Addressing indebtedness in the European Union

Note written by Didier Cahen[1]

Executive summary

Even before the Covid-19 pandemic and the energy crises, global debt had reached an all-time high for peacetime. According to the Bank for International Settlements (BIS), global debt increased from 174.4% of GDP in 2001 to 232.6% in 2023. This unprecedented rise in debt over the past 20 years is due to extremely accommodative monetary policies and historically low interest rates. Furthermore, in Europe, the fiscal rules of the Stability and Growth Pact (SGP) were not respected by some large Member States.

Excessive debt is a source of crisis. In the face of certain countries' over-indebtedness, it is necessary to gradually reduce the current debt excess by reevaluating public budgets, prioritizing qualitative expenditure for the future and undertaking structural supply side-oriented reforms, which are the only way forward and that have been postponed for too long.

On 21 December 2023, the Ecofin Council reached an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament and the Council definitively adopted this reform on 20 April 2024. Admittedly, the revised Stability and Growth Pact do contain some positive elements. In particular, the case-by-case framework – which is a specific technical dialogue between the EU Commission and each Member State regarding their differentiated multi-annual budgetary path – has been introduced in the reformed Pact. This framework allows for a differentiated approach for each Member State, taking into account of the heterogeneity of budgetary positions, public debt and economic challenges in the EU.

However, the goal of simplification of the rules has regrettably not been achieved. Even more concerning is that the Commission's proposal demands the smallest effort to the most indebted countries, which could perpetuate the decline of these economies. Indeed, according to this Ecofin Council compromise, countries that are subject to an excessive deficit procedure (where total public deficit exceeds 3% of GDP) are exempt from the rule requiring them to reduce their public debt by an average of 1% a year until their deficit falls back below 3%. This is not the best way to encourage the worst performers to reduce their debt-to-GDP ratio! It is as exempting the worst performers in a class from extra effort and sanctions as long as their results remain mediocre.

If fiscal, inflationary and economic drift continues in the Eurozone, the 'virtuous' countries will end up paying for it. This would be the definition of an uncooperative game, where most players try to evade their obligations by passing on the cost to those who respect them. We must therefore take the Union's destiny into our own hands and not let it drift. If this is the case, the logical outcome could well be a new and inevitable Eurozone crisis.

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Introduction

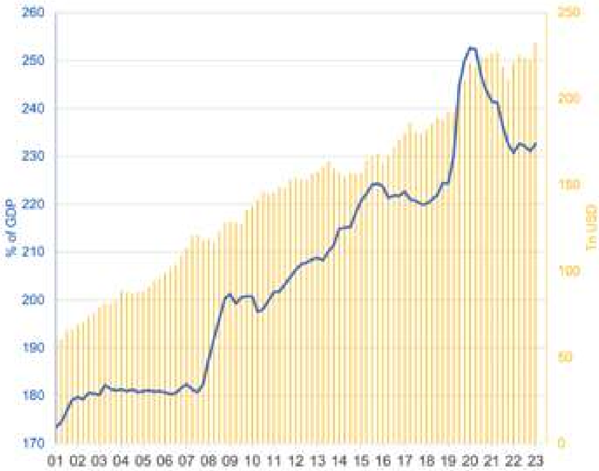
Excessive debt is a source of crisis. Examples abound, such as the European sovereign debt crisis (2011-2012) that would not have occurred if private debt in several EU countries had not risen so fast.

Even before the Covid-19 and the energy crises, global debt was at an all-peacetime record as evidenced by Chart 1. Indeed, the persistence of very low interest rates over the past two decades has encouraged many advanced countries to pursue active fiscal policies and economic agents to borrow more. According to the BIS, global public debt in advanced economies increased from 63.4% in 2000 to 109.8% in 2023. In the Euro area, the ratio of total government debt to GDP rose over the same period from 69.2% to 88.6% over the same period.

The unprecedented rise in debt over the past 20 years is the result of ultra-accommodative monetary policies and very low interest rates. Furthermore, in Europe, the fiscal rules of the Stability and Growth Pact were not respected by some large Member States.

1. This note updates the document published on this topic in February 2024. The author would like to thank Mr. Elias Krief, who actively contributed to the drafting of this note during the second quarter of 2024.

CHART 1.
Global debt as a % of GDP



Source: Bank for International Settlements (BIS)
Note: global debt gathers 45 advanced and emerging economies; last observations from Q4-2023

The Maastricht Treaty specifies reference values – known as the Maastricht criteria – for the general government sector of the various EU Member States: general government deficit should not exceed 3% of GDP, and government debt should remain below 60% of the GDP. But in 1998, political considera tions replaced the strict accounting interpretation of debt. Indeed, Belgium and Italy – two founding countries of the European Union – qualified for entry into the Eurozone with public debt-to-GDP ratios of 117% and 115% respectively.

Since then, the EU institutions have accepted that debt levels in many Member States could rise inexorably. In the Euro area, the divergence in public debt levels has become a major concern. While negative interest rates have ensured the short-term sustainability of European countries' public debt, the absence of structural reforms to gradually reduce these public debt ratios in the long term could lead to economic decline and jeopardize the future of the Euro area.

Monetary policy and the resulting credit expansion in the 2000s played a major role in precipitating the Great Financial Crisis of 2008. Since then, many advanced countries have continued to rely increasingly on public debt, encouraged by persistently very low – and even negative – interest rates, and ultimately passing on a large portion of the costs to future taxpayers that the current generation refuses to assume.

Given the over-indebtedness of some countries, it is necessary to gradually reduce the current debt overhang by reviewing public budgets, prioritizing qualitative spending for the future and implementing the structural reforms that are the only viable path forward and that have been postponed for far too long.

This paper focuses on public and private indebtedness issues in the European Union. The first part of the paper demonstrates that European economies – be they part of the Euro area or not – are characterized by significant divergences in public and private debt. The second explains how public and private debt levels spiraled out of control in many European countries, especially large Member States. The third part outlines the various issues caused by excessive public and private debt levels, while the final part explores the potential solutions that could enable highly indebted countries to restore healthy public and private finances.

1. The Euro area and the EU are characterized by significant public and private debt divergences

The first part of this note aims at depicting the state of public and private debts across EU Member States and identifying certain categories of countries according to their public and private debt levels. Indeed, great divergences can be observed between countries, be it in the levels of debt of governments and of private economic agents – households and Non-Financial Corporations (NFCs).

1.1 Public debt-to-GDP ratios differ widely across Member States

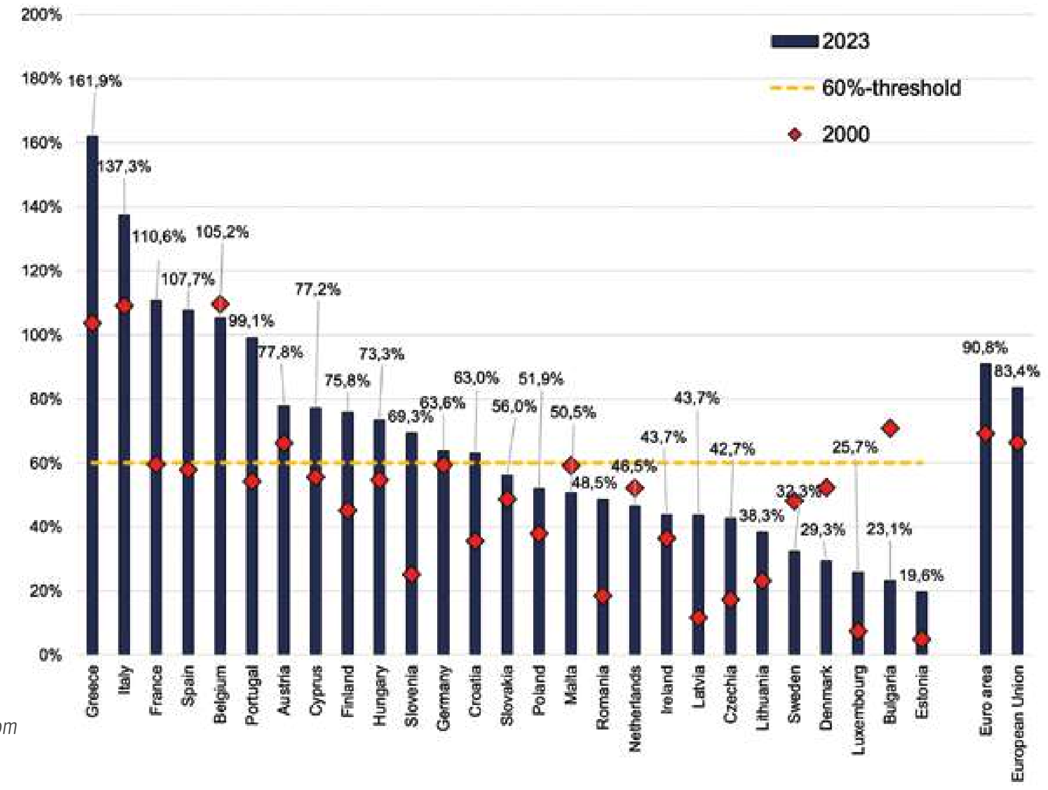
At the end of 2023, public debt has reached very high levels in a small group of large European countries.

Despite the various reforms adopted in the wake of the sovereign debt crisis (European Semester, Six Pack, Two Pack, Treaty on Stability, Coordination and Governance in the Economic and Monetary Union), the public debt-to-GDP ratio has continued to rise in major Euro area countries (*e.g.* France, Italy, Belgium, Spain, Portugal) and is approaching – and in some cases exceeding – 110% of GDP (*see Chart 2*)[2].

On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt-to-GDP of around 60% or less[3].

2. Between 2000 and 2023, gross public debt-to-GDP ratio increased by 28.3 pp in Italy, 51.1 pp in France and 49.8 pp in Spain.
3. Gross public debt-to-GDP ratio increased by 4.3 pp between 2000 and 2023 in Germany and dropped by 5.7 pp in the Netherlands.

CHART 2.
Gross Public Debt to GDP ratio across EU Member States

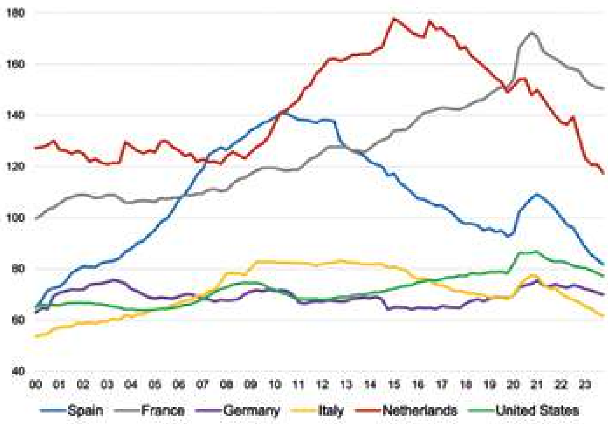


Source: EU Commission; Data for 2023 are taken from EU Commission's Spring Forecasts of May 2024

In 2023, 14 countries in the EU had a public debt-to-GDP ratio below 60% of GDP: Estonia, Bulgaria, Luxembourg, Sweden, Denmark, Lithuania, Latvia, Czech Republic, Ireland, Romania, the Netherlands, Poland, Malta, and Slovakia. However, Greece (161.9%) and Italy (137.3%) had a public debt exceeding 130% of their GDP. France, Spain, and Belgium also had high public debts, exceeding 100% of their GDP (103.4%, 110.6%, 107.7% and 105.2% of GDP respectively), well above the average of the 27 countries (83.4%), while Germany and the Netherlands had public debt levels of 63.6% and 46.5% respectively.

General government debt surged in all countries – whatever their level of indebtedness – as a result of the Covid-19 crisis. However, debt has decreased after its peak of 2020 because of high inflation and enhanced growth – that followed the end of lockdowns, but it remains nowadays at levels above to their pre-pandemic levels.

