PUBLIC SPENDING AND DEBT (2/2):

Deficit, debt:
How have they evolved over time and what do they serve to finance?

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VOICE-OVER: Welcome to Dialogue &co. In these two episodes on the government budget and public debt, Corentin Deredec, macroeconomist with the Banque de France, takes a look at France's fiscal situation. How does a country get into debt and just how deeply in debt can it get? Lucile Rives, podcast production manager for the Banque de France, asks the questions. Enjoy the podcast.

LUCILE RIVES: Hello Corentin.

CORENTIN DEREDEC: Hello Lucile.

PART ONE: HOW A COUNTRY GETS INTO DEBT

LUCILE RIVES: In our first episode, which focused on public spending and public debt, we gave a statistical overview of France's fiscal situation, including a comparison with its European neighbours. In this second episode, I'd like to dive straight in and look at the mechanics of government debt. So, in concrete terms, when you're a state, when you're France, how do you get into debt?

CORENTIN DEREDEC: Well, state governments tend to issue debt on the financial markets. Just to provide some context, more than 80% of French government debt is borne by state government, compared to a little under 10% for local government bodies and social security funds, respectively. So it's mainly state government that will have to finance the debt.

State government doesn't account for the largest share of spending, but it does shoulder the lion's share of the government deficit and public debt. Why? Because it makes numerous transfers to social security funds and local authorities.

And this share of the debt borne by state government is essentially negotiable debt – debt issued on the financial markets. These securities are issued by the French Treasury, the AFT (*Agence France Trésor*). Total outstanding negotiable debt at the end of 2024 amounted to EUR 2,602 billion, with an average maturity of 8 years and 172 days. Which means that, on average, the state government's debt is fully refinanced every 8 years and 172 days.

LUCILE RIVES: You say "on average" because debt management is a continual process. Not all securities mature on the same date. The government doesn't have to refinance its entire debt every 8 years and 172 days. Am I right in saying that?

CORENTIN DEREDEC: Yes, that's right. I say "on average" because not all debt securities mature at the same time, on the same specific date. They have varying maturities. Some securities have to be repaid within a few months, while others have to be repaid years or even decades from now. So, on average, France's public debt has a maturity, or remaining life, of 8 years and 172 days.

LUCILE RIVES: So, what instruments are available to state government to raise funds on the markets?

CORENTIN DEREDEC: OK so what happens is this. The AFT issues securities on what we call the primary market to financial institutions known as primary dealers that specialise in treasury securities. Simply put, it issues short-term treasury bills, with maturities of less than one year, mainly to meet short-term liquidity requirements, and medium and long-term government bonds, with maturities of 2 to 50 years, to meet financing needs and thus finance the government deficit. These medium to long-term issues amounted to EUR 285 billion net of redemptions in 2024. That is what happens on the primary market: the issue is carried out by the AFT and repurchased by the primary dealers.

The primary dealers then sell on the securities on the secondary markets, which considerably diversifies the holders of French debt.

LUCILE RIVES: So do we know who the holders of French public debt are right now?

CORENTIN DEREDEC: Well the securities are purchased by investors – banks, investment funds, insurers....

As for their nationality, 52% of long-term French government bonds were held by non-residents in the third quarter of 2024, the majority of which were European. However, there are a large number of economic agents among the resident holders of French public debt. They include many French people; through their life insurance policies, for example. And they also include institutional players, such as the Banque de France, which held just over a quarter of France's negotiable debt at the end of 2023. This was mainly as a result of quantitative easing policies, which are unconventional monetary policies whereby Eurosystem central banks make mass purchases of securities, corporate securities, and also government debt securities on secondary markets.

LUCILE RIVES: In the introduction to the previous episode, we explained that central banks do not directly finance state governments. But the Banque de France holds a quarter of France's debt. This seems contradictory. Can you elaborate?

