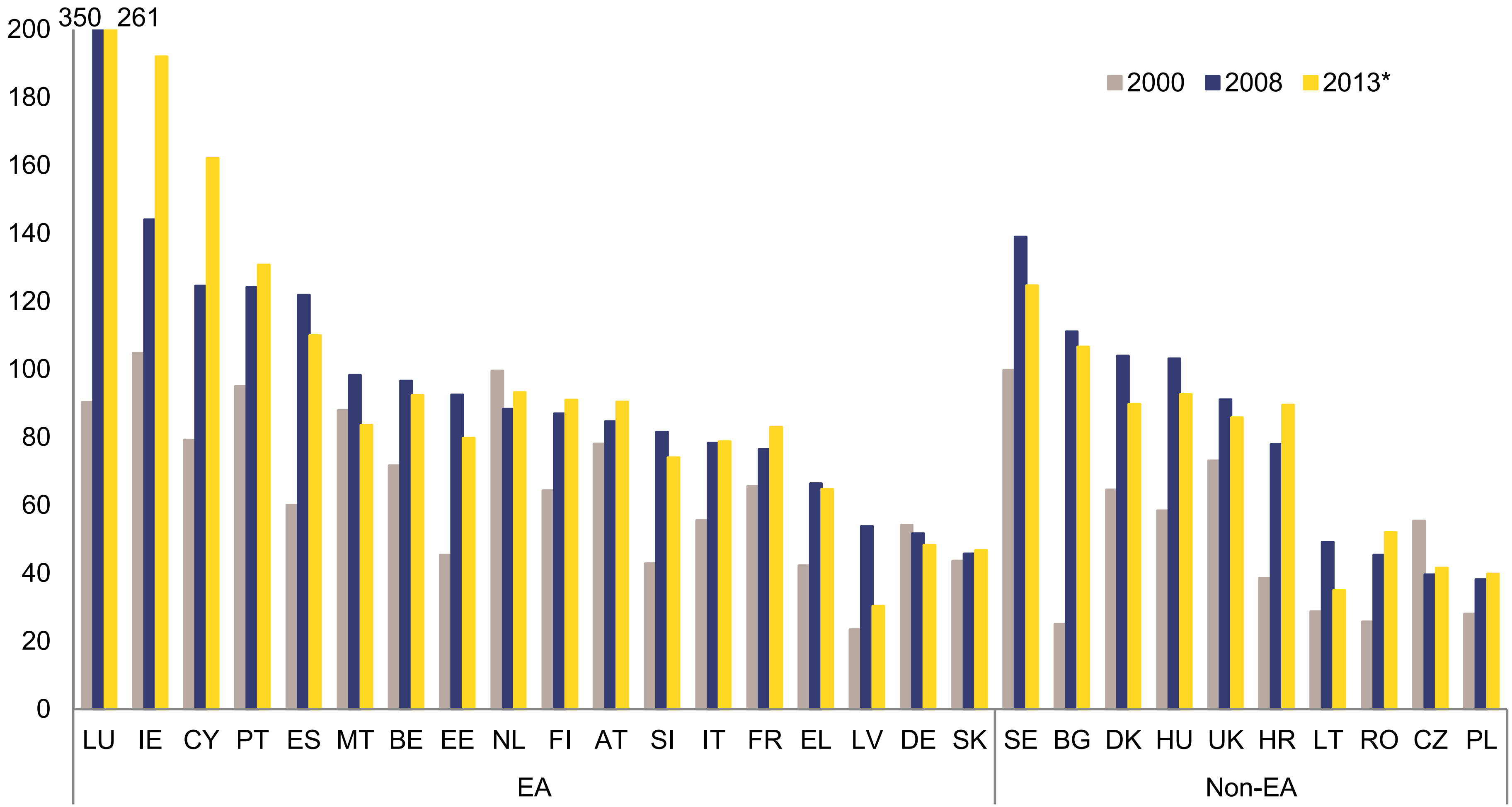
- Balance sheet adjustment, deleveraging (Koo)
- Secular stagnation hypothesis: negative natural real rate of interest (Summers)

