

European Economics Analyst

Euro Area Fiscal Policy—Continued Consolidation and Debt Decoupling (Stott/Taddei)

- Fiscal consolidation in the EMU4 will continue for the next three years. In Germany, the constitutional *Debt Brake* is unlikely to be relaxed until at least the German election in September 2025. In France, the government led by PM Barnier promised a primary balance adjustment of a magnitude unseen outside of post-crisis normalisation in 2011 and 2021-22. The Italian Ministry of Finance has promised a faster fiscal consolidation than expectations, taking the country out of the Excessive Deficit Procedure in 2026. In Spain, the difficulties of the ruling coalition to bridge an agreement with the regional parties and approve the 2025 budget is likely to deliver a steady consolidation on the basis of the 2024 three-year plan.
- Given the broad-based fiscal consolidation, the European fiscal stance will remain negative until 2027, albeit less than this year, providing a drag on growth at about 0.3pp per annum in our estimate. Fiscal support fueled by the European Recovery Fund remained slightly positive in 2024, but fell once again short of our expectations. While Spain has increased the pace of spending, recovery fund expenditures were underwhelming in Italy, the main beneficiary of the plan. We expect Italian spending to increase in 2025 and 2026 with the growth impact peaking in 2025 at the European level.
- The macroeconomic backdrop will continue to proceed toward normalisation. Cooling inflation, subdued but stable real growth and a slight increase in the effective interest rate paid on debt are pushing up the real sovereign borrowing rates across the EMU4. We expect debt-to-GDP ratios will continue to decrease in Spain and, less markedly, in Germany, while debt ratios have begun to increase again in France and Italy. The decoupling in debt paths within the EMU4 reflects a diverging fiscal policy mix: France and Italy are burdened by higher deficits and, in the case of Italy, debt issuance in 2024-27 also needs to fund the 2021-23 construction tax credits.
- The new European fiscal rules established a more transparent set of criteria to achieve debt sustainability. We expect both France and Italy, currently in Excessive Deficit Procedure (EDP), to reduce their structural deficit in line with the rules. The main innovation of the new fiscal framework is the shift in focus to multi-year planning through the medium-term fiscal structural plan (FSP). The biggest challenge in the Italian FSP is to achieve an average reduction of the debt-to-GDP ratio compliant with the rules. We expect the European

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Commission to scrutinise recent fiscal slippage in France but eventually to endorse the government's intended speed of adjustment.

- The cautious fiscal policy outlook in Europe stands out in the international comparison. This policy mix will decrease the chances of market stress in the sovereign space, in our view. However, in the absence of a clear commitment to address the industrial challenges at the European level or implement parts of the Draghi Plan at the EU level, we believe the policy stance will continue to weigh on future growth in the coming years.

