OBSERVATION

TD Economics

February 29, 2012

DELEVERAGING BEGETS WEAK ECONOMIES ACROSS EURO ZONE PERIPHERY

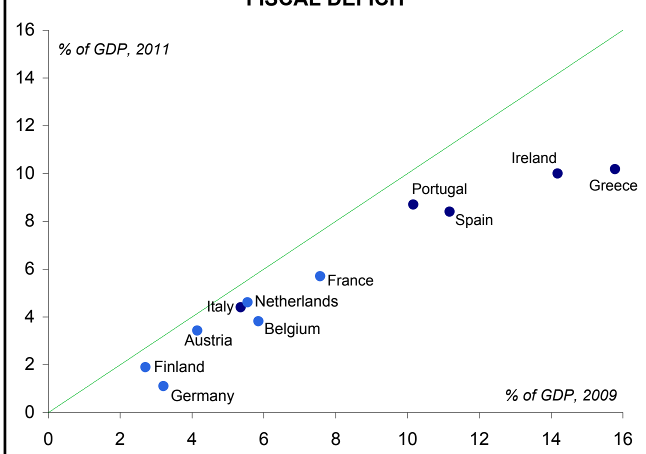
Highlights

- Recent liquidity injections by the European Central Bank have brought relief to the banking system and sovereign bond markets.
- However, macroeconomic fundamentals have not changed that much. Overstretched households' and non-financial firms' balance sheets signal sub par economic growth, particularly in Ireland, Portugal, and Spain.
- Weak economic activity will complicate Irish and Portuguese efforts to meet their IMF / EU program targets. Therefore, we could expect market pressure to rise again for these countries.
- That's why the ECB actions are risky. But without risk there is no return, and sure enough, the ECB bet may have a huge payoff.

Sovereign bond yields across much of the euro zone have dropped markedly in recent weeks. This outcome can be largely attributed to the two 3-year long term refinancing operations – LTROs – conducted by the European Central Bank. At a time of large funding needs, the first LTRO carried out in late December greatly reduced the risks of illiquidity among European banks, bringing relief to the markets. In addition, banks bought sovereign paper in anticipation to the second LTRO to pledge it as collateral with the ECB. Italian and Spanish banks increased their sovereign bond holdings by 13% and 29%, respectively, over a two-month period between December and January. Moreover, now that many of those bonds have been pledged to the ECB as collateral for loans, banks have less incentive to sell them because doing so affects their access to ECB liquidity. The fact that those bonds are now less likely to change hands in the near future would also reduce yields volatility.

However, with many important elements of the second Greek bail-out pending completion, the question remains whether the impact of the ECB actions will prove a transitory improvement to sovereign debt valuations or whether they have a more lasting impact on the crisis resolution. If the Greek program stumbles upon any roadblock, financial markets may reassess sovereign risks, which could reverse the positive market sentiment induced by the ECB extraordinary liquidity injections. At the end of the day, the fundamental macroeconomic factors that have raised solvency concerns over the last two years remain very much in place.

FISCAL DEFICIT



Source: Eurostat, TD Economics. Dots below green line represent improvement in 2011 vis-à-vis 2009; dots above represent deterioration.

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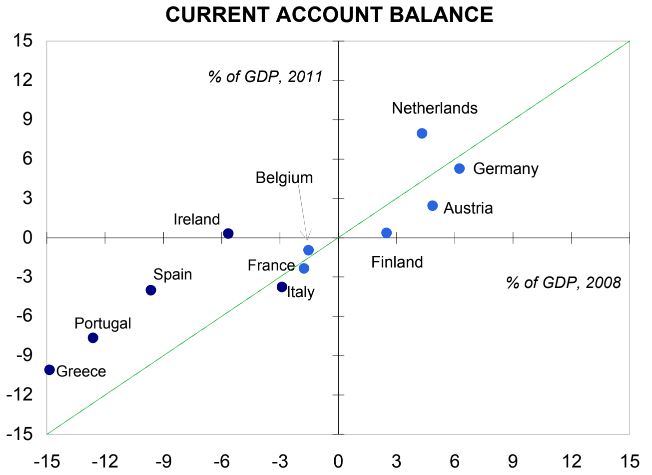


Source: Eurostat, TD Economics. Dots above green line represent improvement in 2011 vis-à-vis 2008; dots below represent deterioration.

