10. FRANCE

Edging towards recovery

Storm successfully weathered; potential growth in need of improvements in the coming years

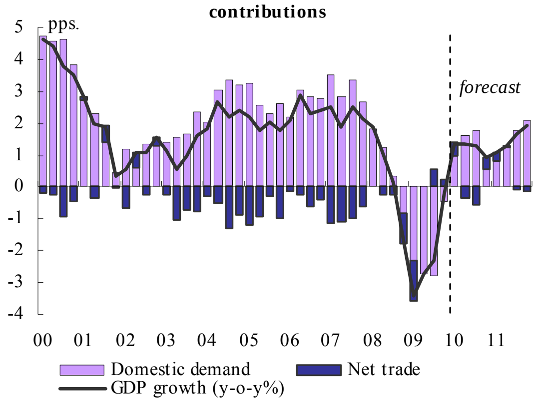
In 2009, the French economy suffered a sharp downturn. The recession was triggered by the free fall in world trade and the financial crisis, as well as their impact on credit conditions and confidence. GDP contracted for four quarters in a row from mid 2008 to the first quarter of 2009, the largest drops being registered in the last two quarters (-1.5% and -1.3% q-o-q respectively). The cumulative loss in GDP over this period reached 3.4%. France came out of the recession in the second quarter of 2009 as GDP rebounded, growing respectively by 0.3%, 0.2% and 0.6% in the last three quarters of 2009. All in all, the contraction of the French economic activity was -2.2% in 2009. Still, France performed much better than the euro-area average as it was relatively less affected by the crisis than its neighbours. This was mainly due to the resilience of private consumption, the relatively low degree of openness of the economy, and the limited size of the manufacturing sector.

Fiscal policy and monetary accommodation contained the economic downturn and added to the sizeable impact of automatic stabilisers. Specifically, the recovery plan got underway in the second quarter of 2009, and succeeded in boosting purchasing power and households' consumption. It amounted to around 1¼% of GDP for 2009-10. Besides, cash-flow support to businesses probably kept numerous companies afloat and limited the impact of the downturn on the French production system. Notwithstanding this, the need to foster potential growth in order to fully benefit from the upcoming recovery is high on the agenda. Indeed, before the recession, French economic performance lagged behind the euro-area average, and good performance during the downturn does not rule out a sluggish recovery, also since the low degree of openness limits the impetus stemming from a rebound of external demand. Reforms aimed at addressing supply-side weaknesses, as well as increasing the utilisation of labour would help the economy enter a virtuous circle by stimulating economic activity and alleviating the challenges facing public finances.

The role played by automatic stabilisers and households' expenditure in the downturn

The resilience of private consumption during the recession, which posted positive growth of close to 1% in 2009, had a stabilising effect on economic activity, whereas in many neighbouring countries households' expenditure shrank and amplified the downturn. Indeed, even if real disposable income growth was almost halved compared to 2008, it remained in positive territory and close to 2% in 2009. The slowdown of earned income, notably due to the substantial rise of unemployment and the recourse to short-time work, and the fall in property income were more than offset by the built-in stabilisers (increase in public transfers and decrease in taxes) and the stimulus measures of the recovery package (payment of one-off bonuses) in conjunction with the drop in inflation. In particular, net cash benefits (social benefits minus taxes) were the key contributor to the growth of households' disposable income in 2009. At the same time, private consumption was successfully boosted by the car-scrapping premium which was part of the stimulus plan. This plan provided rapid support for activity in the short term and attenuated the shock. The good performance of households' consumption in 2009 can thus mostly be explained by temporary factors which can have but a limited impact in the coming quarters.

Graph II.10.1: **France - GDP growth and contributions**



In 2009, the plunge in external demand triggered huge drops in exports, notably of manufactured goods, and in productive investment, both by double digit figures. The large fall in demand, the need for firms to strengthen their balance sheets, and the tight credit conditions also produced a significant reduction in stock building which contributed for more than half of the fall in GDP. All in all, in line with the declining domestic demand, imports fell markedly; thus net trade imposed a rather small drag on growth. The last quarter of 2009 witnessed growth in *trompe l'œil* style: thanks to slightly improved prospects, destocking slowed markedly, thus strongly contributing to growth, while at the same time private consumption surged as households advanced their car purchases in view of the upcoming reduction of the car-scrapping premium.

