241 – 30 September 2024

Investment Institute Macroeconomics

Multi-faceted Balancing Act Needed

- Tough equation for the new French Finance Minister
- France is not the only country going through a soft patch. The ECB should do more, but they remain silent
- US markets still nonplussed by the data flow, although there is still no sign of an imminent, big economic slowdown

That France is now paying more than Spain to fund itself is a reminder that the budget bill for 2025, due to be transmitted to parliament next week, needs to provide enough of a “first instalment” on a credible fiscal correction trajectory. The government is operating in a tricky macro context. French domestic demand is weak. Without the contribution from government consumption and investment, domestic demand would have been falling since Q4 2023. The finance minister must walk a tightrope: cutting the deficit enough as a “statement of intent” to the market and the European authorities, without triggering a recession which would be counter-productive from a fiscal point of view. Yet, a “moderate only” effort for 2025 will be workable only if the medium-term strategy is convincing. From this point of view, preserving the capacity of the corporate sector to invest will be key.

France is not the only Euro area country in a “soft patch”. Registered unemployment continues to rise in Germany and business surveys are not encouraging. Even if growth in the South remains more than decent, the ECB hawks’ sole focus on upside risks for inflation look increasingly difficult to justify, especially since surveys suggest that selling price expectations, including in the services sector, continue to normalise. The market was pricing last Friday a 75% probability of a 25bp rate cut on 17 October. As much as we sympathise with the need to remove monetary restriction fast, the lack of signal from the Governing Council that an outlook change is imminent continues to make us doubt the ECB won’t want to wait until December, even if the call becomes every day closer.

In the US, the market was non-plussed by last week’s data flow, although another fall in initial unemployment claims coupled with a small uptick in core inflation would suggest the Fed may not have to deliver all the stimulus it has hinted at in the latest dot plot. This week’s payroll might change the market dynamics, but the bar for this is probably high.

France at the blackboard

The French Finance Minister has pledged to transmit the budget bill for 2025 to parliament "*in the week of 9 October*". We will come back to the issue once we have it, but given the existing further pressure on the bond market – with France now paying more than Spain across the yield curve – we want to explore some of the challenges now, focusing on **how the cyclical equation – i.e. the short-term cost of delivering some improvement in the deficit in terms of GDP growth – may shape the content of the bill, namely the balance between tax hikes and spending cuts.**

Indeed, beyond the essentially political and institutional question of getting *any* budget through after the general elections in July and the appointment of a minority government, France needs to deal with a regular drift in the estimate for the magnitude of the fiscal deficit for this year already on top of working on a correction path for the years ahead. According to the statement of new budget Minister during his first committee hearing in parliament, "*there is a risk it exceeds 6% of GDP*", after a shot at 5.6% two weeks ago, from 5.1% in the Stability Programme transmitted to Brussels last spring, and 4.4% projected in September 2023 in the pluri-annual scenario of the previous budget bill.

The drift cannot be attributed to major deviation from the associated GDP forecast. According to the latest short-term outlook by INSEE released a few weeks ago, French GDP would grow by 1.1% in 2024, slightly more than the assumption of the Stability Programme from last spring (+1.0%) and not distant enough from the projection retained in the September 2023 budget bill (1.4%) to explain much of any divergence from plan (a good rule of thumb is that a 1% miss in the GDP growth forecast results in a 0.5% drift in the deficit).

Some of the divergence can be attributed to a still partly mysterious – but not unprecedented – disconnection between the evolution of tax bases and tax income, but from a macro point of view, **the key issue for public finances is not so much the general mediocrity of economic growth in France – 0.2%qoq in Q2, in line with the Eurozone average – but rather a very unfavourable composition effect of GDP**. The little growth currently observable in France comes (which is quite rare) from a very positive contribution from foreign trade, with exports holding up relatively well and imports falling over the half-year. So far in 2024 net trade brought a contribution of 1.2% (in carry-over terms), while the government initially projected only 0.1% in the forecasts associated to the budget bill for 2024 in September 2023. While this would be a cause for celebration in other circumstances, the problem is that foreign trade comes with a virtually zero tax yield (no VAT is levied on exports).

