Way forward to address unsustainable sovereign debt in the EU

Mário Centeno

Governor, Banco de Portugal

The pandemic crisis: sustainability, role of monetary policy and the need for long-term growth

The COVID-19 pandemic induced a severe downturn in the economic activity that has been unbalanced across sectors, with harsher consequences in some Member States. The downturn triggered a coordinated and swift response from policy makers. The general escape clause was activated, within the rules of the Stability and Growth Pact. In ten days, the Eurogroup agreed upon three key safety nets for workers, businesses and sovereigns. And last June an extraordinary meeting of the Heads of State or Government agreed upon a recovery package and an European budget.

The speed and scale of the response were unprecedented. The strength of this response goes beyond the financial support. It reinforces solidarity and policy coordination. Some concrete elements will facilitate further steps towards financial integration. The financing of the Recovery Fund is one of them. The Commission is expected to issue debt worth 750 billion euros over the next years; that's an issuer twice as large as the traditional European supranational peers. The EU bonds are not a substitute for a European safe asset, but they will provide a preview which impact on the financial markets should not be underestimated.

The role of the ECB has been critical in the policy response to the pandemic in the euro area. Monetary policy response was strong, stabilizing the financial markets and providing abundant liquidity to economic agents, in a timely manner. The highly accommodative stance of monetary policy – in a regime of low interest rates – will certainly not be reverted for some time. In general, a central bank can assist the government's policy effort not only by reinforcing its lending to the financial system and by lending directly to firms, but also by strengthening its role as a backstop for government funding. As a backstop, the central bank can avoid expectations-driven debt crises without further budgetary implications.

However, if a policy of debt purchases by the central bank reduces interest rate spreads that are due to fundamentals, then it has budgetary implications, eventually translating into inflation and into currency devaluation. Monetary and fiscal policy responses to the pandemic crisis have been decisive and complementary. Central banks ensured ample liquidity provision with favourable conditions, decreased interest rates when policy space was available and reinforced asset purchase programs. As referred, the fiscal response was extensive, leading to soaring public debt in the euro area and elsewhere that may still be impacted by implicit guarantees. Even if public debt is sustainable, the uncertainty and the existent risks on the sovereign debt of the euro area countries should be monitored as to prevent an abrupt increase in spreads over a longer horizon.

Monetary dominance has to be preserved. Otherwise, inflation would likely increase, leading to a depletion of the value of debt. Inflation that is not rooted in the reputation of an independent central bank may be uncontrollable. Furthermore, once the reputation of a central bank is lost, it may be hard to regain it. The euro is an international reserve currency and this status depends crucially on the independence of the central bank.

Monetary and fiscal policy responses to the pandemic crisis have been decisive and complementary.

Against this, it is necessary to guarantee credible fiscal discipline at the country and at the European Union level, which may benefit from a reflection of the existent fiscal rules and improved quality of public expenditures. This is critical as it has to be made compatible with the existent and future investment needs. It is also important to strength the resilience and stability of our financial system putting in place the missing pieces of the Banking Union and, also, of the Capital Markets Union.

Finally, I recall that in a context of low inflation, even with the support of very low interest rates, strong GDP growth also emerges as a necessary condition for fiscal sustainability and for the improvement of social conditions. It is important that the allocation of funds of the recovery plan promote converge in the European Union and, in particular, the ones allocated to the Euro Area member states are used in a way consistent with the monetary union, helping to prevent the build-up of imbalances. ●

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

European-level response can guard against risks to debt sustainability

In light of the Covid-19 pandemic, we – policy makers – seem to have learned our lesson following the previous crisis episodes: this time, fiscal and monetary policies have been carefully coordinated to deliver a consistent economic response to the ongoing crisis. To help the European economy survive the severe disruption and to support the rebound afterwards, the European Central Bank (ECB) has strengthened already highly accommodative monetary policy, while national governments have implemented a large number of wide-ranging fiscal measures, reinforced by pan-European efforts.

