



BMI

a FitchSolutions Company

Fiscal Divergence Will Shape the 2027 Budget Cycle

Spotlight European Union

Key Points:

- EU member-state Sovereign Risks are widening ahead of the 2027 budget cycle as high debt, weak growth, deteriorating balances and rising spending needs – defense, climate adaptation, energy security and industrial policy – create uneven pressures across countries.
- The greatest vulnerabilities arise where macro-fiscal stress coincides with limited political capacity for adjustment. France and Romania stand out: both face weak fiscal trajectories and constrained room to implement politically costly consolidation.
- Fiscal fundamentals and political stability do not always align. Spain and the Netherlands retain relatively sound fiscal positions despite difficult politics, while Italy's credible current fiscal management partly offsets its high debt, though election-related spending pressures could worsen its outlook as elections must be held by December 2027.
- Europe's traditional north-south fiscal divide is fading: Greece, Portugal, Croatia and Cyprus have improving fiscal positions, while risks exacerbated by political fragmentation are increasing in countries such as Belgium, Finland, Poland, Latvia, Slovakia and Bulgaria due to structural spending, defense demands, and weak growth.
- Fiscal trajectory may matter increasingly more than debt levels alone. Countries with both fiscal space and political room to act will be better positioned to sustain strategic investment, while constrained sovereigns may face tougher trade-offs and greater market differentiation rather than a single EU-wide fiscal crisis.

Several EU member states are entering the 2027 budget cycle with high public debt, deteriorating fiscal balances in parts of Central and Northern Europe, and growth too weak to ease adjustment in many countries. At the same time, governments face structurally higher expenditure demands for defense, climate adaptation, energy security, and industrial policy. To assess which countries are most exposed and how they will respond, we examine two dimensions of risk: 1) macroeconomic and fiscal pressure: based primarily on debt-to-GDP, deviation from fiscal balance, and the strength of economic growth; and 2) the political constraints of adjustment: including government stability, ideological compatibility with adjustment, external shocks (such as defense or climate requirements), and public tolerance for fiscal tightening. The framework reveals important distinctions among countries given differences in the need to consolidate versus having the political capacity to do so.

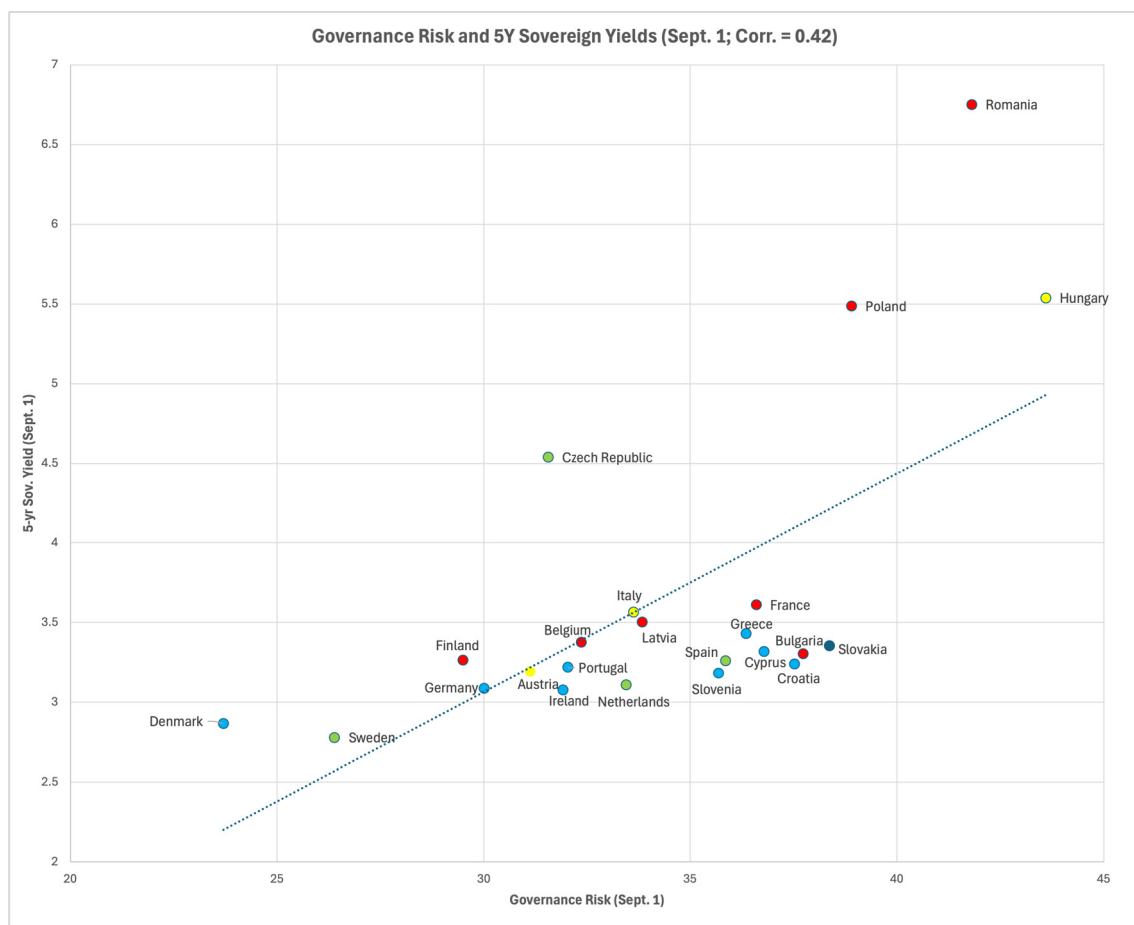
Table 1. Mapping Political Risk against macroeconomic duress