Private non-financial sector indebtedness, % of GDP



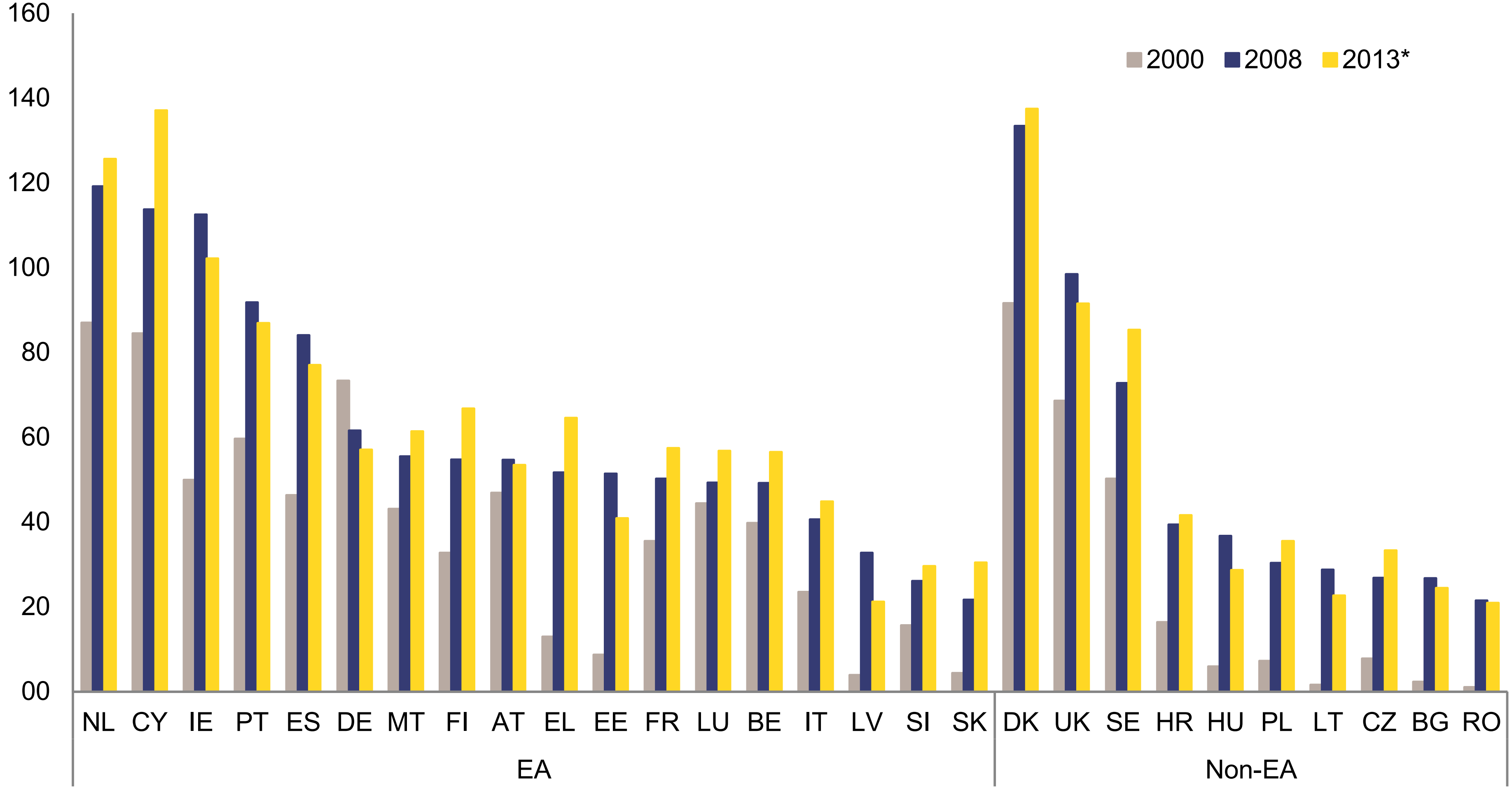
Source: European Commission

NFCs debt, % of GDP



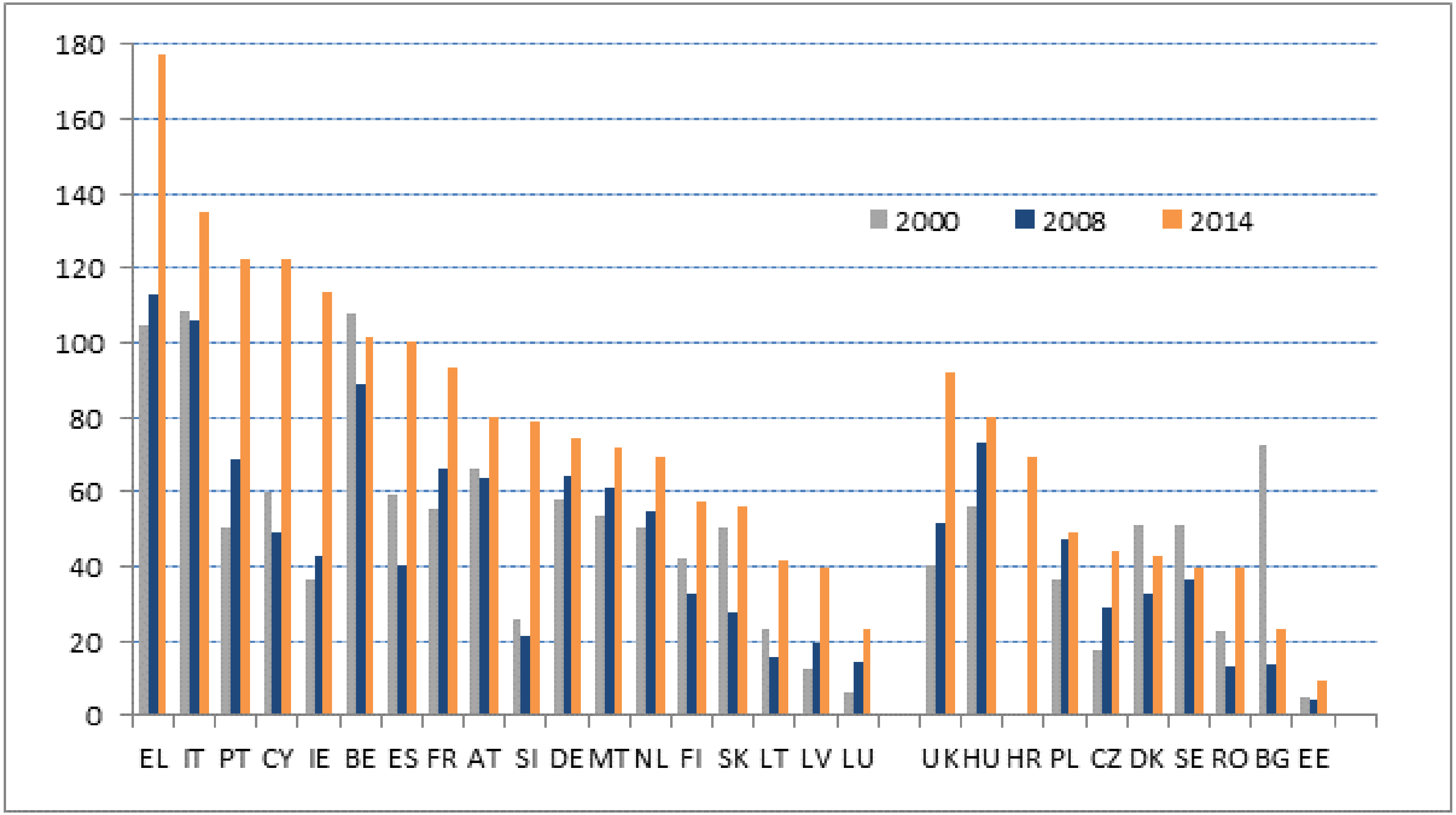
Source: European Commission

Household debt, % of GDP



Source: European Commission

General government consolidated gross debt, % of GDP



Deleveraging

Passive deleveraging

- net credit flows remain moderately positive
- nominal debt stock increases at a rate lower than nominal GDP growth
- smoother deleveraging process.

