Amundi ASSET MANAGEMENT
RESEARCH STRATEGY & ANALYSIS

2017 PRESIDENTIAL ELECTION

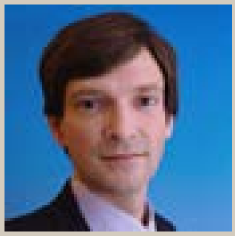
French Presidential Election

French economy recovery: where are we?

Finalised at March 9 2017

France 2017

#2



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Strategy and Economic Research

This note is the second in a series that will accompany you until the results of the presidential and legislative elections (and probably a little further). Here we focus on an assessment of the French economy. Our next editions prepared by our economists and strategists will focus on other specific thematic topics:

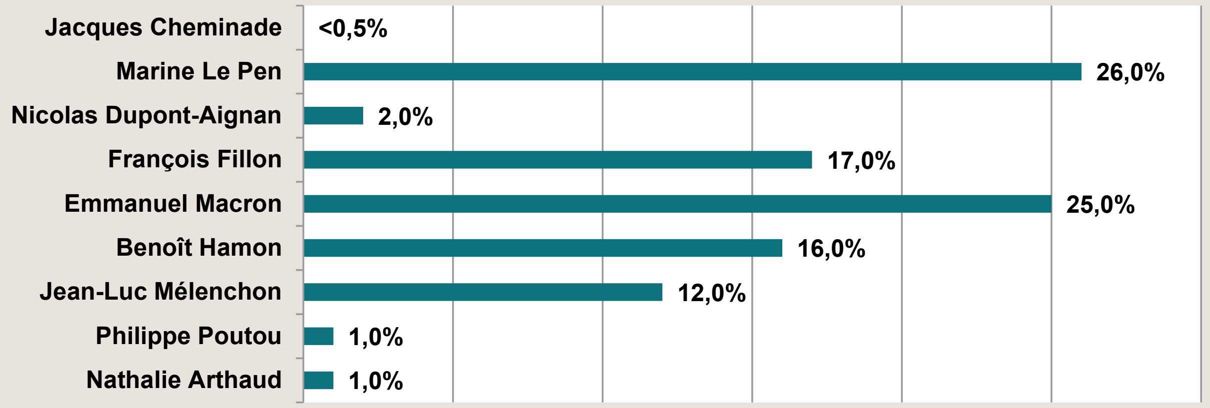
- An analysis of the blockings of the French economy and the reforms, seen by candidates and by international organizations
- Presidential candidates and their position on Europe
- French debt: state of play and points of attention
- Margin rates of French corporates: where do we stand now?
- Presidential candidates and their position on fiscal and tax policy
- OAT yields and OAT/Bund spread: QE impact and perspectives
- ...

We wish you all a good reading.

PHILIPPE ITHURBIDE
Global Head of Research, Strategy and Analysis

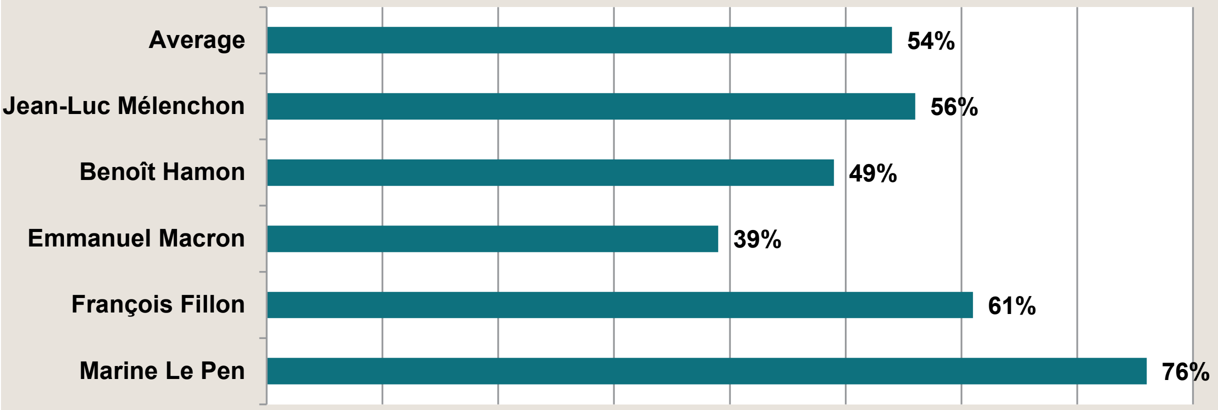
Voting polls: where do we stand?

