BLOG POST

24/04/2025

Guillaume Duval,
Conseiller, avenir de l'intégration européenne à l'Institut Jacques Delors.

European rate hikes: a manageable impact for now

©Getty Images on Unsplash

Interest rates on European government debt have risen significantly in recent weeks. In the public debate, this is often blamed on announcements of future public borrowing, particularly in Germany, to finance European rearmament. For this reason, there would be an urgent need to call into question the European social model in order to be able to finance this defence effort without having to go further into debt. A questionable interpretation and conclusion.

I • A real increase with major consequences

First of all, this rise in interest rates on European debt is very real, and its potential consequences are significant, particularly for countries with high levels of debt such as France and Italy. In the case of France, if interest rates on public debt were to stabilise permanently at the current level of 3.5%, the French State would have to pay €115 billion a year in interest. That's more than the €90 billion national education budget, and more than twice as much as the €50 billion paid last year.

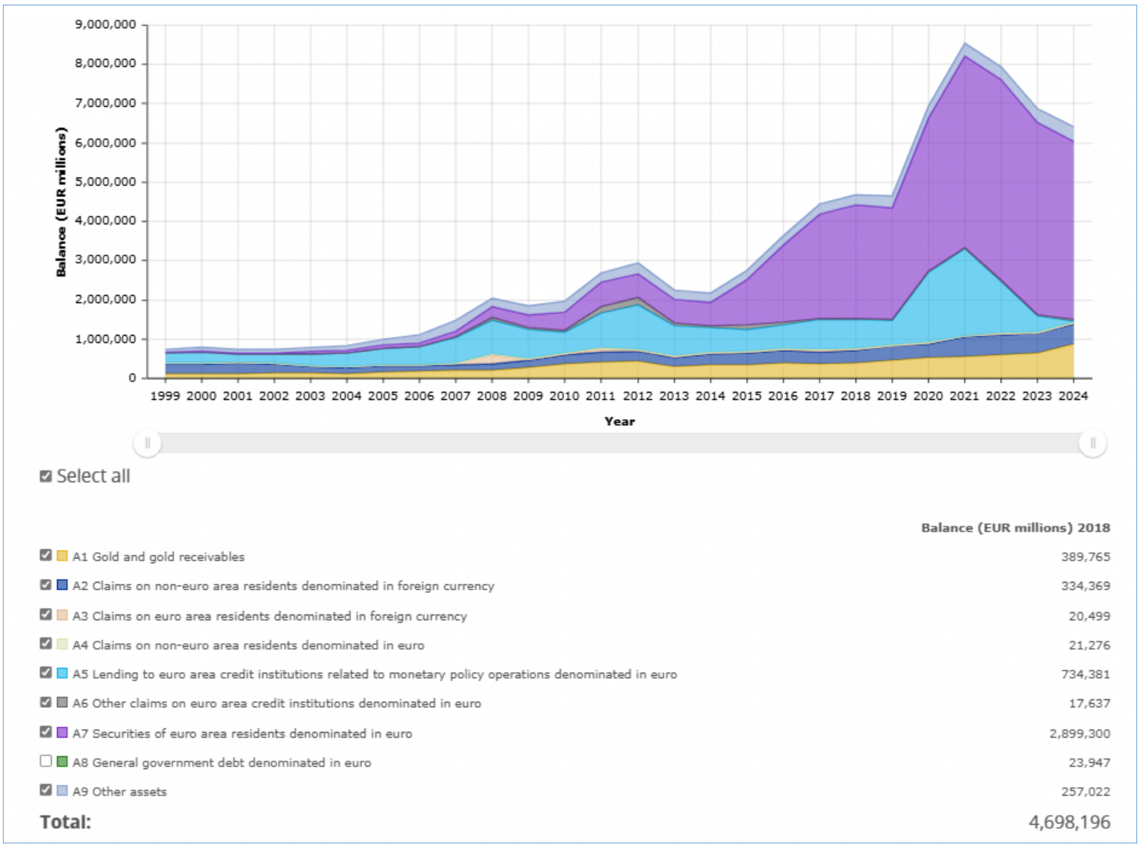
115 billion represents 3.9% of France's GDP. This means that to get back below the 3% deficit required by European rules (and essential to prevent public debt from spiralling out of control), we need to generate what economists call a «primary budget surplus». In other words, the taxes paid by the French should exceed the value of the services and social benefits they receive in return. This is a highly uncomfortable political situation, which France has only experienced for 7 years out of 45 since 1980: between 1988 and 1990 under Michel Rocard and between 1998 and 2001 under Lionel Jospin.

