



A triple whammy for public finances

The public finances of the major eurozone countries will face three challenges in the coming years: rising defense spending, higher interest payments on existing debt, and unfavorable demographic trends. The resulting additional expenditure is unlikely to be offset by savings elsewhere, meaning that budget deficits and debt ratios will rise significantly. This will lead to louder calls for joint debt issuance, and probably increase pressure on the ECB to ease the burden of the highly indebted member states through lower interest rates and bond purchases.

| Dr. Ralph Solveen ^{AC}

German public deficit is rising...

As shown by the federal budget for 2025 and the financial planning for the following years presented to the Bundestag this week, the federal government intends to significantly increase its spending and finance this by taking on additional huge amounts of debt. If the plans are implemented as proposed, the deficit ratio would probably be slightly above 4% of GDP in the coming years.

In the end, the shortfall could be even higher. This is because the coalition partners want to reform, i.e. relax, the debt brake again. If they succeed, the coalition will certainly make use of the additional financial leeway this will create, as despite the planned debt splurge, there are considerable gaps in the financial planning for the years from 2027 onwards. One thing is clear: Germany's debt ratio will rise massively in the coming years.

... but the budgets of other eurozone countries are also under pressure

Germany is not alone among the eurozone countries in facing this prospect. The national budgets of the other large eurozone countries will also be confronted in the coming years – to varying degrees – with the burdens that are at least partly responsible for the additional German government debt: higher defense spending, rising interest charges, and unfavorable demographic trends.

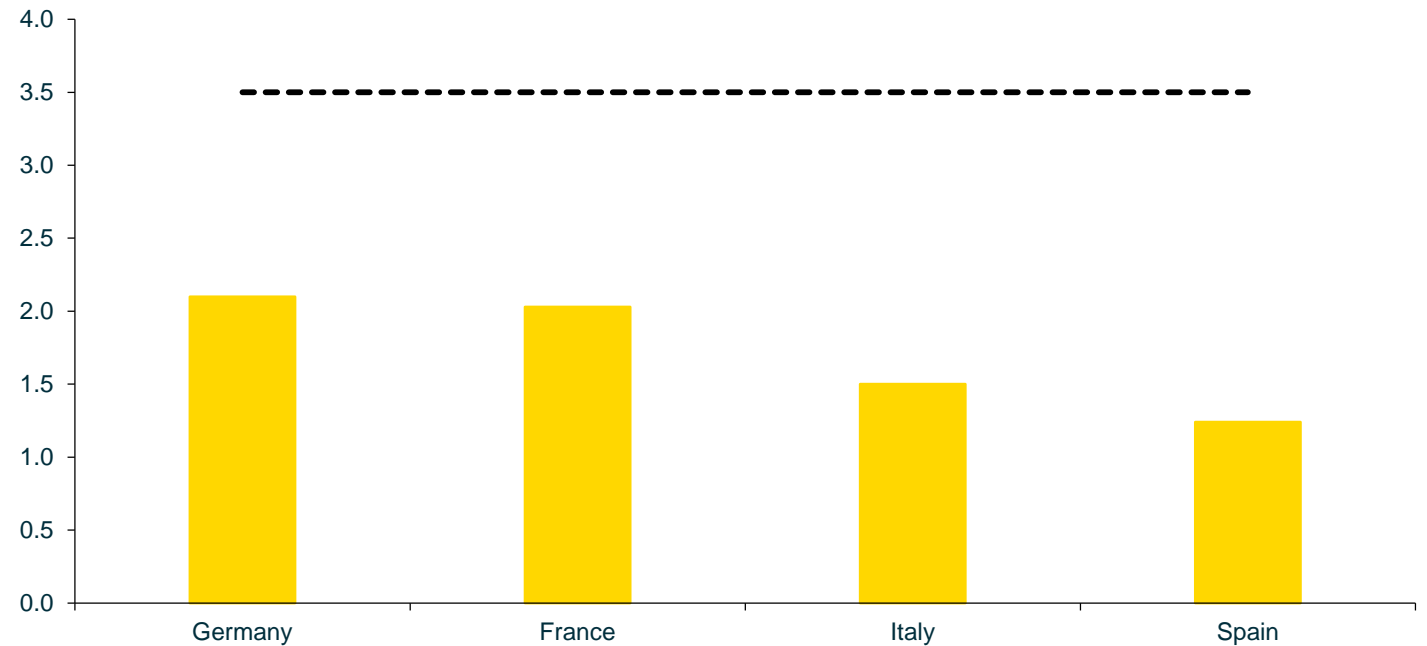
Three stress factors: higher defense spending, ...

