Is Europe Playing With Fire?

Earlier this year, French Finance Minister Éric Lombard warned that his country might be forced to reach out to the IMF for a bailout. British officials offered markets a similar hint. Of course, bailing out industrialized countries is not practical for the IMF given its limited resources. But are European officials suggesting that they are considering an entirely new approach to fiscal/debt policy management and liquidity?

The first steps to this change in approach, some would argue, came earlier this year when Germany altered its constitution to remove its fiscal debt brake (debt not to exceed 60 percent of GDP). Many officials warned this change could give the green light to other, financially less-stable European countries that want to increase their already-bloated budgets.

Is the next step in this new policy the beginning of even more widespread use of EU-Bonds? The European Commission is pushing for further issues of EU-Bonds offered in the name of the European Union. The volume of outstanding EU-Bonds has already reached €650 billion. Yet from a legal standpoint, EU-Bonds do not belong to the category of government bonds principally because the European Union is not allowed to take on its own debt and has only limited scope to generate its own revenues. The EU member states bear the responsibility jointly and severally, which means one or more member states can be made responsible for the amount of a bond issue if other financially weaker members cannot live up to their obligations.

What could be the consequences of these controversial changes? Will these moves enhance the liquidity of European financial markets, which could be particularly useful at a time when European governments are rearming militarily? Note that the European high command also hopes to "professionalize" Europe's capital markets by having Eurex Futures launch EU-Bond futures.

And most importantly, is this new approach involving EU-Bonds and other changes a welcome new development or a controversial gimmick that could jeopardize the credibility of European financial markets? After all, it is still undecided whether such bonds used in this way contradict the "no-bailout" clause of Article 125 of the EU treaty. Are these wise moves or are European policymakers playing with fire?

Nearly two dozen noted observers offer their views.

The French and Germans are like frogs sitting in a pot of water that is slowly heating up.

THOMAS MAYER
Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank Group

Government finances of the two key euro area countries are in dire straits. France has long been concealing its economic decline with reckless government borrowing. And now, instead of setting new fiscal policy priorities to adjust to the changed economic and geopolitical environment, the German government is sharply increasing borrowing. Both countries are ignoring an uncomfortable truth: their fiscal profligacy will ultimately lead to government bankruptcy.

In France, the state has been spending more than it earns for half a century. The debt ratio has risen to 113 percent of economic output, and the budget deficit for 2025 is expected to amount to more than 5 percent of GDP. In a dramatic speech to parliament on September 8, Prime Minister François Bayrou called for an austerity program to finally be put in place. But his minority government was toppled. There were riots in the streets and strikes in factories. The temptation to simply pass the burden on to future generations is greater than any understanding of the need for tough decisions. France lives in a permanent deficit frenzy, protected by the common currency.

Berlin has now fallen into line with Paris. Although its present debt and deficit ratios are lower than those of France, the momentum is similar. In a report on the 2026 draft budget, the Federal Audit Office accused Finance Minister Lars Klingbeil of driving the federal government into a debt spiral.

Structurally, the problems of both countries are similar: an aging society, insufficient growth, and rapidly rising social spending. Since citizens are still living off the prosperity built up in the past, there is no political majority for painful reforms. The French and Germans are like frogs sitting in a pot of water that is slowly heating up, unaware that they will eventually be killed by the rising temperature.

This is extremely dangerous for the stability of the eurozone. If the two largest economies do not get their budgets in order, smaller countries will also have no reason to manage their economies soundly. The entire eurozone is sinking into a sea of debt. Until the coronavirus pandemic, government debtors could count on the help of the European Central Bank. With deflation supposedly looming, the European Central Bank bought up their bonds *en masse* and ensured with low interest rates that virtually any debt burden was bearable. However, having thus lured the long-dormant inflation dragon out of its lair, its hands are now tied.

Instead of from Frankfurt, incorrigible debtors are therefore hoping for help from Brussels. Joint debt with "Eurobonds" is back on the agenda. But this, too, will prove to be an illusion. As more supply meets subdued demand, the interest rates on these bonds will also rise. In the end, the European Central Bank will have no choice but to finance the national debt monetarily—regardless of rising inflation and a declining currency.

EU-Bonds are no solution.

CHEN ZHAO
Chief Global Strategist, Alpine Macro

Periodic bond market crises are inevitable in the eurozone, and the increasing stress in the French OAT market has the potential to become a full-blown bond crisis. This is because there are fundamental design flaws in the European common currency regime.

EU-Bonds are no solution to France's overspending. The European Union cannot issue additional bonds to cover France's budget shortfall—not only would this violate the "no bailout" clause, but it would also create massive moral hazard. Moreover, the European Union lacks the authority to levy taxes directly on member states, leaving it without a credible revenue stream to service large-scale EU bond issuance. All of this has proven, once again, that a common currency cannot function effectively without a common fiscal union.

This leaves fiscal reform as France's only way out, but the French government is not in the position to pursue any serious fiscal restructuring. The problem is that the very design of the euro means that member states must rely on domestic adjustment as the mechanism to preserve the common currency. Such adjustments, however, are extremely painful, and no government will willingly undertake them unless forced by crisis.

Southern Europe endured exactly this after the 2010–2011 euro debt crisis. Greek employee compensation plunged 56 percent from 2007 to 2012 and has never recovered. Italian nominal wages fell 6 percent between 2010 and 2013, while real wages dropped nearly 12 percent. The European Central Bank eventually did "whatever it takes" to save the euro, but that did not spare southern Europe from massive wage and income deflation.

The French government is desperate to avoid a similar adjustment. But with a budget deficit close to 6 percent of GDP, bond markets are increasingly questioning France's ability to service its debt sustainably. Political chaos compounds the problem: in less than two years, France has cycled through five prime ministers without producing a majority capable of passing a credible budget. Powerful unions, meanwhile, have called a general strike to block any meaningful spending cuts.

Without credible reforms, bond markets will continue to pressure Paris. With French ten-year OATs trading at an 85-basis-point spread over German bunds, the market is already in a low-grade crisis. Continued political and policy paralysis could easily trigger a run on French bonds, plunging the economy into recession. That may prove the only way to deflate France's cost structure—though, under such circumstances, ECB intervention would certainly follow.

Europe is not playing with fire.

EWALD NOWOTNY
Former Governor, Oesterreichische Nationalbank, and President, Austrian Society for European Politics

Like many regions of the world, the European Union is facing a number of problems with public finances. However, in contrast to what some alarmists claim, Europe is not playing with fire. The actual numbers show that the combined budget deficit of all EU member countries as a percentage of GDP will be about 3.2 percent in 2025 (compared to 5.9 percent in the United States).

This number masks substantial differences among EU member states, however. While France is facing the biggest problem with a budget balance forecast of -5.7 percent for 2025, Europe's largest economy, Germany, is set to benefit from its frugal policies of the past, despite massive expenditure programs. For the majority of the EU member countries, the deficit ratio will be below 3 percent. Greece even expects a budget surplus of 0.7 percent for 2025—a telling case of the success of the "cash for reform" approach.

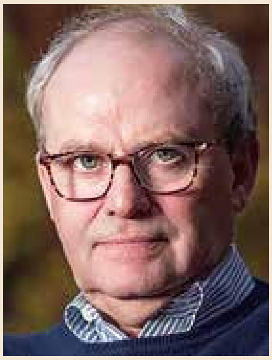
Looking at the medium- and long-term outlook, the European Union is, in fact, confronted with massive financial challenges: the need to increase military expenditures, the effects of an aging society, and the costs of reducing or mitigating climate change. For most EU countries, these challenges seem to be manageable through a combination of expenditure-related and tax policy measures.

With regard to spending, this would mean allowing for a longer time horizon for the implementation of measures in the strategic fields mentioned above. In order to increase public revenue, the most obvious measure to be taken in an aging society is broadening the tax base to include the enormous number of inheritances expected in the near future. All this is, of course, politically challenging, but it can be done in an intelligent piecemeal approach.

Some countries may still be unable or unwilling to adopt such a nuanced approach. What may help in this context is increased pressure from the financial markets getting to the attention of the general public, as has been the case in Italy, for instance.

In extreme cases, when countries are in danger of losing access to financial markets, the European Union and the European Central Bank can deploy the safety nets created in response to the euro crisis. At the euro-area level, the European Financial Stability Facility and its successor, the European Stability Mechanism, disbursed loans in the amount of €295 billion to five European countries between 2010 and 2018. Given the success of these interventions, no further disbursements have been necessary. At the ECB level, the Transmission Protection Instrument would allow the European Central Bank to buy government bonds: it has never been used to date.

