Finanzgruppe
Deutscher Sparkassen-
und Giroverband

STANDPUNKTE
DER CHEFVOLKSWIRTE

# Debt in Europe: Challenges and Policy Options

7th December 2021

**Chief Economists:**
Uwe Dürkop - Berliner Sparkasse
Jochen Intelmann - Haspa
Dr. Ulrich Kater – DekaBank
Dr. Moritz Kraemer - LBBW
Christian Lips - NORD/LB
Dr. Jürgen Michels – BayernLB
Dr. Reinhold Rickes - DSGV
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann
- Kreissparkasse Köln

**Coordinator:**
Dr. Sonja Scheffler
sonja.scheffler@dsgv.de

**The coronavirus pandemic led to a severe global recession and has provoked a massive increase in government debt. The June 2020 Statement by the Chief Economists of the Savings Banks Finance Group set out reform options for tolerating excessive debt levels over the first half of this decade. Consolidating public finances while exhausting all available investment opportunities remain the current imperatives in Germany, as in Europe in general, for future viability. The following are important key parameters:**

- It is not advisable to cut public-sector investment spending, or to increase taxes and fiscal charges, as that would jeopardise the economic recovery. Government measures designed to bolster private investment and promote growth should be stepped up.
- A recalibration of the fiscal rules underlying the Stability and Growth Pact is called for in view of the enduring low-interest phase. This applies in particular to the 60 percent ceiling currently applying to the debt-to-GDP ratio (pursuant to the Maastricht Treaty).
- If public debt is added to via “special funds”, the retrenchment path should be bindingly laid down in Germany too.
- The reform proposals put forward by the Chief Economists in their June 2020 edition of Statement (Linking EU fiscal policy stability and sustainability!), aimed at enhancing governance and strengthening fiscal soundness and solidarity remain valid today.

## Public debt has surged sharply

*Ballooning public debt*

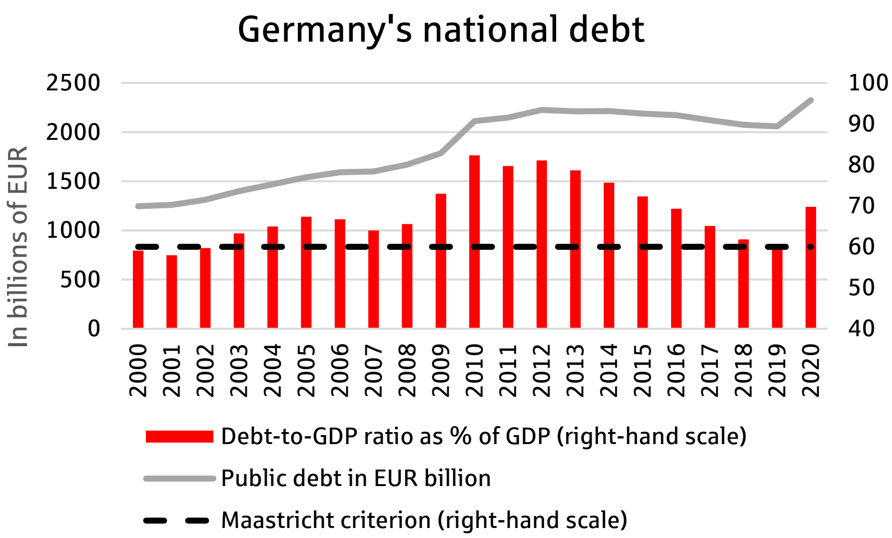
The coronavirus pandemic not only triggered a severe global recession but has also precipitated a massive expansion of government debt. According to estimates by the International Monetary Fund, the global public-debt burden is destined to rise to around USD 100 trillion this year. That corresponds to a public-debt ratio of no less than 100 percent of global gross domestic product (GDP).

*Debt rose particularly fast in the industrialised countries in 2020*

In 2020, the first year of the pandemic, debt-to-GDP ratios (the sum of general government debt relative to nominal GDP) received a double boost ("double whammy"), spiking both as a result of the economic slump and in response to additional borrowing to finance government aid programs. The debt pile increased particularly sharply in the industrialised countries. In the USA, the debt-to-GDP ratio had spiked to 127 percent at the end of 2020. The euro area, roughly comparable to the USA in terms of population, had a debt-to-GDP ratio of 98 percent at the same point in time.

## Germany too is now above the debt ceiling

In Germany, aggregate government liabilities increased by EUR 267 billion to EUR 2,325 billion last year, according to calculations by the European statistics office Eurostat. According to the methodology used by the Federal Statistical Office (Destatis), they stood at EUR 2,172 billion at year-end 2020. The difference can be explained by Germany's inter-governmental loans to other EU countries, which are factored in by Eurostat.



