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France’s 3-Percent Deficit Target for 2013: Harder and Harder to Believe

Although the French government has repeatedly described its 3-percent deficit target for 2013 as “inviolable,” this claim should be taken with a large grain of salt. The fact that investors are willing to pay to hold French sovereign debt suggests that the government has done a good job communicating—no small achievement just when one neighboring country after another is forced to borrow at exorbitant rates. But let’s not be gullible: there is no way that France can meet its target. Even if the official growth forecasts were accurate—0.3 percent in 2012 and 1.2 percent in 2013—this would be an ambitious goal. If the economy goes into negative territory, it will be downright unattainable. Coming after three quarters of stagnation, the steady slide in economic activity since early summer will push France into a full-blown recession. We estimate that GDP should basically be flat this year, before decreasing by at least 0.7 percent on average next year. This differs markedly from the government’s current forecasts, the basis for its budgetary assumptions for 2012 and 2013. With a shortfall totaling 2.3 points of GDP (0.4 points in 2012, 1.9 points in 2013), meeting the 3-percent target in 2013 would require cuts equal to 3.6 points of GDP over those two years, in contrast to the 2.6 points initially forecast! In other words, it would require unprecedented savings, two thirds of them in the coming year. If actually carried out, they would make France the Eurozone’s star pupil in the field of fiscal retrenchment, but it seems unlikely they will be. In fact, it seems more like the government is playing with dynamite.

The Outlook for 2013: Not +1.2 Percent, But –0.7 Percent

The expected moves to sustain purchasing power after the elections could have put off the bad news for a few months. But what was supposed to be a hefty boost has turned out to be just a mild nudge, and its effect will barely be perceptible now that the overall situation is getting worse for France’s households. While a few specialty retailers have benefited from a higher back-to-school bonus, the depressed economic and social climate is holding consumer spending down. In an extremely rare development, consumers even scaled back spending on services in the second quarter, and they may well continue to do so.

Household spending accounted for close to 60 percent of economic growth in France from 1995 to 1997, raising GDP by an average of 1.5 percent per year. Of course, foreign suppliers were among the leading beneficiaries, as the country’s mounting trade deficits clearly show. Yet it would be wrong to underestimate the importance of consumer spending to France’s economy and industry. Just how wrong is suggested by the impact of car sales on local industry or of consumer durable purchases at the height of the real estate boom. More importantly, buoyant consumer spending has most strongly benefited the French economy in the past through its positive spillover effect on business and employment in services and construction. With that effect no longer operating, entire sectors of the economy now find themselves on extremely shaky ground. **The situation for French companies is getting more critical by the day, and this is increasingly so because their domestic growth engine has stalled.**

Nor can exports offset this shortfall in the immediate future. Even leaving aside the issue of national competitiveness, the slowdown affecting all of France's eurozone trading partners, including Germany from here on in, makes any hope of an export-driven upturn completely unrealistic. **Above all, profit margins have slumped to historic lows, so the foreseeable falloff in business activity should prove particularly detrimental to investment and employment in the next few quarters.**

The impact of buoyant consumer spending in France

There is no point in denying the obvious: the French economy is going into reverse. And like its partners in the region, France cannot escape recession. The impact of this trend on the already lackluster outlook for 2012 should be limited. Our estimates suggest a 0.1 percent decrease in average real GDP this year, i.e., roughly in line with the consensus forecast, which was already downgraded to 0.1 percent in August. This will certainly make it more difficult than anticipated for the government to meet its budgetary targets in the next few months, but that difficulty pales in comparison with what we will be facing in 2013. By then, the performance of the French economy will quite clearly be much further from the government's current forecast, as well as from the consensus forecast. **Our outlook at this stage is for the French economy to shrink by 0.7 percent next year, amounting to a difference of 1.9 points with the government's current forecast.**

Real GDP forecasts for France, end of August

Annual change in %	**2012**	**2013**
Government	0.3	1.2
European Commission	0.5	1.3
Consensus	0.1	0.5
RF Research	**–0.1**	**–0.7**

Sources: Government (June 2012), European Commission (May 2012), Consensus Forecasts (August 2012), RichesFlores Research

Such significant divergence in forecasts has major implications for the fiscal outlook. As far back as in July, the *Cour des Comptes* (Court of Audit) warned that to bring the budget deficit down to 3 percent next year, the French government would have to save an estimated €33 billion, assuming the economy grows by 1 percent. **Our own estimate is €44 billion, the equivalent of 2.1 percent of GDP—a clearly unattainable adjustment in the midst of a recession.**

Good Intentions Aren't Good Enough

Fiscal arithmetic is more complicated than a lot of policy recommendations might suggest, particularly during a downturn. The budgetary costs entailed by economic contractions are both high and hard to reduce. Assuming an unchanged overall budget target, France would have to implement structural measures to offset the entire additional deterioration in the cyclical component of the deficit. **According to our calculations, the cyclical component should rise to 2.4 percent of GDP next year, which is 1.1 points higher than in the government's 1.2 percent GDP growth scenario. An equivalent reduction in the structural component of the deficit would therefore be required.**
Now, this is plainly unthinkable. Not only would such an adjustment be of unparalleled magnitude; it would also come on the heels of the substantial cuts carried out in the last several years. As the graphs below highlight, this would make France the eurozone's star pupil in the field of fiscal retrenchment in the period from 2011 to 2013!

These are hardly encouraging prospects. As the experience of Greece, Spain, and Italy with such policies forcefully demonstrates, **an economy in recession is simply incapable of paying back what it no longer has.** The measures required for France to meet its budget commitments would wreak massive economic destruction, while contributing only nominally to fiscal consolidation. And a government elected on the claim that the deficit can't be eliminated without growth is necessarily aware of it.

In any event, its decision-makers may soon be facing an extremely tough dilemma. Should the French government struggle to maintain its credibility for as long as possible with draconian fiscal and tax policies, even if they further undermine the prospects for growth? Or should it postpone the deadline for achieving what will otherwise be an unachievable goal?

At the end of the month, the Council of Ministers will be examining the 2013 Budget Bill, and this should give a first indication of which way the scales are tipping, but it seems doubtful whether all the questions we have raised will be addressed. The government is unlikely to issue new forecasts as negative as ours; the chances are that it will fall roughly into step with the current consensus (0.5 percent growth in August). This will offer a welcome breathing spell that can be used to borrow money at what are still very low rates. **But let's not kid ourselves. In the next few months, the economy will be weakening so fast that the breathing spell is bound to be short-lived.**

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