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Politoscope

No. 3

François Hollande and France's labour-market rigidity: the market will rock both

- **Hollande is bound to clarify his stance on labour-market and fiscal reform, when elected President** on 6 May as is most likely. Indeed, he has so far remained evasive on both for purely but sensible electoral reasons: **clarification now would only spook popular voters to the extremes, thus complicating the political equation**.
- **But Hollande has already signalled to centrist voters he will not undo his opponent's useful measures**, starting with the repeal of the infamous 35-hour scheme. **So far, he has also restrained from announcing any substantial increase in State interventionism**, starting with a commitment not to raise public jobs.
- **In any case, Hollande will have to displease financial markets or voters just like Mitterrand in 1981-83**, when he was the previous socialist President's economic advisor. **But, the Euro-pragmatist in him should wake up to (the threat of) market attacks on French debt**, due notably to the anger of France's Eurozone peers at inaction.
- **Accordingly, in the worst-case (but not the likeliest) scenario, the market will force him to a U-turn as in 1983**. Indeed, Hollande will have to accommodate his left, if only due to the failed 2005 referendum on the EU constitution. **His Eurozone peers would thus be clever if they allowed him to pretend he extracted some concessions** from them on his growth policies, even if irrelevant.

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I—Back to the future: France's reform Big Bang will be forced by the market (Doisy)

■ The indispensable structural Big Bang needed by France should be politically less problematic than in the 1980s

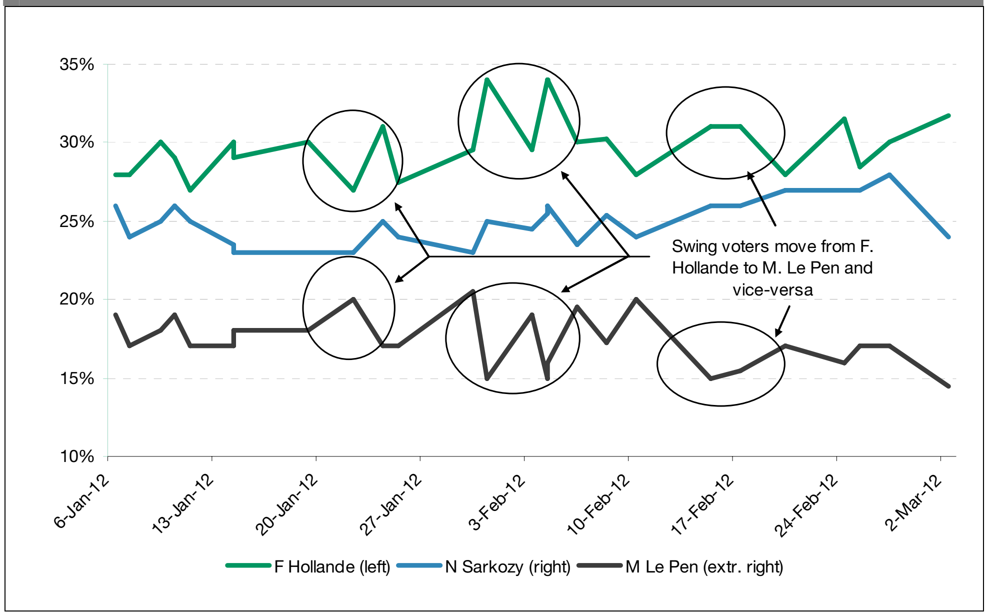
When elected on 6 May, as is most likely[1], Socialist François Hollande will have to clarify his stance on two pressing issues: fiscal austerity and labour-market reform. Indeed, he has remained pretty silent and/or evasive about his intentions on both counts for purely but sensible electoral reasons: he does not want to jeopardise the support he enjoys from popular voters and thus risk losing the election for being too transparent.

This ambiguous stance makes sense until the presidential and general elections are over, as clarification now would only spook popular voters to the extremes. Indeed, as shown by Chart 1, swing voters tend to move from François Hollande (moderate left) to Marine Le Pen (extreme right) on the assumption that these two candidates do not intend to reform the labour market and submit public finances to the new Treaty.

