

## Europe prays that France gets a grip

Political chaos in France is a symptom of wider, more structural problems. It needs to get its act together for the sake of future European economic stability



### This is not a game

I'm a sports fanatic, and when I followed the remarkable Olympic Games in Paris last year, that part of me felt nothing but joy. The economist in me, however, couldn't help but wonder whether splurging on a spectacular Olympic experience is truly sustainable. Maybe it's a leading indicator, or just a coincidence, but over the past twenty years, European hosts of the Olympics have consistently ended up with financial troubles: Greece, the UK, and now France.

French politics has now taken centre stage. Normally, when you think of unstable and fragmented politics, you think of Italy, which had six prime ministers in the 2010s and 14 parliamentary parties. But think again. France has had six PMs since 2020, Italy just three.

### Something structurally wrong

And while we should be proud of our democracy, the more often national governments fall, the stronger the signal that something is structurally wrong. The number of prime ministers isn't the cause of instability - it's a symptom. It suggests that something in the economy and/or society is in need of repair. In France's case, it's the unresolved dilemma of how to reconcile rising

government debt and ageing populations with the urgent need for investment and structural reform. Whatever the next hours, days, or weeks bring in French politics, a solution to this dilemma doesn't seem close.

As a result, expect political instability and uncertainty to leave their mark on the economy, pushing the eurozone's second-largest economy closer to stagnation. Still, this isn't a return of the euro crisis. It's a domestic political and, probably soon, an economic crisis. Direct contagion to other eurozone countries looks unlikely. Indirect contagion, however, is possible. The dilemma France faces isn't unique; many European countries are in similar positions. For those with deep fiscal pockets, like Germany, France's situation is a warning. It illustrates a future where fiscal stimulus isn't matched by structural reform.

And there's more. France's situation will directly impact Europe. Since France and Germany breached the eurozone's fiscal rules in the early 2000s, France has never truly stabilised its public finances. In fact, over the past twenty years, France has only managed to bring its deficit below the 3% of GDP threshold twice. The European Commission and the ECB will have no choice but to play hardball, increasing pressure on the French government to comply with Europe's fiscal rules. If they don't, those rules aren't just broken—they're obsolete.

For the ECB, offering a safety net to France via TPI or OMT would send the wrong signal. It's hard to argue that any widening of spreads is 'unwarranted' when it stems from a self-inflicted political mess.

## We need a strong Franco-German axis

Ultimately, Europe requires a robust Franco-German axis to address its numerous challenges and capitalise on what many have termed the 'global euro moment'—or at the very least, to prevent Europe from falling further behind in the global economy. The last time this axis worked well was during the pandemic, when both countries backed the European Recovery Fund. Since then, it's suffered from German economic weakness and political indecisiveness.

Now that Germany is trying to bounce back and reclaim leadership in Europe, France's turmoil couldn't come at a worse time. In this context, it's hard to imagine Europe making meaningful progress on the Capital Markets Union, safe assets, cross-border investments, or reducing bureaucracy and regulation. Even the long-term EU budget is at risk.

Last year, I thoroughly enjoyed the Olympics in Paris. Admittedly, it's rare that I publicly support the French team. Today is different: Allez les Bleus! And get your act together, for Europe.

## Our key calls this month

- **United States:** Tariffs are having less of an immediate impact on inflation than feared, while we're increasingly wary about the condition of the US jobs market. We expect the Fed to cut rates by 25bp in October and December, with a further 50bp of cuts in early 2026.
- **Eurozone:** The bar for another ECB rate cut remains high, though it is possible were we to see more evidence of a delayed tariff impact, further euro strength, a wider impact of French politics, or delays to German fiscal stimulus. For now, we expect the ECB to remain on hold for the next two years.
- **China:** Barring a stronger September, we expect a steep deceleration in third-quarter growth. Further policy support is likely, and we expect 10bp worth of rate cuts and 50bp of

reserve-requirement-ratio (RRR) cuts from the PBoC. It's possible we also see fresh support for consumption and the property market.

- **United Kingdom:** We no longer expect another Bank of England rate cut this year, though lower inflation and higher taxes in the forthcoming Autumn Budget should unlock further easing in 2026.
- **FX:** Following Sanae Takaichi's victory in the recent LDP leadership election, we have raised our USD/JPY forecasts, reflecting political headwinds surrounding Bank of Japan rate hikes. Separately, we still expect EUR/USD to reach 1.20 by year-end.
- **Market rates:** In the short-term, US 10-year yields could well break below 4%, but in the medium term, we're targeting 4.25-4.5%.

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