Euro area faces fiscal tests

Some credit ratings under pressure as weaker governments struggle with medium-term budget plans

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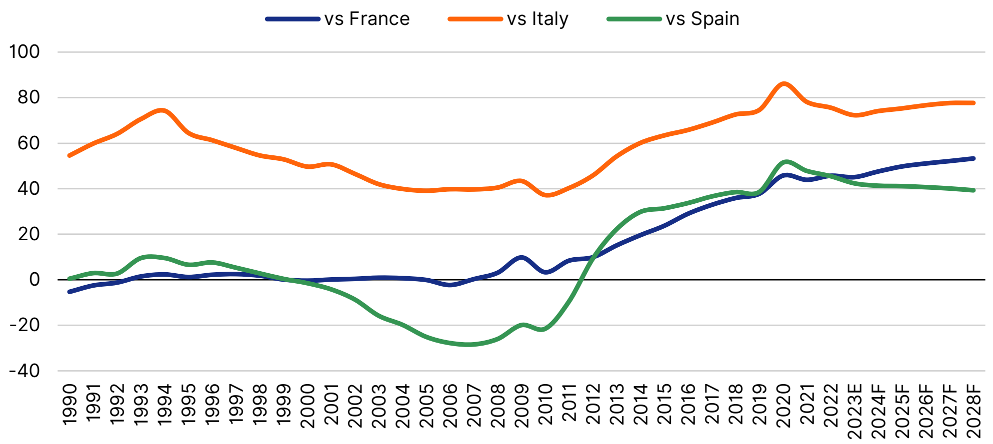
Europe faces a challenging macroeconomic environment in the coming years, with tepid growth, higher interest payments and significant upward pressure on social, environmental and defence spending. The recognition of these fiscal constraints should lead to important fiscal trade-offs. While reducing public debt is feasible, even for highly indebted sovereigns, based on historical fiscal adjustments, weak governments struggling to implement consistent medium-term fiscal plans are putting credit ratings of some euro area sovereigns under pressure.

Figure 1: Euro area fiscal disparities widen since euro area, Covid, and energy crises
Debt differential to Germany, pps of GDP



Source: IMF, Scope Ratings forecasts

Macroeconomic outlook remains subdued despite post-crises rebound

While the EU has demonstrated its ability to respond to and recover from the pandemic and energy crises, we expect moderate economic growth of 1.0% in 2024 and 1.8% in 2025. Raising Europe's long-term growth potential – estimated at 1.4% – remains critical.

Expediting the implementation of Next Generation EU (NGEU), both on reforms and investments, would help. Faster progress on the capital markets union, initiated in 2015, to facilitate cross-border savings and investments and thus a better allocation of resources across Europe would also support growth. The digital transition and innovations such as artificial intelligence (AI) can also help bolster productivity. Europe leads in developing regulatory frameworks for the sector, but risks falling behind other large economies in benefitting from digital and AI-related innovations.

Europe might also decide to open more systematically its borders to address labour shortages, but current political dynamics make it unlikely. Similarly, reforming Germany's debt-brake rule to allow for an investment-driven fiscal stimulus, before the 2025 federal elections appears improbable. While such structural reforms could raise Europe's growth outlook, their swift and full implementation today seems unlikely, underpinning our baseline for only moderate growth.

In addition, Europe faces structurally higher public debt levels after the pandemic and energy crises. Public debt higher on aggregate and fiscal disparities across euro area sovereigns have widened since the crises. For example, the debt-ratio differential between Germany and France has surged from 38pps in 2019 to nearly 50pps, contrasting sharply with the near zero differential between 1992, when the Maastricht Treaty was signed, and 2012, the height of the euro area crisis.