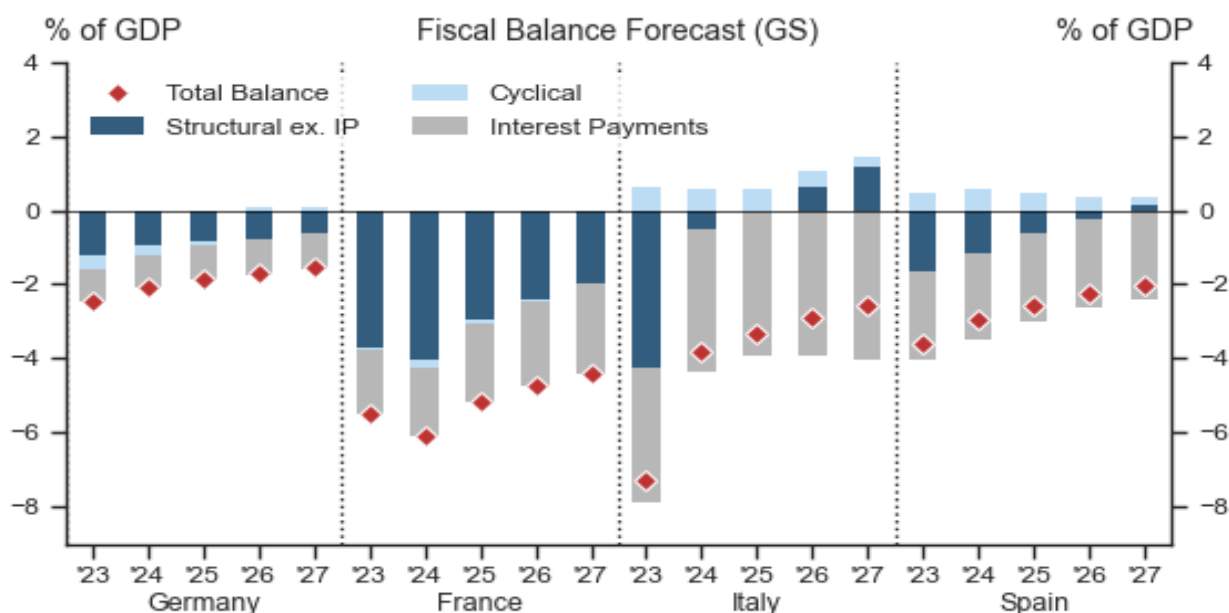
Euro Area Fiscal Policy—Continued Consolidation and Debt Decoupling

The 2025 budgets mark a turning point in the EU policy framework because they are the first that need to comply with the new European fiscal rules. Member states do not only need to provide the usual three-year-ahead planning, but they are also required to present medium-term fiscal structural plans (FSP) offering a credible path toward fiscal consolidation and debt reduction. While the FSPs are still being finalized, this *Analyst* uses the available policy announcements to discuss the challenges to fiscal consolidation taking place while the European outlook weakens.

Faster Fiscal Consolidation Still Ahead

Fiscal consolidation in the EMU4 will continue, in our forecast, for the next three years. The structural balance will improve by an average 0.35pp per annum until 2027 thanks to an acceleration in fiscal consolidation in France, a constant pace in Spain and Italy, and notwithstanding a slight deceleration from 2026 in Germany ([Exhibit 1](#)).

Exhibit 1: Shrinking Deficits and Structural Consolidation



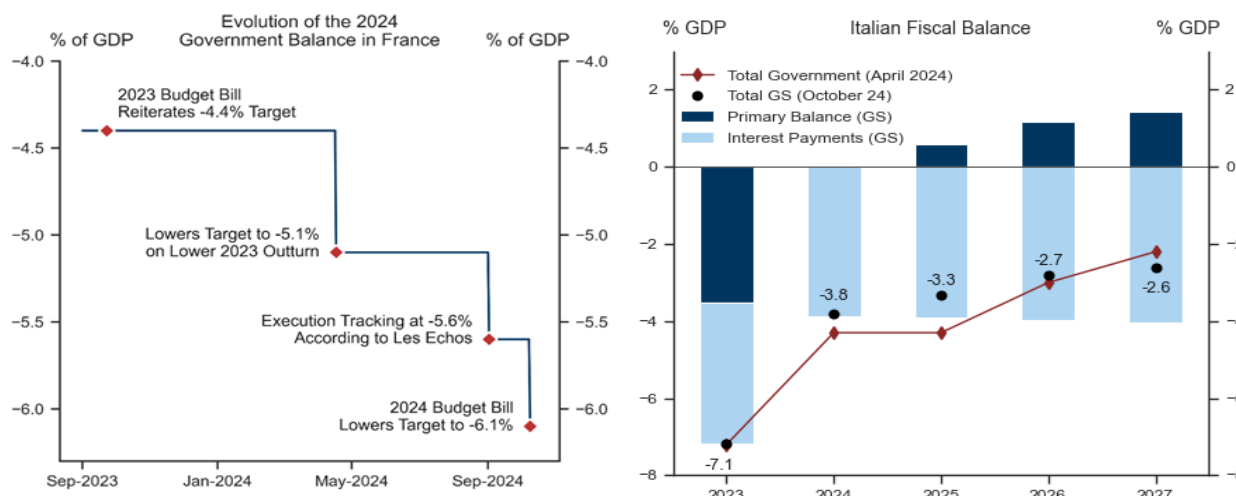
Source: Goldman Sachs Global Investment Research, Haver Analytics

