What Le Pen means for EMU

A possible victory for Le Pen's party in the snap elections for the National Assembly is putting pressure on French government bonds. We analyze the increasing influence of right-wing parties on the statics of the monetary union and whether a government takeover by the Rassemblement National could lead to a sovereign debt crisis.

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Le Pen might win the snap elections ...

The European elections have triggered a political earthquake in France. The right-wing nationalist Rassemblement National (RN), Marine Le Pen's party, won 31.4% of the vote, more than twice as many as President Macron's alliance (14.9%). He responded to this on Sunday with the first early dissolution of parliament since 1997. A new National Assembly will now be elected in two rounds on June 30 and July 7.

In view of the RN's strong performance in the European elections, it is quite possible that Marine Le Pen's party will also become significantly stronger in the national parliament and end up forming the government. This would be the first so-called "cohabitation" since 2002 in which the president and prime minister belong to different parties. The president would dominate foreign policy and would remain commander-in-chief of the armed forces. However, domestic, economic, fiscal and defense policy would be the responsibility of the government.

Jordan Bardella, the 28-year-old leader of the party and successful lead candidate in the European elections, would probably head such a RN government. The RN has already made it clear what its priorities would be: projects such as the Green Deal (already under pressure) or a European migration policy have been clearly rejected. It would oppose any expansion or deepening of the EU and, in particular, keep security policy firmly in national hands. Even if the RN no longer calls for a "Frexit" - i.e. France's exit from the monetary union and the EU - it still wants a Europe á la carte. France would only participate in EU projects that are in the national interest according to the RN, and they also want to set the rules.

