French Contagion

Political fragility and fiscal slippage as the Eurozone's new core risk

→ Political paralysis and fiscal slippage in Paris have turned a founding EU member from anchor to epicenter, reviving contagion fears once confined to the periphery.

→ Rising OAT–Bund spreads and credit downgrades expose how instability in France could fracture market confidence, test European Central Bank backstops, and reshape the balance of power in Europe's fiscal union.

Introduction

France, once considered the Eurozone's anchor, is now in the middle of a dangerous fiscal and political crisis. After expansionary budgets and political turmoil, its fiscal deficit reached 5.8% of GDP, and its public debt climbed to 113% of GDP at the end of 2024.[1]

France's political fragility and fiscal slippage are mutually reinforcing and amplify contagion risks across the Eurozone. Unlike the 2011-2012 sovereign debt crisis, in which instability was concentrated in the periphery, the current crisis involves a core member. This creates a fragmentation risk, in which a country's fiscal stress threatens the stability of its banking sector and challenges the credibility of the European Central Bank's (ECB's) defense mechanisms.

France's political fragility and fiscal slippage are mutually reinforcing and amplify contagion risks across the Eurozone

In modern monetary unions, contagion operates not only through market channels but also through political expectations and institutional credibility. France's case blurs the traditional core-periphery divide, testing the resilience of the ECB's credibility and the EU's fiscal governance model.

France's fiscal and political fracture

France is experiencing a political crisis on top of a fiscal crisis. Its fragmented parliament has made it extremely difficult to form a stable coalition, leading to five governments in the past 21 months.[2] In July 2024, the European Council launched the Excessive Deficit Procedure (EDP) against France to compel it to implement an action plan to lower its deficit.[3] France has proposed a budget to reduce the deficit from 5.4% of GDP in 2025 to 4.7% in 2026, but the parliament has thus far rejected it.[4]

This instability reflects deeper structural changes, including the erosion of traditional party systems, the rise of anti-establishment movements, and growing voter polarization. Such entropy poses a more durable fiscal risk than temporary deficits.

The prospect of radical policy shifts from a highly divided parliament have fueled investor fear

The prospect of radical policy shifts from a highly divided parliament has fueled investor fear. The resulting market volatility is reflected in the spread between French 10-year government bonds (OATs) and the German benchmark (Bunds). As of 3 November, the 10-year OAT yield is 3.44%[5] and the OAT Bund spread is 78 bps.[6] Following downgrades from Fitch and DBRS, S&P Global cut France's credit rating on 20 October, citing political instability that prevents the country from managing its finances.[7]

Transmission channels of contagion

The risk of French fiscal distress spilling into the wider Eurozone operates through three primary channels.

The Sovereign-Bank Nexus. Mark-to-market losses on OATs can weaken financial institutions across Europe and cause panic, making it more expensive for other countries to borrow. OAT losses weaken bank balance sheets by causing mark-to-market losses on high-quality liquid assets. A weaker sovereign is less able to support banks, tightening funding and amplifying stress.

During the 2011–2012 Euro crisis, banking failures required government interventions, dramatically increasing public debt and sovereign credit risk.[8] While French banks are generally diversified, the scale of the French sovereign bond market makes this channel a significant concern.

Bond Market Spillovers. A rapid widening of the OAT-Bund spread can trigger a re-pricing of risk across the entire Eurozone sovereign spectrum, increasing borrowing costs for all member states. A sudden, sharp sell-off could lead to a reordering of the Eurozone sovereign credit spectrum. Despite recent fiscal improvements, investors may demand higher interest rates for Spanish Bonos and Italian BTPs given their high absolute debt levels.

France's current spread of approximately 80 bps remains well below the 2011-2012 extremes, but euro area sovereigns exhibit bilateral and time-varying spillovers in their yield spreads. From 2011-2012, the OAT-Bund spread briefly reached 195-200 bps, causing shocks across sovereign curves. And in March 2020, the ECB's asset purchases quickly compressed spreads and warded off risks of financial fragmentation.[9]

Stress in a founding core member like France represents a political and psychological shock to the EU

Confidence Shock. Stress in a founding core member like France represents a political and psychological shock. It raises political and legal questions about the euro project and the ECB's latitude, which can spook global investors and lead to capital flight, pushing up funding costs for all European assets. The ECB is monitoring spreads and stands ready to use its toolkit if "disorderly" dynamics emerge.[10]

Possible scenarios

Three scenarios are plausible over the next year, differentiated by speed and intensity. Markets currently price in the "gradual erosion" scenario, though surprises in political cohesion or ECB signaling could shift expectations.

