France's debt puzzle

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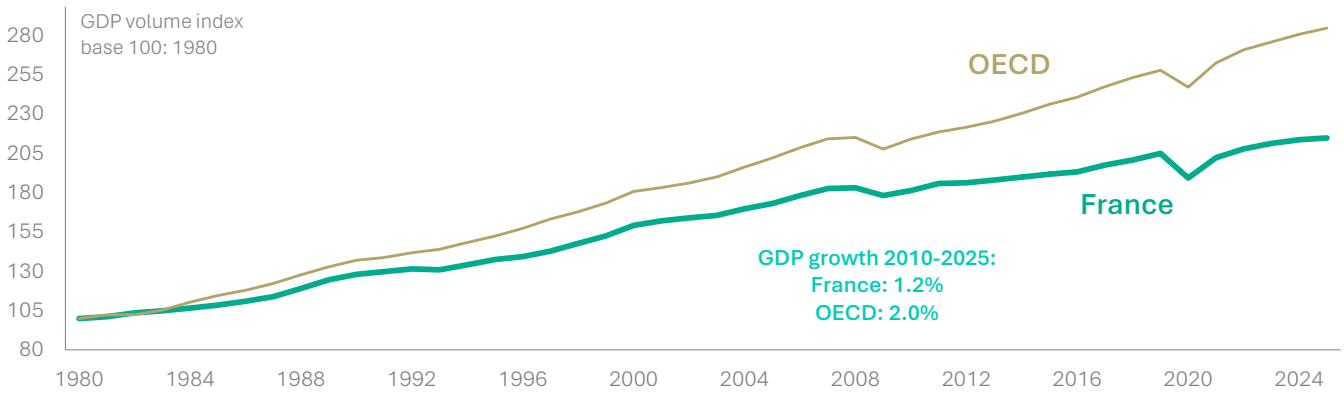
Key takeaways

1. Political deadlock is weighing on the business climate and could erode potential growth
2. A fragmented parliament makes any major fiscal consolidation plan challenging
3. The bond market has already priced in the bulk of the risks, but upside risks on spreads remain
4. Sustainability concerns could resurface if debt costs persistently exceed economic growth
5. The budget debate is expected to stall consolidation efforts, pushing the need for fiscal austerity after 2027

Following the appointment of the Lecornu II government and its general policy statement, calm has temporarily returned to the markets. However, the path between the risks of dissolution and new elections, and the vote on the 2026 budget remains narrow. To maintain the government in place, concessions will have to be made, resulting in less stringent budgetary measures than those outlined in the Bayrou plan. The political concessions on suspending pension reforms are unlikely to satisfy either the political parties or the population, who will still face significant spending cuts and tax rises. The political balance and public finances will remain precarious until the next presidential election in 2027.

Unlike Germany's three-party coalitions or Italy's technocratic governments, French political culture favours direct opposition, even at the risk of deadlock. This political logic is holding the economy hostage, weakening France's position, and contributing to its slow decline. Consequently, ratings agencies will find other reasons to continue downgrading the country's credit rating.

FRANCE'S LONG-TERM GDP (OECD)



Source(s): INSEE, OECD, UBP ETR

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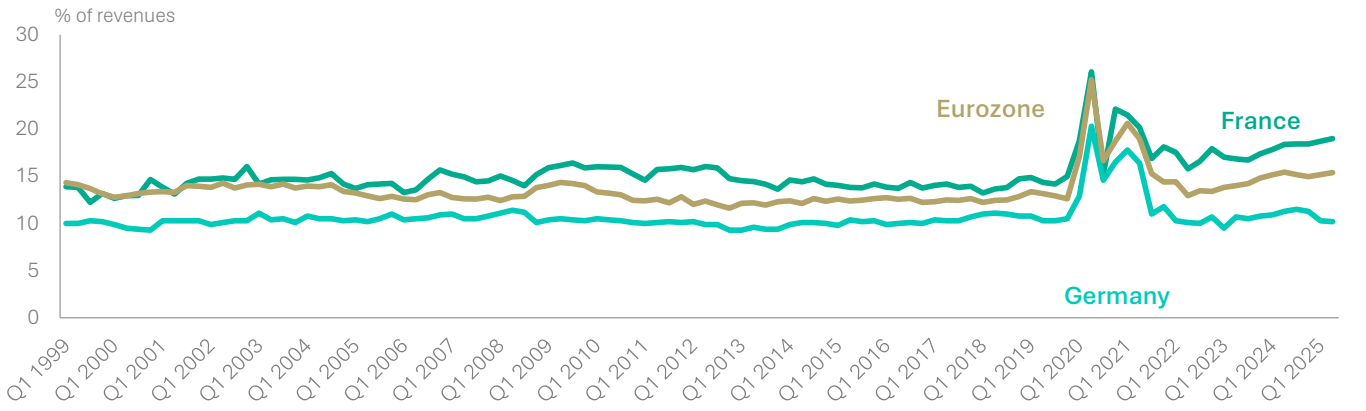
Limited growth below potential

