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ALLIANZ RESEARCH

EUROZONE GOVERNMENT DEBT: QUO VADIS FROM HERE?

20 May 2021

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EXECUTIVE SUMMARY

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- **The fiscal version of "whatever it takes" triggered a notable deterioration in public finances across the Eurozone in 2020.** However, the picture has never proven more heterogeneous at the country level: Seven countries (Greece, Italy, Portugal, Spain, Cyprus, France and Belgium, together representing more than 50% of Eurozone GDP) now boast debt-to-GDP ratios close to or above 120% of GDP i.e. twice the Maastricht debt target.

- **The Covid-19 debt overhang will prove sticky:** In 2021-22, the Eurozone debt-to-GDP ratio should largely stabilize at around 100% as deficits remain bloated. But what happens after 2022 is anyone's guess, depending on a complex mix of assumptions. Our interactive Debt Tool provides a whole range of possible outcomes for the trajectory of government debt in selected Eurozone countries over a 15-year horizon. The key takeaway: Unless Eurozone heavyweights, including France, Spain and Italy, register notable increases in nominal GDP growth and/or improved primary balances, a return to pre-crisis debt-to-GDP levels by 2035 is clearly not on the cards. In particular, a return to a fiscal 'business as usual' – i.e. to the average nominal growth and primary balance observed over the period 2000-19 – would see sovereign debt ratios in key economies move largely sideways over the next 15 years. While Germany would get back to pre-Covid-19 debt levels by 2028, other Eurozone heavyweights would need a lot longer (France 67 years, Italy 26 years and Spain 89 years).

- **What are the implications for EU fiscal policy in a world where 90% could be the new 60%?** The Covid-19 shock will leave a longer-term impact on the region's public finances, not just in the form of a lingering debt overhang but also by reinforcing a paradigm shift when it comes to the thinking around public debt and fiscal policy. However, in a context where flows trump levels, debt is not only bad, active fiscal policy is the main game in town and the planning horizon is becoming increasingly more long-term, a common debt anchor – why not 90%? – is all the more important to ensure fiscal policy soundness and in turn debt sustainability. Meanwhile, cosmetic changes including separately disclosing the Covid-19 debt overhang from the remaining government debt stock, or more controversial proposals such as the cancellation of sovereign debt held by the ECB, will change nothing of substance and could in fact undermine fiscal credibility.

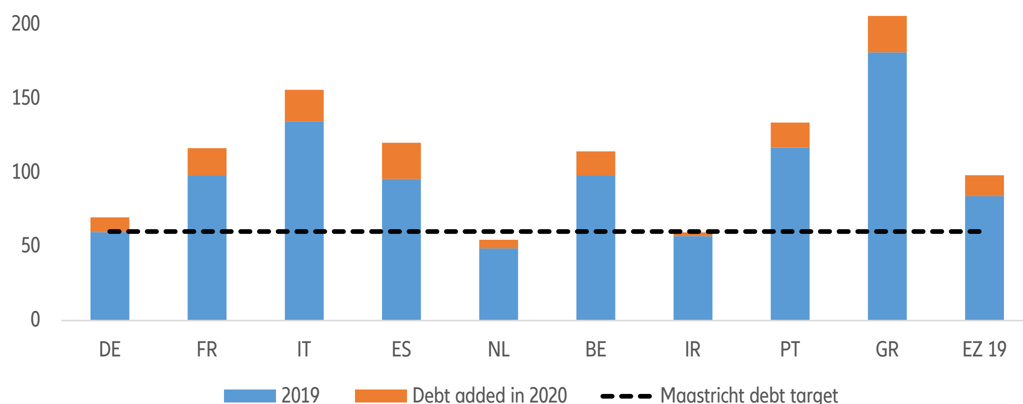
89

Years needed for Spain to reach pre-Covid-19 debt levels with a return to fiscal 'business as usual'

THE PRICE OF EUROPE'S FISCAL 'WHATEVER IT TAKES'

The fiscal policy response to the Covid-19 shock – including unprecedented economic and financial measures – helped cushion the negative impact on economic activity. However, sharp public spending increases together with lower tax revenues left their mark on Eurozone public finances, with government debt jumping by 14pp to 98% of GDP in 2020. While no Eurozone economy managed to avoid a deterioration in public finances, the picture has never proven more heterogeneous at the country level: Seven countries (Greece, Italy, Portugal, Spain, Cyprus, France and Belgium, together representing more than 50% of Eurozone GDP) now boast debt-to-GDP ratios of close to or above 120% of GDP. However, eight countries managed to keep their debt ratios below the 60% Maastricht limit.

