Article | 17 November 2020

How to deal with soaring debt levels

Fiscal deficits have surged to unprecedented levels and government debt in the eurozone is expected to reach the highest level since 2014. While in the short-run, there is definitely no alternative to huge fiscal stimulus, the question of how to deal with elevated debt levels will soon bring back heated discussions

Eurozone sovereign debt

The ongoing pandemic has led countries around the world to take exceptional economic and financial measures. In the eurozone, national measures were followed by pan-European action.

As a result, debt ratios have surged. During the previous financial and sovereign debt crisis, debt ratios in the eurozone rose from 65.9% of GDP in 2007 to around 93% of GDP five years later. By the end of 2019, the ratio had only come down to 87% of GDP, indicating how difficult it is to return government debt to any pre-crisis level.

Right now, we expect government debt in the eurozone to increase by some 15% of GDP to more than 100% GDP in 2020. Italy, Spain and Greece should see the strongest increases, with debt-to-GDP ratios surging by more than 25%.

As we expect many eurozone governments to provide more stimulus and possibly even write off some of the guaranteed loans to tackle the second wave of the pandemic, debt ratios are likely to rise further. As a consequence, discussions on how to eventually reduce debt levels could return quickly.

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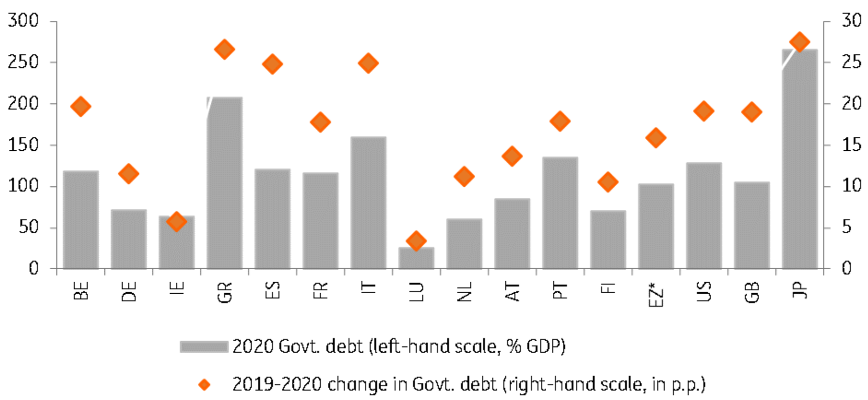
Based on our calculations, even with a return to the fiscal balances and nominal growth of 2018 and 2019, it would take until 2029 for the eurozone to return to pre-crisis debt levels. Luxembourg and Ireland could already be back to their 2019 debt levels by the end of 2021 while Germany could reach its pre-crisis debt level by 2023. However, it would take countries with high pre-crisis debt levels, such as Greece, Spain or France until 2030, 2031 and 2032, respectively. Italy - the country with the second-highest pre-crisis debt level - would take until 2060 to be able to reach a debt-to-GDP ratio of 134.4%.

If governments continue their current accommodative fiscal policies – again all else being equal – nominal growth would have to jump to 14.1% of GDP from 2021 to 2025 to return debt levels to their 2019 level. For example, if Germany were to continue with current fiscal policies, the country would need a nominal yearly GDP growth of nearly 18% to get back to pre-crisis levels by 2025.

2020 government debt per GDP ratios



Source: European Commission, ING estimates

An argument often heard is that very low-interest rates enable governments to have higher debt. If we follow this line of thought, it is also argued that the ECB will actually have a hard time increasing interest rates again as this would put an unbearable burden on public finances. To test this argument, we investigate how an increase in bond yields by 200 basis points would affect public finances.

The eurozone debt ratio, on average, would only return to its pre-crisis level by 2040 at the earliest

A 200bp increase would mean that the average debt ratio in the eurozone would not return to its pre-crisis level until 2040, at the earliest.

Assuming nominal GDP growth and a primary balance at the average 2018 / 2019 level, countries with high pre-crisis debt levels such as Italy, Greece, Spain and France, could have significant difficulties in lowering their debt burden at all. By 2030, Italy and Greece's debt levels would have increased further and reached 188.5% and 222.8% of GDP, respectively. Spain and France would stand at 115.7% and 120.2% of GDP.

In contrast, if bond yields fell by 100bps, we would see eurozone debt levels returning to their pre-crisis stage by 2025.

> Even though there is no alternative to extensive fiscal stimulus to tackle the economic fallout from the crisis, accelerating government debt could return quicker to the European agenda than many might think. Low interest rates are almost an inevitable prerequisite to keeping government debt in check.

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