September 12, 2019

Economics Group

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Special Commentary

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Is There Too Much Debt in the Eurozone?: Part IV

Government Debt Is Not "Out of the Woods"

Executive Summary

Government debt in the Eurozone has been a concern for financial markets at various points over the past decade amid a significant buildup in leverage during and immediately after the Great Recession. In more recent years, however, governments have generally been de-levering relative to the size of the economy. Since the end of 2014, the Eurozone-wide government debt-to-GDP ratio has fallen about six percentage points, and last year the consolidated budget deficit was about 0.5% of Eurozone GDP. Government debt levels remain particularly high in some countries, however, especially Greece and Italy, which is the third largest economy in Europe.

Government debt remains high in a few countries.

In the near term, extremely low interest rates across Europe should keep financing costs in check, helping governments finance their debt without too much trouble. But, if interest rates were to rise substantially, or if one country were to break sharply with European Union budget rules in a way that induced a showdown with Brussels, the result could be an economic downturn that is driven by concerns over excessive government debt. Such a hypothetical downturn could be particularly painful if it were led by a major Eurozone economy, such as Italy, due to the financial sector's exposure to sovereign debt, a topic to which we will turn in the next installment of our series.

Eurozone Government Debt: Elevated, but Generally Declining

At first glance, the public sector is perhaps the most obvious source of concern regarding the build-up of debt in the Eurozone. Indeed, it was not that long ago that the 2011-2012 European sovereign debt crisis led to a recession in the Eurozone. Since the start of the Great Recession, the aggregate amount of government debt in the Eurozone has risen nearly €4 trillion, pushing the debt-to-GDP ratio for the public sector to more than 90% in 2013 from 65% in late 2007 (Figure 1, next page).[1]

The government debt-to-GDP ratio in the Eurozone has receded modestly since 2015.

In more recent years, however, governments have generally been de-levering relative to the size of the economy. Since the end of 2014, the Eurozone-wide debt-to-GDP ratio has fallen about six percentage points. This contrasts with the United States, where the debt-to-GDP ratio for the government has continued to rise.[2] Moreover, the consolidated budget deficit in the Eurozone was only 0.5% of GDP in 2018 (Figure 2, next page) compared to 4.2% of GDP in the United States. Why then do some analysts and financial market participants continue to fret about sovereign debt in the euro area?

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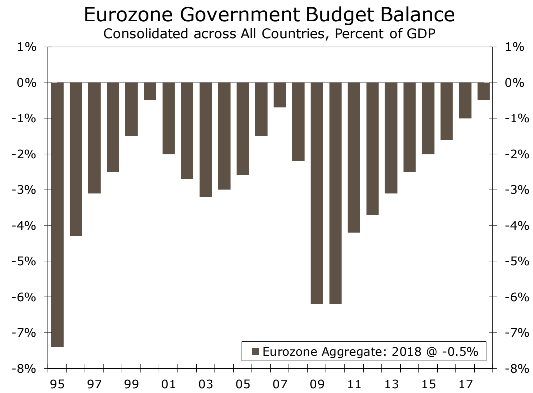
[1] There are multiple ways to measure a country's general government debt. In this report, we use the Maastricht definition, as this is the methodology used by the European Commission when determining if individual countries are in compliance with the bloc's budget rules. There are a few differences between the Maastricht debt levels and the debt levels in the ESA 2010 accounts. Perhaps the most notable is that Maastricht debt is calculated at nominal value, while the ESA accounts use market value.

[2] Federal government debt held by the public has edged up to 76% at present from 74% of GDP at the beginning of 2014.

Figure 1

Figure 2



Source: Eurostat and Wells Fargo Securities

There is significant dispersion among the 19 individual economies.

The aggregate government debt-to-GDP ratio in the Eurozone masks a significant divergence among the 19 individual countries (Figure 3). Seven countries have ratios that are greater than the Eurozone aggregate of 86%. Greece is the biggest outlier, with a staggeringly large government debt-to-GDP ratio exceeding 180%. Italy comes next, with a ratio in excess of 130%, followed by Portugal, Belgium, Cyprus, France and Spain. After Spain, there is a big drop off to Austria, with Germany, the Netherlands and Finland being some of the other large economies with relatively low government debt-to-GDP ratios.

Figure 3

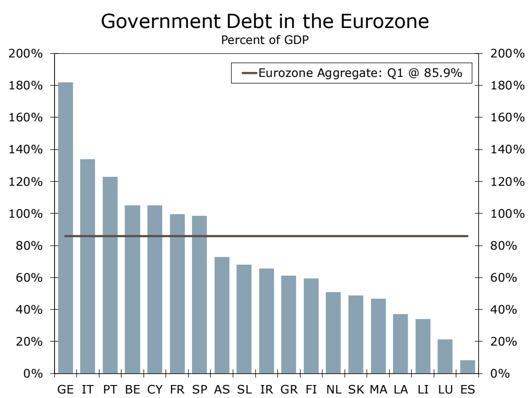
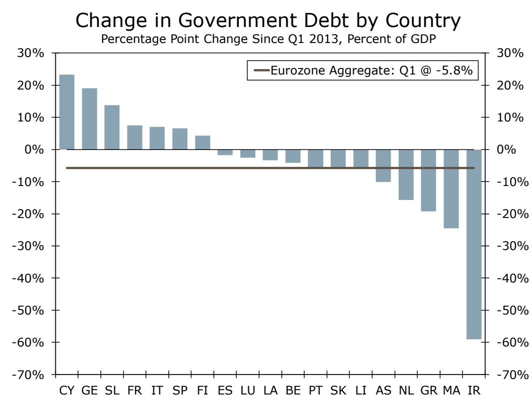


