Yannis Stournaras: Public debt - past lessons, future challenges

Opening address by Mr Yannis Stournaras, Governor of the Bank of Greece, at the International Conference on "Public Debt: Past lessons, future challenges", organised by the Bank of Greece, Athens, 7 November 2024.

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Ladies and gentlemen,

It is my great pleasure to welcome you to this conference. As we gather today, we aim to address a topic of growing importance, not just for individual Member States, but also for our collective future – particularly for the euro area.

Historically, public debt has shaped the economic history of nations because governments have often resorted to borrowing to achieve economic stability and foster growth. While borrowing has at times allowed nations to provide critical support for their economies, it has also raised significant questions about sustainability, fiscal responsibility and intergenerational equity. As we reflect on the lessons of the past, we need to acknowledge the **delicate balance between financing today's prosperity, on the one hand, and safeguarding the well-being of future generations, on the other**.

In Europe, the debt crisis, which unfolded over a decade ago, tested the resilience of our economies, financial systems, as well as the unity – the very fabric – of the European Union. It exposed the vulnerabilities in our fiscal and banking systems, bringing to light critical lessons on fiscal policy, debt sustainability and the health of the banking sector due to the strong sovereign-bank nexus. Indeed, it tested the very existence of the single currency area.

In what follows, I will reflect on these lessons in four key areas: (1) fiscal policy, (2) debt sustainability, (3) financial stability and (4) the interaction between monetary and fiscal policy. These interconnected dimensions are not only relevant for understanding the past, but are also crucial for shaping the future of European economic governance.

1. Fiscal policy: The foundation of stability

Fiscal sustainability lies at the heart of any stable economy. During the European debt crisis, we were reminded of a fundamental truth: unchecked fiscal deficits, combined with large imbalances in the current account, which themselves were mostly related to the fiscal deficits, can trigger severe economic and financial distress. Several of our economies faced enormous fiscal and external sector imbalances, exposing the fragility of the euro area's architecture. What are the lessons that emerged?

Lesson 1: Credible fiscal frameworks.

Sound fiscal policies and strong institutional frameworks are the foundation of economic stability, especially in the context of the euro area, which still remains an incomplete economic union, lacking a central fiscal capacity. Before the crisis, the Stability and Growth Pact (SGP) aimed to impose fiscal discipline across the EU.

However, its enforcement was weak, and many countries repeatedly breached the Pact's deficit and debt limits. The crisis underscored the importance of **stricter fiscal surveillance** and the need for **credible enforcement mechanisms**.

To address these issues, the EU introduced the **Fiscal Compact** in 2012, mandating balanced budgets and stricter oversight. The **European Semester** aimed to coordinate fiscal and economic policies among Member States. Moreover, post-crisis reforms included the **European Stability Mechanism (ESM)**, which provided financial assistance to countries in distress, tying its support to strict fiscal and structural reforms. The ESM is an essential reform within the European economic architecture, as it acts as a financial backstop by providing a safety net for eurozone Member States during times of economic and financial distress, helping to prevent the contagious effects of crises and ensuring stability across the region.

Lesson 2: Countercyclical fiscal policies.

Countercyclical fiscal policies are key to stabilising economies and avoiding self-defeating effects of fiscal consolidation, while also creating fiscal buffers. Many eurozone Member States were forced into procyclical austerity measures during the crisis, including large cuts in public investment, which exacerbated economic contractions and worsened unemployment. Having been Greece's Finance Minister during 2012-2014, I can attest first-hand to the damage Greece had to endure due to the imposition of overly restrictive fiscal measures. Without overlooking the political constraints at the time, since a milder and more gradual fiscal consolidation would have required a larger financing envelope, and the need to enhance market confidence by addressing the country's credibility gap, a **more flexible approach to fiscal policy** could have mitigated the severity of the crisis.

As we move forward, the **new EU fiscal rules** encourage countercyclical fiscal policies, balancing fiscal responsibility with the ability to support economic growth during crises. This is especially relevant in today's context, where high levels of public debt persist after the COVID-19 pandemic. The new framework accounts for country heterogeneity and provides greater flexibility regarding the medium-term fiscal consolidation plans. Moreover, by focusing on **structural fiscal adjustment**, the new framework encourages the authorities to differentiate between temporary and permanent fiscal measures, thereby promoting more prudent long-term fiscal planning.