In 2025, French growth will remain positive but weak: the consensus forecasts that it will come in at between 0.5% and 0.8% in 2025 and 2026, but our scenario points to limited growth of 0.6% in both years. This implies a slowdown in the second half of 2025 given political uncertainty and a deteriorating business climate. In the first half of the year, activity was buoyant thanks to inventory rebuilding in the transport and aeronautics sectors, as well as growth in public consumption; however, private demand remained weak, and foreign trade had a negative impact.

Political developments are having an impact on the business climate: confidence in industry and services is waning, while household confidence appears fragile. Household consumption remains strong in services, but has declined for manufactured goods, particularly automobiles. The household savings rate has risen sharply and could remain high in 2026 (at 19% of disposable income), given the uncertainties surrounding taxation, pensions, and employment.

SAVINGS RATIOS IN MAJOR COUNTRIES



Source(s): Deutsche Bundesbank, Datastream, Eurostat

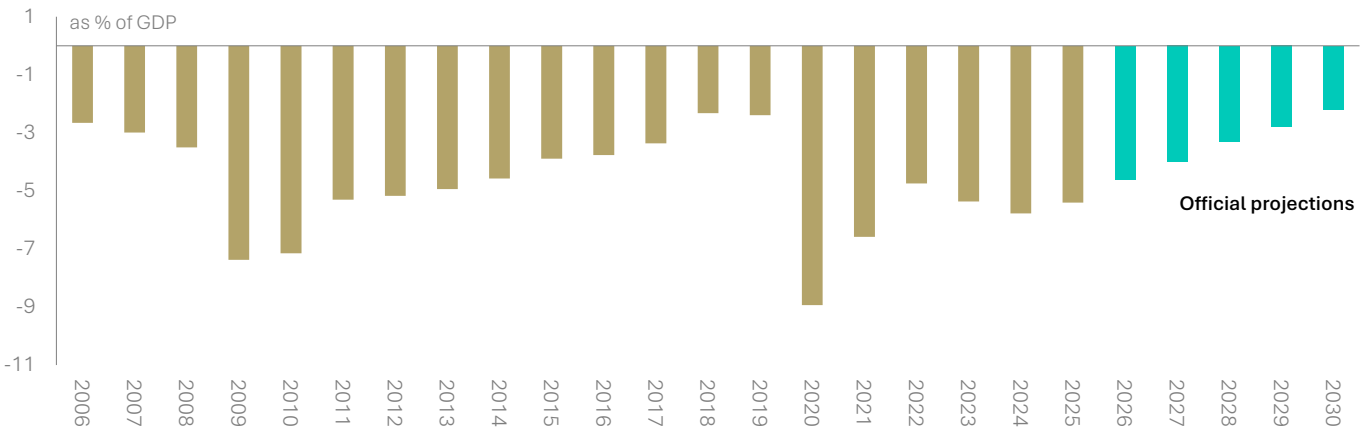
Even if a recession is not anticipated, economic activity could grow by only 0.1% over the coming quarters, with average growth barely exceeding 0.5% in 2025. This will put other pressures on public finances. According to the Observatoire Français des Conjonctures Économiques (OFCE) calculations, the cost of political uncertainty since the general election could represent a shortfall of 0.5 percentage points of growth over a full year. Growth is expected to be well below its potential (expected to be close to 1.2%) in 2025 and 2026. However, this potential could also be revised downwards to less than 1.0% over the next decade, depending on whether political decisions delay structural reforms.