Voting intentions in the first round of the presidential election (2/4 March 2017)
(33% of respondents are unsure whether to vote or have not expressed any choice yet)



Sources: KANTAR - SOFRES - onepoint, Amundi Research

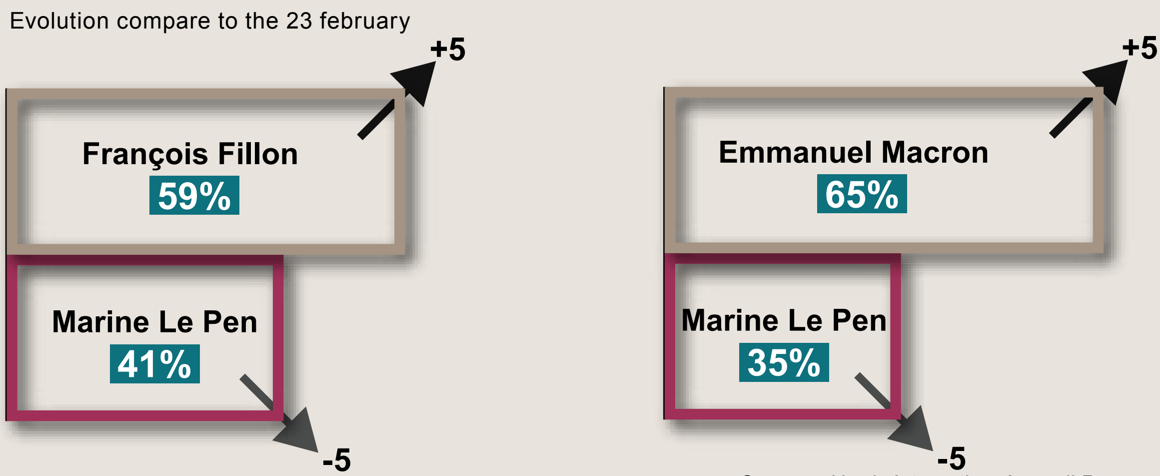
Certainty of vote in the first round of the presidential election (2/4 March 2017)
(For each candidate, percentage of voters considering they are sure of their choice)



Sources: KANTAR - SOFRES - onepoint, Amundi Research

Voting intentions for the second round of the presidential election (9 March 2017)

Hypothesis Fillon vs. Le Pen | **Hypothesis Macron vs. Le Pen**



Sources: Harris Interactive, Amundi Research

Key points

- **The French economy held up well during the recession but has been slow to recover.** After weathering the double-dip recession of 2008-2013, GDP has recovered over the past four years at a positive but weak pace, which has yieled only a recent and modest decline in unemployment and consistently underperformed German economic growth. However, signs of improvement have recently appeared in corporate margins, investment and jobs.
- **France stands out in the Eurozone with its twin deficits**, although they are not very large.** Its public and private imbalances are sustainable as things currently stand but its debt and deficits would be sources of vulnerability if interest rates rose without an acceleration in growth and/or if there was a new recession.
- **Economic policy in recent years** has been marked by: 1/ **fiscal policy aiming at gradually reining in the public deficit**, first through tax increases (aggressive and long-lasting for households, despite a recent pull-back ; temporary on companies before being more than offset by payroll tax reductions), and then through savings on public spending; 2/**moderate structural reforms in several directions**, including a “flexisecurity” approach to the labour market.
- **The now well-entrenched cyclical recovery has the potential to continue. The main short term risks are political and/or external.**

