SPECIAL ANALYSIS

EU Office | February 2016

Have we rid ourselves of the causes of the crisis? Indebtedness in the EU

Vít Macháček

EU Office

ERSTE
Corporate Banking

Introduction

The topic of indebtedness resonates in the media. It isn't, however, only in connection with the financial crisis convulsing Greece – debt is the prime mover in the onset of the entire financial crisis. The economic crisis has severely affected not only member states, but also other economic entities in general.

Economists don't agree on how to respond to the financial crisis that has affected Euro-Atlantic civilisation over the last decade, but they quite clearly agree on its causes – the accumulation of debt in various forms. Seven years have already elapsed since the collapse of Lehman Brothers and the beginning of the economic crisis, and the European Union as a whole has perhaps finally returned to long-term sustainable economic growth. Let's therefore use this opportunity for a recapitulation and look at how the European Union has managed to come to terms with increasing debt and its individual segments.

Since the end of the economic crisis indebtedness in the European Union has not declined and has even increased slightly. Public debt has quite significantly increased, although debt has slightly declined among businesses. It is important, however, to understand the large structural differences – debt in the EU is concentrated primarily in the West, while the Eastern states are not affected so much.

The new member states are doing well from this point of view (with the exception of Cyprus). The difference is noticeable in all sectors, although the biggest difference is in the least indebted financial sector. The Czech Republic is in relation to GDP the fifth least indebted country in the EU. The amount of debt is lower in all sectors, but it's especially noticeable in the financial sector.

Czech entities together owe 159% of GDP, which when calculated per person is around EUR 23,000. Two-thirds of this amount is distributed among the public sector and non-finance businesses, while the rest is evenly split between households and financial institutions.

Debt is a natural and necessary part of any market economy – according to some theories money actually originated as a means of recording debt. On the other hand, however, debt always arouses great controversy because its effects (especially with increasing levels) may easily go into reverse and turn against its owner.

According to the economist Hyman Minsky, debt is the main reason for the existence of the economic cycle – with how the indebtedness of an economy, companies, governments and households grows and competition in the financial sector increases.

Investment begins to flow into riskier projects for this reason until at some point debt it increases to an unsustainable level. At that point a corrective mechanism comes into play in the form of an economic downturn, which should logically be accompanied by a "deleveraging" of the economy, i.e. the decline of overall indebtedness. The question therefore is how this "deleveraging" can be undertaken, but that would be for an independent study.

Overall indebtedness is calculated in this report on the basis of Eurostat data in the form of detailed balance sheets in various sectors.

All liabilities denominated as loans and issued debt instruments are calculated as debt. All countries of the European 28 were included in the analysis.

The European Union has failed to get out of debt

One would expect that states would learn from the adverse developments in countries where the International Monetary Fund has had to intervene with financial injections. Unfortunately, it appears that overall indebtedness in the EU is not declining – total debt at present is approximately four times European GDP.

In comparison with debt in 2009, i.e. immediately after the outbreak of the economic crisis, it had grown by 15 percentage points by 2014. Austerity measures in the EU as a whole did not lead to a decline in debt.

Debt in the EU is growing in the state sector in particular – while the amount of government debt per GDP was less than 60% in 2007, by 2014 it had already exceeded the magical 100% threshold. The only sector where the amount of debt declined throughout the whole Union - the "deleveraging" that took place was the one which in comparison with its size is the least significant – was household debt.

But not even this decline was especially substantial – while households borrowed 68% of European GDP in 2009, in 2014 it was 64%.

