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TRAVEL NOTES
France: Raising The Red Flag For A Possible Victory By Le Pen in 2027

by

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Executive Summary

Economic Developments: The French Economy Remains Resilient

- Despite the uncertain situation caused by the war in Ukraine, the French economy keeps growing, albeit at a modest pace. Even though a contraction in Q4 is expected, the economy remains resilient and the IMF projects a 0.7% growth in 2023. Unemployment is at the lowest levels in decades and wage growth has picked up, but remained in check.
- Both headline and core inflation are rising considerably, but compared to other major economies, the surge in prices is rather limited. This must be attributed to the generous fiscal package aimed at cushioning the impact of the energy crisis (so-called "energy shield").

Political Developments: Macron Needs to Establish a Policy Legacy and Find a Successor

- In 2022, Macron managed to win the Presidential Elections by an extremely narrow margin but lost the majority in the Parliament. Le Pen's popularity continues to rise.
- With 2027 on the horizon, Macron needs to nurture his successor for the next presidential elections and to leave an unquestionable policy legacy in terms of structural reforms.
- Macron hesitates to implement the necessary reforms, as he fears losing popular support as a result of his controversial agenda. While earning the public approval with huge fiscal support, increased public spending might lead market instability if it were to be perceived as non-sustainable and/or inflationary in the medium term. Due to significant support measures, France's fiscal position is deteriorating, having been characterized by profligacy for a long time.

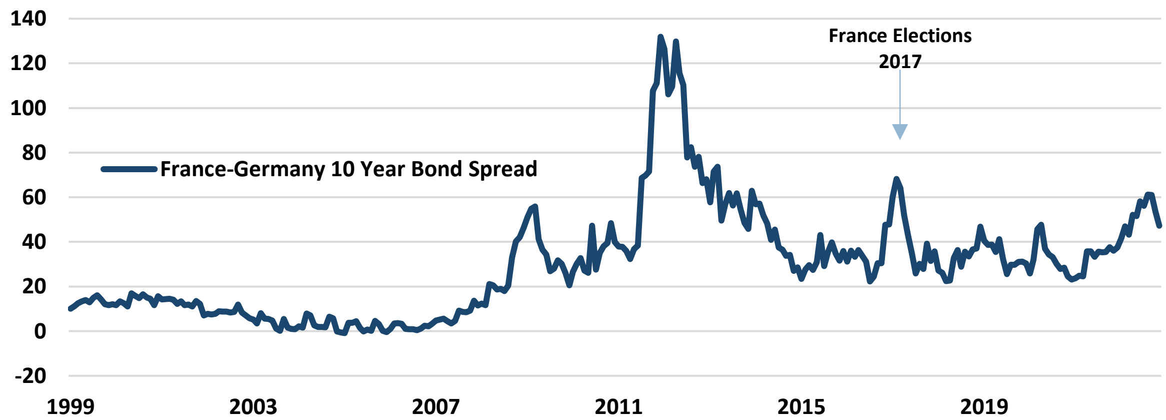
France's Resilience and Recovery Plan To Address Structural Deficiencies

- France's Recovery and Resilience Plan consists of 71 investments and 20 reforms divided into nine thematic components and 175 milestones and targets.
- France received EUR 39.4 bn in grants, of which 46% and 21% are allocated to support climate and digital transition objectives respectively and the rest is accounted for social and economic resilience.

Conclusion: France Is The Country To Watch In Europe

- As long as a lasting legacy is not established, Macron and his party might need to battle for survival. Without a strong successor his party might vanish or be torn between far-left and far-right in 2027.
- Unpopular reforms would lead to masses in the streets and/or a loss of popular support that may increase the chances that Le Pen wins the next presidential election. That may cause a destabilizing increase in the country's sovereign spread – by the middle of Macron's current term - that would force a fiscal austerity that would make Le Pen even more popular and trigger her eventual victory. On the other side, lack of reforms and loose fiscal policies may lead to Macron not having any policy legacy and the inability to anoint a viable and popular successor. That would also leave open the door for a Le Pen win. Given this background, we consider France the country to watch most closely in Europe, because Le Pen's victory in 2027 could destabilize the European integration process and change its course.

