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Public debt in the Eurozone: An Initial Assessment

Costas Lapavitsas SOAS/RMF
Duncan Lindo LUBS/RMF

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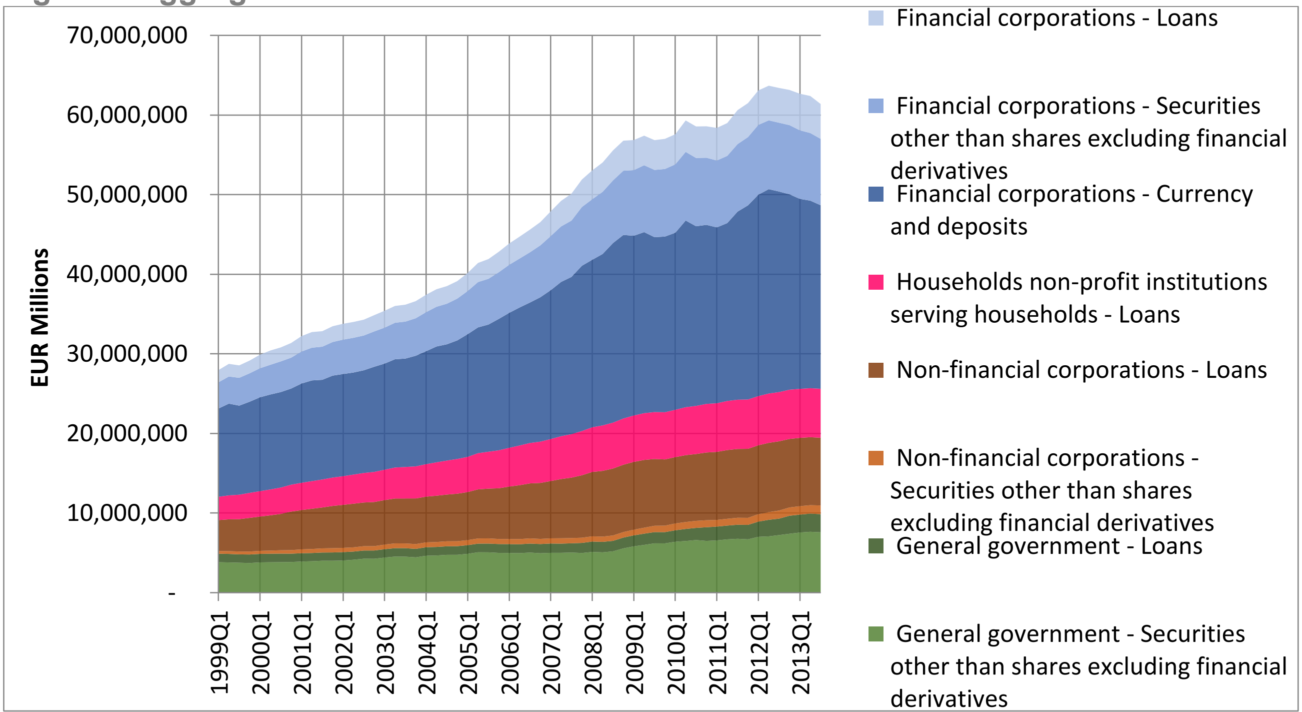
1.The accumulation of public debt in the Eurozone

The Eurozone faces a large volume of debt accumulated from 1999 to 2008, as is shown in Fig. 1. The debt mountain poses significant problems of economic policy, particularly as the various components of debt are marked by different economic and social relations. [1]

