SCOPE Scope Ratings

G7: rising debt heightens sovereign risks

Rising debt-to-GDP trajectories combine with higher-for-longer interest rates

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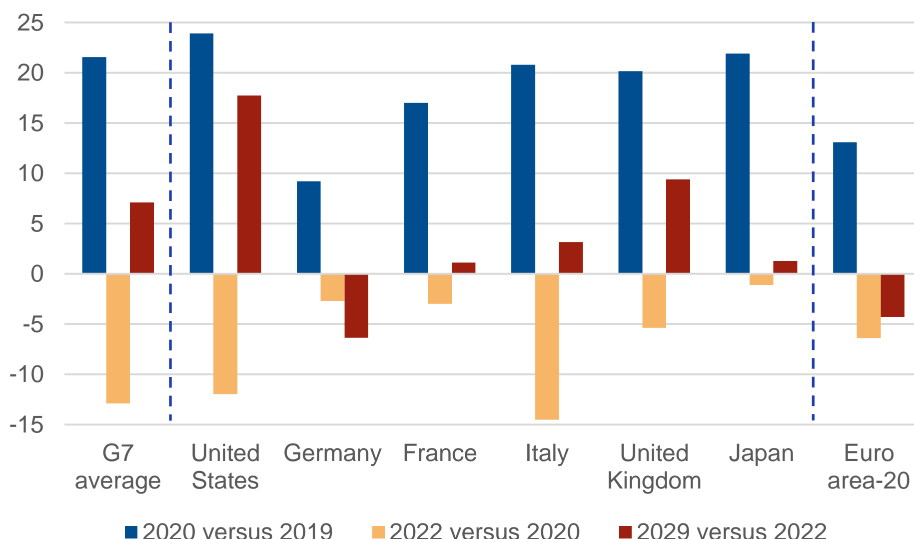
Higher-for-longer rates heighten the stakes for sovereign debt sustainability especially as financial-market and institutional checks on excessive borrowing of rich countries are weaker than they were several years ago. Debt-to-GDP ratios of most G7 sovereigns are likely to continue rising. The fiscal rules of many G7 governments – further weakened during the pandemic crisis – are insufficient to curb rising levels of borrowing while current higher interest conditions might complicate fiscal-consolidation paths.

Elections of several of the G7 countries – France (rated AA and Negative Outlook), the United Kingdom (AA/ Stable) and the United States (AA/ Negative) – are unlikely to result in post-electoral reversals of their debt trajectories. We project G7 general government debt will rise to 135.2% of GDP by 2029, approaching the recent 2020 peak of 139.6% (**Figure 1**). This increase is driven primarily by the rising debt stock of the US, the world's benchmark "risk-free" borrower.

Figure 1: G7 debt ratios declined in 2020-22 but have since increased
Changes in general government debt ratios, pps of GDP



Note: G7 is a weighted average by nominal GDP in nominal (US) dollar terms of Scope debt forecasts on G7 countries excluding Canada; IMFWEO forecasts assumed for Canada (which is not forecast by Scope). Source: Eurostat, IMF and Scope Ratings forecasts.

US debt-to-GDP set to rise regardless of the 2024 election outcome

As the issuer of the global safe asset, the US faces fewer incentives to cut its debt despite warnings from rating agencies and fiscal watchdogs concerning long-run fiscal risks. Regardless of the outcome of the upcoming presidential and congressional elections, we expect US debt to

rise further. The debt ceiling remains the single element within the US fiscal framework with real bite to enforce budgetary rectitude. However, it unfortunately also introduces a risk of technical default every year or two.

If, at this stage, a looming threat of default is needed to compel comparatively moderate cuts of the Fiscal Responsibility Act of 2023, this underscores the pressures that might be needed to ensure a stable debt trajectory. Concerning our AA rating of the US, the combination of debt-ceiling risk long run, elevated political fragmentation, and high and sustained fiscal deficits are the main negative rating drivers – underscored by our Negative Outlook. US general government debt is forecast to rise to 137.8% of GDP in 2029, exceeding the 2020 highs of 132%.

