European balance sheet repairs

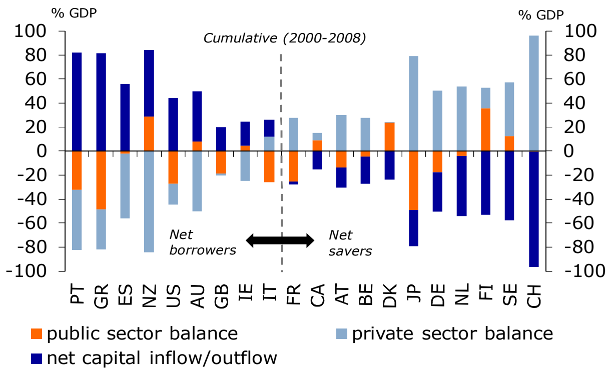
We expect only a moderate continuation of the economic recovery for Europe as a whole this year, not least as a result of the efforts to reduce deficits since the crisis in the European periphery. The gaping holes in government budgets in a number of Member States are leading to severe cuts in spending, which will hinder economic growth. Private sector debt to foreign lenders has also soared in this region in the last decade. The process of paying down this debt could continue to slow the economic recovery in Europe in the next few years.

High level of net debt in the European periphery

Large current account imbalances in the balance of payments (the national savings balance) are not restricted to the US and China. Within Europe, the 'GIPS' countries in the periphery[1] have robust current account deficits, leading to a structural flow of capital from Northern Europe to the GIPS countries. A high level of external debt has been built up, especially in Portugal and Greece, mostly by the government. All the GIPS countries moreover have seen a large accumulation of debt in the private sector (figure 1). Since the crisis, more or less all governments around the world have allowed their deficits to increase further in order to support the financial sector and boost the private sector. The GIPS countries have participated in this process (see figure 2)[2], thereby reducing the foreign financing requirement for the private sector. This turnaround shows that the use of automatic stabilizers can lead to a mutual effect between the deficits, and ultimately also debt positions, of the government and the private sector. The current debate in the market is focused mainly on high levels of government debt; the situation in the private sector is still somewhat unrecognized. This article will look at the private debt situation in more detail.

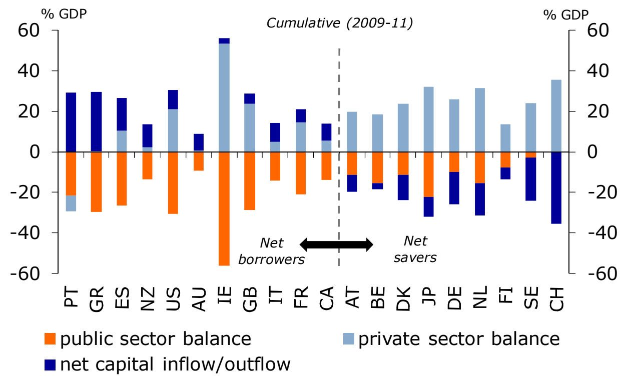
[1] This article focuses on the GIPS countries, here: Greece, Ireland, Portugal and Spain.
[2] For further information on the build-up of government debt, see Kamalodin, S. (2010), *The return of sovereign risk in the industrialized world.* Rabobank Special 2010/3.

