Confidence must be earned

Amundi ASSET MANAGEMENT

Thematic paper | CROSS ASSET Investment Strategy

May 2018

France: significant promises kept, but the most crucial reforms will take time

Research & Macro Strategy

France: significant promises kept, but the most crucial reforms will take time

TRISTAN PERRIER,
Macroeconomic Research

Finalised on 28/05/2018

The essential

One year on from his election victory the French president has already lived up to some of his campaign promises, most visibly regarding labour market regulation and taxation, actions that have generally been welcomed by international financial commentators.

More reforms are planned and will probably be (at least partially) implemented during the rest of the presidential mandate, even though resistance, weak until now, may build up and the political and economic backdrop may become less favourable than it has been so far.

These reforms, a combination of supply-side and flexi-security policies, should play positively on the key economic measures of growth and unemployment. However, they may not be enough to stem, in the long term, the rise of radical political forces, the main medium-term threat to institutions in France as in other European countries.

Facing this challenge will probably also require major changes focused on the goods and services markets, especially to remedy sharp inequalities between territories. While work has begun on a number of such measures that were sketched out in E. Macron's manifesto, they are more difficult to follow by international investors and the real extent of changes that can be expected remains very uncertain.

Financial markets welcomed Emmanuel Macron's election in 2017 for locking France into European institutions and holding out the hope of growth-friendly economic reforms. A year on, the French president has already lived up to some of his campaign promises and set other big initiatives in motion, actions that have not passed unnoticed by international financial commentators.

The election in France took place against a background of chronic underperformance compared to Germany, despite a number of steps taken in recent years.

Emmanuel Macron was voted in, in May 2017, amid an already robust economic recovery, with a slight drop in unemployment and consequent narrowing of the public sector deficit. This improvement, however, could not disguise France's chronic underperformance compared to Germany on a range of key economic ratios, on several of which France actually scores below average for the euro zone. Yet Macron's predecessor, François Hollande, despite being elected in 2012 on a strikingly left-wing platform, had finally swung behind a supply side policy (partly driven by his then advisor, and thereafter Economy minister E. Macron) that included measures to introduce more flexibility to the labour, product and services markets and to reduce taxation on labour and corporations, paid for by spending cuts and heavier taxes on households.[1]

[1] *The structural public sector deficit in France improved from 4.3% of GDP in 2012 to 2.1% in 2017.*

	France	Germany	Eurozone
General public deficit, GDP %, 2017	-2,6	1,3	-0,9
General government debt, GDP %, 2017	96,9	64,8	90,1
Current account, GDP %, est. 2017	-1,4	8,0	3,5
Unemployment rate, %, March 2018	8,8	3,4	8,5
Average ann. GDP growth, % 2014-2017	1,3	2,0	2,0
Industry as a % of value added, 2017	13.9	25.7	20.0

A programme aimed at easing rigidities rather than cutting the size of the government

Emmanuel Macron's programme struck a generally favourable tone towards European institutions and the business world and promised measures mostly in line with those being recommended by the European Commission, OECD et al. and generally oriented towards "flexi-security" on the Nordic model which had previously inspired a number of reform drives in Europe:

- The first plank of this policy is a **reduction in rigidities**, both on the labour market (by introducing more flexibility) and on the goods and services markets (by cutting red tape and increasing competition) so that the reduction of protection for incumbent workers and firms should create greater opportunities for new entrants and foster professional mobility and innovation.
- The second is **that substantial welfare state provision should be maintained** but rejigged to reduce differential treatment based on people's job or special status and to eliminate penalties for career-switching.

Such flexi-security had, to date, barely figured in the programmes of parties bidding to govern France, even if once in power they had often pursued policies very different to their electoral platform (as was the case with François Hollande's spell in charge). The left had traditionally opposed flexible labour markets. The right had little interest in the issue, preferring to call for lower taxes and public spending and generally did not make competition in markets for goods and services a major theme (as it could upset right-leaning professional lobbies).

A year on from his election, Emmanuel Macron has already ticked two important boxes in his economic programme:

- The first is **labour market reform**. He has brought in measures that make it slightly easier to dismiss workers either individually or collectively and devolve part of the labour negotiation process to workplace or company level. Already in place at end-2017, this reform is now being followed by a new drive on **professional training** (long denounced as ineffective by international organisations), **apprenticeships** and **unemployment insurance**. This last measure is designed, among other goals, to better support risk-taking and career switchers.
- The second achievement is a **package of pro-business and labour tax changes:** transferring employees' sickness and unemployment contributions into an income tax with a broader base, converting a tax credit offsetting some employers' social contributions into a permanent cut in the latter, introducing a flat tax on household's investment income, eliminating wealth tax on financial assets and gradually reducing corporate profit tax.

