EDITORIAL

FROM CLIFFS TO SLIPPERY SLOPES

Would you rather find yourself barreling down towards a cliff edge, or mis-stepping onto a slippery slope? The answer seems obvious. The former predicament typically ends with multiple traumas, the latter with bruises at worst, albeit ultimately it also leads to the bottom if one keeps going. European policymakers have shown a knack for U-turning at cliff edges; they now need to learn to get off slippery slopes. It may prove even harder.

The EU, according to the recent report by former ECB President and Italian Prime Minister Mario Draghi, is on a slippery slope of demographic decline, underinvestment, and falling productivity growth, with nothing less than "self-preservation" at stake in escaping it. The corporate world and civil society analysts are by and large quietly cheering its core messages, notably the need for less burdensome regulation and for leveling the playing field with China and the United States; but reactions in Brussels and other EU capitals have been muted.

Pickup of the key recommendations in the letters of mission of new EU Commissioner-designates is light. And national policymakers make no secret of important disagreements with the report, notably regarding its sense of urgency. And yet, absent decisive action, the path outlined by Mario Draghi is one of inexorable decline in economic weight and strategic autonomy relative to the US and China, challenging Europe's most essential societal preferences. The EU Council is set to have a "*first exchange of views*" on the report when it meets on 17-18 October, and that will be by far the most consequential meeting of the upcoming week, not the ECB's Governing Council meeting of 18 October on which media and market commentary is focused. Unusually, that one is likely to be a non-event, as most ECB Governing Council members have understood activity is weaker, and inflation falling faster, than they expected at their September meeting. Hence, they wisely telegraphed that, after all, they would cut policy rates again by 25 bps now rather than wait for December. This is helpful for near term growth prospects, but averting the terminal decline slippery slope rests on EU Council members hearing Mario Draghi's wake-up call.

France, for its part, has been on a *fiscal* slippery slope for some time, with a debt to GDP ratio exceeded only by 2 EU members—Greece and Italy—both of which experienced a fiscal cliff-edge in the last decade. Unlike France they have managed to bring down their debt to GDP ratio significantly, from 207% to 159% and from 156% to 139% respectively since 2020. France's, in the meantime, went from 115% to 112%, and it is now forecast to rise again.

French PM Barnier last week presented a draft budget that seeks to course-correct, with an adjustment of the primary deficit of 1.3% of GDP and would allow France to comply with European rules. This week, the lower house of Parliament, where he lacks a majority, will start debating it. While the details of how the burden of adjustment is split (between taxes and spending, households and corporates, etc.) will no doubt evolve, and matter for the near-term growth impact, the key issue to watch is whether the magnitude of adjustment is preserved and whether the quality of the measures ensures it is sustained.

Why? Not because of an imminent financing crisis. The risk premium on French debt has risen by around 50% since the start of the year, but at 70-80 bps, it remains a fraction of what Greece, Italy and other Southern European economies endured in their times of sovereign debt crisis. Furthermore, the yield on 10Y French government bonds is on par with that of Spain, with debt to GDP of 106%, and over 100 bps lower than what the UK Treasury has to pay investors, despite a debt to GDP ratio of "only" 92% of GDP. But the interest bill is rising, from 1.8% of GDP in 2024 to 2% in 2025 – at 55bn euros already the 3rd largest line in the budget behind defence and education. The higher it gets, the less room for other spending. And anyone wishing for a cliff edge instead should remember that while Greece and Italy have outperformed "core" Eurozone economies in recent years, Italy only just recently recovered its GDP level of 2007, and Greece is still 20 percent below, as we discussed in our latest **Chart of the Week**. Be careful what you wish for.

Isabelle Mateos y Lago

> European policymakers over the years have shown a knack for U-turning at cliff edges; they now need to learn to get off slippery slopes. It may prove even harder."