Political constraint	Lower	Higher
<i>Macro pressure</i>		
<i>Lower</i>	Croatia, Cyprus, Denmark, Germany, Greece, Ireland, Luxembourg, Malta, Portugal, Slovenia	Czechia, Estonia, Lithuania, Netherlands, Spain, Sweden
<i>Higher</i>	Austria, Hungary, Italy	Belgium, Bulgaria, Finland, France, Latvia, Poland, Romania, Slovakia



The scatterplot below presents Governance Risk against 5-year sovereign yields on 1 September, revealing a reasonably strong correlation at 0.42 – higher Risk, higher sovereign yields – given the complicated mechanisms that link governance to sovereign risk. Each dot is colored to reflect rising risk in sequence: blue, green, yellow, and red is highest risk. Though outliers clearly pull the far end of the fitted line upward, the relationship remains positive even if outliers at the high and low ends of the continuum are dropped. The largest positive residuals (Romania, Poland, Hungary, Czechia, Denmark, and Sweden) are outside the euro area, so their positions above the fitted line should not be interpreted as pure governance premia. Their yields are anchored by domestic monetary conditions and include exchange-rate risk, whereas euro-area sovereigns share the ECB’s monetary-policy framework. Euro membership can create a wedge between underlying fiscal vulnerability and observed borrowing costs by compressing financing costs and delaying market discipline. Non-euro members are repriced more quickly through domestic interest rates, inflation expectations, and currency risk. As a result, sovereign yields capture independent monetary regimes as well as fiscal and governance risk.

