22 March 2013

Research

France begins to look like a peripheral country

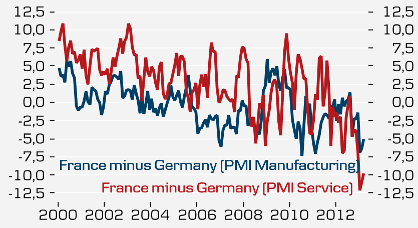
- The short-term outlook for France looks more like that of a peripheral country than the strong German economy to which France used to be compared.
- PMI numbers for France and Germany have diverged significantly and in February French manufacturing PMIs were even worse than the Spanish and Italian numbers.
- The situation in France might not just reflect that the business cycles are out of sync. In contrast to Germany, France has structural problems, headwinds from fiscal tightening will continue and a weakening housing market with declining construction activity has begun to pull growth down.
- President François Hollande has implemented reforms aimed at improving competitiveness and fiscal sustainability but the short-term impact on growth seems to be limited. Some of the reforms are even a step in the wrong direction in our view.
- The continued absence of sufficient reforms implies a significant risk that France could face a lost decade with very little growth.
- The biggest risk factor seems to be the housing market. Affordability looks stressed and the construction sector's expectations of future activity are alarmingly low.
- A negative spiral could start with a decline in house prices which could spill over to growth and increase government debt. In such a situation, fiscal sustainability could be threatened – particularly if investor confidence is weakened.
- Negative headlines on France haven't frightened investors. If Hollande abstains from taking the necessary steps to restore France's competitiveness and improve fiscal sustainability, spreads to Germany could slowly begin to increase.

Disappointing PMIs and divergence from Germany

At the beginning of 2013, the PMI numbers showed an increasing divergence between the two biggest countries of the eurozone. The difference between the French and the German service PMIs reached a historically high in January and the discrepancy was almost confirmed in February and March. While German PMIs point to recovery, French PMIs signal a deepening recession. In February the French manufacturing PMIs were actually lower than the downbeat Italian and Spanish PMIs.

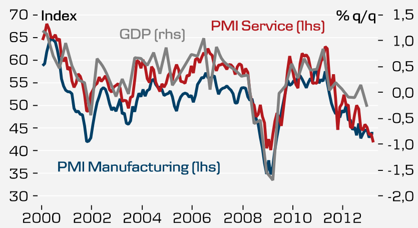
The French PMIs for service and manufacturing point to negative growth of around 0.8% q/q in Q1 13 while the German PMIs indicate an improvement in growth compared with the decline in Q4 12. This could point to a divergence in the French and German conjuncture but the main difference between the two countries seems to be underlying dissimilarities. The business climate has stagnated in France whereas in Germany it is improving. France is faced with deep structural challenges: competitiveness is fragile due to high taxes, high unit labour costs and a rigid labour market. France's competitiveness could also be threatened further by Italy and Spain, who are more engaged in reforms of their labour markets and service sectors. In addition, headwinds from fiscal tightening continue in France while they fade in Germany. Finally, a weakening French housing market with low activity, slightly falling prices and declining construction activity has begun to pull growth down.

February PMIs confirmed France is heading for deeper recession...



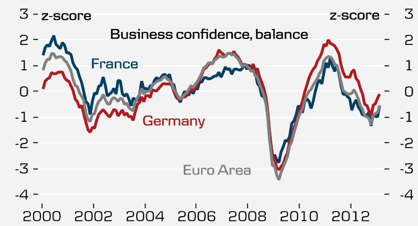
Source: Macrobond, Danske Bank Markets

...and point to negative growth in Q1 13



Source: Macrobond, Danske Bank Markets

Stagnating confidence reflects structural challenges in France



Source: Macrobond, Danske Bank Markets

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Structural reforms are insufficient

France's structural challenges within job creation, economic growth and debt sustainability require reforms. President Hollande has reformed the labour market, changed the pension system and adjusted fiscal policy but it has not been enough to significantly improve fiscal sustainability, restore competitiveness or generate growth. Hollande's initiatives regarding the pension system have increased expenditures and the pension system's deficit as a share of GDP is increasing. The budget plan for 2013, which mainly contained tax increases, had an unrealistic target of reducing the public deficit to 3% of GDP; the included tax increases worsens competitiveness and spending cuts would have harmed growth less. On a positive note, the labour market reform has enhancing elements by means of reducing labour market rigidity. However, a continued absence of sufficient reforms implies a significant risk that France could face a decade with low growth.

