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Eurozone public debt: The interest rates reality check

How the end of zeronomics changes public debt dynamics in Europe

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EXECUTIVE SUMMARY

In recent years, Eurozone governments borrowing more and more seemed to matter less and less as falling interest rates made high and rising debt levels less burdensome. However, sovereign debt dynamics are bound to significantly deteriorate as the ECB raises interest rates to fight rampant inflation. Now all eyes are on new budget announcements by several Eurozone governments. With monetary policy becoming increasingly restrictive, finance ministers need to strike a delicate balance between extending targeted fiscal support and potentially exhausting available fiscal space at a time when growth is slipping and refinancing costs are rising. So far, announced budgets suggest strong crisis support until next year at the risk of delaying fiscal adjustment. We expect budget deficits to decline in all large Eurozone economies, except for France (at 5.5% of GDP). The French government just published its draft budget bill for 2023, which extends support measures to households and firms but implies an overall reduction in real spending.

In this paper, we assess the consequences of the new debt reality in the four largest Eurozone countries by projecting the expected debt path over a 15-year horizon. Our key takeaways are:

- *The largest economies will struggle to reduce elevated government debt.* **In fact, the government-debt-to-GDP ratios in France, Italy and Spain are set to increase**. On the other hand, Germany will cement its position as a fiscal policy outlier by pushing its debt ratio below the 60% mark by 2028.
- *Rising refinancing costs will add pressure to debt sustainability.* Assuming both government debt ratios and the average maturity of government debt are kept constant over the next 15 years, a lasting increase in the interest rate level by 200bps means that interest expenses in relation to GDP will tally up to 1.4% in Germany, 2.3% in France, 2.4% in Spain and a whopping 3% in Italy by 2030. To put these figures into perspective, for Italy and Spain, the additional budget burden exceeds the total public investment in relation to GDP in 2019.

To avoid the interest hangover ahead, and protect fiscal space for spending on the green and digital transitions, governments require much greater fiscal discipline and/or higher nominal growth. However, current debt-to-GDP ratios in France (113%), Italy (151%) and Spain (118%) imply a Herculean fiscal consolidation effort, i.e. a notable reduction in the primary deficit. Relative to its fiscal stance in 2023, the largest adjustment would be needed in France. Conversely, vulnerable countries, such as Italy, would need to almost double potential growth to lower debt levels if fiscal adjustment is not feasible.

New government budgets prioritize crisis support and delay necessary fiscal adjustment.

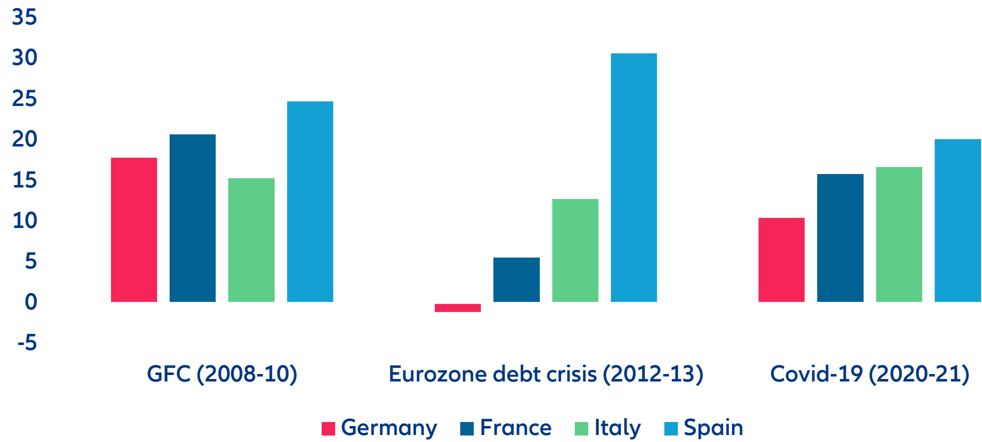
As fiscal policy takes center stage in mitigating the economic cost of the current energy crisis, all eyes are on the upcoming budget announcement by several Eurozone governments. With monetary policy becoming increasingly restrictive, finance ministers need to strike a delicate balance between extending targeted fiscal support and potentially exhausting available fiscal space. The planned budgets will significantly influence debt sustainability at a time when growth is slipping and refinancing costs are rising.

