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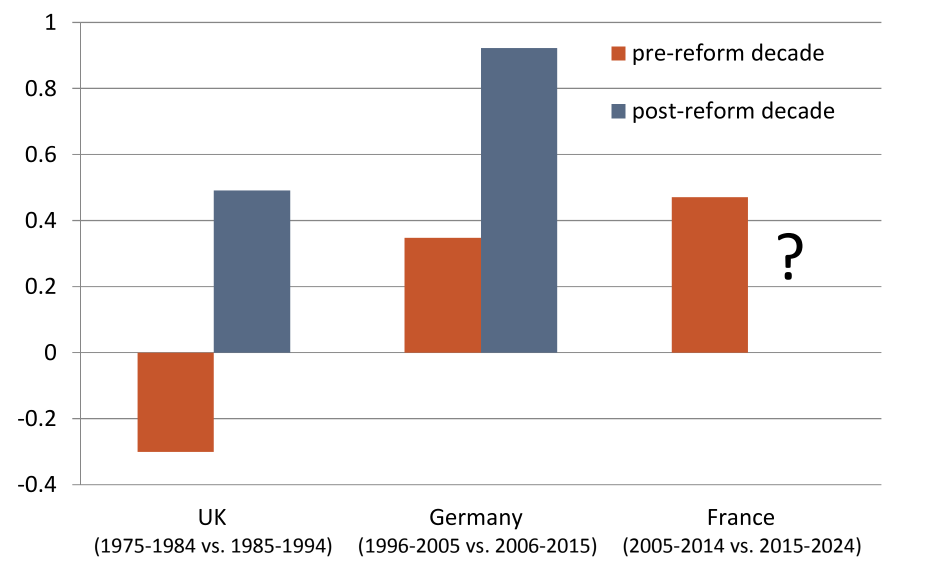
One year Macron: France is turning the corner

- **On track for a golden decade:** One year after we made our call that France is heading for a golden decade, we remain convinced that the country is turning the corner. President Emmanuel Macron hit the ground running, pushing through a labour code reform and corporate tax cuts less than five months after being sworn into office. What is more, he has not slackened his efforts since, bringing further proposals (aimed at, among other areas, railway operator SNCF, unemployment insurance, education and pensions) to the table.
- **Macron's big test – déjà vu 1995?** France is experiencing its biggest strikes since 1995, initiated by labour unions that oppose the railway reform and Macron's overall agenda. In 1995, the government of the time had to cave in. It abandoned its reform plans and lost the next election. Will it happen again?
- **History rhymes, but does not repeat itself:** Macron may offer small concessions to the unions but we expect him and his reform agenda to largely prevail. (1) Macron is striving to deliver on what he was elected for. The feeling of betrayal is, thus, far less prevalent than it was in 1995 when Jacques Chirac tried to implement reforms he had not campaigned on. (2) The labour unions are fighting for privileges many regard as relics of a different era. Many citizens do not think the strikes are justified. (3) Despite a near-term dent to growth, largely owing to one-off factors, the healthy economic upswing allows Macron to prioritise reforms over unpopular spending cuts.
- **Backdrop remains favourable:** Last year, Macron began to fix France's roof while the sun was shining. At the start of 2018, the sky turned slightly cloudy across the global economy: overblown concerns of an inflation surprise and fears of protectionism have triggered a correction in sentiment across Europe. While this poses a headwind for Macron, the overall economic backdrop in Europe and France remains favourable enough to support demand growth at or above trend.
- **Big boost to growth, jobs and stock performance:** Experience suggests that reforms take time to work. The benefits of France's more-flexible labour market may not be fully visible yet at the 2022 election. Still, if Macron implements most of his agenda within the next 12 months, as we expect, he would raise the economy's long-run potential. Jobs growth could accelerate significantly in coming years, as it did in other major European countries after key reforms (see Chart 1). If so, French stocks could outperform their European peers.

Chart 1: Jobs growth before and after major reforms (average annual change, in %)



Source: Quarterly data. Average annual growth rates, in %. Sources: ONS, Eurostat.

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A golden decade for the “sick man of Europe”? Still valid

“La grande nation” has long been the “sick man of Europe”

The label “sick man of Europe” for a country with serious structural problems has been applied at one time or another to nearly every major state in Europe. France is no exception. Over decades, “la grande nation” saw presidents and governments come with ambitious plans to reform the country – and saw them go, after failing to deliver these plans.

While other previously sick men of Europe shaped up, France did not

Meanwhile, previous bearers of the “sick man” label and other countries with severe problems managed to turn themselves around: the UK under Margaret Thatcher after 1979, post-communist Europe after 1989, Scandinavia after the 1990 financial crisis, Germany after 2004, the Baltic countries after their 2007 financial crisis, and the Eurozone periphery countries from 2010 onwards. Many observers argued that France was irreformable, suffering from specific traits that made progress impossible.

We remain convinced that France is turning the corner

This time is different: One year ago, two days before the second round of the French presidential election between Macron and Marine Le Pen on 7 May, we made a big call: if Macron wins and delivers the policies he promised during his presidential campaign, France would be heading for a golden decade, advancing from close to the bottom to near the top of the European growth league. One year later, we remain convinced that France is indeed turning the corner. Unsurprisingly, Macron is facing resistance. Still, his position and his determination to change France remain strong.

The lesson of 2017: France is reformable

Macron’s party enjoys majority in parliament

After Macron’s decisive victory in the second round of the presidential elections, the party he founded just a year earlier, La République En Marche! (LREM), also won the legislative elections by a comfortable margin. Together with its coalition partners the Moderate Democrats (MoDem), LREM has provided Macron with a clear presidential majority (312 plus 47 equals 359 versus a threshold of 289, out of 577 total seats) in the National Assembly, the lower house of parliament.

He hit the ground running and has not slackened in reforming the country

Presidents before him have enjoyed a majority in the National Assembly and talked the talk, but failed to walk the walk. Unlike his predecessors, Macron has made use of the strong mandate by delivering many of the policies he had campaigned on. He has pushed through a labour code reform and corporate tax cuts less than five months after being sworn into office. What is more, he has not slackened in his efforts since.

Macron has convinced investors and overwhelmed labour unions

The share of international companies considering investing more in France jumped to 72% in 2017 from around 35% in the previous years, according to an Ipsos poll. Macron has weakened his enemies, including the labour unions, the notoriously fierce advocates and long-term strongholds of the French social welfare model. They either looked chastened (the more moderate labour unions such as the CFDT and the FO) or powerless on their own (the more extreme CGT). During the 2017 protests against the labour code overhaul, they could not draw the masses they once used to attract to the streets.

