

Euro area: fiscal consolidation is not yet behind us

Low interest rates help debt dynamics, but macro matters more

Key points

- We measure how monetary policy and macroeconomic conditions could affect public debt prospects in four European economies in the next ten years.
- We look into debt sustainability under two alternative scenarios: a “normalisation” case where economic conditions improve and a “secular stagnation” scenario, where low growth and inflation push the European Central Bank to maintain its very accommodative policy.
- First, macroeconomic conditions and interest rates offset each other. Low interest rates reduce the debt service in the short and even medium term, but cannot compensate for the associated low nominal growth.
- Second, in both scenarios, debt-to-GDP ratios across most countries increase in the medium term in the absence of structural efforts. These are therefore necessary to start stabilising public debt ratios.
- Third, assuming significant and country-specific structural efforts, public debt had hardly started to edge down. Decline in structural deficits may thus not be enough as a public finances objective. This is particularly true for Spain and Portugal, which may struggle to stabilise public debt levels even if meaningful structural efforts are implemented.

Exhibit 1

Public debt levels under different scenarios

Public debt in 2026	France	Italy	Spain	Portugal
Normalisation scenario				
2026 debt level without structural effort (% GDP)	101%	124%	119%	133%
Structural effort (% GDP per year) (*)	0.4%	0.2%	0.5%	0.3%
2026 debt level with structural effort (% GDP)	83%	116%	98%	120%
Secular stagnation scenario				
2026 debt level without structural effort (% GDP)	110%	132%	129%	150%
Structural effort (% GDP per year) (*)	0.4%	0.2%	0.5%	0.3%
2026 debt level with structural effort (% GDP)	92%	124%	107%	136%

Source: AXA IM Research

(*) Structural effort needed to cancel the structural deficit within 5 years

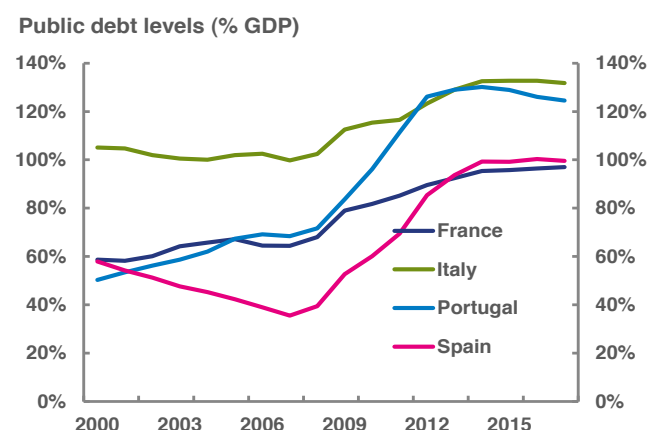
Some point out that ultra-accommodative monetary policy is impacting public debt management in a way that encourages fiscal profligacy and lowers incentives for consolidation. In particular, moral hazard may occur as countries are shielded from market discipline, as highlighted by the Bundesbank¹.

In the following note, we look into public debt sustainability for European economies under two alternative scenarios: a “normalisation” case and a “secular stagnation” scenario. Under both scenarios, we look at the contributions of the macroeconomic outlook and interest rates to sovereign debt dynamics.

We focus on France, Italy, Spain and Portugal, which we think illustrate interesting cases (*Exhibit 2*): mediocre growth and moderate budget deficits (France), low growth and low deficits (Italy) and high growth as well as high deficits (Spain and to a lower extent Portugal). In these countries, the interest rate outlook is far from negligible for public finances. The debt service amounted to respectively 57% and 60% of the total budget deficit in France and Spain in 2015 and was even higher in Portugal and Italy, at 103% and 161% respectively (both countries run primary surpluses).

Exhibit 2

Debt-to-GDP ratios have started to level off, but at high levels



Source: European Commission and AXA IM Research

QE and public debt management

Although monetary policy and public debt management are strictly disconnected to ensure their respective credibility, the frontier between the two remains porous as monetary policy easing influences debt sustainability in several respects:

- **Macroeconomic conditions:** easing monetary policy, if successful, raises nominal GDP and therefore improves debt sustainability, all else being equal;
- **Debt service:** easing monetary policy translates into lower borrowing costs but also lower incentive to reduce deficits.

¹ “The macroeconomic impact of quantitative easing in the euro area”, *Deutsche Bundesbank Monthly Report*, June 2016.

The monetary policy impact on debt sustainability should be neutral over the long run, as these mechanisms are reversed when monetary policy tightens. However, since the current ultra-low rates environment is expected to last for an extended period of time, persistent monetary policy easing is expected to play a meaningful role on debt sustainability over our 10-year forecast horizon.

Treasuries can also adapt their issuance strategies to take full benefit of ultra-low interest rates, and adjust towards more long-term issuances². This is the case in France, for instance, where long-term issues have increased by 10% over the last two years, while short-term issues have fallen by 13%³.

