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EUROZONE

Fiscal policy tailwind not sufficiently exploited

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Thanks to favorable macroeconomic conditions, the consolidation of public finances in the eurozone has made some progress. Nevertheless, the from an economic point of view sunny times were not used sufficiently to repair the roof: Government debt in the eurozone is still well above pre-crisis levels, while in some highly indebted euro countries the decline from the debt mountain has only just begun. Our calculations show that even under favorable conditions the former EMU crisis countries will probably still not meet the Maastricht debt criterion in 15 years' time. Adherence to a consolidation-oriented fiscal policy is essential to make the eurozone weatherproof for future crises. Regaining fiscal leeway is necessary to stabilize the economy during a downturn. This is also the only way to relieve the ECB, whose monetary policy ammunition looks increasingly exhausted.

The development of government debt in the eurozone is broadly in the right direction. In 2017, the government budget deficit stood at 0.9% of economic output – its lowest level since 2007. Looked at by country, the trend in public finances still varies widely, although the gap is now smaller than it was just a few years ago. In 2018, all member states are on course to meet the 3% deficit criterion for the first time since the start of monetary union.

Tailwind from economic recovery and low interest rates

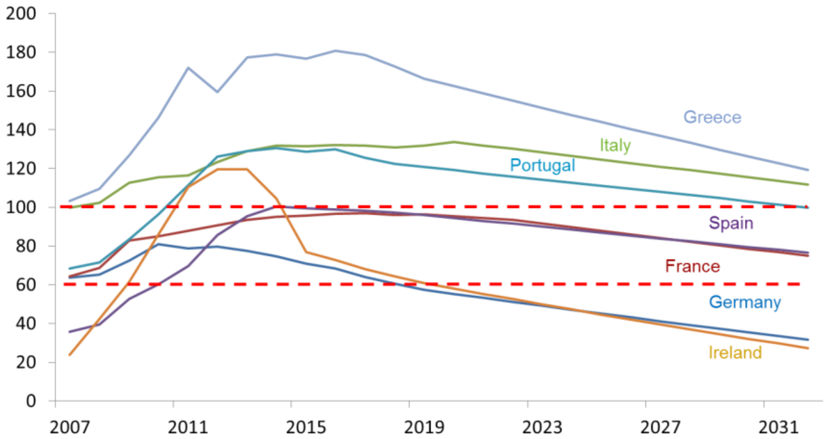
However, the declining public deficit cannot be attributed to a stringent consolidation policy - in fact, government spending has risen steadily since 2007 - but above all to the positive economic development in the eurozone. In 2018 GDP looks set to grow above the potential rate for the fourth consecutive year. 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% in 2012 to 2% in 2017.

Reduction in the debt mountain has only just begun

Despite the headway made in reining in public-sector deficits in the eurozone, the reduction in the debt mountains has barely begun. Although the government debt ratio fell for the third year running in 2017, the debt burden at around 87% of GDP is still almost 20 percentage points higher than it was before the crisis. In 2017 only seven eurozone countries met the 60%-Maastricht debt criterion. In four member states, by contrast, the government debt ratio is still above 100%, in some cases significantly.

Projections for the development of public debt in selected eurozone countries

General government debt (% GDP)



Sources: Eurostat, own calculations and projections.

Fiscal headwinds will increase

You have to fix the roof when the sun is shining. The clean-up work in the eurozone is far from complete in view of the lingering public debt mountains. This is partly due to the fact that fiscal policy tailwinds have not been sufficiently exploited. Going forward, without more fiscal discipline consolidation progress will slow down, as the golden times for fiscal policy are slowly coming to an end: the upswing in the eurozone is showing first signs of old age and interest rates are likely to rise again – albeit gradually – starting in autumn 2019.

Our calculations for the development in 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 is likely to be slow and drawn-out even under good conditions. Over the next 15 years among these countries only Germany and Ireland will manage to meet the 60% debt criterion of the Stability and Growth Pact. Germany will probably succeed as early as next year. Meanwhile Greece, Italy and Portugal should still have government debt ratios of 100% and higher even in 2032.

The adherence to a consolidation-oriented fiscal policy is indispensable to make the Eurozone weatherproof for future crises. For one the high level of legacy public debt increases the eurozone's vulnerability to crises by being a potential trigger itself. In addition regaining fiscal policy scope is also necessary to cushion the economy during a cyclical downturn. This is the only way to relieve the burden on the ECB, whose monetary policy ammunition looks increasingly exhausted.

Our interactive Debt Tool allows you to simulate the development in the debt ratios of selected eurozone economies by applying various assumptions, and to compare the figures with our forecasts. You can find the tool here:

https://www.allianz.com/en/economic_research/research_data/debt-tool/

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