Debt cloud hangs over new governments in France and UK

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The shift to the left in the French elections, which saw a broad anti-fascist movement deal a blow to the ambitions of Marine Le Pen's National Rally (RN) to form the next government and has led to a hung parliament, could have significant implications for financial and currency markets in the coming weeks.

The initial reaction was a slight fall in the value of the euro. It dropped by 0.3 percent but then steadied. However, there could be a return to the turbulence experienced in the lead-up to the elections.

Reporting on the initial downward movement, a Bloomberg article said it was the result of the unexpected strong showing of the New Popular Front "as traders began to digest an outcome they'd largely written off just days ago, and has the potential to reignite a tumultuous few weeks for markets."

A key issue for financial and currency markets is the level of French debt. The French budget deficit is running at 5.5 percent of GDP which is well above the level of 3 percent allowed under the rules of the European Union. The International Monetary Fund has predicted that without spending cuts or revenue raising measures total debt could rise to 112 percent this year.

The yield, or interest rate, on French 10-year debt, known as OATs, is 66 basis points (0.66 percent) above the level on German Bunds which are considered to be the safest. The spread had reached as high as 80 basis points last month, hitting levels last seen in the euro area's sovereign debt crisis in 2012.

James Rossiter, the lead of global macro strategy at TD Securities, said what had been a "shocking result" wrote in a note the spread could go higher again. "Rates markets went into the elections with the OATs vs Bund spread pricing in a scenario for a hung parliament—but a hung parliament led by RN not NFP [New Popular Front]."

Rather than be returned as the main party in the new parliament, RN came in third behind French president Macron's party and the NFP which secured the most seats.

Back in May, before Macron had called the snap election, the ratings agency Standard and Poor's cut its rating for French sovereign debt to AA-.

In the run-up to the elections, the fear in the markets was that a government, which depended for support of the RN, would undertake increased spending. Now this fear has been transferred to the NFP.

Vincent Juvyns of J.P. Morgan Asset Management said the value of French bonds could decline relative to their peers.

"Markets may demand a higher spread [that is, a higher interest rate] as the new government hasn't clarified its fiscal position. The European Commission and rating agencies are expecting 20 to 30 billion of cuts but the government will have to deal with a party which wants to increase spending by 120 billion."

The demands of the financial markets and the institutions of the EU were articulated by the French economy minister Bruno Le Maire who said the country could experience a financial crisis if the program of the NFP were implemented.

Debt problems are by no means confined to France. Public debt in the UK has risen to 104 percent of GDP this year, compared to 86 percent in 2019 and 43 percent in 2007. In France the corresponding figures are 112 percent, 97 percent and 65 percent, according to the International Monetary Fund.

In the lead up the British election, which resulted in the victory of the Labour Party under Keir Starmer, a London-based think tank, the Institute for Fiscal Studies (IFS), said all the major parties had avoided making hard decisions in their manifestos.

According to Isabel Stockton, senior research economist at the institute: "Growth is set to be quite disappointing and debt interest is set to remain high. And that combination of things is looking worse than [for] any other parliament in the postwar history of the UK."

That is a significant assessment given that the Attlee Labour government which came to power in 1945 confronted a British economy significantly drained by the war effort.

The IFS analysis was echoed by the incoming chancellor Rachel Reeves who, in her first major speech, said the Labour government had inherited "the worst set of circumstances since the second world war."

The debt cloud extends beyond France and the UK. It is covering all the major economies, according to calculations by Capital Economics, which found that they are running deficits three percentage points above pre-pandemic levels.

Debt was very much on the agenda at the European Central Bank's annual summer gathering held in Sintra, Portugal, at the start of this month.

In an address to the delegates, ECB president Christine Lagarde said "fiscal matters enormously" and that policymakers were "very concerned" that governments bring down their deficits in line with the EU's limit of 3 percent.

She also indicated that the key target in the ECB's "fight against inflation" is the wages of the working class. She claimed that wage rises of 5 percent, which do not make up for the real cuts imposed by inflation, were pushing up prices for services that were being passed on to consumers.

"We have to look what is behind it, which is a lot of labour costs," she said.

The debt situation of the US is also coming under increased scrutiny. In a panel discussion at the Sintra gathering, Federal Reserve chairman Jerome Powell was asked about the impact of the spending and tax plans of the Democrats and Republicans in the upcoming elections.

He refused to be drawn on specifics but said the economy was too strong to be running such high deficits and this had to be addressed "sooner rather than later."

In a sign of the accelerating pace of US debt accumulation, the Congressional Budget Office (CBO) last month revised its estimate for the deficit this year to $1.9 trillion, or 7 percent of GDP, compared to its projection of $1.5 trillion as recently as February.

Powell said the present level of debt, some $35 trillion, was "completely sustainable but the path we are on is completely unsustainable."

The rising level of debt, much of it fuelled by the higher interest rates imposed by central banks and the escalation of military spending in all major countries, is driving governments into a head-on confrontation with the working class as the financial markets dictate cuts to government spending on social facilities, coupled with the suppression of wage demands.

In an article on the "crushing debt" in Europe published on Monday, the *Wall Street Journal*, citing analysis by David Miles, an official at the Office for Budget Responsibility in the UK, noted: "Lower public spending might require reduced expectations of the role of the state. Those expectation have expanded significantly since the end of World War 2 and might not have adjusted to the reality of recent poor economic performance."

As the article noted, this situation raised the prospect of a repeat, possibly on a bigger scale, of the Liz Truss experience in the UK. When the short-lived British Tory prime minister sought to carry out major tax cuts for corporations and the wealthy without making spending cuts, she set off a bond market crisis in September 2022.

This threat is not confined to the UK but hangs over every government, including that of the US.