

## COUNTRY FOCUS

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### France at a historic crossroads

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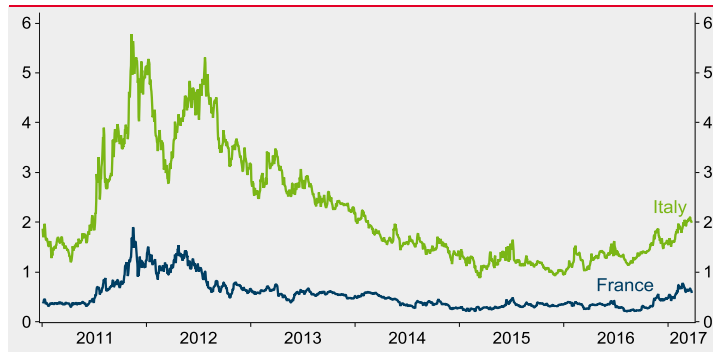
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France is facing a crucial political decision over its future direction. Protectionism and Euroscepticism are not suited to boosting the competitiveness of the French economy. The reform agenda that the government has meanwhile been pursuing should be continued. It is already showing some initial signs of success: business and consumer sentiment is rising, the pace of investment has accelerated and employment is growing, albeit only modestly. Economic growth is likely to reach 1.2 % in 2017, slightly below the average in the euro area of 1.4 %.

With the election in the Netherlands over, financial markets are now turning their attention to the decision of French voters. On 23 April, or more likely in the run-off on 7 May, the next President of France will be chosen. Since the two best-placed frontrunners, the independent candidate Emmanuel Macron and the leader of the Front National, Marine Le Pen, will probably not have their own majority in the National Assembly, elections to the lower house on 11 and 18 June will be at least equally as important. They will decide what majority the new president will have to govern in cohabitation with. The Eurosceptic manifesto of the Front National has unsettled the markets. After all, its candidate intends to end France's membership of the euro and the EU by means of a referendum and constitutional amendment. This has led to a widening in the spreads to Germany. The sentix Euro Break-up Index also indicates that survey participants consider the likelihood that France will leave the euro area to be higher (cf. chart p.2).

#### Rising uncertainty

Spreads between 10-year government bonds and German Bunds, percentage points



Sources: Macrobond, Helaba Research

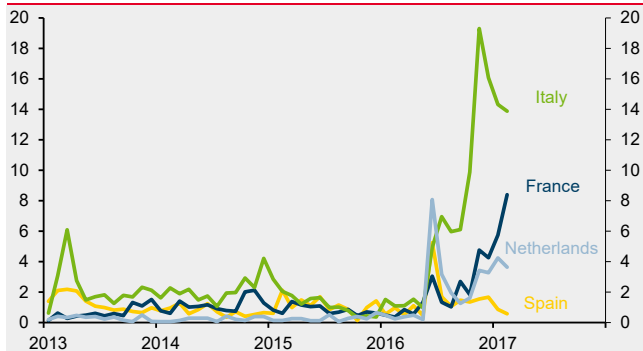
This publication was very carefully researched and prepared. However, it contains analyses and forecasts regarding current and future market conditions that are for informational purposes only. The data is based on sources that we consider reliable, though we cannot assume any responsibility for the sources being accurate, complete, and up-to-date. All statements in this publication are for informational purposes. They must not be taken as an offer or recommendation for investment decisions.

However, opinion polls, among other things, suggest a French withdrawal from the EU or from the single currency is unlikely. Although Marine Le Pen will probably succeed in reaching a run-off, she is not expected to win against either Emmanuel Macron or François Fillon in the second round (cf. charts p.2). Even if Marine Le Pen were victorious, it would be almost constitutionally impossible for France to leave the single currency, since this would only be possible if it also left the EU. In that case, the French constitution would have to be amended. According to Article 88 of the constitution, France participates in the European Union and, pursuant to Article 88-2 "agrees to the transfer of powers necessary for the establishment of European economic and monetary union." It is hard to imagine a constitutional amendment passing in a situation of cohabitation, because Article 89 stipulates that the Prime Minister must propose it to the President. After that, both the National Assembly and the Senate have to agree to it. In both houses, there are unlikely to be appro-

private majorities, especially since only 170 of the 348 Senators are up for re-election by an indirect panel of electors in the Senate elections on 24 September 2017.<sup>1</sup>

