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WEEKLY ECONOMIC COMMENTARY

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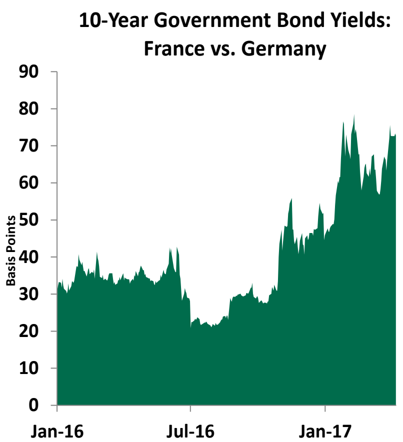
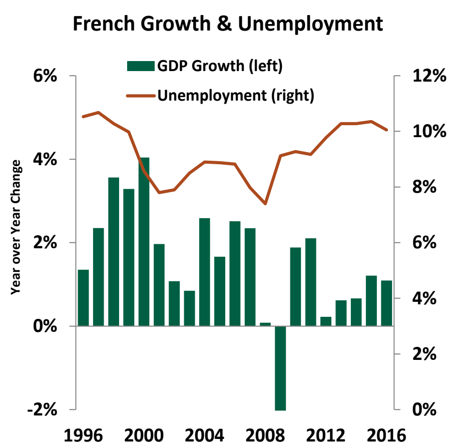
The French take great pride in the uniqueness of their culture, which was once their leading export. But there is nothing particularly French about French politics these days. The country has been afflicted by the same malaise that has caused the rise of populism across the developed world. A potent combination of industrial decline, high unemployment, worries over immigration, and a perceived loss of identity have eroded faith in the status quo.

In something that would have come as a shock just six months ago, both a far right and a communist candidate have a fighting chance at occupying the Élysée Palace. And that prospect has world markets on edge. When France goes to polls for the first round of its presidential elections this weekend, voters will weigh in not only on the future of France, but potentially the future of Europe and its currency union.

Most simulations of the two-round French process predict that independent candidate Emmanuel Macron, a pro-European free-market centrist, will most likely emerge as the winner. Before Macron took his current lead in the polls, the center-right euro-skeptic François Fillon was the leading candidate for the presidency. Though a corruption scandal has taken the wind out of Fillon's sails, he still has a realistic chance of winning.

The markets are most concerned by the prospects of the far right candidate Marine Le Pen, who has promised to hold a referendum on France's membership in the European Union and the euro (and by implication, engineer the redenomination of a large chunk of French public debt into a new local currency).





Sources: Bloomberg, Haver Analytics

Closely following her as a “tail risk” for markets is the far left candidate Jean-Luc Mélenchon, who has promised to raise the top marginal tax rate to 100%, ignore the EU’s fiscal rule, and rethink the “legitimacy” of French public debt.

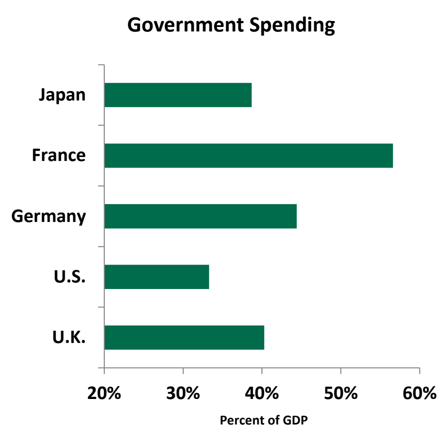
In a race where the top four candidates are polling within a few percentage points of each other, trying to predict a winner is a fool’s errand. (Given the poor performance of pre-election polls prior to the Brexit vote and the U.S. election, these readings need to be used with caution in any event.) But we think that the prospects of a doomsday scenario are exaggerated.

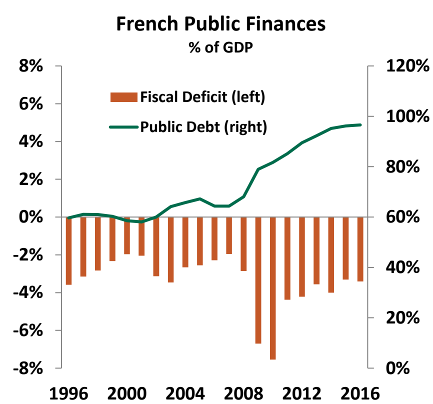
First, it would require an unprecedented fall in voter turnout for either Le Pen or Mélenchon to win in the second round. Second, the president’s executive powers are fairly limited if the parliament and the presidency are held by different parties. Neither Le Pen nor Mélenchon have any prospects of winning a majority in the French assembly, and would therefore have to “cohabitate” with a fractured legislature. There is a small window of two months between the appointment of the president and the election of a new parliament, during which the new president can appoint an interim government and ask it to rubber stamp any decision. But that window would be too tight to announce and hold a referendum on membership in the EU.