But in recent weeks, the rapid rise in interest rates on government debt securities has not just affected France. It has also affected Germany, and it is above all this that has struck a chord in people's minds, who are used to seeing Germany as immune to this type of risk.

II • This increase is primarily the result of heightened uncertainty about the future of Europe

However, blaming this rise on announcements of additional debt issues under Friedrich Merz's 'bazooka' is highly simplistic. The rise is at least as much, and probably much more, the result of the heightened uncertainty about Europe's economic and political future following Donald Trump's reversal of alliance in favour of Vladimir Putin, combined with the violent trade war he has launched against Europe. Such an environment can only mean a slowdown in economic activity and a rise in inflation throughout Europe, prompting investors to demand higher interest rates to lend to European countries, including the most "frugal" ones.

However, the low level of interest rates in recent years has been totally exceptional in historical terms. This situation was mainly the result of the European Central Bank's (ECB) very proactive policy of supporting European countries as they emerged from the eurozone crisis and then during the Covid-19 epidemic. It made massive purchases of government debt securities on the financial markets. In so doing, it increased demand for these securities and, through the mechanical interplay of supply and demand, enabled governments to issue them at very low rates.

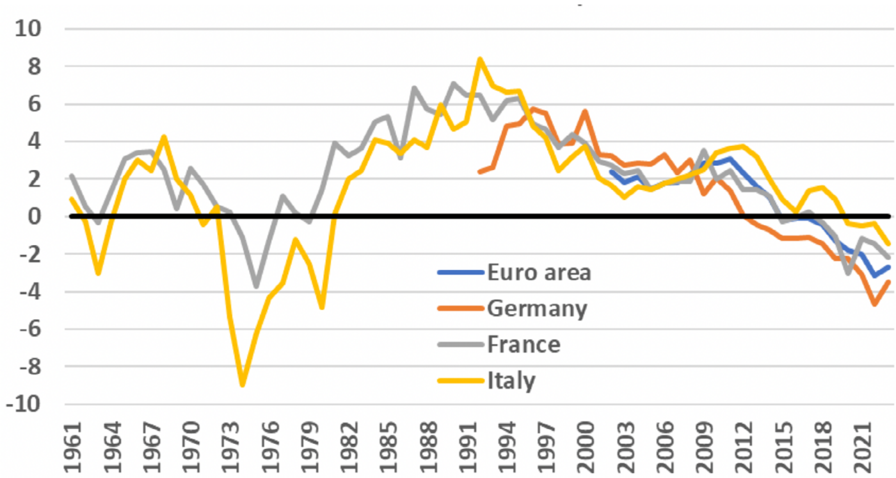


Over the last three years, however, the ECB has returned to a more conventional monetary policy. Not only has it stopped buying securities on the financial markets, it has also reduced the quantity it holds after accumulating them over the previous period. Although it has also lowered the short-term interest rates at which it lends to the banking system in recent months, by doing so it is helping to push up long-term interest rates. In the difficult context in which the EU finds itself once again today, short of resuming the massive purchases of the Draghi period, the ECB should at least stop reducing the size of its balance sheet in order to limit the rise in long-term interest rates.

III . European interest rates are still low

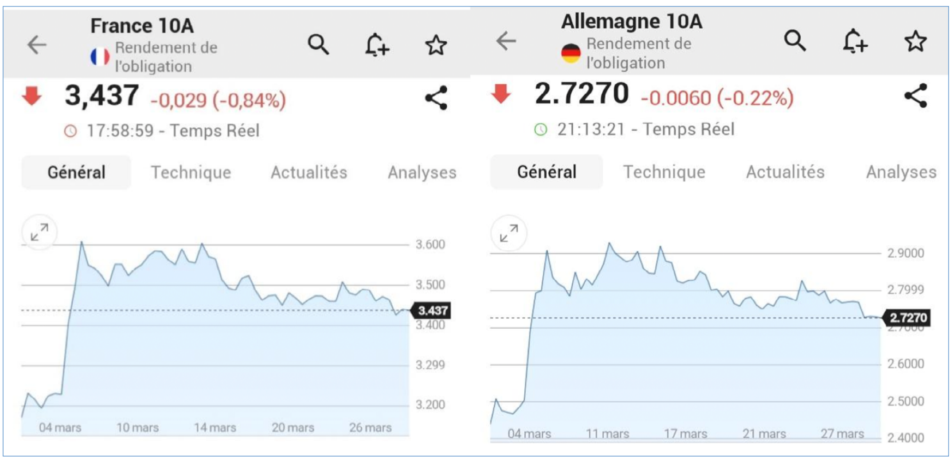
On the other hand, it is necessary to keep cool heads. Even if they have risen compared to the period just mentioned, interest rates on European debt are still historically low. In particular, they are significantly lower – by more than one percentage point for most European countries – than those paid by the US federal government on its debt.

