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France & Italy: Roles in reverse?



Concerns are rising about France's ability to reduce its debt burden amid political instability and debt rating downgrades. Meanwhile, Italy has made progress in reducing its budget deficit in recent years, prompting the question: are the countries roles reversing?

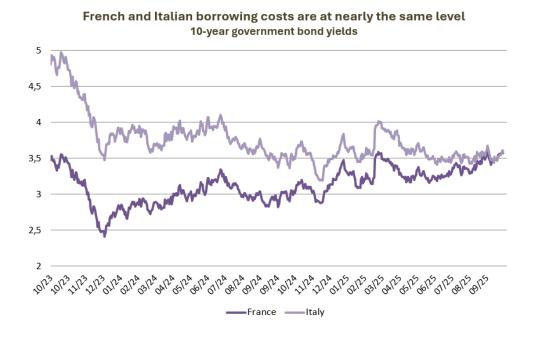
The political turmoil that has plagued France since President Macron called a snap election in June last year reached a new high in September, when the government collapsed after Prime Minister François Bayrou lost a vote of no confidence. Bayrou was ousted and replaced within a day after looking to gain parliamentary support for his deficit-cutting budget, which included tax increases and spending cuts. The baton was then passed to Sébastien Lecornu, who has now begun the race to get the budget across the finish line and approved by parliament before the end of the year. He is France's fifth prime minister in less than two years — one more than is typical for a relay team sharing the sprint to the finish line.

Lecornu received a rather cool welcome to his new role as one of the three major rating agencies, Fitch, downgraded France's debt rating to A+ (stable outlook) from AA- (negative outlook) only days after he took office. This was due to concerns that political instability will hinder the country's ability to reduce its deficit. Within a week, Morningstar DBRS followed suit, demoting France's long-term issuer rating to AA from AA (high) and changing the outlook from stable to negative.

This growing lack of confidence in France's ability to reduce its debt burden, with a deficit of 5.4% of GDP, raises the question:

Is France becoming Europe's new fiscal problem child?

For the last 20 years, this title has often been attributed to Italy, which has become synonymous with reckless spending and unsustainable debt. However, just a few weeks ago, the borrowing costs of both Italian and French 10-year government bonds reached the same level, as the gap between their respective bond yields narrowed to zero basis points (bps). For comparison, the difference between the two countries' 10-year government bond yields was around 40 bps in April this year and 200 bps during the pandemic. A higher yield on government bonds means that governments have to pay more to finance their debt. In this case, it suggests that investors now consider French bonds to be as risky as Italian ones.

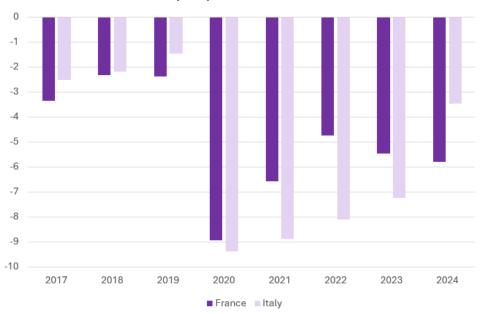


Source: Bloomberg, BIL

One clear difference between the two countries today is, one has had two prime ministers ousted by confidence votes in nine months, while the other has had the same government in power for almost three years. Furthermore, this government has made progress in reducing its country's deficit. When Giorgia Meloni became Italy's prime minister in 2022, the country's budget deficit stood at 8.1%. By 2024, this had fallen to 3.4%, and it is expected to drop below the EU target of 3% next year.

While both countries increased public spending significantly in response to the pandemic and the energy crisis that followed Russia's invasion of Ukraine, France has not yet managed to reduce spending, having introduced tax cuts with the ambition to boost growth in the meantime.





Source: IMF, BIL

The risk perception of Italian government bonds has also improved since Meloni came into power. In October 2022, the BTP-Bund spread (a comparison between Italian government bonds and German Bunds, which is a key indicator of the market's appetite for Italian bonds) was around 250 basis points. Since then, it has narrowed significantly, reaching approximately 80 basis points. Meanwhile, the French equivalent, the OAT-Bund spread, has widened from around 50 basis points before President Macron called the snap election last year, to around 80 basis points. This illustrates the contrasting changes in perception of the two countries.

What are the practical consequences of France's mounting fiscal problems and subsequent credit downgrades?

A downgrade typically increases the risk premium demanded by investors for buying sovereign bonds. However, in this case, it seems that the markets had already priced in France's credit rating downgrade before it was announced. Nevertheless, these kinds of downgrades could prompt investors to review their sovereign risk frameworks, as certain investment mandates may include restrictions on acceptable bond ratings. This is unlikely to be the case with France's downgrade though. After all, the country still holds A+ (stable), AA- (negative) and Aa3 (stable) ratings from the three biggest credit rating agencies, which is a strong assessment of France's government bonds. France's rating also remains several notches above Italy's, which Fitch recently upgraded from BBB to BBB+.

Much will depend on the ability of France's newest prime minister to forge a compromise that not only satisfies his political opponents but also effectively addresses the budget deficit, which the Ministry of Finance projects could rise to 6.1% of GDP by 2026 without intervention. For

France to avoid being labeled as "Europe's fiscal problem child", and the diminished confidence that accompanies such a reputation, the new government will need to build a convincing plan to reduce the country's debt burden, sooner rather than later.

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