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France

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Macron's first year in office has been a success. Reforms have started without much resistance helped by an improving external environment. Growth has recovered while financial balances have strengthened. However, darker clouds are gathering on the global sky, and while Macron last year won landslide elections, rate of abstentions was also high.

Country Risk Analysis

Summary and conclusion

Growth better than expected: Last year's economic performance ended better than expected as growth accelerated in the last three months of the year yielding a 2 percent expansion for the whole year. As a result, the current year received a decent kick-start and despite a very weak first quarter estimates are still for at least 1,8% growth in 2018. That said new clouds on the global horizon, in particular growing threats of trade war and the US withdrawal from the Iran deal, has damped investor confidence. Hopes are pinned on deep cuts to corporate and personal taxes being implemented before year-end.

Shrinking unemployment: Last year unemployment fell sharply to less than 9% as the country generated more jobs than anticipated. The same trend is likely to continue in the current year with the result of bringing down the unemployment ratio to 8%. Employers are reportedly beginning to complain about skill shortages but so far there has been no visible wage pressure.

Budget consolidation: Over recent years the budget deficit has declined in a very gradual manner, but last year it fell more rapidly than expected to 2,6%/GDP, much helped by cyclical factors, though. For the current year this trend will continue seeing the shortfall narrow to 2,3%/GDP which should help stabilize the government debt/GDP ratio at 98%/GDP. The government is aiming at bringing the deficit down to 0,5%/GDP by 2022 and the debt to 94%/GDP a trend that should calm markets.

Outlook: That, however, depends on the successful implementation of the ongoing reform program that to support future growth rate stabilize around 1,5-2%. But that would be under threat should popular resistance to reform rise again or if France were to be hit by adverse developments from abroad, including a global trade war or a new euro-crisis.

Ratings: One rating agency recently raised its outlook from stable to positive for the sovereign. That was before the recent turbulence in European financial markets emerging from the Italian debacle.

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Recent developments

Growth better than expected: Last year's economic performance ended better than expected as growth accelerated in the last three months of the year reaching 0,7% quarter on quarter (QoQ) expansion. As a resulted, the whole year ended up 2%, beating expectations of both the government and most observers. That gave the current year a kick-start of statistical carry-over prompting an upgrade of forecasts to more than 2% for the whole year. However, much of last year's spectacular end-performance was due to a bunching of aircraft deliveries. As they dropped out of the numbers, the result for the first quarter of the current year moderated considerably and was made worse under the impact of higher indirect taxes and cuts in public sector investment demand. The new clouds on the global horizon, in particular growing threats of trade war and the US withdrawal from the Iran deal, has damped investor confidence and prompted a decline in the PMI index, still remaining in clearly positive territory, though. Last year' strong export recovery could now weaken more than expected only a few months ago. Observers have again turned around and reduced whole year forecasts to 1,8% growth, despite the growing likelihood of deep cuts to corporate and personal taxes being implemented before year-end.

Unemployment on its way down so far without impact on core inflation: Last year the rate of unemployment fell below 9% at year-end as the economy created 275000 new jobs. That good result may not be repeated in the current year. In 2018, expectations are for more moderate job-creation, around 200,000 new employment opportunities, in part due to cuts in subsidy contracts for parts of the labor force but with the effect to still reduce unemployment to 8% of the work force. Employers are, reportedly, beginning to complain about labor shortages in particular for skilled labor but so far without much effect on wage growth which last year remained moderate at around 1,4% in line with trends of recent years and in line with subdued price pressure. Estimates for consumer prices in the current year is also 1,4%, up only 0,4pp from 1% in 2017. Core inflation is expected even lower at 0,5%

Steady external developments: Last year's synchronized global upswing boosted exports of goods by 8% while imports rose by 10% in part due to higher prices of imported oil. That caused a widening deficit on the current account deficit which expanded by 0,4 percentage points (pp) to 1,4% of GDP. For the current year, expectations so far have been for another strong year with exports this time outpacing imports thereby paring the current account deficit back to 1,3%/GDP. In itself, that deficit is not much of a concern for the country's creditworthiness. But as a result of past decades of underperformance on this metric France's net external debt is now standing at 33%/GDP whereas peers in the same risk category are in a net external ***asset*** position to the tune of 40%/GDP according to one rating agency.