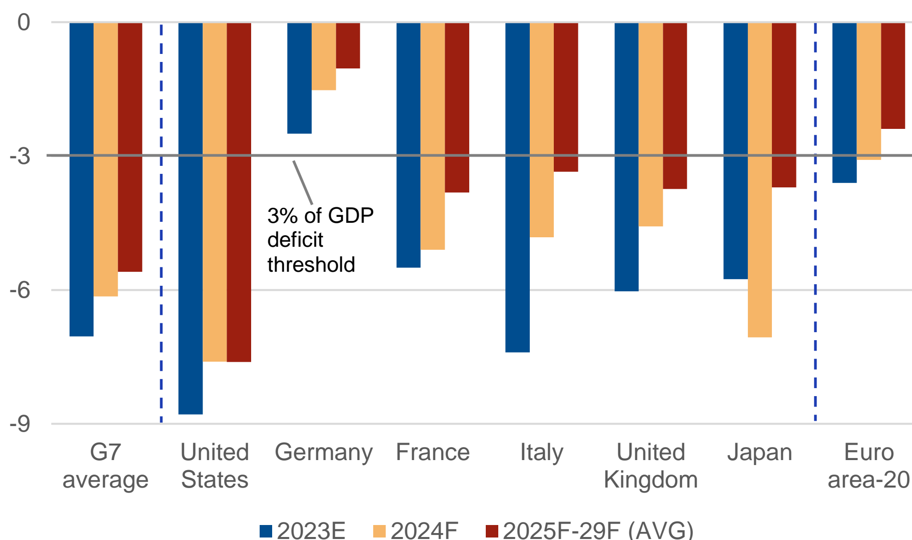
Rising French and Italian debt trajectories

Snap French elections raise new budgetary concerns

Inside the euro area, France is the source of concerns of a deeper regional fiscal crisis after President Emmanuel Macron called for early parliamentary elections, the first round of which took place on Sunday, 30 June, with the second round due this Sunday. The next parliament is likely to see greater representation by both far-right and far-left groupings, possibly forcing Macron to accept a prime minister from an opposition party, causing for political uncertainty.

We expect French deficits of above 3% of GDP through 2029 (**Figure 2**) – even before any policy changes after the elections that might hinder programmed budgetary consolidation. The increase in French debt – at this stage, set to rise *gradually* to 113% of GDP by 2029 from the 110.6% at the end of last year – could make the sovereign vulnerable to further investor unease.

Figure 2: G7 budget deficits set to remain elevated, except for Germany's
General government balance, % of GDP



Note: G7 is a weighted average by nominal GDP in nominal (US) dollar terms of Scope deficit forecasts for G7 countries excluding Canada; IMFWEO forecasts used for Canada. Source: Eurostat, IMF and Scope Ratings forecasts.

Any new French government needs to pursue coherent fiscal consolidation

To avoid that, a new government needs to maintain cooperative relations with France's neighbours and the European Union and pursue coherent fiscal consolidation. The widening of the spread of 10-year OATs against German Bunds of above 20bps since Macron called the snap election after early-June European elections is material, even though spreads recently re-tightened.

The contagion from France to other euro-area sovereign markets has been moderate so far.

Nevertheless, Italy (rated BBB+/ Stable Outlook)'s debt is forecast to increase to 143.6% of GDP by 2029, from the 137.3% as of end-2023. We expect that Italy will achieve a budget deficit of 3% of GDP consistent with Maastricht limits only by 2028.

Italy's public debt to rise to 143.6% of GDP by 2029

The European Commission last month recommended an Excessive Deficit Procedure for France and Italy among others. While this does not eliminate access to the ECB's Transmission Protection Instrument, it does raise eligibility hurdles. Consequently, the ECB may rely more on communication and flexibility under the Pandemic Emergency Purchase Programme (PEPP) as first lines of defence of euro area financial stability if needed.

Euro-area borrowers not free from market risks

The lack of an independent monetary policy means euro-area borrowers remain more vulnerable to bond-market sell-off than sovereigns outside of monetary union such as the US. This is a longer-standing rating constraint for euro-area sovereign states – although policy innovations within the Eurosystem since the euro and pandemic crises, such as PEPP, have partially improved policy makers' capacities within monetary union to address asymmetric crises.

