Fragilities of highly indebted EU countries

The discussion examined the growing fiscal vulnerabilities associated with high public debt in Europe, focusing on how debt sustainability should be assessed, the respective roles of fiscal adjustment and growth, and the implications of Europe's institutional architecture. It also considered how sovereign risks are reflected in ratings and market pricing, and which fiscal, policy and market developments could ultimately trigger a repricing.

1. Diverging debt trajectories

1.1 Growing debt sustainability risks and fiscal fragilities

The Chair outlined the two issues of how to assess sovereign debt sustainability, including what distinguishes highly indebted European countries from the US, UK and Japan, and whether markets have been and remain too tolerant of rising deficits, increasing debt and even unsustainable debt paths.

The Chair highlighted that the European Commission projected debt to drift over 100% of GDP over the next decade. The IMF expected European debt to double to 130% of GDP by 2040 in the absence of policy measures and given new spending pressures.

1.2 Addressing divergent debt trajectories

1.2.1 Country-specific debt dynamics

A policy-maker stressed that projections of rising debt are based on a no-policy-change assumption. There are significant differences in debt levels and trajectories across member states. Several have debt ratios below 60%, but four still have ratios above 100%.

There are also significant differences within the latter group. Greece still has a very high level of debt, but it is declining rapidly, largely because the country has achieved a very high primary surplus. Italy has a very high debt level, with a small primary surplus but rather low growth, meaning that its debt is drifting upwards slowly. France and Belgium combine high debt levels with significant primary deficits and therefore face the greatest adjustment needs.

There is a need to look beyond headline figures. The current approach is firmly anchored in the European Commission's debt sustainability analysis methodology. The analysis goes beyond headline debt figures, assessing risks to debt sustainability, including a country's ability to meet its financing needs and the likelihood that debt remains on a sustainable trajectory. Under this framework, each member state should have a country-specific net expenditure trajectory placing its debt on a downward path.

Several member states still require significant fiscal adjustment, while also needing to create room for other priorities, including defence. Debt dynamics are closely linked to the productivity agenda: the higher structural growth, the easier it becomes to reduce debt. For some countries, like Italy, this may be more important than controlling the fiscal deficit.

1.2.2 Growth cannot substitute for fiscal adjustment

The Chair noted that the US is on an unsustainable public debt path, but its official response is that it will grow out of the problem. That is not an argument generally heard in Europe.

A policy-maker suggested that there are two reasons for this difference. First, current US statements are overly optimistic. Growth is very important, but with a deficit of 6-7% that is expected to persist for the foreseeable future, it is difficult to see how to simply grow out of the US's fiscal situation. Secondly, growth does not happen automatically. Europe has developed a more prudent approach by not factoring in productivity increases before they have materialised.

1.3 Fiscal discipline and the structural pressure from social expenditure

1.3.1 Strengthening market discipline within the fiscal framework

An official suggested that markets should play a stronger role in imposing discipline on countries. However, the European Commission's counter-argument was that only factors within public responsibility should count in the European framework. The bond market should play a stronger role. When there are rising interest rates, countries should consolidate faster. No such requirement is incorporated into the framework. Nonetheless, the excessive deficit threshold would continue to constrain countries. During the negotiations, he had opposed excluding interest payments from the expenditure rule, while acknowledging that the approach was symmetrical: lower interest rates would not count as consolidation either.

1.3.2 Social expenditure, fiscal space and investment needs

The Chair commented that following the pandemic there was an expectation among the population that existing living standards would continue and that public support would be provided whenever risks materialised. At the same time, there was a proliferation of escape clauses, including for defence and energy.

An official highlighted that the old Stability and Growth Pact (SGP) required faster fiscal consolidation, although growth does have to also be taken into account. During discussions on reforming the fiscal rules, a key concern was whether consolidation periods lasting eight, nine or 10 years left countries sufficiently prepared to respond

when the next financial crisis occurred. Countries need to be in a position to react when such a crisis hit, which is not yet the case.

OECD statistics show that social expenditure, particularly in Europe, has grown faster than GDP for decades. Since 2000, the additional amount of social expenditure relative to GDP has been between 2% and 4%. If the trend in social expenditure is not addressed, joint debt will become the only solution for financing investment crowded out by social expenditure. He also noted that, to his knowledge, there was no forum in which these social expenditure dynamics were being identified as a problem to be addressed, as social expenditure was generally considered a member-state responsibility under the Treaty.

1.4 Sovereign ratings reflect debt stocks and fiscal dynamics

1.4.1 Multiple factors explain sovereign ratings and differences across countries

An industry representative stated that, although debt-to-GDP probably has the greatest explanatory power among public finance metrics, it is not the strongest overall determinant of sovereign ratings. Structural indicators can account for just over half of the weighting in models and include factors like the wealth and size of the economy, governance, political stability and the rule of law. Models can do much of the work in determining a rating, but do not determine ratings on their own and can be adjusted. Macroeconomic factors account for around 10% of the weighting, public finances for around 20%, and external finance for around 17%.