Figure 1 Aggregate Eurozone Debt

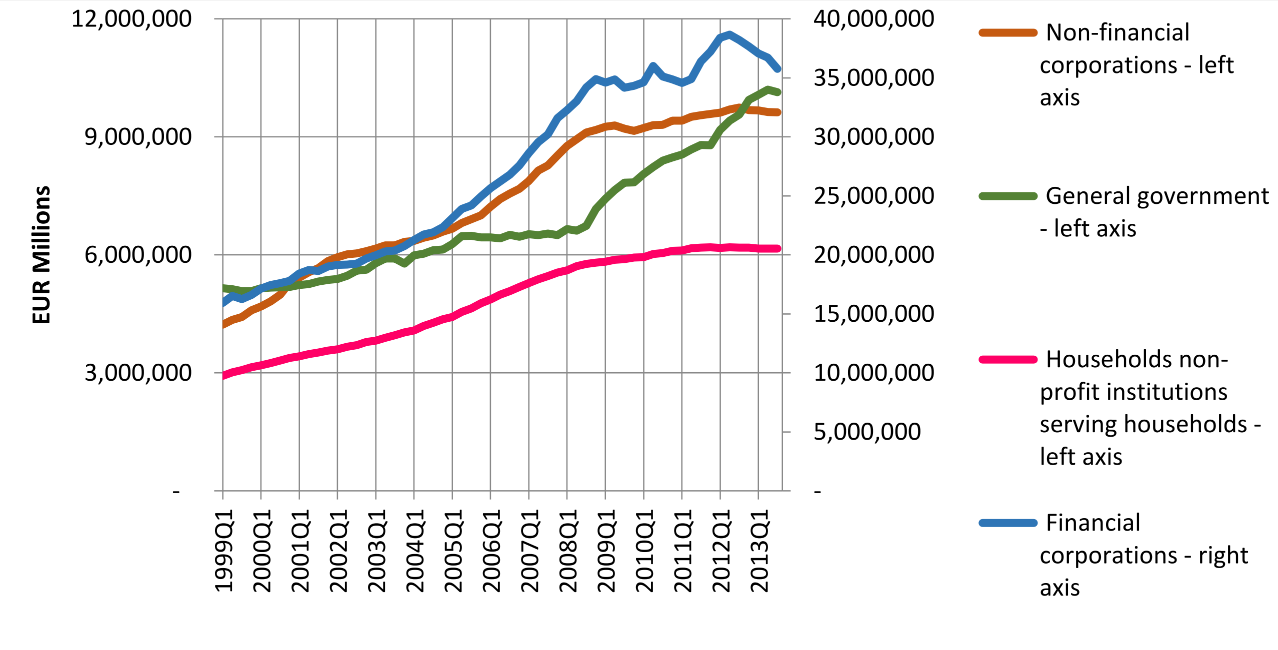


Source: ECB

The most pressing component of Eurozone debt for policy purposes is public debt – Eurozone government debt as a whole approached 100% of annual GDP, and it has been cited as the reason for the crippling austerity measures applied in several countries. The rapid growth of public debt in the Eurozone is a result of the crisis of 2007-9, and was associated with the rapid growth of other forms of debt prior to 2008, particularly financial corporation debt. It was also associated with the sudden halt in the growth of private debt that came with the crisis, again led by the financial sector, as is shown in Fig. 2 below. Essentially, Eurozone countries have increased their public indebtedness to prevent bankruptcy of financial borrowers, and to deal with the impact of recession generated by the global financial crisis of 2007-9.

[1] As was shown in RMF Occasional Policy Papers 5, The Eurozone Debt Mountain: There are debts and debts, http://www.researchonmoneyandfinance.org/index.php/publication/occasional-policy-papers

Figure 2 The Trajectory of the Components of Aggregate Eurozone debt



Source: ECB

The peculiarity of the Eurozone is that the accumulation of public debt as a result of the crisis (which is also observed in the USA, the UK and elsewhere) has occurred in the context of an unbalanced prior accumulation of aggregate debt within its borders. The growth of aggregate Eurozone debt, shown in Fig. 1, hides substantial imbalances within the Eurozone; above all, the core has emerged as the lender to the periphery. To be more precise, during the 2000s, the countries of the periphery, unable to compete against the countries of the core, were led to accumulate large debts (mostly private).[2] Consequently, the rapid growth of public debt after 2008 has had major implications for core-periphery relations as well as for the balance of social forces in both core and periphery. It has also had significant implications for policy to confront the accumulation of debt in the Eurozone as a whole.