Activation of any of these instruments is connected to a number of strict conditions, so this is difficult terrain, both politically and legally, but not excruciatingly so. In any case, though, the notion of an impending IMF bailout is absolutely unfounded.



These are three good arguments for EU-Bonds and the risks appear small.

ANDERS ÅSLUND
Adjunct Professor, Georgetown University, and author, **Russia's Crony Capitalism: The Path from Market Economy to Kleptocracy** *(2019)*

The public financial balances of the twenty-seven members of the European Union differ remarkably in early 2025. National public debt varies from 153 percent of GDP in Greece to 24 percent of GDP in Bulgaria and Estonia. The average EU public debt is 82 percent of GDP, but eight countries have a public debt that is even higher. They are all old EU members—Greece, Italy, France, Belgium, Spain, Portugal, Austria, and Finland.

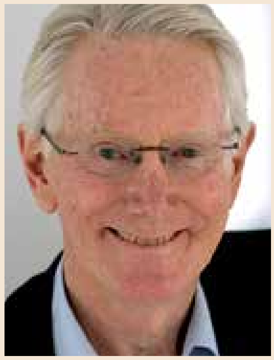
By contrast, the financial performance by the new EU members is largely stellar. At the other end of the spectrum from the old EU members, the European Union has six members with eminent public finances and public debts below 40 percent of GDP. They are Bulgaria, Estonia, Luxembourg, Denmark, Sweden, and Ireland. Bulgaria and Estonia are the stars among the new members, most of whom have small public debts because they faced its great cost. Denmark and Sweden fell into serious financial crisis before they joined the European Union, among the reasons which prompted them to join.

During the euro crisis in 2010–2012, much of the European south was in financial crisis: Greece, Cyprus, Spain, Portugal, and Ireland, and almost Italy. Now the tables have turned. Ireland is once again an outstanding performer. Cyprus, Greece, and Portugal have impressively turned to budget surpluses. Spain and Italy have slashed their budget deficits and Spain has become a new growth engine in Europe.

The new key fiscal concern is France, which seems condemned to a budget deficit of 6 percent of GDP (just like the United States), the highest public expenditures in Europe as a share of GDP, and a steadily rising public debt. It is no surprise that the French treasury bills now require as high a yield as the Italian ones. As is always the case in a country with a financial crisis, its root is political, not financial. The three biggest EU countries—Germany, France, and Italy—stand out for their near-stagnation.

These elementary public finance statistics show how greatly the EU countries vary, and they have adjusted not because of EU rules or admonitions but because of national economic crises. The cure is more sensible economic policies, which may take some time to work out. Greece offers a laudable example, as do all the recuperating countries.

Would EU-Bonds matter? Yes, the three Baltic countries faced a pure liquidity crisis in 2008–2010, which the European Central Bank could have saved them from. Common EU bonds would do three things. First, they would greatly improve EU liquidity, which is vital in a financial crisis. Second, they would provide EU countries with more affordable government financing. Third, they would make the euro a true competitor to the U.S. dollar, which is now subject to arbitrary governance. These are three good arguments for EU-Bonds and the risks appear small.



Further recourse to EU bonds for specific purposes should not be ruled out.

WILLIAM R. WHITE
Former Economic Adviser, Bank for International Settlements

During the covid crisis, the agreement of Northern "frugal" countries to support other EU countries through the European Recovery Fund was considered a hugely symbolic statement. Not least, the agreement that the European Union could issue bonds that were "joint and severally guaranteed" was thought to be a significant, and for some, worrisome step towards fiscal union. The subsequent decision of the German government to remove its domestic debt brake was, again by some, taken as another sign that debt issued centrally by the European Union would be viewed much more favorably in the future.

This interpretation of events was supported by persuasive arguments concerning the benefits of centrally issued debt. A step towards fiscal and political union, it would enhance the global status of Europe in a world otherwise dominated by the superpowers of China and the United States. A larger and more liquid sovereign EU bond market would set a benchmark yield curve encouraging the needed development of a European capital market. By providing national financial institutions with EU bonds, it would help break the worrisome nexus between sovereigns and national banks. Finally, with the reserve status of the U.S. dollar being newly questioned, such a European market would provide an alternative global safe asset and lower European borrowing costs.

Yet this could be wishful thinking. The European Recovery Fund, financed out of the EU budget, was a "one-off" for a specific purpose, like similar funds before it. Crucially, there was no expansion of the European Union's capacity to tax on its own account to service the debt, a move that would require a change to the Treaty on European Union. As for the removal of the German debt brake, this clearly implied a new willingness to invest in Germany, particularly for defense and infrastructure. But it is hard to see how it also suggested a willingness to use taxes in "frugal" countries to support spending elsewhere. Indeed, a common response to all suggestions for more EU-issued bonds has been warnings of moral hazard. It might encourage more national spending and larger debts and raise the likelihood of future financial crises. The number of U.S. state bankruptcies, following Hamilton's initiative to have the U.S. federal government take over existing state debts, is (wrongly) often evoked as an undesirable precedent.

Nor can we forget the strand of thought that has always been suspicious of "still more Europe." This sees monetary union requiring banking union, requiring fiscal union, requiring political union which must be avoided at all costs. Moreover, these traditional concerns have grown dramatically in recent years as national populism has surged, and as "undemocratic" EU institutions have become a lightning rod for populist resistance. As well, national governments seem increasingly focused on using national savings and national debt guarantees to finance national investments. This suggests further resistance to cross-border burden-sharing and a growing vulnerability for EU sovereigns, like France, with large external creditors.

Indeed, the increasing fragility of French government financing is a further impediment to any significant increase in the issue of euro bonds. Recently, interest rates on longer-term French bonds have even crept up beyond rates on Italian bonds. On the one hand, this might seem to call for more solidarity. But on the other hand, it also implies that the cost of such solidarity might have increased very considerably. Better perhaps to wait and see?

Given this resistance, further significant steps towards fiscal union seem unlikely. That said, further recourse to EU bonds for specific purposes, as in the past, should not be ruled out. Moreover, should there be a repeat of the market tensions seen during the European crisis, the European Central Bank would likely buy the debt of the governments under pressure, invoking the (thus far unused) Transmission Protection Instrument introduced in July 2022. While this also is an instrument of mutual support since ECB obligations are community-wide, it is less transparent than the issue of community bonds to support national debt markets. In such difficult circumstances, however, this might be thought more an advantage than a disadvantage.

Expanding EU-level issuance is justifiable.

KLAUS F. ZIMMERMANN

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Public debt in the euro area is high and continues to rise significantly, necessitating a cautious, rules-based approach. Eurostat has reported that the euro area's debt ratio stood at 88 percent of GDP in early 2025, with the entire European Union at about 82 percent. There is considerable variation among member countries. Given the current global economic, financial, and political climate, it is anticipated that aggregate debt will increase substantially over the medium term under various plausible scenarios. Consequently, it is essential to rebuild fiscal buffers while simultaneously prioritizing investments that enhance potential growth and maintain support for Ukraine as a European public good.

A novel approach to fiscal management and market liquidity is achievable, though it should remain narrowly focused in the short term. Under the European Commission's "unified funding" model, the European Union issues pooled "EU-Bonds" under a single label and adheres to semi-annual funding plans. Eurex, the main European derivatives exchange owned by Deutsche Börse, has recently introduced physically deliverable futures on EU-Bonds, offering investors a standardized method to hedge against fluctuations in EU-Bond yields. Provided that issuance remains predictable and transparent, these contracts are expected to enhance secondary market liquidity by connecting cash, repo, and derivatives markets.

Legally, EU-issued securities are obligations of the Union that are used to finance EU programs. The EU budget must be in balance—Article 310 of the Treaty on the Functioning of the European Union requires that revenue and expenditure match. While short-term borrowing on capital markets has been authorized, these liabilities must be repaid in full and in sequence. This approach is distinct from taking on member state legacy debts, highlighting the importance of keeping EU borrowing tied to specific programs and time-limited. Deviating from this approach would not align with European treaties.

Germany has not abolished its debt brake but has constitutionally narrowed it. In March 2025, the Bundestag and Bundesrat approved exemptions for defense expenditures exceeding roughly 1 percent of GDP and established a substantial, multi-year infrastructure special fund. From a conservative standpoint, this approach heightens execution risk and necessitates credible medium-term consolidation. Current experiences already reveal displacement effects: transfers from the core budget into the new fund have created space for non-investment consumption items, effectively crowding out net new public infrastructure efforts and undermining the reform's stated intent. This dynamic highlights the significant risks associated with the chosen approach and underscores the importance of firm guardrails.

