

INTRODUCTION

1. PUBLIC FINANCES IN THE EU: A SNAPSHOT

The EU economy appears set for a delayed rebound in growth amid faster easing of inflation. After subdued growth in 2023, the EU economy has entered 2024 on a weaker footing than previously expected. Already towards the end of 2022, the economic expansion came to an abrupt end and activity has since been broadly stagnating, against the background of falling household purchasing power, collapsing external demand, forceful monetary tightening and the partial withdrawal of fiscal support in 2023. Economic activity is expected to gradually accelerate in 2024. Headline inflation has declined faster than expected in 2023, largely driven by falling energy prices. As inflation has declined, real wage growth and a resilient labour market should support a pick-up in consumption. Despite falling profit margins, investment should benefit from a gradual easing of credit conditions and the continued implementation of the Recovery and Resilience Facility. According to the Commission's 2024 winter forecast, the EU economy is expected to grow by 0.5% in 2023, 0.9% in 2024 and 1.7% in 2025. In the EU, the Harmonised Index of Consumer Prices (HICP) inflation is projected to fall from 6.3% in 2023 to 3.0% in 2024 and 2.5% in 2025. ⁽⁸⁾

Fiscal positions improved slightly in 2023. After reaching the historically high level of 6.7% of GDP in 2020 following the COVID-19 pandemic, the EU aggregate budget deficit fell to 3.3% in 2022. According to the Commission's 2023 autumn forecast, it is projected to decline slightly to 3.2% of GDP in 2023. Crisis-related fiscal measures are estimated to have declined significantly, thanks to the full phasing out of pandemic-related temporary measures, a reduction in subsidies to private investment and a lower net budgetary impact of energy-related measures. The less favourable economic environment and higher interest expenditure are projected to have had a deficit-increasing effect in 2023. The EU aggregate debt-to-GDP ratio fell significantly to 85% at the end of 2022 from a historically high level close to 92% at the end of 2020. This decline was due to the strong post-pandemic economic recovery and high inflation, while high primary deficits continued to lift debt levels. The EU aggregate debt ratio is set to continue to decline to 83% of GDP in 2023 helped by inflation, while higher interest rates on new debt issuances are expected to pass-through interest expenditure only gradually thanks to the long maturity of public debt. At the same time, subdued real GDP growth is expected to hardly contribute to the debt-ratio decline in 2023.

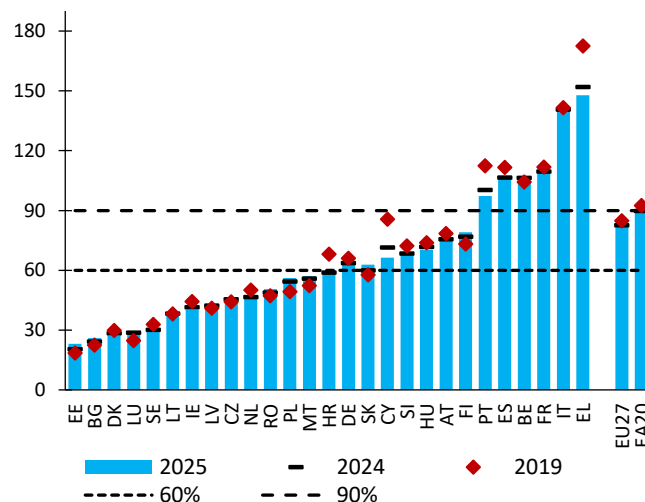
⁽⁸⁾ The Commission 2024 winter forecast published in February 2024 is an interim forecast which only provides an update of the GDP growth and inflation forecast. It is broadly similar to the Commission 2023 autumn forecast, which is the basis of this report.

Deficit and debt ratios remain high in many Member States. According to the Commission’s 2023 autumn forecast, the EU aggregate deficit is set to fall to 3.2% of GDP in 2023, 2.8% of GDP in 2024 and 2.7% of GDP in 2025. This decline is mostly driven by the significant reduction in energy-related measures, while higher interest expenditure is set to increase the deficit. In 2024, twelve EU Member States are expected to have a deficit above 3% of GDP. This number is expected to rise to thirteen in 2025 under a no policy change assumption. The EU aggregate debt ratio is projected to decline to around 83% of GDP in 2023 and to broadly stabilise in 2024 and 2025 above the 2019 level of around 79% of GDP. The interest rate-growth differential is projected to become less favourable as the growth of the GDP deflator decelerates and interest expenditure continues to rise. Primary deficits are projected to continue to weigh on debt developments. Six Member States are expected to still have debt ratios well above 90% of GDP in 2025, and another seven above 60% of GDP.

