

## E=mc<sup>2</sup>: Can France defy the laws of physics?

June 26, 2014

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### Executive summary

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- France has finally engaged in a process of reforms whose aim is twofold: (i) lower unemployment quickly and (ii) bolster firm's competitiveness.
- However, we believe two keys ingredients are missing, namely, 'speed' and 'mass'. Indeed, the reforms look quantitatively insufficient to boost competitiveness, all the more so that the timing is slow.
- Consequently, we believe that GDP growth will remain sluggish in 2014 (+0.7%) and 2015 (+1.2%) and that unemployment will stabilize but will not decrease materially. Finally, we are skeptical that France will be able to achieve its ambitious 3% deficit target for 2015.
- Against this backdrop, we still forecast a slight fall in business insolvencies (-0.5% to -1% in 2014).

### Recent data surprised on the downside but confirmed our below-consensus view

Q1 GDP growth came in flat as private consumption fell 0.5% qoq, Gross Fixed Capital Formation was down -0.9% qoq owing to a large fall in households' investment (-2.6%) whereas net exports contributed negatively (-0.2pts). Investment still remains 9% below the previous peak and does not look set to rebound strongly. The only positive driver was the change in inventories (+0.6pts). All in all, we are comfortable with our +0.7% growth forecast for 2014 and +1.2% for 2015.

### Advanced indicators suggest that GDP growth is likely to remain sluggish in H2

The Consumer and Business confidence surveys have not budged since Sep. 2013, remaining much below the long-run average, thus underpinning the lack of a genuine recovery.

Households are also worried about the state of the labor market, which will stifle any broad-based return in confidence.

Table 1: Key economic forecasts

France	poids	2012	2013	2014	2015
<b>GDP</b>	100%	0,4	0,4	0,7	1,2
<b>Consumer Spending</b>	55%	-0,4	0,3	0,3	1,4
<b>Public Spending</b>	24%	1,7	2,0	1,4	0,5
<b>Investment</b>	22%	0,3	-0,8	-0,5	1,4
	Firms	4,8	-0,6	1,0	2,0
	Households	1,0	-3,1	-4,5	1,0
	Public	-4,4	1,1	-0,5	-0,2
	Other	3,8	4,5	1,1	0,0
<b>Stocks</b>	* 0%	-0,6	-0,2	0,3	-0,2
<b>Exports</b>	27%	1,2	2,4	2,5	2,7
<b>Imports</b>	29%	-1,2	1,9	2,5	1,7
<b>Net exports</b>	* -1%	0,7	0,1	0,0	0,3
<b>Current account</b>	**	-44	-28	-21	-16
<i>Current account (% of GDP)</i>		-2,1	-1,3	-1,0	-0,7
<b>Unemployment rate</b>		9,8	10,3	10,2	10,1
<b>Inflation</b>		2,0	0,9	0,7	1,0
<b>General government balance</b>	**	-100	-89	-84	-72
<i>General government balance (% of GDP)</i>		-4,8	-4,2	-3,9	-3,3
<b>Public debt (% of GDP)</b>		89,5	92,3	94,7	95,3
Nominal GDP	**	2 090	2 115	2 148	2 192

Change over the period, unless otherwise indicated: \* contribution to GDP growth  
\*\* euro billions

Sources: National statistics, Euler Hermes

Still, there are some encouraging developments: except in the Information & Communication and Wholesale Trade sectors, turnovers have rebounded in 2013, albeit slightly. Also, latest surveys show that manufacturing firms plan to increase their investment by 4% in 2014.

### Weak monetary developments

In line with other EZ countries, inflation has continued to decline, falling as low as 0.7% in 2014. Lending to the private sector remains subdued as well, barely growing in March (+0.1%).

### Business insolvencies to stabilize...and decrease?

We estimate that a Real GDP growth of ~1% is necessary to stabilize insolvencies. As such, the (moderate) growth pick-up in H2 leads us to believe in a slight fall in insolvencies (-0.5% to -1%)

### We do not think the government will reach its 3% fiscal deficit/GDP target in 2015

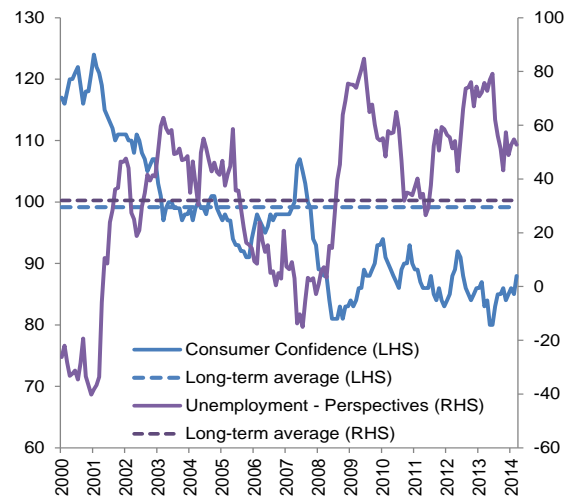
Growth and inflation assumptions used by the French government in their latest Stability program look a bit optimistic to us starting in 2015 (+1.7% and +1.5% respectively) and 2016-2017 (+2.25% and +1.7%). Still, the trend of public spending is clearly oriented downwards, something which seldom occurred in France and that we welcome with open arms. The way this reduction will be enacted leaves much to be desired however, i.e., uniform spending cuts rather than a genuine overhauling of the role of the State and its missions.