Figure 1: Debt accumulation GIPS in perspective



Source: OECD, Reuters EcoWin

Figure 2: Governments intervene since the crisis

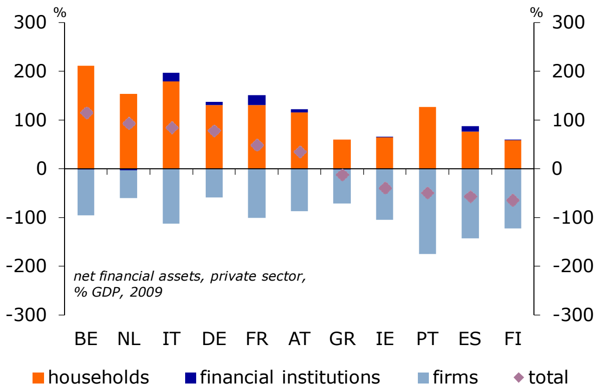


Source : OECD, Reuters EcoWin

Capital positions in the private sectors under the spotlight

Figure 3 shows the net financial capital position (total assets less total liabilities) of households, financial institutions and firms in European countries. The sum of the net financial asset positions of these three sectors shows whether the private sector in a country is on balance a net debtor (if the position is negative) or a creditor (if it is positive). Firms usually have a relatively large amount of non-financial assets (buildings, machinery) compared to their financial liabilities, and therefore have a negative capital position in financial terms. Households mostly have a positive financial position and make this available to borrowers (including firms) in the form of loans, whether or not through financial institutions. As intermediaries, financial institutions mostly have a comparable level of financial assets and liabilities. Figure 3 shows that the private sectors in Ireland, Spain and Portugal, countries whose government debt has been the subject of critical monitoring since last year, have a negative financial asset position. Greece is the exception, which shows that this country's international debt position is mostly in the form of government debt.[3]

Figure 3: Net financial assets private sector

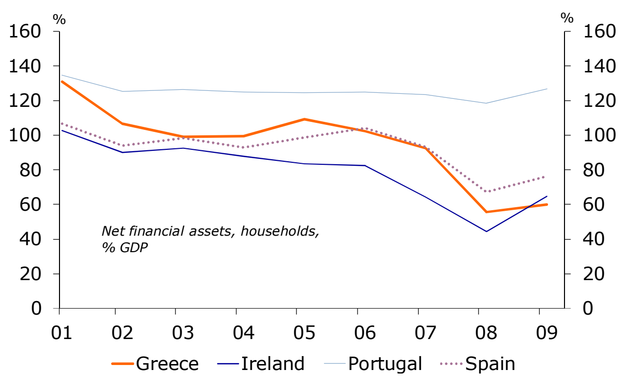


Source : Eurostat, Reuters EcoWin

Figures 4 and 5 show the development of the net assets for households and firms respectively for the GIPS countries over the last decade. With the exception of Portugal, the positive asset position of households declined significantly before the crisis. The negative asset position for firms has

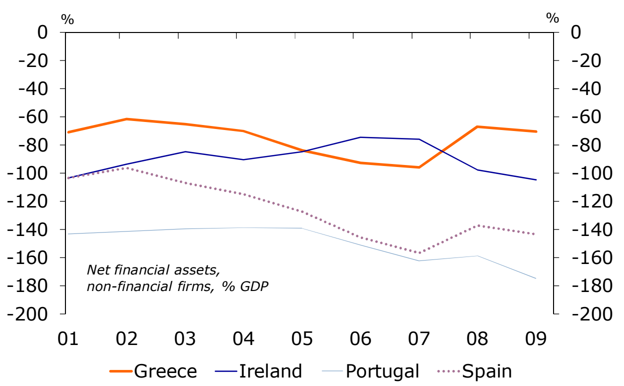
[3] See also: Legierse, T. (2011), *We're not like that!*, Rabobank Special Report, 2011/3.

Figure 4: Households start to rebuild assets



Source : Eurostat, Reuters EcoWin

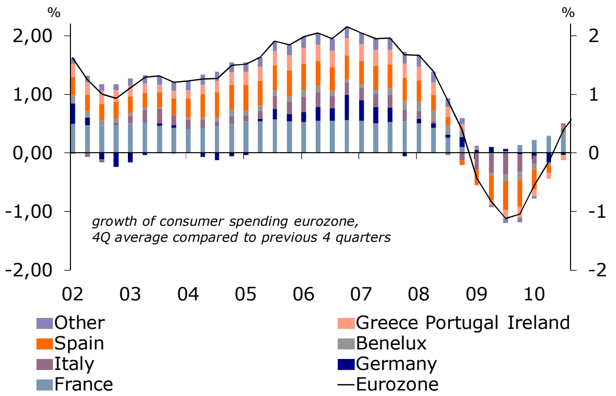
Figure 5: Corporate debt remains stable



Source : Eurostat, Reuters EcoWin

remained fairly constant; only in Spain was there a significant increase. While it is true that firms were more prepared to borrow in the years before the crisis, a major factor in the increased dependence on finance from abroad was the reduced availability of domestic financing from surplus savings held by households. However capital has been accumulated in the private sector since the crisis.[4] While the negative financial assets of firms were still deteriorating in 2009, households increased their net assets, partly through the recovery in the value of their financial assets, but also simply because a higher proportion of income was earmarked for savings.

