

## DEFENCE AND HIGH DEBT CHALLENGES



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### The urgent need to increase defence spending calls for innovative solutions

Fiscal divergences in the EU are not a new phenomenon. If we examine the debt levels of EU countries 20 years ago, we would see similarly significant disparities as today. These differences stem from structural factors of individual EU economies and continue to shape fiscal conditions across the bloc.

So far, the EU has taken proactive measures to address these issues through coordinated economic policies. The European Semester and the economic governance framework have been instrumental in promoting the convergence of economic policies, contributing to a more resilient and balanced economic environment.

Over the last decade markets have demonstrated a higher tolerance for fiscal divergence and higher debt levels compared to the past. This is the result of structural transformations that the euro area has undergone since

the GFC. Stronger financial sector regulation, including the establishment of the Banking Union, has made the EU's financial system more robust, although the lack of EDIS remains a weak point that must be addressed. The evolution of ECB monetary policy has enhanced confidence in both the euro area as a whole and individual member states. Finally, the establishment of the ESM has provided an additional financial safety net to address financial stability risks.

These developments, among many others, have made the eurozone more resilient to economic shocks from the pandemic to inflationary pressures, and geopolitical instability following Russia's war in Ukraine. The euro area has managed to navigate these disruptions without triggering financial instability or causing long-term scarring effects.

Lithuania is a prime example of how euro area resilience benefits member states. As we mark the 10th anniversary of Lithuania's adoption of the euro, it is important to recognize how eurozone membership has strengthened economic stability and accelerated the convergence process. Lithuania has experienced stronger financial integration, lower borrowing costs, and enhanced investor confidence, reinforcing its ability to withstand external shocks. Our experience reflects the broader benefits of euro area membership in increasing economic resilience.

Markets have priced in the euro area's improved resilience by showing greater tolerance for fiscal differences. Member states have been successfully financing long-term debt at yields that remain significantly lower than during the euro crisis, even as the euro area's aggregate debt and the debt levels of some member states remain close to historic highs. This does not mean that debt levels are irrelevant. On the contrary, debt sustainability has emerged as the primary criterion for determining the fiscal paths of individual member states. However, it underscores the fact that financial markets' perception of risk has changed, providing countries with greater fiscal space to manoeuvre and respond to various shocks.

This is particularly important in the current context of geopolitical shocks as the security landscape in Europe has changed dramatically due to Russia's war in Ukraine. An increase in defence

spending has occurred across the EU and especially in the so-called NATO Eastern Flank and Nordic countries, largely due to their geographical proximity to Russia. We have no option but to significantly raise defence expenditures beyond the current NATO benchmark of 2% of GDP. It is costly, but given the threats facing Europe, it is a necessary burden that we must shoulder.

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National-level efforts are crucial in ensuring adequate defence financing and they should be supported by the envisaged flexibility of the EU fiscal rules in the short term. The Commission's proposal to activate national escape clauses, allowing countries to use available fiscal space to finance defence investment, is timely and welcome. However, a coordinated approach is essential to avoid sending the wrong signals to markets and increasing borrowing costs for vulnerable countries. Flexibility must be used wisely to maintain market confidence in the new EU economic governance system.

I strongly advocate that the EU must be united in tackling security challenges. Thus, a dedicated joint borrowing mechanism, as proposed by the Commission, must be part of the solution. Furthermore, given the scale of defence investment needs and financial sustainability concerns, we must seek a solidarity-based burden-sharing mechanism as was done with NGEU that would partly compensate member states that contribute disproportionately to common European security. We must be open to extraordinary solutions, even overstepping our own red lines for the sake of Europe's safety and peace.



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### Financing European military expenditure in times of overindebtedness

The geopolitical landscape of Europe has changed dramatically, heightening urgency around security and military preparedness. The question is no longer whether to increase military spending but how to finance it amid high public debt and economic uncertainty. With threats such as Russian aggression, cyberattacks, and uncertainty over U.S. defense commitments, Europe must reassess its reliance on external military support and focus on strengthening its own defense capabilities.

Russia's actions, particularly in Ukraine, highlight the vulnerability of European borders. Cyberattacks further threaten military security, economic stability, and infrastructure. The unpredictability of U.S. foreign policy, especially with the rise of isolationist tendencies, raises concerns over Europe's long-term security strategy. To mitigate these risks, Europe must develop greater strategic autonomy and financial independence in defense. A failure to act decisively now could leave the continent vulnerable to evolving threats in the coming decades.

A European-wide approach to military spending is the most practical solution. Strengthening the European defense

industry through collaboration among EU member states would enhance security while driving technological innovation. A unified defense infrastructure could deter external threats and improve Europe's economic competitiveness. Coordinated defense investments would also lead to cost efficiencies, better resource allocation, and greater resilience against external economic pressures. Investing in a strong European defense sector could also help create high-tech jobs and spur industrial growth.

