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Sovereign debt: Do we need an EU solution?

High levels of sovereign debt have become a serious issue in the Eurozone. This does not just affect the individual member states: The European debt crisis has shown that difficulties in one euro-area country can spread to the entire currency union. What strategies are being discussed for reducing sovereign debt? Would a stronger role for the EU help to reduce debt over the long term or should this be left solely to the member states?

JACQUES DELORS INSTITUT BERLIN | BertelsmannStiftung

Why is sovereign debt a problem for the Eurozone?

Many members of the Eurozone are heavily indebted. This applies in particular to Greece, Italy and Portugal: The amount of sovereign debt has exceeded 130 percent of gross domestic product (GDP) in these three countries. But even the average level of debt among euro-area countries amounts to 90 percent of GDP. This limits governments' leeway since they must spend ever-larger amounts on interest payments and have fewer resources available to deal with unanticipated events such as an economic crisis.

The Eurozone is prone to end up in a vicious circle of debt. Countries that issue sovereign debt in their own currency are relatively resistant to panics: If government bonds have no buyers for a short period during a crisis, the domestic central bank can provisionally hold them. But the situation is different in the Eurozone. The European Central Bank's purchase of individual countries' government bonds is controversial and permitted, at best, under very strict conditions. Thus, even Spain, which had a debt ratio of just 40 percent of GDP in 2008, experienced payment difficulties after the global financial crisis.

When the government needed money to stabilise the financial system, interest rates on its bonds rose higher and higher, increasingly calling into question the country's ability to pay.

For a long time, the euro-area countries had no plan of action to meet a sovereign debt crisis. At its formation, the currency union was based on a ➔ no-bailout clause. But when the Greek government ran into difficulties with its finances in 2009, a panic broke out in the Eurozone. If a country went bankrupt, the fear was that investors would withdraw their money from other euro-area countries, ultimately leading to departures from the Eurozone and a meltdown in the financial system. The euro-area countries decided to provide ➔ emergency loans and, effectively, to bail each other out.

No-bailout clause
The EU Treaties state that EU member states and the EU are not liable for the debt of other members. This clause is meant to ensure that national governments draw up their budgets so cautiously that they are never at risk of a sovereign debt crisis.

Emergency loans
Since 2010, the euro-area countries have used bailouts to provide loans to countries that are in principle solvent but under heavy pressure from capital markets. Today, the European Stability Mechanism (ESM) is used primarily for this. The ESM is under the control of the euro-area countries and can provide up to 500 billion euro in credit.

"Projects to enhance EU growth potential could be financed by joint debt issuances."

Pier Carlo Padoan, Italian Finance Minister
position paper by the Italian Ministry of Finance in February 2016

"Joint liability combined with far-reaching national sovereignty would be the false path. That would do more to increase the problems in Europe than to solve them."

Jens Weidmann, German Central Bank President
in Die Welt on 25 June 2017

How can Europe reduce its debt?

All euro-area countries want to reduce their sovereign debt, but there is no agreement on the best strategy. The Eurozone has three courses towards reducing debt ratios: Governments can cut spending, they can stimulate growth, or they can seek a haircut.

In the first phase of the euro crisis, austerity policies dominated. Member countries only obtained emergency loans in return for harsh cuts in public spending. The Fiscal Compact also introduced mandatory ➔ **balanced-budget rules** into national law, and the European Commission can impose sanctions more easily since 2011 if countries violate the ➔ **Stability and Growth Pact**. Critics, however, point out that austerity policies in an economic crisis deepen the downturn and thus reduce the affected country's solvency.

The larger a country's economy, the lower its relative debt burden. Growth plays a key role therefore. If Greece, for example, were to take on no new debt and grow annually at three percent, it would cut its debt to GDP ratio in half by 2030.

But the correct path towards growth is controversial: While countries such as Italy and Greece call for governments to stimulate growth through higher spending, Germany and other countries demand an improvement in the overall economic framework.