> "Business-friendly labour market and tax reforms are quickly picked up by international investors."

Highly visible and well sold to the markets by the government (sometimes over-sold in fact, the labour market reforms are actually a continuation of sizeable efforts made under Hollande), **these changes have been welcomed by the international financial observers**. Even more so as France has stood out as a trail-blazer in a year when Germany, Italy, Spain and the UK have all been mired in internal political uncertainties.

In addition, the government has also been active on numerous other fronts, perhaps less obvious to international investors but, to judge by the literature coming out of international bodies, just as important (if not more so) for long-term growth:

- **Reforms to education**, including measures to favour underprivileged areas and a first step toward allowing student selection in universities.
- **A reform** - this one not announced in the official election manifesto and only briefly alluded to in the campaign - **of the state railway company SNCF**, widely perceived as a bastion of traditional unions and social benefits specific to a certain sector.
- **A Housing Law** (see box below).
- **Changes to healthcare provision**, particularly dental and eye care, focused on better reimbursement, which also imply downward pressure on prices.
- **A rise in social benefits directed towards individuals** (the poor elderly and the disabled).
- **A number of cuts in red tape for corporations.**
- Also, though not directly pitched as a reform to the market for goods and services, the **slated elimination of housing tax** (a local tax calculated using a particularly antiquated system) is also an opening sally toward **reform of local authority finance**. Local authorities are big providers of local services and their many overlaps and inefficiencies feature regularly in reports by international organisations.

In contrast, the reduction of the budget deficit to 2.6% of GDP in 2017 (from 3.4% in 2016), while highly visible to investors and much feted in the positive news flow on France, owes far more to the economic environment than the actions of the new president. Ironically, it is precisely on the budget front that he is proving slow to live up to his promises: public spending was virtually unchanged on 2016 at 56.5% of GDP, while the plan is to cut it to 52% by the end of his term of office in 2022. **Most importantly, proposals on how to save on public spending remain short on detail at this stage.**

The drive is set to continue over coming months and years.

Among the most ambitious projects that remain on the government's agenda are:

- **The unification of the pension system** by creating a common basis resting on the principle of notional accounts. Payments will still be funded from current contributions (the pay-as-you-go principle) but rights will now be proportional to contributions made. It is due to be concluded by 2019. As announced, this reform, which focuses on simplification, better steering and equity, will be fiscally neutral, at least in the short term.

Reforms of the State administration and of government institutions themselves, which are still short of details[2]. The aim is to improve the state's functioning **but also to realise the budget savings trailed in the president's programme.**

Further efforts to reshape the market in products and services should also continue, with new measures seeking to reduce obstacles to supply in a number of sectors.

These projects are likely to meet heavier resistance than the surprisingly flaccid push-back encountered so far.

Since his election, Macron and his government have been blessed with an unusually fair wind, helped by a solid parliamentary position (very large majority

[2] *The reform of state administration should include cuts in the number of civil servants (possibly with a voluntary severance plan) and changes to their status, in order to improve flexibility and cross-sector mobility. The reform of government institutions should include (among other) a cut in the number of MPs, the introduction of more proportionality in parliamentary elections, limitations on consecutive mandates the same MP can hold and changes in the way Parliament can amend legislation. More changes should also be decided regarding local authorities.*

with a lot of novices on the benches), a political opposition demoralised by defeat, a deeply split union opposition and a resurgence in economic growth. Labour market reform in particular went through without great opposition. University and railway reforms have stirred some social resistance but thus far this has not been able to erode the government's determination.

This situation could start to change, primarily because of the nature of the reforms coming down the road. While fiscally neutral on a national scale, pension reform is likely to produce losers (notably in sectors that currently enjoy special treatment) and deliver an issue around which unions and left-wing opponents can rally more effectively. That said, their ability to present a united front is far from certain. Reform of the state, meanwhile, could run up against heavy opposition in the Senate (still controlled by the right) and local authorities (jealous of their prerogatives and sources of finance), particularly if it is accompanied by serious budget cuts. Finally, measures to boost competition on markets for goods and services are always prone to run into opposition from bodies representing the regulated professions, which may be more efficient at defending their interests than employee unions.

