

ECB Watchers Conference 2025

# Fiscal Policy Challenges: Implications for ECB Strategy

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# Fundamental Changes in the Environment

- **More Euro Area government debt ahead**
  - large defence investment required
  - green transition, digital transformation, ageing societies
  
- **Euro Area starting position worse than before prior challenges**
  - debt & deficits both higher
  - geopolitical security issues

## Implications for ECB Strategy & Policy

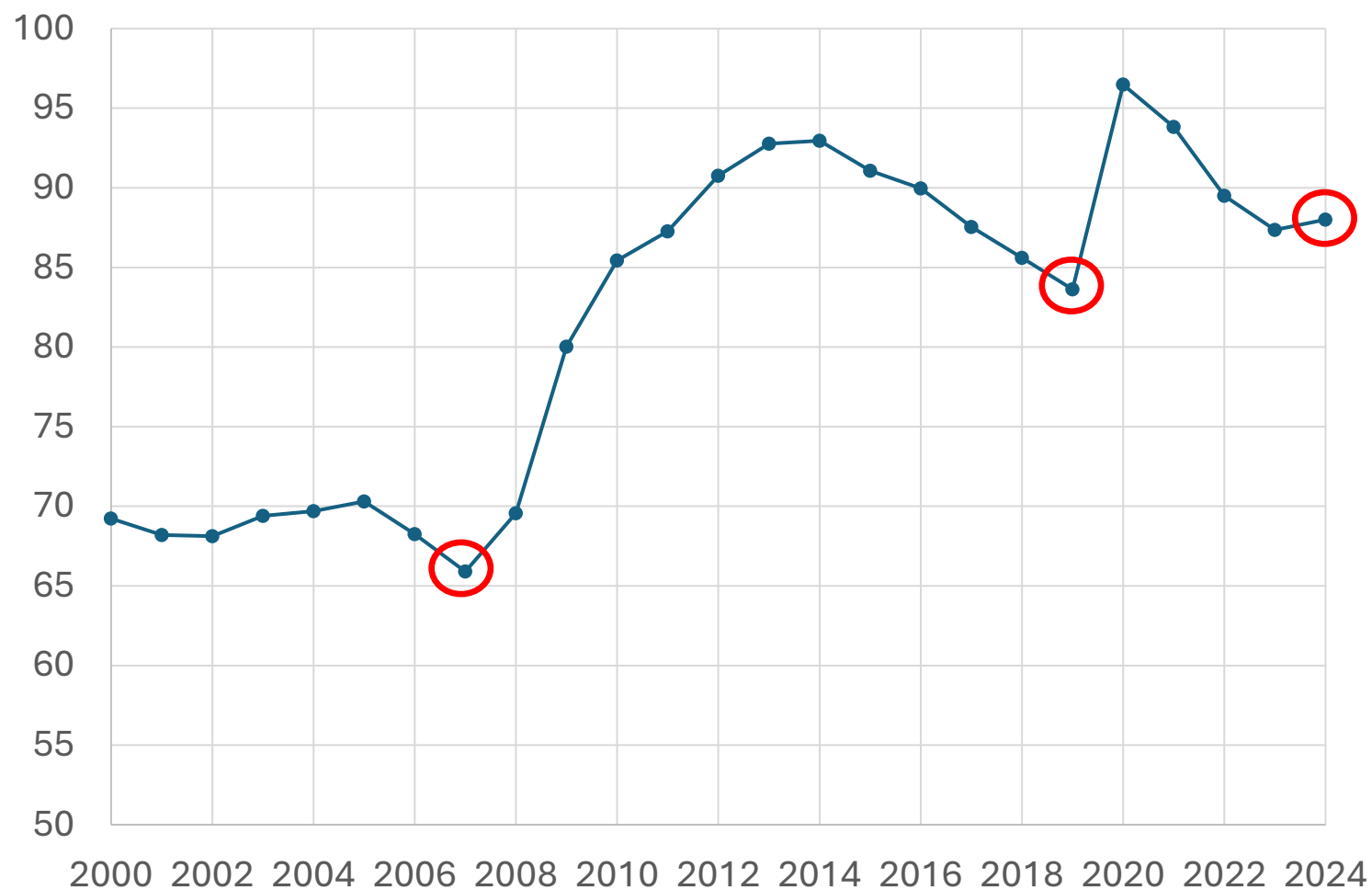
- **Imperative to focus on narrow price stability objective**  
ECB needs to be vigilant about inflation
- **Price stability highly beneficial in times of high debt**  
favorable government financing conditions
- **Price stability & favorable gov. financing conditions complementary**