On the other hand, **private consumption was flat in the first half of the year (the small increase in Q2 only offset the decline in Q1), triggering a mechanically unfavourable effect on VAT revenues**. In addition, the continued correction of the real estate market, reflected in the additional contraction in household investment (-1.1% in Q2 after -1.9% in Q1) shows in the weakness in the collection of house transaction taxes (more than 20 billion euros in good years). The contrast with the economic assumptions used to build the budget bill for 2024 is stark. In September of last year, the government was counting on private consumption growing by 1.8% in 2024 (carry-over by Q2 2024: 0.3%) and household investment dropping by "only" 2.2% (carry-over by Q2: -5.5%).

The only variable which has prevented an outright decline in aggregate domestic demand so far in 2024 was public spending: government consumption increased by 0.4%qoq in volume in Q2, after 0.6% in Q1, and public sector investment by 0.6% after 0.5%, which is of course not sustainable in a deficit reduction regime. To illustrate this point more clearly, without the *direc*t contribution of government spending (i.e. before taking on board transfers to private agents), domestic demand excluding the change in inventories would have fallen by 0.4% cumulatively over the last three quarters, against a gain of 0.1% when taking on board government consumption and investment (see Exhibit 1). Interestingly, such strength in public spending was largely anticipated in the budget bill for 2024, which projected a rise in public consumption of 1.4% (the carry-over as of Q2 currently precisely stands at 1.4%) and 1.3% for public investment (carry-over at 1.8%).

Exhibit 1 – Public spending was cyclically crucial

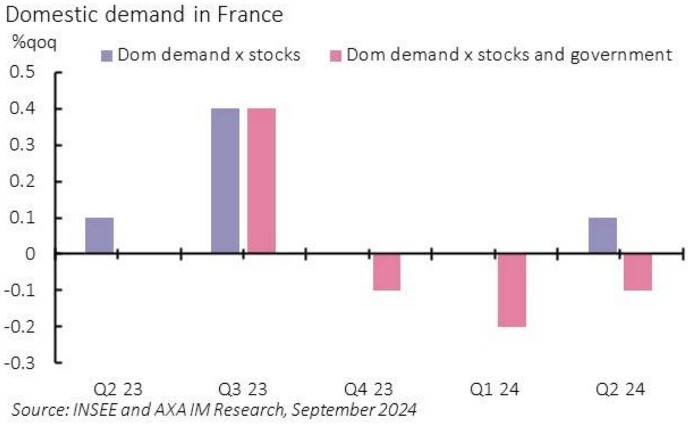
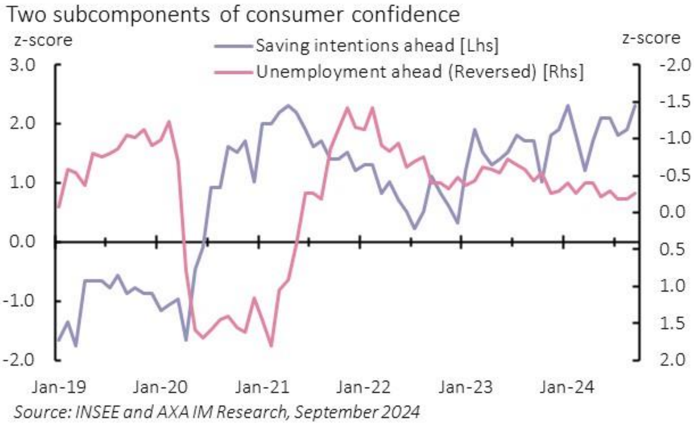


Exhibit 2 – Can France count on more private spending?



Ignoring for now the need to comply with the requirements of the European surveillance framework and, increasingly, to respond to market pressure, the macro equation for 2025 for the government holds in a single, but thorny equation: can they count on a rebalancing of GDP next year which would spontaneously lift tax receipts, while keeping the drift in public spending in check?

Habitual readers of Macrocast will be familiar with our pessimistic view on consumer spending. This is not specific to France, but a lot of the currently more than decent real wages gains are being saved rather than spent, since the savings ratio continues to rise (17.9% in Q2 2024 against 16.9% on average in 2023). Of course, the savings ratio could fall next year – it is so high now by historical standards that a correction is due "at some point", but we are always wary of making forecasts dependent on mechanical mean reversions. In any case, there is absolutely no sign for now that such tipping point has been reached: the latest consumer confidence surveys continue to point to a strong willingness to save (see Exhibit 2). A common explanation behind the rise in the savings ratio post-Pandemic and Ukraine war was the possibility that households want to rebuild their holdings in real terms after the erosion of the stock of financial assets triggered by the inflation shock. We are not convinced by this explanation since the actual savings ratio – and the willingness to save in the 12 months ahead according to the survey – continued to rise in the first half of 2024 even after inflation started to retreat**. If the disinflation of the last 2 quarters did not bring about a decline in the savings ratio, why would it start now?**

