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**GDP, not the Bond Yield,  
should Remain the Anchor  
of the EU Fiscal Framework**

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## Summary

Declining bond yields and rising public debts have caused many economists to suggest raising the debt ceiling in the EU's Stability and Growth Pact. Implicitly, they argue for replacing GDP as the anchor with the bond yield. We discuss the risks of such a shift. While such a change would provide short-term relief to highly indebted EU member states, it is based on the expectation that bond yields will remain low for the foreseeable future. The historical record, however, suggests that prolonged periods of low real bond yields are eventually replaced by periods of high real bond yields. And this phase may have already started. From a long-term sustainability perspective, we conclude that GDP serves as a better long-term anchor for the EU fiscal framework than the bond rate.

**Keywords:** Fiscal framework, European Union, ECB, government debt, fiscal policy.



# Introduction<sup>1</sup>

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Low bond yields and a rapid increase in public debt during the pandemic have reignited the debate on the proper design for the EU's fiscal framework.<sup>2</sup> Many have argued for increasing the debt ceiling, set at 60% of GDP in the Stability and Growth Pact (SGP), which in effect implies replacing GDP with the bond yield as the anchor.

## Reassessing the EU fiscal framework

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The original design of the EU's fiscal policy framework reflects German macroeconomic thinking in the 1990s, which gave priority to fiscal discipline. Here the public debt ceiling of 60% of GDP is of central importance, as argued by Buti and Gaspar.<sup>3</sup> However, two main changes in the macroeconomic and political landscape since the 1990s have contributed to a reassessment of the EU fiscal framework.

First, few countries have been able to adhere to the debt rule. In the EU27, debt has remained above the ceiling ever since 1999 and reached 91% in 2020. Even Germany has consistently broken the debt rule in 18 out of 22 years between 1999 and 2020.

Second, and most importantly, long-term bond yields, nominal and real, have declined since the 1990s, which has lowered the burden of servicing public debt. These declining nominal rates have also reduced the efficiency of monetary policy, forcing central banks to rely on unconventional, and often extreme, expansionary policy measures during major downturns and crises. Increased public borrowing could relieve some of the pressures on monetary policy during such episodes.

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<sup>1</sup> This paper is based on F. N. G. Andersson and L. Jonung, *The Risk of Adopting the Bond Yield as the Anchor for the EU Fiscal Framework*, Lund University Department of Economics, Working Paper 2022:1 (2022).

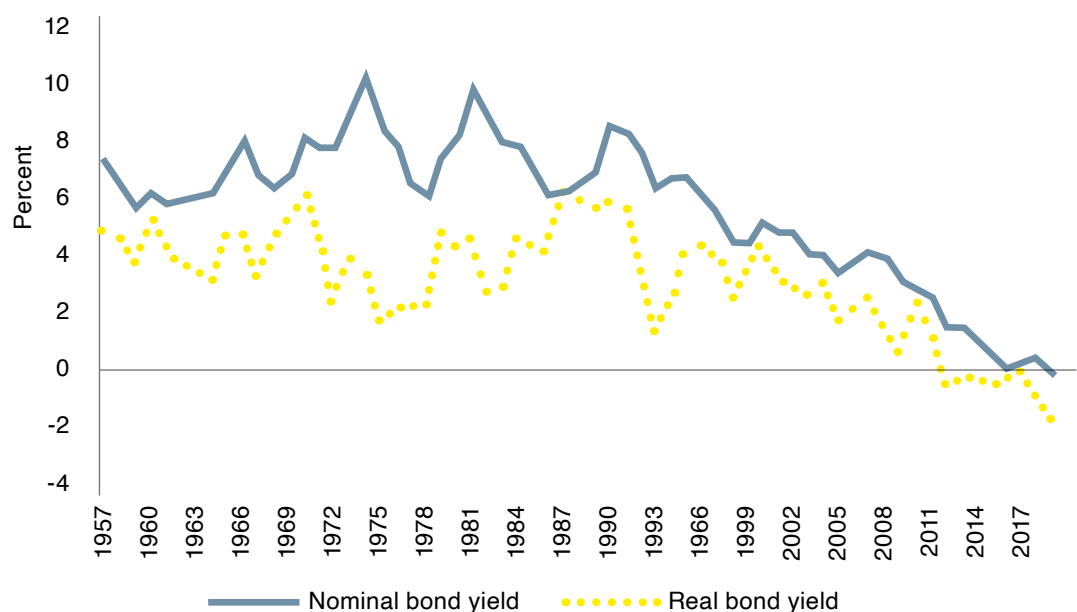
<sup>2</sup> See O. Blanchard, A. Leandro and J. Zettelmeyer, 'Redesigning EU Fiscal Rules: From Rules to Standards', *Economic Policy* 36/106 (2021), 195–236; P. Martin, J. Pisani-Ferry and R. Xavier, 'A New Template for the European Fiscal Framework', *VoxEU.org*, 26 May 2021; and N. Thygesen et al., 'Reforming the EU Fiscal Framework: Now Is the Time', *VoxEU.org*, 26 October 2020.

