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Eurozone public debt sustainability: Make hay while the sun shines

Some countries may come under market scrutiny, but there's a bit of time to take action

Macroeconomic Research

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Key points

- Recent but significant improvements in public-debt-to-GDP ratios across the Eurozone are unlikely to persist in the medium-run. History is no reassuring guide
- Our simple public debt sustainability analysis suggests debt ratios should edge down over the next two years. After that, risks are skewed to the upside. Countries should take advantage of this short time window to take action.
- We examine new EU fiscal rules, and the difficulty of agreeing these across the Eurozone in a timely fashion
- The prospect of an NGEU 2.0 would likely be more influential on the market and could prove more crucial for the future of the Eurozone

The Eurozone's sovereign debt outlook

Since the euro's inception, to 2022 the Eurozone's public debt-to-GDP ratio has increased by more than 20 percentage points (ppt) to 93.2%. Over that time, member states' trajectories have been increasingly divergent.

Looking at fiscal dynamics, we believe the recent and steep falls in debt ratios are unlikely to persist while key countries look set to see a resumption of rising debt in the medium-term unless adequate action is taken.

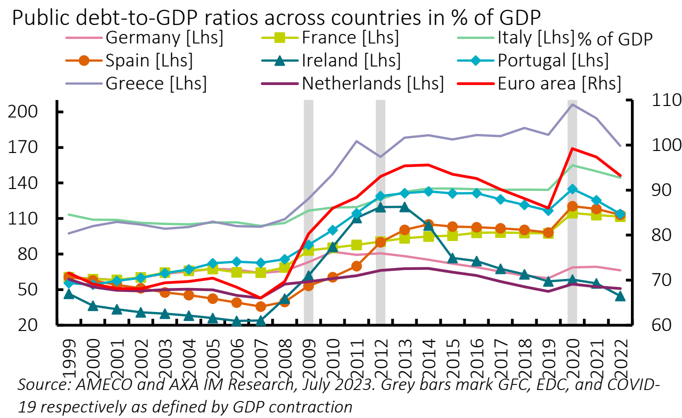
We review the fiscal outlook for key countries by considering simple debt dynamics analysis, including country-specific scenarios, and the more comprehensive framework of the European Commission Fiscal Monitor.

The fraught introduction of new Eurozone fiscal rules looks to address some of the well-flagged concerns of previous regulations but is unlikely to be a panacea. A Next Generation EU (NGEU) 2.0 – a permanent mutualised fiscal capacity – would have much more market impact in our opinion, addressing a fundamental deficiency of the Eurozone's architecture, however, resistance to this will be considerable from some key member states and such an outcome is not our baseline.

Little comfort from history

The marked increase in the Eurozone public-debt-to-GDP ratio since 1999 reflects three major economic shocks: The fiscal policy response to the global financial crisis; the European debt crisis (EDC); and the pandemic (Exhibit 1). Altogether, large increases have more than offset smaller declines in public indebtedness during 12 of the past 23 years, highlighting the vulnerability of the region's public finances to economic shocks – and the procyclicality of (previous) fiscal rules.

Exhibit 1: Increasing yet diverging public debt trajectories dictated by three main economic shocks



Source: AMECO and AXA IM Research, July 2023. Grey bars mark GFC, EDC, and COVID-19 respectively as defined by GDP contraction

Economic policies, including labour and product market structural reforms, as well as extraordinary accommodative monetary policy, together with more secular drivers have helped lower interest rates (r) relative to nominal growth rates (g). When growth rates exceed interest rates, as has been the case in the past decade, debt ratios can fall even if borrowing increases. Since the inception of the euro, the difference between the two has not always been positive on average highlighting underlying vulnerabilities. We use an analysis of these simple debt dynamics to monitor the outlook for countries' fiscal outlooks.[1]

More recently, significant – if not excessive – fiscal consolidation after the EDC has been replaced by protractedly loose (and perhaps poorly targeted) fiscal policy in the wake of COVID-19 and the 2022 energy inflation shock[2] and has come amid the suspension of Stability and Growth Pact fiscal rules. This has broadly contributed to the European Central Bank's (ECB) need to tighten monetary policy more at the margin, which in turn raises questions about the sustainability of member states' public finances.[3]

Moreover, divergence within the Eurozone increased with the standard deviation of public-debt-to-GDP ratios almost doubling, from 25 to 40, between 1999 and 2022 among the 10 largest countries. Aside from some exceptions (e.g., Ireland), countries with historically higher public debt post-EDC have accumulated relatively more, while historically more fiscally conservative countries have remained so (Exhibit 1).

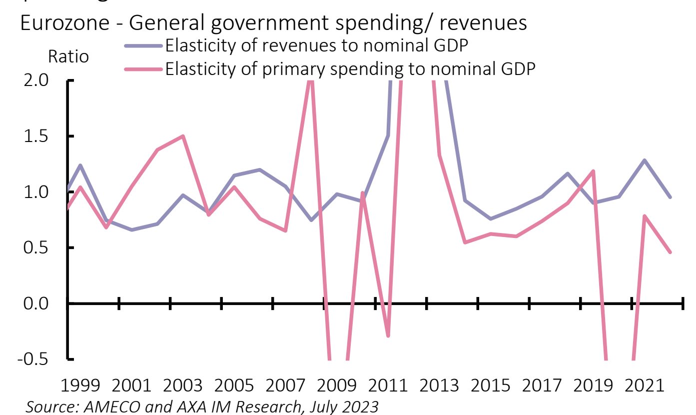
We believe medium-term dynamics signal caution. We think the fast reduction of public indebtedness in 2021 and 2022 is unlikely to persist beyond the next couple of years. We also review the Commission's public debt sustainability framework. While recognising the benefits of such a comprehensive suite of tools, we conduct our own analysis drawing conclusions for France, Italy, Spain and Portugal following an examination of country specific scenarios. We conclude by weighing the benefits of future fiscal rules, and its impact on markets.

