Flash Economics

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Is it necessary to reduce the public deficit in the euro zone?

All the countries in the euro zone are aiming to reduce their deficits and stabilise, or even reduce, their public debt levels.

This policy is justified:

- If business investment is crowded out by the rise in long-term interest rates normally associated with excessive public deficits;

- If there is a shortage of savings, leading to an increase in external debt;

- If there is a risk of financial crisis, with lenders (both resident and non-resident) unwilling to increase their financing of governments.

Today, in the euro zone:

- Business investment is low;

- There is a current account surplus, but it would be difficult to repatriate excess savings to the euro zone;

- For the time being, there is no sign of a public debt crisis.

The fact that business investment is being crowded out seems to be a sufficient argument for reducing the public deficit.

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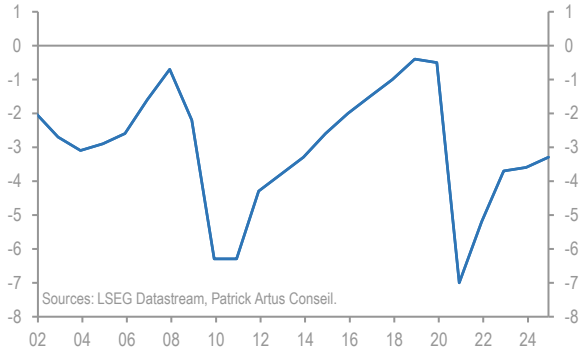
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Objective of reducing the public deficit and stabilising, even reducing, the public debt ratio

All euro zone countries now have an objective to:

- reduce the public deficit (Chart 1);

Chart 1
Euro zone: Fiscal deficit (as % of nominal GDP)



- stabilise or even reduce the public debt ratio (Chart 2).

Chart 2
Euro zone: Public debt (as % of nominal GDP)



It should be remembered that, since the long-term real interest rate is close to potential growth in the recent period (Charts 3A/B), stabilisation of the public debt ratio requires the disappearance of the primary public deficit (Chart 4).

Chart 3A
Euro zone: Real interest rate on 10-year government bonds and real GDP

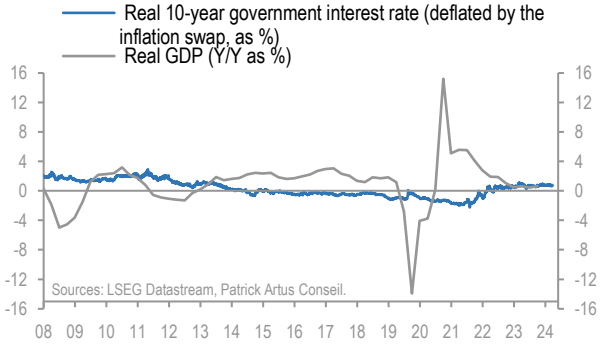


Chart 3B
Euro zone: Real interest rate on 10-year government bonds and real GDP

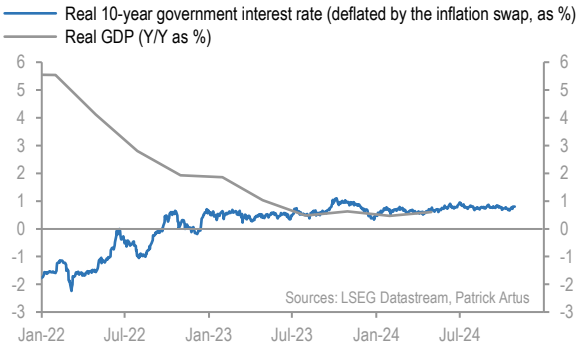
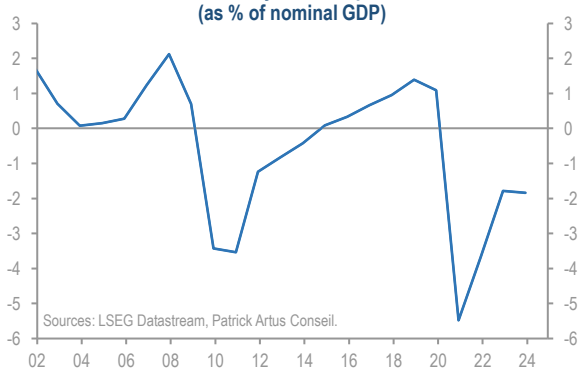
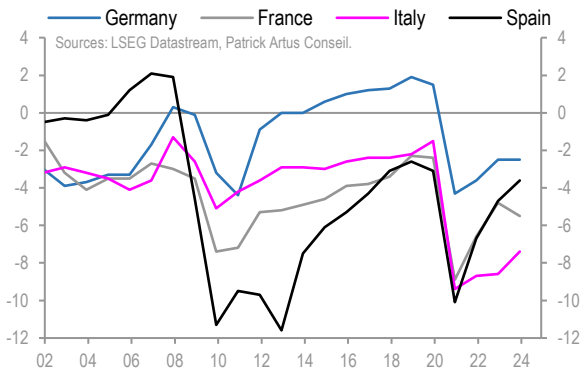


Chart 4
Euro zone: Primary fiscal surplus or deficit
(as % of nominal GDP)



An extreme case is that of Germany, where the application of the **debt brake** (Schuldenbremse) implies a return to a public deficit close to 0 (**Chart 5**).

Chart 5
Fiscal surplus or deficit (as % of nominal GDP)



Are reducing the public deficit and stabilising the public debt ratio necessary objectives?

