Joint Economic Committee
Representative Pat Tiberi, Chairman | Senator Mike Lee, Vice Chairman

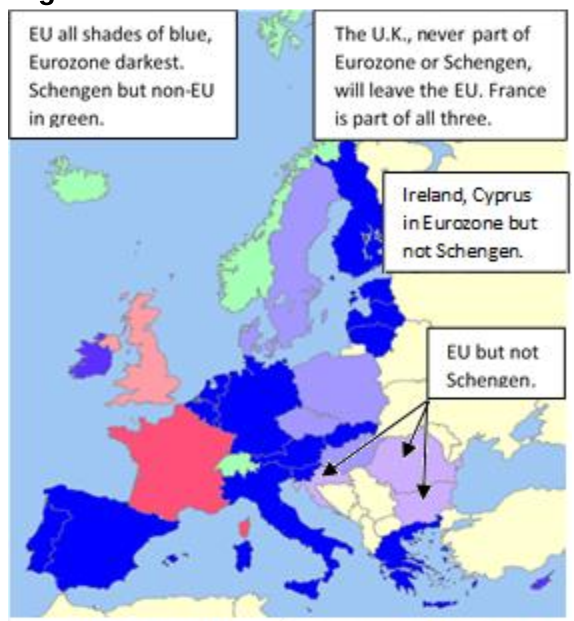
April 21, 2017

French Elections, the Eurozone, and the EU's Fate

BACKGROUND

France was a founding EU member. France was one of the original six signatories to the Treaty of Rome, which established the European Economic Community in 1957, the forerunner to the European Union (EU). France has the third-largest EU economy after Germany and the United Kingdom with a GDP share of 15 percent. France also was a leading advocate of a European common currency and is a member of the Schengen Area within which people can move freely without passport checks. (Not all EU countries are part of the Schengen area.) However, an anti-EU party, the National Front, won 24 out of France's 74 seats—the most of any French party—in the May 2014 European Parliament elections. Its leader, Marine Le Pen, is running in the upcoming national presidential election on a platform that includes withdrawing France from both the Eurozone and holding a referendum on EU membership.[1]

Figure 1



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Stalled EU integration. Momentum toward further economic and political integration of the EU countries has fragmented among the people of Europe. Major concerns are (1) widely different economic, fiscal and banking system conditions in different member states, (2) large streams of refugees and migrants (mostly from Syria, Afghanistan, and Africa), and (3) a perceived lack of democratic accountability on the part of EU institutions in Brussels. Primarily the first two concerns have given rise to popular opposition movements. Some of these movements emphasize their opposition to intra-EU cross subsidies and bailouts while others stress additional demands on public services—including policing and homeland security—and, importantly, the perceived cultural infringement from large, new migrant populations.

The United Kingdom decided last year in a national referendum to leave the EU, and British Prime Minister Theresa May formally initiated the withdrawal process on March 29, 2017.[2] In recent parliamentary elections in the Netherlands parties opposed to EU integration increased their representation, but are not expected to join the government.

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[1] "Marine Le Pen Centers Presidential Run on Getting France Out of Eurozone," *The Wall Street Journal*, January 18, 2017.
[2] See, "'Brexit' Can Give Free Trade New Momentum," *JEC*, March 31, 2017; https://www.jec.senate.gov/public/_cache/files/6f8ec1ce-9ef4-4116-9af1-9d9b866b59be/033117-bre.

The French electoral process.[3] France is a constitutional republic in which the president holds significant authority compared with the prime minister and the parliament. The president is elected separately by popular vote. A candidate wins the presidency, which has a 5-year term, either by receiving more than 50 percent of the votes in the initial round of voting or, if no one receives a majority, by finishing first or second and then winning the runoff election two weeks later against the other qualifying candidate. The first round of voting is set for April 23 and the second round for May 7 this year. The presidential race has always been decided in the second round.