Relying on the U.S. is increasingly uncertain. Political shifts have shown that American military support can be unpredictable, often tied to economic and political conditions. The rise of protectionist policies suggests that Europe must be prepared to shoulder its own defense burden. Enhancing European security integration—potentially including the UK, Norway, and Turkey—could help build a more resilient defense system. Expanding partnerships with NATO allies while asserting greater independence is crucial for long-term stability and strategic self-sufficiency.

A key solution is issuing common European debt to finance military spending. This would allow member states to pool resources without exacerbating national debt burdens. If structured properly, common debt could maintain fiscal discipline while modernizing Europe's defense capabilities. Additionally, such an initiative could strengthen the euro's role as a global currency by creating a stable, liquid European asset that attracts international investment. A European Defense Fund, backed by joint debt issuance, could facilitate technological advancements, military readiness, and long-term sustainability in defense spending.

However, increased military spending must not come at the cost of fiscal mismanagement. The EU must reform its Stability and Growth Pact (SGP) to ensure that military investments align with long-term financial sustainability. Shifting from strict deficit targets to an expenditure-based rule would provide more flexibility while preserving economic stability. Moreover, excluding military spending from traditional public debt calculations could enable necessary defense investments without violating fiscal constraints. This policy shift would allow governments to balance national security with responsible fiscal management, ensuring that increased military spending does not undermine broader economic stability.

European countries could also explore alternative funding sources, such as

utilizing foreign reserves, particularly dollar-denominated assets, to support defense spending. This could provide a temporary financial buffer without resorting to excessive borrowing or taxation. Defense-focused public-private partnerships and sovereign wealth funds could also be leveraged to finance long-term security projects without overburdening national budgets. These financial strategies, if implemented effectively, would support military expansion while preserving economic health.

Despite concerns over debt, well-structured common debt issuance and fiscal reforms could allow Europe to meet its defense needs while maintaining financial stability. The current security and economic crisis presents an opportunity for bold action. Strengthening European unity and financial innovation can help build a self-sufficient defense framework, ensuring both security and economic resilience. A Europe that can defend itself is a Europe that can dictate its own geopolitical future rather than relying on external powers for security guarantees.

In conclusion, financing European military expenditure amid overindebtedness is not just an economic challenge but a geopolitical necessity. Europe must move beyond reliance on U.S. support and take control of its security through greater integration, common debt issuance, and fiscal reforms. This crisis is a chance to reshape Europe's defense strategy and reinforce the EU as a strong, independent geopolitical force for the future. By investing in collective defense and financial resilience, Europe can establish a sustainable security framework that ensures stability and economic growth for generations to come.



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### Whatever it takes – security edition

The world economy is undergoing profound transformations. The transatlantic alliance is weakening, free trade is being undermined and the rule of law is threatened in the country that once promoted democratic values globally. The two largest economic powers, the US and China, are now led by autocratic regimes, with tariffs becoming the favoured policy instrument in the nation that championed the liberal world order.

Truth be told, the EU's competitiveness agenda was conceived in more favourable times: when productivity, rather than tariffs, dictated export success, and innovation and R&D, rather than defence, were the targets of investment policy. Still, half a year after the release of Draghi's landmark report, new geopolitical realities make its findings more rather than less pertinent: Europe is 30% poorer than the US, and the innovation gap is widening. Productive investment is some 5 PP of GDP too low, and risk capital is scarce. The economic structure is stuck in the 20th century, with Europe hosting only 4 of the world's top 50 tech firms. Its defence industry is fragmented and unprepared for a withdrawal of the US security umbrella. The EC's reading

of the "Competitiveness Compass", appeared unambitious and too late, given the political and economic U-turn initiated by the Trump administration. Regrettably, the Compass has largely skipped the defence and security elements in Draghi's report, forcing a harsh awakening this February.

Productivity growth is no longer sufficient for long-term prosperity.

For the EU to demonstrate military sovereignty, it must achieve independence in underdeveloped sectors such as intelligence, space, and communication technologies, alongside a massive boost in investment. Additionally, an EU without an outlet for its industrial overproduction needs to shift towards services and leverage the spending potential of its 450 million consumers. The Compass contains valuable elements in that regard, such as the Quantum Strategy, Space Act, Life Sciences, Single Market Strategy, Start-up and Scale-up Strategy, and Preparedness Union. However, recent developments necessitate prioritising the security agenda, investment in defence, deploying trade defence instruments, and engineering a decisive shift in the EU's growth model.

