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Macroeconomic Imbalances - France 2014

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

France continues to experience *macroeconomic imbalances, which require specific monitoring and decisive policy action*. In particular, the deterioration in the trade balance and in competitiveness as well as the implications of the high level of public sector indebtedness deserve continuous policy attention. The need for decisive action so as to reduce the risk of adverse effects on the functioning of the French economy and of the euro area is particularly important given the size of the French economy and potential spillovers onto the functioning of the euro area. Given the need for policy action already called in the 2013 IDR, the Commission will put in motion a specific monitoring of the policies recommended by the Council to France in the context of the European Semester, and will regularly report to the Council and the Euro Group.

More specifically, the growing trade deficit reflects the long-term decline in export market shares which is linked to persistent losses in both cost and non-price competitiveness. Despite measures taken to foster competitiveness, so far there is limited evidence of rebalancing. While wages have developed in line with productivity, the labour cost remains high and weighs on firms' profit margins. The low and decreasing profitability of private companies, in particular in the manufacturing sector, may have hampered their ability to grow and improve their export performance. The unfavourable business environment, and in particular the low level of competition in services, further aggravate the competitiveness challenge. In addition, rigidities in the wage setting system result in difficulties for firms to adjust wages to productivity. Despite measures taken to reduce the government deficit since 2010, public debt has continued to increase, which calls for continued fiscal consolidation and, given the high level of public expenditure, for specific focus on spending cuts, notably through the search for efficiency gains. France is projected to miss both headline deficit and structural adjustment targets over the entire forecast period.

Excerpt of country-specific findings on France, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that France was experiencing macroeconomic imbalances and indicated that decisive policy actions were necessary. The imbalances concerned in particular the deterioration in the current account and in competitiveness as well as the high general government sector debt. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of an imbalance in April, to examine further the persistence of imbalances or their unwinding. To this end this IDR provides an economic analysis of the French economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **The determinants which supported the French economy at the height of the economic crisis are now hampering the recovery.** France was initially less affected by the crisis than neighbouring economies. The relatively limited openness to external trade, the large automatic stabilisers together with the absence of a significant credit bubble in the years ahead of the crisis, translated into a comparatively stronger resilience. In 2011 and 2012, GDP growth remained subdued, albeit significantly above the euro area. The pace of recovery has been insufficient to put the unemployment rate on a downward path. Moreover, the rising imbalances related to export competitiveness and to the high and increasing level of public indebtedness cast doubts on the sustainability of the French economic recovery.

- **The on-going deterioration in the current account and the international investment position represents a risk for the long-term sustainability of the French growth model.** France has experienced important losses in export market shares over the past few years (-14.0% between 2007 and 2012). While the current external position remains rather benign, the eroding export performance has resulted in a continuous deterioration in the current account which recorded a deficit of 2.2% of GDP in 2012 compared to a 1.0% of GDP surplus 10 years before. Contrary to developments in other deficit countries, limited signs of a durable rebalancing can be seen in France so far.

- **The high cost of labour and rigidities in the wage setting process weigh on the profitability of firms and on their ability to weather shocks.** While wage developments have generally followed the trend in productivity, France is among the euro area economies where the cost of labour is the highest. In particular, the high tax burden on labour reduces firms' profitability. The high minimum wage, together with policies which reduce the tax burden on labour for low-skilled workers result in a distortion in the wage distribution which may limit incentives for workers to increase their skills. In addition, rigidities linked to the wage setting process continue to limit the ability of firms to adjust wages in economic downturns.

- **The efforts to improve the non-cost competitiveness of French companies are hampered by their low profitability and increasing indebtedness**. While French exports are significantly sensitive to price developments, non-cost factors have also played a critical role in the deterioration in export performance. The low profit margins of French companies, which continued to deteriorate in 2012 notably due to a still increasing tax burden, led them to increase their indebtedness in order to finance investment. Although credit constraints appear moderate at this stage, such a situation may reduce their ability to invest and to effectively engage in export activities.

- **The relatively unfavourable business environment also contributes to the poor export performance of French firms.** France's ranking in the various international business environment surveys has deteriorated substantially over the last few years. The administrative burden continues to represent a limitation to the growth potential of companies, with a negative impact on their propensity to export. The low level of competition in services increases the cost of intermediary consumption and distorts the incentive structure between the tradable and non-tradable sectors.

- **The high general government deficit, together with a still rising public debt constitutes a major vulnerability, which calls for further adjustment.** France's government deficit increased sharply in 2009 as a result of the economic crisis. Since then, fiscal consolidation has been undertaken in order to bring the deficit below 3% of GDP by 2013, a deadline which has been extended to 2015. While risks to the medium-term sustainability appear moderate, the increase in public debt following the financial crisis means that the economy has become more sensitive to potential adverse economic events.

- **As the French economy is tightly interconnected with the other Member States, through both trade and financial channels, negative developments in France would potentially have a significant impact on the other euro area economies**. A failure to effectively address competitiveness challenges in France would result in a weaker potential growth domestically. The impact on the euro area of competitiveness enhancing reforms in France would also be positive as the increase in demand for trade partners would prevail over the relative loss in export performance they would suffer from. As the French GDP represents 21% of that of the euro area, sluggish demand growth in France would weigh significantly on the export potential of other euro area economies. In addition, France has played throughout the financial crisis a financial intermediation role, channelling in particular much needed financial flows to euro area peripheral economies. A deterioration in the financing conditions for France, which could eventually result from the growing imbalances, would have a destabilising impact on other euro area Member States.

The IDR also discusses the policy challenges stemming from these imbalances and possible avenues for the way forward. A number of elements can be considered:

- **Efforts to reduce the government deficit need to be enhanced, in line with the trajectory recommended by the Council, and specific attention should be given to reducing public expenditures.** Beyond the objective of bringing the nominal public deficit below 3% of GDP in 2015, further efforts will be necessary to durably put the public debt on a downward path. The high tax burden necessary to finance public expenditures, which are set to represent 57 % of GDP in 2013, leaves limited room to further increase public revenues. Therefore, the government needs to deliver on its commitment to achieve significant expenditure savings over the period 2014-2017, especially in the areas of social security and local governments. In light of the modest results of the efforts to increase the efficiency of public spending so far, ambitious actions will be needed to ensure that expenditure cuts are commensurate with the targeted deficit reduction and the announced further reduction in the cost of labour.

- **Beyond the measure already adopted to reduce the tax burden on labour, additional efforts are needed to support the profitability of companies.** The tax rebate for competitiveness and employment (CICE) which was adopted in 2012 is equivalent to a reduction in the cost of labour for companies of close to EUR 20 billion (1% of GDP). This measure only bridges part of the profitability gap of French companies compared to peers in the euro area. In addition, cost reductions are focused on the lower part of the wage distribution. While this aims to maximise the effect on employment, it reduces the impact on exporting companies as they generally pay higher wages. Measures to further reduce the cost of labour have been announced in January 2014 but little detail is available at this stage. If the targeting adopted for these additional measures is similar to that of the CICE, the impact on competitiveness will most likely be limited.

- **The business environment in France continues to constitute a barrier to firms' growth and export potential.** The "simplification shock" announced by the authorities has not yet resulted in significant measures for companies. There is still considerable room to enhance competition in services with a positive impact on intermediary costs. On the other hand, while important resources have been dedicated to innovation policy, in particular to the research tax credit and the

competitiveness poles, the outcomes appear modest and the efficiency of these schemes would need to be reviewed.

- **Rigidities and distortions on the labour market limit the possibility to adjust wages to productivity developments and may reduce incentives to increase skills.** The measures adopted in 2013 to increase flexi-security seem insufficient to ensure that wages can be adjusted for companies facing difficulties. The importance of the minimum wage in the overall wage setting framework and the limited existing exemptions contribute to wage rigidities and impact on the employment prospects of workers with low productivity. In addition, the social security contribution exemptions, which mitigate the negative impact of the minimum wage on employment for low-skilled workers, may distort the wage distribution and reduce incentives to increase skills. The on-going reflection on a further reduction in the cost of labour could represent an opportunity to foster a wage structure which better rewards skills and productivity improvement.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its third Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific "in-depth reviews" (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up it will recommend to the Council.

This is the third IDR for France. In the previous IDR, which was published on 10 April 2013, the Commission concluded that France was experiencing macroeconomic imbalances and indicated that decisive policy actions were necessary. The imbalances concerned in particular the deterioration in the current account and in competitiveness as well as the high general government sector debt. Overall, in the AMR the Commission found it useful, also taking into account the identification of an imbalance in April, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this IDR provides an economic analysis of the French economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

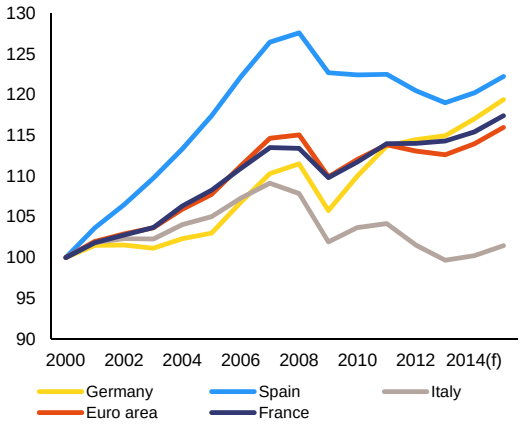
Section 2 provides a broad overview of macroeconomic developments in France. Section 3 focuses more specifically on the potential imbalances. It looks in details at developments in the current account and the impact on the external position. It discusses potential spillovers in the euro area. An analysis of the cost of labour and its main determinants is provided as well as an assessment of the potential impact on trade performance. The main drivers of non-cost competitiveness are also examined, with a specific focus on innovation. The section then concludes by reviewing developments in private and public indebtedness. Finally, based on the analysis presented in the previous section, Section 4 discusses policy avenues to address the imbalances identified.

2. MACROECONOMIC DEVELOPMENTS

The economy was considerably weakened by the global financial crisis

The impact of the global financial crisis was initially less dramatic in France than in the rest of the euro area. The sizeable automatic stabilisers, the absence of a pre-crisis credit boom as well as the relatively limited weight of exports (27% of GDP in 2007 compared to 42% in the euro area), all contributed to limiting the impact on the French economy of the sharp slowdown in international trade in 2009. Private consumption, which increased steadily in 2007-2010 at an average rate of 0.7% p.a., contributed to supporting economic growth. As a consequence, while the aggregate GDP for the euro area (in volume) is still below its 2008 level, the French GDP drop was more modest and it rebounded above its 2008 level already in 2011 (Graph 2.1).

Graph 2.1: **GDP in volume (2000=100)**

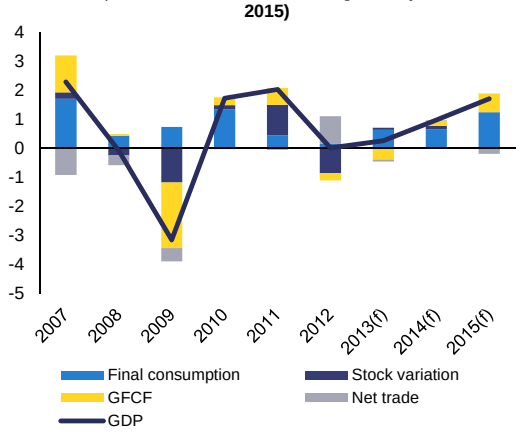


Source: Commission services

However, some of the factors which helped the economy weather the crisis now represent a drag during the recovery phase. The sluggish economic growth since 2010 has translated into a rapid increase in the unemployment rate which reached 10.8% in 2013, close to the 1997 record. The large general government deficit in 2009 and 2010 translated into a rapid increase in public debt to above 90% of GDP in 2012. Private indebtedness, driven in particular by the poor financial situation of non-financial corporations, continued to increase to 141% of GDP on a consolidated basis in 2012.

The continuous deterioration of export competitiveness and the financial constraints for domestic agents are expected to weigh on the recovery. Although France has avoided a prolonged recession, its growth pattern will remain irregular as limited impetus for growth exists. Notwithstanding the exceptional 1 pp. contribution of net exports to growth in 2012, export shares have declined steadily over the last few years (-13.6% in the last 5 years). This deterioration is rooted in both the low cost competitiveness and in the decreasing quality of French exports. Despite policy efforts, this development will therefore not be corrected in the short term (Graph 2.2).

Graph 2.2: **Contribution to GDP growth (2007-2015)**



Source: Commission services

Social indicators show that the crisis took its toll on the most vulnerable groups

Unemployment in France has increased rapidly as a consequence of the sluggish economic growth since 2010. In particular, as was the case in the euro area as a whole, the share of long-term unemployment increased significantly, from 2.9% of the labour force in 2008 to 4.1% in 2012. The situation of young people has particularly deteriorated, with the youth unemployment rate reaching 24.7%. In 2012, 12.2% of people aged 15 to 24 were neither in employment, education nor training, a 2 pps. increase since 2008. Evidence on the quality of employment shows that the situation has also deteriorated since 2008. The share of unemployed people obtaining a permanent contract, which was already on a decreasing trend, fell from 31.4% in 2008 to 30.3% in 2012. Conversely, the share of part-time workers

increased from 16.8% to 17.7% of employment over the same period.

Accordingly, the difficulties faced on the labour market are reflected in increasing poverty rates since 2008. 19.1% of the French population was at risk of poverty ([1]) in 2012, representing 11.8 million people. Thanks in particular to relatively generous social transfers, this ratio is below the euro area average. However, the number of people at risk at poverty has increased since 2008 (by close to 600 000). In particular, in-work poverty has increased in the last two years with 8.0% of employees being at-risk-of-poverty in 2012. Such a development suggests that both the unemployment level and the conditions of employment are at stake. In particular, the Gini coefficient of equivalised disposable income, which measures the degree of inequality in the income that households receive once taxes and social contributions are taken into account, has increased in France between 2007 and 2012 from 26.6 to 30.5. This signals a significant increase in income inequality. By comparison, in the European Union as a whole, the Gini coefficient has remained stable and has decreased in Germany and Italy.

Medium-term growth prospects remain bleak despite a relatively strong potential

According to the Commission Winter 2014 forecast, GDP growth is expected to remain below potential in 2014 and to accelerate only moderately in 2015. Despite a rebound in external demand, net trade is set to contribute only marginally to growth in the medium term. Regarding domestic demand, the high and increasing unemployment level is expected to weigh on disposable income while precautionary savings limit the potential for private consumption growth. Moreover, up to 2015, investment is expected to remain constrained by the lack of demand and the poor profitability of companies. Finally, the continued fiscal consolidation provides little space for a public boost to growth.

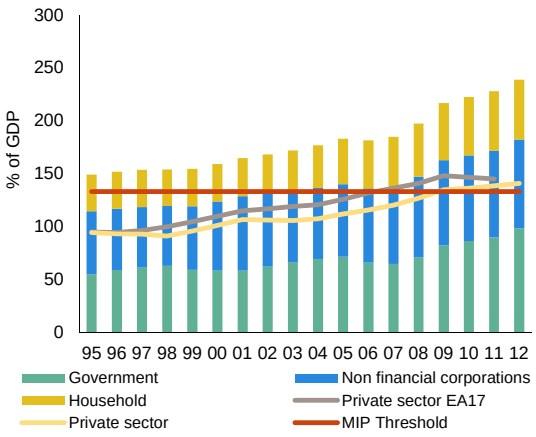
While growth will remain anaemic in the short term, France exhibits a stronger potential growth than the euro area, albeit much below pre-crisis levels. Potential growth in France is expected to stay at 1.0% over 2013-2015. This is clearly above the potential growth rate for the euro area (0.4% in 2013, rising to 0.7% in 2015). However, this represents an important slowdown compared to the 1.8% p.a. average growth between 2000 and 2007 and point to a permanent impact of the financial crisis. Much of this slowdown comes from a fall in total factor productivity growth, from about 1% in 2001 to 0.4% in 2013. In addition, the rising structural unemployment weighs on labour contribution and partly offsets the increase in working age population and in the participation rate. On the contrary, capital accumulation supported potential growth throughout the crisis. In the longer term, while total factor productivity growth will remain close to its 2013 rate, the 0.5% p.a. increase in working age population, together with a relative stabilisation in structural unemployment and a slight increase in the participation rate, is expected to translate into a positive contribution of labour to potential growth.

Deleveraging needs in the private sector appear moderate

The level of consolidated private debt has continuously increased over the last decade to reach 140.7% of GDP in 2012 (Graph 2.3**).** While high in a historical perspective, this ratio remains slightly below the euro area average. This is mainly explained by the relatively lower level of household debt in France. However, household debt, which rose during the years leading up to the crisis has not fallen since as adjustments in the real estate sector are still ongoing. While household debt does not appear particularly worrying, the increasing debt service and potential deleveraging pressures could potentially affect private consumption. Finally, the continuous rise in unemployment and sluggish GDP growth will both weigh on household credit worthiness over the medium run.

