ECO FLASH

N°22-16

2 December 2022

FRANCE: A 2023 BUDGET FACING MODERATE UNCERTAINTIES

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The downside risks are increasing for French growth, to the extent that growth could turn out to be lower than the level incorporated by the government in its draft budget bill.

For 2023 we estimate that growth could be 1 pp below the government's assumed figure and that this is likely to imply a limited gap between a deficit of 5.4% of GDP at budget implementation and a level of 5% of GDP included in the draft budget bill.

Indeed, the risks appear to be moderate in nature, between a deterioration in the labour market which is expected to remain relatively limited and a cyclical rise in business insolvencies, but at a level which should remain below that of 2019. Moreover, the support of public finances, in particular for purchasing power, remains substantial.

NOMINAL GROWTH GAP VS. GAP TO THE BUDGET TARGET

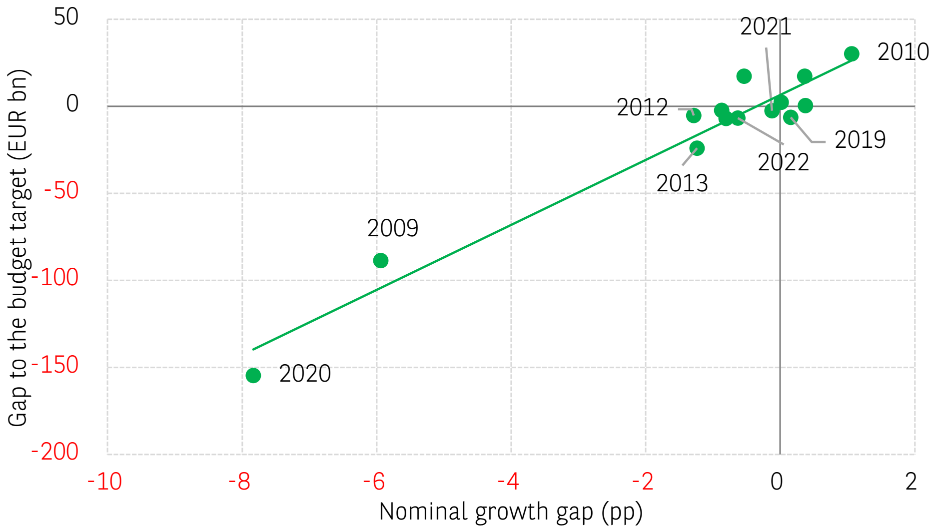

CHART 1

SOURCE: BUDGETARY DIRECTORATE, BNP PARIBAS CALCULATIONS

The French economy is approaching a new period of marked slowdown in growth, a situation that is likely to weigh on the trajectory of public finances. Thus, while the government has incorporated an assumption of 1% real growth and 4.6% nominal growth in GDP, our forecasts for 2023 indicate figures of 0 and 3.6% respectively. This difference could result in a deterioration in public finances in relation to what was incorporated into the draft budget bill for 2023. Chart 1 highlights a close relationship between two differentials: the gap between the assumption for nominal growth incorporated into the draft budget bill and the actual growth achieved, and the difference between the deficit targeted in the draft budget bill and the actual deficit resulting from budget implementation (the revised draft budget bill is used for 2022).

These elements suggest that a gap of 1 pp on growth would widen the public deficit by almost 10 billion euros, which in relation to GDP would result in a deficit of 5.4% of GDP at the end of budget implementation instead of 5% in the initial draft budget bill.

Public finances provide support for the 5th consecutive year, but with decreasing effectiveness

2019 marked a shift in the recent history of French public finances, since from this year onwards they improved the dynamics of household purchasing power, and even more so in 2020, with the implementation of "whatever it costs" (chart 2). In 2021 and 2022, the volume of social benefits was reduced by the withdrawal of these mechanisms, masking budgetary support which was otherwise still present, in particular through the cap on energy prices, as well as the various subsidies (against inflation, and to finance energy in particular) provided to smooth the inflation increase. 2023 is likely to see the gap between the two estimates of purchasing power shown in figure 2 widen again, with in particular the cap of 15% on increases in regulated gas and electricity tariffs (instead of 120%, according to the government), which will equate to avoiding 5 points in overall inflation over the course of 2023. This continuation of support for purchasing power is different from the situation in 2012-13 where an increase in taxation had erased the gains in purchasing power linked to transfers implemented following the 2008 crisis.