The large private debt overhangs accumulated in some euro zone countries in the run up to the 2008 financial crisis are also proving as hard to unwind as the fiscal deficits that ensued in the aftermath of Lehman's collapse. Our analysis shows that, despite recent progress, private debt stocks remain particularly high in Ireland, Spain and Portugal. Thus, the deleveraging process in these countries will continue for a few more years, proving a permanent drag to their domestic demand. On the other hand, Italian private sector balance sheets remain in much better shape, which would give the Italian economy firmer ground to launch a stronger recovery once structural measures begin to take hold. But, again, this will take a few years.

In the meantime, someone has to make up for the funding void, and the ECB has volunteered for the job. That carries risks; but without risk there is no return. And sure enough, the ECB bet may have a huge payoff.

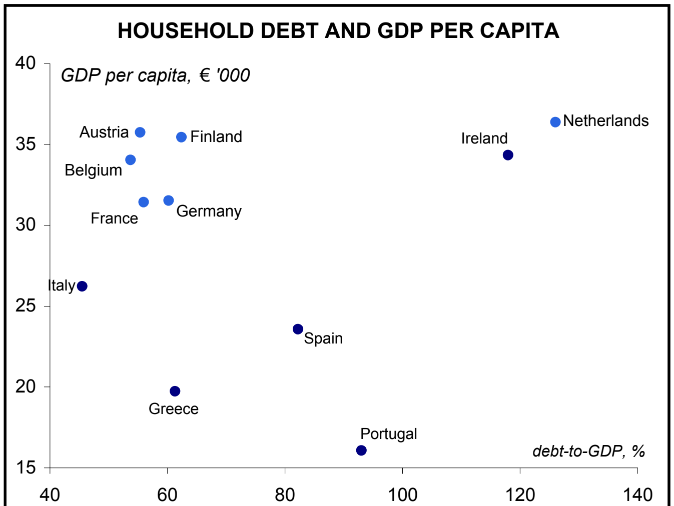
Closing the gaps: fiscal and external adjustment in the euro zone periphery

In early 2010, Greece's ballooning fiscal deficit and mounting sovereign debt was the warning call that made euro zone policymakers embark on fiscal consolidation. Two years later, most euro zone countries have managed to reduce their fiscal gaps. However, as the chart on the first page shows, fiscal deficits remain high, especially in those countries hardest hit by the sovereign debt crisis. This means their debt levels will continue climbing over the next few years. Under current IMF projections, Irish and Portuguese sovereign debt will peak at around 118% of GDP in 2013. Spain's sovereign debt-to-GDP ratio is expected to reach 80% by 2016 and Italy's will peak at around 125% of GDP next year.

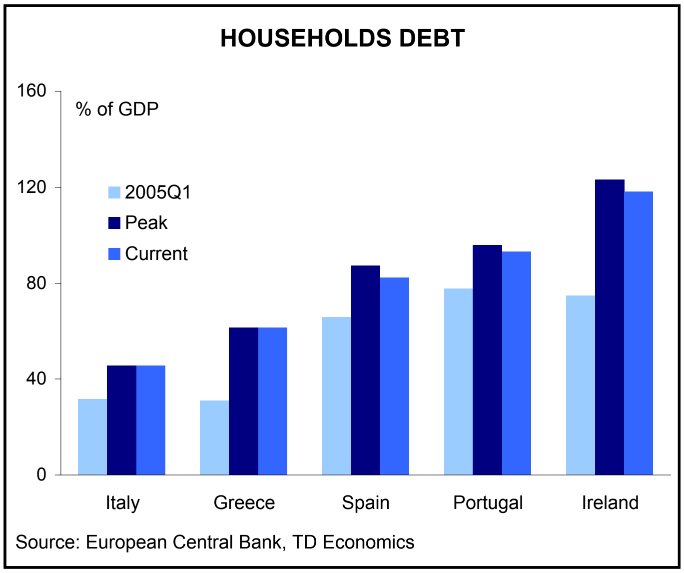
Alongside improvements in fiscal accounts, higher private savings have helped euro zone peripherals, with the exception of Italy, reduce their current account deficits. For example, Ireland went from a current account deficit of 5.7% of GDP in 2008 to a surplus of 0.3% of GDP last year. Spain has more than halved its external gap since 2008, it currently stands at 4% of GDP. Portugal has also made significant progress, but it is still running a large deficit equivalent to 7.7% of GDP. On the other hand, Italy's current account position has deteriorated from a deficit of 2.9% of GDP in 2008 to 3.8% of GDP in 2011. The current account balance represents the net external saving position of a country. Thus, the deficits noted above tell us that Italy, Portugal, and Spain are still absorbing savings from abroad to finance their public and private deficits. However, a key distinction between Italy and the other peripherals becomes apparent when we dig into the corporate and household exposures.

