Addressing indebtedness in the European Union

Note written by Didier Cahen and Alicia Valroff

Executive summary

Even before the Covid-19 and the energy crises, global debt was at an all-peacetime record. According to the BIS, global debt has risen from 173% of GDP in 2001 to 240% in 2023. This 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 have not been 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 excess of debt by questioning public budgets, giving priority to qualitative expenditure for the future and the undertaking of 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 achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament. The goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies. Indeed, according to this Ecofin Council compromise, countries that are subject to an excessive deficit procedure (total public deficit over 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 if the worst performers in a class were exempt 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 to be the case, the logical outcome could well be a new and inevitable Eurozone crisis.

•

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 public debt in several EU countries had not been so high.

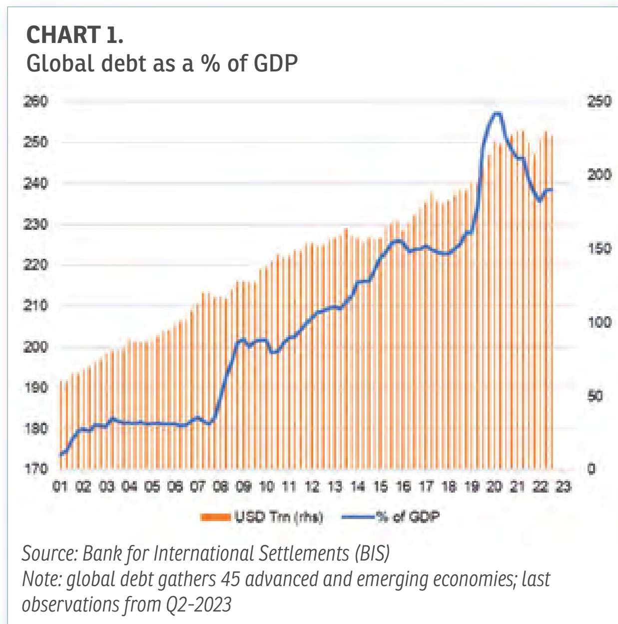
Even before the Covid-19 and the energy crises, global debt was at an all-peacetime record as evidenced by Chart 1. Indeed, the continuation of very low interest rates during the past two decades has pushed many advanced countries to implement active fiscal policies and economic agents to borrow more. Indeed, 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% – debt has grown by one third compared to the pre-crisis level.

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 have not been respected by some large Member States.

The Maastricht Treaty specifies reference values – known as The Maastricht criteria – for the general government sector of the various EU Member States: government deficit should not exceed 3% of the GDP, and government debt should stay below 60% of the GDP. 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 Eurozone with public debt-to-GDP ratios of 117% and 115% respectively.

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 Q2-2023

Since then, the European Union has accepted that debt could be inexorably rising in many Member States. In the Euro area, the divergence in public debt levels has become a major concern. While negative interest rates ensured the sustainability of European countries' public debts in the short term, the absence of structural reforms to gradually reduce these public debt-to-GDP ratios in the long run may lead to economic decline and call into question the future of the Eurozone.

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 – and even negative – interest rates, and eventually to ask future taxpayers to bear a large part of the costs that the present generation refuses to assume.

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

This paper focuses on public and private indebtedness issues in the European Union. The first part of this paper shows that European economies – be they part of the Euro area or not – are characterized by significant public and private debt divergences. The second aims at explaining how public and private debt levels got out of control in many European countries, especially large Member States. The third part outlines the different issues brought about by excessive public and private debt levels, while the last part explores the potential solutions that would enable highly indebted countries to recover 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

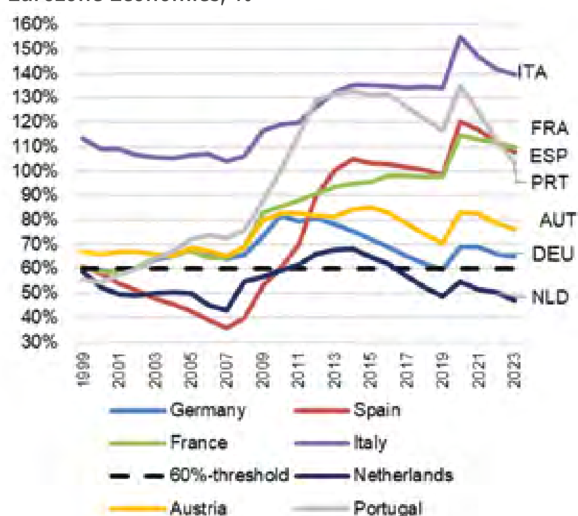
At the end of 2023, public debt has reached a very high level in a small set of mainly large European countries.

Despite the different reforms decided in the wake of the sovereign debt crisis (European Semester, Six pack, Two pack, Treaty of stability, coordination and governance in the Economic and Monetary Union), the public debt-to-GDP ratio has continued to grow steadily in significant countries of the Euro area (*e.g.* France, Italy, Belgium, Spain, Portugal) and is approaching – and even sometimes exceeding – 110% of GDP in certain Member States (*see Chart 2*)[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 about 60% or less[2].

In 2023, 14 countries in the EU had a public debt-to-GDP ratio below 60% (Estonia, Bulgaria, Luxembourg, Sweden, Denmark, Lithuania, Latvia, Czech Republic, Ireland, Romania, the Netherlands, Poland, Malta, and Slovakia). However, two countries had a public debt exceeding 130% of their GDP: Greece (160.9%), Italy (139.8%). Portugal,

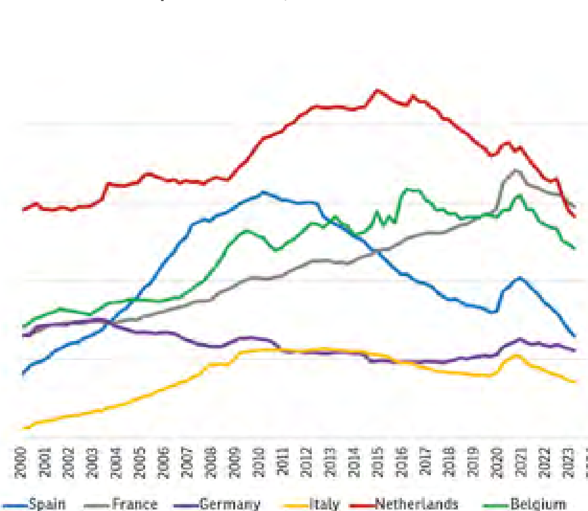
1. Between 2008 and 2022, gross public debt-to-GDP ratio increased by 38.2 pp in Italy, 42.5 pp in France, 20 pp in Spain and 11.6 pp in Belgium.
2. Gross public debt-to-GDP ratio increased by 1.7 pp between 2008 and 2022 in Germany, and by 3.9 pp in the Netherlands.

CHART 2.
Evolution of Gross Public Debt to GDP ratio in Major Eurozone Economies, %



Source: EU Commission; Data for 2023 are taken from EU Commission's Autumn Forecasts of November 2023

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



Source: BIS
Last observation from 2023-Q2

France, Spain, and Belgium also had high public debts, exceeding 100% of their GDP (respectively 103.4%, 109.6%, 107.5% and 106.3% of GDP), well above the average of the 27 countries (83.1%), while Germany and the Netherlands showed respectively 64.8% and 57.1%.

Chart 2 shows a surge in government debt in all countries – whatever their level of indebtedness – due to the Covid-19 crisis. However, debt has marginally 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. Besides, the energy crisis has not widened the gap between Member States' public debt-to-GDP ratios, though the latter have stabilized at elevated levels in many EU countries[3].

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 over the past years as evidenced by Chart 3[4].

In France, private debt has increased from 181.1% of GDP in 2013 to 226.1% in March 2023 according to the BIS.

By contrast, private debt fell significatively in Spain from 202% of GDP in 2013 to 140.9% in March 2023 following the deleveraging of companies and the deflation of the real estate bubble. It also decreased in Italy from 125% of GDP to 107.8% and increased slightly in Germany from 124.3% to 126.4% over the same period.

Although the level of French private debt remains lower than that of the Netherlands until Q4-2022 as share of GDP, it should be noted that the Netherlands' private debt decreased by 48.2 pp in 2023 compared to 2013 while it increased by 47.1 pp in France in the meantime. Since Q1-2023, the private debt of the French NFCs has exceeded the Dutch's one, after the latter fell by an additional 10 pp between Q4-2022 and Q2-2023.