Uneven recovery in 2010, gaining strength in 2011

The temporary factors, which boosted households' disposable income and private consumption in 2009, will gradually disappear in the course of 2010. Purchasing power growth will be sharply reduced compared to 2009. The upturn in earned income is unlikely to offset the slowdown in social benefits and the acceleration in consumer prices. In particular, social security benefits are expected to slow down in line with unemployment benefits as the labour market is set to deteriorate less sharply than in 2009 and no one-off bonuses are planned for 2010 in the recovery package. The outlook for households' wealth is not bright: uncertainty prevails in both the real-estate and the stock market. Besides, the car-scrapping premium is being steadily reduced and will expire by end-2010. A backlash on car purchases is thus expected with a negative impact on households' expenditures. All in all, due to the weakness of real disposable income and the after effects of the car-scrapping premium, private consumption growth is likely to be feeble and even negative in the summer. It will thus give little support to the economic activity in the coming quarters. In addition, as the global economy will grow moderately, economic activity in France will continue to recover softly in 2010, with GDP growing by around 0.3% each quarter.

Production seems to have bottomed out at the end of the year, notably thanks to temporary measures in favour of the automotive industry in France and in other EU countries, like Germany. This rebound seems to be gaining strength as, according to business leaders questioned in April, the industrial economic situation is still improving and getting closer to its historical trend. However, production capacities remain clearly under-utilised. Although credit conditions seem to have started to ease, credit demand by companies has not yet taken off. Fiscal measures and in particular the cancellation of the business tax are likely to provide limited support to productive investment. All in all, after having sharply dropped in 2009, productive investment growth is set to gradually ease and start increasing in quarterly terms from mid-2010, but it would remain negative on average in 2010. As regards investment in construction, the recently observed upturn in permits and construction starts, together with the slight contraction of stocks of unsold homes seem to indicate a gradual recovery of investment in housing. In the same way, public investment will support the construction activity: indeed, part of the public spending scheduled for 2009 in the recovery plan has been delayed. All in all, growth in investment in construction is expected to be negative again in 2010, but less so than in 2009.

In 2011, quarterly GDP growth is projected to be slightly above potential as the output gap closes gradually. Economic activity is expected to expand by 1.5% on average, supported by domestic demand.

Headline inflation declined markedly in 2009 and was close to zero on average (0.1%) due to the fall in commodity prices and weak demand. Under the assumption of higher oil prices and gradually recovering demand, inflation is projected to rise to 1.4% in 2010 and 1.6% in 2011. In line with the profile for wage costs, core inflation is expected to first fall below 1% in 2010 and then slowly increase to 1.4% in 2011.

Several uncertainties surround this scenario. On the positive side, a more vigorous global recovery would boost the demand for French products, leading to a significantly positive contribution of exports to growth. Negative risks are linked to domestic demand as the disappearance of national car-scrapping allowances could imply a sharper drop in household car purchases, but also impact more negatively the French automotive industry.

Benefitting from the expected pick-up in world demand

While France's relatively low degree of trade openness has helped to weather the storm, without some structural adjustment, the French economy may not fully benefit from the foreseeable pick-up of world trade. The combination of rather sustained domestic demand, feeding in turn relatively dynamic imports, together with continuously declining market shares could lead to increasing external imbalances and a sluggish recovery. Additionally, the geographic specialisation of France's exports is not favourable in the current context: 70% of its exports go to Europe, which is expected to grow at a much slower pace than emerging economies and Asia (the proportion of French exports going to Asia – 10% – is half that of Germany, for instance). In the short run, French exports are set to suffer also from the phasing out of stimulus plans in other countries which sustained car purchases from French manufacturers in particular.

Net trade has hampered French growth in a significant way over the last few years. This can be explained on the basis a series of weaknesses on the supply side. A decomposition of French exports clearly points to the medium-high technology positioning of French products, which, together with relatively low investment in R&D and poor performance as regards high-skill education, is placing the country in a situation of innovation follower. Against this background, French exporters have reduced their profit margins in order to contain the loss in terms of price competitiveness. However, compressed profit margins have been insufficient to limit the rapid loss of market shares, given the pressure on prices from competitors in emerging economies. In addition, France's net exports are held back by the size and the number of exporting firms. For a large majority of firms, exports represent a very limited share of their turnover, contrary for example to German companies.

