

## What to expect after “effortless” debt reduction in the euro area?



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*Despite “whatever the cost” and “you’ll never walk alone”: The historically unique tailwind consisting of low interest payments and high inflation ensured “effortless” debt reduction in the euro area in 2021 & 2022. The double tailwind for public finances is diminishing but will remain substantial in the coming years. From a fundamental point of view, there is little to suggest that the issue of government debt will keep markets and the media on their toes in the short and medium term. In the longer term, however, almost no euro area country can afford a fiscal “business as usual”. A “divergence” within the euro area is a danger, the avoidance of which would require a fundamental change of fiscal policy in some countries and thus the realization that fiscal policy is not a one-way street.*

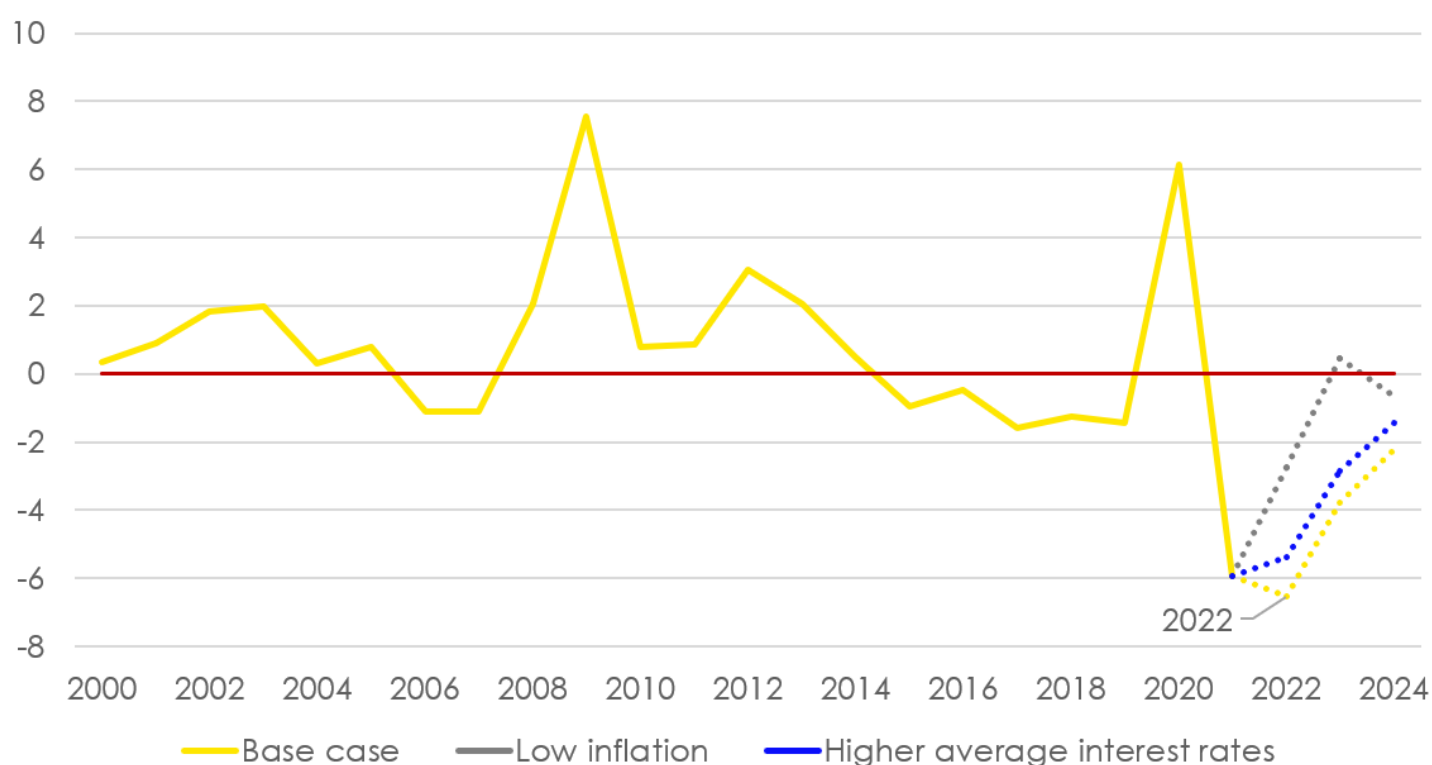
## "Effortless" decline in public debt thanks to double tailwind

From "whatever the cost" to "you'll never walk alone": Money was seemingly not an issue for European fiscal policy in the last three years of continuous state of emergency. But even though one aid package was soon followed by the next one, huge amounts of discretionary spending were unable to shake public finances. After all, two crises later, not even Italy's mountain of debt has faltered, and a "euro crisis 2.0" is hardly an issue, notwithstanding the significant increase in debt seen in 2020 and the ECB rate hiking cycle that is in full swing.