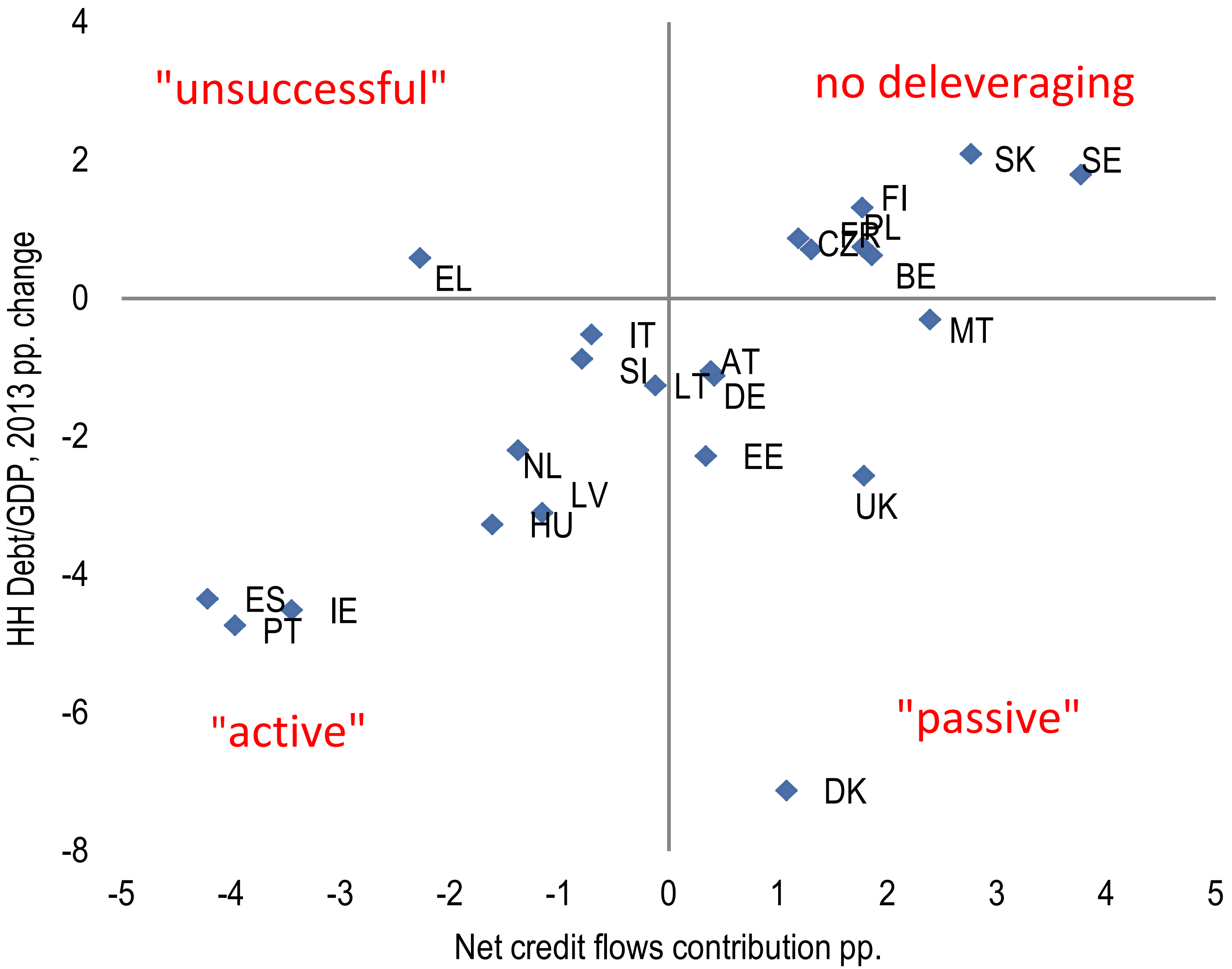
Active deleveraging

- negative net credit flows (nominal contraction of balance sheets).
- headwinds from a falling denominator (nominal GDP) due to a contraction in economic activity and often very low inflation.
- more abrupt (more non-performing loans, debt default), consequences on productivity and economic growth in medium and long term.

Unsuccessful deleveraging

- significant negative net credit flows
- Debt-to-GDP ratio falls only marginally, or even increases
- Contraction aggregate demand, deflationary effects on GDP, outright default and fragilities in the financial sector.

