France: Act II, Scene 1

After decent EU election results, President Macron's reform announcements for the second act of his mandate helped his approval rating to recover to above 30%. Scene I of Act II, however, begins with France's economic outlook looking less supportive and a renewed focus on further change

All the world's a stage for French President, Emmanuel Macron

1.3% French GDP growth in 2019

Our expectations

EU elections could have been better for Macron

The EU election results confirmed that President Macron's party was facing a very weak opposition as the left lost votes to the greens, and the traditional right registered its worst results ever. At only 8.5%, it triggered the departure of senior members of the LR party, including its leader Laurent Wauquiez. The extreme left failed to progress. The French political divide remains, which resulted from the 2017 Presidential election, putting the centre of the political spectrum face to face with its extreme right (Mrs Le Pen's RN gathered slightly more votes than LREM, or 23.3%, but showed no significant progression in its EU results compared to 2014).

An embarrassing personal setback for Macron

The results could have been even better for Macron's LREM, but the party's list leader, Mrs Loiseau, proved to be a very bad strategic choice. After she failed to gather momentum during the campaign, she also had to abandon her bid to be elected as the ALDE group president in the European Parliament given a perceived lack of diplomacy towards her fellow MEP's. The French ambitions about the pivotal role of the new centrist group (and the central role of French MEPs in it), make this miscasting an embarrassing personal setback for Macron himself. The choice of the former Europe minister to lead his party's electoral list was entirely the president's, who is therefore solely responsible for the obvious miscasting of Loiseau, both as a campaigner and as a leading MEP. This, and the fact that Renew Europe (ex-ALDE) remained the third non-Eurosceptic party in parliament, is likely to downsize Mr Macron's ambitions to influence decisively the European Parliament.

A new national programme is set to restart reform efforts

After some difficult months during which attention was monopolised by the "yellow vest" crisis rather than reforms, PM Philippe delivered his government's intentions for the second half of his mandate on June 12th. It confirmed the Government's ambitions to go forward on the pension reform (aimed at pushing the effective retirement age towards 64 against 60 currently, the lowest in the OECD), on bioethics and on the last part of its labour market reform. The latter, aimed at cutting the costs of the unemployment benefits system, was announced on 18th June (see below). PM Philippe also confirmed the tax cut measures taken for households earlier this year to appease the "yellow vest" fever. In total, household taxes should be lowered by €27bn during his mandate (most of which will come from lower housing taxes but €5bn are new, specifically income tax related measures starting to have effect in 2020), or 1.1% of GDP.

The stark progress of the Greens in the EU parliamentary election prompted an attempt to break "the Green monopoly" as PM Philippe put it. However, as the first part of Mr Macron's mandate ended up in the bitter resignation of the popular Environment Minister Mr Hulot, the Government's credentials on the topic are still low. Most of the announced intentions (such as a 100% recycling of plastic wastes by 2025) still have to be translated into concrete measures. This should come as early as July in a Circular Economy law and later, probably in 2020, in a greener housing support bill. In the no-confidence vote that followed Philippe's speech, he got 363 votes, which was only slightly lower than the 370 he received at the beginning of Emmanuel Macron's presidency in 2017.

