France

Proven resilience

The French economy continues to show proof of resilience judging from the stability of its GDP growth – at an annualised rate of just over 1% – and the relatively strong showings of confidence surveys and of the labour market. Although prospects are still favourable, the horizon has darkened in recent months with Germany showing signs of recession, the escalation of trade tensions and lingering uncertainty over Brexit. We expect business investment and exports to decelerate sharply under the weight of a more uncertain, less buoyant external environment. Yet the slowdown is likely to be offset by the expected rebound in household consumption, supported by major fiscal measures to boost household purchasing power.

Cyclical indicators are still flashing green

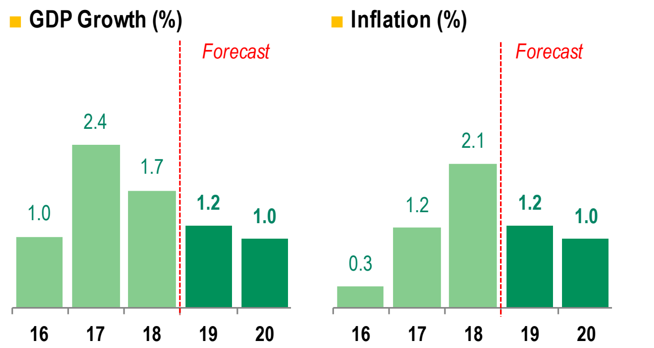
After a preliminary estimate of 0.2% q/q, the second estimate of Q2 2019 growth was revised upwards to 0.3% q/q, in line with expectations. Since Q3 2018, growth has not been very strong but remarkably stable and more solid than it appears at first glance: indeed, it relies on an average 0.4-point contribution of final domestic demand. Hopes of a rebound in household consumption were dashed again in Q2 2019, as it rose by only 0.2% q/q after 0.3% in Q1. This bad news was nonetheless offset by good news on the investment front, with business investment accelerating to 0.9% q/q from 0.6%, and surprisingly strong household investment, up 0.8% q/q from 0.1% q/q. Changes in inventory and net exports moved in opposite directions again, with the former making a negative contribution of 0.2 points (after +0.3) and the latter a positive contribution of 0.1 points (after -0.3). The change in the contribution of net exports can be attributed to imports (-0.2% q/q following +1.1%) while exports remained sluggish (0.0% q/q following 0.1%), strapped by an unusually sharp decline in service exports.

Q3 growth prospects are still looking positive based on business confidence surveys available through September. Survey results suggest that growth will hold at the same pace as in the two previous quarters. On average, the INSEE composite index for Q3 held at the same high level as in Q2 (106), while the Markit composite PMI was slightly higher at 52 (from 51.3). The upward trend of these surveys since the beginning of the year, as timid as it may be, is another encouraging sign, as is the fact that weaker signals from the manufacturing sector have failed to spread to services for the time being. Lastly, consumer confidence is sending the most positive signal of the confidence surveys. In September, consumer confidence increased for the ninth consecutive month to 104. This score is sufficiently higher than the average reference point of 100 to consider that French households are no longer “less pessimistic” but “more optimistic”. Particular satisfaction can be expressed regarding the significant decline in fears about the evolution of unemployment.

Our Nowcast model puts a damper on this positive interpretation of the survey results. Based on these soft data, Q3 growth is estimated at 0.2% q/q[1]. This is in line with our growth forecast, while the INSEE and the Bank of France are estimating Q3 growth at 0.3% q/q. The reason we are somewhat less positive about this quarter and the next ones as well (we have lowered our 2019 and 2020 growth forecasts by 0.1 and 0.2 points, respectively, to 1.2% and 1%[2]) is our fairly negative analysis of Germany’s economic situation (see article in this publication), which spills over to French growth via the export channel.

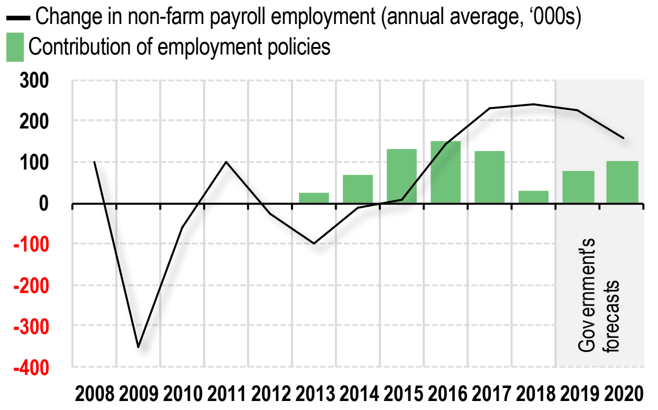
We also expect business investment to drop sharply in the face of uncertainty, whose negative influence will be larger than the favourable impact of the currently loose financial and monetary conditions. Although business confidence survey in the wholesale sector is not showing any early warning signs of such a deceleration

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Robustness of non-farm payroll employment



Source: INSEE, French government, BNP Paribas

[1] The estimate based on hard data is only 0.1% q/q, but it is not very reliable since all Q3 data is not available yet.