This Policy Paper explores the nature of Eurozone public debt, and briefly outlines four possible strategies for dealing with it: growth, inflation, ECB intervention and cancelation. The first 3 are rendered unlikely by the nature of the Eurozone and / or the social relations

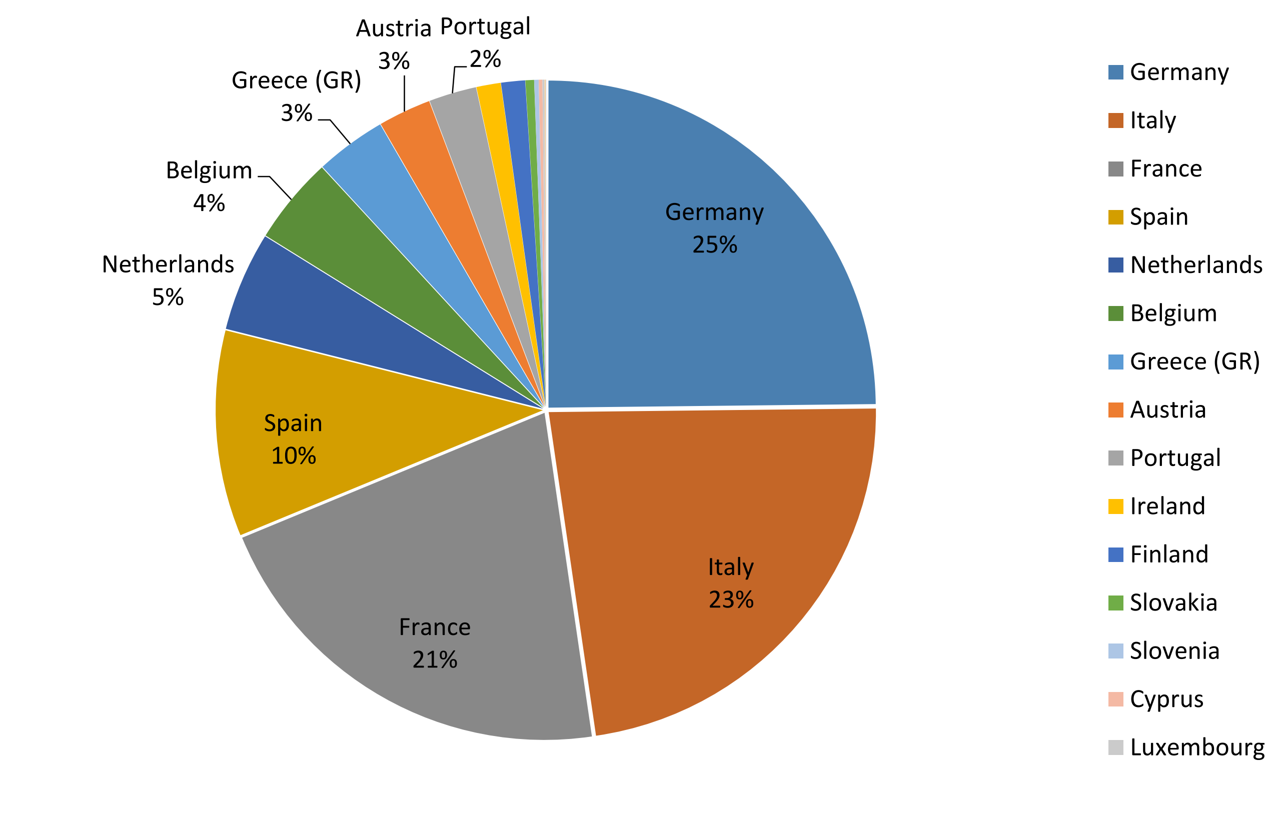
[2] These issues were explored in depth in RMF's first three Occasional Reports – *The Eurozone Reports*, also published as a book by Verso, *The Eurozone in Crisis*. The Eurozone Reports are available here: http://www.researchonmoneyandfinance.org/index.php/publication/eurozone-reports

which underlying the Eurozone's debt mountain - not least that the holders of government debt have increased influence over policy. Cancelation is the most radical option discussed, it would not only remove the debt but would require wholesale changes in the structures of finance and credit in the Eurozone.