Household deleveraging 2013

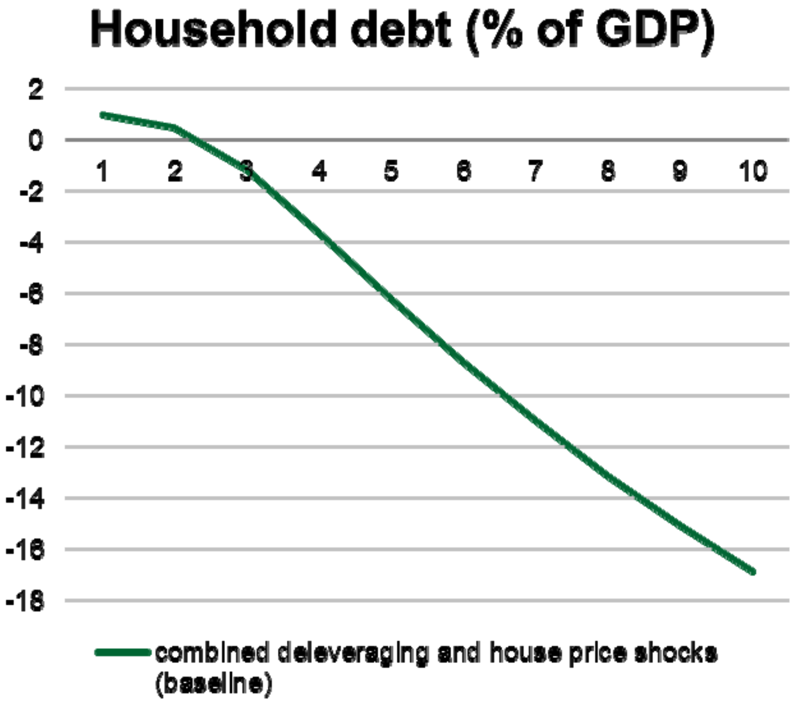


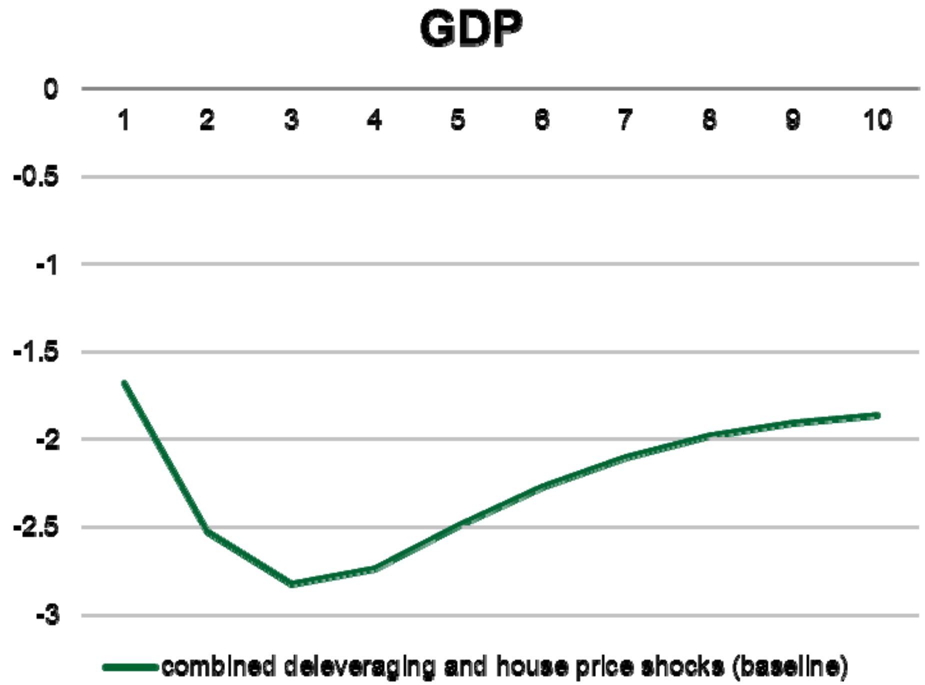
Deleveraging

- What are the effects of private sector deleveraging ?
- What are the effects when both private and public sector are deleveraging ?
- What are the international spillovers ?
- What policy actions can alleviate the costs of deleveraging ?

➢ Model based scenarios

Deleveraging shock: persistent GDP effects





Deleveraging households :

•Tightening credit availability: loan-to-value (LTV) ratio => debt/GDP -20%

•House price decline 15%

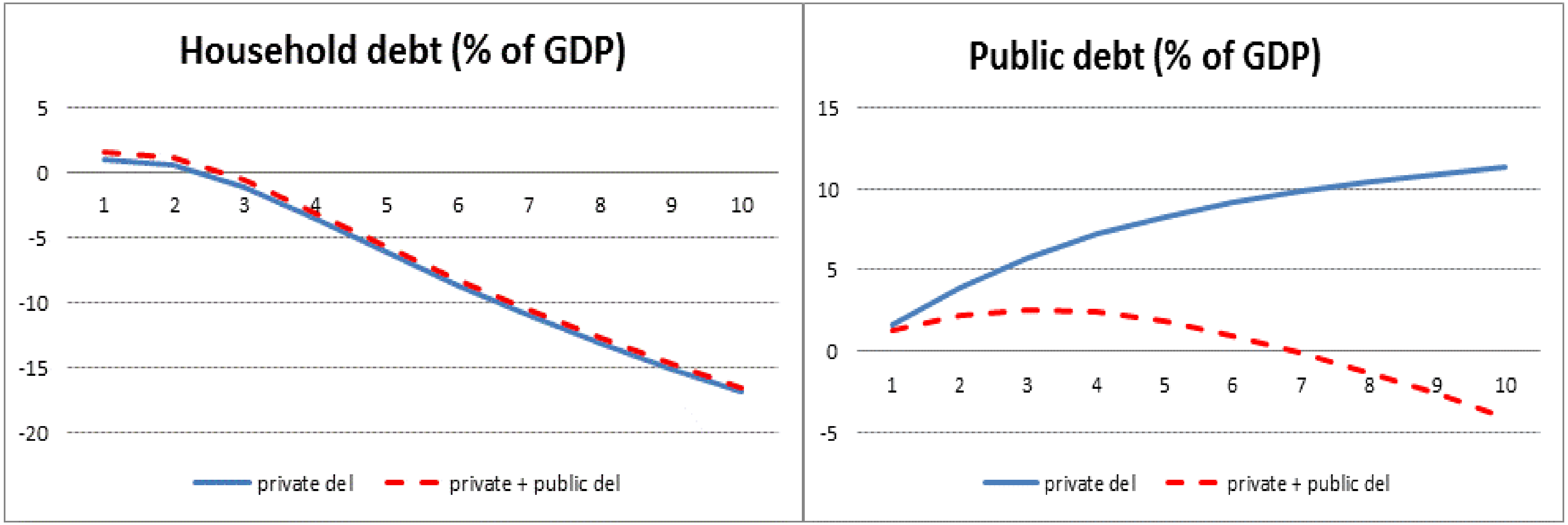
Source: Cuerpo et al (2013)

Deleveraging channels

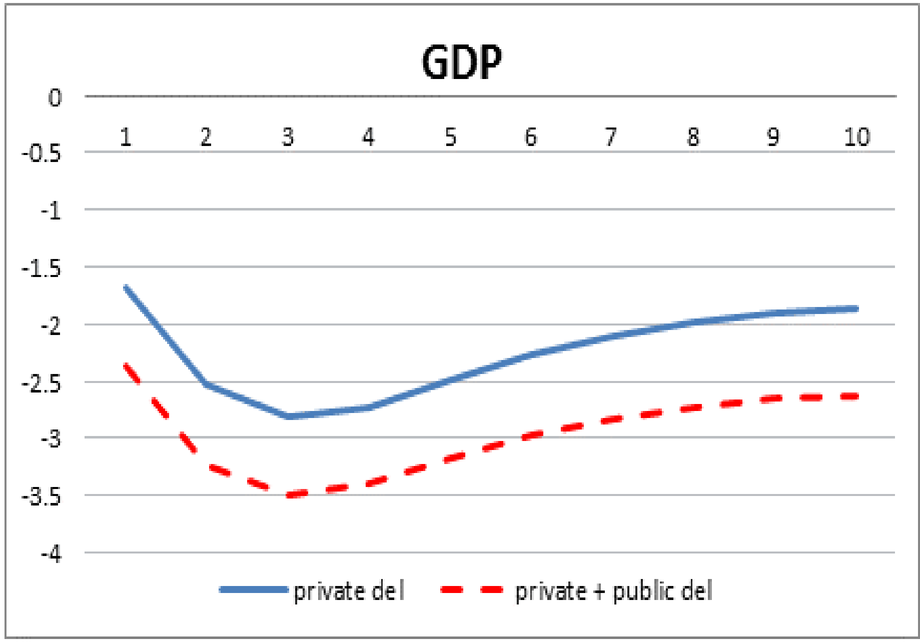
- Demand channel: need to repay debt → consumption ↓ + housing investment ↓ → GDP ↓
- Debt-deflation spiral:

