

Wallace's Daily Policy Debrief

Today:

- 1) Fiscal Policy – Kim Wallace
- 2) French Elections – Todd Mariano
- 3) Policy Calendar

Fiscal: Theory But Not A Game

Most policymakers responsible for macroeconomic policy over the past quarter have been saying publicly what most market participants have acknowledged privately: we are not out of the woods. **The issues that overhung markets much of last year are again affecting market sentiment.**

- European fiscal balances and financial sector conditions remain concerns despite demonstrable progress to address what ails that economy. **Deserved or not, Spain has rotated into chief focus as investors worry about bank balance sheets.** The outcome of France's election could invoke fresh worries about fiscal challenges regardless of recent re-commitments to budget targets.
- U.S. economic recovery after the crisis was destined to be erratic and underwhelming given the depths of the recession. **The April 6 employment report buttressed the view that 2Q12 growth might lag the previous quarter.**
- Iran's mangled handling of meetings set to begin this weekend on Tehran's nuclear intentions reminded the world how high the bar is for constructive outcomes from the sessions in Istanbul. The U.S. team worries that internal discord within Iran's government and those factions' repeated ability to misread global events combines for continued downside risk.

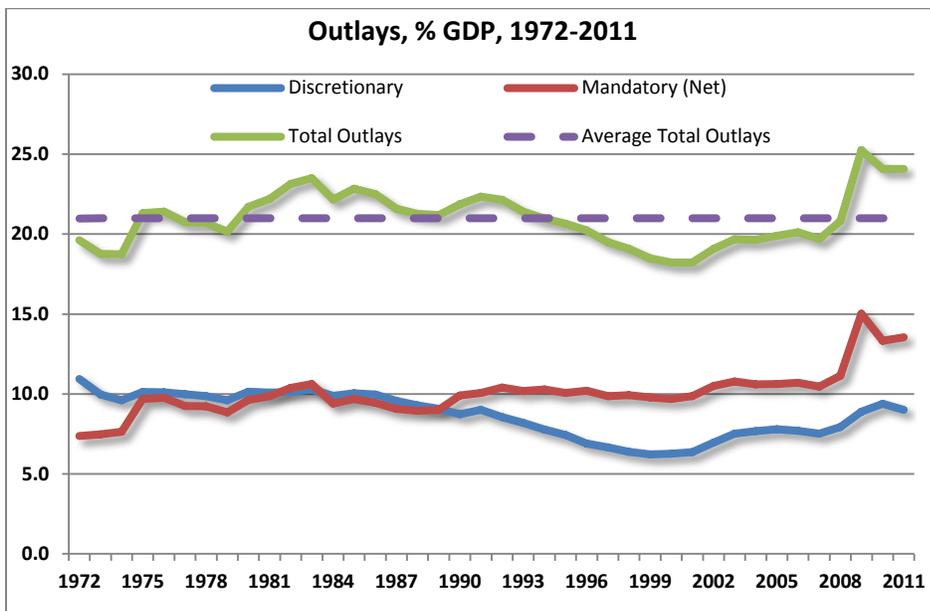
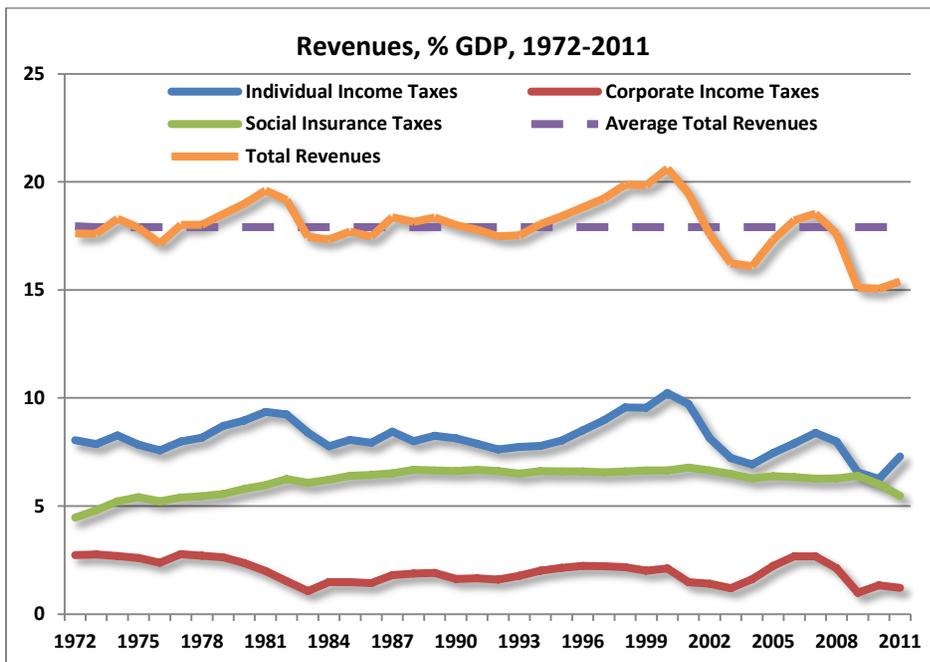
These lingering international matters encourage a focus on developments closest to home. Markets increasingly will signal disapproval to Washington absent clearer signs about the fiscal endgame this year. **Yesterday we covered key dates and other aspects of what likely will be a back-loaded 2012 process addressing tax, spending, and fiscal balance policies.** Our sense is that **catastrophe will be avoided** as Washington balances the need for fiscal retrenchment over time and the immediate burden to continue supporting growth.

