

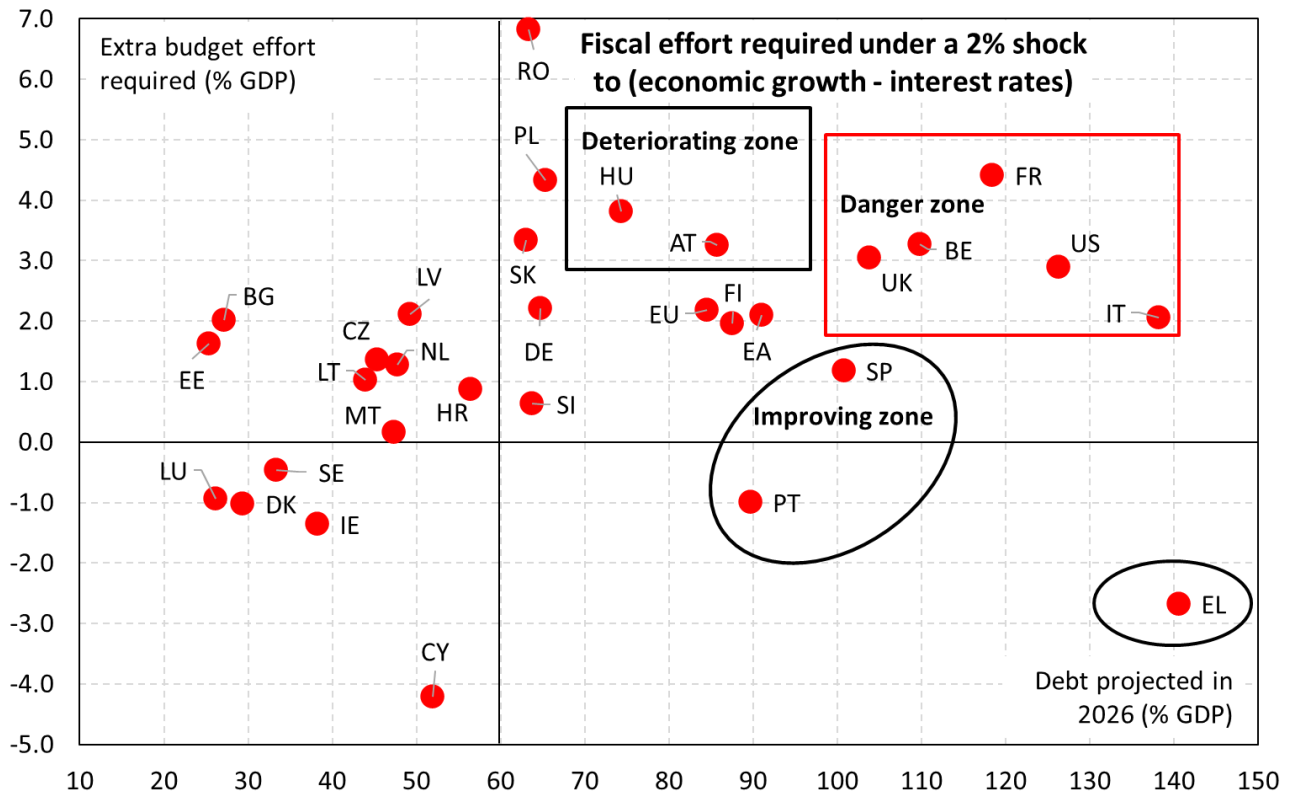
## EUROZONE PUBLIC FINANCES

### Has periphery become core? And core, periphery?

Global long-term rates have increased significantly. Debt sustainability concerns have emerged in the US, the UK, and other countries, including Japan. Could this be sufficient to trigger another sovereign debt crisis in the EU/Eurozone? The French government will soon face an important confidence vote on September 8, amid ongoing challenges in addressing fiscal deficits. Germany remains in the strongest fiscal position within the EU/Eurozone, but the significant increase in defence and infrastructure expenditure could influence long-term yields. I analyse (1) the sustainability factors and current debt dynamics, (2) the risks of a debt crisis in the EU/Eurozone, and (3) what measures are available to prevent it.

