

PRESSURES ON PUBLIC FINANCES IN ADVANCED COUNTRIES ARE MOUNTING, BUT REMAIN MANAGEABLE

Public finances in advanced economies¹ are facing a combination of pressures. The structural rise in interest rates is already complicating the situation, but its effects are not yet being fully felt. When they do (at the end of the decade), most countries will need to generate primary surpluses in order to stabilise their debt ratios. At the same time, governments must fund age-related spending, defence and climate change mitigation. In this climate, higher growth would help to stabilise public debt-to-GDP ratios, and vice versa.

THE FULL EFFECT OF RISING INTEREST RATES IS STILL ON THE HORIZON

After the 2008 crisis, public finances benefited from a long period of low interest rates. This reduced debt-servicing costs, thereby facilitating adjustments or limiting the deterioration of deficits.

The situation has changed, and probably for the long term. Since early 2022, public finances have been subject to rising interest rates. Inflation initially counteracted this effect by keeping real interest rates low. Now that inflation has fallen, real interest rates have begun to rebound. Nevertheless, the relatively long average maturity of public debt is keeping the apparent interest rate on debt well below the market interest rate.

There is a divergence between two groups of countries:

- In the euro area, inflation is already moderate, but the long average maturity of debt is delaying the full transmission of higher market rates to the apparent cost of debt.
- In the United Kingdom, Japan and the United States, inflation remains significant (reaching or exceeding 3%) and is continuing to drive down the real interest rate.

In all cases (high maturity or high inflation), public finances retain some room for manoeuvre because the real apparent interest rate (r) remains below real GDP growth (g). However, over time, r tends to converge towards g . The larger the r - g gap, the larger the primary surplus required to stabilise public debt relative to GDP (and, a fortiori, to lower the ratio). This may even require generating primary surpluses to stabilise debt (see our analysis).

¹ United States, Germany, France, Italy, Spain, United Kingdom and Japan studied here.

According to our calculations (see analysis), Italy is already in this situation, due to historically higher interest rates (but is already capable of generating the necessary primary surpluses). The convergence of r towards g is quite advanced in the United States, where the average maturity of debt is relatively short (6 years, see analysis). Thus, the apparent interest rate already largely reflects the rise in market interest rates.

For other countries, r should catch up with g by the end of the decade. Germany and Japan, which are the countries that have experienced negative rates the most, will not see that convergence until the next decade.

PUBLIC SPENDING IS UNDER INCREASING PRESSURE

Three types of pressure are common to all of the countries considered, albeit to varying degrees: the debt burden, population ageing and defence spending. The IMF has estimated the additional public spending that these factors would require in Europe by 2050. However, part of this additional cost appears to be already weighing on public finances.

The interestservice burden is already being affected by rising interest rates. This is an expense which when it rises intensifies the effort needed on all other spending in order to keep the publicdebttoGDP ratio stable.

At the same time, population ageing also puts upward pressure on public expenditure, especially on the two main socialspending items, health and pensions, which already account for a large share of the budget.

GAP BETWEEN APPARENT NOMINAL INTEREST RATE AND NOMINAL GDP GROWTH (R-G)

1.a: r - g projected to converge to zero by the end of the decade

Eurozone

Other countries

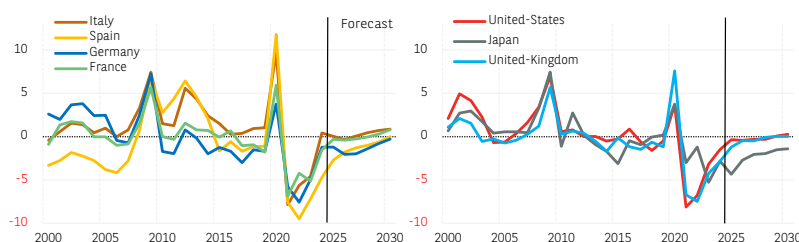
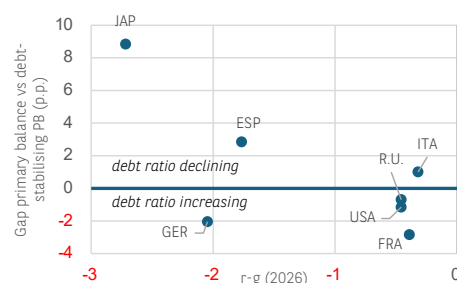


