Eurozone Watch

Group Economics

Financial Markets Research

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French election Q&A

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- **We set out and answer a number of key questions regarding the upcoming presidential and parliamentary elections in France**
- **Our base case is that Emmanuel Macron will win the presidency, but we have also looked at the consequences of a potential victory for the two populist Eurosceptic candidates Marine Le Pen and Jean-Luc Mélenchon**
- **Given the recent election polls and the political programmes of the main candidates, a Macron victory would probably be the best-case scenario for financial markets …**
- **… although his plans for economic reforms and consolidating government finances are less ambitious than those of François Fillon**
- **Nevertheless, both Macron and Fillon would still face major obstacles in passing their programmes**
- **A victory for Le Pen would probably be the worst-case scenario for financial markets, although she would have to cross a number of big hurdles before she could reach her goal of a Frexit**
- **Jean-Luc Mélenchon has enjoyed a recent surge in polls, mostly by drawing voters away from the Socialist candidate, Benoît Hamon**
- **Unless Mélenchon is able to convince centre-leaning voters to back him, it's unlikely he will be a contender in the second round of voting**
- **In the event of a Macron victory, we expect the 10-year French spread to fall back to around 50 basis points and EUR/USD to rise to 1.10**
- **If Le Pen or Mélenchon would win, we expect a significantly less market friendly outcome; the euro would drop sharply and we expect much higher government spreads of respectively 225 and 125bp**

Key dates

- **23 April:** Presidential, 1st round (first results from 20:00 CEST)
- **7 May:** Presidential, 2nd round (first results from 20:00 CEST)
- **11 June:** Lower house elections, 1st round
- **18 June:** Lower house elections, 2nd round

Who will be France's next President?

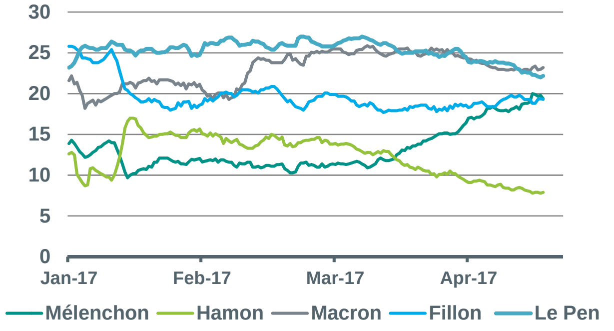
Most likely Emmanuel Macron. In France, presidential elections are organised according to the runoff or "ballotage" system. If a candidate secures an absolute majority (50 percent plus one) in the first round, (s)he becomes President. That outcome is highly unlikely to occur this year; consequently, a second round will be held within 15 days of the first between the two top-scoring candidates in the first round.

According to recent polls, the young centrist Emmanuel Macron is neck-and-neck with the populist Eurosceptic Marine Le Pen (both around 23-24% of the votes). Therefore, it seems these two candidates will progress to the second round, where polling on the (as yet hypothetical) match-up hands the presidency to Macron by a significant margin (around 62 Macron to around 38 percent Le Pen).

However, plenty can happen in two weeks. Since mid-March alone, the populist left-wing candidate Jean-Luc Mélenchon has moved from polling in 5th place (10-12%) to reducing the gap with the centre-right François Fillon and even beating him in some recent polls. If Fillon or Mélenchon ended up taking second place to either Le Pen or Macron on April 23rd, polls suggest that Fillon would be beaten by Macron by a wide margin. If Fillon were to face Le Pen, the race would be closer. However, the polls suggest that he would still beat her comfortably. In recent weeks, a number of polling organisations have started to publish the results of hypothetical matchups between Mélenchon and the other top three candidates. Given the scarcity of existing data, it is challenging to accurately assess Mélenchon's chances. Nonetheless, the early polls hint that he too would beat Le Pen, probably by a wide margin. The race would be a bit closer versus Macron, but it seems Macron would beat Mélenchon comfortably. Summing up, Macron would beat all the potential candidates in the second round, whereas Le Pen would be beaten by all of them.

Polls for the first round ...

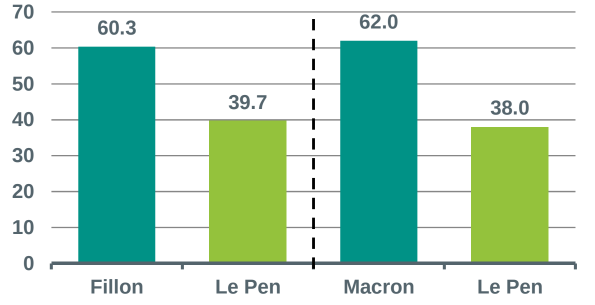
% of votes, 5-poll moving average



Source: various polling institutes

... and the second

% of votes, 3-poll moving average



Source: various polling institutes

Could there be a surprise outcome?

