FRAGILITIES OF HIGHLY INDEBTED EU COUNTRIES

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Temporary improvements in debt sustainability risk a rude awakening

Debt sustainability is largely determined by growth, interest rates, and the primary balance. However, macroeconomic risks and contingencies, together with the capacity to resolve them, also affect markets' assessment of repayment capacity.

When sovereign debt tensions emerged in the euro area in 2010, member states had significantly lower debt-to-GDP ratios than they do today – in some cases below the 60% threshold. Nevertheless, the euro area's institutional architecture was ill-equipped to handle the impact of the large-scale unwinding of imbalances accumulated in the run-up to the global financial crisis. As market sentiment deteriorated, flight-to-safety dynamics exposed the vulnerabilities associated with external borrowing – even when the debt was denominated in the domestic currency.

Countries in a monetary union issue debt in a currency they do not control. Advanced euro area member states thus faced a situation resembling that of emerging markets under balance-of-payments pressure. They could not independently address capital outflows nor break the sovereign-bank feedback loop that ultimately brought five member states under the supervision of the Troika.

A decade later, the COVID-19 pandemic unfolded. Risk spreads of highly indebted countries surged in spring 2020 but were quickly stabilised by decisive ECB intervention. Average debt in the euro area jumped from 84% of GDP in 2019 to 97% in 2020, yet by the end of the year, risk premiums relative to German government bonds were lower than before the pandemic.

> The interest rate – growth differential will turn significantly less favourable.

Institutional developments have increased debt sustainability. Banking union has reduced sovereign-bank feedback loops, notably through common supervision, a resolution framework, bail-in-able capital, and the diversification of banks' sovereign bond portfolios. The ECB's toolkit was expanded by the Outright Monetary Transactions (OMT) programme in 2012, the Pandemic Emergency Purchase Programme (PEPP) in 2020, and the Transmission Protection Instrument (TPI) in 2022, creating the capacity to purchase, on an unlimited scale, debt securities issued by countries affected by market turbulence.

Macroeconomic vulnerabilities have also been reduced. Private indebtedness is lower than before the sovereign debt crisis, driven by passive deleveraging, stricter lending standards, higher capital requirements, and macroprudential policies to limit household borrowing. Current account deficits have been corrected in most cases and NIIPs have improved, reducing risks of sudden stops to capital flows. The composition of NIIPs is also more stable than in the past, with a higher share of non-defaultable instruments.

And finally, the interest rate – growth differential has been negative for some time, reducing the fiscal cost of public debt. Euro area member states continue to benefit from monetary accommodation between 2016 and 2022 via lower effective rates on outstanding debt and longer maturities; extending the time until higher market rates translate into higher effective rates. Moreover, most highly indebted countries have recorded solid growth in recent years, bolstered by substantial inflows from the Recovery and Resilience Facility. As a result, the share of GDP spent on interest rates is lower than in the 2010s, even as the share of debt to GDP is higher.

Still, the euro area lacks certain key characteristics of its global partners. The US dollar remains the dominant reserve currency, providing US Treasuries with a distinct funding advantage – despite increasingly unpredictable policy and a high level of public debt. Also, the US continues to post strong economic growth, driven by technological leadership in key sectors, which ensures a steady influx of foreign capital into equity and portfolio debt. With its own capital market underdeveloped, the EU plays a significant role in underpinning the US dollar's position in the global economy. Japan, by contrast, boasts a strong domestic investor base – a factor that also spared Italy from sharing the fate of other euro area countries.

While the key determinants of debt sustainability have moved in the right direction, some of these movements are temporary and create a false sense of security. The interest rate – growth differential will turn significantly less favourable as the funding advantage of the years 2016-2022 gradually fades from government debt portfolios. At the same time, ageing populations will increase budgetary pressures, while lower potential growth limits revenue growth. Positive interest rate – growth differentials cause debt to explode unless offset by primary surpluses. The EU's fiscal rules, by excluding interest rates from the expenditure benchmark, will likely miss a key element of debt dynamics going forward, holding the potential for a rude awakening.