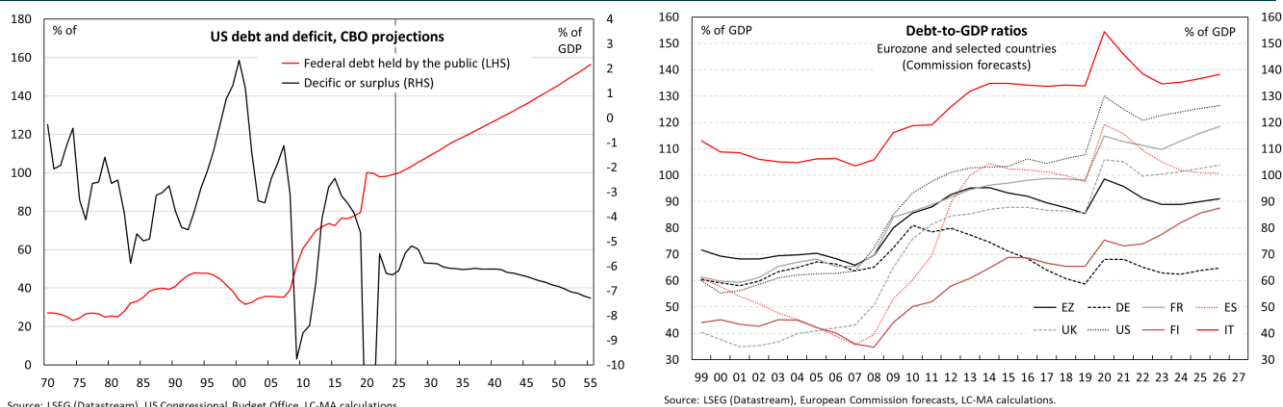
- The US is at the centre of a global increase in yields.** Misguided policies by US President Trump (and overspending by the two previous administrations) are expected to lead to a sharp rise in the US deficit and debt, according to the Congressional Budget Office (Figure 2). Efforts to undermine Fed independence have also raised concerns about the stability of the USD, thereby increasing the risk of higher long-term yields, with inevitable spill-overs into Europe. The UK government is becoming increasingly politically fragile while facing significant fiscal challenges. How much could the global situation affect the financial stability of the EU/Eurozone and trigger another sovereign debt crisis? More importantly, what do EU domestic fundamentals indicate about trends in public debt across various countries? I set aside the political challenges faced by the French Government and others. At the heart of any debt crisis lies a political motive, but it needs to be backed by deteriorating fundamentals. In this commentary, I aim to focus on key economic variables for the sustainability of public finances (forward starting position of the debt ratio, potential growth, the projected fiscal position as described by the cyclically adjusted primary balance, and the cost of borrowing), presenting a simple public finance risk quadrant (Figure 1 below).

