

# Is Europe Playing With Fire?

**E**arlier this year, French Finance Minister Éric Lombard warned that his country might be forced to reach out to the IMF for a bailout. British officials offered markets a similar hint. Of course, bailing out industrialized countries is not practical for the IMF given its limited resources. But are European officials suggesting that they are considering an entirely new approach to fiscal/debt policy management and liquidity?

The first steps to this change in approach, some would argue, came earlier this year when Germany altered its constitution to remove its fiscal debt brake (debt not to exceed 60 percent of GDP). Many officials warned this change could give the green light to other, financially less-stable European countries that want to increase their already-bloated budgets.

Is the next step in this new policy the beginning of even more widespread use of EU-Bonds? The European Commission is pushing for further issues of EU-Bonds offered in the name of the European Union. The volume of outstanding EU-Bonds has already reached €650 billion. Yet from a legal standpoint, EU-Bonds do not belong to the category of government bonds principally because the European Union is not allowed to take on its own debt and has only limited scope to generate its own revenues. The EU member states bear the

responsibility jointly and severally, which means one or more member states can be made responsible for the amount of a bond issue if other financially weaker members cannot live up to their obligations.

What could be the consequences of these controversial changes? Will these moves enhance the liquidity of European financial markets, which could be particularly useful at a time when European governments are rearming militarily? Note that the European high command also hopes to “professionalize” Europe’s capital markets by having Eurex Futures launch EU-Bond futures.

And most importantly, is this new approach involving EU-Bonds and other changes a welcome new development or a controversial gimmick that could jeopardize the credibility of European financial markets? After all, it is still undecided whether such bonds used in this way contradict the “no-bailout” clause of Article 125 of the EU treaty. Are these wise moves or are European policymakers playing with fire?



**Nearly two dozen noted observers offer their views.**

The government's likely struggles to scale up planned investments and defense spending due to supply constraints offer only small consolation. The genie is out of the bottle. There is now no counterweight to deficit-prone governments elsewhere in Europe.

The €500 billion special fund, or *Sondervermögen*, for infrastructure investment is not the core problem. For this purpose, the federal government is borrowing a bit more than 1 percent of GDP each year. Given the parlous state of Germany's infrastructure, this seems justifiable. Investments like these can enhance the economy's growth potential over the medium term, thereby increasing tax revenues to service the debt. The larger share of new debt, however, stems from the federal core budget, where the surge in defense spending is located. Defense expenditures are consumptive in nature: they do not generate cash flows that could be utilized to service these loans. Indeed, Germany's Federal Budget Code unambiguously excludes military expenditures from the investment definition. Debt-financed military spending is a misguided and generationally unfair approach.

The recently passed 2025 federal budget sends a worrying signal. Even the much looser debt constraints were circumvented. When last spring the outgoing Bundestag hurriedly amended the constitutional debt brake, it decided that the "special fund" for investment, financed through additional borrowing, must finance exclusively new investments, not those previously planned. To avoid merely shifting regular, pre-planned funding into the special fund, an "additionality" requirement was enshrined in the constitution. However, the wording of the constitutional article is rather wishy-washy: "Additionality exists when an appropriate investment ratio is achieved within the federal budget for the respective fiscal year." But what exactly is "appropriate"?

From the point of view of Chancellor Friedrich Merz's government, the budget plans proposed by the collapsed "traffic-light coalition" evidently featured "inappropriately" high levels of investment. His coalition government is funneling funds away from investment-oriented expenditures toward higher levels of current spending, especially for social programs. Magically, the curtailed capital expenditures reappear within the debt-financed infrastructure special fund. With these barely concealed accounting gimmicks, the government undermines the constitutional additionality requirement. This sleight-of-hand drives national debt upward while shifting the fiscal burden onto future generations.

With Germany's open defiance of European fiscal rules, it will become much harder for the Commission to commit member states to prudent fiscal policies. At least we can still count on Germany to resist a move towards more joint issuance of Eurobonds, the ultimate free-for-all "solution."



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#### **JOSEF BRAML**

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Europe is undergoing a profound transformation in its fiscal architecture, shifting its fiscal and debt management strategy—particularly through the expanded use of EU-Bonds, and broader liquidity efforts. The success of this strategy hinges on maintaining investor confidence, ensuring fiscal discipline among member states, and clarifying the legal status of EU-Bonds. If managed prudently, these moves could strengthen Europe's financial sovereignty and global competitiveness.

The European Commission plans to issue approximately €160 billion in EU-Bonds in 2025, continuing its unified funding approach that began in 2023. This marks a significant expansion from previous years, with €138 billion raised in 2024, making the European Union the fifth-largest global issuer of green bonds. These funds support initiatives like NextGenerationEU, Ukraine aid, and macro-financial assistance to Egypt and Moldova.

