Addressing sovereign debt challenges in the European Union

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

Even before the Covid and the energy crises, global debt was at an all-peacetime record. Indeed, the continuation of very low interest rates during the past two decades has pushed many advanced countries to implement active fiscal policies and economics agents to borrow more.

Monetary policy and the resulting credit expansion in the 2000s played a major role in preparing the great financial crisis of 2008. Since then, many advanced countries have continued to increase their recourse to public debt encouraged by lasting very low – end even negative – interest rates and eventually to ask future generations to bear a large part of the costs that the present generation refuses to assume.

In such a context, global public debt in advanced economies has grown by 30% between 2007 and 2019, according to the World Bank. In the euro area, the aggregate government debt-to-GDP ratio in the same period rose from 65,9 % to 85,9% – one-third more debt compared to the pre-crisis level.

The Maastricht Treaty specifies reference values for the general government sector of the various EU Member States: 3% of gross domestic product (GDP) for the government deficit and 60% of GDP for government debt (the Maastricht criteria). But in 1998, a political logic replaced the accounting reading of the debt situation. Indeed, Belgium and Italy – two founding countries of the European Union – qualified for entry into the euro zone with a public debt ratio of 117% and 115% respectively. Since then, Europe has accepted that the debt is rising inexorably in many Member States.

In the euro area, the divergence in public debt levels is a major concern. While the negative interest rates ensure the sustainability of European countries' public debt in the short term, the absence of structural reforms to gradually reduce this public debt would lead to economic decline and call into question the future of the euro zone.

In the face of the over-indebtedness of certain countries, it is necessary to gradually get out of the current excess of debt by questioning public budgets, giving priority to expenditure for the future and to undertake structural reforms, which have been postponed for too long, but which are the only way forward.

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

This note focuses on the issue of public debt sustainability in EU countries. To do so, it is necessary to take into account the main figures of private debt in these countries (non-financial corporations and households) and thus to have data on the total debt of the Member States. Public and private debt levels differ greatly across Member States.

1.1 Public debt to GDP ratios differ widely across Member States

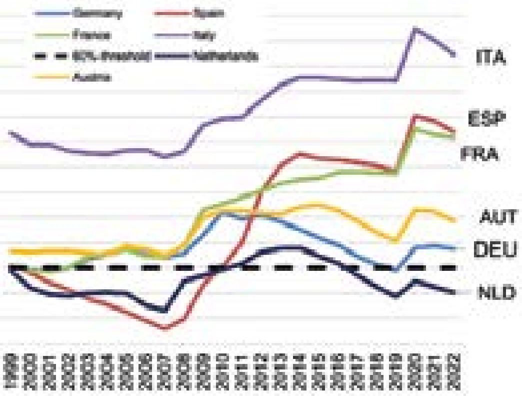
At the end of 2022, public debt vulnerabilities reach a very high level in a small set of mainly large European countries.

Despite the different reforms which took place after 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 ratio has continued to grow steadily in significant countries of the euro area (*e.g.* France, Italy, Belgium, Spain) and is approaching 120% of GDP or even more in certain Member States *(see Chart 1*). Credit to public sector, % of GDP)[1]. 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 even less[2].

In 2022, 14 countries in the EU have a public debt to GDP ratio below 60% (Estonia, Bulgaria, Luxembourg, Sweden Denmark, Lithuania Latvia, Czechia, Ireland,

1. Between 2008 and 2022, gross public debt to GDP ratio increased by 38.2 percentage points in Italy, 42.5 pp in France, 20 pp in Spain and 11.6 pp in Belgium.
2. In Germany, gross public debt to GDP ratio increased by 1.7 pp between 2008 and 2022, and by 3.9 pp in the Netherlands.

CHART 1.
Evolution of Gross Public Debt to GDP ratio in Major Eurozone Economies, %



Source: EU Commission ; Data for 2022 are projections taken from the EU Commission's Automn forecasts of November 2022

Romania, Netherlands, Poland, Malta, Slovakia), according to the EU Commission. However, three countries have a public debt of more than 115% of their GDP: Greece (171.2%), Italy (144.6%) and Portugal (115.9%). France and Belgium also have a high public debt (respectively 111.7% and 114%) well above the average of the 27 countries while Germany and the Netherlands respect 67,4% and 50,3%.

12 EU member countries would have a public deficit below 3% of GDP in 2022, according to AMECO's November 2022 forecast. Four would have a budget surplus, namely Denmark (1.8%), Cyprus (1.1%), Sweden (0.2%) and Ireland (0.2%). The deficit is not expected to exceed 2% of GDP in Luxembourg (-0.1%), the Netherlands (-1.1%), Finland (-1.4%), Croatia (-1.5%), Lithuania (-1.8%) and Portugal (-1.9%). Estonia (-2.2%) and Germany (-2.3%) are expected to have a deficit below 2.5%.

