Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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The collapse of the French government and the limits of fiscal sustainability

The government of François Bayrou collapsed yesterday in Paris. It received 194 votes in its favour in the National Assembly, while 364 MPs voted against it. This ended a nine-month minority government that tried to reconcile budget cuts with a divided parliament.

President Emmanuel Macron must now appoint a new prime minister and do so in a short time, as the draft budget must be submitted to the assembly at the beginning of October.

There is not much time left for political agreements, and the financial markets and rating agencies are showing no patience.

The collapse of the government was expected. The package of measures, totalling around 44 billion euros, which provided for a combination of tax increases and spending cuts, including the abolition of two public holidays, has united both the left and the right against the government.

For the left it was an attack on the welfare state; for the right it was proof that the government was focusing on taxes rather than structural reforms. In such an environment, it was easier to score political points by toppling the government than by taking responsibility for unpopular measures.

A government without a stable majority becomes a risk

However, the essence of yesterday's event lies not in the parliamentary vote but in the economic context. France now pays more for longer-term debt than Greece and Spain, while the gap to German bonds has widened further.

With debt at around 114 per cent of GDP and weak economic growth, the country is entering a phase in which the markets are setting the pace for politicians.

> Investors have been expecting the government to collapse, but they are not prepared to drag out decisions indefinitely

These are not abstract stock market figures but real borrowing costs that could amount to over 100 billion euros per year in interest alone if interest rates and debt remain on their current course. Under these circumstances, a government without a stable majority becomes a risk that is difficult to explain to investors.

The new cabinet cannot afford to hesitate. The budget for the coming year must be presented by the beginning of October. If no majority is found, every measure will be watered down, and the deficit reduction target will be postponed once again.

The rating agencies' timetable follows. Fitch will review France's rating at the end of the week, while Moody's and S&P will come in the autumn. Investors have been expecting the government to collapse, but they are not prepared to drag out decisions indefinitely.

Solutions inspire no confidence

The French political scene has been in a state of permanent deadlock for several years. The three blocs, the left, the centre and the right, have learned to live in mutual competition and without the will to compromise.

Under these circumstances, the government stays if every law receives ad hoc support. Bayrou has not succeeded in forging such an alliance. His appeal for accountability was not enough, as parties on the left and right saw more benefit in bringing down the cabinet than saving it. Thus begins another period in which protests and strikes are more realistic than compromise.

> Too much taxation risks a recession, while sudden cuts without reforms only delay the problem

Behind all the discussions lies a difficult question. How to move from a deficit of over five per cent of GDP to at least around four per cent without stifling growth?

Bayrou offered a combination of spending cuts and higher taxes. On paper this seemed sensible, but in practice it could not survive a political vote.

The Socialists preferred higher taxes on the wealthy and corporations, while the right insisted on tougher spending cuts. Neither of these solutions inspires confidence.

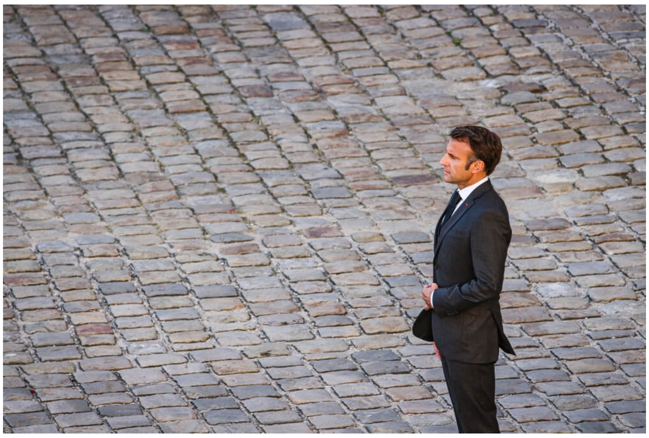
Too much taxation risks a recession, while sudden cuts without reforms only delay the problem. The markets acknowledge the distinctions, yet their primary focus lies on a plan that is feasible to execute.

The cost of decisions is determined by the markets

France is still the second largest economy in the Eurozone, but this position will become a weakness if the country cannot present a credible plan to contain its debt. The era of easy and cheap borrowing is over, and new rules impose high interest rates and tighter market controls.

The European Central Bank no longer provides a safety net, as it has stopped buying government bonds and raised interest rates, so the markets are now setting the price of French debt, which is rising month by month.

Parliament can overthrow governments in such an environment, but the markets determine the cost of these decisions.



If there is no clear direction, the scenario will repeat itself. France will continue to change prime ministers, and the cost of borrowing will rise from mandate to mandate - Emmanuel Macron

From this point of view, the question of the new prime minister is not just a question of political tactics but of the credibility of the state. The budget must be credible and politically viable.

If Macron opts for a deal with the left, he will have an easier path to a fiscal majority but risks a decline in economic activity. If he enters into an alliance with the right, he will be able to cut spending faster, but he will face social resistance. The most likely option is some kind of mix: gradual spending cuts with targeted taxes and a long-term reform plan.

Macron is currently not thinking of calling new elections, as the new assembly would probably have an even less favourable distribution. This means that there will be a period of "minority budgeting", with constant negotiations over points.

The risk of such a scenario is that the country becomes accustomed to living with makeshift solutions, with enough resources to avoid financial collapse but insufficient to restore confidence.

The markets will not tolerate such indecision for long. The widening spread between French and German bonds shows that tolerance is waning.

If the new government presents a convincing plan and shows there is political agreement on some important steps, confidence can be restored more quickly than sceptics believe.

However, if there is no clear direction, the scenario will repeat itself. France will continue to change prime ministers, and the cost of borrowing will rise from mandate to mandate.

The collapse of the government yesterday signals the onset of a new phase in France, characterised by expensive political improvisation and a focus on real billions.

The new prime minister will not have the luxury of making visions and promises. He will have to muster a majority in the Assembly, convince the rating agencies and reassure the markets. If he fails in all three steps at the same time, the end will look just like yesterday, only more expensive.