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France: Rebalancing the economy

…is tough, but at least France is trying

Since our last update in December 2017, we have turned more constructive on the cyclical outlook, as we see real GDP growth staying above 2% in 2018/19E, thanks largely to the favourable global backdrop. Our inflation projections instead remain unchanged, at 1.4-1.5% in 2018/19E, as we see some growing company appetite for higher prices, but equally a fast response from consumers to scale down spending if inflation runs too high.

President Macron has delivered many changes in less than a year in office, touching on all the key three areas that, in our view, were a priority for the electorate: jobs, taxes and education. While the activism and breadth of changes are laudable, we see three obstacles. Greater labour flexibility, coupled with the fact that France has among the highest compensation levels in the EU, in the bottom 40% of the income distribution, in our view, should lead to the repricing of wages lower, in time. This is doomed to hurt his approval rating and caps consumption potential. Secondly, we suspect he has not put enough resources into supporting SMEs: the business sector in France is dynamic, but small companies in this world are ferociously disadvantaged. To prosper, they need more help. Last, but not least, relative to people's perceptions of what the education sector needs, the recently-announced reform may materialise too slowly.

- **#ChangingFrance**

Back in December, we had noted that the message from business surveys in France and across the Eurozone was particularly bullish. The first estimate of 4Q17 real GDP confirmed that the optimism was genuine. The economy grew by 2.4%yoy, the highest reading since 2011, reflecting a growing contribution from net exports and investment, which offset the moderation in consumer spending. Investment, excluding inventories, added 1ppt to the yearly change in real GDP – the biggest contribution since 2008, while net exports added 0.2ppts, which may not seem like a lot, but it is a refreshing change after the negative contributions registered since 2012. Private consumption continued to play an important role – adding 0.8ppts to yearly GDP – but less so than in the past.

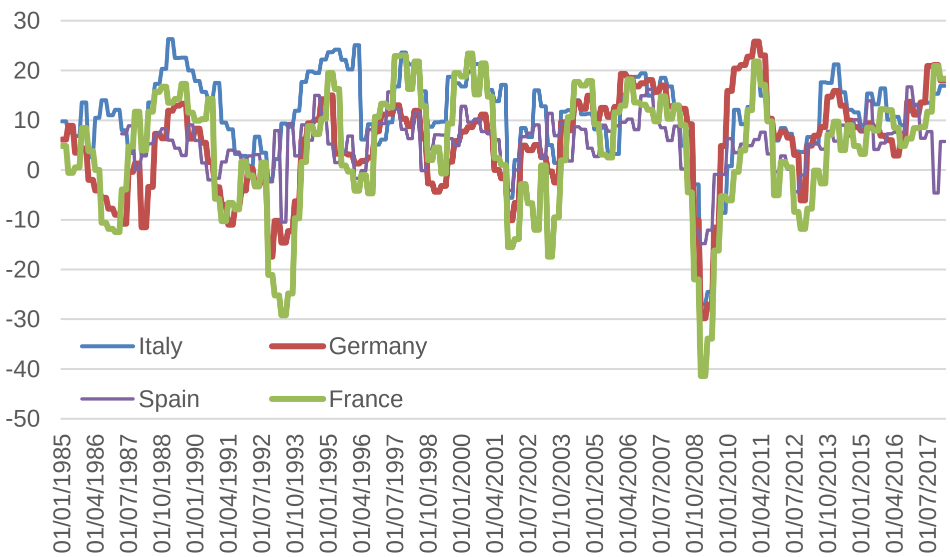
Forward-looking indicators suggest that both exports and investment should continue to fare well. Industrial sector expectations for exports stayed high in 1Q18, close to the previous peak of 2011, and capacity constraints are beginning to bite, suggesting that investment should continue to stay brisk in the coming quarters. President Macron's taxation reforms and bold change of pace towards businesses will also probably add confidence, and thus capex spending, as long as the global economy remains robust. The "Choose France" summit organised by the French president was a strong signal that France is eager to attract entrepreneurs, and it ended with EUR 3.5bn of committed investments over the next five years.

But be mindful of the fragilities. Our previous projections wanted to convey the message that two important fragilities were beginning to emerge.

