# Excuse my French (elections)

*Why this time it's different*

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# Executive summary

France is a two-tier semi-presidential regime, traditionally resting on a two-party system. However, this election is different. Top French politicians (François Hollande, Nicolas Sarkozy and Manuel Valls) have been voted out, and weak economic performance, political defiance and anti-establishment rhetoric - at home and abroad - have caused a blatant lack of forward visibility. The stigmata of a lost decade could be at stake: GDP per capita is almost the same as in 2007; with close to 10% unemployment, inequalities of opportunities have risen between the so-called *insiders* (often with an open-ended job contract) to the *outsiders* (the unemployed); and France's voice in Europe sounds dimmed by a vulnerable macroeconomic dashboard (e.g. 96.7% debt-to-GDP ratio) and a sluggish private sector growth.

The French voter is also different. Her Maslow pyramid for economic policies is mad of 3Rs: Rebalancing (turning savings into investment, generating yields), Reflation (increasing prices and salaries) and Retrenchment (from Europe). The four front-runners in the polls - Marine Le Pen (Front National), Emmanuel Macron (En Marche), François Fillon (Les Républicains), and Benoit Hamon (Parti Socialiste) – are addressing them quite openly, sometimes with disruptive ideas; hence the uncertain political outcome.

In the meantime, investors have sanctioned the uncertainty surrounding the French elections by increasing the cost of financing for France by +30 basis points since the beginning of the year, according to our estimates. If this markup persists, it also means the expectations are those of a minority government.

Beyond the presidential race, the legislative elections do matter and so does the risk of *cohabitation* between the executive and the legislature. We defined four market scenarios with varying impact on financial markets and economic variables. Two of them are of importance: First, a Le Pen win would trigger a confidence shock, in part because of the *Frexit* rhetoric. As a result, the spread between the German 10-year Bund and the French 10-year OAT could increase by +100bps with no majority in the Parliament and up to +300 bps with a parliamentary majority for the Front National; second, the risk of a minority government or the absence of a majority in Parliament would cost +30 bps to the spread because of the partial governability of the country and the limited efficacy to unleash growth. This risk is the one priced in today.

As for growth, deficit, and debt, based on available programs, only Macron would reduce the deficit under 3% of GDP and stabilize the debt by 2018. As for GDP growth, Macron, Fillon and Hamon have identical results by 2018 (+1.5%); only Le Pen would result in a massive deceleration to +0.5% by 2018, assuming a mild defiance shock.

In brief, the good news is that France will have a second wind after the election: a mechanical post-uncertainty boost. The bad news is that it could be short-lived if the winning candidate fights for a majority in Parliament to pass every bill and every reform.

# 1. The stigmata of a lost decade (2006-2016)

## *A mild recovery*

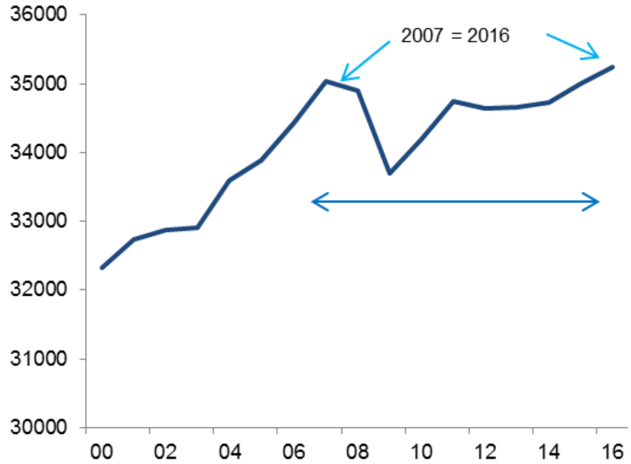
In 2015 for the first time in four years, French GDP growth was above +1% (+1.2%). Private consumption, the traditional driver of economic growth, was the first to recover (+1.8% in 2016), partly helped by the oil dividend. Despite lower growth in 2016 (+1.1%), growth drivers are broadening. Corporate investment accelerated to +4.2% and household investment returned to growth (+1.5%) and is likely to gather further momentum in 2017 (+3.6%).