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While the combined trade and security challenge is unprecedented, it may offer the much-needed boost to R&D, innovation and investment, thereby improving economic confidence and strengthening private consumption. With public budgets strained and the situation urgent, progress on the Savings and Investments Union should be more achievable, making full use of the of the Stability and Growth Pact's flexibility a mere formality and reducing unnecessary regulatory and reporting obligations a shared goal. But the heavy lifting must come from Member States: they need to revitalise the single market for services by reducing entry barriers, harmonising standards, recognising foreign qualifications, and transferring social security entitlements. Member States must also secure funding for defence investments – the 150 bn Euro EU lending facility will not suffice and can only finance certain categories of investments – while the EU could facilitate joint procurement. Furthermore, Member States must drive the modernisation of the EU's economic

structure by allowing struggling firms to exit, improving insolvency frameworks, and ensuring the retraining and requalification of workers. Finally, governments can play a crucial role in fostering confidence to encourage consumption and investment.

There is a silver lining: the combined threat of military and trade aggression has disrupted business as usual. PEC von der Leyen's strategic dialogue with the automotive and steel industries can only achieve so much – a 400 bn Euro German defence investment programme utilising idle industrial capacities can accomplish far more. While a European savings product can channel private savings towards investment, the potential returns from innovation in defence are a more compelling incentive. The close alliance between US tech firms and the Trump administration could boost demand for services "made in EU", supporting the modernisation of our economies. The lack of budgetary leeway will help contain inefficient "industrial policy" and prevent a further loosening of the state aid framework. This should bode well for the single market, which remains the EU's most important asset. The EU has typically excelled during crises – this time should be no different. One final caveat: Don't forget that financial markets like positive and lasting effects on potential growth more than inflation. They rest to be convinced.



## MARKUS FERBER

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### Bridging the divide and saving the Eurozone

#### The consequences of economic divergence in the EU

Economic divides are undermining the cohesion of the eurozone and presenting serious challenges to the functioning of the monetary union. The key issue at hand is the lack of fiscal coordination across the eurozone. While some countries have adhered to fiscal discipline and steadily reduced their public debt, others - most notably France, Italy and Belgium - have experienced rising levels of debt and public deficits. This imbalance is not only affecting individual countries but is also threatening the integrity of the entire eurozone. Wealthier countries fear that they will end up subsidizing the profligate spending of others, while countries with high debt levels might become increasingly unable to tackle the problem without external support.

This divide fosters a sense of distrust, which complicates the establishment of shared fiscal responsibilities. The absence of a coordinated fiscal policy weakens the eurozone and hinders the creation of a deeper economic and financial union. In the absence of a shared commitment to fiscal discipline, the eurozone risks splintering, leading to market

fragmentation, further mistrust, and limited progress on crucial initiatives such as better integrated European banking markets or the Capital Markets Union.

#### Weak growth and high debt: A recipe for sovereign debt crisis

In an environment characterized by weak economic growth and low productivity, high levels of public and private debt pose a substantial risk to the stability of several eurozone countries. This combination of factors makes it increasingly difficult for these countries to service their debt, especially if borrowing costs rise or if an economic shock occurs.

Should these countries fail to make necessary fiscal adjustments, they could find themselves on the brink of a sovereign debt crisis. Rising borrowing costs would lead to a loss of market confidence, diminishing fiscal flexibility and making it harder for governments to manage their debt. A sovereign debt crisis could quickly spiral, leading to political and economic instability in the eurozone.

#### Expansionary monetary policy: Not the solution

Permanently low interest rates could be seen as a temporary solution to the debt crisis. By keeping borrowing costs low, highly indebted countries can service their debt more easily without needing immediate fiscal adjustments. Low interest rates have the potential to stimulate economic demand, which could boost growth and, over time, reduce the debt-to-GDP ratio.

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However, a long-term expansionary monetary policy carries significant risks. First of all, it could distort investment patterns, incentivizing borrowing over saving. This could lead to over-reliance on debt, both by governments and private actors, compounding financial vulnerabilities in the long run. Over-indebtedness and misallocation of resources could eventually trigger a financial crisis, particularly in countries already facing economic underperformance.

Moreover, it overlooks the fact that while the Eurozone was originally designed based on the principle of

monetary dominance, slowly evolving structural factors - such as lower trend productivity growth, an aging population, and global excess savings - have made fiscal policy a more important and effective tool for macroeconomic stabilization, necessitating a shift away from the consensus model of monetary dominance. While low interest rates may provide short-term relief, they cannot address the structural weaknesses within the eurozone economy. What is needed instead are structural reforms aimed at improving productivity, fostering innovation, and ensuring that public spending is both sustainable and effective. Governments in highly indebted countries must take responsibility for reducing debt levels through fiscal discipline and targeted reforms.

#### Future of the Eurozone

If the current economic trends continue, the eurozone faces an increasingly difficult path. The growing debt burdens of countries like France, Italy and Spain combined with weak growth and insufficient fiscal discipline, could lead to a full-blown sovereign debt crisis. Without a shift toward responsible fiscal policies and structural reforms, the eurozone risks falling into a cycle of stagnation and instability. The EU's economic and fiscal heterogeneities will continue to widen, fostering further divisions among Member States and undermining the credibility of the euro.