Europe’s debt burden: challenges ahead - article by Rolf Strauch

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“Europe’s debt burden: challenges ahead”
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Indebtedness improved over the past few years, but public and private debt levels remain high for some euro area economies. During the crisis years, Europe saw its debt levels increase rapidly. Fuelled by the governments’ efforts to combat macroeconomic and financial vulnerabilities aggregate debt ratio climbed from 65% of GDP in 2007at 94% in 2014. Since then, euro area countries started sailing slowly towards calmer waters with favourable economic conditions and overall prudent fiscal policies that brought the aggregate public debt burden gradually down, significantly below debt levels seen, among others, in the US and Japan. However, debt levels remain substantially higher than the pre-crisis levels especially for some large economies. At the same time, private sector deleveraging continued, leading to a lowering of aggregate debt levels, albeit with significantly different pace across countries. In 2017, private sector debt ratios ranged from about 50% of GDP to above 300% of GDP, signalling that in some countries deleveraging needs might still exist.

Sustainability risks remain low in the short term, even if interest rates normalize further, due to favourable debt management and benign market conditions. During the last decade, market conditions allowed countries to issue longer maturities, locking in favourable rates for long. This has reduced countries’ rollover needs and refinancing risks. The average residual maturity increased by 1 year since 2012 and the average interest bill decreased by almost 1% of GDP. The pass through of any gradual interest rate normalization will be slow and with limited effects in the short-run.

Therefore, debt restructuring is, at this stage, not an issue. The favourable debt structure and macroeconomic environment, with low interest rates for the medium-term future, alleviate debt sustainability risks. For individual countries where developments and outlook are less positive, the fiscal space is naturally more limited forward looking. Prudent fiscal policies would strengthen the resilience of these countries before growth softens further as part of the cyclical slowdown. In the longer run, population ageing will add significant fiscal costs, while the countries’ labour force is eroding, weighing on potential growth. Safeguarding long-term debt sustainability requires using the growth enhancing potential of high-quality fiscal policy next to other structural reforms. Experiences show that growth, rather than single-handed fiscal austerity is part of sustained debt reduction.

The decisions of the Euro Summit last December have helped to further strengthen the euro area in facing future crises. The Summit endorsed a stronger role of the ESM as crisis resolution mechanism. It will operate as the common backstop to the European resolution authority, and its financial instruments have been reviewed to be more effective. The approach to assess debt sustainability will be made more transparent and predictable and contractual provisions will be improved to allow for private sector participation, in extreme cases if indispensable, to ensure a country’s debt sustainability.

In addition, further work will be done on the completion of Banking Union with the introduction of the third pillar – a common deposit insurance scheme. The task is to outline a roadmap allowing for the introduction of EDIS and creating the conditions of a safe, profitable and integrated banking sector. Moreover, the introduction of a euro area budget is envisaged to support convergence and competitiveness among euro area countries. These initiatives will further strengthen the resilience of the euro area in pushing forward the landmark changes introduced over the past decade.

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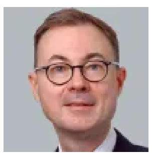

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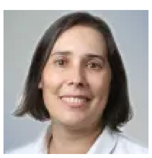

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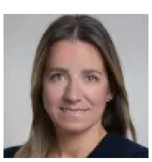

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