France: Q&A on the way forward

A bumpy path to a coalition government

08 JULY 2024, CIO OFFICE & MACRO RESEARCH

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SUMMARY

- Since the establishment of the Fifth Republic in 1958, the French parliament has never been as fragmented as it is now, with no party coming close to a majority. A coalition government is arithmetically possible, but politically difficult to achieve. A period of instability is likely before an agreement can be reached. Meanwhile the deteriorating fiscal situation will be the most pressing challenge facing the next government.
- Financial markets have priced out the tail risk of more extreme scenarios, but protracted political and fiscal uncertainty justifies a higher risk premium attached to French assets. We expect the 10-year French OAT spread over Bunds to hover in a range between 60 bps and 80 bps in the months ahead, and the euro to trade in the 1.05-1.07 range against the USD in H2.

Elections are often full of surprises, and the run-off round of the legislative elections in France this weekend were no exception. While last week, after the first round, the question was how big a majority the Rassemblement National (RN) would win, in the end it came in third, behind the Nouveau Front Populaire (NFP, a coalition of left-wing parties) and Emmanuel Macron's centrist Ensemble movement.

Despite the RN's very good performance in terms of votes, the so-called "republican front" and a high turnaround blocked the party's road to power. All in all, the RN increased its deputies in the National Assembly from 88 to 126, but was well away from forming an absolute majority (289 seats). At the same time, President Macron's coalition lost 82 seats (leaving it with 168), and the NFP increased from 149 to 182, driven by the good performance of the Socialists at the expense of the radical left-wing La France Insoumise (LFI, which remains the main force in the NFP).

This situation raises a number of questions: What are the possible political scenarios? How are governments formed? Can a state budget be pushed through without parliamentary support? How could the election result impact France's fragile debt situation?

WHAT ARE THE POSSIBLE SCENARIOS FOR GOVERNMENT?

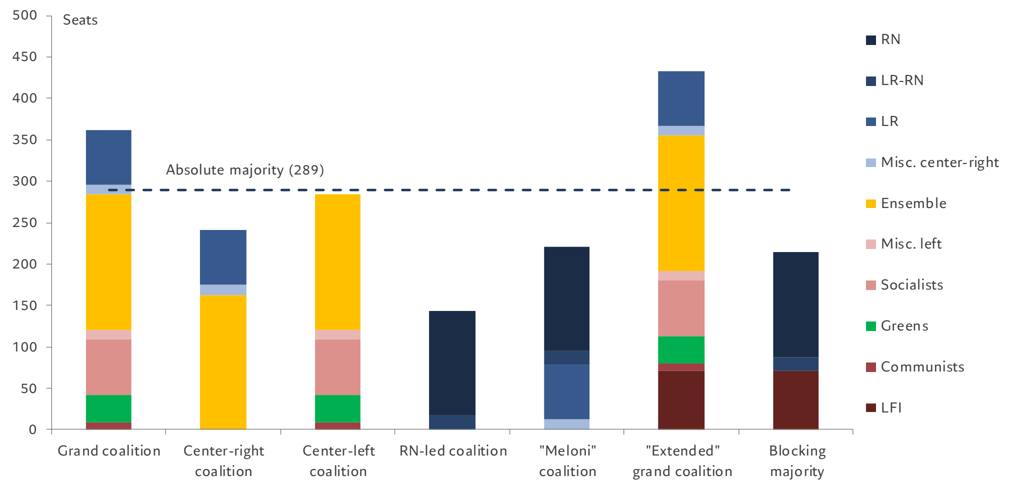
Pending the appointment of a new prime minister, the outgoing government remains in charge of current affairs and Gabriel Attal remains prime minister. This situation could last beyond the Olympic Games, while Emmanuel Macron consults the various political forces with a view to appointing the next government.

Given the fragmentation of the National Assembly, **only one configuration would obtain an absolute majority of seats: a grand coalition**, either in a reduced form, ranging from the left, excluding the LFI, to the right-wing LR, or in an extended form, including the LFI. It goes without saying that this second option is unlikely, given the radical opposition between LFI on the one hand and Ensemble and LR on the other. All the other options (left-centre alliance, right-wing coalition) would be in the minority. Finally, it is important to note that **the LFI and the RN will not have a blocking majority**, which reduces the degree of instability to come.

