

**KOTA INVESTMENT CLUB**

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# **RETHINKING FISCAL SOVEREIGNTY IN THE EUROZONE**

The Conversation Europeans Can No Longer Avoid

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# TABLE OF CONTENTS:

<b>MODERN MONETARY THEORY (MMT)</b>	<b>2</b>
<b>MMT IN THE EUROZONE CONTEXT – CHALLENGES AND IMPLICATIONS</b>	<b>3</b>
<b>GERMANY’S POLICY TURN – MERZ ERA</b>	<b>6</b>
BREAKING THE DEBT BRAKE:	6
COMPETING NARRATIVES: GROWTH, SECURITY, AND SOCIAL FAIRNESS:	7
DEBT, CREDIBILITY, AND WHY GERMANY CAN AFFORD TO BORROW:	7
THE BIGGER PICTURE	8
<b>APPLYING MMT TO GERMANY’S NEW FISCAL STANCE</b>	<b>9</b>
WHERE MMT “FITS”: FUNCTIONAL FINANCE AND FISCAL SPACE:	9
WHERE MMT “FAILS”: INSTITUTIONAL CONSTRAINTS AND SHARED SOVEREIGNTY:	10
A BALANCED VIEW: BETWEEN THEORY AND EUROZONE REALITIES:	10
<b>POLICY RECOMMENDATIONS &amp; CONCLUSION</b>	<b>12</b>
<b>CONTACT, DISCLAIMER &amp; SOURCES</b>	<b>13</b>
CONTACT:	13
DISCLAIMER:	13
SOURCES:	13

## MODERN MONETARY THEORY (MMT)

Modern Monetary Theory (MMT) is a heterodox macroeconomic framework that challenges conventional views on public budgets. At its core, MMT holds that a government issuing its own fiat currency cannot “run out of money” like households or firms, because it can always issue additional currency. Thus, its binding constraint is inflation, not solvency. In this view, taxes and bond issuance do not “fund” government spending in the usual sense; rather, taxes withdraw aggregate demand, and bonds help control interest rates or provide safe assets.

MMT draws intellectual heritage from Abba Lerner’s functional finance (1940s), which held fiscal policy should be judged on its macro effects (employment, inflation, growth) rather than budget balance. In the late 20th and early 21st centuries, economists like Warren Mosler, Randall Wray, and Bill Mitchell developed the framework further; Stephanie Kelton later popularized it with *The Deficit Myth* (2020).

Critics argue MMT underestimates inflation risk and downplay loss of investor confidence and political constraints. Mainstream voices such as Paul Krugman and Olivier Blanchard accept some MMT insights (e.g. low interest rates expand fiscal room) but reject the idea that deficits are inherently non-constraining. Another common critique is that MMT depends on monetary sovereignty; a condition not met by countries that do not issue their own currency (e.g. Eurozone members’).

Across the Eurozone, the tension between MMT’s logic and prevailing fiscal norms is clear. Germany’s “debt brake” (*Schuldenbremse*) epitomizes strict limit-driven budgeting. Under that rule, structural net borrowing is capped at 0.35% of GDP (federal level) except under defined exceptions. On the union level, membership in the euro area is conditional on meeting debt and deficit thresholds (e.g. Maastricht criteria), which enforce constraints antithetical to MMT’s flexible framework.

Yet in times of crisis, MMT presses a provocative alternative: rather than framing deficits primarily as threats, it invites societies to see them as tools for unlocking real economic potential. The question is timely – especially as European powers like Germany and France adopt bold fiscal initiatives, even while carrying high public debt burdens. Should deficits be treated as moral faults or as instruments of growth? The answer depends not only on macro logic but on institutional design – and that is where MMT meets its real test.

## MMT IN THE EUROZONE CONTEXT – CHALLENGES AND IMPLICATIONS

Modern Monetary Theory (MMT) starts from a simple but radical premise: countries that issue their own currency can never run out of money. Their true limit is inflation, not solvency. But this idea rests on a crucial condition – that the government and its central bank form a single, unified authority able to issue money freely (Wray, 2015; Mitchell, Wray & Watts, 2019). In such a system, taxes and bond sales serve mainly to manage inflation and interest rates, not to “fund” spending (Kelton, 2020).