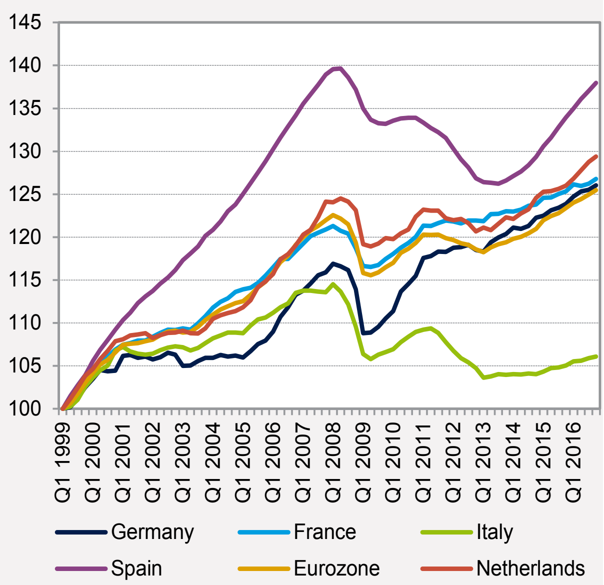
The French economy was less negatively impacted than many others by the economic and financial jolts of the 2008-2013 period, but its performance has been lacklustre since then – neither the Eurozone’s engine nor its “sick man”. Much the same can be said of the major French macroeconomic imbalances, which are undeniable but still bearable for the time being. French economic policy since 2012 has been marked by a steady approach to deficit-reduction and the launching of reforms in several areas, which are paying off, but only very gradually.

I – A lacklustre economy that has consistently underperformed Germany in recent years

France generates about 2.3% of global GDP* (with just under 1% of the world’s population) and 21% of the euro zone’s GDP. Based on many long-term performance metrics and competitiveness indicators, the country ranks generally average among developed economies. However, it suffers recurrently from an **unfavourable comparison with its main partner, Germany**, in many areas, starting with the unemployment rate, the share of industry in the economy, public debt, public deficit and foreign trade (still, the contrast in GDP growth is not as stark and depends on the period reviewed).

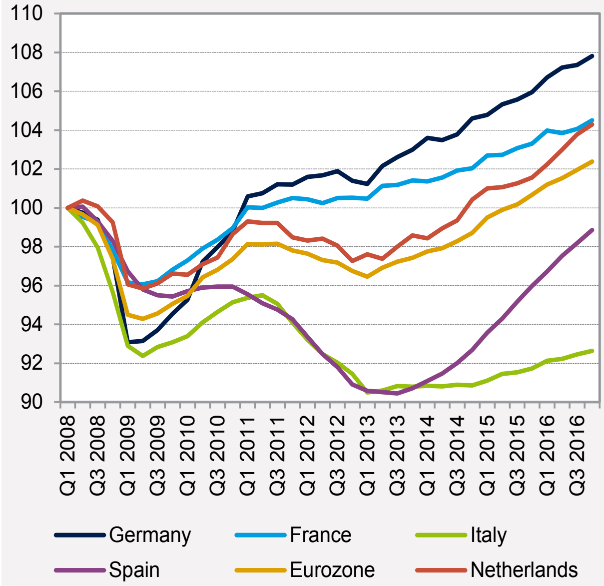
	France	Germany	Eurozone
Public deficit, % of GDP, est 2016	**-3.3**	**0.6**	**-1.7**
Public debt, % of GDP, est 2016	**96.4**	**68.2**	**92.3**
Current account, % of GDP, 2015	**-0.2**	**8.5**	**3.2**
Unemployment rate, %, Jan 2017	**10**	**3.8**	**9.6**
Average GDP growth,%, 2014-2016	**1**	**1.6**	**1.8**
% of value added in Industry, 2014	**14.1**	**25.9**	**20.1**

GDP since the creation of the Euro (basis 100 in Q1 1999)



Source: Eurostat, Amundi Research

GDP since the pre-crisis peak (basis 100 in Q1 2008)



Source:Eurostat, Amundi Research

The economy's disappointing trajectory in recent years has tended to widen this gap even more.

