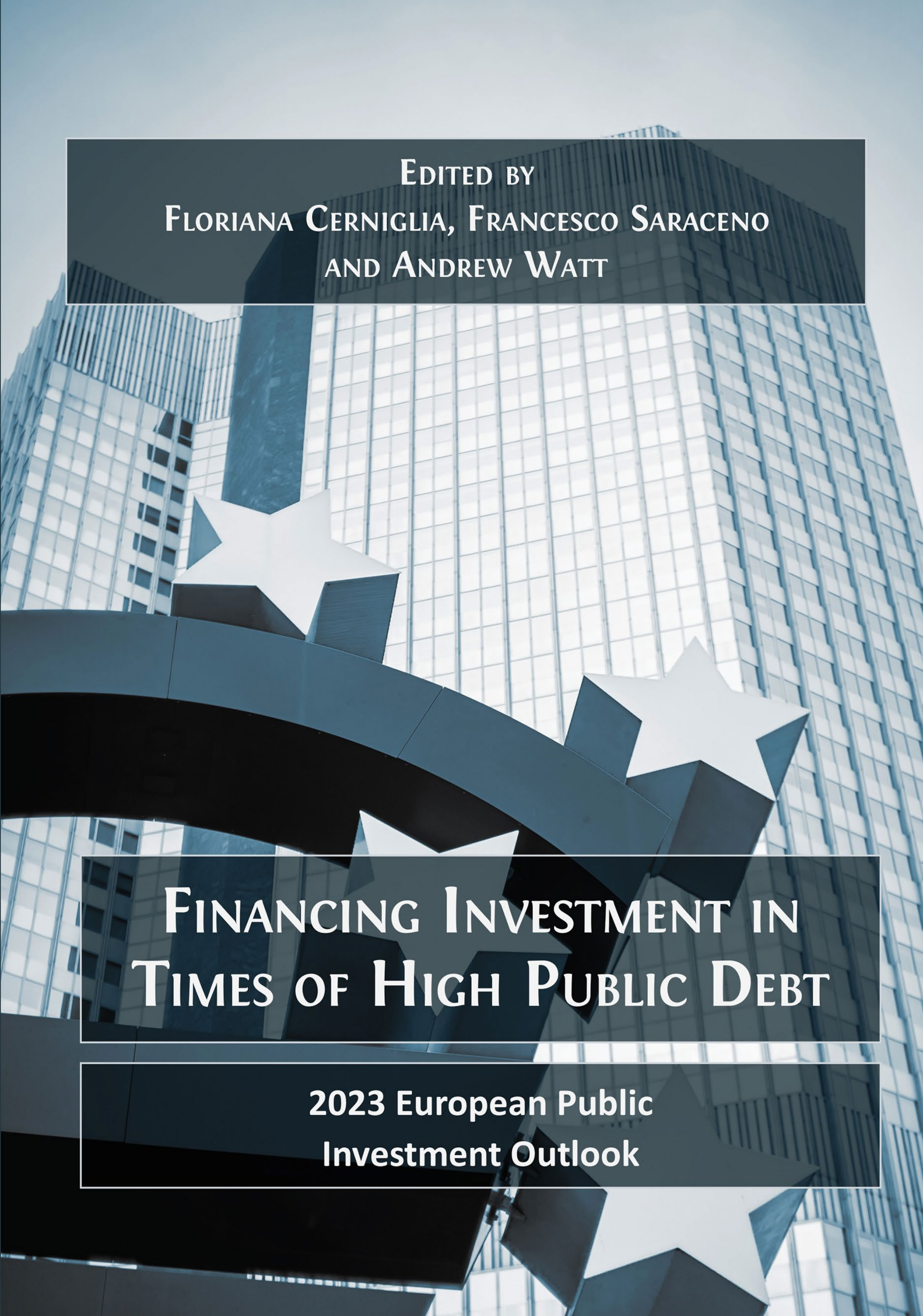

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Financing Investment in Times of High Public Debt

