

Are sovereign debts sustainable in the EU?

I. Public debt vulnerabilities remain high in a small set of-mainly large- European economies

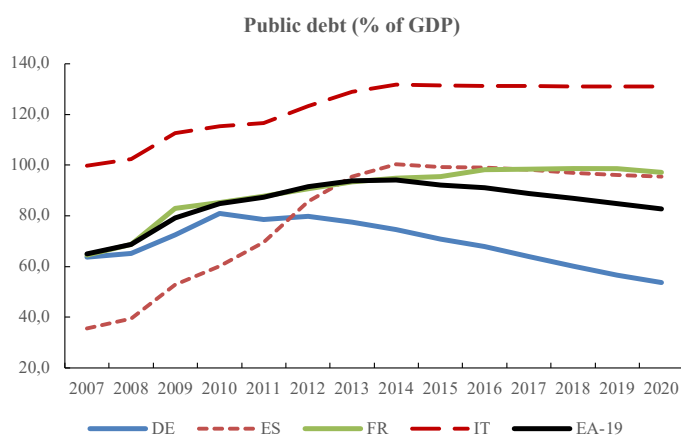
At an aggregate level, EU public finances compare positively to other advanced economies. The euro area government debt ratio has been decreasing since 2014 and reached less than 87% of GDP in 2018. At the same time, some other advanced economies exhibit much higher ratios (around 238% of GDP in Japan and around 106% of GDP in the United-States).

Fiscal positions of EU countries have improved visibly since 2016. All Member States, except Spain, have exited the Excessive Deficit Procedure (EDP), compared to 24 Members in EDP 2011.

But challenges remain in the European Union. The public debt is high in the euro zone excluding Germany. Fiscal risks are essentially concentrated on a small set of - mainly large - European economies. If most EU Member States have successfully managed to reduce their debt ratio over the last few years (notably in Austria, Netherlands and Finland), other countries – such as Italy, France, Spain and Belgium – are still faced with increasing or not sufficiently receding government debt ratios (see Chart 1).

Chart 1

Debt Divergence: in France and Italy public debt keep rising as other countries cut back



Source: Commission services

Although Italian debt is significantly higher than that of France (130% versus 100% of GDP in 2018), unlike Italy, France has had a primary budget deficit for several years and its debt is mainly held by non-residents.

In addition, even though these expansive fiscal policies were put in place a long time ago in these highly indebted countries, they failed to increase their potential growth because they did not carry out sufficient structural reforms (of the labour market, the education system, support for innovative companies, etc.).

As long as we do not understand notably in indebted countries (France, Italy, Spain etc) that excessive debt is a source of under competitiveness, the economic situation will continue to deteriorate in these countries. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an

Table 1

(1)	GG debt (% GDP) *		
	2007	2012	2018
BE	87,0	104,3	101,4
DE	63,7	79,9	60,1
EL	103,1	159,6	182,5
ES	35,6	85,7	96,9
FR	64,5	90,6	98,7
IT	99,8	123,4	131,1
PT	68,4	126,2	121,5

Table 2

(2)	Budgetary balance (% GDP)		
	2007	2012	2018
BE	0,1	-4,2	-1,0
DE	0,2	0,0	1,6
EL	-6,7	-8,9	0,6
ES	1,9	-10,5	-2,7
FR	-2,6	-5,0	-2,6
IT	-1,5	-2,9	-1,9
PT	-3,0	-5,7	-0,7

Table 3

(3)	Primary balance (% GDP)		
	2007	2012	2018
BE	4,0	-0,6	1,4
DE	2,9	2,3	2,5
EL	-2,2	-3,8	3,9
ES	3,5	-7,5	-0,3
FR	0,1	-2,4	-0,8
IT	3,3	2,3	1,7
PT	-0,1	-0,8	2,7

Table 4

(4)	GG expenditure (% GDP) **		
	2007	2012	2018
BE	48,2	55,9	52,0
DE	42,8	44,3	43,8
EL	47,1	55,7	47,6
ES	39,0	48,1	41,1
FR	52,6	57,1	56,2
IT	46,8	50,8	48,1
PT	44,5	48,5	44,0

Source: Commission services

* General government consolidated gross debt

** Total expenditure general government

illusion to try to solve the structural problems of our economies by a prolonged increase in public or private debt. Yet this is what we have tried to do by pursuing lax fiscal, monetary and political policies that pose systemic risks to financial stability and therefore to future growth.

France and Italy notably are suffering from a supply problem, due to the decline in industrial production capacity, the deterioration in cost competitiveness, the low level of labour force skills and the low level of potential growth, especially in Italy. When demand increases in France and Italy, this increase in demand mainly leads to an increase in imports and not in domestic production. Increasing fiscal deficits in these countries could only lead to a noticeable rise in interest rates that may threaten fiscal solvency and dampen private sector demand.

In such a context, France urgently needs to rebalance its public accounts in order to reduce the excessive level of tax and contributions which are detrimental to the competitiveness of French companies. What is needed is a reduction of public expenses, which represented in 2018 56% of GDP compared to 41% in Spain or 43% in Germany (as illustrated in Table 4 on the previous page) and not a lesser increase.

