Economist's Weekly Market View

Wednesday, November 20th, 2024

European political risk back in focus

While much attention has focused on the potential impact of President-elect Trump on the Eurozone economy, the continuing uncertainty around European politics and fiscal policies has also weighed on the euro and local equity markets recently, alongside the continuing "Trump trade". In particular, the expected dissolution of the German Government brings yet further political uncertainty, following the summer elections in France and the European parliament.

With a long lead-in time to an expected German election in February, this uncertainty may hit consumer and business confidence further in Europe's largest economy, which will see another year of weak GDP growth in 2024, following a shallow recession last year. Moreover, the prospect of fresh US tariffs in the new year could disproportionately hit the German industrial sector, which has significant trade linkages with the US economy. Against this backdrop, the European Commission downgraded its growth projections for the Eurozone in 2025 to 1.3% from its previous 1.4% forecast, largely driven by expected weak growth out-turns in Germany and France next year.

Polls suggest the election is likely to yield a change of Government, with the centre-right CDU/CSU returning to power. However, the rise of political extremes in Germany adds a further layer of uncertainty to the outcome. Longer term, a future Government will continue to be constrained by the restrictive "debt brake", which has limited the current Government's room to manoeuvre in supporting economic growth, by mandating a structural budget deficit close to zero.

Certainly, the German Government could have run larger deficits in recent years to underpin growth, particularly as the reliance on imported energy drove inflation higher and the downturn in export markets in Asia buffeted the German manufacturing sector.

Indeed, the budget deficit is expected at just 2% of GDP in 2025, falling to 1.8% in 2026, according to the EU Commission's forecasts – well below the 3% limit mandated by EU fiscal rules, and the 5-6% deficit forecast in France over the same period. With the debt brake a vaunted creation of the previous CDU Chancellor Merkel in 2009, a future centre-right Chancellor is unlikely to meddle substantially with the fiscal rule; albeit CDU leader, Friedrich Merz, has expressed a willingness to examine tweaks to the rule to potentially support capital investment. The overarching takeaway from recent political events on both side of the Atlantic is that the risks to the economic outlook have shifted to the downside in Europe.

David MacNamara
Chief Economist, AIB

AIB Customer Treasury Services
DUBLIN / CORK
aib.ie/fxcentre

Customer Treasury Services NI
BELFAST
aibni.co.uk/fxcentre

Customer Treasury Services GB
LONDON
aibgb.co.uk/fxcentre

Economic Research Unit
AIBeconomics.unit@aib.ie
Tel: 353-1-6600311