Euro Area Viewpoint

France: the very slightly brighter spot

01 December 2023

Macro
Europe

Global Economics Rates & FX
BofAS

Evelyn Herrmann
Europe Economist
BofASE (France)
+33 1 8770 0292
evelyn.herrmann@bofa.com

Erjon Satko
Rates Strategist
BofASE (France)
+33 1 8770 0304
erjon.satko@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

See Team Page for List of Analysts

See Exhibit 17 for definitions of abbreviations and terminology used in the report.

Time for a quick tour of the French outlook

We stick to our view that the French economy is likely to outperform the Euro area average going forward. We forecast 0.9% growth in 2023, 0.8% in 2024 and 1.3% in 2025 vs a Euro area aggregate of 0.5% in each of 2023/24 and 1.2% in 2025. France is one of the few Euro area members where our forecasts are not below consensus. That doesn't mean we expect French inflation to resist an undershoot in 2025. Due to late electricity price hikes, we expect headline at 1.9% in 2025, 40bp above the Euro area average, but core at 1.7%, 10bp below.

Prominent downside (growth), limited upside (inflation)

We discuss three risks in particular. Downward revisions to 3Q GDP growth with data signalling at best unchanged momentum in 4Q already suggest short-term downside. Fiscal policy was a crucial driver of France's recovery from COVID and the relatively smooth trajectory during the energy crisis. Very cautious and slow budget adjustments are the base case, but European fiscal rules are a prominent risk. We worry less about inflation upside though. Recent data flow bolsters that view. But more fundamentally, the rise in French participation rates means labour supply grew at least as much as demand. And there is still a lot of room for more of the same, keeping wage pressures at bay.

Stubbornly constructive French debt

High nominal growth (in relative terms), good positioning with respect to global risk factors, and cheap OAT valuations (dragged this way from SSAs (sovereigns, supranationals & agencies)) make us bullish French debt fundamentally. Political/policy risks, high/increasing elsewhere, are a non-story here (next elections in May-27). Issuance is high in absolute terms but this is no big news. We call 10y OAT-Bund at 35-40bp range as fair (2019 levels).

French credit ratings are going to AA-, but when looking at past credit rating impacts it is difficult to spot consistent market reactions (one-day moves are usually in the order of basis point decimals and often even spread tightening).

Timestamp: 01 December 2023 01:30AM EST

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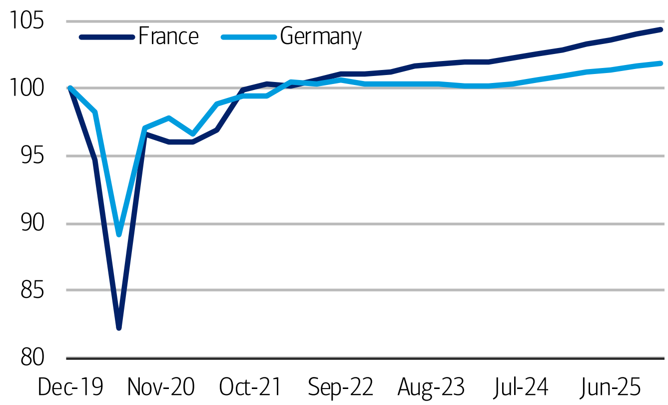
We focus on three particular aspects of our forecasts today. When we initially started working on this piece, we meant to concentrate on fiscal policy and inflation risks. That changed with this week's data flow. Downside to growth forecasts is becoming more acute given the 3Q GDP revisions and latest consumer spending data. Mechanically, 10bp of both 2023 and 2024 forecasts are now at risk from weaker carryovers from the 3Q growth revision from +0.1% to -0.1% qoq. But with recent data flow suggesting at best unchanged growth in 4Q, our 0.1% qoq forecast starts to look optimistic and adds further acute downside to the outlook.

Beyond short-term data, French fiscal policy, like elsewhere in the Euro area, is at risk of having to deliver more tightening than currently planned. The European Commission seems to have taken issue with the plans. We doubt current budget plans are revisited meaningfully, but we are nervous about the prospect of more severe austerity if new or old fiscal rules require faster adjustment.

