Global Macro Research

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#Europe / #Fiscal policy / #Growth

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Are the EU fiscal rules made to be broken, or just broken?

The revamped EU fiscal rules are meant to lower debt and deficit ratios over the long term. But the pressing need for public investment, as well as high and rising interest expenditure costs, will push up on these measures instead. Indeed, the fiscal rules lack credibility and are likely to be watered down again in the future.

Key Takeaways

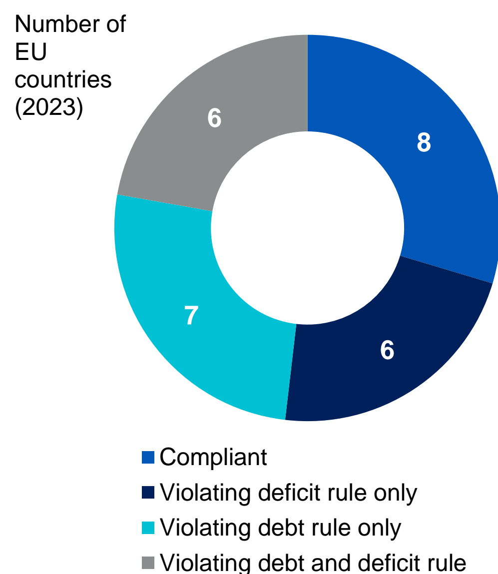
- The return of the EU fiscal rules has seen several European economies including France and Italy immediately fall into excessive deficit procedures.
- They are therefore required to reduce their structural budget deficits by 0.5 percentage points per year.
- But we expect pressing investment needs, the delayed feed-through of higher interest service costs, and political realities will continue to push deficits higher rather than lower over the next few years.
- Indeed, the recommendations in the Draghi report on European competitiveness point to higher investment spending and call for joint borrowing to fund this.
- Eventually, the complex array of exemptions that allow some high-deficit countries to sidestep the full extent of the fiscal rules will expire. At that point, the massive medium-term fiscal consolidations implied by the rules will cease to be credible.
- Therefore, the EU Commission will likely eventually water down the fiscal rules once again, rather than force a showdown with national governments. Changes could include more exemptions for investment spending, and slower deficit reduction.
- Nevertheless, potential flashpoints along the way to this outcome – including the expiry of the temporary adjustment period in 2027 and an array of national-level elections – may cause market volatility akin to the run-up to the recent French legislative elections.

Is a new EU debt crisis?

In April, the European Union (EU) approved a new version of its fiscal rules.

At present, 19 European countries are violating at least one of the rules, meaning they either have deficits above 3% of GDP, or debt ratios higher than 60% of GDP, and in some cases both (see Figure 1).

Figure 1: Most EU countries are falling foul of the fiscal rules in some way

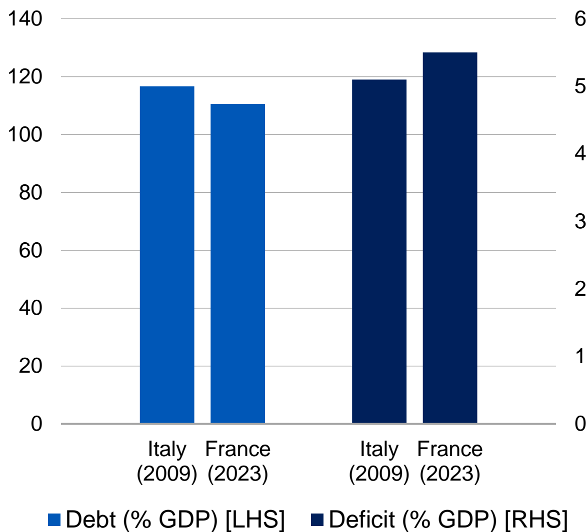


Source: abrdn, Haver, September 2024

Large-scale fiscal expansion in response to Covid and the energy shock has increased European government debt and deficit levels and prompted uncomfortable comparisons to fiscal positions on the eve of the European sovereign debt crisis.