The following graphs provide some of the context for the pending debate and eventual Washington fiscal policy action. Federal revenues generally respond to macroeconomic cycles unless significant policy changes

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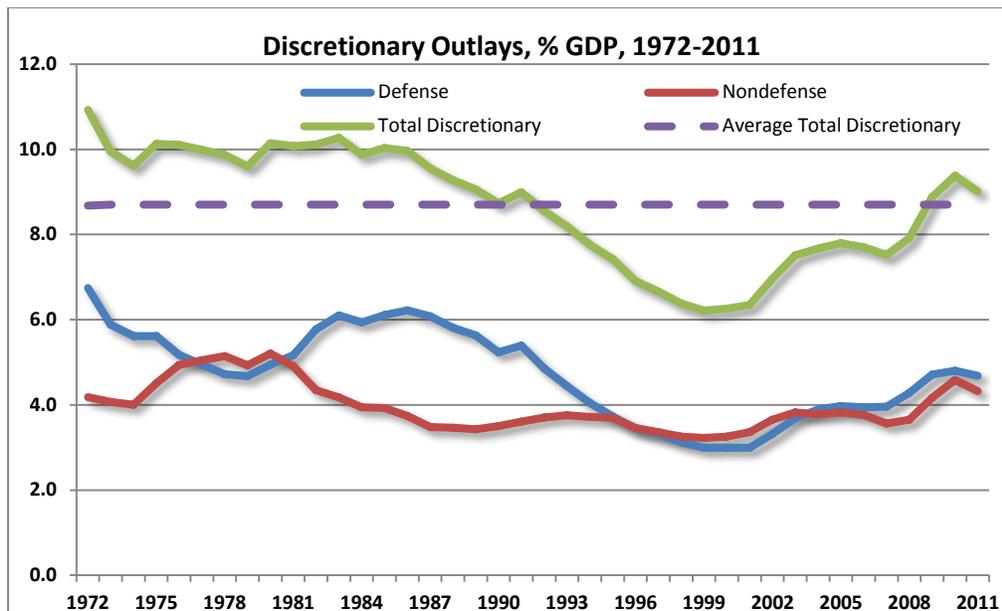
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occur (1982, 1990, 1993, and 2001, for example). **Whenever meaningful fiscal policy is enacted, mandatory spending (health care, retirement, and net interest costs) and revenues will receive plenty of attention.**



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Source: Congressional Budget Office

Possible scenarios for how this story unfolds are numerous. **We offer three that focus more on the near-term imperative to avoid fiscal, market, and economic train wrecks.** First, we give relatively low odds to Washington enacting a five-year plan. There isn't enough time after the elections and insufficient interest before the November 6 plebiscite. Deeply worsening global growth, financial, and geopolitical trends is the chief risk to this view.

