

A fresh look at debt sustainability in the euro area - speech by Rolf Strauch

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“A fresh look at debt sustainability in the euro area”

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Good afternoon,

Is sovereign debt sustainable in the euro area? This is a key question of our times. In 2017, I had the pleasure of speaking at the DebtCon event in Geneva. At the time, we were discussing the lessons learned from the European debt crisis. Today, as we face the pandemic crisis, we again need to draw some important lessons and reassess the way we think about sovereign debt.

A lot has changed in recent years since the framework for debt sustainability analysis (DSA), which we now consider standard, was conceived, refined and applied – among others in the various ESM programmes. Now, Covid-19 is causing quantum leaps both in fiscal deficits and also in how they are being financed. These and other changes warrant a fresh look at how we assess public debt sustainability in the euro area. In my speech, I will point to several issues and suggest how they can be

addressed.

Debt and DSA in ESM programmes, and what has changed since then?

Let me start by looking back at the roots of the euro debt crisis. The adoption of the euro typically led to large capital flows across member countries, reducing borrowing costs, and accommodating significant increases in private and public sector debt. After the Great Recession of 2008-09, a large chunk of private debt ended up on the books of governments - which had to rescue several financial institutions.

These liabilities combined with high public deficits, low growth and weak competitiveness in some member states led to the euro area debt crisis and the subsequent financial assistance from the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM). Euro area debt eventually peaked at 93% of GDP in 2014.

At the time, the debt sustainability framework looked mainly at the debt stock. It was considered sustainable if the primary balance required to stabilise it around a certain level was economically and politically feasible. The sovereign's gross financing needs (GFN) were also considered and the ability to achieve such financing with limited risk, using general benchmarks to determine if the size of GFN could meet this test.

Since then, there have been a number of changes. First, debt levels have been significantly reduced, following the euro crisis, to 84% of GDP in 2019 for the euro area overall because of buoyant growth and strengthened fiscal policies in a number of countries.

In addition, the very low interest rates have reduced significantly the debt service burdens in government budgets. Italy is a good example as the share of interest payments in total government expenditures dropped from over 20% in the mid-1990s to below 7% in 2019. There is a broadening recognition that 'low-for-long' is likely to be 'low-for-very-long', due to the structural persistence of a low natural interest rate, as well as central bank policies.

On the other hand, and partly linked to the lower interest rates, potential output growth is declining. This weaker growth outlook will likely stay with us for a long time and perhaps even weaken further going forward. Keep in mind that due to Covid-19

we have seen a sharp increase of fiscal deficits and debt levels – likely above 100% of GDP for the euro area as a whole by end-2020.

Finally, it's worth mentioning the swift and impressive European response to support low-cost financing: increased asset purchases by the ECB; the €540 billion package of measures adopted by the ESM, EIB, and European Commission (SURE programme); and the €750 billion EU recovery fund, known as the Next Generation EU fund.

The need for a fresh look

Given recent developments, if we performed a simple extrapolation of the standard debt sustainability analysis, we would be predicting an imminent debt crisis in several countries, as debt and GFN exceed, sometimes by far, the levels previously considered as posing an acceptable risk. But, of course, this has not happened; market views on safe debt levels appear to have adapted to the new situation.

At the same time, it is also obvious that countries' fiscal positions will have to return to lower deficits and higher primary balances in order to ensure sustainable debt outlooks.

Our early, preliminary assessment of post-Covid debt outlooks (in connection with the eligibility assessments for the ESM's Pandemic Crisis Support) showed that debts were sustainable, though signalling the need for substantially lower fiscal deficits going forward. The 2020-21 growth outlook has been downgraded since then, but the conditional, baseline judgement of sustainability should still hold.

Beyond these initial assessments, the question is whether and how the existing framework for assessing debt sustainability should be adapted, recognizing the changes that have occurred. Without aspiring to provide definite answers, let me put forward a few general thoughts and key issues to be addressed.

What are the key issues to address?

- We need a fresh look at models, parameters, and stochastic projections. This means reconsidering the benchmark computations done in the past about sustainable debt levels. Forward-looking scenario analysis and stress testing methods will become more relevant to capture good and bad equilibria.

- Rigorous, quantitative analysis remains critical, but increased uncertainties and resulting limitations need to be fully recognised and transparently documented. This includes qualitative judgements, which will be critical and even more relevant with high uncertainties.
- DSA should cover different time horizons and needs to be more explicit about the assumptions underlying short-, medium- and long-term assessments. DSA has traditionally covered 5 years ahead, or in exceptional cases up to 10 years. At the ESM, we do long-term assessments as some of our loans extend beyond 40 years. Providing a DSA that has a negative interest rate – growth differential over 5 years, without considering a longer-term horizon, provides only an incomplete picture.
- We may also need to shift somewhat the focus of our debt sustainability analysis to capture better the state of our economy and inherent uncertainty. .
 - The ability and willingness to service debt (flows) deserves even more emphasis, while perhaps giving less consideration to the debt level (stock) relative to some benchmarks.
 - We should incorporate better some measure of the ‘quality of debt and deficits’, which is the expected future growth dividend of spending and reforms.
 - We need a model with realistic assumptions about the future path of interest rates. This means having a realistic view on how long interest rates will remain low, and the timing and conditions for exit from the exceptional, unconventional monetary policy.
 - We need to be clear and realistic about contingent liabilities, especially in the financial sector where risks may be building up in loan portfolios and other asset prices.
 - In spanning DSA over longer horizons, we should also conceptualize more thoroughly the risks of climate change. Addressing them will entail major costs for all countries, and global warming may present a significant source of macro-economic shocks in the long run.

Overall, the debt sustainability analysis should provide the best possible quantitative analysis of the future path of debt service and associated risks, as useful input for policy makers, creditors and European governing bodies. How we think about debt sustainability is also highly relevant in the context of the European surveillance framework and the debate on revising its fiscal rules.

A few tentative conclusions

These are no doubt difficult questions that cannot be answered hastily. Besides raising these questions as an agenda for future work, let me offer some thoughts on a few aspects which I believe will be crucial for the fiscal policy orientation during the recovery from the pandemic crisis:

- Despite the Covid-related increase in debts and debt service burdens, one cannot jump to the conclusion that debts have now become unsustainable (as might have followed from simple extrapolation under previous frameworks).
- That said, countries (especially those with relatively high debt burdens) will need to make significant efforts to reduce fiscal deficits going forward. Even if debt service burdens are low, and will remain low for a considerable time under a baseline scenario, there is the risk that spreads might jump in response to some trigger event, such as a change in government policies or rising inflation expectations.
- Success (and continuing market confidence in debt sustainability) will depend on the longer-term post-Covid growth outlook. Here I see a critical role of the EU Recovery Fund. First, in how the additional funds will be used and what their growth dividend will be. And second, perhaps even more importantly, can countries, especially those with an already high debt burden and a relatively weak growth outlook, use the post-Covid period and leverage the large EU support to reform their economies and set them onto a new, higher growth path? The Recovery Programmes that countries will design and implement in support of the European Recovery Fund support will be of utmost importance.
- Long-term fiscal challenges (in particular, ageing- and climate change-related ones) need to be taken into account. Prudent risk management policies start early to prepare, both financially (by building buffers) and through policy action (for example, by making gradual changes to pension systems or introducing a carbon tax).

Let me conclude here with these thoughts on the how medium-term fiscal policy should look like during the recovery phase.

Thank you very much for your attention.

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