HSBC Global Research

31 August 2021

Why deficits still matter

Debt sustainability in the 'new normal'

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Economics - Eurozone

- The fall in interest rates globally has improved debt dynamics
- But the hefty fiscal response to the crisis and some degree of scarring could leave countries with higher structural deficits...
- ...meaning that some eurozone countries might still need painful consolidation measures to restore debt sustainability

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How the world learned to stop worrying and love the debt

Pre-pandemic, several leading economists had been arguing that with the steady decline in interest rates globally, particularly relative to nominal growth, the fundamentals of public debt sustainability had improved, reducing the risk of fiscal crises, at least among advanced economies. This view likely contributed to the wide consensus among policymakers – including central banks – that fiscal policy was the main response tool to the COVID-19 crisis, without worrying too much about future consequences. This has been the case in the eurozone, where countries, partly thanks to ECB support, have embarked on hefty fiscal expansions. With EU fiscal rules suspended, there are no signs of belt-tightening yet.

It might not be so simple

While we don't dispute that a strong fiscal response was warranted during the crisis, particularly with many central banks near (or at) the zero lower bound, we question how much countries should still be pushing on the accelerator now and whether fiscal and debt sustainability concerns are really a thing of the past. The IMF has shown that fiscal crises have still occurred in advanced economies – even though they are not as common as in emerging markets – and have tended to be preceded by loose fiscal policy. Although interest rates have declined, higher debt levels increase future refinancing needs, and with that the roll-over risk and exposure to possible future rate rises. Italy, with a debt nearing 160% of GDP, is a case in point. Furthermore, countries such as France and Spain entered the pandemic with large structural fiscal deficits and are likely to exit it with even larger ones, adding to the roll-over risk. Public spending has increased everywhere and in some cases likely in a permanent way – for example, public sector employment has risen sharply and could be difficult to reverse. And tax revenues are likely to be hit by any – even if limited – permanent economic scarring and the changing shape of the economy following the pandemic.

So even if interest rates stay low, substantial fiscal consolidation might be needed in some eurozone countries to put their debts back on a sustainable footing. So far, though, there is no sign of that in the multi-annual budgetary plans submitted to the European Commission in the spring. Meanwhile, dissent is rising within the ECB Governing Council on the still-needed level of support and some Northern European countries are calling for a swift re-introduction of EU rules. Rating agencies have also stressed the importance of credible medium-term consolidation plans. So it seems likely at some point that pressure will start to rise on some countries to start tightening their belts, which will be far from easy with many facing imminent elections.

This is an abridged version of a report by the same title published on 31-Aug-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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Debt sustainability in the 'new normal'

Spend now, worry later

Countries have undertaken major fiscal expansions in response to the crisis without worrying too much

In response to the COVID-19 pandemic, countries across the world have embarked on major fiscal expansions, without worrying too much about the consequences for debt sustainability. We think this was the right course of action both to dampen significantly the rise in unemployment and to limit the degree of permanent economic scarring. Currently, it still is too early to tighten policy and risk nipping a recovery in the bud. But the rapid run-up in public debt may not be without longer-term consequences. In this note we discuss whether debt sustainability concerns could still come back to bite us in the future, focussing on the eurozone in particular.

The fundamentals of debt sustainability

There are many ways to assess the sustainability of public finances. From a theoretical point of view, the condition which has to be satisfied is that the net present value (NPV) of all future government spending equals the NPV of future taxes (i.e. that the so-called inter-temporal budget constraint is met). But this criterion is generally seen as not strict enough, as one can always plug in enough tax hikes in the future so that the constraint is met, without worrying too much about how feasible they might be. For a long time, markets might give countries the benefit of the doubt on whether they will raise taxes enough in the future to meet their budget constraints, but at some point they might start questioning their ability to so. Simply looking at that condition, though, makes it hard to understand when the tipping point might be.

So a more widely used criterion to assess the concrete risks to the public finances of a country is that, at the very least, the debt-to-GDP stabilises over time, without spiralling out of control. The evolution of public debt over time follows the following equation.

$$D_{t+1} - D_t = (r_t - g_t)D_t - PB_t$$

The change in the debt-to-GDP ratio (*D*) between two years is given by (i) the difference between the interest a government pays on its debt (*r*) minus the nominal growth rate of GDP (*g*), multiplied by the level of debt, and (ii) the primary fiscal balance (i.e. the budget balance stripping out interest payments). The first driver, r – g is referred to as the 'snow-ball' effect. If the average cost of debt is higher than nominal GDP growth, the debt-to-GDP ratio tends to increase over time, and vice versa. The second component is more straightforward – primary fiscal surpluses reduce the debt-to-GDP ratio over time, while primary deficits increase the ratio.

