Public finances in the euro area: current developments and challenges

Difficult tasks still lie ahead for fiscal policymakers in the euro area. Although the coronavirus pandemic is subsiding, major challenges still abound for the euro area countries, especially as a result of Russia's war of aggression against Ukraine and the transition to renewable energy. On top of that, public finances are in worse shape than before the coronavirus crisis. Many countries have very high debt ratios and high deficits. At the same time, the macroeconomic conditions have changed. The baseline scenarios of current forecasts for the euro area assume that the economic recovery will continue. However, there are considerable supply-side tensions. Price pressures are high and threaten to become entrenched. Monetary policymakers have therefore initiated an interest rate reversal.

In such a situation, prudent fiscal policy is essential. Additional broad-based, debt-financed support measures and fiscal stimuli are not appropriate. Fiscal policy should instead be targeted. Measures that lower energy prices do not fit this description. In addition, they lessen incentives for switching to renewable energy and make saving energy less attractive. Instead, measures should provide targeted support for low-income households, for instance, as they are hit especially hard by rising prices. Additional government funds are likely to be needed for the transition to renewable energy and for defence activities. However, there is good reason to largely counterfinance targeted additional measures within the budget, too: higher deficits threaten to amplify the existing price pressures and thus to be counterproductive for the economy as a whole. Moreover, public finances, which are already severely strained in some areas, would be further burdened at a time when the focus should be on returning them to a sound footing.

Yet uncertainty about future developments runs high. A different fiscal policy approach would be advisable if negative risks were to materialise – for instance, if demand did in fact collapse. At present, however, this scenario does not form the baseline of most forecasts, including that of the European Commission. Thus, there is no convincing case for the extension of the general escape clause under the European fiscal rules until 2023. Even without this decision, only a few Member States would have had to tighten their planned fiscal stance, whereas now the extension creates scope for additional debt-financed fiscal programmes, which do not appear appropriate as things currently stand. The fiscal situation is fragile in some Member States. The national fiscal policymakers in each Member State are thus called on to strengthen confidence in sound public finances. In this environment, credible fiscal rules are more important than ever, as binding and comprehensible rules can build confidence. Therefore, a stability-oriented reform of the European fiscal rules is key.

European Commission forecast on the development of public finances

Euro area: decline in deficit and debt ratio

Lower deficit due to expiring coronavirus measures and favourable economic developments

The European Commission (hereinafter referred to as the Commission) expects[1] the deficit ratio in the euro area to decline this year and next. After reaching 5.1% last year, it is forecast to fall to 3.7% and 2.5%, respectively. This is due, first, to improvements in the economic situation. According to the Commission, the output gap will be fully closed by 2023. The deficit ratio will therefore fall by ¾ percentage point in 2022 and by ½ percentage point in 2023. Second, budget-burdening measures are expiring. The Commission estimates that measures related to the coronavirus pandemic still amounted to 3¼% of gross domestic product (GDP) in 2021. They will fall to ¾% this year and are then expected to come to an end entirely.[2] Commission estimates for new measures in connection with the war in Ukraine and soaring energy prices amount to ¾% of GDP for 2022. These deficit-increasing measures are mostly set to expire in 2023. The easing effect of cyclical and temporary influences masks the fact that the other budgetary developments are increasing the deficit ratio markedly: by 1¼ percentage points in 2022 and ¼ percentage point in 2023. According to the Commission's forecast, the debt ratio will fall from 97.4% last year to 92.7% in 2023, driven mainly by the rather sharp increase in nominal GDP in the denominator.

Fiscal stance difficult to interpret at present

It is particularly difficult to assess the current fiscal stance at present. The conventional indicator does indeed show a restrictive stance (i.e. a fall in the structural[3] primary deficit ratio) for this and next year combined. However, this is mainly due to the expiry of coronavirus measures. These government measures often replaced losses in income or turnover that households and enterprises suffered during the coronavirus crisis, but these can now be earned as usual. This means that the replacement payments can largely be brought to an end without this having a restrictive effect. This is similar to cyclical fluctuations in unemployment expenditure (automatic stabiliser). In the same vein, it would therefore be more appropriate to remove a large part of these expiring coronavirus measures from the indicator, which does not contain automatic stabilisers. The fiscal policy stance for 2022 and 2023 together is thus likely to be interpretable not as restrictive but, in fact, as rather expansionary.