At this stage, we see three main possibilities: a ‘restrained’ grand coalition that has a majority of seats but is vulnerable given the divisions between the various parties involved; a minority centre-right or centre-left government that is exposed, like the last government, to frequent motions of censure; or a government of technocrats that conducts government affairs until new elections are called in a year’s time. The most likely scenario seems to be a grand coalition, but this could come after several unsuccessful or short-lived attempts at minority government.

In all cases, a new government would certainly be provisional, and its main task would be to expedite the most urgent issues, including the state budget for 2025. **A provisional government may only emerge after lengthy negotiations between the political parties and president Macron and will be inherently fragile.**

Chart 1: potential coalitions in the French parliament



Source: Pictet Wealth Management, French minister of the Interior, as of 8 July 2024

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HOW IS A GOVERNMENT FORMED?

The prime minister is appointed by the President of the Republic, to whom the Constitution grants almost total freedom of choice. There are no conditions or criteria governing the president's approach to picking a prime minister. In theory, he is not even obliged to follow the results of parliamentary elections. However, with the advent of 'cohabitation' in the 1980s (meaning the prime minister is not from the same political family as the president), the practice of appointing the leader of the party that came first in elections to the Assembly as prime minister became established (thus, the centre-right Jacques Chirac became prime minister in 1986 under socialist president François Mitterrand and socialist Lionel Jospin became prime minister in 1997 during the presidency of Chirac). But there is no constitutional obligation for this. Indeed, during the second cohabitation in 1993, Jacques Chirac won the legislative elections but refused to become prime minister, prompting François Mitterrand to appoint instead another centre-right politician, François Balladur.

Today, given the lack of a strong majority, Emmanuel Macron appears to be particularly free in his choice. It is likely that the NFP, having come out on top, will ask the president for a mandate to form a government once it nominates a candidate for prime minister from its ranks. It remains to be seen whether the president will grant such a mandate.

Ministers are also appointed by the president, but are proposed by the prime minister. The president can refuse to appoint certain personalities, particularly to posts that fall within his "reserved domain", i.e. defence and foreign affairs. In this sense, Emmanuel Macron will therefore have a say in the composition of the next government or governments.

Finally, unlike most parliamentary systems, **a French government does not need the confidence of the National Assembly to be sworn in**. It can start work as soon as it is appointed by the president. However, the government remains accountable to the National Assembly, which can dismiss it if a motion of no confidence is passed by an absolute majority of the Assembly's members. Importantly, however, **the constitution limits the number of motions of censure that can be tabled during a parliamentary session**, which usually lasts from October to June: they must be signed by 10% of the Assembly (58 deputies) and each deputy can only sign three. Given the political configuration after the elections, LFI, for example, will only be able to table three motions of no confidence, while the RN will only be able to table seven. In any case, the next government will be exposed to repeated motions of no confidence. Yet a total stasis seems unlikely, as it is not in the parties' interest to appear as a destabilising factor in the eyes of the electorate.

CAN A BUDGET BE PASSED WITHOUT PARLIAMENTARY APPROVAL?

In short, parliamentary approval is required, at least to authorise tax collection and borrowing. A French-style shutdown scenario can therefore not be ruled out, but the absence of a far-right/far-left blocking majority limits this risk.

Under normal circumstances, the constitution provides the government with powerful tools to push through the annual budget. Parliament has 70 days to vote on a draft budget once it has been submitted by the government, after which the government automatically has the right to implement it by decree. Similarly, the government can waive its responsibility for adopting a budget (Article 49.3): the budget is then adopted without a vote if the National Assembly does not adopt a motion of censure to overthrow the government. While the latest election results reduce the potential such constitutional provisions are applied, they should not be dismissed entirely. For example, the parties that censure the government in a budget vote would have to face the consequences of the resultant crisis.

But what happens if the draft budget is simply rejected by the National Assembly anyway? What if the National Assembly censures the government? These risks are all the greater given that the main threat to the National Assembly i.e. a dissolution cannot be mobilised for another year. While our base case scenario remains that a budget for 2025 will be adopted before the end of the year, there is a risk that it is not. **If a government is unable to present a draft budget in time for it to be adopted before 31 December, it will have to make an emergency request to parliament** for authorisation to levy taxes and then issue decrees to open the appropriations corresponding to the last budget adopted. This procedure was used once, in 1979, after the 1980 budget was censured by the Constitutional Council.