2.The path and the composition of Eurozone public debt

Consider, first, the breakdown of aggregate Eurozone public debt by country:

Figure 3 Eurozone Government Debt by Country Share – 2012 [3]



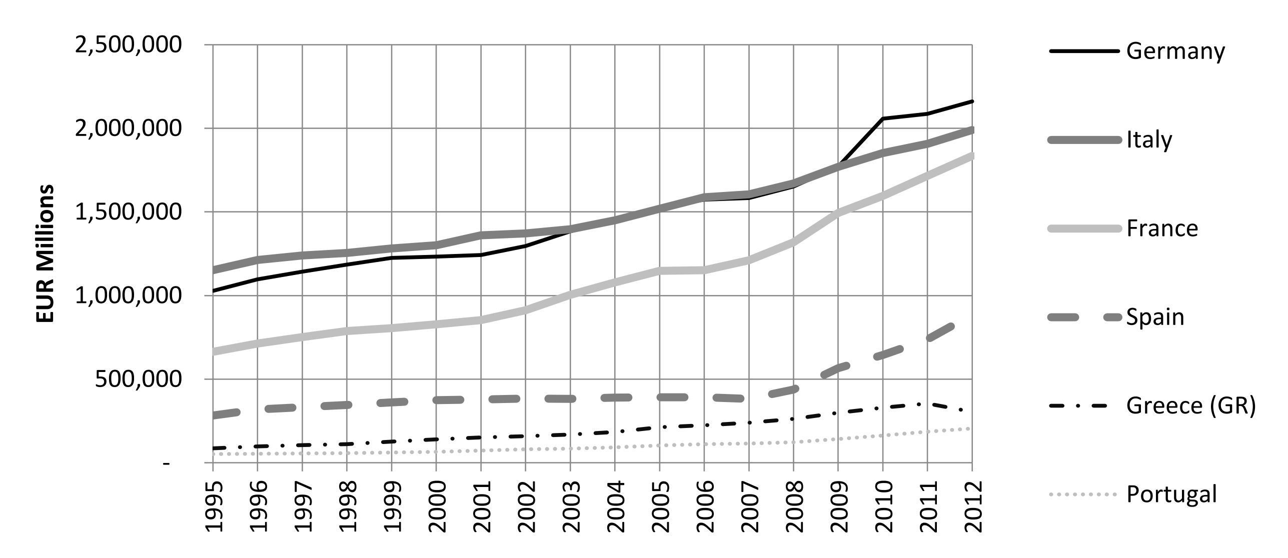
Source: ECB

Four countries (Germany, Italy, France, and Spain) account for the vast bulk of Eurozone public debt (79%) and 6 countries account for 88% of the Eurozone 17's public debt. Fig. 4 shows that the debt of the four has risen steadily throughout the period, but has accelerated rapidly after the outbreak of the crisis, the most striking increases being observed for Germany and Spain. For Germany, the jump appears to be a reflection of its leading role in confronting the Eurozone crisis, including the threat of default by peripheral countries; for Spain, which has had a very conservative stance on public debt in the

[3] Note that Ireland's debt is taken from 2009, the last available data point in the ECB's Statistical Data Warehouse.

previous period, the jump indicates that there was an increase in public debt related to the previous accumulation of financial and non-financial corporation debt.

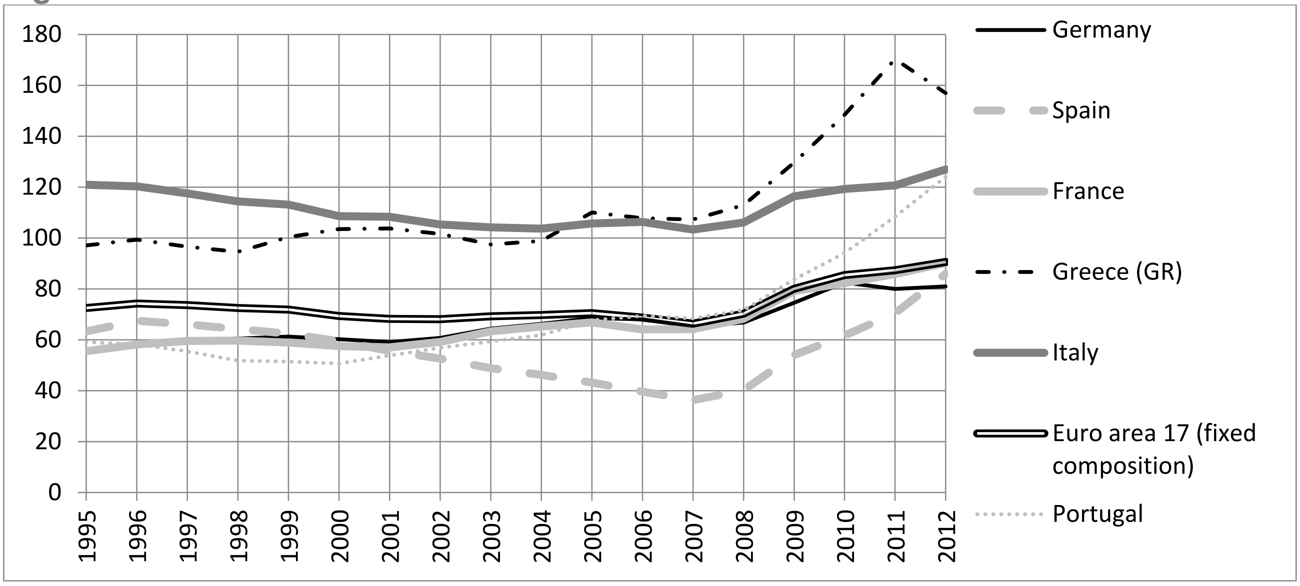
Figure 4 Path of Government Debt - Selected Countries



