France: political uncertainty and fiscal risks

Brace for a structurally higher risk premium

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SUMMARY

- The outcome of the French parliamentary election remains uncertain. Opinion polls continue to hint at a far-right victory but with a wide range of projected seats. The momentum could shift in either direction between the two rounds.
- The most plausible scenarios all entail significant fiscal and financial risks, including a far-right government with or without an absolute majority, or a hung parliament resulting from a strong rise of the left. The most positive outcome of a broad centrist coalition may only materialise as a result of an institutional crisis.
- Irrespective of the immediate reaction in financial markets, we expect the French (fiscal) risk premium to remain structurally higher for longer.

PARLIAMENT AND GOVERNMENT COMPOSITION REMAINS HIGHLY UNCERTAIN

The combination of a fragmented political landscape and a complex electoral system makes it difficult to predict the exact distribution of seats in the future assembly. Based on current polls, the different coalitions and the likely carry-over of votes in the second round, **the far-right Rassemblement National (RN) seems likely to come in first**, although the number of seats they can win remains very uncertain.

An absolute majority would allow the RN to govern alone while a relative majority would require ad hoc coalitions. If the shortfall relative to the absolute majority of 289 seats is small enough, the RN may enter into a coalition with (part of) the conservatives Les Républicains (LR). In case of a more fragmented parliament, the RN may remain in the opposition with an eye on the next presidential election.

A victory for the left-wing alliance, the Nouveau Front Populaire (NFP), looks less likely, mainly because the pool of votes in the second round appears to be more limited. Even if the NFP won, an absolute majority would be difficult to achieve. Given the antagonisms between the outgoing majority and the most radical left-wing parties, a minority government would also be very challenging.

Finally, a centrist pro-Macron majority looks very unlikely based on current polls.

That is why a majority of observers expect **a hung parliament**, leading to very different outcomes eventually including a minority government, a broad centrist coalition, or a technocratic caretaker government. In the event of a deadlock, **a temporary coalition including moderates** from the NFP, Macron's Renaissance, and LR could be formed, at least to deal with budget emergencies. However, a centrist coalition would be structured around the outgoing majority, so it may only be envisaged in case Renaissance fares better than expected. It would also be highly unstable, likely leading to new elections in a year's time.

Last but not least, the president could always resign after the election. Emmanuel Macron repeatedly ruled out this option regardless of the results, but the pressure would rise immensely in case of a large defeat of his party, or after it becomes clear that no stable government can be sworn in. In that case, for all the provisions included in the constitution to preserve institutional continuity, extreme uncertainty would likely trigger another round of market stress until the next election.

POLITICAL MANIFESTOS AND LAST-MINUTE ADJUSTMENTS

The main political blocs have provided the broad contours of their programmes, with some details left intentionally vague, including in terms of timing and costs.

Chart 1: selection of parties' manifestos

	Left (Nouveau Front Populaire)	Center (Renaissance)	Conservatives (Les Republicains)	Far-right (Rassemblement National)
Pensions	- Revoke the 2023 reform and restore legal retirement at age 60 - Increase in minimum pension	- Keep current legislation	- Keep current legislation	- Revoke the 2023 pension reform at a later stage - Retirement possible after 42 years of work
Wages	- 15% increase in net minimum wage (to €1'600 / month) - 10% raise in public sector wages - Wage indexation to inflation	- Cuts in employers' contributions - Transferring employees' social contributions to VAT	- Cuts in social contributions (for employees earning less than 3x the minimum wage)	- Exempt wage increases from employers' social contributions (up to 10% and up to 3x the minimum wage)
Taxation	- Increase tax income progressivity into 14 brackets - Reinstate wealth tax (ISF) - Revisit tax breaks on corporates - Financial transactions tax	- No increase - Additional tax cuts on production if possible	- Tax cuts on production and lower social contributions - Tax free inheritance up to €1 million tax (+ reduce gift taxes)	- Replace real estate wealth tax with tax on financial wealth - Introduce new taxes on "superprofits" and financial transactions
Energy prices	- Freeze energy, food and essential goods prices - Undo a 12% planned gas price increase on July 1	- 10-15% decrease in electricity price in 2025	- Decrease in electricity prices	- Reduce VAT on energy products from 20% to 5.5% - Further reduce electricity prices by challenging EU electricity market rules
Spending	- Increase employment in health and justice system - Increase education subsidies	- €20bn savings expected in 2024 (€10bn spending cuts + €10bn credits cancelled)	- €25bn savings (reduction in civil servants and public structures) - Reduce social spending by merging minimum social benefits	- Nationalise French motorways to cut road tolls - Curb immigration financial support