PURCHASING POWER EXCLUDING AND INCLUDING TRANSFERS

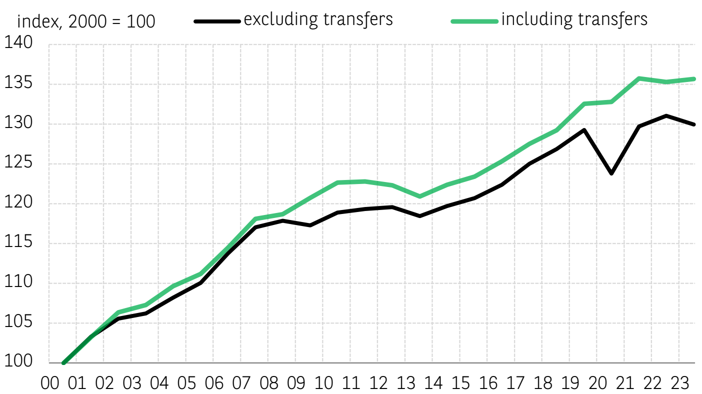

CHART 2 SOURCE: INSEE, BNP PARIBAS CALCULATIONS

Public finances were extensively mobilised during Covid, with notable effectiveness. A particular feature of this period was the systematic use of tools that in the past were used more in Germany, such as the furlough scheme. This has helped to limit the impact of the 2020 recession on employment. This impact was short-lived and the subsequent rebound was rapid: employment returned to the level it would have reached in the 3rd quarter if its average growth seen between 2017 and 2019 had continued at the same rate up to the present.

This upturn contrasts with the situation observed at the time of the 2008 recession and the euro zone crisis in the early 2010s, which opened up a long period of stagnation in employment (chart 3).

The other element that was very different during the Covid period relates to business insolvencies (chart 4), which would have increased due to cash shortages which appear comparable at the start of the Covid period to those encountered during the 2008 recession (chart 7) and which at the time resulted in a marked increase in business insolvencies.

