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Economic Insight

How far will the public debt in the euro area increase?

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Dr. Vincent Stamer [AC]

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In the coming years, the debt levels of several major euro area economies are likely to rise significantly. In addition to higher defense spending, massive increases in interest payments are likely to weigh on government budgets. Without strong action from policymakers, high interest payments will jeopardize the sustainability of debt, particularly in Italy and France. This is likely to increase pressure on the ECB and the EU to support these countries.

Public finances in the euro area are likely to deteriorate further in the coming years. This is because yields on government debt have risen significantly in recent years, so that more and more old debt will have to be refinanced at higher interest rates.

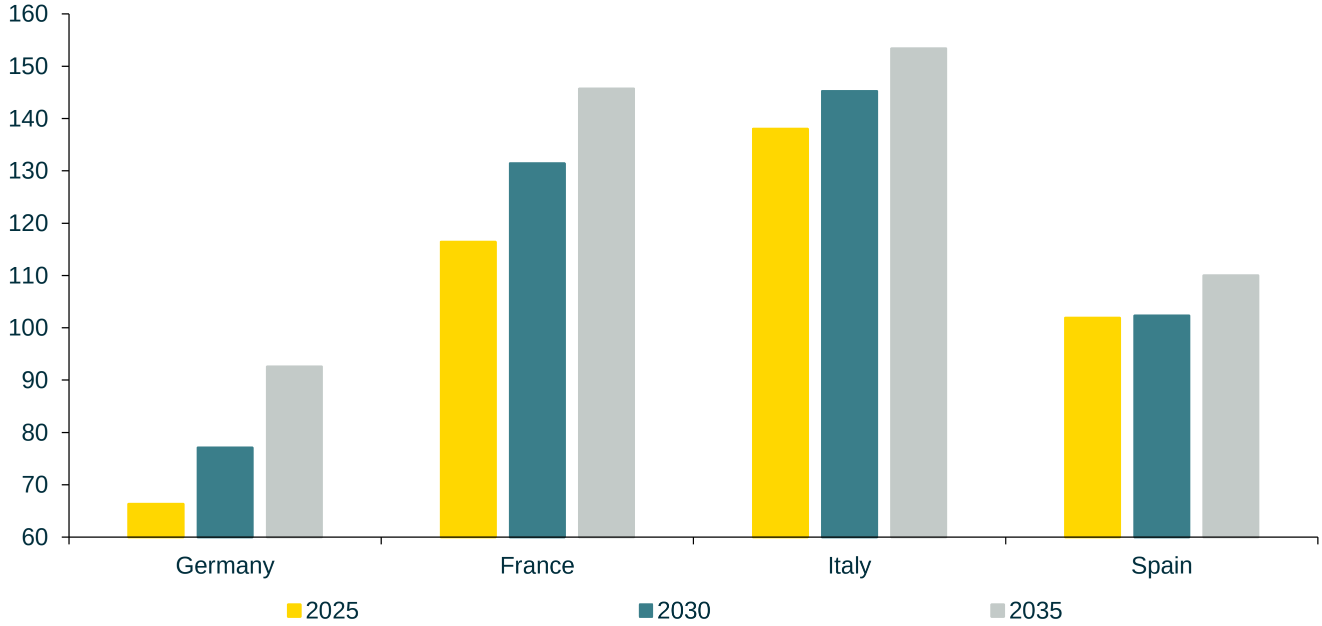
We have calculated how much interest payments will rise in the four largest countries in the currency union in the coming years and how far debt-to-GDP levels will rise. To do this, we have made assumptions about the development of primary deficits, interest rates, economic growth, and inflation in Germany, Italy, France, and Spain (see Box).

Debt hits record highs in several countries

The calculations show that the debt levels of Germany, France, and Italy are likely to rise significantly over the next ten years (Chart 1). While Germany's sovereign debt in relation to gross domestic product will be rising to a somewhat elevated level of 93% in 2035, France's debt ratio is expected to rise to 146% and Italy's to 154%. Notably, the indebtedness of France will rise much faster than that of Italy. In Spain, the debt ratio is likely to remain largely unchanged over the next five years and will only increase moderately between 2030 and 2035.