A generic sense of "unease" or uncertainty pushing households into precautionary savings is another candidate, albeit difficult to substantiate. We would however note that French households are getting gradually less optimistic about their employment prospects: the balance of opinion in the consumer survey on "unemployment in the next 12 months" is still above its long-term average, but now getting very close to it. This is where the fiscal equation is particularly tricky. **A tough, front-loaded tightening, with its adverse effect on demand, could tilt employment prospects into a properly contractionary territory, lifting the savings ratio up again**. If at the same time household income is hit by slower social transfers and/or higher tax, consumption would slow down further, offsetting much of the fiscal saving effort by dampening VAT receipts.

Given the already precarious state of the French cycle, and consumption in particular, **the government could be tempted to tilt the fiscal effort to those with a lower immediate propensity to spend or adjust their spending to short-term gyrations in taxation**, i.e. the wealthier individuals and the corporate sector. While this could dampen the short-term adverse effect on aggregate demand, this would offer only temporary relief if no long-term plan to address the underlying fiscal issues comes to complement it.

Corporate investment has little direct, immediate impact on tax receipts, but it is of course key to sustain and hopefully lift potential growth and is hence key to long-term fiscal sustainability. It has been poor so far in 2024, with a carry-over of -1.2% as of Q2. **What we think is an under-discussed issue now is the drop in profit margins in the French corporate sector**, which fell to 30.8% in Q2 2024, from 32.9% in 2023, back to the average level of 2019. The capacity to fund investment with internal resources fell to 79.4%, while it was very close to 100% at the beginning of last year. Unless interest rates fall faster, and the appetite of banks to originate more credit rises significantly, this is hardly a configuration conducive to much of a rebound in corporate investment. Separately, we agree with Olivier Blanchard's point in his interview in "Challenges" last week: it made more sense to levy exceptional taxes on firms one or two years ago, when "excess profits" were easier to substantiate, than today when profits have normalised.

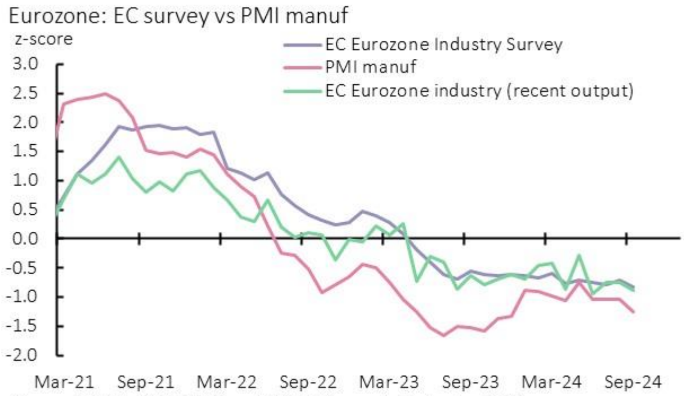
What is probably urgent at this stage is to send a "generic austerity message" conducive to enough deficit reduction next year to convince markets that despite the complicated political situation, France is not ignoring the situation. Yet, beyond this absolute necessity, observers need to be convinced that the underlying fiscal challenges are being addressed, and given France's position relative to its peers, focus should squarely be on reining in spending.

Olivier Blanchard made the point in the same interview that the primary deficit needs to be gradually brought back to zero. France barely satisfies the conditions for debt stabilisation with zero primary deficit. Assuming the average interest rate on the stock of public debt gradually converges to the current level of 10-year interest rates (3%), this would be just below what could be considered as a conservative estimate for trend nominal GDP growth in France (2% inflation + potential growth at c.1.2/1.3%). For now, the average interest rate on debt is only at c.2% since the French Treasury benefits from the volume of debt issued at the time of zero or even negative interest rates. This opens a window of a few years to "balance the books", but such respite should not create the illusion of a wide margin of manoeuvre. Resorting to purely provisional measures on tax would not provide the needed structural improvement – another point made by Blanchard. **There is no reason to go into "crash action" on spending this year already, at the risk of precipitating a recession, but this will work only if a proper long-term strategy is provided at the same time**.