Capacity of euro area sovereigns to respond to a new shock is diverging…

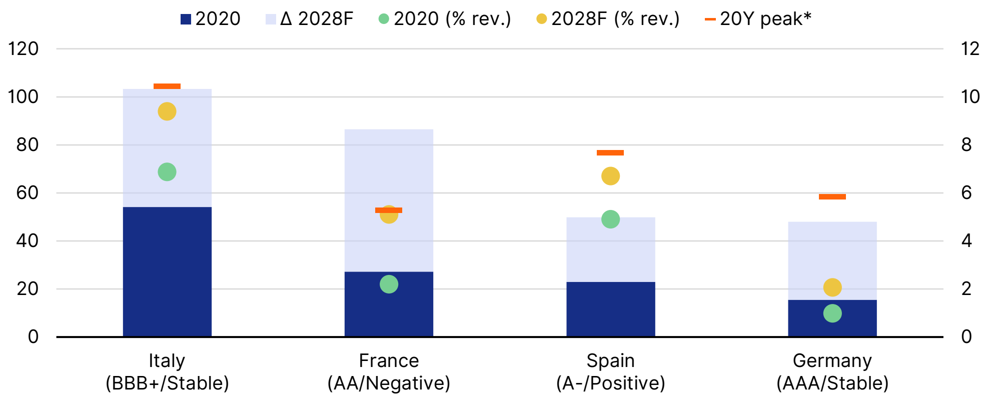
Resilience gap growing within euro area

This matters because different public debt levels imply varying capacities to respond to the next shock. Moreover, divergent fiscal positions may also complicate discussions about future solidarity and fiscal risk sharing, especially in case of country-specific rather than region-wide shocks.

Finally, we expect permanently higher interest rates compared with pre-Covid years, even as central banks ease rates starting later this year. Interest payments will continue to rise as public debt issued at lower rates before and during the pandemic matures and is now refinanced at higher rates. Italy, Germany, France, and Spain collectively will pay almost EUR 170bn more in interest in 2028 compared with 2020. While net interest payments as a share of revenues will remain below previous peaks, the expected higher interest payments will constrain fiscal space, forcing governments to reduce expenditure elsewhere, increase taxes, or borrow more.

Figure 2: Interest payments on the rise for large euro area sovereigns

EUR bn; net interest payments as a % of government revenue



Source: IMF, Scope Ratings forecasts
*Refers to highest share of net interest payments/government revenues over 2004-24 period

… while spending on welfare, the environment, and defence is rising…

Welfare costs, environmental spending, defence needs all rising

These three challenges – moderate growth, high public debt, and rising interest payments – coincide with pressures for higher spending and investment, exacerbated by demographic shifts and a declining working population. Together, these trends will strain fiscal budgets by around 1.5pps of GDP, on average, in the coming years. Similarly, substantial investment needs to achieve carbon neutrality by 2050 are estimated at about 0.5% to 1.0% of GDP per year for the public sector alone, based on European Commission data.

Europe also faces large investment needs to meet NATO defence targets, in some cases of around 0.5% to 1.0% of GDP, in addition to funding support for Ukraine. Moreover, industrial policies to bolster domestic production for economic autonomy and national security will also squeeze European government budgets, through lower taxes and/or more generous subsidies. All told, Europe's identified policy priorities imply higher spending and investment needs of about 3-4% of GDP at a time when growth is modest at best.

... which should lead to important fiscal trade-offs...

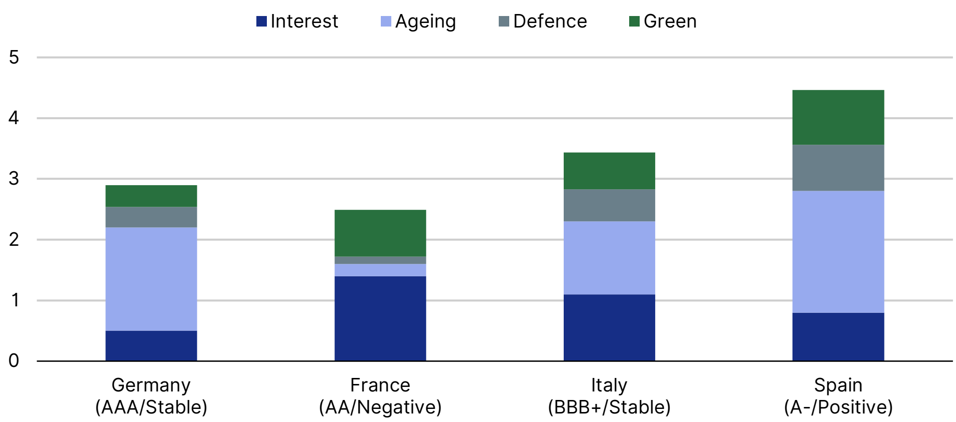
Defence priorities differ across euro area

The resulting financial constraints should lead to difficult trade-offs between reforming generous welfare systems, financing Europe's green ambitions, meeting defence expenditure targets, or raising taxes. How governments prioritise here will depend not only on their specific circumstances but also on the degree of European solidarity.

