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What to watch: European Commission plays bad cop, the fiscal pinch of the left in France and overcapacities in China

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Executive summary

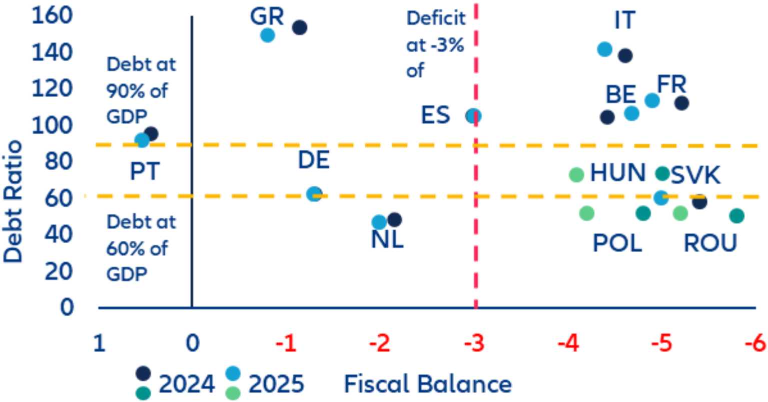
This week, we look at three critical issues:

- **European Commission plays bad cop on fiscal deficits.** France, Italy, Poland, Belgium, Hungary, Slovakia and Malta have been named and shamed for running fiscal deficits above -3% of GDP. But we will only find out in mid-July how forcefully the new fiscal rules will be applied – and how much wiggle room is offered to the EU members. For Italy, an Excessive Deficit Procedure would mean a significant fiscal adjustment in the structural balance (~1% of GDP per year) and up to 0.05% of GDP in fines. In France, the fiscal deficit is likely to remain above -4.5% of GDP in 2025-26 no matter who wins the parliamentary elections in July.
- **French elections: The fiscal pinch of the Front Populaire.** Polls indicate that the left-wing alliance could secure around 28% of votes in the first round, more than President Macron's Renaissance alliance (18%) but less than the right-wing alliance (33%). The left-wing alliance aims to unleash EUR125bn of spending, funded by substantial tax increases, with a net fiscal cost of around EUR33bn or close to 1.2% of GDP. The French government bond spread would widen to 120bps in 2024, nearly double the increase expected under a far-right government, and GDP growth would be hit by a contained -0.3pp in 2025 as tighter financial conditions more than offset the growth-boosting effect of fiscal expansion. But the public deficit would rise above -6% of GDP, and negative economic impacts could build up over time amid lower potential growth and a loss of competitiveness.
- **Overcapacities in China call for higher outbound investment.** This month's G7 statement is the latest to raise concerns about excess capacity in China, where the industrial capacity-utilization rate has declined from 77.2% in Q1 2021 to 73.6% in Q1 2024, the lowest level since 2016 (outside Covid-19). A cyclical imbalance is again at play today amid still-soft domestic demand and supply-side stimulus measures. The domestic context is giving Chinese exporters room to further lower prices to maintain or expand overseas market share, or to make up for higher tariffs. And China's trade surplus is set to rise further, particularly with emerging economies who account for nearly 60% of Chinese exports. Increasing outbound investment could be a win-win solution to mitigate the trade surplus, but is likely to face geopolitical pushback.

European Commission plays bad cop on fiscal deficits

In the middle of Europe's political turmoil, the European Commission has initiated the Excessive Deficit Procedure[1] (EDP) for seven countries: Belgium, France, Italy, Hungary, Malta, Poland and Slovakia. After being suspended during the Covid-19 pandemic and then overhauled significantly in 2022-23, EU fiscal rules are getting ready to bite. This week, as we had previously expected[2], three major Eurozone economies – France, Italy and Belgium – have once again come under the fiscal spotlight for running fiscal deficits above the targeted 3% of GDP (no debt limit or debt-reduction breach could have triggered an EDP in 2024, Figure 1). Next up, the Economic and Financial Affairs Council will discuss policy coordination on 21 June, and a European Commission warrant to open the procedure will follow, before the ball is passed over to the European Council.