EMPLOYMENT IN THE PRIVATE SECTOR

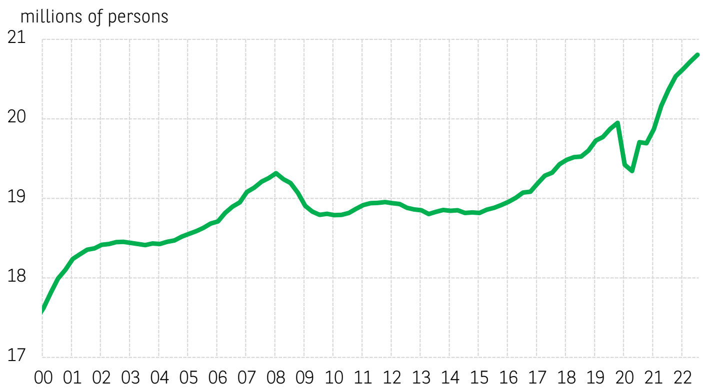

CHART 3 SOURCE: INSEE, BNP PARIBAS

BUSINESS INSOLVENCIES (ACTUAL), 12-MONTHS ROLLING SUM

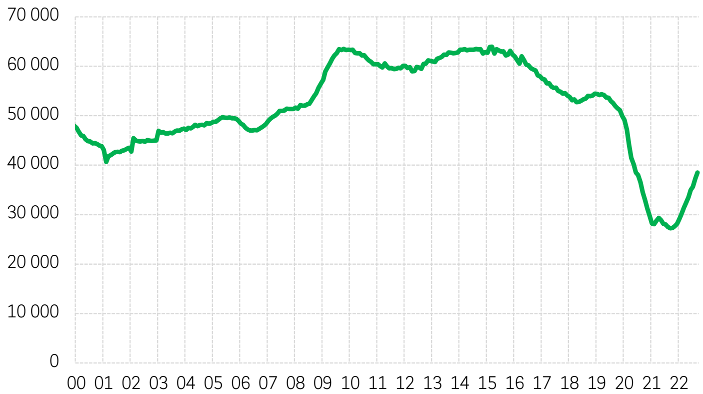

CHART 4 SOURCE: BANQUE DE FRANCE, BNP PARIBAS

REAL GDP LEVELS

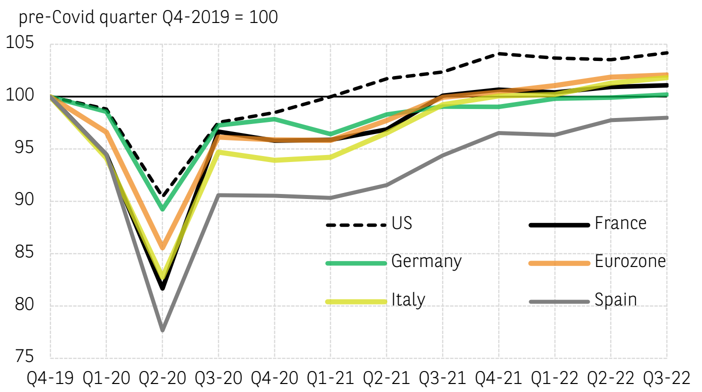

CHART 5 SOURCE: MACROBOND, BNP PARIBAS CALCULATIONS

"Whatever it costs" therefore in fine had a much better outcome than the way previous crises were handled, in which jobs and companies were not so well protected.

The French economy has faced up to a significant new (energy) shock with the experience of how it managed to absorb the previous shock (Covid), becoming the first country in the euro zone to return to its pre-Covid level of activity from the 3rd quarter of 2021 (chart 5).

Since then, France has seen lower growth than the euro zone. Inflation has had a particularly negative impact on domestic consumption, notwithstanding the substantial support from budgetary policy for household purchasing power.

Lower growth and higher inflation: a negative impact overall on the dynamics of public finances

2023 is expected to open with a recession, with negative growth in activity likely in both the 4th quarter of 2022 and the 1st quarter of 2023. This represents a difference between our scenario and the government's one, which means we are expecting zero real growth in 2023 compared with the government's +1%. At the same time, the expected increase of the GDP deflator is the same (3.6%).

The underlying difference between these two scenarios highlights a difficult period during which we anticipate that the momentum in job creation will be interrupted and will give way to an reduction of around 50,000 positions in the 1st half of 2023, before stabilising, a shock of a moderate magnitude compared to those occurring from 2008 onwards or in 2020. Moreover, labour hoarding, i.e. retention of staff even during periods of underactivity, is likely because of the current difficulties which companies are having in recruitment.

The persistence of nominal growth, due to high inflation, in parallel with a drop in real activity is a major difference from previous recessions. While they had stagnated in 2009, net nominal compensation is expected to increase by 5.5% in 2023 (chart 6) because of the dual effect of higher wage increases (+5% in 2023 for basic monthly salaries based on our forecasts, following +3.6% in 2022) and high employment (which implies a favourable baseline effect, with the decline anticipated in the 1st half of 2023 unlikely to cancel out the increase seen over 2022). Therefore, after a drop which we estimate to be 0.3% in 2022, household purchasing power should rise slightly in 2023 (+0.3%), despite an inflation rate close to 2022 levels (5.4% on average after 5.3% in 2022).

At the same time, the situation of companies is more open to question, to the extent that they are seeing the end of the support linked to "whatever it costs", which has giving rise to an increase in business insolvencies (starting from an abnormally low level, see chart 4). The increase in interest rates and the high energy costs have impacted on company cash levels, albeit to a degree which for the time being seems to be more moderate than in 2008, 2020 or even in 2011 (chart 7). In addition, both building and services are in a more favourable liquidity position today than between 2009 and 2018. This risk mitigation factor makes a normalisation of business insolvencies (continuing to close the gap on what was seen in 2019) a more likely scenario than that of a "wall" of insolvencies (as recorded between 2009 and 2015).

Despite developments in the labour market and in terms of corporate failures which are expected to remain contained, it is however likely that, as in recent years, the 2023 draft budget bill will be followed by the adoption of amending budget laws. The volatile economic activity during Covid and the subsequent rise in inflation have necessitated the adjustment of support mechanisms.

