

10. FRANCE

Relatively resilient private consumption, rapidly deteriorating public finances

Weaker domestic demand in 2008

In 2008, GDP grew by 0.7% in real terms, down from 2.1% in 2007. Growth decelerated markedly in the course of the year and collapsed in the fourth quarter with a drop of 1.1% q-o-q, the worst quarterly performance ever registered.

The weakening of world trade as well as the impact of the financial crisis on credit conditions and confidence took their toll on the French economy. In 2008, growth was exclusively driven by domestic demand, in particular by private consumption, while net trade and stocks acted as a drag on activity. But even domestic demand slowed as household disposable income was hit first by inflation and then by deteriorating labour incomes, whilst investment suffered from the downturn in the housing market and in the investment cycle. For 2008 as a whole, domestic demand contributed 1.2 pps. to GDP growth, compared to close to 3 pps. in 2007. Net exports again put a drag on growth, as French exports slowed down more than imports. At the same time, faced with funding difficulties and heightened uncertainties, businesses chose to run down their inventories to meet demand, with a huge negative impact on growth in the fourth quarter, and a -0.2 pp. effect for 2008 as a whole.

Real GDP in negative territory throughout 2009

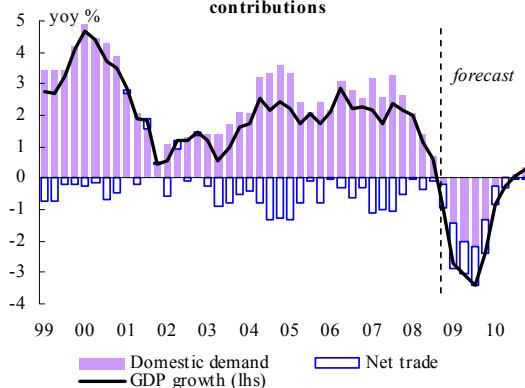
There are no clear signs of recovery in the short term. Business surveys have continued to deteriorate in recent months in most sectors. In services and in the manufacturing sector,

expectations of activity are at historically low levels, suggesting that the decline in production and the recession will continue. Thus, GDP is assumed to have fallen sharply again in the first quarter of 2009, by 1½%. GDP growth is expected to remain negative throughout 2009, but at a steadily diminishing rate as the recently introduced stimulus plan, the expected impact of monetary easing and a stabilisation of activity in France's trading partners lead to a timid recovery in late 2009. In 2010, activity will still be very weak, with growth remaining close to stagnation on average.

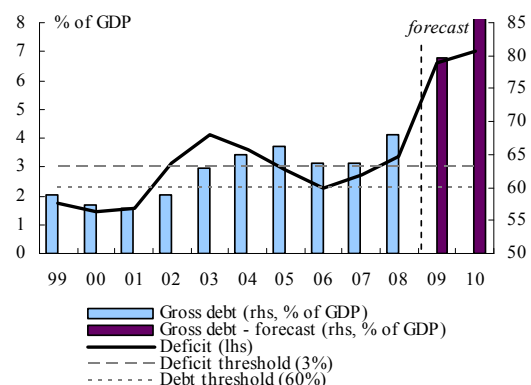
Private consumption will slow markedly but remain slightly positive in 2009 and 2010. On the one hand, household disposable income should be more and more penalised by the drop in earned income, as employment declines sharply and the rise in unemployment puts downward pressure on wages. On the other hand, households' disposable income should benefit more from the fall in inflation, the increase in welfare benefits – notably family benefits and retirement pensions –, the tax cuts and higher unemployment benefits implemented to cushion the effect of the crisis. However, faced with a deteriorating labour market and uncertainties about the economic situation, households can be expected to be cautious, increasing their precautionary savings instead of spending the additional revenues. The saving rate would thus rise to 16½% by 2010.

