Flash Economics

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If public deficits in the euro zone really need to increase, how should it be done?

The Draghi report shows that half of the increase in investment needed in Europe (4.5% of euro zone GDP) will be borne by the public sector. This involves investment in the energy transition, in digital technology and in the financing of breakthrough innovation. Furthermore, for the euro zone to reach the level of military spending of the United States, the expenditure would have to increase by 1.6 points of GDP. All in all, given the challenge of reducing social spending and of increasing the tax burden, the need for additional public deficit is almost 4 points of GDP. To avoid this prospect of additional public deficit driving up long-term interest rates considerably, it would be necessary:

- For euro zone residents to use up all their savings to buy European public debt, or European Union public debt, which would be more appealing than the debt of European countries;
- For the ECB to resume quantitative easing (while it is today reducing the size of its balance sheet), and stating that its purchases of public securities are irreversible (in these conditions, ECB purchases of public securities amount to cancelling these securities).

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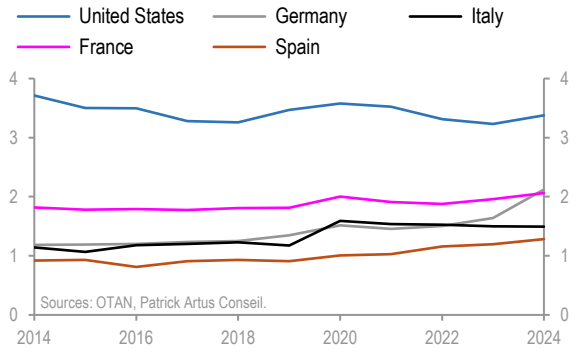
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A huge need for additional public spending in the euro zone

The Draghi report shows that the need for additional investment in Euro zone countries (investment in energy transition, digital transition, financing disruptive innovations...) amounts to 500 billion euros (4.5% of Euro zone GDP in 2024), half of which is to be borne by the public sector.

Furthermore, for the euro zone to reach the level of military spending of the United States (Chart 1), military spending would have to increase by 1.6 points of GDP.

Chart 1
Military expenditures (as % of GDP)



In total, the necessary increase in public spending, under these assumptions, would be 3.9 points of GDP.

It seems clear that it will be difficult to reduce other public spending significantly (with the effects of demographic ageing, the needs of the healthcare and education systems - Table 1 shows the very poor performance of the education system in the major euro zone countries).

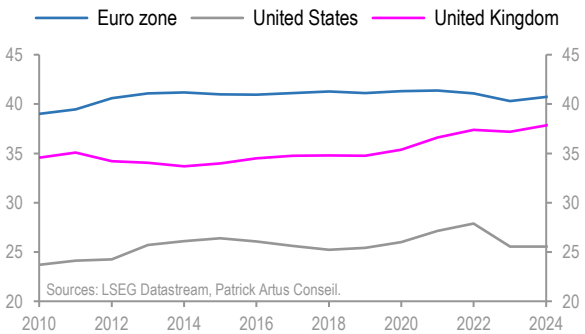
Table 1: OECD PISA results (overall score, by descending score from 2022 survey)

Country	2012	2015	2018	2022
Japan	540	529	520	533
Canada	522	523	517	506
Finland	529	523	516	495
United Kingdom	502	500	503	494
United States	n.d	488	495	489
Sweden	482	496	503	487
Germany	515	508	500	482
France	500	496	494	478
Spain	490	491	482	477
Italy	490	485	477	477

Source: OCDE

The room for manoeuvre to increase the tax burden (Chart 2) is also reduced.

Chart 2
Tax burden (as % of nominal GDP)



Given the starting point for the euro zone's public deficit (Chart 3), one must consider increasing the public deficit from 3% of GDP to 7% of GDP. Is this feasible? In particular, irrespective of the budgetary rules in force in the euro zone, is this possible without triggering a massive rise in long-term interest rates (**Chart 4**)?