Figure 1. Sovereign yields reflect relative Governance Risk



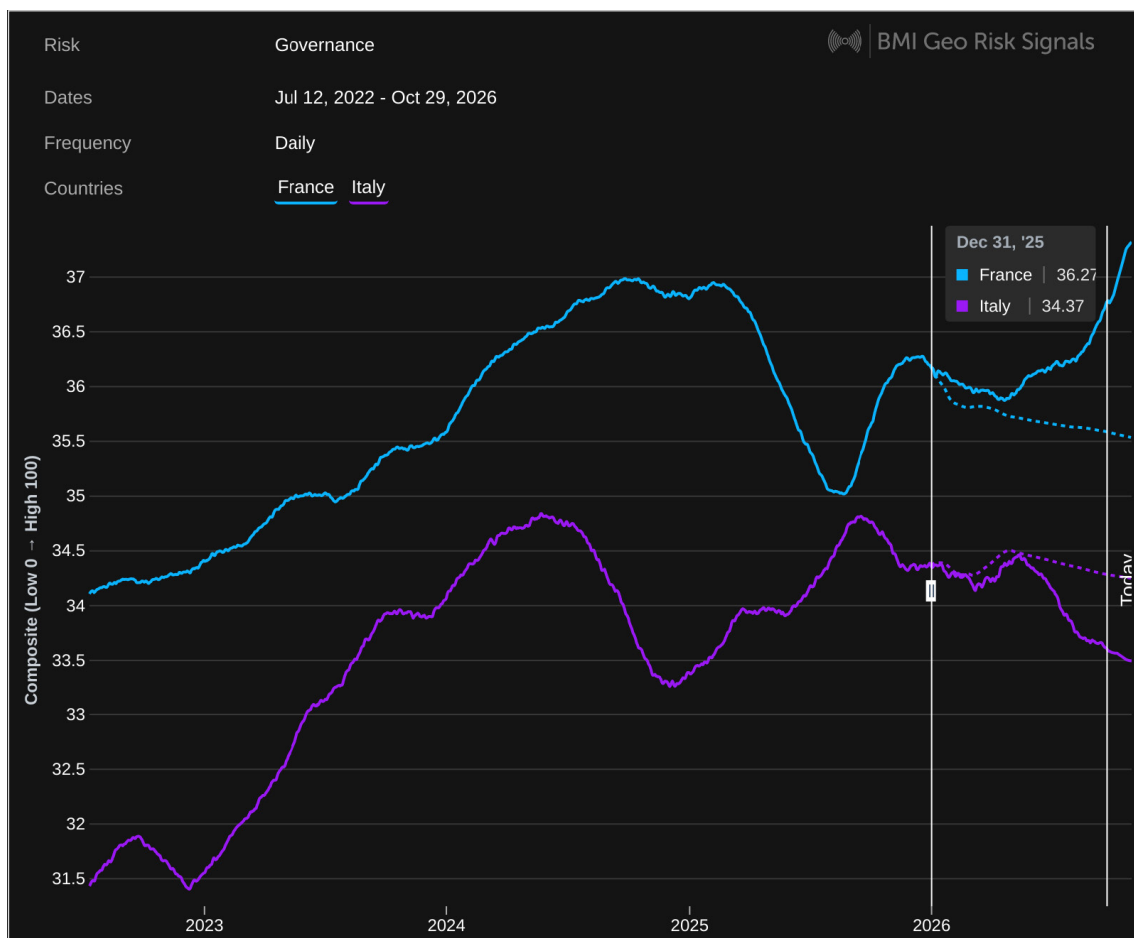


France and Romania face the EU's most acute fiscal and political challenges

France and Romania stand out with elevated Governance Risk, which reflects political weakness as a constraint, increasing the likelihood that fiscal deterioration persists rather than prompting retrenchment. **Romania** arguably faces the EU's most difficult combination of fiscal and political vulnerability. Its deficit remains among the bloc's largest even after substantial tightening, growth has slowed sharply, and debt is rising quickly from a relatively low base. Government instability has reduced capacity for further consolidation and threatens reforms required for EU funding at a time of weakened demand and reduced social tolerance for further austerity. Romania therefore faces a difficult trade-off: insufficient adjustment raises sovereign ratings and financing risks, while more aggressive tightening could further weaken growth and strengthen anti-establishment forces.

While Romania records the sample's largest positive yield residual, **France** remains below the fitted line, suggesting that the euro-area monetary anchor continues to cushion French financing conditions despite its mounting fiscal and governance vulnerabilities. With Governance Risk rising above forecast (blue dotted line, figure below), France combines high and rising debt, a large deficit, weak growth, and rising interest costs with limited political room for consolidation. The government lacks a parliamentary majority, while the approaching 2027 presidential election reduces incentives for either governing or opposition parties to support politically costly reforms. Higher defense spending and climate-related costs further constrain the country's fiscal space. France is therefore likely to pursue gradual rather than decisive adjustment, leaving debt on an unfavorable trajectory and Sovereign Risk sensitive to political developments.

