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Economics Group

Special Commentary

Jay H. Bryson, Acting Chief Economist
jay.bryson@wellsfargo.com • (704) 410-3274
Michael Pugliese, Economist
michael.d.pugliese@wellsfargo.com • (212) 214-5058
Hop Mathews, Economic Analyst
hop.mathews@wellsfargo.com • (704) 383-5312

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

NFC Sector Not Quite as Weak as It Was a Few Years Ago

Executive Summary

The combination of increasing leverage in the non-financial corporate (NFC) sector and rising interest rates led to a deterioration in the debt servicing abilities of many non-financial businesses in the years leading up to the global financial crisis. Although the financial health of the NFC sector has improved in recent years, it is not as robust as it was at the launch of the European Monetary Union (EMU) in 1999. Although we do not believe that debt-servicing issues in the NFC sector will be the catalyst for the next recession in the Eurozone, a downturn, should one occur, would weaken growth in net income, thereby impairing the debt-servicing capabilities of some non-financial businesses. The resulting financial strains in the NFC sector could deepen any recession in the euro area.

NFC's financial health is good, but not quite back to 1999 level.

The NFC Sector Has De-levered Modestly in Recent Years

In this our third installment in a series of reports on debt in the Eurozone, we focus on the debt of the NFC sector.[1] Total NFC debt in the euro area trended up to more than €12 trillion in early 2019 from €4.5 trillion at the advent of European Monetary Union (EMU) in 1999 (Figure 1). Although the corporate bond market in the Eurozone has increased in size over the past two decades, loans still account for the vast majority of the outstanding NFC debt in the euro area. Unlike the United States, where corporate bonds account for more than 40% of business sector debt, the Eurozone remains largely a bank-financed economy.[2]

But as we have noted on numerous occasions in previous reports, it is not the absolute amount of debt that matters as much as debt scaled by some other variable. In that regard, the debt-to-GDP ratio among non-financial businesses in the Eurozone rose to more than 110% in 2015 from 70% in 1999, although it has receded modestly over the past few years (Figure 2). Measuring NFC debt as a percent of gross operating surplus, which we use as a measure of corporate income, reveals a similar portrait. That is, the NFC sector in the euro area has de-levered modestly over the past few years, although it is more levered today than it was prior to the global financial crisis.

NFC debt-to-GDP in the euro area is higher than in the U.S., but not an outlier.

As a point of reference, the NFC debt-to-GDP ratio in the Eurozone has historically been higher than the comparable ratio in the United States, which currently stands at roughly 75%. That said, the ratio for the overall euro area is by no means an outlier among large economies. Canada and Switzerland have NFC debt-to-GDP ratios that are roughly similar to the Eurozone's ratio of 105%, whereas the ratios in China and Sweden each currently stand at roughly 160%.

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[1] We provided a high level overview of total debt in the euro area in our first report, and we drilled down into the debt of the household sector in our second report.
[2] Non-corporate businesses, which tend to be smaller enterprises, are financed largely by bank loans in the United States. But bonds account for roughly two-thirds of the debt financing of American non-financial corporations.

Figure 1

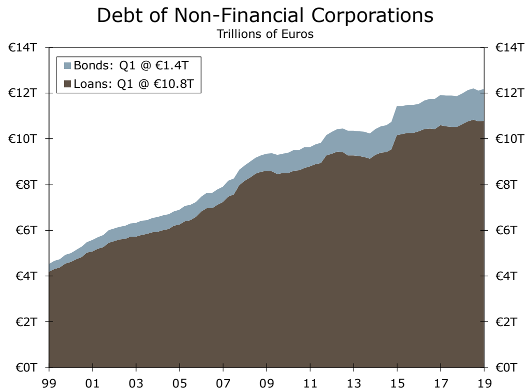
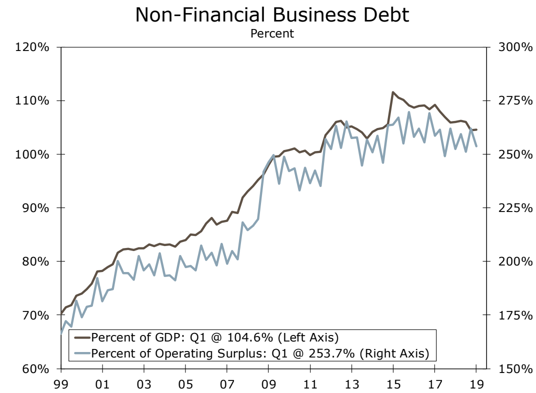


Figure 2



Source: Eurostat and Wells Fargo Securities

The Eurozone aggregate masks the differences between each country.

