



BANQUE CENTRALE DU LUXEMBOURG

EUROSYSTEMÈME

Challenges of Excessive Indebtedness

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1. The global rise in debt levels
 2. Global economic challenges
 3. The case of the euro area
 4. Under market scrutiny
 5. Main difference to other currency areas
 6. Institutional challenges

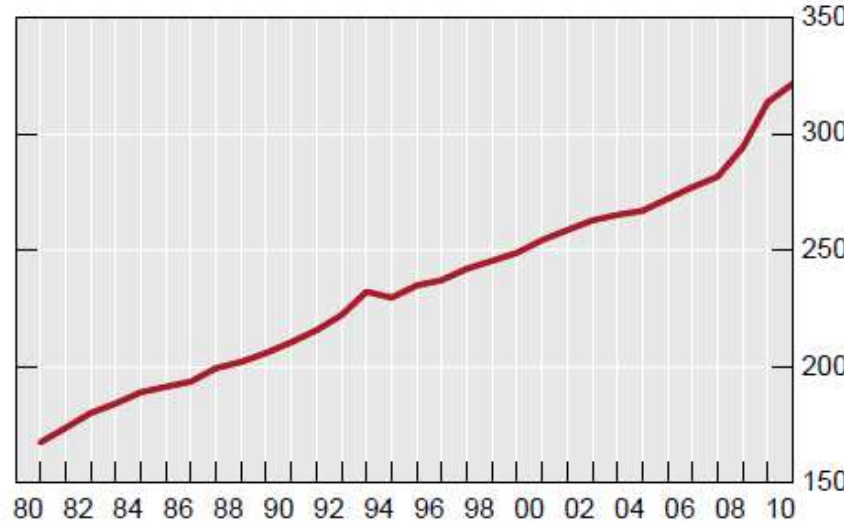
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Decades of rising debt in the mature world

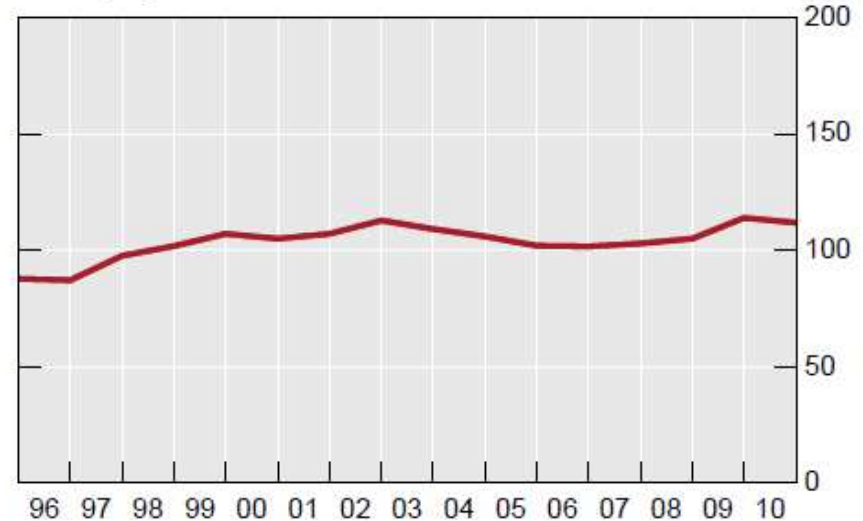
Aggregate non-financial sector debt^{1,2}