Healthy economic upswing is welcome tailwind

The healthy economic upswing across the globe certainly helped. Like many other countries, France benefited from the stronger cyclical dynamics that set in across the globe in late 2016. Sentiment turned buoyant and business investment rose by 3.8% in 2017, after 2.7% in 2016 and around 0.9% in 2015. 2017 was the best year in a decade in terms of GDP growth in the Eurozone (2.5%).

Macron is not a “lucky general”, but makes his own luck

In 2017, Macron was a “lucky general” of the sort Napoleon hoped for. But, he is a general that makes his own luck. Macron is not only fixing the roof while the sun is shining, but also, and possibly more importantly, he is making (painful) changes early in his presidency, so they have time to play out over the medium-term. Macron has already shown that France is reformable.

Overcast start to 2018

Trade tensions and growth moderation in Q1

Global tailwinds are not blowing as strong in 2018 as before

In 2018, the global tailwinds are still blowing, but not as strongly as before. A surprise rise in US wage inflation sparked a market correction as fears arose that the central bank would have to normalise its accommodative stance quicker than expected. Incoming data for the Eurozone have disappointed this year. Some correction after the outsized surge in industrial output in late 2017 (+1.5% qoq in Q4) seemed normal. Exceptional factors (weather, influenza, rebasing of some data series) also weighed on measures of activity.

Trade tensions weigh on sentiment

But the major risk is that of protectionism, stoked by US President Donald Trump, which has been weighing on Eurozone businesses. In the end, we expect the US, China and the EU to avoid trade wars and strike deals that will improve access, especially to the Chinese market. Once the dust settles, business sentiment could recover.

At least a near-term dent to growth

Still, the resulting uncertainty could continue to weigh on sentiment, especially if the disputes were to turn noisy again, or in the unlikely case of an escalation. While France may turn out to be less affected by the uncertainty than more export-oriented member countries of the Eurozone, it is suffering at least a near-term dent to growth too (French GDP expanded by 0.3% qoq in Q1 after more than 0.6% on average qoq in 2017).

A marked global slowdown could put Macron's reform agenda at risk

As companies become more cautious, they may not raise investment as much as we had expected at the beginning of the year. At a stage of the cycle where investment growth is a key contributor to the above-trend growth, a serious slowdown in capital expenditure and employment gains would hurt the current global upswing. If so, it may limit the tolerance of the French public towards Macron's reforms.

Strikes in France

Peace is over: country-wide strikes in France against SNCF changes and reform agenda in general

Circumstances have also changed at home. Now the time of peace between the government and labour unions is over, Macron faces his biggest test, yet. In February, Macron's Prime Minister (PM), Edouard Philippe, introduced, among other reforms, proposals to shake up the national railway company SNCF (Société nationale des chemins de fer français). The idea is to cut costs, make the company more efficient and open the current railway monopoly up to competition, as required by EU law.

Changes would put an end to extensive privileges granted to SNCF workers

The SNCF is not only a large employer (150,000 workers), it is also notorious for running large deficits (2017: €3bn) and amassing big piles of debt (end of 2017: €45bn) while receiving large subsidies (2017: €14bn). Its operating costs are 30% higher than those of comparable railway companies in neighbouring countries, and its performance is poorer. For this record, many blame the privileges granted to SNCF workers: life-long job security, automatic annual pay rises, early retirement (from the age of 52 onwards) and generous pension entitlements. Philippe's proposals would effectively put an end to all of this.

SNCF is one of the last surviving epitomes of French social welfare model for labour unions

While most of the privileges SNCF workers have enjoyed for more than a century are anachronistic relics, the SNCF is a sacred cow to French unionism as a last surviving epitome of the French social welfare model. As such, this is a matter close to the labour unions' hearts. Labour unions have called for country-wide strikes in opposition to Philippe's reforms. In total, unions have announced a strike for 36 days between April and June of which 26 fall on workdays – that is two out of every five workdays. A number of workers from other industries, both union members and non-union personnel – including employees of Air France, and businesses dealing with recycling and disposal management – have joined the railway workers with their own strikes. Meanwhile, some students are protesting against the introduction of more-selective university entry requirements.

Neither the government nor the labour unions have backed down so far

After six weeks, neither Macron nor Philippe have signalled that they will back down on their demands. And neither have the MPs of LREM and MoDem. The National Assembly, France's lower house of parliament, in which Macron's party has a majority, took the first step in approving the SNCF reforms on 17 April. The SNCF bill will go to the Senate on 29 May. While LREM/MoDems do not enjoy an outright majority in the upper house of parliament, approval is expected to be concluded by early July. Behind closed doors Macron and Philippe may be willing to offer cosmetic concessions here and there to union leaders. But in multiple meetings with unions' representatives, they have held their stance firm, insisting that the SNCF has to change, and their proposals would be the best way to make the railways fit for the 21st century.

This dispute may be existential for either side

As there is so much at stake for all parties and this fight may well be existential for either side, neither the unions nor the government looks set to back down any time soon. After six weeks of strikes, and possibly six more weeks to go, the question is how this dispute will end.

Who will blink first in the strikes?

What does history tell us: 1995, Schröder or Thatcher?

We have been here before – three scenarios

We have been here before, in France and in other major European countries. Experience tells us that the standoff between the government and the labour unions could follow three possible scenarios.

France 1995: government yield to unions

(1) **Reformers are defeated – the France/Alain Juppé 1995 scenario:** The labour unions hold firm, show no sign of compromise and win support from the general public. The government has to yield to the pressure of a large social movement and withdraw its reform plans. The unions proclaim victory. In such a scenario, the introduction of the rest of President Macron's reform agenda and the government would be at risk, similar to 1995. France could soon be called the "sick man of Europe" again.

Germany 2003-05: both sides compromise

(2) **Unions get real – the Germany/Gerhard Schröder 2003-05 scenario:** The unions adjust under pressure and, after some initial fierce posturing, take a less confrontational approach, especially as the government offers some concessions. Both sides compromise. Macron can proceed with his reform agenda, but possibly at a slower speed and with a smaller scope. The reforms will still add to raising France's long-term potential. The unions have managed to ward off, or at least slow, down the twilight of their power.

UK 1984-85: labour unions back down

(3) **Unions lose outright – the UK/Margaret Thatcher 1984-85 scenario:** The government holds its stance, broadly supported by the general public to pursue its policies. Cracks appear among the labour unions. Ranks break apart as some labour unions push for compromise. Eventually, the labour union opposition loses its force. The government can proceed with the SNCF overhaul and its other reforms. Macron is dubbed the "monsieur de fer" ("Mister Iron"), echoing Thatcher's "Iron Lady" title of the 1980s. Victory in such a decisive battle against the labour unions would clear the way for the rest of Macron's reform agenda and would remove another obstacle to raising the long-term growth potential of the French economy. It would also accelerate the twilight of the power of unions, having failed to prevent Macron's reforms.

