7 November 2024

Research euro area

Fiscal policy to slow growth in 2025 - but mind the RFF

Fiscal policy in the euro area is set to tighten in 2025 as governments cut back national spending to comply with EU fiscal rules. We project the public budget deficit in the euro area to decline from 3.5% of GDP in 2024 to 2.9% 2025 due to active tightening of national fiscal policies. The consolidation of public finances comes at a time when the euro area economy is faced with a deteriorating economic outlook and risks of increased unemployment. An important question for the economic outlook is thus how much a drag on growth the fiscal tightening of public finances will be next year?

The *draft budgets* for 2025 submitted to the Commission in mid-October show how governments intent to cut public spending next year. Part of the consolidations are due to the final phase-out of crisis related measures while other discretionary measures are made to comply with the new EU fiscal rules. To gauge the magnitude of the discretionary changes in next year's fiscal policy we look at the change in the cyclically adjusted primary balance (CAPB). **We estimate that the euro area will experience an active fiscal tightening of national polices of 0.7 percentage points of potential GDP in 2025.** The tightening is especially driven by France and Germany that project a change in the CAPB of + 1.3 p.p and + 0.8 p.p, respectively, while Spain and Italy both forecast a change of + 0.5 p.p. The tightening is set to slow growth as it is the biggest seen in more than ten years when excluding the previous years after COVID. However, the exact impact on growth is uncertain and subject to the specific fiscal consolidation measure chosen and its horizon.

EU grants from RFF to partially counter national tightening

While the effect of national fiscal policies in the euro area is set to slow growth next year, it is partially countered by increased EU grants under the RRF programme. We estimate the RRF grants to *ease* the fiscal stance with 0.4 p.p of potential GDP, meaning the overall tightening of the fiscal stance is 0.3 p.p. **Hence, the overall impact of fiscal policy on growth is only slightly contractionary next year.** The RRF programme has a total amount of EUR 177 bn left in grants for 2025 and 2026, corresponding to 1% of EU GDP. In Italy, revenue from RFF grants is projected to increase from 0.3% of GDP to 0.6% in 2025, and in Portugal from 1.3% to 2.3% of GDP while German and French receipts are set to remain at 0.1% and 0.2% of GDP, respectively. We thus estimate the sum of the national and EU fiscal policy change to be clearly contractionary in France and Germany, neutral in Spain and Italy, and even expansionary in Portugal. Hence, fiscal policy next year is set to amplify the growth divergence that have been observed recently between Southern Europe and Germany and France, see *Research euro area - Southern Europe to continue outperforming* , 23 September.

Fiscal tightening supports ECB easing at every meeting

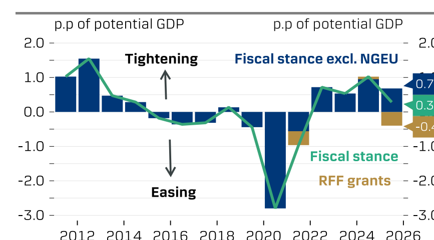
Our projection of a change in fiscal stance of +0.3 p.p next year when adjusted for RRF grants is slightly higher than the latest ECB projections that saw only a change of +0.1 p.p.

Public deficits will decline significantly next year

	2024	2025
France	-6.1	-5.0
Germany	-2.5	-1.75
Italy	-3.8	-3.3
Spain	-3.0	-2.5
Portugal	-0.4	-0.3
Netherlands	-2.5	-1.8

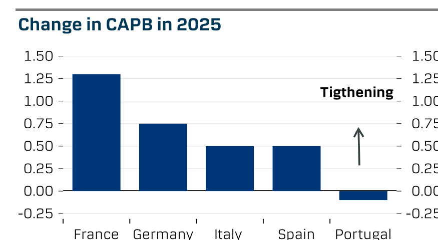
Note: Numbers are based on draft budgets submitted for the EU Commission in mid-October, shown in percent of GDP
Source: Danske Bank

Fiscal stance to tighten next year but RFF grants make total effect only slightly contractionary



Source: Danske Bank

Germany and France to see biggest tightening of national fiscal policy



Source: Danske Bank

Analyst, euro area economist
Rune Thyge Johansen
+45 40 26 04 37
rujo@danskebank.dk

Hence, we expect the ECB to slightly increase their estimate of the fiscal stance given the draft budgets that are available now. **Fiscal policy in 2025 thus adds to the risks of a downside revision of the ECB growth projections and reinforces our call of rate cuts at every meeting from December until September.**

Uncertainty over the budgets and their impact on growth is high

While the draft budgets are submitted to the EU-Commission we stress that the Commission still needs to approve them, which leaves risks of even larger tightening to meet the new fiscal rules. On the other hand, the final budgets have not been approved yet in parliaments in France, Spain, and Germany, meaning the tightening could be smaller to gain support for the budgets.

