

A Different Tale on Eurozone Debts

by Marco Fortis

1. The war of debt

Until now the «war of debt» has been essentially trench warfare, only marginally involving the big powers. So far the heaviest damage has hit almost only peripheral countries: Greece, Portugal and Ireland. But Spain and Italy have been in difficulty for some time, too, and France may also have trouble as soon as it becomes clear that Paris cannot meet the Fiscal Compact easily.

The US economy, which has the largest public and private debt in absolute values, appears for the time being in a safe position, well defended by three pillars: strategic and military strength, the dollar as worldwide unit of account, and quantitative easing. Thanks to Europe's weakness the US have even managed to let markets and economic analysts forget that the financial contagion was triggered by Wall Street's toxic bubbles.

Germany is also protected even though it has the second-largest public debt and the third-largest private debt in the western world. Great Britain seems to be safe, too, though its private debt is the second largest among the European and North American countries and in a couple of years, at the current deficit rates, its public debt will also be the third largest, at the same level as Italy's (no longer the black sheep, but among peers) and France's.

So, though it may look like a paradox, at the moment the three aggregate-debt «biggs» of the western world (US, Germany and UK) are paying interest rates at the lowest all-time levels, as if they had profited from, rather than being hit or endangered by, the financial war. Whereas in Italy and Spain, left alone because of the lack of a coordinated and effective European strategy, the interest rates are fluctuating close to unsustainable levels and in the three smaller and weaker «peripheral» countries the interest rates on government securities have been rocketing off-scale for months.

Yet it is a long time since, apart from Japan (not considered here because most of its debt is in Japanese hands) the only public debts considered critical in the world were Italy's and Belgium's and nobody thought even for

a moment that private debts could be a serious problem. On the contrary, now all the western economies are burdened by debts, both public and private (the dangerousness of the latter, and its rapid switch-over to sovereign debt, as shown by the escalation of the Spanish case, was understood too late). Nonetheless, only a few countries, whether small in size (like Greece), medium (Spain) or medium-large (like Italy with its eternal, now undeserved, unreliability stain) are under cross fire from downgrading, speculation, disinvestment and risk of capital flight. This situation is also a consequence of the weakness of the Eurozone, which let the Greek crisis grow bigger and bigger instead of acting immediately and which until now has only taken weak initiatives, such as the European Financial Stability Facility, to cope with the speculative attacks on sovereign debt, leaving to the BCE under Mario Draghi the burden of supplying liquidity to the system through the Long-Term Refinancing Operation (LTRO). In addition, the Eurozone has not yet given serious consideration to the proposal of Eurobonds to stabilize debts and re-launch investments in infrastructures.

However, the crisis is not confined to the Eurozone. It is the entire advanced world that is plagued by debts, both public and private. In fact it is from private debt that the crisis started with the failure of Lehman Brothers late in 2008. According to the McKinsey Institute, between 2000 and 2008 the overall public and private debt in the major advanced economies rose by over 40,000 billion dollars. About 75% of the increase was not produced by the governments through public debt, but by the private sector, through the debts of households, banks and businesses.

Only the Greek crisis originated mainly from public debt, whereas in the rest of the advanced world the financial crisis and its economic consequences produced a big shift from private to sovereign debt. In the US, for example, the public federal debt (excluding the debt of individual States, some of which, like California, are in big trouble) rose from 9.2 trillion dollars at the end of 2007 to 15.2 trillion at the end of 2011 (+65%). For comparison purposes, Italy's debt rose from 1,602 to 1,897 billion euros (18.2%) over the same period and Germany's public debt rose from 1,582 billion euros to 2,088 billion (+32%, i.e. half the US debt growth).

The «war of debt» is not only a financial one, but also a continuous battle of communication, which the Eurozone is losing face to the US, UK and Japan because of a lack of strategy. The Eurozone sovereign crisis is convenient to the US and the UK and, at least in the short time, even to Germany, which benefits from low interest rates originated by the «flying to quality».

As long as the big debtor powers manage to confuse markets and investors on the real sustainability of their debts, they will be spared and will go on profiting from disinvestments from the other countries. But the moment of truth might be close and at that time the war will extend to the bigger countries. If they want to avoid it, they had better start some sort of moratoria on debt (including their own), thus putting an end to the speculation that so far has only attacked the smaller countries.

