SOVEREIGN DEBT CHALLENGES

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Bad debt drives out good?

Debt levels increased worldwide as governments and Central Banks intervened massively to support the economy after imposing lockdowns in 2020. To avoid a collapse in the midst of a pandemic certainly justifies exceptional measures. However, a look at figures makes clear that for some euro area countries, the current debt level is not the result of exceptional, time-limited measures but rather a long-term tendency. EU safeguards (and mutual commitments) conceived to keep national debts under control were largely ignored.

When the euro was launched, governments explicitly agreed to keep their debt below 60 % of GDP. Not all did. Most of the euro area current stock of debt existed long before COVID: either since the inception of euro when EC governments closed their eyes on some figures, or from the Great Financial Crisis. Some, like Mario Draghi as he served as Prime Minister in Italy, argue in favour of "good" public debt, "the debt that serves to finance well-targeted public investments; the debt that makes it possible to absorb exogenous shocks such as defense against a war or, precisely, as was the case with the pandemic; the debt used to make counter-cyclical policy"[1].

Well targeted public investments certainly have positive effects on growth, which increases the capacity to reimburse debt, creating a virtuous circle. Green transition, digital transformation and new geopolitical threats actually require investments of an unprecedented magnitude. But the necessary future flows of credit cannot be separated from the existing stock that was neither targeted, nor entirely productive. Statistics show that only a minor part of public expenditures were dedicated to productive investments (below 5 %): net public investment in the euro area between 2011 and 2019 was the lowest of advanced economies, but Japan. The most indebted countries of the euro area had (before Covid) in average less growth, less productivity gains and more unemployment. How can we be sure that governments will do better in the future, in particular when the elasticity of public expenditure is low, as they represent mainly wages of public servants and social allowances?

> **Time has come to make public opinions aware that our need to invest more in our security and in transition to Net-Zero implies difficult choices.**

According to EU treaties, the ECB is strictly prohibited from giving credit to any public entity. Nevertheless, the total amount of monetary support goes above 5000 billion euros (2500 already before COVID). In 2022, 97 % of the exceptional pandemic purchase program (PEPP) consisted in sovereign bonds (states and supranational)[2].

For all these reasons, debt management is not a technical issue to be solved by playing only with maturity and rates. It is becoming a democratic issue.

Firstly, parliaments were born to make sure that representatives of the people consent to taxation and check the good use of public money, in the interest of the whole country. For decades, in some EU countries at least, national Parliaments got more and more used to authorize large deficits and to build piles of sovereign debt though their tax payers don't get what they pay for in debt services. Some political parties openly build their success on making people believe that money is available to live beyond one's means, at the detriment of future generations. Should we be surprised that difficult "structural reforms" (such as the increase of retirement age or competition) are rejected?

Secondly, the most indebted EU countries are not always the ones that have the fairest tax systems. Still sovereign bonds are considered "safe assets" because governments are entitled to raise taxes to reimburse them. Can we continue to envisage mutual monetary support, and more broadly cross border solidarity, without any convergence of tax bases in the Euro area?

Finally, it is striking to see rules that were democratically adopted by the European Parliamentarians and national ministers in 2011, the two branches of legislative power, aiming at reducing debt were not taken seriously. A reform of the Stability and Growth Pact is envisaged but there is no magic stick to deal with debt reduction; we should all begin with respecting more our mutual commitments.

As inflation requires now monetary tightening, which implies increased interest rates, the cost of public debt is increasing, making bad habits unsustainable. Time has come to make public opinions aware that our need to invest more in our security and in transition to Net-Zero implies difficult choices. Markets may no longer accept that, even for the best reasons, we pretend to raise debt according to our "needs", without taking into account our "abilities".

Only God can supply our needs in a sovereign way[3].

1. Accademia dei Lincei, July 1st 2021.
2. Banque de France, Deux ans après son lancement, bilan du PEPP, Bloc-Notes Eco, n°276, juin 2022.
3. Philippians 4-19

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Towards healthy public finances

Public finances rely on fiscal policy, cyclical economic developments in the short and medium term as well as longer term structural factors, such as ageing and retirement policies.

