SESSION SUMMARY - BERLIN SEPTEMBER 2020

Way forward to address unsustainable sovereign debt in the EU

The global Covid-19 crisis has prompted governments to roll out unprecedented fiscal initiatives to protect economies and societies. However, the COVID-19 crisis occurred while the level of public debt was problematic. Global public debt in advanced economies has grown by 30% between 2007 and 2018 to reach nearly 105% of GDP in 2018, according to the World Bank. In the euro area, the government debt to GDP stands at 86.3%, compared with 84.1% at the end of the fourth quarter of 2019.

The economic consequences of the current COVID-19 crisis are worsening this situation. Each crisis leaves the EU more highly indebted. Each increase in debt leaves it more exposed to the next crisis. The debt burden will become very challenging in some EU member states. Boosting growth is the main way forward to address the debt problem.

1. The sustainability of the public finances of EU member states following the COVID crisis is concerning

1.1 'This time it is different': a unique crisis, a unique policy response

A Central Bank official quoted a well-known sentence: 'this time it is different'. A sanitary crisis has become a severe economic downturn unbalancing across sectors, and with harsher consequences in some Member States. Monetary policy response has stabilised the financial markets and provided economic agents with abundant liquidity. On the fiscal side, three new safety nets for workers, businesses and sovereigns were established in April. In addition, there was agreement in July on a package of €750 billion. The package of measures amounts to almost €6 trillion. The speed and scale of the response explain the success, so far, in the containment of the sharp contraction, but also contributed to an economic rebound and a recovery in the years ahead.

Another Central Bank official agreed that this time is different. The pan-European reaction is very important. For the first time, Europe coordinated monetary and fiscal policies to deliver a consistent economic response to the ongoing crisis. Debt to GDP levels in different member states was different before the crisis and will be different after the crisis. But 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.

A public representative noted that, in the US, the historic record of people filing for unemployment has been broken by tenfold. The situation in Europe was different because of European labour regulations and public policies. Under the EU agreement on Next Generation EU, the Commission will be able to borrow up to €750 billion on the markets and this will provide additional means to address the challenges posed by the COVID-19 pandemic. The crisis is historic but the solidarity debt issuance by the European Commission is also of a historic nature. Nonetheless the fiscal response will take a significant toll on national and European debt.

An industry representative stated that, if a lockdown is imposed, the impact on households must be mitigated through income support. Corporates that lose their revenue must be supported through emergency liquidity and emergency credit. These measures immediately lead to large deficits and will bring the economy back to around 90-95% at best. As was noted by a previous speaker, unemployment in the US increased to 15-16%. However, unemployment is already back below 10%, so there is some V-shape in the recovery.

It is unlikely that the economy will return to 100%. There is some structural damage, some industries will not return to normal and the private sector cannot be relied upon to invest. The private sector has been damaged and faces major uncertainty. Europe will rely on a boost from public sector investment. That is the right answer to get through the emergency phase. Fiscal policy has been accommodated by monetary policy, not just in Europe but also in the US, the UK and Japan. The Bank of England indicated that it would be willing to buy in the primary market. This is close to what could be called helicopter money. The only difference is that the debt is kept on the books, but the expansion of the monetary basis is only temporary.

1.2 The debt burden seems manageable for some

An industry representative stated that for now current debt is sustainable in the EU. The representative's institution has not so far taken any negative actions in relation to the major European economies. Although the fiscal shock has been enormous, the response has been enormous as well. Debt levels will rise by 10 to 20 percentage points on average over 2020 and 2021, even in the most highly indebted countries. Debt affordability is very high as interest rates and spreads are very low. These sovereigns are strong in terms of their economies, institutions, and overall setup. Investors have confidence that governments will be able to sustain the nominal growth needed to cover interest payments and that policymakers will achieve the fiscal and economic outcomes needed to contain and reverse the rise in debt.

However, confidence could vanish if investors conclude that the debt is not sustainable. This could happen through a failure of policy. Debt is assessed on the debt burden, the amount of debt, the level of growth available and the size of nominal GDP available to support that debt.

Another industry representative stated that the laws of sustainability have not been broken. It is uncontroversial that there was a big fiscal loosening in the first round of the current crisis.