Key Picture: The French OAT-Germany Bund Yield Spread May Increase Again Ahead of the 2027 Elections



Source: Investing.com

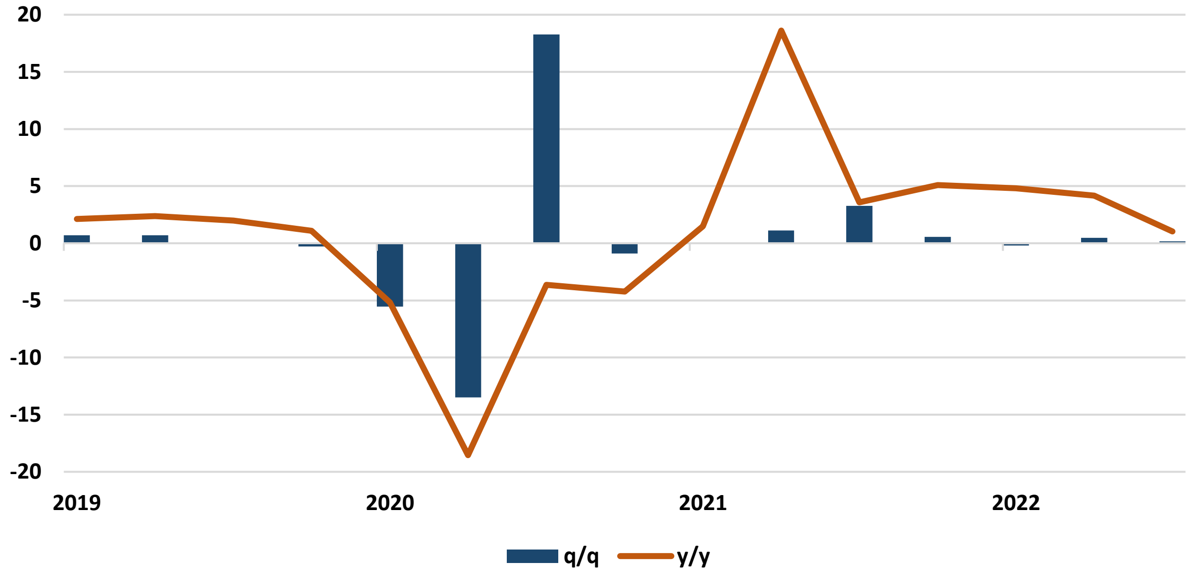
We recently visited France and had the chance to reconnect with our policy and academic contacts and had the chance to reassess economic activity, the latest presidential and parliamentary elections in 2022 and policy reforms. In this report we discuss the following issues: 1) macroeconomic developments; 2) political developments; and 3) France's Recovery and Resilience plan.

Macroeconomic Developments: The French Economy Remains Resilient

France's GDP increased by 0.2% q-o-q in Q3-2022 as expected, slowing from 0.5% growth in Q2 **(Figure 1)**. The second straight quarter of expansion was supported by domestic demand (+0.4 points) and robust fixed investment. Inventories also contributed to GDP growth by +0.3 points, whereas net trade contributed negatively this quarter (-0.5 points). Exports slowed down considerably, while net trade was a drag. Exports (*a:* +2.0%; *p:* 0.9%) increased more moderately than imports (*a:* +3.5%; *p:* 1.6%). Household consumption decreased slightly by 0.1%, marking a slowdown from 0.4% in Q2, whereas government spending rebounded (*a:* 0.2%; *p:* 0.0%). Furthermore, gross fixed capital formation accelerated by 1.7% (*p:* 0.5%), boosted by business investment in automobiles and computer services. On a yearly basis, the economy rose by 1.0% y-o-y (p: 4.2%), marking the weakest growth since the Covid pandemic started in 2020.

Despite an apparent slowdown and a possible contraction in Q4, the economy remains resilient. Indeed, according to the latest IMF WEO (October 2022), in 2023 France's real GDP is expected to advance by 0.7%, whereas GDP is expected to shrink in Germany and Italy. So, if a recession were to occur, it is now thought to be milder than expected only 6 months ago, and probably milder than in Germany and Italy, given France's greater diversification of energy inputs.

