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THE ECB AND FRANCE – NOT CLOSE TO INTERVENTION POINT, THOUGH ECB WOULD INTERVENE REGARDLESS OF FISCAL RULES IF SYSTEMIC CRISIS LOOMED

The political crisis in France with the fall of the Barnier administration over a proposed budget that aimed to cut the fiscal deficit has driven French spreads in line with those on Greek debt – throwing the spotlight on the ECB reaction function.

We are still a substantial distance from the point at which we think the ECB would intervene in the French bond market. The shock is country-specific and endogenous to French politics, while France is not in compliance with new fiscal rules, key reference points for the ECB's spread management Transmission Protection Instrument (TPI).

France is not (currently) facing a fiscal crisis. The increase in spreads has been orderly so far, the level of spreads does not pose immediate danger, a high average maturity slows the repricing of the outstanding debt stock, the fall in risk-free yields has partly offset the rise in spreads, and contagion to date has been minimal.

So for some distance from here we think the ECB will hold to the TPI standards, stand back and hope market pressure will discipline French politics, pushing the parties to compromise on the budget.

But, we have zero doubt that in the final analysis if French bond market pressures ever looked as if they were spiraling out of control, the ECB would intervene regardless of TPI standards.

There is no EU or euro without France. It is the definition of systemic, and it would be impossible for a sovereign debt crisis in France not to spill over. At this dangerous geopolitical moment, the ECB will be still more ready to act on necessity.

We explore some metrics and possible triggers in the full note below.

The fact that investors believe in this out-of-the-money put helps stabilize the French bond market and makes it less likely market pressures morph into a sovereign crisis.

But this also means spreads may not rise enough to break the impasse in France over fiscal consolidation – unless ECB speakers deliberately raise doubts about the backstop, a very risky game.

This may leave France trapped in a chronic rather than acute political-fiscal crisis potentially for years until something breaks or the fiscal order in Europe shifts again, with the German elections offering some glimpse of possibility there.

Renewed political instability in France has generated questions about its implications for interest rates and monetary policy in the eurozone.

Analysis of recent developments in EZ bond markets points to three key results: (i) the spread between French and German government bond yields has only slightly increased in response to the government's collapse, (ii) French yields have actually gone down in recent weeks, and (iii) there are no signs of contagion to other EZ countries, and in particular to Italy.

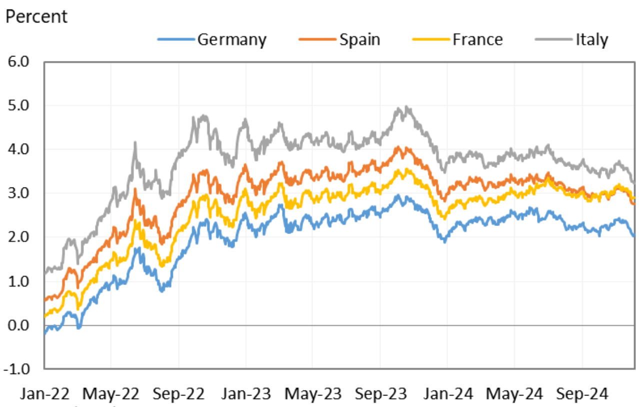
Looking at the data, the increase in the spread between 10-year French and German government bonds since the French government started looking increasingly unlikely to last has been limited. As of December 4, the 10-year FRA-GER spread stood at around 84bp, which is about 10bp higher than its recent low level of 73 bp on November 18. As a result, the spread is close to the levels observed in late June 2024 – ahead of the first round of the snap French election – and at the of Q3 – before the ECB cut rates by 25bp again in October.

Crucially, while the 10-year spread between France and Germany has slightly increased in recent days, yields have actually decreased. In particular, the 10y rate on French government bonds has fallen by about 25bp over the last three weeks. At 2.9 per cent, the 10-year yield is close to end-Q3 levels, when concerns on political instability in France were more contained.

This reflects in part an important contextual difference – that TPI was introduced when risk-free rates were going up, and spread increases threatened to magnify the overall increase in yields, but risk-free rates are now going down, offsetting some of the impact of spread increases on yields and absolute borrowing costs.

