France: political uncertainty to persist

Macroeconomic Research

Hugo Le Damany
Economist (Euro area),
Macro Research

Key points

- The left alliance NFP secured c. 180 seats in the National Assembly – still far from the majority threshold – the centrist Ensemble came second with c. 168 and the far-right RN third with just 143, well below poll projections.
- None of the most radical macroeconomic platforms tabled during the campaign has a realistic chance to be implemented. But the new problem is how a three-way split can be pulled into a workable government.
- Most concerns and a likely timetable for resolution focus on France's budget and fiscal outlook. With France facing an Excessive Deficit Procedure, a new government must deliver a budget adhering to EU rules by early October.
- The path forward is uncertain, France having no history of this type of coalition. We expect several trial-and-error attempts at a solution but think a short-term government with limited mainstream agenda is a likely outcome.

Front Républicain holds the line

The surge in the Rassemblement National (RN) in the European elections continued into the first round of the national elections: the far-right party came out first in 297 constituencies. The second-round brought however a very sharp correction. Not only did the RN fail to achieve the outright majority that it had hoped – although we suggested looked unlikely after the first round – but it fell well short of other groups, coming in third with just 143 seats, below Macron's Ensemble that recorded c.168 seats (down heavily from 245 in 2022) and the Nouveau Front Populaire (NFP) – the left-wing alliance – that came first with c.180 seats (there is still some margin around the numbers per party since deputies have until 18 July to declare their affiliation to a parliamentary group).

The "Republican tradition" is that the President of the Republic appoints someone from the biggest group in parliament as Prime Minister, although it is not a constitutional obligation. NFP is using this tradition to claim the job, with internal jockeying among the various components of the alliance, which ranges from the radical La France Insoumise (LFI), probably the biggest caucus with NFP once deputies declare their affiliation, to historical government parties (Socialists, Communists and Greens). Arithmetically, a "NFP-only" government, implementing the alliance's radical economic platform, would have almost zero chance of survival, since all the other groups would have the numbers to force a NFP Prime Minister to resign by voting a motion of no confidence.

Symmetrically, a government based on an alliance between the centrists and the centre-right (c.60 seats) – which probably was Emmanuel Macron's preferred outcome into the elections – would fail to secure much more than 230 seats, thus opening itself to the same issue an NFP-only government would face.

Numerically, an alliance of NFP excluding LFI, centre-left deputies elected outside NFP and the centrists could command an absolute majority – just – at about 295 seats. Still, these various groups are themselves divided on the desirability of such arrangement, and the policy content of such a government. Extending such a "central coalition" to the centre-right would provide a much stronger numerical base, but at the cost of even more acute political tensions within such grouping. In any case, any broad coalition could probably agree on only a small number of key principles guiding policies, probably ushering in a rather "minimalist" government.

In short, while the outcome of the vote conformed to our base line outlook that no single party or group would achieve an overall majority, it is still difficult to work out a clear path forward with the French system not used to coping with three, rather than two, large blocks, and numerically viable solutions will take some form of dislocation of the current alliances, which may take some time.

The French way forward

Despite the lingering uncertainty, there are two strong take-aways from this weekend's election results. The most radical and potentially market upsetting macroeconomic proposals came from the more extreme ends of the political spectrum, from RN and from LFI. Neither of these programmes will now be able to be delivered in full, regardless of who holds the prime ministership, as alternative groups hold a majority and can stop these proposals through tabling motions of no confidence. The corollary of that is that neither can these more extreme parties block legislation coming from some form of central coalition, as even combined they do not form a majority.

France has no history of forming coalitions across traditional family lines. This will make adopting the compromises necessary to form a working government this time all the more difficult. This likely explains some of the more "maximalist" negotiating stances initially proposed by some. We thus expect this government formation process to proceed on a basis of tâtonnement – "trial and error" - until a workable solution is achieved. This is likely to involve significant pressures as different potential combinations – some of them possibly quite "baroque" are tested to destruction. This process is also likely to take time, we expect months, not weeks. All of which is likely to add to episodes of stress in French asset markets.

At this stage, the least unstable agreement looks like a technocratic government. This would be a form of government in which the decision-makers are selected based on their expertise in a given area of responsibility This would attempt to remove the 'political' aspect of any decision, although would inevitably be more centrist than either many in the NFP or the centre-right would choose. Such a government would likely exist to achieve the bare basics of a functioning state. It would deliver a "minimalist" fiscal bill – perhaps without support, but without material objection from the rest of parliament to avoid a risk of a government shutdown.

