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What to watch: France budget short of savings, Europe's climate tools to test affordability and competitiveness and central banks week ahead

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In summary

France's budget bill: (Still) desperately seeking savings. The approval of the social security bill (PLFSS) this week has cleared a key hurdle for the French government to adopt a budget. But the reduction in policy uncertainty comes with a cost: insufficient reduction in government spending. Voting the state budget (PLF) before year-end will be challenging and a Special Law could be used to bridge the funding gap until a PLF is voted in early 2026. If MPs agree on EUR8bn of savings (instead of the EUR22bn needed to achieve the -4.7% of GDP deficit target), the French deficit will be -5.1% of GDP in 2026. On the positive side, GDP growth is expected to accelerate to 1.1% in 2026 from 0.8% this year. Investors signaled a clear preference for a scaled-down budget and government continuity but this technical truce is fragile and political uncertainty can re-emerge any time. OAT spreads should trade in a fair range of 65-80bps in the coming months. The 2027 presidential election may drive OAT spreads temporarily out of this range as political risk increases. Below 100bps for the 10y OAT-Bund spread, no contagion should be expected.

Climate policy: Europe's industrial shield or a drag on competitiveness? Europe is entering a significant transition in climate policy with the introduction of the CBAM (2026) and ETS2 (2028), which extends the EU carbon price to sectors such as buildings and transport. While limiting carbon leakage, the CBAM will effectively act as a terms-of-trade shock, hitting countries with metal-heavy supply chains, notably Italy (USD8.1bn in levies), Germany (USD6.7bn) and Poland (USD4.4bn). Hungary, Croatia and Romania face the largest tariff equivalents. In a full pass-through scenario, CBAM could add +0.1pp to Eurozone inflation, while ETS2 could add +0.5pp, while the EU27 would on average face +0.9pp cumulatively. Germany faces +0.7pp in price increases while Poland (+2.3pp), Slovakia (+2.1pps) and the Czech Republic (+1.7pps) are most affected. Eurozone GDP growth could fall by close to -0.2pp annually. While these policies are essential to meeting climate targets, Europe will need effective revenue recycling and strategic reinvestment to mitigate adverse competitiveness impacts and reinforce sustainable growth.

BoE, ECB, BoJ: Cut, hold, hike. Next week, the BoE is likely to cut rates to 3.75%, the ECB will stay on hold at 2.0% and the BoJ will deliver another rate hike to 0.75%. The BoE is expected to continue to lean dovish despite persistently above-target inflation. Signs that the economy is cooling and inflationary pressures easing would support two further cuts, taking it to the bank rate to 3.25% by September 2026. Unlike markets, which have priced in an ECB hike by 2027 following hawkish remarks, we rather believe risks are rather tilted to the dovish side as Europe battles structural headwinds, including geopolitics, demographic pressures and fading competitiveness versus the US and China. Finally, the BoJ is likely to continue its rate-hiking cycle closely in line with levels prescribed by the Taylor rule, with inflation still above target in the coming quarters. We continue to see the terminal rate at 1.5% by end-2027. All three central banks do have one thing in common though: rapid QT will continue and put upside pressure on bond yields.

France's budget bill: (Still) desperately seeking savings

In a very close vote, the French National Assembly approved the social security budget, easing policy uncertainty. But it still lacks structural savings measures to reduce spending growth. On 9 November, the National Assembly approved the social security budget bill (*Projet de Loi de Financement de la Sécurité Sociale*, PLFSS) by a tight margin (247 votes for versus 234 votes against). The centrist ruling coalition supported the bill but had to contend with abstentions from the center-right party Horizons. Facing opposition from both extremes of the Assembly, the bill ultimately passed thanks to the support of the Socialist Party, which backed the text after securing several concessions. The social security budget formalizes the suspension of the pension reform and eases planned cuts to social spending, most notably by rejecting the proposed freeze on social benefits and retirement pensions (Table 1). In addition, the growth target for health-related spending has been revised up to +3% y/y, rather than +1.6% in the initial version. These reduced savings are only partly offset by some targeted tax hikes, focused in particular on capital gains (CSG) and private health insurance companies[1]. Compared with the government's initial draft, the final version does not include additional business taxes (such as higher employer contributions on meal vouchers and holiday vouchers (EUR1.0bn), plans to double medical co-payments and flat-rate health contributions (EUR2.3bn), the proposed freeze of social tax (CSG) brackets for certain incomes, including retirement pensions, disability benefits and unemployment benefits (EUR0.3bn) and the exemption of employee social contributions for apprentices (EUR1.2bn). Besides, the government will have to pay out a subsidy of EUR4.5bn to fill the holes. As a result, the social security deficit is now projected to reach EUR19.6bn in 2026, compared to EUR25bn in 2025, and the EUR17.5bn initially forecast. Without the government's EUR4.5bn subsidy, the social security deficit would be unchanged, highlighting the absence of savings. The bill is now being reviewed by the Senate, and is expected to be finally approved by the National Assembly on 16 December.