Madame Le Pen plans to lead France out of the Eurozone and then call a referendum on leaving the EU. However, Le Pen's party, the National Front, currently holds only two seats out of 577 in the National Assembly (the lower chamber of parliament) and is unlikely to win a majority in the next election, which means she may not be able to proceed with her plan. The National Assembly election will be held on June 11 and 18. If opposition parties to the president win a majority, the parliament has the right to appoint a prime minister in consultation with the president (an arrangement called cohabitation). It is conceivable that Le Pen would try to call a referendum before the parliamentary elections under Article 11 of the constitution, but the prime minister must submit the motion, which he or she could refuse to do, and the council of state (a constitutional court) must grant approval, which it could delay until after the legislative vote.[4]

IF FRANCE LEAVES THE EUROZONE

The return of exchange rate risk. Marine Le Pen has said that during the first six months of her administration she would negotiate with other countries that also want to leave the Eurozone establishing with them a basket of national currencies pegged to one another at mutually agreed rates to function in parallel with the euro. The currency pegs in the basket would be adjustable, so that individual countries could devalue or revalue their national currency as their circumstances change and as they see fit. A reintroduced French franc would be in the basket. The plan's details and the practicality of its implementation are not entirely clear, however.[5]

Reverting to the franc would mean that bank deposits in France would need to convert from euros to francs. Domestic financial obligations would presumptively convert to franc as well, including government debt, because the French must be able to make all their payments with the currency in which their earnings and savings are denominated. Prices for goods and services would have to be stated in francs as well, and the government should provide enough bills and coins for the population to convert their physical euro currency holdings to francs.

In this scenario an exchange rate risk arises with respect to French debt held by foreigners whose home currency is not the French franc but the euro or another currency. The French franc may have less purchasing power than the euro. Uncertainty over its exchange value could motivate holders of French bonds to try selling them while they can still get euros for them, which, as France owes a significant amount of external debt, could bring on another Eurozone financial crisis.

Total public and private French debt is about 385 percent of GDP and 57 percent is external debt. Roughly €1.4. trillion (about $1.6 trillion) of French debt is owed to foreign banks and €3.5

[3] See "France's 2017 Presidential Election: In Brief," Paul Belkin, Congressional Research Service, April 13, 2017.
[4] "President Le Pen's first 100 days," *Politico*, April 21, 2017; http://www.politico.eu/article/president-marine-le-pens-first-100-days-hypothetical-french-election/
[5] "Marine Le Pen Centers Presidential Run on Getting France Out of Eurozone," *The Wall Street Journal*, January 18, 2017.

trillion (nearly $4 trillion) to foreign non-bank financial intuitions. The countries with the largest exposure to French debt are the U.K., Germany, and Japan (using IMF data that identifies about half the non-bank debt). U.K. banks have the most exposure (over $400 billion) followed by German banks ($215 billion). American banks have only $85 billion worth of exposure to French households, businesses and government.[6] Trade with France accounts for a small share of total U.S. external trade, although the EU as a whole is America's largest trading partner in terms of exports and imports combined.

Even though a French departure from the Eurozone may be years away, uncertainty over the timing and form of conversion[7] nonetheless could start to raise the cost of French government debt, lower the value of French bonds and other assets, put renewed pressure on banks that hold French assets as part of their capital requirements, and make European sovereign debt generally appear less safe, especially the sovereign debt of countries on Europe's periphery. The most imminent risk of a Le Pen victory is to the sovereign debt market and the European banking system.

FRANCE HAS NO NEED TO LEAVE THE EUROZONE

Domestic policy is key. France faces serious economic challenges, in particular an unemployment rate of about 10 percent and slow economic growth—only 1.1 percent last year—but they are due mostly to domestic tax and labor laws that inhibit investment and hiring, not the euro. For example, France has the highest capital gains and estate tax rates in the developed world, the second-highest corporate income tax rate, and a highly regulated labor market.[8]

The common currency has benefits. The euro eliminated exchange rate risk and transaction costs associated with currency exchanges between France and its Eurozone trading partners. The European Central Bank (ECB) controls the supply of euros and euro interest rates. But it is not clear how a Le Pen government would use the fiscal and economic flexibility afforded by the French central bank's ability to control the money supply and move interest rates. Creating too much money would lead to higher borrowing costs, a weakening currency, higher import prices, and slower economic growth eventually. The French franc had not been among the world's strongest currencies and France gave it up willingly.[9]

