Euro Area Watch

France: another try?

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Economics
Euro Area

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Majority against parliamentary dissolution…

Our trip to Paris with clients to meet policymakers, politicians, public institutions, and polling experts could not have come at a more crucial time. On the ground, we found little conviction in a solution that would generate real stability and a consistent medium-term path for public finances. But, as confirmed by ex-PM Lecornu's interview yesterday evening, there is some willingness to find a negotiated solution on the 2026 budget, via painful compromises on pensions and new taxes – to avoid snap elections. President Macron is now expected to nominate a new Prime Minister by Friday night, allowing a budget draft to be presented to parliament by the Oct 13th deadline.

…means a budget path still exists

It's difficult to be confident in the political path and we do not take a strong stance on that. An agreement of the centrist bloc with the left could end up delivering a budget with some limited adjustments on the fiscal side and higher taxes, which wouldn't be far from our baseline assumption of a slight reduction of the deficit vs 2025 (this year's deficit target is 5.4%). A temporary suspension of the pension reform would have manageable budget implications in the near-term, especially if it's limited to a freeze of the pension age increase (Lecornu mentioned c€3bn for 2027, but the cost would be much higher in the medium term). To reach a compromise on the 2026 numbers, the controversial Zucman tax could be replaced by tamer versions directed to large personal financial assets and by targeting tax loopholes.

Fragile compromise, bumpy ride

The latest news would suggest a majority for a negotiated budget is reachable, but the Assembly is very fragmented, and divisions are building even within each party. Without the support of Les Republicains, a centre-left agreement would have very narrow margins in parliament and a few MPs could easily block the process. An open budgetary process in this parliament, without the use of the 49.3 article of the constitutions, is likely to be volatile process. The risk of new elections and a more volatile near-term path has somewhat reduced but remains, in our view, high.

Many scenarios, but large deficit swings unlikely

On the deficit side, despite the wide range of political scenarios, we think the trajectory for next year's deficit is relatively range-bound. We would guess that a centre-left agreement could target a number around 5%. We have always found the chances of a drop below 5% next year to be limited. But, unless a new shock materialises, a deficit deterioration to 6% or even above is unlikely too. If a budget cannot be approved on time, a "special law" could extend the 2025 budget into next year. There are many moving parts but, overall, this temporary arrangement is unlikely to lead to a deterioration in deficit because 1) it freezes central government spending at nominal level, 2) there could be more tightening than the outright nominal numbers would suggest, as ministries & local actors take extra precautions (as it happened in 1Q25), 3) additional executive orders (eg to freeze some spending chapters) could also be taken.

continued inside…

French economy: fundamentals vs low confidence

On the economy, our view remains that French fundamentals are good (especially compared to the main European partners) but bleak consumer confidence and high saving rates are keeping domestic demand subdued. Political uncertainty is likely to remain persistent and the distribution of savings is tilted towards pensioners with low consumption-propensity, so we are doubtful of a quick conversion of savings into higher demand. In the near term, the main bright spot is the strong numbers of the aerospace industry, which should translate into decent export growth.

OAT-Bunds: 75-80bp on new govt, risks skewed wider

In a scenario of a centre-left government with compromises being presented to pave the way for successful budgetary negotiations, we see the 10y OAT-Bund spread trading back in the 75-80bp range. This would be a modest tightening from the current 83bp level, as we already recorded a 2.5bp tightening on the optimism voiced by Lecornu yesterday morning, and extra tightening would be limited by three factors:

1. The compromise would likely require a wider deficit than targeted by Bayrou & Lecornu, and a suspension of the pension reform that may raise concerns about France's ability to deliver on structural reforms,
2. risks that the parliamentary process is still derailed, and
3. as we had flagged in our previous notes, the OAT-Bund spread could remain under pressure due to the rating reviews. Even if the current level is already consistent with a lower rating (given where other EGB spreads trade), the downgrade cycle can still maintain cheapness in OATs as the buyer base shifts.

Those three factors suggest to us that it will be hard to price out the full 10bp cheapening observed in OAT spreads since July relative to the EGB complex (Exhibit 1). For this to happen and OAT-Bunds to approach 70bp, we would need to get a certainty on the 2026 budget passing, with clarity on the longer-term fiscal path and commitments on the planification of debates and adjustments to the pension reform.

Exhibit 1: Residual of 10y OAT-Bund spreads based on principal component analysis of 10y EGB spreads to Germany (bp)

A c.10bp cheapness has built in OAT-Bunds since July.