The aggregate NFC debt-to-GDP ratio for the Eurozone masks some significant differences among the 19 individual economies that comprise the euro area. Luxembourg, Ireland and Cyprus' ratios are at the upper end of the spectrum (Figure 3). That said there are some special factors that push up these ratios and, moreover, none of these countries rank among the largest economies in the euro area.[3] NFC debt crises in Luxembourg, Ireland and Cyprus, should they occur, likely would not have a meaningful effect on the overall Eurozone economy, let alone the global economy. Large economies that have NFC debt-to-GDP ratios in excess of the Eurozone aggregate include France, which is the bloc's second largest economy, the Netherlands (5th largest) and Belgium (6th largest). On the other hand, Spain (4th largest) and Italy's (3rd largest) ratios are below the Eurozone average. The ratio in Germany, which is the largest economy in the euro area, is about one-half the size of the Eurozone aggregate.

Figure 3

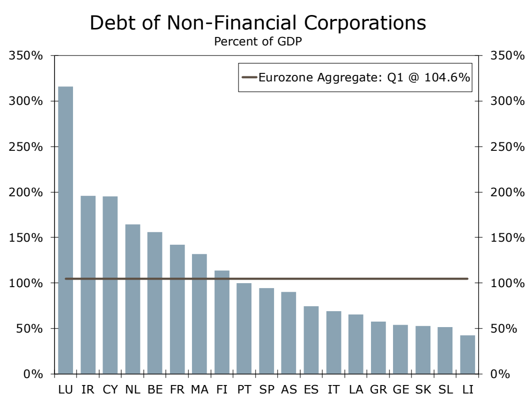
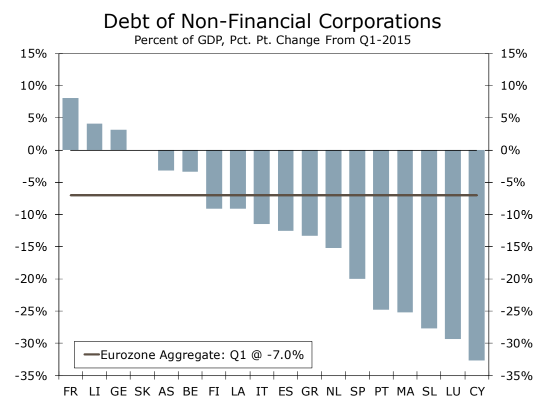


Figure 4



Source: Eurostat and Wells Fargo Securities

As noted previously, the NFC debt ratio in the euro area has receded modestly in recent years, and most individual economies have experienced a similar phenomenon. Only France, Lithuania and Greece have higher ratios today than they did in 2015 (Figure 4). On the other hand, Portugal, Malta, Slovenia, Luxembourg and Cyprus have all achieved reductions in their respective NFC debt ratios of 25 percentage points or more over the past four years.

It is also important, however, to consider the asset side of the balance sheet. Figure 5 plots the financial assets-to-debt ratio of the NFC sector in the overall euro area. This ratio currently stands

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3 Due to favorable tax treatment, some large companies choose to incorporate in Ireland or Luxembourg. Although they may have limited presence in the country, their debt is included in the country total.

near its 20-year high of 2.2. In other words, financial assets have grown faster than debt over the past decade among non-financial businesses in the euro area. As noted previously, the debt-to-GDP ratio of the French NFC sector is currently higher than the Eurozone average. But the financial asset-to-debt ratio in France is the highest among the 19 individual economies in the euro area (Figure 6). Indeed, the ratio in France has trended higher since the depths of the Great Recession and currently stands near an all-time high. Germany and Spain have relatively high financial assets-to-debt ratios as well. Most of the countries with ratios that are well below average, with the notable exception of Italy, tend to be smaller economies.

Financial assets-to-debt ratio stands near its 20-year high.

The balance sheets of non-financial businesses in the Eurozone have generally strengthened in the past few years. The debt-to-GDP ratio has receded modestly since 2015, not only for the aggregate euro area but in most individual economies as well, and financial assets have grown faster than debt since the depths of the Great Recession. That said, balance sheets in the NFC sector generally are not as solid as they were two decades ago when the sector's debt-to-GDP ratio was significantly lower.

Figure 5

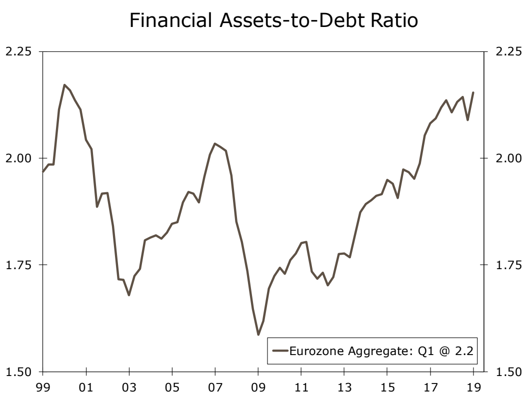
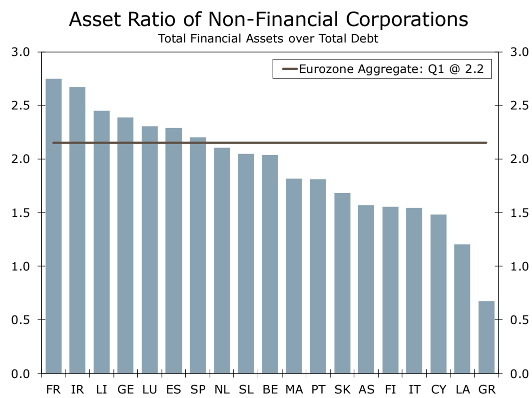