Yes. Although the polls suggest that Macron will be the next president indeed, there still is a lot of uncertainty. To begin with, polling agencies are also including the option "Abstention/Protest/Spoilt Vote". Around 25 to 30 percent of the voters plans to vote for this option, which is well above the polling results for the current top-two candidates. Moreover, around 25-30% of the voters still is undecided. It is a mistake, therefore, to present Macron's victory in this election as a foregone conclusion. Another factor which could play against Macron is turnout. Participation in this presidential election is expected to be historically low (60-65%) compared to the historical turnout rates of 80-85%. Marine Le Pen stands to gain from low participation, as around 85% of her supporters are certain of their choice, whereas only some 65% of Macron backers are sure of theirs.

What are the candidates main economic plans?

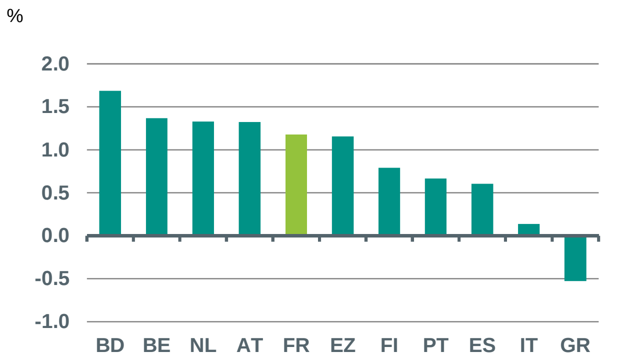
If either Fillon or Macron won the presidency, we can expect the French government to begin pursuing labour market reforms and cut excessive public spending. Fillon plans to end the 35-hour work week, decentralise labour market negotiations and raise the retirement age to 65 from the current 62. He wants to cut taxes by EUR 50bn (EUR 40bn for companies, 10bn for households), reducing the corporate tax rate to 25% (from 28% for SMEs and 33.3% for large corporates). In addition, Fillon plans to cut public spending by EUR 20bn annually (around 1% of GDP). By the end of his term he expects France to have a balanced budget.

Macron plans to push for a EUR 50bn public investment drive during the five years of his term (around + 0.5% GDP per year). This will be compensated by cuts in public spending, amounting to a total of EUR 60bn (2.7% of GDP) by 2022. Regarding weekly working hours, Macron has stated that he will maintain the limit of 35 hours, but will allow companies to negotiate different arrangements on a case-by-case basis. He wants to introduce universal unemployment insurance and pension schemes. Finally, the centrist candidate explicitly states that France will maintain a budget deficit of below 3%.

Le Pen's economic plan targets stronger GDP growth for France: 2% from 2018, reaching 2.5 percent by the end of the term. This would be significantly above the current potential growth rate of the French economy of around 1.25%. She wants to reduce the tax rate on SMEs and simplify the corporate tax relief system. Le Pen also proposes imposing a tax on the hiring of foreigners (which is expected to bring in EUR 2bn annually). Moreover, she has proposed that the Banque de France be allowed to directly finance the government's deficits. Last but certainly not least, she also wants France to leave the euro (see below).

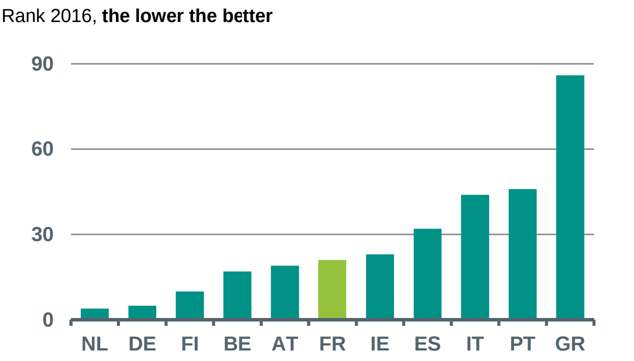
Turning to Mélenchon's agenda, it blends populism, institutional scepticism and radical left-wing economics. He advocates a drastic redistribution of wealth, increasing the minimum wage, hiking taxes for high incomes, exiting NATO, cutting the working week to 32 hours, abandoning nuclear energy and rewriting the constitution. Also, he proposes a public spending stimulus of EUR 173bn (8% GDP) to tackle poverty, improve public services and protect the environment. Finally, he wants to re-negotiate European treaties (for instance changing the mandate of the ECB) and, if unsuccessful, also leave the euro.

