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A WORD ON HIGHER RATES AND PUBLIC DEBT

HIGHER RATES AND PUBLIC DEBT IN THE EURO ZONE

At a time when euro zone governments are releasing their draft budgets, the markets are once again focusing on fiscal policies and public deficits.
Here is some insight from Ombretta Signori, Head of Macroeconomic Research and Strategy, and Romain Faquet, Economist and Macro-strategist, at Ofi Invest Asset Management, on the challenges that governments face.

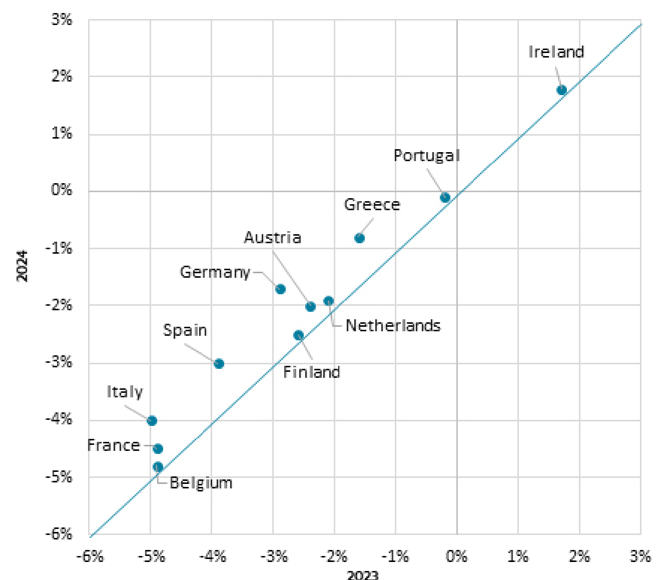
What is your overall take on fiscal policy trends in 2024?

Ombretta Signori: All European governments must operate in a challenging economic environment. Inflation is slowing but is still high, and economic activity has flatlined for almost one year now. Governments are facing tighter fiscal constraints, as interest rates have normalised, thus raising the average cost of debt. Moreover, the Covid and energy crises have, on the whole, exacerbated their debt burden. Keep in mind that these two tail events and the "whatever it takes" policy have sent euro zone debt as a percentage of GDP from 84% in 2019 to 91% in 2022.

The overall picture painted by the International Monetary Fund (IMF) in the new projections it released in early October is that fiscal impulse will be negative in 2024 in the euro zone, with wide discrepancies in fiscal deficits between countries. According to these forecasts, three of the main euro zone countries will probably still have deficits over 3% in 2024. They are Italy, France and Belgique.

Of these three, Italy is the one the markets are most worried about, as the government there has announced a fiscal overrun in raising its deficit forecasts from 4.5% to 5.3% for 2023 and from 3.7% to 4.3% for 2024. Market fears triggered a widening in the BTP-Bund spread to more than 200 basis points in early October. The overrun is due to the "superbonus", a measure the Conte government adopted that offers Italian households a 110% tax credit for energy renovation and insulation projects. The basic problem with this measure is that the economic benefits of the tax credits are now in the past, while their costs (about 140 billion euros estimated in all) will continue to show up in future years.

The other problem is that most of the reduction in European deficits since 2022 have resulted from the end of support measures that had bene implemented for the energy crisis, rather than from a true fiscal effort. The risk to public finances remains asymmetric, in our view, and the IMF's forecasts do look optimistic. Moreover, geopolitical risks suggest that we are still not completely shielded from new risks to commodity prices and in some cases, governments may decide to renew some emergency measures.