The great laggard in 2016 were exports which decreased by EUR -3bn in 2016. However, alongside structural weaknesses of the French export sector (only 124k corporates were exporters in 2016, compared to 300k in Germany), we also saw exceptional events. Agriculture output tumbled 6%, aeronautics exports stalled and export prices slipped. 2017 should be a more normal year, implying a recovery with export gains of EUR28bn. More generally, the expected acceleration in growth from +1.1% in 2016 to +1.4% in 2017 will be partly driven by the normalization of 2016 exceptional events (agricultural production loss sliced 0.2pp off 2016 GDP growth) and by improving private sector confidence in early 2017. Manufacturing confidence increased to 107 - the highest level since 2011- whereas consumer confidence recovered to its long-term average (100), a level last seen in 2007.

## Mind the gaps: Income, profits, jobs and investment

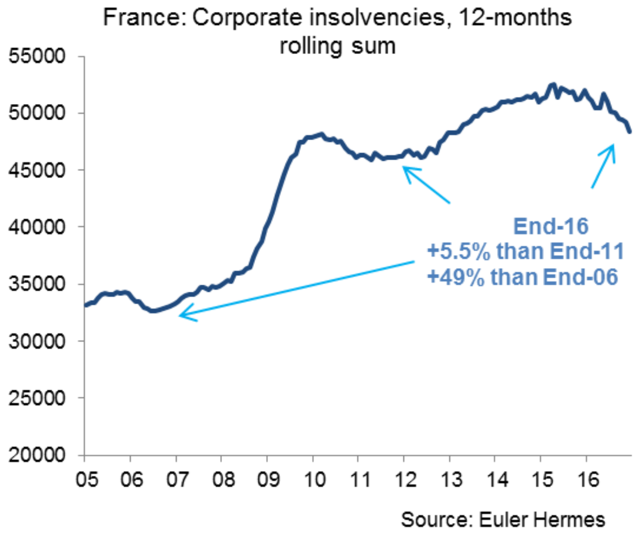
- Income gap: GDP per capita was only marginally higher in 2016 than in 2007 (see 1st chart). It grew by an almost negligible average of +0.07% per year. Growth should continue since we expect +1.4% in 2017, but the popular perception is that the current aggregate income is the same as it was ten years ago while prices have increased by 12% since 2007. This backdrop may fuel reform fatigue and demand for higher wages.

France : GDP per capita, constant prices

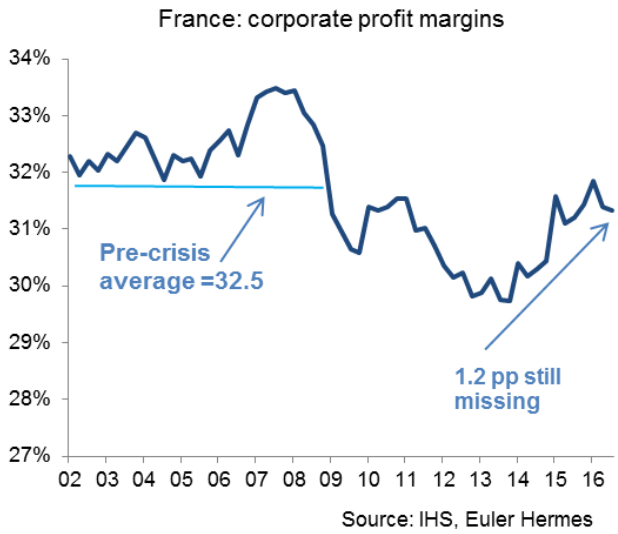



Source: IMF, Euler Hermes

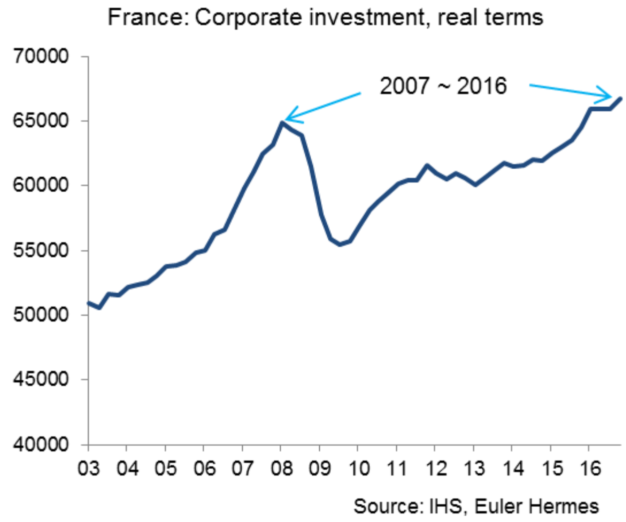
- Profits gap: The crises weighed on corporate balance sheets. Compared to their pre-crisis average levels, corporate margins decreased by 3pp to 29.6% at end-2013 (see 2nd chart). Favorable events (oil price slump) and government measures (CICE, Pacte de responsabilité) helped margins recover somewhat but are now behind us. The road back to pre-crisis levels is still long. This means that corporates are still prone to shocks and are likely to want to self-insure against this by sticking to conservative investment plans.