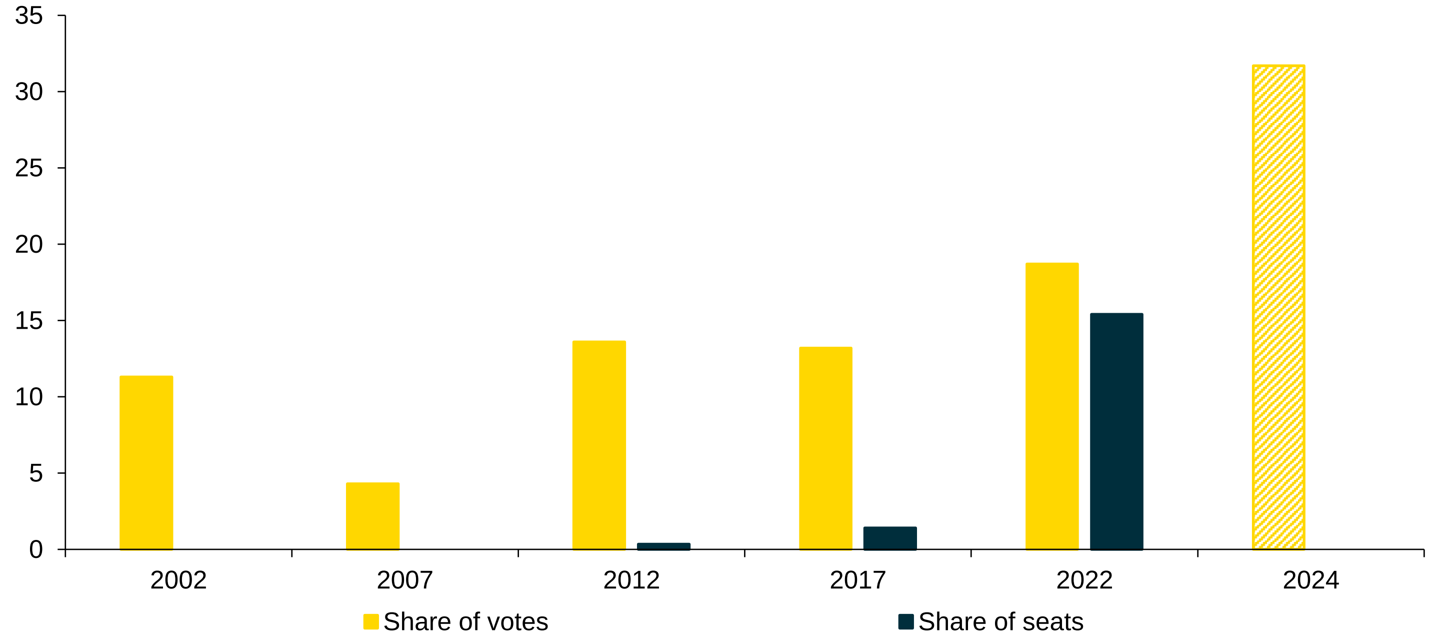
... and form a government

Due to French electoral law, it is difficult to estimate how likely such an election victory for the RN is. Unlike the European elections, which are based on proportional representation, elections to the French National Assembly are based on majority voting. If no candidate achieves an absolute majority in a constituency in the first round – which was usually the case in previous elections – there is a second round of voting in which all candidates who won more than 12.5% of the vote in the first round are allowed to run. In previous elections, an RN candidate's victory in the second round was often prevented by the fact that most of the "traditional" parties agreed that only the strongest of their candidates would run in the second round.

In the 2022 election, however, this consensus had already clearly cracked, so that the RN was represented in parliament with 89 out of a total of 577 parliamentary seats, largely in line with its share of the vote in the first round (18.7%) (Chart 1). If it were to achieve a similar result again, it would probably be very difficult to form a government without its participation, especially as the RN could even benefit from the majority voting system without the cooperation of the other parties and could even come close to an absolute majority with a vote share of over 30%, as in the European elections. Although President Macron has appealed to the other parties to return to the old consensus, he has had no visible success so far. However, a majority for his own party is unlikely in view of its poor performance in the European elections and the latest polls.

Chart 1 - Le Pen to get many more seats in the National Assembly

Share of the Front National (until 2017) and the Rassemblement National (2022) in votes in the first round and in seats in the National Assembly, in percent; 2024: share of votes in the European elections



Source: Wikipedia, Commerzbank Research

But even if the other parties manage to prevent an RN government once again in this election, it could happen later because the RN is on a clear upward trend. The next presidential election in 2027 (and the parliamentary election likely to follow) would be the next, and probably even greater, opportunity for Marine Le Pen and her party to take power.

Confederation of states does not fit in with monetary union

France is not the only country where right-wing parties are strong. Despite all the differences, most right-wing parties in Italy, Poland or Hungary, for example, are, like the RN, against closer political integration of the EU countries. They do not want the EU to develop into a kind of federal state with a strong central government in Brussels. Instead, they want to limit the EU to a confederation of states with a Commission that carries out the orders of the heads of state and government like a mere employee.

Now, one can argue about the desired depth of integration of the EU. But a monetary union is simply not compatible with member states acting autonomously. If a member state of the monetary union massively increases its debt, unsettled investors could at some point refuse to continue financing this state. Sooner or later, it would become insolvent. The banks and insurance companies, which hold many of their state's bonds for regulatory reasons, would also be at risk. Private individuals and companies would withdraw their money, and the country's banking and payment system would collapse. In the case of a larger member state, banks and companies in other member states would also be affected because they have economic relations with the country in crisis. If this were to happen, the monetary union could break apart.

There are two ways to prevent such a chain reaction in a monetary union:

- **Fiscal rules:** If the member states commit to rules for sound budgetary policies from the outset, as required by the Maastricht Treaty, there would be no excessive debt and destabilization of the monetary union. That is the ideal solution. But the right-wing parties (and most of the left-wing parties, by the way) in the southern countries and France reject common budget rules across the board because they believe they restrict the autonomy of the member states too much.

- **Backstops:** The alternative to budget rules would be backstops that provide financial assistance to highly indebted member states in the event of an emergency. If these instruments were credible from the investors' point of view, they would continue to finance the affected states and the monetary union would not get into difficulties. But right-wing parties in the northern countries categorically refuse to take on massive financial risks for the highly indebted, mostly southern member states.