CORENTIN DEREDEC: That's a very good question. And it's a point that may indeed seem a little contradictory, but which can be explained by the distinction between direct financing, which I mentioned earlier in the context of debt monetisation – on the primary market when securities are issued – and indirect financing, when securities are sold on by investors on the secondary market. Central banks are prohibited by treaty from directly purchasing debt issued by governments during primary issues. So, as I said in the previous episode, the issue is carried out by the AFT and repurchased by the primary dealers. This arrangement avoids debt monetisation. However, purchases on the secondary market are not prohibited within the monetary policy framework. They are permitted. And this is what happened as part of the past decade's quantitative easing.

LUCILE RIVES: So, borrowing money. That comes at a cost. What is France's borrowing rate at the moment?

CORENTIN DEREDEC: The benchmark rate that's often used is the 10-year bond yield, because it reflects both monetary policy expectations and investor confidence. Currently, the 10-year yield for France is around 3.4%. The domestic political uncertainty and the deterioration in public finances in 2024 that was more severe than expected have led to a widening of the gap between the French rate and the German rate, which is, in a sense, the benchmark interest rate for Europe, as Germany is perceived to some extent to be the safest issuer in the euro area. The difference between the two rates is called a spread. And this spread has risen from 0.5% in May 2024 to 0.7% today.

Meanwhile, France has drifted closer to countries such as Italy. We can see that the spread between France and Italy is narrowing. The 10-year spread fell from 0.8% in May 2024 to less than 0.4% today, i.e. over the same period. So the risk premium that investors require to buy French public debt is higher today than it was a year ago.

PART TWO: THE EUROPEAN FISCAL FRAMEWORK

LUCILE RIVES: So the widening spread is actually the markets indicating that a country's fiscal situation is deteriorating. But there are other indicators, too. I'm particularly thinking about the European Stability and Growth Pact requirements, which set limits on the deficit – no more than 3% of GDP – and on debt – no more than 60% of GDP. So, could you explain what happens to a euro area country like France that exceeds its limits? But before that, could you remind us how the thresholds were determined?

CORENTIN DEREDEC: Well, this brings us back to the link between monetary policy and fiscal policy that we discussed previously. Simply put, it's all about preventing excessive government debt in one euro area country from having too great an impact on other euro area countries, as they use the same currency. These thresholds – 3% deficit and 60% debt – date back to the 1990s. Why? Because at the time, the deficit threshold of 3% of GDP was considered to be the maximum deficit level that would still allow debt to be maintained at a stable ratio of 60% of GDP. This is known as the debt-stabilising primary balance.

Now to answer your second question, although the European fiscal framework was suspended between 2020 and 2023 during the Covid crisis to allow Member States greater fiscal leeway to deal with the pandemic, it was reactivated in 2024. As France exceeded the 3% deficit and 60% debt thresholds, it became subject to a European Union excessive deficit procedure in July 2024, along with seven other EU Member States, including Italy and Belgium. So, not only does the deficit level pose economic and financial risks for the country itself, France's failure to meet its commitments puts it at risk of European financial sanctions.

LUCILE RIVES: In 2024, the requirements of the Stability and Growth Pact were reactivated. And in the same year, the European fiscal framework was also radically reformed. Basically, it gave Member States greater fiscal leeway to gradually reduce their public debt. Today, what matters most in the new European fiscal framework? And in particular, are the 3% and 60% thresholds still in force?

CORENTIN DEREDEC: The Stability Pact's 3% and 60% requirements continue to be the anchor values. In other words they provide a clear framework for avoiding fiscal drift and for reassuring the markets. But, yes, if these requirements were strictly applied, it would imply considerable fiscal consolidation for many Member States, which would thus have to make enormous efforts to eliminate their deficits and restore their public finances.

The new EU economic governance framework that you referred to and that came into force in April 2024 left the SGP reference values unchanged, but introduced greater flexibility into the national fiscal adjustment paths for achieving them. The reform means that risks specific to each country – such as the scale of interest payments, an ageing population, and so on – can be taken into consideration while ensuring that public debt remains sustainable, i.e. that a country is able to repay its debt in the long term without destabilising its economy.

