SPECIAL REPORT

TD Economics

April 18, 2017

POPULISM THREAT, ROUND 2: POTENTIAL ECONOMIC IMPLICATIONS OF THE FRENCH PRESIDENTIAL ELECTION

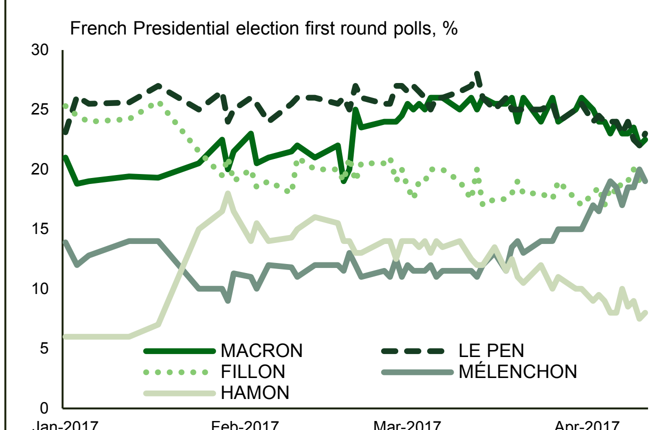
Highlights

- Recent polls suggest that populist French Presidential candidates, Marine Le Pen and Jean-Luc Mélenchon, are both in the running to win the first round of voting. However, polling for the second vote suggests that at least one of the two candidates, Le Pen, is unlikely to clinch the winner-take-all runoff election. Polls and betting odds appear to be on the same page for this election, unlike Brexit and the U.S. election last year.
- While a victory for one of the more centrist parties appears the most likely outcome, we cannot completely rule out a victory by a populist, anti-EU candidate. In this scenario, we would anticipate a period of elevated financial market volatility, likely accompanied by a small drag on economic activity resulting primarily from a reduction in business investment in France and possibly the broader Eurozone.
- It should be clear, however, that a populist victory does not imply an exit by France from the euro or the EU. Instead, it's just the first in a sequence of increasingly improbable events necessary to trigger a successful and legally binding referendum on the euro/EU. This may help to limit the extent of both the initial moves in financial markets and the drag on economic growth from elevated political and policy uncertainty.
- Much of the attraction of populist candidates has been driven by the slow economic recovery in France following the Great Recession of 2009. As such, the new French President will have an important role in advocating for policies to reduce unemployment, particularly amongst youth and immigrants, while looking at fiscal measures that help rein in the budget deficit.

With the French presidential election just days away, all eyes have turned toward the second national electoral contest in Europe this year between establishment, pro-EU parties and populist, anti-EU challengers. Polls currently suggest that there is very little chance of populist, anti-EU candidates such as Marine Le Pen, leader of the Front Nationale (FN) party, winning the French presidential election. However, there is still concern that we may witness yet another against-all-odds victory, on par with last year's UK referendum, or Donald J. Trump's Presidential win.

The good news is that the polls for the French Presidential election have historically been consistent in predicting the winner. That would imply that Emmanuel Macron (leader of En Marche! or EM), or Francois Fillon (leader of Les Republicains or LR) have the greatest chance of becoming the next President of France if they succeed in getting to the second round of voting.

CHART 1: MELENCHON'S MOMENTUM HAS RAISED FEARS OF AN ANTI-EU RUNOFF



Source: FT Research (https://ig.ft.com/sites/france-election/polls/). Last poll: April 14, 2017.

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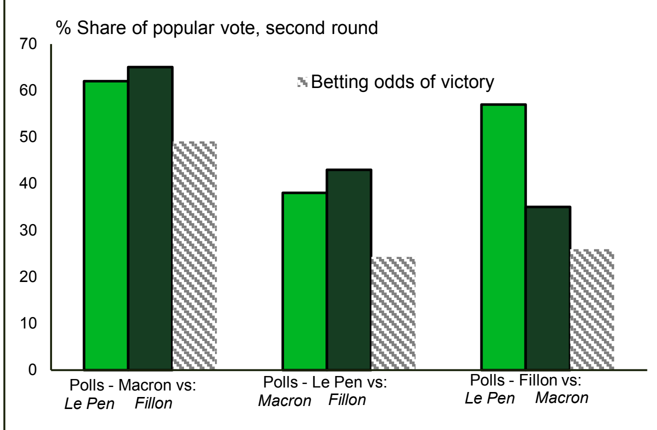
Support for the populist candidate platform appears to be largely driven by the poor performance of the French economy in recent years. Indeed, over the last few years the French economy has struggled to absorb those who were left unemployed from the Great Recession of 2009. Perhaps more importantly, the French economy has performed poorly in comparison to its peers on a number of other economic measures as well, including the integration of immigrants into French society.