# Euro Area Relative to Other Currency Areas

- **Euro Area most attractive among the world's biggest currency areas**
  - lower debt & lower deficits
  - more credible & stable institutions
- **With independent defence & return to economic growth**

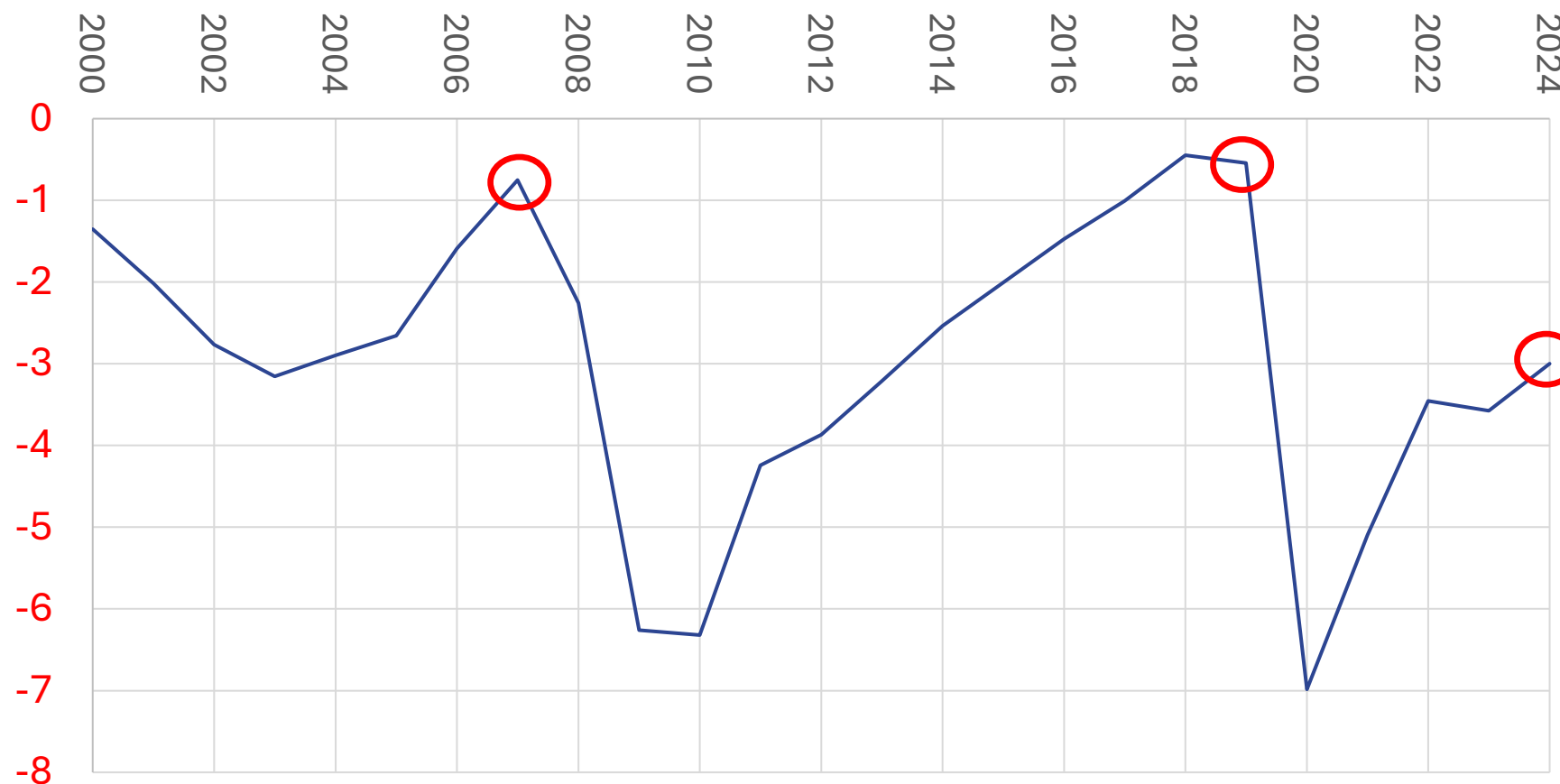
**Euro well positioned to become dominant intl reserve currency**
- **ECB focus on narrow mandate helps dominant reserve status: reduces financing costs further**

