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Economic Research:

French Economic Outlook: Sideways Or Upward?

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Economic Research:

French Economic Outlook: Sideways Or Upward?

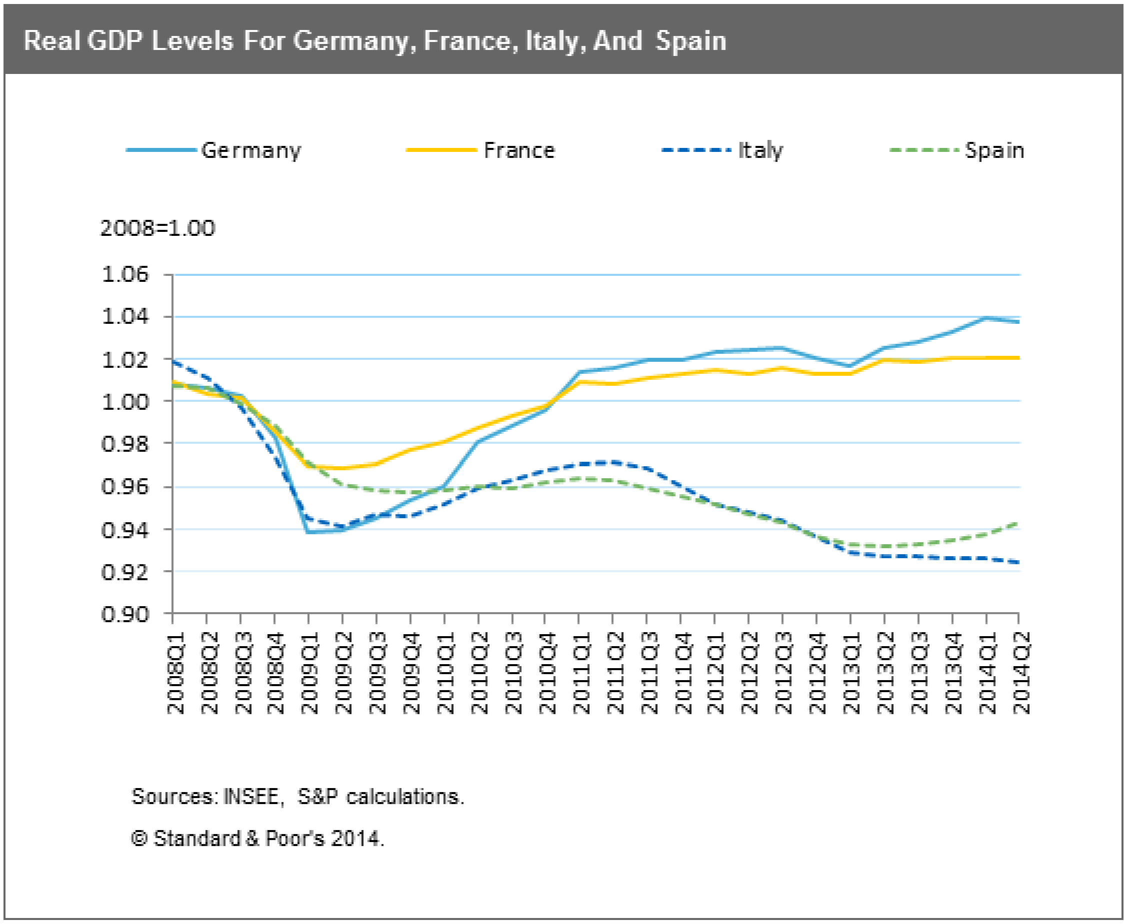
The French economy weathered the global financial crisis relatively better than most of its peers in Europe. French GDP recovered from the 2009 recession as early as 2011 and as of mid-2014 stood about 2% above its 2008 level. The resilience of domestic consumption, thanks in particular to fiscal stabilizers, goes a long way in explaining this performance that stands in contrast with that of Italy or Spain.

Yet the French economy has hardly grown since the beginning of 2013. While the eurozone as a whole was experiencing a (still modest) revival, French output growth has lagged behind the average. Only in the third quarter of 2014 did it exceed the eurozone's performance (0.3% versus 0.2%), and then only because of a surge in public consumption. Equally worrying, the latest purchasing managers' survey (November) showed the French index remaining stubbornly below the critical 50 line that delineates expansion from recession, suggesting that growth in the coming months is likely to remain sluggish. From our vantage point six years after the crisis, it looks as if the French economy has the ability to weather external shocks but lacks the dynamics to bounce back once global conditions start improving.

Overview

- A surge in French GDP growth in the coming two years depends on household consumption, which has stagnated since 2011.
- The weak corporate sector, both in terms of competitiveness and profitability, is in our view at the heart of France's sluggish economic performance.
- Reforms introduced in the past two years to free up the labor market and lower corporate taxes will take time to contribute to growth; meanwhile we forecast French GDP growing only 0.7% next year.

