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January 2012

Debt and deleveraging: Uneven progress on the path to growth

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Debt and deleveraging: Uneven progress on the path to growth

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Executive summary

The deleveraging process that began in 2008 is proving to be long and painful, just as historical experience suggested it would be. Two years ago, the McKinsey Global Institute published a report that examined the global credit bubble and provided in-depth analysis of the 32 episodes of debt reduction following financial crises since the 1930s.[1] The eurozone's debt crisis is just the latest reminder of how damaging the consequences are when countries have too much debt and too little growth.

In this report, we revisit the world's ten largest mature economies[2] to see where they stand in the process of deleveraging. We pay particular attention to the experience and outlook for the United States, the United Kingdom, and Spain, a set of countries that covers a broad range of deleveraging and growth challenges. We also look at the relevant lessons from history about how governments can support economic recovery amid deleveraging. We discuss six markers that business and government leaders can look for when monitoring progress, and we assess how close to these milestones the United States, the United Kingdom, and Spain are today. Among our key findings:

- The deleveraging process is in its early stages in most countries. Total debt has actually grown across the world's ten largest mature economies since the 2008–09 financial crisis, due mainly to rising government debt. Moreover, the ratio of total debt to GDP has declined in only three countries in our sample: the United States, South Korea, and Australia (Exhibit E1).

- The deleveraging episodes of Sweden and Finland in the 1990s are particularly relevant today. They show two distinct phases of deleveraging. In the first, households, corporations, and financial institutions reduce debt significantly over several years, while economic growth is negative or minimal and government debt rises. In the second phase, growth rebounds and government debt is reduced gradually over many years.

- Today, the United States most closely follows this debt-reduction path. Debt in the financial sector relative to GDP has fallen back to levels last seen in 2000, before the credit bubble. US households have reduced their debt relative to disposable income by 15 percentage points, more than in any other country; at this rate, they could reach sustainable debt levels in two years or so.

- Deleveraging in the United Kingdom and Spain is proceeding more slowly. The ratio of UK debt to GDP has continued to rise and UK households have increased debt in absolute terms. In Spain, households have barely reduced debt ratios and corporations continue to carry the highest level of debt relative

1 *Debt and deleveraging: The global credit bubble and its economic consequences*, McKinsey Global Institute, January 2010 (www.mckinsey.com/mgi).

2 The list comprises, in descending order by GDP: the United States, Japan, Germany, France, the United Kingdom, Italy, Canada, Spain, Australia, and South Korea.

to GDP in our ten-country sample. It could take many more years to finish an orderly deleveraging in the United Kingdom and Spain.

- The Swedish and Finnish deleveraging episodes reveal six critical markers of progress before the economic recovery takes off: the financial sector is stabilized and lending volumes are rising; structural reforms have been implemented; credible medium-term public deficit reduction plans are in place; exports are growing; private investment has resumed; and the housing market is stabilized, with residential construction reviving.

Despite concerns over the strength of its recovery and the protracted debate over how to reduce public debt, the United States has reached more of these milestones than other nations and is closest to moving into the second, growth phase of deleveraging. Still, no country has all the conditions in place to revive growth. For business leaders trying to navigate the new world of debt reduction, understanding the course of deleveraging is of critical importance. Although growth in the time of deleveraging may be slower and more volatile in some countries, there are also clear opportunities to invest ahead of demand and exploit pockets of growth even within slowly expanding economies.

Exhibit E1

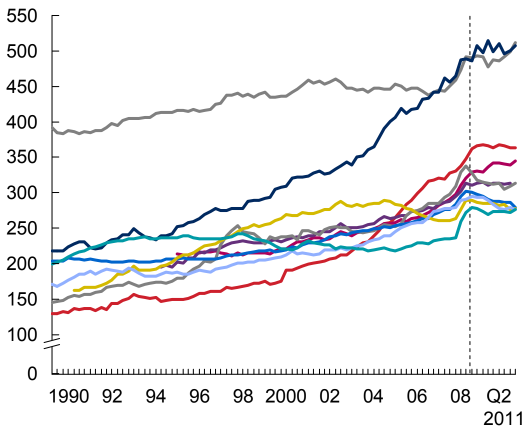
Deleveraging has only just begun in the ten largest developed economies

Total debt,[1] 1990–Q2 2011

% of GDP

▲ Significant increase in leverage[2]

▼ Deleveraging



	Change Percentage points	
	2000–08	**2008–Q2 2011[3]**
Japan	37	39 ▲
United Kingdom	177	20
Spain	145	26 ▲
France	89	35 ▲
Italy	68	12
South Korea	91	-16 ▼
United States	75	-16 ▼
Germany	7	1
Australia	77	-14 ▼
Canada	39	17

1 Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
2 Defined as an increase of 25 percentage points or more.
3 Or latest available.

