[How bond investors soured on France (economist.com)](economist.com)

Keeping up with the neighbours

How bond investors soured on France

They now regard the euro zone's second-largest economy as riskier than Spain

Photograph: Getty Images

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When Michel Barnier, France's new prime minister, submits his budget to parliament on October 10th he will be doing so against a painful market backdrop. A fortnight ago the yield on French ten-year government debt surpassed that of Spain, suggesting that investors see the euro zone's second-largest economy as riskier than its southern neighbour's (see chart 1). That is quite the turnaround. In January Spanish yields were around 0.4 percentage points higher than their French equivalents; at the worst of the euro-zone crisis, the gap was nearer five full percentage points. French borrowing costs are now well above the levels of Portugal and closer to those of Greece and Italy than they are to Germany's.

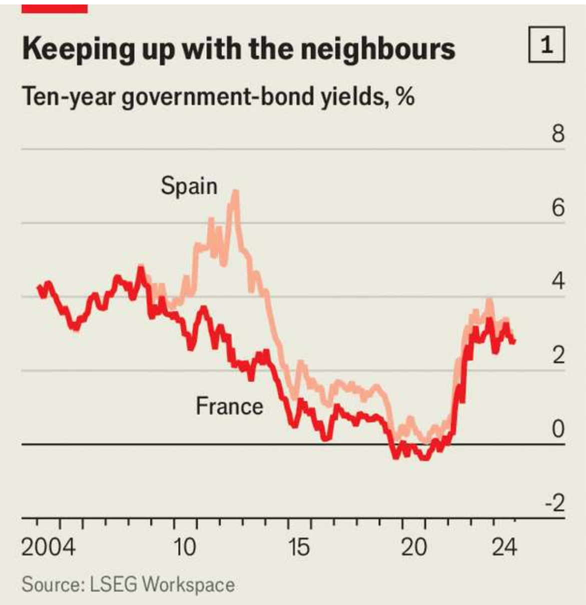

Chart: The Economist

Investors were once willing to give France the benefit of the doubt, even as it racked up debt. What has spooked them is the political turmoil following President Emmanuel Macron's decision to hold snap legislative elections in July and the precarious minority government that has resulted. Government debt stood at 111% of GDP at the end of March, well above the European Commission's recommendation of under 60%. France's deficit this fiscal year is on course for around 6% of GDP, exceeding forecasts. Mr Barnier's budget will include tax rises and spending cuts. But his government faces an uphill task getting the budget passed. It has already pushed back plans to bring the deficit down to 3% of GDP from 2027 to 2029.

The reversal in French and Spanish yields also reflects developments south of the Pyrenees. The Spanish economy grew by 2.7% in 2023, boosted by a strong labour market and a booming tourism sector, almost seven times faster than the euro-zone average and well above France's sluggish 0.7% expansion.

Spain also lacks a majority government. Oddly, though, European bond managers have in recent years seen this as a fiscal strength. Rather than haggling over budget-setting, Pedro Sánchez's minority left-of-centre government has taken to rolling forward previously passed fiscal plans. This has helped keep a lid on spending. Spain has also received around four times more of the EU's covid-19 recovery funds than France, helping the economy bounce back relatively quickly from the pandemic.

Despite the diverging fiscal and economic outlook, France retains a higher credit rating than its southern neighbour. That makes French bonds look cheap relative to their current rating (see chart 2). But some big investors believe the gap probably reflects market expectations of a downgrade. Fitch and Moody's, two rating agencies, are due to review their ratings for France on October 11th and 25th, respectively. S&P, another agency, is due to follow suit on November 29th.

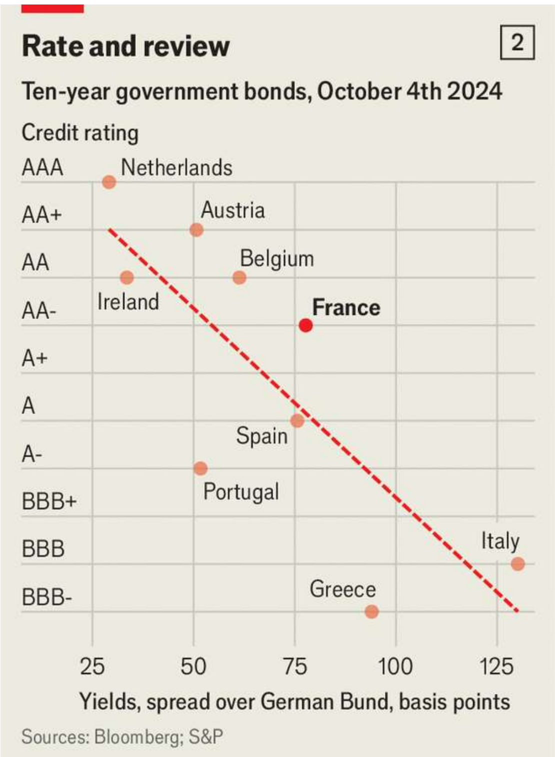

Chart: The Economist

For the past 15 years or so France has benefited enormously from the fact that the euro zone's southern members were in a bad way. International investors wanted exposure to euro-denominated public debt. But the fiscally prudent northern member states, such as Austria, Germany and the Netherlands, issued too few bonds to satisfy them, and Greek, Portuguese and Spanish debt was deemed too risky. French bonds, which were relatively plentiful, became attractive by comparison. Since then, however, Greece, Portugal and Spain have undertaken painful fiscal adjustments. France's weak growth, high debt levels and volatile politics are not an attractive offer for investors now that other options are available.

French policymakers cannot rely on the European Central Bank (ECB) to come to the rescue. In 2022 the central bank approved the use of the Transmission Protection Instrument (TPI), which allows it to intervene in the sovereign-debt markets of individual euro members if it believes a country's financing conditions are deteriorating in a way that is "not warranted by country-specific fundamentals". The TPI, in theory, allows the ECB to buy unlimited amounts of bonds if it believes that the transmission of monetary policy is being impeded by market moves. In reality, though, the ECB knows that such an act would be deeply unpopular in Germany and other fiscally prudent member states. In any case, it is hard to argue that the increase in French borrowing costs is not driven by fundamental factors.

As a result, more pain lies ahead. The risk premium on its debt means that France will not benefit as much from the ECB’s interest-rate cuts in the months to come. Meanwhile, fiscal policy will gradually tighten; soggy growth may become soggier still. France reaped rewards as its neighbours struggled. Now they have put their own fiscal houses in order, it will have to do the same. ■