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

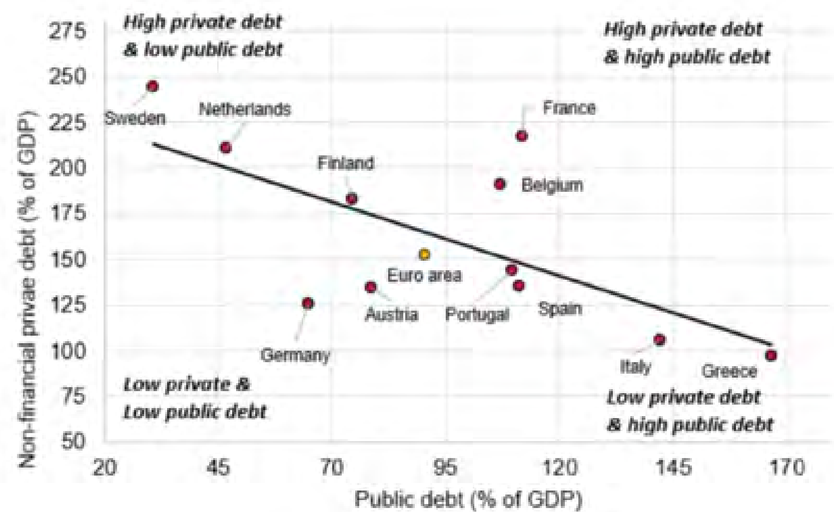
As underlined above, private and public debt levels vary across EU Member States, and debt profiles fall into four categories that are observable on Chart 4.

The first category gathers countries that have both low public and private debts, namely Germany and Austria below Eurozone average.

The second category encompasses countries that have high public but low private debts. This category includes Italy, Greece, Spain and Portugal, which are among the countries with the highest public debt-to-GDP ratios in the Euro area while their level of private debt is below the Euro area average.

3. See 2.1.4.
4. It must be acknowledged that private debt has often increased due to the indebtedness of non-financial corporations than of households since 2010; see Appendix 1.

CHART 4.
Private debt v. public debt across selected Euro area Member States, as of Q2-2023



Source: BIS

The third category encapsulates countries that have low public but high private debts. The Netherlands, Finland and other EU Member States that are not part of the Euro area like Sweden fall into this category. For instance, the level of Dutch public debt is one of the lowest in the Euro area – 48.4% of GDP in Q2-2023 – while that of the private sector ranks among the highest with 215% of GDP.

The fourth category is made of countries that have both high public and private debts. It includes France and Belgium which have respectively a public debt of 112.5% and 107.4% of GDP and a private debt of 226.1% and 193.9% of GDP, well above the average for both public and private debt in the Euro area (152.1% of GDP). This category is more exposed to challenges linked to the rise in interest rates; all economic agents – be they public or private – are more vulnerable to the macro-economic and monetary changes. The threats of a financial crisis are all more important in such countries, especially since potential growth is low.

2. How did we get there?

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

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

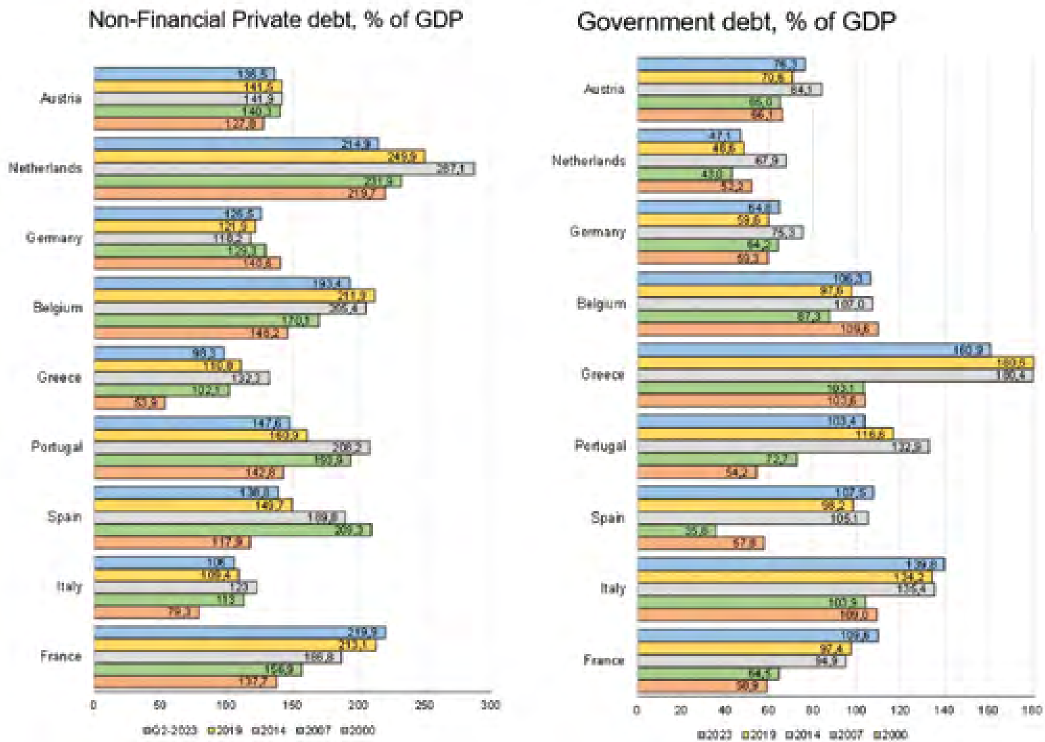
Chart 5 and the following sections aim at providing a chronological understanding of diverging debt trajectories in EU Member States. The first section focuses on the period 2000 and the EU sovereign debt crisis by showing that, despite the fact that most Eurozone countries met the Maastricht fiscal criteria until 2007, public debt levels soared in all parts of the EU in the wake of the Great Financial Crisis (GFC) and the EU sovereign debt crisis.

The second section studies the increase in Member States' fiscal heterogeneities between 2014 and 2019, while the third section shows that these fiscal heterogeneities have been exacerbated by the Covid-19 crisis. Section 4 shows that the divergences in terms of 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 Even though most Eurozone countries complied the Maastricht fiscal criteria between 2000 and 2007, their public debt soared with the Great Financial Crisis and the EU sovereign debt crisis

Before the subprime crisis, with a few exceptions, fiscal deficits were relatively limited (*see Chart 6*). Thus, in the period preceding the crisis (2000-2007), the fiscal balance was, on average, positive in

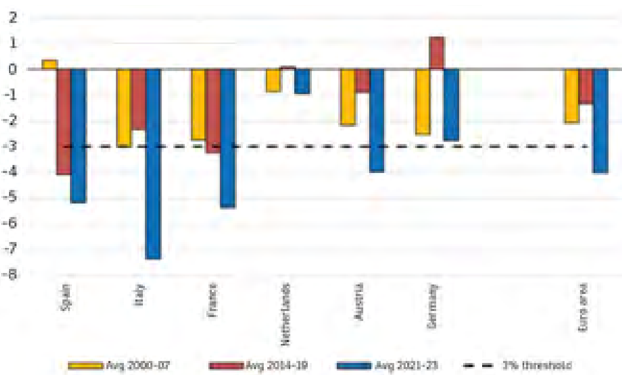
CHART 5.
Government and private sector debt across selected Eurozone Member States since 2000, % of GDP



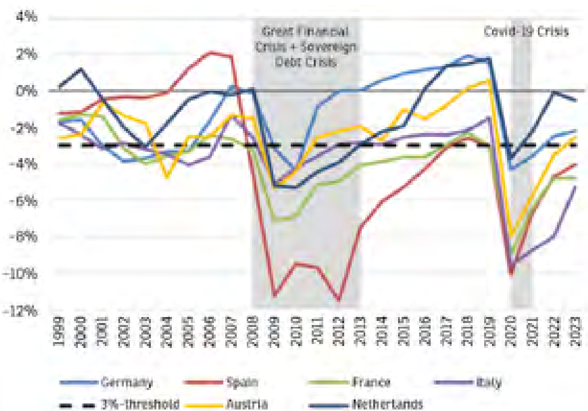
Source: BIS, EU Commission's Autumn Forecasts (November 2023)

CHART 6.
Total Budget Balance across the main EU Member States since 1999, % of GDP

6a. An average over selected non-crisis periods



6b. Since 1999



Source: EU Commission

Ireland (1.4% of GDP) and Spain (0.4%)[5]. It should be noted, however, that both countries' government revenues were kept artificially high by tax revenues generated by with a real estate boom. In contrast, fiscal balances were negative in Austria (-2.2%), Germany (-2.5%), France (-2.7%) and Italy (-3%), but only Greece (-6.4%) did exceed the Maastricht criterion of 3%.

When the crisis broke out in 2007, public debt-to-GDP ratios soared, especially in Southern Europe countries, as evidenced by Chart 5. For instance, Spain had a public debt of only 35.8% of its GDP; in 2013, its debt reached 100.5%. In Ireland and Greece, over the same time period, the debt-to-GDP ratio rose from respectively 23.9% and 103.1% to respectively 119.6% and 178.2%. Countries of Southern Europe have been particularly hit by the GFC because of "sudden stop" in capital flows: over the period 2000-2007, they benefited from massive foreign capital flows, which suddenly stopped in the aftermath of the collapse of Lehman Brothers.