In Germany, while the government lowers its growth projections, fiscal consolidation remains consistent with the constitutional *Debt Brake*. The federal government could leverage its fiscal space to address the structural and cyclical challenges of its economy. This decision would require triggering the debt brake's escape clause in 2025 or try to amend the constitutional rule. However, the opposition of the Liberals (FDP) in the ruling majority and the Cristian Democrats (CDU) in the opposition makes it unlikely that such a policy shift takes place before the German election scheduled for September 2025, at the earliest.

In France, the government conceded that the deficit in 2024 would likely reach 6.1% of GDP. Slippage relative to the initial 4.4% target would therefore amount to 1.7pp (Exhibit 2, left). One of the reasons we had looked for the government to announce some corrective measures was to allow for a more gradual consolidation. The government led by PM Barnier instead set the deficit target for 2025 at 5.0%, consistent with a 1.3pp improvement in the primary balance. An adjustment of this magnitude in France remains unseen outside of post-crisis normalisation in 2011 and 2021-22. Moreover, the reliance on tax increases reduces our confidence in the ability of the government to meet its 2025 deficit target of 5.0%. We are therefore pencilling in some fiscal slippage and have raised our 2025 deficit forecast to 5.2%.

In Italy, the only country in the EMU4 that presented its FSP at this time, the government lowered the fiscal deficit targets from 2024 to 2026, committing to an improvement of the structural balance by 0.5pp per annum. The faster fiscal consolidation plan advanced by the Italian Ministry of Finance exceeded our and market expectations. This more ambitious fiscal consolidation comes on the back of a meaningful upward revision of nominal GDP, while the Italian economy shows signs of weakening real growth momentum, but tax revenues remain resilient (Exhibit 2).

Exhibit 2: France and Italy in the Spotlight



Source: Goldman Sachs Global Investment Research, Haver Analytics, French Ministry of Finance, Italian Ministry of Finance

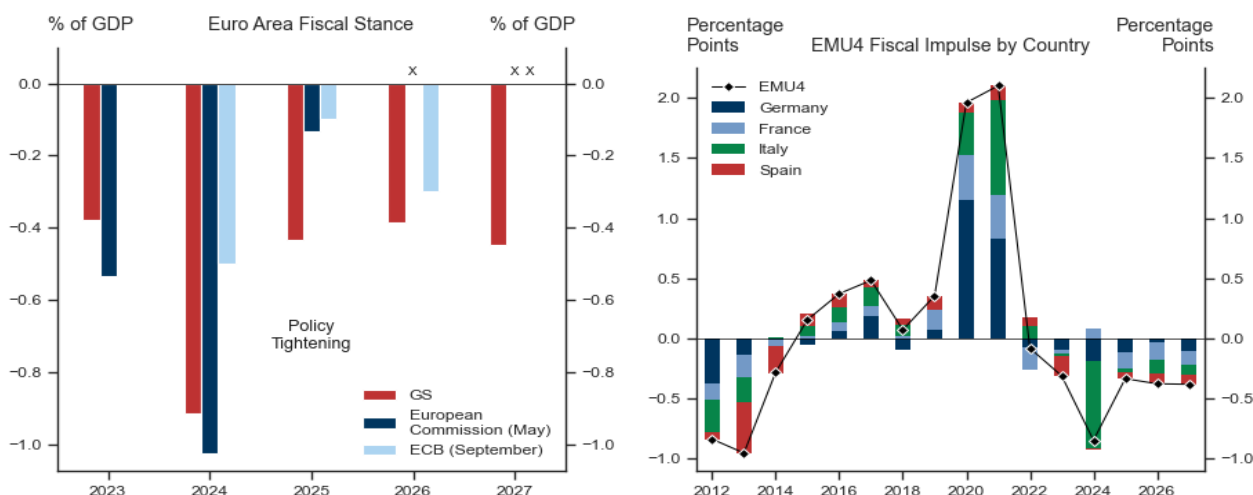
In Spain, the ruling coalition supporting the minority government of PM Sanchez has sought to bridge an agreement with the regional parties, among which the Catalan independentists (Junts) hold a pivotal role. The approval of the 2025 budget is far from