Figure 1: Change in government debt (% GDP) 2020 vs. 2019 for selected Eurozone countries



Sources: Refinitiv, Euler Hermes, Allianz Research.

A RETURN TO FISCAL 'BUSINESS AS USUAL' WON'T SUFFICE TO ELIMINATE THE COVID-19 DEBT OVERHANG

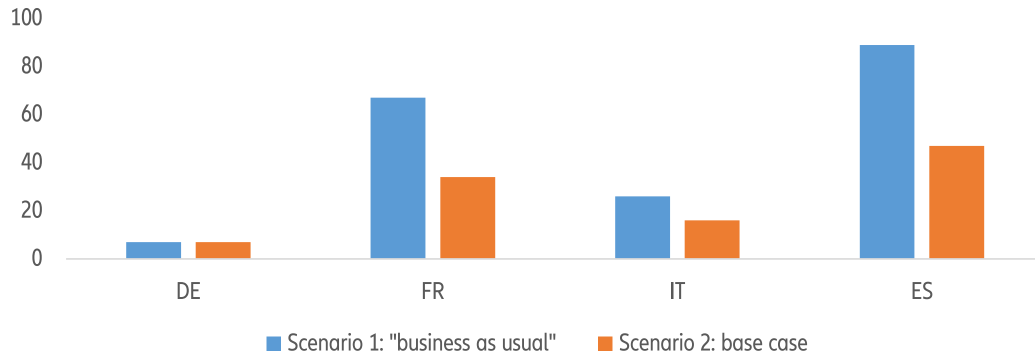
As the Eurozone's vaccine-enabled economic recovery looks set to shift into overdrive in H2 2021, the gradual normalization of fiscal flows is likely to begin. Despite strong tailwinds from the rebound in GDP growth, the Eurozone debt ratio should largely stabilize at around 100% in 2021-22 as deficits in key member states will still remain bloated. What happens after 2022 is anyone's guess, depending on a complex mix of assumptions, including election outcomes in key Eurozone member states (Germany in September 2021, France in Spring 2022 and Italy in 2023); governments' investment and spending decisions as well as their willingness and capacity to implement economic reforms; ageing pressures, inflation prospects and an expected overhaul of EU fiscal rules.

Rather than betting on one scenario only, with the help of our interactive Debt Tool we provide a whole range of possible outcomes for the trajectory of government debt in selected Eurozone countries over a 15-year horizon. We refer to the following equation for government debt (D) using long-term assumptions for nominal GDP growth (g), the primary balance (PB) and the average interest rate on government debt (r).

$$D_t = \frac{(1+r_t)}{(1+g_t)} D_{t-1} - PB_t$$

For the subsequent analysis, however, we focus above all on real GDP growth and the primary balance, given that their values can – at least to some degree – be directly influenced by government policy via decisions on economic reforms, spending and taxation. Meanwhile we lay out only one scenario for the evolution of inflation as well as interest rates. When it comes to inflation, we assume that it will remain close to but below 2% on average over the forecast horizon. In addition, we expect sovereigns' refinancing costs to rise only gradually from current record lows over the forecast horizon. After all, the ECB should phase out its strong presence in Eurozone sovereign debt markets only very gradually. Moreover, governments have managed to lock in low interest rates by issuing debt at ultra-long maturities (France, Spain, Italy and Austria have all been selling 50-year debt in recent months) and going forward, rising yields should only slowly feed through into higher sovereign borrowing costs, with governments likely to opt increasingly for shorter maturities. One final simplification is that we ignore stock-flow adjustments in our debt tool equation, which account for changes in government debt other than via the budget balance. Examples include, for instance, privatization proceeds (debt-reducing impact) on the one hand and public loans granted or equity injections into corporates (debt-increasing impact), on the other hand. If anything, given the large use of public guarantees during the Covid-19 crisis, our analysis is likely to overestimate any decline in government debt.

Figure 2: Number of years needed to eliminate the Covid-19 debt overhang



Sources: Refinitiv, Euler Hermes, Allianz Research.