Does history repeat itself, or just rhyme?

The question is whether French history repeats itself (and we are in for scenario one), or history only rhymes and France takes the German (scenario two) or British (scenario three) path, or a middle course.

Game theory suggests general public and stage of economy are crucial

Game theory may be helpful in this respect and suggests it is important to study where the general public stands and how the economy is doing (for a game theory conceptualisation of the current labour dispute, see the appendix at the back of the report). A good example is the labour dispute of 1995.

Déjà vu: is it 1995 all over again?

1995 labour dispute did not end well for French government

The last time France experienced equally prolonged and broad strikes was in autumn 1995 after the then-conservative government of President Jacques Chirac and his PM Alain Juppé announced a similar reform of the SNCF. Analogous to today, the government pushed for this reform in the context of a larger overhaul of the French economy.

Government introduced plans to reform country

Late in August and early in September in 1995, Juppé outlined measures to reform the country. Among other proposals, these reforms included requiring public employees to work for 40 years (instead of 37 and a half years) to be eligible for pensions and shifting the running of the health care system from unions to parliament. It did not end well for the government, as a large social movement built in opposition to the reforms.

Large social movement built in opposition to these plans – government conceded eventually

The first signs of broad-based unrest arose on 10 October 1995 when – in opposition to government plans to freeze civil service salaries in 1996 – 57% of civil servants stayed away from work and 5m workers went out on strike. More groups joined the strikes. The movement turned significantly stronger when, from late November 1995, SNCF, air transport, telephone company and many other salaried workers joined. By early December, over one third of all public employees were on strike. By mid-December 1995, the government conceded to the railway workers and all public employees on crucial issues, including the age of retirement. Most unions returned to work thereafter. 18 months later, Juppé formally resigned after a stinging defeat in the legislative elections of June 1997.

Dispute determined France's image as irreformable

This period of history contributed to France's image that the country is irreformable. In 1996, the government estimated that the labour dispute and strikes had shaved off between 0.4-0.5 ppt off quarter-on-quarter GDP growth during the strikes.

Reasons for failure of government: it was not a lack of political power

A number of reasons have been put forward to explain why the government was unsuccessful, but a lack of political power was not one of them: strikingly, Chirac's majority in the lower house of parliament in 1995 was bigger than Macron's is today (see Chart 2). Unlike Macron, Chirac also held a majority in the Senate, the upper house.

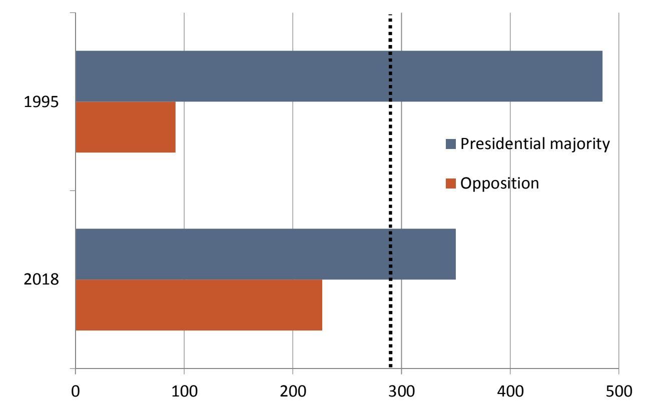
But, the fiscal adjustment was big …

The failure, in our view, mainly resulted from how Chirac went about trying to implement change and the stage of the economic cycle. First, the task to correct public finances was big. In 1995, the French fiscal deficit had reached c5% of GDP, substantially larger than the 3% maximum set by the Maastricht Treaty that France had to comply with in 1998. Chirac, inaugurated in May 1995, thus had to reduce the deficit by over one third in only two years. Cuts to government spending, higher taxes and health care contributions to confront the fiscal deficit were a dominant part of the government's agenda in 1995. Social security represented roughly 52% of total French government expenditure in 1995 (compared to 46% in Germany and 44% in the UK). Coincidentally, the social security system marked its 50th anniversary in October 1995 which bolstered public sentiment towards it.

… and it came as a surprise to many French

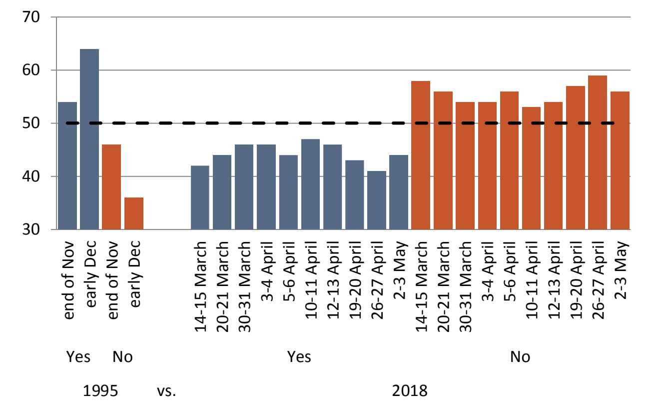
Second, Chirac and Juppé had not been explicit about the extent of spending cuts and the need to reform the country during the election campaign. Consequently, in 1995, the feeling of betrayal among the general public was widespread, as was the resultant opposition to the reforms. While the economy had started to slowly recover in 1994, the unemployment rate had increased in 1991-94 from 7.5% to 10.4% and was still elevated at above 9% in late 1995. There was little willingness among the general public to tighten belts. On top of that, Chirac and Juppé's push for a seemingly conservative agenda and a perceived attack on women's rights was met with square refusal in wider parts of the population, such as students.

Chart 2: In 1995 parliamentary majority was stronger …



Number of seats in the National Assembly. In 1995 the RPR, UDF and DVD built a majority of 485 to 92. In 2018, the majority of the REM and MoDems is 350 to 227. Source: French Ministry of the Interior

Chart 3: … but crucially public support was weaker than in 2018



Answer to the question whether the strikes are justified. Sources: Le Parisien, Ifop

Majority of general public backed the strikes

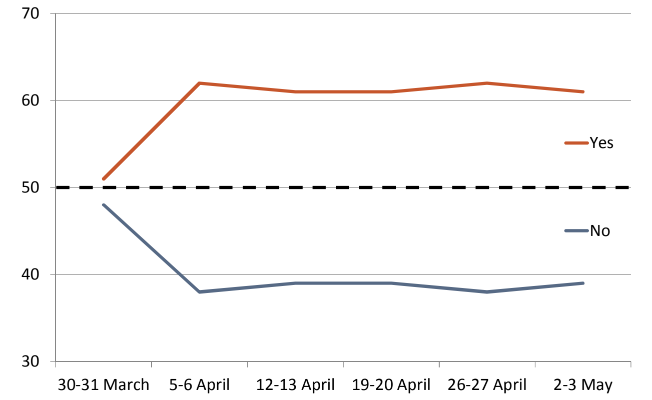
Although irritated by the disruptions, a growing majority of the French supported the strikes. In late November 1995, a poll by the daily *Le Parisien* found that 54% of the population backed the strike. In a poll published by the same paper in early December 1995 that number had risen to 64% (see Chart 3).