- Jobs gap: Despite recent improvement, unemployment was still at 10% in 2016, and no dramatic improvement is expected (9.7% in 2017). At end-2016, corporate insolvencies (see 3rd chart) were also still above pre-crisis levels (+5.5% from end-2011, +49% from 2008), despite a -7% decrease in 2016. This means that the current cyclical improvement is still too gradual to fuel a faster improvement.




- Investment gap: Crisis legacy implies that demand and corporate balance sheets were not good enough to drive a decisive rebound in corporate investment. Despite an increase by +4.2% in 2016, investment is still more or less stuck at the 2007 level (see 4th chart). The corporate sector is losing production capacity, eroding overall potential GDP growth. The fiscal burden is one explanation, since overall taxes make up 60% of gross profits in France compared with the OECD average of only 40%. In order to sustain such an effort, public spending may decrease from its current high level (57% of GDP) to average levels observed in the Eurozone (49%), not least since public debt is already quite high (96.7% of GDP in 2016).




The weak economic performance explains part of the political defiance and anti-establishment rhetoric. The political landscape has been nudged almost every week since last November and uncertainty is extremely high. Political scenario-building has become an art and should be treated with caution.

# 2. Why is this election different?

2017 promises to be full of surprises in Europe with elections in the Netherlands, France, Germany and possibly Italy. Yet, the French elections have been at the center stage for two reasons: (i) they are the major elections post-Brexit vote and the election of President Trump. The populist vote could become the norm, or be defeated; (ii) France has been awaited by its sparring partner Germany, and other Eurozone countries to lead the way out of an institutional deadlock, as the world becomes more isolationist. Everyone wants France to be stronger, or at least to give it a try.

## The Maslow pyramid of the French voter: Rebalancing, Reflation and Retrenchment

In light of the resurgence in populism across the world, we defined a somewhat different framework to understand the upcoming French vote and compare front runners' programs: The 3Rs, which stands for Rebalancing, Reflation and Retrenchment. This framework aims at assessing the need for change, rather than capture the protest vote; it comes on top of traditional ones by sector or population segments.

1. To Rebalance the French economy to raise competitiveness, reduce fiscal and trade deficits, and improve taxation.

France's structural reforms are long due. Along with public spending cuts, competitive disinflation and labor market reforms would level the playfield with other Eurozone countries and enable a stronger core and more balanced growth path. Increasing VAT (weighing on consumption, including imports) and reducing labor taxes (helping local production, including export-oriented sectors) are among the solutions which Germany adopted under Schröder and Merkel's leadership. The resulting competitiveness could help produce more growth and fiscal space and control debt levels. Incentives and time are pivotal to success, especially as costs will be borne by individuals if this trickle-down approach is adopted. It also confirms the need to rethink rebalancing without opposing segments of the population, and by adding trust to go along more flexibility.

2. To reflate the economy allow for higher income growth, favor social mobility through redistribution, boost demand while avoiding rent-seeking

The end game is household purchasing power. Prices are expected to pick up in the near future so disposable income has to follow either through lesser taxation or higher wage growth. Household consumption lagged during the crisis and consumption of durable goods (as shown by the oil dividend) has been affected. A policy designed to reflate the economy may be more popular if outsiders are eventually on boarded. Labor market reform (active labor market policies, hiring and firing costs controlled) as well as a clear unleashing of growth in protected sectors could help kick-start the economy. Previous attempts have had a limited impact: El Khomri Law, Macron Law, because of a lack of systemic approach to social protection and the labor markets.

