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France: the reform momentum stays alive after the Yellow Vest crisis

Research & Macro Strategy

France: the reform momentum stays alive after the Yellow Vest crisis

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The essential

- During the first 18 months of his presidential term, Emmanuel Macron has put through a highly ambitious set of reforms inspired by supply-side economics and the Nordic flexicurity model.
- While the biggest accomplishments have been in taxation and the job market, the goods and services markets and social benefits programmes have also been addressed.
- Macron's policies have been praised by business-friendly international organisations, with some of them ranking France as the developed country that had conducted the most long-term pro-growth reforms in recent years, in clear contrast with its major neighbours.
- Public accounts also continued to improve gradually.
- But then, the yellow-jacket crisis forced the government to deviate from its initial stance and to enact demand-side measures and less aggressive fiscal consolidation.
- Even so, supply-side momentum is still well under way, with, here again, major accomplishments carried out or planned in 2019 and beyond.
- Despite the yellow-jacket crisis and the mixed political outcome of the European elections, the balance of political power remains favourable to continuing the reforms.
- The main test will be a major pension reform, which is now planned for Q1 2020.
- However, the government's fiscal targets are now probably overly ambitious.
- In the short term, the main risk is more from a resurgence in social unrest than from the mainstream political opposition, which has been weakened into insignificance.
- The cumulative impact of reforms will be positive and will show up in potential growth and structural unemployment, which will improve the French economy's relative position compared to its neighbours' economies.
- However, this macroeconomic improvement alone may not be enough in responding to the widespread discontent caused by the structural transformations of the economy in France as in other developed economies.

“The biggest accomplishments have been in taxation and the job market,”

During the first 18 months of his presidential term of office, Emmanuel Macron has put through a highly ambitious set of reforms inspired by supply-side economics and Nordic flexicurity, while facing little opposition.

- **In 2017 and 2018, Emmanuel Macron implemented several economic reforms that are generally in accordance with the recommendations of organisations such as the OECD and the European Commission.** These reforms seem to adhere to both supply-side economics and the Nordic flexicurity model, i.e., seeking to create a pro-business environment focused on innovation, competition and new market entrants, less

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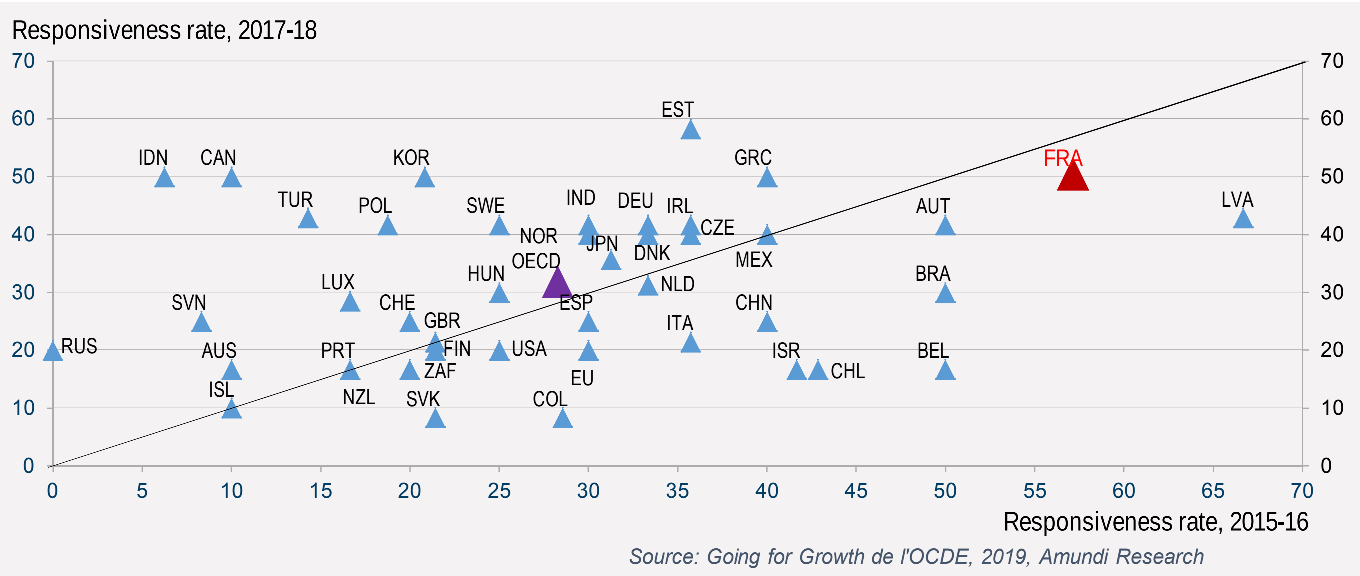
protection for entrenched incumbents on the job, goods and services markets, a focus on mobility and training, and reforms of some major social welfare programmes to simplify them and improve their governance, in some cases by centralising them, rather than by downsize them drastically. There has been little resistance to these reforms, owing to the weakness of traditional political parties, humbled by their severe election defeat of 2017, and wide divergences in viewpoints between trade unions.

