François Hollande after six Months

16 November 2012

Summary

- This week marks six months in the French Presidency for François Hollande. Despite a strong Presidential election victory and socialist strength at all levels of French government, Hollande's popularity ratings are now lukewarm, with approval levels hovering around 40% of French voters.

- Hollande has delivered much of what his leftwing electoral coalition asked for, but with some huge and symbolic exceptions. He has cast himself as a fiscal pragmatist, but continued to irritate French business, with who he has yet to rebuild many of the bridges burnt during his election campaign.

- Hollande passed the European Fiscal Compact after pledging to rip it up, raised VAT after pledging not to, passed the toughest budget for thirty years but funded it largely with taxes on corporates and high earners. This is a record almost guaranteed to please nobody entirely.

- Hollande's attempts to define a French version of 'progressive austerity' still appear to many – not least Berlin – to be dodging any real confrontation with the French public on the need for structural reform. The market has been patient with Paris. It may not stay that way.

- But Hollande has also faced arguably the most difficult prospect for a French President in Europe for decades. He is being drawn by events and by Berlin into an evolution of the Eurozone with which Paris and the French public are deeply uncomfortable. Like Sarkozy before him, his ability to resist or shape this process is constrained by France's own relative weakness. The net result is a Franco-German relationship that is tenser than it has been for many years.

This week marks six months in the French Presidency for François Hollande. The election of a French President is always an important moment for wider European politics but Hollande's election in May felt like an important determinant of the political weather in Europe and that is indeed how it has played out. Rallying a coalition on the left of French politics to defeat a divided right, Hollande became, without really seeking to, an alternative pole outside of France in the European debate on Berlin's austerity-driven model of Eurozone integration (See <u>*GCI 10/02/12 François Hollande says Non*</u>)

Delivering on that implicit promise has proven difficult.

Despite holding an unprecedented sweep of all levels of French government in June, Hollande's popularity ratings are now lukewarm, with approval levels hovering around 42% of French voters (Chart 1). Hollande has also struggled with a deteriorating Franco-German relationship that is being strained by very different views of how the Eurozone should be governed. He may have campaigned as the antidote for a hyperactive and expansive Nicolas Sarkozy, but his first six months appear have left the impression for many commentators of insufficient stature, decisiveness and influence. This Global Counsel Insight assesses that judgment.

Cuts and rises

In reality, Hollande has of course done plenty in his first six months, including a lot of what he pledged to do on being elected. He has partially reversed the rise in the French retirement age, added 25% to the annual 'rentrée scolaire' payment to the parents of school-age children and raised the French minimum wage by 2%. He has reversed the elimination of social security payments on overtime wages and set in train the creation of a French Public Investment Bank. All electoral commitments.

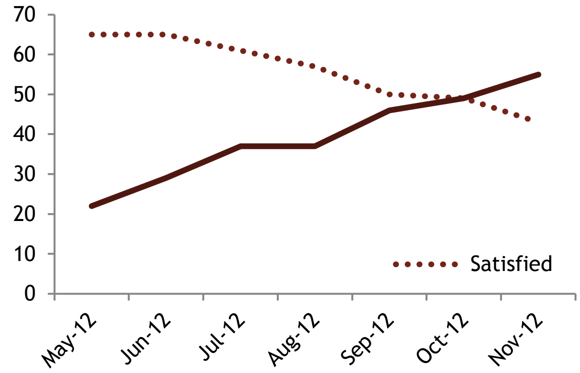

Chart 1: Levels of satisfaction and dissatisfaction with François Hollande as President.

Source: IFOP for Journal du Dimanche 2012

So why the dissatisfaction? The trouble focusses more on a number of very big ticket items than these more marginal commitments. Hollande passed the European Fiscal Compact he promised to tear up. He raised VAT after pledging not to. He set out to establish his fiscal credibility with the toughest French budget in 30 years but funded it largely with tax rises on the wealthy and corporates. All of these might have been designed to antagonise either his left-wing electoral coalition, his right-wing opposition or French business.

Hollande's September budget was the centrepiece of his first six months and the basic expression of this political dilemma. Sensitive to the prospect of market dissatisfaction with anything other than substantial contraction in the gap in French public finances, he proposed almost €37billion in deficit reduction. Much as he had implicitly promised in his election campaign, he funded it with more than €20billion in new taxes on sales, capital gains, large corporates and high incomes. Public spending cuts were largely confined to defence and agriculture and a real terms freeze in health funding. The government explicitly rejected the notion of austerity, at least as is being experienced in Spain and Ireland.