Third, our base case has inflation undershoot the target. Yet, we are often confronted with the view that the French labour market is tight, like elsewhere in the Euro area, and wage pressures are perhaps even more likely given the more favourable real economic recovery so far. While we would share the view that more persistent wage growth could be more likely in France than elsewhere, it is still a tail risk and with a reducing likelihood given the weakening growth outlook. Recent surveys suggest price expectations are back to pre-COVID norms, and wage growth is past the peak. What's more, headline unemployment and employment levels mask a substantial rise in labour supply recently, an increase in the overall labour productivity of the country's working-age population, with still room for much more of the same.

Exhibit 1: Real GDP levels (4Q19=100)

France's recovery has progressed more smoothly and will continue to do so compared with Germany, in particular



Source: INSEE, Destatis, BofA Global Research

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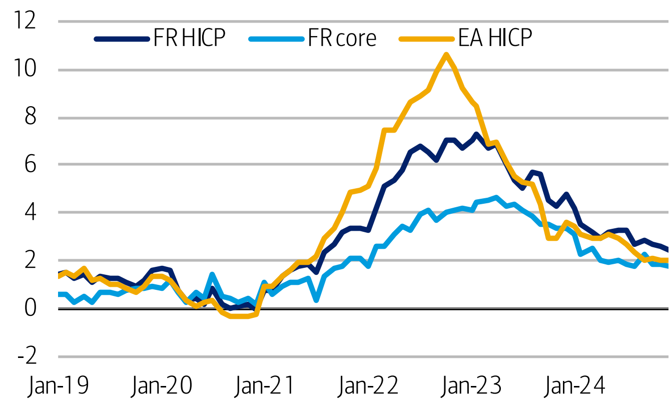
Exhibit 2: French and Euro area inflation forecasts

French policy choices have attempted to smooth the energy price shock over a longer period of time



Source: Eurostat, INSEE, BofA Global Research

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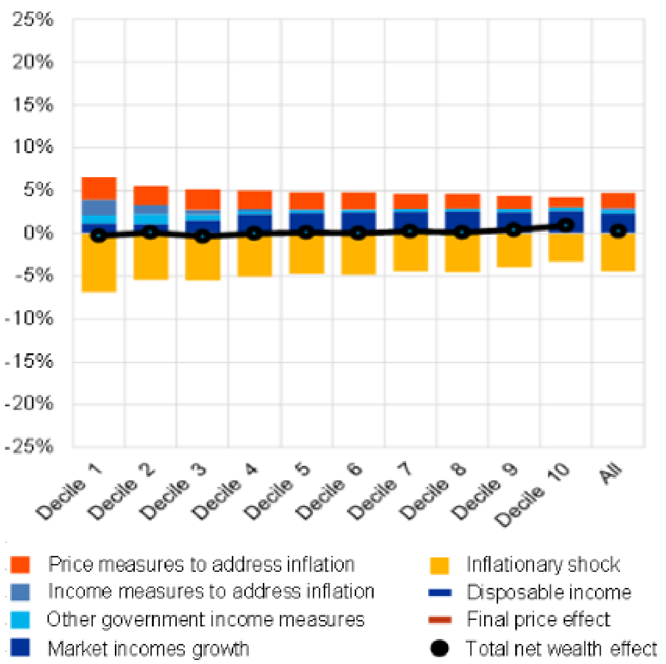
Fiscal policy helped the recovery substantially

Our relatively optimistic French outlook compared with the Euro area is largely a function of the starting point into the severe monetary policy tightening shock. That doesn't make it a particularly comfortable or robust outlook per se, just a better one than elsewhere. What drove the better starting point? The strong post-COVID recovery and relatively smoother trajectory through the energy crisis were partially due to structural features (a generally more domestic demand-driven economy, less gas dependence, and less export exposure to autos and/or China). But to a large extent, the recovery has also been the result of timely, fairly generous and arguably well-designed fiscal policy support.

To illustrate that, we refer to a recent ECB blog post: the authors show that in the Euro area as a whole, the energy shock has hit lower-income households harder than higher-income groups, even after fiscal policy came to the (partial) rescue. This is not so in France, where the mix of very early gas and electricity price caps (introduced in autumn 2021 and phased out only this year) and select one-off payments has helped to almost entirely offset the energy price shock across all income groups (Exhibit 3).

