

## European public debt in the medium term: sustainability and challenges

European public debt will experience a sharp rise in 2020. Specifically, it will go from 86% of euro area GDP in 2019 to 103%, according to the European Commission. This increase is inevitable, and to some extent desirable, given the current circumstances. Indeed, the macroeconomic shock caused by the COVID-19 pandemic is forcing the governments of the various Member States to take ambitious action to cushion the fall in economic activity and support the sectors hardest hit. Indeed, it can be argued that in order to avoid a long recession, the cost of the fiscal measures introduced should be similar to the decline in GDP.<sup>1</sup>

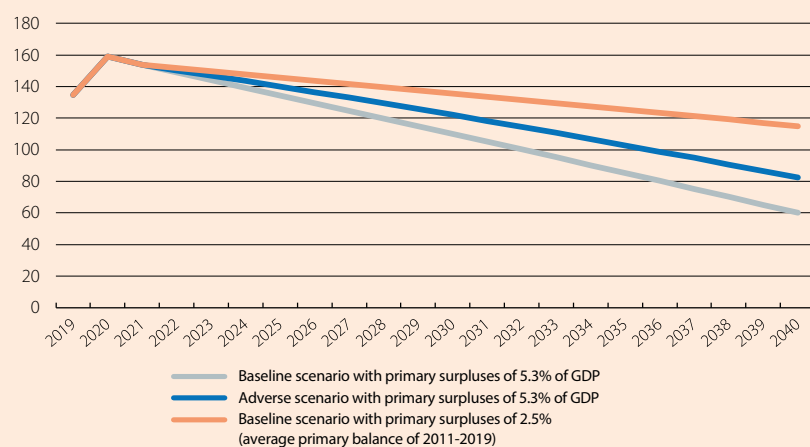
Nevertheless, while this increase in public debt is inescapable in the short term if we want to avoid an aggravation of the economic situation, it poses significant challenges in the medium term both in terms of sustainability and with regard to the macroeconomic effects it could entail.

On the sustainability front, the fact is that the situation is manageable provided that measures are taken to reduce public debt once the worst of the crisis has passed. According to the European Commission<sup>2</sup> public debt will peak in 2020, before gradually falling back down. As for how gradually: according to the Commission's simulations, in 2024 there is an 80% probability that euro area public debt will still stand at between 90% and 100% of GDP.

What factors can offer us cause for relative optimism? For starters, the ECB's ambitious asset purchase programmes in the secondary market have managed to reduce the risk premiums of the peripheral economies, making a spike in sovereign risk unlikely. Other factors worth highlighting include the positive differential between the growth rate of the economy ( $g$ ) and interest rates ( $r$ ) which are at historical lows, as well as the composition of European public debt (the maturity of the obligations has increased, and by mid-2020 it stood at around 7.5 years on average). This positive differential provides a safety net in the short term, but it will be essential to design a plan that ensures the sustainability of the public accounts; sooner or later, the interest rate at which the public treasury is financed will start to rise.<sup>3</sup>

### Italy: paths of public debt reduction

(% of GDP)



**Notes:** A stable nominal GDP growth of 2.2% is assumed, in line with the IMF's long-term forecast as of October 2019. It is assumed that the cost of debt will remain constant at its 2019 level (2.5%). Deficit and public debt forecasts by the European Commission for 2020 and 2021. The adverse scenario assumes a 0.5-pp-lower GDP growth and a 50-bp-higher cost of debt.

**Source:** CaixaBank Research.

done in recent history. With the aforementioned average primary surplus of 2.5% of GDP, the debt would still be reduced, but it would not reach 60%... until 2065. To set the debt on a downward trajectory, sustaining primary surpluses above 0.6% of GDP would suffice.

In contrast, in Germany, which is starting from a position of very healthy public accounts, the situation is clearly better: the country could allow itself the luxury of sustaining primary deficits of 0.6% of GDP until 2040 (the average of the last eight years has been a primary surplus of 1.7%) in order to reach the level of 60% of GDP in that year.

1. See the editorial «[Exceptional measures for exceptional times](#)» in the MR04/2020.

2. See the report by the European Commission «[Assessment of public debt sustainability and COVID-related financing needs of euro area Member States](#)» of April 2020.

3. The historical evidence tells us that economies where  $g-r > 0$ , but which have a higher-than-average public debt to GDP ratio, have more than a 75% probability of falling into a situation in which  $g-r < 0$ , compared to a 25% probability in the case of those with a lower-than-average public debt to GDP ratio. See W. Lian, A.F. Presbitero and U. Wiriadinata (2020). «Public Debt and  $r-g$  at Risk». IMF Working Paper 20/137.

Reducing public debt will be necessary to ensure that there are no sustainability issues that could lead to financial instability and difficulties in countries obtaining financing in the markets. But this is not the only reason: there is broad consensus among economists that failing to reduce high levels of public debt has negative consequences for growth in the short and medium term. In the short term, high debt is particularly problematic in the euro area as it is a monetary union in which national authorities primarily use fiscal tools to mitigate asymmetric economic shocks, and high debt means less scope for implementing countercyclical fiscal policies. We are already seeing this with the COVID-19 crisis if we compare Germany's ample fiscal margin with the tighter margins of countries with high levels of public debt such as Italy or Spain.

