Who should bear the cost of deleveraging?[1]

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Introduction

That one of the legacies of the current crisis is a mountain of debt, private slowly becoming public, which is a serious obstacle to growth and employment is a subject which surfaces here and there in comments upon the crisis but is never seriously addressed in public discussion, in spite of the fact that in past crises the debt has never been repaid in its entirety. Furthermore,to the extent that excessive debt may be the main cause of the recessions following a crisis (MIAN and SUFI), it is of interest to think not only of what ought to be done with the current burden of debt, but also of which rules could be implemented in order to reduce the likelihood of excessive debt in the future.

Definitions

Leverage is the ratio of debt to own funds in the liability side of a balance-sheet (B/S). The higher the leverage,the smaller the safety cushion against an impairment on the asset side. A precise “excessive leverage” could be the subject of a separate discussion, we’ll stick to our intuitive meaning in this note.

To de-leverage means to reduce leverage. This can be done in either one of three ways: reducing liabilities, either by repayment or by restructuring, expanding assets and increasing capital.

The notion of leverage is applicable to households, firms and financial institutions alike. It is especially relevant in the case of financial institutions, since the problems caused by excessive leveraging as well as those deriving from forced de-leveraging may affect the entire economy.

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Why de-leverage?

Reducing excessive leverage is meant to reduce the vulnerability of an economy to sudden shocks. It should be recognized that such shocks can come from unexpected sources, especially in a globalized economy; they will affect the asset side of all B/S, and leverage amplifies the effect of such shocks on the economy:

-On households: shocks may affect their B/S directly (housing bubbles) or indirectly, through loss of income from unemployment or wage reductions; the effect, less consumption, will be greater the higher their leverage. The same applies to spending by firms.

-On financial institutions: in response to an impairment of the asset side, Banks may try to reduce their liabilities (deposits), the effect being a credit crunch, the greater the higher the leverage. Fire-sales of assets to restore liquidity positions may compound the effect.

One might say that the problem is one of externalities: neither households nor financial institutions take into account the effects that their own decisions may have on other actors. Such externalities are more visible in the case of financial institutions. Intervention is needed, since the individual optimum leverage will be higher than the social optimum, which takes externalities into account.

Costs of de-leveraging

-The costs of household de-leveraging are sudden and large falls in private consumption as households restore their B/S, with their effects on output and employment. They are borne, in varying degrees, by the entire economy under the form of falls in demand, output and employment.

-The costs for financial institutions differ according to the form the adjustment takes:

-Shrinking B/S: that reduces the flow of credit to the economy (credit crunch). The cost is borne by the entire economy, through less investment and firm failures.

-Raising new capital: the cost is borne by shareholders in the form of dilution, but with the offset of a higher protection against bankruptcy (lower risk).

-Debt restructuring: the cost is borne by creditors, in various forms and different degrees.

It has often been argued, especially by the banking sector, that raising capital ratios (the second way suggested above) would result in a lower volume of more expensive credit for the economy, hence in a credit crunch. The arguments supporting this view have been shown (ADMATI and HELLWIG, ADMATI et al.) not to be very consistent.

Who should bear the costs?

The debt problem is internal to the Eurozone. Current debt ratios are high in some member States. With low growth, de-leveraging means mostly reducing debt. Current financial arrangements put the entire burden of the adjustment on the borrower, household, firm or financial institution. This will severely constrain growth for a long time in the countries concerned, putting them on a knife-edge between recovery and debt-deflation and depression, which in due course will affect growth, to a lesser extent, in the rest of the Eurozone. Thus a better sharing of the burden of debt is desirable for the entire Eurozone, although the degree of desirability for core countries may be, and is, disputed.

The main criterion for apportionment of the burden should be ensuring appropriate growth, which is, after all, the only guarantee of sustained and rapid debt reduction.

-Household debt relief: one should quantify the effect of leverage on consumption (MIAN and SUFI); since consumption is about two-thirds of aggregate demand, one could arrive at the desirable leverage that could ensure a given growth of output. Since a large part of household debt is mortgage debt, debt relief would imply added relief for the banking sector.

-Debt relief to firms: excessive debt has the same effect on business spending as consumption, and a larger immediate effect on employment. Relief should be provided on the same criterion of growth.

-Financial institutions: even though most have undergone substantial adjustment already, and would seem to need, little extra relief,any write-offs from households or firms would impair the asset side of their B/S and on that account they in turn would need help, although here the criterion might be mere sustainability rather than growth.

And who should provide such debt relief?

The answer is inescapable: a fund to which all member countries ought to contribute, in proportion to their financial capabilities. The ECB, by purchasing impaired assets, and thus acting as a “bad bank”, might be the source of funds. Member States would have to contribute to the recapitalization of the Bank at a later stage. All this would need a degree of agreement among member states which does not seem to exist at present.

What would the incentive be for the contributors? To ensure higher growth and more stability for all concerned in the future. There is no question that this may prove a very weak incentive for two reasons: first, symptoms of recovery in the peripheral countries provide an excuse for inaction, although the debt issue remains unsolved); second, in the creditor countries public opinion has been armed with a distorted image of the debtor countries which has made it more hostile than usual to any form of rescue.

Thus the current debt issue may remain unsolved so long as things do not get worse. But in any case legislation must be discussed and passed to ensure that, in the future, debt contracts are less asymmetrical, in such a way that the value of debt does not remain constant under all circumstances but keeps pace with the value of the underlying asset (MIAN and SUFI). This might be a substantial contribution to smoother business cycles in the future.

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