Figure 1: France's GDP Is Decelerating



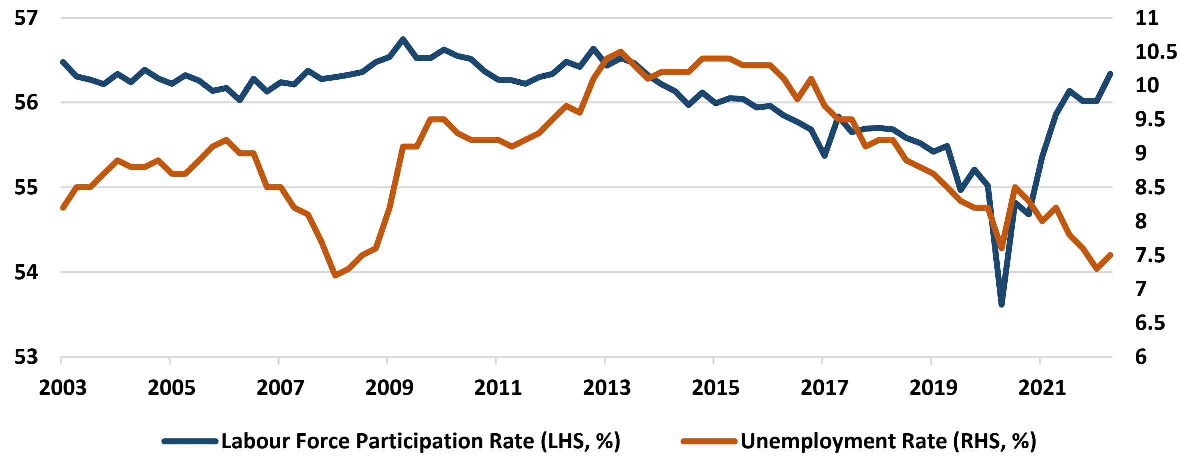
Source: OECD

When looking at business activity, the leading indicators continue to shrink. In November, S&P Global Composite PMI fell to 49.7 (p: 50.2), below the preliminary of 48.8, marking the first contraction in business activity since February 2021. The S&P Global Manufacturing PMI increased to 48.3 from 47.2, albeit being revised downward from an initial estimate of 49.1. The S&P Global Services PMI reading is also under 50, standing at 49.3 (c: 49.4; *p:* 51.7).

France's labour market has proved to be strong, and thus the government is introducing reforms to reduce unemployment benefits by at least 25%. Indeed, in Q3, the unemployment rate edged down to 7.3% (*p:* 7.4%, **Figure 2**), in line with consensus, as the number of unemployed decreased by 17k to 2.3mn. Meanwhile, the labour force participation rate rose to 68.3% from 68.0%, reaching the highest level. Youth unemployment rose to 18.3% (*p:* 18.0%).

Wage growth is under the radar screen in France like everywhere else, but so far its hasn't been cause for major concern. Importantly, after being hit by strikes, oil giant TotalEnergies convened a wage agreement, envisaging an overall "envelope" of 7% wage increase, including a 5% general rise plus a "variable bonus" addition to that may differ from person to person. Furthermore, Carmaker Stellantis offered workers a 5.3% wage hike. Regular wage compensation is around 3-4%, well below inflation; this trend perhaps indicates that the worst part for wage negotiations is behind and suggests that inflation may be peaking.