So far, announced budgets suggest continued crisis support until next year and a protracted fiscal adjustment. On 26 September, the French government published its draft budget bill for 2023, which extends support measures to households and firms but still implies an overall reduction in real spending due to spending cuts in non-core areas and a tax hike on energy companies. However, extending the caps on regulated energy tariffs and offering effective tax cuts through inflation-indexing limits the fiscal adjustment to merely 0.2% of GDP. In Germany, current plans suggest a budget deficit of less than 3% of GDP next year. Earlier this month, the government also announced that the constitutional debt brake will not be affected by the current EUR65bn relief package. Even the just announced "protective shield" to fund a gas price cap, for which up to EUR200bn (5.6% of GDP) has been earmarked, would not require a supplementary budget (but the exact cost will depend on specifications that still need to be decided over the coming weeks). While the Italian Cabinet approved the updated economic and fiscal projections on 28 September, a 2023 draft budget is expected only in November due to the recent parliamentary elections that swept a new right-wing coalition into power. Much like in Germany and France, we are likely to see crisis support pushing back fiscal consolidation in Italy. Overall, for 2023, we expect budget deficits to decline in Italy (-4.6%), and to a lesser extent in Germany (-2.5%) and Spain (-5.4%). The budget deficit is set to widen only in France to -5.5% of GDP.

Over the past two decades, the only way for Eurozone government debt was up.

Eurozone government debt relative to GDP has risen by a whopping +50% since 2007. During this time, governments resorted to sweeping fiscal support to mitigate the economic fallout of three major crises: When the Covid-19 shock hit Eurozone economies in early 2020, many were still grappling with legacy debt they had piled up following the global financial crisis (GFC) and the subsequent Eurozone debt crisis. As a result, the Eurozone government debt ratio jumped to a new all-time high of 97% in 2020. Meanwhile, falling interest rates helped accommodate higher debt burdens by pushing down refinancing rates (Figure 1).

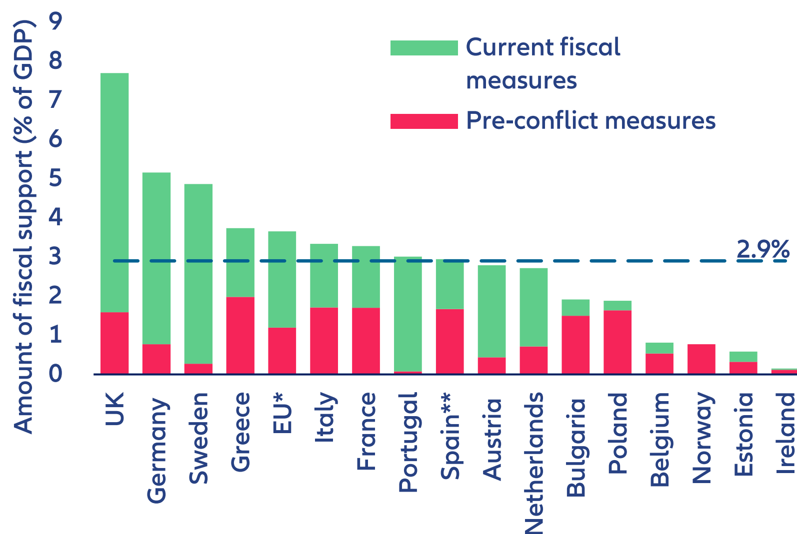
Figure 1: Change in the government debt ratio during crisis times (pps)



Sources: Refinitiv, Allianz Research.

In 2022-23, Eurozone public finances will remain stretched, with fiscal policy once again called upon to help soften the economic fallout from the evolving energy crisis. Most governments have already announced a wide range of mostly targeted support measures, covering both households and corporates to the tune of 3% of GDP (Figure 2). Adding government debt guarantees and liquidity facilities to energy utilities to the tab would push the potential fiscal bill to roughly half a trillion euros. As a result, we expect the aggregate Eurozone government debt ratio to remain close to 100% in 2022-23.

