

10. FRANCE

Domestic growth weakened by global risks and declining confidence

Economic recovery gradually fading away

After real GDP expanded by 1.5% in 2010, the economy continued accelerating in the first quarter of 2011 and grew by a strong 0.9% q-o-q, still supported by exceptional factors such as the car scrapping premium or the catch-up of inventories. Growth came to a halt in the second quarter, again partly reflecting temporary factors such as low energy consumption due to exceptionally mild weather conditions. Without these various elements, the decline in growth in the second quarter would have been less pronounced. Against this backdrop, GDP is still expected to increase in quarter-on-quarter terms in the third quarter, with a technical rebound of a modest 0.2% (mostly thanks to private consumption), before entering into slightly negative territory in the last quarter, in line with rapidly deteriorating confidence indicators. This quarterly profile translates into annual growth in 2011 of 1.6%.

In 2012, growth is expected to turn marginally positive again in the first quarter, in parallel with a stabilisation of economic sentiment. However, the subdued pace of the recovery will only slightly strengthen during the second half of the year, resulting in annual 2012 growth of a mere 0.6%.

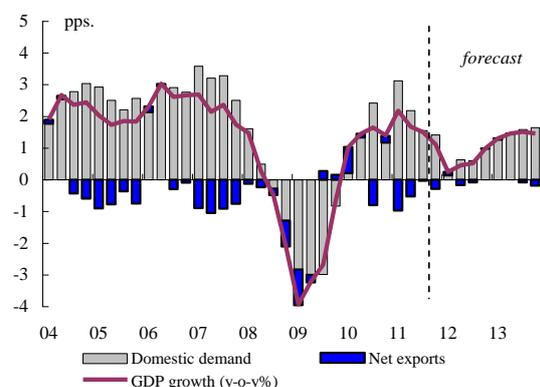
In 2013, annual growth is expected to accelerate to 1.4%, as confidence improves gradually in line with a fading of the sovereign-debt crisis. Investment growth is forecast to pick up towards the above-average pace seen in 2011, as the catch-up following the 2008-09 crisis has yet to fully materialise.

All components of domestic demand slowing down markedly

The significant downward growth revision compared to the spring forecast stems from the deterioration of the external environment, notably in the euro area and the US, with negative confidence effects weighing on both domestic and external demand and affecting consumers and companies. This can mainly be attributed to the impact of the sovereign-debt crisis on financial markets, which feeds into economic agents' expectations. In particular, the household saving rate is expected to stabilise at the high levels

already recorded, and corporate investment is forecast to slow down markedly in 2012. Moreover, the inventory cycle seems to have now come to an end with the very strong contribution recorded in the first quarter of 2011. France's external trade deficit has reached new highs in mid-2011, although this was partly related to more resilient domestic demand than in some partner countries (as shown by the positive contribution of net trade to growth in the second quarter, when domestic demand retreated).

Graph II.10.1: France - GDP growth and contributions



The marked GDP slowdown in 2012 is expected to have the strongest impact on investment, in a context of somewhat tighter financing conditions, falling utilisation rates and demand, and deteriorating profit margins. A key issue will be the ability of the French banking system to take the necessary measures to satisfy Basel III requirements while limiting deleveraging in its domestic market.

Private consumption: retreating but still somewhat resilient

Household consumption growth is expected to be slowed down by a lacklustre labour market, which has been the principal factor driving the observed fall in consumer confidence indexes in mid-2011. The escalation of the sovereign-debt crisis and the corresponding tensions on financial markets further depressed sentiment.

In this regard, household consumption will be significantly shaped by the general climate of the

crisis. Although wealth effects tend to be rather limited in France, the very high saving rate already reached in the second quarter of 2011 tends to suggest a more Ricardian attitude of French households: in spite of their relatively limited indebtedness, households might now be anticipating the consequences of fiscal consolidation needs in their country and abroad. Therefore, the household saving rate is expected to stay constant over the forecast period, in spite of its elevated level. Private consumption is nevertheless expected to accelerate from 0.9% in 2012 to 1.6% in 2013, in line with the evolution of real disposable income (increasing from 1.1% to 1.4%).