Markets currently price in the gradual erosion scenario, though surprises in political cohesion or ECB signaling could shift expectations

Stabilization at a higher premium. Partial but credible fiscal adjustment under the EDP keeps the deficit on track and aligns the 2026 budget with EU net spending ceilings. The OAT-Bund spread steadies at 60-100 bps, signaling a higher but stable premium. Market volatility eases, and the ECB's backstops remain unused while EU confidence improves.

Gradual erosion. A gradual erosion of confidence follows if political gridlock blocks consolidation and the government fail to meet EDP milestones. The early warning signs would be a sustained OAT-Bund spread above 100 bps, a failure to pass or implement key adjustment measures, and a negative rating outlook or downgrade. Such developments would indicate a weakening policy anchor and loss of reform momentum. Capital would begin to flow toward the stronger euro area core. EU fiscal surveillance would tighten, and the ECB would increase rhetorical pressure, signaling readiness to act if market conditions deteriorate further.

Sharp loss of confidence. A sharp loss of confidence could follow a political or ratings shock—such as a failed budget, government collapse risk, or disorderly auctions—triggering capital outflows and debt repricing. In this setting, the OAT-Bund spread would likely surge to 150-200 bps, accompanied by declines in bank equities and signs of liquidity stress in sovereign auctions. The ECB would then face mounting pressure to intervene.

The Eurozone's defense architecture

Contagion containment falls on the ECB and the EU's fiscal governance framework.

The ECB's Transmission Protection Instrument (TPI) can address unwarranted fragmentation if a member state is broadly compliant with the fiscal framework, faces no severe macroeconomic imbalances, and maintains sustainable policies. The Outright Monetary Transactions (OMT) is the heavier backstop, activated only with a European Stability Mechanism (ESM) program and strict conditionality. Any large-scale intervention could face legal scrutiny from Germany, which has historically challenged the legality of non-conventional monetary policy. As the ECB stresses that markets are not "disorderly," credibility rests on the national government's actions.[11]

The EDP is the EU's framework for fiscal discipline. It sets a multi-year net expenditure path to reduce the deficit below 3%.[12] It also enforces net expenditure ceilings and milestones to lend credibility to a member state's commitment to reform and limit spillovers. Credibility rests on enforcement and realistic plans. However, the case of France presents a quandary for the EU as sanctions against a core member risk political fragmentation, while inaction creates moral hazard and undermines the EDP's credibility.

The case of France presents a quandary for the EU as sanctions against a core member risk political fragmentation, while inaction creates moral hazard and undermines the EDP's credibility

Implications and recommendations for Spain

France's current challenges should remind Spain and other member states of the importance of fiscal credibility, consistent communication, and institutional coordination. Spain's experience during its 2010 and 2012-2013 fiscal crises and its responses may also offer France some relevant lessons.

Notably, the contagion from the French sell-off has been limited so far, with Spanish spreads remaining contained and, at times, tightening relative to French OATs

Spain's sovereign risk has improved significantly in recent years. Its debt ratio has decreased from a peak of 115% of GDP to approximately 102% of GDP, and its credit ratings have also improved.[13] Notably, the contagion from the French sell-off has been limited so far, with Spanish spreads remaining contained and, at times, tightening relative to OATs. This limited spillover suggests it is differentiating itself from its highly indebted Eurozone peers.

The following is a reminder to Spain of the actions it should take to mitigate contagion risk.

<u>High priority</u>

Build fiscal buffers, maintain Treasury discipline, and communicate Spain's improving debt metrics to markets. Ask Banco de España to conduct stress tests for direct and indirect exposures to French sovereign and financial sector assets. Track the contribution of sovereign holdings to liquidity cover ratio buffers and identify concentrations.