> "A decline in structural unemployment is necessary, but may not be sufficient, to stem the tide of anti-establishment politics."

The current economic and political situation could also become less favourable. It cannot be taken for granted that the European economic recovery will sustain its vigorous pace of recent quarters. Also, Emmanuel Macron will face his first serious electoral test in a year's time with the May 2019 European elections, followed by municipal elections in 2020. Finally, international geopolitics could at any moment divert the government's attention into matters other than domestic structural reform. Note, too, on this point that the result of Macron's attempts to inject new life into the European project remain highly uncertain as yet, with Germany and the Northern member states giving a very muted response to these plans.

Nevertheless, as it stands, the government's determination to press ahead seems undiminished and, barring major new developments, it is very probable that more measures of its program (or, in general, other pro-supply side measures that the markets will like) can indeed be implemented, even though some of the initial ambitions will inevitably have to be adjusted downwards.

The government's flexi-security and supply-side policies will probably play positively on potential growth and structural unemployment.

Judging by the analyses of international organisations, by the relatively positive economic and social outcomes achieved in the Nordic countries who have applied them long term and by their generally encouraging results in countries that have recently increased at least labour market flexibility (notably Germany and, more recently, Spain), measures that combine supply side policies with flexi-security should very probably, if pursued over several years, yield positive macroeconomic results.

Therefore, **it does not seem overoptimistic to expect the policies of Emmanuel Macron (and the deferred effect of those of his predecessor) to at least slightly raise potential growth and reduce the structural unemployment rate after a few years.**

Some of the factors that have caused France to underperform Germany and some other euro zone countries may, therefore, be gradually eliminated. However, it is hard to quantify this improvement. Not only are the structural rigidities of the French economy many and complex, but also the impact of similar measures has varied from country to country.

Moreover, some aspects of flexi-security are being deployed by the French government in a way that differs substantially from that followed by other countries (more specifically, the government constantly gives the impression that it tends to curtail the role of unions, seen as overly corporatist, rather than bring them into decision-making as they do in Northern countries).

Yet these improvements may not be enough to fend off the rise of anti-establishment political forces, a challenge that probably requires deeper changes notably on the products and services markets.

> "Healing the country's regional fault lines also demands major reforms to the markets in goods and services."

We note, however, that while a rise in growth and fall in unemployment are probably necessary conditions to head off the rise in anti-system political forces - the main political challenge facing France and many other developed countries - **they may not on their own be sufficient.** While the French have long been told that unemployment is the source of all evils, Brexit and the victory of Donald Trump in 2016 gave a glaring illustration in two big developed countries that even a rock-bottom unemployment rate is no absolute protection from a simmering pool of dissatisfaction with the existing political establishment. Voting patterns in the US and UK have thrown up other kinds of social divide than that between the employed and the workless. Some of these fault lines, particularly between metropolises embedded in globalisation and neglected other territories, map easily onto the French electoral landscape.

Fixing these territorial fault lines is a very complex endeavour with no certain comprehensive solutions (and certainly not even a consensus regarding what the goals should be). Yet it seems likely that policies that aim at improving the supply of product and services (notably of those with large territorial implications) could be at least as important as the quantitative drop in unemployment being promised (probably with good reason) by the flexible labour market so beloved of international organisations. Policies regarding urban planning, housing, transportations or those aiming at a rise in quality or an improvement of the access to some key services in underpriviledged areas (health and education, among other) are probably essential in this respect. While the program of E. Macron (who is sometimes perceived, or described by his opponents, as the "President of rich cities") includes efforts in these directions (see box below), it is still too soon to assess their real extent, their ability to overcome many unavoidable resistances, and their capacity to produce visible effects a few years from now.

Emmanuel Macron's programme: what are his proposals to close France's territorial fault lines?

The regional fault lines and inequalities that afflict France, and many other developed economies, manifest themselves in at least two ways: very high housing prices in big city centres and a feeling of abandonment elsewhere (deprived suburbs, mid-sized towns and rural areas), where citizens face a vicious circle of declining employment and gradual retreat and degradation of public and private services.

