

A New Republic?



You'd be forgiven for not knowing many of France's prime ministers. The nation's political system has in recent history put much more emphasis on a hyper-powerful president, who directs policy to a friendly and aligned National Assembly. This is an oversimplification, but nevertheless a useful practical understanding. It also no longer applies. President Macron's decision to call a snap election has led to an extremely divided lower house. Any policy agenda, including a much-needed budget, will require negotiations spanning different ideologies. We ultimately think that the French political system, the economy, and financial markets, will cope with the new reality. But the necessary move to a political culture of compromise will see volatility, and the 2027 Presidential election looms large.

The people have spoken (over each other)

Macron's centrist political grouping, Ensemble, fared poorly at the European Parliament elections on June 9, 2024. His party secured around 15% of the vote, similar to the Socialist party, but less than half of the hard-right National Rally (RN). Opinion polls beforehand predicted this outcome, and waning popularity for his party and agenda had already cost Macron a majority in the National Assembly in 2022. The surprise was not the result itself, but Macron's decision to immediately call a snap French parliamentary election, to be held at end of the very same month.

After a blisteringly quick campaign, chaotic alliances and tactical voting, the results show an even more divided political landscape than before. Ultimately, the result has created three evenly sized blocs within the National Assembly. This was in stark contrast to predictions following the first round, where either a relative or outright majority for the National Rally looked likely.

Who's who?

A hastily-arranged left wing alliance, New Popular Front (NFP), secured the most seats in parliament but fell far short of a majority. This bloc consists of a broad alliance of left-wing parties, the largest four of which are: The Socialists, the Greens, the Communists and Jean-Luc Mélenchon's France Unbowed (LFI). The group ran on a joint and radical plan including: overturning the recent pension reform and boosting public sector salaries. This would be funded by a variety of tax increases, including the introduction of a wealth tax.

A collection of centrist parties aligned to Macron ended up with the second most seats in the parliament. Notably, this group shied away from references to Macron himself during the campaign. The concern was that he may have become an electoral liability. While the eventual outcome of 159 seats is far better than early predictions of fewer than 70, this still represents a one-third loss since the 2022 election.

Despite winning the largest percentage of the popular vote, the nationalist-right and historically Eurosceptic RN ended up with the third-most seats in the Assembly. This is a reflection of France's two-round electoral system. To put this into international context, the British Labour party has just won a landslide majority in the UK parliament on a similar vote share to RN; around a third of all votes. The RN was campaigning from a position of strength, with Jordan Bardella seen as the most likely replacement to the current prime minister, Gabriel Attal. While still radical, and in some cases in direct confrontation with the EU, there was an attempt to moderate their policy platform to maximise electoral appeal. Nevertheless, significant constitutional questions were raised during the campaign on the division of power and the limits of the presidency.

The left and centrists successfully negotiated electoral pacts between the first and second round, and implored their voting base to vote against the RN. A high number of possible three-way races were reduced to a choice between the RN and another candidate. This tactic proved highly effective, defying initial predictions of an outright RN victory and leading directly to today's divided chamber.

Lastly, the traditional centre-right began the campaign in disarray as party leader Éric Ciotti called for an electoral pact with the RN. Stunning scenes included footage of him locking himself in the party headquarters to avoid a vote of no confidence in his leadership and a power struggle over the party's social media accounts. There remain a number of centre-right Republicans in the new parliament, and they may play a key role in supporting a possible government.

Avoiding censure

The French Fifth Republic is not designed for this set up. A 'cohabitation' refers to a period where the President and the prime minister, as the head of the parliament, are in opposition to one another. Although it has happened previously, this was mainly the result of a mismatch between the terms of the president and the legislature, which were aligned in 2000. Macron himself has stated he intends to serve out his full Presidential term through to 2027, but his agenda will be constrained by the new complexities of the lower house.

From here the main question is whether a stable government can be found that avoids a vote of no confidence in the Assembly. This is a crucial point, as a government does not necessarily need a majority if some parties abstain from censure votes. This may not necessarily take the form of an official coalition with an agreed policy platform, but could be a form of a caretaker government, which a majority in parliament implicitly or explicitly agree not to bring down via votes of no confidence. Given how divided parliament is, there is an enormous degree of uncertainty here.

One clear possibility is an eventual 'grand coalition' spanning the centre left and right. This would span less radical elements of both the left and the right, and include Macron's group. It also relies on parties such as the Socialists breaking away from the NFP, which although possible is not certain. Whether a grand coalition would be truly stable, and what specific policies could be agreed upon is unclear. As such, a realistic scenario is now a policy stasis in France. This scenario is likely to be one of the most palatable for financial markets.