Figure 2: Fiscal measures to address the impact of the energy and cost-of-living crisis

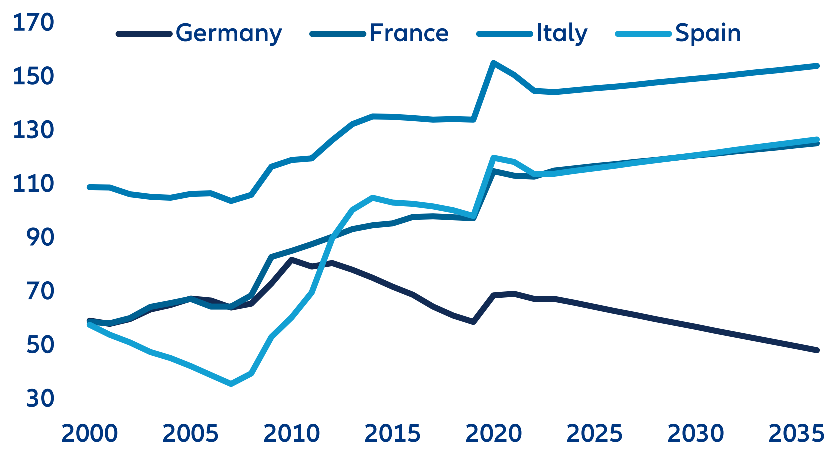


*Sources: National authorities, Bruegel, Allianz Research. Note: fiscal measures include energy-related transfers, price caps and reduced energy surcharges, as well as credit lines to energy utilities (e.g. Austria, Germany, Sweden, and the UK). */ EU is approximated as the GDP-weighted average of the sample countries; **/ assumes an energy subsidy of EUR150 for 11.5mn (lower-income) households; ***/ includes the current EUR56 bn package but does not consider additional measures being proposed.*

It was fun while it lasted but we think the best days for sovereign debt are over.

The return of inflation is a true game-changer for Eurozone debt dynamics. In fact, we do not expect inflation to revert to its anaemic pre-Covid-19 levels any time soon. To add to this, the "three Ds" – demographics, decarbonization and deglobalization – are likely to keep price pressures elevated. Higher inflation helps beautify debt ratios by lifting nominal GDP growth. However, this effect tends to be short-lived as central banks raise interest rates to control inflation. Rising interest rates meanwhile will slowly but surely feed into a higher interest burden for sovereigns. In this new environment, even stabilizing public debt burdens will prove to be an uphill battle.

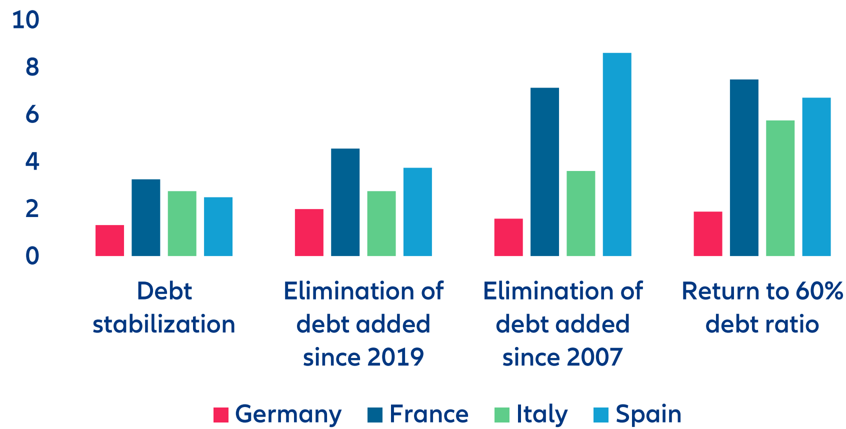
Figure 2: Baseline scenario for Eurozone government debt (% GDP)



Sources: Refinitiv, Allianz Research.

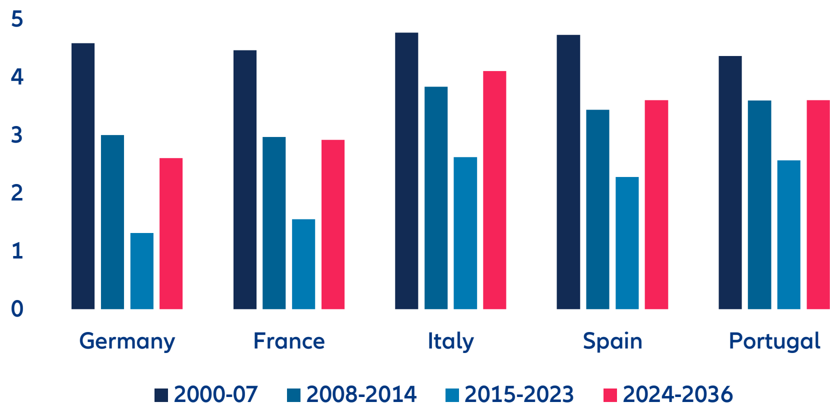
What would it take to stabilize debt at current levels, or even return to the 60% debt ratio outlined in the Maastricht Treaty? With the help of our interactive Debt Tool, we assess the consequences of this changed debt reality in the four largest Eurozone countries by projecting the likely debt path over a 15-year horizon (Annex). Given the deterioration in the primary balance since 2020, all Eurozone heavyweights would need to make significant improvements. among the four largest Eurozone economies, only Germany will succeed in reducing government debt (Figure 2). To stabilize debt at current levels, France stands out as the country facing the largest adjustment from an expected primary deficit of -3.7% in 2023 to an average of -0.5% over the period 2024-36. But given the government's current plan of reducing the budget deficit to less than 3% GDP only in 2027, a significant fiscal adjustment could prove challenging. In fact, France has only managed to run a primary deficit of -0.5% or less four times since 2000 (Figure 3).