Nicolas Sarkozy is somewhat bolder and more transparent on the fiscal and labour-market issues, but is also widely seen as losing the presidential ballot. Back in 2007, he was elected on a supply-side platform, but did not deliver on it. Logically, he is not getting much credit among centrist voters for this more open stance today. In addition, the economic crisis makes his platform unpalatable for the popular voters he is fishing for.

While shrewd from an electoral point of view, Hollande's strategy is sure to backfire once elected: either popular voters or financial markets will be disappointed. Just like in 1981-83 for François Mitterrand, the previous socialist President (see Box 1), François Hollande will have to displease either financial markets or voters right after the end of the 2012 electoral cycle, as he is sure to be unable to reconcile both.

CHART 1 - VOTING INTENTIONS FOR THE FIRST BALLOT OF THE PRESIDENTIAL ELECTION



Source: BVA, CSA, Harris, IFOP, LH2, Opinion-Way, TNS Sofres

[1] See Politoscope No.1 " The French 2012 elections: an upcoming shift back to the left".

Warned early as a politician of the risks of upsetting both financial markets and Germany, Hollande knows he will eventually have to give in to the latter's demands (see Box 1). Indeed, market pressure will not relent until France clarifies its stance regarding the Euro(pean) project. With not much bargaining power to resist Angela Merkel, due to the poor shape of the French economy, Eurozone membership will prevail, as in 1983.

Box 1 – François Mitterrand (1981-95):
The U-turn of a Keynesian Socialist turned pragmatic by the market

Back in 1981, Socialist François Mitterrand was elected President on a very left-wing platform that included the nationalisation of the banking and insurance sectors plus a Keynesian stimulus, just when interest rates were rising due to Volcker's anti-inflation stance. For the next two years, he stuck to this political line until he was forced to make a U-turn, after being humiliated under market pressure at the Versailles G7 meeting held in 1982.

In March 1983, his party lost the crucially important municipal elections (as these were the first politically important elections since 1981) by a humiliatingly large margin. François Mitterrand was thus forced to change his mind after uselessly devaluing the French Franc three times in a row, in 1981-83. This U-turn is still remembered today in French public opinion as "*le tournant de la rigueur*" ("the austerity turn").

From then on, François Mitterrand's economic policy was exclusively focused on restoring export competitiveness and controlling inflation and public finances without resorting to quick fixes like devaluations. The austerity measures imposed on the French populace included price and wage controls as well as the creation of the first flexible labour contracts next to the sacro-sanct permanent contract[2] to try and contain unemployment.

In March 1986, François Mitterrand also lost the next general elections (for the *Assemblée nationale*, the lower chamber of Parliament) to his right-wing opposition and thus became a lame-duck President for the next two years. During these two years, Prime Minister Jacques Chirac led an even more market-friendly economic policy, including large privatisations and the repeal of the so-called "*autorisation administrative de licenciement*"[3].

When re-elected in 1988, François Mitterrand did not even try to undo the reforms put in place by the previous government led by Jacques Chirac, in particular because the Communists had declined to take part in the new Socialist government. Having to make do with a more centrist parliamentary majority, François Mitterrand decided to continue the so-called "*politique de désinflation compétitive*" (competitive disinflation policy).

In 1981-83, François Hollande was very privy to Mitterrand's U-turn, especially in March 1983, as he was an economic adviser to President François Mitterrand, when the latter eventually decided France would stay in the European Economic Community (EEC). In 1983-86, François Hollande remained highly privy to Mitterrand's U-turn and subsequent electoral disaster as the head of the government spokesperson's private office.

With France likely to be confronted to the same need for sensible economic policies from July 2012 as in 1981-83, it would be pretty unlikely that François Hollande has forgotten the lessons of his formative years. In particular, the lesson that hesitating for too long between two policy options is very costly for an economy under market pressure and that, in such circumstances, the best policy has to be clear-cut and Euro-friendly.