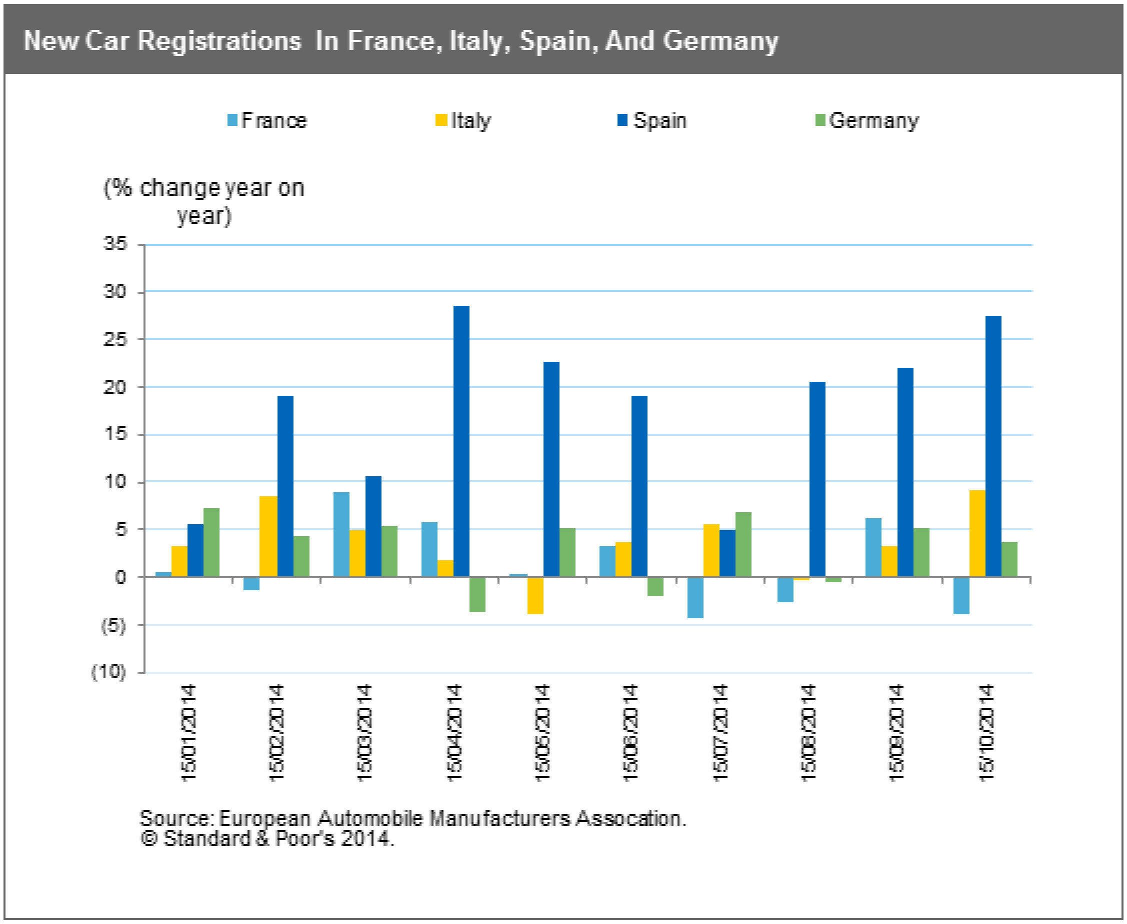
Chart 1



The Car Market Is A Case In Point

Trends in the French car market illustrate that point. In the 10 months to October 2014, new car registrations surged 6.5% in the EU (to 10.6 million). The recovery has been spectacular in the U.K. (9.5%), in Spain (18.1%), and in Ireland (30%). However, the French market was up a mere 1.4% and for the month of October alone it contracted 3.8%. The market has stabilized at around 1.8 million new registrations a year, down from 2 million before the crisis. What's more, there are no signs that it is likely to rebound before 2016 or even 2017, according to the European car manufacturers association.