Low interest rates to the rescue

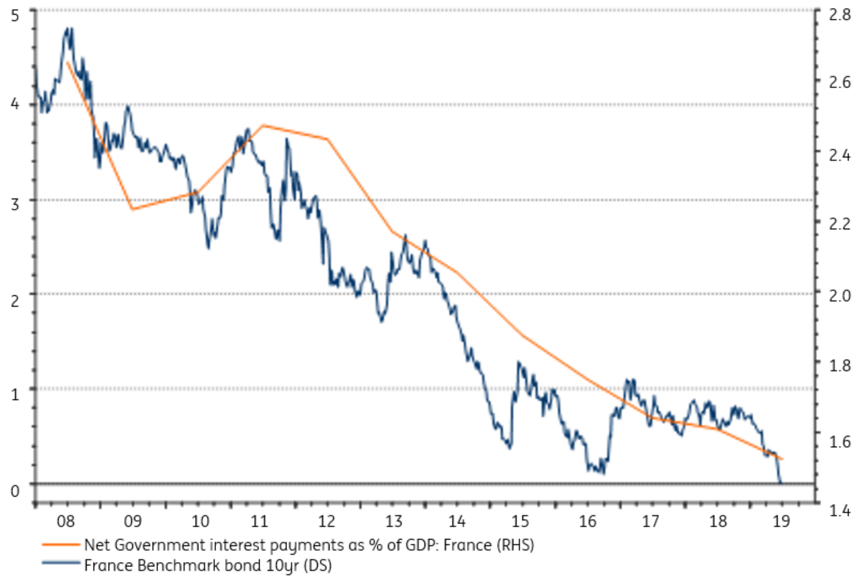
A key component of President Macron's programme was to lower both expenditures and revenues in % of GDP. The current finance law continues seeing expenditure going from 56.1% of GDP in 2017 towards 51.6% in 2022 with increasing efforts in 2020-2022. The structural effort is also three times higher on 2020-2022 than in 2017-2019 (1.4 pp compared to 0.5pp over 3 years). It could well be that the upcoming economic downturn slows down the effort and the deficit should still remain below the 3% threshold after 2019. In particular, the planed corporate tax cuts (from 33%

to 25% over five years) have been slowed down. In 2019, it went from 33.3% to 31% only for companies with a turnover below €250m. They should benefit from further cuts to 28% in 2020 and 25% in 2021 while larger companies will see their tax rate decline more slowly (if ever).

France will be allowed to pretend it is back among European fiscal role models

Moreover, lower debt service costs will continue to help: they have decreased by €15bn since 2008 while the average maturity of the public debt increased from 8 to 10 years. The recent wave of central banker activism even pushed the 10-year yield of the reference government bond into negative territory for a few minutes in June. All in all, we think that 2020 will probably be too soon for Brussels to put into question the current French plans. As long as the debt-to-GDP ratio remains on a downward trend, France will be allowed to pretend it is back among European fiscal role models.

Net interest payments are now less than 1% of GDP thanks to ultra-low rates



Source: Thomas Reuters Datastream, ING

Private consumption growth is set to accelerate in 2H19

After the dip in both consumer confidence and spending during the fourth quarter in the midst of the “yellow vest” crisis, private consumption had a tepid beginning of the year. It was up by 0.4% in 1Q19 and it was growing by only 0.8% on the year, the fourth quarter below 1%.

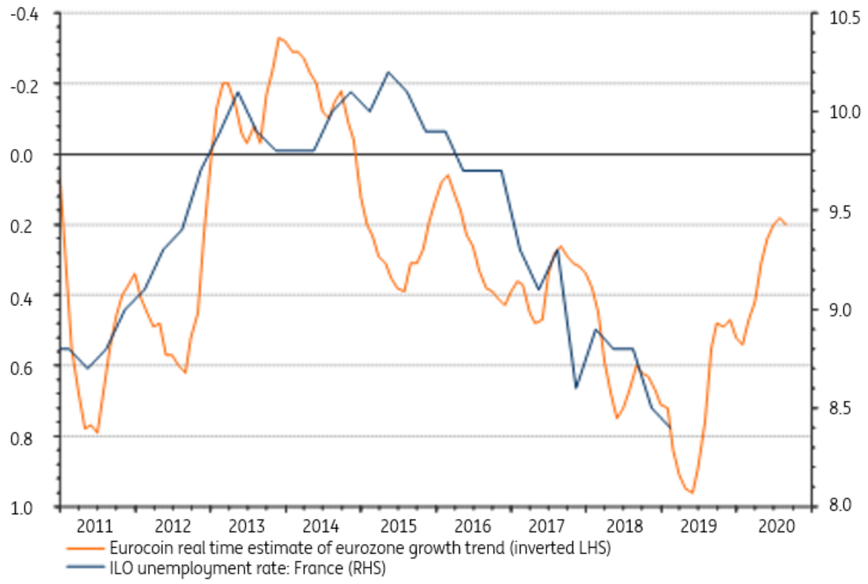
Given the strong preference for savings that consumer surveys have been showing since last October, we expect that the tax cuts announced as a conclusion of the “Big Debate” will not entirely be translated into higher spending. However, the announced €27bn tax cut package (over