For example, France's debt-to-GDP and deficit-to-GDP ratios are at similar levels to Italy's in 2009 (see Figure 2).

Figure 2: France's fiscal position now looks like Italy's during the financial crisis



Source: abrdn, Haver, September 2024

In principle, the return of the EU's fiscal rules, which were suspended between 2020 and 2023, requires highly indebted countries to undergo a period of fiscal consolidation.

But rising interest costs, the need for greater investment, and the political difficulty of reducing spending, are all barriers to fiscal consolidation. The complex design of the EU's fiscal framework will in theory require even greater fiscal consolidation in the future, but it is more likely that the rules themselves will be watered down.

Large deficits, or just low growth?

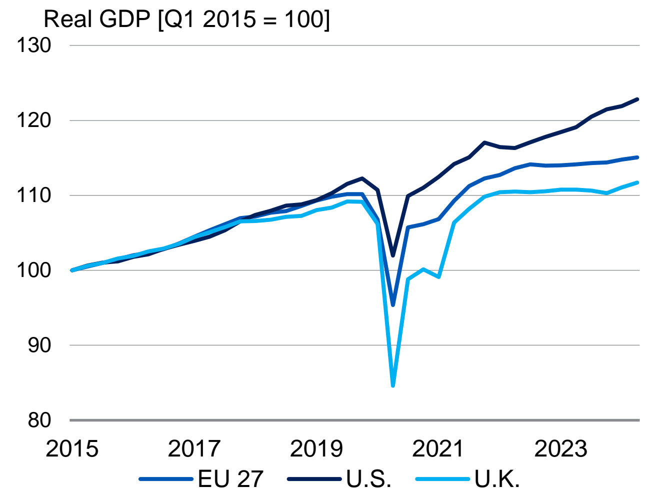
The absolute scale of the post-pandemic increase in European government debt, deficit spending, and debt servicing costs is not an international outlier.

Instead, what distinguishes Europe has been its failure to match the pace of economic growth of countries such as the US (see Figure 3). This means that debt-to-GDP levels have risen more rapidly in Europe than they otherwise might have.

Draghing the EU economy into the 21st century

Former European Central Bank President Mario Draghi, who is also the former prime minister of Italy, recently analysed the EU's relative stagnation in his report on *The Future of European Competitiveness.*

Figure 3: European GDP growth has lagged the US



Source: abrdn, Haver, September 2024

We think that, while some of Draghi's proposals do indeed have the potential to boost the EU's long-term growth prospects, most are unlikely to be implemented.

For example, the EU's failure to carve out a niche for itself in emerging high-tech industries could be partially addressed by Draghi's recommendation for simpler, more integrated, less stringent regulation. However, forging a consensus across EU countries in favour of sweeping regulatory reform and further EU integration is likely to be a profoundly difficult task.

The report's proposed fiscal reforms will be similarly difficult to implement. Draghi has diagnosed an annual investment shortfall of 5% of GDP and argued that the public and private sectors should share the task of making this up. This would result in an enormous rise in government spending, which is precisely what the EU's revamped fiscal rules are designed to guard against.

Draghi recommends the EU authorities circumvent this by issuing joint-EU debt. We agree that the need to expand investment is pressing, but the issuance of joint-EU debt is extremely likely to be vetoed if proposed, probably by Germany.