On the flip side, economic contraction and the unprecedented fiscal policy response will inevitably cause public deficits and debt ratios to rise sharply in 2020. However, the current low interest rate environment helps alleviate the sovereign debt burden as necessary fiscal measures are being implemented. It is estimated that even with rising debt-to-GDP ratios the debt position should remain sustainable over the medium-term across the EU.

Fiscal and monetary support will remain vital in the foreseeable future, especially in view of high uncertainty regarding the course of the pandemic, as well as the partial and rather fragile recovery expected for 2021. Fiscal support at the national level throughout the next year should be continued, as withdrawing fiscal accommodation prematurely could weigh on the recovery and increase the risk of long-term scarring effects. Of course, considering a longer time horizon, delivering an appropriate fiscal stance remains a balancing act. Once countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent medium-term fiscal positions.

Focusing on the euro area, due to a number of factors the policy response among euro area countries has differed in terms of size and composition – despite the overall strength of the fiscal action on the aggregate level. This has raised the risk of fragmentation within the single currency union. Asymmetric growth outcomes could increase economic divergence among countries and impair the transmission of the ECB monetary policy, while, at the same time, render it more difficult to calibrate an appropriate euro area-wide policy stance.

In this vein, I would like to recall a phrase that was popular in the central banking community prior to the current crisis: monetary policy cannot be the only game in town. Or, rather, it cannot once again become the only game in town. In a currency union, this is all the more true when the economy-wide shock – which affects all jurisdictions – is not overcome to the same level of success in all countries. We cannot rule out the possibility that diverging fundamentals – which would also induce financial fragmentation – may ultimately pose new challenges to long-term debt sustainability in certain Member States. At the end of the day, the solution to this issue lies not in euro area-wide monetary accommodation but in fiscal policy and structural reforms, combined with proactive use of the macroprudential tools.

To propel the European recovery and increase convergence, sizeable fiscal support – at least in some parts of Europe – will be required beyond that already provided at the national level. In fact, the recent initiative on the temporary recovery instrument Next Generation EU is a step in a right direction. Complementing national efforts to support structural reforms and public investment, Next Generation EU will provide sizeable fiscal transfers to the most affected European countries.

Nonetheless, moving forward a permanent solution must be developed: the Next Generation EU could serve as basis for a centralized fiscal instrument with a substantial common borrowing capacity. If appropriately designed, a permanent fiscal capacity would provide macroeconomic stabilisation and help counteract asymmetric shocks, thereby contributing to the overall resilience of the Economic and Monetary Union and supporting the single euro area-wide monetary policy. ●

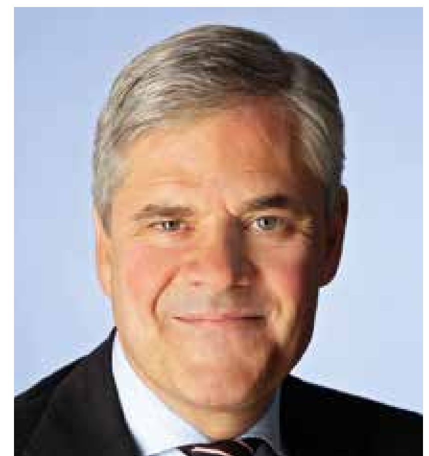
Andreas Dombret

Global Senior Advisor, Oliver Wyman & Member of the Board, Bundesbank from 2010 to 2018

ECB and EU have acted swiftly and with determination

The global Covid-19 crisis has prompted governments to roll out unprecedented initiatives to protect economies and societies. EU member states took fiscal measures of nearly five percent of the EU GDP, partially as guarantees, but mostly through direct fiscal outlays, supporting, inter alia, labor markets and health care.

Unfortunately, the crisis hits at a time when several Eurozone countries are still facing a significant public debt burden and so markets questioned the debt sustainability of those economies. The European Central Bank acted swiftly by establishing the Pandemic Emergency Purchase Program with an envelope of €750 billion to backstop debt markets. In doing so, ▶



▶ the ECB has acted swiftly and with great determination.