Real long-term interest rates, GDP deflator



▲ European commission

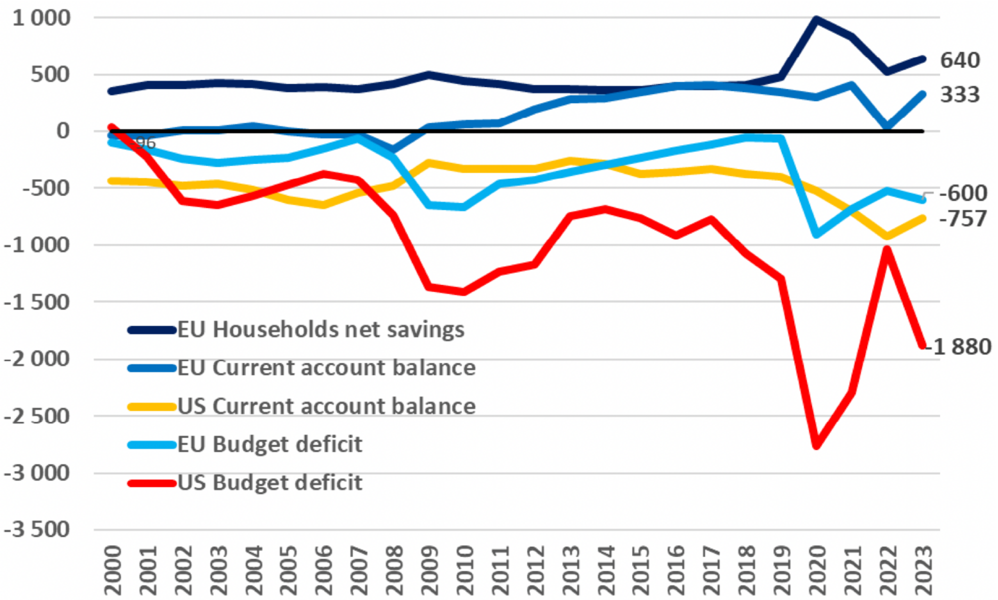
What's more, when it comes to interest rates, it's not so much nominal interest rates that count as real interest rates, taking into account both expected future growth rates and inflation. With 1% growth and 2.5% inflation per year, an interest rate of 3.5% is effectively zero in real terms. In other words, the sum repaid to creditors for the public debt does not represent a greater proportion of the wealth produced than was initially borrowed. The creditors have not enriched themselves at the expense of the economy to which they have lent, and these repayments do not a priori have a snowball effect on the indebtedness of the government concerned. This is precisely the rate at which the French government is currently borrowing.



What's more, the public borrowing announced will itself enable investment and thus increase economic activity, as recommended in the Draghi report. Of course, a priori it would be better to prioritise other areas than defence, but European rearmament will boost growth and employment in Europe, which will automatically reduce the future debt burden of the European States in relation to the wealth produced. It will also give democratic Europe a stronger deterrent capability against its enemies, which will increase its stability and chances of survival. Two factors that are likely to reassure its creditors.

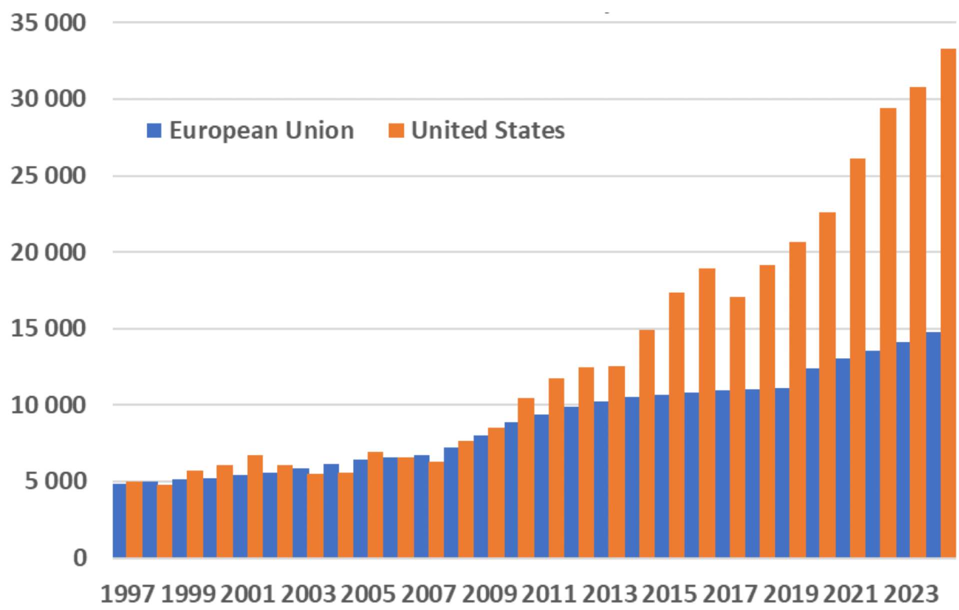
And after the understandable reaction of concern that followed Trump's reversal of his alliance on the Ukrainian question, long-term interest rates on European debt have fallen again in recent days following the measures announced. Investors clearly understood that the additional debt envisaged was fully in line with what Europe urgently needed to guarantee its stability and future.