Table 1: Social security budget bill (PLFSS): additional spending and revenue offsets (in EUR bn)

Additional spending embedded in amendments	
Abandonment of plan to double medical co-pays and flat-rate contributions	2.3
Exclusion of the proposed freeze on social benefits and retirement pensions	3.6
Rejection of additional business taxes (i.e. higher employer contributions on meal vouchers and holiday vouchers)	1.0
Rejection of the proposed freeze of social tax (CSG) brackets for certain incomes	0.3
Exemption of employee social contributions for apprentices	1.2
Total cost	8.4
Additional revenue offsets	
Transfer from the state budget	4.5
Targeted increase in the CSG social tax on certain capital gains	1.5
Total revenue	6.0

Sources: French government, Allianz Research

The next step is to pass the budget bill, which will be challenging before year-end. Ultimately, we think a compromise will be found by early 2026 at the latest with a watered-down version. The Prime Minister has ruled out resorting to article 49.3, which would allow him to push through the draft budget bill (*Projet de Loi de Finances, PLF)* without requiring a formal vote from MPs. Should the legislative process fail to conclude by 23 December, the government would need to enact the 2026 budget through a Special Law, which allows the French state to continue to run without a budget. However, given the many drawbacks implied, we doubt that MPs will be comfortable with using it for more than a few months. First, there are risks of fiscal slippages because of uncertainties relating to local government and social security spending. This could revive tensions in financial markets, threatening to knock out growth. Besides, a Special Law would potentially incur significant political costs for political parties. For instance, several public service counters could struggle to operate efficiently, hit by a shortage of public funding. Planned

[1] *Surcharge on mutual insurance plans and hike on the CSG on capital income (excluding life insurance, home savings plans, property income).*

hikes in military spending would be frozen, undermining France's credibility with regard to its commitment to NATO and European allies amid the Russia-Ukraine war. In this context, it is likely that political parties will ultimately compromise on a watered-down PLF, if not over the next days then in January or February, with the Special Law ensuring short-term bridge funding for the state. Some measures may be taken out to reach a compromise, or the government may also opt to pass the budget through ordinances, with the implicit backing of a majority of MPs.

The government is not likely to find more than EUR8bn of savings (EUR6bn in spending cuts, EUR2bn in revenue measures), which means the French headline deficit will only reduce to -5.1% of GDP in 2026. The main amendments are likely to include the (potentially partial) rejection of the proposed freeze on personal income tax brackets (foregoing savings of EUR1.9bn), the retention of the 10% tax deduction on pensions (EUR1.0bn), tax exemptions for long-term illnesses (EUR0.4bn), a less ambitious reduction of fiscal loopholes (potentially costing EUR1.0bn), a narrowing of the scope of the proposed tax on holdings (EUR0.9bn), as well as measures proposed by the Senate to ease the financial burden on local authorities, adding EUR2.6bn in additional expenditures. Anticipated new revenues include a reform of the real-estate wealth tax (EUR0.5bn), increased taxes on tech giants and social media advertising (potentially generating EUR1.0bn) and a tax on small imported parcels (EUR0.5bn). At this stage of the legislative process, the spending component of the budget bill is under Senate amendment, with a likely emphasis on ambitious reductions in state expenditure. The ultimate scale of spending reductions that will be achieved in the National Assembly remains uncertain, and this will determine the overall deficit outcome of the bill. Out of the EUR22bn of savings needed to achieve the -4.7% of GDP deficit target, we estimate that MPs have found only EUR2bn for now (in revenue-raising measures, Table 2).. We think that MPs will eventually find only EUR8bn in total (EUR6bn in spending cuts, EUR2bn in revenues), meaning that the deficit will only fall mildly to around -5.1% GDP, from -5.3% in 2025.

Table 2: Central government budget bill (PLF) measures (EUR bn)

Additional spending embedded in amendments	
Rejection of the proposed freeze on personal income tax brackets	1.9
Retention of the 10% tax deduction on pensions	1.0
Tax exemptions for long-term illnesses	0.4
Less ambitious reduction of fiscal loopholes	1.0
Reduction of the scope of the proposed tax on holdings	0.9
Easing of the financial burden on local authorities	2.6
Total cost	7.8
Additional revenue offsets	
Reform of the real-estate wealth tax	0.5
Increased taxes on tech giants and social media advertising	1.0
Tax on small imported parcels	0.5
Other measures reducing state spending	?
Total revenue	At least 2.0

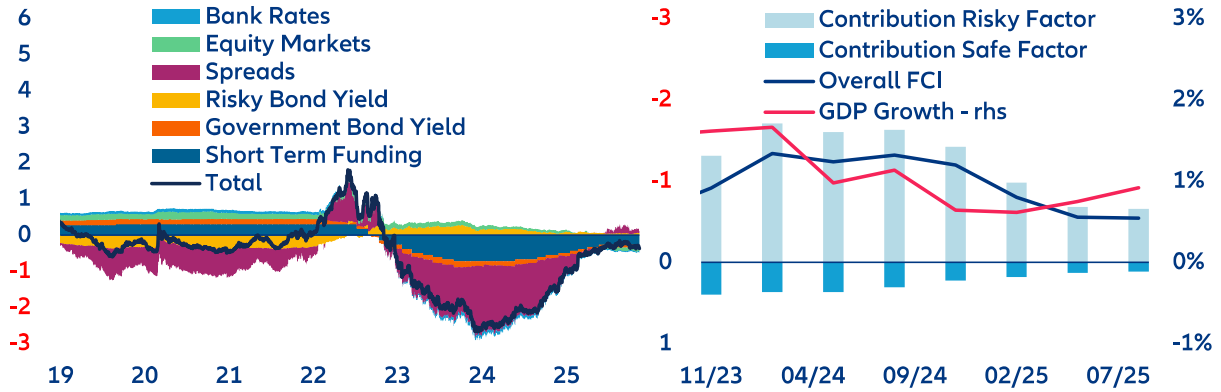
Sources: French government, Allianz Research

What does this mean for growth? French financial conditions remain loose and supportive of growth, but their contribution has diminished since the 2024 dissolution. We use BIS-built financial conditions indices (FCI) to assess the growth impulse of overall financial conditions[2]. French "risky" financial conditions have been very loose through 2023 and H1 2025 (Figure 3, left), thanks to tightening spreads (government and corporate bonds). However, since the dissolution of the National Assembly in June 2024, risky financial conditions have turned increasingly less loose because of widening spreads. As a result, the positive impulse of financial conditions on growth has faded (Figure

[2] *Financial conditions and the macroeconomy: a two-facto view, BIS Working Papers No 1272, 16 June 2025.*

3, right). Nevertheless, overall financial conditions continue to support French growth, helped by accommodative "safe" conditions.