Potential GDP growth …



Source: Thomson Reuters Datastream, EC, ABN Amro Group Economics

… and ranking on global competitiveness index



Source: World Economic Forum, The Global Competitiveness Index

What are consequences for Europe and the European project?

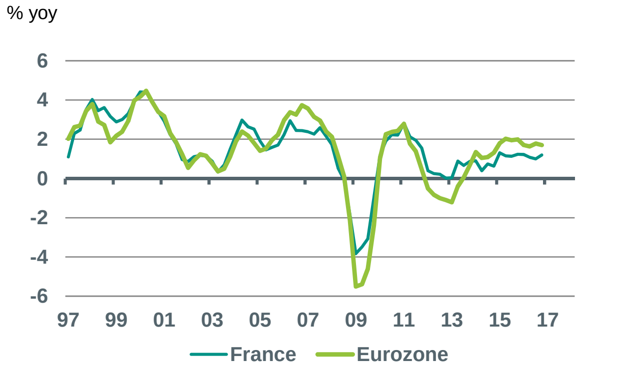
In the event of a Macron or Fillon victory, France is expected to reaffirm its place at the heart of the European Union and the eurozone. Both candidates propose creating a form of oversight authority (a "parliament") for the common currency and installing a "eurozone finance minister". The candidates differ, however, in certain specific policies: Fillon will push forward measures to make the euro a global reserve currency like the US Dollar and will renew the Franco-German economic axis to create a "European NASDAQ", as well as a common digital market.

Macron proposes enhancing European cooperation by creating a Common European Defence Budget (estimated to cost France between EUR 0.9bn and 1.2bn) and by establishing a European border police. More generally, Macron will increase France's defence spending to 2 percent of GDP by the end of his term (up from 1.77% today). He will also introduce a "Buy European Act", which would award public contracts to only companies which conduct operations primarily (at least half) in Europe. Finally, he is in favour of creating a eurozone budget. This budget will be used to support investments and provide emergency financial assistance to individual countries to allow the currency area to better react to crises.

Marine Le Pen's victory wouldn't bode well for the health of European institutions. She plans to immediately renegotiate France's relationship with the EU and will then submit her plans to a national referendum. She will also move to withdraw France from the euro (Frexit) and return to the French Franc. She has toned down her rhetoric about Frexit during recent debates, but considering that it has been one of her main policy objectives in the past, we think it is extremely likely that she would still try and organise a Frexit referendum (see below about the hurdles she would need to overcome).

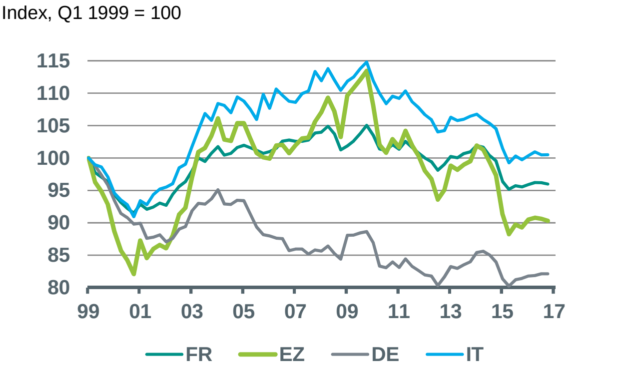
Finally, the candidate on the opposite extreme side of the political spectrum, Jean-Luc Mélenchon, wants to "change Europe or leave it". The left-wing candidate will renegotiate the European treaties, for instance change the mandate of the ECB, which will probably meet a lot of resistance in Germany. He wants to leverage France's weight in the EU to push for these treaty changes, which he will then submit to a referendum. If he is unable to restructure the EU, however, he has not excluded Frexit.

GDP growth versus the eurozone



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Unit labour costs eurozone big-three

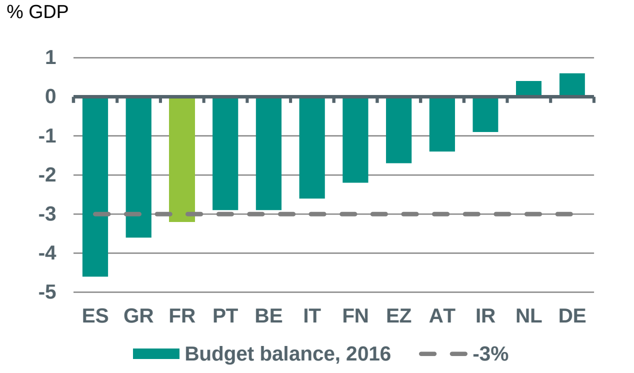


Source: Thomson Reuters Datastream, ECB, ABN Amro Group Economics

What would be the consequences for the French economy?