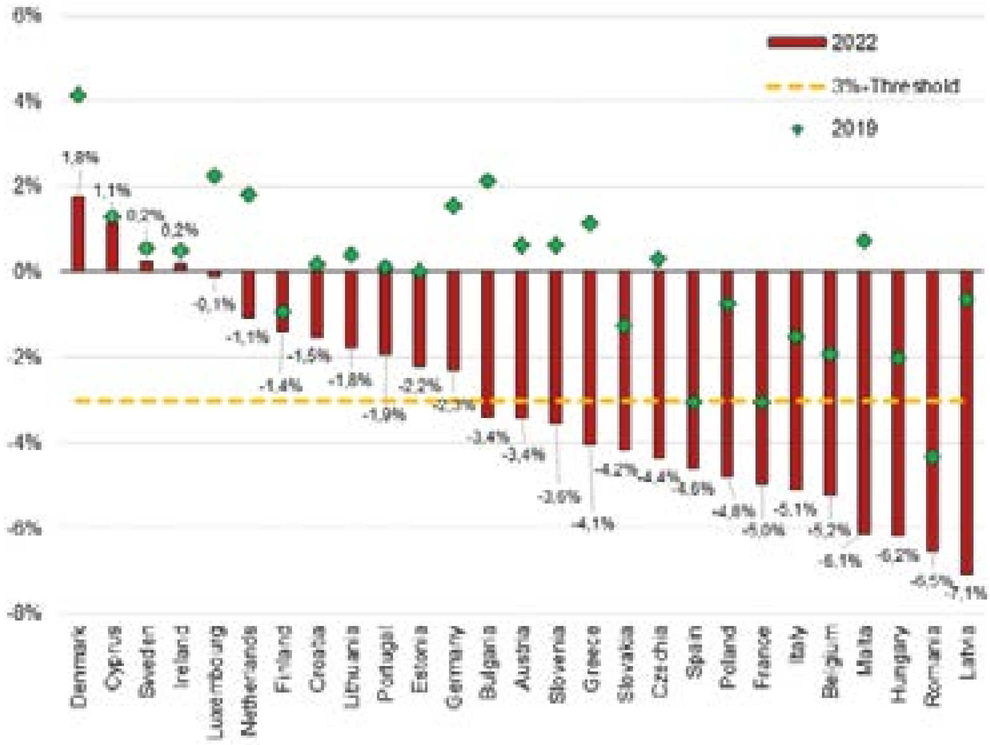
Of the remaining 15 member states with deficits above 3% of GDP in 2022, 3 would have deficits below 4% of GDP, including Bulgaria (-3.4%), Austria (-3.4%) and Slovenia (-3.6%). 5 countries would have a deficit between 4 and 5% in 2022, including Greece (-4.1%), Slovakia (-4.2%), the Czech Republic (-4.4%), Spain (-4.6%) and Poland (-4.8%). The rest of the member countries are expected to have a deficit above 5% of GDP in 2022. Among them are France (-5%), Italy (-5.1%), and Belgium (-5.2%). It would exceed 6% in Malta (-6.1%), Hungary (-6.2%), and Romania (-6.5%), and exceed 7% in Latvia (-7.1%).

1.2 Private debt also differs across EU countries

Private household and Non-Financial corporate debt has also strongly diverged across EU Member States during the past years.

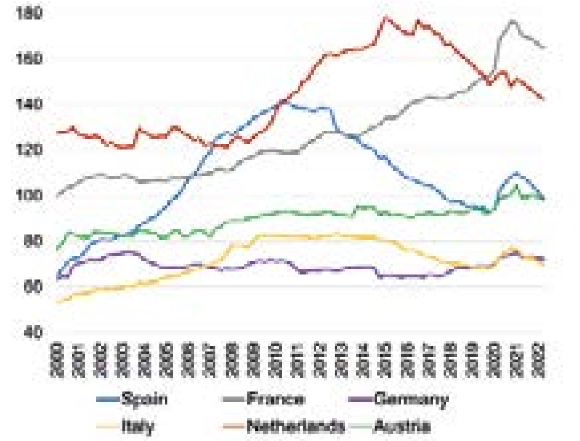
In France, private debt (households and non-financial companies) has increased from 181.1% of GDP in 2013 to 231.2% in June 2022, according to the BIS.

CHART 2.
Total Budget Balance in 2022, % of GDP



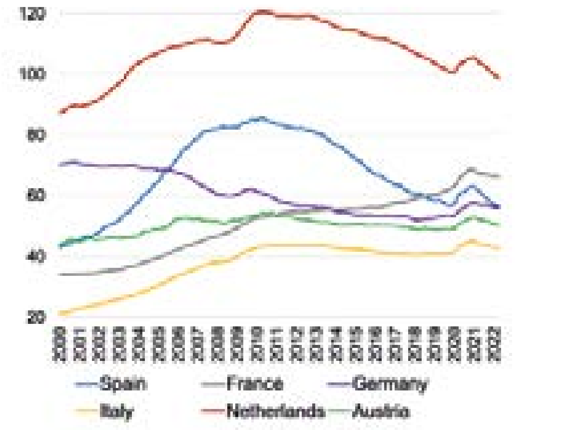
Source: European Commission (Autumn Forecasts of November 2022)

CHART 3.
Credit to Non-Financial Corporations (% of GDP)



Source : Bank for International Settlements

CHART 4.
Credit to Households ((% of GDP)



Source : Bank for International Settlements

By contrast, it fell significantly in Spain (from 202% to 155.3% over the same period following the deleveraging of companies and the deflation of the real estate bubble); it also decreased in Italy (125% in 2013, 112.8% in June 2022) and increased slightly in Germany over this period (124.3% in Germany in 2013 and 128.3% in June 2022).

Although the level of French private debt remains lower than that of the Netherlands in Q2-2022 as share of GDP, it should be noted that the latter decreased by 39.4 points compared to 2013 in the Netherlands, while it increased by 50.1 points in France during this period. In Belgium, the ratio increased by 8 points.

1.3 Global debt challenges in the European Union

By analysing the levels of public and private debt relative to GDP in the main euro area economies in Q2-2022, several groups of countries stand out.

A first group includes Germany and Austria, which both display a low level of public debt (67.4% of GDP in Germany and 82.8% in Austria in Q2-2022 vs. 94.3% in the euro zone) and private debt (128.3% of GDP in Germany and 148% in Austria versus 167.2% in the euro zone) compared to other euro area countries.

A second group contains countries where the public sector is highly indebted, unlike the private sector, which is weakly indebted compared to the euro area average. These include Italy, Spain and Portugal, which are among the countries with the highest public debt ratios in the euro area (resp. 150.1% of GDP in Q2-2022, 116%.4% and 123.3%), while the level of private debt is below the euro area average (resp. 112.8% of GDP, 155.3% and 161.5%).

Conversely, the level of Dutch public debt is one of the lowest in the euro zone (50.9% of GDP), while that of the private sector (240.9% of GDP) is among the highest. This applies to both non-financial corporations and household debt.

Finally, France and Belgium both display the highest public debt (113.3% of GDP and 106.9%) and private debt (231.2% of GDP and 199.8%) compared to the main Eurozone Member States.

2. The divergence in public debt levels across Member States is a major concern

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the Union European is not a state and that negative externalities – stemming from questionable national fiscal policies – should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination.

The comparison of the ratio of public debt to GDP between France and Germany, which is natural given the place of these two countries in Europe, is striking: 67.4% for Germany in 2022, compared with 111.7% for France, whereas these two countries were at the same level, around 65%, in 2007.

In 2022 the total public expenditure in relation to GDP was 49.5% in Germany but this ratio reached the European record of 57.0% in France.