### Fears of euro area disintegration

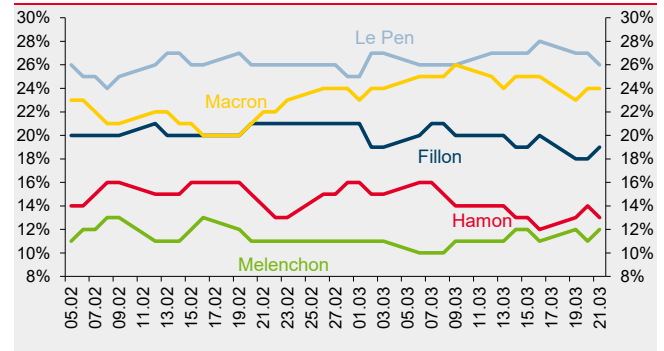
Probability of exit from euro in the next twelve months\*, %



\*sentix Euro Break-up Index Sources: Bloomberg, Helaba Research

### Le Pen and Macron could reach run-off

% of votes, first round



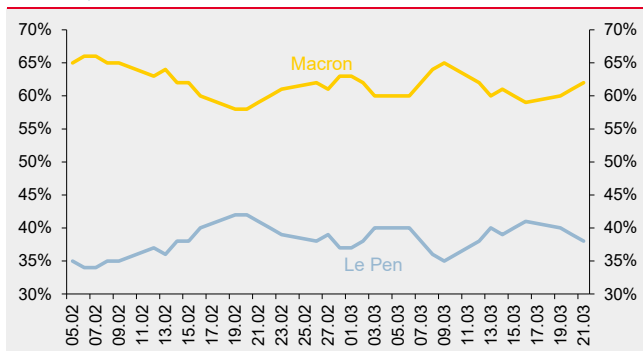
Sources: Bloomberg, OpinionWay, Helaba Research

Protectionism a futile aim for France

Even if withdrawal by France from the EU and the common currency area is rather unlikely, a Le Pen win would certainly still lead to enormous uncertainty on capital markets. There would be a danger of widespread capital flight from the country. In addition, the Franco-German axis is like to be massively weakened. That would leave Europe essentially “leaderless”. Political upheaval in France could not be ruled out and protectionist tendencies would probably increase even further. This would only ostensibly be of help to French companies; strengthening the competitiveness of the French economy would be more meaningful. Isolating companies could even lead to their being more reluctant to make efforts in this direction.

### Emmanuel Macron and ...

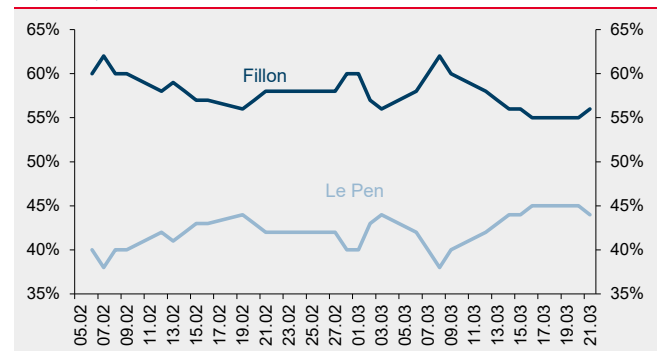
% of votes, second round



Sources: Bloomberg, OpinionWay, Helaba Research

### ... François Fillon both in with good chances

% of votes, second round



Sources: Bloomberg, OpinionWay, Helaba Research

Little growth in recent years

### French economic growth more sluggish than in Germany

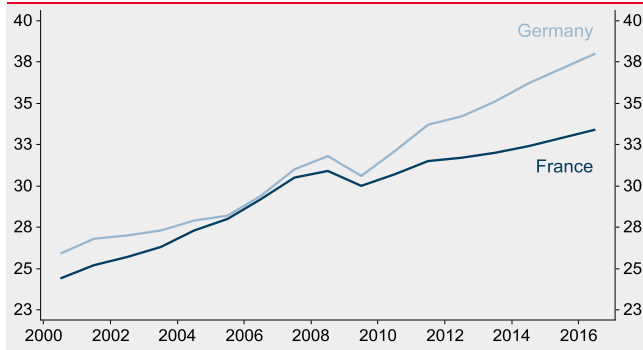
Economic growth has been considerably weaker in the last five years in comparison with that of Germany. For instance, French gross domestic product (GDP) has only risen by 0.8 % p.a. since 2011, while Germany has managed 1.2 %. This divergence is also apparent when looking at the per capita development. Income disparities were negligible as little as ten years ago. However, by 2016 gross domestic product per capita had reached EUR 38,000 in Germany, a full EUR 4,400 above the French level (cf. chart p.3). Economic growth has not been high enough to have had any significant effect in bringing down unemployment – a reason for the widespread dissatisfaction

<sup>1</sup> The possibility of using Article 11 of the French Constitution does not appear to be a promising option, either. This Article only permits the holding of referenda if they do not include an amendment to the Constitution. Since withdrawal from the euro implies exiting the EU, the conditions for a plebiscite to take place are not met.

among French people with the economic situation. In 2016, the unemployment rate of 10 % was even above that in 2011 (9.2 %). Most recently, youth unemployment (under 25) was more than 23 %.