At the NATO summit at the end of June, the allies agreed to increase their defense spending to 3.5% of their GDP by 2035. In addition, 1.5% of GDP is to be allocated to infrastructure investments to make it fit for defense.

The 3.5% for defense in the narrower sense is significantly more than the governments of the four major eurozone countries spent last year (Chart 1). While Germany and France at least narrowly achieved the old NATO target with slightly more than 2% of GDP, Italy and Spain in particular fell well short of it.

Chart 1 - Defense spending well below new NATO target

Defense spending according to NATO definition as a percentage of GDP, dotted line: new NATO target for 2035



Source: NATO, Commerzbank-Research

According to current financial plans, the German government wants to achieve the new NATO target already by 2029. However, it is questionable whether the other three countries will actually aim for this target or play for time. The Spanish government believes it has agreed on an exemption with the other NATO countries, but the other governments deny this. There are therefore good reasons to believe that Italy and Spain in particular will not achieve the 3.5% target in the end. But even they are unlikely to be able to avoid significantly increasing their defense spending.

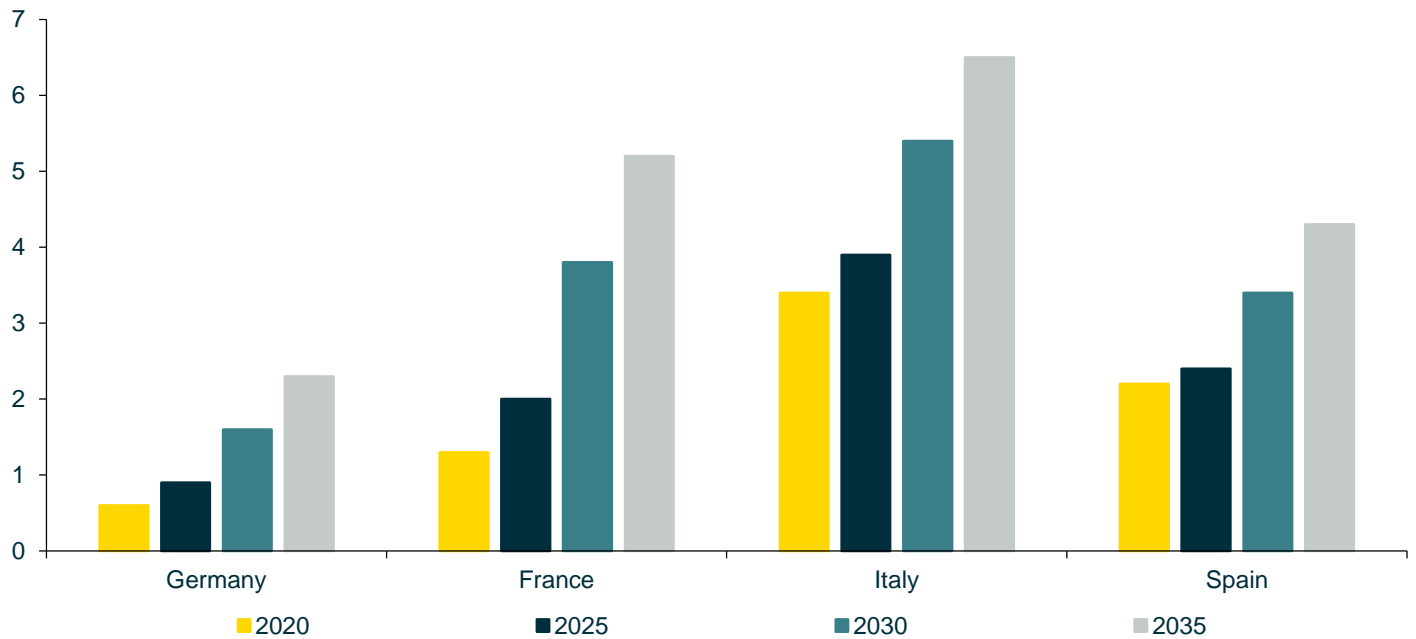
... rising debt service ...

