

# Prospects

No.19/113 – 27 June 2019

## ITALY – Economic Environment

### Macroeconomic and banking review

- After two quarters of contraction in activity, the Italian economy experienced a contained rebound in Q1 2019 (+0.1% over the quarter). While the recession in H2 2018 proved to be “technical” and characterised by exceptional factors, the risk of a real recession is not far away.
- Against a backdrop of uncertainty over foreign demand, the gradual weakening of domestic demand is a source of concern. We forecast GDP growth of 0.2% in 2019 and 0.4% in 2020.
- Weak consumption can be attributed to an increase in the savings rate since end-2018. This can be explained by several factors: rebuilding of real cash holdings after negative asset valuations, property objective due to home purchases that are becoming increasingly accessible; precautionary savings in light of the decline in consumer confidence.
- Productive investment has decreased. Although there has been an erosion in profitability, it remains high. Therefore, it is primarily uncertainty over demand that is adversely affecting investment decisions, as well as poor visibility on government policy which has substantially reduced the tax measures to encourage investment.
- The government seems to have the budgetary leeway and political will to make the required adjustment to the 2019 deficit and attempt to avoid an excessive debt procedure. The government has undertaken to achieve a deficit of 2.1% in 2020, whereas the Commission is forecasting 3.5%. The room for manoeuvre is therefore more restricted, but does exist. However, it requires political choices that could have consequences on the cohesion of the government.
- As anticipated, the deterioration in the economic environment has hampered the credit momentum that characterised 2018. The Q1 2019 results of banks in the sample are in line with previous quarters, with revenues even more under pressure, good cost control and the continued decline in the cost of credit risk. In this sluggish environment and whereas the Italian banks have already been proactive in addressing the NPL issue, their exposure to sovereign risk has again become a subject of concern. The resumption of the stand-off between the Italian government and EU on the budget has subjected them to a widening of the BTP-Bund spread, that could affect their revenues and their solvency, especially as their exposure has increased.

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## Macroeconomy: less choice

After two quarters of contraction in activity, the Italian economy experienced a contained rebound in Q1 2019 (+0.1% over the quarter).

Growth in 2018 has been downgraded (+0.7% vs. +0.8% estimated previously), i.e. a sharp slowdown compared with 2017 (1.7%). Since spring 2018, domestic demand has relinquished the annual pace of more than 1.5% that it posted since 2015. Domestic demand has since grown by only 0.6%, which is not sufficient in a context of weak foreign demand. Foreign demand has relinquished growth rates of over 5% to increase at an average rate of 1.8% over the last year. Moreover, companies have been engaged in a destocking process since they began to downgrade their demand expectations in spring 2018.

The rebound in GDP in Q1 2019 can be attributed to the positive contribution of foreign demand which offset the negative contribution of domestic demand. For the second consecutive quarter, destocking by companies had a very negative impact on growth removing 0.7 points of GDP growth.

While the recession in H2 2018 proved to be “technical” and characterised by exceptional factors, the risk of a real recession is not far away.

It will be difficult to strengthen the rebound in exports and industrial production seen at the beginning of the year over the next few months. The industrial production index rose by 1% in Q1 (the last quarterly positive change in the index was recorded in Q4 2017). The new European standards concerning vehicle gas emissions paralysed production last summer, affecting primarily Germany and Italy (linked by major supply contracts). However, the recovery observed at the beginning of the year did not last: the index fell 1% in March and 0.7% in April and, year-on-year, it is down 1.5%. The sectors of economic activity that experienced a positive trend were electricity, gas, steam and air supply (+5.8%), as well as the food industry, beverages and tobacco (+4.9%). The biggest falls were recorded in the textile, clothing, leather and accessories industries (-8.2%), in the manufacture of coke and refined petroleum products (-7.4%) and in machinery and equipment production (-6.2%). There was better news for car vehicle production which rose 3% in April (-17% year-on-year).

Leading indicators are not sending any encouraging signals. PMI surveys point to a less substantial decline in industrial activity, but new incoming orders in April were down 1.4%, driven by a significant contraction in orders from abroad. However, there are signals that activity is still expanding in the services sector.