Fiscal situation varies widely among the Member States

Reference values breached in many cases …

The fiscal situation varies widely among the Member States (see the table on p. 78). However, it is expected to improve in all countries in 2022 and 2023, driven mainly by the expiry of coronavirus measures. Nevertheless, in 2022, 12 countries will have a deficit ratio above the reference value of 3%. This figure will still amount to seven in 2023, including the very highly indebted countries of Belgium, France, Italy and Spain. By contrast, in Greece and Portugal – which also have very high debt ratios – the deficit ratios will fall to 1% by 2023.

… but rule-compliant improvement forecast

Next to no Member State is expected to achieve the target of a structurally close-to-balance budget (medium-term objective, MTO) by 2023. This means that, for the most part, the situation is substantially less favourable than prior to the coronavirus pandemic. At the same time, the Commission forecast concludes that the output gap is closed in most countries, and the burden stemming from temporary crisis measures is now only of minor importance. In Belgium, France, Italy, Malta, Slovenia and Spain, the structural deficit ratios are above 3%

1 See European Commission (2022a).
2 The Commission's data on coronavirus-related burdens refer to the EU as a whole.
3 Structural means that the impact on the deficit of cyclical developments and of certain temporary measures is factored out of the calculations. This reveals the underlying fiscal position, relevant for the long-term development.

Fiscal analysis distorted by the lack of data on EU-level deficits and debt

The European Commission does not report EU-level deficits and debt in its economic forecast; nor does Eurostat (the European Commission's statistical office) yet make these available for past periods. The European Commission's data for the EU and for the euro area therefore cover only the aggregated deficits and debt of the Member States. The fact that the EU Council is calling for the compilation of EU institutions' statistics is a welcome development. It would be desirable for Eurostat to provide them in the same structure and definitions as required for the Member States (in line with the national accounts and the Maastricht definitions).

The picture on public finances is distorted as a result of incomplete data. If the European Commission incurs debt on behalf of the EU and uses it to make transfers to the Member States, a deficit is created at the EU level that is not counted in national government budgets. Yet these transfers, taken in isolation, reduce the deficits and debt of the Member States. The EU-level deficits generate EU-level debt, which – like national debt – has to be shouldered by the taxpayers of the Member States. In economic terms, this means that deficits are merely shifted within the EU (from the Member States to the EU level), while the statistics report lower deficits and lower debt for the EU as a whole.

Last year, a marked deficit was recorded for the first time at the EU level owing to the NextGenerationEU (NGEU) recovery fund. This may have amounted to around ½% of gross domestic product (GDP). Up to 2026, further deficits are planned for the purposes of paying NGEU grants to EU countries.[1] According to the Stability and Convergence Programmes, the euro area countries set to record the largest receipts from grants of this kind up to 2026 are Greece (a total of around 8% of GDP), Portugal and Spain (around 5½% of GDP each).[2]

For analytical purposes, reported deficits and debt for the EU should include the EU level. In addition, EU-level deficits and debt should be taken into account when assessing the finances of the individual Member States. As things stand, EU-level debt is being serviced from the EU budget. National taxpayers will therefore have to make higher contributions to the EU budget in future. Member States' financing of the EU budget is broadly in line with their share in the EU's gross national income (GNI). In economic analyses, it would therefore make sense to allocate EU-level deficits and debt to the Member States according to their GNI share.[3]

Moreover, the European fiscal rules should also be applied including the EU-level deficits and debt. Otherwise, the rules are in danger of becoming ineffective: borrowing could simply be shifted to the EU level, rendering it exempt.

1 In addition, the supranational EU debt is being used to make NGEU assistance loans to EU countries. Statistically, this is not reflected in the EU deficit but only in EU-level debt.
2 See European Commission (2022b). The data are not complete, however.
3 See Deutsche Bundesbank (2020). Introducing new taxes to finance the EU budget will not alleviate the burden on taxpayers either.