Private deleveraging in an age of weak aggregate demand

As the accompanying charts show, Ireland, Spain, and Portugal entered the financial crisis with households' debt-to-GDP ratios larger than those of most of their euro zone peers. In the years prior to the crisis, the marked increase in private debt levels in both Ireland and Spain resulted from a credit-fueled real estate boom. For example, during the boom years of 2004-2008, construction explained 8% of total Spanish private sector credit growth, real estate development accounted for 22%, and mortgage loans for 33%.

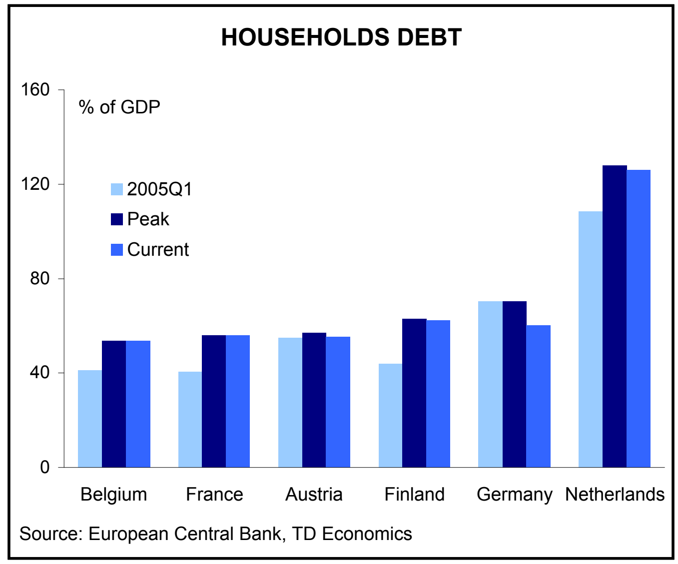


Source: Eurostat, IMF, TD Economics.



