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France's fiscal outlook deteriorates, but a full-blown crisis remains unlikely

It will be a challenge to form a new government following the resignation of Prime Minister François Bayrou. There is more uncertainty in France as public finances worsen. But we think a full-blown crisis can be averted

Prime Minister François Bayrou lost the confidence of parliament and resigned

Forming a new government will be very difficult

On Monday 8 September, Prime Minister François Bayrou lost the confidence of Parliament and subsequently resigned. The next day, President Emmanuel Macron appointed Sébastien Lecornu, a close associate from the centre-right, as the new prime minister. Lecornu now faces the daunting task of forming a government and presenting a 2026 budget in a deeply fragmented parliament.

To avoid a vote of no confidence, he must secure tacit support from either the left or the far-right, a scenario unlikely unless the budget proposal undergoes significant revisions.

As a result, we anticipate protracted negotiations. If these talks succeed, it will likely be at the cost of a less stringent fiscal path, effectively slowing budgetary consolidation. However, there remains a strong possibility that Lecornu will fail to build a viable coalition, which would increase the probability of new parliamentary elections. In our view, the likelihood of Macron resigning is very low at this stage.

Weak growth will only exacerbate the problem

The fall of the government and the low probability of a swift resolution to the political crisis have added a new layer of uncertainty to an already weak economy. Indeed, France's GDP growth in early 2025 appeared resilient, but underlying fragilities persist. The modest expansion was driven almost entirely by inventory accumulation, masking stagnation in private consumption and contractions in investment and net exports.

While industrial production showed a slight uptick, overall momentum remains weak. Labour market conditions are deteriorating, and household confidence is fragile. Political instability further clouds the outlook, making a recovery in the second half increasingly unlikely, especially as the higher risk premium on French bonds is likely to weigh on interest-sensitive sectors like construction and real estate.

On average, GDP growth could reach just 0.6% in 2025, down from 1.1% in 2024. With a weak starting point for 2026, growth is expected to remain below potential, continuing to weigh on public finances.

The public finance situation is serious

According to the Ministry of Finance, public spending is projected to increase by €51.1bn in 2026 without corrective measures, resulting in a budget deficit of 6.1% of GDP, which significantly exceeds the 4.6% target submitted to the European Commission. With little prospect of resolving the current political crisis and even less likelihood of rapidly securing an agreement on the 2026 budget, the fiscal outlook is poised to deteriorate further.

Without a shift in policy, public debt is projected to climb from 113% of GDP in 2024 to 125.3% by 2029. France's fiscal challenge is largely structural, driven by demographic trends and weak potential GDP growth.

The existence of TPI should help

The political crisis has already caused government bond (OAT) spreads to widen, though not to levels seen during the sovereign debt crisis. Importantly, the European Central Bank retains significant firepower to limit excessive widening of eurozone government bond spreads, and markets are well aware of this.

In theory, the ECB could activate the Transmission Protection Instrument (TPI) if elevated interest rates on OATs begin to impair monetary policy transmission. While the TPI requires compliance with EU fiscal rules, which France currently does not meet, the ECB has stated that these criteria are "inputs into its decision-making and may be dynamically adjusted".

It is unlikely that France would receive a free pass upfront, but the ECB would likely trigger TPI if spillover risks threaten financial stability. As such, the mere existence of the tool may be sufficient to prevent spreads from spiralling upwards, avoiding a full-blown crisis.

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