EXECUTIVE SUMMARY

1. A CLOSE MONITORING OF DEBT SUSTAINABILITY RISKS IS KEY IN THE CURRENT ENVIRONMENT

The EU economy is at a turning point

The EU economy expanded strongly in the first half of 2022 after having recovered to the pre-COVID-19 pandemic output level in the third quarter of 2021. However, Russia's war of aggression against Ukraine has caused untold suffering and destruction in Ukraine, but has also had strong repercussions on the global economy. The EU is among the most exposed economies due to its geographical proximity to the war and its heavy reliance on imports of fossil fuels. The sharp rise in inflation, driven by the pressure of energy, food and other commodity prices, is affecting the EU economy. In particular, it has eroded the purchasing power of households and led to a significant decline in consumer and business sentiment. According to the Commission 2022 autumn forecast, real GDP growth in the EU is estimated to be 3.2% in 2022 and 0.3% in 2023, before reaching 1.6% in 2024. The Harmonised Indices of Consumer Prices (HICP) inflation rate in the EU is projected to decline from 9.3% in 2022 to 7% in 2023 and 3% in 2024. ([1])

Fiscal positions still benefited from robust growth in 2022

The aggregate EU government deficit is estimated to have declined from 4.6% of GDP in 2021 to 3.4% in 2022, thanks to the economic expansion. However, new deficit-increasing discretionary policy measures, including those adopted to mitigate the impact of higher energy prices on households and firms, are estimated to have more than offset the phasing out of the COVID-19 pandemic-related support measures in 2022. According to the Commission 2022 autumn forecast, the public debt-to-GDP ratio in the EU as a whole is estimated to have fallen from the historically high level of 91.5% of GDP in 2020 to 89.4% in 2021 and 86% in 2022. This reduction is driven by strong economic growth, lower primary deficits and inflation. Higher interest rates will only gradually increase the implicit cost of public debt and the favourable interest-rate growth differential is still expected to reduce debt ratios.

The NextGenerationEU package should further improve the quality of public finances and lift potential growth

NextGenerationEU (NGEU) continues to support all Member States, in particular those hardest hit by the COVID-19 pandemic. Its centrepiece, the Recovery and Resilience Facility (RRF), provides financing support to reforms and investments in Member States until the end of 2026. In particular, the RRF aims to make European economies and societies more sustainable, resilient and better prepared for the challenges and opportunities of the green and digital transitions. The RRF is expected to reduce debt sustainability risks by strengthening the quality of public finances and lifting potential growth. The absorption of Recovery and Resilience Facility (RRF) grants is set to increase significantly over the forecast horizon i.e. until 2024.

However, deficit and debt ratios remain high

As economic activity weakens, the EU aggregate deficit is expected to increase to 3.6% of GDP in 2023, before declining to 3.2% of GDP in 2024. Eleven Member States are projected to have a deficit greater than 3% of GDP in 2024. The projected deficits and lower growth rates weigh on debt developments in the coming years. The debt-to-GDP ratio is expected to remain elevated at around 85% in 2023 and 84% in 2024 in the EU as a whole. In most Member States, debt levels are set to remain above pre-

([1]) The Commission 2023 winter forecast published in February 2023 is an interim forecast which only provides an update of the GDP growth and inflation forecast. It is broadly similar to the Commission 2022 autumn forecast.

COVID-19 pandemic levels in 2024. They are projected to exceed 60% of GDP in half of the Member States and remain above 100% of GDP in six countries. Therefore, a close monitoring and assessment of fiscal sustainability risks remains important.

Financing conditions have been tightening

In response to the rising inflationary pressures, central banks in the EU have tightened their monetary policy stances. The ECB, and most central banks in non-euro area Member States, are expected to keep hiking policy rates throughout 2023. Short-term rates should therefore keep increasing over the forecast horizon. Long-term real rates of most Member States are well into positive territory. The spreads of sovereign bonds with respect to the German Bund benchmark have widened since mid-2022.

The outlook is surrounded by a high degree of uncertainty

The uncertainty surrounding the economic outlook is high. The largest downside risk stems from adverse developments on the gas market and the risk of shortages. In addition, the EU remains exposed to further shocks from other commodity markets due to geopolitical tensions. More persistent inflationary pressures and a potential disorderly adjustment on global financial markets to the new higher interest rate environment are additional risk factors, which could also complicate the definition of an appropriate policy-mix between fiscal and monetary policies. Finally, pandemic-related health hazards and the impact of climate change represent additional downside risks to the EU and the global economy.