This time is different

2018 is not 1995: the general public largely backs the government and the reforms, not the unions and the strikes

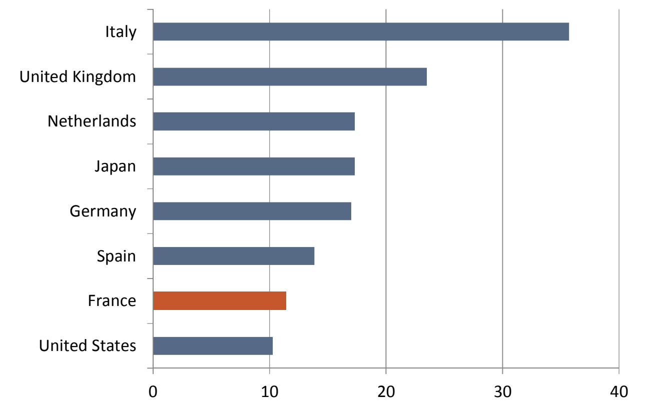
In 2018, the situation is different. While Macron faces stronger opposition to his reforms than in 2017, it is smaller than that which Chirac had to confront in 1995. Crucially, some of the privileges granted to SNCF workers seem like anachronistic relics that are too costly to maintain. For that reason, the general public, of which most face less generous working conditions in comparison to SNCF staff, do not regard the strikes as justified (on average 56% over the last couple of weeks; see Chart 3). Instead of siding with the labour unions, the general public is largely backing the government and supports the SNCF reform. An Ifop poll taken on a regular basis shows that the general public's support for the SNCF reform has actually grown, from 51% in late March to 62% in early May (see Chart 4).

Chart 4: Support for SNCF reform



Answer to the question whether the SNCF reform is a good measure.
Source: Ifop

Chart 5: Labour union density low by comparison



2016 or most recent data. Ratio of wage and salary earners that are trade union members, divided by the total number of wage and salary earners, in %.
Source: OECD

Macron's approval remains high relative to his predecessors

Macron's personal approval remains solid and, according to some metrics, has actually improved since May last year. According to an Ifop poll, when asked for whom they would vote if the first round of presidential elections were to take place today, 33% of the panellists chose Macron (versus 28% in October 2017 and 24% in last year's election). More citizens are satisfied with Macron (42%) than with his two predecessors after one year in office (Hollande: 21%; Sarkozy: 28%). He trails only Chirac (58% in 2003, during his second term), but beats him on whether he has kept his election promises (57% believe so compared to 48% that believed in 2003 that Chirac had kept his word). Macron also scores better than his predecessors on whether he will succeed in improving economic growth, the labour market and the public deficit.

There are three main reasons for Macron's positive approval ratings.

Macron ran on a pro-reform ticket

(1) Macron was clear about his plans to overhaul the country. He ran on a clear pro-reform presidential ticket. A majority decided to go for that ticket, so the general public now does not feel betrayed like it did in 1995.

He is careful what not to push for

(2) The government has been careful in what not to push for.

- With respect to the SNCF reform, Macron scrapped very early plans to close some railway tracks in the countryside. Such measures would have exposed some of the government party's MPs to fierce opposition in the local constituencies. The government has, therefore, managed to hold its ranks and continues to enjoy its big majority in the National Assembly, the lower house of parliament.
- Macron is not pushing for controversial social issues, which seemed to be crucial in turning a strike of labour unions into a social movement in 1995. Students have, this year, protested against more-selective university entry requirements. However, this protest lacks the size and verve of a general student movement. Furthermore, polls show that the general public do not judge the current student protests as justified.

The healthy economic environment plays into his hands

(3) Stronger economic growth is playing into the hands of Macron. Both the domestic and global economy picked up after late 2016, just in time to ease fiscal constraints for Macron. He does not have to invest most of his political capital in spending cuts. His approach has, instead, so far been largely to slow down spending increases, or freeze spending at the current level at most, and let (higher) tax revenue do all the fiscal rebalancing. And thanks to stronger growth, this strategy seems to be working.

The government's mandate today is stronger than in 1995. In contrast, the unions' mandate looks weaker.

Unions' powers still considerable

Nonetheless, the unions still wield considerable power. The strikes show that, despite the low membership and apparent divisions among confederations, the labour unions are able to mobilise French workers to great effect. The level of unionisation is one of the weakest in Europe, with only around 11.4% of employees in unions (see Chart 5). Unions are divided into a number of rival confederations, competing for members, with the biggest being the more moderate CFDT, then the hardliner CGT and the FO, between the two (formerly part of the CGT).

Unions' power stems from negotiations between unions and employers being generally binding

That labour unions can mobilise many workers despite low membership and their divisions can be explained by three reasons.

(1) Negotiations between unions and employers' associations are generally binding, irrespective of whether employers or employees are part of the associations/unions. For companies, this is a challenge. For employees, there is no upside of being a labour union member – only the downside of paying a membership fee (and having to attend meetings at the weekends).

(2) The unions are caretakers of the French health care and social security system. Along with employers, they effectively manage the funds.

(3) The unions represent employees in the workspace, in the works council. Managers must consult health-and-safety councils over such matters as the reorganisation of office furniture, for example, in order to prevent stress.

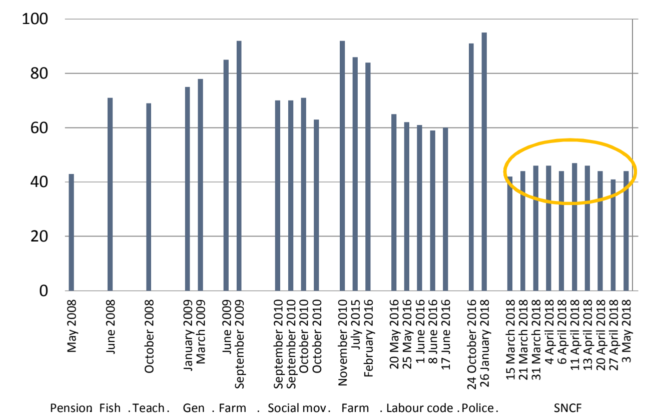
Macron's reforms aim to limit unions' powers

Macron intends to limit these powers, which is why the unions so fiercely oppose his reforms. While he agreed to strengthen the significance of settlements between national unions and industry associations (otherwise he would not have won the support of the FO) in his September 2017 labour market reform, he managed to ensure small companies (with fewer than 50 employees, equivalent to 95% of French companies) can discuss the working conditions, such as working hours and pay, directly with their employees. This process renders the most-efficient solutions because all negotiating parties at the company level have a direct stake in the outcome of the discussions. Furthermore, if these companies successfully forge deals with their workers, other companies will copy the settlements. Whether smaller French firms choose not to hire more than 49 employees, in order to avoid having to deal with a works council, remains to be seen. As part of his proposed reform of the unemployment insurance system, Macron also wants to put an end to the co-management of the funds by the unions and employers. This would further reduce unions' powers. Most unions have also realised during the last year that they can only obtain concessions from the government via negotiations.