Figure 4



Source: Eurostat and Wells Fargo Securities

How has de-levering progressed at the individual country level? The European sovereign debt crisis brought the potential danger of high government debt levels into the spotlight, and the subsequent economic recovery and steep decline in interest rates afforded an opportunity for some countries to de-lever. Figure 4 illustrates the change in each country's debt-to-GDP ratio since 2013.[3] Government debt-to-GDP ratios in Cyprus and Greece have risen by about 20 percentage points since 2013 despite substantial budget consolidation in both countries, highlighting the enormous challenges policymakers in these countries face in bringing their debt trajectories back to sustainable paths. Among Europe's larger economies, debt-to-GDP ratios are up slightly in France, Italy and Spain, while the German government has de-levered about 20 percentage points. All of

[3] As we have noted in previous reports, the change in Irish debt ratios since 2013 are distorted by the structural break in Irish GDP that occurred in Q1-2015. That said, the Irish government has de-levered relative to the size of the Irish economy recently. The outstanding amount of Irish government debt has been more or less flat in recent years while nominal GDP in that country has risen 30% since Q2-2105.

these major economies have seen their budget deficits either narrow or, in Germany's case, flip into surplus since 2013. But, disappointing nominal GDP growth has prevented a more significant deleveraging in many countries.

Do These Debt Levels Represent a "Problem"?

Does the sovereign debt situation in Europe represent a potential buildup of too much leverage? In the near term, probably not. The debt-to-GDP ratio of the overall euro area is not that much different than it is in the United States, and it is well below the level in Japan.[4] Furthermore, government debt as a share of GDP has gradually been declining over the past few years, and the consolidated budget deficit was a relatively small 0.5% in 2018. It appears likely that the European Central Bank will maintain an extraordinarily accommodative policy stance for years, suggesting interest rates are likely to remain low for the foreseeable future. Historically low or even negative sovereign bond yields in Europe should help keep financing costs in check.

Low interest rates should keep financing costs in check, at least in the near term.

That said, there are still reasons to be concerned that European sovereign debt could return as a potential flashpoint at some point. First, the distribution of government debt within the Eurozone varies greatly. As noted previously, some economies, notably Greece and Italy, are burdened with high debt levels that policymakers have struggled to reduce even in an environment of low interest rates. Italy in particular is a troubling case, as it is the third largest economy in the Eurozone, and its politicians have been pushing for more lenient treatment when it comes to the European Union's fiscal rules.[5]

Conversely, some countries, perhaps most notably Germany, arguably have scope to undertake more expansionary fiscal policy in the current environment. Germany's budget surplus, paired with extraordinarily low borrowing costs, is a recipe for a further rapid reduction in the German government's debt-to-GDP ratio in the coming years.[6] The European Commission projected in the spring that Germany's debt-to-GDP ratio would fall another five percentage points by 2020, and since then the yield on the 10-year German bund has declined roughly 50 bps. An easing of fiscal policy in Germany would help boost flagging demand domestically, and should provide at least a modest boost to other Eurozone economies.

What could be the spark that would bring European sovereign debt back to the forefront as a major concern for financial markets? So long as interest rates remain extraordinarily low, the group of countries within the Eurozone that have high government debt burdens should not have much trouble financing their high debt burdens. But, if interest rates were to rise meaningfully above growth in nominal GDP, then investors could begin to worry once again about the sustainability of the government debt loads in Italy, Greece, Portugal and elsewhere. These various governments would be trying to roll over a very large and growing stock of debt at higher rates, creating even more debt and squeezing revenue resources.

Political considerations could cause some governments to abandon fiscal austerity.

Italy's experience is a case in point. The Italian government has generally run primary surpluses for years (Figure 5).[7] But it has incurred overall budget deficits over that period due to the interest payments that it must make on its sizeable debt stock. If interest rates were to shoot higher, then the Italian government would need to run even larger primary budget surpluses to prevent its debt-to-GDP ratio from moving even higher. Maintaining a high degree of fiscal austerity can eventually become politically challenging for governments.

[4] The government debt-to-GDP ratio in Japan has mushroomed to about 240% today from roughly 60% in the early 1990s.
[5] In a recent special report, we outlined Italy's current political situation as well as two possible scenarios and their implications for fiscal policy.
[6] For example, on August 28 the German government issued €2.3 billion worth of 10-year notes with a coupon of 0%. The notes were auctioned at a price of 107.28, resulting in a yield-to-maturity of -0.70%.
[7] A government's primary budget balance is defined as its revenues minus non-interest spending.