Food for Thought for the ECB

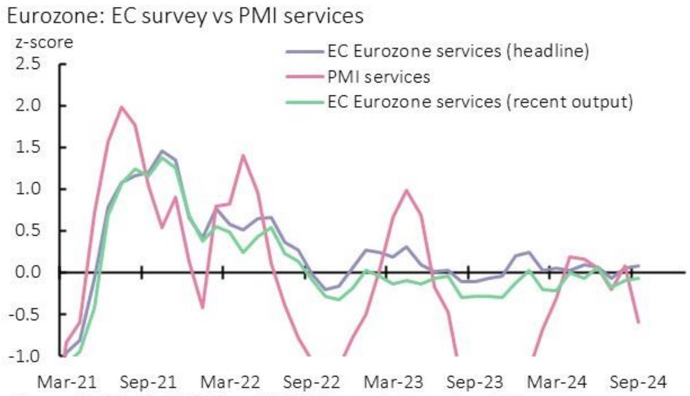
The softness in French growth – the second largest economy in the Euro area – is an issue for the Euro area as a whole and cannot be ignored by the ECB. France often acts as the "European consumer of last resort" when times are tough for its neighbours. As we have discussed in the previous section, this is not the case now and is unlikely to be next year. The latest surveys are not painting a great picture of European dynamics as a whole.

Exhibit 3 – Convergent on negativity



Source: IHS Markit, Refinitiv and AXA IM Research, September 2024

Exhibit 4 – Are services PMIs "too low"



Source: IHS Markit, Refinitiv and AXA IM Research, September 2024

The various sources are remarkably convergent when it comes to the state of the European manufacturing sector, with the Purchasing Managers' Index (PMI) and the European Commission survey within a similar range when corrected for their different long-term average and volatility (see Exhibit 3). The same cannot be said about the services sector: the PMI for September plunged. The French Olympics-related rebound in August proved short-lived as we expected, but the German print was not great either, coming out at 50.6, down from 51.2 in August. Yet, the European Commission survey is less deteriorated, hovering around its long-term average (see Exhibit 4). The PMI is probably too volatile, but the mediocrity of the European Commission survey should still call for attention.

Exhibit 5 – German labour market deteriorating

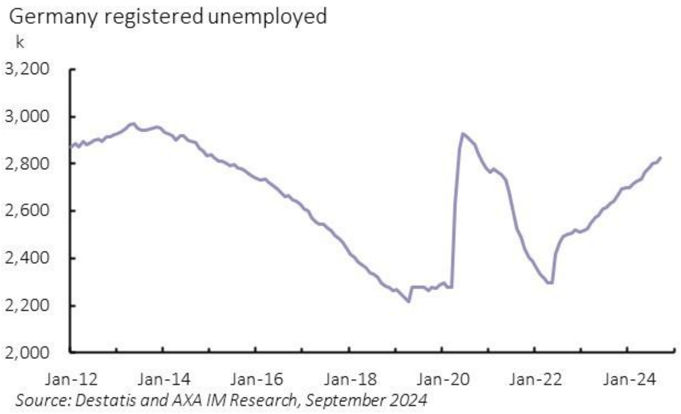
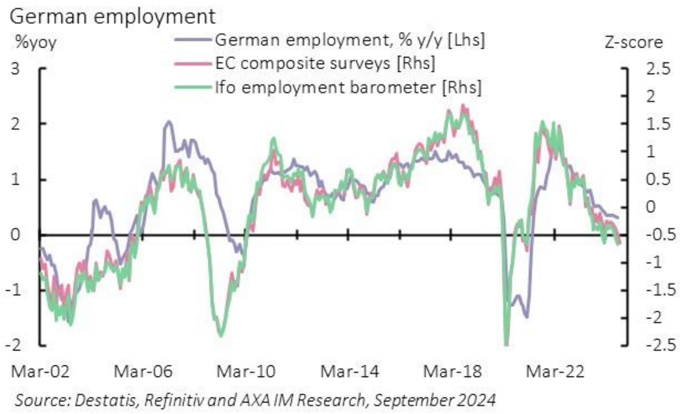


Exhibit 6– The surveys do not point to an improvement



Still, beyond those conflicting sources, and while signals from the South of the Euro area are still generally upbeat, it is clear that the German economy continues to soften. Unemployment – using the national measure, which differs quite significantly from the one consistent with the International Labour Organization (ILO) definition – has been constantly up for two years and is getting uncomfortably close to its pandemic-era peak (see Exhibit 5). The various surveys are remarkably convergent on a continuation of the deterioration of the German labour market in the months ahead (see Exhibit 6).

