Focal Point

Macron's reforms start being implemented

August 30, 2017

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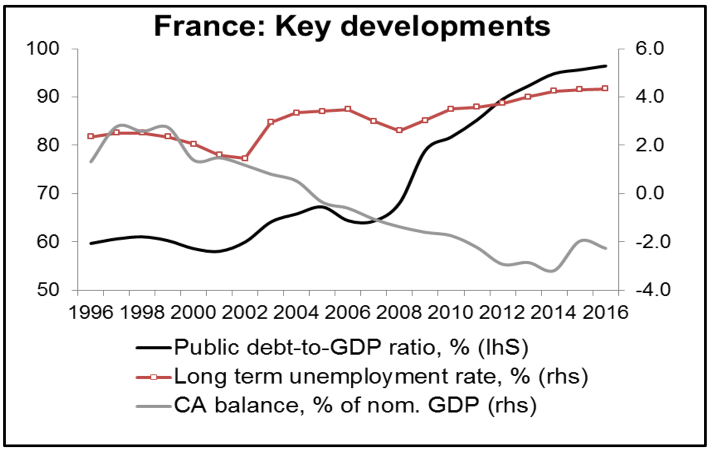
- Following a landslide victory in this year's parliamentary elections, the Macron government laid out its economic agenda aiming at higher growth via structural reforms and lower taxation while also envisaging expenditure cuts.
- Near term, the focus is on the labor code reform. Public resistance by means of protests and strikes have already been announced. Ultimately, however, we expect the French government to weather these protests.
- The implementation of the reform agenda will likely lift the French potential annual growth rate of currently 1¼ %.
- The reforms imply a less ambitious fiscal consolidation strategy than outlined in the latest Stability Program but the government announced that it will not allow the deficit to exceed the 3% threshold any longer.
- If implemented, the reforms will bode well for the rating outlook. Rating agencies see potential for a positive rating momentum upon implementation. Also, market confidence will be affected positively and French assets be supported.

Emmanuel Macron not only became French president but also secured an overwhelming absolute majority of his party in the June lower house elections. This enables him to go ahead with reforms more easily than former governments. Indeed, the country suffers from poor external competitiveness that leads to a rising long-term unemployment rate as a result of a rigid labor market, a heavy tax burden hindering investment activity, increasing public debt and a structural current account deficit. Growth remained subdued and was below EMU average over the past three years.

On July 4th, Macron's Prime Minister Philippe outlined the government's reform agenda. In what follows we take a closer look at it and assess its ability to tackle the economic challenges France is facing.

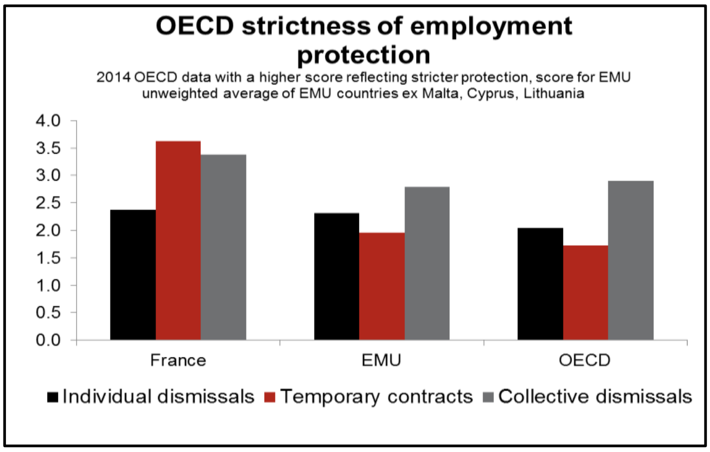


Near term: Labor code reform in focus

Labor market rigidity is at the heart of the economic problems in France. During his time as Minister of the Economy, Macron pushed through the so called 'Loi Macron' in August 2015 which focused on liberalizing the services sectors (transportation, notaries). Moreover, in 2016 the so called El Khomri Law (more flexibility regarding the 35h week, reinforcing the role of collective company-level agreements, clarification of the criteria justifying layoffs like business termination, reorganization of the company, operating losses etc.) introduced more labor market flexibility thereby supporting employment creation.

On Aug 1 the lower house and on Aug 2 the upper house adopted a bill allowing the government to fast-track changes in the labor code. Macron and his new government plan to pass a series of measures by executive order in late September. Details are to be unveiled on August 31 but it has already been announced that employers shall have more power to negotiate conditions with workers at the company level and that the compensation awarded by courts in case of dismissals shall be capped.

Indeed, the OECD's strictness of employment protection indicator shows that in France especially dismissals of temporary workers or collective dismissals are especially hard to engineer. This is a severe hurdle for hiring. The latest available OECD data are from 2014 and with the labor market reforms since then and the implementation of the current reform proposal, employment protection in France will likely come close to the OECD average.

