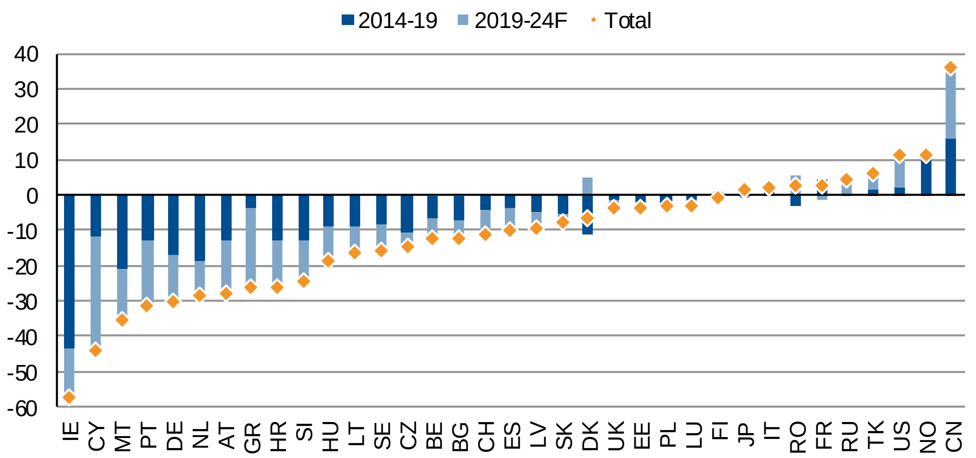
Diverging sovereign debt trends: Who has used the good times well, and how?

Understanding the drivers of sovereign debt developments is key in assessing public-debt sustainability challenges. Our analysis looks at the different factors affecting debt-to-GDP ratios of 35 sovereigns over the 2014-24 period. We found that most countries (26) will reduce their debt-to-GDP ratio, while only a few (9) will see an increase, with fiscal stances being the main reason for divergences.

Between 2014 and 2019, a growing global economy and declining interest rates supported fiscal consolidation. Most countries used the opportunity to reduce public debt levels. Still, projections for the next five years show diverging debt trajectories (**Figure 1**). With global economic prospects weakening, despite low interest rates, there is a rising risk of wider fiscal deficits, particularly for sovereigns that have relied largely on cyclical factors to improve primary balances.

We look at four factors driving changes in public debt ratios between 2014 and 2024: i) primary balances; ii) real GDP growth; iii) real interest rates; and iv) stock-flow adjustments (SFAs). We examine how countries have made use of the 'good times' and what the main drivers of debt developments will be in the coming years.

Figure 1. Change in gross public debt-to-GDP ratios, 2014-24F
pps of GDP



Source: IMF, Scope Ratings GmbH

Our analysis highlights the following key takeaways:

- Most countries in our sample, particularly in the euro area, have reduced their debt ratios and are projected to continue to do so until 2024. Only China (A+/Negative) is projected to have a significant increase until 2024.
- Primary balances are the main driver of the diverging debt trends in our sample. Primary surpluses helped reduce debt ratios in Europe whereas significant primary deficits in China and the US (AA/Stable) are contributing to rising debt ratios.
- Ireland (A+/Positive), Malta (A+/Stable), Estonia (AA-/Stable) and Lithuania (A-/Positive) are more exposed to an economic slowdown, given their main reliance on cyclical factors to improve budget balances.
- Buoyant GDP growth and declining interest rates have contributed positively to sovereigns' debt trajectories. Going forward, the contribution from real GDP growth will decline while real interest rates will remain supportive of fiscal consolidation efforts.

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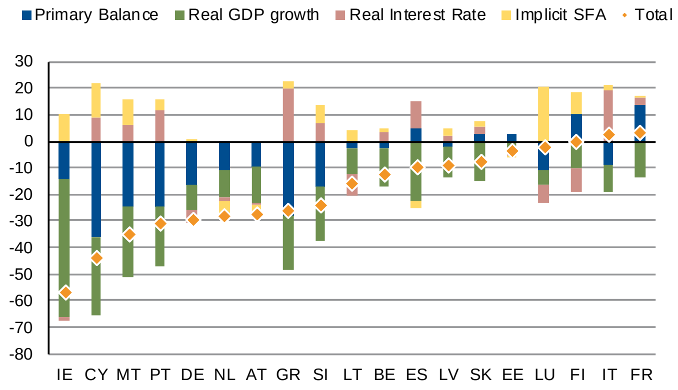
Diverging debt trajectories across regions

Wide variations in debt trajectories over the 2014-24 period

Debt trajectories over the 2014-24 period vary widely across our country sample: euro area countries except for France and Italy will record the strongest debt reductions, whereas debt will increase for most sovereigns outside Europe, especially the US and China. For example, Ireland's debt-to-GDP ratio is set to fall by 57pps while China's will rise by 37pps.