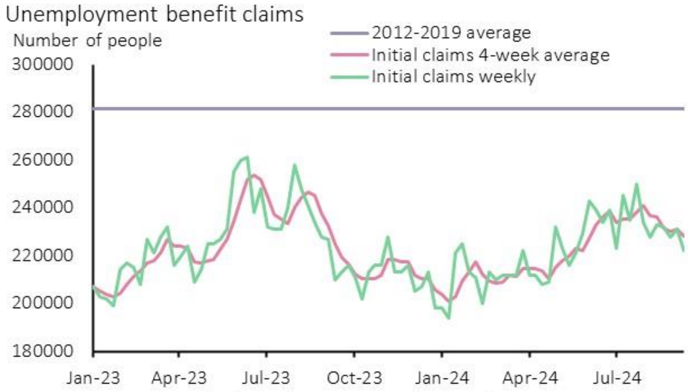
Exhibit 7 – Reassuring surveys on the inflation front

In these circumstances**, the hawks' focus on the upside risks to inflation is getting increasingly difficult to justify**, especially since the surveys also point to the continuation of a normalisation, albeit from a still elevated relative level, of selling price expectations even in the services sector (see Exhibit 7). Unsurprisingly, the market is "pushing". **The forward contracts as of last Friday were consistent with a 75% probability of a rate cut at the October meeting**, up from 28% at the end of the previous week. We have been arguing that from a normative point of view, we think the European Central Bank (ECB) should cut quickly, but what still prevents us from following the market on this is the absence of clear signals that the hawks are reconsidering, or that the general balance of power within the Governing Council is shifting. The preference for waiting until December was in our view quite clear at the last press conference. Still, if indeed the ECB is preparing to "disappoint the market" and stick to its guns on 17 October, its spokespeople should take to the wires before the start of the purdah period to make this plain. Waiting until December is becoming a very close call.

US: still no strong enough signal

Markets have not changed their mind about the Federal Reserve (Fed). As of last Friday, according to the forward contracts, Fed Funds were expected to fall to 2.85% by the end of 2025 (a level the Fed "dot plot" does not reach before December 2026), exactly the same as at the end of the previous week. **The dataflow had no impact whatsoever, despite still showing no sign of any significant slowdown in the US economy, or inflation falling more decisively**. If anything, last week's initial unemployment insurance claims continued to suggest that the US labour market is still in a more than decent shape, hitting their lowest level since the spring. Paradoxically, the trend has tilted downward since the Fed, from the middle of summer onward, changed focus to its employment objective (see Exhibit 8). Arguably, there was little fresh inflation in the Personal Consumption Expenditures (PCE) print for August, coming after the Consumer Price Index (CPI), but if anything, inflation does not seem to be heading South that quickly now. In year-on-year terms, core PCE hit 2.7%, slightly above July (2.6%). As usual for our part we focus on momentum: this was **the first time since April that core inflation re-accelerated on a 3-month annualised basis**, driven by services (see Exhibit 9).

Exhibit 8 – Unemployment claims down



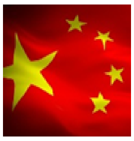
Source: US Department of Labor and AXA IM Research, September 2024

Exhibit 9 – A pause in the PCE deceleration

Source: Bureau of Labor Statistics and AXA IM Research, September 2024

True, these developments could well boil down to "data randomness", but markets can be fickle and are prone to react – and over-react to tiny changes in the dataflow. We suspect the market is nonplussed because of the torrent of dovish statements which have come from the Fed speakers since Jay Powell's press conference. The general impression is that the Federal Open Market Committee (FOMC) has got to the conclusion that whether the economy slows down, in any case the monetary stance had become too tight.