<sup>3</sup> M. Buti and V. Gaspar, 'Maastricht Values', *VoxEU.org*, 8 July 2021.



Figure 1 illustrates the nominal and real yield on a German 10-year government bond between 1957 and 2019. Both yields have fallen significantly in recent decades. From the late 1950s to the mid-1990s, the average real yield was about 3.5% per annum. Beginning in the early 2000s, the yield started to decline, averaging 1.5% until the global financial crisis of 2008, when it fell further. Once central banks began to increase the volume of credit in the economy through various quantitative easing programmes, the yield fell into negative territory.

Figure 1 Nominal and real German 10-year bond yield, 1957–2019



Source: Data from OECD database.

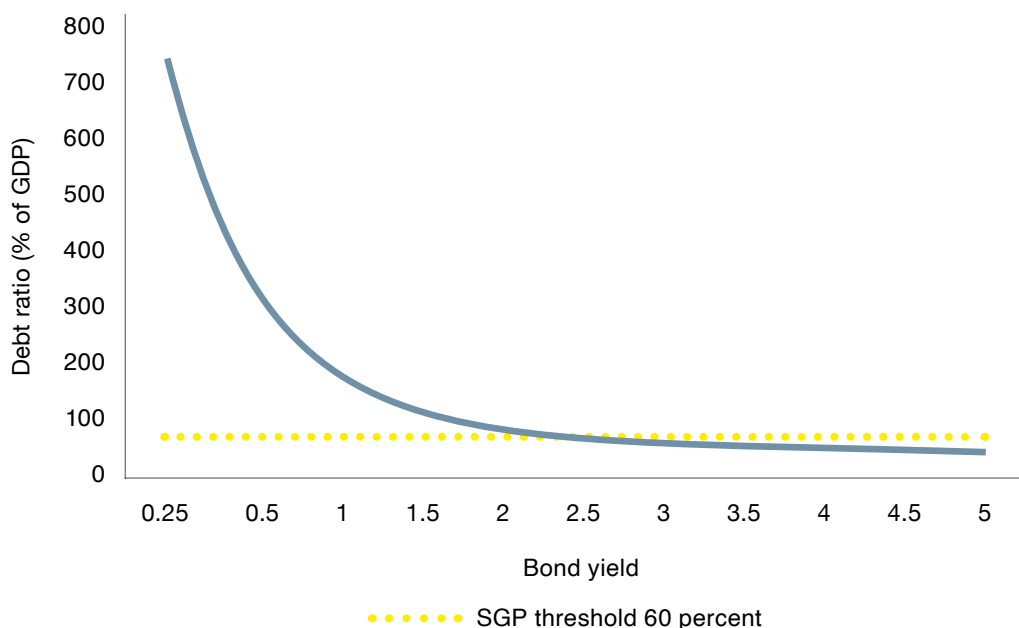
The key metric for the state of public finances is the cost of servicing the debt. Every time the bond yield is cut in half, public debt can double without increasing the cost of servicing the debt. This creates a non-linear relationship. Reducing the bond yield from say 3% to 1.5% cuts the interest rate in half, allowing for a doubling of the debt. A further halving of the bond yield to 0.75% allows for a further doubling of the targeted debt ratio. Thus, as the bond yield approaches zero, the possible debt increases rapidly. It reaches infinity as the bond yield reaches zero. The non-linear relationship between the real bond yield and the debt ratio is illustrated in Figure 2.