3. To retrench as a way to protect the victims of globalization or technological progress

The first wave of globalization brought cheaper goods and services to all having a positive impact on purchasing power. The second wave created job outsourcing and caused a negative distributional impact (inequalities) while keeping a positive aggregate impact (GDP terms). There are several options to solve this conundrum but the most popular is isolationism. The EU has been blamed for much of the problems of the industrial sector in France when the evidence base is inexistent. A *Frexit* is part of the solutions from extreme parties (Front de Gauche and Front National) and a redesign of European ties is present in all candidates' programs.

The chart below summarizes how candidates compare when it comes to this 3Rs framework.

| | REBALANCE | REFLATE | RETRENCH |
|---|---|---|---|
| Fillon<br>*First a tax breaker, then a rebalancer* | Fiscal devaluation: corporate tax cuts first (increasing the deficit) then VAT increase (rebalancing) | Some reflation measures to a lesser extent (universal family allowances, suppression of the wealth tax) | "Social" retrenchment (curbing immigration flows) and nuanced opinion about the CETA |
| Macron<br>*A balanced reflator* | Probable balancing of his reflation measures (abiding by the 3% deficit rule) | Favoring social mobility with redistribution and labor tax cuts without VAT increase (flexicurity) | No retrenchment measures |
| Le Pen<br>*A reflationary retrencher* | Plans to decrease the deficit even though the credibility of her program can be questioned | Strong reflation component, increasing social benefits and defense and security spending | Primary retrencher: denouncing international norms, immigration and promoting economic patriotism |
| Hamon<br>*A reflator bound to softly retrench* | No rebalancing measure. Abandonment of the 3% deficit objective | Universal income, increases in investment and public spending (hire civil servants) | Bound to a soft retrenchment: defying the EU through his will to break fiscal rules |

François Fillon's economic program is mainly designed to rebalance the economy. But the right-wing candidate has promised to begin his five-year term by lowering taxes in order to win the run-off. Once economic activity picks up, the plan is to increase the VAT and reduce public spending in an effort to stabilize the fiscal deficit and public debt.

Emmanuel Macron's program is the one of a reasonable reflator, willing to stimulate income and profits growth and keep the pace of fiscal consolidation. Most of his reforms are self-financed, for instance: the equalization of lower worker payroll taxes with the increase in CSG, the *Contribution Sociale Généralisée*, a payroll tax with a larger tax base; the replacement of the CICE, *Crédit d'Impot pour la Compétitivité et l'Emploi*, by an actual cut in corporate tax. Mr. Macron is also the one candidate with a strong European and globalization stance.

Marine Le Pen's program favors retrenchment, including through some unconstitutional measures (extra tax on foreigners' jobs). Le Pen's program also features some elements of reflation and rebalancing, the former could be limited by a defiance shock linked to the high retrenchment angle.

Benoit Hamon has a program fully oriented towards boosting the income of the most vulnerable (universal income to be implemented for young adults) including through government-led initiatives (public sector wages, minimum wage). Hamon, therefore, appears as the ultimate 'reflator', without striking a budget balance, and including some game-changing retrenchment from Eurozone fiscal rules.

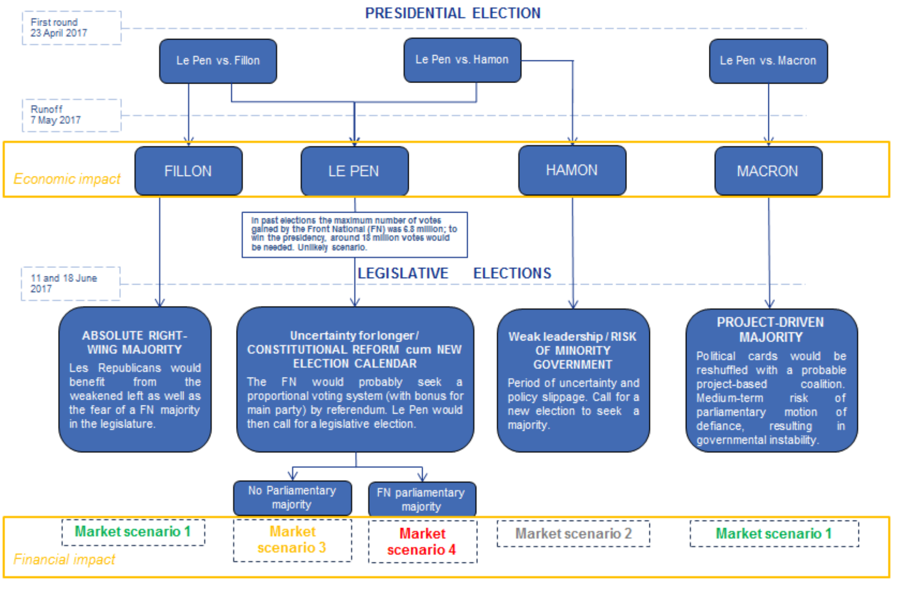
## A universe of possible outcomes: The twilight zone