Figure 2: Governance Risk rising above 2026 forecast in France, below forecast for Italy





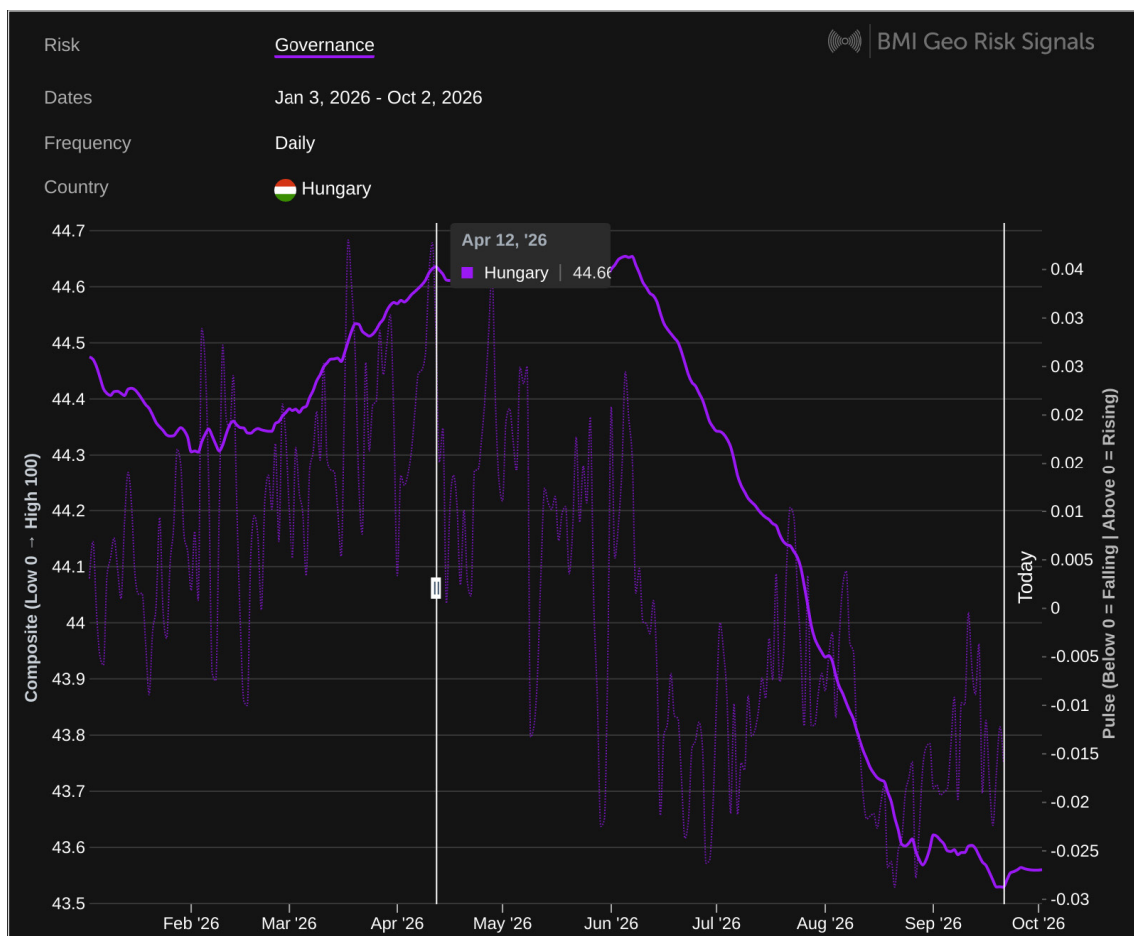
Political capacity can decouple fiscal risk from political instability

However, in select cases, political instability does not map onto fiscal vulnerability. Spain and the Netherlands, for example, face difficult governing environments but retain relatively strong fiscal fundamentals. In contrast, several more politically stable governments face deteriorating trajectories. For example, **Italy's** debt remains among the highest in Europe and weak growth leaves little margin for error, but PM Meloni's government has maintained comparatively credible fiscal management as reflected in falling Governance Risk relative to its 2026 forecast (purple dotted line, figure above). The main risk is thus directional: the approach of the 2027 election is likely to increase pressure for tax relief, household support, and additional spending, potentially moving Italy toward the high-pressure, high-constraint quadrant.

While Italy lies close to the fitted relationship, consistent with markets balancing its weak debt position against greater political continuity, Hungary remains above the line as inflation, currency, and fiscal premia persist despite recent improvement in governance. **Hungary** presents the clearest positive political shift in Governance Risk (Figure 3). Its fiscal starting position remains weak, but the new Tisza government enters office with a strong mandate, improved relations with Brussels, and a commitment to fiscal normalization. Restored access to EU funding will ease adjustment, although high voter expectations and costly campaign promises mean political capital will need to translate quickly into spending discipline.