Figure 3: Necessary improvement in the primary balance (in pps) to achieve consolidation targets in the period 2024-36



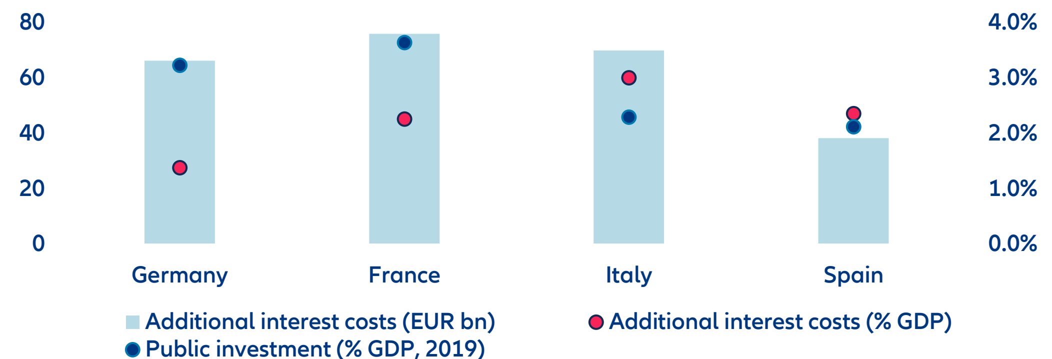
Sources: Refinitiv, Allianz Research.

Figure 4: Average interest rate on debt (%)



Sources: Refinitiv, Allianz Research.

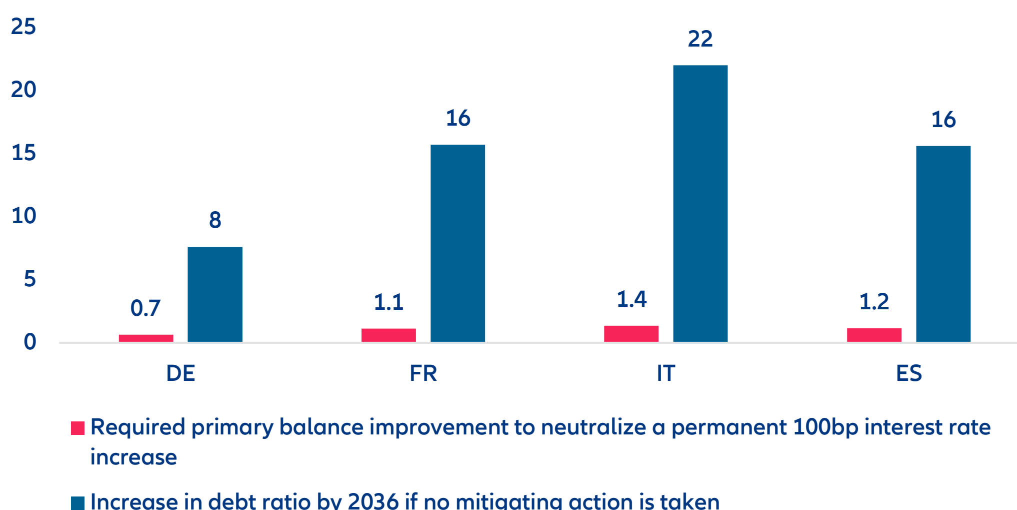
Figure 5: Additional interest costs (% GDP, ths and EUR bn, lhs) once the higher interest rate level has fully fed through to the average interest rate on debt vs. public investment in 2019 (% GDP)



Sources: Refinitiv, Allianz Research.

