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INSIGHT

## Corporate not sovereign risk is the big worry for the eurozone

The precarious financial position of eurozone governments has polarised recent market concerns, and the still fragile condition of banks is well known. What has so far attracted much less attention, however, is the financial position of households and non-financial corporations (NFCs).

Yet it might well hold the key to the area's recovery prospects. While exports have kick-started the eurozone economy, sustainable growth depends on private consumption and investment, and both have, over time, become more sensitive to financial conditions. In recent research we have taken a closer look at the issue, and the results are sobering. Eurozone households and corporates ramped up their leverage during the credit boom. Household debt rose from 49 per cent at the end of 1999 to 63 per cent by mid-2009. For NFCs the ratio rose from less than 70 per cent to nearly 100 per cent. The debt servicing burden increased apace, as interest payments rose markedly as a proportion of earnings and disposable income respectively.

Households luckily started from relatively low leverage: even at 63 per cent, the debt-to-GDP ratio compares favourably to the US at nearly 100 per cent and the UK at more than 100 per cent.

Even more encouragingly, eurozone households have quickly started to deleverage and repair their balance sheets. Meanwhile, the ECB's monetary easing helped alleviate the burden. Our composite financing interest rate measure dropped from a peak of 6 per cent in October 2008 to 4.9 per cent in

November 2009. Higher savings also enabled households to reduce liabilities without relying heavily on liquidating assets, unlike in the US, and hence allowed them to benefit from the recovery in asset prices of the last ten months. Overall, therefore, we can be cautiously optimistic that as labour market conditions stabilise, the savings rate will peak, supporting a recovery in consumption. But it will be a moderate rebound, and the higher debt ratios leave households more vulnerable to the rise in interest rates which will inevitably accompany the ECB's exit strategy.

The position of corporates looks much weaker. The post-Lehman collapse in global economic activity caused profitability to plunge, impairing NFCs' self-financing ability: their gross savings, which had been growing at 5.5 per cent a year between 2001-05, turned into a contraction of 8.5 per cent in the first half of 2009. NFCs reacted by virtually halting investment. In the past, a slowdown in the pace of investment normally went hand in hand with a narrowing of the corporate sector's financing gap – which is the extent to which NFCs need to resort to external sources of funding to cover their investment and operational expenses. This time the financing gap kept widening, to a peak of 5.5 per cent of gross value added in the second quarter of 2009. Faced with a combination of a high debt burden and plunging profitability, NFCs struggled to increase savings and deleverage, even as the ECB's monetary easing and the rebound in equity markets brought about a steep decline in financing costs.

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corporate sector is particularly worrisome, as it worsens the creditworthiness of NFCs as borrowers. This comes at a time when banks need to reduce the overall riskiness of their assets and ensure that the risk is adequately priced, and are under pressure to increase their

## **The weakened financial position of the corporate sector ... comes at a time when banks need to reduce the overall riskiness of their assets**

capitalisation ratios. Combined with very low levels of capacity utilisation, this inevitably clouds the outlook for investment.

To be sure, the aggregate numbers mask significant distributional and cross-country variations within the eurozone. Italy stands out for the prudence of its household sector, with a debt of just 34 per cent of GDP, in sharp contrast to the Netherlands (107 per cent) and Spain (84 per cent). German companies had bucked the trend and deleveraged during the pre-crisis years, and are now in a sounder position than for example Italian corporates, which experienced a substantial rise in leverage.

But the aggregate figures still send a clear and troubling message – households and companies were not immune to the leveraging binge of the credit boom years, and this has left them in a vulnerable financial position. The ECB will soon need to move forward with its exit strategy, but it will have to keep a nervous eye on consumers and corporates whose high debt ratios leave them dangerously exposed to the attendant rise in financing costs. Moreover, once the economic recovery is more firmly established, companies will still need to continue the process of deleveraging, to avoid getting to the next downturn in as vulnerable a position: at nearly 100 per cent of GDP the debt ratio for eurozone NFCs is twice as high as in the US, where it has risen by a modest seven percentage points in the past 10 years.

Corporate debt is the Achilles heel of the eurozone's recovery – less talked about but just as dangerous as household debt in the US.

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