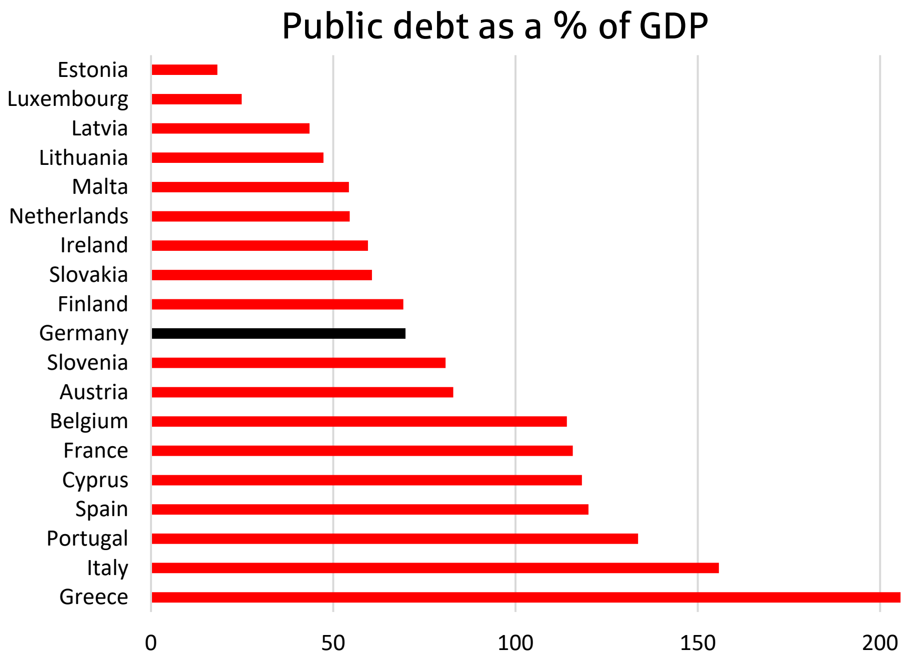

Source: Eurostat

In Germany, the debt-to-GDP ratio was standing at 69.8 percent at the end of 2020, having fallen below the upper limit of 60 percent of GDP set down in the Maastricht Treaty in the previous year for the first time since 2002. The highest reading was measured in 2010 - 82.3 percent of GDP.

## The euro area has accumulated public debt equivalent to gross domestic product

In the euro area, the debt-to-GDP ratio worked out at 98 percent in 2020. So Germany was in the middle of the pack with its ratio of 69.8 percent. The European Commission estimates that the euro area public-debt ratio will rise to 102 percent of GDP in 2021. Italy and Greece have comparatively high debt-to-GDP ratios. Not coincidentally, these two countries also consistently have the widest yield spreads compared with Germany.

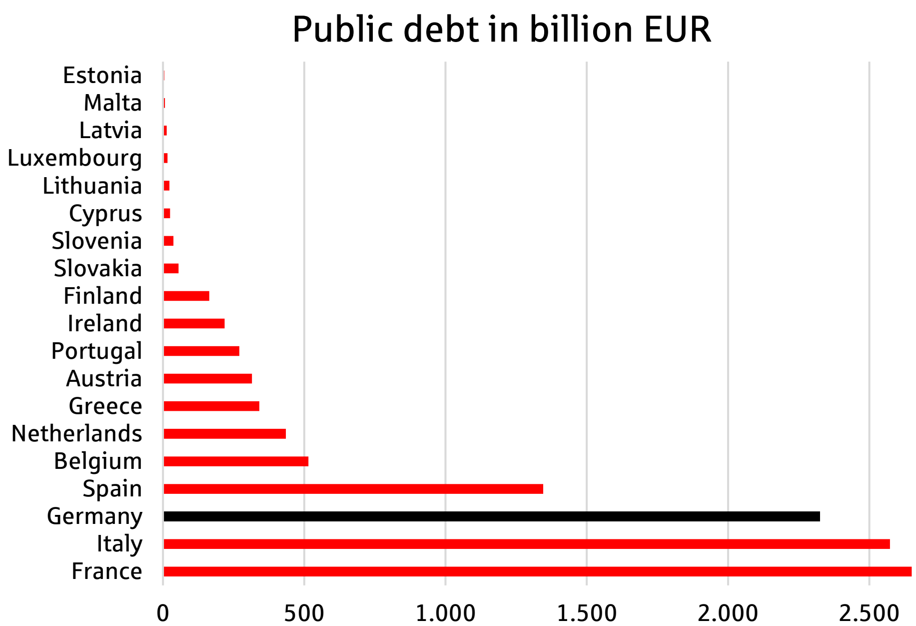
*Germany's public-debt ratio was at 69.8 percent at year-end 2020*




Source: Eurostat

In absolute terms, Germany, France and Italy have the highest debt in the euro area. This shows that the debt of these countries is of particular importance for the euro area.

