Sharp rise in public debt: will the euro area resist?

- **The COVID-19 crisis is causing a sharp increase in public debt. However, the sustained reduction in interest rates and the lengthening of maturities are offering European economies some cover and are easing the financial burden.**
- **In 2021, general government funding needs will be supported by European funds and the ECB's accommodative policy.**

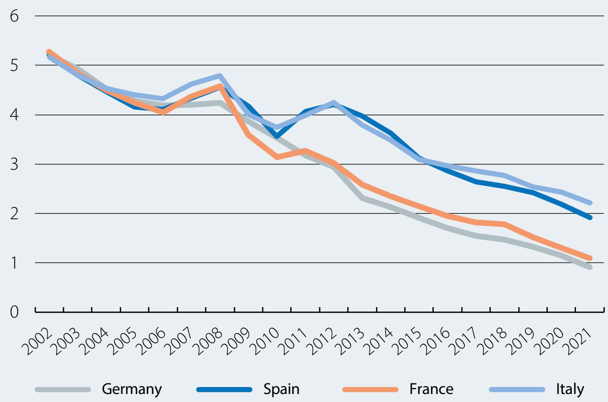
The COVID-19 pandemic is causing a sharp increase in debt. Since the outbreak of the pandemic, public debt ratios have risen suddenly and significantly to almost unprecedented levels (the historical precedents are closely linked to major wars). For instance, in Italy and Spain a jump of +25 pps of GDP is expected in just one year, whereas it took five and three years, respectively, to amass a similar increase after the financial crisis of 2007-2008 (and that was starting from a position of greater margin for fiscal manoeuvre).[1]

The rise in public debt is a necessary and effective reaction to soften the blow of an unprecedented fall in household and business incomes: borrowing entails cutting this exceptional decline up into smaller parts and distributing them over time. In many cases, however, public debt was already high to begin with. The sustainability of the debt is not in question,[2] but the surge has generated concern, and in the medium term there are worries that a heavier debt burden will hold back economic performance.

One basic condition for managing the sharp increase in public debt, and for laying the groundwork in order to gradually reduce it in the future, is that the economic recovery must be underpinned by sustained growth. To this end, it is key that the crisis does not become entrenched (for instance, due to an overly timid economic policy or premature withdrawal of the stimulus), and that opportunities to boost underlying growth are taken advantage of (for instance, by improving the economy's capacity to adapt to new technologies and to the energy and environmental transformations).

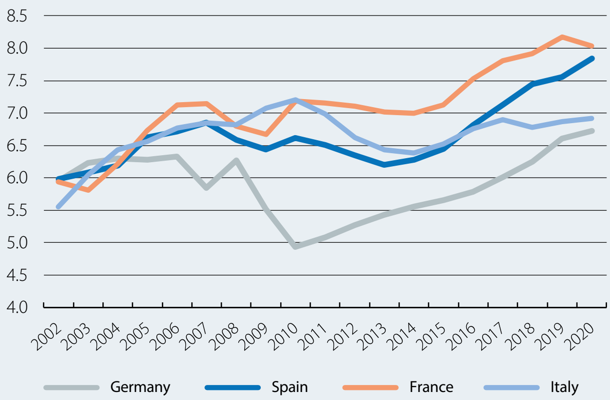
Furthermore, when assessing the consequences of the increase in debt, not only is it necessary to consider the level it reaches but also, in the short term, the financial burden it entails (debt payment flows relative to income flows). In an environment of low interest rates and with debt financed over long maturities, the financial burden should be manageable. Indeed, the current conditions in the euro area should allow for precisely this. In particular, the sustained reduction in interest rates over the past two decades (see first chart) and the lengthening of debt

Implicit interest rate of public debt
(%)



Source: *CaixaBank Research, based on data and forecasts from the European Commission (autumn 2020 forecast).*

Average maturity of public debt
(Years)



Source: *CaixaBank Research, based on data from the Treasury Departments of Germany, Spain, France and Italy.*

maturities (second chart) are offering European economies breathing space and easing their debt burden in terms of payment flows. In other words, as the third chart shows, the debt service ratio (formally defined as the interest and maturing principal payments as a percentage of GDP) has become much less stressed than the sharp increases in the debt-to-GDP ratios might suggest.

In 2021, the more sustained revival of the economy should provide some relief for the debt burden, both because of the «denominator effect» of GDP on public

1. See the article «The debt burden of the COVID-19 crisis» in the Dossier of the MR10/2020.
2. See the Focus «Should we be concerned about the sustainability of public debt in the euro area?» in the MR05/2020.

debt or public deficit ratios, and because of the inherent cyclical impact of economic activity on the public accounts (with the recovery of tax revenues and reduced pressure from the automatic stabilisers on expenditure). On the other hand, while in this scenario the public accounts will not have such a large deficit in 2021 as they have had in 2020, the public balances will nevertheless remain in clearly negative territory. That said, government funding needs are well covered. Firstly, investors' risk appetite has withstood the onslaught of the pandemic, as demonstrated by the success of the issues of debt by all national treasury departments in 2020. Secondly, in 2021 we will see the first disbursements of European funds under the Next Generation EU programme.[3] Thirdly, the ECB's accommodative monetary policy will continue to provide cover for the necessary action from fiscal policy. Indeed, the ECB's asset purchase programmes will remain highly active in the secondary markets throughout 2021, generating significant liquidity and favouring the willingness of private investors to absorb public funding needs in the primary markets (see fourth chart).