- The main stages of this policy have been:
  - # **Tax reform**, with some of the burden shifted away from companies and employees and towards wealthy retirees, tobacco and fuel;
  - # **Reforms of the job market, apprenticeships and professional training** to introduce more flexibility and, in some cases, to reduce trade-unions' role in professional negotiations and the financial administration of social welfare systems;
  - # **A reform of French railways** (SNCF) including the end of a special professional status for future railway workers;
  - # **Measures in favour of education,** particularly in underprivileged neighbourhoods;
  - # **An increase in certain minimum entitlements (for the handicapped and elderly);**
  - # **Various measures to ease regulatory constraints holding back supply** on the markets for products and services (including the very large real-estate and medical services markets);
  - # The launch of a five-year €57bn (about 2.5% of GDP) investment plan.
- **These measures have been praised by international organisations:** in its April 2019 report on France, the OECD estimated the **positive impact on GDP at 3.2% after 10 years** just from the reforms already enacted in taxation, the job market and administrative streamlining. The OECD also ranked France in its *Going for Growth 2018* report as **the major developed country that enacted the most long-term pro-growth reforms in 2017 and 2018** (tied with Canada). France had already been ranked first in 2015-2016 (the second half of François Hollande's term had also featured major supply-side reforms).

> "France's measures have been praised by international organisations."

1/ **Responsiveness to *Going for Growth* recommendations**



Source: Going for Growth de l'OCDE, 2019, Amundi Research

- **Moreover, public accounts continued to improve early in Macron's term**, with a deficit equivalent to 2.5% of GDP in 2018 (down from 2.8% in 2017), achieved through a slight reduction in the weight of public expenditure and an even more moderate cut in the weight of mandatory levies. The structural deficit also improved to -2.3% of GDP (down from -2.4% in 2017).

But, in retrospect, that was the easy part. In November 2018 the sudden outbreak of the yellow-jacket crisis ultimately forced the government into significant concessions, including more demand-side policies and less aggressive fiscal consolidation.

- **In all, more than €15bn (or 0.7% of GDP) in fiscal measures were announced** between December 2018 and April 2019, including the cancellation of planned petrol tax hikes, tax cuts or the cancellation of tax hikes for medium income households, cost-of-living adjustments to some pensions, tax exemptions for overtime work and some bonuses, and an increase in tax credits for low-income workers. **One impact of these decisions will be to raise the French public deficit temporarily above 3% of GDP in 2019** (keeping in mind that a temporary hike in the deficit to 2.9% in 2019 was already planned prior to the yellow-jacket crisis, due to the one-time overlap this year of a corporate tax credit and cuts in payroll tax that will replace it from here on out). These measures will be partly funded by postponement of planned corporate tax cuts and caps on some tax shelters.

> "The outbreak of the yellow-jacket crisis ultimately forced the government into significant concessions."

