



The impact of current fiscal and economic divergence across the EU on the monetary union and the euro

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Fernando Navarrete Rojas (Chair)

Fernando Navarrete Rojas welcomed attendees and introduced the panellists. The current situation facing the EU is unprecedented. The EU has been operating for nearly a decade without binding fiscal rules, which is a situation deemed entirely new and concerning. For some, fiscal rules may be seen as hindrances to achieving legitimate policy objectives, while others viewed them as integral to ensuring a stable and well-functioning monetary union. Fiscal rules as political constraints help maintain fiscal stability before market discipline is exercised, which can occur abruptly and harshly when it does. This has been seen with former UK Prime Minister Liz Truss and President Donald Trump, which suggests that the eurozone is similarly susceptible to immediate market reactions if fiscal governance falls short. Recent sacrifices made for speed in fiscal decision-making have potentially destabilised the economic vessel.

Fernando Navarrete Rojas asked panellists to share their insights on the possible consequences of economic divergences among key EU countries relating to public debt.

Markus Ferber

Markus Ferber stated that it is difficult to answer the question succinctly; there can be a very negative impact if everything goes wrong, and it can be not as

crucial if everything goes well. There is an importance of proactive fiscal governance, which is linked to the saying, 'You should fix the roof while the sun is shining,' which emphasises fixing problems while conditions are favourable. However, during recent economically favourable years, necessary repairs to fiscal frameworks have been neglected, leaving the eurozone ill-prepared for current pressures. Eurofi is taking place in Poland, which borders Ukraine, meaning it is very close to a potential threat in the form of Russia.

However, the rules at the end of the last legislative period have been improved. The Commission has gained significant tools to negotiate with member states about establishing mid-term paths to reduce debt levels. The hope is that these tools will be applied judiciously, particularly under the stormy conditions the eurozone is facing. There is concern regarding the lack of fiscal space available to address emerging challenges, particularly those surrounding increased defence spending.

Markus Ferber concluded by noting his role as rapporteur on the significant legislative file, and acknowledging the ongoing discussions about the national escape clause and its implications on fiscal governance.

Jérôme Grivet

Jérôme Grivet highlighted that structural divergence should normally not occur in a monetary union. There

could be some temporary divergence if a specific situation arises in a specific country, but from a structural point of view it is important for eurozone members to be much more aligned in terms of fiscal trajectory. The initial objective of the eurozone was to encourage convergence among participating countries, even those with historically lax fiscal discipline. However, there is regret that actual fiscal divergences have been exacerbated by the existence of the euro; as a result of the eurozone and the fact that France belongs to the eurozone, France has been able to have more fiscal divergence than would have been the case if it had kept the franc, which can be viewed as a problem.

From the perspective of a bank, the situation France currently faces is concerning, but it is not an area of immediate danger. French banks are very well managed, and hold sovereign bonds from the eurozone and France. They are very robust from a solvency point of view and a liquidity point of view. However, persistent fiscal imbalances could lead to adverse effects on the French economy. Emphasis needs to be placed on the importance of pursuing clear-cut reforms to align budgetary and economic trajectories. While this will take time, achieving a more sustainable fiscal framework will ultimately benefit both fiscal governance and economic health.

Jacques de Larosière

Jacques de Larosière expressed agreement with the previous speakers, stressing that continuing with mounting governmental debt, particularly seen in countries like France, is unsustainable. Unaddressed fiscal challenges could culminate in a financial crisis. The OECD's 2025 report on global debt highlights that much of the accumulated governmental debt has financed current expenditures, rather than generating future returns. Ongoing deficits characterised by military expenditure could exacerbate the situation, as such expenses typically do not yield returns for the economy.

An argument can be made for reinstating the fiscal standards set forth in the Maastricht Treaty, namely the 3% deficit and 60% public debt to GDP limits, as those are rational measures essential for ensuring a credible monetary union. If the EU continues down the path of ignoring these principles and exempting military expenditures from fiscal calculations, then it risks creating an enormous debt burden that offers no returns, which could threaten the fundamental viability of the EU's economic framework. The validity of the economic and monetary union is now at stake, and the threat is extremely grave.

Rimantas Šadžius

Rimantas Šadžius noted that, despite differing political affiliations, it is important to preserve the economic and monetary union (EMU)'s integrity. Lithuania has been in the eurozone for 10 years, but excessive divergence among member states had been a concern even prior to accession. Significant challenges have been faced by Lithuania during the financial crisis, where the eurozone's common bond markets initially seemed to operate uniformly across member states.

In 2008, Lithuania had a very small public debt, of around 15% to 16% of GDP. When the financial crisis hit, all eurozone countries were seen by the markets equally in terms of risk. Every country in the eurozone borrowed almost at the same rate, which was reasonably low. It increased due to the financial crisis. Lithuanian borrowing cost reached 23% in 2009, because there was no other choice. It was clear that fewer problems would have been seen inside the eurozone.

The situation has changed later as excessive differences remain in public debts, deficits and interest rates. The crisis revealed that market perceptions varied significantly by country. The internal structure of the eurozone, EMU has changed, as well as the market assessment of the validity of the EMU.

It is a fact that, despite high public debts and increasing public debts overall and on average, in the long term it is possible for sovereign debts to be financed at quite reasonable low yields. It is likely that the prolonged period of negative and zero interest rates had an influence, but it is also due to the instruments that have been established, such as the European Stability Mechanism, the Banking Union, the Single Supervisory Mechanism (SSM), and the Single Resolution Mechanism. The one outlier is deposit insurance, which has remained at the same stage for 12 years.