Recent debt dynamics: A misleading guide for the future

Bucking the longer-term trend, public-debt-to-GDP ratios across the Eurozone have fallen sharply in the last few years (Exhibit 1). We believe such short-term improvement is misleading for medium-term developments for three key reasons:

– Fiscal revenues have responded more quickly than primary spending to higher inflation in the economy (Exhibit 2), comparing the elasticities of fiscal revenue and primary spending to GDP. This is the so-called 'inflation dividend', reflecting the short-term effect of more dynamic tax revenues versus short-run spending rigidities

Exhibit 2: Revenues responded to inflation more quickly than spending



Source: AMECO and AXA IM Research, July 2023

– Lengthened debt maturities have delayed the burden of rising interest rates. In part thanks to ultra-loose monetary

[1] For a detailed description of the analytical framework, see. "How governments can respond to the COVID-19 debt surge", October 2020.

[2] Update on euro area fiscal policy responses to the energy crisis and high inflation, ECB Economic Bulletin, 2/2023

[3] ECB monetary policy statement, June 2023

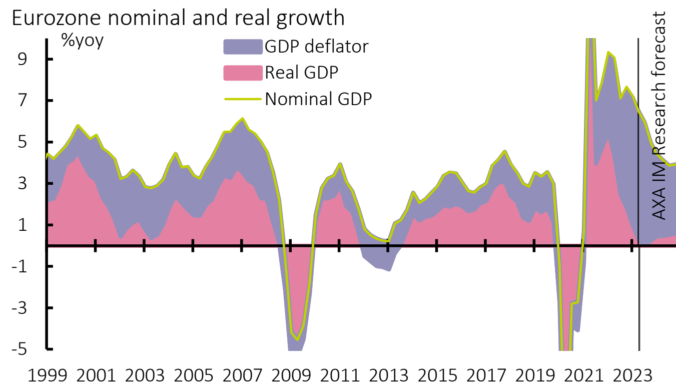
policy, some debt management offices have meaningfully extended their debt maturity profiles in the past decade or so (Austria and Belgium by over 50%). This has allowed debt interest rate burdens to continue to fall in Belgium in 2022, while they rose in Germany where debt maturity is shorter

– Nominal GDP has been buoyant, with inflation – the GDP deflator more than compensating slowing real growth, after the last economy reopening post confinement

These factors are temporary and likely to reverse. Expenditure rigidities (e.g., civil service wages and pensions) are likely to catch up with the past inflation shock. Nominal growth looks set to dwindle, affecting both the numerator and the denominator of public-debt-to-GDP ratios. Our stagflation outlook already implies anaemic real GDP growth (+0.1% quarter on quarter on average through to end-2024) underpinned by fiscal normalisation, past monetary policy tightening and a tepid global environment (Exhibit 3).

In turn, the GDP deflator will be the main source of nominal growth but following our core inflation forecasts, this too should be on a downward path. By the end of our forecast horizon, we project Eurozone nominal GDP growth to decelerate to around 4% at the end of 2024 from 7.4% in the first quarter (Q1) 2023, and 8.2% on average in 2022, with further deceleration likely beyond that. Finally, higher-for-longer interest rates mean extended maturities provide only a short-term buffer to an increasing interest rate burden.

Exhibit 3: Significant deceleration ahead in nominal GDP growth



Source: Eurostat and AXA IM Research, July 2023

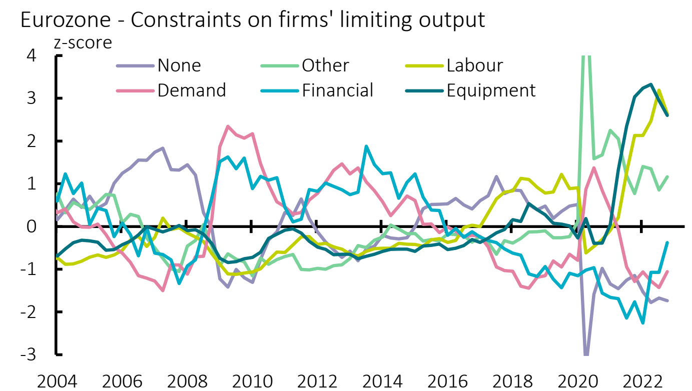
Supply shocks more costly over medium term

The risks to the outlook are also impacted by the type of shock. ECB simulations show, over the medium term, "slower growth resulting from an adverse external *supply* shock may outweigh the positive impact of higher inflation on public debt ratios, while an internal *demand* shock would reduce the debt burden"[4].

It suggests that in an external supply shock scenario, a 1ppt increase in the Harmonised Index of Consumer Prices (HICP) over three years would lead to a 6ppt increase in public-debt-to-GDP ratio over a 10-year horizon. In case the inflation shock comes from internal demand, the public-debt-to-GDP ratio would be reduced by close to 3ppt over a similar horizon.

The current situation is likely a mix of supply and demand factors. Recent ECB modelling shows that in Q4 2022, supply and demand shocks were broadly of similar magnitude.[5] The Commission's quarterly survey concludes that supply shocks, although abating, remain dominant in affecting firms' ability to increase output. Furthermore, long-term challenges such as an ageing population, ecological and energy transitions as well as neo-globalisation are all supply shocks by design – although the policy response to these may imply a more balanced outcome. For both the short and the medium term, we are tempted to conclude that supply shocks will dominate.