France, Italy and Belgium share the same reserve currency through the euro and have fairly similar sovereign net foreign asset positions and external positions. Their macroeconomic performance is also fairly similar, with growth at roughly 0.8%. Italy is somewhat weaker in areas like government effectiveness, control of corruption and the rule of law. Public finances are the main factor explaining the rating differential between the three countries. Italy's debt-to-GDP ratio is approximately 138%, which is around 30 percentage points higher than Belgium and 20 percentage points higher than France. France and Belgium are rated A+, compared with BBB+ for Italy.

1.4.2 Diverging fiscal flows are driving rating convergence

An industry representative commented that, despite its higher debt stock, the market recognises Italy's discipline on the flow side, including its ability to run primary surpluses. Although Italy faces higher interest costs, its overall deficit is expected to remain just below 3% over the next few years, which is a debt-stabilising level.

By contrast, despite having a debt ratio around 20 percentage points lower than Italy's, the market is penalising France on the flow side. Its deficit is running at around 5% and, unaddressed, could reach 7% by the end of the decade. Interest costs are adding around 0.2% of GDP per year. Interest costs stood at around 2% of GDP in 2024. Belgium is in a similar position, with a deficit of around 5%, although there are fewer risks around that figure. These contrasting dynamics are already reflected in rating actions. Fitch has been downgrading France and Belgium while upgrading Italy and other southern European countries; Cyprus provides a particularly striking example, having been upgraded nine notches in 10 years.

If these trends continue, the current differences in debt ratios could narrow substantially by the end of the decade, implying continued convergence in sovereign ratings. Italy's debt ratio could be only around 9 percentage points higher than France's and around 17 percentage points higher than Belgium's.

1.5 Markets distinguish between debt levels and fiscal trajectories

1.5.1 Italy and Belgium's vulnerabilities are largely understood by markets

An official suggested that markets are not materially underpricing the risks of any specific country at present. However, France might be more vulnerable because of its flow problem, compared to Italy with its stock problem or Belgium and its institutional fragmentation.

Italy's debt stock is very high, but investors understand the challenge. Italy has demonstrated an ability to generate primary surpluses, has a diversified investor base and benefits from a long debt maturity profile. Belgium's challenges - including ageing pressures, fiscal deficits and institutional fragmentation - are also relatively well understood.

1.5.2 France's less favourable fiscal trajectory is a key vulnerability

An official reported that although France's debt ratio is lower than Italy's, its direction of travel is less favourable. Persistent primary deficits, rising interest expenditure and limited fiscal consolidation mean that debt continues to accumulate.

Markets have been patient with France because it has a deep and liquid market, strong institutions and a large economy. However, that does not imply indifference. Investors can become much less comfortable when they start questioning whether the debt trajectory is improving or deteriorating. The key issue is therefore not which country has the highest debt ratio today, but where the largest gap lies between current fiscal performance and the adjustment required to put debt on a clearly declining path.

2. Completing the European architecture while preserving fiscal discipline

2.1 Europe's fiscal architecture provides a basis for common debt

2.1.1 Euro area fragility reflects market fragmentation

An industry representative highlighted that the fiscal situations of the US, the UK and Japan were considerably worse than Europe's. The euro area today is not that of

2010. This is not only because of the facilities that have since been put in place, but also because the central bank conducts counter-cyclical policy.

There is no a priori difference between the European Central Bank (ECB)'s indirect support and the direct support provided by the Federal Reserve, the Bank of England or the Bank of Japan. The possibility of a central bank stepping in to buy debt is not comforting.

The relevant issue is there is significant demand for Eurobonds that European countries and governments are choosing to not satisfy. As a result, Europe pays more to finance its debt than it has to. European debt fragmentation creates a different market structure compared to other jurisdictions, but that is not a fundamental difference in sovereign risk. Investors focus on policy intentions. An industry representative illustrated the importance of policy intentions with the example of a French presidential candidate proposing to "burn the debt", arguing that such signals are captured by markets.

2.1.2 Supporting common debt issuance

An industry representative argued that the SGP was a major success because it anchored European countries around the 3% deficit threshold. In this respect, Europe was in a much better position. It should take advantage of its better fiscal framework by issuing common debt that would enable Europe to fund its debt at a lower level.

2.2 Conditions for a European safe asset

2.2.1 Common debt

A Central Bank official suggested that greater market and capital market integration is needed to support growth and fiscal sustainability in Europe. Given the fragmentation of European public debt markets, a sufficiently large and liquid common debt instrument could help bridge some of these divides under certain assumptions. She stressed that she was considering both the benefits and drawbacks rather than advocating such an instrument.