While the European average in percent of GDP was 167,2% in Q2 2022, the level of private debt reached 231.2% for France and 128.3% in Germany *(see above).*

These economic divergences make it more difficult to define in Europe a common interest, encourage a policy of "every man for himself", create a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the euro zone.

Without Franco-German understanding, it is impossible to imagine a Europe capable of competing economically with the other great powers. France's fiscal and economic weaknesses have become an economic and political handicap that prevents it from influencing its German neighbour.

France urgently needs to undertake fiscal measures (reduction of public spending in relation to GDP, achieving a primary surplus) and structural measures to increase productivity and potential growth and eventually regain the path of economic convergence with German and regain a credibility capable of relaunching economic, financial and political Europe.

Some may think that fiscal discipline is no more indispensable because of the persistence of low interest rates. This is a profound misconception: interest rates will not stay negative in real terms for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetisation of public debt is not consistent with the functioning of our monetary union.

If this fiscal drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them. If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

3. How did we get here?

3.1 Between 2000 and 2007, most eurozone countries met the Maastricht fiscal criteria, except for Italy and Greece

Before the subprime crisis, with a few exceptions, budget deficits were relatively limited. Thus, in the period preceding the crisis (2000-2007), the budget balance was, on average, positive in Ireland (1.4% of GDP) and Spain (0.4% of GDP). It was negative in Austria (-2.2%), Germany (-2.5%), France (-2.7%) and Italy (-3%), but only in Greece (-6.4%) did it exceed the Maastricht criterion (3%).

When the crisis broke in 2007, Spain had a budget surplus of 1.9% of GDP and its public debt was only 35.8% of GDP. In 2012, its debt reached 90%. In Ireland over the same period the debt to GDP ratio rose from 23.9% to 119.6%. In the meantime, the sovereign debt crisis[1] has hit these two countries in particular and governments have been forced to intervene.

3.2 Fiscal heterogeneities across EU Member States have increased between 2013-2019

In 2019, the Netherlands and Germany, after several years of efforts to reduce their public deficit and debt, brought back their public finance in line with EU fiscal rules. Indeed, between 2014 and 2019, they ensured an average public surplus of 1.2% and 0.04% of their GDP, respectively. Such fiscal efforts allowed them to gradually reduce and stabilise their public debt, at respectively 59.6% and 48.7% of GDP in 2019, from 81.1% and 66.7% in 2013. Austria also made such efforts over that period, contributing to reduce its public debt burden by nearly 11 pp to 70.5% of GDP in 2019.

By contrast, during the post-Global Financial Crisis period, the public debt ratio of Spain, Italy and France has kept rising. Between 2012 and 2019, France increased its public debt in relation to GDP from 90% to 97%; Italy's one jumped from 126% to 136%, and Spain's rose from 86% to 95%.

The continuous rise of public debt-to-GDP ratio in these three Member States is mainly due to the accumulation of yearly fiscal deficits. As shown in Chart 5, the average deficit of France and Spain exceeded 3% of GDP, the threshold of Maastricht fiscal rules, between 2014 and 2019. Unlike Italy, these two countries have not delivered any primary surplus, since 2002 for France and 2008 for Spain. Between 2014 and 2019, their average primary deficit reached 1.5% of GDP, while Italy secured a primary surplus at the same period of 1.4% *(see Chart 1 in Annex)*.

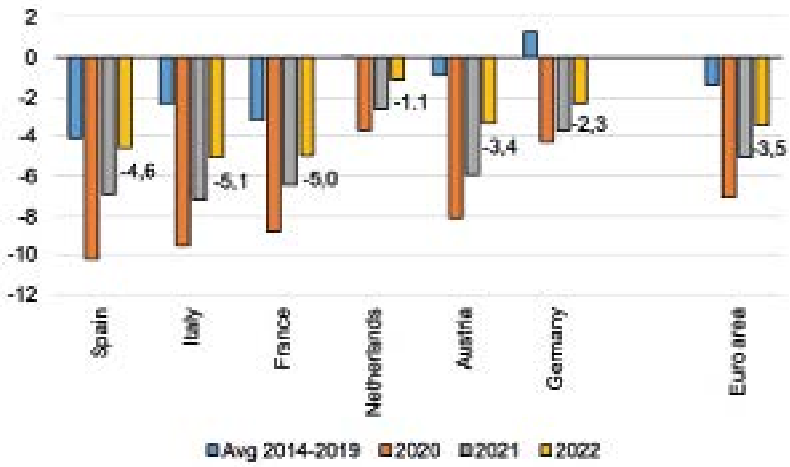
Chart 2 in Annex illustrates the cumulative change in the debt ratio and the various components that contribute to it in the four main countries of the euro zone from 2007 to 2021.

Over this period (and despite the extraordinary expenses linked to the pandemic in 2020 and 2021 which have greatly increased the primary imbalances in all countries), only Germany and Italy maintained a primary surplus which contributes to limiting the increase in the debt ratio. In France and Spain, the increase in public debt is mainly explained by recurrent primary budget deficits reflecting the structural imbalance in public finances in these two countries.

3.3 The Covid crisis has exacerbated these fiscal heterogeneities

Following the Covid-19 crisis, monetary and fiscal policies have been more active than before, widely contributing to the shock absorption. The ultra-accommodating monetary policy during the Covid crisis allowed the shock of the pandemic to be absorbed by protecting household living standards, facilitating the financing of public debt and providing companies with the necessary funding.

CHART 5.
General Governement Budget Balance, % of GDP



Source: Eurostat, EU Commission's Automn Forecast (November 2022)
Notes: Labels relate data for 2022 ; data for 2022 are taken from the EU Commission's forecasts of November 2022

But it has encouraged states to allow economic divergences between states to widen: France's public deficit in 2020 and 2021 has risen to 15.5% of GDP compared to 8.1% in Germany.

The aggregate government debt-to-GDP ratio rose by around 12 percentage points between 2019 and 2021 for the euro area, and 10.2 percentage points for the EU, reaching respectively 97.2% of GDP in the euro area and 89.4% in the European Union according to Eurostat.

Divergences of fiscal performance across euro area Member States have widened between 2019 and 2021. Five EU Member States still saw their public debt exceeding 110% of GDP in 2021: Greece (194.5%), Italy (150.3%), Portugal (125.5%), Spain (118.3%) and France (112.8%). Spanish debts jumped by 20 percentage points between 2019 and 2021 to reach respectively 118.3% of GDP in 2021. It increased by 15.4 percentage points in France, and 16 percentage points in Italy, to reach respectively 112.8% of GDP and 150.3% in 2021.