The euro is not causing France austerity. The conditions established for membership in the Eurozone—government deficits not to exceed 3 percent and gross government debt not to exceed 60 percent of GDP—have been assailed by some member states that find it difficult to meet them and require accommodative policies from the ECB and financial assistance from other member states.[10] Marine Le Pen has spoken out against the conditions and France's budget

[6] "Who Has Financial Exposure to French Debt?" Special Commentary, Jay H. Bryson, *Wells Fargo,* March 28, 2017.
[7] Alternative conversion scenarios are conceivable, including partial conversion. To illustrate, Harvard economist Martin Feldstein had suggested in the case of Greece reverting to the drachma for wages and prices while bank balances and obligations would remain in euros. "Let Greece take a eurozone 'holiday'," *Financial Times*, February 16, 2010. In any case, technical questions arise over how the central bank of France and the ECB would manage the euro money supply with another currency entering circulation to take its place in one country.
[8] See, Reasons 6, 7, 8, and 9 in "Ten Reasons to Reform the Tax Code," *JEC*, April 12-18, 2017, and "France opts for big over small with its labour reforms," *Financial Times*, March 20, 2016; https://www.ft.com/content/c248a776-eb63-11e5-bb79-2303682345c8
[9] By contrast, the U.K. refused to give up the British pound for the euro and the Deutsche Mark was a strong currency that West Germany gave up only in exchange for reuniting with East Germany and anchoring the unified Germany in a more united Europe. Other, smaller European countries, some in the EU and some part of Schengen or the European customs union, also have kept their national currencies.
[10] For example, see, "Austerity Only Benefits Germany and Destroys Europe, Renzi Says," *Bloomberg,* September 2016.

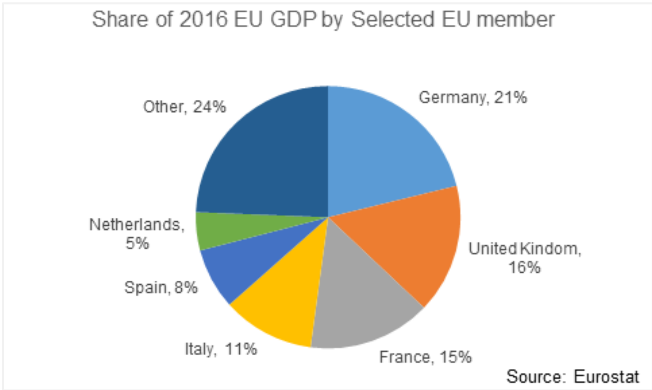
deficit also does not meet them, but France does not need assistance. Furthermore, while the ECB's primary mission is to maintain price stability, in the aftermath of the financial crisis that caused severe, prolonged economic, fiscal, and banking problems in several Eurozone countries, the ECB also made clear that it will "do whatever it takes" to counteract these problems in order to preserve the Eurozone.[11] Thus it is unclear why disapproving of the specific terms of Eurozone membership should motivate Le Pen and the National Front to take the drastic step of rejecting the euro.

Possible alternative reasons for their position may be to pursue still higher government deficit spending and to deflect attention away from the need for domestic reforms so difficult to implement that current President Francois Hollande had to bypass regular parliamentary voting procedures to enact even relatively modest changes to labor laws.[12] But more government spending and turning away from market reforms will not benefit the French economy over time.

IF FRANCE LEAVES THE EU

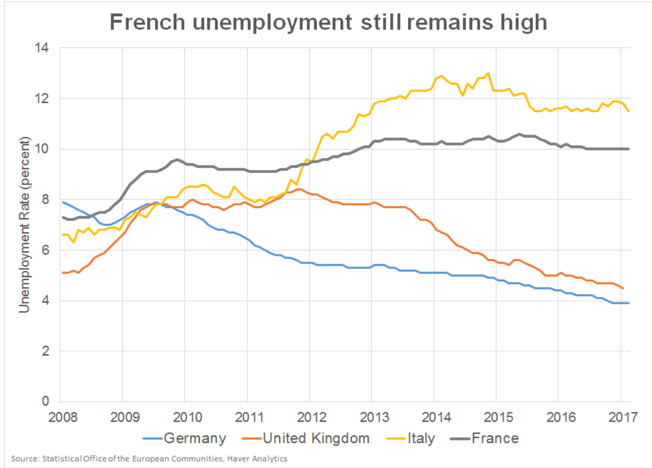
End of EU in its current form. France joining the U.K. in exit negotiations with the EU could have far-reaching consequences. First, it would end the European project as it is currently understood. The 28 member states have a combined population of 510 million, of which 64.6 million live in France and 63.5 million live in the U.K., meaning that 25 percent of the people in the heart of Europe would be leaving the Union. The EU would lose its second- and third-largest economies that together account for over 30 percent of EU GDP (Figure 2).