However, the government cannot raise taxes or borrow money if parliament refuses its request. There would then be a considerable risk of a French-style government shutdown. The Constitutional Council would certainly be called upon to find an interpretation of the Constitution that guarantees essential public services until a more permanent solution is found.

HOW SERIOUS IS FRANCE'S FISCAL SITUATION?

There was considerable fiscal slippage in 2023, with the public deficit reaching 5.5% of GDP, compared to 4.9% projected in the original budget. **Since the beginning of the year, budget execution has not improved**: the public deficit is estimated to have reached EUR113 bn at end May, EUR7 bn higher than at the same time last year. The outgoing government had planned savings of around EUR20 bn this year and the same amount next year. But these plans are now on hold.

In the run-up to the elections, **the European Commission opened an Excessive Deficit Procedure against France**. While financial sanctions against Paris are out of the question in the short term, the next government is, in theory, required to submit new plans to bring the deficit under control to Brussels by September, with an assessment due in November.

Finally, **the rating agencies will review France's sovereign rating in the autumn**. Fitch (AA-), Moody's (Aa2) and Standard & Poor's (AA-) will give their opinions on 11 October, 25 October and 29 November, respectively. All have a stable outlook on their ratings. A revision of the outlook to "Negative" cannot be ruled out for Fitch and especially Moody's, whose rating has remained unchanged since 2015.

WILL THE ECB INTERVENE IN THE BOND MARKET IN CASE OF RENEWED FINANCIAL TENSIONS?

The short answer is no. The somewhat longer answer is still no, barring a full-blown crisis.

The ECB's most obvious intervention tool would be the Transmission Protection Instrument (TPI). This has eligibility criteria attached to it. These include compliance with European fiscal rules (no Excessive Deficit Procedure (EDP) in course) and 'fiscal sustainability' criteria (based on debt sustainability assessments by the ECB itself, the European Commission, the European Stability Mechanism and the International Monetary Fund). On 19 June, the European Commission said it would recommend France and six other EU countries to be formally put under an EDP. True, the ECB may be more flexible in practice, but for France to be eligible to TPI interventions it would need to at least show a strong commitment to European rules, including "effective corrective action". In plain English, **the ECB would have no legal or political ground for intervention** in the event of a democratically-elected government implementing fiscal measures that lead to a widening in bond spreads.

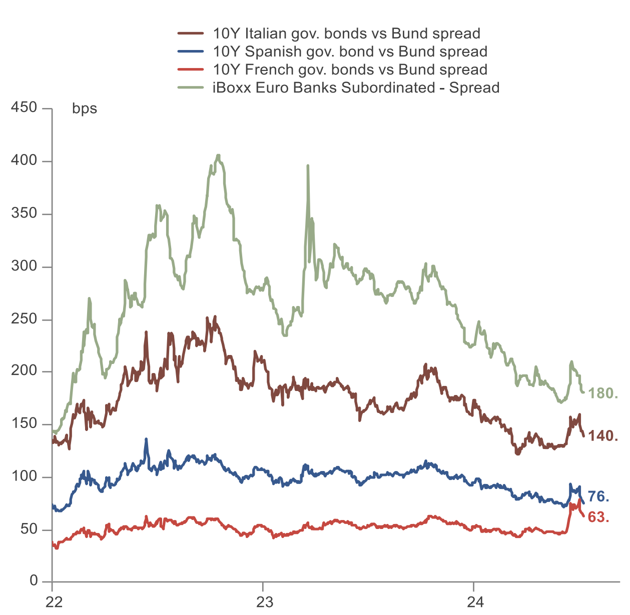
This doesn't mean that the ECB would not intervene under any circumstances. First, the ECB may have no choice but to react in the event of a major liquidity crisis that threatens the stability of the banking system. In that case, we could imagine a new facility targeting the repo market, for instance. Second, in case of broad-based financial contagion, the ECB could activate the TPI to buy sovereign debt from other countries like Italy or Spain seen as innocent "collateral victims" of a French crisis. In other words, **it's not so much the level of the French bond spreads than a disorderly market re-pricing that would trigger ECB interventions**.