The need for **labour market reforms** in France is urgent. The labour market is characterised by rigidity and in the latest *Competitiveness Report of World Economic Forum* France was placed at number 141 out of 144 countries on 'hiring and firing practices'. Additionally, France's competitiveness has weakened and unit labour costs are well above the euro area average, while real labour productivity per person employed is below. No French government has succeeded in undertaking substantial structural reforms that would improve competitiveness in the past 20 years. In January, Hollande changed the history of his predecessors as he won a union accord on labour flexibility, which allowed companies to reduce hours and wages during economic slumps and also made it easier to fire people and at lower cost.

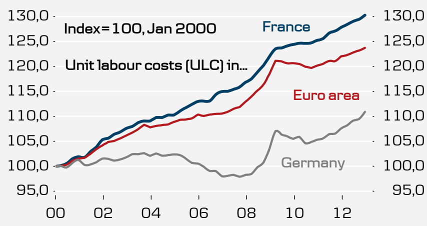
The reform took an important step towards reducing the competitiveness gap that has opened up over the past decade with Germany. However, the changes are not expected to result in a sharp decline in unemployment as they mainly make the labour market more flexible in times of a slowdown. In that perspective, more needs to be done to stimulate the economy so that businesses have a reason to hire workers in the first place.

The reform increased welfare charges by employers on short-term contracts in an attempt to make permanent contracts more attractive but it would have been more appropriate to mitigate rigidity. However, the reform did not improve the wage setting system, which is characterised by inertia and a high minimum wage. Nor did it change the fact that France has the shortest working week in Europe. French people work an average of 225 hours less each year than the Germans, according to OECD.

The French competitiveness disadvantage also calls for a **tax reform** as rates of taxation are among the highest in Europe. Hollande's budget plan for 2013 ignored this as tax increases should provide around two-thirds of the EUR30bn needed to lower the deficit to 3% of GDP in 2013 from 4.6% in 2012. The rest of the savings were planned to come from government spending cuts by freezing spending excluding debt repayments and pensions. The tax increases in the budget included:

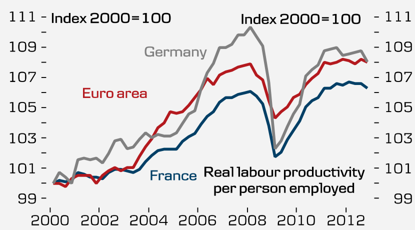
- A 75% levy on income above EUR1m (was rejected by top constitutional authority because it was applied to single persons not households) and a 45% income tax rate on incomes above EUR150,000.
- Capital gains and dividends should be subject to the income tax regime.
- Elimination of a ceiling on wealth taxes, so that assets of more than EUR1.3m will be subject to the income tax regime.

Competiveness still worsening



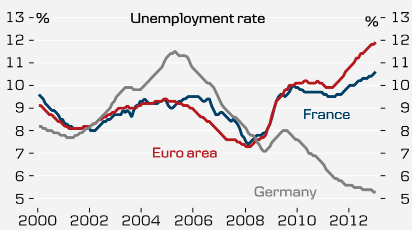
Source: Reuters EcoWin, Danske Bank Markets

Real labour productivity low in France



Source: Macrobond, Danske Bank Markets

Unemployment on a rising path



Source: Macrobond, Danske Bank Markets

Taxes among the highest in Europe

	Total government revenues from taxes and social contributions			
	2008	2009	2010	2011
Euro area	40,5%	40,2%	40,0%	40,5%
France	44,8%	43,9%	44,2%	45,6%
Italy	42,6%	43,0%	42,6%	42,6%
Germany	39,8%	40,5%	39,0%	39,8%
Spain	33,5%	31,3%	32,9%	32,1%
Denmark	48,4%	48,5%	48,2%	48,4%

Source: Eurostat, Danske Bank Markets

The budget plan was launched as a 'combat budget' aimed at tackling debt and bringing much-needed growth to the nation. However, the elements drag down on growth and it was widely criticized for being too growth optimistic. Consequently, the ambitious target of lowering the budget to 3% of GDP also seemed unrealistic. At the beginning of 2013, the French government realised this but did not want to take additional measures or as Prime Minister Jean-Marc Ayrault put it "We won't take the responsibility of further weakening the weak economic growth".