While the contribution of foreign demand has become positive again since Q4 2018, this is mainly due to weak imports (down 1.7% in Q1 2019). There

has been confirmation of the slowdown in exports (from 7.6% in 2017 to 3.1% in 2018) for non-EU partners (in particular Turkey, China, Japan and Russia) and EU partners (in particular Spain, where exports have halved compared with 2017). The pace of export growth was positive but very low in Q1 2019 (+0.3%). Exports to main partners have picked up since the beginning of 2019 but business surveys regarding orders from abroad are still too volatile to establish any clear signals. Downside risks related to the slowdown in international trade remain present due to the escalation of the China-US trade war.

Against this backdrop of uncertainty over foreign demand, the gradual weakening of domestic demand is a source of concern. Private consumption has increased at a stable but very moderate pace (0.6% in 2018 and 0.1% in Q1). The durable goods consumption cycle is in an advanced phase: household spending for this category rose by 3.6% in 2018, slower than in 2017 (+5.1%). This relatively robust component (+2.8% year-on-year in Q1 2019) should continue to support consumption in the medium term. Moreover, households' acquisition intentions for Q2 2019 with regard to homes and vehicles have improved significantly compared with Q1.

The positive situation in the labour market continues to support the growth in households' disposable income. Job creations have continued at a more moderate but still positive rate (0.5% year-on-year in March, vs. 1% a year earlier). The unemployment rate continues to decline (10.2% in April) and the employment rate is at its highest level, exceeding its pre-crisis level (58.8% in April 2019). In terms of forecasts, available information is encouraging: recruitment prospects have improved since the beginning of the year for the construction, services and retail sectors. Only the manufacturing sector shows a slight decline, for the moment not confirmed by PMI surveys, which point to expansion in employment in all sectors.

The acceleration in wages has been clearly visible for a year and gained momentum at the beginning of 2019. Wages increased by 2.8% in Q1, driven by the industrial and construction sectors.

Weak consumption can be attributed to an increase in the savings rate since end-2018. This can be explained by several factors. Firstly, a desire to rebuild real cash holdings after negative asset valuations at end-2018. But also a property objective due to home purchases that are becoming increasingly accessible. The assumption of an increase in precautionary savings is also credible in light of the decline in consumer confidence.

Investment growth was still positive in Q1 2019 (0.6% over the quarter). However, this was the result of the sharp acceleration in construction investment (+2.6%) in both its components (residential and non-residential). This trend has benefited from particu-

larly favourable weather conditions but also an improvement in demand, as reflected in the number of residential transactions having returned to 2010 levels. However, productive investment has fallen (-1.29% for machinery and equipment and -5% for transport). Non-financial companies have seen their margins decline from their 2017 peak, but they remain high. It is primarily uncertainty over demand that is adversely affecting investment decisions, as well as poor visibility on government policy, which has substantially reduced the tax measures to encourage investment.

#### Box 1

##### **Investment: a helping hand for the railways**

*Italy's state-owned railway company, Ferrovie dello Stato Italiane (FS), has submitted its investment plan for the period 2019-2023: €58 billion will be invested in infrastructure and the renewal of the fleet. After the successful renewal of the long-distance network, with the introduction of 50 high-speed units having contributed to significantly reducing aeroplane use for intercity journeys (in 2008, 36% of journeys between Rome and Milan were by train vs. 67% in 2017). FS is now embarking on the renewal of its regional fleet. The annual investment is therefore more than doubled: FS invested €95 billion over the period 2000-2018 and is now investing €58 billion over the next five years. The company has estimated the impact for Italian growth at between 0.7 and 0.9 points of GDP over the period 2019-2023.*

The growth overhang for 2019 comes out at -0.01%. Leading indicators point to growth at best zero in Q2 2019. A potential boost for growth may come from the end of the destocking process that has been under way for six months now. This originated from the dislocation of car production during the summer which caused a substantial accumulation in inventories. It was reinforced by the gradual deterioration in the outlook for the industry. This destocking has significantly impacted growth and its normalisation should have a positive impact on activity over the next few quarters.