Within the range of scenarios for government debt in key countries, we highlight two in particular:

- Scenario 1, 'business as usual', assumes that the primary balance as well as nominal GDP growth over the next 15 years take on the average values recorded during the period 2000-19.

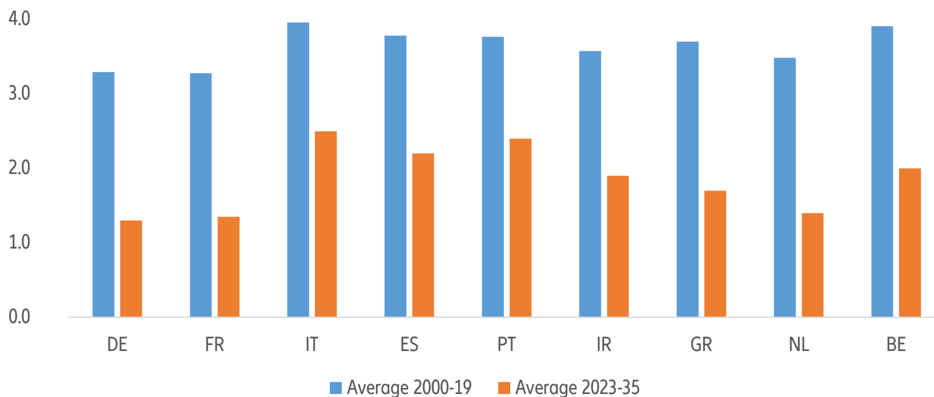
- Scenario 2, the 'base case', includes our best estimates for what the primary balance and nominal growth could average at over the 15-year forecast horizon.

Our calculations for the trajectory of government debt in selected Eurozone economies shows that the Covid-19 debt overhang will prove very sticky in many member states. Under both scenarios that we consider, the majority of countries will struggle to bring down government debt to pre-Covid-19 levels.

Our findings in Scenario 1 tell us that a return to a fiscal 'business as usual' - i.e. to the average nominal growth and primary balance observed over the period 2000-19 – will see sovereign debt ratios in key economies move largely sideways over the next 15 years. While Germany would get back to pre-Covid-19 debt levels by 2028, the other Eurozone heavyweights would need a lot longer (France 67 years, Italy 26 years and Spain 89 years). Hence, even though a lower interest burden may help make debt more sustainable, it would not help ensure that debt reverts back to a marked downward trend over the next 15 years.

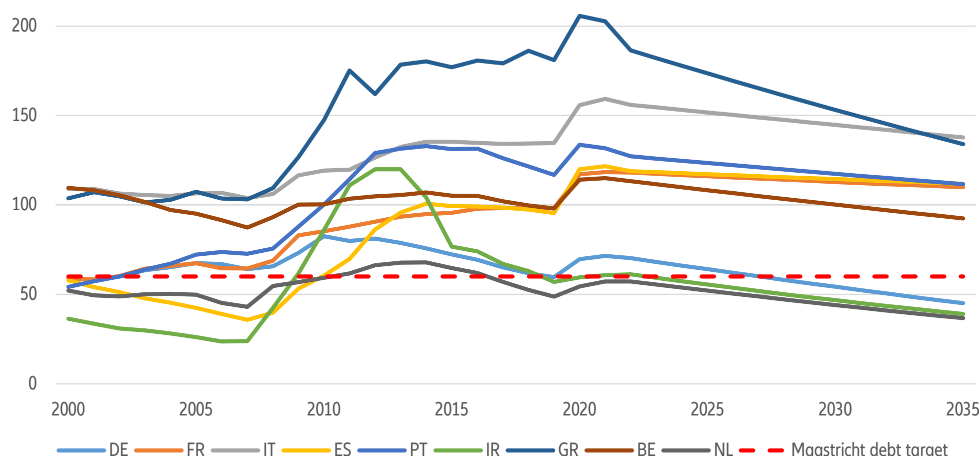
However, in our base case scenario we do expect stronger consolidation tailwinds, thanks to more favorable nominal growth prospects and/or the primary balance compared to the first 20 years of the Eurozone. As a result, while sovereign debt mountains would still prove elevated remaining a key feature of the post-pandemic world, we do expect France, Italy and Spain to make more progress, needing 34, 16 and 47 years, respectively, to return to pre-Covid-19 debt levels (see section 3 for more details). At the end of the forecast horizon, only Ireland, Germany and the Netherlands would meet the 60% Maastricht debt target, while all other countries would still boast debt ratio of close to 100% of GDP or more.