SOURCE: Haver Analytics; national central banks; McKinsey Global Institute

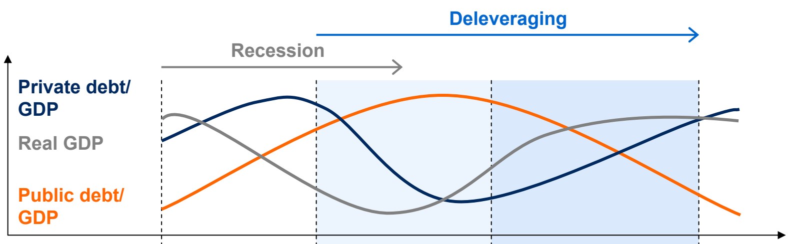
THE PATH TO DELEVERAGING: A TALE OF THREE COUNTRIES

In our previous work on debt and deleveraging, we studied 32 episodes of debt reduction following financial crises. We find that the experiences of Sweden and Finland in the 1990s offer case examples for today's deleveraging economies.[3] In the 1980s, both Nordic nations experienced credit booms and housing bubbles that ended in financial crises. Starting in 1990, both nations experienced severe recessions, as private-sector debt was reduced and government debt rose sharply—doubling in Sweden and tripling in Finland. But these countries moved decisively to resolve their financial crises and enacted reforms to set the stage for growth. By 1994, GDP growth had rebounded in both countries and a long period of fiscal discipline and government deleveraging began (Exhibit E2).

Exhibit E2

Deleveraging typically begins in the private sector, even as government debt continues to grow

Average of Swedish and Finnish deleveraging episodes



	Pre-crisis period	Early stage of recession	Private-sector deleveraging	Rebound and public-sector deleveraging
	10 years	1–2 years	4–6 years	~10 years
Real GDP growth Annual average (%)	3%	-3%	1%	3%
Change in debt/GDP Percentage points				
▪ **Private sector**	60	8	-26	87
▪ **Public sector**	3	15	21	-30

SOURCE: International Monetary Fund; Haver Analytics; McKinsey Global Institute

Today, the United States is following the Swedish and Finnish examples most closely and may be two years or so away from completing private-sector deleveraging. The United Kingdom and Spain have made less progress and could be a decade away from reducing their private-sector debt to the pre-bubble trend.

The United States: A light at the end of the tunnel

Since the end of 2008, all categories of US private-sector debt have fallen relative to GDP. Financial-sector debt has declined from $8 trillion to $6.1 trillion and stands at 40 percent of GDP, the same as in 2000. Nonfinancial corporations have also reduced their debt relative to GDP, and US household debt has fallen by $584 billion, or a 15 percentage-point reduction relative to disposable income. Two-thirds of household debt reduction is due to defaults on home loans and consumer debt. With $254 billion of mortgages still in the foreclosure pipeline,

3 Of the 32 episodes, 21 were in emerging markets. Some that occurred in mature economies predate the modern financial era (e.g., the US after the Great Depression and the UK after World War II), and others involved high inflation, which mechanically reduced the ratio of debt to GDP (e.g., Spain in 1976).

