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Global Economics &
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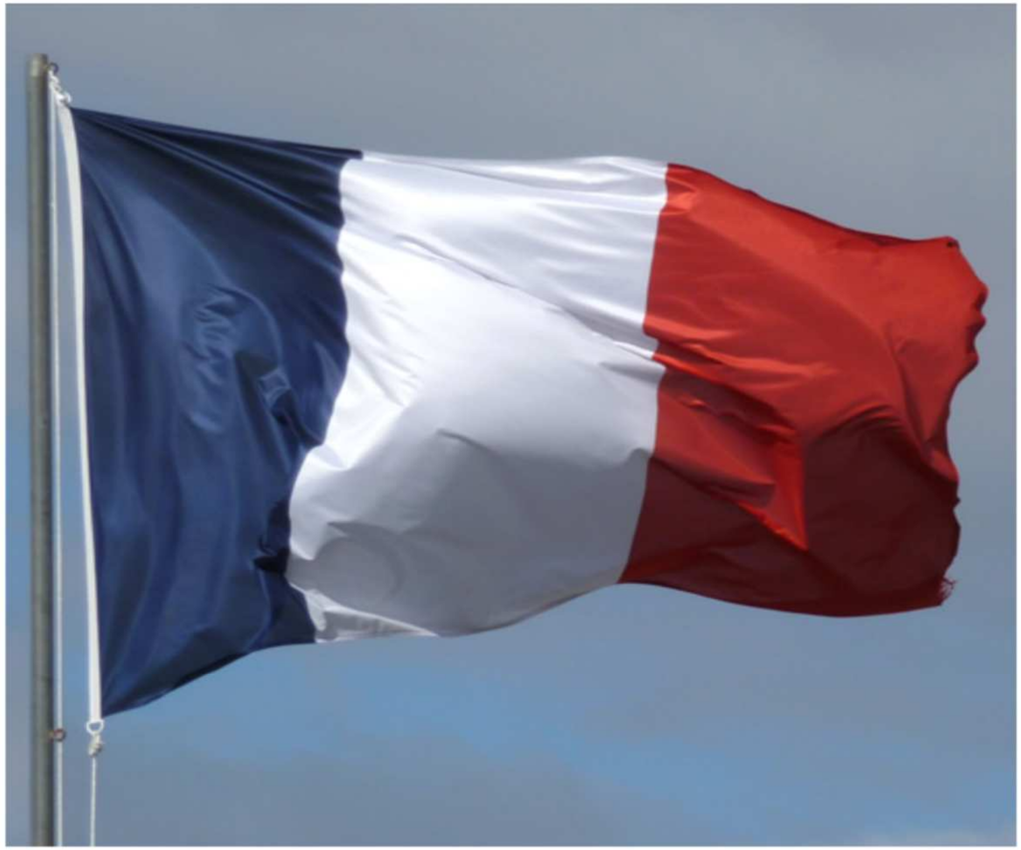

Working paper - 61

The French Issue

January 15th , 2014

A common concern, I have perceived among investors from different parts of the world, is whether France is really embodying the risks of a massive threat that, being still latent, could break the torpid calm we have achieved in recent times.

It is globally accepted that France meets some of the essential criteria for a debt crisis and, what is worse, stands out in Europe as the country that seems to be refusing to undertake major reforms.

Everybody knows that the Euro would not work without France, so investors assume that the ECB will support the country whatever the problem. Some have even assumed the singular (and simple) idea that the ECB is the Bank of France. This explains why the French debt has never stopped receiving support from markets.

The two question that my colleagues (and many of our clients) ask me is whether there is a risk that France is abusing this privilege and will not be able to curve debt dynamics? And also, whether the market could run out of patience at some point?

These are the questions to be addressed in this paper.

The main drivers of public debt dynamics

Change in D/GDP ratio = [Snowball Effect] - [Primary fiscal balance] + [stock/flow adjustment]

- ✓ [Snowball Effect]: Is the impact of the difference between the cost on outstanding debt and the nominal GDP growth.
- ✓ [Primary fiscal balance]: Is the budget balance excluding interest payments, as a % of GDP.
- ✓ [Stock / Flow adjustment]: Net changes in the public debt ratio that does not affect deficit (i.e Funds to bail out domestic banks that must be funded in the international markets, official bailouts received from abroad, repayment of funds by rescued banks, etc.)