CHART 3.
Non-financial private debt, % of GDP



Source: Bank for International Settlements. Last observation from 2023-Q4

1.2 Significant divergences among Member States are also observed in private debt levels

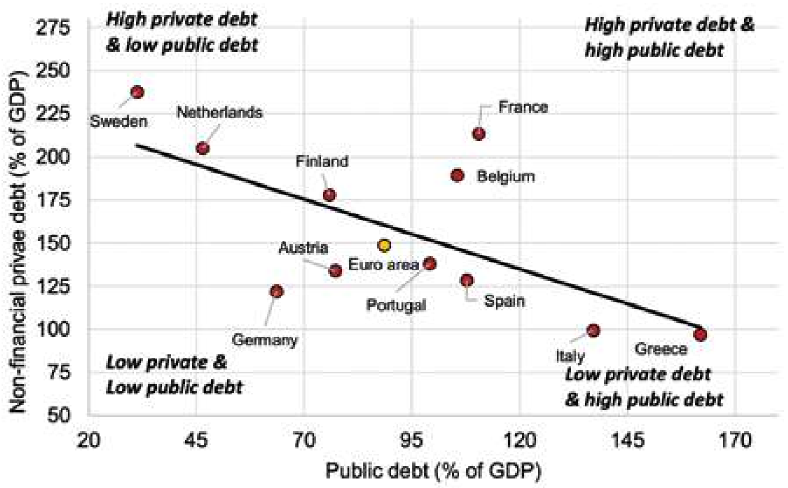
Private debt, *i.e.* the debt of households and non-financial corporations, has strongly diverged across EU Member States since the Sovereign Debt Crisis (*see Chart 3*).

In France, private debt increased from 181.1.7% of GDP in 2013 to 213.4.1% in 2023 according to the BIS.

By contrast, private debt fell significatively in Spain from 202% of GDP in 2013 to 128.6% in 2023 following corporate deleveraging and the deflation of the real estate bubble. It also decreased in Italy from 125% of GDP to 99.4% and remained stable in Germany from 124.3% to 122% over the same period.

Although the level of French private debt (as share of GDP) remained lower than that of the Netherlands until Q4-2022, it should be noted that private debt in the Netherlands fell by 75.2 pp between 2013 and 2014, while it increased by 32.3 pp in France.

CHART 4.
Private debt v. public debt across selected Euro Member States, as of Q3-2023



Source: Bank for International Settlements, EU Commission (Spring Forecasts of May 2024)

1.3 Several categories of countries can be drawn from their levels of public and private debt

As underlined above, private and public debt levels vary across EU Member States, and debt profiles fall into four categories that are observable on Chart 4.

The first category includes countries with both low public and private debt, namely Germany and Austria which are below the Euro area average.

The second category includes countries with high public debt but low private debt – Italy, Greece, Spain and Portugal, which are among the countries with the highest public debt ratios in the Euro area, while their private debt levels are below the Euro area average.

The third category comprises countries with low government debt but high private debt. The Netherlands, Finland and other EU Member States that are not part of the Euro area, such as Sweden, fall into this category. For example, the Dutch public debt is one of the lowest in the Euro area – 46.4% of GDP in Q4-2023 – while the private sector debt is one of the highest at 205% of GDP.

The fourth category consists of countries with both high public and private debt. It includes France and Belgium, which have public debt of 110.5% and 105.5% of GDP respectively and private debt of 213.4% and 189.3% of GDP, well above the Euro area average for both public and private debt (88.6% and 152.1% of GDP respectively). This category is more exposed to the challenges associated with rising interest rates; all economic agents, whether public or private, are more vulnerable to macroeconomic and monetary changes. The risk of a financial crisis is even more important in these countries, especially as potential growth is low.

2. How did we get there?

The second part of this note focuses on the two main explanations for the diverging debt levels illustrated above. First, a chronological study of debt trajectories over the last two decades shows that some large EU Member States have let their public debt-to-GDP ratios slip in non-crisis times while others have shown greater discipline with respect to the fiscal criteria of the Stability and Growth Pact (SGP), and that in some cases private debt levels have followed the same path as public debt levels. Second, excessive public debt in some EU Member States has been greatly facilitated by the ECB's ultra-accommodative and asymmetric monetary policy since the EU sovereign debt crisis (2011-2012).

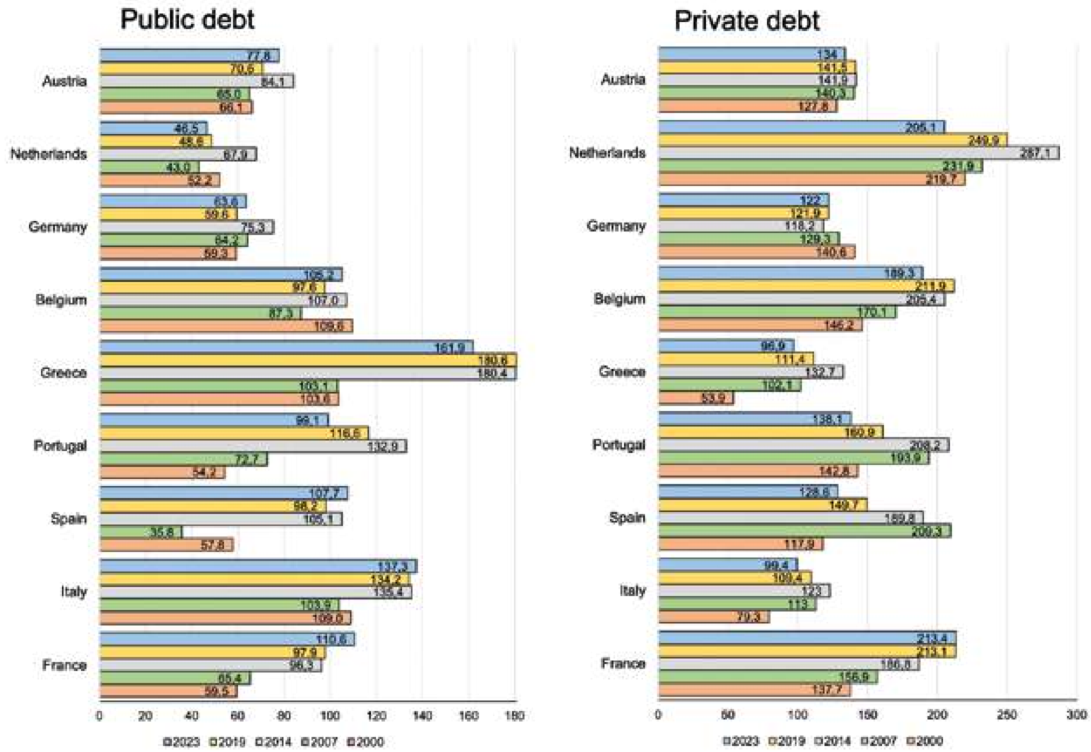
2.1 A chronological observation shows that debt levels of over-indebted EU countries have risen in crisis-times (GFC, sovereign debt crisis, Covid-19...) as well as in non-crisis times[4]

Chart 5 and the following sections aim at providing a chronological understanding of diverging debt trajectories in EU Member States. The first section focuses on the period 2000-2007 and the EU sovereign debt crisis by showing that large Eurozone countries failed to meet the Maastricht fiscal criteria for most of the time and the expansion of private debt in some peripheral Member States put them at the center of the sovereign debt crisis.

The second section analyses the Member States' fiscal heterogeneities between 2014 and 2019, while the third one shows that these fiscal heterogeneities have been exacerbated by the Covid-19 pandemic. Section 4 shows that the divergences in terms of

4. This section is largely based on the *Eurofi Macroeconomic Scoreboard* (September 2024).

CHART 5.
Government and private sector debt across selected Eurozone Member States since 2000, % of GDP



Source: Bank for International Settlements, EU Commission (Spring Forecasts of May 2024)

fiscal deficits and public debt have not been accentuated by the Russian war in Ukraine, but that public debt-to-GDP ratios have stabilized at high levels in 2022 and 2023. Eventually, the fifth section puts in perspective the private and public debt trends.

2.1.1 2000-2007: Large Eurozone countries failed to meet the Maastricht fiscal criteria for most of the time and the expansion of private debt in some peripheral Member States put them at the center of the sovereign debt crisis

The Monetary Union had an inauspicious start. Although, the public debt ratios of France and Germany were close to 60% of GDP in 1999 and their public deficits were limited (1.5% of GDP in 1999), by 2002, fiscal deficits had already begun to exceed the 3% threshold.

Germany improved its public finances between 2004 and 2007, with the fiscal deficit narrowing from -3.3% to a balanced position. However, such a virtuous budgetary path did not materialize across the board. For instance, despite a favorable economic climate between 2004 and 2007 (average annual real GDP growth of 2.5% over these 3 years), France continued to record public deficits above 3% of GDP, thus abandoning the economic discipline it had adopted in order to join the Eurozone.

In the pre-crisis period (2000-2007), the fiscal balance was positive, on average, in Ireland (1.4% of GDP) and Spain (0.4%). It should be noted, however, that government revenues in both countries were kept artificially high by tax revenues generated by the real estate boom. In contrast, fiscal balances were negative on average between 2000 and 2006, in Austria (-2.2%), Germany (-2.5%), France (-2.7%) and Italy (-3%). Greece (-6.4%) and Portugal (-4.6%) exceeded the Maastricht criterion of 3%.

In some peripheral countries, healthy public accounts masked a surge in private debt, fuelled by very accommodative financial conditions.

As there is only one key interest rate in a currency zone, real interest rates (after adjusting for inflation) in peripheral countries became lower than in northern countries, or even negative after joining the euro. This created a greater incentive to borrow. The easing of financial conditions stimulated the distribution of credit (particularly real-estate mortgages) in southern Europe and Ireland, leading to a sharp rise in property prices.

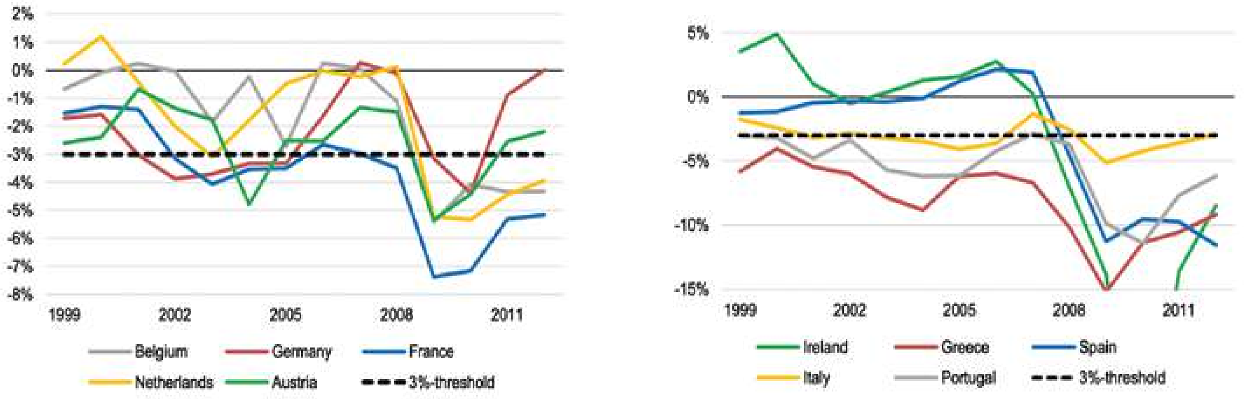
The “GIPS” (Greece, Italy, Portugal, Spain) experienced significant increases in private debt between 2000 and 2007; for instance, the Spanish private debt nearly doubled from 117.9% of GDP in 2000 to 209.3% in 2007. In Italy and Portugal, private debt

CHART 6.

Total Budget Balance across the EU Member States between 1999 and 2012, % of GDP

6a. Core countries

6b. Peripherical countries



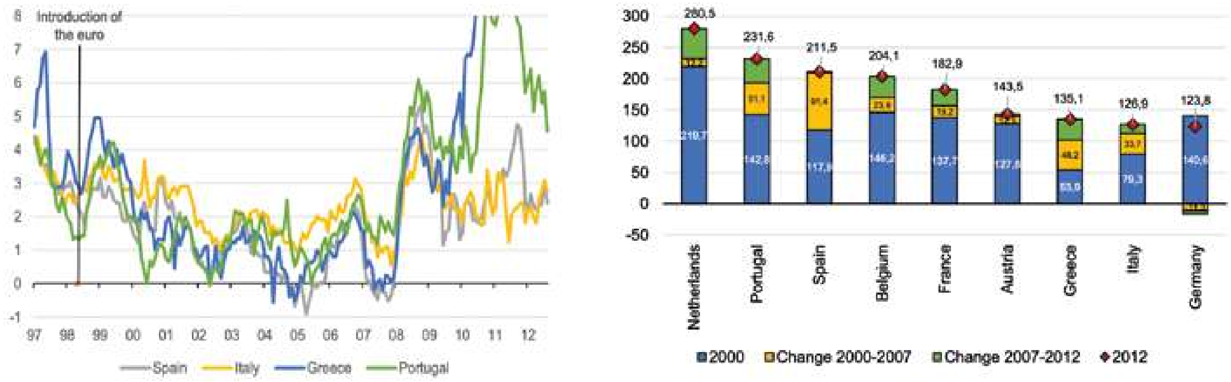
Source: EU Commission

CHART 7.