Therefore, expanding EU-level issuance is justifiable for well-defined European public goods, such as defense readiness (including ongoing support for Ukraine), energy security, single-market deepening, and climate-critical infrastructure, as long as it is grounded in transparent program law, strict conditionality, and repayment plans within the European Union's seven-year long-term budget. With these safeguards, deeper EU issuance and the new futures market can enhance liquidity and resilience without obscuring sovereign-risk pricing; without them, mutualization would invite moral hazard and undermine market credibility.

Europe is doing the unavoidable.

HEINER FLASSBECK

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Europe is doing what is absolutely unavoidable

Everything currently being discussed on the subject of government debt and fiscal rules tacitly assumes that conditions exist in all countries that allow the government to reduce its debt without major economic upheaval, provided that the political will to do so exists. This is wrong. A country's public sector can only reduce its revenue deficits, that is its new debt, if other sectors such as private households or companies (domestic or foreign) or even the public sector in other countries accept that their expenditure surpluses—their debts—will increase or their revenue surpluses—their savings—will decrease. If this condition is not met, and this is the case for France and Italy, any attempt by a country's public sector to save will lead to a recession in that country and will sooner or later have to be abandoned by the government because it will have to cushion the effects of the recession, or at least bear them, for example in the form of increased social security expenditure and reduced tax revenue.

Debt always arises when there is a gap between expenditure and revenue in an economic unit. This is usually due to a real imbalance of such a nature that this economic unit lives beyond its means (that is, it consumes more real resources than it puts into the cycle) and another lives below its means. For a closed economy or the world as a whole, there can be no living above or below one's means because real resources can only be distributed and consumed once.

The gap between the income and expenditure of an economic unit is not a problem if there are conditions within an economy (and in the world as a whole) that ensure that the under-the-circumstances living of one group is systematically offset by the over-the-circumstances living of another group. Typically, it is private households that spend less than they earn. The financing balance of private households is therefore regularly positive: there is a constant surplus. Companies would have to counterbalance private households and spend more than they earn because they are the most important drivers of investment.

The state does not actually need to incur debt as long as it is certain that the corporate sector will invest at least as much as is saved elsewhere, meaning that it will fill the spending gap of private households with its own investment demand and correspondingly high debt. However, this is by no means certain. In many economies, companies are showing surpluses, thereby exacerbating the problem of insufficient demand. If the state wants to ensure positive economic development, it must therefore either create conditions that encourage the corporate sector to fully assume its inevitable role as debtor, or it must itself aim for expenditure surpluses by incurring debt.

Foreign countries consist of the same sectors as domestic countries and are therefore in no way suited to being net debtors in the long term in order to fill the gap in a country's overall demand caused by the domestic sectors' willingness to save. It should be obvious that every country in the world has to solve the same problem of private savings behavior as the domestic sector. Individual countries may have surpluses of revenue over expenditure (current account surpluses), which are necessarily offset by current account deficits in other countries.

The Deutsche Bundesbank has been calculating the sectoral financial balances for Germany since the 1950s. The latest calculation dates from June of this year and covers the year 2024 as the last available result. The figures show that saving and debt are two sides of the same coin. The state can never detach itself from its connection with the rest of the economy, and any analysis that assumes this is pointless from the outset. The German debt brake and the European debt rules are purely legal constructs with no inherent economic logic. Both systematically lead to fiscal policy actions that are damaging or unsustainable because they completely neglect the state's crucial task of stabilizing the economy.

France in particular has no way of solving its problem simply by tightening its belt. It must either enter into competition with Germany for high current account surpluses via wage dumping or accept government deficits. The former would be fatal for the European Monetary Union because it would trigger a lasting deflationary process.

For Europe to seize its "euro moment," it must first reach its "Hamiltonian moment."

MANSOOR DAILAMI

Former Manager, Emerging Trends Team, World Bank Group

Throughout human history, few developments can compare to Europe's integration initiatives, which have significantly shaped the continent's cultural, political, and economic landscape. With each challenge there has come a milestone to cross, and each milestone has strengthened leaders' determination to move forward. Just look at the landscape since the incarnation of the euro as the common currency of (now) twenty EU countries and as the linchpin of their unified monetary policy. Since then, Europe has faced the 2009–2012 sovereign debt crisis, the Covid-19 pandemic, and more recently intensified U.S.-China economic tensions.

Europe is currently experiencing significant security and fiscal challenges. A recent Eurobarometer survey found that 78 percent of citizens are concerned about EU defense and security, and 77 percent view Russia's invasion of Ukraine as a threat to EU security. Security concerns are also voiced internationally. Europe convened two recent emergency UN Security Council meetings—one requested by Poland on September 12 and another by Estonia on the September 22—to denounce Moscow's repeated violations of European airspace and affirm NATO's readiness to defend itself.

Yet Europe's security demands more than just rearmament or joint procurement systems; it requires also fiscal stability. This is a major challenge now. Nine EU countries are currently under the excessive deficit regime due to increased government debt from the pandemic. The pandemic led to recession and higher public debt, limiting governments' ability to maintain the European social model while boosting defense spending. Bond markets have reacted negatively as investors have shunned risky government bonds. The yield spread between French government bonds and German bunds has recently increased to about 80 basis points. Investors remain uneasy as France has seen five prime ministers lose office in under two years, creating political uncertainty at a time when France is reeling from a precarious fiscal situation. France's fiscal deficit is projected to range from 5.4 percent to 5.8 percent of GDP this year, with government gross debt estimated at 113 percent of GDP in 2024. The need is no longer just about budget cuts; it is also about restoring financial market credibility.

France's debt problem puts pressure on the government to reach a viable fiscal agreement with Brussels or the International Monetary Fund, while also testing its parliamentary system. Parliament must rise above party politics to safeguard national priorities and use France's position within the EU hierarchy to advance a common bond market.

This marks a milestone that Europe is now required to accomplish. European integration requires aligning investments on EU priorities, including defense, digitalization, and infrastructure (such as decarbonization), with common funding strategies. These options have not been fully implemented, which currently leads to additional structural costs in managing public debt. Generally, there are two main types of costs. First, there are the increased borrowing expenses faced by non-German euro area governments, which result from their higher bond yields compared to German bunds (currently approximately 40 basis points on average). Second, other euro area borrowers face higher borrowing costs because mispriced debt stems from the absence of a unified yield curve.

Estimating the magnitude of such costs is challenging, and they are unlikely to be negligible. If bond spreads align with benchmark German bunds, sovereign debt servicing costs in the euro area could fall by about 0.3 percent of GDP or about €43 billion per year.

A unified European sovereign debt market backed by collective fiscal resources of EU members would benefit eurozone borrowers, but progress remains slow. The main obstacle is not a lack of creative ideas or constraints on financial innovation, but rather the absence of political agreement necessary to formulate the European Union's distinct approach to constitutional federalism. For Europe to seize its "euro moment," it must first reach its "Hamiltonian moment." European safe assets make up about one-third of U.S. Treasury volumes, although the EU single market's purchasing power nearly matches that of the United States.

We have a long, though painful, history of sovereign debt crises and resolutions. One lesson from that experience is the importance of taking decisive action before investors run to the floor. Europe's 2009–2012 sovereign debt crisis, particularly Greece's debt restructuring, was a significant event in international finance. The crisis led to major reforms in EU public finance, such as Germany amending its constitutional debt brake and exemptions for extra defense spending. Now is the moment to build on these reforms and draw on the European integration vision of Robert Schuman and Jean Monnet to avert the escalation of French debt into a crisis.

EU bonds are part of the solution. The European Union face many challenges, but debt is not the primary concern.

LORENZO CODOGNO

Visiting Professor in Practice, London School of Economics and Political Science, and Founder and Chief Economist, Lorenzo Codogno Macro Advisors Ltd.

EU bonds are not the problem. They are part of the solution.

The European Union and eurozone face many challenges, but debt is not the primary concern. According to harmonized statistics from the European Commission, 2024 general government debt stood at 88.9 percent of GDP in the eurozone, 82.2 percent in the European Union, 101.3 percent in the United Kingdom, 124.1 percent in the United States, and 247.8 percent in Japan. Global debt cannot continue to rise at the current rate, and eventually, the bubble will burst. However, Europe is not the center of this global phenomenon. Debt trends are far more concerning elsewhere. Even considering Germany's intentional fiscal expansion for infrastructure and defense, the eurozone debt ratio is expected to increase by less than five percentage points by 2030.