In the medium term, high public debt restricts growth mainly through two channels. On the one hand, the empirical evidence<sup>4</sup> shows that the general government's increased funding needs reduce the funding that is available to the private sector. This results in lower corporate investment at the aggregate level. On the other hand, the need to raise taxes in the future in order to bring down public debt will reduce household consumption, as people's future disposable income will be lower.

We can illustrate this point with some figures in order to provide an idea of the macroeconomic impact in question. Two IMF economists<sup>5</sup> estimate that, on average, an initial 10-pp increase in an economy's public debt to GDP ratio reduces the growth of its real GDP per capita by 0.2 pps per year. This effect is mainly explained by the reduction in investment and a lower accumulation of capital.

At the European level, a recent study<sup>6</sup> estimates that an increase in public debt from 60% to 120% in the euro area's peripheral economies could lead to a permanent loss of around 3.0% of GDP in the long term. This exercise leaves us with another interesting lesson: the greater the degree of distortion of the taxes that are increased, the greater the negative impact of having high public debt. In other words, tax policy matters – a lot – hence the importance of having a simplified and efficient tax system.

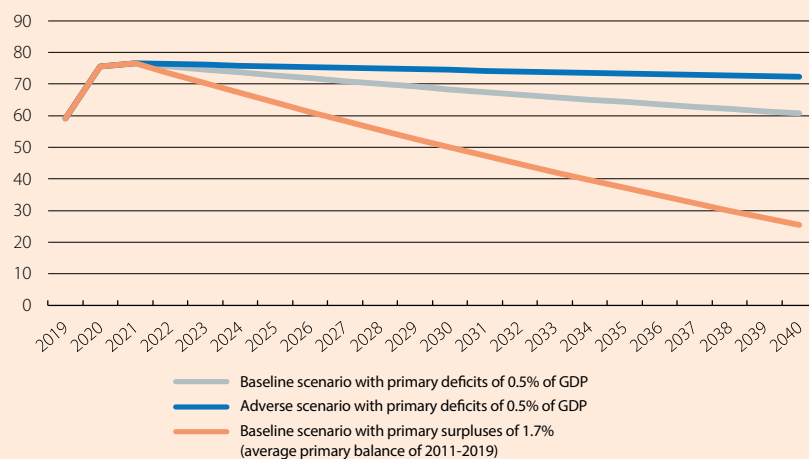
While it will be necessary to reduce public debt, there are good and bad ways to achieve this objective. More specifically, this process must be undertaken with great care: studies warn us that very rapid reductions in public debt in the absence of sustainability issues can generate rampant contractionary effects, while providing only minor benefits (in the form of a reduced likelihood of a debt crisis in the future).<sup>7</sup> Furthermore, questions have begun to be raised over whether it is a good idea to focus too much on determining public debt thresholds that are considered negative for growth (traditionally around 90% of GDP, although they actually depend on the characteristics of each country's economy): some economists<sup>8</sup> advise focusing less on absolute amounts and more on whether the debt is on a downward trajectory and whether its composition is reasonable.

In short, Europe faces the challenge of steadily reducing its public debt in the medium term. It is very encouraging to note that this process should be achievable without excessive doubts over its sustainability. As always, the main tools for achieving this will be boosting economic growth and ensuring sound management of the public accounts. The challenge will not be easy, especially in a continent with an ageing population where a significant portion of public spending is inertial. But the fact that overcoming the challenge ahead will not be easy does not mean that it cannot be done or, even less, that it should not be tried.

*Javier Garcia-Arenas and Adrià Morron Salmeron*

### Germany: paths of public debt reduction

(% of GDP)



**Notes:** A stable nominal GDP growth of 3.3% is assumed, in line with the IMF's long-term forecast as of October 2019. It is assumed that the cost of debt will remain constant at its 2019 level (1.3%). Deficit and public debt forecasts by the European Commission for 2020 and 2021. The adverse scenario assumes a 0.5-pp-lower GDP growth and a 50-bp-higher cost of debt.

**Source:** CaixaBank Research.

4. See Y. Huang, U. Panizza and R. Varghese (2018). «Does public debt crowd out corporate investment? International evidence». IHEID Working Papers 08-2018.

5. J. Woo and M.S. Kumar (2015). «Public debt and growth». *Economica*, 82(328), 705-739.

6. P. Burriel *et al.* (2020). «Economic Consequences of High Public Debt: Evidence from Three Large Scale DSGE Models». ECB Working Paper Series n° 2450.

7. See M.J.D. Ostry, M.A.R. Ghosh and R.A. Espinoza (2015). «When should public debt be reduced?». *International Monetary Fund*.

8. See M. Pesaran *et al.* (2015). «Is there a debt-threshold effect on output growth?». (n° 245). Federal Reserve Bank of Dallas.