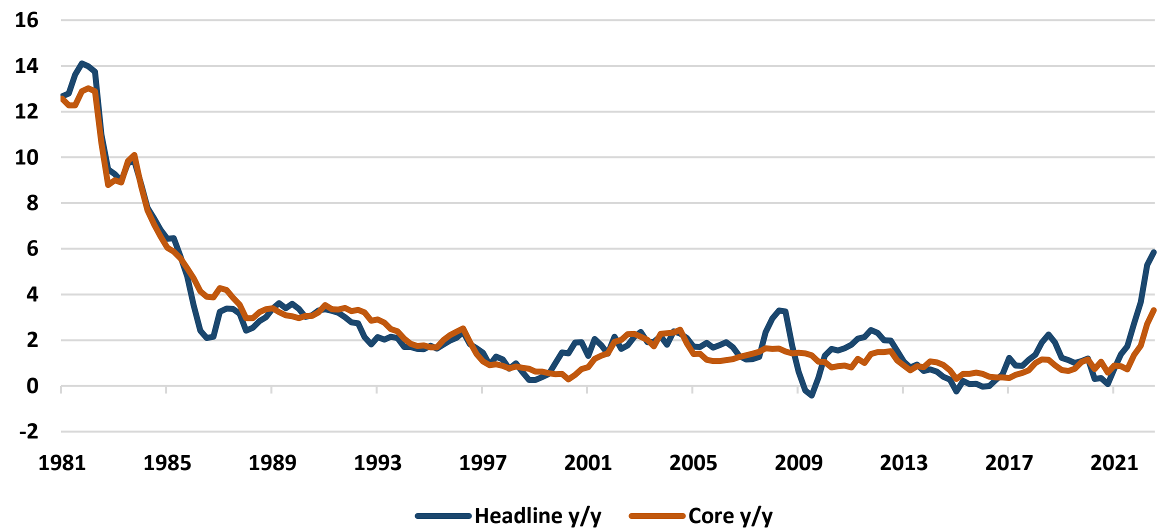
Figure 2: The French Labour Market Is Performing Relatively Well



Source: OECD

Turning to the red-hot theme of inflation, CPI annual inflation rate remained at 6.2% in November as expected, though marking the highest level since June 1985 **(Figure 3)**. Upward pressures came from: *i)* food (*a:* 12.2%; *p:* 12%); and *ii)* manufactured products (*a:* 4.4%; p: 4.2%), whereas the costs of: services (*a:* 3%; *p:* 3.1%) and energy (*a:* 18.5%; *p:* 19.1%) eased off. On a monthly basis, consumer prices inched up by 0.4% (*p:* 1.0%) in line with market consensus. Meanwhile, HICP remained unchanged at a record-high 7.1% y-o-y and fell 0.5% m-o-m (*c:* 0.4%; *p:* 1.2%).

Figure 3: Inflation Is Surging, But Stays Under Control



Source: OECD

While inflation is at the highest level since the 1980s, it is also around 1/3 lower than in the Eurozone as a whole. This is thanks to a very generous "energy-crisis protection scheme" that in France is commonly known as "energy shield" that has been given "*erga omnes*", so not as targeted as it should have been.

In fact, following a heated debate among the policy circles about the type of fiscal package, the consensus was reached on a generalized support, instead of targeted one. The main argument behind the decision was that it is more straightforward to remove general fiscal measures at the end of the program, rather than targeted ones. But we would object that, when fiscal support is provided to everybody, then public backlash could be stronger when it's removed.

The other argument was that the terms of trade shock, estimated to be around 3% of GDP, represented a 3% "transfer of wealth" from France to the "rest of the world" – in this case by energy-producing countries. Since this was a shock that hit the country as a whole (50% absorbed by the government), the entire country reportedly needed protection. Again, the reality is probably that France didn't have granular enough data to adopt more targeted mean-tested measures (helping mostly the poor and the part of the middle class – say rural citizens – that use private transportation more frequently). In practice the across the board fiscal support to all households and businesses was also a way to keep the popularity of Macron higher (as Le Pen might have ridden the tiger of higher energy costs) but at the cost of further fiscal policy deviance. Macron repeatedly appears to endanger fiscal rectitude to maintain a greater popularity and to contain the ascent of Le Pen's popularity.

More specifically, the "energy shield" was worth EUR 45bn. Measures implemented included a cap on rises in gas and electricity at 15% for 2023. France will also spend EUR 8.4bn to help companies pay their energy bills, in order to cushion the impact of surging electricity and gas prices and help them compete with German businesses. The French parliament also approved a bill for payment of an energy check of up to €200 for 12 million lowest-income households.

