Sovereign debt challenges in the EU

Public indebtedness is a global issue, but sovereign debt raises specific challenges in the euro area since there is a single monetary policy but no common fiscal and economic policy

The Chair stated that the very high level of debt is not only a European issue, but is something that is happening everywhere. Even before the Covid and energy crises global debt was at an all-peacetime record. Fiscal responses to the COVID-19 pandemic drove record levels of debt issuance in the OECD area in 2020, with gross sovereign borrowing requirements peaking at $15.4 trillion. Borrowing levels moderated slightly in 2021 and again in 2022 but are forecast to rise by 6% in 2023 to $12.9 trillion.

Europe has a currency without a state, so the specificity could have consequences that would not be the case elsewhere. It is timely to discuss the topic of sovereign debt challenges in the week that the Commission produced a draft reform of the Stability and Growth Pact (SGP), even though some rules are enshrined in the treaty itself or in the protocol. It is also very timely because of the war in Ukraine and climate change. The need to keep room to manoeuvre to face shocks is more acute than ever before.

1. Euro area sovereigns face debt sustainability challenges

1.1 The heterogeneity of public debt levels in the eurozone varies widely

An industry representative explained that Moody's offers investors guidance on credit risk. In terms of sovereign debt sustainability challenges, particularly in the EU, the very simple answer is look at the Moody's rating, because that is exactly what it speaks to. It speaks to the ability of governments to manage their debts without having to refinance in a disorderly way or a default. At the moment in the EU there are still a number of top rated Aaa sovereigns including Germany, the Netherlands and Sweden. The lowest rated sovereign Moody's has in the EU is Greece, with a Ba3 rating, which is a 12 notch difference. Moody's publish data on rating performance and defaults back to 1920. A one notch downgrade corresponds to about a 50% to 60% increase in relative credit risk. There is substantial heterogeneity within the EU.

Moody's assessment is not that different to the one it made just after the global financial crisis. Ratings have not moved in a huge way. Debt to GDP is not a sufficient statistic to determine sovereign creditworthiness, as it is only one indicator in one part of Moody's sovereign approach. Beyond a broader assessment of fiscal strength, there are three other factors – economic strength, institutions and governance, and susceptibility to event risk – that are distinct from fiscal issues. Moody's examines lots of other indicators as well before it overlays judgment. Obsessing about one piece of data is not healthy.

In conversations from policymakers and politicians about debt to GDP ratios, they really like talking about GDP. There is always a strong focus on growth. Moody's understands that, because when it thinks about debt dynamics it thinks about the economy rising, probably in line with trend real growth and target inflation over the long term. On the top it thinks about interest rates and the price paid for borrowing money. History has shown that depending on the denominator does not definitely deliver desirable debt dynamics. One should also worry about the numerator.

The last rating action that Moody's took on an EU sovereign was to upgrade Ireland to Aa3 in May 2023. Ireland's debt to GDP trajectory was 120% of GDP 10 years ago, and in 2023 it is going to be about 40% of GDP. Everybody wants to talk about the growth, but they lose track of the fact that Ireland did a significant amount on the numerator. Ireland was running deficits below 1% of GDP by 2016 and was running fiscal surpluses in 2018, 2019 and 2022. Dealing with debt dynamics is a policy choice that can be made. Moody's thinks that debt to GDP in Sweden will be about 34% of GDP in 2023. Sweden went through the same pandemic as everyone else, but was less exposed on the energy shock. That is a 5-percentage point (ppt) reduction in debt-GDP since 2018, but in Italy, Spain or France there have been increases of more than 10%. There is heterogeneity within the EU and policymakers make choices that are different.

1.2 Policymakers want sustainability when discussing the environment but not when discussing debt

A market expert stated that at the previous day's Eurofi panel he had felt a sense of déjà vu, having left the EU 10 years ago and returning to the same debates as 10 years ago. Rules on sovereign debt are being discussed again at this point in time. It is good that the mood among the regulators on this panel is not as complacent as it was on the previous day. Europe needs to prepare for dealing with a new round of problems even if it not yet had be a problem. Europe should be prepared to solve problems if they were to materialize.

