

## QUICK TAKE

# FRANCE'S REFORM PARALYSIS ADDS TO MARKET UNCERTAINTY

SEPTEMBER 2025

### KEY TAKEAWAYS:

- French bond spreads exceed periphery, signalling rising investor concern.
- Political instability and looming ratings reviews fuelling market volatility.
- French assets trade at a discount to peers, reflecting greater risk premium.

The ousting of Prime Minister François Bayrou after he lost a self-called parliamentary confidence vote on Monday - a first in French history - has sparked another political crisis that risks spreading to the markets, with protests and a potential ratings downgrade looming.

President Emmanuel Macron named Defence Minister Sébastien Lecornu as the new premier, with his appointment punctuated by street protests and strikes over the prospect of spending cuts. Initial impressions suggest his appointment does not clearly address the challenges previously faced by Bayrou, and as a result, the overall outlook remains broadly unchanged. During his first term, Macron appointed only two premiers. He is already on his fifth in the first two years of his final term, which ends in 2027.

Originally from the centre-right, Lecornu is a trusted ally to Macron and the only minister to have served continuously for Macron's years in the Palais Élysée. If this longtime loyalist fails to deliver political stability, widespread speculation suggests that Macron may be compelled to call another parliamentary election.

### LIMITED OPTIONS

Political fragmentation in the French parliament continues to obstruct meaningful fiscal reform. Bayrou's €44 billion (\$52 billion) package of tax hikes and spending cuts aimed to address this.

France's deepening political paralysis has unsettled investors, pushing the yield on its ten-year government bond close to levels last seen during the eurozone debt crisis. The loss of reform momentum and rising uncertainty have led markets to reassess France's risk profile, with spreads widening sharply in recent weeks.

Once viewed as a safe haven within the eurozone, France's bond market- among the largest in the bloc- has seen its yield premium rise following last year's snap legislative election, which resulted in a hung parliament. In contrast, Germany is pressing ahead with large-scale investment plans, reinforcing its position as the region's fiscal anchor. France, meanwhile, faces rising borrowing costs and limited room for manoeuvre.

Macron's legacy was damaged by the snap election he called and lost last summer. Meanwhile, the far-right Rassemblement National (RN) is gaining momentum, with recent Harris polling showing 41% support to lead the next government.

The political uncertainty adds to market volatility and complicates France's already strained fiscal outlook.

## EUROZONE CRISIS REDUX?

Despite the upheaval, France's debt structure remains more resilient than its peers such as the UK. This is due to the lower exposure to floating-rate instruments and a smaller share of interest costs in its overall budget. For example, interest payments on French government debt are projected to equate around 2% of GDP in 2026 compared to the UK at 4%.

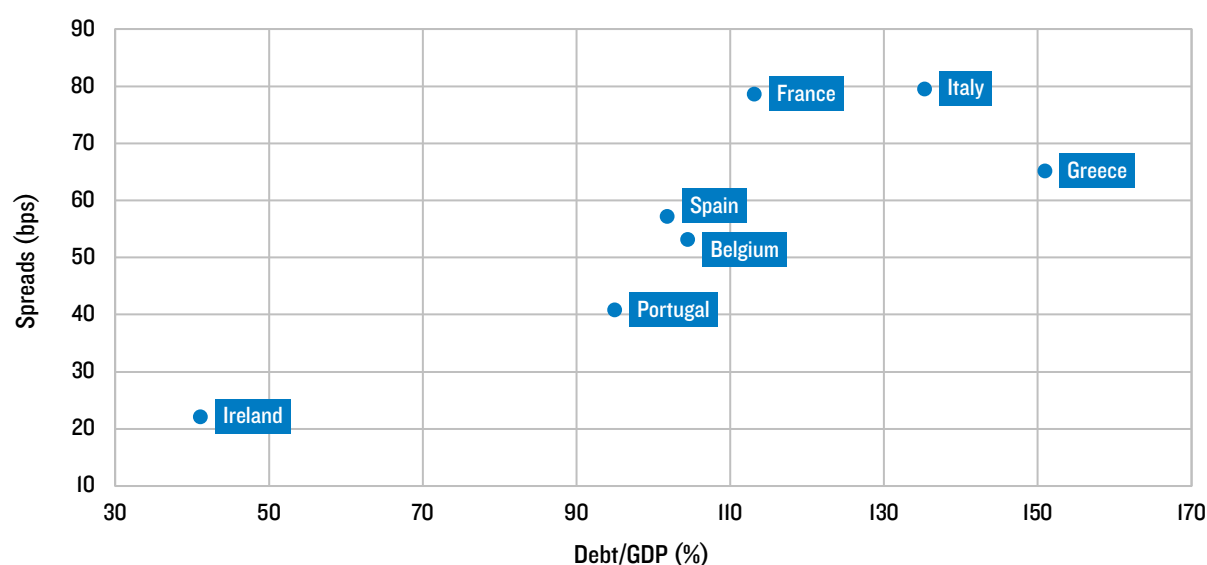
Crucially, France has already covered around 84% of its 2025 funding needs, reducing the risk of market pressure from additional issuance.