The Eurozone, however, was built on the opposite design. Its member states use a shared currency they do not control. The European Central Bank (ECB) alone can create euros, and European treaties (Articles 123 and 125 of the TFEU) explicitly forbid direct monetary financing or bailouts of governments. This means Eurozone countries face a constraint that MMT’s core framework does not account for: they can run out of euros even if the system as a whole cannot.

Mainstream economists and European policy analysts often diagnose the same problem in the Eurozone, but from different perspectives. European economist Paul De Grauwe (2011), writing from a policy-institutional viewpoint, argues that members of a currency union are exposed to market pressure because they borrow in a currency they do not control. Without a guaranteed central-bank backstop, even fiscally sound countries can fall victim to self-fulfilling debt crises. By contrast, Olivier Blanchard (2019), a leading figure in mainstream macroeconomics, emphasizes the mechanics of debt sustainability: when the interest rate is lower than economic growth ( $r < g$ ), debt dynamics are manageable – but only if credibility and institutional coherence are maintained when fiscal and monetary powers remain separate.

The debate now turns on whether the ECB’s evolving toolkit has recreated some form of “monetary sovereignty” at the national level. One group of scholars argues that policies such as Outright Monetary Transactions (OMT, 2012), the Pandemic Emergency Purchase Programme (PEPP, 2020), and the Transmission Protection Instrument (TPI, 2022) have effectively given governments more fiscal breathing space. By signalling the ECB’s readiness to intervene when spreads widen unjustifiably, these measures have largely calmed fears of sudden liquidity crises (Corsetti & Dedola, 2016; Lane, 2022).

However, others remain sceptical. These ECB tools are conditional and reversible – OMT requires compliance with the European Stability Mechanism (ESM), and TPI activation depends on the ECB’s own judgment of whether market stress is “unwarranted.” Legal and political boundaries,

reinforced by national constitutional courts and EU fiscal rules, mean that governments cannot rely on the ECB as an unconditional lender of last resort (Buiter, 2020; Wyplosz, 2012).

In practice, this means that a country could find itself cut off from the ECB's secondary-market purchases if it is deemed non-compliant with EU fiscal or policy standards. Its bonds would then be left to private markets, where yields could spike, as seen during the sovereign debt crisis of the early 2010s. Thus, Euro members face what can be described as institutional solvency risk: not the danger of running out of euros, but the risk that access to the ECB's balance sheet, and therefore to affordable financing, depends on legal, political, and increasingly, environmental discretion rather than guaranteed support.

This uncertainty has recently deepened with the ECB's decision to incorporate climate considerations into its corporate bond purchase framework, and its public statements that sovereign bond purchases may in the future also reflect countries' climate and ESG performance. While still at an exploratory stage, such measures suggest that ECB support could become more selective, reinforcing the perception that access to central-bank intervention may soon hinge on broader policy criteria as well.

MMT's leading scholars themselves acknowledge these limits. Wray (2015) and Mitchell, Wray & Watts (2019) describe the Eurozone as an example of impaired fiscal capacity precisely because monetary and fiscal authority are institutionally divided. Without the ability to issue currency, national governments must rely on the ECB's willingness to act – a relationship that is political and discretionary rather than automatic. Kelton (2020) also stresses that MMT does not deny inflation or governance constraints; it simply reorders them within the logic of monetary sovereignty. In Europe's case, that sovereignty is shared, conditional, and legally fragmented – ultimately making full MMT impossible to apply.

Taken together, this yields several implications. First, despite its limited applicability, MMT's analytical lens still remains useful in a Eurozone context: it refocuses debate on real economic capacity and inflationary pressure rather than on arbitrary deficit limits. The framework's emphasis on “functional finance” can help reorient European fiscal discussions toward outcomes like employment, investment, and resilience, rather than toward compliance metrics.