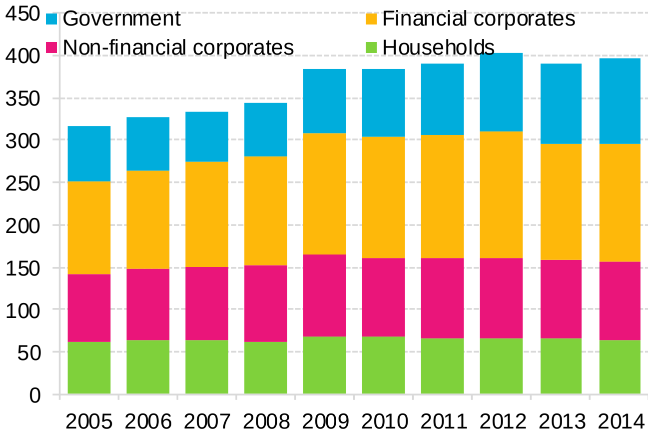
In absolute terms, household debt has in practice stagnated, so the relative fall tends to correspond to growth in GDP. The trend in other sectors – i.e. non-financial and financial enterprises – is not clear.

While debt grew slightly in the years immediately after the crisis, since 2013 it appears that it has been very slowly declining.

The situation looks even more unsatisfactory if we compare current indebtedness with the only the pre-crisis period.

The massive indebtedness on both sides of the Atlantic (especially in the financial sector) which led to the open outbreak of crisis had been simmering away for some time under the surface.

Development of indebtness in the EU (% of GDP)



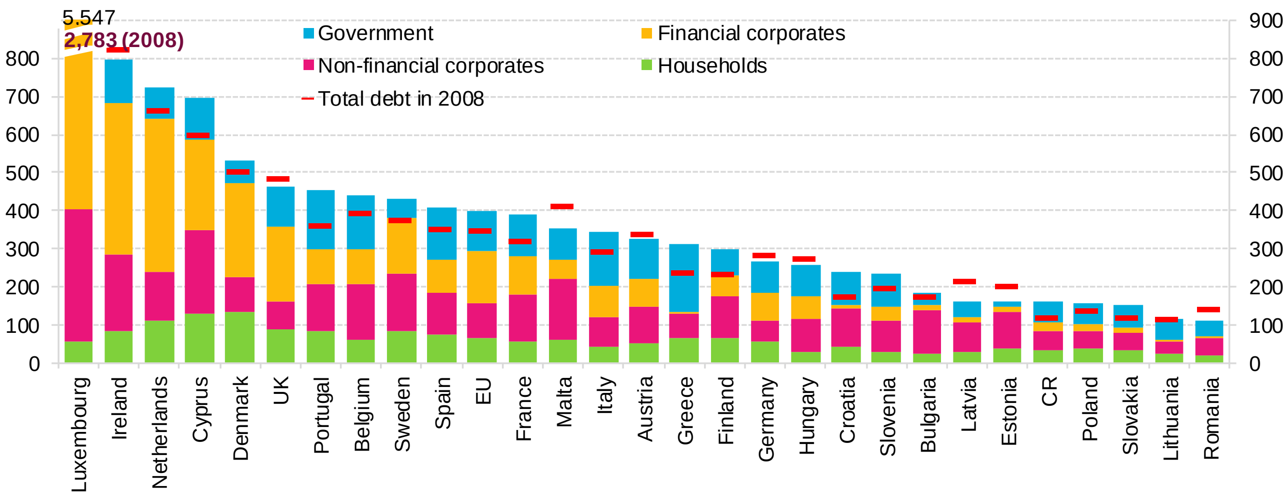
Source: Eurostat

In comparison with 2005, European Union debt has grown in relation to GDP by 80 percentage points to a total of nearly 400% GDP.

By far the greatest part of the additional debt is state debt, followed by the debt of financial corporations. Households and non-financial enterprises have also accounted for a moderate growth in their debt to GDP.

Winners and losers

Debt structure in the EU member states in 2014 (%of GDP)



Source: Eurostat; the total debt in 2008 shown for comparison

Looking at the results clearly shows that the countries of “old Europe” are significantly more indebted. Clearly the most indebted EU country is Luxembourg, which incredibly “owes” 55-times its own GDP. More than 90% of this amount has been generated by the financial sector – thanks to its tax system, Luxembourg attracts financial houses from all over the world.

West Europe is clearly more indebted – more than 500% of GDP is owed by Ireland, the Netherlands, Great Britain and Denmark. At the other end of the rankings, on the other hand, are almost exclusively new member states.