France has committed to controlling its debt…

France is subject to an excessive budget deficit procedure with the European Commission and has pledged to reduce its budget deficit to 2.8% of GDP by 2029, and to cut its public debt to 100.9% of GDP by 2041, with a reduction to 116% by 2029. This plan assumes that the primary budget deficit will fall from 3.6% of GDP in 2024 to 0.3% in 2028 and to +1.8% in 2031, requiring an annual adjustment of 0.5% of GDP to stay

on track. Recent data show that tax revenues were stronger in the first half of the year thanks to the surge in activity. The 2025 projected deficit should therefore be slightly lower than the 5.8% of GDP observed in 2024. However, a deterioration in revenues is possible in the second half of the year, which could leave the budget deficit at between 5.4% and 5.8% of GDP in 2025.

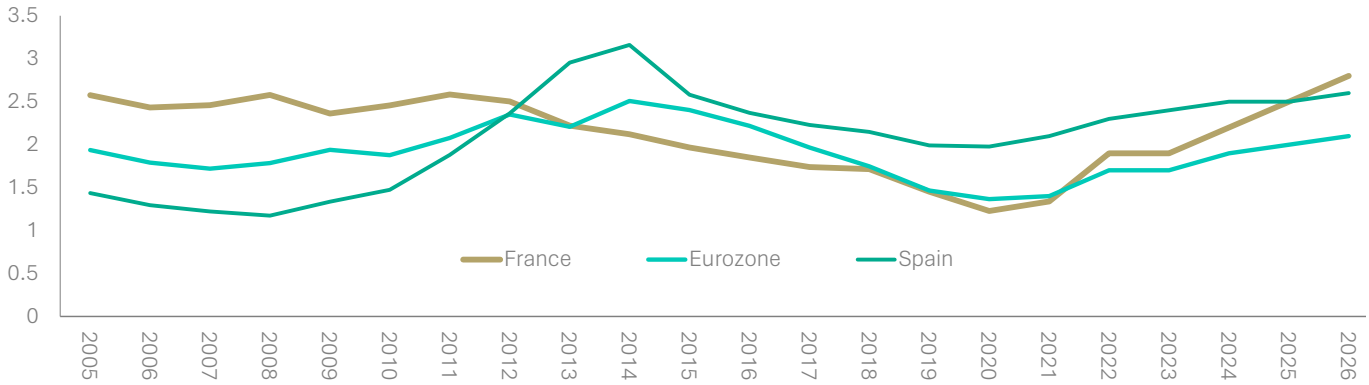
BUDGET DEFICIT FORECAST



Source(s): OECD, European Commission, France Finance Ministry, UBP ETR

As has been the case in several major developed countries, the cost of servicing debt in France is expected to increase significantly between 2024 and 2026, reaching around 3.0% of GDP according to European Commission forecasts. This contrasts with an average of 1.7% between 2016 and 2020, and less than 2.0% between 2021 and 2023. A rise in risk premiums on financial markets in the event of a political and/or financial crisis would exacerbate this trend further.