*In absolute terms, France is carrying the most debt*




Source: Eurostat

## The solidity of public finances is on the front burner

In the June 2020 Statement by the Chief Economists of the Savings Banks Finance Group, debt was identified as one of the defining issues of the 2020s. At that time, it was argued that excessive debt levels could be tolerated during the first half of the decade due to the prospect of comparatively low interest rates. They also urged that Europe – pandemic permitting – should continue on a sustainable consolidation course. The main objective, it was advocated, should remain to ensure the long-term soundness of the public finances of EU member states. We continue to warn that Europe should not compromise on this basic philosophy.

*No compromises are to be made on ensuring solidity*

There are different ways of achieving the sound-finances target. In essence, the reform proposals drawn up by the Chief Economists in June 2020 regarding the European Commission's demands still stand. In the following, some of them will be analysed in an updated form, particularly in the light of the developments witnessed over the past year, and equipped with recommendations from an economic perspective.

## No higher taxes and fiscal duties

In the run-up to September's German general election, there were calls for higher taxes and levies to improve the government's revenue position. However, it should be noted that higher taxes and fiscal charges entail a reduction in the disposable income of private households and lower profits for companies. A greater financial burden on private households, especially for those with higher consumption shares, would be highly problematic in view of the need to stabilise aggregate demand at a time when risks to the macroeconomic trend remain elevated, but also with regard to distribution issues.

*An increase in taxes and levies primarily affects those on low incomes*

Lower corporate profits could also reduce the potential growth rate of the German – as of the wider European – economy via declining investment activity. Higher wage, income and corporate taxes stunt aggregate demand and accordingly erode macroeconomic growth. Imposing such tax hikes would endanger the still only partially completed economic recovery, which remains fragile due to the pandemic.

*Tax hikes would crimp economic growth*

It would appear more expedient to adopt targeted growth-enhancing measures in order to chip away at debt ratios through higher growth rates. In the current environment, a government-initiated investment offensive would be a suitable option, as called for in the September 2021 Statement by the DSGV Chief Economists (Strengthening private and public investment). In this context, the government ought to offer financial incentives for accelerated private investment. For example, significantly improved depreciation options for future-oriented investments could be considered, as recently highlighted by the ifo Institute.

## It would be a mistake to cut government spending

*A reduction in transfer payments would dampen aggregate demand*

The decision to extend the duration of the government coronavirus-assistance program until March 2022 is appropriate in the light of the current surge in the tally of infections. If the fourth Covid-19 wave were to subside, it would be right to aim at phasing out these demand-side support measures. Public-sector spending on investment has a particularly significant bearing on the recovery process: such dynamic expenditure must be boosted rather than diminished. Otherwise, production cuts and layoffs would be the medium-term consequence. If the economic recovery were to stagnate due to the ongoing pandemic, lower tax revenues and higher social spending would continue to be on the cards.

## Growing our way out of debt

*Germany logged moderate debt reduction post-2015*

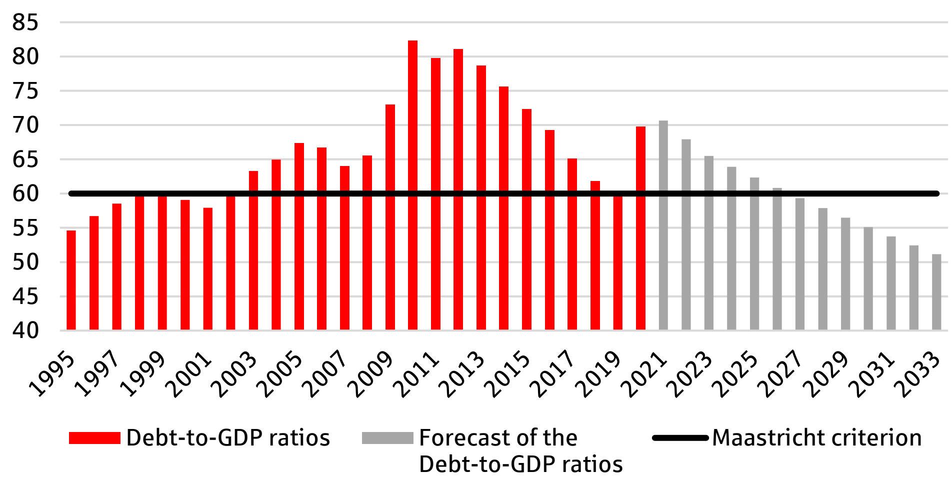
Following the financial market crisis of 2008 and 2009, public-debt ratios soared. In 2010, Germany recorded aggregate liabilities of EUR 2.1 trillion, corresponding to a record ratio of 82.3 percent of GDP. In the years following the crisis, Germany managed to stabilise its national debt in the EUR 2.2 trillion range. From 2015 onward, moderate debt consolidation took place. At the same time, nominal GDP grew from EUR 2.4 trillion in 2009 to EUR 3.4 trillion in 2019. In the process, the debt-to-GDP ratio fell to just under 60 percent of aggregate economic output. According to calculations by research institutes, growth in nominal GDP made the largest contribution to this reduction, accounting for around three-quarters. To put the point more graphically, Germany outgrew its debts. Now Germany, and Europe in general, have another chance to roll out this model, this time in order to overcome the coronavirus pandemic. Everything must now be done to invigorate the forces of growth in Germany, as elsewhere in Europe.