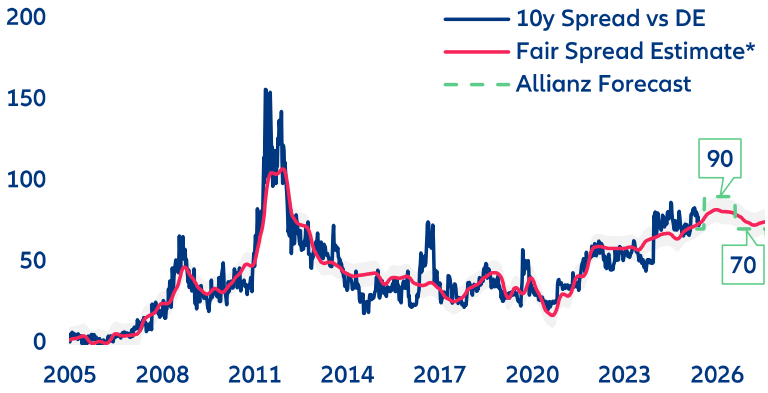
Figure 3: Risky financial conditions (left), GDP growth & financial conditions impulse (right)



Sources: LSEG Workspace, BIS, Allianz Research

Markets are pricing procedural, not political stability. The recent return of the French 10y OAT spread to a range of 70-75bps over German Bunds indicates markets anticipated a procedural resolution to the budget process, signaling a clear preference for *some budget* over *no budget*. But this technical truce is fragile and political uncertainty can re-emerge anytime as main driver of recent OAT spread spikes can re-emerge anytime. Our fundamental model combining fiscal, economic (current account, REER, GDP, private wealth) and technical (stock-flow pressure, free float, Bund substitution) factors suggests OAT spreads should trade in a fair range of 65-80bps in the coming months. But with the presidential election in early 2027, we expect political risk will start to be repriced at the end of 2026, driving OAT spreads temporarily out of this range. The pricing of political risk in the 10y OAT spread has occurred in increments of 5bps lately. In that regard, we see a two to three notch increase on the political risk scale, which would put the 10y spread at around 90bps by the end of 2026 (Figure 4).

Figure 4: France 10y OAT spread versus Germany, in bps

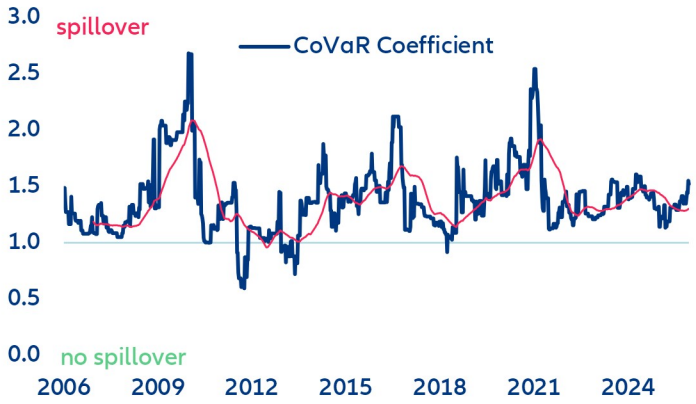


**based on fiscal fundamentals, competitivity, private wealth, technicals and risk aversion*
Sources: LSEG Workspace, Allianz Research

Spillover from France to other Euro government bonds (EGB) should remain limited as long as 10y OAT spread stays within a 100bps range. So far France can be seen as an outlier in the European Government Bonds (EGB) market as its bonds run counter to the prevailing trend of convergence in EGB spreads. We only see spillover risks emerging if OAT spreads move into a 10% tail risk territory above 150bps. Figure 5 shows the spillover power between French OATs and Italian BTPs measured by Conditional Value-at-Risk (CoVaR) – meaning the extreme levels of BTPs conditional on OATs being in distress (at their 90% VaR 90% level un this case). In such extreme scenarios, the spillover (CoVaR) coefficient is estimated below the levels seen in previous high risk episodes (GFC,

Eurocrisis or Covid-19) (Figure 5). Contagion is real when we approach extreme OAT levels, but it has become less pronounced than in the past. We would also expect such periods to be short-lived as idiosyncratic OAT risk escalating into a systemic risk for the entire Eurozone would very likely trigger an intervention by the ECB under its Transmission Protection Program.

Figure 5: Contagion risk from French OAT (10y) to Italian BTP (10y)

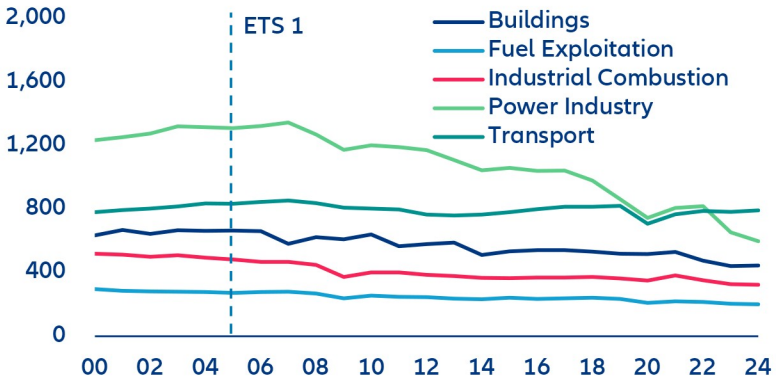


Sources: LSEG Workspace, Allianz Research. Note: CoVaR is the VaR of an asset conditional on other assets being at their VaR level. The difference between the usual VaR and the CoVaR captures the contagion risk from other assets in times of stress. (CoVaR coefficient). Notes: Adrian, T. and Brunnermeier, M., "CoVaR", Federal Reserve Bank of New York Staff Report, September 2008

Climate policy: Europe's industrial shield or a drag on competitiveness?