2023 European Public Investment Outlook

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Introduction

Floriana Cerniglia, Francesco Saraceno and Andrew Watt

When the first *European Public Investment Outlook* (Cerniglia and Saraceno 2020) was published, in the summer of 2020, the world economy was in the middle of an unprecedented health and ensuing economic crisis. The policy response to the crisis was bold in all EU countries and involved a significant fiscal effort. Central banks accommodated this effort, in EU countries as well as in the USA, with massive purchases of bonds: the EU's 1.8-trillion-euro Pandemic Emergency Purchase Programme (PEPP) ran from 2020 to the spring of 2022. This allowed interest rates to be kept low and shielded EU governments from possible market pressures in the face of a large increase in public debt (see Figure 0.1).

The macroeconomic environment changed drastically in the Summer of 2021, not only with respect to the pandemic, but also with respect to the previous decade. The economy rebounded virtually everywhere, and the disarticulation of the supply side led to inflationary pressures, most notably in the energy and food sectors. This pressure was later compounded by geopolitical tensions and by the invasion of Ukraine. As inflation picked up, the attitude of central banks changed, and the policy stance turned restrictive. Both the US Federal Reserve and the ECB engaged in a long series of rate increases (the end of which is not yet certain at the time of writing in November 2023) and started shrinking their balance sheets. In this new macroeconomic environment — as sovereign interest rates increase, while economic growth slows and the risk of an economic downturn increases — the issue of public-debt sustainability has come to the fore.

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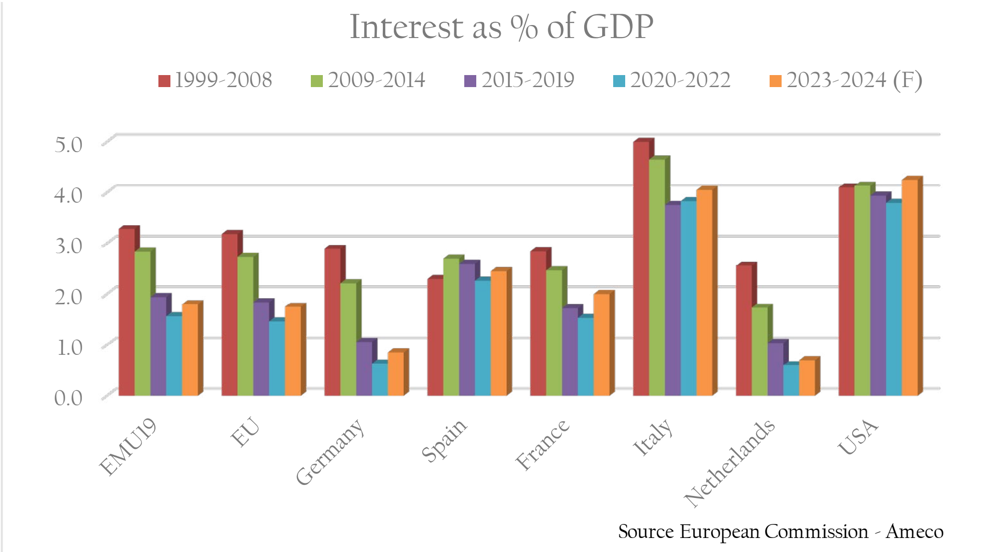