DEBT SERVICING IN SELECTED COUNTRIES
INTEREST EXPENDITURE AS % OF GDP

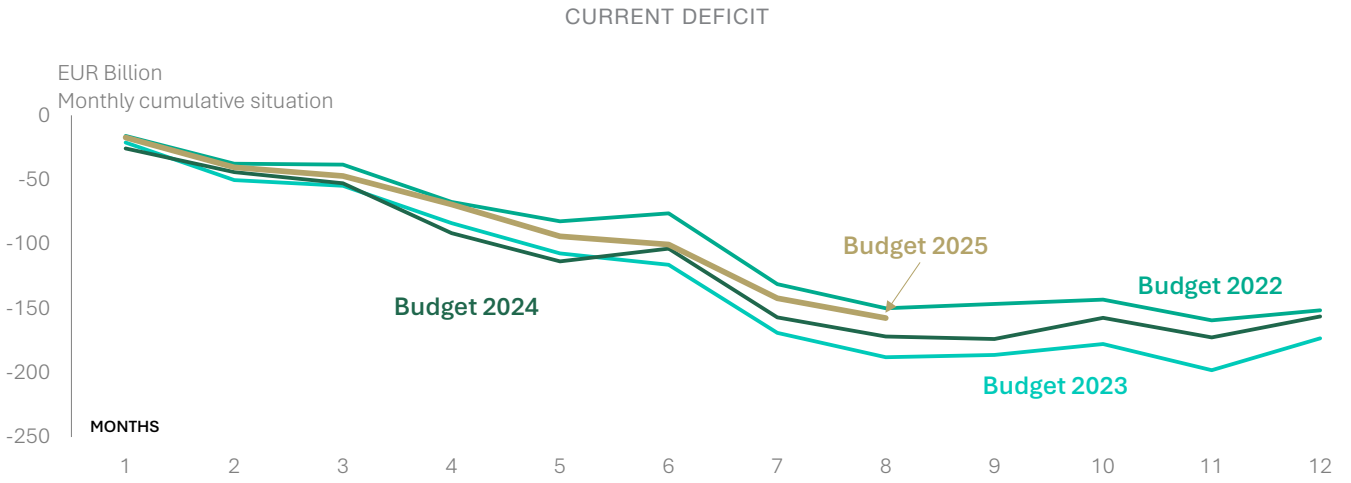


Source(s): World Bank, European Commission, UBP ETR

…however, successive governments are struggling to impose fiscal discipline

The objective of the Bayrou government was to reduce the budget deficit to 4.6% of GDP by making savings of EUR 44 billion. Measures included spending cuts for central government, local authorities, agencies and social security, a freeze on indexation, and the abolition of two public holidays. However, according to the plan submitted to the European Commission, this would have resulted in debt rising from 113% in 2024 to 115.9% of GDP in 2026.

The new Lecornu government has proposed measures that focus on suspending pension reforms and include numerous adjustments to revenue and expenditure, with the aim of achieving EUR 30 billion in savings. Postponing the pension reforms would incur manageable costs of EUR 0.3 billion in 2026 and EUR 3.0 billion in 2027, but this would increase to EUR 20 billion per year by 2030, keeping debt above 125–130% of GDP.



Source(s): France Ministry of Finance, LSEG Datastream

The measures under consideration (see inset at the end) are likely to spark heated debate in the French parliament and result in less fiscal consolidation than expected in an effort to secure the passage of the 2026 budget. According to our scenario, the 2026 deficit will therefore remain closer to 5.0% rather than the promised 4.6% due to negotiations and a more cautious growth scenario than that predicted by the government and the consensus. However, the European Commission could ensure compliance with the multi-year plan presented at the beginning of the year. A 2026 deficit close to 5.0% and a structural adjustment of less than 0.5 percentage points of GDP (primary deficit reduction) could lead the Commission to adopt a more critical stance on economic policy and demand greater adherence to the reform timetable.

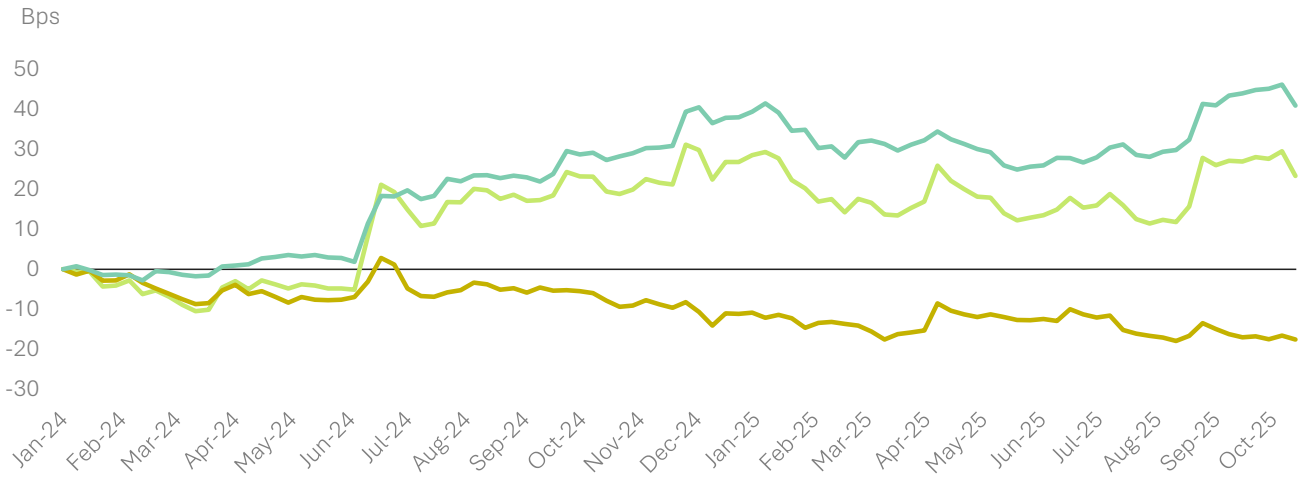
The markets have already factored in several pieces of bad news

The political drama surrounding Lecornu's resignation and subsequent reappointment by President Macron has once again rattled French bond markets. The 10-year Obligation Assimilable du Trésor (OAT)–Bund spread widened to as much as 86 basis points (bps), just shy of its December 2024 peak of 88 bps, before settling at 77 bps following the government's survival of no-confidence votes. Naturally, this raises the question: have French bonds fully priced in the country's political and fiscal risks, or is there still a risk that the spread will widen further?