Having said this, due to successfully shielding the country from energy cost increases, as mentioned above France is keeping its inflation rate lower than its neighbors. In November 2022, France's CPI inflation rate was 6.2%, compared with 10% in Germany, 11.8% in Italy and 10.7% in the UK. Thus, at least in the short run the energy shields prevented a spike in the inflation rate that could have led to a de-anchoring of inflation expectations and a potential wage-price spiral. However, financing a permanent term of trade shock rather than adjusting to it lead to excessive over-heating of demand that may rekindle grater inflationary pressures down the line.

Political Developments: Raising A Red Flag For A Possible Victory By Marine Le Pen In 2027

On 10 and 24 April 2022, the French Presidential Elections were held. As no candidate won a majority in the first round, a runoff was held, in which Emmanuel Macron was re-elected to a second 5-year term with 58.5%, beating far-right candidate Marine Le Pen, leader of the National Rally (*Rassémblement National*, the re-incarnation of the Front National created by her father). The elections highlighted how divided France was, more than ever before. In addition to that, the results masked several worrying issues. Firstly, Le Pen's second-round vote total of 42% amounts to the best showing by the populist far-right in its history, as the support for her continues to rise steadily. And secondly, the two centre-right and centre-left mainstream parties, the Gaullists and Socialists, have imploded.

The French legislative elections were held on 12 and 19 June 2022. As a surprise result, Macron's list lost its absolute majority in the National Assembly and reportedly the President has not yet recovered from the shock of this major setback. Therefore, Macron has to seek a different majority for each law that will need to be passed by parliament. The other option is using article 49.3 of the Constitution, which allows the government to pass legislation by decree subject to a confidence vote. This is an extreme instrument that the government and the president sometimes use to get their agenda through parliament, but it's clearly an instrument that needs to be used selectively: controversial legislation – such as pension reform – passed by decree may lead to mass demonstrations against the government (as the rise in fuel prices led to the Gilet Jaunes movement) and it would to a fall in the popularity of Macron and his party while making Le Pen even more popular.

In 2027, Macron won't be allowed to run as President. Ahead of that election, he will need to create a legacy in terms of policies adopted (read: reforms) and nurture a successor that can take the helm of the party he created in 2017.

Regarding his successor, possible contenders include Finance Minister Bruno Le Maire, Interior Minister Gérald Darmanin, and former prime minister Edouard Philippe. Another potential contender could be the current Prime

Minister Élisabeth Borne, who is gaining her political space. Some consider Christine Lagarde as a potential future leader of centrist or center right moderate forces, either as a future leader of Macron party or a the leader of the now declining Gaullist or as a leader of center and moderate center right forces. Being a very qualified female and once with an incredible global policy pedigree – former MD of the IMF and currently President of the ECB – she could be the charismatic leader that centrist and moderate center right forces are looking for. But she is a "globalist" – having run major global institutions such as the IMF and the ECB – and that may not be appealing if Le Pen runs on a campaign against the globalists and the europhiles; Lagarde has also had her own share of legal issues – now resolved – and she is certainly not appearing a a woman of the masses in term of her policies and overall persona. So whether she could beat Le Pen – assuming she does win the nomination of centrist and moderate center right forces – is to be seen.

Regarding the policies to be adopted, Macron wants to leave a legacy of a true reformer. The first years of the first Macron's presidency have been characterized by a large and ambitious reform agenda, including the tax, labour market, university, and training reforms. Since his re-election he has introduced a proposal for a reform to reduce unemployment benefits and to increase the incentives for vocational training. Macron has further fostered the introduction of so-called "lycées professionnels." He also wants to reform the way public employment departments work, both at the centre and in the periphery.

During his latest electoral campaign in June 2022, Macron said he would reform the pension system, something he could not do during his first term in office. He was aiming to get an electoral support for the reform, but having failed to reach a majority in parliament leaves the question open of whether the French people really want this pension reform to be adopted. He is reportedly willing to try again to introduce the reform, which would harmonize the very diversified pension systems in the country and increase the pension age from the current 62 to at least 65. But the strategy is really risky, even if Macron could count on the parliamentary support of the Republicans. With variable majorities an electoral incident is always possible, and this could lead to a new election, in which Macron loses further seats.