Public finances of the euro area countries

European Commission's spring forecast, May 2022

Country	General government fiscal balance as a percentage of GDP			General government gross debt as a percentage of GDP			Structural budget balance as a percentage of potential GDP		
	2021	2022	2023	2021	2022	2023	2021	2022	2023
Austria	− 5.9	− 3.1	− 1.5	82.8	80.0	77.5	− 4.4	− 3.0	− 1.6
Belgium	− 5.5	− 5.0	− 4.4	108.2	107.5	107.6	− 4.6	− 4.5	− 4.2
Cyprus	− 1.7	− 0.3	− 0.2	103.6	93.9	88.8	− 2.1	− 0.4	− 0.7
Estonia	− 2.4	− 4.4	− 3.7	18.1	20.9	23.5	− 3.3	− 3.8	− 3.0
Finland	− 2.6	− 2.2	− 1.7	65.8	65.9	66.6	− 2.0	− 1.7	− 1.4
France	− 6.5	− 4.6	− 3.2	112.9	111.2	109.1	− 5.3	− 4.5	− 3.3
Germany	− 3.7	− 2.5	− 1.0	69.3	66.4	64.5	− 2.6	− 1.8	− 1.0
Greece	− 7.4	− 4.3	− 1.0	193.3	185.7	180.4	− 5.5	− 3.0	− 0.9
Ireland	− 1.9	− 0.5	0.4	56.0	50.3	45.5	− 3.2	− 2.0	− 0.9
Italy	− 7.2	− 5.5	− 4.3	150.8	147.9	146.8	− 6.3	− 5.8	− 4.8
Latvia	− 7.3	− 7.2	− 3.0	44.8	47.0	46.5	− 6.9	− 6.6	− 2.7
Lithuania	− 1.0	− 4.6	− 2.3	44.3	42.7	43.1	− 0.9	− 4.0	− 1.5
Luxembourg	0.9	− 0.1	0.1	24.4	24.7	25.1	0.9	0.1	0.4
Malta	− 8.0	− 5.6	− 4.6	57.0	58.5	59.5	− 7.4	− 5.2	− 4.3
Netherlands	− 2.5	− 2.7	− 2.1	52.1	51.4	50.9	− 2.0	− 3.2	− 2.5
Portugal	− 2.8	− 1.9	− 1.0	127.4	119.9	115.3	− 1.3	− 1.9	− 1.5
Slovakia	− 6.2	− 3.6	− 2.6	63.1	61.7	58.3	− 5.7	− 3.3	− 2.6
Slovenia	− 5.2	− 4.3	− 3.4	74.7	74.1	72.7	− 6.1	− 5.5	− 4.5
Spain	− 6.9	− 4.9	− 4.4	118.4	115.1	113.7	− 3.8	− 3.5	− 4.3
Euro area	− 5.1	− 3.7	− 2.5	97.4	94.7	92.7	− 4.0	− 3.4	− 2.6

Source: European Commission (ameco).
Deutsche Bundesbank

for 2023 despite the fact that, in some cases, extensive transfers from the NextGenerationEU recovery fund are alleviating the burden on government budgets. As long as a Member State fails to meet its budgetary objective, the fiscal rules require convergence towards it. For this to happen, the country usually has to reduce its structural deficit by 0.5% of GDP per year. The standard limits will not apply next year, as the general escape clause has been extended. Nevertheless, according to the Commission's forecast, most countries will achieve the regular improvement of 0.5% of GDP – often even with room to spare. Only Spain is set to fall short of this consolidation step and widen the already large gap between its position and the budgetary objective. The main reason for the significant structural improvement in most Member States is that the structural balances reported by the Commission also include temporary measures. These will expire in 2023 according to the plans.

Debt ratios in 2023 very high in some cases

Debt ratios will fall in all countries in 2022 and 2023, but often only moderately. In some cases, primary deficits are high and are dampening the impact of very favourable interest rate-growth patterns. Owing to the extensive fiscal stabilisation during the coronavirus crisis, debt ratios are mostly set to be significantly higher in 2023 than before the pandemic. The gap is particularly large in those countries that were already heavily indebted, with the exception of Greece and Cyprus.

New challenges for fiscal policy

Although the coronavirus pandemic is gradually coming to an end, extensive fiscal challenges remain, …

Times of crisis place particular demands on the state. During the coronavirus crisis, for example, it was important to bring in supportive measures. The economy collapsed, demand was also low, and price pressures were initially weak. Amid such conditions, it was appropriate for Member States to finance measures through

deficits and thus through greater debt. Although the coronavirus pandemic is subsiding, fiscal policy (too) still faces major challenges, particularly on account of Russia's war of aggression against Ukraine and the necessary transition to renewable energy sources. However, given that the underlying conditions are fundamentally different from the situation during the coronavirus crisis, the fiscal policy response should also be different.