Of course, the recently agreed EU rescue package is clearly welcome – the question is whether it will be sustainable. Is it truly "Hamiltonian"?

First and foremost, the package is supposed to be a one-off, extraordinary initiative aimed at kickstarting economies, as well as funds to compensate for the economic contraction, for example via short-term worker benefits and health spending. But the issues that weaker Eurozone economies are facing are not just Covid-19 related, they are deeply structural.

Many member states have embarked on a painful path of fiscal consolidation over recent years, most of them with respectable success. Selected economic indicators such as productivity trends do not look promising. For example, Italy is burdened by youth employment of 27.6 percent which means that a substantial share of the Italian workforce is not only underemployed but may not be able to catch up anytime soon, therefore dragging down growth in Italy for years to come.

As always, it is questionable whether the package will need to be expanded in volume and time to be truly "Hamiltonian". But the conflicts that erupted at the Council summit show that several net contributors to the Eurozone budget are not open to a transfer or a debt union. Others regard the recent decisions as long overdue toward further European integration. While this would require extensive political debate and even a change of the EU Treaty, much will depend on the effectiveness of the package that has just been agreed.

Should it become evident that the committed €750 billion is not being spent wisely and does not support tangible convergence of Eurozone economies, preparedness to support such transfers in the future or to provide the EU with additional fiscal and debt capacity, will decline further. The concerns of the "frugals" should therefore be taken seriously, also keeping in mind that similar disagreements have just prompted the second largest European economy to leave the Union.

Conditionality and governance are key now. The EU must ensure that the economic stimulus is spent wisely and supports both targets: Immediate economic turnaround and sustainable investment into the economic and political future of the EU. The challenge will be ensuring efficient outreach of national measures to those in the respective member states having suffered from the Covid-19 crisis. And the challenge will come with national interpretation of what the EU Commission has given out as strategic targets: digitization, in other words, fundamental technological renewal and management of climate and environmental risks, for example, by Co2 emission reduction and avoidance of plastics. All of this should not, however, divert attention from the crucial need to increase productivity in all Eurozone countries, and from efforts to fully utilize and train the workforce in an increasingly complex world.

All of this said, one also needs to keep in mind that political leaders are not the only decision makers. The concerns that have prominently been voiced by the "frugals" are widely shared among EU citizens. Any further integration must come at a speed that allows countries and citizens to follow, in other words, the integration needs to be step by step. Being transparent about consequences, drawbacks and risks is important for any future buy-in, as an integration through the back door could eventually undermine the entire European project.

The greatest danger therefore lies in the disappointment of EU citizens who are meant to benefit from all the above. Grants will need to be implemented against clear and verifiable criteria mapped back to the EU strategic targets. But successfully executed, the EU will prosper. ●

Alastair Wilson

Managing Director and Head of Sovereign Risk Group, Moody's Investors Service

Debt, growth and policymaking – the EU's trilemma

Moody's is often asked why the current crisis has had limited ratings implications in the EU despite its dramatic impact on growth and debt. The simple answer is that we assume that policymakers will contain and ultimately reverse the impact. But we also recognise the enormous challenges in achieving that outcome and the clear risks. Since 2007, overall public debt of the then-EU members has risen from 66% to 80% of total GDP. While that is down from a peak of 92%, the decline mainly occurred in countries with the strongest credit profiles and in those worst hit by the crisis a decade ago. In some of the largest EU economies, debt has proven sticky or has even continued to rise.

Debt burdens will get worse. This crisis will lower the level and growth of GDP in the EU and worsen the fiscus. Temporary fiscal support may well prove long-lasting. EU governments will likely emerge from the crisis more indebted and more exposed to shifts in financing conditions. Moody's forecasts that the EU debt burden will rise by a further 18 percentage points over 2020 and 2021 on average, with some countries' debt burdens rising by more than 20 pp.

