

ECONOMIC VIEWPOINT



The European Debt: No Cause for Alarm Yet But an Economic Shock Could Lead to Volatility

The European sovereign debt crisis that erupted in 2010 raised the bond yields of the economies in greater debt, such as Portugal, Italy, Ireland, Greece and Spain (PIIGS), leaving the very existence of the euro zone in doubt. Their financial markets have calmed down in the past three years or so, but the recent political instability in Italy has revived concerns about the European public debt. Bond yields in Italy and the euro zone's periphery economies have gone up as a result. Is the monetary union on the brink of a second sovereign debt crisis? What progress has been made since 2010?

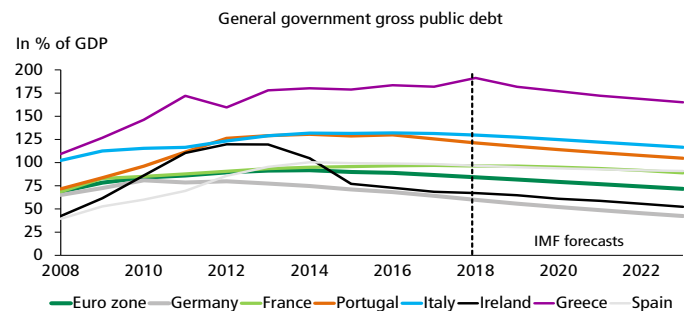
The Euro Zone Debt Has Eased Overall, but Not Uniformly

Italy is now in the hands of a eurosceptic government that has publicly denounced the policies of the European Union (EU). The coalition between the Northern League and the Five Star Movement has solidified, and Antonio Conte has become Prime Minister with the leaders of those two groups as Deputy Prime Ministers. Among other things, Antonio Conte's government is proposing to raise the deficit above the euro zone's authorized limit, reduce taxes, lower the retirement age, and introduce a universal basic income. His position on the status of the euro is uncertain; both parties have talked about leaving the monetary union but neither one made it a platform plank. That instability has reawakened fears of a second sovereign debt crisis in Europe at a time when the PIIGS are still fragile.

Overall, however, the gross public debt ratio in the euro zone has gone down since the 2010 crisis. From a high of close to 92% of GDP in 2014, it has dropped to just under 87% in 2017. This is a stable trend in most euro zone countries. The improvement has to be viewed in context, however, since it seems to be based mainly on the Euroland economy's good performance. Indeed, the euro zone debt has continued to climb, but the ratio still went down mainly due to a strong rise in GDP. The International Monetary Fund (IMF) is now forecasting an improved debt ratio for all members of the monetary union over the next five years, as it foresees an improvement in budgetary policies and a robust economic growth. If that were to change, the gross debt ratio could get worse, but right now there seems to be not too much cause for concern.

We should point out, however, that public finances vary widely across the euro zone. The gross debt to GDP ratio ranges from 9% in Estonia to 182% in Greece. With the exception of Ireland, the PIIGS still have excessively high levels of sovereign debt, most of them exceeding 100% of GDP (graph 1). The same is true of fiscal responsibility, with the budgetary balance varying from a deficit of 3% of GDP to a surplus of 2%, depending on the country. Under the euro zone rules, a country whose public debt exceeds 60% of GDP needs to maintain a cyclically adjusted deficit of less than 0.5% of potential GDP. In 2017, only four of the countries whose debt levels were above the ratio limit complied with that rule. Italy, France and Spain were among the worst offenders (graph 2 on page 2), although the IMF expects the structural deficit to improve in Italy and France. Its predictions are based on the assumption that those countries

GRAPH 1
Public debt varies widely between euro zone countries



IMF: International Monetary Fund
Sources: FMI and Desjardins, Economic Studies

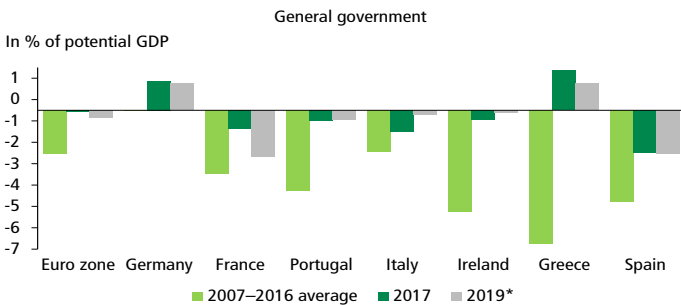
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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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GRAPH 2
Europe's structural budget deficit has improved, but is still too high