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Debt markets are patient, not indifferent

Financial markets have shown remarkable tolerance towards rising debt levels in many advanced economies. Debt-to-GDP ratios that would once have triggered concern are now absorbed with limited market reaction. In the euro area, spreads remain contained despite weaker fiscal positions, slower growth and expenditure pressures linked to ageing, pensions, healthcare, climate transition, defence and digital transformation.

This apparent calm raises an important question: why are investors willing to finance indebted sovereigns at moderate risk premia, and what could trigger reassessment?

Part of the answer lies in the profound changes in the European institutional framework over the past fifteen years. The euro area today is not the euro area of the sovereign debt crisis. Governance, banking supervision, crisis-management tools and debt management practices have evolved. Markets recognise that self-fulfilling liquidity crises are less likely.

The European Central Bank has played a crucial role. Instruments designed to preserve monetary policy transmission and safeguard financial stability have reduced fears of disorderly market fragmentation. Investors do not necessarily expect intervention; rather, they draw confidence from credible backstops reducing tail risks.

Sovereign debt management has also become more resilient. Many European issuers entered the recent tightening cycle with longer average debt maturities, diversified investor bases and well-developed funding strategies. This has allowed governments to absorb higher interest rates gradually and reduced refinancing vulnerabilities.

Yet none of this means that markets have become indifferent to fiscal fundamentals. Markets are not complacent; they are distinguishing more carefully between liquidity risks and solvency risks. ECB backstops have reduced the former, but the latter remain ultimately determined by fiscal fundamentals, growth prospects and policy credibility.

Market tolerance is not unlimited; credibility remains the ultimate anchor.

Current pricing reflects confidence that governments will maintain sustainable debt trajectories. Investors may tolerate temporary deterioration when imbalances remain manageable and institutions credible. What markets reward is policy predictability, economic resilience and the capacity to adjust when necessary.

The more difficult question is not why markets are calm today, but what could cause confidence to change. Repricing rarely results from a single debt threshold. Markets do not react automatically when debt reaches a particular percentage of GDP. Instead, reassessments occur when debt concerns combine with weaker growth, higher financing costs, political uncertainty or doubts about institutions.

Several catalysts could trigger a sharper reaction. Persistent weak growth would undermine the denominator of the debt equation. Prolonged elevated interest rates could raise debt servicing costs faster than anticipated. Ageing-related expenditure, including pensions, healthcare and long-term care, may place sustained pressure on public finances, especially where potential growth is weak and reform momentum slows. Defence, climate adaptation and digital investment may intensify competition for fiscal space. Geopolitical shocks or financial sector stress could also lead investors to reassess sovereign risk. Above all, loss of confidence in a government's willingness or ability to implement corrective policies could rapidly alter sentiment.

Some observers argue that ECB backstops, more flexible fiscal rules and strong market demand may reduce incentives for adjustment. This concern should not be dismissed. Institutional safeguards can create a perception that financing conditions will remain favourable regardless of underlying fiscal dynamics.

However, fiscal discipline has not become irrelevant. The reformed European fiscal framework places greater emphasis on national ownership, medium-term planning and debt sustainability. Its success will depend on national implementation, enforcement and political ownership. If applied credibly, it can help identify risks and guide corrective action before crises emerge.

The real challenge is maintaining willingness to act while market conditions remain favourable. Consolidation is easier when undertaken gradually and proactively than when imposed by market stress. Governments should view periods of confidence as opportunities to strengthen resilience and rebuild buffers, not as justification for postponing adjustment.

There remains, therefore, an effective discipline mechanism in the euro area. Markets may react more gradually than in the past, but debt sustainability constraints have not disappeared. Markets, fiscal institutions and European governance mechanisms continue to signal when debt trajectories become unsustainable. Policymakers should not wait for those signals to become crises.

Market tolerance is best understood as confidence earned through credibility, not as a permanent guarantee. Investors remain patient, but patience should never be mistaken for indifference.