Figure 6



Source: Eurostat and Wells Fargo Securities

The Debt Servicing Ability of the NFC Sector Has Improved

Debtors encounter financial difficulties when they are unable to adequately service their debt payments. The debt service ratio, which measures the amortization and interest payments that a debtor needs to make as a percentage of their income, depends on the amount of debt that is outstanding as well as the interest rate that applies to the debt. As discussed previously, the debt-to-GDP ratio of the NFC sector followed an upward trend between 1999 and 2015. Consequently, the sector's debt service ratio also trended higher during that period (Figure 7).[4] In recent years, however, the NFC sector has de-levered modestly and interest rates have fallen to unprecedentedly low levels. Both of these factors have contributed to the decline in the NFC debt service ratio since its peak in 2012. At roughly 41% at present, the debt service ratio has receded to its lowest level in 13 years.

The debt service ratio is at its lowest point in more than a decade.

[4] **A debt service ratio for the NFC sector in the euro area is not readily available. But we have created a proxy, which is plotted in Figure 7, by using data on eight large individual economies that are shown in Figure 8. Together, these eight economies account for more than 80% of the NFC debt in the euro area.**

Figure 7

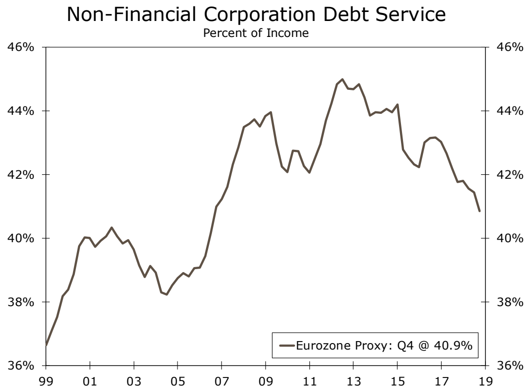
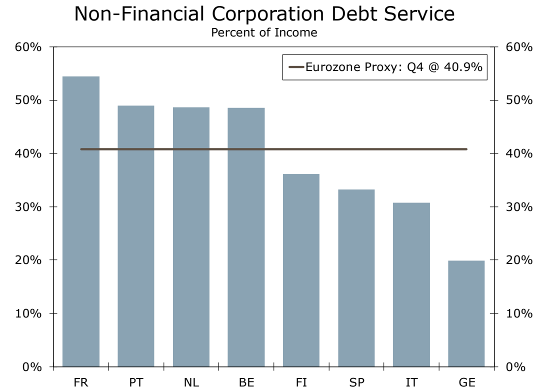


Figure 8



Source: Bank for International Settlements and Wells Fargo Securities

Among individual economies, France, Portugal, the Netherlands and Belgium all have NFC debt service ratios that exceed the Eurozone average at present. That said, the respective ratio in each of these four economies has receded from its peak a few years ago. On the other hand, Finland, Spain, Italy and Germany all have ratios that are below the Eurozone average at present. German businesses devote only 20 percent of their income to servicing debt.

The good news is that the debt servicing ratio in the Eurozone NFC sector has receded in recent years. The bad news, however, is that it remains elevated relative to the level that prevailed when EMU was launched twenty years ago. Although businesses likely will remain in de-levering mode for the foreseeable future, and the European Central Bank will not be raising interest rates anytime soon, the ability of some businesses to service their debt could become impaired if the Eurozone were to slip into recession. Because economic growth in the euro area has slowed to a crawl recently and because the global economy is full of uncertainties at present, the probability of recession in the euro area in the foreseeable future is not remote.

Conclusion

NFC sector debt is not a likely catalyst for recession.

The financial position of the NFC sector in the Eurozone generally has improved in recent years. The sector's debt-to-GDP ratio has receded modestly since 2015, and financial assets have grown faster than debt in the sector. The decline in the debt service ratio in recent years shows that the ability of non-financial businesses to service their debt has improved. Among large individual economies, Germany appears to have one of strongest NFC sectors in terms of overall financial health. On the other hand, the financial health of the French NFC sector, with its relatively high debt-to-GDP ratio and elevated debt servicing ratio, is weaker.

However, the financial health of the NFC sector is not as robust as it was when EMU was launched in 1999. Although we do not believe that debt-servicing issues in the NFC sector will be the catalyst for the next recession in the Eurozone, a downturn, should one occur, would weaken growth in net income, thereby impairing the debt-servicing capabilities of some non-financial businesses. The resulting financial strains in the NFC sector could deepen any recession in the euro area, which could then have adverse effects on the debt-servicing abilities of the financial sector and the public sector. We will analyze the financial health of the financial sector and the public sector in the Eurozone in two forthcoming reports.

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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