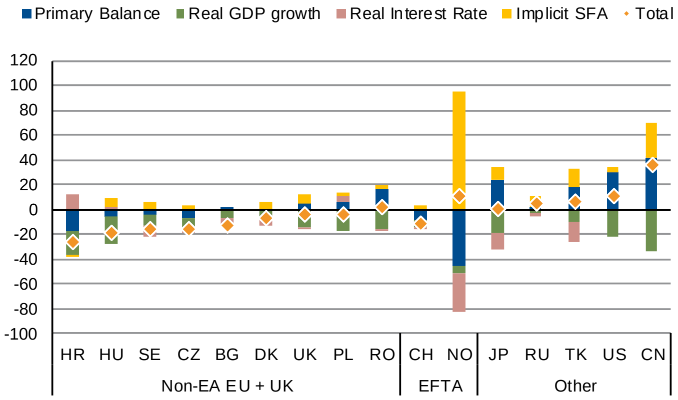
To analyse what drives these diverging trends, we have de-composed each country's debt development into its individual components. We separated the cumulative debt change into contributions from: i) primary balances; ii) real GDP growth; iii) real interest rates; and iv) implicit SFAs. **Figures 2** and **3** present the components of the cumulative changes in each sovereign's debt ratio over 2014-24[1]. **Annex I** provides an overview of the analysis.

Figure 2. Changes in debt ratios: euro area, 2014-24F
pps of GDP



Source: IMF, Scope Ratings GmbH

Figure 3. Changes in debt ratios: non euro-area, 2014-24F
pps of GDP



Source: IMF, Scope Ratings GmbH

Euro area sovereigns to reduce debt ratios the most, with two exceptions

Debt-to-GDP ratios will decline for most euro area sovereigns until 2024 (17 out of 19), on the back of high primary surpluses, solid real GDP growth and low interest rates. The two exceptions are France (AA/Stable) and Italy (BBB+/Stable), although for structurally different reasons. France runs primary deficits as part of a reform-friendly and expansionary fiscal policy, while Italy is negatively impacted by high real interest rates and anaemic economic growth.

Cyprus (BBB-/Stable), Greece (BB/Positive), Ireland (A+/Positive) and Portugal (BBB+/Stable), i.e. countries affected by the sovereign debt crisis and subsequent EU-IMF assistance programmes, are among the sovereigns to reduce their debt ratios the most. Cyprus, Greece and Portugal achieved primary surpluses via fiscal consolidation measures implemented since the crisis broke out. This, together with solid growth rates (which picked up after the respective programmes concluded), led to sizeable reductions in debt ratios, albeit from high levels. In addition, these countries achieved this despite the high real interest rates on their debt stock compared with those for other euro area sovereigns.

For Ireland, the country in our sample with the highest debt ratio reduction, real GDP growth was the main driver. However, we note that Ireland's gross GDP data is inflated by activities of foreign firms that relocated headquarters to the country for its favourable tax regime and access to the European market. Ireland's public debt adjusted to gross national income, which aims to remove the effects of firm relocation, decreased to a lesser extent (-32pps) than the debt-to-GDP ratio (-41pps) over 2014-18[2].

[1] Note that changes in debt-to-GDP ratios must be interpreted with respect to initial debt levels; countries with high debt ratios are more likely to see stronger variations in percentage-point terms than those with low debt ratios.
[2] The latest available data for Ireland's public debt adjusted to GNI is for 2018.

Non-European sovereigns are set to increase their debt ratio, most notably China and the US

Outside of Europe, we expect China (A+/Negative), Japan (A+/Stable), Russia (BBB/Stable), Turkey (BB-/Negative) and the United States (AA/Stable) to record increases in their public debt ratios until 2024. The main reason is primary deficits due to expansionary fiscal policies, notably in China, Japan and the US. China is also set for the highest debt-ratio increase over 2014-24, at 35pps. So far, the effect of primary deficits on debt has been tempered by high real GDP growth (also in part due to expansionary fiscal policies), most notably in China and the US. In Japan, on the other hand, fiscal stimulus has not been as effective: debt reduction attributable to real GDP growth is expected at 19pps over 2014-24, lower than that of the US (-22pps) and China (-33pps), despite a much higher initial debt stock.