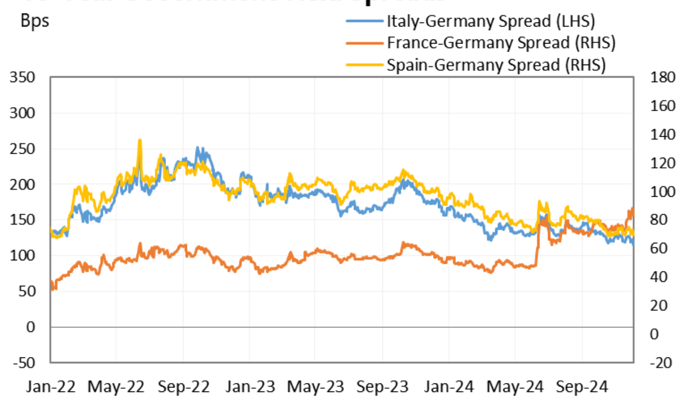
Another important aspect is that political instability in France has had no spillovers to other major EZ countries, whose spreads with respect to German rates actually have decreased since November. While the France-Germany 10-year spread has gone up by around 11bp compared to its November low, the corresponding spread between Italy and Germany has decreased by about 17bp from its November high.

10-Year Government Yields

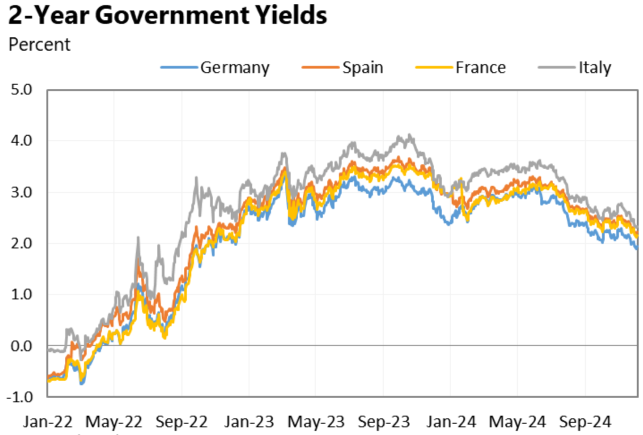


Source: Bloomberg, Evercore ISI

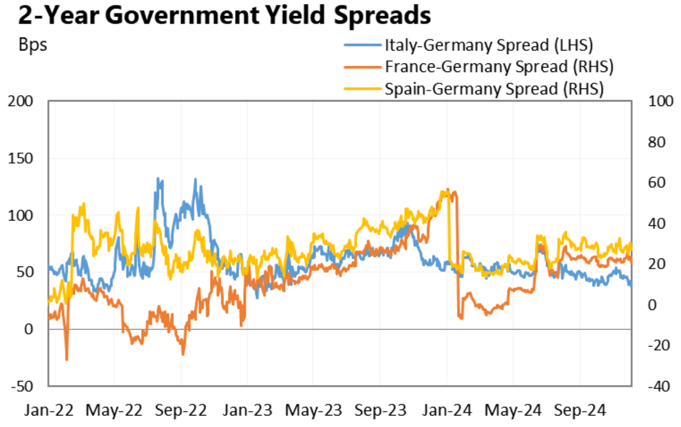
10-Year Government Yield Spreads



Source: Bloomberg, Evercore ISI



Source: Bloomberg, Evercore ISI



Source: Bloomberg, Evercore ISI

Based on this evidence, it is unlikely that the standard for activating the Transmission Protection Instrument (TPI) to compress yield spreads in the EZ has been met or is close to being met at present. TPI was introduced in July 2022 as an instrument to "ensure that the monetary policy stance is transmitted smoothly across all euro area countries."

TPI was created "to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area." This means the ECB would generally expect to observe some sort of overblown market response that does not seem consistent with macro fundamentals. Indeed, the announcement of TPI was the response to sharp increase in the spread between Italy and Germany in mid-2022, which were not obviously justified on the basis of macro and fiscal developments.

The changes in spreads and yields across the EZ do not point to a risk of an imminent systemic crisis. On the contrary, the market response to political developments in France appears sensible and consistent with a revision of the fiscal outlook for France, as fiscal consolidation seems even less likely than before.

As a comparison, the 10-year spread between Italy and Germany almost reached 240bp in June 2022 from 150bp three months earlier, leading to the creation of TPI. Of course, France and Italy are different in many dimensions, but the comparison further supports the view that we are still a substantial distance from the threshold that needs to be crossed in order for the ECB to trigger TPI.

But, we think the ECB's tolerance for stress in the French bond market would not be unlimited. So the key question is where the threshold for ECB intervention lies. We can think of two main scenarios.

If political instability in France translates into real risk of contagion, with yield spreads increasing in other EZ countries, then the ECB will assess that market developments are hampering monetary transmission and could easily justify activating TPI. The ECB would probably seriously consider activating TPI when the ITA-GER spread gets close to 200bp, which implies a FRA-GER spread at around 140-150bp assuming that the spread between Italy and France returns to the 50bp of end-Q3.

The more complicated scenario for the ECB involves French yields that continue to increase but with limited spillovers to other EZ countries. In this case the ECB will be inclined to frame it as a country-specific problem stemming from fiscal issues, as long as the crisis does not become sufficiently acute, but would in our view be willing to depart from what might look like TPI norms if the stress became truly acute.

