Flash Economics

N° 15
February 6th, 2026

The short-termism of buyers of French or Italian public debt

At the end of January 2026, the 10-year interest rate spread between France and Germany and between Italy and Germany tightened sharply. Yet, the economic outlook for France and Italy is not favourable:

- In France, the public deficit will only narrow slightly in 2026, with increases in social benefits and corporate taxes perpetuating underinvestment, which investors are unlikely to approve of; the growth outlook for industry and services alike is very unfavourable; the skills of the population and the quality of the education system are very low; and political risk is high;
- In Italy, although the public deficit will fall below 3% of GDP in 2026, growth is particularly weak in the manufacturing industry; the investment rate is low; productivity is declining; the skills of the population and young people are low; demographics are very unfavourable; and research and development efforts are very limited.

The optimism of public debt investors regarding the economic outlook for France and Italy is therefore difficult to understand; these investors, particularly in the case of France, have overreacted to the absence of a short-term political crisis.

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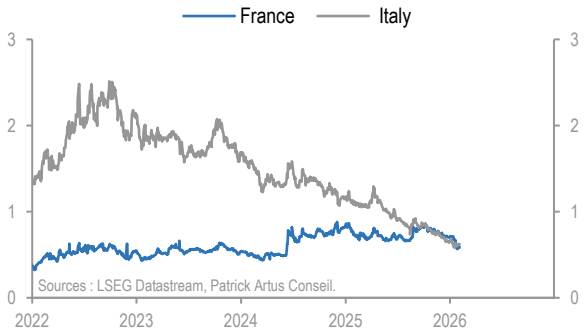
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Significant tightening at the end of January 2026 in the interest rate spread between France and Germany, Italy and Germany

From mid-January 2026 onwards, **the spread between the 10-year rates** (on Treasury bonds) **of France and Germany tightened significantly**, while the spread between the **10-year rates of Italy and Germany tightened markedly** (**Chart 1**).

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

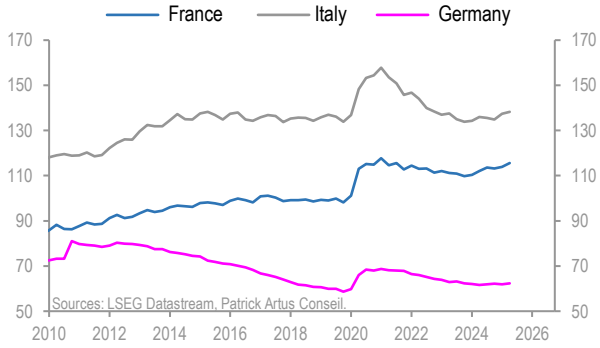


Admittedly, Germany's public finances are deteriorating as a result of the stimulus plan devised by Friedrich Merz's government (**Chart 2**), but Germany's public debt ratio will remain significantly lower than that of France or Italy (**Chart 3**), and moreover, the increase in the public deficit was not announced in January 2026, but well before that.

Chart 2
Germany: Fiscal surplus or deficit (as % of nominal GDP)



Chart 3
Public debt (as % of nominal GDP)

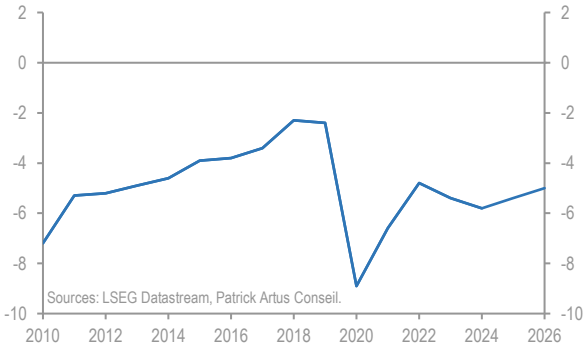


We believe that the fundamental economic situations in France and Italy do not justify this tightening of long-term interest rate spreads relative to Germany.