Despite this, French bond spreads relative to German debt have moved sideways since 2024 whereas other periphery bond spreads have continued to decline. As a result, French bond spreads now exceed those of Portugal, Spain, and Greece, and indeed are approaching levels seen in Italy, countries previously seen as the 'weak links' in the eurozone.

This shift reflects growing investor concern over France's political instability and lack of credible fiscal consolidation, with some analysts predicting the country might lie at the epicentre of the next eurozone crisis.

The European Central Bank has introduced multiple tools and policies since the eurozone crisis to prevent a recurrence. While the ECB's Transmission Protection Instrument (TPI) helps contain broader contagion risk, it is unlikely to be deployed to address France-specific fiscal concerns.

**Table 1: European 10y Gov Bond Spreads (bps) vs Germany and Debt/GDP (%)**



Sources: Bloomberg, IMF. As of 10 September 2025.

## OUTLOOK FOR INVESTORS

Broadly, the macro backdrop in Europe is solid and while risks remain, France has found ways to muddle through multiple political crises in recent months even as domestic markets have struggled. Local stocks, which previously sold at a valuation premium to German equities, now trade at a discount.

Bond yield spreads are also already pricing heightened fiscal concerns and political turmoil. French spreads are consistent with a ratings downgrade and are wide relative to other European government debt with similarly high public debt.

Given this backdrop, we remain attentive to tactical opportunities that may open in France and other EGBs. For long-term investors who can tolerate volatility, valuations are interesting. Curves are very steep, twice as steep in France and Italy compared to the U.S., and hedged yields are attractive especially for US investors.

In the very short term, however, we would flag the risk that rating agencies could decide to downgrade France. Fitch is scheduled to review France on Friday, followed by Moody's Ratings on Oct. 24 and S&P Global on Nov. 28.

Slow growth is particularly problematic for a high-debt country like France, which reached 3.3 trillion euros in June or 114% of GDP. While that is lower than Greece's 153% or Italy's 138%, unlike France, both countries run considerable budget surpluses.

The risk scenario that investors fear is that if bond yields continue rising, both governments and businesses will be forced to scale back investment as debt servicing consumes a growing share of revenues.

This dynamic risks triggering a negative feedback loop: lower investment slows economic growth, which reduces tax revenues and widens deficits further.

At some stage, a fundamental re-engineering will be needed to support growth. In the meantime, higher spreads combined with weak growth and limited default risk could make French debt relatively more attractive than equities in the short to medium term.

Broadly, politicians who advocate fiscal discipline, such as Bayrou in France, Shigeru Ishiba in Japan, and Rachel Reeves in the UK, often face political backlash and instability. It is particularly acute in the U.S., where the government has little appetite to decrease its deficits.

This pattern suggests fiscal dominance remains entrenched, and meaningful consolidation may only come when markets force a reckoning.

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