To assess how much risk is imbedded in French government bonds we can break down the 10-year OAT–Bund spread into two components: a common component, driven by broader European market trends, and an idiosyncratic component, specific to France. The latter has surged to its highest level in years since the dissolution of France's parliament in June 2024. The market has increasingly priced in France-specific risks and, today, the idiosyncratic risk premium stands at +41 bps, slightly above the levels seen following Michel Barnier's failed confidence vote. This suggests that the market is already discounting France's political instability and no major fiscal consolidation. The budget negotiations are still ongoing and could still bring unwelcome surprises. However, markets appear to have already factored in the likelihood of a 2026 budget being approved, with the OAT–Bund spread printing below 80 bps. Nevertheless, major shocks, such as an early presidential election or snap parliamentary elections, could push the spread above 80 bps and even into the 90–100 bps range.

Over the past 18 months, OATs have cheapened significantly, reflecting a growing risk premium attached to France. However, the spread has been distorted by two factors. First, Germany's fiscal regime changes have led to an idiosyncratic cheapening of Bunds. Second, spreads in other European government bonds (EGBs), particularly in Spain and Italy, have compressed as their economic fundamentals improved, exerting a downward bias on the OAT–Bund spread.

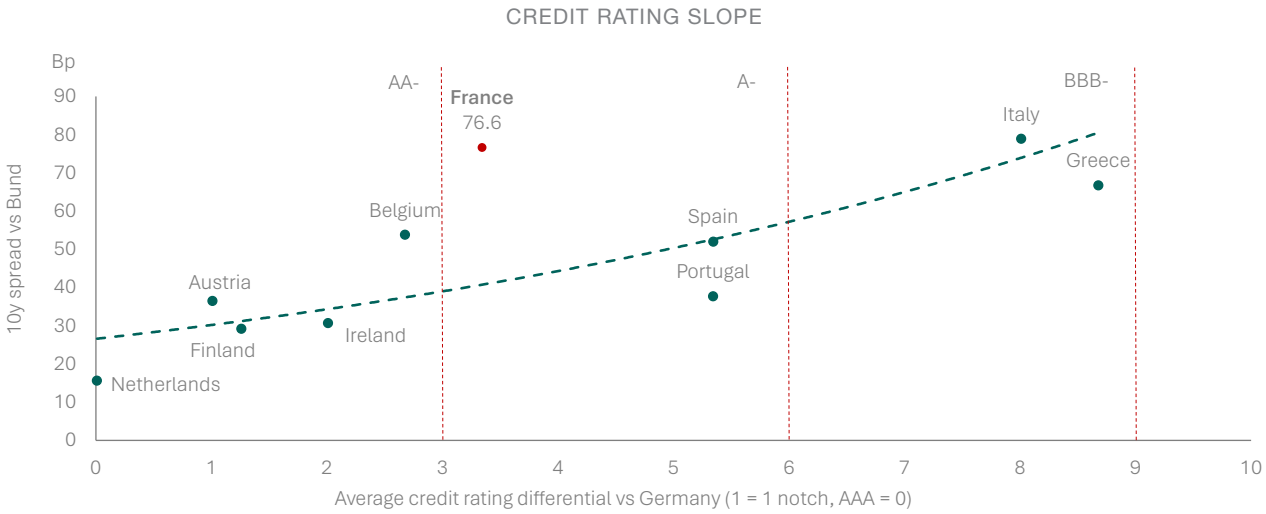
FRANCE'S IDIOSYNCRATIC RISK HAS SURGED



Source(s): LSEG Datastream, UBP ETR
Note: The common eurozone factor is the first principal component (PC1) of EMU-10 (ex-France) 10-year spreads vs. Bunds. France's OAT-Bund spread change is then projected on that factor; the fitted part is the common component and the reisudual is the idiosyncratic component

From a credit-rating perspective, the market has already discounted further downgrades. France's credit rating has been on a downward trajectory, with S&P downgrading it to AA- in May 2024, followed by Moody's later that year. In 2025, Fitch and S&P surprised the market and downgraded France to A+, citing ongoing political turmoil and weak prospects of fiscal consolidation while Moody's is set to review France's rating on the 24 October. This unfavourable rating momentum raises the probability of seeing a further downgrade, as the parliamentary arithmetic makes any major medium-term fiscal consolidation plan challenging.

