Flash Economics

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Let's not forget that what matters is the comparison between the long-term real interest rate and the long-term real growth rate

There is a lot of commentary on the rise in nominal long-term interest rates, lamenting the fact that the public debt interest burden keeps increasing.

But it is important to remember that what matters is the hierarchy between the long-term real interest rate and long-term real growth.

As long as the rise in nominal interest rates is offset by the rise in inflation or by real growth, there is no problem with the sustainability of public debt.

Concern must be expressed about recent developments in the United Kingdom, Germany, France and Italy (but not Spain or the United States), where the real long-term interest rate has risen above the level of potential growth, or is close to potential growth, which requires delivering a primary budget surplus, or at least a primary budget balance, to avoid a limitless rise in the public debt ratio.

As of today, only Italy has a primary budget surplus. All the other countries have primary budget deficits, and the United Kingdom, the United States and France have large deficits. Currently, the two countries experiencing the most difficult budgetary situation are the United Kingdom and France.

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Recent rise in long-term interest rates

We consider the situation in **the United States, the United Kingdom, Germany, France, Spain and Italy**.
Since the end of Q3 2024, **all these countries have seen a significant rise in long-term interest rates** (**Charts 1A/B**).

Chart 1A
Interest rate on 10-year government bonds (as %)

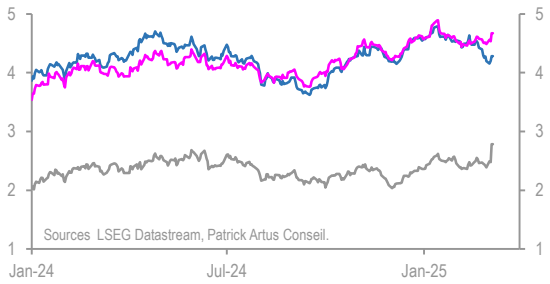
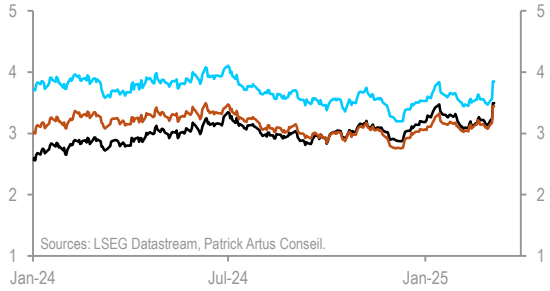


Chart 1B
Interest rate on 10-year government bonds (as %)



This rise in long-term interest rates is worrying many investors and observers, as it **implies higher interest payments on public debt** (**Charts 2A/B**).

Chart 2A
Interest paid on the public debt (as % of nominal GDP)

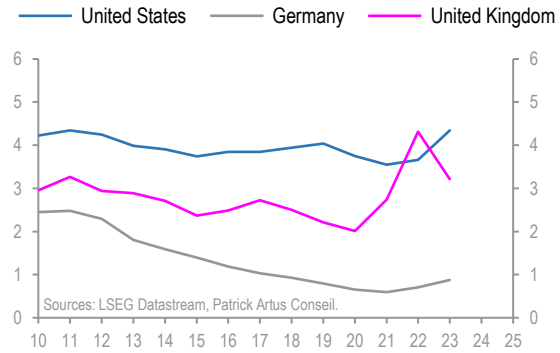
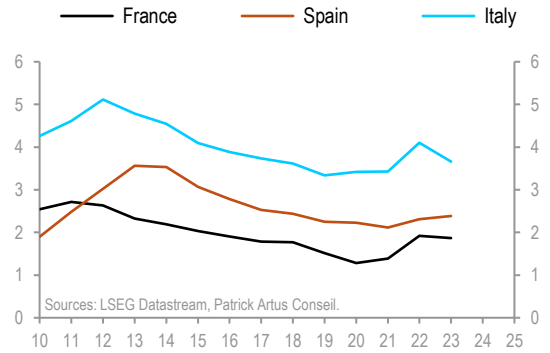


Chart 2B
Interest paid on the public debt (as % of nominal GDP)



But there is an important point to remember: it is not the absolute level of long-term nominal interest rates that matters, it is the hierarchy between long-term nominal interest rates and long-term nominal growth, or equally, **the hierarchy between long-term real interest rates and long-term real growth**.

Why it is the hierarchy between long-term real interest rates and long-term real growth that matters

As long as the long-term real interest rate is lower than long-term GDP growth:

- The public debt ratio converges towards a finite limit (which is equal to the ratio of the primary public deficit to the difference between the long-term real growth rate and the long-term real interest rate);
- Even if there is a large primary public deficit, since the public debt ratio stabilises in the long run, the sustainability of public debt is guaranteed.