Source: BofA Global Research.

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Relative to the 75-80bp range discussed above, we see risks as skewed to the upside (wider spread). For one, reduced optimism on the pick-up in European growth over coming quarters could generally pressure EGB spreads wider, including OAT-Bunds. Then new parliamentary elections could push the spread above 90bp as the outcome would be quite uncertain. The market may take comfort that a potential alliance between Les Republicains and Rassemblement National may deliver the same outcome as Meloni's term in Italy, but this is far from given. A resignation of Macron, albeit in our view very unlikely, would represent unchartered territory and could widen OAT-Bunds significantly beyond 90bp. Those scenarios are also likely to lead to broader EGB spread widening.

EUR: risks less asymmetric

While the latest developments offer some relief, risks to the EUR around France remain skewed somewhat downwards in our view, given the long EUR positioning (see Liquid Cross Border Flows 6 Oct '25).

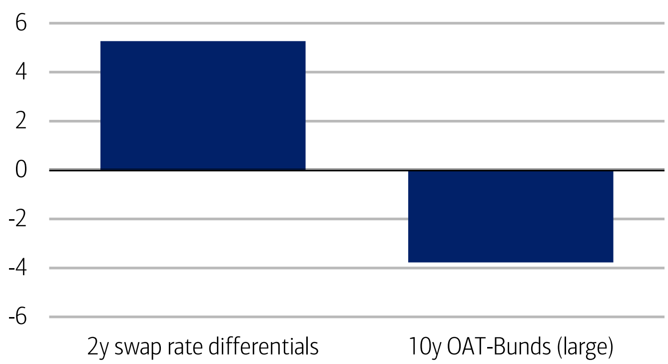
This is a key reason we closed our long EUR trade recommendation (see FX Alpha: Close long EURUSD on France concerns 7 Oct '25). Of concern to us were the stronger than usual EUR-USD reaction to the widening in OAT-Bund spreads, both this week and in late August (Exhibit 2), and the drop in near-dated EUR-USD risk reversals (Exhibit 3).

To be sure, the risk of protracted political instability and fresh National Assembly elections concerns us the most: our economists expect modest fiscal tightening, and our rates strategists note OAT-Bund spreads are trading a much lower implied rating.

We still prefer to position for downside France-related risks in EUR crosses (e.g., EUR-CHF, EUR-AUD), whereas our medium-term USD bias remains bearish, even if mostly on US developments – we forecast EUR-USD at 1.20 by year-end and 1.25 next year.

Exhibit 2: Wider OAT-Bund spread by 1pp comes alongside 4% weaker EUR-USD

EUR-USD beta to 2y swap rate differentials and large 10y OAT-Bunds shocks



Source: BofA Global Research, Bloomberg. Weekly data until from Jan-2015 until September-2025. We define as large spreads those with 2-year z-scores greater than 1 (in absolute value). Betas show the % change in EUR-USD attached to a 1 percentage point (100bp) wider 2-year EUR-USD OIS differentials and to a 1 percentage wider 10-year OAT-Bunds spreads.

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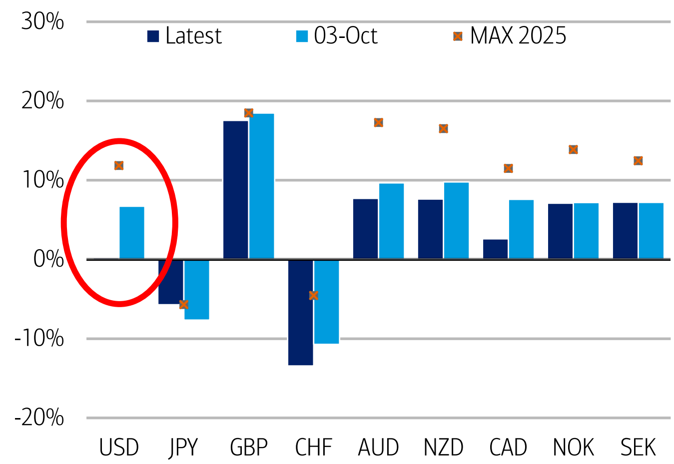
Exhibit 3: Risk premium most apparent in EUR-USD and EUR-CAD

EUR-G10 3-month 25 Delta risk reversals (% of implied vol)



Source: BofA Global Research, Bloomberg

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