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France: inflation is not responding

- Inflation remains uncomfortably low in France, due to a combination of falling commodity prices and weak growth.
- This weakness is widespread: core inflation stood at just 0.7% y/y in November 2015.
- This is a source of concerns in several respects, but particularly on account of the deflation risk.
- Nevertheless, we believe the positive effects of low inflation (particularly support for household purchasing power) outweigh the negatives.
- Moreover, inflation is likely to be a little less weak by the end of 2016, when it is expected to stand at just over 1% y/y compared with 0% today.
- This upturn should stem mainly from the expected fading impact of lower oil prices, while inflationary pressures are likely to be contained.
- This limited upturn in inflation should not hold back the recovery. Nevertheless, we would prefer to see a higher inflation rate that had been caused by higher growth.

Inflation remains uncomfortably low in France, even more so than economic growth. In November, the consumer price index (CPI) fell 0.2% m/m (non-seasonally adjusted). On a y/y basis, inflation decelerated again, falling to 0%. Should we be worried about such low inflation? If so, how worried? We address these questions in this paper. We answer the first question in the affirmative, and conclude that there are no grounds for excessive concern. The consequences of low inflation for economic growth appear to entail more positives than negatives; and, in any case, inflation should start to move upwards by the end of 2016.

From uncomfortably low inflation at the present time…

The currently low inflation is not just the result of a distortion of relative prices triggered by a fall in some prices. Such a distorting effect was observed in 2009, for example, when the fall in the oil price led to inflation at -0.7% y/y in July 2009; but at that time core inflation was around 2% y/y.

■ Extremely low inflation

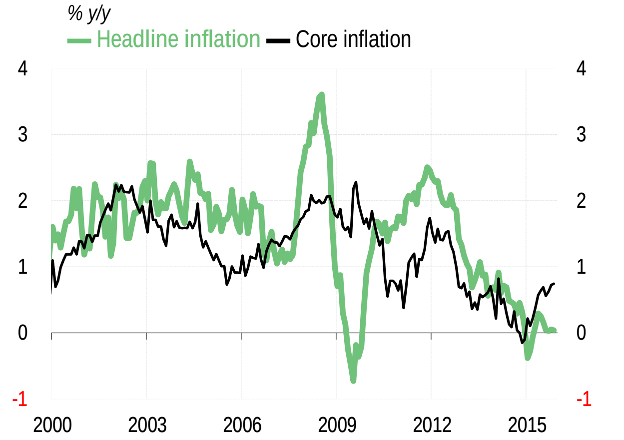

Chart 1 Source: INSEE

We are far from that today: core inflation[1] is particularly low, even if not as low as headline inflation (0.7% and 0% y/y respectively in November 2015) and not as low as a few months ago, at the end of 2014, when it dipped just below zero (see chart 1). The widespread nature of low inflation can be seen in the relatively high percentage of prices that are falling (33% in November), and of those that are rising by between 0 and 1% inclusive year on year (42%). These two cumulative percentages stopped increasing at the beginning of 2015, but only after rising strongly in both 2013 and 2014 (see chart 2). Besides, prices for both services and manufactured goods contribute to the broad-based inflation weakness (see chart 3). On a y/y basis, services prices (47% of CPI) have risen by just 1.2% and have been decelerating since mid-2014 (+2% y/y at the time). Manufactured goods' prices (26% of CPI) are down on a year-on-year basis (-0.6%), but this decline has eased since the start of the year (-1.7% y/y in February 2015).

Over a prolonged period, such a low rate of inflation, well below the 2% a year that is considered comfortable[2], is concerning for

[1] *The INSEE core index excludes products with volatile prices (notably oil and food products) and those that are subject to government intervention (electricity, gas, tobacco).It is also adjusted for tax measures and seasonal effects.*
[2] *This rate covers an overestimate of inflation at around 1% (on account of the difficulty of assessing quality effects) and a safety margin of around 1% in the event of*

several reasons. In the first place, there is a significant risk of low inflation turning into deflation (a widespread and self-sustaining fall in prices). Based on the IMF's work on this subject, we have constructed a vulnerability index for France that factors in inflation dynamics, rates of growth, the output gap, the exchange rate, the stock market, credit and money supply growth (see inset 1 and chart). According to this index, the risk of deflation is moderate in France, but it does exist, and it is fed by low inflation.

