Q&A

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A strong euro depends on the solvency of the States and a complete EMU

What are consequences for the functioning of the monetary union of the growing economic and fiscal divergences between EU countries? Is it reasonable to envisage a review of the SGP criteria for increasing defense spending?

While Eurozone countries were generally presenting deficits below 3% (0.5% on average) and primary surpluses (except France and Spain) in 2019, the Covid crisis rapidly deteriorated fiscal metrics leading to a rapid increase in the debt-to-GDP ratio from 83.6% in 2019 to 96.5% in 2020.

With strong GDP recovery and low interest rates allowing for rapid improvement in fiscal metrics, the debt-to-GDP ratio began to decline uninterruptedly until 2023. The pace of improvement in fiscal positions has varied: very rapid in Portugal and Spain, slower in Italy and Germany, and much slower in France. Among major Member States, the primary surplus in 2024 is expected to be positive or close to balanced everywhere except France, Germany, and Belgium.

Fiscal trajectories have converged since the exit of the Covid crisis, but the slowdown in GDP growth and inflation reduces the potential for a rapid fall in debt ratios. Even if the average interest rate on debt remains low at 2% in 2024, the negative gap between interest rates and GDP growth is reducing, limiting the automatic reduction in the debt ratio. This places more burden on improving the primary surplus.

The recent reform of the Stability and Growth Pact (SGP) has provided a framework that supports sustainability, capping expenditure growth and designing personalized adjustment paths based on structural macro-fundamentals, favoring better political appropriation.

With an extended range of potential events triggering the escape clause, the current framework does not require further reform. However, in a context of more frequent and adverse shocks due to the new geopolitical cycle, the risk of triggering the escape clause has increased. Even with structural balances in equilibrium and allowing automatic stabilizers to work, strong adverse shocks will deteriorate fiscal metrics beyond SGP margins. Resorting to the escape clause is not a viable solution as weakened budget positions require subsequent severe adjustments. While the SGP is useful for piloting fiscal policy around a regular cycle with a sustainability anchor, additional instruments should exist to handle severe shocks with a common fiscal backstop to avoid drifts in debt trajectories and maintain fiscal space for investment needs. A countercyclical common fiscal capacity activated in case of major adverse events would prevent such drifts and reduce the burden on monetary policy.

The recent decision of the European Commission (EC) to activate the General Escape Clause of the SGP to provide fiscal space for defense spending, intending to generate EUR 650 billion in four years, with average public spending in defense at 1.5% of GDP, i.e., 0.4% per year. From an economic efficiency standpoint, this may not be the optimal instrument. Utilizing this fiscal space depends on the initial fiscal position, with highly indebted countries having less leverage and greater market stigma as defense expenditures increase the debt ratio. The EC proposal for a new EU instrument to provide Member States with loans backed by the EU budget of up to EUR 150 billion is better suited, considering European defense is a communal European good best funded by an ad-hoc fund guaranteed by EU budget own resources (NGEU-like common borrowing). While such loans also increase the debt burden, they carry lower interest payments than national debt for high-debt countries due to the EU's high-quality rating.

Does this divergence hinder the integration of the EU financial system and the deepening of the single market, and if so for what reasons?

The Great Financial Crisis and subsequent sovereign crises have shown that divergences in fiscal trajectories and market appreciation of sovereign risk drive rapid withdrawal of cross-border financial flows, undoing a decade of financial integration that has not yet been reversed.

These divergences materialize in fragmented financial conditions for the private sector, hindering the transmission of unique monetary policy. They increase the concentration of domestic sovereigns in bank holdings, reinforcing the sovereign-bank nexus. Thus, they are a major obstacle to achieving the Banking Union, providing arguments for ring-fencing practices by national authorities.

What is the risk that the high level of debts in certain countries and the uncontrolled drift of French public finances could lead to a sovereign debt crisis? What adjustments are urgently needed to prevent such a crisis?

While some countries still present high debt-to-GDP ratios, many have already brought fiscal deficits to safe positions, with primary surpluses or very low primary deficits.

French public finances still pose challenges in managing deficit flows with a poor historical record in primary surpluses and a weak majority unable to enact major reforms and spending cuts. Although markets have shown complacency with both French and Italian sovereigns, sudden reappreciation of geopolitical risks could occur in a non-linear way, requiring fiscal and monetary authorities to act.

As long as macroeconomic conditions affecting debt sustainability remain aligned, there is no immediate risk for sustainability other than a risk of abandoning the fiscal adjustment trajectory negotiated with the EC. With slower GDP growth, stronger fiscal adjustment may be required limiting fiscal space for long-term investment needs.

The EC's decision to activate the SGP escape clause to fund defense spending could provide a positive fiscal impulse and support GDP growth. However, debt sustainability analysis by the EC suggests even a limited slowdown in GDP growth with slightly higher rates can rapidly deviate fiscal trajectories, hindering the projected fall in the debt ratio. Focusing on growth and providing a stable rate environment is paramount to sustainability, with governments expected to make efforts in deficit reduction.

The Eurozone is equipped to face a sovereign liquidity crisis, with the ESM providing a fiscal backstop and the ECB providing a monetary backstop with the Transmission Protection Instrument (TPI), though monetary policy should not be burdened with fiscal sustainability goals to avoid unintended consequences. The Eurozone needs a fiscal backstop in the form of countercyclical instruments in case of common shocks to growth to avoid significant deviations in debt trajectories.

How could banks, companies, and EU economies be affected by rising sovereign risks and a weakening euro?

Since the European sovereign debt crisis, the link between sovereign risk and banking risk has often been central to political and economic debates. With sovereign risk recently increasing in many countries, particularly in France, there are growing concerns for the banking sector. European banks hold a significant share of sovereign debt: around 3% of total assets in France and Germany, but over 10% in Italy and Spain. Therefore, an increase in sovereign risk will directly impact banks.

The consequences for banks of heightened sovereign risk are manifold. First, an increase in sovereign risk leads to higher government financing costs, which may also raise banks' financing costs. Recently, although the 10-year OAT has risen sharply due to political uncertainty in France, the market financing costs for French banks have remained stable. This stability reflects the resilience of French banks (and the broader European banking sector) to sovereign risks and continued investor confidence in banking institutions. Additionally, limited exposure to sovereign bonds in some countries helps mitigate risks to banks' balance sheets. Another impact on banks is their credit rating: rating agencies may downgrade their ratings. Moody's recently downgraded several French banks' credit ratings following a downgrade of France's sovereign rating. However, this downgrading has been moderate and has not significantly affected perceptions of banking risk. Furthermore, banks' lending activities could be affected. If banks' refinancing costs rise significantly, they may pass these costs onto customers, leading to increased financing costs for non-financial agents and a slowdown in loan demand.

While rising sovereign risk has caused some concern, current data do not indicate significant tensions in banks' financing conditions or an immediate threat to their stability. The banking sector remains solid, supported by diversified financing structures and a robust regulatory framework.