A populist victory, however improbable, is likely to have near-term financial market and economic implications for France, with possible spillovers into other Eurozone countries. Logic dictates that market sentiment should reflect the sequence of improbable events necessary for an anti-EU President to hold a legally binding referendum on remaining part of the euro/EU. However, financial market participants have already begun to drive a larger wedge between French and German bond yields. This is a harbinger of what's to come should the first piece of the puzzle be set in place with a Le Pen first-round win that subsequently transpires into an unexpected Presidential win. At that stage, the most obvious casualty from the resulting period of elevated political and policy uncertainty would be business investment, which could be delayed until there's clarity on the new President's ability to form government. A clear risk is that financial markets would remain in a state of anxiety until there's confidence that the new government lacks the ability to push a referendum agenda on Eurozone and/or EU membership.

Polls have consistently identified French Presidents

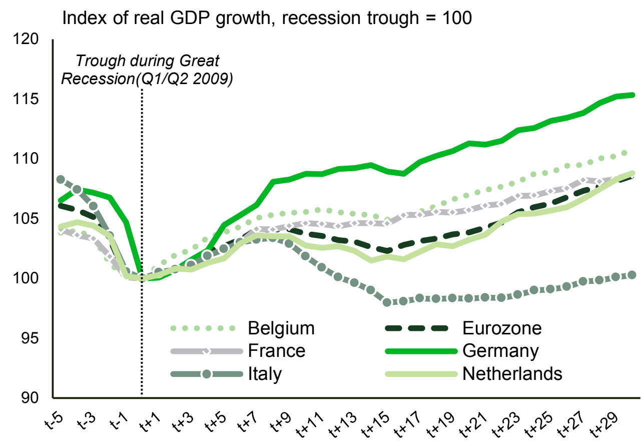
French voters are set to first go to the polls on April 23rd. Election polls currently show a close race between

CHART 2: POLLS AND BETTING ODDS BOTH PREDICTING A MACRON VICTORY



Source: Financial Times Research, oddsmaker.com. As at April 17, 2017.

CHART 3: FRANCE'S ECONOMIC RECOVERY HAS BEEN A BIT SLOWER THAN SOME OF ITS PEERS



Source: National statistical agencies via Haver Analytics. TD Economics.

four presidential candidates in the first round of elections: Emmanuel Macron (EM), Marine Le Pen (FN), Francois Fillon (LR), and a surging Jean-Luc Mélenchon (France Unbound/Rebellious France) – a socialist candidate running a platform similar to that of U.S. democratic party nominee Bernie Sanders (Chart 1). Since none of these candidates are likely to achieve the 50% required to win the Presidency, a second round of voting set for May 7th will be needed to determine the winner.

Historically, the polls for France have been relatively accurate in predicting the winner. Indeed, in the last five elections, the polls have done a good job in identifying the winning candidate. This is typical of all election polls generally speaking, including the surprising results of last year's UK referendum and U.S. presidential election. In fact, contrary to popular opinion, both of last year's unforeseen results were broadly within the error bands of pre-election polls. However, both outcomes were largely missed by betting markets. In contrast, both the polls and betting markets appear to be on the same page for this year's French Presidential election (Chart 2).