This is all the truer as further reductions in interest costs are not to be expected to the same extent as in the last decade and as, at the same time, demographic developments are set to put a damper on potential growth in the coming decade. Under the “outgrowing debt” strategy, the sum of debt in the numerator needs to grow more slowly than nominal GDP in the denominator; if it does, the debt ratio will decline from year to year. The process will accelerate at higher inflation rates. A deliberate reflation policy would cause ratios to decline more quickly, but should not be pursued.

The order of the day is therefore to switch from an expansionary fiscal policy involving extensive support measures for consumption (coronavirus assistance for both citizens and companies) to a supply-supply economic approach. Such an approach should be accompanied by structural reforms to strengthen competitiveness and, in particular, to overcome supply bottlenecks and the price increases associated with the latter on a medium-term horizon. If this generates macroeconomic growth, the mountain of public debt built up in Germany and Europe could also be brought down again in the medium term.

According to the scenario sketched below, Germany's debt-to-GDP ratio would be back down below the Maastricht limit of 60 percent again as early as in 2027. The following assumptions were made for this purpose. (1) Debt peaks at EUR 2,550 billion in 2023 and then plateaus at this level, even if it is assumed that some debt could be repaid. A possible offsetting item here is that new debt would have to be raised in response to, for example, the fourth wave of the pandemic. (2) German GDP grows by 2.5 percent in 2021, by 4 percent in 2022, by 2 percent in 2023 and by 1 percent annually thereafter. (3) Inflation weighs in at 3 percent in 2021, 2.5 percent in 2022, 2 percent in 2023 and 1.5 percent annually thereafter. Minor deviations from the assumed parameters will have no significant impact on the outcome.

Debt-to-GDP ratios as a % of GDP for Germany




Source: Eurostat

*The new government needs to accelerate the "growing-out-of-debt" process*

An economic perspective urges that the new federal government in Berlin should not increase taxes or fiscal charges in order to reduce public-debt ratios. Consumption-oriented coronavirus-related aid should be reduced, but it would be wrong-headed to implement cuts to investment-oriented spending. Government measures to promote private-sector investment and macroeconomic growth are the most effective way to speed up the process of growing one's way out of debt. In addition, the new German government, in cooperation with the other member states, could negotiate a simplification of the Stability and Growth Pact at the pan-European level.

## Reforming the Stability and Growth Pact

*The SGP: Coordination and surveillance*

The Stability and Growth Pact (SGP), signed and sealed in 1997, is a rules-based framework for the coordination and surveillance of national fiscal policies across the European Union. The SGP is intended to guarantee sound public finances. The convergence criteria for euro area membership, which were established as early as in 1992 in the run-up to the introduction of the euro, stipulate a general government fiscal deficit of no more than 3 percent of GDP and a maximum public-debt level of 60 percent of GDP. These rules have been continuously adjusted. Today, however, it is more than obvious that the economic environment on the basis of which the reference values were calibrated at the time has altered significantly. The interest-rate landscape has changed completely: the interest-rate structures prevailing in the 1980s and 1990s no longer exist. To that extent, reforms should start with these axiomatic benchmarks, and a regular review (for example, every 5 or 10 years) should be anchored on a Europe-wide basis.

It also needs to be taken on board that the public-debt criterion, in particular, has never – or, at any rate, rarely – been complied with by some countries. A debate has once again begun in the EU on reforming the budget and debt rules. The rules in question are currently suspended due to the pandemic and are not expected to come back into force until 2023, and then only in a modified form. It accordingly remains important to agree on important reforms in 2022. On this score, many aspects of the kind highlighted by the Chief Economists in their June 2020 Statement – such as sanctions, creation of fiscal councils, etc. – need to be considered. What remains central, however, is to remodel the anchor variable for public debt and the approach to achieving this goal.

*Rapid debt consolidation would entail disadvantages*

The economic think-tank Bruegel also points out that consolidating public budgets overly quickly would be detrimental. By way of illustration, the rapid reduction of budget deficits from 2011 onwards became, in Bruegel's assessment, the main driver of the 2012 recession. Ironically, the principal victim of these austerity measures was public-sector investment.

*The EU's goal is to be climate-neutral by 2050*

A particular challenge in the coming years will be to reconcile the policy goal of consolidating government budgets with the task of generating massive additional public investment in order to comply with Europe's climate targets. After all, the EU is aiming to be climate-neutral by 2050. The "Fit for 55" program envisages that $CO_2$ emissions should already have been reduced by 55 percent as of 2030 compared with 1990 levels. To achieve even this interim target, public-sector investment across the EU is going to have to increase by EUR 100 billion per year, according to Bruegel's estimate. The Chief Economists of the Savings Banks Finance Group likewise believe that investment requirements are very high, as we pointed up in our September 2021 position paper (Strengthening private and public investment). Estimated investment requirements for Europe work out at between EUR 90 billion and EUR 732 billion, with the German share amounting to between EUR 22 billion and EUR 172 billion.