The only exception is Cyprus, which owes seven-times its own annual product. Least indebted Romania owes approximately as much as it produces in one year.

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What is interesting is that the Romanian financial sector is practically debt-free – financial debt represents less than 5% of GDP. Apart from Romania, the other end of the rankings are occupied by practically the entire CEE region. Lithuania, Slovakia, Poland, the Czech Republic, Estonia and Latvia have debt that is less than 200% of GDP. Slovenia, Hungary and Croatia have exceeded this threshold, but nevertheless the European Union average is still twice as much in comparison.

The least indebted states of Western Europe – Germany and Finland – owe less than 300% of their GDP. Greece's situation may be surprising for some – in terms of total indebtedness it is the third least indebted country of the old European 15, albeit with significantly higher public debt.

It's important not to lump them all together – there are large differences in individual states and in the dynamics of debt. Nine member states managed to reduce their indebtedness. The record-holder is Malta, which since 2008 has reduced debt by 60 percentage points to 350% of its GDP.

Remarkable success can be seen in the Baltic states which were heavily affected by the crisis and a sudden outflow of capital. Yet both Estonia and Latvia managed to reduce their indebtedness by more than 40 percentage points of GDP.

Success in this area can also be attributed to Romania, Ireland and Great Britain. On the other hand, 19 European Union member states have failed to reduce their debt and in 17 of them it has even increased by more than 20 percentage points. An alarming example is Luxembourg, whose financial debt has ballooned and total indebtedness has increased by 27-times its GDP. For the other countries the changes have not been so dramatic – the second greatest indebtedness affects Cyprus which increased its debt by 100 percentage points, while Portugal and Greece have deteriorated by more than 90 and 75 percentage points respectively.

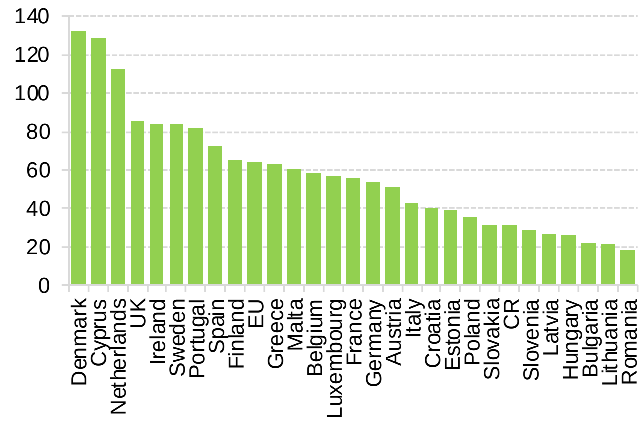
France has also been very badly hit – one of the largest European economies has increased its debt by more than 70 percentage points to its present 390% of GDP. But this is still under the European Union average.

Household debt

The smallest contribution to overall debt in the EU comes from the household sector – in 2014 household debt was around 15% of total debt. Household debt in particular includes mortgages, credit cards and other forms of consumer loans. As in the case of overall indebtedness, household debt is significantly higher in original member countries than in the new member states (again with the honourable exception of Cyprus).

Household debt is the most stable of all the sectors – in the pre-crisis period households owed just over 62% of GDP. Thanks to the turbulence on the financial markets the debt climbed in the short-term to 68% in 2009. Since then, household debt has slowly returned to 64% - here we can speak of deleveraging.

Household debt in 2014 (% of GDP)



Source: Eurostat

The most indebted countries from a household point of view is Denmark, whose households owe approximately 1.3x the Danish GDP. Analysis of the Danish Central Bank, however, shows that Danish debt is concentrated in the hands of households with the highest income and does not represent such a high risk for macroeconomic stability. Following in Denmark's wake is Cyprus, which has long basked in the role of the financial gateway to the EU, but has recently been hit. Household debt in the Netherlands is also more than 100% of its GDP. The position of the least indebted households in Europe is occupied by Romania, where households owe a mere 18% of GDP.