Mind the interest hangover ahead! As the outlook for sovereign debt enters a new phase, governments need to be aware of the looming debt hangover resulting from the mounting interest burden. Based on our interest rate outlook, the average interest rate on government debt will return to levels last seen in the period 2008-14 – i.e. before the ECB embarked on quantitative easing. Assuming the government debt ratio is kept constant over the forecast horizon, the additional tab for interest expenses in relation to GDP will tally up to 1.4% in Germany, 2.3% in France, 2.4% in Spain and a whopping 3% in Italy (Figures 4 and 5). For the latter two countries, the added budget burden exceeds what was spent on total public investment in relation to GDP in 2019. If interest rates rise more than expected (e.g. by an additional +100bps), a stronger fiscal tightening would be required to neutralize the adverse impact on debt dynamics – from 0.7pp in Germany to twice that in Italy (Figure 6).

Figure 6: Required primary balance improvement to neutralize an additional +100bp increase in interest rates & projected debt ratio increase by 2036 if no mitigating action is taken



Sources: Refinitiv, Allianz Research.

In this context, Eurozone governments clearly need to future-proof their public finances now. A primary deficit close to the long-term historical average will not be sufficient to bring down debt levels in several key Eurozone countries in an environment of rising interest rates. Given the growing demands on fiscal policy, solely cutting back on government spending (or reallocating funds to more growth-friendly measures) is unlikely to be an option. Instead, governments should rather (i) cut down on wasteful spending by implementing comprehensive spending reviews, (ii) implement growth-boosting structural reforms to raise potential growth and (iii) prioritize public investment over consumption, using limited public funds to crowd in private investment.

Country deep dives

Germany: Six years before hitting the 60% debt criterion

Germany will remain a clear fiscal outlier across the Eurozone's largest economies. We expect Germany's government debt-to-GDP ratio to drop below the 60% mark, before reaching a fresh record low by the end of the forecast horizon.

After briefly dropping below the 60% debt level criteria in 2019 – for the first time since 2002 – Germany's debt burden rose above 69% in 2021 in the wake of the Covid-19 shock. We expect it to remain close to 70% in 2022-23. For the forecast horizon 2024-36, we estimate German real

GDP growth to average at +1.1%. We forecast inflation at +2% – above the average registered during the past two decades. The average interest rate on debt should only rise modestly from the record low of 0.9% in 2021 to on average 2.6% over the period 2024-36. Assuming average primary surpluses of +1.2% in line with the average registered in the two decades running up to the Covid-19 shock, the expected primary deficit for Germany of -0.4% is higher than would be required to stabilize debt. Thus, we expect Germany's debt level to gradually decline to 48% by 2036 – notably below the 60% Maastricht debt criterion.

Figure 7: Germany – Debt-stabilizing primary balance (% GDP)

Germany: Debt stabilizing primary balance (% GDP)

Average interest rate on government debt (%) \ Nominal GDP growth (%)	1	1.5	2	2.5	3	3.5	4	4.5	5
1	0.0	-0.4	-0.7	-1.0	-1.3	-1.6	-2.0	-2.3	-2.6
1.5	0.4	0.0	-0.4	-0.7	-1.0	-1.3	-1.6	-2.0	-2.3
2	0.7	0.4	0.0	-0.4	-0.7	-1.0	-1.3	-1.6	-2.0
2.5	1.0	0.7	0.4	0.0	-0.4★	-0.7	-1.0	-1.3	-1.6
3	1.3	1.0	0.7	0.4	0.0	-0.4	-0.7	-1.0	-1.3
3.5	1.7	1.3	1.0	0.7	0.4	0.0	-0.4	-0.7	-1.0
4	2.0	1.7	1.3	1.0	0.7	0.4	0.0	-0.4	-0.7
4.5	2.4	2.0	1.7	1.3	1.0	0.7	0.4	0.0	-0.4
5	2.7	2.4	2.0	1.7	1.3	1.0	0.7	0.4	0.0

Sources: Refinitiv, Allianz Research.
Note: The table shows the debt-stabilizing primary balance for combinations of nominal GDP growth and the implicit effective interest rate on debt. The red star resembles the constellation that we assume in our base case going forward. Cells shaded in red= a primary surplus is needed to stabilize debt, cells shaded in green = a primary deficit is sufficient to stabilize debt.

