Insights
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France's Fiscal Fragility Strains the Eurozone

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In our second Focus on Fiscal article, we examine the challenges facing the euro area, and France in particular, over the coming years. To paraphrase Tolstoy, each fiscal situation is problematic in its own particular way, yet none is more so than in the eurozone — given the nature of the monetary union.

Fiscal stress in one member state can have direct spillover effects across the entire currency bloc. Furthermore, there are multiple political layers between national and European bodies that can undermine market confidence. While we believe a repeat of the European sovereign debt crisis (2010–2012) remains unlikely, low growth and pandemic-driven excess government spending are setting the scene for increased fiscal stress and internal tensions toward the end of this decade.

What does this mean for investors? This fiscal landscape portends a weaker euro given that Europe's lower growth and inflation picture suggests a steeper monetary easing cycle than in the United States.

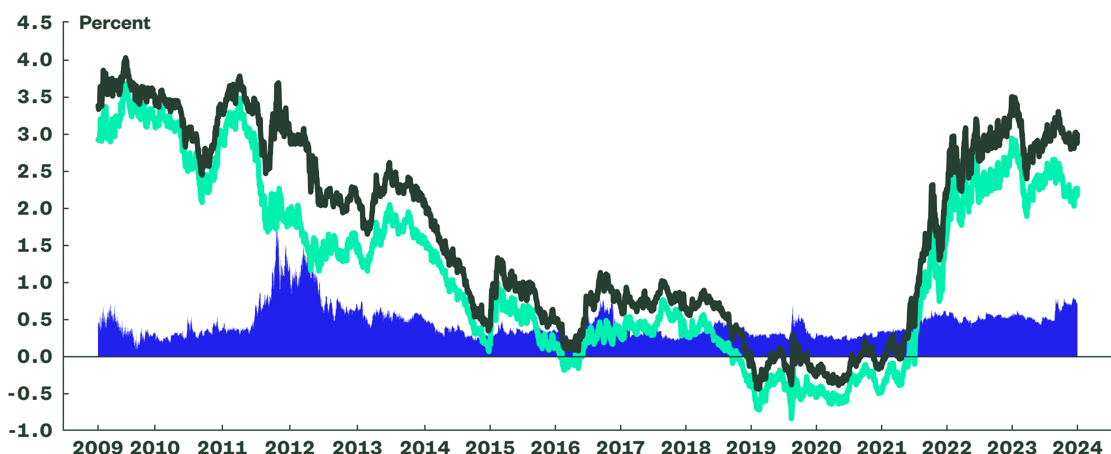
Eurozone Sovereign Risk Migrates From Periphery to France

A brief historical recap helps frame where fragility sits in the current system. The original monetary union had fixed fiscal requirements, but they were not rigidly applied. In addition, the Global Financial Crisis (GFC) of 2008 revealed structural imbalances in several economies, leading to a saddling of liabilities on the sovereign balance sheet. This led to the 2010-2012 eurozone sovereign debt crisis when worries about the potential for sovereign defaults in the periphery took center-stage — Greece, Spain, Ireland, and Portugal — and heightened the threat of a disintegration of the currency area.

To restore market confidence, European policymakers imposed a procyclical policy mistake in the form of austerity in recession time. Years of below-trend gross domestic product (GDP) growth followed, accompanied by 'internal devaluation' in several so-called peripheral countries. While these governments' finances did eventually stabilize, the low-growth era exposed Italy as the sovereign with the highest debt burden and the epicenter of market concerns. Italian government bond yields drove intra-eurozone cross-border capital flows as well as the euro exchange rate. While Italy has actually pursued responsible budgeting since the 1990s, running primary surpluses nearly every year, it had joined the single currency with a large mountain of legacy debt. In 2020, the pandemic triggered continent-wide fiscal intervention and narrowed the gap between Italy and the rest.

By 2024, annual deficits have still not normalized in many countries, most notably in France. The latter's size and centrality to the monetary union mean that today's fiscal stress and sovereign risk are largely concentrated in France's budgetary politics.

Figure 1
French and German Yields Widen
(10-Year Yields, 2009–2024)



Source: Macrobond, State Street Global Advisors, as of November 1, 2024.

France's Fiscal Weakness Emerges

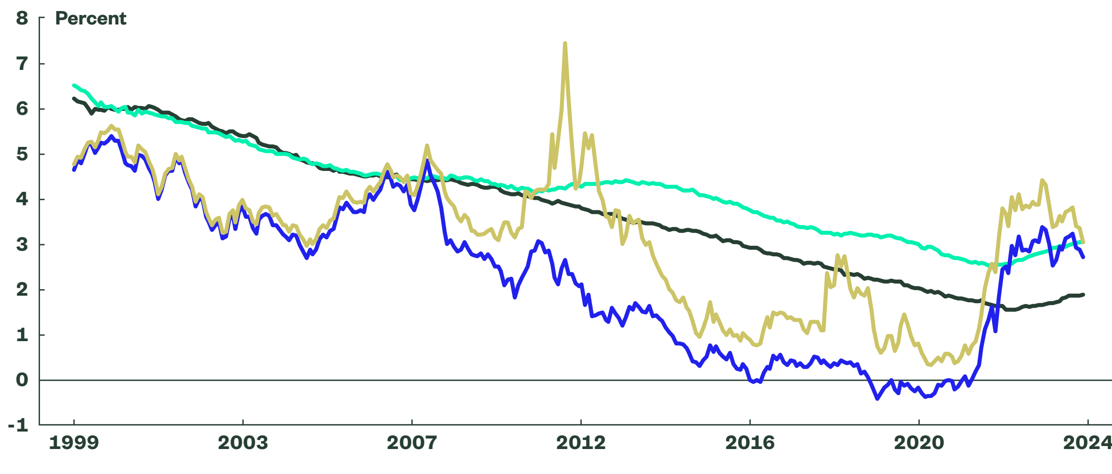
During the post-2008 period and the pandemic era, France enjoyed tailwinds that eased pressure on public finances. The sovereign debt crisis drove capital allocation from peripheral countries to the core, primarily toward Germany but France was also a beneficiary. In 2009, non-residents held about 40% of France's debt stock. This figure rose to above 50% by 2015. When that peaked, the European Central Bank (ECB) began its quantitative easing (QE) program to help lift European growth. Due to the requirement to match the ECB's capital key, this included sizable purchases of French government bonds, leading the ECB to acquire 17% of outstanding debt by 2019.