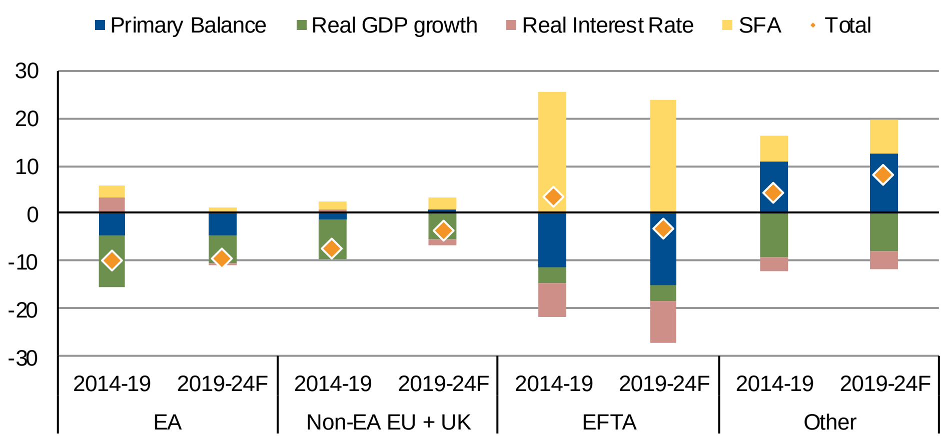
Differences in fiscal stances and cost of debt are the main differentiating drivers

As most countries in our sample are benefitting from real GDP growth, albeit to varying degrees, the main driver of diverging debt trajectories is differences in fiscal policies. Of the nine countries whose debt ratios are set to increase over 2014-24, seven have debt-increasing primary balance effects (of which five are non-EU countries). In addition, not all countries have benefited from lower interest rates: real interest rates have remained high for about half the countries in our sample, adversely impacting their public debt trajectory.

The importance of debt ratio drivers over time

Looking ahead, will the drivers of debt trajectories change as the global economic cycle reaches a mid-to-late phase and the strong decline in interest rates abates? **Figure 4** compares the different components of debt developments per region, divided into the historical period (2014-19) and the forecast period (2019-24).

Figure 4. Average cumulative debt components, 2014-19 versus 2019-24F
pps of GDP



NB. Cumulative contributions per component are calculated per country and then averaged for the region.
Source: IMF, Scope Ratings GmbH

Real GDP growth and low interest rates supported debt reduction across the sample

Overall, we expect real GDP growth and its contribution to debt reduction to slow for most of the countries. Conversely, due to the accommodative stances of all major central banks following the Great Financial Crisis, interest rates across Western economies declined to record lows and are forecasted to remain low. This means interest payments will also continue to be low, positively affecting the debt trajectory for most of the countries.

We expect broadly unchanged fiscal stances in the euro area but slightly expansionary fiscal policy in non-euro area European countries. Norway and Switzerland are set to post record primary surpluses, while China and the US are likely to expand fiscal policies even further, adversely affecting their debt trajectories.

In detail:

- **Primary balances**

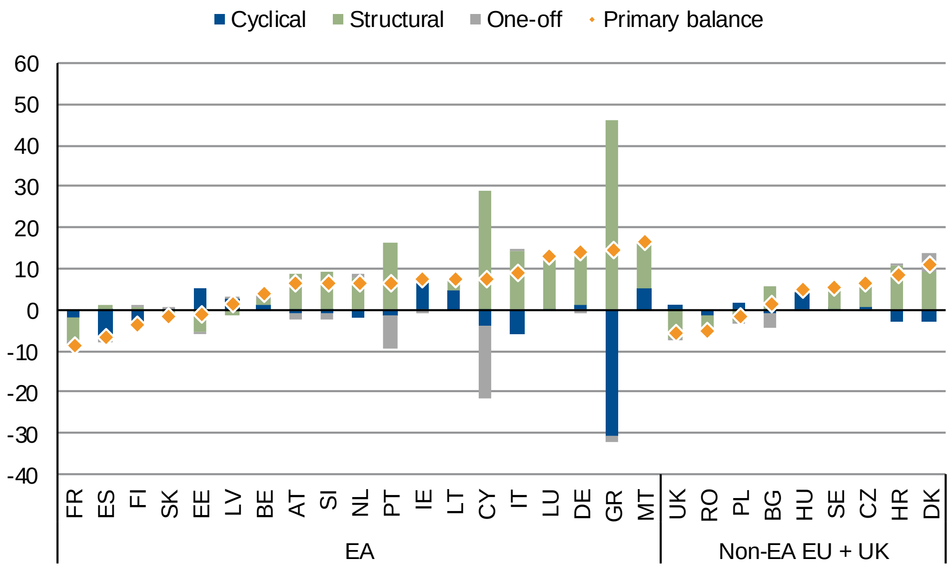
Primary balance trends are mostly stable over time