Chart 1 - The debt-to-GDP levels should rise significantly above the 60% mark

General government debt as a share of gross domestic product, in %



Source: World bank, Bloomberg Economics, Commerzbank-Research

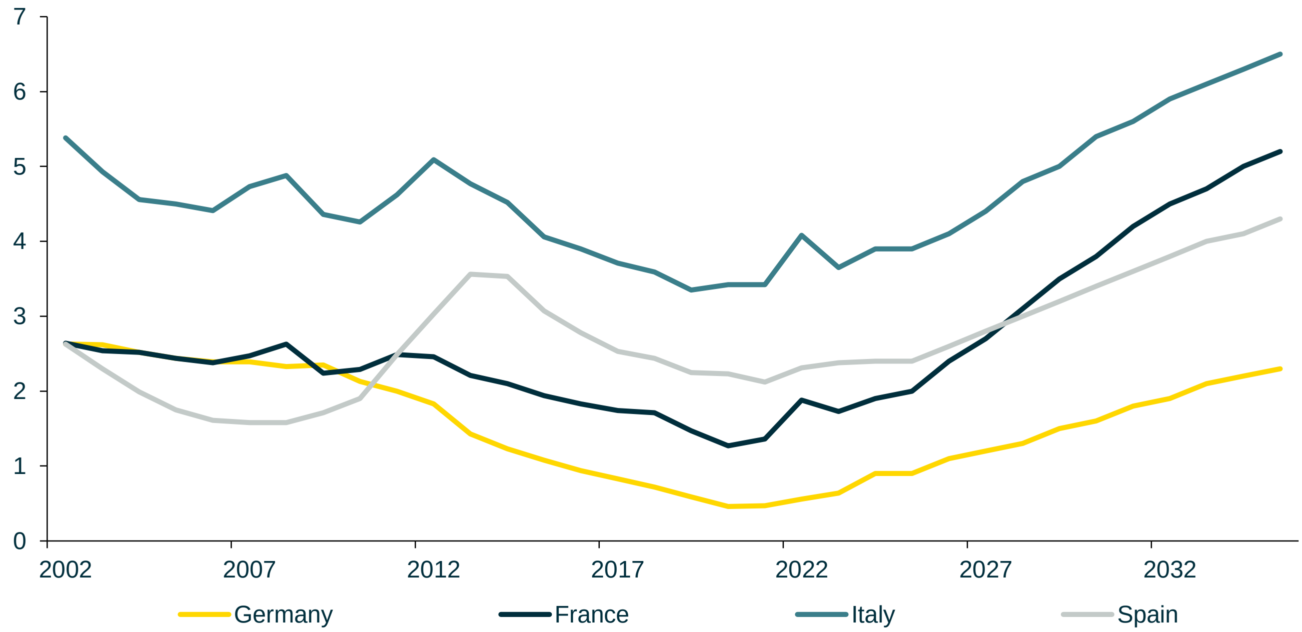
Interest payments heavily burden public finances

One key factor driving high levels of debt in the future is the noticeable increase in interest payments on government debt. After bond yields had fallen since 2012, easing the burden on government budgets, the yields rose again in the last three years. This rise in interest, as well as higher debt levels, have increased the interest payments on public debt as a percentage of gross domestic product. This trend will continue in the coming years, as a significant share of old debt will have to be refinanced at higher interest rates. We also expect bond yields to rise slightly in the foreseeable future.

Given its already high level of debt, Italy will continue to bear the highest interest burden relative to economic output. It will rise from 3.9% as of late to around 6.5% by 2035 (Chart 2). Although France's future interest burden of 5% is also expected to be lower than Italy's in 2035, it will increase significantly faster in the coming years. The German government's interest burden as a percentage of gross domestic product will also increase by around one percentage point from its current low level, but will remain significantly lower than that of the three other large countries in the monetary union.