Euro area more sensitive to bond-market sentiment…

Nevertheless, greater susceptibility of the euro area to changes in investor sentiment probably curtails the extent of moral hazard stemming from expectations a G7 safe-haven sovereign might have that it can count on support of the monetary authority in the event of financial turmoil. The UK mini-budget crisis was resolved quickly after the Bank of England intervened. The comparatively tighter financial-market straight-jacket for euro-area sovereigns may itself *partially* explain comparatively more benign government debt projections, with weighted-average debt ratios of the bloc seen edging lower to 87% of GDP by 2028, from 88.7% in 2023. This includes a deficit forecast at slightly below 3% of GDP at the euro-area level by 2025.

… but monetary union may help reduce moral hazard.

UK: rising debt risk for the sovereign rating

The UK, rated AA with a Stable rating Outlook, is in similar position to that of the US in facing a significant increase in general government debt to 110% of GDP in 2029 from 101% as of 2023. Memories of the mini-budget crisis two years before are unlikely alone to be enough to ensure tight fiscal policy after parliamentary elections.

Material fiscal consolidation not on a Labour government agenda

The opposition Labour Party, headed for victory in the general elections according to opinion polling, has ruled out increases in income tax, corporation tax or national insurance payments. This constrains the party's room for budgetary manoeuvre for stabilising the debt trajectory short of relying on very high inflation and/or unrealistic growth expectations. Government spending in the coming years is likely to prove significant. Without policies from the next government to curb borrowing, this debt trajectory could place greater long-run pressures on the sovereign's credit ratings.

Improved Outlook for Japan

Meanwhile, we recently revised our Outlook of another G7 sovereign: Japan (rated A) to Stable, from Negative, as more-durable inflation, breaking a very-long record of deflation, has supported the public-debt outlook.

Inflation has helped bolster the credit Outlook of Japan

Debt-to-GDP has fallen from post-Covid peaks

To be sure, average debt-to-GDP of G7 sovereigns has declined from their pandemic-crisis peaks. On the global basis, general government debt ratios declined from 2020 to the present. This includes for the euro area as an aggregate from 97% of GDP at 2020 peaks to 89% by the end of last year. The US de-levered from 132% to 122% over the same period as did the UK, from 106% to 101%, while Italy's debt corrected sharply from 155% to 137%. Japan's debt also eased to 252%

Post-Covid debt-ratio decline unlikely to be sustained

in 2023, from 258% as of 2020. This was due to unusually strong post-pandemic recoveries as economies re-opened and an ensuing phase of elevated inflation.

This earlier correction of debt-to-GDP does provide governments with some further fiscal space to absorb re-rises. Most G7 governments can furthermore in principle sustain much higher government debt ratios than other sovereigns due to their significant debt tolerance.

Nevertheless, the change of the outlook for rates to stay higher for longer changes things. Rising debt-to-GDP not only raises questions over long-run debt sustainability but also limits governments' near-term budgetary headroom. Before the pandemic crisis, the prevalence of ultra-low rates ensured interest payments fell even as governments increased their borrowing. Today, the proportion of government expenditure for servicing government debt is rising as older low-cost debt is re-financed at higher rates even absent assuming any change of the stock of borrowing.

G7 countries face mounting investment requirements

The G7 economies with rising government debt – such as France, Italy, the UK and the US – need to find ways to reinforce their fiscal frameworks and achieve adequate budgetary consolidation even allowing for the institutional advantages they have. They each face more onerous spending on defence, digitalisation, the environment and social welfare, creating unavoidable pressures on balance sheets.

Germany is an outlier: is fiscal discipline undermining long-run growth?

Germany is a G7 outlier due to fiscal discipline

Conversely, G7 sovereigns set to *cut* public-debt ratios include Germany (AAA/ Stable Outlook), where historical fiscal prudence remains with balanced-budget rules and the debt brake. Unlike most other G7 governments, Germany is set for fiscal deficits of under 2% of GDP this year and in the years ahead. This fiscal discipline gives the government space to continue reducing debt even as the role of *inflation* in supporting recent debt declines diminishes.

However, Germany faces the challenge of needing substantial investment in modernising its public infrastructure and adapting its industrial base to challenges, from the shift to greater reliance on renewables and non-Russian natural gas supplies to growing protectionism that hinders export-led growth. A more-buoyant German economy would in turn help bolster growth of neighbouring economies and support the sustainability of their higher debt ratios.

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