Sovereign debt credit risk premia show option-like traits, decreasing gradually but capable of blowing up suddenly. This is even more pronounced in the eurozone, where two important policy tools are no longer under individual country control: the currency and monetary policy. Currently, the main concern centers on France, which faces a complex political situation that hampers policy responses to a deteriorating budgetary position. However, since the global financial crisis and the eurozone government bond crisis, many lessons have been learned. A substitute for the lender-of-last-resort role of the central bank has been established, and EU/eurozone countries have learned to collaborate and support each other during crises. Lastly, a flexible and adaptable fiscal framework has been introduced.

The fiscal boost in Germany, although frontloaded on paper, will take longer to show its effects. Meanwhile, other countries will continue to maintain fiscal discipline and reduce their debt ratios. The budgetary stimulus in Germany is welcome, as the country needs to move out of the doldrums through investment spending, hoping to at least partly address its structural issues.

EU-Bonds are neither a new approach nor a controversial gimmick that could jeopardize the credibility of European financial markets. They are a necessary and logical step if the EU/eurozone aims to seriously pursue economic and financial integration, reform its underdeveloped internal markets, and foster innovation and economic transformation.

Furthermore, using EU-Bonds to finance European common goods would offer numerous advantages, such as creating a liquid and deep safe asset market that would bolster the global role of the euro and the European capital market. Support for ambitious structural reforms aligned with the so-called Draghi agenda is growing. However, as is often the case, cross vetoes, national interests, and political divisions hinder or delay progress.

So, European policymakers are not playing with fire. The fire has already spread elsewhere, and the increasingly complex geopolitical developments demand greater political unity and, importantly, reformed institutions capable of enabling the necessary transformation. Focusing on debt alone is like putting the cart before the horse, as the real issue today is how to deepen integration to protect the core values for which the Union was established and to better prepare for today's global geopolitical challenges. Europe is not playing with fire; it is, in its own way and with great difficulty, trying to extinguish the fire that has already taken hold elsewhere.

Europe is not playing with fire. But individual countries are.

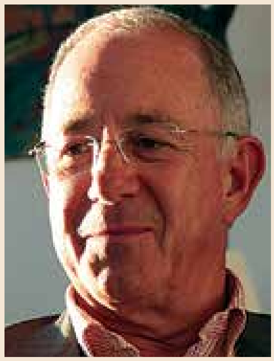
HOLGER SCHMIEDING
Chief Economist, Berenberg

Europe is not playing with fire. But individual countries are. The fiscal position of France is almost as untenable as that of the United States. French politics seem to be as polarized and dysfunctional as in the shutdown-prone giant economy across the Atlantic. But whereas the United States still attracts capital as a global safe haven in an unsettled world and as one of the two global engines of artificial intelligence, France does not have these two advantages. Paris is thus under more immediate pressure to act than Washington, D.C. Despite impressive progress under prime ministers Mario Draghi and Giorgia Meloni, Italy is also not on yet fully on the safe side. Its trend rate of growth remains too paltry for comfort.

Can Eurobonds be a way out? Not really. In theory, much more common European borrowing could make sense. A bigger and more liquid market for a common safe asset would make Europe and the euro more attractive for global currency and bond investors. But permanent and substantial common borrowing would have to come with hard central controls on how countries use the money. Otherwise, it might not be spent in a way that enhances a country's growth potential. Without hard conditions, it would also be politically unacceptable in Germany, and other countries who would *de facto* have to underpin the common bonds with their fiscal credibility. But hard conditions are tough to accept for sovereign nations, except during crises.

The European Union can help its members. In case of a severe crisis, Europe can offer conditional loans through the European Stability Mechanism or the European Central Bank for its member countries. That the European Union cuts national governments some slack by not counting additional military expenditures as breaches of its fiscal rules also makes sense. The same would apply for common bonds to finance weapons and reconstruction help for Ukraine, using the frozen Russian central bank assets as indirect collateral for such loans. But these are limited exceptions to the rule.

Germany is a special case. Under its strict debt brake ceiling for public borrowing, the country had used its remaining fiscal leeway to raise public consumption while neglecting public investment. The recent targeted relaxation of this straitjacket for more defense and investment spending can correct these mistakes. While Germany's ratio of public debt to GDP may rise from 62 percent now to close to 80 percent in the ten years, Germany would remain miles below the debt ratios of almost all other advanced economies. But because its low-debt starting position was so different from that of its peers, Germany cannot and most likely will not serve as an example for other countries. For example, bond markets would not allow the United Kingdom or France to get away with similar increases in debt-financed spending. Ultimately, individual countries will themselves have to make the tough choices how to put their fiscal houses in order.



As long as France continues to be unwilling and unable to put its public finances in order, a eurozone common public debt market will remain a pipe dream.

PHILIPPE RIÈS
Former Chief Economics Editor and Tokyo and Brussels Bureau Chief, Agence France Presse

A quarter of a century after the birth of the euro, the European Union has yet to create properly integrated financial markets. The so-called banking union is little more than a regulatory framework, with not much to regulate. National governments, most recently Germany, continue to resist cross-border mergers between large financial institutions.

The end result of this fragmentation and shallowness is well documented: the huge pool of European savings is financing growth and innovation elsewhere, especially in the United States.

As I argued back in 1998 in my book about the Asian financial crisis (*The Asian Storm*), modern financial markets were born out of the necessity to finance exploding budget deficits and growing public debts. In other words, the ensuing "financialization" of the global economy—with the (limited) benefits and massive negative consequences (financial crises, runaway asset inflation, growing inequalities with serious social and political implications, declining productivity, and so forth) that came with it—has been the result of public policies. Critics of free-market thinking and private institutions have been barking up the wrong tree.

By failing to embrace the global financial trend at the Community level, the European Union has been experiencing its negative consequences without benefiting from its advantages. True, every recent exogenous shock, from the Great Recession (made in America) to the Covid-19 pandemic (manufactured in China), has triggered calls to address the issue, sometimes followed by the creation of strictly dedicated and limited common borrowing operations.

But overall, the European Union continues to operate on an extremely meager budget (1 percent of the area's GDP) and without an integrated common public debt market.

The problem, of course, is that while the cause of creating such a market of "EU Treasuries" (or EU-Bonds) is more than justifiable and necessary, its most vocal advocate, France, has been the wrong one.

For the past fifty-one years, the French Republic has never achieved a balanced budget, while becoming the developed world's record-holder in terms of taxation and public expenditure. The public debt-to-GDP ratio, at 115.6 percent, continues to rise, while it is stable or declining in other long-time delinquents of the so-called "Growth and Stability Pact" such as Italy or Greece. At €3,400 billion, a new but ephemeral record, the public debt stock requires €300 billion in financing in 2025. The budget deficit this year will amount to a staggering 44.7 percent of the French state's overall revenue, a ratio much more telling than the usual reference of 5.4 percent of GDP. In short, France has become a free rider in the eurozone.

Until now, unlike, for example, Italy during the sovereign debt crisis of 2011–2013, the French inept ruling *nomenklatura* has benefited from the bizarre complacency of the European institutions. Since November 2003 and the nighttime coup engineered by the German and French governments against the late Pedro Solbes, then European commissioner for monetary affairs, we have known that the Pact is as good as dead when it comes to the so-called Big Countries. France, the second-largest economy in the eurozone, is obviously deemed "too big to fail."

The question is: for how long? With the current political instability reigning in Paris (a new government lasted … fourteen hours), markets have finally started to notice. France's borrowing cost is now higher than that of any other member state of the eurozone, including Italy. Even the usually sleepy rating agencies have opened an eye. Recently downgraded, France is now rated a notch above Portugal.

In conclusion, as long as a key player like France continues to be unwilling and unable to put its public finances in order, the creation of a eurozone common public debt market will remain a pipe dream. Unfortunate but understandable.

Europe must embrace a new organizing principle: speed over perfection.

PIROSKA NAGY MOHÁCSI
Visiting Professor, London School of Economics and Political Science

Europe has entered an age of truly hard choices. For the first time since its creation, the European project faces existential threats on multiple fronts—and at the same time, a historic opportunity to upgrade its role in a transformed world.

Russia's imperial war at the European Union's border has destroyed post-Cold War complacency. The U.S. security umbrella—once unquestioned—now looks conditional and thinner. Inside Europe, anemic productivity and divergent fiscal paths erode competitiveness and cohesion. Outside Europe, geopolitical shocks are rewriting the rules and institutions of multilateralism that existed since the Second World War.