The payroll report for September due out this Friday may change the market dynamics – the consensus is for a similar print as in August for the Establishment survey, in the 140-150K range – if it comes out stronger than expected, in line with the recent signals from unemployment benefits, especially if the Institute for Supply Management (ISM) surveys still point to more than decent economic activity, the market may start to re-adjust but the bar to change a sentiment looks very high to us.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• VP Harris published economic plan and discussed migration, continues to gain at the polls • US GDP revisions, Q2 unch at 3.0% (saar), but 2023 +0.4ppt and 2022 +0.6ppt. Income revised higher so saving rate Q2 rev'd to 5.2% from 3.3% • PCE index (Aug) 2.2% (from 2.5%), core 2.7% (2.6%) • Conf Bb Cons Conf (Sep) fell more sharply from upward revised Aug – no sign of weaker spending	• Employment report (Sep) payrolls expected broadly unch, but we see upside risk to Sept. Unemp stable at 4.2%. Watch earnings which rose 0.4%mom Aug. • Jolts survey (Aug) vacancies fell in last two months • ISM mfg idx (Sep), most surveys a little better, but watch new orders, which fell to 44.6 in Aug • ISM servs idx (Sep) subdued at 51.5; servs PMI 55.4 • Vehicle sales (Sep) rebound expected from Aug dip
	• New Fr minister of public account already mentioned the deficit could rise above 6% of GDP • Fr and Sp harmonised inflation (Sep) decelerated to 1.5%yoy and 1.7%, below expectations • The SPD won elections in Brandenburg (Ge), AfD was 2nd. Greens and FDP (coalition) were below 5% • Mixed signals from EMU business surveys: neg for PMIs, slightly neg for Ifo, more neutral for EC survey and INSEE Fr conf / Ge Urate (Sep) at 6% (unch.)	• Ge, It and EMU inflation (Sep) are expected to decelerate. EMU should be below 2% at around 1.7-1.8%, core at 2.6%yoy (-0.2pt from Aug.) • Unemployment rate at EMU level (Aug.) • Fr Industrial output (Aug.)
	• Flash PMIs (Sep) composite edged down to 52.9, from 53.8 on the back of declines in both manu (51.5, from 52.5) and services (52.8, from 53.7) surveys	• Final GDP (Q2) look out for further increase in saving ratio • BoE cons. credit (Aug) look for signs of rising spending. Mortgage approvals (Aug) should tick up • Final PMIs unlikely to change
	• Flash PMIs (Sep) showed weakness in manu. output • Dovish sentiment from the BoJ • Tokyo CPI inflation (Aug). CPI ex. food and energy held firm at 1.2%	• IP (Aug) look for weakness in line with surveys • Retail sales (Aug) look for evidence HHs are spending. Cons. conf. (Sep) will remain weak • Tankan survey (Q3) look for signs of rising activity
	• Industrial production dropped to 0.5% YTD yoy in August, from 3.6%; -17.8% on the single month from +4.1% in July	• 30 Sep: NBS mfg and non-mfg PMI (Sep); Caixin mfg and services PMI (Sep)
	• CB: 25bp cut in Hungary (6.5%) Czech (4.25%) and Mexico (10.5%) as expected • CPI yoy (Aug): Malaysia (1.9%), Singapore (2.2%)	• CB: Poland (5.75%) on hold, Romania (6.5%) expected to cut by 25bp, Colombia (10.75%) expected to cut by 50bp (consensus), we pencilled in 75bp cut • CPI (Sept): Indonesia, Korea, Philippines, Poland, Turkey, Peru • IP (Aug): Brazil, Hungary • PMI survey (Sep) across the board

Upcoming events		
	US:	Tue: JOLTS (Aug), ISM mfg (Sep); Wed: ADP emp change (Sep); Thu: Initial jobless claims (w/e 28 Sep), Composite PMI (Sep), ISM non-mfg (Sep), Factory orders (Aug); Fri: Non-farm payrolls (Sep), Unemp (Sep), Avg earnings and weekly hours (Sep)
	Euro Area:	Mon: It, Ge HICP (Sep, p), Ge CPI (Sep); Tue: Sp, It mfg PMI (Sep), Ez HICP (flash) (Sep); Wed: Ez unemp (Aug); Thu: Sp, It services PMI (Sep), Ez Composite PMI (Sep), Ez PPI (Aug); Fri: Fr, Sp IP (Aug)
	UK:	Mon: GDP (Q2), Private consumption (Q2), Business investment (Q2), Current account (Q2), Mortgage approvals (Aug), Net Mortgage lending (Aug), Consumer credit (Aug); Tue: BRC index (Sep), Mfg PMI (Sep); Wed: BoE Financial Policy Summary publication; Thu: Services and composite PMI (Sep); Fri: Construction PMI (Sep)
	Japan:	Mon: IP (Sep, p), Tue: Tanken mfg index (Q3)
	China:	Mon: NBS mfg and non-mfg PMI (Sep) Caixin mfg and services PMI (Sep)

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