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FRANCE AND ITALY: RISK UPDATE

Berenberg Macro Flash

Jointly with a select group of investors, I've just spent almost three days discussing the economic and political outlook for France and Italy with senior officials from both countries in London, Paris and Rome. We visited the finance ministries, Banca d'Italia, the OECD, industry and banking associations, and the Italian parliament. We also spoke to a number of senior consultants including a French professor specialising on constitutional law.

Of course, our contacts did not have uniform views. In Paris, some preferred Emmanuel Macron over Francois Fillon, others saw it the other way round. Some were convinced that Marine Le Pen stands no chance of winning while others were more afraid of a potential upset. Some even believed that she couldn't do too much damage if in power anyway.

Nonetheless, a few semi-common themes emerged:

ECONOMIC OUTLOOK
In France and Italy, the economies are gradually on the mend. Although the effects are hard to quantify, both countries benefit from some recent reforms. A lot remains to be done, though. While France has tried a large number of small-scale reforms in recent years, only some of them have really made a difference. Resistance from French trade unions, who have little exposure to what actually happens on the shopfloor, remains a major problem. In Italy, the Renzi labour market reform has contributed to employment growth although the expiry of some temporary subsidies has now caused a corrective dip in the employment data.

Whereas the international environment is also helping a little, domestic demand is the major driver of the cyclical recovery in France and Italy. After unusually low oil prices had temporarily boosted private consumption last year, investment is now firming in both countries. On balance, growth could be slightly stronger in 2017 than last year.

Officials in both countries hope for some further initiatives to strengthen the cohesion of the Eurozone once the French and German elections are out of the way.

FRENCH POLITICS
In France, our contacts differ as to whether or not Le Pen has a chance to win the presidential election this time. But the risk that Le Pen could also muster a majority in the French parliamentary elections on 11/18 June and hence implement her agenda seems to be very small. To the extent that she could influence actual policies, she would probably focus mostly on her domestic "law and order" agenda and immigration control. Her anti-EU and anti-euro stance could be more negotiable and hence potentially be softened according to some of our contacts.

Against the wishes of a prime minister who needs to be backed by parliament, a president Le Pen could not call a referendum on leaving the EU. Whether she could theoretically hold a referendum on leaving the euro against the wishes of a parliamentary majority might have to be decided by the Constitutional Council in the end. (I would expect this council of often elderly worthies to exercise their discretion with a pro-European tilt).

Opinion polls give a clear lead to **Macron** over **Fillon** for the first round on 23 April. But whereas the polls have shown fairly steady support for Le Pen at around 26% over time, the polls were no reliable guide to the relative strength of her potential mainstream opponents in the last four months. For instance, the polls did not fully capture the surge of Fillon at the expense of Sarkozy and Juppe in the Republican primaries. Fillon thus still has a chance to snap back, even if most of our contacts did not see that as the most likely scenario.

Both Fillon and Macron are planning serious structural reforms. Whereas Fillon's programme is more Thatcherite with significant front-loaded cuts to public spending and longer working hours, Macron's wants to emulate the Scandinavian "flexicurity" model for the labour market with less radical but well targeted changes. Macron's ideas are largely in line with OECD reform recommendations for France.

A **president Macron** would - like Le Pen - almost certainly not have a parliamentary majority of his own. He would thus have to work with either moderate Socialists (with those who do not defect to him in the first place) and/or with the centre-right Republicans who are likely to do better in the parliamentary elections than in the presidential vote. If so, the actual policies a prime minister appointed by Macron and backed by a parliamentary majority may pursue could include ideas coming from other parties.

To which extent a **president Fillon** could implement his reform agenda if elected seems unclear. While some of our contacts believe that he could and would largely do what he has proposed, one contact suggested that he might lack the legitimacy and support for drastic change as a second-round vote for Fillon would be seen more as an anti-Le Pen vote than an endorsement of Fillon's programme.

ITALIAN POLITICS
In Italy, the **risk of early elections** in 2017 has receded, although it has not fully vanished. Instead, the Gentiloni government is more likely to last until the "natural" end of the current 5-year parliamentary term in early 2018. That is good news. Until Fillon's 'fake jobs‘ scandal fattened the tail risk that Le Pen might win in France, we had seen early elections in Italy as the top risk for Europe this year. A sign that elections might still come early would be if the major parties (that largely means Renzi and Berlusconi) were to agree on a new election law fast. Unlikely but not impossible.

The most likely outcome of new elections would be a hung parliament. Whereas Matteo Renzi will probably win the leadership contest within his centre-left Democratic Party in the open primaries on 30 April against the soft-spoken justice minister Andrea Orlando, he probably won't do so very convincingly, probably garnering just 50-60% of the votes.

What the **Five Stars** would be up to if they ever got close to power remains a mystery, probably even to themselves. They seem to be more erratic than ideological, more Trump than Le Pen, more Tsipras (who ultimately decided to stay in the euro) than Varoufakis. That the Five Stars could forge a stable alliance with the radical right of the Lega Nord (and the even more radical Fratelli d'Italia) seems unlikely as the left wing of the Five Stars would be very uneasy about it.

A **hung parliament** after new elections in Italy would prolong the period of political uncertainty for Italy (nothing new for the country). However, it would probably not put the country on the road to euro exit. While many voters in Italy (and France) are unhappy with how their economy has performed in the euro, there is little nostalgia for the Lire in Italy (or for the Franc in France).

In Rome, we spent quite some time discussing the **banking problems**. Italy has made progress. The stock of non-performing loans finally started to fall late last year. Both the Banca d'Italia and the Italian Banking Association presented evidence that Italy is not suffering from a major credit crunch. Offloading non-performing loans would not raise credit growth very much as the still tepid but improving flow of new loans reflects demand for credit much more than credit supply. Meagre economic growth of around 1% would probably suffice to gradually strengthen the profitability of banks amid ongoing cost cuts. While deposits are migrating from a few weak regional banks to their stronger competitors, the overall deposit base remains solid. Politics and macroeconomic fundamentals rather than banking issues will shape the economic performance of the country according to them.

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