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FRANCE

France’s budget offers no quick relief for bond markets

France’s fiscal package would prevent the deficit from reaching 6.5% of GDP next year, but it would not stabilise public debt. With a difficult political process ahead, French bonds are likely to remain under pressure, while the threshold for ECB intervention remains high



French PM Sébastien Lecornu today unveiled the country's 2027 draft budget

What is in the new budget?

France’s minority government today presented its plans for the state budget (PLF), and a separate bill covering the financing of the social security system (PLFSS). The government aims to bring the public deficit back to 5% of GDP in 2027, after an expected increase from 5.1% in 2025 to 5.4% in 2026. Without corrective measures, the deficit would instead reach around 6.5% next year, as interest payments, pensions and other expenditure continue to rise.

The budget contains €43bn of measures compared with this no-policy-change scenario. Together with the growing impact of previous decisions, the total effort affecting the 2027 accounts would reach €54bn.

Much of the adjustment would come from higher revenues. The tax burden would rise from 43.9% to 44.2% of GDP through targeted measures affecting households and companies.

These include a lower tax allowance for pensioners, changes to the taxation of sick leave and termination payments, fewer tax exemptions and stronger action against fraud. The surcharge on large companies would remain in place, while employers' social security reductions would be cut.

Public spending would continue to rise, but more slowly than economic growth. It would decline only slightly as a share of GDP, from 57.1% in 2026 to 56.9% in 2027. Interest payments are projected to jump by €12bn to €91bn, while defence spending would rise by €6.4bn.

Savings would therefore fall on other areas. Most ministerial budgets and civil service pay would be frozen, along with housing benefits and family allowances. Higher pensions would not be indexed to inflation, generating €4.1bn in savings, while smaller pensions would be protected. Healthcare and local government spending would also be more tightly controlled. The structural effort (excluding cyclical factors and the debt burden) to reduce the deficit is estimated at 1.2% next year, which is in line with the European criteria limiting the growth of so-called 'controllable' expenditure (at +0.7 per cent, the lowest rate of growth since 2017).

Even if fully implemented, the budget would only slow the deterioration. Public debt, already at 119% of GDP in mid-2026, is projected to reach 121.7% in 2027. A deficit of 5% would still be far too high to stabilise it.

A modified budget is the most likely outcome

The two bills must be formally filed at the National Assembly by 6 October, with the plenary debate scheduled to begin on 13 October. From the filing date, parliament has 70 days to complete the procedure for the state budget and 50 days for the social security budget. The main deadlines will therefore fall between late November and mid-December.

A straightforward parliamentary agreement appears unlikely given the absence of a stable majority. The more plausible route is that several weeks of negotiations produce a modified budget, but not enough support for a formal vote. The government could then use Article 49.3 of the constitution, which allows it to pass the bill without a formal vote, unless an absolute majority of MPs vote to bring down the government.

A successful no-confidence motion would force the government to resign and prevent the budget from being adopted through Article 49.3. It would not automatically trigger a general election, which would require a separate decision by the president.

If parliament failed to complete the procedure before the constitutional deadlines, the government could try to implement the budget by ordinance. This has never been done for a budget under the Fifth Republic and would be politically and legally contentious. If no full budget were ready by 1 January, a special law could temporarily maintain existing taxes and

essential expenditure, but that would lead to a sharper deterioration of public finances.

The key question therefore is whether the opposition can assemble an absolute majority for censure. Both the Socialist Party and the Rassemblement National face a difficult choice. Bringing down the government would underline their opposition, but could prolong the uncertainty and leave the winner of the 2027 presidential election facing an even more urgent fiscal problem.

The RN currently appears inclined to avoid censure. According to *Le Monde*, it would prefer to enter 2027 with an imperfect budget that could later be amended rather than inherit no full budget and have to prepare an emergency one after the election. Crucially, the RN and the Socialists do not need to support the budget. For them, it might look more comfortable to blame the current government for the austerity policies in the run-up to the presidential elections. Unless they unite behind the same no-confidence motion, the motion is unlikely to secure the required majority.

A modified budget is therefore likely to be adopted eventually, probably through Article 49.3 rather than a parliamentary vote. But before that, the coming weeks are likely to bring lengthy negotiations, amendments and shifting political positions.

Buying time, not solving the problem

Adopting a full budget would be a relative success. It would prevent the deficit from rising towards 6.5% and avoid a prolonged period without a proper fiscal framework.

But it would not resolve France's structural fiscal problems. The deficit would remain too high to stabilise the debt ratio, while ageing-related expenditure and interest payments would continue to rise. The next government will therefore have to make further difficult choices.