Real interest rates and credit dynamics across Euro area Member States [2000-2012]

7a. 10-year sovereign bond yields, adjusted for inflation in selected periphery Member States(%)

7b. 10-year sovereign bond yields, adjusted for inflation in selected periphery Member States(%)



Sources: Bank for International Settlements, OECD

increased by more than a third over the same period. Excessive private debt levels –closely linked to real estate bubbles in certain cases, such as Spain – became a source of financial vulnerabilities that materialized during the GFC.

When the crisis broke out in 2007, public debt ratios soared, particularly in southern European countries. Spain, for example, had a public debt of only 35.8% of GDP in 2007; by 2014, the debt ratio had surged to 105.1%. In Ireland and Greece, the debt-to-GDP ratio rose from 23.9% and 103.1% in 2007 respectively to 119.6% and 180.4% in 2014 (*see Chart 5*). Southern European countries were particularly affected by the GFC due to the 'sudden stop' of capital flows: from 2000 to 2007, they benefited from massive foreign capital inflows, which suddenly stopped following the collapse of Lehman Brothers.

2.1.2 2012-2019: While private debt has fallen in the most vulnerable Member States as a result of corporate deleveraging, public debt has stabilised at high levels in these countries

Private debt in peripheral countries most affected by the sovereign debt crisis declined between 2014 and 2019. For example, Spanish private debt fell from 209.3% in 2007 to 189.8% in 2014 and 149.8% in 2019 (compared with 117.9% in 2000), and Portuguese private debt peaked at 193.9% in 2007 and fell to 208.2% in 2014, and then to 160.9% in 2014, still higher than its 2000 level of 142.8%. In Italy, private debt fell from 123% of GDP in 2014 to 109.4% in 2019.

While private debt fell in all Euro area countries, France was the exception. Its private debt increased from 186.8% of GDP in 2014 to 213.1% in 2019.

This was the highest level of private debt in the Euro area after the Netherlands (249.9% of GDP in 2019), which, unlike France, saw its private debt ratio fall sharply over the period (by 30 points between 2014 and 2019).

With the exception of France, all Eurozone countries had improved their public accounts by 2019 compared to their 2010-12 levels.

- The **Italian** deficit fell below 3% of GDP from 2015 onwards, fluctuating between 2.5% and 1.5% of GDP. Fiscal efforts are reflected in the achievement of primary surpluses over the period (an average of 1.6% between 2014 and 2019), although insufficient to offset the much higher interest burden (3.9% of GDP on average).
- With a deficit at 5.9% of GDP in 2015, the **Greek** fiscal balance moved into surplus the following year, fluctuating around 0.8% of GDP until 2019. Adjusted for interest payments, it stood at 2.2% of GDP over this period.
- The consolidation of government finances was also visible in **Portugal**, which achieved its first primary surplus in 2015 (+0.1%). By 2019, this had risen to 3.1%.
- The fiscal adjustment was less pronounced in **Spain**, where the deficit fell below 3% of GDP only once between 2012 and 2019. In 2019, the deficit will still be 3.1% of GDP, lower than in the previous year (-2.6%). Unlike Italy, Greece and Portugal, Spain never recorded a primary surplus between 2012 and 2019.
- **France** stands out as an exception, maintaining budget deficits above 3% of GDP throughout the period. Between 2012 and 2019, the French government deficit fell below 3% in only two of those years. Unlike all the other large Member States, and similar to Spain, France never achieved a primary surplus during this period.

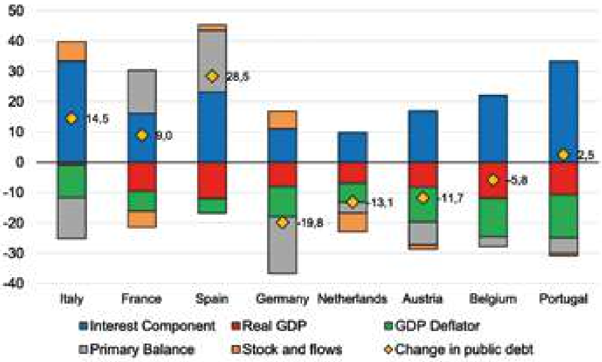
In 2019, seven Member States had a public debt ratio above 90% of GDP. The ratio exceeded 100% of GDP in Greece (180.6%), Italy (134.6%) and Portugal (116.6%). It exceeded 90% in France (97.9%), Spain (98.2%), Belgium (97.6%) and Cyprus (93.1%).

In **Italy** and **Greece**, the primary surpluses recorded were not enough to prevent an increase in their debt ratios, which rose by 18.7 points and 7.7 points respectively between 2012 and 2019. On the other hand, they were beneficial to Portugal, where the public debt ratio fell by 12.5 points over the same period.

In **France** and **Spain**, which both ran primary deficits throughout this period, public debt increased by 6.2 points and 8.2 points respectively between 2012 and 2019. The deterioration in public finances in France and Spain contrasts sharply with the budgetary efforts made by **Germany**, the **Netherlands**, and **Austria**, where the public debt ratios fell by 21.5 points, 17.7 points, and 11.3 points respectively between 2012 and 2019.

While some Member States (**Spain**, **Portugal** and **Belgium**) moved slightly closer to the 60% of GDP threshold between 2012 and 2019, **Italy**, **France** and **Greece** moved further away from this threshold over this period.

CHART 8.
Change in the level of Gross Public Debt to GDP ratio between 2012 and 2019, breakdown by components



Source: EU Commission, Ekonomics calculation
Notes: all components are expressed in percentage points ;
labels design the change in gross public debt between 2012 and 2019

2.1.3 2020-2024: fiscal divergences exacerbated by the Covid-19 crisis (2020) and the energy crisis (2022)

In 2020, the crisis impact on public accounts and economic growth was greatest in the countries with the worst public finances in the pre-Covid-19 period.

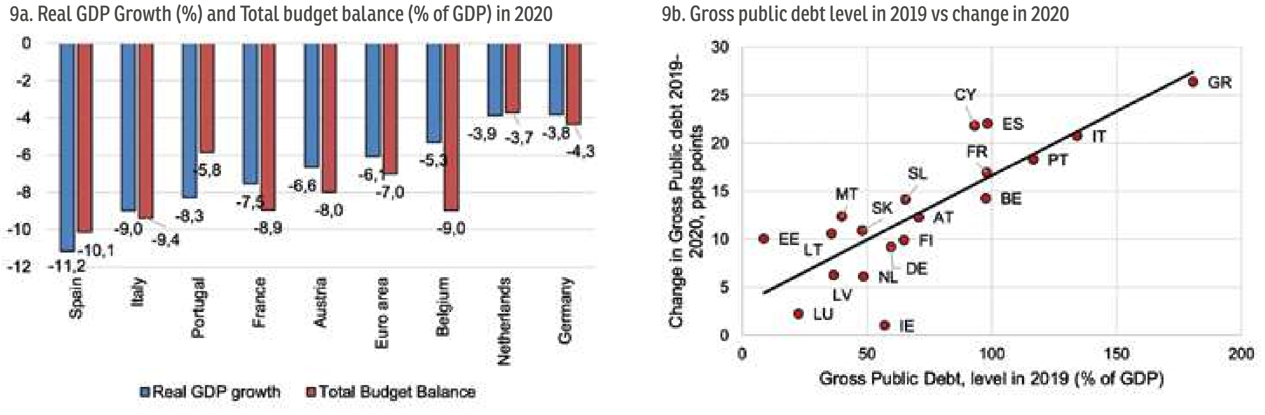
EU countries that best managed their public finances after the GFC (2008) and the EU Sovereign crisis (2011-13) are those that suffered the least from the Covid-19 shock.

Thanks to the fiscal discipline achieved since 2013, Germany and the Netherlands largely contained the shock induced by the Covid-19 crisis. At 4.3% of GDP and 3.7% respectively, their 2020 fiscal deficit remained below the Eurozone average of 7%. These achievements contrast with the close to double-digit deficit ratios that France (-8.9% of GDP), Spain (-10.1%) and Italy (-9.4%) experienced during the crisis.

During the Covid-19 crisis, France, Italy, and Spain experienced the most significant output shortfall in

CHART 9.

Real GDP growth, Budget Balance & Gross Public Debt dynamics across EA Member States during the Covid-19 crisis



Source: EU Commission

the Euro area. In 2020, Spain's GDP plummeted by 11.2%, while Italy and France saw declines of 9% and 7.5%, respectively.

With public finances already deteriorated on the eve of the pandemic, these three countries recorded some of the largest increases in their public debt-to-GDP ratios between 2019 and 2020. Spain experienced the highest rise (+22 percentage points, against 13.2 pp for the Euro area). Italy and France followed, as their public debt grew by respectively 20.8 pp and 17 pp.

The energy crisis exacerbated by the war in Ukraine in 2022 was handled differently by the Member States, widening economic and fiscal divergences between them.

In 2023, France and Italy recorded budget deficits above 5% for the third consecutive year since 2020, leading them to enter the excessive deficit procedure. In 2023, the deficit in both countries was above 5% of GDP for the third consecutive year, at 7.4% in Italy and 5.5% in France. Belgium (4.4%) and Spain (3.6%) also remain above 3% of GDP in 2023.

Germany, Portugal and the Netherlands managed to maintain relatively balanced current account balances, in some cases even surpluses, thanks to sustained efforts to reduce their public deficits to 3% or less since 2021.

Although high inflation has helped reduce the public debt ratio from 2021, rising interest burdens combined with slower GDP growth are expected to reverse this trend from 2024 in some indebted countries[5].

Until 2023, the persistence of high primary deficits combined with the increase in the debt burden was more than offset by nominal growth, which in turn was largely boosted by inflation. This mechanism has been particularly favorable to the most heavily indebted countries, which have seen their debt ratios fall from 2021 onwards. In Spain, the public debt ratio has fallen by 13 points, from 120% of GDP in 2020 to 107% in 2023. From 155% of GDP in 2020, Italy's government debt amounted to 138.6% of GDP in 2023. In France, the ratio has fallen by 4 points, from 114.9% in 2020 to 110.6% in 2023.

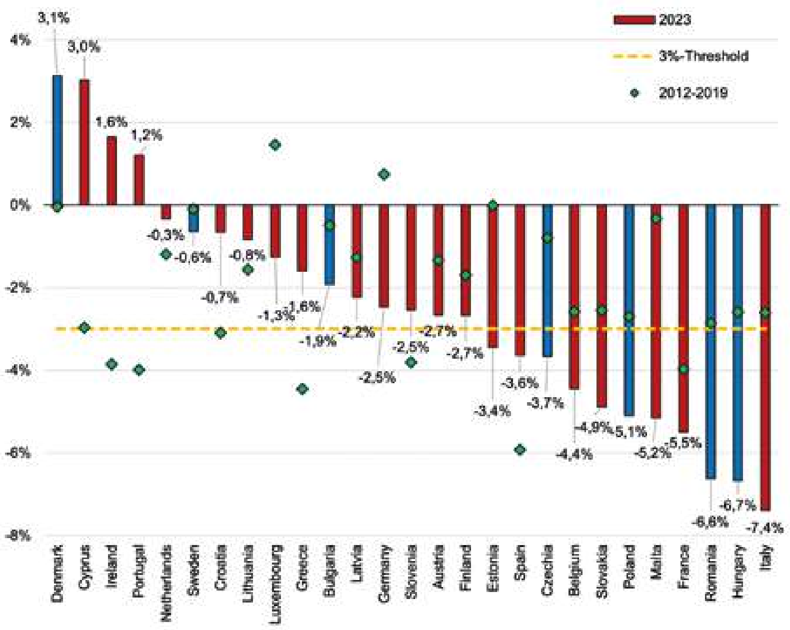
However, this trend is set to reverse as early as 2024. The decline in nominal growth, combined with rising interest charges and continuing high primary deficits, could lead to an increase in the debt ratio in some Member States. According to the European Commission's May 2024 forecasts, debt ratios are projected to start rising again from 2024 in France (from 110.6% of GDP in 2023 to 112.4% in 2024) and Italy (from 137.3% to 138.6%). Contrarily to France, where the primary deficit is expected to remain above 3% of GDP (3.3% in 2024 vs. 3.8% in 2023), the increase in Italy's government debt is more likely to be linked to the expected rise in the interest burden, which the reduction in the primary deficit (-0.5% in 2024 vs. -3.6% in 2023) may not be able to offset.