Let us start with the first term: "The Snowball Effect"

✓ Remember, the Snowball Effect is the impact of the difference between the cost on outstanding debt and the nominal GDP growth. Dynamics are quite simple here. The larger the quantum of debt, the greater the multiplier effect coming from the difference between the cost of debt and nominal growth.

$$\textit{Snowball Effect}\ (t) = D\,(t-1) \times \frac{\textit{Int.rate}\ (t) - \textit{Var GDP nom}\ (t)}{1 + \textit{Var GDP nom}\ (t)}$$

Sensitivity Table to exemplify the variation mechanism of the Snowball Effect

	Cost of Debt >> Nominal growth	Cost of Debt > Nominal growth	Cost of Debt = Nominal growth	Cost of Debt < Nominal growth	Cost of Debt << Nominal growth
Nominal GDP t-1 (bn €)	1,935	1,935	**1,935**	1,935	1,935
D t-1 (bn €)	1,799	1,799	**1,799**	1,799	1,799
% Cost of Debt (t) (B)	3.00%	3.00%	**3.00%**	3.00%	3.00%
Nominal GDP growth (t) (A)	2.00%	2.50%	**3.00%**	3.50%	4.00%
Snowball Effect (t) (bn €)	**17.64**	**8.78**	**0.00**	**-8.69**	**-17.30**
Snowball Effect (t) (% GDP)	**0.89%**	**0.44%**	**0.00%**	**-0.43%**	**-0.86%**

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Now we can project the value for the "Snowball Effect" in France for the coming years

Remember

$$\textit{Snowball Effect}\ (t) = D\ (t\text{-}1) \times \frac{\textit{Int.rate}\ (t) - \textit{Var GDP nom}\ (t)}{1 + \textit{Var GDP nom}\ (t)}$$

Projections for French aggregates (%) (Source IMF & Andbank)

	13	14	15	16	17	18
Real GDP growth (IMF projections)	0.20%	1.00%	1.50%	1.70%	1.80%	1.90%
Inflation (IMF projections)	1.40%	1.70%	1.50%	1.70%	1.70%	1.90%
Nominal GDP (t-1) (bn €)	1,935	1,987	2,047	2,116	2,190	2,274
Debt (t-1) (bn €)	1,799	1,810	1,801	1,789	1,772	1,755
% Cost of Debt (t) (B)	2.20%	2.20%	2.30%	2.40%	2.50%	2.60%
Nominal GDP growth (t) (A)	1.60%	2.70%	3.00%	3.40%	3.50%	3.80%
Snowball Effect (t) (bn €)	10.6	-8.8	-12.2	-17.3	-17.1	-20.3
Snowball Effect (t) (% GDP)	**0.54%**	**-0.43%**	**-0.58%**	**-0.79%**	**-0.76%**	**-0.86%**

And now we just have to do our exercise

The IMF expects real growth to revive gradually but modestly.

We expect the cost of debt to remain structurally low but rise moderately (our estimates for rates are higher than IMF's ones)

But we are still missing two concepts that will eventually set the level of debt: The Primary Deficit & The Stock/Flow adjustment

Projections for French aggregates (%) (Source IMF & Andbank)

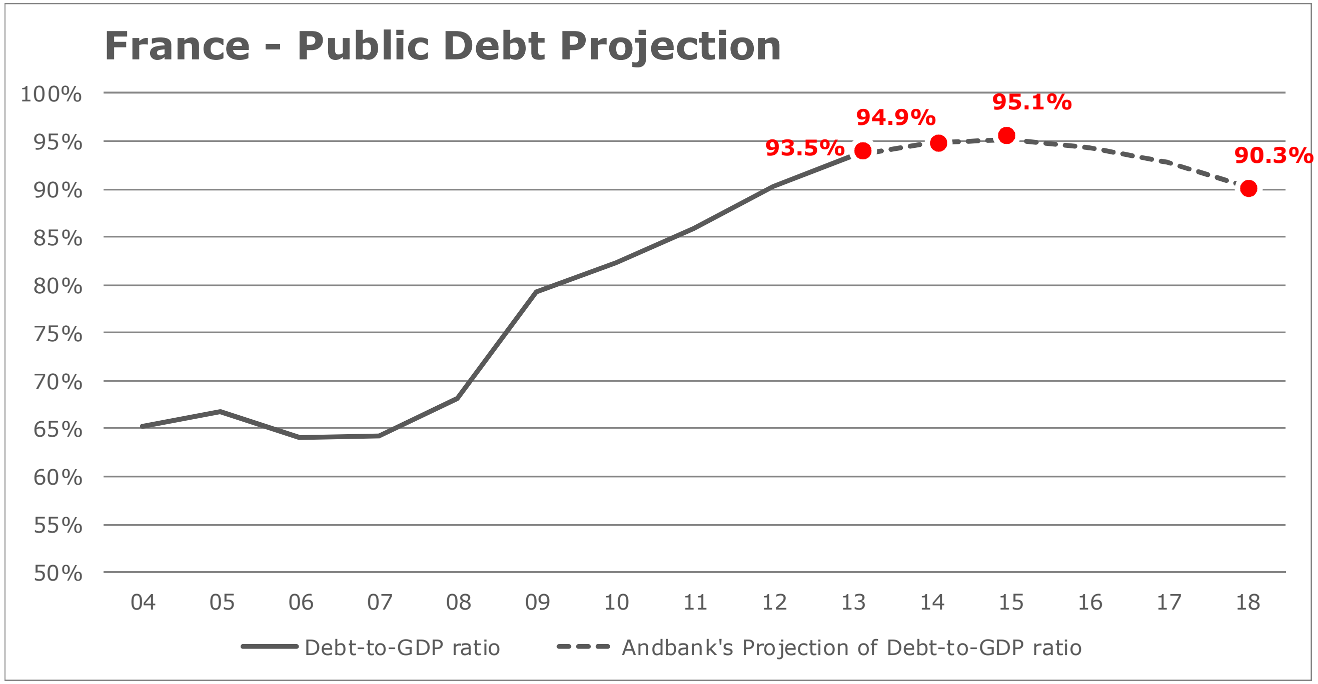
	13	14	15	16	17	18
Snowball Effect (t) (% GDP)	0.54%	-0.43%	-0.58%	-0.79%	-0.76%	-0.86%
Primary Deficit (% GDP)	2.00%	1.50%	0.70%	-0.10%	-0.90%	-1.70%
Stock / Flow adjustment	0.70%	0.30%	0.10%	0.10%	0.10%	0.10%
Change in Debt Ratio (pp)	3.24%	1.37%	0.22%	-0.79%	-1.56%	-2.46%
New Debt-to-GDP ratio	93.5%	94.9%	95.1%	94.3%	92.7%	90.3%