Second, the Eurozone's architecture shifts the nature of risk. Because governments borrow in a currency they do not control, default risk becomes institutional and political rather than economic. What matters most is confidence in the ECB's continued support and in national adherence to fiscal and policy norms. This dependence creates uncertainty: access to stable financing hinges not on the productive capacity of the economy but on whether the ECB, national courts, and EU

institutions perceive a member state as compliant, credible, and aligned with broader policy priorities.

Third, while the ECB's evolving tools like OMT, PEPP, and TPI reduced that vulnerability, they have not eliminated it. The Bank's growing integration of climate and ESG considerations into its bond purchase frameworks underscores that future sovereign support could become even more selective. What began as monetary stabilization may soon intertwine with environmental and governance criteria, further blurring the boundaries between macroeconomics and policy alignment.

In sum, MMT cannot be applied to the Eurozone in a wholesale manner: its premise of unified fiscal-monetary sovereignty is incompatible with Europe's multi-level structure. Yet its spirit remains relevant. By urging policymakers to focus on the real limits and outcomes of public policy, MMT highlights the potential for a more coherent framework if the ECB's stabilizing role were clarified, rules were simplified, and fiscal space were treated as a tool for shared prosperity rather than a constraint to fear.

## GERMANY'S POLICY TURN – MERZ ERA

### BREAKING THE DEBT BRAKE:

For years, Germany has treated fiscal discipline not merely as economic policy but as a moral virtue. The Schwarze Null, the “black zero” balanced-budget rule, became a symbol of prudence, restraint, and reliability. It was the anchor of Germany’s self-image as Europe’s fiscal guardian, shaping everything from infrastructure funding to political rhetoric. That orthodoxy has now been fundamentally challenged.

In 2025, Chancellor Friedrich Merz ushered in what he calls a “new era of responsibility through investment.” His government has departed from the debt-averse habits of the Merkel and Scholz years, launching a federal budget centered on record levels of public investment in defense, infrastructure, and climate transition.

The 2025 federal budget earmarks over €115 billion for investment — an increase of about 35% compared with 2024. It channels funds toward transport upgrades, energy grids, housing, and digital infrastructure, as well as a newly established Special Fund for Infrastructure and Climate Neutrality, which will mobilize more than €500 billion in capital over the next decade. Parallel to this, defense spending has been raised significantly and, crucially, placed outside normal borrowing constraints.

The shift marks a harsh break with the Schwarze Null philosophy. Once, fiscal surpluses were held up as a moral necessity; now, investment is framed as an act of national preservation. Merz has described this change as a response to “a new world that demands resilience rather than rigidity.”

To make the new fiscal stance legally possible, the government has moved to reinterpret and amend Germany’s debt brake (Schuldenbremse), which is enshrined in the constitution. In early 2025, parliament approved targeted amendments allowing borrowing exceptions for categories deemed essential to national security and long-term competitiveness such as defense, climate, and infrastructure.

While Merz’ policy adjustments do not abolish fiscal discipline completely, they certainly stretch its boundaries. The debt brake remains in place for ordinary spending, yet “strategic investments” are now exempt. The Merz government frames this as a modern form of prudence – borrowing today to secure tomorrow’s resilience. Critics, including constitutional lawyers and the Bundesrechnungshof, warn that repeated exemptions risk turning the brake into a “permanent loophole,” while fiscal conservatives fear a gradual erosion of the rule’s credibility.

## COMPETING NARRATIVES: GROWTH, SECURITY, AND SOCIAL FAIRNESS:

The government's justification rests on three interlinked arguments: competitiveness, security, and future growth. Germany's physical and digital infrastructure is aging, the energy transition requires vast upfront spending, and Russia's war in Ukraine has made defense a political imperative. Merz and Finance Minister Christian Lindner frame these investments as "modernization expenditures" that will strengthen productivity and reduce future fiscal burdens.

At the same time, the coalition has pursued welfare reform aimed at limiting the growth of social spending, particularly pensions and unemployment benefits. This combination of fiscal expansion for investment but consolidation for welfare reveals an internal tension. Supporters see it as a rational reprioritization: borrowing for projects that raise productive capacity while containing consumption-driven outlays. Critics, especially from opposition and trade unions, see ideological inconsistency: a government loosening the purse strings for tanks and roads while tightening them for citizens.

