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France fails in overdue attempt at budget consolidation

On Sunday, we will witness something of a miracle: just five years after the devastating blaze, and against all odds, the Parisian cathedral of Notre-Dame will reopen its doors. President Emmanuel Macron had promised swift reconstruction immediately following the disaster. At the time, few believed it possible.

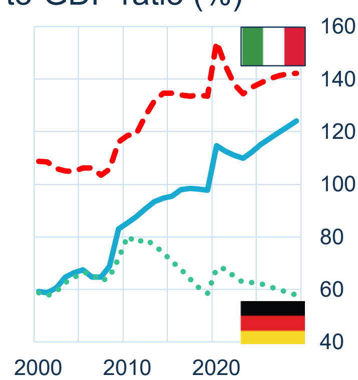
A second Advent miracle, however, eluded Macron. On Wednesday the three-month-old minority government of Michel Barnier collapsed following a vote of no confidence from the left-wing faction, joined by Marine Le Pen’s far-right Rassemblement National (RN).

The opposition puts political calculus over economic sense

France's dire state finances

The trigger was the minority government's attempt to rein in the runaway public finances. In France, government spending, including social security, currently stands at 57°% of GDP, the highest in the developed world (compared to 48°% in Germany or 51°% in Italy), and the overall deficit is estimated to reach 6°% of GDP (Germany, including special funds, at 2°%). The IMF forecasts that the debt-to-GDP ratio of the Grande Nation will climb to 124°% by 2029 (see Fig. 1). The urgent need for fiscal reform is evident. Yet, France is deeply politically divided. There is not only a strong far-right party but also an extreme left movement. Together, the left-wing alliance and the Rassemblement National (RN) hold the majority in parliament. Anyone who has studied Latin and read Caesar's Gallic War will experience a déjà-vu: all of Gaul is divided into three parts!

Fig. 1: Government debt-to-GDP ratio (%)



Source: IMF, LBBW Research

The government has fallen. There is no budget for the new year starting in only 25 days. In such a situation, this year’s budget is automatically carried over. Without savings measures. New elections are not possible until the summer of next year at the earliest. According to the constitution, the president can dissolve parliament only once a year. And in June, following the shock of the European elections, Macron put everything on the line with new elections – and lost.

What now?

Le Pen seeks Macron's downfall

Macron will likely try to buy time by installing a technocratic government without a political agenda – which would be effectively powerless. The left-right opposition could increase the pressure and bring down the new government with another vote of no confidence. And this on repeat. What the opposition truly wants is Macron's resignation and early presidential elections, which are not scheduled until 2027. If elections were held today, Le Pen would clearly win. And she is in a hurry. In mid-November, the prosecutor's office demanded her ineligibility for five years in a case involving the embezzlement of EU funds. The verdict is expected by the end of March. The RN leader needs presidential elections as soon as possible.

Investors start to show nervousness

The EU Commission will raise a concerned finger: Stability Pact and all that. But the toothless tiger in Brussels is unlikely to bite. Former Commission President Jean-Claude Juncker explained laconically in 2016 why no sanctions were imposed on Paris despite serial breaches of the Maastricht rules: "Because it is France!". The rating agencies also seem to be lenient: last week, S&P confirmed its AA rating with a stable (!) outlook. Ça alors!

Fig. 2: Risk premiums over German Bunds (2024, in %, 10-year government bonds)

Source: Bloomberg, LBBW Research

Nevertheless, investors are becoming increasingly nervous. This week, the risk premium for French government bonds briefly surpassed that for Greek bonds (see Fig. 2). A euro debt crisis is not imminent. But if fiscal laxity in Paris (and also in Rome) is not curbed soon, the day of reckoning will likely come before the end of this decade.