We have slightly upgraded our forecasts for 2019 to an average of 0.2% due to stronger than anticipated growth in Q1. The contribution of consumption and foreign demand is likely to remain modest. Investment is expected to return to barely positive growth. We anticipate the same dynamics in 2020, with growth downgraded to 0.4%.

### Public finances: proving of credentials

For the second time in less than a year, the European Commission has been obliged to compile a report on the state of Italian debt. While last year the European Commission concluded that the debt criterion had been observed and that the opening of an excessive debt procedure was not justified, it nevertheless referred to a review in 2019. This has been carried out and the European Commission has recommended the opening of an excessive debt procedure, stating that:

- For 2018, Italy has not adhered to the objective in terms of public spending growth and structural deficit adjustment, with a difference of 0.4 points in GDP (€7 billion)
- For 2018, Italy has not adhered to the objective in terms of a decline in debt (with debt increasing from 131.4% in 2017 to 132.2% in 2018).
- For 2019, the deficit risks a significant deviation with an overshoot of 0.6 points compared with the objective.
- Budget developments for 2020 are likely to lead to the breaching of the rule of a 3% deficit (which the Commission expects to be 3.5% vs. 2.1% for the government).

Therefore, the Commission has not taken account of the responses provided by the Italian government which it considers too vague. With regard to the increase in the debt/GDP ratio in 2018, the government has invoked deteriorated macroeconomic conditions and temporary factors (asset flows-inventories).

However, it is mainly the responses provided for the 2019 deficit that the Commission considers unsatisfactory. Italy has activated a safeguard clause for an additional €2 billion decline in expenditure, to limit the overshoot for the current year but this is not sufficient. The government also suggests that better than expected revenues and lower disbursement related to new social spending should contain the deficit at a level below the 2.4% anticipated by the Commission. Moreover, the government suggests that given the weakness of the economy, the output gap is likely to be more negative than indicated by the Commission, justifying the request for a structural adjustment of the accounts of 0.25 rather than 0.6 points. In this case, the deviation would not be excessive. The Commission has brushed aside these arguments. It has requested adjustment measures during the year to make up for the deviation in the 2018 deficit and the anticipated deviation in the 2019 deficit (expected to be 2.5%, vs. 2.4% anticipated in the April Stability Programme).

The Commission and Italy's partners appear to want to accelerate the timeframes in order to take a decision on the excessive debt procedure. The Council's technical body has deemed the Commission's recommendation acceptable.

The government seems to have the budgetary leeway to make the adjustment required to the 2019 deficit (0.3 points of GDP could be sufficient). The government (supported by Social Security estimates) has already identified €1.7 billion of reduced expenditure for the "citizen's income" and €1.3 billion for early retirement, representing a total of €3 billion and 0.2 points of GDP. It has announced that it has unblocked €2 billion related to cuts in expenditure and expects €3.2 billion of additional revenues. A total of €5.2 billion (0.3 points of GDP), sufficient to reduce the deficit to 2.1% of GDP in 2019.



This could avoid the opening of the excessive debt procedure and postpone discussions with the Commission to October when the 2020 draft budget will be presented. The government has undertaken to achieve a deficit of 2.1% in 2020, whereas the Commission is forecasting 3.5%. The room for manoeuvre is more restricted, but does exist. However, it requires political choices that could have consequences on the cohesion of the government. Reduced spending, amounting to 0.4 points of GDP, in respect of early retirement already seems possible due to lower than expected demand from eligible persons. Secondly, the €8.3 billion of revenues from the increase in VAT provided for in the Stability Programme (and not taken into account by the Commission) could be partially implemented (let's say a third, equivalent to 1 point of VAT, that could therefore provide 0.2 points of GDP from additional revenues).

To further reduce the deficit, political decisions would be necessary: i.e. reducing the government's two flagship measures, the universal basic income which involves a cost of €5.9 billion and early retirement, representing €8.3 billion in 2020. Secondly, waiving the reduction of the IRPP (*flat tax*), whose cost is estimated at €12 billion or financing it, at least partially, by a more general overhaul of the tax system, notably by removal of tax deductions (whose cost is estimated at €5-6 billion).