Figure 1: Projected fiscal metrics (% of GDP)



Sources: LSEG Datastream, EC AMECO, Allianz Research

The decision could not have come at a more complicated time as European Commission President Ursula Von der Leyen seeks to secure her second term and France is heading into very turbulent parliamentary elections. But we will have to wait until mid-July to find out just how strongly the rules will be enforced. Playing wisely, the Commission has left it up the Council to decide on the recommendations for countries in breach on 16 July, when the ministries of finance will meet. It is possible that there could be strong opposition to the proposal, given the large weight of France, Italy and Belgium, as well as their political allies, in the EU. And even if the EDP is officially launched, the formal adoption will only take place in November under the new European Commission. Moreover, sanctions will only be applied from next year as 2024 is considered a transition year for fiscal-policy coordination.

The old fiscal framework was known for a lack of implementation (Figure 2) and weak enforcement. Will this time be different? Sanctions for non-compliance have never been applied, hindering the credibility of the old set of rules and not incentivizing governments to build up fiscal buffers. Nonetheless, the reformed framework promises greater enforcement through fines. At the same time, being in the transition period of a new procedure and the presence of additional safeguards allow space for interpretation and, consequently, for some flexibility. For example, the proposed corrective path in an EDP may initially exclude the interest payments, giving some room to current governments to adjust while adding challenges for policymakers after 2027.

This time, it is really about politics. For Italy, an EDP would mean a quite significant fiscal adjustment in terms of the structural balance (some 1% of GDP per year) and a cost of up to 0.05% of GDP in fines[3]. Prime Minister Giorgia Meloni could leverage her strong political consensus both domestically and in Europe to contest the unfavorable decision. But the 7.4% fiscal deficit caused by years of generous and untargeted tax credits will eventually need to be reduced to maintain her credibility in the eyes of EU allies. In France, none of the possible political outcomes from the upcoming parliamentary elections in July are likely to deliver a deficit reduction. Even under our baseline

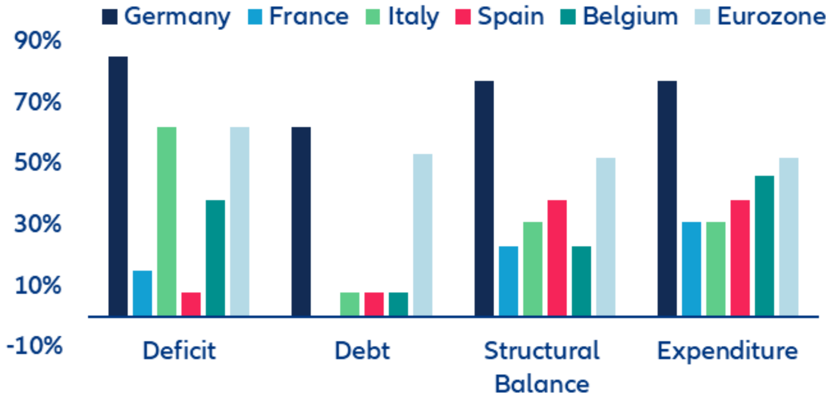
[1] *Excessive deficit procedures - overview - European Commission (europa.eu)*

[2] *2024_03_07_what_to_watch.pdf (allianz.com)*

[3] *The fine in case of non-compliance will amount to up to 0.05% of GDP and accumulate every six months until effective action by the country concerned is taken.*

scenario of a "technocratic" government, we expect the French public deficit to be above 4.5% of GDP in 2025-26. In fact, the recent political events in France are a reminder of how the doom loop persists and is ready to shake markets. Any *faux pas* could widen the spreads of highly indebted countries.