No need to worry

With yields falling, debt dynamics look more comfortable for countries

In recent years, an increasing number of prominent economists have started to argue that because of the steady fall of interest rates globally, debt sustainability has become less of a problem in the developed wold. In particular, in his 2019 presidential lecture at the American Economic Association, Oliver Blanchard argued that debt tends to pay for itself and therefore the welfare costs of deficits and debts are smaller than commonly thought. His argument was based on three key observations:

- A negative r – g has been "the norm rather than the exception in the US in the past";
- r – g is also likely to remain often negative, reflecting a low equilibrium interest rate related to, among other things, Larry Summers' secular stagnation hypothesis (Summers 2015);
- the primary deficit is independent of r – g and small enough to not outweigh debt service costs.

Following from that, Mr Blanchard concluded that with low interest rates, economies can sustain higher debt levels, and importantly that "low interest rates may also lower debt's economic costs, such that high debt levels pose less harm to future economic growth". This goes against

some of the findings from previous literature that higher debt levels can be harmful to growth.[1] He therefore called for a bigger role for fiscal policy, particularly in a situation where central banks are stuck at the zero lower bound, arguing that “at a minimum [...] policies may need to become more aggressive both ex-ante and ex-post with a rebalancing of the roles of monetary, fiscal, and financial policies”.[2]

Economists have been calling for a larger role for fiscal policy as a crisis response tool without worrying too much

This thinking, shared by many other leading economists, has contributed to the very broad consensus among international organisations and policy makers that fiscal policy had a major role to play in response to the COVID-19 crisis – even though Mr Blanchard himself warned of excessive size and possible inflationary consequences of the Biden administration's USD1.9trn fiscal stimulus package implemented in January[3]. But should fiscal crises really be considered a thing of the past for developed countries? And to what extent should governments keep pushing on the accelerator in terms of fiscal policy as their economies recover?

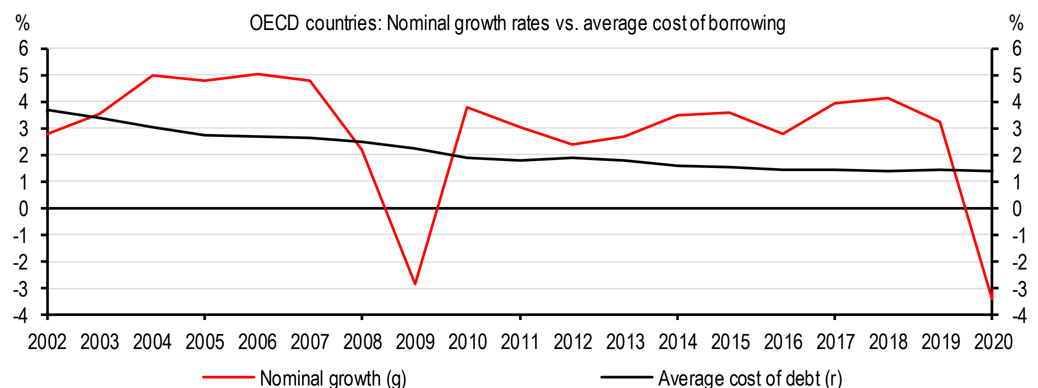
Not so fast

Nominal growth versus borrowing costs

Interest rates have come down a long way in recent years in the developed world

Granted, interest rates have come down a long way in recent years in advanced economies, particularly relative to the other key driver of debt dynamics, nominal growth rates (chart 1).

1. The average cost of borrowing has been on a steady decline in recent years



Source: HSBC calculations based on IMF.

Nominal growth outstripping the average cost of debt is not always the case though

However, using a database of OECD countries since 1961, Charles Wyplosz showed that it is not always the case that nominal growth is higher than average cost of debt, even for advanced economies.[4] This is only true in around half of the years overall and a little more (56%) for the US. Italy ranks lowest, with just 10% of the years.

We have replicated the analysis using IMF data from 1980 and found that nominal growth outstrips the average cost of debt in about two-thirds of the cases overall, although still with exceptions (chart 2). Given our shorter time series, this suggests that the gap between nominal growth and cost of debt has improved further in more recent years (indeed, the share increases to just over 70% considering just the last 10 years).