However, the design of such an instrument is critical, particularly to ensure that it did not erode market discipline. A European bond could potentially become an international safe asset and compete with other international safe assets. Such an asset would be coupled with the currency, so it could also contribute to a greater international role for the euro. International currencies need to be widely used in international transactions and trade. The euro performs relatively well at the regional level, but less so globally.

2.2.2 Trust, fiscal sustainability, liquidity, size and returns

A Central Bank official grouped the parameters underpinning trust into three categories. The first is trust in the value of the asset, which requires institutions that protect investor rights. The second is political stability. The third is fiscal sustainability.

Liquidity and size are crucial considerations in determining whether the instrument could function as an international safe asset. Investors would not hold a safe asset without returns. This creates a chicken-and-egg problem: higher returns on European investments are needed to underpin a safe asset, while a safe asset could itself support higher returns by fostering greater market integration.

2.3 Common debt requires fundamental changes to the European architecture

2.3.1 Stronger financial supervision

An official, who was not particularly supportive of common debt, argued that Europe still lacks a framework capable of adequately addressing the moral hazard problem. Making common debt viable would require changes comparable in scale to those made when the euro was introduced; without them, it would not deliver the savings some envisaged.

Financial sector supervision is where Europe has made the greatest progress. The European supervisory model, based on the ECB and the Single Supervisory Mechanism (SSM), is superior to the US model. However, important gaps remain in the resolution framework. He compared the resolution framework to a bridge extending only halfway across a river; Europe has not yet experienced a major resolution case in which this gap proved problematic.

2.3.2 The credibility of the fiscal framework

An official criticised the tendency to introduce new escape clauses whenever a new problem arises. Doing so creates poor optics and undermines the credibility of the fiscal framework. More broadly, he considered that the jury was still out on whether the new rules would work better than the old ones and suspected that the previous problem had been less the rules themselves than a lack of willingness to apply them. The escape clauses give countries more time to adjust rather than allowing them to avoid adjustment altogether.

2.4 National ownership can strengthen fiscal enforcement

A policy-maker argued that rules, laws and measures have a greater chance of sticking when they are genuinely owned by a country. Greater national ownership makes enforcement easier. Under the new framework, the central indicator is the country-specific net expenditure path. Once agreed, this forms the basis for surveillance and enforcement. The enforcement mechanism itself remains roughly the same as before.

2.5 Fiscal adjustment strategies

An official stressed that it is difficult to distinguish between what is genuinely infeasible and what reflects a lack of political willingness to consolidate. Greece was cited as an example of a country that achieved sizeable fiscal consolidation despite an international institution having previously argued that such an adjustment was not feasible.

The US's deficit of around 7.5%, combined with a huge investment boom financed by debt, including by hyperscalers currently generating negative cash flows, could produce strong growth in the short term. The question is whether this gamble will pay off over the longer term.

3. Market discipline increasingly depends on fiscal trajectories, policy credibility and the investor base

3.1 Interest rates and sovereign spreads reflect investment and policy uncertainty

3.1.1 Higher interest rates

The Chair queried whether markets have been too tolerant, given fiscal developments, and what threshold might trigger a market reaction and repricing.

An industry representative identified two reasons for the increase in interest rates. The positive reason is that the period of stagnation that followed the global financial crisis has ended. Both the private and public sectors are investing and competing for funds. The less positive reason is that repeated increases in energy prices are leading markets to question the reaction function of central banks and how sensitive monetary policy has become to energy prices. The speaker described the first development as an "investment glut", with demand for financing exceeding supply. On the second, reduced forward guidance was adding to uncertainty and could contribute to some over-tightening of financial conditions.

3.1.2 Markets differentiate countries by policy responses

An industry representative highlighted that markets remain willing to finance investment. Whether this ultimately produces a favourable outcome depends on what countries do with that investment and whether they translate it into future growth.

European countries are not at a disadvantage in this respect. Instead, markets are pricing the quality of policies and the uncertainty surrounding those policies. That explains the French spread reaching the level of Italy's. Italy typically responds to deteriorating conditions by tightening its primary balance, giving markets a known and tested policy reaction; France, by contrast, has continued to find reasons not to tighten its primary balance.

3.2 Debt stocks determine rating levels; fiscal flows drive rating changes

3.2.1 Ratings adjust more slowly than markets

An industry representative reported that a rating change can result from a shock affecting several variables simultaneously. A crisis, for example, can produce a growth shock, reduce government revenues and prompt a policy response that widens the budget deficit and rapidly increases debt. Outside crisis periods, however, a rating is more likely to change because a single existing weakness continues to deteriorate until it crosses a threshold.