Policies

Fiscal consolidation begins in earnest: In 2017, the fiscal deficit fell to 2,6%/GDP 0,3pp better than estimated at the beginning of the year marking the first time in almost a decade that Paris had been able to contain the shortfall to less than 3% in line with EU's old Maastricht criteria. That should enable France to exit its long standing and repeated Excessive Deficit Procedures (EDP) of the European Commission. However, the Commission's new growth and stability pact requires that the performance is measured against another yardstick, the structural fiscal deficit. Even though the current year's shortfall is set to shrink further to 2,3%/GDP

in headline (nominal) terms, Banque de France estimates that the structural deficit will rather widen by 0,4pp because much of the improvement to the headline balance is more due to the improved environment rather than government efforts.

Legacy problems: France's fiscal problems today is a legacy from years of high fiscal spending in the period leading up to the GFC ten years ago. That was a time when many welfare schemes had been enhanced and these were difficult to dismantle as the crisis proved longer than expected. That brought the expenditure side of the government budget up to the present level of 57%/GDP one of the highest among peers. High government spending is now at the heart of the fiscal problems and contribute peaking at almost 5%/GDP in 2012. The result has been a mounting debt for the government which in a low growth environment has accumulated fast to more than 98%/GDP.

Further budget consolidation: Following reforms to the labour market, the new President's next priority has been to rationalise the budget's expenditure side and make the tax system more efficient. But budget consolidation is still not front loaded. The priority to boost the economy is coming first including tax cuts for corporates as of next fall from 33% to 25% of profits. The declared ambition is to decrease the deficit to within 0,5%/GDP by 2022. That should have reduce the debt burden to 94%/GDP early next decade provided reasonable growth of 1,5%-2% a year.

Government deficit financing: Since Macron's election victory a year ago markets have turned upbeat on French government debt and accepted gradually lower risk premium. Last year the government's average yield fell to 0,7% for new issuance cutting the total interest/revenue ratio to only 3%. This year the premium it has dropped further to only 20bsp over Bunds. A relatively long maturity of almost 8 years makes the debt rather immune to higher market rates at least for the first couple of years following a rate rise. More than 50% of the debt is held by non-residents', however, often cited as a concern in case of rising market turmoil.

The banking sector is gaining strengths but EM exposure could be a warning sign: Declining insolvencies and stabilizing levels of bad loans (NPL) were instrumental in reviving loans growth to an annualized 6% in late 2017, faster than most other euro-countries. As a result, leverage in the domestic economy has grown to 72%/GDP, up from 50% ten years ago for corporates and to 58% for households. The latter is still regarded as manageable – the leverage is around 108% compared with household incomes – but the former has attracted the attention of the central bank prompting new regulation on banks' exposure to large corporates with weak performance. Observers are also warning of French banks' high exposure to emerging markets, including China and some of the more crisis prone, Turkey and Brazil. Banks are also highly reliant on wholesale funding and clearly less insulated against rising interest rates than the sovereign. That said, though, at least larger banks have been able to improve buffers, profitability and capitalization since the crisis and also reduce their reliance of wholesale funding. They are meeting their MREL[1] and TLAC requirements.[2]

Structural policies: Over the last 10-15 years, various governments have made it a priority to address France's competitiveness problem having seen global market shares fall more sharply than those of peers, Macron is the first to have delivered in

[1] Minimum **requirement** for own funds and eligible liabilities
[2] Total Loss Absorbing Capacity

earnest. It certainly has helped that he clearly campaigned on a platform of reforms, often unpopular with the country's forceful vested interests.

Labour markets: The pre-crisis period opened a competitiveness gap in particular against Germany, largely reflecting differential wage developments. Macron's first priority has been to reform the labour market beginning with strengthening wage negotiations on the factory floor, rationalising entitlements to unemployment benefits and limiting judicial recourse in cases of dismissals of employees. Other structural challenges are linked to a high tax and regulatory burden which produces a sizeable labor tax wedge. The worst, however, for business is not that the overall tax burden on capital and labour is high but that rules are changing frequently including for the corporate tax regime. That is clearly reflected in France's scoring below most peers in surveys such as "Ease of doing business" of the World Bank.