5 years) should keep supporting private consumption growth in the second half of the year and in 2020. That said, because of high saving intentions and a negative base effect stemming from the second half of 2018, private consumption growth in 2019 should be barely above 1%, after only 0.9% last year. It is probably only when households feel they have rebuilt their savings that these measures will have a stronger acceleration effect on private consumption, which is why we expect it to grow by 1.4% in 2020.

The current economic downturn bodes ill for the jobs market

A stronger labour market could help in this regard. In the four first months of the year, the unemployed population declined by 47.5k, twice the drop registered during the same period last year. In 1Q19, the unemployment rate was 8.7%, 0.5pp below its 1Q18 level. Unemployment in metropolitan France was 8.4% and we think it should continue to decrease and briefly go below 8% at the end of next year. However, the current economic downturn bodes ill for the jobs market (see Figure 2) and we expect it to come up again in the second half of next year. An element that could hold it back is the unemployment benefits reform just approved by the government, which should bring back some active people into employment.

Unemployment should continue to go down in the short term



Source: Thomas Reuters Datastream, ING

Labour market reforms

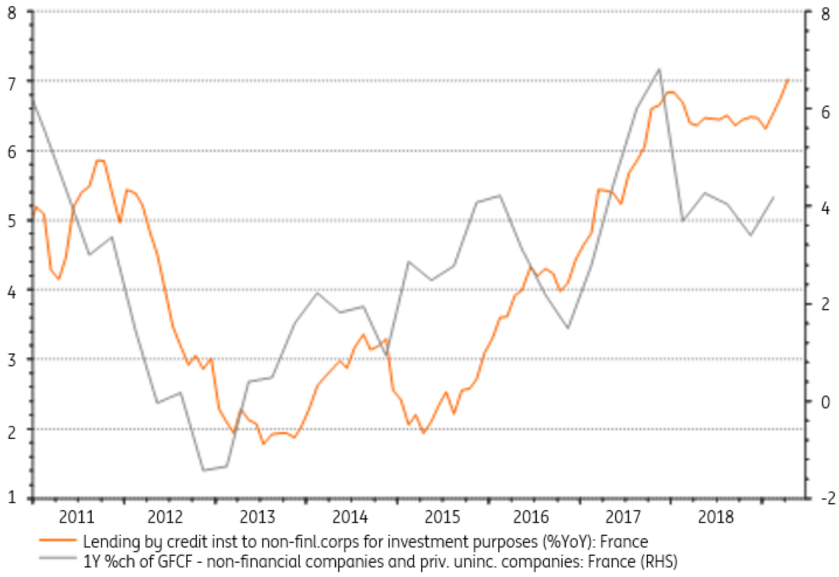
Under the new law, which should save the current system €3.4bn a year, beneficiaries will have to have worked 2 months more than before (6 out of last 24 instead of 4 of last 28) to benefit while that social security will be cut after 6 months for the 10% highest-earners (above €4,500/month gross). The aim is to push parts of the unemployed population back towards the jobs market, especially those who earn more from employment benefits than on their previous jobs (estimates of these cases go as far as 20% of the currently unemployed population). Finally, the government acted on its intention to increase social charges for short-term contracts to make long-term contracts more popular again. Since it made it safer and easier to dismiss workers in a previous reform, the government now clearly wants companies to shift away from short-term contracts which made up to 85% of all new contracts at the peak of the crisis.