Figure 3: Average interest rate on debt (%)



Sources: Refinitiv, Euler Hermes, Allianz Research.

Figure 4: Eurozone debt dynamics in Scenario 2 'base case' (% GDP)



Sources: Refinitiv, Euler Hermes, Allianz Research.

Implications for EU fiscal policy in a world where 90% could be the new 60%

Once the sense of economic emergency gives way to a strong economic rebound across the region from the second half of 2021 onwards, the normalization of fiscal flows should also begin. But what is normal? After all, the Covid-19 shock looks set to leave a longer-term impact on the region's public finances, not just in the form of a lingering debt overhang but also by reinforcing a paradigm shift when it comes to the thinking around public finances and fiscal policy.

For one, the sharp increase in government debt across the Eurozone has made the long-overdue overhaul of EU fiscal rules – which are currently suspended until 2023 - even more pressing. With countries representing more than 50% of 2020 GDP now boasting a debt-to-GDP ratio of close to 120% of GDP or above, the 60% Maastricht debt target has lost all meaning. Similarly, the rule that debt in excess of 60% of GDP needs to be reduced at 1/20th per year can no longer be applied as it would require Italy to run a primary surplus in excess of 5% of GDP for every year over the next 15 years. Such a scenario would hardly be realistic, since in addition to a gradual phasing out of Covid-19 measures, rising spending pressures related to structural challenges including demographics and climate change are bound to slow any fiscal consolidation progress in the coming years, nor would it be desirable. After all, the consensus on fiscal policy has shifted notably since the Maastricht rules where first written down 30 years ago in that all debt is no longer considered as bad. As our analysis shows, without a notable pick-up in nominal GDP growth, any deleveraging will remain limited at best and the Eurozone will remain vulnerable to external shocks. For instance, a 100bps increase in the average interest rate on government debt in our base case scenario would suffice to put debt ratios in France, Italy and Spain on an upward trend over the forecast horizon. The key insurance policy for sound fiscal prospects is higher nominal growth. Hence, growth-boosting reforms coupled with a debt-financed investment drive in education and infrastructure (Italy is leading the way here) remains a necessity. Similarly, discretionary fiscal policy is now seen as key to cushioning economic shocks.

So with no swift adjustment in the fiscal position on the cards as fiscal policy takes a more long-term perspective, as well as a more active policy function, a common debt anchor – why not 90%! – becomes all the more important to ensure fiscal policy soundness and in turn debt sustainability.

In contrast, cosmetic changes, including separately disclosing the Covid-19 debt overhang from the remaining government debt stock, or more controversial calls such as the cancellation of sovereign debt held by the ECB, will change nothing of substance and could in fact undermine the Eurozone's fiscal credibility.

COUNTRY ANALYSIS
GERMANY, FRANCE, ITALY, SPAIN

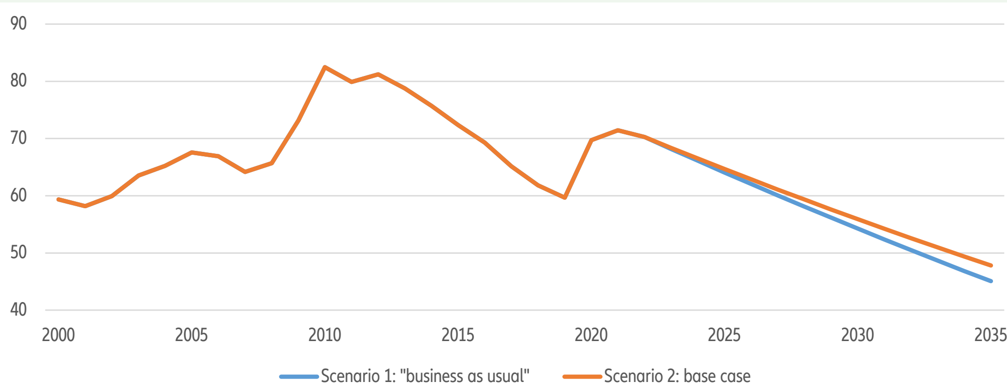
Germany: The fiscal outlier

Germany remains a clear outlier among the large Eurozone heavyweights: Not only do we expect the Covid-19 debt overhang to be eliminated within seven years, but Germany's government debt-to-GDP ratio should decline to a fresh record low by the end of the forecast horizon - even if the country spends an additional EUR36bn on investment each year between 2023-35.