So were the warnings exaggerated? What is true is that after the historically unprecedented rise from 84% of GDP in 2019 to 97% of GDP just one year later, public debt in the euro area has already returned to a downward trend in the second year of the pandemic (2021), which will continue in the coming years according to forecasts by both the IMF (April 2023) and the European Commission (November 2022). In 2024, the debt ratio in the euro area should already be closer to the pre-Covid level than to the record highs of 2020. The fiscal collateral damages from the health and energy crises would thus be almost half repaired — despite a fiscal policy that will continue giving households and companies more support in 2024 than before the pandemic (lower structural primary balances). Having said this, according to the IMF, the debt burden of the monetary union should still be slightly above the pre-Covid level even in 2028 (end of the forecast horizon).

This effortless reduction in debt ratios is made possible by the double tailwind of historic magnitude from which public finances have benefited since 2021 (see chart below) and which makes falling government debt ratios

**Figure 1: Euro area: "Effortless" reduction of debt ratios through double tailwind (i-g)\***



\*Difference between implicit interest rate and nominal GDP growth (i-g); baseline scenario: 2022-2024 forecast of the EU Commission (Nov-22) for i and IMF (Apr-23) for g; low inflation: inflation (GDP deflator) corresponds to the 2013-2019 average already from 2022 onwards; higher average interest rates: implicit interest rate corresponds to the current market interest rate level already from 2022 onwards (weighted average of EA countries Jan-Mar 2023). Source: European Commission (Ameco), IMF (World Economic Outlook), Refinitiv, RBI/Raiffeisen Research.

## “Low for longer”: Actual interest burden still low for years to come despite ECB rate hiking cycle

There is a simple reason why the actual interest burden remains so low: Even the fastest and most powerful interest rate hiking cycle in ECB history cannot undo the many years of zero and negative interest rates. The average interest rate level of sovereigns will thus remain low in the coming years, notwithstanding higher refinancing costs on the primary market. Consequently, while the increased level of market yields and interest rates is the dominant theme, it is only beginning to be reflected in the actual interest burden of sovereigns. On the one hand, to the extent that low-yielding government bonds mature and have to be replaced by new, higher-yielding papers. And on the other hand, to the extent that new bonds have to be issued to finance current deficits. This means that even if government bond yields were to remain at the current elevated level, Italy's government debt, for example, would hardly be higher at the end of 2024 after two years (2023-2024) of “high” interest rates than if the Italian government was able to continue issuing bonds at the favourable conditions of 2021 (138.5% of GDP vs. 138.1% of GDP; interest rate on newly issued bonds: 3.90% vs. 0.37%).

## Inflation gains far greater than interest rate gains

The rise in interest rates therefore only arrives at countries' public finances with a certain delay. The situation is completely different with high inflation, from which public finances benefit in real time. However, this is not primarily because of the bubbling tax revenues, but rather because government expressed in relation to nominal GDP, is diminished by high inflation (or, to be more precise, by the not insignificantly inflation-driven high nominal GDP growth). Thus, governments are clear “inflation winners” even apart from rising tax revenues.

These “inflation gains” clearly outshine the gains generated by the still low average interest rate level. My calculations reveal that if the stock of government bonds had not continued to be characterized by the years of zero and negative interest rates, i.e. if the sovereigns had had to pay the current (higher) market interest rate level on all outstanding liabilities from the beginning of 2022 until the end of the 2024, 12 of the 20 euro area countries would still have lower debt ratios in 2024 than in 2020, compared with 16 countries according to the latest (November 2022) European Commission forecasts as well as those of the IMF (April 2023).

