showCASE
No 27 | 15.05.2017

CASE – Centrum Analiz Społeczno-Ekonomicznych
CASE – Center for Social and Economic Research

Overview: In this week's showCASE, our experts analyze to what extent President-elect Emmanuel Macron could reform the French economy, in particular its strained labor market. CASE then zooms in on the heated debate between Russia and the European Bank for Reconstruction and Development following the latter's decision to freeze investments in the country.

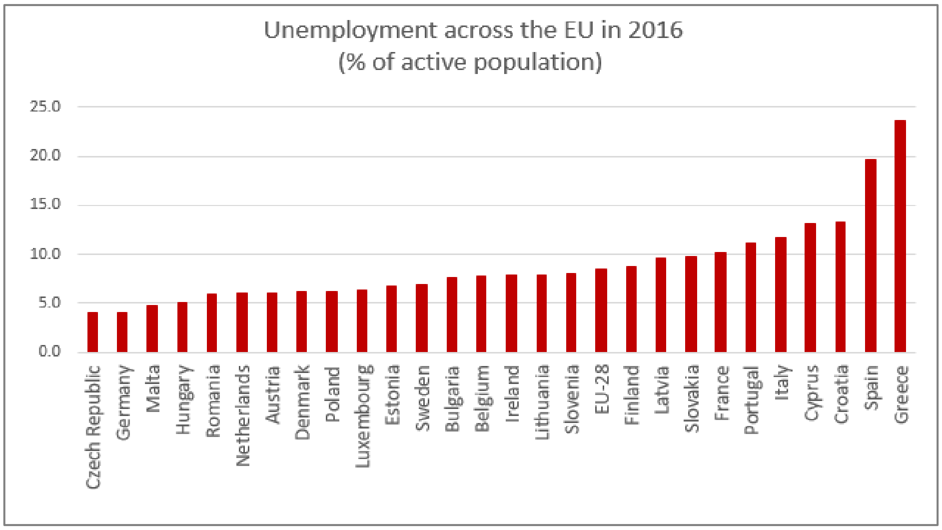
French elections: at best a Pyrrhic victory for the French economy

By: *Iakov Frizis*, CASE Economist

After months of persistent uncertainty, the defeat of Marine Le Pen, leader of the "Front National", has vested markets with newly found confidence about the future of both France and Europe. However, the victory of Emmanuel Macron, leader of the centrist "En Marche!" party, fails to put the nail in the coffin on populism in either France or Europe. Instead, his election triumph appears to be a Pyrrhic victory, as the results of the first round forecast the lack of a mandate to introduce badly-needed economic reforms in France. Without such reforms, the specter of populism will remain alluring for many voters.

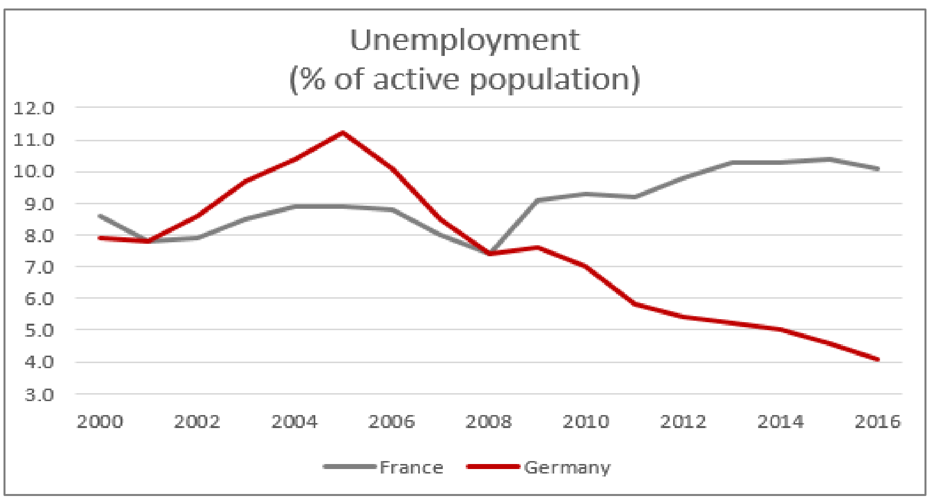
As the key example, institutional malaise in the French labor market is pervasive, as its rigid structure significantly impairs macroeconomic adjustment. In terms of unemployment, France is the 7th weakest performer within the EU, finding itself in the company of primarily crisis-plagued Member States. Sluggish labor-side adjustment dynamics within the French economy remain visible when one compares France (the EU's 3rd largest economy) to Europe's leading economy, Germany. Following the outbreak of the Eurozone crisis, French unemployment shot up from 7.4% in 2008 to 10.4% in 2015. Conversely, over the same period, German unemployment contracted from 7.4% to 4.6%.