For now, that debt burden is manageable. Debt affordability has improved in recent years as interest rates have fallen. The ECB's response to the current crisis has left

policy and market rates very low and we expect them to remain so for a long time. Even the most indebted countries can still refinance expensive global financial crisis debt at lower rates. ▶

But is it sustainable over the longer term? Each crisis leaves the EU more highly indebted. Each increase in debt leaves it more exposed to the next crisis. And it has already faced two in a decade.

Large, advanced economies with strong institutions can sustain large debt burdens. The last crisis showed however that there are limits, which rest ultimately on investors' willingness to continue to refinance enormous sums falling due each year. And investors are mercurial. As we saw during the last crisis, that willingness is not guaranteed.

It rests, ultimately, on confidence in growth and policymaking – two factors at the heart of Moody's own analysis. Investors will step up as long as they believe that governments will be able to sustain the nominal growth needed to cover interest payments, and more broadly as long as they believe policymakers will achieve the fiscal and economic outcomes needed to contain the rise in debt, and in most cases ultimately to reverse it.

There lie the roots of the EU's debt problem. Even by advanced economy standards, growth has been low for many years. Demographic pressures, low productivity growth and perhaps the legacy of the current crisis suggest it will remain so for years to come given.

The EU debt burden will rise by a further 18 percentage points over 2020 and 2021 on average.

Meanwhile, policymakers have had mixed success in implementing the fiscal and economic reforms needed to revitalise growth and reduce debt burdens. After some significant progress early in the decade, momentum has slowed and, in some respects, reversed. Austerity fatigue has emerged long before austerity policies have achieved their goals. The actions needed to deal with the coronavirus pandemic will only add weight to the expansive political narrative.

That leaves the EU, or at least important parts of it, vulnerable to a shift in sentiment, with high debt burdens revealed to be unsustainable. This risk will rise as the environment normalises and interest rates rise. But the risk is not so much a general rise in interest rates as a rise in spreads, and a corresponding fall in debt affordability, for the countries perceived to pose the greatest risk – those with the highest debt, the slowest growth and the weakest institutions.

It may prove difficult for the EU's governing institutions to see off such a threat. The last crisis illustrated the lack of common ground on mutual support initiatives. The ECB continues to play its crucial 'buyer of last resort' role.

But recent negotiations around the Recovery and Resilience Facility show that starkly different visions persist for the EU, and little progress has been made on the closer fiscal and economic integration needed to bolster the euro area's resilience to shocks. ●

Christian Noyer

Honorary Governor, Banque de France

Public debts held by central banks: what are the consequences?

Today, central banks hold huge amounts of public debt. This is geared at legitimate monetary policy objectives, but the situation may change more rapidly than usually thought.

The origin of this massive intervention of central banks on public debts markets is the quantitative easing (QE) that has been used by central banks after the financial crisis. The reason was simple: in the pursuit of their statutory objective of price stability, central banks were confronted with an extraordinary and persistent disinflationary context. The use of traditional tools, i.e. interest rates, met with a limit, the zero-lower bound: attempts to move below zero, although conceivable in theory, and achieved in practice by a few central banks, in particular the ECB, has proven to be little effective, simply because the transmission is very limited. It also generates many counter-productive consequences.

Therefore, the main tool used to increase the accomodation of monetary policy has been the pressure on long term interest rates and the flattening of the yield curve, via the purchase of bonds. And because Government bonds are usually the safest, the most liquid pool and the benchmark of any currency's market, they have been the main instrument used by central banks.

These extraordinary purchases by central bank will have an end, maybe sooner than often thought...

Whereas central banks were progressively trying to normalize their policies, and at least stop increasing their bond portfolios, the pandemic crisis forced them to start new purchase programs. Indeed, with a huge recession triggered by the freeze of many activities, with durable effects on several key sectors, new deflationary pressures were threatening to push inflation significantly below the objective

of price stability. What Central banks have done is therefore clearly linked to their remit, i.e. maintaining price stability. And so far, they are still confronted with a weakness of price developments, which vindicates their monetary policy action.