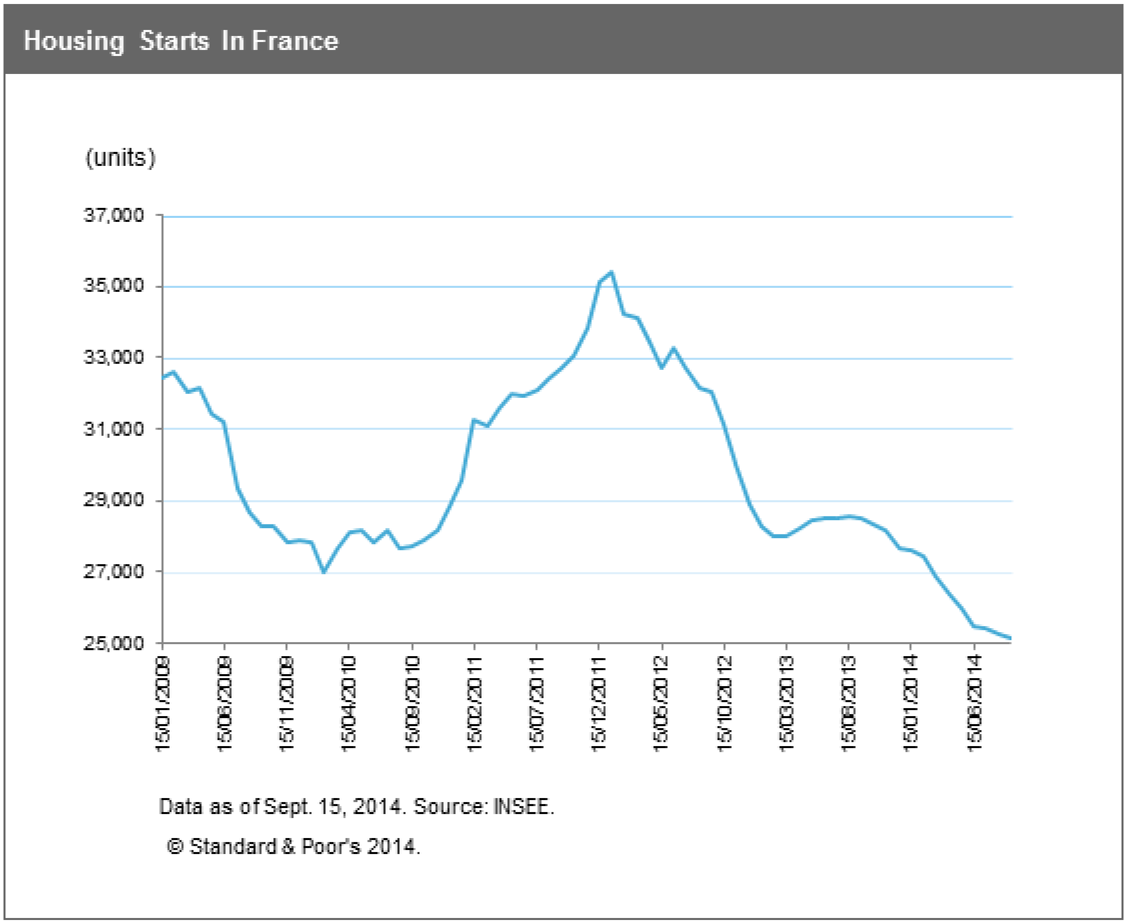
Chart 2



Another Traditional Growth Driver Switches Off

Along with the car market, the construction sector had been a strong contributor to French growth for decades. Recent trends suggest otherwise. Housing starts have been steadily declining since early 2012. From September 2013 to October 2014, starts reached a cumulative 301,758, down 11.7% from the same period a year earlier. This is well below the government's official target of 500,000, a number which incidentally was never achieved in recent history.

Chart 3



Activity in the residential housing sector depends on three key drivers: The first one is household purchases of newly built homes. Here, the recent restrictions on zero-interest loans have curbed demand from first-time buyers who were already struggling to access the market given high affordability ratios. Second, the buy-to-let segment has contracted 17% over the past 12 months, in part because of uncertainties about regulatory changes regarding rent. Lastly, social housing has also declined. Overall, housing investment is likely to contract 7% this year, its sharpest decline since 2009, with no signs of improvement in the short term.

