

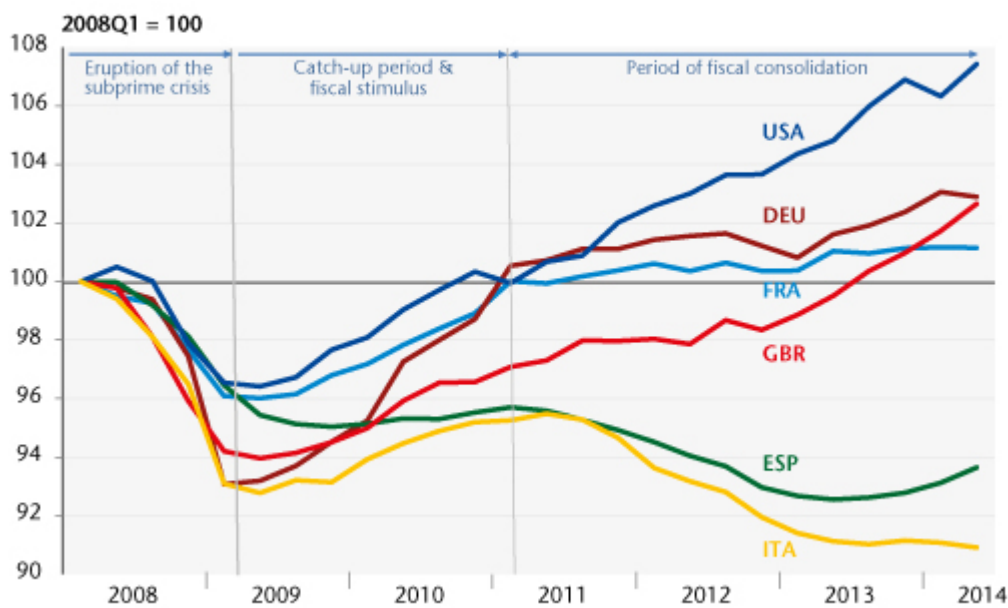
France: duty-free growth

By [Bruno Ducoudré](#) , [Éric Heyer](#), Hervé Péléraux, [Mathieu Plane](#)

This post summarizes the [2014-2015 outlook for the French economy](#)

In early 2011, France was one of the few developed countries to have regained its pre-crisis level of GDP. Economic growth exceeded 2%, even reaching 3% yoy in the first quarter of 2011. Since then the situation has changed: the recovery was interrupted, and while the economy is experiencing positive growth, the rate is close to zero (Figure 1). Four types of shock explain why the post-recession recovery in 2011 died out. Growth was already being battered by austerity and by deteriorating credit conditions, and was then also hit by fluctuations in oil prices and by the impact of price competitiveness in 2012 as a result first of wage deflation in France's competitors and then in 2013 of the rise of the euro (Table 1).

Figure 1. Comparative development of GDP in France and in its main partners



Sources: National accounts.

In 2014, the improvement expected on the economic front did not occur: the stimulus due to the gradual easing of austerity is being offset by the powerful brake exerted by the significant appreciation of the euro that has taken place since mid-year as well as by the collapse in consumer investment in housing. As in the previous two years, growth is expected to come to 0.4%, which is not enough to reverse the rise in unemployment or to reduce the public deficit significantly. Worse, while the public deficit has been cut by over 3 GDP points since 2009, it is now expected to rise slightly once again, reaching 4.5% of GDP (Tables 1 and 2).

Table 1. The brakes on French growth (2013 – 2015)

In points of growth			
	2013	2014	2015
GDP growth	0,4	0,4	1,1
Impact on GDP of			
... changes in oil prices	-0.1	0.0	0.0
<i>Direct impact on the French economy</i>	-0.1	0.0	0.0
<i>Impact via addressed demand</i>	0.0	0.0	0.0
... price competitiveness	-0.1	-0.4	0.2
<i>Impact of change in euro exchange rate</i>	-0.1	-0.2	0.1
<i>Effect of Intra-euro zone competitiveness</i>	0.0	-0.2	0.1
... credit conditions	-0.1	-0.2	-0,1
<i>Direct impact on the French economy</i>	-0.1	-0.1	-0.1
<i>Impact via addressed demand</i>	0.0	-0.1	0.0
... austerity measures	-1.5	-1.2	-1.0
<i>Direct impact on the French economy</i>	-0.9	-0.8	-0.6
<i>Impact via addressed demand</i>	-0.6	-0.4	-0.4
Achievement	-0.1	0.3	0.1
Cumulative effect of shocks	-1.9	-1.6	-0.8
Other factors (housing investment, underestimation of accounts, declining potential, etc.)	-0.1	-0.4	-0.5
Spontaneous growth rate (excluding shocks)	2.4	2.4	2.4

Sources: INSEE, quarterly accounts; OFCE emod.fr forecast 2014-2015, made in October 2014.