LUCILE RIVES: And what do Member States have to do in practice, and what does France in particular have to do, to comply with these new European fiscal rules?

CORENTIN DEREDEC: Member States must submit a medium-term fiscal-structural plan to the European Commission, covering a period of 4 to 7 years and detailing commitments in terms of fiscal adjustment to achieve the 3% deficit and 60% long-term debt-to-GDP ratio.

In the case of France, its adjustment period is seven years and should ensure that the debt-to-GDP ratio stabilises and then comes down even under adverse macroeconomic and financial scenarios simulated using a DSA model.

LUCILE RIVES: To clarify a little, could you tell us a bit more about these DSA models and what they offer compared to the tools used in the three-year macroeconomic projections that you mentioned in the first episode?

CORENTIN DEREDEC: We have tools that enable us to analyse debt trends over a 10-year period, beyond the three-year horizon I talked about earlier. The tool we use is called DSA, or Debt Sustainability Analysis, and it's designed to model debt trajectories over a 10-year horizon. It allows us to see how a level of debt would react to a number of shocks, such as on interest rates, and a number of scenarios in order to gauge the uncertainty surrounding a trajectory.

So DSA is useful in two ways. First, it allows us to go beyond the three-year horizon that we apply in our macroeconomic assessments. It therefore complements the work we do on that front. Second, it helps in the implementation of monetary policy, strictly speaking. How? Using DSA, we can estimate when a country will no longer be subject to an excessive deficit procedure. And once a country is no longer subject to an excessive deficit procedure, it can benefit from certain tools such as the TPI, the Transmission Procurement Instrument, which was created a few years ago to ensure that ECB monetary policy is transmitted uniformly throughout the euro area.

PART THREE: THE SUSTAINABILITY OF PUBLIC DEBT

LUCILE RIVES: So we've seen that France is the third most indebted country in the euro area. And you mentioned a slight widening of the spread with Germany and the fact that France is subject to an excessive deficit procedure. This all brings me to the question: is there a maximum level of debt that a country can sustain?

CORENTIN DEREDEC: Economists have devoted a great deal of time and effort to this question. In the case of France, we have not been able to define a precise level of debt as a percentage of GDP after which it would become unsustainable. What's more, there are countries with much higher levels of debt as a percentage of GDP than ours. For example, the United States and Japan. Their debt-to-GDP ratios stood at 119% and 240%, respectively, in 2023.

But our debt ratio cannot increase indefinitely and we have to stabilise our debt ratio in line with our European commitments. To comply with the new European fiscal requirements, France must commit to reducing its debt ratio before the end of the seven-year adjustment period. Otherwise, there is a risk of sanctions.

LUCILE RIVES: I imagine that sanctions are one of the reasons behind a country wanting to heal its public finances. But what other problems are caused by a continuous increase in the debt-to-GDP ratio?

CORENTIN DEREDEC: Over and above the risk of sanctions, a continuous increase in the debt ratio would definitely pose several major problems. First, the rise in inflation, and then interest rates, mean that we are now borrowing at much higher rates than a few years ago, even though – it's true – that was a rather atypical period when state governments were borrowing sometimes at close-to-zero or even negative rates. In 2024, the AFT was borrowing at an average rate of 2.91% for its issues of medium and long-term securities. In 2021, the average rate was still negative. As a result, the French government debt burden rose from just under EUR 30 billion in 2020 to EUR 53 billion in 2023, or 1.9 percentage points of GDP. This debt burden will significantly reduce our fiscal leeway and is expected to increase considerably in the coming years. From 2024 onwards, interest payments will exceed the budget for the army, the budget for defence. Within two years, they will be on a par with the entire budget of the Ministry for Education, which is the very epitome of investment in the future.