Rising interest payments on government debt are another burden on national budgets. After many years of benefiting from falling interest payments, governments are now seeing the tide turn. This is because bonds with low coupons are increasingly having to be refinanced on less favorable terms. Added to this is rising debt.

Based on certain assumptions (for details, see [here](#)), we have calculated how interest payments will develop in the coming years. Even assuming that yields on 10-year bonds will rise only slightly in the coming years, the interest burden ratio – i.e., the government's interest payments as a percentage of GDP – will rise significantly over the next ten years. Germany is likely to get off relatively lightly with an increase of just under one and a half percentage points compared with the current year. For Spain, it will rise by more than two percentage points, for Italy by two and a half, and for France by more than three (Chart 2).

Chart 2 - Interest payments will increase significantly

Interest payments by the government as a percentage of GDP, from 2025 simulations by Commerzbank



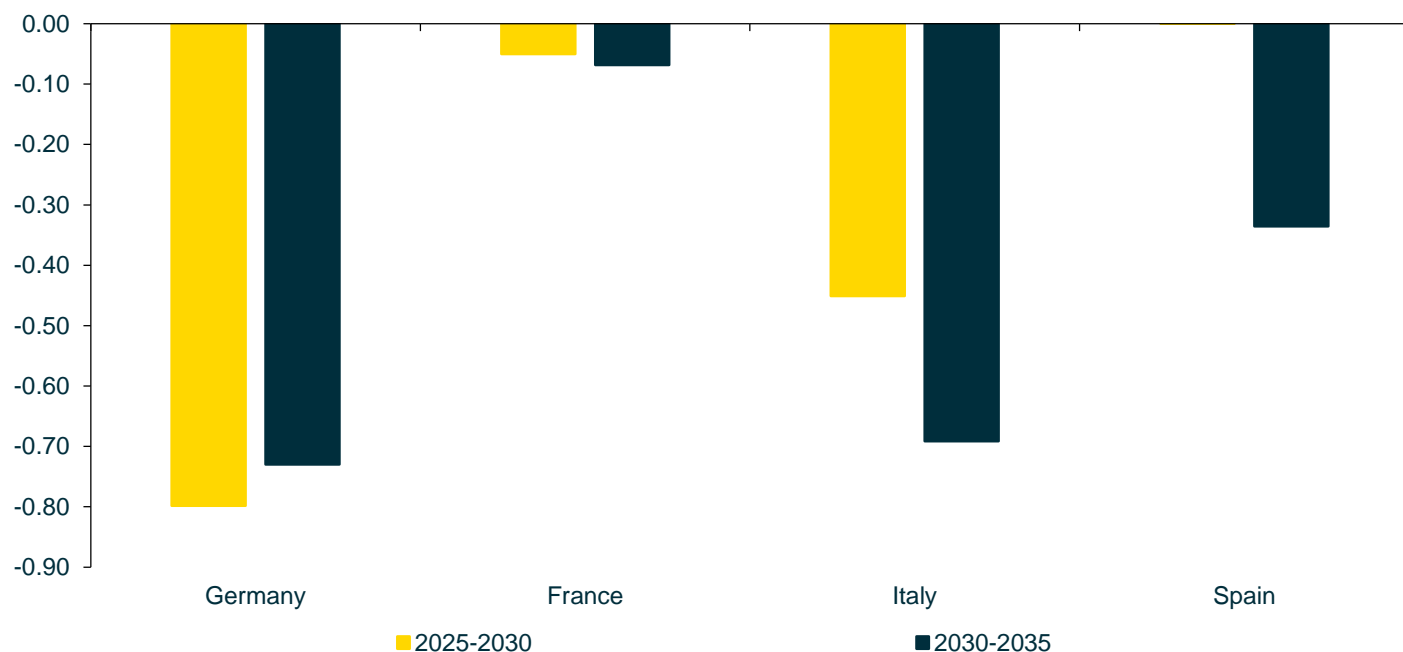
Source: Bloomberg, Commerzbank Research

... and unfavorable demographics

In addition, demographics will deteriorate in all four major eurozone countries over the next ten years. According to current Eurostat projections, the labor supply – defined here as the number of residents between the ages of 20 and 64 – will shrink. At