For example, the Baltic states, central and eastern European countries and Finland are unlikely to scale back on defence whereas for countries where perceived threats are lower, like Spain, defence is likely to take a back seat. Similarly, countries with very high tax burdens – like France and Belgium – are unlikely to raise taxes further. Like Germany and Austria, these two countries may consider rebalancing tax structures away from labour, which is becoming scarcer, towards capital, ownership and environmental factors.

These fiscal pressures may also accelerate a discussion about which expenditure ought to remain at the national level, and which expenditure should shift towards the European one. The past years have shown that health, energy and defence are European as much as national public goods.

Figure 3: Rising expenditure and investment needs in France, Germany, Italy and Spain
% GDP



Source: Latest National Energy and Climate Plans, European Commission, NATO, Scope Ratings
Definitions: Interest: difference between 2020 and 2028 Scope forecast. Ageing: difference between 2035 and 2023 total cost of ageing expenditure based on EC 2024 Ageing Report. Defence: difference between 2023 defence expenditure and 2% target. Green: estimates based on latest National Energy and Climate Plans, assuming 1/3 public and 2/3 private investment shares.

... if reform-minded governments make gradual, credible adjustments

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Historical precedents exist for fiscal consolidation

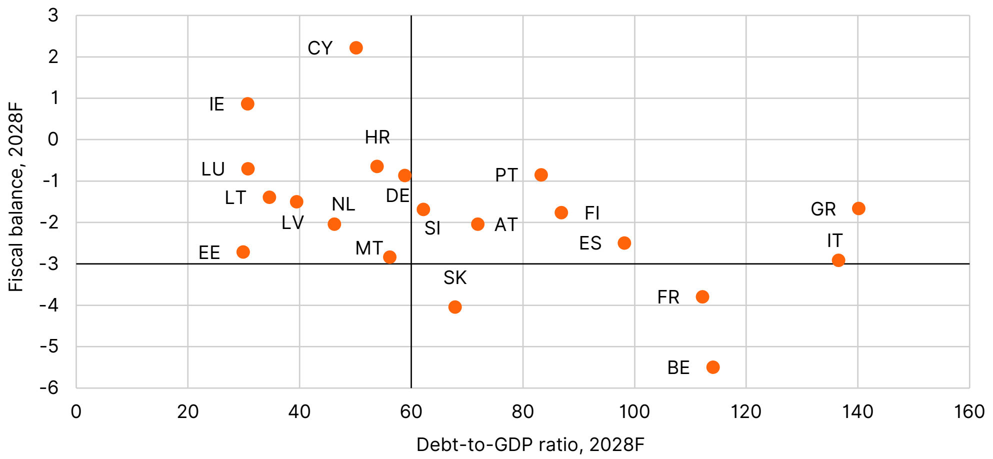
This is feasible based on historical adjustments of fiscal positions, although past consolidation efforts usually benefitted from higher nominal growth. However, today, for several European sovereigns, complacency is the key risk. Here, weak governments postpone and delay important reforms, which at some point may lead to a confidence crisis, and the subsequent need to implement ad hoc austerity measures, with their adverse impact on public investments and growth. The UK's recent experience shows that even G7 countries are not exempt from these dynamics.

Conversely, fiscal risks are likely to rise over coming years

We are concerned about heavily indebted countries, with large primary deficits, and governments operating in a highly fragmented political environment struggling to implement reforms today.

Previously crisis-hit countries such as Greece, Ireland, Portugal, Spain and Cyprus have implemented important reforms under EU financial assistance programmes, resulting in more favourable macroeconomic trajectories. However, not all euro area countries have as effectively used the past years of loose monetary policy to address the fiscal challenges they face.

Figure 4: Diverging public debt trajectories for select euro area sovereigns
% GDP



Source: Scope Ratings forecasts

France, Belgium need to confront difficult fiscal challenge

Belgium, France on negative Outlook

For example, France and Belgium, both of which we rate with a Negative Outlook, risk failing to fully acknowledge their financial constraints. Government plans that only aim to stabilise public debt at current elevated ratios imply that debt will continue to rise whenever the next crisis emerges.

France's recent upward revision of its fiscal deficit to 5.5% of GDP for 2023 further challenges the government's consolidation plan, which may now, according to the Court of Auditors, require additional savings of around EUR 50bn, or 2% of GDP, over coming years ahead of the 2027 presidential elections.

Similarly, in the absence of policy changes in Belgium following the federal and regional elections in June, we expect Belgium to record the largest fiscal deficit in Europe, exceeding 5% of GDP over the coming years. This would result in a steadily increasing debt trajectory, and the third-highest public debt level in Europe by 2028, after Greece and Italy.

Related Research

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