Fiscal reforms: To set the fiscal trajectory on a more sustainable path has been paramount for several years. Even though the government has kick-started reforms by promising tax cuts in particular for corporates before year-end, it is now urgently needed to attack the expenditure side which will have to take the brunt of fiscal consolidation. The fulcrum seems to be making local government operate in a more efficient manner and limit growth in their budgets. Plans continue for merging administrative units – *communes* in particular – to achieve economies of scale. As to pension reforms, the focus is mainly on simplifying the system to increase transparency and fairness. France is among the few advanced economies not facing a major medium to long term pension crisis as the dependency ratio is no longer increasing. Pension reforms is therefore not about less generosity and as such are less likely to meet strong resistance.

Political developments

Landslide elections: General elections about a year ago ended as good as market could have wished for with the former Wall-Street banker winning a landslide election and then shortly after followed by another victory at the polls for his newly started *France en Marche* party which, to the surprise of most observers, took 61% of the seats in the National Assembly. The feat was remarkable inasmuch as Macron was a relative political neophyte and the first independent to win the presidency since the beginning of the Fifth Republic in 1958. By this Macron not only beat back his populist opponent, Marine le Pen of the *Front Nationale*, but also dealt a blow to much of the political establishment. Recently his popularity has fallen from its post-election high but popular support for reforms has overall remained solid.

Fly in the ointment: The only fly in the ointment, however, could be that his victory was based on low participation among voters which could suggest that public sentiment may not remain steadfast shift with political and social resistance complicating the social dialog. In that sense, current window of opportunity could close quickly while reforms will require strong political support over an extended period as the growth payoff takes time to materialize. Slowing reforms may cause medium term growth and fiscal objectives to lag with the effect to worsen government debt dynamics.

Outlook

Growth under Macron has so far surprised on the upside: Last year's performance is unlikely to be repeated in full for the current year, but 1,8% economic expansion is

still a reasonable result for an advanced economy. While the current year had a weak start, hopes are that tax breaks promised before year end will revive in particular corporate investment demand while private consumption continues along a steady path of some 2% a year. Against that background, the government should have a reasonable chance in reining in the budget deficit to gradually lower the government debt ratio. While that may not present a direct threat in itself over the next few years under reasonably benign circumstances and low interest rates it leaves little fiscal space to fight another recession.

For the medium term horizon the outlook remains benign as well. Next year the economy will probably edge slightly down to 1,6% growth although the replacement of the CICE tax credit with a permanent reduction in social contributions should provide a small fiscal stimulus. That may raise the budget deficit somewhat but apparently, quoting most observers, not enough to derail the ongoing fiscal consolidation up to 2022, when the government aims at a deficit reduction to less than 1%/GDP.

The downside risk is first of all that resistance to reforms may eventually rise. Without reforms fiscal consolidation may come under new scrutiny from markets and probably raise risk premium on government debt. That will attack the government debt ratio from both sides: higher deficit and lower underlying growth making it harder to achieve any debt reduction.

External factors: Factors beyond the control of the country itself include the threats of global trade war in particular and to a lesser extent the loss of the Iranian market for many French companies. All these threats, however, are trumped should the Euro-zone fall into a new crisis, this time centered on Italy.

Key ratios	2018
Population (millions)	67
GDP/capita ($)	43954
GDP (change)	2,1%
Inflation	1,4%
Curr.acc. balance/GDP	-1,3%
Reserves/imports (months)	0,0
Budget balance/GDP(*)	-2,8%
Government debt/GDP(*)	96%

