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Interpreting signals
from the global economy
and financial markets

Decoder

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In Focus

- **France is on an unsustainable fiscal trajectory. The current political situation is unclear, but it is hard to see politicians change course.**
- **The increase in French sovereign debt since 2000 is similar to Greece's. Also, French sovereign spreads are now at par with the Greek spreads.**
- **Before meaningful action is undertaken, interest rates probably have to rise further. France does not get disciplined as much by the market because of its inextricable link to the euro.**

Où allons-nous?

Mon Dieu! France is in a political mess. Its government finances are in disarray. These two observations are not unrelated, which makes it hard to put things in order. Unfortunately, there is no prospect of a spring cleaning anytime soon. In this Decoder, we look into the implications for French sovereign debt and the outlook for interest rates.

French evolution

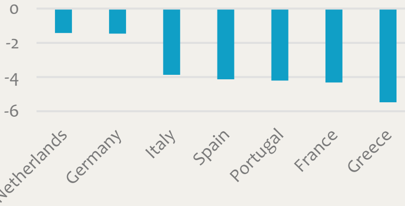
Organizing great Olympic games. Rebuilding the Notre Dame within schedule and on budget. Creating luxury brands. All testaments to French capabilities and a 'can do' attitude. However, this mindset does not seem to extend to fixing government finances. Reform efforts often go up in smoke – sometimes quite literally, with Paris burning because of protesters lighting fires. It is not without consequence. The average budget deficit since 2000 has been 4.3% of GDP, only surpassed by Greece's 5.5% (see chart overleaf). As a result, France has added a whopping 53% of GDP to its debt pile in a quarter century, only just outdone by Greece (adding 54%, chart overleaf).

France cannot go on like this. Nominal GDP growth is some 3% (about 1% real growth plus 2% inflation). The debt stock is rising much faster. With a primary deficit of some 4% of GDP and interest payments of a little under 2%, the debt-to-GDP ratio will grow by 2-3% a year. Note that this picture is flattered by the low interest rates of the past decade or so. The rate on new debt – about half is up for refinancing in the next five years – is easily 100 bps higher than the average rate of 1.6% on existing debt, making the calculation worse. A vicious cycle of high deficits causing higher rates causing higher deficits should be prevented.

Enter Michel Barnier. His plan was to bring down the deficit from 6% of GDP in 2024 to 5% in 2025 and then gradually redress it to 2.8% in 2029 – only just within the EU's 3% deficit limit. Strong enough to reassure bond markets and Brussels, mild enough to be politically palatable, it seemed. However, cuts to social security turned out to be unacceptable to both extreme wings in the Assemblée Nationale, due to a combination of substance and electoral calculus. Exit Barnier: from *Bonjour* to *Au*

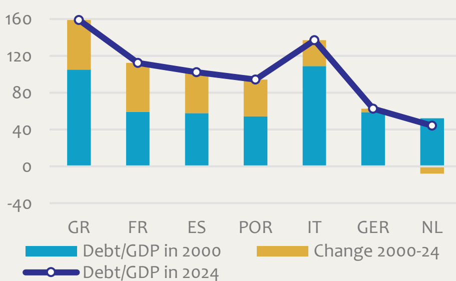
In Figures

Falling short: average deficits 2000-24



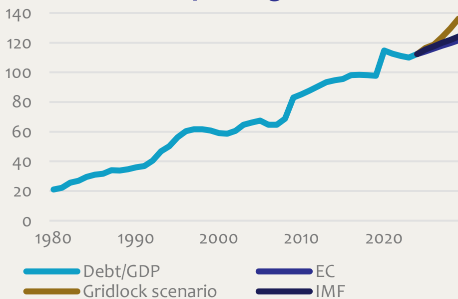
Sovereign deficits as a percentage of GDP (IMF World Economic Outlook, October 2024).

Rising debt experience...



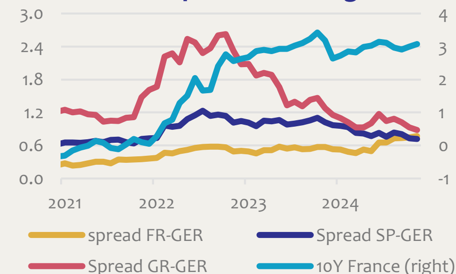
France and Greece have seen the largest increase in debt-to-GDP levels in the past quarter century. In Germany the additional debt is negligible, the Netherlands have actually seen a decrease, helped by negative real interest rates for much of the period.

... could soon be pushing 140%



The French government debt-to-GDP ratio is projected to increase to 122-124% in 2029, according to autumn forecasts by the European Commission and IMF. We show a 'gridlock scenario' in which the primary deficit remains 4%, nominal growth is stuck at 2% and the average interest rate paid on outstanding debt climbs to 4% in 2029. This would push the debt ratio close to 140%.

France-Greece spreads convergence



Le spread, the French-German spread, has converged with the Spanish and Greek spreads.

Data: IMF, EC, Macrobond, APG AM.

revoir within three months. As Barnier had it in his final address to parliament, you cannot wish away economic realities. What's French for *inescapable arithmetic*?

The only way is up?

For now, France is without a budget for 2025. President Macron has appointed the political veteran Francois Bayrou as new Prime Minister – the fourth one in a year's time. It remains the question whether he can pass the 2025 budget that felled his predecessor Barnier. It seems more likely that the 2024 budget will be extended. The proposed increase in social security contributions and various taxes on corporations and high incomes won't be realized then. However, tax brackets will now not be indexed to inflation – effectively a tax hike. Also, public spending will have to come down in real terms, as the 2024 budget does not take into account 2025 price levels. Retirees will get a lucky break. Pensions *are* automatically linked to inflation, a practice that the proposed budget would have suspended. On balance, all this would result in some fiscal consolidation. Still, this is by far not enough to put public finances on a healthy footing.