Rimantas Šadžius concluded by highlighting that questions remain about the current relevance of the Maastricht criteria, given market dynamics that seem to tolerate higher levels of debt than envisaged. However, the points made by Jacques de Larosière are correct: there should not be an exemption for military expenditure from fiscal accountability. There also needs to be a focus on debt sustainability within national budgets.

Fernando Navarrete Rojas

Fernando Navarrete Rojas asked panellists to provide their views on what the long-term solutions would be to finance structurally higher defence-related public

expenditure. A separate question is whether the current fiscal framework is fit for purpose, and whether there is a case for more European joint action and joint financing in the area of defence.

Jacques de Larosière

Jacques de Larosière noted that the situation could be manageable in the short term, as the markets are still amenable and eager to finance the deficits which are growing in the eurozone. However, the job of politicians and parliaments is to look at the longer horizon. When looking at the longer horizon, a point will be reached when the markets will react if the bad habits that have been exacerbated in recent past years continue to be maintained. A failure to monitor long-term fiscal sustainability constitutes negligence and could provoke an unavoidable market reaction.

The markets are fragile, especially in the current political context of the United States. The Fed has reduced its quantitative tightening because it is afraid of a lack of liquidity in the government bonds market. It has reduced the pinching of liquidity in the market because it is conscious and concerned about a transition between possessing these titles in the central bank and shifting them to the private sector. If they are moved to the private sector, which is tightening, the private sector needs to be willing to buy them. If the private sector is less willing to buy them then a liquidity trap could be entered into, leading to interest rates that can become uncontrolled.

A monetary union can only be stable if there is a common will to participate in disciplinary action, but there is currently no disciplinary action at all. The union cannot last if there is no modicum of collaboration.

Markus Ferber

Markus Ferber stated that defence spending referred to expenditures that are consumed, not expenditures that are invested in. When governments buy things like tanks, fighters, jets, artillery and ammunition, it does little to lift the potential growth of an economy. That is why debt financing is not the best option at a national level or an international level. However, there are still some possibilities where European cooperation can create a benefit for member states in reducing costs, because they are not being scaled up. Every member state has its own weapons systems, which makes it very expensive for the taxpayer, the state and the public budget. Those possibilities should be used more. If there is a better way to do things inside the EU than external countries such as Canada, the UK and South Korea should be invited into a coalition of the willing.

On the other hand, four years is close. The first time Germany tried to use the rules, they were misused, which was discussed with the responsible Commissioner. When the Covid pandemic hit, countries started with the general escape clause, not the national escape clause, as it was a threat to all of Europe. The general escape clause was activated, and the €100 billion Support to mitigate Unemployment Risks in an Emergency (SURE) programme was subsequently created. The EU also had the Recovery and Resilience Facility (RRF), but, five years on, the question remains as to what additional growth has been seen from that.

The RRF was also linked with investments and demands of member states to deliver. There is room for improvement, which is why there is a significant concern that the same thing is happening again. Debts are debts, whether they are on a European level or a national level. Consumptive expenditures should not be financed by debts in general.

Jérôme Grivet

Jérôme Grivet highlighted that there are two ways of looking at the issue of how to finance additional defence spending. The first is a way that has garnered significant public debate in France, which is how to finance the providers such as the weapons companies. The most important issue is how to finance the public spending that should be engaged in passing purchase orders to the weapon companies. Adding up new deficits is not a good idea, even if it is provided by an escape mechanism. Europe already has a debt level that is too high, as well as interest charges that are too high.

It is possible to raise additional taxes but doing that in France will definitely jeopardise the growth and the economy. Choices amongst public priorities must be made. It is obvious that one of the very important choices France has to make is to engage into real pension reforms, because working longer and putting some money in pension funds would definitely be good for the budget as well as for the economy. That will be the most relevant way of trying to find the margin of manoeuvre to finance additional expenditure for Europe's common defence. As long as weapons companies have purchase orders well budgeted by their only client, there will be no difficulty for banks and investors to provide them with the additional capital and loans they may need.

Rimantas Šadžius

Rimantas Šadžius agreed that some negative aspects can be corrected. Military spending is mostly consumptive, but it is unlikely that that can be changed.

One problem is that there is no true market for these issues. There is no true market for ammunition, howitzers or tanks. Collective spending and collective purchases is probably the only way that can currently be done to try to push down the prices. Some issues should be bought collectively, such as air defence systems, as it makes no sense for different countries to have different systems.

A crucial, excessive divergence is the level of defence expenditure in the budgets of different countries. Historically defence spending has been measured as a percentage of GDP. But when talking about expenditure in nominal terms we see much greater divergences. For example, 0.1% of GDP of Germany is equal to 5% of GDP of Lithuania. Lithuania has no other choice, but to allocate such financing for defence, because it is on the front line.

We need a collective response and collaborative action. To finance needs like a collective air defence system we need an additional EU-level instruments or EU level fiscal capacity, mobilising resources in proportionate way, as it is done with the European budget, or a European Stability Mechanism (ESM). Different options

are available, and it is up to the member states to determine what the best solution is.

Rimantas Šadžius concluded by noting that there are five or six papers on how to create an additional financing mechanism or armament bank in Europe with the participation of different countries, including third countries like the UK, Norway, as well as the US. There are different options, but to keep the smallest EU member states, who border Russia, safe, we need some kind of the EU-level fiscal capacity that has been previously mentioned.

Fernando Navarrete Rojas (Chair)

Fernando Navarrete Rojas acknowledged that discussions around defence entail significant realities that must be confronted. He appreciated the insights provided by the panellists, and emphasised the critical nature of the topics addressed, encouraging further dialogue on valid fiscal strategies to ensure the stability of the monetary union in light of current challenges.