- **The government also attempted to reassure rural areas and give its policies a less elitist image** through other targeted promises, including a pledge not to close any schools or hospitals during the rest of the presidential term of office and the closing of the Ecole Nationale d'Administration, which is often regarded as a symbol of the training of senior civil servants who are cut off from the daily lives of ordinary people.
- **These concessions raised fears that reform momentum would come to a halt. Likewise, with its spectacular and heavy foreign media coverage, the yellow-jacket crisis dented the international credibility of the French president, who had championed the strengthening of European institutions**. On the European front, Macron's results were, in any case, only mixed. True, France was able to achieve significant headway in establishing a budget for the eurozone (albeit one that was restricted to investment missions and support for convergence, and not economic stabilisation). However, northern Europeans continued to look askance at Macron's initiatives, wary that they could go too far in terms of risk-sharing. This was especially the case of Angela Merkel's successor as head of the CDU, Annagret Kramp-Karrenbauer. At the same time, Italian leaders, whose "anti-system" government is in many ways the polar opposite of Macron's, tried to exploit the French government's domestic issues for political gain.

Key macroeconomic figures, comparison

	France	Germany	Euro area
Real GDP Growth, %, EC forecast for 2019	1.3	0.5	1.2
Real GDP Growth. 2015-2018 average ann. %	1.5	1.9	2.1
Unemployment rate, 2018, %	9.1	3.4	8.2
General gov. budget balance, 2018, % of GDP	-2.5	1.7	-0.5
General government debt, 2018, % of GDP	98.9	60.9	88.0
Current account, 2018, % of GDP	-0.7	7.4	3.0

Source: Eurostat, IMF

- **The yellow-jackets crisis faded during spring 2019, and Macron's popularity rose back** (to 30% in June 2019, i.e., what it had been prior to the yellow-jacket crisis, during which it had fallen as low as 18%). And while his party garnered only 22.4% of the votes in the **May 2019 European elections** – the first major electoral test since 2017 – i.e., a little less than the first round of the presidential election and less than the Rassemblement National party – the outcome was nonetheless greeted with relief, given the scores that had been feared a few months before.

Despite a political and social environment that is now clearly less favourable than early in Macron's presidential term, with the current lull not dispelling the risk of a resurgence in social unrest, the government is determined to continue its supply-side reforms.

- **Three major projects have already made headway since the yellow-jacket crisis or are expected to be finalised by early 2020:**
  - **A reform of the civil administration**, which was approved in late May by the National Assembly. The reform aims to make civil servants' careers less unidirectional, to lessen the power exerted over them by the trade-unions, and to diversify hiring in public administrations.
  - **A new stage in the reform of unemployment benefits**, the principles of which were announced in mid-June. It aims in particular to reduce the practice of switching back and forth between short-term contracts and payment of unemployment benefits. This is a costly practice and often considered an important cause of the high level of structural unemployment in France. A reduction in benefits paid to high wage-earners, which are among the world's most generous, is also planned.
  - **Most important, a very ambitious pension reform**, the probable principles of which have been announced in July, is scheduled for Parliamentary approval in H1 2020. It aims to merge the 40-odd existing systems into a single set-up in 2025, and to use a points-based system to match contributions to benefits. This reform, which was initially presented as a structural transformation that would be fiscally neutral in the short term, will nonetheless be accompanied by incentives to extend the effective age of retirement.

"The government is determined to continue its supply-side reforms."

- **There is less visibility on plans for the last years of Macron's presidential term, but the government's action is expected to continue in at least three main directions:**
  - **New supply-side sector-based measures on the markets for goods and services** (with increased competition and support for innovation via the ongoing roll-out of the investment plan)**.**
  - **Additional headway on flexicurity** through the merger of several welfare entitlements into a single universal scheme.
  - **Greater fiscal consolidation via savings in public spending.** The structural deficit is expected to decline in limited fashion in 2019 and 2020 (from 2.3% to 2.2% of GDP in two years, due to the yellow-jacket concessions), but a new drive to lower it to 1.5% in 2022 is announced thereafter.