It appears important to form a view on public debt sustainability in Europe over the medium term in this unusual context of ultra-low interest rates. A normalisation of interest rates could weigh on debt-to-GDP ratios, although that would probably happen only in a scenario of stronger economic growth. Given that macroeconomic conditions and the level of interest rates tend to offset each other in the debt sustainability framework, the net effect of a potential quantitative easing (QE) exit is not obvious. Conversely, ultra-low rates for a long time in a context of mediocre nominal growth have unclear implications for public debt prospects.

We aim to shed some light on this question and analyse the impact of meaningful structural efforts on public debt prospects.

Debt dynamics in our two scenarios

We compute debt dynamics in a classical framework, looking at primary balances, debt services (interest payments) and nominal GDP growth. Our ultimate objective is to analyse how structural efforts could help to bring public debt levels down under different scenarios.

We consider two macroeconomic scenarios and two associated monetary policy paths over the 2016-2026 period. The baseline scenario is a **normalisation** scenario where GDP growth recovers slowly, thanks to stronger investment and improved productivity. This economic rebound brings inflation back to 2% by 2022. The European Central Bank (ECB) tapers QE progressively and normalises monetary policy, starting in 2018.

The downside scenario is **secular stagnation**, where GDP growth remains sluggish, as weak confidence weighs on the investment recovery. The ECB struggles to deliver on its 2% inflation target over the medium term. Its very accommodative monetary policy is thus maintained until inflation starts picking up in 2021. The combined effect of low inflation expectations and low economic activity translates into weak inflation prospects. Scenarios are presented in *Exhibit 3*⁴.

² “Government debt management at the zero lower bound”, Hutchins Center, Brookings, *WP n°5*, September 2014

³ According to auctions data of *Agence France Trésor (AFT)*.

⁴ We use our GDP forecasts for 2016-2017 and estimate potential growth for the 2018-2026 period, using a growth accounting framework in line with the Conference Board methodology. Regarding inflation projections, we assume common forecasts for

We expect interest rates to go up again over our horizon, either slowly in the stagnation case or faster in the normalisation case. In the simulation, we take the 7-year government bond yield as a proxy for borrowing costs as it matches the average maturity of government debt for our countries. It reaches nominal GDP growth level by 2022, and remains in that steady state afterwards.

What matters for debt sustainability though is the average interest rate paid on outstanding debt, which in turn determines interests paid (the debt service). Forecasting this average interest rate requires assumptions on the amount of new issuances each year and the interest rate paid at issuance. First, we assume a constant primary balance (stable at the 2015 level as a share of GDP). Then, we consider structural efforts needed to cancel structural deficits⁵ within five years, and report the implied effort on the primary balance. This assumption is based on the intuition that all countries will attempt to recover some fiscal space by bringing structural deficits back to balance.

Exhibit 3
2016-2026 average assumptions in both scenarios

2016-2026	France	Italy	Spain	Portugal
Normalisation scenario				
Real GDP	1.5	0.7	1.5	1.1
Inflation	1.6	1.4	1.5	1.4
Gov Bond yields (7y)	2.5	2.3	2.5	2.9
Debt service (% GDP)	2.0	2.6	2.7	3.3
Secular stagnation scenario				
Real GDP	0.9	0.4	1.0	0.7
Inflation	0.8	0.7	0.6	0.9
Gov Bond yields (7y)	1.2	1.1	1.3	1.8
Debt service (% GDP)	1.6	2.2	2.1	2.9

Source: AXA IM Research

We assume redemptions based on the historical average maturity of debt. We then estimate the yearly gross borrowing requirements (sum of primary balance, interest payments and redemptions) of each country over the period 2016-2026, to which we apply our average interest rate forecasts.

Given these assumptions on interest rates, the debt service bottoms out around 2020 and starts rising thereafter, increasingly weighing on budget deficits.

This work presents the caveat of being a partial equilibrium analysis that does not take into account interaction with global developments, but helps to shed some light on debt prospects issues.

Towards a sustainable path

Our simulation results yield the following conclusions.

First, as expected, macroeconomic conditions and interest rates offset each other, but macroeconomic

the four countries. Inflation remains weak, especially in the secular stagnation scenario.

⁵ As measured by the IMF.

factors appear to dominate: debt prospects are worse in the secular stagnation scenario. This is important as it goes against the usual perception that the current low interest rate environment is a blessing for debt sustainability. It indeed reduces the debt service in the short and even medium term, but cannot compensate for the associated low nominal growth.

Second, in both scenarios, debt-to-GDP ratios across most countries increase in the medium term in the absence of structural efforts (*Exhibit 4 to 7*). *Exhibit 1* shows the impact of the necessary structural effort to bring structural deficit back to zero within five years.

Third, these structural efforts are enough for public debt ratios to stabilise or start declining. They remain at high levels though, implying limited room for manoeuvre for fiscal expansion in the case of an economic shock.

In France, the secular stagnation scenario impacts debt prospects substantially: while the debt level remains manageable under the normalisation scenario, it rises above 110% of GDP in the pessimistic scenario. A yearly 0.4% of GDP effort on the structural balance yields declining public debt ratios under both scenarios.

In Italy, the public debt ratio reached the record high level of 133% of GDP in 2015. It is expected to decline under both scenarios, even in the absence of structural effort. This is due to an already small structural deficit, at 0.8% of potential GDP, after years of austerity. This results in a persistent primary surplus. In case a structural effort is implemented (0.2% of GDP per year), debt declines further and reaches 117% of GDP by 2026, under our normalisation scenario.