Figure 2: Compliance tracker[4] (2011-2023)



Notes: The Compliance Tracker traces numerical compliance with the four main rules of the Stability and Growth Pact. It assesses whether in pure quantitative terms the relevant fiscal aggregates – the budget balance, the debt-to-GDP ratio or government expenditure – evolved within or outside the perimeters defined by the fiscal rules.
Sources: European Commission, Allianz Research

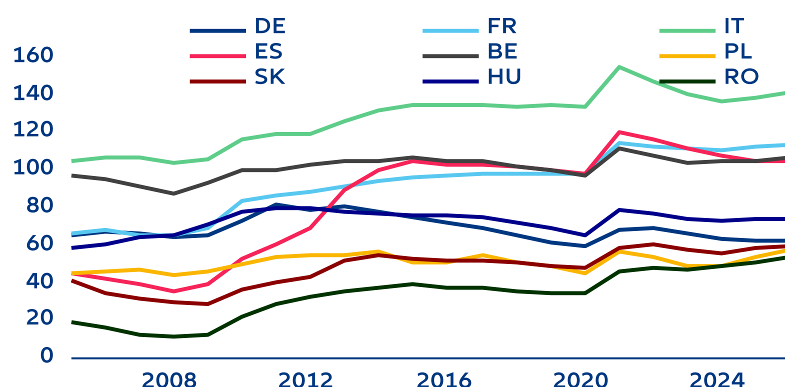
In Central and Eastern Europe (CEE), we do not expect the EDP to trigger a sweeping change in policymaking. The risk of a fiscal crisis in the near future is relatively low in the region, although we are concerned about the medium-term outlook for public finances, particularly in Romania. Countries outside the Eurozone (e.g. Poland, Hungary, Romania) are exempt from fines for non-compliance with the EDP, so the opening of the EDP may result in a restriction of fiscal policy only in Slovakia. In the short term, however, we are not concerned about fiscal risks in CEE countries as the energy crisis has eased, growth prospects have improved and some fiscal consolidation measures have been announced. Our view is supported by declining market interest rates and our own Public Debt Sustainability Risk Score, which assigns CEE economies a moderate risk of sovereign debt stress over the next two years.[5] But the medium-term outlook gives us more cause for concern as public-debt-to-GDP ratios are likely to increase further due to the expected persistently high annual fiscal deficits of more than -4.5% of GDP, the recent rise in debt interest costs and the associated higher cost of rolling over debt in the coming years, as well as pressure to increase public spending due to military commitments and the aging population in CEE countries. Romania looks most worrisome as it has not taken any effective measures since its EDP was opened in 2020.

All in all, while this week's decision will have no major impact in the short term, the countries named and shamed are likely to remain under the spotlight for a while. While European countries are expected to present their medium-term fiscal plans by 20 September, no major fiscal-consolidation effort is expected. Public deficits have been hit hard by crisis after crisis, and are likely to only gradually decline from historic highs. Debt ratios had declined from their Covid-19 peaks, thanks to the strong rebound in activity and elevated inflation, but they are projected to increase again in France, Italy and Belgium as growth slows down (Figure 3). For now, the market reaction has been muted, as in the case of recent episodes of fiscal slippages (i.e. Italy's announcement of a larger-than-expected 2023 deficit), but attention could return to the topic after the elections in France, which are now keeping markets busy.

[4] *Compliance Tracker - European Commission (europa.eu)*

[5] *Romania was ranked 37th, Poland 53rd and Hungary 54th out of 95 emerging and developing economies in our latest Public Debt Sustainability Risk Score, with rank 1 reflecting the highest risk; see 2024_02_08_what_to_watch-AZT.pdf, p.11.*

Figure 3: Government debt to GDP



Sources: LSEG Datastream, EC AMECO, Allianz Research

French elections: The fiscal pinch of the *Front Populaire*

Polls indicate that the left-wing Nouveau Front Populaire (NFP) alliance could secure around 28% of votes in the first round of parliamentary elections in France, more than President Macron's Renaissance alliance (18%) but less than the right-wing Rassemblement National (RN) and Les Républicains (LR) alliance (33%). The NFP is a revamped version of the NUPES alliance of moderate- and far-left parties (the Socialist Party, French Communist Party, Green Party and *La France Insoumise*), which banded together to win 131 seats in the June 2022 elections. Despite several disagreements over the past two years, the left parties have been reunited by the strong showing of the RN during the June 2024 European elections and the prospect of it securing an absolute majority in the National Assembly.