Exhibit 4: Supply constraints seemingly running high according to European Commission survey



Source: European Commission and AXA IM Research, July 2023

'Simple' public debt sustainability analysis

Given high public indebtedness, higher-for-longer interest rates and an uncertain growth path affected by multiple (supply driven) factors, investors need to find the appropriate balance between comprehensive analysis and agility in case shocks emerge affecting medium-term public debt dynamics.

We have analysed country specific public debt sustainability (DSA) scenarios, covering France, Italy, Spain and Portugal, which we summarise below with more comprehensive details in the appendix. In short, renewed increases in Italy and France debt profiles are likely beyond the next two years unless strong policy

[4] Box 1 in Fiscal policy and high inflation (europa.eu)

[5] The role of supply and demand in the post-pandemic recovery in the euro area, ECB Economic Bulletin, issue 4/2023

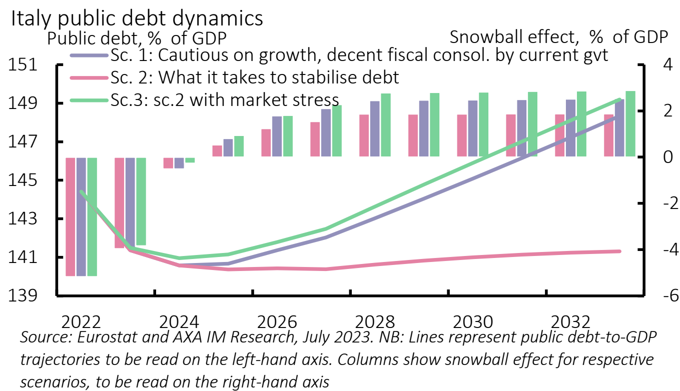
action is taken - timely and efficient implementation of NGEU recovery funds for the former; and enhanced policy action towards primary surpluses for the latter. By contrast, the Spanish and Portuguese outlooks suggest ongoing declines in debt ratios, with Portugal well on track to see debt stabilise at or below 90% within the next decade.

Italy: NGEU implementation critical for long-term growth

Italy has a historical nominal GDP growth deficit – and as a result adverse rates-growth (R-G) dynamics – while it has managed to deliver sizeable primary surpluses on a consistent basis (for more see Appendix 1).

This puts the focus on implementation of Italy's NGEU funding to spur the nation's long-term growth potential amid the adverse cost of an ageing population. The European Commission projects the fiscal cost of ageing to increase to 1.1% of GDP in 2029 and 2.0% in 2033 from nil in 2024. We think delays in actually spending the money received (applying to about a third of the circa €67bn total) is worrying, but it remains too early to draw definitive conclusions.

Exhibit 5: Italy: Fast increasing interest rate burden leaves little room for mistakes (on growth)



Source: Eurostat and AXA IM Research, July 2023. NB: Lines represent public debt-to-GDP trajectories to be read on the left-hand axis. Columns show snowball effect for respective scenarios, to be read on the right-hand axis

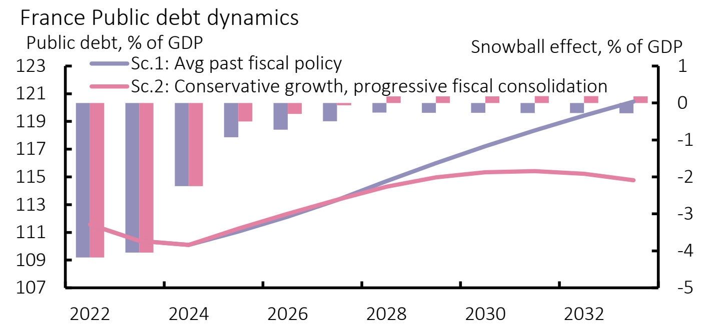
Our scenario analysis suggests (detailed in Appendix 1).

- A persistently high sizeable primary surplus is an (ongoing) pre-requisite to stabilise Italy's public debt in the medium run – let alone to yield continued debt reduction. Italy's historical performance suggests the government's plan can be credible
- Dynamic growth is also required. Close monitoring of National Recovery Resilience Plan implementation will be paramount. Italian government forecasts for above 3.0% nominal growth by 2026 appear optimistic. Slower than expected growth would require a significantly higher primary surplus to stabilise the debt trajectory (our scenario one)
- Despite Italy's relatively shorter-than-peers debt maturity (seven years), our baseline envisages debt-to-GDP ratios to continue receding this year and next owing to still-strong nominal growth
- However, it is also implying that a persistent interest rate shock – our scenario three - can send debt on an increasing path relatively quickly, bar primary surpluses exceeding 2.7%, which would likely be very costly (Exhibit 5)

France: The shadow of limited past fiscal consolidation

At 111.6% in 2022, France's public-debt-to-GDP ratio decreased by a small amount compared to its peers over the past two years and is among the largest in the Eurozone. The root cause is the same as in the 1990s: a persistently (high) primary deficit.