… and will need managing in a difficult setting

In its baseline scenario, the Commission (like other institutions) projects that the economy will recover. The output gap is expected to close in 2023. At the same time, there are supply-side tensions, and price pressures are high and threaten to become entrenched. This has prompted monetary policymakers to initiate an interest rate reversal and announce their intention to dial back the expansionary stance. They want to prevent inflation expectations from becoming de-anchored.

High debt is another fiscal challenge

When it comes to public finances, deficits and debt remain high – in some cases very high. Rising risk premia in the capital markets, in particular, indicate that there is an increasing need to strengthen confidence in the soundness of public finances again. It is therefore important for the concrete planning of highly indebted Member States to exhibit marked declines in their debt ratios. It is up to fiscal policymakers at the national level to make their country's public finances more resilient. Creating the European Stability Mechanism (ESM) has brought into play an intergovernmental fiscal institution that can provide assistance in this endeavour, if needed. It is not the task of monetary policy, on the other hand, to guarantee fiscal policy leeway and favourable capital market funding conditions.

Continued expansionary stance would be risky

Against this macroeconomic and fiscal backdrop, prudent fiscal policy is important. At present, general, debt-financed support measures and fiscal stimuli are not appropriate. This does not mean that fiscal policy is incapable of acting and has to forego necessary measures. However, it is – first – advisable to provide support only on a temporary and targeted basis. Measures that lower energy prices do not fit this description. In addition, they lessen incentives for switching to renewable energy and cutting energy consumption and thus run counter to key climate policy objectives. Instead, any measures should be targeted, for example, at low-income households – as they are hit especially hard by rising energy prices – and at those enterprises which are particularly affected and have a valid business model. Additional, carefully directed government funds are also likely to be needed for defence and the transition to renewable energy sources. As a second point, any new targeted measures of this kind should not be financed with debt either. Instead, the countries should largely counterfinance additional measures within their budgets: higher deficits threaten to amplify the existing price pressures and thus to be counterproductive for the economy as a whole. Moreover, bigger deficits would further burden public finances, which are already severely strained in some areas, at a time when the focus should be on returning them to a sound footing.

Uncertainty high

Yet uncertainty about future developments is high. And a different fiscal policy approach would be advisable if existing negative risks were to materialise – for instance, if demand did in fact weaken on a broad basis. However, such a scenario is not the baseline at present and, as such, it should not form the basis for current planning.

Use the reform of fiscal rules to build confidence

Credible fiscal rules more important than ever

The fiscal situation is fragile in some countries, and risk premia in the capital markets have recently increased. This is an environment in which credible, binding fiscal rules are more important than ever. It would therefore be dangerous to undermine or de facto abolish the European budgetary limits.

Case for extending the general escape clause …

In May 2022, the Commission recommended the continued suspension of EU fiscal rules. The general escape clause, which was first activated in 2020, is to be extended until 2023, with the Commission pointing to heightened uncertainty and strong downside risks as justification. It decided against reactivating the applicable budgetary limits next year, arguing that the situation has not yet normalised and that countries need to be given space to respond to Russia's invasion of Ukraine and the energy supply problems that this is entailing. The Commission also pointed out that the absence of budgetary rules will enable the transition from broad-based to targeted support. The euro area finance ministers (Eurogroup) welcomed the extension of the general escape clause.

… unconvincing at present

There is no convincing case for extending the general escape clause at this time. The decision to do so does not tally with the improving economic situation currently projected in the baseline scenario. It is also concerning that the Commission does not go into more detail about what it regards as normal. For example, there is reason to think that high energy prices will be the norm in future too – at that point, in the context of more stringent climate policy. However, this should not result in exemptions from debt limits; sustainable climate policy should not come at the expense of sustainable fiscal policy.

Risks call for review at a later date

The possibility that risks will arise in the future and that extending the general escape clause would ultimately make sense after all cannot be ruled out. However, it would have been appropriate to review this again at a later date, rather than pre-emptively suspending the standard fiscal limits.