The last two years have seen robust economic growth, very strong labour markets, and a surge in inflation. The strong economy has boosted the fiscal balance, and inflation has to some degree reduced debt-to-GDP levels. These factors offer no room for complacency. There are significant risks to the fiscal balance and public debt sustainability going forward.

The inflationary environment, including energy-inflation, is an indication that economic demand, including energy demand, and activity exceeds the potential offered by supply factors, and a correction is therefore needed. To that end, monetary policy has been tightened, following a long period with very low interest rates. Bringing back economic activity to a non-inflationary environment will weaken some of those cyclical factors which are currently improving the public finance balances.

The lift in inflation works in the short term to cut the debt ratio, but only because it was unexpected. Going forward, higher inflation is accompanied with higher debt service due to higher interest rates. A lag between inflation and interest rates may also work the other way round in the coming years as inflation is brought back to target. That will raise the debt ratio. Inflation is no recipe for sustainable public debt ratios.

What can assist public debt sustainability is a low or negative r-g, the difference between interest rates and growth. Fiscal policy has, however, been expansionary for the last three years. First to compensate companies and wage earners for the lock-downs. Second to address a perceived risk of a confidence crisis following the lock-downs. And third by offering fuel subsidies in the context of soaring market prices, despite strict supply constraints at the regional markets for electricity and gas.

Expansionary fiscal policy in the inflationary environment raises the burden on monetary policy to bring inflation back to target, and such a policy mix will increase r-g. The direct budgetary impact from fiscal expansion thus risks to be reinforced by un-favorable debt-dynamics.

What can be done in the context of the Stability and Growth Pact to assist Member States in moving towards stronger public finances, debt sustainability and a better policy mix?

In good times with strong employment fiscal policy should be restrictive.

First, finding a good balance of ownership, flexibility and peer pressure. Sometimes twisting the emphasis and role of national plans can boost attention and incentives for delivery.

Second, stressing the need for tuning fiscal policy to economic conditions. In good times with strong employment fiscal policy should be restrictive, building up buffers for bad times and avoid raising the burden on monetary policy to contain inflation. In difficult economic times with low inflation, where a stimulus may be needed, credibility gains from including budget-improving structural reforms for the medium and longer term, not least retirement reform.

Third, the composition of public expenditures and revenues should continuously be reviewed with a view to improving structural conditions for growth and employment.

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In the long run nothing is more expensive than free money

The European Central Bank (ECB) has just hiked interest rates again at its March 16th meeting and has taken interest rates from -0.5% to 3.5%. Monetary policy still remains expansionary, and the ECB is far from a hawkish policy stance with inflation at 8.6%/8.5% in January/February 2023. The ECB is still counting on the fact that the increase in inflation since 2021 will only be temporary and that inflationary pressure will decrease in the coming months even without a decisive tightening of monetary policy. The trend over the last few months and the ECB's own inflation forecasts indicate that inflation will continue to fall.

However, the ECB is playing a dangerous game by betting everything on this card. Economic forecasts have always been subject to a high degree of uncertainty. The impact of lockdowns, the unprecedented expansion of monetary and fiscal policies during the pandemic and the sweeping economic sanctions against Russia are virtually impossible to model and predict. The fact that inflation forecasts are all pointing downwards does not mean that inflation will actually fall or that uncertainties about future inflation developments have diminished. In fact, the ECB's inflation forecast have turned out to be grossly wrong quarter after quarter after quarter.

Forecast uncertainty today is not lower than before the war in Ukraine, it is greater. It is very easy to imagine an escalation scenario over the summer that could lead to a renewed surge in energy prices. The ECB is therefore counting on a fall in inflation despite forecast uncertainty remaining high.

The long and variable lags of monetary policy transmission combined with the too-late reaction of monetary policy to the rise in inflation poses major challenges for the ECB and its anti-inflation credibility. To be successful, monetary policy must act with foresight and thus be based on forecasts. But the more unreliable these forecasts are, the more important risk management becomes. In an environment of high uncertainty, monetary policy must above all avoid making major mistakes. In principle, two mistakes are now possible: the ECB can be too restrictive or too expansionary.

The long-run costs of a prolonged period of ultra-loose monetary policy and free money would be huge.