But if the long-term real interest rate is higher than long-term GDP growth, for the public debt ratio to stabilise in the long run, **a primary budget surplus must be delivered that is greater than the product of the public debt ratio by the difference between the long-term real interest rate and the long-term growth rate**.

Long-term interest rates and long-term volume growth

Here, we compare:

- The most recent values of the nominal 10-year interest rate in the United States, the United Kingdom, Germany, France, Spain and Italy (Charts 1A/B above);
- And average real GDP growth over the long term (2010-2024) and the short term (2023-2024), Charts 3a/b and Table 1;

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

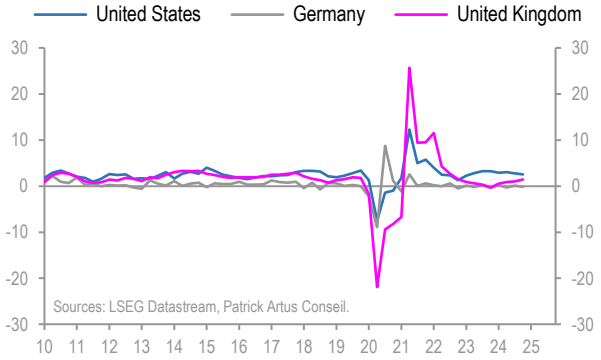


Chart 3B
Real GDP (Y/Y as %)

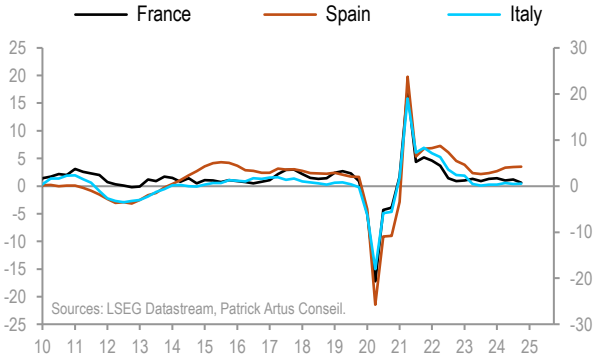


Table 1: Average real GDP growth rates (as %)

Average real GDP growth rates	United States	Germany	United Kingdom	France	Spain	Italy
From 2010 to 2024	2.41	0.33	1.68	1.24	1.29	0.57
From 2023 to 2024	2.84	-0.04	0.66	1.09	2.96	0.64

Sources: LSEG Datastream

- Average GDP price growth over the long term (over 2010-2024) and short term (in 2024), Charts 4A/B, Table 2;

Chart 4A
GDP price deflator (Y/Y as %)

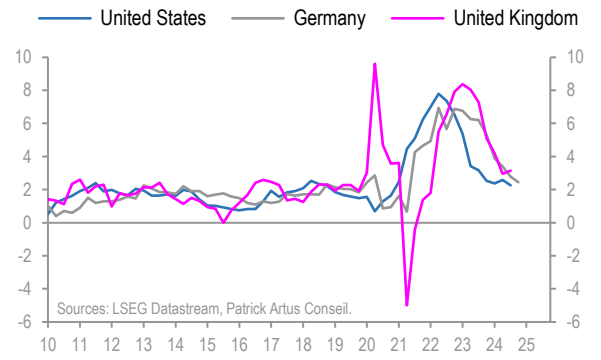


Chart 4B
GDP price deflator (Y/Y as %)

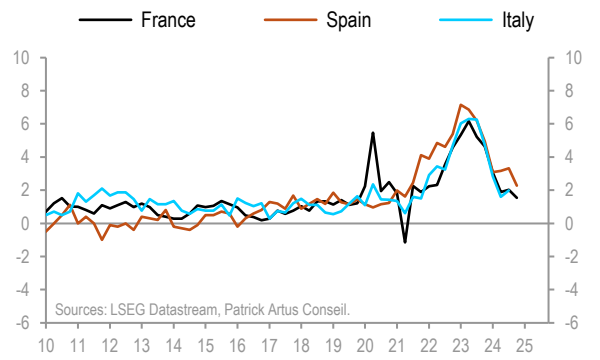


Table 2: Average GDP deflator (%)

Average GDP deflator	United States	Germany	United Kingdom	France	Spain	Italy
from 2010 to 2024.Q3	2.35	2.36	2.55	1.59	1.49	1.68
from 2024.Q1 to 2024.Q3	2.40	3.35	3.43	2.33	3.19	2.14

Sources: LSEG Datastream

- The 10-year inflation swap at the start of 2025 (Chart 5A/B).