A study by the Boston Consulting Group (BCG) even envisages that in the end the only possible solution might be a concerted cut of the total debts (of governments, households and non-financial firms) of all countries. According to the study, the aggregate debt of each economy should be brought below 180% of the GDP (assuming a conventional 60% GDP ceiling for each of the three categories of non-financial operators). But how should such aggregate debt reduction be achieved? The BCG suggests a coordinated one-time tax on households' financial assets, which are the biggest and more easily movable portion of the nations' net wealth. Even though we do not share this proposal, we are in fact against any wealth tax, it is an interesting idea because it is an indirect proof of what we have been maintaining for a long time, i.e. that it is not the debt/GDP ratio that should be used to show the face sustainability of a national debt, but the existence of substantial national wealth¹.

For the purpose of cutting the debt/GDP ratio sharply, the GDP is not very useful: as a matter of fact, it is barely sufficient to produce the fiscal revenue required to balance the annual state accounts. In order to reduce (or, better, show to be able to reduce) the debt/GDP ratio significantly, it would be necessary to draw on (or show to be able to do so) wealth, provided that there is enough. If countries and rating agencies abandoned the debt/GDP ratio logic and switched over to the much more stringent debt/equity concept, it would be easier to identify which debts are really sustainable and which ones are not. The rating indices would also change. But this might not please the bigger countries, first and foremost the US.

But this is not all. The BCG maintains also that, in order to reduce the aggregate debt to acceptable levels, only the wealthier citizens should be taxed. Though the study does not mention what would be the resulting individual burdens, we can try to assess them by updating the BCG figures, which date back to 2009, to 2011 based on the public and private debt estimates provided by the Bank of Italy in its latest Report on financial stability (Figure 1) and crosschecking them with the data contained in the households' «Wealth Data Book 2011» from Credit Suisse.

This latter report clearly shows that Italy is the second western country after the US (and third in the world after Japan) for total number of adults with property and financial assets over 100,000 US dollars (about 30 million Italian adults, i.e. 61% of the adults, vs. only 36% in the US and 41% in Germany).

In order to achieve a reduction of the aggregate debt 2011 to less than 180% of the GDP, the Italian debt should be cut by 1,067 billion euros (equal to 67% of our GDP), Germany's by 802 billion, France's by 1,352, Spain's by 1,144, the UK's by 1,888 and the American one by as much as

¹ As already set forth in our article in *Economia Politica* published in April 2011 (see References).

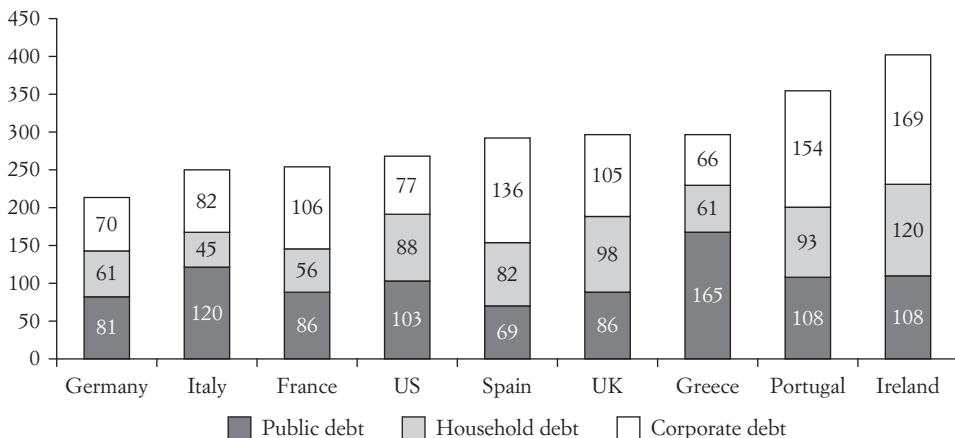


FIG. 1. Nonfinancial-sector Debt, Year 2011 (Percent of GDP).

Source: Banca d'Italia, Financial Stability Report, April 2011, table 1.1, p. 10.

