European macro outlook: France

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A pro-growth and pro-EU reform agenda is a window of opportunity to reinvigorate economic momentum

Macron's labour market reforms appear difficult to enact in the face of historic stiff opposition from labour unions. But unlike his predecessor Francois Hollande, who ran on a socialist agenda, Macron is different in that as an "independent" he can be more confrontational with labour unions and force them to negotiate. The clear pro-business mandate laid out in his reform agenda during his campaign should make it politically easier for Macron to extract more concessions from labour unions than Hollande ever could. Ruling by decree also means he could bypass parliament seeking amendments to bills.

More flexible working hours and pay to boost employment and productivity will be demanded, as well as empowering individual companies and businesses to set their own wages by cutting loose collective wage bargaining at the sectoral level in which they operate. Simplifying France's labour laws is also part of the plan. These must be pushed through quickly to keep Macron's momentum alive. Failure to do so risks insufficiently reviving the labour market in time for the new government to appear credible enough to win the next election, both from within his broad left-centre coalition and from outside when faced with labour unions and the electorate. Macron's strategy to reform the labour market has a realistic chance of succeeding because it is pragmatic: in making pro-business laws sellable to his electorate and centre-left party allies, it will—for now, at least—not touch the welfare state and social programmes.

The budget reform plan which entails investment stimulus of at least EUR 50 billion into infrastructure projects and new industries (funded primarily from government savings of EUR 60 billion over the next five years) is—while balanced and a nod to the EU for respecting the 3% deficit rule—unlikely to deliver the extra GDP boost needed. Unless the labour market laws are loosened successfully for boosting private sector jobs, cutting the civil workforce by 120K through attrition will blunt the fiscal stimulus. The bigger trigger is the proposed corporate tax cuts (bringing it down to 25% from 33%), which should attract more business investments from domestic and foreign investors.

Macron's budget plan will however set a precedent for more constructive talks with the EU on reinvigorating growth through more investments. If deficit spending limits cannot deliver the fiscal stimulus needed to fund large scale investments, a major scaling up of Europe's investment plan—set up in 2015—could. This plan has so far collected EUR 21 billion of guarantees from mainly the EU budget to potentially raise EUR 209 billion of private sector funding committed to large scale infrastructure projects and investment needs of SMEs all over the EU.

For France, as for all large EU members, the EFSI is simply too small to deliver meaningful stimulus at home. But a debt-financing scheme where all EU member are guarantors—such as through a Eurobond programme[1]—could significantly raise more funds to achieve the desired fiscal stimulus. Fiscal hawks such as Germany, The Netherlands, Austria and Finland will require convincing that sharing the debt burden makes sense and that France is not merely free riding the benefit of paying lower interest rates than if it were to issue its own Treasury Bond. But unlike ongoing government debt issuances that for the most part service and refinance existing debt, such Eurobonds could potentially be limited in issue size and be securitised, for instance through explicit backing with future cash flows from the very projects they finance.

Like Italy, France is not religiously beholden to fiscal restraint as Germany is. And with the UK no longer part of the EU, where as a member it has always taken a neutral stance to Germany's and France's often diverging views, the influential counterweight to Germany's EU interests will undoubtedly now become France. Hence, Macron, who is enjoying significant legislative powers and on a platform of reform and change, will have an opportunity to muster support from austerity-worn Italy (and potentially Spain) to promote investment-led growth. Italy and Spain need it more than France, given their vulnerability to Euroscepticism from mainly disillusioned youth with no immediate economic prospects. For instance, in Spain and Italy, the unemployment rate for under 25 year olds is (while trending down) 39% and 37%, respectively. And while on the face of it, for France it appears less of a concern with a markedly lower youth unemployment rate of 22%, the problem becomes equally pressing once France's high youth underemployment, at 8% and not far below Spain's, at 9.4%, is taken into account.

Assuming the rate of decline in youth unemployment is to continue at a similar pace since its peak, it suggests that Italy and Spain will require at least another four years to get employment conditions back to pre-crisis levels. The point is that the still high levels of youth unemployment and underemployment means the EU must act quickly to embrace the plan of more fiscal union, or risk suffering lasting political damage to the European project the next time the Dutch, French, and Italians go to the polls.

Ahead of the Italian elections, the outlook for European risk assets is bullish. We favour Eurozone equities with strong balance sheets and a bias towards IT, consumer and industrial sectors, along with small-caps to potentially position tactically around France's pro-growth pro-EU reform agenda. If the Italian elections foster continued stability in the government and don't cut short investor confidence, the quality-growth and small-cap style bets may also be considered strategically. Within Europe's equity markets, we see Italian banks as having one of the best potential to perform strongly on the back of ongoing restructuring efforts. This should be a key driver for restoring financial performance and accompany a re-rating of many if not most of Italian banks' deeply discounted valuations.

Chart 1: Jobs growth crucial to containing Eurosceptiscism and populist rhetoric. But the window to considerably boost jobs to avert the next political backlash is narrow

Source: WisdomTree, Bloomberg.

Dotted lines are based on extrapolation of decline rates from peak to end of May 2017.

[1] That is, government bonds issued in Euros by Eurozone members jointly to loan out funds to individual governments and a plan Macron has quietly endorsed.

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