Rigidities in the French labor market primarily manifest themselves through unemployment adjustment and only to a lesser extent through adjustment in wages. In particular, labor market adjustment in France is hampered by high labor costs, high level of employee protection which supports a dual labor system (and which sets insiders against outsiders), and poor matching technology characterized by low labor mobility and an ineffective training system. These factors contribute to an environment of sluggish adjustment to adverse macroeconomic shocks, where idle stocks of labor and capital account for the underperformance of the French economy vis-à-vis its full potential.



Source: Eurostat

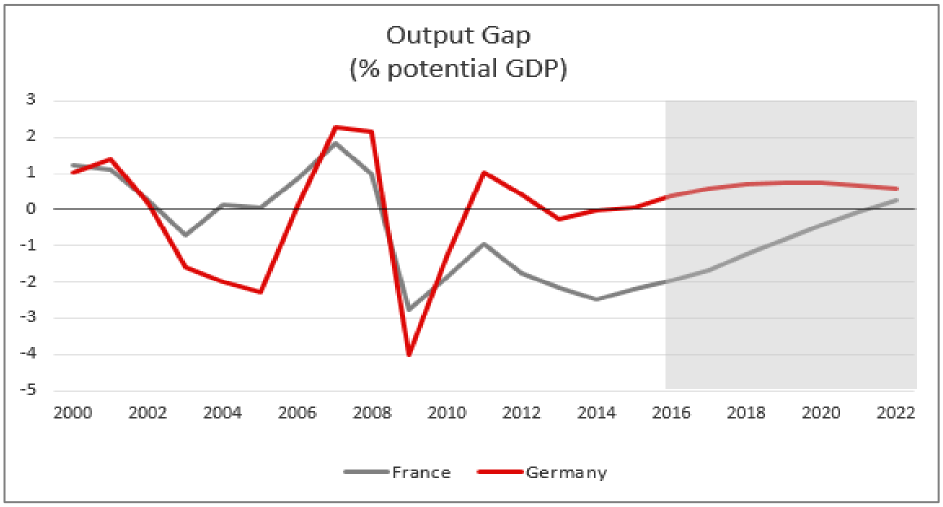
Differences in economic performance between France and Germany do not stem from German federal policy in the labor market, but from lack thereof. Decentralization of wage bargaining during the early 1990s allowed growth in wages to lag productivity growth, introducing significant reductions in unit labor costs as well as substantial competitiveness gains. The Hartz reforms, seen by many as a bifurcation point, merely supported the existing labor market flexibility by capping unemployment benefits and creating personal service agencies to match unemployed people with employers. Contrast this with Germany's western neighbor, where the French labor market has largely remained as it was in 1995, requiring a minimum of 1.5% y/y GDP growth just to keep the unemployment level at stasis.



Source: Eurostat

In a manner similar to his predecessor, President Macron's ability to introduce significant labor market reforms does not only rely on his capacity to pass legislation through parliament, a factor which will be determined in the June 2017 parliamentary elections. More so, the reform rests on the appetite of the French population to support the government in reforming the labor market. Unfortunately, the first round of the elections signified a limited desire for economic liberalization as the two populist parties, *Front National* and *La France Insoumise*, jointly attracted the support of 40.9% of the population. This foreshadows a reform deadlock, whose resolution will likely resemble that of the July 2016 labor law. Last year, President Hollande made use of the controversial Article 49-3 of the Constitution, sanctioned under *state of emergency* in France, to pass a watered-down version of the original reform, despite the French people's disapproval.

Macron will soon find himself standing between a rock and a hard place, as labor reform comes at a high political price. Reverting to use of emergency power will undoubtedly give strength to populism in France. Alternatively, if he chooses to ignore his core electorate, he will fail to introduce the reforms that the French economy badly needs to ignite growth. This unstable equilibrium only showcases the strength of populism in France, not its weakness. Le Pen may have lost the election, but her damaging economic ideas appear to be winning the hearts and minds of the French people.