On sovereign debt, there is a complacency that '100 (debt/GDP ratio) is the new 60,' which is not true. When policymakers talk about explicit government debt they forget one thing: sustainability is key. Policymakers only and always talk about sustainability when talking about the environment, but not when talking about public debt or deficits, where sustainability is typically

seen as a nice-to-have instead of a must-have feature. There are few representatives in this room of the young generation, nor anybody that could speak for future generations. In addition to explicit debt/GDP ratios, which on average are now around 100%, there is a massive implicit government debt problem. Implicit debt is the net present value of all un-funded future liabilities relative to future expenditure.

A public representative appreciated what a market expert (Axel A. Weber) had said, because the matter should be looked at globally. It is also striking how sensitive some people are for climate sustainability and how ignorant they are about fiscal sustainability. Putting aside the issue of economic growth, Europe needs to work on finding out what the main issues are that is slowing it down.

1.3 The coexistence of an increasing public debt on one side and structural deficiencies on the other is worrying

An expert noted that he shares most of the views expressed. It is not the size of the public debt that is worrying, it is the coexistence of an increasing public debt on one side and structural deficiencies on the other. The lethal mixture is when having a rising public debt of more than 100% of GDP associated with low employment, high unemployment or low productivity gains, and an inelastic supplied economy because of lack of investment. When all of that happens together the sovereign debt becomes a problem. Europe has unfortunately seen that some of its high indebted countries were the ones where the structural deficiencies were the most staggering. Whether it is 116% of GDP or 80% of GDP is not the important issue, the important thing is whether Europe is growing. The only way to eventually eliminate too much debt is to have a big denominator growing. The worry is the coexistence of very deep structural inefficiencies leading to low growth and high public debt.

The Chair agreed with this overview. Europe would make a considerable mistake not to look at the question as also a vital question for the European Union, because a default would mean that the project would be killed. Members of the European Parliament can play a role.

1.4 Accumulation of debt is not the result of financing the priority expenditures, but rather the inability to manage ordinary expenditures

A public representative stated that Europe is facing a very strong deficit bias in the fiscal policy. During the times when the left is governing a country it is mostly taking place in the form of increased expenditures. When it swings to the right they often cut taxes, which does not have a counterparty in reducing the expenditures. There is a deficit bias, which is why Europe sees an accumulation of debt. In fact, accumulation of debt is not the result of financing the priority expenditures, but the non-ability to manage ordinary expenditures or to adjust the revenues of the governments accordingly. If a short period of excess spending is not followed by a longer period of normalisation of fiscal policy near a very low level of deficit, then fiscal sustainability can be put in danger, as the level of debt can steadily grow. Politically speaking, most governments believe that there is a very limited reward for managing their fiscal house well, while there could be rewards to overspending money and giving it to some people or cutting taxes and making another group of people happy.

1.5 The policy mix in Europe currently has is creating some financial stability risks in the system: expansionary fiscal policies in the euro area raises the burden on monetary policy to contain inflation

A Central Bank official noted experience from hands-onwork with the SGP and its implementation back in the 2000s. The annual examinations of the programmes took a great deal of care for equal treatment. The examinations were open and transparent. The problem then and potentially now is that pretty basic macroeconomic considerations are too absent from the fiscal framework. The policy mix Europe currently is creating sovereign and financial risks.

It is clear from the imbalance between supply and demand that monetary policymakers need to tighten up monetary policy. At the same time, Europe has a fairly expansionary fiscal policy and in recent years there have been quite a few chunks of expansions working against the ambition of central banks to squeeze out inflation from the system. It is vital to ensure that Europe has an SGP and an implementation which takes macroeconomics and inflation issues into account.

1.6 Europe needs to have the courage to look at its own economic and fiscal data

A public representative stated that Europe should look at the data. In the last 15 years Europe has gone through three very serious crises, and in each of these crises there had been a very strong fiscal reaction and governments had substantially increased the deficit. If this is the new normal, then Europe must be really sure that in any time other than bad times it will create substantial buffers to be ready for those bad times.

Regarding UK data, since the end of the 1960s until 2008 the debt level hovered around 40% of GDP. The outcome of the first crisis was that it jumped up to 70% of GDP. The result of the second crisis was that it jumped up to 100% of GDP. Before the first crisis the GDP per capita in the UK measured in purchasing power parity was just above $44,000. 2021 data showed that it is now below $45,000 per capita. A circuit breaker is needed, otherwise more and more governments will get into similar paths that are probably not as visible.

