Public and Private Debt

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Introduction and summary

Some countries in the Eurozone are currently labouring under a mountain of debt, mostly private; the increase in public debt results largely from the recession caused by a bubble in the housing sector.[1] Rising debt is forcing governments to implement large budget cuts quickly, which risks not only hindering growth, but also hurts vulnerable segments of society. The purpose of this note is to show how excessive debt is created by a bubble, the policy choices involved in its reduction and their consequences, and what could be done, not so much to get out of the current crisis as to avoid future ones, or alleviate their effects. Reference shall be made to the case of the Eurozone, and in particular to that of Spain, whose large external position has often been seen as precarious. In describing the consequencies of the bursting of a bubble, we shall disregard, for the sake of simplicity, most of the many positive feedback loops that one encounters at every stage, within the banking sector as well as between the financial sector and output end employment; one should of course not forget that it is just the presence of such loops -'downward spirals' in popular terms- that makes bubbles so dangerous.

Bubbles and debt

Debt is the unavoidable result of the bursting of a bubble. A bubble originates in the market of an asset, whose price rises as a result of an increase in demand not matched by a rise in supply. As the upward price trend continues, the asset is bought on the expectation of a future capital gain; purchases are made on credit, thus involving the financial sector. Bank balance sheets carry an increasing amount of loans to speculators, often with the asset as collateral. As the expectations of ever rising prices wane, the market becomes vulnerable: at the smallest piece of bad news, asset prices begin to fall; forced sales by debtors unable to repay their loans or by bank creditors selling collateral will further depress the price of the asset, and force banks to reduce their balance sheets by contracting the volume of their loans; the

[1] Greece is an exception: its debt is the result of excessive public spending.

end result will be the credit crunch which is one of the most damaging effects of a bubble[2]. On the other hand, if assets melt, debt does not: *"As the boom collapses, the fundamental problem facing the economy is one of excessive divergence between the debts incurred to purchase assets and the cash flows generated by them*"[3].

As the excessive debt loses value through worsening expectations, banks' balance sheets deteriorate, and are forced to reduce credit. The credit crunch, through several channels, some reinforcing one another, will depress growth and raise unemployment; the magnitude of that effect, that is, the main damage caused by the bubble, will depend, first, on the weight that the financing of the asset object of the bubble has in banks' portfolio; second, on the weight of the asset itself in households' wealth; third, on the amount of debt contracted by households to purchase the asset during the boom. The combination of these three factors explains why a housing bubble is especially severe, and often leads to a recession. A fourth factor makes it worse: the fact that the asset, housing, requires for its production real resources, capital and labour, which will be laid off during the bust.[4]

From private to public

The recession itself, through the action of the automatic stabilizers, worsens the fiscal position: revenues fall due to decreasing activity, expenditures rise due to higher unemployment claims. If, as was the case during 2008-2009, Governments try to substitute temporarily public for private spending, for instance by launching public works programs, the public deficit increases further. If the stimulus does not suffice, and the economy remains flat or contracts, the end result is, not only a higher volume of public debt, but a rise in the debt-to-GDP ratio, which is often taken by investors as a rough indicator of the financial health of the country. Governments are then asked by investors to return to fiscal balance by reducing the public deficit deficit. This must needs be attempted by cutting expenditures, which reduces aggregate demand and growth. In the last loop of the process, rising debt and poor growth prospects erode investors' confidence, raise the cost of financing any new public debt, worsen the prospects of its ever being paid back and force further budget cuts. Investors think

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[2] This is a simplified version of MINSKY' description. S. C.P. KINDLEBERGER, *Manias, Panics and Crises* (1996), Ch. 2.

[3] KEEN, S.: Instability in financial Markets: Sources and Remedies, paper presented at the INET Conference, Berlin, April 12-14, 2012.

[4] Two other factors in the 2007 crisis: the bubble was financed through opaque instruments, and in an integrated capital market.

either that the deficit is excessive, or that growth is too little. In this way, excessive private debt ends up generating excessive public debt.

Alternative strategies

Faced with the danger of a recession, following the bursting of a bubble, the choice made by the authorities lies somewhere between two extremes: the first consists in addressing directly the credit crunch and, restablishing the flow of credit, avoid a collapse of private demand, consumption and especially investment. The second, in replacing temporarily failing private demand by public spending, maintaining aggregate demand through the multiplier effect, and hoping that banks will restore their balance sheets through the flow of current profits. The first strategy in turn has two levels: if the bubble is not too big, the crisis will be one of liquidity, which the central bank can solve in its role as lender of last resort. If the crisis is more serious, it becomes one of solvency: in this case, credit can only be restored if some at least of the banks are closed or nationalized; or, alternatively, if their dubious assets are exchanged for public debt, so that lending can be resumed (the ‘bad bank’ solution). It should be noted that the ‘bad bank’ strategy is feasible only at an early stage of the crisis, when sovereign debt is still above investors’ suspicion.

The risk of the first strategy is that extensive damage may be wrought on the entire financial system if the number of insolvent entities is large, and if they are indebted to other banks, in which case liquidating any one of them may have a domino effect. Even if the true state of the banks is sound, lack of confidence may provoke runs with which the central bank may be unable to deal. The risk of the second strategy is that the fiscal stimulus may not succeed in reviving the economy before the level of debt generated by public spending becomes too large for investors’ comfort; when that happens, the spiral described above sets in, and the economy enters a path of contracting output and increasing debt. The choice faced by the authorities, under the pressure of time and with limited information, is a difficult one: to leave private debtors to fend for themselves may result in financial collapse, while giving priority to private debt at the expense of public debt may result in an over-indebted public sector and a stagnant economy.