([1]) People at risk of poverty are those with an equivalised disposable income (after tax) representing less than 60% of the average.

Graph 2.3: **Debt decomposition, consolidated**



Source: Commission services

While the level of debt to GDP of French non-financial companies has kept rising over the last few years, their leverage is not particularly high compared to euro area peers. Debt to GDP of French non-financial companies (NFC) continued increasing in 2012 to a level above the euro area average. In contrast, debt to equity fell in 2012 (50%) below the euro area average (68.9%). However, the moderate potential for further private consumption growth combined with the poor profitability of French companies is a potential source of concern. The reduction in non-financial companies' gross operating margins has indeed affected companies' ability to invest and innovate but may also translate into difficulties for firms to service their debt as reflected in the increase in the number of bankruptcies in 2013.

French banks generally resisted well during the financial crisis and made progress in meeting new solvency requirements although potential risks remain. The French banking system, which is dominated by five large institutions, remained resilient during the financial crisis years due to the robust retail sector. With a 6.8% return on equity and a 0.4% return on assets in June 2013 ([2]), the profitability of French banks, while lower than in 2012, remains above the average in the euro area. Furthermore, progress in meeting solvency requirements as banks strengthened their balance sheets and the reduction in liquidity risks, together with the measures adopted by the ECB were reflected in the improvement of banks' financing conditions via a reduction in bank yields in 2012. Despite banks' deleveraging, there have been no signs pointing towards a credit tightening by banks to enterprises. Investment constraints indeed appear to be mostly explained by weakened loan demand and more reliance on market financing by NFCs. However, downside risks to the French banking sector may arise from banks' over-reliance on wholesale funding. This could potentially translate into liquidity risks in the event of a shock in wholesale funding. Furthermore, the exposure of French banks to peripheral economies of the euro area could also be a source of concern if tensions in sovereign debt markets were to arise.

([2]) Source: ECB's Statistics on Consolidated Banking Data

Public deficits, which were already high before the crisis, remain excessive and affect government's debt adversely

France has experienced increasing fiscal imbalances for the last 40 years: the general government balance was last at surplus in 1974. In the last 20 years, the public deficit has systematically remained close to 3% of GDP if not above. France entered the Excessive Deficit Procedure in 2009 but this was only partly due to the impact of the economic and financial crisis, with the deficit already very close to the 3% of GDP threshold in 2007. The deadline for correcting the excessive deficit has since been extended twice notably due to worse than expected macroeconomic developments. The current deadline is 2015. Importantly, the cyclically-adjusted balance has also been systematically negative over the last few decades (-3.3% of GDP on average over 1978-2013). This means that, beyond the effect of the economic cycle on fiscal metrics, expenditure has systematically exceeded earnings. The ratio of public expenditure to GDP, forecast at some 57.2% in 2013, is the third highest in the euro area after Slovenia and Finland.

As a consequence, the general government debt has increased almost continuously since 1990, a trend which has accelerated since the start of the crisis, with the debt ratio expected at 93.9% of GDP in 2013. This was slightly below the euro area average of 95.5% of GDP but clearly above the reference value of 60% specified in the scoreboard and referred to in Article 126(2) TFEU. The threshold was first exceeded in 2003 and the debt has been almost continuously on an upward trend since then. Despite this trend France has weathered the euro area sovereign debt crisis

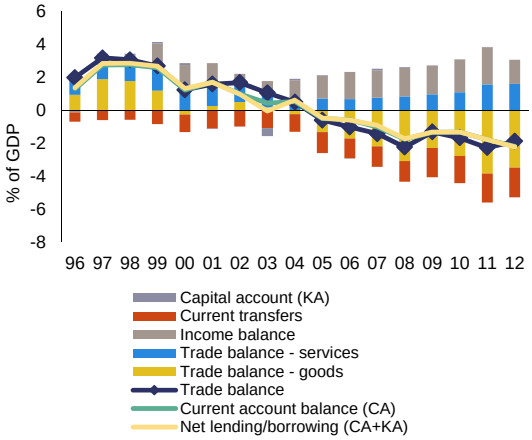
without experiencing major tensions on sovereign yields so far. The latter have actually fallen below historical levels, with increased risk aversion supporting German bunds and filtering through to other euro area economies including France to the detriment of peripheral economies. This has helped contain interest payments but also prevented negative spillover effects to the financial sector and the real economy. According to the Commission Winter Forecast, the debt ratio is set to continue increasing up to 97.3% of GDP in 2015.

The deterioration in trade performance has resulted in an increasing current account deficit

The trade balance has been decreasing steadily since 1997 from a surplus of 3.2% of GDP to a deficit of 1.9% of GDP in 2012 (a slight improvement compared to the record deficit of 2.3% of GDP in 2011). Most of this development is due to the rapid deterioration in the trade balance for goods (Graph 2.4). The energy deficit, linked in particular to increasing oil prices, contributed to 50% of the increase in the trade deficit between 2004 and 2012. However, France has also lost ground in non-energy goods and services. A review of cost developments shows that export prices explain a limited share of these developments. In 2013, the trade balance deficit has decreased due to a contraction of both imports and exports in goods and to a good performance of services. In its Winter forecast, the Commission expects that, despite measures to reduce the cost of labour and improve competitiveness, the trade deficit will remain stable in 2014 and 2015 due to a recovery of internal demand which will lead to higher imports.

As a consequence of the deteriorating trade balance, the current account balance, which was still at a surplus of 2.8% of GDP in 1998, recorded growing deficits from 2005 on, reaching 2.2% in 2012. While current transfers have remained steady over the last 10 years, the income balance, which still remains positive thanks to the revenues from French investments abroad, has decreased by 44% in 2012. Within the forecast horizon, the current account balance is expected to stabilise, in line with the trade balance. After an improvement in 2013 to 1.9% of GDP, the current account deficit is set to increase somewhat to 2.0% of GDP in 2014 and 2.2% in 2015.

Graph 2.4: **Decomposition of external position**



Source: Commission services

The evolution of the current account is mirrored by a sharp decrease in the net international investment position (NIIP) over the last five years. The NIIP, which was in surplus still in 2006, recorded a deficit of 21% of GDP in 2012. Large valuation effects, which have not been compensated since then, contributed to the drop in the NIIP seen in 2008. However, these do not fully explain the deteriorating trend and the still significant current account deficit will continue to weigh on the NIIP in the medium term. In terms of composition, the NIIP is increasingly financed by interest-bearing instruments, as the increase in external debt shows. This development is in particular driven by the increasing holding of public debt securities by foreign investors (representing close to 50% of GDP). The increasingly negative NIIP will impact on the income balance which could become negative in the future, making the rebalancing of the current account even more difficult.

Table 2.1:

Key economic, financial and social indicators - France	2007	2008	2009	2010	2011	2012	Forecast 2013	2014	2015
Real GDP (yoy)	2.3	-0.1	-3.1	1.7	2.0	0.0	0.3	1.0	1.7
Private consumption (yoy)	2.4	0.2	0.3	1.6	0.6	-0.3	0.4	0.6	1.6
Public consumption (yoy)	1.5	1.3	2.5	1.8	0.4	1.4	1.7	1.2	1.4
Gross fixed capital formation (yoy)	6.3	0.3	-10.6	1.4	2.9	-1.2	-1.9	0.9	3.3
Exports of goods and services (yoy)	2.3	-0.3	-12.1	9.5	5.4	2.4	0.6	4.4	5.6
Imports of goods and services (yoy)	5.5	0.9	-9.6	8.9	5.1	-1.1	0.7	4.0	5.8
Output gap	2.8	1.3	-2.8	-2.1	-1.1	-2.0	-2.6	-2.5	-1.8
Contribution to GDP growth:									
Domestic demand (yoy)	3.0	0.5	-1.5	1.6	1.0	-0.1	0.3	0.8	1.9
Inventories (yoy)	0.2	-0.2	-1.2	0.1	1.1	-0.9	0.1	0.1	0.0
Net exports (yoy)	-0.9	-0.3	-0.5	0.0	0.0	1.0	-0.1	0.0	-0.2
Current account balance BoP (% of GDP)	-1.0	-1.7	-1.3	-1.3	-1.8	-2.2	.	.	.
Trade balance (% of GDP), BoP	-1.4	-2.2	-1.3	-1.7	-2.3	-1.9	.	.	.
Terms of trade of goods and services (yoy)	1.3	-0.7	2.8	-1.5	-2.2	-0.7	0.6	-0.7	-0.1
Net international investment position (% of GDP)	-1.5	-12.9	-9.4	-12.5	-18.8	-21.1	.	.	.
Net external debt (% of GDP)	10.8	19.1	21.3	29.7	29.2	35.0	.	.	.
Gross external debt (% of GDP)	174.7	181.4	190.1	198.8	199.7	200.3	.	.	.
Export performance vs. advanced countries (5 years % change)	-9.4	-11.7	-1.9	-5.3	-3.3	-5.0	.	.	.
Export market share, goods and services (%)	4.0	3.9	4.3	3.8	3.7	3.5	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	11.7	11.7	12.6	12.1	12.2	11.7	.	.	.
Private credit flow (consolidated, % of GDP)	11.9	9.7	3.9	4.9	6.2	3.5	.	.	.
Private sector debt, consolidated (% of GDP)	120.1	126.7	134.6	136.3	138.4	140.7	.	.	.
Deflated house price index (yoy)	3.6	-1.9	-5.6	3.7	3.6	-2.3	.	.	.
Residential investment (% of GDP)	6.7	6.7	6.0	5.9	6.1	6.1	.	.	.
Total Financial Sector Liabilities, non-consolidated, (% of GDP)	13.1	2.5	0.2	3.1	7.3	-0.1	.	.	.
Tier 1 ratio (1)	.	8.4	10.1	10.7	10.9	13.3	.	.	.
Overall solvency ratio (2)	.	10.3	12.2	12.6	12.2	14.0	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	2.6	3.1	4.3	4.5	4.6	4.5	.	.	.
Employment, persons (yoy)	1.7	-0.2	-1.7	0.9	0.8	0.0	-0.3	-1.1	1.1
Unemployment rate	8.4	7.8	9.5	9.7	9.6	10.2	10.8	11.0	11.0
Long-term unemployment rate (% of active population)	3.4	2.9	3.4	3.9	4.0	4.1	.	.	.
Youth unemployment rate (% of active population in the same age group)	19.8	19.3	24.0	23.7	22.9	24.7	25.5	.	.
Activity rate (15-64 years)	69.9	70.0	70.5	70.5	70.4	71.0	.	.	.
Young people not in employment, education or training (% of total population)	10.3	10.2	12.4	12.4	12.0	12.2	.	.	.
People at-risk poverty or social exclusion (% total population)	19.0	18.5	18.5	19.2	19.3	19.1	.	.	.
At-risk poverty rate (% of total population)	13.1	12.5	12.9	13.3	14.0	14.1	.	.	.
Severe material deprivation rate (% of total population)	4.7	5.4	5.6	5.8	5.2	5.3	.	.	.
Persons living in households with very low work intensity (% of total population)	9.6	8.8	8.4	9.9	9.4	8.4	.	.	.
GDP deflator (yoy)	2.6	2.5	0.7	1.0	1.3	1.5	1.1	1.3	1.3
Harmonised index of consumer prices (yoy)	1.6	3.2	0.1	1.7	2.3	2.2	1.0	1.2	1.2
Compensation of employees/head (yoy)	2.6	2.8	2.0	2.5	2.5	2.2	1.6	1.3	1.6
Labour Productivity (real, person employed, yoy)	0.9	-0.6	-1.9	1.7	1.4	0.1	.	.	.
Unit labour costs (whole economy, yoy)	1.7	3.2	3.7	0.7	1.2	2.1	1.0	0.7	0.4
Real unit labour costs (yoy)	-0.9	0.7	3.0	-0.3	-0.1	0.6	-0.1	-0.6	-0.9
REER (ULC, yoy)	1.3	1.6	0.8	-1.9	0.5	-2.1	2.9	1.3	-0.8
REER (HICP, yoy)	0.6	1.5	0.4	-4.1	-0.7	-3.1	1.6	1.2	-0.7
General government balance (% of GDP)	-2.7	-3.3	-7.5	-7.1	-5.3	-4.8	-4.2	-4.0	-3.9
Structural budget balance (% of GDP)	-4.4	-4.1	-6.0	-5.8	-4.8	-3.7	-2.9	-2.5	-2.9
General government gross debt (% of GDP)	64.2	68.2	79.2	82.4	85.8	90.2	93.9	96.1	97.3

(1) domestic banking groups and stand-alone banks.
(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.
Source: Eurostat, ECB, AMECO.

3. IMBALANCES AND RISKS

3.1. EXTERNAL IMBALANCES: SUSTAINABILITY OF THE CURRENT ACCOUNT AND NIIP DEVELOPMENTS

3.1.1. Current account developments

The French current account balance has been on a downward trend for most of the last 10 years. After a slight improvement in 2009 and 2010 as a result of the crisis, the on-going deterioration in the current account resumed, up to a deficit of 2.2% of GDP in 2012. As mentioned in the previous IDR, most of this deterioration comes from the increasingly negative trade balance which showed a deficit of 1.9% of GDP in 2012. More precisely, trade in goods has shown increasing deficits while net service exports have remained positive. In 2013, the trade balance deficit narrowed significantly to 1.4% of GDP. This positive development is mainly linked to an improvement in the good balance on the back of lower domestic demand. This suggests that the improvement is mostly of a cyclical nature. Indeed, the Commission Winter forecast projects that, after a significant improvement in 2013, the current account deficit will stabilise in 2014 and 2015 as domestic demand picks up.

A sectorial decomposition of the current account developments shows that while households and financial companies are net lenders to the economy, the government and non-financial companies have continuously recorded deficits since 2000. Since the beginning of the 2000s, households have actually slightly increased their lending to the economy thanks in particular to the increase in precautionary savings. Most of the deterioration in the net borrowing position of the economy during that period came from increasing borrowing needs of the government and of non-financial companies. The government budget has recorded a deficit every year since 1974. In 2009, as a result of the financial crisis, the government deficit spiked at 7.5% of GDP in 2009 from 3.3% one year earlier. The government deficit has gradually abated since then but remains high (4.8% of GDP in 2012). The difficulties met by non-financial companies have also resulted in increasing borrowing needs, although they have also resulted in a slowdown in investment.

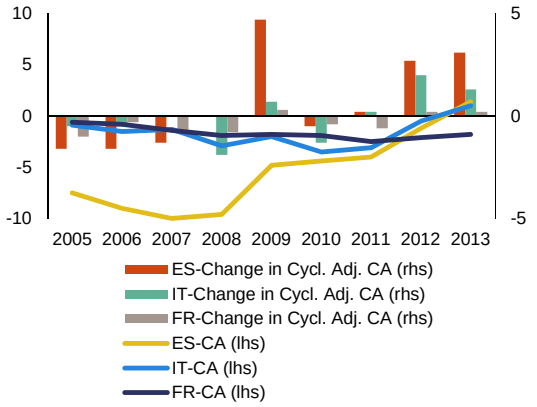
In 2012, the improvement in the French trade deficit for goods and services, to 1.9% of GDP, appears smaller than in most other countries in the euro area. This improvement reflects a slight contraction in imports together with a modest expansion in exports (+0.2 pp. of GDP). Such an improvement in the trade balance is observed in a majority of euro area countries and in most cases, its magnitude is larger than in France. The trade balance increased for example by 0.8 pp. in Germany, 2.6 pps. in Italy and 1.8 pps. in Spain. In addition, a number of euro area economies experienced a significant increase in exports (e.g. by 1.8 pps. and 1.4 pps. of GDP in Spain and Italy respectively) suggesting that improvements in export competitiveness since the start of the crisis have been much more significant in these economies than in France. In 2013, the deficit in the trade balance for goods, driven by a contraction of imports sharper than that of exports, decreased by 0.5 pp. of GDP. Meanwhile, the service balance increased by 0.1 pp, leading to a 28% improvement in the current account deficit.

The reduction in the trade balance deficit in 2012 was offset by a sharp decrease in the income balance. Revenues from French investment abroad brought the income balance to a record 2.3% of GDP in 2011. In 2012, the lower profitability of direct investment abroad and the slump in net revenues on debt securities, which became negative, contributed to a close to 10% fall in net revenues from investment. Consequently, the income balance fell back to its 2006 level. In 2013, a slight recovery of the income balance was recorded although its level remains significantly below the 2010-2011 historical high. In the longer term, the increasingly negative NIIP should lead to eroding net revenues from investment. Such a phenomenon will only add to the challenge of rebalancing the current account.