As a consequence of the GFC, growth fell in every part of the world, leading public debt-to-GDP ratios to mechanically increase. Additionally, "the

5. Data for Ireland and Spain are from R. Baldwin & F. Giavazzi, "The Eurozone Crisis A Consensus View of the Causes and a Few Possible Solutions", CEPR Press (2016).

governments also supported the financial system by increasing deposit insurance ceilings, providing guarantees for bank liabilities, and recapitalizing banks being bailed out or wound down. In addition, they implemented fiscal measures to reduce the fall-out of the crisis on the rest of the economy. This resulted in a mix of 'automatic stabilizers' (decreasing tax receipts coupled with increased government welfare payments as the economy slows down) and targeted discretionary fiscal measures, such as tax relief and subsidies for part-time employment. These actions let to a dramatic escalation of public debt"[6]. For instance, the Spanish government debt has tripled from 35.8% of GDP in 2007 to 105.1% of GDP in 2014 (*see Chart 5*).

Such increases have cast doubt upon the ability of governments to sustain large debt burdens; higher debt-service costs combined with a plummeting GDP made many investors suspect that several Member States' debts might be unsustainable. Indeed, EGOV explains that "the [Sovereign debt] crisis occurred as a result of soaring public debt: it was triggered when the under-reporting of the Greek public debt and deficit was revealed in 2009. A domino effect followed owing to a massive loss of confidence on the part of financial markets in the creditworthiness of several other Member States. Ireland and Spain came under scrutiny owing to negative effects caused by the bursting of real estate bubbles and the increasing public debt used to bail out banks. Portugal owing to a large and increasing macroeconomic imbalances, and Cyprus following a profound banking crisis"[7].

2.1.2 Fiscal heterogeneities across EU Member States have increased between 2014 and 2019

In low-indebted Member States such as Germany, the Netherlands and Austria, enhanced growth and primary surpluses contributed to maintain healthy public finances.

In 2019, after several years of efforts to reduce their general government deficit and debt, the Netherlands and Germany brought back their public finance stance in line with EU fiscal rules. Indeed, between 2014 and 2019, they ensured an average public surplus of respectively 1.3% and 0.1% of their GDP per year. Such fiscal efforts resulted in a gradual reduction and a stabilization of their public debt, at respectively 59.6% and 48.6% of GDP in 2019, from 75.3% and 67.9% in 2013. Austria also made such efforts over that period, contributing to reducing its public debt burden to 70.6% of GDP in 2019, down from 84.1% in 2013 (*see Chart 5*).

In countries where debt exceeds 100% of GDP, public debt trajectories have been heterogeneous between 2014 and 2019.

Over the period running from 2014 to 2019, a period characterized by economic stability, some EU Member States still saw their public finances deteriorate, or at least did not see significant improvements. It is the case of France, Italy, Spain, Belgium, Portugal and Greece (*see Chart 5*).

First of all, some EU Member States such as France and Spain deviated permanently from the fiscal rules established by the Stability and Growth Pact. The French debt rose from 94.9% of GDP in 2014 to 97.4% of GDP in 2019, and this is due to the accumulation of yearly fiscal deficits. Indeed, the total deficit of France between 2014 and 2019 averaged 3.2% of GDP per year, exceeding the 3%-threshold decided by the Maastricht fiscal rules. Over the period 2014-2019, Spain also had yearly fiscal deficits exceeding 3% of GDP: namely Spain's deficits averaged 4.1% of GDP per year between 2014 and 2019, and were rarely below 3% except in 2018 (2.6% of GDP). Yet, its public debt has been reduced a little, from 105.1% of GDP in 2014 to 98.2% in 2019 mainly thanks to denominator effect (high nominal GDP growth), which mechanically reduced its public debt-to-GDP ratio.

Second of all, other EU Member States like Italy and Greece have been more rigorous and have accumulated primary surpluses. Nevertheless, their fiscal efforts have been insufficient to compensate low growth and high debt-servicing costs. Indeed, over the period 2014-2019, Italy and Greece had average primary surpluses of respectively 1.6% and 2.3% of GDP per year, but this was insufficient to compensate for (i) large debt-servicing costs amounting to respectively 3.9% and 3.4% of GDP and (ii) stagnant growth, which averaged respectively 0.9% and 0.7% per year. As a result, public debt in Italy was only reduced by 1.2 pp in 5 years, and the Greek public debt stabilized at about 180.5%.

Eventually, other heavily indebted countries such as Belgium and Portugal managed to reduce their public debts thanks to enhanced growth and primary surpluses. Indeed, over the period 2014-2019, Belgium and Portugal were among the countries that had the most dynamic real GDP growth, averaging respectively 1.8% and 2.3% per year – which is close or above the growth of Germany (1.8%) and France (1.5%). Moreover, the two countries both accumulated primary budget surpluses with respective average of 0.6% and 1.1% per year between 2014 and 2019. Additionally,

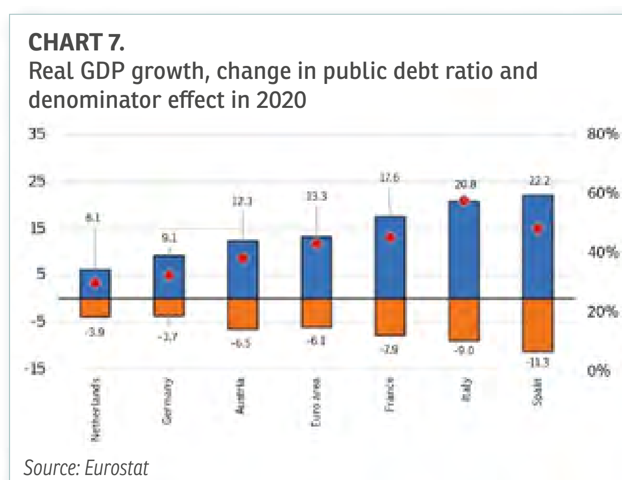
6. "A decade on from the crisis", EGOV, 2019.
7. Op. Cited think tank of the European Parliament.

Belgium benefitted from an relatively higher inflation of 1.6% – which was of the same magnitude as that of Germany (1.8%) and above that of France (0.8%) and Italy (0.9%). Consequently, the public debt of Belgium went from 107% in 2014 to 97.6% in 2019, while Portugal saw its debt decrease from 132.9% in 2014 to 116.6% in 2019.

2.1.3 The Covid-19 crisis has exacerbated the already existing fiscal heterogeneities

EU countries that have best managed their public finances after the GFC and the EU sovereign debt crisis are those that have suffered the least economically from the Covid-19 shock. By contrast, 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.

CHART 7.
Real GDP growth, change in public debt ratio and denominator effect in 2020



Source: Eurostat

As observable in Chart 7, France, Italy and Spain have been the most severely hit in terms of output shortfall in the Euro area. In 2020, real GDP in Spain collapsed by 11.3%. It fell by 9% and 7.9% in Italy and France, respectively. With public finances already deteriorated on the eve of the crisis, these three countries registered the strongest increase of their public debt-to-GDP ratio between 2019 and 2020. Spain experienced the highest rise (+22.2 pp, against 13.3 pp of the Euro area). Italy and France followed, as their public debt grew by 20.8 pp and 17.6 pp respectively. These figures are twice as high as those experienced in the Netherlands (+6.1 pp) and Germany (+9.1 pp) between 2019 and 2020.

Accordingly, the Covid-19 has worsened the fiscal heterogeneities across Member States in terms of public debt-to-GDP. Five EU Member States saw their public debt exceeding 110% of GDP in 2021: Greece (194.9%), Italy (147.1%), Portugal (124.5%), Spain (116.8%) and France (112.9%). By contrast, eighteen countries kept their ratios below 75% of GDP in 2021. Among them are Germany, the Netherlands and Finland which had their public debt-to-GDP ratios hovering respectively at 69%, 51.7% and 72.5% of their 2021 GDP. Compared to 2019, the public debt-to-GDP ratios prudently increased by 3.1 pp in the Netherlands and 9.4 pp in Germany.

2.1.4 The war in Ukraine has not accentuated divergences in terms of fiscal deficits and public debt between Member States, but public debt-to-GDP ratios have stabilized at high levels in many EU countries in 2022 and 2023

Economies of the EU have been affected differently by the war in Ukraine as inflation pressures have intensified. But divergences in terms public debts have not increased across Member States, despite large levels of fiscal deficits maintained by several Member States in 2022 and 2023. One reason is that GDP growth has rebounded; another the is that inflation was high, mechanically leading the public debt-to-GDP ratio to decrease in the short run.

In such an economic context, for 2022, the ratio decreased marginally in France from 112.9% of GDP in 2021 to 111.8% in 2022. It fell by 5.2 pp in Spain (from 116.8% to 111.6%), and by 5.4 pp in Italy (from 147.1% to 141.7%) according to the EU Commission[8].