1.3 For others the debt burden will become unsustainable and should be addressed without any delay

An industry representative stated that they are more pessimistic than other speakers with regard to debt sustainability in the euro area. 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 the end of 2020. Interest rates are at a record level Germany and other countries are even in negative territory. Around 70% of all euro-area denominated sovereign debt has negative yields. In that environment, a quasi-temporary sustainable debt situation is possible. However, Europe is not stationary and there is zero guarantee that interest rates will remain at these low levels.

Interest rates will remain low, but negative rates will not remain negative. Negative rates are negative for everyone. Policies, politics and distribution effect will become increasingly important. The distribution of societies has become much more unequal. In the recent past, Greece had a debt restructuring, in terms of a net present value reduction of debt. If the ECB does not act as it does, there will be very different interest rate levels in Europe and very different interest rate differentials among the sovereigns. There are 19 sovereigns in the euro area and one central bank, but fiscal policy remains a national responsibility. Debt sustainability is only a given if growth is created. Growth is lacking in Europe. Even if interest rates remain low forever, there will be less capacity in future to absorb new shocks with higher spending. Today's record debts are not sustainable and must be addressed.

The Chair summarised that the three representatives of the private sector have indicated that debt is sustainable for now, but there are several issues.

2. Boosting growth is key to addressing the debt problem

The record low cost of borrowing is good news for debt sustainability, but there is no guarantee that interest rates will remain low forever. Moreover, the longer the debt problem is postponed, the worse it will become. The time to act is now. There is only one solution to address the record debt levels: boosting sustainable growth by enhancing productivity. This will include using EU funds to reform economies, investing in the EU's common priorities, notably green and digital, carrying out structural reforms and preparing fiscal consolidation.

2.1 A wise use of EU funds combined with a temporary accommodative stance of monetary policy could contribute in the short run to overcome the debt problem

A Central Bank official stated that the speed and scale of the response is key to the success so far and will contribute to an economic rebound in the years ahead, but policy-makers' work is not complete. Monetary policy Pandemic Emergency Purchase Programme (PEPP) should remain flexible and Next Generation EU funds should be used efficiently. The 'whatever it takes' stage must be followed by a 'whatever is worse' stage. There should be a level playing field among sectors and member states. The convergence process should be promoted. Monetary and fiscal policies are needed at the same time.

So far, the crisis resembles a V-shape, but the final miles of this process will be characterised by an increase in labour-market churn. This presents risks but is needed to promote the return to previous GDP levels. The flexibility provided by supervisors should continue to be used to lend credit to the economy. Economies will come out of the current crisis with a higher debt level. The monetary and fiscal responses are temporary measures in response to the temporary threat. Premature withdrawal could be detrimental to any rebound. According to the ECB forecast, at the end of 2022 the euro area will be four percentage points below expectations according to the December 2019 forecast. This is less than what happened in the last crisis in 2008.

There is no indication that the virus affects the animal spirit of economies. A great deal of reallocation is going to happen in euro-area economies and such a reallocation is necessary and conditions should be provided for it to increase its efficiency and growth. Some industries will be replaced by others. Moreover, Europe is the most advanced society in global history in terms of health, education and the welfare state. This is an asset in a crisis.

2.2 Today's monetary and economic solutions (continuous increase in public debt, monetisation of public spending by central banks) cannot last forever

Europe should not rely on fiscal and monetary activism forever, because there will be a moment when it stops.

2.2.1 Monetary dominance or fiscal dominance?

Europe's debt will soar to new heights in the aftermath of the COVID-19 pandemic. 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. Without a plan to 'bend the fiscal curve', debt issuance will be on an unsustainable course. Governments need to show that they can both confront the immediate crisis and plan for fiscal consolidation.

A Central Bank official stated that monetary dominance has to be preserved. Otherwise, inflation will increase, reducing the value of debt. But once the reputation of a central bank is lost, it is hard to regain. The euro is an international reserve currency, and this status depends on the independence of the central bank. Therefore, credible fiscal discipline at the country and European Union level must be guaranteed and compatible with the existent and future investment needs.

Another Central Bank official underscored the importance not to rely solely on low interest rates to manage the possible indebtedness of different member states. Instead, structural reforms are needed. Every country knows what they have to do: there are country-specific recommendations every year. Once countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent medium-term fiscal positions.

