France's Debt Woes

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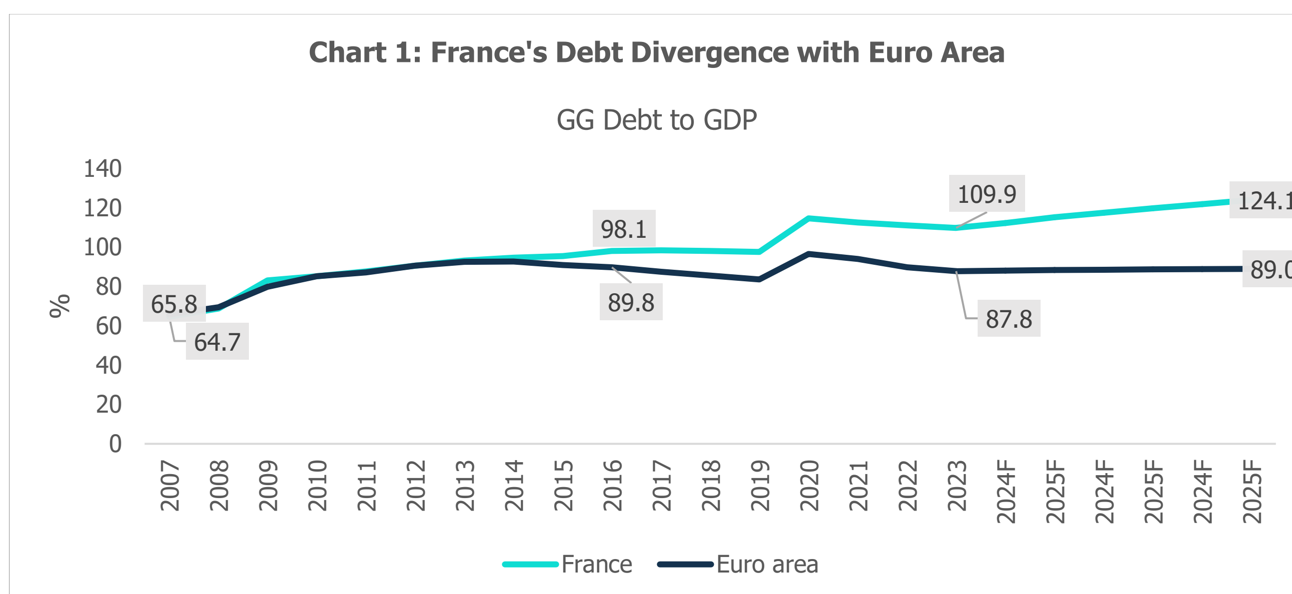
The year 2024 has been a tough for France, with budget crises, slowing economic growth, bad weather, and political turmoil. The general government debt-to-GDP is expected to reach 112% in 2024, up from 95% in 2014. Unlike its European counterparts, Germany and Netherlands, France's poor fiscal record has led to a large accumulation of debt. Consistent budget deviations indicate a poor debt culture. Exceptionally low interest rates in the past decade led to higher borrowing without significantly increasing the debt burden. However, post the Russia-Ukraine war in 2022, inflation as well as interest rates rose sharply. The prices have normalized since then and the European Central Bank is expected to continue to cut interest rates, however, the rates are expected to be higher than the near-zero interest rates (as seen in the 2014-21 period); thus, adding to the debt burden. Moreover, yields on France's 10-year government bonds have widened over Germany by 75 bps over the last year indicating a gradual loss of investor confidence.

1. Mounting Debt Burden

The 2008-09 subprime crisis and the subsequent Euro debt crisis led to a surge in debt levels across Euro Area countries. Post 2014, as the monetary union began to stabilize, most countries implemented corrective measures to actively pursue debt consolidation, while France failed to do so. This led to divergence in the debt-to-GDP path between France and the other Euro Area counterparts. Following the Covid-19 shock, the divergence almost doubled and is expected to grow wider in the next 5 years (Refer Chart 1). France's debt-to GDP is expected to rise to 124% by 2028, 35 percentage points higher than the Euro Area average of 89%.