The German Climate Protection Act, as amended in August 2021, even provides for a 65 percent reduction in greenhouse-gas emissions by 2030 compared with 1990 levels. In addition, various programs have been launched to promote industries of the future, such as hydrogen and semiconductors, so as to secure the independence of Germany and of Europe. Extensive public-sector investment also needs to be planned to modernise infrastructure, promote research and accelerate digitalisation.

*A "Green Golden Rule"*

How can taking on the necessary additional debt be squared with the goal of consolidating public budgets in the post-pandemic period? Bruegel proposes a "green fiscal pact". This includes, amongst other things, a "Green Golden Rule", according to which debt for "green" investments is to be excluded from the calculation of debt rules. The observance of "golden rules" also had a special status in the June 2020 Statement by the Chief Economists. Now of all times, we therefore advocate that sustainable public-sector investments should be specially evaluated when allowing the fiscal rules to "breathe with the cycle". On the other hand, we believe that no new fixed rule should be anchored for this purpose.

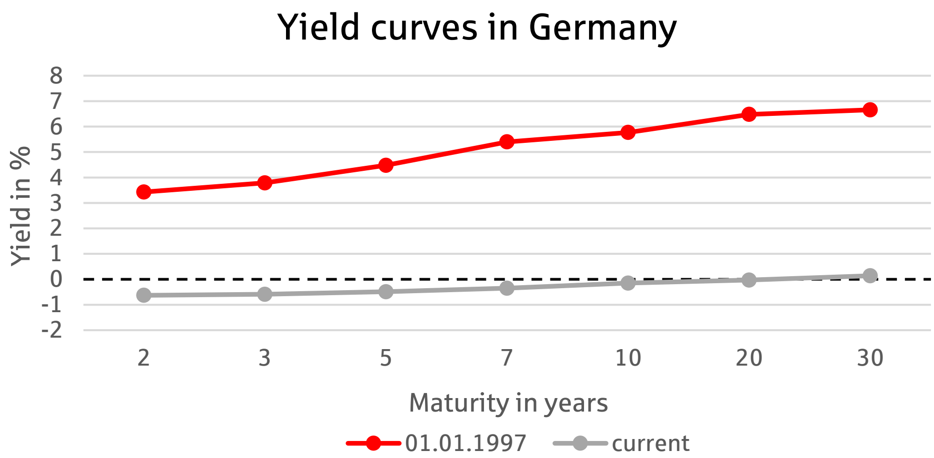
Such flexible proposals meet with approval in Southern Europe, while in Northern Europe in particular – at least so far – no fundamental need for an amendment of the Stability and Growth Pact is seen. France, by contrast, is pushing for reform because, in their view, there is a danger that an overly ambitious reversion to the (currently suspended) stability criteria would limit growth too quickly. In addition, the French argue that such a reversion would render it impossible for EU member states to finance the necessary investments for the future from their ordinary budgets, especially on a medium-term horizon.

The criteria underlying the Stability and Growth Pact were adopted at a time when growth rates, inflation rates and bond yields were significantly higher than today. The criteria were appropriate at the time and were chosen in such a way that public-debt ratios could be brought back into the targeted range with growth rates running at 3 percent per year and inflation rates at 2 percent.

Over the past couple of decades, the entire environment has changed significantly. The interest-rate structure is completely different from what it was in the late 1990s. More specifically, low growth rates and the ultra-accommodative monetary policy pursued by central banks have greatly reduced both bond yields and the equilibrium interest rate. In addition, it is unlikely that the fundamental framework data prevailing at the time when the Maastricht criteria were set are going to make a comeback.

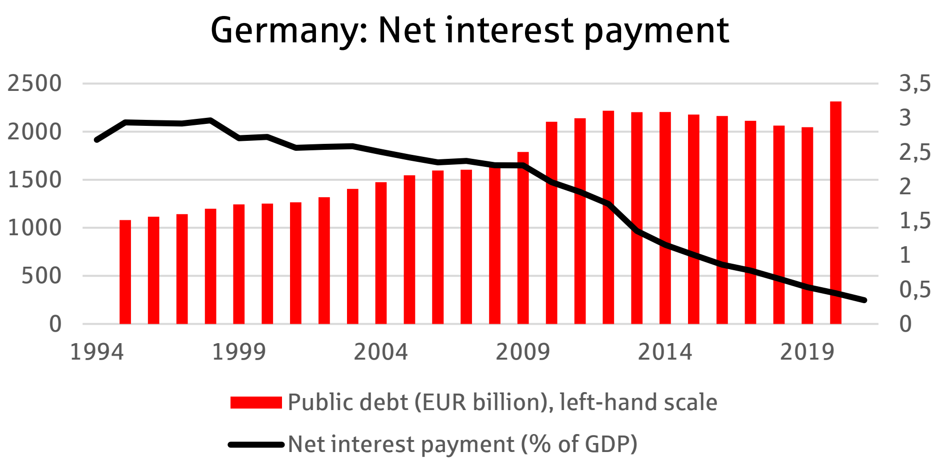
*A paradigm shift in the interest-rate landscape*

