MACROECONOMIC *view*

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European fiscal risks after the interest rate shock

KEY HIGHLIGHTS:

- Refinancing rates for public debt have once again risen above growth rates.
- This is forcing governments to tighten their budgets and make adjustments.
- Increased vigilance from Brussels, the financial markets, and rating agencies is to be expected.
- France faces fragility due to excessive spending, while Italy grapples with high debt levels.

European governments have prepared their 2024 budgets under challenging conditions. They've had to factor in three constraints: first, the weakening of economic activity, second, the surge in borrowing costs to levels not seen in a decade; and third, heightened scrutiny from institutions and rating agencies with regard to the sustainability of public debt.

As a result, fiscal policy will have to take a more restrictive - or less expansionary - turn for the first time in four years. Since 2020, public budgets had been used almost without limit, first to navigate the challenges of the Great Lockdown in 2020, then to mitigate the effects of the energy crisis in 2022. These two shocks have now been largely overcome. It is therefore perfectly normal to put public finances back in order. The problem is that the parameters to set up the budgets (growth, inflation, interest rates) make this objective difficult to achieve.

Before analysing the risks involved, let's summarise the fiscal landscape after four unprecedent years. In the spring of 2020, when governments enforced lockdowns to curb the spread of the coronavirus, public finances suffered an unparalleled shock. Tax revenues plummeted as the economy ground to a halt, while spending soared in a bid to support businesses and households. For the eurozone as a whole, this translated to a budget deficit increase of more than 10 points of GDP, rising from 0.9% of GDP at the end of 2019 to 12% by mid-2020, an all-time record. Over the four-year period from 2020 to 2023, the deficit averaged 4.8% of GDP annually, similar to the 5.1% recorded between 2009 and 2012.

The debt trajectory has been very different. After the 2008 global financial crisis, the debt ratio soared (+25 points of GDP in four years), never to return to its starting point. During the pandemic, following a very sharp rise (+13 points in one year), the debt ratio fell back by around 10 points, as the lifting of restrictions allowed a strong rebound in activity and, later, a price shock, which inflated revenues. **In short, the environment was deflationary after the financial crisis, then became inflationary after the pandemic. Inflation reduces the debt burden and makes it easier to accommodate an increase in spending, but it is not a long-term 'solution'.**

This is where the current environment presents numerous risks. Tax revenues are a function of nominal GDP. Yet, recent trends point to a joint slowdown in business volumes (stagnation and the risk of a recession) and prices (disinflation). Nominal GDP grew by 7.8% in 2021, 8.2% in 2022, and should grow by 6.2% in 2023. Our forecast is 3% for 2024.

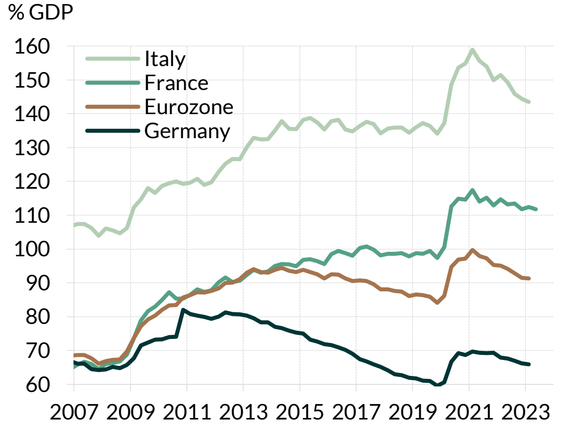
Furthermore, after a spectacular rise over the last two years, interest rates are now higher than economic growth rates. Between October 2021 and October 2023, the yield on ten-year government bonds rose from -0.3% to nearly 3% in Germany, from 0% to 3.5% in France, and from 1% to nearly 5% in Italy. This increase is adding to debt servicing costs. Admittedly, the impact is fairly modest in the short term, given the stock of debt's average lifespan of around eight years in Europe, but it will increase over time if borrowing rates do not fall.

Finally, fiscal vigilance will intensify. Rating agencies have resumed their warnings or sanctions, against France for example. The slightest fiscal announcement is closely scrutinised. The mini-budget crisis that gripped the United Kingdom last year serves as a reminder that no nation is immune to a surge in the risk premium required by investors. What's more, after a four-year suspension, the European Union is set to reinstate these budget rules, initially in their old form, before a reform is agreed amongst member states. The debt criterion (60% of GDP) will no doubt be largely ignored, but not the budget deficit limit (3% of GDP). Countries exceeding this threshold, such as France and Italy, will have to make structural adjustments.

The difficulty lies in striking the right balance so that fiscal choices do not weigh too heavily on the economy (monetary policy being very restrictive) while remaining credible. For the eurozone, the required effort is less strenuous than after the financial crisis. Back then, the primary budget balance widened by 3.5 points of GDP; this time, post-pandemic, it was only 1.5 points.

However, the room for manoeuvre is not uniform across all countries (see chart). Although Germany faces bleak growth prospects, its debt levels are relatively low, resulting in a moderate fiscal risk. Conversely, Italy's debt levels are very high, to the extent that its entire projected deficit for 2024 will be consumed by interest charges. Italy usually manages to balance its primary budget. **France appears fragile on all fronts.** Its debt is high, its expenditure excluding interest charges is chronically higher than its revenue, and its tax burden is already one of the highest in the OECD. We cannot rule out a few bouts of fiscal stress in 2024.

GOVERNMENT DEBT RATIOS



Source : Eurostat, ODDO BHF

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