9,553 billion euros (i.e. about 88% of the US GDP) (see Table 1). Which countries could better bear such theoretical cuts? It all depends on the starting aggregate debt level (Germany, Italy and France show the lowest levels as GDP percentages) and on the best distribution of the private wealth to be taxed among the citizens (Italy has by far the best distribution, with the lowest Gini index).

If, theoretically speaking, in order to cut the aggregate debt below 180% of the GDP, each country taxed the financial wealth of its adults having assets in excess of 100,000 dollars, the lowest one-time wealth tax would be levied in Germany (29,000 euros), closely followed by Italy (34,000 euros) and then by France (58,000 euros). Among the larger and richer countries, the most heavily taxed citizens would be Great Britain's (72,000 euros per adult) and the US' (as much as 113,000 euros), while the figures for Greece, Spain, Portugal and Ireland are not even imaginable for countries in the present crisis (ranging from 86,000 to over 200,000 euros). In practice only Germany, Italy and France would be able to reduce their aggregate debts below 180% of the GDPs without soaking up the assets of their wealthier citizens (see Figure 2).

This theoretical exercise, based on a mix of debt/equity and distribution of wealth, is a powerful indicator of debt sustainability: it does not provide a possible solution to prevent a world war of debt (as rather optimistically thought by BCG), but indirectly shows how national ratings should be recalculated now to take full account of the financial fundamentals of the various economies and of the interconnections between public and private debts. Italy, in particular, would deserve a much better rating, closer to Germany's. If then Germany teamed up with Italy and France, since they, the «core coun-

TAB. 1. *Write-offs necessary to achieve sustainable debt levels, year 2011 (Percent of GDP if not otherwise indicated)*

	Germany	Italy	France	UK	Spain	Greece	US	Portugal	Ireland
Household Debt	60.2	45.4	56	97.6	82.2	61.2	88.3	92.8	119.6
Corporate Debt	69.8	82	105.8	105.4	135.9	66.4	76.9	154.3	168.8
Government Debt	81.2	120.1	85.8	85.7	68.5	165.3	102.9	107.8	108.2
Total nonfinancial-sector debt	211.2	247.5	247.6	288.7	286.6	292.9	268.1	354.9	396.6
Total GDP	2,571	1,580	2,001	1,737	1,073	215	10,843	171	156
Necessary debt reduction to reach 180 percent nonfinancial-sector debt-to-GDP ratio (in percent of GDP)	31.2	67.5	67.6	108.7	106.6	112.9	88.1	174.9	216.6
Necessary debt reduction to reach 180 percent nonfinancial-sector debt-to-GDP ratio (Euro billions)	802	1,067	1,352	1,888	1,144	243	9,553	299	339
Millions of adults with a net financial and nonfinancial wealth exceeding 100,000 US dollars	27.49	30.9	23.26	26.26	13.29	2.25	84.73	1.71	1.69
One-time wealth tax that would be charged on each adult with a financial and nonfinancial wealth exceeding 100,000 US dollars to reduce nonfinancial-sector debt to 180% of GDP (Euro per adult)	29,178	34,519	58,143	71,905	86,098	107,932	112,747	174,900	200,451

Sources: compiled by the author on data from Boston Consulting Group, Banca d'Italia, Eurostat and Credit Suisse.

