FRANCE

STRONG GROWTH

Despite April's lockdown, French GDP rose strongly in Q2 2021, up 1.1% q/q. The lockdown's negative impact was very mild, and the economy rebounded strongly in June. Q3 growth is expected to reach 2.2% q/q, on the one hand buoyed by Q2 strong momentum, but on the other hand curbed by the supply-side constraints at work. In business climate surveys, optimism still prevails, although it has been fading since June. In Q4, GDP growth is expected to virtually close the gap, covering the last percentage point before economic activity returns to 100% of pre-crisis levels. This would bring average annual growth to 6.3% in 2021. In 2022, GDP growth is expected to return to more normal levels although it will remain strong, bolstered by the fiscal impulse. In addition to the downside risk of the health situation and the inflation surge, there are new fears about the scope of China's economic slowdown. Yet growth could also surprise on the upside thanks to the freeing of surplus household savings, the preservation of the financial health of companies, and fiscal stimulus measures.

Q2 MOMENTUM WILL BOOST Q3 GROWTH

According to the INSEE's second estimate, French GDP rose 1.1% q/q in Q2 2021 (0.2 points more than its preliminary estimate). This brings year-on-year GDP growth to 18.7%, thanks to a very favourable base effect (at the height of the Covid-19 crisis in Q2 2020, GDP plummeted 13.5% q/q). GDP is 3.2% below the pre-crisis level of Q4 2019. The GDP breakdown reveals some major and instructive differences between components (see chart 2). On the one hand, household consumption and exports remain depressed (5.9% and 9.5% below pre-crisis levels, respectively). On the other hand, corporate and household investment stand out for their dynamism (2.3% and 2.2% above pre-crisis levels, respectively). Seen in this light, the large forced savings accumulated by households currently seem to be benefiting housing investment more than consumer spending.

The Q2 growth figure was stronger than expected: we were looking for growth of 0.8% and the INSEE, 0.7%. Although French growth is not nearly as high as the Eurozone average (2.2% q/q) or in the United States (1.6% q/q), it is still a strong performance given the circumstances. Indeed, it is significantly positive despite the third lockdown in April. The negative impact of this lockdown was even smaller than the second one. According to the Bank of France, the loss of GDP relative to its pre-crisis level barely increased, from a little less than 4% in March to just over 4% in April 2021, while the gap widened from -3% in October 2020 to -6% in November. In May 2021, the shortfall narrowed again, to a little less than 4%. This was followed by stronger improvements in June and July, to about -2% and -1%, respectively. In August, the gap remained unchanged before narrowing slightly to -0.5% in September. This means the French economy is operating at 99.5% of its pre-crisis level.

For the Bank of France, these slight fluctuations in activity would lead to growth of nearly 2.5% in Q3, buoyed by the strong momentum of the Q2 rebound. Looking at this forecast and the INSEE's 2.7% forecast, there would seem to be some upside risk to our own estimate of 2.2%. Yet stronger growth in Q3 would mean less growth in Q4, because if the catching-up effect moves forward into Q3, then the residual automatic effect would be smaller in Q4. Our scenario is based on a mild catching-up effect in Q3 (due to supply-side constraints, see below), leaving GDP at 99% of its pre-crisis level, before virtually closing the gap with the last 1 percentage point in Q4. We are also counting on the gradual rollout of the France Relance recovery plan to support growth in Q4, lifting our forecast to 0.9% q/q, compared to the INSEE estimate of 0.5%. Although GDP is expected to return to pre-crisis levels in Q4 2021, this good news should not mask the persistence of major sector differences.

GROWTH AND INFLATION (%)

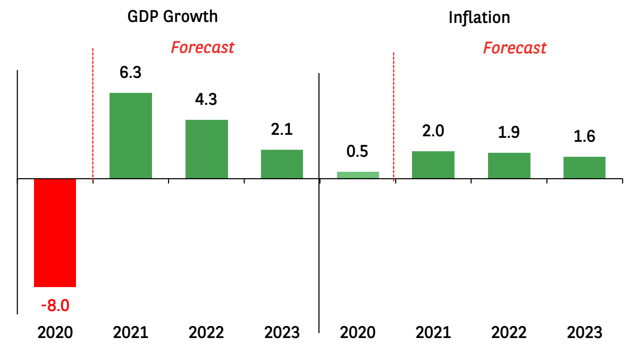

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

GDP AND ITS COMPONENTS COMPARED TO THEIR PRE-CRISIS LEVEL

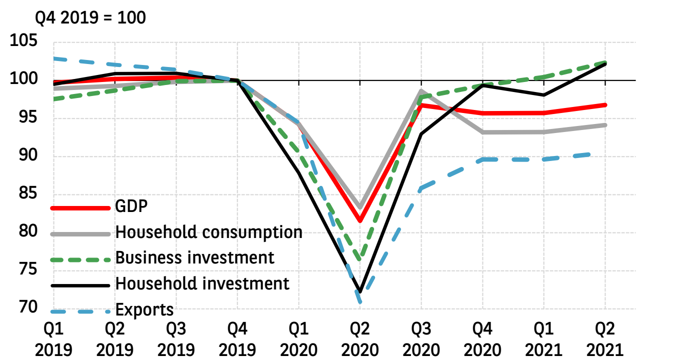

CHART 2 SOURCE: INSEE, BNP PARIBAS

The Covid-19 crisis has left deep scars on transport equipment manufacturing, transport and storage services, hotel and food services, and leisure activities (activity is down 23%, 8%, 14% and 11%, respectively in September 2021 compared to Q4 2019 according to INSEE). In contrast, the information and communications sector outperformed the other sectors, and business is 7% above the pre-crisis level.