Chart 2 - The increasing interest payments heavily burden the future budgets

Interest payments, as a share of GDP, in %



Source: World Bank, Bloomberg Economics, Commerzbank-Research

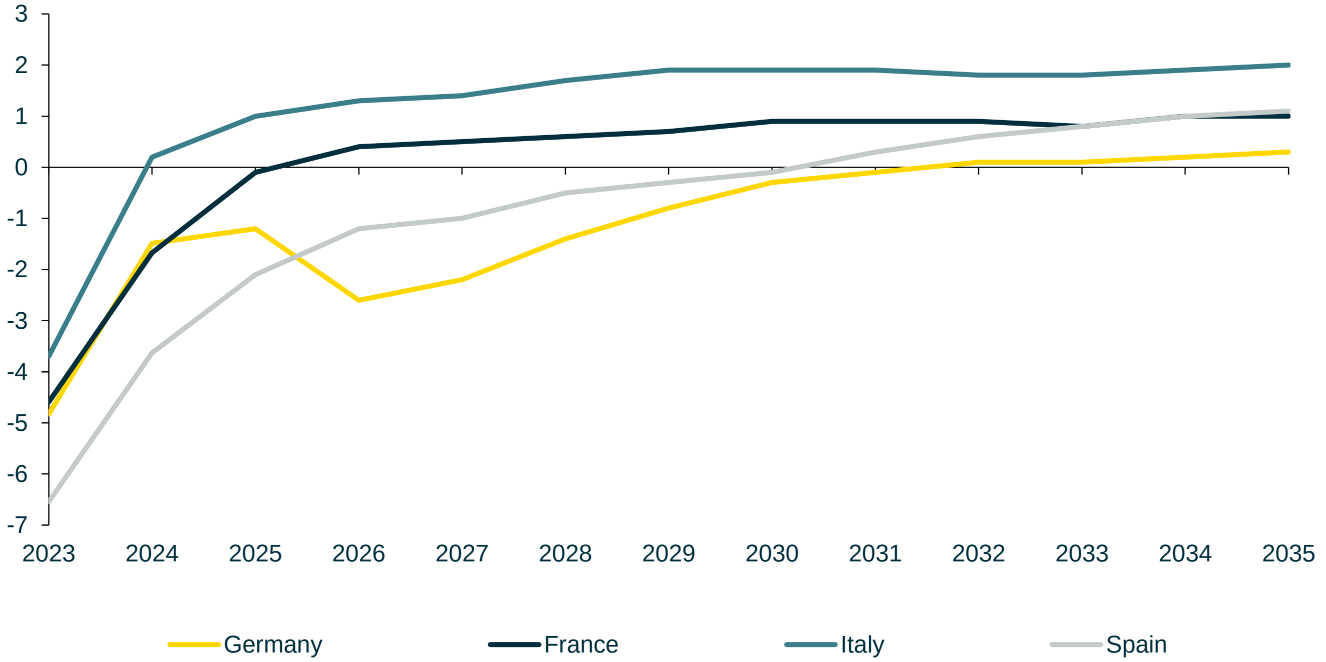
Debt sustainability is serioulsy weakening

The trends described above jeopardize the long-term sustainability of debt. If the effective interest rate on public debt is higher than the nominal growth of the economy, a country can no longer simply "grow out" of its debt. This also applies even if the primary budget – i.e. the budget excluding interest payments – is balanced (as further discussed in **Is public debt still sustainable?**). In Italy, the average effective interest rate is already higher than the nominal growth rate this year, and this difference is likely to increase significantly in the coming years (Chart 3). In France, too, the effective interest rate is likely to exceed the growth rate in the coming years. The Spanish economy is currently growing fast enough to keep the debt burden as a share of gross domestic product stable despite a slight primary deficit. In the 2030s, growth in Spain is also likely to slow down due to the deteriorating demographic trend.

Conversely, these figures imply that especially France and Italy will have to generate significant primary surpluses (or significantly higher primary surpluses than assumed by us) in order to prevent a further increase in their debt ratios. In Germany, on the other hand, a balanced primary budget would be sufficient to stabilize the debt ratio well into the coming decade.

Chart 3 - The r-g indicator shows falling debt sustainability

The difference between the effective interest rate and the nominal growth of gross domestic product, expressed in percentage points. A value above zero indicates unsustainable debt.



Source: World Bank, Bloomberg Economics, Commerzbank-Research

Either governments act ...

The best course of action for governments would certainly be to stimulate potential growth through reforms. This would improve the growth rate relative to the effective interest rate and ultimately enable countries to “grow out" of their debt.