Second, we see slightly higher chances of a one- or two-year deal to avoid near-term imprudent outcomes. **An election that delivers a status quo balance of power in Washington (albeit with tighter margins in the House and Senate) could drive such an outcome. In this case, partisans recognize they can't invite calamity and acknowledge the necessity for compromise.**

Third, unified GOP government or Congress run by Republicans facing a second-term Democrat likely results in Washington agreeing to the least common denominator: a one-year deal that allows Republicans to coalesce around a longer-term deal designed to confront the Executive. **Our sense is that a shorter-term deal is the most likely scenario, even if we miss the major reasons for it.**

- Kim Wallace

France: Hollande Victory Remains Likely; Policy Options Narrow

France heads to the polls for the first round of its presidential election on April 22, with a second round runoff between the top two candidates on May 6. Incumbent president Nicolas Sarkozy has chipped away at challenger François Hollande's longstanding lead in 2012, even slightly overtaking Hollande in most of the recent polls for the first round. However, he still remains, on average, 8 points behind for the second round—with all polls now including the modest bump in support Sarkozy received for his widely-approved handling of the Toulouse standoff. While Sarkozy will likely find it difficult to substantially overturn the personal rejection

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of his record in office that has led many voters to support Hollande, the sitting President's adept campaigning skills may yet boost his chances to eke out a win. Higher than predicted turnout from the far right in the second round may also work to Sarkozy's advantage.

Given Hollande's favorable second-round prospects, markets have focused on the potential for policy disruption at the European level, as Hollande had promised to renegotiate the fiscal compact and redraw relations with Germany. **Prognostication on those issues always merits caution, as campaign promises do not always translate wholesale to policy outcomes in office.** Tellingly, Hollande recently moderated this position, calling for the addition of pro-growth provisions rather than a full reopening, a sign that he may already be preparing for the practicalities of governance. Hollande's preference for pro-growth measures is not without support among Europe's leftist parties and indeed within France, but the overall ability of these parties to forge a meaningful pivot away from the center-right policies now in place is unclear. Brussels would likely be able to forge a compromise along the lines of Hollande's pivot that preserves the pact's key provisions. **The loss of one half of the Merkel-Sarkozy tandem could be a short-run negative for the region's crisis management, however, especially if new problems emerge in the periphery.** Although Merkel is more politically secure than she was a year ago, and Germany continues to be the primary driver of Eurozone financial policy, the "Merkozy" duo became the face of the Eurozone's efforts to fight its financial crisis. Their solidarity or lack thereof was often a key determinant of outcomes, and it would take time for Hollande to establish working relations with his European counterparts.

The spending required to finance some of Hollande's campaign promises has caused concern for fiscal deterioration and France's credit outlook. The campaign/office distinction applies here as well, though in fact both he and Sarkozy are competing over budgetary rectitude. Hollande's advisors have also sought to placate the markets by noting the Socialist party's strong track record on liberalization and Hollande's ties with the business community. **Whether Hollande or Sarkozy wins the election, there will ultimately be little macroeconomic policy leeway for Paris amid low growth, fiscal austerity, and financial sector risk.** However, the Socialist party looks set to win the French legislative elections in mid-June, which would be a positive for Hollande's agenda should he win in May, and a negative for Sarkozy's ability to enact reform should he prevail.

Latest Poll Averages*	Sarkozy	Hollande	Le Pen	Mélenchon	Bayrou
First round	28.5%	27.4%	15.1%	14.1%	10.4%
Second round	45.8%	54.2%	--	--	--

Sources: BVA, CSA, Harris, Ifop, Ipsos, LH2, Opinion-Way, TNS-Sofres

Key Indicators	2011	2012E	2013E	2014E
GDP growth	1.7%	0.2%	1.0%	--
Public debt-to-GDP (%)	87.0	90.7	93.1	--
Budget deficit (% GDP)	-4.4	-3.3	-3.1	--
Industrial production	2.4%	-0.8%	1.0%	1.2%
Unemployment	9.7%	10.5%	10.6%	10.1%
10yr spread to Germany*	125 bps / 52-week range = 29 – 190 bps / YTD change = -8 bps			

Sources: IMF, Insee, Economist Intelligence Unit, Bloomberg (* = As of April 9)

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Policy Calendar

Wednesday

- 1pm EDT, Treasury auctions 10-year notes
- 2pm, Federal Reserve's Beige Book
- 2pm, Treasury releases March budget results
- 2:10pm, Franklin Templeton's Mobius discusses emerging market outlook
- G8 foreign ministers meet in Washington today and tomorrow (US, UK, Germany, France, Italy, Canada, Japan, and Russia)

Thursday

- IMF's Lagarde reviews global economic conditions
- First day of North Korea's announced window for a date for latest rocket launch (Apr. 12-16)
- ECB speakers: Asmussen in Dublin; Praet in New York

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