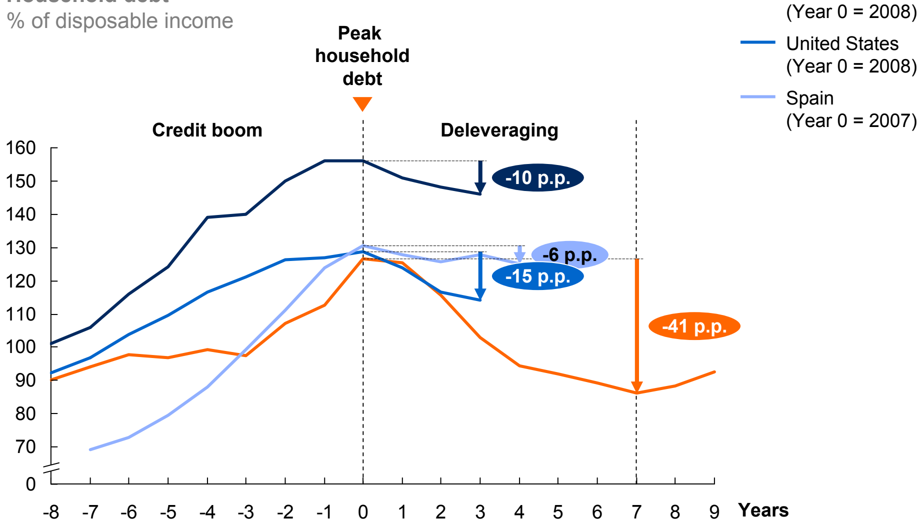
the United States could see several more percentage points of household deleveraging in the months and years ahead as the foreclosure process continues.

Historical precedent suggests that US households could be as much as halfway through the deleveraging process. If we define household deleveraging to sustainable levels as a return to the pre-bubble trend for the ratio of household debt to disposable income, then at the current pace of debt reduction, US households would complete their deleveraging by mid-2013. When we compare US household progress to the Swedish deleveraging episode, in which the ratio of household debt to income declined by more than 40 percentage points, we see that US household deleveraging is a little more than one-third complete. Because US interest rates today are lower than interest rates were in Sweden during its deleveraging, US households may be able to sustain somewhat higher levels of debt (Exhibit E3).

Exhibit E3

US households are about one-third of the way to the Swedish level of debt reduction

Household debt
% of disposable income



NOTE: 2011 figures are as of Q2 2011.
SOURCE: Haver Analytics; Statistics Sweden; McKinsey Global Institute

Even when US consumers finish deleveraging, however, they probably won't be as powerful an engine of global growth as they were before the crisis. One reason is that they will no longer have easy access to the equity in their homes to use for consumption. From 2003 to 2007, US households took out $2.2 trillion in home equity loans and cash-out refinancing, about one-fifth of which went to fund consumption. Without the extra purchasing that this home equity extraction enabled, we calculate that consumer spending would have grown about 2 percent annually during the boom, rather than the roughly 3 percent recorded. This "steady state" consumption growth of 2 percent a year is similar to the annualized rate in the third quarter of 2011.

US government debt has continued to grow because of the costs of the crisis and the recession. Furthermore, because the United States entered the financial crisis with large deficits, public debt has reached its highest level—80 percent of GDP in the second quarter of 2011—since World War II. The next phase of deleveraging, in which the government begins reducing debt, will require difficult political choices that policy makers have thus far been unable to make.

The United Kingdom: Deleveraging has only just begun

Total UK public- and private-sector debt has risen slightly, reaching 507 percent of GDP in mid-2011, compared with 487 percent at the end of 2008 and 310 percent in 2000, before the bubble. The composition of UK debt—how much is owed by different sectors of the economy—diverges from that of other countries (Exhibit E4). While the largest component of US debt is household borrowing and the largest share of Japanese debt is government debt, the financial sector accounts for the largest share of debt in the United Kingdom. Although UK banks have significantly improved their capital ratios, nonbank financial companies have increased debt issuance since the crisis. British financial institutions also have significant exposure to troubled eurozone borrowers, mainly in the private sector. Nonfinancial companies in the United Kingdom have reduced their debt since 2008.

