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Euro Area Gross Financing Needs in 2020: rise mitigated by favourable composition

The euro area's gross financing needs (GFNs) are set to rise sharply in 2020, but remain slightly below that during the global financial crisis peaks on aggregate while their composition will change significantly. Favourable debt profiles and lower interest payments have created the fiscal space for governments to run higher deficits to offset the impact of the Covid-19 pandemic on the economy.

Gross financing needs are a key input to sovereign debt sustainability analysis in providing an aggregate figure of the volume of maturing debt, fiscal deficits and interest payments in a fiscal year. For 2020, we currently expect gross financing needs (GFNs) in the euro area to increase to around 18% of GDP, up 6 percentage points from 2019.

Our main conclusions are:

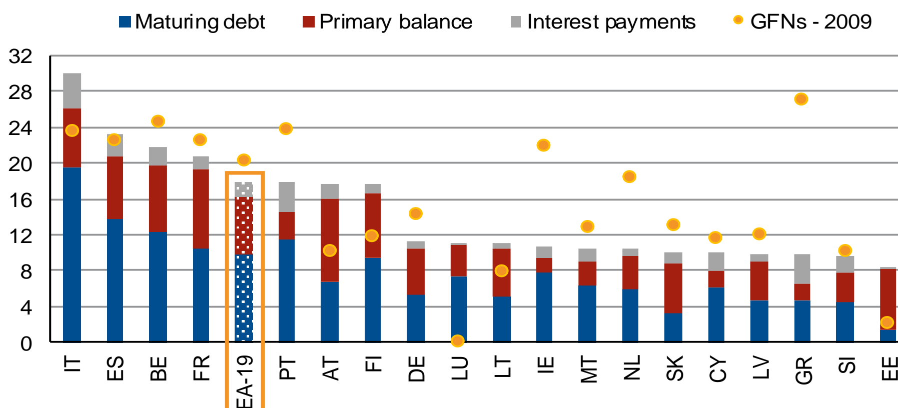
1. The composition of euro area GFNs compares favourably with the situation during the global financial crisis in 2009 given that fiscal spending is driving the increase rather than debt service.
2. Fiscal consolidation in the aftermath of the global financial crisis and a more favourable debt structure have contributed to a reduction in the volume of debt maturing each year.
3. Substantial difference between 2009 GFNs and those in 2020 across euro area members.

Over the medium term, financing some countries' gross financing needs could prove challenging, especially for those governments with already weak balance sheets when the pandemic struck. Italy in addition to Spain, Belgium and France have GFNs in 2020 near or above 20% of GDP. They have narrowing fiscal space for extra spending in the future, even in the context of the ECB's ultra-loose monetary policy, without substantially higher growth. That said, the euro area's gross financing needs for 2020 remain far below those of some other countries with reserve currencies such as the United States (38.5% of GDP) or Japan (45.6% of GDP).

Our GFN projections include an aggregate primary fiscal deficit in the euro area equivalent to 6% of GDP (3.4% in 2009) and a general deficit of 8% of GDP. This, together with the cyclical deterioration, results in an aggregate increase of the euro area's public debt to GDP ratio from 84% in 2019 to 98% of GDP at the end of this year. In total, we find only seven countries with higher expected gross financing needs in 2020 than in 2009. Except for Italy and Spain, these countries have all either low- or medium-sized levels of public debt.

The projections are based on our baseline scenario for GDP growth as outlined in the 2020 Q2 Sovereign Update. We therefore may envision downside risk, especially on fiscal balance figures, should the lockdown measures remain in place longer than expected.

Figure 1: Gross financing needs in the euro area in 2020, % of GDP



NB: Italy's GFNs are projected at 30.7% of GDP when including additional materialisation of contingent liabilities

Source: IMF, Scope Ratings GmbH

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Gross financing needs: size and composition matter

Euro area gross financing needs on a steep year-on-year rise in 2020 but…

GFNs capture the forthcoming financing requirements of government, including the expected annual fiscal deficit and maturing debt during the year[1] in question. They are one of the key flow variables in debt-sustainability analysis, as they offer a comprehensive measure to capture refinancing risk. The IMF indicates a threshold of 20% of GDP for gross financing needs to categorise advanced economies under "high scrutiny". While the overall size of GFNs is important to measure fiscal space, composition is of equal importance to assess a sovereign's fiscal flexibility over time.