The pension reform is a major political risk for Macron as it is highly unpopular. According to one survey 72% of French are opposed to it (with 81% of those close to retirement – aged 40 to 54 – opposed to it given the proposed increase in retirement age). Recently all key trade unions and youth groups have issued a statement against the reform and threatened a "mobilization" – ie mass demonstrations and strikes – against it like those that took place in the winter of 2019 when Macron first attempted a pension reform. Thus, the pension reform that was supposed to be announced last week has been postponed until January 10th, officially to allow more consultations on it and unofficially to prevent mass demonstrations during the holiday period.

Macron also appears to be avoiding unpopular domestic issues by being busy in non-stop foreign trips (most recently Egypt for COP27, Bangkok for APEC summit, Bali for G20 summit, US for a state visit, Qatar for the World Cup final) and foreign policies matters (the Russia - Ukraine war). At home there is a now potentially an energy crisis and the risk of electricity power cuts and blackouts that may affect up to 60% of the French population (in a worst-case scenario) right in the middle of a coming winter. Indeed, half of the French nuclear reactors are currently not working because of maintenance issues or corrosion problems. And it may take years – with new reactors – to resolve the power issues. Meanwhile France may be forced to import electricity from abroad at a time when all of Europe has energy supply constraint problems. This electricity crisis is likely to further dent the popularity of Macron, a president that has always been perceived as being a bit imperial and out of touch with the masses.

During his presidency, Macron has also faced Europe's two most of most multifaceted crises – the Covid Pandemic and the war in Ukraine. Trying to lift the country out of an economic squeeze, Macron keeps a highly accommodative fiscal policy and stepped up its fiscal support to cushion energy price shocks with gas and power price freezes, cash transfers and fuel price rebates. Indeed, in order to not upset the general public, Macron is willing to open the purse's strings; otherwise, dissatisfaction with the government policies would open the way for a victory of Marine Le Pen or another protest movement such as the Gilets Jaunes.

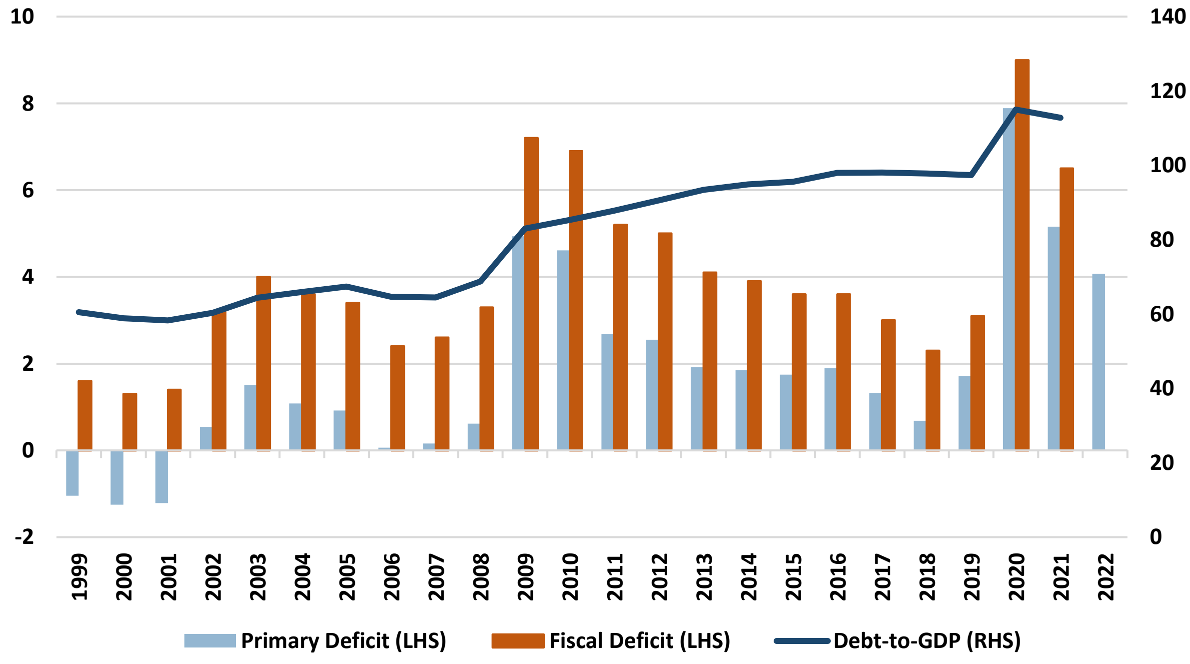
On the other hand, these measures come at a steep cost, as increased public spending leads to an increased public deficit. In an extreme case, the market could react negatively to the worrying picture of deficit spending. Especially, considering these measures, if market participants see inflationary pressures building up, the market might turn against Macron as it did in the UK against Truss and Kwarteng, when they presented an unrealistic fiscal plan. The paradox would be that while Macron adopts these policies in order to win France back and counter Le Pen's rising popularity, the market might turn against him and a widening of the French-German yield spread could be expected during his term **(**see **Key Picture)**.