[2] The French permanent labour contract is the famous "CDI" which stands for "*contrat à durée indéterminée*", i.e. open-ended labour contract. Among the many new flexible labour contracts introduced in France over the past two decades and a half, one has become central: the infamous "CDD" or "*contrat à durée déterminée*", i.e. fixed-term labour contract.
[3] The "*autorisation administrative de licenciement*" was a procedure whereby a company had to get an authorisation from the local representative of the Ministry of labour in order to lay off workers.

■ The real issue will be the labour-market reform more than fiscal discipline and Eurozone membership

France's over-riding objective will be to remain in the Eurozone <u>but also</u>, and as importantly, to continue playing the role of the <u>bloc's co-sponsor</u> with Germany. Over the past three decades since the "*tournant de la rigueur*" of 1983, this objective has been blindly pursued by every French President (starting with François Mitterrand), be it at the price of high unemployment. François Hollande will surely be no exception to this rule.

Very unfortunately for François Hollande, the need for labour-market liberalisation is the direct result of Eurozone membership, so that none can go without the other. Indeed, to a degree in gravity, France's economic situation is no different from that of Italy. Whoever he is, the next President will thus have to streamline public finances as well as foster growth, both of which call for ambitious fiscal <u>and</u> labour-market reform.

Since <u>Hollande's proposed growth policy is sure to fail</u>, it is probably meant as a trick to avoid the labour-market issue during the campaign and a sweetener beyond. Intended to "re-industrialise" France with public subsidies for the hiring of young workers and R&D, it will not sufficiently reduce France's cost-competitiveness disadvantage anytime soon. Indeed, it has taken Germany a decade of tough reforms to do so.

Thus, the only issue is whether François Hollande will <u>even</u> attempt to stick to his promises or whether he will <u>willingly</u> renege on them <u>as soon as</u> elected. Common sense would advise him to go for the indispensable labour- and service-market liberalisation right away. But Hollande's innate cautiousness and his party's politics will apply the brakes: as a result, only an <u>external constraint</u> will tip French policy in the right direction.

With Germany having liberalised its labour market recently (and Spain and Italy now following suit), François Hollande will likely have very little choice on this issue. Indeed, not addressing it when everyone else was doing the same was not a problem, back in the 1980s and 1990s (see Box 2). But this time, France would face its Eurozone partners' anger (and that of the market) by refusing to implement a reform others had/have to.

Box 2 – The failed liberalisation of the labour market in France and continental Europe during the 1980s and 1990s

In the second half of the 1980s, when the rise in unemployment appeared inexorable, many European governments (starting in France) felt squeezed between the popular demands for employment protection and the need to cut some slack to companies regarding their headcount. They succeeded in reconciling both… but only for a while.

Indeed, instead of going for a single flexible labour contract as the United Kingdom or Ireland did at the time, continental governments decided to introduce a second tier of very flexible fixed-term labour contracts. This strategy proved a winning one to the extent that the demands of companies and employed workers were satisfied.

However, it proved counter-productive to the extent that it reinforced the rigidity of the main open-ended labour contract and forced commensurate additional flexibility on workers under the second-tier fixed-term contracts. In other words, the protection of incumbents came at the price of rising flexibility <u>and</u> unemployment for young and old workers.

The British and Irish cases are living proof that, like it or not, the only really effective labour-market reform has to offer <u>only one sufficiently flexible labour contract</u> for companies to optimise their headcount. Very importantly and contrary to a widely held view, liberalisation does not have to come at the expense of workers' fundamental rights.

■ In the worst-case but not the likeliest scenario, pressure from Eurozone peers and markets will force a U-turn as in the 1980s

If only because of the failed referendum on the EU constitution in 2005, François Hollande will have to navigate through opposing forces running through the left. Then, the Treaty was rejected because it aimed at enshrining free markets as a founding principle of the EU through the inclusion of the Services Directive in the Constitution[4]. This rejection was a manifesto of typical French (left- and right-wing) anti-market prejudice.