Additional QE followed the onset of the pandemic. The net effect is that financing conditions for the French sovereign were flattened for a long period — e.g., the 10-year bond was yielding an average of just one percent in the 2014–2022 period. This era is now definitely over as price-insensitive buyers like the ECB retreat from the market.

The recent widening of the yield spread between French government bonds and German government bonds (OAT-Bund spread) has commanded much attention. However, what matters most is how yield levels translate into what a country ultimately pays for its public debt — a country's interest bill is determined by the average coupon, not the prevailing yield. The coupon on newly-issued debt is generally set close to prevailing market yields. Therefore, over time, those yields feed into the average coupon on the entire stock of debt. The good news is that France's average coupon is less than 2% due to the ultra-low yields noted above (Figure 2). However, the bad news is that France has substantial quantities of debt to refinance in the coming years — almost 50% of its total public debt between 2025 and 2029. And as long as market yields remain above 2%, the average interest bill on France's public debt will rise.

Nonetheless, the Italian experience during the eurozone debt crisis is instructive. Because the extreme spike in yields was quite brief, those yields did not have a significant impact on the overall average coupon, which rose by a relatively modest and very manageable 0.27% between early 2011 and the peak in mid-2013. Of course, the other side of that coin is that a sustained loss of market confidence could become self-fulfilling for French public debt if higher yields do percolate into a sizable wall of maturing debt.

Figure 2
A Comparison of France and Italy Coupons



Source: Bloomberg L.P. Data as of September 30, 2024.

Implications of France's Fiscal Stress

The outlook for France's fiscal policy will drive market prices and it is not rosy. France's economy has the highest share of government expenditure (57% of GDP), not only in the eurozone but among all developed economies worldwide. Similarly, France also imposes the highest tax burden of any country in the Organization for Economic Co-operation and Development (OECD), so there is limited room to extract more tax revenue from the economy. To compare, France spends about 7% more on public expenditures than the eurozone average, and this is one of the main reasons for France's fiscal stress.

In contrast to Italy, where higher nominal GDP growth is the key to sustainable public finances, France's vulnerability is that high deficits are driven by excess spending that cannot conceivably be offset by higher growth. Instead, some fiscal consolidation is required while being extremely difficult to achieve politically.

Concurrently, the eurozone's fiscal rules, in addition to market pressure, run counter to French politics. Brussels just implemented a reform that not only simplifies the fiscal rules, but also makes them more customized to each country's needs [A Better Macro Policy Framework for Europe]. However, one of the changes is that the European Commission emphasizes net expenditures: i.e. total net government spending minus one-off revenues, EU funding or cyclical unemployment costs. On this metric, France looks particularly weak. And by 2028, this figure will be extended to include interest costs, so there is an urgency to reduce the deficit in advance.

Investment Outlook for France and the Eurozone

The reality is that there is no credible fiscal consolidation imaginable that would enable France to escape the Brussels designation of the excessive deficit procedure (EDP). The EDP is a mechanism that the EU uses to ensure that EU member states maintain budget discipline and avoid excessive government deficits. Similarly, markets will continue to impose an extra risk premium on France, with the OAT-Bund spread not returning to its longer-term average in the foreseeable future. In contrast, fiscally strong eurozone members, including the periphery, will see further spread compression as some allocations to French debt are redistributed across the monetary area.

A more conceivable path toward French debt sustainability lies outside its borders. The most desirable scenario would be for those eurozone sovereigns with large fiscal space (e.g. Germany and the Netherlands) to use it for growth-enhancing measures. Europe's economic integration would ensure a substantial spillover that would lift overall regional growth, especially if defense spending continues to rise. The less desirable alternative would be a return of the ECB's bond-buying under weak economic conditions. This would lead to renewed reduction in debt servicing costs assuming that what is gained in lower absolute yields is not lost in further spread widening since the core problem remains unsolved.

The Bottom Line

France stands at the epicenter of fiscal instability in Europe as its debt burden is unnerving for EU partners and markets. We see the likely pathway for France to resume fiscal health coming from growth measures by EU members like Germany or the Netherlands. As noted, fiscal stress in one country can have sharp ripple effects across the EU. While we are not anticipating a repeat of the European sovereign debt crisis, we do see low growth and post-pandemic fiscal spending increasing fiscal stress and internal strains that could heighten pressures in the region over the medium term. Finally, all this portends a weaker euro given that Europe's lower growth and inflation suggest a steeper monetary easing cycle than in the United States.

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* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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