On housing in high-demand areas, Macron's programme proposed: simplifying building regulations, allowing the central government to overrule more often local authorities on planning and permits so as to engineer a "supply shock" of new homes, and changes to letting rules to ease access to housing for the young, those moving for work and tenants wanting to move while remaining in the social housing system.

On ways to improve service provision in neglected territories, the government has announced a string of initiatives straddling s**everal areas of policy**: doubling the number of "*maisons*" (one-stop shops) for public and health services, accelerating urban renewal for deprived areas, promoting innovative forms of transport (sharing economy, etc.) to cut the cost of relying on private vehicles, prioritising renovation and better use of existing infrastructure rather than costly new projects, promoting telemedicine, adapting medical training to take account of the needs of the regions, etc. A number of sub-programs in a general €50 bn investment plan would support these policies, which are also inextricably tied to planned changes in local authority governance and funding.

Since the election, a **housing law** should soon be voted, implementing some of the announced measures, including major changes to the governance of social housing. Work has also begun on other complex i**ssues such as reforming local authorities and the hospital system**.

However, the final extent of these reforms and the results that can be expected a few years from now remain highly uncertain. These are indeed policy domains where announcements and the creation of new schemes usually matter less than the effective and sustained implementation over time of policies that must be coherent across many sectors.

Thus, one year after the election, the improvement in the perception of France by financial markets seems to us at least partly justified. Indeed, the already implemented reforms, and the probable new reforms to come, will probably be conducive to at least a slight reduction in the French underperformance in terms of growth and unemployment relatively to other developed economies, especially Germany. However, the current government's actions will only turn into a long lasting success (giving long term legitimacy to investors' renewed interest) if it also successful in alleviating some of the deepest national fault lines that continue to feed the threat of major political shocks in coming years. Facing this challenge will require more than a partial economic catch-up, as some of the countries that today enjoy better figures than France are also confronted with similar political issues. What will matter a lot in this respect is the application (and an indispensable strengthening) of the measures in the presidential programme relating to key markets for goods and services, especially when they intend to make them more accessible by the inhabitants of underprivileged areas.

Last publications

THEMATIC PAPERS

Profit trend and cycle analysis: a long-medium-short term sanity check
Federico CESARINI, Lorenzo PORTELLI — Multi-Asset Strategy

Cross road the landscape of the fixed-income market
Valentine AINOUZ, Sergio BERTONCINI — Credit Strategy
Silvia DI SILVIO — Fixed Income and FX Strategy

Brexit_how the future trade agreement is going to shape UK financial assets
Didier BOROWSKI — Head of Macroeconomic Research
Monica DEFEND — Head of Strategy, Deputy Head of Research
Andrea BRASILI et Tristan PERRIER — Macroeconomic Research
Bastien DRUT, Roberta FORTES et Silvia DI SILVIO — Fixed Income and FX Strategy
Eric MIJOT et Ibra WANE — Equity Strategy
Lorenzo PORTELLI — Multi-Asset Strategy

The improvement of peripheral bonds has accelerated
Bastien DRUT — Fixed Income & FX Strategy

US credit don’t worry about the macro_focus on technicals
Valentine AINOUZ — Credit Strategy

Italy-back to growth
Andréa BRASILI — Macroeconomic Research

How the ECB’s quantitative easing transformed the European sovereign bond market
Bastien DRUT — Strategy and Economic Research

Will the reshuffling of the FOMC change the monetary policy outlook in the United States?
Bastien DRUT — Strategy and Economic Research

US HY default rates: trends, projections and perspectives
Sergio BERTONCINI — Strategy and Economic Research

What higher bond yields may mean for corporate bond valuations
Sergio BERTONCINI — Strategy and Economic Research

Markets underestimate Fed’s ability to hike rates
Valentine AINOUZ, Bastien DRUT — Strategy and Economic Research

Election in Germany_Continuity… but mind a few details
Tristan PERRIER — Strategy and Economic Research

NOTES

CROSS ASSET
INVESTMENT STRATEGY

May 2018 | Thematic paper

DISCLAIMER

Document issued by Amundi, a société anonyme with a share capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris www.amundi.com

Photo credit: iStock by Getty Images - Dennis van de Water

Editor

ITHURBIDE Philippe, Global Head of Research

Conception & production

Berger Pia, Research and Macro Strategy
Poncet Benoit, Research and Macro Strategy

Find out more about
Amundi research team
research-center.amundi.com

Amundi
ASSET MANAGEMENT