

Richard McCreery's Business Blog

The 100 billion Euro question: how France intends to cut its deficit



Richard McCreery's Business Editorial RLTV 25 Jun 10

Riviera based Independent Investment Adviser, Richard McCreery, has joined the expanding *RivieraLife.tv* team as Business Editor. Richard publishes a weekly Financial Editorial every Friday with informed comment on topical financial matters relevant to residents and businesses on the Cote d'Azur.

This week the French government announced plans to get the French budget deficit from 8% of GDP this year to below the 3% limit that was supposed to be part of the criteria for Euro-zone membership. This limit was originally established as a kind of minimum standard for the new and existing members, as part of the stability and growth pact that was designed to maintain confidence in the Euro. In recent years it has been discarded as financial discipline in the major Euro-zone countries has gone out of the window, to the point where the only country out of the 27 EU members that currently complies is Luxembourg.

Conscious of the threat to France's triple-A credit rating and the rise in borrowing rates that this implies, Mr Sarkozy's government will make cuts to spending programmes and benefits that are expected to total at least 100 billion Euros by 2013. In a country that is famous for its strikes and protests when someone even suggests a change to government spending this is a tall order, and the unions are unlikely to accept the reality of the financial crisis without a fight. French workers have enjoyed a privileged welfare system for many years and young employees will often talk about how they prioritise job security and look forward to their retirement, a sad illustration of how the generous state system can sap youthful ambition, but events in the Euro-zone have moved quickly in recent months and the fragility of the socialist state system has been exposed.

However, apart from fact that the government usually caves in to union demands and backtracks on many important changes, there is also an obvious potential weakness in their calculations. Around half of the 100 billion Euros reduction in the deficit depends on average annual GDP growth of 2.5% per year to 2013 which would boost tax revenues but France hasn't experienced that kind of strong growth since the 1990s, and has only averaged around 1.5% GDP growth per year since 2000 according to the World Bank. Not surprisingly the European Commission and the IMF have both criticised France's 'optimistic' growth assumptions. The other half of the 100 billion Euros is supposed to come from spending cuts and tax rises but neither of these strategies are likely to help GDP grow strongly either. France hasn't managed to balance its budget for over 30 years so it might be bit unfair to expect it to happen now but this time there is a sense of urgency and financial markets are forcing the state of play, as we've already seen in Greece.

The recent announcement of Mr Sarkozy's plan to raise the state retirement age from 60 to 62 and raise pension contributions should really cause some fireworks. Even once this change has been implemented French workers will still retire earlier than most Europeans but the promise of a comfortable retirement is hugely important to the French, regardless of whether the State can afford it or not. The State pension funding gap is expected to hit €43bn by 2018 if nothing changes and such controversial reforms have usually been pushed back by former governments. Now, if the government does nothing then financial markets could take action, but if they push ahead with important changes to the fabric of French society then they can expect fierce opposition.

So far the government has failed to provide many concrete details of the actions it intends to take but in addition to lowering the retirement age there are rumours of a public sector pay freeze combined with tax rises for businesses and the wealthy. One can easily envisage a scenario of strikes and rioting amongst those who really have to pay for the financial mismanagement of the car companies, construction companies and the banks, namely the middle classes. The wealthy often have the option of upping sticks to a more tax-friendly country and it doesn't take long for big business to 'outsource' as much work as possible to countries where there is less chance of management being held for ransom, a tactic that only seems to be successful in Iraq, Somalia and French factories. However, it is the middle classes in the private sector who are likely to bear most of the brunt of tax rises, cuts to everyday public services and transport disruptions due to striking workers. To cap it all they will face the prospect of a longer working life than their parents. France is beginning to dig its way out of its financial hole but it won't be easy or pleasant and the French people are not going to take it sitting down. It's not in their nature.

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