

# STABILIZING DEBT IN ADVANCED ECONOMIES

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Countries must shift toward fiscal discipline and reforms that raise long-term growth

**M**any highly indebted advanced economies face a grim fiscal outlook. Under current policies, the public debt ratios of countries including Belgium, France, the United Kingdom, and the United States are set to deteriorate over the next two decades. They still have room to borrow, but there are limits.

So far, financial markets have been forgiving. But recent tremors suggest that they may become more sensitive to negative news about the fiscal or economic outlook. They may demand higher interest rates even from countries with highly liquid government bond markets, making the job of reducing debt that much harder.

AI-driven productivity growth may slow the increase in debt ratios and reduce the needed adjustment. But the magnitude and timing of this effect are unclear. Population aging and growth declines linked to trade fragmentation and political uncertainty pull in the opposite direction.

What will it take to stabilize debt ratios? In a recent paper with Gonzalo Huertas and Lennard Welslau, we assessed the fiscal adjustment needed in EU countries, the UK, and the US. Using official growth forecasts and market-based projections for

interest rates, exchange rates, and inflation, combined with simulated shocks, we generated probability distributions for future debt ratios under different scenarios for the primary balance, which excludes interest payments on the debt.

We considered a 20-year horizon starting in 2024 and divided it into two periods. In the first, a seven-year period, governments raise the primary balance to a level that ensures debt sustainability. In the following, 13-year, period, governments keep the primary balance constant, excluding spending changes driven by an aging society. We aimed to ensure a 70 percent probability that the fiscal adjustment in the first period was large enough to stabilize the debt ratio over the final five years of the 20-year horizon.

## Mixed findings

On the positive side, the required long-term primary balance does not look dramatically high in many cases. For example, it is 1.3 percent of GDP for France and the US, 1.8 percent for Belgium and the UK, and 2.5 percent for Italy. On the negative side, however, given large deficits in 2024, substantial adjustments are likely to be needed. About a dozen countries require adjustments of more than 3 percent

of GDP; five of those—France, Poland, Romania, the Slovak Republic, and the US—need adjustments of 5 percent relative to 2024.

On paper, almost all EU countries plan adjustments to stabilize the debt ratio. However, several use macroeconomic assumptions that are more optimistic than the EU's common methodology. Germany's plan, for example, assumes higher inflation and growth than expert forecasts. If actual growth and inflation turn out lower, Germany's deficit and debt will end up much higher than it projects.

Moreover, forecasts by the European Commission and the IMF suggest that countries with the biggest adjustment needs are unlikely to deliver the measures needed to stabilize their debt levels. This reinforces doubts about the likelihood of these adjustments.

### Historical precedents

While the US and several other advanced economies are unlikely to make fiscal adjustments needed to stabilize debt in the medium term, they may try later. To see how likely this is, we looked at historical precedents: how often countries achieved the required primary balance, the longest period balance was maintained, and how often they made the needed adjustment within seven years.

Our results show that primary balances at the level needed to stabilize debt in several high-debt advanced economies—and the large adjustments needed to get there from current fiscal positions—are rare. France, for example, would need a primary surplus of 1.3 percent of GDP to stabilize its debt, which has happened only six times in five decades. This does not mean such adjustments are impossible, but history suggests it will be difficult and likely to take longer than the seven years EU fiscal rules envisage.

Policymakers in these economies can take heart from the transformation of what were once considered the euro area's weakest links. In 2024, Greece posted a primary balance of 4.0 percent, adjusted for swings in the business cycle—well above what is needed to stabilize debt. Portugal needs only a minor adjustment of 0.5 percent of GDP; Ireland's required adjustment of 1.9 percent is modest, and the country's debt ratio is exceptionally low, at 39 percent of GDP, far below 122 percent in the US and the UK's 101 percent.

How did countries that faced severe fiscal crises 15 years ago become examples of discipline today? After the 2008 global financial crisis, financial markets drove them to the edge of collapse, forcing them to accept EU/IMF lending programs. Despite design flaws, these programs' essential fiscal tightening and structural reforms put their economies back on track for sustainable growth. The

adjustment was painful and, in the case of Greece, very long-lasting, but it was eventually effective.

The results speak for themselves. With average annual growth between 3.1 percent and 4.2 percent in 2022–25, all three countries exceeded the US pace of 2.6 percent.

The lesson: Fiscal discipline and structural reforms—along with public and private debt restructuring when debt is unsustainable—pay off eventually. Not surprisingly, these reforms and restructurings did not stem from domestic political momentum but were forced on them by market pressure.

### Recognize the risks

The question is, How will countries adjust this time? We see several possibilities.

The best outcome would combine growth-enhancing reform—including by implementing the Draghi report's single-market agenda in the EU—with deep reforms to social security and pension systems. It could also include overhaul of tax systems to raise revenue without discouraging growth. The latter is particularly true for the US—the only Organisation for Economic Co-operation and Development country without a value-added tax.

Unfortunately, this outcome is also politically the most difficult. A more likely path to fiscal consolidation involves a shift in domestic political leadership that prioritize fiscal discipline but not necessarily deep reform. Italy offers an example. Scarred by near disaster in the early 2010s, Italian governments across the political spectrum have kept budgets broadly under control. Italy's debt ratio of roughly 135 percent of GDP is still high, but its cyclically adjusted primary balance of 0.3 percent of GDP looks far healthier than those of Belgium, France, or the UK.

A hard-landing scenario could be triggered by a sudden spike in borrowing costs, leading to debt distress. As debt rises, interest rates could also climb, and markets might become more sensitive to news that calls fiscal sustainability into question. Governments might attempt forms of financial repression—for example, encouraging domestic banks or institutions to absorb additional government debt—but such measures have limits. Surprise inflation could temporarily ease fiscal pressures, but persistently higher inflation would eventually drive up nominal interest rates.

Let's hope that policymakers recognize these risks and act early enough to prevent such an outcome. **F&D**

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