The importance of the ECB's role is apparent not only when analysing the 2021 public deficits, but also when assessing the debt burden in terms of debt-to-GDP ratios. In fact, the public debt ratios are much less stressed when the role of the ECB is taken into account (see last chart). In other words, public debt as a whole has a more stable investment base, and this protects it from financial turbulence. Moreover, the ratios also show less stress when taking into account net debt: that is, when financial assets held by the government (such as gold reserves, foreign currencies, deposits or debt securities) are discounted from the usual ratios (which are gross). However, it should not be forgotten that at some point the central bank will stop accumulating public debt on its balance sheet. When that time comes, it will be important for governments to have sufficiently cleaned up their accounts.

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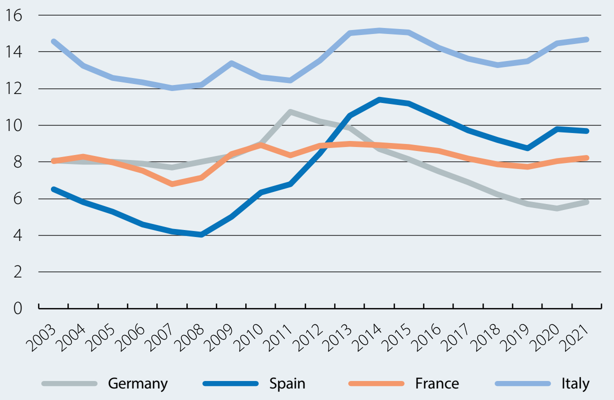
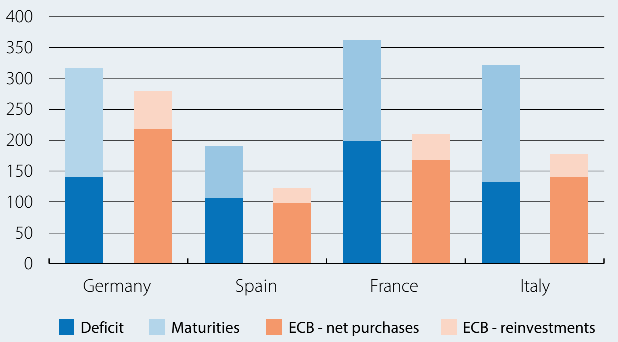
3. See «Everything you ever wanted to know about the European Recovery Plan but were afraid to ask» in the MR11/2020. In addition, Member States can also apply for loans from the European Stability Mechanism (ESM).

*Debt service ratios estimates **
(% of GDP)



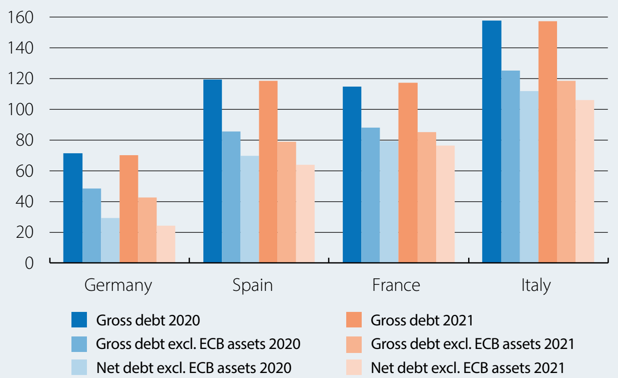
Note: ** Ratio between payments of interest charges and annual maturities, and nominal GDP.*
Source: *CaixaBank Research, own calculations based on data from the European Commission (average cost of debt, nominal GDP and gross public debt) and from the Treasury Departments of Germany, Spain, France and Italy (average residual maturity of the debt).*

Public funding needs in 2021
(EUR billions)



Note: *It is assumed that the ECB makes purchases under the PEPP at a rate of 60 billion euros per month (i.e. at a similar rate to that of Q4 2020 and with which 65% of the programme's total remaining capacity is spent in 2021), while the APP continues to have net purchases of 20 billion per month throughout 2021.*
Source: *CaixaBank Research, based on own calculations and forecasts, forecasts by the European Commission (autumn forecast) and data from the Treasury Departments of Germany, Spain, France and Italy.*

Public debt (1,2)
(% of GDP)



Notes: *1. It is assumed that the ECB makes purchases under the PEPP at a rate of 60 billion euros per month (i.e. at a similar rate to that of Q4 2020 and with which 65% of the programme's total remaining capacity is spent in 2021), while the APP continues to have net purchases of 20 billion per month throughout 2021. 2. Net debt subtracts government-owned financial assets (gold, currencies, deposits, debt securities, loans, insurance, etc.) from gross debt.*
Source: *CaixaBank Research, based on own calculations and forecasts, and forecasts by the European Commission and the International Monetary Fund.*