In October the IMF projected a debt-to-GDP ratio of 124% in 2029, from 112% this year. Barnier's original plans – approved by the European Commission – had the debt ratio rise to 122% in 2029 (see chart). Clearly, that is still an upward trajectory. As such it is a move in the wrong direction and more must be done to stabilize the debt ratio. Fiscal consolidation is inevitable. 'Simply' solving the issue by pushing up nominal economic growth is a tall order. France would need a growth boost to the tune of 2.5%. Every year. *Bonne chance avec ça.*

It is easier to imagine the opposite case, one of economic stagnation and political gridlock. If nominal growth gets stuck around 2%, the primary deficit remains 4% and the average interest rate gradually climbs to 4% in 2029 (150 bps above the IMF's projection), the debt ratio will approach 140% in 2029 (see chart). Is that a problem? Not necessarly. The point at which investors become nervous is unclear, but it is not particularly advisable to experimentally find out.

Spreads over the German 10 year rate reached a peak of 88 bps early in December, a level not seen since 2012. The French spread now exceeds the Spanish spread (see chart). Some days in December the French even had to pay more than the Greeks. To be fair, this is as much about falling Greek and Spanish spreads as it is about a rising French spread. In all, it is not a sign of market panic, but there clearly is some caution.

The reckoning

At an interest rate of 3%, fixing public finances should still be feasible. But didn't we think the same much of the last decade when rates were south of 1%? If it was politically difficult back then, it is not going to be any easier now. Moreover, political polarization has increased. New parliamentary elections cannot be held before June 2025. And it remains to be seen if that leads to a fiscally responsible Assemblée (as Napoleon had it: *in politics, stupidity is not a handicap*). Also, it cannot be ruled out that after President Macron – his second term ends in May 2027 – the French will end up with a populist candidate from the far left or the far right. A lot can be said about their diverging visions, but neither side has a strong affinity with fiscal conservatism.

So how does this end? It seems markets trust that it will all end well. Bottom line: a eurozone without France is inconceivable, so some solution will be found. That assessment of the final destination may be right, but it will be interesting to see along which route we will get there. If the ship does not change course, at some point the tide will turn the ship. It seems we have not reached that point yet.

We are in an equilibrium – likely temporarily – in which French politicians feel no urge to act as long as spreads are still reasonable and sovereign ratings are stable. Spreads may be kept in check by the belief that the ECB is able and willing to put a lid on interest rate divergence (using the Transmission Protection Instrument, Outright Monetary Transactions, or some other tool). Not only Frankfurt, but also

Brussels may come to the rescue. It seems the European Commission has not been the strictest of teachers when assessing the latest budgetary plans (those of Barnier that aimed for compliance with the 3% norm in 2029). Also, an increase in the EU budget and funding, directionally along the lines of the Draghi-plan, could help France.

But if the markets' belief in a solution is the very source of inadequate action by politicians, it is unsustainable. Things might first have to get worse, before they get better. Roughly, there are two routes to get there:

- **Fiscal consolidation** at last. Initially no progress is made on fiscal consolidation, which ultimately leads to lower credit ratings. Spreads over Germany rise and debt dynamics start to become unhealthy. France starts crying for help, but Frankfurt and Brussels do not come to the rescue until the crisis reaches a boiling point and interest rates peak. Part of the deal is that France puts its fiscal house in order. It doesn't make the EU very popular in France, but it calms the markets.
- **Inflation.** A bout of inflation (far above interest rates) can help bring the debt ratio down. But France is not in control of monetary policy. So how could we get there? Think of a messy geopolitical environment with inflationary supply shocks where French public finances are the least of our troubles. The EU spends heavily on defense, energy transition and income support for those hit by high energy and food prices. In this environment, no one wants an escalation of internal European affairs on top of the geopolitical crisis at hand. France gets away with high deficits and because of the drop in the debt-to-GDP ratio (due to inflation), it buys more time. Obviously, this is a route to a lower debt ratio, but not due to a better economic environment.

Investment implications

So what does that all mean for investors? It is unlikely that the French state will default outright. It will ultimately be good for its money, although that money may come with less purchasing power in an inflationary scenario. The possibility of inflation as a solution to the French problem is something to consider more generally in the strategic asset allocation: it's bad for bonds at large.

The more benign fiscal consolidation route may come with bumps in the road. At current spreads versus Germany of 80-90 bps, French politicians seem to feel little urgency to restore fiscal order. Who knows at which point – 100 bps? 200 bps? – they will change course and also *when* that is going to happen? Long term investors have the advantage that they don't need to worry about market timing. They can pick up an attractive yield now. Of course, a rise in spreads will lead to mark-to-market losses, but this should correct in the long term, as the ultimate default risk is low.

But before we reach that destination, we probably have to get through some turmoil first. Sometime in the future, newspapers may be full of protests in Paris, political crisis in the Eurozone, drawdowns in bond portfolios and a falling euro. Institutional investors will get critical questions about why they were so naïve to be exposed to France. It will take steel nerves to stay put, and communication skills to explain why. But just before a French U-turn – perhaps with some help from Frankfurt and Brussels – would be the worst time to divest from French bonds.

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