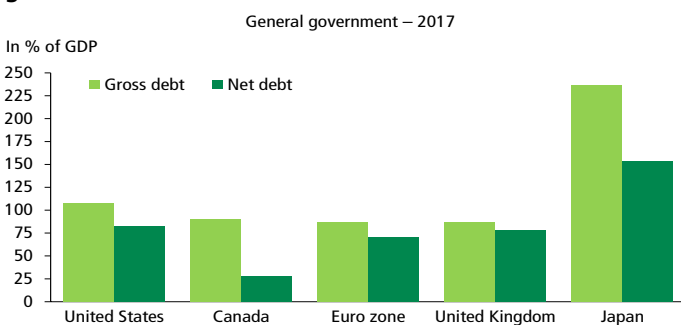


* International Monetary Fund forecasts.
Sources: International Monetary Fund and Desjardins, Economic Studies

will continue their budget tightening measures, a situation that now seems less certain with the new government in Italy. Among the stronger players, the governments of Germany and the Netherlands have shown remarkable fiscal responsibility. Their gross debt ratios, which were already low, have dropped since the crisis and they now maintain budget surpluses.

Internationally, the euro zone's gross debt does not rank so badly against the advanced economies. Japan's gross debt is substantially above 200% of its GDP, while the United States (at 108%) is the only advanced economy whose debt will rise in 2023, according to the IMF. However, if we look at government assets, we see that the monetary union's debt, like that of the United Kingdom, is going down less than the debts of the other advanced economies (graph 3). Its net debt remains similar to its gross debt, unlike Canada, for example, whose position improves significantly in net terms, with a 90% gross debt changing over to a 28% net debt.

GRAPH 3
In the euro zone, unlike elsewhere, net debt remains similar to gross debt

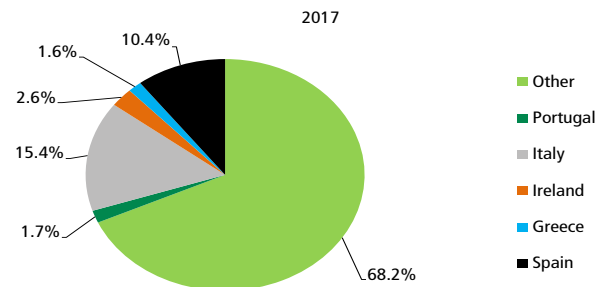


Sources: International Monetary Fund and Desjardins, Economic Studies

While the overall euro zone picture is more favourable, it may be interesting to zoom in on the countries that sparked the 2010 crisis. Italy and Spain are quite important players in the monetary union, and their GDP, combined with that of the other

PIIGS, amounts to a third of the euro zone's GDP (graph 4). When those countries are in trouble, it affects the rest of the euro zone.

GRAPH 4
The PIIGS represents more than one third of the euro zone's GDP



PIIGS: Portugal, Italy, Ireland, Greece, Spain
Sources: International Monetary Fund and Desjardins, Economic Studies

Ireland Stands Out

The financial and economic crisis of 2008–2009 quickly plunged Ireland into severe debt: the gross debt went from 24% of GDP in 2007 to 120% in 2012. However, things quickly got better. Unlike the other countries affected by the 2010 crisis, Ireland's debt ratio dipped to a more sustainable level in 2017, below 70% of GDP. The improvement is largely due to the country's unusually high economic growth in 2015, as real GDP shot up by 26%. Growth has returned to more normal levels since then, but remains robust, and the debt is lower in absolute terms. An increase in revenue and lower interest rates have been major causes of Ireland's improved financial situation, allowing it to significantly reduce its debt service expenditures. The other expenditure categories have remained rather stable since 2012.

Greece Is Doing Better, but Is Still Far from Healthy

Greece is another country that has greatly improved its public finances. Although the debt ratio is still at a worrisome level, the general government budget balance is now positive. The country has managed to increase its revenue and reduce expenditures, despite negative economic growth. The more favorable economic scenario for Greece could reduce its debt load, if its government is not tempted to reverse those budget cuts. However, its revenue derives mainly from consumption taxes rather than personal and corporate income taxes, which may limit purchasing power for the poor and incentivize tax evasion as well as a shift to the informal economy. The IMF raises that problem in its latest report on Greece, suggesting that consumption taxes be reduced and over-generous exemptions for personal income taxes be abolished.¹

¹ *Greece: 2017 Article IV Consultation-Press Release, Staff Report, and Statement by the Executive Director for Greece*, International Monetary Fund, IMF Country Report No. 17/40, February 7, 2017, 92 p.