Figure 2



Further strengthening of Eurozone more difficult. Second, even if France were to continue using the euro while it extricates itself from the Union, it is less likely to further integration of the European banking system and other stabilization policies. Some Eurozone countries have found it much harder to overcome the last financial crisis without the ability to create their own money, adapt interest rates to their individual circumstances, and adjust currency exchange rates relative to their major trading partners. A national currency provides flexibility that using the euro does not. Without a more cohesive banking system and more reflexive financial and economic stabilization mechanisms, the currency union is more vulnerable to defections.

Figure 3



[11] Speech by ECB President Mario Draghi at the Global Investment Conference in London, July 26, 2012.
[12] "French government forces labor law through parliament, shrugs off protests," World News, Reuters, July 5, 2016; http://www.reuters.com/article/us-france-politics-protests-idUSKCN0ZL0TM

Other countries may be encouraged to leave. Eurosceptics in Italy, the fourth-largest EU/Eurozone economy, have somewhat stronger reasons to seek more monetary control than in France. Since the financial crisis, Italy has experienced significant economic austerity. Italy's debt-to-GDP ratio is over 130 percent, and its unemployment rate is higher than that of France (see Figure 3). ECB policy assists Eurozone governments that have large national debts, face economic stagnation, and may have difficulty borrowing, but fiscal, labor market, and social program reforms ultimately are needed to restore sustained growth. The ECB urges such "structural" reforms but they can be very difficult to implement politically. Voters rejected Prime Minister Renzi's constitutional referendum last December, which would have reduced the role of the Italian parliament's upper chamber in the policymaking process and made introducing reforms easier. Among opponents of structural reforms, returning to the national currency may appear more appealing.

The eurosceptic Five Star Movement (MS5) gained momentum in Italy amid economic stagnation, high unemployment, and outside pressure to make uncomfortable changes. Many observers believe an early election will be called sometime before early 2018.[13] If Marine Le Pen were to win the presidency of France, an erstwhile core advocate of European integration, it could encourage more Italians to advocate leaving the Eurozone and the EU.

CONCLUSION

Whatever Marine Le Pen's chances of winning the French presidency are, the National Front is much less likely to win a majority in the June parliamentary election. This could lead to a government that stays the course on EU and Eurozone membership.

Le Pen has outlined a plan to first prepare for exit from the Eurozone and then to call a referendum on France leaving the EU. If a president-elect Le Pen were to attempt calling for a referendum before the parliamentary election, the effort would likely fail as the time is very short to organize one and the prime minister or the constitutional court could thwart it. However, even though she may be unable to hold a referendum either in the near or long term, and even though a decision to leave the EU would not take effect for many months and perhaps years, a turbulent period could ensue. Uncertainty and anxiety over what will happen could have immediate deleterious effects on the bond market and business investment and employment in France and spill over to all of Europe.

France and other EU countries are in a bind between sluggish economic growth and certain EU/ECB policies that range from only modestly helpful to unwelcomed. France, in particular, does not need to leave the EU or Eurozone to solve its problems and doing so may not produce the anticipated benefits. Pro-growth market reforms could boost its economy, and the same holds for other EU countries. But the EU is wise to consider alternative paths forward as well.[14] Even if Marine Le Pen and the National Front do not win, discontent with the way the EU functions in various respects likely will not disappear but continue to feed euroscepticism.

[13] "How Early Elections in Italy Could Test Populists: QuickTake Q&A," Bloomberg, February 21, 2017; https://www.bloomberg.com/politics/articles/2017-02-09/how-early-elections-in-italy-could-test-populists-quicktake-q-a
[14] A European Commission White Paper on "The Future of Europe," March 1, 2017, lays out five scenarios.