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A 60% DEBT TARGET FOR THE EUROZONE AS A WHOLE

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THE LEVEL OF PUBLIC debt in the euro-area, generally considered excessive, represents the main hurdle on the way to wider risk-sharing among member states and deeper political integration in Europe. Understandably, fiscally sounder countries such as Germany would hesitate before assuming mutual responsibility with countries that have a heavy debt legacy or tradition of less fiscal discipline. However, for some weaker countries and, above all, for Greece, public debt is a fundamental issue because its debt level is so high as to be considered unsustainable. The peculiar architecture of a monetary union often makes risk-sharing happen through the backdoor, in an inefficient and non-transparent way, while at the same time jeopardizing the sustainability of national debts. In this short piece, we suggest a possible way to manage the problem without resorting to either full mutualization of fiscal policies or painful restructuring of national debts. The proposal has far-reaching consequences for the whole euro-area.

A new target for the total public debt of the eurozone as a whole should be fixed at 60 percent of total GDP. In the framework provided by this common target, all countries would aim to converge toward the 60 percent threshold, but some would be allowed to run a higher debt ratio provided that the entire area remains within the 60 percent limit, thus preserving the financial attractiveness and stability of the euro.

For countries like Greece that have public debts exceeding 60 percent of GDP, the path toward convergence of their national debt would still be determined according to the automaticity of the debt-brake rule, as stated in the so-called Fiscal Compact, which prescribes a one-twentieth yearly cut of the exceeding debt. However, the reference value for the exceeding debt would be measured in terms of what is required for the entire euro-area to reach the 60 percent threshold, rather than for the individual country.

Since a few countries, Germany included, are expected to post public debts below 60 percent after 2020, countries with higher debt ratios would be allowed to converge more gradually. The direct consequence for Greece would be that the required fiscal correction would be smoothed out, allowing the necessary primary surplus to be met at a more tolerable pace.

Some kind of solution for the Greek debt might be inescapable. According to the analyses provided by the International Monetary Fund, "even with concessional financing through 2018, Greek debt would remain very high for decades and highly vulnerable to shocks. Assuming official (concessional) financing through end–2018, the debt-to-GDP ratio is projected at about 150 percent in 2020, and close to 140 percent in 2022." Current revisions point toward an even worse scenario. Most analysts do not dispute that a "haircut" yielding a reduction in debt of over 30 percent of GDP would be needed to meet the debt targets that European institutions had set as a parameter of debt sustainability in the negotiations with Greece in November 2012. Moreover, with debt remaining very high, any further deterioration in growth rates or the medium-term primary surplus relative to the baseline scenario would result in significant increases in debt and gross financing needs. A primary surplus of above 4% and full implementation of structural reforms yielding a yearly growth rate of around 2% would still be required to maintain the Greek debt on a sustainable path. Although those requisites are very demanding, any deviation would derail the program. This points to the debt dynamics' high level of vulnerability.

According to 2014 estimates by the International Monetary Fund, Greece's general government primary surplus (net lending) as a percent of GDP was expected to reach 3 percent in 2015, 4.5 percent in 2016, and remain above 4 percent through 2019. In the longer term, the primary surplus must remain above 3 percent in order to reach a 60 percent debt-to-GDP ratio by 2040. The original adjustment program designed by the EU Commission projected Greek debt to be around 90 percent of GDP in 2030 (under a median scenario). Now, if we assume a compromise between Athens and EU institutions, and update the scenario to capture the Greek government's policy proposals to call off part of the privatization plans and reach a primary surplus around 1 percent lower than hitherto prescribed, then Greek public debt should decline to 110 percent of GDP by 2030 and around 90 percent by 2040.

Notoriously, the economic governance of the euro area prescribes that public debts should converge toward the 60 percent threshold. It also sets as a general rule the need to keep the budget balanced, although under a number of specifications. These thresholds are defined in a protocol of the Maastricht Treaty on European Union. According to the debt-brake rule, member states whose governments' debt-to-GDP ratio exceeds the 60% reference level in the latest recorded fiscal year shall reduce it at an average rate of at least one twentieth (5%) per year of the exceeded percentage points.

For its part, Germany remains determined to stick to a balanced or slightly positive general budget. This would bring the German public debt to around 52 to 53 percent of GDP in 2030, and slightly over 30 percent in 2040. Such projections would, if realized, bring the level of total eurozone debt markedly lower. German debt currently amounts to almost one-fourth of the total debt of the eurozone.

If the eurozone were to set a target of 60 percent of total eurozone public debt, the halving of German debt would allow other countries substantial leeway. In particular, Greek debt, which amounts to slightly over 3 percent of total eurozone debt, could easily remain at around 90 percent without jeopardizing the stability of the euro, and a Greek primary surplus consistent with a 90 percent target would be compatible with the government's agenda.

Since Germany, Italy, and France represent around 70 percent of total eurozone debt, they should take the initiative. A limit of 60 percent for eurozone debt as a whole would:

- allow national policy preferences to remain distinct, unless otherwise desired;
- moderate the steep reduction of public debts prescribed by the fiscal compact that is choking economic growth;
- keep the supply of government securities at a level consistent with the demands of the eurozone banking and financial system;
- maintain differences among each state's governmental policies, corresponding with its citizens' definition of an adequate level of taxation;

The Greek-German trajectory to different debt levels—broadly defined, 30% for Germany and 90% for Greece in 2040—is likely to require the same primary surplus level in the long term in both countries—around 2 percent of GDP. This would align the fiscal stance and broad orientation of governmental policies of both countries. Assuming that the current account balance of payments will reach a better equilibrium in both countries over the long term, an identical primary surplus of the public budget implies the same behavior in both countries in terms of aggregate consumption and savings. The distinction between creditor and debtor countries would not only be overcome, but, in cultural terms, the two countries would respect the ethical principle of "living within their own means" to an equal degree. This would represent a powerful attestation of the convergence of policy preferences in the different countries of the euro-area.