certain, but we expect Spain to present its FSP around 15 October and continue to deliver a steady reduction of its structural balance on the basis of the three-year plan approved as part of the 2024 budget.

Not a Growth-Friendly Policy Mix

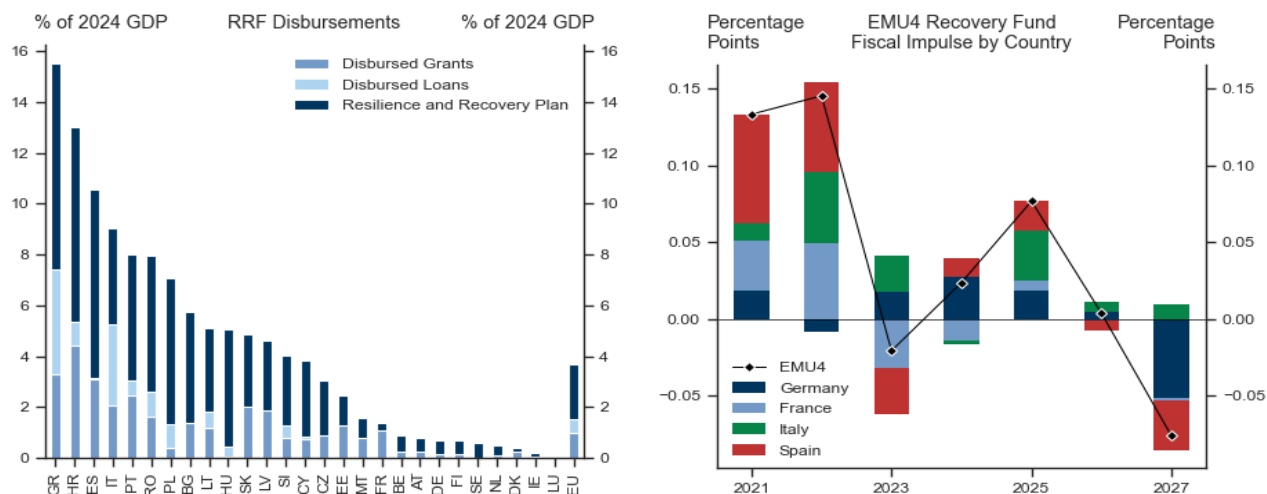
Given the broad-based fiscal consolidation, we believe the European fiscal stance — i.e., the change in the structural fiscal balance — will increase but remain markedly negative until 2027. During the same period, the ensuing fiscal impulse will continue to drag growth, albeit less than in 2024, at an average of about 0.3pp per annum in our estimate. The very large fiscal drag we estimate in 2024 is less negative than our previous estimate because of the fiscal slippage in France and, to a much smaller extent, to a minimal reduction in German consolidation because of weaker economic activity (Exhibit 3).

Exhibit 3: Shifting Fiscal Consolidation: Less in 2024, More in 2025



Source: Goldman Sachs Global Investment Research, European Commission, European Central Bank, Haver Analytics

Fiscal support fueled by the European Recovery Fund remained slightly positive in 2024, but fell once again short of our expectations. Implementation has slightly improved in Eastern Europe since 2023, but remains quite slow. While Greece and Spain have increased the pace of spending, recovery fund expenditures were underwhelming in Italy, the main beneficiary of the plan. We now expect Italian spending to increase in 2025 and 2026 with the growth impact peaking in 2025 at the European level (Exhibit 4).