After dropping just below the 60% Maastricht debt criteria in 2019 – for the first time since 2002 – Germany's debt burden rose to 69.7% in 2020 in the wake of the Covid-19 shock. A notable pick-up in government spending aimed at cushioning the economic impact, combined with a drop in revenues, saw Germany's primary balance record its first deficit since 2010. We expect the debt-to-GDP ratio to peak at 71.4% in 2021, - noticeably below the levels reached during the 2012 financial crisis, when it topped 81% - with a strong economic recovery from H2 2021 onwards providing some tailwind to the decline in debt.

Assuming that after 2022 Germany would return to its historical stance when it comes to the primary balance as well as nominal GDP growth, the Covid-19 debt overhang would be eliminated and in turn the 60% Maastricht target reached again by 2028. By 2035, Germany's debt could even drop to 45% of GDP. However, in our base case for the German public debt trajectory, we expect the primary surplus to be smaller, given fiscal headwinds including an aging society and high investment needs for the green and digital transitions. In this scenario, thanks to slightly higher nominal GDP growth, Germany's debt-to-GDP ratio would still decline to 48% by the end of the forecast horizon.

Figure 5: Germany - Government debt (% of GDP)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 6: Germany- Change in government debt until 2035 (% GDP)

Germany: Change in government debt until 2035 (% GDP)

nominal GDP (%)	Primary balance (% of GDP)								
	2	**1.5**	**1**	**0.5**	**0**	**-0.5**	**-1**	**-1.5**	**-2**
4	-44	-38	-33	-27	-22	-16	-10	-5	1
3.5	-41	-36	-30	-24	-18	-13	-7	-1	5
3	-38	-33	-27	-21	-15	-9	-3	3	9
2.5	-35	-29	-23	-17	-11	-5	1	7	13
2	-32	-26	-20	-13	-7	-1	5	12	18
1.5	-29	-22	-16	-9	-3	3	10	16	23
1	-25	-18	-12	-5	2	8	15	21	28
0.5	-21	-14	-7	0	6	13	20	27	34
0	-16	-9	-2	5	12	19	26	33	40

Sources: Refinitiv, Euler Hermes, Allianz Research

Note: The table shows combinations of nominal GDP growth and the primary balance and their impact on the debt trajectory. The red star represents the historical stance if applied going forward and the green star the constellation that we assume in our base case going forward. Cells shaded in red = government debt ratio increases until 2035, cells shaded in yellow = debt declines but by less than what was added by the Covid-19 shock, cells shaded in green = debt declines by more than the Covid-19 overhang by 2035.

The fate of German public finances will depend heavily on the outcome of the September 2021 general election. While no revolution should be expected, evolution is on the cards, with proposals from across the party spectrum calling for a softening of Germany's strict debt brake, which limits the structural deficit at 0.35% of GDP. Proposals include a 'golden rule', which would allow for investment to be financed by debt, as well as the creation of a *Deutschlandfonds* – as mulled by CDU chancellor candidate Armin Laschet - which would operate outside of the budget deficit and in which not only the public but also the private sector could participate. No matter which solution is chosen in the end, the outlook for German government debt would remain very solid. In a simplified exercise, we calculate that even if compared to our base case Germany spent an additional EUR36bn on investment per year between 2023-2035 – and without factoring in any growth dividend – the debt-to-GDP ratio would remain on a firm downward trajectory and drop to 57% by 2035. Assuming that such an investment drive would have a positive impact on GDP growth, the decline in government debt could be even swifter