French fiscal metrics, official figures and forecast (in % of GDP)

	2017	2018	2019	2020	2021	2022
General government budget balance	-2.8	-2.5	-3.1	-2.1	-1.7	-1.3
Structural balance (% of pot. GDP)	-2.4	-2.3	-2.2	-2.2	-1.8	-1.5
General government outlays	55	54.4	53.8	53.2	52.7	52.1
Taxes	45.2	45	43.8	43.9	43.9	43.8
Public debt	98.4	98.4	98.9	98.9	98.3	97

Source: French Ministry of Finance, 2 July 2019

The most likely outcome is that at least some of these plans will become reality and that there is therefore still some momentum for reform in France, despite the risks involved and overly ambitious fiscal projections.

- **The current balance of power is still in the government's favour. While Macron did not expand his electoral base, the European elections did put the spotlight on him as the only credible defender of mainstream institutions against the "anti-system" right** while illustrating the extreme weakness of the major traditional parties. For, while the 2017 election had already seen the Socialist party fall below the 10% threshold of votes, the same thing happened, and for the first time, in European elections, this time to the Republicans (moderate right). Macron can therefore rather justifiably claim that nobody other than him is able to face down the Rassemblement National (which led, with 23.3% of the votes), whose arguments are still rejected by the majority of French people.

- **In addition to this legitimacy by default, the French president can count on his very large majority in Parliament**, which is still in place, as well as on the divisiveness among trade-unions and their inability, as demonstrated during the yellow-jacket crisis, to exploit popular discontent.

- **Pension reform early next year will be the main test on whether reforms will remain on track.** This is a significant risk the government is taking, given that surveys show that public opinion is less favourable than a few months ago (with 47% of negative opinions, according to an opinion survey in early July). However, there is no guarantee that reform opponents will manage to join their forces together, given how technical the issue is, and the fact that the vast majority of persons concerned are unable to understand how the reform will affect them. Moreover, some employee trade-unions are at least favourable to the structural aspect of the reform (albeit with some nuances), and it affects neither current retirees, nor persons planning to retire within five years.

- **As usual, reforms of the markets for products and services will run into opposition from entrenched incumbents in the professions concerned, but a determined government could still push them through.** Moreover, resistance could have fewer political relays than in the past, due mainly to the weakening of the traditional right, which has historically defended the interests of a number of self-employed professions, some of whom are often regarded by international organisations as excessively shielded from competition by regulations.

- **However, it is not at all certain that the government will be able to energetically purse the reduction in the structural deficit.** The fear of stoking new social unrest, the electoral agenda (with municipal elections in spring 2020, followed by the 2022 presidential campaign), and the determination to save the reforms are likely to compromise the targeted savings in public spending. Moreover, while it is true that because of its smaller manufacturing sector, France is being hit less directly by international trade tensions than Germany or Italy, the 1.4% growth forecast on which the government has based its assumptions could very soon look a little over-optimistic in the event of a bump in the road in growth for the entire euro zone. On the other hand, the extremely low interest rates will provide public finances with a bigger reprieve than expected*.

- **Lastly, visibility remains low on France's ability to rally its partners around new European initiatives,** given that Germany, which will be busy managing its own political transition, may be hesitant to line up behind it. Moreover, keep in mind that the rise of China, a major event in international relations, while a potential rallying point, may also make European coordination even more of a challenge. The reason for this is that the stakes and risks involved may raise special issues for France, which is geopolitically heavily exposed in Africa, the Indian Ocean, and the Pacific, a situation that the other eurozone countries share little or not at all.

"Pension reform early next year will be the main test on whether reforms will remain on track."

"In the short term, the main risk remains a resurgence in social unrest, especially with the pension reform in perspective."

** The average interest rate on French public debt has fallen from 4.4% in 2008 to 1.9% at the end of 2018, which has enabled the government to make very significant savings over the past ten years. With the average interest rate on debt falling below the level of nominal GDP growth, it is easier to stabilise public debt, even in the presence of a primary deficit.*

- **However, in the short term, especially with the pension reform in perspective, the main risk remains a resurgence in social unrest and a repetition of the events of late 2018 and early 2019.** Remember also that the 2020 municipal elections (and their prolongation in the Senate) could be an opportunity for Macron's party to gain ground in offices where it is still mostly absent, but this could well be a double-edged sword if some segments of the population had the feeling that too much power was being concentrated.

