Letter from the Editors

For years, Europe enjoyed an unusually forgiving financial climate. Governments could borrow at historically low interest rates, central banks provided a reassuring backstop in sovereign debt markets, and even sharp increases in public debt brought little immediate pressure from financial markets. The pandemic put that stability to the test: While the subsequent recovery, together with inflation and nominal GDP growth, helped bring debt ratios down from their peaks, the underlying fiscal weaknesses remained.

That period of relative stability now appears to be over. European governments can still borrow. But at what cost? And how much fiscal room for manoeuvre will that leave to finance the policy priorities of the coming decade?

These tensions are emerging against an increasingly demanding geopolitical and demographic backdrop. Governments face mounting spending pressures from competing priorities such as defence, ageing populations and energy security. Businesses need to invest in technology, infrastructure and productivity. Yet these demands are growing just as the interest burden on existing sovereign debt is rising. The consequences extend beyond government balance sheets, as higher sovereign yields reverberate through financial markets and borrowing costs across the economy.

This is hardly the first time European leaders have faced such a dilemma. The return of higher borrowing costs has exposed a familiar problem: public debt does not have to become unsustainable to constrain economic policy. Even when debt ratios are stable or declining, refinancing existing obligations at higher interest rates can gradually absorb resources that might otherwise be available for investment or public services. These pressures accumulate gradually, eroding fiscal flexibility long before they necessarily develops into a full-blown crisis. France now represents the most immediate sovereign risk, one that, if it materialises, could have far-reaching consequences for the wider euro area.

Spain offers a particularly interesting natural experiment in terms of both the progress made and the challenges that remain. Stronger economic growth has helped reduce the country's debt-to-GDP ratio from the highs recorded during the pandemic, while its fiscal position compares favourably with that of several other large European peers. Nevertheless, debt remains elevated, and the benefits of growth cannot indefinitely offset the rising cost of servicing it. Preserving that relative advantage will require a credible fiscal trajectory without sacrificing the investment needed to sustain longer-term productivity.

The implications of Europe's elevated public debt burdens extend beyond

government finances. Sovereign bonds remain central to European capital markets and bank balance sheets, creating channels through which fiscal pressures can affect financial stability. The risk of a sovereign-bank doom loop has diminished, but the underlying links between public finances and the banking system have not disappeared.

Although European banks are better capitalised than during the last sovereign debt crisis, they are also adjusting to higher funding costs and greater market uncertainty. The era of exceptionally cheap credit has ended, prompting financial institutions to reassess the composition and cost of their funding. Competition for deposits has intensified, while market financing is no longer available on the exceptionally favourable terms of the past. While higher interest rates initially boosted bank profitability, rising funding costs and greater market uncertainty present a more complicated outlook. The resilience built up over the past decade will be important, but it should not be mistaken for immunity from renewed sovereign stress.

Yet Europe's challenge extends beyond containing financial risks. Persistent weaknesses in capital formation and productivity have limited its competitiveness relative to other major economies. Higher financing costs make the investment needed to close that gap more difficult to mobilise, adding to the pressure on Europe's economic prospects.

This is where the case for deeper European financial integration takes on renewed urgency. Europe's problem is not a shortage of savings, but its persistent inability to mobilise them effectively in support of its own investment priorities. Too much European capital continues to find its way abroad, even as the continent struggles to finance its technological ambitions, energy transition and security needs. In an increasingly fragmented geopolitical environment, completing Europe's financial architecture is therefore no longer merely an exercise in market efficiency. It is becoming a question of strategic autonomy: whether Europe can put its considerable financial resources to work in shaping its own economic future, rather than remaining dependent on the priorities and decisions of others.

Ultimately, fiscal discipline and investment cannot be treated as competing objectives. Unchecked debt burdens threaten fiscal credibility, but consolidation at the expense of productive investment risks undermining the growth on which debt sustainability depends. Europe's challenge is to preserve fiscal space while investing in its longer-term economic future.

More broadly, the choices facing Europe are therefore increasingly interconnected. Fiscal credibility, financial stability and economic competitiveness can no longer be pursued as separate objectives. Europe's ability to deliver on any one of them will depend on its success in addressing the others.

Therefore, the question is not simply how Europe will finance its debt, but how it will finance its future. The continent has considerable financial resources, sophisticated institutions and the economic capacity to meet its ambitions. What remains uncertain is whether it can translate those advantages into the political choices and investment decisions that the coming decade will demand. Higher borrowing costs have made those choices more difficult, but also more urgent.