A second problem is that the rise in the debt-to-GDP ratio, against a backdrop of slowing growth, throws up questions about France's credibility. First, credibility with investors, given that some rating agencies have downgraded France's rating, as Moody's did in December 2024. Currently, investor confidence remains strong, so France has no difficulty borrowing on the markets. But it has been shaken, which is clear, for example, from the change in the spreads that we mentioned earlier. And in addition to credibility with investors, there is a risk that France may become increasingly dependent on its creditors, which poses a risk to our sovereignty.

Lastly, our credibility with our European partners is at stake. For example, in the context of the reform of European fiscal requirements, the state of France's public finances could weaken its position in negotiations within the European Union.

LUCILE RIVES: There may not be an absolute theoretical maximum level of debt for a country, but there is an economic concept used to assess the sustainability of public debt. This concept is technically known as “R-G” and is better known as “the snowball effect”. The idea is to assess the gap between the cost of debt and the economic growth at which a government could expect to generate revenue. So we ascertain the difference between R – Rate – which is the interest rate, the cost of debt, and G – Growth, economic growth. What this concept tells us is that the greater the gap between R and G, the more likely debt is to spiral out of control, as interest payments exceed what the economy can generate. So how does the R-G concept apply to France and how does it affect the trajectory of French debt?

CORENTIN DEREDEC: To answer your question, we can break the evolution of public debt down into two factors. The first is the primary deficit – the deficit excluding interest payments – and the second is a snowball effect, R-G.

In France, we have seen that it’s mainly the primary deficit that has led to an increase in public debt over the past 50 years. There has been no significant snowball effect. Excluding periods of economic crisis, the R-G differential has rather helped to reduce the debt ratio in recent years, as growth outpaced real interest rates. In other words, R-G was negative.

However, heightened political and financial uncertainty has led to higher interest rates and refinancing rates in France, as we have already seen. And at the same time growth forecasts have been revised downwards several times in recent months. In the years to come, we will have to make sure that R-G doesn’t stay positive for indefinite periods if we are to avoid any debt spirals and snowball effects.

PART FOUR: THE OUTLOOK

LUCILE RIVES: The European fiscal requirements aim to prevent these debt spirals by encouraging countries to keep their debt under control by reducing it to, and maintaining it at, 60% of GDP. But if we cannot rely on economic growth to heal our public finances, what tools are available to us?

CORENTIN DEREDEC: The most realistic approach is to start by stabilising the debt ratio, to halt the increase in debt as a percentage of GDP. This means that the primary balance has to be higher than the debt-stabilising primary balance.

LUCILE RIVES: So we have to cut back on spending to cut back the deficit and therefore debt. What level would be needed for this stabilising fiscal balance to enable France's public debt to be gradually brought down to 60% of GDP?

CORENTIN DEREDEC: The level will depend on the gap between the rate of economic growth and the real interest rate, this much-discussed R-G. However, when growth is weak, G is fairly low, and debt only stabilises when the primary deficit is reduced to zero. In other words, when the primary balance excluding interest payments is zero. So this means cutting spending or increasing revenue.

And that's not an easy thing to do given our current economic and geopolitical situation. Certain crises require solutions that can sometimes be costly. For example, the public health crisis and the inflationary crisis entailed exceptional spending – the discretionary measures we discussed in the previous episode. And these measures to protect the economy and households cost EUR 97 billion between 2022 and 2024. More recently, geopolitical tensions have meant that a number of state governments are considering an increase in their military spending. And at the same time, we mustn't forget that significant investment is still required, to finance the ecological transition or to cope with an ageing population, for example.

LUCILE RIVES: And have any countries already succeeded in consolidating their debts?