# Euro Area Debt-to-GDP Ratio



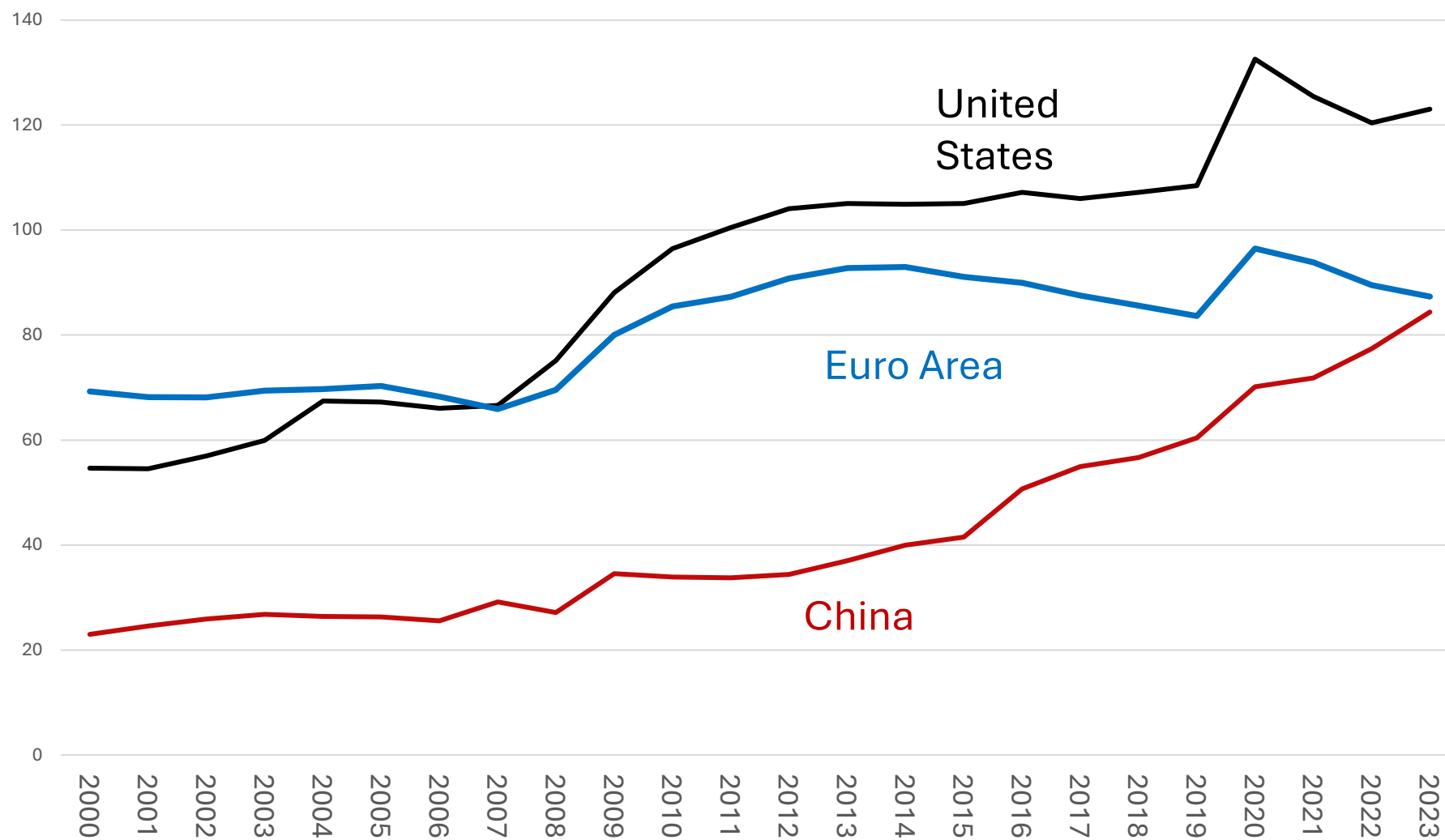
Source: Eurostat, fixed composition over time (Euro Area 20), value for 2024 is an estimate

# Euro Area Deficit-to-GDP Ratio



Source: Eurostat, fixed composition over time (Euro Area 20), value for 2024 is EU Commission estimate from November 2024.