The EU Emissions Trading System (ETS), established in 2005, remains the cornerstone of Europe's climate policy. By putting a price on carbon, the ETS internalizes the environmental cost of greenhouse gas emissions, creating strong financial incentives for emitters to reduce pollution, adopt low-carbon technologies and transition toward cleaner energy sources. Its effectiveness is particularly evident in the power sector, where CO2 emissions have fallen by over -54% since the inception of ETS1, driven by the combination of a robust carbon price signal and the increasing competitiveness of renewable energy, which accelerated the phase-out of coal-fired generation. In contrast, sectors not initially covered by ETS1, such as transport and buildings as well as energy-intensive industries that received free allowances, have experienced only marginal improvements, reflecting the limits of coverage and transitional support (Figure 6). The upcoming ETS2 will expand carbon pricing to additional sectors, including buildings, road transport fuels and industrial installations previously uncovered, extending the carbon price signal more broadly across the economy and strengthening the EU's ability to drive emission reductions.

Figure 6: EU27 sector emission developments since introduction of ETS1, in MtCO2e

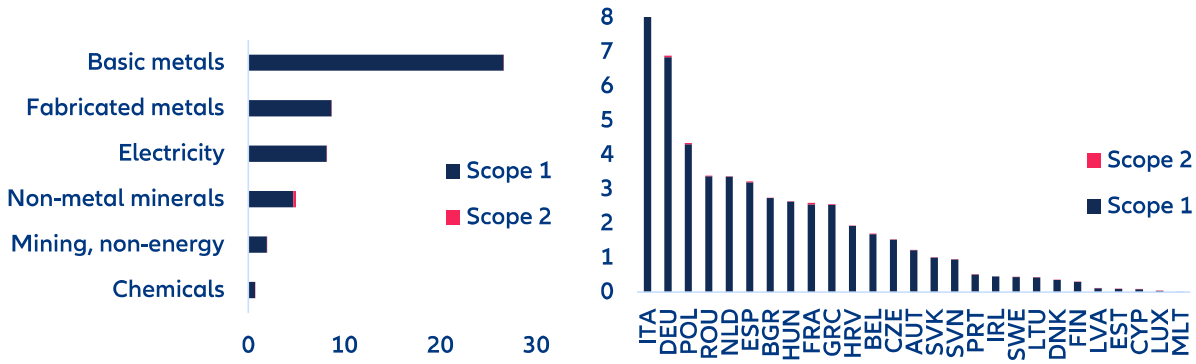


Sources: JRC EDGAR, Allianz Research

The EU Carbon Border Adjustment Mechanism (CBAM), set to take effect in January 2026, is designed as a complement to the EU ETS, ensuring that Europe's climate ambition is not undermined by carbon leakage. By requiring importers of carbon-intensive goods, such as steel, cement, aluminum, fertilizers, electricity and hydrogen, to purchase CBAM certificates reflecting the embedded CO_2 emissions in their products, it aligns the carbon costs of imported goods with those faced by EU producers under ETS. This intends to create a level playing field, to protect the competitiveness of domestic industries and to extend the EU's influence on global decarbonization by providing foreign producers with a strong incentive to adopt carbon pricing and cleaner technologies. To reduce administrative and financial burdens, recent revisions of CBAM exempt smaller importers below a de minimis threshold, ensuring that 90% of importers by number are not directly affected while still covering the vast majority of emissions. CBAM is closely linked to the gradual phase-out of free ETS allowances between 2026 and 2034, ensuring that domestic and imported goods face comparable carbon costs while giving industries time to adapt. Beyond Europe, CBAM has already influenced global climate policy by encouraging countries like India and China to strengthen domestic carbon pricing, while the UK plans its own border adjustment mechanism, highlighting its potential as a model for climate-aligned trade and encourage cleaner export-oriented production globally.

But CBAM also acts as a terms-of-trade shock. Its impact on EU industrial competitiveness through higher carbon prices and free-allowances removal on the value added of CBAM-protected industries is negatively felt throughout Europe's wider supply chains. The most covered trade flows are Scope 1 emissions from the basic metals sector (Figure 7, left). By raising the price of imported intermediates, it increases input costs for downstream industries such as automotive and machinery. This results in uneven impacts across sectors and EU states. Germany, for example, imports nearly USD400bn in CBAM-covered products per year, mainly in non-metal industries, electricity and basic metals. The CBAM levy on these imports is USD6.7bn (Figure 7, right). Italy imports USD232bn annually and is subject to the largest CBAM levy among EU countries (USD8.1bn). Poland follows with about USD100bn in CBAM-covered imports and a levy of USD4.4bn. This clearly demonstrates that the impact depends heavily on the emission structure of a country's direct imports relative to intermediary production. With a carbon price of EU80 per ton of CO2 and no change in supply chains, Europe could lose up to -USD14bn in imports from non-EU countries.