CHART 1

1.b.: In 2026, many countries would still run deficits large enough to prevent debt to GDP stabilisation



SOURCE: IMF, BNP PARIBAS FORECASTS



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The US Congressional Budget Office (CBO) estimates that the combined share of health and pensions will rise from 8.3% of GDP in 2024 to 11.2% in 2050 in the US. In Japan, the IMF projects a combined 23% share by 2040.

In terms of pensions, the impact of ageing on public finances depends on the ratio between those who pay contributions (the working population) and those who receive benefits (pensioners). Although this ratio varies from one country to another, it has fallen dramatically everywhere and is already well below 2 in most economies (Japan, Italy, Germany and France included), and current and projected demographic trends indicate a continued deterioration.

In order to limit the impact of ageing on social spending, several countries have undertaken reforms to raise the statutory retirement age. In addition, measures to promote combined employment and retirement have recently been announced in Germany. Policies to raise labour-force participation are also expanding, with some targeting young people (apprenticeships and vocational training), but most aimed at older workers. The Netherlands is a particularly good example of this trend, with an employment rate of nearly 75% among 55–64-year-olds.

According to our estimates, if France were to raise the 55–64 employment rate by four percentage points (to the EU average), it could generate an additional EUR 25 billion (0.8% of GDP) for its public finances each year. This result would come from both an increase in revenue (social security contributions, VAT and income tax, as working people have higher consumption and income than pensioners) and a reduction in expenditure (lower pension outlays).

The size of social spending also reflects policy choices, not only demographics. These choices relate both to the level of benefits (in France, for example, the average level of pensions is comparable to the average wage, whereas it is lower in other countries) and to their developments (in particular, the level of indexation to inflation during the inflationary crisis, which is above 100% in France, but often lower in other countries).

RE-ARMAMENT EFFORTS WILL ALSO EXERT INCREASING PRESSURE

The United States already spends 3.5 % of GDP on defence and is likely to maintain that level, with NATO members expected to converge toward the same norm. The European Union has pledged to reach this target by the end of the decade, compared to an average of around 1.9% of GDP in 2024. The United Kingdom has also started to increase its spending, but budgetary constraints mean that the increase is likely to remain gradual (around 0.1 percentage points per year to reach 2.6% of GDP in 2027). Japan has significantly increased its budget to bring it closer to the minimum level required by NATO (2% in 2025, compared to almost half that amount until 2022). The stakes are high for all countries, as this constraint weighs heavily alongside those mentioned above.

In Europe, the plans announced in spring 2025 are generally progressing on time and within the defined budgets ([see our analysis](#)). According to our estimates, defence spending will reach 2.8% of GDP in 2027. However, the burden will not be evenly distributed. Most of the increase is expected from Germany, which, thanks to a temporary suspension of EU deficit rules and a specific exemption to its debt brake rule, and given the country's low public debt ratio, can afford a higher defence outlay. By contrast, Spain is only expected to increase its spending to around 2% of GDP.