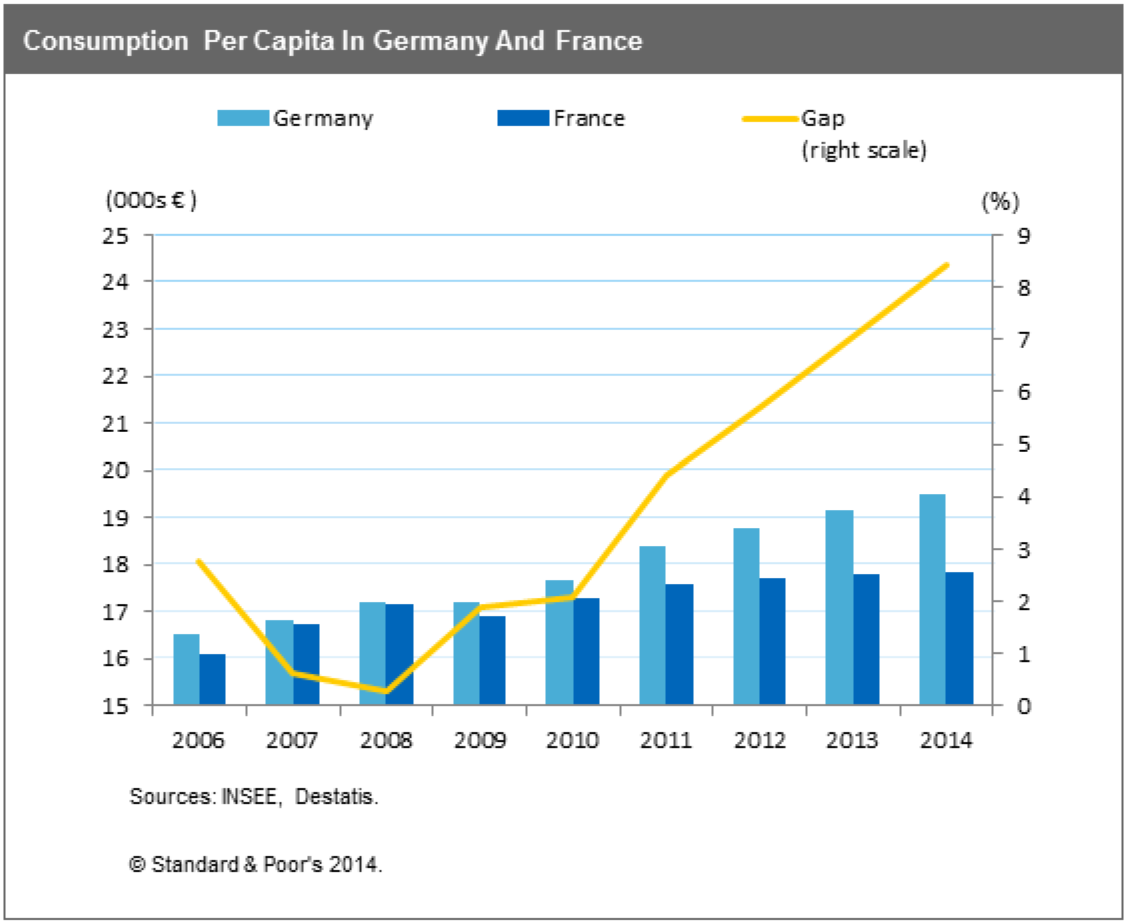
Fiscal Uncertainties Weigh On Consumer Demand

These two examples point to a larger issue: household consumption, whose resilience at the peak of the crisis served as a restoring force, has stagnated since 2011. A surge in overall GDP growth in the coming two years depends crucially on this key variable.

Let's not forget that French consumption per capita has been almost flat since 2006. The gap with German consumption per capita was 2.7% in 2006 and it reached 8.4% in 2014. Of course, contrasting demographic trends have played a role: Germany's population has been stable (- 0.1%) in the past eight years but has grown 4% in France.

These positive demographics are typically supportive of long-term growth, but has in the case of Franc resulted in relative impoverishment in terms of unit consumption per inhabitant.