Crucially, unions have not won the wider public over

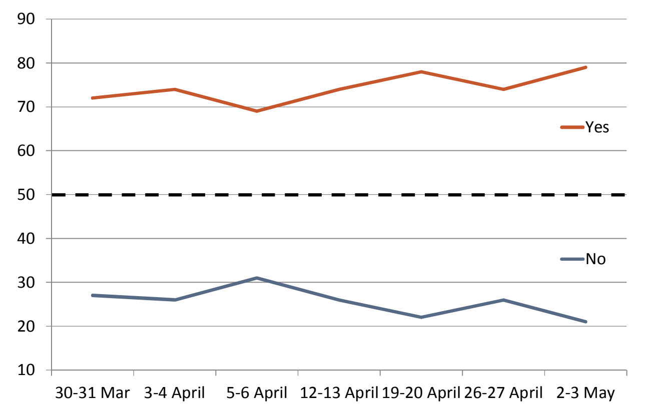
While the unions' powers remain considerable for the time being, the current labour dispute shows that they have lost crucial support. Despite having mobilised a large number of union members and non-union supporters from different sectors, alongside some students, the unions have not won the wider public over in their crusade against Macron's reforms. The level of support for this strike remains low compared to previous protests (see Chart 6). Under Hollande, the strikes against the changes to the labour code during May and June 2016 had the support of 59% to 65% of the population. In fact, we must go back to the pension reform of 2008, under Sarkozy, for the last time there was minority support for a strike (43%).

Chart 6: Weak support for recent strikes versus to previous ones



Share of "yes" answers to the question whether the strike of a particular group or against a particular measure is justified. Source: Ifop

Chart 7: Strong conviction that Macron will hold firm



Answer to the question whether the government will pursue the reform without giving concessions. Source: Ifop

In other words, the weakish unions, which have shrunk in size, face a strong government, that so far enjoys sufficient public backing. Macron and Philippe can, therefore, feel more comfortable than their predecessors in 1995 (Chirac and Juppé). The pressure from "the street" may likely affect the labour unions in an equal way which – at some point – will cause them to largely back down and end the strikes. The number of train drivers taking part in the strikes has already fallen over the last six weeks (from 77% on 3 April, the first day of action, down to 53% in early May). This indicates that the strikes have started to lose momentum. Amid falling support for the protests, unions have decided to consult employees on whether they support the SNCF reform – the week-long consultation will take place between 14 May and 21 May.

Contrary to 1995, the government does not need to back down – or only as much as the labour unions

Lessons from elsewhere: the Schröder-Thatcher mix

Since the situation is different from 1995, labour disputes in other countries may provide insights into how the disagreement may end. Consider, for example, the dispute in the early 2000s between German Chancellor Gerhard Schröder and German labour unions or the confrontation between Thatcher and the British labour unions.

Labour dispute outcomes in two other countries may provide insights

Macron and his reforms have been likened to Schröder and his "Agenda 2010" in the early 2000s (Scenario 2). Schröder's reforms transformed France's neighbour on the other side of the Rhine from the sick man of Europe into its powerhouse in the following decade. Like Macron now, Schröder faced opposition from labour unions when he pushed for supply side reforms between 2003 and 2005. When Schröder presented his reforms to overhaul the German labour market, the unions rejected many proposals as socially imbalanced, short-sighted and inappropriate to offer a path to more growth and employment. Labour unions organised country-wide strikes in 2004 and 2005.

Does Macron have to play it by Gerhard Schröder?

Macron is, however, facing a tougher challenge than Schröder as the French labour unions are much more confrontational and ideologically driven than the Germans were. In Germany, Schröder's centre-left SPD was the natural ally of the labour unions. The labour unions feared that a change in government to the centre-right Christian Democrats led by Angela Merkel would result in even harsher reforms. Consequently, the unions went through a reckoning and turned less confrontational towards the government. Schröder, as the chancellor of a centre-left party pursuing supply side reforms, earned his nickname as the "comrade of the bosses" (*Genosse der Bosse*).

Macron faces a tougher challenge – German labour unions were less ideologically driven

Schröder's experience with German labour unions may not be the one that Macron can hope for. He may have to go further back in history, and across the channel, for some guidance: Thatcher's experience may be more comparable with the situation that Macron must confront (scenario 3).

Macron may face what Thatcher was confronted with

During the 1979 election, the Conservative Party vowed to restore "a fair balance between the rights and duties of the trade union movement". Thatcher, the party's leader, believed that labour laws encouraged unions to use strikes "as a weapon of first rather than last resort". As a consequence, she was determined to face down strikes, especially that of the miners in 1984-85, whatever the scale of the industrial action – and she did. It cemented Thatcher's reputation as the "Iron Lady". She convinced the country that the UK could not be successful if unions were to keep their oversized power. Today's UK, with its dynamic economy, flexible labour market and service-sector-oriented, vibrant capital of London, owes a great deal to Thatcher's reforms and victory over the labour unions in the 1980s.

Thatcher crushed the power of the bolshie British labour unions

Does Macron have what it takes to be "Mister Iron"? Can he reform France like Thatcher reformed the UK? Probably yes. French unions have already accused the government of refusing to compromise an inch. Officials at the more reform-minded CFDT union have said that their proposed amendments to the SNCF shake-up had fallen on deaf ears. More than two thirds of French citizens expect the government to make no concessions (see Chart 7). In a recent TV interview, Macron vowed to maintain the same pace of change while asking for "patience" and saying the task ahead was "immense". France may, therefore, have to endure heavy disruptions during the long weekends in May.

Is Macron "Mister Iron"?