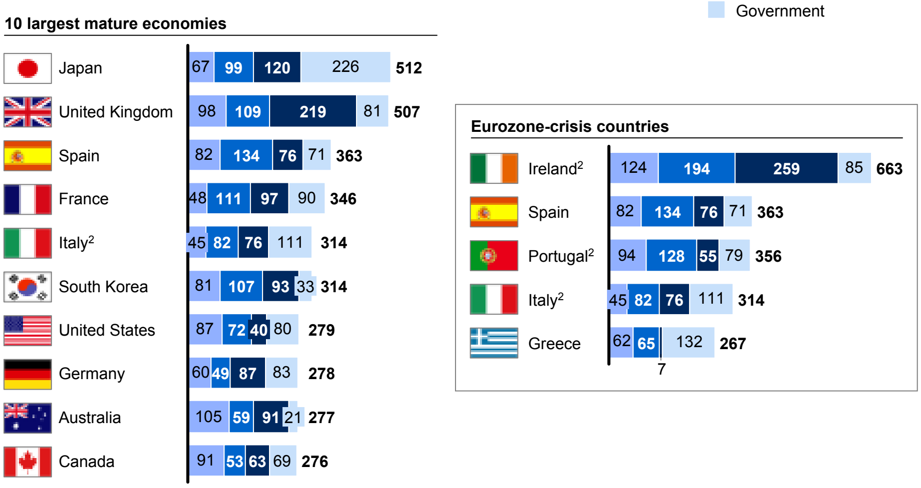
Exhibit E4

The composition of debt varies widely across countries

Total debt,[1] Q2 2011

% of GDP

Households
Nonfinancial corporations
Financial institutions
Government



1 Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
2 Q1 2011 data.
NOTE: Numbers may not sum due to rounding.
SOURCE: Haver Analytics; Bank for International Settlements; national central banks; McKinsey Global Institute

UK household debt, in absolute terms, has increased slightly since 2008. Unlike in the United States, where defaults and foreclosures account for the majority of household debt reduction, UK banks have been active in granting forbearance to troubled borrowers, and this may have prevented or deferred many foreclosures. This may obscure the extent of the mortgage debt problem. The Bank of England estimates that up to 12 percent of home loans are in a forbearance process. Another 2 percent are delinquent. Overall, this may mean that the UK has a similar level of mortgages in some degree of difficulty as in the United States. Moreover, around two-thirds of UK mortgages have floating interest rates, which may create distress if interest rates rise—particularly since UK household debt service payments are already one-third higher than in the United States.

The United Kingdom therefore does not appear to be following the deleveraging path of Sweden. At the recent pace of debt reduction, we calculate that the ratio of UK household debt to disposable income would not return to its pre-bubble trend for up to a decade. Overall, the United Kingdom needs to steer a difficult course: reduce government deficits and encourage household debt reduction—without limiting GDP growth. The United Kingdom will need renewed investment by nonfinancial businesses to achieve this.

Spain: The long road ahead

The global credit boom accelerated growth in Spain, a country that was already among the fastest-growing economies in Europe. With the launch of the euro in 1999, Spain's interest rates fell by 40 percent as they converged with rates of other eurozone countries. That helped spark a real estate boom that ultimately created 5 million new housing units over a period when the number of households expanded by 2.5 million. Corporations dramatically increased borrowing as well.

As in the United Kingdom, deleveraging is proceeding slowly. Spain's total debt rose from 337 percent of GDP in 2008 to 363 percent in mid-2011, due to rapidly growing government debt. Outstanding household debt relative to disposable income has declined just 6 percentage points. Spain also has unusually high levels of corporate debt: the ratio of debt to national output of Spanish nonfinancial firms is 20 percent higher than that of French and UK nonfinancial firms, twice that of US firms, and three times that of German companies. Part of the reason for Spain's high corporate debt is its large commercial real estate sector, but we find that corporate debt across other industries is higher in Spain than in other countries. Spain's financial sector faces continuing troubles as well: the Bank of Spain estimates that as many as half of loans for real estate development could be in trouble.[4]

Spain has fewer policy options to revive growth than the United Kingdom and the United States. As a member of the eurozone, it cannot take on more public debt to stimulate growth, nor can it depreciate its currency to bolster its exports. That leaves restoring business confidence and undertaking structural reforms to improve competitiveness and productivity as the most important steps Spain can take. Its new government, elected in late 2011, is putting forth policy proposals to stabilize the banking sector and spur growth in the private sector.

GROWTH IN THE TIME OF DELEVERAGING

We see from the experience of Sweden and Finland that economies that succeed in restoring growth after deleveraging share certain characteristics. In these nations, we see six critical markers of progress that business and government leaders can look for when they evaluate how today's deleveraging economies are progressing and what priorities to emphasize. Without these conditions, growth and public-sector deleveraging are unlikely, as illustrated by Japan, which did not reach these markers and has suffered two decades of slow growth and rising debt since its 1990 crisis.