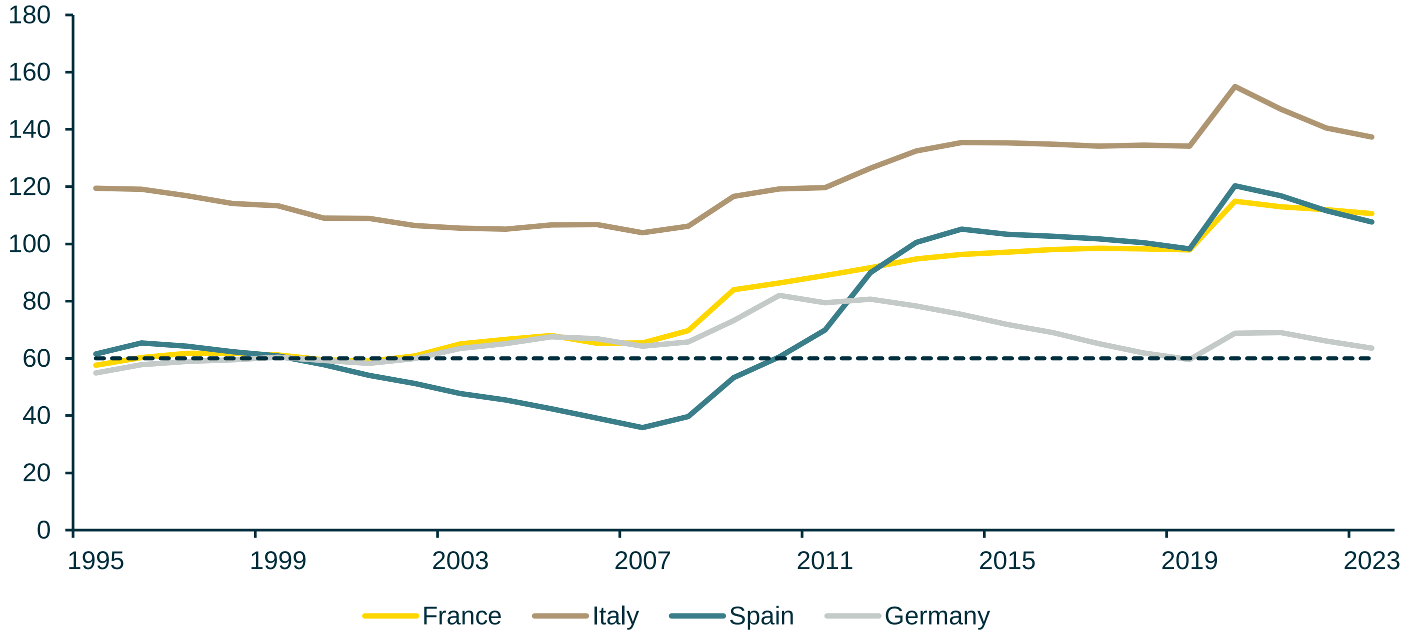
These two safeguards would be further weakened by the increasing influence of right-wing parties, which could destabilize the monetary union in the long term.

Public finances are already in a tight spot

Unfortunately, the increasing political risks are being met with public finances that are in a delicate situation in many member states. With France, Italy and Spain, the public debt ratio in three of the four largest countries in the monetary union is significantly higher than during the sovereign debt crisis (2010 - 2012). In Italy, the debt ratio of 137% is more than twice as high as the maximum 60% permitted under the Maastricht Treaty. In France, it is now almost as high as in Italy in the run-up to the sovereign debt crisis (Chart 2).

Chart 2 - Only Germany has its debt halfway under control

Government debt in % of GDP. Dashed line: Maastricht threshold (60%)

