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The European Union's Debt Crisis

New Sustainability Regulations for Debt Reduction and Prevention

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As a result of the financial and economic crisis, the public debt in numerous EU member states has been estimated at well over 60% of gross domestic product (GDP). Several highly indebted member states will not be able to markedly reduce their indebtedness before 2025; they should introduce reductionary measures as soon as possible to address their budget deficits in order to remain creditworthy. Debt reduction based on higher inflation, on the other hand, should be avoided based on macroeconomic considerations. The upper limit applied to budget deficits, namely 3% of GDP, has encouraged indebtedness to increase in many cases. This limit should be eliminated and replaced by a regulation, which judges changes in indebtedness based on economic growth. The EU Commission should be responsible for monitoring and sanctions.

In 2007, EU debt levels still seemed to be under control. Ireland, the "Celtic Tiger", was pleased to have a total public indebtedness of only 25% of GDP. In just three years of the financial and economic crisis, this value has tripled and is still growing. Spain and Great Britain were considered lightly indebted; since then, their public debt has grown at high rates.

For 2011, the EU Commission expects a debt ratio for the eurozone that exceeds by a third the admissible Maastricht upper limit of 60% of GDP. Indebtedness only remains at moderate levels in the new member states, but it is growing quickly. The example set by Greece is insofar instructive as in spite of a growing debt ratio as of the 1980s the catching-up of the Greek economy faded away. A continuing debt increase translates into a drag on the GDP growth.

There is considerable fear that the common currency could become "weak" due to the falling exchange rate against the US Dollar. This is not, however, necessarily the case. While a depreciating Euro implies higher prices because energy imports from the dollar zone will be more expensive, it could result in a positive net effect, as the depreciation would also boost EU exports to the USA, China and the Middle East. In terms of the domestic market, the Euro will only become weaker if inflation begins to noticeably decrease its real purchasing power. For this reason, the European Central Bank (ECB) should not abandon its current goal of holding inflation at 2%.

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Table
Public debt rates for 2011 and their reduction to 60% of GDP by 2020: Necessary surpluses as well as financial strain

Nr.	Country	Debt rate 2011, % GDP	Budget surplus required in order to reduce debt to 60% of GDP*	Percentage of budget, %	Expected budget balance in 2011, % BIP
1	Greece	133.9	7.7	20.8	−4.1
2	Italy	118.9	6.6	14.6	−0.2
3	Belgium	100.9	5.1	10.5	−1.2
4	Portugal	91.1	4.1	9.4	−4.4
5	France	88.6	3.8	8.1	−4.5
6	Ireland	87.3	3.7	10.9	−8.6
7	Great Britain	86.9	3.6	9.2	−6.9
8	Germany	81.6	3.0	7.1	−2.0
9	Hungary	77.8	2.6	5.7	0.1
10	Austria	72.9	1.9	4.1	−1.7
11	Malta	72.5	1.9	4.5	−0.4
12	Spain	72.5	1.9	5.2	−6.2
13	Netherlands	69.6	1.5	3.3	−2.8
14	Cyprus	67.6	1.2	2.8	−4.8

* 2011–2020, % of GDP; calculations by author. Source: Eurostat, 2010.

Growth-Neutral Debt Reduction

Measures aimed at reducing debt must be metered so that they don't endanger the fragile economic recovery. On the other hand – since the EU in general and the eurozone in particular are unified economic areas – *all* of the member states must return to stability so that a free rider effect does not emerge. Member states with a significant reduction in debt – Ireland up until 2007, Denmark, Sweden, and most of the central and eastern European states – were able to grow their way out of debt. The combination of rapid growth and a global drop in interest rates at the start of the 1990s aided this process.

Therefore it is desirable for the nominal interest rates on the total debt to be lower than the nominal GDP growth rate. According to Eurostat, however, the nominal interest rates in all of the states are now higher than the nominal GDP growth rates. Insofar, revenues must be higher than spending. The difference is based on the debt ratio and the timeframe over which the debt reduction is envisioned. At the same time, 14 of the 27 member states have debt that exceeds 60% of GDP (see Table). It is unthinkable that the countries ranking high on the list here will succeed in returning to the Maastricht level within the next ten years even if they immediately took debt reduction actions. The budget surpluses that would be needed would be socially and economically unacceptable.

Based on the divergent debt ratios, indiscriminate calls for reducing debt to 60% of GDP are unreasonable. In reality, debt policy issues require tailor-made strategies: *How much debt reduction would be yielded over the next ten years (mathematically) if a given country were to undertake the most strenuous fiscal efforts realistically possible?* The EU's debt statistics show that over extended periods, states can achieve pre-interest payment budget surpluses of 4% of GDP. This type of effort is absolutely feasible for Greece and Italy. Over the next ten years, this would result in Greece's debt dropping to 90% of GDP and Italy's debt falling to 80% of GDP. In the cases of Belgium and Portugal, a reduction to 75% of GDP is possible with

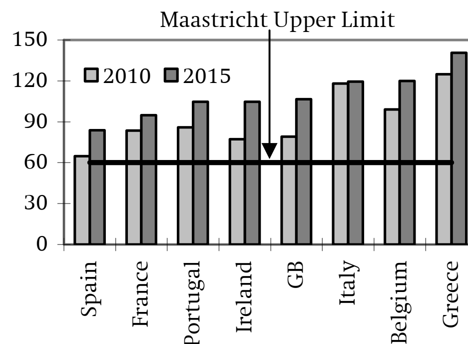
budget surpluses of 3% and 2%, respectively. Hence it is possible to reduce the high levels of indebtedness without overwhelming the economy.