II – An economy that weathered the recession well but has been slow to recover

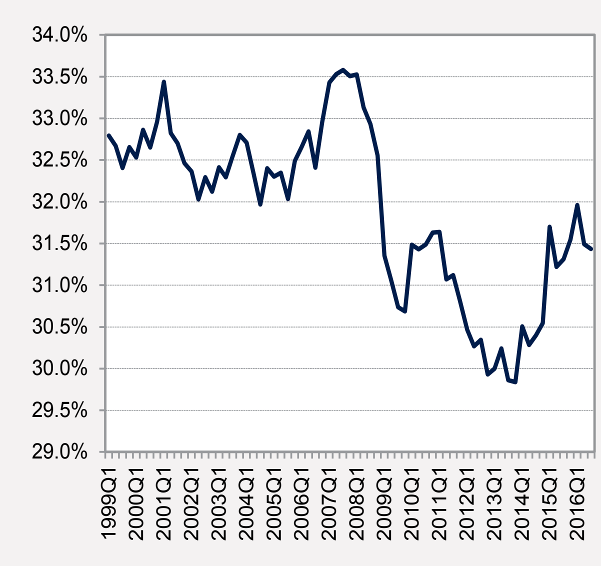
The French economy did hold up well during the 2007-2008 recession, protected by its traditional shock-absorbers (household consumption and public spending), a solid banking system, and its lower exposure to international trade than Germany. It then suffered through a second recession during the 2011-2013 Eurozone sovereign debt crisis, but without a collapse comparable to those seen in Italy and Spain, and without having investors raising too many eyebrows at its public debt (safe for a brief period at the end of 2011).

Since 2013, French real GDP growth has moved back into positive territory but has stalled at barely more than 1% annually, below the Eurozone average. A weaker recovery than in Spain or the Netherlands may be due to the lack of pent-up demand because of a shallower previous decline, but this cannot be the reason for its gap with Germany over the same period (during which German GDP expanded by 1.6% on annual average).

While GDP has not accelerated, some notable improvements have nonetheless been seen over the past few quarters:

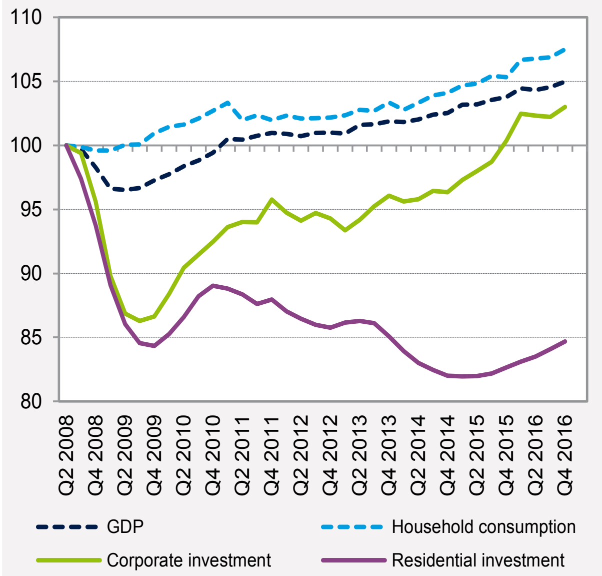
- **An improvement in corporate margins** from lower levels than in other major euro zone countries, and which had bottomed out in late 2013.
- **A rebound in investment,** which had until then missed out on the recovery**.** This improvement has been seen in both business investment (driven by improved margins) and residential construction (which moved back into positive territory in 2016).