In the euro area, primary balances will continue to be a major factor in debt reduction. The average cumulative effect will be roughly equal for the 2019-24 and 2014-19 periods, at around 4.5pps, bolstered by measures that promote balanced budgets, such as EU fiscal rules, Germany's debt brake and post-crisis fiscal consolidation in periphery countries. For the forecast period, primary deficits are expected to drive up debt ratios for only five euro area sovereigns.

For the rest of the EU, plus the UK, the average cumulative contribution to the debt ratio from the primary balance will turn positive, signaling a slightly more expansive fiscal stance going forward. The primary-balance contribution is expected to stay balanced for the region overall, with some variation between the countries, i.e. sizeable primary deficits in Romania (+10pps contribution) and primary surpluses in Croatia (-8pps).

For the other countries, we expect primary deficits will increase debt ratios throughout the forecast period. Especially in China, Turkey and the US, expansionary fiscal policies over the next five years will increase the contribution of primary-deficits between the two periods and constitute the main factor for higher debt ratios.

Figure 5. Cumulative primary balances – cyclical versus structural, 2014-19
pps of GDP



Source: AMECO, Scope Ratings GmbH

Cyclical factors benefitted Ireland, Malta, Lithuania and Estonia

Finally, for European countries for which AMECO provides data, we decompose the 2014-19 cumulative primary balances into their cyclical, structural and 'one-off' components (**Figure 5**). In the euro area, Ireland's budget balance benefitted the most from cyclical factors during 2014-19, followed by Malta, Lithuania and Estonia. By contrast, cyclical factors had a deeply negative impact on the budget balances of Greece, Italy and Spain, reflecting the prolonged effects of the crisis.

Largest structural adjustment in Greece, Cyprus and Portugal

Cyprus's public finances suffered from adverse cyclical factors as well as one-off impacts linked to capital injections in the banking sector. Periphery countries, except for Spain, also saw the strongest contributions from structural adjustments, which helped offset negative cyclical pressures on budget balances. Cyclical effects were limited among non-euro-area countries while the UK's and Romania's primary balances suffered from structural deficits.

Global slowdown results in lower contributions from growth going forward

➢ **Real GDP growth**

For the euro area, real annual GDP growth will slow to 1.3% by 2024, according to the IMF, diminishing its contribution to debt reduction for most sovereigns in the region. Greece is the only country where this contribution is set to increase, reflecting the pick-up in growth after the economic adjustment programme ended in August 2018.

Sovereigns in the rest of Europe, including the UK, will record slower GDP growth for 2019-24, resulting in real GDP growth contributing less to debt reduction.

The remaining countries in our sample will see the same trend, albeit to a lower degree than in the euro area. The exception is China, whose contribution from real GDP growth *in percentage point terms* is expected to pick up over 2019-24, owing to an increased debt stock at the end of 2019 relative to 2014. A marked economic slowdown is expected in Japan – the IMF forecasts real GDP growth of 0.5% by 2024 – resulting in a diminished contribution of growth to debt reduction, from -13pps of GDP in 2014-19 to just -6pps in 2019-24.

Real interest rates are expected to stay low across most of the sample

➢ **Real interest rates**

In the euro area, monetary easing has led to record-low refinancing costs for sovereigns over 2014-19, which should remain the case over the forecast period. For periphery countries, the average cumulative contribution from real interest rates led to a significant increase in debt ratios, reflecting the elevated risk premia on their sovereign debt. This effect is expected to soften substantially over 2019-24 but will remain high for Greece (+5.5pps of GDP), Italy (+6.7pps) and Portugal (+4.1pps). The average real-interest-rate contribution will therefore be broadly debt-neutral for the euro area over 2019-24.