Though debt-to-GDP ratios have stabilized, important heterogeneities were observable in fiscal imbalances. In 2022, fifteen Member States have experienced a deficit higher than 3% of GDP. Spain experienced a fiscal deficit of 4.6% in 2022 while it exceeded 5% of GDP in France (-5%), Italy (-5.1%), and Belgium (-5.2%). By contrast, fiscal deficits in Germany (-2.5%) and the Netherlands (-2.7%) should remain below 3% of GDP.

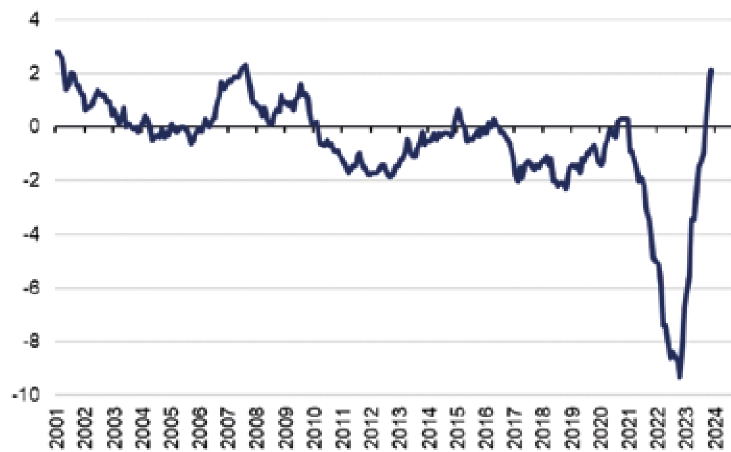
2.1.5 Did private debt trends follow the same path as public debt in EU Member States?

Several trends are observable regarding the trajectories of private debt levels in the EU over the period running from 2000 to 2023 (*see Chart 6*).

As observable on Chart 6, the "GIPS" (Greece, Italy, Portugal, Spain) saw their private debt increase significantly between 2000 and 2007; for instance, the Spanish private debt nearly doubled from 117.9% of GDP in 2000 to 209.3% in 2007. Excessive private debt levels – which was in certain cases, such as Spain, closely linked to real estate bubbles – has been a source of financial vulnerabilities which materialized during the GFC.

8. 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 ratios in Spain is all the more significant as in France, where the primary deficit of 2.8% of GDP in 2022 was much higher than in Spain (-1.6%), for instance.

CHART 8.
Real refinancing rates in the Euro area (policy rate minus inflation rate), % points



Source: BIS

Between 2013 and 2023, private debt levels in the GIPS have been on a downward trend but stabilized in Q2-2023 at levels higher before the GFC (*see Chart 5*). For instance, the Spanish private debt decreased from 209.3% in 2007 to 189.8% in 2014 and 138.8% in Q2-2023 (compared to 117.9% in 2000), and the Portuguese private debt peaked to 208.2% in 2014 from 193.9% in 2007, and then decreased to 147.6% in Q2-2023 which is still higher than its 2000 level of 142.8%.

In Austria and Germany, private debt seemed to have followed the path of public debt by remaining low comparatively to other EU Member States. Chart 5 shows that German private debt stabilized around 125% of GDP between 2000 and 2023 and private debt in Austria remained around 140% over the same period.

However, private indebtedness has remained high in France, the Netherlands and Belgium. France and the Netherlands have private debt levels among the highest in the Eurozone, and even in the world. While private debts of France and the Netherlands in 2023 stood at similar levels (respectively 219.9% and 214.9% of GDP), the French one was up by nearly 40 pp from 166.8% in 2014 while the Dutch one was down by more than 70 pp from 287.1% in 2014. In that regard, one can say that both French and Dutch private debts have followed the trend of their public debts. And even though the Dutch trajectory is encouraging, Dutch private debt at Q2-2023 remains nearly 40 pp above the average private debt of advanced economies (161.5%)[9].

Eventually, Belgium has managed to slightly reduce its private debt from 211.9% of GDP in 2019 to 193.4% in 2023, after having continuously increased from 146.2% of GDP in 2000.

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 explains to a large extent this public debt overhang

The monetary policy has created favorable conditions for Member States to accumulate debt for 2 main reasons. The first is that real interest rates have been most of the time negative between 2000 and 2023 (*see Chart 8*), maintaining favorable financial conditions for borrowing.

The second reason is the ECB's balance sheet policies, which has led it to purchase government securities massively, in particular since 2015. Initially decided in the context of the GFC and the EU sovereign debt crisis, these non-conventional policies were not removed once the crises ended.

One key illustration has been the launch of the Asset Purchase Program (APP): the ECB decided to embark in a massive asset purchase program. Launched in January 2015, it aimed at purchasing public and private securities at a monthly pace of €60 bn, as part of the APP.

What favored over indebtedness is that in the non-crisis period running from 2014 to late-2019, non-conventional policies have not been stopped, quite the opposite insofar as the ECB announced its Quantitative Easing policy (QE) in 2015. By pursuing non-conventional policies in a period of stability, the ECB contributed to the monetization of the debt and central banks have de facto become the agents of fiscal policies.

9. See Appendix 1.

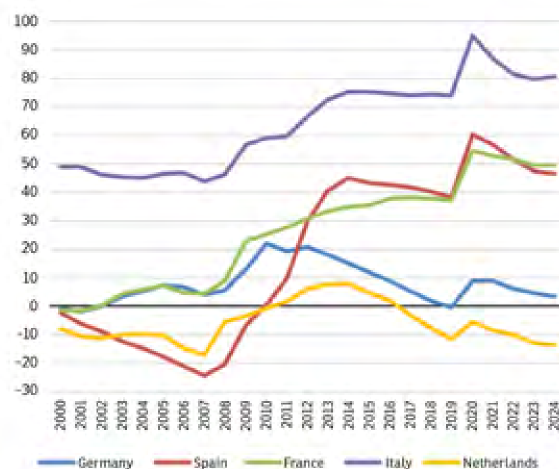
In the wake of the pandemic, this whole configuration has been exacerbated: the Governing Council decided in March 2020 to launch the Pandemic Emergency Purchase Program (PEPP) on top of the already existing APP, which had a total intended envelope of €1,850 tn. Thus, the Eurosystem had a leading role 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. Consequently, 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 absorbed the entire public debt issued in 2021, but it also repurchased part of the debt that matured in 2021[10].

The purchase of sovereign bonds since 2015 has led the Eurosystem to hold more than a third of the Euro area's public debt in 2023. 26.8% of the French public debt and 25.7% of the Italian debt were held by the Eurosystem in June 2023. 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 obeyed by many large European countries (France, Italy, Spain...) which has contributed to their over-indebtedness.

The outcome of the diverging debt trajectories since 2000 is that the deviation of levels of public debt to the 60%-threshold enshrined in the Stability and Growth Pact has significantly diverged between Euro area Member States. Indeed, Chart 9 shows that in 2000, Spain, France and Germany had similar public debt levels (around the 60%-threshold). In 2023, France and Spain have public debts' 50 pp above this threshold (*i.e.* their debts exceed 105% of GDP) while Germany's public debt only exceeds the threshold by 3 pp. Regarding Italy, its debt was already 40 pp above the 60%-threshold when it joined the Eurozone in 1999; in 2023, this gap has increased to 80 pp.

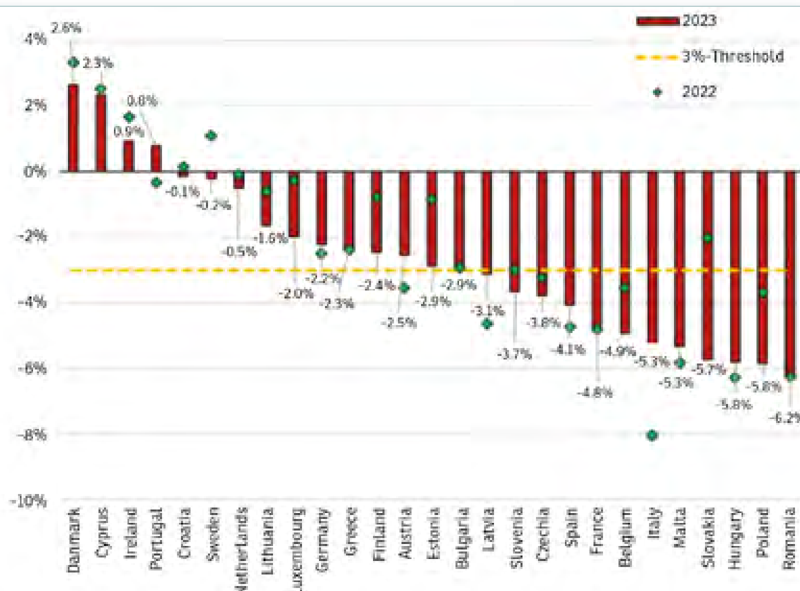
CHART 9.
Gross public debt-to-GDP ratio, deviation from the 60%-threshold across the major Eurozone (percentage points)



Source: EU Commission's Autumn Forecasts (November 2023)

The fiscal rule enshrined in the Stability and Growth Pact is the 3%fiscal threshold. Similarly, repeated failure to comply with this rule by Member States is obvious (see Chart 10). Out of the 27 Member States, only 4 showed primary surpluses in 2023, and 12 experienced deficits exceeding 3% of GDP, – among them Spain (-4.1%), France (-4.8%), Belgium (-4.9) and Italy (-5.3%).