But of course, this happens in a very specific context, where Governments have tried to counter the unprecedented recession by a temporary but huge increase of public expenditures, in particular massive support to corporates and entrepreneurs ▶

with a view to limit to the lowest possible extent layoffs and bankruptcies, and avoid a spiraling move into depression. Governments are bound to accumulate enormous amounts of public debt during the year 2020, that will need to be kept and rolled over for a long period of time, and their amortization is likely to take decades.

From the point of view of central banks, there does not seem to be a real danger per se. It is not unlikely that inflationary pressures start to rise again in the coming years, under the combined effect of huge liquidity and possibly less deflationary pressures from globalization. But if needed, provided that central banks stop buying bonds, increase as necessary their interest rates, and withdraw the excess liquidity they have poured into the market, they should be able to strictly adapt monetary and financial conditions so as to maintain price stability. And to withdraw liquidity, no need to sell bonds massively on the market: they can easily achieve the same objective by using reverse repos for instance.

For Governments, it means that they might not be put under pressure for this extraordinary debt issuance linked to the pandemic crisis. All this debt kept in the books of central bank is in fact of no cost, whatever the interest rate paid in the future (when this debt is eventually rolled over), since the amounts paid by a Government to its central bank increases its profits which are distributed to the former. This is true in particular for the governments of the euro area, the bulk of QE purchases decided by the ECB being done by the National central banks of the Eurosystem, each on its own national government debt.

At the same time, thanks to the flexibility it gave itself within the PEPP, the ECB has provided effectively the necessary degree of accomodation throughout the euro area, ensuring the resilience of the entire currency zone.

But Governments should clearly see the following: these extraordinary purchases by central bank will have an end, maybe sooner than often thought; and interest rates will eventually increase, and with them the cost of newly issued debts that will have to be kept by the private sector. Therefore, ensuring sound public finance for the years to come is of the essence.

Christian Keller

Chief Economist, Barclays

Dealing with Europe's high debt: complicated but not impossible

Europe's debt will soar to new highs in the aftermath of the COVID-19 pandemic, but its aggregate level is not higher than elsewhere: we estimate public debt to GDP in 2020 to reach 108% for the euro area versus 136% in the US, 104% in the UK and 276% in Japan. However, these forecasted debt levels within the euro area vary widely, from 198% in Greece to 20% in Estonia. Crucially, euro area sovereigns issue debt in euro, their common currency, independently controlled by the ECB. Thus unlike sovereigns who issue in their own (fiat) currency, euro area sovereigns would not be able to, as a last resort, print their own money to avoid default.

Otherwise, governments can reduce their debt as a share of GDP in only these basic ways: 1) generate primary surpluses (ie. a fiscal surplus after interest rate payments on the existing debt); 2) achieve GDP growth rates higher than the average interest rates paid on their debt; 3) restructure their debt. However, debt restructurings are realistically only an option for smaller, non-systemic economies, and most governments will need to pull on all other levers to keep their debt dynamic sustainable.

Fiscal consolidation makes sense only after economies have recovered from the current crisis. At such a time, we would expect it to be pursued more through the revenue rather than the expenditure side: because of the unpopularity of 'austerity'; the bigger role of government as consequence of the COVID-19 crisis, and the fact that tax rates have generally fallen over the past decades.

As for increasing GDP growth, structural reform efforts and increased public investment could help. But demographic trends in Europe make large increases in real growth rates unlikely. Similarly, Europe is unlikely to be able to 'inflate' debt away. Not only because this depends on how inflation affects fiscal balances and how rapidly creditors can react to higher inflation, but because Japan has also shown how difficult it is for ageing economies to break out of low inflation, regardless of easy monetary policy.

However, an environment of inflation and low real interest rates can also help to sustain much higher public debt ratios than in the past. Central banks already play a crucial role. By setting very low - even negative - short-term policy rates while also buying longer term government debt, they keep the entire yield curve very low and flat. This allows governments to lengthen the maturity of their debt profiles, locking in extremely low and often negative interest rates - which will become even more negative in real terms, if central banks do successfully raise inflation rates over time.

