

## France's fiscal credibility under pressure

Political instability and missed fiscal targets are raising doubts about France's ability to meet EU rules and avoid further rating downgrades. Here's what's happening and how the markets are reacting



Facing the pressure: Sébastien Lecornu, France's latest Prime Minister

### A new prime minister, but no majority

The downgrade of France's credit rating by Fitch, from "AA-" to "A+", underscores the scale of the challenge the country is facing. Friday's move is the first of the three major agencies to downgrade France's double-A status. Moody's and S&P are expected to decide on their rating on 24 October and 28 November. It all reflects the country's inability to restore public finances, which remain severely deteriorated.

And that's because of the febrile and fractured political environment. On Monday, Prime Minister François Bayrou lost Parliament's confidence and resigned. The next day, President Emmanuel Macron appointed Sébastien Lecornu, a centre-right ally, as Prime Minister. Lecornu now faces the challenge of forming a government and presenting the 2026 budget in a fragmented parliament where he lacks a majority.

### Budget targets drift further from EU commitments

According to the Ministry of Finance, public spending would rise by €51.1bn next year without corrective measures, pushing the deficit to 6.1% of GDP—well above the 5.4% expected this year

and far from the 4.6% target submitted to EU authorities. Without policy changes, debt is projected to rise from 113% of GDP in 2024 to 125.3% by 2029.

The fiscal deterioration is not just cyclical. Social and healthcare spending reached 32.3% of GDP in 2023, compared to the EU average of 26%. These costs are expected to rise further due to demographic ageing. With potential GDP growth stuck near 1.2%, financing these rising costs becomes increasingly difficult, especially when actual growth falls below potential, as expected this year and next.

France's tax-to-GDP ratio is already the highest in the EU at 45.6%, compared to the EU average of 40%. This leaves little room for additional revenue measures, making fiscal consolidation even harder.

## Political instability clouds fiscal outlook

Since mid-2024, France has seen three different governments. Confidence in the country's ability to reduce its deficit below 3% by 2029 is waning. To avoid a no-confidence vote, Sébastien Lecornu must secure tacit support from either the left or the far-right. Talks are currently focused on the Socialist Party (PS).

To this end, Bayrou's draft budget has been shelved. Instead of 44 billion in savings, the Prime Minister's allies are now talking about 35 billion, which should bring the deficit down to just under 5%, not 4.6% as promised. Some of Bayrou's flagship measures, such as the abolition of two public holidays, have already been abandoned. With a major day of trade union action announced for 18 September, negotiations are only just beginning. We believe they are likely to be protracted.

If these discussions are successful and the Prime Minister manages to keep his position, it will probably be at the cost of less rigorous fiscal consolidation, effectively postponing the promised budgetary consolidation. However, it remains possible that Mr Lecornu will not succeed in forming a viable coalition. In this case, Macron could appoint a new Prime Minister, but the chances of success would not be any higher. This could ultimately lead to another dissolution of the National Assembly. In our view, the probability of Macron resigning is very low at this stage. Nevertheless, instability will remain at least until the 2027 presidential elections.

*Charlotte de Montpellier*

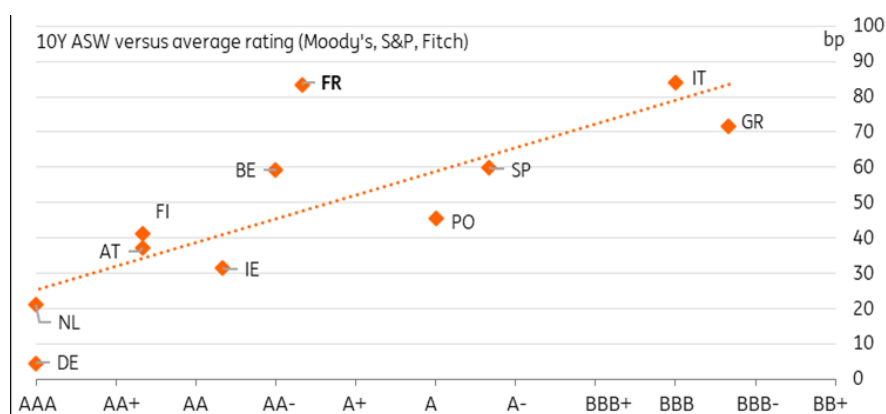
## Muted market reaction

Market reaction to the downgrade was very muted. A small initial widening of the 10y French government bond spread over Bunds has already reversed. With the spread at close to 80bp and basically on par with Italy's, markets had already incorporated the prospect of French rating downgrades.

The French political and fiscal problems so far have limited spill-over into other markets as well. That it remains an idiosyncratic story was underscored over the weekend by Spain and Portugal seeing rating upgrades at the same time that France lost its first AA rating. In fact, market pricing has for some time reflected expectations of a reordering in European government bond space.

*Benjamin Schroeder*

## Spreads vs average rating



Source: Macrobond, ING Research

## French corporate bonds defy sovereign weakness

Within the corporate bond space, French names were the laggards last week around the French vote of no confidence. But this was short-lived, and spreads have mostly rebounded. Fitch's downgrade has not put any pressure on French corporates and banks. We still see some examples of highly rated corporates trading through OATs, and more recently, we are even seeing new issues being priced through OATs, namely the 12yr Schneider Electric bond that's priced 15bp inside OATs a couple of weeks ago.

Danone and L'Oréal are examples where curves are trading at the same spread level as OATs and, in some cases, trading tighter than them. French Banks, on the other hand, are a touch wider and are generally trading with a pick up over the OATs. These tight corporate bonds relative to these long-dated government securities are not typical, as in the past, OATs, much like other country spreads, would act as a barrier and typically always trade wider. In the past, it was only a few examples of highly rated corporates trading inside country spreads in the likes of Italy and other periphery countries.

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