Exhibit 3: % change in equivalized disposable income 2021 across income deciles

France's policy mix has helped to neutralise the energy shock for all income groups, while elsewhere, lower-income groups were still squeezed



Source: ECB Blog "Fiscal policy to the rescue: How governments shielded households from inflation", 23 Nov 202

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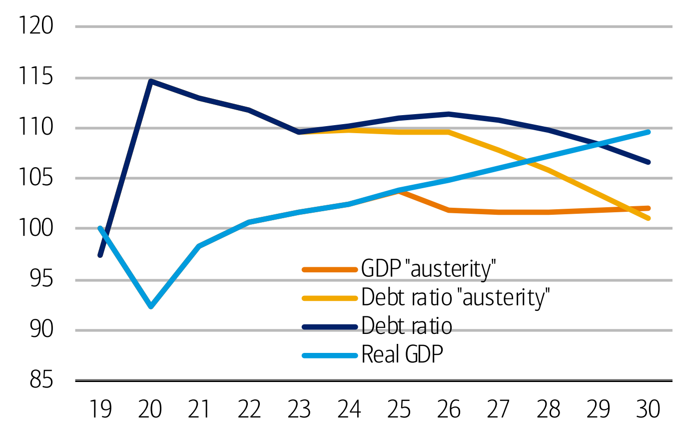
Exhibit 4: Debt (% of GDP) and GDP (2019=100) trajectories in the base case and under the assumption of imminent debt ratio stabilisation

Moderate deficit adjustments by c 50bp as planned would lead to a downward trend in debt ratios starting 2026. The GDP cost of an imminent stabilisation of debt ratios would be sizeable



Source: BofA Global Research Note: we assume standard fiscal multiplies of 0.6, i.e., each 1ppt tightening in policy vs the base case reduces growth by 0.6ppt. Severed inflation trajectories could actually further complicate the ambition to stabilize debt quickly

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But fiscal rules create risks looking ahead

Perversely, it is fiscal policy that features prominently in downside risks to the outlook (although the risks in France are considerably less acute than in Germany, see Euro Area Watch: German budget: it's getting special, 24 November 2023).

The 2024 French budget plan foresees a deficit of 4.4% of GDP, a 0.5ppt improvement vs 2023, mainly by fading most of the energy crisis support measures. That is still a large deficit, but would deliver the 40-50bp p.a. correction needed to return gradually to the 3% threshold in EU rules by 2027. Debt ratios, as a consequence, would also only start to properly inflect then.

To us, the "weakness" of the budget plan is the growth assumption. The government expects 1.3% growth next year, 50bp above our forecast. Cyclical factors could hence raise the deficit by 20-30bp, but that would arguably not be a game changer.

A priori, the budget (like that of other countries, i.e., see Euro Area Watch: Italy: unstable equilibrium, 19 October 2023) looked to be designed not to provoke Brussels. Yet, the European Commission seems to take a different view, flagging the possibility of France being put under an Excessive Deficit Procedure again in the spring.

One of the Commission's two main criticisms is that France is to maintain energy price measures worth c 0.3% of GDP in 2024. That mainly reflects France's decision to keep regulated electricity prices below what market prices of the past two years (which usually determine prices) would imply. But in terms of budget implications, this decision is a wash: higher electricity prices would mean higher EDF profits looped back to the consumer via slower hikes in consumer prices than standard formulas would suggest with zero budget impact and a positive growth outcome, arguably. We are surprised that the Commission has criticised this budget-neutral redistribution policy and would assume no proper action on that measure as a consequence.

The other European Commission criticism relates to the pace of expenditure growth, largely a function of underlying technical assumptions. Again, we assume that action on the back of that remains limited.

What the European Commission communication shows, however, is that the return of old fiscal rules, or a potential reform thereof, can easily result in tighter fiscal policy than we currently assume – in France and the Euro area more broadly. And that potentially represents sizeable downside risks to our forecasts of 2024/25, or even the trajectory beyond.

To explain the trade-off, we illustrate a (mechanical) extreme scenario of debt ratio stabilisation as early as next year. That would require an additional primary deficit correction of 0.7%ppt or so, reducing growth by half. By 2026, the overall budget balance would need to reach zero to keep debt ratios broadly unchanged, but that would come at the cost of a recession that year. The debt ratio would then start to fall very quickly, but the socio-economic cost of such a scenario, showing in a significantly severed GDP trajectory, would be more than sub-optimal, making such a scenario (hopefully) unlikely in reality (Exhibit 4).