However, Macron's approach still seems to be far less confrontational than that of Thatcher. He has struck a conciliatory tone here and there. More importantly, he is choosing his reforms wisely. For example, the most controversial changes to the SNCF will affect new employees only (from 1 January 2020), not current staff. Unlike last year, the government will not use executive decrees to bypass parliament for the reform of the unemployment insurance system, and possibly also for the other measures. That takes

Macron has struck a conciliatory tone

some of the sting out of the debate. Macron and his government have also been more open in discussing their reform proposals with labour unions right from the start.

A bit of Schröder and Thatcher

On balance, Macron seems to be going for just the right dose of both Schröder and Thatcher to persuade the labour unions to compromise and push through the SNCF changes and the rest of his reform agenda.

France is shaping up under Macron

Macron's reform agenda

If successful, it would pave the way for the rest of Macron's agenda ...

If Macron holds firm, possibly winning over the support of the more moderate labour unions by making some cosmetic concessions to the SNCF reform, it would pave the way for the rest of his reform agenda.

... public sector, unemployment insurance, training, education, pension, EU agricultural subsidies, constitutional changes

Besides overhauling the SNCF, and having already reshaped the labour code and cut corporate taxes, Macron is focusing on a number of other reforms.

- He has introduced plans to make the whole public sector smaller, less expensive and more productive by cutting 120,000 of the 5m public servant jobs (except in health care) until 2022 by offering voluntary buyouts, allowing for more temporary contracts and linking pay more closely with performance.
- To reform the unemployment insurance system, among other initiatives, Macron has proposed that jobseekers' efforts to find work will be monitored more closely. He also wants to open the system up to the self-employed and, under certain conditions, employees who resign.
- Changes are also planned to the professional training system and the education system, for which Macron hopes to increase funding, especially for those citizens that have few qualifications, have dropped out of school and live in poor neighbourhoods. Many companies complain they cannot find skilled labour despite high unemployment. The key will be to link funds closer to performance.
- Much political energy will also be channelled into the overhaul of the pension system: the plan is to abolish the privileges of various groups (early retirement for train drivers at 52) and merge the 37 separate schemes into one.
- Macron has even considered revisiting the EU's agricultural subsidies and slashing the number of MPs by one third – the latter reform will be passed by referendum if parliament refuses to enact the change.

It was all part of his presidential campaign programme

For those who listened to Macron's presidential campaign promises, these initiatives are not a surprise. Still, Macron has surprised many observers in two major ways: (1) he is actually keeping his word and implementing the reforms; and (2) he is doing so at a pace that overwhelms many of his opponents.

Macron's strategy: going about change quickly, overwhelm and ...

His strong political mandate, his parliamentary majority and the healthy economic environment give him the means to keep his word. He also knows that it is better to push these reforms through early since it takes time for the benefits to emerge while the costs usually hit immediately. By going so quickly about change, he is overwhelming many who will struggle to focus on each individual reform and, therefore, fail to form a broad opposition to stop any controversial measure.

... reap the benefits of his reforms early to be re-elected in 2022

Macron intends to implement all major reforms within his first two years in office, ahead of the European Parliament election in May 2019. During that period he will largely ignore his approval ratings. From 2020 onwards, we expect him to start giving some small gifts here and there, to make sure his approval ratings rebound and he is re-elected in 2022.

Long-term growth healthy

France's growth potential could soar

If Macron succeeds in pushing through his reform package, the impact could match that of the measures of Thatcher for Britain in the 1980s and of Schröder for Germany in the 2000s.

Labour reforms have paid off in the UK and in Germany ...

The labour market holds huge potential for France (see Chart 1 on page 1). Focusing on the decade preceding and the decade following major reforms and confrontations between the government and the labour unions, the experiences of the UK and Germany send a strong message. The UK suffered a lost decade between 1975 and 1984, with employment falling at an average annual growth rate of 0.3%. However, in the period after Thatcher made the labour market more flexible, employment grew at an average annual rate of 0.5% as companies started to create jobs again from 1985-1994. In Germany, meanwhile, firms were reluctant to hire in the early 2000s amid a "reformstau" ("reform backlog"), but the rate of employment growth tripled after Schröder's "Agenda 2010" reforms, despite the hit from the financial crisis in 2008-09.

... and will likely also do so in France

The question is whether France can do the same thing. Between 2005 and 2014, French employment grew by an annual rate of 0.5%. Since then, thanks to labour market measures during 2015-16 and the overhaul of the labour code in 2017, employment has risen by 0.8% yoy on average, similar to the rate of jobs growth in Germany (see Chart 10). The strong growth so far probably owes more to the return to normal cyclical dynamics over the last couple of years than to the actions taken so far. In fact, some companies have made use of the lower barriers to hire new employees that resulted from last year's reform of the labour code by actually laying off some of their workers. Net employment has still been positive thanks to the cyclical upswing and should sustain a healthy pace, especially if the domestic environment improves further.

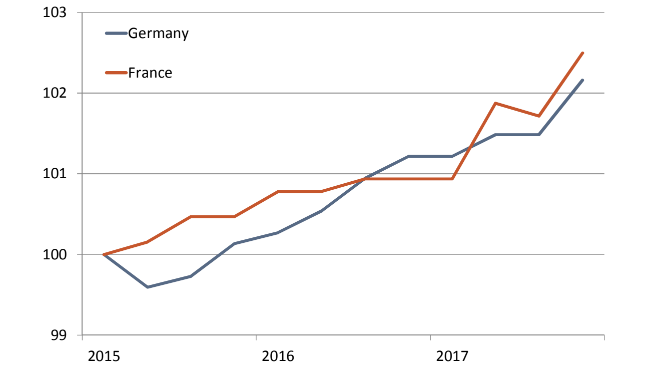
But reforms will take time to take full effect ...

In any case, the reforms will need time to take full effect. Some benefits will take years to become visible, possibly not before the next downturn. The German experience of overhauling the labour market tells a sobering tale: the robustness of the German labour market did not manifest itself so strongly in the global upswing years from 2005-08 vis-à-vis other countries, but rather in how quickly the labour market recovered in late 2009 – that was more than five years after the reforms.

... maybe not before the next downturn

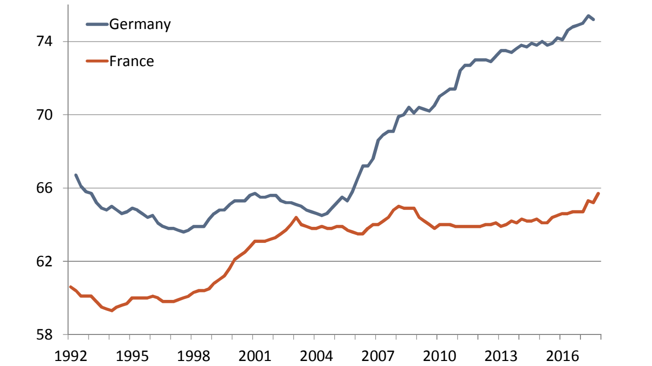
While France may make stronger gains in employment than it would have without the measures taken last year, as employers take advantage of lower burdens for companies in terms of both regulation and taxation, the real benefit of the labour market reform could become visible in the next stage of the cycle. During the double whammy of the financial and euro crises, unemployment in Germany rose only slightly (less than 1ppt during the financial crisis, 0.1ppt in the euro crisis) and healthy employment forces set in quickly.