EVOLUTION OF HOUSEHOLD NET NOMINAL COMPENSATIONS

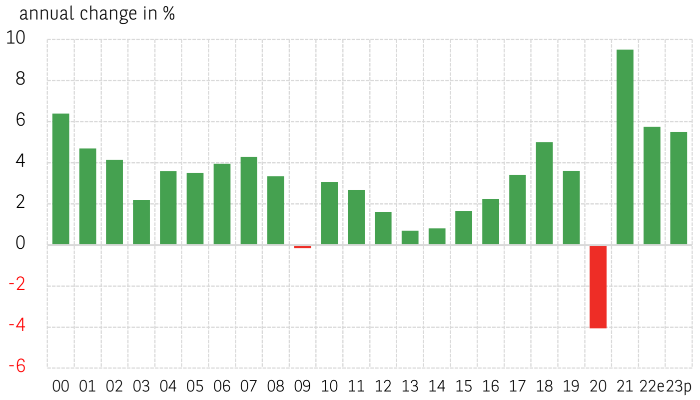

CHART 6 SOURCE: INSEE, BNP PARIBAS ESTIMATES

CASH SURVEYS OF CORPORATES

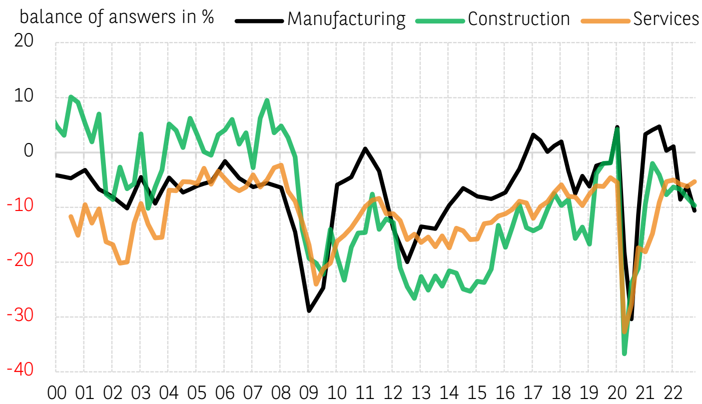

CHART 7 SOURCE: INSEE, BNP PARIBAS

The consequences of the recession, combined with high inflation, are likely to require adjustments to the draft budget over time.

However, while the gap between the initial drafts and final execution may therefore have been significant during Covid, it should be much less so in 2022 (as the differential in nominal growth has been moderated, chart 1). As regards 2023, this leads us to expect on balance a budget deficit which should only deteriorate by around 10 billion euros compared to the draft budget bill, i.e. a higher deficit of 5.4% of GDP, instead of 5% forecast for the moment.

The very nature of an inflationary shock is in fact to generate additional budgetary resources, with revenues being better correlated with nominal GDP than with real GDP (chart 8 below, which substitutes the difference in nominal growth used in chart 1 with the differential in real growth, shows a somewhat more tenuous link with the gap to the budgetary target).

Thus, higher or more sustained inflation would not necessarily deteriorate public finances beyond mechanical effects such as its impact on the servicing of inflation-indexed debt, as well as the government's decision to help households and businesses in the face of high inflation. Its effect on growth is different when analysed in real terms, with growth falling from 2.5% in 2022 to 0% in 2023, or in nominal terms, with a change from 4.9% to 3.6% based on our scenario.

Our anticipation of a public deficit which is likely to grow only moderately should not be called into question by the impact of discretionary measures. Although high in absolute value terms (45 billion euros), the price cap on gas and electricity benefiting households in 2023 is expected to be financed by around two thirds by the contribution from electricity producers who produce from resources (nuclear, renewable, thermal) other than gas.

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REAL GDP GROWTH GAP VS. GAP TO THE BUDGET TARGET

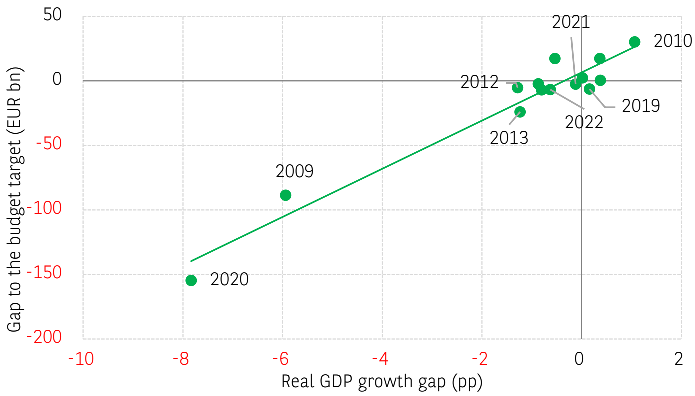

CHART 8 SOURCE: BUDGETARY DIRECTORATE, BNP PARIBAS CALCULATIONS

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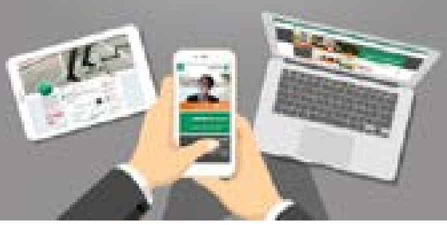

Published by BNP PARIBAS Economic Research

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Head of publication : Jean Lemierre / Chief editor: William De Vijlder