By contrast, nineteen EU countries kept their ratio below 75% of GDP in 2021. Among them, Germany, the Netherlands, and Finland had their public debt compared to GDP hovering respectively at 68.6% of GDP, 52.4% and 72.4% in 2021.

The public debt-to-GDP prudently increased during the same period by 3.9 percentage points in the Netherlands and 9.7 percentage points Germany, to reach respectively 52.4% of GDP and 68.6% in 2021.

3.4 The divergence in terms of fiscal and public debt between the Member States has not increased with the war in Ukraine but the public debt-to-GDP ratio has stabilized at elevated levels in many EU countries

Economies of the European Union are affected differently by the war in Ukraine; inflation pressures have also intensified but divergences in terms of public deficits and public debts have not increased across Member States notably thanks to very negative real interest rates.

However, the economic policies chosen to deal with inflation are a further source of divergence. While France is subsidising household purchasing power through the deficit in 2022, other countries, such as Germany and Italy, have allowed prices to rise. Thus, France's lower inflation has as a counterpart a lower reduction of its public debt compared to GDP.

In such an economic context, for 2022, the ratio should have reduced marginally in France from 112.8% of GDP in 2021 to 111.7% in 2022, according to the EU Commission (Autumn Forecast). It should have fallen by 4.3 pp in Spain (from 118.3% to 114%) and by 5.7 pp in Italy (from 150.3% to 144.6%), according to the EU Commission.[3]

3.5 The ECB's 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

Lasting zero or even negative interest rates have been a disincentive for many member States to undertake structural reforms. Moreover, the Stability and Growth Pact has not been enforced for the majority of the time over the last two decades.

3.5.1 The very accommodative monetary policy in the euro area over the last 20 years explains to a large extent this public debt overhang

In fact, with lasting interest rates at ultra-low levels, debt service costs were at post war troughs during the past ten years. The debt burden has never felt so

3. Spain and Italy experienced higher inflation and nominal growth in 2022 than France, given the measures to freeze energy prices in that country. The decline in public debt to GDP in Spain and Italy is all the more significant than in France, where the primary deficit of 3.2% of GDP in 2022 was much higher than in Spain (-2.4%) and Italy (-1.1%).

light as during this period. Thus, governments were under no pressure to reduce their debts. Negative interest rates encouraged them to borrow more and has disincentivised fiscal discipline.

3.5.2 In Europe, the fiscal rules of the Stability and Growth Pact have not been obeyed by many large economies of the EU (France, Italy, Spain...[4]) which has contributed to their over-indebtedness

Furthermore, in the EU, the rules of the Stability and Growth Pact (SGP) have, most of the time, not been respected by many large economies of the EU (*e.g.* France, Spain, Italy, Belgium) since their implementation in 2002 *(see Chart 4)*. In those countries, gross public debt has continued to rise since the EU sovereign debt crisis (2011-2012). Such a dynamic is due to the accumulation of yearly large public deficits. The sanctions originally provided by the SGP were never implemented. In other words, Europe does not have the instruments to impose fiscal discipline.

4. The very low long-term interest rates of the last few years allow the sustainability of the public debt of European states in the short term, but the absence of structural reforms to gradually reduce this public debt would lead to economic decline and compromise the future of the euro zone

4.1 The sustainability of a public debt is linked to the confidence of creditors

It depends on several factors:

- The total amount of public debt and its maturity,
- The potential growth and income available to the borrower to meet its debt obligations,
- The average interest rate on the stock of debt issued by the government compared to the capacity to tax the economy,
- The primary budget balance which will increase the debt in the case of a deficit or reduce it in the case of a surplus: the higher the debt, the greater the primary surplus required
- The percentage of debt held by non-residents[5],
- The nature of the expenditure financed by this debt (infrastructure and social expenditure having different effects on long-term activity).

4.2 A government's public debt appears sustainable when its average interest rate is lower than the growth rate of GDP in value terms

The public debt-to-GDP ratio, growth and interest rates determine the stabilising primary balance and the capacity to stabilise the public debt.

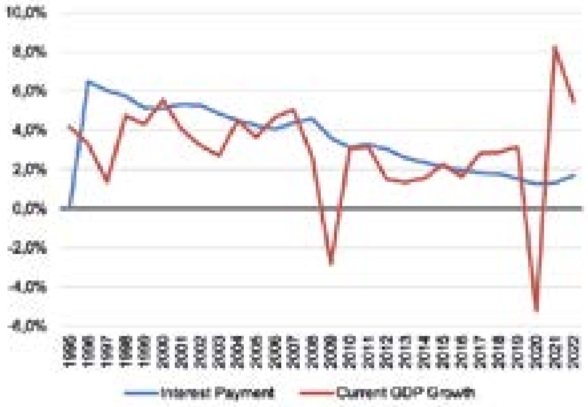
For the public debt-to-GDP ratio to be stable, the primary government balance as a % of GDP must be equal to (r - g) × D/Y, where r is the average interest rate on the sovereign debt[6], g is economic growth, and D/Y is the public debt-to-GDP ratio.

For example, with a level of debt to GDP of 120% and a gap (r-g) = 1.1, which is the average gap observed in France between 2000 and 2020, the stabilising primary balance would be 1.32 % of GDP[7].

When the interest rate is higher than economic growth, *i.e.* with (r- g) > 0, there is a debt snowball effect. The debt is self-sustaining due to the accumulation of interest charges, and a primary surplus is needed to stabilise it.

In the case where (r-g) < 0, the primary public balance stabilising the debt is negative.