Figure 5

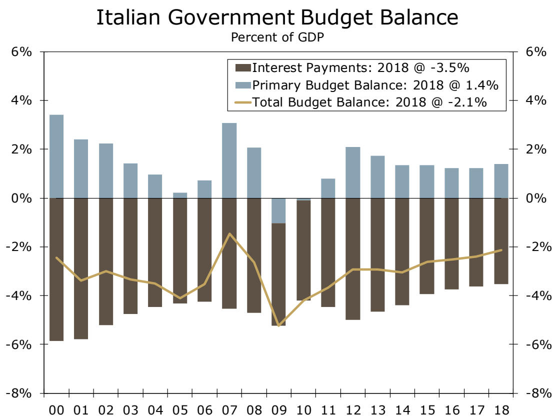
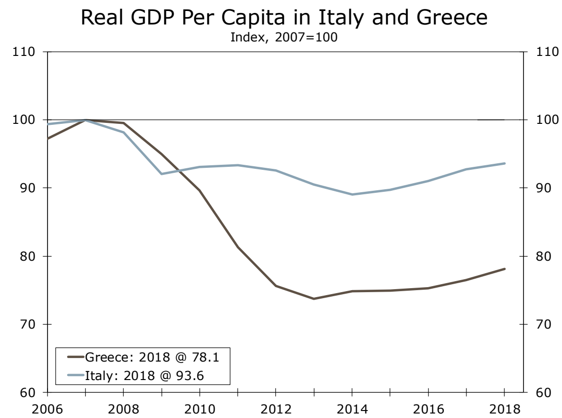


Figure 6



Source: International Monetary Fund, IHS Markit and Wells Fargo Securities

In that regard, another potential spark could be the decision by one country's government to completely disregard the European Union's fiscal rules and push ahead with a sizable fiscal stimulus. As mentioned earlier, Italian politics over the past couple years have been marked by a rising call for less fiscal austerity among the leading parties. The Lega (the League), which is led by Matteo Salvini, has seen its popularity skyrocket in recent years at least in part due to its support for less austerity. More recently, Salvini's efforts to call for a national election backfired, and the Five Star Movement (5SM) formed a coalition government with the center-left Democrats. Markets perceive this coalition to be more pro-EU and generally more likely to be compliant with EU budget rules. The yield spread on the Italian 10-year government bond relative to its German counterpart has tightened roughly 80 bps over the past month.

Still, it remains to be seen whether this coalition can stand the test of time, particularly in a period of slow growth and with Salvini likely agitating from the sidelines. Indeed, it was not that long ago that the 5SM and the Lega were in a coalition together with the joint goal of easier fiscal policy. The ongoing drama in Italy has many causes, but they likely stem at least in part from the economic stagnation in parts of Europe over the past decade. Real GDP per capita in Greece and Italy, for example, is still below 2007 levels (Figure 6). The erosion in living standards in these countries raises the question of whether fiscal policymakers will eventually boldly break the EU's budget rules in an effort to revive their domestic economies.

The willingness of financially robust countries to 'bail out' a debt-laden country is always an open question.

The possibility for an intra-Eurozone dispute about the appropriate path of fiscal policy highlights what is probably the key difference between government debt in the Eurozone and the United States. Although aggregate government debt-to-GDP ratios are not significantly different between the two, the United States has a comprehensive, single market for its debt securities, while the Eurozone has 19 different countries crafting 19 different fiscal policies with 19 different sovereign bond markets, all under the umbrella of a common currency. Because individual economies do not have their own central bank—the ECB is the central bank for all 19 economies—the sovereign debt of any individual country is effectively external debt. The willingness of financially robust countries of the Eurozone to 'bail out' a debt-laden country is always an open question, and tensions related to this question became apparent when Greece skirted dangerously close to default earlier in the decade. A reprisal of these tensions, especially if the debtor country were a large economy such as Italy, could spark a downward spiral similar to that which occurred during the 2011-2012 sovereign debt crisis.

Conclusion

Since the end of 2014, the government debt-to-GDP ratio in the overall euro area has fallen about six percentage points, and the consolidated budget deficit was about 0.5% of GDP last year. However, government debt ratios remain particularly high in some individual countries, notably in Greece and Italy, the latter of which is the third largest economy in Europe. In the near term, extremely low interest rates should keep financing costs in check, helping governments finance their debt without too much trouble. But, if interest rates were to rise substantially, or if one country were to break sharply with EU budget rules in a way that induced a showdown with Brussels, the result could be an economic downturn in the Eurozone that is driven by concerns about excessive government debt. Such a scenario would be particularly problematic in Italy, where the outstanding debt of the Italian government currently stands at nearly €2.5 trillion. In a worst case scenario, the Italian government could default. Such an outcome, should it occur, could have potentially catastrophic consequences for the banking systems in European countries, some of which hold significant quantities of Italian government debt. We will address the topic of the Eurozone financial sector in the next installment in this series.

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