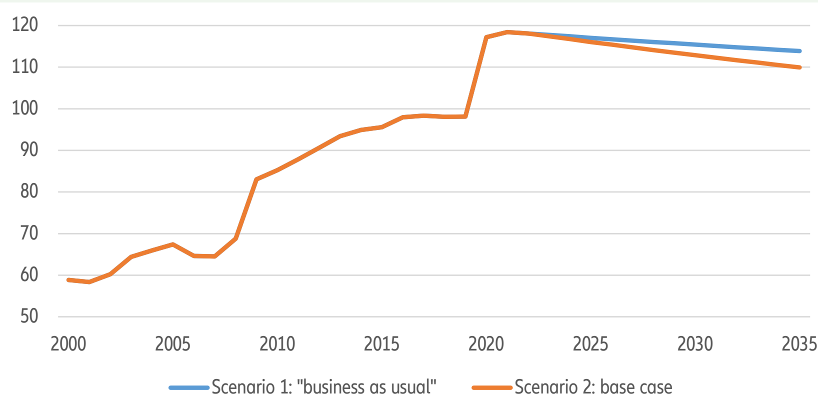
France: Not much room for policy mistakes

Unless France manages to notably boost nominal GDP growth and/or improve its primary balance, it will largely tread water when it comes to making progress on bringing down its Covid-19 debt burden. Even a mild deterioration in the two variables going forward could put France's debt-to-GDP ratio on an upward trajectory over the forecast horizon.

France will see a 20pp increase in its debt-to-GDP burden by 2021 as a result of the Covid-19 shock, with government debt expected to peak at 118%. As French government debt never really embarked on a marked downward trend in the aftermath of the Eurozone debt crisis, this constitutes a new record high. Compared to the year 2000, French government debt has now doubled. In 2022, we it to embark on a very gradual downward trajectory, thanks to the looming recovery tailwinds.

Assuming that for the period 2023-2035, France returns to its historical stance when it comes to the primary balance as well as nominal GDP growth, government debt would hardly decline over the forecast horizon, reaching 114% of GDP in 2035. Going back to fiscal "business as usual" would hence eliminate not even half of the Covid-19-debt overhang in relation to GDP. In fact, in such a scenario, it would take France 67 years to reach pre-Covid-19 debt levels.

Figure 7: France - Government debt (% of GDP)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 8: France - Change in government debt until 2035 (% GDP)

France: Change in government debt until 2035 (%GDP)									
	Primary balance								
nominal GDP %	2	1.5	1	0.5	0	-0.5	-1	-1.5	-2
4	-56	-51	-45	-40	-34	-28	-23	-17	-12
3.5	-52	-46	-40	-34	-29	-23	-17	-11	-6
3	-46	-40	-34	-29	-23	-17	-11	-5	1
2.5	-41	-35	-29	-23	-16	-10	-4	2	8
2	-35	-28	-22	-14	-8	-2	3	9	15
1.5	-28	-22	-15	-9	-3	4	10	17	23
1	-21	-15	-8	-2	5	12	18	25	32
0.5	-14	-7	0	7	13	20	27	34	41
0	-6	1	8	15	22	29	36	43	50

Sources: Refinitiv, Euler Hermes, Allianz Research

Note: The table shows combinations of nominal GDP growth and the primary balance and their impact on the debt trajectory. The red star represents the historical stance if applied going forward and the green star the constellation that we assume in our base case going forward. Cells shaded in red = government debt ratio increases until 2035, cells shaded in yellow = debt declines but by less than what was added by the Covid-19 shock, cells shaded in green = debt declines by more than the Covid-19 overhang by 2035.

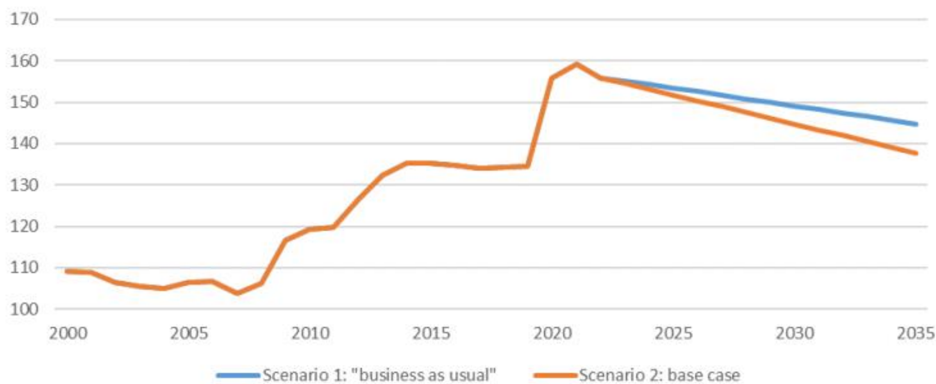
In our base case scenario, we don't really expect France to achieve a much more favorable scenario as regards its fiscal policy. Given a limited appetite and capacity to push through growth-boosting reforms, we see very little room to boost nominal GDP growth. Meanwhile, elevated social discontent and spending pressures deriving from an aging society are unlikely to allow for a notable reduction in government spending. Therefore, France's debt-to-GDP ratio should still only drop to 110% by 2035 in this scenario. However, it would take 34 years to get back to pre-Covid-19 debt levels. Nevertheless, even under reformed EU fiscal rules, such limited progress may not suffice and could see France vulnerable in the case of an adverse shock. After all, even very limited policy lapses could cause France's debt-to-GDP ratio to rise over the forecast horizon.