At the same time, central banks and regulators can effectively force private agents to hold such low-yielding government debt, eg. through statutory liquidity coverage ratios. Such 'financial repression' keeps governments' debt service burden low.

An optimistic scenario thus looks as follows: the combined effort of structural fiscal reforms and accommodative monetary policy help boost real growth and inflation (temporarily even

above target); as this translates into a higher real interest rate burden only with a long lag, governments have enough time to consolidate their fiscal positions in the meantime. Debt-to-GDP ratios would be high but not become unsustainable.

However, moral hazard and political economy dynamics pose significant risks. As central banks continue to absorb government debt with seemingly no harmful consequences, politicians may feel less pressure to make reform efforts. This moral hazard is particularly relevant in the euro area, where in spite of a common monetary policy, fiscal policy remains largely in the hands of national governments. The EU's recent generous crisis package seems based on the hope that this gesture of solidarity will also create a sense of responsibility for the common European project.

Ultimately, a proper European fiscal union, where member states would largely relinquish fiscal sovereignty in return for a mutualisation of debt on the European level would in theory solve the issue. But such a 'United States of Europe' seems very far away, if at all desirable. At the other extreme, a sovereign default of a larger systemic euro area member would seriously challenge the survival of the currency union.

Pedro Marques

MEP, Committee on Economic and Monetary Affairs, European Parliament

Helicopter money to land in Europe?

These days, every new economic forecast is worse than the previous one. Most of the countries face severe crisis and the fears of massive unemployment arise, following the end of lay-offs or equivalent measures which were able to sustain jobs. The pace at which those measures are phased-out is now critical, since smoothening the growth of unemployment can result in the smoothening of the crisis itself.

Although the crisis is inevitable, its size and duration depend on a large scale on the measures that are put in place by national and European authorities – and the speed in which they are put in place. The analogy with healthcare is clear: the faster we initiate the healing the higher are the patient odds of getting better. So, at the beginning of the deconfinement phase of this crisis, short-term measures are still essential, both on fiscal and monetary policy.

The Recovery Plan is very important, of course, but its money will never reach the real economy before the end of 2021 or even the beginning of 2022. Meanwhile, millions of jobs might be destroyed.

The response to this crisis needs to be effective starting now, and not in a year from now.

To increase demand and stimulate the economy, Member States have to dramatically increase public investment, support private investment and money transfers to households. This will lead to a substantial growth of public debts.

But not to increase (or even decrease) public expenditure could, in the end, result in even higher levels of public debt, as a result of a more profound crisis, with the consequent reduction of Government revenues and increase of social expenditures (e.g., unemployment benefits). That was the (bad) experience from the last financial crisis and we should not forget the lessons learned and make the same mistakes.

In such a demanding situation, monetary policy must be used at its full potential. The starting point must be to assure that the low-interest rates environment that resulted from ECB's interventions in the recent past are maintained for a large number of years, as a way to incentivize private and public investment. But the ECB can do much more.

Within its mandate, it is clear that ECB can assume a more assertive position. Through this crisis, the rhythm of expansion of the ECB's balance sheet has to continue and even speed-up significantly.

If an effective response to the crisis and its consequences demands legal intervention, we should face that reality and not be bounded to old solutions that might not work for the new problems. The unprecedented challenges we face must give us the strength to challenge taboos.

Helicopter money is one of the taboos. If we consider the current limitations of the transmission of monetary policy, transferring money directly to households could be the most efficient way to raise the persistently low inflation up to the 2% target. At the same time, stimulating demand with this unconventional and effective policy would increase rapidly investors' confidence, and therefore investment, growth, and job creation could become a reality again in the short-term.

> *The unprecedented challenges we face must give us the strength to challenge taboos.*

Other taboo, the monetization of public deficits, relies on the same fear: inflation. But the real danger at the moment is deflation and massive unemployment.