As a percentage of nominal GDP

Advanced economies³



Emerging markets⁴



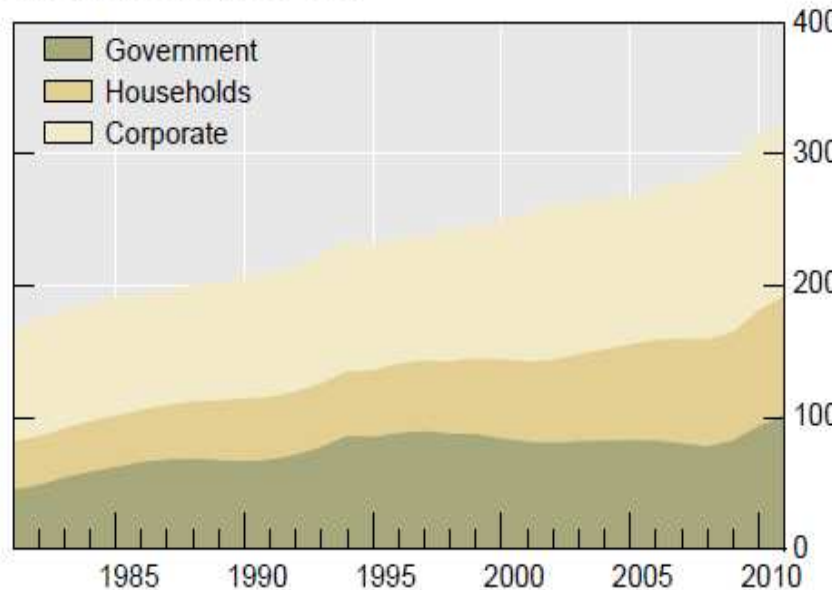
¹ Total of general government debt and private sector debt. For emerging markets, private sector debt is the total of domestic bank credit to the private sector, external loans of BIS reporting banks (on the residence basis) vis-à-vis non-bank sector and international debt securities issued by the non-bank sector. ² Simple averages across listed countries. ³ 18 OECD economies. ⁴ 21 emerging markets: China, India, Indonesia, Korea, Malaysia, Philippines, Thailand, Peru, Argentina, Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Hungary, Poland, Russia, Turkey, Saudi Arabia, South Africa and United Arab Emirates.

Sources: BIS locational banking statistics by residence; BIS securities statistics; Datastream; IMF *International Financial Statistics*; IMF *World Economic Outlook*; OECD; national data.

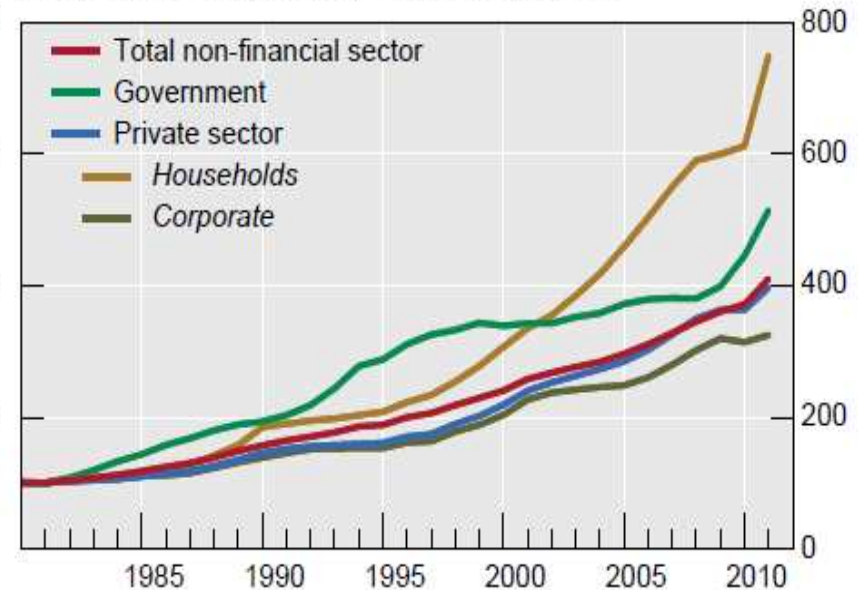
Indebtedness in advanced countries is still high – and rising

Industrial country non-financial sector debt

As a percentage of GDP¹



Real levels, deflated by consumer prices²



¹ Simple averages for 18 OECD economies. ² Rebased to 1980 = 100; simple average of 16 OECD economies, including the United States.