Homemade inflation: hope springs eternal

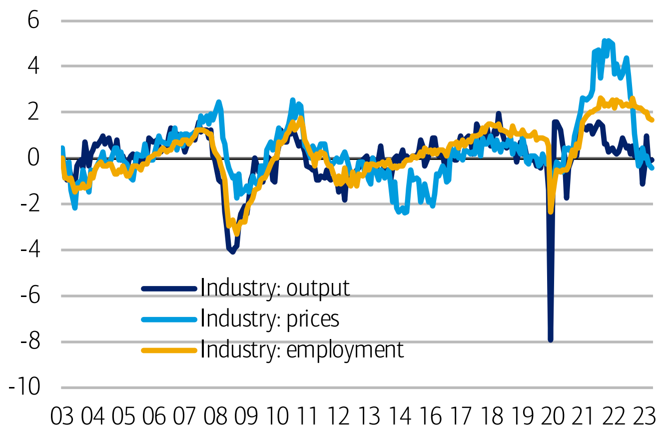
Back to something more cheerful (perhaps): given the relatively more robust economic recovery than the Euro area average, it is tempting to argue that France is perhaps the country best positioned in the region to deliver higher wage growth and hence inflation at or above 2% more durably. That is not our base case – we expect headline inflation at 1.9% in 2025, above the Euro area forecast of 1.4% courtesy of France's delayed electricity price passthrough, and core at 1.7%, 10bp below the Euro area average.

Survey data actually conveys a fairly convincing disinflationary picture. Z-scores of INSEE's price expectations survey shows even short-term inflation expectations back at or below average 2003-19 levels for consumers (not shown) and the industry sector (Exhibit 5) . The service sector currently still stands out somewhat (Exhibit 6), although at the current juncture, that looks more like a delay than a shift in underlying sector trends.

Inflation optimists would likely point to exactly that services sector survey or the absolute tightness of the labour market to argue more inflation for longer is coming. But we remain sceptical.

Survey data is far from conclusive. In the industry sector, price and output expectations are back to or even below normal, but hiring intentions are robust (Exhibit 5). In the services sector, outlook and hiring intentions have deteriorated simultaneously, but price expectations seem to be sticky (Exhibit 6). To spin this into an inflationary story, we would need to argue that services-specific inflation expectations have persistently moved higher, while industry-specific labour market tightness would trigger inflation. That would be twisting data signals too much, we would argue.

Exhibit 5: Industry sentiment components (z-scores)
Activity and price expectations back to normal, hiring intentions elevated



Source: INSEE, BofA Global Research, normalized to 2003-19

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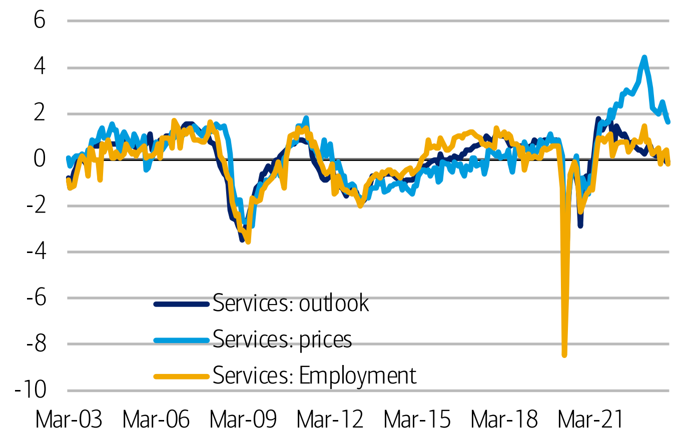
Exhibit 6: Industry sentiment components (z-scores)
Activity and hiring expectations back to normal, prices a bit lagged



Source: INSEE, BofA Global Research, normalized to 2003-19

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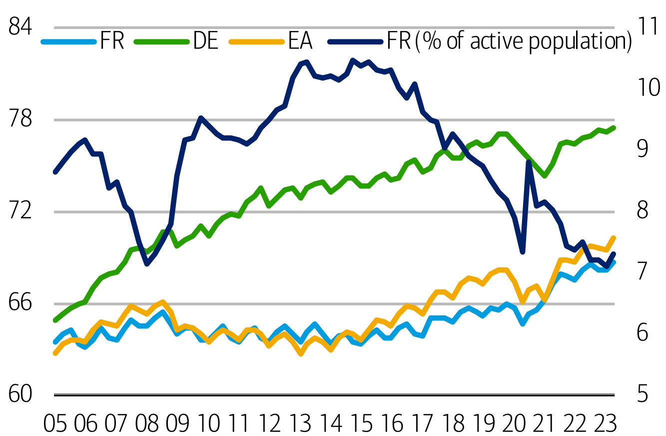
Exhibit 7: Employment in % of working age population
France's labour supply has grown a lot with still plenty of potential