## DEBT, CREDIBILITY, AND WHY GERMANY CAN AFFORD TO BORROW:

Despite higher spending, Germany's fiscal position remains enviable. Public debt stood at 62.5% of GDP in 2024, down from over 70% after the pandemic. Under the 2025 budget trajectory, debt is expected to rise modestly to around 64% by 2028—still well below the euro area average of 89%. The cost of borrowing remains historically low, and demand for Bunds, Germany's federal bonds, continues to exceed supply.

The Bund's status as the euro area's safe asset provides unique leeway. Investors perceive German debt as risk-free, not because of perfect fiscal rectitude but because of political stability, institutional credibility, and the implicit belief that the ECB will not allow default on core sovereigns. Even as issuance rises, yields remain among the lowest in the monetary union.

This gives Germany something close to quasi-sovereign borrowing power within the Eurozone's institutional limits. Its fiscal activism, therefore, does not provoke the same market reaction as similar moves might in Italy or Spain. However, that privilege is contingent: it depends on continued investor confidence and on the ECB's ability to maintain monetary stability without reviving austerity pressures elsewhere.

## THE BIGGER PICTURE

The Merz government's fiscal pivot is more than a budgetary event—it's a political statement. By redefining the debt brake and prioritizing investment over austerity, Germany is effectively rewriting the moral code of European fiscal policy. The old paradigm equated debt with irresponsibility; the new one frames investment as national duty.

Still, this rebalancing comes with contradictions. Germany's willingness to borrow for growth may ease the continent's long-standing underinvestment problem, but its selective application—borrowing for defense while cutting welfare—reflects enduring ideological lines. Whether this marks the start of a sustained fiscal modernization or merely a temporary deviation will depend on how markets, voters, and European partners respond.

For now, one thing is clear: the age of the Schwarze Null is over. Germany has entered an era where balanced budgets are no longer a political mantra but a negotiable choice. The challenge ahead will be to ensure that this new fiscal activism strengthens, rather than undermines, both economic capacity and social cohesion.

## APPLYING MMT TO GERMANY'S NEW FISCAL STANCE

Germany's new fiscal trajectory provides a compelling case study through which to test the core propositions of MMT. Having long embodied the Eurozone's fiscal conservatism, Germany's pivot toward large-scale public investment under Chancellor Merz offers an opportunity to evaluate whether MMT's logic can illuminate the rationale, risks, and limits of this policy shift.

### WHERE MMT "FITS": FUNCTIONAL FINANCE AND FISCAL SPACE:

In its essence, MMT rests on functional finance, the idea that fiscal policy should be guided by real economic capacity – employment, output, inflation – rather than arbitrary deficit targets (Lerner, 1943; Wray, 2015). By this standard, Germany's reorientation is economically coherent. Years of underinvestment have left visible bottlenecks: crumbling infrastructure, energy transition delays, and underfunded defense. A functional-finance perspective views borrowing for these purposes as rational capacity building.

Furthermore, MMT underscores that the sustainability of public debt depends less on the nominal size of deficits than on the interest-growth differential ( $r-g$ ). When borrowing costs remain below the economy's growth rate, public debt ratios can stabilize or fall even with ongoing deficits (Blanchard, 2019). Germany's modest debt trajectory, combined with its historically low yields, aligns neatly with this view: fiscal expansion directed toward productive assets is self-sustaining in the medium term.

The behaviour of the sovereign bond market reinforces this point. Germany enjoys structurally high demand for Bunds. This demand stems not only from domestic saving and regulatory preferences but also from the global role of Bunds as collateral. As MMT would predict, this strong appetite allows Germany to run deficits without encountering serious market penalties. In practice, the disciplinary power of financial markets is muted, enabling a degree of fiscal freedom that would be unattainable for smaller or riskier Eurozone members.