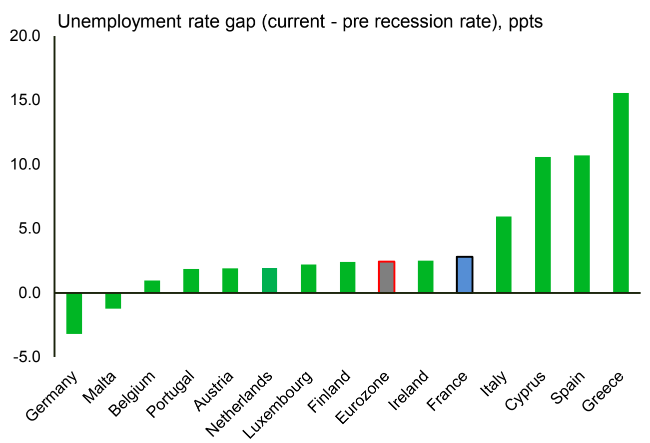
While polls are currently suggesting that a populist candidate has little chance of victory, there is still a large contingent of undecided voters. Some reports suggest that more than 40% of eligible voters in France are undecided, and that voter apathy could result in a record low turnout.[1] Therefore a scenario in which the large pool of undecided voters throw their support behind either Le Pen or Mélenchon, or even poor weather hampers turnout for all but the most determined voters cannot be completely ruled out. While a statistical tail event, such a scenario would be the first populist victory in Europe this year, and would increase economic uncertainty, ultimately working against the economic recovery in both France and the Eurozone.

France's economic malaise fuels populist support

Historically, populist political movements have often found support among those who have suffered economic misfortune or brutality from authoritarian regimes. In the case of France, it appears to be the perception of economic suffering following the Great Recession of 2009 that has fueled the shift toward economic populism. While France escaped the financial crisis relatively unscathed (with its banking sector intact and a quick return of economic growth), its economic performance since the Eurozone crisis of 2011-2012 has been more subdued than other major Eurozone economies (Chart 3). After rebounding strongly from the Great Recession, growth slowed to an average of about 0.5% in 2012-2014, about half of the OECD's estimate of trend growth during that period.

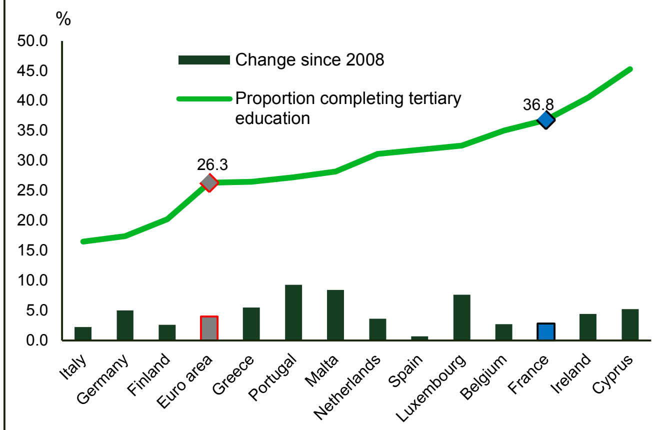
Perhaps more relevant to the French election was the toll that the Great Recession took on the French labour market. The headline unemployment rate remains about 3 percentage points above its pre-recession level (Chart 4). Moreover, the details of the unemployment rate are indicative of a labour market that is far from healthy. Long-term unemployment in France has continued to rise during the post-crisis period, with both males and females experiencing roughly a proportional increase in those unemployed for 12 months or more. Similarly, the very long-term unemployment rate has also risen (defined as unemployed for longer than 24 months), with men more likely than women to fall into this category.

CHART 4: FRENCH UNEMPLOYMENT HAS FALLEN BUT REMAINS ABOVE PRE-RECESSION LEVEL



Source: Eurostat via Haver Analytics, TD Economics. As at 2016Q4.

CHART 5: FRENCH YOUTH ARE SOME OF THE MOST HIGHLY EDUCATED IN THE EUROZONE



Source: Eurostat, TD Economics. Statistics for youth aged 20-29 who have successfully completed tertiary education (bachelor's, master's, doctorate).

Most concerning is the elevated level of youth unemployment in France (defined as 15 to 24 years of age). At 6 percentage points above its 2008 pre-recession level, it is similar in both the change and level to the Eurozone average, but markedly higher than neighbouring Germany, Austria, and Belgium. While high youth unemployment has historically been a structural feature of the European labour market, the lack of progress since 2008 is unusual, and reflects the long tail of the most severe financial crisis since the Great Depression. What's more, about 40% of French youth aged 18-24 are expected to vote for Le Pen this election, suggesting that the failure of past governments to make progress in lowering youth unemployment is partly fuelling support for anti-EU candidates.[2]

