



## Eurozone fiscal risks haven't gone away

Following a relatively calm period in Europe of late, as attention focused on events in the US and Middle East, political risks have come to the fore once more in France. The announcement of a confidence motion on September 8th by the prime minister François Bayrou has rattled the political system and created some tremors in European financial markets. With the minority Government at risk of collapse, attention will now focus on the ability of this or a future administration to push through the cuts needed to bring France's deficit back to a sustainable path. The confidence vote was spurred by the Prime Minister's failure to legislate for a €44bn fiscal consolidation plan which was expected to move the deficit back to 3% of GDP from the current near-6% level.

What has been surprising is the relatively muted market reaction to the events in France, compared to the ructions following the announcement of parliamentary elections by President Macron in June 2024. That saw the yield spread on the French 10-year bond to the German 10-year blow out from below 50 basis points (bps) to over 80bps, and the French sovereign has continued to trade in the 70-80bps range over Germany since that time. This time, while spreads have widened, the French 10-year yield is only about 8bps higher following Bayrou's announcement. The decline in equity markets has also been somewhat contained, with the CAC index falling 2.5% on the week, suggesting investors have taken a sanguine view of the current impasse, perhaps betting the political system will cobble together a working majority to pass the necessary cuts. Investors might also be betting the ECB would, in any event, prevent further widening in spreads or contagion through its Transmission Protection Instrument, à la the 2022 episode in the Italian bond market. It's worth noting that the French 10-year yield has moved above its Greek counterpart in recent weeks.

Nonetheless, it is unlikely a future administration in this parliament will have the numbers to push through the necessary cuts, which could bring fiscal vulnerabilities into sharper focus for investors in the coming months. A fresh round of elections could also crystallise a sharper move in French and European asset prices, with the likelihood of a more populist French government based on current political polling, increasing domestic fiscal risks. This scenario could also raise broader geopolitical risks around European coordination on infrastructure, defence, and the necessary economic reforms to boost economic growth advocated in the 2024 Draghi Report. Fresh election could also create an unhelpful backdrop for the euro in the months ahead.

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