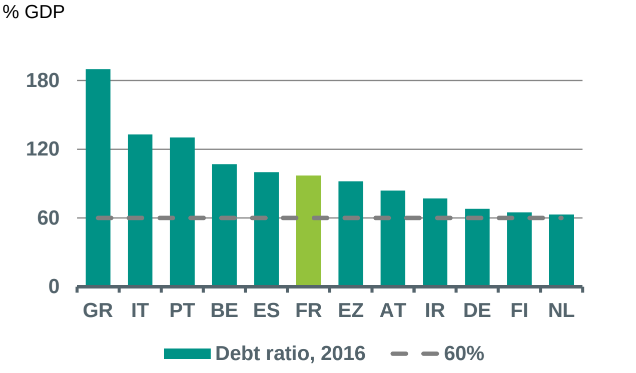
France's economy takes a mid-table position in the eurozone with regard to potential GDP growth and the ranking on the Global Competitiveness Index (see graphs above). Yet is has grown somewhat below the eurozone total during the past few years. This is largely due to the fact that France is lagging behind a number of countries that experienced a housing market crisis or a financial crisis (or both) during the years 2011-2012 (e.g. Spain, the Netherlands, Ireland, Portugal, Greece). These countries have all implemented significant economic reform programmes, have regained competitiveness and have reduced the share of government expenditure in GDP during the past few years (with an government expenditure quote of 57% France is well above the eurozone total of 49%). The growth gap between France and these countries is expected to widen further in the coming years unless France catches up with regard to economic reform. In this respect, a victory of Fillon would be the best-case scenario, as his plans are the most ambitious with regard to stimulating economic growth and also the most beneficial for government finances. That said, given the recent polls of the first and second round of voting, a victory for Macron is more likely. We think that in regard to economic reforms and consolidating government finances his plans are also favourable, albeit less ambitious than Fillon's. Still it should be noted that even presidents with the best intentions have struggled to pass reforms in France. They have been blocked by vested interests, street protests and strikes in the past. Macron could also face the obstacle of not having a parliamentary majority (see below).

Government budget balance …



Source: Thomson Reuters Datastream, ABN Amro Group Economics

… and debt ratio



Source: Thomson Reuters Datastream, ECB, ABN Amro Group Economics

The potential impact of the programmes of the two populist candidates Le Pen and Mélenchon is highly uncertain, particularly since both candidates have a possible Frexit on the agenda. That said, if either of the two were to become president, it is likely that we would see a shift towards a regime of higher domestic inflation. First, the new currency would likely decline significantly versus the euro, leading to imported inflation. The Banque de France (BdF), having broken away from the Eurosystem, would have less inflation-fighting credibility than the ECB in terms of its monetary policy framework. Moreover, more generally, the BdF would come under pressure to finance fiscal spending. It could also face implied losses on its holding of French bonds, which would be redenominated into the new currency, which would likely trigger default status. The financial and economic uncertainties associated with a victory of either of these two candidates will probably weigh heavily on economic growth. It could seriously damage the investor climate towards France and raises the risks of a financial and economic crisis. In a worst-case scenario, a Le Pen (and to a lesser extent Mélenchon) victory, could result in Frexit, which could threaten the existence of the eurozone. Both France and the eurozone would likely experience a deep recession in this scenario.

If she won the presidency, could Le Pen also win a majority in parliament?
Unlikely. Marine Le Pen's party, the Front National (FN) currently has two seats (out of 577) in the lower house (*Assemblée Nationale* - AN) and none in the upper house (Sénat). Although a victory in the presidential election generally gives the winner's party a push forward during the subsequent elections for the lower house ("winner's bonus") the FN would need to gain 287 additional seats to get a majority. Given the electoral system of the AN, the chances of FN achieving this seem minimal. Each delegate in the AN represents a constituency (circonscription législative), of which the mean population is 120,000 people. Like the Presidential election, the vote in June uses the two-round "runoff" approach, albeit with slight differences. A candidate may be elected during the first round (*premier tour*) only if (s)he receives at least 50 percent of votes, which must themselves represent 25 percent of the electorate in the voting district. During the runoff, the candidate with the absolute majority of votes (among those cast) wins the election.