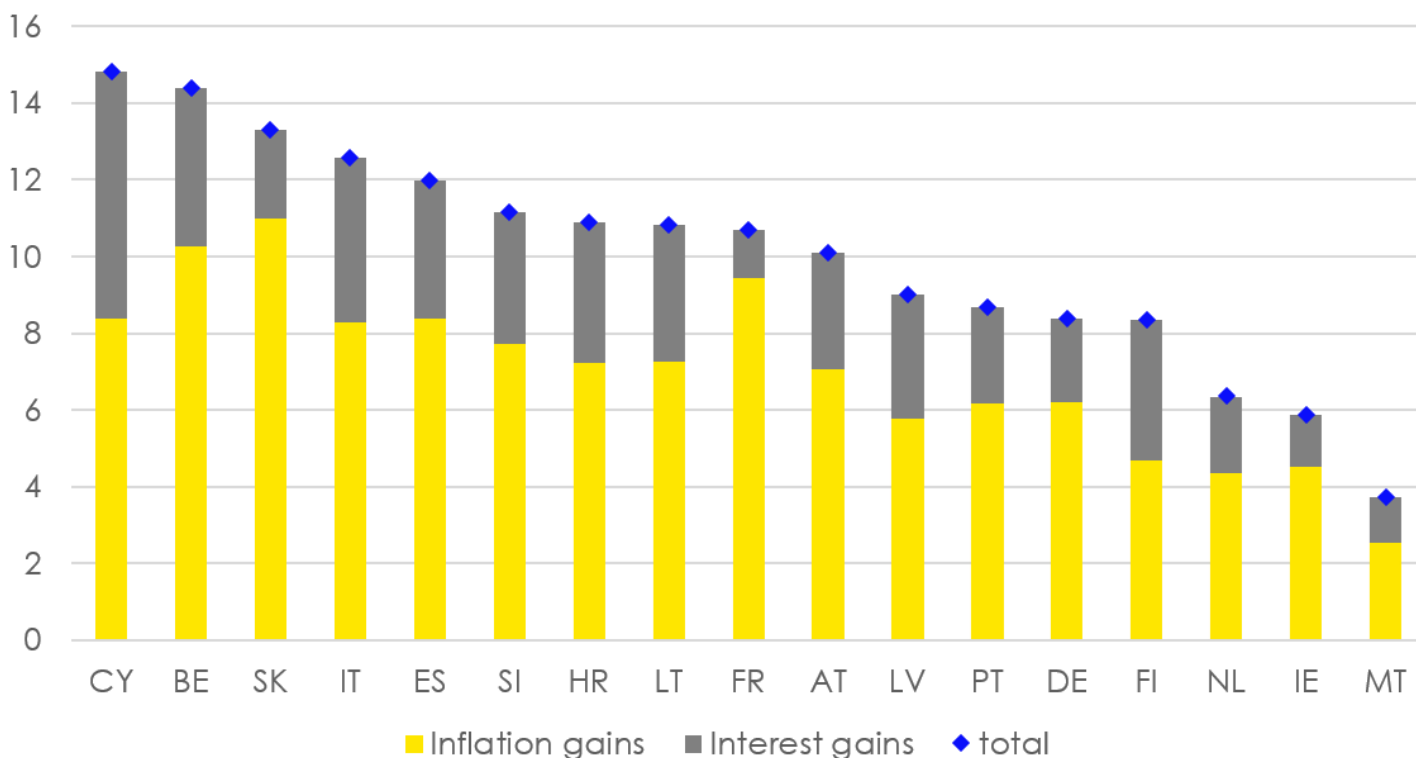
By contrast, the effects would be far greater if the current inflationary tailwind were to turn into a headwind, i.e. if inflation had seamlessly picked up in 2022 where it left off before Covid. Thus, a fallback to the pre-pandemic (2013-2019) era of (too) low inflation would merely leave the euro area debt-to-GDP ratio stagnant from 2022 to 2024 — despite continued tailwind from low average interest rates (implicit interest rates). In many cases, a reduction in debt would be unthinkable without the changed inflation environment, as less than half (8) of the euro area countries would be able to achieve this (debt reduction in 2024 compared with 2020) in a “lowflation” environment. That leaves no doubt that it is not so much the after-effects of years of zero and negative interest rates, but primarily high inflation that is responsible for the fact that the topic of budget consolidation is currently not a pressing issue on the political agenda.

