Flash Economics

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What fiscal adjustment is needed in the four largest countries in the eurozone?

We calculate the size of the reduction in the public deficit needed to stabilise the public debt ratio in Germany, France, Spain and Italy.

Our starting point is the primary public deficit and the gap between the long-term interest rate and potential growth.

We find that, compared with the deficit forecast for 2024, the primary public deficit (excluding interest on public debt) will have to be reduced by 1.4 points of GDP in Germany, 3.8 points of GDP in France and 1.8 points of GDP in Italy, while Spain has a primary public deficit lower than that which stabilises the public debt ratio.

Since the reduction in the primary deficit reduces activity and therefore tax revenues, the increase in the tax burden or the reduction in public spending required is greater than the necessary reduction in the public deficit in a proportion that depends on the size of the fiscal multiplier (effect of a reduction in public spending or an increase in the tax burden on GDP).

If there is no Ricardian neutrality effect (fall in the private savings rate when the public deficit is reduced), the prospect is that of many years of fiscal austerity.

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What is required to stabilise the public debt ratio?

Stabilising the public debt ratio requires that the primary budget surplus be greater than or equal to the product of the public debt ratio by the gap between the real long-term interest rate and potential growth, which is:

Primary budget surplus ≥ Public debt ratio × (real long-term interest rate – potential growth in volume)

Obviously, if the real long-term interest rate is lower than the potential growth in volume, a primary budget deficit is compatible with the stability of the public debt ratio.

What primary budget surplus or deficit is necessary to stabilise the public debt ratio in the four largest countries of the euro zone?

Charts 1A/B show the **primary budget deficit** of Germany, France, Spain, and Italy.

Chart 1A
Primary fiscal surplus or deficit (as % of nominal GDP)

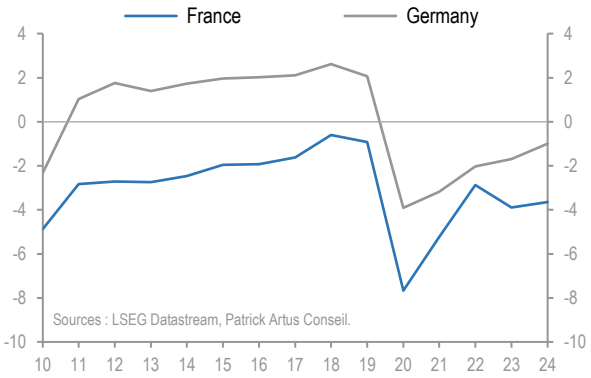
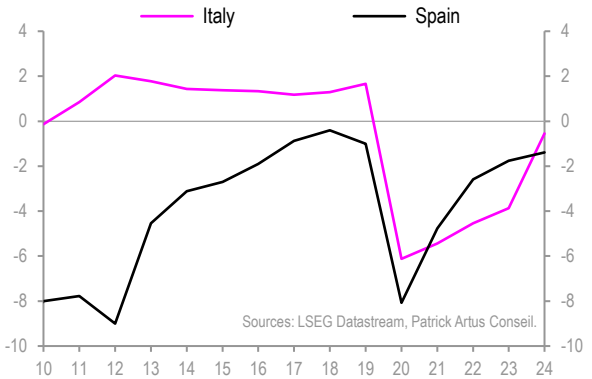


Chart 1B
Primary fiscal surplus or deficit (as % of nominal GDP)



One can see that in 2024, only France will have a primary public deficit exceeding 2% of GDP (around 4% of GDP).
Charts 2A/B show the **nominal 10-year interest rates** of the four countries.

Chart 2A
Interest rate on 10-year government bonds (as %)

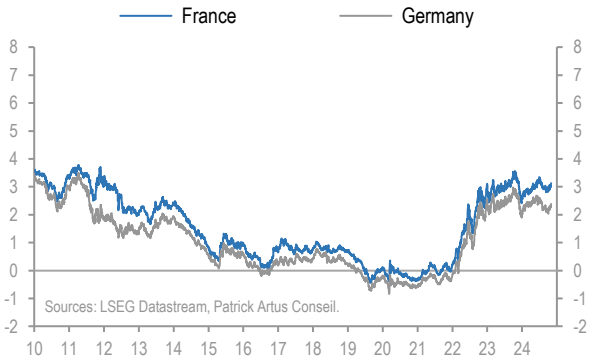
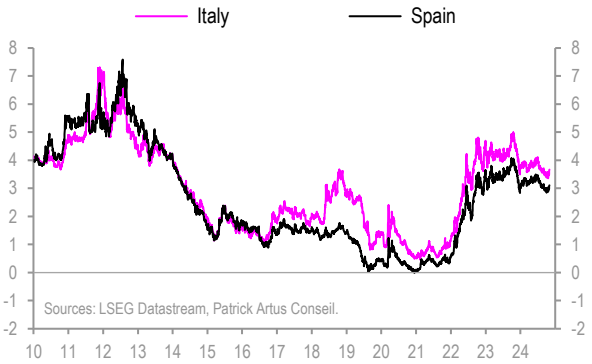


Chart 2B
Interest rate on 10-year government bonds (as %)



Charts 3A/B show **the growth rates of GDP prices**.