We estimate that the NFP's economic platform would unleash EUR125bn of new spending (EUR 142bn with the unwinding of the pension reform), funded by substantial tax increases of EUR92bn. This would result in a net fiscal cost of around EUR50bn (Figure 4). Key campaign pledges include bumping up civil servants' salaries (EUR20bn), increasing social benefits (close to EUR20bn), additional spending on kindergartens (EUR3.7bn). To fund these measures, the NFP plans to generate around EUR92bn via a substantial increase in taxation, notably a tax on super-profits (EUR10bn), the creation of a wealth tax with a climate provision (EUR10bn) and increased social contributions (EUR14bn). It has also pledged to increase the inheritance tax (EUR17bn) and scrap some tax breaks (EUR20bn).

Figure 4: Main budget measures of the Nouveau Front Populaire (NFP)

Spending	Estimated amount (€)	Revenues	Estimated amount (€)
Increase social benefits 1/	19.7	Reinstate wealth tax with climate provision	10
Bump up civil servants' salaries 2/	20	Taxation of super-profits	10
Increase in budgets (culture, foreign aid, sport)	27.4	Increase pension contributions on capital income	10
Housing policy (housebuilding, housing benefits, etc)	4.9	Increase social contributions (incl. Generalized Social Contribution)	14
Others (VAT cut, NGO funding, free museums, etc)	4.1	Increase number of income tax thresholds	5
Creation of a public body for medicines	6	Scrapping of flat tax on capital income	2
Increase in kindergarten facilities*	3.7	Broadening of exit tax	1
Reduction of utility bills*	16	Increase of inheritance tax	17
Indexation of pensions to wage growth	9	Scrapping of some tax breaks	20
Fully free schools	7.9	Financial transaction tax	3
Increase +14% minimum wage	6.7		
Scrapping of pension reform	17		
Total	142.4	Total	92

*Notes: Items marked with * are one-offs spending measures. 1/ Minimum income for low-income households below age 25 (14bn) + increase in minimum pensions (1.7bn) + increase in disability benefits (4bn)*
Sources: Ministry of Finance, Insee, Cour des Comptes, Nouveau Front Populaire, Allianz Research

A far-left victory would see the French government bond spread surge to around 120bps in 2024, nearly double the increase expected under a far-right government, amid heightened concerns about fiscal discipline, regulatory stability and the economic policy direction. In 2025, the expected spike in growth momentum could lead to a rapid reduction in the risk premium but some structural widening effects might take longer to dissipate, especially if France's credit rating is downgraded in the process. A similar effect would be felt across the risky asset portfolio, with corporate credit spreads potentially climbing up to 250bps in 2024 and equity markets declining by -12%, followed by a gradual recovery in 2025 as economic growth increases slightly due to fiscal spending. The far-left scenario would also have a deep impact on French real estate markets as the increase in discount rates would impact the already affected valuations of such assets (Figure 5). But both a far-left and far-right government could bring some tailwinds for house prices as some of their proposals would boost renovations and social housing benefits[6], though these would be subject to budgetary and operational constraints.

