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EMU

Slow descent from the debt mountain

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The consolidation of Eurozone public finances has made good progress in recent years, with the average fiscal deficit falling to a record low in 2018. But the legacy of the European debt crisis still looms large. Many Eurozone member states continue to sit on high mountains of debt, the consolidation of which is likely to be a slow and drawn-out process. Our calculations show that by 2033, of the three EMU heavyweights and the four former crisis countries, only Germany and Ireland will comply with the 60% debt criterion. Spain and Portugal will make good progress over the next 15 years, and in France the trend is going in the right direction. Greece and Italy, however, will still boast debt levels of well above 100% of economic output in 2033. Even to achieve these consolidation results most countries will have to display more fiscal discipline because the prevailing low interest rate environment will only partially compensate for slowing economic growth and lower primary balances. In the long-term, this is hardly a sustainable strategy to reduce government debt in the Eurozone.

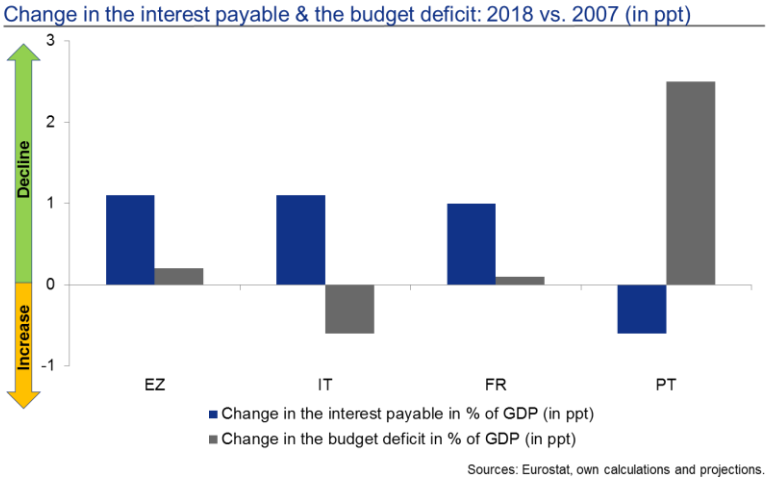
Our interactive Debt Tool allows for the simulation of debt ratio trends in selected Eurozone countries by applying alternative assumptions, and the comparison of the figures with our forecasts.

PUBLIC FINANCE IN THE EUROZONE: STATUS QUO – IN 2018 THE FISCAL DEFICIT STOOD AT 0.5%, ITS LOWEST LEVEL SINCE THE YEAR 2000

Tailwind from economic recovery and low interest rates

The development of public finances in the Eurozone has been seeing some improvement in recent years. In 2018, the average government budget deficit stood at 0.5% of economic output – its lowest level since 2000 and down from 6.2% as recently as 2012. However, this cannot be attributed to a stringent consolidation policy but rather to the positive economic developments in the Eurozone. Even though government spending as a percentage of GDP has fallen for the fifth year in a row (to 46.8% in 2018 after 48.5% in 2015), in absolute terms it has risen continuously since 2012. In 2018, it registered about 20% above pre-crisis levels. Another key driver of the declining budget deficit is the European Central Bank's ultra-loose monetary policy. Since the ECB announced that, within its mandate, it would do whatever it takes to save the euro, the overall interest burden in the Eurozone has fallen sharply – from 3.0% in 2012 to 1.8% in 2018. However, not all governments have used the additional fiscal space resulting from a shrinking interest burden to consolidate their finances.

Change in the interest payable and the budget deficit since 2007



The reduction of the debt mountain has only just begun

Despite the headway made in reining in public-sector deficits in the Eurozone, the consolidation of government debt has barely begun. Although the government debt ratio fell for the fourth year running in 2018, the debt burden at 85.1% of GDP is still almost 20 percentage points higher than it was before the crisis. In 2017, only eight Eurozone countries met the 60% Maastricht debt criterion. In five member states, the government debt ratio was still above 100% in 2018.