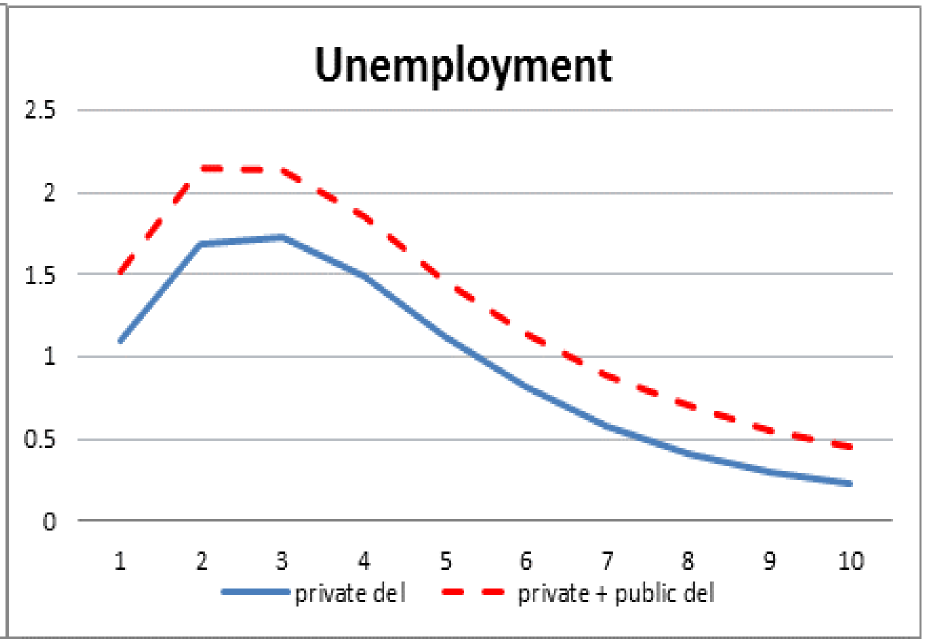
  demand↓→ deflation → real debt↑ → more deleveraging → demand↓ → ....
- Interest rate channel: lack of independent monetary policy (zero lower bound) → nominal interest rates do not sufficiently fall + deflation → real interest rate ↑ → corporate investment falls → larger fall in GDP

Simultaneous deleveraging : private and public sector



Cost of deleveraging higher when combined with public deleveraging





Private and public sectors deleveraging

- Private deleveraging deteriorates the government's budget balances, raising public debt → slows down public deleveraging → additional second-round effects
- Direct demand effect: falling public demand → larger fall in GDP
- Second-round effects: increased taxes and lower demand for labour → weakened demand and costlier supply → further deteriorated impact on GDP (and public budget balances)
- Public debt-inflation spiral: falling prices → higher real public debt → more aggressive public deleveraging needed → ...

Public deleveraging 2011-13:

Changes in primary structural balance general government (% of potential GDP)

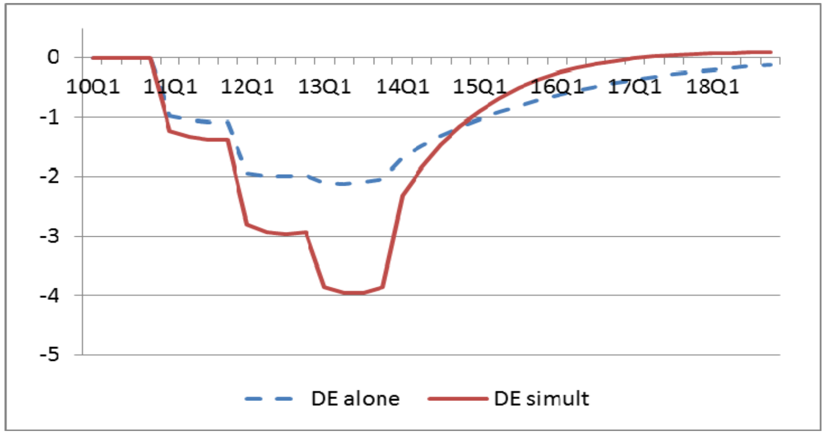
	Consolidation efforts			Cumulative		
	2011	*2012*	*2013**	2011	2012	2013*
Germany	*1.42*	*1.16*	*0.03*	1.42	2.58	2.61
France	*1.37*	*1.02*	*1.30*	1.37	2.38	3.68
Italy	*0.47*	*2.75*	*0.73*	0.47	3.22	3.95
Spain	*0.68*	*2.32*	*1.45*	0.68	3.00	4.45
Ireland	*1.63*	*0.64*	*1.77*	1.63	2.27	4.04
Portugal	*3.50*	*2.72*	*0.51*	3.50	6.22	6.73
Greece	*4.82*	*2.24*	*1.85*	4.82	7.06	8.91
Rest of EA	*0.46*	*0.62*	*0.46*	0.46	1.08	1.54

Source: in 't Veld (2013)

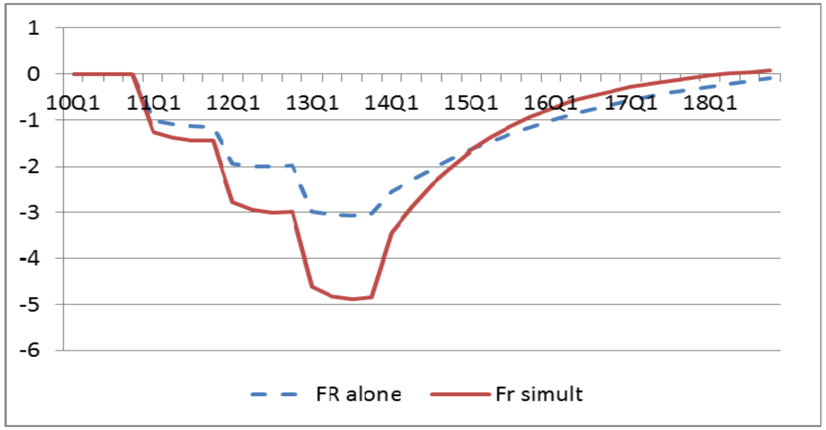
Spillovers simultaneous consolidations 2011-13

