MARKET COMMENTARY

France's political crisis: scenario analysis

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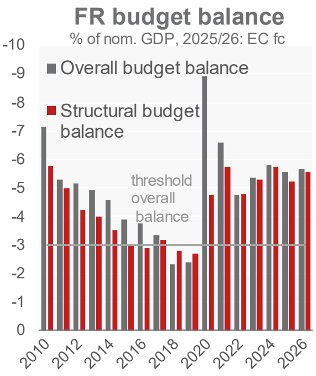
- **Unprecedented: Four PM resignations in 20 months. First time in the 5th Republic a PM lost a Confidence Vote.**
- **New PM Sébastien Lecornu will rely on a minority coalition (Renaissance/centre + LR/conservatives). He faces an urgent budget deadline (7 October) and tough policy battles (agriculture, Mercosur, energy). The risk of censorship toppling this government in the next 3-6 months looms large.**
- **Political instability weighs on growth: Q2 rebound driven by stockpiling, but fundamentals are weak. The fiscal consolidation is likely to be slower than that proposed by F. Bayrou.**
- **We discuss four stylised scenarios: 1/ "kick the can", 2/ new elections bring a majority ("positive"), 3/ another split parliament ("negative"), 4/ full-blown crisis. We look at implications for the OAT-Bund spread, and can provide extended forecasts on request (rates, credit, equity, FX).**
- **The OAT market has priced a lot of bad news, but scenarios 1 (at the margin), 3 or 4 would still imply further spread widening. The end of the stalemate (election & majority) would instead be a buying opportunity for French assets.**
- **The ECB is unlikely to intervene unless France accepts strict reforms. Rating cut from AA-/Aa3 more likely than not but chained or multi-notch downgrades a rather remote risk.**

An unstable political context. President Macron this week received the resignation of his Prime Minister for the fourth time in just 20 months (E. Borne, G. Attal, M. Barnier, F. Bayrou). Never, under the 5th Republic (1958), had three consecutive governments stayed in power for such a brief period. PM Bayrou was the first ever to lose a Confidence Vote. He did not lose small: 364 against, 194 for. Indeed, even some of the LR (Conservative) MPs, who had been supporting his government, voted against – highlighting the fragility of the minority coalition, or "common base" (Renaissance/centre + LR/conservatives).

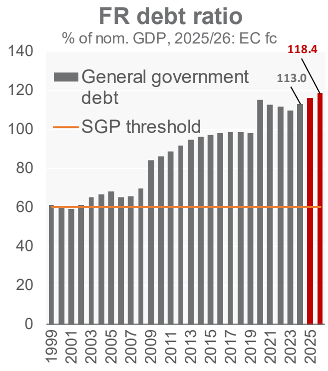
President Macron wasted no time to call a close ally, **Sébastien Lecornu** (who was a member of LR before joining E. Macron's campaign in 2017), to the PM position. His key priorities will be to form a government, then present his policy plan to parliament. While this plan is usually subject to a confidence vote, this is not an obligation, and PM Lecornu may choose to skip this step to avoid the risk of immediate collapse. Then he will need to **present a budget to the parliament by 7 October**. F. Bayrou's budget, which targeted €44bn of savings (via spending cuts and tax hikes), will be revamped. Other sensitive topics include **agriculture** (Loi Duplomb), the **Mercosur trade deal** and the pluriannual **energy policy**. On any of these debates, the survival of government may be tested, as the threat of Motions of Censorship – where Parliament can only topple the government via an absolute majority (289 votes) – looms large. The "common base" is 79 seats short of a majority. RN (far right) will be the king maker. Even the moderate left (PS) has refused to be part of the new government; they may vote against it unless PM Lecornu gives them significant concessions. The upcoming political agenda, namely the local election of March 2026 and the presidential election of May 2027, greatly reduces hopes of a broader collation.

President Macron's approval rate has dropped to a new low, at just 15%. He hopes for this new minority government to stay afloat for the 20 months into the 2027 elections – which looks very unlikely. RN has reiterated their call for snap legislative elections. A recent Ifop poll showed that almost two thirds of French people wanted elections in the coming months.

