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France's Fiscal Challenges Should Have Limited Eurozone Impact

Economist(s)

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Summary

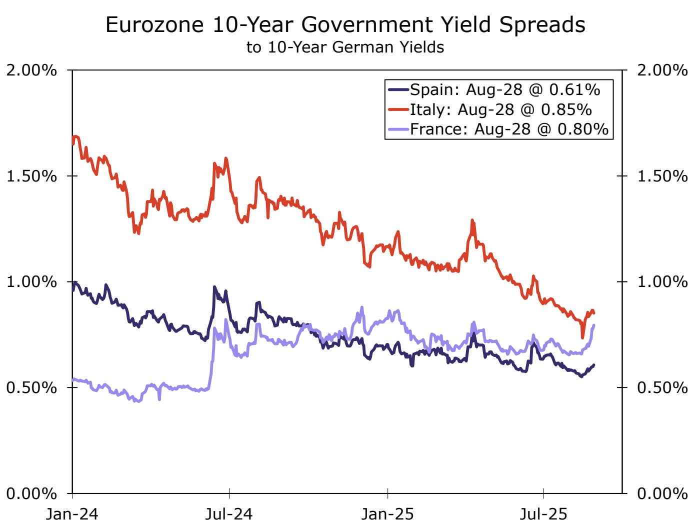
- French political and fiscal uncertainties have resurfaced in the past week, with PM Bayrou calling for a confidence vote on September 8 in an effort to consolidate support for the government's budget proposals. However, several opposition parties have indicated they will not support the motion, which would force the government to resign, and also impact fiscal consolidation plans. Political uncertainty has also surfaced in the Netherlands, with an opposition party calling for a no-confidence motion in the government. Relative to Germany, French 10-year yield spreads have widened in recent days, although Dutch 10-year yield spreads have been relatively stable.
- While clearly problematic for the French economic outlook, from a longer-term perspective we believe France's fiscal uncertainties will have limited impact on the broader Eurozone economy and the euro. France's fiscal challenges appear to be relatively isolated, as opposed to being more broadly shared across the region.
- Some countries with elevated government debt levels (Italy and Spain) have enjoyed significant progress in reducing their budget deficits in recent years. Other countries with modest government debt levels (Germany and Netherlands) have pursued more expansive fiscal policies, which nonetheless have not significantly impacted the sustainability of public finances for those countries.
- Taking these trends into account, from a Eurozone-wide perspective, government deficit and debt levels have been reasonably stable in recent years, and we do not view the latest developments as a significant headwind for Eurozone-wide economic growth. We remain comfortable with our outlook for a broadly steady Eurozone GDP growth of 1.0% for 2025 and 1.2% for 2026. With fiscal concerns also seen remaining mostly contained to France, we also do not expect the latest French developments to have a long-lasting impact in the euro over the medium-term.

France's Fiscal Challenges Should Have Limited Eurozone Impact

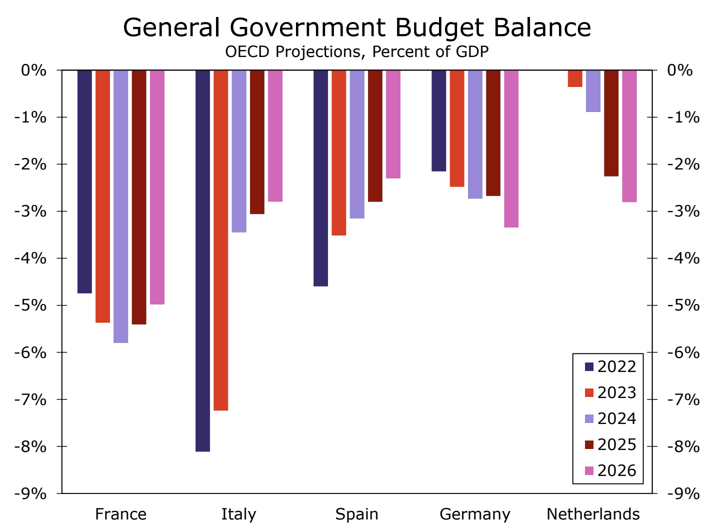
France's fiscal challenges and political uncertainties returned to the forefront this week, as Prime Minister Francois Bayrou called for a confidence vote in an effort to consolidate support for the government's budget plans. The government has faced pushback against €44 billion in spending cuts and tax increases, as well as its proposal to abolish two of France's public holidays. However, the far-right National Rally party, the leftist France Unbowed and the Greens have indicated they would vote against the Setpember 8 motion, while the Socialists have said that they wouldn't back the government. Should the confidence vote fail, Bayrou would be forced to submit his government's resignation.

Should the government be toppled, President Macron could seek to appoint another caretaker Prime Minister or, potentially, new elections could be called. Expectations appear to be leaning towards the appointment of a new Prime Minister, perhaps by offering some budget concessions to opposition parties in exchange for their support. A new round of elections would of course provide a more extended period of volatility. In any case, the political uncertainties and the potential fiscal challenges prompted by recent developments have seen French 10-year government bond yields move higher, while the spread between French and German 10-year government bond yields has widened to 80 bps. That yield spread is wider than for other countries such as Spain, Portugal, Greece and Ireland, and only modestly narrower than Italy.