Yet this is also a moment of immense possibility. Europe can re-emerge as a full geopolitical actor, grounded in its own values and capabilities. It can turn the euro into a global currency that rivals the dollar. And it can build a coalition of the willing—a community of democracies defending the rule of law and due process against the rising tide of authoritarian assertiveness.

To seize this moment, Europe must abandon incrementalism and embrace a new organizing principle: speed over perfection. It needs to also accept that key sovereign member states are strong and have better leadership capacities than Brussels. The founding generation of Monnet and Schuman built Europe through bold, pragmatic leaps—not endless coordination rounds without clear leadership. The same spirit must return.

Four priorities stand out. First and most obvious, finish the European Single Market project. It is disheartening to see evidence of still-significant internal barriers to trade and finance that the International Monetary Fund has repeatedly pointed out. Some progress has been made, particularly in implementing the recommendations of the Draghi and Letta reports, but this has been too slow. Also, use a combination of carrots and sticks to incentivize (with subsidies) and penalize any national blocking of cross-border mergers, such as the so-far frustrated takeover of the German

Commerzbank by Italian bank Unicredit. Europe needs to allow the creation of European champions.

Second, consolidate Europe's fiscal backbone. As long as there is no meaningful central fiscal authority, Europe should use more "back-door federalism," building on the model of NextGenerationEU funds or the European Stability Mechanism. This clearly requires more EU bonds to finance new EU priorities, whether simply "joint" or "joint-and-several" obligations where each EU member is jointly and individually responsible for the underlying debt issue. These EU bonds would finance specific cross-border projects, not a general EU budget, for which there is little political appetite. Markets seem to be interested in such safe assets.

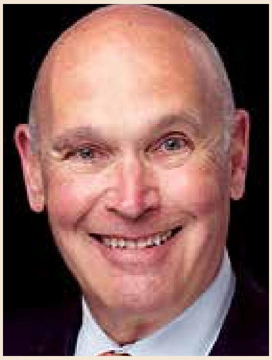
Just as important, market signals should be allowed to operate fully on sovereign bond markets in the euro area. Today they are not. Country risk premia are *de facto* capped by ECB lending facilities such as the Transmission Protection Instrument. Supposedly an "anti-fragmentation" tool, it allows for the (threat of) the European Central Bank limiting what it considers "unwarranted, disorderly" country risk premia. Yet this undercuts market signals on country risk and amounts to large contingent assets and liabilities among euro area countries. They increase the risks of fiscal profligacy. In the end, country risk premia that reflect real fiscal positions do not undermine but strengthen the Single Market through powerful market feedback on member states' fiscal positions.

Third, accelerate Europe's rearmament and link it to the growth agenda. As I argued earlier on these pages, the model should be high-tech–led military and human development. To achieve this, joint procurement and shared capabilities, and a European Defence Fund that is large enough to matter, are the optimal choices—but nation-based jump-starting such as in Germany that has ample fiscal space should also be encouraged.

Finally, fourth, mobilize the euro as a source of geopolitical and economic power. Politicians seem to forget that the euro is uniquely popular across the continent. Eighty-three percent of residents support the euro, according to the latest Eurobarometer poll. Populations of countries that at some point faced the risk of falling out of the euro area (Greece but also Portugal and Spain) or not being able to join it (the Baltics) consistently opted for often painful economic adjustment to avoid such predicament. Bulgaria will finally adopt the euro in 2026 after a complex political economy journey since 1997.

The euro is Europe's ultimate economic and political integration tool, and it is time for politicians to leverage its popularity for the success of the European project. Moreover, a "Global Euro" (and digital at that) beyond the continent would further strengthen the European project with tangible benefits, as ECB President Christine Lagarde has recently laid out.

"Whatever it takes" once saved the euro. Today, we know what to do. Today, speed is of the essence.



The European Union needs to move forward and quickly on utilizing EU-Bonds.

FRANCIS J. KELLY

Founder & Managing Partner, Fulcrum Macro Advisors

The questions of whether the European Union can and should pursue greater reliance on EU-Bonds are particularly timely, as the European Union truly grapples with taking the steps necessary for a more robust common defense and greater competitive capabilities. To date, there is clearly an appetite among financial markets for them as well. Indeed, a new €175 billion double-tranche was issued on October 8, bringing the overall market size to more than €650 billion. I would argue that the successful placement alone answers the question of whether EU-Bonds are good for liquidity in the European financial markets.

However, to the broader question of the European Union more robustly using EU-Bonds (and settling the questions and challenges around the EU Treaty's Article 25), it really can only be answered after other more challenging questions are first answered regarding EU leadership. First, are EU leaders truly committed to making the structural changes needed to meet the challenges Mario Draghi outlined in his competitiveness report? And second, who within the European Union is capable of successfully championing the expanded use of EU-Bonds?

Arguably, the answer to those two questions is "yes, sort of" and "no one" respectively. At the time of this writing, the "Big Three" of the EU power structure—European Commission President Ursula von der Leyen, French President Emmanuel Macron, and German Chancellor Friedrich Merz—are besieged by weak economic outlook reports and growing domestic political challenges (or in the case of von der Leyen, two more no-confidence votes from the EU Parliament—the second round of the year).

Meanwhile, Chancellor Merz—who wisely achieved relief from the debt brake—is now grappling with anemic growth projections for 2026, anticipated to come in around 0.2 percent with industrial production having dropped to 2005 levels. At the same time, the far-right AfD party's poll numbers are rising to new heights. Fortunately, the economic outlook is likely to change mid-year 2026, with significantly healthier growth projections for 2027 and beyond.

As for President Macron and France, it seems only a matter of time before new parliamentary elections are called, with a serious risk that Marine Le Pen's National Rally Party will finally break through and win a parliamentary majority—an event that will have massive fiscal and market ramifications for France, which will bleed over to the rest of the European Union.

So for the near term, it would appear nearly impossible for Merz, Macron, or von der Leyen to lead the charge for greater use of EU-Bonds, meaning the best hope may be the emergence of a broader coalition of EU leaders making the case for a more robust EU bond market.

But the bottom line is the European Union needs to move forward and quickly on utilizing EU-Bonds more broadly. The global competitive gap is growing by the day. And Russia is proving to be increasingly aggressive and volatile toward EU/NATO nations. All current political and economic challenges aside, the European Union will only lose by not pursuing a broader EU-Bond marketplace.

With the far-right on the march in Germany, it is wishful thinking to believe that France will be bailed out by a large Eurobond issuance.

DESMOND LACHMAN
Senior Fellow, American Enterprise Institute

France, whose public finances have become unsustainable and whose politics have become dysfunctional, could pose an existential threat to the euro. As the eurozone's second-largest economy and being many times the size of Greece, France is too big to fail if the euro is to survive. However, by the same token, it is far too big to bail, at least without IMF-like conditions being attached to such lending.

According to the International Monetary Fund, France's budget deficit is likely to remain at around 6 percent of GDP for as far as the eye can see. That is set to take the country's public debt-to-GDP ratio to a Greek-like 128 percent by 2030. With taxes and public spending as high as 51 percent and 57 percent of GDP, respectively, France has little option but to cut public spending if it is to regain public debt sustainability.

There is no political appetite for France to rebalance its budget. Both the far-left and far-right parties, which dominate the French Assembly, are opposed to budget belt-tightening. There also appears to be little prospect that the Assembly's composition will change very much in the event of an election.

The other reason to doubt that the budget deficit will be corrected is that France is stuck in a euro straitjacket. That straitjacket precludes France from using exchange rate depreciation or monetary policy loosening as an offset to the contractionary effect of budget belt-tightening. This implies that even if France had the political will to correct its budget deficit, trying to do so would likely precipitate a French economic recession that would erode its tax base.

With the far-right on the march in Germany, it is wishful thinking to believe that France will be bailed out by a large Eurobond issuance. The country's only real hope is an ECB bailout. However, given the large amount of French government bonds that the European Central Bank would be required to buy, it is unlikely to would do so without attaching conditionality that would currently be anathema to France's political class. It is difficult to see how France will avoid an economic crisis next year that could have economic ripple effects across world financial markets.

The underlying aim is to suck capital out of the United States, raise U.S. interest rates and unemployment, and "force Washington to the negotiating table."