Additional tax measures announced in August are not expected to weigh heavily on private consumption, as they mostly target high revenue earners or large profitable firms, which show a lower propensity to consume or invest. A recent drop of inflation expectations – in line with the slowdown expected in this forecast – is also set to exert a positive impact on private consumption in 2012-13. Still, lower inflation expectations are projected to be more than offset by the above-mentioned significant deterioration of households' employment expectations, the uncertainties associated with the sovereign-debt crisis, and the continued fragility of the financial sector.

Investment and inventories significantly affected by uncertainty

Capacity utilisation rates have generally been retreating somewhat from June 2011 onwards, suggesting that the causes for the investment slowdown began to materialise even before the summer turmoil on financial markets. Moreover, composite business climate indices are now generally below their long-term averages and have been rapidly deteriorating, casting doubts over growth prospects for the coming quarters. A deceleration of gross fixed capital formation seems therefore unavoidable, although the third quarter of 2011 is expected to have benefited from the lagged impact of rather robust housing starts in the preceding quarters. Financial institutions sector, still posting large profits in the first half of the year despite a substantial provisioning for Greek bonds in balance sheets, is under stress as a result of the sovereign-debt crisis, which is forecast to weigh on credit supply. Specifically, credit conditions are expected to tighten as banks need to strengthen their capital positions. However, recent

announcements by French banks suggest that adjustment will focus mostly on corporate and investment banking, export credit, and retail activities abroad. At the same time, on the demand side, depressed business confidence caused by the sovereign and financial crisis is expected to cause some postponement of planned investment projects. The above-mentioned supply constraints can therefore be masked for some time by depressed credit demand.

As far as inventories are concerned, these are now found to be slightly above desired levels, suggesting a limited negative contribution to growth in the two last quarters of 2011 and the first quarter of 2012.

External trade improving somewhat, thanks to weak domestic demand

France has been losing market shares for a number of years. Some further decrease is expected over the forecast period in the context of steady increases of unit labour costs (peaking at 1.9% in 2012), as the French labour market is expected to adjust mostly through employment. Foreign demand will also suffer from the worsening of economic prospects in large economies like the US, Germany or the Mediterranean neighbours. However, the contribution of external trade to GDP growth is expected to be almost neutral, thanks to the marked slowdown of imports associated with weaker domestic demand. Overall, after a pronounced widening in 2011, in line with record trade deficits, the current external deficit is expected to decline somewhat, back to 3.0% of GDP in 2013.

Labour market weighs on confidence in spite of rising disposable income

Due to the rigidities of the French labour market, the corporate sector is likely to adjust wage bills more through a freeze on hiring than through wage adjustment. Unemployment is consequently expected to increase over the forecast period, with net job creation not fully absorbing the increase of the active population. This was already observed in the second quarter of 2011, even before the slowdown of investment. However, the rise in labour force participation observed in 2011 corresponds to a transitory supply shock. This shock is underpinned by recent measures, including the general pension reform and cancellation of exemptions to the job search

obligation, which boost the active population, while the working age population is set to remain stable in 2012 and 2013. This largely explains why so far the increase in unemployment has hit older workers harder than other groups. Moreover, the rise in subsidised employment towards the end of 2011, in line with announcements made several months ago, is expected to cushion headline unemployment figures somewhat in the short run.

Overall, employment is still expected to expand. Combined with relatively steady nominal wage growth per head in the private sector (2.4% in 2012, 2.5% in 2013), this is set to result in fairly dynamic nominal compensation of employees.

Stable inflation prospects

The previous annual average HICP inflation forecast for 2011 remains unchanged at 2.2%, but in 2012 it is somewhat lower than expected in the spring (now 1.5% instead of 1.7%), and in 2013 inflation is set to decline to 1.4%. The disinflationary impact of lower oil prices and the dim macroeconomic environment in 2012 is set to be only partly offset by various measures associated with the latest fiscal package. These include the increase of excise taxes on tobacco, strong alcohols and soft drinks, as well as some other corporate taxation measures likely to indirectly impact consumer prices. In the absence of significant hikes of consumption taxes (VAT) or administered prices, headline HICP inflation is forecast to stay below levels recorded in a number of peer countries. Core inflation is set to amount to around 1½% in 2012 and 2013.

