Perspectives on Public Debt and Productivity Growth in the Euro Area

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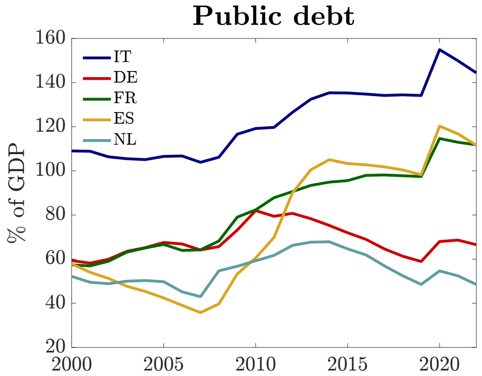
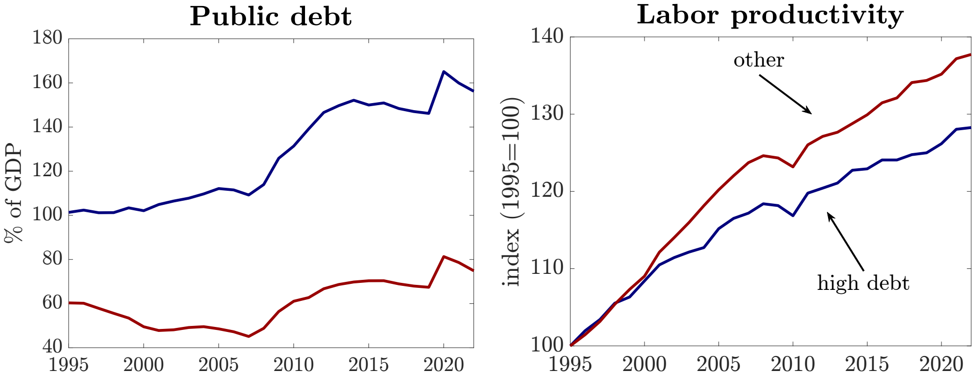
The issue

- What are the implications of heterogeneous public debt levels in the euro area?
  - Focus on relationship between public debt, investment and productivity growth, as a potential source of divergence among member countries

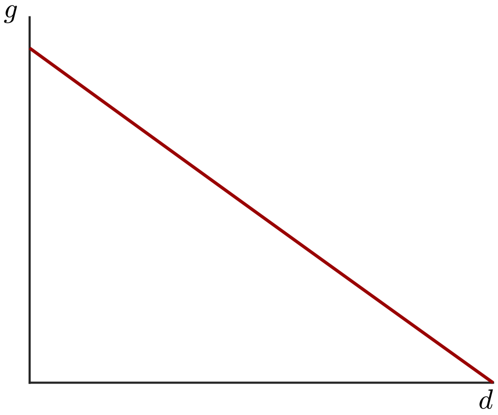


The public debt/productivity growth nexus



Notes: sample of 16 advanced economies. High debt countries have average public debt-to-GDP ratios higher than 90%.

Low growth → high public debt-to-GDP

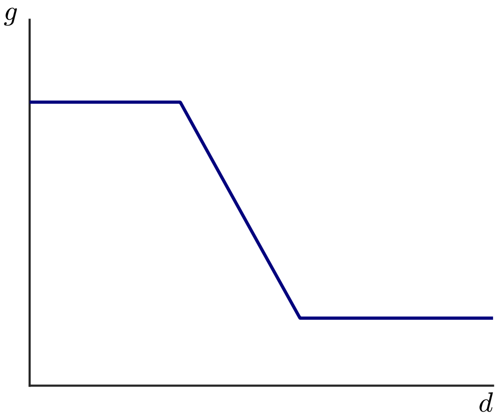


Lower productivity growth → lower future output → higher public debt-to-GDP

$$\uparrow d_{t+1} = \frac{R_t}{\downarrow g_{t+1}} (d_t - s_t)$$

Fornaro & Wolf (2025), Fiscal Stagnation

High public debt-to-GDP → low growth

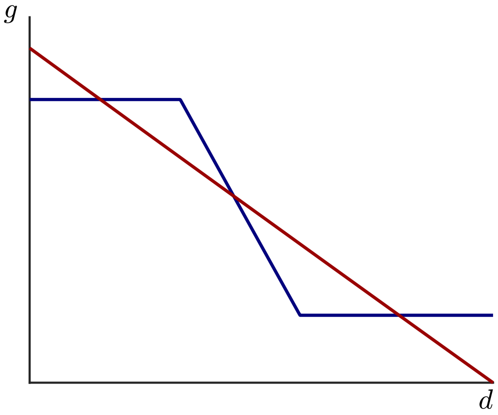


Higher public debt → higher fiscal distortions → lower investment and growth

- High taxes on capital and labor
- Low spending on public services/investment
- Little space to run countercyclical fiscal policy during recessions