Chart 4

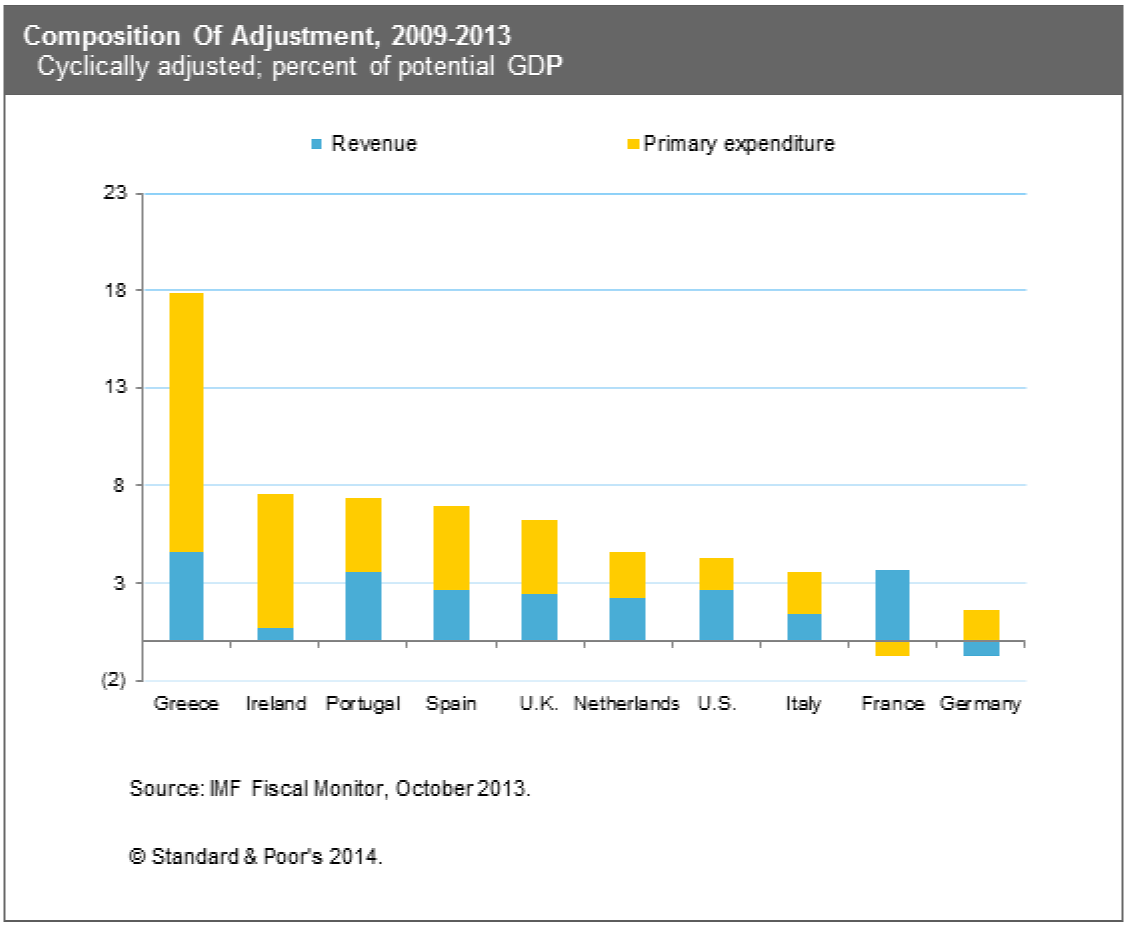


Part of the explanation lies in the labor market in France. The unemployment rate has risen to 10.2% (International Labour Organization definition) in second-quarter 2014 from 7.2% in first-quarter 2008. The rise is smaller than in many other eurozone countries (Italy and Spain, for instance), but from a strikingly high level. At the peak of the previous economic cycle, the jobless rate still exceeded 7%. This reflects deep rigidities in the labor market, suggesting a high structural unemployment rate. What's more, long-term unemployment has been steadily rising. As of May 2014, 22% of jobseekers had been unemployed for more than two years, the highest percentage ever.

The large tax wedge (the difference between before-tax and after-tax wages) is often mentioned as a hurdle to job creation: social contributions (by employers plus employees) are among the highest in the eurozone: 18.8% of GDP in 2013, compared with 16.9% in Germany. France's labor market regulatory reforms introduced in 2013 should add some flexibility. The new tax wedge reduction (tax credit or CICE in French) is calculated to reduce each private company's wage bill by up to 6% (excluding wages exceeding 2.5 times the minimum wage). The goal is to reduce employers' social contributions by €20 billion by 2017. The government announced an additional reduction of €10 billion as part of the "responsibility pact." So far, the effect of those measures has been modest. The French statistical office INSEE noted in its June 2014 economic outlook that for now the measures have only somewhat slowed the pace of job losses.

Higher income taxes also weigh on consumer demand. The International Monetary Fund (IMF) has recently calculated that France stands pretty much alone in the way it's been adjusting its public finances since the beginning of the crisis. According to the IMF's estimates, France is the only country where increased tax revenues were the single source of the adjustment. Such calculations are of course subject to some degree of uncertainty because they partly rely on concepts such as potential GDP, which are difficult to calculate. Nevertheless, they illustrate that the fiscal pressure on the private sector, and especially on households, has steadily increased at the expense of demand.

Chart 5



Looking ahead, the French government has stated numerous times recently that no new household taxes would be introduced in 2015. However, opinion polls show that French consumers are so far skeptical, given their recent experience. As a result, they are likely to keep a fair proportion of their incomes as precautionary savings.