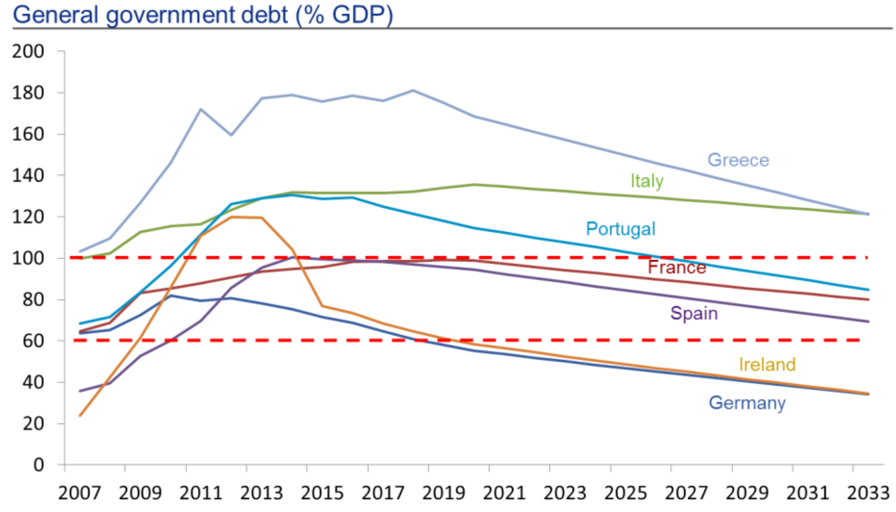
PUBLIC FINANCE IN THE EUROZONE: QUO VADIS? OVER THE NEXT 15 YEARS, ONLY GERMANY AND IRELAND WILL MEET THE 60% DEBT CRITERION

Each year we forecast the development of government debt (D) in selected Eurozone countries over a 15-year horizon using long-term assumptions for nominal GDP growth (g), the primary balance (PB) and the average interest rate on government debt (r). We refer to the following equation:

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

Our calculations for the development of government debt in the Eurozone Big Three (Germany, France and Italy), and in the four former crisis countries (Spain, Portugal, Ireland and Greece), show that a sustained reduction in the respective debt mountains even under rather favorable conditions is likely to be a slow and drawn-out process.

Projections for the development of public debt in selected Eurozone countries

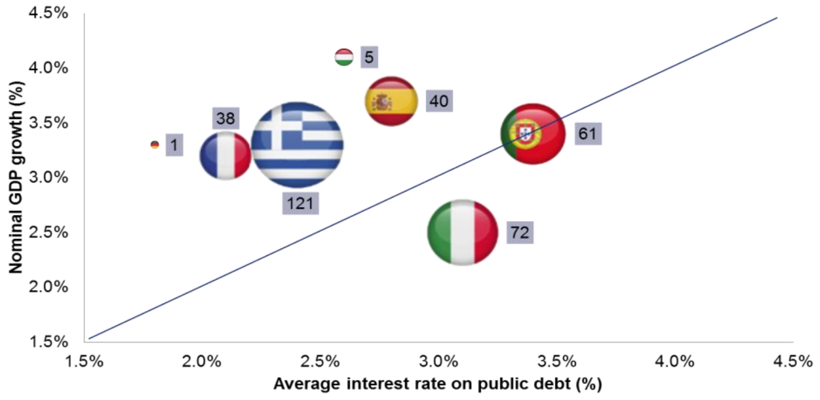


Sources: Eurostat, own calculations and projections.

Over the next 15 years, only Germany and Ireland will manage to meet the 60% debt criterion laid out in the Stability and Growth Pact. Germany will probably succeed as early as 2019. Spain and Portugal continue to make good progress and the trend is also moving in the right direction in France. Meanwhile Greece, as well as Italy, stand out for still featuring government debt ratios of 100% and higher - even at the end of the forecast horizon. While Greece, with a debt level of 181% in 2018, has the worst starting point, in Italy it is the very unfavorable growth prospects compared to the interest burden that will hinder progress in consolidation.

Public debt reduction prospects in selected Eurozone countries

Nominal GDP growth*, average interest rate on public debt* & debt to GDP** >60% (size of the bubble)



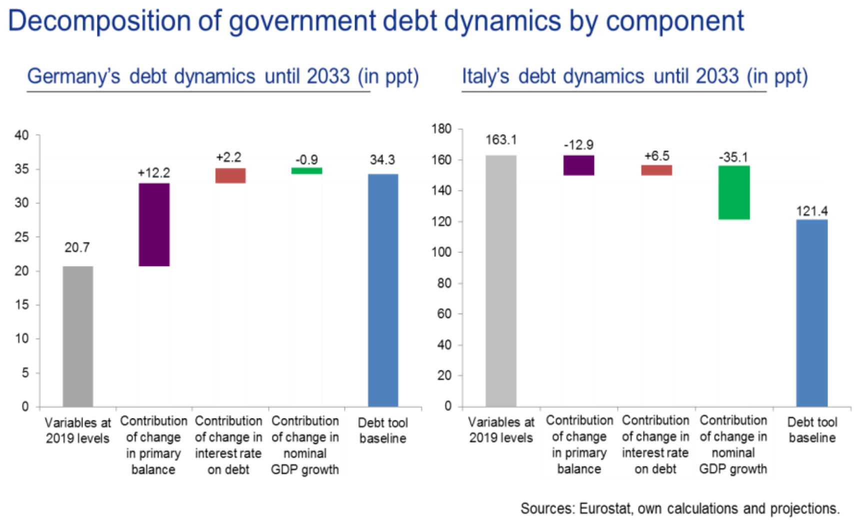
Sources: Eurostat, own calculations and projections.