A very painful alternative would be to consolidate government budgets across the board in order to generate significantly higher primary surpluses than we have assumed. This would stabilise the debt ratio, even if the GDP growth rate falls below the effective average interest rate. From today's perspective, however, this is rather unlikely. This is because higher defense spending has become necessary and a demographic situation that is very unfavorable in some cases will place an additional burden on budgets. Political majorities are also likely to make a thorough consolidation of public finances difficult, at the very least.

... or pressure on the EU and the ECB will increase.

Without a change in national policy, pressure on the EU and the ECB to intervene in debt financing is therefore likely to increase. Discussions center on the European Union to issue joint debt to finance defense spending, for instance. However, this would at most reduce the effective interest rate to be paid. This is because even joint EU debt must ultimately be repaid through contributions from the member states.

A sharp rise in bond yields, especially the spread to other bond yields such as German Bunds, is also likely to prompt the ECB to take action. It could push down yields, at least temporarily, with additional bond purchases and/or a cut in its key interest rates. While this would ease financing conditions, it would not change the level of debt. Furthermore, if the ECB were forced by fiscal policy to deviate from its mandate of price stability (known as “fiscal dominance”), this would have significant consequences: inflation would rise and economic growth would subsequently decline, and in the long term, nominal interest rates for longer maturities would probably be higher than without the ECB's intervention due to stronger price increases.

Box: Methods and assumptions

To project general government debt and interest payment levels as a share of the GDP, we have made assumptions about the future government budgets excluding interest (primary balance), as well as about economic growth and inflation. We discuss these assumptions below for each country. We have subsequently calculated future interest payments and the effective interest rate on the general government debt burden using the Bloomberg Economics fiscal model. This model makes it possible to simulate the refinancing of government bonds maturing in the future and the financing conditions for future government debt.

These projections represent what we believe to be the most realistic scenario. In particular, higher or lower budgetary discipline could cause developments to deviate significantly from our projections.