We also stress that both the French and German budgets could have an even larger impact on growth than the direct one of the fiscal stances, as the current disputes over the budgets increase political uncertainty, which could lower sentiment and investments. The German government has collapsed, and the country is now heading for snap elections in March due to disagreements on the budget, and in France the uncertainty also remains due to the fragmented parliament (see appendix section for a summary of the budgets in each of the largest countries).

Cyclically adjusted primary balance (CAPB)

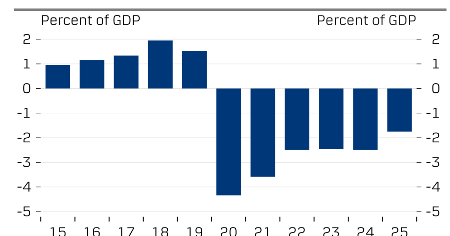
The CAPB is the government's budget balance adjusted for interest rate payments, temporary revenues (e.g. from sales of public companies), and cyclical expenditures (such as unemployment benefits). The CAPB is thus the "active" part of national fiscal policy, and its expenditure part has thus become the key metric in the new framework of fiscal rules in the EU. However, it is important to highlight the uncertainty of this measure as it requires a real-time estimate of potential GDP

Appendix: Public 2025 draft budgets in Germany, France, Italy, and Spain

German government implodes over budget disagreements

The German chancellor, Olaf Scholz, has fired his finance minister, Christian Lindner and called for snap elections in March, throwing the country into political disarray. A no-confidence vote on Scholz will be held on January 15 in which the Bundestag will most likely vote in favour of a snap election to be held in March given the low approval ratings of Scholz. The firing of Lindner from the liberal party comes after many months of disagreements over the 2025 budget and a longer-term plan to revive the German business model. The pro-business finance minister had refused raise taxes to cover a shortfall in the 2025 budget and to change the "debt brake" that imposes strict limits on German public finances. Increased political uncertainty will not be positive for the already fragile German economy and curt hurt growth through lower investments. **Combined with the projected tightening of +0.75 p.p in the CAPB the snap election makes the short-term outlook for the economy worse.**

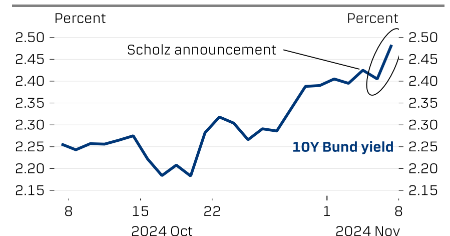
German public budget balance



Source: EU Commission, Danske Bank

The collapse of the government increases uncertainty of the budget for 2025. However, Germany will not face a "government shutdown" like in the US as a provisional budget management will be in place. **The main market focus is currently on the prospects of increased debt issuance to finance a package to revive the German economy, which has increased yields on German government bonds.** The liberal finance minister was the main opponent of increasing debt, markets are increasingly seeing chances of fiscal stimulus, although the "debt brake" and a court ruling on off-budget funds make the path towards increasing debt challenging. Hence, on the longer horizon a new government could be positive for German growth as the old one was not functioning and as the view on fiscal policy is set to be eased.

Prospects of increased debt following election send Bund yields higher

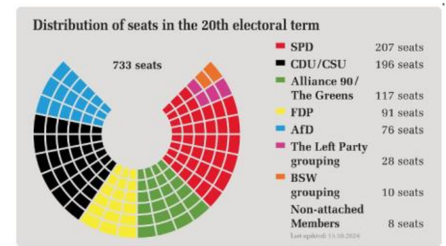


Source: Bloomberg

The economic outlook naturally depends on the election outcome. Current polls show a support of 15% for Scholz's SPD, 11% for the Greens, and only 4% for the Liberal party,

meaning the current government only has support from 30% of German voters according to polls. **Hence, the conservative CDU/CSU alliance is the most likely to win an early ballot, as they currently lead opinion polls with more than 32% of the votes**. They would need support from other parties to rule, and many coalitions are possible which we will get more clarity on as campaigning starts, and we get more polls. However, with the far-right AfD party set to receive 18% of votes, according to polls, it could be complicated to form a government as all parties refuse to work with the AfD, thereby increasing political uncertainty in Germany at a time when Trump has just won the US elections.