CHART 6.
Average interest rate on public debt (r) and current GDP growth rate (g) for France



Source: FIPECO via J. Arthuis, « Commission pour l'avenir des finances publiques – documents préparatoires » (March 2021); EU Commission (Automn Forecasts of November 2022)

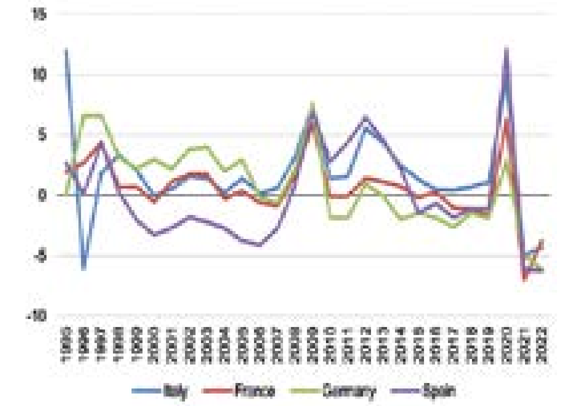
4. In 2019, 16 of the EU members (including Germany and the Netherlands) had a public debt/GDP ratio below.
5. Foreign ownership is a stronger constraint for the borrowing state.
6. This is the ratio of interest payment for the year compared to the level of debt at the end of the previous year.
7. See Commission pour l'avenir des finances publiques – Documents préparatoires, March 2021.

To stabilise the public debt, a primary balance must be generated equal to the product of the debt at the end of the previous year and the difference between its apparent interest rate and the growth rate of GDP in value. This primary balance is the stabilising primary balance.

A few elements about the dynamics of r-g in France, Italy, Spain and Germany in recent years are worth noting:

- With the exception of Italy, r - the interest payment expressed as a % of total debt – was overall lower than nominal growth between 2014 and 2019 on average for France, Germany and Spain, whereas the relationship was positive between 1999 and 2007 on average for the first two countries. Spain enjoyed much higher nominal growth than the other members (7.7% vs. 4.2% in France and 2.5% in Germany), during this period (1999-2007).
- Compared to Germany, France and Spain, Italy suffers from relatively low nominal growth for a relatively high debt burden, which is the source of a positive r-g over the entire 1999-2022 period. Already prevalent in 1999-2007, this dynamic worsened in 2014-2019, with the deterioration in nominal growth (4% on average between 1999-2007 and 1.8% between 2014-19), which the fall in the interest payment was unable to offset (5% between 1999-2007 vs. 3% between 2014-2019).
- After a sharp rise in 2020 following the collapse of nominal growth, r-g has become negative again since 2021 for the four member countries, to the point of reaching historically low levels since the creation of the euro zone. This dynamic continued in 2022, given the exceptionally high nominal growth due to inflation, while interest charges barely increased.

CHART 7.
Average interest rate on public debt (r) compared to nominal growth (g), across key EU Member States, Percentage points



Source: EU Commission (Automn Forecasts of November 2022)
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

CHART 8.
Average interest rate on public debt (r) compared to nominal growth (g), across key EU Member States, Percentage points

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

Source: EU Commission (Automn Forecasts of November 2022)
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

The table above shows that the level of r-g was much more negative in Germany than in France in 2022, because, compared to the France, Germany supports a lower debt service cost (r) for a higher nominal growth (g). In 2022, interest payment, calculated as the ratio between the amount of interest paid and the stock of public debt of the previous year, amounted to 1% in Germany, against 1.7% in France. Nominal GDP growth was 7% in Germany, compared to 5.5% in France. The GDP deflator (measure of core inflation), twice as high in Germany (+5.3%) as in France (+2.8%), contributed to explain this nominal growth differential between the two countries in 2022.

Between 2014 and 2019, r-g was also weaker in Germany than in France for quite similar reasons. Germany benefited from lower debt service costs than in France (1.7% of public debt on average in Germany vs. 1.9% in France). Also, nominal GDP growth was significantly higher in Germany than in France (3.6% in Germany versus 2.4% in France on average). The latter resulted from a higher real GDP growth (+1.8% in Germany vs. 1.5% in France) and a higher GDP deflator in Germany (1.8% in Germany vs. 0.8% in France).

4.3 The very low interest rates of recent years help reduce debt-servicing cost for the most indebted States in the euro zone in the short run

The very low or negative long-term interest rates of the last ten years in the eurozone countries still ensure the sustainability of the public debts of these States: they allow them to have larger public deficits without increasing the level of debt.

However, it is far from certain that the interest rate on the debt will always remain lower than the growth rate, unless central banks abandon their objective of fighting inflation, which would then pose other difficulties (economic stagnation, risks of social movements, inflation hitting the poorest, etc.).

In a context of high inflation in the countries of the euro zone, we note that growth rates in value terms are nevertheless low while long-term interest rates are rising. It is therefore urgent that the most indebted Eurozone countries secure primary budget surpluses. This is all the more important as r-g seems likely to remain positive for a long period. Indeed, the next few years are likely to be marked by positive nominal rates and low growth rates, which will gradually deteriorate the solvency of the debt of these countries unless they make efforts to control their public deficits and carry out reforms capable of increasing their potential growth.

Otherwise, sooner or later investors will decide that such debt levels are unsustainable and drive Eurozone debt spreads much wider.

4.4 Is inflation a solution to reduce public debt?

It is often said that inflation would be an effective way to reduce public debt ratios. It is true that It is theoretically easier to stabilise or reduce public debt when inflation is higher. Indeed, the higher the inflation, the higher the GDP in value terms, which tends to lower the debt/GDP ratio. However, the debt must not increase faster than GDP under the effect of the primary deficit and the interest burden.

But one should be careful with this argument. After the wars, inflation was high, and this helped to reduce public debt ratios. But now central banks have a clear inflation target which should lead them to raise their interest rates and reduce their balance sheets in the coming months. For inflation to become a tool of reducing public debt rates again, central banks would have to change their inflation targets, which would raise other structural problems: Lasting high inflation slows down economic activity. It makes the future more uncertain for economic agents and discourages them from investing. Moreover, if it is higher than that of the main trading partners, inflation reduces the competitiveness of companies in relation to their foreign competitors. Lastly, inflation increases social risks and the development of populism. It is a factor in increasing inequalities between households – it hits the poorest first – because the ability of economic agents to preserve or increase their purchasing power and their assets in periods of high inflation varies greatly.

4.5 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

The climate challenge implies the substitution of decarbonized energy for fossil and polluting energy. To achieve this substitution, it is necessary to release additional public resources to make the necessary ecological investments more financially viable.

This implies another substitution in overindebted countries: replacing unproductive public spending (financing current deficits) with public spending that incentivizes the financing of the ecological revolution.

A special treatment for growth-enhancing expenditure, on the occasion of the revision of the Stability and Growth Pact to be finalized in the coming months, would not be helpful. It comes from the illusion that public financial means are not scarce. Actually, it is a matter of refocusing the priorities. Unproductive public spending needs to be replaced by productive public spending.

