SUSTAINABILITY OF EU DEBTS

1. Different sovereigns pose different credit risks in the EU

The 2018 edition of the Commission Fiscal Sustainability Report (FSR) points to persisting fiscal sustainability risks. In the short-term, fiscal sustainability risks are identified in Cyprus, in the light of continuing macro-financial vulnerabilities and the sharp increase of its government debt in 2018. Spain, France, Italy and Hungary present some short-term vulnerabilities stemming from their fiscal position. Italy appears particularly exposed to sudden changes in financial market perceptions, notably given its sizeable government financing needs. In the medium-term, high risks are identified in Belgium, Spain, France, Italy, Hungary, Portugal and the United Kingdom, driven by the debt levels, current and perspective, and the sensitivity to adverse shocks. In the long-term, considering the fiscal pressure due to demographic ageing, high risks are identified in Belgium, Spain, Italy, Luxembourg, Hungary and the United Kingdom.

1.1. Public debt vulnerabilities remain high in a small set of mainly large European economies

A policy-maker noted they have come a long way since the crisis. The EU has successfully reformed itself, though there is more to achieve. At an aggregate level, public-debt ratios have significantly decreased since 2014; this is also true at country-specific levels. In a significant number of countries, debt has been on a declining path. Compared to other advanced economies, this is a good performance; trends in the US and Japan are far worse than Europe.

There are, though, still risks concentrated in some countries. Unfortunately, some are found in relatively large economies. Current momentum remains favourable, despite the slowdown in growth. Indeed, financial conditions are very supportive, and these countries are encouraged by the European Commission to rebuild their fiscal buffers. It is not just about a short-term fix and fiscal consolidation, but a longer-term perspective to reform economies. There are important trade-offs that attempts are being made to address in terms of ensuring a sustainable debt trajectory, whilst at the same time not weakening economic systems.

An official outlined the high level of sovereign debt in a few countries, with around five close to or over 100%. Given the low interest environment, this is not causing a great deal of stress, but these countries have very thin fiscal buffers. With a decline in growth or a downturn they will be forced into a pro-cyclical fiscal tightening; both uncomfortable and difficult to deliver.

One of the recent worries has been that growth has been well above its potential in Europe. Second, when interest rates and sovereign borrowing costs have been far lower than anticipated, owing to low inflation and an accommodative low monetary policy interest rate environment, these countries have not built fiscal buffers and reduced their debt burdens.

1.2. There is no simple metric to define debt sustainability

An official noted that there is no metric that will rule one country sustainable and another unsustainable. It is complex, and the discussion around debt sustainability should be framed about risks and opportunities for countries in favourable times.

Another speaker stressed that their company focuses on four key factors for defining debt sustainability: economic strength; institutional strength; fiscal strength; and susceptibility to event risk. They use a range of indicators to inform the assessment of these factors on a forward-looking basis, including the longer-term challenges that many sovereigns face about health spending and other public service provisions given their demographic profiles; these challenges, in particular, could lead to debt-GDP ratios rising dramatically over the longer term. Together, these four key factors give a sense of how sovereigns compare with each other. Ultimately sovereign ratings reflect an institution's own opinions, incorporating analytical judgment as well as quantitative analysis.

In terms of whether debt is sustainable or not a Central Bank official felt that it all depends. Debt sustainability depends mainly on fiscal policy, including retirement systems as the crucial part. The official warned that economic growth cannot solve the problem, as GDP levels are three times higher than in the 1960s, with public finances not having improved substantially. This increase affects revenues, taxes and expenditure at the same time.

A speaker noted that sustainable public finances are about demographics and pension reform, markets and interest rates and last but not least annual fiscal policy in the context of the EU fiscal framework. Within the EU, national member states maintain their responsibility for fiscal policies. This should always be the starting point for discussing the common fiscal framework.

A Central Bank official questioned whether there is a real need to tie the private sector in its entirety, including banks and non-financial companies, to the sovereign, as is happening at present. From that angle, if stronger policies can be pursued in terms of the diversification of sovereign debt holdings of banks, it would be easy to introduce some concentration risk changes to facilitate better diversification. Getting a capital markets union to work, so that risk is not only shared but there are also financing opportunities which go much further than relying on the domestic market alone, would be a benefit for all.

As long as interest rates are rock-bottom as today, the risk of losing control in the short-term is limited. The worry is what will happen if a recession kicks in, with room for fiscal policy manoeuvre virtually non-existent in these countries. This is a serious risk. A chance can be seen of rebalancing in the system, as there may be a more expansionary fiscal policy in the north, thereby also contributing to a limiting of imbalances in the euro-area. However, it takes a great deal of discipline to avoid expansionary fiscal policy in a recession. In a few countries, this is not possible and would be risky if attempted.