Reducing debt via a haircut was applied in the case of Greece in 2012. This cannot be easily repeated for multiple reasons, however. Negotiations with creditors are very complicated and slow. Furthermore, banks often hold their own country's government bonds so the financial system may collapse in the event of a sovereign default. If other euro-area countries are rather the primary creditors, a haircut would hurt their national budgets and conflict with the no-bailout clause.

Balanced-budget rule
A law, often constitutionally anchored, that requires governments to barely spend more than they receive in revenue. The permitted deficit for most euro-area countries is -0.5 percent of GDP. In recessions, somewhat more may be spent, while in periods of high economic growth less.

Stability and Growth Pact
A package of European rules designed to reduce Eurozone members' sovereign debt to below 60 percent of GDP over the medium term. Among other things, it limits budget deficits in Eurozone countries to a yearly maximum of three percent of GDP. The European Commission monitors compliance with the pact and can impose fines in the event of any breaches.

"I personally consider eurobonds to be a possible instrument in order to finance future common tasks of the European Union at favourable conditions. However, they should not be used to shift debt that a state issued in the past onto the backs of other Europeans."

Sylvie Goulard, Member of the European Parliament
in the Frankfurter Allgemeine Sonntagszeitung on 13 May 2017

"Macron also ultimately proposes to move towards harmonisation, and ultimately debt mutualisation. By contrast, I am in favour of finally adhering to the rules again."

Christian Lindner, Chairman of the FDP
in an interview with Politico on 21 June 2017

SOVEREIGN DEBT

SCENARIO 1

Growth and limited risk sharing

If euro-area countries cannot agree on a common approach, they have to manage their sovereign debt within the scope of the rules already in place. National governments by and large decide on their debt-reduction strategy by themselves. However, they cannot implement large debt-financed economic programmes since the European Commission monitors compliance with the Stability and Growth Pact. Minor violations are often tolerated in practice.

In this scenario, some countries succeed in stimulating economic growth through reforms and a redirection in government spending, while other countries in the currency union have to combat a stagnating economy and ever-higher government debt.

If the debt in a country gets out of control, the European Stability Mechanism intervenes with emergency loans. It remains unclear, however, whether it can act quickly enough to stop a crisis at its inception and has enough resources available to stabilise large member states as well.

SCENARIO 2

Insolvency regime and haircuts

In this scenario, the euro-area countries adhere to the original principle of denying any common liability for sovereign debt. There are no longer loans for countries caught in an emergency. Instead, a sort of insolvency regime is introduced for states, allowing for an orderly haircut inside the currency union. For the financial system to handle such a shock, banks may no longer treat government bonds as risk-free as they do today. Instead, they must build provisions in case the bonds lose their value.

Consequently, there are no disputes about austerity conditions imposed by the European Commission since national governments are given autonomous control of their budgetary policy. Depositors, banks, insurance companies and other capital-market participants differentiate between more and less solvent countries when buying government bonds and thereby reward the effort to lower debt.

At the same time, Eurozone member states would remain susceptible to market panics and speculative attacks as seen during the euro crisis. Countries that have high sovereign-debt levels would also have to pay significantly higher interest on their government bonds, which would make an insolvency regime politically unlikely.

SCENARIO 3

Common guarantees and control

In this third scenario, the euro-area countries decide in favour of a fiscal union, that is for a large-scale sharing of risk and sovereignty. Sovereign debt is guaranteed collectively. This entails extensive monitoring of national budgets by the European Commission so that countries cannot issue limitless debt.

