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Debt, growth and policymaking – the EU's trilemma

Moody's is often asked why the current crisis has had limited ratings implications in the EU despite its dramatic impact on growth and debt. The simple answer is that we assume that policymakers will contain and ultimately reverse the impact. But we also recognise the enormous challenges in achieving that outcome and the clear risks.

Since 2007, overall public debt of the then-EU members has risen from 66% to 80% of total GDP. While that is down from a peak of 92%, the decline mainly occurred in countries with the strongest credit profiles and in those worst hit by the crisis a decade ago. In some of the largest EU economies, debt has proven sticky or has even continued to rise.

Debt burdens will get worse. This crisis will lower the level and growth of GDP in the EU and worsen the fiscus. Temporary fiscal support may well prove long-lasting. EU governments will likely emerge from the crisis more indebted and more exposed to shifts in financing conditions. Moody's forecasts that the EU debt burden will rise by a further 18 percentage points over 2020 and 2021 on average, with some countries' debt burdens rising by more than 20 pp.

For now, that debt burden is manageable. Debt affordability has improved in recent years as interest rates have fallen. The ECB's response to the current crisis has left policy and market rates very low and we expect them to remain so for a long time. Even the most indebted countries can still refinance expensive global financial crisis debt at lower rates.

But is it sustainable over the longer term? Each crisis leaves the EU more highly indebted. Each increase in debt leaves it more exposed to the next crisis. And it has already faced two in a decade.

Large, advanced economies with strong institutions can sustain large debt burdens. The last crisis showed however that there are limits, which rest ultimately on investors' willingness to continue to refinance enormous sums falling due each year. And investors are mercurial. As we saw during the last crisis, that willingness is not guaranteed.

It rests, ultimately, on confidence in growth and policymaking – two factors at the heart of Moody's own analysis. Investors will step up as long as they believe that governments will be able to sustain the nominal growth needed to cover interest payments, and more broadly as long as they believe policymakers will achieve the fiscal and economic outcomes needed to contain the rise in debt, and in most cases ultimately to reverse it.

There lie the roots of the EU's debt problem. Even by advanced economy standards, growth has been low for many years. Demographic pressures, low productivity growth and perhaps the legacy of the current crisis suggest it will remain so for years to come given.

Meanwhile, policymakers have had mixed success in implementing the fiscal and economic reforms needed to revitalise growth and reduce debt burdens. After some significant progress early in the decade, momentum has slowed and, in some respects, reversed. Austerity fatigue has emerged long before austerity policies have achieved their goals. The actions needed to deal with the coronavirus pandemic will only add weight to the expansive political narrative.

That leaves the EU, or at least important parts of it, vulnerable to a shift in sentiment, with high debt burdens revealed to be unsustainable. This risk will rise as the environment normalises and interest rates rise. But the risk is not so much a general rise in interest rates as a rise in spreads, and a corresponding fall in debt affordability, for the countries perceived to pose the greatest risk – those with the highest debt, the slowest growth and the weakest institutions.

It may prove difficult for the EU's governing institutions to see off such a threat. The last crisis illustrated the lack of common ground on mutual support initiatives. The ECB continues to play its crucial 'buyer of last resort' role.

But recent negotiations around the Recovery and Resilience Facility show that starkly different visions persist for the EU, and little progress has been made on the closer fiscal and economic integration needed to bolster the euro area's resilience to shocks. ●