Financing conditions have eased somewhat but remain tighter than in the past. Most EU central banks tightened monetary policy further in 2023 in response to remaining inflationary pressures, albeit slightly less than in 2022. Financial markets expect policy rates in the EU have peaked in 2023. Government bond yield spreads have risen in several Member States in 2022, but have fallen in 2023 and are overall contained. The impact of higher interest rates on government debt burdens is expected to be gradual in many Member States, as debt maturities had been lengthened over the previous decade. Sovereign ratings remain favourable and stable on average across the EU, with some differences between Member States. Overall, financing conditions in many EU countries have eased somewhat compared to autumn 2022, but remain less supportive than in the period before., in line with the expectations of ‘higher-for-longer’ policy rates.

The outlook is surrounded by high uncertainty amid geopolitical tensions. Protracted geopolitical tensions and the broadening of the Middle East conflict to the Red Sea tilt the balance of risks towards more adverse outcomes. Additional trade disruptions could bring renewed stress to supply chains, hampering production and adding price pressures. Domestically, a faster recovery of consumption, higher-than-expected wage growth and a lower-than-anticipated fall in profit margins could hold back the disinflation process. On the downside, a more persistent transmission of the still tight monetary conditions could further delay the rebound in economic activity, pushing inflation lower. Climate risks and the increasing frequency of extreme weather events continue to pose threats.

Graph 1: General government debt developments (% of GDP)



Source: Commission services.

The Debt Sustainability Monitor (DSM) provides a topical assessment of fiscal sustainability risks in EU countries. The situation of public finances described in this section, and challenges looming ahead, entails that a close monitoring and assessment of fiscal sustainability risks remains important at the current juncture. Moreover, the reformed EU fiscal surveillance framework will give a stronger role to debt sustainability analysis. The rest of this introductory chapter is organised as follows: Section 2 provides a brief overview of the Commission’s fiscal sustainability analysis framework; Section 3 describes the role of this analysis in the EU economic and fiscal surveillance framework.

2. THE COMMISSION FISCAL SUSTAINABILITY RISK FRAMEWORK

2.1. Main features

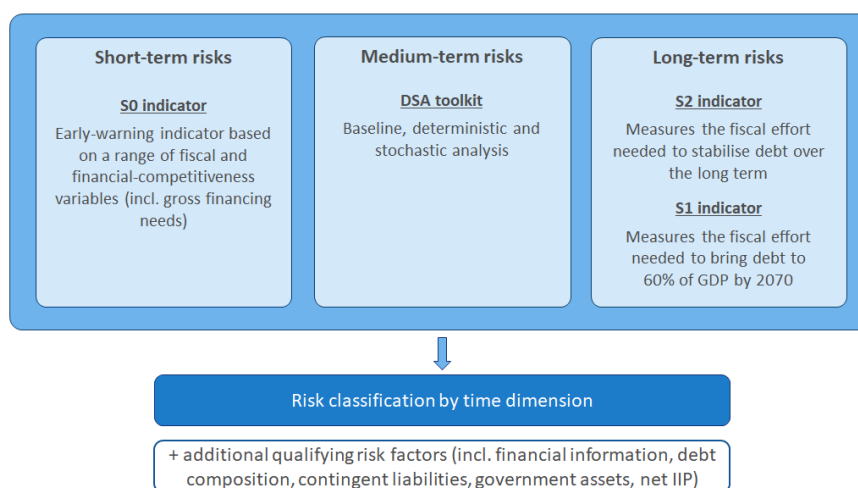
Fiscal sustainability risks in the short, medium and long term are assessed based on a multi-dimensional approach. Fiscal sustainability risks are assessed with the Commission’s well-established fiscal sustainability risk framework. This framework integrates findings from the debt sustainability analysis (DSA) and fiscal sustainability indicators. It offers a coherent view of fiscal sustainability risks over short, medium, and long-term horizons across countries, based on a set of transparent criteria. Key results are summarised in an overall summary heat map of fiscal sustainability risks per time dimension. This framework is intended to help identify the size, nature and timing of fiscal sustainability risks. Such a comprehensive and multi-dimensional assessment framework is key to monitor risks and help designing appropriate policy responses.