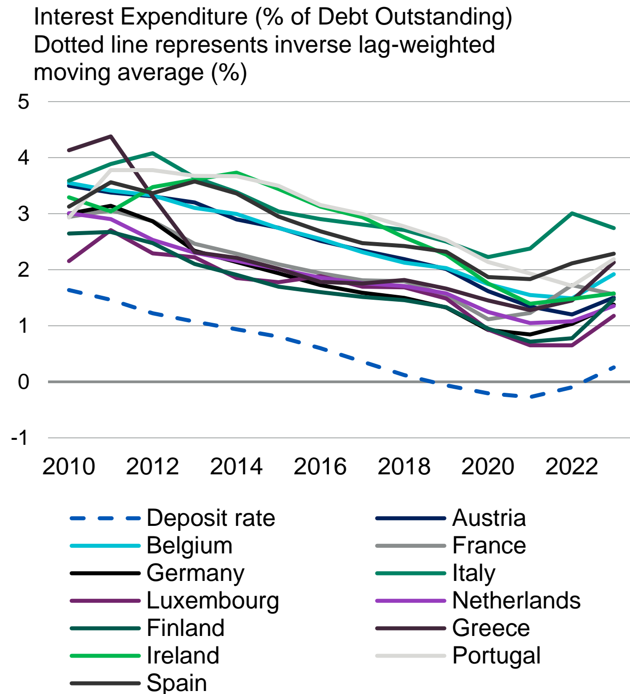
If innovative solutions such as these cannot be passed, European growth prospects are likely to remain in a vicious cycle: growth prospects limited by a lack of fiscal headroom, and fiscal headroom limited by low growth.

Our potential GDP forecasts for the Eurozone therefore remain low. We think trend growth currently sits at 1.0-1.2% and will drop to 0.8% over the next decade. Governments can't count on a strong rebound in growth to create the space for greater spending.

Interest expenditure is on the rise

Despite the ECB's interest rate cutting cycle, governments' borrowing costs remain near their highest levels in two decades. In fact, the impact of earlier rate *hikes* is still passing through to governments' interest payments, as debt is refinanced at higher rates than in the past (see Figure 4).

Figure 4: Higher interest rates will continue to feed through to higher government interest expenditure



Source: abrdn, Haver, September 2024

This will make reducing deficits even more difficult. We estimate the effect of interest rate changes alone will push up on government deficit-to-GDP ratios by a further percentage point by 2027.

Fiscal framework quirks could become flashpoints

The upward pressure on deficits from interest expenditure is the primary reason behind one important carve-out in the revamped EU fiscal framework.

Under the new rules, during an adjustment period lasting until 2027, countries with deficits in excess of 3% of GDP are required to reduce their *structural* deficit (which adjusts for cyclical fluctuations and excludes interest expenditure) rather than their *total* deficit. After 2027, deficit reduction requirements will revert to applying to *total* deficits.

This change is designed to soften the process of fiscal consolidation. In particular, countries don't have to reduce their primary deficit to offset a rise in interest costs.

But relaxing aspects of the fiscal rules could undermine the fiscal framework's credibility and introduce a ratcheting effect towards ever-looser rules over time.

Indeed, there is a significant risk that countries will still be running excessive deficits when the adjustment period expires.

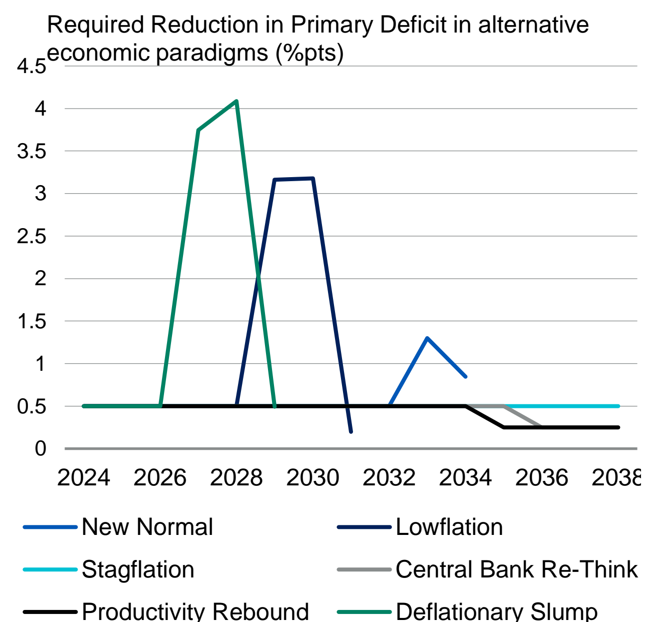
More generally, the EU's revamped fiscal rules grow more burdensome as time passes. For example, under the debt reduction rules, countries with debt in excess of 90% of GDP should reduce their debt-GDP ratio by an average of 1 percentage point per year. But debt reduction plans come into force only once deficits have returned to compliant levels.