Increasing labour utilisation – key for a successful recovery

As a result of the strong deterioration in economic activity, the French labour market adjusted sharply. Temporary employment was hit first, in particular in the industrial and construction fields, due to the automotive crisis, the temporary closing of plants, as well as with the reversal in the housing market. As of end 2008, labour shedding spread to all economic sectors. In 2009 as a whole, employment in the market sector declined by 2.2% and 70% of job losses were recorded in the industrial and construction sectors. Job destruction is set to continue throughout 2010, although at a clearly slower pace (-0.7%). In 2011, the French economy should create some jobs again. As the labour force is expected to rise slightly over the forecast horizon, due to an increasing population at working age, the unemployment rate is likely to increase until end 2010, almost reaching 10½%, three points more than before the beginning of the downturn. The unemployment rate is then expected to improve marginally in the course of 2011 in line with the expected recovery.

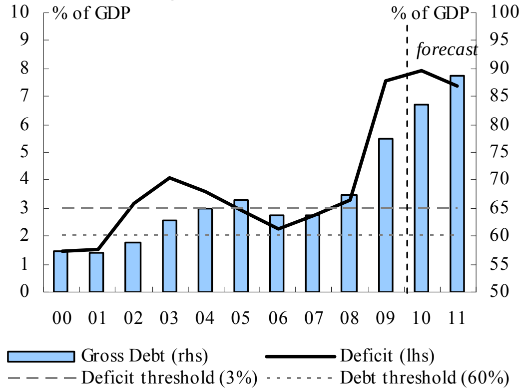
As a consequence of continued job losses, the employment rate will decrease again, to below 64% in 2010. This could add to the historically insufficient utilisation of labour, which is one of the main bottlenecks of the French economy. Poor labour-market functioning in France manifests itself in a rather low participation rate at both ends of the age spectrum (young and older workers), a high unemployment rate, and a low number of average hours worked. Future increases in the minimum wage could also factor in the need to ensure wage differentiation at the lower end of the wage scale. During the crisis, the unemployment rate of the young has jumped from an already high level compared to European standards (24.4% in 2009 from 19.4% in 2007, compared to 15.4% in the EU as a whole). Additionally, it seems that many employers are currently actively encouraging early retirement. Furthermore, tax cuts on overtime hours may incite employers to favour overtime over new recruitment when the recovery is back on track and thus delay job creation. Finally, the re-integration of the low-skilled and the young into the workforce after the crisis is a major challenge. A successful response would avoid permanent destruction in human capital and a durable rise in long-term unemployment.

Deficit to improve in 2011, but debt to approach 90% of GDP

The deficit increased significantly in 2009 and reached 7.5% of GDP, after 3.3% in 2008. This deterioration reflects the working of automatic stabilisers as a result of the economic downturn, as well as the impact of the fiscal package in line with the EERP (European Economic Recovery Plan), which is estimated at 1.1% of GDP. The deficit is expected to further increase in 2010 to 8% of GDP in line with the latest official forecast. This is notably due to the rise in social benefits related to continued job losses and the increase in interest payments. The balance of discretionary measures for 2010 should be neutral: the partial phasing out of the stimulus package (from 1.1% of GDP to 0.4%) together with some further consolidation measures of around 0.1% of GDP (mostly the increase in taxes included in the social security budget) would be compensated by new stimulus measures included in the budget for 2010 amounting to 0.7% of GDP (among which the reform of the local business tax) and by measures stemming from a public loan (*Emprunt national*) amounting to around 0.1% of GDP. A reversal of the deterioration of public finances is anticipated for 2011, mainly due to the complete withdrawal of the fiscal package in line with the EERP on top of the phasing-out of the transitory impact of the reform of the local business tax. The measures stemming from the previously mentioned public loan would worsen the deficit by another 0.1% of GDP.