SOCIAL SPENDINGS, % OF GDP

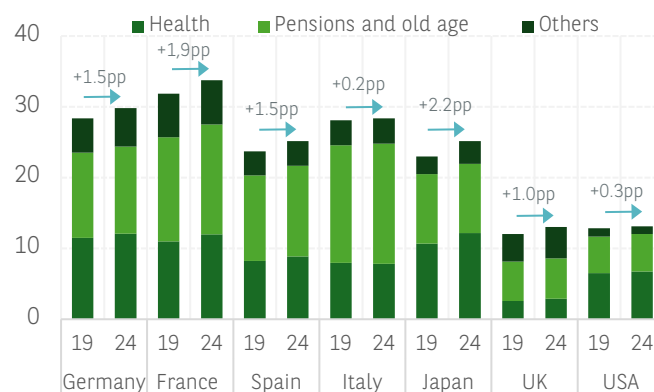


CHART 2

SOURCE: EUROSTAT, NIPSSR, CBO, BNP PARIBAS

Furthermore, the effort will remain gradual, particularly in countries where high public deficits are reducing fiscal room for manoeuvre. For France, the EUR 6.7 billion increase in the defence budget announced in the 2026 Finance Bill translates into roughly +0.2 percentage points of GDP in additional defence spending. This increase is expected to continue until the end of the decade, reaching nearly 3% of GDP in 2030.

MORE GROWTH COULD HELP TO FIND SOLUTIONS, BUT LESS GROWTH COULD COMPLICATE MATTERS

In a recent analysis ([see details](#)), we have showed that the debt ratio is expected to continue to decline by the end of the decade in Japan, Italy and Spain, albeit from a high level. In the United States, France and the United Kingdom, the increase is expected to continue, while Germany is expected to see a turnaround. However, according to our forecasts, the public debt ratio would stabilise by the end of the decade in most of these countries, thanks to fiscal consolidation efforts. The United States would notably have a primary budget balance still well below the level required to stabilise the public debt-to-GDP ratio by 2030.

Nonetheless, the success of these consolidation paths depends on three parameters that are subject to considerable uncertainty: GDP growth, the pace of fiscal consolidation and interest-rate levels. However, these factors interact with each other.

We believe that the risks to growth are balanced and that the probability of them occurring is significant. If a negative shock were to occur, it would lead to a more erratic growth trajectory than in a naturally smooth scenario, which would cause a pause in consolidation and further compromise the stabilisation of public debt by 2030. This situation would call for a monetary-policy response designed to generate a rebound in growth, which our baseline scenario does not incorporate.

Conversely, our current growthpotential assumptions may underestimate the impact of innovation, especially artificial intelligence (AI). AI is already boosting real growth, directly through investment in technological equipment and software, and indirectly via wealth effects.