Meanwhile, the debt ratio will continue to grow in the highly-indebted states (see Graphic), because with the exception of Hungary they cannot expect budget surpluses for the time being. These member states, however, are not necessarily faced with over-indebtedness. Nominal debt levels do not give any indication of the critical point at which the debt can no longer be financed. Some member states have been successful in significantly reducing their debt without experiencing an economic collapse:

- The EU's current record holder is Belgium; its debt ratio at the start of the 1990s was significantly higher than Greece's in 2010.
- In the past, Italy's mountain of debt was larger than it is today.
- Denmark and Sweden both succeeded in bringing debt ratios that far exceeded the Maastricht level of 60% of GDP down to acceptable levels.
- Ireland had a very high debt ratio in the mid-1980s, but has since been able to cut it by three quarters and was nearly debt-free up until 2007.
- The same is true for Great Britain, which successful debt reduction allowed for plenty of deficit spending in 2008 and after combating the financial crisis.

Moreover, there has been virtually no point at which the financial markets refused to refinance debt. Just demonstrating a commitment to reducing debt was sufficient to calm the financial markets and make them willing to offer credit. Liquidity exists globally and across the entire EU: important export economies like Germany, the Netherlands, Sweden, Austria and Finland continue to achieve current account surpluses of up to 4.8% of GDP. This liquidity is available whenever the solvency of the member states is deemed secure.

Graphic
Highly-Indebted Member States: Debt Rates 2010 and 2015, % of GDP



Calculations by author.
Sources: Eurostat, Deutsche Bank Research, 2010.

Preventing Future Debt Crises

Over the past years, two patterns have emerged for over-indebtedness mechanisms in the EU. They refer to:

1. Economies with loss of competitiveness and growing current account deficits, but relatively healthy financial and banking sectors (e.g. Greece, Portugal, Italy, France, Spain, Hungary);
2. States with healthier public finances and stable trade balances, but over-indebted private/financial sectors (Ireland, Great Britain, Belgium to some extent, Denmark and Latvia [as well as Iceland]).

In both groups of nations, the state attempted to cushion the effects of private inefficiency through massive financial involvement. The current account deficits in the first group of countries have resulted in a loss of jobs in the manufacturing sector and a drop in demand, which increased the burden of unemployment costs borne by the state. In the second group of nations, the extensive issuance of private credit has caused important credit institutes/banks to collapse which necessitated costly state recovery programmes.

The hitherto practice of state regulation of private losses offers the temptation to repeat this paradigm – this time via seigniorage. An inflation of the debt, however, is not an option as this would result in a rapid loss of purchasing power and a weak

euro. Due to growing expectations of inflation, the current unemployment rate would remain at a high level far above the so-called natural rate of unemployment (Phillips Curve). As a result of persistently high unemployment rates, economic growth would lag behind its potential growth rates. Correspondingly, debt would grow at a much more rapid pace than GDP even if one just considers the nominal interest rates at the current low levels.

In order to deal with future debt crises without introducing a fiscal transfer mechanism, the following recommendations stand:

- Firstly, a "current account deficits" criterion should be adopted for the preventive arm of the Stability and Growth Pact, which currently only covers budgetary oversight. Such deficits have a destabilising effect due to the resulting loss of jobs and commonly associated foreign indebtedness of the private sector in the non-eurozone member states. In states with deficits as well as those with surpluses, unit labour costs must be oriented on a national level towards growth in productivity.
- Secondly, the markets did not levy sanctions against transgressors – interest rates in Greece, Italy, Belgium and Hungary remained low for a long time in spite of the high debt levels. Instead of relying entirely on market signals, the highly-indebted member states should lay out a ten-year program for budget surpluses and regularly report on progress in the Council.
- Thirdly, the 3-percent rule, which allows for debt ratios to rise while GDP growth rates remain low, should be replaced with a sustainability rule. *Accordingly, the (structural) budget deficit should be smaller or equal to the nominal GDP growth (in %) times the debt ratio (as a % of GDP).* Oversight and sanctioning should be incumbent on the Commission. The advantage of this instrument is that it makes changes in the debt ratio conform to expected GDP growth.
- Fourthly, debt brakes must involve the private sector. States that once enjoyed healthy finances are now over-indebted following the conversion of private debt into public debt. Indicators such as "Deposits to Loans of the Household Sector" should be defined by national credit oversight authorities and these indicators should be monitored in order to avoid the collapse of institutes important to the financial system and ensuing expensive bailout packages for banks. The ECB and other central banks were also unable to stem credit expansion because property prices were rising much more quickly than nominal interest rates in many EU member states.

The mathematics and economics of rigorous debt reduction are feasible without economic disruptions. In the future, the Stability and Growth Pact must be carefully followed and any severe indebtedness of the public *and* private sector must be avoided.

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