Production is affected by an outlook of weak demand, almost no signs of recovery in order books, the underutilisation of production capacities and funding difficulties. All of these factors,

Graph 2.10.1: France - GDP growth and contributions



Graph 2.10.2: France - General government gross debt and deficit



combined with widespread declines in profits and the need to strengthen their balance sheets, mean that businesses are expected to sharply cut their investment through 2009. This will also lead to further inventory reduction. Together with a very negative carry-over from 2008, stocks are expected to put a large drag on growth in 2009 as a whole. In the course of 2010, productive investment will very timidly recover once economic activity stabilises. As far as investment in construction is concerned, the housing market shows very limited signs of improvement and is thus expected to carry on falling. Buyers are adopting a "wait and see" attitude, new housing stocks are swelling and sales are down. In addition, tightening lending conditions, slowing incomes as well as expectations of further price decreases are preventing many households from buying a property. However, public investment, boosted by the recovery plan, should somewhat cushion the drop in construction sector activity. All in all, overall investment is expected to fall by around 6% in 2009 and then 3% in 2010.

In a context of a general fall in activity, world demand for French products is forecast to be down by close to 10% in 2009 for both goods and services as tourism will also suffer from the widespread economic crisis. Exports are set to fall dramatically – by a two-digit figure – in 2009. In a context of contracting final demand, import growth is set to diminish significantly but less than exports as private and public consumption remain positive. Net trade is therefore expected to put a large drag on growth in 2009 and a smaller one in 2010. In this context, the current-account deficit will deteriorate in line with the trade balance. The sharp fall of import prices of goods triggered by commodity prices in 2009 will, however, soften this deterioration.

Job losses and rising unemployment

Despite modest GDP growth, employment continued to expand in 2008, by around 1%, due to dynamic job creation in the first half of 2008. In 2009 and 2010, employment prospects will reflect the weakness of economic activity in general. Specifically, the job shedding which started in the third quarter of 2008 is expected to gain momentum as a result of the contraction of global activity and then gradually stop in the course of 2010, reflecting the traditional lag between growth and employment. Total employment will fall by around 2% in 2009 and 1% in 2010. Despite the

fact that the working-age population is still growing, the labour force is expected to slightly contract over the forecast period with people leaving it because they are discouraged by the scale of the downturn. This will somewhat dampen the increase in the unemployment rate, which will nonetheless climb to 11% in 2010, crossing the psychological threshold of 3 million unemployed. Given the deterioration in the labour market, wage growth is expected to be very moderate over the forecast horizon.

Inflation will continue to fall and is expected to be close to zero in 2009 on average, pushed down by several factors: the sharp fall in commodity prices, notably in energy prices and production costs, the pressure on profit margins of businesses and distributors due to slackening demand, as well as some impact on retail prices from the Loi de Modernisation de l'Economie⁽²⁾. Core inflation is likely to slow until the end of the forecast period to 1% in 2010.

Public finances: high deficit and sharply increasing debt

The general government deficit breached the 3%-of-GDP threshold in 2008, increasing from 2.7% in 2007 to 3.4% of GDP in 2008. The structural deficit (the cyclically-adjusted deficit net of one-offs) added a further 0.4 pp. to the deterioration of 0.5 pp. in 2007.

The sharp decline of economic activity in the fourth quarter weighed on government revenue. The tax burden decreased to 43% of GDP in 2008 from 43.4% in 2007, and total revenue from 49.6% to 49.3%. The corporate tax and VAT were particularly squeezed by the downturn, as well as duties on real estate transactions. Discretionary measures, such as rebates on the local business tax and the so called TEPA package which comprises various tax cuts, notably on overtime, also had a negative impact on revenue. On the expenditure side, according to the information available the zero volume growth rule for central government expenditure appear to have been met. However, the target for expenditure in value was exceeded, notably due to interest expenditure in a context of high inflation. Furthermore, the social security spending objective seems to have been adhered to. Local expenditure was rather contained, reflecting the end of the electoral cycle. In 2009, the deficit is projected to rise markedly, to 6½% of GDP. This increase reflects the difficult economic

environment and takes into account the recovery measures announced so far. Tax revenue is forecast to be hit hard by the economic downturn and particularly by the sharp decline in asset prices, which is expected to have a significant impact, notably on corporate and property transaction taxes. Concerning expenditure, on top of higher social transfers in line with unemployment, this forecast takes into account the impact of the recovery plan on the deficit (0.8 pp.), as well as the measures announced following the 18 February social summit in favour of households (0.1 pp.). It is assumed that the zero volume growth rule for central government expenditure will be adhered to. Local authorities' investment growth is expected to remain relatively moderate. Overall, the revenue-to-GDP ratio is estimated to decrease by about ½ pp. of GDP, while the expenditure-to-GDP ratio is set to increase by 3 pps. of GDP.

