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Emmanuel Macron's High-Stakes Gamble

Moritz Kraemer -- Chief Economist
LBBWResearch@LBBW.de

June 21, 2024

France's snap election could push its deficit to dangerous heights

Should you be living near overlapping tectonic plates, then you will know: the aftershocks can be even more dangerous than the main earthquake itself. The political equivalent of this geological jolt was the European election, with France feeling a particularly massive shockwave. There, Macron's centrist alliance was so severely rebuked that the president decided to go all in, dissolving parliament and calling for snap elections.

Political earthquake in Paris

The political center is being crushed from both sides

If the calculus was to bring about a return of voters towards the political middle, this gamble is currently backfiring. In polls, Macron's camp is languishing in third place. Not only has Marine Le Pen's right-wing faction outpaced him, but the hard-left camp around Jean-Luc Melenchon is also significantly ahead.

Le Pen has abandoned her formerly radical positions one by one to become more palatable to the political center. No more talk of leaving the EU. Antisemitic undertones have vanished. And, most recently, the former Putin sympathizer has also changed her foreign policy stance, advocating for weapons for Ukraine. Her clear distancing from the even more radical German AfD party points in the same direction.

Le Pen's party is heading into the election as the clear favorite. Many economic commentators now see her as the lesser of two evils. Melenchon is openly hostile to business and an arch-Eurosceptic. His unabashed antisemitic tendencies make him unelectable for many people anyway. Whether Le Pen can achieve a parliamentary majority is hard to predict due to the French two-tier election system.

Fig. 1: France risk spread

Yield difference between ten-year government bonds of France and Germany, in basis points.

Source: Refinitiv, LBBW Research

That such an election outcome is no longer seen as the worst conceivable disaster in French politics painfully illustrates how far the shrinking of the political center has progressed already.

Dieu nous en préserve! Capital markets are worried.

Regardless of Le Pen's overtures to the political middle ground, investors are alarmed. The risk premium for French government bonds has shot up since Macron's dramatic move (see Fig. 1). And the stock market's leading index has dropped by about 6%. No matter how respectable Le Pen tries to appear, many see her as a wolf in sheep's clothing.

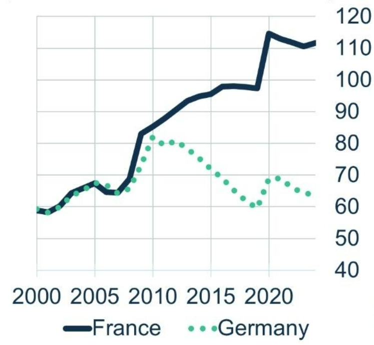
Concerns mainly revolve around public finances. The deficit was already at 5.5% of GDP last year, and debt has reached a level where there's little room for error (see Fig. 2). Among other things, Le Pen has promised to roll back Macron's pension reform and to reduce consumption taxes on fossil fuels. The think tank Institut Montaigne estimates that Le Pen's presidential campaign program in 2022 would have increased the deficit by over 100 billion EUR, or an additional 3.5% of GDP.

France is on a fiscal policy collision course. If the government does not change direction, and there's less indication of that now than there was before the European election, the likelihood of a Euro crisis 2.0 dangerously grows. The Greek crisis was bad. But a financial crisis with Paris (or Rome) at its epicenter would be dramatically worse for all of Europe. The European Central Bank has rightly insisted that it's high time to repair public finances. And the Commission has initiated a deficit procedure against France, among others, on Wednesday.

But still, Paris is speeding towards a financial cliff hidden behind a fog wall...

Le Pen's plans: pouring oil on the deficit fire

Fig. 2: Public Debt (% of GDP, 2000-2024)



Source: IMF, LBBW Research

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