PICTET WEALTH MANAGEMENT

France: the fiscal equation is getting tougher

Fiscal slippage raises risks to sovereign rating and growth outlooks

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SUMMARY

- Lower-than-expected tax revenues pushed France's budget deficit to 5.5% of GDP in 2023, overshooting the government's 4.9% target. With European elections looming in June, it was decided not to revise the 2024 budget, leaving the bulk of the fiscal consolidation to 2025 and beyond.
- We see increased downside risks to the French sovereign rating from this political arbitrage, with Fitch (AA-, stable), Moody's (Aa2, stable) and Standard & Poor's (AA, negative) due to review the rating in the coming weeks. Looking ahead, the fiscal tightening planned from 2025 on is substantial, confirming our view that fiscal policy is now one of the main downside risks to our growth scenario.
- The budget slippage has resulted in a widening of the yield spread between French and German 10-year government bonds, reflecting concerns about France's fiscal stability. In light of the risk to France's sovereign rating, we forecast that the spread on French 10-year bonds over their German equivalents could stand at 60 bps at year's end.

THE 'MONEY ILLUSION' TRAP

When the rise in inflation automatically improves a government's fiscal position without any change in policy, economists call this the 'money illusion': thanks to higher tax yields, inflation spontaneously increases the growth in state revenues but not automatically expenditure. All this temporarily supports the government's cash position. At the same time, the increase in nominal GDP automatically reduces the public debt ratio, which reinforces the impression that public finances are easier to manage.

But when disinflation arrives, the pitfall for governments is not to anticipate the fall in tax revenues: public revenue dynamics slow down when indexation to past inflation of certain expenditures (pensions, public contracts, etc.) kicks in. If no real

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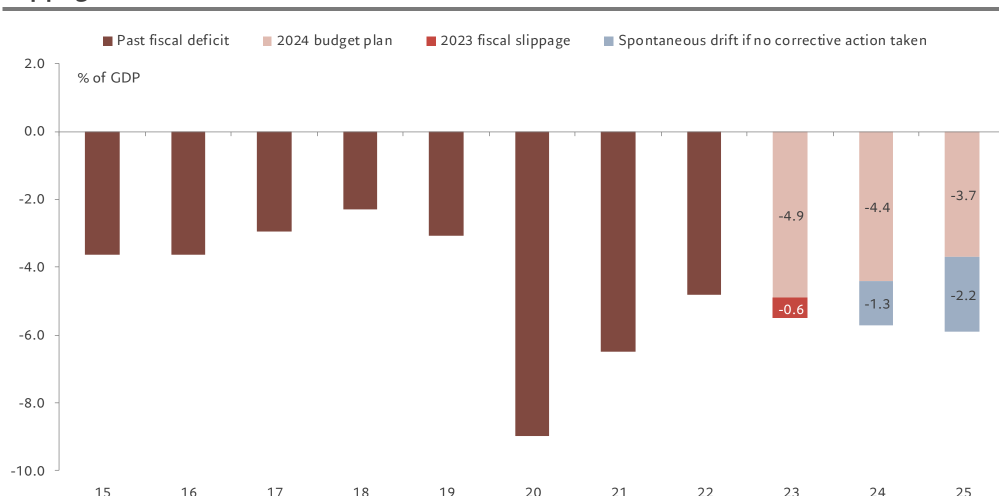
corrective action is taken, the budget balance worsens, especially if the government approved extra spending in the meantime, funded by the temporary fiscal windfall that came with inflation.

The French government fell into this trap in 2023. The public deficit, which in its 2023 budget was projected to be 4.9% of GDP came in at 5.5%. This was due to an unexpected fall in the yield from certain taxes, which led to a much larger-than-expected drop in revenues: around EUR11 bn according to the national statistics agency INSEE, compared with EUR1 bn forecast in the budget. At the same time, expenditure rose slightly more than forecast (by 3.7% compared with the 3.4% projected).

This slippage calls into question the government's plans for deficit consolidation path. In the absence of corrective measures, according to the technical forecasts of the Ministry of Finance, the public deficit could widen to 5.7% of GDP in 2024 and 5.9% in 2025, figures far above the government's initial forecasts of 4.4% and 3.7%, respectively.

Chart 1: France's initial multiannual fiscal path in the 2024 budget and subsequent slippage



Source: Pictet Wealth Management, French Finance Act 2024, Finance Committee of the French Senate

DELAY TO DEBT REDUCTION PUTS COUNTRY RATING AT RISK

Emmanuel Macron has earned a reputation in European political and financial circles as a reformer and credible fiscal manager since he became French president in 2017. Apart from 2020, a year marked by the covid pandemic, the governments he has appointed have recorded lower-than-expected deficits. Accepting the slippage in 2023 without at least correcting the trajectory would put this credibility at risk.

Yet this is the path the French authorities have taken. Amending the 2024 budget before the summer has been ruled out. No doubt, the 8-9 June European elections, which are set to be challenging for Macron's centrist Renaissance party, are a factor in this stance. Furthermore, the government, which has a minority in parliament, was exposed to the risk of a no-confidence motion by the vote on an amending

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budget. It wouldn't have been the first time, but this time the Republicans (the centre-right party), who usually support the government on fiscal issues, threatened to support a motion of no confidence. The risk was deemed too great to take just a few months before the Paris Olympics.

Corrective measures will be taken in 2024, but within the framework of the current budget. Thus, they will not be substantial (a total of EUR 10 bn, 0.2 percentage point (pp) of GDP, on top of the EUR 10 bn already budgeted) and insufficient to keep the deficit on the reduction path planned in this year's budget. In the Stability Programme submitted to Brussels on 17 April, the government foresees the government deficit falling to 5.1% in 2024, 0.7 pp above the initial budgetary target. The deficit trajectory suggests the government is *de facto* abandoning its aim to reduce the public debt ratio, which could rebound to 112.3% of GDP this year after three years of decline.

