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Should we feel bad about debt?

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Deficits, which combine to form debts, are usually seen as negative – the result of poor financial management. Yet debts and deficits are market economy instruments and essential to the existence of their counterparts: assets and savings. These instruments allow money to flow from sectors with savings to sectors wishing to invest. So, it is difficult to praise surpluses and assets while at the same time condemning deficits and debt.

Debt levels in Germany have been the subject of discussion for many years now, especially with reference to public debt. The euro crisis – often referred to as the debt crisis – has fuelled the debate. Measures such as the establishment of a “debt brake” or the publication of a national “debt clock” suggest that economic entities with debts cannot operate sustainably.

The fact that debt is inevitable in a market economy, as it is the flipside of savings in the form of financial receivables, tends to be overlooked in the debate. Essentially, anyone with financial assets needs someone else who is willing to borrow.

Germany has net assets

When a private household has financial assets, such as a bank account with a positive balance, that account constitutes a financial liability for the bank. Receivables, or financial assets, in any one sector always appear somewhere else, usually in another sector, as liabilities. Equally, the same private household may have liabilities in the form of a loan, for example, which constitutes a receivable for the lending bank. The difference between receivables (in this case, the bank balance) and liabilities (loan) constitutes the private household’s net receivable, or net financial assets.[1]

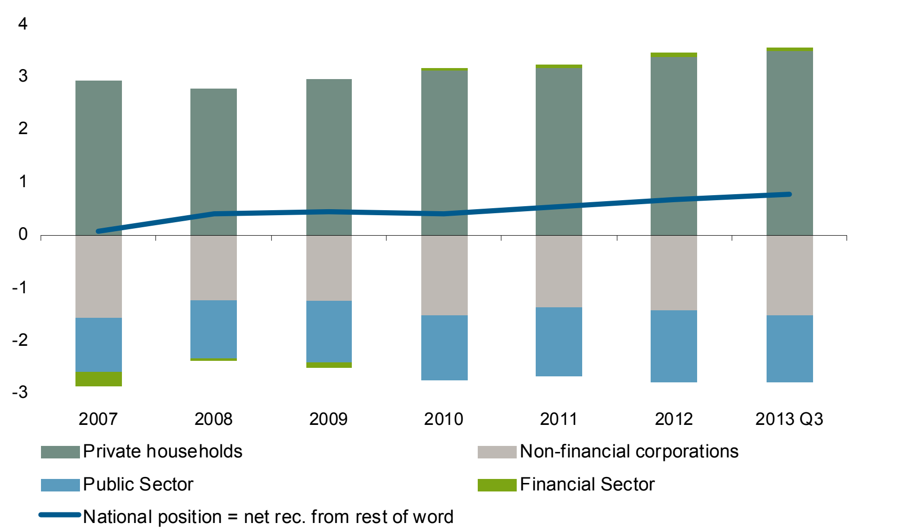
Figure 1 shows a breakdown of net financial assets by sector in Germany. Positive values indicate that a sector’s financial receivables exceed its liabilities. In Germany, this is almost exclusively the case for private households. In contrast, the public sector and non-financial corporations are net borrowers. The financial sector is more or less in balance, which should not come as a surprise, since banks and other financial companies act as intermediaries.

If Germany was a closed economy, with no foreign trade, then net receivables would need to match net debt. However, Germany’s net receivables are around EUR 775 billion higher than its net debt (as at 30th September 2013), which corresponds to just under 30 % of nominal GDP for 2013.[2] The outstanding debt position needed to balance the German net receivables comes from abroad. In other words, the rest of the world owes Germany a total of EUR 775 billion.

The simple act of reducing debt – repaying debts as they mature, not renewing or borrowing less on renewal – has no net effect on the domestic economy as a whole or on the individual domestic sectors. If a private household repays a loan, on the one hand the household’s debt will be lower, but on the other hand the money is no longer in its bank account. Reducing debt does not make us richer as such. However, it can lay the foundations for further borrowing at a later stage.

The distribution of net receivables and liabilities is similar in other national economies (see Figure 2). The German public and private sectors are not unusual in being net borrowers. It is only the level of the balances that varies and with it the country’s total assets in relation to the rest of the world. In the USA – the world’s largest economy – and Spain, a major eurozone economy, private households have a net surplus, but this is offset by a greater national propensity to borrow. Consequently, both countries are net debtors.

Figure 1: Net financial assets in Germany (EUR trillion)



Source: Bundesbank

Financial assets are formed from savings and debts are derived from deficits – which effectively entails borrowing. Double-entry bookkeeping is also used to record savings and deficits: positive (net) savings mean a deficit elsewhere.

What are the benefits of having net assets?

Within a national economy or monetary union, net receivables are usually advantageous as they represent the cumulative savings available to lend to domestic sectors seeking finance with a view to investing.