Source: BIS

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The risk of a debt trap

- At high levels of debt, borrowers' ability to repay becomes progressively more vulnerable to reductions in income and increases in interest rates.
- The probability of default rises together with the level of debt for a given shock.
- Fiscal authorities become constrained in their scope for traditional countercyclical stabilisation and as lenders of last resort during a financial crisis.
- Growth is hampered. Recent BIS work found that beyond 85 per cent of debt-to-GDP an additional 10 percentage points of debt reduces average per-capita growth by 13 to 14 basis points.

No easy way out

Public Finance

Fiscal consolidation and sustainable pension systems



Growth dynamics

Structural reforms to strengthen competitiveness, increase flexibility and enhance longer-term growth potential

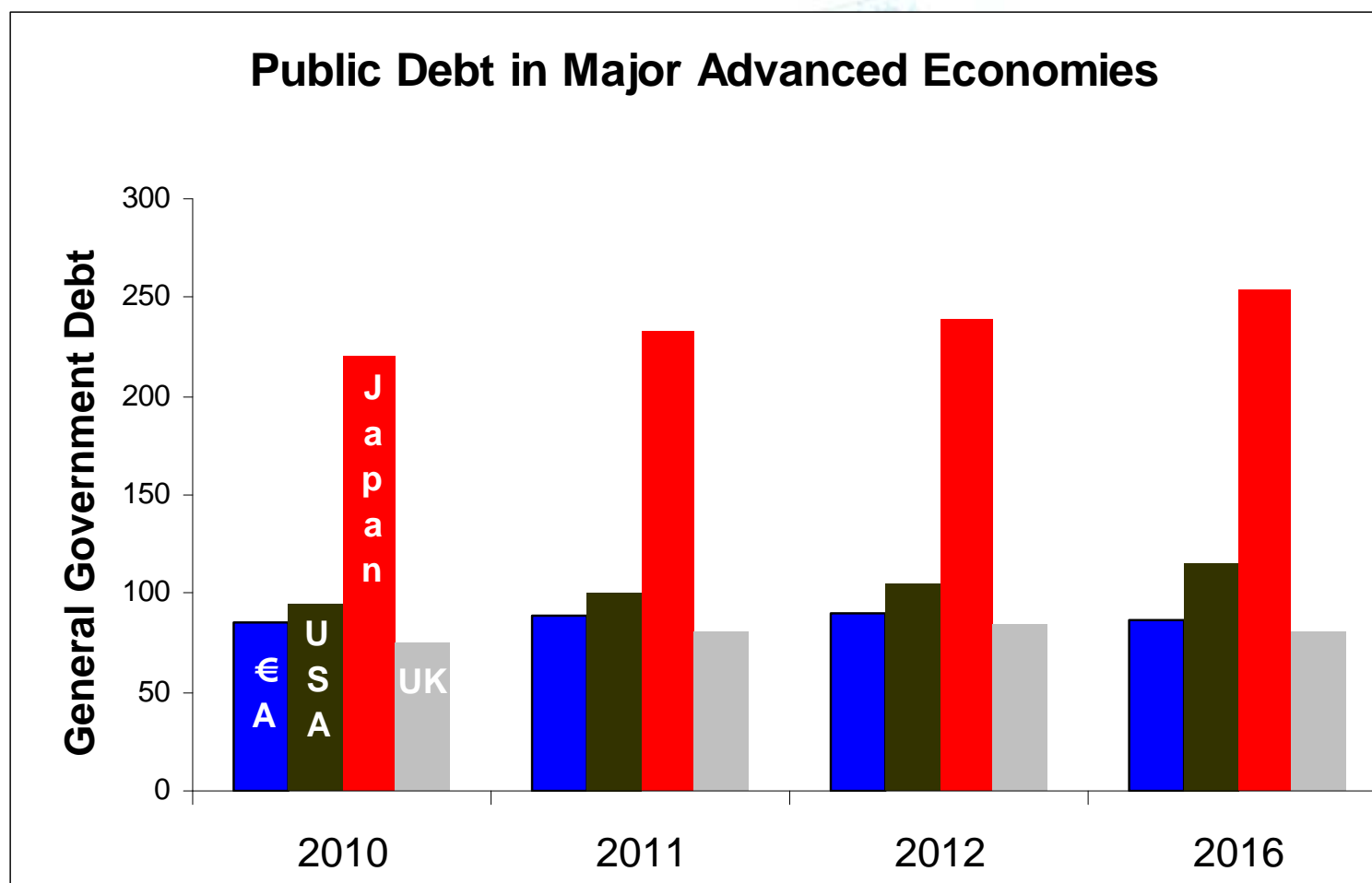


Inflation? – No option, because of:

- Risks of higher future inflation and uncontrollable wage-price-spirals
- Greater output volatility
- Reduced incentives for governments to lower their debt levels

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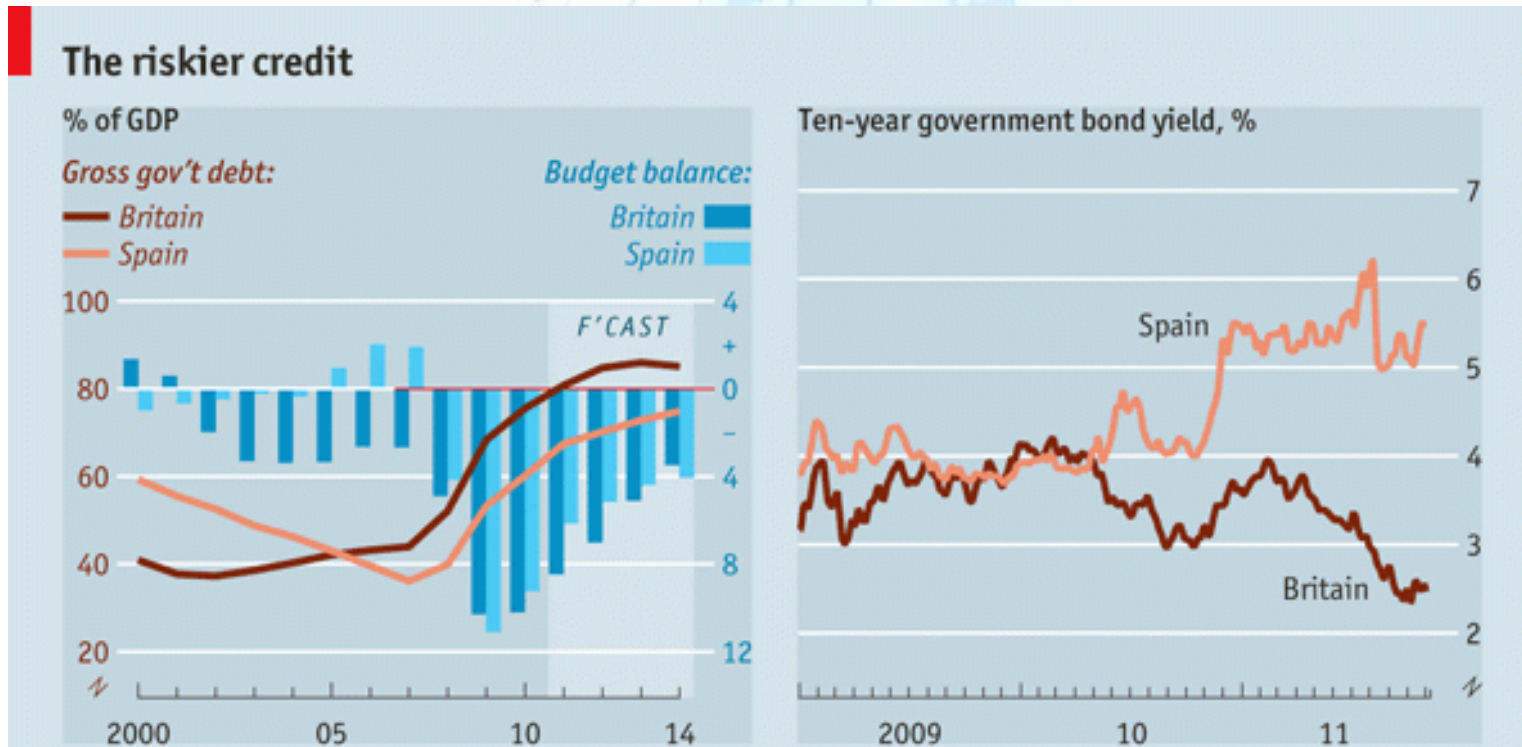
EA public debt in relatively good shape