In the first case of a too restrictive monetary policy stance, the ECB causes an unnecessarily deep recession, accompanied by stronger disinflation and a possible renewed pockets of weakness and crisis in the financial or real estate markets. This is undoubtedly an unpleasant scenario, but not an existential risk for the monetary union. The tools for fighting deflation, should it emerge, are well known by now and some are still in place. It would also be wrong to change the course of monetary policy now in reaction to the recent financial market turmoil and banking jitters.

There are other policies tools like macro-prudential policy and micro-prudential banking supervision to deal with the problems of individual financial market segments or specific banks. Furthermore, central banks should be mindful in of the long-run consequences of a period of too-low for too-long interest rates. The current too-late tightening has made it necessary to move at an unprecedented speed and with mega-sized steps.

The tailwinds for asset prices and financial markets from ultra-low interest rates combined with ample liquidity from massively expanded central bank balance sheets have now turned into headwinds. The eruption of renewed financial instability is seen by markets not just as a reason for central banks to pause but to reverse the entire monetary policy tightening. This would be a grave policy mistake. The long-run costs of a prolonged period of ultra-loose monetary policy would be huge. 'Mission aborded' instead of 'mission accomplished' would undermine central banks' anti-inflation credibility even further. Central banks should not allow themselves to be held hostage by markets.

In the second case of keeping monetary policy too expansionary, inflation continues to be high and may even rise further. The ECB would then be forced to raise interest rates significantly further, possibly to a level above the rate of inflation. This scenario would pose an existential risk for the euro area, because many highly indebted member countries would face the risk of unsustainable debt dynamics and may be confronted with bond markets again betting against some governments' ability to service their debt.

If central banks act too hesitantly on inflation due to concerns about the impact of interest rate increases on public finances, they could risk being held hostage to fiscal dominance. Such a persistent inflation scenario in my view is undoubtedly today the more dangerous scenario and the best choice currently is to maintain a restrictive monetary policy stance in the face of high uncertainty amidst emerging signs of second round effects in wage-price dynamics.

The ECB pausing now could in the long run be the bigger risk for the cohesion of the euro zone than further removing monetary stimulus. Not doing so is playing with fire.

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The connection between over-indebtedness and the EU's fiscal framework

Debt depends on several factors.

First, one has to look at the growth potential of a country's economy, as the higher the potential rate of growth, the higher relation of debt to GDP that a country can afford.

Second, one has to observe the size of a country's tax base - the bigger the tax base, the more possible it is for an economy to allow itself a higher debt to GDP ratio.

Third, often one mentions that the sustainability of a public debt is dependent on who holds the debt. It is assumed that residents provide for a higher stability of the debt in comparison to non-residents who are said to more easily change their sentiments and preferences and unload their holdings of public debt. Nonetheless, there is a trap in this kind of thinking. The recently observed banking occurrences show that high dependence on domestic financial institutions may create financial stability risks, which many have overlooked or underestimated.

A crucial factor in these deliberations is the level of interest rates. In the last 10 years we have gotten used to the thought that the interest rates will remain on a very low level for many decades to come. For some even a debt of 100% of GDP could have been perceived as sustainable. The recent developments, also connected to the outcomes of the Russian war in Ukraine, have proven that this way of thinking was a ticking bomb and is simply untrue. Central banks have been increasing interest rates in order to fight inflation, which - in most countries - stays way above the target rates. This, on the other hand, has been leading e.g. to banks' problems with solvency.

There is no such thing as a one-size-fits-all public debt to GDP relation that secures public debt sustainability. Still, one can agree that increasing public debt is dangerous.

People might believe that - as the post-WWII experience shows - high inflation rates might be an effective way to reduce public debt. However, high inflation undermines growth and cannot be tolerated by central banks forever.

The current fiscal framework should be replaced with a system that combines flexibility with fiscal discipline.

That being said, how to cope with high levels of indebtedness in the EU, especially in the euro area?

The Stability and Growth Pact does not function the way it should - it is not effective and frequently politically feasible. It is also pro-cyclical. Therefore, virtually everybody is convinced that some kind of reform of the macroeconomic management in the European Union is needed.

