

## Rising interest rates, Eurozone private sector debt: Nothing to fear but fear itself

- The private sector in the eurozone can cope with rising interest rates; the relative interest burden will remain below the pre-crisis level even in six years' time
- In the most likely scenario, annual interest payments increase by EUR 160bn in 2022 – compared with relief of almost EUR 300bn in the years of extreme low interest rates
- Beyond the eurozone average, pockets of vulnerability are detectable: Portuguese households as well as French and Italian corporates will face rather sharp increases.

**MUNICH – 26 APRIL 2017** -- Euler Hermes and Allianz Research teams recently analyzed the impact of monetary normalization on debt service payments of the private sector in the eurozone. In contrast to the public sector (and big companies), the majority of smaller companies and households cannot shield themselves against rising rates by issuing long-term debt, locking in current ultra-low interest rate levels. Dependent on bank loans, their “pass-through” is much faster; today roughly 80 percent of new corporate bank loans have a rate fixation of less than one year (if at all). The notable exception relates to mortgage loans in several eurozone countries, including Germany.

Regression analyses were used to estimate how an increase in the ECB key interest rate will impact average interest rates on bank loans for households and the corporate sector. Three scenarios describe the development of the ECB key interest rate up to 2022. The base scenario is one of “soft normalization”, with the ECB only starting to hike the key rate from 2019 onwards; the other two scenarios are called “moderate” and “hard normalization”. The key rate would reach 2 percent at 2022 year-end in the base scenario, 3 percent in the second and 4.25 percent in the third scenario. Assuming that the years of deleveraging have also come to an end, with the moderate recovery in the euro area continuing, private debt will rise in sync with overall economic activity.<sup>1</sup>

“The days of extremely low interest rates are numbered,” said Michael Heise, chief economist at Allianz. “Fears in the market are growing that the withdrawal of cheap money could bring the economy crashing down – because it rests on a foundation of debt and because economic players are hooked on the “drug” of cheap money. But our study clearly shows the additional interest burden for the private sector in the eurozone remains moderate on the whole. It is certainly not an excuse for continuing to print money: from this perspective, there is nothing standing in the way of a return to normal monetary policy.”

In contrast to the public sector, the private sector took the last few years as an opportunity to whittle down its debt level. Relative to economic output, private debt in the eurozone has dropped significantly - 16 percentage points since its 2009 peak. In combination with ultra-low interest rates, this resulted in a significant drop in interest payments. The debt service ratio (interest payments expressed as a percentage of GDP) dropped by 3.4 percentage points to only 3.0 percent - this was also down considerably on pre-crisis years when it hovered around 5 percent or more. The absolute numbers are astounding: annual payments fell by around

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<sup>1</sup> For further details on methodology, see the paper: A. Boata, K. Brandmeir & A. Holzhausen (2017), ECB QE – Quest for Exit. The private sector is able to cope with rising interest rates, Allianz Research.

EUR 300bn between 2008 and 2016; on a cumulative basis, the private sector “saved” roughly EUR 1,550bn across eight years.

“All in all, the ECB did a great deal to support private debtors,” said Kathrin Brandmeir, economist at Allianz Research and co-author of the study. “The relief for private debtors was most pronounced in the crisis countries. In terms of GDP, Ireland, Spain and Portugal reaped the greatest benefit from the drop in interest rates, with their interest burden falling by around seven percentage points. On the other hand, the relief for the core EMU countries - Germany, the Netherlands, France and Belgium - has been much less pronounced, but substantial nonetheless at 2.3 percentage points on average.”

However, in the future interest rates and debt levels will increase again. This will naturally result in higher debt service payments for the private sector. This will not, however, simply mean that the previous relief is reversed. Even in the least favorable scenario of “hard normalization”, the interest payments will ‘only’ increase by roughly EUR 280bn 14 years later - in 2022: their absolute value will still fall short of the level reached at the 2008 peak of the credit boom. In the more likely event of “soft normalization”, interest payments are only expected to increase by around EUR 160bn, almost one quarter lower than in 2008 in absolute terms. In relation to economic output, the increase in the euro area is likely to come to between 0.7 (“soft”) and 1.6 percentage points (“hard”), reaching 3.7 percent or 4.7 percent respectively. The bottom line: for the eurozone as a whole, the relative interest burden is set to stay not only below the 2008 peak, but also generally lower than in the pre-crisis years – even in the risk scenario.

However, the average number masks fairly large differences between the eurozone members. Portuguese households are in for a rather bumpy ride. For them, the increase in interest payments could be – in the risk scenario – a hefty 4 percentage points of disposable income, more than doubling the relative interest burden. In the corporate sector, French and Italian companies are the most exposed to rising interest rates, for two reasons: interest payable as a percentage of operating surplus is already high - well above the European average, and the expected increase is also rather sharp. However, even in the most adverse scenario, the relative interest burden of French and Italian companies will remain comfortably below the 2008 peak. Moreover, the corporate sectors in both countries sit on fairly large high cash piles as additional buffers.

“In short, a return to rising interest rates will not come as welcome news for private debtors,” said Ana Boata, economist at Euler Hermes and co-author of the study. “The extent to which households and companies in the euro area are affected will vary. However, the euro area private sector has the constitution to digest normalization of monetary policy. The extra interest burden will not be substantial enough to fuel fears of another economic slump, so there is no reason to fear a rise in interest rates.”

### Interest payments by the private sector...

		...in EUR bn		
		2008	2016	2022*
#1	Germany	136	82	117
#2	France	103	67	99
#3	Italy	107	53	79
#4	Netherlands	55	42	55
#5	Spain	109	30	50

#6 Belgium	15	10	15
#7 Austria	17	8	14
#8 Ireland	23	7	11
#9 Portugal	18	6	11
<b>Eurozone</b>	<b>617</b>	<b>326</b>	<b>483</b>

	...in percentage of GDP		
	2008	2016	2022*
#1 Netherlands	8.6	6.0	6.6
#2 Portugal	10.1	3.3	4.7
#3 Italy	6.6	3.2	4.1
#4 France	5.2	3.0	3.8
#5 Spain	9.7	2.7	3.6
#6 Austria	5.9	2.2	3.3
#7 Ireland**	12.2	2.7	3.1
#8 Germany	5.3	2.6	3.1
#9 Belgium	4.2	2.4	2.9
<b>Eurozone</b>	<b>6.4</b>	<b>3.0</b>	<b>3.7</b>

\*scenario 'soft normalization'

\*\* One-off effect: From 2015 onwards, data is not comparable due to changes in the National Accounts Statistics. Without this effect, the ratio of interest payable to GDP was approx. one percentage point higher.

The complete study is available at <https://www.allianz.com/economic-research/en/> in the Publications/Research paper section.

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