WHAT COULD BE THE IMPACT OF THE ELECTION ON FRENCH BONDS?

Markets underwent a relief rally after the first round of the French elections as it became clear that a hung parliament was becoming more likely, and this led the 10-year French government bonds (OATs) spread over Bunds to come off its recent highs, closing at 63 on Friday 5 July (see *Chart 2*). While the outcome of the French parliamentary election reduces the probabilities of large-scale, unfunded spending promises being enacted, there is still a risk that France's budget deficit worsens. We therefore expect OATs will continue to pay a higher risk premium than before the elections, with **the 10-year French OAT spread over Bunds likely hovering in a range between 60 bps and 80 bps in the months ahead**. Nevertheless, we maintain our 10-year French OAT-Bund spread year-end forecast unchanged at 60 bps, as **we would expect any new government to agree on fiscal consolidation, thus limiting the risk of a further rating downgrade of French sovereign debt in the short term.**

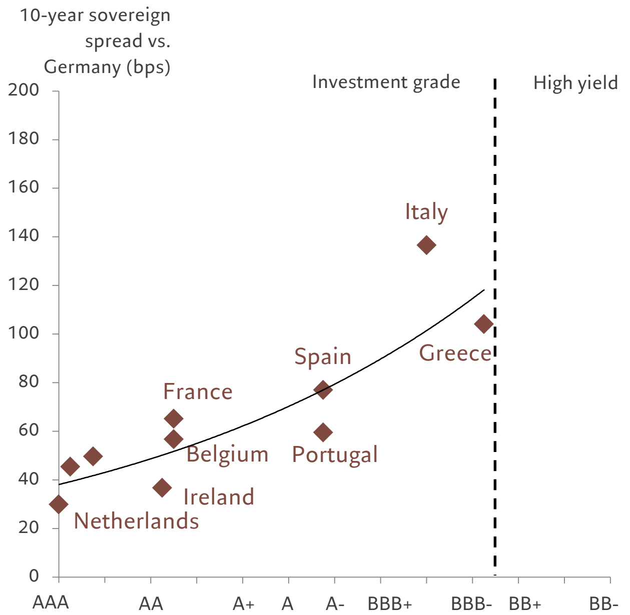
Longer-term risks remain regarding France's sovereign rating on the back of fiscal slippage and an elevated public debt-to-GDP ratio. After France's downgrade by S&P to AA- in May, France's average sovereign debt ratings remains in the AA bucket, well above the average rating for Spain and Portugal (see *Chart 3).* Given the diverging fiscal dynamics between France and these two countries, we would expect France's risk premium to converge towards its lower-rated peers in the medium term. Nevertheless, because of the stabilising factors we have identified in a previous note (see France: high-stakes election), we see limited risks for the 10-year French government spread to widen beyond 100 bps this year.

Chart 2: Euro bonds spreads



Source: Pictet Wealth Management, FactSet, 05.07.2024

Chart 3: Euro sovereign spread and average rating*



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 05.07.2024 (* average rating from DBRS, Fitch Ratings, S&P Global, Moody's)

Foreigners held 53% of total OATs outstanding at the end of 2023. Past episodes of political uncertainty in Europe have seen foreign investors selling European bonds. Moreover, we see risks of heated budgetary discussions between whatever new government is formed in France and the European Commission this autumn. Foreigners have been net buyers of European bonds since the beginning of 2023, but we would expect these inflows to moderate in H2, with the risk that foreigners become net sellers. This could mean that European sovereign bonds continue to pay a higher premium than before the snap elections announcement. This underpins our forecast that spreads will widen slightly by year's end for 10-year Italian government bonds (to 160 bps) and their Spanish counterparts (to 90 bps).

At the same time, the German Bund's safe-haven status and the prospects of further ECB rate cuts lead us to expect a fall in the 10-year Bund to 2.3% by year-end from its current level of 2.56% (on 5 July). The surprise calling of French parliamentary elections in June has caused euro investment-grade (IG) corporate spreads to widen but yields to fall slightly (see *Chart 4*). The spread widening can be explained by the fact that French issuers represent 21% of the ICE Bank of America euro corporate index, with French banks alone accounting for 7%.