The public debt ratio should continue to decline in Portugal (99.1% to 95.6%) and Greece (161.9% to 153.9%) thanks to continued primary surpluses in 2024, Combined with nominal growth still above 5%, the reduction in Spain's primary deficit should also contribute to a reduction in the public debt ratio in 2024 (105.5% in 2024 vs. 107.7% in 2023). Despite their encouraging trends, the public debt ratios of Spain, Greece and Portugal will nevertheless remain well above those of Germany (62.9%) and the Netherlands (47.1%) in 2024.

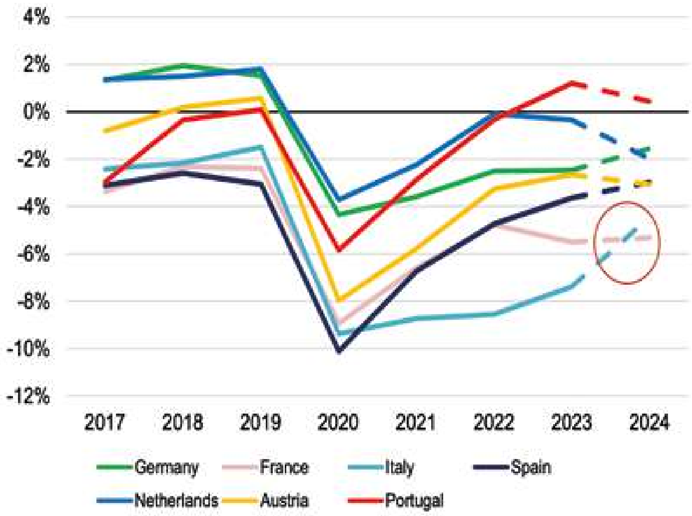
5. For a detailed analysis of the government debt dynamic between 2020 and 2024 for Germany, France, Italy and Spain, *see Part 4.1.*

CHART 10.
Recent trend in Governement Budget Balance across EU Member States

10a. Across all EU Member States, % of GDP



10b. Across the main EA Member States, % of GDP



Source: AMECO Spring Forecasts (May 2024)

2.2 The ECB ultra-accommodative and asymmetric monetary policy since the European sovereign debt crisis (2011-2012) and the lack of fiscal discipline have led to excessive public debt in some EU Member States

The very accommodative monetary policy in the Euro area over the last 20 years largely explains this public debt overhang

The monetary policy has created favorable conditions for Member States to accumulate debt for two main reasons. The first is that real interest rates have been most of the time negative between 2000 and 2023 (*see Chart 11a*), maintaining favorable financial conditions for borrowing.

The second reason is the ECB's balance sheet policies, which have led to the massive purchase of government securities since 2015 (*see Chart 11b*). Originally implemented in response to the GFC and the EU sovereign debt crisis, these unconventional policies were not phased out once the crises ended.

One key illustration is the launch of the Asset Purchase Program (APP). Launched in January 2015 by the ECB, it aimed at purchasing public and private securities at a monthly pace of €60 bn.

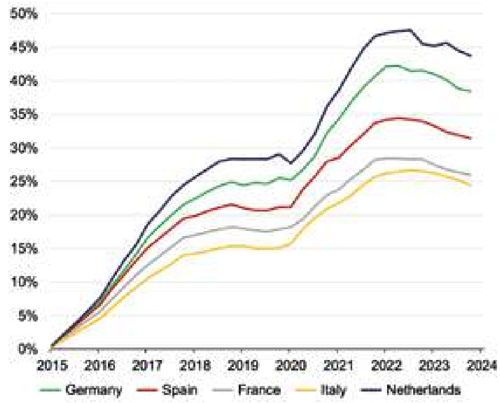
What favored over-indebtedness is that during the non-crisis period from 2014 to late-2019, unconventional policies were not haltered; quite the opposite, as the ECB announced its Quantitative Easing (QE) policy in 2015. By continuing non-conventional policies during a period of stability, the ECB contributed to the monetization of the debt and central banks effectively became agents of fiscal policy.

In the wake of the pandemic, this situation was further exacerbated: in March 2020, the Governing Council decided to launch the Pandemic Emergency Purchase Program (PEPP) on top of the already

CHART 11.
ECB Monetary policy stance since 2000

11a. Real refinancing rates in the Euro area (policy rate minus inflation rate), % points

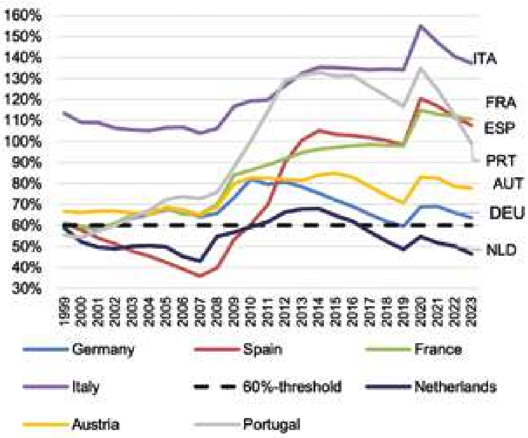
11b. Share of public debt held by the Eurosystem



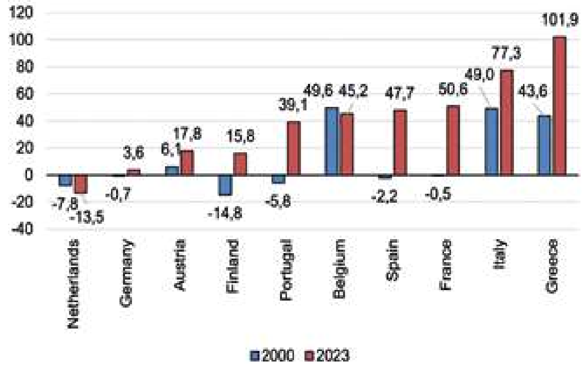
Sources: ECB, Eurostat, Ekonomics Calculations. Last observation from July 2024 for Chart 11a and 2023-Q4 for Chart 11b

CHART 12.
Gross public debt across Member States

12a. Gross Public Debt, % of GDP



12b. Deviation from 60%-threshold (pts%)



Source: EU Commission (Spring Forecasts of May 2024)
Lecture (Chart 12b): While France's public debt ratio was just below the 60% threshold in 2000, it is now 50.6 points above the Maastricht standard for 2023

existing APP, with a total intended envelope of €1,850 tn. Consequently, the Eurosystem played a leading role in public debt monetization during the Covid-19 crisis and until mid-2022, as its public securities purchases amounted to most of governments' borrowing requirements. As a result, the Eurosystem absorbed 85.2% of new government issuances in 2020 and 147.5% of public debt issuances in 2021, meaning that not only did the Eurosystem absorb the entire public debt issued in 2021, but it also repurchased part of the debt that matured that year[6].

The purchase of sovereign bonds since 2015 led the Eurosystem to hold more than a third of the Euro area's public debt by 2023. As of December 2023, the Eurosystem held 25.9% of the French public debt and 24.4% of the Italian debt. The share of Dutch and German government debt still exceeded the 33% threshold, initially set under the APP but suspended under the PEPP.

The fiscal rules of the SGP have not been respected by many large European countries (France, Italy, Spain…) which has contributed to their over-indebtedness.

The diverging debt trajectories since 2000 have led to a significant divergence in how Euro area Member States' government debt levels deviate from the 60% threshold of the Stability and Growth Pact. Indeed, Chart 9 shows that in 2000 Spain, France and Germany had similar levels of government debt (around the 60% threshold). By 2023, France and Spain were 50 percentage points above this threshold (*i.e.* their debt exceeded 105% of GDP), while Germany's debt was only 3 percentage points above the threshold. As for Italy, its debt was already 49 pp above the 60% threshold when it

6. *See 2.4* of *Eurofi Monetary Scoreboard*, September 2024.

joined the Euro area in 1999; in 2023, this gap increased to 77 pp.

The fiscal rule enshrined in the Stability and Growth Pact is the 3% fiscal threshold. However, repeated failure by Member States to comply with this rule is obvious (*see Chart 10a*). Out of the 27 Member States, only 4 showed primary surpluses in 2023, while 11 experienced deficits exceeding 3% of GDP, – among them Spain (-3.6%), France (-5.5%), Belgium (-4.4%) and Italy (-7.4%). As shown in Chart 10a, most of these countries still had deficits above their pre-crisis average (2014-2019) in 2023.

Fiscal coordination is essential in a monetary union. This necessity arises from the fact that the European Union is not a state and that negative externalities – stemming from questionable national fiscal policies – must be considered and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy, hence the need for fiscal coordination.

3. Why is excessive public and private debt a problem in Europe?

This part aims to highlight several issues arising from excessive levels of debt, be it private or public. The first issue is related to debt sustainability which can be challenged in the context of rising interest rates and low growth. Second, high sovereign debt makes countries more vulnerable to shocks. Additionally, excessive private debt levels pose a threat to financial stability in Europe. Furthermore, both public and private over-indebtedness act as barriers to productive investments. Over-indebted EU Member States also risk losing their leadership in Europe and put the European construction in a deadlock. Eventually, high levels of public debt are costly for future taxpayers who will bear a burden they are not responsible for.

3.1 France, Italy, Belgium, and Spain are currently concerned with debt sustainability issues, especially in the context of high interest rates and slowing growth

3.1.1 The sustainability of public debt is linked to the confidence of creditors

The variation of the debt in a given country is explained by its primary budget balance, the difference between r and g and the level of public debt in the previous period[7] which determines the cost of debt service. As a result, creditors are attentive to:

- The potential growth and revenues available to the government to meet its debt obligations,
- The average interest rate on the stock of debt issued by the government compared to the capacity to raise taxes,
- The primary budget balance which increases debt in the case of a deficit or reduces it in the case of a surplus; the higher the debt, the higher the primary surplus required.

However, these determinants are influenced by several other factors including:

- The total amount of public debt and, in particular, its maturity are crucial, especially when interest rates are rising,
- The share of debt that is held by non-residents as foreign ownership is a strong constraint for the borrowing state,
- The type of expenditure financed by the debt (infrastructure and social expenditure have different effects on long-term growth).

3.1.2 Over-indebted Member States are burdened by important debt servicing costs, which can challenge the sustainability of their debt

Debt service costs in heavily indebted countries followed a paradoxical trajectory between 2012 and 2021: while debt rose or stabilized at high levels, interest payments on debt fell as a share of GDP. The ECB's highly accommodative monetary policy has played a key role in this outcome.

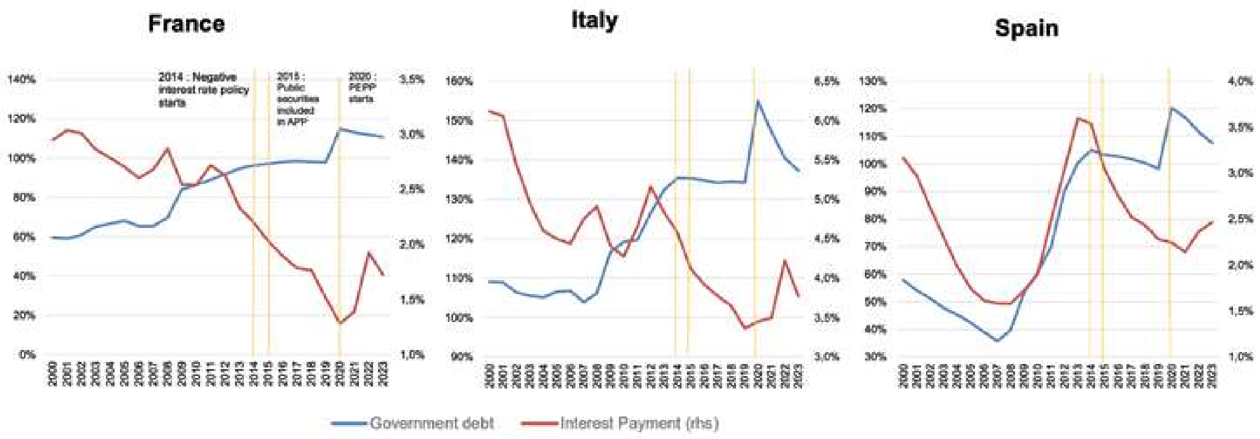
This trend is particularly evident in France:

- In the years before the GFC (2004-2008), the public debt ratio averaged 66.2% of GDP and the interest burden 2.7% of GDP.
- In the pre-Covid-19 years (2014-2019), the debt ratio continued to rise (97%) and the interest burden to fall (1.4%).
- By 2021, the debt ratio jumped to 114.6%, while the interest burden had further decreased to 1.3%.