Present ratings:
Fitch: AA
S&P: AA
Moody's: Aa2

Peers:
Japan
UK
Germany

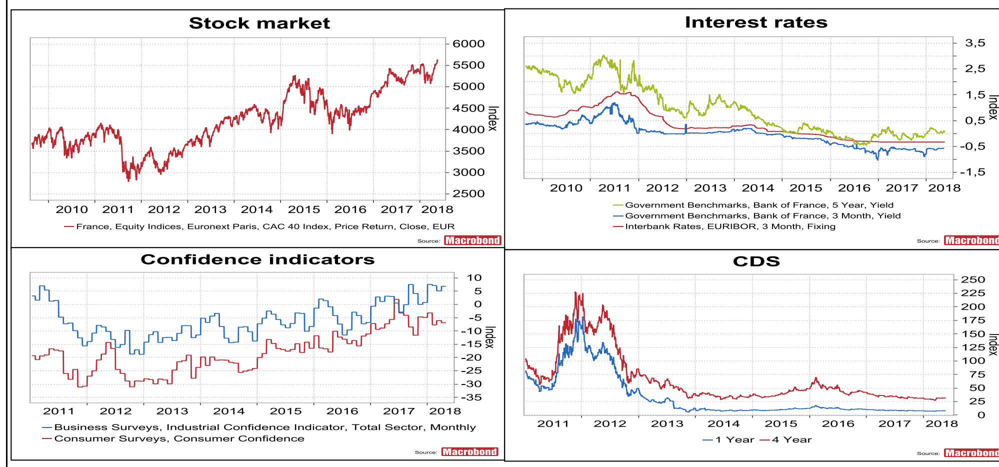
Graph: France's risk profile almost matches that of Japan except for liquidity where France scores higher reflecting the benefits of being part of a major currency area.

Key data:	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
GDP (bill. US$)	2039	2044	2056	2077	2097	2120	2163	2207	2249	2291
GDP/capita (US$)	43970	40950	42697	43085	36520	36827	38519	43954	46412	47173
GDP (change)	2,1%	0,2%	0,6%	1,0%	1,0%	1,1%	2,0%	2,1%	1,9%	1,8%
Investments/GDP	22,1%	22,1%	21,8%	21,6%	21,6%	21,9%	22,3%	22,6%	22,8%	22,9%
Budget balance/GDP*	0,0%	-4,8%	-4,1%	-3,9%	-3,6%	-3,4%	-2,9%	-2,8%	-2,8%	-2,7%
Govt debt/GDP**	86,6%	90,3%	92,6%	94,7%	95,8%	97,0%	97,2%	95,9%	95,7%	95,2%
CPI inflation (%)	2,1%	2,0%	0,9%	0,5%	0,0%	0,2%	1,0%	1,4%	1,5%	1,6%
Money demand (%)	4,3%	2,9%	1,7%	1,1%	3,0%	5,2%	7,5%	5,7%	4,5%	3,9%
Stock prices	2656	2509	2982	3317	3721	3436	4056			
Interest rates	1,4%	0,6%	0,2%	0,2%	0,0%	-0,3%	-0,3%	-0,3%	-0,1%	0,3%
Exch. Rate ($)	1,39	1,28	1,33	1,33	1,11	1,11	1,13	1,26	1,29	1,28
Trade/GDP (%)	45%	45%	45%	44%	44%	44%	46%	47%	48%	49%
Oil price (Brent)	$111	$112	$109	$99	$52	$44	$54	$67	$65	$66
billions US $										
Export of goods	594	566	589	594	517	516	558	668	723	753
Imports of goods	699	653	667	668	565	566	626	732	792	821
Other:	75	55	52	38	37	28	37	35	41	45
Current account	-30	-33	-26	-37	-10	-22	-31	-29	-28	-23
(% of GDP)	-1,5%	-1,6%	-1,3%	-1,8%	-0,5%	-1,0%	-1,4%	-1,3%	-1,2%	-1,0%
FDI	-20	-19	14	-47	2	-29	13	-9	-9	-9
Loan repayments	771	832	879	843	775	780	771	751	734	726
Net other capital flows	-718	-786	-865	-758	-763	-725	-752	-710	-696	-694
Balance of payments	2	-6	2	1	4	5	0	2	1	0
Reserves	33	27	29	30	33	38	39	41	42	41
Total debt	5395	5821	6152	5904	5427	5463	5394	5255	5135	5079
o/w short term debt	3121	3482	3862	3706	3359	3327	3297	3194	3101	3051

Sources: Oxford Economics, IFS and SEB estimates.

Rating history						
Fitch (eoy)	AAA	AAA	AAA	AA+	AA	AA
Moody's	Aaa	Aaa	Aa1	Aa1	Aa2	Aa2

Type of government: Republic
Next elections 2022
Other:
Latest PC deal None
Latest IMF arrangements None



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