[2] These forecasts are lower than the Consensus mean. Our scenario is relatively pessimistic, explaining why we see risks as evenly balanced.

in business investment, the balance of opinions about investment are more mixed in the services sector. Moreover, in July, industrial business leaders revised sharply downwards their investment expectations for 2019. Moreover, after peaking in early 2018, capacity utilisation rates have also fallen by a little more than two points to 83.4%.

Since household consumption has still not picked up, we have also revised downwards our expectations. The latest monthly figures for household consumption of goods in August hardly showed any signs of a rebound. Consumption of core manufactured goods is not a lot more vigorous (transport equipment, residential goods, clothing and other goods). Even so, a rebound still seems like the most probable hypothesis, especially given the recent upturn in household confidence and new government measures to boost household purchasing power in the 2020 budget.

Support from the labour market

The buoyant labour market is both a cause and a consequence of the observed and expected resilience of French economic growth. The labour market's strength can be seen above all in the number of job gains, which continues to be surprisingly strong. The growth of private sector payroll employment is only slightly lower than the pace of GDP growth (1.3% in Q2 vs. 1.4% in year-over-year terms). This relatively robust momentum is accompanied by tensions (hiring difficulties, labour shortage) which, though no longer rising, are still strong. The upward pressure this tends to put on wages, however, has been limited so far, for a part because of the feeble labour productivity gains arising from the job-rich nature of growth. According to the DARES, this might also reflect the nature of labour market tensions: *"higher pressures seem to be largely due to high job turnover rates in certain very labour-intensive sectors for low-skilled workers, such as construction, personal services and food & hotel services"*[3].

Unemployment statistics also reveal the robust nature of the labour market. The unemployment rate, which has fallen continuously since mid-2015, dropped to 8.5% in Q2 2019, the lowest level in ten years. Apparently, this is not only a cyclical decline. According to the DARES, the structural component has also fallen thanks to the reforms undertaken in recent years, notably to reduce the cost of labour.

Labour market prospects are still favourable too, both in the short term, based on the survey results available to date, and from the horizon of 2020, given the measures taken to enrich the job content of growth[4] (see chart 2).

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[3] DARES, *Le marché du travail en Ffance : bilan des deux dernières années et perspectives*, Rendez-vous de Grenelle, 12 September 2019

[4] CICE tax credit switch into an employers' contributions cut, Pacte law, hiring bonus, investment in skills plan (PIC), reform of the apprenticeship and vocational training system, unemployment insurance reform, increase in in-work bonus.

3- Green budgeting

Following the One Planet Summit in 2017, the OECD launched the Paris Collaborative on Green Budgeting to encourage the sharing of best practices in green budgeting (methodology and tools). In this respect, national budgets stand out as key levers for governments in fulfilling their environmental commitments.

A green budget details the environmental impact of government spending and revenue. A color-coded classification system, ranging from brown to green, highlights the environmental effects of fiscal and budgetary measures. Such a layout provides greater transparency for evaluating the budget's compatibility with the country's environmental goals. Moreover, this method can spur a virtuous circle from one year to the next, as the classification of measures as "brown" may create greater incentives for taking corrective measures.

In France's case, the Inspection Générale des Finances* *(IGF) and the* Conseil Général pour l'environnement et le développement durable** *(CGEDD) submitted a preliminary report on this topic to the government in September 2019. They focused solely on classifying spending measures, as a consensus on the definition of environmental taxes has already been established. The report defines six environmental criteria:*

- *Fighting climate change;*
- *Adapting to climate change;*
- *Sustainable management of water resources;*
- *Transition to a circular economy and risk prevention;*
- *Prevention of pollution;*
- *Preservation of biodiversity and the sustainable management of natural spaces, farmland and forests.*

Each spending item is given a score for each of these criteria using a scale of -1 (unfavourable) to 3 (very favourable).

As part of their study, the IGF and the CGEDD applied this method to four missions of the 2019 draft finance bill, in which EUR 55 bn of spending measures appeared as non-neutral. Between EUR 33 bn and 36 bn of spending measures were marked as favourable to the environment for at least one of the six criteria, and EUR 25 bn were marked as unfavourable for at least one of the criteria. Nearly half of the spending measures deemed unfavourable to the environment for at least one criterion (representing EUR 12 bn) are tax expenditures, and more precisely exemptions from domestic energy consumption taxes on petrol.

As a new practice, green budgeting is still at an early stage. The government has announced that it will introduce its first real green budget in 2021. The 2020 budget already fits within this framework given the publication of a new appendix to the budget proposal, entitled "Financing the Ecological Transition: economic, fiscal and budget tools at the service of the environment and the climate". As provided for in the 28 of December 2018 finance bill for 2019, it replaces the three existing appendices on the topics of environmental protection and climate change. This represents a first step in simplifying the analysis of the compatibility of the French budget with the country's environmental commitments.

** The General Inspectorate of Finance*
*** The General Council on the Environment and Sustainable Development*

Source: French government, IGF, press.
Text box compiled by Zoé Klein, intern, BNP Paribas Economic Research Group