Low inflation creates further difficulties. Generally speaking, it penalises debtors. It acts as a brake on growth by the monetary tightening it causes in real terms. Similarly, the resultant increase in real wages can run counter to the adjustment mechanisms needed for a decrease in the unemployment rate[3]. Finally, low inflation drags down nominal growth. This contributes to a deterioration in a number of ratios, including the public debt ratio.

...to slightly higher inflation in the future

The picture is not completely bleak, however: opposite to these negative effects of low inflation, there are positive elements that should be factored in and which, in our view, have greater weight. The first is the significant support provided to household purchasing power[4]. The price falls observed (see chart 4) are not causing households to delay their purchases in the hope that prices will fall even further; on the contrary, they are encouraging them to take immediate advantage of the resources freed up in order to consume more. Insofar as the inflation weakness is largely due to the fall in commodity prices, especially oil, corporates and the government sector are also benefiting from the situation thanks to the reduction in their intermediate consumption costs. For corporates, this is also a competitiveness factor. For public finances, another advantage is the diminished rise in index-linked welfare benefits, contributing to slow down public spending growth. Furthermore, all economic agents benefit from the ensuing fall in nominal interest rates (limiting any rate rises in real terms).

Moreover, the outlook is for a contained rise in inflation: it should keep its distance from the dangerous level of zero, without jeopardising the recovery. According to our forecasts, inflation should reach 1.3% y/y by the end of 2016 (1.4% in terms of harmonised inflation). This pickup should mainly stem from the dissipation of the oil price impact, which is currently fairly marked (contribution of -0.5 percentage points of the energy component to annual inflation in November). Inflation should also continue to be pushed moderately upwards by the depreciation of the euro and by the planned increase in green taxation and regulated gas

Low inflation across the board (1)

Cumulative percentage of CPI items with a y/y change between 0 and 1% inclusive, and those with a negative change

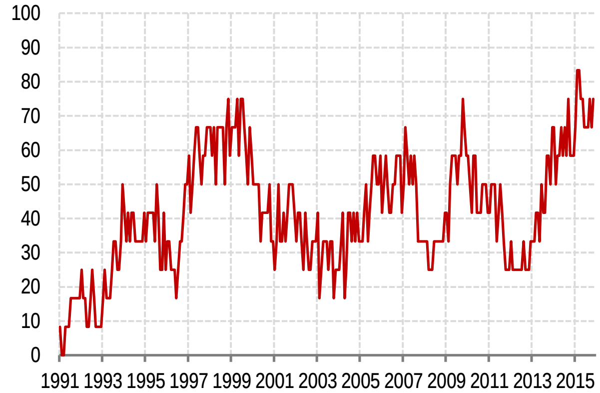

Chart 2 Source: INSEE

Low inflation across the board (2)

% change y/y

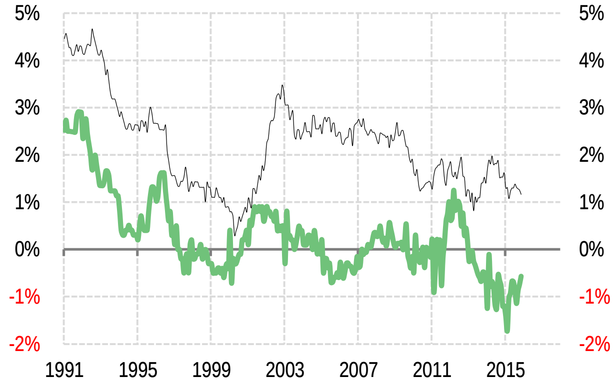

Chart 3 Source: INSEE

Weak rises and sharp falls

% change y/y in November 2015 for main CPI items and their corresponding CPI weight (in brackets)