Italy: Could Covid-19 emerge as a game-changer for public finances?

Italy's public finances have long been the elephant in the room – during the Eurozone debt crisis and even more so during the Covid-19 crisis, which pushed its debt-to-GDP ratio close to 160%. However, with Prime Minister Mario Draghi overseeing the implementation of the EUR238bn recovery plan, the stars may be aligning for renewed momentum to tackle Italy's long-standing lack of economic growth, and in turn its excessive public debt burden.

In Italy, government debt looks set to jump to a new record high of 159.3% in 2021 – up roughly 25pp since 2019. A return to a 'business as usual' fiscal stance, i.e. the average primary balance and nominal growth rates as seen during the period 2000-19, would see Italy only make little progress in climbing down the debt mountain. In fact, by 2035, the debt-to-GDP ratio would only come down to 145% and therefore eliminate only around 50% of the Covid-19 debt overhang in relation to GDP. The key issue holding back a more meaningful reduction in government debt remains low nominal GDP growth, which registered on average at +2% per year during the two decades running up to the Covid-19 shock. Meanwhile, sizeable primary surpluses of on average 1.6% of GDP during that time acted as an important shield against market concerns about Italian debt sustainability but were nevertheless more than offset by a hefty interest rate bill in relation to GDP.

Figure 9: Italy - Government debt (% of GDP)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 10: Italy - Change in government debt until 2035 (% GDP)

Italy: Change in government debt until 2035 (% GDP)

nominal GDP \ Primary balance (%)	2	1.5	1	0.5	0	-0.5	-1	-1.5	-2
4	-54	-48	-42	-36	-30	-24	-18	-12	-6
3.5	-46	-40	-34	-28	-22	-16	-10	-3	3
3	-38	-32	-26	-19	-13	-7	0	6	12
2.5	-29	-23 ★ (green)	-16	-16	-3	3	10	16	23
2	-20	-13	-6	0	7	14	20	27	34
1.5	-10	★ (red) -3	4	11	18	25	32	39	45
1	1	8	15	22	30	37	44	51	58
0.5	13	20	28	35	42	50	57	64	72
0	25	33	41	48	56	63	71	78	86

Sources: Refinitiv, Euler Hermes, Allianz Research

Note: The table shows combinations of nominal GDP growth and the primary balance and their impact on the debt trajectory. The red star represents the historical stance if applied going forward and the green star the constellation that we assume in our base case going forward. Cells shaded in red = government debt ratio increases until 2035, cells shaded in yellow = debt declines but by less than what was added by the Covid-19 shock, cells shaded in green = debt declines by more than the Covid-19 overhang by 2035.

In our base case for the Italian debt trajectory, however, we see reasons to be more optimistic. In particular, the combination of Mario Draghi taking over as Prime Minister in February 2021 and the expected growth dividend from the successful implementation of Italy's EUR238bn recovery plan - which centers on higher public investment coupled with key reforms of the judiciary, public administration, bureaucracy and competition - could be a major game-changer and justify an upgrade of Italian GDP growth expectations. In fact, we expect that with the plan's full and timely implementation, the Italian economy could well grow at an average pace of +2.5% until 2035. Even though the primary surplus may prove lower at 1.4% in such a scenario, government debt would decline to 138% by 2035. In fact, in our base case, higher growth expectations would cut the number of years needed to eliminate the Covid-19 debt overhang from 26 to 16.