Chart 10: French job creation has matched the German recently ...



Quarterly data. Employment as % of working-age (15-64 years) population. Indexed at 2015Q1=100. Sources: Eurostat, INSEE

Chart 11: ... but has a long way to go



Quarterly data. Employment as % of working-age (15-64 years) population. Sources: Eurostat, INSEE

French versus German employment rate: big gap, big potential

Today only about 65% of all French people aged 16 to 64 are in work (see Chart 11). In Germany, this employment rate has risen from 65% to over 75% since 2004 because of the reforms. Thanks to the additional tax and contribution payers and the lower expenditure on unemployment, Germany has enjoyed a fiscal surplus and a golden decade. With its reforms, France may shrink its employment gap to Germany over the next 10-15 years. With increasing employment and higher tax revenues, it can experience its own golden decade, while Germany is likely to fall back slowly due to a lack of new reforms. Furthermore, the UK benefited from deregulation and the emergence of the service-sector economy, and Germany just had the right industrial products on the shelf when China was starting to ask for them in the 2000s. Similarly, in the long-term, France could be a major beneficiary of China and other emerging markets' growing appetite for the finest consumer and luxury goods in the world. France has the brands that consumers crave.

Stakes are higher for France to get it right

There may, however, be a major difference to past reform episodes in the UK and Germany: France is reforming itself in the aftermath of the highly disruptive great financial crisis of 2008-09 and the euro crisis of 2011-12. Partly because of the costs of these crises, populists are riding high in opinion polls in the early stages of the reform process. Such populists barely existed in the UK or Germany 10 and 30 years ago, respectively. As a result, France cannot afford to get it wrong. Otherwise, Le Pen or an almost equally dangerous Jean-Luc Mélenchon on the political left could take over at the next election in 2022. The stakes are high.

Stock market performance

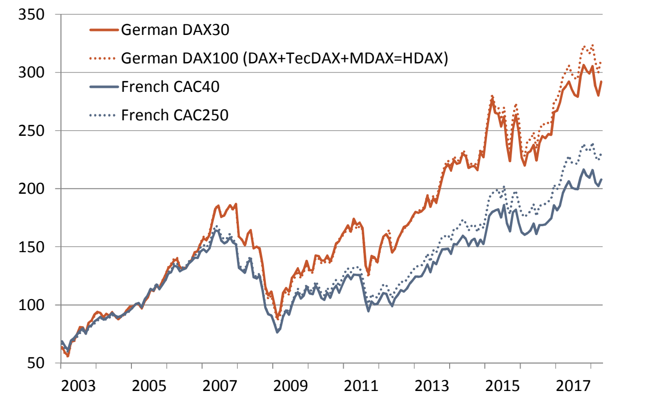
Looking at the stock market performance, it becomes obvious that it will take time for the beneficial effects of the reforms to materialise. Between Macron's election in May 2017 and the market correction in early February 2018, French CAC40 stocks yielded a solid total return (capital appreciation and dividends) of almost 7%. The total return of German stocks in the DAX30 was only slightly lower in the same period (c6%). That the German stocks performed so well relatively to the French ones is probably because German stocks usually respond more to cyclical dynamics. As trade and economic growth picked up across the globe in 2017, German stocks performed particularly well and almost as strongly as French shares.

French versus German stock performance over the last 12 months …

Yet, the German example of labour reforms tells an encouraging tale: for the years to come, even without a major escalation into a trade war (that would weigh on German stocks more than French ones), France seems to have more potential than Germany, whose stocks may already have run most of their course. After years of stock market performance similar to that of French shares, German stocks shifted into a higher gear in 2005 and 2006 – the two years after the introduction of major labour market reforms. To some extent, again, this is because of the German economy's greater cyclicality. Furthermore, Germany's bigger losses in 2008 almost offset its bigger gains in the years before. However, from 2010, German stocks pulled away as the domestic economy did much better than many Eurozone peers. While the French economy did surprisingly well – and performed better than peripheral countries during the two crises – its stocks did not match their German counterparts' performance (see Chart 8 and 9 – German stocks yielded a constant average annual return of c13.0% between 2003 and 2014 while the French stocks yielded only c7.9%).

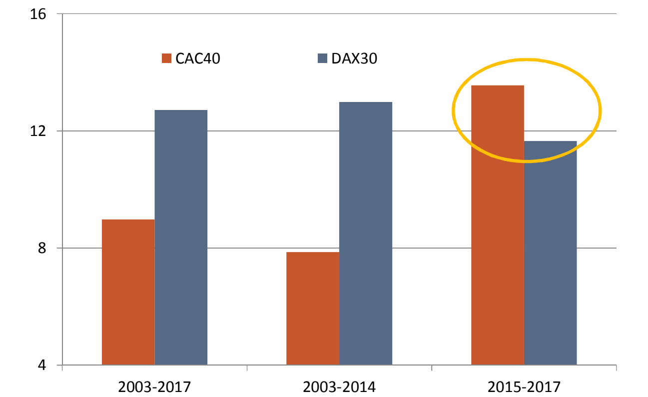
… and over the last 15 years

Chart 8: French versus German stock market performance …



Monthly data. Indexed at Jan-2005=100. Total return used for both indices. Sources: NYSE Euronext, Deutsche Börse

Chart 9: … across different periods



Monthly data. Constant average annual growth rates, in %. Sources: NYSE Euronext, Deutsche Börse

The German outperformance stopped in 2015. From the start of 2015 until the end of 2017, French stocks have performed better than their German counterparts (a constant average annual growth rate of 13.5% versus 11.7%, see Chart 9). While this may be explained by some catch-up of the French economy relative to the German one, it may also point to some payoff from pro-growth reforms in the later stages of the presidency of Macron's predecessor, President Hollande. Spearheaded by then-economics minister Macron, France had already introduced measures to make the labour market more flexible in 2015-16, which pushed the country to the top of the reform league among the major advanced economies, as compiled by the OECD.