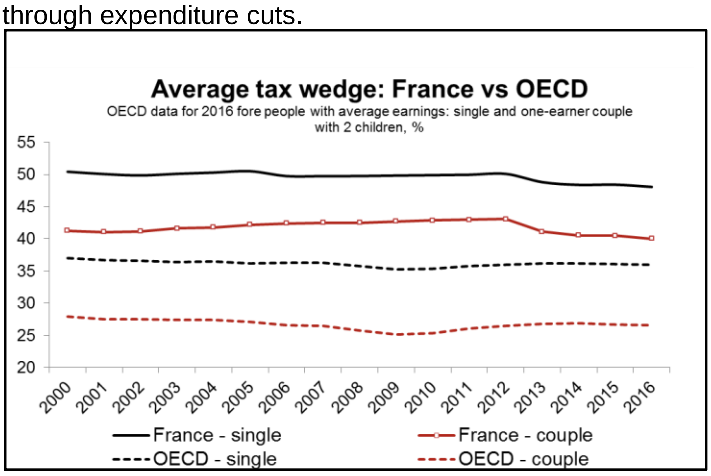


Government to weather stiff reform resistance

However, as the El Khomri Law, the new reform initiative will face stiff resistance from trade unions. The hard-left CGT already announced anti-government protests for September 12 and left-wing former presidential candidate Mélenchon called for a demonstration on September 23. The road towards reform implementation starts with the Constitutional Court allowing the proposals to be translated into law (week of Sep. 4th) and is scheduled to end in October with the ratification of the bill in parliament (Assemblèe Nationale). While some adjustment of the initial reform proposal cannot be excluded, we ultimately expect the government to push though these reforms: First, Macron had laid out the main lines of reforms already before the elections so that they have explicit democratic legitimacy. Second, after years of stagnation, the general need for reforms is acknowledged as surveys show. Third, reforms need time to unfold and the potential negative short term effects from structural reforms are dampened by the ongoing recovery. Fourth, by frontloading reforms and letting his popularity coming down (which now is even lower than Hollande's after four months in office) Macron might be able to reap the full political benefits and to avoid a Front National victory in the 2022 presidential elections.

Further reforms to lift French potential growth

Indeed, in his general policy statement before the National Assembly, Prime Minister Philippe outlined the government's reform agenda (see box). This strategy primarily targets the supply side of the economy. The basic idea is to further reduce the costs of labor (e.g. by making the Crédit d'impôt pour la compétitivité et l'emploi (CICE) tax credit permanent), support firms by means of lower corporate tax rates and to consolidate public finances mainly through expenditure cuts.



Empirically, the past (but not permanent) reduction of the CICE has had a positive effect on employment and profit margins. According to a study cited by the European Commission (1), the new definition of economic dismissals by the El Khomri Law will increase employment by 200k in the long term. Hence, the structural unemployment rate (NAIRU) which the European Commission currently sees at 9.4% will come down. There is also evidence that the reduction of the corporate tax rate significantly increases the investment-to-GDP ratio (2). Accordingly, the envisaged reduction of the corporate tax rate by 8 pps would lift investment spending by around 1.6 % or € 36 bn in terms of 2016 nominal GDP. Moreover, activity over the coming years will also be supported by the stimulating effect of the € 50 bn of investment spending and by its potentially positive effect on productivity. According to estimates (EC, OECD, Oxford Economics) French potential growth currently is around 1¼ %. The proposed reforms will, if implemented, lift potential growth. The French government sees potential growth rising from 1.25% as of now to 1.35% by 2022. Qualitatively, this view is also backed by various studies simulating the effects of supply side reforms.

Macron's economic key reforms

Source: Edouard Philippe, General policy statement, July 5

French social model:

- Strengthening of social dialogue at firm and sector level
- Scrapping employees' contribution to health and unemployment insurance, financed by an increase in the general social welfare contribution (CSG) on all households
- Strengthening vocational training and apprenticeship

Economy:

- Making the tax credit for companies (CICE) permanent from Jan 2019
- Gradually reducing the corporate tax rate from currently 33.3% to 25% by 2022
- Scrapping the self-employed workers' health insurance scheme (RSI) and merge it with the general one
- Narrowing the scope of the solidarity tax on wealth (ISF) around a housing wealth limit by 2019
- A single levy rate of around 30% on savings income, to round off the wealth tax reform
- Investment plan of € 50 bn (energy transition, digital revolution, forge a powerful industrial network of SMEs/ mid caps)

Public finances:

- Bring public deficit below 3% in 2017
- Over the next five years tax burden to be reduced by 1 pp of GDP and public expenditures cut by 3 pp of GDP
- Restoring balance to the social security system by 2020 and make it easier and fairer

Public finances to improve only slowly

The French consolidation strategy is built on expenditure cuts and higher growth engineered via structural reforms and less taxation. Growth is clearly prioritized against fiscal consolidation. The strong reliance on growth makes consolidation especially vulnerable to the business cycle situation. The growth assumptions for 2017 of 1.6% (GI: 1.7%) and 2018 of 1.8% (1.6%) are not unrealistic. Whether a growth rate of 1.7% can be maintained depends in our view on whether the supportive international and monetary policy environment will last and how fast the growth-enhancing effects of the reforms will kick in.