Source: Eurostat, BofA Global Research

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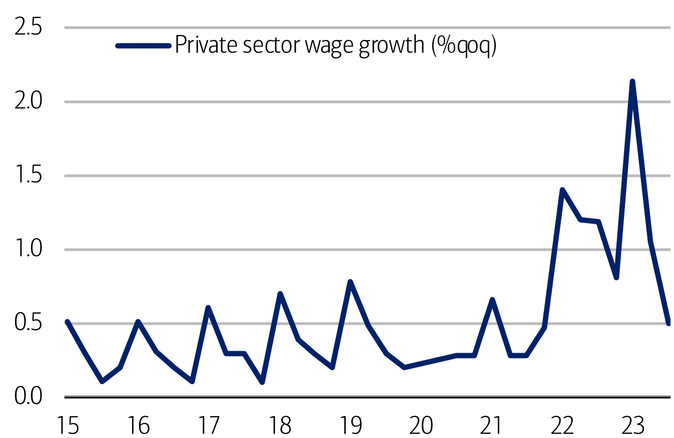
Exhibit 8: Private sector wage growth (%qoq)
GDP, employment and arguably wage growth past peak already



Source: Dares, BofA Global Research

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Labour market supply has grown fast

France is likely to be yet another country where the labour market looks tighter than it is. Unlike at the Euro area aggregate level, hours worked per employee are fairly close to pre-crisis trend. But participation rates in France have risen more than elsewhere. We actually took inspiration from a recent Banque de France blog post[1], flagging that the French drop in labour productivity per hour may be a very partial analysis of the labour

[1] O. Garnier and T. Zuber, "A measure of efficiency in the use of labour resources: beyond productivity", Banque de France Eco Notepad 15 November 2023

market. Employment ratios as a % of the working-age population (rather than of the "active" population) have picked up meaningfully. Productivity of the population, rather than a very select sub-sample, has improved.

From an inflation perspective, the rise in labour market participation is crucial. Yes, the economic recovery was strong, and yes, employment has grown a lot. But in fact, labour market supply is currently growing at least as fast as labour demand (the recent increase in unemployment rates would suggest even faster than demand). Compared with peers (Germany in particular), France still has considerable unused capacity in its working-age population. That should help to contain wage pressures, which have arguably eased already substantially in the second half of this year (Exhibit 8).

Stubbornly constructive French debt

High nominal growth (in relative terms), good positioning with respect to global risk factors, and cheap OAT valuations (dragged this way from SSAs) make us bullish French debt fundamentally. Political/policy risks, high/increasing elsewhere, are a non-story here (next elections on May-27). Issuance is high in absolute terms but this is no big news.
We call 10y OAT-Bund at 35-40bp range as fair (2019 levels).

Exhibit 9: Projected supply net of coupons, redemptions, buybacks, QE
Monthly supply through 2024, with 2023 totals comparison

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total	Chg.
Austria	7	0	5	1	5	2	-7	1	4	-7	1	1	12	2
Belgium	5	5	1	5	5	-7	4	3	5	-6	0	0	22	0
Finland	4	0	1	-3	4	1	0	3	-1	1	2	0	10	-3
France	32	1	-4	17	-6	29	16	14	32	20	-12	3	140	17
Germany	12	4	9	3	9	12	22	9	7	12	27	-5	120	-23
Greece	2	0	0	-1	1	0	1	0	0	1	0	0	3	0
Ireland	4	0	-6	0	1	0	0	0	1	0	0	0	0	0
Italy	14	21	3	8	-1	31	9	0	0	13	17	-14	101	41
Holland	-4	7	6	3	5	6	-9	0	6	3	3	0	26	6
Portugal	3	-4	1	2	1	1	0	0	1	1	1	0	6	4
Spain	11	23	16	-4	-1	23	-3	7	19	-5	-2	5	89	18
Total	89	57	31	31	22	95	32	37	75	32	38	-10	530	65

