Flash Economics

N° 24
September 19th, 2024

The risk of dislocation of the European bond market

The risk of dislocation in the European bond market is currently linked above all to the political risk in France.

If the political deadlock in France persists (government threatened by a vote of no confidence, absence of a parliamentary majority, lack of consensus on the budget for the State and Social Security), and if there is no longer any prospect of reducing public spending, the financial markets are certain to react very negatively.

We can then fear a dislocation of the European bond market, with a sharp rise in the interest rate spread between France and Italy (by contagion) on the one hand and Germany on the other.

The use of the Transmission Protection Instrument by the ECB in this context is highly unlikely.

Patrick Artus

@PatrickArtus

Marketing communication: this document is a marketing presentation. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research; and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

The euro zone bond market is holding up well for the time being

For the time being, 10-year interest rate differentials with Germany are narrow, including for French debt (**Charts 1a/b**).

Chart 1A
Yield spread on country's 10-year government bonds against Germany (as % point)

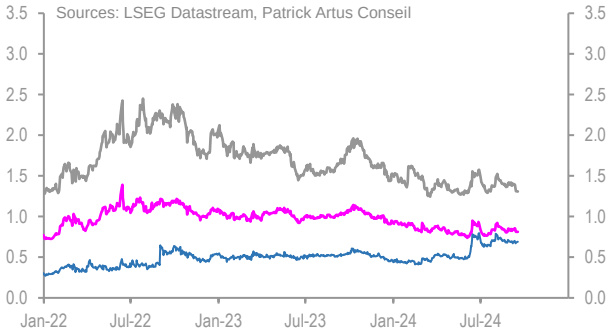
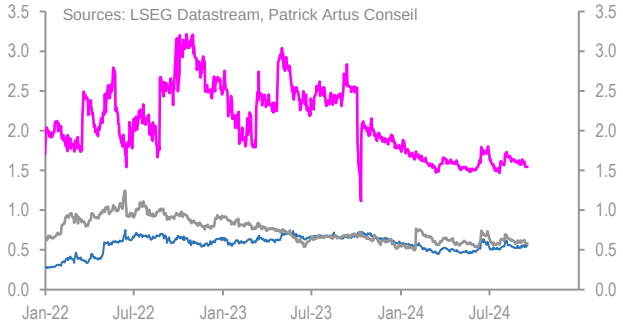


Chart 1B
Yield spread on country's 10-year government bonds against Germany (as % point)



This means that investors do not believe that certain countries in the euro zone, particularly France, are going to pursue very expansionary fiscal policies or dangerous economic policies (high wage rises, high tax increases) over the long term.

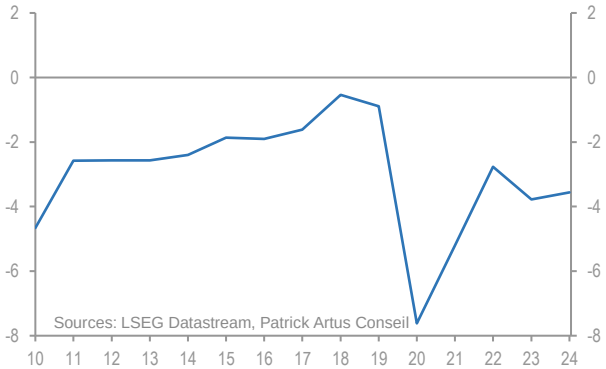
However, the situation in France is cause for concern

It seems politically impossible in France to form a government supported by most members of Parliament, and compromise is not part of the French political culture.

The economic agendas of the left and the right seem irreconcilable, and **it is therefore unlikely that a government can be formed that can sustainably pursue a policy of reducing the public deficit.**

We know that, given the level of France's primary budget deficit **(Chart 2), it would be necessary to reduce the primary deficit in France by 3.6 points of GDP relative to its level in 2024,** and given the negative effect of increasing the tax burden or reducing public spending on activity and tax revenues, **it would be necessary either to increase the tax burden or to reduce public spending by around 6 points of GDP.**

Chart 2
France: Primary fiscal deficit (as % of nominal GDP)



It seems highly unlikely that the centrist parties will accept such a sharp rise in taxes and that the parties on the left will accept such a sharp fall in public spending.