Overall, therefore, the entire fiscal-policy corset in Europe needs to be uncluttered. In that way, arguments about fine-tuning fiscal policy in line with cyclically-adjusted deficits, or about more detailed methods of defining productivity, could be avoided. The decisive factor must be to pursue the goal of consolidation while keeping an eye on the whole range of macroeconomic data. In this context, a more moderate line needs to be found for the macroeconomic-imbalance procedure when trade surpluses/deficits arise in the euro area. After all, export strength or weakness is always too a market outcome. In the future, whilst duly respecting the independence of the European Central Bank, more attention should be paid to the interest-rate structure when framing the fiscal-policy stance as well.




Source: Refinitiv Datastream

The sharp drop in bond yields has led to a massive reduction in the government debt burden. More specifically, Germany's net interest payment has fallen from a shade under 3 percent of GDP in the 1990s to a current level of just 0.3 percent of GDP. Over the same period, the Federal Republic’s overall public debt grew from c. 1 trillion euros to 2.3 trillion euros.




Source: Refinitiv Datastream

Furthermore, the rules of the Stability and Growth Pact have become more and more complex due to ever new additions, becoming almost arbitrary in the process. Simplification is urgently needed in order to push back against political influence on the assessment of each member state's debt. The simpler such fiscal policy rules are, the better.

*The Stability and Growth Pact urgently needs to be simplified*

The basic idea of controlling public debt should definitely be retained when carrying out the reform. We do not, in any way, subscribe to the view that the government-debt ceiling should be open on the upside, provided only that the respective central bank purchases enough bonds. Every purchase by a central bank is accompanied by an increase in the monetary base and thus carries with it the potential to induce a greater expansion of the money supply. If citizens and companies are then no longer willing to hold such inordinate amounts of money, inflation is the result. For this reason, debt limits – anchored as far as possible in the constitution – are indispensable.

*Uniform debt limits should be defined for all euro area member states*

The limits for sovereign debt cannot be clearly determined scientifically, especially since they depend on many idiosyncratic characteristics of a given economy and of a given political system. Nevertheless, uniform limits can be defined for the association of euro area member states, and this should remain the case in future.

*The budget-deficit ceiling of 3 percent per year should be maintained*

The debt sustainability of each borrower depends on the prevalent interest-rate level and on their income trend (measured in the case of sovereigns by GDP growth). The reform should stick to the criterion calling for a maximum annual budget deficit of 3 percent of GDP. The public-debt ceiling, on the other hand, could be changed. If the sharply lower interest rate-level, which is likely to prevail for quite some time to come, is to be taken into account, a recalibration of the limit could be considered. An increase in the debt ceiling from the current level of 60 percent to 80 percent of GDP would be justifiable in view of the stubbornly low-interest-rate environment. Our advice here is for a cautious increase of this kind rather than for a less gradualistic step-change to 100 percent, as proposed by the ESM economists. At all events, such reforms must prevent Europe from lurching down the road leading to a debt union. In this respect, such a reform should also be combined with a regular review in accordance with a sunset clause. At the end of this decade, for example, an examination should be conducted to establish how interest-rate structures have changed on the markets, and then the public-debt ratio should be recalibrated accordingly.

If the debt ceiling is linked to the interest-rate level in this way, it must logically also be possible to lower the debt limit again if interest rates rise. To prevent this from leading to hectic swings in fiscal policy, such a regular review of the ceiling should only take place on a long-term basis, i.e. roughly every 5 to 10 years. So far, in our view, too little attention has been paid in the debates on fiscal-rule reform to this aspect of recalibrating the rules in response to the structurally significant change in the interest-rate situation. We therefore want to particularly emphasise this aspect.

*A realistic reduction of the public-debt burden*

Countries with excessive debt loads should continue to work on reducing their public-debt ratio. However, this must be done within a realistic framework. The automatic reduction targets set so far are too ambitious and should be defined individually with each country. As in the existing Stability and Growth Pact, sanctions for violations need to play a significant role. If a country receives aid or transfer payments from within the EU, such aid programs should be subject to conditions. In extreme cases, consideration should also be given to intervening in the budgetary policies of countries that do not adhere to their reduction plans.