Figure 5: Capital market implications of different scenarios for the French elections

				Technocratic - baseline		Majority far-left		Majority far - right	
Market Indicators	Unit	2023	Last	2024	2025	2024	2025	2024	2025
10y OAT spread	bps	53	75	60	50	120	90	90	70
IG - Corp. spread	bps	133	113	120	120	250	190	190	150
EQ - CAC 40	y/y%	16.5	3.3	7	10	-12	9	-6	5
Real Estate *									
Housing	y/y%		-1.5	-2.4	1.6	-3.7	1.7	-3.2	1.2
Commercial	**				-2.9		-8.8		-4.9

Note: The numbers for house prices include the impact of specific housing-market measures in the far-right and far-left scenarios; in the case of an unsuccessful implementation, the price rebound in 2025 would be below 1%. **cumulative 24-25 performance / We have slightly revised up (positive) our estimates for a far-right government from our previous publication*
Sources: LSEG Datastream, Allianz Research

We would expect GDP growth to be hit by a contained -0.3pp in 2025 under a NFP government. But the public deficit would rise above 6% of GDP, and negative economic impacts would build up over time amid a loss of competitiveness. Taking into account the expected widening of OAT spreads (120bps in 2024, 90bps in 2025), the outlook for equity prices (-12% in 2024, +9% in 2025) and the fiscal impulse (1.2% GDP, excluding the cost of unwinding the pension reform), we find that an NFP government could cost GDP growth 0.3pp in 2025[7]. In such a scenario, the growth-boosting effect of the fiscal expansion would be more than offset by the negative effects of lower confidence and tighter financial conditions. Moreover, we find that the net effect of raising the minimum wage by +14% between 2025-2026 – another core pledge of the NFP – would result in a neutral effect on GDP in 2025 as the support to household consumption (+7% rise in minimum wage supports economy-wide wage by +0.7[8]) would be neutralized by the loss of jobs caused by higher labor costs in the lower end of the wage distribution[9] and the decline in companies' competitiveness (a +7% increase in minimum wage would lead to around115,000 jobs being

[6] *Other measures, such as caps on rental growth and increased home construction would have a less clear impact on aggregate (the former) or would see most of the effects not kicking-in before 2026.*
[7] *As in last week's analysis of the economic consequences of a potential RN government, we use the Global Economic Model developed by Oxford Economics for our simulation. The caveats are the uncertainty around the relationship between fiscal policy announcements and deficits and the reaction of financial markets, as well as the exact timing of the fiscal easing (we assume it would be spread over 2025-26). Furthermore, we only consider the net fiscal easing impact on growth, while different policy measures may have different impact on growth, and if the government struggles to find enough receipts to fund its pledges, the risks of a fiscal crisis would increase.*
[8] *Quelles conséquences économiques du coup de pouce sur le Smic?*, Éric Heyer & Matthieu Plane, OFCE.
[9] *The increase in labor cost typically occur in the lower end of the wage distribution, because i) the diffusion to higher wages of minimum wage increases gets diluted, and ii) employers' social contributions cutbacks typically increase because of the set-up of the French tax system.*

shed after one year, or 0.4% of employment)[10]. However, past the short term, we would expect the NFP policies to lead to higher economic costs through lower job creations (especially at the low end of the wage-distribution) and lower labor market participation (due to elevated taxes and increased social benefits disincentivizing participation in the labor market and working hours[11]).

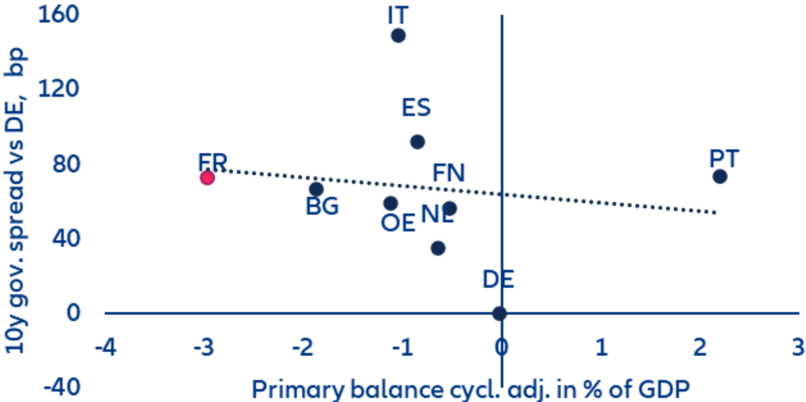
Figure 6: Macro-economic impact under various scenarios