In this respect, Germany's fiscal expansion approximates MMT's ideal of functional fiscal policy – calibrated to real needs, sustained by favourable  $r-g$  dynamics, and reinforced by investor confidence.

## WHERE MMT “FAILS”: INSTITUTIONAL CONSTRAINTS AND SHARED SOVEREIGNTY:

Yet, applying MMT to the Eurozone context quickly encounters structural limits. A central tenet of MMT is that governments issuing their own currency cannot involuntarily default; they can always create the money necessary to service their obligations. This assumption collapses in the case of Germany, which does not issue the euro. The ECB holds the monopoly over money creation and is legally and politically independent from national fiscal authorities.

As De Grauwe (2011) argued, this separation makes member states vulnerable to liquidity crises: investors, uncertain about ECB intervention, can trigger self-fulfilling sell-offs. The ECB's crisis instruments have mitigated these risks but not abolished them. Unlike the U.S. Federal Reserve's implicit fiscal backstop, the ECB's support remains conditional, discretionary, and revocable.

Germany's fiscal expansion therefore relies not on its own monetary sovereignty but on credibility and trust. More concretely, Merz relies on the expectation that markets and the ECB will treat German debt as unquestionably safe. While this expectation has held, it is not guaranteed. The European Court of Justice (ECJ) and Germany's own Constitutional Court have both scrutinized ECB asset-purchase programs, underscoring that legal and political constraints can reassert themselves swiftly.

Moreover, the debt brake remains embedded in constitutional law. Though recently amended for strategic investments, it continues to constrain fiscal flexibility and reflects deep cultural and institutional attachment to balanced budgets. Price stability still defines the ECB's core mandate. As such, even a fiscally expansive Germany operates under a framework fundamentally at odds with MMT's consolidated treasury-central bank model.

## A BALANCED VIEW: BETWEEN THEORY AND EUROZONE REALITIES:

Taken together, Germany's fiscal turn demonstrates both the insight and incompleteness of MMT in the European context. On the one hand, the MMT emphasis on real-resource constraints and on debt sustainability through  $r-g$  dynamics provides a more realistic and less moralized lens through which to view Germany's investment drive. The new fiscal stance validates MMT's contention that productive public spending can strengthen rather than weaken macroeconomic stability.

On the other hand, Germany's case reaffirms that monetary sovereignty matters. Within the Eurozone, fiscal expansion remains dependent on the political will and interpretive flexibility of

the ECB and the European treaties. MMT's prescriptions cannot be fully enacted without institutional reforms that integrate fiscal and monetary authority.

Thus, Germany's shift weakens Europe's long-standing austerity orthodoxy but does not herald a genuine "MMT regime." It instead represents a hybrid model: a fiscally active yet rule-bound policy framework, sustained by credibility and constrained by law.

## **POLICY RECOMMENDATIONS & CONCLUSION**

The most immediate implication concerns the ECB's communication and backstop design. To safeguard monetary transmission while accommodating legitimate fiscal differentiation, the ECB should clarify and institutionalize its Transmission Protection Instrument (TPI). Establishing transparent, rule-based triggers for central-bank intervention would reduce uncertainty and shield investment-driven fiscal policies from self-fulfilling market pressures.

In parallel, maintaining flexible reinvestments under the PEPP framework would allow the ECB to smooth temporary tensions without compromising its price-stability mandate. Such measures would not result in "monetary financing" but would uphold the functioning of a unified monetary policy, representing the institutional precondition MMT identifies as essential for functional finance to operate.

Germany's departure from *Schwarze Null* marks a turning point in European fiscal thinking. It confirms that responsible borrowing, when directed toward capacity-building and backed by market trust, can coexist with monetary stability. MMT helps explain why this is economically sound.

In short, Germany is practicing a pragmatic version of MMT without the printing press: applying the theory's logic of real-resource mobilization while operating under institutional constraints that keep monetary creation at arm's length. Whether this experiment endures will depend less on deficits themselves than on the ECB's and Germany's ability to sustain credibility as well as Europe's willingness to see investment, not austerity, as the truer mark of fiscal responsibility.

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