A regulator noted that ESM programme countries have done much to address the situation. It is important to have the right perspective on debt.

Two aspects are important in such an assessment of ESM's operation. Firstly, looking at debt levels is not enough; the prime country here is Greece, and looking only at the debt level of 170-180% does not tell us much. With ESM loans, they have substantially extended maturity, so that for 50% of its debt Greece receives loans for a weighted average maturity

of 42 years, at an interest rate of 1% and below. This gives an entirely different perspective on the debt level per se, which is important to note. Greece is an exceptional case, but it can be noted that other euro-area sovereigns have in the past years extended the maturities of their debt structure, leaving room for financing as well as giving a certain stability in terms of interest rate increases. Second, one lesson from the crisis and post-crisis experiences was that it is necessary to take the right direction. A case in point here is what has been seen with Portugal subsequent to the programme, where there had been initial doubts about whether the Portuguese government would stick to the budget, but afterwards the return to confidence has had a tremendous effect.

These two metrics are important and need to come into the picture when looking at the debt situation. EFSF/ESM were set up to provide financial assistance for euro-area countries that could no longer access capital markets at affordable rates. Cyprus, Greece, Ireland, Portugal and Spain obtained loans from the EFSF/ESM at much lower interest rates than those that would theoretically have been offered by the market.

The Chair noted there has been a great deal of development over the last 10 years, with fiscal frameworks being adjusted and added to. The ESM has been created, which is an important institution. At the same time, there is still a tension between governments and investors being held accountable. A Central Bank official had talked about member states being responsible for fiscal policy choices, not only from a policy setting perspective, but a consequential implication. At the heart of it, an issue exists about how to balance market risk and sovereign-debt sustainability. A regulator has given an example of Greece and extended maturities, but it cannot be forgotten that this came after two sovereign defaults. Apart from institutions, there are fundamental questions about what will happen should another eurozone country find itself in market, credit or fiscal distress.

With this in mind, the discussion can focus on the sovereign side and what needs to change, given that Italian debt-to-GDP is at 130% or higher and showing no signs of coming down. In France, there is little concrete sign of a material downward trend in the debt to-GDP ratio. These risks are out there, and there is less fiscal space in Europe than 15 years ago.

2. What needs to change or possible ways forward

The Chair posed the question to the panel of what needs to change, or what may be a possible way forward on sovereign debt.

2.1. Weakening the sovereign – bank vicious circle by encouraging banks to diversify their sovereign debt holdings

The Chair noted the idea that diversification on banks' concentration of sovereign-debt holdings would be enough to weaken the links between banks and sovereigns. Some people could see the direct link in terms of the sovereign getting into trouble and having an impact on the capital ratio, and the assets held deteriorating in quality. There are, however, broader macroeconomic links that come via different transmission channels from a sovereign getting into trouble that will necessarily have an impact on the domestic banking sector. Is this sufficient to diversify banks' portfolios or does more need to be done to weaken the link?

A Central Bank official felt the answer is yes, diversification is enough to weaken it, but it is impossible to decouple the banks from the state or the sovereigns. It is possible, though, to do quite a bit to weaken the link, including in the two areas highlighted.

Spill-overs to the banking system can be reduced by incentivising stronger diversification of the banks' exposure to sovereign-bonds. Spill-overs to the national private sector can be reduced if well-functioning banking and capital markets unions offer broader access to financing, thereby also having broader private risk-sharing, so that spill-overs to other sovereigns can be reduced in the context of a comprehensive framework offering financing support for innocent bystanders.

A Central Bank official noted that the negative interplay between sovereigns and financial institutions needs to be addressed. It cannot be fully solved, but not much is being done to solve it. This link needs to be weakened, especially in a eurozone with one currency and a plethora of national policies.

The no-bailout principle will not be credible without further reforms, and this has to do with the interplay between sovereigns and financial institutions. Governments and investors need to be accountable for their actions, which is why the no-bailout principle is so important.

A Central Bank official explained that if there are no clear majorities for having a European finance minister, and no taxation at a European level, then there are still national policies and the credibility of the no-bailout principle is still required. This is undoubted.

2.2. A stronger "firewall" role for the ESM is welcome

An official felt that the existence of the ESM demonstrates that the Maastricht no-bail-out clause is not credible. Europe did not have any firewalls, but now has very good firewalls.

A Central Bank official agreed that the ESM plays a critical role in sustainability and combatting crises in the euro-area, which is why it needs to be further strengthened wherever possible.

The ESM is a very important institution, and having a backstop available is important, but there is a chance to protect innocent bystanders from spill-over and contagion. The ESM has the potential to alleviate some of the pressure in the system.