(GDP, %)

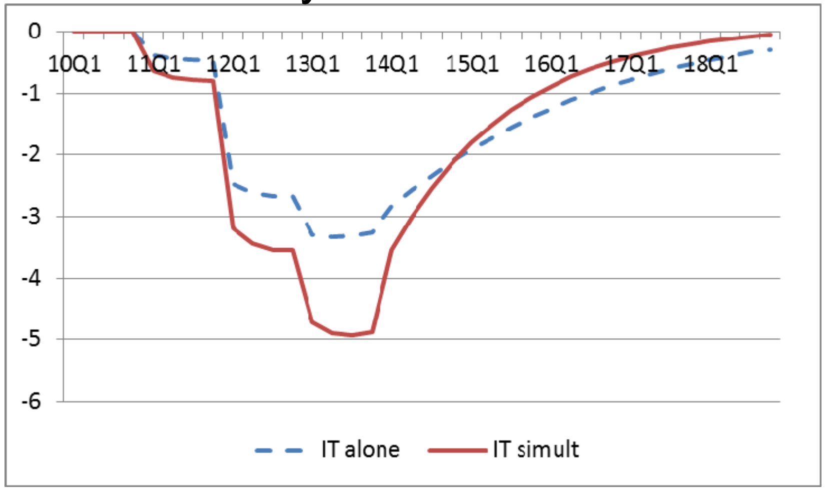
Germany



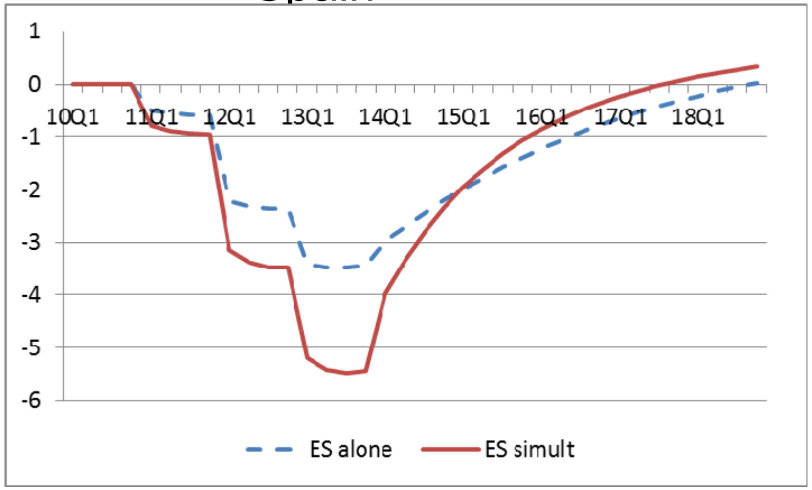
France



Italy



Spain



Source: in 't Veld (2013)

Demand shocks can have significant cross-country spillovers

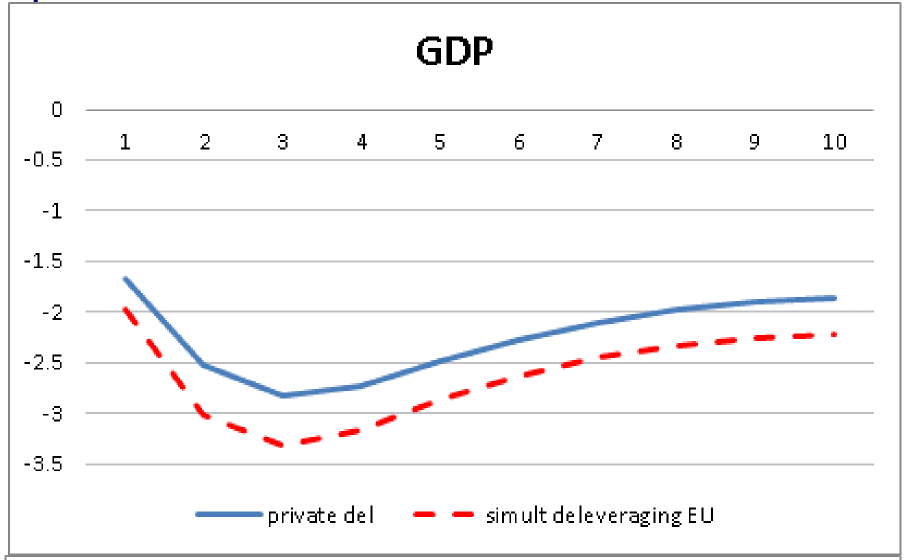
Public deleveraging shocks:

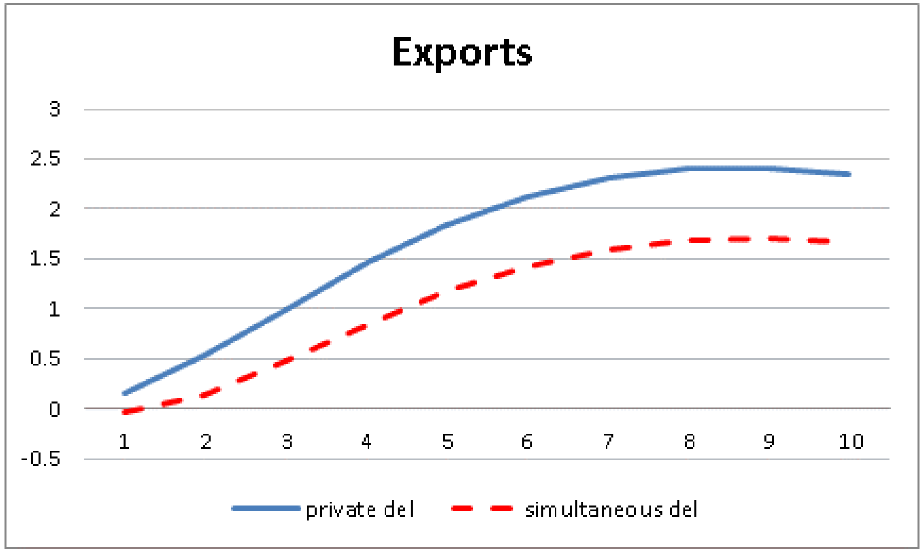
	DE	REA	FR	IT	ES	IE	PT	EL
Germany	1.00	0.19	0.18	0.17	0.09	0.01	0.01	0.02
Rest of EA	0.25	1.00	0.17	0.16	0.09	0.02	0.01	0.02
France	0.22	0.17	1.00	0.16	0.10	0.01	0.01	0.02
Italy	0.21	0.16	0.16	1.00	0.09	0.01	0.01	0.02
Spain	0.22	0.16	0.18	0.16	1.00	0.01	0.02	0.02
Ireland	0.25	0.23	0.20	0.18	0.11	1.00	0.02	0.02
Portugal	0.23	0.17	0.18	0.17	0.18	0.01	1.00	0.02
Greece	0.23	0.17	0.18	0.18	0.10	0.01	0.01	1.00