Source: WEO Database, IMF (gray area denotes estimated values)

Russia's clash with EBRD leaves the lending freeze in place

By: Givi Gigitashvili, CASE Analyst

Following the imposition of sanctions on Russia in 2014 by the US and EU, the European Bank for Reconstruction and Development (EBRD) imposed a lending freeze, halting new investments in the country. Moscow has consistently disputed this decision, saying that the EBRD was not compliant with its own internal rules and such a suspension went beyond its core mandate. Nevertheless, after Russia's complaint letter to the EBRD's Board of Directors last year, the EBRD did not find any violations in its guidance to stop investments in Russia. Against this backdrop, Russian representatives once again denounced the decision on halting investments during the 2017 annual meeting last week and alluded to Moscow's intention to find "legal solutions of the situation".

The Russian side has several claims against the EBRD in this matter. The first is that the Board of Directors' decision violated Article 8.3 of the EBRD's establishing agreement, which states that the Board can suspend a state's access to the Bank's resources "in cases where a member might be implementing policies which are inconsistent with Article 1 of this Agreement, or in exceptional circumstances." Given that Article 1 has only economic connotations, Russia claims that is has not done anything in breach of this particular Article.

Secondly, in the light of the Bank's declared mission to promote open and sustainable market economies, the investments suspension was seen in Moscow as an explicitly political decision, camouflaging geopolitical and foreign policy objectives of the biggest shareholders (the US, UK, and Germany). On these grounds, Russia claimed that the Board of Directors breached Article 32 of the EBRD establishing treaty about impartiality in decision-making and exceeded its mandate.

Source: European Bank for Construction and Development

Thirdly, Russia claims that the Board of Directors, which is responsible for the operations of the EBRD, violated certain procedural provisions, namely, the EBRD establishing agreement, which stipulates that a suspension of member's access to the Bank's resources "shall be taken by the Board of Governors by a majority of not less than two-thirds of the Governors." But in Russia's case, the Board of Governors, the highest body, has not voted for imposition of a lending freeze.

Since 1991, the EBRD has invested a quarter of the bank's entire investments in Russia (over 26 billion euros) and was the biggest single foreign investor in Russia over the last decade. Indeed, its lending portfolio in this country was the largest one until 2015. Despite the freeze of new investments, the EBRD is still running its pre-2014 projects in Russia and its current portfolio there amounts to € 3.7 billion. After the imposition of this restriction, the EBRD's lending shifted to Turkey and Ukraine, two countries that recently have had tensions with Russia. Given that its net capital flow is recovering slowly, Russia badly needs the resumption of the EBRD investments.

Source: European Bank for Construction and Development

The EBRD's response to these allegations was that Russia's complaints were speculative, with the Board of Governors concluding last Wednesday that the Bank had not broken its internal rules, upholding the existing ban on investments. Not surprisingly, Russia promptly announced countermeasures, including not participating in the bank's capitalization in case the Bank's financial situation deteriorates in future and presenting evidence advising the international rating agencies to downgrade EBRD's AAA rating. In addition, Moscow is going to rely more on "de-politicized" development banks, such as Asian Infrastructure Investment Bank (AIIB) and the BRICS New Development Bank (NDB).

Overall, upholding the lending freeze is bad news to Russia, which experiences a slowdown of economic growth since 2014. On the other hand, not enough evidence is available to suggest that the lending freeze will significantly deteriorate the financial performance of the EBRD. Furthermore, when it comes to the hint about "legal measures", the EBRD is an international financial institution, which cannot be sued in an external court. Last but not least, if Russia decides to leave the EBRD, which is not being considered yet, it can further aggravate the country's economic isolation.

Source: Trading economics

Countries at a glance

Center for Social and Economic Research

This week: In a new economic forecast, CASE experts discern several positive trends in the Polish economy. Real GDP is expected to grow by 3.3% in 2017 and 2.9% in 2018, compared to 2.8% in 2016. Real Total Gross Fixed Capital Formation is forecast to increase by 2.9% in 2017 and by 2.7% in 2018, following on a decline by 5.5% in 2016. Inflation will be 1.9% in 2017 and 2.0% in 2018, whereas in 2016 consumer prices showed a deflation of minus 0.6%.