A regulator felt there is a question of the immediate and longer-term policy agenda, and discussions to be have as a follow-up to the euro summit last December about the strengthened role of the ESM. The summit indeed endorsed a stronger role of the ESM as a crisis resolution mechanism. It will operate as the common backstop to the European resolution authority, and its financial instruments have been reviewed to make them more effective. Consideration is now centred on the transposition and implementation. Part of this is relevant for the panel, and other important parts on the completion of the Banking Union and the Capital Markets Union will be dealt with elsewhere. There is an idea of making the instrument toolbox better geared towards protecting the innocent bystander in terms of making the precautionary credit line more useful.

2.3. The need for debt restructuring: For a case by case approach

A regulator emphasised the need for clarity on debt sustainability in the future; there is a consequent call for a predictable and transparent framework of debt sustainability analysis. Part of this agenda is the idea of changing the contractual relationships on debt in order to make hold-up problems more manageable in future. This means that the general approach taken about going forward on sovereign debt will remain as it is currently. Some have been asking for automatic debt restructuring in a debt crisis, but this is not the way to go, and so they will remain in a framework of case-by-case situations to be dealt with, with instruments to do this.

A Central Bank official noted that debt restructuring is a key point. Nine years before, the German Central Bank had made a proposal: if there is a country which triggers a certain weak point, and if it is in the bylaws of the sovereign-bond, there is a certain period of time when there is no redemption and no interest payment, which gives the country the possibility of restructuring. It will only be taken up later, so that investors already know that if a certain trigger point is hit then there will be no redemption and no payments on that sovereign-bond. This gives fiscal space for restructuring.

An official noted that, at the macro-level, it comes back to the issue of when it is triggered and what the trigger is. In terms of any country's fiscal policy stance, it is easy to ask whether the fiscal stance is sustainable under certain assumptions. This is the mechanical part of doing projections and passing views on sustainability. The difficult part is what to do if a projection has led to an unsustainable debt. A fiscal adjustment is necessary. A primary balance can be calculated as the primary balance surplus that a country needs to run. The difficult question is whether it is economically or politically feasible in that country. This is what 'case-by-case' means.

Many people in the early 2000s had not believed, even inside the IMF, that Turkey could run a 6.5% primary surplus for three years. Turkey had almost done this and not needed a debt restructuring. This is what is meant by 'case-by-case'. It is not something that can be explained exactly. As to whether debt restructuring is necessary or not, it means a very complicated political discussion. Greece can be talked about in the same way.

A policy-maker noted that in the projection of Irish public debt, it had been supposed to reach 125% of GDP. On that basis, there were important risks to debt sustainability. An automatic system of restructuring would have had disruptive effects. Now Ireland's debt is expected to fall below 60% of GDP and this has been achieved in a few years.

The Chair queried whether it necessarily rules out more clarity on how restructuring takes place, if it is deemed necessary on a case-by-case basis. A policy-maker felt the risk is of self-fulfilling prophecies: if they start talking about it, it is more likely to happen. The Chair disagreed, as there have already been three sovereign defaults in the euro-area.

An official agreed that in the event of debt restructuring it is right to have claims and bond contracts to make restructuring easier. Everything, from collective-action clauses to what is being discussed as single-limb aggregation, is very constructive.

A Central Bank official suggested that it has not always been boring, and it has become standard to think of northern economies as fiscally prudent with solid economies. In the early '80s they had been in a miserable situation, with public development levels at 80% of GDP. The interest rate had been 20%, later falling to 10%, but this was still a heavy burden. It is possible to run a primary surplus for an extended period; it is just necessary to compensate for expenditures.

Debt restructuring for a sovereign is a very bad thing, and part of the problem rather than part of the solution. It cannot be completely excluded from happening, but it would be a better world if at an earlier stage people took stock of the situation and spoke with the ESM. Public debt restructuring only makes up for savings and is not predictive. If market price is in at a sufficiently early stage that this may happen, the expenditure is frontloaded to a large extent, and a self-fulfilling hypothesis is created that there may be default.

A Central Bank official agreed with the case-by-case study. However, the market will still have certain triggers in mind. From a certain point in time, whether or not case-by-case, if there is a selection of sovereign-bonds, they will lose interest and drop certain sovereign-bonds. Therefore, a mechanism is needed not to go to the ESM straight away, but to have time to restructure before using the ESM crisis management system. Market mechanisms need to be considered.

A regulator did not see a debt restructuring coming immediately. There is a need for caution. The experience with Italy in 2018, which led to a drying-up of one of the biggest debt markets in Europe at very short notice, showed there will be trigger points to be conscious of. At the same time, market discipline cannot be relied on. This is a new normal for governmental finance in Europe, and the old pre-crisis regime with no risk differentiation has gone. Risk differentiation will continue across countries. There will be some volatility, which is why safeguards of better fiscal rules and financial instruments of more stabilisation are needed.