Under the conventional assumption of unchanged policies, the deficit could widen further in 2010, to 7% of GDP. Although the almost complete phasing-out of the recovery plan will have a positive impact on the expenditure-to-GDP ratio, this is expected to be more than offset by the effect of the normal functioning of automatic stabilisers and increased interest payments. Revenues as a

share of GDP are projected to slightly increase as the economy begins to recover.

Debt, which stood at 68% of GDP in 2008, is forecast to reach almost 80% of GDP in 2009, before attaining a record level of 86% of GDP in 2010. This is due to the high expected deficit and to the financial rescue measures already implemented. In particular, this projection includes liabilities stemming from the *Société de financement de l'économie française*, a scheme to improve the liquidity of banks (around 3.7% of GDP).

- (²) The law (summer 2008) relaxed the rules governing the negotiation of sales conditions and the opening of large-scale retail outlets with a view to increasing competition in the retail sector.

Table 2.10.1:

Main features of country forecast - FRANCE

	2007		Annual percentage change							
	bn Euro	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices	1892.2		100.0	1.9	1.9	2.2	2.2	0.7	-3.0	-0.2
Private consumption	1072.0		56.7	2.0	2.6	2.3	2.4	1.4	0.2	0.3
Public consumption	438.0		23.1	1.6	1.2	1.3	1.4	1.7	1.8	1.1
Gross fixed capital formation	406.3		21.5	1.9	4.4	4.7	4.9	0.5	-5.9	-2.6
of which : equipment	113.4		6.0	3.2	3.2	2.8	5.8	-0.5	-11.4	-4.4
Exports (goods and services)	501.9		26.5	5.4	3.1	5.4	3.1	1.2	-11.7	-1.0
Imports (goods and services)	538.3		28.4	5.2	5.9	6.1	5.6	2.2	-6.9	0.0
GNI at previous year prices (GDP deflator)	1902.1		100.5	2.0	1.7	2.2	2.0	0.7	-3.0	-0.2
Contribution to GDP growth :										
Domestic demand				1.8	2.6	2.6	2.7	1.3	-0.8	-0.1
Stockbuilding				0.0	0.0	-0.1	0.2	-0.3	-1.2	0.2
Foreign balance				0.1	-0.7	-0.2	-0.7	-0.3	-1.0	-0.2
Employment				0.6	0.6	0.8	1.7	0.6	-2.2	-1.2
Unemployment rate (a)				10.2	9.2	9.2	8.3	7.8	9.6	10.7
Compensation of employees/f.t.e.				2.6	3.1	3.4	2.6	2.8	1.3	1.5
Unit labour costs whole economy				1.2	1.8	2.0	2.1	2.7	2.0	0.4
Real unit labour costs				-0.3	-0.3	-0.5	-0.4	0.3	0.6	-0.7
Savings rate of households (b)				-	-	14.9	15.6	15.4	16.1	16.5
GDP deflator				1.5	2.0	2.5	2.5	2.4	1.4	1.2
Harmonised index of consumer prices				1.8	1.9	1.9	1.6	3.2	0.2	0.9
Terms of trade of goods				0.1	-1.3	-0.5	0.2	-2.7	3.0	-0.3
Trade balance (c)				0.6	-1.3	-1.5	-2.0	-2.9	-3.1	-3.4
Current account balance (c)				1.0	-1.8	-2.1	-2.8	-3.8	-4.3	-4.6
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				1.0	-1.8	-2.0	-2.8	-3.8	-4.4	-4.7
General government balance (c)				-3.5	-2.9	-2.3	-2.7	-3.4	-6.6	-7.0
Cyclically-adjusted budget balance (c)				-3.2	-3.5	-3.1	-3.8	-4.2	-5.5	-5.5
Structural budget balance (c)				-	-4.1	-3.4	-3.9	-4.3	-5.5	-5.5
General government gross debt (c)				55.9	66.4	63.7	63.8	68.0	79.7	86.0

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