GDP (Q4 2016)

2.5% y/y

Up from 2.4% in Q3

Inflation (Apr 2017)

2.0% y/y

Unchanged from Mar 2017

Unemployment (Mar 2017)

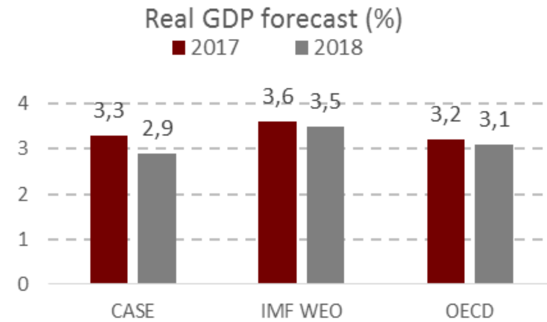
8.1%

Down from 8.5% in Feb

NPB Base rate

1.5%

From 2% Mar 2015



This week: On May 9, The Victory Day Parade took place in 28 major cities of Russia, and the associated costs went in millions. The military parade in Moscow was the most expensive among them, and cost 456 million ruble (EUR 7.3 m), compared to 210 million ruble last year. Russia also arranged various events in more than ten different capitals abroad, the total cost of which was 9.4 million ruble (EUR 150,000).

GDP (Q4 2016)

0.3% y/y

Up from -0.4 in Q3

Inflation (Apr 2017)

4.1% y/y

Down from 4.3% in Mar

Unemployment (Mar 2017)

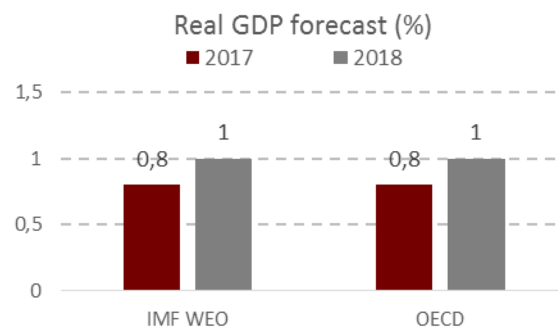
5.4%

Down from 5.6% in Feb 2017

CBR Base rate

9.25 %

Down from 9.75%



This week: Rising transportation costs have been prompting inflation upwards in Germany. Preliminary inflation estimates for April indicate an upswing to 2% from 1.5% in March, y/y. New PMI values were also published, indicating an overall positive sentiment across both manufacturing and services. The Services PMI improved from 54.70 in March to 55.40, while the Manufacturing PMI remained stable at 58.20.

GDP (Q4 2016)

1.2% y/y

Down from 1.5% in Q3

Inflation (Mar 2017)

1.5% y/y

Down from 2.2% in Feb

Unemployment (Q4 2016)

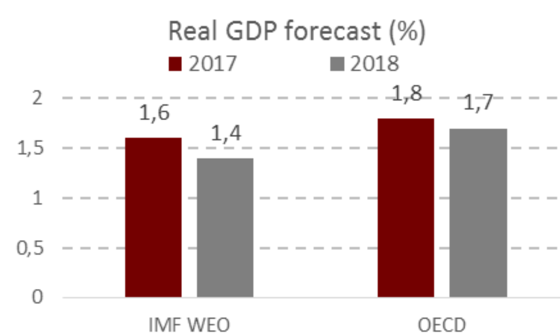
3.9%

Down from 4.15% in Q3

ECB Deposit rate

-0.4%

From -0.3% Dec 2015



This week: The National Bank of Ukraine estimates that national GDP grew by 3.0% in the first quarter of 2017 after increasing by 4.7% in the last quarter of 2016. A significant factor inhibiting the growth was the ongoing freight blockade of the Donbas, Ukraine's well industrialized eastern region that is occupied by Russia-controlled guerilla since early 2014.

GDP (Q1 2017)

3.0% y/y (est.)

Down from 4.7% in Q4

Inflation (Apr 2017)

12.2% y/y

Down from 15.1% in Mar

Unemployment (Q4 2016)

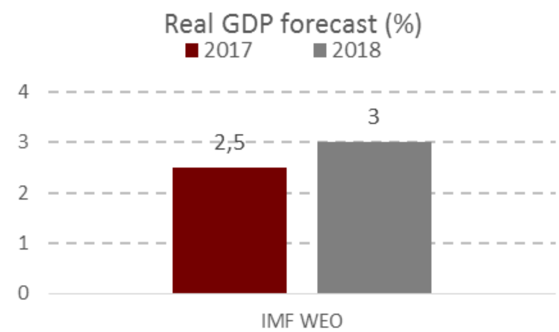
10.0%

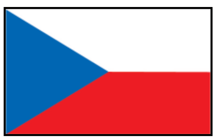
Up from 9.2% in Q3

NBU Base rate

13.0%

From 14.0% in Apr





This week: President Milos Zeman is visiting Beijing to discuss economic cooperation and to promote Prague's participation in the Silk Road project. He met with Vladimir Putin last Sunday and as it was underlined, trade turnover growth of over 44% was observed between two countries in the beginning of this year. Zeman is also going to meet his Chinese counterpart.

