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Economics in Brief

››› Public debt reduction in the euro area – initial progress

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Conditions for reducing debt are favourable

The conditions for reducing government debt in the euro area states have improved significantly in the past few years. This can be seen in the snowball effect, which measures the influence of interest rates, real growth and inflation on debt levels – in other words, economic parameters that cannot be controlled directly by policies in the short term. The snowball effect shows by how many percentage points government debt would have changed if the primary balance had been zero. In the past five years, the snowball effect has dropped from nearly 3 to -1 % of GDP (Figure 1).

One reason for this reduction and even negative values in the past three years (estimate for 2017) is the lower interest burden on governments. Since the euro area was created, interest expenditure as a proportion of GDP has halved in the member states – although public debt has risen noticeably during this period. Interest payments have been substantially lower since 2012, in particular as a result of the expansionary monetary policy. Another reason is that more dynamic growth since 2014 has contributed to reducing the debt-to-GDP ratio.

Conditions for reducing euro area debt were similarly favourable already before the financial crisis. The economy grew without interruption over 19 consecutive quarters between Q3/2003 and Q1/2008. The average snowball effect during that period was zero. Figure 2 shows the cumulative decline in debt to GDP for that period (dark line). The date t0 marks the end of the respective previous phase of cyclical weakness and t1 marks the beginning of the upswing. Before the financial crisis, the euro states took advantage of the favourable environment to reduce debt by just under four percentage points overall (five points compared with the maximum debt ratio achieved during the economic recovery).

Debt reduction is now moderate ...

The current upswing began in the second quarter of 2013 (t0 marks the last quarter of the recession in the debt crisis) and has been underway for 18 quarters so far (latest available data: Q3/2017). During this period, the snowball effect has averaged zero – that is, the debt ratio would have stabilised without political intervention.

In fact, the debt-to-GDP ratio decreased after the crisis – by a similar rate as between 2003 and 2008. But that is no reason to lower the guard. Two important restrictions must be considered. First, the debt ratio is now 88 % of GDP. Compared with the 66 % at the end of the last debt reduction cycle, the road to the Maastricht reference level of 60 % is considerably longer. Second, debt reduction focuses on much fewer countries this time. Nearly 85 % of the reduction involves the three states that have made the greatest progress in this effort. Germany alone accounts for more than half the debt reduction. Before the financial crisis, the three states that were most successful in terms of volume accounted for not even 60 % of the debt reduction in the euro area.

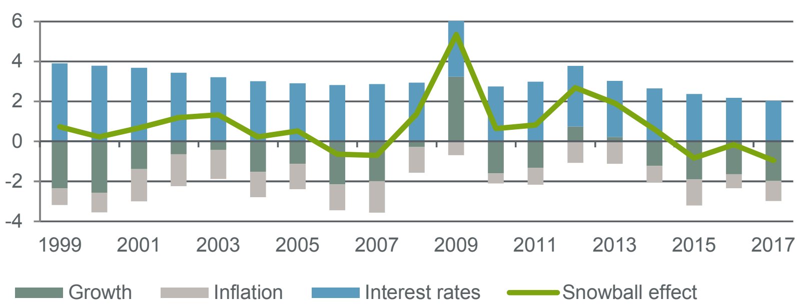
... but there is still time

However, there is good reason to hope that the current recovery will remain robust for some time yet. Growth could continue for at least one or two years or even longer and debt reduction might pick up pace. The cycle may then possibly end with a significantly more successful debt reduction than in the past decade.

The conditions for further declining government debt ratios are favourable. The upswing is stable and interest rates are on historically low levels. Even if the expansionary monetary policy ends soon, the average debt service to be paid on overall debt is rising only slowly. The euro states extended the maturities of their bonds in the low-interest environment. Higher bond yields will therefore only gradually be reflected in the national budgets. ■

Figure 1: Negative snowball effect

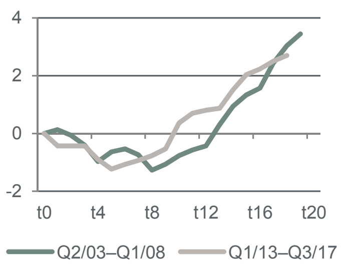
Contributions to changes in gross euro area government debt, percentage points of GDP



Sources: AMECO, KfW Research

Figure 2: Similar pace

Cumulative decline in debt ratios during euro area recovery, levelled out, in percentage points of GDP



Sources: AMECO, KfW Research