France is in denial as fragile banks add to economic woes

The second biggest economy in the eurozone is grappling with public debt, stalled growth and high unemployment

Angelique Chrisafis in Paris
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France's President Nicolas Sarkozy, desperate not to be the president that loses France its triple-A rating, has published belt-tightening budget proposals for 2012. Photograph: Charles Platiau/Reuters

In her small fashion boutique in a village near Saint-Étienne, Valérie Dongrazi was feeling the pressure of French banking jitters and the economic rut.

The 44-year-old shopowner has not paid herself a salary for more than a year. When she did, it was €1,300 (£1,130) a month. She's had to start buying cheaper foreign stock as clients in her village in south-eastern France who once paid €270 for a good winter coat, can now afford just €150. To stay on top of overheads, she relies on going to her bank to increase costly overdrafts or ask for loans.

But with a big question mark over French banks' stability, shares in the biggest banks plummeting and talk of a state bailout, the lifeline of bank credit to businesses like Dongrazi's is drying up. French banks are nervous about lending money, companies are struggling and consumer confidence has fallen to the lowest level since February 2009, when France was suffering its worst recession since the second world war. "There's a mood of fear; people are not buying for pleasure, barely for necessity. I'm not optimistic," she said.

Rumours about the fragility of French banks and their ability to cope with losses from Greek debt has thrown a spotlight on the wider woes of the economy and its slippery hold on its triple-A rating. The shares of France's biggest banks have lost half of their value in just three months. In any other country, this might signal panic on the streets, but France believes it is battling bigger economic problems: spiralling public debt, stagnant growth, low business morale and high unemployment.

French banks continue to insist they do not need a state bailout and can withstand losses. Although big international firms have begun moving funds out of Paris banks, households are not rushing to withdraw savings. A Northern Rock-style bank run would be unlikely in France, where savings have high state protection. As one economist said, there is a notion that the state will "always step in" as protector. There is little chance of a major French bank going under because it has been made clear that the government could, within minutes, take the decision to recapitalise.

But the banking wobble has highlighted serious wider problems in the sluggish economy. Just as the omnipresent state offers a safety net for the banks, business lobbies say its suffocating grip on the country's financial workings are more of a problem than ever. France didn't fall quite as low as Britain or Ireland in 2008 but – famous for red tape, regulation and high labour costs – it is still struggling to bounce back. The eurozone's second biggest economy failed to grow at all in the second quarter as consumer spending nosedived.

"I think the seriousness of the banks' situation was exaggerated," said Marc Touati, economist at Paris-based Assya. "The real problem is growth. Unfortunately, a recession is approaching."

He sees the risk of a slowdown that could last into 2012. With no growth, there would be higher unemployment and more public debt. Failure to rein in France's public deficit – one of Europe's highest – could threaten credibility abroad and social cohesion at home. "In France, even more than elsewhere, all this depends too much on politics and political decisions," he added.

With seven months until a presidential election, the role of politicians is crucial. The priority is to plug the hole in state coffers created by decades of the state living beyond its means. France has a vast social security deficit, as well as big holes in local authority and central government finances. The country hasn't balanced a budget since 1974.

Sarkozy, desperate not to be the president that loses France its triple A rating, has published belt-tightening budget proposals for 2012, to raise taxes. The government wants to stick to its target to cut the deficit to 3% of GDP in 2013. But, though it has cut its growth predictions to 1.75% for 2011 and 2012, economists fear growth will not be strong enough to generate the tax revenues the government is counting on.

Some politicians privately acknowledge that taking measures severe enough to correct the public deficit would mean "blood and tears" for the French. But few political figures on any side are prepared to announce such drastic measures while they are busy trying to get elected. Economists believe the government is merely trying to steady the ship, the country will have to wait until June 2012, after the presidential election, for a concrete economic action plan.

"What's the economic strategy for the next decade? I don't think anyone has a clue," said Alexander Law, chief economist at Xerfi. "There is an idea France will have to start copying Germany, be slightly less generous to households and more accommodating fiscally to companies. That hasn't seeped through into the political echelons; the 2012 budget is taxing everyone a bit more.

France's fiscal structure favours household consumption as opposed to investment. "Tax will move from companies towards consumers – people know that's going to happen, but they don't know when and how, or how unpopular it's going to be – ranging from very unpopular to horrendously unpopular," he said.

Jean-Guilhem Darré, of the SDI union for businesses with fewer than 20 staff, said the next six months would be hard. "We're not yet in the same state as in 2008, but we see the elements returning to have the same type of crisis as 2008."

Pierre Coinaud, who represents business leaders in the old industrial heartlands of the the central Limousin region and runs an office supplies firm with 80 employees, blames the overweening state. "State rules and regulations are so rigid it's difficult for firms to react quickly or adapt to economic realities," he said. "France's problem is that we don't export enough, we live in an internal market, kept afloat and helped along by the state. Now the state needs to tighten its belt and that will have an effect on the market. French businesses need more freedom, more air to breathe."