France: Not much room for policy mistakes

We do not expect the French government debt ratio to decline at all over the forecast horizon. French government debt never really embarked on a clear downward trend in the aftermath of the Eurozone debt crisis. In fact, a fresh record high was reached in 2020 at 115% of GDP, almost double the level in 2000. For the forecast horizon 2024-36, we estimate that French real GDP growth will come in at +1.3% on average, broadly in line with the Eurozone average, while we expect inflation to register around +2%. For the average interest rate on government debt, we forecast a marked increase from 1.2% in 2021 to 2.9% on average over the forecast horizon. An expected primary deficit of -1.2% - in line with the historical average - will not suffice to allow for a reduction in the debt ratio. Under these conditions, government debt would remain on a clear upward trajectory over the forecast horizon, reaching 125% of GDP by 2036.

Figure 8: France – Debt-stabilizing primary balance (% GDP)

France: Debt stabilizing primary balance (% GDP)										
		Nominal GDP growth (%)								
Average interest rate on government debt (%)		1	1.5	2	2.5	3	3.5	4	4.5	5
	1	0.0	-0.6	-1.1	-1.7	-2.2	-2.8	-3.3	-3.9	-4.4
	1.5	0.6	0.0	-0.6	-1.1	-1.7	-2.2	-2.8	-3.3	-3.9
	2	1.1	0.6	0.0	-0.6	-1.1	-1.7	-2.2	-2.8	-3.3
	2.5	1.7	1.1	0.6	0.0	-0.6	-1.1	-1.7	-2.2	-2.8
	3	2.3	1.7	1.1	0.6	0.0	-0.6	-1.1	-1.7	-2.2
	3.5	2.8	2.3	1.7	1.1	0.6	0.0	-0.6	-1.1	-1.7
	4	3.4	2.8	2.3	1.7	1.1	0.6	0.0	-0.6	-1.1
	4.5	4.0	3.4	2.8	2.3	1.7	1.1	0.6	0.0	-0.6
	5	4.5	4.0	3.4	2.8	2.3	1.7	1.1	0.6	0.0

Sources: Refinitiv, Allianz Research.
Note: The table shows the debt-stabilizing primary balance for combinations of nominal GDP growth and the implicit effective interest rate on debt. The red star resembles the constellation that we assume in our base case going forward. Cells shaded in red= a primary surplus is needed to stabilize debt, cells shaded in green = a primary deficit is sufficient to stabilize debt.

Italy: No progress on debt reduction

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 up by more than 20pps to almost 155%. The key issue holding back a more meaningful reduction in government debt has been low nominal GDP growth, which registered at +2% per year on average during the two decades prior to the Covid-19 shock.

However, we do see reasons to be more optimistic about growth prospects. In particular, the expected growth dividend from the successful implementation of Italy's EUR238bn recovery and resilience plan (RRP) under the NGEU – which focuses on higher public investment coupled with key reforms of the judiciary, public administration and competition – justifies a mild upgrade of Italian GDP growth expectations. Thanks to a slight upward revision to our inflation forecasts, Italy's nominal GDP now looks set to expand at +2.5% on average until 2036.

Higher interest rates will add to fiscal consolidation headwinds. We expect the average interest rate on debt to rise gradually – assuming the next government continues to pursue fiscally responsible policy measures – from 2.3% in 2021 to an average of 4.1% over the forecast horizon. Meanwhile, the primary surplus of +1.6% is expected to register close to the average over the past two decades. Under these conditions, Italian government debt would rise – albeit very gradually – over the forecast horizon, reaching 154% by 2036.

Figure 9: Italy – Debt-stabilizing primary balance (% GDP)

Italy: Debt stabilizing primary balance (% GDP)									
Average interest rate on government debt (%) \ Nominal GDP growth (%)	1	1.5	2	2.5	3	3.5	4	4.5	5
1	0.0	-0.7	-1.4	-2.1	-2.8	-3.5	-4.2	-4.8	-5.5
1.5	0.7	0.0	-0.7	-1.4	-2.1	-2.8	-3.5	-4.2	-4.8
2	1.4	0.7	0.0	-0.7	-1.4	-2.1	-2.8	-3.5	-4.2
2.5	2.1	1.4	0.7	0.0	-0.7	-1.4	-2.1	-2.8	-3.5
3	2.8	2.1	1.4	0.7	0.0	-0.7	-1.4	-2.1	-2.8
3.5	3.5	2.8	2.1	1.4	0.7	0.0	-0.7	-1.4	-2.1
4	4.2	3.5	2.8	2.1	1.4	0.7	0.0	-0.7	-1.4
4.5	4.9	4.2	3.5	2.8	2.1	1.4	0.7	0.0	-0.7
5	5.7	4.9	4.2	3.5	2.8	2.1	1.4	0.7	0.0