Under France's semi-presidential political system, if a President's party is different to that of the majority of members in parliament the government is divided – this is called "cohabitation". Such a scenario seems likely in the event of a Le Pen, but also a Macron victory. When this happens, the President can become a marginal figure in national politics, although they maintain pre-eminence in areas of foreign affairs and national security. In this case, implementing reform becomes very difficult. In 1998, for example, the Socialist government of PM Lionel Jospin used its parliamentary majority to pass legislation shortening the work week from 39 to 35 hours, against the wishes of the centre-right President Chirac.

Economic impact of the programmes

	Le Pen	Macron	Fillon	Mélenchon
GDP growth	-	+	++	-
Inflation	++	+/-	+/-	++
Government finances	-	+	++	--
European integration	--	++	+	-

Source: ABN AMRO Group Economics

Will there be a “Frexit”?

It’s unlikely (but not impossible). Marine Le Pen would only be able to trigger Article 50 and withdraw France from the European Union if she overcomes a combination of practical, constitutional and legislative hurdles. France’s membership in the European Union is a matter of constitutional concern: under Article 88 of the constitution, “France participates in the European Union”.

Thus Marine Le Pen would be confronted with the obligation to strike this article from the constitution before she could legally proceed with her ambition. As President, Le Pen could propose a “revision project” (via the Prime Minister) to Parliament (where it must be approved by 60% of members) or she could (under Article 11 of the constitution) submit a proposed revision directly to a referendum by the French people. If, as expected, FN does not command a majority of seats in parliament following the June legislative elections, Le Pen will likely resort to the option of a popular vote to leave the EU.

However, there is disagreement among legal scholars as to whether the President is actually empowered to do so; Charles de Gaulle called a referendum in 1962 via his powers under Article 11, but since then another article (61) has curtailed this presidential prerogative by submitting any proposed revision to the oversight of the Constitutional Council (the highest legal authority in France on such matters). If Mrs Le Pen chose the Article 11 route for her referendum, she would be required to stand before the court and argue for the legal grounds of her Frexit referendum. Many legal scholars believe that the Council could exert its power to block any “Leave/Remain” plebiscite. Simply put, Marine Le Pen’s ambitions have the potential to set off a significant constitutional crisis.

Three election outcomes; the good, the bad and the ugly

In basis points, 10-year generic spread France - Germany

Source: ABN AMRO Group Economics, Bloomberg

What will be the impact on markets?

Just a week shy of the first round of elections, French bonds have come under renewed pressure. The generic French-German 10-year yield spread has widened to around 75 basis points, up from below 60 basis points at the end of March. In addition, due to the flight to safety in German short dated bonds, the 2-year French-German yield spread has even reached new post-sovereign-debt-crisis levels at 55 basis points. The revival of French political risk is due to the rising popularity of left-wing populist Jean-Luc Mélenchon. His surge in popularity is bad news for French bonds as the policy plans of

Mélenchon are perceived to be much less investor friendly than those of, for example, Fillon or Macron. In addition, it could increase the chances of a Le Pen victory in the second round, even though polls suggest he would win such a run-off. Although our base case still includes an eventual Macron victory in the second round, investors are pricing in the additional risk of a surprise win for Mélenchon or Le Pen. As the Presidential elections are turning out to be thrilling four horse race, we expect increased volatility and upward pressure on French spreads to continue to up to the first and potentially to the second round of the elections. In particular, if the second round would consist of a Le Pen-Mélenchon clash, this would be by far the least market friendly outcome.

In our base case scenario of a Macron victory, we expect the 10-year French-German spread to fall back and stabilise at around 50 basis points. In this base case scenario, we expect EUR/USD to rise to 1.10 by the end of this year. However, in the event of a Mélenchon or Le Pen second round victory, the spread is expected to be much higher. Especially in the case of a Le Pen second round victory, in which the future of the eurozone could be under threat, the spread could balloon back to sovereign debt crisis levels of around 225 basis points. In such a case, EUR/USD would break to levels well below parity and EUR/JPY could move towards 100. In the event of a Mélenchon victory, we expect that French sovereign bonds would be priced closer to those of Spain, given his radical plans and the sharp deterioration of the outlook for the French public finances. Although there would be a lot of uncertainty, Frexit does not seem to be a main focus of Mélenchon. In the event of a Mélenchon win, we would therefore expect the spread to increase to around 125 basis points over German 10-year sovereign bonds. In case of a Mélenchon victory, we also expect euro weakness. EUR/USD could drop towards parity and EUR/JPY to 110.

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