When the threshold value of 60% was set in 1997, the German 10-year real bond yield was close to 3% on average, which resulted in a debt servicing cost of 1.8% of GDP. The black curve in Figure 2 shows the maximum public debt



level for different bond yields assuming the targeted debt service cost is set at a constant rate of 1.8% of GDP. The dotted yellow line shows the present SGP debt ceiling of 60% of GDP. As the real bond yield declined to 1.5% in the early 2000s, the debt-to-GDP ratio was able to increase to 120% without increasing the debt service cost as a ratio of GDP. Currently, negative real yields imply that the size of the public debt is of minor importance.

**Figure 2 Possible public debt-to-GDP ratios with a constant debt service cost as implied by the SGP value of 1.8% of GDP for different bond yields**



*Source: F. N. G. Andersson and L. Jonung, The Risk of Adopting the Bond Yield as the Anchor for the EU Fiscal Framework, Lund University Department of Economics, Working Paper 2022:1 (2022).*

## Should the debt ceiling be raised because of falling bond yields?

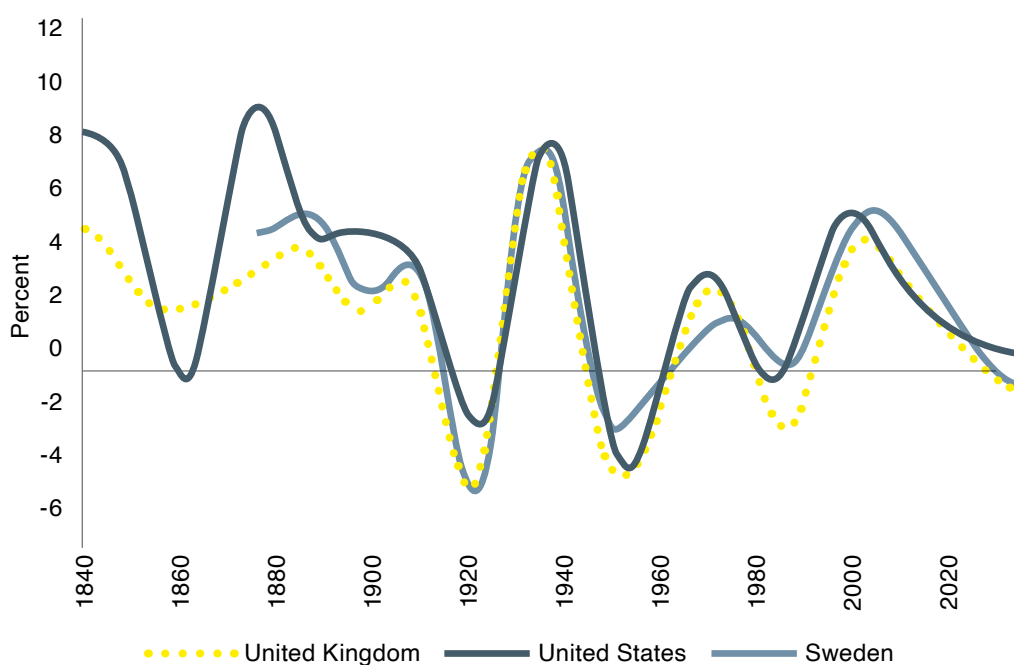
Declining bond yields provide an argument for raising the public debt ceiling, especially for highly indebted countries with debt ratios well above 100% of GDP such as Belgium, France, Greece, Italy and Spain. However, raising the public debt ceiling should not be viewed as a free lunch. Higher debt ratios expose the public finances to greater fiscal risks. While it is



possible for a government to increase the debt ratio rapidly, reducing it again will necessarily take time, often many decades.