Other combinations are also possible, yet all of them have distinct weaknesses. The near future is also complicated by the summer parliamentary recess, a possible need for an extraordinary session, and the beginning of the Olympics. Some point to the possibility of a 'technocratic' government, inspired by international examples. This would be a 'non-political' government, not tied to any specific party or agenda, with a mandate to stabilise the functioning of the government within narrow bands. While possible, this is unlikely as a longer-term solution as separating policy from politics is hard in practice. There are further possible combinations, including attempts at a forming minority government by each ideological camp. The NFP have the strongest claim to this initially as the single largest faction in parliament. The same issue crops up again here: avoiding a no confidence vote and passing legislation is very difficult. Lastly, the RN's role in this should be watched, as it is likely that the greater the role the left-wing plays in any coalition, the higher the likelihood that they try to trigger votes of no confidence. New elections are possible in a year, but there is a significant chance that they will result in a similarly divided Assembly.

The Sands of Time

One way of looking at the new scenario is that it is a fair reflection of long-running trends in French politics. The traditional parties of past French Presidents, the Socialists and the Republicans, now represent less than a fifth of voters. Macron's centrist forces have been incrementally losing support to harder variants of the right and left throughout his term. One positive within this is that while Euroscepticism does exist on both the right and the left, it played a consistently diminishing role during campaigning. The three-way split in today's Assembly is broadly representative of the varied views of the French public. This implies that coalition building may be an increasingly necessary French political skill. Any future President may no longer be able to take a parliamentary majority for granted as a by-product of their own electoral success.

Challenges

Even prior to the elections financial markets were growing nervous about the French debt outlook. This is a key concern for any new government. It was also a motivation to tone down fiscally expansionary rhetoric during the campaign. French debt-to-GDP currently stands at around 110%. Disappointing revenue receipts saw the 2023 deficit worsen to 5.5% of GDP, and this year it is likely to remain over 5%. France has been placed into an Excessive Deficit Procedure, the new rules of which were recently agreed upon following a pandemic suspension. This stipulates a regular reduction in the structural budget deficit and overall debt levels, with a seven year plan and European Commission oversight. Any new government will need to negotiate and implement this plan in conjunction with Brussels.

Within the Eurozone sovereign bond complex, French bonds have long been expensive when compared to simple debt and deficit metrics. This premium is disappearing. After years of 10yr French bonds trading around 0.3%-0.4% above German debt, we are seeing a new discount of between 0.5%-0.8%. We see this as a reasonable repricing that reflects a more challenging environment amid the need for budget consolidation. These higher spread levels do not reflect crisis levels, but do highlight the need for vigilance over the debt trajectory. It is likely we will still see more volatility in this spread, particularly as we approach the 2025 budget negotiations.

Chart 1: France's debt to GDP has grown faster than the Eurozone average



Source: Bloomberg

A riposte: Optimism

Despite this new political reality and the challenges highlighted above, there are structural positives benefitting the French economic outlook. There are precedents within Europe where political stasis does not necessitate negative economic activity nor market returns. Whisper it quietly, but Macron has overseen hard-fought and reasonable reforms to improve economic dynamism. These reforms may well stay. Today, French unemployment stands near historic lows at 7.4%. Since Macron's term began in 2017, France has grown at more than twice the pace of Germany and has matched the Eurozone average. Efforts have been made to foster and encourage a much-needed start-up culture, which is key to Europe's successful adaptation to the rapid pace of technological innovation globally. Despite the political uncertainty, the economic situation today continues to improve. In the Eurozone, and France specifically, inflation is falling. The ECB has begun to cut interest rates, and the US Federal Reserve may soon boost the rest of the world by cutting their own.

Chart 2: The French unemployment rate is near historic lows



Source: Bloomberg

Looking towards 2027

While new National Assembly elections may happen a year from now, there is a plausible case for a political bargain and relative stability for the time being. The next presidential election is due to be held in 2027. Macron, having served two terms, is not eligible to run. His highly individual style complicates the process of finding a successor. It is likely that two recurring figures on opposing ends of the ideological spectrum will run again: Marine Le Pen and Jean-Luc Mélenchon, or at least politicians representing their views. Other parties, including the traditional and centrist forces will likely field their own candidates. The two-round system delivered a broadly representative and divided Assembly. But, there will be only one President. The two candidates with the highest vote share in the first round go through the second round. As such, it is possible that both the qualifying candidates could be from the extreme, and opposite, ends of the political spectrum. Three years is a long time in politics and in financial markets but an incredibly short time in a nation's history.



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