We all saw what happened in Japan, where persistent deflation forced Governments to implement fiscal policies that resulted in public debt that, at first glance, seemed to create an impossible economic situation. But Japan's answer was a *de facto* monetization of public debt, which was very positive for the economy: Bank of Japan (BoJ) bought Government bonds that represent around 100% of the GDP. What was the result? i) it did not create uncontrolled inflation; ii) it was not necessary to raise taxes to pay the debt; iii) and, anyway, the profits

that BoJ gets from that debt are Government revenues.

Monetization of public deficits and helicopter money, as well as other unconventional tools, can generate strong reactions in many economists and policy-makers, but they deserve a second thought.

If the biggest downside of those measures – inflation – is not a real concern now, not to analyse it may not be a rational option.

We can study the amounts involved, the consequences, the institutional framework, the operational issues, and the safeguards that would be necessary to make it acceptable for those who are more reluctant. It could, perhaps, be necessary to reinforce the economic governance and the creation of a Finance Minister for the Eurozone. A lot would have to be studied and discussed. But it is a discussion we certainly should have.

Jerome Haegeli

Group Chief Economist, Swiss Re

Europe – now is the time to invest

Vast fiscal stimulus may keep Europe afloat this year, but the long-term solution is investment.

Governments have unleashed unprecedented fiscal stimulus to keep economies afloat through the COVID-19 pandemic. The crisis has so impacted public finances and output simultaneously that the Euro area aggregate debt-to-GDP ratio is set to surpass 100% for the first time in history. Debt in a few member states is particularly high, notably Italy and Greece, where the ratio will likely rise above 150% and close to 200% respectively. Even Germany's debt to GDP is expected to climb to about 75% from 60% at end-2019 following one of the largest stimulus packages in the EU. While the immediate urgency is focused on the rebound from the economic crisis, eventually the question will arise: how to reduce these exorbitant debt levels?

The good news for debt sustainability is the record-low cost of borrowing. There is no guarantee, however, that interest rates will remain low forever and even if they do, we will have less capacity in future to absorb new shocks with higher spending. From all angles it is clear that we have to address today's record debts.

Inflating away debt is unlikely to be an option. The European Central Bank has tried for more than seven years to increase inflation sustainably to its close to 2% target. We expect the focus will shift back to fiscal restraint, with the EU likely to try to keep government spending in check after the crisis subsides. However, austerity introduced after the global financial crisis has been widely criticised for impeding growth. An increase in taxes to finance spending is more likely but may prove both contentious and not a good policy, especially in countries that already have high tax burdens.

The most desirable and indeed only viable long-term route is to boost GDP growth by enhancing productivity. To address our record debt levels, we must spend wisely to lift economic growth. The recently agreed EUR 750 billion EU recovery fund, and the European Green Deal launched in 2019, are welcome steps towards enhancing GDP growth. Yet they are not enough: more decisive policy decisions are needed to secure Europe's future and preserve its single market. Investments should focus on productivity enhancing areas such as infrastructure, technology in a way that advances climate goals. Building new sustainable infrastructure and upgrading the old has a significant multiplier effect on GDP growth.

Throughout Europe's history, transformative decisions have emerged from crises. Today we face the most acute economic and health crisis of modern times and the time to act is now. Europe needs to invest and is stronger with private capital at work. A single currency alone is insufficient to attract long-term investment capital from institutional investors such as insurance companies – we must accelerate the capital markets union. Well-functioning, dynamic capital markets are key for the competitiveness of European companies, particularly as competition will intensify as China opens its financial markets further and attracts a much larger slice of global capital.

To expand Europe's capital markets, we ultimately need a risk-free euro rate and a form of burden-sharing for governments. The EU could use the newly created borrowing power of the recovery fund for joint debt issuance, for example in the form of perpetual bonds, as the UK and US have issued in centuries past. With no maturity date, perpetual bonds allow for cheap long-term financing, with the advantage that the mutual obligation would stop at paying annual interest.

