Despite a difficult 2014 for the French economy, France is still far from being the 'sick man of Europe'

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A number of concerns have been raised about the French economy following disappointing economic figures in 2014. As part of our 'economies of Europe' series, **Mathieu Plane** *assesses the development of the French economy since the crisis and whether commentators are right to regard France as the new 'sick man of Europe'. He argues that while France remains highly dependent on effective policy action at the European level, there is more reason for optimism concerning the economy in 2015 than is commonly recognised.*

Last year was marked for France by the risk of European Commission sanctions for the failure of its budget to comply with the Treaties; by the downgrading by the ratings agency Fitch of French government debt (following a similar move by S&P a year earlier); by the absence of any sign of a drop in the unemployment rate; by a rising deficit after four years of consecutive decline; and by the distinction of having the worst current account deficit of comparable European countries. Economically, it seemed like the country's worst year since the beginning of the crisis in 2008.

France did not of course go through the kind of recession it did in 2009, when the Eurozone experienced a record fall in GDP (-4.5 per cent and -2.9 per cent for the EMU and for France respectively). But for the first time since the subprime bubble burst, in 2014 French GDP grew more slowly (0.4 per cent) than the Eurozone average (0.8 per cent). The country's weakening position is fuelling the view that France may be the new sick man of Europe, a victim of its leaders' lax fiscal approach and its inability to reform. Is this really the case?

France: the sick man of Europe?

It is worth noting first that the French economic and social model proved its effectiveness during the crisis. France weathered the crisis better than most of its European partners thanks to its system of social safety nets, a combined (consumers, business, government) debt level that is lower than the Eurozone average, a household savings rate that is higher than the Eurozone average, a low level of inequality, and a relatively solid banking system. Indeed, between early 2008 and late 2013, French GDP grew by 1.1 per cent, while during that same period the Eurozone as a whole contracted by 2.6 per cent; France also avoided the recession in 2012 and 2013 that most Eurozone countries experienced.

Looking at Europe for the six years from 2008 to 2013, France's economic performance was relatively close to that of Germany (2.7 per cent), better than that of the UK (-1.3 per cent) and well ahead of Spain (-7.2 per cent) and Italy (-8.9 per cent). Similarly, during this period investment in France contracted less than in the Eurozone as a whole (-7.7 per cent versus -17 per cent), and unemployment increased less (+3 points versus +4.6). Finally, the French economy's ability to stand up better to the crisis was not linked with a greater increase in public debt compared to the Eurozone average (+28 GDP points for both France and the Eurozone) or even the United Kingdom (+43 points).

Nevertheless, France has seen its position in the Eurozone deteriorate in 2014. This was marked not only by lower growth than its partners, but also by higher unemployment (the Eurozone rate has gradually fallen), an increase in public debt (which virtually stabilised in the Eurozone), a decline in investment (which improved slightly in the Eurozone), an increase in its public deficit (while that of the Eurozone fell) and a substantial current account deficit (the Eurozone is running a significant surplus). Why this divergence?

While France does have a problem with competitiveness, it should be noted that almost half of its current account deficit is cyclical due to more dynamic imports than its major trading partners, which generally have worse output gaps. Furthermore, until 2013, the country's fiscal adjustment was focused more on the tax burden than on public spending. Conversely, the focus in 2014 was more on public spending. Given France's position in the business cycle and its budget decisions, the fiscal multiplier in 2014 was higher than in previous years, so that fiscal consolidation imposed a heavy toll in terms of growth.

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In terms of competitiveness, French industry is caught in the middle of the Eurozone between, on the one hand, peripheral countries of the euro area, including Spain, which have entered into a spiral of wage deflation fuelled by mass unemployment, and the core countries, especially Germany, which are reluctant to give up their excessive trade surpluses through higher domestic demand and more inflation. Faced with the generalisation of wage devaluations in the Eurozone, France had no choice but to respond with a policy to improve the competitiveness of its businesses by cutting labour costs.

Thus, the CICE tax credit and the Pact of Responsibility represent a total transfer of 41 billion euros to the firm system, mainly financed by households. While the positive impact of these transfers will be felt over the medium-to-long term, the financing effort together with the country's fiscal consolidation effort had an immediate adverse effect on purchasing power, which goes a long way toward explaining the poor growth performance of 2014. Finally, 2014 also saw a steep fall in housing investment (-7 per cent), the largest drop since the real estate crisis of the early 1990s (excluding 2009).

The French economy in 2015

There are several reasons why France's poor performance is not likely to be repeated in 2015. First, in order to halt the decline in construction, emergency measures were taken in August 2014 to free up housing investment, with the first effects to be felt in 2015. Second, the programmes enacted to improve business competitiveness will begin to take full effect from 2015: the CICE tax credit and the Responsibility Pact will slash business costs by 17 billion euros in 2015, up significantly from only 6.5 billion in 2014.

Third, the slowdown in the fiscal consolidation programmes of France's commercial partners and the introduction of a minimum wage in Germany will both help French exports. In addition, the lower exchange rate for the euro and falling oil prices are powerful levers for boosting the French economy in 2015, and together could amount to one extra point of growth. Given the ECB's policy on quantitative easing, interest rates should also remain low for several more quarters. Finally, although timid, the Juncker plan along with marginal changes in Europe's fiscal rules will favour a pickup in investment. These factors will put some wind in the sails of French growth by helping to offset the negative impact of the reduction in public spending for 2015, so that the economy finally reaches a pace that will be sufficient to begin to reverse the unemployment curve and reduce the public deficit.

While France is not the sick man of Europe, it is nevertheless still very much dependent, like all Eurozone countries, on Europe having strong macroeconomic levers. Up until now, these have had a negative impact on business, be it through overly restrictive fiscal policies or a monetary policy that has proved insufficiently expansionary in light of other central banks' action. In an integrated currency zone, deflation cannot be fought on a national basis. The choice of a European policy mix that is more geared towards growth and inflation is a novel development since the start of the sovereign debt crisis. Boosted by lower oil prices, let us hope that these levers will prove strong enough to halt the depressive spiral that the Eurozone has been going through since the onset of the crisis. The recovery will be European, before being French, or there won't be one.

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Note: This article was cross-posted in French at the blog of the OFCE (French Economic Observatory – Sciences Po) and gives the views of the author, not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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