Markets have an almost unlimited number of basis points through which to reflect changing conditions, whereas ratings are inherently stickier. There are only 22 rating levels. Ratings can remain unchanged even as underlying conditions evolve, because there is some headroom within each rating. A downgrade normally creates additional headroom, allowing the new rating to remain stable for some time. Belgium went nine years between downgrades, compared with only two and a half years for France; Cyprus had been upgraded nine times in 10 years.

3.2.2 Sovereign ratings respond differently to market and fiscal developments

An industry representative emphasised the distinction between stock and flow variables. The debt-to-GDP ratio is more important in explaining the existing rating level. Flow variables, by contrast, are more for assessing what could cause a rating to change. Among the relevant flow variables, he highlighted the budget balance and the interest-to-revenue ratio.

A very high debt stock can make it considerably more difficult for a country to respond to a shock. Italy is expected to continue to have a higher debt ratio than France and Belgium by the end of the decade, even though Italy's debt ratio is declining while France and Belgium's are deteriorating.

3.3 Fiscal rules provide an anchor for market discipline

An industry representative emphasised that rules matter because they anchor what is politically feasible. For example, with the 3% deficit benchmark, a deficit of around 5% in France raises concerns because it is measured against the 3% anchor, whereas a deficit of around 7% in the US attracts less attention as there is no comparable fiscal anchor. When the European Commission indicates that a country is not doing what the rules require, markets pay attention, thereby reinforcing the disciplinary role of the fiscal framework.

Market pricing does not clearly indicate that Europe is in a worse position than the US or the UK. The UK has combined the highest real interest rate with the weakest expected growth, followed by the US and then Europe. The market pricing is a signal of the degree of discipline that markets expect from each jurisdiction.

3.4 The changing investor base can amplify sovereign debt market risks

A Central Bank official described a long-term shift in the investor base away from sovereign investors, sovereign wealth funds, official asset managers and banks investing on their own books. More recently, non-bank financial institutions (NBFIs) have increasingly taken up the market. At the same time, central banks have been withdrawing following the end of quantitative easing (QE), and quantitative tightening (QT) adding further supply to the market.

The NBFI investor base includes relatively stable investors such as pension funds and insurance companies, as well as investment funds and leveraged hedge funds. Hedge funds can employ leveraged strategies such as basis trades, exploiting spreads between sovereign bonds and their funding costs through instruments including repo, cross-currency swaps and foreign exchange swaps.

These strategies are more sensitive to pricing, risk sentiment and funding conditions. As a result, markets can become more volatile and respond more rapidly to shocks, changes in sentiment or funding conditions,

independently of underlying debt sustainability. These new market dynamics need to be taken into account.

At high debt levels, such dynamics can become particularly dangerous, because higher funding costs feed into government budgets and can ultimately generate adverse fiscal sustainability dynamics.

3.5 Restoring credibility requires sustained policy action and ownership

An official noted it took Cyprus nearly 10 years to regain investment-grade status. That experience demonstrates that credibility takes years to build but can be lost very quickly. Although the fiscal numbers were corrected relatively early, it took much longer to rebuild confidence that the improvements would prove durable. Its first upgrade back to investment grade came in September 2022.

Confidence was not restored through debt reduction alone. Policymakers also had to demonstrate a sustained willingness and ability to take difficult decisions. This involved a combination of fiscal discipline, banking sector restructuring and structural reforms, with the involvement of the European Commission and the IMF, and strong political ownership of the adjustment.

Speed also mattered. Cyprus exited the programme after three years of strict implementation. Ownership and the ability to move forward with the necessary adjustments were important in restoring confidence.

3.6 Assessing potential triggers for market repricing

The panel was asked which of the countries discussed faces the most serious risk of market repricing over the following year, and what variable might trigger such a repricing.

An industry representative pointed to France, citing the tone of the political campaign.

An industry representative is monitoring all countries, but particularly where debt is currently rising rapidly. France's debt is rising quite quickly, although its downgrade the previous year created some headroom. US debt is also rising quite steadily. UK debt is not increasing particularly quickly. All the countries discussed currently had stable outlooks.

An official pointed to the US and France based on their track records. The technical nature of the problems in France was understood, but there is insufficient political willingness to address them. The US lacks sufficient recognition of its fiscal situation.

An official was cautious about singling out one country. However, the gap between market expectations and policy delivery in France can be highlighted; whether the primary deficit narrows will be monitored.

A policy-maker stated that the US would be well advised to adjust, while stressing that this also applied to other countries.

A Central Bank official stated that concern is more general. Looking ahead, there are potential implications from AI on fiscal dynamics. It could affect growth expectations and therefore tax revenues, while potentially shift the composition of income from labour toward capital income. These developments could have important consequences for fiscal positions and fiscal dynamics over the coming years. She also stressed that she did not see a sovereign crisis "around the corner".