The choice of the Eurozone

All through the crisis, the strategy chosen by the Eurozone has been closer to the first extreme: 'no bank must fail' was taken as a given in all analyses and policy recommendations made to countries in difficulties: the result has been to increase enormously the external public debt of some countries –notably Ireland- and to lead investors to expect that private debt would be fully honoured; this assumption in turn has led investors to equate private and public debt, to compare the resulting amount of public debt with the country's fiscal capacity and to declare the total unsustainable; thus, for the last two years, markets have remained volatile, sometimes because investors thought the deficits too high, and demanded further austerity measures, sometimes because they thought growth prospects to be too low (due to the fiscal contraction) to enable the country to service her debt. Meanwhile, the real economy has remained flat or worse, so that the banks' balance sheets have not improved enough to enable them to restore the flow of credit. As a result, some countries are faced with the need to reduce their deficit through large budget cuts while their economy is contracting, partly as a result of these cuts, while investors doubt that the deficit targets can be reached and are reluctant to continue their lending.[5] Enough has been said to make it clear that the policy choice was always difficult, and it is easy to say, with the benefit of hindsight, that it has proved a failure. But a failure, so far, it has been.

Better regulation is unavoidable

The debt problem faced by the Eurozone is an internal one, since the net external position of the Eurozone as a whole is extremely sound: at around 8,7% of the Eurozone's GDP, it is similar to that of Austria. It is becoming increasingly clear that the debt markets will stabilize when, and only when, the Eurozone's debt is backed, in some form, by the fiscal resources of the Eurozone. It is to be hoped that the ECB's liquidity support suffices to buy the time needed to convince all parties that such a solution is unavoidable (and need not be very harmful).

In order to prevent the next crisis, three things must be kept in mind: first, that crises are a natural feature of a market economy with a developed financial sector; second, that they are extremely harmful; third, that they have their roots, not so much in irresponsible behaviour

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[5] For a summary statement of the Eurozone's fiscal imbalances and external positions, s. CESIfo's *EEAG 2012 Report*, Ch. 2. Estimates of the size of the primary surplus needed to stabilize public debt may be found in CECCHETTI, S.G.: The Future of Public Debt: Prospects and Implications, *BIS Working Paper #300*, March 2010. Growth prospects are provided in the IMF'S latest *WEO*, April 2012.

on the part of the public sector as in the mass of private debt generated by an asset bubble: that it originates with private, not public debt.

Crises are a natural feature of our economy due to the special nature of the banking system. Banks are generators of externalities: in good times, by creating purchasing power out of thin air, they make it possible for entrepreneurs to invest, while only part of their effort is captured by them under the form of profits; but in bad times, by destroying purchasing power, they paralyze the system, and the harm they cause exceeds their losses and affects the entire economy. Externalities are a textbook case of market failure, so that one cannot expect the market to yield a satisfactory result, and, although there are several texbook solutions to the problem, the best one, in the case of the banking system, is proper regulation.

What proper regulation ought to be is the subject of debate, but three features seem to be emerging as essential: first, it should be the province of a single authority, which would be in charge of supervision across the entire eurozone; second, it should cover what are called macro-prudential aspects of banking activity: that is, not only the behaviour of individual entities, but that of the entire system. [6] Third, it should seriously consider the possibility of discouraging individual entities from becoming systemic[7].

Lastly, proper regulation needs independent regulator: as independent from private interests as they are from governments, but which, at the same time, are accountable to, and brought to account by the public[8]. The cases of regulatory failure in the current crisis, at least in a number of countries, are well known.

A citizen's guide

Regulation may be a technical subject, but proper regulation needs popular support to be enacted, since it faces enormous resistances. Everyone needs to keep in mind the following very simple facts: first, crises will recur if proper regulation is not in place. It may be that the scare caused by the current one leads to a period of conservative banking, as happened, for instance, after the Great Depression, but that period will lay the ground for the next bubble[9].

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[6] Individual supervision is indifferent between recapitalization and lower lending, while it is clear that the latter, if adopted by all, leads to a credit crunch.

[7] This is the 'too big to fail' controversy. S. Mervyn KING's speech to Edinburgh business organisations, Oct.20, 2009 and JOHNSON, S. and KWAK,J.: 13 Bankers (2010), passim.

[8] S. BLINDER, A.: *Central Banking in Theory and Practice*, in fine.

[9] This is MINSKY's well-known thesis. S. KEEN, cit.

Second, crises inflict very great harm to everybody, and especially to the most vulnerable segments of society, those most likely to lose their jobs and those most dependent on public support. It is these costs that must be weighed against the possible reduction in profits that may follow the implementation of better regulation.

Third, even in the early stages of a bubble, warnings abound, and they are routinely disregarded, when not actively suppressed[10]. Suppression ought not to be allowed in a free society, and ordinary citizens should try to heed those warnings. In themselves, that is, insofar as they may affect speculators and investors, they may prove to be futile, but an alert [11]public opinion may encourage regulators to take action; for the great profits made by the financial sector in the last decade (it is estimated that forty percent of private profits in the US went to the financial sector) provide a measure of the resistance to be encountered by any attempt at proper regulation. Ordinary citizens should keep in mind a simple rule: extraordinary profits if they exist, carry extraordinary risks, hence are not within everyone's reach. This is the rule for prevention of bubbles, the only way to avoid the losses that follow a bust, and it is by being vigilant that everyone can make a contribution to the better functioning of an economy.

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[10] The classic reference is KINDLEBERGER, *cit.*, 83-86. In the current crisis there are many documented instances of warnings to regulators, as well as to active suppression of unfavourable studies and reports and legislation passed to prevent regulation to proceed.