How will the big debt wave end?

Not only in Germany, but also in most other eurozone countries, government debt will rise rapidly in the coming years. The EU is likely to help finance ministers by increasing joint borrowing. The ECB is providing support with a monetary policy that is too loose in case of doubt and, in the event of a sovereign debt crisis, with broad-based bond purchases. All of this helps finance ministers muddle through, but in the long run it jeopardizes the stability of the monetary union.

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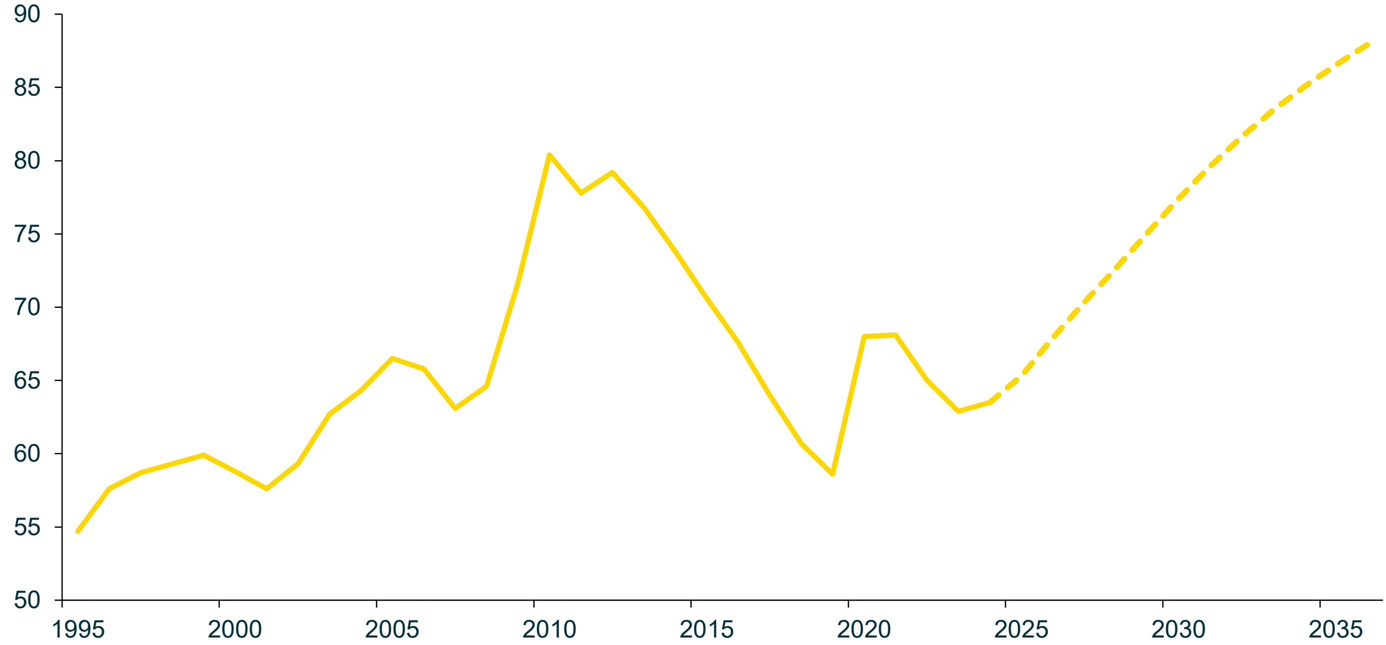
Germany's debt is rising rapidly...

Last night, the Budget Committee put the finishing touches to the federal budget for the coming year. The budget is expected to be approved by the Bundestag the week after next. According to the government's plans, the federal government will take on more than €180 billion in new debt next year – almost €40 billion more than estimated for the current year. A look at the financial planning up to 2029 shows that similarly high deficits are planned for the coming years. All in all, government debt is likely to rise to almost 90 percent of GDP over the next ten years. The debt ratio would then be significantly higher than during the financial crisis (Chart 1).

Chart 1 - German public debt set to increase significantly

Public debt in percent of GDP, starting 2025 Commerzbank froecast



Source: Ameco, Commerzbank Research

... which also applies to the rest of the eurozone

Despite this sharp increase, Germany's debt ratio will still be well below the eurozone average in 2035. This is because debt in the eurozone is likely to be just under 90 percent of GDP this year and is expected to rise further in the coming years. The budgets of almost all eurozone countries are being burdened by higher financing costs, rising defense spending, and unfavorable demographics, which many governments will finance in part through new debt (see title chart). The alternative – radical budget consolidation through lower spending or higher taxes – is meeting with resistance from politicians and voters, and not only in Germany and France.