It would be a grave mistake to push the extreme fiscal limits in the present situation. Investment-friendly rules – such as a golden rule to protect public investment implying a separate capital account – will lead to add borrowings to already overindebted countries fostering potential risks to debt sustainability.

This fiscal substitution has nothing to do with austerity. It is not a question of reducing public support for the economy. On the contrary, it is a question of increasing it by redirecting the public expenditure towards productive energy related investments. It is about defining financing mechanisms that benefit from a state guarantee in order to encourage households or SMEs to make green investments.

NextGenerationEU is a powerful ecological lever provided it is rapidly implemented. Indeed, this European plan proposes European financing (grants and loans) to the States insofar as the latter commit to implementing the proposed structural reforms defined in the framework of the European Semester.

4. 6 Lasting negative real interest rates and high public deficits (>3%) and debts (<90/100%) are synonymous with a decline of productive and public investment

The economic consequences of high sovereign debt

In its Economic Bulletin (Issue 3/2016), the ECB explains the significant economic challenges raised by high government debt.

First a high government debt burden makes the economy more vulnerable to macro-economic shocks and limits the room for counter-cyclical fiscal policy. For instance, a rise in long-term interest rates may reignite pressures on more vulnerable sovereigns, thereby triggering a sovereign risk re-pricing. Second a high government debt entails the need to sustain high primary surpluses over long periods, which may be difficult under fragile political or economic circumstances. Indeed, high primary surpluses are difficult to maintain under adverse economic conditions.

Third theoretical and empirical literature suggests that high government debt burdens can ultimately impede long-term growth. Indeed, several studies suggest that beyond a threshold of 90%-100%, public debt has an impact on growth performance. However, it is important to analyse the nature of the expenditure financed by this debt, as infrastructure and social expenditure do not have the same effects on long-term activity. In any case, productive investment and public investment have declined in the most indebted countries during the last decade.

Lasting loose monetary policies discourage productive investment and growth

Net public investment in the euro area during the 2011-19 period was the lowest of the advanced economies, with the exception of Japan. Before the global financial crisis (2008), public investment levels were at around 4% of gross domestic product (GDP) in the euro area. But, according to F. Panetta[8], after the sovereign debt crisis, public investment tumbled by more than one percentage point. When accounting for the depreciation of capital stock, net public investment fell from about 1% of GDP in 2010 to around 0% in 2013. It hovered around that level until 2019 and even turned negative between 2014 and 2017. Euro area governments invested around € 500 billion less in the 2011-19 period compared with the 2000-09 pre-crisis period.

Negative or very low interest rates are supposed to encourage productive investment, which has been in decline for more than 10 years. However, the reality is quite different. it has been shown that negative interest rates discourage savers, particularly in Europe, from investing in the long term and encourage them to hold on to their liquid assets. A saver is not going to finance a risky investment if it does not bring him any return!

If interest rates remain negative in real terms, it is to be feared that investment will not pick up again. How can savers be encouraged to invest in future projects that carry a certain amount of risk if they receive zero return, or even a tax, on the money they invest?

4.7 Increasing public spending and public debt in over-indebted European economies inevitably leads to economic underperformance and to the questioning of the existence of the euro

The Eurofi Macroeconomic Scoreboard shows that:

- The most indebted countries of the euro zone had also achieved the lowest productivity growth performance in the past two decades.
- The most indebted EU Members have experienced the highest unemployment rates in the EU since 2007, as Spain (14,8% in 2021), Italy (9,5%) and France (7,8%).

Large deficits and high levels of debt and deficit have not been conducive to growth, especially in Europe. Indeed, the most indebted countries, (*e.g.* France, Italy) have achieved the lowest growth performance of the eurozone since 2013[9].

The most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020. Likewise, the most indebted EU Members have experienced close to double-digit level of unemployment rate since 2007, as Spain (14.5% in 2019), Italy (9.9%) and France (8.5%). Despite their significant deficit, the three countries are among those with the highest share of long-term and young unemployment rate. EU countries with the highest level of government expenditure as percentage of GDP (*e.g.* France, Belgium) are also those with the least competitive firms. Such levels of public expenditures have been reached at the expense of productive investment.

By contrast, the EU countries that have best managed their public finances after the Global Financial Crisis and the EU Sovereign crisis (*e.g.* Germany, the Netherlands, Austria) are those that have suffered the least from the Covid-19 shock. At 4.2% of GDP (Germany) and 4.3% (the Netherlands), their 2020 public deficit has remained mainly below the euro zone average of 7.2%. Those countries also record among the lowest unemployment rate within the euro area, with 3.2% for the Netherlands and 3.5% Germany as of June 2021[10].

4.8 Thinking that monetary creation can solve the problems arising from excessive debt is an illusion. Despite Quantitative Easing policies, the fiscal constraint remains

Between March 2020 and June 2022, central banks and notably the ECB have been carrying a primary role in public debt monetisation, as they purchased a large share of new public debt issuances[11]. In sight of the massive debt purchases, central banks have de facto become the agents of fiscal policies. This "fiscal dominance" that is still taking place puts in question the independence of central banks and is a major disincentive for governments to engage in structural reforms.

8. P. Panetta, "Investing in Europe's future: The case for a rethink", Milan, 11 November 2022.
9. See the Eurofi Macroeconomic Scoreboard, April 2023.
10. According to Moody's Analytics Economic Indicators (can be found at https://www.economy.com/indicators).
11. Refer to the Eurofi Monetary Scoreboard: 64% of French debt issuances have been bought by the Eurosystem in 2020. The figure reaches 79.8% in Germany, 70.1% in Spain, 74.5% in Austria, 101.3% in Italy, 98.5% in the Netherlands.

Central bank purchases of public debt do not change the total indebtedness of the state. It prevents interest rates from rising in the long term, but it cannot be permanent or it will become inflationary and create asset bubbles.

Prudent fiscal policy sustains credibility, not monetization

The idea that States can compensate for everything by exposing their balance sheets is unfortunately a fantasy. Indeed, it is not because budget deficits are monetised that they disappear. Despite the QE and its possible magnitude, the budget constraint remains. Analysts and rating agencies continue to examine ratios and make judgments about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of an issuer's "signature" and a key factor in the decision to buy securities by private investors, especially non-residents. As they are very sensitive to the rating, they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgments voiced by the markets actually do not matter, because the central bank will always be there to buy, is doubly inaccurate: the central bank will not always be able to buy everything, as we shall see below, and the quality of a state's signature is an essential element of confidence that must be preserved at all costs for the country's future.