Source: IMF, World Economic Outlook, Sep 2011

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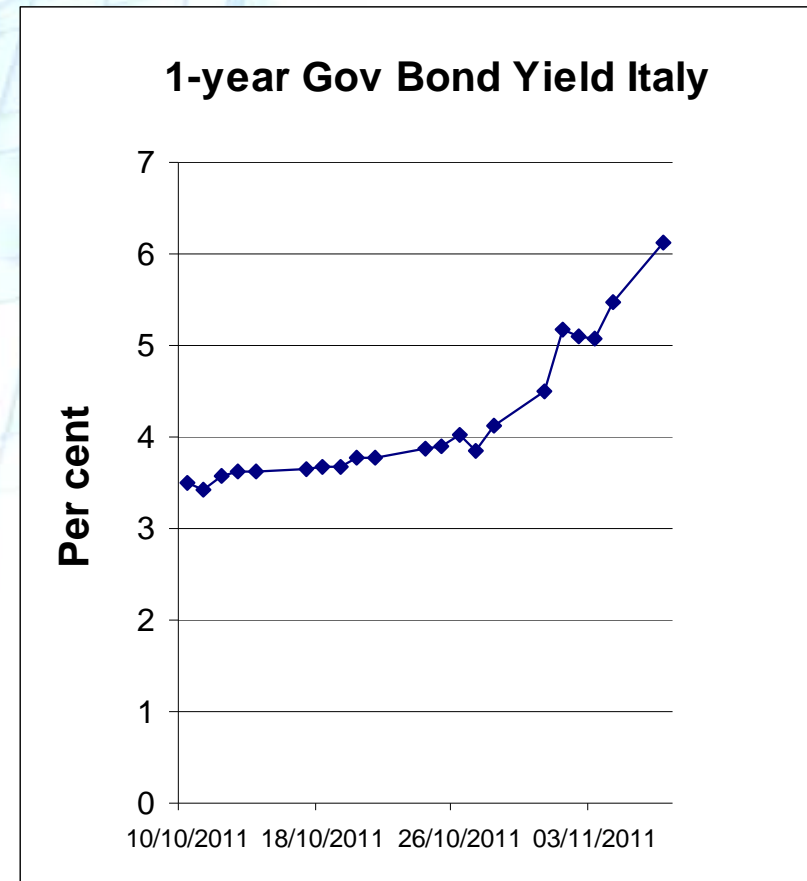
Unequal treatment