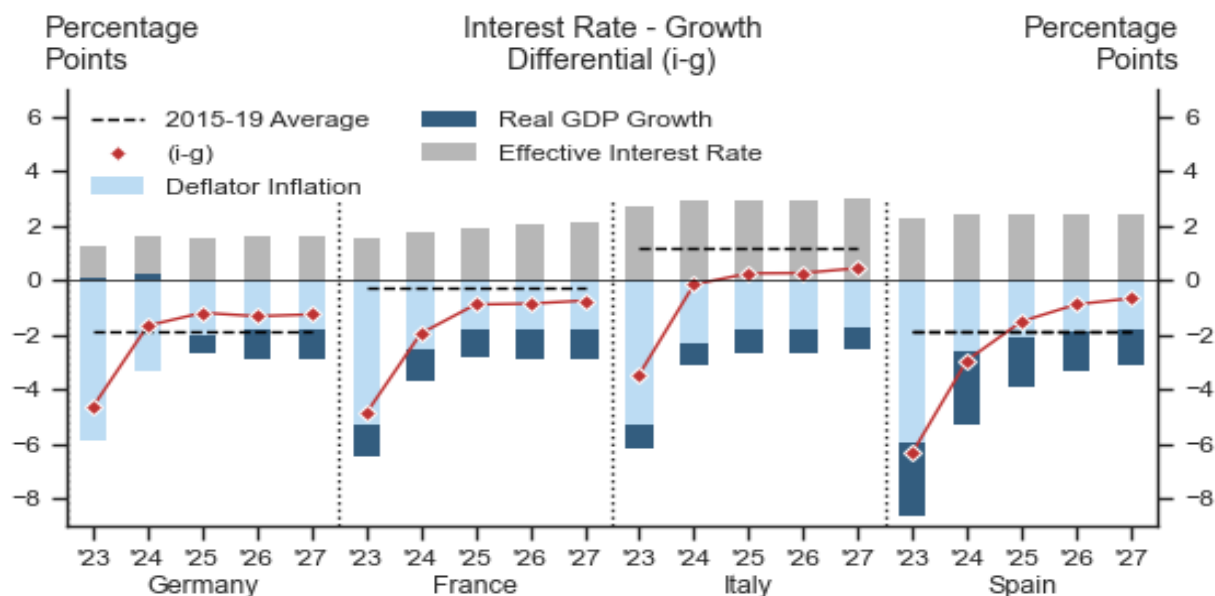
Exhibit 4: European Fiscal Support Coming to an End

Source: Goldman Sachs Global Investment Research, Haver Analytics, European Commission

The impact of the European Recovery Fund is not enough to overturn the contractionary stance of European fiscal policy, in our view. [President Draghi's report](#) highlights that slow European productivity growth in the last 20 years is concentrated in seven sectors requiring additional investments to catch up. The report estimates at EUR 750-800bn (4-5% of EU GDP) the total annual additional investment needs in the EU. It is very unlikely that the EU will be able to close the investment gap with the US without public support to private investment and the current fiscal outlook in Europe does not prioritize investment growth, according to the report.