Underlying this trend is a continued decline in the implicit rate on debt, from an average of 4.1% in 2004-2008 to 1.1% in 2020. According to BIS data, the real (inflation-adjusted) interest rate on 10-year government bonds has fallen from an average of 5.9% in 1984-1995 to -0.6% for the

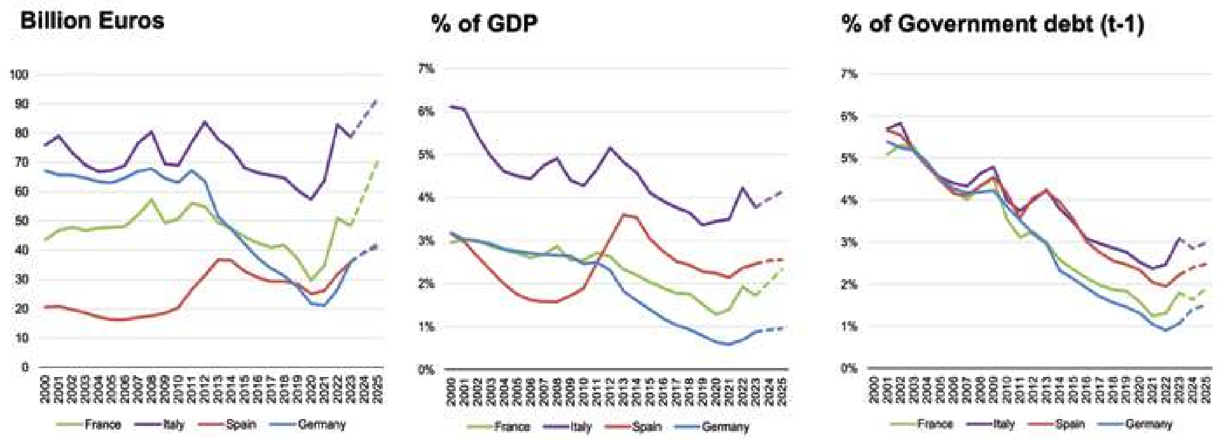
7. The precedent period (t-1) can be a year, a quarter, a month... depending on the chosen reference period (t).

CHART 13.
Government debt and interest payments, % of GDP across key indebted EA Member States



Source: EU Commission's Spring Forecasts (May 2024)

CHART 14.
Debt service costs according to different metrics across key EU Member States



Source: EU Commission
Notes: data for 2024 & 2025 are projections taken from the EU Commission's Spring Forecasts (May 2024)

period 2013-2023 and to -3% for the years 2021-2023 alone (-2.4 in June 2023). This trend is also observed in other heavily indebted countries such as Italy and Spain (*see Chart 13*).

As explained by P. d'Arvisenet, "[this situation] is the consequence of the ultra-aggressive monetary policy (policy rate in negative territory – the ECB deposit rate had been gradually reduced to -0.5% between 2014 and mid-2022), quantitative easing with the APP and PEPP programs which leads one to question the nature of central banks' independence."[8]

From 2022 onwards, debt service costs have been increasing alongside the increase in market interest rates and will be a concern for over-indebted countries in the coming years.

In France, debt servicing costs rose from €36.1 bn in 2019 (1.5% of GDP) to €48.3 bn in 2023 (1.7% of GDP), now exceeding the defense budget in 2023 (€43.9 bn). Projected by the EU Commission to reach €70.5 bn in 2025 – a record high since 1979 when the first data became available – debt servicing costs are set to become the largest government budget item, ahead of education (€59 bn in 2023).

Spain and Italy have also seen a sharp increase in their debt servicing costs since 2022. In 2023, the Italian government allocated €78.6 bn to servicing its debt, compared with €60.4 bn in 2019. The cost is expected to exceed €90 bn in 2025, according to the Commission forecasts. In Spain, €36 bn were earmarked for interest payments in 2023, up from €28.4 bn in 2019. The amount is expected to reach €41.1 bn in 2025 (*see Chart 13 and Appendix 2*).

8. Op. Cited P. d'Arvisenet and *see Eurofi Monetary Scoreboard* (September 2024).

3.2 High sovereign debt makes Member States more vulnerable to shocks

A high government debt burden makes the economy more vulnerable to macro-economic shocks and limits the scope for counter-cyclical fiscal policy. For instance, a rise in long-term interest rates may reignite pressure on more vulnerable sovereigns, thereby triggering a sovereign re-pricing risk.

Additionally, a high government debt entails the need to maintain high primary surpluses over long periods, which may be difficult under fragile political or economic circumstances, as it is the case today.

3.3 Excessive private debt levels also pose a threat to financial stability in Europe

The non-financial private sector is challenged by rising debt servicing costs, and higher funding costs are encouraging corporate defaults.

As underlined by the ECB's financial stability review[9], "Steep increases in interest rates are particularly challenging for borrowers carrying high levels of debt contracted at variable rates or loans that fall due for refinancing in the near term." Indeed, the unanticipated surge in interest rates can challenge borrowers that must honor their commitments in the near future and a fortiori the financial stability of the Euro area as emphasized by the ECB's review: "Financial stability risks associated with high interest rates are emerging in the context of a challenging macro-financial outlook and geopolitical tensions."

3.4 Both public and private over-indebtedness is a barrier to productive investments

Theoretical and empirical literature suggests that high government debt burdens can ultimately impede long-term growth. Indeed, several studies have found that beyond a threshold of 90-100%, public debt negatively impacts growth performance. However, it is crutial to analyze the nature of the expenditure financed by this debt, as infrastructure and social spending do not have the same effects on long-term economic activity. In any case, over-indebtedness eventually impoverishes countries and traps them into a vicious circle.

In countries where debt exceeding 90-100% of GDP and outstanding public spending ratios are high, it has become difficult to prioritize measures fostering productivity and public investment. These efforts are constrained by public spending decisions made in the past that have been automatically renewed for years[10].

Excessive levels of private debt burden productive investments.

A strong corporate sector is crucial for investment, innovation and eventually economic growth. Yet, high corporate indebtedness has a negative impact on investment as it implies higher interest expenses and thus less money available for investment. Firms with high debt also find it harder to obtain new funds from external sources due to their higher default risk. Moreover, the desire to repair weak balance sheets leads firms to reduce their debt burden, and thereby forgo investment opportunities.

In an ECB research document[11], the authors found "a strong interaction between firm indebtedness and investment amid activity shocks. Firms with higher leverage reduce investment significantly more than their peers with lower debt. Over the four years after a large economic contraction, the growth rate of tangible fixed capital of high-debt firms is some 15 percentage points below that of their counterparts with lower debt burden."

This is all the more concerning that the EU is counting on more capital expenditure to promote recovery from the pandemic, to kick-start the European economy and support the ecological and digital transitions, making Europe more resilient and better adapted to future challenges. Namely, the NextGenerationEU program was launched in July 2020 and dedicates a nearly €800 bn envelope to foster investment as well as growth and promote recovery and resilience in all EU Member States.

Indeed, fostering a sustainable path to stronger growth is essential. This requires structural reforms and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries has led to the deterioration of the potential growth which cannot be improved by cyclical policies.

Excessive levels of public debt burden productive investments, hence reducing productivity gains.

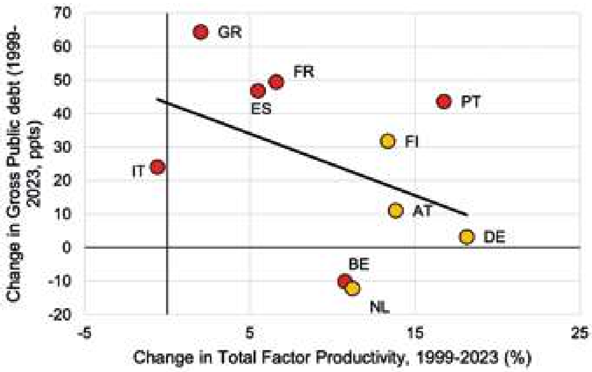
As shown in the Macroeconomic Scoreboard[12], since 1999, Member States whose public debt to GDP has risen the most to reach the highest levels in the Eurozone have recorded the weakest performance in terms of total factor productivity growth. In fact, the countries where public debt

9. "Financial Stability Review", ECB, November 2023.
10. Op. Cited J. de Larosière.
11. "Medium-term investment responses to activity shocks: the role of corporate debt", ECB Working Paper Series N°2751, November 2022.
12. J. de Larosière, D. Cahen & E. Krief, "Macroeconomic Scoreboard", Eurofi (September 2024).

increased the most between 1999 and 2023 are those where productivity grew by less than 5% over this period. Most of these countries have public debt well above 90% of GDP, such as France, Italy – where productivity kept falling over the past 25 years – and Spain.

Such a negative relationship between public debt and productivity gains also shows the extent to which excessive recourse to public debt can damage the supply side of the economy by undermining incentives for undertaking long-term investments and innovation. This is detrimental to productivity.

CHART 15.
Change in public debt vs change in productivity across the main EA Member States between 1999 and 2023



Source: EU Commission
Notes: Countries with red dots had a gross public debt to GDP ratio above 90% in 2023

Over-indebted EU Member States risk losing their leadership in Europe and put the European construction in a deadlock

Over-indebted countries, such as France, are currently losing their credibility and leadership insofar as they fail to meet the commitments they made when signing the Maastricht Treaty, namely to keep their public debt below 60% of GDP and their public deficit below 3% of GDP.

As a result, the EU currently faces a deadlock. Indeed, heterogeneous economic situations make it difficult for EU Member States to define a common interest and a common vision for the future of the Union. Consequently, with diverging interests, no meaningful agreements are reached, and the EU is not moving forward.

As a result, divergent interests prevent meaningful agreements from being reached and the EU from moving forward. For example, progress towards a genuine banking and capital markets union is hampered by the lack of trust between Member States resulting from these economic and fiscal divergences, and even the euro itself has become "a permanent source of issues to negotiate" and is "regularly a source and a manifestation of some discord among Member States[13]."

3.6 The current high levels of public debt are unfair to the future taxpayers who will have to bear a burden they are not responsible for

The high level of public debt generated by large public deficits represents a burden for posterity, especially when these deficits are used to finance public spending rather than productive investment – as is the case in France, where public spending reached 57.9% of GDP in 2022. It is not legitimate to make future taxpayers bear the cost of servicing debt and honoring commitments made to finance major unproductive expenditure. Indeed, future taxpayers will also have to pay for these public expenditures, but they will also need more than ever to have room for maneuver in public finances in order to make the necessary investments for the green and digital transitions, and this will be all the more difficult if they already have outstanding debts[14].

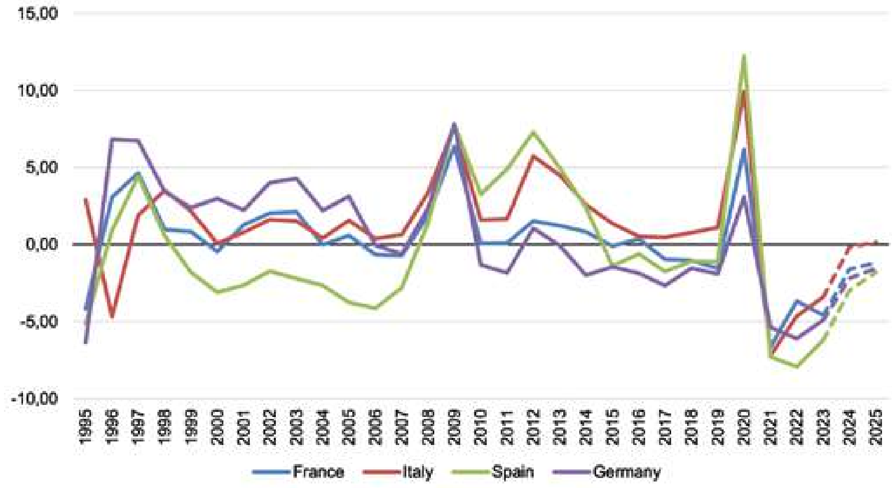
4. How can public debt in the EU be reduced?

