Debt risks after the pandemic crisis - speech by Klaus Regling

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22/01/2021
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Klaus Regling, ESM Managing Director

“Debt risks after the pandemic crisis”

EIB Annual Economics Conference (virtual)

22 January 2021

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Good afternoon. At the start of the New Year, we can look ahead with cautious optimism that the Covid pandemic will be brought under control. Even if that is the case, however, its economic effects will linger for a much longer time.

EU Member States continue to spend huge amounts of funds on health care, as well as on financial support for businesses and households affected by the crisis.

EU fiscal rules were rightly suspended to allow for this large increase in government spending. This has been a necessary response to an external shock that threatened the lives and well-being of European citizens.

We can safely say that the fiscal response, along with decisive ECB action, prevented much more severe hardship, recession and financial crisis. Deficit financing was also appropriate given the sharp increase in private savings that resulted from the drop in private consumption. Without these public sector measures, the recession would have surely been much deeper. And the level playing field of the Single Market and the functioning of Economic and Monetary Union (EMU) could have been jeopardised.

That said, this necessary policy response comes at a cost: the higher deficits and lower GDP growth have pushed public debt-to-GDP ratios sharply higher. Euro area-wide, the ratio has increased to around 100% of GDP in 2020, from around 86% in 2019. Given varying pre-pandemic debt levels, some countries now face debt ratios significantly higher than that.

In the past, such debt developments would have caused immediate, sharp market reactions and acute concerns about debt sustainability. This has not occurred this time, and rightly so, because the circumstances are different compared to the great financial crisis.

The Covid debt shock is an external shock that has hit euro area economies much better prepared than they were 10 years ago.

Furthermore, global interest rates are much lower and will likely remain low for some time. And finally, the pandemic shock is temporary, with prospects for a quick, though partial reversal when lockdowns are removed and much-reduced fiscal deficits.

These factors, together with the unprecedented policy response particularly at the European level, suggest that the higher debt levels as such are not a concern in the short term.

But should we be concerned looking into the longer term? How will debt sustainability evolve, and what new risks might there be for future debt trajectories?

I would like to highlight three potential adverse developments to future debt dynamics.

First, the significant amount of debt accumulating in parts of the household and corporate sectors, and the risk that a sizable portion of those debts may end up on public sector balance sheets.

Second, the longer-term costs of climate change and ageing, not accounted for in standard debt sustainability analysis.

And third, the increased gross financing needs associated with higher debt levels may lead to higher debt servicing costs, once the exceptional ECB support to public debt markets is removed or reduced.

Considering these risks, but also the “radical uncertainty” that was discussed yesterday and which requires some buffers, I would advocate a cautious stance towards continued debt-financed public spending, once the economic consequences of COVID-19 are overcome. The accumulation of debt should be reduced when macroeconomic conditions allow it, while maintaining growth-friendly spending to ensure the needed longer-term growth benefits.

As EU countries face the twin challenge of supporting the recovery and managing the heightened risks to debt sustainability, the large-scale financial support offered by European institutions is hugely significant.

The first support package agreed in April last year amounts to €540 billion. It consists of three safety nets: for sovereigns, businesses and workers, provided by the ESM, the EIB and the European Commission.

On 1 January this year, the EU's €1.8 trillion recovery budget entered into force. Its centrepiece is the Recovery and Resilience Facility (RRF), offering ultra-low-cost financing and grants to EU Member States in support of reforms and growth-enhancing investment. The focus on reforms and investment, if well implemented, will improve the medium-term outlook for all European economies, and will also improve future debt dynamics.

In addition, we will see positive effects of the RFF thanks to the joint bond issuance that will finance the recovery fund. European institutions have top ratings, markets are looking for safe borrowers, and large issuance of safe European assets will support capital market integration and strengthen the international role of the euro.

The RRF is a landmark of European solidarity. In terms of scale (€673 billion) it can be seen as a precedent, although transfers between EU countries have been a tangible expression of that solidarity since the Treaty of Rome in 1957.

The institution that I manage, the ESM, was also created as a manifestation of European solidarity. Our mission is to safeguard macro-financial stability in the euro area. The ESM reform, now fully agreed at the political level, has given us a new mandate to become the backstop to the Single Resolution Fund.

Let me also note that the ESM’s Pandemic Crisis Support facility is available until end-2022 to all euro area Member States to help finance health-related expenditure. It can serve as bridge finance until the RFF funds are available.

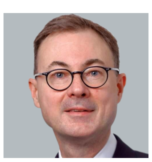
If a country requests the facility, it will be able to draw ESM loans at zero or negative interest. It means that about half of euro area countries can finance their health-related needs more cheaply via the ESM than by borrowing directly from capital markets. This would translate into significant budgetary savings, making their public debt more sustainable, to the benefit of financial stability in the whole euro area.

Thank you very much.

Author

Klaus Regling
Managing Director

Contacts



Cédric Crelo
Head of Communications and Chief Spokesperson
+352 260 962 205
c.crelo@esm.europa.eu

[Anabela Reis](#)
Deputy Head of Communications and Deputy Chief Spokesperson
+352 260 962 551
a.reis@esm.europa.eu

Juliana Dahl
Principal Speechwriter and Principal Spokesperson
+352 260 962 654
j.dahl@esm.europa.eu

George Matlock
Senior Financial Spokesperson
+352 260 962 232
g.matlock@esm.europa.eu