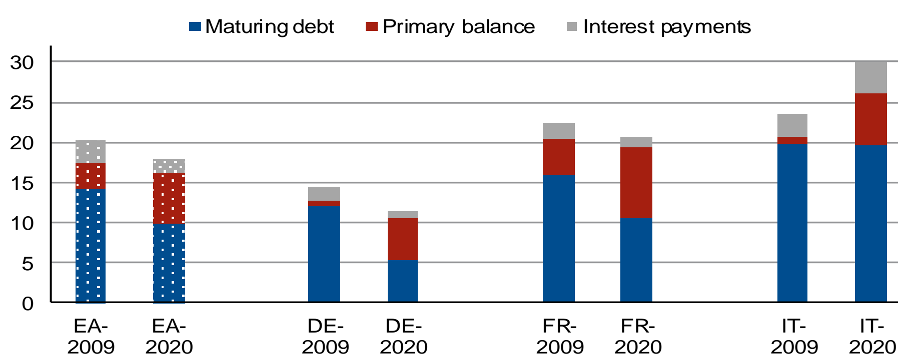
For 2020, we expect GFNs at around 18% of euro area GDP[2], with aggregate primary deficits of 6.2% of GDP and interest payments at 1.8% of GDP. This would represent a 6pp increase from 2019 GFNs (12% of GDP), mainly driven by widening budget deficits after the cyclical effects of the economic recession, as well as the unprecedented fiscal response implemented by governments. In 2019, the euro area in aggregate had a primary surplus slightly below 1% of GDP, while maturing debt (11% of GDP) and interest payments (1.6% of GDP) broadly correspond with our expectations for 2020.

…still compare favourably with 2009 in terms of composition

A comparison of 2020 with the fiscal shock experienced during the global financial crisis in 2009 reveals a similar size of GFNs, close to 20% of GDP, while the composition differs substantially from our projections for 2020 (**Figure 2**).

In 2009, the euro area aggregate primary deficit was slightly above 3% of GDP, equal to interest payments at 3% of GDP and debt amortisation at 14% of GDP. In 2020, more favourable debt profiles and lower interest costs provide euro area members with the necessary fiscal space to raise more debt to finance the stimulus needed to help offset the impact of the Covid-19 pandemic whilst still maintaining similar levels of total GFNs to those in 2009. Euro area governments can on aggregate mobilise more resources, though significant differences in national fiscal flexibility persist within the single currency zone.

Figure 2: Gross Financing Needs, 2009[3] versus 2020, % of GDP



NB: Italy's GFNs are projected at 30.7% of GDP when including additional materialisation of contingent liabilities

Source: IMF, Eurostat, ECB, Scope Ratings GmbH

Sizeable country-specific differences

Germany with a track record of fiscal prudence is an example of those countries with favourable debt profiles and low interest costs, giving them ample room to ramp up spending in response to the Covid-19 shock. Highly indebted countries such as France have also implemented large stimulus packages, while keeping gross financing needs below the level in 2009 thus far, thereby managing more tolerable levels of refinancing risk.

Meanwhile, countries with stretched public finances and weak economic performance pre-shock face higher gross financing needs in 2020 than in 2009. For instance, Italy has very

[1] ESM, "Debt stocks meet gross financing neds: A flow perspective into sustainability", 2017
[2] In our baseline scenario for GDP growth, see Scope Sovereign Update 2020 Q2
[3] In 2009, Estonia, Latvia and Lithuania were not members of the euro area; in 2020 they account together for around 4% of euro area GFNs

similar amounts of amortisation and interest expenditure today compared to 2009 despite recurring primary surpluses in the aftermath of the financial crisis. The government's expected fiscal stimulus of around 4.5% of GDP in 2020 contributes to a further narrowing of fiscal space, even in the absence of higher refinancing costs.