However, OATs are already trading at levels that imply a credit rating around five notches below France' s current standing, which would argue for a muted reaction in the event of a downgrade. Nevertheless, the downgrade of France to A+ by two of three major rating agencies could have implications for institutional investors, including pension funds, Undertakings for Collective Investment in Transferable Securities (UCITS), insurance companies, and banks bound by internal regulations. Many of these investors rely on average credit ratings to guide their allocations. As a result, it could prompt these market participants to reduce their OATs holdings. Also, the fact that 50% of French public debt is held by non-resident investors increases the risk of seeing a sell-off in the case of another downgrade, as was seen with Japanese investors at the start of 2025. These investors tend to be more sensitive to political risks and fiscal concerns. Fortunately, these portfolio outflows typically reverse once tensions subside, highlighting the relative medium-term stability of foreign debtholders.

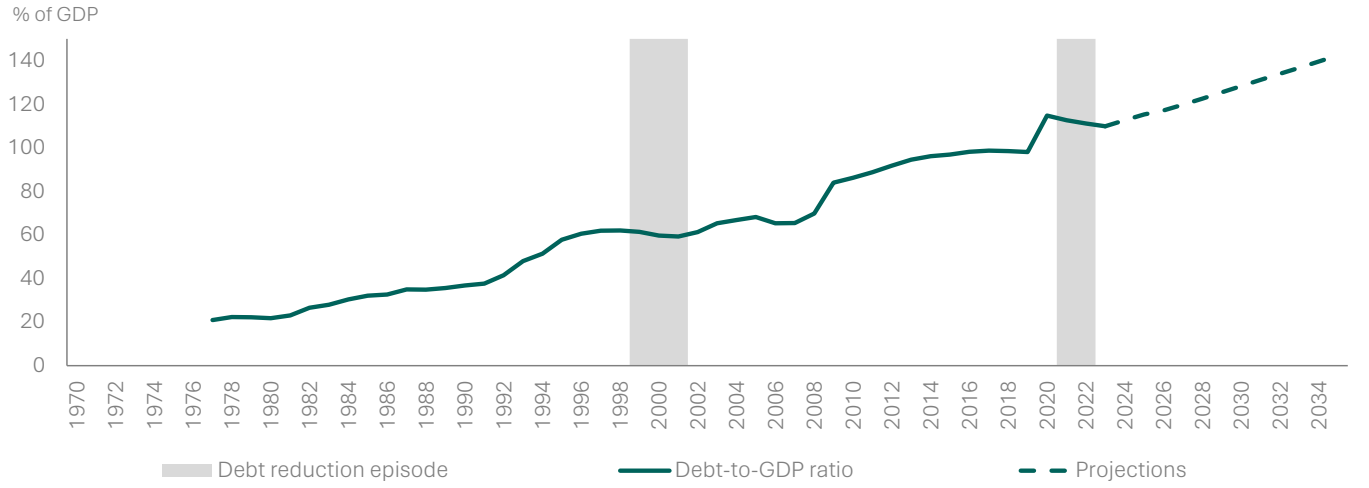


Source(s): : LSEG Datastream, UBP ETR
Note: a downgrade from AA- to A+ represents 1 notch

Is French debt sustainable in the medium term?

The widening OAT–Bund spread not only reflects immediate political uncertainty but also revives deeper questions about France's long-term fiscal trajectory. Beyond the near-term volatility sparked by budgetary disputes, France's structural vulnerabilities remain, as sluggish potential growth is compounded by a persistent primary deficit. Moreover, since borrowing costs have risen over the last five years, the debate over France's debt sustainability is set to intensify, bringing long-term fiscal reform challenges back to the forefront of the policy agenda.

FRANCE'S HISTORICAL DEBT DEVELOPMENT



Source(s): IMF, UBP ETR

Seen through the 'r–g' lens, i.e. the difference between the cost of government debt (r) and nominal GDP growth (g), France's fiscal situation appears increasingly worrying. The country's debt ratio, hovering around 113% of GDP in 2024, will drift higher if no significant action is carried out on the primary fiscal deficit.