For the non-European countries, the real-interest-rate contribution is also set to be stable over 2019-24. While nominal interest rates are higher for these countries, this is balanced by their higher inflation and real GDP growth rates. The exception is Japan, with real interest rates projected to be major driver in debt reduction (-10pps), due to the highly accommodative policies by the Bank of Japan. The real interest rate is also helping to reduce the debt ratio in Turkey (-6pps contribution), due to high inflation rates anticipated until 2024.

Stock flow adjustments reflect idiosyncratic developments

➢ **Stock-flow adjustments (SFAs)**

SFAs combine all effects not captured by the other three debt-ratio drivers. They relate to the net acquisition of financial assets, debt adjustment effects and statistical discrepancies. Examples include capital injections, privatisation proceeds and changes in assets held by the government[3].

In the euro area, capital injections in the banking sector led to debt-increasing SFAs over 2014-19 in some of the countries subject to economic adjustment programmes. Over 2019-24, we expect the impact of SFAs to be neutral for the debt ratios of most EU countries. The exceptions are Finland (+6pps of GDP) and Luxembourg (+9pps) – potentially linked to their asset-rich social security funds – as well as Slovenia (+5pps), Denmark (+12pps), and Greece (-4pps).

In the EFTA group, Norway will continue to record sizeable debt-increasing SFAs, due to changes in the assets of its sovereign wealth fund, projected at a cumulative 90pps over 2014-24. Finally, all non-European countries will see SFAs put upward pressure on debt ratios over 2019-24.

[3] European Commission (2019), Stock-flow adjustment for the Member States, the euro area (EA-19) and the EU-28, for the period 2015-2018.