2. DSM 2022: METHODOLOGY AND USE

This report presents an update of the Commission's fiscal sustainability risk assessment

This edition of the Debt Sustainability Monitor (DSM) provides an updated assessment of fiscal sustainability risks in EU countries compared with the Fiscal Sustainability Report (FSR) 2021. The assessment is based on the latest available Commission macroeconomic and fiscal forecast from autumn 2022. It relies on the Economic Policy Committee's (EPC) commonly agreed methodology to project medium-term GDP growth ([2]), largely taking into account the expected impact of NGEU. The DSM also reflects the agreed long-term economic and budgetary projections from the joint European Commission - EPC Ageing Report 2021.

The assessment is based on the well-established fiscal sustainability risk framework of the Commission

Fiscal sustainability risks are assessed with the well-established comprehensive fiscal sustainability framework. This framework brings together results on debt sustainability analyses (DSA) and fiscal sustainability indicators. It facilitates a horizontally consistent overview of fiscal sustainability risks across three different time horizons (short, medium and long term) and across countries, based on a set of transparent criteria.

([2]) GDP growth over 10 years is projected in line with the EU commonly agreed methodology. It incorporates to a large extent the expected favourable impact of NextGenerationEU, both in the short-term forecast up to 2024 and in its T+10 extension through persistence effects. The expected impact of structural reforms is reflected insofar as these reforms have already been legislated or are certain and known in sufficient detail (see Blondeau, F., Planas, C. and A. Rossi (2021): Output Gap Estimation Using the European Union's Commonly Agreed Methodology: Vade Mecum and Manual for the EUCAM Software, European Commission Discussion Paper 148, October).

The report benefits from two methodological improvements

This edition of the report introduces two methodological improvements as already proposed in the 2021 FSR. (3) First, fiscal sustainability challenges over the *medium term* are now captured through the sole use of the DSA toolkit, and no longer through the joint use of the DSA and the S1 fiscal sustainability indicator. This facilitates the use of a single tool that is a well-established reference to assess medium-term risks. Second, fiscal sustainability challenges over *the long term* are now captured through the S2 fiscal sustainability indicator (4) complemented by the revised S1 indicator (instead of the DSA). The revised S1 indicator measures the fiscal gap to bring the debt-to-GDP ratio to 60% in the long term rather than in 15 years (5). The joint use of S1 and S2, with similar time horizons, allows for an identification of long-term challenges deriving from population ageing, while capturing potential vulnerabilities stemming from high debt levels. (6)

The key findings are highly relevant for the EU fiscal surveillance process

The analysis of fiscal sustainability challenges presented in this report contributes to the monitoring and coordination of Member States' fiscal policies. It plays a key role for the surveillance under the Stability and Growth Pact (SGP) (7) and the European Semester, including the formulation of structural-fiscal country-specific recommendations and post-programme surveillance. It also provides the starting point for the assessment of debt sustainability in the framework of financial assistance programmes.

The debt sustainability analysis could also play a greater role in the reformed EU fiscal governance framework according to the orientations put forward by the Commission

Debt sustainability analyses could also play a greater role in the EU economic governance framework according to the Commission's orientations for a reformed framework released on 9 November 2022 (8). The orientations seek to ensure that the framework becomes simpler, more transparent and effective, with greater national ownership and better enforcement, while allowing for strategic investment and reducing high public debt ratios in a realistic, gradual and sustained manner.

The orientations aim to strengthen debt sustainability and promote sustainable and inclusive growth in all Member States. They propose to move towards a more risk-based surveillance framework that puts debt sustainability at its core and differentiates between Member States with low, moderate or substantial public debt challenges. This classification would correspond to the Commission's standard assessment of low, medium or high fiscal sustainability risks over the medium term as assessed based on the debt sustainability analysis and presented in this report. Moreover, the Commission would provide a technical trajectory based on its debt sustainability analysis framework. (9) At the same time, this would mean

