

France Business Forecast Report Q2 2014

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Abstracts

Core Views

While the rest of the eurozone is showing early signs of recovery, the French economy continues to stagnate. While the improving regional economic outlook may provide some limited upside potential, this might not be sufficient to drive a recovery in French manufacturing unless the country first addresses its outstanding competitiveness issues.

While we are likely to see a gradual increase in positive rhetoric towards structural reforms, President François Hollande is unlikely to become an ambitious reformer of the French model. While we expect some reformers will take baby steps in the right direction, the ability of Hollande to implement sweeping reforms will be limited by divisions within his own party and core support base, and resistance from the proliferation of special interest groups that will make unilateral reform a troublesome and compromised process.

We expect pressure on the government to engage in more concerted fiscal consolidation to mount over the coming quarters, particularly as lower growth begins to translate into lower government revenues. While France has thus far not fallen prey to the bond vigilantes like the peripheral countries of the eurozone, the country nonetheless has one of the largest public sector debt piles in Europe and remains susceptible to contagion effects.

Major Forecast Changes

We have revised up our 2013 real GDP growth estimate for France to 0.2%, from a previous forecast of 0.0%, on the back of stronger-than-expected household consumption.

Key Risks To Outlook

Downside Risks To Fiscal Forecast: The possibility of a further intensification of the eurozone sovereign debt crisis and the potential need for state-led capital injections in the domestic banking sector keeps the risks to our fiscal deficits over the medium term firmly to the downside.

Rising Debt Loads Could Weigh On Growth: We see continued possible hazards to the fiscal outlook, including the potential for interest rate shocks, further fiscal slippage and a stagnant growth environment, and caution that the next 24 months will be extremely important in determining France's long-run debt trajectory.

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Far Right Making Inroads

2014 is shaping up to be a tumultuous year for French politics, with the far right expected to make substantial inroads at both the municipal and EU level. We also expect to see the rift between France and Germany widen owing to the failure of President François Hollande to implement urgently needed economic reforms.

Table: Political Overview

Long-Term Political Outlook

A Tumultuous Decade Could Lie Ahead

We expect several dynamics to come to the forefront of France's political scene in the coming decade. These include France's role in the world, economic reforms, the challenge of demographics and the potential resurgence of left-wing parties.

CHAPTER 2: ECONOMIC OUTLOOK

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Lagging Behind The Eurozone Recovery

The economy will struggle to return to anything more than marginal growth in 2014, dogged by rising unemployment and poor export competitiveness. While the improving regional economic outlook may provide some limited upside potential, this might not be sufficient to drive a recovery in French manufacturing unless the country first addresses its outstanding competitiveness issues.

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Lack Of Reform Stifling Potential Productivity

We believe France's current account deficit is unlikely to narrow substantially – the

result of a sustained decline in cost competitiveness and robust household consumption supported by social transfers and comparably low levels of household debt. While we expect the current account deficit to remain wide over 2014 and 2015, as the lack of economic reform that has been undertaken continues to stifle potential productivity gains for exports, we expect some slight further narrowing owing to weaker household consumption.

Table: BALANCE OF PAYMENTS

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Social Debt Ceiling Adds To Fiscal Woes

The government is struggling to rein in the fiscal deficit, and growing domestic opposition to tax hikes has forced reversals on a number of planned revenue-raising measures. However, with unemployment rising and growth still stagnant, spending cuts remain equally controversial. While we have long argued the need for new competitiveness measures for France, including reduced labour tax wedges, these will bring their own challenges, potentially forcing the government to shift the burden to households or face a widening of the increasingly unsustainable social security deficit.

Table: FISCAL POLICY

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Euro Strength Unsettling The ECB

Passive monetary tightening and improved investor sentiment will compound policy inertia from the European Central Bank (ECB), which has kept the euro strong heading into 2014. However, weak economic growth, high unemployment, euro strength, deflation risks, a potential long-term refinancing operation (LTRO) cliff and anaemic structural reform are becoming increasingly unpalatable for policymakers. As such, we expect substantial monetary intervention in 2014. If this comes in the form of an LTRO top-up, then the euro will initially hold firm before sliding by end-year as growth will remain weak. If, however, the ECB opts for negative deposit rates (a far more extreme option), we expect a sharp and disorderly euro correction.

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