The ECB was careful not to tie TPI to any hard requirements or automatic triggers, but simply listed some criteria will be nothing more than "an input into the Governing Council's decision-making." The four criteria are compliance with the EU fiscal framework, absence of severe macroeconomic imbalances, fiscal sustainability, and sound and sustainable macroeconomic policies.

It is easy to see that France does not meet the TPI criteria and in particular the ongoing Excessive Deficit Procedure by the European Commission will likely induce the ECB to postpone the use of TPI until and unless the risk of a France-centered systemic crisis increased significantly.

Recent comments by Bundesbank chief Nagel were in line with this approach, as he said that "what happens with individual government bonds is typically a reflection of what may be happening politically in the country at the time" and added that "political risks, which may then be reflected in higher risk premiums on financial markets, wouldn't be an issue that would justify us concluding that the transmission of the monetary-policy impulse is disrupted."

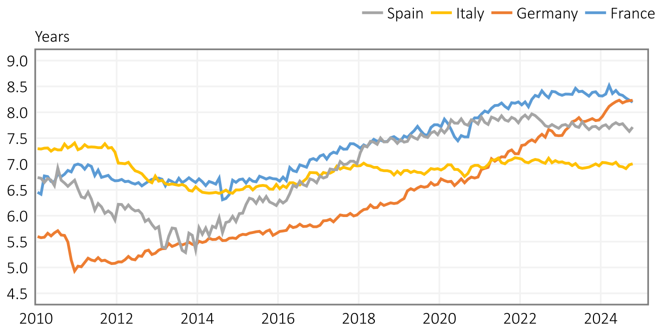
Although the TPI criteria are not binding, it would be complicated for the ECB to activate TPI to support a country that is openly defying the new fiscal rules, which would create a dangerous precedent. If it has the choice, the ECB would much prefer not to be responsible for killing the new growth and stability pact, even though in our view it already resembles Monty Python's parrot.

The ECB probably hopes that the situation does not deteriorate until the new government comes to power in Germany. Merz's likely push for additional fiscal spending with the blessing of the Bundesbank (which Nagel called more fiscal space to address structural threats "a very smart approach"), could lead to some renewed revisiting of the EU fiscal framework, taking France off the hook and lowering the bar for the ECB to intervene in bond markets with TPI.

The maturity structure of France's government debt will buy the ECB some time. The average residual maturity of French government bonds stood at 8.2 years in October, close to Germany's and more than one year higher than Italy's.

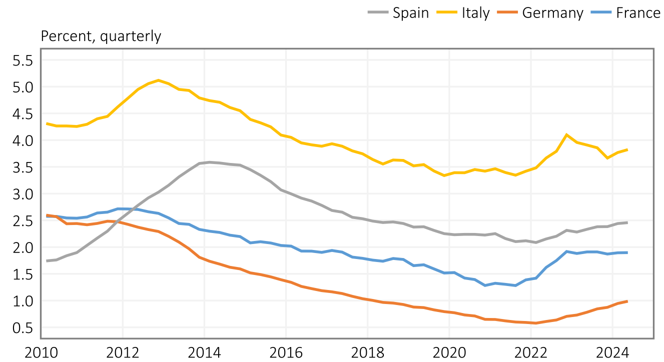
The relative high duration of public debt implies that a potential surge in French yields will only slowly feed into interest payment expenditure, which amounted to 1.9 per cent of GDP in Q2 2024, significantly below that of Italy (3.8 per cent). Importantly, in recent weeks the FRA-GER spread at the 2-year maturity has remained essentially stable and is actually about 8bp below the late June levels, which further reinforces the view that political instability may lead to a steepening more than a shift in the yield curve.

Average Residual Maturity for Total Government Debt Securities



Source: Evercore ISI, ECB (European Central Bank)

Government Interest Expenditure (as % of GDP)



Source: Evercore ISI, ECB (European Central Bank)

The lower rate-sensitivity of France's debt compared to Italy could remove some of the pressure from the ECB to respond with urgency, which was instead the case with Italy in the past. This will allow the ECB to give some time, as well as distance in yield space, for higher yields to pressure French political parties into compromise.

But if French yields spike before Merz becomes chancellor, the ECB Council will not be able to afford to wait for a signal from the European Council or Commission regarding France's compliance with fiscal rules. We think the ECB would ultimately break whatever rules there are – including fiscal rules and TPI criteria – to prevent a systemic crisis in France, if deemed necessary.

Even without contagion to other countries, facing a 10-year spread between France and Germany that gets close to 180-190bp, the ECB will likely blink and activate TPI. We think that hawks within the ECB council are aware that a sovereign debt crisis in France represents an existential threat to the eurozone and will not sacrifice the euro in the name of fiscal discipline.

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