Why France’s budget headache is back in the news

Fears about the sustainability of France's public finances are back in the spotlight, driving up spreads. There are no easy solutions, and we're not expecting many signs of improvement in the coming months

French Prime Minister, Michel Barnier. We don't think it'll be long before France's budget fiasco finds itself back in the headlines

A difficult budget situation

Barely in office, Michel Barnier's hard-pressed new government is facing a string of bad news about public finances. First of all, new government estimates indicate that the public deficit – forecast at the start of the year at 4.4% and already revised upwards in April – should exceed 6% of GDP this year after 5.5% in 2023. This is a huge budgetary blow, which the government believes must be blamed on lower-than-expected tax revenues, against a backdrop of economic growth driven by exports rather than domestic consumption which has generated lower VAT receipts. The wait-and-see attitude of businesses, which in recent months have suspended a large number of investments and recruitments due to political uncertainty, has led to much lower-than-expected tax receipts. Finally, spending by local and regional authorities has been higher than forecast at around €16bn for 2024.

According to the Treasury, if no corrective measures are taken, the deficit should reach 6.2% in

2025, 6.7% in 2026 and 6.5% in 2027. Reaching the 3% target that France has promised its European partners in 2027 would require savings of €110bn between now and 2027, an effort that has never been made in France (and is virtually impossible).

While the target deficit of 3% of GDP by 2027 is unattainable, the government will nevertheless have to take action to improve the sustainability of public finances. Not only is France already the subject of an excessive deficit procedure by the European Commission, but the markets are starting to get nervous, as shown by the recent rise in spreads between French and German government bonds.

Disinflation complicates matters

It should be noted that the current context of strong disinflation in France is not doing the government any favours, as it makes the budgetary equation even more difficult. When inflation is high, all it has to do is not increase certain expenditures or social benefits by the same amount to reduce the budget without appearing to do so. Today, this is no longer possible. What's more, revenues such as VAT and social security contributions react very quickly to a slowdown in inflation, whereas public spending is more inert. While this always stabilises in the end, in the short term, disinflation generally results in a slightly higher deficit.

On the other hand, as the experience of recent years has shown, high inflation allows debt to fall as a percentage of GDP, despite high deficits. Once inflation moderates, debt stabilisation becomes much more difficult and the debt-to-GDP ratio tends to rise more rapidly – a worry for France which saw its debt reach 112% of GDP at the end of the second quarter of 2024.

Two new ministers in charge of the public finance headache

Within the new French government, two new ministers have to deal with this explosive situation: the new Economy Minister, Antoine Armand, and the Budget Minister, Laurent Saint-Martin. The latter now reports directly to Prime Minister Michel Barnier, which is unusual and a sign of the seriousness of the situation.

Normally, the budget should have been completed in September, and the multiannual trajectory of public finances sent to the European Commission by 20 September. However, France has obtained an extension from the European authorities until 31 October. The new government plans to present the budget to the National Assembly next week, which means that the text will have to be finalised in the next few days and sent to the Haut Conseil des Finances Publiques and the Conseil d'Etat, both of which are responsible for assessing it before it is sent to parliament.

Options on the table for solving the situation

Numerous ideas are circulating for limiting the public deficit over the next few years, but the final decisions have yet to be unveiled. It seems clear that restoring public finances will primarily involve cutting spending, but it is not yet clear how this will be achieved. The fact that there are currently no specific plans to reduce public spending circulating in the media seems to indicate that this is easier said than done – and if the government is serious about it, given the scale of the efforts required, it is certain that the decisions taken will not be popular.

In addition, tax hikes are now being considered, breaking the taboo that has been in place since Emmanuel Macron took office. The government is considering an exceptional and temporary contribution on the profits of large companies, of 8.5 percentage points on top of the 25% corporation tax. Only groups with sales of €1bn or more would be affected. This could raise up to €8bn by 2025. In addition, the government wishes to introduce a tax on share buy-backs, of the order of 1% on the actual amount of share buy-backs. This tax would apply only to groups with sales in excess of €1bn and is expected to raise €200m a year. There are also plans to increase the amount and tax base of the car eco-tax, which could bring in €316m by 2025, and to increase the tax on Airbnb-type furnished holiday accommodation, which has not been budgeted for. In addition, the government seems determined to impose a tax on the wealthiest households, probably via income tax.

All in all, the solution to France's public finance headache remains unclear. It is certain, though, that the decision is close at hand and that the new executive will be communicating very soon. However, it remains to be seen whether the measures announced will be credible and sufficient enough to convince markets that the government is taking the problem seriously. What's more, once the plan has been drawn up, the government will then have to convince the members of parliament, which promises to be almost as difficult... We certainly haven't heard the last of France's public finances!

Markets maintain a pessimistic outlook

While the political situation seemed to be headed in a market-friendly direction compared to a more left-winged or populist government, the yield differential between French and German 10-year bonds has widened again. At 80bp currently, the spread is only just below the peak of 82bp right after Macron’s call for elections. These levels are in line with a rating that would be one or two notches lower than the current AA-.

Besides the blow to the fiscal picture, the widening comes at a time of a broader weakening of the eurozone economic outlook. For instance, the latest services and manufacturing PMIs for France both turned into contractionary territory, which can only add to the challenges ahead. The silver lining is that the current government seems dedicated to addressing the fiscal deficits, which mitigates the chance of a disorderly sell-off such as the one triggered by the unfunded budget proposal from former British prime minister Liz Truss in the UK in 2022.

The uncertainty going forward remains significant from a market perspective. Long-term plans will have to be credible, which will be difficult to convince investors of given the fragile position of the current government. Rating agencies will also be critical and further downgrades seem likely in the eyes of the market. Add in the probability of a successful no-confidence vote, forcing President Macron to nominate a new prime minister (who has to form a new government), and we see many paths that could lead to even higher spreads from here.

Author

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

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