**Figures 1. A public finance risk quadrant for EU countries, the UK and the US.**



Source: LSEG (Datastream), European Commission data and projections, LC-MA

## Figures 2 and 3. US deficit and debt projections; changes in Eurozone debt ratio since 4Q19.



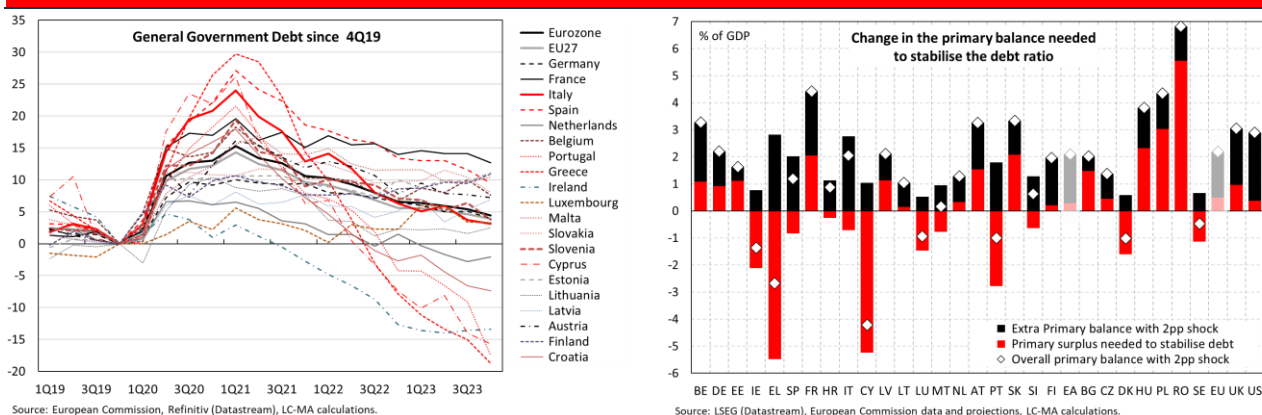
- A simple framework to assess the situation.** Following the publication of medium-term structural plans by EU governments, there is now an opportunity to analyse the long-term dynamics of variables relevant to debt sustainability. However, initially, a simpler framework is helpful. I take the EU Commission projections (Spring 2025) for the debt ratio in 2026 as the starting point. Then, I use the debt sustainability equation<sup>1</sup> with the following projected variables: (1) the cyclically-adjusted primary deficit/surplus as a proxy for the long-term fiscal position, (2) the implicit interest rate in 2026, and (3) 2026 potential GDP growth as a proxy for long-term growth. The debt ratio projected by the European Commission for 2026 serves as a kind of state variable, indicating how vulnerable the country's forward-looking position is. Conversely, the other variables define the debt dynamics. Next, I shock the difference between the primary budget balance and the cost of borrowing by 2.0 percentage points, and then determine how much additional fiscal correction would be necessary to stabilise the debt ratio. Results are shown in Figure 1. Figure 3 illustrates the developments of the debt ratio (Commission's projections for 2025-2026). Figure 5 shows the projected debt ratios given the 2.0pp shock.
- What do the fundamentals indicate?** I assume the projections of the Commission for the next couple of years are sufficiently accurate, and long-term potential growth and the fiscal position are correctly proxied by those projected for 2026. Then, I can assess (1) the country's debt position (horizontal axis) and (2) the effort required to stabilise the ratio (vertical axis). Countries can be categorised into three groups: (1) the dangerous zone, (2) the improving zone, and (3) the deteriorating zone. In the perilous area are countries with a high debt ratio, making them vulnerable to adverse combinations of economic growth, borrowing costs, and unfavourable budgetary positions that determine unfavourable debt dynamics.
- Greece: From being an *enfant terrible* to a model.** Greece still has the highest estimated debt ratio in 2026 (although the Commission's estimates are probably too pessimistic). Still, its debt dynamics project a sharp decline over the coming years. Therefore, there is no need for additional fiscal effort in the event of an adverse shock, as there is an almost 3pp annual margin. Note that the debt-to-GDP ratio was 197.3% in 2021, decreasing to 177.0% in 2022, 163.9% in 2023, and 153.6% in 2024. Although the difference between potential growth and the real cost of borrowing has become less favourable than before (1.9% vs 0.1% in 2026), it still supports a significant drop in the ratio if paired with the budgetary position (4.8% primary surplus in 2024, and a cyclically adjusted balance projected at 3.0% in 2026). With this in mind, the Commission's projections are likely too cautious, as Greece's fiscal developments are likely to continue surpassing expectations. Rating agencies will probably keep improving the country's rating, and financial markets have reasons to remain bullish (barring a global shock in risk premia).
- Italy: From a basket case to a more stable country?** Fiscal figures sharply worsened during and after the pandemic, and Italy faced difficulties during the energy crisis, as it relied heavily on Russian gas. However, the improvement was significant. The positive change in public finances was driven by (1) a strong economic rebound after the pandemic, partly supported by EU funds, (2) excellent labour market performance, with a notable increase in labour participation, which resulted in rising revenues from social security contributions, (3) a boost in fiscal revenues due to the lack of adjustment in tax brackets that caused a sharp rise in the overall tax burden (although the government partly offset this trend), and (4) some improvement in tax compliance. Italy has the most liquid and deep government debt market in the EU, along with sound debt management, which has

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$$\Delta b_t = \left( \frac{r_t - g_t}{1 + g_t} \right) b_{t-1} - p b_t + d d a_t$$

contributed to a steady decline in government bond yield spreads. Nonetheless, the fiscal improvement is less impressive than it appears. The sharp decrease in the deficit from 7.2% in 2023 to 3.4% in 2024 was aided by an accounting phenomenon, namely the frontloading of Superbonus-related spending in previous years and the subsequent improvement from 2024 onwards. Yet, there is also some genuine progress that is likely to continue at a moderate pace if real GDP posts at least half a percentage point annual growth. Italy is expected to surpass the improvements currently projected by the Commission.