So far, none of the main presidential candidates has presented a sufficiently detailed plan explaining which expenditure would be reduced, which taxes would change or how the debt ratio would eventually be stabilised. The 2027 budget could buy France some time. It would not make the fiscal problem disappear.

Charlotte de Montpellier

Bond spreads face further widening pressure as positive catalysts remain elusive

The budget plan marks a substantial effort towards fiscal consolidation. It may offer some temporary relief for spreads. But this is the government trying to convey the urgency of the situation – and bond markets will watch whether parliament takes notice or remains preoccupied with pre-election positioning.

Even taking into account some potential relief now, looking ahead we see spreads remaining in a range well above the 100bp level – more likely testing levels towards 150bp.

At the time of writing, the widely watched 10y OAT/bund spread has already topped 130bp. That is a 46bp widening since the start of September when the spread stood at 86bp. Picking out next target levels appears arbitrary at this point, as there are few anchors to hold on to. The next local highs were at 145bp, last seen during the sovereign debt crisis. The combination of increased volatility and a prolonged timeline of uncertainty is likely to keep the spread under widening pressure as it curbs investor appetite for French risk even if valuations start to look stretched. A positive catalyst appears elusive for now.

With a view to next year's presidential elections, the candidates' fiscal plans remain too vague to offer reassurance. With the latest polling results coming in, markets are increasingly concerned about the presidential race becoming a face-off between Le Pen on the far right and Melenchon on the far left. That is another potentially growing tail risk that markets have to consider, risking further spread widening. Remember that Melenchon spooked the establishment with a controversial proposal to convert French bonds held at the Bank de France into zero-coupon perpetual bonds.

There was a notable shift from the market pricing a mainly political risk premium towards pricing actual credit risk, at least judged by the credit default swaps market. French 5y CDS spreads have widened by 36bp to 72bp since the start of September. In terms of dynamics, it slightly surpassed the pandemic impact, and we are now on par with levels last seen when Le Pen ran on a 'Frexit'platform in the 2017 elections.

It is important to add some perspective: the levels are only slightly above a range where Italy was traded from 2024 to early 2025 – and Italy's spread had spiked to above 250bp when the pandemic hit. But before markets can return to assessing France's pricing relative to underlying fundamentals, we will likely need to see political stability first. A path that Italy has also shown.

Benjamin Schröder

Will the ECB step in?

The widening French spread raises the question of whether the ECB could intervene through its Transmission Protection Instrument (TPI). TPI allows the ECB to purchase securities issued by member states whose financing conditions have deteriorated for reasons not justified by country-specific fundamentals. However, before activating it, the Governing Council considers a cumulative set of criteria to determine whether the countries concerned are pursuing sound and sustainable fiscal and macroeconomic policies. In practice, this includes compliance with the EU fiscal framework, which would, at a minimum, require the proposed French budget to be fully adopted. Hence, the statement of Banque de France governor Emmanuel Moulin:

"There are mechanisms that are linked to very critical situations on markets that prevent the proper transmission of monetary policy. But these mechanisms are only used if measures are taken at a national level."

The ECB has nevertheless left itself some discretion, stating that the intervention criteria "will be dynamically adjusted to the unfolding risks and conditions to be addressed". This brings back memories of the famous "because it's France" by former European Commission President Jean-Claude Juncker. Generally speaking, the ECB will be in a difficult position: intervening too quickly in support of France may be viewed unfavourably by other member states and interpreted as monetary financing of the debt of a country unwilling to follow the rules. That argues strongly against early intervention. Also, don't forget that the leadership changes at the ECB over the next months (Schnabel, Lane, Lagarde) could also affect how the ECB views TPI.

However, in any case, if turmoil in the French bond market spreads and drives up yields in other highly indebted member states, pressure on the ECB to act would increase. That action would not necessarily have to come through the TPI immediately. The ECB could instead pause quantitative tightening temporarily and reinvest maturing bonds in its portfolio "flexibly", sending a positive signal to bond markets. This had already happened during the Covid period. Still, the more contagion in eurozone bond markets, the higher the risk that markets will eventually force the ECB to start TPI.

Broader market stress would also affect the ECB's interest rate policy. In a speech to the European Parliament's Committee on Economic and Monetary Affairs this week, Christine Lagarde noted that "while growth has been resilient, since our last meeting long-term interest rates have risen notably, which will slow growth and reduce pass-through by more than projected in our September exercise." In other words, tighter financial conditions are already doing some of the ECB's work.

According to our own estimates, the bond yield surge since the ECB's September meeting has a similar effect on growth and inflation as another 25bp policy rate hike. All of this reinforces our view that the 90 basis points of rate increases priced in by markets over the next 12 months are probably too aggressive.

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