SOURCES OF FRICTION (CONTINUED)

In Q2 2021, growth carry-over reached nearly 5%. This means there is a good chance that our full-year forecast of 6.3% will be met, even though Q3 and Q4 growth prospects do not look quite as strong as at the beginning of the summer. The sectors hit hardest by the crisis are returning to normal only slowly due to the health situation and ongoing restrictions. Above all, supply chain constraints, hiring difficulties and rising input prices have all accelerated since the beginning of the year and are having a more significant negative impact on the recovery than expected. The optimism shown in business confidence surveys has faded slightly, in addition to their expected normalisation after June's spike. At this stage, however, the decline is still mild and confidence remains high (see chart 3). Industry and construction are more exposed to supply-side tensions, while the service sectors are hit harder by health restrictions. In the months ahead, there could be a reversal in the performance of these sectors, with the services sectors pulling ahead, followed by construction and then industry.

Looking more specifically at hiring troubles, one positive point to keep in mind is that they are the corollary of some good news: the employment recovery. The size of the problem is surprising (given the available labour pool, based on the combination of unemployment, halo unemployment and underemployment) but also alarming since it restrains growth (although at this point it is hard to evaluate to what extent). There are several explanations for these hiring troubles: the specific nature of the Covid-19 crisis, stop-and-go growth trends, the preservation of jobs through job-retention schemes, the very heterogeneous nature of the sectoral shock and the ensuing difficulties of immediately reallocating and remobilising the workforce. This comes on top of existing structural problems, such as the attractiveness of certain professions and the mismatch between available labour and the skills that are needed. All of this further complicates the smooth matching of labour supply and demand. Yet as the economy and the job market begin functioning more normally, these hiring problems should gradually dissipate.

The other problem associated with hiring difficulties is their likely translation into wage inflation and the possible triggering of a wage-inflation loop and second round effects against a backdrop of surging inflation. For the moment, there is only anecdotal proof of wage pressures. Moreover, it is worth being cautious based on the experience of the years 2015-19, when the increase in hiring troubles was accompanied by only mild wage inflation (see chart 4). There is still slack in the labour market. Recent fiscal measures have also sparked a net rebound in corporate mark-ups, leaving more room for wage increases. Yet this leeway is limited, and it risks being absorbed by the concomitant rise in industrial input prices. There is also a small possibility, at least in most cases, that it will be passed on to output prices. In the end, it seems most likely that wage inflation will remain mild, although as the Bank of France warns, it could well prove to be stronger than expected. In our eyes, this would be rather good news if it signals a more normal functioning of the economy, and allows inflation to approach the ECB's target.

Another source of concern is the possible negative effect of the inflationary surge (1.9% year-on-year in August) on household confidence and consumption. As we have written in our analysis of the Eurozone, although the surge in inflation might be short-lived and contained (core inflation was still low at 1.5% year-on-year in August according to the INSEE national measure), it is still eroding purchasing power. However, the negative impact on consumption is likely to be mitigated by the strength of the labour market, the possibility of dipping

CONFIDENCE SURVEYS

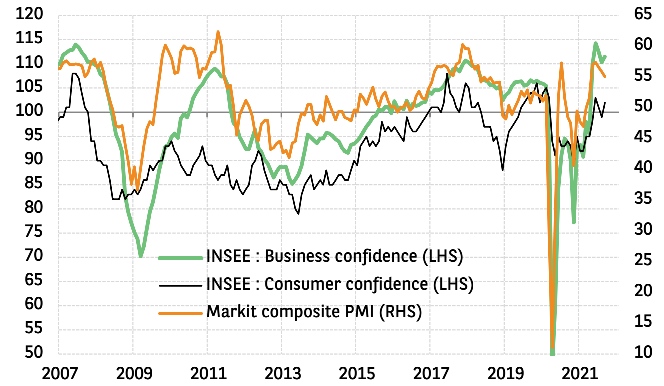

CHART 3 SOURCE: INSEE, MARKIT, BNP PARIBAS

HIRING DIFFICULTIES AND WAGES

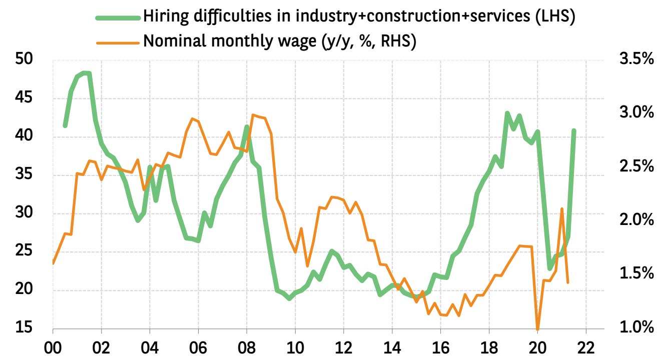

CHART 4 SOURCE: INSEE, BNP PARIBAS

into the accumulation of forced savings, the automatic minimum wage increase, which was moved forward to 1 October 2021, and a supplementary energy check of EUR 100, to be disbursed in December.

In 2022, supply chain disruptions and the health situation are unlikely to hamper growth as much as they did this year, but the automatic catching-up effect of the pre-crisis level is also likely to play a much smaller role. Even so, growth should remain strong (4.3%), buoyed by the fiscal impulse. The upside and downside risks to this scenario seem to balance each other out. The health situation remains a downside risk, to which we must add the inflation surge and fears about the size of China's economic slowdown. Inversely, growth could surprise on the upside thanks to the accumulation of surplus household savings, the preservation of the financial situation of companies and fiscal stimulus measures. Our 2021 and 2022 growth forecasts are respectively 0.2 points and 0.5 points above the September consensus.

Completed on 23 September 2021

Hélène Baudchon
helene.baudchon@bnpparibas.com