The Chair added that the UK data was both useful and very sad, but Europe needs to have the courage to look at its own data. A public representative noted that 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 in good times. With the current increase in interest rates the 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.

1.7 Politicians think about the next election and short-term ruling rather than reforming their country to face the challenges of the future

The Chair observed that in the western part of Europe people look at some eastern European countries, including Poland, and say that there is less interest for all those issues.

A public representative stated that if the political class consisted entirely of finance ministers and governors of central banks then Europe would be in much better hands, as they tend to have a longer term view than politicians.

The Chair was of the view that all politicians think in terms of the next election. A public representative agreed with this but noted that finance ministers are slightly different, because the main enemy of every finance minister are their colleagues in the government. Governors of central banks are quasi-independent, so there is a difference. Unfortunately, politicians think about the next election and short term ruling. 10 to 15 years ago Poland did something to harness the explosion of the implicit debt, with a rather dramatic increase in retirement age by seven years, preceded by a transition from a benefit determined to a contribution determined social security system, which immediately decreased the public representative's (Marek Belka's) own retirement benefit by 30% or 40%. Both of these things have since been reversed by another government. Europe tends to invest in the past or the present.

A public representative added that on climate young people in Poland are maybe five years behind young people in Sweden, but the gap is shortening. They tend to think about the future, but they do not vote. The grey lobby votes and is at the pulse, and politicians treat them much more seriously than young people.

2. Ways forward to address debt sustainability challenges

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

A public representative noted that Europe has changed its approach towards public debt with the end of the zero-interest rate era. Some time ago some people tended to treat it lightly, as with zero interest rates they did not care about the public debt level. That has now changed, which has allowed the central issue and the discussion about the reform of macroeconomic management in the EU and also in the European Parliament.

The existing EU fiscal framework does not work, as it is ineffective, procyclical and frequently politically impractical. A new framework should combine three elements. The first is fiscal responsibility, which is the concern of the so called north. The second is the need for flexibility, which is the concern of the so-called south. There is an eternal tension concerning any SGP reforms between the north and the south of the EU. Indeed, the former emphasises the importance of fiscal discipline and adherence to fiscal rules. The latter emphasises that what is needed is flexibility and a system that can react to shocks, especially asymmetric shocks. What one needs is an effective effort to strengthen the fiscal rules to reconcile both sides. The third objective of the revised EU fiscal framework is to stimulate competitiveness and potential growth, and to provide for space for investment.

The blueprint that Valdis Dombrovskis briefed everyone about is an attempt to achieve all these objectives, at least partially. An individual or case-by-case approach is understandable, although it means that the European Commission will have a formidable task in dealing with countries, especially as the discussion, as usual, will be based on the unobservable variables such as output gap and potential growth. Unobservable variables are unobservable by definition, and tended to be dramatically erred upon, especially in turbulent times. That means there will be a lot of 'wiggle room', especially used by the bigger member states.

Simple expenditure rules should be used to alleviate the problem, but it is open how much the Commission will be allowed to treat it as a benchmark in discussions with individual countries. An ideal system will be a combination of simple expenditure rules, although individually determined, and the permanent fiscal instrument to be used in a case of serious difficulties. Even though it is not beloved by all, NextGenerationEU is a testing ground for such an instrument. In theory it could satisfy both the north and south of the EU, but in political practice that is far from the case. Europe is two crises away from such a solution, but Europeans only move forward when pushed against a wall.

2.2 In good time fiscal policy should be restrictive, building up buffers for bad time

A Central Bank official stated that distinctions need to be made between good times and bad times. Looking back through the experience of the 2000s it was very clear that Europe was short of some instruments. When a country could argue that the deficit looked great, and the public debt level was low, in spite of large macroeconomic imbalances that provided clear indications that it would not go on forever, Europe did not have the instruments needed to push for consolidation in good times. An operational criteria for having good times is when central banks need to raise interest rates to squeeze out demand. Europe has typically made large fiscal expansions in bad times and run neutral fiscal policy, at most, in good times. Europe also needs to do much sharper impact assessments on the outcome of the large expansions and their composition.

A separate issue is how the risk of sovereign debt should be coped in the books of central banks, but perhaps more importantly in the private banking sector. Work had been done on that for many years, but a clear solution never came out.