4 This figure is mainly loans to real estate developers and does not apply to home mortgages, where the rate of nonperforming loans is relatively low. Under the Bank of Spain's definition, troubled loans include nonperforming loans, substandard loans (loans that are performing but are considered at risk of not performing), and foreclosures.

1. Is the banking system stable?

In Finland and Sweden, banks were recapitalized and some were nationalized, and the government set up special institutions to take over and dispose of the bad loans that clogged the financial system. This decisive resolution of the banking crises was critical to kick-starting lending during the growth phase of deleveraging. By contrast, in Japan, failure to recognize and resolve nonperforming loans in the corporate sector weighed on Japanese banks for more than a decade.

In response to the crisis, the United States and the United Kingdom moved quickly to provide liquidity and capital to banks, and they forced mergers and nationalized banks where needed. But vulnerabilities remain. In most parts of the United States, the housing market is still depressed, limiting the mortgage origination business. The UK financial sector is heavily exposed to the euro crisis, with $359 billion in loans to private and sovereign borrowers in troubled eurozone countries. Spain shut some regional banks, but only recently began discussing a more comprehensive plan to deal with the large number of troubled loans that its banks hold.

As the euro crisis continues, forced deleveraging—a rapid contraction in bank lending driven by acute funding and capital shortages—remains a risk for all of Europe. To date, access to bank lending has not been an issue in most of Europe, primarily because demand for business credit has been weak since 2008. The eurozone crisis, however, raises the risk of a credit contraction in 2012 if banks face funding constraints at the same time they face rising capital requirements. Such a forced deleveraging would significantly damage the region's ability to escape recession.

2. Is there a credible plan for long-term fiscal sustainability?

Moving too soon and too aggressively to cut government spending can slow the recovery, as Finland found in 1992. But it is also important for governments to demonstrate a commitment to addressing government debt. In Sweden, the Social Democratic Party campaigned on a platform of fiscal reform and won election in 1994. Through budget restraint and renewed growth, Sweden eliminated its fiscal deficit by 1998. Government debt fell from 82 percent of GDP in 1998 to 45 percent a decade later.

Today's deleveraging economies face a more difficult situation. Sweden was running government surpluses when its crisis hit, while the United States and the United Kingdom were already posting widening deficits prior to the financial crisis in 2008. In the past two years, the UK and Spanish governments have adopted austerity plans. The UK program to limit government spending is credited with keeping government borrowing rates very low, but the impact of austerity on the strength of the recovery remains a subject of debate. In Spain, despite a commitment to cut the fiscal deficit to 4.4 percent of GDP by 2012 (from 11 percent in 2009), rates on government bonds have continued to rise. In 2011, Spain took the additional step of adopting a constitutional amendment requiring a balanced budget by 2020. The United States, by contrast, has failed to adopt a long-term plan to reduce the federal deficit, leading to the first credit rating downgrade of US government debt.

3. Are structural reforms in place?

Sweden and Finland enacted significant structural reforms that helped clear the path to stronger recovery and sustainable growth. The most sweeping change was joining the European Union in 1995, which allowed both nations to attract more foreign investment and boost exports. In addition, they enacted reforms to raise productivity and spur growth in sectors such as retail and banking. Japan, by contrast, did not adopt structural reforms, resulting in a two-tier economy with some highly productive, export-oriented companies but many small, less productive firms in domestic sectors.[5]

Today's deleveraging economies need reforms tailored to their own circumstances. The United States, for instance, could encourage growth by investing in infrastructure and workforce skills, streamlining regulatory approvals for business investment, and simplifying the corporate tax code.[6] UK planning and zoning rules can be reviewed to enable expansion of successful high-growth cities and to accelerate home building. Infrastructure improvement and continuing to allow immigration of skilled labor can help ensure that the United Kingdom remains attractive to multinational companies.[7] Spain can drastically simplify business regulations to ease the formation of new companies, help improve productivity by promoting the creation of larger companies, and reform labor laws.[8]

4. Are exports rising?

From 1994 to 1998, Swedish and Finnish exports grew by 9.7 percent and 9.4 percent a year, respectively, helping lift these economies into the second phase of economic growth and public-sector deleveraging. This boom was aided by a small group of strong export-oriented companies, including Finland's Nokia, whose success in the 1990s generated 25 percent of Finnish exports. Currency depreciations of up to 34 percent during the crisis also helped boost exports.