Source: Pictet Wealth Management, political manifestos, as of 24.06.2024

On the far-right, the leaders of the **RN** have remained evasive, backtracking on some key measures of their original such as the reinstatement of the 60-year retirement age or a VAT cut on basic goods, torn between the break with the past they want to embody in the eyes of the electorate and the desire to appear "responsible" in the eyes of the business community. In this respect, **RN's leader Jordan Bardella has hinted at a "two-stage approach"** by prioritising some policy measures and post-poning other reforms to a later stage. In the same vein, the RN has made a large part of its programme conditional on **a prior audit of public finances**, in a classic move that may justify further concessions by blaming the outgoing government. In terms of priorities, most RN measures would focus on boosting purchasing power and real wages (e.g., via a VAT cut on energy products, a reduction in low-income taxes, or the exemption of social contributions for companies increasing wages).

On the left, the **NFP** presented a detailed joint programme, also distinguishing between short-term priorities and longer-term measures, including significant tax and spending increases. Some of their flagship campaign promises include a return to 60-year minimum retirement age, a sharp increase in wages, larger state interventions, and an overhaul of income, corporate and wealth taxation, including the reinstatement of the solidarity wealth tax (ISF). The NFP would also seek to implement emergency measures to freeze the prices on energy and basic goods.

In the **centre and centre-right**, the proposed measures are in line with what can legitimately be expected from these parties. Renaissance is in line with the outgoing majority's record, especially in terms of budgetary savings. The LR programme aims to reduce the role of the state in the economy, in particular by lowering the tax burden, financed by a reduction in public spending.

The available estimates of the cost of these various programmes are often based on the programmes of the 2022 legislative elections and should thus be treated with caution. Moreover, the underlying assumptions in terms of the financing of each measure, but also their second-round effect on the economy and the budget are fraught with considerable uncertainty. That said, most estimates are consistent with **a very large fiscal cost attached to both programmes of the NFP and the RN**. For the centre and centre-right, the programmes would be less costly, but still challenging given the precarious budgetary situation in which the French economy finds itself today.

FISCAL RISKS: SHORT-TERM BUDGET CONSTRAINTS, LONG-TERM DEBT CHALLENGES

Irrespective of the outcome of the elections and the first measures that will be implemented, the next government will have to make very challenging decisions over the next couple of months starting from a weakening fiscal position. Indeed, 2023 was marked by a significant budgetary slippage, with the deficit reaching 5.5% of GDP, compared to the budgeted 4.9% (Chart 2). This was the main reason for the Standard & Poor's decision to downgraded France's sovereign rating to AA- last May. To make things worse, the monthly budget data from the Ministry of Finance suggest that the situation did not improve in the first four months of 2024 (Chart 3).

The government was already expected to pass a corrective budget to make up for last year's slippage while committing to a new fiscal path sent to Brussels in April. To be consistent with a reduction of the public deficit below 3% by 2027, this

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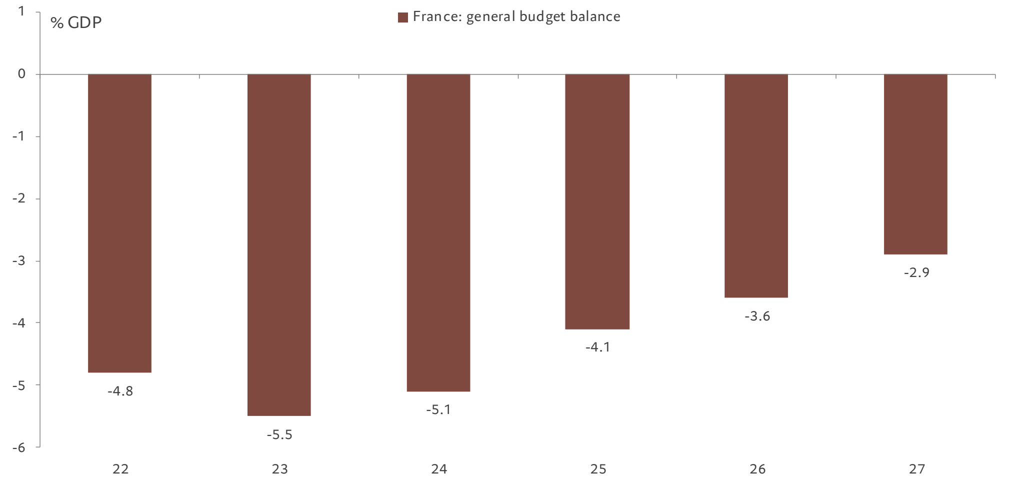
adjusted medium-term plan would imply **a large fiscal consolidation of around one percent of GDP in 2025**, on top of future fiscal requirements.