Even though bond yields have declined over many years, we caution against expecting bond yields to remain at record low levels forever, judging from the evidence in Figure 3. This figure presents an estimate of the trend in the 10-year real government bond yield between 1840 and 2019 for two major economies, the US and the UK, and for a small economy, Sweden. Germany and other continental European countries are not included in this figure due to the impact of the World Wars on the continental European economy.<sup>4</sup>

**Figure 3** Trend estimate of the real interest rate for the US, the UK and Sweden, 1840–2019



*Source: F. N. G. Andersson and L. Jonung, The Risk of Adopting the Bond Yield as the Anchor for the EU Fiscal Framework, Lund University Department of Economics, Working Paper 2022:1 (2022).*

From Figure 3, we can draw two conclusions. First, there are prolonged periods, lasting many decades, of either rising or declining real yields. From a historical perspective, the recent period of declining rates is not exceptional. Periods of low yields eventually give way to periods of high yields and vice versa. Thus, policymakers should take the possibility of higher real yields into account when designing fiscal policy rules, at least if their intention is to provide long-term stability.

<sup>4</sup> The real yield is calculated as the nominal yield on a 10-year government bond minus the observed inflation rate.



Some central banks, most prominently the US Federal Reserve, have recently raised their policy rates or made it likely that rates will be raised in the near future in order to restrict the rise of inflation following, inter alia, the pandemic and the war in Ukraine. Other central banks are following the US Federal Reserve by raising their policy rates. The ECB will follow this pattern as well in due course. It is impossible to state whether these events will herald a period of long-term rising rates. We should not rule out this possibility, however.

Second, there is a high correlation across the yield estimates for all three countries, which indicates that the long-term bond yield is set by global, rather than domestic forces.

## The risks of adopting the bond yield as a fiscal anchor

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The bond yield displays considerable long-term volatility as illustrated by Figure 3. Some of the short-term shocks and long-term structural factors that have impacted interest rates during the past 20 years are outlined in Table 1.

Five major short-term shocks have prompted central banks to lower short term nominal interest rates: the bursting of the dot-com bubble in 2000, the 9/11 terrorist attack in 2001, the global financial crisis in 2008/09, the European debt crisis of 2010–15 and the COVID-19 pandemic. Such a string of severe negative shocks is unusual in a historical context. The world economy is usually hit by both positive and negative shocks over a 20-year period.



**Table 1 Short- and long-term factors behind falling bond yields, 2000–21**

Short-term shocks	Long-term structural changes
2000: End of dot-com bubble	Declining productivity growth
2001: 9/11 terrorist attack	Globalisation <ul style="list-style-type: none"><li>- China joins WTO</li><li>- EU enlargement</li></ul>
2008/09: Global financial crisis	Digitalisation
2010–15: European debt crisis	
2020–21: COVID-19 pandemic	

*Source: F. N. G. Andersson and L. Jonung, The Risk of Adopting the Bond Yield as the Anchor for the EU Fiscal Framework, Lund University Department of Economics, Working Paper 2022:1 (2022).*

Over the long term, three major structural changes have contributed either directly or indirectly to lower interest rates. The growth of total factor productivity has declined since the late 1990s. Lower growth by this measure is correlated with lower demand for capital and a downward pressure on interest rates. Globalisation, including China's entry into the WTO and the EU's expansion eastwards, has induced lower inflation, which in turn has caused central banks with inflation targets to pursue more expansionary monetary policies. Globalisation has reduced profit margins and provided the world economy with relatively cheap labour that has held back wages and limited inflation.<sup>5</sup> China has provided the global economy with a savings surplus, which has reduced interest rates,<sup>6</sup> while digitalisation has reduced marginal costs and inflationary pressures.<sup>7</sup>

<sup>5</sup> D. Andrews, P. Gal and W. Witheridge, *A Genie in a Bottle? Globalisation, Competition and Inflation*, OECD Working Paper 1462 (Paris, 2018); and J. Knight, Q. Deng and S. Li, 'The Puzzle of Migrant Labour Shortage and Rural Labour Surplus in China', *China Economic Review* 22/4 (2011), 585–600.

<sup>6</sup> B. Bernanke, 'The Global Saving Glut and the US Current Account Deficit', speech at the Sandridge Lecture, Virginia Association of Economists, Richmond, VA, 10 March 2005.