2.2.2 How long the situation will last is not known

An industry representative commented that how long debt levels will remain sustainable is not known. Some people believe central banks have artificially created a low interest rate environment. However, most economists agree that the natural rate of interest has been decreasing for decades. Central banks are now trying to push it a bit below the equilibrium rate in order to drive growth in the economy. It seems as if inflation is not coming back any time soon, but this is not certain. The actions being taken now are the correct ones, but the question is if they can be stopped when necessary. When the interest rate and inflation go up, growth must be increased as well. If growth drives up the interest rate, the situation will be sustainable. The denominator, GDP, will be growing and it will be possible to make fiscal adjustments.

Policies and spending should be focused on growth. Demand, for example handing out unemployment benefits, helps now, but will not drive future growth. Currently, money can be printed and does not create inflation. That is the dream for politicians who run for election, because they promise things without having to raise taxes. Central banks are right to act as they are. However, there will be a moment when this may have to change. When money is no longer easy politicians have to be willing to make the adjustment. This may come at a time when countries are not at their best.

2.2.3 Europe should not rely on fiscal activism. The new recovery instrument, Next Generation EU, is a positive step forward but not a game changer. Accelerating CMU is essential

An industry representative stated that Next Generation EU is not a Hamiltonian moment. The EU recovery fund will not be a game changer. It is positive, but not because of its size: €750 billion is only 6% of the 2020 EU national budget. It is positive because it gives the European Commission access to capital markets and allows the European Commission to use the newly created borrowing power for joint debt issuance, for example in the form of perpetual bonds.

It is right that spending should be currently unconstrained, but an orderly exit will be needed. Europe cannot rely on low interest rates and fiscal activism forever. Europe must accelerate the Capital Markets Union (CMU) in order to increase the competitiveness of European companies and to attract long term investment capital from institutional investors such as insurance companies. Raising Europe's competitiveness is the only viable strategy to deal with the debt and for this completing the CMU is key. It is time for Europe to invest capital and in deep capital market reforms.

2.3 Implementing the domestic fiscal and economic reforms needed to revitalise growth and achieving a common ground on mutual support initiatives

2.3.1 Governments need to show they can both confront the immediate crisis and plan to return to a more normalised fiscal situation

An industry representative stated that policy will need to address both numerator and denominator of the debt ratio compared to GDP. Extremely tough policy challenges will be faced across Europe over the next five to 10 years. It is not critical that they should be addressed now. The actions that will be needed to help Europe ride out the crisis are necessary and will not worsen debt sustainability. At some point, attention will need to turn to growth and debt limitation. Over the last 10 years, European policy-makers' success in making difficult choices to revitalise growth and reduce debt burdens has been mixed. The political economy at the moment is less susceptible to difficult policy choices. The risk remains that, at some point in the next decade, investors will conclude that not enough is being done. At that point, the debt may become unsustainable.

A Central Bank official commented that complementary between monetary policy and fiscal policy is the most important aspect. Policymakers will be the main actors. The solution to the debt issue lies not in euro-area-wide monetary accommodation but in fiscal policy and structural reforms that enhance productivity and improve the business climate. The Chair thanked the Central Bank officials for their positive stance and for mentioning structural reforms in order to boost potential growth.

2.3.2 Progress on closer fiscal and economic integration is needed to bolster the euro area's resilience

An industry representative stated that their organisation does not have a precise target for which level of growth Europe needs to achieve debt sustainability as there are too many moving parts. There are two sets of problems: national and collective. It is a national problem because national policymakers are going to take action to undo the legacy of this crisis. It is a collective problem for all the reasons that have become familiar over the last 10 years. The survival of the EU or euro area is dependent on the survival of the weakest. The weakest are those that have the highest debt and the lowest growth.

Around the time the euro was first set up, Romano Prodi commented on the absence of effective economic policy instruments at the EU level. It was politically impossible at that time to introduce those policy instruments, but they would be introduced when a crisis occurred. Some instruments were introduced in the 2007-2012 crisis. The second crisis has now happened. It is not Europe's fault. It is collateral damage from a global shock. Europe has faced two cathartic crises in just over a decade. The question is how far collective action will enable Europe to survive those crises. The recovery fund is larger than expected but the negotiations to achieve this agreement illustrates the continuing difference in vision between different parts of Europe. From a credit perspective, there are the stronger and the weaker nations in Europe. The absence of vision and collective responsibility at the moment is worrying. Nations cannot respond to this crisis alone. Nations that are weaker from a credit perspective are already highly reliant on collective action for their debt to remain sustainable.