- Portugal: Continued strong improvements in fiscal balances.** Portugal has a reasonably strong potential growth rate (2.0%) combined with a low real cost of borrowing (0.5%), while the cyclically adjusted primary surplus for 2026 is projected to be 1.4%. Additionally, debt has fallen significantly in recent years (it was 123.9% in 2021 and 94.9% in 2024). The 10-year yield spread versus Germany has already decreased substantially (to just below 50bp), with the 10-year constant maturity bond yield now below that of Spain. There is limited scope for further improvement from current levels, but there seems to be little risk as well.
- Spain: It is a growth story.** The advantage of Spain is robust real GDP growth that keeps surprising to the upside. Spain has one of the strongest estimated potential growth rates among major EU countries. With an estimated 2.2% real GDP growth potential in 2026 (which will likely be revised up in future estimates), Spain can easily absorb a higher real cost of borrowing (projected at 0.6%), while the cyclically adjusted primary balance is still anticipated in negative territory in 2026 (-0.8%). The decline of the debt ratio should continue at a steady, albeit moderate, pace. With the debt ratio at 101.8% in 2024, there is still vulnerability for a turn in the global scenario, but Spain has also sufficient growth to absorb shocks. Together with Portugal, it is in the 'improving zone' of Figure 1.
- The problematic countries: Romania, Hungary, Austria, and Finland.** Romania's accounts have worsened sharply. The Maastricht definition net borrowing requirement (the deficit) increased from 6.4% in 2023 to 9.3% in 2024 and is forecasted to stay at 8.4% in 2026. Despite a decent potential growth rate of 1.7%, real interest rates are expected to reach 2.4% in 2026. With a cyclically adjusted primary deficit of 5.1% in 2026, the debt trajectory looks quite bleak, even though the starting position of the debt ratio is relatively low at 54.8% in 2024. It is projected to rise to 63.3% in 2026. Hungary's debt ratio is somewhat higher (73.5% in 2024, forecasted at 74.3% in 2026, but it could turn out to be much higher). With a much lower potential growth rate of 1.2% and real interest rates of 3.4%, the debt dynamics seem considerably worse than the modest projected increase in the debt ratio. Along with a deteriorating policy environment and weakened institutions, ratings could decline, and interest rates might climb. Lastly, Austria's situation is also worsening, and to a lesser extent, Finland's. Austria was severely impacted by the energy crisis, and being surrounded by mountains limits diversification options. Finland, on the other hand, is spending on its defence. Both Austria and Finland have low potential growth rates (0.4% and 0.5%, respectively), but also low borrowing costs (0.1% and -0.1%, respectively). With a solid policy framework, their ratings remain very high (though slightly deteriorating). The projected cyclically adjusted primary deficit is larger in Austria (1.8%) than in Finland (0.7%) in 2026. Both countries have moderately high debt ratios, but both are on the rise.