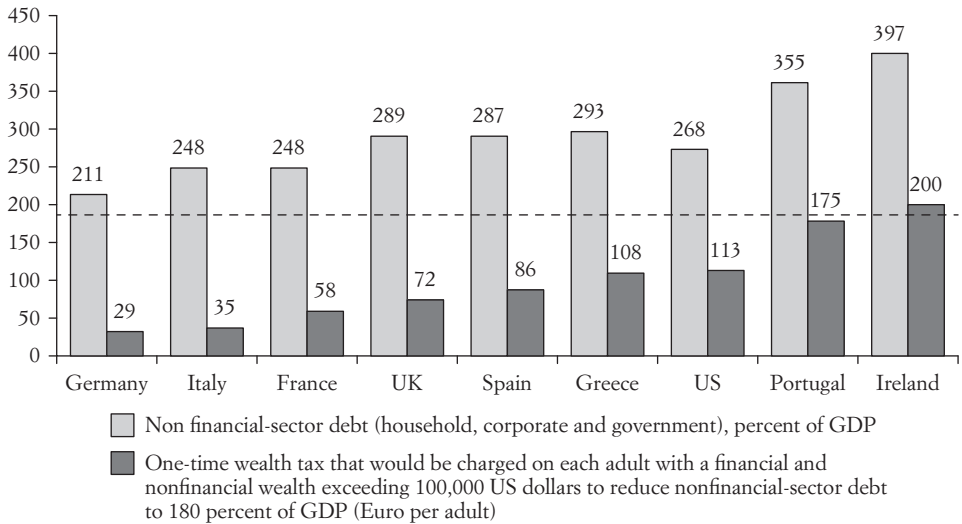


FIG. 2. One-time wealth tax to reduce nonfinancial-sector debt to 180 % of GDP: Year 2011.

Sources: compiled by the author on data from Boston Consulting Group, Eurostat, Banca d'Italia and Credit Suisse.

tries» of the Eurozone, have the better sustainable aggregate debts in relation to private wealth and its distribution, things would change for the Eurozone, which, being aware of its sound assets, could not only help Greece and the other countries in trouble more effectively, but even show the rest of the world an image of Europe much wealthier than the US or UK.

2. Long-term debt sustainability

In April 2012 the Bank of Italy published the third «Financial stability report» (FSR), that starting from this year will appear every six months (the first two reports were published in December 2010 and November 2011). At a time of deep financial crisis like this the FSR is an essential tool to understand the economic and financial trend as well as Italy's position in the crisis. Therefore it deserves a careful examination. Without underestimating the persisting risks and the structural criticalities of our country, the FSR is important because it contains a number of indicators showing Italy's little known financial stability strengths. In particular, the FSR presents many financial indices concerning Italy's public and private sectors compared with the US, Japan, Great Britain and 6 Eurozone countries, namely Germany, France, Spain, Greece, Portugal and Ireland.

It appears from the FSR that our country, though burdened with a high long-standing public debt, presents some very encouraging financial indi-

ces in the public and private sectors over the 2011-2013 period: in the first place, a satisfactory state budget (over the three-year period Italy is the second-best after Germany in comparison with the countries considered) thanks to its excellent primary budget surplus (Italy will do better than Germany in the 2012-2013 period). In addition, our country records the lowest private debt (especially thanks to low households' debts) and a net external deficit (23% of the GDP) not much higher than France's, Germany's or the US's and much lower than those of the peripheral European countries (ranging from as much as 92% of the GDP for Spain to 103% for Portugal).

The Report of the Bank of Italy shows also a number of medium-to-long term debt sustainability indicators that highlight the good situation of our country. This is very important because the debt challenge will be faced not only in the coming months, but, even more hardly, on the longer term, i.e. when the fiscal imbalance of many countries now considered stable, first of all the US, will emerge. The Report provides in particular three indices:

a) The S2 index of the European Commission: it is the increase in the primary budget/GDP ratio required, based on demographic and macro-economic projections, to meet the public administrations' intertemporal constraints. The estimate takes into account the debt level, the economic growth prospects, the trends of interest rates and of future primary surplus flow, which are affected by the expenditure dynamics tied to demographic changes. Among the countries considered Italy has the best S2 Index (together with Estonia in the EU).

b) European Commission's composite fiscal vulnerability index: this index is based on a wide range of fiscal and macro-financial variables, not only tied to public accounts. As a matter of fact, it takes into consideration also households' debts, the financial institutions' levy level, the excessive weight of the construction sector in the generation of value added, the current accounts balance and other economic and demographic variables. A composite index value above the threshold level shows a possible fiscal crisis. The index was introduced for the first time by the European Commission in the report on *Public Finances in EMU 2011*. Based on the latest FSR indices, Italy's vulnerability index is the same as Great Britain's, a country that, unlike ours, has the advantage of the same interest rates as Germany's. In addition, our index is only little higher than that of France and far better than the so-called PIGS's.

c) IMF sustainability index: it is the primary surplus/GDP ratio increase that should be achieved by 2020 (and maintained for another decade) to bring the debt/GDP ratio to 60% by 2030. It includes the estimated increases in health and pension expenditures between 2011 and 2030. According to the IMF figures provided in the FSR, Italy and Germany have the best sustainability index, whereas the US, Great Britain and Japan will be facing huge fiscal challenges to prevent a dramatic rise in their public debts.