Fornaro & Wolf (2025), Fiscal Stagnation

Public debt/productivity growth vicious cycle

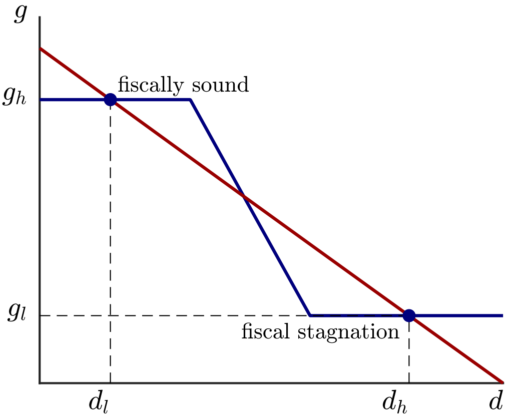


Bad shock → fiscal adjustment

- Lower investment and growth
- Higher public debt-to-GDP
- More fiscal adjustment to stabilize debt
- Lower investment and growth,...

Fornaro & Wolf (2025), Fiscal Stagnation

Falling into fiscal stagnation



Fornaro & Wolf (2025), Fiscal Stagnation

Desirable fiscally sound equilibrium

- Low public debt and high growth support each other

Countries with high legacy debt may fall into fiscal stagnation

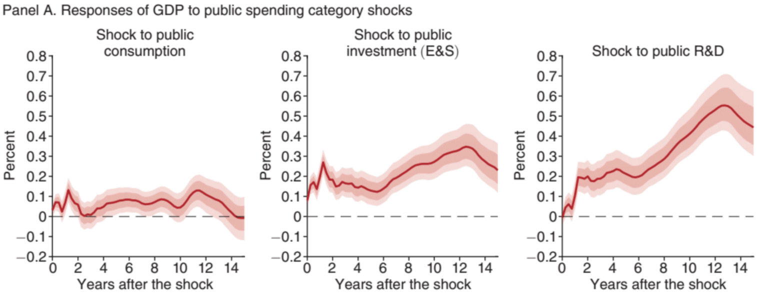
- High public debt and low growth self-perpetuate each other

Toward a two-speed monetary union?

- Large public investments envisioned for green transition, digitalisation and defence
  - Potential to boost productivity growth (e.g. Fieldhouse & Mertens (2025) estimate the return on public R&D capital in the US to be between 140 and 210 percent)
  - Public debt overhang may hinder investment in part of the union
- Union may split into a fiscally sound/high-growth block, and a fiscally stagnant one
  - Just one Silicon Valley in the US, but hard to spread the gains of a European Silicon Valley without fiscal union and with limited capital markets integration
- Single monetary policy ill-suited to deal with a two-speed union
  - Fiscally stagnant block: low productivity growth depresses demand and sustains inflation

Policies to mitigate the risk of fiscal stagnation

- Pro-growth fiscal policies to jumpstart a productivity/public debt virtuous cycle
  - At the national level: preferential treatment of public investment in Stability and Growth Pact, automatic investment stabilizers
  - Joint financing of EU public goods, especially public R&D programs



Notes: shock normalized such as to increase total government spending by 1 percent of GDP. US data for the period 1905-2015. Source: Antolin-Diaz & Surico (2025).

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  - Joint financing of EU public goods, especially public R&D programs
- Monetary policy can complement supply-side policies to stimulate productivity growth
  - Anchored inflation expectations $\rightarrow$ low interest rates in the medium run
  - Strongly countercyclical monetary policy $\rightarrow$ avoids scarring effects of deep recessions
  - Maintain robust aggregate demand $\rightarrow$ sustains firms' incentives to increase productivity