The polls to date show that Le Pen commands the largest share of votes which should send her through to the second-round. Meanwhile, support for the other candidates still exhibits a high level of uncertainty, implying different likely second-round scenarios. However, with three or four equally strong contenders, one candidate may qualify for the second-round with about 20%.

The strong extreme votes, the growing center base and the growing divide in the Parti Socialiste and Les Républicains pose an unprecedented uncertainty in the French modern era: the risk of a President who is not backed by an absolute majority after the parliamentary elections. Macron may try to work with the situation by seeking a project-driven majority, but the first no-confidence vote since De Gaulle in 1962 may prove to be a risk for effective governing. Le Pen announced she would call for a referendum to amend the constitution to turn the voting system into a proportional voting system with a 30% Assemblée seats bonus for the winner (the list that was ranked first) and with a 5% threshold to enter the Assemblée. The possibility (and feasibility) of this constitutional reform, just like the proposed *Frexit* vote are deemed extremely unlikely at this point.

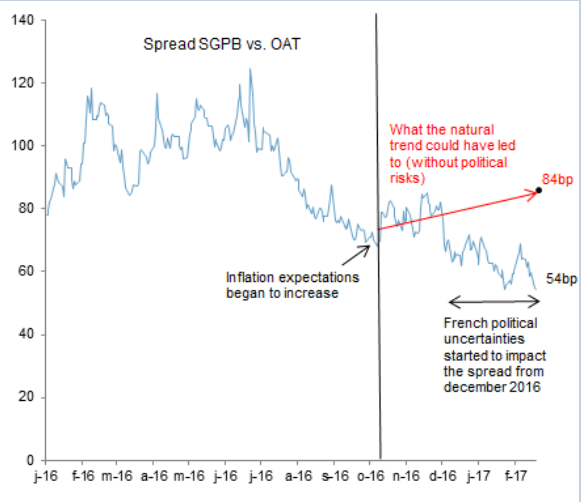
In the end, the risk of a minority government is also one that needs to be evaluated further (see below). Without attributing probabilities for these elections' outcome, given possible twists, the one likelihood that is higher is the one of a lack of majority among lawmakers which could handicap or dilute the President-elect's announced programs and plunge France in the twilight zone (dissolving the Parliament, protest vote, rapidly-changing alliances).

The chart below identifies the four possible scenarios as anticipated by financial markets depending on both the Presidential vote and the legislative one. It is indeed a rather complex set of outcomes at this stage, which means an unclear governability till mid-June 2017.



## Box: The cost of uncertainty or the pricing in of a minority Government

Two confounding factors have been weighing on the cost of financing for the French government: (i) reflation and possible announcement of tapering in the Eurozone; and (ii) a heightened risk of a Le Pen win with a possible *Frexit* outcome. We tried to disentangle those effects in order to identify the impact of political uncertainty and understand what efficient markets may be expecting for outcome of this election. We compared the 10-yr OAT (French government bonds) to the 10-yr SPGB (Spanish government bonds) between mid-October and end-November, when inflation expectations in the Eurozone began to increase, but political uncertainty was low. During this period, we observed a trend increase of the spread (inflation expectations increased more rapidly in Spain than in France). After this period, inflation expectations continued to increase, but the first fears of political uncertainty emerged. We applied a similar increase to the inflation-no-political risk period to date to estimate what would be the end level for the spread, without political uncertainty. The difference between this level (84 bps) and the current spread (54 bps) is an estimate of the cost of political uncertainty in France: +30 bps (see chart below). It is also consistent with our market scenario 2 of a minority government.