Figure 7: CBAM levy by sector (left) and by importing EU country (right), in USDbn

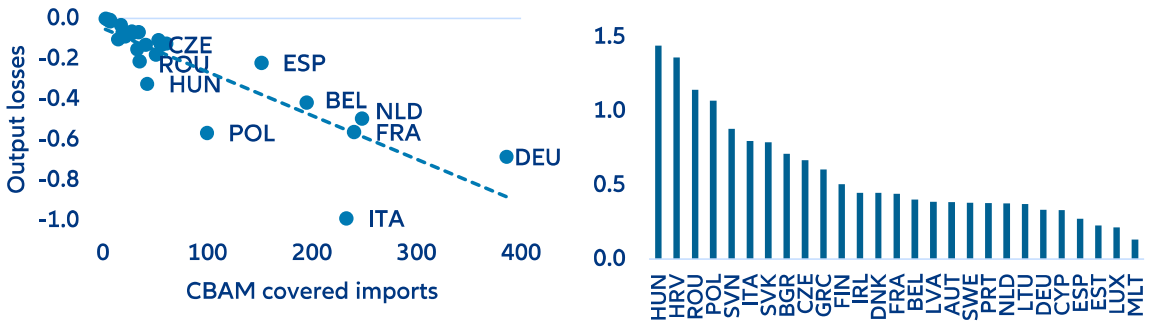


Sources: UNComtrade, OECD ICIO, OECD IOT, World Bank, Allianz Research. Note: The CBAM levy is calculated as the difference between the EU carbon price and the carbon price in the exporting country times the covered Scope 1 emissions in addition to the costs from Scope 2 emissions.

EU countries with metal-heavy supply chains are under the most pressure, with those in Eastern Europe bearing the brunt due to their industrial structure. The use of CBAM-covered products in intermediary output structures and losses in CBAM-covered imports due to the de facto CBAM tariff result in estimated maximum output losses of -USD6.45bn for the EU27. Without any redistribution or supply-chain adaptation, Italy would lose -USD1.0bn, Germany -USD0.7bn and Poland and France -USD0.6bn each (Figure 8, left). Treating CBAM as a de facto carbon tax means that the EU faces on average tariff increase of +0.6pp. The highest tariff equivalents from CBAM (Figure 8, right), added to the existing EU tariff structure, are expected in Hungary (+1.4pp), Croatia (+1.3pp) and Romania (+1.1pp). Although CBAM could encourage expenditure to shift towards EU-made goods, given Europe's relatively lower emissions intensity, this benefit is limited by higher domestic energy prices, a narrow sectoral scope and limited spare capacity. The removal of free allowances combined with the increase in the price of EU ETS permits

will further increase costs for EU producers and lead to a small reduction in the value added of the CBAM industries as some production is shifted to non-EU countries, potentially negating any competitive advantage gained through cleaner production methods. To avoid losing market share, exporters may absorb part of the CBAM levy. This would dampen trade diversion but also limit decarbonization incentives in countries that are not already aligned with EU climate policy.

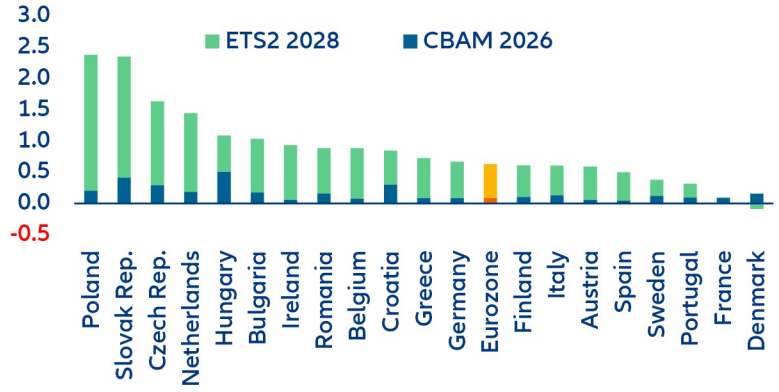
Figure 8: CBAM-covered imports and output loss, in USDbn (left) and CBAM tariff equivalents in pp (right)



Sources: UNComtrade, OECD ICIO, OECD IOT, BEA SUT, Allianz Research

Central and Eastern Europe in particular are likely to face a significant increase in inflation. We model the macroeconomic effects of the ETS2 and CBAM mechanisms to assess their impact on inflation and growth across EU countries. The simulations capture the introduction of CBAM in January 2026, modelled as a terms-of-trade shock on carbon-intensive imports, and ETS2 in January 2028, represented by an assumed EUR 59/t CO_2 price shock applied to the share of emissions covered by the emissions trading system. Initially, energy suppliers will pay for carbon allowances based on their CO_2 emissions, but they are expected to pass these costs on to consumers in the form of higher prices for petrol, diesel, gas and coal. While fuel prices are likely to rise quickly, household energy prices will increase more gradually due to long-term contracts and regulatory pricing. Combined, the two effects can exceed +2pps of additional inflation in countries such as Poland and Slovakia, while for the Eurozone as a whole, the cumulative impact would be around +0.6pp (Figure 9). The overall extent of the increase depends on the weight of energy-components in the CPI basket, initial energy prices and exchange rate dynamics. But it also reflects the stronger pass-through of energy and import costs in economies with less-diversified energy systems. In contrast, some highly energy-efficient and less carbon-intensive economies, such as Denmark, would even experience a mild disinflationary effect under ETS2 as the shift toward low-carbon electricity and heating would reduce exposure to fossil-fuel price pressures. Secondary effects from higher transport costs and inflation expectations may amplify impacts. On the other hand, EU-level changes to ETS2, national resistance to implementation and potential government subsidies could all reduce inflationary pressures. Divergent national decisions, such as possible non-implementation in the Czech Republic, pose additional uncertainty. Overall, while ETS2 could raise inflation in 2028, political pushback and mitigation measures may significantly soften the final impact and the resulting implications on monetary policy.