The debt-to-GDP ratio is foreseen to increase continuously throughout the forecast horizon, eventually reaching 88.6% in 2011. This rise is mainly due to the high expected deficits. The public loan is anticipated to increase the general government debt by around 0.3% of GDP in 2010 and by another 0.2% of GDP in 2011 (including a 0.1% of GDP impact on the deficit in both 2010 and 2011). The sharp increase in debt-service requirements due to the deterioration of public finances could crowd out more productive expenditure necessary to stimulate growth, which underlines the importance of fiscal consolidation.

Graph II.10.2: **France - General government gross debt and deficit**



The French authorities announced that the consolidation strategy would mostly rely on measures aimed at curbing expenditure growth at all sub-government levels. This consolidation strategy would build on the outcome of a conference on public finances organised in January 2010 with the aim of addressing the significant deterioration of French public finances. Several working groups were set up to, *inter alia*, consider new budgetary rules and propose new reforms, notably aimed at further curbing the evolution of health-care spending, or at better controlling local expenditures.

Table II.10.1:

Main features of country forecast - FRANCE

	2008				Annual percentage change					
	bn EUR	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP		1950.1	100.0	1.9	2.2	2.3	0.4	**-2.2**	**1.3**	**1.5**
Private consumption		1114.1	57.1	2.0	2.4	2.5	1.0	**0.8**	**0.6**	**1.3**
Public consumption		451.6	23.2	1.5	1.3	1.5	1.2	**1.6**	**1.4**	**0.3**
Gross fixed capital formation		427.2	21.9	2.0	4.1	6.5	0.6	**-6.9**	**-2.4**	**1.9**
of which : equipment		119.9	6.1	3.2	2.2	9.5	2.7	**-10.6**	**-1.2**	**2.7**
Exports (goods and services)		515.6	26.4	5.2	4.8	2.6	-0.2	**-11.5**	**4.7**	**5.1**
Imports (goods and services)		563.8	28.9	5.3	5.6	5.4	0.8	**-9.8**	**4.1**	**4.5**
GNI (GDP deflator)		1963.0	100.7	2.0	2.6	2.4	0.0	**-2.3**	**1.3**	**1.4**
Contribution to GDP growth :	Domestic demand			1.9	2.5	3.1	1.0	**-0.7**	**0.2**	**1.2**
	Inventories			0.0	0.0	0.0	-0.3	**-1.3**	**1.1**	**0.2**
	Net exports			0.0	-0.3	-0.8	-0.3	**-0.2**	**0.1**	**0.0**
Employment				0.6	1.0	1.5	0.6	**-1.3**	**-0.7**	**0.3**
Unemployment rate (a)				10.1	9.2	8.4	7.8	**9.5**	**10.2**	**10.1**
Compensation of employees/f.t.e.				2.6	3.2	2.5	2.7	**1.8**	**1.6**	**1.7**
Unit labour costs whole economy				1.2	2.0	1.8	2.8	**2.8**	**-0.4**	**0.5**
Real unit labour costs				-0.3	-0.3	-0.7	0.3	**2.0**	**-1.2**	**-1.0**
Savings rate of households (b)				-	-	15.3	15.1	**16.3**	**16.5**	**16.5**
GDP deflator				1.5	2.4	2.5	2.5	**0.8**	**0.7**	**1.5**
Harmonised index of consumer prices				1.8	1.9	1.6	3.2	**0.1**	**1.4**	**1.6**
Terms of trade of goods				0.0	-0.3	1.1	-1.8	**3.7**	**-2.3**	**0.1**
Trade balance (c)				0.5	-1.5	-2.0	-2.7	**-2.2**	**-2.7**	**-2.6**
Current account balance (c)				0.8	-1.8	-2.3	-3.3	**-2.9**	**-3.3**	**-3.6**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.8	-1.8	-2.2	-3.3	**-3.0**	**-3.4**	**-3.6**
General government balance (c)				-3.5	-2.3	-2.7	-3.3	**-7.5**	**-8.0**	**-7.4**
Cyclically-adjusted budget balance (c)				-3.3	-3.0	-3.7	-3.7	**-6.2**	**-6.6**	**-6.2**
Structural budget balance (c)				-	-3.2	-3.8	-3.8	**-6.2**	**-6.2**	**-6.2**
General government gross debt (c)				56.7	63.7	63.8	67.5	**77.6**	**83.6**	**88.6**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.