Of course the Bank of Italy report underlines the severity of this moment, made even more serious by the Greek crisis. It points out that the financial

stability risks have eased off in Europe, also thanks to the massive liquidity injections from the ECB, but have not disappeared; and that Italy, despite noteworthy steps forward in its public finances, is still affected by contagion and recession. According to the FSR, it is therefore necessary to proceed quickly and consistently with the broad structural reforms plan, which can have positive effects on future income expectations, without which it would be more difficult to strengthen the consolidation of our public accounts and seize any global recovery opportunities.

3. The Italian case

It is true, Italy is in recession. However, the huge toll the country is paying especially through taxation (that ought to be accompanied by some bold step in spending cuts) are at least producing, and will continue to do so, tangible results in our public accounts. While this is not happening in other countries under special surveillance like Spain. Unfortunately the markets do not seem to be able to see this positive diversity of our country, and the BTP-Bund spread remains high.

And yet over the three years 2011-2013 Italy will be achieving the highest cumulative primary budget surplus among the advanced economies statistically considered by the IMF. Only two other quite peculiar countries, because of their huge financial resources (they even avail themselves of Sovereign Wealth Funds to manage their surplus) will do better than Italy: Norway and Singapore. No other «normal» advanced economy in the world will generate a cumulative primary surplus even close to Italy's 7.8% of GDP in 2011-2013. Not even Germany, that will record 3% only. This appears from the IMF statistics (see Table 2).

It is true that over the same period other developed countries will be able to boast about some decimal points of GDP growth more than Italy, but they will be burdened by massive cumulative primary deficits because their economic growth will still be financed through budget deficits. Over the three years considered France will record a cumulative primary deficit of 6.6% of its GDP, Canada 9.7%, the Netherlands 10.2%, Denmark 10.8%, Spain 13.2%, the UK 15.1%, the US, 17.8% and Japan as much as 25.5%.

Even the Fiscal Compact is in perspective virtually «demolished» by the IMF projections. But this will not be Italy's fault. On the contrary, among the bigger economies that signed it, only Italy and Germany seem to be able to achieve, over 2012-2014, not only a deficit/GDP below the 3% of Maastricht, but even the more ambitious cycle-adjusted structural deficit below 0.5%. According to the IMF data, the three other major Eurozone countries (as well as many smaller ones) are quite far from the target of the Fiscal Compact. Beginning with Spain, that even in 2014 will still record, according to the IMF, a deficit/GDP ratio of 5.2% and a structural deficit of 3.5%, France (-3.1% and -2.3% respectively) and the formerly virtuous Netherlands (-4.7% and -3.3%).

TAB. 2. *General government primary balance. G-7 countries and most important other european economies (Percent of GDP)*

	2011	2012	2013	Cumulated Primary Balance 2011-2013
Italy	0.8	3	4	7.8
Germany	0.7	1	1.3	3
Belgium	-1	0.5	1.2	0.7
Austria	-0.5	-0.9	-0.1	-1.5
Sweden	-0.7	-1.1	-0.4	-2.2
Poland	-2.5	-0.4	0.1	-2.8
Finland	-1	-2	-1.5	-4.5
France	-2.9	-2.2	-1.5	-6.6
Canada	-4.1	-3.1	-2.5	-9.7
Netherlands	-3.5	-3.2	-3.5	-10.2
Denmark	-3.4	-5.5	-1.9	-10.8
Spain	-6.6	-3.6	-3	-13.2
United Kingdom	-5.8	-5.3	-4	-15.1
United States	-7.3	-6.1	-4.4	-17.8
Japan	-9.1	-8.9	-7.5	-25.5

Source: IMF, Fiscal Monitor, April 2012, Statistical Table 2, p. 62.

Even on the long term it appears from the EC and IMF figures that Italy is the country that in the last 7 years achieved the highest cumulative primary surplus (Figures 3 and 4), which shows that our country has always held its public accounts under control, even though households and firms had to bear a rising tax burden. Of course this went to the detriment of the GDP growth, also because the private debt level remained low and there was no housing bubble in Italy to boost the economic growth, at any rate unsustainable, as in some other countries.