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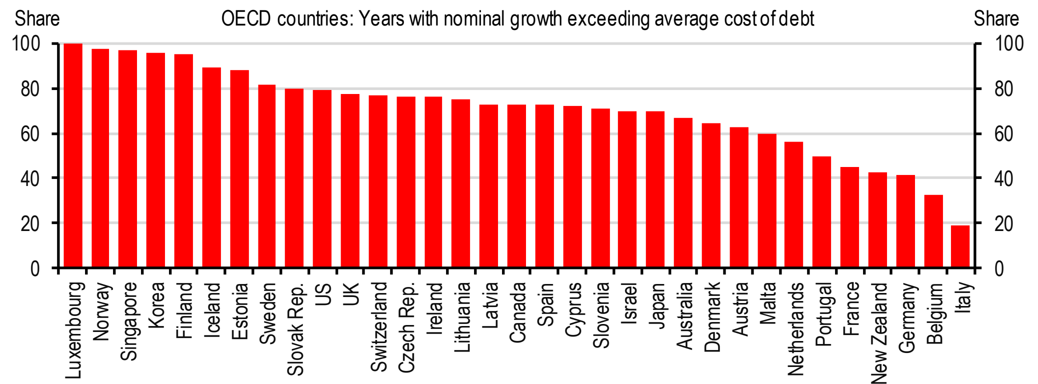
[1] See the seminal paper by Carmen M. Reihnart and Kenneth S. Rogoff (*Growth in a Time of Debt*, American Economic Review, May 2010), who had found that "for levels of external debt in excess of 90 percent of GDP growth rates are roughly cut in half".

[2] For more detail see Blanchard, O (2019), “Public Debt and Low Interest Rates”, NBER working paper, February 2019 and Oliver Blanchard and Lawrence H. Summers, Evolution or revolution: An afterword, VOX EU column, 13 May 2019.

[3] See Olivier Blanchard, *In defence of concerns over the $1.9 trillion relief plan*, PIIE blog, 18 February 2021

[4] See Charles Wyplosz, *Olivier in Wonderland*, VOX EU column, 17 June 2019.

2. Nominal growth in most advanced economies is higher than interest rates, but not all



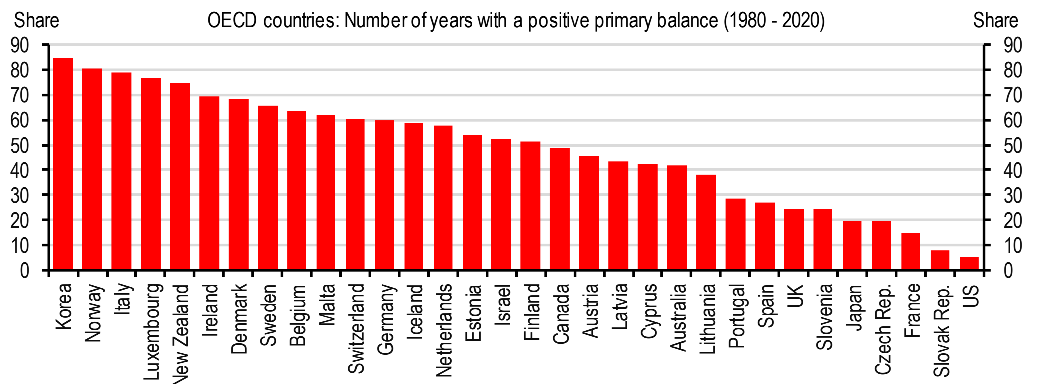
Source: HSBC calculations based on IMF. Notes: Data from 1980 (where available).

Even then, the primary fiscal balance still matters in determining whether the debt-to-GDP ratio will fall

The primary balance matters

In a "lower for longer" world, the gap might even be more favourable in the future. But even with nominal growth higher than the average cost of debt, the debt-to-GDP ratio could still rise, depending on the primary budget balance. And primary surpluses are certainly not the norm among advanced economies. Between 1980 and 2020, OECD countries only had primary surpluses in about half of those years, with some doing it fairly consistently (Italy or Germany) but others much less so (Spain, France or Japan). The US has done it only once in the last 20 years, in 2001 (chart 3).

3. Primary fiscal surpluses are not so common among advanced economies



Source: HSBC calculations based on IMF.

The growth, borrowing costs and primary surplus triangle

Table 4 shows, for different levels of the primary fiscal balance (columns) and the debt-to-GDP ratio (rows), the gap between the nominal growth rate and the average cost of debt required to stabilise the debt-to-GDP ratio. For example, for a symbolic country with a debt-to-GDP ratio of 125% and a primary fiscal deficit of -2.0% of GDP (which is roughly what France and Spain had before the pandemic), that gap has to exceed 1.6ppt for debt-to-GDP not to rise. So nominal growth has to exceed the cost of debt by some margin for debt to fall if countries still want to spend more (without including interest payments) than what they raise with taxes in the future.