CORENTIN DEREDEC: Yes, there are several examples among our European neighbours. And we can point to a fairly recent example – Portugal. Like France, Portugal had not had a budget surplus since 1974, which is rather unusual, but quite similar to our situation. Portugal's public debt ratio fell from 133% of GDP in 2014 to 95% in 2024, even dropping 18 points below the pre-crisis level – the level in 2019. This rapid decline in the debt-to-GDP ratio is linked to a careful management of the primary balance over recent years. Portugal achieved this fiscal consolidation mainly by reducing its primary public spending, which fell by a fairly significant 6 percentage points of GDP between 2014 and 2024, but also thanks to increased public revenue driven by economic activity. In 2019, Portugal posted a surplus for the first time since 1974. And after the health and inflation crises, it achieved a budget surplus of 0.7% in 2024, at the same time that France posted a deficit of 5.8%. The consolidation of Portugal's public finances has had a direct impact on its credibility on the financial markets and the 10-year spread between Portugal and Germany is now 0.5%, much lower than the Franco-German spread I mentioned earlier.

LUCILE RIVES: Is there anything that we can learn from Portugal's experience to help us stabilise France's debt?

CORENTIN DEREDEC: To stabilise public debt, choices have to be made. And they are political choices and therefore fall to the government and our elected representatives. However, given France's European commitments, it is possible to give some general indications of the scale of the effort needed to achieve these objectives. Firstly, in order to return to a deficit of less than 3% by 2029, which is the target set by the government in the documents it submitted to the European Commission, the Governor of the Banque de France, in his letter to the President of the Republic delivered a few weeks ago, stresses that we must limit the rise in primary expenditure to 1.2% per year in value terms between now and 2029, which generally equates to stabilising our total expenditure in volume terms. This stabilisation is ambitious in light of past trends, but not impossible. Between 2014 and 2018, France succeeded in limiting growth in total spending – not just primary expenditure but total expenditure – in volume terms to 0.5% per year.

LUCILE RIVES: In concrete terms, based on current public spending levels, and by institutional sub-sector or by major items of expenditure, do we know what types of spending should be targeted to attain a debt-stabilising primary balance?

CORENTIN DEREDEC: To reduce spending as required, efforts to control expenditure need to be extended to all public administrations, including social security and local government administrations, whose expenditure is continuing to rise by 2% a year in volume terms. They must not be concentrated solely on the state budget, which only accounts for 36% of total expenditure, as we discussed in the previous episode.

LUCILE RIVES: I imagine that these are measures that can't be rolled out all at once, so as not to penalise economic growth and also for them to be accepted by French society. So, in terms of the pace of consolidation, what timeframe could be envisaged?

CORENTIN DEREDEC: A major adjustment is absolutely necessary, but staggered over time. In this regard, the adjustment path that France has committed to under the new European fiscal requirements, i.e. between four and seven years, is gradual enough to spark a reduction in our public debt ratio while maintaining dynamic economic growth. We have to capitalise on the dynamism of the labour market and economic activity to stay on this adjustment path as, according to our latest macroeconomic projections from March 2025, growth will slow in 2025 and 2026 but pick up strongly by 2027. So they will be key factors and must be given due consideration in order to restore our public finances.

LUCILE RIVES: Thank you, Corentin!

CORENTIN DEREDEC: Thank you, Lucile.

VOICE-OVER: Thank you all for listening. Don't forget to subscribe to Dialogue &co and to leave us your comments and stars on your podcast listening platforms. In our next episode, Agnès Bénassy-Quéré, Deputy Governor of the Banque de France, will discuss the issues and challenges associated with a major, yet poorly understood financial player: non-bank financial intermediaries. Until next time!

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FOR MORE INFORMATION:

- General government expenditure by function (source Eurostat): link
- Comparaison de la détention des dettes souveraines par des étrangers (Source IFRAP): link
- Interest Rates, Growth and Public Debt Sustainability (Source Direction générale du Trésor): link
- Putting French public finances on a sustainable footing (Source Conseil d'analyse économique): link
- Les risques d'un endettement public hors de contrôle (Source : FIPECO): link
- L'effet de boule de neige et le solde stabilisant la dette (Source : FIPECO): link