Country in the Spotlight - France

On a slippery path

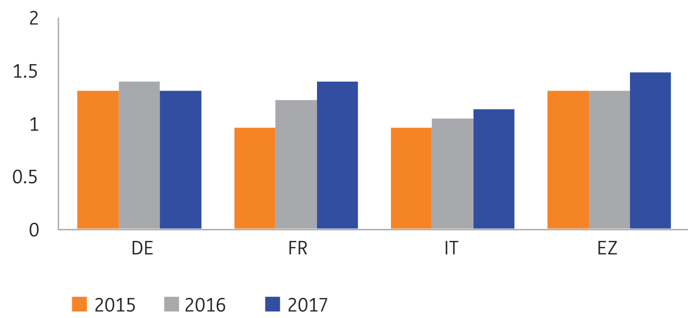
The French economic recovery remains on track, though it becomes hard to bank on a strong acceleration given that the main recovery drivers were temporary in 2015. Higher employment growth remains necessary to support the recovery rhythm, while corporate investments should continue to recover. We expect GDP to grow by 1.4% in 2016 and 1.6% in 2017 after 1.1% in 2015.

Leading indicators show that the French economic recovery remains on the right track, but 2015 saw several helping factors that will prove temporary. Especially, low oil prices have been a booster for private consumption which grew by 1.4% last year whereas employment growth is still lagging behind. Unemployment should start to decrease, but this will probably not be sufficient to support the current (weak) recovery rhythm, which is why we expect consumption growth to decelerate in 2016.

Corporate investments grew by 2% in 2015 and should continue to recover, notably thanks to investment-friendly policies, while both public investments and housing investments should continue to lag the recovery. However, the fact that they are stabilizing is likely to help total investments to continue their catching up this year. All in all, GDP growth should reach 1.4% in 2016 and 1.6% in 2017.

France remains one of the world's top innovative countries, thanks to the state involvement in research and development projects but also to world leader companies in the telecommunication, transport and chemical industries. This has helped labour productivity to keep growing at a slightly faster pace than France's European partners. Together with a strong active population growth, this should help potential growth in the next decade.

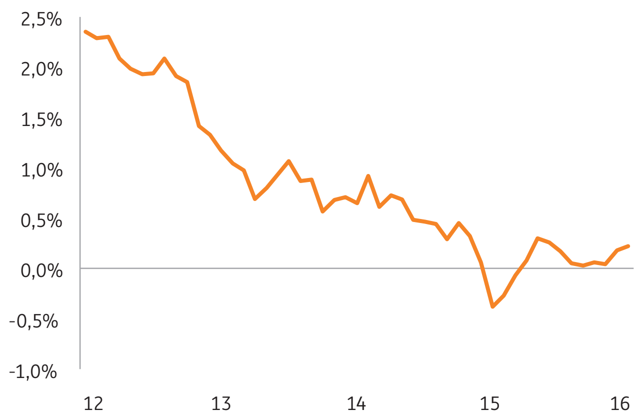
Main GDP growth forecasts (% YoY)



Source: ING

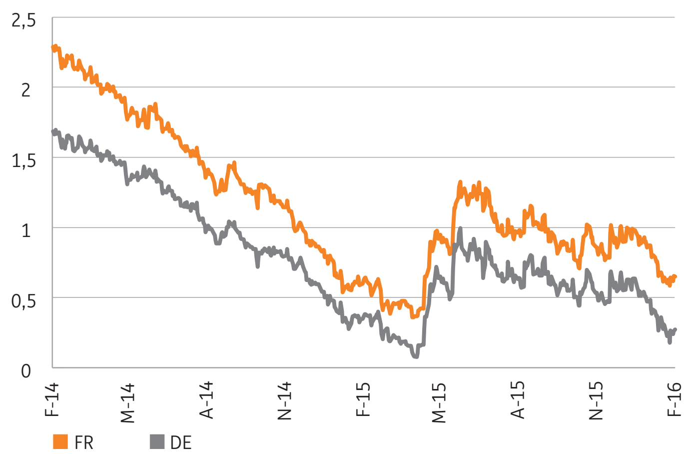
Also, labour productivity contributed, together with several tax-related cost adjustments, to the recent productivity gains which allowed for a better export performance in 2015. To be sure, the dynamic export growth was also due to a weaker euro, higher Airbus orders and a relatively strong Eurozone demand, which is also why external trade should contribute less positively to growth in 2016.