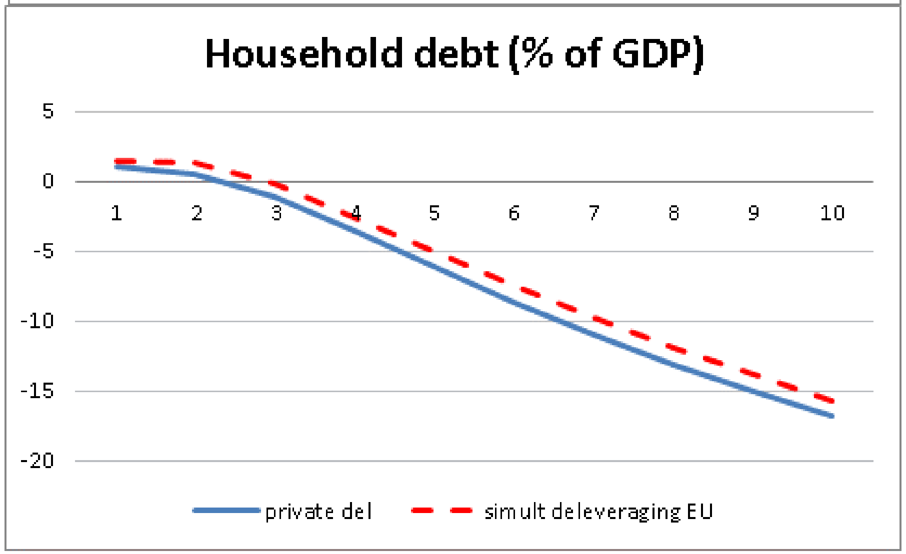
Specific household deleveraging shock in periphery:

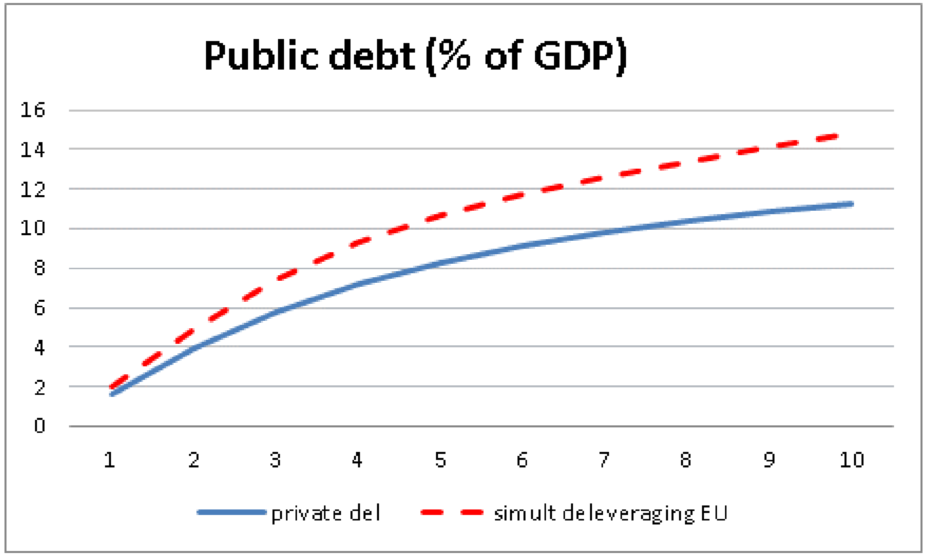
	Periphery	Germany	Poland	Czech rep.
GDP	1	0.3	0.1	0.2

Simultaneous private sector deleveraging EU: spillovers









Spillover effects from abroad

- External demand effect: falling demand from abroad has an additional negative impact on domestic GDP
- Crucial role of the ZLB assumption:
  - Falling output in the currency union would, under 'normal' circumstances, make the central bank cut interest rates
  - That would cushion effects of deleveraging in both domestic economy and rest of the union
  - When restricted by the ZLB: the economic adjustment is to a larger degree borne by households and firms
- Slower speed of domestic deleveraging

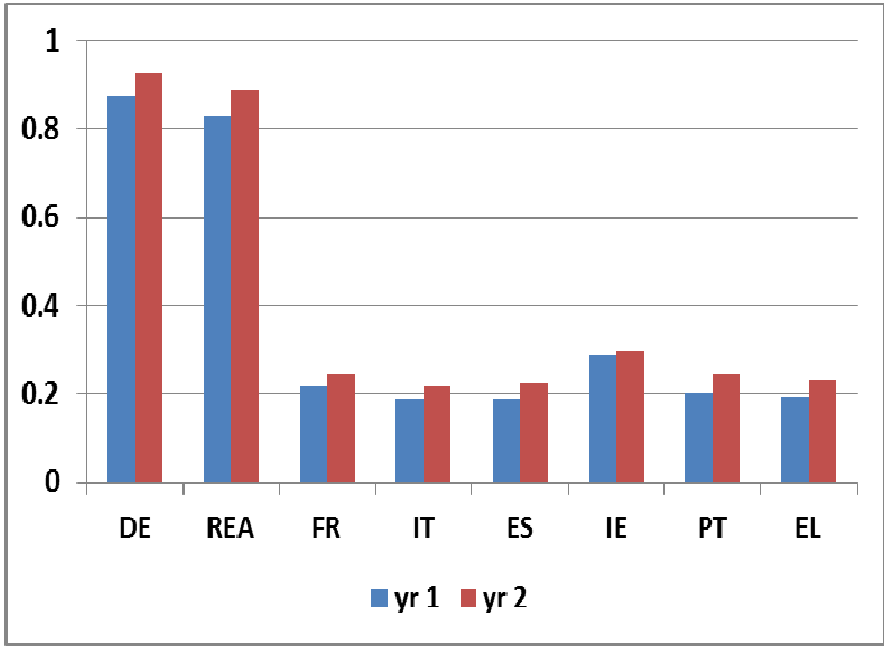
Possible policy actions to alleviate costs