Accordingly, the only way to regain credibility would be through introducing deficit cuts and austerity measures, which obviously would lead to protest movements. Ultimately, in such a turn of events, the general public would favor Le Pen over Macron at the next election. A similar dynamic that makes Le Pen more popular could occur if Macron passes very unpopular reforms – like a pension one – via article 49.3 or convincing the Republicans to vote for it; then mass demonstration could make him unpopular leading Le Pen to surge in the polls and leading the a similar widening of spreads that would force again an unpopular fiscal austerity that would lead to a surge in Le Pen's popularity.

France's Fiscal Position Is Becoming Less Reassuring

France has long been characterized by its fiscal profligacy. As mentioned above, to finance this generous fiscal support, the government increased its spending considerably, with the debt-to-GDP ratio reaching 115% and the deficit-to-GDP ratio rising to -9.0%. Although the debt ratio declined in 2021, it still remains at an elevated level. Despite praise for successfully mitigating the energy crisis, the IMF suggests that France should start to rein in finances next year. In effect, the primary deficit of France is even higher than that of Italy whole the debt-to-GDP ratios in the UK and Germany stand at much lower levels of 94% and 72% respectively.

Figure 5: France's Fiscal Position Is Worse Than Italy's (From a Primary Deficit Perspective)



Source: Eurostat. All figures are expressed as % of GDP.

France's Recovery and Resilience Plan To Address The Country's Structural Deficiencies

France's Recovery and Resilience Plan consists of 71 investments and 20 reforms divided into nine thematic components and 175 milestones and targets. In order to foster a strong recovery and make France future-ready, France was allocated EUR 39.4 bn in grants, of which 46% and 21% are allocated to support climate and digital transition objectives respectively and the rest is accounted for social and economic resilience **(Figure 5)**. These funds complement the 54bn euros of the national reform plan called "France 2030)." Some 13% of the grants (around EUR 5.1 bn) was disbursed to France in pre-financing on 19 August 2021. The reforms are aimed to tackle bottlenecks to sustainable growth, whereas investments are addressed to accelerate the transition towards a more sustainable, low-carbon and climate-resilient economy. Supporting the digital transformation of all economic actors including public authorities is a key objective in addition to making the economy more resilient due to investments in the health sector and skills.

Regarding the expected benefits of the Plan, most importantly, an increase between 0.6% and 1.0% in GDP by 2024 is projected. As reported, GDP could be 0.2 % higher after 20 years. The spill-over effects, for instance, increasing exports, are said to constitute 0.4 pp of the 1% GDP impact by 2024 and 157,000 additional jobs are expected to be created by 2026.

France is behind in the development of renewable energies as for decades its government thought that nuclear energy could “fix every problem,” but clearly this wasn’t the case. So, out of the resources allocated to the green transition, the largest funds account for building renovation (EUR 5.8 bn), sustainable transport (EUR 4.4 bn in the modernisation of the railway network) and R&D innovation in the field of low carbon hydrogen (EUR 1.9 bn).