Strong Economic Growth Has Helped Spain

Spain was seriously affected by the 2008–2009 crisis; its economic growth contracted and its unemployment rate shot up from 8% to over 24%. This had an immediate impact on Spanish government finances. The budget balance went from being positive to a low of -11% of GDP and gross debt tripled, reaching 100% of GDP in 2014. Spain has managed to stabilize its public finances in recent years. Its budget expenditures have gone down, as has the deficit. Although gross debt (98%) and the deficit (3%) are still high, they are definitely showing progress. The political scandals in Spain in recent weeks have not had the same effect as the scandals in Italy, since the party replacing Mariano Rajoy's government is pro-Europe and much more moderate contrary to Italy's new governing body. If this trend continues, Spain should no longer be a source of concern. That said, its annual economic growth has been above 3% for three years in a row, which has supported the drop in the debt ratio. An economic slowdown could dampen the country's recent progress.

Portugal Is Starting to Demonstrate Greater Responsibility

Portugal has been overspending for several years, maintaining a deficit between 3% and 11% of GDP, and this has led to a heavy debt load. However, the government budget has improved nicely in the past two years, helped by the reduction in spending and favourable economic conditions. This has also allowed the gross debt ratio to go down, although in 2017 it was still very high at 125% of GDP. This sound financial management is quite new for Portugal, and it is too soon to know whether it will continue.

The Italian Debt: A 40-Year-Old Problem

Italy is the third largest economy in the euro zone, but also the most indebted one; in 2017, its gross public debt was around €2,250B. In comparison, Greece's debt, which caused much fears during the crisis, stood at €320B in 2017. When expressed in relation to its GDP, the Italian debt (at 131%) ranks second in the euro zone after Greece (182%). However, Italy's debt problems are nothing new. They date back to the 1980s, when the central bank had to impose very high interest rates to keep the lira stable in relation to the German mark within the European monetary system, the precursor of the euro zone. Since that time, the Italian debt has generally been above 100% of GDP, despite the fact that its budget deficit since 1990 was similar to that of Spain, which carries less debt. What's more, if interest payments are subtracted from the budget, Italy actually has a budget surplus. One of its problems then seems to be the weight of the debt service. Another is an economy that never completely recovered from the 2008 recession, with Italy's GDP still not back to its pre-crisis level.

The new government's proposals may increase the debt load even further. The Bruegel Institute² estimates that those

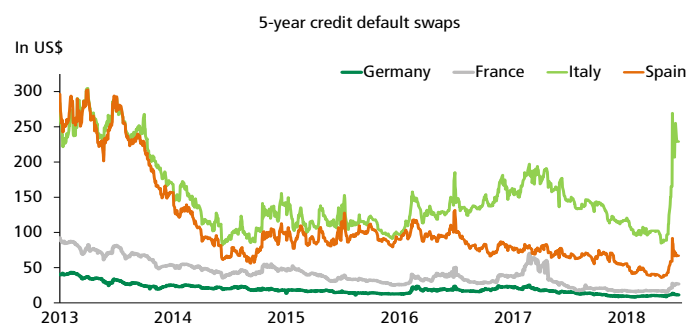
² Silvia MERLER et al., *How worried should we be about an Italian debt crisis?*, The Bruegel Newsletter, May 28, 2018.

proposals could cost up to €126B, or 7% of GDP. If Italy were to pull out of the monetary union (*Italexit*), that might mean the end of the euro and a sovereign default for Italy. It would be surprising if all the promises were kept, but the government is still a risk to the cleanup of Italian public finances and the stability of the European continent.

Some Contagion Might Be Possible

The anxiety about Italy's political issues seems to have somewhat spread to other PIIGS, with some seeing their bond yields rise against German yields, which are considered risk-free. Credit default swaps (CDS) have also increased in Italy and Spain following the Italian developments (graph 5). The Italian CDS have even gone back to their 2013 levels—those prevailing at the end of the crisis—but are still far from previous peaks. This indicates that the markets are only somewhat concerned about a possible sovereign default.