<sup>7</sup> K. Charbonneau et al., *Digitalization and Inflation: A Review of the Literature*, Bank of Canada, Staff Analytical Note 2017–20 (2017).



Factors that have pushed interest rates downwards may now be shifting in the other direction. Combating climate change requires large capital investments in new energy sources, infrastructure and production processes, which will drive up the demand for capital.<sup>8</sup> Globalisation processes have slowed in recent years and may even reverse in the near future, reducing the supply of cheap labour and the level of competition.<sup>9</sup> The economic benefits of digitalisation may lead to a new investment boom among firms similar to the effect seen with the introduction of new computer technologies in the late 1980s and the 1990s, which at that time caused higher interest rates.<sup>10</sup>

Of course, we cannot tell whether these new trends will materialise and, if they do, whether they will cause higher interest rates. In any event, policymakers should be prepared for a change of circumstances and thus for a rise in the bond yield.<sup>11</sup> For this reason, it is very risky to base the fiscal framework on the assumption of permanently low bond yields.

In addition, we see two additional arguments against a bond yield anchor. First, such an anchor, instead of the present GDP anchor, would create a strong connection between fiscal and monetary policy. In this situation, it would be extremely difficult for the European Central Bank to remain politically independent as any increase in the bank's policy rate would immediately require fiscal austerity.

Second, if a bond yield anchor were to be adopted, such a change would most likely undermine the credibility of the entire EU fiscal framework. Its credibility is already weak. A new framework would be viewed as an additional sign of weakness. If the fiscal framework is changed, many would then expect it to be changed again to adjust to new circumstances.<sup>12</sup>

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<sup>8</sup> OECD, *Financing Climate Futures. Rethinking Infrastructure. Policy Highlights* (Paris: OECD, 2018).

<sup>9</sup> K. H. O'Rourke, 'Economic History and Contemporary Challenges to Globalization', *The Journal of Economic History* 79/2 (2019), 356–82; and C. Reinhart and V. Reinhart, 'The Pandemic Depression. The Global Economy Will Never Be the Same', *Foreign Affairs*, September/October 2020, 84–95.

<sup>10</sup> F. N. G. Andersson, 'Sekulär stagnation. Vad är det, finns det och hur påverkar det penningpolitiken?', *Ekonomisk Debatt* 45/7 (2017), 13–25.

<sup>11</sup> On this point, see a warning that low interest rates will not last forever from, *inter alia*, R. Rogoff, 'Fiscal Sustainability in the Aftermath of the Great Pause', *Journal of Policy Modeling* 43/1 (2021), 783–93.

<sup>12</sup> Of course, we are aware that a move to a bond rate anchor for the EU fiscal framework would require changes to the legal framework of the EU. Given the present political set-up in the EU, the likelihood of reaching a consensus on a new fiscal framework is small. There may be agreement that the present system does not work, but there will probably be less agreement regarding the introduction of a bond rule. Fiscally well-behaved member states are likely to oppose such an attempt.





# Conclusions

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Replacing GDP with the bond yield, directly or implicitly, as the anchor for the EU fiscal framework would be a highly risky venture. Betting on permanently low bond yields is a gamble that historically has backfired for public as well as private borrowers. Historically, prolonged periods of relatively low bond yields have been followed by periods of relatively high bond yields as the economic circumstances have changed. Rising bond yields could quickly cause a fiscal crisis, or even a sovereign debt crisis, among highly indebted EU member states.

Raising the public debt ceiling might provide policymakers in several EU member states with a short-term respite from consolidating public finances. However, it would not solve the euro area's core economic problem: weak economic growth. There is a risk with the present debate about the future of the EU fiscal framework that it puts the focus on the wrong issue. Neither a more expansionary fiscal policy nor the abolition of the Maastricht rules is the way to improve economic growth in the long run. Only growth-oriented reforms will increase the long-term growth rate in the EU.

To sum up, we see strong reasons to maintain the present EU fiscal framework based on GDP and resist the short-term temptation to use the currently very low bond rates as an argument for basing the fiscal rules on the bond rate. Instead, the debate should concentrate on improving the growth potential of the EU.



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## Credits

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