Everyone can agree in the abstract that debt should be reduced, and the deficit should be healthy, but when it

comes to the specific policy decisions impact assessments should be undertaken that are transparent across the entire European Union preferably before a decision is taken. If it is not done before the decision has been taken then it is important to do it afterwards, even if it is politically inconvenient to be exposed to the consequences of some decisions. If fiscal policy runs counter to monetary policy in expanding when monetary policy is contracting then the policy mix is raising 'r minus g', which is the famous ratio between interest rates and growth, making the sustainability of public finances more problematic.

2.3 A discussion on public indebtedness and growth is urgently needed at European level. The question is whether Europe wants a change of direction on monetary, fiscal and environmental policy, or whether it wants to continue to talk about these issues without taking action

2.3.1 Overcoming the political cost of structural reforms

An industry representative stated that the one thing that sovereigns typically have is time. There is still time for people to take different decisions, but there is a political cost to be paid for some of these decisions. Harald Waiglein put it brilliantly when he talked about jumping into the swimming pool without wanting to get wet. Europe is now in a situation where it is a deep pool and one has to be sure they can swim, but there are also external checks and balances. Reference has already been made to the reaction seen in UK bond markets last year, but the market reaction to the mini-budget was an incredibly important mechanism. Investors in sovereign debt are much more focused on that. Europe cannot just think about rules for itself, but it has to also engage with the people it is selling the debt to.

A market expert explained that the last time he had looked at explicit debt was when he was on the German Council of Economic Advisors (CEA). Implicit German government debt then had already been 270% of GDP. The CEA had told the head of the German chancellor at the time, Gerhard Schröder, that the government needed to do a pension reform. There is today the same debate in France, only 20 years later. Gerhard Schröder's coalition government did the pension reform, but it was not appreciated by the electorate, and he lost the election. The lesson every policymaker has learned from that is exactly the wrong lesson: if there is a public debt or implicit un-funded government liability problem, then it should not be touched, because it could lose policymakers the next election. The explicit debt numbers are probably now more than 300% of GDP.

2.3.2 Europe spends increasing amounts of money for financing the past instead of investing in the future

A market expert noted that the third public and private liability is the unfunded liability for climate change by less than a 1.5% increase in global temperatures. That is an environmental liability. The current generation is passing the planet onto future generations in the worst condition it has ever been, with a dynamic that continues to be adverse. It is also passing on public finances in the worst condition they have ever been, both in terms of implicit and explicit government debt/GDP ratios. The numbers are staggering. Around 120 trillion of green finance is needed until 2050 to achieve the 1.5 degree maximum global warming target, which is around 120% of global GDP. Within Europe you need to add 100% explicit debt/GDP ratio and a 300% implicit debt/GDP ratio. To illustrate this in a over-simplified way: current generations owe future generations more than 500% of GDP compared to a state of affairs where they achieved sustainability and had their house in order. Instead, they are passing on a huge burden. With an employment ratio of roughly 50% in the average European economy, this is equivalent to 10 years of work for every future citizen to counteract this inheritance.

Future generations protest against inheriting this massive debt and environmental liability should not surprise anyone. It is time that the richest generation of post war people living and retiring today in Europe recognises that our generation of parents and grandparents, who inherited Europe from the ruins of war, did not have the luxury to borrow from the future to get Europe's house in order. They had to work hard and spend their hard-earned money to get Europe back on a growth path. Current generations have the same obligation: live less at the expense of the planet and pass less of a liability to future generations. With interest rates rising again in Europe, governments will be confronted with spending increasing amounts of money for financing their past liabilities instead of investing into the future. What is needed in the discussion around the stability and growth pact is less focus on the numbers and the room for manoeuvre implied. The discussion should be about whether Europe wants a turnaround in fiscal, monetary and environmental policy, or whether policymakers just want to keep talking instead of acting.

2.4 For increasing sustainable growth and reduce macro-risks for the EU wide economy, Europe needs credible fiscal and climate rules

A public representative stated that Europe needs robust and respected rules on fiscal issues. At the previous day's Eurofi it had been said that Europe does not just need benchmarks for the corrective arm, but also for the preventive arm, otherwise the benchmark will be 100% of GDP. With 100% of GDP and the interest rate jumping to 4% then 4% is added to the debt service cost. That is impossible, so benchmarks are needed. Within that there cannot be any exemptions for so-called priority expenditures. Europe needs to start to deliver robust rules for climate. The rules in place are quite stable, but Europe needs to find the obstacles for more mobilisation of private money, because private money must do the trick. Europe cannot expect that public money will pay for that, because it is out of the question.