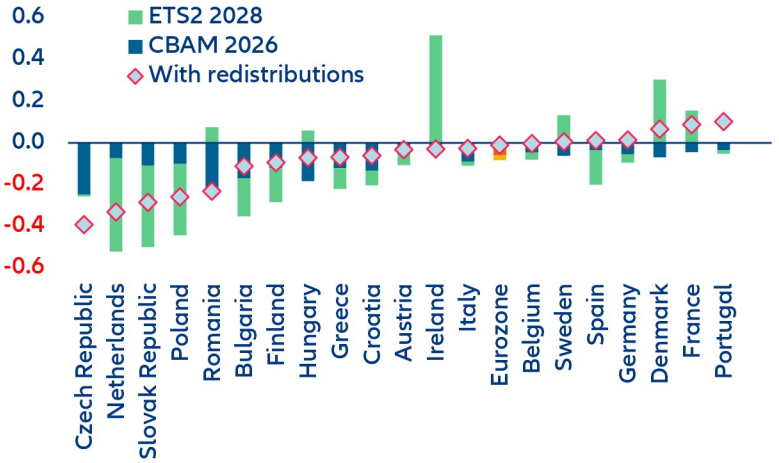
Figure 9: Full-pass through to inflation impact by policy, in pp



Sources: Oxford Economics Model, Allianz Research. Note: We model the impact of CBAM coming into force in January 2026 as a terms-of-trade shock on carbon-intensive imports, and ETS2 in January 2028 as an assumed EUR 59/t CO_2 price shock applied to the share of emissions covered by the emissions trading system.

The impact on GDP would be less severe. Looking purely at the shocks from higher tariffs and carbon prices, the effect on growth remains contained, with the strongest declines of around -0.4pp in the most exposed economies and an average impact of -0.1pp for the Eurozone overall (Figure 10). Countries such as France, Sweden, Denmark, Luxembourg and Ireland would see a net positive benefit from ETS2 because they are already energy-efficient, electrified and low in fossil-fuel use. As a result, their costs would rise less, they would save money on energy imports, remain competitive, use ETS2 revenues effectively and have economic structures that suffer little from higher CO_2 prices. At the same time, their strong innovation and green tech sectors would benefit from rising demand. This indicates that early decarbonization reduces future adaptation costs and increases GDP in the long term. The effects on GDP improve overall once revenue recycling and partial redistribution are taken into account. For ETS2, we assume that 20% of revenues are redistributed directly to households and 80% reinvested by governments, supporting consumption (more beneficial) and public investment (less beneficial), similarly for CBAM, reflecting compensatory mechanisms and transitional support. Under these assumptions, the negative drag on Eurozone growth largely disappears, becoming broadly neutral overall and even slightly positive in some countries, where the investment impulse outweighs the initial cost shock. This underscores how the design of redistribution mechanisms can meaningfully soften the transition, turning short-term adjustment costs into longer-term gains in resilience and green investment.

Figure 10: GDP impact with and without redistribution of levies, in pp

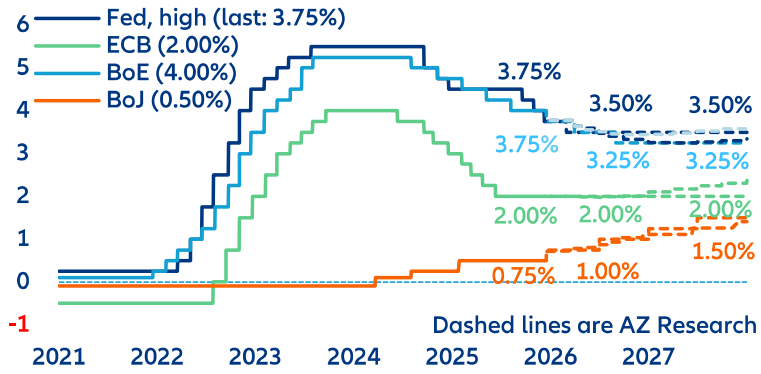


Sources: Oxford Economics Model, Allianz Research. Note: Redistribution of collected revenues is assumed at 20% directly to households contributing to private consumption, while the rest of collected revenues is invested by the government.

BoE, ECB, BoJ: Cut, hold, hike

Next week will see the ECB, the BoE and the BoJ delivering the whole spectrum of possible policy moves. After the Fed meeting this week, which delivered a well anticipated rate cut, three more major central banks are meeting next week, but each one is likely to move in a different direction: The Bank of England (BoE) will cut rates to 3.75%, the European Central Bank (ECB) will stay on hold at 2.0% and the Bank of Japan (BoJ) is set to hike again, bringing rates to 0.75% (Figure 11).