4. Gap between nominal growth and average cost of debt needed to stabilise debt/GDP

	Primary balance (% GDP)								
Debt (% GDP)	**4.0**	**3.0**	**2.0**	**1.0**	**0.0**	**-1.0**	**-2.0**	**-3.0**	**-4.0**
50	-8.0	-6.0	-4.0	-2.0	0.0	2.0	4.0	6.0	8.0
75	-5.3	-4.0	-2.7	-1.3	0.0	1.3	2.7	4.0	5.3
100	-4.0	-3.0	-2.0	-1.0	0.0	1.0	2.0	3.0	4.0
125	-3.2	-2.4	-1.6	-0.8	0.0	0.8	1.6	2.4	3.2
150	-2.7	-2.0	-1.3	-0.7	0.0	0.7	1.3	2.0	2.7
175	-2.3	-1.7	-1.1	-0.6	0.0	0.6	1.1	1.7	2.3
200	-2.0	-1.5	-1.0	-0.5	0.0	0.5	1.0	1.5	2.0

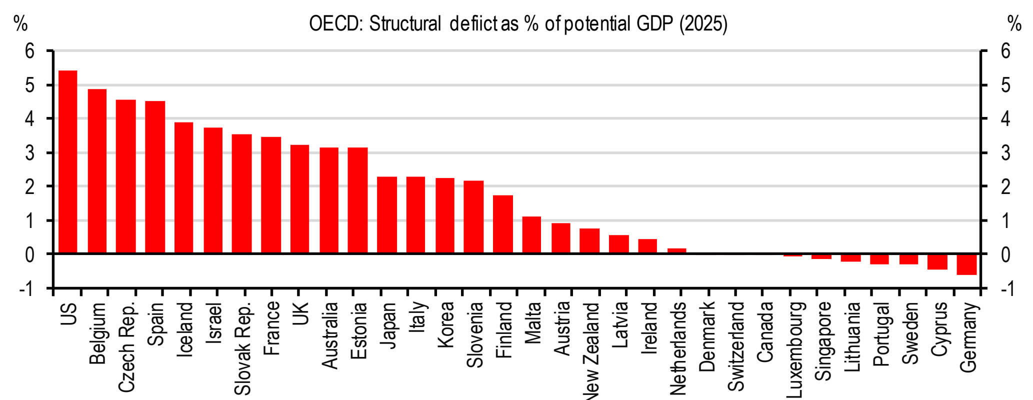
Source: HSBC calculations. Note: The columns have the primary fiscal balance, the rows the debt-to-GDP ratios.

The crisis might have left some degree of fiscal scarring

The structural fiscal deficits are likely to be higher after the crisis than entering it

Furthermore, the level of fiscal deficits before the crisis might not necessarily be a good gauge of where deficits will settle after the pandemic. Crises tend to leave countries with higher structural deficits, with some spending increases implemented in response to the crisis turning out to be permanent and changing output composition creating a structural hole in tax revenues. This crisis might be no exception. The IMF estimates that some countries will have very high structural deficits coming out of the crisis, in the region of 5% of GDP in the US and Spain, and 4% in France and the UK (chart 5). In turn, this means that a greater gap between nominal growth and the average cost of debt will be needed for debt-to-GDP ratios to start falling.

5. The IMF expects the crisis to leave countries with permanently higher deficits too



Source: HSBC, IMF.

It's not just about stabilising debt

Why countries face fiscal distress

There are many reasons why countries might face a situation of fiscal distress

But that might not be the end of the story. Whether countries manage to stabilise their debt-to-GDP ratios or not, might not be the only reason why they could face a possible situation of fiscal distress. A recent IMF paper shows that while fiscal crises are more common among emerging markets than developed ones, advanced economies are still not immune, having experienced 25 fiscal crises in the 45 years between 1970 and 2015.[5] According to the analysis, the triggering event has been either the loss of market confidence, an implicit default (defined as inflating-away the debt or accumulation of domestic arrears) or the recourse to large official financing, for example from the IMF. The paper also found that fiscal crises tend to be preceded by loose fiscal policy, with real government spending growing at a faster pace than usual.

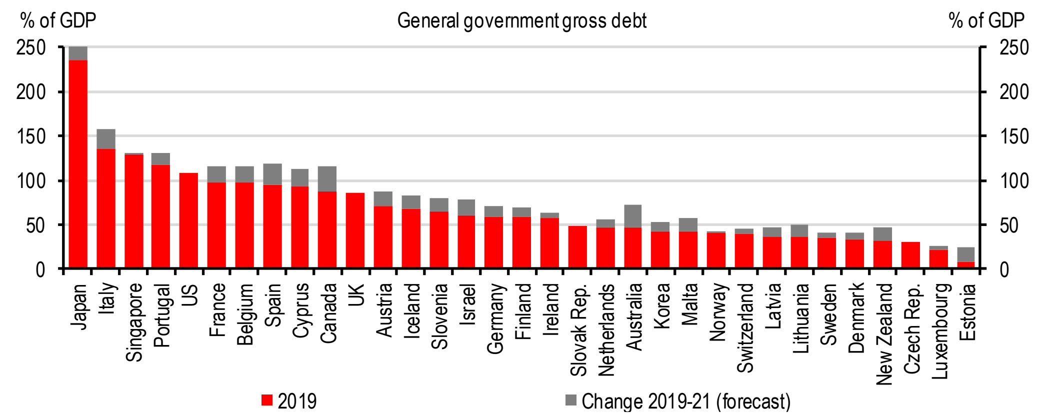
[5] Fiscal crises, IMF working Paper 17/86, January 2017.