On the investment side, households' investments in new construction stagnated in 1Q19 after the 0.3% contraction registered in the last quarter of 2018. Compared to the 6.6% growth registered in 2017, 2018's 2% growth look pale. Given the extremely low levels of mortgage interest rates across the French market, we expect household investments to rebound in 2019 and 2020. However, they remain 10% below their early 2008 levels and are unlikely to catch up fully in the next two years.

Business investments remain the stronghold of French growth

Supported by affordable financial conditions and growing credit (credit to non-financial businesses was growing by 7% on the year in April), business investments continued to grow despite the confidence dip registered during the "yellow vest" crisis. They were up in 1Q19, by 0.7% after 0.8% in 4Q18. This brings their growth to 4.2% on the year, which is very positive given the weakness of domestic demand. We do not expect a major drop in the pace of investment growth in 2019, which should still reach 3.5% after 3.9% in 2018 and a peak of 5% in 2017. Indeed, financial conditions are set to remain attractive and there are only partial signs of weakening from the industrial side. If some sectors suffered from the "yellow vest" crisis, especially the consumer goods segment, manufacturing production rebounded by 1.1% QoQ in 1Q19 and capacity utilisation was only marginally lower. Recent surveys also point to lower inventories and better order books, which should support a high rate of capacity utilisation and new investments.

A dynamic credit cycle should continue to support investments



Source: Thomas Reuters Datastream, ING

External demand to the rescue of order books

External demand has been supportive of French industrial production in the last few quarters, compensating somewhat for the lower domestic demand in companies' order books. Despite the trade wars and the slowdown in global export growth, French exports have benefited from the USD strength: exports to the US in April were 12% above their 24-month average. Exports towards the eurozone are broadly stable. However, we note a sharp slowdown of exports towards the UK in April as the inventory build-up that took place before the previous Brexit deadline (boosting French exports) faded. Net exports nevertheless shaved off 0.3pp of GDP growth in the first quarter, the first negative contribution in more than a year, as imports recovered on the back of a somewhat stronger domestic demand.

While net exports had a particularly high contribution to growth in 2018 (0.6pp was the highest since 2012), we do not think it can be repeated in 2019 as we expect a slightly negative effect of foreign trade on growth. Indeed, the slowdown in world trade and Eurozone growth will have an impact on French external demand. Also, the expected recovery in domestic demand should continue to support imports. Finally, the recent gains in export growth do not seem to stem from a particular improvement of the competitive position of France which has, at best, stabilised over the last two years; it's rather down to temporary exchange rate effects.

2019 starts in minor mode

Looking at the first quarter figures, it seems that domestic demand will still need some time to recover from the abnormal levels of anxiety recorded at the turn of the year in consumer surveys. They still show a strong preference for savings and higher fears of unemployment than last year despite the resumption of job creation. Given the expected slowdown of the economic environment in Europe in 2019 and 2020, GDP growth should remain in these two years at a level close to its potential (1.3%) before slowing down in 2021 when we expect the effects of a more global downturn to be felt throughout Europe.

This article is taken from the Eurozone Quarterly, which you can find here

The French economy in a nutshell (% YoY)

	2018	2019F	2020F	2021F
GDP (%)	1.7	1.3	1.2	1.0
Private consumption (%)	0.9	1.1	1.4	1.1
Investment (%)	2.8	2.9	2.4	1.8
Government consumption (%)	0.8	1.2	1.3	1.0
Net trade contribution (%)	0.7	-0.2	-0.5	-0.2
Headline CPI (%)	1.9	1.1	1.3	1.4
Unemployment rate	9.1	8.4	8.5	9.0
Budget balance as % of GDP	-2.5	-3.3	-2.3	-2.2
Government debt as % of GDP	98.4	99	98	97.5

Source: Thomas Reuters. All forecasts ING estimates. Unemployment rates according to ILO definition