Exhibit 6: France requires significant primary deficit reduction to keep lowering debt



Source: Eurostat and AXA IM Research, July 2023. NB: Lines represent public debt-to-GDP trajectories to be read on the left-hand axis. Columns show snowball effect for

We draw the following conclusions from our scenario analysis:

- Decent nominal growth projected in our baseline, combined with over eight-year average debt maturity, should see public debt fall this year and next – consistent with a very negative snowball effect[6]
- Repeating average past policy would then send public debt on an ascending path (scenario one). Such a scenario comes close to the Commission's 'no policy change' scenario which envisages the public-debt-to-GDP ratio deteriorating to above 120% in 2033. Such a path, at odds with current and future fiscal rules, would likely be met with an adverse market reaction, further worsening debt dynamics
- The snowball effect should be watched closely. It is reassuring to see that even a very slight primary deficit would stabilise the public debt trajectory in our scenario one. Lower assumed growth in scenario two would require a greater effort to stabilise debt, though within reach judging by instances of fiscal adjustment in other Eurozone countries in the past

[6] Snowball effect refers to the difference between nominal interest rate and nominal growth from which can be derived the debt stabilising primary balance

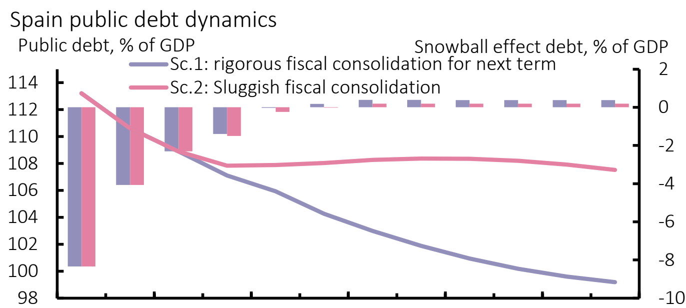
- High public debt, like other countries examined in this note, implies limited room for manoeuvre against adverse (cyclical) shocks, but also for long-term investment purposes (Exhibit 6)

In its recently published annual report,[7] the French audit office signalled that a planned return to a 3% public deficit in 2027, later than its European peers, will require a substantial effort, highlighting that it also relies on optimistic growth assumptions. We agree. Finally, the institution dedicates an entire chapter to a much-needed comprehensive review on the quality of public spending (more in Appendix 2).

Spain: Finding the right balance between growth and fiscal consolidation

In the wake of the global financial and debt crises, strong GDP growth has been key in bringing down Spain's public-debt-to-GDP ratio despite relative political instability.

Exhibit 7: Spain: Although unlikely, public debt could remain stuck at high levels



Source: Eurostat and AXA IM Research, July 2023. NB: Lines represent public debt-to-GDP trajectories to be read on the left-hand axis. Columns show snowball effect for respective scenarios, to be read on the right-hand axis

We draw the following conclusions from our DSA (Appendix 3):

- We think strong nominal growth is likely to persist during the rest of 2023 and into 2024, consistent with ongoing meaningful public debt adjustment
- In its stability programme, the socialist minority-led government had pencilled an ambitious fiscal adjustment (from a deficit of 2.4% in 2022 to primary surplus from 2025). There is initially little concern over a significant loosening of fiscal policy that would jeopardise public debt dynamics, as shown in our scenario one. While not a significant issue in the short-term, a protracted unresolved political situation could become a worry if it were to persist into next year and beyond. Scenario two reflects a very sluggish fiscal consolidation with the primary balance improving by only 0.1ppt every year – reaching surplus only in 2029. This would be consistent with debt stabilising at high levels, around 108%
- Finally, we draw investors' attention to possible delays in NGEU funds disbursement and spending in light of the inconclusive snap elections, an additional €84bn loan request and the inclusion of RepowerEU funding. Were NGEU funds delayed, the previous government's nominal growth projections of 3.9% and 3.6% in 2025-2026 may be on the high side, though not totally unrealistic.

Portugal: The 'ex'-peripheral country

Serious implementation of reforms and political stability have enabled a profound transformation of the Portuguese economy since the EDC. A continuation of these healthy policies made Portugal one of the very few countries posting a primary surplus already in 2022 (1.6%).

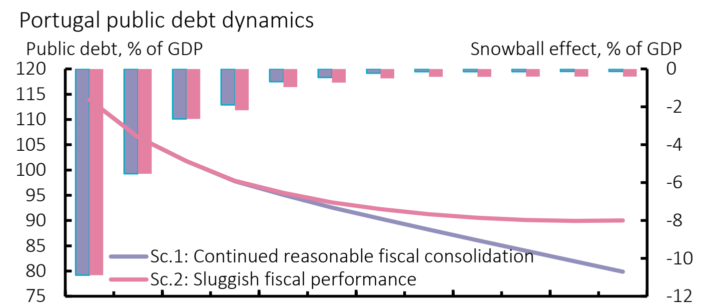
It is therefore little surprise the public-debt-to-GDP ratio has dropped by over 20ppt since 2020. In fact, at 113.9% in 2022, it stands lower than in 2019. Without a major shock, there is little concern over Portugal's public debt trajectory.

Our two DSA scenarios highlight that (detailed in Appendix 4=:

- Continued reasonable fiscal consolidation (more modest than the government's intention to reach a primary surplus of 2.9% in 2027) would still be consistent with a persistent fall in the public-debt-to-GDP ratio (scenario one)
- Assuming more profligate behaviour (a primary balance edging down by 0.3ppt a year from 2024 would imply public debt stabilising at around 90% (scenario two)

All in all, our set of assumptions point towards very limited risk for Portugal's public debt sustainability, concurring with the Commission's DSA monitor which foresees public debt edging down across almost all its scenarios.