Source: iMF October 2024 Database, F= Forecasts

2. What caused the divergence?

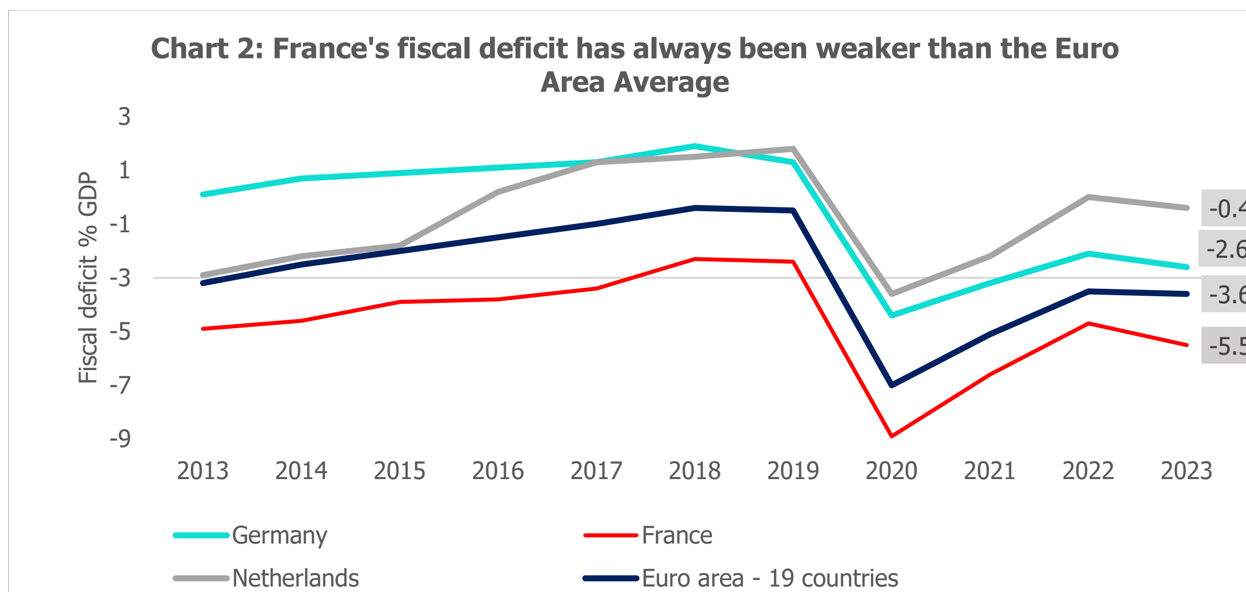
A sharper rise in France's government debt to GDP can be explained by its poor fiscal record, very high spending ratio and lack of political consensus to conduct fiscal reforms. We discuss each of these below.

A. Poor Fiscal record

Post-2014, while most Euro Area counterparts started containing or reducing their fiscal deficit, France continued to have a large general government fiscal deficit, consistently exceeding the EU target of 3% of GDP. This issue worsened post the Covid shock, with France still running fiscal deficits above 5% of GDP, while many other Eurozone governments have kept reducing theirs.

In 2024, France was placed under the Excessive Deficit Procedure (EDP), a mechanism designed by the European Union to ensure member states adhere to a 3% deficit ratio and a 60% debt ratio as enshrined in the EU treaties. France's general government fiscal deficit is expected to be 6% of GDP in 2024, compared to the first draft budget plan of 4.4% of GDP. This is second consecutive year of higher actual than budgeted deficit. Overestimating revenue receipts and overspending have led to many deviations from planned fiscal deficits in the past, resulting in France being placed under EDP several times.