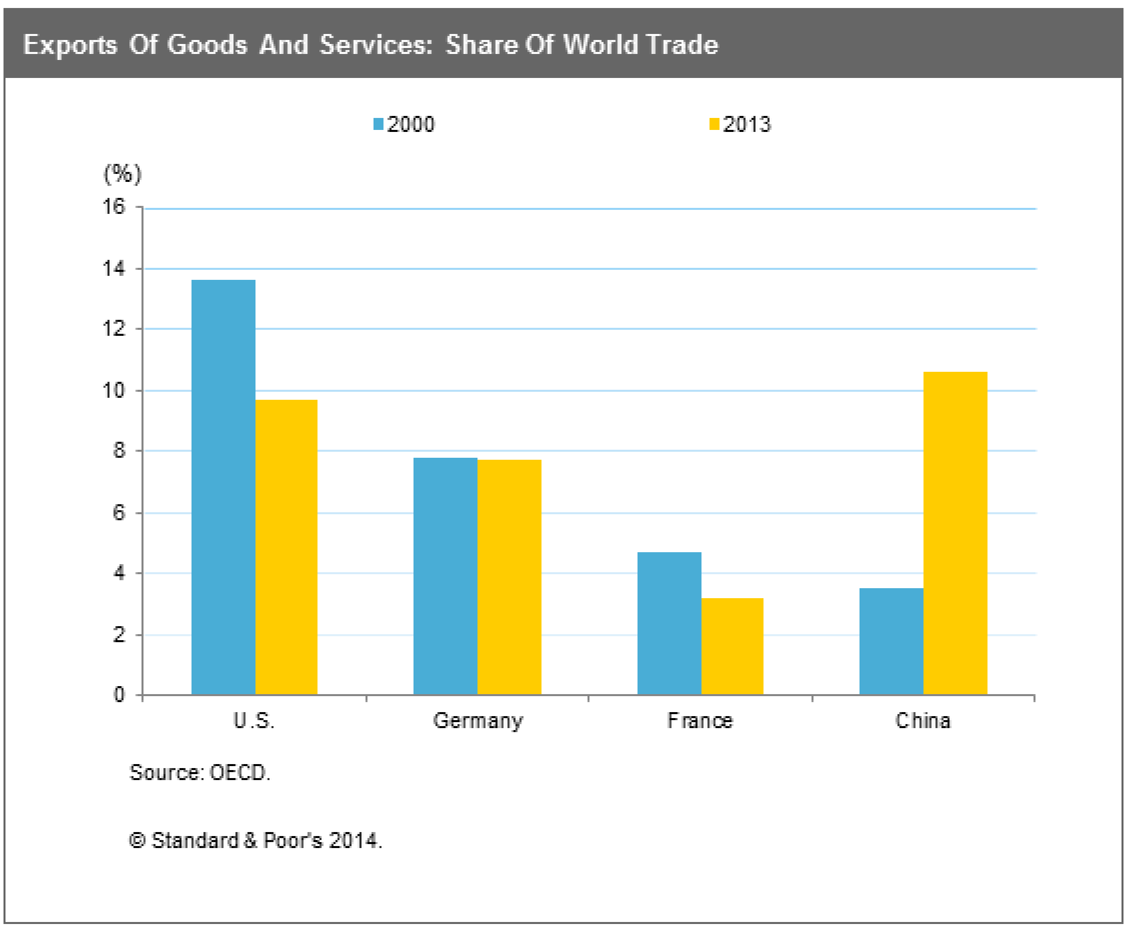
We do see some factors that should give a bit of a boost to French consumers' spending power in 2015 and beyond. Low inflation has generated a slight improvement in real earnings growth that for the private sector should reach 0.7% in 2014 (versus 0.3% in 2013) and 1.1% in 2015 and 2016. In addition, the large fall in oil prices, although somewhat smaller converted in euros, should provide an additional lift to consumption. Econometric models suggest that a $10 fall in the price of a barrel of oil (Brent) lifts consumption by 0.2% in real terms after four quarters. The sharp drop in the price of oil since the middle of 2014 should push the average price to about $85 to $90 in 2015, a $15 drop from the 2014 average. This will be positive for consumers, but perhaps not enough to erase all of their doubts about higher taxes and concerns about the need to save.

Overall we forecast consumption to rise 0.9% next year and 1.4% in 2016. This would still be well below the 2.6% yearly average in the decade to 2007.

Exports Are Not Coming To The Rescue

Exports have not compensated for the slack in domestic demand. Since 2005, French foreign sales have underperformed compared to other eurozone countries, rising by a total of 28.4% compared to Germany's 48.5% climb and Spain's 49.6% increase. The share of French goods in world trade has steadily declined since the beginning of the previous decade.

Chart 6



There are many reasons for the weak export performance. As wages grew on average more rapidly than productivity between 2000 and 2007, firms had to compress their margins to stay competitive. In turn, they increasingly allocated investment for the maintenance of existing capacity. INSEE, in a December 2013 report, noted that only about 20% of capital expenditures was allocated to innovation and modernization. The relatively weak share of automation in the French industry reflects the lack of innovation-oriented investments: According to the International Federation of Robotics, the operational stock of multipurpose industrial robots in 2013 amounted to 167,578 in Germany, 58,400 in Italy, 31,600 in France, and 28,700 in Spain. This means that French exporters have increasingly been competing on price, therefore squeezing their margins, creating a vicious circle where lower profits hamper investments and in turn innovation.