CHART 10.
Total budget balance in 2023, % of GDP



Source: EU Commission's Autumn Forecasts (November 2023)

10. See 2.4 of Eurofi Monetary Scoreboard, September 2023.

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the European Union 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, hence the need for fiscal coordination.

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

This part aims at highlighting 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. Parallelly, excessive private debt levels pose a threat to financial stability in Europe. Furthermore, both public and private over-indebtedness is a barrier to productive investments. Additionally, over-indebted EU Member States 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 low growth

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

The variation of the debt in a specific country is explained by its primary budget balance, the difference between r and g and its level of public debt for the precedent period[11] which determines the debt service costs[12]. As a result, creditors are attentive to:

- The potential growth and income available to the sovereign to meet its debt obligations,
- The average interest rate on the stock of debt issued by the government compared to the capacity to raise tax,
- The primary budget balance which will increase the debt in case of deficit or reduce it in case of surplus; the higher the debt, the greater the primary surplus required.

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

- The total amount of public debt and especially 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 nature of the expenditure financed by the debt (infrastructure and social expenditure having different effect 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 servicing costs have followed a paradoxical trajectory in indebted countries between 2012 and 2021: while debt has risen, or stabilized at high levels, interest expenses on debt has fallen as a proportion of GDP, thanks to the ECB's ultra-accommodating monetary policy.

This is particularly visible in France:

- In the years preceding the GFC (2004-2008), the public debt ratio averaged 66.2% and the interest burden 2.7%.
- In the pre-Covid-19 years (2014-2018), the debt ratio continued to rise (97%) and the interest burden to fall (1.4%).
- By 2021, the debt ratio had jumped to 114.6%, while interest expense had further fallen to 1.3%.

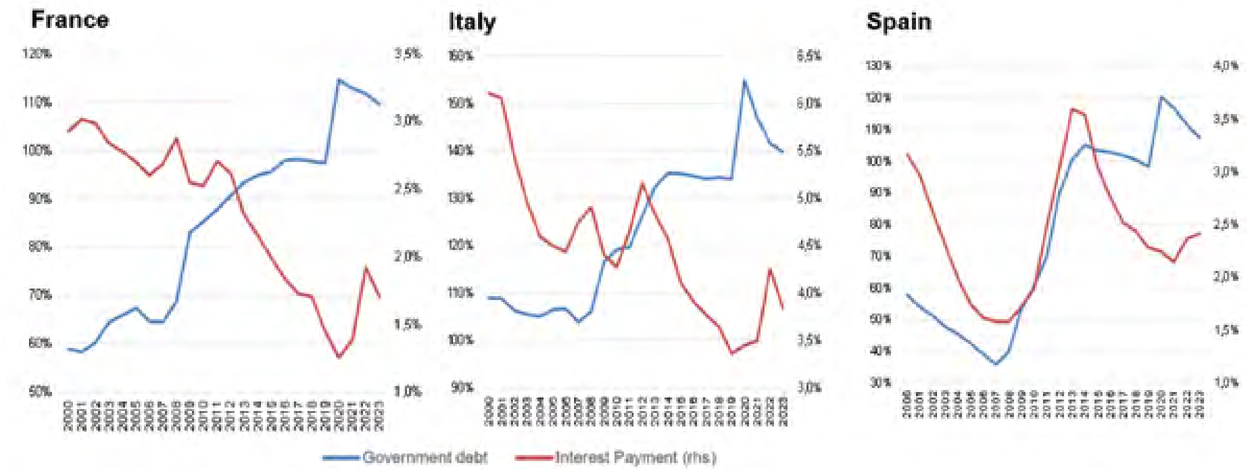
Underlying all this is a continued decline in the implicit rate on debt, from an average of 4.1% in 2004-2008 to 1.1% in 2020. According to BIS data, the real (inflation-adjusted) interest rate on 10-year government bonds has fallen from 5.9% on average 1984-1995 to -0.6% for the period 2013-2023, and to -3% for the years 2021-2023 alone (-2.4 in June 2023).
This also applies to other indebted countries, such as Italy and Spain (*see Chart 11*).

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"[13].

Since 2022, debt servicing costs have been increasing alongside the increase in market

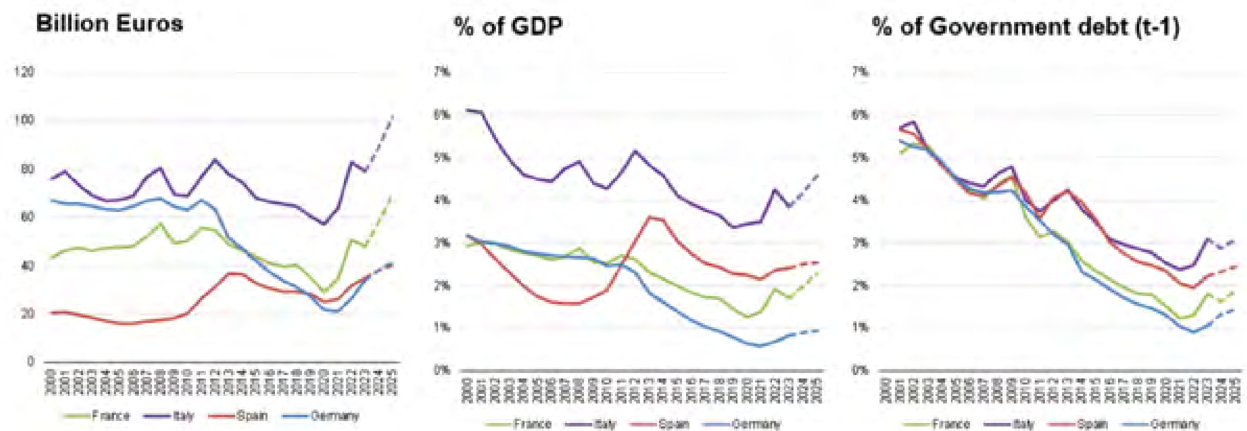
11. The precedent period (t-1) can be a year, a quarter, a month… depending on the chosen reference period (t).
12. See 4.1.
13. Op. Cited P. d'Arvisenet and see Eurofi Monetary Scoreboard.

CHART 11.
Government debt and interest payments, % of GDP across key indebted Member States



Source: EU Commission
Notes: data for 2023 are projections taken from the EU Commission's Autumn Forecasts (November 2023)

CHART 12.
Debt service costs according to different metrics across key EU Member States



Source: EU Commission
Notes: Data for 2023 & 2025 are projections taken from the EU Commission's Autumn Forecasts (November 2023)

interest rates and will be a cause for concern for the next few years in over-indebted countries.

In France, debt servicing costs rose from €35 bn in 2019 (1.4% of GDP) to €48 bn in 2023 (1.7% in 2023). French current interest burden is at its highest level since 2007, and it exceeded the defense budget in 2023 (€43.9 bn). Projected at €69.5 bn euros in 2025 by the EU Commission, debt servicing costs are set to become the government's biggest budget item, ahead of education (€63.6 bn).

Spain and Italy have also seen sharp increases in their debt servicing costs since 2022. In 2023, the Italian government allocated €79.1 bn to servicing its debt, compared with €60.4 bn in 2019. The cost should exceed €100 bn in 2025, according to the Commission's forecasts. In Spain, €34.1 bn were earmarked for interest payments in 2023, up on 2019 (€28.4 bn). The amount is expected to reach €40.2 bn in 2025 (*see Chart 12 and Table 1*).

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 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 re-pricing risk.

Additionally, 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, as it is the case nowadays.

TABLE 1.
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	35,3	48,1	69,5	1,4%	1,7%	2,3%	1,5%	1,6%	2,2%
Germany	27,4	34,1	41,5	0,8%	0,8%	0,9%	1,3%	1,3%	1,5%
Italy	60,4	79,1	101,6	3,4%	3,8%	4,6%	2,5%	2,9%	3,4%
Spain	28,4	35	40,2	2,3%	2,4%	2,5%	2,3%	2,3%	2,5%
Austria	5,6	5,8	7,6	1,4%	1,2%	1,4%	2,0%	1,7%	2,0%
Netherlands	6,2	7,7	8,6	0,8%	0,7%	0,8%	1,5%	1,6%	1,7%
Portugal	6,3	5,4	6,7	2,9%	2,0%	2,3%	2,5%	2,0%	2,4%
Belgium	9,5	10,9	14,2	2,0%	1,9%	2,2%	2,1%	1,9%	2,2%

Source: EU Commission
Notes: Data for 2023 & 2025 are projections taken from the EU Commission's Autumn Forecasts (November 2023)

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

Non-financial private sectors are challenged by a rising debt-service costs, and higher funding costs spur corporate default.