Europe's fiscal challenge is therefore ultimately one of political authority: common rules can identify the adjustment required but they cannot generate parliamentary majorities, overcome institutional vetoes, or secure public consent for difficult trade-offs. This strengthens the case for greater common EU fiscal capacity, even as those same political divisions make agreement on burden-sharing more difficult.

Figure 3. Political alternation improving Hungary's Governance Risk outlook

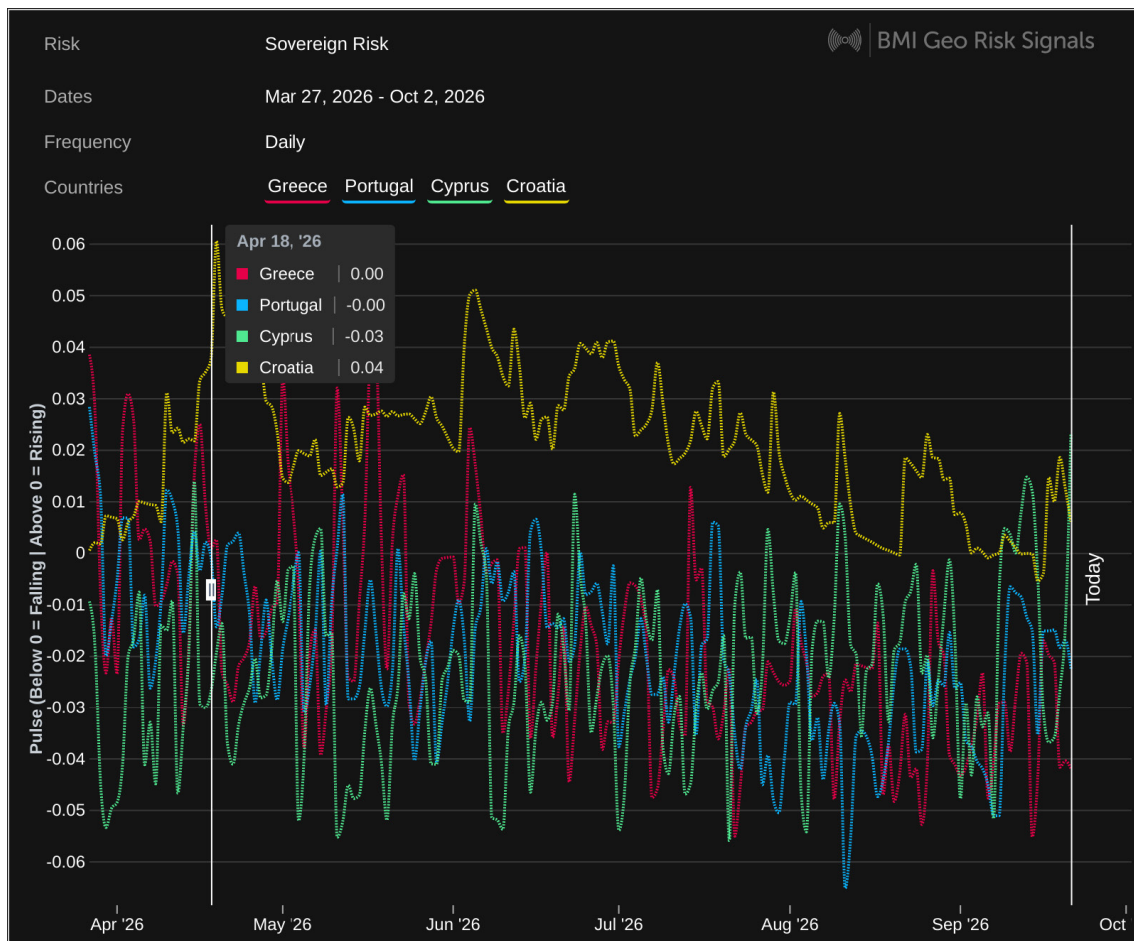




Europe's traditional fiscal geography has broken down

The traditional north-south fiscal divide has narrowed substantially. Greece, Portugal, Cyprus and Croatia all sit below the fitted line, indicating that improving fiscal trajectories – observed in Sovereign Pulse Risk remaining below or falling toward zero (Figure 4) – and the common euro-area monetary anchor are keeping yields lower than their Governance Risk scores alone would imply. Portugal combines near-balanced budgets with declining debt, while Greece's high debt burden is offset by improving debt dynamics and reasonable growth. Croatia and Cyprus also benefit from relatively strong growth and falling debt, while Denmark and Ireland retain substantial fiscal buffers. Germany remains in the lower-pressure group despite wider deficits because these largely reflect deliberate investment in defense and infrastructure from a comparatively strong starting position.