Cyclical conditions seem to have played a minor role in the deterioration of the current account. Imports in France are strongly impacted by the sluggish growth of domestic demand. In 2012, the output gap in France was much wider (-2.1% of GDP) than the average in the 40 largest trading partners (-1.5% of GDP). The poor export performance is therefore comparatively less accounted for by a low cyclical demand from trading partners. Overall, as shown in Graph 3.1,

adjusting for the position in the cycle actually deteriorates the current account balance (by 0.3% of GDP in 2012). Such a feature is common to most other euro area Member States except Germany, Ireland and Malta. However, France stands out as the only deficit country in the euro area where the structural deficit of the current account has increased since 2008 (by 0.5 pp. of GDP). In Spain and Italy, the large current account correction observed in the past few years is also partly due to cyclical conditions. Still the structural adjustment in the current account since 2008 for these two economies (7.1 pps. and 1.6 pps. of GDP respectively) suggests that rebalancing efforts have been much more pronounced than in France.

Graph 3.1: **Current account balance and variation in the Cyclically adusted CA (% of GDP)**

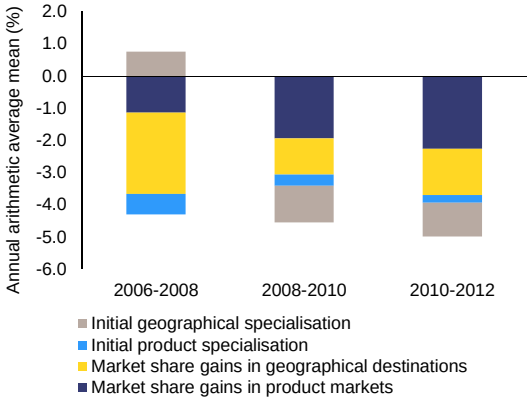


Source: Commission services

3.1.2. A deteriorating export performance

The poor trade performance reflects increasing difficulties for French products to compete on international markets. The French market share in exports of goods and services has been on a decreasing trend since 2004. While export growth has been positive every year except in 2009, its pace has been insufficient to keep up with the increase in international demand. Regarding goods, as can be seen from Graph 3.2, the geographic specialisation of France, whose exports are focused on the euro area, has played a negative role in the market share developments since 2008. Similarly, despite the importance of the high-tech sector in total exports (18.6% in 2011 compared to 13.4% in Germany and less than 10% in Italy and Spain), the product specialisation of France contributed negatively to its export performance. However, only a minor part of the poor goods export performance is linked to the initial specialisation and most of the deterioration comes from losses in the product and geographical markets where France is present.

Graph 3.2: **Geographical and sectoral composition of nominal (USD) rate of change of goods exports - France**



Source: Commission services

Both price and non-price developments have contributed to the poor export performance of French goods. Estimating export equations for France, Spain, Italy and Germany, INSEE (2013) shows that French exports are quite sensitive to price-competitiveness developments with a close to one-to-one impact of an increase in the real effective exchange rate (REER) on exports in the long term. By contrast, German exports are only marginally impacted by REER developments. While France and Germany experienced an appreciation in their REER based on consumer prices of a similar magnitude between 2000 and 2008, the negative impact on export performance was much more pronounced in France. The relatively strong sensitivity of French export to cost competitiveness is consistent with the findings by Sautard et al (2014) that a significant share of French exports focuses on price-sensitive product categories. Since 2000, export performance for these products has experienced a slump which the increasing exports of quality-related products could not offset. Still, econometrics studies indicate that the direct contribution of price factors to export performance is significantly lower than that of non-price related indicators. Estimates of the impact of cost developments on export market shares, in particular through the real effective exchange rate, show that price developments have only played a limited role in the deterioration of

the French trade performance (European Commission, 2011).([3]) Together, these findings confirm that improving France's export performance requires a two-pronged policy strategy based both on efforts to reduce costs and to promote non-cost competitiveness.

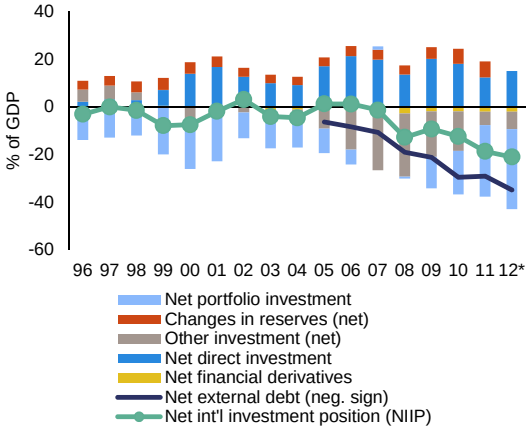
3.1.3. Impact on the international investment position

The net international investment position (NIIP) which was still in surplus in 2006, has recorded an increasing deficit since then. In 2012, the NIIP reached -21% of GDP while the net external debt represented 35% of GDP. The NIIP, which experienced a slump in 2008 due in particular to changes in valuation, has further deteriorated since then due to the current account deficit. In terms of composition, the net stock of foreign direct investments (FDI) continues to remain positive as, in the past, net flows of French investment abroad have been consistently higher than net flows of investment in France. Accordingly, most of the negative NIIP is financed by portfolio investments (Graph 3.3).

While the net FDI stock has been relatively stable, inward FDIs, an indication of the attractiveness of France for foreign investors, are decreasing. In 2012, France ranked as the world's tenth largest direct investor in the rest of the world and the 15th largest receiver of FDI.([4]) This position, which reflects the internationalisation of French corporates, remains strong but it has deteriorated substantially compared to 2008, a year when France was the 7th largest receiver and the 4th largest investor. Between 2008 and 2012, France's ability to attract investors was outperformed in particular by some large developing economies such as Brazil and India while, in the European Union, only the United Kingdom, Ireland, Luxemburg, and Spain appeared more attractive in 2012. Banque de France's monthly data on the balance of payments show that in 2013, inward FDI decreased by 82% compared to 2012. However, this was more than compensated by strong disinvestment abroad by French companies, bringing the net inflow of FDI into positive territory. This turnaround compared to historical trend may weigh on the NIIP.([5])

The stock of portfolio investment has been increasingly negative, reflecting the increasing borrowing needs of the French economy. In particular, since 2010, French financial institutions have reduced their exposure to foreign markets both by reducing their indebtedness vis-à-vis foreign sources and by selling foreign securities. This has resulted in rising net claims, recorded in the investment portfolio, together with a reduction in the foreign stock of "other investments", which include cross-border loans. Claims vis-à-vis public administrations represent the bulk of the flow in portfolio investment with the purchase of public securities by foreign investors contributing for EUR 21.8 billion to the overall EUR 39.2 billion flow. In 2012, foreign investors held for EUR 1 092 billion of the public debt, 62.2% of the total marketable public debt. ([6])

Graph 3.3: **Decomposition of Net International Investment Position**



Source: Commission services

While the current level of the NIIP does not point to significant risks, the dynamics could become worrying as the external debt burden

([3]) Similarly INSEE (2013) considers that over 2000-Q2 2008 non-cost competitiveness, which is captured through a negative trend in export volumes and through the export equation's residual, contributed -3.6 pps. to the annual export variation (compared to -0.9 pp. on average for the REER)

([4]) Source: United Nation Conference on Trade and Development (UNCTAD)

([5]) Due to sign conventions, net inflows of FDI contribute negatively to the NIIP. Data available from the Banque de France since 1997

([6]) While the absolute amount held by foreign investors has increased since 2010, the share of public debt held by foreign investors has actually decreased. This is mainly due to a lower weight of short-term bonds, which are favoured by foreign investors, and to increased holdings by French banks.

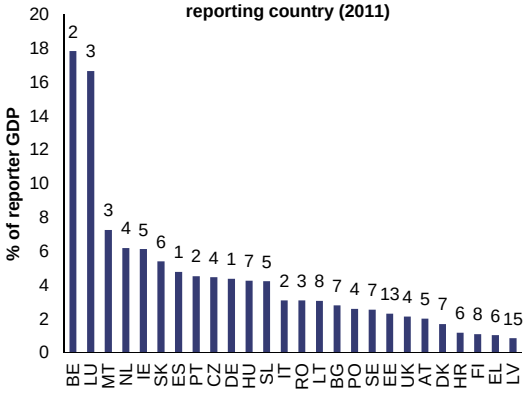
could weigh on future growth. Notwithstanding future potential valuation effects, stabilising its NIIP would require France to cut its current account deficit to 0.7% of GDP, a level last recorded in 2007. In order to halve the NIIP deficit by 2023, a current account surplus of 0.4% of GDP would need to be maintained for the next 10 years. On the contrary, if the pace of deterioration in the current account over the past 5 years (close to 0.2 pp. per year) was to persist, the NIIP deficit would reach 40% in ten years, excluding valuation effects. All things being equal, such an increase would mean that a larger share of domestic income is dedicated to paying interests and dividends to foreign investors. In addition, this would result in risks regarding the market perception of external debt, a large share of which consists in claims on the government. The potential hike in interest rates which could result from a change in the market perception of French debt would deeply affect public finances, making it necessary to record significant primary balances to cover an increasing interest burden. This could result in either a sharp contraction in public expenditure or even further tax increases, both with a recessionary impact. Moreover, if debt sustainability concerns were to increase in such a scenario, asset depreciation as well as more general financial contagion could hit France's euro area peers.

3.2. INTERLINKAGES WITH OTHER EURO AREA MEMBER STATES AND POTENTIAL SPILLOVERS

3.2.1. Trade and financial linkages between France and the rest of the euro area

France accounts for around 22% of overall euro area output, and is thus an important export destination for the other euro area countries. As shown in Graph 3.4, France is the main export destination for the large euro area countries such as Germany and Spain (exports to France amount to roughly 4 and 5% of their respective GDP) or the second most important for Italy (exports to France are approximately 3% of GDP). In Belgium and Luxembourg, exports to France even account for roughly 17% of GDP. Developments in the French domestic demand have strong spill-overs for euro area partners and a sudden drop would result in a significant slowdown for the area as a whole.

Graph 3.4: **Exports to France as a % of GDP in reporting country (2011)**



Note: Figures above the bars indicate the rank of FR among export destinations for each country.
Source: UNCTAD, Commission services, authors' calculation

France exports large volumes of final and intermediate goods and services to other euro area countries. In particular, French exports to Belgium and Luxembourg account for over 12% of their respective GDP and in both cases France is their third most important trade partner. French exports are also important for a number of other euro area countries, including the large economies such as Spain, Germany or Italy. In all of these countries' imports from France account for around 3% of GDP and France is their second biggest source of imports.

France features very strong financial linkages with other euro area countries and it plays an important financial intermediation role in the euro area. This can be seen from the geographical decomposition of the NIIP. The mildly negative overall NIIP is hiding rather significant net positions with different groups of countries, which points to its role as an intermediator of financial flows. In 2010, France held sizeable net foreign assets in the euro area countries which posted significant current account deficits before the onset of the crisis, amounting to around 30% of GDP. These were mirrored by important net liabilities to countries outside of the EU. A large share of these liabilities was with the US and also foreign central banks, which held French government bonds.

Throughout the crisis, France channelled much needed capital to euro area peripheral countries. Before the financial crisis, France, which was already among the important net originators of financial flows for deficit countries,

became the main source of financing once the crisis started and other investors withdrew. These flows predominantly took the form of debt instruments. Following the onset of the financial crisis, this exposure to the euro area periphery translated into the important valuation losses recorded on the French foreign portfolio.

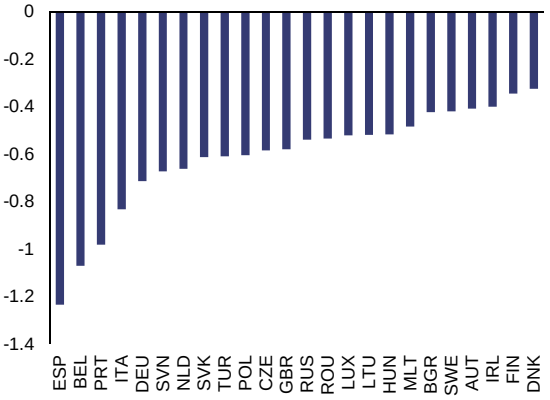
Strong interlinkages exist between the banking sectors in France and in other euro area countries. In 2012, claims on France represented close to 35% of GDP in the Netherlands and in the United Kingdom and almost 20% in Germany and Belgium. Regarding sovereign bond holdings in particular, 60 major non-French EU banks held EUR 75 billion of French public debt as of June 2013.([7]) A hike in financing rates on French securities could trigger a downward re-evaluation of asset prices which would have an important impact on these economies. Such a shock would also impact on French banks both through their holdings of French bonds and through the cost of capital. As French banks hold close to 45% of the total foreign liabilities of Italy, 20% of those in the Netherlands and Spain, and 10% in Germany, these potential difficulties could lead French banks to deleverage rapidly, with a significant destabilising impact on the external debt in other Member States.

3.2.2. France's imbalances and spillovers to the euro area

In the long term, failure to tackle structural challenges in France can adversely affect not only the French economy itself but also its euro area partners. So far, the French trade deficits have contributed to increasing the aggregate demand in the euro area, with limited negative spill-overs at this stage. Through its current account deficit, France actually helped boost the sluggish aggregate demand in the euro area. Indeed, most of the increase in the trade deficit in the last few years is related to trade with other euro area countries. Moreover, the French potential growth is expected to remain higher than that in the euro area up to 2015. However, in the longer run, the deteriorating external position could durably weigh on the French growth performance. The relative distribution of trade losses among France's trade partners associated with sluggish growth in France can be simulated based on a simple input-output framework following the recent work on the World Input-Output Database. Such an exercise takes into account the complex inter-sectoral and inter-regional links, which are important to properly assess the extent to which economic activity in one country spills over across borders. On the other hand, this linear exercise fails to reflect the general equilibrium effects and neglects other transmission channels for cross-border spill-overs such as FDI or other financial flows or labour flows.

The negative spill-over effects on other euro area countries of a deterioration in final demand in France are significant. As can be seen from Graph 3.5, a 10% decline in French domestic demand would result in exports decreasing by some 1.6% in Spain while Belgian and Portuguese exports would decrease by 1.1% and 1.0% respectively. Other euro area countries would also be affected although the magnitude of the impact would be lower. For example Italian, German, Slovenian, Dutch and Slovak exports to France would decrease by more than 0.5%. The overall effect for the euro area would be a reduction of total exports by 0.8%. The impacts on non-EU countries are more modest.

Graph 3.5: **Decrease in exports as a result of 10% decrease in French domestic demand**



Source: Authors' calculation based on the WorldInput-Ouput Database

Conversely, the benefits of policies to increase potential growth would benefit France itself and would also have direct and indirect effects on the rest of the euro area. Simulations based on the Commission's QUEST III model show that measures to bring France closer to best practices in

([7]) EBA 2013 EU-wide Transparency Exercise.

the euro area on a number of policy areas (including market competition and regulation, Research and development (R&D), taxes, labour market and education) would result in a substantial boost to GDP growth (European Commission, 2013a). Such reforms would also have tangible positive spill-overs on other euro area countries.([8]) In general spill-overs of supply shocks are more muted than those of demand shocks as, in the former case, the impact on trade partners of an increase in domestic income is gradually offset by competitiveness effects. More precisely, spill-overs are higher in the short run as structural reforms would increase domestic demand in France, and hence imports. In the longer term, increased income in the partner economies would stimulate higher imports and reduce the positive impact on partners' trade balance. In addition, the supply side reforms would lead to a decrease in relative costs and prices in France, which would boost its competitiveness and also induce some expenditure switching towards domestic production. Last, the improved returns on investments linked to higher competitiveness would increase capital inflows to France, including from outside of the euro area, exerting upward pressure on the euro. This could have an additional, albeit limited, dampening impact on the other euro area members. Countries that would benefit most from reforms in France in the first two years would include Portugal, Spain, Slovakia or Greece. Over the longer term, the spill-overs would weaken considerably but remain broadly positive (European Commission, 2013a).

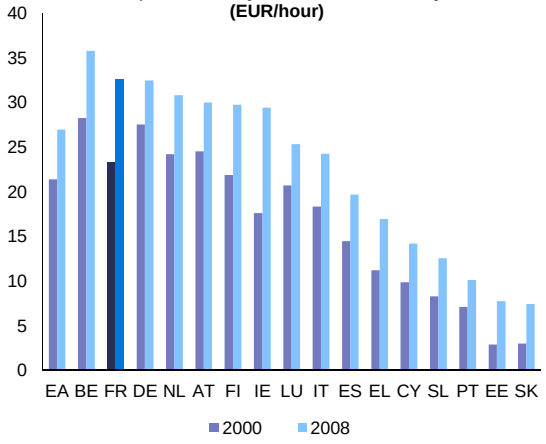
3.3. DEVELOPMENTS IN THE COST OF LABOUR IN FRANCE AND THEIR CONSEQUENCES FOR COMPETITIVENESS

While non-cost factors play a major role in France's poor export performance (see section 3.1.2), the price sensitivity of French exports suggests that efforts to regain competitiveness require improvements in cost factors. In particular, the cost of labour, which is higher in France than in most other economies in the euro area could be an impediment for exporters. Accordingly, this section will review the development in the cost of labour in relation to productivity and discuss its drivers. In particular, the institutional setting guiding wage dynamics will be reviewed in order to assess whether it entails rigidities which may impact on wage dynamics and competitiveness.

