Jerome Haegeli

Group Chief Economist, Swiss Re

Europe – now is the time to invest

Vast fiscal stimulus may keep Europe afloat this year, but the long-term solution is investment.

Governments have unleashed unprecedented fiscal stimulus to keep economies afloat through the COVID-19 pandemic. The crisis has so impacted public finances and output simultaneously that the Euro area aggregate debt-to-GDP ratio is set to surpass 100% for the first time in history. Debt in a few member states is particularly high, notably Italy and Greece, where the ratio will likely rise above 150% and close to 200% respectively. Even Germany's debt to GDP is expected to climb to about 75% from 60% at end-2019 following one of the largest stimulus packages in the EU. While the immediate urgency is focused on the rebound from the economic crisis, eventually the question will arise: how to reduce these exorbitant debt levels?

The good news for debt sustainability is the record-low cost of borrowing. There is no guarantee, however, that interest rates will remain low forever and even if they do, we will have less capacity in future to absorb new shocks with higher spending. From all angles it is clear that we have to address today's record debts.

Inflating away debt is unlikely to be an option. The European Central Bank has tried for more than seven years to increase inflation sustainably to its close to 2% target. We expect the focus will shift back to fiscal restraint, with the EU likely to try to keep government spending in check after the crisis subsides. However, austerity introduced after the global financial crisis has been widely criticised for impeding growth. An increase in taxes to finance spending is more likely but may prove both contentious and not a good policy, especially in countries that already have high tax burdens.

The most desirable and indeed only viable long-term route is to boost GDP growth by enhancing productivity. To address our record debt levels, we must spend wisely to lift economic growth. The recently agreed EUR 750 billion EU recovery fund, and the European Green Deal launched in 2019, are welcome steps towards enhancing GDP growth. Yet they are not enough: more decisive policy decisions are needed to secure Europe's future and preserve its single market. Investments should focus on productivity enhancing areas such as infrastructure, technology in a way that advances climate goals. Building new sustainable infrastructure and upgrading the old has a significant multiplier effect on GDP growth.

Throughout Europe's history, transformative decisions have emerged from crises. Today we face the most acute economic and health crisis of modern times and the time to act is now. Europe needs to invest and is stronger with private capital at work. A single currency alone is insufficient to attract long-term investment capital from institutional investors such as insurance companies – we must accelerate the capital markets union. Well-functioning, dynamic capital markets are key for the competitiveness of European companies, particularly as competition will intensify as China opens its financial markets further and attracts a much larger slice of global capital.

To expand Europe's capital markets, we ultimately need a risk-free euro rate and a form of burden-sharing for governments. The EU could use the newly created borrowing power of the recovery fund for joint debt issuance, for example in the form of perpetual bonds, as the UK and US have issued in centuries past. With no maturity date, perpetual bonds allow for cheap long-term financing, with the advantage that the mutual obligation would stop at paying annual interest.

Second, Europe needs to address the problem of so-called zombie companies – highly leveraged and unproductive firms. A European bad bank and clear principles would enable orderly corporate restructuring and unwinding of government credit. An EU-wide recapitalisation fund would support otherwise-viable private companies that lack access to capital markets. Third, a harmonized EU-wide insolvency regime would constitute a tool to deal with non-performing loans created by the debt bazooka. To sum up, raising Europe's competitiveness is the only viable strategy to deal with the debt and for this completing the capital markets union is key It is time for Europe to invest capital and in deep capital market reforms. ●