France is not the only Eurozone country impacted by political uncertainties in recent days. In the Netherlands, Prime Minister Dick Schoof also faces a no-confidence motion in parliament, a motion that was filed by the head of the DENK party, after that center-right party quit the coalition. The ruling coalition had already collapsed in June, and with the Dutch parliament fractured between 15 different parties and elections currently scheduled for October, the path forward is not entirely clear. Moreover, an extended period of negotiations over a new government following any elections could also contribute to an extended period of uncertainty. Still, such negotiations are not without precedent in the Dutch political landscape, and with the Netherland's fiscal position in much sounder shape compared to France, these latest developments have not contributed to significant strains in Dutch government bond markets so far. The spread between Dutch and German 10-year government bond yields is relatively narrow and relatively stable, at 18 bps.



Source: Datastream and Wells Fargo Economics

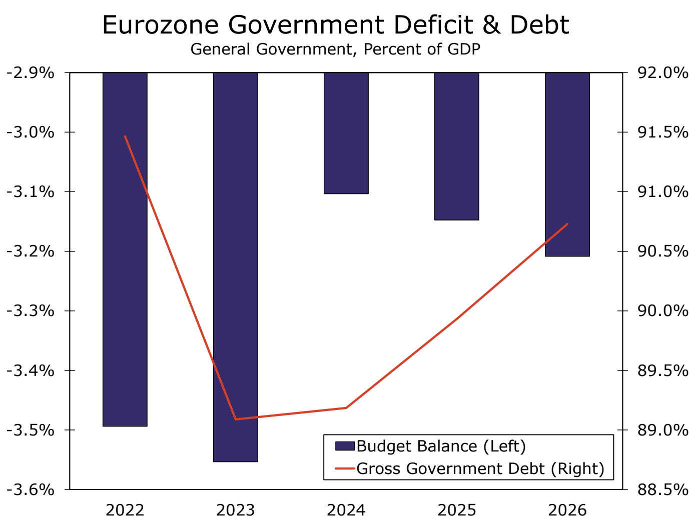


Source: OECD and Wells Fargo Economics

While clearly problematic for the French economic outlook, from a longer-term perspective we believe France's fiscal (and political) uncertainties will have a limited impact on the broader Eurozone economy and the euro. France's fiscal challenges appear to be relatively isolated, as opposed to being more broadly shared across the region. In recent years, some other Eurozone countries with elevated government debt levels (Italy and Spain) have enjoyed significant progress in reducing their budget deficits. Meanwhile, some countries where government debt levels are modest (Germany and the Netherlands) have pursued more expansive budget policies, a fiscal approach that has nonetheless not significantly impacted the sustainability of public finances for those countries. From a Eurozone-wide perspective, therefore, both budget deficit and government debt levels have been reasonably stable in recent years. This is reflected in the most recent projections from the Organization for Economic Cooperation and Development (OECD) which, assessing actual developments from 2022 to 2024, and projections for 2025 and 2026, envisage broadly stable deficit and debt levels for the Eurozone as a whole during that period.

This relative stability from a Eurozone-wide perspective is important, in our view, for both for the Eurozone economy and currency. With the more expansive fiscal policy in countries such as Germany and the Netherlands offsetting budget consolidation efforts in countries such as Italy, Spain (and to a lesser extent France), we do not view budget developments as a headwind to Eurozone-wide economic growth. The OECD projects a broadly stable budget deficit at just over 3% of GDP for 2024, 2025 and 2026. Indeed, if anything, given the pledges from European governments to increase defense spending in the years ahead, budget developments could even provide a modest tailwind to Eurozone growth prospects. Against this backdrop, we remain comfortable with our outlook for broadly steady Eurozone GDP growth of 1.0% for 2025 and 1.2% for 2026.

We also expect fiscal concerns to remain mostly contained to France, rather than becoming a broad-based source of uncertainty or volatility across the region. Countries pursuing more expansive fiscal policies generally have lower government debt levels, while those countries with more elevated debt levels have achieved a degree of budget consolidation in recent years (outside of France). Given the absence of generalized fiscal uncertainty across the Eurozone region, we also do not expect the latest French developments to have a long-lasting impact on the euro over the medium-term.



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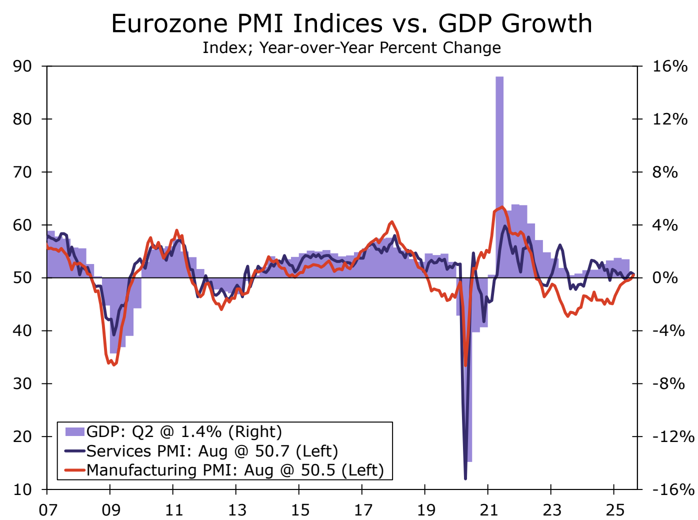

Source: Datastream, Bloomberg Finance L.P. and Wells Fargo Economics

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