- Monetary policy: unconventional measures
- Fiscal policy: demand stimulus (public infrastructure) can also raise potential growth (and positive spillovers)
  - Possible exceptions: countries with already high debt-to-GDP ratios - risk adverse market reaction
- Structural reforms: lower real/nominal rigidities can alleviate the negative impact of deleveraging

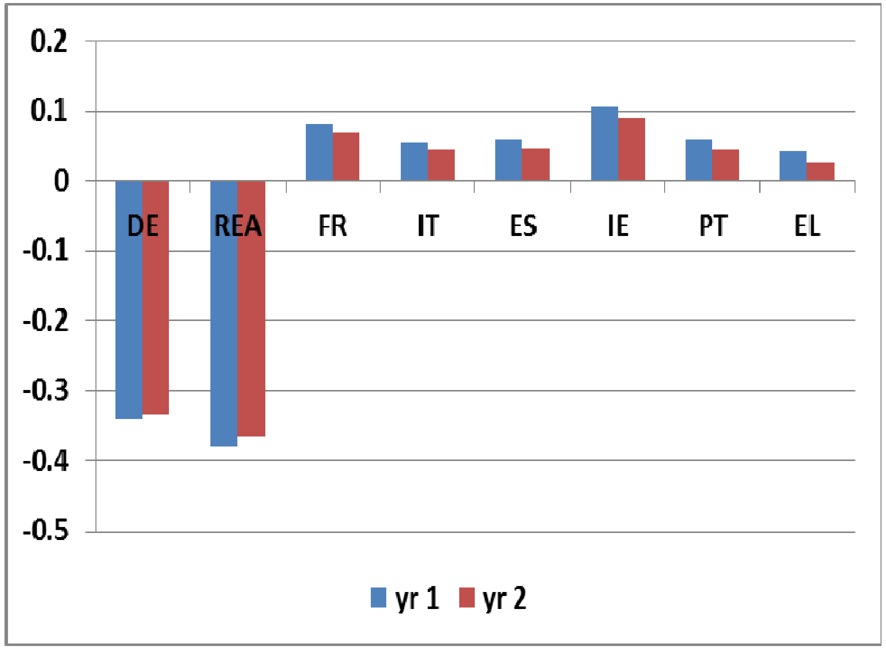
1. Fiscal stimulus

Example: temporary increase public investment 1% of GDP

GDP



Current account (% of GDP)

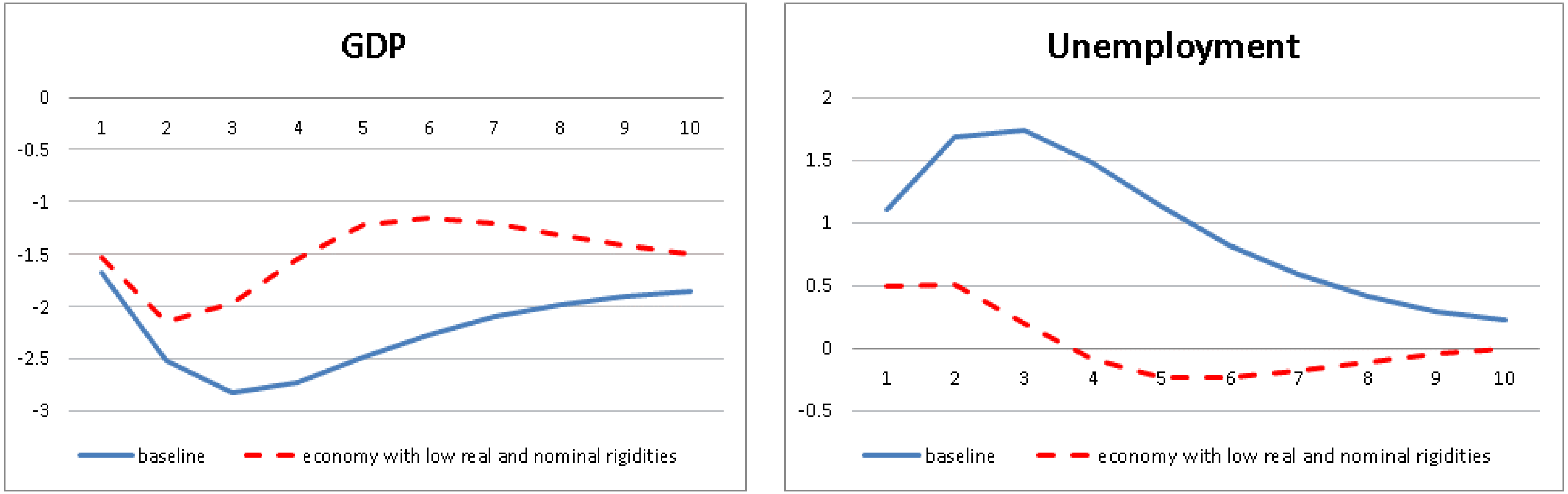


$\Rightarrow$ Boost growth at home, positive spillovers abroad

Source: in 't Veld (2013)

2. Structural reforms: lower rigidities

Private sector deleveraging in more flexible economy



More flexible economy => lower output and unemployment costs

Source: Cuerpo et al (2013)

Structural reforms can alleviate the costs of deleveraging

- Demand (investment, consumption) less affected → smaller fall in GDP
- Flexible wage effect: real wages adjust faster → smaller fall in demand for labour → smaller rise unemployment → demand less negatively affected
- But constrained households more affected (wages↓)
- Interest rate channel: quicker upward adjustment in prices after an initial fall → positive inflation → real interest rate falls → corporate investment less negatively affected

Potential GDP effects of jointly implemented structural reforms closing performance gaps