Unlike other European states, in particular Italy which has a fairly successful tradition there, France has never experienced a technocratic government, with previous cohabitations arising from periods of majority. This would in itself be a period of high uncertainty, with little guide to how institutions and the public would respond. But its duration would likely be short. We think this could stand until another round of elections are organised in a year's time, when the President has the right to dissolve parliament again, when hopes of delivering a stable majority may return.

"It's the budget, stupid"

In any case, the negotiations and timeline are likely to be corralled with one overriding issue – the delivery of a budget and broader financial market concerns about the fiscal outlook. Arguably the most basic requirement of any government is to deliver a finance bill and to ensure the smooth continuation of the state and economy. France will have difficulties in passing a budget formally supported by a majority of the new parliament. However, France's Constitution does have several contingencies to deal with such a circumstance. Article 49.3 allows for the passage of legislation as long as an absolute majority does not block it through a motion of no confidence, which in turn forces a resignation of the government. Another option to consider would be a configuration in which Parliament cannot even vote on a budget, wallowing in procedural bottlenecks. The Constitution stipulates that if parliament "*has not given its opinion within seventy days, the provisions of the bill may be brought into force by ordinance.* "Ordonnances" are basically decrees which the government can take without approval by parliament.

A bigger problem would arise if parliament has formally rejected the budget (i.e., voted against, or voted in favour of a motion of no confidence). There is still a solution there: If another finance bill setting out the resources and expenditures for a financial year has not been tabled in time to be enacted, "*the government shall urgently request authorisation from*

Parliament to levy taxes and shall open the credits by decrees". We would find it unlikely that no majority would be found in parliament to authorise the government to "roll" the budget into 2025. But this would imply a considerable fiscal tightening, both on the revenue side (income tax brackets would not increase) and expenditure side (inflation indexation would not take place). This would have material ramifications for the growth outlook. But might provide a sufficiently dire potential outcome to allow the passage of an alternative budget, if parties were worried about being blamed for a more damaging economic outlook ahead of expectations for another election in 2025.

This also takes place at a time when markets are already asking questions of France's fiscal outlook having, as one of several Eurozone economies, breached EU fiscal rules and become subject to a European Commission having Excessive Deficit Procedure. Indeed, last year, France proposed a budget that would not have seen the deficit fall below the 3% of GDP required by the EU before. And even then, we considered this outlook to be based on pretty optimistic conditions. Since then, revised estimates of France's deficit have worsened and the near-term economic outlook has not met original expectations. We note that Moody's is already communicating on the need for adjustment in France, probably preparing minds for a shift to "negative outlook" of their rating.

A new budget will be required by early October. Around the same time, under the revised European fiscal surveillance framework, France will have to submit its 4-year fiscal plans to the European Institution, setting out a path to return the French deficit to a longer-term sustainable level (<3%) over a "reasonable" time period. There are, of course, different ways to deliver fiscal rectitude. Given the expected left-leaning skew to the new government, it may well be that a future outlook leans more into considering tax increases than spending cuts. But a technocratic government may be better placed to deliver politically unpalatable measures to meet fiscal rule requirements.

With France having now avoided some of the extremes of government that could have created significantly more tension with fiscal rules, this should also mitigate any spillover effects for the rest of the Eurozone. France's sovereign bond spread over Germany has been broadly stable since the second round of the election, currently at 67bps, having fallen back from over 80bps before the first round. But Italian spreads, which rose alongside French spreads on the back of the election uncertainty reaching 155bps before the first round have continued to decline after the second round and are now back to 133bps, broadly back to levels that had prevailed for most of Q2. Despite the ongoing uncertainty, this election does not look like it will raise any existential concerns for the EU or the functioning of broader monetary policy.

That said, the need for fiscal restraint in France is going to make it difficult to assuage the underlying tensions in French society. Business sentiment and investment may become more persistently downbeat against a backdrop of uncertain finances and potential tax hikes in the short-term, but ongoing political uncertainty in the medium-term as doubts about whether any new government will last beyond the anniversary of this election will persist. In turn, this risks acting as a headwind to French GDP and productivity growth, in turn adding to pressures on the finances.

Cautious market reaction

Unsurprisingly given the marked uncertainty that continues to hang over the immediate political outlook, financial market reaction to the weekend's polls has been muted. We have noted the basic stability in the French OAT 10-year bond spread. The French CAC 40 equity index is -1.3% after Sunday's second round (despite being up 1.0% from before the first round), unwinding some of the post-first round euphoria that saw it rise 2.8%. This compares to a Eurostox 50 index which is down 0.8% since the second round (and up 0.9% from before the first). The euro has been broadly stable, easing 0.2% to the US dollar from the second round, having risen by 1.1% from before the first vote to before the second.

10 July 2024

Our Research is available online: www.axa-im.com/investment-institute

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826