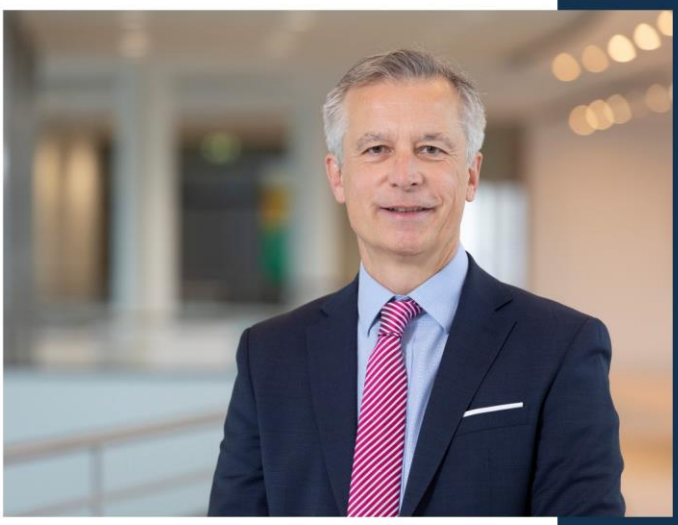


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To the point!

Cross-Asset- and Strategy-Research

Postcard from Paris

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November 6, 2026

France's government between Scylla and Charybdis

This week, work took me back to France for a speaking engagement, my first visit in a while. I also met up with my daughter, who is spending a semester in Paris on the Erasmus student-exchange program. Not necessarily at university, though: protesters have been blocking access for weeks. Instead, she is spending her time studying the city – not by choice, but certainly enjoying herself and learning plenty.

France is in a real bind. Crowds are taking to the streets to demand more spending on education and a lower cost of living – at times resorting to violence, arson and looting. On Saturday, I witnessed clashes between protesters and security forces at the Place de la Bastille.

Meanwhile, French government bonds are under pressure. With yields approaching 5%, public finances already out of control are coming under further strain. The yield spread over German government bonds has reached 160 basis points (see fig. 1). It was last this wide during the euro crisis. Back then, Germany was still seen as the guardian of fiscal prudence. Those days are gone, too. France's government is now struggling to secure a majority for its 2027 budget. The draft envisages a deficit of 5%. That is distinctly unambitious.

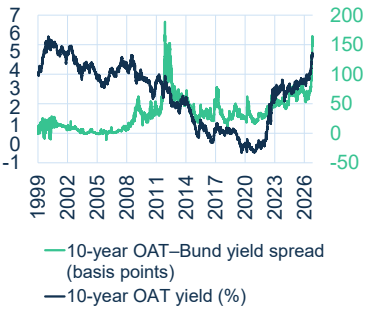
Présidente Le Pen at the gates

Complicating matters further, a presidential election is due in April. Marine Le Pen of the right-wing National Rally (RN) is considered a strong contender and could well enter the Élysée Palace on her fourth attempt. The good news is that the RN's platform is less radical than it once was, when the party toyed with such reckless ideas as leaving the euro.



Vandalized ATMs and boarded-up shops in Paris.
Photos by the author

Fig. 1: French government Bonds (Interest Spread over Bunds)



Source: LSEG, LBBW Research

Le Pen would certainly not be investors' preferred candidate. There are worse alternatives: Jean-Luc Mélenchon, leader of the populist left-wing party La France Insoumise (LFI), advocates canceling outright the government debt held by the central bank. That would probably have adverse consequences elsewhere in the euro area, too, since it would call the rule of law into question. Fortunately, the likelihood of this happening is very low.

The approaching election leaves little political room for maneuver. Emmanuel Macron's centrist government lacks a majority; so would the RN or the far left. The rival camps block one another, understandably unnerving markets. In 2018, fiscal concessions helped quell protests by the so-called yellow vests, or gilets jaunes. Today, that escape route is closed. Capital markets would punish any such concessions severely.

The government led by Prime Minister Sébastien Lecornu must navigate this fiscal strait much as Ulysses sailed between the sea monsters Scylla and Charybdis in Greek mythology. Whether it can do so remains an open question.

The sick man of Europe

Business sentiment is subdued. Consumption and private investment are correspondingly weak. Little wonder that real GDP has stagnated for a year (see fig. 2). Since the final quarter of 2025, France has been the worst performer among the euro area's four largest economies. That makes the necessary structural fiscal adjustment still more challenging.

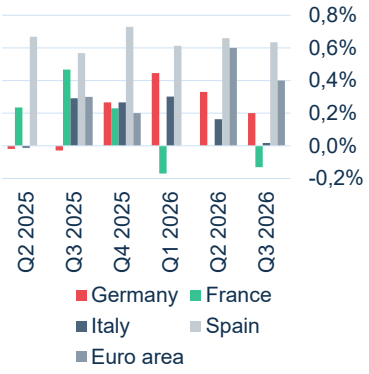
Yet this is not a second euro crisis. Nor should it become one. With government spending accounting for 57% of GDP, there ought to be ample scope for savings. There are also signs that investors would return to French government bonds at yields above 5%.

The European Central Bank is extremely unlikely to deploy its Transmission Protection Instrument (TPI) for France. The TPI would allow the ECB to target its purchases at a particular country's government bonds. But the instrument is intended for governments facing speculative attacks through no fault of their own. France could hardly claim to meet those conditions. And the ECB can only buy time anyway. Paris must put its own house in order.

The prospects for structural solutions look bleak before the election. Le Pen at least talks about fiscal consolidation. But spelling out how she would repair the public finances is naturally difficult for a populist politician. Specifically, she has proposed reducing France's contributions to the EU. Since those are governed by treaty, little is likely to come of that. Investors will probably have to tighten the screws further before the government can bring itself to take measures that put the public finances on a sustainable footing.

Rien ne va plus

Fig. 2: Quarterly GDP growth rates



Source: LSEG, LBBW Research

The ECB is unlikely to activate the TPI

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This document is a translation of Kraemers Klartext, "Postcard from Paris", original publication date: 06.11.2026. The translation has been made for convenience only with the German original always prevailing in all aspects, especially in case of potential discrepancies resulting from the translation.

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