	Pre-election baseline			Technocratic government			Majority RN government			Majority Nouveau Front Populaire government		
	GDP growth	Public deficit	Public debt	GDP growth	Public deficit	Public debt	GDP growth	Public deficit	Public debt	GDP growth	Public deficit	Public debt
2024	0.9	-5.2	111.7	0.9	-5.2	111.7	0.8	-5.3	111.7	0.8	-5.4	111.9
2025	1.3	-4.3	112.6	1.3	-4.9	113.2	1.0	-5.7	114.4	1.0	-6.0	114.7

Sources: Oxford Economics, Allianz Research. Note: GDP growth in %, public deficit and debt in % of GDP.

Contagion effects would be visible no matter who wins the elections. But they should be contained, given the implicit guarantee by the ECB to step in should there be any "disorderly market dynamics".[12] The earlier-than-expected elections have increased not only French government bond spreads (23bps since 7 June) but also those of other countries, with Italy and Spain (15bps each) leading the field among the larger economies. Though the French election outcome is largely a domestic concern, there could be some contagion effects ranging from potentially lower financial support from the second largest EU contributor to a marginally increasing risk of a break-up of the Eurozone. Our more severe non-baseline scenarios would certainly lift all spreads to some extent. However, given the ECB's Transmission Protection Instrument (TPI), we would not expect a repeat of the 2011 European debt crisis at this stage.

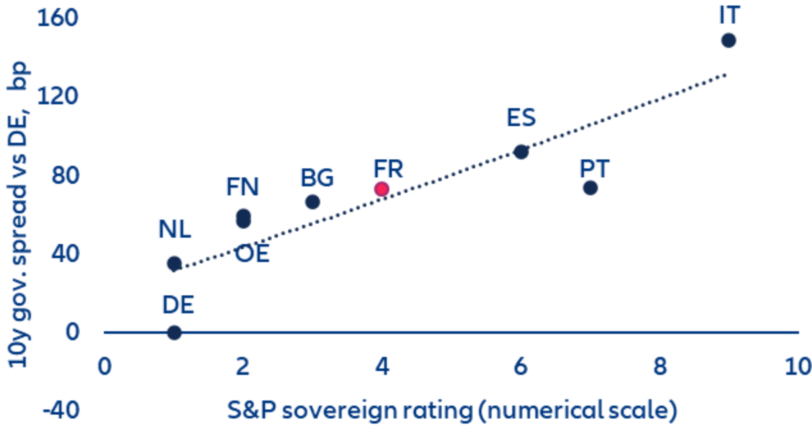
Figure 7: 10y government bond spreads versus fiscal position



Sources: LSEG Datastream, Allianz Research

[10] *Same a 4.*
[11] *Part of the economic literature establishes that a tax burden of over 60% (including income tax, VAT and social contributions) on household income leads to lower economic activity. France is already there for high-income earners.*
[12] *See The Transmission Protection Instrument*