(3) See European Commission (2022), Fiscal Sustainability Report 2021, Vol. 1, Institutional Paper 171, Box I.3.3. Possible future methodological revisions, p. 100.
(4) The S2 indicator shows the required fiscal adjustment, in terms of structural primary balance, to stabilise the debt ratio over the infinite horizon.
(5) The revised S1 indicator shows the required fiscal adjustment, in terms of structural primary balance, to bring the debt-to-GDP ratio to the 60% of GDP reference value in 2070.
(6) A thorough description of the Commission multi-dimensional approach can also be found in Chapters 1-3 and in Annex A1 of this report.
(7) See FSR 2018 for a detailed description of the multiple roles of this analysis in the context of the SGP. Moreover, according to the 'general escape clause', "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, *provided that this does not endanger fiscal sustainability in the medium term"*.
(8) European Commission (2022), Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final 9 November.
(9) The approach largely draws from the Commission's standard DSA presented in this report with only few adaptions due to the specific application of the DSA to compute the technical fiscal trajectories. The few adaptations refer to (i) the time horizon

adhering to a transparent and common EU framework consistent with the 3% of GDP and 60% of GDP reference values of the Treaty. National medium-term fiscal-structural plans for Member States with substantial or moderate public debt challenges should ensure that debt is put on a plausibly declining path, or stays at prudent levels, and that the deficit remains credibly below the 3% of GDP reference value over the medium term. They should outline the medium-term fiscal path, together with reform and investment commitments.

3. KEY RESULTS

Short-term fiscal risks are considered to be overall low despite some vulnerabilities

Chapter 1 of this report shows that short-term fiscal sustainability risks are overall low in 2022 (see Table 1 and 2 for an overview). According to the Commission's early-warning indicator, the S0 indicator, all countries have low risks of fiscal stress in 2023, as indicated by values of S0 below its critical threshold. Nevertheless, the S0 indicator identifies some vulnerabilities in the short term. In particular, government gross financing needs, an important predictor for short-term fiscal sustainability risks, are expected to remain sizeable in six Member States in the short term. In addition, sovereign yields have recently increased in the EU. However, interest rates are expected to feed only gradually into the government debt burden, as debt maturities have been lengthened over time.

Over the medium term, government debt is expected to decline only temporarily in case of no policy action

Chapter 2 shows that in the EU as a whole, the debt-to-GDP ratio is projected to decline slightly at unchanged fiscal policy until the late 2020s. It will then rise again due to the increasing cost of ageing and a gradually less favourable snowball effect, which combines the impact of interest payments and nominal growth on debt dynamics. Under the baseline scenario, the interest-growth rate ('r-g') differential is assumed to remain only slightly negative by 2033 and will therefore only marginally dampen the increasing pressure from ageing costs on public finances. An alternative scenario shows that debt could nearly fall back to its pre COVID-19 pandemic level by 2031 (before increasing again) if the structural primary deficit converged back to the balanced position observed on average in the past 15 years. A more limited fiscal adjustment, a less favourable 'r-g' differential or temporary financial stress would instead weigh on debt dynamics. Moreover, the stochastic projections point to significant uncertainty around the baseline. With an 80% probability, debt will lie between around 80% and 102% in the euro area as a whole by 2027, coming below the 2022 level with a 67% probability.

Compared with the 2021 FSR, almost half of the Member States are projected to reach higher debt levels by 2033, despite a more favourable starting position. In almost all Member States, the initial debt levels expected for 2023 are lower than in the 2021 FSR, mainly due to the stronger-than-expected recovery in 2021 and higher inflation in 2022 and 2023. A large part of this revision is projected to carry over until 2033. However, for most Member States and on aggregate, the growth outlook has been revised

considered to compute the technical fiscal trajectories (10 years *after the adjustment period*); (ii) the lower SPB scenario to stress test the robustness of the medium-term adjustment path instead of the short-term forecast and (iii) the historical SPB scenario, which is omitted since it is relevant to assess risks, including based on past fiscal performance, that support the differentiation of Member States according to public debt challenges, but not in the context of guiding the preparation of the plans.

downwards and the interest rate-growth differential is expected to be less favourable for debt-reduction compared with the 2021 FSR. These more adverse assumptions highlight uncertainty, as well as the protracted impact of the COVID-19 pandemic and of Russia's war of aggression against Ukraine on economic activity, and the tightening financing conditions in a context of higher inflation.

Medium-term risks are high in nine and medium in 10 EU countries

Nine Member States are found to be at high fiscal sustainability risk in the medium term: Belgium, Greece, Spain, France, Croatia, Italy, Hungary, Portugal and Slovakia. The high-risk classification is mainly driven by high and/or increasing debt ratios under the baseline scenario (Belgium, Greece, France, Italy and Portugal), along with elevated uncertainty surrounding the baseline projections (Slovakia), as captured by stochastic analysis, and by vulnerability to more adverse assumptions (Spain, Croatia and Hungary). Furthermore, projected financing needs suggest that countries with the highest debt ratios could also be exposed to liquidity challenges.