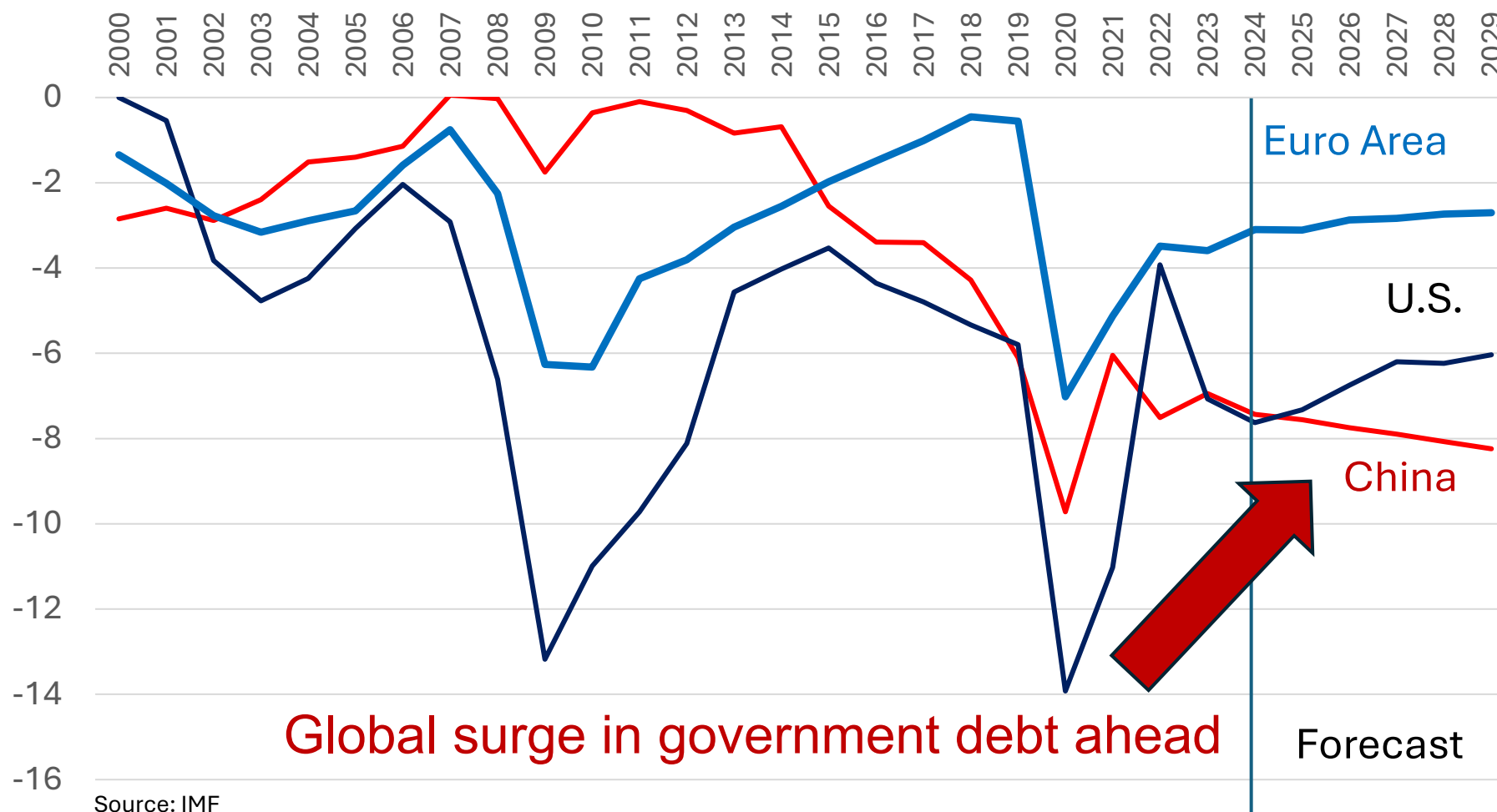
## Debt-to-GDP Ratio: International Comparison



Source: IMF & Eurostat, Euro Area is 20 members fixed composition

# Overall Government Balance: IMF Forecasts

(in % of GDP)



Source: IMF



# Implications of Government Debt Surge

## **(1) Narrow focus on price stability in strategy desirable**

- keeps inflation premia & inflation risk premia low
  - safeguards ECB independence when monetary policy decision have strong fiscal implications due to high debt
  - promotes the Euro as a safe haven and intl reserve currency
- => all contribute to keeping financing conditions favorable!