Sources: The Economist, IMF, Thomson Reuters

Irrational Pessimism

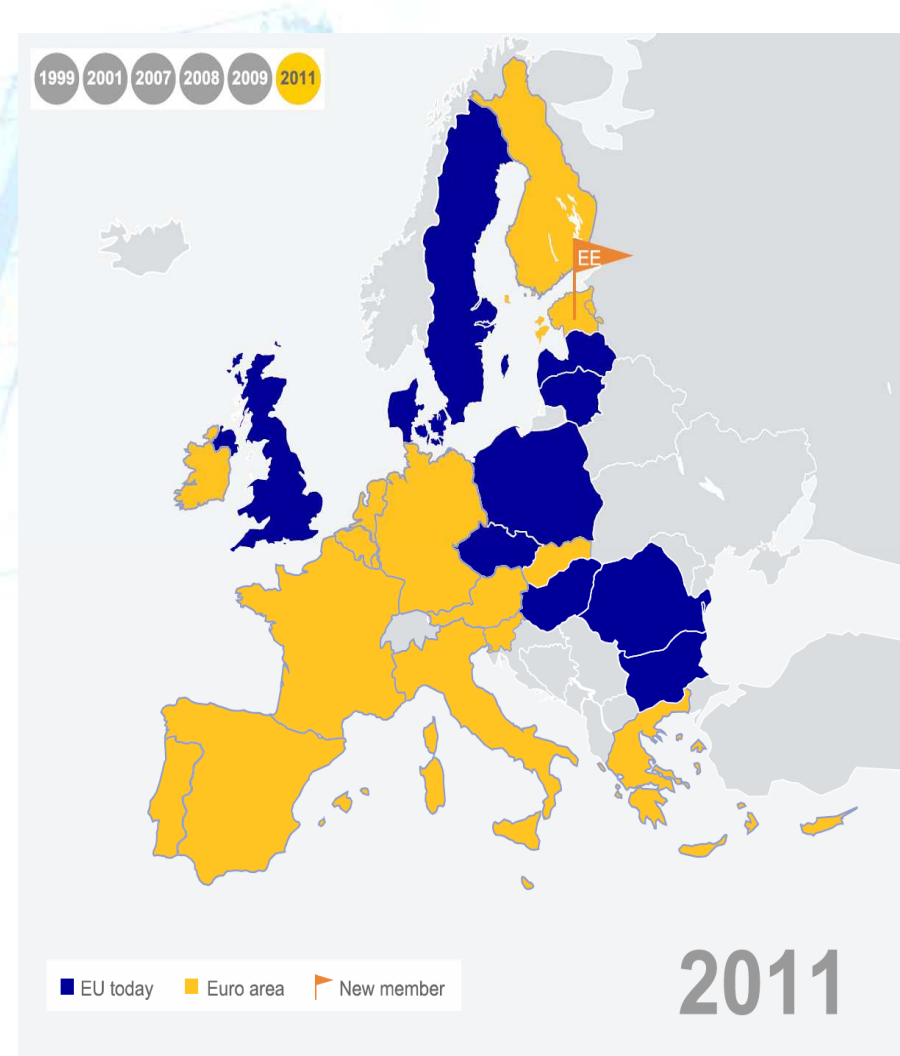
- Currently, markets seem to be irrationally pessimistic.
- Even wealthy states with sound economic fundamentals are in trouble to refinance themselves at reasonable conditions.
- Market sentiment can deteriorate dramatically within days – without a change in fundamentals.



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Currency without a state

1. The euro area has no central government or a fiscal center.
2. The management of a single currency in a union of sovereign states is challenging.
3. Effective rules are required to safeguard the credibility of the currency.



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Institutional challenges

The euro area sovereign debt crisis revealed serious weaknesses in the fields of financial, fiscal and economic governance on the preventive side.

Moreover, the euro area had lacked a crisis resolution mechanism.

Bold decisions have been taken

Improved governance of the euro area

- Quasi automatic sanctions in corrective and preventive arm
- SGP complemented by “European Semester”
- Excessive Imbalances Procedure
- Introduction of constitutional fiscal rules (debt breaks)
- Structural reforms to enhance growth and employment