3.3.1. Cost of labour

France is among the euro areas economies where the hourly cost of labour is the highest. In the industrial sector, the hourly cost of labour stands at EUR 32.60 per hour (see Graph 3.6), second only to Belgium in the euro area and EUR 5.6 above the average. With a cost of labour of EUR 31.80 per hour in services (see Graph 3.7), France is even further away from the average in the euro area (EUR 25.5 per hour) in this sector. Moreover, hourly labour costs experienced strong increases over the last 10 years. Between 2000 and 2008, the hourly labour cost in the industrial sector rose by EUR 9.20 per hour, the second largest increase in the euro area after Ireland. In services, the hourly cost of labour also increased (by EUR 6.60 per hour) although to a lesser extent. These developments contrast with the moderate growth observed for example in Germany and Austria.

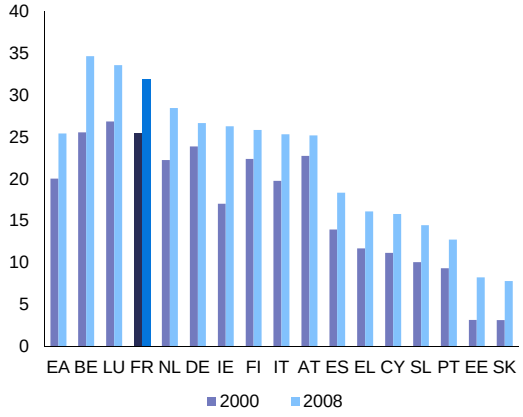
Graph 3.6: **Hourly labour cost - Industry (EUR/hour)**



Source: Commission services

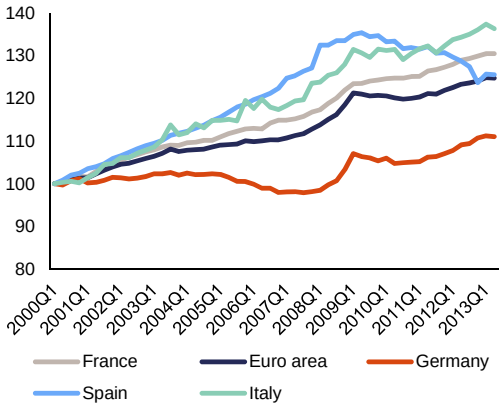
([8]) This exercise allows capturing full general equilibrium effects and considers also potential trade spill-overs. The simulations were based on measures closing half of the gap in structural indicators (e.g. tertiary education expenditure, share of high-skilled workers, entry cost, R&D subsidies, etc.) vis-à-vis the three best-performing countries in the EU. The expected gains in France result in particular from an increase in the labour market participation of senior workers.

Graph 3.7: **Hourly labour cost - Services (EUR/hour)**



Source: Commission services

Graph 3.8: **Unit labour cost in selected euro area economies (2000=100)**

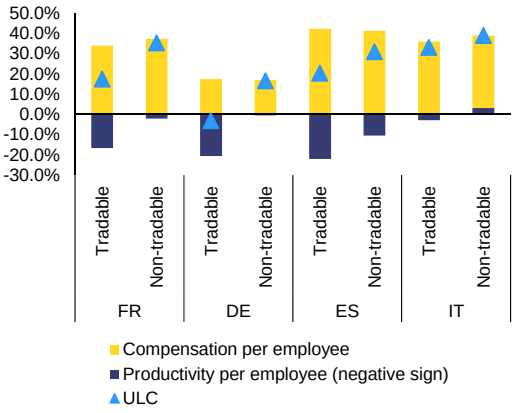


Source: Commission services

While the hourly cost of labour increased at a relatively rapid pace in France, so did productivity. As a consequence, over the last 20 years, the growth in nominal unit labour costs (ULC) has not significantly outpaced developments in other European economies (Graph 3.8). Three periods can be differentiated in the French nominal ULC growth historical trend. Up to 2000, ULC growth was more moderate in France than in most other larger euro area economies except Germany. Between 2000 and 2008, nominal ULC accelerated significantly growing by 2.0% per annum on average. Since 2008, the sluggish inflation and the rise in unemployment have resulted in moderate nominal wage dynamics and in a relative slowdown in nominal ULC developments. While ULC developments in France are mostly in line with those observed in the euro area as a whole, they stand in stark contrast with developments in Germany and Austria. In particular, over 2000-2008, wage moderation in Germany resulted in negative ULC growth (and below 1% in Austria). The difference between ULC developments in France and in Germany since 2000 has resulted in a deterioration of the relative cost competitiveness of France vis-à-vis Germany with a gap which is now equivalent to 17% of the French ULC.

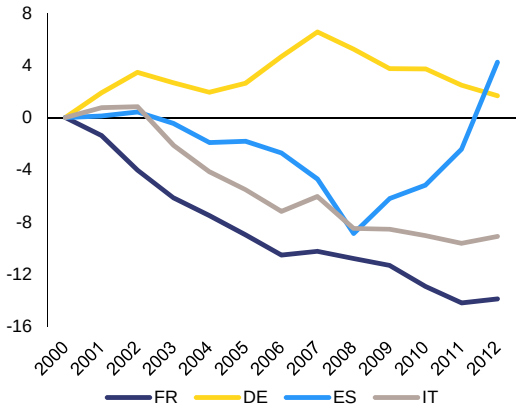
Nominal unit labour costs in France experienced contrasted developments in the tradable and non-tradable sectors. Indeed, between 2000 and 2012, unit labour costs increased by 35% in the non-tradable sector and by only 17% in the tradable sector. While employees' compensation in the tradable and the non-tradable sectors increased at similar paces (2.6% and 2.7% p.a. respectively between 2000 and 2012), productivity in the non-tradable sector increased at a much slower pace than in the tradable sector. Indeed, the gap in unit labour costs between France and Germany appears to result from significantly higher wage inflation in France, both in the tradable and non-tradable sectors, despite somehow similar productivity developments in the two countries. Conversely, in Italy, poor productivity developments, in particular in the tradable sector, are the main contributor to the faster ULC growth (Graph 3.9).

Graph 3.9: **ULC developments in the tradable and non-tradable sectors (2000-2012)**



Source: Commission services

Graph 3.10: **Gap between REER on export price and on ULC (compared to IC-37, 2000=0)**



Source: Commission services

The diverging developments in the cost of labour and export prices suggest increasing constraints on exporters' margins. While developments in the cost of labour appear to be in line with productivity and are comparable to developments in other euro area economies, France has experienced an increasing gap between the real effective exchange rate based on ULC and based on export prices (compared to IC 37). Indeed, between 2000 and 2012, the REER based on ULC increased by 12.1%, a sign that unit labour costs increased slightly faster in France than in other industrial countries. In comparison, export prices remained steady, decreasing by 1.7% between 2000 and 2012 (Graph 3.10). While the change in relative cost and price competitiveness could result from a change in the export product mix and from a change in the structure of employment, it still suggests that exporters have increasing difficulties to pass through domestic cost increases to customers. This would result in a decreasing profitability of French companies with a negative impact on growth and competitiveness. Such difficulties are not specific to France. However, in other economies, the gap appears much smaller and in some cases, such as Spain and the UK, it has much decreased since 2008. In Germany, the wage moderation in most of the 2000s has led to an improvement in the relative prices compared to the relative unit labour costs which is currently fading out.

3.3.2. Development in wages

While nominal wages are mainly what matters for international competitiveness purposes, equilibrium on the domestic labour market rather depends on developments in real wages. In a competitive setting, these are driven by productivity with a significant deviation from this yardstick indicating an increasing wage share, to the detriment of profitability. In France, the wage share for the total economy decreased strongly between 1981 and 1989 mainly due to strong increases in productivity (+3.0% on average over the period) not matched by real wage increases. Since then, the wage share for the total economy has been on a slightly downward trend, from 68% of GDP in 1990 to 66% in 2008 before returning to 68% in 2012, suggesting that labour hoarding occurred during the crisis. Since 2008, the lower price inflation has only partially passed through to nominal wages, resulting in an uptick in the wage share in the last 4 years.

Wage equations for France suggest that, except in the early 2000s and in the aftermath of the crisis, wage increases over the last 10 years do not diverge from fundamentals. In order to estimate the contribution of the various drivers of wages to developments in the last few years, a wage equation, based on a wage-setting model, is estimated. The wage level depends on (expected) inflation, the level of unemployment and productivity. Moreover, the wage-setting framework suggests that, beyond short-term dynamics, real wages converge towards a long-

Box 3.1: **Modelling wages using an error correction model**

In order to assess to what extent wage development have reflected developments in prices, productivity and unemployment, a wage equation is fitted based on quarterly data over 1983-2013. The relationship between nominal wages and its determinants is specified as an error-correction model based on Engel-Granger (1987) two-steps approach.

In the long term, real wages increase almost in line with productivity. Productivity hikes also impacts on wages in the short run although the impact is much smaller due to gradual adjustment of wages to productivity. Besides productivity, real wages are driven by the unemployment rate, which tends to depress them in the long term, and by the level of the real minimum wage, which pushes them up both in the short and long run. As wages do not adapt immediately to changes in prices, real wages are also dependent on prices in the short term. Indeed, due to nominal rigidities, an unexpected hike in inflation reduces real wages in the short term although these adjust in the longer term. The lag of the dependent variable is also introduced in the equation to reflect the rigidity of wages in France.

Overall, the nominal wage equation is as follows:

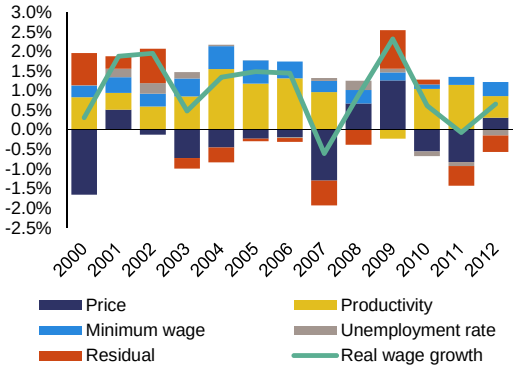
$$\Delta \log Wage = \underset{(-1.8)}{-0.02}\left(\log price + 1.05 \log prod - 0.15 \log Unempl + 0.11 \log rsmic\right)_{-1} + \underset{(4.1)}{0.21} \Delta \log price_{-1}$$
$$+ \underset{(4.7)}{0.22} \Delta \log prod + \underset{(2.9)}{0.04} \Delta \log rsmic + \underset{9.6}{0.58} \Delta \log Wage_{-1} - \underset{(-1.6)}{0.01}$$

Wage represents the average wage per head according to national accounts while *price, prod and Unempl* stand respectively for the deflator of private consumption, productivity computed as the ratio between GDP and employment among wage earners and the unemployment rate according to Eurostat. *Rsmic* represents the level of the hourly minimum wage divided by the deflator of private consumption

The equation is estimated using ordinary least square with an adjusted R^2 of 78%. The Breusch-Godfrey test for various orders confirms that no significant serial correlation remains among the residuals of the estimated equation.

term equilibrium (see for example Bardaji et al, 2010). Such a model for real wages (see Box 3.1) suggests that developments in real wages are mostly accounted for by traditional drivers. Over the last 10 years, the period which saw France's loss of market shares accelerate, two episodes of wage growth above what fundamental drivers would suggest can be seen: in 2000 as an aftermath of the reduction in working hours, and in 2009 as downward rigidities limited the adjustment of real wages to the fall in productivity (see Graph 3.11). This latter finding is common to several EU economies (ECB, 2009).

Graph 3.11: **Contribution of explanatory factor to growth in real wages**



Note: Average wage per capita divided by the deflator of private consumption
Source: Commission services, author's calculation

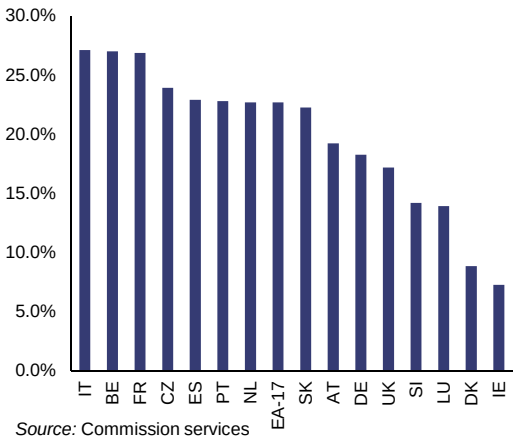
However, the actual wage level seems above the level suggested by fundamentals. A cross-country assessment of the determinants of the

wage level, in purchasing power standards, reveals that average wages are about 10% higher than the level consistent with the underlying fundamentals (European Commission, 2013b). Indeed, based on the level of productivity, unemployment and education, a wage benchmark for European economies can be built. The difference between nominal compensation per employee and this wage benchmark in France has increased between 2009 and 2011. These findings suggest that wages have been overvalued in France and that, due to the absence of wage moderation, no adjustment has taken place yet. This is consistent with the observation that, while developments in the wage share suggest that significant wage moderation took place in the 1980s, developments have remained muted since then. By comparison, in a number of euro area economies, a significant decrease in the wage share continued to be observed throughout most of the 1990s. At 68% of GDP in 2012, the wage share in France is higher than that in Germany, Italy and Spain (65%, 64% and 60% respectively).

3.3.3. Tax burden on labour

The high level of social contributions in France contributes to the relatively high cost of labour. Indeed, while the wage negotiation focuses on gross wages, the high level of social security contributions in France also weighs on the cost of labour. In France, employers' social security contributions represented 27% of compensation paid to employees in 2012, among the largest shares in the EU (see Graph 3.12). The weight of employers' social security contributions decreased from 27.5% in 1990 to 26.2% in 2008 as a result of the increasing weight of social contribution exemptions on lower wages. Since then, the rate of employer's social contributions has gone up by 0.7 pp.

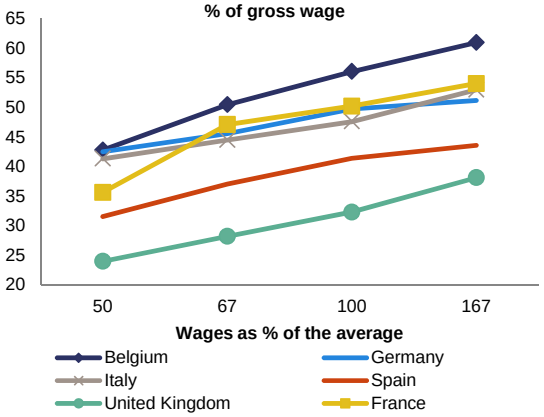
Graph 3.12: **Employer's social security contributions (in % of total compensation, 2012)**



Source: Commission services

The tax wedge, which measures the gap between the cost of labour for employers and the revenues for workers, is higher in France than in most other EU economies. In France, the tax wedge on labour reaches 54% of the labour costs for workers paid 1.67 times the average wage, one of the highest ratios in the EU (see Graph 3.13). At the average wage, it still represents 50% of the labour cost. However, as a result of the exemptions and of various schemes to reduce income tax for the least paid workers it represents a much more moderate 36% of labour costs for workers paid half the average wage. With the implementation of the tax rebate on competitiveness and employment (CICE), which will reduce employers' contributions by 6% of gross wages for workers paid less than 2.5 times the minimum wage from 2014 on, the tax wedge at 50% of the average wage will further decrease to close to 30%, bringing it below the tax wedge for Spain.

Graph 3.13: **Tax wedge by level of wages, 2012, in % of gross wage**



Note: Tax wedge for a single worker on a full-time job
Source: Commission services

3.3.4. Wage bargaining system

Besides the traditional drivers of wages developments, institutional factors can have a strong impact on wage dynamics. Indeed, the adjustment of wages to the evolution of fundamentals very much depends on the wage bargaining process. The wage bargaining in France is characterized by the importance of industry level agreements. Three main groups of countries can be distinguished in the European Union (See ECB, 2008). In some countries, including Belgium, Finland and Greece, wages are predominantly determined at the central level. At the other end of the spectrum the UK and Czech Republic for example have largely deregulated and decentralised wage bargaining systems. France belongs to an intermediary group, which comprises most EU Member States, where wages are determined by the interaction of industry-wide agreements and company-level negotiations.

