John Iannis Mourmouras: A post-Brexit assessment of risks to debt sustainability in the euro area

Speech by Professor John Iannis Mourmouras, Deputy Governor of the Bank of Greece, at the third OMFIF Main Meeting in North America, St. Louis, 14 July 2016.

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Views expressed in this speech are personal views and do not necessarily reflect those of the institutions I am affiliated with.

This is an abridged version.

The 2008 global financial crisis has led to a rapid accumulation of government debt in most countries of the euro area. Indeed, the euro area government gross debt-to-GDP ratio is estimated to have risen by 28 percentage points from its pre-crisis level in 2007 to stand at 93% in 2015. However, financing concerns are currently mitigated by low sovereign funding costs for almost all sovereign rating categories and solid demand for government bonds against the backdrop of the Eurosystem's ongoing asset purchase programme (QE). Total debt service of euro area governments for the next 12 months is around 16% of GDP (around €1.6 trillion), a figure which comprises 13.9% of principal and 2.1% of interest expenditure. It is true, however, that despite the fact that debt servicing is much easier today given that lower nominal interest rates worldwide are reflected in reduced coupon payments, risks to debt sustainability are on the downside, as reminded in the latest (pre-Brexit) ECB Financial Stability Review (May 2016). Our objective here is to examine if and how, after the Brexit vote, these risks are indeed heightened. I identify below three such downside risks to debt sustainability in the short- to medium-term, in the aftermath of the British referendum.

1. A low interest rate environment, the new global norm, due to persistently low inflation, increases the disincentive to fiscal consolidation and structural reforms. For instance, negative nominal yields, if applied too long, may act as an anaesthetic to euro area governments. The fiscal space gained from lower debt service costs may slow enactment of necessary fiscal and structural reforms. Brexit could well amplify the above downside risk. The initial market reaction to the Brexit vote was a typical risk-off mode – lower curves, wider spreads, flatter curves. The UK 10-year gilt yield fell under 1% for the first time in records, while German Bunds yields fell to all-time lows over the period, currently trading in negative territory out to a maturity of 15 years with the 10-year German Bund trades around -0.10%. In addition to the flight to safety, the first reaction by major central banks, in an attempt to calm financial markets, has been rather dovish and more accommodative monetary policies are expected in the near future. So, the Bank of England is widely predicted to cut by a quarter point its base interest rate in the August MPC meeting – while a new round of QE is also likely. The ECB may also ease further and its QE programme may be extended beyond March 2017. In Japan, there is even talk of 'helicopter money', while in the US, as a result of the Brexit shock a July hike is not on the table, and the market implied probability of a Fed rate hike in 2016 has declined from about 50% on the eve of the UK vote to roughly 10% today. As a result, the 4 major central banks' divergent monetary paths, which have been the dominant theme in the financial markets since the start of the year, seem to be off the table for now. Indeed, at present, there is a shift from "monetary policy divergence" to "financial markets divergence" through stock-bond markets. It is worth reminding a relevant comment made by ECB President Mario Draghi in a recent speech: "[low interest rates]… are not the problem. They are the symptom of an underlying problem, which is insufficient investment demand, across the world, to absorb all the savings available in the economy" (see also right below).

2. Of course the problem in the euro area is that inflation is persistently low, but so too is nominal demand (1% annual increase over the last seven years compared with 3.7% before the 2008 global financial crisis). Clearly, the denominator effect is a risk to public debt sustainability, while anaemic growth and/or a very low inflation are far from helpful. According

to the latest ECB forecasts, inflation is now projected to be at a very low level of 0.2% on an annual basis in 2016. Real GDP growth is also expected to be lower than projected in June at 1.6% for 2016 and follow an even more downward trend due to the Brexit effect (the hit to the European economy is a real GDP decrease of around 0.5% over the next three years, but this is a very early forecast).

3. Last but not least, political risks have increased, posing a challenge to fiscal and structural reform implementation. Rising political uncertainty (especially in Spain, Portugal, Greece, Italy and France) and increasing support for populist political parties which seem to be less reform-oriented and with eurosceptic credentials contribute to the downside risks to debt sustainability in the euro area. Of course, in the aftermath of the British referendum the biggest political risk to the whole of Europe is Brexit. Brexit represents a shock to the institutions and norms that underpin markets. Thus, Brexit is different from the euro break-up fears of 2012, the global financial crisis of 2008 or the bursting of the high-tech bubble of 2001. It is not financial contagion, as in 1998, or this February. Instead, it represents a contagious political development. No matter whether we have a full-blown or a light Brexit, the political risk for the rest of the continent is that the referendums will mushroom across Europe in a tug-of-war between populist forces and the political establishment and elites. This risk is particularly heightened for countries with strong anti-European sentiment such as Hungary, the Netherlands, Denmark, even France.

There is an old saying in Brussels that Europe’s leaders are known to have a tried-and-tested method for coming up with policy fixes when forced to cope with emergency situations. Post-Brexit Europe has the potential to become an emergency in the not-too-distant future. I only hope that this time is not different. Times will tell.