As an accounting phenomenon, the mechanisms for reducing public debt are well known and can be assessed in order to find a realistic way to reduce public debt in the EU. The first solution would be to rely on inflation and money creation, but such a strategy is inefficient and even harmful in the long run. Another obvious solution would be to expect growth to continue to outstrip interest rates, but there is always uncertainty about the evolution of these two variables.

Consequently, the only credible solution for reducing public debt is to achieve primary surpluses. The latter requires fiscal discipline, starting with the rationalization of public expenditure and the implementation of structural reforms. In this respect, the project for reform of the Stability and Growth Pact introduced in December 2023 may not be sufficient to achieve a genuine debt reduction strategy in over-indebted EU Member States for the coming decade.

13. J. de Larosière, "EMU: myth or reality?", Keynote Address – Towards EMU 2.0: Hindsight and Prospects, 4 October 2023.
14. M. Pébereau, "Mieux gérer nos finances publiques", Académie des Sciences Morales et Politiques, 25 September 2023.

CHART 16.
(r-g) difference across key EU Member States since 1995



Source: EU Commission (Spring Forecasts of May 2024)

4.1 As an accounting phenomenon, the mechanisms for reducing public debt are well known

Public debt increases when the primary budget balance is lower than the 'stabilizing' balance.

The dynamics of public debt is an accounting phenomenon. Its variation from one period to another is based on the interaction between three key indicators: (i) the r-g differential, (ii) the level of public debt in the previous period and (iii) the primary budget balance.

A 'stabilizing' primary budget balance, which stabilizes the public debt ratio, can be derived from the r-g differential and the level of government debt (*see Appendix 3 for the calculation method*). Any primary balance below this 'stabilizing' balance is then associated with an increase in the debt ratio. The sign of the r-g differential determines the shape of this stabilizing balance.

- A **negative** r-g differential (r<g) implies a deficit stabilizing balance: public debt can be reduced despite a primary deficit, provided that the primary deficit is lower than the stabilizing deficit.
- Conversely, a **positive** r-g differential (r>g) implies a surplus stabilizing balance. To reduce public debt, the primary balance must therefore be in surplus and greater than the stabilizing balance.

The difference between the stabilizing budget balance – derived from the r-g differential and the level of public debt – and the observed budget balance thus determines the path of public debt.

This accounting mechanism helps to explain the significant decline in public debt in some Eurozone countries between 2021 and 2023, in an inflationary context and despite the maintenance of high budget deficits.

Between 2020 and 2023, the debt ratio fell by 4.2 points in France, 17.7 points in Italy and 12.6 points in Spain, to 110.6% of GDP in 2023 in France, 137.3% in Italy and 107.7% in Spain.

This decline took place while budget deficits have been maintained at levels well above their long-term average. In France, the primary deficit reached an average of 3.9% of GDP per year between 2021 and 2023, twice as high as the pre-Covid-19 (2014-19) average of 1.5% per year (*see Table in Annex 5*).

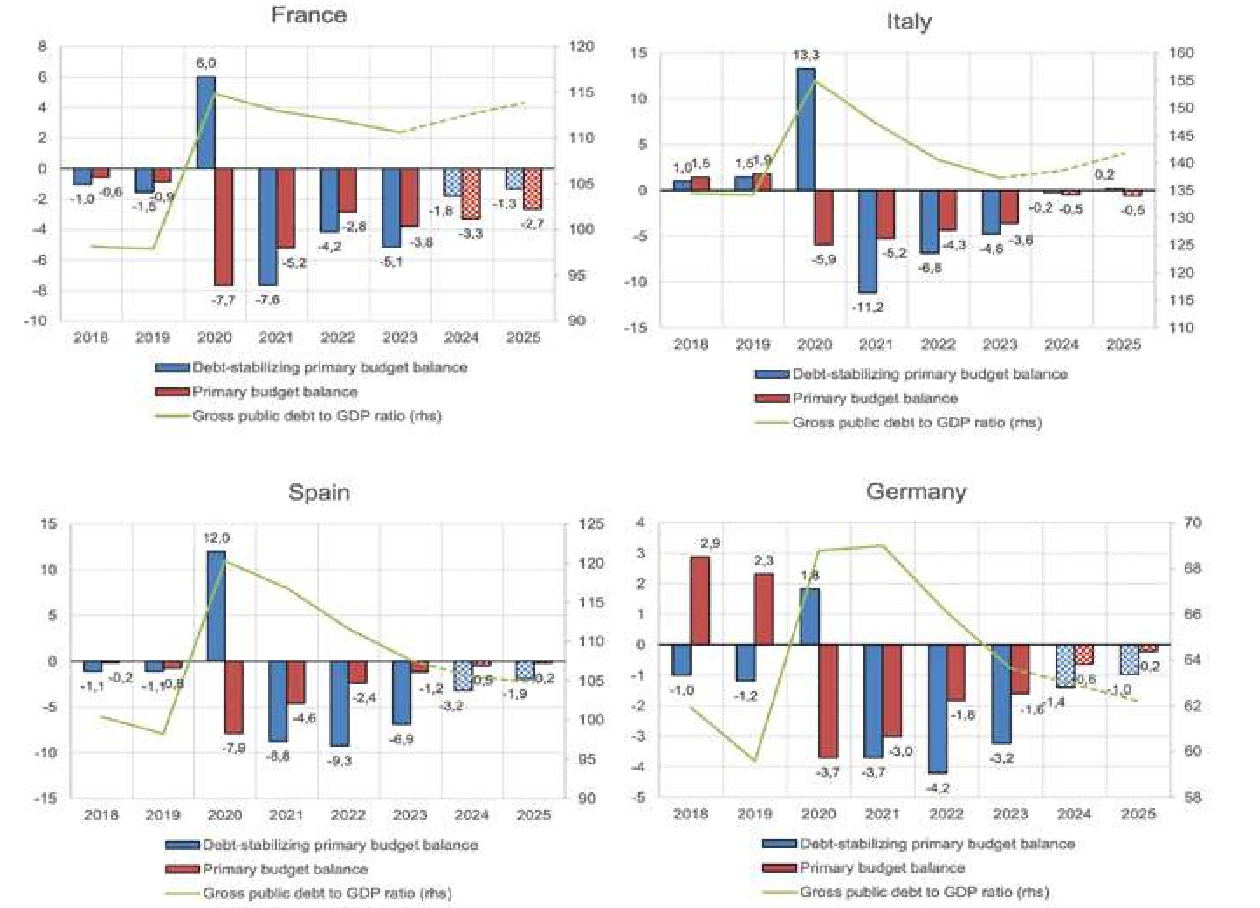
The situation is similar in Spain, where the deficit amounted to 2.7% of GDP between 2021 and 2023, double its pre-Covid-19 average of 1.3% per year. In Italy, the deficit is 4.4% of GDP, compared with an average surplus of 1.6% per year between 2014 and 2019. Despite their high level, the French, Italian and Spanish deficits remained below their respective stabilizing balances during this period. To stabilize its debt ratio, France should have achieved a primary deficit of 5.2% of GDP per year between 2021 and 2023. This was lower at 3.9% per year. The situation is similar in Italy and Spain, where the primary deficits of 4.4% and 2.7% are below the stabilizing balances of 7.6% and 8.3% of GDP respectively.

This particularly favorable situation for government debt is mainly explained by the historically low level of the r-g differential, which is used to calculate the stabilizing balance (*see Chart 16 and Appendix 4*). In France, the cost of debt was 5 percentage points lower than nominal GDP growth between 2021 and 2023, compared with only 0.4 percentage points between 2014 and 2019. In Spain, the gap between the two variables reached 7.1 points between 2021 and 2023, compared with 0.6 points between 2014 and 2019. After more than 20 years in positive territory, the r-g differential in Italy reached -5.1 points between 2021 and 2023.

The strong growth of the GDP deflator combined with the stability of the debt burden, despite the

CHART 17.

Gross public debt, primary balance and debt-stabilizing primary balances across the main EA Member States



Source: Ekonomics' calculations based on EU Commission's Spring Forecast (May 2024)
Notes: public debt-to-GDP ratio increases when the primary balance exceeds the debt-stabilizing primary balance

rise in market interest rates, made this configuration possible. In France, for example, the GDP deflator rose by 3.3% per year between 2021 and 2023 – three times faster than its pre-Covid-19 average of 0.8% per year – while the interest burden fluctuated between 1.4% and 1.7% of GDP, adjusting to the rise in market interest rates with a lag.

However, in France and Italy, the public debt ratio is expected to resume its upward trend from 2024 onwards, as the budgetary adjustment will be insufficient to counter the gradual decline in inflation and the increase in the cost of debt.

While the inflationary context and the stability of the cost of debt provided a relatively favorable environment for the dynamics of public debt between 2021 and 2023, this trend is expected to reverse in 2024. According to the European Commission's May 2024 forecasts, the growth of the GDP deflator[15] in France and Italy will halve compared to 2023, while the interest burden will increase further. These dynamics should significantly reduce the gap between the cost of debt and nominal growth, which should fall from -5 points in 2023 to -1.6 points in 2024 in France. In Italy, his gap is expected to shrink from -3.4 in 2023 to -0.2 in 2024.

The anticipated narrowing of the r-g differential, with inflation expected to return to around 2% next year, suggests a reduction in the stabilizing balance. In France, the primary deficit needed to stabilize the public debt ratio is projected to be 1.8% of GDP in 2024 (compared with 5.1% in 2023). However, according to the Commission forecasts, the primary deficit would be 3.3% of GDP in 2024 (compared with 3.8% in 2023), *i.e.* twice as high as the stabilizing deficit. The insufficient fiscal adjustment projected by the European Commission in May 2024 - the primary deficit is expected to fall by only 0.5 points between 2023 and 2024 - is thus expected to lead to

15. In general terms, an implicit deflator measures price changes in an area of the economy by dividing the magnitude in value by the same magnitude in volume. Implicit deflators are named according to the aggregate used. The deflators for GDP, final consumption expenditure, gross fixed capital formation, exports and imports measure price changes in their respective parts of the economy. They are used to correct aggregates for the effects of inflation. According to INSEE, the GDP deflator differs from the CPI as a function of changes in the prices of imports, exports and gross fixed capital formation.

an increase in the public debt ratio of 2.4 points, from 110.6% of GDP in 2023 to 112.4% in 2024. This increase in the debt ratio is projected to continue into 2025 for the same reasons, with the primary deficit reaching 2.7% of GDP, still well above the stabilizing balance of 1.3%.

Like France, Italy's public debt ratio is expected to rise in 2024 and 2025, from 137.3% of GDP in 2023 to 141.7% in 2025 according to the European Commission's projections. However, unlike France, this dynamic is expected to occur despite a significant reduction in the primary deficit, which is projected to be -0.5% of GDP in 2024, down from -3.6% in 2023, but still insufficient to counteract the rise in the interest burden, which is expected to exceed 4% of GDP from 2024 onwards.

The projected trajectories of France and Italy are expected to contrast with those of Germany and Spain in 2024 and 2025. For these two countries, the decline in government debt should continue thanks to major budgetary adjustments – the primary deficit should be halved in Spain and tripled in Germany between 2023 and 2024 – relatively more favorable inflation conditions than in France and Italy and a stable interest burden.

4.2 Monetary phenomena such as inflation and monetary creation cannot solve the problems arising from excessive debt

4.2.1 Is inflation a solution to reduce public debt?

It is often said that inflation would be an effective way of reducing the public debt ratios. In theory, it is easier to stabilize or reduce the public debt when inflation is higher. Indeed, the higher the inflation, the higher the value of GDP, which tends to reduce the debt ratio. However, the primary deficit and the interest burden must not allow debt to grow faster than GDP.

Another argument often used is that inflation increases tax revenues in the short run (through taxes directly linked to consumption, *e.g.* the tax on fossil fuels), while expenditure adjusts more slowly. This difference temporarily improves the budget balance and thus reduces the public debt.

But one should be careful with these arguments. After the Second World War, inflation was high and helped to reduce public debt ratios. But today, central banks have clear inflation targets, which has led them to raise interest rates and reduce their balance sheets since 2022.