Chart 5A
10-year inflation swaps (as %)

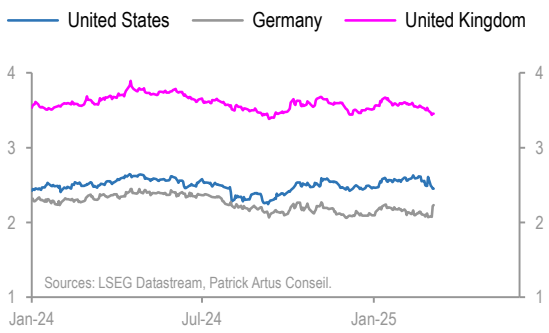
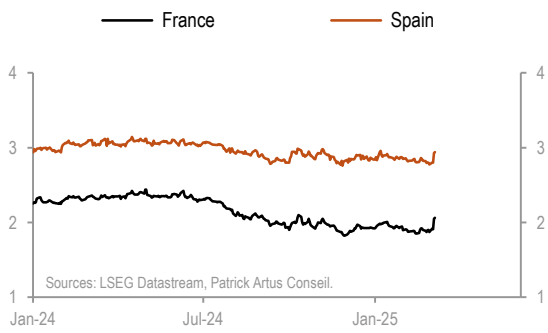


Chart 5B
10-year inflation swaps (as %)



We can see that the nominal 10-year interest rate in the most recent period is:

- 4.25% in the United States;
- 4.50% in the UK;
- 2.45% in Germany;
- 3.20% in France;
- 3.10% in Spain;
- 3.50% in Italy;

and that nominal GDP growth over the short period is, depending on whether the GDP price or the 10-year inflation swap is used, between:

- 5.2% and 5.4% in the United States;
- 3.4% and 3.7% in the United Kingdom;
- 2.0% and 3.3% in Germany;
- 3.0% and 3.4% in France;
- 5.9% and 6.2% in Spain.

It is 3.7% in Italy (we do not have a 10-year inflation swap for Italy).

Summary: there is a debt sustainability problem in the UK and France

When we compare:

- the nominal 10-year interest rate;
- and GDP growth in value terms, calculated as an average over 10 years or 2 years, using the GDP deflator or the long-term inflation swap, we see that the nominal 10-year interest rate is clearly higher than GDP growth in value terms in the case of the UK and Italy, and is close to GDP growth in value terms in Germany and France.

This implies that the UK and Italy should have a primary budget surplus, and Germany and France a primary budget balance.

When we consider the primary budget deficit or surplus, we see (**Charts 6A/B**) that **only Italy has a primary budget surplus and that the United Kingdom and France have large primary budget deficits**.

Chart 6A
Primary fiscal surplus or deficit (as % of nominal GDP)

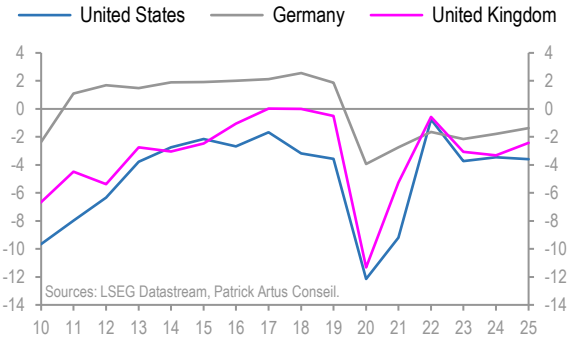
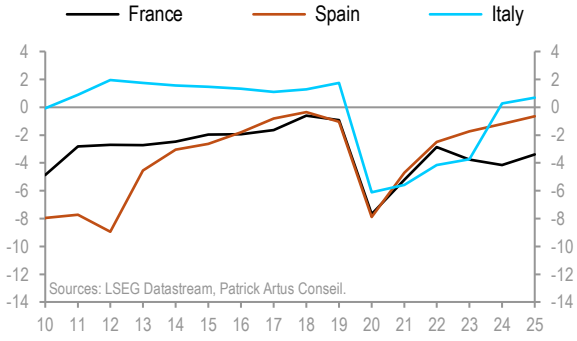


Chart 6B
Primary fiscal surplus or deficit (as % of nominal GDP)



Therefore, the two countries currently experiencing the most difficult budgetary situation are the United Kingdom and France.

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