The ECB could absorb extra GFNs short-term…

In the short term, refinancing risk remains under control for euro area countries, in large part the result of the ECB whose bond-buying programmes will keep interest costs low, limit any rise in risk premiums across countries and absorb part of the additional gross financing needs resulting from higher primary budget deficits. In absolute terms, we estimate euro area fiscal deficit for 2020 at around EUR 890bn. This compares with the ECB's purchase programmes of additional EUR 120bn under the standard Public Sector Purchase Programme (PSPP) and of EUR 750bn under the new Pandemic Emergency Purchase Programme (PEPP)[4]. We can expect around 70% of such programmes as related to government securities.

…but medium-term risks increase with uncertainty on refinancing

For countries with already large debt stocks before the pandemic, gross financing needs are set to rise over the medium term, following the increase in their stock of debt. Even with the ECB acting as a lender of last resort, some countries have limited fiscal space and face higher interest payments on their debt. These risks could quickly materialise in higher refinancing costs, if investors start questioning the likelihood of continuous monetary support and/or policy makers fail to agree on an enhanced financial framework for the euro area, including mechanisms such as a recovery fund, new forms of emergency lending, and region-wide unemployment insurance.

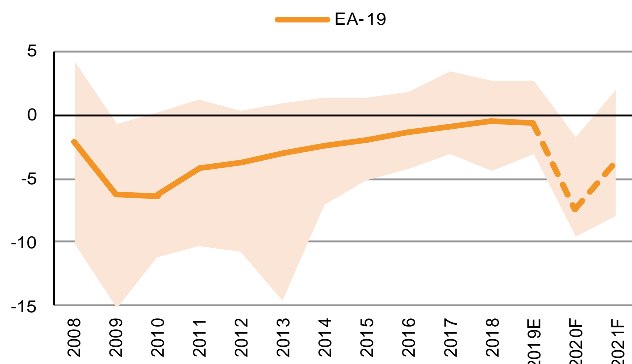
Implications for public debt and future GFNs

Fiscal policy is more homogeneous across member states

On aggregate, euro area governments have taken advantage of the extra space for fiscal spending created by more favourable debt amortisation profiles and lower interest payments, with the aggregate primary deficit projected at 6.2% of GDP in 2020, almost twice the deficit of 3.4% of GDP in 2009.

Fiscal policy this year is, moreover, better coordinated across euro area countries (see **Figure 3**). We expect fiscal deficits as a percentage of GDP to range between 10% to 2% of GDP, compared to a range from 15%[5] to 1% of GDP in 2009. Improved coordination could underpin a robust recovery from the Covid-19 shock and defuse political tension within the euro area over fiscal policies.

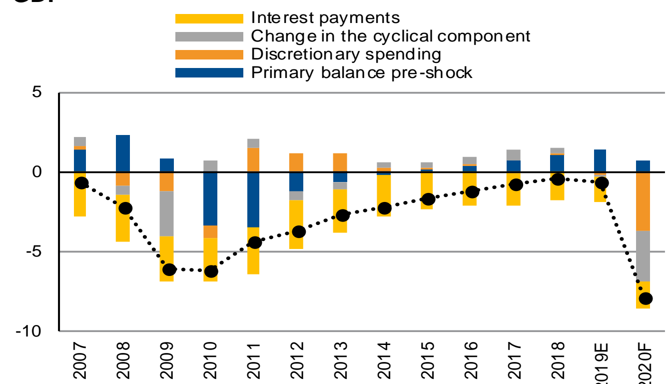
Figure 3: Fiscal balance in euro area countries, min-max range, % of GDP



NB: excludes Ireland[6]

Source: IMF, Scope Ratings GmbH

Figure 4: Composition of euro area fiscal balance, % of GDP



Source: AMECO, Scope Ratings GmbH

[4] In addition, in November 2019 the ECB announced new net asset purchases for 20bn monthly, which amount to additional 240bn annually in 2020 from 2019.
[5] Excluding Ireland, whose deficit was at 32% of GDP in 2009
[6] See footnote 1