Reaction of the financial markets in the absence of an improvement in France's economic situation

If France's economic situation does not improve, if there are conflicts over the economic policies that should be followed or if the government implements a very sharp increase in the tax burden, **the financial markets' reaction will be very negative**.

This could lead to a dislocation of the euro zone bond market, with a sharp rise in France's interest rate spread relative to Germany, and by contagion a sharp rise in Italy's interest rate spread relative to Germany (Chart 1b above).

Summary: Would the ECB react in the event of a sharp rise in France's interest rate spread relative to Germany?

The ECB has the '**Transmission Protection Instrument' (TPI)**, which allows it to buy an unlimited quantity of the public debt of a country whose interest rate spread is too wide. But the use of the TPI is conditional on the country agreeing to fiscal consolidation measures and ensuring the sustainability of its public debt.

If the political disorder in France leads to these conditions not being met, for example if the public deficit remains too high, the ECB will not intervene to stabilize France's debt situation.

Disclaimer

This marketing communication and the information contained in this publication and any attachment thereto is exclusively intended for a client base consisting of professionals, eligible counterparties and qualified investors.

This document and any attachment thereto are strictly confidential and cannot be divulgated to a third party without the prior written consent of Patrick Artus Conseil. If you are not the intended recipient of this document and/or the attachments, please delete them and immediately notify the sender.

Reference prices are based on closing prices (if mentioned in this document).

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions. Neither Patrick Artus Conseil or any other person may be deemed liable to any person in relation to the distribution, possession or delivery of this document in, to or from any jurisdiction.

This document has been developed by Patrick Artus Conseil. It does not constitute a financial analysis and has not been developed in accordance with legal requirements designed to promote the independence of investment research. Accordingly, there are no prohibitions on dealing ahead of its dissemination.

This document and all attachments are communicated to each recipient for information purposes only and do not constitute a personalized investment recommendation. They are intended for general distribution and the products or services described herein do not take into account any specific investment objective, financial situation or particular need of any recipient. This document and any attachment thereto shall not be construed as an offer nor a solicitation for any purchase, sale or subscription. Under no circumstances should this document be considered as an official confirmation of a transaction to any person or entity.

Prices and margins are indicative only and are subject to change at any time without notice depending on, inter alia, market conditions. Past performances and simulations of past performances are not a reliable indicator and therefore do not anticipate any future results. The information contained in this document may include results of analyses from a quantitative model, which represent potential future events that may or may not be realized and is not a complete analysis of every material fact representing any product. Information may be changed or may be withdrawn at any time without notice.

The statements, assumptions and forecasts contained in this document reflect the judgment of its author(s), unless otherwise specified, and do not reflect the judgment of any other person. The information contained in this document should not be assumed to have been updated at any time subsequent to the date shown on the first page of this document and the delivery of this document does not constitute a representation by any person that such information will be updated at any time after the date of this document.

Patrick Artus Conseil or ay other person shall not be liable for any financial loss or any decision taken on the basis of the information disclosed in this presentation. In any event, you should request for any internal and/or external advice that you consider necessary or desirable to obtain, including from any financial, legal, tax or accounting adviser, or any other specialist, in order to verify in particular that the transaction (as the case may be) described in this document complies with your objectives and constraints and to obtain an independent valuation of the transaction, its risk factors and rewards.

All of the views expressed in this report accurately reflect the author's personal views regarding any and all of the subject securities or issuers. No part of author compensation was, is or will be, directly or indirectly related to the specific recommendations or views expressed in this report. The personal views of authors may differ from one another.