Political crisis hits economy ahead of recovery. Following a respectable growth rate of 1.2% in 2024, headwinds from global trade uncertainties, tariffs and the local political situation are weighing on activity. Growth rebounded in Q2 to 0.3% qoq, the fastest in three quarters, but driven by inventory accumulation (+0.5 pp) due to firms stockpiling ahead of the anticipated trade woes. Fundamentally the economy is anything but strong. Employment has been receding since 4Q24 and consumer confidence has weakened over the course of the year. Investment activity is structurally weak, as the OECD points out, and slightly declined in



Source: Datastream, EC, GenAM



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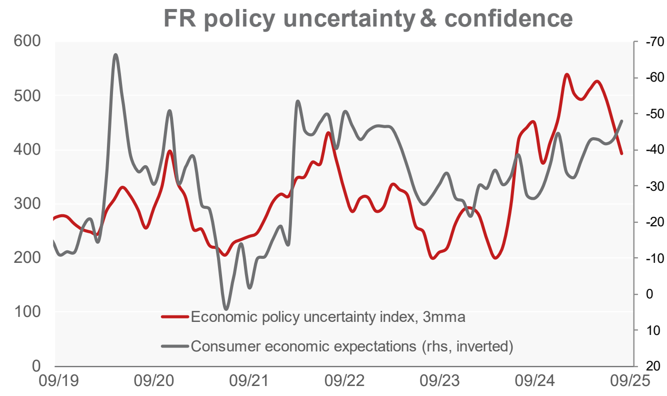

Source: Datastream, GenAM

Q2. Investment is among other factors held back by heightened political uncertainty since the early general elections of June 2024. Moreover, a restrictive fiscal policy (fiscal impulse of -0.9 pp in 2025 according to the latest EC projection) dampens activity. Luckily, with trade woes abating and the monetary policy impulses supporting activity, confidence has started to improve: the composite PMI recovered in August to the highest since April 2024. With fiscal policy potentially turning less restrictive in 2026 (fiscal impulse of -0.1 pp in 2026 according to the latest EC projection) we expect GDP growth at 0.6% in 2025 and 0.8% in 2026 – with risks on both sides depending on political developments (see below).

Four political scenarios. The table below frames scenarios for 2025-26, with attached probabilities for the next 3-6 months. The situation is fluid and a transition from one scenario to another appears likely.

- The nomination of S. Lecornu as the new PM fits with **scenario 1 – "kick the can down the road".** The slower fiscal consolidation and persisting political uncertainties would likely keep the 10y OAT-Bund elevated, or slightly wider (85bp end 2025, 90bp end 2026). The eventual fall of the government would either open the door to a "technical" government (still scenario 1) or to new elections (scenario 2 or 3).

- **Scenario 2 assumes that early elections would deliver a majority – a positive outcome**. Though this could take various shades of grey, the newfound stability would reassure investors (spread around 65bp in our books).

- **In scenario 3 the general elections deliver a split parliament again**, with three blocks, including a significantly smaller centrist group. This would put intense pressure on president Macron to resign. Indeed, the quagmire would continue for another 12 months at least, given the legal impossibility for him to call another election. Importantly, a *newly elected* president would most likely be allowed to call fresh legislative elections – i.e. the 12-month rule would no longer apply. Though a presidential resignation remains unlikely, in this scenario France may fall into a constitutional crisis - we see the spread initially widening to 100bp, before cooling marginally as we get closer to the 2027 election cycle.

- **Scenario 4 sees a full-blown crisis**, for any of the reasons spelled out in the table. In this scenario, we assume that the spread would widen to circa 130bp initially and stay wide throughout 2026 – if still below the peak experienced through the euro area sovereign crisis in 2011 (150bp, and even briefly 180bp), before the ECB enlarged its toolbox.

We have enriched our scenario analysis with related **forecasts on other financial variables** (rates, credit, equity, FX) and stand ready to provide those **on request**. **Strategically, we do not see the recent market price action on French assets as a buying opportunity just yet**. The emergence of a new majority would be, but it will likely require conclusive elections. The contagion from OATs to French credit has been very muted, with the most visible impact being on subordinated bonds issued by French banks and utilities. In equities, France has strongly underperformed EMU over the past 18 months (some 15pp in the MSCI space) but this largely reflects much slower earnings growth.

What if another election? Our probability distribution below implies that another early election in the next 6 months is more likely than not. Recent polls do not include seat projections just yet. Importantly, cracks suggest that a union between extreme left LFI (extreme left) and others (PS, Greens, and Communists) may not be repeated next time – a key strategic element in France's first-past-the-post electoral system. This would increase the risk of 3-party battles in many jurisdictions, in the second round, making predictions particularly difficult. Another uncertainty stems from the voters' support for the "republican front," i.e. the political combinations that we saw in the past to block the RN from winning a majority. A recent Elabe poll showed that 53% of the voters are now opposed to such strategies. Polls suggest a fairly stable score for the RN (33% in the first round in 2024), but 1) the smaller 'Reconquête' party (far right) is expected to make significant gains vs. 2024, from 0.75% to about 5% and 2) a weaker "front républicain" will translate into more seats for the extreme right. RN is already the biggest party in parliament, with 123 seats (majority at 289). Polls suggest that E. Macron's Ensemble may lose about 5 points from 21% in 2024. The united left may also erode from the 28% gained in 2024; a split may lead to a higher cumulated share but would likely result in a lower number of seats after the second round. We still deem it unlikely that RN would win an absolute majority. While it may not be in LR's interest to enter a coalition with RN ahead of the 2027 elections, a conditional support may reassure investors, as a guarantee of greater fiscal discipline.