Source: ECB

However, the true position of the periphery (including Italy which occupies a peculiar position between core and periphery in the Eurozone) becomes apparent when debt is shown as a percentage of GDP. Figure 5 shows that public debt worsened dramatically after 2008, even in Greece which became the focus of the Eurozone crisis. By far the worst outcome emerged in Portugal which rose from a lower ratio than the Eurozone average to a considerably higher one. The average ratio for the Eurozone, not surprisingly in view of Fig. 4, is dominated by France and Germany.

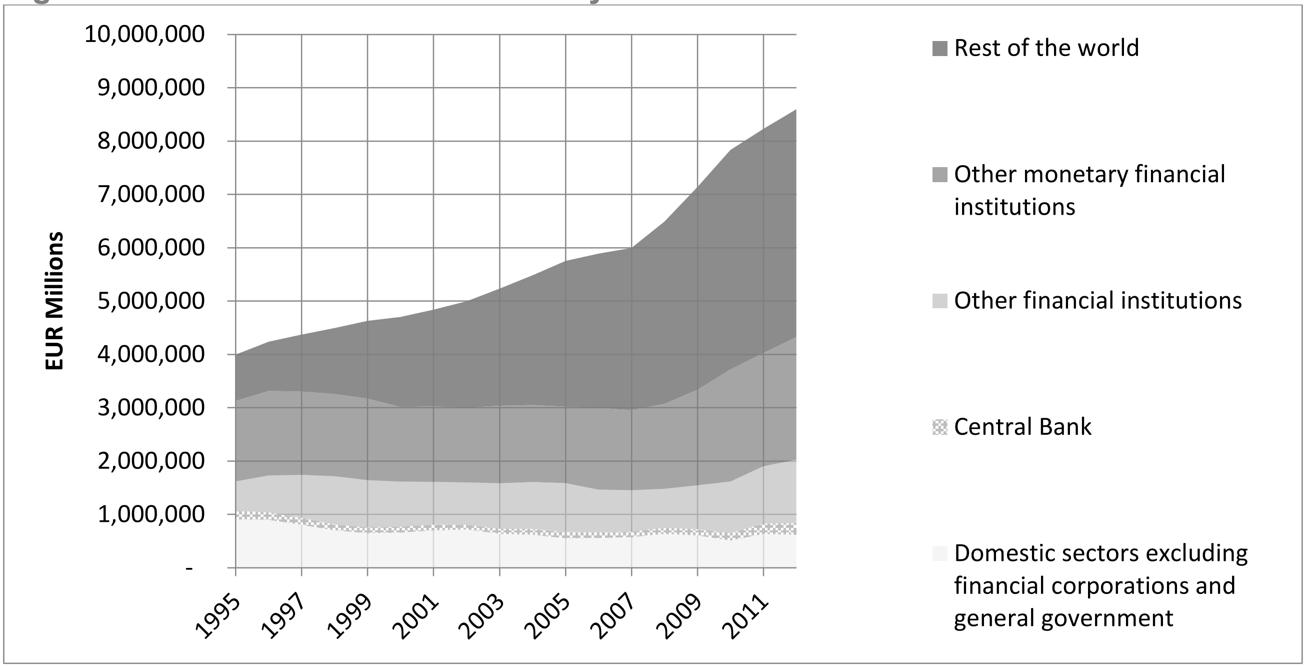
Figure 5 Path of Debt/GDP Ratio - Selected Countries