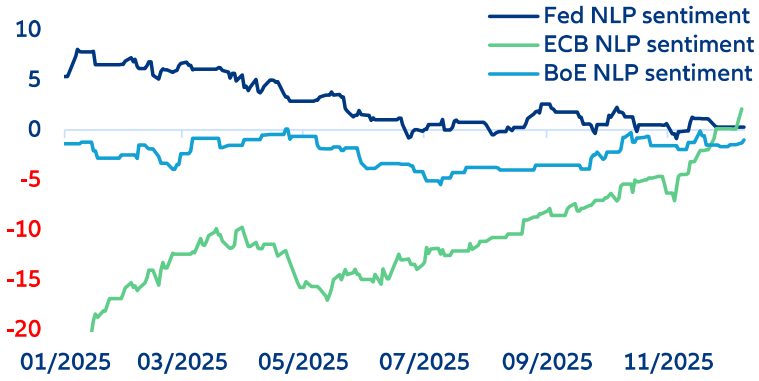
Figure 11: Central bank policy rates, %



Sources: Bloomberg, Allianz Research

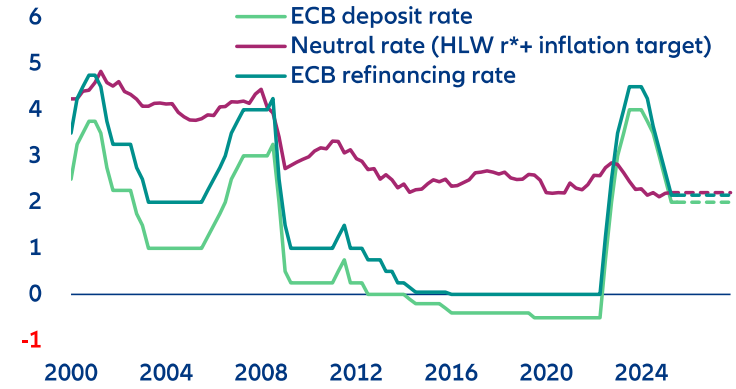
Contrary to recent ECB speech and market pricing, we do not see rate hikes as the most likely next step. The ECB is expected to keep its deposit rate unchanged at 2.0% when the Governing Council meets on 18 December. Given the latest uptick in inflation to 2.2% in November (core inflation: 2.4%) and GDP growth at +0.3% q/q in Q3 (annualized: +1.1%) – close to potential growth – the council is in a good spot to keep rates at current neutral levels. Yet, recent ECB speech has turned more hawkish (Figure 12). Board member Isabel Schnabel even indicted that she was "comfortable" with markets pricing in a hike as the next move. On that point we strongly disagree. Even in the near term, risks are tilted to the downside, with a simple Taylor rule still showing the necessity of slight easing given the moderately negative output gap. Our proprietary leading indicator points to subdued growth as standardized measures of credit demand, economic sentiment, consumer confidence and manufacturing PMIs remain in negative territory. In the medium run, there are strong doubts over whether Germany's economic stimulus package will truly delivers substantial growth, given structural headwinds from red tape to demographics. And the AI revolution will rather have a negative impact on inflation than a positive one in Europe. Supply-side effects (higher labor productivity leading to lower labor demand) will most likely outweigh demand-side effects (investment demand for data centers) as Europe as of now is an "AI consumer" not an "AI contributor", with global tech giants located elsewhere. Last but not least, and as we repeatedly pointed out earlier, despite the fact that the current policy rate of 2% sits near the estimated nominal neutral rate, historically the policy rate was mostly below that rate (Figure 12). Given all the structural headwinds, from geopolitics to demographics to fading competitiveness vis a vis China and the US, it seems more likely that Europe would need monetary policy support than restrictiveness.

Figure 12: Bloomberg Natural Language Processing (NLP) index of central bank speak, index



Sources: Bloomberg, Allianz Research. Note: Values above zero indicate more hawkish sentiment; values below zero indicate more dovish sentiment.

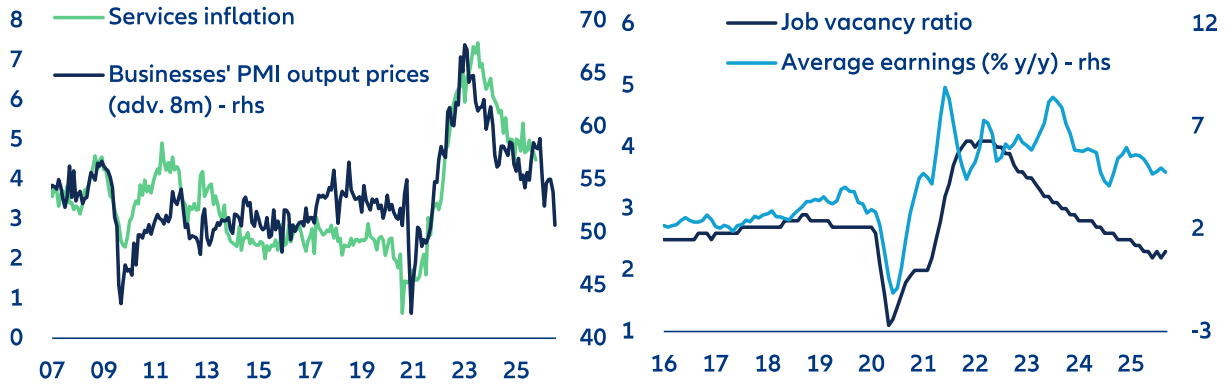
Figure 13: ECB policy rates compared to Holsten-Laubach-Williams neutral rate, %



Sources: LSEG Datastream, FED New York, Allianz Research

Meanwhile, the BoE's 25bps rate cut next week should be followed by two others in the spring (April most likely) and summer (September) of next year. The BoE has kept a dovish bias through 2025, despite GDP growing at a decent clip (+1.4% expected, after +1.1% in 2024) and inflation stubbornly way above the Bank's 2% target, at +3.6% in October (core at +3.4%). Last month, the nine voting members of the Monetary Policy Committee (MPC) were more split than expected on the decision to hold rates at 4% (five in favor) versus delivering a cut (four in favor), with Governor Bailey the deciding vote. This points to a continued dovish bias, and Governor Bailey's vote in the next MPC will be crucial. We think he is more likely to vote for a 25bps cut this time, titling the balance of the MPC. Though inflation and wage growth remain high, doves in the MPC could point to encouraging forward-looking indicators signaling easing pressures: In the services sector, business surveys point toward services inflation – the most sticky part of inflation – cooling substantially through 2026 (Figure 14, left). The sharp rise in the National Living Wage and the rise in employers' National Insurance (NI) contributions in April have increased businesses' labor costs substantially, likely supporting wage and inflation pressures initially as businesses passed on higher costs to their selling prices. However, they also contributed to a substantial cooling of the labor market as firms held back on hiring, with the job-vacancy ratio well below recent the historical average (Figure 14, right). A loose labor market looks to be increasingly weighing on prices. In this environment, positive developments on inflation and a cooling economy should prompt the BoE to continue cutting rates through 2026, through cautiously amid persistently above target inflation. We expect a 25bps cut in the April MPC, followed but another one in September, taking the bank rate to 3.25%.