Risks to the forecast are large given the global uncertainty

There are upside as well as downside risks associated with the ongoing sovereign-debt crisis, depending on the timing of crisis decisions likely to impact on confidence. If confidence returns, it could prove robust and consequently translate into healthier growth patterns than those envisaged in the current forecast, particularly thanks to a drop in the household saving rate and a bringing forward of investment decisions.

There is also significant uncertainty about the extent of the transmission of the financial tensions to the real economy. The current scenario only assumes some limited credit tightening, with a significant but contained impact on investment

(and private consumption, via confidence and consumer credit). However, a more restrictive stance cannot be fully excluded, depending on the evolution of the global environment. In this adverse scenario, a sharper fall in investment would heavily affect employment prospects, with a significant second-round impact on private consumption. Exports would also drop due to the deterioration of domestic demand in partner countries.

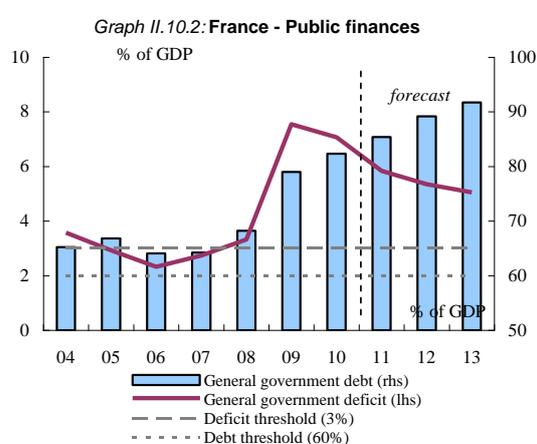
Fiscal consolidation: need for close vigilance

In 2011, the public deficit is projected to reach around 5¾% of GDP, down from 7.1% of GDP last year. This is broadly in line with the latest official forecast (5.7% of GDP) at time of publication. Expenditure growth is set to remain below historical levels, with no increase in central government spending in volume terms and only subdued growth in social benefits. While this is partly due to the phasing-out of the remaining stimulus measures, some consolidation measures also contribute to the planned adjustment: a freeze on base wages for civil servants, the replacement of only half of retiring civil servants, a tighter healthcare spending norm combined with improved monitoring, and a nominal freeze on transfers to local authorities. On the revenue side, discretionary measures are expected to reduce the deficit by around 1% of GDP, mainly consisting of a reduction in tax expenditure together with the end of the temporary cost of the local business tax reform.

Concerning 2012, the French authorities announced in August 2011 a new fiscal package of around ½% of GDP. The package mainly consists of revenue measures, while new expenditure cuts represent less than 0.1% of GDP. In particular, additional revenues would be raised through a further cut in tax expenditure, limiting the possibilities for carrying over losses in the calculation of corporate income tax, and a rise in excise duties on tobacco and alcohol. An additional temporary tax on top incomes is due to remain in force until the 3% of GDP deficit target for 2013 is met. However, according to this forecast, the deficit is expected to reach about 5¼% of GDP in 2012, thus remaining well above the slightly revised official target of 4.5% of GDP (4.6% in the April 2011 update of the Stability Programme). The difference mainly stems from divergent macroeconomic scenarios (approximately 0.6 pp.) and does not take into

account possible additional measures. Such measures might be adopted if the macroeconomic scenario underlying the draft budget for 2012 is revised downwards by the authorities after the cut-off date of this forecast, as these have recently indicated. Furthermore, while the recently adopted pension reform will start yielding savings, expenditure is set to increase somewhat faster than currently envisaged by the authorities. This is due to expected higher social benefits in line with a more cautious employment outlook and higher interest payments reflecting the recent rise in interest rate.

