Presentation notes - Private and public debt

Milan, 4 May 2012

The increase in public and private debt in the decades leading up to the crisis was a widespread phenomenon

- **Total indebtedness rose substantially in most developed economies from 2000 to 2008** (slide 4)**.** In GDP terms, it increased by almost 160% in the UK, over 150% in Spain, 80% in France and 70% in the US (overall, growing more than twice as fast as in the previous decade). There were two outstanding exceptions: Germany and Japan, where the pace of growth slowed (both countries went through a process of excessive debt beforehand).
- **The problem of indebtedness and the composition of this debt that has "over-accumulated" is not the same in all countries** (slide 5). Curiously, Greece does not have a high level of debt: the problem is that most of the debt has been assumed by the public sector. The reverse has occurred in Spain: most of the debt is private and the problem is that experience shows that a large part of this debt is transferred in the end to the public sector.
- **Another feature shared by some of the more highly indebted countries is that a very significant proportion of this debt relates to the property sector**, which experienced an exceptional boom in countries such as Ireland, USA, UK and Spain**.** As a result, house prices shot up in the last decade (slide 6).
- **In some countries, domestic savings have been systematically insufficient to fund investment** (slide 7)**:** year after year, they built up high current account deficits (i.e. they became "recurring" importers of capital). In return, countries with a surplus of savings adopted an increasing role as lenders. For example, in Ireland, Portugal and Spain, when a bank provided a loan to purchase a home, the money used for the finance came mainly from another saver in the EMU, from a country with a current account surplus (Germany, the Netherlands, etc.). Thanks to the efficiency of the EMU capital markets and agents' confidence, these European savings were distributed to whoever needed them, at a very low cost. But this changed with the sovereign crisis, due to the "nationalisation" of capital surpluses in the EMU.

The global deleveraging process has only just begun and it will take time to run its course

- **In global terms, the deleveraging process has only just begun:** in the last two and a half years, total debt with respect to GDP increased in the ten largest economies. The main culprit is the public sector which, in general, will continue to increase its indebtedness in relative GDP terms over the coming years (slide 9).
- **The private sector has made progress in reducing debt** (slide 10), following a traditional pattern of behaviour: historically, it is the private sector (businesses and households) that leads the deleveraging process. Governments start on this process later, when their support for recovery is no longer so necessary.

- McKinsey is performing an analysis of the deleveraging process in three developed economies that experienced a credit boom prior to the 2008 recession: USA, UK and Spain. Of these, **the US private sector has cut its indebtedness most**.
  - The debt of US households has been cut back by almost USD 600,000 million. In disposable income terms, it stood at 114% in 2Q11, 11pp below the high reached in 1Q09. Around two thirds of this reduction occurred through default on mortgages and credit card debt. Moreover, certain similarities can be observed between the current situation in the US and the deleveraging process that occurred in Nordic countries in the 1990s. In the first phase, the private sector deleverages quickly, while government debt rises (to offset the adverse impact on growth of private deleveraging). In the second phase, the economy recovers the rates of growth prior to the crisis and the public sector's solvency begins to improve.
  - On the contrary, in the **UK**, households are continuing to bear excessive levels of debt (which have hardly decreased at all and are above the highest levels recorded in the US, in disposable income terms). Moreover, the financial sector will probably suffer the effects of mortgage debt, which has continued to rise - there is a larger stock of latent repossessions than in the US and the default ratio is expected to rise further.
  - **In Spain**, households have deleveraged only slightly and the Spanish business sector is highly indebted: in GDP terms, twice that of the US and six times more than in Germany.
- **The process to cut debt and establish the bases for sustainable, long-term growth must be simultaneous**. In previous deleveraging processes (Finland and Sweden in the 1990s and South Korea in 1997), economic growth was key for completing a process of cutting back debt in five to seven years. Although the private sector deleverages in the recession, government debt cutbacks only occur once the economy has started to grow again. This is because the main factor behind the increase in debt following a banking crisis is none other than the drop in income from taxes, ahead of the impact of the automatic stabilisers.

Lessons from past episodes of deleveraging

- Historically, **the most common way to solve the problem of excessive debt has been** (see slide 13):
  - **A fiscal consolidation process** (this is the most common one) where all the effort is borne by the borrowers.
  - **With high inflation** (second most commonly observed), transferring part of the costs to the lenders.
  - **Default**, which usually leads to a rapid transfer of a very significant part of the cost to the lenders.
- **GDP growth is very weak or negative in the early years of the deleveraging process and this process takes a long time** (slide 14). Historically, debt in relative GDP terms does not usually drop until two years have passed since the beginning of

the crisis (on average) and, once the debt reduction process has started, it normally lasts between six and eight years. In total, ten years may pass from the beginning of the crisis until the deleveraging process has ended.

Consequences for the immediate future

- In such a delicate situation as the current one, it is foreseeable that (slide 16):
  - The deleveraging process might last even longer than normal. In most of the similar episodes occurring in the past, only one major economy, or a few small economies, were affected (regional or local crises). However, now that the crisis is global and affects most of the major economies, not all economies can deleverage at the same time.
  - Public debt will increase in most major economies (offsetting all or part of the debt cutbacks in the private sector). Otherwise, the recovery could fail.
- Past experience suggests that certain factors help to “soften” the process (slide 17):
  - **A strengthened banking system**. The banking sector in Sweden and Finland was recapitalised, some banks were nationalised and “bad bank” schemes were used to help remove toxic assets. In South Korea, there were mergers and a drastic solution to the toxic asset problem, which helped lending to expand again.
  - **Structural reforms.**
  - **The export sector**. Finland, Sweden and South Korea boosted their economies by increasing exports, largely from the competitive devaluations that were performed. In the current situation, given the global slowdown, this option seems less viable.
  - **Stimulus from private investment**. In general, there is room for private investment to stimulate growth in the short and medium term due to: (i) current low interest rates; (ii) very limited public expenditure; and (iii) the business sector’s liquidity reserves. At least this would be the case for the US and the UK, but not for Spain, where businesses have progress to make in their deleveraging process.
  - **A stabilised housing market**. Currently, the US housing market is beginning to show early signs of turning around after six years of recession. However, in Spain housing is still over-priced and the huge stock of completed buildings is a cause of concern.