Rollover risk rising

A country's refinancing needs might be a better gauge of the possible risks

So while stabilising debt in the medium term is important, how much a country has to raise each year on the markets to finance itself might be more indicative of its risk of facing possible fiscal distress in the future. A country's Gross Financing Needs (GFN) depend on (i) the amount of debt which has to be rolled over each year and (ii) the level of the fiscal deficit. Countries will be exiting the COVID-19 crisis with higher debt-to-GDP ratios (chart 6), which means higher refinancing needs for the future. And even when GDP has recovered its pre-crisis levels, the debt generated during the crisis will remain and not be washed away by the recovery.

6. Countries will exit the crisis with much higher levels of the debt-to-GDP ratio

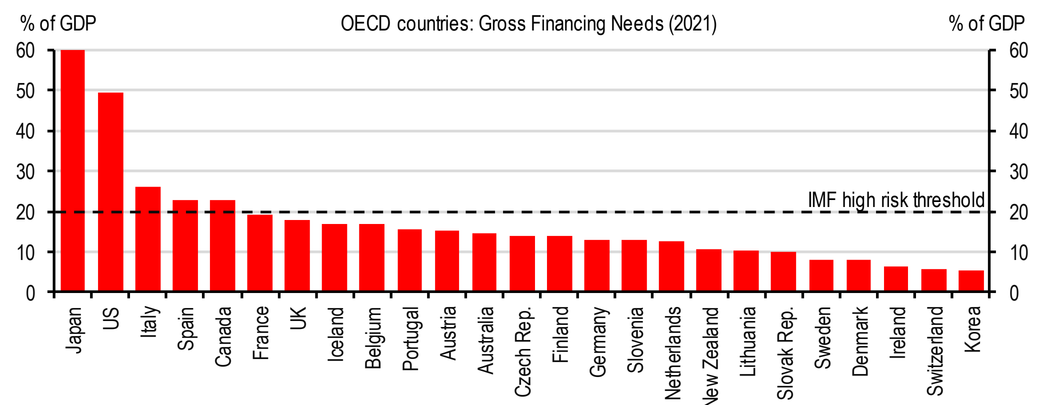


Source: HSBC calculations based on IMF.

Many advanced economies are well above the IMF high scrutiny threshold for Gross Financing Needs

The IMF indicates a threshold of GFN at 20% of GDP to categorise advanced economies as being under "high scrutiny"[6] and many countries are currently above that (chart 7). Granted, this year deficits are still abnormally large, reflecting ongoing restrictions to economic activity and the large level of support to households and firms affected, so as the situation normalises, GFN should fall. But as discussed, due to higher debt the refinancing needs will be permanently higher, and so will likely be the deficits. The fact that in many cases central banks have acquired most of the extra sovereign bond issuance through large QE programmes has certainly helped countries refinance far, but unless they keep rolling-over the new exposures indefinitely, eventually countries will have to roll-over the expiring debt on the market.

7. The IMF expects the crisis to leave countries with permanently higher deficits too



Source: HSBC calculations based on IMF.

[6] See https://www.imf.org/external/pubs/ft/dsa/mac/pdf/higherc.pdf

What it all means for the eurozone

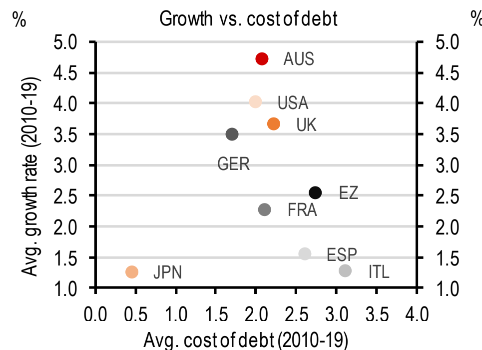
Most eurozone countries have faced a less beneficial trade-off between nominal growth and average cost of debt

Less growth, more pressure on primary surpluses

Relative to other advanced economies, in the 10 years between the Global Financial Crisis and COVID-19 pandemic, the eurozone has enjoyed relatively low nominal growth rates compared with other developed economies (other than Japan) but a higher average cost of debt (Chart 8). The smaller gap between the two –in some cases it is negative (Chart 9) – implies more pressure on achieving large primary fiscal surpluses to stabilise the debt-to-GDP ratio. Alternatively, eurozone countries will have to achieve consistently higher growth in the future, which won't be straightforward.