Source: Bloomberg, Euler Hermes

# 3. A first estimate of financial and economic impacts

Impacts for the economy and for financial markets are closely intertwined. Based on available programs, we have estimated the impact on growth, deficit and debt for the main front runners (Le Pen, Macron, Fillon and Hamon), assuming full execution. We also have looked at historical relationships between uncertainty and the cost of financing for France (10-year OAT) to calculate the impact of our four market scenarios: non-FN candidate with a majority, non-FN without a majority, FN without a majority and FN with a majority.

## Growth, deficit and debt trajectories

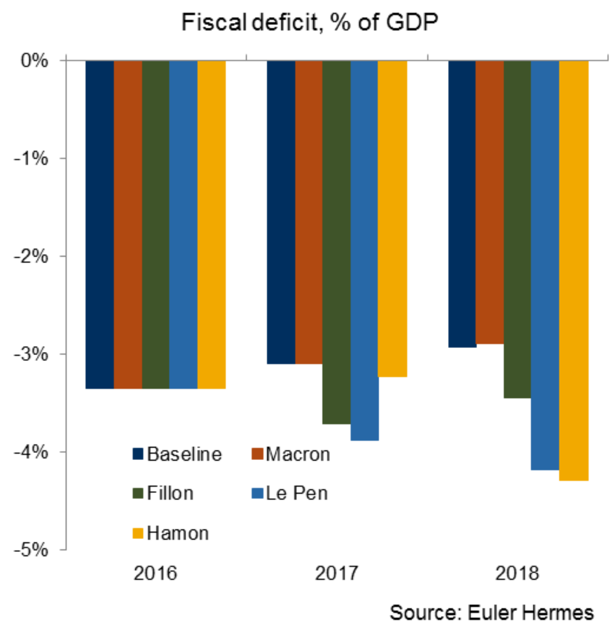
François Fillon's plan to cut taxes will weigh on the fiscal balance in the short run. As a consequence, public debt will rise again in 2017. A gradual fiscal consolidation starts in year 2. The impact on economic activity should be positive with key measures such as lower corporate taxes to boost private sector confidence. The negative impact of VAT hikes in 2018 should be offset by the positive impact of better business confidence on corporate investment.

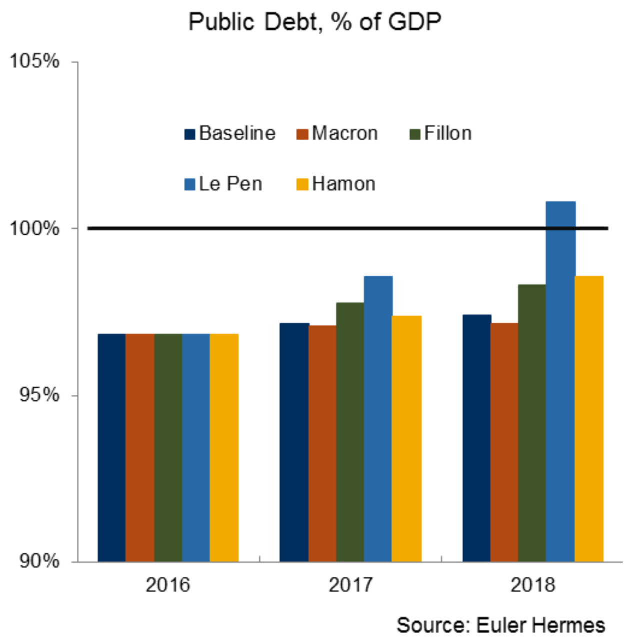
Emmanuel Macron's program points to stabilizing fiscal balance and public debt. Structural reforms (social protection and labor markets e.g.) and a stronger push for progressive taxation for households (worker social taxes replaced by a rise of the CSG) and companies (tax cut to replace CICE) may boost business and consumer confidence, implying higher economic growth in 2017 and 2018.

Marine Le Pen's program includes higher public spending, smart protectionism, a monetary overhaul (*Frexit* à la UK/Denmark), and a costly reindustrialization. Most of the negative impact on growth is driven by a confidence shock as the bridge to the new dual currency system is unclear; so is the future of the euro. GDP growth should be lower, from 1.4% in the baseline to 1% in 2017, and from 1.3% in the baseline to 0.5% in 2018. Corporate investment could drop sharply and household consumption growth would also be hit. Public debt will break the 100% threshold (up to 100.8% in 2018 from 96.7% in 2016).