Source: ECB

The bulk of government debt comprises, quite naturally, public securities. Statistics on the holders of securities must be treated with caution - securities by their very nature change hands, often rapidly. Figure 7, detailing the ECB's statistics on public debt holdings suggests that, after the introduction of the euro, holdings of euro-denominated public assets by the rest of the world increased rapidly and indeed the rest of the world appears also to have absorbed much of the increase in public debt securities after 2008. While treating these statistics with caution the role of the euro as reserve currency to rival the US dollar would suggest that a large portion of Eurozone public debt continues to be held by those outside the Eurozone – note that the major financial centres where debt is mostly traded, above all London, are not in the Eurozone.

Figure 7 Eurozone Government Debt by Holder

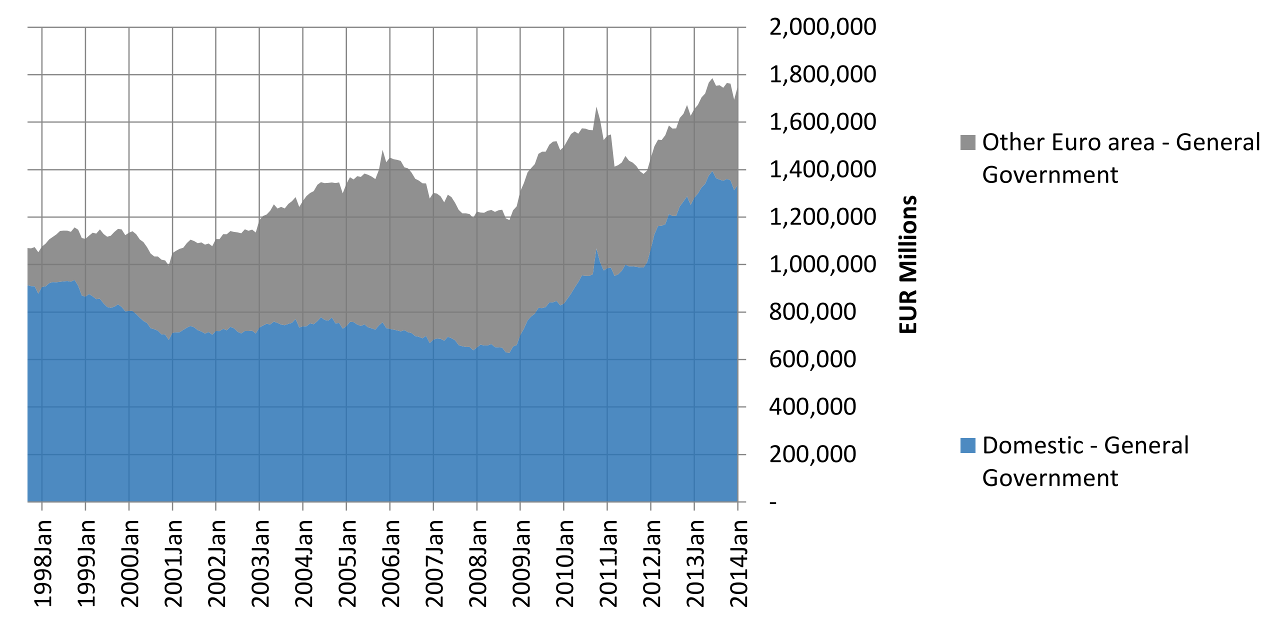


Source: ECB

Figure 7 also suggests that Eurozone banks increased their holdings of Eurozone government paper after 2008. More reliable statistics on bank's holdings are available from aggregated bank balance sheets. These show that since 2008 banks quite dramatically increased their holdings of government securities, most especially of their own national governments, as Figure 8 below shows.[4] The embrace between private banks and the state has become tighter. Thus, the sector whose debt has contributed greatly to the crisis of 2007-9 has not only induced a rise in public debt after 2008, but also found itself in possession of much of the newly issued debt. The financial sector has, consequently, strengthened its ability to influence public policy and the distribution of GDP in the Eurozone.