## Box 2

**Reopening of discussions on the “mini-BOT” scheme**

*An old idea of the League and aspect of the yellow-green government coalition contract, mini-BOTs generated much discussion a year ago. Conceived by the League, the mini-BOT scheme involves the recognition of debts for small amounts (between €5 and €100) circulating between public authorities and their suppliers, to enable public authorities to settle their debts with suppliers, and be used to cancel tax credits or to pay other public authorities, or even other suppliers. It would be a form of parallel currency (initially issued on a 1/1 parity with the euro, but which could subsequently be subject to a downward revision of the parity) that could serve to ensure a transition towards a withdrawal from the euro.*

*Having disappeared from the radar a year ago, this proposal returned to the table on 28 May during a non-binding motion in the Chamber concerning measures to accelerate the settlement of public authorities' overdue payments to suppliers. The inventory of late payments had reached €91 billion in 2012. Several measures were implemented for the payment of €45 billion. The parliamentary majority's motion, amended and voted by the opposition parties, provided, after verifying its feasibility with the Ministry of Finance, for the stabilisation of the clearing mechanism between trade receivables and fiscal debt (introduced in 2013) and the extension of this clearing system to government securities involving small amounts (mini-BOTs).*

*The context of the motion, with a highly consensual desire to accelerate payment terms, but also a not very accurate formulation of the details of the objective, misled Italian parliamentarians in the opposition who saw no risk in the situation. It is difficult to make accusations against the parliamentary majority, but the request for clarification came from the Bank of Italy: mini-BOTs will represent public authority debts with the private sector but are not recognised in existing debt and will be new debt whose immediate registration as public debt would increase the inventory of public debt by 2.4 points of GDP.*

*The central bank highlighted: making mini-BOTs a parallel currency would violate Article 128 of the TFEU and imply a withdrawal from the eurozone and the EU. The European Central Bank added: if it is debt, the inventory of debt increases, if it is currency, it is illegal, there is no third solution. The Italian Minister of Finance specified that no need justified the study of financing measures (of any type and even less of issues of sovereign securities involving small amounts) to resolve the problem of the €53 billion of overdue payments. Confindustria also gave its opinion as a representative of creditors: in the case of debt, mini-BOTs are pointless and it is better to issue debt securities and pay suppliers with the cash collected.*

*Mini-BOTs would not therefore be legal tender, they would be less liquid than money as they would be linked to the €53 billion of overdue payments (vs. €202 billion in circulation) and there would be no obligation for the private sector to accept them. They could play the role of a store of value like a debt security, but having no interest, there would be little incentive for the banking sector to discount them except with a haircut.*

*The rating agencies have given an opinion. For Moody's, their introduction is a factor likely to trigger a decline in the rating. For Fitch also, it would be a sign of not wanting to work within the framework of the European rules.*

## Banking sector: an additional test

**The Q1 results season ended for the seven banks in the sample<sup>1</sup> with a sense of déjà vu, with revenues under pressure (-7.7% year-on-year).**

The other components of the income statement differed little from the trends observed previously: good cost control and a further decline in the cost of credit risk. This enabled the banks to post cumulative net income (group share)<sup>2</sup> of €2.8 billion, down 13% year-on-year, and an improvement in ROE (net income/regulatory capital) over the last three quarters to 7.8%, vs. 8.4% in Q1 2018.

**The deterioration in the macro-economic environment observed during H2 2018 is not foreign to this situation** and the very low growth prospects for 2019 and 2020 are again expected to adversely affect banks' results. This deterioration has impacted credit activity, both the variation in outstandings and new business. In terms of outstandings, the slowdown has been gradual and was confirmed in April. The year-on-year variation in outstanding loans to private residents<sup>3</sup> (households, companies and non-banking financial sector) came to 0.8% in April 2019 (2.6% for households and -0.6% for non-financial companies (NFC)), vs. 2.9% one year earlier. The deterioration in the economic climate is affecting new loan business, both to NFCs and households. While new business for the quarter was higher year-on-year (+2.8% at end-March), it declined by 5.7% in Q1. Interest rates on deposits have been moving around 0.35% and 0.43% for several quarters, while rates on outstanding loans are also fixed at a level still adversely affecting banks' revenues.