The resumption of the monetisation of an increasing share of public debt stock and new issues in case of increasing financial fragmentation in the euro area would eventually promote financial instabilities and could lead to a loss of confidence in the currency.

The ECB cannot absorb all public debt forever

If some national central banks are theoretically free to monetise the entirety of their states' public debt, the same cannot be said of the ECB, which is governed by an international treaty that prohibits the monetisation of public debt. Similarly, the idea that central banks purchasing public securities could cancel their assets in order to reduce their states' debt to zero is, in the European case, legally impossible. The subsidy to the states that would be implied by the cancellation of public debts is not compatible with the Maastricht Treaty, which prohibits the monetary financing of Treasuries.

We cannot pretend that money creation can exempt our societies indefinitely from having to face the question: "who will pay?". Do we seriously believe that unlimited issuance of sovereign securities will never come up against a fundamental questioning of the markets as to the solvency of States?

What we need is more long-term investment to cope with the challenges of reduced labour and the green and digital transition

This will not be achieved with more distribution through budgets or more money creation. It will only be possible if structural – supply side oriented – reforms as well as a normal remuneration of risky investments are made possible. This combination requires a reining in of excessive current public expenditure (*i.e.* fiscal normalisation), alongside a qualitative shift towards reasonable public investment.

As long as we do not understand notably in indebted countries (France, Italy, Spain etc) that excessive debt is a source of lack of competitiveness, the economic situation will continue to deteriorate in these countries. Only domestic structural reforms can resolve structural issues and increase productivity and potential growth.

It is an illusion to try to solve the structural problems of our economies by a prolonged increase in public or private debt. Yet this is what we have tried to do by pursuing lax fiscal, monetary and political policies that pose systemic risks to financial stability and therefore to future growth.

If we continue to live on the illusion that fiscal stimulus can "replace" monetary stimulus, we will have two negative results:

- Fiscal dominance because fiscal stimulus cannot co-exist with high rates.
- A financial crisis because excessive leverage always leads to it.

Furthermore, if this fiscal drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them. If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

5. It is economic growth that eventually solves indebtedness issues

A monetary union does not by itself create economic convergence. The eurozone is a currency area comprising heterogeneous countries (their productivity levels, their productive specialisation, the level of fiscal deficits and indebtedness, the level of labour force skills are different) with a low level of federalism. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States[12].

Monetary policy can erase spread differentials in the euro area but cannot relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece).

This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect the persistent doubts of investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

Adequate remuneration of risk, implementation of structural, supply side-oriented reforms and sustainable fiscal policies are essential to promote a return to healthy growth in overindebted countries.

Remuneration is a key driver for contributing to sustainable growth

The world – and the euro area in particular – should move gradually and cautiously towards monetary normalisation, in order to avoid cliff effect. The market – the supply and demand of capital – must be gradually be reintroduced in the determination of medium and long-term interest rates. This would be a step to a more productive post-pandemic period of higher growth and productive investment.

Raising long term potential growth is of the essence to solve the indebtedness issue.

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 in particular has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything: only domestic structural reforms can resolve structural issues and increase productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

France and Italy notably are suffering from a supply problem, due to the decline in industrial production capacity, the deterioration in cost competitiveness, the low level of labour force skills and the low level of potential growth, especially in Italy. When demand increases in France, this increase in demand mainly leads to an increase in imports and not in domestic production. Increasing fiscal deficits in these countries could only lead to a noticeable rise in interest rates that may threaten fiscal solvency and dampen private sector demand.

In such a context, France urgently needs to rebalance its public accounts in order to reduce the excessive level of tax and contributions which are detrimental to the competitiveness of French companies. What is needed is a reduction of public expenses, which represented in 2022 57,9% of GDP compared to 48,7% in Spain or 49,5% in Germany (as illustrated in the following graph) and not a lesser increase. In other words, 56% of GDP in France is used to finance administration and redistribution expenditures. This represents an 8-to-9-point difference with the European average. This is a burden for economic players, because public spending has to be financed by taxes and social contributions that are 8 points of GDP higher than in the other countries. This additional tax and social burden explain the de-industrialisation of France over the last forty years. Moreover, in a monetary union, Member States cannot devalue our currency in order to regain competitiveness vis-à-vis our neighbours. There is no other way than to lower taxes if we want to restore sufficient profit margins so that companies can invest. France suffers from chronic under-investment, at least in industry.

Italy, for its part, needs to increase its potential output and reduce public debt, which represents a major potential source of financial spill over for the rest of the euro area. Italy's public debt is very high and financing needs are large. After increasing by 20 percentage points of GDP in 202, Italy's public debt declined somewhat in 2021 nearly to 150 percent of GDP. Further sustained and significant reduction in the public debt ratio is needed to safeguard debt sustainability. As mentioned by the IMF in its Article IV report (August 2022), "key risks stem from a disappointing growth trajectory, a sharper increase in financing costs and materialization of large contingent liabilities... Reaching a primary surplus of 2 percent of GDP no later than 2030 is required. It would create room for priory investments in education, digitalization, and the energy transition while also reducing public debt to around 130% of GDP in 2030, with further reduction thereafter".

12. See J. de Larosière, D. Cahen & E. Krief, Eurofi Economic Scoreboard, February 2022.

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Growth will be the only way to handle the debt problem. In over indebted countries, governments must take corrective actions to ensure a path to primary fiscal balances and reduce unproductive and inefficient public spending. No illusions should be held over the capacity to stimulate demand in these countries.

However, some economists explain that global secular stagnation[13] was and is driven by deep structural factors lowering interest rates for safe assets that neither Covid nor inflation have done anything to reverse: demographic evolutions lead to a longer retirement. This induces people to save more for their retirement. Consequently r < g should remain the prevalent regime for some time to come. In such an environment of lasting very low interest rates, governments should be encouraged to take on more debt in order to finance the public spending that is necessary for the future.