The question is: how?

There is an eternal tension concerning any SGP reforms between the North and the South of the EU. The former emphasize the importance of fiscal discipline and adherence to fiscal rules. The latter, on the other hand, emphasize that what one needs is flexibility and a system that can react to shocks, especially asymmetric shocks. What one needs is some effective effort to strengthen the fiscal rules to reconcile both sides.

In the European Parliament the discussion on the possible modification of the fiscal rules has been on the top of the agenda of the Economic and Monetary Committee since the beginning of the mandate. One of the discussion is on a possibility to introduce a certain kind of a "golden rule", which would liberate the budget rules by allowing more spending, especially green investments or military purposes.

In that case, what can be "given" to the frugal countries of the North? They need something to appease their public but also to make the system more coherent.

I believe that a proper way of action is to introduce some kind of expenditure rule, while having in mind that the simpler it is, the better it would function. This rule should define a limit of expenditure over the expected inflation. This measure would be less dependent on unobservable variables and could only function if the countries needing more flexibility would be given some kind of permanent fiscal facility to tap on in case of trouble.

To summarize, the existing way of managing macroeconomic activities, especially within the EU currency union, is impractical and may deepen market segmentation. It should be replaced with a system that combines flexibility with fiscal discipline.

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EU's fiscal sustainability challenges amid recent crises

In recent years, the global economy, particularly the EU, was impacted by a series of unprecedented shocks, beginning with the global economic and financial crisis, followed by unprecedented pandemic, and more recently, security and energy crises triggered by the Russian attack on Ukraine. Society and economies have sustained these adverse events relatively well, but a major role was played by unprecedented fiscal policy interventions. Even though some of these measures were temporary, they have substantially increased budget deficits.

After the first of these events, the global crisis of 2008, some years allowed for correction of the situation, but not all states used this option. Good illustrations of this can be seen in the data from the two largest EU economies, Germany[1] and France[2], before the crises, at their peaks, and in 2015 or 2017.

While in general, the "good years" between global financial crisis and the pandemic were used for debt reduction, the stock of debt, especially for some Member States, was a source of concern.

The strong fiscal policy response to the pandemic was fully justified, as were some measures used to address energy crisis. Nevertheless, it should be noted that while in theory, the proper response to such crises should be directed towards those most affected and in need of help, in reality, according to several analyses, only a relatively small part of the measures (less than one-third) were used in such a way.

Again, while in theory, these should be rather one-off measures, the reality can be different, as the data from post-2010 illustrates. If a short period of excess, spending is not followed by a longer period of "normalization" of fiscal policy near a very low level of deficit, fiscal sustainability can be put in danger as the level of debt can steadily grow.

There are at least four factors that can be a concern for fiscal sustainability: lack of growth, lack of rules, the possible end of a low-interest rate environment and lacking adjustment to the new normal. Below I set out the reasons for my line of thinking.

Balancing crisis response and fiscal sustainability is crucial for the EU's economic future.

Lack of growth

It is no secret that at least some EU economies have problems with growth. Starting with growth not supporting demographic outlook and ending up with problems in enforcing necessary reforms. One cannot count on strong nominal GDP growth that supports fiscal sustainability even in the case of relatively high debt.

Lack of rules

EU fiscal rules based on "unobservable variables" (output gap, potential growth) do not provide fiscal guidance in the short run, which is essential for "good" yearly budgets of Member States. Unfortunately, the Commission was too slow to present a well-considered proposal based on the long-term work of the EU fiscal board. Therefore, fiscal rules that will be again fully applicable after the expected lifting of the "general escape clause" will not be adequate and will not play a sufficient role in navigating budgets to a safer path.

Possible end of a low-interest rate environment

A few years ago, when I was involved in assembling the EP view on the new fiscal rules, it was taken for granted that nearly zero percent interest rates would remain forever. As we now see, this was a big mistake, and some countries are paying a high price. It is just a matter of arithmetic to see how substantial the impact of "not low interest rates" on highly indebted countries is.

Lacking adjustment to the new normal

Lastly, we should consider whether the experiences of the last decade and a half of substantial fiscal involvement in dealing with various crises should be reflected in policy setup. The situation where governments are supporting businesses in crises with billions of euros in grants is simply inconsistent with efforts to keep corporate tax rates very low, for example.