French corporate margins (% of gross value added)



Source: Insee, Amundi Research

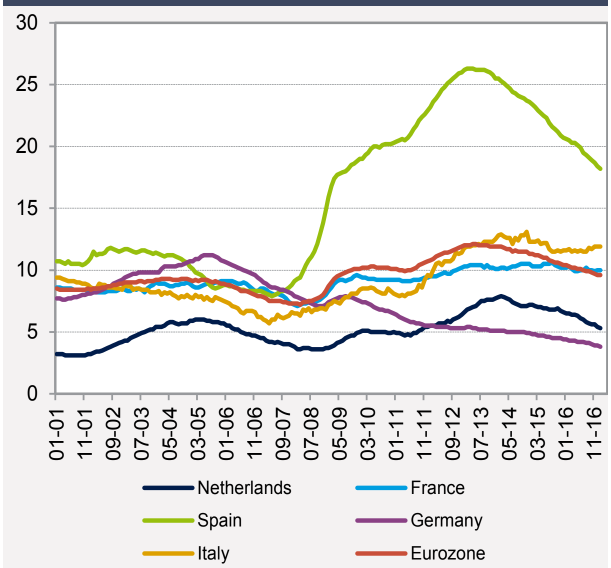
France : components of private internal demand, basis 100 in Q1 2008



Source: Insee, Amundi Research

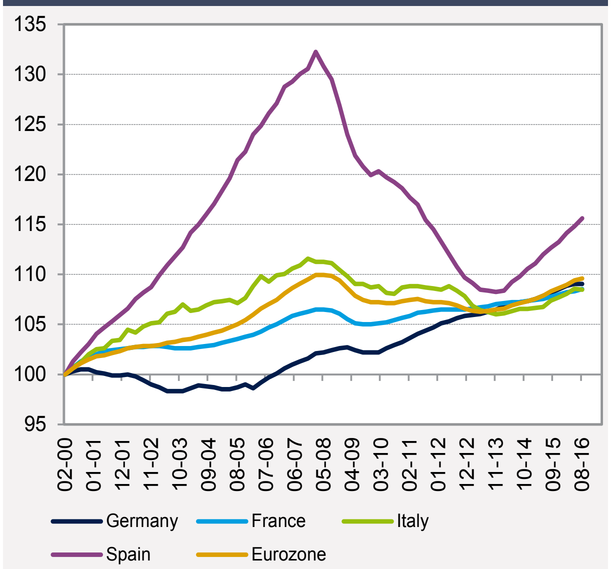
- **A decline in unemployment**, to 10% in January 2016 after peaking at 10.6% in August 2015, with an acceleration in employment (+1.2% from Q4 2015 to Q4 2016, vs. +0.7% one year earlier).