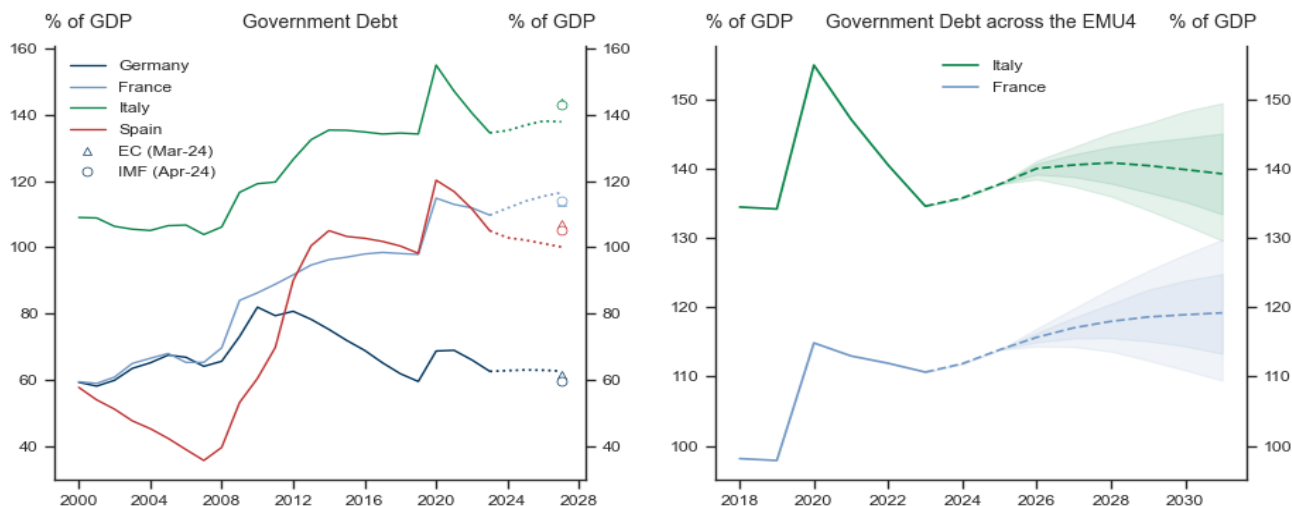
Macro Normalization and Debt Decoupling

We expect the macroeconomic backdrop will continue to proceed toward normalisation. Cooling inflation, **subdued but stable** real growth and a slight increase in the effective interest rate paid on debt are pushing up the real sovereign borrowing rates across the EMU4. We look for the (nominal) interest rate – growth differential to remain negative in Germany, France, and Spain, but turn positive in Italy from next year. That said, our forecast implies that Italy would face a less challenging macroeconomic backdrop than before the pandemic, thanks to higher nominal growth and a limited increase in sovereign borrowing costs ([Exhibit 5](#)).

Exhibit 5: The Snowball Effect (i-g) on Public Debt Stopped Melting

Source: Goldman Sachs Global Investment Research, Haver Analytics

We estimate debt-to-GDP ratios will continue to decrease in Spain and, less markedly, in Germany, while debt ratios have begun to increase again in France and Italy. The decoupling in debt paths within the EMU4 reflects diverging fiscal policy mix ([Exhibit 6, left](#)). While Germany and Spain share lower levels of fiscal deficits, France and Italy are burdened by higher fiscal deficits and, in the case of Italy, debt issuance in 2024-27 also needs to fund the 2021-23 construction tax credits. In our baseline scenario, where medium term real GDP growth and the primary fiscal balance converge to 0.8% and 1.6% for Italy and 0.8% and 0.5% for France, our [proprietary](#) dynamic model forecasts the debt-to-GDP ratios to reach 139% and 119%, respectively. In particular, the increase in Italian debt reflects the tax credits (*stock-flow adjustment*), while the French debt increases over the forecast horizon because of higher fiscal deficits ([Exhibit 6, right](#)).

Exhibit 6: Debt Decoupling

Source: Goldman Sachs Global Investment Research, Haver Analytics, European Commission, IMF