Exhibit 8: Portugal: Limited public debt dynamics concern



Source: Eurostat and AXA IM Research, July 2023. NB: Lines represent public debt-to-GDP trajectories to be read on the left-hand axis. Columns show snowball effect for respective scenarios, to be read on the right-hand axis

[7] French audit office 2023 report, July 2023

EC Fiscal Monitor’s comprehensive assessment

The European Commission (EC) publishes an annual fiscal monitor in April. The DSAs it includes are enshrined in the ECB’s Transmission Protection Instrument decision-making as well as in future Eurozone fiscal rules. We review the key findings here.

The Commission relies on three independent synthetic indicators classifying countries on short, medium, and long-term risk.

For the short term, the Commission combines 25 fiscal (including, for example, debt stabilising primary balance, cyclical adjusted balance, and short-term debt) and financial-competitiveness variables (including net international investment positions, household savings, non-financial corporations and households’ short-term debt) into a synthetic indicator. Using a signal approach based on past fiscal stress events,[8] Commission staff judge the fiscal vulnerability as low for the upcoming year across countries (Exhibit 9).

The Commission’s medium-term approach relies on a ‘typical’ debt sustainability analysis, but with a few interesting twists. It provides debt dynamics under a no-policy-change scenario, useful to compare across jurisdictions. It also provides it with a range of deterministic alternative scenarios. Finally, a detailed cost of ageing is also very useful (for instance worth 2.0% and 1.5% of GDP in Italy and Germany respectively versus 0.4% in France in 2033[9]). Exhibit 9 shows a much more differentiated picture across countries than for the short term: France and Belgium in the high-risk category over the medium term, together with Italy, Spain, Portugal and Greece.

For the long-term analysis, we find the Commission’s ‘S2’ indicator the most interesting: The fiscal effort to stabilise public debt in the long run. Both Belgium and Netherlands stand in the high-risk category. Portugal and Greece are rated as low risk (Exhibit 9).

Exhibit 9: Commission’s fiscal risk assessment

Risk classification		Germany	France	Italy	Spain	Netherlands	Belgium	Portugal	Greece
Short-term	Low	Low	Low	Low	Low	Low	Low	Low	Low
Medium-term	Medium	Medium	High	High	High	Medium	High	High	High
Long-term	High	Medium	Medium	Medium	Medium	High	High	Low	Low

Source: European Commission 2022 fiscal monitor. NB: Blue corresponds to low risk classification, pink: medium, and green: high

New fiscal rules: Better, but no game changer

COVID-19 and the Russia-Ukraine conflict have postponed an overdue review of the Eurozone fiscal framework. A broad consensus emerged that fiscal rules inherited from the Maastricht treaty were too complex, opaque and procyclical, while complaints also surrounded the enforcement process.

Exhibit 10 summarises the four key pillars of the proposed new fiscal rules made by the Commission last November. These create an integrated framework between fiscal consolidation, structural reforms and public investment – an obvious yet welcome lesson from adjustment programmes in the wake of the debt crisis – a proper comprehensive economic policy approach.

Exhibit 10: Eurozone fiscal rules in short

Key pillars	In details
National medium-term fiscal & structural plans	Member states to submit four-year plans setting 1) fiscal adjustment path, 2) reforms, 3) public investment commitments which can be extended to seven years.
Fiscal adjustment based on simpler and more transparent rules	Multi-year simple net primary expenditure* target, consistent with public debt reduction and a fiscal deficit below 3% at the end of period. For member states above SGP criteria, EC is to issue DSA. Debt to be on a downward trajectory and deficit reduction has to be more than 0.5% of GDP per year as long it remains above 3%.
New minimum standards for independence and technical capacity for national independent fiscal institutions	Enhanced role for national fiscal councils.
Better enforcement	Excessive Deficit Procedure (EDP) is: - unchanged for public deficit above 3%. - amended for when debt is above 60%, when there is deviation to multi-year expenditure target (rather than the 1/20th reduction). Escalation to be quicker, and financial sanctions less punitive.

*Source: EC and AXA IM Research, July 2023. * net primary expenditure would excude (1) discretionary revenue measures, (2) interest expenditures, (3) cyclical unemployment expenditures*

It is, however, worth highlighting that the new, simpler net primary expenditure rule excludes discretionary revenue measures. Moreover, in excluding (cyclical) unemployment the rule would still rely on unobservable indicators – now the unemployment gap rather than the previous output gap. While simpler on paper than the previous rule, crucially set on a country-by-country basis, it is not clear that in practice this will prove as simple and transparent as intended.

While we welcome the enhanced role for national fiscal councils, it is unclear how confrontational to government policy these will dare to be and what legal processes will be required – going above and beyond the consultative role they have now.

The Commission’s DSA will become central when member states fall into Excessive Deficit Procedure (EDP): Public deficit-to-GDP ratio above 3% at the end of forecast horizon, or deviation from the multi-year expenditure target. To be compliant, public debt needs to be on a downward trajectory and deficit reduction must be more than 0.5% of GDP per year. Transferring this power to the Commission is a contentious point for Germany, at odds with enhanced national ownership and the supposedly enhanced role for national fiscal councils.

[8] Methodology can be found in the document: Debt Sustainability Monitor 2022 (europa.eu)

[9] which we gather does not include France’s pension reform passed earlier this year

There is also strong disagreement on the required effort for high-debt countries. Most recently, 10 countries have joined German Finance Minister Christian Lindner, in requiring high indebted countries to reduce their public-debt-to-GDP ratio by 1ppt every year, significantly opposed by high-indebted countries like France and Italy.

Past fiscal reforms have taken more than a year to implement, so it is a challenge to attempt full approval ahead of next year when the current fiscal rules' general escape clause will elapse. While a final agreement would ideally be struck before the 2024 draft budget presentations are due in mid-September to mid-October, it will not be easy to get the new rules ratified (a mix of European Union (EU) Council and EU Parliament approval) before the European Parliament goes into recess in February, ahead of next year's European Union elections.