Following Covid-19, France benefited from a negative r–g: borrowing costs were below nominal growth, allowing debt to stabilise even with large primary deficits. However, that favourable arithmetic is set to reverse. Fortunately, France's average cost of debt is low today (at around 2%) and with a weighted average maturity of 8.5 years it will cushion the pass-through from market yields to higher costs of financing. However, as market rates remain above France's average cost of debt, the interest burden will gradually increase, pushing 'r' above 'g'. In that scenario the government's capacity to run primary surpluses becomes crucial in order to stabilise the debt-to-GDP ratio.

Among eurozone countries, Italy's fiscal challenges bear similarities to those of France. Italy's debt-to-GDP ratio is one of the highest in the euro area (135% of GDP in 2024) and its long average debt maturity exceeds seven years which has also limited the rise of Italy's cost of government debt (3% in 2024). However, Italy had already returned to a primary fiscal surplus in 2024, driven by the fiscal discipline introduced under Giorgia Meloni's leadership, which helps to counteract unfavourable 'r–g' arithmetic and decreases debt sustainability concerns. Spain offers a more optimistic outlook. With a lower initial debt stock (101% of GDP), a recent track record of robust nominal growth, and a broadly credible fiscal consolidation plan, Spain has managed to keep debt sustainability concerns at bay, which was reflected in the compression of its spreads and its positive rating momentum (from A to A+ by S&P).

To address its long-term fiscal challenges, France must act on both sides of the r–g equation. On the 'r' side, maintaining fiscal credibility through multi-year expenditure control is key to preventing a lasting risk premium. On the 'g' side, reforms that lift productivity and potential growth are needed to strengthen the denominator of the debt ratio. That said, political fragmentation makes both harder to achieve, as shown recently by the budget concession required to keep Lecornu's government in office. Without consensus on long-term fiscal strategy, France risks a rising debt burden and a widening OAT–Bund spread, reflecting growing concerns over its debt sustainability.

Is the European Central Bank the market's last resort?

The European Central Bank (ECB) has the means to intervene in markets if interest rates come under significant pressure, or to lend directly to a struggling country. The ECB monitors the situation closely to avoid problems with the transmission of its monetary policy and to prevent any fragmentation of the European bond market or contagion between countries. These extreme conditions have not been observed in the case of France, and therefore the ECB has not intervened.

The ECB's anti-fragmentation mechanism (the Transmission Protection Instrument or TPI) can only be activated to calm market tensions when a country meets several criterias. These include agreeing with the European Commission on its fiscal and debt trajectory, taking measures to maintain debt sustainability, and economic policy conduct (reforms and implementation). The country must also not be subject to an excessive deficit procedure. The ECB's Governing Council then decides whether intervention is appropriate. In this case, however, intervention has not been justified because market tensions remain limited, and several criteria have not yet been formally met. These measures could only be mobilised in the event of very tough market tensions, contagion risk, and/or serious political instability. ECB intervention is therefore not automatic and would only occur in the event of serious deterioration.

Conclusion: fiscal austerity is unavoidable after 2027

The French economy is currently experiencing difficulties, which highlights the challenge of finding a balanced way to exit the fiscal support measures introduced during the pandemic, while other European countries have already ended their interventions. The current budget debate is likely to delay some consolidation efforts until after the 2027 presidential election. The risk, therefore, is that, after this date, genuine fiscal austerity will be imposed as there will be no other option due to the performance gap compared with other eurozone countries. To remain within the deficit and debt-reduction targets presented to the European Commission in 2025, this would result in cuts of around EUR 40 billion per year (1.3% of GDP).

Key measures presented by the Lecornu II government

- Refusal to use the budget blocking vote (Article 49.3)
- Tax increases for those on the highest incomes
- The renewal of the exceptional corporate surtax
- A new tax on the financial assets of holding companies
- The creation of an exceptional contribution for large fortunes (excluding professional assets)
- Freezing of the tax scale and ending certain deductions for pensioners (under-indexation of pensions in 2026)
- Increase in company contributions for terminations of contracts
- Increase in the VAT threshold for small businesses
- Limitation of tax exemptions for companies
- Savings: various measures to reduce healthcare costs (sick leave, medication, medical consultations)
- Taxation of mutual insurance companies
- Reduction in the number of civil servants

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