In 2015, growth will pick up some, to +1.1%, due to the weakening of the negative factors that have stifled it since 2010, in particular credit conditions and austerity. Furthermore, the effect of price competitiveness, a factor that has played a very negative role in 2014, will be

reversed, due first to the depreciation of the euro, and second to the rising impact of the CICE tax credit, whose primary goal is to ensure lower export prices. But with GDP growth of 1.1% next year, the path towards expansion is still a long way from what can usually be seen during a post-crisis recovery (i.e. 2.4%). As the output gap is not closing, the anticipated growth cannot be deemed a recovery. Companies will benefit from this renewed pick-up to gradually restore their financial situation. This strategy is based primarily on increasing productivity, which will help to reduce surplus capacity and restore profit margins. The unemployment rate in metropolitan France will rise slightly to 9.9% in late 2015, and to 10.3% for France as a whole. The counterpart to loosening the austerity reins is a public deficit that is higher than what was originally programmed. It is expected to be 4.3% of GDP in 2015, departing significantly from its path back towards 3%.

Table 2. Summary of forecast for 2014 and 2015

%, annual average

	2010	2011	2012	2013	2014*	2015*
GDP growth rate	2.0	2.1	0.4	0.4	0.4	1.1
Imports	8.5	6.5	-1.2	1.9	2.4	1.2
Household consumption	1.7	0.3	-0.5	0.3	0.2	1.3
Government consumption	1.2	1.0	1.7	2.0	1.8	1.1
Total investment	1.9	2.1	0.3	-0.8	-2.2	-1.6
Exports	8.6	7.1	1.2	2.4	2.5	2.6
<i>Contribution to growth</i>						
Domestic demand excl. inventory	1.8	1.0	0.3	0.4	0.0	0.6
Change in inventory	0.3	1.1	-0.6	-0.2	0.4	0.1
Trade balance	-0.1	0.0	0.7	0.1	0.0	0.4
Growth rate of euro zone GDP	1.9	1.6	-0.6	-0.4	0.9	1.4
<i>Other indicators</i>						
Inflation (consumption deflator)	1.2	1.8	1.4	0.6	0.6	0.7
Savings rate (% of GDI)	15.8	15.7	15.3	15.1	15.5	15.2
Unemployment rate	8.9	8.8	9.4	9.9	9.7	9.8
Public deficit (GDP points)	-6.8	-5.1	-4.9	-4.1	-4.5	-4.3
Public debt (GDP points)	81.5	85.0	89.2	92.2	95.4	97.4
GDP growth rate (year-on-year)	2.2	1.5	0.0	0.8	0.4	1.4

*OFCE e-mod.fr forecast for 2014 and 2015
Sources: INSEE, quarterly accounts; OFCE.

In order to meet its commitments on structural efforts and

nominal deficits, the government could decide to vote to make an additional effort of 8 billion euros. This would correspond to a 1.2 point hike in the standard rate of VAT. If that happens, GDP would grow no more than 0.8% next year, and the deficit would be reduced by only 0.2 GDP point, compared to our baseline scenario (Table 3).

Table 3. Impact on the French economy of an 8 billion euro hike in VAT

In %, difference from central accounts

Impact on ...	2015
... GDP	-0.3
... General government financing capacity (% GDP)	0.2
... Market sector employment (%)	-0.1
... Unemployment rate (percentage points)	0.1

Source: OFCE emod.fr forecast 2014-2015, made in October 2014.

Austerity without end – or, how Italy found itself trapped by European rules

By Raul Sampognaro

If the budget submitted by France is out of step with the rules on fiscal governance in the euro area (see the recent posts on this subject by [Henri Sterdyniak](#) and [Xavier Timbeau](#)), Italy is also in the hot seat. The situations of France and Italy are, however, not directly comparable: the case of Italy could be far more restrictive than that of France, once again reflecting the perverse effects of Europe's new governance. While, unlike France, Italy is no longer subject to an Excessive Deficit Procedure (EDP), with its budget deficit at the 3% threshold since 2012, it is still covered by the Stability and Growth Pact's preventive arm and thus enhanced

surveillance with respect to the debt criterion. The country's debt of 127% of GDP is well above the 60% level set by EU rules and, according to its medium-term budgetary objective (MT0), Italy must come close to balancing government spending.