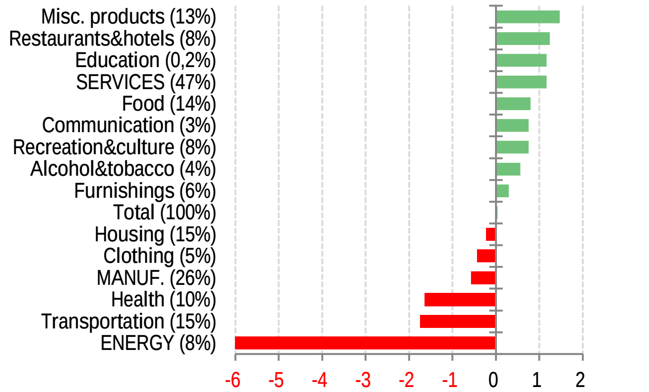

Chart 4 Source: INSEE

and electricity prices. The expected strengthening of the recovery should also have some impact, but marginally, with inflationary pressures remaining limited, not to say non-existent. The upward trend in core inflation since the end of 2014, while modest, is in keeping with our forecast. Its near-stability in annual average terms (from 0.5% in 2015 to 0.6% in 2016)

negative shocks. 2% inflation is neither too much, nor too little: it's the right rate for growth, a neutral pace that does not influence economic behaviour in either direction.

[3] *However, this negative effect can be mitigated by the positive effect on demand of higher real wages, which can lead to a decline in the unemployment rate.*

[4] *In consumption equations, inflation acts as a negative (more inflation leads to less consumption), the purchasing power effect outweighing any "flight from currency" effect. As for real interest rates, the substitution effect (negative) tends to take precedence over the revenue effect (positive). The current low pace of inflation thus has opposite effects on household consumption: positive via the boost to purchasing power, negative via the increase in real interest rates. As purchasing power is a more important determinant than interest rates, the positive effect holds sway.*

masks a clearer trend on a y/y basis (0.6% at end-2015, 0.9% at end-2016).

Several factors are helping to hold back inflationary pressures in the short term. Economic growth, although recovering, is likely to remain moderate; as a result, the output gap, while it should start to close, looks set to do so slowly (see chart 5). Nor is growth strong enough to bring unemployment significantly down. The pause in the upward trend should admittedly ensure that the downward pressure on wages increases should not be exacerbated, while such increases have already slowed sharply (+1.1% y/y for the basic monthly salary, a historical low; see chart 6), but the still high level of unemployment should limit any acceleration. Moreover, wages will only find limited support from the automatic annual increase in the minimum wage (+0.6% in January 2016, no extra discretionary rise), which itself has been held back by the low level of inflation and wages increases (see inset 2). All in all, a price-wage loop is in operation, but not in the sense commonly described, because at the moment salary and price increases are self-sustaining in a downward, not upward, direction (see chart 7).

Weak demand is not the only factor holding back prices: there is also pressure from competition and efforts to increase competitiveness. One way for a company to win back market share is to lower its selling prices. All else being equal, the result is a potentially problematic narrowing of margins. The difference is that today, unlike in the past, companies are benefitting from the job creation tax credit (CICE) and lower charges as a result of the responsibility pact. By diminishing the cost of labour, these measures enable companies to avoid or limit margin compression. This facilitates efforts to improve price competitiveness. The effect of all these downward pressures on prices can be seen in the fact that there has been no pickup in the "price of production" component of the composite PMI since 2013 (stuck below 50, oscillating around 46 on average).