The use of the **expenditure rule** as a single operational indicator used to monitor compliance with the new framework contributes to a more sustainable fiscal environment by encouraging disciplined budgeting and, thus, more effective expenditure-based fiscal consolidation plans. Expenditure rules mitigate fiscal risks and create fiscal buffers, by curbing excessive spending during periods of economic boom. Also, these rules allow flexibility for public investment and enhance predictability and market confidence in fiscal strategies.

Lesson 3: National ownership of fiscal consolidation.

The experience of the euro area debt crisis has clearly indicated that **national ownership of fiscal adjustment efforts is critical for ensuring the success and sustainability of fiscal reforms**. Successful fiscal consolidations depend on political

consensus and effective social dialogue. When countries take ownership of their fiscal policies, aligning them with domestic economic conditions and political realities, this strengthens their commitment to sound fiscal management. National ownership of fiscal consolidation plans allows governments to design tailored measures that reflect the specific needs of their individual economies, while fostering public support, because citizens are more likely to back homegrown reforms than those that are externally imposed.

Within the EU, where fiscal rules are in place, national ownership helps bridge the gap between EU-level requirements and domestic policy priorities. By embracing fiscal responsibility voluntarily, rather than merely complying with EU rules, Member States can promote fiscal discipline, improve credibility with markets and enhance trust in European institutions.

This approach supports long-term fiscal sustainability and economic stability, ensuring that fiscal consolidation efforts are both effective and politically feasible.

But let me emphasise that trust, or credibility, is not something that can be obtained overnight. We will have to earn it. Our new fiscal framework provides a necessary vehicle for doing so. The rest is up to us. As the old saying goes, "The proof of the pudding is in the eating."

2. Debt sustainability: A multifaceted discipline

Debt sustainability was perhaps the most immediate concern during the European debt crisis. The skyrocketing public debt levels in several Member States led to a loss of market confidence, rising borrowing costs and fears of sovereign defaults. In this context, the European debt crisis offered key insights into managing sovereign debt effectively.

Lesson 4: A holistic approach to debt sustainability.

The crisis revealed that managing public debt is not simply about medium-term solvency, but also about *long-term* sustainability. The concept of debt sustainability analysis (DSA), which had traditionally focused on the medium-term evolution of the stock of debt, was expanded to include longer-term projections (due to the concessional terms of official sector loans) as well as vulnerabilities of the debt trajectory to various adverse macroeconomic, fiscal and financial sector shocks.

The extended analysis reinforced the notion that safeguarding a favourable **contribution of the snowball effect** to debt reduction is equally important as pursuing a *structural* fiscal adjustment. Moreover, medium-term projections of **Gross Financing Needs** (GFNs) are also important in identifying debt sustainability risks, because they reflect the underlying characteristics of the public debt structure. For example, high levels of short-term debt or relatively high shares of floating-rate debt can make a country more vulnerable to interest rate shocks and high liquidity risks. Such projections are particularly important in detecting sustainability risks that would otherwise have gone unnoticed.

The European institutions (EC, ESM, ECB) as well as the IMF played a central role in providing assistance based on DSAs, ensuring that fiscal consolidation targets the country's structural fiscal position (thereby promoting structural fiscal reforms, especially in the pension and social security systems), while also advocating for productivity-enhancing reforms in the labour and product markets in order to raise long-term potential output growth.

Today, we understand that debt sustainability is not solely about reducing debt ratios, but also about ensuring that debt levels remain manageable under varying economic conditions. The new European fiscal framework is centred on a **risk-based surveillance framework**, which puts debt sustainability at its core and differentiates among countries, taking into account their specific public debt challenges.

The incorporation of **stochastic debt sustainability analysis** in determining the structural fiscal adjustment needs of EU Member States provides significant advantages because it accounts for uncertainty and incorporates a range of potential economic scenarios. Unlike traditional methods, stochastic DSA helps policymakers to assess more realistically the likelihood of various debt outcomes, identify risks earlier and manage debt levels proactively.

Lesson 5: Flexibility in debt servicing – Reform of the euro area debt restructuring framework.

Flexibility in debt servicing can help alleviate immediate fiscal pressures and prevent defaults. The ESM and the IMF introduced measures such as **debt maturity extensions** and **lower interest rates** for countries receiving bailout packages. These measures provided temporary relief and helped restore market confidence.

Moreover, the overall **debt restructuring framework** in the euro area, shaped by the experience of the European debt crisis, has evolved significantly to address more effectively sovereign debt challenges. In particular:

- The **ESM**, which acts as a permanent crisis resolution mechanism, has the legal mandate to restructure sovereign debt if necessary.