[4] Changes in banks' lending and securities holdings and the consequences of these shifts are further explored in RMF Occasional Policy Paper 6, The 'Draghi' Effect on Eurozone Banks: Shrinkage and National Fragmentation. Available at: http://www.researchonmoneyandfinance.org/index.php/publication/occasional-policy-papers/165-the-draghi-effect-on-eurozone-banks-shrinkage-and-national-fragmantation

Figure 8 – MFI (excluding Eurosystem) holdings of Eurozone government debt (domestic non-domestic) - millions of euro



Source: ECB

4.What could be done about Eurozone public debt?

A discussion of policies to confront the problem of Eurozone public debt merits a separate Policy Paper, but it is worth briefly spelling out the options here. Throughout, it is worth bearing in mind that there are complex economic relations behind the various forms of private debt and, moreover, that private debt (especially financial corporation debt) is capable of inducing a rapid increase in public debt.

With regard to public debt, the first point to stress is that the problem has far greater urgency for the periphery than for the core, as is apparent from figure 6. Confronting public debt in Greece, for instance, is far more pressing than in Germany. Nonetheless, leaving aside the imbalances and the possible frictions within the Eurozone, confronting Eurozone debt as a whole presents four options.

First, there could be rapid economic growth that would lighten the ratio of debt to GDP in a short space of time. The problem with this option, however, is that it puts the cart before the horse. Debt has emerged as a drag on growth in recent years. In the Eurozone, in particular, dealing with public debt has been the main cause of austerity policies accompanied by further liberalisation. These measures have reached extreme dimensions in the periphery, especially Greece. On this basis, there can be no realistic expectation of a substantial rise in the pace of growth in the Eurozone.

Second, there could be sustained inflation reducing the value of debt over a period of several years. There are, however, two problems with this option. The first is that the major holders of public bonds will resist it strongly and probably successfully, given their influence over policy. Indeed, the lenders are actually backing the austerity policies currently in place in the Eurozone, which are contributing to the opposite effect as inflation is declining. The second is that, if inflation was successfully ignited, the side effects on the distribution of income and on output would be far from clear, and they would not be negligible. Sustained inflation over a period of years poses significant risks, not least in bringing it back under control.

Third, a large part of the public debt of the Eurozone could be taken over by the ECB. Figure 7 shows that a negligible proportion of Eurozone debt is currently held by the central bank, a feature of the ECB that is quite unique among the leading central banks. There has been no shortage of proposals to enable the ECB to acquire large volumes of public debt, without necessarily monetising it directly, for instance, by charging it onto future seigniorage.[5] The fundamental problem with such suggestions, however, is that the EMU lacks an overarching state and thus the ECB is not a normal central bank. Any policy of acquiring Eurozone public debt on a large scale would necessarily mean that some countries would take upon themselves the risk of losses from the debt of other countries, even if this risk simply meant a lower seigniorage income in the future (accruing in proportion to national participation in the capital of the ECB). There is no evidence that the countries of the core are prepared to accept this risk, not least because it requires an explicit principle of solidarity in the running of the Eurozone. In practice, the monetary union is run as a hierarchical alliance of nation states, a feature strengthened by the crisis as Germany has been catapulted into a leadership position.

Fourth, there could be cancellation of debt. This option would be most appealing to

[5] As discussed, for example, by Buiter and Rahbari (2012) and by Paris and Wyplosz (2014), available, respectively, at: http://blogs.r.ftdata.co.uk/money-supply/files/2012/02/citi-Looking-into-the-Deep-Pockets-of-the-ECB.pdf and http://www.wyplosz.eu/ICMB/Home_files/Geneva%20Special%20Report%203.pdf

peripheral countries for which public debt is at its most pressing and which, with the exception of Italy, carry modest parts of aggregate Eurozone debt. However, given the paucity of other options, cancellation should also be considered for other countries. It is apparent that cancellation would have major implications for the holders, which are typically financial institutions in the Eurozone and other lenders across the world. A coherent policy of cancellation, therefore, must also make provision for other policy measures, including public intervention in the financial sphere and capital controls. Indeed, if cancellation of debt was to become general, it would mean nothing less than a wholesale transformation of the economy of the Eurozone with dramatic implications for the international role of the euro. Cancellation is clearly the most radical option currently available and it ought to be considered with the seriousness if deserves by those who wish to argue for alternative policies in Europe.