The prospects of prolonged political and fiscal uncertainty are likely to ensure that European and French corporate bond issuers continue to pay a higher risk premium than their US peers in the coming months (see *Chart 5*). As a consequence, we have decided to move from an overweight to a neutral stance on euro IG corporate bonds, aligning it with our already neutral stance of US IG.

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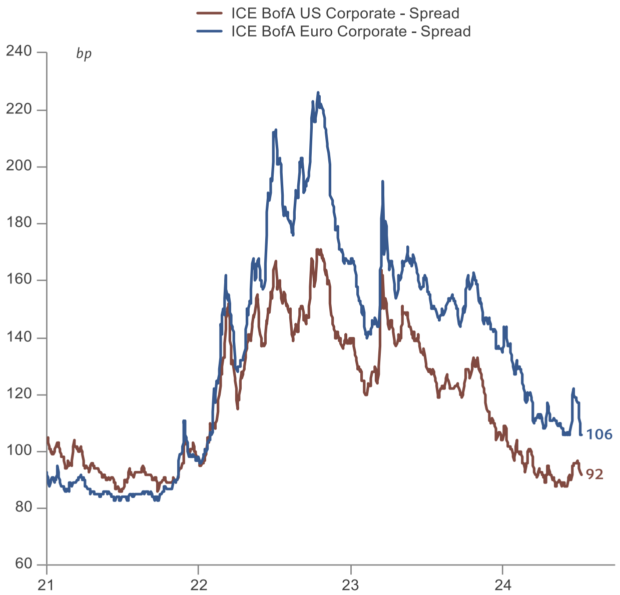
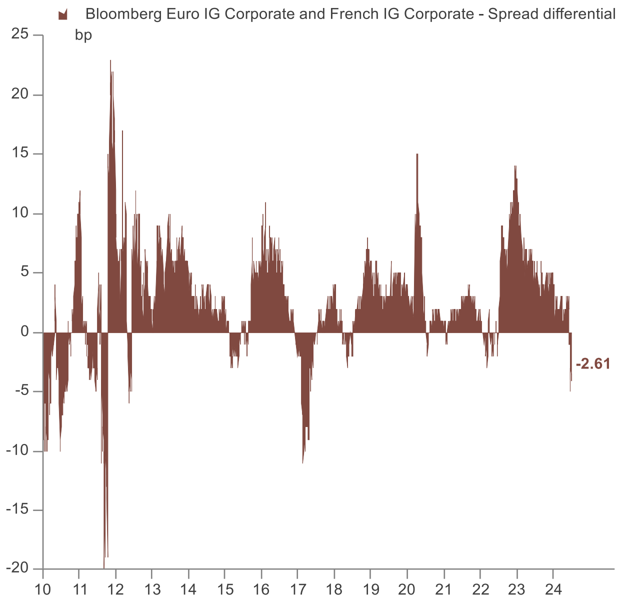
Chart 4: US and euro IG corporate spreads



Source: Pictet Wealth Management, FactSet, 05.07.2024

Chart 5: Spread differential between euro and French IG issuers



Source: Pictet Wealth Management, FactSet, 05.07.2024

WHAT'S IN STORE FOR THE EURO AFTER THE FRENCH ELECTION?

Two days is a long time in politics. Since Friday, a centrist coalition or a technocratic government has looked the most likely outcome of the elections in France, with the risk of far-right or a far-right led government declining substantially. Importantly, this means the sharp fiscal downside risks, such as a repeal of the pension reform, action on energy prices or minimum wages, have been pushed back. But a centrist or technocratic government will only be able to buy time, not address France's pressing fiscal issues. Indeed, the fiscal adjustment programme the outgoing government sent to the European Commission envisaged a budget deficit below 3% only by end-2027, whereas France's year-to-date fiscal performance is already worse than last year's (resulting in a 0.6% of GDP overshoot).

Muddling through is not enough. As a result, while the election outcome may cap the downside, for both the budget and the euro for now, it provides little upside. The need for fiscal adjustment remains great, especially if the French economy grows only 0.8% as we forecast. After the relief rally on Monday, we can thus expect pressure on both OATs and the euro to reemerge. **We maintain our forecasts for the euro to trade in the 1.05-1.07 range against the USD in H2.**

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