Unemployment rate



Source: Eurostat, Amundi Research

Total employment, basis 100 in Q1 2000



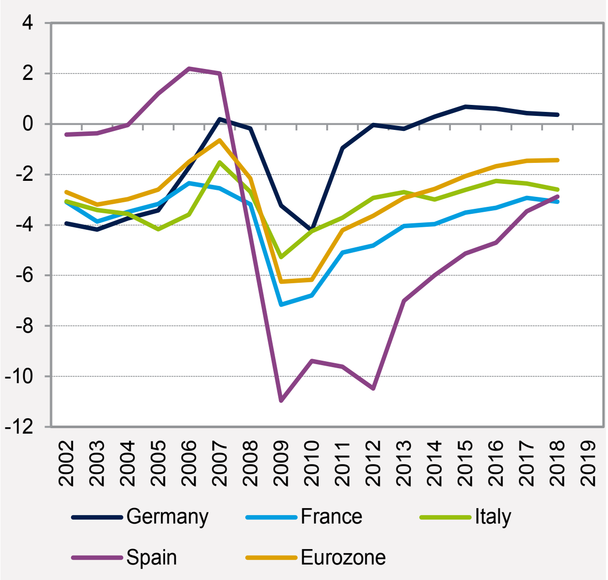
Source: Eurostat, Amundi Research

Looking at the most recent figures, we see that, after a relatively solid Q4 2016 GDP growth (+0.4% vs. Q3), the initial business climate indicators for early 2017 are sending out a very optimistic message. This is the case, notably, for PMI Indices, the INSEE's business confidence indicators and the OECD's leading indicators (the latter were higher for France, as of January 2017, than for other major developed economies). However, the importance of those short term signals must not be exaggerated, all the more so that several government measures (payroll tax cuts, support for construction, and tax cuts for certain households) have been calibrated to provide their full impact in 2016 and 2017, an impact that may not recur with equal intensity from 2018 on. A far greater and lasting improvement is needed to both truly begin catching up with Germany and decisively remedy the French economy's major macroeconomic imbalances.

III – Twin deficits**and debt: sustainable... for the time being

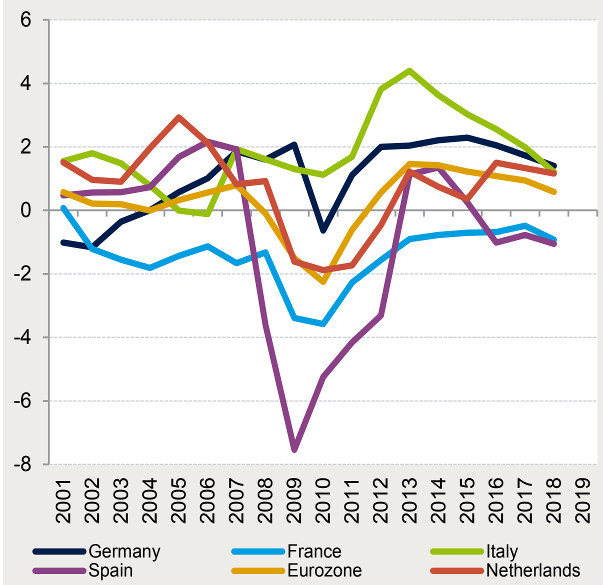
France's public deficit is still slightly above the European threshold of 3% of GDP (at an estimated 3.3% in 2016), but has shrunk steadily in recent years (since setting a record at 7.2% of GDP in 2009), as market leniency has allowed the country to opt for a far more gradual approach than the drastic austerity imposed on its southern European neighbours. This improvement is due partly to the economy and partly to falling interest rates. However, the cyclically adjusted primary deficit, which reflects structural adjustments, has still shrunk from 3.4% to 0.9% of GDP since 2009. The level of public debt, meanwhile, at nearly 100% of GDP (up from 64% in 2007) is slightly above the Eurozone's average and far higher than Germany's. However, it has stabilized in recent years.

General budget balance, % of GDP (estimations à partir de 2016)



Source: Eurostat, Amundi Research

Cyclically-adjusted primary deficit, % of potential GDP (forecast from 2016 on)

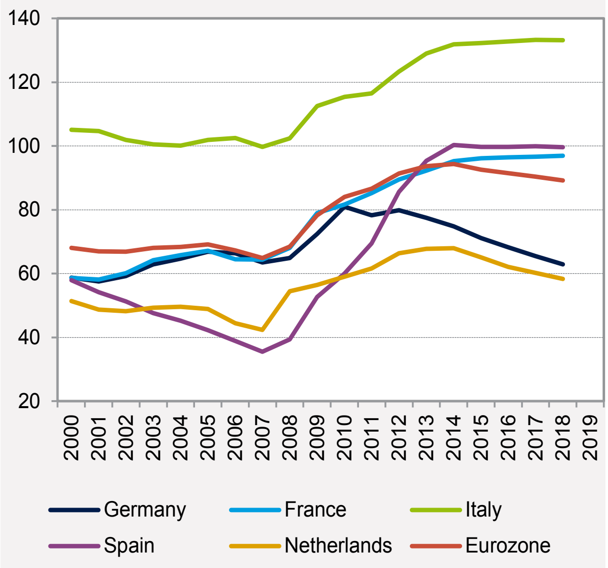


Source: Eurostat, Amundi Research

France also has a recurring current account deficit; although not a very large one (roughly 1% of GDP in 2014, according to Insee, its reduction to well below this level in 2015 and 2016 being due essentially to the lower oil bill). Its most problematic component is the balance in goods and services deficit, which reflects insufficient external competitiveness. While all other major Eurozone countries have a current account surplus, France is therefore alone in showing twin deficits