The Commission has done great work to identify the pension risk, but it is not enough. Europe needs to move to a system when the pension decisions will be depoliticised, because it is a relatively simple arithmetic calculation to make sure that there is not 100% of GDP deficit on the way. Another option is to make voters more aware of the cost of running an unsustainable policy, because most politicians believe that there is a

reward for running an unsustainable policy because they can overspend or overcut taxes. A communication line is needed that will make sure people understand that they will pay the price for all the excess spending or excess tax cuts.

An expert observed that Europe does not have a capital market. In the United States when there is a recession or a problem with substates because they are too privately indebted and with not enough sufficient output capacity the result is that a natural flow of funds comes from the wealthier parts of the country towards the less wealthy parts. There is an automatic correction, but Europe does not have that.

2.5 The quality of public spending and composition on public finances must be given more importance than quantity

An expert underlined that the policy of permanently low interest rates has been accompanied by a reduction in productive investment and by a deterioration in the quality of public services in France. Structural problems need to be addressed by structural reforms. A qualitative change in budget expenditure is required. When there is a long period of zero or negative interest rates in nominal terms it makes the life of those who elaborate budgets much easier. There has been a coexistence of easing monetary policy on the one side and easing fiscal policy on the other side.

When looking into the situation of some European countries that have very large public debts and very large deficits it is possible to observe that the structurally important investments like research, justice and the rapidity of justice is an important element in the financial effectiveness. These sectors are sacrificed in a country like France, which has an enormous amount of public expenditure, something like 60% of GDP, versus an average European expenditure of 50%. What is important is not only the amount of deficit, 5% to GDP, it is the quality of the expenditures. The SGP needs to examine all the elements of the budget that are favourable or unfavourable to growth.

2.6 Impact assessments, coordination and more transparency are essential for pricing climate

The Chair noted that a serious question is how to price the structure. Europe does not price climate properly and makes out that it is impossible to price the negative externalities of climate change. The Netherlands Central Bank work shows all of the biodiversity loss. It is important to make sure that the geopolitical pressure from outside, the urgency of fighting against climate change and biodiversity loss and the need to face the spending of aging societies are taken into consideration in all the political discussions.

2.6.1 Transparency in sovereign credit risk assessment is important

An industry representative clarified that Moody's does not price anything. The financial markets do pricing on a minute-by-minute basis, but Moody's is focused on the fundamentals of credit risk. Moody's is increasingly engaged on issues such as how social injustice or inequality affects not just the credit standing of companies but also the credit standing of sovereigns, and the environmental risks, not just in terms of the financial cost needed to mitigate or address the issues, but the damage that can be done from environmental disasters. A lot of Moody's recent focus has been on trying to be more transparent. Moody's has always worried about whether issues are meaningful for sovereign credit risk, but in recent years it has put a lot of time and effort into trying to be much more transparent about doing that. When going onto Moody's website and looking at the rating there are now explicit credit impact and issuer profile scores which explicitly say how Moody's think those factors are impacting on creditworthiness and what the overall effect is.

2.6.2 The European reaction to energy prices in 2022

A Central Bank official stated that on pricing the climate in summer 2022 Europe did the opposite. There was a hard supply constraint on the regional electricity markets and gas markets, so prices went sky high. In a situation with fixed supply, if one starts subsidising the consumption of fuels by hundreds of billions of euros, then market prices will go up accordingly in the short term. End user prices will necessarily with or without government subsidies increase to the point where the market is cleared and demand limited to the supply of energy available. The large subsidies for fuel consumption will thus have a limited impact on end user prices but offer large gains for energy exporters and intermediaries. Over time, of course, such profits for energy producers will boost supply and push back prices again. Impact assessments of the tax incidence, coordination and more transparency would have helped.

The Chair stated it is important to think big and include sustainability in the large sense, and to look at more than just GDP. It is now up to the European Parliament and the Council to deliver the best possible rules. Time has come to make public opinions aware that the need to invest more in our security and in transition to net-zero implies difficult choices.