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Dealing with Europe's high debt: complicated but not impossible

Europe's debt will soar to new highs in the aftermath of the COVID-19 pandemic, but its aggregate level is not higher than elsewhere: we estimate public debt to GDP in 2020 to reach 108% for the euro area versus 136% in the US, 104% in the UK and 276% in Japan. However, these forecasted debt levels within the euro area vary widely, from 198% in Greece to 20% in Estonia. Crucially, euro area sovereigns issue debt in euro, their common currency, independently controlled by the ECB. Thus unlike sovereigns who issue in their own (fiat) currency, euro area sovereigns would not be able to, as a last resort, print their own money to avoid default.

Otherwise, governments can reduce their debt as a share of GDP in only these basic ways: 1) generate primary surpluses (ie. a fiscal surplus after interest rate payments on the existing debt); 2) achieve GDP growth rates higher than the average interest rates paid on their debt; 3) restructure their debt. However, debt restructurings are realistically only an option for smaller, non-systemic economies, and most governments will need to pull on all other levers to keep their debt dynamic sustainable.

Fiscal consolidation makes sense only after economies have recovered from the current crisis. At such a time, we would expect it to be pursued more through the revenue rather than the expenditure side: because of the unpopularity of 'austerity'; the bigger role of government as consequence of the COVID-19 crisis, and the fact that tax rates have generally fallen over the past decades.

As for increasing GDP growth, structural reform efforts and increased public investment could help. But demographic trends in Europe make large increases in real growth rates unlikely. Similarly, Europe is unlikely to be able to 'inflate' debt away. Not only because this depends on how inflation affects fiscal balances and how rapidly creditors can react to higher inflation, but because Japan has also shown how difficult it is for ageing economies to break out of low inflation, regardless of easy monetary policy.

However, an environment of inflation and low real interest rates can also help to sustain much higher public debt ratios than in the past. Central banks already play a crucial role. By setting very low - even negative - short-term policy rates while also buying longer term government debt, they keep the entire yield curve very low and flat. This allows governments to lengthen the maturity of their debt profiles, locking in extremely low and often negative interest rates - which will become even more negative in real terms, if central banks do successfully raise inflation rates over time.

At the same time, central banks and regulators can effectively force private agents to hold such low-yielding government debt, eg. through statutory liquidity coverage ratios. Such 'financial repression' keeps governments' debt service burden low.

An optimistic scenario thus looks as follows: the combined effort of structural fiscal reforms and accommodative monetary policy help boost real growth and inflation (temporarily even above target); as this translates into a higher real interest rate burden only with a long lag, governments have enough time to consolidate their fiscal positions in the meantime. Debt-to-GDP ratios would be high but not become unsustainable.

However, 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. The EU's recent generous crisis package seems based on the hope that this gesture of solidarity will also create a sense of responsibility for the common European project.

Ultimately, a proper European fiscal union, where member states would largely relinquish fiscal sovereignty in return for a mutualisation of debt on the European level would in theory solve the issue. But such a 'United States of Europe' seems very far away, if at all desirable. At the other extreme, a sovereign default of a larger systemic euro area member would seriously challenge the survival of the currency union. ●