Figure 4: Sovereign Pulse Risk is below zero, signaling falling Risk, or moving in that direction





Europe's fiscal risk map is broadening

Fiscal vulnerability is spreading beyond the EU's traditional high-debt economies because adjustment is being constrained by a mix of weak growth, rigid spending commitments, and rising strategic costs. In Belgium and Slovakia, the main problem is structural: pensions, transfers, and other politically sensitive expenditures are difficult to reduce, and Belgium's fragmented federal system further complicates multi-year reform. Finland, Poland and Latvia face a different constraint as higher defense spending becomes effectively non-discretionary, limiting room for consolidation even where institutions remain strong or growth is comparatively resilient. Poland's strong growth and EU investment provide some buffer, but large deficits, rising debt, and generous social commitments will make adjustment increasingly difficult ahead the election due by November 2027.

Elsewhere, the concern is less current debt levels than the risk that current fiscal deterioration becomes entrenched. Bulgaria still has very low debt but rapidly widening deficits, persistent political instability, and resistance to tax increases make corrective action difficult. Finland and Latvia similarly illustrate how countries can move toward greater fiscal vulnerability from relatively strong starting positions when weak growth combines with external security pressures and declining political room for further tightening. The broader implication is that Europe's fiscal risk map is broadening not because all countries face the same problem, but because different combinations of structural spending rigidity, security demands, and political constraints are producing increasingly similar fiscal pressures.

Trajectory may increasingly matter more than debt levels alone. Poland, Finland and Belgium are moving further toward the high-pressure, high-constraint group; Bulgaria and Latvia are deteriorating from stronger starting positions; Italy faces rising political constraints as elections approach; while Hungary could improve if political stability and EU financing translate into credible consolidation.

Unsurprisingly, EU membership and common fiscal rules have not produced uniform fiscal trajectories. Instead, common pressures are exposing differences in national political capacity and widening divergence across the Union. The result is a more differentiated fiscal landscape that no longer follows Europe's traditional fiscal divide.

Fiscal capacity will increasingly shape Europe's broader economic divergence

The key question is increasingly what governments can still afford to do? Countries with stronger balance sheets and greater political room will be better able to finance defense, energy security, climate adaptation, industrial policy and household support, while fiscally constrained governments will increasingly have to choose among these priorities. Those able to preserve investment while maintaining fiscal credibility may improve productivity and competitiveness, while governments forced to cut infrastructure or delay strategic spending risk weakening potential growth and making future adjustment harder. The result is likely to be greater market differentiation rather than a common European fiscal crisis. The emerging sovereign-risk landscape is defined less by a simple division between fiscally prudent core states and vulnerable peripheral states than by differences in governments' capacity to manage mounting common pressures. Euro membership can cushion financing conditions, while domestic monetary regimes, inflation and currency risk can amplify them, but political constraints and broader governance risks impact whether fiscal adjustment is politically achievable. As defense, demographic, and investment demands intensify, governance risk will increasingly shape which countries can convert fiscal pressure into credible policy adjustment and which allow it to develop into sovereign stress.

**BMI**

a FitchSolutions Company



About BMI

In an uncertain macroeconomic environment, BMI's systematic, independent and data-driven market insights, analysis and forecasts enable you to recognize and assess risks and opportunities across 200+ markets and 20+ industries. For more than 40 years, we have provided impartial and transparent analytics, data and research

across themes, countries and sectors, with deep insight into emerging markets. Our detailed intelligence is frequent, consistent and systematic, enabling you to easily make comparisons and interrogate data to support your strategic plans and investment decisions.

Learn more at fitchsolutions.com/bmi

Client Services

A dedicated team of client services professionals based in New York, London, Hong Kong, Singapore and Tokyo provide client support. You can contact this team by the following email fscustomersupport@fitchsolutions.com or the phone numbers below:

LONDON

+44 20 3530 2400

NEW YORK

+1 212 908 0800

HONG KONG

+852 2263 9999

SINGAPORE

+65 6796 7231

TOKYO

+81 3 6897 8986