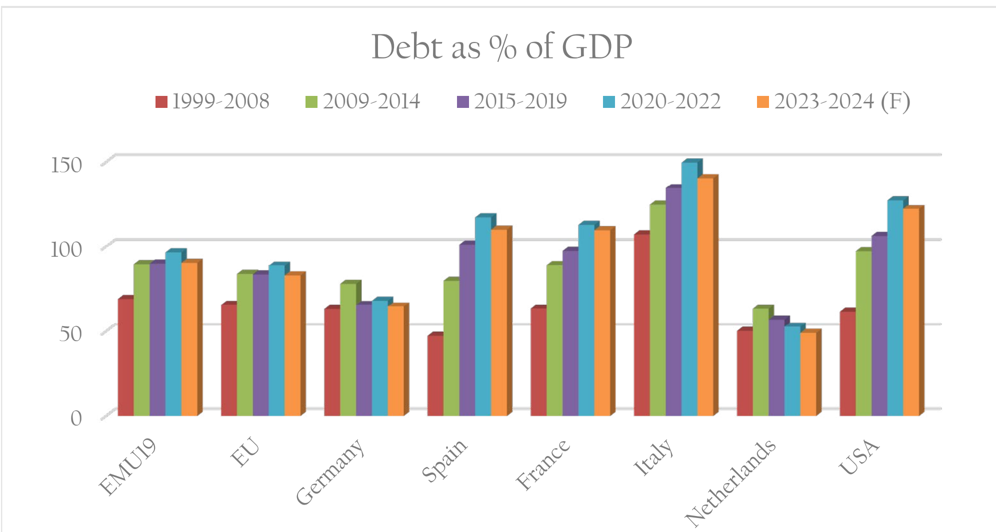

Fig. 0.1 Government Interest Payment and Debt.
Source: European Commission–Ameco.

In the meantime, the legacy of the many crises of the past fifteen years is one of a renewed attention to the role of government. The 'New Consensus' paradigm (Saraceno 2022a) that had dominated since the 1980s was challenged by the Global Financial Crisis of 2007–2009, prompting a wide-ranging process of 'Rethinking macroeconomics' (to cite the title of a series of conferences held at the IMF in the early 2010s and organised by the then Chief economist Olivier Blanchard; see, for example, Blanchard 2016). This process of rethinking is still in progress, and it is quite unclear what will emerge as a new consensus in economics, if one will emerge at all. Nevertheless, whatever the result of the current debate will be, it is highly unlikely that we will return to the pre-2008 consensus of a limited role for public policies in regulating and shaping the economy. The multiple crises that hit the world economy in the past fifteen years were due to a mix of endogenous (the financial crisis), self-inflicted and policy-induced (the sovereign-debt crisis), and exogenous (the pandemic) causes. All highlighted the need for a renewed role of the government in the economy and for a reassessment of the policy mix. Whether that mix calls for a classic Keynesian business-cycle stabilization, as in 2008, for public investment and industrial policies to favour and steer the ecological and digital transitions, for the provision of global public goods such as health and education, or for a coordinated approach by fiscal and monetary policies to fight inflation (or, indeed, secular stagnation) is secondary: few economists today would argue, as many would have done before 2008, that we should constrain public policies and let markets tackle the contingent and structural challenges that our societies repeatedly confront. Thus, advanced economies face a dilemma: how to reconcile the now widely accepted need to finance the public policies that are necessary to manage an increasingly complex environment in which structural, contingent, and geopolitical factors are inextricably linked, with the objective of public-debt sustainability?

After the pandemic, it seemed that policy makers in most European countries had decided on a clear priority in this dilemma: rethink fiscal policies to guarantee the fiscal space necessary to pursue all the pressing policy objectives, while guaranteeing the sustainability of public finances. In other words, sustainability was a constraint on the objective of granting policy-makers the tools to implement proactive policies. The return of inflation in 2021–2022, though, marked a partial revival of the pre-2008 emphasis on limiting the role of government. This was reflected in the return of long-discredited monetarist ideas (Saraceno 2023) but has also resulted in a shift of focus in the debate on policy and sustainability. At least in Europe, against the background of higher interest rates, the main preoccupation in many policy quarters is returning to the question of how to curb public debt. Sustainability, instead of being a constraint in the attempt to create fiscal space, has returned to being the main objective of policy-makers.