Inflation (%)



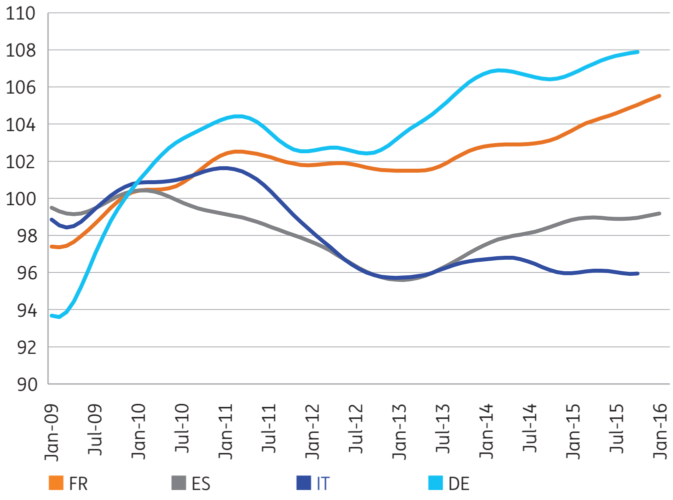
Source: Thomson Reuters

10Y yields



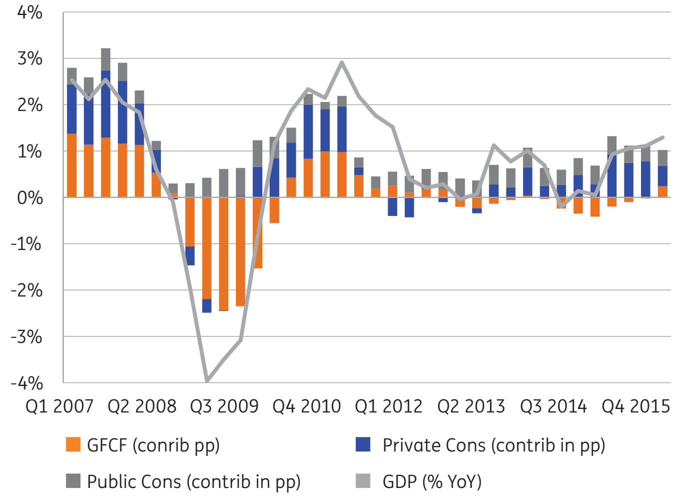
Source: Thomson Reuters

Fig 1 OECD Composite Leading indicators



Source: Thomson Reuters Datastream

Fig 2 French domestic demand bounced back in 2015



Source: Thomson Reuters Datastream

1. Economic recovery remains on the right track

Looking at leading indicators gives some assurance that the current – weak – positive economic cycle remains on the right track in France and that GDP growth should continue to accelerate. However, if French GDP indeed recovered in 2015, with an annual growth rate of 1.1% after an average of 0.4% in 2012-2014, it was partly thanks to temporary factors. In Figure 2, one can look at the different components of domestic demand and see that if public consumption remained high in 2015, private consumption was the main growth engine while investments started to contribute again positively to growth at the end of the year. Yet, unemployment remained elevated: the unemployment rate even increased to 10.6%, hitting more than 3.5 million people, a historical high. One reason behind this private consumption recovery lies therefore in oil prices: taking only the household consumption of energy, the impact of lower oil prices is a boost of around 0.9% of total private consumption, or 0.5% of GDP in 2015. Therefore, once this boost will be consumed, other engines – primarily employment growth – should support consumption if one has to see the recovery sustain itself.