*Average forecast for the period 2019-2033, **Debt in % of GDP in 2018 above the 60%-mark.

The breakdown of the change in the public debt ratio into its key drivers – economic growth, primary balance and average interest rate on government debt – shows which factor, compared to its 2019 value, makes the main contribution to reducing the debt ratio by 2033. The results vary greatly from country to country. In Italy, for example, a lasting recovery of growth prospects and the primary surplus – both of which are currently at very low levels due to the government's expansive fiscal course -– are a prerequisite for reducing the debt burden.

By way of comparison, should Italy maintain its current fiscal stance in an unchanged economic environment, government debt would rise to 163% of economic output by 2033 rather than decline to 121% as envisoned in our baseline scenario. Like Italy, most countries considered here will have to display more fiscal discipline to achieve the calculated consolidation results, with the prevailing low interest rate environment only partially compensating for slowing economic growth and/or lower primary balances. In the long-term, this is hardly a sustainable strategy to reduce government debt in the

Eurozone. In contrast, in Germany we expect a slowing debt reduction momentum – thanks in particular to lower primary surpluses – over the forecast period.



If Germany were to maintain the primary surplus of around 2% expected for 2019, government debt would not fall to 34% but to around 20% of economic output by 2033, assuming an unchanged economic backdrop. Meanwhile, the moderate expected increase in the average interest rate on government debt over the forecast period will have only a minor impact on the government debt dynamics in Italy and Germany.

Our interactive Debt Tool allows you to simulate the development of the debt ratios of selected Eurozone economies by applying alternative assumptions, and to compare the figures with our forecasts.

How have our results for the long-term debt sustainability in the Eurozone changed over the past year?

Even minor changes in fiscal and economic policy are reflected in a change in long-term debt sustainability. Over the past 12 months, the following changes have occurred in the individual variables we forecast:

- Economic growth: Our current forecasts for long-term nominal GDP growth in Germany, France, Italy and the four former EMU crisis countries Spain, Portugal, Ireland and Greece are slightly lower on average compared to one year ago. In addition to the gloomy medium-term outlook for world trade, the impact of lingering populist tendencies is also reflected here. These will hamper the implementation of growth-promoting structural reforms. Measured against last year's already very cautious growth forecast, the correction in Italy's GDP forecast is particularly marked: from +1.1% to +0.8%.

- Primary balance: In almost all the countries considered here, we now expect a slightly lower primary balance in the long term. In addition to weaker economic growth, which is likely to weigh on government revenues, the decisive factor is the rising pressure on government spending as a result of populism.
- Average interest rate on government debt: We now assume that the ECB will not begin normalizing its monetary policy before 2021. This means that the current low interest rate environment will be maintained for much longer than expected, which will have a positive effect on the average interest rate on government debt.

In conclusion, for all countries considered here, government debt at the end of the forecast period is now estimated to be somewhat higher, with the exception of Spain and Portugal, where there will be slight improvements. For Italy, we see a significant deterioration in the dynamics of debt reduction. Our forecast for government debt as a percentage of economic output rises from 112% to 121% for 2033.

Changes of long-term assumptions regarding the projection of government debt in selected Eurozone countries

Changes 2019 vs. 2018 (in ppt)

	Germany	France	Italy	Spain	Portugal	Ireland	Greece
Nominal GDP growth	-0.10	-0.20	-0.30	0.00	-0.10	-0.40	0.00
Primary balance % of GDP	-0.50	-0.60	-0.40	0.30	0.60	-0.70	0.00
Implicit effective interest rate on debt	-0.30	-0.20	-0.10	-0.20	-0.10	-0.40	0.00

Sources: Own calculations and projections.

LONG-TERM DEBT PROJECTIONS FOR SELECTED EUROZONE COUNTRIES

Germany: Debt ratio halved by 2033

Although Germany cannot exactly be described as a country with a particular zest for reform, the economy is strong enough to allow an average increase in GDP of +1.5%, in real terms over the forecast horizon. Our forecast puts the rate of inflation at 1.8%, slightly above the average rate for the period from the start of the monetary union to date. When it comes to reducing debt, Germany has the most favorable starting position out of all the countries under consideration. In 2018, the debt ratio came in at 61% and looks set to fall below the 60% debt criterion set out in the European fiscal rules in 2019. In addition, the fact that German government bonds are considered a safe haven is helping to keep down the interest burden, which we estimate to equal 1.8% over the next 15 years. Assuming average primary surpluses of 1.1%, German government debt, in relation to GDP, will be pushed down to an impressive 42% in 2028 and 34% in 2033.