As underlined by the ECB's financial stability review[14], "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".

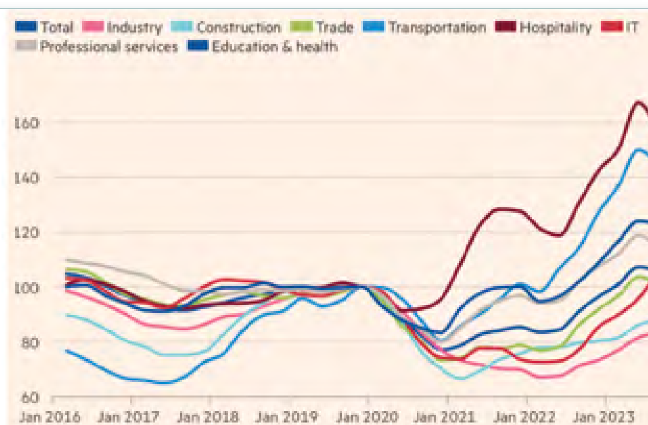
Manifestations of the financial stability risks in Europe have been illustrated by a recent article by V. Romei and Chart 13[15]. For instance, "Germany, the EU's largest economy, said bankruptcies rose 25 per cent from January to September 2023 compared with the year-ago period. Since June 2023, monthly "double-digit growth rates have been consistently observed compared to the previous year". Moreover, Eurostat estimates that "across the bloc, corporate insolvencies rose 13 per cent year on year in the nine months to September 2023 to reach their highest level in eight years".

Chart 13 also evidences that the labor-intensive hospitality, transportation and retail sectors have been hit the hardest.

Financial stability risks are also triggered by the excessive debt level of some households has emphasized by the ECB: "Euro area households, especially those with lower incomes and in countries with mainly floating-rate lending, are increasingly being challenged by higher interest rates. Resilient labor markets as well as government support measures and excess savings accumulated during the pandemic have so far mitigated Euro area household vulnerabilities.

However, real household incomes and consumption remain under pressure, especially in the lower income segments. At the same time, higher interest rates have begun to feed through to higher debt service costs, notably in countries where the share

CHART 13.
Declarations of bankruptcies in the EU, by activity, Q1-2015 to Q3-2023
Seasonally adjusted data; 2015=100



Source: Eurostat

14. "Financial Stability Review", ECB, November 2023.
15. V. Romei, "Bankruptcies soar as high rates and end of Covid-19 aid hit businesses hard", Financial Times, 18 December 2023.

of variable-rate lending has historically been very high. Going forward, households may see their debt servicing capacity erode if energy prices soar again, interest rates remain higher for longer and/or labor market conditions deteriorate significantly"[16].

V. Romei concluded its article affirming that currently, "bankruptcy numbers remain modest by historical standards in big economies, including the US, Germany and France". However, the risk posed by over-indebtedness *vis-à-vis* financial stability is still looming as "higher debt service costs are increasingly challenging indebted firms, households and sovereigns, with the real economy impact of tighter financial conditions yet to fully materialize", hence the necessity to take meaningful measures to reduce indebtedness in the EU.

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 found that beyond a threshold of 90-100%, public debt has an impact on growth performance. However, it is important to analyze 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, over-indebtedness ends up impoverishing countries and lock them into a vicious circle.

In countries that have debt exceeding 90-100% of GDP and outstanding public spending ratios, it has become difficult to prioritize measures fostering productivity and public investment because they are hindered by public spending decided in the past and that have been automatically renewed for years[17].

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, except for Japan. Before the global financial crisis (2008), public investment levels were at around 4% of GDP in the Euro area. But, according to F. Panetta[18], 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 to 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 long-term projects and encourage them to hold on to their liquid assets. A saver is not going to finance a risky investment if they are not entitled to receive 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?

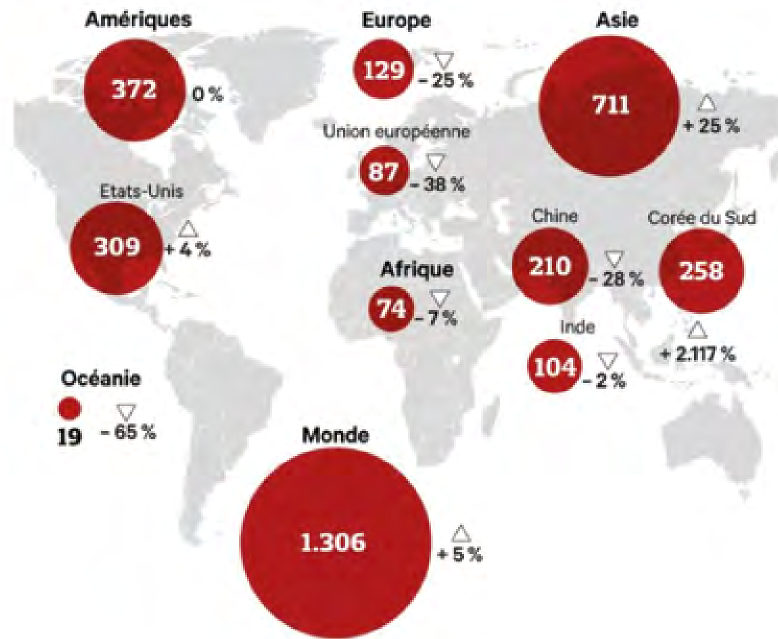
Excessive levels of private debt also burden productive investments.
A strong corporate sector is crucial for investment, innovation and eventually economic growth. Yet, high corporate debt has a negative impact on investment. Indeed, high corporate indebtedness implies higher interest expenses and thus 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[19], 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 €750 bn envelope to foster investment as well as growth and promote recovery and resilience in all EU Member States.

16. Op. Cited ECB.
17. Op. Cited J. de Larosière.
18. F. Panetta, "Investing in Europe's future: the case for a rethink", Milan, November 2022.
19. "Medium-term investment responses to activity shocks: the role of corporate debt", ECB Working Paper Series N°2751, November 2022.

CHART 14.
Distribution of investment by region
In $bn, between July 2022 and June 2023 compared with the period June 2021-June 2022:
△▽ evolution, in %



Source: Trendeo, Fives, McKinsey, extracted from Les Échos

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.

As observable on Chart 14, the EU is lagging in terms of investment, even more than 2 years into NGEU's lifetime. Investments in the US have increased by 4% over the period from July 2022 to June 2023 compared with the period June 2021-June 2022: this figure even reached -38% in the European Union (compared with the period June 2021-June 2022).

The results of the same research document[20] "question the capacity of the corporate sector to promote the recovery from the Covid-19 crisis via an increase in capital spending". Moreover, the war in Ukraine, the fight against climate change and the digital transition will also require large-scale corporate investments. Therefore, it is urgent that private debt also be under control to foster investment and, in the long-run, economic growth.

3.5 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 are not living up to the commitments they took when signing the Maastricht Treaty, namely, to contain their public debt-to-GDP under 60% and their public deficit under 3% of GDP.

As a result, the EU currently faces a deadlock. Indeed, heterogeneous economic situations make it hard 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. For instance, progress towards a genuine banking and Capital Markets Unions is hampered by the lack of trust among Member States that stems 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"[21].

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 levels of public debt generated by important public deficits constitute a burden on posterity, especially if these deficits are used to finance public spending and not productive investment as it is the case in France where public spending reaching 57.9% of GDP in 2022. It is not legitimate to make future taxpayers bear the burden of debt-servicing costs and honoring commitments

20. Op. Cited ECB Working Paper Series N°2751.
21. J. de Larosière, "EMU: myth or reality?", Keynote Address – Towards EMU 2.0: Hindsight and Prospects, 4 October 2023.

that have been made to finance important unproductive expenditures. Indeed, future taxpayers will also have to incur these public spending, but they will also more than ever need room for maneuver in terms of 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[22].

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 rely on inflation and monetary creation, but such a strategy is inefficient and even harmful in the long run. Another apparent solution would be to expect growth to continue to exceed interest rates; yet, uncertainty remains around the trajectory of these two variables.

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

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

The sustainability of public debt depends on its long-term trajectory which depends on fiscal policies – *i.e.* the accumulation of primary balances, and on the gap between the interest rate (r) and the activity growth rate (g).

The dynamic of public debt ratios depends on:

- The difference between the implicit interest rate (interest expenditure/debt) and the nominal GDP growth (real growth + inflation),
- The level of public debt as a percentage of GDP of the previous year,
- The primary budget balance, as a percentage of GDP.