This shift of narrative and of priorities can be seen clearly in the discussion on the reform of EU fiscal rules. In November 2022, the European Commission (2022) issued a Communication on the reform of the Stability Pact. This centred around a medium-term perspective in assessing sustainability and on setting out country-specific trajectories that granted some policy space while ensuring that the policies implemented would not threaten sustainable public finances. Most notably, it enabled Member States to argue for fiscal space for specific public investment projects that could convincingly show a positive longer-run impact on debt-servicing capacity. In the few months that passed between the Communication and the actual proposal, that was put on the table in April 2023 (European Commission 2023), the approach changed substantially. Curbing debt was reinstated as a primary objective of the fiscal rules: the amendment to the old Stability Pact originally proposed by the Commission was meant to avoid excessively curbing governments and to limit, at least to some extent, pro-cyclical fiscal policies. The issue of creating the fiscal space, which the current Stability Pact does not provide for, has been downgraded in the latest proposal and is now ancillary with respect to the debt-reduction objective.

This is the background against which this *European Public Investment Outlook*, the fourth of a series, tackles the issue of financing public expenditure and, particularly, public investment in European countries. The authors who contributed to this *Outlook* may differ somewhat on aspects of fiscal policy and on the fiscal rules that the EU should adopt to replace the Stability Pact. Yet, they all share the conviction that, in the coming years, public investment should be not only protected but expanded and deployed, together with other instruments, to facilitate and steer the ecological and digital transition. We hope that this volume of the *European Public Investment Outlook* will contribute to rebalancing the debate on sustainability and fiscal space.

Fiscal sustainability can never be overlooked when designing public policies for the simple reason that the effectiveness of such policies would be hampered if they were to lead to the loss of confidence in the government's credibility and to turbulence in sovereign debt markets. This is especially true in a complex institutional environment like the eurozone, which requires member countries to coordinate twenty fiscal policies among themselves and with the common monetary policy. Yet, we believe that the issue of sustainability should not be dramatized in the current situation and that it should not overshadow the more important issue of how to ensure that fiscal space is created to respond to the challenges of the time. There are, in fact, several reasons why we believe that debt reduction is given too much emphasis in current European debate.

First, although monetary tightening and inflation have caused interest rates to go up quite substantially and caused spreads to reopen between sovereign-debt yields, nominal growth has also increased, because of inflation. The fact that current real interest rates are actually lower than before does not mean much going forward (nominal interest rates will likely not decrease much as inflation returns to normal). Nevertheless, most countries took advantage of low rates in the past few years to increase the average maturity of their debt, and interest payments, as a percentage of GDP, are forecast by the Commission to barely move in the short run, even for more problematic countries like Italy (see Figure 0.1 and Chapter 1). In most of the Eurozone, then, the interest bill will remain smaller, as a percentage of GDP, than had been the case in earlier years and also than in the USA.

Second, while the European Central Bank (ECB) is currently focused on its core business of fighting inflation, it is unlikely to revert to its former non-interventionist attitude regarding spreads and sovereign debt-market instability. Since the 'whatever it takes' speech by then-ECB President Mario Draghi in 2012 and the subsequent launch of the Outright Monetary Transactions (OMT) program, the ECB has implicitly targeted spreads, de facto acting as a lender of last resort. In mid-2022, the Transmission Protection Instrument (TPI) was launched explicitly to permit — in principle, unlimited — purchases of bonds from countries experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. Because turbulent times are (unfortunately) bound to continue, it is inconceivable that the ECB will readopt a non-interventionist stance. Of course, this cannot be taken as a green light to embark on irresponsible fiscal policies: first, the OMT comes with heavy conditionality; second, the TPI, with its caveat about country-specific fundamentals, sends the clear message that only countries with sound fiscal policies can be protected. With these instruments, however, Euro-area member states can now count on a Lender of Last Resort, even if this function is more conditional than in countries such as Japan and the USA. With it in place, they are less likely to face speculative attacks and much better equipped to fight them if they do occur.