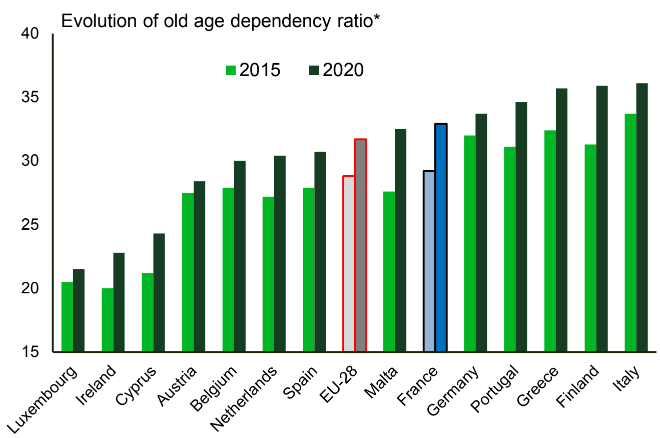
There are some bright spots in the French labour market. For one, France has managed to maintain one of the most highly educated labour forces in Europe, an important feature for the new knowledge based workforce. The completion rate of tertiary education didn't stumble in the aftermath of the recession or the Eurozone crisis (Chart 5). What's more, despite having relatively slower population growth than its peers, it has a more youthful population, corresponding with a relatively lower old age dependency ratio (Chart 6). However, as with most advanced economies, the French old age dependency ratio is expected to rise in the coming decade, putting a strain on public services and government finances.

Of course, in an advanced economy where government expenditure comprises nearly 30% of annual activity, the sustainability of government finances is a key concern. The political platforms of leading presidential candidates share similarities on this front: they generally advocate varying degrees of fiscal consolidation, with the aim of ending France's long string of primary budget deficits. Some progress has been made on this front since the deep deficits amounting to about 4% of French GDP after the 2009 recession (a reflection more of the fiscal tools used to battle the recession than profligacy). But the budget deficit is still expected to remain in excess of 1% of GDP over the next few years. And, while our analysis on fiscal space earlier this year suggests that France does indeed have some room to incur more debt at current interest rates, this low interest rate environment may soon be coming to an end in Europe.

Along with economic policy, voters are likely to also consider which candidate offers the best platform on social issues. For one, France still has room for improvement on gender equality. Although the female labour force participation rate has risen in the last couple of decades, the economy would benefit from policies that would encourage its relatively highly-educated female population to remain engaged in the labour market after childbirth.

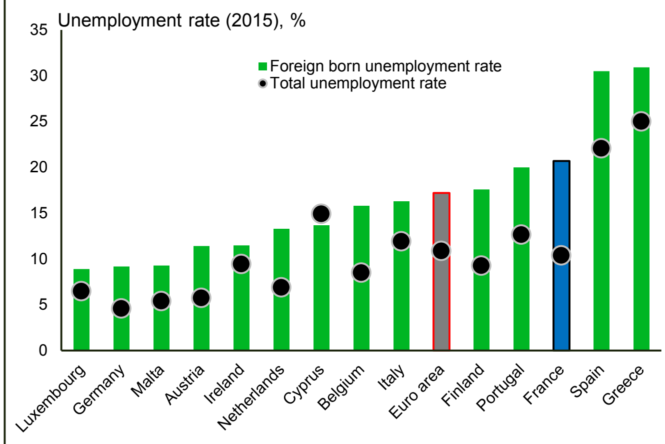
Another often touchy topic has been France's poor integration of immigrants into the broader labour force. Unemployment statistics for foreign born French residents are roughly double those of Austria, Germany, and the Netherlands (Chart 7). Perhaps rather than seeking to reduce or end immigration altogether, French politicians are better off concentrating on how to develop social policies that help provide immigrants with the skills and job opportunities necessary to contribute to society.

CHART 6: FRENCH ENTITLEMENTS TO BECOME INCREASINGLY UNDER PRESSURE



Source: Eurostat. Projections as of February 2017. *Old age dependency ratio is the 65+ population per 100 people in the working age population (aged 15-64).

CHART 7: THE FRENCH FOREIGN BORN UNEMPLOYMENT RATE IS HIGHER THAN MOST OF ITS PEERS



Source: Eurostat. Unemployment rate for those aged 15-64.

A populist victory wouldn't be the end of the EU

Despite some of the media hyperbole, a populist victory does not imply the death of the euro or the EU. Rather, it would likely result in a long period of economic uncertainty, with the resulting political gridlock having financial market and economic implications such as potentially reducing business investment. Such an outcome would thicken the layer of market uncertainty that will also be adjusting to a redefined UK relationship within Europe in the months and years to come.