All Central European and East European countries have debt below 40% GDP.

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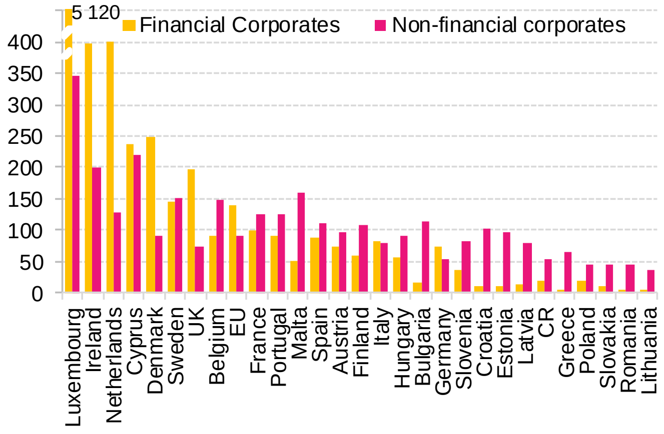
Corporate debt

We analysed corporate finance in two sectors – in financial institutions and businesses that don't focus on finance and only use if for realising their investments.

For businesses it concerns loans from banks and the value of bonds issued. In the case of financial institutions it concerns liabilities on the interbank market and toward other institutions, as well as issued bonds. Last year corporate debt totalled nearly 60% of all indebtedness, of which two-thirds comprised financial sector debt.

The most indebted European Union country from the point of view of corporations is Luxembourg, whose indebtedness is so high that it ranks first in terms of overall debt.

Corporate debt in 2014 (% of GDP)



Source: Eurostat; ordered by the sum of both indicators

Thanks to its legislative environment, which attracts financial institutions, its indebtedness at 40-times its GDP is truly astronomic.

Its overexposure to the financial sector has paid off for Luxembourg so far – Luxembourg's economic performance was not affected by the crisis more than other states with lower exposure. Nevertheless, what didn't happen, can – since 2010 Luxembourg's enormous exposure to the financial sector has doubled.

The next state in line is Ireland, which is well known for its financial adventures. Cyprus completes the picture in third place.

The least indebted is the banking sector in Latvia and Romania where financial institutions contribute less than 5% to the total debt.

In terms of non-financial corporations the situation is very similar – the most indebted are businesses in Luxembourg, Cyprus and Ireland; businesses in these countries owe more than 200% of GDP.

Non-financial businesses are also more indebted in Western Europe than in the East, although the differences are not so gaping.

While financial institution debt in the majority of Western European countries significantly exceeds the debt of other businesses, in the new member states the opposite is true.

Debt financing is needed in all countries, but the financial sector has significantly evolved from a certain level of development.

Public debt

Public debt is heavily publicised in the media and there's a reason for this – it's the fastest growing of all the sectors. While state budgets owed less than 60% of European GDP in 2007, in 2014 the magical threshold of 100% had already been exceeded. nAfter a mere seven years, states became more indebted by more than a half – and at a time when nearly all European states had undertaken more or less strict austerity measures. Austerity policies have proved unsuccessful and probably nobody can reliably answer the question what policies would lead to greater success. The most indebted public budget in the European Union is in Greece.

Irresponsible fiscal policies in the period prior to the crisis and inappropriately designed austerity measures didn't lead to a reduction in the Greek debt, but rather the opposite – state debt accelerated and in 2014 it reached nearly 180% of GDP, which is half as much again as before the crisis. The other "victors" are also well-known – in second place is Portugal where debt exceeds 150% of GDP, and Italy, which is slightly below the same threshold. It may be surprising for some that Belgium, which isn't greatly talked about as an indebted state, owes 140% of domestic product in public debt.

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Politicians, however, should be praised – the least indebted country in the EU is Estonia, whose government apparently refused to enrich the present generation at the expense of the future. The Estonian public budget owes only 12% of its GDP. However, Estonia tends to be the exception that proves the rule – only Luxembourg (25% of GDP) and Bulgaria (29% of GDP) come under the 40% GDP threshold.

