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A Euro zone debt crisis redux?

Events currently unfolding in France show how difficult it is for politicians to shift unsustainable fiscal settings back on to a sustainable trajectory. There are only three pathways: one - achieving higher sustainable growth – takes time and is very difficult, while the other two - raising more revenue or cutting spending - are deeply unpopular.

After the debt crisis of the early 2010's, Europe put several measures in place to prevent another crisis. The centrepiece is the European Stability Mechanism, the key feature of which is the rule by which countries within Europe must keep budget deficits below 3% of GDP.

France has been a serial offender. After many years of fiscal slippage borne of too optimistic growth and revenue forecasts, new Prime Minister Barnier's government has recently proposed a Budget that includes €60 billion in spending cuts and tax increases that is expected to see the French budget deficit down from this year's likely 6.1% of GDP to 5% of GDP in 2025 and back below the EU limit by 2029.

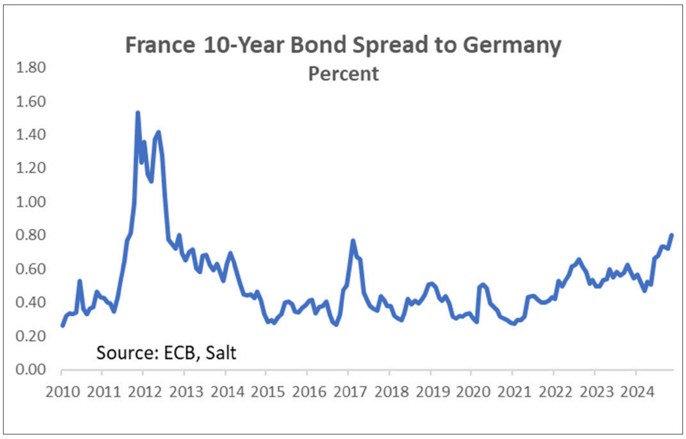
The challenge for Mr Barnier is to get his Budget approved by a fractious coalition that includes the left-wing New Popular Front and Marine Le Pen's National Rally (formerly the National Front). Ms Le Pen has threatened to pull the pin on the fragile coalition.

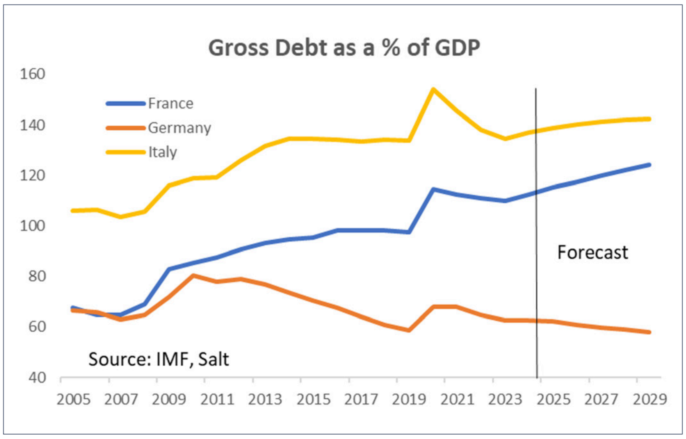
As this crisis has unfolded, bond investors have taken the French 10-year bond yield spread to Germany to its highest level since the Euro zone debt crisis and the same level as Greece.

This raises the inevitable question of whether another Euro zone debt crisis akin to that of the early 2010's in possible.

The first point is that it's not all bleak in Europe. Italy has long been vilified within the Euro zone for not getting its fiscal house in order. Indeed, Italy's deficit came in at a massive 7.4% of GDP last year, largely on the back of a poorly thought-out tax incentive for green home renovations that ended up costing over €200 billion. But in its latest Budget forecasts, the Italian Government is predicting a return to deficits below the European Unions' 3% deficit limit by 2026, three years earlier than France. That said, Italy's debt level remains uncomfortably high and is forecast to move higher.

In its latest Fiscal Monitor report, the International Monetary Fund estimates that by 2029, France's debt to GDP ratio will rise from 112% of GDP currently to 124%, while Italy's will rise from 136.9% to 142.3%. And these are countries that do not have the benefit of being the world's reserve currency!





It’s structural

Fiscal sustainability is not Europe’s only fragility. Europe’s fiscal woes are wrapped up in a far bigger problem of structural economic weaknesses highlighted in a recent report commissioned by the European Commission and written by former European Central Bank President and Italian Prime Minister Mario Draghi: “The Future of European Competitiveness”.

While the report has been criticised for its lack of actionable recommendations, it highlights Europe’s structural weaknesses, including fragmented markets, excessive regulatory burdens, and limited access to unified funding pools across the region. These hinder scaling innovative industries, particularly in technology. It also emphasises demographic challenges, low productivity growth, and slow adoption of digital and green transitions, threatening long-term economic resilience.

ECB warning

It is in this environment of a spotlight being thrown onto Europe’s structural weaknesses and the political challenges of achieving fiscal sustainability that the European Central Bank, in its November 2024 Financial Stability Review, has raised fresh concerns over the Euro zone’s vulnerabilities and the possible reignition of another sovereign debt crisis in Europe.

While much work has been done since that crisis to shore up the viability of the common currency including the establishment of the European Stability Mechanism alongside efforts to centralise banking supervision and resolution to protect the banking sector, the underlying problems of shared monetary policy but separate fiscal policies still pose risks.

Divergent economic performances and inconsistent fiscal policies among member states weakens collective resilience to crises. Without deeper fiscal integration, the Eurozone remains vulnerable to contagion effects, as financial instability in one country can spread rapidly, just as we saw in 2010.

Right now, pressure is mounting as maturing debt is now being rolled over at significantly higher interest rates, pushing up sovereign debt servicing costs. This puts extra pressure on highly indebted countries to get their fiscal house in order.

The ECB’s emphatic conclusion is that complacency is not an option. Let’s see.

Implications for bond investors

Regular readers will know that our diversified portfolios and single sector asset class selections have been made with a particular set of challenges funds will have to navigate in the period ahead in mind. These include higher inflation, challenges to fiscal sustainability and higher interest rates, amongst others.

The implication for our bond portfolio is that while sovereign bonds have traditionally been a go-to refuge for investors in periods of market disruption, these securities will continue to be challenged by higher inflation and rising debt levels.

This means that investors need to look further than sovereign debt to offset equity risks or to diversify their funds in a way that helps lift the investment returns received for bearing a higher level of volatility. Bond investors should be looking for a solution with exposure to a well-diversified credit, securitised and agency-linked portfolio in addition to sovereigns, which can be actively expanded or contracted as the cycle plays out.

As the universe of credit securities with acceptable risk levels and ratings has greatly expanded, and as some bonds outside the traditional sovereign issuers’ even begin to rival certain governments in their future cashflow surety, investors have sound reasons for no longer relying on financing government’s budgets in order to safely satisfy their portfolio’s income needs.