**Figures 4 and 5. Debt ratios since the pandemic; Primary balances needed to stabilise the debt ratio.**

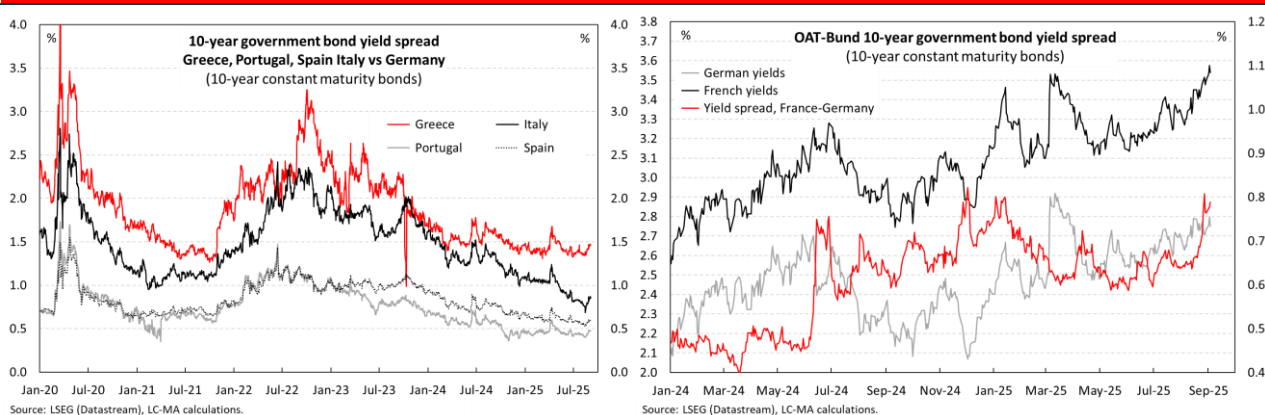


- Germany faces no immediate challenges.** With a strong fiscal position, Germany can finance a large budgetary expansion plan focused on defence, security, and infrastructure. However, a decade-long plan could raise the debt ratio by around 20pp over time, increasing bond supply and possibly pushing rates somewhat higher. Market expectations have already shifted slightly, as the spread between government bonds and swaps has widened. I do

not foresee Germany's fiscal position worsening significantly, but risks remain, mainly linked to its weak economic performance. Projected potential growth rises from 0.1% in 2024 to 0.3% in 2026, despite a considerable fiscal stimulus that may turn out to be more diluted than currently anticipated. Despite upward pressure on government yields stemming from the international environment, the potential for a substantial worsening in the fiscal situation appears limited.