4. Conclusions

The experience of the 2008-2012 world financial crisis shows that the boundary between private and public debt is increasingly uncertain. Only the Greek crisis was mainly caused by a public debt out of control and unfortunately concealed by the Athens government. In Ireland, Great Britain, the US and, more recently, Spain, the household and corporate debt crisis quickly developed into a banking crisis and, through the latter and combined with the economic recession effects, into a crisis of state finances and public debt.

According to some studies, the aggregate debt (households, firms and governments) of each country should be quickly cut below 180% of the GDP. The problem is that only the countries with substantial and widespread household wealth, such as Germany, Italy and France, could endure such a debt reduction. According to our mere theoretical calculations, if each country, in order to bring the aggregate debt below 180% of the GDP, taxed

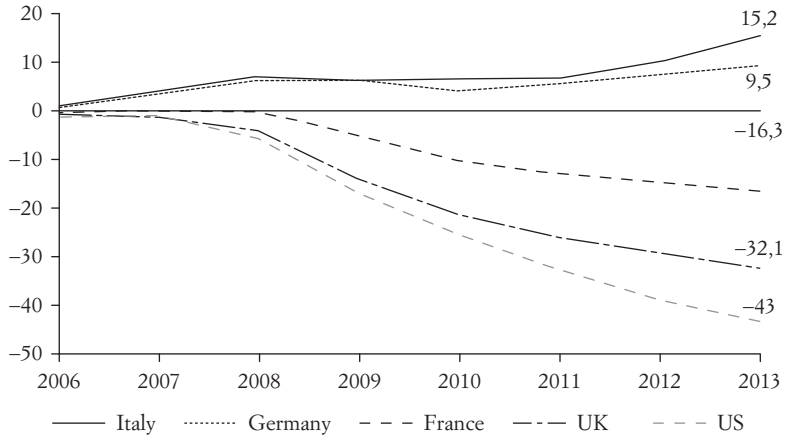


FIG. 3. Dynamic of cumulated primary balances, 2006-2013 (% of GDP).

Source: compiled by the author on data from European Commission and IMF.

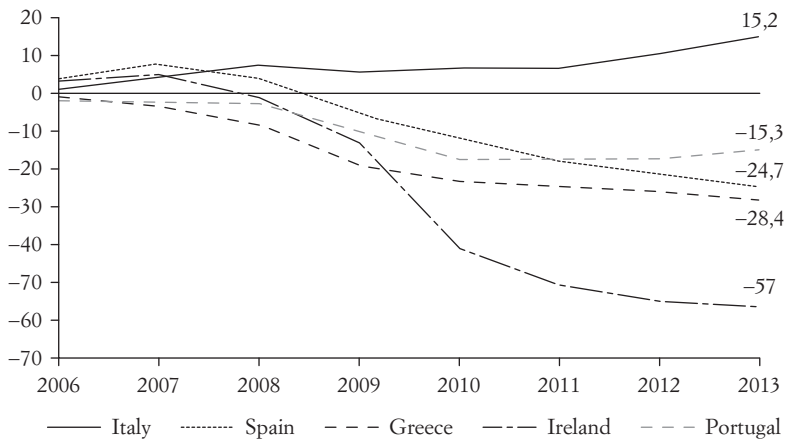


FIG. 4. Dynamic of cumulated primary balances, 2006-2013 (% of GDP).

Source: compiled by the author on data from European Commission and IMF.

only the financial wealth of the adults with more than 100,000 dollars, Germany would have the lowest individual one-time tax (29,000 euros), closely followed by Italy (34,000 euros) and, at a greater distance, by France (58,000 euros). Among the larger and richer countries, the highest tax would have to be paid in Great Britain (72,000 euros per adult) and the US (as much as 113,000 euros). The corresponding figures for Greece, Spain, Portugal and Ireland are even unimaginable for countries facing this crisis (ranging between 86,000 and 200,000 euros per rich adult).

Considering its low aggregate debt, Italy's rating should be much higher, not very different from Germany's. Also according to the Bank of Italy, «the recent development has contributed to more onerous borrowing conditions for Italy, but it does not appear to take full account of the strengths of the Italian economy, such as the prudent conduct of fiscal policy in recent years, the solid financial situations of households and firms, the low level of foreign debt, the absence of imbalances in the real estate sector, and the soundness of the banking system».

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