In larger economies, such as the United States and the United Kingdom, exports alone do not have the same potential to drive GDP growth. However, they are important contributors to rebalancing growth away from consumer spending. Service exports, including the "hidden" ones generated by tourism, are a potential source of further export growth. Both nations also have a competitive advantage in business services, as evidenced by trade surpluses in those sectors. In Spain, increasing goods exports and tourism will be critical.

5. Is private investment rising?

A revival of private investment contributed to GDP growth in Finland and Sweden and helped offset more moderate consumption growth during the second phase of deleveraging. In both countries, investment grew at twice the rate of

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5 See *Why the Japanese economy is not growing: Micro barriers to productivity growth*, McKinsey Global Institute, July 2000 (www.mckinsey.com/mgi).

6 See *Growth and renewal in the United States: Retooling America's economic engine*, McKinsey Global Institute, February 2011; and *Growth and competitiveness in the United States: The role of its multinational companies*, McKinsey Global Institute, June 2010. Both are available at www.mckinsey.com/mgi.

7 See *From austerity to prosperity: Seven priorities for long-term growth in the United Kingdom*, McKinsey Global Institute, November 2010 (www.mckinsey.com/mgi).

8 See *A growth agenda for Spain*, McKinsey & Company and FEDEA, December 2010.

consumption during the recovery, and in Sweden investment grew nearly as fast as exports, albeit from a very low level during the recession.

Both business and real estate investment declined sharply during the credit crisis and the ensuing recession in the United States, the United Kingdom, and Spain. In the United States and the United Kingdom, private business investment declined by roughly one-third during the crisis, and US residential real estate investment plummeted by twice that amount.

Since the end of the crisis, growth in business investment has remained weak in all three economies, and companies in the United States and the United Kingdom have been adding to cash reserves. As long as the business sector continues to save rather than invest, the strong economic growth that was the biggest factor in reducing government deficits in Sweden and Finland will not materialize. Therefore, a critical policy goal must be to rebuild business confidence and create the conditions in which executives are willing to invest.

Additionally, given current very low interest rates in the United Kingdom and the United States, this would be a good time for private investment in infrastructure, another important enabler of long-term growth. There are ample opportunities to renew the aging energy and transportation systems in both countries, provided that pricing and regulatory structures are in place to generate reasonable returns. Spain, too, has opportunities for infrastructure investment.

6. Has the housing market stabilized?

A stabilized housing market and a rebound in construction are important elements in returning to normal economic conditions. Residential real estate construction equaled between 4 and 5 percent of GDP in the United States before the housing bubble, and housing drove sales of durable goods and other consumer products. Today, the number of US housing starts is only one-third of the long-term average, and home prices continue to decline in many parts of the country.

While the United States has a glut of unsold houses, the United Kingdom is in need of new homes, thanks to low investment in housing before the crisis (just 3.5 percent of GDP, compared with 6 percent in France and Germany and as much as 12 percent in Spain). Land use rules that prevent many tracts from being developed should be reviewed to address the housing shortage.

In Spain, the legacy of the housing boom is more than 1.5 million excess homes. This inventory could take a decade or longer to clear and will likely weigh on property prices and construction employment in the meantime.

FINDING BUSINESS OPPORTUNITIES AMID DELEVERAGING

Deleveraging has important implications for business executives as they plan investments and consider geographic and strategic priorities. Current macroeconomic models do not fully capture the impact of deleveraging on demand.[9] Therefore, standard forecasts must be overlaid with a perspective on how deleveraging is proceeding in different markets. As we have seen, not only

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9 See Olivier Blanchard, Giovanni Dell'Ariccia, and Paolo Mauro, "Rethinking Monetary Policy," IMF Staff Positon Note, February 12, 2010; and Gauti B. Eggertsson and Paul Krugman, "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo approach," the Federal Reserve Bank of New York, November 16, 2010.

does the pace of debt reduction vary across economic sectors and nations, but it can also vary considerably within states and regions, creating very different demand profiles. Finding opportunities will require a very granular approach to strategy. In this environment, business leaders should:

- **Expect constrained consumer demand.** As consumers continue to deleverage and rely more on current income than credit to fund purchases, growth in consumer spending will be limited. In many nations, slow housing starts also will dampen demand in many categories. Current growth rates in consumer spending may be the "new normal" for quite some time.