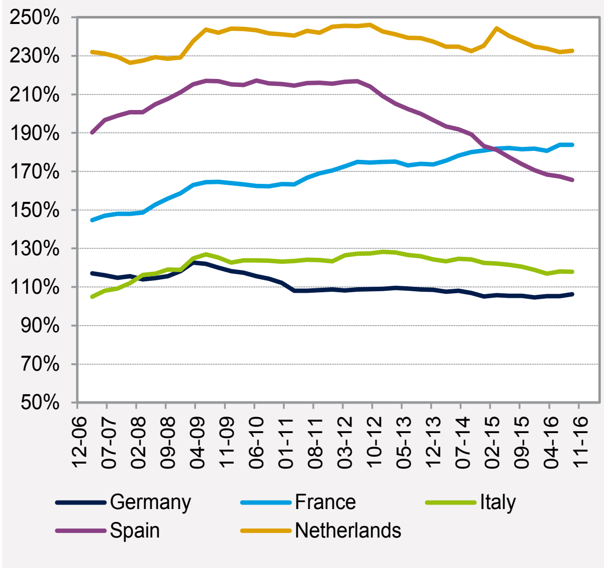
Private debt is not excessive but is growing. In contrast to Italy and, even more so, Spain, it has continued to rise in recent years in France. Corporate debt, the growth of which is due more to weak margins than to investment, is now rather high compared to France's large neighbouring countries (at about 130% of GDP). However, it is not raising any major flags at this point. Household debt (57% of GDP) is also on an upward trajectory, but is still far lower than just before the 2009 crisis in countries that were later hit hard by serious mortgage debt crises.

Gross Public Debt, % of GDP (estimates from 2016 on)



Source: Eurostat, Amundi Research

Non-bank private debt, % of GDP



Source : BIS, Recherche Amundi

For the moment, these imbalances are sustainable, even in an environment of slow growth. But both public and private debt would be heavy sources of vulnerability in the event of a new recession or a sharp rise in interest rates without an acceleration in growth.

IV – Economic choices in recent years: a gradual reduction of the public deficit, moderate structural reforms

Faced with a still-high public deficit and an unemployment rate that had been rising since the serious crisis of the late 2000s, the administration that took office in 2012 put through a policy whose main directions have been the following:

-Sharp tax increases in 2012 and 2013, both on households (VAT and income tax) and companies and capital (corporate income tax and capital gains tax), that were also intended to meet new spending promised during the campaign programme (which was far to the left).

-Corporate tax cuts beginning in 2014: a three-year €40bn programme, mostly tax credits and cuts in social contributions). Taxes on households continued to rise in 2014 before decelerating sharply from 2015 on.

	New taxes, total for the 2012-2017 period (including the effect of decisions taken by the previous administration), €bn
Corporations	-18.5
Households	47.3
Corporations & Households	11.1
Fight against fraud	2.8
Total	42.6

Source: OFCE

- **Savings on public spending, beginning in 2015**: a €50bn, three-year plan involving national and local administration and social welfare, of which roughly €40 bn should indeed be implemented by the end of 2017.

-Structural reforms along several lines, including:

- **the job market:** several reforms between 2013 and 2016, guided by a "flexicurity" approach to make layoffs easier and to simplify and decentralise labour negotiations (at a sector or company level, rather than at national level). Measures have also been undertaken to generate savings in the pension system.
- **the market for products and services:** measures for simplifying standards; creating greater competition and streamlining healthcare organization.
- **the administration, particularly at the local government level:** with a merger of regions, development of the metropolitan area status and incentives for municipalities to group activities at an "intercommunal" level.