OECD estimate of the impact of some of the 2017-18 reforms in France on GDP per capita after 10 years

	GDP per capita	Through employment	Through productivity
2017-18 Labour market reforms			
Higher targeted spending on lifelong training	0.6	0.4	0.1
Lower administrative extension of branch-level agreements	0.7	0.7	0
Reduced uncertainty around dismissal costs	0.3	0.2	0.1
Tax measures			
Reduced tax wedge	0.2	0.2	0
Reduction of capital taxation	0.8	0	0.8
Steady increase in in-work benefits	0.5	0.5	0
Product market and simplification measures	0.4	0.2	0.2
Total	3.2	2.1	1.1

Source: OECD report on France. April 2019

International organizations' assessment of the structural challenges of the French economy

French structural economic problems have been long analysed by "market-friendly" international organizations, which generally share similar conclusions.

The IMF, in the concluding statement of its *Article IV* annual review, identified a number of "long-standing" challenges. It stressed that France retained a high level of public debt and the highest level of public spending relative to GDP in Europe. From a social standpoint, while acknowledging that aggregate inequality and poverty outcomes are better in France than in peer economies, it mentioned the elevated structural unemployment, especially for vulnerable groups, the sluggish living standards and the persistence of inequality of opportunity. It also noted the rise of private debt* in recent years.

In a similar way, in its 2019 *Economic Survey* of France, the OECD stressed the high level of public spending, the particularly high unemployment rate for some segments for low-skills, young and older workers, the rigidities of the labour, product and services markets and the inability of the current taxation system to provide adequate incentives to foster greener growth.

** According to the Bank of International Settlements' figures, French households debt increased from 49% to 59% of GDP from the end of 2008 to that of 2018. French non-financial corporate debt increased from 117% to 139% of GDP over the same period. These trends are very different from those of other large Eurozone economies (Germany, Italy and Spain) where households and corporate debt decreased, relatively to GDP, in the last 10 years (except Italian households debt, which remained roughly stable). Thus, unlike in comparable economies, French economic growth could be partly explained by a rise in private sector debt.*

Despite all the foot-dragging and dangers, we believe that momentum in favour of structural reforms in France, which has thus far been strong, is not yet exhausted. The results of these reforms, in terms of potential growth and a declining structural jobless rate, should show up within a few years (some

of the effects of reforms carried out in the second half of François Hollande's term are already visible today). In fact, the final outcome could be even better than the aforementioned OECD estimates, which do not reflect all the reforms.

From this point of view, France stands out against its large neighbours, where the political environment are not currently conducive to supply-side reforms. We therefore expect, at least, an improvement in France's economic performances relative to the rest of the euro zone during the coming years.

However, it would be jumping the gun to say that a mere macroeconomic improvement, if it indeed happens and even if it is significant in scope, will be enough to soothe once and for all the discontent that recently broke out in spectacular fashion in France, that is to be found in various forms in many developed economies, and that is generally put down to structural shifts in the job market and social disruption from globalisation and technological trends. Indeed, a few more percentage points of growth or a few less percentage points of unemployment brought about by the current reforms, which are straight from the "toolbox" of organisations like the OECD or the European Commission, may utterly fail to calm the hostility of a portion of the population to the ruling institutions. Keep in mind that while no one possesses a cure-all for social unrest, the yellow-jacket crisis showed in France that population discontent had a strong territorial dimension (large cities' capturing of most of the positive impacts of globalisation, to the detriment of the rest of France). Healing these divides will probably require, at the very least, pro-active supply shocks in housing, infrastructure, and land-use planning that are more ambitious than those currently planned.

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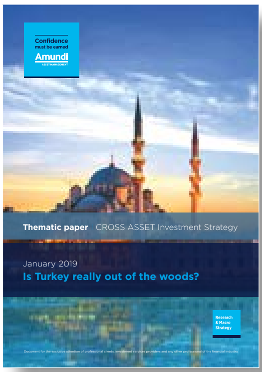

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