Although the expected 2017 growth rate is above the 1.5% stated in the latest Stability Program (SP), the public spending watchdog (Court de Comptes) detected a shortfall in the budget of around € 9 bn with respect to the 2.8% deficit target for 2017. The government announced that it will not let the deficit slip beyond the 3% threshold and already announced additional savings. We deem this credible because the French government wants to communicate to its European partners that France complies with the European rules thereby putting it also in a better position to ask for EMU reforms further down the road.

Looking ahead, the consolidation path is generally less eager than the one outlined in the 2017 SP that was still made by the former government. Likewise, the projected debt-to-GDP ratio is higher than in the SP and is expected to start declining only from 2020 onwards (against 2018 in the SP). Taking the dealing with this year's deficit as a blueprint, we think that the government will want to ensure that the 3% threshold is not exceeded but otherwise let the actual outcome breath according to the macro situation.

France: Medium term public finance projections

source: Minitsry of Finance, Rapport préparatoire au débat d'orientation des finances publiques, July 2017

	2017	2018	2019	2020	2021	2022
Budget balance (% of nom. GDP)	-3.0	-2.7	-2.9	-1.5	-0.9	-0.5
Structural balance (% of pot. GDP)	-2.2	-2.2	-1.8	-1.5	-1.2	-1.1
Public expenditures (% of nom. GDP)	54.7	53.8	53.1	52.2	51.7	51.3
Taxes and social security contributions (% of nom. GDP)	44.6	44	43.1	43.3	43.5	43.5
Public debt (% of nom. GDP)	97	97	97 1/2	96 1/2	94 1/2	92
GDP growth (% yoy)	1.6	1.8	1.7	1.7	1.7	1.8
Potential growth (% yoy)	1.25	1.25	1.25	1.25	1.3	1.35

Conclusions

Macron puts the focus on growth enhancing measures that will lift potential growth over the coming years. The structural reforms will be facilitated by a less ambitious consolidation path. In this respect the agenda of Macron resembles previous approaches. But a key contrast to previous reform approaches is that a focus is put on at the heart of the labor market problems by aiming at decentralized bargaining and reducing the costs for dismissals. Still, more could be done. For instance, the tax wedge has come down over the last years but will even after the planed reforms still stay strongly above the OECD average.

Near term, the major risk is massive resistance against implementation but it is likely to be more contained than in the past given Macron's strong commitment also before he came into office. The projected improvement of the public finances outlook is not out of reach but in our view also rests on the assumption of a supportive global environment. However, by sticking to the budget objectives, the government also risks to dampen growth that it intends to stimulate. For instance, the French Ministry of Finance announced recently that the scrapping of the employees' contribution to health and unemployment insurance scheduled for the January 2018 will come in two steps whereas the increase in the general social tax will not be delayed.

All in, as France is now digging deeper into labor market reforms, we think that this will lay the ground for higher future growth. S&P (current rating AA), Moody's (current rating Aa2) and Fitch (current rating AA) have confirmed their ratings of France and maintained a stable outlook. The later two have, when recentling confirming the French rating, announced that they see leeway for a positive credit rating momentum to the extent that reform implementation will seed up growth. This would also positively affect our internal rating.

Much of the improved outlook on France is already priced in at the sovereign bond market which has moved from Frexit concerns to Macron excitement after the elections. For instance, the OAT-Bund spread receded sharply from a peak of 79 bps to currently 30 bps which is well below the long term average of slightly above 40 bps. Near term, a bad result of Macron's party in the September 24 Senate elections and widespread protests related to the reforms could weigh on French assets. The passing of the labor market reform against strong expected public resistance in autumn will be seen as a litmus test by markets but in the end will in our view continue to back French assets. Moreover, with France credibly embarking on a reform path, we expect further support to market confidence and see French assets generally better underpinned than in the past.

References:

(1) European Commission: Country Report France 2017
(2) Djankov et al. (2010): The Effect of Corporate Taxes on Investment and Entrepreneurship. American Economic Journal: Macroeconomics 2, 31-64.

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