Italy, for its part, needs to increase its potential output and reduce public debt, which represents a major potential source of financial spill over for the rest of the euro area. No illusions should be held over the capacity to stimulate demand in these highly indebted euro-zone countries.

2. The economic consequences of high government debt

We cannot see any positive outcome of the situation of high public debt in certain EU countries, notably considering the budgetary costs of population ageing (pensions, healthcare). For the public finances, higher rates increase the cost of the debt and make it more difficult to reduce the debt-to-GDP ratio. Higher long-term interest rates and a re-pricing of sovereign risk may reignite government debt sustainability concerns in the absence of further reforms and consolidation efforts.

In its Economic Bulletin (Issue 3/2016), the ECB explains the significant economic challenges raised by high government debt.

First a high government debt burden makes the economy more vulnerable to macro-economic shocks and limits the room for counter-cyclical fiscal policy. For instance, a rise in long-term interest rates may reignite pressures on more vulnerable sovereigns, thereby triggering a sovereign risk re-pricing.

Second a high government debt entails the need to sustain high primary surpluses over long periods, which may be difficult under fragile political or economic circumstances. Indeed, high primary surpluses are difficult to maintain under adverse economic conditions.

Third theoretical and empirical literature suggests that high government debt burdens can ultimately impede long-term growth. This is particularly the case when it is contracted to finance unproductive expenses. While country heterogeneity plays an important role, several studies reveal that detrimental growth effects may appear at levels of around 80-100% of GDP.

3. Favourable macroeconomic conditions and an accommodative monetary policy should be used to re-build fiscal buffers

The more limited room for policy manoeuvre on the monetary policy and fiscal sides relative to pre-crisis should give us cause for reflection. In high-debt countries, failure to reduce government

debt increases the risk of heightened market pressures, which could have negative spillover effects on other Member States. Hence, in a context where uncertainties remain high - both on the external and domestic sides - Member States need to run prudent fiscal policies to ensure sound public finances in the short to longer term.

In several countries, public debt levels have not decreased, or have done so at a slow pace, and remain close to their historical peaks. Close to 90% of GDP at the euro area aggregate level in 2018, public debt ratios linger around 100% of GDP in Belgium, Spain, France and Cyprus, and around 130% of GDP in Italy and Portugal. Several countries remain therefore exposed to unfavorable shocks.

According to the Fiscal Sustainability Report (FSR 2018) published by the EU Commission, EU and EA overall debt ratios are projected to remain in 10 years' time above their pre-crisis levels, and well above the 60% of GDP Treaty reference threshold. These remaining important debt-vulnerabilities impede the mobility of cross border capital flows within the EU and expose highly indebted Member States to unfavourable shocks, in particular to hikes in interest rates. For instance, an increase of market interest rates of 100 basis points (combined with lower economic growth), compared to the baseline scenario, would raise public debt ratios by around 10 pps. of GDP or more in high-debt countries. Stabilising public debt in a higher interest rate environment would thus require larger fiscal efforts.

This analysis of the EU Commission also states that seven countries are deemed at high fiscal sustainability risk in the medium-term, as a result of inherited high post-crisis debt burdens, weak projected fiscal positions in some cases, and / or sensitivity to unfavorable shocks. This concerns Belgium, Spain, France Italy, Hungary, Portugal and the United-Kingdom. In five additional countries, namely Croatia, Cyprus, Romania and Slovenia, medium-term fiscal sustainability risks are deemed medium.

4. The debt rule in the EU fiscal framework has effectively not been implemented since the start of the EMU

All 28 EU member states are committed by the paragraphs in the EU Treaty, referred to as the Stability and Growth Pact (SGP), to implement a fiscal policy aiming for the country to stay within the limits on government deficit (3% of GDP) and debt (60% of GDP); and in case of having a debt level above 60% it should each year have a declining trend.

However, the Stability and Growth Pact regarding debt criteria has effectively not been implemented since the start of the EMU. In 2007, a number of countries recorded government debts to GDP ratios. Despite the different reforms which took place after the sovereign debt crisis¹, the public debt ratio in significant European Union countries continues to increase and is approaching 100% of GDP or even more in certain Member States.

Looking ahead, it should be ensured that compliance with the requirements of the debt reduction benchmark is not unduly delayed. This requires complementary policy action. A monetary union is not workable without economic convergence and fiscal discipline. The enforcement of the Stability and Growth Pact has been too lenient since 2003. EU Fiscal rules need to be enforced more rigorously and should be more binding and effective. By converging towards lower levels of government debt and regaining fiscal buffers, the euro area will increase its resilience and fiscal space to cope with potentially adverse economic shocks in the future.

¹ A reform (part of the 'Six-Pack') amending the Stability and Growth Pact entered into force at the end of 2011. Another one, the intergovernmental Treaty on Stability, Coordination and Governance, including the Fiscal Compact, entered into force in early 2013. A regulation on assessing national draft budgetary plans (part of the 'Two-Pack') entered into force in May 2013.