REPORT ON THE ECONOMIC SITUATION

7/2024

France and concerns about another EU debt crisis

Exclusive report for ACATIS Investment: Prof. Dr. Dr. h.c. Lars P. Feld, University Freiburg and Walter Eucken Institute

It seems that the worst has been averted for now: After the first round of elections for the French national assembly, it looked as though the Rassemblement National (RN), the French populist right surrounding the Le Pen family, was going to win. But in the second round of the elections, the left alliance Nouveau Front Populaire (NFP), which also includes the French Socialist Party, La France insoumise, Les Écologistes and the French Communist Party, won the largest number of seats. Financial markets breathed a sigh of relief and granted France a discount on the risk premium that French government bonds have to carry compared to German government bonds. The French must have felt like the people of Cologne: Et hätt noch emmer joot jejange.

But it only appears that way. First, the initial relief is certainly understandable. The RN is extremely critical of the EU and sceptical of Germany; it wants more mercantilist protectionism; its program contains many promises that are not covered by financial policy. But it is here that the connection between the NFP and the RN become obvious: The left alliance wants to reverse Macron's pension reforms, re-introduce wealth taxes and increase the overall tax burden on corporations; it would also continue to drive up government debt with additional expenditures that are not covered by the requisite financing. As a result, the programs of both the right and left populists would reverse many of the structural reforms that were implemented in France in the past couple of years, which in turn would adversely affect France's competitiveness and create significant financial problems. Therefore we cannot breathe a sigh of relief.

At 110.6 percent of the gross domestic product (GDP), France already has a sovereign debt ratio that is far above the 60 percent level of the European Stability and Growth Pact (SWP). The budget deficit (5.5% of GDP) was also well above the 4.9% of GDP that was promised in the year previous. It took the EU Commission until the middle of June this year to commence proceedings against France on account of excessive deficits. At the beginning of June, Standard & Poor's lowered the rating for French government bonds from AA to AA-. When it comes to France, this is not a time for tranquillity in the bond markets.

This raises the question of what could happen if France’s financial policies continue to drift in the direction of unsustainable government debt. The experience of earlier debt crises has shown that potential creditors in bond markets are willing to stay quiet for a long time, particularly in the case of large debtors such the French government. If such a debt policy continues without changes, however, all that is needed is a singular event, an exogenous shock, an irresponsible financial policy decision, or a subsequent report of a much higher deficit to reverse the sentiment in financial markets. In that case, risk-averse institutional investors will start to withdraw very quickly, which will start a spiral of ever stricter and deteriorating refinancing conditions.

However, the Transmission Protection Instrument (TPI), which the European Central Bank (ECB) introduced at the start of its rate hike cycle, also makes it possible counter risk premiums applied to the bond yields of a member state, which are not justified by fundamental data, through bond purchases. There are already discussions under way whether such risk premiums would be justified by the fundamental data. Indeed, one fundamental date of French financial policy is the government's unwillingness to consolidate its finances since the 1980s. France has cared little about European fiscal rules; it did not have to because - in the words of former EU president Jean-Claude Juncker - it is France, after all.

Therefore the use of the TPI would only be justified if contagion effects in other Eurozone countries (e.g. Italy) and therefore another sovereign debt crisis in the EU as a whole could be avoided. Can the ECB afford to do that? At a conference, and before the second round of French parliamentary elections, Germany's federal finance minister Christian Lindner expressed his doubts in that regard. Because the German government is feeling the pressure of the German Constitutional Court. Triggering the TPI could be unconstitutional, so that the federal government's hands would be tied.

The solution? The announced consolidation process in France must continue. The new government parties must agree to that. The EU Commission faces a big responsibility if it wants to enforce the new rules of the SWP for France.

Sincerely yours

Prof. Dr. Dr. h.c. Lars P. Feld