To keep checks on the general government balance, France's European neighbours have implemented various strategies. For instance, since the 1980s, the Swedish economy adopted a new budgetary governance framework comprising of budget surplus and expenditure ceiling. Similarly, Germany constitutionalised the Debt Brake law in 2009. France introduced multiyear budgeting in 2008. These budgets are presented to parliament for discussion and approval, along with the annual budget laws. Ever since the introduction of this system, France has submitted multiyear fiscal plans and consistently failed to follow through on its commitments raising credibility issues.

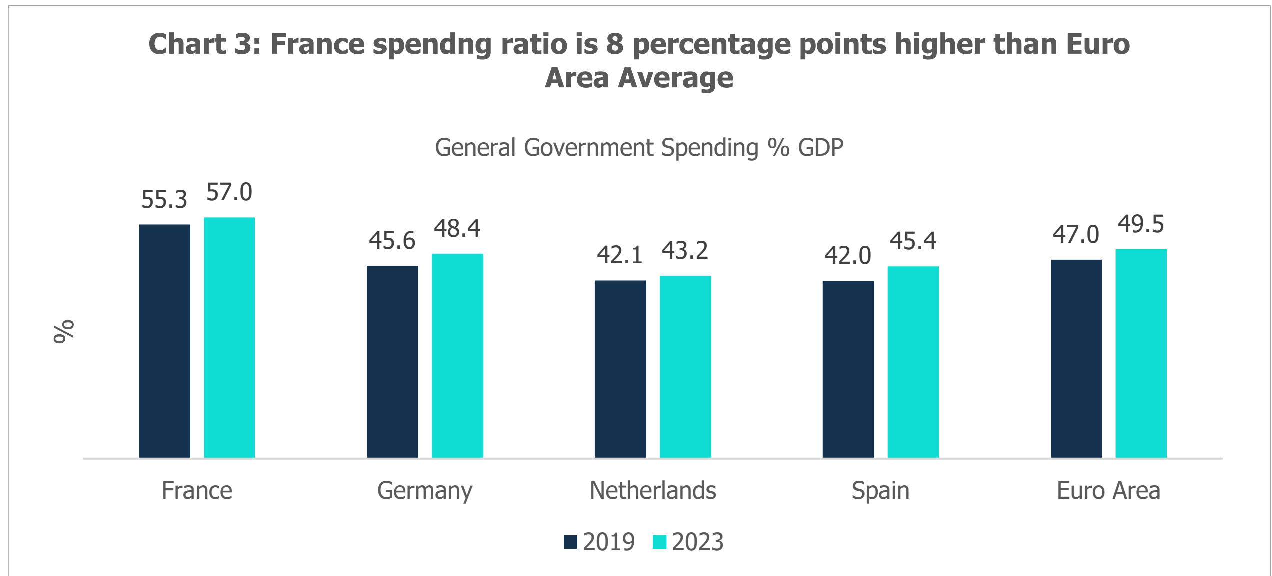


Source: Eurostat

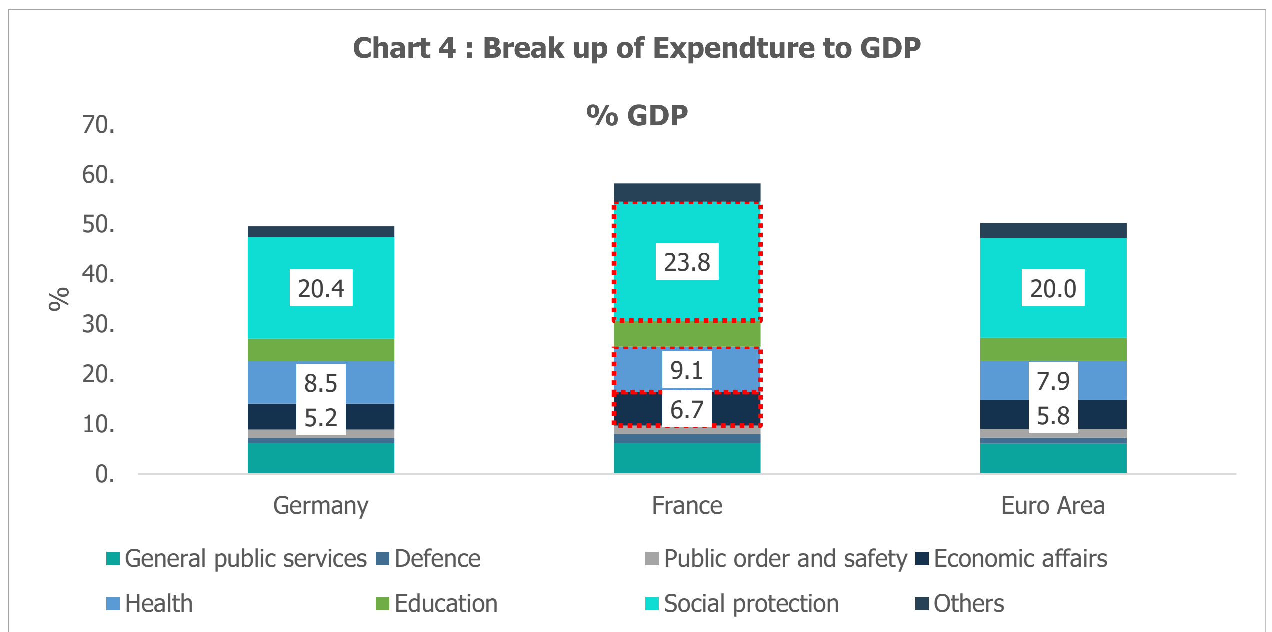
B. High Spending Ratio

France has one of the highest taxes to GDP ratio reflecting in high general government revenue to GDP ratio at 51% of GDP in 2023, one of the highest among the OECD economies. Consistently high public expenditure has caused the French malaise. Even though other European counterparts also share the same social model, France's public expenditure as a percentage of GDP is higher than other economies in the region and the gap have widened in the last decade- a gap of 8 percentage points of Euro average in 2023. This gap in spending can be attributed to high welfare spending- pensions, healthcare subsidies and unemployment benefits (Refer to Chart 4). To reduce spending, France increased its retirement age to 64

in 2023, and reduced the unemployment benefits, however, these were offset by spending related to the pandemic and energy prices-related support measures.



Source: Eurostat



Source: Eurostat, Subsidies constitute major part of Economic Affairs, Data is for the year 2022

