RICHES FLORES RESEARCH
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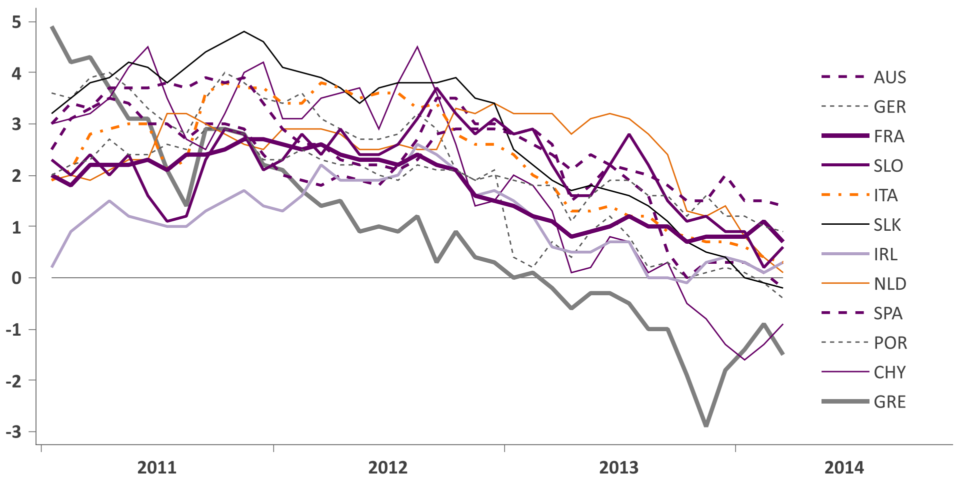
# The last straw for the French economy

***Either eight or nine countries in the euro area are probably in the grips of deflation. In response to the situation, the direction of economic policy will play a decisive role. It's a foregone conclusion that the ECB will not take measures in the near term that will be aggressive enough to stem the onslaught of this plague. It will be up to fiscal and tax policies to take on this responsibility. By complying with the European Commission's constraints, France risks plunging its economy into a deflationary abyss and with it, undoubtedly, all of the euro area.***

## 8: the number of countries probably in deflation already...

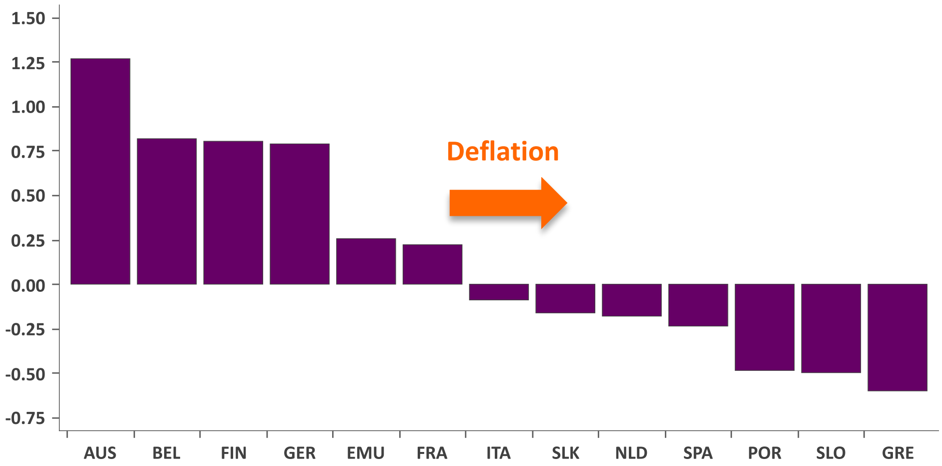
**Harmonized Annual Rate of Inflation, in %**




Sources: RichesFlores Research, Macrobond

The details on euro area inflation data for the month of March were published this week. The findings are unequivocal. Deflation is sinking its teeth into a growing number of countries in the region: Greece, Portugal and Spain; while four others are on the brink: Italy, Ireland, Netherlands...and France. In the latter case, core inflation (commonly accepted to be the change in prices excluding energy and food) is still in positive territory: 0.5% in Ireland and the Netherlands, 0.7% in Italy and 1% in France. Unfortunately, these numbers are not good enough to stave off the risk of a bigger slide. Not only has disinflation picked up in each of these countries month after month but, more importantly, data corrected for tax changes paint a much more worrisome picture. Tightening fiscal and tax policies have often been accompanied by consumer tax hikes and, as a result, inflation trends are actually more accurately reflected by the latter measure. Yet, inflation at unchanged tax rate does indeed reveal the absolute fall in prices in the Netherlands and Italy and point to very low inflation of only 0.2% per year in France.