HOUSEHOLDS DEBT

Source: European Central Bank, TD Economics



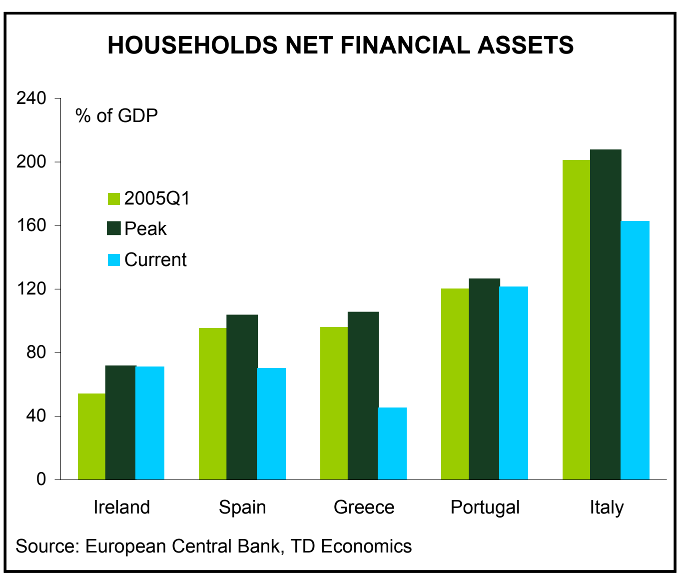
HOUSEHOLDS DEBT

Source: European Central Bank, TD Economics

When the real estate boom turned into a bust, these countries where forced to embark on a painful deleveraging process. As a result, Irish household debt has declined by roughly 30% since its pre-crisis peak. In Spain, the decline has been more modest, at around 3.5%. Although there is no optimal level of debt that could act as a benchmark to help us understand how much longer this process should go, a comparison with the euro zone average suggests that in Ireland, Spain, and Portugal, households debt should decline further. Based on Ireland's projected nominal GDP growth rates, the stock of household debt would have to decline 8% annually over the next five years for the household debt-to-GDP ratio to converge to the euro zone average. Portuguese and Spanish households' debt should see annual declines of 5% and 1.4%, respectively, to achieve the same outcome.

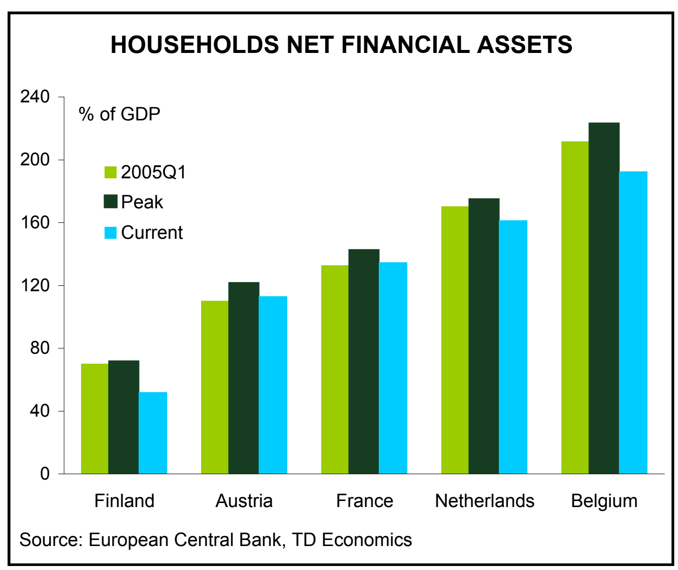
Unlike its southern neighbors, Italian households' debt accumulation has been very moderate in recent years. Moreover, relative to the country's GDP, it compares favorably even when measured against core euro zone countries. The strength of Italian households' balance sheets vis-à-vis Ireland, Portugal, and Spain is also evidenced by their much higher net financial assets position.

The comparison of non-financial firm's debt levels across these countries paints a similar picture. Italian non-financial firms' liabilities have stabilized around 88% of GDP in recent years. On the other hand, despite their recent progress towards deleveraging, Irish, Portuguese, and Spanish non-financial firms still present much higher



HOUSEHOLDS NET FINANCIAL ASSETS

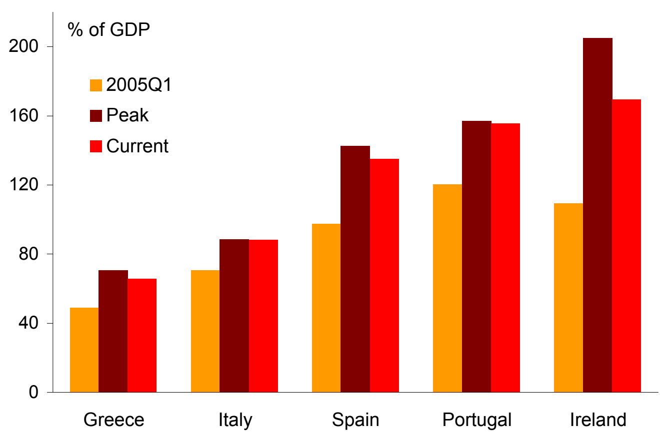
Source: European Central Bank, TD Economics