Figure 8: 10y government bond spreads versus sovereign rating

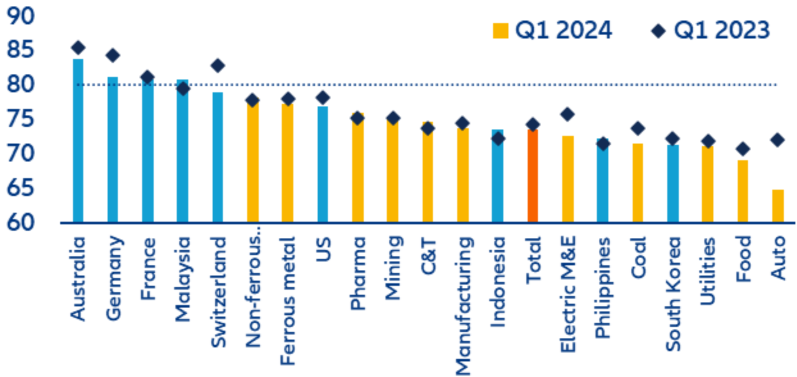


Sources: LSEG Datastream, Allianz Research

Overcapacities in China call for higher outbound investment

Trade tensions are on the rise as overcapacities mount in China, especially in strategic, high-tech and green sectors. The G7 statement[13] released this month is the latest to raise concerns about excess capacity in Chinese industrial sectors. Since the pandemic and the start of the ongoing real estate crisis, China has indeed seen a downwards trend in its industrial capacity-utilization rate, which declined from 77.2% in Q1 2021 to 73.6% in Q1 2024, the lowest level since 2016 (apart from the initial Covid-19 lockdowns in Q1 2020). But overcapacities are not a new phenomenon in China: in the last episode, the steel and coal sectors faced overcapacities in the aftermath of the stimulus measures that followed the Great Financial Crisis. Today, a cyclical imbalance is again at play, between still-soft domestic demand and policy stimulus geared once more towards supply-side measures, which is not addressing the issue of underconsumption. What is different this time round is that sectors that are deemed strategic, high-tech and/or green are involved: capacity-utilization rates have declined by around -9pps since Q1 2021 in the electric machinery & equipment and automotive manufacturing sectors, reaching 72.7% and 64.9%, respectively, in Q1 2024 (Figure 9).

Figure 9: Capacity utilization rates (%), China total and sectors vs. selected countries



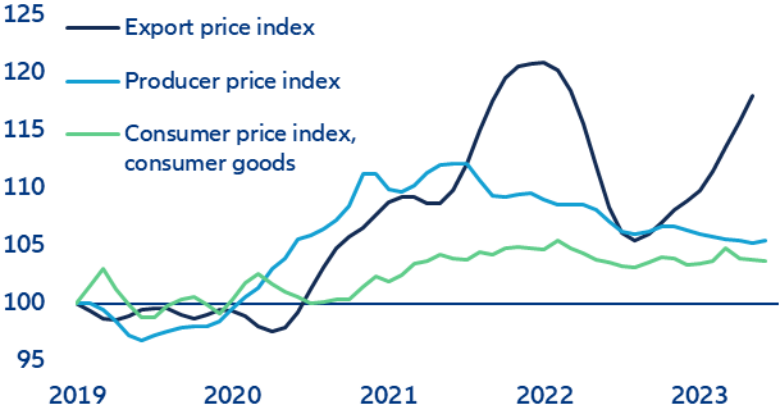
Note: C&T = Computers & Telecom, Electric M&E = Electric machinery & equipment.
Sources: LSEG Datastream, Allianz Research

The gap between domestic and export prices is giving Chinese exporters room to further lower their prices to maintain or gain further overseas market share or to make up for higher tariffs. The lower capacity-utilization

[13] *G7 Leaders' Statement in Borgo Egnazia, Italy. | Élysée (elysee.fr)*

rate will keep prices lower for longer in China as it increases competition among firms, forcing them to cut prices and even take a hit on margins to retain market share. In this context, the number of loss-making industrial enterprises has been rising in y/y terms since the last quarter of 2021, while producer prices have been in deflation since October 2022 (averaging -3% y/y in 2023 and -2.5% y/y in the first five months of 2024) and prices of consumer goods contracted on average by -0.3% y/y in 2023 and -0.4% y/y in the first five months of 2024. Zooming in on sectors that saw the largest declines in capacity-utilization rates over the past years, deflation is visible in the consumer prices of home appliances (-0.5% y/y on average in the first five months of 2024), communication equipment (-2.3% y/y) and vehicles (-4.9% y/y). Amid declining global demand last year, export prices also declined sharply (-8.2% y/y on average in the second half of 2023). However, they have been rising since the end of last year (Figure 10), breaking from the usual correlation with domestic producer prices. This suggests that Chinese firms may be using overseas markets to make up for lower margins in the domestic market.