The French sovereign rating is likely to be the main victim of this political arbitrage. On 26 April, Fitch Ratings and Moody's will publish their updated assessments. The former already lowered France's rating by one notch last year, from AA to AA-, with a stable outlook. Since 2015, Moody's has kept the country's rating unchanged at Aa2, also with a stable outlook. In both cases, a revision of the outlook from stable to negative cannot be ruled out. **Standard & Poor's, which has had a "negative" outlook on its AA rating for France since December 2022, is due to present its update on 31 May, with a strong risk that the rating is downgraded to AA-.**

FISCAL TIGHTENING WILL POSE A SIGNIFICANT RISK TO GROWTH IN 2025

Looking ahead, stronger fiscal consolidation from 2025 risks curbing France's economic growth. With the EU fiscal rules reactivated, there is now no doubt that the Commission will open an Excessive Deficit Procedure (EDP) against France (and other states) this year, certainly after the European elections.

The reformed fiscal rules are expected to be finally adopted by the European Parliament at the end of April and will apply to 2025 state budgets. For countries facing an EDP, they provide, as did the old rules, for structural consolidation of 0.5 pp of GDP per year until the deficit converges to 3% of GDP. In practice, they will be temporarily more flexible, allowing Member States to adjust the structural effort to the increase in their interest payments until 2027. Nevertheless, the French government has preferred to comply with the theoretical rule, certainly in anticipation of being placed under the procedure. **The Stability Programme foresees a substantial primary structural effort of 1.2 pp of GDP in 2025, 0.5 pp in 2026 and 0.7 pp in 2027, centred on expenditure cuts.** Thanks to this tough stance, the government aims to reduce the public deficit to 2.9% in 2027 and put the public debt ratio back on a declining path from 2026.

Such a large-scale budgetary effort was last undertaken during the euro area sovereign debt crisis of 2011-2013. It came at the cost of a recession. It therefore remains to be seen whether the government really intends to risk sacrificing growth in an already tense political and social context. Nevertheless, recent developments confirm our view that governments' fiscal stance is one of the main downside risks to our medium-term growth forecasts.

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LIMITED RISE IN FRENCH SOVEREIGN YIELDS

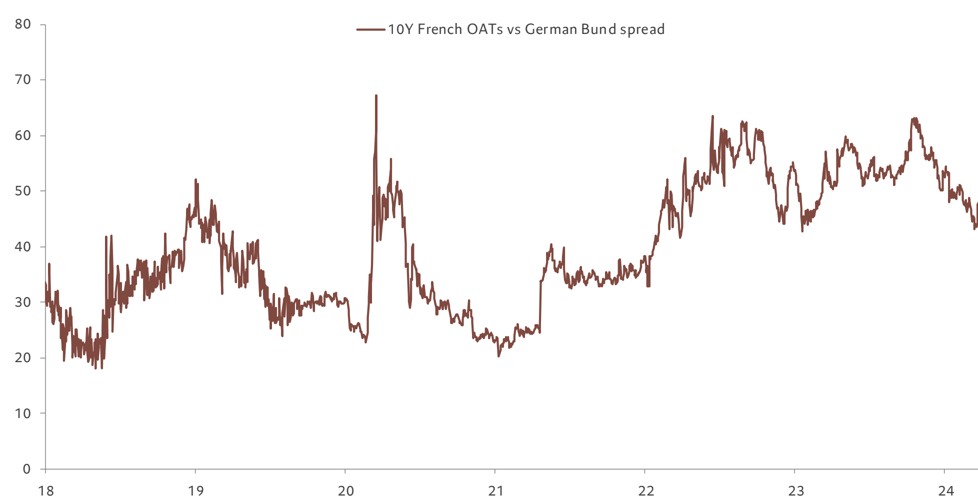
Despite these various risk factors, we do not expect a sharp and sustained rise in French government bond yields over the coming months. Admittedly, a persistent primary deficit, current account deficit and the rise in external liabilities over the past 10 years make the economy vulnerable to episodes of risk aversion. Demand for OATs from private investors, especially non-residents, has held up recently, but market sentiment could change despite the structural strengths of French debt (market depth, quality of management, etc.). The opening of an EDP could also worsen market conditions as it would *de facto* make France ineligible for the ECB's latest bond-buying tool, called the Transmission Protection Instrument (TPI).

However, it is worth remembering that the ECB was at the start of a rate-hiking cycle in 2022 when it announced the TPI, with this tool seen as a way of countering any unwarranted tightening of financial conditions in euro area countries with fragile finances. By contrast, this year, the ECB is expected to start cutting its policy rates from June onwards, with a total of 100 basis points in rate cuts on the cards this year in our central scenario. **This easing of financing conditions should dampen the effect of a rise in real interest rates**.

Also, one should not forget that **a quarter of French marketable debt is currently held on the Banque de France's balance sheet.** With quantitative tightening only gradually having an impact, the central bank's hold on market debt is still helping to compress the term premium.

Since news that the French government had overshot its deficit targets, the spread between French and German 10-year government bond yields a has widened from 44 bps to 51 bps (as of 19 April). Nonetheless, spreads remain within a range consistent with France's current sovereign debt ratings. While a possible downgrade of these ratings in the coming weeks could lead to further spread widening, we maintain our year-end spread of 60bps for French 10-year bonds. While this allows scope for spreads to widen further from their current level, we do not expect the market to overshoot beyond this.

Chart 2: French 10-year government bond spread



Source: Pictet Wealth Management, FactSet, as of 22.04.2024

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