Current Bundestag distribution

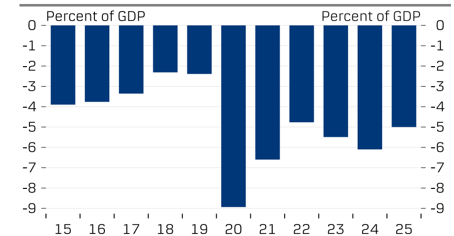


Source: German Bundestag

Uncertainty over the budget remains in France

The French government has presented its proposal for the state budget which aims at a deficit of 6.1% of GDP in 2024 and 5.0% in 2025. As Barnier's government only has 213 seats it needs the (tacit) support from at least 289 members and negotiations will likely continue until mid-December**. The reduction in the deficit of 1.1% of GDP is driven by an EUR 60 bn worth of tax hikes and spending cuts, which on the surface could steer the fragile economy towards a recession.** However, some factors imply that the effect on growth will be smaller than the headline number suggests. First, the government uses an unconventional assumption of spending growth, which the independent fiscal watchdog in France has questioned. The watchdog says that the projected increase in spending is too high and thus the fiscal consolidation is only EUR 42 bn and not EUR 60 bn. The watch dog says 70% of the adjustment will come through tax hikes and 30% of expenditure cuts, while Barnier claims 33% will be tax hikes and 66% spending cuts. This matter as Macron's centrists strongly opposes tax hikes and it will be more difficult for Barnier to get the budget through with substantial tax hikes. Second, some of the EUR 42 bn consolidation will likely not impact aggregate demand much as it includes higher taxes on wealthy individuals and large companies worth € 15.6 bn. Additionally, the increase in electricity taxes (€2bn) will be well compensated by declining market prices for electricity. However, the other half of the financing is likely to affect growth as e.g. the proposed six-month delay of indexation of pensions to inflation (EUR 3.6 bn) could hurt consumption. Several parties including Le Pen's National Rally have railed against Barnier's budget proposal for being too restrictive. **Hence, to pass the budget with support from Le Pen's party and Macron's coalition, Barnier will likely end up with a less contractionary proposal but still one that lowers GDP growth.**

French public budget balance

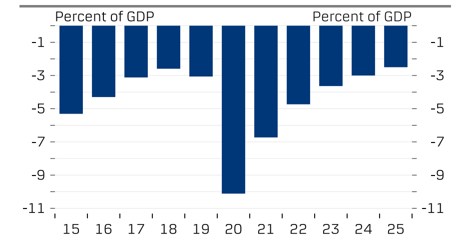


Source: EU Commission, Danske Bank

Spanish government has presented a three-year plan to reduce the public deficit to 1.8% of GDP in 2027 but lacks support

The Spanish government laid out an ambitious three-year plan this summer to lower the public deficit from 3.0% of GDP in 2024 to 2.5% in 2025, and all the way to 1.8% in 2027. However, the minority government led by Sanchez failed to pass the budget in parliament both in July and September as the socialist government relies on support from a host of smaller parties to pass legislation. Hence, the final budget could end being less contractionary to gain support from e.g. the far-left Podemos that demands a 40% lowering of house rents. Nevertheless, Spain will likely see a tighter fiscal stance from national fiscal policy as the complete phase-out of energy price related measures will reduce the deficit by 0.3 p.p. and the strong growth makes it easier to pass a fiscal tightening. **However, as Spain is one of the largest receivers of EU RFF grants, we do not expect the total fiscal policy to slow the strong growth in Spain.**

Spanish public budget balance

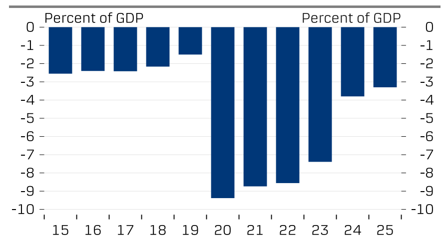


Source: EU Commission, Danske Bank

Italian consolidation unlikely to hit growth

The Italian government passed a budget bill outlining how it intends to comply with the EU fiscal rules over the next seven years. It outlines a fiscal consolidation of 0.5 percentage points on the primary budget balance until 2031 with the government deficit falling to 3.3% of GDP in 2025 from 3.8% in 2024. The budget shows that Italy intends to adhere to demands from the EU, which has been awarded with a 'positive' rating outlook by *Fitch*. The government will lower taxes for low-income households and provide various support measures for the most vulnerable citizens while also increasing public sector wages. To finance the expenditures the government will introduce a tax on bank stock options, lower costs of Italian ministries, and bring forward deferred tax revenues from banks and insurance companies to 2025 and 2026. **As these deferred taxes were expected to be paid by financial companies at a later stage and no consumers will face higher taxes we do not estimate that the fiscal consolidation of 0.5 p.p next year is set to impact growth.**

Italian public budget balance



Source: EU Commission, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank').

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Danske Bank is authorised by the Prudential Regulation Authority in the UK. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

Danske Bank's research reports are prepared in accordance with the recommendations of Capital Market Denmark.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank A/S's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 7 November 2024, 11:15 CET

Report first disseminated: 7 November 2024, 11:45 CET