This mechanism can be illustrated by the following equation:

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

with: b, the government debt to GDP ratio; r, the implicit interest rate (debt service cost/government debt at t-1); g, the nominal GDP growth; and d, the primary budget balance as % of GDP.

From equation (1), the stabilizing budget balance (-d*), *i.e.* the budget balance for which the debt/GDP ratio is constant between two periods, can be deducted. This balance is equal to the differential (r-g), multiplied by the debt-to-GDP ratio of the previous period. The following equation proves it:

$$b_t - b_{t-1} = 0 \longleftrightarrow d_t^* = b_{t-1} \times (r - g) \quad (2)$$

The difference (r-g) is thus the determinant of the dynamic of public debt. As described by P. d'Arvisenet[23], several configurations are to be considered 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* explained above in equation (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 provided that there is no primary deficit greater than -d*.

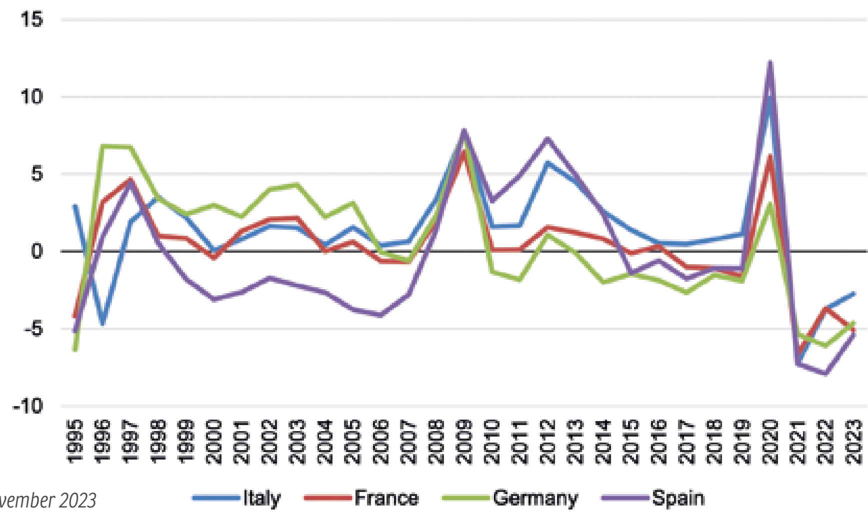
To understand this better, here is a numerical example to illustrate the dynamic of a public debt. Let's consider an implicit interest rate (r) of 4% and growth (g) of 2%. The primary budget surplus needed to stabilize a debt ratio of 50% is 1%, 2% for a debt of 100% and 3% for a debt of 150%. Conversely, 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%, 3% for a debt ratio of 150%.

But beyond that, as stressed by J. de Larosière[24], debt problems cannot be only addressed by accounting tricks. Rising debt levels raise key issues to both economy and society.

History has shown that r < g is not sufficient to ensure public debt control in the absence of a primary surplus. The analysis of the conditions that have enabled debt ratios to be reduced in the past after a major crisis indicates that successful

22. M. Pébereau, "Mieux gérer nos finances publiques", Académie des Sciences Morales et Politiques, 25 September 2023.
23. P. d'Arvisenet, "Maitriser l'endettement, enjeu de souveraineté et de prospérité", working paper, October 2023.
24. J. de Larosière, Roundtable: "jusqu'où financer l'emprunt ?", Fondafip Think Tank, 24 November 2023.

CHART 15.
(r-g) difference across key EU Member States since 1995



Source: EU Commission (Autumn Forecasts of November 2023

reduction episodes have relied on a combination of negative (r – g) spreads and primary surpluses.

Since 2015, most of the Member States have benefited from a negative (r-g) difference.
A few elements about the dynamics of (r-g) in France, Italy, Spain and Germany in recent years are worth noting:

- Apart from 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 (*see Chart 15*). Spain enjoyed a much higher nominal growth than the other members (7.7% v. 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 and 2007, and 1.8% between 2014 and 2019), which the fall in the interest payment was unable to offset (5% between 1999 and 2007 v. 3% between 2014 and 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 Eurozone. This dynamic continued in 2022, given the exceptionally high nominal growth due to inflation, while interest charges barely increased.

Table 2 shows that between 2014 and 2019, (r-g) was weaker in Germany than in France because, compared to France, Germany supports a lower debt service cost (r) for a higher nominal growth (g). Germany benefited from lower debt service costs than France (1.7% of public debt on average in Germany v. 1.9% in France). Additionally, nominal GDP growth was significantly higher in Germany than in France (3.6% in Germany v. 2.4% in France on average). The latter resulted from a higher real GDP growth (+1.8% in Germany v. 1.5% in France) and a higher GDP deflator in Germany (1.8% in Germany v. 0.8% in France).

TABLE 2.
Implicit interest rate on public debt (r) and current GDP growth rate (g) across key EU Member States

	r - g, percentage points			
	Italy	France	Germany	Spain
Avg 1999-2022	1,6	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	-7,2	-6,6	-5,4	-7,3
2022	-3,7	-3,7	-6,1	-7,9
2023	-2,8	-5,1	-4,6	-5,4

Source: EU Commission (Autumn Forecasts of November 2023)
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 level of (r-g) was much more negative in Germany than in France in 2022 for quite similar reasons. 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 domestic production price inflation), twice as high in Germany (+5.3%) as in France (+2.8%), contributed to explain this nominal growth difference between the two countries in 2022.

Comparatively to 2022, the level of (r-g) has been slightly reduced in 2023 in most EU Member States but remained well below the pre-pandemic level. This important difference between r and g reflects the particularly high level of nominal growth. The latter is enhanced by the deflator growth which exceeds the implicit interest rates. Thanks to the maturity of the debt, those are still moderate despite the rise in market interest rates. Contrary to its neighbors, France had in 2023 a wider differential (r-g) (-5.1 in 2023 v. -3.7 in 2022) because of the acceleration of the deflator compared to 2022 (+6.7% in 2023 v. +5.9% in 2022). These dynamics have remained favorable to the trajectory towards lower levels of debt in 2023.

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 to reduce public debt ratios. It is theoretically easier to stabilize 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-to-GDP ratio. However, the debt must not increase faster than GDP under the effect of the primary deficit and the interest burden.

Another argument often defended is that inflation boosts fiscal revenues in the short run (via taxes directly indexed to consumption, *e.g.* the tax on fossil fuels) while expenses are slower in adjusting. This difference improves the budgetary balance temporarily, thus reducing public debt.

But one should be careful with these arguments. After the WWII, inflation was high and 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 for reducing public debt ratios again, central banks would have to change their inflation targets, which would raise other structural problems: lasting high inflation slows down the economic activity. It makes the future more uncertain for economic agents and discourages them from investing and consuming, which 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 via the decrease of consumption while it increases the government expenditures. The latter can also increase because of public servants' wage revaluation and of pension revaluation in reaction to inflation. All these elements end up deteriorating the fiscal balance, which is detrimental for government debt trajectories.

Moreover, if it is higher than that of the main trading partners, inflation reduces the foreign competitiveness of domestic companies, further depressing growth. Lastly, inflation increases social risks and the development of extremism. 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 is not equally distributed.

Consequently, inflation is never a proper long-term solution to reduce public debt and could even turn out to be dangerous for the resilience and the prominence of Europe in international trade.

4.2.2 Monetizing debt is not a credible and sustainable solution

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

Central banks purchases of public debt do not change a state's total indebtedness. 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 monetized that they disappear. Despite the QE and its possible magnitude, the budget constraint remains. Analysts and rating agencies continue to examine ratios and make judgements about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of the quality of an issuer's "signature" and a key factor in the decision to buy securities by private investors, especially non-residents. Indeed, private investors are very sensitive to the rating and thus they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgements 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 every bond, 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 ECB cannot absorb all public debt forever

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

Money creation cannot indefinitely exempt our societies 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?

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

Except for some countries like Italy, most EU Member States have 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 lasting low interest rates largely caused the negative difference from 2013 to 2021, their recent increase in long-term interest rates since 2022 could reverse this trend. In 2023, nominal interest rates remained elevated compared to their 2019 levels, coinciding with a slowdown in global growth, particularly in Eurozone countries. Accordingly, the combination of higher interest rates and lower growth raises doubts about the future path of (r – g) in the years ahead. As described earlier, this differential depends on uncertain variables such as GDP growth and interest rate levels, making long-term predictions challenging.

Thus, uncertainty looms, especially regarding the future path of interest rates which are driven by inflation and monetary policy. Ongoing structural changes such as energy transition, population aging, and global trade fragmentation could sustainably keep inflation above pre-pandemic levels. In March 2023, Larry Summers expected long-term average inflation to be 2.5% in the US and "assign a very low likelihood to it being well below two"[25]. This could lead investors to demand higher compensation to protect their real asset returns.