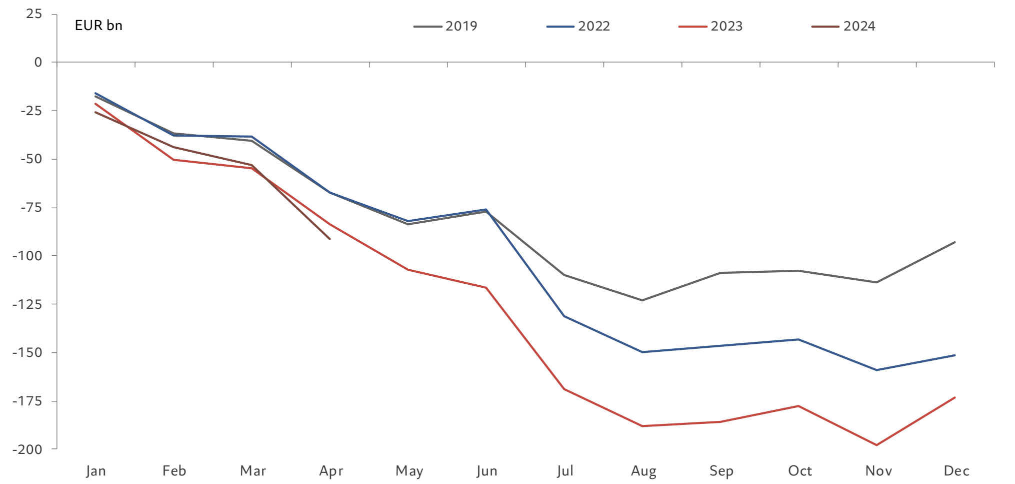
Chart 2: outgoing government's fiscal balance expected path (2024-2027)



Source: Pictet Wealth Management, French Stability Programme, as of 20.06.2024

Last but not least, the European Commission formally opened an **excessive deficit procedure** against seven European countries last week, including France and Italy. Depending on the election results and planned policy measures, France could thus be forced to amend its medium-term fiscal path again and submit it to Brussels by September. The process will likely take some time as member states will also have to submit their draft budgetary plans for 2025 by mid-October, with the new European Commission providing their first assessment in November.

Chart 3: monthly fiscal budget balance



Source: Pictet Wealth Management, French Ministry of Finance, as of 20.06.2024

In short, France won't be facing formal sanctions or fines any time soon, but the stage looks set for potential confrontation with Brussels on many fronts.

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FINANCIAL MARKETS LIKELY TO PRICE IN A STRUCTURALLY HIGHER RISK PREMIUM

Our baseline scenario is that a RN-led government would act as cautiously as possible and seek to avoid direction confrontation with Brussels and financial markets, simply because that wouldn't be in its interest over the longer run. **However, there is still scope for acute stress,** including a real risk of social unrest. **We are also sceptical of the notion that so-called 'Melonisation' of the RN** will lead to a more benign market outcome. While Giorgia Meloni and her allies already had experience of governing and dealing with the business community before she was elected prime minister in 2022, RN leaders have no government experience, no strong relationships with French businesses and little influence in European circles.

A hung parliament would likely prolong the uncertainty hanging over the French economy and financial markets. **A centrist coalition tasked with passing a budget** would be the most favourable scenario, but it may only emerge after complete deadlock and it would likely be unstable, leading to new elections in a year's time. Alternatively, **a technocratic government** dealing with current affairs may be broadly neutral for markets but would do nothing to address underlying budget issues.

A very strong score for the leftist coalition NFP would arguably be the worst outcome for markets and **raise fears of a 'Liz Truss moment'**. However, the coalition looks fragile. There is a chance that far left leader Jean-Luc Mélenchon could drop out of the race to become PM in the face of rising pressure from inside the NFP. This could be a game-changer for the left, and possibly a less negative outcome for markets if the most radical part of the NFP is effectively side-lined to the benefit of the more moderate Parti Socialiste (PS).

So, what to watch for after the first round of the election on Sunday?

- **Turnout**: We expect a sharp rise in the participation rate compared with previous elections, to 65% or higher. A higher turnout could favour centrist parties as part of a 'Republican spurt', but also the far right if we see more 'triangulaires' in the run-off elections on 7 July (i.e., three-way contests involving candidates who won more than 12.5% of votes in the first round).
- **Winner's score**: A stronger-than-expected showing of one of the three main parties would raise the odds of them forming a government eventually by creating incentives for new alliances.
- **Post-election rhetoric**. Depending on the results and the number of three-way (or four-way) runoffs, party leaders may hint at such future alliances during interviews after the first round on Sunday.

While the immediate market reaction will likely be driven by the size of an incoming government's majority, the willingness and ability of this government to respond to France's fiscal challenges and its stance vis-à-vis Brussels will determine the road further out. **All the most plausible scenarios point to a structurally higher risk premium being attached to French bonds and risk assets**.

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