### France falling behind, ...

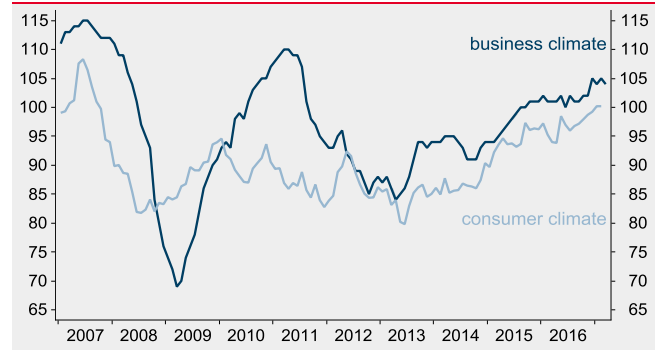
Annual GDP per capita, nominal, in EUR billions



Sources: Macrobond, Helaba Research

### ... but sentiment is improving

Indices



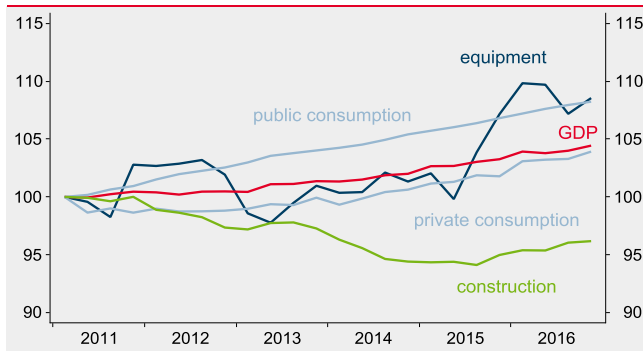
Sources: Macrobond, Helaba Research

#### Turnaround in construction activity

Recently, momentum in the French economy has picked up somewhat. GDP in the last quarter of 2016, for instance, was 0.4 % higher than the preceding three months. Since last year, growth in the economy has also been broader based. In 2016, consumer spending (1.8 %) and public-sector consumption (1.5 %) were not the only factors contributing to economic growth. For the first time in four years, construction investment (1.3 %) also rose. This growth came from non-residential construction, with house building only rising slightly. The strong increase in residential building permits, however, points to a quicker pace this year. Residential property prices have seen a modest increase since 2015, while equipment spending has gathered speed (5.4 %). Despite the weak euro, the contribution to growth by foreign trade was once again negative in 2016.