### Extensive but insufficient reform agenda

The new government has announced material reforms whose aim is twofold: (i) lower unemployment and (ii) bolster firm's competitiveness, in particular in the industrial sector. The government's idea is to lower labor costs around the minimum wage where the impact on firms' hiring is the highest. The government also plans to lower corporate taxes, first by removing the 'C3S' (~5-6bn EUR) over the next 3 years and then by lowering the main corporate tax rate from 33.3% to 28%, starting in 2017. In our opinion, the reforms look quantitatively insufficient to boost competitiveness, all the more so that the timing is slow.

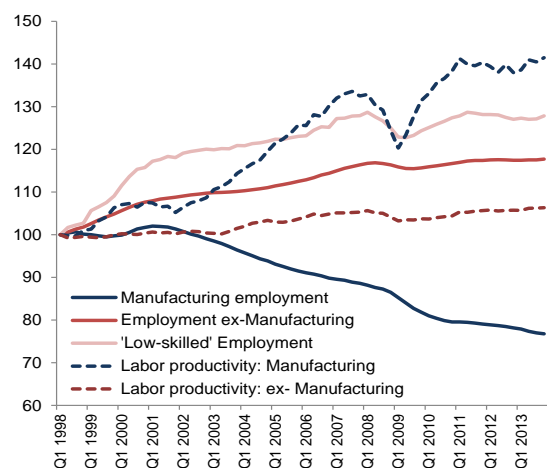
This is troublesome because France is stuck in a vicious circle where low corporate margins prevent further investment, which leads to low innovation and prevents firms to produce higher-quality goods. In turn, firms face a difficult choice between losing market shares and lowering prices.

Chart 1: Consumer confidence (LHS) and unemployment perspectives (RHS)



Sources: IHS Global Insight, Euler Hermes

Chart 2: Evolution of employment and productivity between manufacturing and non-manufacturing sectors (Base 100 = 1998)



Sources: IHS Global Insight, Euler Hermes

Chart 3: Exports and labor cost indices (base 100 = 2000)



Sources: IHS Global Insight, Euler Hermes

## General Information

GDP	USD2612.878bn (World ranking 5, World Bank 2012)
Population	65.7 million (World ranking 21, World Bank 2012)
Form of state	Republic
Head of government	François HOLLANDE (PS)
Next elections	2017, presidential and legislative

## Strengths

- Dynamic demographics and elevated hourly productivity
- Infrastructures (e.g., transport) and public services are of high quality
- Many international market leaders
- Diversified economy
- Tourism revenues
- Quality education system

## Weaknesses

- Dual labour market: Insiders vs. outsiders, leading to structurally high unemployment rate
- Low employment rate among youth and seniors
- Higher inequalities in spite of costly redistribution
- Rapid deindustrialisation and low competitiveness of manufacturing firms
- Lack of large SMEs that can bear the sunk costs associated with innovation and exports
- Rent-based economy (e.g., retail distribution, taxis)
- Elevated level of public spending and questionable efficiency

## Trade structure

By destination / origin

Exports	Rank	Imports
Germany	16% 1	18% Germany
Belgium	8% 2	10% Belgium
Italy	8% 3	8% Italy
Spain	7% 4	7% Spain
United Kingdom	6% 5	7% China

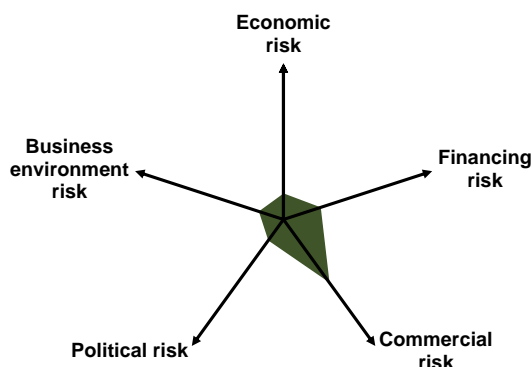
By product

Exports	Rank	Imports
Aeronautics	9% 1	7% Crude Oil
Pharmaceuticals	6% 2	6% Cars And Cycles
Cars And Cycles	4% 3	4% Refined Petroleum Products
Engines	4% 4	4% Pharmaceuticals
Toiletries	4% 5	4% Aeronautics

Source: Chelem

## Risk Dimensions

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Source: Euler Hermes

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