The composition of the French assembly makes a referendum to leave the EU very unlikely.

We believe insufficient attention is being paid to the June parliamentary election and the checks and balances within the French government. Disenchantment with the status quo notwithstanding, the euro remains popular in France, with almost 70% approval ratings.

There are important economic choices facing the French electorate. Onerous labor regulations discourage employers from hiring full-time employees, because it is so difficult to fire them if conditions change. The result is a proliferation of contract workers, double digit overall unemployment, and 24% youth unemployment. Indeed, France suffers from a paradox of high productivity and high unemployment because the barriers to entry into full-time jobs are so high. Both Macron and Fillon have promised to reduce some of this regulatory burden.





Source: Oxford Economics, Haver Analytics

France also has the biggest welfare state in the developed world, with government expenditures accounting for 57% of the gross domestic product. The flipside of a large state are high taxes, and often deficits and debt. It is a matter of debate how strictly binding the public debt constraints really are for a country with a reserve currency, but French public finances have been falling afoul of the eurozone’s self-imposed deficit and debt rules. While Mélenchon is campaigning to get rid of the rules altogether, both Fillon and Macron have made proposals to narrow the deficit.

It is important to keep in mind that a potential Macron presidency would also be a cohabitation, because he is an independent candidate without a party of legislators. He therefore would not be able to dictate the country's economic policy. In fact, it is likely that Fillon's Republican Party would be the single largest party in the assembly, and that cabinet is likely to focus on reducing the size of the state and the deficit.

The focus must be on tackling the French economy's structural issues.

These plans would not curb deficits in the absence of accelerated economic growth. Both Fillon and Macron have promised a number of market-oriented reforms to spur business activity in order to achieve that growth. It remains to be seen whether a fractured parliament and a charged political environment would allow them to implement many of the painful measures.

In the unlikely event that one of the left-leaning candidates emerges victorious and somehow imposes their will on the assembly, the impact on EU would be truly seismic. If a core member of the EU compact moves to withdraw, the viability of the union would truly be at risk. Our base case remains that tail risk will be avoided and the center will hold.

Yesterday's tragic shootings in Paris underline the difficult and uncertain times we live in. But the French have proven inspiringly resilient in the wake of prior attacks. It isn't just a series of candidates that will be on the ballot this Sunday; it may also be the fate of the 60-year-old European experiment and the principles it espouses.

Negativity Isn't Always Bad

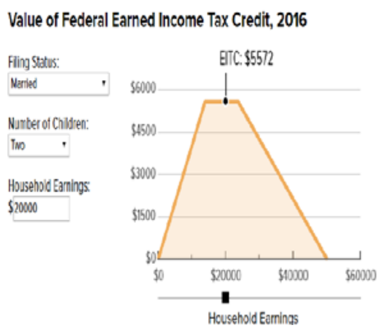
Many Americans are breathing a sigh of relief this week, after completing the sometimes painful process of filing their income taxes. It's likely that some cursing of the code took place as the calculations were completed. But one feature of the American tax system deserves praise, and should be extended.

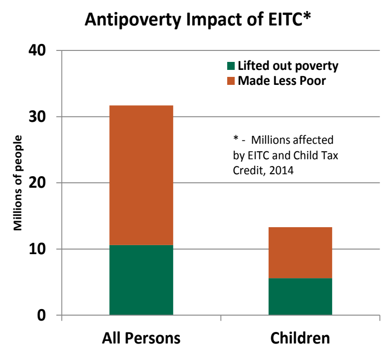
Policy discussions about income inequality and the struggles of segments of the labor force have been especially active recently. Some have proposed direct transfer payments or even universal basic income as a way of softening the consequences for workers displaced by international trade or technology. But programs of this type can create major disincentives to work.

The Earned Income Tax Credit (EITC) is a feature in the U.S. tax code that aids the less fortunate in an economically elegant manner. The idea for the EITC can be traced to Milton Friedman's book *Capitalism and Freedom*, in which he proposed a negative income tax in place of numerous forms of public assistance.

In many cases, welfare benefits are forfeited if an individual returns to work, which inhibits labor supply. Under the EITC, the government offers a tax rebate to people earning below a certain threshold of income, which is the reverse of income tax. In this way, the EITC provides motivation to continue working. The amount of assistance provided through the EITC program is tied to the recipient's income, marital status and number of children. The tax credit starts with the first dollar of earned income until it reaches a maximum and then phases out gradually as income increases.

The Internal Revenue Service estimates that 27 million eligible workers and families received more than $67 billion in EITC in 2015. During 2015, the average EITC was $3,186 for a family with children, raising wages by around $265 a month. Studies indicate that EITC pays for necessities, helps to repair homes, supports maintenance of cars needed for commuting to work, and helps recipients obtain an education. Families receiving EITC tend to have children with better school performance, and they are more likely to attend college.





