

Economics Group

Special Commentary

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Is There Too Much Debt in the Eurozone?: Part I

Some De-leveraging Has Occurred But Should We Worry?

Executive Summary

In the first report in an upcoming series on debt in the Eurozone we show that the debt-to-GDP ratio in the Eurozone has receded modestly in recent years. However, it probably would be premature to sound the all-clear siren because leverage could rise again if the euro area were to slip into recession. Moreover, the structure of the Eurozone economy makes it more vulnerable than its American counterpart, everything else equal, to a debt crisis in one region of the economy spreading to other regions. In coming weeks, we will drill down into four sectors (non-financial business, financial, government and household), to determine if there is indeed too much debt in the Eurozone.

The Eurozone Has De-Levered Somewhat in Recent Years

In a recent series of reports, we analyzed debt in the U.S. economy, which has risen more than \$16 trillion (a 30% increase) since the end of the Great Recession.¹ But the United States is not the only economy in the world that has experienced an increase in debt over the past decade. As shown in Figure 1, total debt outstanding in the 19 countries that comprise the euro area has risen roughly €10 trillion (also a 30% increase) since 2009. The government sector in the overall Eurozone leads all sectors with the largest increase in debt since 2009 (€4.3 trillion). But debt in the non-financial corporate sector, which is up nearly €3 trillion over the past 10 years, the financial sector (€2.5 trillion) and the household sector (about €850 billion) has increased as well.

Debt in the Eurozone has risen roughly €10 trillion since 2009.

Figure 1

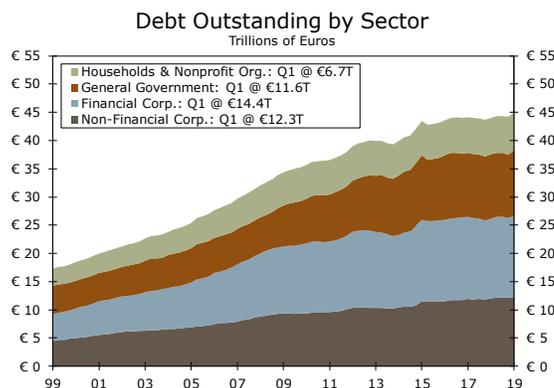
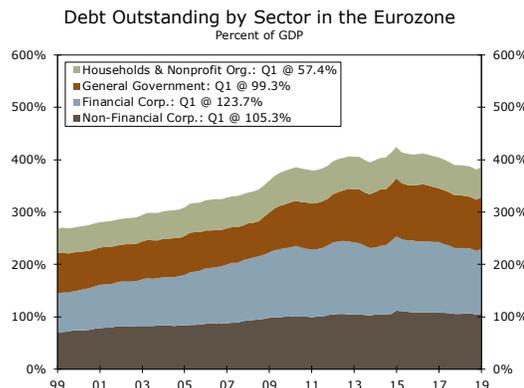


Figure 2



Source: Eurostat and Wells Fargo Securities

¹ See "Should We Worry About American Debt?" This series of seven reports is posted at www.wellsfargo.com/economics or is available upon request.



The overall euro area has de-levered somewhat in recent years.

As we noted in our series on American debt, the ability of an economy to service debt is directly related to its size, everything else equal. In that regard, the overall debt-to-GDP ratio in the Eurozone has receded to 385% today from its peak of 424% in early 2015. In other words, the overall euro area has de-levered somewhat in recent years just as the United States has done. The financial sector, where the debt-to-GDP ratio is 18 percentage points lower than it was in 2015, has accounted for nearly one-half of the de-leveraging in the euro area, although comparable ratios in the other three sectors are also lower today than they were four years ago.

But is the Eurozone Still Vulnerable to a Debt Crisis?

That said, debt-to-GDP ratios in each of the major sectors of the economy are significantly higher today than they were when the European Monetary Union was launched in 1999. Indeed, it was the sharp build-up in debt in the euro area, especially in the government sector, that led to the European sovereign debt crisis in the early years of this decade. The overall Eurozone experienced a modest recession in late 2011 through early 2013 due, at least in part, to the financial tensions that arose out of that episode. So-called “peripheral” countries (e.g., Greece, Italy, Portugal and Spain) suffered through deep downturns during that period.

Fast forward a few years. Economic growth in the euro area is looking a bit fragile again, and some observers are worried about a potential recession. If recession were to occur, then debt-to-GDP ratios could start to climb again, at least in some countries. Could renewed concerns about debt, and the financial market volatility that accompanies it, start to rear its head again?

The structure of the Eurozone economy makes it more vulnerable to a debt crisis than the U.S. economy.