## Double tailwind prevents discussion about limits of fiscal policy

Keeping this in mind, it is not surprising that there is hardly any discussion about the limits of fiscal policy. After the pandemic and energy crisis, the focus is now on driving the green transformation with fiscal aid and not being inferior to the US and China in the race of subsidies. The challenges are great, and questions about the budgetary room for maneuver seem to be of secondary importance in view of that and are met in fiscally weaker countries with demands for new EU debt (EU sovereignty fund).

Yet a discussion about consolidation measures would already be unavoidable without the double tailwind. If, for example, Austria wanted to have the same government debt ratio in 2024 in a “lowflation” environment (inflation 2022-2024 as low as 2013-2019) as assumed in the EU Commission's current baseline scenario (74.9% of GDP), consolidation measures totalling EUR 35 billion would have to be implemented by then. If, in addition, the continuing tailwind from years of zero and negative interest rates was to disappear, the consolidation requirements would increase to EUR 51 billion. This exceeds the discretionary measures implemented by Austria in 2022 in the wake of the energy and inflation crisis (EUR 32.7 billion 2022-2026).

**Figure 2: Inflation and interest rate gains in the period 2022-2024 (in % of GDP)\***



\*“Inflation gains”: necessary fiscal efforts to reduce the debt-to-GDP ratio in an environment of low inflation (GDP deflator 2022-2024 corresponds to the average of the years 2013-2019) by 2024 to the same level as in the European Commission's baseline scenario; “interest rate gains”: necessary fiscal efforts to reduce the debt-to-GDP ratio in an environment of higher interest rates (implicit interest rate 2022-2024 corresponds to the average market interest rate level of the months January-March 2023) by 2024 to the same level as in the European Commission's baseline scenario. Source: European Commission (Ameco), RBI/Raiffeisen Research.

Of course, this “hypothetical consolidation volume” is based on assumptions that deviate strongly from current circumstances and those foreseeable for inflation in the next 1-2 years. Inflation is likely to remain above the ECB target even in 2025. Moreover, the after-effects of monetary policy measures implemented in the low-inflation period on average interest rates of euro area sovereigns will still be evident in 2024 and beyond. Over the next few years, the double tailwind for government finances will diminish but remain substantial.

The issue of government debt is therefore not expected to return to the focus (of markets) in the short term. In the medium and especially in the longer term, however, this could change. Although the average interest burden is rising only slowly, it is rising. And even if demographics, friend- and nearshoring, ESG and supply chain laws are all factors that argue for a structurally, i.e. longer term, higher inflationary pressure than in the phase of low inflation that prevailed until the start of the pandemic: the historically high inflation rates of 2022 and 2023 do not represent the new normal. In the longer term and on average, inflation will be much closer to the two percent mark than to the roughly eight and a half percent of 2022.

## When the wind changes: Fiscal policy after “effortless” deleveraging

But what do ever-rising average interest rates combined with structurally higher inflation than before the pandemic mean for debt ratios in the second half of this decade, especially in the more indebted euro countries (these are in the focus of this analysis, along with the core euro area)? Clearly, the answer to this question hugely depends on the underlying input variables, which are, however, based on plausible basic assumptions given the current state of information. These assumptions deliberately do not represent extreme scenarios but reflect a more realistic picture of a new normal situation in the years from 2025.

### The assumptions

Up to and including 2024, we assume that inflation (GDP deflator), real GDP growth and the primary balance will develop as forecasted by the IMF in April. By contrast, my assumptions regarding interest rate developments are based on current market conditions. We therefore assume that new government bonds issued in 2023 and 2024 will have an issuance yield equal to market conditions prevailing in the first quarter of 2022 (average secondary market yield January-March 2023). The following (own) assumptions are then used for the years from 2025 onward:

Interest rates: Government bond yields are already above those levels that we consider appropriate from a fundamental perspective in the long term, i.e. on a multi-year horizon. We therefore use the minimum of daily government bond yields seen in the first three (Jan-Mar) months of 2023 for the years from 2025 onward (for the period 2023-2024 we use, as mentioned, the respective average). For German government bonds (10y), for example, the low is 2.0% (Ø beginning of January - beginning of April: 2.3%). A value which, in the case of Germany, reflects quite well our view of an appropriate or neutral level of yields in the long run (in reality, interest rates will almost always be below or above this level). Furthermore, it is assumed that sovereigns will keep the average remaining maturity of their government bonds constant at the current level (IT: 7 years, AT: 12 years).