Medium-term fiscal sustainability risks are medium in 10 Member States: Czechia, Germany, Cyprus, Malta, the Netherlands, Austria, Poland, Romania, Slovenia and Finland. In Czechia, debt is projected to be on an increasing trend remaining below 60% of GDP. In Germany, Malta, the Netherlands, Poland, Romania and Slovenia, debt is also on an increasing trend, but projected to exceed 60% of GDP both at unchanged policies and under some alternative scenarios. Moreover, among these countries, the debt dynamic is subject to significant uncertainty in the case of Romania and there is a risk that debt does not stabilise by 2027 in Slovenia, as flagged by the stochastic projections. For Austria and Finland, debt would decline under the baseline scenario, but is vulnerable to adverse conditions, under which debt could increase well above 60% of GDP. For Finland, the classification also reflects the risk that debt will not decline by 2027 according to stochastic simulations. Finally, despite its downward debt trend, Cyprus is found to be at medium risk because the stochastic projections point to large uncertainty surrounding the baseline projections.

In the remaining eight Member States (Bulgaria, Denmark, Estonia, Ireland, Latvia, Lithuania, Luxembourg and Sweden), medium-term fiscal sustainability risks are low.

Long-term risks are high in seven and medium in twelve EU countries

Chapter 3 concludes that long-term fiscal sustainability risks are high in seven Member States and medium in twelve Member States. The countries with high long-term risks are Belgium, Luxembourg, Hungary, Malta, the Netherlands, Slovenia and Slovakia. The driving factor behind this risk assessment is based on the S2 indicator, and largely reflects increasing ageing costs. The latter is due to the significant projected increase in pension spending (largest component in Luxembourg, Hungary, Malta, Slovenia and Slovakia), as well as in healthcare and/or long-term care spending (largest component in Belgium and the Netherlands).

Twelve Member States face medium fiscal sustainability risks in the long term (Bulgaria, Czechia, Germany, Ireland, Spain, France, Croatia, Italy, Austria, Poland, Romania and Finland). The driving factor behind this risk assessment is generally the S2 indicator, reflecting projected increases in ageing costs (largest component in Czechia, Germany, Ireland, Austria and

Finland) and/or an unfavourable initial budgetary position (largest component in Bulgaria, Croatia, Poland and Romania). Only in the cases of Spain, France and Italy, the overall risk classification is driven by the S1 indicator, with a significant fiscal effort (above 2 pps. of GDP) needed to reduce the debt-to-GDP ratio from current high levels to 60% by 2070. In eight other Member States (Denmark, Estonia, Greece, Cyprus, Latvia, Lithuania, Portugal and Sweden), long-term fiscal sustainability risks are low, either reflecting the expected reducing long-term impact of past pension reforms (as in Greece and Portugal) and / or the favourable initial budgetary position (as in Denmark, Estonia, Latvia, Lithuania and Sweden in terms of debt level, or Cyprus in terms of structural primary balance).

Compared with last year, short-term sustainability risks have declined, but medium- and long-term risks remain broadly unchanged

Compared with the 2021 FSR, the assessment of fiscal sustainability risks has changed as follows.

Short-term fiscal sustainability risks have declined in particular thanks to the robust growth in 2022. The 2022 DSM concludes that short-term fiscal sustainability risks are overall low in all Member States despite some vulnerabilities. By contrast, short-term risks were considered high in two countries in the 2021 FSR and in 17 countries during the global financial crisis.

Over the medium term, the risk classification is unchanged compared with the 2021 FSR in the vast majority of Member States. However, the updated classification shows a less favourable risk assessment for two Member States (Poland from low to medium risk, and Hungary from medium to high risk) and a more favourable assessment for four Member States (Bulgaria from medium to low risk, and Malta, Romania and Slovenia from high to medium risk).

The worsened risk assessment in the cases of Poland and Hungary reflects less favourable macro-financial outlooks than in the 2021 FSR. The weaker potential growth outlook and tightened financing conditions weigh on their debt dynamics. The improved risk classifications in Malta, Romania and Slovenia mainly result from a more favourable fiscal outlook. In particular, Malta and Slovenia exit the high-risk category as, with a structural primary balance assumed to remain at the improved level forecast for 2024 (and, for Malta, a stronger growth outlook over the medium term), their debts are no longer projected to exceed 90% of GDP under any of the scenarios. For Romania, the high-risk classification in the 2021 FSR was due to the S1 indicator, which would have pointed to medium risk based on the latest forecast, while the DSA-based medium risk signal from the FSR is confirmed in the 2022 DSM. Finally, the classification for Bulgaria improves to low risk because the stochastic projections no longer flag high uncertainty.