> *Raising Europe's competitiveness is the only viable strategy to deal with the debt …*

Second, Europe needs to address the problem of so-called zombie companies – highly leveraged and unproductive firms. A European bad bank and clear principles would enable orderly corporate restructuring and unwinding of government credit. An EU-wide recapitalisation fund would support otherwise-viable private companies that lack access to capital markets. Third, a harmonized EU-wide insolvency regime would constitute a tool to deal with non-performing loans created by the debt bazooka. To sum up, raising Europe's competitiveness is the only viable strategy to deal with the debt and for this completing the capital markets union is key It is time for Europe to invest capital and in deep capital market reforms.

Dino Kos

Chief Regulatory Officer, CLS

Free money will not last – planning for the shift

The fiscal and monetary response to COVID-19 has been quick and massive. The ECB and other central banks have reduced interest rates and purchased assets, including large amounts of government bonds that have been issued by sovereigns to finance the fiscal response. As a result, sovereigns in Europe and other developed markets can borrow at near-zero or even negative interest rates, easily financing deficits that have exploded. Those deficits, which add to the already existing level of debt, further add to the future burden that taxpayers will ultimately bear.

Given the cheap financing costs, is this expansion of fiscal policy really a problem? After all, if governments do not use spending flexibility in a time of pandemics and economic shutdown, then when would such flexibility be used? Indeed, providing necessary stimulus so that the economy minimizes social dislocation and lost production seems justified. That argument has merit.

Alas, the justified short-term response has, so far, not been coupled with a medium-term plan to return to a more normalized fiscal situation. While increased debt levels are frequently criticized for pushing repayment onto future generations, that does not account for risks that could be confronted much sooner. Even if the current cost of issuing new debt is low, or negative, it would be foolish to presume this period of "free money" is permanent. While numerous risks could disrupt this happy situation, I want to highlight three in particular.

Refinancing risk: The debt issued in 2020 will almost certainly not be repaid at maturity. Instead it will be rolled over into new debt. The cost of that new issuance could increase for any number of reasons, vastly adding to interest costs and forcing a higher level of borrowing.

Rollover risk: When today's bonds mature in the future, the sovereign may not be able to rollover that debt. A liquidity and potentially solvency crisis may result that could lead to a rescheduling of debts, forced fiscal consolidation, slower growth, and reduced living standards.

Inflation risk: COVID-19 has had a deflationary impact on the global economy. In the medium-term, the impact of reduced trade, de-globalization, interrupted supply chains, and "re-onshoring" are all trends that will push prices higher. If globalization had a depressing impact on prices, then shouldn't the reversal of that trend nudge prices higher? If that scenario plays out, central banks will take two actions. First, they will increase interest rates. Second, they will stop buying government bonds (and other assets) and, in extremis, sell those bonds. Such a scenario would be the catalyst for both refinancing risk and later rollover risk.

The current period of zero interest rates will not last forever. Central banks will pivot not because they have failed but because they have succeeded! Buying enough time for economies to recover is probably the right decision. But just as central banks stimulated economies during the pandemic, they will reverse course when the recovery is self-sustaining and the output gap has closed.

Governments need to show they can both confront the immediate crisis and plan for the future as well.

Governments need to plan for this "positive" scenario. Without a plan to "bend the (fiscal) curve", debt issuance will be on an unsustainable course and ultimately lead to crisis. Europe has experienced that within the past decade and could again. Who would pay the cost of long-term fiscal profligacy? The average citizen will pay in the form of higher taxes, higher inflation eating into purchasing power, and lower living standards. Governments need to show they can both confront the immediate crisis and plan for the future as well.

Finally, it should be noted that Europe is not alone in this situation. The US budget deficit is forecast to top $3.7 trillion this year – almost 20 percent of GDP. That international backdrop raises the stakes for Europe (and others) to be prepared when the monetary and fiscal tide starts its inevitable reversal. Nobody can know when that will be, but the stakes are too high not to be prepared.