The budget provoked the predictable mixed reaction. The 0.8% growth assumptions in 2013 that allowed the French government to predict a return to a deficit of 3% of GDP are twice the IMF equivalents and were widely questioned. Business was alarmed, and said so. The Governor of the Bank of France Christian Noyer made a rare political intervention to say that the balance in the budget between taxes rises and spending cuts was wrong. A revolt by tech entrepreneurs against the rise in capital gains tax provoked a surprisingly pliant repeal in a matter of days.

On the perennial question of French structural market reform, Hollande has had comparatively little to say. The 35-hour week has remained firmly off limits, with Prime Minister Jean-Marc Ayrault provoking a brief storm by suggesting that it might not be, before reversing himself. French employers and union representatives are set to sit down this month in an attempt to try and agree a package of labour market reforms, with employer bridling at restrictions on plant closures.

When former EADS CEO Louis Gallois published the report on French competitiveness that Hollande commissioned from him in early November, he explicitly urged the President to cut where the budget did not: at the large employer contributions to social welfare funding. Implicit tax rates on labour in France hover around 39%, the highest in Europe. The Hollande administration ruled out major changes to labour taxes, but this week under pressure to respond substantively to the Gallois critique, the Hollande administration announced a large package of tax breaks on employer charges for low wage workers.

The balance that Hollande is trying to strike here is simple enough. His left-wing electoral coalition with the Parti du Gauche reinforced Hollande's own instincts to run for the Presidency from the left. His campaign platform was heavy on tough language on bankers, ambivalence to big business and the wealthy and a general attack on the harsh austerity that has been dished out in the European periphery. In office he has governed as he campaigned: creating a new 75% tax bracket for high incomes and repeating his intention to impose some form of structural reform on the country's banks, probably along the lines of the US Volcker rule.

But Hollande also let it be known during the campaign that he was a fiscal pragmatist with a general commitment to balancing the French budget. When he committed to meeting the French National Audit Office estimates of a required €33billion euro rebalancing in July, Parti Du Gauche leader Jean-Luc Mélenchon said in advance he would reject any such budget. The September budget was an attempt to square this political circle: the sharpest adjustment in the French fiscal balance since the 70s, paid for in large part by substantial tax rises on the targets of his campaign rhetoric. Mélenchon has pledged his party to vote against it anyway.

Problems with the neighbours

But if Hollande has struggled to protect and consolidate his left flank on the budget he has provoked even greater dismay on the European Fiscal Compact. Having run explicitly on a platform of rejecting Berlin's model of fiscal deficit targeting, he instead pushed the Fiscal Compact through the French National Assembly in October 2012 unchanged, save for a handful of parallel commitments from Brussels and Berlin on growth measures in 2013.

His Parliamentary majority was large enough to absorb 45 dissenting votes from his own side and avoid reliance on conservative UMP opposition votes to do it, but it was jarring break from a campaign policy of tearing the document up. The August ruling by France's Constitutional court that the adoption of the Fiscal Compact did not require amendment of the French Constitution came as an immense relief to Hollande, as this would have required either a referendum or a 60% majority in the Assembly to approve it.

If Paris essentially ended up doing Berlin's work on the Fiscal Compact, the wider pattern of relations with Germany has been one of increasing deterioration. Angela Merkel campaigned openly for Nicolas Sarkozy's re-election in April, and relations between President Hollande and the German Chancellor are cool. Berlin is increasingly sceptical of Paris' commitment to structural reform (a scepticism it shares with Brussels), and suspicious that Paris favours higher inflation, pooled debt liability in the Eurozone and bottomless ECB liquidity support without tougher guards on states spending. Senior voices like former German Chancellor Gerhard Schroeder have openly said that Hollande lacks the willingness to talk straight to the French people about structural reform.

Paris in turn, resents Berlin's insistence on deficit targeting and deeper European political and fiscal integration. The federal German system is broadly much more comfortable with the idea of new autonomous powers and even institutions at the EU or Eurozone level to lock states into fiscal disciplines. Its instinctive preference for exercising its own power indirectly reinforces the same preference for a higher level of political integration at the level of the Eurozone. It also produces a general desire to see the greatest possible overlap between the structures of the EU and of the Eurozone as a way to keep large counterbalancing influences like that of Britain inside the inner councils of the European Union.

Put crudely, France has a much more centralised structure, and has always seen the EU as a way of projecting French preferences onto Europe rather than allowing European preferences to shape France. Paris has put up stiff resistance this week to any serious reduction in agricultural subsidies in the EU budget negotiations – perhaps the single most emblematic expression of the shaping of the EU by French preferences.