This will be further complicated by:

- Inconclusive Spanish snap elections on 23 July, which may lead to either a potentially weak government or fresh elections towards year-end, while the country holds the rotating EU Council presidency as of 1 July
- The Dutch government resignation on 7 July. Snap elections will take place in the autumn and coalition talks in the Netherlands can take several months (the last successful attempt took 271 days). It is unclear a care-taker government would be able to sign off on these new rules
- The Italian government is seemingly using the ratification of an amended European Stability Mechanism (ESM) treaty as a bargaining chip (unanimity is required) with future fiscal rules and the presentation of a modified National Recovery and Resilience Plan. No vote on the former is planned before November[10]

These new fiscal rules tackle some of the past issues. However, even pending the final details, it is hard to see them as a solution to ensure fiscal sustainability. Previous experience does not inspire confidence of sufficient national ownership. In any case, known hurdles in the ratification process suggest a return to old rules for next year is a distinct possibility.

Furthermore, the global economy has become more uncertain – globalisation, geopolitics, energy and green transition – which will likely require enhanced public intervention. The past three years have certainly taught how (long-term) threats could hit the economy and in turn, the public finances. As such, these new fiscal rules are unlikely to be a game changer for the Eurozone, nor for markets. Rather, they may act as a bridge towards further fiscal harmonisation – a possible NGEU 2.0 – post-2026, after the last scheduled NGEU disbursement.

The future of the Eurozone: NGEU 2.0

NGEU was a mutualised debt tool delivered exceptionally during the height of the pandemic. In the NGEU 2.0 we would consider a permanent mutualised fiscal facility – funded by joint issuance – redistributing to countries via a mix of subsidies and loans. This would be aimed at stabilising cyclical developments and spurring long-term growth. Such a permanent fiscal facility would fix one of the key, longstanding missing elements of the Eurozone's architecture, allowing proper coordination between national and EU fiscal policy. It could be a genuine game changer, and thus a key market event, creating a permanent de facto 'Eurozone safe asset'.

Future Eurozone fiscal rules are likely a necessary precondition for further debt mutualisation for two reasons: First, the aim should be for an adequate policy mix reaping the benefits of strong nominal growth for the next couple of years, while extended debt maturity delays the snowball effect from the increased interest rate burden. They should also help improve investor perceptions and crucially work towards rebuilding trust among countries.

Sufficient conditions for the NGEU 2.0 are two-fold in our view. First and foremost, to make the current real life NGEU experiment a success. This implies a significant step-up from the current pace of actual spending. Second, this will require an 'adequate political mix', recalling the key drive from French President Emmanuel Macron and then-German Chancellor Angela Merkel in May 2020. Recent elections in Italy, Greece, and election results in Spain show a return towards more moderate parties on economic policies. However, the political spectrum remains highly divided – crucially in Germany, which would likely play a key role in deciding to embark onto NGEU 2.0. In any case, ahead of such an event, key political elections lie ahead, with EU parliament elections due in spring 2024 and German elections in autumn 2025, while Italy and France will go the polls in autumn 2026 and spring 2027 respectively.

The upshot

Public-debt-to-GDP ratios have dropped materially across the Eurozone in the past couple of years, but this dynamic is likely to end and reverse over the coming years. A high public debt is likely to be affected by dwindling nominal growth while the debt interest burden is set on an upward path, all the more so as supply shocks dominate.

However, extended public debt maturities in the past decade and still decent, if decelerating nominal growth, provide a crucial buffer for the next 18 to 24 months. This time must be

[10] ESM Treaty - consolidated version (all official languages of ESM Members) | European Stability Mechanism (europa.eu)

used wisely. The European Commission's annual fiscal monitor points to worrying dynamics in Italy, France and Belgium, while prospects in previously distressed countries including Spain and Portugal are more reassuring.

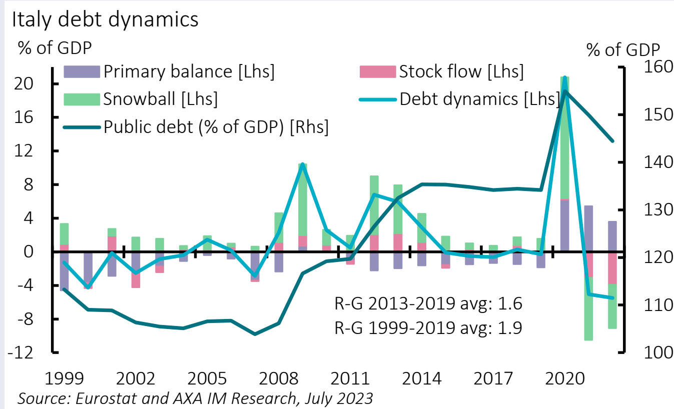
Our debt sustainability analysis concurs with the above, and it is critical to remain agile in monitoring key public account imbalances in the context of a very uncertain macro outlook and relentless monetary policy tightening (rates and balance sheet). On our assessment, in Italy, timely and efficient NGEU spending will be key. In France, the implementation of a comprehensive review of public spending would help public finance dynamics and go some ways to shore up investor concerns.

Details of future Eurozone fiscal rules are yet to be ironed out. From an investor perspective, whether these act as a bridge towards further debt mutualisation will be relatively more important than the rules themselves in terms of improving economic policy coordination, economic performance and market confidence, and thus securing Eurozone public debt sustainability.