BERNARD CONNOLLY
Author,* The Rotten Heart of Europe: the Dirty War for Europe's Money *(1996) and* You Always Hurt the One You Love: Central Banks and the Murder of Capitalism *(2024)

What are the EU-Bonds now being advocated by the European Commission intended to achieve? On one level, the answer is straightforward: the Commission's overriding objective is, as always, to increase its own prestige and unaccountable power. A former member of the ECB board, Lorenzo Bini-Smaghi, once commented that EU-Bonds with joint and several liability would ultimately entail transfers of sovereignty and the extension of EU "competence" to ever-more numerous areas. Now, the desired end-point of the proposed issue of EU-Bonds for defense procurement is clearly the creation of a European superstate (one can note that every step towards "more Europe" over the past thirty-odd years has been accompanied by a worsening of the relative economic performance, diplomatic significance, and defense capability of the European Union).

Is there an even more fundamental motivation? Proponents of EU integration used to say that it was intended to prevent "a third European civil war." It would have been more accurate to say that it was intended to reverse the result, as perceived by Western European elites, of the World War II: "Anglo-Saxon" hegemony. One of the fathers of the euro, Philippe Maystadt, said that its purpose was "to prevent the encroachment of Anglo-Saxon values in Europe." When Britain fell into the clutches of the European Union, that country's subjugation and humiliation were seen as a triumph by the European elites—hence the fury and anguish when Britain escaped. But the major target is the United States. There can be little doubt that while public advocacy of EU-Bonds is in terms of improving liquidity and bond-market efficiency, the underlying aim is to finally bring to fruition what a former high French official set out as an objective of the euro area: to suck capital out of the United States, raise American interest rates and unemployment, and "force Washington to the negotiating table" on global economic relations. That is not a uniquely European outlook, as U.S. President Donald Trump has made clear in his words and actions. EU-Bonds might soon be overtaken by a stablecoin arms race, as competing blocs strive to create demand for their own bonds as backing. But the United States is not just a bloc. It is a country. "Europe" is not.

For forty-five years after the war, "Europe" had no choice but to accept American hegemony. The fall of the Soviet Union then allowed the proponents of a European superpower to make their intentions more explicit. Now, the external threat from Russia and China is seen as requiring not greater cohesion in the West but the eradication of national sovereignty in Europe. Economics and finance—French financial difficulties—and the rise of the AfD in Germany obtrude. The key question for EU-Bonds is whether a desire of the Commission and its allies to elevate themselves can overcome the reluctance of Germany, the Netherlands, and the newer EU members to be on the hook for France in particular. The struggle could be played out in the differing motivations of the European Court of Justice with its *certaine idée de l'Europe* on the one hand, and the German Constitutional Court—which may fear putting more wind in AfD's sails—on the other.

France and Germany are addicted to debt, jeopardizing the credibility of the euro.

GUNTHER SCHNABL
Director, Flossbach von Storch Research Institute, and Professor of Economic Policy, Leipzig University

France and Germany, the euro core countries, are addicted to debt, jeopardizing the credibility of the euro.

In France, Prime Minister Bayrou was ousted as he attempted to tackle the €180 billion budget deficit. Government debt stands at 114 percent of GDP, far beyond the 60 percent Maastricht limit. Noticeable consolidation is not in sight.

In Germany—for a long time the monetary and economic anchor in Europe—government debt is still at 62 percent. Yet its fiscal debt brake was softened, with debt possibly approaching 100 percent of GDP within ten years.

Whereas macroeconomic stability was long seen as the fundament of the European Union, sentiment is changing towards what the Germans call *Schuldenunion*—"debt union."

France, which has fulfilled the Maastricht government debt limit of 3 percent of GDP in only eight of twenty-six years of euro membership, demonstrates the European Union's inability to fulfill its task of controlling and curbing public debt of member states.

Moreover, although the EU budget is required to be balanced according to Article 310 TFEU, Eurobonds seem to become the new normal, possibly with the justification of financing common defense. Eurobonds are politically convenient, because they do not directly require national parliamentary approval—and do not increase the officially calculated national debt levels. NextGenerationEU, which has helped to stabilize the euro via large transfers to Italy and Spain—and soon to France?—is the blueprint.

Since the birth of the euro, a high degree of heterogeneity within the euro area implied a persistent pressure on the European Central Bank to keep—"whatever it takes"—the euro together with the help of unconventional monetary policy tools.

With supranational borrowing unlikely to reduce national borrowing, pressure on the European Central Bank to buy national government bonds will persist. Since 2022 the Transmission Protection Instrument allows the

European Central Bank to buy unlimited amounts of government bonds from countries experiencing "unjustified" yield increases.

Central bank financing of government debt is likely to be established additionally on a supranational level, as the European Central Bank has supranational bonds (EIB, ESM, EU) already on its lists of eligible securities.

Former and current ECB Presidents Mario Draghi and Christine Lagarde have stressed that a common EU safe asset would strengthen the international role of euro.

Yet even more debt is more likely to undermine the trust in the euro, while the Transmission Protection Instrument undermines the disciplinary function of capital markets.

The EU Taxonomy, that is, the classification of corporations according to environmental and climate criteria to serve as a basis for bank lending, is an additional recipe for boosting capital flight.

The fast-growing wealth in Western Europe after World War II was based on currency competition between the hard German Mark and the soft southern European currencies, which pushed the German economy into ever larger productivity increases.

But with Germany's monetary hegemony being broken and with the euro being transformed into a soft currency, the golden goose got slaughtered.

European policymakers should become aware that only a hard euro can finance their ever-larger spending requests without disruptions caused by inflation.

Europe's fiscal challenges are serious but nuanced.

NEIL SHEARING

Group Chief Economist, Capital Economics

Getting to grips with Europe's fiscal challenges means answering three straightforward but vital questions: which countries are most fiscally vulnerable, what might trigger a crisis, and how damaging would one be if it arrived?

Let's start with who's most at risk. Some commentators have suggested that Germany's decision to ease its constitutional debt brake is the thin end of a long and dangerous wedge. This is nonsense. Yes, Berlin's budget deficit is large by its own standards and the debt ratio has risen. But the idea that Germany is on a slippery slope to fiscal ruin misunderstands the nature of the problem. The planned fiscal expansion will not materially affect Germany's long-term fiscal outlook. Moreover, the country's private sector savings surplus remains huge, ensuring a sizable current account surplus. Far from living beyond its means, Germany continues to live comfortably within them—arguably too much so. The real fiscal headaches lie elsewhere.

Italy's bond markets have been calm of late, but its debt burden—north of 140 percent of GDP—remains a standing invitation for trouble. Yet the more immediate source of fiscal risk lies in France. The French state is large, the deficit substantial, and successive governments have repeatedly failed to enact credible plans to put the public finances on a more sustainable footing. Investors have so far granted Paris the benefit of the doubt, but patience is not limitless. France, not Germany, is the country to watch.

What, then, could light the fuse? There are two broad types of triggers. The first is economic in nature—a sharp slowdown in growth or a banking crisis that swells public liabilities. The second is political—a shift in government or political leadership that leads markets to reassess a country's fiscal trajectory. While the former can never be ruled out (who foresaw covid?), the bigger danger at present looks political. France is now on its fourth government in just over a year. The steady churn of prime ministers has fostered the sense of a political system unable to take tough decisions. Meanwhile, populist forces promising easy fixes are gaining strength. If Europe experiences another bout of fiscal stress, politics, not economics, is likely to be the culprit.

Finally, what about the fallout if things do go wrong? Here, there are reasons for measured optimism. Fiscal strains will undoubtedly weigh on growth in the affected economies—France in particular—but comparisons with the euro crisis of the early 2010s are overdone. French banks have limited exposure to their own sovereign debt, reducing the risk of a destructive "doom loop" between banks and the state. The European Central Bank, too, has both the tools and the willingness to counter contagion to the rest of the region. And unlike in the crisis countries a decade ago, France's external position is broadly balanced; there's no fundamental need for a painful adjustment in domestic demand.

Europe's fiscal challenges are therefore serious but nuanced. The continent is not on the brink of another existential crisis for the single currency, but several countries still need to take credible steps to stabilize their public finances. Unlike in the 2010s, this now includes large and systemically important economies such as France. For the moment, markets are accommodating: there has been no sign of a buyers' strike in bond markets and borrowing costs remain manageable. Yet this benign environment will not last indefinitely. If politicians fail to push through the fiscal correction that is necessary over the medium term, markets will eventually do the job for them—and far more brutally.

The strategy boils down to transferring French sovereignty up to the European level, and most certainly plays with fire.

BRIGITTE GRANVILLE
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The point of such warnings is precisely to scare. The message boils down to saying: if we don't put our own [fiscal] house in order, we shall be forced into the humiliation of outsiders dictating conditions to us in return for financial rescues. In the Greek crisis of 2009–2015, that "external administration" turned out to be the "troika" of the International Monetary Fund, the European Central Bank, and the European Commission.