In this sluggish environment, the **still high rate of NPLs (10.5% at 31/12/2018 vs. 15% at end-2017)** and *sofferenze* loans (gross ratio of 5.4% at 31/03/2019 vs. 9.2% a year ago) in banks' balance sheets is fuelling the negative perception concerning them, despite constantly improving fundamentals. However, there should no longer be any doubt regarding their capacity to settle this painful legacy, as demonstrated by the extent of the reduction in the NPL inventory between 2016 and 2018 (-€144 billion) and the estimated amount of disposals expected for 2019 (around €30-40 billion). Nonetheless, the percentage of NPLs remains well above the European average of 2.8%. The latest statements by Andrea Enria, Chair of the Supervisory Board of the ECB, demonstrate that regulators' expectations remain high and that banks must continue to work to significantly reduce the size of their inventory of non-performing loans in the near future.

Moreover, the "Carige" saga is not foreign to the still dented image of the Italian banking sector. The withdrawal of the North-American asset manager BlackRock, the only contender with a firm takeover

offer, a few days before the deadline of 17 May, has left a bitter taste. The press has echoed numerous hypotheses of a takeover involving foreign fund players (Blackstone, Warburg Pincus). The latest information transmitted concerns the Apollo Fund. It has supposedly submitted an offer requiring a capital increase of €450-500 million, or less than the capital increase of €630 million recommended by the administrators and in which it would participate for an amount of €120/130 million. The envisaged financial arrangement does not seem very credible since the FITD is expected to convert the €320 million bond issued in the autumn into shares, taking its stake in Carige to more than 51%, in contradiction with its articles of association. Today, the outcome remains uncertain and the voices are discordant on the issue. Firstly, in terms of the banks, Unicredit would tend to be inclined to help Carige in order to maintain the stability of the Italian financial system whereas Intesa and BPER have proved reluctant to finance an additional rescue (BPER having recently been cited as a potential takeover candidate). In terms of the government, the divergences have been highlighted by the press, with the hypothesis of a preventive recapitalisation evoked by the Minister of Infrastructure and Transport, of the League, a solution ruled out by M5S. Meanwhile the majority shareholder (27%), Malacalza Investimenti, has said that it is prepared to do everything to support the Genoa-based bank, despite its opposition last December to the capital increase. For the administrators appointed by the ECB, whose mandate has been renewed until September, the issue of the takeover is essential in order to contain the flight of deposits. However, the takeover will only take place after the disposal of an inventory of non-performing loans, crucial to any takeover solution.

Whereas the structural reforms launched in 2015 are now behind us, aggregation of BCC banks and conversion of *popolari* banks into joint-stock companies (although two *popolari* banks still have to be transformed), there is still the issue of the number of institutions in difficulty in this fragmented banking landscape (505 banking players operate in Italy including 31 *popolari* banks not concerned by the conversion). The expected vote between now and the end of June of a tax measure enabling banks in the south of the country to benefit from tax relief of up to €500 million on the losses related to a merger process should also make it possible to continue with this consolidation and improvement trend for the benefit of the entire system.

However, with the threat of the European Union opening an excessive deficit procedure against Italy, the political risk has re-emerged for the banks, due to their exposure to Italian government securities whose amount has increased to reach €402 billion at end-April (vs. €376 billion at end-December 2018).

<sup>1</sup> Sample of 7 banks representing 59.4% of total banking assets at 31/03/2019: Unicredit, Intesa, Monte Paschi, UBI, Banco BPM, BPER and Credem. Carige was withdrawn from the sample.

<sup>2</sup> Includes for Unicredit the net impact of €320 million for the write-back of provisions related to the agreement with the North-American authorities.

<sup>3</sup> Data adjusted for securitisations.