**Figure 3: Interest rate assumptions**

	implicit interest rate (%)*					yield level (%) - sovereign bonds**			
	2015	2021	2022	2025	2030	2021	2022	2023 (Ø Jan-Mar.)	2023 (Min. Jan-Mar)
Germany (8)***	1.9	0.9	1.0	1.1	1.3	-0.5	1.1	2.3	1.9
Austria (12)	2.9	1.4	1.5	1.6	1.9	-0.1	1.7	3.0	2.6
Netherlands (9)	2.0	1.1	1.2	1.3	1.6	-0.3	1.3	2.6	2.2
Finland (8)	2.0	0.7	0.9	1.0	1.7	-0.3	1.6	2.8	2.5
France (8)	2.1	1.3	1.7	1.8	2.0	-0.2	1.4	2.7	2.3
Belgium (11)	2.8	1.6	1.5	1.6	1.9	0.0	1.8	3.0	2.5
Spain (8)	3.0	1.9	2.0	2.1	2.4	0.1	2.0	3.2	2.7
Italy (7)	3.1	2.5	2.8	2.9	3.1	0.4	2.7	3.9	3.3
Portugal (7)	3.6	1.9	1.9	1.9	2.2	-0.1	1.7	3.0	2.6

\*Average interest rate on outstanding government debt, 2025/2030: own calculation based on secondary market yield, minimum Jan-Mar 2023, primary balance Ø 2013-2019, assumptions regarding GDP and inflation see below; \*\*secondary market yield on government bonds according to average remaining maturity; \*\*\*in brackets: average remaining maturity of outstanding government bonds in years. Source: European Commission (Ameco), Refinitiv, RBI/Raiffeisen Research.

Inflation: As outlined above, inflation is likely to be structurally (i.e. on average) higher after normalization than before the pandemic. While inflation (HICP) in the euro area averaged at 1.7% yoy between 2000 and 2019 (2013-2019: 1.3% yoy), we expect it to average at 2.0% yoy in the longer term. In this specific case we use the IMF's long term inflation forecasts (average forecast value of the GDP deflator for 2027-2028), as the Monetary Fund provides inflation forecasts for all euro countries beyond 2024. However, at least with regard to the monetary union as a whole, the long term inflation view hardly differs from ours (IMF HICP: 1.9% yoy, IMF GDP deflator: 1.9% yoy).

**Figure 4: GDP, inflation & budget balance assumptions**

	Real GDP (ø % yoy)				Inflation (GDP deflator, ø % yoy)					Primary balance (ø % GDP)			
	2000-2019	2013-2019	2021-2022	2023-2024	2000-2019	2013-2019	2021-2022	2023-2024	long-term*	2000-2019	2013-2019	2021-2022	2023-2024
Euro area	<b>1.4</b>	1.6	4.4	1.1	1.6	1.3	3.4	4.0	<b>1.9</b>	0.0	<b>0.4</b>	-3.2	-1.7
Germany	<b>1.4</b>	1.6	2.2	0.5	1.3	1.8	4.3	3.9	<b>1.9</b>	0.8	<b>2.1</b>	-2.7	-2.0
Austria	<b>1.6</b>	1.4	4.8	0.8	1.8	1.8	3.4	5.2	<b>1.9</b>	0.1	<b>0.6</b>	-3.9	-1.2
Netherlands	<b>1.6</b>	1.8	4.7	1.1	1.8	1.4	3.9	5.1	<b>2.1</b>	0.1	<b>0.7</b>	-1.4	-1.9
Finland	<b>1.6</b>	1.1	2.6	0.7	1.6	1.5	3.2	4.4	<b>1.8</b>	0.8	<b>-1.5</b>	-2.4	-2.0
France	<b>1.4</b>	1.4	4.7	1.0	1.4	0.8	2.2	3.1	<b>1.7</b>	-1.4	<b>-1.6</b>	-4.1	-3.4
Belgium	<b>1.7</b>	1.6	4.6	0.9	1.7	1.5	4.8	3.5	<b>1.9</b>	1.7	<b>0.3</b>	-3.6	-3.6
Spain	<b>1.8</b>	2.0	5.5	1.7	1.9	0.7	3.3	3.7	<b>1.7</b>	-1.7	<b>-2.1</b>	-3.7	-1.8
Italy	<b>0.4</b>	0.5	5.3	0.7	1.8	1.0	1.8	4.2	<b>2.0</b>	1.4	<b>1.4</b>	-4.7	0.6
Portugal	<b>0.9</b>	1.8	6.1	1.3	2.1	1.7	3.0	3.5	<b>2.0</b>	-1.8	<b>0.6</b>	-0.3	1.0