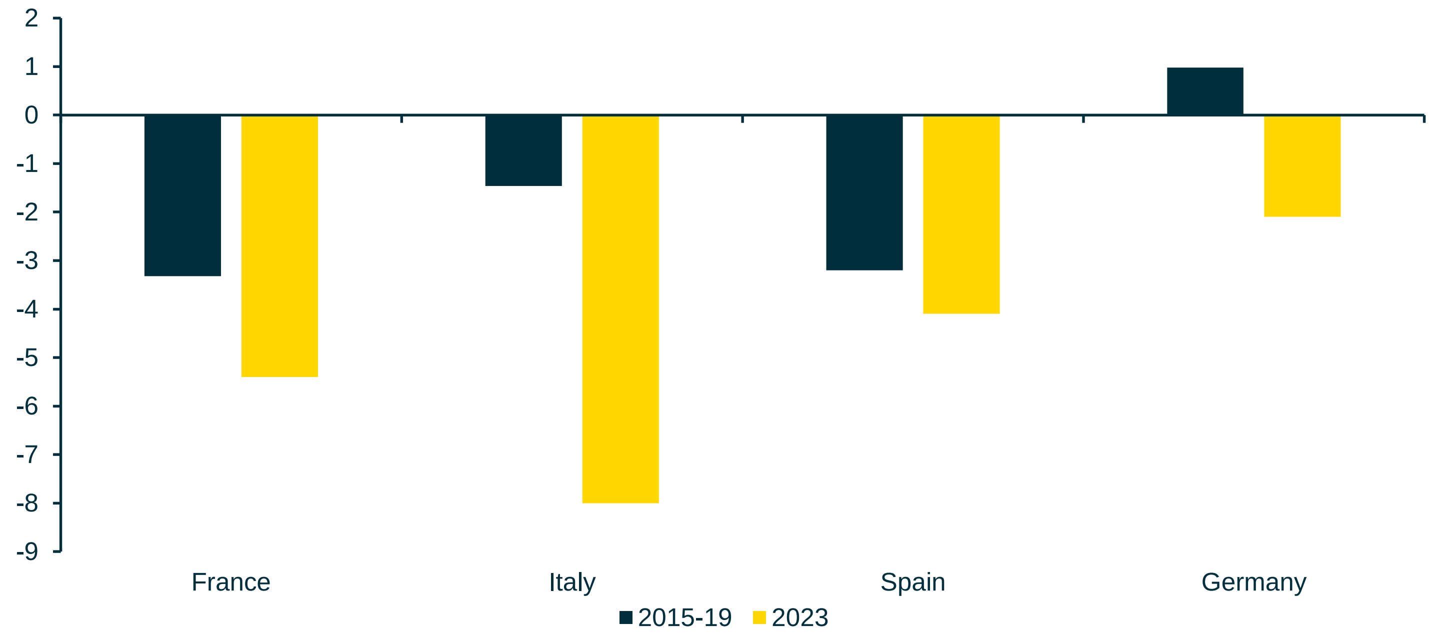


Source: Eurostat, Commerzbank Research

This is unlikely to change for the time being. Governments have even loosened their budgetary policy further in recent years. Last year, government deficits adjusted for economic fluctuations were significantly higher than in the years before the outbreak of the coronavirus pandemic. In France and Italy, the structural deficit is even well above the 3% of GDP stipulated in the Maastricht Treaty (Chart 3). The fact that the debt ratio has nevertheless fallen over the past three years is solely due to high inflation which has raised the denominator of this ratio, nominal gross domestic product. However, this effect will become less significant as inflation falls, meaning that the debt ratios in most large countries will rise again without budget consolidation. This is all the more true as government budgets are under pressure due to the rise in interest rates and the upcoming additional expenditure resulting from an ageing society, armaments and climate policy.

Chart 3 - Fiscal policy is looser than before Corona crisis

Government budget balance in % of GDP, adjusted for cyclical component, 2015-19 avergae (i.e. in the years before the pandemic hit) and 2023



Source: Ameco, Commerzbank Research

In an emergency, the ECB will spring into action, ...

If a highly indebted country got into difficulties, as in the sovereign debt crisis, it would be more difficult to put together support packages for individual countries or groups of countries in a eurozone that has moved to the right politically. However, investors learned during the sovereign debt crisis that the ECB would intervene to help struggling member states if the worst came to the worst. The ECB now has a defense-in-depth system:

1. **OMT**: The Outright Monetary Transactions allow the ECB to buy an unlimited amount of bonds from failing member states if the worst comes to the worst. The mere existence of this program effectively ended the sovereign debt crisis in 2012.
2. **TPI:** The ECB created the Transmission Protection Instrument shortly before the first interest rate hike in July 2022. It allows the ECB to buy government bonds if it considers the yields on government bonds to be fundamentally excessive.
3. **Structural bond portfolio:** As part of its new operational framework, the ECB recently decided on a "structural bond portfolio", with which it has finally made holding government bonds a permanent condition. This reduces the influence of private investors on government bond prices.

If the government bonds of member states in a monetary union that has moved to the right politically were to run into serious problems, the ECB would intervene. It has powerful instruments at its disposal and would even create new ones to prevent a massive deterioration in government financing conditions. If the worst came to the worst, it would stabilize the monetary union once again.

... whereby the side effects would be massive

We already pointed out during the sovereign debt crisis that the ECB can contain a sovereign debt crisis. If the RN wins the French parliamentary elections, there is unlikely to be a sovereign debt crisis as there was in 2010, even if the risk premiums on French government bonds would rise sharply once again.

However, the ECB can only gloss over the fundamental budget and credibility problems. It is even preventing necessary structural reforms because the member states are relying on the ECB's intervention and have fewer incentives for reforms. Fundamentally, the ECB's support measures reinforce undesirable economic developments, forcing the ECB to hold even more government bonds. Through the ECB's balance sheet, the stronger countries in the north of the monetary union would have to take on more and more risks for the benefit of the southern countries. If the donor countries also move further to the right politically, resistance to such a transfer union is likely to increase over time. All in all, these risks argue for structurally higher risk premiums – both for government bonds and for the euro.

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