Sources: Refinitiv, Allianz Research.
Note: The table shows the debt-stabilizing primary balance for combinations of nominal GDP growth and the implicit effective interest rate on debt. The red star resembles the constellation that we assume in our base case going forward. Cells shaded in red= a primary surplus is needed to stabilize debt, cells shaded in green = a primary deficit is sufficient to stabilize debt.

Spain: Sticky primary deficit keeping a lid on debt consolidation

Spain's government debt-to-GDP ratio reached a fresh record high of 120% in 2020 – constituting an almost 3.5 fold increase relative to 2007. We forecast real GDP growth to average at +1.9% over the next 15 years. Meanwhile, inflation should register at around +2%. The average interest rate on government debt will increase notably from 1.9% in 2021 to a long-term average of around 3.6% for the period 2024-36. Spain should generate annual primary deficits of -1.3% in relation to GDP. In such a scenario, Spanish government debt would remain on an upward trajectory, rising to 127% in 2036.

Figure 10: Spain – Debt-stabilizing primary balance (% GDP)

Spain: Debt stabilizing primary balance (% GDP)									
Average interest rate on government debt (%) \ Nominal GDP growth (%)	1	1.5	2	2.5	3	3.5	4	4.5	5
1	0.0	-0.6	-1.2	-1.7	-2.2	-2.8	-3.3	-3.9	-4.4
1.5	0.6	0.0	-0.6	-1.2	-1.7	-2.2	-2.8	-3.3	-3.9
2	1.1	0.6	0.0	-0.6	-1.2	-1.7	-2.2	-2.8	-3.3
2.5	1.7	1.1	0.6	0.0	-0.6	-1.2	-1.7	-2.2	-2.8
3	2.3	1.7	1.1	0.6	0.0	-0.6	-1.2	-1.7	-2.2
3.5	2.8	2.3	1.7	1.1	0.6	0.0	-0.6	-1.2	-1.7
4	3.4	2.8	2.3	1.7	1.1	0.6	0.0	-0.6	-1.2
4.5	4.0	3.4	2.8	2.3	1.7	1.1	0.6	0.0	-0.6
5	4.5	4.0	3.4	2.8	2.3	1.7	1.1	0.6	0.0

Sources: Refinitiv, Allianz Research.
Note: The table shows the debt-stabilizing primary balance for combinations of nominal GDP growth and the implicit effective interest rate on debt. The red star resembles the constellation that we assume in our base case going forward. Cells shaded in red= a primary surplus is needed to stabilize debt, cells shaded in green = a primary deficit is sufficient to stabilize debt.

ANNEX

With the help of our interactive Debt Tool, we assess the consequences of this changed debt reality in the four largest Eurozone countries by projecting the likely debt path 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), i.e. the difference between government revenues and spending, and the average interest rate on government debt (r):

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

Our baseline scenario is based on our 15-year forecast of the primary balance and real growth – the two variables that are strongly influenced by government policy via decisions on economic reforms, spending and taxation. Notably for the primary balance, we choose the long-term historical average over the period 2000-2019. We also assume that the ECB will reach its inflation target of 2% over the medium term after front-loading its policy normalization plans by quickly raising the policy rate to neutral territory – at least 1.5%. With a real neutral rate of 0% in the Eurozone, this would mean that refinancing costs for governments increase by about 200bps (without a change in the risk premium) over the longer term. We take into account the interest burden as the weighted-average interest rate on debt (not the current market rate) and calculate the refinancing cost from debt rollover based on the weighted-average duration of outstanding debt (e.g. for Germany, each year, about 14% of debt stock is subject to a rising interest rate).[1]

[1] One final simplification is that we ignore stock-flow adjustments, which account for changes in government debt other than via the budget balance. Examples include privatization proceeds (debt-reducing impact) on the one hand and public loans granted or equity injections into corporates (debt-increasing impact) on the other. Given the large use of public guarantees during the Covid-19 crisis, and first hints of a similar policy move amid the energy crisis, if anything our analysis is likely to overestimate any decline in government debt.

These assessments are, as always, subject to the disclaimer provided below.

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