At the current juncture, it is still difficult to see employment growth accelerating enough for private consumption to maintain a GDP growth contribution as elevated as in 2015. The expected acceleration of employment growth towards 1% a year, should only allow for a more limited private consumption growth in 2016. This is confirmed by the currently weak levels of confidence measured in the service sector, which is the main job creating sector: the PMI service index for example, has been again hovering around the 50.0 threshold since November, indicating that activity is on the verge of contracting again. For the moment though, it has not impacted hiring in the sector which remains upbeat about future employment (the EU Commission survey of the service sector shows that a majority of companies intend to hire in coming months, the index has not been as encouraging as in January 2016 since 2011).

Our current private consumption growth forecast of 1.2% (after 1.4% in 2015) in 2016 already assumes some acceleration in employment growth thanks to the last tax cuts measures of the Government (it is practically costless to hire low-wage employees) which should slowly bring results. A large training scheme for the unemployed should also help the unemployment rate to decrease in coming quarters, and hence support consumer confidence, but it will do little to boost employment growth in the short run. Finally, a lower tax pressure on French households and the fact that oil prices should not rebound very quickly this year will continue to support consumer confidence together with the slowly improving outlook for employment.

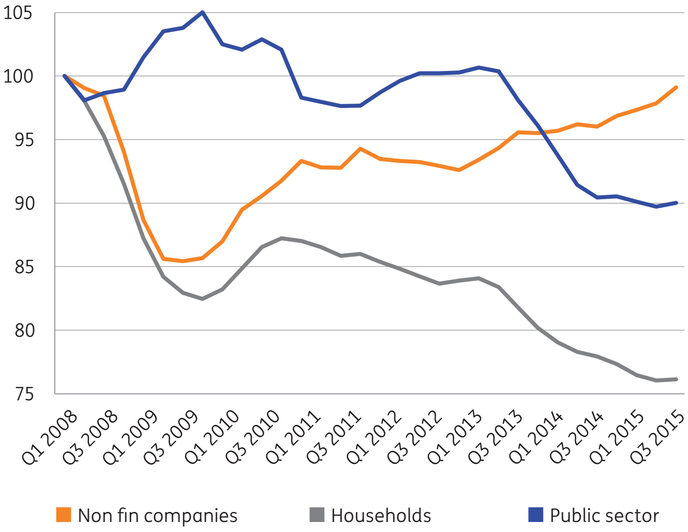
2. Corporates are investing again

Looking at domestic demand drivers, it looks as if the set of investment supporting measures decided in recent years by the Government are slowly making their way into French companies. Corporate investments are indeed almost back to their pre-crisis level, and posted a decent 2.0% growth in 2015. Even if a specific measure aimed at boosting capital investments by industrial SMEs in 2015 and 2016 probably helped the recovery, better filled order books and higher confidence also helped. The level of capacity utilization, if not at record levels, has been increasing since early 2014, and is consistent with a yearly corporate investment growth of around 3%.

The story is different when looking at other sectors. Public investments have indeed been the main victims of the minimal spending cut program implemented under Mr Hollande's Presidency. While public spending continued to grow, public investments were at the end of 2015 10% lower than before the financial crisis.