- Since 2013, all new euro area government bonds with maturities of more than one year must include **Collective Action Clauses (CACs)**. The use of CACs is a core component of the new debt restructuring framework, designed to ensure that restructuring can be carried out in an orderly manner, limiting market disruption.

- The ESM and the EC play a central role in conducting **DSA** before providing financial assistance. The framework is used to guide decisions on the necessity and the scale of any potential debt restructuring.

- The experience of the Greek debt restructuring highlighted the significance of the **Private Sector Involvement (PSI)** in sovereign debt crises. The Greek case revealed the potential benefits and challenges of PSI, where the involvement of private creditors helped reduce Greece's debt burden, but the process also raised concerns about contagion risks.

- The euro area crisis underscored the need for **orderly and predictable debt restructurings**. Past experience has shaped principles to minimise financial market volatility. Timely intervention is crucial, as early restructuring, if needed, is more likely to be successful before debt levels spiral out of control, than long, drawn-out restructurings.

- The **legal and institutional framework for debt restructuring** has been enhanced to prevent moral hazard, ensuring that governments adhere to fiscal rules. The Fiscal Compact and the revised SGP impose stricter fiscal discipline to prevent excessive debt accumulation. The framework also ensures that sovereign debt restructuring is treated as a last resort, after all other policy measures (such as fiscal adjustment, structural reforms, liquidity support) have been exhausted.

All in all, following our experience, the eurozone is much better equipped to manage sovereign debt crises in the future. However, the need for continued vigilance, early intervention and fiscal prudence remains essential to ensure that sovereign debt crises can be prevented and, should they arise, be resolved efficiently.

3. Financial stability: A pillar of economic resilience

The crisis also exposed vulnerabilities in Europe's **financial stability framework**. The increase in the sovereign-bank nexus created a vicious circle of contagion, where failing banks weakened sovereigns and vice versa.

The euro area's banking system was one of the weakest links during the debt crisis. Several factors accounted for this circumstance. For one thing, euro area banks typically hold relatively large shares of the debts issued by their respective national governments in their portfolios. Related to that, and in contrast to the situation in the US and the UK, the ECB does not have the mandate to act as a lender of last resort to sovereigns.

Banks in several countries, especially those exposed to housing bubbles and sovereign bonds, found themselves undercapitalised and struggling with high levels of **non-performing loans (NPLs)**. The crisis in the banking sector intensified the sovereign debt crisis, as governments were forced to bail out failing banks, adding to their fiscal burdens.

Furthermore, the crisis highlighted the importance of a **well-functioning financial market infrastructure**. This includes payment systems, securities settlement systems and central clearing counterparties. A robust infrastructure can help mitigate systemic risks and ensure the smooth functioning of the financial system.

Lesson 6: Strengthening financial oversight.

A strong regulatory and supervisory framework is essential to monitor and mitigate systemic risks. Before the crisis, financial regulation in Europe was fragmented, with national authorities being responsible for supervision. This lack of coordination allowed financial imbalances to grow unchecked.

In response, the EU took significant steps to enhance **financial supervision and regulation**. The creation of the **Single Supervisory Mechanism (SSM)** and the **Single Resolution Mechanism (SRM)** under the Banking Union framework aimed to centralise supervision and resolution at the European level. This ensures that systemic banks across the eurozone are subject to uniform standards and that failing banks can be resolved without burdening taxpayers.

Lesson 7: Macroprudential policies.

The crisis also highlighted the need for **macroprudential policies, which include tools designed to address systemic risks**. The ECB and the national authorities have adopted a series of macroprudential measures, such as capital buffers, to enhance the resilience of the banking sector, prevent the build-up of financial bubbles and excessive leverage, and reduce procyclicality.

Lesson 8: Bank recapitalisation and resolution frameworks.

A key takeaway from the crisis is the importance of ensuring that banks are well-capitalised and that there are mechanisms in place to resolve failing banks without jeopardising financial stability. The creation of the **European Banking Authority (EBA)** and the **Single Resolution Board (SRB)** have helped address this matter. These institutions have improved the regulatory framework and ensured that banks maintain sufficient capital buffers to absorb shocks. Moreover, measures to effectively manage credit risk were essential in order to improve the quality of the loan portfolio.

Lesson 9: Reducing the sovereign-bank nexus.