Last but not least, high interest rates may not be here to stay, as many currently believe. The forces behind the secular downward trend of neutral interest rates (demographics, inequality, high debt and the ensuing increase in the propensity to save, etc.) have been temporarily muted by the sudden inflation burst that began in 2021. When the certainly-persistent-but-still-temporary drivers of inflation subside, there are reasons to believe that secular stagnation and a chronic tendency to excess savings may start to haunt monetary authorities again (Blanchard 2023; Saraceno 2022b). In any case, the restrictive impact on activity of the interest rate hikes already implemented are still feeding through the economy. A slowing economy will constrain the ability of both price- and wage-setters to seek higher nominal incomes, and policy rates will be cut again.

Previous instalments of this series (Cerniglia et al. 2021; Cerniglia and Saraceno 2020, 2022) highlighted the deterioration of the public capital stock of EU countries, even the richer ones. Many of the dozens of authors involved in the chapters of the previous *Outlook*s emphasized the need, in today's world, to steer away from a purely accounting definition of public investment in favour of a notion encompassing both tangible and intangible capital, such as social capital. These themes emerge in the current *Outlook* as well, in chapters written by academics, policy makers, economists at think tanks and at international organisations, and practitioners. This installment has a specific focus on the issue of financing. Unfortunately, the currently predominant sentiment of EU policy-makers on debt and interest rates is quite unaligned with our assessment: it is likely that debt-reduction will remain one of their primary preoccupations in the near future. How to finance public policies, most notably investment, in an environment of tight budget-constraints, therefore, will be central in the next few years. This question is addressed in the chapters of the first part of this *Outlook* that take into account selected countries' particular challenges and options. The chapters of the second part, taken together, evoke multiple sources of financing of public investment, including the mobilizing of national public resources but also public investment banks, European agencies, monetary policies, financial markets, the EU budget, and so on. It is vital that the European policy and institutional framework both permit and encourage national-level public investment and make adequate provisions for financing European public goods at EU level. Decisive for the former is an investment-friendly reform of the fiscal rules. At the European level, a robust, substantial, and permanent investment facility is needed in view of the urgent challenges relating to decarbonization and of the imminent end to the Next Generation EU's Recovery and Resilience Facility (RRF; Watt 2022).

Financing Investment in Times of High Public Debt, like its predecessors, is divided in two parts. Part I offers an analysis of the state of the art of public investment in Europe (Chapter 1) followed by individual country reports on the European Union's four largest economies: France in Chapter 2, Germany in Chapter 3, Italy in Chapter 4, and Spain in Chapter 5. These chapters share a common focus on comprehending the scope for maintaining and expanding public investment in the coming years while considering the difficulty of financing it at a time when debt-to-GDP ratios are increasing in some countries due to higher interest rates and low growth, and, in some cases, the foreseeable end of finance through the RRF. As in the preceding *Outlook* reports, the country-specific chapters, when relevant, update the information presented in earlier instalments. Additionally, some chapters discuss impact and policy responses related to the economic-recovery plans deployed to address challenges stemming from the COVID-19 pandemic and further compounded by geopolitical tensions, low growth, high inflation, and high interest rates.

Chapter 1, by A. Brasili, A. Kolev, D. Revoltella, J. Schanz, and A. Tueske, assesses the role of public investment within the EU's response to both short-term and long-term challenges such as managing inflation, ensuring financial stability, effecting fiscal consolidation, coping with energy- and food-price shocks, and transitioning towards climate neutrality while maintaining energy security. It provides a comprehensive depiction of the dynamics of public investment in Europe in 2022, encompassing planned investment for the current fiscal year and the ongoing implementation efforts of the RRF along with the associated emerging challenges and hurdles. The analysis draws on data from a multitude of sources, including Eurostat, the *Stability and Convergence Programmes* of Member States, the implementation progress of the RRF, and data from the TED-procurement database.[1]

In Chapter 2, M. Plane and F. Saraceno provide a historical overview and describe the different phases, from the 1940s until today, of public investment in France. An assessment is made of the pace of public-capital accumulation since the COVID-19 pandemic (it is increasing slowly). Two main findings emerge from an analysis of stocks

1 TED (Tenders Electronic Daily) is the online version of the 'Supplement to the Official Journal of the EU', dedicated to European public procurement.

and flows: first, public investment and the stock of capital have been largely affected by the macroeconomic cycle; second, the capital stock is still significant (and larger than in other countries). General government net wealth remains positive, although it has decreased significantly since 2008. A large gap exists between the central government and local authorities in terms of savings and investment financing. The authors also discuss how public investment is financed in France and whether the current level of public debt is sustainable.