Chart 3A
GDP deflator (Y/Y as %)

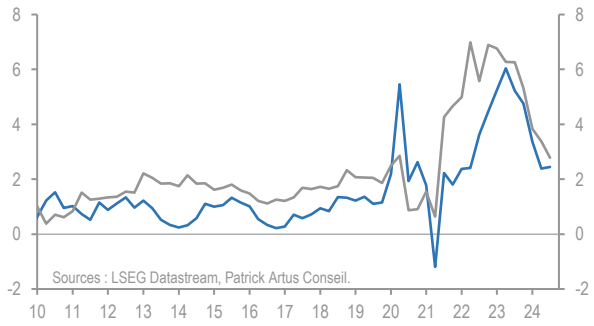


Chart 3B
GDP deflator (Y/Y as %)

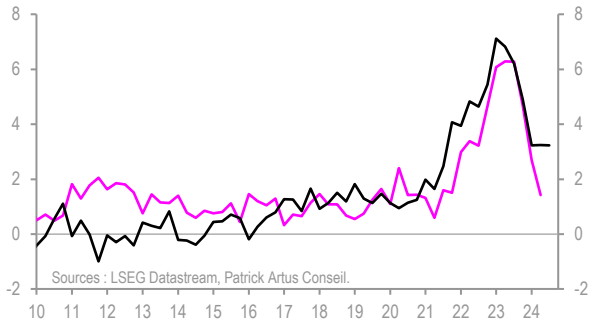
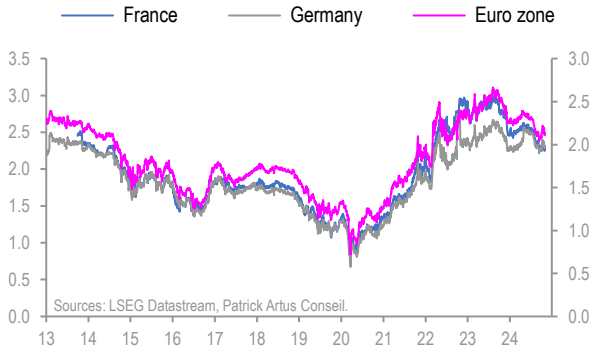


Chart 4 shows **the 5-year inflation swaps in 5 years**, which represents the long-term inflation expectations of financial markets.

Chart 4
5-year inflation swap in 5 years (as %)



Charts 5A/B show the **GDP growth rates in volume.**

Chart 5A
Real GDP (Y/Y as %)

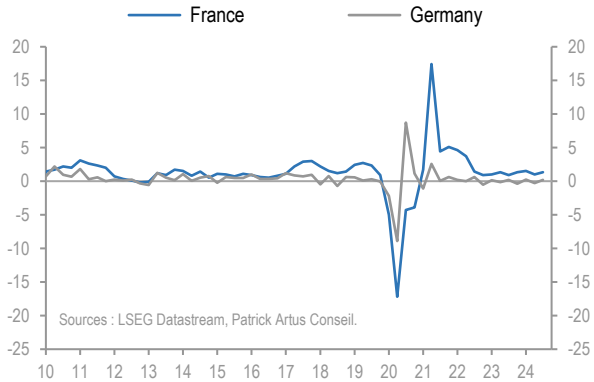
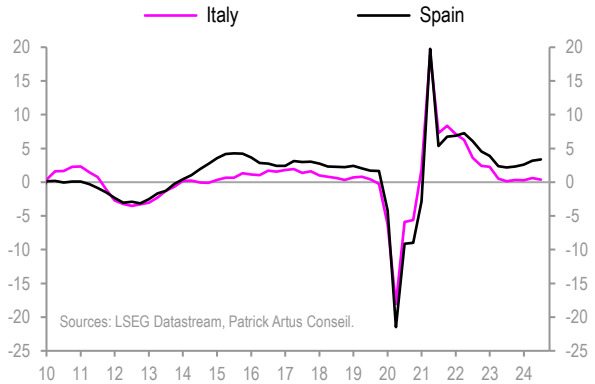


Chart 5B
Real GDP (Y/Y as %)



Finally, charts 6A/B show the public debt ratios.