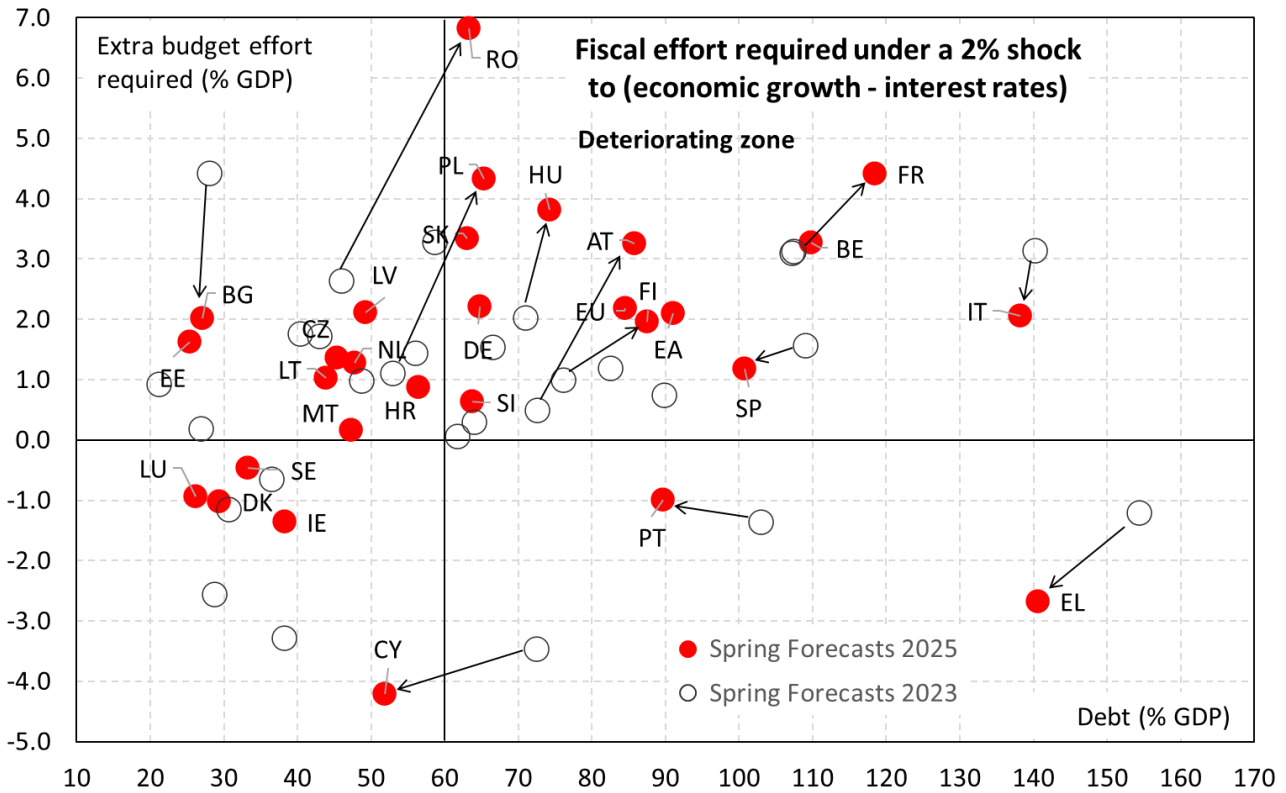
- US and UK: not in a good position.** I have also included the US and the UK for comparison. Using harmonised statistics produced by the Commission, both the US and the UK are in the danger zone. Using the harmonised Maastricht definition of debt, the US was at 124.1% in 2024 and the UK at 101.3% of GDP. Debt dynamics are also unfavourable. In both cases, potential real GDP only slightly exceeds the cost of borrowing. In the UK, potential growth is projected at 1.4% versus the cost of borrowing at 1.1% in 2026. In the US, the rates are 2.3% and 1.9%, respectively. The 2026 primary deficit is 1.3% and 0.9%, respectively. This is enough to project a steady, albeit moderate, increase in the debt ratios, at least based on fiscal fundamentals alone. Finally, with a debt ratio still at 247.8% of GDP in 2024, any rise in interest rates due to a normalisation of inflation could become a serious problem in Japan.