In terms of digital transition, resources amounting to EUR 1.8 bn are designated to be invested in developing and deploying key digital technologies, such as cybersecurity, quantum and cloud. About EUR 385 ml is expected to be spent on supporting businesses in digital technologies. The largest amount of economic and resilience fund is aimed at fostering training and jobs for young people (EUR 4.6 bn) and investing in improving governance of hospitals, including e-health and medical centres and residential care homes (EUR 2.5 bn).

Figure 6: France’s Overall Recovery Plan

Measures	Total Amount (EUR bn)	% of the French Plan
Green Transition	**18**	**21%**
Developing and Deploying Key Digital Technologies		
Building Renovation		
Sustainable Transport		
Decarbonization of Industrial Processes		
R&D and Innovation		
Digital Transition	**8.4**	**46%**
Support to Businesses in Digital Technologies		
Digitalization of Primary and Secondary Schools		
Further Digitalization of Public Services		
Economic and Social Resilience	**13**	**33%**
Jobs and Training for Young People		
Inclusive education System		
The Reform of the Governance of Public Finances		
Apprenticeships		
Reinforcing the Resources of Public Employment Services		

Source: https://commission.europa.eu/business-economy-euro/economic-recovery/recovery-and-resilience-facility/frances-recovery-and-resilience-plan_en

Conclusion: France Is The Country To Watch

The French economy shows signs of resilience. Albeit inflation increased to record-high levels, it is still under control and relatively lower than in other major economies. Certain concerns have also been raised over the state of social cohesion in France, but overall the situation is stable. However, some risks are emerging.

As long as a lasting legacy is not created, Macron and his party might need to battle for survival. Without a strong candidate for the 2027 Presidential Elections (which has not emerged yet), Macron’s party Renaissance (RE) could risk vanishing. Effectively, Macron should strike a balance between implementing even controversial reforms (to create his own unquestionable legacy) and not upsetting too much the general population (not to lose face). In case he loses the balance, this might open the door for a victory by Marine Le Pen. In fact, the European Elections in 2024 would be a turning point, which tends to be an informal check on the popularity of the president. People would release all of their negative sentiments while knowing that there are no direct consequences on the government, only the signals. This is a realistic scenario, as Le Pen's party National Rally won most French votes in the EU election in 2019.

If Macron tries to approve the controversial reforms – such as the pension one - before the European Elections in 2024, he might effectively increase his chances of losing that election. If Macron decides not to carry on with his reforms before 2024 (or to dilute them to point that they are not meaningful f enough), it would be extremely complicated to regain popularity and create a legacy before 2027, with the limited time left. The fact that Le Pen is not far from reaching a majority of votes (she received 42% of the votes in 2022) compounds the problem, especially considering that the two centre-right and centre-left mainstream parties have been almost obliterated. Thus the election in 2027 is a possible contest between far-left (Melanchon's La France Insoumise) and far-right (Le Pen's National Rally) candidates rather than a contest between a moderate and a populist (of the right – most likely - or left). And our contacts in France consider a victory by Le Pen not only a risk scenario, but quite likely at this point.

In case Le Pen were to win the presidency she may or more likely not win a majority in the parliamentary elections. She isn't likely to win a parliamentary majority as her party popularity may be smaller than her personal one in a presidential contest. But a strong presidential win would boost the chances of a strong parliamentary showing. Even without a parliamentary majority the French political system is a presidential one where the president has significant executive powers. Certainly a president Le Pen would take a very antagonist attitude towards Europe, the EU and the Eurozone. Market discipline and a lack of parliamentary majority may partly constrain her behavior and policies but her positions and populist policies would imply a radical shift of French policies and of France's approach to Europe and European integration.

We thus consider France the country to watch most closely in Europe, because Le Pen has a real chance of winning, destabilizing the European integration process and changing its course. There is little probability that Le Pen could be France's Giorgia Meloni. This could not be the case, as besides being a moderate, Meloni is constrained in many ways; the views of Le Pen are much more radical and anti-European than those of Meloni. Especially as Germany is lacking in terms of leadership, Le Pen's presidency could affect the course of Europe's future. Given Macron's mandated departure in 2027, a leader who is young, energetic, and pro-European, the EU integration process is at huge risk.

Nato Balavadze contributed to this analysis