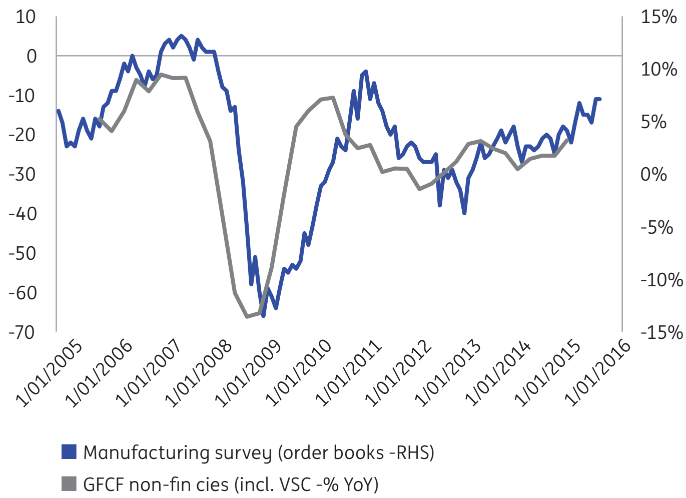
Households' investments are also lagging behind. Housing starts are at their lowest level since 2003 and 26% below their pre-crisis level. Declining house prices and legal uncertainties

Fig 3 Total investments by sector (mid 2008 = 100)



Source: Thomson Reuters Datastream

Fig 4 Improving order books have been driving corporate investments



Source: Thomson Reuters Datastream

have been behind the negative trend in recent years, which lead to a 25% drop in investments (if we compare the Q4 2015 level to the pre-crisis level). Now that a new law has been put in place to reassure investors and that housing prices are stabilizing, this trend should reverse slowly. It will however take years to see them reaching their pre-crisis level, which is why total investments will remain low in absolute terms.

Fig 5 The economy in a nutshell (% YoY)

	2014	2015F	2016F	2017F
GDP	0.2%	1.1%	1.4%	1.6%
Private consumption	0.6%	1.4%	1.2%	2.0%
Investment	-1.2%	-0.1%	2.8%	3.5%
Government consumption	1.5%	1.5%	1.4%	1.0%
Net trade contribution	-0.5%	-0.2%	-0.4%	-0.2%
Headline CPI	0.5%	0.0%	0.2%	1.5%
Unemployment rate	10.3	10.5	9.9	9.1
Budget balance as % of GDP	-4.0	-3.8	-3.5	-3.1
Government debt as % of GDP	95,3	97	98	99

Source: Thomson Reuters Datastream, ING estimates

3. The sweet spots

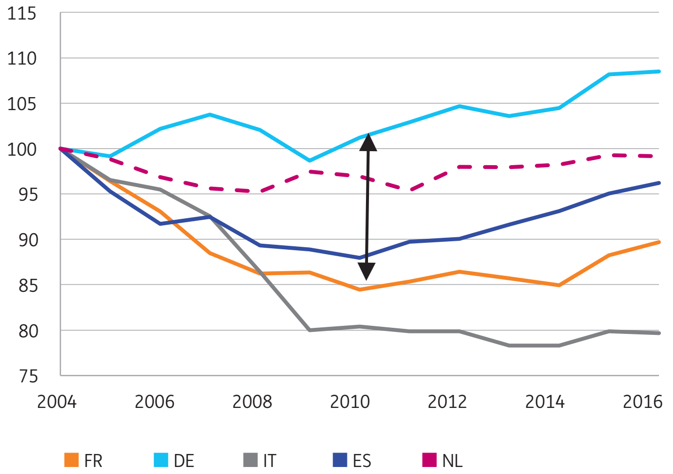
If investments are only coming back, this should not hide the fact that France did not fall behind in terms of research and developments (R&D) and labour productivity. The latter increased by 11% since 2000 (while it fell by 7% in Italy), which is slightly higher than in Germany or the Netherlands. This, together with the drop in labor costs (coming from the last efforts of the Government to cut tax-related costs for hiring low wage workers) registered in the last quarters allowed France's export performance to improve in 2015. If it remains 10% below its level of 10 years ago and is far from closing the gap with Germany, it is nevertheless a sign that efforts can pay.

Besides, France remains one of the most innovative countries in the world, with 10[1] institutions among the top 100 world innovative companies, mainly in transportation, telecommunication and chemical industries. This is notably thanks to a continuous effort in R&D spending as despite the crisis, total R&D spending in France rose from 2.1% to 2.3% of GDP between 2008 and 2015. One has to note however, that the role of the French State should not be underestimated: with 3 public research centres among the 10 institutions ranked by Thomson Reuters, the French state is a major engine of innovation. In 2015, out of the 2.3% of GDP of R&D spending, only 1.5pp came from private companies.