The Commission’s assessment of fiscal sustainability risk focuses on three different time horizons:

Short-term fiscal sustainability risks are assessed in particular with the Commission’s early warning indicator S0 (see Part I, Chapter 1). S0 is a composite indicator that combines fiscal, financial and competitiveness variables to detect risks of fiscal stress in the coming year using a signalling approach. It is based on a set of 25 variables that have proven to be good predictors of emerging fiscal stress in the past. It can be further divided into two sub-components: fiscal risks and financial-competitiveness risks.

The analysis of *medium-term fiscal sustainability risks* relies on the Commission’s comprehensive debt sustainability analysis (DSA) toolkit (see Part I, Chapter 2). The DSA combines deterministic debt projections up to 2034 with stochastic projections covering a wide range of possible shocks. The

Graph 2: Key elements of the Commission’s fiscal sustainability risk framework



Source: Commission services.

projections include the impact of ageing-related expenditure. They consider alternative scenarios to the ‘no-fiscal-policy-change’ baseline, such as reverting to past fiscal behaviour, implementing only part of the forecast structural adjustment, benefiting from a less favourable interest-growth rate ($r-g$) differential, and facing temporary turmoil on financial markets. This is complemented by an assessment of potential liquidity challenges based on government’s gross financing needs.

Long-term fiscal sustainability risks are assessed based on two complementary fiscal gap indicators (see Part I, Chapter 3). The S2 indicator measures the fiscal effort needed to stabilise public debt over the long term. The S1 indicator measures the fiscal effort required to bring the government debt-to-GDP ratio to 60% in 2070, hence capturing vulnerabilities due to high debt levels.

The assessment includes sensitivity tests to account for uncertainty. The current high level of uncertainty means that sensitivity tests and alternative scenarios, which are routinely included in the DSM, are particularly relevant. For the DSA, various deterministic scenarios and stress tests are performed to complement the baseline. Stochastic projections are an important complement to this analysis, simulating a very large number of shocks together, based on the historical volatility of each economy and the correlation of shocks (Part I, Chapter 2). In addition, some alternative calculations to the baseline are made for the long-term fiscal sustainability indicators, including stress tests of the results against alternative developments in productivity growth or non-demographic drivers of health and long-term care expenditure (see Part I, Chapter 3).

Additional aggravating or mitigating risk factors are taken into account to ensure a balanced assessment of overall fiscal sustainability risks. The quantitative results and the resulting risk classification based on this horizontal framework need to be complemented by the consideration of additional qualifying factors. To this end, a number of additional aggravating and mitigating risk factors, such as the structure of debt, government liabilities beyond (EDP) public debt, in particular contingent liabilities, as well as government assets and net debt, are also considered to complement the model-based quantitative results and inform the overall assessment of fiscal sustainability challenges (see Part I, Chapter 4 and the country fiches in Annex A7). The importance of such factors, which are sometimes more qualitative (such as institutional factors) and/or country-specific, and the prudent application of judgement to arrive at a final assessment of fiscal sustainability risks, has been a key feature of the Commission’s DSA framework since 2014 and is in line with the practice of other international institutions.

2.2. Information used and methodological improvements included in the report

The assessment presented in this report is based on latest available information as of March 2024, including updated ageing costs. The DSM is based on the Commission 2023 autumn forecast (which is the latest full-fledged forecast). It relies on the commonly agreed methodology of the Economic Policy Committee (EPC) for projecting medium-term GDP growth,⁽⁹⁾ which takes into account the expected impact of implemented reforms. Importantly, the DSM also reflects the agreed long-term economic and budgetary projections of the Ageing Report 2024, jointly prepared by the European Commission and the EPC. The latter are reflected both in the DSA and the fiscal sustainability indicators.⁽¹⁰⁾

⁽⁹⁾ GDP growth over 10 years is projected in line with the EU commonly agreed methodology. It incorporates the expected favourable impact of implemented reforms (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).

⁽¹⁰⁾ See Ageing Report 2024, Volume 1 for the macroeconomic projections (published in November 2023) and the forthcoming Ageing Report 2024, Volume 2 for the budgetary projections. The latter were endorsed by the EPC in January 2024 and will be published in the second quarter of 2024.

