Are EU sovereign debts sustainable?

Collin Ellis

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Different sovereigns pose different credit risks in the EU

Public debt ratios rose substantially in the aftermath of the 2008/9 recession, fuelled both by the economic downturn and the direct actions of governments to support banks and other entities. This erosion of sovereign fiscal strength has generally not been reversed, with only three euro area countries – Germany, the Netherlands and Malta – currently having lower public debt-GDP ratios than in 2007. At the same time, we must never forget that we have seen three sovereign defaults in the euro area since 2012; investors are well aware that governments do not always pay their debts in full or on time. This obviously raises questions about the sustainability of sovereign debt in the future.

Debt sustainability generally refers to the borrower's ability to generate resources sufficient to cover operating expenses and interest costs now and in the future, including its ability to roll-over existing debt at affordable rates. There is no single magic number that can define debt sustainability, regardless of whether a borrower is a bank, company, household or a government. In a market context, the sustainability of debt will also depend on other factors including the ability of market participants to assess and price risk, the transparency of market mechanisms and clarity around default scenarios.

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>
> \- COLLIN ELLIS

In the case of sovereign debt, one advantage is that data in Europe are – generally – of a relatively high quality, relative to financial data available in some other parts of the world or for other issues. The role of statistical offices in defining and enforcing statistical standards is critical in this regard. But even armed with good data, assessing the sustainability of sovereign debt is a complex endeavor.

At Moody's, we focus on four key factors: economic strength; institutional strength; fiscal strength; and susceptibility to event risk. We use a range of indicators to inform >>>

>>> our assessment of these factors on a forward looking basis, including the longer-term challenges that many sovereigns face around health spending and other public service provision given their demographic profiles; these challenges, in particular, could lead to debt-GDP ratios rising dramatically over the longer term.

Together, our four key factors give us a sense of how sovereigns compare with each other. But ultimately our sovereign ratings reflect our own opinions, incorporate analytical judgment as well as quantitative analysis.
Excluding Greece and Cyprus, which are both recovering from past defaults and have non-investment grade ratings, our range of sovereign ratings in Europe ranges from Germany and the Netherlands, at Aaa, down to Italy at Baa3. Given that a one-notch downgrade roughly corresponds to a 60% increase in relative credit risk, this illustrates the different credit risks that different euro area sovereigns pose for investors. And while these ratings incorporate our judgments on future event risks, calibrating these is intrinsically difficult hard ex ante. Given the nature of the euro currency union in particular – with individual member states issuing debt in a currency they do not control – greater clarity around potential restructuring mechanisms, even if they are never used, would help investors calibrate associated risks.

For now, European sovereigns generally look well placed to weather the next downturn in credit conditions; most have taken advantage of low yields to extend maturities and reduce financing costs, and new issuance yields remain below maturing yields for many countries. But sooner or later several countries will have to take concerted action to contain explosive debt dynamics; and the financial and political cost of doing so later, when risks are more pressing, is likely to be higher than doing so now while credit conditions remain relatively benign. ●

Rolf Strauch

Chief Economist, Management Board Member, European Stability Mechanism (ESM)

Europe's debt burden: challenges ahead

Indebtedness improved over the past few years, but public and private debt levels remain high for some euro area economies. During the crisis years, Europe saw its debt levels increase rapidly. Fuelled by the governments' efforts to combat macroeconomic and financial vulnerabilities aggregate debt ratio climbed from 65% of GDP in 2007at 94% in 2014. Since then, euro area countries started sailing slowly towards calmer waters with favourable economic conditions and overall prudent fiscal policies that brought the aggregate public debt burden gradually down, significantly below debt levels seen, among others, in the US and Japan. However, debt levels remain substantially higher than the pre-crisis levels especially for some large economies. At the same time, private sector deleveraging continued, leading to a lowering of aggregate debt levels, albeit with significantly different pace across countries. In 2017, private sector debt ratios ranged from about 50% of GDP to above 300% of GDP, signalling that in some countries deleveraging needs might still exist.

Sustainability risks remain low in the short term, even if interest rates normalize further, due to favourable debt management and benign market conditions. During the last decade, market conditions allowed countries to issue longer maturities, >>>

>>> locking in favourable rates for long. This has reduced countries' rollover needs and refinancing risks. The average residual maturity increased by 1 year since 2012 and the average interest bill decreased by almost 1% of GDP. The pass through of any gradual interest rate normalization will be slow and with limited effects in the short-run.

Therefore, debt restructuring is, at this stage, not an issue. The favourable debt structure and macroeconomic environment, with low interest rates for the medium-term future, alleviate debt sustainability risks. For individual countries where developments and outlook are less positive, the fiscal space is naturally more limited forward looking. Prudent fiscal policies would strengthen the resilience of these countries before growth softens further as part of the cyclical slowdown. In the longer-run, population ageing will add significant fiscal costs, while the countries' labour force is eroding, weighing on potential growth. Safeguarding long-term debt sustainability requires using the growth enhancing potential of high-quality fiscal policy next to other structural reforms. Experiences show that growth, rather than single-handed fiscal austerity is part of sustained debt reduction.

