France

Inflation picks up slightly

- **Inflation continues to rise gradually, driven by the contribution of energy prices, now slightly positive. Core inflation continues to trend slightly downwards.**
- **We expect these trends to continue in 2017 and forecast a mild increase in inflation (from +0.5% today to +1.3% year-on-year at end-2017).**
- **Inflation, less low, will reduce household purchasing power gains. As a result, consumer spending is expected to slow down significantly, placing a drag on growth.**

At this time last year, we observed that inflation in France remained uncomfortably low, even more so than growth. This observation is still true today. At 1.1% year-on-year in Q3 2016, growth was identical to the Q3 2015 pace. On the inflation front, things appear to be a bit better: Inflation rose from 0% year-on-year in November 2015 to 0.5% a year later according to preliminary INSEE estimates. Yet this mild acceleration is mainly due to energy prices, the contribution of which was less and less negative over the course of the year before becoming slightly positive (-0.5 percentage points in November 2015, +0.2 points in November 2016). However, core inflation slowed slightly over the period, to 0.5% year-on-year in November 2016 from 0.8% in November 2015.

We expect these trends to continue in 2017. Headline inflation is expected to pick up from an average annual rate of 0.2% in 2016 to 1% in 2017, due solely to the impact of the expected rebound in oil prices. Core inflation should, however, slow down slightly, from 0.6% in 2016 to 0.4% in 2017. Two factors are contributing to the low level of core inflation. First, there is a currency effect: for a few more months, the past appreciation of the euro will continue to have a downward impact on durable core goods prices. The opposite, inflationary, effects of the very recent depreciation of the euro will materialize later, and in a context still characterised by significant slack in the economy. This is the second explanation of low inflation.

Granted, it is impossible to measure with any precision the size of the output gap (the difference between real and potential GDP), as illustrated by the wide range of estimates for 2016 (-1.4% according to the European Commission; -1.8% according to the IMF and -2.3% according to the OECD). The true scope of the output gap raises a lot of questions, especially since some consider that the 2008-2009 economic and financial crisis and the following sluggish recovery lowered not only potential growth, but also the level of potential GDP. In this case, the output gap might not be as negative as commonly thought. Yet the low level of inflation argues, to the contrary, that the output gap is still fairly wide. Besides, according to our forecasts, it will remain this negative in 2017, since the growth rate is expected to be more or less equal to the potential growth rate (average annual rate of 1.1%).

Weak inflation

Consumer price index, year-on-year, %

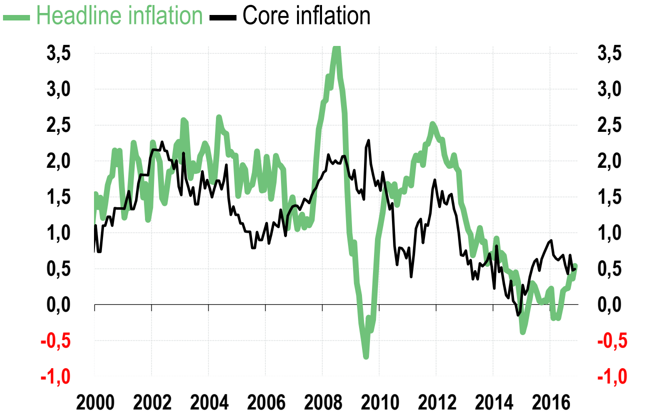

Chart Source: INSEE

The large degree of slack in the economy can also be seen in the labour market. Unemployment has begun declining but it is still high. Consequently, wage growth is also expected to remain subdued (1.2% a year for the monthly base wage in Q3 2016, an all-time low). Besides, wages will get only limited support from the automatic annual revaluation of the minimum wage (each 1st January). Given the weakness of inflation and limited wage increases, we estimate it at +0.9%, with no extra boost assuming the government follows the expert committee's recommendation. The wage-price loop is functioning in slow motion, with low inflation and wage moderation influencing each other.

Low inflation can be seen in two different lights: as a symptom of sluggish growth, and as a support factor for household purchasing power, consumer consumption and thus growth. The absence of inflation is, indeed, the main reason for the purchasing power gains observed since 2014 (average annual gains of +0.7% in 2014, +1.6% in 2015 and +2% year-on-year in Q2 2016). Consequently, we expect the upturn in inflation, as mild as it may be, to reduce purchasing power gains (to +1.2% in 2017, according to our estimates), which will only get limited support from employment and wage growth. For this reason, our central scenario calls for a significant slowdown in household consumption (up 1% in 2017 in annual average terms compared to +1.5% in 2016). The dip in purchasing power gains could be absorbed by a decline in the personal saving rate, but this seems unlikely in an environment of high unemployment. We think the most likely hypothesis is that the personal saving rate will remain more or less steady at about its current level of 15% of gross disposable income.

This scenario is highly dependent on oil prices trends, which introduces a lot of uncertainty. Yet, beyond their recent rise, the balance of risks seems to lean towards lower-than-expected oil prices, in which case, all other factors being the same, growth might be stronger in 2017.