Not only are there some concerns about a renewed build-up in debt in the event of recession, but the structure of the Eurozone economy makes it more vulnerable to a debt crisis than the U.S. economy, everything else equal. Financial institutions in the United States are backed by the financial resources of the U.S. government. If a bank in, say, California failed, then the bank’s depositors would be indemnified by the Federal Deposit Insurance Corporation (FDIC). The failure of that California bank would not necessarily imply trouble for other American banks. But German banks are essentially backed solely by the German government, banks in Italy are essentially backed solely by the Italian government, etc. Some financial institutions in Europe are more or less equivalent in size to their American counterparts, but the financial resources available to their respective national governments are significantly smaller than the financial firepower of the U.S. government. Therefore, a debt crisis in, say, Italy could potentially bring down a number of Italian banks, which could then lead to financial crises in other Eurozone economies due to the extensive financial and economic ties that exist among individual economies in the euro area.

Consequently, we need to look at debt in each individual country to ascertain whether any Eurozone-wide vulnerabilities exist. As shown in Figure 3, the Netherlands currently has the highest debt-to-GDP ratio among individual economies in the euro area.² Countries in which overall debt-to-GDP ratios exceed the Eurozone aggregate of 383% include Ireland, Cyprus, Belgium and France. At the other end of the spectrum, the Baltic countries of Lithuania, Estonia and Latvia have debt-to-GDP ratios that are significantly below the Eurozone aggregate.

However, the highly indebted economies noted above generally have de-levered the most over the past few years. For example, the debt-to-GDP ratio in Ireland, which is the second most highly leveraged economy in the euro area, has receded more than 300 percentage points since Q1-2015 (Figure 4). Some of this decline in the Irish debt-to-GDP ratio reflects strong economic growth in Ireland in recent years.³ But the Irish non-financial business sector, household sector and government sector have also reduced their respective amounts of outstanding debt over that period. Debt-to-GDP ratios in Cyprus, the Netherlands, Portugal, Slovenia, Malta, Spain, Italy and Belgium

² We exclude Luxembourg because its eye-popping debt-to-GDP ratio in excess of 7000% blows out the scales in our charts. However, the ratio is inflated by the tiny size of the Luxembourg economy, which totaled only €58 billion in 2018.

³ The 335 percentage point decline in the overall debt-to-GDP ratio in Ireland overstates the amount of de-leveraging that has occurred in that economy. There was a structural break in Irish GDP data that caused a one-off 30% jump in the level of Irish GDP in Q1-2015. That said, nominal GDP growth in Ireland grew in excess of 6% per annum on average between 2016 and 2018, placing Ireland among the fastest growing economies in the euro area.

have also receded in recent years. On the other hand, the ratios in Finland and Slovakia, which are below the Eurozone aggregate at present (Figure 3), have edged up a bit since 2015.

Figure 3

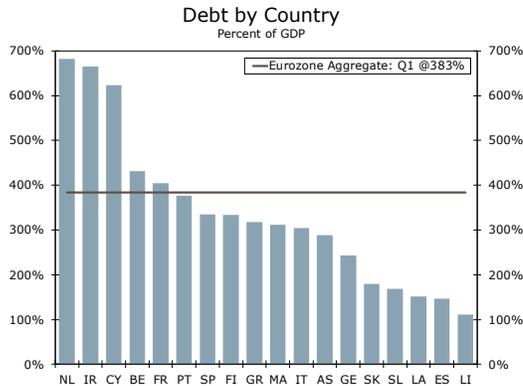
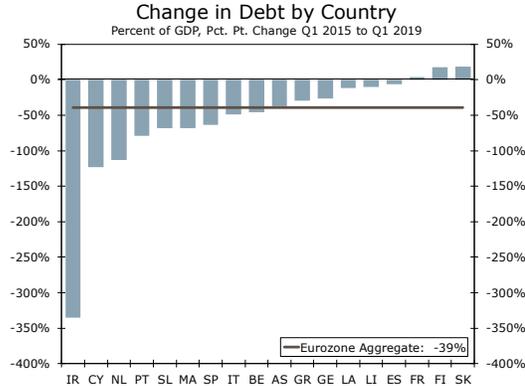


Figure 4



Source: Eurostat and Wells Fargo Securities

Nevertheless, de-leveraging in the Eurozone has been underway for only a few years. As noted previously, debt-to-GDP ratios for most countries and most sectors in the euro area are significantly higher today than they were prior to the advent of the global financial crisis. So the title of this series of reports—“Is There Too Much Debt in the Eurozone?”—still appears to be valid. In coming weeks we will drill down into individual sectors, not only for the overall euro area but also for individual economies, to determine if there is indeed too much debt in the Eurozone.

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