The decisions of the Euro Summit last December have helped to further strengthen the euro area in facing future crises. The Summit endorsed a stronger role of the ESM as crisis resolution mechanism. It will operate as the common backstop to the European resolution authority, and its financial instruments have been reviewed to be more effective. The approach to assess debt sustainability will be made more transparent and predictable and contractual provisions will be improved to allow for private sector participation, in extreme cases if indispensable, to ensure a country's debt sustainability.

In addition, further work will be done on the completion of Banking Union with the introduction of the third pillar – a common deposit insurance scheme. The task is to outline a roadmap allowing for the introduction of EDIS and creating the conditions of a safe, profitable and integrated banking sector. Moreover, the introduction of a euro area budget is envisaged to support convergence and competitiveness among euro area countries. These initiatives will further strengthen the resilience of the euro area in pushing forward the landmark changes introduced over the past decade. ●

Stéphanie Pamies

Head of Sector, Sustainability of Public Debt, DG for Economic and Financial Affairs, European Commission

Fiscal sustainability challenges in the EU: the Commission latest assessment

At an aggregate level, EU public finances compare positively to other advanced economies. The EU government debt ratio has been decreasing since 2014 and should remain on a downward path in the coming years. Some other advanced economies (e.g. United States and Japan) exhibit much higher ratios and less favourable trends. Yet, challenges remain, with fiscal risks concentrated on a small set of - mainly large - European economies. Some countries – such as Italy, France, Spain and Cyprus – are still faced with increasing or not sufficiently receding government debt ratios. In some of these high-debt countries, most notably Italy, interest rate spreads have increased, and fears of disruptive sovereign-bank loops re-emerged.

"The Commission Fiscal Sustainability Report points to persisting fiscal sustainability risks."

- STÉPHANIE PAMIES

The Commission fiscal sustainability analysis critically contributes to the monitoring and coordination of Member States' fiscal policies, as well as of the aggregate fiscal stance for the euro area. As "sound public finances" is one of the guiding principle of the Union's >>>

>>> economic policy, the Commission fiscal sustainability analysis plays a key role notably for the implementation of the Stability and Growth Pact (SGP) and of the European Semester, the EU integrated surveillance framework. Based on a horizontal and transparent framework, the Commission provides, on a regular basis, a comprehensive assessment of debt sustainability and fiscal risks across the EU.

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

In the long term, taking into account in particular the fiscal pressure due to demographic ageing, high risks are identified in Belgium, Spain, Italy, Luxembourg, Hungary and the United-Kingdom.

Against this backdrop, there is a pressing need to make better use of the current economic momentum, including the low levels of interest rates, to re-build fiscal buffers in those Member States with high government debt. Adhering to European fiscal rules remains essential, along with some fiscal expansion by Member States with fiscal space. Continuing appropriate policy action on all age-related areas (pension, health-care and long-term care) – and not reverting past reforms - is also crucial.

Implementing a combination of policies ensuring macro-financial stability and sound public finances will not be sufficient to address the fiscal sustainability challenge. These policies should be coupled with reforms that increase productivity, growth and employment, as highlighted by the Ecofin Council conclusions supporting the FSR 2018. ●

Per Callesen

Governor, Danmarks Nationalbank

The fiscal rules – how to muddle through

Sustainable public finances is about demographics and pension reform, markets and interest rates and not least annual fiscal policy in the context of the EU fiscal framework. Can the latter be improved?

Since the establishment of the EMU and the Stability and Growth Pact (SGP) there have been discussions on – and political controversy over – the EU's fiscal framework, especially when it comes to member states' lack of compliance, credible enforcement and optimal design of fiscal rules.

Within the EU, national member states maintain the responsibility for fiscal policies. This should always be the starting point for discussing the common fiscal framework.

Sound national fiscal policies are – like other sound economic policies – always in member states' own interest. This may appear more obvious today, also in the short term, because markets are more awake than before 2008. But sound fiscal policy is often politically difficult to manage due to trade-offs between short-term and long-term interests. Fiscal rules can be an important and helpful tool for policymakers to fend off the pressure for short-termism. The EU fiscal framework is at its best when national governments use it as a helping hand, respecting and communicating advice, nudging and pressure from partners as assisting real economic needs, while avoiding using it as a scapegoat.

Can the EU fiscal framework be simpler? This is not very likely. Innovations were made over time because there were strong economic arguments for making the rules more sophisticated, which also made them more complex. The more flexible they are, and the more they work by discretion, the larger the risk of being politicised. The more tuned they are to account for institutional differences and measurement problems in order to be seen as reasonable and fair, the more they have to be detailed and thereby complex.

The fiscal rules were tightened and made more economically refined after the 2008 crisis. Can they be made still tighter to improve compliance at national level? Perhaps, but this is not obvious. Better enforcement and ownership would help. But, by the end of the day, nationally elected governments may wish to test alternative theories and put short-term popularity over long-term interests, despite peer advice.

"The EU fiscal framework is at its best when national governments use it as a helping hand."

\- PER CALLESEN

Therefore, complementing remedies could rely on greater transparency of risk analysis and protection against spillovers from adverse consequences in terms of stronger market pressure on the government.

Spillovers to the banking system can be reduced by incentivising stronger diversification of the banks' exposure to sovereign bonds.

Spillovers to the national private sector can be reduced if well-functioning banking and capital markets unions offer broader access to financing, thereby also having broader private risk-sharing.

And spillovers to other sovereigns can be reduced in the context of a comprehensive framework offering financing support for innocent bystanders. ●