Over the long term, the risk classification is also unchanged in the majority of Member States compared with the 2021 FSR. However, one Member State faces higher risks and six Member States lower risks. For the Netherlands, long-term risks are now high compared to medium in the 2021 FSR. This deterioration is driven by a worsening in the S2 indicator due to the less favourable initial budgetary position. Czechia, Spain and Italy are now at medium risk compared to high risk in the 2021 FSR. Greece, Cyprus and Portugal are now at low risk compared to medium risk in the 2021 FSR.

These changes are either due to an improvement of the value of the S2 indicator (Czechia, Spain and Italy), capturing a more favourable initial budgetary position, and/or reflect (for Greece, Cyprus and Portugal) the methodological change using the revised S1 instead of the DSA as a complementary indicator to the S2 in the overall risk classification (see Box 3.1). However, the more favourable assessment for these countries is conditional on them maintaining the structural primary surpluses expected in 2024 over the long term.

Several additional factors need to be taken into account in a balanced assessment of fiscal sustainability risks

Chapter 4 analyses additional risk factors as a complement to the quantitative results of the framework to ensure a balanced overall assessment of fiscal sustainability challenges. These factors are only partially factored in the quantitative results of the framework.

On the downside, the share of short-term debt has increased in many Member States as a result of the COVID-19 pandemic and it is non-negligible in some Member States. Some non-euro area Member States are also exposed to foreign exchange rate risks. In addition, risks exist concerning government contingent liabilities, which increased significantly during the COVID-19 pandemic, as many Member States granted substantial support to the private sector in the form of guarantees. These guarantees are expected to continue declining in 2023 according to Member States' Draft Budgetary Plans. A snapshot analysis of bank balance sheets points to contained vulnerabilities. Yet, simulations based on the Commission's SYMBOL model conclude that (implicit) contingent liabilities' risks linked to the banking sector exist in some Member States, in particular under a stressed scenario.

On the upside, several factors contribute to mitigating debt sustainability risks across the EU, notably the lengthening of debt maturities in past years. The asset purchases' programmes by the Eurosystem in past years also resulted in a substantial increase of the share of government debt held by central banks, representing a stable financing source. Moreover, the structural reforms under the NGEU/RRF, if fully implemented, could have a further positive impact on overall EU GDP growth in the coming years, and therefore further mitigate the debt sustainability risks of Member States.

Table 1: **Fiscal sustainability risk classification by Member States (if different, the risk classification from the FSR 2021 is shown in brackets)**

	Overall SHORT-TERM risk category	Overall MEDIUM-TERM risk category	Overall LONG-TERM risk category
BE	LOW	HIGH	HIGH
BG	LOW	LOW (MEDIUM)	MEDIUM
CZ	LOW	MEDIUM	MEDIUM (HIGH)
DK	LOW	LOW	LOW
DE	LOW	MEDIUM	MEDIUM
EE	LOW	LOW	LOW
IE	LOW	LOW	MEDIUM
EL	LOW (HIGH)	HIGH	LOW (MEDIUM)
ES	LOW	HIGH	MEDIUM (HIGH)
FR	LOW	HIGH	MEDIUM
HR	LOW	HIGH	MEDIUM
IT	LOW	HIGH	MEDIUM (HIGH)
CY	LOW (HIGH)	MEDIUM	LOW
LV	LOW	LOW	LOW
LT	LOW	LOW	LOW
LU	LOW	LOW	HIGH
HU	LOW	HIGH (MEDIUM)	HIGH
MT	LOW	MEDIUM (HIGH)	HIGH
NL	LOW	MEDIUM	HIGH (MEDIUM)
AT	LOW	MEDIUM	MEDIUM
PL	LOW	MEDIUM (LOW)	MEDIUM
PT	LOW	HIGH	LOW (MEDIUM)
RO	LOW	MEDIUM (HIGH)	MEDIUM
SI	LOW	MEDIUM (HIGH)	HIGH
SK	LOW	HIGH	HIGH
FI	LOW	MEDIUM	MEDIUM
SE	LOW	LOW	LOW

Source: Commission services.