around 3/4 percent per year, the decline is likely to be strongest in Germany (Chart 3). In Italy, this effect will be somewhat smaller in the first five years, but between 2030 and 2035 it will be similar to that in Germany. In France, the labor supply will hardly change, but it will stop growing, so that economic growth is likely to be limited to productivity gains alone. In Spain, the labor supply will remain largely constant at first, but will then also decline noticeably in the 2030s.

Chart 3 - Labor supply set to shrink significantly

Number of people aged 20 to 64 per year, change per year in percent, Eurostat projections



Source: Eurostat, Commerzbank Research

This unfavorable demographic trend could be partially offset by higher immigration and other measures such as extending the working life. However, as discussions in Germany and France show, the latter is politically difficult to implement, and political resistance is also likely to prevent migration from having a sufficient balancing effect. Nevertheless, the impact of demographics may not be as strong as current projections suggest. Nevertheless, it will still be noticeable.

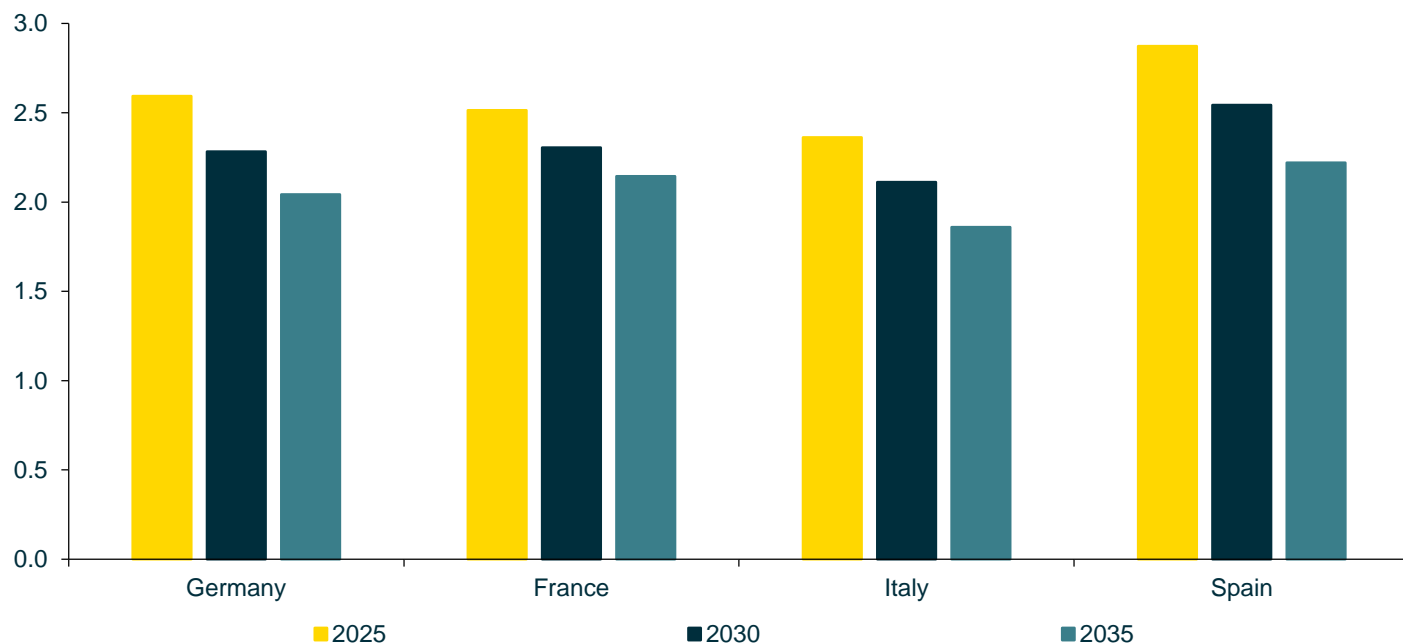
Weaker growth due to a shrinking labor supply will make it more difficult for countries to “grow out” of their government debt, i.e., to reduce their debt ratio even with an existing budget deficit and a resulting increase in absolute debt, at least as long as inflation does not pick up.