- **Emphasize value.** When they do spend, consumers are likely to be far more cautious: impulse purchases are no longer in household budgets, and brand loyalty may have less influence than price.

- **Accelerate productivity improvements.** With consumers reluctant to spend and overall growth tepid, margin pressures will likely increase across industries. This makes additional productivity gains imperative.

- **Invest ahead of demand.** When private-sector deleveraging concludes, demand will increase. Depending on which economy, this process may take several years or more. Companies that invest before demand picks up will be in position to gain market share. Often in slow periods, future sector leaders make their moves.

- **Take a granular view of markets.** The after-effects of the debt crisis are not spread evenly across mature economies or within them. While Nevada and Florida struggle under the burden of unsold homes and weak consumer demand, Texas and New York have returned to pre-crisis levels of economic output.

- **Consider new opportunities in public-sector projects.** There is enormous need, particularly in the United States and the United Kingdom, for infrastructure improvements and other public investment—which governments are not in a position to fund by themselves. Investments by the private sector in such projects may be a solution.

- **Think long term.** As we have seen, there are no quick fixes when economies are recovering from financial crises and credit bubbles. Nonetheless, there will be opportunities for businesses that understand the economic environment.

□ □ □

Navigating through the time of deleveraging requires an understanding of how countries can succeed in reducing debt without unduly restraining economic growth. It is a difficult process, requiring structural changes to raise productivity and rebalance sources of growth. But history shows that countries that rise to the challenge can set their economies on a path of sustainable and robust long-term growth.

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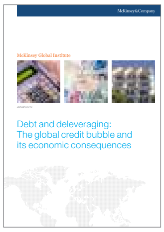


Debt and deleveraging: The global credit bubble and its economic consequences (January 2010)

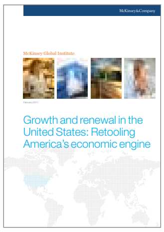
The bursting of the great global credit bubble left a large burden of debt weighing on many households, businesses, and governments—directly affecting the prospects for economic recovery in countries around the world. Leverage levels are still high in ten sectors of five major economies. If history is a guide, one would expect many years of debt reduction.

Mapping global capital markets 2011 (August 2011)

The 2008 financial crisis and worldwide recession halted a three-decade expansion of global capital and banking markets. Today, growth has resumed, fueled by expansion in developing economies but also by a $4.4 trillion increase in sovereign debt. The total value of the world's financial stock has increased from $175 trillion in 2008 to $212 trillion at the end of 2010, surpassing the previous 2007 peak.

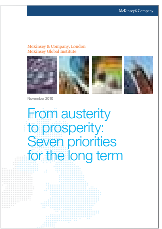
The emerging equity gap: Growth and stability in the new investor landscape (December 2011)

The rapid accumulation of wealth and financial assets in emerging economies, and aging, changing pension regimes, growth of alternative investments, and new financial regulations in developed economies, are changing how money is invested. These forces point to significantly reduced investor demand for publicly listed equities, causing a projected decline in the share of global financial assets held in equities.



Growth and renewal in the United States: Retooling America's economic engine (February 2011)

As baby boomers retire and the female labor participation rate plateaus, increases in the workforce will no longer provide the lift to US growth that they once did. To match the GDP growth of the past 20 years, the United States needs to boost labor productivity growth from 1.7 to 2.3 percent a year. That's an acceleration of 34 percent to a rate not seen since the 1960s.



From austerity to prosperity: Seven priorities for the long term in the United Kingdom (November 2010)

Over the last 15 years the United Kingdom's productivity growth has been encouraging, matching the strong performance of the United States and closing the productivity gap with the EU-15. Overall productivity levels, however, are still nearly 20 percent below the US and 10 percent lower than those of Germany.

Beyond austerity: A path to economic growth and renewal in Europe (October 2010)

Europe faces multiple, simultaneous pressures on GDP growth at a time when scope to stimulate growth from public funds is limited by high debt and deficit levels. The threat to growth is unlikely to dissipate in the short or even medium term and significant imbalances in unit labor costs and current account positions between European economies intensify the strain.

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