Editorial: Debt – Blessing or Curse?

PETER HENNECKE, DORIS NEUBERGER, AND DOROTHEA SCHÄFER

Peter Hennecke, FOM University of Applied Sciences Hamburg, E-Mail: peter.hennecke@fom.de
Doris Neuberger, University of Rostock, E-Mail: doris.neuberger@uni-rostock.de
Dorothea Schäfer, German Institute for Economic Research DIW Berlin, E-Mail: dschaefer@diw.de

Since the 1980s, especially in the new millennium, the issue of debt is increasingly the focus of political debates, as an analysis of parliamentary speeches since 1949 shows.[1] More than ten years after the outbreak of the Great Financial Crisis and almost ten years since the beginning of the European sovereign debt crisis, there are not just questions about the opportunities and risks of debt but also ongoing debates about debt brakes.

Debt is the driving force behind investment, economic growth, and prosperity: without the indebtedness of private households, companies, and governments, there are no interest-bearing securities, such as government bonds or corporate bonds, in which savers can invest. Banks that do not find borrowers to lend to will, at some point, also be unable to take on further savings. Real interest rates are generated by productive investments in the real economy. The current low interest rates point to insufficient investment activity and a surplus of savings. On the other hand, the global financial crisis was a crisis of over-indebtedness resulting from unproductive investments in non-valuable financial instruments. Over-indebted banks had to reduce their debts and reorganize themselves, or the state rescued them. Countries borrowing on the international capital markets had to pay higher interest rates, then they fell into crisis and received new debt through “rescue packages.” At the same time, debt ceilings represent an obstacle to overcoming crises through credit-financed investments. Private households face similar problems: on the one hand, they need loans for productive participation in economic life and for business start-ups; on the other hand, consumers with lower incomes or liquidity are vulnerable to over-indebtedness. In order to avoid insolvency, they often have to accept rescheduling loans or revolving loans with expensive payment protection insurance policies that further increase their debt burden. In this context, the question arises to what extent consumers are affected by irresponsible or usurious lending as well as what regulatory measures are necessary to prevent this. Market failures in credit markets, whether due to usury, exclusion of customer groups or speculative exuberance in the pricing of bonds, can be corrected by government intervention in order to increase welfare.

1 https://www.zeit.de/politik/deutschland/2019-09/bundestag-jubilaeum-70-jahre-parlament-reden-woerter-sprache-wandel#s=schulden (accessed: October 29, 2019).

This issue of the *Quarterly Journal of Economic Research* deals with the economic and social effects of debt and its appropriate regulation. It is divided into two parts. The first part of this issue deals with sovereign debt and the second with private sector debt.[2]

Sovereign Debt

Whether public debt is a blessing or a curse for euro member states is the subject of intense debate. The euro area has a single monetary authority, while sovereign debt with varying levels of risk remains in national hands. Gabriella Chiesa shows in her contribution, "Sovereign Debt, the blessing aspects and the implications for the Euro Area," that a common safe asset through pooling of sovereign debt would be a blessing for the euro area. The greater the amount of safe liquid assets, the greater the volume of real investment. If there is a negative correlation between crisis states, the pooling of high-risk sovereign debt and subsequent tranching to isolate the safe component would allow for a total amount of safe assets higher than would be achieved by tranching sovereign debt at the national level. Therefore, optimal debt management policies cannot be implemented at the country level. The common cost of the risky bond issue for euro member states would decrease. However, how these benefits could be shared among countries is an open question.

Sovereign debt brakes may be a curse for future generations by impeding productive investments in e. g. infrastructure, human capital, or a green new deal. If they are poorly designed, e. g. by initiating or increasing pro-cyclicality, they may even be a curse for living generations. In their article, "The German Debt Brake – Approaches for an Improvement of the Technical Design," Thomas Lenk, Christian Bender, and Philipp Glinka examine the German debt brake from a technical point of view. By designing it on the basis of the EU method to estimate the production potential and output gap, an adequate division between the cyclical and structural components of the budget balance should be possible, while at the same time pursuing a countercyclical fiscal policy. However, both the behavior of the NAWRU[3] – a central element of the production function approach – as well as its revisions seem to be a source of a pro-cyclical influence on the German debt brake. An outline of reform proposals shows that a change of the Basic Law is not necessary in order to improve the dynamics of the fiscal rule at hand.