GDP (Q4 2016)

1.9% y/y

1.9% in Q3

Inflation (Apr 2017)

2.0% y/y

Down from 2.6% in Mar

Unemployment (Q1 2017)

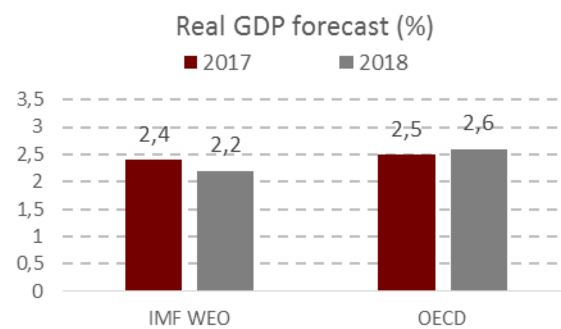
3.4%

Down from 3.6% in Q4

CNB Base rate

0.05%

Unchanged since Nov 2012



This week: The European Bank for Reconstruction and Development upgraded its forecast of economic growth in Hungary in 2017 to 3% from the previous 2.4%. The Bank noted that the reduction of the CIT rate to 9%, the lowest in the European Union and effective from the beginning of 2016, is likely to stimulate private investment.

GDP (Q4 2016)

1.6% y/y

Down from 2.2% in Q3

Inflation (Apr 2017)

2.2% y/y

Down from 2.7% in Mar

Unemployment (Q1 2017)

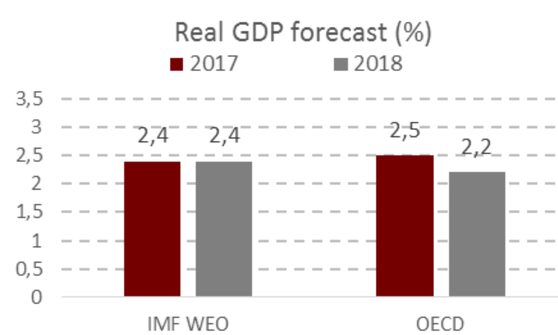
4.5%

Down from 4.4% in Q4

MNB Base rate

0.9%

From 1.05% May 2016



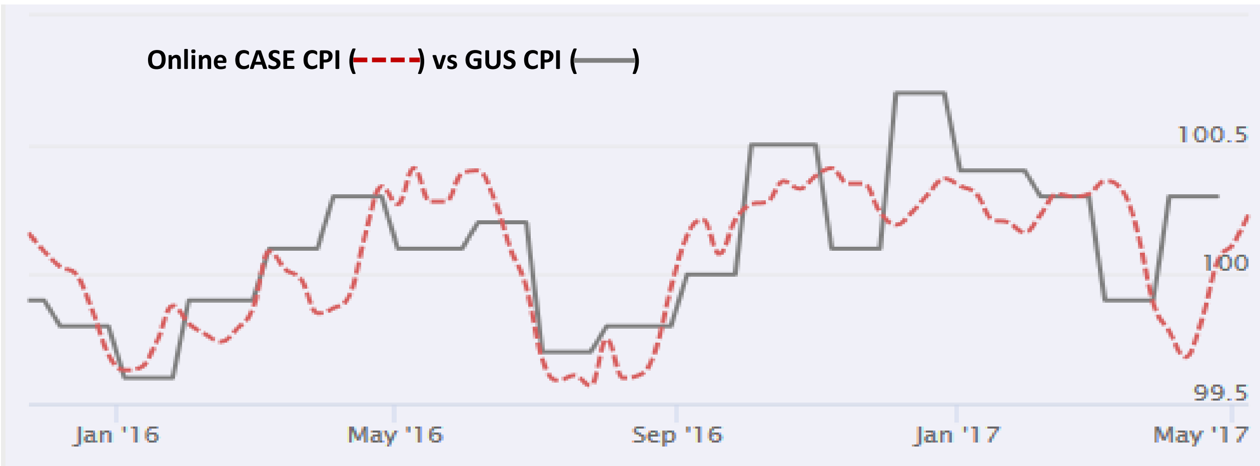
Other CASE products

CASE Center for Social and Economic Research

The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI



Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, CPI, among others.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2017	3.3	3.5	2.9	3.8	1.9
2018	2.9	3.0	2.7	3.7	2.0
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2017	4.7	201.6	201.8	-0.2	-4.7
2018	3.5	211.3	213.1	-1.8	-5.9

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