HOUSEHOLDS NET FINANCIAL ASSETS

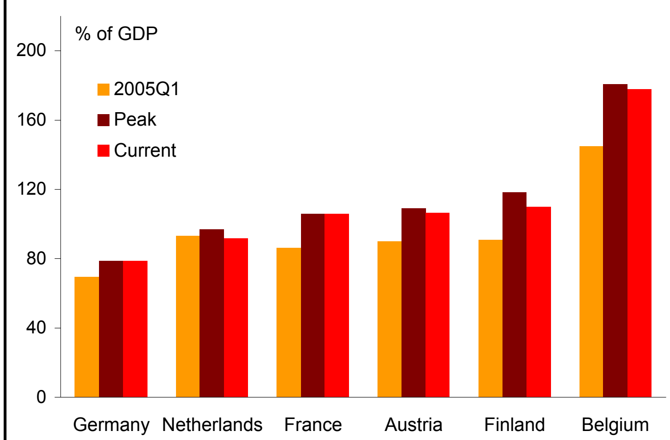
Source: European Central Bank, TD Economics

NONFINANCIAL FIRMS DEBT



Source: European Central Bank, TD Economics

NONFINANCIAL FIRMS DEBT



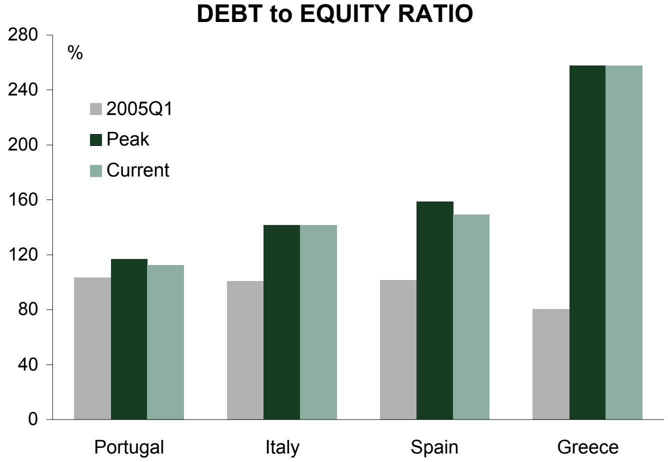
Source: European Central Bank, TD Economics

debt-to-GDP ratios. Furthermore, this private deleveraging has occurred in part at the expense of public accounts, as governments in the three countries have absorbed some of the losses incurred by their banking systems. In Ireland, for instance, non-financial corporations liabilities declined to 170% of GDP in the third quarter of last year from a peak of 205% of GDP a year earlier. However, this improvement was largely facilitated by the transfer of liabilities from private to public accounts via bank restructurings and the associated €70 billion loan transfers to the National Asset Management Agency.

Bringing their non-financial firms' debt-to-GDP ratios in line with the euro zone average by 2016 would require annual contractions in the stock of debt around 6.5% in both Ireland and Portugal, and 2.4% in Spain.

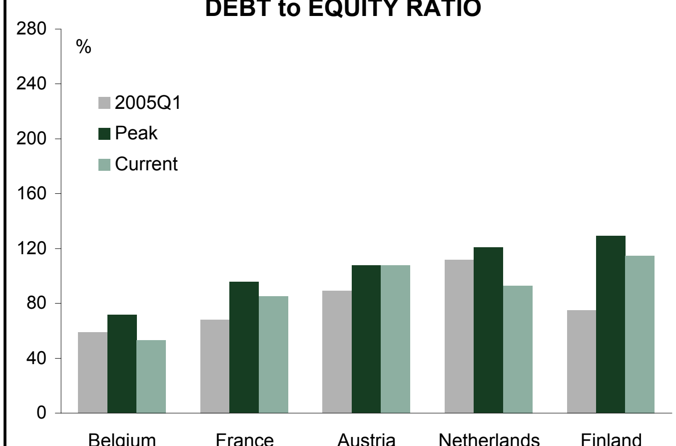
Private deleveraging and fiscal austerity will constraint economic growth in these three countries for a number of years. Ireland and Spain, where construction and real estate activities accounted for a significant share of their economic growth during the boom years will have to endure a particularly tough adjustment process. The good news is that these three countries only account for roughly 16% of euro zone GDP, so their sub-par economic growth should not cast that long of a shadow to the entire region. The bad news is that weak economic growth will undermine their fiscal consolidation efforts. This is particularly relevant for Ireland and Portugal, as they strive to meet the targets set by the IMF and the European Union on their financial assistance programs.