Stronger financial market supervision

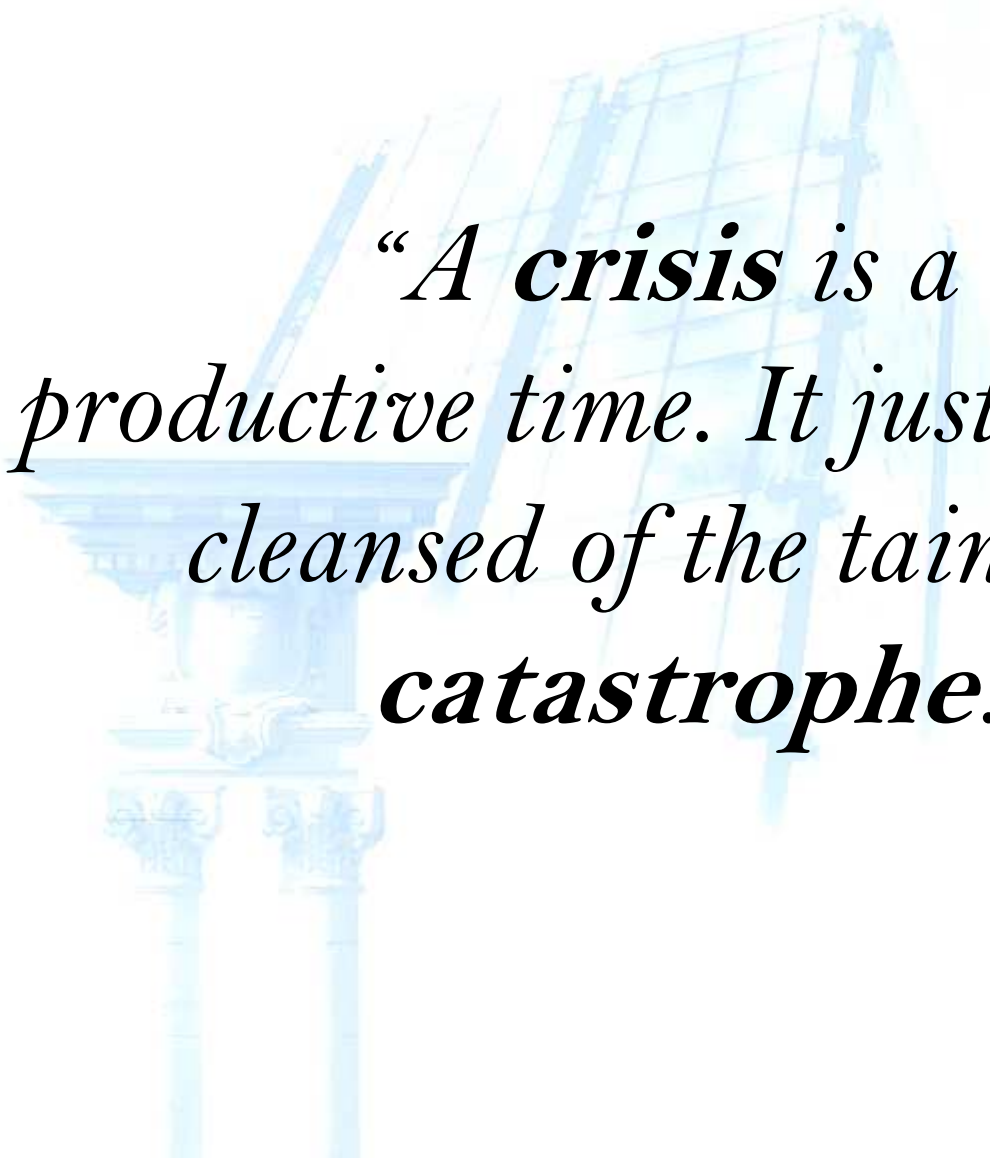
- Regulatory reform for financial markets (Basel III)
- True European supervisory bodies and a “European Systemic Risk Board” (ESRB) to monitor macroprudential risks

Crisis resolution mechanism

- New European Financial Stability Facility ESFS (2011)
- Permanent European Stability Mechanism ESM (2013)

More remains to be done

- The implementation gap must be closed to regain confidence. As soon as possible the new governance rules must be applied completely and rigorously.
- In the medium to long run, a more comprehensive fiscal coordination is needed. In this context, we will need an institution that is solely responsible for the euro area.



*“A **crisis** is a
productive time. It just has to be
cleansed of the taint of a
catastrophe.”*

Max Frisch