France: growth will be stifled

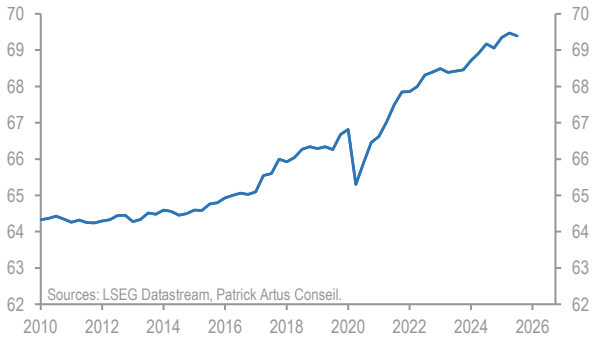
France's public deficit will remain at 5% of GDP in 2026 (**Chart 4**), but more importantly, the **budgetary and fiscal decisions taken are likely to stifle growth**. Indeed, it has been decided to:

Chart 4
Germany: Fiscal deficit (as % of nominal GDP)



- **Freeze pension reform**, which will contribute to **halting the rise in the employment rate** (**Chart 5**);

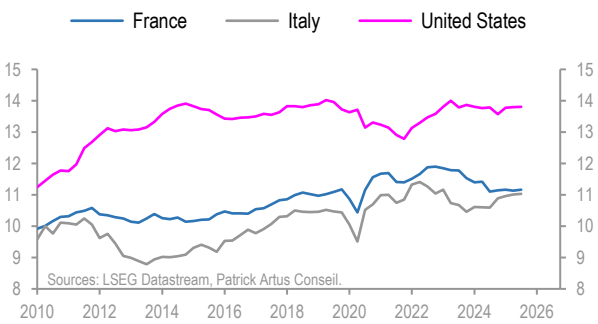
Chart 5
France: Employment rate of population aged 15 to 64
(as %)



- Index pensions to inflation and allow healthcare spending to increase by 3%;
- Increase corporate income tax by €8 billion and cancel production tax cuts (CVAE).

Economic policy decisions will **perpetuate underinvestment** (**Chart 6**), which will reduce growth prospects in industry and services alike (the manufacturing PMI for January 2026 is 51.0, while the services PMI is 47.9, which overall is consistent with a decline in activity).

Chart 6
Investment of corporations
(in value terms, as % of nominal GDP)



Furthermore, in France, **the skills of the working population are low** (**Table 1**), as is the **quality of the education system** (**Table 2**), which does not promote rapid growth in economic activity.

Table 1: Results of the OECD PIAAC survey (by decreasing score from the 2023 survey, overall score*)

Pays	2016	2023
Finland	285	289
Japan	292	285
Sweden	279	281
Germany	271	267
England (UK)	267	266
France	258	253
Spain	249	246
Italy	249	240

*In 2016, average score in numeracy and literacy
Source: OECD

Table 2: Results of OECD PISA surveys (overall score, by decreasing score in the 2022 survey)

Country	2018	2022
Japan	520	533
Finland	516	495
United Kingdom	503	494
Denmark	501	491
Sweden	503	487
Germany	500	482
Netherlands	502	480
France	494	478
Italy	477	477

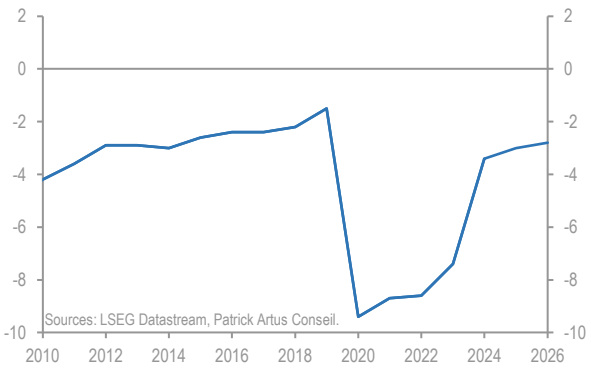
Source: OECD

All in all, with the decision to prioritise household income support and consumption over investment, it is difficult to be optimistic about the outlook for the French economy.

Italy: multiple structural drawbacks

Italy now has its public finances under control (**Chart 7**).