The fact that labour productivity did not lose ground compared to France's main European partners is also a good thing for growth in the longer run. Indeed, potential growth depends on one country's active population growth and on the ability of these workers to produce more goods and services at a time. France can increase its efforts in terms of labour productivity, but it will need less efforts than others thanks to a higher growth in the active population. Indeed, projections by the United Nations show that the active population in France should not decrease between 2010 and 2030 while the decline should reach more than 5% in Western Europe and more than 10% in Germany. Potential growth in France has therefore better prospects than elsewhere in Europe. This should not hide the fact however that the capacity to increase labour

1 Thomson Reuters 2015 – Top 100 Gobal Innovators (annual report – 5th edition)

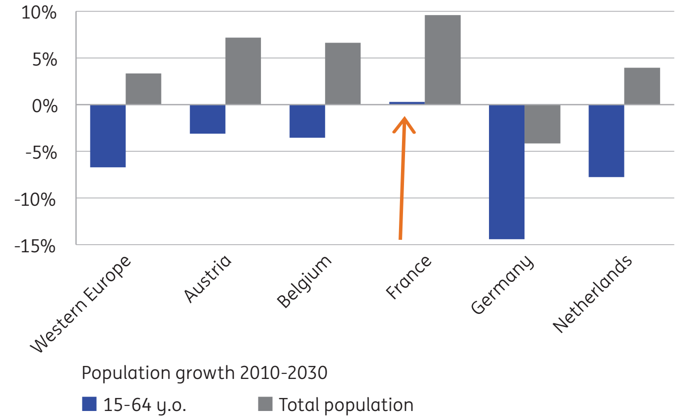
Fig 6 Export performance has improved since 2014



Note: Export performance (2004 = 100) refers to the ratio of export volumes and export market growth

Source: OECD

Fig 7 France has an advantage in the long run



Source: Thomson Reuters Datastream

productivity further has been lowered by the financial crisis in the Western world, which certainly call for more efforts in that field, including in France.

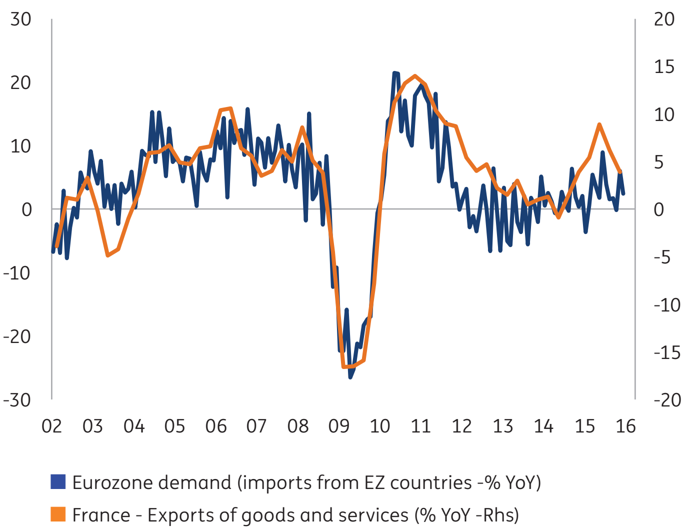
4. France's international trade structure and prospects

Thanks to some improvement in competitiveness, export performance improved in 2015. In the first half of the year, demand from the Eurozone largely supported growth, but this engine has been fading at the end of the year. Meanwhile, France's export growth towards the US and the UK have been the second largest growth contributor in 2015, thanks to the weaker euro. Together with the drop in oil imports' values, this lead to an almost balanced current account last year (for the first time in more than ten years), even though services exports (and notably tourism) posted a weaker positive growth contribution than in 2014.