However, these reforms (some of which were pushed by Emmanuel Macron, who served as advisor to the president and then minister of the economy) have met with fierce resistance, forcing the government on several occasions to lower the bar (particularly in easing the conditions of layoffs, the opening up of some professions to competition, and the reduction of municipalities' prerogatives).

The unpopularity of some reforms (in addition to the tax hikes), the fact that they were counter to campaign promises, and the fact that this type of reforms generally takes time to pay off are among the main reasons for President François Hollande's lack of popularity, that led him to decide not to run for re-election.

** IMF estimate according to its purchasing power parity methodology.*

*** A country is said to be running twin deficits if it has a public deficit (its public agencies spend more than they collect in taxes and other revenues) and a deficit in its trade with the rest of the world. Economic theory suggests that there is a link between these two deficits.*

Conclusion

As 2017 begins, the current phase of political uncertainty is therefore unfolding in the midst of an economy that, while still growing at a disappointing pace, has nonetheless improved in recent quarters and should continue to improve in the coming months. Although the effects of some short term policy measures could lose strength in 2018, and while the measures implemented by the future government (especially the fiscal stance) could affect the detailed growth outlook, the positive trend is also supported by important cyclical factors (employment and investment) and some of the gains of the reforms undertaken in recent years are probably yet to come. The main risks to a further recovery do not reside today in domestic economic factors, but in political shocks that could jeopardize the continuity of Eurozone institutions, whether originating from France or from other Eurozone countries, or in external events that could undermine the current cycle of expansion in the global economy.

France - Financial markets in a nutshell

	09/03/2017	Change over the week	Ytd
2y. bond yield			
United States	1,28	9,99	9,41
Germany	-0,84	2,50	-7,10
France	**-0,49**	**-2,00**	**16,90**
10y. bond yield			
United States	2,45	8,25	1,02
Germany	0,29	2,50	7,70
France	**0,92**	**-2,00**	**23,20**
2y. bond yield spread			
France	**35**	**-5**	**24**
Italy	82	-10	23
Spain	70	7	21
10y. bond yield spread			
France	**63**	**-12**	**16**
Italy	185	-14	25
Spain	141	-4	24
Sovereign CDS 5y.			
France	**57**	**-11**	**19**
Italy	184	0	26
Spain	75	-4	-1
Equity markets			
EurostoXX 50	3381,3	1,42	2,76
DAX 30	12052,9	0,88	4,98
CAC 40	**4959,8**	**1,40**	**2,01**
MIB 30	19352,9	2,83	0,62
IBEX 35	9729,8	2,49	4,04
Credit markets			
ItraXX main	71	-3	-1
ItraXX XO	281	-13	-8
ItraXX Financials sen.	88	-6	-5
ItraXX Financials sub.	202	-17	-20
Exchange rates			
EURUSD	1,05	-0,50	0,11
EURGBP	0,86	1,89	0,61
EURCHF	1,06	-0,08	-0,74
1m. implied volatility			
VIX	12,5	0,8	-1,5
VDAX	14,7	0,5	-3,2
EURUSD	7,9	-0,9	-2,4

Read more

- Taking stock of the situation and decrypting current issues *(already published)*
- An overview of the French economy;
- Rigidities of the French economy and potential reforms: the opinions of international organisations and of the candidates for the presidential election *(forthcoming)*;
- Europe: what do the candidates for the presidential election think about it precisely? *(forthcoming)*;
- French debt: state of play and points of attention *(forthcoming)*;
- Margin rates of French companies: where do we stand now? *(forthcoming)*;
- The positions of the candidates for the presidential election on fiscal and tax policy *(forthcoming)*;
- French bond yields and OAT / Bund spread: ECB's role and perspectives *(forthcoming)*

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