Forecasts 2023-2024: IMF World Economic Outlook (April 2023), bold columns: corresponding periods are included in the following debt simulation; \*average IMF forecasts (April 2023) for the years 2027-2028. Source: IMF (World Economic Outlook), Refinitiv, RBI/Raiffeisen Research.

Real growth: Unlike interest rates and inflation, the real growth outlook does not necessarily show a trend break compared with the pre-Covid period. Consequently, GDP growth from 2025 onward is assumed to equal the 2000-2019 average. Over this period, with all its ups and downs, the euro economy grew by 1.4% yoy in real terms. This is roughly in line with our assumption for potential growth in the monetary union (1.3% yoy) and is slightly below both the average of the immediate pre-Covid years, which were quite positive from an economic perspective (2013-2019: 1.6% yoy), and the assumptions of the IMF (2025-2028: 1.6% yoy).

### The results

The first conclusion, which is bad and obvious at the same time, is that very few countries can afford a fiscal “business as usual”, i.e. primary deficits even after 2024 as forecasted by the IMF for this year and next year or as seen in recent years. At first glance, Austria, Italy, and Portugal would get off lightly. After all, their public debt ratios would stagnate or even decline by 2030 compared with the level expected for 2024. However, this does not mean that after years of very expansive fiscal policy a fiscal turnaround is not necessary in the mentioned countries. Rather, the IMF anticipates this to some extent already in its forecasts for 2023 and 2024. In Italy in particular, the IMF expects (noticeably) improved primary balances as early as this and next year compared with 2021 – 2022. The situation is different in Germany, the Netherlands, Belgium, Spain, Finland and especially France, where comparatively small improvements in primary balances are assumed in 2023 and 2024. Consequently, debt ratios in these countries at the end of the decade would be 3 to 12 percentage points above the level expected for 2024.

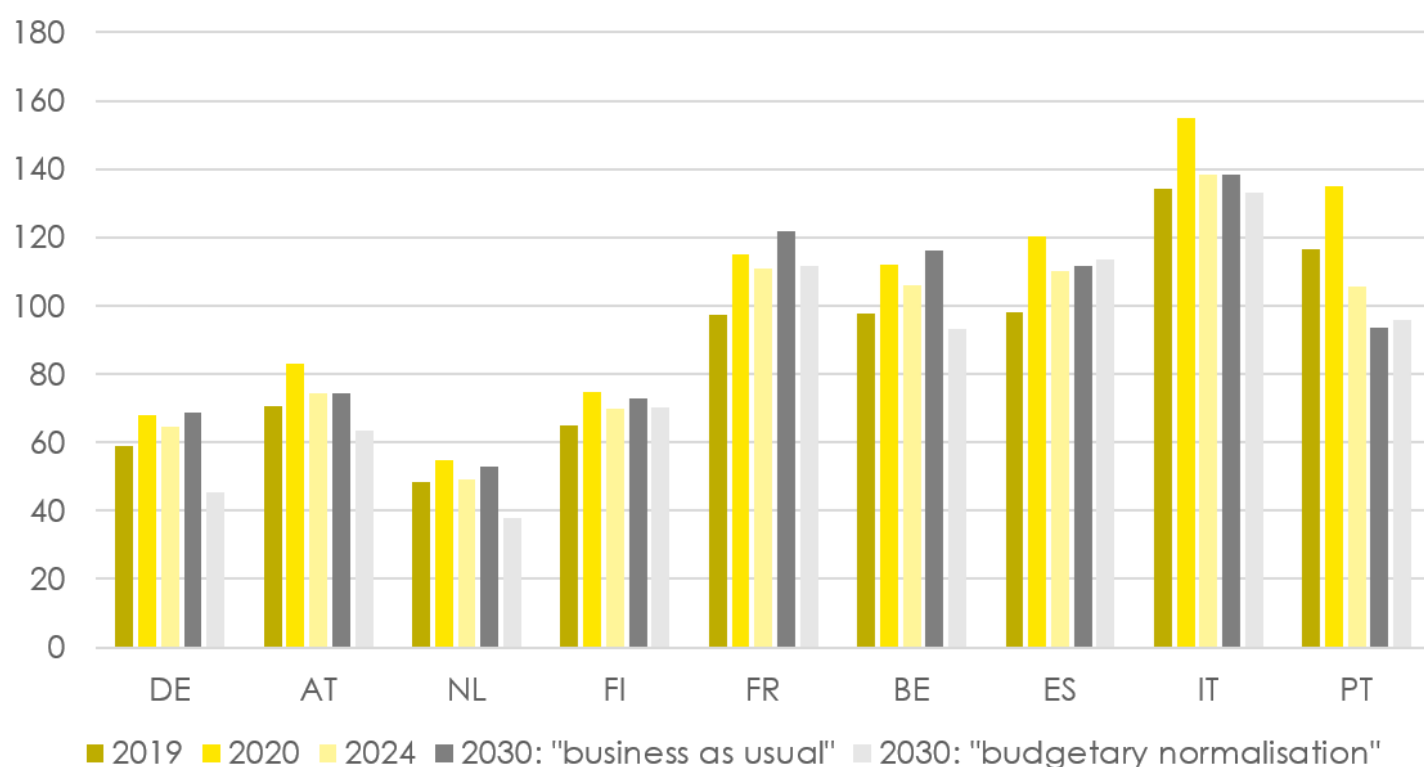
**Figure 5: Gross debt ratio (% GDP): Budgetary “business as usual” not possible**