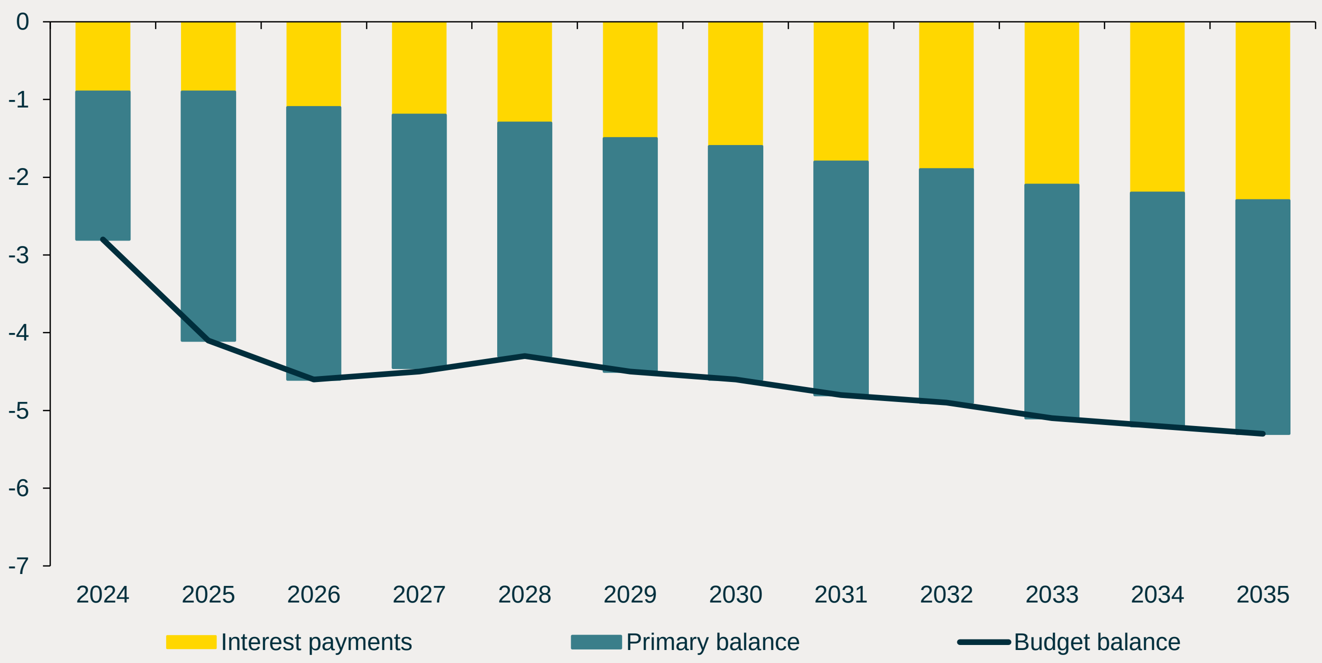
Germany

Following the constitutional amendments passed by the Bundestag in the spring, the German government is planning significantly higher government spending. Partly as a result of this very expansionary fiscal policy, the German economy is likely to grow faster than its potential output growth in the next three to four years. In the medium term, however, growth is likely to fall back to the very low potential growth rate of 0.4%. This is due to the extremely unfavorable demographic situation and our assumption that the additional spending will do little to increase the potential of the German economy.

The significantly higher government spending is likely to cause the German primary deficit ratio to rise from 1.9% in 2024 to 3.5% in 2026 (Chart 4). In the medium term, this figure is likely to level off at around 3%. Together with increasing interest payments, this will result in a deficit ratio of slightly more than 5% in 2035.

Chart 4 - Projections on the budget balance

General government interest payments, primary deficit and budget balance for Germany, in % of GDP



Source: World Bank, Bloomberg Economics, Commerzbank-Research

Frankreich

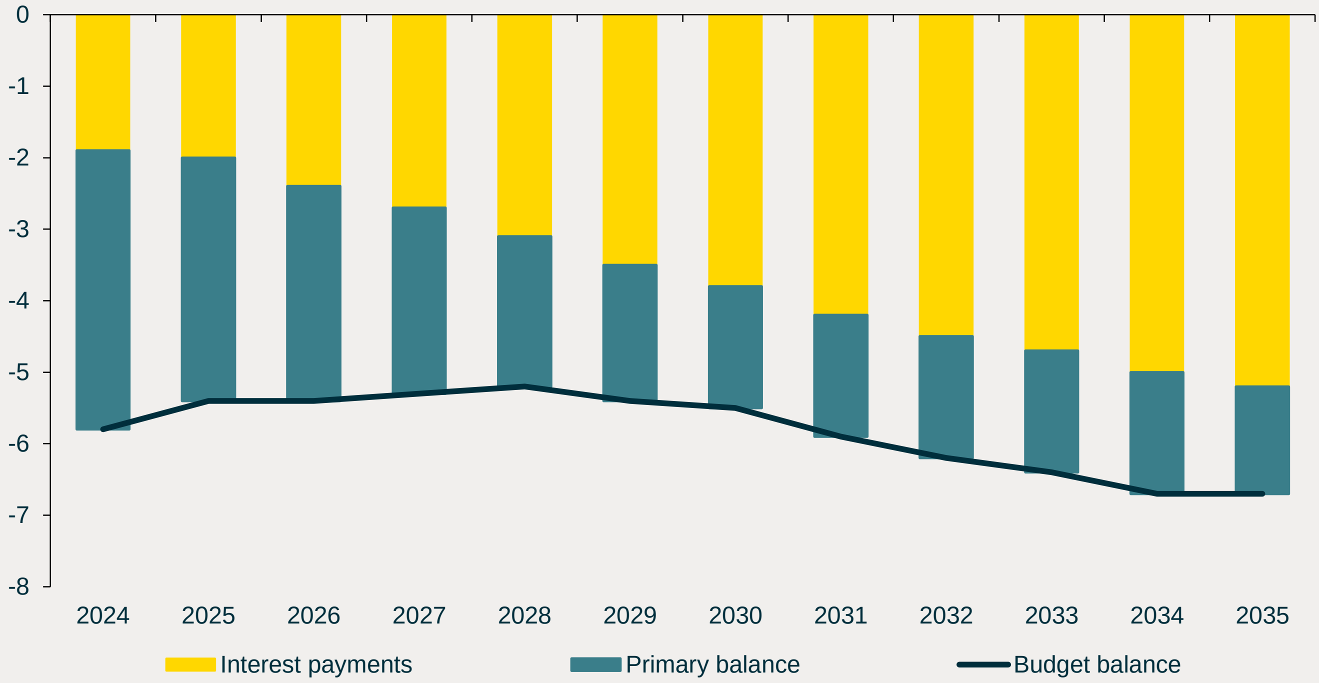
At 5.8%, France's general government budget deficit was significantly higher last year than in the other major euro area economies. The government's current budget plan does provide for a reduction in the deficit to 3.0% of GDP by 2029, which would align it with EU requirements. However, this target is unlikely to be achieved. Interest payments as a percentage of gross domestic product are likely to rise from around 2% in 2024 to around 3.5% in 2030 (Chart 5). In addition, the minority government under Prime Minister

