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French Referendum No Threat To Financial Markets

On Sunday May 29, France will hold a referendum on the European Constitution. Although the margin of victory is likely to be small, current opinion polls suggest that the most likely outcome is a “no” vote. Nonetheless, we believe that the impact on either the functioning of the European Union (EU) or financial markets is likely to be modest.

What is the European Constitution?

The European Constitution is the latest incarnation of the Treaty of Rome, which established the EU in 1957. In this respect, it can be seen as another step on the road towards the eventual political unification of Europe. In practice, however, the main aim of the Constitution is to simplify the institutional setting of the EU and to streamline a complex decision-making process.

The Constitution was agreed by EU governments in June 2004. However, before it can come into effect it must be ratified by all EU member states. In the past, the ratification process in most countries has tended to be carried out by parliament. However, the use of the term “constitution” rather than “treaty” has prompted several countries, including France, to opt for referendums.

What happens if France votes “no”?

A French “no” vote would be deeply embarrassing for Europe’s leaders. In the past, however, the EU has shown itself to be remarkably adept at dealing with setbacks. Denmark’s “no” to the Maastricht Treaty in 1992 and Ireland’s rejection of the Nice Treaty in 2001 were followed by small adjustment to the treaties and successful second referendums. In any event, the Constitution is not due to come into effect until January 2007, giving the EU sufficient time to find a solution.

Implications for financial markets

A French “no” vote is unlikely to have a significant impact on financial markets. The main reason for this is that the Constitution has no direct impact on the institutional setting of the single currency or the European Central Bank (ECB). In this respect, it is different from the Danish “no” vote in June 1992, which called into question future progress towards a single currency and led to a dramatic unwinding of convergence trades.

There has been some speculation that a French “no” vote might represent a step on the road towards the eventual break-up of the single currency. We believe such views are misplaced. However, it is possible that a “no” could have an adverse impact on investor sentiment. If so, it would most likely be felt in euro-area countries with especially weak fiscal positions, such as Italy and Greece **(Display 1),** or in countries hoping to join the euro at a later date. In the latter case, it is important to note that the framework for countries to join the euro is well established and will not be affected by the French vote. As a result, any adverse reaction would probably be short-lived.

Conclusions

France is not the only country that might vote “no” to the European Constitution. The Netherlands, for example, holds a consultative referendum on June 1, and this too could result in a “no” vote[1]. However, as one-half of the Franco-German axis that has driven European integration, a French “no” would be the most significant and embarrassing for Europe’s leaders. That said, it will not prevent the EU from functioning and will not have a direct impact on either the single currency or the ECB. Hence, it is unlikely to have a significant or lasting impact on financial markets.

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[1] The Dutch referendum could result in a “no” vote if turnout is very low. However, the government is not bound by the result if turnout is low.

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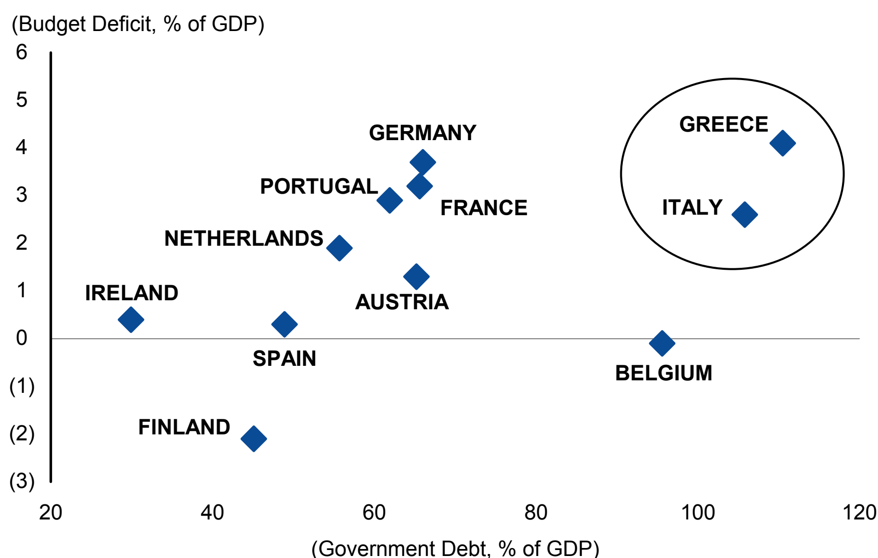
Display 1: Italy and Greece Have the Most Worrying Fiscal Positions

Government Debt and Government Deficits in the Euro Area, 2004



Source: European Commission and Alliance Capital Fixed Income, April 29, 2005

The fiscal outlook in Italy and Greece is especially worrisome, with government debt still above 100% of GDP and high budget deficits. This would make both countries vulnerable should investor sentiment react adversely to a possible "no" vote in the French referendum. To some extent this has already been reflected in wider spreads to the core euro-area countries.