Source: Center on Budget and Policy Priorities

The impressive track record of EITC supports a modification of the program.

Welfare schemes involve administrative costs, create disincentives to work, and distort the relative prices of goods and services subsidized. They may be limiting labor force participation in the United States. In addition to limiting these costs to society, the EITC offers other benefits that render it superior to other anti-poverty programs.

The EITC expansion of the 1990s led to half a million families moving out of cash welfare assistance programs. Research indicates that the EITC motivated single mothers to work and raise their wages. Increasing employment and wages through the EITC ultimately will lift Social Security retirement benefits, which is important in the march toward reducing poverty in old age.

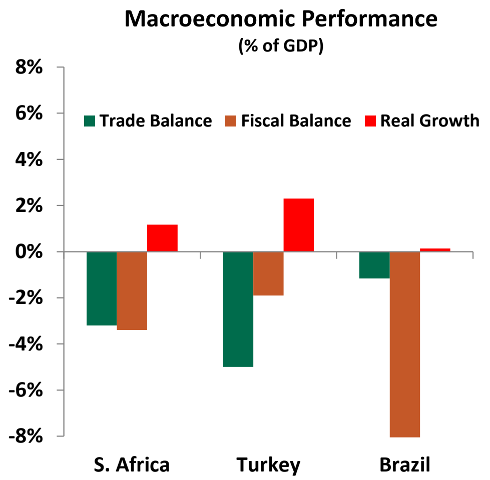
The EITC program could be enhanced by changing the qualifying conditions for childless couples and individuals. Currently, the maximum credit for the childless is $506, and it phases out at a very low income level. These restrictions result in 97% of EITC recipients being families with children. These rules should be relaxed to enable a larger population to avail themselves of the EITC.

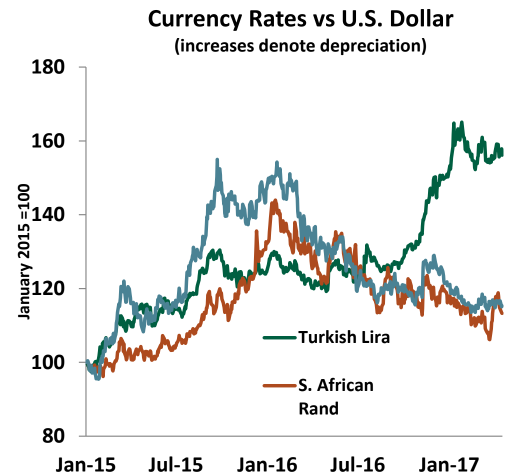
Incentives matter in economics, and the EITC gets them right. As Washington searches for the right combination of programs to aid the scores of discontented Americans, the EITC deserves a prominent role.

Turkey and South Africa: Waiting for 2019

Turkey and South Africa continue to underperform their emerging market peers due to domestic politics. This past week brought some medium-term certainty: Turkish President Recep Tayyip Erdogan narrowly won the constitutional referendum to create an executive presidency, while South African President Jacob Zuma survived another attempt to unseat him. But we may have to wait until the next round of general elections in 2019 before any progress is made on economic reforms in the two countries.

South Africa, the second largest African economy, suffers from chronic stagflation, high unemployment and inequality, rampant corruption, and wide fiscal and current account deficits. The sacking of the well-respected Finance Minister Pravin Gordhan indicates that President Zuma is putting the preservation of his post-political future (term limits prevent him from standing again) over tackling these challenges. South Africa is likely to be stuck in a vicious cycle of credit rating downgrades, capital outflows, balance-of-payment difficulties, currency weakness, tight monetary policy and weak growth.





Source: Oxford Economics, Haver Analytics

Turkey's key concern is the sustainability of growth and its wide current account deficit. For some time now, the economy has become reliant on massive credit expansion and state subsidies to faltering businesses for growth. With Erdogan's focus on winning the next general election to assume the executive presidency, he is likely to continue with the economic stimulus and delay rebalancing. Portfolio flows, Turkey's Achilles' heel given its large current account deficit and external debt stock, will remain sensitive to politics and economic policy.

Both Turkey and South Africa will continue to suffer as long as economics comes a distant second to political self-preservation.

These situations present an interesting contrast with another politically embattled emerging market. Brazil is still recovering from the crisis of early 2016, and its growth remains the weakest among major emerging markets. But the government has demonstrated seriousness in pushing through unpopular reforms and the financial markets have rewarded it. It is possible that corrective measures can flip the narrative around Turkey and South Africa as well - much like India experienced during the 2014 general elections after the corruption scandals and balance of payment scare in 2013 had tanked Indian assets.

We may not see a similar evolution in Turkey or South Africa before 2019. But international forces can have a very positive influence on domestic politics in the emerging markets. Autocracy may play well locally, but may not play well globally.

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