This surge in EU-Bond issuance reflects a broader ambition: to create a deep and liquid Eurobond market that can rival U.S. Treasury markets and bolster Europe's strategic financial autonomy. The rationale is clear—amid geopolitical tensions and rising defense spending, Europe needs robust financial tools to fund its ambitions without relying excessively on external actors.

The European Union's efforts to professionalize its capital markets—including the launch of EU-Bond futures via Eurex—could enhance liquidity and attract institutional investors. This would help reduce borrowing costs and improve the European Union's financial resilience, especially as defense and climate-related expenditures rise.

Furthermore, European markets are likely to serve as a secure environment for investors, whereas the United States may lose its "safe harbor" status under President Donald Trump.

U.S. finances are heading like a big ship towards a dangerous fiscal iceberg. With a national debt of over US\$37 trillion and the significant refinancing risks

looming for 2025, the United States is sailing into turbulent fiscal waters: \$9.2 trillion in U.S. debt is due in 2025, a quarter of the country's total debt. Many of these loans were taken out cheaply, but now have to be refinanced at a higher cost, and this significantly increases the pressure on the bond markets. The United States needs foreign investors to extend its existing bonds and place new bonds. A decline in demand can lead to an increase in yields.

Credit rating downgrades and higher yields on U.S. Treasuries already indicate some uncertainty in the markets. Many economists fear that the United States will lose its safe haven status under Trump. A rising gold price already reflects investors' distrust of the dollar. If the United States is seen as politically unstable, it could affect the dollar's role as a reserve currency and shift capital flows to more stable countries.

Given the high level of U.S. government debt, a deep, liquid market for safe EU bonds could provide an opportunity for international investors to diversify risk. This would give the option of investing capital in euro-denominated bonds instead of U.S. Treasury bills.

Rather than allocating foreign exchange reserves to U.S. bonds, European countries and investors should specifically strengthen their own currency, security, digital infrastructure, and future technologies in order to arm themselves for the increasingly fierce geoeconomic competition.



*Europe is not inevitably playing with fire.*

#### **ANDREAS DOMBRET**

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Europe is at a crossroads once again. After decades in which fiscal discipline, epitomized by Germany's "debt brake," anchored investor confidence, a new willingness to accept larger public deficits is emerging in Europe. This is taking place just as EU member states confront costly strategic priorities: rearmament, the green transition, and post-pandemic repair. Germany, for

example, has taken the bold decision to use its fiscal space for a much-needed €1 trillion investment in defense and infrastructure.

The result is a renewed European push for supranational financing, potentially including expanded issuance of EU-level bonds. A sober assessment must weigh the tangible opportunities against equally real risks.

It is true that Europe's fiscal landscape is marked by mounting debt in several member states. By mid-2025, the European Commission had activated Excessive Deficit Procedures for multiple nations, indicating that fiscal deficits remain a challenge. Debt-to-GDP levels in countries such as Greece (~154 percent), Italy (~136 percent), and France (~113 percent) are responsible for renewed debt sustainability concerns.

There is no doubt a well-designed euro-denominated benchmark could improve market acceptance of EU sovereign debt. Large, liquid EU bonds offer investors a clear, tradable claim that could reduce fragmentation across national markets, compress financing costs for smaller issuers, and deepen Europe's capital markets. The launch of EU bond futures and the growing stock of EU-backed paper—already substantial—point to demand for a cohesive euro asset class and could support better price discovery and hedging that banks, pension funds, and asset managers need.

Yet the appeal in principle of joint issuance cannot obscure legal and incentive problems. Under current Treaty arrangements, the Union lacks broad taxing authority and cannot straightforwardly assume sovereign debt; member states remain ultimately liable for many EU-backed instruments. We do not yet live in a "United States of Europe." And Article 125's "no bail-out" clause casts a long shadow over any arrangement that risks implicit mutualization of sovereign liabilities. If common bonds are perceived as a backdoor bailout, moral hazard would no doubt intensify. National authorities might delay difficult reforms, reassured that a supranational floater cushions markets. That would weaken, not strengthen, the euro area's fiscal resilience.

There are also market structure dangers. Creating a new instrument does not guarantee liquidity. Without concentrated, predictable supply, without primary dealer support, and without derivatives to facilitate hedging, EU bonds could be thin and volatile in stress episodes, amplifying fragmentation rather than alleviating it. And politically charged perceptions of cross-border risk-sharing could prompt litigation and fractious domestic politics, further unsettling investors.

This is not an argument rejecting supranational finance out of hand. Rather, it is a call for realism and a very disciplined design. Credibility rests on four pillars: a clear legal basis for issuance; strict limits on purpose and scale—for example, financing agreed for Europe-wide