Chapter 3, by K. Rietzler, A. Watt, and E. Juergens, assesses public investment in Germany. After more than a decade of weak public investment, Germany has accumulated a significant backlog. The additional public investment required over the next decade is estimated to be in the range of €600–800bn, equivalent to 1.6–2.1% of GDP. The current fiscal situation had appeared as relatively favourable from a financing perspective. However the ruling by the constitutional court, just as the publication was going to press, that government plans to finance investment through borrowing, evading the debt brake, are unconstitutional has cast this into serious doubt. There is a serious risk that policy, far from expanding investment, will begin to tighten as early as 2024. Germany lacks the political will to remedy the situation which the debt brake and the court ruling have created and provide the needed boost in public investment, whether through higher borrowing or by raising taxes.

Chapter 4, by G. Barbieri, F. Cerniglia, and E. Dia, provides the country report on Italy with an analysis of the role of the Italian National Recovery and Resilience Plan (NRRP) in boosting public investment up to and beyond 2026. Italy's NRRP, with more than €235bn available for investments and reforms makes it one of the most remarkable modernization initiatives in the last seventy years. The impact of the NRRP is assessed and specific implementation challenges are highlighted, some of which have been caused by factors such as fragmented governance, a lack of effective monitoring, and compliance issues. Overcoming these difficulties is crucial for continuing to receive disbursements from the Commission. The effectiveness of its governance is also examined. Moreover, the authors note that the question remains of how to ensure a positive capital spending trajectory (especially after 2026) in compliance with the new rules set out in the Stability and Growth Pact; only by increasing public investment can the debt-to-GDP ratio decrease at a faster pace.

Chapter 5, by F. Pérez and E. Benages, looks into public investment, the deficit and public debt in Spain from 1995 to 2022. Spain's public investment during that time has had a very erratic trajectory, with some years seeing large capital accumulation and others with negative net investment The sustainability of the pace of investment has been challenged by expenditure policies that are procyclical rather than having a stabilizing effect.

These and other lessons learned should be incorporated into the revision of the EU's economic governance framework to improve the compatibility between the fiscal rules and the increased investment envisaged by the Recovery and Resilience Facility.

Part II of the *2023 European Public Investment Outlook* covers several themes that together address the European Union's available policy options and the toolkit of resources and instruments at its disposal to raise its game as regards public investment. EU policies and investment financing are analysed from the perspective of fragmentation and secular stagnation (Chapter 6), tools to help foster stability, like national promotional banks (Chapter 7), upgrading EU public goods by also introducing a permanent central fiscal capacity (Chapter 11), and options for a permanent EU sovereign fund (Chapter 12). Three chapters have a green focus, acting as natural bridges to the 2022 instalment of *The European Public Investment Outlook — Greening Europe*. These chapters focus on including green public expenditures in the EU budget and fiscal framework (Chapter 8), the role of monetary and financial policies in financing climate investments in the EU (Chapter 9), and a set of measures to deal with the crisis of climate change and restore fiscal progressivity (Chapter 10).

In Chapter 6, P. C. Padoan makes the case that the EU has been impacted by multiple crises due to economic and geopolitical factors. The crises have left scarring effects and may lead to fragmentation with serious and permanent consequences. The author analyses the EU's primary response strategy: Next Generation EU and the associated Recovery and Resilience Facility. This recovery instrument, based on public investment and structural reforms, can be an effective policy tool, provided it combines public investment and structural reforms and allows for adequate time to complete the reform cycle. Its efficacy must be evaluated in the context of a new policy mix designed to solve the multiple crises plaguing the EU's institutional structure.