On the investment front, inventories stand at a 17-year high of 1.7% of GDP and, thus, while accumulating inventories have a positive effect on GDP growth, sooner or later they will need to be run down, which will have the opposite effect. Our view on this issue has not changed: 4Q17 GDP showed that new inventories were less than before, but the total size, on a 4Q rolling basis, was still high, at 1.7% of GDP. That said, we believe that the confidence in the market, the capacity constraints and the low borrowing costs may all lead to more investments, excluding inventories, relative to what we expected previously.

On the consumption front, we noted that French households already benefit from super-low interest rates and high wages (compared with most of the other EU countries). As QE is slowly coming to an end, there is no further space for reducing borrowing costs. In addition, as labour laws are being adjusted, this usually leads to a repricing of labour, which has not happened yet in France. Households surveys also signal that families want to increase precautionary savings and that they expect a sharp rise in inflation. These factors imply that some consumption growth will persist, because new jobs are being created, but the pace of spending is not accelerating; rather, it will stay low (we expect 1% in real terms), or even fall modestly. Our new GDP projections continue to reflect this dynamic, but at a slightly more favourable pace than before.

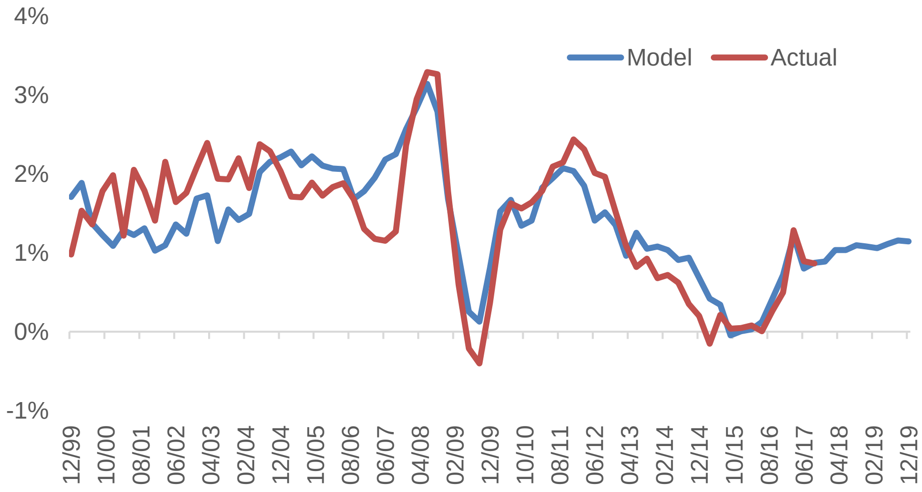
Expected order book for exports in the big-4



Source: Macrobond data, ADA Economics Ltd.

Inflation steady around 1.4-1.5%. Our inflation model signals positive, but rather constrained, inflation prospects. The biggest positive influence, in our view, will be the gradually widening output gap, which we see rising to 1.1% of GDP by the end of 2018E and 2.1% of GDP by 2019E, assuming potential growth of 1.2%. Looking at the industrial surveys, there is a clear positive message for construction – thus, house prices – while, from the industrial sector, the message is that pricing power has increased, but it seems to be stabilising at a higher level, rather than accelerating. If we are correct on the consumption outlook, then companies' attempts to raise prices will not be fully successful as demand will weaken fairly quickly in response.