Compared to other countries, France is characterized by the relatively stronger role played by the industry-wide agreements. Indeed, branch agreements in France apply to unionised and non-unionised workers and extension mechanisms, which make the agreement reached by social partners within a branch compulsory for all workers in that branch upon a decision by the Ministry of Labour, are widespread. Moreover, the Ministry can take the decision to "extend" the agreement beyond its initial domain. In large companies, which generally set specific company-level agreement, the negotiated wages are much higher than the ones resulting from the branch agreement. Actual wages are therefore less impacted by changes in the wage floors than in smaller companies. Similarly, branch agreements have a much stronger impact for blue-collar workers than for managers as wages for the latter are often negotiated on an individual basis. For workers, a 1% increase in the branch level agreement is associated with a 0.8% increase in the actual wage perceived (André, 2012b). Accordingly, the importance of industry-wide agreements on wages has contributed to limiting the ability of firms to negotiate downward wage adjustment throughout the crisis (Askenazy et al, 2013).

Recent reforms have created only limited flexibility for employers to depart from sectorial agreements. A number of countries in the European Union, notably Germany and, more recently, Spain, have introduced opening clauses which give a more prominent role to company-level agreement. In France, the 2004 Fillon law created general mechanisms providing for derogations on collectively agreed wages. Until then, a collective agreement at company level could only improve the employees' rights: the so-called "favourability principle". Since 2004, a company-level agreement can deviate from the provisions of a sectorial agreement unless such derogations are explicitly forbidden in the sector-level agreement. However, the favourability principle remains in force in terms of minimum wages, job classifications, supplementary social protection and multi-company and cross-sector vocational training funds. In practice, reductions in overall wage costs were mainly obtained by departing from sectoral-level agreements in terms of working time (Ramos-Martin, 2011). The recent law on securing employment (*loi de maintien de l'emploi*) for companies experiencing economic difficulties now provides for reductions in wage levels but under specific conditions. In particular, wage reductions cannot apply for workers earning less than 1.2 times the minimum wage, which may reduce the effectiveness of these derogation clauses (see Box 3.2).

Box 3.2: A recent reform of the wage bargaining process - the 'accords de maintien de l'emploi'

On 11 January 2013, social partners reached an agreement on a series of measures with a view to reforming the labour market. The agreement was then translated into a law on securing jobs which was adopted in July 2013. The law globally allows the implementation of the measures, some of which still remain to be enforced through subsequent negotiations between social partners. While the reform was of a broad scope, it created a framework for firms in financial difficulties to adjust wages and working hours: the "accords de maintien de l'emploi".

In case of serious economic difficulties, firm level collective agreements, approved by a majority of workers, may modify for a maximum of 2 years wages paid above 1.2 times the minimum wage and working time in exchange for a guarantee of employment for signing employees. The agreement has to be approved by unions representing at least 50% of employees, compared to 30% for a standard collective agreement, and also has to be signed individually by employees. Employees refusing to sign the agreements can be dismissed. In that case, the dismissal of more than 10 employees does not trigger the usual obligations related to a collective dismissal.

This measure extends the scope for firm level derogation to branch agreements introduced in 2004 (law 2004-391 of 4 May 2004 - the Fillon law on social dialogue). The 2004 Fillon law mentions that company-level or sectorial agreements may deviate from all or part of a sectorial or inter-sectoral agreement even in pejus unless such a derogation is expressly forbidden at the higher level. The "accords de maintien de l'emploi" framework explicitly mentions the possibility of a temporary downward adjustment to wages although minimum wages, both national and sectorial, need to be respected. These are limited to workers paid more than 1.2 times the minimum wage; a constraint which may represent a significant impediment to the effectiveness of the scheme as, in a number of sectors, a large share of workers is paid close to the minimum wage.

Preliminary evidence on firm level agreements concluded since the adoption of the law introducing the "accords de maintien de l'emploi" point towards mixed results. Indeed, only in a few cases was the new scheme used while a number of companies have decided to use the previously existing framework. First, the need to have the agreement, which may include an increase in working hours and a reduction in wages, signed by trade unions representing a larger share of employees than previously is a barrier for the adoption of these schemes. Second, the "accords de maintien de l'emploi" can only be signed if the financial difficulties met by the company are of a temporary nature. Enterprises facing long-term difficulties will therefore prefer the previous type of scheme (e.g. PSA resorted to the 2004 framework to increase working hours in October 2013 in exchange for a guarantee of production). Finally, significant legal uncertainties for employers could derive from the difficulty to define rigorously what temporary cyclical difficulties are. Indeed, a dismissal of more than 10 employees under an "accord de maintien de l'emploi" could be requalified by a judge as a collective dismissal, with significant costs for the company.

In the cases where the "accords de maintien de l'emploi" were signed the agreements focused on changes to the working hours and to the organisation of work. In addition, employees agreed to a wage freeze. However, no reduction in the actual wages was included. In one of the cases, a significant share of the employees (close to 15%) refused to sign the agreement and was therefore dismissed. As the company did not have to file for a collective dismissal, the cost of these dismissals was reduced compared to the previous situation. However, this goes against the initial intention to maintain employment within the firm.

3.3.5. Minimum wage

The minimum wage in France, which is a key component of the wage setting, is among the highest in the EU. Among the 21 Member States with statutory minimum wages, France is among the ones with the highest minimum wage both in nominal and relative terms. In 2013, the gross minimum wage in France stood at EUR 9.43 per hour and EUR 1,430.22 per month, the fifth highest nominal level in the euro area following Ireland, the Netherlands, Belgium and

Luxembourg. Based on purchasing power parity, the minimum wage in France offers the second highest living standards in the EU. Such a high level has various impacts on the situation of the labour market and, on a wider perspective, on social outcomes. Relative to the national median wage, the minimum wage in France is the highest in Europe having risen to more than 60% of the median wage in 2012.

Developments in the French minimum wage are guided by an automatic indexation mechanism which can be complemented by discretionary hikes decided by the government. Annual automatic indexations of the minimum wage take place every year on January 1st; automatic increases may also take place during the year if price inflation exceeds 2% since the previous revision. The revaluation is based on inflation of the consumer price index plus half of the increase in the purchasing power of hourly average wages for workers and employees. In theory, the strict implementation of the indexation formula would gradually lead to a gap between the minimum wage and the average. However, the government can decide on discretionary increases of the minimum wage beyond the required automatic increases. Since 1990, these hikes have pushed the minimum wage close to 20% beyond the level prompted by the automatic revaluation. In order to better take into account the impact of potential discretionary increases, a group of economic experts on the minimum wage was established in 2009. Since its inception, this working group has consistently advocated limiting hikes to the legal requirement.

The minimum wage in France is also characterized by a high degree of uniformity. Very few exceptions exist to the minimum wage in France. Firms can reduce the level of the minimum wage by 20% for workers under 17 and by 10% for employees between 17 and 18. Reduced rates also apply for apprenticeships and professionalization contracts. However, while some Member States such as Ireland, the United Kingdom and the Netherlands have set up differentiated rates for specific categories, no general exception exists in France besides those relatively limited cases.

Increases in the minimum wage have a detrimental impact on employment. In spite of significant social contribution reductions, France has one of the highest costs of labour at the minimum wage level in Europe (OECD, 2013a). In this sense, increases in the minimum wage can have a significant impact on the level of structural unemployment. Econometric evidence suggests that a 1% increase in the French minimum wage leads to a reduction in employment at the minimum wage of 1.5% (Kramarz and Philippon, 2001). As 12.3% of employees are directly affected by increases in the minimum wage, the impact on overall employment is significant.

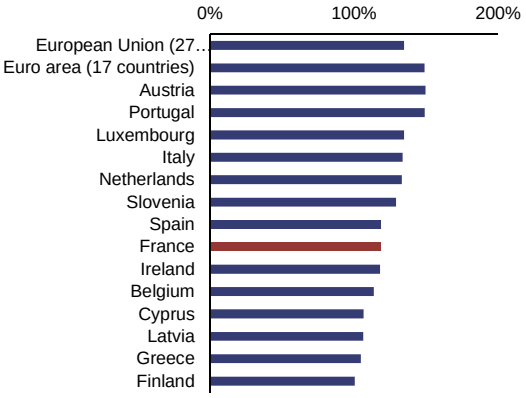
3.3.6. Impact on the wage distribution

Developments in the minimum wage impact the overall wage growth. Sensitivity analysis shows that a 1% increase in the minimum wage translates in the next few quarters into a 0.4% increase in wages between 1 and 1.1 times the minimum wage and into a 0.1% increase for wages between 1.4 and 1.5 times the minimum wage (Koubi and Lhommeau, 2007). In the longer run, a 1% hike in the minimum wage appears to have one-to-one effect on wages between 1 and 1.1 times the minimum wage, an impact which gradually decreases for higher wages down to a 0.5% impact for wages between 1.4 and 1.5 times the minimum (Cette et al, 2012, also see Goaran and Muller, 2011). The impact of minimum wage increases on the overall wage level suggests that circularity exists between the minimum wage and the benchmark used to compute the legal revaluation (Cette et al 2012). As a consequence of this circularity, discretionary hikes can result in an upward spiral of the minimum wage with potential inflationary impact on the average wage (Cette and Wasmer, 2010).

Past increases in the minimum wage, together with exemptions from social security contributions on lower wages, have resulted in a distortion of the wage structure. The high level of the French minimum wage means that, in the lower band of the wage distribution, employers have limited scope to adjust wages in line with productivity. In addition, exemptions from social security contributions, which represent up to 26% of the cost of labour at the minimum wage level and decrease gradually up to 1.6 times the minimum wage, contribute to increasing the marginal costs of increasing wages. In 2012, 10.4 million workers benefitted from these exemptions, close to 40% of the labour force. Between 2002

and 2006, a period when the minimum wage increased rapidly, the gap between the median wage and the lowest decile narrowed significantly. As a result, the overall cost of social security contribution exemptions for low wages soared (Ourliac and Nouveau, 2012). Since 2006, despite the ending of discretionary hikes in the minimum wage,([9]) the gap between the lowest decile of the wage distribution and the median wage has not significantly widened.

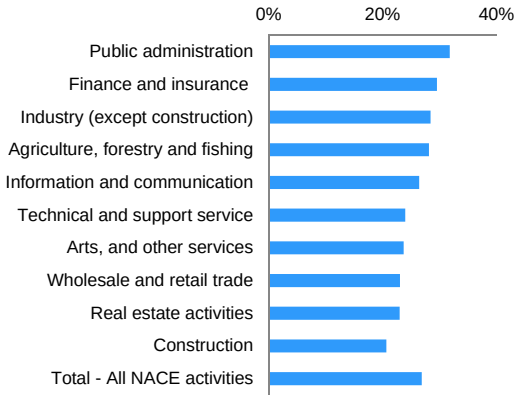
Graph 3.14: **Mean monthly earnings of employees with upper secondary education compared to workers with only primary or pre-primary (2012)**



Source: Commission services

Such a development may have had a detrimental impact on the incentives for employees to increase their productivity and to invest in human capital. Employees with an upper secondary education are paid 18% more than workers with only primary or pre-primary education. As can be seen in Graph 3.14, such a premium seems rather low in a European perspective. Indeed, although the unemployment rate of people with only primary education is much higher (16.6% in 2012 compared to 9.9% for people with secondary education), the premium that one can expect from completing upper secondary education in France is close to the one in Spain (19%) and much below the ones in Italy (34%) and in the euro area as a whole (34%). ([10]) Preliminary findings of the PIAAC survey (OECD, 2013b) also show that the increase in wages with skills is weaker in France than in the average OECD economy. Lower returns to skills may have contributed to the low adult participation in life-long learning. In the long term, a compression of the wage distribution could result in a distortion of the skill structure towards less qualified jobs with a detrimental impact on productivity. This may have contributed in particular to the significantly higher share of workers with a low level of skills in France (22.7% in 2012) compared to Germany (14.0%). There are risks that the limited incentives to increase skills in France may result in a long-term skill deficit and contribute to the deterioration in non-cost competitiveness. In addition, the sizeable reduction in social security contributions on low wages means that sectors which employ a large share of low-skilled workers benefit from a comparatively lower tax burden on labour (Graph 3.15). For example, in the accommodation and the construction sectors, social security contributions represent respectively 17% and 21% of compensations while in the industrial sector, whose export potential is significantly higher, they amount to 28% of total compensations. Similarly, the CICE, which seeks to further reduce the cost of labour for workers paid less than 2.5 times the minimum wage does not primarily support exporting companies (see Box 3.3). In the long term, such discrepancies may impact on the industrial structure.

Graph 3.15: **Social security contribution by sector, 2012, in % of total compensation**



Source: Commission services

([9]) With the exception of a 2.0% discretionary hike decided in July 2012, of which 1.4% consisted in an anticipation of the next revaluation.

([10]) The premium associated with tertiary education, which is less affected by developments in the lower band of the wage distribution appears in line with what is observed in other euro area economies

Box 3.3: **The tax credit on competitiveness and employment**

In response to the 2012 Gallois report, Prime Minister Jean-Marc Ayrault presented a series of measures as part of a "National Pact for Growth, competitiveness and employment" in November 2012. The Pact's main measure was the creation of a Tax Credit for Competitiveness and Employment (*Crédit d'Impôt Compétitivité Emploi* or CICE). The CICE is a "tax credit" on payroll taxes for wages up to 2.5 times the minimum wages applying to all firms regardless of status or sector. As of 2014, the CICE will amount to a 6% reduction in the wage bill leading to an average reduction in labour costs of 2.7% according to INSEE.

According to government estimates, the CICE is expected to increase GDP by 0.5 pp and to create no less than 300 000 jobs by 2017. While the CICE should indeed have a positive impact, these expectations seem to be on the optimistic side since the CICE will only partially offset the substantial increase in the overall tax burden on firms since 2010. Firms may indeed use the tax credit to restore profitability and investment postponing the impact on employment of the measure. An alternative assessment expects the measure to create approximately 150 000 new jobs and to boost GDP by 0.1 pp by 2018 (Plane, 2013).

Following the introduction of the CICE in January 2013, the monitoring committee set up by the government published its first report in October 2013. This assessment shows that 72% of companies could use the CICE, as the eligibility threshold appears relatively low (65.7% of total companies' wage bills). The report by the monitoring committee also insists on potential disparities between company size, sector and region using the CICE. As they generally distribute lower wages, SMEs and non-exporting companies will benefit more from the scheme than larger exporting firms. 38% of the CICE will be allocated to non-exporting companies while 27% benefited companies that export more than 5% of their revenue. While it is still early to measure the ex-post effectiveness of the measure, this first report shows that the CICE will not primarily benefit exporting companies where wages tend to be higher, suggesting a relatively modest direct impact of the scheme on exports' competitiveness.

Finally, the future of the CICE remains uncertain. President Hollande indeed announced in January 2014 that his government was going to reduce social charges by EUR 30 bn by phasing out employer family welfare payroll charges by 2017. However, whether this measure will encompass the CICE or complement it remain unclear. Although the details are not known at this stage, shifting from a tax credit to a reduction in social contributions could have important distributional effects.

3.3.7. Impact on social indicators and poverty

The high level of the minimum wage contributes to limiting inequalities in France. At 60% of the median wage, the level of the minimum wage effectively reduces the dispersion of wages at the lower end of the distribution. Accordingly, the income for the last quintile of the wage distribution represents 4.5 times the income of the first quintile, compared to 5.1 in the euro area.([11]) In the first quintile of the wage distribution, 75% of people are at risk of poverty, compared to 86.2% in the euro area as a whole.

The social and fiscal redistribution system also has a strong impact on poverty reduction. Taking into account social transfers and taxation reduce the Gini coefficient, which measures the degree of inequality in the distribution of earnings, by 20 pps. in France (compared to 18 pps. and 17 pps. in Italy and Spain respectively and 21 pps. in Germany). In particular, the existing tax exemptions and income subsidies for workers earning low wages, in particular the active social revenue (Revenu de solidarité active) and employment bonus (Prime pour l'emploi), partly compensate for wage inequalities. These two schemes contribute to increasing the living standards of workers paid the minimum wage by 6% on average while, for the other workers, taxes and social contributions reduce earnings by 5% (Rapport d'experts sur le SMIC, 2013).

The increase in in-work poverty shows that, despite measures to support earnings, the situation of employees on the French labour market is increasingly difficult. While 6.5% of

([11]) It should be noted that in 2012, despite the absence of a national minimum wage, this ratio stood at 4.3 in Germany.

French employees earned less than 60% of the median revenues in 2008, this share has increased to 8% in 2012. While the overall level remains lower than the euro area average (8.9%), it increased at a faster rate. In-work poverty is often linked to the large share of part-time employment within the lowest deciles of revenues. Only about half of the workers earning the minimum wage are actually working full time (Rapport d'experts sur le SMIC, 2013). For a single worker working half a full-time, net wages represent only 57% of total income, compared to 94% for a single worker working full-time. For workers with part-time jobs paid close to the minimum wage, wage increases reduce social transfers as those are based on revenues. Altogether, the impact of wage increases and of hikes in the minimum wage on actual earnings is marginal for this category of workers (Rapport d'experts sur le SMIC, 2013).