**Annual Inflation at Constant Tax Rates, March 2014, in %**




Sources: RichesFlores Research, Macrobond

According to this data, deflation is creeping beyond the countries that were hardest hit by the sovereign debt crisis. It is now affecting five of the oldest members of the euro area (maybe six as Irish data was not published). The most recent additions to the monetary union must also be added, including Slovakia, Slovenia and Cyprus.

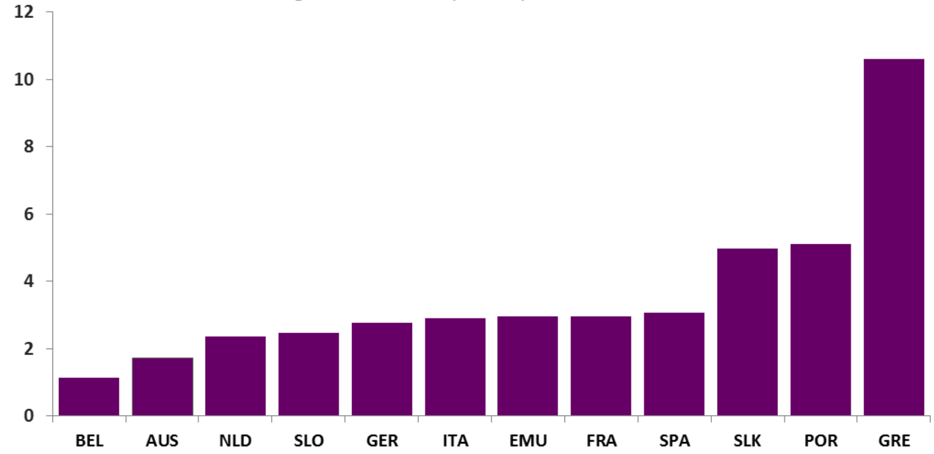
## Next up? France and the rest of the euro area

Against this backdrop, the direction of economic policy will obviously be crucial in determining how the situation will evolve. Let's not kid ourselves: the ECB will not take immediate and effective action. The current waffling by the Frankfurt institution is ingrained in its *modus operandi*. In fact, it seems obvious that it will eventually intervene in a much more forceful way than what it is generally willing to admit. However, it will be a long road before we get to that point, undoubtedly too long to be able to effectively combat the forward march of deflation - especially since fiscal restraint is ongoing.
Therein lies the origin of current deflation. And the affected countries' ongoing slip into the deflation quagmire has been expedited by the low level of global

inflation. Not surprisingly, the inflation rate hierarchy closely reflects (inversely) the degree of fiscal restraint of governments in the euro area since 2010.

**Degree of Fiscal Tightening : 2010 - 2013**

Change in structural primary balance in % of GDP



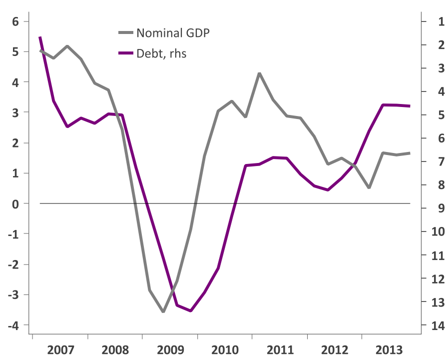

Source : RichesFlores Research, base AMECO

By tightening its fiscal policy another notch (€50bn or 2.5% of French GDP), the direction of French policy seriously risks sending France into deflation. The risk is undoubtedly worsened by the type of measures being taken, many of which will be borne by households.

Such a move is naturally caused for concern for a variety of reasons:

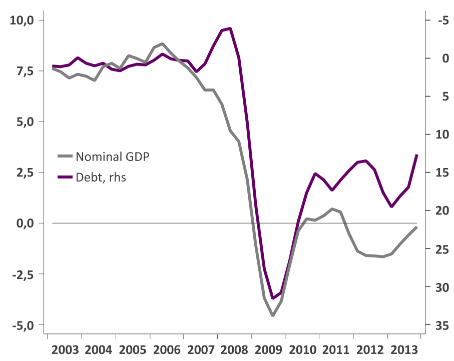
- On the growth front to start with as measures aimed at stimulating investment have no chance of succeeding amid deflation and anemic domestic demand,
- On the future deficits and public debt front as no country has managed to cut spiraling debt with zero or negative inflation,
- On the European front as the French economy (#2 in the euro area) is particular influential,
- On the political and social front as France is a young and demographically dynamic country, which is fundamentally at odds with deflation.

**France : Nominal GDP and Public Debt**




Sources: RichesFlores Research, Macrobond

**SPAIN: Nominal GDP and Public Debt**




Sources: RichesFlores Research, Macrobond

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