Source: BofA Global Research. Note: Numbers are expressed in EUR bn. We assume PEPP reinvestments happening at 50% of the total from H2 onwards

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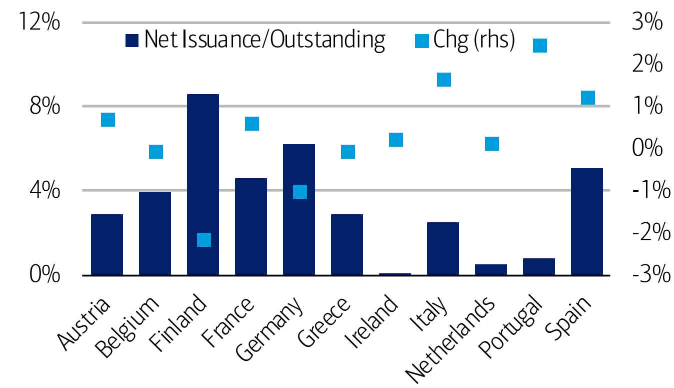
Exhibit 10: Net-net issuance in 2024, level and change, vs outstanding
French issuance does not particularly stand out on this metric



Source: own calcs, ECB, National treasuries

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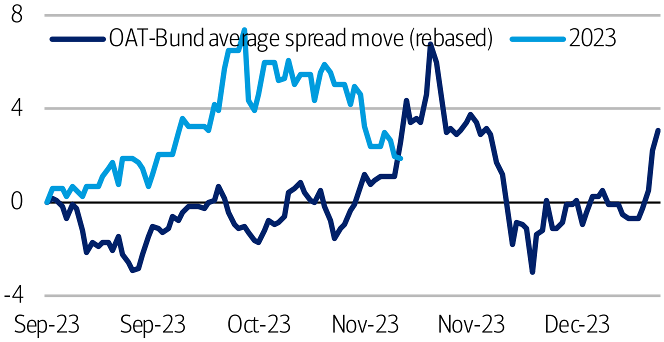
End of year usually brings OAT underperformance on year-ahead supply risks pricing (Exhibit 11). We cannot rule out that happening again. But we have possibly already passed that phase with the early autumn global bond sell-off. Supply risks pricing has abated significantly since then, according to our surveys (see FX and Rates Sentiment Survey).

Exhibit 11: OAT-Bund spread px action year-end (bp, rebased)
Year-ahead supply pricing tends to attract OAT shorts, historically



Source: Bloomberg

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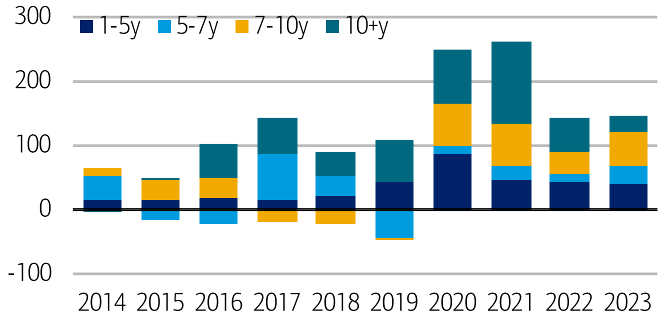
Exhibit 12: Yearly EUR SSA supply by maturity bucket
Rates curtailing appetite for SSAs primary market activity, especially long-end. Tougher NGEU milestones may add downside risks past 2024



Source: ICE Data Indices, LLC. Numbers in EUR billions

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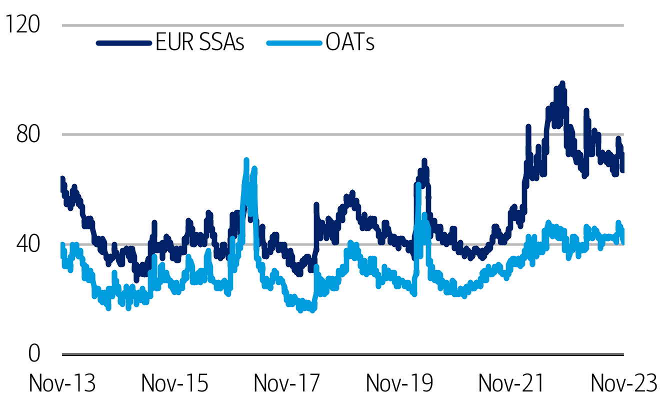
5y point still relatively cheap, may get help from banks/foreign investors

OAT valuations look historically stretched, mainly because of the spillovers from the SSAs issuance shock in 2020-21. The outlook for the latter is relatively benign. EU issuance may accelerate, but for the block as a whole policy tightening is keeping primary market activity off the recent highs.

