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# The Lost Criteria

## A long time ago in a Union far, far away....

Star Wars aficionados will recognize this opening line from the movies. For economists, it currently feels like the Maastricht criteria (or, more officially, EU convergence criteria) are something that happened at another time in another galaxy.

This newsletter focuses on budget deficits globally and revisits the Maastricht criteria to check what the status is and where we go from here.

## Global fiscal policy = global deficits

Over the last 12-18 months, all the leading central banks in the world have tightened monetary policy in order to combat inflation. Official interest rates have risen to levels not seen in decades. Even on the liquidity side, central banks are slowly starting to implement QT (Quantitative Tightening) to curb inflation.

Unfortunately, economic policy coordination between monetary and fiscal policies is sorely lacking at the moment.

During COVID-19, governments around the world increased public spending in order to kick-start economies and keep them going.

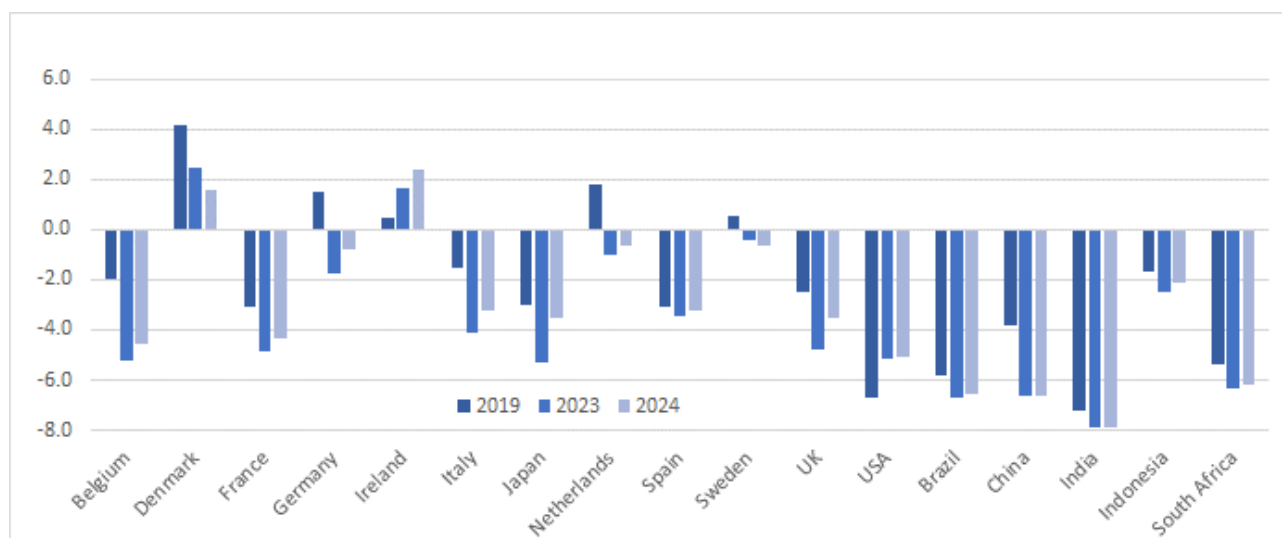
However, the normal lag of fiscal policies impacting the real economy is often 12-18 months and, by the time these policies began to be implemented, the economies had already recovered.

The consequence was, and is, that increased public spending is continuing to raise demand in an economy - running at full capacity - central banks are trying to slow down in order to rein in inflation.

Currently, public spending is replacing private spending, but for how long can this continue?

In June 2023, the OECD published its latest forecast for its member states and other major economies. According to that report, there is no doubt that the public sector will continue to run large deficits in the period forecast.

**Figure 1 OECD June 2023 - General government net lending as a % of GDP**



In this chart, 2019, the last year before COVID-19, is a reference point for the OECD forecasts for 2023 and 2024.

According to the OECD, with the exception of Denmark and Ireland, all EU countries and major OECD economies will run significant deficits in the “general government”, or public, sector.

Even fiscally conservative countries like Germany and the Netherlands are expected to run deficits.

For 2023, the OECD forecasts that Japan, the UK and the US, as well as Brazil, China, India and South Africa, will have net lending of more than 4.5% of GDP.