The role of National Promotional Banks and Institutions (NPBIs) is addressed in Chapter 7, by L. Zylberberg, who specifically studies their impact within the EU context. NPBIs experienced a paradigm shift with the great financial crisis of 2008–2009, which was further reinforced by the COVID-19 pandemic and the Ukraine crisis. The Juncker Plan shed light on the existing investment gaps across Europe and demonstrated that a dynamic European policy was possible. Thanks to the InvestEU programme, European actors such as the EIB Group or national actors via NPBIs and Financial Institutions have thrived in their specific role of fostering essential long-term investments. The author underlines the necessity of developing practical accounting rules that integrate both positive and negative externalities.

A. Pekanov and M. Schratzenstaller, in Chapter 8, discuss two paths to foster increased green public investment in the EU: through possible amendments to the current EU fiscal framework and through funding from the EU budget. Since the Commission's proposal (November 2022) regarding orientations for a reform of the

EU governance framework widens the leeway for debt-financed public investment but does not sufficiently consider existing green public investment needs, several options are considered to ensure a level of green public investment which—together with private resources—could close the existing gaps in green investment. To this end, the EU budget needs to be reoriented towards measures that are effective in achieving decarbonisation and which cannot sensibly be performed at national level, such as the Connecting Europe Facility.

Chapter 9, by Y. Dafermos and M. Nikolaidi, delves into the unprecedented transformation of the EU fiscal, industrial, trade, and regulatory policy frameworks that are necessary to address the climate crisis. The authors advocate that this transformation requires the alignment of EU monetary and financial policies with environmentally sustainable practices. A set of tools are presented that central banks, financial regulators, and financial supervisors can employ to advance the EU decarbonisation and climate-resilience targets.

Fiscal reform is the focus of Chapter 10, by D. Guzzardi, E. Palagi, T. Faccio, and A. Roventini, who probe how to formulate an adequate policy response to restore fiscal progressivity, which is seen as fundamental in addressing the current climate challenge. They advocate closing the tax-rate gaps between income levels to ensure that the green transition, which demands significant financial resources, occurs in a more equitable manner. The authors thus propose a mix of EU fiscal policies, from which the resulting additional resources can be used to promote climate mitigation and adaptation policies. This approach will lower inequality and help move EU economies toward inclusive and sustainable growth.

The importance of including European Public Goods (EPGs) in the ongoing debate on EU reforms is emphasized in Chapter 11, written by M. Buti, A. Coloccia, and M. Messori. They argue that EPGs are a promising step toward a more effective economic union, which needs a permanent fiscal capacity. The discussion of EPGs, they believe, should take into account a number of factors, including the convergence of economic, institutional, and political coherence on the green, digital, and social transition. It should also address the supply of critical raw materials, health, security, and defence.

Another tool that can be used to address the climate challenge and promote economic stability is proposed in Chapter 12. P. Heimberger and A. Lichtenberger argue in favour of a new, permanent EU fiscal capacity using the Recovery and Resilience Fund (RRF) as an operational blueprint. They suggest that, overall, the current tools available to the EU as well as the new ones proposed fall short of providing a realistic vision of financing the required public investment.

Overall, the contributions in *Financing Investment in Times of High Public Debt* focus, from different angles, on the urgent need for a coherent EU framework and fiscal capacity that better facilitates the huge investment needed to ensure macroeconomic growth while addressing the implementation challenges of the green transition. The EU has been slow to establish an appropriate response through its frameworks and existing tool kit and offer only piecemeal solutions. Once again, 'political' reticence toward greater joint-public investment is a theme running through this *Outlook*, bringing to the fore the need for more resources to finance public investments as well as governance reforms that are necessary to make progress.

We hope that *Financing Investment in Times of High Public Debt*, like its previous instalments, will continue to serve as a contribution to the ongoing public policy debate, a discourse that, as clearly stated in all the volume's chapters, is destined to continue to play a pivotal role beyond the end of *Next Generation EU*, in 2026.

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