Chart 6A
Public debt (as % of nominal GDP)

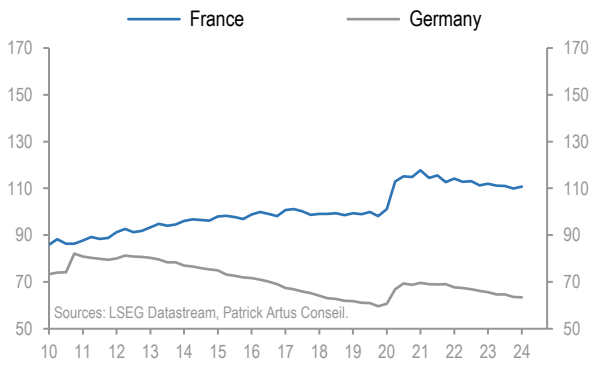
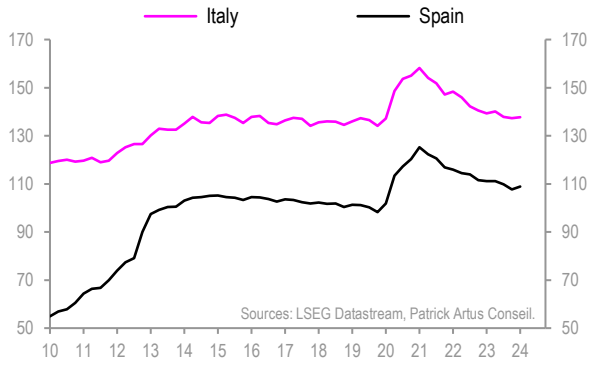


Chart 6B
Public debt (as % of nominal GDP)



The data for the most recent period are included in the table.

Table: Potential growth, interest rate, public debt and primary budget balance stabilizing the public debt ratio (2024)

	Germany	France	Spain	Italy
Primary fiscal deficit (as % of nominal GDP)	-1	-3.7	-1.4	0.6
Public debt (as % of nominal GDP)	63	112	109	138
Interest rate on 10-year government bonds (as %)	0.4	1.1	1.1	1.7
Potential growth (as %)	0	1	2.7	0.8
Primary fiscal surplus or deficit stabilizing the public debt ratio (as % of nominal GDP)	0.3	0.1	-1.9	1.2

Source : LSEG Datastream

One can see that:

- Spain ensures the sustainability of its public debt;
- Germany and Italy should have a primary budget surplus while they currently have a deficit;
- France is very far from ensuring the sustainability of its public debt.

The need for correction of the primary budget deficit will be amplified by the effects of restrictive fiscal policies

We have seen that the primary budget deficit must be reduced, starting from its 2024 level, to ensure the sustainability of the public debt rate by:

- 1.3 points of GDP in Germany;
- 3.8 points of GDP for France;
- 1.8 points of GDP for Italy.

In Spain, the primary public deficit is lower than that which stabilises the public debt rate.

But this reduction of the primary public deficit, whether achieved through lower public spending or higher taxes, will lead to lower growth and lower tax revenues.

Given this effect, whose magnitude depends on the level of the fiscal multiplier (effect on GDP of a change in public spending or taxes), the reduction in public spending or the increase in taxes that will be necessary to stabilise the public debt rate will be even higher than what is calculated above.

Summary: a very significant budget adjustment is necessary to stabilise the public debt rate in France.

If we do not take into account the effects on activity and tax revenues of increasing taxes or reducing public spending, the budgetary adjustment necessary to stabilise the public debt rate, starting from the situation in 2024, is 1.3 percentage points of GDP in Germany, 3.8 percentage points of GDP in France, and 1.8 percentage points of GDP in Italy, with Spain already having a primary public deficit lower than that which stabilises the public debt rate.

If we consider the effect on GDP and tax revenues of the budgetary adjustment, the size of the adjustment is even greater. One can see that in France, the size of the budget adjustment is very significant.

Can we hope to benefit from a Ricardian equivalence effect, i.e., a decrease in the private savings rate when the public deficit is reduced, as part of the savings was set aside in anticipation of budgetary adjustment?

Charts 7A/B show the household savings rate.

Chart 7A
Gross household savings rate
(as % of gross disposable income)

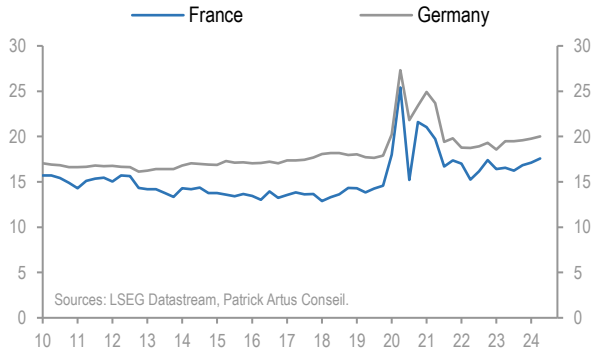
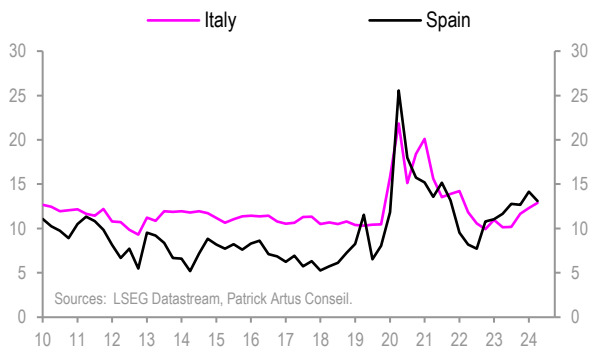


Chart 7B
Gross household savings rate
(as % of gross disposable income)



It appears that **a decrease in the household savings rate cannot be expected anywhere.**

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