However, with Eurozone demand now damaged by the weakening of the German industry which followed the drop in Asian demand and the euro weakening largely over, prospects are weaker for 2016. After a limited negative contribution to growth in 2015 (-0.2 pp), we expect net exports to contribute more negatively to GDP growth in 2016 on the back of a strengthening euro and slower Eurozone demand growth. In the graph below, one can see that the positive contribution to export growth of France's main European partners has faded quickly in recent months.

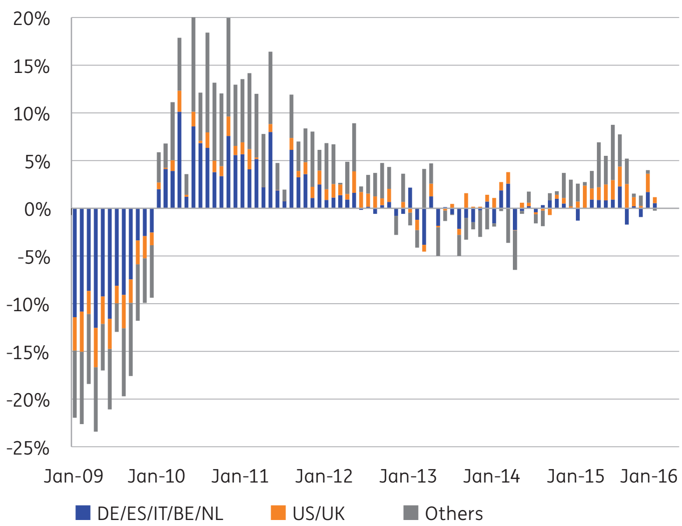
Please see hereafter two appendixes on French international trade.

Fig 8 The lack of European demand is limiting the export recovery...



Source: Thomson Reuters

Fig 9 ...while the UK and the US have both been drivers for French exports since the end of 2014



Source: Thomson Reuters, ING calculations

Appendix A. France's trade with the US and the UK in figures

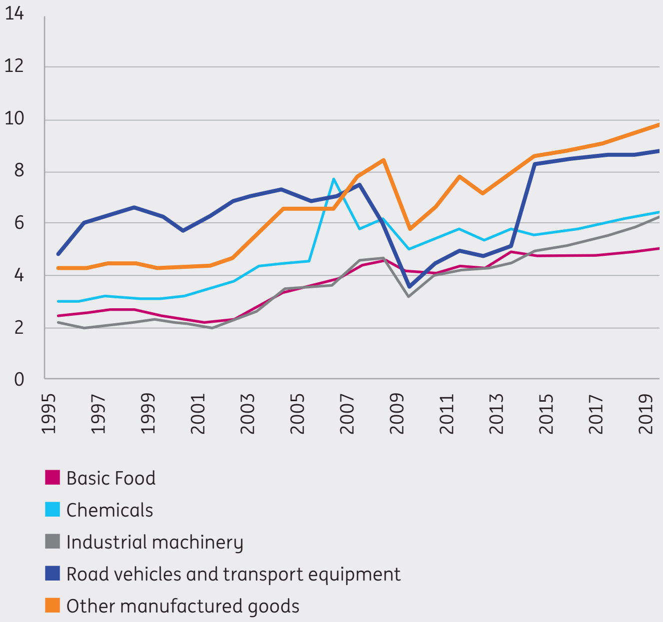
A closer look at bilateral trade flows with the UK and the US shows that, interestingly trade balances are diverging.

Naturally trade forecasts are affected by expectations of economic conditions in the future, the value of the Euro against the Dollar and against the British pound directly affect the competitiveness of exports from the Eurozone. In addition, expected economic conditions affect the demand goods in general and therefore also for imported goods.