The BTP-Bund spread stood at 276 basis points on 6 June, the highest level since the beginning of the year, generating fears of a deterioration in solvency ratios at end-June. **Apart from the deterioration in the economic environment, sovereign risk is therefore an additional shadow hovering over the sector.** ■

*Written on 19 June 2019*

# Italy: economic overview at 19 June 2019

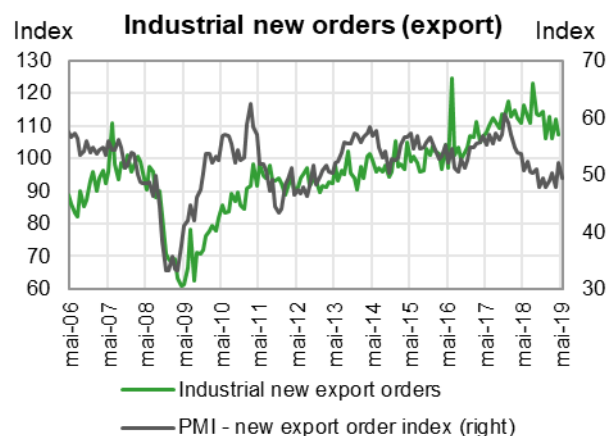
CRÉDIT AGRICOLE S.A.

Yearly average  
(YoY, %)

Italy	2018	2019	2020	2021
GDP	0,7	0,2	0,4	0,6
Households consumption	0,6	0,5	0,6	0,6
Investment	3,2	1,6	1,3	2,4
Change in inventories*	-0,1	-1,0	0,1	0,0
Net exports*	-0,1	0,6	-0,1	-0,0
Unemployment	10,6	10,3	10,2	10,1
CPI	0,8	0,0	0,1	0,9
Government net borrowing	2,1	2,2	2,9	2,7

\* Contributions to GDP growth

Source : Crédit Agricole S.A., forecast

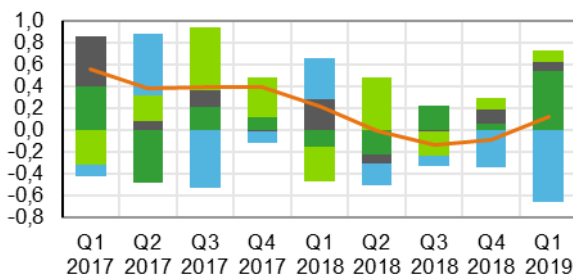


Source : Istat, Markit, Crédit Agricole S.A. Base 2015 = 100

After the timid rebound in activity in Q1, we have slightly revised our annual average forecasts for 2019 from 0.1% to 0.2%.

Foreign orders have declined since the beginning of the year, which means we do not expect a healthy export momentum.

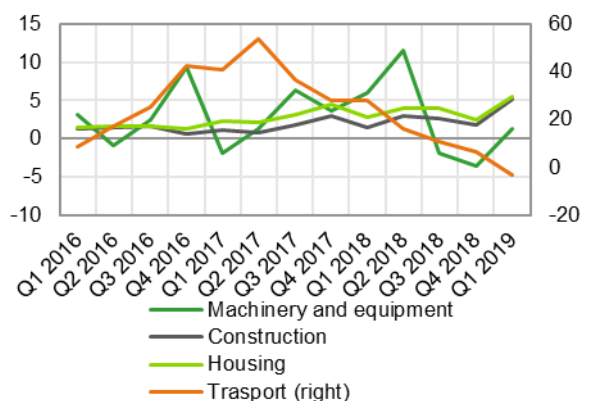
## Italy : Contribution to GDP Growth



Changes in inventories Investment  
Private consumption Net exports  
GDP

Sources : Istat, Crédit Agricole S.A.

## Investment by type

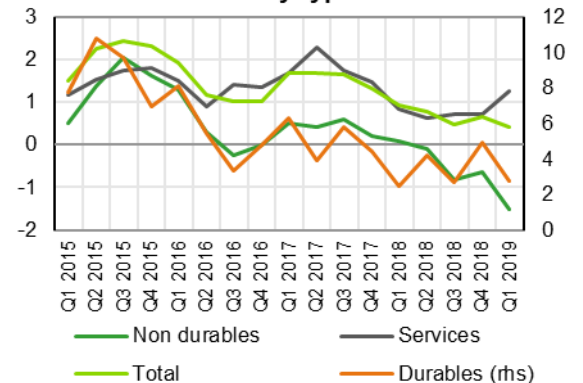


Source : Istat, Crédit Agricole S.A.

Inventory change had a very negative impact on growth in Q4 2018 and Q1 2019, but the slowdown in domestic demand is a source of concern.