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EVOLUTION OF THE PRIMARY BALANCE UNDER ALTERNATIVE GROWTH SCENARIOS

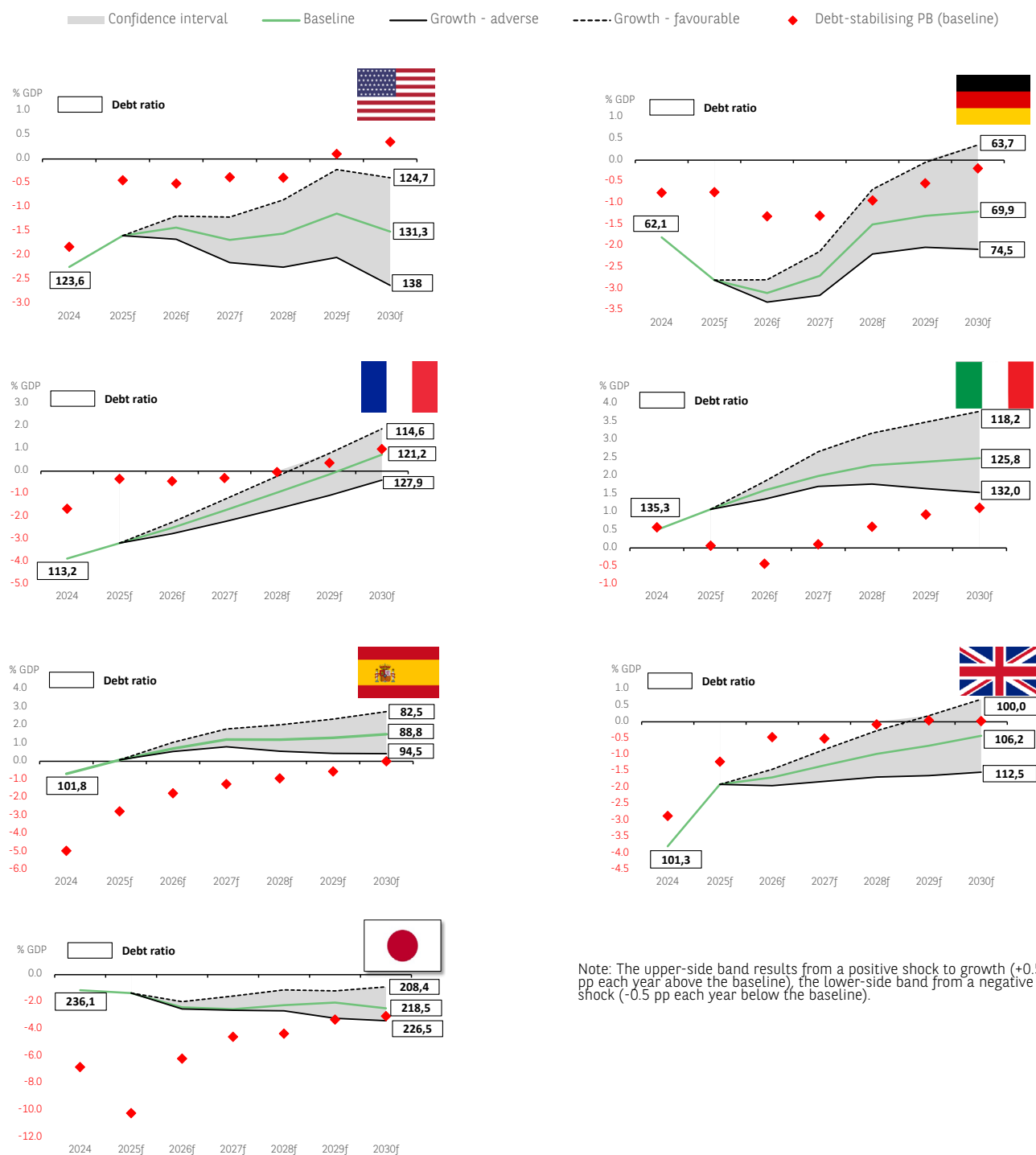


CHART 3

SOURCE: BNP PARIBAS



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Rapid adoption by the rest of the economy - while currently still embryonic - would constitute a bullish scenario for growth, even though the fiscal boost from higher tax revenues could be tempered by AI's relatively low employment intensity. European rearmament efforts are also drivers of growth and productivity gains, as they should support the activity rebound that we are forecasting for the euro area over the next two years and beyond. Investments related to the energy transition and decarbonisation are another growth factor.

Figure 3 assesses the extent of these upside and downside risks to the likely path of fiscal consolidation.

Logically, for countries where the required consolidation effort is already significant (France, the United Kingdom and the United States, notably), repeated negative shocks would permanently push the primary balance away from the threshold needed to stabilise the debt ratio. In Spain, Italy and, to a lesser extent, Japan, the impact of lower growth on the primary deficit would not be sufficient to cause an increase in the public debt ratio.

A positive shock (growth of 0.5 points higher than our current scenario) would enable France and the United Kingdom to achieve a primary deficit that stabilises public debt as early as 2028. In the United States, given the very high level of the budget deficit, such additional growth would not fully stabilise the ratio, but would bring it much closer. In other euro-area countries and Japan, higher growth would help to chart a more favourable public debt trajectory (stabilisation by 2028 in Germany, and a more pronounced reduction in public debt in Italy, Spain and Japan).

ADDITIONAL FISCAL PRESSURES AHEAD

Beyond the items already discussed, public finances will also have to meet new demands, notably the green transition, industrial policy and AI development. The exact fiscal weight of these needs is hard to gauge, as it will depend on national strategies and on how the necessary funding is shared between the public and private sectors. However, the total cost could be significant.

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