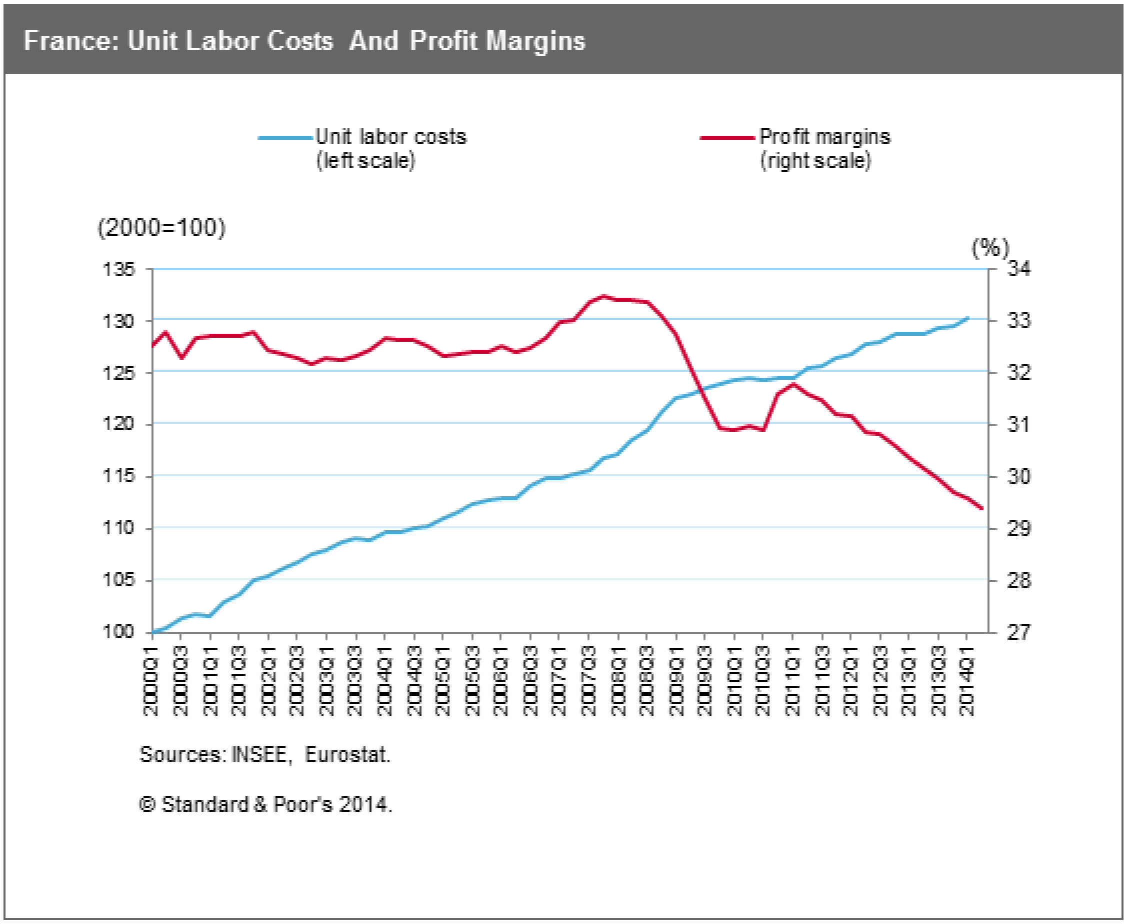
This situation tends to make foreign sales less attractive for small and midsize companies, and explains why France has fewer small and midsize exporters at 120,000 than Germany or even Italy at 307,000 and 208,000, respectively (2012 data).

We believe the underperformance of French foreign sales is unlikely to change meaningfully soon. Stronger growth in world trade in the coming two years and the weaker euro will be helpful, of course. But structural weaknesses--low margins, lack of research and development and innovation spending--require longer-term solutions.

The Heart Of The Matter: A Fragile Corporate Sector

The weak corporate sector, both in terms of competitiveness and profitability, is in our view at the heart of France's sluggish economic performance. The steady deterioration in profit margins has hurt the sector's ability to keep up with international competition, as the constant drop in global market shares illustrates. That deterioration reflects the corrosion in the industry's cost competitiveness. Unit labor costs have been rising more quickly than in many other countries, such as Germany, and haven't meaningfully declined since 2007, as they did in Spain, for instance. In addition, French industrial firms have experienced an increase in the price of their intermediate consumption of goods and services. As a result, they were forced to lower margins to maintain their price competitiveness, as noted earlier. As of the beginning of 2014, French nonfinancial corporate profitability stood as one of the lowest among the major EU economies.