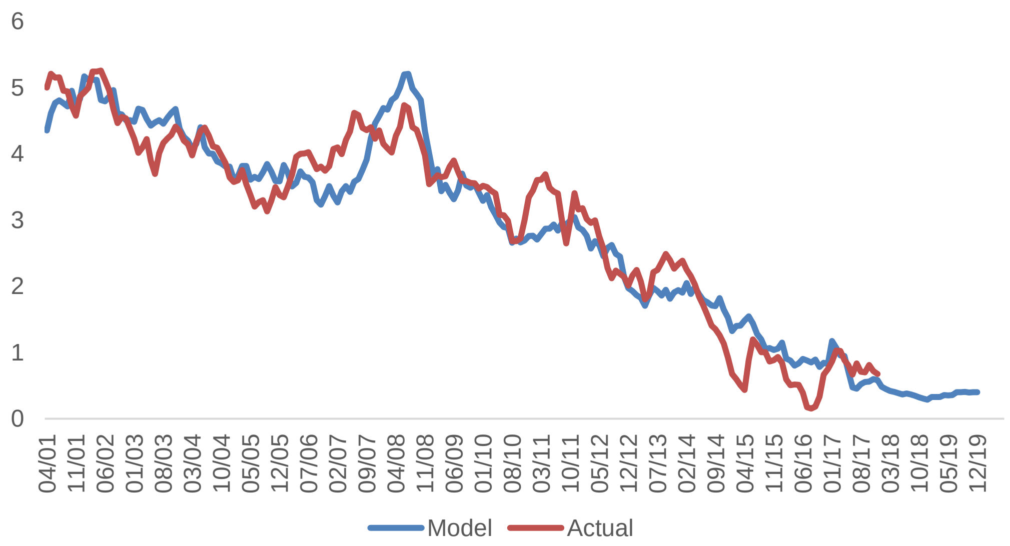
CPI yoy growth rate



Source: CEIC, ADA Economics Ltd.

Bond yields: have we seen the peak of the long end already? Today, we introduce our bond yield model for the 10yr part of the curve. Similarly to the models we run for the rest of Europe, it aims to capture the trend, rather than giving an accurate forecast for the near term. The model is based on inflation, the debt-to-GDP ratio, the ECB refi rate and the ECB's balance sheet. We have assumed that inflation and debt develop in line with our projections, and we have priced in 20bps of tightening starting from the first half of next year. We assume that the ECB will cease the monthly purchases in September 2018, but that reinvestment will continue over the full forecast horizon.

Bond yields



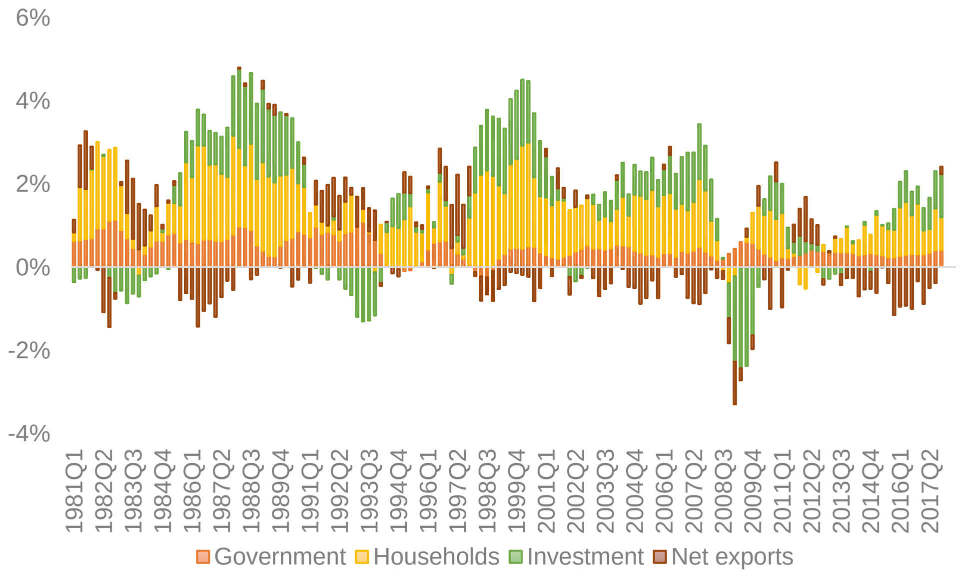
Source: CEIC, ADA Economics Ltd.

A very active first year in office – but more probably needed for SMEs and education. In the past six months, many changes have been introduced with regards to labour laws, social security contributions, changes affecting training at all levels, and taxation affecting companies and households. A very ambition education reform is also in the pipeline, which aims to narrow the gap between education and the workplace, and targets to be phased in fully by 2022E. The good news, in our view, is that President Macron touched on all the key economic priorities that the electorate wanted to see: more jobs, lower taxes and more resources for education (see the results of our field study published last year, *France: this election is all about jobs*).

The downside, however, is that, in our view, the resources for SMEs remain fairly small compared with the scale of the challenge, and the education reform will be phased in over several years, at a time when France should begin to start some form of fiscal austerity, which always means that some sectors, such as education, see budget freezes and thus end up under-delivering relative to the hype when a reform is announced.

A lot more charts on these issues can be found in our chartbook – have a look and pls let us know if you would like to discuss!

Contributions to GDP growth



Source: CEIC, Eurostat, ADA Economics Ltd.

Shubhra Singh & Raffaella Tenconi, 22 February 2018

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