French Minister of Economics and Finance Éric Lombard's version of this scare tactic was particularly explicit: necessary fiscal retrenchment is painful, but the pain will be worse if the public finances are allowed to deteriorate further, with the painful measures imposed by external actors. Injury added to insult, as it were.

On the face of it, therefore, this warning is also about loss of sovereignty. The plausible version of this scenario in the United Kingdom would see bond market vigilantes forcing the government to tighten its present self-imposed fiscal rule. In France, by contrast, there is a latent hypocrisy about the scare tactic.

Fiscally challenged countries that are part of Europe's monetary union have no need for IMF funds even if the IMF had sufficient resources for the purpose. The ECB has unlimited capacity to intervene in bond markets to ensure that governments can continue to service their ballooning debts at a sustainable rate of interest. In the last resort, the European Stability Mechanism can act like the eurozone's in-house IMF to provide direct bailouts. The present cap on ESM interventions of €500 billion could easily be increased, and the ESM's capital market funding in effect amounts to "federal" obligations of the European Union much like the EU-Bonds issued to fund the NextGenEU fund set up during the covid pandemic.

In principle, such support from eurozone institutions comes with conditions in the same way as an IMF program. The present implicit understanding in the eurozone is that if the European Commission approves a member state's budget plans, then the ECB has the political cover to use its various intervention tools at will. Ever since instigating the monetary union thirty-five years ago, the French ruling establishment has dreamed of tapping European "federal" resources at no cost. Since France is indispensable for the continuation of the European project to which Germany and others are existentially committed, any conditions imposed on France will be symbolic. Now France favors large-scale new issuance of EU-Bonds to finance the rearmament that is beyond its own means.

The strategy boils down to transferring French sovereignty up to the European level which Parisian officials would somehow continue to control as if Europe were just a larger France. This strategy most certainly plays with fire—the fire in question being a backlash, possibly from other European countries, but increasingly likely from within France itself.

With Germany's open defiance of fiscal rules, it will become much harder for the Commission to commit member states to prudent fiscal policies.

MORITZ KRAEMER
Chief Economist and Head of Research, LBBW Bank

The most consequential change in European fiscal policy in recent years was the sweeping about-face of Germany's new coalition with respect to the strict constitutional debt brake. In fact, it was less a reform of the debt brake than trashing it altogether. Berlin now forecasts federal deficits of 3.5 percent or more until the end of its legislative term in 2029. And whereas habitual deficit offenders like Italy or France at least pretend to aim for the Maastricht deficit ceiling of 3 percent of GDP, Germany is unabashedly transiting from being a fiscal saint to sinner.

The government's likely struggles to scale up planned investments and defense spending due to supply constraints offer only small consolation. The genie is out of the bottle. There is now no counterweight to deficit-prone governments elsewhere in Europe.

The €500 billion special fund, or *Sondervermögen,* for infrastructure investment is not the core problem. For this purpose, the federal government is borrowing a bit more than 1 percent of GDP each year. Given the parlous state of Germany's infrastructure, this seems justifiable. Investments like these can enhance the economy's growth potential over the medium term, thereby increasing tax revenues to service the debt. The larger share of new debt, however, stems from the federal core budget, where the surge in defense spending is located. Defense expenditures are consumptive in nature: they do not generate cash flows that could be utilized to service these loans. Indeed, Germany's Federal Budget Code unambiguously excludes military expenditures from the investment definition. Debt-financed military spending is a misguided and generationally unfair approach.

The recently passed 2025 federal budget sends a worrying signal. Even the much looser debt constraints were circumvented. When last spring the outgoing Bundestag hurriedly amended the constitutional debt brake, it decided that the "special fund" for investment, financed through additional borrowing, must finance exclusively new investments, not those previously planned. To avoid merely shifting regular, pre-planned funding into the special fund, an "additionality" requirement was enshrined in the constitution. However, the wording of the constitutional article is rather wishy-washy: "Additionality exists when an appropriate investment ratio is achieved within the federal budget for the respective fiscal year." But what exactly is "appropriate"?

From the point of view of Chancellor Friedrich Merz's government, the budget plans proposed by the collapsed "traffic-light coalition" evidently featured "inappropriately" high levels of investment. His coalition government is funneling funds away from investment-oriented expenditures toward higher levels of current spending, especially for social programs. Magically, the curtailed capital expenditures reappear within the debt-financed infrastructure special fund. With these barely concealed accounting gimmicks, the government undermines the constitutional additionality requirement. This sleight-of-hand drives national debt upward while shifting the fiscal burden onto future generations.

With Germany's open defiance of European fiscal rules, it will become much harder for the Commission to commit member states to prudent fiscal policies. At least we can still count on Germany to resist a move towards more joint issuance of Eurobonds, the ultimate free-for-all "solution."

Given the high level of U.S. government debt, a deep, liquid market for safe EU bonds could provide an opportunity for international investors to diversify risk.

JOSEF BRAML

European Director, Trilateral Commission, and co-author,* World to Come: The Return of Trump and the End of the Old Order *(2025)

Europe is undergoing a profound transformation in its fiscal architecture, shifting its fiscal and debt management strategy—particularly through the expanded use of EU-Bonds, and broader liquidity efforts. The success of this strategy hinges on maintaining investor confidence, ensuring fiscal discipline among member states, and clarifying the legal status of EU-Bonds. If managed prudently, these moves could strengthen Europe's financial sovereignty and global competitiveness.

The European Commission plans to issue approximately €160 billion in EU-Bonds in 2025, continuing its unified funding approach that began in 2023. This marks a significant expansion from previous years, with €138 billion raised in 2024, making the European Union the fifth-largest global issuer of green bonds. These funds support initiatives like NextGenerationEU, Ukraine aid, and macro-financial assistance to Egypt and Moldova.

This surge in EU-Bond issuance reflects a broader ambition: to create a deep and liquid Eurobond market that can rival U.S. Treasury markets and bolster Europe's strategic financial autonomy. The rationale is clear—amid geopolitical tensions and rising defense spending, Europe needs robust financial tools to fund its ambitions without relying excessively on external actors.

The European Union's efforts to professionalize its capital markets—including the launch of EU-Bond futures via Eurex—could enhance liquidity and attract institutional investors. This would help reduce borrowing costs and improve the European Union's financial resilience, especially as defense and climate-related expenditures rise.

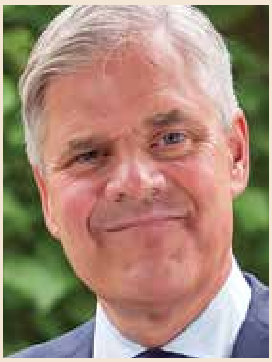
Furthermore, European markets are likely to serve as a secure environment for investors, whereas the United States may lose its "safe harbor" status under President Donald Trump.

U.S. finances are heading like a big ship towards a dangerous fiscal iceberg. With a national debt of over US$37 trillion and the significant refinancing risks looming for 2025, the United States is sailing into turbulent fiscal waters: $9.2 trillion in U.S. debt is due in 2025, a quarter of the country's total debt. Many of these loans were taken out cheaply, but now have to be refinanced at a higher cost, and this significantly increases the pressure on the bond markets. The United States needs foreign investors to extend its existing bonds and place new bonds. A decline in demand can lead to an increase in yields.

Credit rating downgrades and higher yields on U.S. Treasuries already indicate some uncertainty in the markets. Many economists fear that the United States will lose its safe haven status under Trump. A rising gold price already reflects investors' distrust of the dollar. If the United States is seen as politically unstable, it could affect the dollar's role as a reserve currency and shift capital flows to more stable countries.

Given the high level of U.S. government debt, a deep, liquid market for safe EU bonds could provide an opportunity for international investors to diversify risk. This would give the option of investing capital in euro-denominated bonds instead of U.S. Treasury bills.

Rather than allocating foreign exchange reserves to U.S. bonds, European countries and investors should specifically strengthen their own currency, security, digital infrastructure, and future technologies in order to arm themselves for the increasingly fierce geoeconomic competition.



Europe is not inevitably playing with fire.

ANDREAS DOMBRET

Global Senior Advisor, Oliver Wyman, former Member of the Board, Deutsche Bundesbank, and former Member of the Supervisory Board, European Central Bank

Europe is at a crossroads once again. After decades in which fiscal discipline, epitomized by Germany's "debt brake," anchored investor confidence, a new willingness to accept larger public deficits is emerging in Europe. This is taking place just as EU member states confront costly strategic priorities: rearmament, the green transition, and post-pandemic repair. Germany, for example, has taken the bold decision to use its fiscal space for a much-needed €1 trillion investment in defense and infrastructure.