**Figures 6 and 7. Peripheral government bond spreads; German and French government bond yields.**

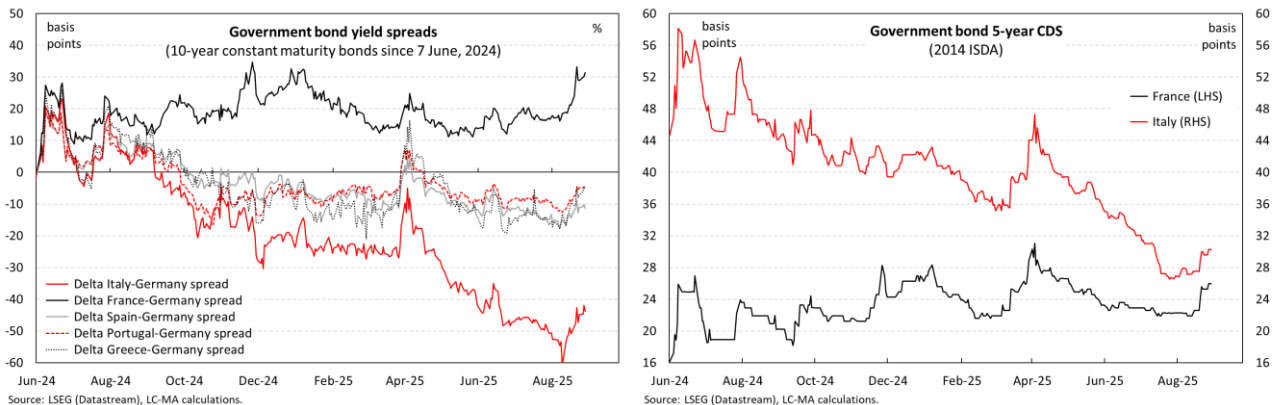


- France's weak fiscal fundamentals.** Finally, let me address the French situation, which is currently under the spotlight of financial markets. The political situation is tricky, and the confidence vote scheduled for September 8 looks of paramount importance. Yet, leaving aside politics, the fundamentals appear weak. According to the Commission's data, the deficit was 5.8% in 2024. It is projected to decline only marginally to 5.7% in 2026. The projected cyclically adjusted primary deficit for 2026 is 2.7%. On the positive side, thanks to favourable demographic trends, potential growth in 2026 is estimated at 1.0%, surpassing that of Germany and Italy. Moreover, it is higher than the cost of borrowing, at least according to the Commission's projections published in April. Since then, however, the cost-of-borrowing situation has worsened, and the risk is that it will deteriorate further due to political instability. The debt ratio was 113.0% in 2024, but the Commission projects it to rise to 118.4% in 2026. Taxation in France is already high, and the rigidity in spending is well-known. The expenditures-to-GDP ratio was 57.1% of GDP in 2024, second only to Finland among EU countries. Reducing it appears to be highly challenging. On the positive side, a solid and well-diversified economy should be able to withstand adverse scenarios if they materialise.
- Has periphery become core? And core, periphery?** Figure 8 displays the shifts in the quadrant from the Spring Forecasts 2023 to the Spring Forecasts 2025. It is immediately clear that changing fiscal fundamentals is not a matter of just a couple of years, and the periphery remains in a considerably worse budgetary position than the core. However, the shift has been significant. Spain, Portugal, Greece, and Cyprus have experienced notable changes in both projected debt levels and debt dynamics. Italy's improvement is less dramatic, as some of it was already forecasted in 2023. France's deterioration is considerable, while Belgium remains broadly unchanged in a risky zone. Bulgaria's progress has also been notable as it prepares to join the monetary union. Poland saw a sharp deterioration, mainly due to increased defence and security spending, with projected debt slightly above the 60% threshold. Romania's debt dynamic has worsened drastically. Worsening trends are also visible in Hungary, Austria, and Finland. Changes in debt dynamics matter in financial markets, and they have been accompanied by relative movements in yield spreads (Figure 9), as well as in the CDS market (Figure 10).

**Figures 8. The shift of EU countries from the SF 2023 to the SF 2025.**



**Figures 9 and 10. France vs. Italy: The spread is moving in opposite directions, as reflected in CDS values.**



- It is not just about debt sustainability analysis.** Debt sustainability analysis is more of an art than a science. Here, I have presented a stylised scenario that helps to understand the overall situation. However, financial markets and rating agencies conduct a much broader assessment of the economy's underlying structure, its diversification, exposure to various risk factors, as well as the quality of its institutions and political developments. Rating agencies employ a variety of economic tools to evaluate the sustainability of a country's government debt and key variables. Additionally, they also rely on judgment. However, financial markets can react much more swiftly if a trigger changes expectations.
- US monetary policy remains vital.** A significant gap exists between policy rates in the US and the Eurozone due to differing inflation and growth expectations. However, long-term rates often respond to global trends, mainly influenced by the US market. Therefore, if the Fed stops cutting interest rates (my view) or even raises them, it could impact the US yield curve and cascade into the wider world. An even more critical factor might be a global

shift in risk premia, which could also increase borrowing costs for the EU/Eurozone's most vulnerable nations. With equity and credit markets overstretched, this represents a notable risk. The trigger for a crisis might also stem from domestic political issues. France, given its systemic importance in Europe, is under scrutiny. Nevertheless, other countries, such as Italy, because of its high debt, or Romania and Hungary, owing to soaring fiscal deficits, could once again become sources of instability.

- **The Eurozone now has much better tools than before.** If countries follow their fiscal adjustment programme, the ECB's Transmission Protection Instrument could be activated to maintain financial stability within the Eurozone. Additionally, the ECB might restart quantitative easing, temporarily buying government bonds. Compared to 2010-2011, the ESM could step in to provide credit lines under specific European programmes. If the EU/Eurozone faces an economic downturn, some fiscal capacity at the centre could be used to support the economy. Overall, EU/Eurozone-specific risks appear to be limited, while those linked to the international scenario are considerably higher. Finally, there seems to be more improvement in the periphery amid some deterioration in the core, suggesting that, beyond fragmentation, convergence could remain the central theme in financial markets.

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