Appendix 1 – Italy's public debt context and sustainability analysis assumption details

Italy has an historical nominal GDP growth deficit consistent with adverse R-G dynamics post European debt crisis but also since the Eurozone's inception. On the bright side, it managed to deliver sizeable primary surpluses on a consistent basis – thought only just enough to broadly stabilise debt dynamics prior to COVID-19, rather than engage in a consistent downward path (Exhibit 11).

Exhibit 11: Italy: Economic shocks, unfavourable R-G dynamics more than offset strong primary balance records



Source: Eurostat and AXA IM Research, July 2023

We consider three scenarios for Italy:

Scenario 1: Cautious nominal growth (2.7% on 2025-2033 average; limited effect from NGEU) combined with decent fiscal consolidation effort (primary surplus stable at 1.3% from 2025). Primary balance would need to level to some 2.5% to stabilise debt dynamics.

Scenario 2: "What it takes to stabilise public debt". We assume improved nominal growth (3.0%) but would also require a more sizeable primary surplus (1.6%) from 2026.

Scenario 3: Scenario 2 affected by an adverse market reaction. We assume here a 10-year BTP-Bund spread increase to 300 basis points (bp) from 220bp otherwise assumed on a persistent basis. Interestingly, this would fundamentally affect public debt dynamics coming slightly worse than in scenario one.

Exhibit 12: Italy DSA assumptions

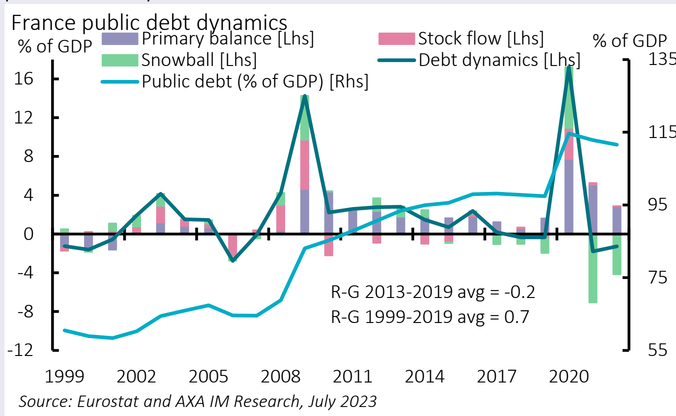
	Nominal GDP (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	4.0	0.8	1.3	2.7
Scenario 2	-	-	-	3.0
Scenario 3	-	-	-	3.0
	Implicit interest rate (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	5.0	3.7	3.3	4.2
Scenario 2	-	-	-	4.2
Scenario 3	-	-	-	4.8
	Primary balance (% of GDP)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	2.4	1.4	1.5	1.3
Scenario 2	-	-	-	1.5
Scenario 3	-	-	-	1.5

Source: Eurostat, Refinitiv and AXA IM Research, July 2023

Appendix 2 – France's public debt context and sustainability analysis assumption details

France's adverse public debt dynamics to date are rooted in a persistently high primary deficit. Since 1995, France has managed to generate meaningful primary surplus for only four years in a row (1998-2001). Despite decent growth potential against peers, R-G dynamics have not been favourable and have contributed to adverse public debt dynamics (Exhibit 13).

Exhibit 13: France: Persistent primary deficit key for adverse public debt dynamics



Source: Eurostat and AXA IM Research, July 2023

Since 2014, France has implemented numerous supply side reforms (labour market flexibility, permanent cut in social charges/production tax, unemployment benefits and pensions) aimed at boosting the economy's growth potential. While primary spending growth has been tamed, an ambitious strategic public spending reform is still missing.

In light of the above, we have generated two scenarios.

Scenario 1 illustrates debt dynamics should past fiscal policy steps be repeated: Assuming a broadly stable primary balance at -1.6% (2012-2019 average) between 2025 and 2033. Meanwhile, nominal GDP growth would stand at 3.2% on average throughout, above implicit interest rate (2.8%) assuming unchanged 65bp 10-year Bund-OAT spread (2025-2033).

Scenario 2 displays a stabilising public debt trajectory engineered by a very reasonable but continuous annual improvement (0.3ppt) below the government's commitment in its stability programme (0.7ppt) in primary balance between 2025 and 2033. This would be consistent with slower nominal growth (2.8%, government at 3.4% between 2025-2027) equalling unchanged assumed interest rate path from scenario one. Public debt would stabilise at circa 115% of GDP in 2033 (but only 2.5ppt above government commitment by 2027).

Exhibit 14: France DSA assumptions

	Nominal GDP (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	4.2	2.1	2.3	3.2
Scenario 2	-	-	-	2.8
	Implicit interest rate (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	4.8	2.8	2.4	2.8
Scenario 2	-	-	-	2.8
	Primary balance (% of GDP)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	0.2	-2.4	-2.0	-1.6
Scenario 2	-	-	-	-0.5

Source: Eurostat, Refinitiv and AXA IM Research, July 2023

We have extracted the following measures from the French audit office dedicated chapter on a needed comprehensive review on (the quality of) public spending from its recently published annual report:[11]

- More comprehensive cost-benefit analysis for new measures
- Ensure coherence of measures across administrations (central government, social security, local authorities)
- Focus contracts on objectives, performance and means to ensure engagement on efficiency and quality
- Publication of data allowing civil society to carry its own analysis
- Enshrine into law interim assessments on which depends prolongation (or not) of the measure