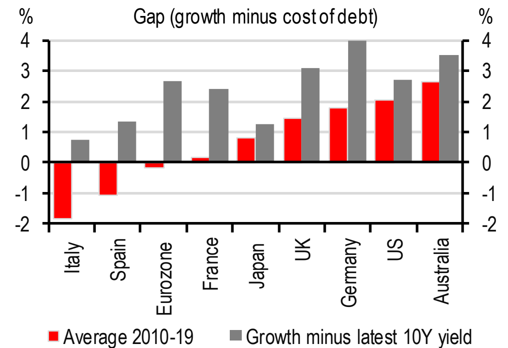
Granted, if we consider the most recent yield on 10Y government bonds rather than the average cost of debt (as a possible indication of where the cost of debt might settle in the medium term) the situation looks better (Chart 9), as yields have fallen further in the eurozone than in other parts of the world. But this partly reflects the ultra-accommodative monetary policy of the ECB, which may not last forever, given possible legal and institutional constraints (see later).

8. The eurozone had lower growth rates and an higher average cost of debt



Source: HSBC, IMF, European Commission.

9. The smaller – or negative – gap means more pressure on the primary surplus



Source: HSBC calculations based on IMF, European Commission.

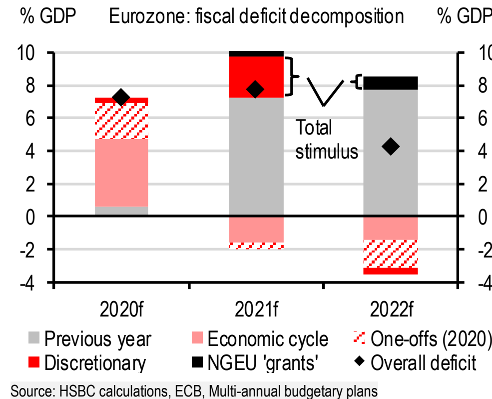
High structural deficits might come to bite

Eurozone countries have provided a large amount of fiscal support to their economies (Chart 10) and, unlike what happened after the Global Financial Crisis, there are no signs of them pulling back support yet, which is helping the recovery. It also helped that European Fiscal rules were suspended last year, giving countries the freedom to intervene to support their economies as they saw fit. The European Commission (EC) has said the rules will remain suspended next year as well and won't be reintroduced before output has recovered to pre-crisis levels (which for the eurozone as a whole should happen at some point next year). The hope is that when output has fully recovered, countries will be able to pull back support without causing too much damage to activity levels.

The sharp rise in public sector employment could be difficult to unwind

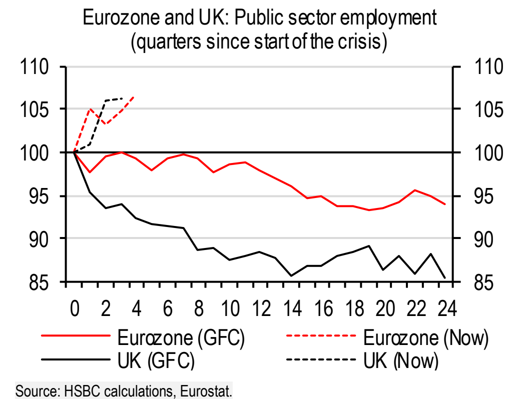
This is the theory. In practice, however, not all the support provided so far might be temporary, and could translate into higher permanent spending. For instance, the rise in public sector hiring – in the eurozone as well as in the UK – is striking relative to the previous crisis and might be hard to unwind, causing permanently higher spending (Chart 11). Furthermore, the changing growth mix coming out of the crisis could mean that tax revenues might not fully recover, even if GDP does, thereby creating a structural hole, particularly considering the generous tax credits (particularly to the construction sector). At the same time, the imminent unwinding of short-time work compensation schemes could cause pressure on unemployment and thus unemployment benefits.

10. Eurozone fiscal policy stays expansive



Source: HSBC calculations, ECB, Multi-annual budgetary plans

11. The public sector has expanded fast



Source: HSBC calculations, Eurostat.

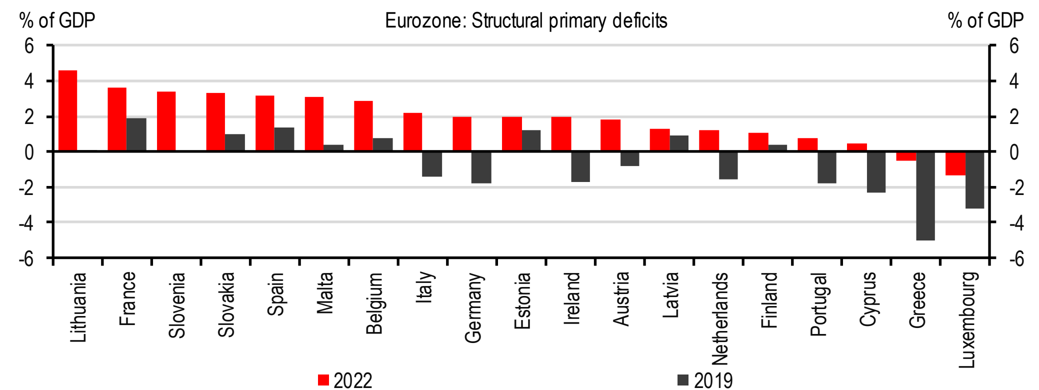
Come later for consolidation

As a result, countries will likely exit the crisis with much higher structural deficits – and crucially also primary ones – than before it (Chart 12). Without fiscal consolidation, this will raise the bar in terms of the gap between nominal growth and cost of debt needed to stabilise the debt-to-GDP ratio in the future. With higher debt levels and higher deficits, the amount of financing countries will require each year will also increase, and with that, the roll-over risk.