Indeed, a 1.7% primary surplus may seem very ambitious, specially if we consider that represents a situation that France has never enjoyed.

However, some aspects must be considered at this point.:

1. As the output improves from 2015 to 2018, the French government will presumably take the opportunity of a better growth environment to reduce public spending and comply with the EU's fiscal compact.
2. It is not an unattainable goal. Some of France's neighbors have exerted strong control over their public finances that, in many cases, has resulted in a considerable primary surplus (Germany posted a 2.5% primary surplus already in 2012, and Greece's primary surplus as of November 2013 was near the 1.5% of GDP)

Thus, if we are to believe the conservative projections for real GDP growth and inflation … then we only need to be patient with the French for just one year before this situation stabilizes.



According to our projections for debt costs, and considering the conservative estimates for nominal GDP…

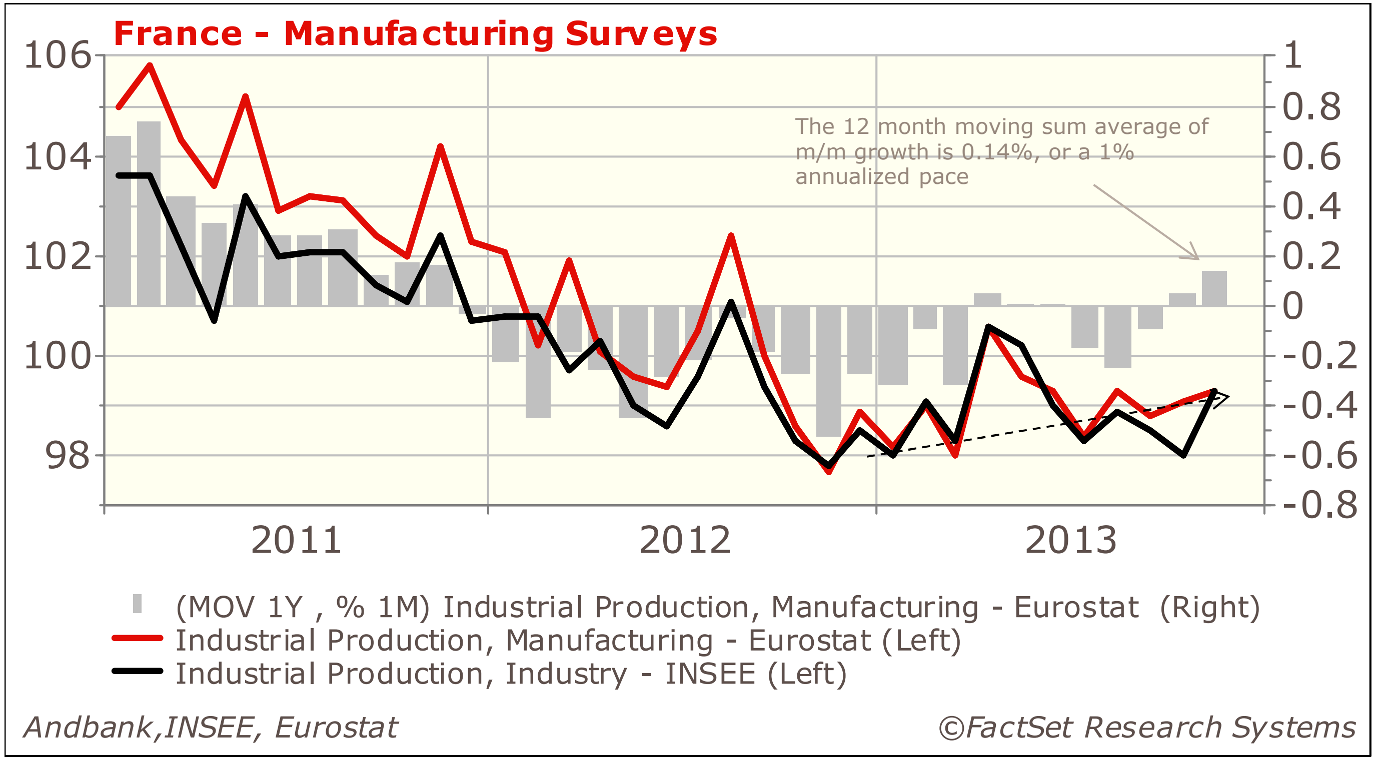
… our joint analysis of the three main factors driving the quantum of debt *(snowball effect, primary deficit and flow adjustment)…*