### France sees hesitant recovery

Components of GDP, index: Q1 2011 = 100, real



Sources: Macrobond, Helaba Research

### Corporate profits have been rising since 2014

Gross profits of non-financial companies, % of gross value added

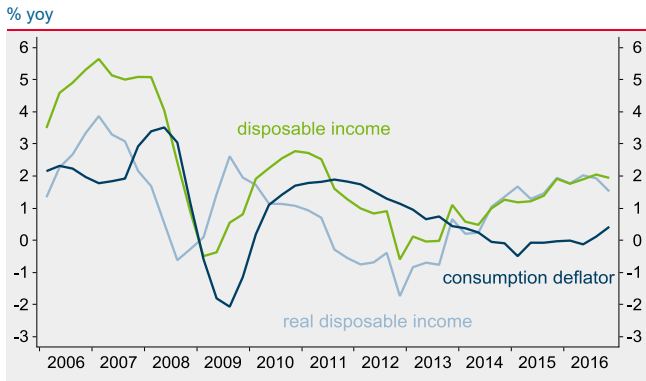


Sources: Macrobond, Helaba Research

#### Change in economic policy from 2014

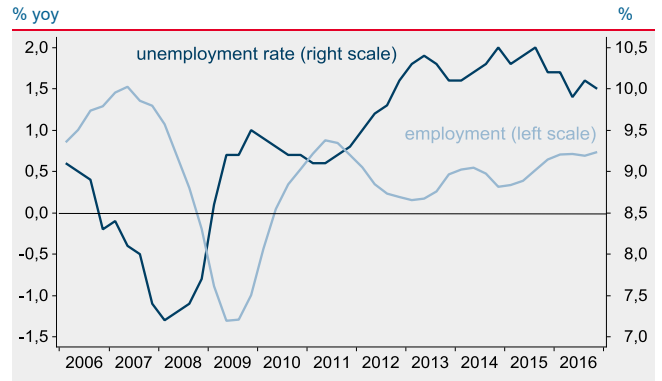
Economic policy measures by the government are likely to have contributed to the more buoyant investment activity in 2016. Having pushed through tax rises for companies and consumers as recently as 2012 and 2013, this was followed by a change in policy. A reduction in social insurance contributions and taxes as well as the introduction of temporary tax relief improved the situation for companies. This has contributed to an increase in companies' margins. On top of that, the government made public and social spending cuts in an amount of EUR 50 billion within three years. In spite of this, public-sector consumption has continued to rise at a rate of around 1 ½ % p.a.

### 2017: Higher prices weigh on real incomes



Sources: Macrobond, Helaba Research

### Rising employment hardly reduces jobless rate

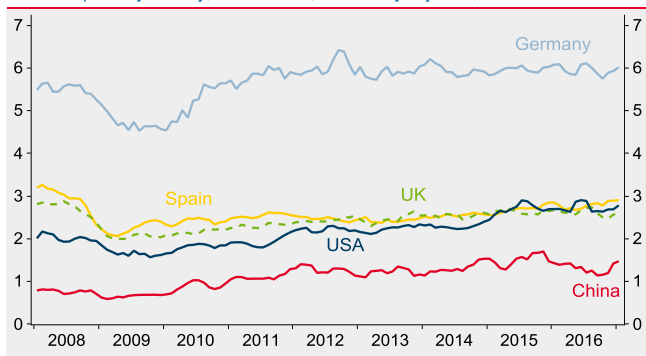


Sources: Macrobond, Helaba Research

These positive effects of a broad-based economic upturn will continue into 2017, albeit without the stimulating impact of a low oil price. The inflation rate in 2016 was only 0.3 % and will probably reach an average of 1.6 % this year. This will act as a drag on real incomes if wage rises are similar to last year. This effect will be offset by marginally higher employment. The savings rate is likely to remain almost unchanged. Moreover, consumers are optimistic despite the continued high level of unemployment. Sentiment among consumers is at its highest level since 2007, after all. For this reason, consumer spending is only expected to grow by 1.3 %. In addition, political uncertainty in the run-up to the elections is likely to put a brake on investment activity for the time being. A return to stronger growth cannot be expected until the situation becomes clearer. Nevertheless, capacity utilisation in the industrial sector has risen substantially since 2014. Despite this, it remains slightly below the long-term average. Business sentiment in service sectors has also continued to improve. The tendency here should also be towards a further rise in the propensity of companies to invest.

### Germany most important trading partner

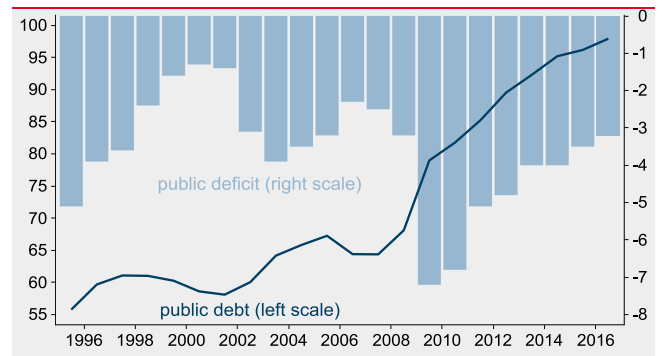
French exports by country, EUR billions, seasonally adjusted, smoothed



Sources: Macrobond, Helaba Research

### National debt approaches 100 %

% of GDP



Sources: Macrobond, Helaba Research

#### Anaemic growth in foreign trade

Growth in French exports is low and results in part from the poor competitiveness of exporting companies and their range of products. Excluding the construction industry, the industrial sector only contributes a share of 14 % to gross value added; the equivalent figure in Germany is almost 26 %. Furthermore, weak domestic growth is having an adverse effect on imports. The country's most important trading partner is Germany: around 16 % of French exports go there and 17 % of imports come from its eastern neighbour. In recent years, France has not managed to increase its exports to Germany. This is probably due to the fact that the country supplies only few semi-finished goods to German industry in contrast to certain Central European countries, for example. There have even been no significant increases in exports to growth markets such as China.

Approximately 60 % of French goods are sold in the EU. A possible withdrawal from the union would cause economic damage to France, especially in view of the need to renegotiate appropriate trade agreements. It is likely that the enormous rise in uncertainty alone would jeopardise economic growth.