Chart 7
Italy: Fiscal deficit (as % of nominal GDP)



However, Italy is hampered by **multiple structural problems**:

- **Decline in manufacturing output** (**Chart 8**), with a January 2026 manufacturing PMI of 48.1, well below the threshold of 50, above which there is expansion;

Chart 8
Italy: Manufacturing production (2010.M1 = 100)



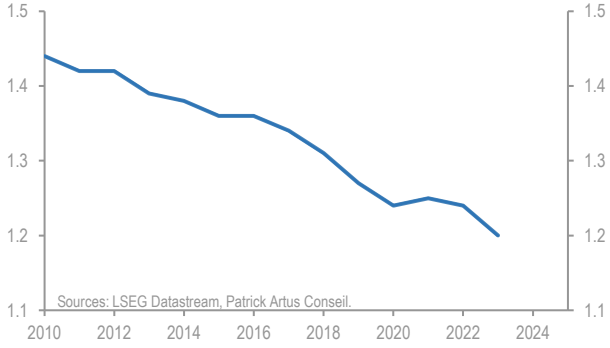
- **Decline in labour productivity since mid-2022** (**Chart 9**);

Chart 9
Italy: Real labour productivity per hour worked
(2010.Q1 = 100)



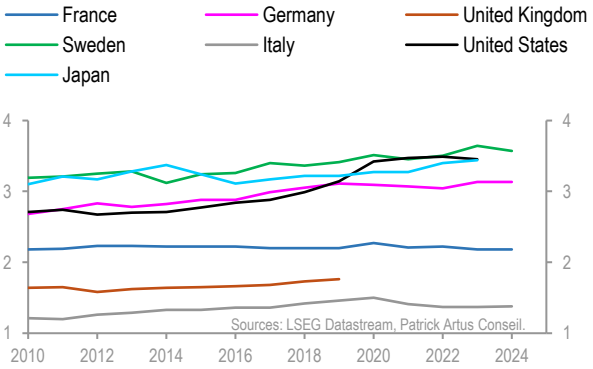
- **Low investment rate** (**Chart 6** above);
- **Very low skills among the adult population and young people** (Tables 1 and 2 above);
- **Unfavourable demographics** (**Chart 10**);

Chart 10
Italy: Fertility rate (births per woman)



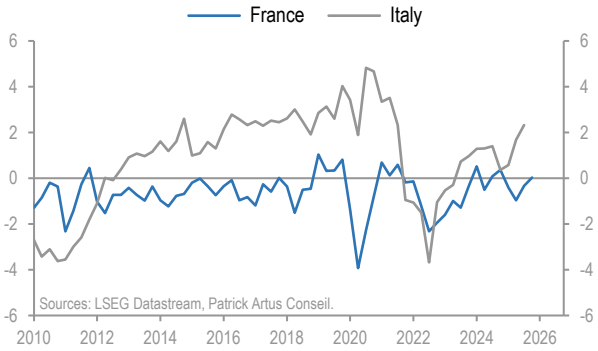
- **Insufficient research and development efforts** (**Chart 11**).

Chart 11
Total R&D spending (as % of nominal GDP)



The fact that Italy has reduced its public deficit to below 3% of GDP and is generating a significant external surplus (Chart 12) should not obscure the weakness of its industry, investment, productivity, skills, R&D spending, and birth rate.

Chart 12
Current account balance (as % of nominal GDP)



Summary: Investors have a short-term outlook

Investors significantly upgraded their perception of France and Italy in January 2026. Political stability (in the short term, not the long term, particularly in France) and a slight reduction in the public deficit led to increased demand for French and Italian government bonds and a tightening of interest rate spreads between France and Italy and Germany.

But we must consider:

- In France, the preference for consumption over investment, weak growth prospects, and low skill levels among young people and adults;
- In Italy: the decline of industry and productivity, weak investment, low skills, insufficient R&D efforts, and accelerated demographic aging.

The optimism of sovereign bond investors regarding the outlook for France and Italy therefore seems difficult to understand.

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