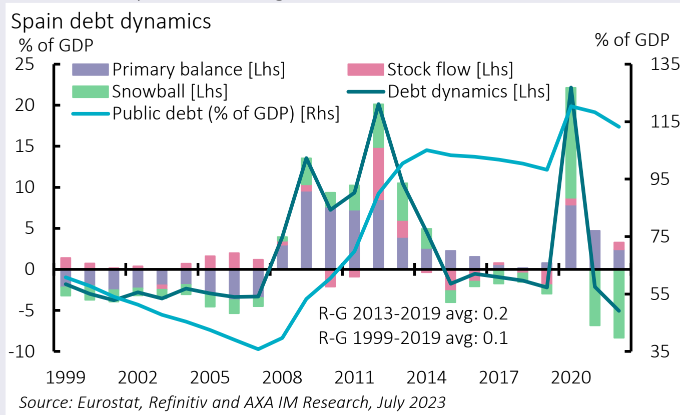
[11] French audit office 2023 report, July 2023

Appendix 3 – Spain public debt context and sustainability analysis assumption details

In the wake of the financial crisis and subsequent European debt crisis, strong real GDP growth performance was key in bringing down Spanish public-debt-to-GDP ratio, consistent with only slightly positive R-G dynamics (Exhibit 15), despite relative political instability.

Both the manufacturing and private services sector have fuelled the recovery then and now. The industry sector weight in the economy has gained almost 2ppt to 17.7% since Q4 2019. The latest business cycle surveys confirm the good form of the services sector, likely ensuring growth overperforming the Eurozone amid a looser grip than previously seen from ECB monetary policy tightening.

Exhibit 15: Spain: Growing out of its indebtedness



Source: Eurostat, Refinitiv and AXA IM Research, July 2023

We consider two key scenarios for Spanish public-debt-to-GDP trajectory:

Scenario 1: Rigorous fiscal consolidation for next government term, assuming the primary balance reaches 1.9% in 2027, receding thereafter, amid cautious nominal growth assumption (3.1% 2025-2033 average). This would imply public debt to edge down continuously from 113.2% in 2022 to 99.5% in 2033.

Scenario 2 assumes a more sluggish fiscal consolidation path: The primary balance improving by 0.1-0.2ppt every year (0.0% in 2028, 0.6% in 2033). The GDP growth path is key at this juncture, a 3.1% nominal growth rate would broadly stabilise debt path at 108% in 2033, while 3.4% would see it fall almost continuously to 106% in 2033.

Exhibit 16: Spain DSA details

	Nominal GDP (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	7.7	0.2	1.6	3.1
Scenario 2	-	-	-	3.3

	Implicit interest rate (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	4.9	3.7	3.3	3.2
Scenario 2	-	-	-	3.2

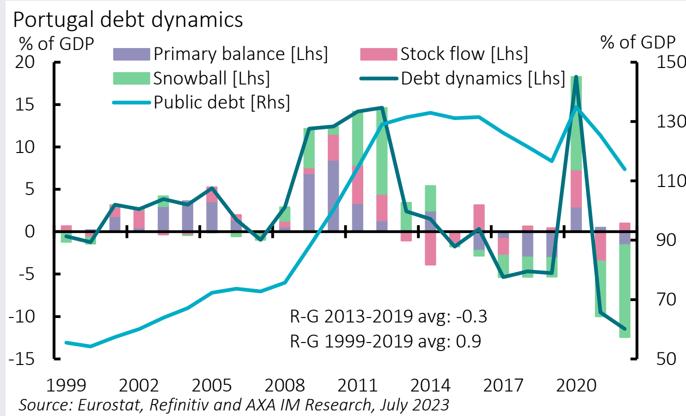
	Primary balance (% of GDP)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	2.6	-5.4	-3.5	1.2
Scenario 2	-	-	-	0.1

Source: Eurostat, Refinitiv and AXA IM Research, July 2023

Appendix 4 – Portugal public debt context and sustainability analysis assumption details

The Portuguese economy has gone through an exceptional transformation since the debt crisis: Serious implementation of reforms (e.g., public expenditure control, cleaning banking sector) and political stability have enabled the country to yield persistent primary surpluses – against a history of continuous deficit – while boosting growth potential performance (Exhibit 17). The European Commission estimates potential GDP will be close to 2%, more than double prior to 2008 crisis.

Exhibit 17: Portugal – A remarkable transformation



Source: Eurostat, Refinitiv and AXA IM Research, July 2023

With public debt-to-GDP ratio at 113.9% in 2022, it stands lower than in 2019. Without a major shock, there is little concern of public debt trajectory. Our two scenarios are as follows:

Scenario 1: Continued reasonable fiscal consolidation, which would see the primary balance stabilising at 2.0% in the medium term (below government intention to reach 2.9% in 2027), while we take a conservative nominal growth assumption (3.3%). These would unsurprisingly yield a consistent public-debt-to-GDP ratio decline to circa 77%.

Scenario 2: Assuming more profligate behaviour: Primary balance edging down by 0.2-0.3ppt every year from 2024, hand in hand with slightly more dynamic nominal growth (3.6%) would imply public debt stabilising at around 90%.

Exhibit 18: Portugal DSA details

	Nominal GDP (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	5.3	0.4	2.1	3.3
Scenario 2	-	-	-	3.6
	Implicit interest rate (%)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	4.8	3.8	3.4	2.8
Scenario 2	-	-	-	2.8
	Primary balance (% of GDP)			
	1999-07 average	2010-15 average	2010-19 average	2025-33 average
Scenario 1	-1.6	-2.6	-0.7	2.0
Scenario 2	-	-	-	0.6

Source: Eurostat, Refinitiv and AXA IM Research, July 2023

Our Research is available online: www.axa-im.com/investment-institute

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