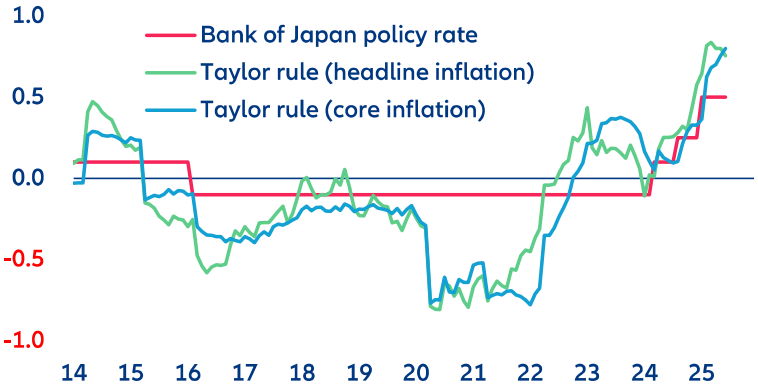
Figure 14: UK services inflation, job-vacancy ratio and wage growth (right)



Sources: LSGE Datastream, Capital Economics, Allianz Research

The BoJ is likely to hike its policy rate from 0.5% to 0.75%, and we continue to see the terminal rate at 1.5% by end-2027. The BoJ started its rate-hiking cycle in March 2024, ending nearly a decade of negative rate policy. In the current cycle, the central bank has delivered three rate hikes (+20bps in March 2024, +15bps in August 2024 and +25bps in January in 2025), and economic conditions suggest that further monetary tightening is likely. In their latest prints (October 2025), both headline and core inflation came in around 3%, above the BoJ's target. While the supplementary budget announced by the government in late-November is likely to temporarily reduce headline inflation[3], core inflation is likely to remain above 2% in the coming quarters. The upcoming yearly wage negotiations (*shunto*, due to be concluded in spring) could potentially result in a third year of wage growth above 5%, and the supplementary budget will also stimulate domestic demand. Our revised forecasts see headline inflation at 1.9% in 2026 and 2.4% in 2027 (after 3.2% in 2025), and GDP growth at +1.4% in 2026 and +1% in 2027 (after +1.4% in 2025). While we were expecting the BoJ to deliver the next rate hike at its January monetary policy meeting (after having gathered sufficient information about *shunto*), the latest speeches by Governor Ueda (on 1 and 9 December), highlighting inflationary pressures and receding economic uncertainties, suggest that it could be ready to act at the December meeting. These communications can be seen as the BoJ's efforts to avoid delivering a surprise and adjusting market expectations, which are now pricing in a rate hike at next week's meeting, which would put the policy rate at 0.75%, bringing it closely in line with levels prescribed by the Taylor rule (see Figure 15). Beyond the short term, we continue to see three more rate hikes by end-2027, bringing the policy rate to 1.5%.

Figure 15: Bank of Japan policy rate vs. Taylor rule (%)

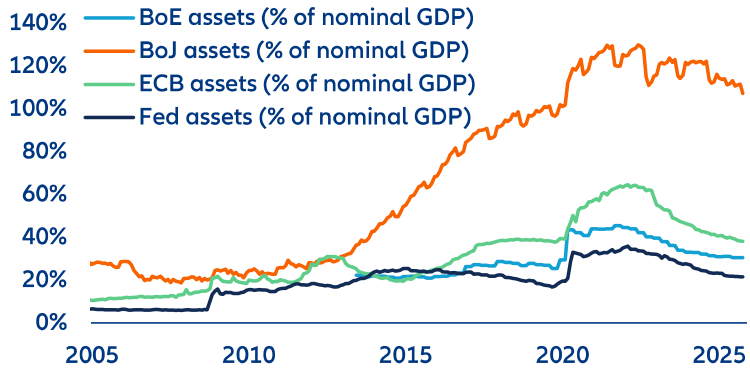


Sources: LSGE Datastream, Allianz Research. Note: In a Taylor rule, the policy rate depends on i) the natural interest rate, ii) the output gap (slack in the economy) and iii) inflation relative to the target. The natural interest rate is derived from market pricing; the output gap is the estimate from the Bank of Japan.

[3] *See our report What to Watch 28 November 2025.*

All three central banks do have one thing in common: rapid quantitative tightening. Contrary to the Fed, quantitative tightening (QT) will continue for the ECB, the BoE and the BoJ – as long as markets are able to absorb the additional supply in an orderly manner. Figure 16 shows that all central banks still have significantly larger balance sheets relative to the size of the economy compared to the Fed and compared to the pre-quantitative-easing area – above all the BoJ. This means that bond investors will need to absorb large amounts of government bonds amid already high fiscal deficits. In fact, at the current pace, the equivalent bond supply of 3.2% (ECB), 2.4% (BoE) and 6.4% (BoJ) of GDP just from QT will continue to put upside pressure on rates in these regions. However, any signs of a "Truss moment", i.e. a government bond sell-off with signs of market dysfunction, would immediately change the course of any central bank.

Figure 16: Central bank assets, % of nominal GDP



Sources: LSEG Datastream, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

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