Given the uncertainty about inflationary expectations and the growth rate, and if we include in the reasoning the need for investments in order not to miss the ecological and digital turn, believing that the r-g equation will be permanently negative seems more like a risky bet than a certainty:

Indeed, the truth is that investment needs are increasingly high, especially those related to then green and digital transition – the EU Commission estimates them at 650 billion euros per year until 2030 – and should change the medium – and long-term interest rate situation. The permanence of secular stagnation is not guaranteed, and fortunately it is so.

Furthermore, those who support the thesis of the permanence of negative r-g, what assumptions do they make about quantitative tightening and its impact on long-term interest rates? This subject and more generally the normalization of monetary policy, is passed over.

While it is true that the secular decline has led to a decline in interest rates for structural reasons, many economists often forget that the hyper-accommodating monetary policies conducted since the great financial crisis of 2008 – and in particular the Quantitative Easing policies (QE) – have exerted downward pressure on medium and long-term interest rates, which would not have been as low over the last 15 years without these massive securities purchases.

Moreover, the gradual setting of rates by the market and no longer by the central banks would lead to a better remuneration of savings. Fiscal deficits will have to be reduced in such a context, structural reforms will be encouraged, share buy backs will have to decline investment would be favoured.

It is also important to understand that if fiscal policies were to remain expansionary, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus.

Olivier Blanchard[14] recognized that there are many reasons why investment might become stronger and increase r. "Geopolitics suggest that defense spending, a form of investment, may go up. Reshoring and friendshoring, for security or other reasons, may imply both higher investment and possibly lower growth as some of the benefits of trade are lost. The fight against global warming will increase green investment, while at the same time potentially slightly decreasing growth. All these may lead to an increase in r – g and thus reduce the room for fiscal space and the use of fiscal policy".

In such a context, in order to ensure the sustainability of their public debt, countries with large budget deficits (*e.g.*, >3%) and excessive debt (*e.g.*, >100% of GDP) must achieve and maintain a primary surplus to be defined and monitored in the context of the current review of the Stability and Growth Pact.

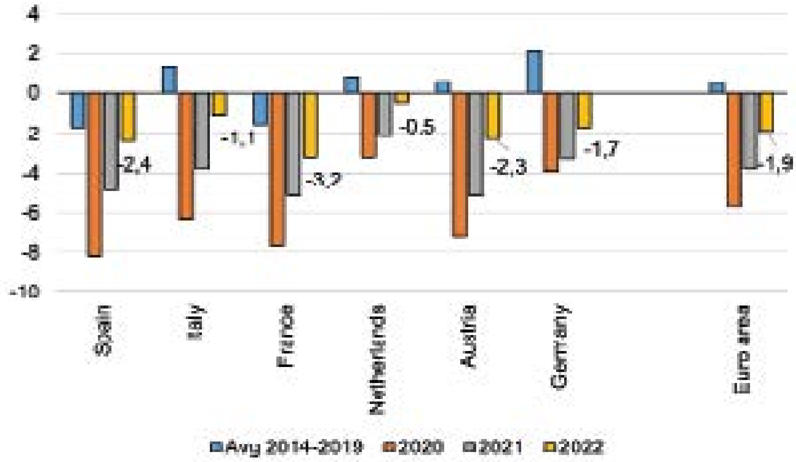
A recomposition of public finances focusing on the nature of spending is therefore urgent and essential in highly indebted European countries. The climate and digital transition will indeed have a significant cost for the public finances of states. But this effort must be undertaken by redirecting current expenditure (unproductive) towards investment expenditure (productive). Reforming the Stability and Growth Pact is an urgent necessity and has to take into account this objective[15].

Only productivity enhancing, and supply side-oriented reforms can foster productivity and growth, neither negative real rates, nor QE.

13. For those who support this analysis, the steady decline in real interest rates observed over the past 40 years is the result of excess savings compared to low investment and high demand for risk-free assets, leading to a lower equilibrium rate.
14. O. Blanchard, "Secular Stagnation is not over", PIIE, 24 January 2023.
15. J. de Larosière & D. Cahen, "Reforming the Stability and Growth Pact" – February 2022 (available in the Eurofi Regulatory Update – February 2022.

Annex

CHART 1.
General Governement Primary Budget Balance, % of GDP



Source: Eurostat, EU Commission's Automn Forecast (November 2022)
Notes: Labels relate data for 2022 ; data for 2022 are taken from the EU Commission's forecasts of November 2022

CHART 2.
Change in the level of Gross Public Debt to GDP ratio between 2007 and 2021, breakdown by components

Source: J. Castillo, « Italy once again in the eye of the storm», Special Report, Natixis Economic Research, June 2022

TABLE 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)		
	2008	2013	Q2-2022	2008	2013	Q2-2022	2008	2013	Q2-2022	2008	2013	Q2-2022
United States	66,1	96,2	113,4	168,8	150	155,1	72,5	67,5	79,5	96,3	82,5	75,6
United Kingdom	50,8	85,3	101,3	184,8	166,3	150,2	90	77,8	66,3	94,8	88,5	83,9
Japan	145,1	194,3	233,6	163,8	159,5	187,4	103,6	98,2	118,5	60,3	61,3	69
China	27,1	37,3	75	111,9	170,8	220,3	93,9	137,5	158,7	17,9	33,3	61,6
Euro area	69,8	93	94,3	157,2	163,3	167,2	96,5	101,8	108,5	60,7	61,5	58,7
France	68,8	93,3	113,3	164,2	181,1	231,2	116,2	125,6	164,7	48,6	55,5	66,5
Germany	65,8	78,2	67,4	129,9	124,3	128,3	70,1	68,8	72,3	59,8	55,6	55,9
Italy	106,2	132,5	150,1	116,5	125	112,8	77,5	81,7	70	39	43,3	42,8
Spain	39,7	100,5	116,4	214,2	202	155,3	131,6	124,3	98,7	82,6	77,7	56,6
Netherlands	54,7	67,7	50,9	234,7	280,3	240,9	123,2	164,1	142,2	111,5	116,3	98,7
Austria	68,7	81,3	82,8	142,5	146,6	148	90,5	95,6	97,9	52	51	50,1
Portugal	75,6	131,4	123,3	206,3	220,1	161,5	117,4	134	97,8	88,9	86,1	63,6
Belgium	93,2	105,5	106,9	192,1	205,1	199,8	142,2	148,7	139,3	49,9	56,4	60,5

Source: Bank For International Settlements