Flashnote

HSBC Global Research

Macro
France

French public debt: the impact of Ireland

Ireland's call for EFSF assistance has no impact on sustainability of French public debt

- **The EUR17.7bn EFSF loan for Ireland should imply a French guarantee of EUR3.8bn, or just 0.2% of GDP**
- **Despite the spending cuts in 2011, the weakness of the French public finances remains the large primary deficit…**
- **… which makes stabilisation of the debt-to-GDP ratio difficult, particularly if interest rates are rising**

The impact of Ireland's call for funds on French debt

The European Financial Stability Facility (EFSF) may contribute up to EUR440 billion to refinance Eurozone Member States in difficulty. France's nominal share of the EFSF guarantee is EUR89.6bn, but given that the member state using the facility does not participate, it is necessarily higher in practice. This is why the French parliament authorised the finance minister during the passage of the amended Finance Act to increase the amount of France's guarantee to a maximum EUR111bn. France's guarantee does not affect the government deficit or government debt until it is actually taken up.

The EUR17.7bn EFSF loan to Ireland does exactly that, as it implies a French guarantee of EUR3.6bn. If neither Ireland nor Greece are guarantors, the amount rises to EUR3.8bn (see table 1). Indeed if a Eurozone member state which guarantee the EFSF becomes a borrower, it ceases to be a guarantor if all the other member states agree. Assuming this is the case, French government debt should be EUR3.8bn higher. We assume that the guarantee will be given in 2011 for all the EUR3.8bn which will be added to the French debt stock even if Ireland has not drawn down the total amount at that point. This means that the French debt-to-GDP ratio could amount to 86.9% of GDP by end-2011 rather than our earlier 86.7% projection. The interest rate of 5.8% or so that Ireland pays on the loan will not push the French public deficit down because interest payments will be kept by the EFSF as a cash reserve to be distributed to guarantors only after repayment of all bonds issued by EFSF.

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1. Implicit guarantee by Eurozone member states for the EUR17.7bn provided to Ireland through the EFSF

	Scenario I: Original Guarantee Commitments		Scenario II: excluding Ireland and Greece		Scenario III: excluding Ireland, Greece, Spain and Portugal	
	Implicit contribution key (%)	Implicit guarantee EUR bn	Adjusted contribution key (%)	Adjusted guarantee EUR bn	Adjusted contribution key (%)	Adjusted guarantee EUR bn
Germany	27.1	4.8	28.4	5.0	33.4	5.9
France	**20.4**	**3.6**	**21.3**	**3.8**	**25.1**	**4.4**
Italy	17.9	3.2	18.7	3.3	22.1	3.9
Spain	11.9	2.1	12.4	2.2		
Netherlands	5.7	1	6	1.1	7	1.2
Belgium	3.5	0.6	3.6	0.6	4.3	0.8
Greece	2.8	0.5				
Austria	2.8	0.5	2.9	0.5	3.4	0.6
Portugal	2.5	0.4	2.6	0.5		
Finland	1.8	0.3	1.9	0.3	2.2	0.4
Ireland	1.6	0.3				
Slovakia	1	0.2	1	0.2	1.2	0.2
Slovenia	0.5	0.1	0.5	0.1	0.6	0.1
Luxembourg	0.3	0	0.3	0	0.3	0.1
Cyprus	0.2	0	0.2	0	0.2	0
Malta	0.1	0	0.1	0	0.1	0
Total	100	17.7	100	17.7	100	17.7

Source: EFSF web site, HSBC calculation

Ireland's call for guarantees makes no difference to the sustainability of France's public finances

In its most recent 2011 Finance Act, the government provides for a cut in public spending and increases in certain taxes that in our view lend credibility to its forecasts of a budget deficit of 6% of GDP in 2011, down from 7.7% in 2010 (for more details, see *The 2011 French budget : a convincing deficit reduction,* 29 September 2010).

Government spending excluding pensions and debt service costs is to fall by 0.2% in 2011. This incorporates an almost EUR10 billion drop in State operating spending as well as the replacement of only one out of every two retiring civil servants. Civil service pay will also be frozen next year, excluding bonuses. Within the social security system, spending growth will be limited by the current pension reforms. According to the government, the raising of the minimum retirement age from 60 to 62 years and the age of full pension entitlement from 65 to 67 years will save EUR400 million next year.