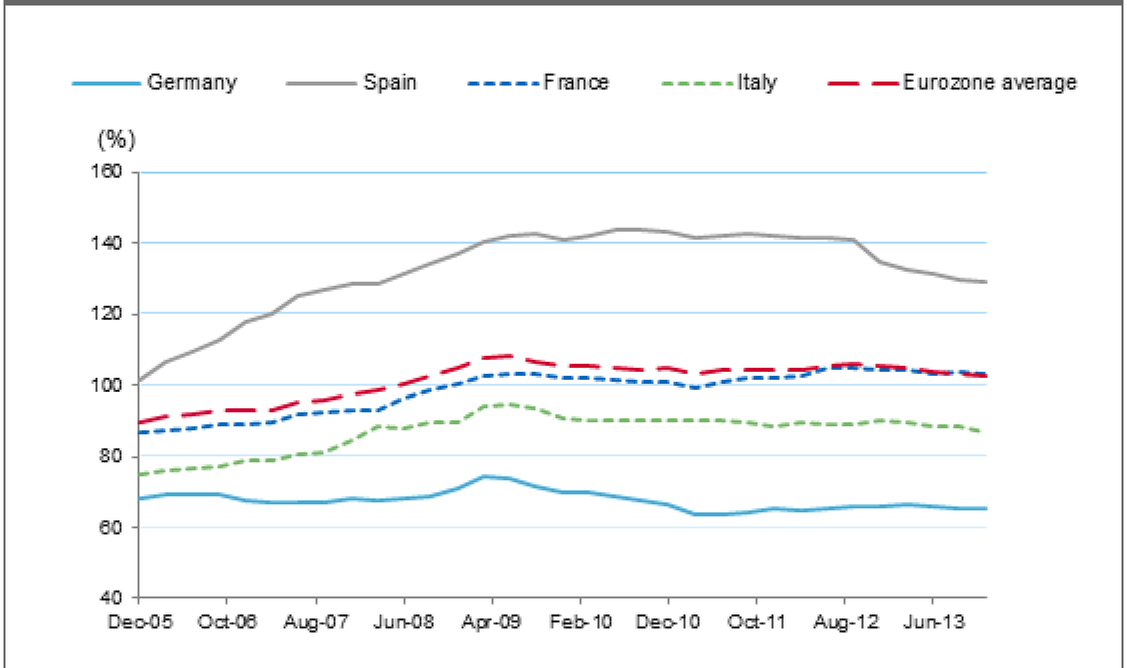
Chart 7



On the other hand, corporate debt has remained close to the eurozone average, above that of Germany and Italy, but well below Spain's. This suggests that the weakness in the French corporate sector stems mainly from "operational" issues—such as the level of taxation and labor market structure--than from past excess.

Chart 8

Nonfinancial Corporate Debt As A Share Of GDP In The Eurozone



Source: European Central Bank.

The government introduced a series of "supply side" measures--under the CICE (tax credit) and the "Responsibility Pact"--to reduce social contributions and labor costs. For 2015, those measures should represent about €30 billion. When taking into account the previous increases in taxes and contributions put in place from 2011, this means that the tax burden on the corporate sector at the end of 2015 will be back to where it was at the end of 2010, a positive but still modest step forward.

Reforms, In Time, Should Help The Economy

The French economy's resilience to external shocks has been remarkable in some ways but so has its inability to reform itself. The deterioration of the labor market during the crisis has been less dramatic than in other parts of Europe, but the many precrisis structural rigidities are still in place. The fiscal adjustment after 2009 relied nearly entirely on increased taxation, leaving the economy with one of the highest ratios of public spending to GDP in the EU, with the immediate consequence that consumers and corporates are unconvinced that the shift toward public spending cuts promised by the new cabinet of Prime Minister Manuel Valls will happen.

Some reforms were introduced in the past two years to loosen labor market regulation and lower corporate taxation.

Those measures will take time to produce some effects, and our forecast has French GDP growing only 0.7% next year (0.4% in 2014). What will critically affect the medium-term outlook for the economy will be the authorities' success in convincing economic agents--consumers, business leaders, and investors--that they will broaden the supply side policies they've started to unveil to benefit the entire economy. Trust and confidence are at the root of effective economic policies.

Table 1

Standard & Poor's Main European Economic Indicators, November 2014

Central forecast

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2012	0.6	0.4	-2.4	-1.6	-1.6	-0.1	-0.6	0.7	1.0
2013	0.2	0.4	-1.8	-1.2	-0.7	0.2	-0.4	1.7	1.9
2014(f)	1.4	0.4	-0.2	1.3	0.8	1.0	0.8	3.1	1.3
2015(f)	1.1	0.7	0.2	1.9	1.0	1.1	1.0	2.7	1.7
2016(f)	1.6	1.2	0.8	2.1	1.3	1.3	1.4	2.5	2.1
CPI inflation (%)									
2012	2.1	2.2	3.3	2.4	2.8	2.6	2.5	2.8	-0.7
2013	1.6	1.0	1.3	1.5	2.6	1.2	1.3	2.6	-0.2
2014(f)	0.9	0.6	0.2	-0.1	0.3	0.5	0.5	1.6	0.0
2015(f)	1.2	0.9	0.3	0.1	0.7	0.8	0.7	1.5	0.0
2016(f)	1.6	1.4	0.9	0.5	1.1	1.2	1.1	1.7	0.7
Unemployment rate (%)									
2012	5.5	9.8	10.7	24.8	5.3	7.7	11.3	8.0	2.9
2013	5.3	10.3	12.2	26.1	6.7	8.4	12.0	7.5	3.2
2014(f)	5.1	10.2	12.6	24.6	6.8	8.5	11.5	6.1	3.1
2015(f)	5.3	10.3	12.6	22.8	6.4	8.5	11.2	5.4	3.0
2016(f)	5.2	10.2	12.5	22.3	6.4	8.2	11.0	5.3	2.8

f--Standard & Poor's forecast.