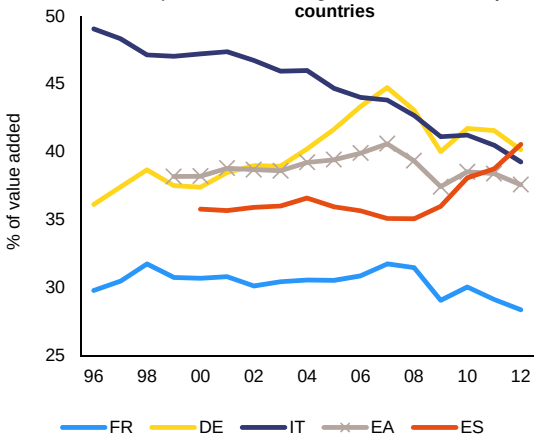
3.4. NON-COST COMPETITIVENESS: LOW PROFITABILITY AND NON-COST FACTORS

Although French exports are sensitive to cost factors, non-cost factors are the main driver behind the deterioration of the French export performance since 2000 (see section 3.1.2). Non-cost competitiveness is manifold and encompasses a variety of micro-economic factors such as product quality, innovation, design, after-sale service and distribution networks. In France, the ability of companies to perform well on these aspects is hampered by their low profitability. Furthermore, the relatively unfriendly business environment together with the lack of innovation in the private sector may be additional obstacles to the non-price competitiveness of French firms.

3.4.1. The low profitability French firms

The profit margins of French non-financial companies reached a trough of 28% of value added in 2012, a lower level than what they had registered in 2009. This trough is particularly worrying when compared to the situation in other EU countries. As shown in Graph 3.16, French firms are the least profitable in the EU (37% for the EU average), and in particular are far less profitable than their German counterparts (40%). This situation may be linked in particular to the high cost of labour which, although it has increased at par with most other economies in the euro area, has constrained the profit margins of French companies in a context of decreasing export prices.

Graph 3.16: **Profit margins in selected European countries**

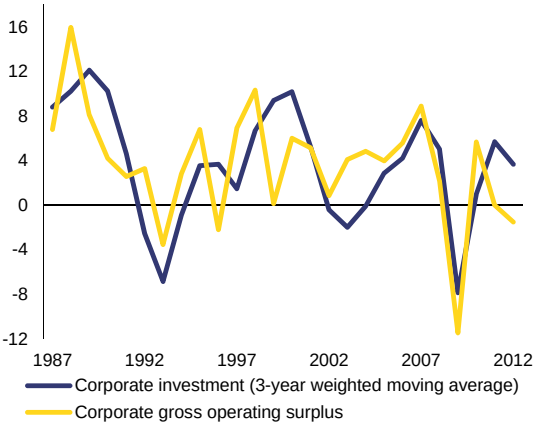


Source: Commission services

Weak profitability may have contributed to the low investment and to the deterioration in the price competitiveness of French companies. After a short-lived pick-up in 2010, equipment investment decelerated and has kept on decreasing since 2012 and remains 9% below its pre-crisis level. Apart from expected demand, profit margins as well as financing conditions are significant explanatory factors for investment (Herbet, 2001). Indeed, in the case of France, low profitability has contributed to the poor confidence of entrepreneurs, who have in turn focused on the short-term restoration of their financial situation through cost controls, to the detriment of their investments in equipment (Graph 3.17). Conversely, developments in Germany in the 2000s illustrate how improving profit margins can contribute to fostering investment and innovation in the long term (COE-Rexecode, 2011). The reduction in production costs in Germany through wage moderation, both in the industry and intermediary services, as well as off-shoring practices have durably restored profit margins from 2000. This may have strengthened entrepreneurs' expectations, which have translated into a recovery in business investment from 2005 and in improvements in competitiveness. In France, the tax rebate on competitiveness and employment adopted in December 2012 (see Box 3.3) goes in the right direction. The amount of the tax credit represents close to 7% of the gross value

added of non-financial corporations. In that respect, even if the full amount was used to increase the profitability of firms, it would not be sufficient to bridge the profitability gap compared to the EU average. Furthermore, this measure only offsets part of the corporate tax increases since 2010. Furthermore, it seems poorly targeted to the manufacturing sector. While an indirect impact on the industry through a price reduction in services could be expected, the magnitude of this effect remains uncertain due to the low level of competition in many services.

Graph 3.17: **Investment and gross operating surplus (NFC, % annual change)**

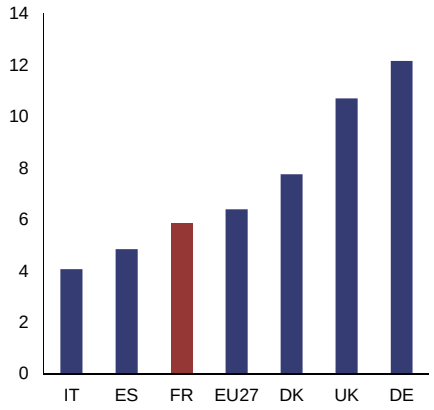


Source: Commission services

3.4.2. A lack of medium-sized companies and the decreasing technology intensity

A particular structural feature of French firms is the lack of medium-sized companies. In 2012, the average French firm employed 5.8 people, compared to 6.4 in the EU and 12.2 in Germany (Graph 3.18). In the same year, medium-sized enterprises, i.e. employing between 50 and 250 employees, represented 0.9% of all French companies, against 1.1% in the EU and 2.6% in Germany. In particular, in the manufacturing sector, which accounts for the largest share of total export turnover, medium-sized companies account for only 3.8% of all companies, compared to 8.2% in Germany.

Graph 3.18: **Average number of employees by firm (2012)**



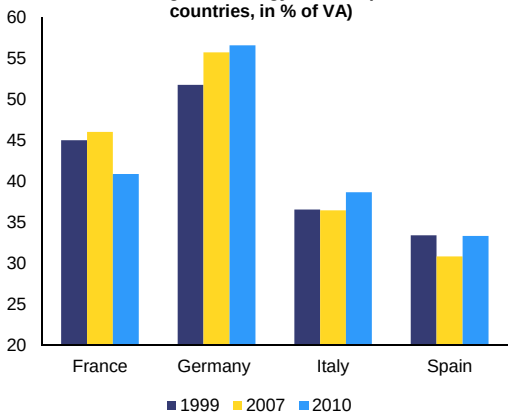
Source: Commission services

The French industrial firms may find themselves handicapped when exporting, due to their relatively small size, as engaging in export activities entails significant fixed costs. These costs are diverse and include for example the cost of establishing a representative office, administrative burden or logistic costs. Therefore, small firms will find it particularly difficult to export to distant regions where most dynamic markets lie. A recent study from the French Customs (2013) highlighted that the medium-sized firms represented 4% of exporters in 2012, but achieved 33% of the value of exports, while the 96% smaller exporting companies only achieved 23% of exports. Large companies, which only represent a marginal share of the total number of firms, account for the remaining 44% of exports. Furthermore, 10% of their exports go to emerging countries, against only 7% for smaller SMEs. Moreover, several studies based on microeconomic data suggest a strong correlation between firm size and export performance. Altomonte, Aquilante and Ottaviano (2012) show that firms need to reach a minimum performance threshold, i.e. a minimum size of activity, in order to achieve internationalisation. In the case of France, Ceci and Valeirsteinas (2006) empirically established at around 100 employees the critical size for a firm to start exporting to distant emerging countries. In addition, their smaller size might be a hampering factor for innovation which is not simply related to R&D but also to other expenditures on intangibles, such as training, design or marketing. Indeed, larger companies benefit from a better access to finance, better internal resources, economies of

scale and higher returns on R&D expenditures (Ciriaci and Hervas, 2013).

The crisis seems to have particularly hit French medium-high technology sectors. Before 2008, in France, like in most OECD countries, the technology intensity of production was on an upward trend. The share of manufacturing value added in high and medium-high technology sectors([12]) rose from 40% to 46% between 1999 and 2007. However, it fell again to 41% in 2010, while it continued increasing in Germany, Italy and Spain, i.e. France's main competitors (Graph 3.19). This weakness is mainly due to the decreasing weight of medium technology sectors. On the contrary, high technology sectors, in particular the aeronautical and pharmaceutical sectors, have remained relatively resilient. This trend suggests that there is a risk that the technology intensity of French goods may decrease, with a negative impact on the ability of French firms to compete on products which are less sensitive to price developments.

Graph 3.19: **Share of value added in high and medium-high technology sectors (selected countries, in % of VA)**

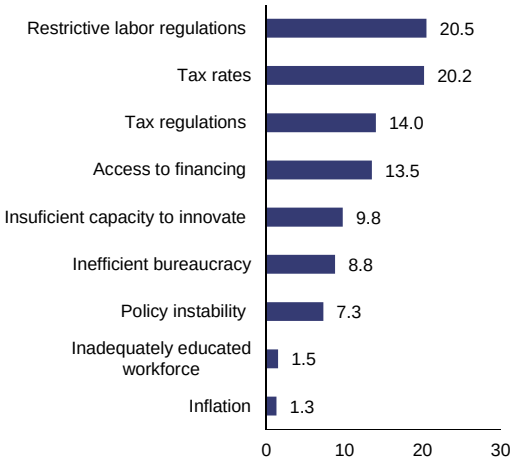


Source: Commission services

3.4.3. An unfriendly business environment

The relatively unfriendly business environment may weigh on firms' growth potential. The global ranking of France in a number of international business environment surveys has deteriorated. In particular, the 2013 World Economic Forum (WEF) puts France at the 23rd rank compared to 21st last year and 18th the year before. In particular, France's relative position has deteriorated on the perceived efficiency of the labour market, with the survey highlighting the rigidities of the rules on firing and hiring, a criterion on which France is ranked 144th out of 148 countries. The low quality of labour-employer relations (135th), a tax regime which is perceived as highly distortive to decisions to work (127th), and the burden of government regulation (130th) are also pointed out as the most problematic factors for doing business in France (Graph 3.20). This relatively unfriendly environment may have contributed to the 82% fall of FDI recorded in 2013 in a context of increasing global investment.

Graph 3.20: **Most problematic factors for doing business in France**



Note: Average ranking provided by respondent on a 1 (most problematic) to 5 (least problematic) scale.
Source: World Economic Forum

([12]) High-technology sectors include aerospace, pharmaceuticals, computers, office machinery, electronics-communications, and scientific instruments. Medium-high-technology sectors gather electrical machinery, motor vehicles, chemicals, other transport equipment and non-electrical machinery.

Box 3.4: **Regulatory thresholds related to the number of staff in French firms, under the labour law or under accounting regulations.**

From ten employees on:
Payment of social security contributions on a monthly basis, rather than on a quarterly basis, obligation to pay transportation assistance in some geographical areas; partial support of economic, social and union training; increase of the contribution rate for vocational training from 0.55% to 1.05%; loss of the possibility of a simplified balance sheet and income.

From eleven employees on:
Payment of a minimum allowance of 6 months wages in the event of dismissal without any real or serious justification; obligation to organize the election of a staff delegate, without obligation of result, who will have a credit of 10 hours per month for representational activities.

From twenty employees on:
Contribution to the National Fund for Housing Assistance; requirement to have internal regulations; obligation of work for the disabled; participation in building (0.45 % of the payroll);increase of the contribution rate for vocational training from 1.05% to 1.60%; compulsory compensatory rest of 50% for overtime beyond 41 hours per week.

From twenty-five employees on:
Obligation of having a refectory if requested by 25 employees; distinct electoral colleges for the election of representatives; increased number of delegates from 26 employees.

From fifty employees on:
Possibility to appoint a union delegate; obligation to set up a committee for health, safety and working conditions and to train its members; obligation to establish a works council with meeting at least every two months; display of fire precautions in establishments which gather more than 50 employees; obligation to establish participation to results; requirement to use a social plan in case of economic dismissal concerning 9 or more employees; loss of the possibility of a simplified Annex 2 of the accounts; obligation to appoint an external auditor.

In particular, insufficient competition in some product and service markets increases prices and hampers the reallocation of resources to the best performing firms. Business services are indeed an essential input for the industrial sector and represent an important share of production costs. Market services represent 25% of the cost of production in the manufacturing sector. High wages in services therefore affect all sectors, through the interplay of intermediary consumption. As a consequence, the 26% increase in unit labour costs in the service sector in France over the last decade has put pressure on the profitability of manufacturing companies, hence negatively affecting the competitiveness of the whole economy. Furthermore, the lack of competition in services which hampers services' productivity impact manufacturing productivity and ability to innovate, as competition in services may generate spillovers and create incentives to innovate in the manufacturing sector (Ciriaci, Montresor and Palma, 2013). Conversely, increasing competition and removing barriers in product markets can be expected to result in a substantial increase in output (Roeger, Varga and In't Veld, 2008). According to Bouis and Duval (2011) improving the regulation of product markets would enable France to increase total factor productivity in the next ten years by more than 3%. Although competition in services has become stronger, in particular as a result of the implementation of the Services directive, a number of sheltered sectors remain (including the retail sector, network industries such as transport or energy but also some regulated sectors). A strengthening of competition in these sheltered markets could contribute to lowering the cost of these services, hence indirectly improving the competitiveness of the French economy.

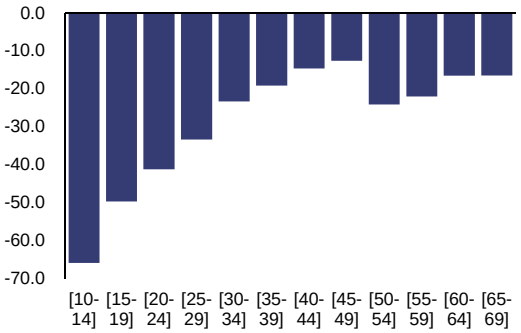
Box 3.5: **The Research Tax Credit (RTC)**

The research tax credit is a tax deduction based on firms' R&D spending originally introduced in 1983 to encourage innovation. The tax credit was significantly simplified and expanded in 2008. According to the current scheme, companies can deduct 30% of their volume of R&D spending up to EUR 100 million from income tax and a 5% tax credit with no ceiling beyond that. In order to stimulate innovation for SMEs, these can benefit from the RTC on a number of innovation-related expenditures (e.g. prototypes). The overall cost of the measure, which was close to EUR 1.6 bn in 2007, went up significantly after the reform to EUR 4.1 bn in 2008 and is set to amount to EUR 5.8 bn in 2014 according to the 2014 draft budgetary plan.

In a 2013 report on the RTC, the Cour des Comptes highlighted that nearly 15 000 corporates, of which 80% were SMEs, benefited from the measure in 2011, more than twice as much as in 2007 with a total credit envelope of EUR 5.2 bn. If France was to reach its objective of dedicating 2% of GDP to corporate R&D expenditure, the cost of the measure would reach EUR 11 bn (0.6% of GDP). Several studies have highlighted a positive effect of the measure on corporate R&D spending. In particular, an ex-ante study estimated that one euro of research tax credit increased R&D spending by EUR 1.7 in the long run (Mulkay and Mairesse, 2013). The ex -post effectiveness of the measure is however difficult to assess so far, owing to the recent overhaul in the scheme. The Cour des Comptes also insists that further efforts should be implemented in order to accelerate data production regarding the RTC.

In particular, several regulations are associated with specific size thresholds that may hamper the growth of French firms and play a role in the difficulties of SMEs to reach the size that would allow them to export, as well as to innovate. These size thresholds either stem from the labour code or from accounting rules (see Box 3.4). The exact impact of these administrative discontinuities on the demography of French companies is difficult to assess, as the available corporate databases (fiscal, social or statistical) are not always fully consistent. However, the "10 employees" threshold and above all that of "50 employees" can be considered as significant. Indeed, using firms' fiscal database, Ceci and Chevalier (2010) highlighted that the number of firms with "10 employees" was 48% lower than that of "9 employees" firms, and, similarly, the number of firms with "50 employees" was 58% lower than that of companies with "49 employees". They also assessed the effects of administrative thresholds on firms' growth and on the long-term corporate distribution as statistically significant. Furthermore, according to the INSEE's SIRENE corporate directory, there are 24% fewer firms of "50-54" employees than companies of "45-49" employees (Graph 3.21). The accumulation of regulations at the "50 employees" threshold, in particular the obligation to establish a works council, seems to make it particularly difficult for firms to cross this threshold.