The government is also implementing tax increases to raise an additional EUR10.5 billion in 2011. They include the following:

- an increase in the 40% income tax band to 41%, with a contribution from stock options (EUR500 million in 2011)
- a levy on banks (EUR500 million in 2011)
- increased VAT on "triple play" offers (EUR1.1 billion in 2011)

2. New forecast of the French budget deficit from 2010 to 2013 including Ireland effect

	2009	2010f	2011f	2012f	2013f
Government forecasts					
Budget deficit (% of GDP)	-7.5	-7.7	-6.0	-4.6	-3.0
Government debt (% of GDP)	78.1	82.9	86.2	87.4	86.8
Real GDP growth (%Yr)	-2.6	1.5	2.0	2.5	2.5
Nominal GDP growth (%Yr)	-2.1	2.2	3.7	4.25	4.25
New HSBC Global Research forecasts					
Budget deficit (% of GDP)	-7.5	-7.6	-6.2	-5.2	-4.2
Government debt (% of GDP)	78.1	82.8	86.9	89.3	90.4
Real GDP growth (%Yr)	-2.5	1.6	1.5	1.8	1.8
Nominal GDP growth (%Yr)	-2.1	2.2	3.2	3.5	3.6
HSBC forecasts, excluding Ireland effect					
Budget deficit (% of GDP)	-7.5	-7.6	-6.2	-5.2	-4.2
Government debt (% of GDP)	78.1	82.8	86.7	89.1	90.2

Source: Ministry of finance, HSBC

Primary deficit is still the main weakness of France's public finances

The government deficit could decline in 2011 to roughly 6% and the government financing requirement could remain at EUR189.4 billion in 2011, as we previously expected. However, for 2012, details of measures to cut growth in public spending by half have not yet been given. Moreover, the French government's commitment to limit growth in central government, local authority and social security spending to 0.8% per year between 2011 and 2014 could be difficult to adhere to in 2012 due to the pre-presidential election.

The government expects the primary balance (budget balance excluding interest payments) to remain in deficit until 2012, despite the momentum of French debt. In view of this large primary deficit and the existing debt-to-GDP ratio, reflecting past government policy, the primary balance that would need to stabilise the debt-to-GDP ratio in 2011 at its end-2010 level to achieve a surplus of 0.1% of GDP. This compares with the primary public deficit forecast by the European Commission of -3.6% of GDP (see table 3). Furthermore, the debt-stabilising primary balance is particularly sensitive to changes in interest rates. If the interest rate is 4% rather than 3%, the primary surplus that would need to be achieved is 0.5% of GDP in Germany and 0.7% of GDP in France, but the primary deficit forecast by the EC for France in 2011 is -3.6% compared with -0.3% in Germany. Therefore, the fiscal effort (spending cuts and revenue increases) required to stabilise the debt-to-GP ratio would be more than 4% pt of GDP in France compared with less than 1% pt in Germany.

3. Efforts needed to stabilise public debt are amongst the highest in France according to European commission forecasts

% of GDP	Primary balance in 2011	Public debt in 2010	Effective interest rate in 2011	Primary balance for stabilising public debt in 2011	Primary balance for stabilising public debt in 2011 with interest rates of...			Fiscal effort needed to stabilise public debt in 2011 with interest rates of...		
					3%	4%	6%	3%	4%	6%
France	**-3.6%**	**83%**	**3.4%**	**0.1%**	**-0.2%**	**0.7%**	**2.3%**	**3.4 pts**	**4.3 pts**	**5.9 pts**
Germany	-0.3%	75.7%	3.3%	-0.1%	-0.3%	0.5%	2%	0.0 pts	0.8 pts	2.3 pts
Italy	0.5%	118.9%	4.1%	1.7%	0.4%	1.5%	3.9%	-0.1 pts	1 pts	3.4 pts
Spain	-4.1%	64.4%	3.8%	1.3%	0.8%	1.4%	2.7%	4.9 pts	5.5 pts	6.8 pts
Eurozone	-1.6%	84.1%	3.7%	0.6%	0.0%	0.8%	2.5%	1.6 pts	2.4 pts	4.1 pts

Source: HSBC calculation based on European Commission
Note: The results are based upon the European Commission nominal GDP growth for 2011 of a 3.2% in France, 3.4% y-o-y in Germany, 2.7% y-o-y in Italy, 1.8% y-o-y in Spain and 3% y-o-y in the Eurozone.

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