… results in a French gross public debt rising from 93% of GDP in 2013 to a **peak near the 95% in 2015, but then stabilizing and eventually decreasing to 90% of GDP in 2018**

Conclusions

1. Looking at the PMI's surveys alone, indeed it seems as if the French economy is still contracting.
2. However, despite some business surveys pointing South (Markit's PMI manufacturing plunged to 47 in December), other well-established business surveys pointed North (BdF and INSEE Manufacturing surveys suggest that activity rebounded at the end of last year, averaging a m/m growth of 0.14% in the last 12 months, or a 1% annualized pace. –see the appendix-).
3. Certainly, it is difficult to favor one survey over another, but it is worth mentioning that while PMI's surveys are based on a sample of 400 firms, the INSEE and BdF surveys are based on a sample of about 10.000 firms. Admittedly, the PMI surveys are considered by some market participants as superior since only factual information is reported (there is no sentiment questions asked). Yet looking at the INSEE's and BdF factual sub indices, a clear improvement has also been reported.
4. Leaving aside the business surveys, and taking a more general view, it must also be considered that the external environment in Europe clearly favors the recovery that we noted for France, since the rest of advanced economies in the region are firmly in growth territory. Not surprisingly, the last Eurozone-wide PMI index expanded to 52.7 in December (a 31-month high).
5. In sum, we would align ourselves with those stating that France's recovery is "just a bit more painful and taking that much longer".
6. All these factors look compatible with the underlying real growth rate of around 1% that the IMF currently estimates for France in 2014. Certainly a very modest forecast in our opinion as (1) it assumes no acceleration over the coming quarters – *it is expected the economy to expand at 0.4% QoQ in 4Q13 or a 1.2% annualized*-. (2) A 1% pace is not an unattainable level specially after two years of recession, and (3) above all if one considers the strong mood of the German economy.
7. Beyond 2014, the IMF's projections for real growth are also conservative as it considers only a gradual acceleration in 2015 to reach a cautious 1.5% pace, and for subsequent years, the international organization only projects a 0.10% acceleration each year. Inflation should remain subdued in this scenario. As such, we share the 1.5%-2.0% target range for inflation in the 2014-2018 period.
8. **The combined scenario of low real growth and low inflation will dampen the pace in nominal GDP growth. A factor that could certainly spread (as is well underway) fears of a wild "snowball effect" in the years to come**. In that regard, we firmly believe in the ability of the ECB to manage tensions in the interbank market, and specially, in its ability to continue bringing the cost of debt below the pace of nominal growth. Should the ECB manage to achieve this, the risk of a sharp misalignment between growth and cost of debt will remain low, and thus, the "snowball effect" will exert a downward pressure in the debt to GDP ratio in France.
9. Accordingly, our joint analysis of the three main factors driving the quantum of debt *(the snowball effect, the primary deficit and the stock/flow adjustment)* results in a **French gross public debt rising from 93% of GDP in 2013 to a peak near the 95% in 2015, but then stabilizing and eventually decreasing to 90% of GDP in 2018.**
10. We are confident in meeting our projections for French debt, since it does not require optimistic assumptions on growth. Notwithstanding, the key risk to our projections lies on how France manages its primary deficit.

Appendix


France - Manufacturing Surveys
106
104
102
100
98
1
0.8
0.6
0.4
0.2
0
-0.2
-0.4
-0.6
-0.8
The 12 month moving sum average of m/m growth is 0.14%, or a 1% annualized pace
2011
2012
2013
(MOV 1Y , % 1M) Industrial Production, Manufacturing - Eurostat (Right)
Industrial Production, Manufacturing - Eurostat (Left)
Industrial Production, Industry - INSEE (Left)
Andbank,INSEE, Eurostat
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