Private Debt

Whether the current indebtedness of the private sector poses a threat to financial stability depends on adequate regulation of the entire financial sector and the projects already underway to strengthen banking system stability. However, undesirable side effects for the financing of the real economy can occur, as Giovanni Ferri and Valerio Pesic point out in their contribution, "The Spillover Effects of Prudential Regulation on Banking Competition." Debt reduction as a result of increased regulatory capital requirements has led to a reduction in lending, particularly by larger

2 The complement to this issue is Peter Hennecke, Doris Neuberger, Dorothea Schäfer (Eds), Schulden – Segen oder Fluch?, Vierteljahrshefte zur Wirtschaftsforschung 88 (2019), https://elibrary.duncker-humblot.com/zeitschriften/id/25/vol/88/iss/2173/art/12337/, https://doi.org/10.3790/vjh.88.4.5.

3 The Non-Accelerating Wage Rate of Unemployment (NAWRU) is an estimate of the structural unemployment rate. It is the level of the unemployment rate that keeps the growth rate of wages constant.

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banks in Europe. Although this decline was partially offset by medium-sized banks, a significant deterioration in the quality of their loan portfolios resulted. This is proving tricky through the prolonged European dip. Small banks appear to be less affected as they rely more on relationship banking technologies with soft information.

One of the aims of macroprudential capital adequacy regulation is to limit the pro-cyclicality of lending by banks. Debt cycles can be caused by financial sentiment over the economic cycle, as Korkut Ap Ertürk and Jake Jennings point out in their article, "Debt and Financial Sentiment. Early Keynes on Balance Sheet Effects of Asset Price Changes." As Keynes describes in "A Treatise on Money," asset price changes can change unexpectedly if doubts arise about the value of assets. Financial sentiment begins to tilt when economic performance is unexpectedly below average, raising concerns that current asset prices are excessive. While the economy is driven by debt when financial sentiment is strong, it tends to move into over-indebtedness as sentiment weakens. Thus, whether debt is perceived as a blessing or a curse depends on the mood.

Not least, the great "subprime" financial crisis showed that over-indebtedness of private households due to unsustainable lending represents a systemic risk. However, how can sustainable debt be distinguished from unsustainable debt and which households are affected? Damon Gibbons explores these questions in his article, "Unsustainable Household Debt: addressing the problem of measurement." He shows that aggregate measures of household indebtedness (e. g. household liabilities relative to income) are severely flawed. They do not fully capture the debt servicing burdens of households, nor do they provide insight into the distribution of debt burdens, which may be important for both future financial stability and economic growth. Combining a new analysis of aggregate data with insights gleaned from household debt surveys in the United Kingdom, he finds a significant increase in household debt burdens between 2016 and 2018. A significant minority of households are in dire financial straits: cutting back on their consumption in order to maintain their debt repayments and falling into arrears with their payments. The findings indicate a need for policy makers to develop alternative measures or to lower the thresholds used in official measures of financial vulnerability and over-indebtedness; at the same time, they should pay greater attention to relieving the financial pressures facing households in debt.

Unsustainable debt may be due to excessive loan prices or so-called usury. Is usury in consumer credit markets a market failure or a regulatory failure? Doris Neuberger and Udo Reifner show in their article, "Systemic Usury and the European Consumer Credit Directive," that both are the case and especially affect low-income households. This is not about exploitation by greedy lenders, but about social discrimination as a systemic problem, where belonging to a group that is statistically discriminated against leads to entrapment in a chain of usurious credit and financial contracts. The explanations for this are monopoly power, risk-based pricing, and negative externalities. However, the 2008 European Consumer Credit Directive erroneously assumes that usury can be eliminated through more information and transparency. As it implicitly recognizes usurious practices and products as legal, it thus undermines national fights against usury.

Debt markets play a key role in market economies and are a blessing, if they enable productive investments that cannot be financed by own funds. Unfortunately, debt markets are subject to market imperfections and failures that might turn debt into a curse. Therefore, prudent regulation of products and credit institutions is called for. Moreover, whether sovereign debt is a blessing or a curse also depends on its design, such as pooling to a common safe asset in the Eurozone or the possible procyclicality of the German debt brake.

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