Kick the can (new PM)

- President Macron names a new PM. Situation, remains **fragile** given lack of majority in Parliament.
- We assume the 2026 budget gets adopted, with limited consolidation, maybe half of the 44bn proposed by Bayrou – so slightly negative.
- This scenario **may mutate** into Scenario 2 or 3 in the coming months, in case the new government loses a Motion of Censorship.
- True day of reckoning = Pres. election of May 2027.

**Positive
New election, majority**

- New early general elections delivers a **majority**.
- In this scenario, we assume this majority will run a somewhat **responsible fiscal policy**.
- This scenario may take various forms, the most positive (but unlikely) being a broad centrist coalition; the most likely may be a scenario "à la Meloni" whereby, for the first time, the RN goes into government, thanks to an unprecedented alliance with the Conservatives (LR).

**Negative
New election, no majority**

- New election delivering a fragmented parliament *again*, **testing the resilience of the Constitution**.
- It is virtually impossible to box all possibilities in just 4 scenarios, so this 'negative' one also encompasses the case of a majority running a lose fiscal policy and **sustainably large deficits**, or a consolidation based mostly on a tax shock (left wing majority) that would hurt growth significantly.

Full-blown crisis

- Full-blown attack on OATs due to heightened social and/or political crisis, which could take many forms.
- Foreign investors own about 55% of the French debt and may start to panic in the face of a **constitutional crisis**, and/or a **sharp deterioration of local economic** conditions, and/or fiscal slippage that would suddenly **threaten debt sustainability,** and/or fast **rating downgrades**.

Proba* | Impact			
35% |	20% |	30% |	15% |

* Probabilities reflect the 3-6m outlook. Near term, scenario 1 is effective, but the life expectancy of the new government appears rather low.

Daunting fiscal challenges. In our pre-crisis base case we projected that France would manage to reduce the 2024 public deficit of -5.8% in 2024 to 5.0% by 2026. This was already less ambitious than the planned -4.6% (2026) by the Bayrou government, reflecting our doubts about the capacity to implement all consolidation measures (such as scrapping two public holidays). In this scenario the debt ratio would reach 118% of GDP by 2026, up 5 pp from 2024. PM Lecornu has not made his intentions clear yet, but we assume a mild relaxation of the Bayrou's targeted savings. Only in case of new elections resulting in a majority government would we expect a more benign outcome. In the case of elections failing to bring a majority, we fear slippage to around -6% in 2026, and the debt ratio reaching or breaking the 120% threshold. The Bayrou plan foresaw a decline of the deficit to -2.8% by 2029 and a reversal of the trend in the debt ratio to 117%. Without action taken the debt ratio was simulated to reach 125% of GDP by 2029. We see an increased risk of slippage in this unstable political environment.

ECB will not bail France out. Following the GFC & euro crisis, the ECB supported governments – as a side effect of emerging deflation risks – by means of bold QE. It spent over € 2.6 tr during the first QE phase (2015–2018), mostly on government and corporate bonds, which helped compress spreads and reduce borrowing costs. Currently, there are no deflation risks in the foreseeable future. The ECB is still reducing its QE stock, as it has stopped reinvestments. The only way French public debt could be supported by the ECB right now is via devoted programs. But they require preconditions. The most imminent tool would be the Transmission Protection Instrument (TPI), though it is aimed at supporting fundamentally sound sovereigns facing "unwarranted, disorderly market dynamics" which pose a threat of monetary policy transmission; they shall be supported by potentially unlimited purchases. However, France is currently not suffering from contagion, rather its deteriorating public finances are at the core of the market stress. While the ultimate decision whether to activate the TPI is in the hands of the Governing Council, we deem the hurdle to do so high. There now exist various programs by the European Stability Mechanism (ESM) which offer support in exchange for reforms. Only if France were to join such a program and to accept surveillance, would OAT purchases by the ECB would become more likely (via the OMT).

Rating downgrade? Fitch will review France's rating (AA-/Negative outlook) on 12/9. Then Moody's (Aa3/stable) on 24/10 and S&P (AA-/Neg) on 28/11. Predictions are always difficult; a negative outlook from Moody's may be coming, although the downgrade in December already assumed that "the country's public finances will be substantially weakened over the coming years." Still, the heightened political uncertainty and deteriorating debt affordability may tilt the outlook. The other two agencies may want to wait for a political clarification, or not; the risk of a downgrade to A+ is very significant, if mostly priced by the market. The rating trend for France remains negative, yet a quick multi-notch downgrades, experienced by other countries through previous crises, appears unlikely given France's "large, wealthy and diversified economy", the enlarged ECB toolbox (even if not likely to be used any time soon) and legitimate hopes of a political clarification in the next 12-24 months.