

# FIXED INCOME RESEARCH

## FRENCH ELECTIONS EXAMINED

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### EVENT UPDATE/OVERVIEW

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France has largely avoided market crosshairs during the on-going sovereign crisis and only recently came into sharper focus on the back of Standard and Poor's downgrade of the sovereign to AA+. However, France is capable of significantly disrupting the limited positive momentum in Europe with a possible change in its administration at the upcoming election. A change would alter France's role in EU crisis leadership as well as the very important Franco-German relationship. Additionally, if France fails to set itself on the correct policy path, the size and scope of its necessary reforms in the context of a deeply entrenched entitlement society is also likely to rattle markets.

France, guided by Nicholas Sarkozy, has played a key role alongside Germany and Angela Merkel, in setting policy during the crisis. Now Sarkozy is facing re-election and is significantly behind in the polls and could be out the administration in as little as 3 months. The far left candidate Francois Hollande increased his lead over Sarkozy to 34 vs. 26 per cent in the first round and 58 to 42 per cent in the final round according to pollster BVA as of Monday February 6. The high likelihood of the change in administration increases the uncertainty around both necessary French reforms and the wider EU response to the crisis.

Sarkozy quickly lost favor with the French electorate after assuming power in 2007 because he largely abandoned campaign promises of pro market reforms and growth enhancing policies once in office and faced with opposition. He also was viewed as somewhat un-French for his public displays of wealth and predilection for a glamorous lifestyle. His administration was in trouble but the EU debt crisis allowed him to regain some level of public respect when he joined forces with Merkel to guide the EU through the crisis. Even then though, Sarkozy was more powerful on the international stage versus the domestic.

The tight bond between Germany and France in setting EU policy now translates to Chancellor Merkel campaigning for President Sarkozy to remain in power. Chancellor Merkel stated in a press conference that she supported his re-election campaign and will work with him, not as the chancellor of Germany but as head of the Christian Democrat party, a party with similar beliefs as Sarkozy's UMP party. However, the actual difference is lost in the visual of the leader of Germany campaigning for a French presidential candidate. The risks to Merkel are significant; she could appear distracted to her German constituents by being too heavily involved in domestic French affairs, she could be viewed negatively by the French public and most importantly, she may have to work closely with a president whom she campaigned against after the election. Merkel cites the previous close relationships between Germany and France but her involvement is still somewhat shocking though it does lend itself to interpretations of a borderless Europe. Merkel will face her own re-election campaign in 2013.

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If Hollande wins the presidential election, it may prove difficult for Germany and France to continue its close relationship and policy coordination on the EU crisis. These two countries have provided some stability and organization to the crisis and the market has welcomed their partnership. There would likely be a loss in faith of EU policy and implementation if Hollande were elected especially given the possible antagonistic relationship between Merkel and Hollande as a result of her campaigning against him.

The French presidential elections will quickly be followed in June with general elections. Although the president is a strong policy figure, parliament does play a key role in the legislative process. Reform, either from Sarkozy or Hollande will need to be supported through the parliament. Sarkozy hasn't demonstrated much savvy in his dealings with parliament and Hollande might benefit from strong support for socialists in the general elections if he wins the presidency but neither man is likely to have a *carte blanche* from parliament.

President Sarkozy hasn't formally declared his presidency though it is expected this week. It is a technical issue as to when he declares his campaign because there is an immediate tightening in regulation on his public speaking time, and travel and events need to be paid for by his party versus the government. Additionally, policy implementation is limited and there will be a break in the parliament before the presidential and general elections.

Despite these constraints, Sarkozy made sweeping policy announcements only last week. Granted these policies could only be implemented post his election and will likely be partially watered down by the opposition depending on the outcome of general elections in June. The reforms, if fully implemented could put the French economy on a more dynamic and certainly robust path. However, these reforms strike at the heart of the French entitlement and welfare system and are likely to prove very challenging to implement while maintaining political support. The President proposed a hike in the standard VAT rate from 19.6% to 21.2% effective 1 October 2012 (post election) to compensate for a cut in employers' social contributions in order to reduce unit labor costs in hopes of making the French economy more competitive. In tandem, President Sarkozy wants to see an end to the 35-hour working week and allow workers and employers to negotiate more flexible agreements on hours to allow for the natural ebb and flow of demand instead of higher structural employment and uncompetitive businesses. These reforms are in coordination with other measures to close the almost 3% primary deficit and bring France's almost 100% debt to GDP ratio down. France needs a total fiscal adjustment of more than 6%, larger than Belgium or Italy, to put its debt on a downward trajectory. On a lesser note, President Sarkozy is suggesting a unilateral financial transactions tax of 0.1% to take effect in August but there are significant issues with the implementation and application of the tax.

Hollande replaced Dominique Strauss Kahn as the socialist's candidate after Strauss Kahn's very public scandal in New York surrounding allegations of sexual assault. The socialists have not held executive power for over 24 years and Strauss Kahn was almost assured victory prior to his scandal. However, as the polls suggest, Hollande is a very strong contender himself despite having never held a high ranking position in the government. He was a mayor of small town in central France, the secretary of the French Socialist Party and a deputy to the national assembly from the province of the town where he was mayor. His partner, Segolene Royal and the mother of his four children, was the socialist candidate for president in 2007 and they separated shortly after her loss. He was then found to be involved with a journalist.

Candidate Hollande ruled out many of Sarkozy's reforms as quickly as Sarkozy announced them. He also stated he will increase public sector hiring, increase spending on education and set up a special development bank to support innovation and return the retirement age from 62 to 60. Even though he has spoken favorably about Eurobonds and more European consolidation, he is adamant about renegotiating the Fiscal Compact Treaty. It is likely the market would initially react unfavourably to a Hollande victory though it would remain to be seen how much he could actually accomplish given firstly market tolerance for any deviation away from austerity and peer pressure from the EU to maintain those similar austerity measures. Secondly, the composition of parliament after the June general election may also hinder implementation. While the market would likely react favorably to a Sarkozy victory, he could be equally constrained by parliament, opposition lead or otherwise.

The French election is the first example in the Eurozone where the various parties have no consensus on either the cause of the crisis or the remedy. In Portugal, Ireland and Spain we saw agreement on the necessity for austerity and the need for reform in various sectors. That is absent in France. While the French election will definitely be hotly contested and pit left against right in France: it is also likely to affect valuations on Europe wide assets as well given the key policy role France and France and Germany as a team played and continue to play in the EU crisis.

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