GRAPH 5
Italy's political issues have also affected Spain

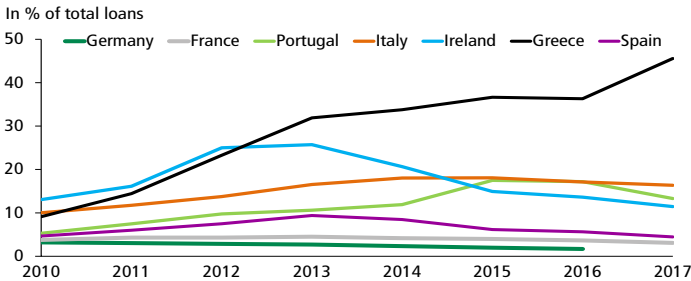


Sources: Bloomberg and Desjardins, Economic Studies

Although the Italian banks are the most exposed in terms of Italy's public debt, since they were holding some 45% of bonds in February 2018, the French and Spanish banks could also be at risk if Italy defaults. According to figures from the Bank for International Settlements, French financial institutions held close to €55B of Italy's sovereign debt in 2017, their second largest foreign bond holding after that of the United States. The European Central Bank (ECB) would also be vulnerable should Italy default, since the Italian debt share of the sovereign bonds held by the ECB has jumped from around 4% in 2010 to 17%.

A default by Italy could therefore disrupt financial markets throughout the rest of Europe. The effect would be amplified by the exposure of European financial institutions to the Italian institutions, which have been weakened by their high level of non-performing loans (graph 6 on page 4). A default on the Italian debt would affect the already fragile Italian financial system and could spread to the rest of Europe. Italy's economic importance within the euro zone, the extent of its gross debt and its intertwined links with the European financial system all make that country "too big to fail."

GRAPH 6
Italian and Greek banks still have a high level of non-performing loans

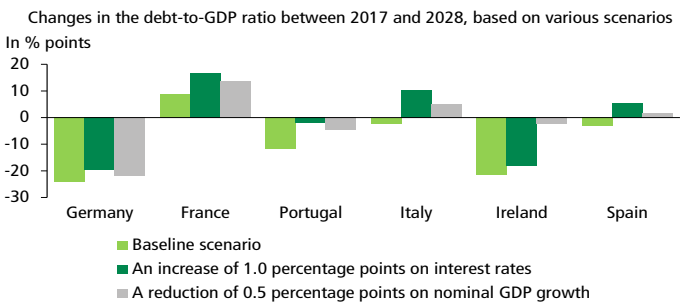


* The figures for Germany do not go beyond 2016.
 Sources: International Monetary Fund and Desjardins, Economic Studies

What If There Is an Unforeseen Shock?

It goes without saying that the euro zone’s sovereign debt could improve if economic conditions remain favourable. Conversely, if interest rates were to rise sharply or economic growth was weaker than expected, the progress in debt reduction could be halted or even reversed. In particular, a study by the European Commission (EC)³ concludes that France, Italy and Spain would be particularly affected by unfavourable economic conditions (graph 7). Ireland and Portugal would still be able

GRAPH 7
An unfavourable economic shock would mainly affect the public debts of France, Spain and Italy*



* Results of a simulation produced by the European Commission.
 Sources: European Commission and Desjardins, Economic Studies

to improve their positions, however. Against a backdrop of the ECB possibly buying fewer bonds, bond yields increasing internationally and a resurgence of downside economic risks, various possible scenarios should be taken into consideration.

Conclusion

Overall, the euro zone debt has improved considerably since the 2010 crisis, and although some of the more vulnerable countries are still very much in debt, they seem to be back on track. The EC study referred to earlier shows that the debt of most euro zone countries would in fact go down if they made no changes to their existing budgetary policies. France is not one of them, although Emmanuel Macron’s reforms should go a long way toward cleaning up the country’s public finances. Right now, the new Italian government remains the most significant risk to the stability of the monetary union. We will have to wait and see if its program will really be applied before worrying about a real European sovereign debt crisis. An *Italexit* is unlikely, but the country may be heading for a confrontation with Brussels’ policies.

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³ *Debt Sustainability Monitor 2017*, European Commission, Economic and Financial Affairs, Institutional Paper 071, January 26, 2018, 256 p.