For inflation to once again become a tool for reducing public debt ratios, central banks would have to change their inflation targets. However, this would raise other structural issues: lasting high inflation slows down the economic activity, makes the future more uncertain for economic agents, and discourages them from investing and consuming. This could depress economic growth, and mechanically increase the debt-to-GDP ratio. Additionally, in the long run, the deterioration of the economic activity reduces fiscal revenues due to lower consumption while it increases the government expenditures. The latter may also increase due to the revaluation of public sector wages and pensions in response to inflation. All these factors lead to a deterioration in the budget balance, which further exacerbates public debt.

Moreover, when inflation is higher than that of the main trading partners, it reduces the external competitiveness of domestic companies, which further depresses growth. Finally, inflation increases social risks and fuels the rise of extremism. It also exacerbates inequalities between households – it disproportionately impacts the poorest – because the ability of economic agents to maintain or increase their purchasing power and wealth during periods of high inflation is not equally distributed.

As a result, inflation is never an appropriate long-term solution for reducing public debt and could even prove dangerous for Europe's resilience and international trade position.

4.2.2 Monetizing debt is not a credible and sustainable solution

Between March 2020 and June 2022, central banks and notably the ECB carried a leading role in the monetization of public debt, buying a large share of new public debt issues. In the face of massive debt purchases, central banks became de facto agents of fiscal policy. This current 'fiscal dominance' calls into question the independence of central banks and is a major disincentive for governments to undertake structural reforms.

Central banks purchases of public debt do not change the overall level of government debt. It prevents interest rates from rising in the long run, but it cannot be permanent, or it becomes inflationary and creates asset bubbles.

Prudent fiscal policy sustains credibility, not monetization.

The notion that governments can manage everything out by leveraging their balance sheets is, unfortunately, a fantasy. Budget deficits do not vanish simply because they are monetized. Despite the scale of QE and its potential impact, the fiscal constraint remains. Analysts and rating agencies continue to scrutinize ratios and assess the quality and sustainability of public debt. This point should not be underestimated: rating changes are a crucial component of an issuer's creditworthiness and a key factor in private investors' decisions, especially non-residents, to buy securities. Private investors are highly sensitive to rating and thus continue to play a decisive role in the demand for public securities offered for issuance.

It would be a grave mistake to assume that these market judgements are insignificant because the central bank will always be there to buy: the central bank cannot always purshase every bond, and the quality of a government's creditworthiness is an essential element of confidence that must be preserved at all costs for the country's future.

The ECB cannot absorb all public debt forever

If some national central banks are theoretically free to monetize the entire public debt of their country, the same cannot be said of the ECB, which is bound by an international treaty that prohibits the monetization of public debt. Any subsidy to the state that would be implied by the cancellation of public debt is incompatible with the Maastricht Treaty, which prohibits the monetary financing of public debt.

The creation of money cannot indefinitely exempt our societies from the question: "Who will pay?" Do we seriously believe that the unlimited issuance of government bonds will never lead to a fundamental questioning of the solvency of states by the markets?

4.3 Uncertainty remains for the future path of a (r – g) difference in the context of higher interest rates and slowing growth

Except for a few countries such as Italy, most EU Member States benefited from a negative r-g differential over the past decade (2013-2021), *i.e.* a higher nominal growth rate (g) relative to the implicit interest rate (r). However, there is no guarantee that this trend will continue in the coming years. While persistently low interest rates were largely responsible for the negative difference between 2013 and 2021, the recent rise in long-term interest rates since 2022 could reverse this trend. In 2023, nominal interest rates remained higher than in 2019, coinciding with a slowdown in global growth, particularly in the Euro area countries. Accordingly, the combination of higher interest rates and lower growth raises doubts about the future path of (r-g) in the coming years. As described above, this difference depends on uncertain variables such as GDP growth and interest rate levels, making long-term forecasts difficult.

Uncertainty therefore looms, particularly over the future path of interest rates, which are driven by inflation and monetary policy. Ongoing structural changes such as the energy transition, population ageing, and global trade fragmentation could keep inflation persistently above pre-pandemic levels. In March 2023, Larry Summers expected long-term average inflation in the US to be 2.5% and "assign a very low likelihood to it being well below two."[16] This could lead investors to demand higher compensation to protect their real asset returns.

In addition to influencing bondholder attitudes, the prospect of structurally higher inflation could lead to less accommodative monetary policy than in the past decade. From 2023, the ECB has begun to reduce the stock of government bonds it has accumulated since 2015, putting upward pressure on long-term interest rates. As Mahmood Pradhan and his co-authors note (2023[17]), the "trends suggest a new paradigm with more public debt being financed by the market, marking a shift from the pandemic period when central banks effectively financed the net issuance of government debt in most jurisdictions. At the end of this process, financial markets will hold much more government debt than they currently do. [...] How quickly central banks can unload their holdings, and the impact this will have on market yields, will also depend on how much additional debt (net issuance) governments might issue."

4.4 The only credible solution to reduce public debt is to achieve primary surpluses

The Euro area should move gradually and cautiously towards monetary normalization to avoid a cliff effect. The market – the supply and demand of capital – needs to be gradually reintroduced into the setting of medium and long-term interest rates, as remuneration is a key factor in contributing to sustainable growth. This would be a step towards a more productive post-crisis period of higher growth and productive investment.

Conversely, in the absence of fiscal adjustment, investor mistrust may emerge, forcing over-indebted countries to pay higher risk premiums, thereby hampering their ability to repay their debts.

4.4.1 Fiscal discipline is needed to recover primary surpluses

Running primary surpluses is the only credible and safe way to reduce debt. There are two main levers that countries can use to achieve this: on the one hand, increasing revenues, usually in the form of

16. O. Blanchard & L. Summers, "Summers and Blanchard debate the future of interest rates", Virtual event, PIIE (March 2023).
17. M. Pradhan, L. Portelli & T. Perrier, "Central banks' endgame: a new policy paradigm", SUERF Policy Note, Issue No 328 (November 2023).

tax increases, and on the other hand, cutting public spending and/or implementing growth-enhancing reforms. Over-indebted countries such as France, Italy and Belgium therefore urgently need to get back on track with fiscal discipline, as sound fiscal policies are needed to weather shocks and maintain sustainability. Given the already high level of tax burden in these countries[18], a further tax increase is hardly acceptable, hence the focus on rationalizing public spending.

In this regard, the IMF's Article IV provides country-specific guidance on the reforms to be undertaken to achieve fiscal consolidation, debt reduction and more productive investment. The IMF stresses the need for effective fiscal reforms in over-indebted countries to restore potential growth, reduce debt, and improve the ability to cope with shocks and the green transition.

For instance, one of France's main priorities to recover healthy public finances is to implement a "steady, expenditure-based consolidation until reaching a structural deficit of 0.4 percent of GDP in 2030" and "reduce the [fiscal] deficit"[19], as well as restore potential growth. France is therefore expected to steer continued structural reforms, particularly in the areas of pensions, unemployment and product and services markets, which are essential for future fiscal health as well as improved competitiveness and growth. To this end, France needs a credible package of reforms to rationalize public spending (*e.g.* pension and unemployment benefit reforms) to narrow the gap with European and EA peers and regain fiscal space for the green/digital transition.

In addition, the IMF recommends that "to minimize drag, the consolidation [should be] gradual and focus on current spending while protecting investment (particularly given large green/digital investment needs), underpinned by structural reforms."

In Italy, extensive fiscal policy support and rising interest costs have kept fiscal deficits very high in recent years. Yet, the IMF stated that "given the moderate risk of sovereign stress and the need to support disinflation and build fiscal buffers, a faster improvement in the primary balance is warranted and feasible."[20]. The IMF also deemed that "there is scope for further increase spending efficiency, including in the near term" and that "beyond the near term, a credible fiscal framework with well-defined measures, accompanied by growth enhancing reforms, is needed to anchor debt reduction."

The IMF also suggests that Belgium's top priority should be advancing fiscal consolidation to preserve its social model, reduce debt, rebuild buffers and lower inflation. Indeed, Belgium is facing rising spending pressures from aging (0.3 ppt of GDP per year), defense needs, the green transition and other capex investment while "the limited fiscal space is constraining Belgium's ability to address future shocks as risks to the outlook abound. To avoid an abrupt adjustment should a risk or a combination of risks materialize, Belgium needs to rebuild the fiscal buffers that the pandemic and energy crisis eroded[21]." Therefore, fiscal consolidation is particularly challenging for Belgium, and the country should primarily focus its fiscal adjustment on rationalizing public spending and increasing efficiency. Given its already high level of taxation, Belgium has very little room to mobilize additional tax revenue and should instead implement efficiency-enhancing tax reforms.

4.4.2 A change in the nature of budgetary expenditure is required to address the financing challenges related to the climate transition: from unproductive to productive goals

Relying on a proactive fiscal policy to compensate for the diminishing effectiveness of monetary policy would be a great mistake. Fiscal or monetary stimulus will not necessarily enhance potential growth. Indeed, the huge monetary and fiscal stances of the last decades have not led to investment or higher growth. There is no automatic substitution effect: less monetary expansion is offset by more fiscal deficits.

Fiscal deficits – if they are increased beyond their current huge levels – will only be possible if monetary policy and interest rates remain accommodative. One of the most worrying consequences of accommodative and low interest rates for long policies has been precisely the marked decline in global productive investment over the last 15 years: lasting low interest rates do not foster, by themselves, more productive investment. What they do – notably in the EU – is to encourage economic agents to keep their financial assets in liquid instruments or to favor purely financial investment (*e.g.* share buybacks, M&A) rather than long-term productive investments.

What we need is more long-term investment to cope with the challenges of reduced labor and the green transition. This will not be achieved through more distribution via budgets or increased money

18. In 2023, current tax burden amounted to 46% of GDP in France. It reached 42.6% in Italy and 45.1% in Belgium. In the three countries, tax burden exceeded the Euro area average of 41%.
19. IMF Country Report No. 23/56 (Article IV), International Monetary Fund, January 2023.
20. IMF Country Report No. 23/273 (Article IV), International Monetary Fund, July 2023.
21. IMF Country Report No. 23/386 (Article IV), International Monetary Fund, December 2023.

creation. It will only be possible if structural – supply-side oriented – reforms and a normal return on risky investments are made possible. Achieving this requires reining in excessive current public expenditure (*i.e.* fiscal normalization), alongside a qualitative shift toward adequate public investment.

If we continue to live under the illusion that fiscal stimulus can 'replace' monetary stimulus, we will face two negative outcomes:

- Fiscal dominance because fiscal stimulus cannot coexist with high interest rates,
- A financial crisis as excessive leverage inevitably leads to it.

4.4.3 How credible is the reform of the Stability and Growth Pact agreed by the Ecofin Council in April 2024?

On 26 April 2023, the Commission presented a package of three legislative proposals: two regulations aiming to replace (preventive arm) or amend (corrective arm) the two pillars of the Stability and Growth Pact first adopted in 1997, and an amended directive on requirements for budgetary frameworks of member states.

On 21 December 2023, the Ecofin Council achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament on the preventive arm regulation and the Council definitively adopted this reform on 20 April 2024.

The goal of simplification of the rules has regrettably not been achieved.

The European agreement on the Stability and Growth Pact of April 2024 contains some positive elements:

- The case-by-case framework – which is a specific technical dialogue between the EU Commission and each Member State regarding their differentiated multi-year budgetary path – has been introduced in the reformed Pact. It allows for a differentiated approach to each Member State taking into account the heterogeneity of fiscal positions, public debt and economic challenges across the EU.
- This dialogue will be based on a new indicator, the "net expenditure[22]", which should serve as a basis for setting a fiscal path and carrying out annual fiscal surveillance for each Member State. The multi-annual trajectory for this indicator, prepared by each Member State, must also be adopted by the Ecofin Council, which should reinforce the self-discipline of Member States.
- An obligation to reduce the public debt-to-GDP ratio by at least one percentage point of GDP per year on average over a period of 4 to 7 years has been introduced for countries with an outstanding public debt of more than 90% of GDP (the preventive aspect of the Pact). This obligation is reduced to 0.5% for countries whose debt ratio is between 60% and 90%.