Reducing the public deficit and stabilising the public debt ratio are necessary objectives in three cases:

- excessive government deficits or debt ratios lead to **higher real interest rates and crowd out business investment**;
- an excessive government deficit leads to **a shortfall in savings**;
- an excessive public deficit or public debt ratio creates **the risk of a public debt crisis and a difficulty in financing the State.**

1- Is private investment being crowded out in the euro zone?

Chart 3 shows **the long-term real interest rate. Chart 6** shows **the investment rate of non-financial corporations.**

Chart 6
Euro zone: Investment of non-financial
corporations (in value terms, as % of nominal GDP)

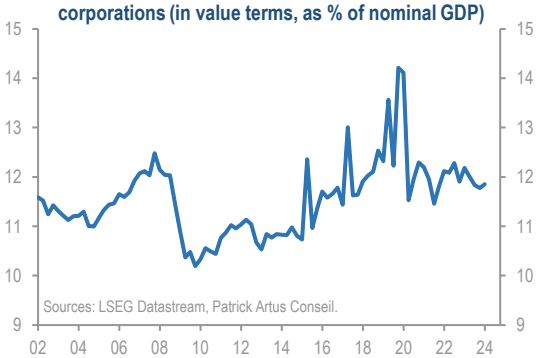
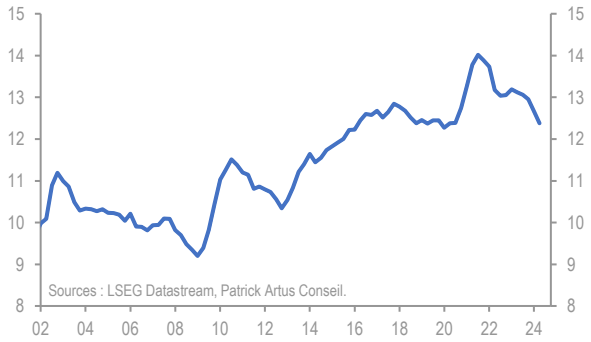


Chart 7 shows **the profits of non-financial corporations** as a percentage of GDP.

Chart 7
Euro zone : Profits after tax and interest of non-financial corporations (as % of nominal GDP)

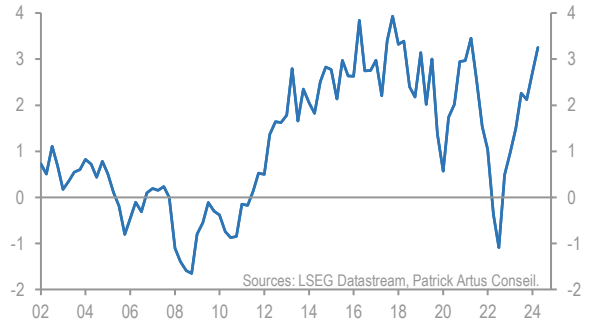


One can see that business investment has been weak since 2020 and has not kept pace with the rise in business profitability.

2- Is there a shortage of savings in the euro zone?

Chart 8 shows **the euro zone's current account balance.**

Chart 8
Euro zone : Current account balance (as % of nominal GDP)



One can see that the euro zone has a **structural surplus of savings**, which is consistent with the observation that investors have a strong appetite for public debt.

3- Is there a risk of a public debt crisis?

A public debt crisis **manifests itself as a rise in the long-term interest rate differential between** countries and Germany, before the ECB intervenes to stabilise the bond markets.

Charts 9A/B show that **France is the only country to have seen its long-term interest rate diverge from that of Germany in the recent period.**

Chart 9A
Yield spread on country's 10-year government bonds against Germany (as % point)

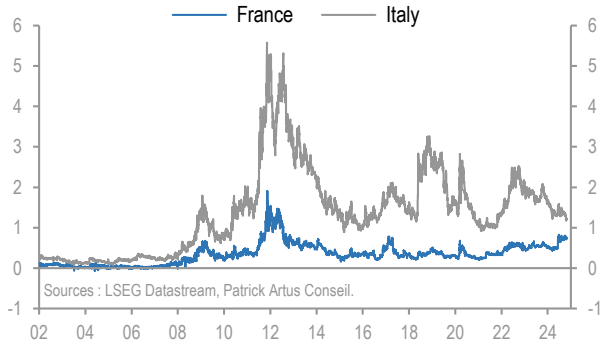
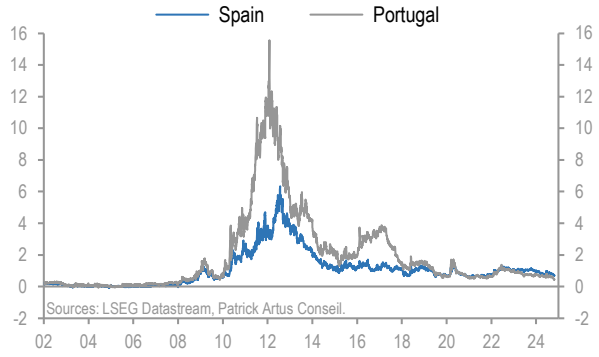


Chart 9B
Yield spread on country's 10-year government bonds against Germany (as % point)



Summary: it makes sense to reduce public deficits and stabilise public debt levels in the euro zone

Even if the euro zone benefits from a structural excess of savings, we believe that it is prudent to reduce public deficits and public debt levels in the euro zone:

- excess savings in the euro zone are invested in the rest of the world, particularly in the United States where the return on capital is higher than in the euro zone. It is therefore not certain that it can be used to finance the public deficits of euro zone countries;
- the rate of business investment has been low since 2020, while profitability is high;
- as the experience of the 2010s has shown, the euro zone could experience a public debt crisis in countries with excessive public deficits. The ECB can intervene (currently using the Transmission Protection Instrument), but only on condition that the country pursues policies that ensure the sustainability of its public debt.

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