A more comprehensive **fiscal reform** would be very welcome, as it could reduce the very large public sector, which is likely to dampen growth. Government expenditure accounted for 56% of GDP in 2011, which was the highest in the euro area. France has not had a balanced budget since 1974 and its government debt has now reached 90% of GDP. Thus reforms are needed to improve fiscal sustainability.

Following Sarkozy's **pension reform** including increasing the retirement age by two years to 62, one of Holland's key election pledges was to lower the retirement age again and in autumn 2012 the pledge was adopted for those who started their working lives before turning 20 years. This has increased pension expenditures and according to France's council for retirement policy, the pension system's deficit was set to increase to EUR21.3bn in 2017 from EUR14bn in 2011. This corresponds to an increase in the deficit from 0.7% of GDP in 2011 to 1.0% of GDP in 2017.

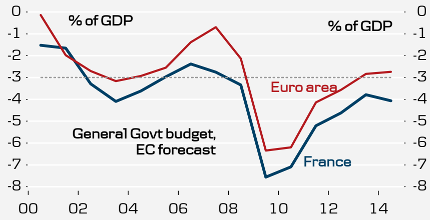
The higher pension costs combined with a realisation that the deficit target of 3% of GDP cannot be realised in 2013 has resulted in speculation that Hollande may propose separating pension increases from inflation. A plan to delink state pensions from inflation could offer upfront savings, unlike an increase in the retirement age, which will not affect those who are about to retire and then not feed through to the budget immediately. Hence, this would be a welcomed reform seen from the financial markets.

French housing market a significant risk factor

On top of the less encouraging structural situation, the outlook for the housing market appears to be weakening and declining construction activity is beginning to pull down growth. The housing market could be the most important risk factor to growth. House prices are close to an all-time high but the upward trend appears to have stopped. Bank lending for house purchases, which has decreased since summer 2011, is now lower than in 2009 and even though demand for house loans has been supported by policy initiatives including zero-interest loans for first-time buyers, it has been declining since 2011. Furthermore, new homes for sale are at a high level, whereas new homes sold have fallen. Affordability looks stressed and the construction sectors expectations of future activity have also come down significantly.

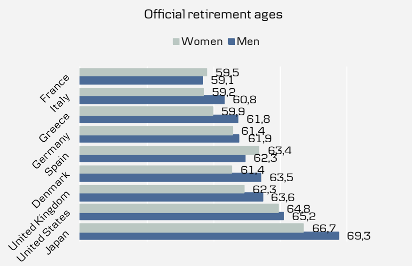
All in all this may indicate that house prices could decrease in the near future. This would result in a slowdown in construction as well as private consumption and consequently growth will be harmed. The spill-over effect to growth depends on the size of the correction in prices. The housing market might not look particularly overvalued at current low interest rates, but at more normal rates a 20% correction seems reasonable. *The Economist* sees the housing market as a big risk factor as it argues that European valuations are most stretched in France by as much as 50% judging by rents and by 35% on the basis of incomes. The IMF is much less concerned and concludes in its recent article IV consultation that "There is a perception of price overvaluation especially in Paris… However, there is no housing glut or household debt overhang that could trigger a sudden price adjustment".

Fiscal consolidation is needed



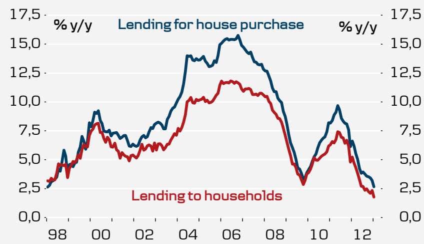
Source: Reuters EcoWin, Danske Bank Markets

