Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 13/02/2025

Trump, Macron or Merz: Who Will Destabilize the Fragile Euro?

by MORITZ PFEIFER* & GUNTHER SCHNABL

Abstract

The euro is not an optimum currency area and divergences in the eurozone are growing, making the euro economically and politically unstable. Donald Trump could further destabilize the euro through a trade war and pressures for more debt-financed defence spending in Europe. Emmanuel Macron is jeopardizing the euro with an unbridled debt policy. A debt-financed investment offensive under Friedrich Merz could remove the euro's last anchor of stability.

Zusammenfassung

Der Euro ist kein optimaler Währungsraum und die Divergenzen wachsen, so dass der Euro wirtschaftlich und politisch instabil ist. Donald Trump könnte den Euro durch einen Handelskrieg und den Druck zu mehr schuldenfinanzierten Verteidigungsausgaben in Europa destabilisieren. Emmanuel Macron gefährdet den Euro durch eine ungezügelte Schuldenpolitik. Eine schuldenfinanzierte Investitionsoffensive unter Friedrich Merz könnte dem Euro den letzten Stabilitätsanker nehmen.

* University of Leipzig

1. The ECB's Interest Rate Cuts Seem Hasty

The year 2025 is likely to be the year of disruption. Donald Trump's presidency heralds a break from the cooperative geopolitical order that Europe has, perhaps naively, long relied on. Politics in the EU appear largely paralyzed. The European Central Bank (ECB) is reacting with ever new interest rate cuts. The ECB's main refinancing rate has fallen by 1.6 percentage points to 2.9% since June 2024.

This increasingly sets the ECB apart from the US Federal Reserve. The Fed has raised its key interest rate more than the ECB since 2022 and has lowered it by only one percentage point since September 2024. The federal funds rate is therefore around 1.5 percentage points higher than the ECB's main refinancing rate. The gap is likely to widen, as the ECB, unlike the Fed, has already signalled further rate cuts.

The ECB's interest rate cuts seem hasty. In July 2022, the ECB only raised interest rates one year **after** inflation had risen above the two per cent target in July 2021. Still in December 2021, when the inflation rate of Germany was 5.2 per cent, ECB Governing Council member Isabel Schnabel argued that inflation was "rather too low". By contrast, the ECB cut its key interest rates in June 2024, three months **before** the inflation rate fell below the two per cent target in September. Now it aims to cut interest rates further, even though inflation has risen above the two per cent mark again. Why?

2. Excessive Government Spending Drives Inflation

It cannot be ruled out that the ECB has already stabilized inflation. The ECB's current inflation forecasts are 2.1 per cent for 2025 and 1.9 per cent for 2026. Rising confidence in a lasting decline in inflation has allowed for a considerable easing of monetary policy restrictions, Isabel Schnabel has argued.

From a historical perspective, inflation has always been associated with excessive government spending obligations. At almost 90 per cent of gross domestic product, government debt in the eurozone is well above the Maastricht threshold of 60 per cent. In Spain it is over 105 per cent, in France over 110 per cent and in Italy even close to 140 per cent. There are no serious consolidation efforts.

In Germany, where the debt level is significantly lower, political pressure is mounting to soften the debt brake to restore the country's ailing infrastructure and defence readiness. If the ECB keeps monetary policy tight, further risks could surface in the property market, where low interest rates have driven an unhealthy rise in prices between 2010 and 2022.

3. The Euro Is Not an Optimum Currency Area

Even worse: the euro is not an optimum currency area according to Mundell (1961), in which the business cycles of all member states are synchronized. If, for example, Germany is in crisis and Spain is booming, as it was the case after the turn of the millennium, the ECB cannot set the right interest rate for both countries. Differences in economic structures and cycles were well-known problems even before the introduction of the euro.

A common finance ministry and social system like in the USA could automatically synchronise the business cycles in the eurozone. Lower tax revenues in the crisis-hit country would be offset by higher tax payments in the booming country. Lower financing requirements for social security in the booming country would enable higher social spending in the crisis-hit country, which would stabilise the economy there. However, a common tax, financial and social policy in Brussels is not in sight.

Shortly after the introduction of the euro, uncoordinated financial policies have, in fact, destabilised the eurozone. While Germany's economy weakened due to fiscal austerity, Spain and other southern eurozone countries experienced a boom in government spending and property markets, largely fuelled by credit inflows from Germany. The ECB amplified the exuberance by keeping interest rates too low for the southern eurozone, which led into the European financial and debt crisis. The crisis caused capital to flow back to Germany, driving up property prices there.