Looking at positioning, we note domestic banking, pension/insurance as particularly underweight. The same applies to non-residents. Demand from banks should continue (there's room for another €250-600bn despite headwinds from shrinking central banks). Demand from pension/insurance should remain positive, albeit volumes suffer from savers rebalancing from these schemes to bonds. Demand from non-residents has also resurfaced bidding €250bn so far this year (all types of bonds), but there's over €600bn to go until neutral balancing. The supply/demand picture should help contain the cheapening in the 5y in spread terms (Exhibit 14).

Exhibit 13: Average spreads of OAT and EUR SSA bond indices
OATs struggle cheapening beyond 50bp, barring idiosyncratic risks



Source: ICE Data Indices, LLC. Values in basis points

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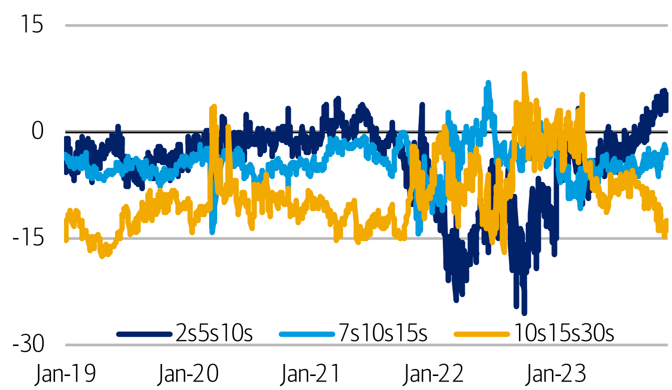
Exhibit 14: France-Germany OAT curve flies (bp, constant maturity)
5y is relatively cheap on the OAT-Bund spread curve



Source: Bloomberg

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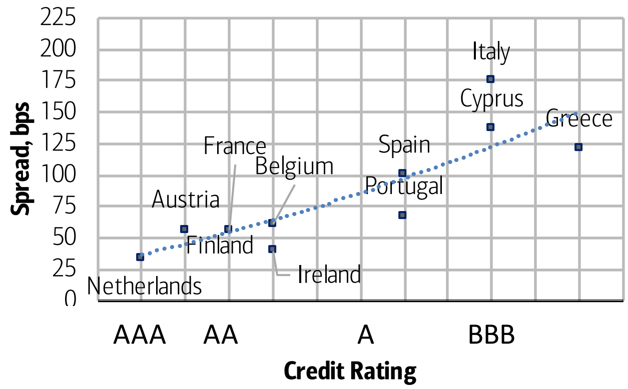
Rating going to AA-, but market impact is usually muted

The rating outlook for France is not encouraging. The market prices French debt in line with an AA rating (in line with the current composite), but the current public finance trend has a downgrade to AA- baked in, in our view (starting from S&P this Friday). That said, when looking at the market impact of downgrades since 2008, we note that at the time of these ratings, market reactions remain very muted (OATs often even rally on the day).

Exhibit 15: EGB 10y spreads (benchmarks) vs average credit rating
OATs trade broadly in line with current ratings



Source: Bloomberg, BofA Global Research calcs.

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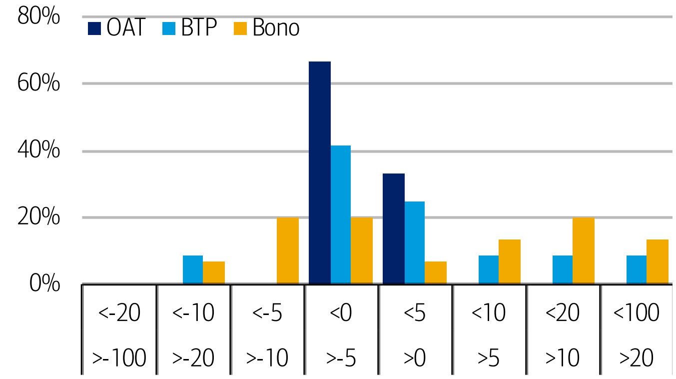
Exhibit 16: Frequency histogram of 1-day moves around rating events
French downgrades often bring small OAT selloffs, if not outright rallies



Source: Bloomberg, BofA Global Research calcs.