The expected acceleration in inflation, being limited, should not hold back the recovery. The increase in the purchasing power of household disposable income looks set to be less strong in 2016 than in 2015 (annual average of 1.1% after 1.6%, on our forecasts) but it should have somewhat more solid supports, boosted by a pickup in employment. As a consequence, household consumption growth should not decelerate much between the two years: we forecast it at around 1.5% in 2016, like GDP growth, the latter also being sustained by the pick-up in investment.

The risks to this scenario are on the downside though. The Bank of France highlights this in its latest macroeconomic projections, based on the persistence of a high level of unemployment and a downward revision to the global growth outlook. To this, we should add the fall in oil prices, which does not look like it is over yet[5]. On the other hand, we should not overlook the risks of higher inflation, even if they are not dominant. An overestimate of the output gap is a possibility. In such a case, the first inflationary pressure could manifest itself earlier than expected.

[5] *The fall in the price of Brent since the start of October brought it to below $40/barrel in the first week of December, its lowest level since the end of 2008.*

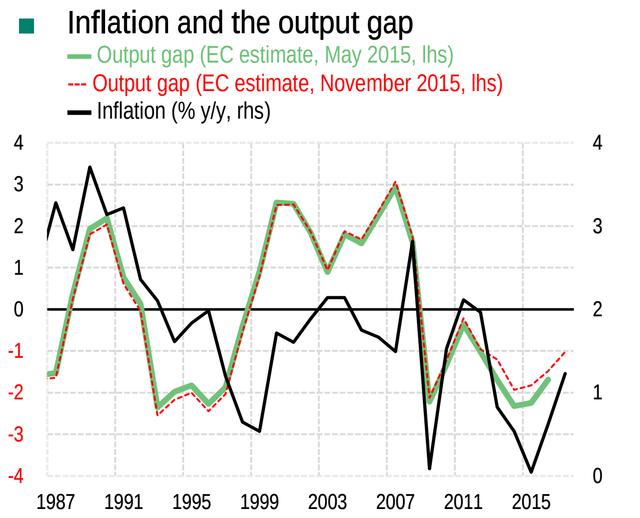

Chart 5 Source: INSEE, European Commission

Chart 6 Source: INSEE, BNP Paribas forecasts

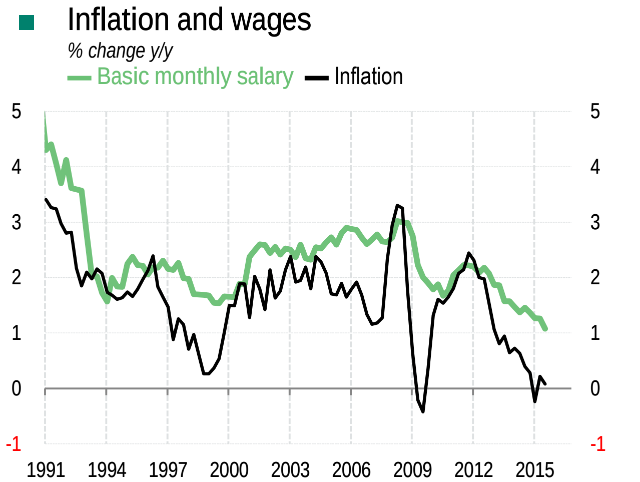

Chart 7 Source: INSEE

The European Commission's small, but significant, downward revision to its estimate illustrates this risk (see chart 5).

We conclude with a few words on the ECB's monetary policy, because the central bank's efforts are aimed precisely at combatting extremely low inflation. Its achievements are currently mixed, but we can count on its resolution to do what is needed in future. At the present time, the ECB is still far from fulfilling its mandate to keep inflation close to but below 2%. Growth also lacks dynamism. Nevertheless, its unconventional monetary policy has proved convincingly effective in reducing risk aversion and improving financing conditions (as evidenced by the euro depreciation, the fall in interest rates and risk premiums, the recovery in credit, the rise in equity markets). It is therefore contributing, slowly but surely, to the recovery (0.4 points in 2015 according to INSEE estimates for France[6]); and ultimately, more growth means more inflation.