Graph 3.21: **Percentage change in the number of firms between contiguous size bracket (2012)**



Reading note: There are 50% fewer firms in the 15-19 employees bracket than in the 10-14 employees bracket.
Source: INSEE, SIRENE

Most likely as a consequence of these difficulties to grow, French SMEs, in particular the most dynamic ones tend to be prematurely absorbed by larger groups, resulting in a loss of dynamism especially if their creators leave them. Nefussi (2007) pointed to the high share of French SMEs yearly absorbed by a group. On average a French SME is absorbed by a group six years after its creation (Table 3.1). The absorbed SMEs tend to be growing faster and to have a higher technological level, before being sold (Graphs 3.22 and 3.23). As pointed out by Artus (2011), these early absorptions may not only stem from the willingness of large groups to acquire the new technologies developed by innovative SMEs,

Table 3.1:

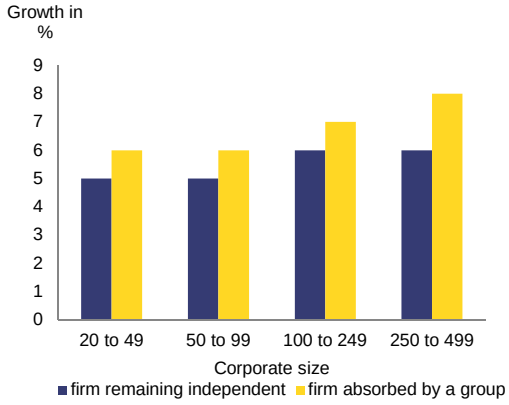
Share of French SMEs absorbed each year by a group

20 to 49 employees	8.0
50 to 99 employees	12.0
100 to 249 employees	14.0
250 to 499 employees	16.5

Source: INSEE.

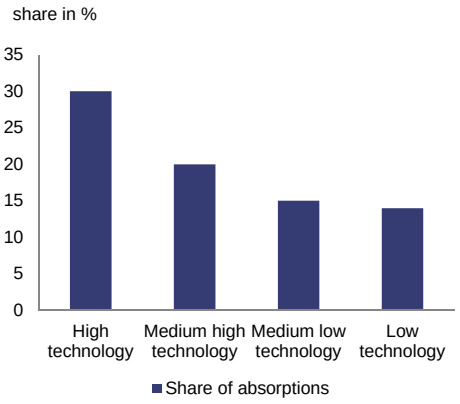
but also by the increasing difficulties met by entrepreneurs as their firms become larger, which encourage them to sell their own enterprise. In the end, these early absorptions may dampen the particular dynamism of these innovative SMEs, as the managing teams are changed and the drive stemming from their independent status may be reduced.

Graph 3.22: **Average annual growth of firms' value added (before absorption) depending on whether they are absorbed or remain independent**



Source: INSEE

Graph 3.23: **Share of absorption of SMEs according to technology level**



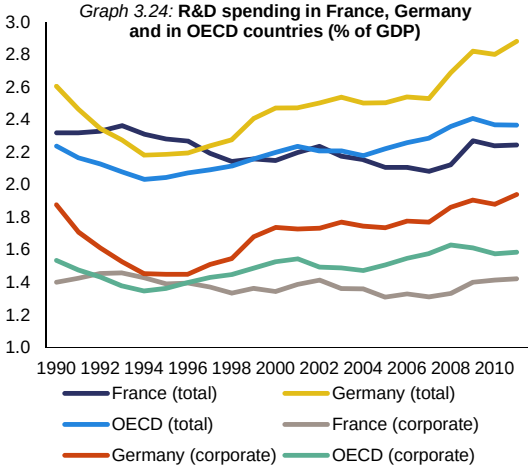
Source: INSEE

The authorities have implemented some limited reforms to improve the business environment, but further action needs to be taken. The Warrsmann report (2011) pointed to the need of business simplification and a "shock" of simplification was announced in July 2013. While still in the implementation phase, the simplification initiative has translated into a law of administrative simplification and the announcement of the revision of the complex labour regulation and taxation system, composed of not less than 153 different taxes on businesses, need to be undertaken.

3.4.4. A lack of Innovation

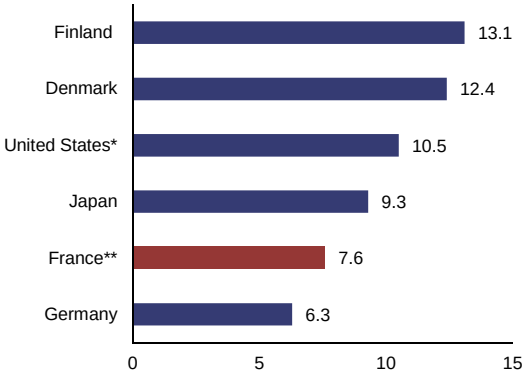
R&D intensity is lower in France than in innovation leaders in the EU such as Germany or the Scandinavian countries, mainly due to weak corporate R&D. France does not appear to invest enough in R&D activities. With R&D spending accounting for 2.2% of GDP in 2011 (Graph 3.24), France's R&D intensity is well below that of Germany (2.9%), the Scandinavian countries (3.4% in Sweden, 3.8% in Finland and 3.1% in Denmark), the United States (2.8%) and Japan (3.4%). The gap between its main partners is entirely linked to low R&D in the private sector. Indeed, while the level of public R&D spending in France amounts to 0.8% of GDP, as much as in Germany and slightly above the OECD average, private-sector spending only accounts for 1.4% of GDP, compared with 1.9% in Germany and 2.6% in the OECD. Furthermore, it has remained flat since 1994, while the OECD average rose slightly (by 0.3 pp. of GDP). This average performance of French firms in terms of R&D spending is linked to the declining share within the whole economy of the industrial sectors the most likely to invest in R&D. These sectors do not seem to find an environment suitable for their development. In the medium term, the lack of private R&D could compromise the future position of France among the knowledge-based economies.

Graph 3.24: **R&D spending in France, Germany and in OECD countries (% of GDP)**



Source: OECD-MSTI (2013)

Graph 3.25: **Number of researchers in the private sector (per 1 000 employees, 2011)**



*Note: * 2007; ** 2010*
Source: OECD-MSTI (2013)

The low level of business R&D may stem from some reluctance of firms to hire researchers, as well as from the lack of medium-sized companies. Researchers account for only a small share of industrial employment in France compared with countries where firms spend heavily on research. There are 7.6 researchers per 1 000 jobs in industry in France, compared to 13.1 in Finland, 12.4 in Denmark, 10.5 in the United-States and 9.3 in Japan (Graph 3.25). The limited number of researchers in the private sector may be partly explained by the relatively small size of companies, as large industrial corporations generally account for the vast majority of private-sector R&D. In the case of France, large companies in car manufacturing, pharmaceuticals and the aerospace sectors represent 37% of overall private R&D spending according to the Ministry of Research. In order to stimulate private research, the authorities have implemented a research tax credit (see Box 3.5). This measure may have contributed to support corporate investments in R&D, but at a significant cost of EUR 4 bn. Its efficiency needs therefore to be further evaluated to ensure that the substantial resources dedicated actually translate into stronger innovation activity.

Beyond R&D spending, innovation remains low in France. The European Commission's report on innovation output in Europe (2013c) places French innovation as 'average'. France ranks 10th for innovation output, behind its main European competitors such as Germany, Sweden and the United Kingdom. The number of triadic patents([13]) in France is 59% below that in Germany, 84% below the United States and 85% below Japan. Again, the weakness in innovation may stem from the relatively small size of firms. As Cohen and Levinthal (1990) pointed out, the "absorptive capacity" of firms, i.e. their incentives to embark on innovative projects depends to a large extent on their ability to exploit the knowledge produced by their competitors or by publicly-funded research centres. French firms seem to face some particular difficulties in absorbing the knowledge available, which can be linked not only to their relatively small size and the low share of researchers among their staff, but also to an environment that insufficiently enables the diffusion of innovation (Ciriaci, 2011). The European Commission's 2013 innovation competitiveness report (2013e) recommends to focus on framework conditions in order to elicit the creation of innovation-driven clusters, similar to the Silicon Valley in the US, that may generate high-growth innovative enterprises. In addition, as innovation is increasingly based on comprehensive solutions that integrate manufacturing and services, the

([13]) Triadic patents are patents filed at the European Patent Office, as well as at the United States and Japan Patent Offices, for the same invention, by the same applicant or inventor.

Box 3.6: **The Competitiveness Poles**

Implemented in 2005, the competitiveness poles policy seeks to develop linkages between firms and with research organizations, universities by creating clusters focusing on specific technologies. It complements the R&D tax credit measure and aims at enhancing the use of public R&D by the private sector and in particular by SMEs. It also aims at creating an environment helping SMEs to materialise their investment projects thanks in particular to a unique inter-ministerial fund (FUI). This fund allocated EUR 1.3 bn of subsidies to collaborative R&D projects over the 2005-2011 period. In total, 71 poles have been created among which 18 are considered of international dimension. These include for example the Aerospace valley in Toulouse, Minalogic (Micro-nanotechnologies, software) in Grenoble and Cap Digital in Paris.

Several evaluations of the competitiveness poles have been conducted since 2011, including two commissioned by the government. These assessments point towards a mixed effectiveness of the measure. On the one hand, the policy develops a real dynamic of partnerships between firms and public research actors. An increasing number of companies, SMEs as well as large groups, participate in competitiveness poles (+50 % over the 2008-2011 period). The R&D expenditures of members increased as a result of their participation and, over the period 2008-2011, 2500 innovations were generated and 93 start-ups have been created thanks to collaborative projects (5 % of the annual number of start-up created). The poles have also increased employment of researchers by 0.9 employees on average in participating firm, representing 5.6 % of researchers in those firms.

However, the action of the poles has been more focused on supporting R&D projects than on launching innovations on the market. Dortet-Bernadet (2013) highlighted that the corporates participating in poles do not apply for patents more than those outside the poles. Besides, the membership in poles does not have any effect on firms' turnover. There is therefore still room for improvement and the competitiveness poles. In particular, only a few poles have effectively generated a tangible network dynamic.

development of high-tech knowledge-intensive services is a key factor of international competitiveness. Cluster policies need to encourage such integrated approaches as well as partnerships between public and private sectors. In France, competitiveness poles (see Box 3.6) have effectively supported R&D spending but have generally failed to generate strong network dynamics. By comparison with the 2006 German "high-tech strategy", which focuses on fewer clusters and thematics, the large number of poles may reduce network and scale effects. Therefore, the French clusters could be efficiently reorganised and further efforts could be made to support the emergence of "geographic concentrations of interconnected companies, specialized suppliers, service providers, and associated institutions" (Porter, 1998) with an enhanced positive impact on the diffusion of innovation and productivity.

3.5. PUBLIC AND PRIVATE INDEBTEDNESS

The level of consolidated private debt, which was above the threshold of 133% of GDP in 2011, continued rising to reach 140.7% of GDP in 2012. While a number of economies in the EU have experienced significant deleveraging since 2009, private indebtedness in France has continued to grow at a relatively rapid pace throughout the crisis.

3.5.1. Stability of the banking sector

The French banking sector is very concentrated on a few large, and well capitalised, institutions. Large banks in France hold 98% of the total assets compared to 74% in the EU and 67% in the euro area. The four largest French banking institutions are considered of global systemic importance by the Financial Stability Board. Overall, French banks appear more profitable than their counterparts in the euro area, with a return on assets which amounted to 6.8% in 2013, a slight decrease compared to 2012, compared to 1.8% on

average in the euro area. With an average solvency ratio of 14.7% and their Tier 1 ratio of 12.6%, the capitalisation of French banks appears in line with that of their euro area counterparts (15.0% solvency ratio and 12.6% Tier 1 capital ratio). Their loan portfolio appears also slightly less risky, with non-performing loans representing 4.5% of the total portfolio in June 2013 compared to 5.4% in the euro area. This ratio has increased in the last two years as a consequence of the rather sluggish growth but remain below its 2009 level.

The main weaknesses of the French banks are their dependence on wholesale funding as well as their international exposure. Credit represented 144% of total deposit in June 2013. While part of the difference with the euro area originates from the weight of life-insurance and off-balance sheet savings instruments, French banks depend significantly on market-resource for refinancing. Such dependence can prove a weakness when inter-bank markets experience difficulties. Starting in 2011, French banks engaged in significant deleveraging in order to reduce their loans-to-deposit ratio. Although cyclical conditions, which are marked by a low demand for credit from both companies and households and by high levels of precautionary savings, contributed to the reduction in loans-to-deposit ratio, structural measures were also adopted. More emphasis was put on developing the domestic retail banking activities and credit activities in USD were reduced. While they remain significantly exposed to sovereign debt of peripheral economies, and in particular from Italy, French banks have also significantly reduced activities. The overall exposure of the 6 largest banks to Spain, Greece, Ireland, Italy and Portugal decreased from close to EUR 70 billion in 2010 to little over EUR 30 billion in 2012. While such an effort weighted on profitability, it contributed to the reduction in the yield of credit-default-swap on French banks bonds, an indicator of the perceived riskiness of the underlying securities.

While further efforts are granted due to regulatory changes, French banks seem able to adapt. So far, French banks have performed well in the various stress test exercises. Recapitalisation needs of the French banks involved in the exercises organised by the European Banking Authorities have generally been modest. However, the changing regulatory environment has prompted measures to strengthen balance sheets. In particular, French banks have confirmed their forecast that they would be able to reach a common equity tier 1 ratio of 9% by the end of 2013, as computed according to the upcoming European methodology (CRD 4). The recent law adopted in France to insulate the most risky activities from the main business of the banks has so far had limited impact on their profitability and on their capital structure.

3.5.2. Household financial situation

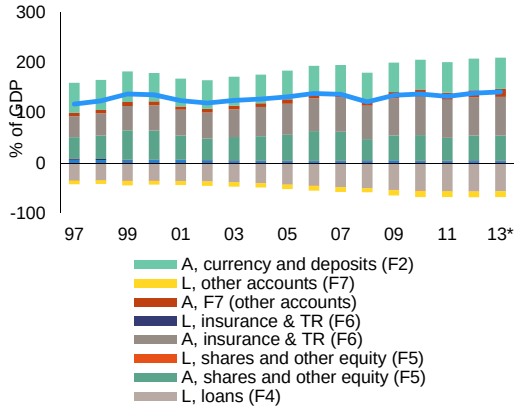
The indebtedness of French households has continued to rise in 2012 although the pace has slowed down significantly since 2010. Household debt represented 56.7% of GDP in 2012, a ratio which has increased by 2.7 pps. since 2009. By contrast, household debt in the euro area, which represented a significantly higher 63.9% of GDP in 2012, has reached a peak in 2009 and has started to decrease since then. Comparing the level of debt with gross disposable income, a measure of the affordability of household debt, yields similar results, with French household leverage on the rise but still below the euro area average. In particular, in 2012, although credit growth slowed down, so did gross disposable income, notably as a consequence of the tensions on the labour market.

Despite the increase in the debt level over the last ten years, the financial balance sheet of French households continues to exhibit a rising level of net financial assets. In 2012, net financial assets, which accounts for financial assets and liabilities, reached 139.4% of GDP, 0.5 pp. above its pre-crisis level (see Graph 3.26). Moreover, on average, the interest burden represented 1.7% of gross disposable income, a significantly lower share than in the euro area. Overall, the credit worthiness of French households remains unproblematic at this stage when compared to European peers. However, the slowdown in credit growth could be a sign that households are starting to reduce their debt, with potential impact on private consumption and investment.

The main driving force behind household indebtedness dynamics over the last ten years was the continuous growth in real estate credit, sustained in particular by dynamic housing prices and low interest rates in the years leading up to the crisis. Real estate prices, which

continued to rise after 2009, reached a peak in 2011 and have started to decrease since then. However, the magnitude of the correction has remained limited (-4% between the third quarter of 2011 and the first quarter of 2013). Consequently, the outstanding volume of loans for house purchase (41.7% of GDP) has remained stable and the share of households exposed to real estate credit increased slightly from 31.0% in 2011 to 31.4% in 2012 despite the sharp fall in transaction volumes. Recent indicators suggest that activity on the real estate market has started to pick up. Transaction volumes have rebounded and, possibly due to a further decrease in interest rates, real estate credit recovered in 2013 after falling by 32% in 2012.

Graph 3.26: **Balance Sheet by Instrument, Households**



Source: Commission services

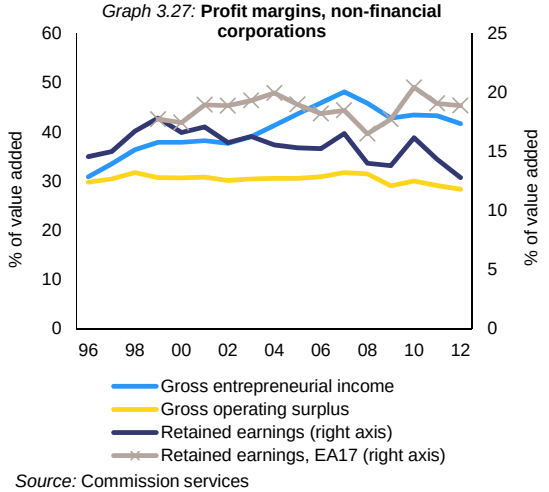
While real estate credit explains most of the increase in household indebtedness in the past few years, limited risk seems to arise from a potential deflation in real estate prices. First, structurally strong demand supported by positive demographic trends and the absence of excess housing supply together with prudent credit supply by banking institutions suggest that the current soft landing of real estate prices could continue. A rise in interest rates on loans or a further correction in prices could potentially translate into credit volumes and transactions falling again. However, such a development is unlikely to have a strong impact on deleveraging pressures as France is characterised by the low level (approximately 10%) of variable interest rate real estate credit loans and by credit standards based on revenues rather than on asset value.