Beyond influencing bondholders' attitude, the prospect of structurally higher inflation could induce less accommodative monetary policies than seen in the past decade. Since 2023, the ECB has begun reducing the stock of government bonds accumulated since 2015, exerting upward pressure on long-term interest rates. As Mahmood Pradhan and his co-authors note (2023[26]), 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 a lot 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, in order to avoid a cliff effect. The market – the supply and demand of capital – must be gradually reintroduced in the determination of medium and long-term interest rates as remuneration is a key driver for contributing to sustainable growth. This would be a step to a more productive post-pandemic period of higher growth and productive investment.

Conversely, in the absence of fiscal adjustments, investor mistrust may arise, forcing over-indebted states to pay higher risk premiums, thus hampering their ability to repay their debts.

4.4.1 Fiscal discipline is needed to recover primary surpluses

Generating primary surpluses is the only credible and certain path to debt reduction. To do so, countries have two main levers of action: one is increasing their revenue, usually in the form of tax increases, and the second is cutting public spending and/or conducting growth-enhancing reforms.

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

Over-indebted countries such as France, Italy and Belgium must thus urgently get back on track with fiscal discipline as healthy fiscal policies are required to navigate shocks and preserve sustainability. Given the already high level of tax burden in these countries[27], a further tax increase is hardly acceptable, hence the focus on rationalizing public spending.

In that respect, the IMF'S article IV offers country-specific guidelines on the reforms to steer in order to achieve fiscal consolidation, debt reduction and more productive investment. The IMF insists on the urge to introduce effective fiscal reforms in over-indebted countries to restore potential growth, reduce debt, and improve the ability to address 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"[28], as well as restore potential growth. France is thus expected to steer continual structural reforms, particularly in pensions, unemployment, and product and services markets that are essential for future fiscal health as well as better competitiveness and growth. To do so, France needs a credible package of reforms to rationalize public spending (*e.g.* pensions and unemployment benefits reforms) to narrow the gap with European and EA peers and to recover fiscal space to make the green/digital transition. Additionally, the IMF recommends that "to minimize drag, the consolidation (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"[29]. 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 is advancing fiscal consolidation in order 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 while 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"[30]. Thus, fiscal consolidation is particularly challenging for Belgium, and the latter 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 for mobilizing 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

A proactive fiscal policy to "substitute" for a dwindling 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 above their huge present levels – will only be possible if monetary policy and interest rates remain accommodative. One of the most worrying consequences of accommodative and low rates for long policies has been precisely the marked reduction of 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 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 though more distribution through budgets or more money creation. It will only be possible if structural – supply-side oriented – reforms as well as a normal payoff of risky investments are made possible.

27. 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%.
28. IMF Country Report No. 23/56 (Article IV), International Monetary Fund, January 2023.
29. IMF Country Report No. 23/273 (Article IV), International Monetary Fund, July 2023.
30. IMF Country Report No. 23/386 (Article IV), International Monetary Fund, December 2023.

This combination requires a reining in of excessive current public expenditure (*i.e.* fiscal normalization), alongside a qualitative shift towards reasonable public investment.

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.

4.4.3 How credible is the reform of the Stability and Growth Pact agreed by the Ecofin Council in December 2023?

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.
In essence, the reviewed SGP would give 4 to 7 years to Member States that have fiscal deficits exceeding 3% of their GDP to return to fiscal deficits below 3% of GDP (corrective arm).
The rule to reduce public debt by an average of 1% a year for countries having a public debt to GDP over 90% (preventive arm) does not apply as long as its fiscal deficit exceeds 3% of the GDP. Additionally, for Member States displaying a public debt-to-GDP ratio between 60 and 90%, the reduction must be on average 0.5% a year.

The goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies. For instance, the debt trajectory of France until 2027 would remain almost unchanged by such an agreement[31].

The European agreement on the Stability and Growth Pact of December 2023[32] 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 budget trajectory – has been introduced in the reformed Pact. It enables a differentiated approach towards each Member State to take account of 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[33]", 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.
- The obligation to reduce the public debt-to-GDP ratio by a minimum average of one percentage point of GDP per year over a period of 4 to 7 years for countries where outstanding public debt exceeds 90% of GDP (preventive aspect of the Pact) has been introduced. This measure is reduced to 0.5% for countries whose debt 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 when calculating 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 did not begin to rebuild their primary budget surpluses.
- Countries that are subject to an excessive deficit procedure (total public deficit over 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's as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.

31. According to the draft budgetary plan submitted by the French Treasury to the EU Commission in November 2023, the French public debt as a percentage of GDP should reach 108.1% in 2027, compared with 109.7% in 2023, assuming a real GDP growth of 1.7% per year. For further details, see the table 7 of "Draft Budgetary Plan", French Treasury (November 2023).
32. At the time this note is written, the preventive arm of the proposal still has to be adopted by the European Parliament.
33. "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).

- Adjustment implementation horizons seem very long: 4 to 7 years to reduce 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[34]. As mentioned by L. Garicano, "the framework is also vulnerable to manipulation through creative accounting and over-optimistic growth assessments".
- Reference is made to the structural deficit in both the corrective and preventive sections of this revised Pact. Its definition as a "cyclically adjusted deficit" risks weakening the agreement. Why take up this complicated reference, which has failed to reduce excessive deficits in the past, and not keep the simple notions of total public 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:
- Recent monetary history (2014-2021) puts the emphasis on the paradigm of easy money which leads to excessive debt that does not stimulate economic growth. Persistent low (or even negative) interest rates over this period have not led to an increase in productive investment but has on the contrary encouraged savers to keep their financial assets in liquid instruments (see Eurofi Scoreboards) and not to channel them in securities geared to long-term investments[35]. Furthermore, persistent low interest rates encourage indebtedness and the proliferation of asset bubbles, increase wealth inequalities and favor a misallocation of resources (*e.g.* 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 translate into increased production but leads to a widening of trade deficit if a country does not have an efficient production system. On the contrary, what is needed to increase potential growth and achieve a better allocation of resources is:
  - To return to primary surpluses as soon as possible,
  - To rationalize of public spending – qualitative public spending must be an absolute priority – in countries where the public spending-to-GDP ratio exceeds the European average,
  - To steer supply side-oriented reforms that enhance productivity gains.

In over-indebted countries, governments must take corrective actions to ensure a path to primary fiscal surpluses and reduce unproductive and inefficient public spending. Illusion over these countries' capacity to stimulate demand should be ditched out.

A review of the composition of public finances focusing on the nature of spending is therefore urgent and essential in highly indebted countries. To do so, there is a need for a deep review of all the

34. L. Garicano, "The EU's new fiscal rules are not fit for purpose", Financial Times, 8 January 2024.
35. 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.

layers of national public spending – renewed because voted beforehand – and for the reduction of unproductive and socially not efficient spendings.

The climate and digital transition will indeed have a significant cost for the public finances of Member States. But this effort must be undertaken by redirecting current expenditure toward investment expenditure that are productive. One can lament that the current proposal for the reform of the SGP excludes this objective.

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

If the current drift in public debt were to continue, the fiscally "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 to be the case, 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	Q2-2023	2000	2008	Q2-2023	2000	2008	Q2-2023	2000	2008	Q2-2023
United States	48,6	66,1	110,4	135,2	168,7	150,2	64,3	72,6	76,5	70,8	96,1	73,7
United Kingdom	37,7	50,8	102,4	136	185,3	146,7	70,7	90	66	65,3	95,3	80,7
Japan	114,6	145,1	227,2	187,5	163,8	183,7	117,7	103,5	116,2	69,8	60,3	67,5
China	22,9	27,1	79,4	109,3	111,9	228	n.a	93,9	166	n.a	17,9	62
Euro area	69	69,6	90,4	126	156,7	152,2	76,5	96	97	49,6	60,8	55,2
France	58,8	68,8	111,8	137,7	164,2	217,3	104	115,6	152,6	34,2	48,6	64,7
Germany	59,3	65,8	64,7	140,6	129,9	125,3	69,4	70,1	71,8	71,2	59,8	53,5
Italy	108,8	106,2	142,3	79,3	116,5	105,1	56,6	77,5	65,6	22,6	39	39,5
Spain	57,8	39,7	111,3	117,9	214,2	134,9	72,5	131,6	85	45,4	82,6	49,9
Netherlands	52,2	54,7	46,9	219,7	234,7	211,1	130,1	123,2	121	89,6	111,5	90,1
Austria	66,1	68,7	78,6	127,8	142,5	134,2	83	90,5	88,3	45,3	52	45,9
Portugal	54,2	75,6	109,7	142,8	206,3	143,7	83,9	117,4	86,4	58,8	88,9	57,3
Belgium	109,6	93,2	107,1	146,2	192,1	190,6	105,4	142,2	130,9	40,8	49,9	59,7
Aggregate	n.a	55,5	85,9	n.a	130,7	155	n.a	76,8	97,7	n.a	53,9	57,3

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