NONFINANCIAL FIRMS DEBT to EQUITY RATIO

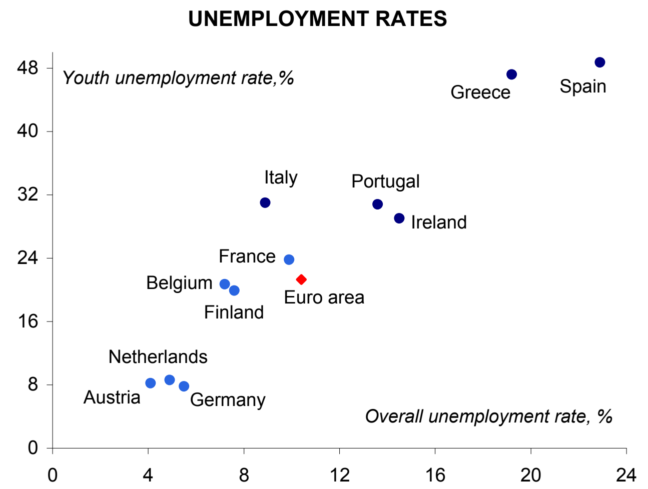


Source: European Central Bank, TD Economics

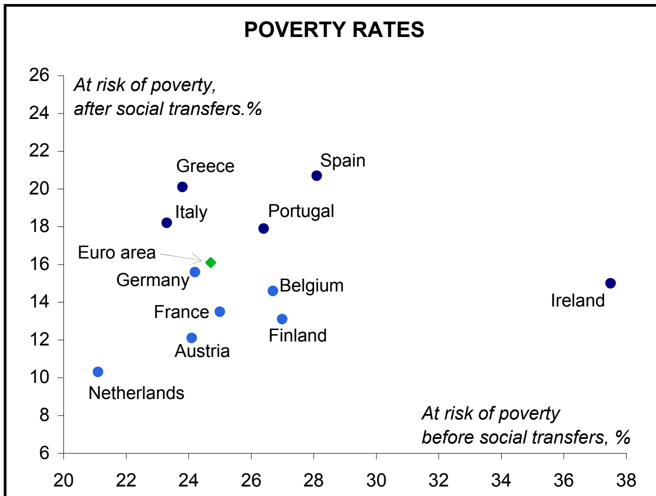
NONFINANCIAL FIRMS DEBT to EQUITY RATIO



Source: European Central Bank, TD Economics



Source: Eurostat, TD Economics



Source: Eurostat, TD Economics. At risk of poverty rate defined using a cut-off point of 70% of median equivalised income.

Final Remarks

We have provided a brief recount of the progress made thus far by peripheral euro zone countries in their fiscal consolidation efforts. We also looked how far their private sectors have gone down the path of deleveraging.

Despite its very large level of government debt, Italy's stronger private balance sheets put it in a better position to withstand the fiscal tightening efforts that lie ahead. Simply put, the Italian economy should prove more responsive to structural reforms, because both firms and households will be in a position to ramp up spending once those structural reforms begin to bite. On the other hand, private deleveraging in Portugal, Ireland, and Spain still has some way to go. Especially in the latter two countries, because they still have significant debt overhangs from their real estate binge, which high unemployment rates will make more difficult to absorb. This, against a backdrop of continued fiscal consolidation, will undermine the ability of these economies to grow over the next few years.

A side-effect of this deleveraging process is that it will cause the monetary transmission channel to work less effectively in these countries than in the rest of the euro zone. In other words, households and non-financial firms in Ireland, Spain and Portugal will make use of low interest rates to ease their balance sheet consolidation processes, but this will not show up immediately in the form of stronger domestic economic activity. Contrarily, in the core euro zone countries, the ECB's very accommodative stance will have much more bang for the buck, because their firms and households will be in a better position to make use of ample liquidity at low interest rates to increase spending. To be sure, this is a good thing for the peripherals as well, because stronger domestic demand in the core of will translate into better export prospects for the periphery.

From this perspective, the ECB's LTROs may end up providing the capital to finance the external rebalancing across the euro zone, after capital markets became unwilling to keep financing the spendthrift periphery's current account deficits. With the benefit of hindsight, a few years from now we might conclude that this was the true stroke of genius of the ECB in its role on the crisis resolution.

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