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How Draghi consolidated Germany’s public finances

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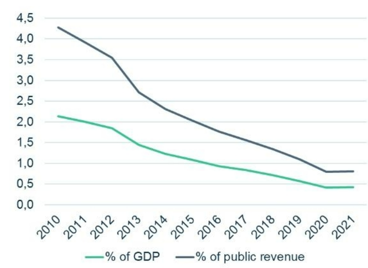
Low interest rates have been a big contributor to fiscal consolidation

The current rapid rise in long-term interest rates is without precedent in recent financial history. After the yield on the ten-year federal bond briefly fell back below zero following the outbreak of the Ukraine war, it easily surpassed the 1% mark at the beginning of May. That may not sound like much to some, but it is a financial tectonic quake. And the rise is not over yet, even if its rapid pace is likely to slow over the coming months.

Germany managed something quite unusual in the 2010s: until the outbreak of the Corona pandemic, the general government budget (all levels of government) had been in surplus for eight uninterrupted years. By way of comparison, France's last surplus dates back to 1974. Both the economic profession and politicians are debating whether the price paid by Germany for fiscal rectitude was too high, for example in the form of decaying public infrastructure or a lack of effective defense capability.

Germany: Interest burden on the federal government



Source: IMF, LBBW Research

The ECB's role in budget consolidation

The focus here is on the contribution of the long period of low interest rates to the consolidation of public budgets, which was spearheaded by then Minister of Finance Schäuble. The chart on the right shows how the government's interest burden collapsed over the past decade. This was not because investors thought that Germany had become less risky than before the financial and euro crisis. The federal government has always benefited from a top-notch credit rating. That has never been in doubt.

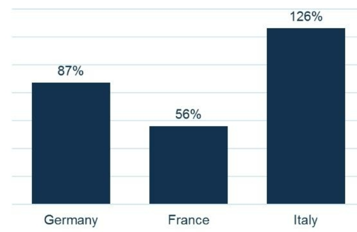
The state spends less than 1% of its revenue on interest!

Nor was the decline in interest payments due to a reduction in liabilities, even if the moderate drop in the debt ratio from 80% of GDP ten years ago to around 70% today plays a supporting role.

In fact, the massive decline in the interest burden is a corollary of Mario Draghi's “Whatever-it-takes” policy, a low-interest-rate policy that, at its core, continues today. If the changed interest burden is removed from the budget calculation, the average surplus of the 2012-2019 period (the “good old years” between the euro and Corona crises) of 0.9% of GDP would collapse like a soufflé, to exactly zero!

To be sure, this would still be a respectable achievement. But it was the ECB's full-throttle policy that activated the German budget consolidation turbo. Interest savings accounted for 87% of the budget improvement between 2012 and 2019 (see chart).

What portion of budget improvements is attributable to lower interest expenditures?, 2019 compared to 2012



Source: IMF, LBBW Research

Nevertheless: Germany's public finances are sound

The rapid rise in long-term interest rates is no reason to be acutely concerned about the state of Germany's public finances. Yes, the tailwind is becoming a headwind. But it is more of a gentle breeze than an icy gust. A return to the interest rates of the 2000s (between 3% and 5%) is highly unlikely. The debt level is easily sustainable for the foreseeable future, even if a new unexpected crisis were to hit us, such as a halt in gas supplies from Russia (see last week's edition of To the point!).

> Without the low interest rate policy of the ECB, the high surpluses would have been impossible.

All of this also means that the state has sufficient flexibility to solidly finance the major tasks of the future, such as fighting climate change and upgrading the German armed forces.

Whether these investment plans will remain compatible with the debt brake that effectively banns fiscal deficits on the one hand, and the ruling coalition’s commitment against tax increases on the other, is another question. Skepticism is warranted that this squaring of the circle can succeed. As I have argued before in this column, something may have to give.