Annex I. Overview of cumulative contributions to public debt ratios

		Cumulative change	Gross debt	Cumulative debt trend contribution (pps of GDP)				Cumulative change	Gross debt	Cumulative debt trend contribution (pps of GDP)				Cumulative change	Gross debt
		pps of GDP	*% of GDP*	2014-2019				*pps of GDP*	*% of GDP*				2019-2024F	*pps of GDP*	*% of GDP*
		2014-24	**2014**	Primary balance	Real GDP growth	Real interest rate	Implicit SFA	**2014-19**	**2019**	Primary balance	Real GDP growth	Real interest rate	Implicit SFA	**2019-24F**	**2024**
EA	**AT**	**-27.50**	83.8	-4.26	-8.13	0.92	-1.56	**-13.03**	70.7	-5.49	-5.15	-1.67	-2.16	**-14.48**	56.3
	BE	**-12.38**	107.5	-3.49	-7.98	4.02	0.94	**-6.51**	101.0	0.88	-6.56	-0.54	0.35	**-5.87**	95.1
	CY	**-44.05**	108.0	-12.91	-18.93	9.76	10.17	**-11.91**	96.1	-23.01	-11.11	-0.61	2.58	**-32.15**	63.9
	DE	**-30.00**	75.6	-10.58	-5.95	-1.03	0.57	**-16.99**	58.6	-6.08	-3.43	-3.75	0.24	**-13.01**	45.6
	EE	**-3.49**	10.4	1.61	-1.68	-1.63	-0.55	**-2.25**	8.2	0.91	-1.07	-1.20	0.12	**-1.25**	7.0
	ES	**-9.84**	100.4	5.47	-14.41	8.14	-3.16	**-3.96**	96.4	-0.59	-7.96	2.22	0.45	**-5.89**	90.5
	FI	**-0.53**	60.2	5.79	-5.73	-3.00	1.68	**-1.26**	58.9	4.55	-4.20	-5.87	6.25	**0.73**	59.7
	FR	**2.89**	94.9	7.43	-7.24	4.24	-0.01	**4.42**	99.3	6.21	-6.74	-1.41	0.40	**-1.53**	97.8
	GR	**-26.08**	180.2	-16.21	-8.73	14.06	7.30	**-3.57**	176.6	-11.90	-12.01	5.53	-4.12	**-22.51**	154.1
	IE	**-57.23**	104.5	-6.63	-43.43	-2.46	8.93	**-43.59**	60.9	-7.54	-8.38	0.68	1.60	**-13.64**	47.3
	IT	**2.19**	131.8	-6.60	-6.04	12.64	1.37	**1.37**	133.2	-1.98	-4.40	6.65	0.56	**0.82**	134.0
	LT	**-16.10**	40.5	-3.81	-6.02	-2.64	3.72	**-8.74**	31.8	1.26	-3.48	-5.50	0.36	**-7.36**	24.4
	LU	**-2.61**	22.7	-7.18	-2.89	-2.74	11.41	**-1.40**	21.3	-3.66	-2.77	-4.22	9.44	**-1.21**	20.1
	LV	**-9.37**	40.9	-1.61	-6.77	1.52	2.26	**-4.60**	36.3	-0.48	-5.10	0.36	0.44	**-4.77**	31.6
	MT	**-35.07**	63.4	-15.00	-19.58	3.48	10.09	**-21.01**	42.3	-9.81	-6.56	2.40	-0.10	**-14.07**	28.3
	NL	**-28.21**	68.0	-6.81	-6.95	0.98	-6.00	**-18.79**	49.2	-3.95	-3.48	-2.21	0.21	**-9.43**	39.8
	PT	**-31.35**	130.6	-8.34	-14.80	7.88	2.20	**-13.06**	117.6	-15.94	-8.36	4.08	1.94	**-18.29**	99.3
	SI	**-24.23**	80.3	-7.10	-13.27	5.27	1.85	**-13.25**	67.1	-9.65	-7.74	1.54	4.86	**-10.98**	56.1
	SK	**-7.66**	53.5	0.87	-8.88	3.59	-0.75	**-5.17**	48.4	1.59	-6.36	-0.22	2.50	**-2.48**	45.9
Non-EA EU + UK	**BG**	**-11.98**	26.4	0.92	-4.44	-2.25	-1.46	**-7.23**	19.2	-0.74	-2.50	-1.77	0.27	**-4.75**	14.4
	CZ	**-14.67**	42.2	-6.29	-6.64	0.22	2.16	**-10.55**	31.6	-0.72	-3.85	-0.75	1.19	**-4.12**	27.5
	DK	**-6.09**	44.3	-1.85	-3.94	-0.60	-4.88	**-11.28**	33.0	1.77	-2.85	-5.27	11.53	**5.19**	38.2
	HR	**-25.98**	84.0	-9.12	-11.63	8.81	-0.98	**-12.92**	71.1	-8.45	-7.68	2.71	0.36	**-13.06**	58.0
	HU	**-18.56**	76.6	-3.96	-14.49	2.91	6.40	**-9.13**	67.5	-1.23	-8.53	-0.80	1.14	**-9.42**	58.1
	PL	**-3.03**	50.4	0.48	-10.76	4.38	3.25	**-2.64**	47.8	5.66	-6.28	0.05	0.18	**-0.39**	47.4
	RO	**2.64**	40.5	6.71	-9.15	-1.65	1.03	**-3.07**	37.4	10.26	-6.16	0.73	0.87	**5.71**	43.1
	SE	**-15.53**	45.0	-3.92	-5.36	-4.62	5.81	**-8.09**	36.9	-0.57	-3.19	-4.07	0.40	**-7.44**	29.5
	UK	**-3.69**	87.0	3.98	-7.51	0.16	1.90	**-1.46**	85.6	0.03	-6.39	-2.07	6.21	**-2.23**	83.3
EFTA	**CH**	**-10.84**	43.0	-5.43	-3.54	0.86	3.77	**-4.34**	38.6	-2.46	-2.75	-1.32	0.03	**-6.50**	32.1
	NO	**11.52**	28.4	-17.32	-3.01	-15.07	46.92	**11.52**	40.0	-27.91	-3.60	-16.06	47.56	**0.00**	40.0
Other	**CN**	**36.64**	39.9	16.88	-14.69	0.89	12.57	**15.65**	55.6	24.15	-18.47	-0.54	15.85	**20.99**	76.6
	JP	**1.49**	236.1	14.61	-12.90	-4.39	4.30	**1.62**	237.7	9.94	-5.82	-9.77	5.52	**-0.13**	237.6
	RU	**4.79**	16.1	2.45	-0.45	-2.63	1.05	**0.42**	16.5	-0.92	-1.78	-0.52	7.59	**4.37**	20.9
	TK	**6.42**	28.8	5.71	-5.62	-9.43	10.67	**1.33**	30.1	12.19	-5.12	-5.72	3.74	**5.09**	35.2
	US	**11.36**	104.4	13.63	-12.83	1.14	-0.12	**1.81**	106.2	16.60	-9.44	-1.01	3.40	**9.55**	115.8

Source: IMF, Scope Ratings GmbH

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