In conclusion, the recent crises have presented significant challenges to fiscal sustainability in the EU, particularly due to the strong fiscal responses and the lack of subsequent surpluses or very low deficits. With the current increase in interest rates, these risks are becoming more apparent, and it cannot be assumed that interest rates will remain low in the long term. While the responsibility for ensuring fiscal sustainability primarily lies with individual Member States, the EU should also introduce more straightforward and controlled fiscal rules to reduce macro risks for the EU-wide economy.

By working together, the EU can mitigate the challenges posed by these crises and ensure a sustainable fiscal future.

[1] https://tradingeconomics.com/germany/government-debt-to-gdp
[2] https://tradingeconomics.com/france/government-debt-to-gdp

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Euro area sovereigns face medium-term challenges to debt sustainability

Governments around the world have faced a challenging few years as they responded to large shocks. The public sector balance sheet has played its role as the ultimate backstop to cushion against these negative shocks, and we see this reflected in substantial increases in government debt around the world, including in Europe. Our outlook for euro area sovereign credit this year is negative, reflecting the sizeable fiscal challenges those sovereigns face, as geopolitical, energy and economic trends remain adverse in the near term, while longer term structural shifts pose growing credit risks.

Stepping in to provide support during the COVID-19 pandemic, and more recently to cushion households and businesses from the fallout from Russia's invasion of Ukraine in the form of elevated energy prices, were sensible steps for governments to take. But these fiscal measures over the past three years followed two decades that witnessed several negative shocks that have left public debt burdens at near-time highs in many euro area countries. France, Italy, Spain and Belgium all have debt-GDP burdens in excess of 100% and those burdens are all more than 10 percentage points higher than pre-pandemic levels at a time when interest rates are rising.

At the moment we have negative outlooks on our sovereign ratings for Italy and Slovakia, amongst others, where downside credit risks will grow over the medium term without clear steps to counter them. Importantly, these risks are not simply about the recession many euro area countries may experience this year; euro area sovereigns should be relatively resilient to short-lived downturns in economic activity, although removing energy support measures may prove politically challenging.

Rather than near-term dynamics, it is the list of medium-term challenges facing governments that is more troubling. Demographic effects of aging populations are already lowering trend growth in many places; this is compounded by the rising real cost of healthcare funded by sovereigns; social risks are rising as citizens' living standards stagnate or fall; stuttering globalization is hitting Europe's model of trade-driven growth; and both domestic and geo-political risks threaten policy predictability and effectiveness. With unchanged economic and fiscal strategies, a number of euro area sovereigns face adverse debt dynamics over the long term, with a few of them facing dire prospects.

Investors remember the three sovereign defaults in the euro area.

This is clearly a potent and worrying mix. The good news is that euro area countries have both the opportunity and the time to address these risks, and some have made significant strides. Examples include the former programme countries Greece, Portugal, Cyprus and Ireland – three of these currently have positive outlooks on their ratings. In this context, the Next Generation EU (NGEU) plan is a transformational prospect for European countries, and should bolster growth and employment over coming years as the funding flows and structural reforms are enacted. That said, for most countries we expect the positive impact from NGEU to be more than offset by the slowdown in potential growth from ageing populations by the end of the decade. And the true test of NGEU will be whether it raises sustainable rates of economic growth long after the money is spent.

Euro area countries, like many other advanced economies, have relatively long average debt maturities. This means that recent rises in interest rates and yields will be felt gradually in terms of the public finances. That being said, total debt with a maturity of less than one year exceeds 20% of GDP in Italy, is around 17% in Spain and over 14% in France. So euro area sovereigns would not be immune to market disruption. Prolonged market dislocations for sovereigns would worsen governments' debt-affordability prospects further, increasing interest payments relative to revenues, and could significantly weigh on their credit profiles.

It is now ten years since three sovereign defaults in the euro area shocked financial markets and left investors facing sizeable losses. Investors remember these events. Euro area governments must be alive to the risks that sustained and repeated increases in public indebtedness bring in the context of sluggish medium-term growth prospects.