New EU debt to ease the burden on national finances?

Against this backdrop, there are repeated calls for the EU to take on additional debt and pass on the funds raised to member states either as loans or even grants, or to take on certain tasks that were previously financed by the states. Many see the recovery fund agreed during the pandemic as a blueprint, even though it was emphasized at the time that this was to be a one-off measure.

The advantage of joint debt for countries with weaker credit ratings is that the EU has to pay less interest than they do. In addition, individual countries have to issue fewer bonds, which also reduces financing costs.

As part of the multi-annual budget for 2028 to 2034, the EU Commission is planning initial steps in this direction:

- First, a fund called "Catalyst Europe" is to be filled with €150 billion through the issuance of joint debt. This fund is to grant loans to EU countries to finance investments in line with EU objectives. Commission President von der Leyen cited investments in the defense industry, energy infrastructure, and "strategic technologies" as examples.

- Second, a credit facility of just under €400 billion is to be created, from which loans can be granted to EU countries in crisis situations. This credit facility is also to be refinanced by taking on joint debt in the event of an emergency.

These proposals by the EU Commission, published in the summer, met with resistance in Germany and some other member states. However, Chancellor Merz recently proposed a procedure to support Ukraine in which a bond guaranteed by the member states plays a central role. In addition, Bundesbank President Nagel had proposed a European defense budget to be financed through joint debt.

Even if Germany's rejection of joint debt seems to be softening somewhat, the EU Commission's plans are unlikely to be implemented, at least not to the extent proposed. But that is likely to change in the next crisis, if not before.

ECB helps with a loose monetary policy in case of doubt

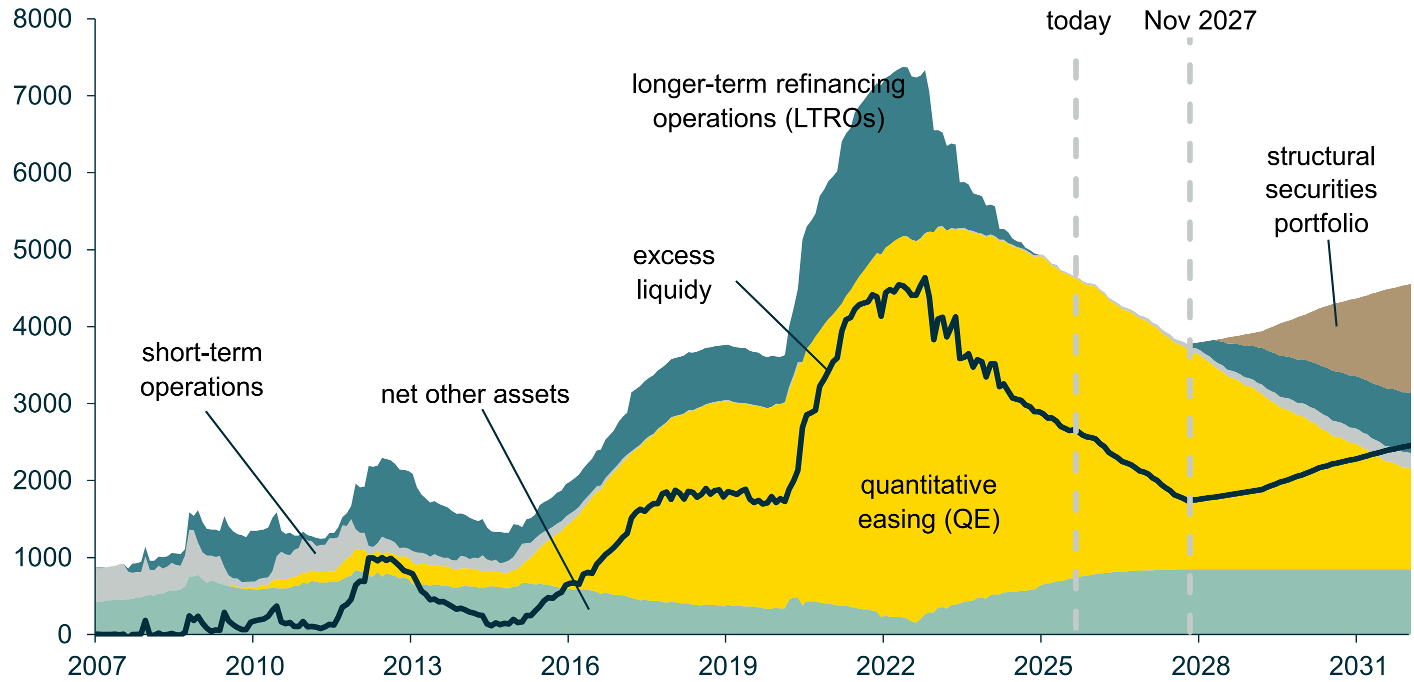
The ECB is also likely to help take pressure off finance ministers:

- ***Loose monetary policy:*** The ECB is likely to lean toward low key interest rates due to high government debt. This phenomenon, known as fiscal dominance, was acknowledged by Belgian central bank chief Pierre Wunsch in a speech a good two years ago, when he said that "we cannot act on monetary policy without thinking about the fiscal implications." A tendency toward loose monetary policy will lead to higher inflation in the longer term. However, it would help finance ministers for a few years in that tax revenues would rise rapidly, while inflation induced higher coupons would only have to be paid on newly issued bonds.

- ***Structural bond portfolio:*** According to its operational framework updated in 2024, the ECB will not completely reduce its still large bond portfolio. Instead, it is targeting a so-called structural bond portfolio with a considerable volume (Chart 2). This is likely to happen in the end because a permanently large portfolio will reduce the bond supply to be sold to private investors and thus lower the term premium on government bonds.

Chart 2 - ECB bond holdings to rise again from end 2027

Balance sheet of the European System of Central Banks (ESCB), assets, in EUR billion; from October 2025 Commerzbank projection



Source: ECB, Commerzbank Research

In the worst-case scenario, the ECB will activate the TPI

If, despite the measures discussed above, a buyer strike on the bond market and a sovereign debt crisis were to occur at some point, the ECB would likely activate the **Transmission Protection Instrument** (TPI) adopted in 2022 to assist finance ministers. The TPI provides for the large-scale purchase of government bonds if financing conditions in a member state deteriorate significantly without this being justified by country-specific fundamentals. The ECB writes that the country must therefore be innocent of the massive rise in bond yields.

The ECB lists four criteria for this, such as compliance with EU fiscal rules. But even if a member state were subject to excessive deficit proceedings, it would still qualify for the TPI as long as it did not violate the EU Council's fiscal policy recommendations, which are formulated in a very vague manner.

Furthermore, it should be noted that these criteria are only "an input" for the decision-making of the Governing Council. Nevertheless, the Governing Council may come to different conclusions. The situation was similar in the run-up to monetary union, when the EU Council admitted countries such as Italy to the monetary union even though they violated the fiscal rules of the Maastricht Treaty with public debt exceeding 60% of GDP. However, the treaty (Article 109j, paragraph 4) merely stipulated that the EU Council should decide on the countries to be admitted “taking into account” the fiscal rules.

All in all, the hurdles for activating the TPI are quite low. But that does not mean that the ECB would activate the purchase program prophylactically, i.e., before a sovereign debt crisis occurs. Doing so would openly violate the TPI's goal of countering disorderly market dynamics, which would damage its reputation. There would therefore have to be considerable stress on the bond markets, and it would have to feel like the beginning of a sovereign debt crisis before the ECB would activate the TPI. In the event of a sovereign debt crisis, the bond-buying program would therefore not be able to prevent it entirely. However, a sovereign debt crisis would not drag on for several years as it did around fifteen years ago, but would be quickly contained.

But in the long term, none of this is a solution

New EU debt, loose monetary policy, lots of government bonds on the ECB's balance sheet, large-scale bond purchases if the worst comes to the worst – with all these measures, the EU and the ECB can help highly indebted countries muddle through for many years. But all this would have massive side effects and would therefore not be sustainable:

- Joint debt obscures responsibility for the debt. The EU is perceived as a cow that gives milk on earth but grazes in heaven. There are strong political incentives for individual countries to continue borrowing at the expense of the EU. Joint bonds drive up debt across the EU, drain resources from the private sector, and ultimately weaken economic growth.

- A monetary policy that is lenient in times of doubt leads to higher inflation in the long term, as do bond purchases. If, as is usual in such programs, the ECB buys bonds from the banks, this initially only results in an asset swap in the banks' balance sheets: instead of bonds, they hold more ECB reserves. But when banks buy new bonds from finance ministers to pass them on to the ECB, they credit the equivalent value to their ECB accounts. Sooner or later, finance ministers will spend this money, putting it into circulation. If the monetarily financed budget deficits are high enough, as they were during the coronavirus crisis, they are likely to fuel inflation.

Ultimately, the EU and ECB's support measures weaken economic growth and increase inflation. They make the eurozone less attractive and strengthen the political forces that seek salvation outside the monetary union. An economically weak euro-zone is not stable in the long run.

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