However, there are several areas of concern:

- For the transitory period in 2025, 2026 and 2027, the Commission may exclude the expected rise in the debt service costs from the calculation of the adjustment effort, despite the fact that it will be the largest item of budget expenditure in some countries, such as France.
  This measure raises questions insofar as it reduces the effectiveness of the mechanism and weakens efforts to consolidate the public finances of over-indebted Member States.
  The credibility of the Pact in terms of restoring structural balances in a period of higher interest rates is questionable, given that between 2014 and 2019, Member States that benefited from very low interest charges due to zero or even negative interest rates have not started to restore their primary budget surpluses between 2014 and 2019.
- Countries subject to the excessive deficit procedure (total government deficit above 3% of GDP) are exempt from the rule that imposes a reduction of their general government debt by an average of 1% per year until their deficit falls below 3%. This is not the best way to encourage the worst performers to reduce their debt-to-GDP ratios! It's as if the worst performers in a class are exempt from extra effort and sanctions as long as their results remain mediocre.
- The horizons for implementing the adjustment appear to be very long: 4 to 7 years to bring the public deficit below 3% (the annual adjustment of the structural primary deficit must be 0.5%) and decades to return to the 60% public debt ratio. Such horizons also extend beyond typical political cycles, and experts deem the Commission unlikely to force a government elected with different priorities in the middle of the seven-year cycle to implement policies agreed by its predecessor[23]. As mentioned by L. Garicano, "the framework is also vulnerable to mani-

22. "Net expenditure" means "government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programs of the Union fully matched by revenue from Union funds, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures" (Chapter 1, article 2).
23. L. Garicano, "The EU's new fiscal rules are not fit for purpose", *Financial Times*, 8 January 2024.

pulation through creative accounting and over-optimistic growth assessments."

- Both the corrective and preventive arms of this revised Pact refer to the structural deficit. Its definition as a "cyclically-adjusted deficit" risks weakening the Pact. Why use this complicated reference, which has failed to reduce excessive deficits in the past, and not keep the simple concepts of overall government deficit (as a % of GDP) or primary budget surplus, which are essential ratios for putting the public debt trajectories of the most indebted countries back on a sustainable footing?
- The Commission's powers to enforce these 'new' rules have not been strengthened, even though it can initiate an excessive deficit procedure based solely on the criterion of public debt in relation to GDP.

What makes these new rules any more likely to be implemented than the previous ones? All the more so as the final discussions in the Council focused on minimum safeguards, which risk becoming maximum rules...

The postponement of the of budgetary adjustment for countries subject to an excessive deficit procedure and the extremely long periods granted to over-indebted countries to bring their public debt back to below 60% of their GDP (around 50 years for France, 80 years for Italy) are based on two erroneous prejudices:

- The reduction in the public debt ratio is based on a return to very low medium and long-term interest rates, which is likely to prevent budgetary efforts (*i.e.* cuts in public spending). The peak of the increase in the interest burden on the public debt of hyper-indebted countries is expected to be reached by 2027 and should subsequently fall as a result of the return to permanently low interest rates. This is the "easy money" paradigm: an accommodating monetary policy (permanently low interest rates) avoids budgetary efforts.
- Any budgetary adjustment is 'by nature' recessionary because economic growth is based primarily on domestic demand.

These two assumptions should lead European countries with excessive debt to continue their economic decline. There are several explanations:

The recent monetary history (2014-2021) highlights the paradigm of easy money, which leads to excessive debt that does not stimulate economic growth. The persistence of low (or even negative) interest rates over this period has not led to an increase in productive investment but, on the contrary, has encouraged savers to keep their financial assets in liquid instruments (*see Eurofi Scoreboards*) rather than in securities geared to long-term investments[24]. Furthermore, persistent low interest rates encourage indebtedness and the proliferation of asset bubbles, increase wealth inequalities and favor a misallocation of resources (*e.g.* the development of zombie firms).

Excessive deficits and debt jeopardize economic growth. They require an increasing tax pressure, which deteriorates further the competitiveness of companies in these countries. Stimulating demand does not lead to increased production but to a widening of the trade deficit if a country does not have an efficient production system.

On the contrary, what is needed is to increase potential growth and achieve a better allocation of resources is:

- **Returning to primary surpluses as soon as possible,**
- **Rationalizing public spending – the quality of public spending must be an absolute priority – in countries where the ratio of public spending to GDP exceeds the European average,**
- **Pursuing supply-side reforms that enhance production.**

In over-indebted countries, governments need to take corrective action to ensure a path to primary budget surpluses and reduce unproductive and inefficient public spending. Illusions about the ability of these countries to stimulate demand should be dispelled.

A review of the composition of public finances, focusing on the nature of expenditure, is therefore urgent and essential in highly indebted countries. This will require a thorough review of all levels of national public spending – renewed because they have been previously voted in – and a reduction in unproductive and socially inefficient spending.

Indeed, the climate and digital transitions will impose significant costs on Member States' public finances. But this effort must be made by redirecting current expenditure towards productive investment

Only productivity-enhancing and supply side-oriented reforms can foster productivity and growth, and not negative real interest rates or Quantitative Easing.

24. Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets.

If the current trend in public debt continues, the fiscally 'virtuous' countries will ultimately bear the cost. This would exemplify an uncooperative game, where most participants evade their obligations by shifting the burden onto those who comply. We must therefore take the Union's destiny into our own hands and prevent further drift. If we fail to do so, the logical outcome could well be a new and inevitable Eurozone crisis.

APPENDICES

APPENDIX 1.
Credit to Non-Financial Private Sector, Public Sector, Firms and Households, % of GDP

	General Government			Private Non-Financial Sector (a + b)			Non-Financial Corporations (a)			Households (b)		
	2000	2008	Q4-2023	2000	2008	Q4-2023	2000	2008	Q4-2023	2000	2008	Q4-2023
United States	48,6	66,1	113,4	136,7	170,8	150,1	65,9	74,6	77,2	70,8	96,1	72,9
United Kingdom	37,7	50,8	102,2	136	185,3	143,7	70,7	90	64,2	65,3	95,3	79,5
Japan	114,6	145,1	219,4	187,5	163,8	180,5	117,7	103,5	114,8	69,8	60,3	65,7
China	22,9	27,1	83	105,5	108	200,4	n.a	89,8	138,3	n.a	17,9	62,1
Euro area	69,2	69,8	88,6	126	156,7	148,6	76,5	96	94,9	49,6	60,8	53,7
France	59,4	69,8	110,5	137,7	164,2	213,4	104	115,6	150,4	34,2	48,6	63
Germany	59,3	65,8	63,6	140,6	129,9	122	69,4	70,1	69,9	71,2	59,8	52,1
Italy	108,8	106,2	137,1	79,3	116,5	99,4	56,6	77,5	61,7	22,6	39	37,7
Spain	57,8	39,7	107,7	117,9	214,2	128,6	72,5	131,6	81,7	45,4	82,6	46,9
Netherlands	52,2	54,7	46,4	219,7	234,7	205,1	130,1	123,2	117,5	89,6	111,5	87,6
Austria	66,1	68,7	77,2	127,8	142,5	134	83	90,5	89,8	45,3	52	44,2
Portugal	54,2	75,6	99,1	142,8	206,3	138,1	83,9	117,4	82,9	58,8	88,9	55,2
Belgium	109,6	93,2	105,5	146,2	192,1	189,3	105,4	142,2	130,6	40,8	49,9	58,7
Aggregate	n.a	55,6	87,3	n.a	130,1	147,1	n.a	76,1	90,4	n.a	54	56,7

Source: Bank for International Settlements
Note: 'Aggregate' gathers 45 advanced and emerging economies

APPENDIX 2.
Debt service costs according to different metrics across key EU Member States

	Billion Euros			% of GDP			% of Government debt (t-1)		
	2019	2023	2025	2019	2023	2025	2019	2023	2025
France	36,9	48,3	70,1	1,5%	1,7%	2,3%	1,6%	1,6%	2,1%
Germany	27,4	36,1	42	0,8%	0,9%	1,0%	1,3%	1,4%	1,6%
Italy	60,4	78,6	91,6	3,4%	3,8%	4,1%	2,5%	2,8%	3,1%
Spain	28,4	36	41,1	2,3%	2,5%	2,6%	2,3%	2,4%	2,5%
Austria	5,6	5,6	7,5	1,4%	1,2%	1,4%	2,0%	1,6%	1,9%
Netherlands	6,2	6,5	8,2	0,8%	0,6%	0,7%	1,5%	1,4%	1,6%
Portugal	6,3	5,8	6,3	2,9%	2,2%	2,2%	2,5%	2,1%	2,4%
Belgium	9,5	11,8	14,1	2,0%	2,0%	2,2%	2,1%	2,0%	2,2%

Source: EU Commission
Notes: Data for 2024 & 2025 are projections taken from the EU Commission's Spring Forecasts (May 2024)

APPENDIX 3.

Method of calculating the stabilising budget balance

The dynamics of government debt is an accounting phenomenon. Its variation as a percentage of GDP depends on (i) the difference between the apparent interest rate and nominal GDP growth (real growth + inflation), (ii) the level of public debt as a percentage of GDP in the previous period and (iii) the primary budget balance as a percentage of GDP. This mechanism can be illustrated by the following equation:

$$b_t - b_{t-1} = b_{t-1}(r - g) + d_t \qquad (1)$$

With the public debt/GDP ratio in period t; the public debt/GDP ratio in period t-1 ; r, the implicit interest rate (interest burden/public debt in t-1); g, nominal GDP growth; , the primary budget deficit as a percentage of GDP.

From equation 1 we can derive the stabilising balance (-d*), *i.e.* the balance where the debt ratio is constant between two periods. This balance is equal to the difference r-g multiplied by the debt/GDP ratio of the previous period. In other words:

The r-g differential is therefore a determining factor in the dynamics of public debt. There are several configurations to consider, depending on whether r>g or r<g:

- **If r>g**. With a zero primary balance, the debt ratio will increase exponentially at the rate r-g. To put the debt ratio on a downward path, the primary balance must be **positive and greater** than the stabilizing primary balance (-d*, see eq.2), otherwise the debt ratio will increase.
- **If r<g**. Fiscal adjustment is easier, and if the primary balance is zero, the debt ratio will fall steadily. It will also fall if the primary deficit does not exceed -d*.

A numerical illustration: Consider an implicit interest rate (r) of 4% and a growth rate (g) of 2%. The primary surplus required to stabilize a debt ratio of 50% is 1%, 2% for a debt of 100% and 3% for a debt of 150%. Conversely, if r=2% and g=4%, the debt ratio can be stabilized with a primary deficit of 1% for a debt ratio of 50%, 2% for a debt ratio of 100% and 3% for a debt ratio of 150%.

APPENDIX 4.
Implicit interest rate on public debt (r) and current GDP growth rate (g) across key EU Member States

	r - g, percentage points			
	France	Italy	Spain	Germany
Avg 1999-2023	0,2	1,4	-0,3	0,2
Avg 1999-2007	0,6	1,0	-2,8	2,3
Avg 2014-2019	-0,4	1,1	-0,6	-1,9
Avg 2021-2023	-5,0	-5,1	-7,1	-5,5
2021	-6,6	-7,2	-7,3	-5,4
2022	-3,7	-4,6	-7,9	-6,1
2023	-4,6	-3,4	-6,2	-4,9
2024	-1,6	-0,2	-3,0	-2,2
2025	-1,2	0,2	-1,8	-1,6

Source: EU Commission (Spring Forecasts of May 2024)
Notes: r = total interest payment over year t divided by the debt stock at the end of year t-1; g = nominal GDP growth rate at year t

APPENDIX 5.
Observed vs debt-stabilizing primary budget balance across the main EA Member States, % of GDP

	France		Italy		Spain		Germany	
	Stabilizing	Observed	Stabilizing	Observed	Stabilizing	Observed	Stabilizing	Observed
Avg 1999-2023	-0,1	-1,8	1,5	0,7	-0,4	-1,6	0,0	0,6
Avg 1999-2007	0,6	0,3	1,3	2,4	-1,4	2,3	1,8	0,0
Avg 2014-2019	-0,4	-1,5	1,5	1,6	-0,6	-1,3	-1,3	2,4
Avg 2021-2023	-5,6	-3,9	-7,6	-4,4	-8,3	-2,7	-3,7	-2,1
2021	-7,6	-5,2	-11,2	-5,2	-8,8	-4,6	-3,7	-3,0
2022	-4,2	-2,8	-6,8	-4,3	-9,3	-2,4	-4,2	-1,8
2023	-5,1	-3,8	-4,8	-3,6	-6,9	-1,2	-3,2	-1,6
2024	-1,8	-3,3	-0,2	-0,5	-3,2	-0,5	-1,4	-0,6
2025	-1,3	-2,7	0,2	-0,5	-1,9	-0,2	-1,0	-0,2

Source: Ekonomics' calculations based on EU Commission's Spring Forecast (May 2024)