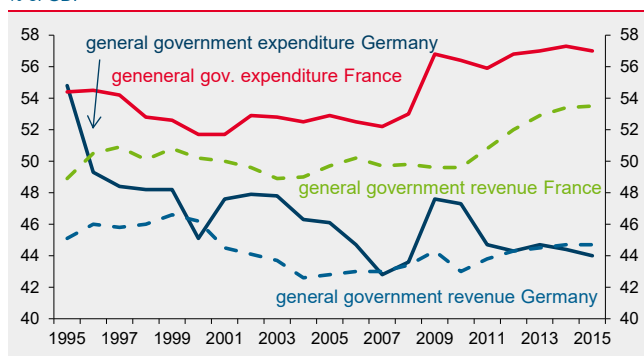
### Rigorously adhere to policy of reform after the election

Large stimulus package  
not an option

As a result of a deceleration in consumer spending, economic growth in 2017 of an estimated 1.2 % will be hardly any stronger than in the previous year (1.1 %). At 1.3 % it is unlikely to change very much in 2018, either. France has not been able to fulfil the Maastricht deficit criterion of 3 % of GDP since 2007. This has led to a constant rise in the national debt, which should hit the 100 per cent-mark by next year. Therefore, it is clear that the new government will have little room for manoeuvre to increase public expenditure. A larger-scale stimulus package is thus likely to remain out of the question as an economic policy option. Reducing bloated government spending will be crucial in order to make room for tax cuts. Total public expenditure by the French state amounts to 57 % of GDP and is thus 13 percentage points higher than in Germany; tax revenues are also correspondingly higher. The election manifestos of both candidates, Emmanuel Macron and François Fillon, include the aim, to a greater or lesser extent, of reducing public spending.

### French public spending too high

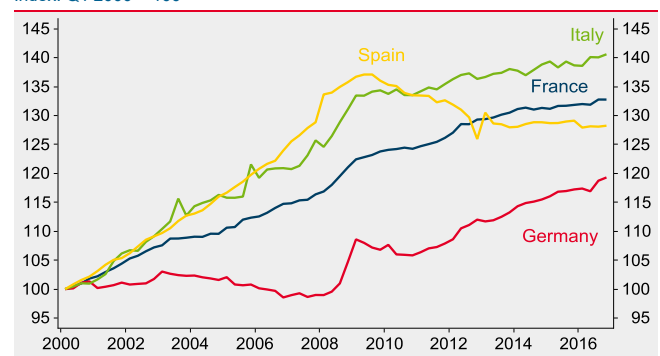
% of GDP



Sources: Eurostat, Helaba Research

### French unit labour costs rising more slowly

Index: Q1 2000 = 100



Sources: Macrobond, Helaba Research

Although the French economy has benefitted from the low oil price, the weak euro and tax relief for business investment, growth has remained anaemic. Persistently high costs may be a reason for this: until recently, unit labour costs had been rising, while in Spain, for example, the trend had been reversed. In addition to a continuation in the moderate wage policy, “microeconomic” reforms should be enacted after the election that may be able to contribute to boosting productivity. For instance, greater efforts should be made in the education and training sector, especially to improve the vocational training of young people. International studies have shown that France has some catching up to do in this respect. An “age old” problem is the high level of the minimum wage, which reduces the chances of young people and those who are less well qualified of getting a job. Implementation of a German-style dual training system could lead to progress in this area. Furthermore, more decentralised wage bargaining, with the aim of a better alignment between wage formation and a company’s profitability, would make sense. In addition, further steps towards the liberalisation of protected professions could lead to higher efficiency. Thanks to the Macron law of 2015, some initial measures have already been implemented, such as the liberalisation of the long-distance bus sector. This should be followed up by further reforms in pension policy, with the aim of reducing costs. The employment rate among 60 to 64-year olds in France is considerably lower than those of other advanced countries. This could be addressed by gradually extending people’s working lives.

## France – Forecast at a glance

		2015	2016	2017	2018
GDP, real	%, YoY	1,2	1,1	1,2	1,3
Budget deficit	%, YoY	-3,6	-3,4	-3,2	-2,9
Current account	%, YoY	-0,2	-1,2	-1,0	-0,9
Unemployment rate	%	10,4	10,0	9,6	9,2
Inflation rate	%, YoY	0,1	0,3	1,6	1,4

Sources: Macrobond, Helaba Research; 2017/2018: Forecasts

In the medium term, France will probably only be able to generate higher growth if it continues its reform policies. However, even if one of the best-placed candidates defeats Marine Le Pen, it can be expected that the pace of implementing reforms will probably remain slow against a backdrop of likely cohabitation and widespread scepticism among the population. ■