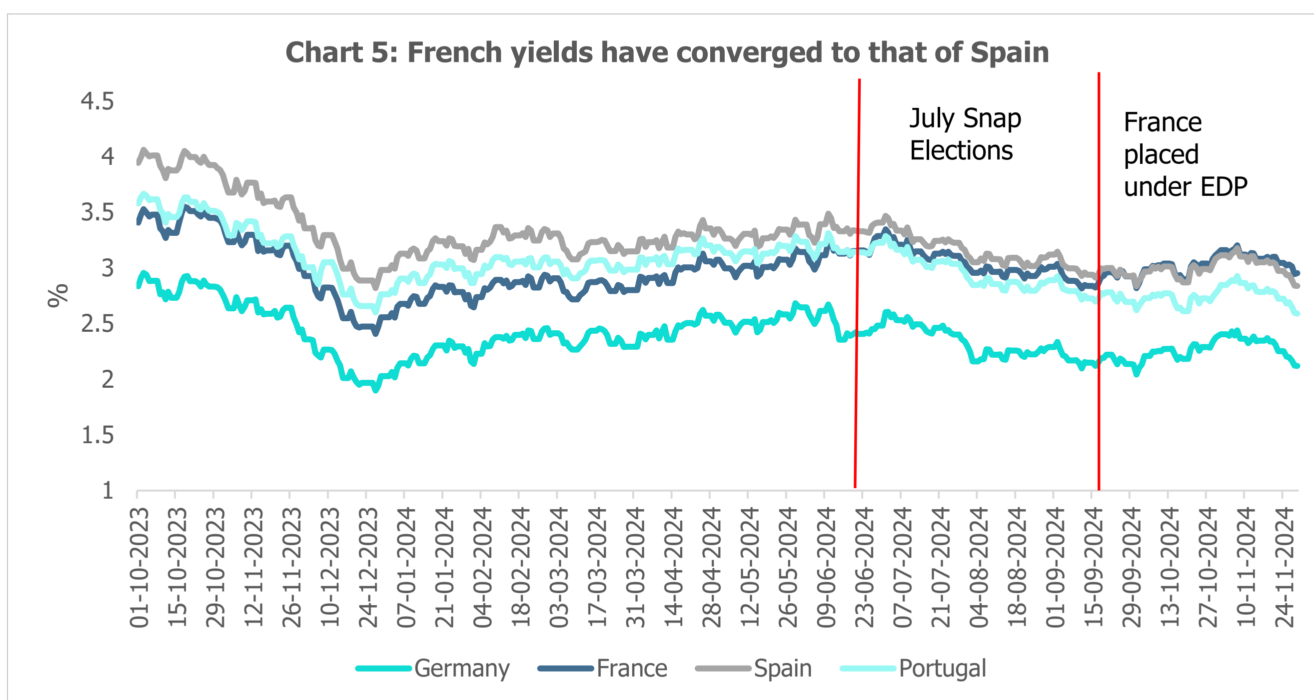
C. Political Turmoil adds more uncertainty

President Macron's decision to call early elections backfired leaving the seats split evenly between three blocs- Far Right, centre and far left bloc. The lack of political consensus has increased uncertainty regarding the fiscal consolidation path. Even in the past, it hasn't been easy for France to implement fiscal reforms, especially pension reforms, for instance, Former President Mr Hollande during his tenure (2012-17) met with strong opposition from Members of Parliament, labour unions and the public when he pursued pension reforms. Similarly, Macron faced public furore when he increased the retirement age to 64 in 2023 and the far-right demanded reversal of the same.

3. Rising Borrowing Costs Further Adding to the Debt Burden

While the European Central Bank commenced with its interest rate cuts early this year, the rates are expected to be higher than the near-zero interest rates as seen in the 2014-21 period. According to the recent winter European Commission forecasts, France's interest expenditure to revenue is expected to rise to 5% in 2026 from 3.3% in 2023.

Post the July snap elections and higher-than-expected fiscal deficit, the 10-year yield differential for France with Germany has widened. In fact, the yield differential of France with Germany has gone higher than Portugal and converged to Spain indicating a gradual loss of investor confidence (Refer Chart 5). Moreover, France's remarkably high share of external debt of about 40% of total general government debt (in 2023) could pose a risk amid rising uncertainties.



Source: LSEG Datastream

4. Road Ahead

Given the upward trajectory of general government debt to GDP, it has now become imperative for France to make tough choices by prioritising spending and improving spending efficiency. France also must improve the targeting of social and housing benefits. Furthermore, France needs to improve credibility by adhering to a fiscal consolidation path in the future. On the positive side, France has support from the European Commission in the form of funds worth EUR 80 billion under the National Recovery and Resilience Plan (NRRP) targeted towards green transition, digitisation and next-generation reforms. Going ahead, the impending deleveraging process is expected to weigh on economic growth.

Contact

Rajani Sinha	Chief Economist	rajani.sinha@careedge.in	+91 - 22 - 6754 3456
Shobana Krishnan	Consultant	c-shobana.krishnan@careedge.in	+91 - 22 - 6754 3456
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CareEdge Global IFSC Limited
(subsidiary of CARE Ratings Ltd.)
Unit No. 06, 11 T-2, Block-11, GIFT SEZ, Gift City, Gandhi Nagar, Gujarat – 382355 I CIN-U66190GJ2024PLC151103

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 I CIN: L67190MH1993PLC071691

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