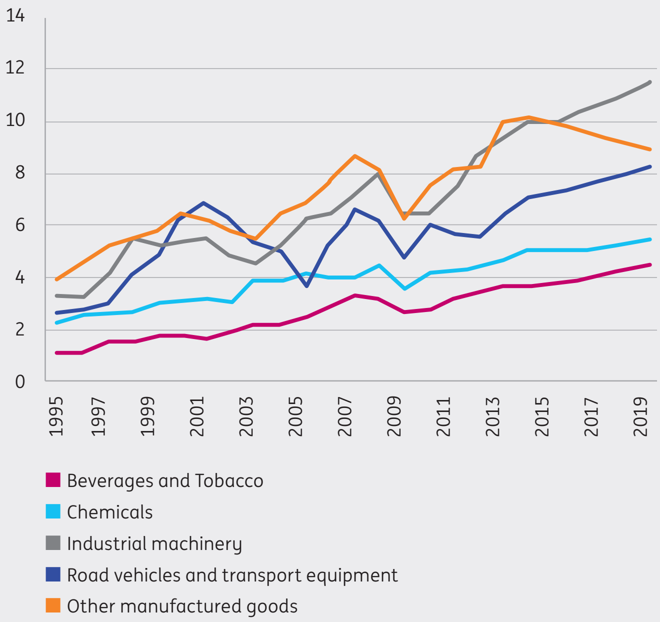
ING expects the USD and the GBP to appreciate in the first half of 2016 after which both currencies are expected to weaken slightly which may negatively affect French export growth. GDP growth in the US and the UK (2016: 2.4%, 2017: 2.7%) are expected to remain fairly strong, however, are estimated to remain strong (2.6% in 2016, 2.3% in 2017), which is an expected outperformance of the Eurozone (2016: 1.6% and 2017: 1.8%, respectively). We have incorporated these expected developments in our forecasts for export to the UK and the US.

The figure below shows the five largest exports by sector to the UK. As we can see, the export of industrial machinery, other manufactured goods (which consists primarily of semi-finished products) and chemicals are rising, while road vehicles and transport equipment and basic food are not expected to show significant growth.

French export to UK, bn USD



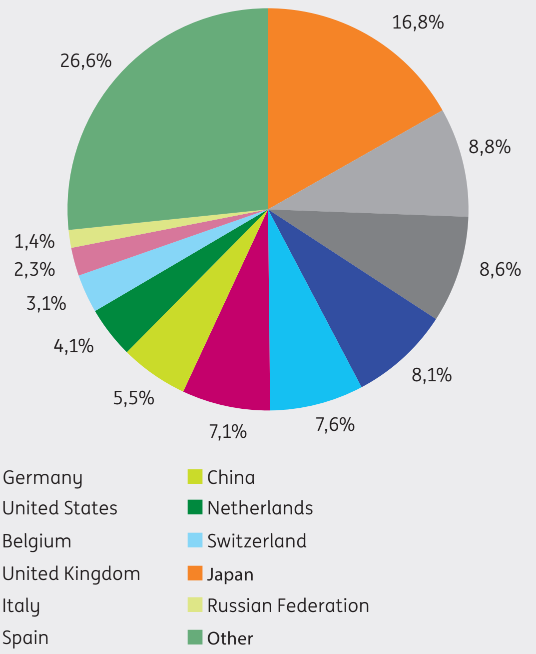
French export to US



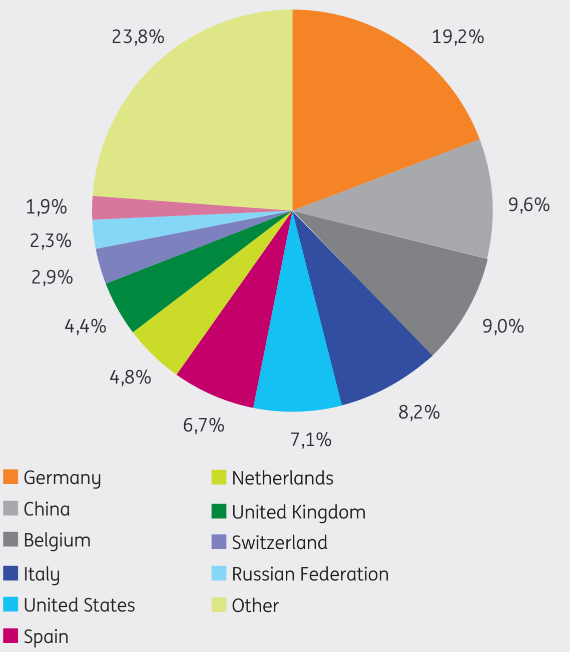
Source: all forecasts are from ING International Trade Research