This edition of the Debt Sustainability Monitor introduces one main methodological improvement relative to the 2022 issue regarding the assumption on stock-flow-adjustments (SFA) beyond the short-term forecast horizon. SFA represents the difference between the change in government debt and the government balance. This variable is affected by various drivers and tends to be highly volatile, hence difficult to predict over the medium term. For this reason, it was generally assumed that SFA returned to zero beyond the short-term forecast horizon. However, in some cases, SFA appear to be significantly and systematically different from zero, due to structural factors (e.g. the build-up of public pension funds, or deferred interests linked to official loans). Based on horizontal criteria, and notably making use of the latest Ageing Report projections, the DSA now includes a non-zero SFA assumption where necessary to take account of these cases (see Part II, Chapter 2). A couple of additional technical adjustments were made to the approach: the *no-fiscal-policy-change assumption*, used in assessing medium- and long-term fiscal sustainability risks, was re-anchored on the first forecast year (T+1), for the needs of the reformed Stability and Growth Pact (see Part II, Chapter 1 - previously anchored on the second forecast year (T+2)). Finally, the *treatment of the underlying quarterly data* for the *stochastic projections* was enhanced (see Annex A4).

3. ROLE OF THE COMMISSION'S FISCAL SUSTAINABILITY ANALYSIS IN EU SURVEILLANCE

The Commission analysis of fiscal sustainability risks has contributed to the monitoring and coordination of Member States' fiscal policies for many years. It plays a key role for the surveillance under the Stability and Growth Pact (SGP) and the European Semester, including the formulation of structural-fiscal country-specific recommendations and post-programme surveillance.

The debt sustainability analysis will play a greater role in the reformed EU economic governance framework. In February 2024, the European Parliament and the Council have reached a provisional political agreement on the most ambitious and comprehensive reform of the EU's economic governance framework since the aftermath of the economic and financial crisis. ⁽¹⁾ The objectives of the reformed framework are to strengthen Member States' debt sustainability and to promote sustainable and inclusive growth in all Member States through growth-enhancing reforms and priority investments. The reform aims to make the framework more risk-differentiated and effective, with greater national ownership and better enforcement. It will help Member States reduce high public debt levels in a realistic, gradual and sustained manner. The new framework also aims at promoting investments and reforms, not least to support the EU green and digital transition, notably building on the lessons learned from previous crises.

The new fiscal governance framework takes account of different fiscal challenges. The new framework introduces risk-based surveillance, which differentiates between Member States according to their individual fiscal positions. For Member States with a government deficit above 3% of GDP or a public debt above 60% of GDP, the Commission will issue a country-specific “reference trajectory”. This trajectory will provide guidance to Member States in preparing their plans and will ensure that debt is put on a plausible downward path or stays at prudent levels, and that the deficit is brought and maintained below 3% of GDP over the medium-term. The approach also includes safeguards to ensure a minimum debt decline (the debt sustainability safeguard) and to provide a safety margin below the Treaty deficit reference value of 3% of GDP (the deficit resilience safeguard). Member States with a government deficit below 3% of GDP and public debt below 60% of GDP will have to ensure in their plans that the deficit is maintained below 3% of GDP over the medium term and that debt remains below 60% of GDP. These Member States can request technical information from the Commission. For the first round of plans, the plausibility of public debt declining in the medium term should be based on the methodology described in this Debt Sustainability Monitor 2023 (see Part II, Chapter 1). A working group for debt sustainability

⁽¹⁾ See <https://www.consilium.europa.eu/en/press/press-releases/2024/02/10/economic-governance-review-council-and-parliament-strike-deal-on-reform-of-fiscal-rules/>

analysis will explore possible methodological improvements, including on underlying assumptions. The plans will be assessed by the Commission and endorsed by the Council, based on common EU criteria, while a single operational indicator – net primary expenditure – will serve as the basis for the monitoring and the assessment of compliance.

The rest of the report is structured as follows. The *first part of the report* presents the key findings of the Commission’s fiscal sustainability risk framework. Chapter 1 presents the short-term fiscal sustainability analysis. Chapter 2 covers the medium-term fiscal sustainability analysis based on the DSA results. Chapter 3 focuses on the long-term fiscal sustainability analysis. Chapter 4 reviews additional aggravating and mitigating risk factors. The *second part of the report* presents special issues. Chapter 1 presents the DSA methodology in the new economic governance framework. Chapter 2 describes the revised stock-flow adjustment (SFA) assumptions. Finally, the annex provides detailed country analysis and methodological information.