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Exhibit 17: Common acronyms/abbreviations used in our reports
This list is subject to change

Acronym/Abbreviation	Definition	Acronym/Abbreviation	Definition
1H	First Half	IT	Italy
2H	Second Half	Jan	January
1Q	First Quarter	Jul	July
2Q	Second Quarter	Jun	June
3Q	Third Quarter	lhs	left-hand side
4Q	Fourth Quarter	m	month
ann	annualized	MA	Moving Average
APP	Asset Purchase Programme	Mar	March
Apr	April	MBM	Meeting-by-meeting
AS	Austria	mom	month-on-month
Aug	August	Mon	Monday
BdF	Banque de France (Bank of France)	MPC	Monetary Policy Committee
BE	Belgium	MWh	Megawatt-hour
BEA	Bureau of Economic Analysis	NGEU	NextGenerationEU
BLS	Bank Lending Survey	NE	Netherlands
BoE	Bank of England	Nov	November
BofA	Bank of America	NRRP	National Recovery and Resilience Plan
BoI	Banca d'Italia (Bank of Italy)	NSA	Non-seasonally Adjusted
BoJ	Bank of Japan	OAT	Obligations assimilables du Trésor
BoS	Banco de España (Bank of Spain)	OBR	Office for Budget Responsibility
bp	basis point	Oct	October
BTP	Buoni Poliennali del Tesoro	OECD	Organisation for Economic Co-operation and Development
Buba	Bundesbank	ONS	Office for National Statistics
c	circa	p	preliminary/flash print
CA	Current Account	PBoC	People's Bank of China
CPI	Consumer Price Index	PEPP	Pandemic Emergency Purchase Programme
CSPP	Corporate Sector Purchase Programme	PMI	Purchasing Managers' Index
d	day	PSPP	Public Sector Purchase Programme
GE	Germany	PT	Portugal
Dec	December	QE	Quantitative Easing
DS	Debt sustainability	qoq	quarter-on-quarter
EA	Euro area	QT	Quantitative Tightening
EC	European Commission	RBA	Reserve Bank of Australia
ECB	European Central Bank	RBNZ	Reserve Bank of New Zealand
ECJ	European Court of Justice	rhs	right-hand side
EFSF	European Financial Stability Facility	RPI	Retail Price Index
EGB	European Government Bond	RRF	Recovery and Resilience Facility
EIB	European Investment Bank	SA	Seasonally Adjusted
EMOT	Economic Mood Tracker	SAFE	Survey on the access to finance of enterprises
EP	European Parliament	Sat	Saturday
SP	Spain	Sep	September
ESI	Economic Sentiment Indicator	SMA	Survey of Monetary Analysts
ESM	European Stability Mechanism	SNB	Swiss National Bank
EU	European Union	SPF	Survey of Professional Forecasters
f	final print	Sun	Sunday
Feb	February	SURE	Support to mitigate Unemployment Risks in an Emergency
Fed	Federal Reserve	S&P	Standard & Poor's
FR	France	Thu	Thursday
Fri	Friday	TLTRO	Targeted Longer-term Refinancing Operations
GC	Governing Council	TPI	Transmission Protection Instrument
GDP	Gross Domestic Product	TTF	Title Transfer Facility
GNI	Gross National Income	Tue	Tuesday
GR	Greece	UK	United Kingdom
HICP	Harmonised Index of Consumer Prices	US	United States
HMT	His Majesty's Treasury	WDA	Work-day Adjusted
IMF	International Monetary Fund	Wed	Wednesday
INSEE	National Institute of Statistics and Economic Studies	y	year
IP	Industrial Production	yoy	year-on-year
IR	Ireland	ytd	year-to-date
PCA	Principal Component Analysis	EGB	Eurozone Government Bond
ORI	Optional Reverse Inquiry	C&R	Coupons and redemptions
DV01	Dollar Value of one basis points change		

Source: BofA Global Research

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Research Analysts

BofA Euro Economics
BofA Europe (Madrid)
europeaneconomics@bofa.com

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