## A Climate Stabilisation Fund

*The new federal government may well set up public investment and transformation funds*

The new federal government in Berlin can use the current framework conditions to launch a comprehensive investment program designed to finance the necessary investments for the coming years. For example, public investment and transformation funds that provide companies with state equity could be set up. The Economic Stabilisation Fund, which the German government launched after the onset of the coronavirus crisis, has a volume of EUR 600 billion, the monies in this fund being earmarked for state investments and to secure loans. Less than EUR 10 billion has been drawn on so far, as most companies have come through the crisis without government assistance. Against this background, it would be worth considering continuing to keep the remaining funds on tap and converting the Economic Stabilisation Fund into a Climate Stabilisation Fund.

## Strengthening private investment with "citizens' funds”

*Strengthening private investment capacity*

Despite all the debates about new government-debt modalities, it remains important to continue to strengthen private investment capability. In addition to necessary regulatory relief, for example, the currently high deposit levels in banks and savings banks which savers have set aside could be promoted without equity support by the state (for example through tax incentives) via "citizens' funds" in order to bolster sustainable and digital investments over the course of this decade. Such approaches should be pursued not only in Germany but also in the other euro area states, or indeed in the wider EU. They reflect the interplay between self-responsibility and solidarity that is embodied in the principle of subsidiarity.

## It is important to lay down a debt-reduction path

In view of the interest-rate situation and the suspension of the debt brake due to the coronavirus outbreak, 2020 will certainly offer various opportunities to significantly expand government debt via “special funds”. However, it is imperative to clearly define a binding reduction path for this additional debt in Germany and to take into account the need for consolidation, which is important in the medium term. This should also be a requirement at a pan-European level with a view to the “NextGenerationEU”-recovery plan.

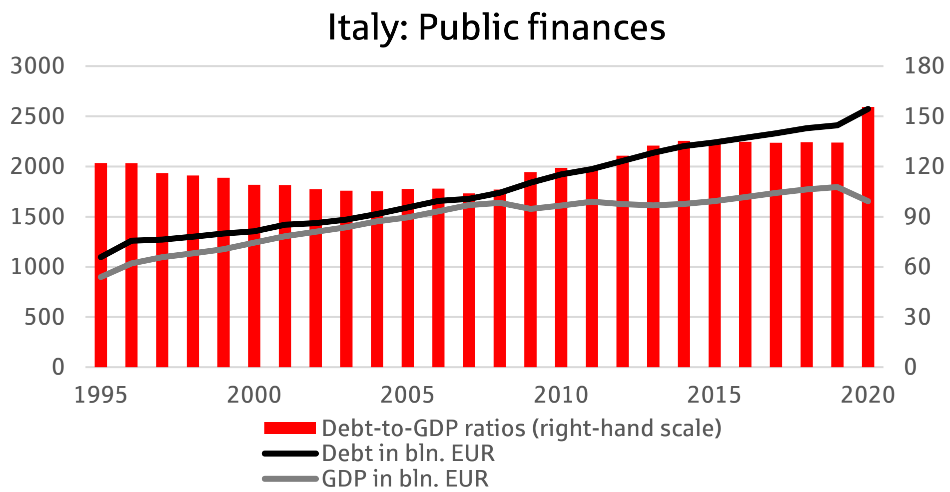
*The contribution made by the ECB’s low-rate policy*

The soundness of public budgets is the basic prerequisite for government-debt sustainability. The European Central Bank's low-interest-rate policy is making a significant contribution to ensuring, or rather restoring, this despite the great dangers such a policy incurs due to moral hazard, fiscal dominance of monetary policy and a redistribution that is not democratically legitimised, as can be illustrated by the example of Italy.

## Excursus: Italy's public finances are on the road to recovery

*Italy's public debt stands at EUR 2.6 trillion*

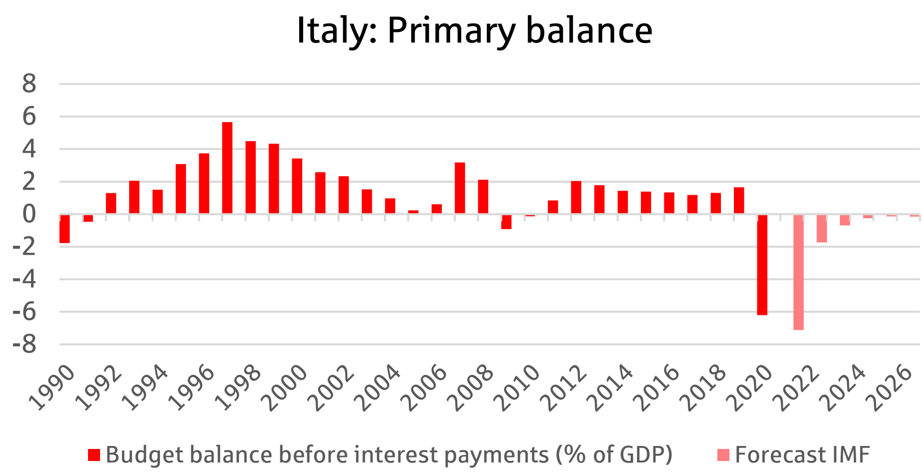
Italy is indebted to the tune of around EUR 2.6 trillion and has a debt-to-GDP ratio of almost 156 percent. The debt burden of the fourth-largest economy in the euro area has repeatedly been the target of criticism and doubts about the European Monetary Union and the common European currency, the euro.