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Index of vulnerability to deflation

The vulnerability index compiles responses to the 11 questions below. A positive response is assigned a score of 1, and a negative 0 (responses to these questions in Q3 2015 are shown in brackets). The index corresponds to the percentage of variables on which the response is positive: the higher the percentage, the greater the risk of deflation. It provides a synthetic overview of the multiple causes and dimensions of a potentially deflationary situation. Nevertheless, it represents only a rough guide to a highly complex phenomenon. It acts as a warning of deflationary risk, not as a prediction that deflation will definitely occur.

- Is headline inflation below 0.5%? (1)

- Is inflation, as measured by the GDP deflator, below 0.5%? (0)

- Is core inflation below 0.5%? (0)

- Has the output gap increased by more than two percentage points during the last four quarters? (0)

- Is the output gap currently greater than -2%? (0)

- Is current growth weaker than the average for the previous two years? (0)

- Have share prices fallen by more than 30% during the last three years? (0)

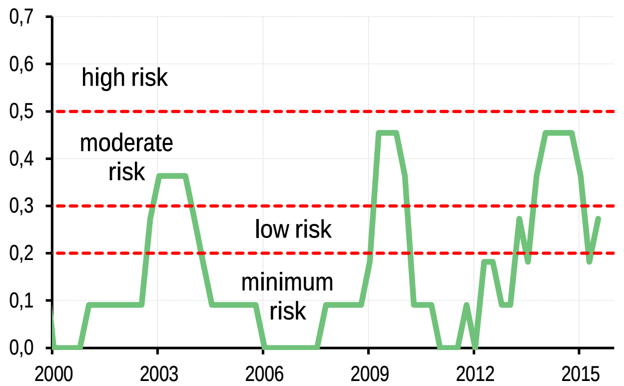
- Has the real effective exchange rate increased by more than 4% during the past year? (0)

- Has cumulative credit growth been less than 10% over the last three years? (1)

- Is y/y credit growth below nominal GDP growth? (0)

- Has money supply growth been at least two percentage points weaker than growth in the monetary base during the last eight quarters? (1)

Inset 1 Source: BNP Paribas



Overview of French minimum wage (SMIC)

*The SMIC (*salaire minimum interprofessionnel de croissance*) applies to all workers in all sectors (excluding interns and apprentices). In January 2015, around 2 million private sector employees (11% of the total) were impacted by the increase in the SMIC. It is adjusted in January each year on the basis of a formula providing two guarantees:*

- a guarantee of purchasing power (by indexation to the consumer price index, excluding tobacco, for households in the first quintile of revenue distribution, measured on a y/y basis in November);

- a guarantee of "participation in the economic development of the nation" (equal to half the change in the purchasing power of the hourly average gross monthly salary of workers and employees (SHBOE), measured on a y/y basis in September).

Note that if inflation exceeds 2% compared with the last legal increase in the SMIC, the latter is increased earlier.

The SMIC may also benefit from one-off increases. The last dates back to 1 July 2012 (+0.6%) and was the first such since 2006. Since 2008, a committee of independent experts has issued its opinion on the trend in the SMIC, and notably on the advisability of a one-off increase. The last report, published in late November, advised against, as did the previous ones, in order not to hamper competitiveness and employment.

On 1 January 2016, the SMIC will be increased by 0.6% to 9.67 euros per hour (1,467 euros gross monthly salary). The French minimum wage is one of the highest in Europe and even in the OECD. Its automatic increase is a feature specific to France. The importance of the SMIC in wage distribution is also greater in France than in other OECD countries.

Inset 2 Source: BNP Paribas

[6] *J.C. Heam, B. Marc, R. Lee and M. Pak, 2015, "L'assouplissement quantitatif de la BCE a fait baisser les taux d'intérêt et contribue à la reprise de la zone euro", ["The ECB's QE has brought down interest rates and contributed to the recovery in the eurozone"] INSEE Note de Conjoncture [economic note], December.*

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