The Czech Republic

The Czech Republic certainly belongs among the least indebted countries in the European Union – total debt is just over one-third of the average European Union debt – thanks to this the Czech Republic is the fifth least indebted country in the EU. The indebtedness of the Czech Republic, however, is growing more quickly than European Union indebtedness. While overall debt in the European Union increased by a quarter, in the Czech Republic it jumped by more than a half. In 2014, overall debt was thus a total 159% of Czech GDP. In absolute numbers, the Czech economy has accumulated EUR 245 billion in debt, which corresponds approximately to EUR 23,000 per person. This doesn't mean that each individual would owe so much – household debt per capita is approximately EUR 4,500, i.e. a little more than CZK 100,000. A third of Czech debt is formed by non-financial businesses and the other two-thirds by government. Financial institution debt in the Czech Republic is in comparison with other countries very small – it constitutes 20% of Czech GDP.

In comparison with the European Union the difference is up to seven-fold – financial debt constitutes the biggest difference between the states of the entire region of Central and Eastern Europe (CEE) – a region represented by the Czech Republic and the European Union. The Czech Republic is also slowly but surely becoming more indebted. Government is becoming indebted the fastest – while the public budget owed less than 30% of GDP in 2005, today this amount exceeds 50%. There is also a noticeable difference with non-financial businesses which have expanded their debt portfolio by 15 percentage points of GDP to today's 53%, and with households where debt has climbed in the same period from 15% to nearly one-third of GDP.

The structure of debt in the Czech Republic and the EU

	CR		per capita	EU		per capita
	2005	2014	2014 (EUR)	2005	2014	2014 (EUR)
Households	17%	20%	4 562	19%	16%	17 735
Non-financial businesses	38%	34%	7 868	25%	23%	25 284
Finance businesses	15%	13%	2 994	35%	35%	38 323
Public debt	29%	34%	7 792	21%	26%	27 941
Total debt	**97% GDP**	**159% GDP**	**23 228**	**317% GDP**	**398% GDP**	**109 282**

Source: Eurostat

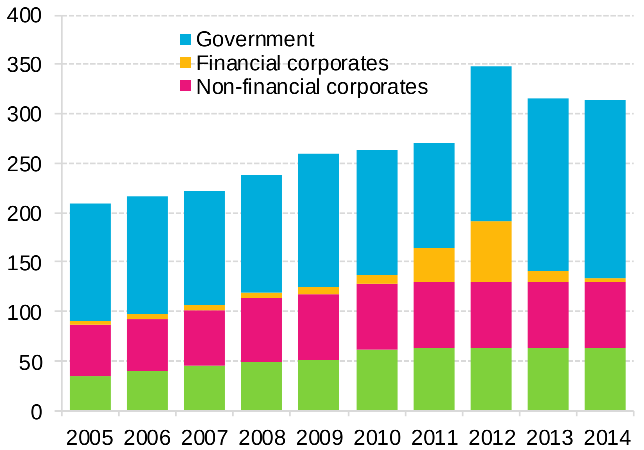
Greece

One can easily get the feeling from reading the news that Greek debt is unrivalled. However, a look at the statistics makes that claim highly relative. In terms of overall debt, the Greeks are in 15th position amoung EU member states, i.e. in the second half.

Overall debt slightly exceeds three-times its GDP, but this is still less than the EU average. Greece suffers from high public debt which is the biggest in the EU, but if we look at total private debt, then it's only slightly higher than the Czech Republic.