Bayrou is unlikely to succeed in securing a parliamentary majority for extensive spending cuts. The target for the 2025 budget balance has already been revised downwards from -5.0% to -5.4%.

Furthermore, as the only nuclear power in the European Union and an important supporter of Ukraine, the French government is likely to increase its defense budget from the current level of 2% of GDP. As a result, the primary deficit is likely to improve only marginally, from 3.9% in 2024 to 1.7% in 2030. This means that the overall deficit ratio will hardly change in the coming years and will even rise slowly again from 2030 onwards. The reduction in the primary deficit is likely to cause France's economic growth to be lower in the coming years than in recent years. In the medium term, we assume potential growth of 0.7%.

Chart 5 - Projections on the French budget balance

General government interest payments, primary deficit and budget balance for France, in % of GDP



Source: World Bank, Bloomberg Economics, Commerzbank-Research

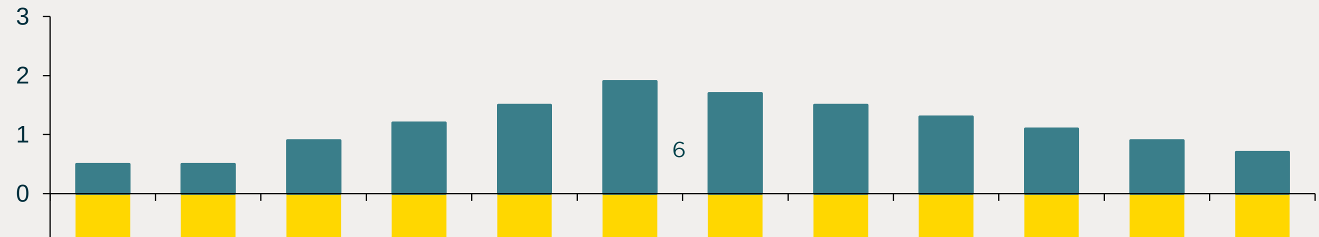
Italy

Italy was the only major euro area country to achieve a primary surplus in 2024. With a budget balance of -3.4%, the balance was less negative than expected by the Meloni government (-3.8%). The government plans to gradually reduce the budget deficit in the coming years. However, this is hardly feasible given the unfavorable demographics, sharply rising interest payments, and likely higher defense spending. The Italian Ministry of Economy's “Aging Reports,” for example, predict that Italian government subsidies for the pension system will rise from just under 5% of gross domestic product to almost 6% by 2040. In addition, Italy is likely to significantly increase its NATO quota, which stood relatively low at 1.5% in recent years. We do expect some defence spending increase as a percentage of GDP in the medium term, even if the new target of 3.5% is unlikely to be reached. As a result, the primary surplus is likely to fall again from 2030 onwards. As the burden of interest payments will rise significantly at the same time, the budget balance deficit is likely to remain above 3% and rise again noticeably from 2030 (Chart 6).

The long-term sustainability of government debt is further complicated by the fact that potential growth will be very low in the coming years due to the sharp decline in the working-age population. We estimate it at 0.4% per year.

Chart 6 - Projections on the Italian budget balance

General government interest payments, primary deficit and budget balance for Italy, in % of GDP