So, France, Italy and Belgium – all countries with debts over this threshold as well as excessive deficits – will first be bound only by the relatively straightforward requirement of absorbing a small negative fiscal impulse. However, when their total deficits drop below 3% of GDP, the debt reduction rule becomes binding. This will see required deficit reductions increase.

We think the implied negative fiscal impulse associated with compliance with the debt rule may end up being so large as to become extremely difficult to achieve.

To illustrate this, we've modelled countries' fiscal obligations under our long-term alternative economic paradigms (our forecasts for growth, inflation, and interest rates over a 10-year horizon). We find that in some of the paradigms, the required tightening in primary expenditure in highly indebted economies is north of 3% of GDP in some years – an implausible tightening. (see Figure 5).

Figure 5: France's future debt reduction obligations could be very burdensome



Source: abrdn, Haver, September 2024

These simulations tease out some of the perverse incentives embedded in the complex design of the fiscal rules.

For example, the most highly indebted governments are not required to make large cuts under the “stagflation” paradigm, because spiralling interest costs keep total deficit-to-GDP ratios above 3%, meaning the debt reduction rule does not apply.

Admittedly, the fiscal framework does have a mechanism to deal with this distortion. Debt reduction requirements are defined over a seven-year horizon, rather than a one-year period, as previously. This alteration to the fiscal rules tends to favour backloaded tightening.

Thus, the flashpoint that places fiscal rules under strain could come later than our modelling might otherwise suggest.

In addition, the flexible, long-term obligations associated with the debt rule are structured in a way that incentivises governments to submit favourable economic projections. In this regard, the key features of the EU’s new debt rule resemble those of the UK’s main fiscal rule: long-term projections must show debt falling as a percentage of GDP by a certain amount (for the UK, this amount is fractionally greater than zero). For EU countries, so long as the combination of GDP and fiscal forecasts produce long-term projections that show the debt to GDP ratio falling by 1% per year on average, highly indebted governments can avoid painful short-term consolidation.

A further complication are the national-level fiscal rules in operation in Europe, outside the EU framework. In particular, the German debt brake – which limits deficit spending to 0.35% of GDP excluding off-budget emergency spending – is a binding restraint on fiscal policy.

The governing traffic light coalition’s finance minister – the Free Democrat’s Christian Lindner – is committed to this policy, meaning it will stay in place for now.

However, the pressing need for investment, especially in Germany’s struggling industrial sector, leads us to believe that the debt brake will eventually have to be materially relaxed or abolished.

More adjustments may be necessary

The EU’s current fiscal framework has an expiry date, although when that is remains to be seen. The strain these rules will come under will depend on several interlinked factors, including macroeconomic paradigm shifts, economic shocks, and political developments.

Potential flashpoints include the expiry of the adjustment period in 2027, the implementation of the debt reduction plans once major countries in excessive deficit procedures lower their deficit-GDP below 3%, and major elections including the next French presidential election.

Risks deriving from these event may drive financial market volatility in a similar fashion to the run-up to the recent French legislative elections.

If the fiscal rules are revisited once again, a sensible outcome would be to introduce more exemptions for investment spending and reduce the required pace of debt reduction.

We think the European Commission has the room to make adjustments of this kind without seriously jeopardising member states’ long-term fiscal stability. While the biggest threat to fiscal sustainability would be a shift to a stagflationary paradigm that permanently pushes interest rates many percentage points higher, we consider this unlikely.

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