Like the Czech Republic, debt is gradually increasing. This also appeared in Greece in the past as a problem with the high indebtedness of the

Indebtness in Greece (% of GDP)



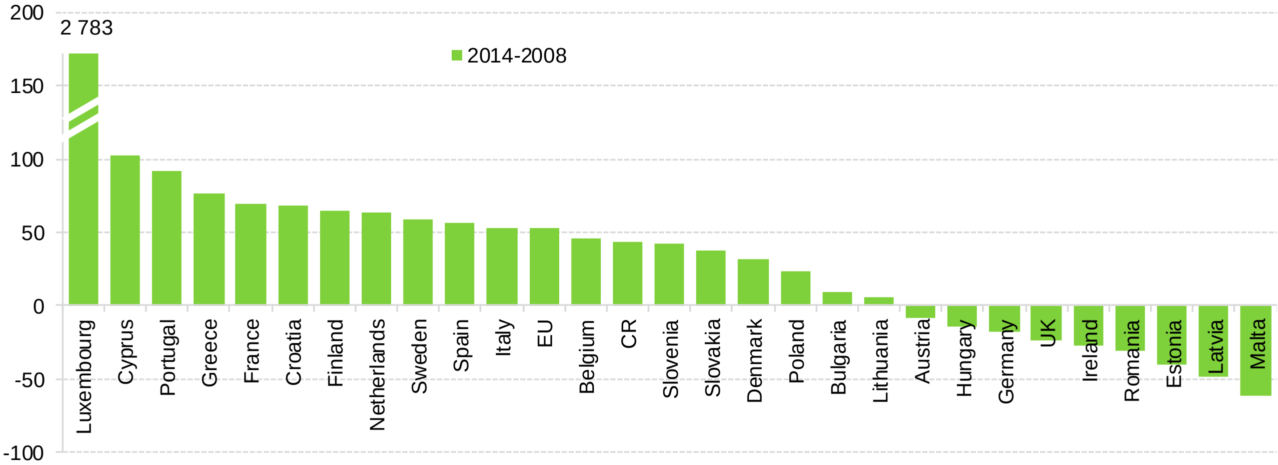
Source: Eurostat

financial sector, which was full of “toxic” assets, and Greek banks thus had trouble repaying their liabilities. At the time it culminated in 2012 it had reached 60% of GDP. But then a one-off restructuring took place and financial debt dramatically declined to less than 5% in 2014. Even during the period of the worst debt, however, the overall debt in Greece didn’t exceed the European Union average, but was rather far below it. Greece suffers from a huge debt burden in its state budget. This debt, however, can’t be transferred en bloc to all Greeks, otherwise the rest of Greece is relatively conservative regarding their debts.

Conclusion

According to many classical macroeconomic variables, we are already out of the crisis. The European Union as a whole is growing and according to preliminary indicators it appears that the wheels of the economy were turning very well in 2015. Nevertheless, in terms of debt, we haven’t got very far since the crisis erupted. There are essentially two ways to get rid of debt – one is to get rich and thus reduce debt in a relative sense, and the second is to adopt radical austerity measures. It appears that we’ve tried to find a third way in the European Union – apply the brakes a bit, but not too much so that we don’t overly hurt anyone. Politically, it’s totally understandable and in a certain sense it’s the maximum possible. Unfortunately, it has been shown that such a compromise doesn’t work. In macroeconomic reality these views are complicated – when the brakes were applied in Europe, the economy nearly came to a halt, but debt conversely began to rise. Ultimately, however, it appears that we’re out of the worst and the economy is again beginning to produce, innovate and employ. This growth should be used to repay debt from recent years.

The change in total debt between 2008 and 2014



Source: Eurostat

EU OFFICE / KNOWLEDGE CENTRE - Česká spořitelna, a.s.
Budějovická 1518/13a, 140 00 Praha 4
tel.: +420 956 718 012
e-mail: eu_office@csas.cz
http://www.csas.cz/eu

Tomáš Kozelský – manager
e-mail: tkozelsky@csas.cz
tel.: +420 956 718 013

Jan Jedlička
e-mail: jjedlicka@csas.cz
tel.: +420 956 718 014

Tereza Hrtúsová
e-mail: thrtusova@csas.cz
tel.: +420 956 718 012

Max Wandler
e-mail: mwandler@csas.cz
tel.: +420 956 714 291

Radek Novák
e-mail: radeknovak@csas.cz
tel.: +420 956 718 015