New Fiscal Rules to Address Old Problems

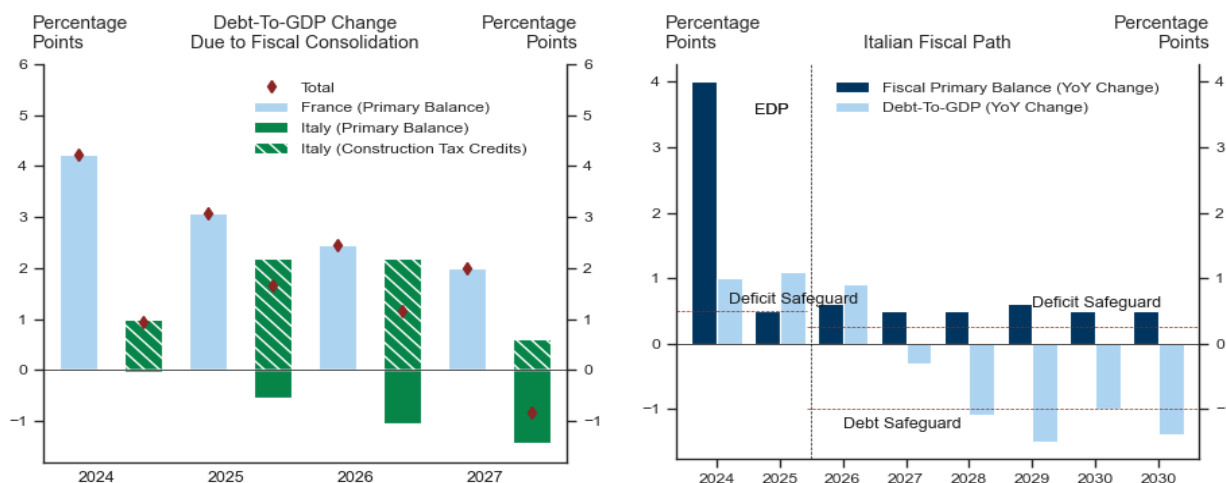
The new European fiscal rules came into force last April with the objective to establish a more transparent set of criteria that could guide fiscal consolidation and deliver debt sustainability. We expect both France and Italy, currently in Excessive Deficit Procedure (EDP), to reduce their structural deficit net of interest payments by 0.5pp per annum, as required for countries in EDP. Although fiscal consolidation is ongoing, in our estimate the post-pandemic legacy and future primary balances will continue to keep the debt-to-GDP ratio in both countries on an increasing path until 2027 (Exhibit 7, left).

The main innovation of the new fiscal framework is the shift in focus from a single year to a multi-year basis through the medium-term fiscal structural plan (FSP). All member States with a public debt exceeding 60% of GDP or a government deficit exceeding 3% of GDP need to meet two requirements. First, they need to put debt on a plausible downward path, with a minimum annual average reduction of 1pp as long as the debt-to-GDP ratio exceeds 90% (*debt sustainability safeguard*). Second, they need to bring fiscal deficit below 3% of GDP over the medium term, with the fiscal adjustment continuing until the structural deficit falls to 1.5 % of GDP (*deficit resilience safeguard*).

The pace of minimal annual fiscal consolidation depends on the length of the FSP, either 4 or 7 years. While the longer plan requires a stricter commitment to a set of reforms and investments, it has the advantage that the required adjustment in the structural primary balance is limited to 0.25pp of GDP, instead of 0.4pp of GDP for the 4-year plan. We expect the European Commission to scrutinise recent fiscal slippage in France but eventually to endorse the government's intended speed of adjustment. The European Commission might adopt a more demanding stance regarding the structural reforms required to extend the adjustment period from 4 to 7 years. Italy, the only country in the EMU4 with an FSP already presented, has opted for the 7-year plan. The biggest challenge in the Italian plan is to achieve an average reduction of the debt-to-GDP ratio compliant with the European fiscal framework given the legacy of construction tax

credits (Exhibit 7, right).

Exhibit 7: Temporary Hurdles and Compliance Challenges



The left chart uses GS estimate while the right chart reports the commitment of the Italian government from the FSP.

Source: Goldman Sachs Global Investment Research, European Commission, Haver Analytics, Italian Ministry of Finance

The cautious fiscal policy outlook in Europe stands out in the international comparison. This policy mix will decrease, in our view, the chances of market stress in the sovereign space and country-specific spreads to the Bund might only reflect temporary idiosyncratic policy deviations. However, in the absence of a clear commitment to address the industrial challenges at the European level or implement parts of the Draghi Plan at the EU level, we believe the policy stance will continue to weigh on future growth in the coming years.

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