Appendix B. France's international trade in a nutshell

French export to UK, bn USD



French export to US



France is one of the largest players of the world in international trade. In 2014 it was both the fifth-largest exporter and importer. Nonetheless, France maintains a trade-to-GDP ratio of 59% which indicates France is relatively closed for a member of the euro area (the ratio is 85% for Germany).

Looking at bilateral export flows, we find that exports to Germany (16.8% of total exports), the US (8.8%) and Belgium (8.6%) are France's largest export destinations. Export to Germany is expected to grow by an average of 1.7% the coming years, to the US by 3.8% and to Belgium by 1.5%. Higher growth figures are expected for China (5.5% of total exports, 10.7% average growth until the end of 2019) where growth is expected to come largely from the export of road vehicles and transport equipment.

The largest import flows come from Germany (19.2% of total imports), China (9.6%) and Belgium (9.0%). Growth of imports from Germany (+4.2% on average the coming years) and Belgium (+3.5%) is expected to remain strong. Nonetheless, imports from China are expected to grow much faster (+9.5%).

France is a large exporter of road vehicles and transport equipment (20.3% of total), non-transport manufactured goods (18.4%), and chemicals (12.9%). France is expected to see large increases in the exports of pharmaceuticals (6.3% of total now, +8.7% annually, the coming four years), and fuels (3.3% of total now, +6.3% annually).
Large French import categories are other manufactured goods (20.9%), road vehicles & transport equipment (14.2%), and fuels (12.1%), we currently expect that fuel import will increase (+10.5%), however, as we forecast at current prices, a further fall of oil prices will lead to a downward adjustment. We also expect an increase in the import of pharmaceuticals (+10.5).

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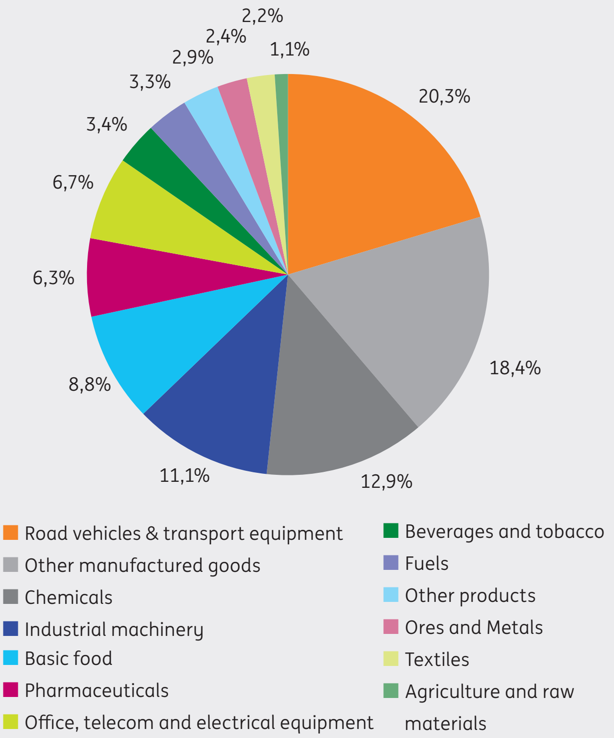
Exports by category



Source: all forecasts are from ING International Trade Research

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