Benoît Hamon's program points to higher public spending through the cost of adoption of a universal income for young from 2018 onwards. This increased spending will imply a permanent increase of the fiscal deficit given since tax revenues are hold constant. Higher wages (minimum wage and civil servant wages) should give a boost to private consumption from +1.8% in the baseline to +2.3% in 2018. As a result, GDP growth may accelerate in 2018 to +1.5%. But the impact on public debt will be to cross the 100% threshold during his Presidency.

In summary, in the short-run (2018), only Macron would reduce the deficit to under 3% of GDP and stabilize it by 2018. As for GDP growth, Macron, Fillon and Hamon have identical results by 2018 (+1.5%); only Le Pen would result in a deceleration to +0.5% by 2018, assuming a mild defiance shock. Note that these estimates are limited to first-order impact on GDP components based on available programmatic elements.






**GDP growth scenarios**

| | 2016 | 2017 | 2018 |
|---|---|---|---|
| Baseline | 1.1% | 1.4% | 1.3% |
| Fillon | 1.1% | 1.4% | 1.5% |
| Macron | 1.1% | 1.5% | 1.5% |
| Le Pen | 1.1% | 1.0% | 0.5% |
| Hamon | 1.1% | 1.4% | 1.5% |

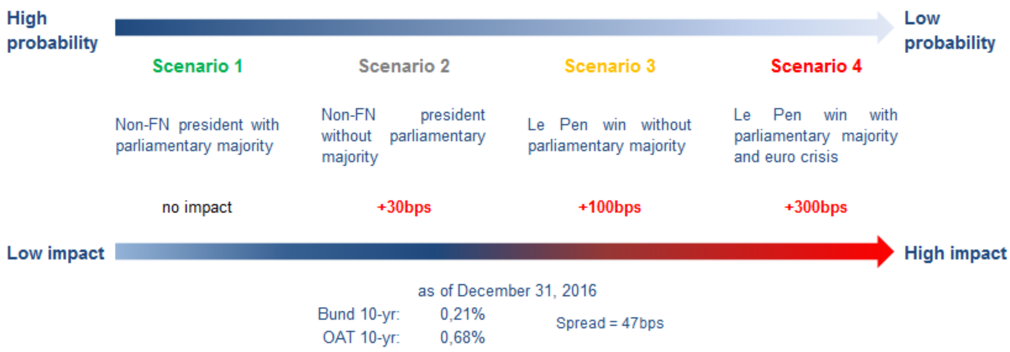
Source : Euler Hermes

## Financial markets impact

The French elections will continue to be a source of volatility in European market spreads over the coming months. The OAT spread will act as an indicator of market sentiment and impact the valuations of sovereign or corporates in Europe. It is important to note that in the past OAT spreads were usually impacted by developments outside of France: they widened during the euro crisis in 2012 based on negative news from the periphery. This time will be the other way around meaning that European spreads will be in part determined by developments in France.

As of the end of January, the OAT spread-to-swap rate stood at roughly 20bps, whereas peripherals spread levels reached 80bps and 145bps for Spanish and Italian govies respectively. Historically, peripheral spreads have exhibited a higher volatility than the OAT spread due to weaker economic conditions in these countries. During the Eurozone debt crisis in 2012 especially, Spanish SPGBs and Italian BTPs significantly underperformed OATs by more than three times. This period also marks the highest historical values seen on European spreads so far.

To assess the impact of OAT widening on European government and corporate bonds in the respective scenarios, we looked at their historical relationship over the last 10 years. More specifically, we focused on the historical correlation of spread variations of the OAT to the 10-year Bund – and European swap rate, BTPs, SPGBs, Euro corporates and European equity markets. The chart below indicates the results on the first and maybe the one that epitomizes the different first-order scenarios:




***scenarios are made on the OAT spread-to-swap rate. The initial spread on the bund is indicated for sake of comparison.**

Market scenario 1 corresponds to two low-risk scenarios presented above, including the project-based coalition under Macron's presidency. Market scenario 2 stands for the medium-risk political scenarios of a full-fledged minority government, and market scenario 3 and 4 correspond to the high-risk scenario. The legislative elections are an essential part of the market impact and the final say will have to wait for mid-June.

On financial indicators for the periphery, the spread could increase by +150-300bps under scenario 3 and 4. Equity markets could go down by -15% to -40% also in scenarios 3 and 4. The impact would be nil under scenarios 1 and 2 because of the underlying pro-euro vote.

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