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Changing investor landscape creates new risks in European sovereign debt markets

Public debt levels are on the rise

Global public debt levels have increased markedly over the past two decades, partly reflecting the fiscal response to major crises, including the global financial crisis (GFC) and the pandemic. Public debt in EU Member States stood at around 82 per cent of GDP in 2025. The European Commission projects a rise to 100 per cent over the coming decade, albeit with significant country dispersion.

High debt and increasing borrowing costs reduce fiscal space and limits the ability to respond to future shocks. This also constrains governments' capacity to finance EU strategic priorities such as defense, energy security, and the green transition.

Persistent debt accumulation can raise market concerns about fiscal sustainability. As Europe experienced during the sovereign debt crisis, changes in market sentiment can quickly become self-fulfilling, with far-reaching consequences for financing conditions, growth, and financial stability.

The financial sector is stronger today thanks to post-GFC reforms

High sovereign debt can affect financial stability through several channels. Sovereign stress may impact banks directly through their sovereign exposures. The impact can also be indirect, through higher risk premia and increased borrowing costs for households and firms, weighing on economic activity.

Europe is better prepared today than before the sovereign debt crisis. The Banking Union, the European Stability Mechanism and broader regulatory reforms have strengthened the resilience of both banks and sovereigns. Yet the link between sovereigns and banks has not disappeared. If elevated sovereign risks increase materially, vulnerabilities could re-emerge.

A shifting investor landscape presents new risks

A major difference from before the European debt crisis is the growing role of non-bank financial intermediaries (NBFI) in government bond markets. Pension funds, investment funds and highly leveraged offshore hedge funds now account for a larger share of sovereign debt trading and holdings. ECB analysis indicates that hedge funds accounted for more than half of secondary market trading in euro area government bonds in 2023, up from one quarter in 2018.

> Sound public finances and oversight of the financial sector are key to mitigating emerging risks.

This shift may have profound implications for sovereign bond market dynamics. A broader investor base can improve market liquidity in normal times. But it may also make sovereign bond markets – and capital flows more broadly – more sensitive to global shocks. Some non-bank investors tend to adjust portfolios more rapidly than banks during periods of stress, and current tolerance of debt levels could quickly evaporate.

As a result, changes in global risk appetite or investor balance-sheet capacity could lead to greater volatility in government bond markets, potentially spilling over into other market segments. This may increase risk premia and government borrowing costs, further reducing fiscal space across EU Member States.

Policy priorities

First, the reformed EU fiscal framework should be implemented credibly and consistently. Sustainable public finances are essential for economic resilience, financial stability and effective monetary policy transmission.

Second, public balance sheets cannot be expected to meet Europe's investment needs. More private capital needs to be channeled towards productive investments. Deeper and more integrated European capital markets are therefore essential. Progress on the Savings and Investments Union, including the Market Integration and Supervision Package, and the Banking Union are key in thata regard.

Third, simplification of EU financial regulation can support these objectives by reducing unnecessary burdens and strengthening the competitiveness of the banking sector. However, simplification should not come at the expense of resilience. Core regulation must be preserved, including strong capital and liquidity requirements. The lessons of past crises remain highly relevant.

At the same time, regulation and supervision should focus more strongly on banks' material risks and taking a risk-based approach. This includes addressing European banks' sovereign exposures and encouraging prudent diversification over time, while avoiding abrupt adjustments that could themselves create instability. It also includes monitoring og addressing the growing importance of NBFIs, including in government bond markets.

Conclusion

Europe's combination of high public debt, large investment needs and a changing investor base requires attention. While post-GFC reforms have strengthened the resilience of both sovereigns and banks, elevated debt levels in many EU countries and the growing importance of NBFIs may increase the sensitivity of government bond markets to periods of stress and global shocks. Preserving sustainable public finances, deepening and integrating European capital markets, and ensuring effective oversight of both banks and NBFIs will be essential in the years ahead.