	Gross debt ratio (% GDP)				Primary balance ø 2023-24		Primary balance ø 2013-19	
	2019	2020	2022	2024	2030	2035	2030	2035
Germany	58.9	68.0	67.4	64.8	68.7	73.2	45.3	31.5
Austria	70.6	82.9	78.5	74.6	74.2	75.0	63.4	55.8
Netherlands	48.5	54.7	50.3	49.2	53.0	56.8	37.3	29.9
Finland	64.9	74.8	70.7	70.0	72.9	77.4	70.4	73.0
France	97.4	115.0	111.7	110.7	121.9	132.2	111.5	113.6
Belgium	97.6	112.0	106.2	106.1	116.0	125.5	93.3	84.9
Spain	98.2	120.4	114.0	110.0	111.8	115.2	113.4	118.0
Italy	134.1	154.9	144.6	138.5	138.4	140.6	133.2	131.0
Portugal	116.6	134.9	115.9	105.8	93.5	86.0	96.0	90.2

Assumptions/input factors: debt-to-GDP ratio 2024: GDP/inflation/primary balance forecasts according to the IMF, interest rates: average secondary market yield Jan-Mar 2023, constant residual maturity; debt-to-GDP ratio 2030/2035: primary balance ø 2013-2019 or ø 2023-24 (IMF forecasts), GDP real (% yoy): ø 2000-2019, inflation (% yoy): GDP deflator ø 2027-2028 (IMF forecasts), interest rates: minimum secondary market yield Jan-March 2023, constant residual maturity; (dark) red: increase in debt-to-GDP ratio vs. 2024 (by more than 10 pp), (dark) green: decrease in debt-to-GDP ratio vs. 2024 (by more than 10 pp). Source: IMF (World Economic Outlook), European Commission (Ameco), Refinitiv, RBI/Raiffeisen Research.