The main pressure for households to reduce indebtedness rather results from uncertainties on cyclical conditions. Indeed, the high level of unemployment, together with the weak GDP growth in the coming years (0.9% in 2014 and 1.7% in 2015), is expected to weigh on disposable income. Thus, facing uncertainties on future revenues, households may be prone to reduce indebtedness. The slump in consumer loans since 2009, both in volumes and the share of household holding such a loan, is a sign that cyclical factors are the main constraint for credit growth.

3.5.3. Non-financial corporations

The non-consolidated debt of non-financial companies increased in 2012 to reach 105.0% of GDP, slightly above the euro area average (97.3%). Netting out intercompany loans, the consolidated level of non-financial corporations reached a peak of 84.0% of GDP in 2012 (compared to 80.9% in the euro area). Despite the somewhat higher level of debt, the leverage of companies, particularly measured through the debt to equity ratio (50%) is not particularly worrying as it remains below the euro area average (68.9%). In 2012, net assets of non-financial corporations represented 116.4% of GDP in France and 94.5% of GDP in the euro area. The leverage of companies which spiked in 2008 as a result of a sharp decrease in equity, has somewhat decreased since, despite the continuously growing debt.

Graph 3.27: **Profit margins, non-financial corporations**



Source: Commission services

The decreasing level of profitability for non-financial companies may also affect companies'

ability to service their debt. As pointed out in the 2013 IDR, although the actual financial structure of non-financial corporations does not point to specific weaknesses, the erosion of their profit margins is a source of concern (Graph 3.27). The financial difficulties experienced by firms are partly reflected in the increasing number of bankruptcies. In September 2013, the number of bankruptcies cumulated over the last 12 months rose by 5.5% compared to September 2012. The rise in bankruptcies was more pronounced for SMEs and was particularly strong in the retail and real estate sectors. Overall, the low and deteriorating profitability of French non-financial companies compared to other euro area countries, together with the increasing number of bankruptcies, point to potential vulnerabilities.

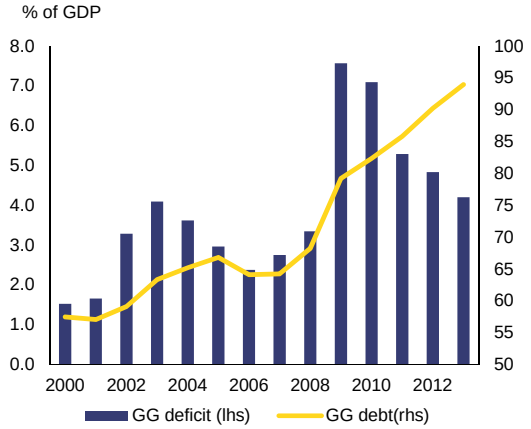
3.5.4. Public sector indebtedness

France's public debt rose further in 2013, reaching an estimated 93.9% of GDP, on the back of a still high general government deficit relative to nominal GDP growth. This was slightly below the euro area average of 95.5% of GDP but clearly above the reference value of 60% specified in the scoreboard and referred to in Article 126(2) TFEU. The threshold was first exceeded in 2003 and the debt has been almost continuously on an upward trend since then (Graph 3.28).

The ratio of general government debt to GDP is expected to further increase in 2014 by 2.2 pp. to 96.1%, although this is a smaller increase than in previous years. Indeed, the forecast improvement in the deficit, to 4.0% of GDP from 4.2% in 2013, together with higher nominal GDP growth will curb the rise in debt but will not suffice to reverse the trend. The government plans to put the ratio on a downward path from 2015 and bring it close to 90% of GDP by the end of its five-year term (2017). However, past experience shows that risks are clearly on the upside. Debt targets contained in the successive stability programmes and state budgets have regularly been revised upwards and often missed. For example, the budget for 2013 targeted a debt ratio of slightly above 80% of GDP in 2017, nearly 10 pps. lower than current plans.

The fiscal side of the economy continues to pose potential challenges in the medium term. France does not appear to face a risk of fiscal stress in the short term (European Commission, 2012b). However, under a no-policy change assumption, public debt would not be reduced below 95% of GDP by 2030. Moreover, different sensitivity tests show that adverse economic events (such as a 1 pp. permanent increase in interest rates) may have a significant negative impact on debt dynamics in the long run (see Graph 3.29).

Graph 3.28: **General government deficit and debt**

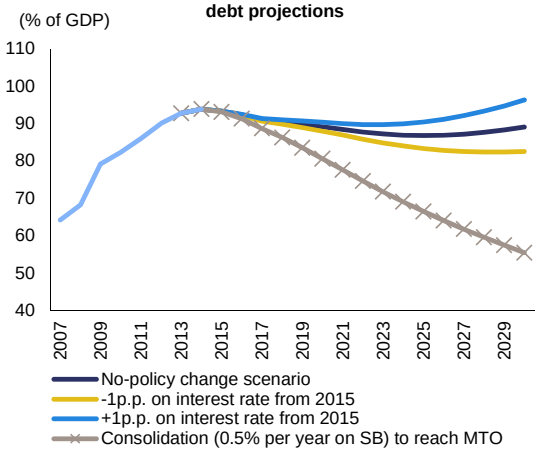


Source: Commission services

France's high public debt could adversely affect the country's banking system, whose exposure to French sovereigns has increased over the last year. As of June 2013, the four major French banks had a total of EUR 150 billion in French government bonds according to the European Banking Authority([14]), up by around a third compared to June 2012 levels (EUR 115 billion). Although sovereign yields have somewhat increased over the past year, they still remain below historical levels. This has so far prevented domestic banks from experiencing significant losses on national government bond holdings and additional funding and liquidity constraints. While it is difficult to predict the timing, speed or direction of any change to this situation, a significant increase in sovereign yields is likely to raise financial stability concerns and lead to a fall in bank equity prices as experienced in 2011. French banks had then seen their access to short-term funding sharply curtailed because of fears about their exposure to peripheral EU countries and in particular to sovereign debt.

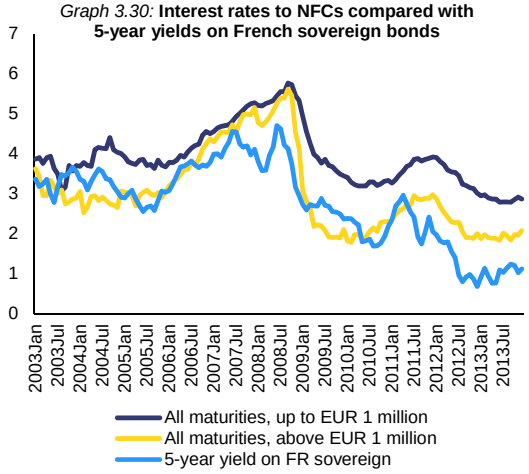
([14]) EBA 2013 EU-wide Transparency Exercise.

Graph 3.29: **Public Debt - Medium- and long-term debt projections**



Source: Commission services

Graph 3.30: **Interest rates to NFCs compared with 5-year yields on French sovereign bonds**



Source: Commission services

A significant rise in French sovereign yields would also have a negative impact on non-financial corporations. As discussed in the 2013 IDR and described in detail in ECB (2012), developments in benchmark interest rates, including sovereign bond yields, are the main determinants of the conditions of direct financing in financial markets for both non-financial and financial corporations. In France as in the rest of the euro area, bank-based financing is the predominant source of external debt financing for the non-financial private sector. Therefore, factors that have an impact on credit intermediation through banks also exert a particularly strong influence on the financing conditions of firms and households via banks' lending rates, non-price conditions and lending volumes. As shown in Graph 3.30 recent developments in French sovereign yields have indeed translated into similar movements in the financing conditions for non-financial corporations. In contrast, this means that a (significant) increase in government bond premiums can become a major obstacle to granting loans to the real economy, similarly to what peripheral EU countries have experienced since the start of the sovereign debt crisis.

The debt service would also be negatively affected in the event of increased market pressure, with a likely impact on growth prospects and competitiveness. Despite the rising stock of public debt, the amount of interest payments has remained broadly unchanged at around 2.5% of GDP over the last few years and has even slightly decreased compared to the pre-crisis period. This came after French sovereign yields started to fall mid-2008 and reached historical lows in 2013, with the implicit interest rate on general government debt falling from an average 4.5% over 2000-07 to an estimated 3% over 2008-13.([15]) This development has so far limited the risk of the debt service crowding out more productive government expenditure, e.g. public investment which is generally considered as having a productivity raising effect at various time horizons. From this perspective, France actually appears in a relatively favourable position since it is the only country among large euro area Member States to have kept a stable share of public investment as a share of GDP (around 3%) over the last 20-30 years; other countries have either reduced the latter gradually over time (Germany, Italy) or have drastically cut public investment since the beginning of the crisis (Spain). In contrast, a sharp rise in sovereign yields would either necessitate cutting expenditure elsewhere or raising an already elevated tax burden, with the latter further weakening the competitiveness of French companies. On the other hand, losses of competitiveness render high debt levels even more

([15]) Using the ratio of interest expenditure to end of previous year debt level as a proxy.

problematic as they weigh on growth prospects, which in turn make it more difficult to put the debt ratio on a downward path. These two effects are mutually reinforcing and could turn into a vicious circle. In addition, the fiscal space to tackle further shocks or severe private imbalances tends to decline with the stock of government debt.

Increasing public debt and related future developments in sovereign yields warrant close monitoring in France. The debt stock will continue to rise in the short term due to high deficits relative to nominal GDP growth prospects. As a consequence, higher interest rates in the short to medium run cannot be excluded, even though a credible medium-term consolidation strategy can make an important contribution to averting this. In fact, some rebalancing in sovereign yields has already taken place, with core euro area sovereigns on an upward trend since mid-2013, but this has so far remained limited. Most importantly, persistent concerns from different stakeholders, including investors, international organisations, rating agencies and think tanks on France's capacity to achieve budget plans and carry out structural reforms might exacerbate pressures and lead to a change in market sentiment, with a risk of overreaction of the markets given the high debt ratio and especially after a protracted period of time that has not seen any extreme events affecting France materialising. The risk associated with increasing public debt levels is even bigger when considered in conjunction with rising private sector debt. Hence the combination of private and public sector indebtedness could reinforce financial feedback loops.

4. POLICY CHALLENGES

The analysis in this IDR indicates that the French economy is subject to a significant deterioration of its export competitiveness and to risks linked to the high and increasing level of government debt. While the current level of external debt is still relatively benign, its increase is a worrying trend which may weigh on the recovery and could ultimately have a negative impact on growth in the euro area as a whole. France's poor trade performance is related both to cost and non-cost competitiveness factors. In particular, a number of distortions and rigidities on the labour market translate into difficulties for firms to adapt to changing conditions and may contribute to lower non-cost competitiveness in the long term. More generally, the unfriendly business environment in France seems to be an obstacle to the development of a dynamic, competitive and more innovative private sector. In a context of moderate growth and low inflation, the level of government debt has continued to increase despite the significant efforts to reduce the general government deficit. Specific focus should be put on reducing public expenditure, by systematically identifying the potential for more efficient and less costly public services.

Cost of labour: **Further efforts to reduce the cost of labour appear warranted.** France is among the countries in the European Union where the cost of labour is the highest. Despite the high labour productivity, the cost of labour impacts negatively the profitability of companies. The evolution of wages over a long period indicates that these have increased in line with productivity. The drift in export performance since 2000 can therefore not be primarily attributed to an excessive increase in unit labour costs over the last few years. On the other hand, wage benchmarks provide indications that the wage level itself may be high. The social security contributions paid by employers in France are also among the highest in the EU. Despite efforts to maintain competitive prices, the competitiveness of French firms is hampered by the high cost of labour. Indeed, French firms' profit margins are the lowest in the EU and restoring them is a pre-condition for firms to increase investment, improve the quality of their products, and hence increase their non-cost competitiveness.

Measures planned so far will not be sufficient to fully restore the profitability of non-financial companies. The tax credit for competitiveness and employment (CICE), which was adopted in 2012, has contributed to improving the financial situation of companies. As part of the responsibility pact presented on 14 January 2014, a further reduction in employers' social security contributions was announced by President Hollande. While more information is needed on that second step, the reduction in the tax burden on labour goes in the right direction and will contribute to restoring private companies' profitability. However, at this stage, the amounts considered will only bridge part of the profitability gap vis-à-vis France's main trading partners in the euro area. In particular, it will be insufficient to compensate for the contrasted wage developments seen in France and Germany between 2000 and 2008. Moreover, as the measures presented so far are generally targeted to lower wages in order to increase their impact in terms of employment, there are risks that they do not primarily benefit exporting firms as the latter generally pay higher wages.

Rigidities and distortions on the labour market: Rigidities in the wage setting remain strong and recent reforms have only marginally improved the situation. Despite recent efforts to increase the flexibility of the labour market, wage developments in France continue to be characterised by significant downward rigidities. These could accentuate the financial difficulties met by companies during downturns. In this regard, although the recently adopted reform of the labour market seeks to increase the possibilities for firms facing temporary difficulties to adjust wages, preliminary evidence suggests that this new legislation has not yet reached its objectives. More generally, the weight of the minimum wage in the French wage setting system, its relatively rigid revaluation mechanism as well as the limited number of exemptions have negative impacts on the labour market outcomes for the most vulnerable populations and contributes to the overall wage rigidities although it contributes to reducing wage inequalities. The resulting distortion in the wage distribution could reduce incentives to increase skills and productivity. The social security contributions exemptions targeted to lower wages and which aim to compensate the negative impact of the minimum wage on

employment, together with the current tax credit for competitiveness and employment, increase the relative costs of highly skilled workers compared to low-skilled ones, with a potentially negative long-term impact on productivity and competitiveness.

Business environment: **There is considerable scope for improving the business environment despite recent efforts to reduce firms' administrative burden.** Efforts have been made as part of a "simplification shock" launched in July 2013 to ease the relationships between firms and the administration. However, a number of barriers to firms' growth persist. In particular, some size thresholds appear particularly difficult to cross (50 employees). Limited initiatives to enhance competition, in particular in the service sector, have been taken. Low level of competition in services translates into higher intermediary costs for firms and less innovative services. As a result, further stimulating competition both in the product and services sectors would benefit exporting firms and contribute to their competitiveness.

Innovation: Policy initiatives to boost R&D spending and innovation by private companies, in particular the tax credit on research and the competitiveness poles, have yielded mixed results so far. A large share of R&D spending remains financed by public money either directly through public research or indirectly through subsidies. There is scope for improving the effectiveness of the existing tools in order to trigger higher R&D expenditures and innovation in the private sector. In particular, resources allocated to the competitiveness poles could better foster scale effects and improve the diffusion of innovation. In addition, the effectiveness of the policy could be strengthened by enabling these poles to become real networks of firms with positive spillovers.

Government sector indebtedness: Efforts to put the government debt on a downward trend need to be enhanced. France has weathered the euro area sovereign debt crisis without experiencing major tensions on sovereign yields. The latter have actually fallen below historical levels, with increased risk aversion supporting German bunds and filtering through to other euro area economies, including France. However, the stock of general government debt has continued to increase and the trend will not stop in 2014, according to the Commission Winter 2014 forecast. In order to limit risks of increased market pressure or a reversal in investor sentiment, which would in turn necessitate additional fiscal tightening and trigger spillovers to the financial sector and the real economy but also to the rest of the euro area, it is crucial to put public debt on a steadily declining path. This requires enhanced efforts at fiscal consolidation, in line with the trajectory recommended by the Council, which calls for a correction of the excessive deficit in 2015 and the achievement of the medium-term objective in 2016.

Given France's high tax burden by international comparisons, and more so regarding the tax burden on labour, the necessary improvement in fiscal metrics requires stepped-up efforts at reining in government spending. In this respect, the French authorities have promised to achieve expenditure savings in the order of EUR 50 billion (2.5 % of GDP) by 2017, especially in the areas of social security and local governments. Past experiences of expenditure savings initiatives (the former *Revue générale des politiques publiques* and the on-going *Modernisation de l'action publique*) have not resulted in a significant reduction in public expenditures. Therefore, a more ambitious approach is necessary to effectively identify the potential for efficiency gains in public services and achieve expenditure savings commensurate with the deficit objectives set by the government.

Financial sector: **While the French financial sector has proved resilient throughout the crisis, its systemic importance calls for specific attention**. The banking sector remains well capitalised and its profitability, though decreasing, is in line with that of European peers. Its main risks are related to the refinancing structure, with wholesale funding representing a comparatively large share of liabilities. While French banks have performed well throughout the various stress tests organised at the national and European level so far, the on-going comprehensive review conducted by the European Central Bank will be instrumental in better identifying potential vulnerabilities and the need for potential recapitalisation.

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