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Shocks and secular trends straining sovereign public finances

Fitch Ratings estimates developed market (DM) sovereign general government debt will exceed USD75trn by end-2026, up USD4trn in just 12 months. By many estimates, that would make this year's increase alone larger than the entire private credit market, one of investors' top concerns in 2026. Shocks and secular trends have pushed DM government debt to about 104% of GDP over the past two decades, from 68%. Rating implications have been negative: the average DM sovereign rating is now 'AA', around two notches below where it stood 20 years ago.

Euro-area diversity

Nonetheless, aggregate debt deterioration masks a diverse sovereign picture. Nowhere is this clearer than in the euro area, where sovereign ratings span half Fitch's scale, from 'AAA' to 'BBB', upgrades and downgrades have been fairly balanced recently, and ratings have converged towards an average of 'A+'. Fitch expects debt ratios to rise in 12 euro-area sovereigns over 2026-2028, but to remain stable or fall in nine, including Spain and Italy. We think six euro-area sovereigns, including France, Spain and Italy, will have debt above 90% of GDP at end-2028, but that around half of the zone's members will be below 60%, a level associated with limited concern over DM debt sustainability.

High sovereign debt is not the same as high fragility. Even so, fiscal loosening by Germany and high debt in the next three largest euro-area economies raise questions about whether highly indebted euro-area sovereigns are structurally more fragile than DM peers elsewhere, why markets remain tolerant of worsening global debt dynamics, and what could trigger a reassessment of risk.

Strong secular expenditure demands

Budget balances and their effect on debt trajectories strongly influence market perceptions of debt sustainability. We expect the euro-area median budget deficit to be broadly flat at around 2.9% over 2026-2028, slightly higher than the all-DM median, but much lower than the US. There is little to suggest large euro-area sovereigns are structurally disadvantaged versus other large DMs in terms of expenditure pressures. Rising demands on budgets from defence, ageing populations, climate change and interest costs, often amid difficult politics, are as relevant in the euro area as in other highly indebted sovereigns such as the US, Japan and the UK, although emphasis and timing may differ.

> High sovereign debt is not the same as high fragility.

Institutional and financial frameworks

More meaningful differences emerge at the institutional and financial framework level. The US and Japan borrow in currencies they control and benefit from the financing flexibility of monetary sovereignty. By contrast, the euro area remains an incomplete union: monetary policy is centralised, while fiscal policy is largely national. Its institutional architecture is far stronger than a decade ago, with the EU also acting as a stabilizing mechanism. ECB backstops, stronger banking supervision, the European Stability Mechanism, the Transmission Protection Instrument and joint funding through NextGenerationEU have all reduced risks. Still, this asymmetry can matter for individual sovereigns when public finances are weak and markets become more discriminating.

The US also benefits from the world's dominant reserve currency. Nearly 57% of global FX reserves are held in US dollars, which also account for 90% of FX transactions and 60% of external debt issuance. Major commodities such as copper, wheat and oil are largely priced in dollars, and the US Treasury market remains by far the deepest and most liquid in the world.

Japan's debt/GDP ratio is currently falling but remains far above that of major euro-area sovereigns and weighs on its rating. However, debt tolerance is supported by stronger structural governance indicators than in most euro-area countries, as well as very strong funding capacity from deep private-sector savings. Only 15% of Japan's government debt is held by non-residents, versus around 35%-55% in the big four euro-area countries.

Economic resilience and debt structure mitigate risks

While higher yields since the Iran war mostly reflect changing policy rate expectations, there are also signs at the long end that investors are becoming more concerned about fiscal deterioration. Nonetheless, markets have remained broadly tolerant. There is no universal debt threshold at which panic sets in. Investors, like credit ratings, focus less on a single debt-to-GDP figure than on a broader set of credit factors: governance, policy effectiveness, debt trajectory, affordability, external strength, growth and macroeconomic resilience. The global economy has proved resilient to the Iran war energy shock, and higher yields will feed into budgets only gradually, given long average debt maturities.

Geopolitical risks, technological disruption, climate change, populism and political polarisation point to high susceptibility to shocks at present. Those shocks appear to be becoming more frequent and represent the biggest threat to debt dynamics and to markets' tolerance of them.