Figure 6: Consumption growth in Europe



Source : Rabobank, Reuters EcoWin

Increased savings hit the economy

The savings behaviour of households can partly be explained by the deep recession. High unemployment and declining purchasing power make consumers cautious when it comes to big ticket items. The limited availability of domestic credit could also be a factor. From the point of view of the financial soundness of countries in the medium term, this is a positive development. The other side of the coin however is that growth in consumer spending has completely stalled in these countries. This has a substantial effect on the European economy, especially when one remembers that prior to the crisis the European periphery was an important driver of European growth in consumer spending (figure 6). Lower growth in consumer spending affects other countries due to a decline in demand for imports, which has negative consequences for intra-European trade. The North European countries are therefore also hit by the rebuilding of assets in the periphery. A mitigating effect for European exports is that the euro has come under pressure as a result of the turmoil resulting from the levels of (sovereign) debt in the GIPS countries. It has to be noted, however, that the negative material effects of balance sheet strengthening in the European periphery will remain once the concerns in the financial markets in relation to Europe and the euro subside (which will lead to a stronger euro).

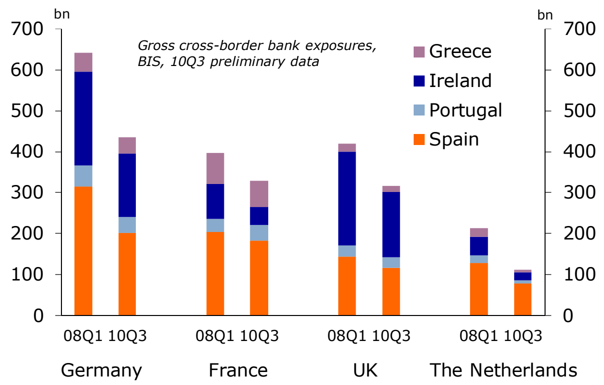
What can we expect in the next few years?

A net debt position in the corporate sector is not in itself a reason to pay down debt. As long as there is confidence in the sector's ability to repay, debt levels can even rise further. A dependency on financing is however being created.

[4] Recent current account data show that this trend continued in 2010.

And if confidence in the ability to repay is damaged, businesses will ideally have to restore it by improving competitiveness, in terms of price or quality, or a combination of the two. Businesses can then compete more effectively with foreign suppliers in both foreign markets (through higher exports) and domestic markets (through lower imports). The process of adjustment is however usually painful and lengthy, and the (re)financing required in the meantime is still difficult to obtain and involves significant risks for the economy. Let us assume that households in the European periphery increase their savings rate, meaning that they can afford to finance their national industry to a greater extent. This is a good thing in the long term, but it has negative side-effects on the economic prospects for Europe. Large-scale additional savings will be required, meaning that consumption will remain at very low levels for several years.

Figure 7: Bank exposures to decline



Source : BIS, Rabobank

Furthermore, there is a fair chance that the savings made by households will be insufficient and that businesses will continue to depend on foreign funding. The need for funding by the private sectors in the periphery is indeed huge. So it is necessary that the (re)financing from abroad remains in place, so that the availability of credit, partly through South European banks, can continue. The question is, however, to what extent is Northern Europe for instance prepared to refinance loans maturing in the next few years? Figure 7 gives an indication that this refinancing might not be that straightforward, although part of the reduction in the cross-border bank positions in the European periphery can, in addition to active debt reduction, be achieved by downward revaluation and ECB intervention. It is therefore crucial that a sufficiently credible policy turnaround occurs so that confidence in the ability to repay is restored.

Conclusion

In addition to towering levels of government debt, the private sector in the European periphery has accumulated a significant net debt position in the last decade. Households are becoming increasingly less able to meet the growing need for finance by businesses, as they are consuming more and saving less. Although there are significant differences within the European periphery, households have made a start on rebuilding their assets since the crisis. The effects for the European economy will depend on the extent to which foreign credit providers are prepared to give the private sector time to reduce its dependence on foreign finance by improving its competitive position.

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