In Spain, debt appears on an unsustainable path in our simulation, reaching more than 125% by 2026 in the secular stagnation scenario. Hence, even when considering a meaningful structural effort of 0.5% of GDP per year until 2020, the debt level barely stabilises.

Portugal is also worrisome: debt reaches record highs (133% of GDP in the normalisation scenario, 150% in the secular stagnation scenario under the no-effort assumption). A 0.3% of GDP of structural effort per annum allows public debt to start declining at a slow pace in the normalisation scenario, while it continues to rise in the secular stagnation case.

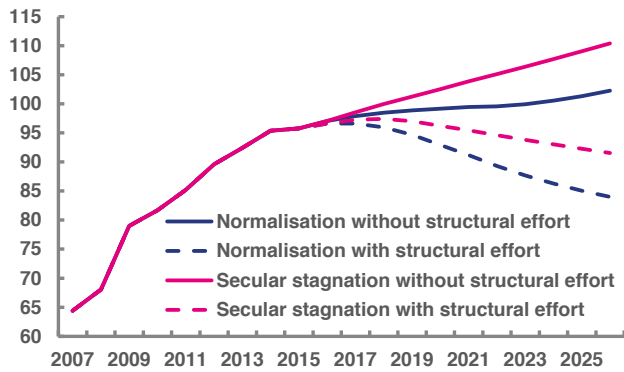
Conclusion

Fiscal policy is a crucial aspect of the policy mix and has regained some importance recently as monetary policy is widely considered overburdened. However, our analysis shows that ultra-low interest rates are no panacea for public debt sustainability. As a result, the current environment cannot be an excuse to avoid reforms: delivering stronger potential growth should remain a critical objective to improve debt sustainability. Loose monetary policy buys some time but growth will be badly needed when, sooner or later, the debt service rises as interest rates normalise.

Exhibit 4

France: secular stagnation impacts debt prospects substantially

Public debt scenarios - France (% GDP)

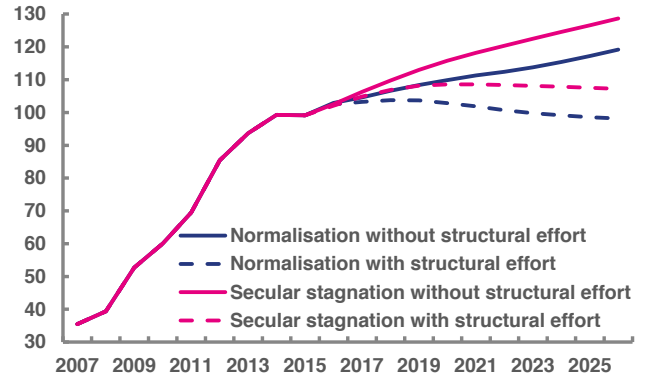


Source: European Commission and AXA IM Research

Exhibit 6

Spain: public debt is sustainable if sufficient structural effort is made

Public debt scenarios - Spain (% GDP)

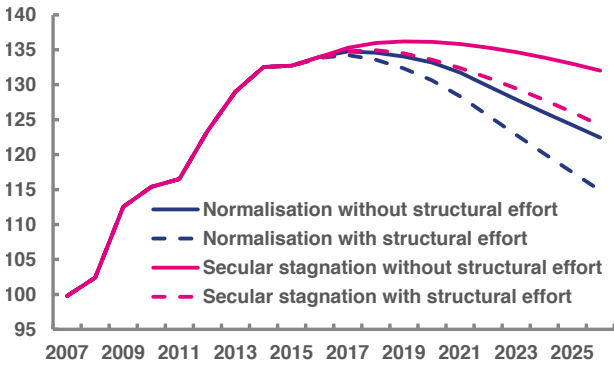


Source: European Commission and AXA IM Research

Exhibit 5

Italy: public debt ratio will decline in any case, but remains at high levels

Public debt scenarios - Italy (% GDP)

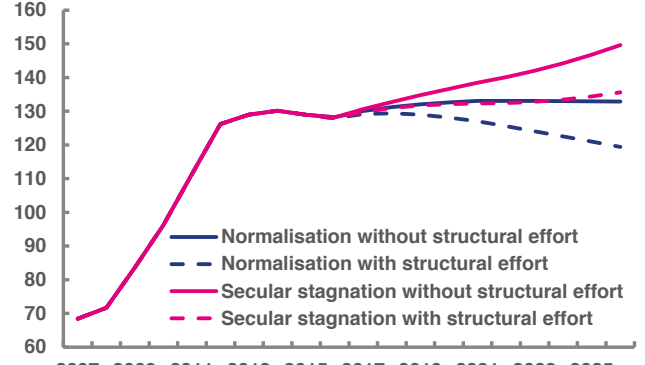


Source: European Commission and AXA IM Research

Exhibit 7

Portugal: public debt level remains high and requires significant structural effort

Public debt scenarios - Portugal (% GDP)



Source: European Commission and AXA IM Research

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