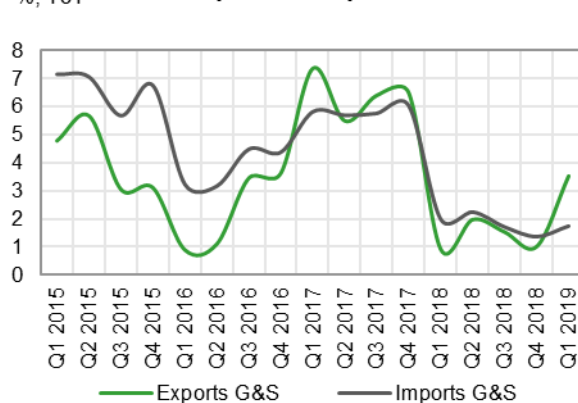
Investment in machinery/equipment and transport decreased in Q1 2019.

## Households consumption by type



Sources : Istat, Crédit Agricole S.A.

## Exports & Imports



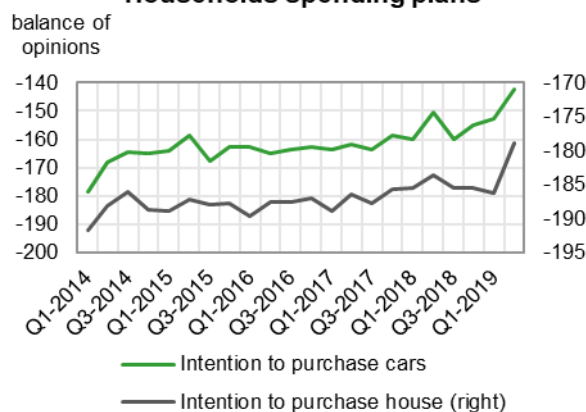
Source : Istat, Crédit Agricole S.A.

The durable goods consumption cycle is in the process of running out of steam, but remains positive.

Net exports have made a positive contribution to growth but the global environment remains hostile.



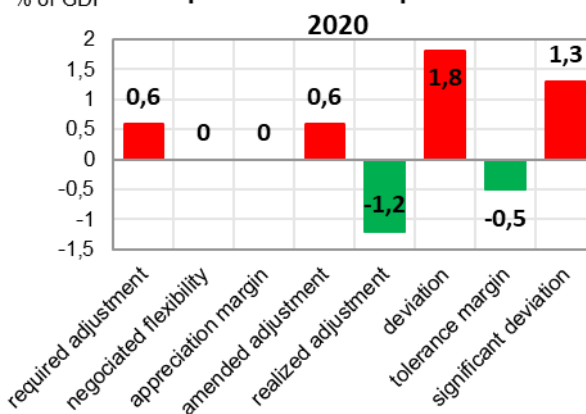
### Households spending plans



Sources : Istat, Crédit Agricole S.A.

Durable goods purchase intentions are at a historically high level and continue to point to an ongoing consumption cycle.

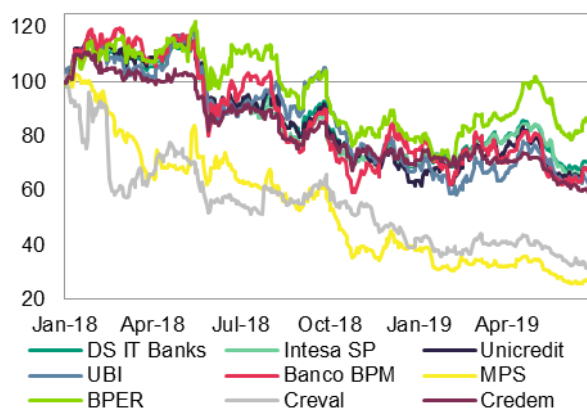
### Compliance with European rules :



The government has undertaken to achieve a deficit of 2.1% in 2020, whereas the Commission is forecasting 3.5%.

