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Cross-Asset- and Strategy-Research

A fiscal accident waiting to happen

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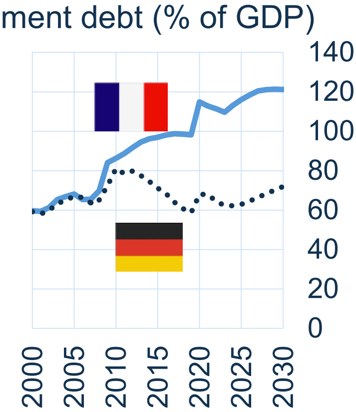
But France is not the only country losing control of its public finances

When I began analyzing European sovereign credit at a major rating agency in early 2001, Germany and France were almost indistinguishable in terms of debt, deficits and broader macroeconomic indicators. They were, to borrow from the “Tintin” comics, like the near-identical detectives Thomson and Thompson – distinguishable only to committed connoisseurs. The finance and foreign ministers of what were then the twelve member states of the European Community did not pick a public-debt ceiling of 60% of GDP in the Maastricht Treaty at random. That level essentially mirrored the debt ratios of the bloc’s two economic heavyweights, Germany and France.

There was little to worry about when the euro was launched

That was a long time ago. Fast forward to today, and the contrast could hardly be starker – even though Germany itself has now embarked on a debt-funded spending spree. France’s general-government gross debt stands at 118% of GDP, compared with 65% in Germany (see fig. 1). Since 2020, France’s budget deficit has averaged just under 6% of GDP – roughly twice Germany’s (see fig. 2). Over the same period, French public spending has risen to 57% of GDP. In Germany, that ratio is expected to exceed 50% for the first time this year – a threshold beyond which, as former German chancellor Helmut Kohl once quipped, socialism begins.

Fig. 1: General government debt (% of GDP)



Source: IMF, LBBW Research

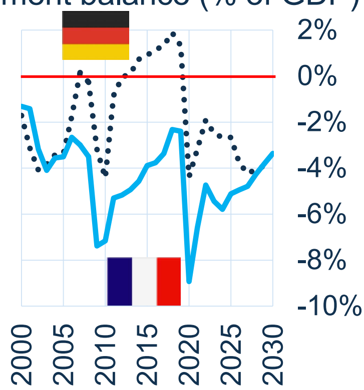
Quel dommage!

Why have the numbers drifted so far apart when the two countries were near-macroeconomic twins some 25 years ago? The explanation is not weaker growth in France. Since the turn of the millennium, the French economy has in fact grown slightly faster than Germany’s. My own view is that the divergence largely reflects different approaches to fiscal rules – with Germany, until recently, sticking to its self-imposed “debt brake,” a constitutional cap on structural deficits. Fiscal rules tend to work best in societies that least need them, because of a preexisting broad consensus on the virtues of cautious fiscal policy. France last recorded a budget surplus in 1974. In German, on the other hand, the word for “debt” is the same as for “guilt”.

Many societies today are sharply polarized – Germany increasingly among them. The deeper the divisions, the weaker the attachment to fiscal discipline is likely to be. Governments try to win over voters with generous promises, even though this tactic has yet to deliver lasting results anywhere. Against that backdrop, the highly contentious presidential election that France faces in 2027 is another source of anxiety.

Fiscal rules have made all the difference

Fig. 2: General government balance (% of GDP)



Source: IMF, LBBW Research

The slow unravelling of Europe’s stability pact

In theory, the European Union’s Stability and Growth Pact (SGP) – designed to keep member states’ deficits and debts within bounds – could have played a role similar to Germany’s debt brake. In practice, Brussels has struggled to enforce it through credible sanctions. Some may still recall the comment made in 2016 by then-European Commission president Jean-Claude Juncker, when he explained why Paris was being granted more fiscal leeway: “Because it is France!”

Europe’s stability pact has fallen short

Successive exemptions and special arrangements have further undermined the SGP’s credibility. And, unsurprisingly, the adjustments have been one-sided: in difficult times the EU has effectively relaxed the limits; in more benign periods – for instance during the long era of ultra-low interest rates – there was no offsetting tightening of the targets.

Capital markets now have to deliver the wake-up call

In principle, it falls upon rating agencies to sound the warning. Yet they increasingly appear reluctant to confront the very sovereigns that regulate them. The wave of lawsuits and regulatory counter-attacks in the euro area after the sovereign-debt crisis was not lost on the agencies. The fact that two of the three major firms (S&P and Fitch) now assign France only an A+ rating is less daring than it might seem. Historically, according to data from S&P Global, the five-year default probability for a sovereign in the A category has been only about 1% – essentially negligible. Germany’s AAA – the credit-rating equivalent of a top grade with an extra star – remains unquestioned by all agencies.

Only capital markets can now enforce discipline

That leaves capital markets to enforce discipline through higher borrowing costs – precisely the outcome the SGP was meant to prevent. With every year that the debt binge continues – not just in France, but [across most large advanced economies] – the risk grows that governments will exert such pressure on central banks through their fiscal stance that monetary policymakers can no longer focus on price stability without pushing sovereigns into trouble. That is a bleak prospect – for price stability and financial stability alike. Better to make a fiscal U-turn now!

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