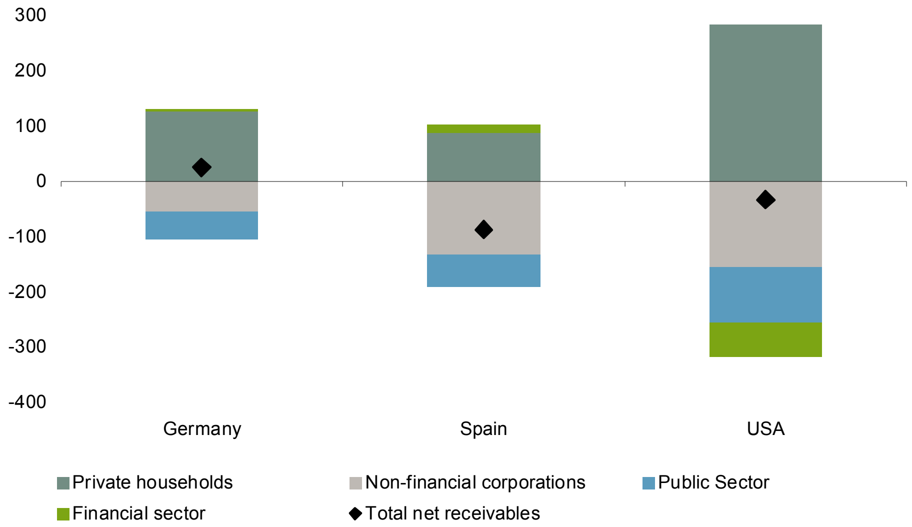
A net receivables position vis-à-vis the rest of the world means that combined national savings have been used to finance investment and consumption in other countries. This can be a disadvantage if this is the consequence of an unattractive domestic investment environment that is unable to absorb all domestic savings, or when there is a clear need for significant investment but the level of debt associated with using the available savings is not considered acceptable. If, in addition, it emerges that the claims on the rest of the world have not maintained their value – for example, because governments are unable to repay – then the national economy does not benefit from having invested the surplus abroad.

Constantly increasing receivables from the rest of the world could also potentially exacerbate international imbalances, triggering undesirable reactions on the capital and currency markets. Various bodies, such as the IMF, World Bank and EU, consistently highlight these issues and encourage national governments to reduce and limit global imbalances as far as possible.

However, having a positive net asset position relative to other countries is not in itself a bad thing. A national economy in which savings in all domestic segments exceed requirements should invest the excess abroad rather than put the money into unsustainable or unnecessary domestic investments. This can also help to promote development in certain countries that do not have sufficient financial resources or mature capital markets. Whatever happens, a country can only be a net lender if the rest of the world is willing to be a net borrower. No matter how sceptical one is about debt, there is no getting around this fact.

Figure 2: Comparison of net financial assets

Percentage of nominal GDP, as at 31th December 2012



Source: Bundesbank, Federal Reserve, Banco de España, Feri, own calculations

It is not possible for everyone to have a surplus

Debt is still perceived as an autonomous national economic problem, even though it is backed up by equivalent financial assets. This is understandable to some extent in that in the past some borrowers have been unable to service their debt, as was the case in the eurozone recently. Obviously this is not a desirable state of affairs for the lenders or the borrowers. Reducing debt levels in order to avoid this kind of occurrence is entirely reasonable.

However, debt reduction is dependent on making net savings, which generally can only be achieved through deficits in other sectors or countries. It is simply not possible for all domestic sectors and the rest of the world to build up a surplus and thereby reduce debt simultaneously. Any such attempt would result in a “battle of the surpluses”. This would be dangerous for the national economy as it would also entail a massive reduction in consumption and investment, which in turn would reduce macroeconomic demand. Surpluses should therefore be economically proportionate and should never be an end in their own right, although sometimes one could be forgiven for assuming the latter was true.

Conclusion

Financial assets always require a counterpart financial debt elsewhere. The obvious corollary is that surpluses (net savings) always need a balancing deficit position. It is therefore illogical for assets and surpluses to regularly be presented as good news, while debt and deficits are commonly viewed as negative.

If a national economy always has more savings than it needs for investment purposes, then it will be a net lender. The position itself is neither positive nor negative: it depends on how the surplus is used. It is not advisable for an economy to neglect important domestic investment while increasing unrecoverable lending to other countries. However, if domestic investment requirements have been covered, then it is intelligent – and indeed necessary – to invest the remaining savings in the rest of the world.

The question of whether a country is a net global borrower or lender is closely linked to the issue of global imbalances, which has only been mentioned in passing in this article. The imbalances within the eurozone were a major contributing factor to the euro crisis. Ideally those imbalances should be eliminated. However, if a nation decides to make relatively high financial assets a long-term target, that certainly does not entitle it to criticise others for having debt. ■

[1] The terms net assets, net financial assets and net receivables are used interchangeably in this article, although technically they are not identical. The differences are negligible for our line of thought in this article.

[2] This data, Figure 1 and parts of Figure 2 are based on the German national financial accounts, which contain a sectoral breakdown of financial flows as well as of assets and liabilities (inventory). Owing to the different calculation methods used, the reported net claims on the rest of the world do not accurately reflect Germany's foreign assets as calculated from the balance of payments. The balance of payments reports foreign assets totalling roughly EUR 1.26 trillion for Germany as at 30th September 2013, which amounts to just under 62 % of nominal GDP. The question of whether a net foreign asset position is meaningful will be discussed later, but the significance is all the more apparent given the figures calculated from the balance of payments. However, the underlying relationships remain the same.