Figure 10: China price indices, January 2019 = 100

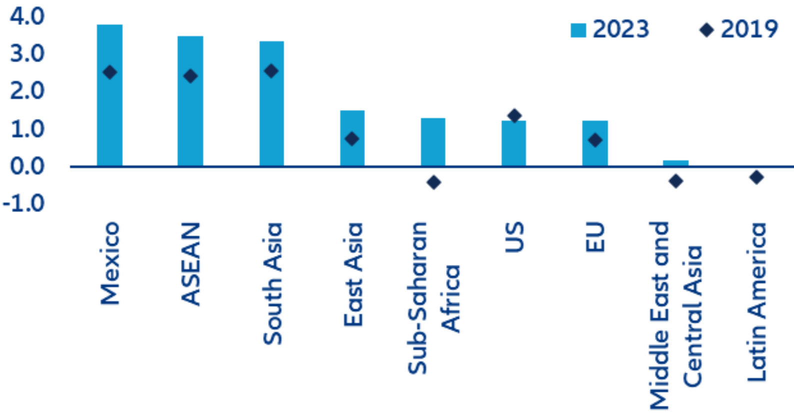


Sources: LSEG Datastream, Allianz Research

Against this backdrop, China's trade surplus is set to rise further – particularly with emerging economies. China's still-soft domestic demand and increased manufacturing capacity, along with government support, cost-competitiveness, high production efficiency and innovation, mean that the industrial surplus has been finding its way into overseas markets. China's global export market share[14] rose from 17.8% in the pre-pandemic era (2015-2019 average) to 20% on average between 2021 and 2023 and into the first months of 2024. Emerging economies account for more than half of Chinese exports (55.6% on average between 2015 and 2019 vs. 56.3% in the first months of 2024). The focus on these markets is especially notable in the electric vehicle (EV) industry. With an ever-intensifying cutthroat price war in the domestic market eroding EV makers' profitability, exploring opportunities overseas has become a priority for many. As Europe and the US, two of the world's largest EV markets after China, are imposing trade barriers against Chinese EVs, many Chinese EV makers are turning their attention to developing countries, especially in Southeast Asia and South America. Though EV markets in these regions are not as large, they are growing rapidly under massive government support and, more importantly, they are more welcoming of Chinese exports. In Thailand, the largest EV market in Southeast Asia, four out of the five best-selling EV brands and models in 2023 originated from China. Other Southeast Asian countries have also seen significant participation from Chinese EV makers. For instance, BYD has achieved significant market penetration, topping EV sales in Singapore, Thailand and Malaysia. As a result, and in conjunction with still weak imports, China's trade balance with emerging economies has risen quickly in recent years (Figure 11).

[14] *Out of the world's top 25 exporters*

Figure 11: China trade balance with partners, as % of partner GDP



Sources: ITC, LSEG Datastream, Allianz Research

China's increasing outbound investment could help to mitigate the trade surplus but may face geopolitical pushback. Increasing outbound investment could shift some of China's production capacity abroad, while sharing knowledge and technology, providing an additional source of capital and helping to develop manufacturing capacities in other countries. There are signs of rising Chinese outbound investment: between April 2023 and March 2024, at least 41 Chinese manufacturing and logistics projects were announced for Mexico (vs. less than 20 the previous year) and at least 39 for Vietnam (vs. less than 10 the previous year). In the EV sector in South America, Mexico and Brazil are major destinations for Chinese auto investment, each for different reasons. For example, since the beginning of this year, at least three major Chinese EV makers have pledged to invest in Brazil to take advantage of the Brazilian government's USD19bn green package. Meanwhile, Chinese investment in Mexico has grown mainly as a strategic move to circumvent US tariffs and restrictions. Last year, 33 Chinese auto suppliers were registered in Mexico, 18 of which exported to the US. All told, increasing Chinese investment abroad could be a win-win solution in the long run, as Japan's experience in the 1980s had shown. However, while this is already happening and likely to ramp up in emerging economies, Chinese investment will face geopolitical pushback in the US and Western Europe.

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