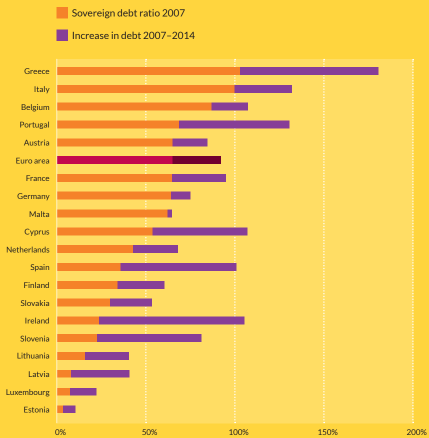
This model offers maximum protection against speculative attacks in the Eurozone. It creates common safe bonds that banks use as a capital buffer and can be purchased by the ECB in any acute crisis. Countries with little or no debt would likely have to spend more money on interest payments than before, while heavily indebted countries would have to pay less.

These common guarantees and controls would substantially limit the sovereignty of euro-area countries, however, which only a few seem to be willing to accept today. Furthermore, moving to a fiscal union does not answer the fundamental question of whether economic crises should be met by increasing spending or adopting austerity measures.

A fiscal union is also conceivable in a milder form: For example, common debt and extensive European supervision could be used only in times of crisis. An alternative would be that the debt of a country could only be jointly guaranteed up to a maximum level, for example 60 percent of GDP. All other debt would be guaranteed by the issuing country alone and could at a pinch be restructured.

FACT #1

The debt levels of Eurozone countries rose greatly during the crisis
Sovereign debt as a percentage of GDP

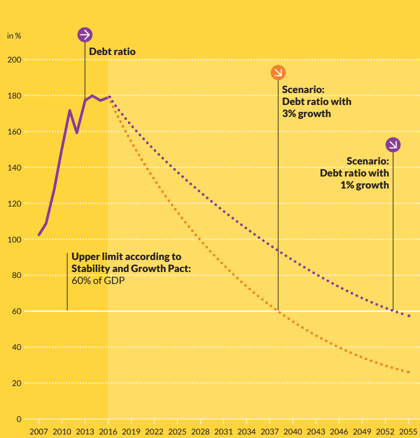


In the course of the crisis, the level of sovereign debt increased greatly in the Eurozone. Affected in particular were states such as Greece and Portugal, which already had high levels of debt prior to the crisis. However, the crisis also impacted countries such as Spain and Ireland, which were hardly indebted beforehand, but paid large amounts for the stabilisation of their financial systems.

Source: Eurostat 2017.

FACT #2

Growth reduces Greece's debt burden
Debt as a percentage of GDP



The degree to which a country is affected by its debt depends largely on economic growth. Even a very heavily-indebted country such as Greece would achieve a debt ratio of 60 percent of GDP in 21 years, that is the level allowed by the Stability and Growth Pact, if the economy grew three percent per year. If the economy expanded by only one percent, this would take fifteen years longer. The model calculation assumes for the period after 2017 that the ECB achieves its price stability goal of two percent inflation per year and the absolute level of debt remains unchanged.

Source: Eurostat 2017, author's calculations.

FACT #3

Initiatives for a reduction of debt in the Eurozone
Selection

	Measure	Content
Existing	Stability and Growth Pact	Upper limit for sovereign-debt ratio and budget deficits, which are monitored by the European Commission
	Fiscal Compact	Eurozone countries must adopt national laws that automatically limit new debt
Under discussion	Insolvency regime for states	Simplifies a debt restructuring; creditors must accept losses on bonds from over-indebted countries
	Accountability Bonds	New debt that is not in conformity with EU rules, enjoys fewer guarantees and can be restructured more easily
	Debt redemption fund	Legacy debt is guaranteed collectively, which reduces the interest payments of heavily indebted countries
	Blue bonds & red bonds	Common guarantees for a portion of the sovereign debt; debt in addition to this is restructured in the case of a debt crisis
	Eurobonds	New debt is jointly guaranteed by Eurozone members in order to facilitate the servicing of debt and to stop a self-reinforcing debt crisis

Source: Author's own illustration.

"The various proposals do not have to be mutually exclusive; they can often be combined in a fruitful way. The Eurozone needs more growth and more explicit sharing of risk so that it can act credibly in the next crisis. Against the backdrop of such a stable system, an insolvency regime for states could work."

Jörg Haas
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