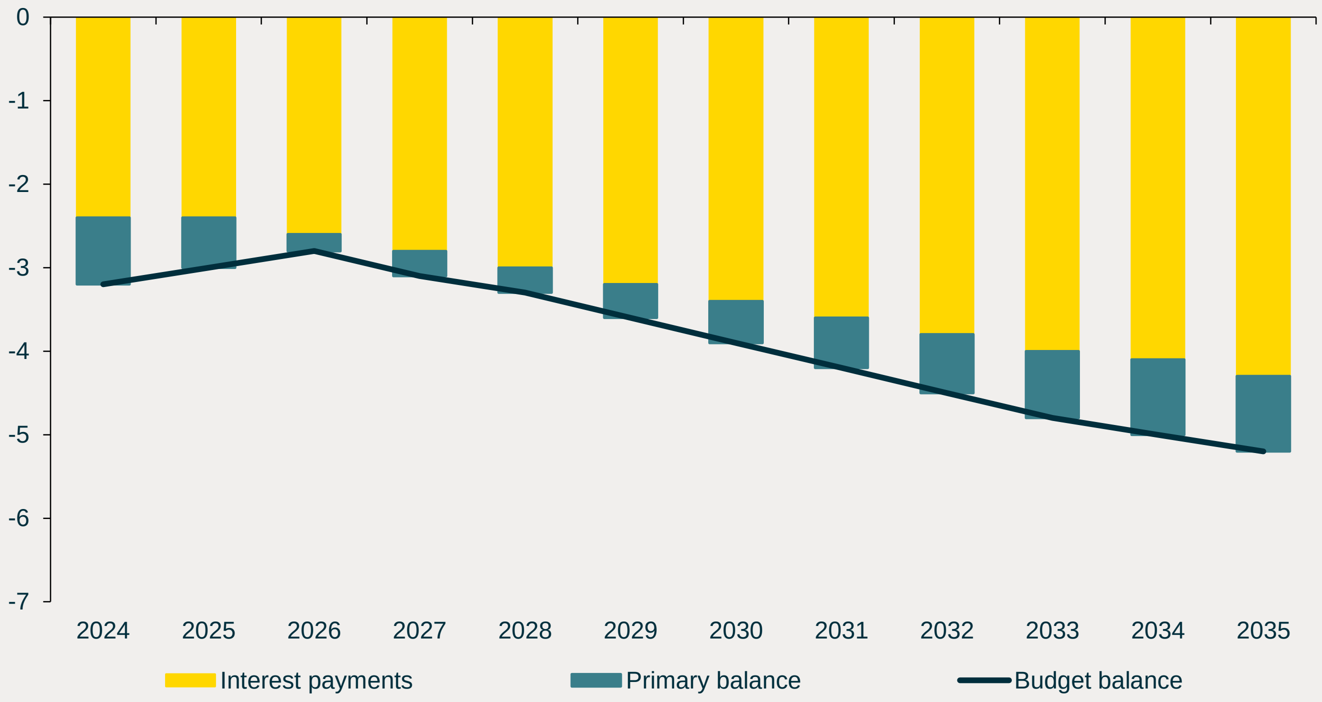


In Spain, the debt ratio, which rose sharply during the pandemic, has recently fallen significantly due to strong economic growth. The country benefited significantly from the EU's NextGeneration program and a more favourable demographic development than other EU countries. While the EU program is now coming to an end, the working-age population is expected to continue to rise slightly until 2030. After that, it will also fall in Spain. We therefore assume that real GDP growth in Spain will decline from the current 2.3% to 0.7% in 2035. Due to higher growth in the coming years, the GDP deflator in Spain is likely to rise slightly faster than in other countries.

The starting position for Spain's government budget has improved in recent years, with the primary deficit amounting to 0.8% of gross domestic product, 0.4 percentage points of which were caused by one-off expenditures related to flooding in Valencia. We therefore expect the primary deficit to fall to 0.2% in the short term (Chart 7). Given the rising political tension in Spain, higher defence spending, and a declining working-age population from 2030 onwards, the primary budget deficit is likely to rise yet again to 0.9% in the following years. In addition to the higher interest burden ratio, this will cause the Spanish budget deficit to increase as well.

Chart 7 - Projections on Spanish budget balance

General government interest payments, primary deficit and budget balance for Spain, in % of GDP



Source: World Bank, Bloomberg Economics, Commerzbank-Research

Analysts

Dr. Vincent Stamer AC
Senior Economist
+4969935345800
vincent.stamer@commerzbank.com

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60327 Frankfurt	London, EC2P 2XY	NY 10281-1050	Singapore 189773
Tel: + 49 69 136 21200	Tel: + 44 207 623 8000	Tel: + 1 212 703 4000	Tel: +65 631 10000