Demographic issues will also have an enormous impact on growth. Significant action will be needed to generate productivity growth in Europe to even sustain the already low pre-crisis levels. This is a problem of growth and also a problem of debt. This is not a monetary policy problem. Monetary policy has been, and will continue to be, an enabler, but the actors will be the finance ministers and the economy ministers. They will need to sustain growth and introduce the structural reforms to counter the demographic impact while reducing debt, spending less and raising more in revenues.

An industry representative stated that the divergence in economic performance between Member States of the EU is a huge issue. The north may have a V-shaped recovery. The elephant in the room is Italy. Debt restructuring in Greece has been mentioned by other speakers, but Greece had a very tiny debt in a global context. Italy has the third-largest sovereign debt in the world, at €2 trillion. Currently, 70% of that debt is held by the Italians themselves, but 30% is still held by foreigners. Restructuring is not an option. When the going gets tough, politicians can no longer insist that they are sovereigns and will do what they promised to their voters, when they are now asking for more spending by the central banks. Solidarity goes with responsibility. It is uncertain if the political economy issue has been overcome.

The Chair acknowledged the industry representative's remarks with regard to Italy. There are 19 member states, but the function of the European Commission is to ensure member states work together.

2.3.3 This is particularly necessary in a context where euro-area sovereigns, unlike sovereigns who issue their own (fiat) currency,

would not be able to, as a last resort, print their own money to avoid default

An industry representative noted that Europe has 19 sovereign governments with sovereign fiscal policies. In the US and Japan, the democratic vote will vote for a government. That government will implement a fiscal policy and works with one independent central bank. It is much more complicated in Europe, with 19 governments and one central bank. There is not only the intergenerational transfer of debt but potentially also a transfer between different regions and sovereigns.

An industry representative stated that the situation looks similar from Switzerland. There are various quasi-sovereigns and one real currency in Switzerland, but there is a complete CMU and one sovereign.

2.4 Should the unprecedented challenges we face lead to a challenge to taboos?

A public representative commented that this crisis is not a normal crisis. Public finance has previously been put on a sustainable path after a very difficult decade. After the global financial crisis in 2008, politicians, economic policy and fiscal policy delivered. By 2019, debt was beginning to come down significantly. The current shock is external and there is no moral hazard issue. The proper answer by European instruments of debt was correct. Solidarity was needed.

The debt to GDP ratio will be around 20% higher at the end of the crisis. Future generations already have the burdens of demographics, decarbonisation and debt from the financial crisis. Whether an additional burden of this 20% debt to GDP should be put on the next generation's shoulders is something to question. The risk at the moment is not inflation but long term unemployment. If every country in Europe has 20% more debt and everybody starts to put public finance on the correct path, there is the prospect of a decade lost in terms of long-term unemployment. The support for populists and extremists that was seen with Brexit and the results of the elections in France was a result of a long-term lack of prospects for employment and growth in Europe. Additional possibilities on the side of monetary policy should be discussed to avoid an additional burden on future generations.

Regarding Italy, a public representative noted the ratio of debt to GDP in Portugal is also very significant as a result of the financial crisis. The situation in Italy is better than in Portugal, because Italian debt is nationally owned in a much more significant part. The Italian government has to produce the reforms that create growth so that this debt is sustainable. European governments put public finance in a sustainable stance before this crisis. That is the only way to address debt and will need to be done in Italy and the other countries after the shock of the crisis. The shock on internal demand has not ended yet, so after the crisis everyone will have to play a part in returning to sustainable public finance. This should be a focus of monetary policy. Solidarity is necessary.

A Central Bank official commented that the ECB's Governing Council is a very creative and flexible body. Helicopter money is not discussed, but additional steps will be taken if needed.

The Chair summarised that there is general agreement on the assessment of debt sustainability, but speakers' views start to differ when future policies are discussed. ■