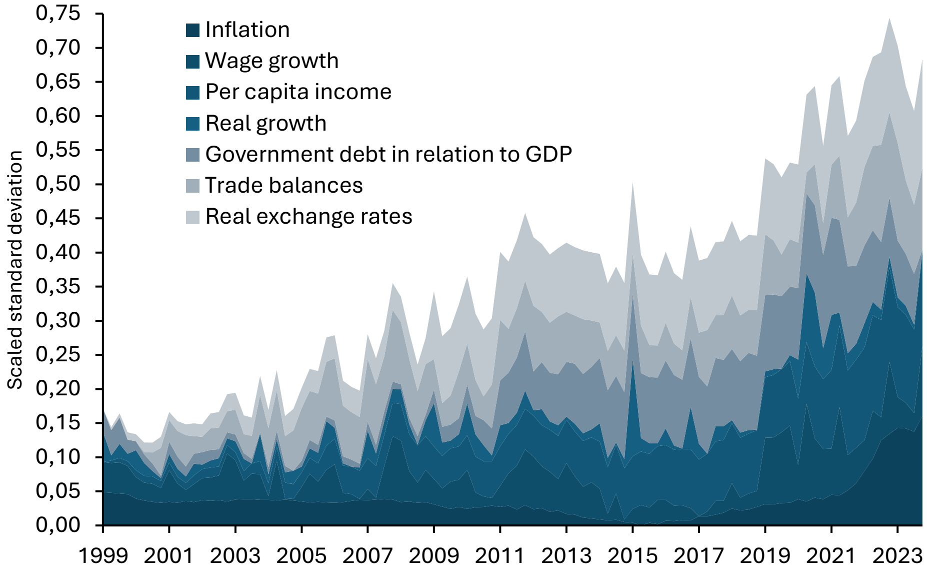
4. The Rifts Within the Eurozone Are Widening

Economic disparities in the eurozone continue to grow. In 1999, the year the euro was introduced, inflation rates in the eurozone countries ranged from 0.5 per cent in Austria to 2.4 per cent in Ireland, a difference of 1.9 percentage points. In 2024, the difference was already 3.4 percentage points (0.9 per cent in Lithuania and 4.3 per cent in Belgium). In 1999, public debt as a proportion of gross domestic product ranged between 6.7 per cent in Luxembourg and 114.7 per cent in Belgium, a difference of 108 percentage points. By 2024, the gap had risen to 136 percentage points (Estonia: 24 per cent, Greece: 160 per cent).

Our divergence indicator, which measures the heterogeneity in the eurozone in terms of inflation rates, growth rates, per capita income, government debt, changes in real exchange rates, trade balances and wage growth, clearly points to an increasingly heterogeneous currency area (see figure). The rifts within the eurozone are widening.

During the European financial and debt crisis, the ECB was able to hold the eurozone together with low interest rates and extensive government bond purchases, living up to its “whatever it takes” motto. What was once considered an emergency measure has now become the new normal. In 2022, the ECB introduced the “Transmission Protection Instrument”, which allows purchasing government bonds for the purpose of fiscal stability in the case of emergency. Perhaps France, which clocked a budget deficit of over 6 per cent of gross domestic product in 2024, will be the first benefactor.

Figure: Divergence indicator for the eurozone



Source: Pfeifer and Schnabl 2024.

5. Trump, Macron or Merz: Who Will Destabilise the Euro?

Unlimited government bond purchases by the European Central Bank may patch up even the largest cracks in the eurozone. However, high government debt and permanently low interest rates are paralysing growth and devaluing savings. The losers of these policies are drifting to the political fringes, which have already become dangerously strong in many eurozone countries. The euro is therefore economically **and** politically unstable, making a new euro crisis increasingly likely.

Now, enter Donald Trump. A trade war with the USA could further weaken growth in Europe. More debt for European defence could undermine confidence in the euro. If President Emmanuel Macron fails to rein in the country's rampant increase in public debt, France could become the target of short sellers. In Germany, a new Chancellor Friedrich Merz could drive up interest rates across the eurozone with a debt-financed investment program, a move that could deprive Germany of its position as the last anchor of stability in the eurozone.

If capital flight from the eurozone accelerates for one or more of these reasons, the euro would depreciate, the prices of imported goods would rise and, with higher inflation, so would long-term interest rates. Should the ECB then feel compelled to activate the Transmission Protection Instrument in favour of France and/or other eurozone countries, the loss of confidence in the euro would only deepen. Meanwhile in the USA capital inflows from Europe would likely be welcomed.

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