Things started to change as early as 2015 in France – with Macron as economics minister

Short-term economic outlook volatile

In the short-term, one-off factors may weigh on GDP growth. In Q1, France experienced unusually heavy snow in late February and early March – GDP growth slowed from 0.7% qoq in Q4 2017 to 0.3%. In Q2, the economy will experience a positive bounce back from the weak Q1. However, this effect will be neutralised by the dampening impact from the strike disruptions. In net terms, we expect GDP to expand by 0.4%. The strikes have a direct effect by lowering public sector output, and an indirect effect from the impact on the wider economy, such as commuters and tourists having to cancel their trips. In 1995, when there

Volatile growth in the short-term affected by exceptional factors were 22 days of strikes, GDP growth slowed from 0.5% in Q2 qoq to almost a standstill in H2 (0.1% qoq in each quarter). Since the current strikes are much narrower, and we do not expect them to last that as long as in 1995, we believe the effect will be smaller.

From Q4 2018 growth at around 0.6% qoq

After some bounce back again in Q3 from the end of strike disruptions (0.7% qoq), from Q4 onwards – in the current global environment – we expect the French economy to expand by a rate of close to 0.6% qoq and 2.4% on an annualised rate over the medium-term. Even if the current strong growth dynamics across the globe were to fade, or headwinds were to arise, the French economy should weather such an environment better than before.

Appendix: what does game theory tell us?

Game theory may be helpful

Economists use game theory to analyse conflicts. In a simplified game theory conceptualisation of the labour dispute, each player has two options: "compromise" or "no compromise". The option each player will ultimately choose depends on each option's payoff (see Table 1).

Both players can choose to compromise or not to compromise

The labour unions (Player 1) want to maintain the status quo of the SNCF in particular and the French social welfare system in general. They choose the "no compromise" option. The government insists on changing the status quo because it is too costly and inefficient to be maintained. Yielding to labour unions' opposition would also jeopardise the power to push through other reforms. So, the government holds firm and rejects compromise.

Base case scenario

Both the labour unions' and the government's preferred option is not to compromise – both lose out (pay or tax revenue)

The only way both players gain (a payoff of 1 for each) is if both choose the "compromise" option. Otherwise, one player gains while the other loses out (a payoff of 2 for the non-compromiser versus a payoff of -2 for the compromiser). However, the unions have gone on strike and the government has chosen not to yield to their pressure. Both players have chosen "no compromise", because that option is the one that seems to provide a larger payoff for either player than the "compromise" option, whatever option the other player chooses (a payoff of 2 versus 1 if the other player chooses to "compromise" or -1 versus -2 if the other player chooses the "no compromise" option). Since both players have chosen the "no compromise" option, neither player receives anything, and instead each suffers a small loss (-1). The union members lose pay as they strike and the government loses tax revenue as the unions strike.

Table 1: A labour dispute in game theory, the base case

		Player 2 (Government)	
		Compromise	**No compromise**
Player 1 (Unions)	Compromise	1 \ 1	-2 \ 2
	No compromise	2 \ -2	**-1 \ -1**

In each cell the number before the backslash refers to Player 1's payoff and the number after the backslash to Player 2's payoff. The bolded option indicates each player's preferred option; the shaded payoffs indicate the outcome of the labour dispute. Source: Berenberg

Payoffs and preferred options can change

Crucially, the game is not just played over one round, but many rounds: payoffs can change from round to round and the stalemate – both players choosing the "no compromise" option – can be resolved.

General public plays a decisive role in determining payoffs and outcome ...

As it is affected by the labour dispute and its outcome, the general public may play a decisive role in the way the payoffs of the government and the labour unions change, and ultimately in the outcome of the labour dispute. First, as time goes by, the option of "no compromise" turns more expensive for either side – the general public turns against both the labour unions and the government, as citizens assume each party has a shared responsibility for whatever harm the strike may cause (limited, delayed or no functioning services). Alternatively, the general public may blame one side over the other. In other words, each player's payoff and, therefore, the outcome of the game are influenced by which player the general public sides with. Whether a player wins the public's support determines how much it can afford to stick to its "no compromise" approach, or have to yield and compromise.

... and so does the economic environment

The general public may side with one or the other player for all sorts of reasons. The business cycle is a key driving force. In times of economic stress, usually the general public blames the government for personal hardship – whether justified or not – and will more likely take the opposing side to the government. Meanwhile, during a cyclical upswing, when the economy is growing at a healthy pace, the government can avoid unpopular spending cuts and reforms may meet more understanding among the general public.

1995: reformers are defeated

In 1995, the government's preferred option turned from "no compromise" to "compromise" – and it conceded on critical issues

In 1995, the general public clearly did not side with the government. The backlash from the general public to the government's uncompromising approach – despite the unions' equally uncompromising approach – was big (indicated in Table 2 by a bigger loss than in the base case of Table 1: -3 versus -1). It was, effectively, too big to bear for the government. Consequently, the government's preferred option throughout the dispute with the labour unions changed from "no compromise" to "compromise". The unions' preferred option continued to be "no compromise". Supported by a larger social movement, the gain from sticking to an uncompromising approach in response to "no compromise" by the government had actually increased (1 versus -1). So, it was just a matter of time until the government would realise that its uncompromising approach would get it nowhere and it conceded on crucial issues eventually.

Table 2: The 1995 labour dispute

		Government (Chirac, Juppe)	
		Compromise	No compromise
Unions	Compromise	1 \ 1	-2 , 2
	No compromise	**2 \ -2**	-1+2=1 \ -1-2=-3

In each cell the number before the backslash refers to the unions' payoff and the number after the backslash to the government's payoff. The bolded option indicates each player's preferred option; the shaded payoffs indicate the outcome of the labour dispute. Source: Berenberg

2018: the unions get real

In 2018, both the government and the unions may end up compromising

In 2018, the situation is different. Given the lack of support for the strikes, the "no compromise" option cedes its status as the preferred choice not only for the government – as in the case of 1995 (see Table 2) – but also for the unions (see Table 3). Judging by the payoffs, neither the "compromise" nor "no compromise" option (always) provides a bigger reward. But, overall, the cost for each player of the "no compromise" option – if the other player also chooses an uncompromising approach – is higher and the benefit to "compromise" – if the other player also chooses a compromising approach – is higher than in the base case (see Table 1 for comparison: 2 versus 1 and -2 versus -1, respectively). It could produce an outcome of the labour dispute that is not only different to 1995, but also to the base case. It is more likely than before both players could go for the compromising approach – and receive a payoff of 2 each.

Table 3: The labour dispute in 2018 – multiple equilibria

		Government (Macron, Philippe)	
		Compromise	No compromise
Unions	Compromise	1+1=2 \ 1+1=2	-2 \ 2
	No compromise	2 \ -2	-1-1=-2 \ -1-1=-2

In each cell the number before the backslash refers to the unions' payoff and the number after the backslash to the government's payoff. Source: Berenberg

Disclaimer

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