Any fiscal consolidation has been postponed until 2023 at the earliest

Meanwhile, partly due to the suspension of EU rules, there appears to be little or no sense of urgency from countries to start consolidating their public finances. Any planned consolidation has been postponed until 2023 at the earliest. This increases the implementation risk, considering upcoming elections in France (spring 2022), Italy (by spring 2023) and Spain (by the end of 2023).

12. Countries will likely have higher structural primary deficits than before the crisis



Source: HSBC calculations based on EC.

Debt dynamics could look tricky

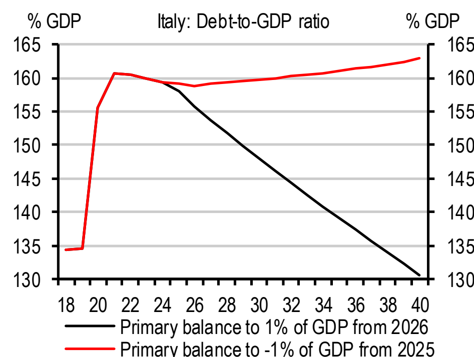
Some countries might face a challenge to restore debt sustainability after the crisis

The charts below show the Italian debt-to-GDP ratios in two different scenarios regarding the primary surplus adjustment in future years. Clearly, even accounting for lower borrowing costs, being able to return to a primary surplus at least close to what the country had before the crisis is key for debt stabilisation (see Chart 13). And countries such as France and Spain, which entered the crisis already with a primary deficit, rather than a surplus like Italy, despite lower debt levels might face an even bigger consolidation challenge.

Ageing-related costs could add to the fiscal pressures

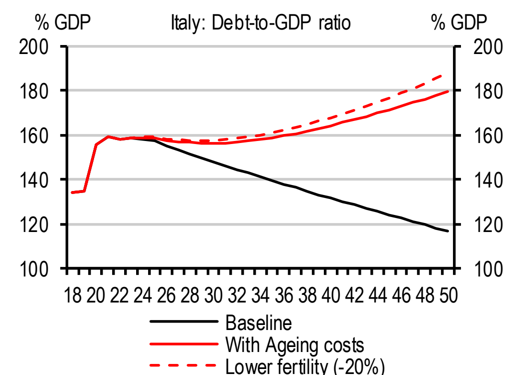
Furthermore, the public finances of many eurozone countries will face additional pressures in the coming years due to ageing-related costs. Italy, for example, has a public pension bill of over 15% of GDP, which due to poor demographics and a rather generous system inherited from the past – and despite the recent reforms – is set to increase steadily until peaking at almost 18% of GDP in 2035 according to the latest EC's Ageing Report. This could push the debt-to-GDP ratio towards 200% by 2050 (Chart 14). Some European countries are set to see even bigger increases in public sector spending. As for the UK, last July's Fiscal Sustainability Report, the Office for Budget Responsibility (ORB) showed similar dynamics, with debt rising above 200% of GDP by 2050. This adds to the challenges facing government in the future to restore debt sustainability.

13. Restoring a primary fiscal surplus is key for Italy to reduce debt in the future



Source: HSBC calculations based on EC Ageing Report, OECD. Key assumptions in the baseline scenario are potential growth of 0.7% and primary budget balance reverting to 0.9% of GDP by 2026. Spread over German bund 100bps.

14. Ageing costs could add further pressures on Italy's fiscal balances



Source: HSBC calculations based on EC Ageing Report, OECD. Key assumptions in the baseline scenario are potential growth of 0.7% and primary budget balance reverting to 0.9% of GDP by 2026. Spread over German bund 100bps.

ECB saving the day?

As mentioned, the ultra-accommodative monetary policy by the ECB so far during the crisis has played a key role in enabling an expansionary fiscal policy by eurozone countries. Through its Pandemic Emergency Purchase Programme (PEPP), the ECB has picked up most of the extra sovereign bonds issuance resulting from higher deficits (Chart 15). This has helped keep the countries' borrowing costs low, particularly combined with the recent explicit commitment by the ECB to keep financing conditions favourable, which sounds like a de-facto yield control.

But the PEPP programme is set to expire next March and we don't expect it to be continued beyond that – unless a renewed wave of COVID-19 and related restrictions pushes the eurozone back into recession. And even though we expect the pace of the 'normal' QE programme (APP) to be increased from next April to reduce the cliff-edge, the overall level of monthly purchases should drop, to probably about half the current pace in our view.