### Evolution of Italian banks' shares

1/1/2018=100

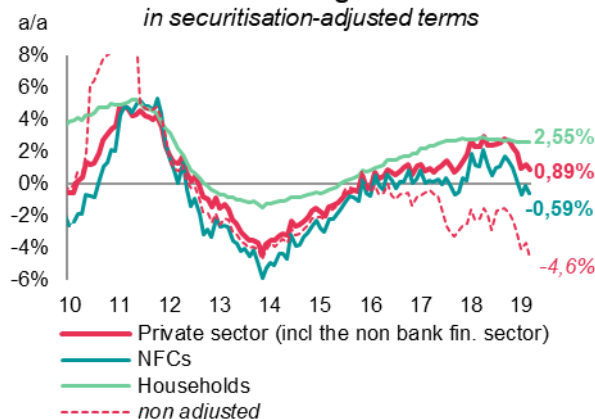


Sources: Datastream, Crédit Agricole S.A./ECO

Already under pressure, Italian banks' share prices have plummeted even further following Matteo Salvini's statements in mid-May.

### Change in private sector outstanding loans

in securitisation-adjusted terms

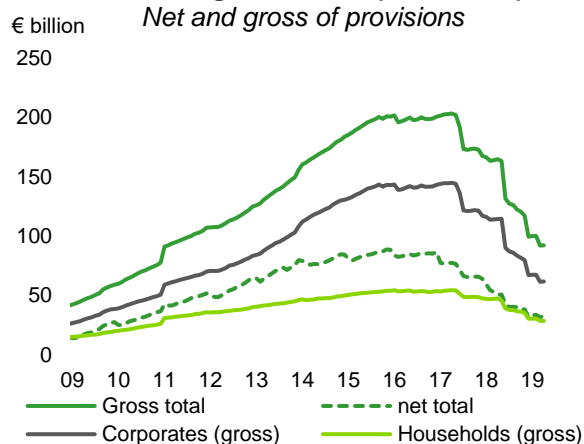


Sources: Datastream, Bank of Italy, Crédit Agricole S.A./ECO

The variation in outstanding loans (adjusted for securitisation) is still moving in positive territory (+0.8% year-on-year) but there is a clear slowdown in trends.

### Outstanding Bad Debts (sofferenze)

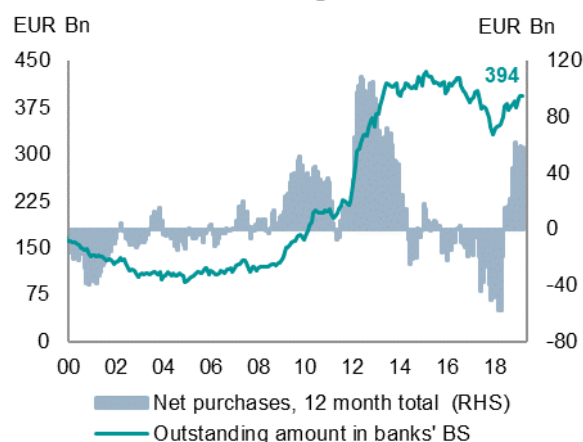
Net and gross of provisions



Sources: Datastream, Bank of Italy, Crédit Agricole S.A./ECO

Outstanding *sofferenze* loans have reduced considerably to €92 billion (gross) and €32 billion (net), taking the ratios on outstandings to 5.4% and 1.9% respectively.

### Italian Sovereign Assets



Sources: Datastream, Bank of Italy, Crédit Agricole S.A./ECO

The amount of sovereign securities in banks' balance sheets has risen by 15.5% year-on-year and by 7% compared with December 2018 to €402 billion at end-April 2019.



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Date	Title	Theme
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13/05/2019	<u>France –2019-2020 Scenario: 2019, Gains in purchasing power will limit the growth slowdown</u>	France
07/05/2019	<u>France – Political issues: Response to the Great Debate</u>	France
06/05/2019	<u>Italy Monthly digest</u>	Italy
26/04/2019	<u>Germany – 2019-2020 scenario: a more marked slowdown in growth</u>	Germany
12/04/2019	<u>World – Macroeconomic Scenario for 2019-2020: prevention better than cure</u>	World, Scenario
12/04/2019	<u>World - Macroeconomic Scenario for 2019-2020: Economic &amp; financial forecasts</u>	World, Forecasts
09/04/2019	<u>Italy – Economic environment: Macroeconomic and banking review</u>	Italy, Macroecono, banks
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