Chart 3
Euro zone: Fiscal deficit (as % of nominal GDP)

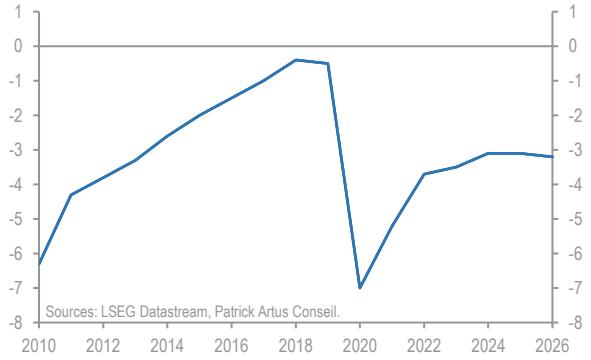


Chart 4
Euro zone: Interest rate on 10-year government bonds (as %)

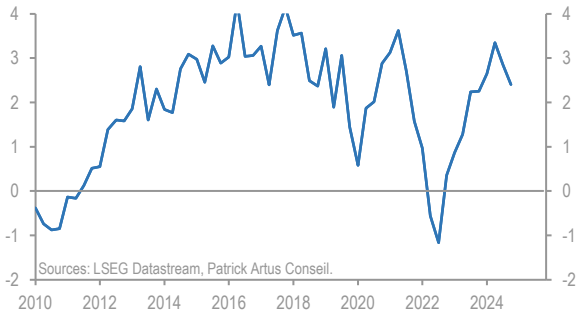


How to significantly increase the public deficit without adversely affecting long-term interest rates?

1. Use up all European savings

A significant proportion of euro zone residents' savings is lent to the rest of the world (as shown by the euro zone's current account surplus, **Chart 5**), and in particular to the United States.

Chart 5
Euro zone : Current account balance (as % of nominal GDP)



The euro zone would have to use up all its savings to invest (particularly for the investments mentioned in the Draghi report) or to cover its military spending. This would be easier if the European Union itself issued public debt, instead of individual member countries, because demand for EU debt is strong (and its rating is AAA for Fitch and Moody's, AA+ for S&P).

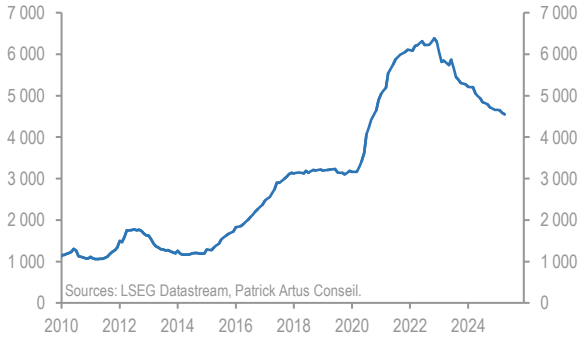
This redirecting of European savings towards Europe is underpinned:

- if the investments financed are highly profitable (investments in the digital transition, in disruptive innovations);
- because of the risks currently faced by the US economy (protectionist inflation, attacks on researchers, etc.).

2. Reopening quantitative easing

The ECB is currently engaged in quantitative tightening (reducing the size of its balance sheet, **Chart 6**).

Chart 6
Euro zone: Monetary base (EUR bn)



If the euro zone countries were to have higher public deficits (due to additional investment and military spending requirements), **in order for these public deficits not to impact long-term interest rates, quantitative easing would have to be reopened, and this quantitative easing would have to be irreversible**.

Indeed, if the ECB buys public debt and renews it when it matures, since the ECB passes on its profits to euro zone governments, the interest paid by governments to the ECB on the public debt purchased is returned by the ECB to governments. This public debt held by the ECB is therefore free and has been taken out of the bond market; the process would therefore be equivalent to cancelling this public debt.

Summary: a higher euro zone public deficit is very likely, and can only be sustained if the euro zone retains all of its savings and the ECB reopens irreversible quantitative easing.

The need for public investment described in the Draghi report and the rise in military spending will contribute to the rise in the public deficit, since it will be very difficult to reduce other public spending and increase the tax burden.

To prevent this rise in public deficits from pushing up long-term interest rates, one must ensure that:

- Euro zone savers keep their savings in the euro zone, instead of lending part of it to non-residents;
- the ECB use irreversible quantitative easing, the equivalent of cancelling the public debt purchased by the ECB.

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