Although it's deemed unlikely that a candidate like Le Pen would be able to successfully pull out of the euro and/or EU, presented below are the sequence of events necessary to get there:

1. Le Pen or Mélenchon earns enough support in the first round to qualify for the second round and wins the French presidential election on May 7th.

2. The President could then try to initialize a referendum vote on euro/EU membership in one of three ways:

a. Traditional method - This would require the majority support of both houses of Parliament. It would also require that their party wins a majority of the 577 seat National Assembly this June (FN currently hold only 2 seats and support for Mélenchon's party is unknown). An Opinion Way poll last year projects that FN could potentially win up to 64 legislative seats.[3] However, this is more of a high end estimate given that some centrist or leftist parties may choose to drop out of the race in certain ridings in order to avoid splitting the vote and thereby reducing the chance of getting the FN candidate elected.

b. Shared initiative – A referendum can be held if about a fifth of Parliament asks for one and is supported by a tenth of registered voters via petitions submitted within a nine-month period. However, this ultimately requires support of both houses since the referendum proposal is nullified if 60 or more members of either house decide to discuss it.

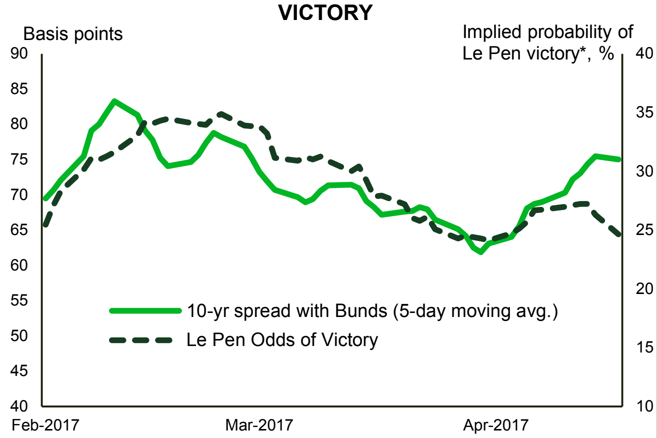
c. The de Gaulle precedent – The French Prime Minister can ask the President to call for a referendum according to Article 11 of the French constitution. This assumes the unlikely circumstance that an anti-EU president will be able to successfully form a government and select a Prime Minister that Parliament will support, and that the referendum proposal won't be stuck in the courts and cause a constitutional crisis.

3. The referendum proposal survives constitutionality test by the courts.

4. With a referendum threat in hand, the President then may seek to renegotiate France's terms of membership in the euro and/or EU over the course of the next six months.

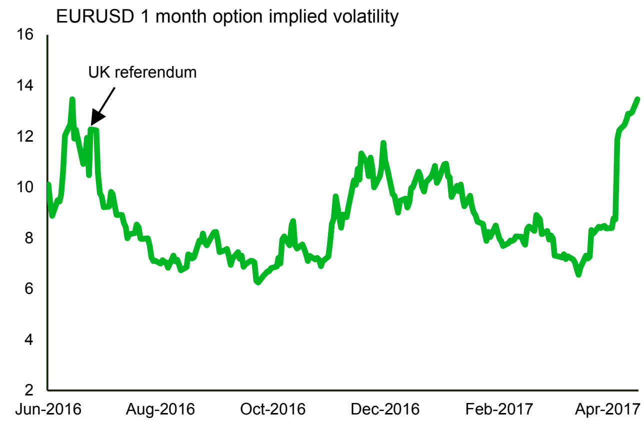
5. Unsuccessful negotiations would likely then result in the President setting a date for the referendum late in 2017. A successful referendum outcome – one that results in an exit from the euro and/or the EU – would require a major shift in French public opinion polls from the current standing that shows majority support for remaining part of the Eurozone and EU.

CHART 8: FRENCH BOND YIELDS HAVE WAXED AND WANED WITH THE ODDS OF A LE PEN VICTORY



Source: National central banks via Haver Analytics. *From oddsmaker.com via Bloomberg. Last observation: April 17, 2017.

CHART 9: EURUSD IMPLIED VOLATILITY HIGHEST SINCE THE UK REFERENDUM



Source: Bloomberg. Last observation: April 17, 2017.