Retirement age low in France



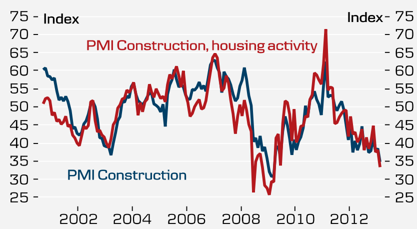
Source: OECD, Danske Bank Markets

Lending for house purchases lower than in 2009



Source: Reuters EcoWin, Danske Bank Markets

Low construction sector expectations



Source: Macrobond, Danske Bank Markets

Sensitivity of fiscal sustainability

As highlighted above, the housing market seems to be the biggest risk factor in France, as it could start a negative spiral with declining growth. Lower growth will in itself deteriorate the primary budget as it implies higher outlays and reduced receipts through higher unemployment. The budget could worsen even further if the French government experiences difficulties in containing spending as planned. This could turn into a vicious circle as markets will demand a higher risk premium because the credibility of fiscal performance has declined. This turn in investor confidence resulting in higher interest rates completes the negative spiral as it would have a negative impact on economic growth.

In an attempt to quantify the effect of the negative spiral described above and to evaluate the sustainability of debt we have set up three scenarios. Our baseline is the IMF's projection where government debt peaks at 91.3% of GDP in 2014.

- A 1pp lower GDP growth rate results in a peak in gross debt at 92.8% of GDP in 2015.
- Combining the case of a lower growth with a 1pp higher primary deficit results in an increasing debt to GDP until 2016 where it peaks at 96.2% of GDP.

As debt-to-GDP starts to decline within the horizon, in both scenarios fiscal sustainability seems to be contained. The higher debt ratio could nevertheless add to investor concerns, leading to a removal of the high level of finance-ability and send government yields and thereby funding costs markedly higher. Higher interest rates will affect the debt-to-GDP ratio through higher interest payments and there will be a minor effect from the primary budget, as the higher rates affect it negatively.

- A 1.5pp increase in interest rates, combined with the effects above, implies that the debt ratio will be on an increasing trajectory to 2020.

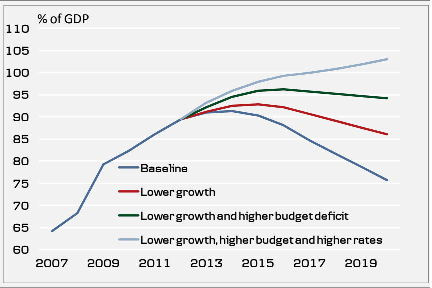
Even though an increasing debt to GDP ratio is very concerning, the ratio is not much above 100% and compared with the peripheral countries, this is less alarming. Added to this a loss of investor confidence could put France under pressure to implement the much-needed reforms, which would improve growth and possibly start the reverse spiral than described above.

Market implications

France has had historically low interest rates despite the weaker outlook and negative press headlines. The French government bond market is very liquid and generally trades with a small spread to Germany. Foreign investors own about 63% of all French government bonds. Substantial domestic funding sources could be activated to support the bond market if needed.

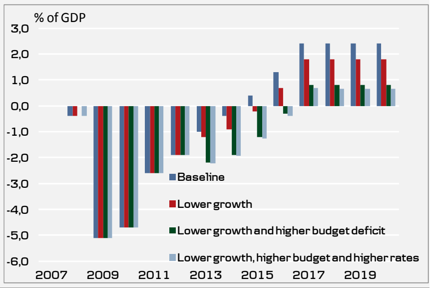
The government bond spread to Germany did increase at the end of 2011, reflecting an escalation of the debt crisis only to come down after the ECB's OMT announcement. A continuation of negative news from France could also result in some spread widening. This may eventually become more pronounced if Hollande abstains from taking the necessary steps to restore France's competitiveness and improve fiscal sustainability.

French government debt projections



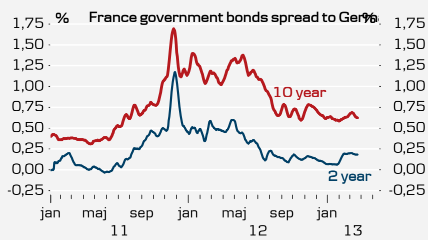
Source: IMF, Danske Bank Markets

Primary budget scenarios



Source: IMF, Danske Bank Markets

Spreads have increased before



Source: Reuters EcoWin, Danske Bank Markets

Disclosure

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report are Frank Øland Hansen, Senior Economist and Pernille Bomholdt Nielsen, Analyst.

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