Various macroeconomic data for the European Union and the United States in billions of euros



▲ European commission

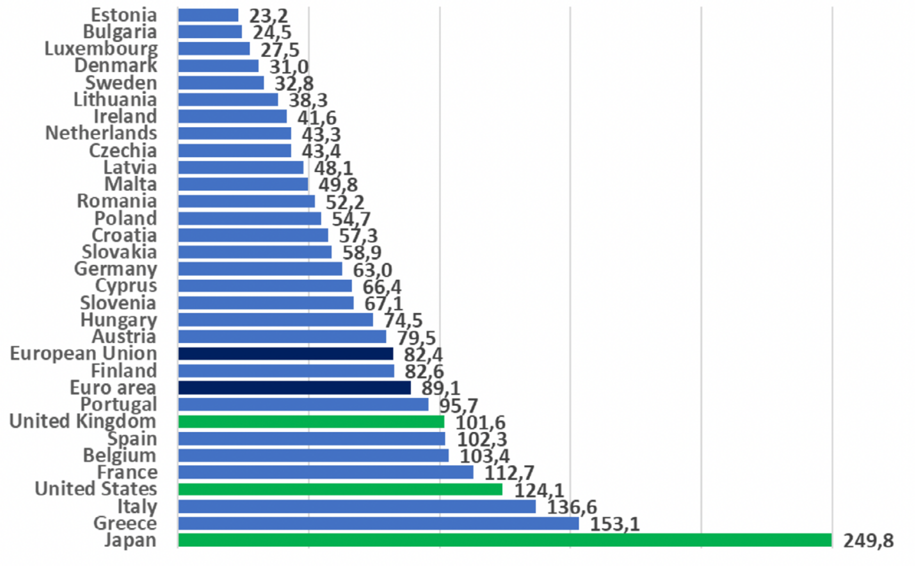
Debt in billions of euros



▲ European commission

Finally, as recommended in the Letta report, Europe's abundant savings could be better channelled, via a unification of European financial markets, into financing the Union's economic and military rearmament. In this way, they would be put to better use than off-setting the external deficit of the United States and filling the gigantic public deficit of the American federal state, as has been the case for too many years. Even if this means a temporary increase in Europe's public deficits and debts . We still have a long way to go before we catch up with the United States at EU level.

Gross public debt as % of GDP in 2024



▲ European commission

In order to make this rearmament effort, both economic and military, more effective and better coordinated, it would however be much preferable to finance it mainly through debt contracted jointly at EU level rather than through national efforts. The Union itself has very little debt at present, unlike several of its Member States, such as France and Italy. This absolutely essential additional budgetary effort could destabilise these countries, which are already very fragile. This would increase the risks of division and break-up of the Union at a time when, on the contrary, it is more necessary than ever to strengthen its unity.

In short, yes, the strong uncertainties prevailing in our environment have strained the situation regarding interest rates on European debts and the financial constraint is increasing significantly, but the level of these rates remains manageable at this stage on the scale of the Union. And this is no reason to abandon the idea of financing Europe's economic and military rearmament effort mainly through additional debt. Cutting social spending to avoid going into debt would certainly have very dangerous political effects, driving Europeans into the arms of those who are prepared to give in to Donald Trump and Vladimir Putin.

Institut Jacques Delors
Penser l'Europe • Thinking Europe • Europa Denken
18 rue de Londres 75009 Paris, France • www.delorsinstitute.eu
T +33 (0)1 44 58 97 97 • info@delorsinstitute.eu

Institut Jacques Delors
Thinking Europe
Penser l'Europe
Europa denken
Notre Europe

PREMIER MINISTRE
Liberté
Égalité
Fraternité

This project is funded by the European Commission's Citizens, Equality, Rights and Values Programme (CERV) under project number 101104850 – IJD 2025.