If the ECB scales back support and deficits stay high, it could be tougher for some countries to refinance themselves

Granted, fiscal deficits will also narrow next year as the temporary support measures are unwound and tax revenues bounce back with the economic recovery. The EC expects deficits to fall relatively fast, and even if we are a little less optimistic, we still have them at about half this year's levels in 2022. For example, in the case of Italy this would likely leave a financing gap which will have to be filled by private investors (Chart 15), even though it should not necessarily be a problem.

QE has also marginally increased the sensitivity of the cost of debt to rates

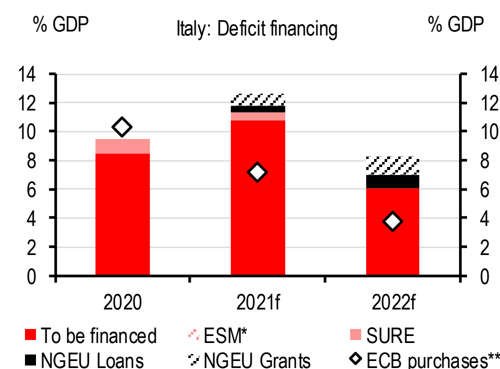
But over the medium term, if deficits remain persistently higher than before the crisis and the ECB scales back support further – some Governing Council members have expressed concerns that QE will last too long – it could become more challenging for countries to refinance themselves. The ECB could even become a net seller of bonds at some point in the future (PEPP reinvestments are currently set to continue until "at least the end of 2023"). On top of that, QE has marginally increased the sensitivity of the cost of debt to possible future policy rate rises, as central banks will have to pay a higher rate or reserves and therefore they will be able to redistribute back to governments smaller amounts from the coupons of the bonds they own.

There are limits to what the ECB can do if a country faces a situation of fiscal distress

The ECB now also has skin in the game, owning a large share of sovereign bonds across the eurozone (Chart 16), and would be concerned about the possibility that any country might face a situation of fiscal distress. But there are limits to what the ECB might be able to do on a permanent basis once we are out of the crisis. For one, there are practical limits: the flexibility of bond purchases relative to the capital key is only temporary, as reiterated in the accounts of recent ECB meetings. And the German constitutional court announcement in May served as a reminder that the ECB's ability to act is bound by the EU treaty and can face legal constraints.

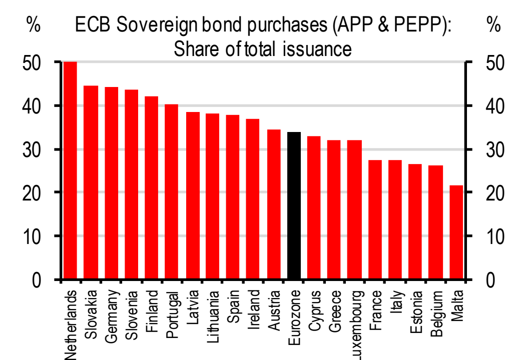
Furthermore, with the Governing Council looking increasingly divided on the course of monetary policy going forward, the ECB could face increasing criticism – both internal and external – that its accommodative monetary policy stance might help countries monetise their deficits, as raised in the July meeting (*ECB press conference (July): So what about the 'forceful' response?*, 22 July 2021) which would go against the "no monetary financing" requirement in the EU Treaty.

15. ECB purchases might fall short of issuance next year, even with more APP



Source: HSBC calculations based on HSBC forecasts, EC, ECB. *No ESM credit line has been requested so far. ** Based on doubling APP purchases from April.

16. The ECB now owns a large share of sovereign bonds across the eurozone



Source: HSBC calculations based on Refinitiv Datastream, ECB. Note: Does not take into account state-owned agencies. Data as of the end of July 2021.

Pressure towards consolidation might rise

The ECB, Norther European countries and rating agencies might increase the pressure towards consolidation

All in all, if fiscal deficits do not shrink fast as the ECB scales back support, countries might face some problems in finances themselves in the future. Consolidation might be tough, particularly against the backdrop of looming elections. Pressure towards consolidation might not just come from the ECB. Some Northern European countries have started to call for the reintroduction of EU fiscal rules sooner rather than later and have pushed back strongly – most recently Austria's finance minister, Gernot Blümel (Politico, 6 October) – against the possibility of softening the rules in the future hinted at by several Southern European countries and the EC. Rating agencies have also been stressing the importance of a credible medium-term fiscal consolidation strategy for the sustainability of public finances, so the lack thereof could be a factor affecting ratings. So while it seems unlikely countries face imminent risks, the possibility that they could face a situation of fiscal distress in the future might not be completely off the cards, even in the 'new normal'.

Disclosure appendix

Analyst Certification

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