In 2013, under the usual no-policy-change assumption, the deficit is forecast to improve only marginally to around 5% of GDP, mainly due to the increasing impact of the pension reform (additional estimated impact of 0.2% of GDP). The expected outcome thus remains significantly above the official target of 3.0% of GDP. This is mainly linked to the less benign macroeconomic scenario and a significant base effect. In addition, the authorities envisage even more subdued expenditure growth than in previous years, for which corresponding structural measures are however not yet specified and which therefore cannot be taken into account in this forecast.



Overall, this implies an improvement in the structural balance of approximately 1¼% of GDP over the forecast horizon, mainly concentrated in 2011 and 2012 (1% and ¾% of GDP respectively).

The debt ratio is expected to continuously rise over the forecast horizon, reaching 92% of GDP in 2013. This projection includes the impact of guarantees to the EFSF, bilateral loans to Greece, and the participation in the capital of the ESM as planned on the cut-off date of the forecast (together 1% of GDP). The State guarantee to Dexia Group and its subsidiary Dexia Crédit Local is not expected to have an impact on public debt.

Table II.10.1:

Main features of country forecast - FRANCE

	2010			Annual percentage change						
	bn EUR	Curr. prices	% GDP	92-07	2008	2009	2010	2011	2012	2013
GDP	1932.8	100.0	100.0	2.0	-0.1	-2.7	1.5	1.6	0.6	1.4
Private consumption	1124.2	58.2	58.2	1.9	0.2	0.2	1.4	0.7	0.9	1.6
Public consumption	479.9	24.8	24.8	1.5	1.3	2.3	1.2	0.8	0.4	0.3
Gross fixed capital formation	373.3	19.3	19.3	2.4	0.3	-9.0	-1.2	3.0	0.8	2.7
of which: equipment	101.2	5.2	5.2	3.5	3.5	-9.6	4.1	9.1	1.2	5.8
Exports (goods and services)	492.2	25.5	25.5	5.0	-0.3	-12.4	9.7	4.9	3.5	4.9
Imports (goods and services)	537.5	27.8	27.8	5.2	0.9	-10.8	8.8	6.1	3.3	4.6
GNI (GDP deflator)	1968.1	101.8	101.8	2.1	-0.1	-2.9	1.7	1.6	0.7	1.5
Contribution to GDP growth:										
Domestic demand				1.9	0.5	-1.3	0.9	1.2	0.8	1.5
Inventories				0.1	-0.2	-1.2	0.6	0.9	-0.2	0.0
Net exports				0.0	-0.3	-0.2	0.1	-0.4	-0.1	-0.1
Employment				0.7	0.7	-1.4	0.1	0.6	0.4	0.4
Unemployment rate (a)				9.9	7.8	9.5	9.8	9.8	10.0	10.1
Compensation of employees/f.t.e.				2.6	2.4	1.8	2.1	2.3	2.1	2.1
Unit labour costs whole economy				1.3	3.2	3.2	0.7	1.3	1.9	1.1
Real unit labour costs				-0.3	0.6	2.7	-0.1	0.1	0.4	-0.6
Saving rate of households (b)				14.9	15.3	16.2	15.6	15.5	15.6	15.5
GDP deflator				1.6	2.5	0.5	0.8	1.2	1.5	1.7
Harmonised index of consumer prices				1.8	3.2	0.1	1.7	2.2	1.5	1.4
Terms of trade of goods				0.0	-0.7	2.2	-2.6	-2.6	-0.4	1.1
Merchandise trade balance (c)				0.2	-2.7	-2.2	-2.6	-3.8	-4.0	-3.9
Current-account balance (c)				0.8	-1.9	-2.1	-2.2	-3.2	-3.3	-3.0
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.8	-1.9	-2.1	-2.2	-3.1	-3.1	-2.8
General government balance (c)				-3.4	-3.3	-7.5	-7.1	-5.8	-5.3	-5.1
Cyclically-adjusted budget balance (c)				-3.7	-3.9	-6.2	-5.8	-4.7	-4.0	-3.9
Structural budget balance (c)				-	-4.0	-6.2	-5.7	-4.7	-4.0	-3.9
General government gross debt (c)				57.7	68.2	79.0	82.3	85.4	89.2	91.7

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