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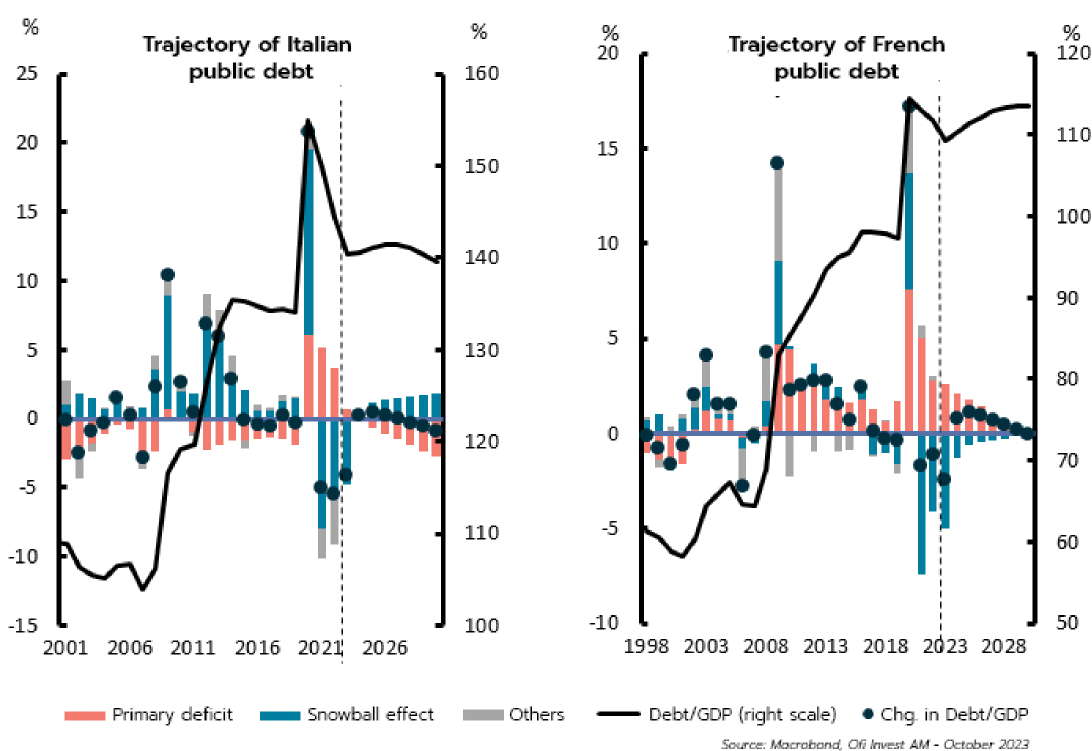
The markets have fully priced in central banks' flagging of higher for longer short-term rates. How will this affect the sustainability of public debt, particularly in France and Italy?

Romain Faquet: In recent years, the trajectory of public debts has benefited from a relatively low debt-service burden, thanks to many years of ultra-accommodative monetary policies. This trajectory, combined with very high nominal growth in the past three years made it possible to limit the increase in public debt ratios after the pandemic and the energy crisis. But now that European bond yields will probably stay high for some time to come and in a context in which inflation will probably recede by 2025 to close to 2%, France and Italy will no longer be able to count on such a favourable gap between high nominal growth and very low nominal rates (see the snowball effect, in blue in the two charts below). This favourable gap is likely to vanish by 2024 in Italy and gradually fade to almost zero in France by 2030.

In the coming years, France and Italy will have to make a constant effort to improve their primary balance to be able to gradually stabilise their debt/GDP ratios, based on realistic macroeconomic assumptions[1]. And, remember that in quiet periods, the gradual stabilisation of debt/GDP ratios can be regarded as a reasonable minimum criterion of sustainability. Based on our simulations, any significant shock to interest rates (100 basis points or more compared to the levels the markets are pricing in) would threaten the stabilisation of debt/GDP ratios by 2030 and, hence, the sustainability of public debt.



Source: Macrobond, Ofi Invest AM - October 2023

What are the critical milestones to track in the coming months?

Romain Faquet: European countries have just submitted their draft budgets to the European Commission, which is expected to render an opinion on them by the end of November. Meanwhile, several agencies will be updating their sovereign debt ratings. The most important of these to keep an eye on will probably be Moody's (on 17 November), which has already placed Italian debt on a negative outlook, with the risk of a downgrade to high yield (i.e., rated below BB/Baa).

The Commission will then have until next spring to launch, or not launch, excessive debt procedures in countries whose deficits surpass 3% of GDP. The Commission is likely to take a flexible interpretation of fiscal rules for at least three reasons.

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[1] Our projections are based on growth potential of 1% in France and 0.7% in Italy, inflation close to 2%, constant 10-year yields (3.4% in France and 4.5% in Italy) and constant debt maturity. Based on these assumptions, stabilisation of debt vs. GDP will require a constant fiscal effort to achieve a primary budget balance in France by 2030 and a surplus of close to 2 points of GDP in Italy.

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First, the trajectories set by European rules have seldom been strictly enforced, in part in acknowledgement of their procyclical character. Second, the rules have been suspended since the Covid crisis began, and negotiations on new fiscal rules have bogged down. And, third, a highly detailed analysis by the Bruegel Institute[2] has shown how especially unfavourable the latest reform proposals will be to France, which will be forced to achieve an unrealistic primary surplus within a few years. All in all, there is little chance of approval by the Commission by yearend. Third, regarding Italy specifically, tensions with the Commission are likely to remain under control, as the "superbonus" that is to blame for the Italian overrun had been approved by the European Commission as a component in the stimulus plan. Against this backdrop, discussions are likely to focus on the credibility of the receipt figures projected by the Italian government, a portion of which is based on privatisations.

That being said, a negative opinion by the Commission on the Italian budget in the coming weeks would feed market fears and the risk of a downgrade in the country's rating.

[2] *"A quantitative evaluation of the European Commission's fiscal governance proposal", Z. Darvas, L. Welslau and J. Zettelmeyer, Bruegel, 18 September 2023.*

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