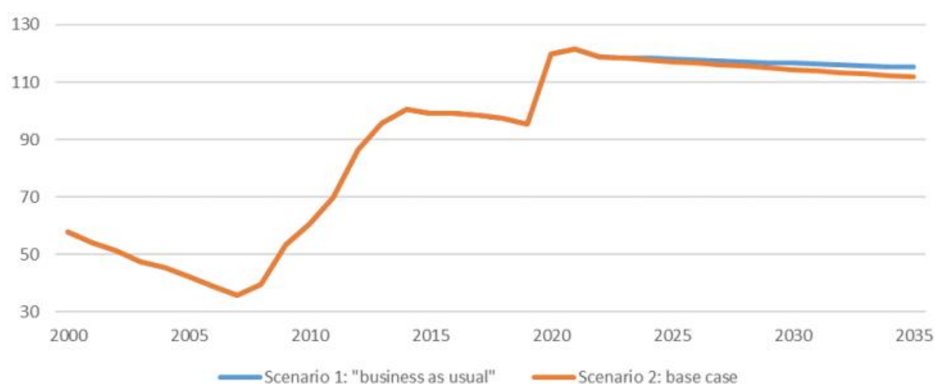
The stakes are high: As the overview table shows, at the historical average (red star) any loosening in the fiscal stance that fails to boost long-term growth prospects would lead to a rising debt burden over the forecast horizon, which would certainly alert investors and rating agencies.

Spain: Sticky primary deficit keeping a lid on debt consolidation

Spain's issue is not the lack of growth but its difficulty in reigning in its (primary) deficit: Any progress on this front would provide a notable tailwind to Spain's deleveraging process. Without such a fresh impetus, Spanish government debt will move largely sideways over the forecast horizon.

Spain's government debt-to-GDP ratio is on track to peak at 121.7% in 2021 – a 26pp increase compared to end-2019. In a back to 'business as usual' scenario, Spanish government debt would move largely sideways over the forecast horizon, registering at a still elevated 115% of GDP in 2035. At this pace of debt reduction, it would take 89 years for Spain to eliminate the Covid-19 debt overhang. With nominal GDP growth averaging at 3.6% during the period 2000-19, the slow descent from the debt mountain would largely be attributable to Spain's struggle to control its primary balance, which averaged at -1.3% in relation to GDP. The latter explains to a large degree why Spain only made very limited deleveraging progress in the aftermath of the Eurozone debt crisis. In fact, Spain saw its last (primary) budget balance in 2007.

Figure 11: Spain - Government debt (% of GDP)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 12: Spain - Change in government debt until 2035 (% GDP)

Spain: Change in government debt until 2035 (% GDP)

nominal GDP (%) \ Primary balance (% GDP)	2	1.5	1	0.5	0	-0.5	-1	-1.5	-2
4	-50	-44	-39	-33	-27	-21	-15	-9	-3
3.5	-45	-39	-33	-27	-21	-15	-9	-3	3
3	-39	-33	-27	-20	-14	-8	-2	4	11
2.5	-33	-26	-20	-14	-7	-1	6	12	18
2	-26	-19	-13	-6	0	7	13	20	27
1.5	-19	-12	-5	2	8	15	22	29	35
1	-11	-4	3	10	17	24	31	38	45
0.5	-3	5	12	19	26	33	41	48	55
0	6	14	21	29	36	44	51	58	66

Sources: Refinitiv, Euler Hermes, Allianz Research

Note: The table shows combinations of nominal GDP growth and the primary balance and their impact on the debt trajectory. The red star represents the historical stance if applied going forward and the green star the constellation that we assume in our base case going forward. Cells shaded in red = government debt ratio increases until 2035, cells shaded in yellow = debt declines but by less than what was added by the Covid-19 shock, cells shaded in green = debt declines by more than the Covid-19 overhang by 2035.

Arguably the 2000-19 average for variables underpinning Spanish government debt dynamics may not be the most appropriate yardstick. In fact, we think that the years in the run-up to the Covid-19 crisis may serve as a more appropriate guide – i.e. the aftermath of the Eurozone debt crisis. Therefore, in our base case, we pencil in a lower primary deficit compared to the long-term averages as well as slightly lower nominal growth prospects. In such a scenario, Spanish government debt would decline somewhat swifter, reaching 112% of GDP by 2035. The number of years needed to reduce the Covid-19 debt overhang would almost halve from 89 to 47.

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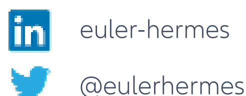

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