Fiscal deficit components: cyclical versus discretionary spending

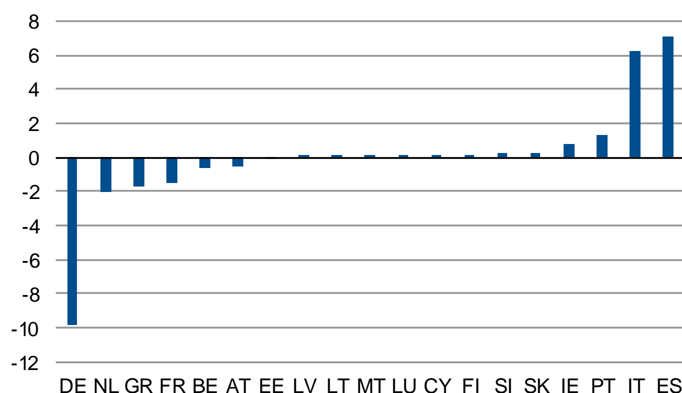
Our projections for this year's deficits include a component breakdown of the fiscal balance into the pre-shock primary balance, shock-related incremental discretionary spending, the cyclical component (higher unemployment benefits, lower tax revenues) and interest payments.

The magnitude of our 2020 deficit projection at 8% of GDP and the differences in composition compared to 2009 are displayed in **figure 4.** While our projection for the cyclical component compares well with 2009, interest payments are significantly lower, providing governments more room for fiscal stimulus. We also note a trend of prudent fiscal policies between 2013-19, which would have resulted in consecutive aggregate fiscal surpluses before taking into account gradually decreasing but still substantial interest payments.

Interest burden has shifted substantially across countries

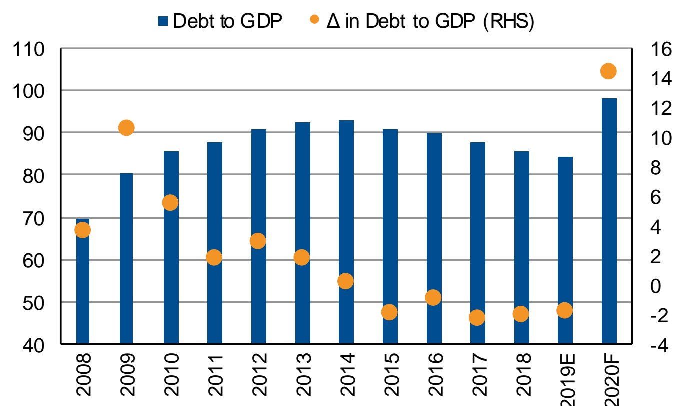
The share of interest payments across the euro area as shown in **figure 5** reveals that the interest burden has shifted from Germany to Italy and Spain. This trend is likely to intensify after this crisis and exemplifies the need for a sustainable framework to deal with public finance imbalances within the currency union. Higher public debt is manageable with low refinancing cost and long maturities as shown by France and Belgium (both with debt ratios of near 100% in 2019), but other governments face disproportionately higher roll-over costs, leading to widening yield spreads across euro area members that is likely to increase further and lead to marked differences in fiscal policy flexibility.

Figure 5: Change in shares of total euro area interest payments, 2009 to 2020, in percentage points



Source: Eurostat, Scope Ratings GmbH
NB: Calculated as change in the share of total interest payments on public debt in the euro area

Figure 6: Debt to GDP projections, euro area aggregate



Source: Eurostat, IMF, Scope Ratings GmbH

Public debt to remain structurally higher in the medium term

We project the euro area's aggregate debt-to-GDP ratio to increase to around 98% in 2020, up from 84% in 2019 (**Figure 6**). The projected 15pp increase is higher than the around 10pp rise in the global financial crisis in 2009. This is a consequence of the unprecedented economic shock to the euro area with a contraction of at least 6.5% of GDP this year compared with the 4.5% slump in 2009.

Risks arising from elevated euro area public debt include: i) economic distortions from higher taxes and crowding out of private investment, ii) vulnerability to volatile market sentiment, and iii) limited fiscal space to mitigate future shocks.

The euro area has ways to cope with the structural repercussions of higher debt on countries' economic fundamentals, such as : i) lengthening debt maturities to lower annual refinancing needs; ii) improving the euro area's long-term fiscal capacity (such as creating a recovery fund, new forms of emergency lending, region-wide unemployment insurance); iii) continued monetary policy support during times of market volatility, and iv) common programmes to raise the euro area's growth potential.

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