2.4. Amending fiscal rules is not appropriate

A Central Bank official concluded that the EU fiscal framework is better than its reputation and has contributed positively to the situation not being worse. At the end of the day, it only made a difference where countries perceive that systems were helping toward proper policies. It is a democratic choice to challenge the rules or the markets, and there are implications for this.

A Central Bank official noted that they were a minority to not insist on simpler fiscal rules. There is a good reason for complexity. For rules not to be subject to discretion or Commission and Council assessments, which will politicise them, they have to be tuned so that the outcome is perceived to be fair across countries. This requires sophistication. It is not perfect, nor without reason. The more flexible they are, and the more discret, the larger is the risk of politicisation. The more tuned they are to be seen as reasonable and fair, the more complex they have to be.

2.5. An EU macro-stabilisation facility makes sense but requires first that the fiscal rules of the Stability and Growth Pact are implemented in all parts of the EU

The Chair noted that the IMF published work on the central fiscal facility the previous year. The debate has since moved on. The Chair questioned whether the IMF still stands by the principles it set out for the euro-area?

An official confirmed that it does. It is not a unique IMF proposal, but one of a number from the Commission and other bodies. Discussions around the eurozone budget and the next Multiannual Financial Framework are a good direction of travel, but too small for a macro-stabilisation facility.

A Central Bank official noted the absence of any mention of the financial and sovereign debt crisis yet, but it highlights the need for reform, meaning the reform of the governance framework in the European monetary union. Financial stability needs to be safeguarded, in the future as well as in the past.

A deeper economic and fiscal-policy integration would imply a more logical progress to be achieved, but there is a lack of consensus as to how this should be done. There is no apparent majority for transferring powers to the European level, and not many national policymakers are pursuing change in EU treaties. As long there is a lack of consensus, concentration is needed on what is most important.

A policy-maker noted that it is very important to ensure that EU policy-makers have the right instruments for the right objectives. Fiscal rules are meant to ensure sound public finances, but over time they have evolved, and there is concern about stabilisation issues. The key is developing a new stabilisation function at the EU level, even step-by-step, so that

there is an ex-ante way of absorbing the effects of shocks and no need for the ESM to deal with illiquidity or a worse crisis.

An official agreed with the need for a stabilisation capacity at the centre to address shocks, and for a simple set of rules. Two issues have not been mentioned. One is that even with a central fiscal-stabilisation facility it is essential to have compliance with the existing fiscal rules. Countries cannot be contributing to a central fund capacity without compliance with these rules. Second, any feasible central fiscal capacity will not relieve national governments of responsibility for national fiscal policy. When countries are running debt 100% plus of GDP, the problem cannot be solved.

A regulator noted that for the longer term there is an important link to be made, which has to do with fiscal rules and trust on the one hand, and on the other the instruments that make the euro-area more robust. There is a call for fiscal rules to be made more effective, and these have been better than mentioned and have helped to contain fiscal behaviour. There is, however, the issue of making them work better to create more trust and better fiscal behaviour.

On the other hand, when it comes to the financing conditions there could be more discussion on stabilisation through a euro-area budget, and more discussion on euro-area safe assets, which would do a great deal to create common financing conditions, and strengthen the euro-area capital market, and therefore the international role of the euro. Trust is needed first, though.

Conclusion: Fiscal discipline is of the essence

All 28 EU member states are committed by the paragraphs in the EU Treaty, referred to as the Stability and Growth Pact (SGP), to implement a fiscal policy aiming for the country to stay within the limits on government deficit (3% of GDP) and debt (60% of GDP); and in the case of having a debt level above 60% it should each year have a declining trend.

However, the Stability and Growth Pact regarding debt criteria has effectively not been implemented since the start of the EMU. In 2007, several countries recorded government debt to GDP ratios. Despite the different reforms which took place after the sovereign debt crisis[1], the public debt ratio in significant European Union countries continues to increase and is approaching 100% of GDP or even more in certain member states.

Looking ahead, it should be ensured that compliance with the requirements of the debt reduction benchmark is not unduly delayed. This requires complementary policy action. A monetary union is not workable without economic convergence and fiscal discipline. The enforcement of the Stability and Growth Pact has been too lenient since 2003. EU Fiscal rules need to be enforced more rigorously and should be more binding and effective. By converging towards lower levels of government debt and regaining fiscal buffers, the euro-area will increase its resilience and fiscal space to cope with potentially adverse economic shocks in the future.

1. A reform (part of the 'Six-Pack') amending the Stability and Growth Pact entered into force at the end of 2011. Another one, the intergovernmental Treaty on Stability, Coordination and Governance, including the Fiscal Compact, entered into force in early 2013. A regulation of the assessing of national draft budgetary plans (part of the 'Two-Pack') entered into force in May 2013.