## Worrying facts of structural deficit in the public sector

Without any of the large economies being in “full” recession, governments are already running significant deficits in public finances, indicating that there are structural deficits in their respective public sectors.

Furthermore, in the US and the EU, it has been decades since unemployment rates were as low as they are currently. Total employment in many countries has

never been higher and yet governments are not running a surplus on public finances.

If the US and EU economies are hit by a real recession in which unemployment rates increase, deficits in many countries could quickly explode to unsustainable levels. Increases in public sector deficits will arise from higher unemployment costs as well as a serious drop in tax revenue.

For many countries, adding to the future public deficit will be additional defence spending that has already been agreed, but not yet implemented. Also, an aging population with increased costs for health care and pensions, as well as a diminishing number of people in the workforce, will inevitably diminish the tax-base.

Lastly, those nations that have incurred large public debts will also have to deal with increased interest payments (that debt can no longer be financed at close to 0%; 3%-5% is more likely).

The structural deficit in the public sector will thus present a serious challenge in the coming years.

## **Maastricht criteria – now a club of one**

During the last five years, the Maastricht criteria have completely disappeared from the economic policy discussion.

There was a reason why the Maastricht criteria for joining the euro were established: to create a currency union based upon sound economic policies.

Why should these sound criteria be abandoned just because they have become inconvenient for policymakers?

Unfortunately, economic policy in the public sector today seems to focus on solving problems with additional spending, and there is apparent disinterest in making structural changes to the economy.

This has led to a situation where inflation is out of control, deficits in the public sector are ignored and public debt is increasing rapidly. Currently, EU states that actually fulfill the Maastricht criteria make up a small and exclusive club - of one!

Below is a reminder of the Maastricht Criteria:

## The Maastricht criteria:

- general government or public sector should have a deficit of less than 3% of GDP;
- debt of general government should be less than 60% of GDP;
- inflation over the last 12 months in any country should not be higher than the average of these countries + 1.5%.

**Table 1 Maastricht criteria as of 2022 with HICP for June 2023**

	General Government deficit of less than 3% of GDP	General Government debt less than 60% of GDP	HICP average over last 12 month for the 3 lowest countries + 1.5%
Belgium	-3.9	105.1	9.2
Bulgaria	-2.8	22.9	13.9
Czechia	-3.6	44.1	17.3
Denmark	3.3	30.1	10.0
Germany	-2.6	66.3	13.0
Estonia	-0.9	18.4	20.7
Ireland	1.6	44.7	10.5
Greece	-2.3	171.3	8.9
Spain	-4.8	113.2	7.2
France	-4.7	111.6	8.8
Croatia	0.4	68.4	11.9
Italy	-8.0	144.4	12.8
Cyprus	2.1	86.5	8.3
Latvia	-4.4	40.8	21.3
Lithuania	-0.6	38.4	19.2
Luxembourg	0.2	24.6	7.1
Hungary	-6.2	73.3	25.3
Malta	-5.8	53.4	7.1
Netherlands	0.0	51.0	12.7
Austria	-3.2	78.4	12.5
Poland	-3.7	49.1	15.5
Portugal	-0.4	113.9	9.8
Romania	-6.2	47.3	13.7
Slovenia	-3.0	69.9	11.3
Slovakia	-2.0	57.8	15.0
Finland	-0.9	73.0	9.8
Sweden	0.7	33.0	11.1

Only Luxembourg would fulfill the Maastricht criteria currently, which is quite worrying.

The fiscal discipline that was originally required to be able to join the eurozone has now completely disappeared and is no longer on the agenda.

If the OECD forecasts are any guide, there are no indications that the situation is going to change fundamentally before 2025, which will lead to further increases in public debt as a percentage of GDP.

If recession hits the European economies before the end of 2025, and unemployment begins to rise as a result, public sector deficits could very quickly become uncontrollable.

## **Impact on the financial markets**

If the fiscal situation deteriorates due to higher debt burdens, it could lead to the downgrading of credit ratings for a number of EU countries, which we have already seen happening in the US.

This would very likely necessitate increased interest rates on government bonds and place an additional burden on public finances.

As mentioned above, extra costs for the public sector are already foreseen, which would, in turn, imply more severe cuts in other areas of public spending.

Public spending cuts in a period of negative growth would only deepen a recession, and this would have a severe impact on all financial markets.