Source: Refinitiv Datastream

*A budget surplus was predominantly racked up in the period to 2019*

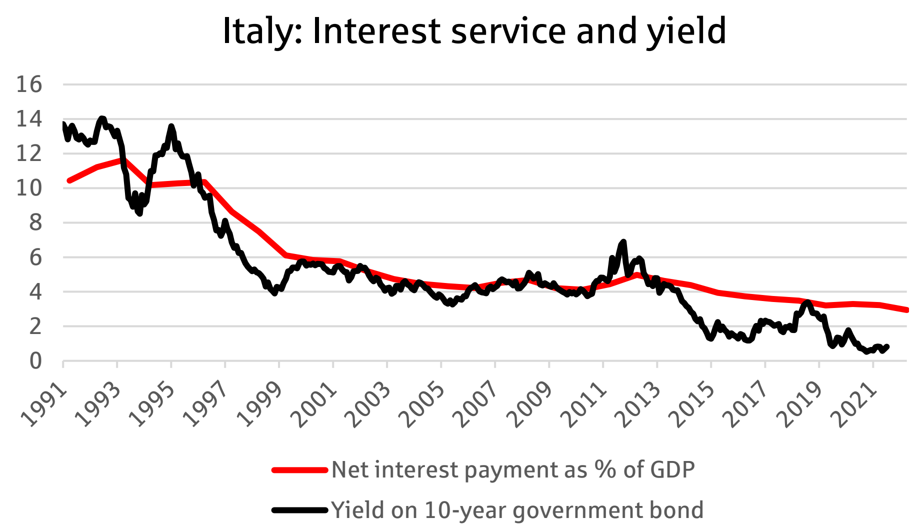
From the beginning of the 1990s right through until the pandemic struck, the primary balance (i.e. stripping out interest payments) of the Italian government budget has been in surplus almost without exception. Excluding interest costs, then, Italy thus mostly achieved budget surpluses in the period to 2019. According to IMF estimates, the primary balance will approach zero again from 2024 onwards.




Source: Refinitiv Datastream

Expenditure on government interest service has been rising steadily since the 1970s, peaking at just under 12 percent of GDP in 1993. Since then, the downward trend in bond yields has eased the situation. Where yields on 10-year Italian government bonds (BTPs) were still in the double digits until 1996, they now stand at less than 1 percent. As a result, annual government interest service for Rome has dwindled to around 3 percent of GDP.

*Italy's interest service peaked in 1993 at just under 12 percent of GDP*




Source: Refinitiv Datastream

By the end of 2023, the majority of Italian government bonds carrying coupons of 4 percent or higher will have matured. In the course of the debt-roll-over process, high-yielding old debt is going to be refinanced by bonds with much lower coupons. True, this will not downscale the mountain of debt. However, the interest burden on the Italian government budget will be reduced. The boot-shaped peninsular's debt sustainability will be accordingly strengthened. At the same time, Italy's fiscal vulnerability, and thus that of the euro area too, stands to be reduced.

*Italy's fiscal vulnerability is decreasing*

The current example of Italy shows that it is possible for a country to grow its way out of high debt levels in the medium term, through a combination of European solidarity and soundness, with the help of structural measures. So far, however, the country south of the Alps has not succeeded in using its primary surpluses to lower its public-debt ratio. It is important to avoid a situation in which the ECB is compelled to keep interest rates low permanently so as not to jeopardise Italy's debt sustainability.

What remains crucial for Italy is to safeguard financial-market stability through a clear commitment to the need for sustainable budgetary policies while exploiting investment opportunities at all levels. All these aspects should also be taken into account by the new German government, in tandem with the European Commission, as well as in discussion forums involving the finance ministers and heads of state and government of the European Union.

## Disclaimer

This position paper by the Chief Economists does not necessarily reflect the position of Deka-Bank or the stance of the respective Landesbanken and savings banks.

## Impressum


**Publisher**
Deutscher Sparkassen- und Giroverband
Abteilung Financial Markets & Economics
Charlottenstrasse 47
D-10117 Berlin
Tel: +49 30 20225-5303
DSGV-Volkswirtschaft@dsgv.de
www.dsgv.de

**Editorial deadline for this issue**
2th December 2021

**Design**
Franz Metz, Berlin

**Picture credits**
unsplash/nadin mario



**Responsible**
Dr. Thomas Keidel - DSGV
Director
Head of Department
Financial Markets & Economics
Thomas.Keidel@dsgv.de

Dr. Reinhold Rickes – DSGV
Chief Economist
Deputy Head of Department
Financial Markets & Economics
Reinhold.Rickes@dsgv.de



**Note**
All publications in this series can be found at:
https://www.dsgv.de/en/statements.html#chief-economists

ISSN
2509-3851