



Getting Slimmer
Why Europe needs to cut debt and reduce leverage

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Debt and demography

- Demography recognized as limiting Europe's medium term growth potential.
- Debt (overhang) has similar effect.
- A well functioning financial system allows economy to reach potential.
- Not the case in Europe (especially euro area).
- A Japanese future?

An quick look at demography

- 2013-2015 inflection point in many respects.
- Deceleration is what counts: strongest for Europe.
- Slight improvement in Japan.

Demography is Europe's destiny working age population declines

Working age population (15-64), annual growth rates



Debt and leverage

- Debt = claims fixed in nominal amount have an important function in the financial system.
- But what happens if too much of these claims are accumulated, outstripping the capacity for debt service (=debt overhang)?
- System becomes brittle and stifles growth.
- Aggregate debt service capacity = GDP.
- Excessive debt/GDP ratio negative for growth.

Leverage

Micro versus Macro

- Micro: leverage = debt/equity
- Macro: leverage = claims fixed in nominal amount relative to GDP debt (public + private)/GDP.
- Some improvement on micro side (Basel III).
- But what is happening at macro level?

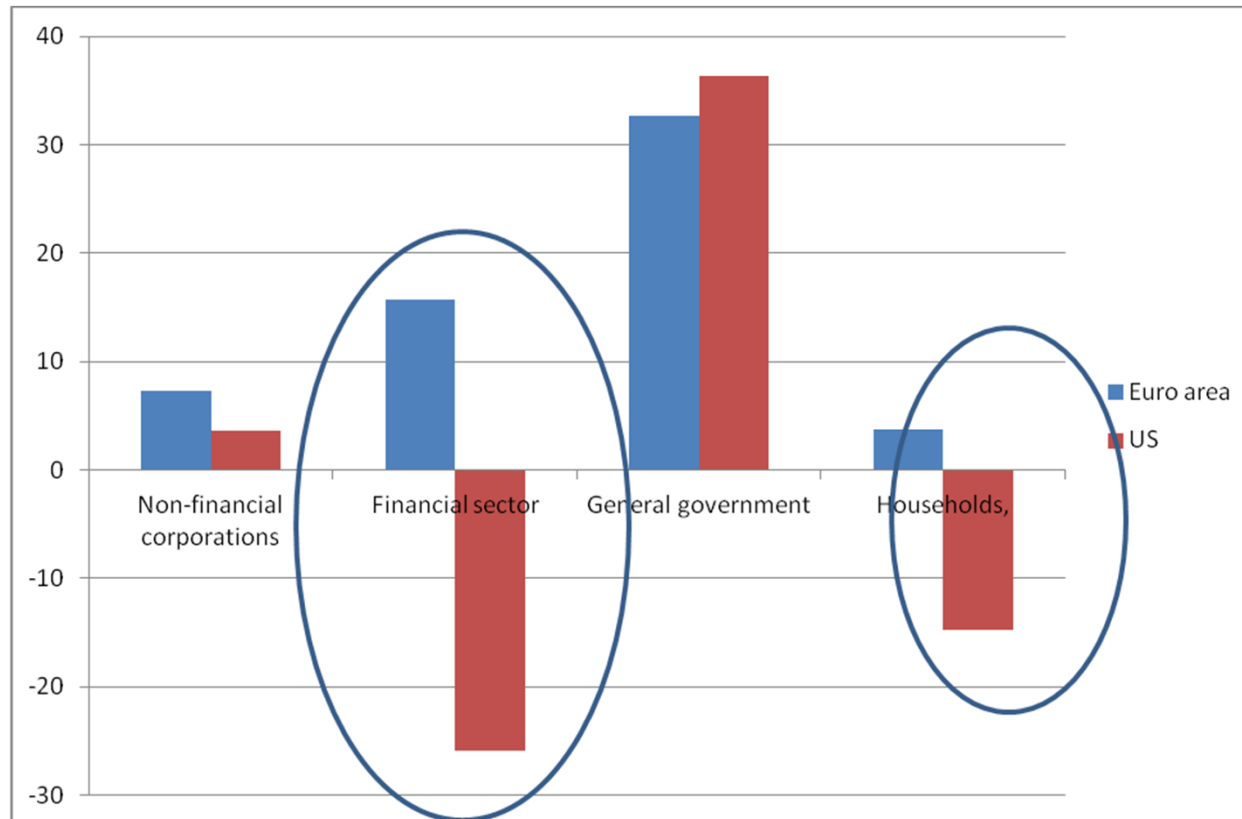
Euro Area leverage: Debt as percentage of GDP

	Non- financial corporations	Financial sector	General government	Households	Total economy
1999	63	64	76	45	248
2007	92	112	69	62	334
2012	99	128	102	65	394
change 1999-2007	29	48	-7	16	86
change 2007-2012	7	+16	33	4	59

US leverage: Debt as percentage of GDP

	Non- financial corporations	Financial sector	General government	Households	Total economy
1999	61	73	53	66	253
2007	76	113	56	96	341
2012	80	87	92	81	340
change 1999-2007	15	41	2	30	88
change 2007-2012	4	-26	36	-15	-1

Comparison of changes in leverage



Why is leverage up in Europe?

- Many individual banks retrench, but inter-bank pyramids (including ECB) seem to grow.
- Bank debt sacrosanct until Cyprus (ECB intervenes in Ireland, Austria, etc.).
- Fear of 'Lehman II' now overcome?
- Defense of national champions (sometimes regional ones (Germany)).
- DG Comp only defender of market principles.



Banking Union: Can it help?

Yes

- SSM (SRM) should be less beholden to special interests as EU level institutions are further from political interests (organized at national level).
- Heterogeneity of economic and political conditions protects ECB/Commission. Example role of DG Comp in Spain and elsewhere.
- Supervisory barriers against intra area cross border flows diminished (?).

But quick deleveraging unlikely

This is a problem:

- Debt service capacity has fallen (and more dispersed across Member States) – both for some sovereigns and corporate sectors.
- => Increases likelihood of widespread insolvencies, making banking system more fragile.

Debt servicing capacity: the non financial sector

	Boom (until 2008)	Bust (since 2008)	Change
EA	-0.3	-2.7	-2.4
DE	-2.1	-2.1	0.0
ES	3.6	-3.9	-7.5
IT	-0.7	-3.6	-2.8

Europe's conundrum

- Bad debt dynamics combine with bad demography.
- Can structural reforms deliver more growth (improving debt dynamics)?
- The solution is not in Brussels (EU 2020).

Is EU 2020 sufficient (to revitalize Europe?)

	R&D Expenditure per GDP in %	Employment Rate in %	Tertiary Education in %	Early School Leavers in %
Benchmark 2020	3	75	40	10
EU-27	2.0	68.6	35.8	13.5
Japan	3.4	74.5	56*	***
US	2.9	70.4	41*	20***

If you wonder where the Euro Area is going....

Look at Japan today!

- Similarities:
 - ageing population,
 - current account surplus,
 - weak internal demand.
 - Oversized banking system!

Europe's most likely future: Stability in Stagnation

- Stability (of euro) seems assured as periphery turns into current account surplus.
- But stability breeds complacency:
- External surpluses allow governments to protect national champions and thus prevent financial system from shrinking.
- Continuing debt overhang limits growth below a potential that is diminishing due to population decline.

Stable stagnation difficult to overcome

- Stability is considered success.
- Decline in living standards gradual.
- Decline in global influence also gradual, but much more rapid as emerging markets continue to grow.
- By 2030 euro area same weight in global economy as Japan now (less than 10 %)?