In this respect, it would prove politically helpful if his Eurozone peers allowed Hollande to pretend he extracted some concessions from them, even if irrelevant in reality. Hollande's demand for a renegotiation of the treaty would thus be used to trick the French public into accepting less palatable reforms, including the labour market. Allowing him to claim his growth policies were included would thus be just a political sweetener.

Thus, the worst-case (though unlikely) scenario is that France will resign itself to labour-market liberalisation, only after such inefficient growth policies proved useless. This would hopefully unfold over a few months (and not years as in the 1980s) without too much social unrest. A possible (and unfortunately desirable) catalyst for such a U-turn would be a substantial and unstoppable rise in unemployment, in particular for young people.

Another efficient catalyst in this context would be the market pressure likely to follow if Hollande were to prove too hesitant to go for a bold enough reform platform. An unpleasant prospect for a freshly-elected President, this should prove a powerful incentive for him to avoid playing stupid games with markets. The alternative (relentless market attacks) should quick enough prove sufficiently close to the worst-case scenario.

The ultimate guarantees for a better-case scenario are twofold: François Hollande must remember 1981-83 and has always been a convinced European at heart[5]. This should help him make the choice of effective pro-growth reforms such as cutting public spending and liberalising the labour (and services) market(s) one way or another. The real challenge for him here will be to find the political formula to sell it to the French public.

*

François Hollande has already signalled to centrist voters that he will not undo some of his opponent's most symbolic and useful measures (if and) when elected. In particular, he has made it known that he will not reinstitute the infamous 35-hour scheme that has been undone by Nicolas Sarkozy[6]. He also has explicitly subscribed to the fiscal deficit reduction path agreed by Nicolas Sarkozy with his Eurozone peers.

He has so far restrained from committing to anything substantial in terms of pleasing the supposed appetite of his popular electorate for State interventionism. He has also been rather prudent not to elaborate on how he would reduce the deficit, just like his opponents. He has proposed only marginal amendments to his opponent's reform of the pension system or staffing policy with no increase in the number of public jobs.

All in all, François Hollande's only ambiguity so far is not to have made any proposition of supply-side reforms, regarding labour-market rigidity in particular. While he cannot be blamed for being tactical, clarification will be needed soon after the elections. (The threat of) market attacks on French sovereign debt markets due to France's Eurozone peers' anger at inaction should suffice to force the Europhile pragmatist in him.

Nicolas Doisy

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[4] The Services Directive (aka the Bolkestein Directive) aimed at completing the European internal market by liberalising non-financial services but was substantially watered down after the French referendum.
[5] In 1993-97, Hollande presided over Jacques Delors' political think-tank, the "*club Témoin*".
[6] In a different but highly symbolic matter (foreign and defence policy), he has let it known that he will not repeal Sarkozy's decision for France to reintegrate NATO's integrated command.

II— Two hot topics in the French elections: the Euro and the labour market (Perrineau)

For several months now, voting intentions for the French presidential election (on 22 April and 6 May 2012), have been pointing to a victory for the Socialist candidate, François Hollande, who is expected to obtain the most votes in both the first and second ballots. However fragile or reversible these voting intentions may be, in a French and European context in which volatility of the electorate is a stark reality, we nevertheless must envisage the prospect of a victory of the Socialist candidate and the impact that it could have on the economic and social situation in France.

The French Socialist party has traditionally been viewed as unique among the European left wing: it has always been strongly attached to the "socialist" label. Albeit defined as "left-wing reformist", it dismisses the term "social democrat", and has never showed any sympathy towards the "third way", promoted in the UK by Tony Blair and Anthony Giddens. It is thus useful to examine how François Hollande, if he were to win the next presidential election, envisages politics in France at an economic and European level.