However, the good news is that if the euro countries were to return to the fiscal policy of the pre-Covid years (2013 - 2019), debt ratios would fall in most of the euro countries under consideration and particularly significantly in those belonging to the core euro area (DE, AT, NL) and in Belgium. Even the debt level of 2019 would be clearly undercut in these cases as early as 2030. Portugal's “debt backpack” would also be significantly lower in 2030 than before the pandemic. The country can thus be described as the fiscal “role model” of the Southern euro area. However, the exceptions are all the more prominent: Besides Spain, it is France in particular where a return to the fiscal policy of 2013 to 2019 would result in slightly rising debt ratios by the end of the decade (and Finland with de facto stagnation). In both cases, this is put into perspective by the fact that the years 2013 to 2019, which especially in the core euro area were (also) quite positive from a fiscal perspective, were no such years for either Spain or France. Yet the fact that the budgetary situation in Spain and France deteriorated in the pre-Covid years despite passable business cycle dynamics can hardly be seen as an excuse. On the contrary, France and Spain stand out as two countries whose inadequate austerity efforts in the past make stagnating debt ratios in the future already an optimistic outcome. The recent pension protests in France show how difficult it will be to change the fiscal course. By contrast, Italy, which is under “special scrutiny” in terms of government debt, would behave “inconspicuously” if fiscal policy returned to the fiscal normality of the pre-pandemic years. After all, Italy’s debt ratio would decline by 5 percentage points by 2030 and would thus be just below the 2019 level. Mostly unnoticed by the general public, the country managed to generate considerable primary surpluses year after year prior to the pandemic, which is a striking contrast to France (∅ 2013-2019: 1.6% of GDP, France: -1.5% of GDP). Italy’s debt problem is therefore essentially a problem of low potential growth and high legacy debt.

**Figure 6: Gross debt ratio: Reduction of various crisis costs for France & Spain huge effort\***



\*Gross public debt in % of GDP, "business as usual": ∅ primary balance (% GDP) 2023-2024 (IMF forecast), "budgetary normalisation": ∅ primary balance (% GDP) 2013-2019. Source: IMF (World Economic Outlook), Refinitiv, RBI/Raiffeisen Research.

## Conclusion

The fact that still high debt ratios are not in the (market) spotlight is due to the unchanged double tailwind of low average interest rates on government bonds already issued and, in particular, high inflation. Even in 2024 and beyond, the after-effects of the zero/negative interest rate environment on the average interest burden will still be evident. The double tailwind for government finances is diminishing but will remain substantial in the coming years. From a fundamental point of view, therefore, there is little to suggest that the issue of government debt will keep markets and the media on their toes in the short and medium term. It should also not be forgotten that after years of QE (quantitative easing), a considerable fraction (between 13% and 47%) of outstanding government bonds is not held by private investors but by the ECB or the euro area national central banks (NCBs). This reduces risks regarding public debt sustainability as these government bonds are not subject to the free play of (market) forces.

In the longer term, however, almost no euro area country can afford a fiscal “business as usual”. A “re-thinking” of fiscal policy is therefore necessary. Rising debt ratios in the second half of this decade would otherwise hardly be avoidable. Most countries in the core euro area are in a comparatively favourable starting position though. After all, in this group of countries, a return to the budget policy path of pre-pandemic years would be more than sufficient to reduce debt ratios to below the 2019 level by 2030, despite higher interest rates. This does not hold for parts of the Southern euro area. However, it is not the “usual suspect” Italy (nor Portugal) that is in the spotlight this time, but rather Spain. Together with France, these two countries are the fiscal “problem children”. No matter how you look at it: Both countries would have to put in an fiscal effort not seen before, at least not in the years prior to the pandemic, to reduce their debt-to-GDP ratio well below the 2024 level — not to mention the pre-Covid level of 2019. As a consequence, a “divergence” within the euro area is thus a real danger, the avoidance of which would require a fundamental change of fiscal policy in some countries and thus the realization that fiscal policy is not a one-way street. After all, reform and austerity efforts without acceptance among the population (“ownership”) are doomed to failure from the outset, as the years of the euro debt crisis have shown. In any case, the short term political costs of such policies should not be underestimated. After years of “effortless” debt reduction, higher inflation and lower interest rates could therefore be seen as more attractive alternatives. Of course, it should not go unmentioned that in addition to consolidation efforts, higher inflation and lower interest rates, improving the growth potential via structural reforms is another possibility that would at least reduce the need for consolidation. ■



## About the author

**Matthias Reith** looks back on 12 years of experience at Raiffeisen Research (Raiffeisen Bank International) in Vienna. The senior economist's focus is on the Austrian economy, and he also played a key role in setting up the research on the Austrian residential real estate market. Furthermore, Matthias Reith deals with other euro countries as well as the entire euro area and, in addition to business cycle dynamics, also looks at fiscal policy issues.

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