This suspicion of a weakening of French prerogatives and of new 'community' rules and structures, leaves Paris much more inclined to 'inter-governmental' arrangements that leave courses of action to be determined among the sovereign states in the European Council. Differences of tone aside, Sarkozy and Hollande share precisely the same instinct for guarding 'political' sovereign initiative against European institutions. These instincts were strongly reinforced in France by the loss of the 2005 French referendum on the European constitution, which seemed to suggest concrete limits to French public tolerance of European integration where it acts as a dilution on French autonomy.

None of this is to say that France and Germany are not capable of compromise on these things. But there is a tension between preserving sovereign autonomy and creating new checks on sovereign action in the Eurozone that is a pretty reliable predictor of the basic positions of Paris and Berlin respectively. The same line divides Paris' priority of action to secure market confidence in the liquidity of the Eurozone and Berlin's concern over protecting the Eurozone creditors from the laxity of their debtors. The current debate in Brussels about creating a measure of fiscal autonomy for the Eurozone budget is a case in point. Paris would like it to be a fiscal buffer for European states experiencing negative demand shocks. Berlin wants to use it as an incentive for states to meet the terms of reform 'contracts' with the European Commission.

The next six months

Hollande ends his first six months as French President weakened at home and with a comparatively weak hand in Europe. Domestically he has delivered a lot of the small things his left-wing base demanded but struggled with the larger commitments. He has lost support from the left for reversing commitments on the Fiscal Compact and VAT. Hollande has spent six months trying to produce 'austerity with a leftist flavor' and struggled to convince both left and right (Chart 2).

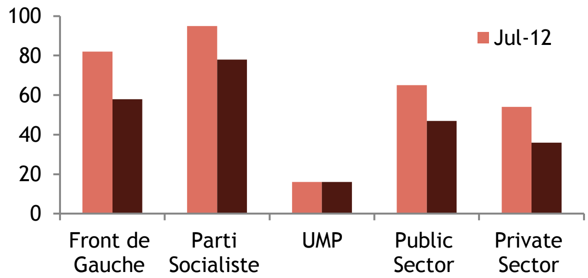

Chart 2: Satisfaction with François Hollande, by political allegiance and employment sector

Source: IFOP for Journal du Dimanche 2012

Any moves towards the basic expectations of French business and the familiar prescriptions for labour and product market reform – reforms to pensions, cuts to social security contributions, relaxation of hiring and firing rules – will pull him further away from the centre of gravity of his left wing coalition. If the UMP elect a market-friendly moderate like Francois Fillon to take Sarkozy's place as leader next week, Hollande may find he has reduced scope for winning over centrist opinion to compensate for doubters on his left (An IFOP poll last week suggested 53% of the French electorate prefers the UMP leadership candidate to Hollande). The more Hollande plays to the instincts of his left flank, the more he risks a wider swing in market sentiment.

His problems in Europe are just as knotty, and may have big implications for the future evolution of the Eurozone. Although Berlin is careful not to emphasise the point too starkly, Paris' fragile public finances and fragile banking sector make it the weaker partner in the Franco-German partnership and far more vulnerable to a turn in financial market sentiment. Sarkozy's high profile partnership with Berlin was to some degree an admission of weakness. The former President often bridled against German policy but felt constrained by market pressure to align himself as close as possible with Merkel and against the recalcitrant periphery states of the EU.

The same problem hovers over Hollande. Ultimately, he had no choice but to pass the Fiscal Compact; anything else would have been to throw the Eurozone into crisis and France's credit rating to the dogs. Yet with markets still pricing

France's credit risk closer to Germany than Rome or Madrid, Hollande appears to have judged Sarkozy's degree of caution and proximity to Berlin less necessary.

This may be the key thing about the next six months for Paris. Perhaps surprisingly, the one constituency that has barely registered Hollande's first six months are financial markets, which continue to price French debt generously. This probably reflects a combination of the general calm created by the ECB's massive promises of liquidity support and an element of withheld judgment on Hollande's fiscal and reform ambitions. Given that the instincts of the market lean more towards German Eurozone prescriptions of structural reform and binding fiscal rules, Paris could still easily find its hand both domestically and in Europe being forced by a deterioration of market sentiment.

What might trigger this? A closer look at wobbly French banks. The collapse of talks on labour market reform. A worsening economic growth outlook. Deepening market scepticism about progress towards banking union. The list is a long one. Yet six months is also just a tenth of a Presidency. He has some time and scope to reassert his reform credentials, and a successful phase of union-employer negotiations later this month would send a strong signal. France's fractional third quarter growth has helped perceptions. A wider political swing in Europe against the kind of deep fiscal contraction being experienced in Spain may yet strengthen him and France. The verdict: *trop tôt pour juger*.

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