On a European level, one of the strong points of European politics that the Socialist candidate wants to put in motion relates to a renegotiation of the European treaty resulting from the Summit of 9 December 2011, which, with the exception of the UK and the Czech Republic, decided on a reform towards faster economic and budgetary integration of the euro zone countries.

This approach reminds us of the demand for a revision of the euro zone Stability Pact presented by the Socialists during the general elections campaign of 1997. The Treaty on Stability, Coordination and Governance that was approved by 25 heads of State is the fruit of complicated negotiations on extremely sensitive subjects. It is an essential mechanism which – beyond the message that it sends to Europeans – attempts to reassure players within the system such as the European Central Bank, European Commission, or the financial markets.

Calling into question this balance will not be an easy task and could appear "counter-productive", particularly vis-à-vis financial markets and rating agencies. Combined with other proposals, this demand for renegotiation contributes to undermining the image of the Socialist candidate as a responsible administrator. The proposals on the nuclear issue, public spending and increasing the number of civil servant jobs, along with the planned measure to create government-subsidised jobs for youths, constitute measures that reinforce interrogations over the status of the Socialist candidate's project.

Will Hollande's promises ultimately be sharply scaled back, or not kept, or are they premises of public policy that will be implemented, with a risk of destabilisation? This hesitation can create tumult among centrist voters, whose European bent is known. It is true that this type of strategy corresponds to Mr Hollande's will to clearly reposition himself on the left and please the left-wing players that will support him as of the first presidential round (the popular left-wing Socialist deputy Arnaud Montebourg, for example) or those whose support he will need in the second ballot (the far left).

Thus, without calling into question the necessity to reduce the public deficit and debt, Hollande has taken the risk of damaging his capital as a "realistic candidate", as who could believe that anytime in the short term the CDU-FDP majority leading Germany would allow the creation of eurobonds, or the mutualisation of sovereign debt, or even give the ECB the ability to finance States via currency printing?

Beyond these European issues, a blind spot remains in the Socialist candidate's current project: that of the reform of the labour market. As a matter of fact, the European countries that currently seem to be doing the best are the ones that have adopted winning combinations of both budgetary adjustment and deep reforms of the labour and production markets[7].

Three months away from the presidential elections, the Socialist candidate's programme remains very elusive on the subject. As for a considerable portion of the outgoing majority, the reason is the fear, in the event of a victory for the left, of a highly reactive social movement related to this subject (which we got an idea of during the long protests of autumn 2010 against the reform of the retirement age).

However, with proposals stemming from both government projects and outgoing president Nicolas Sarkozy as candidate, it is possible that the presidential debate will focus on the reform of the labour market based on – to use Prime Minister François Fillon's expression – four "structural decisions": training for the unemployed, easing of the cost of labour, measures to boost the competitiveness of companies and the length of the work week.

However, the room for manoeuvre in this debate remains relatively limited, in that current voting intention polls show that Sarkozy's score is tightly squeezed (with 25-26% of voting intentions), for the time being, between the Socialists, which have a high level of voting intentions (above 30%), and a strong extreme-right National Front party (between 17% and 19%).

Moreover, beyond all their differences, the Socialists and the National Front are not inclined towards a debate on the labour-market reform. Beyond the presidential campaign and the emerging power struggle, the prospect of a victory of the Socialist candidate and the strong level of influence of the extreme right put both the debate on European policy and the reform of the labour market "under influence".

In the event of a victory of the left wing, Hollande will be led to make concessions to a portion of the left-wing powers who made up the "No" campaign in 2005, at the time of the French referendum on the Treaty for the European Constitution. On the other side of the political chessboard, the electoral threat presented by National Front leader Marine Le Pen contributes to reducing the leeway of the debate on decisive issues such as the euro zone or the reform of the labour market.

Pascal Perrineau

[7] The Netherlands, Denmark, the UK and Germany have all explored these paths, and, despite their differences, all find common ground: these countries have implemented budgetary adjustments based on spending alongside public policies that seek to boost demand for labour and deregulate the production and labour markets.

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