The result is a renewed European push for supranational financing, potentially including expanded issuance of EU-level bonds. A sober assessment must weigh the tangible opportunities against equally real risks.

It is true that Europe's fiscal landscape is marked by mounting debt in several member states. By mid-2025, the European Commission had activated Excessive Deficit Procedures for multiple nations, indicating that fiscal deficits remain a challenge. Debt-to-GDP levels in countries such as Greece (~154 percent), Italy (~136 percent), and France (~113 percent) are responsible for renewed debt sustainability concerns.

There is no doubt a well-designed euro-denominated benchmark could improve market acceptance of EU sovereign debt. Large, liquid EU bonds offer investors a clear, tradable claim that could reduce fragmentation across national markets, compress financing costs for smaller issuers, and deepen Europe's capital markets. The launch of EU bond futures and the growing stock of EU-backed paper—already substantial—point to demand for a cohesive euro asset class and could support better price discovery and hedging that banks, pension funds, and asset managers need.

Yet the appeal in principle of joint issuance cannot obscure legal and incentive problems. Under current Treaty arrangements, the Union lacks broad taxing authority and cannot straightforwardly assume sovereign debt; member states remain ultimately liable for many EU-backed instruments. We do not yet live in a "United States of Europe." And Article 125's "no bail-out" clause casts a long shadow over any arrangement that risks implicit mutualization of sovereign liabilities. If common bonds are perceived as a backdoor bailout, moral hazard would no doubt intensify. National authorities might delay difficult reforms, reassured that a supranational floater cushions markets. That would weaken, not strengthen, the euro area's fiscal resilience.

There are also market structure dangers. Creating a new instrument does not guarantee liquidity. Without concentrated, predictable supply, without primary dealer support, and without derivatives to facilitate hedging, EU bonds could be thin and volatile in stress episodes, amplifying fragmentation rather than alleviating it. And politically charged perceptions of cross-border risk-sharing could prompt litigation and fractious domestic politics, further unsettling investors.

This is not an argument rejecting supranational finance out of hand. Rather, it is a call for realism and a very disciplined design. Credibility rests on four pillars: a clear legal basis for issuance; strict limits on purpose and scale—for example, financing agreed for Europe-wide public goods such as joint defense procurement or green infrastructure; robust conditionality and close surveillance to preserve national incentives; as well as market plumbing that ensures genuine secondary liquidity, including futures and market-making arrangements.

If all those conditions are met, and if the political will can be secured in all member states, EU bonds could be a constructive complement to national financing. Such financial instruments would deepen markets, lower systemic fragmentation risk, and help finance transnational investments that no single state can efficiently provide. If they are pursued as open-ended mutualization without legal clarity or without fiscal safeguards, however, they will deteriorate Europe's sovereign credit architecture and provoke the very market stress they aim to prevent.

Europe is not inevitably playing with fire. European policymakers can well try to turn a combustible moment into constructive reform by pairing joint instruments with institutional strengthening, transparent governance, and hard constraints on use. Let's not forget that Europe reacted well, united, and swiftly during the covid pandemic. Done in the right way, joint EU bonds could be an instrument of integration and resilience. Done poorly, they would be a costly experiment in fiscal complacency. As usual, the proof is in the pudding.

Europe's policymakers will clear the path for public investment and, as a bonus, a deeper and wider financial system.

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Europe's policymakers are playing with fire, a fire that will clear the path to a more economically enlightened emphasis on public investment and, as a bonus, a deeper and wider financial system.

Europe is moving past the Stability and Growth Pact script that members pledged allegiance to soon after the November 1, 1993, official formation of the European Union. That script focused single-mindedly on reducing deficits and debt, for understandable reasons. However, it took a toll on public infrastructure. The new script looks to ambitious investments in military, transportation, and environmental infrastructure, and will affect four areas. First, it will make Europe more self-sufficient militarily, sharing the burden with the United States of promoting geopolitical stability. Second, it will improve the living standard of its citizens, which has fallen from the U.S. level in the past twenty-five years, owing to immigration headwinds, the European Union's enlargement (Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia in 2004, Bulgaria and Romania in 2007, and Croatia in 2013), and struggles in the core (Germany's living standard has dropped to 64 percent of the U.S. level from 70 percent at the turn of the millennium, France's to 58 percent from 66 percent, and Italy's to 50 percent from 65 percent). Third, it will promote continued economic integration of the European Union's unique historical experiment, and finally, it will expand markets for international trade partners.

Germany is taking the lead. The March 2025 constitutional reforms that released Germany's fiscal brake (*Schuldenbremse*)—a 2009 political agreement promising strict constitutional limits on government spending that aimed to keep its structural deficit no higher than 0.35 percent of GDP and to prohibit new net debt for the federal states—include ambitious infrastructure investment in transportation, military, and the environment. [The release of its fiscal brake followed a failure to repurpose temporary (2020–2022) emergency pandemic funding. That in turn forced an unacceptable re-engagement of the pre-pandemic fiscal brake and triggered a collapse of the governing coalition.] Germany's ambitious investment agenda will jump-start one of Europe's important economic engines and break the ice for others. The new script is economically sound, because it will reverse the toll on public infrastructure left by the stark gap between the political calculus (deficit constraints) that guides public investment and the economic calculus (weighing benefits versus costs) that guides private investment. Commuters, and not just Germans, know about this. But the benefits of greater military self-sufficiency, continued integration of the European Union, and improved environmental quality, although difficult to calculate, are far greater than the easier-to-calculate cost of congested transportation grids.

Europe's ambitious investment agenda will expand its "external" financing needs, with the European Union's 40 percent of GDP tax burden high. That will lead to greater use of EU-Bonds. For sure, EU-Bonds embody different risks than traditional sovereign debt. First, the European Union has limited scope to generate its own revenues (this may change down the road). Second, EU member states bear responsibility jointly and severally (each country individually is responsible for the entire amount of debt) and that will place a greater burden on one or more of the members that can be made responsible if weaker members are unable to honor their obligations. Also, the "no bail-out" clause of Article 125 of the EU treaty is an issue. But these challenges are no different than the usual menu of risks that investors must assess and that get reflected in risk premiums.

At the end of the day, an increased dependence on market sources of financing will prove to be the jewel in the crown of Europe's new script, duplicating benefits that a parallel evolution of finance in the United States since the 1970s, including the rise of securitized finance, have delivered. A deeper and broader financial system lowers credit costs, broadens access to credit markets, accompanies more checks and balances on consumer and business activities, promotes greater risk diversification, and delivers better tools for managing and monitoring risk. Infrastructure investment activities—both public and private—that give greater deference to market signals promote transparency and bring about better alignment of benefits and costs that tend to be missing in investment decisions that are guided by a political GPS.

Europe's evolution will write a new chapter that will strengthen the economic vitality of the region, with benefits for its trade partners.

EU member states may need to move towards fiscal union.

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EU member states and their citizens know that they may need to move towards fiscal union. They are extremely reluctant to do so, however, unless forced by imperative necessity. The NextGenerationEU program was a major step in the direction of fiscal policy integration, with unprecedentedly large amounts of borrowing by the European Commission on behalf of the European Union and redistributive impact among member states. But it was decided in late spring 2020 in a context of massive uncertainty as to how the Covid-19 pandemic would impact European economies and financing conditions. By contrast, financing conditions for EU countries are now rather favorable, as global investors seek to diversify some of their exposures away from the United States. Even France, despite its longstanding fiscal drift and acute moments of political crisis, has hardly had to increase the remuneration it pays investors for its debt.

The European Union's steadfast support to Ukraine's fight against Russia represents a growing and inescapable financial commitment. The European Union is now trying to meet it with a smart scheme to leverage the idiosyncratic situation generated by the immobilization of about $200 billion of Russian assets at Euroclear Bank. If that does not work, if other crises create new large-scale financial needs, or if financial conditions become less benign, then it is likely that the European Union will at least revive the NextGenerationEU template. Given European public opinion's awareness of the need for common defense, it is not impossible that in the medium term it may go further by moving closer to a genuine fiscal union. That would require the ability to raise revenue on a European scale—what the Brussels jargon euphemizes as "own resources," or in plain English, euro-taxation. It may require changing the EU treaties, a process fraught with political uncertainty, and would in any case entail resolving difficult tradeoffs for national leaders of EU countries. Over the long term, however, it is far from clear that the European Union will have alternative options. ◆