**Recent German experience shows:**

**inflation premia & inflation risk premia not negligible!**

# Yield of the German 8-Year Nominal Bund

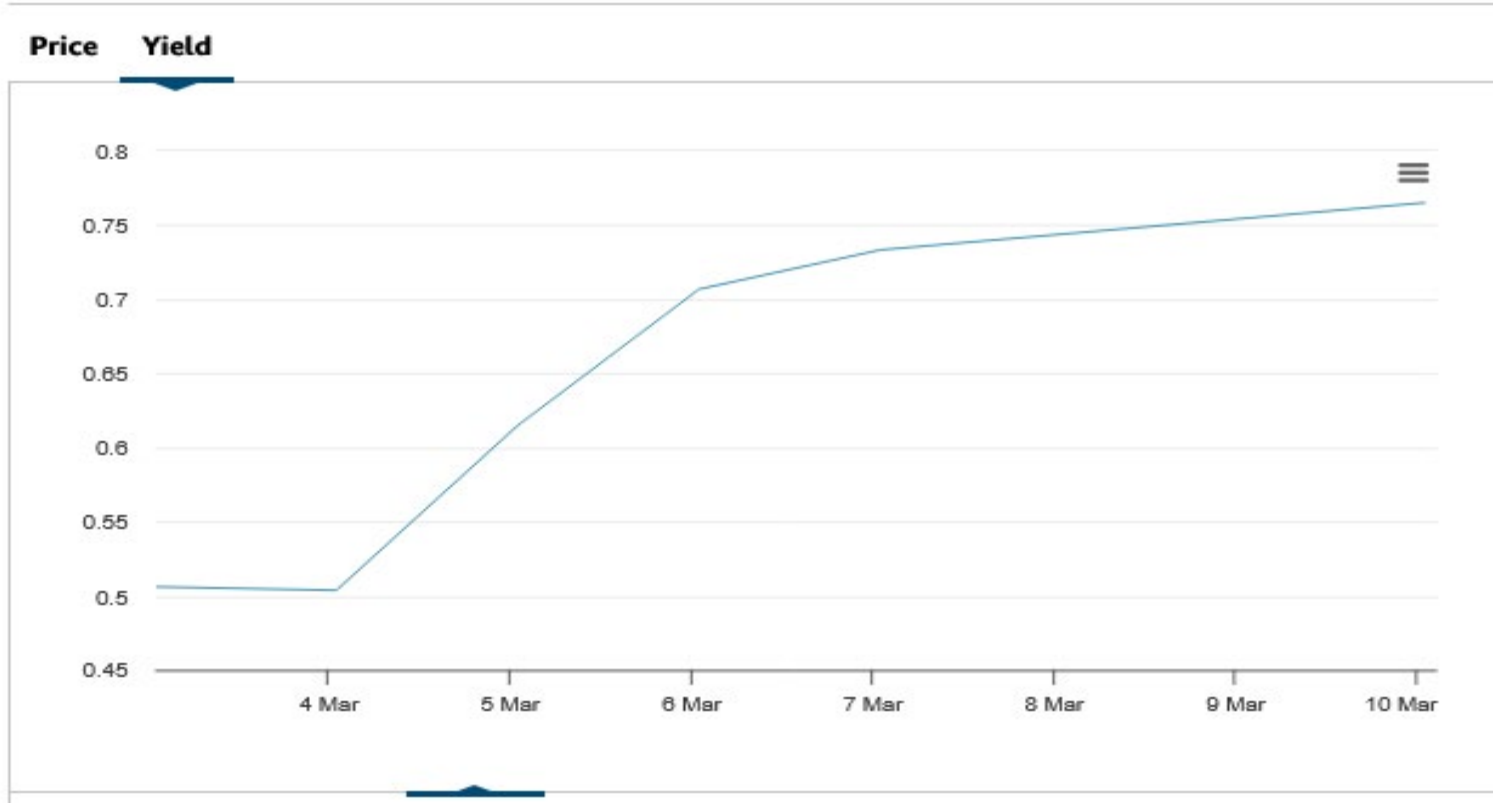


Following last week's news of German spending plans:

2.35% => 2.70% **+ 35 bps**

# German 8-Year Inflation-Indexed Bund

ISIN DE0001030583



Following news of German spending plans:

0.52% => 0.77% **+ 25 bps** => inflation/inflation risk premium **+10bps**

# Implications of Government Debt Surge

## (2) International competition for savings heating up

Long-term real interest rates/natural rates 

Laubach (2009) for United States:

1 pp increase in deficit/GDP ratio: 25 bps

1 pp increase in debt/GDP ratio: 3-4 bps

 need quantification for Euro Area for domestic/global supply

**Long-term rate increase has positive & negative effects:**

- + Eurosystem profitability in the long term
- + lower risk of hitting the lower interest rate bound
- for government finances: **low inflation risk premia of the essence!**

## Conclusions

- **Surge in global government debt ahead**
- **Focus on ECB's primary mandate imperative**
  - keeps inflation risk premia low
  - safeguards CB independence
  - promotes Euro as an international reserve currency
- **Price stability & favourable financing conditions complementary**