Reducing the sovereign-bank nexus is critical to preventing future crises. The European debt crisis has demonstrated how weak banks could exacerbate sovereign debt problems and vice versa. The introduction of **bank resolution mechanisms under the Bank Recovery and Resolution Directive (BRRD)** ensures that shareholders and creditors bear the losses in the event of bank failures, rather than taxpayers. This has helped weaken the link between banks and sovereigns, thereby decoupling risks in both sectors and enhancing their resilience to economic shocks.

4. Monetary-fiscal policy interactions: Complementarity of policies is critical

The interaction between monetary and fiscal policies is central to understanding how Europe can navigate its future debt challenges. The consistency between fiscal and monetary policies is critical in shaping sustainable economic recovery paths, while managing the delicate equilibrium between growth, inflation and fiscal sustainability.

Regardless of the near-term budget outlook, the current high levels of public debt complicate the task of monetary policy, limit the room for manoeuvre and worsen the trade-offs faced by central banks. Evidence from the recent crises in the euro area have underscored the **need for alignment of monetary and fiscal policy objectives, highlighting the benefits of complementarity between the two policies**. Risks of fiscal dominance could emerge if debt dynamics are left unchecked by the fiscal framework, or if fiscal policies lack countercyclicality.

Lesson 10: Effective complementarity of monetary and fiscal policies.

In the current multi-crisis environment, the complementarity of monetary and fiscal policies is critical for achieving two interrelated goals in the European context: fiscal sustainability and price stability. The ECB has long emphasised the **importance of *complementarity* between these two policy areas**, particularly during periods of economic turbulence. Moreover, over the medium-term horizon, the benefit of the negative interest rate-growth differential is expected to gradually fade, highlighting the risks of low growth and the effect of relatively higher interest rates levels (as compared to the pre-Covid period) on debt dynamics going forward.

Monetary policy, driven by the ECB's mandate to maintain price stability, operates most effectively when complemented by sound fiscal policies that ensure public debt levels remain sustainable over the long term. This interplay is especially important in the eurozone, where fiscal policy remains the responsibility of national governments, while monetary policy is centralised through the Eurosystem. Therefore, **in the short-to-medium-term horizon, the development of a framework to monitor and steer the aggregate euro area fiscal stance, including through a permanent central fiscal capacity of sufficient size, is important for increasing the effectiveness of monetary policy.**

A failure to align fiscal policies with the ECB's efforts could lead to inflationary pressures and undermine monetary policy effectiveness, as excessive government borrowing risks overheating the economy or raising inflation expectations. Therefore, fiscal policy needs to be disciplined and forward-looking, focusing on long-term sustainability to allow monetary policy to maintain price stability.

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The European debt crisis was a wake-up call for policymakers, businesses and citizens across the continent. It exposed deep-rooted weaknesses in our fiscal, financial and banking frameworks, but it also instigated a wave of reforms that have made the eurozone more resilient. Further reforms aimed at strengthening the EMU, such as a deeper fiscal union, a complete banking union and a well-functioning capital markets union, can help prevent future crises and make the euro area more robust.

Today, Europe stands at a crossroads, grappling with debt burdens that have grown due to a series of recent crises, such as the global financial collapse of 2008, the sovereign debt crisis of 2010-13, the COVID-19 pandemic and the energy shock triggered by the war in Ukraine. Addressing debt sustainability concerns is even more complex within the European framework, with its unique challenges – ranging from the complicated eurozone economic structure and the lack of efficient fiscal coordination to balancing national sovereignty with collective responsibility.

How do we ensure that the consequences of today's decisions do not unfairly impact future generations? How do we manage debt levels without stifling growth? How can Europe create a framework for shared prosperity while maintaining fiscal discipline?

Over the course of today's discussions, we will try to delve into these issues from both historical and forward-looking perspectives, focusing on how we can learn from history

while navigating the challenges of an uncertain future. Our goal is not just to understand how we got to where we are, but to contribute to the overall discussions on charting a responsible path for the future.

The challenges we face today – ranging from high debt levels to climate crisis, geopolitical risks posed by conflicts, geoeconomic fragmentation, demographic shifts, low productivity and deglobalisation trends – require us to remain vigilant and adaptive. Should we confront rising debt vulnerabilities, the need for innovative and sustainable fiscal solutions will be more urgent than ever.

The decisions we make today will determine not only Europe's financial stability, but also the well-being of future generations. Striking the right balance between fostering growth, ensuring fiscal sustainability and protecting the long-term interests of our societies is no easy task, but it is one we must face together.

Thank you all for your participation, and I look forward to the fruitful discussions.