Escape clause not conducive to finding the path that is appropriate at present

From today's perspective, even without the general escape clause, the rules do not unduly restrict fiscal leeway for 2023. It is true that structural deficit ratios would then need to be brought down by 0.5% per year, as almost all euro area countries are in breach of at least one of the quantitative caps (the 3% reference value for the budget deficit, the debt limit of 60% or the medium-term budgetary objective). However, the Commission's forecast sees almost all euro area countries achieving this improvement without consolidation measures, as expiring coronavirus measures are taken into account. But the extended general escape clause now opens up scope for additional deficits in the coming year. This is not an advisable course of action (see above).

Many countries in breach of reference values in 2021 and 2022

As part of its regular budgetary surveillance, the Commission also examined whether countries were running excessive deficits necessitating excessive deficit procedures. This is because the general escape clause does not override excessive deficit procedures, only the quantitative limits for excessive deficits laid down in the rules. Many countries exceeded the deficit and debt reference values in 2021 or plan to exceed them in 2022. The Commission recommends that no procedures be opened[4] as it believes that the situation is currently too uncertain to set out a detailed path for fiscal policy. It is also of the opinion that the "1/20 debt reduction path"[5] is too demanding for those countries under review with debt above 60% of GDP, reasoning that countries complying with this adjustment path might risk lower GDP growth.

Current method not a suitable basis for future assessment

Regardless of the decision to maintain the general escape clause for 2022, it would be concerning if the method currently pursued by the Commission in its fiscal surveillance were to be applied to future assessments under the rules. As in the country-specific recommendations, the Commission looks at growth in various expenditure categories. It does not take thresh-

4 The Commission has published a report in accordance with Article 126(3) of the Treaty on the Functioning of the European Union (TFEU), in which it reviews the opening of excessive deficit procedures for all 18 countries that appear, prima facie, to be in breach of the criteria. See European Commission (2022c).
5 The debt criterion requires that a debt ratio above 60% nears this reference value at a sufficient pace. This requirement is fleshed out further in regulations. Accordingly, the portion of debt in excess of the reference value is meant to decrease by one-twentieth per year. However, other factors, not exhaustively listed, are to be taken into account as well.

olds for expenditure growth overall as a basis. For example, when it comes to current primary expenditure, any deficit-increasing measure related to higher energy prices is excused. Moreover, high and rising investment expenditure is welcomed with open arms. There is then the risk that high structural deficits or high debt ratios might fall off the radar.

Reform of fiscal rules should secure confidence in public finances

This year, the Commission intends to present proposals for reforming the fiscal rules. A proposal to establish its current approach as a rule would be highly problematic. This would make fiscal policy stance the subject of only vague qualitative coordination between the Commission and individual countries. It would also be inappropriate to exclude some categories of expenditure from quantitative limits. That could lead to persistently high and even rising debt ratios. Reforms should therefore instead aim at setting binding numerical budgetary ceilings. This means that the rules should be determined ex ante, be transparent and set out concrete quantified requirements. The stipulations should be non-negotiable. And they should be chosen in such a way that a high debt ratio reliably shrinks if a country complies with the rules. Breaches of the rules should be sanctioned. It is important to build confidence that the rules will guide public finances onto a sound path. Such confidence makes things easier for fiscal policymakers, but it also helps monetary policymakers. In this spirit, the Bundesbank has put forward proposals on how the Stability and Growth Pact could be improved in a stability-oriented manner.[6]

6 See Deutsche Bundesbank (2021).

List of references

Deutsche Bundesbank (2021), Bundesbank contribution to the public debate on the review of the EU economic governance (October to December 2021), http://www.bundesbank.de/content/884870, December 2021.

Deutsche Bundesbank (2020), The informative value of national fiscal indicators in respect of debt at the European level, Monthly Report, December 2020, pp. 37-47.

European Commission (2022a), European Economic Forecast Spring 2022, Institutional Paper 173, May 2022.

European Commission (2022b), Commission staff working document: Fiscal Statistical Tables providing background data relevant for the assessment of the 2022 Stability and Convergence Programmes, May 2022.

European Commission (2022c), Report from the Commission: Belgium, Bulgaria, Czechia, Germany, Estonia, Greece, Spain, France, Italy, Latvia, Lithuania, Hungary, Malta, Austria, Poland, Slovenia, Slovakia and Finland – Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union, May 2022.