France: Moderate fiscal discipline means that debt reduction will only progress at a slow pace

We estimate that real French economic growth will come in at +1.5% in the long term, broadly in line with the EMU average, while we expect stable inflation rates to reach around 1.7% in the long run. In order to meet the European consolidation requirements as best it can, we assume that the French government will generate a primary surplus corresponding to 0.2% of GDP. Despite the low yields on French government bonds of 2.1% on average, this will not be sufficient to achieve a rapid reduction in government debt. The debt ratio will drop from over 98% in 2018 to 87% in 2028 and 80% at the end of the forecast horizon.

Italy: Weak economic growth results in limited scope for debt reduction

The continuing weak growth momentum of the Italian economy is only likely to allow for average annual growth to the tune of +0.8% over our forecast period. We expect the annual rate of inflation to come in at 1.7%. A primary balance (balance of government revenue and government spending, excluding interest payments) of 1.5% is a realistic prospect, given moderate economic growth and the necessity to gradually consolidate government spending. The average interest rate on sovereign debt is tipped to amount to 3.1% over the forecast period. Italy will only be able to make sluggish progress in reducing its public-sector debt: the debt ratio will fall, over the period analyzed, from the current level of 132% of economic output to about 121%, meaning that it will still remain far above the 100% debt level threshold in 2033.

Spain: Debt ratio only slightly above 60% in 2033

The Spanish program of reforms is paying off and we predict average GDP growth till 2033 to come in at +1.8%. Long-term inflation rates of 1.9% on average will prove consistent with the ECB's price norm (close to but below 2%). The average interest rate on sovereign debt will remain low from a historical perspective and yield around 2.8% p.a. Together with strong economic growth, Spain will generate annual primary surpluses of approximately 1.1% in relation to GDP. Therefore, Spain will manage to reduce its debt ratio fairly quickly from the current level of almost 100% to 79% in 2028 and 69% in 2033.

Ireland: Strong economic growth driving debt reduction

Last year saw Ireland achieve the highest rate of economic growth in the Eurozone once again, at +6.7%. The high GDP growth figures are still due to a catch-up process after the deep recession. In the long term, we expect Irish average economic growth to come in at +2.3% a year. We assess the growth outlook of the flexible Irish economy to be the best among the considered EMU member states. Based on an inflation rate averaging 1.8% over the forecast horizon, this will result in a strong nominal increase in GDP of +4.1%. This will make a considerable contribution to reducing the mountain of sovereign debt. Assuming primary balances of 1.3% of GDP on average and sustained moderate interest rates on public debt averaging 2.6%, the country's debt ratio will drop from the current level of around 65% to 35% in 2033.

Portugal: Debt reduction supported by improved competitiveness

The reforms implemented over the past few years have made the Portuguese economy more competitive, meaning that average annual growth of +1.5% over the forecast period is realistic. Based on an inflation rate of 1.9%, this produces dynamic nominal economic growth of +3.4% per year. Given the favorable outlook for the Portuguese economy, the country can achieve a primary surplus of 2.1% a year in the period leading up to 2033. The average interest rate on sovereign debt is tipped to amount to 3.1% over the forecast period. Portugal will be able to push its debt ratio down from the current level of 121% of economic output to around 85% in 2033.

Greece: Debt ratio will remain far above the 100% mark in 2033

Under the assumption that Greece remains on its reform path, we expect the Greek economy to achieve annual economic growth of +1.6% until 2033. As the under-utilization of the Greek economy is expected to continue, we predict an average inflation rate of 1.7%. The economic recovery that appears to be on the cards is likely to allow Greece to achieve a primary surplus averaging 2.6% of gross domestic product. Thanks to the various forms of relief granted by its lenders, we predict that the average rate of interest on Greece's sovereign debt will come in at 2.4% over the forecast period. Therefore, Greece will be able to reduce its debt burden from the current level of 181% of economic output to

121% in 2033. Despite good progress, the Greek public debt ratio will remain the highest of all considered EMU member states.

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The Allianz Group is one of the world's leading insurers and asset managers with more than 92 million retail and corporate customers. Allianz customers benefit from a broad range of personal and corporate insurance services, ranging from property, life and health insurance to assistance services to credit insurance and global business insurance. Allianz is one of the world's largest investors, managing around 673 billion euros on behalf of its insurance customers. Furthermore our asset managers PIMCO and Allianz Global Investors manage more than 1.4 trillion euros of third-party assets. Thanks to our systematic integration of ecological and social criteria in our business processes and investment decisions, we hold the leading position for insurers in the Dow Jones Sustainability Index. In 2018, over 142,000 employees in more than 80 countries achieved total revenues of 131 billion euros and an operating profit of 11.5 billion euros for the group. These assessments are, as always, subject to the disclaimer provided below.