In addition, the ratio of people in work to pensioners will deteriorate significantly in all four countries, including France and Spain. In Germany, for example, there will be only two people aged between 20 and 64 for every person over the age of 65 in ten years’ time, compared with two and a half at present (Chart 4). The effect is somewhat smaller in France and somewhat larger in Spain.

This less favorable ratio between age groups will naturally affect social security systems first and foremost, as the ratio between contributors and recipients will deteriorate. However, this is also likely to have an impact on government budgets. This is because part of the financing gap in social security will probably have to be bridged by subsidies from the government budget. In addition, an increase in social security contributions would in itself slow down growth and thus reinforce the effect described above.

Chart 4 - Fewer young people take care of the elderly

Ratio of the population aged 20 to 64 to the population aged 65 and over; Eurostat projections



Source: Eurostat, Commerzbank Research

Adequate countermeasures unlikely

Of course, the additional expenditure resulting from the three effects described above could be offset by savings elsewhere. However, governments have so far found this difficult to achieve, and the rise of political fringe parties in all four countries is making it increasingly difficult to form coalition governments with similar economic policy ideas.

The EU is also unlikely to enforce a sustainable consolidation of government budgets. On the one hand, the Stability and Growth Pact has become increasingly non-binding as a result of numerous reforms. On the other hand, most countries are plagued by the same problems, so there is unlikely to be a majority in the European Council in favor of any sanctions.

Higher deficits cause debt ratios to rise further

This raises fears that budget deficits will continue to rise in the coming years, causing government debt ratios to trend upward. However, due to stronger economic growth, Spain's debt ratio will increase relatively little, reaching around 110 percent in ten years. Germany's ratio is likely to be significantly higher than at present (2024: 62.4 percent) at more than 90 percent in 2035, but still lower than Spain's. The biggest problem children are France and Italy, whose debt ratios will no longer be far apart at just under and just over 150 percent (see title chart).

No acute crisis, but risk is rising

Even if a crisis in the near future is unlikely given the persistently low yields in a long-term comparison, the risk that the markets will no longer consider the debts of individual eurozone countries to be sustainable in view of the ever-increasing burden of debt servicing will naturally increase over time. If they then demand higher risk premiums, there is a danger of a vicious circle.

Calls for joint debt are growing louder...

Against this backdrop, it is no wonder that there is repeated discussion about taking on joint debt, and despite resistance from Germany and some other countries, the trend seems to be moving in this direction. [1] However, without a change in the national fiscal policy of all eurozone countries, joint debt would only buy time. Ultimately, the debt would simply be shifted to another level, but would still have to be borne by the individual countries. Moreover, it is questionable whether Germany, with a significantly higher debt ratio, would still be regarded by the markets as a sufficient fiscal anchor to guarantee the repayment of this joint debt. In that case, the interest rate advantage of joint bonds and the resulting relief for national budgets would probably not be as great as some would like.



... and pressure on the ECB will increase

This would increase pressure on the ECB to lower key interest rates and, in the long term, to buy bonds in order to reduce the financing costs of the eurozone countries. This would initially reduce financing costs, and the resulting higher inflation in the medium term would reduce the debt burden in real terms. In the longer term, however, inflation expectations and thus government bond yields would probably rise even more sharply than assumed in our simulations, so that, on balance, government budgets would actually be burdened in the long run.

[1] The EU Commission wants to raise up to €150 billion on the capital markets in order to be able to grant loans to EU countries for investments in defense. In addition, there are media reports that the EU Commission is planning a new instrument to support EU countries with fiscal problems as part of the new multi-annual financial plan. This would also ultimately require joint borrowing. ([back to text](#))



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This report was completed 11/7/2025 07:15 CEST and disseminated 11/7/2025 07:15 CEST.

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