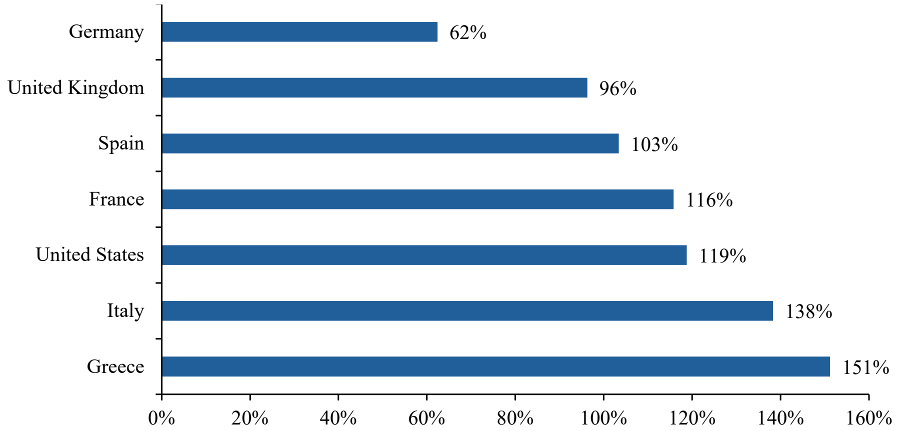
<u>Medium priority</u>

Strengthen surveillance and macroprudential readiness, ensuring flexible capital buffers and steady debt management in the event of spillovers.

<u>Contingency</u>

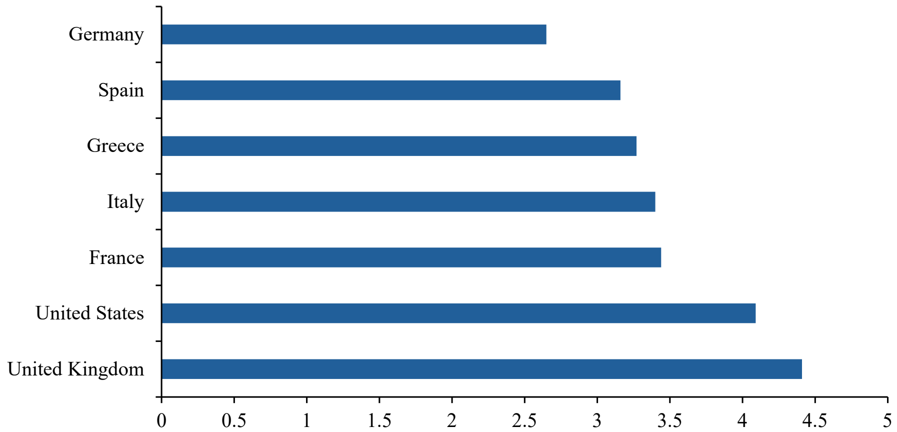
Support credible EU fiscal enforcement and coordinate with ESM partners so the OMT safety net remains operational if needed.[14]

EXHIBIT 1.0 – TOTAL PUBLIC DEBT AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT



Note: Data through 30 June 2025.
Sources: European Central Bank, Federal Reserve Bank of St. Louis, UK Office of National Statistics.

EXHIBIT 2.0 – 10-YEAR GOVERNMENT BOND YIELDS, %



Note: Data as of 3 November 2025.
Source: Bloomberg.

Notes

[1] https://www.insee.fr/en/statistiques/8542247

[2] https://www.nytimes.com/2025/10/07/world/europe/france-government-turmoil-sebastien-lecornu.html

[3] https://www.consilium.europa.eu/en/press/press-releases/2025/01/21/stability-and-growth-pact-council-adopts-recommendations-to-countries-under-excessive-deficit-procedure

[4] https://www.reuters.com/business/france-gets-only-brief-reprieve-budget-pressure-2025-10-20/

[5] https://www.wsj.com/market-data/quotes/bond/BX/TMBMKFR-10Y#:~:text=France%2010%20Year%20Government%20Bond%20TMBMKFR%2D10Y%20(Tullett,CEDT%2010/22/25.%20*%20Yield.%203.352%25%20*%200.006

[6] https://www.globalcapital.com/article/2fheaz5x20rr7pfu1gt1c/ssa/sovereigns/momentum-back-in-euro-ssa-market-despite-france-downgrade#:~:text=The%2010%20year%20OAT%2DBund%20spread%20was%20back,came%20to%20risk%20for%20the%20euro%20market

[7] https://www.reuters.com/business/france-gets-only-brief-reprieve-budget-pressure-2025-10-20/

[8] https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2177.en.pdf

[9] https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html

[10] https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op372.en.pdf

[11] *Ibid.*

[12] https://www.consilium.europa.eu/en/press/press-releases/2025/01/21/stability-and-growth-pact-council-adopts-recommendations-to-countries-under-excessive-deficit-procedure/

[13] https://www.bde.es/webbe/en/estadisticas/temas/administraciones-publicas.html

[14] https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html