While the French budget deficit for 2015 will be the highest in the entire euro area (excluding countries subject to a programme [\[11\]](#)), since the latest announcements on October 28, Italy has a deficit of 2.6%, which should not trigger a new EDP. However, the Pact's preventive arm puts constraints on changes in the country's structural balance:

- (i) in the name of convergence towards its MT0, Italy must make a structural adjustment of 0.5 percentage point per year for 3 years (i.e. cut its structural deficit by 0.5 point per year),
- (ii) if the structural deficit defined in the MT0 is not sufficient to reach a debt level of 60% within 20 years, the country must make an extra effort under the *debt criterion*. According to the latest forecast by the Commission, Italy must provide an average annual structural effort of 0.7 point in 2014 and 2015.

Yet the government is counting on a *deterioration* in the structural balance of 0.3 point in 2014, followed by an *improvement* of 0.4 point in 2015.

Thus, while according to the Commission the treaties require Italy to make a cumulative effort of 1.4 point in 2014 and 2015 (for its part the Italian Government considers that this effort should instead be 0.9 point), Italy is announcing an *improvement* in its structural balance of 0.1 point during the period, a difference of 1.3 points from that demanded by the Commission. From this perspective, Italy is further from European requirements than France, and will have to justify its lack of a structural adjustment. In addition, Italy is not expected to reach its MT0 in 2015, even though at the end of

the European Semester in July 2014 the Council had recommended it stick to the 2015 target.

Italy is the first country to be constrained by the *debt criterion* and is serving as a laboratory for the application of the rules by showing some of their adverse effects. Indeed, the adjustment required under the *debt criterion* is changing in line with several parameters, some of which were not really anticipated by the legislator. For example, the amount of the adjustment depends on a forecast of the ratio of nominal debt / nominal GDP at the end of the transition phase. However, the fall in prices currently underway in Italy is lowering the nominal GDP forecast for the next three years, without any change in fiscal policy. Thus, the debt criterion is tightening mechanically without any government action, endlessly increasing the need for structural adjustment as the new adjustments induce more deflation. In addition, the procedures used to find deviations from the debt criterion are slower because the controls are carried out essentially *ex post*, based on the accumulated deviations observed over two years. However, the magnitude of the deviation announced by the Italian government could spark procedures based on *ex ante* control. Recall, however, that unlike France, Italy is not currently in a procedure. This would have to be opened before any sanctions could be envisaged against Italy. This preliminary and necessary step gives the Italian government time to take suitable measures or to justify its deviation from the MTO.

Furthermore, the EDP's preventive arm provides more opportunities for deviation than the corrective arm. In addition to the clause on exceptional economic circumstances, Italy can argue major structural reforms that will improve the future sustainability of the debt. This argument, which is also raised by the French government, is not set out in the EDP text (the Commission could accept some flexibility). Here, however, the Renzi government is drawing on its reputation as

more of a reformer than the French government.

Both governments have requested the application of the exceptional economic circumstances clause in order to break their commitments. The Commission could be more sensitive to the Italian request because its economic situation has deteriorated: Italy has seen 3 years of falling GDP, which is continuing in the first half of 2014. The country's GDP is 9 points below its pre-crisis peak, while in France it is one point higher. The latest survey indicators, for example on industrial production, do not augur well for recovery in the short term. Finally, Italy is suffering deflation.

In summary, while the Italian gap seems larger than that of France, it could benefit from greater indulgence. The procedures applied to each country differ and give Italy more time before any sanctions can be applied. The country's willingness to reform could win it higher marks than France from the Commission. Finally, the most important point in the discussion is that Italy's economic situation is much more serious, with an uninterrupted recession since the summer of 2011 and with prices falling.

But in both cases the reinforced pact, whether it is corrective or preventive, implies endless structural adjustment. Italy demonstrates that getting out of the excessive deficit procedure will demand continuing efforts to meet the debt criterion. If France leaves the EDP in 2017, its debt will be, according to government forecasts, around 100% of GDP. It must then continue with adjustments of more than 0.5%. Confirmation of deflation will make the Pact's rules even more recessive and absurd. Ultimately, the fiscal pact meant to preserve the euro by chasing free-riders or stowaways could lead to blowing it apart through an endless recession.

[\[1\]](#) Greece, Ireland and Portugal have received European aid

and thus have been subject to joint monitoring by the ECB, the IMF and the European Union. Ireland and Portugal are now out of their bailout programme.