Given this complicated sequence of events, it's unlikely that a victory by a populist candidate will result in an exit by France from the euro and/or the EU. But that doesn't negate the risk of an increase in political and policy uncertainty in the event of such a victory. Indeed, markets are already getting a bit skittish, as evidenced by the increase in the spread between French and German 10-yr yields (Chart 8), and the rise in demand for protection against a big move in the EURUSD (Chart 9).

Immediately following a populist victory, the most obvious concern would be that capital would flow to more stable neighbours like Germany, but also to the U.S. and advanced EU economies with their own currency. The EURUSD would likely feel the brunt of the election result, with a material depreciation expected in the immediate aftermath, although this could be tempered given the low probability of a populist being able to select a Prime Minister willing to carry through with their platform and also be accepted by Parliament – somewhat mutually exclusive objectives. French sovereigns and equities would likely weaken, as the risk of default for French sovereigns rises given the possibility of a redenomination of national debt in French francs and peg to the euro becoming closer to reality. Furthermore, it's not entirely clear when the initial knee-jerk reactions in financial markets would begin to settle down. Given that the legislative elections occur just over a month after the second and final presidential vote, we could see a prolonged period of volatility before markets become confident on the likelihood of France's chances of successfully leaving the euro and/or EU. As a reminder, the financial market shock of Brexit wore off in a couple days, and the negative market reaction to the U.S. election outcome unwound in a matter of hours. Political wins and policy expediency and implementation don't necessarily go hand in hand.

On the economic front, the longer uncertainty lingers on the political and policy front, the more likely it would be that new business investment in France would stall, leading to a deterioration in the growth outlook. Spillovers would be most severe in its Eurozone partners, with elevated uncertainty likely resulting in a more subdued demand outlook for the broader Eurozone as a whole. In the event that market volatility was exceptionally intense, the European Central Bank (ECB) would likely act quickly to calm financial markets, announcing measures to ensure adequate liquidity is available for Eurozone banks and possibly signaling further easing measures at its June meeting if the balance of risks suggest a deterioration in the inflation outlook.

France to post solid growth over next two years

In our last quarterly forecast update, we pointed to the European elections this year as a source of uncertainty that may have economic implications, particularly if populist parties were to secure large victories. So far this year this has not been the case. The Netherlands election came and went with a victory for the establishment parties, and the election results were well within the margins of error from the pre-election polls.

If current polls are correct, Emmanuel Macron is set to become the next President of France. In this base case scenario, we anticipate that the French economy should expand by about 1.4% annually in 2017-18 – just above the trend rate of growth estimated at around 1%. Growth of this magnitude should see the gradual absorption of economic slack in the economy, and is consistent with a decline of the French unemployment rate of between a half to a full percentage point, to just above 9 per cent from the current 10 per cent. Furthermore, as a self-professed pro-business candidate and former economy minister under the current President, a Macron victory may provide some upside risk to our baseline, particularly if he is able to push through a number of business and labour market reforms early in his term of office.

Obviously a win by Marine Le Pen or Jean-Luc Mélenchon would force us to revisit this outlook not only for France but for Germany, Italy, and the Eurozone as a whole. The risks to the outlook from this scenario would be clearly to the downside: elevated political uncertainty at a minimum would result in reduced business investment, which should act as a drag on economic activity primarily in France, and possibly spilling over into other Eurozone nations as businesses question the future of the entire European project.

In sum, given that the French Presidential election is unlikely to be won by a populist candidate, our baseline economic outlook of slightly-above-trend growth and corresponding drop in the unemployment rate should help to alleviate some of the economic anxiety faced by some of France's most marginalized citizens. However, we anticipate that European financial markets will become more sensitive to changes in the polling in the coming days.

ENDNOTES

1 For example, see "The voter apathy that helped Donald Trump win is about to hit France". Quartz.com, April 5, 2017. https://qz.com/950677/france-presidential-election-2017-the-voter-apathy-that-helped-donald-trump-win-could-help-elect-frances-marine-le-pen/. Return to text

2 "Economic frustration drives young French voters towards Le Pen". Financial Times, March 18, 2017. https://www.ft.com/content/5119f9ac-08cb-11e7-97d1-5e720a26771b. Return to text

3 Source: Opinion-Way https://www.opinion-way.com/fr/sondage-d-opinion/sondages-publies.html?task=document.viewdoc&id=1408. Return to text