Brussels, 2.6.2021
SWD(2021) 405 final

COMMISSION STAFF WORKING DOCUMENT

In-Depth Review for France

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

{COM(2021) 500 final} - {SWD(2021) 401 final} - {SWD(2021) 402 final} - {SWD(2021) 403 final} - {SWD(2021) 404 final} - {SWD(2021) 406 final} - {SWD(2021) 407 final} - {SWD(2021) 408 final} - {SWD(2021) 409 final} - {SWD(2021) 410 final} - {SWD(2021) 411 final} - {SWD(2021) 412 final}

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EXECUTIVE SUMMARY

The 2021 Alert Mechanism Report concluded that an in-depth review should be undertaken for France to examine further the persistence of imbalances or their unwinding. In February 2020, under the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "macroeconomic imbalances" in France. These imbalances related to risks of high public indebtedness and weak competitiveness dynamics, in a context of low productivity growth. The analysis shows that these vulnerabilities remain. It should be noted that the context of the assessment of vulnerabilities in this year's in-depth review (IDR) for France is markedly different from last year. Also, the evolution of the COVID-19 pandemic, the strength of the recovery, and possible structural implications of the crisis are all still surrounded by high uncertainty, requiring caution in the assessment. In general, policy action over the past year focused on cushioning the impact of the COVID-19 shock and facilitating the recovery. This has added to indebtedness but should support adjustment in the medium-term. Looking forward, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment and reforms needs.

Main observations and findings of this IDR analysis are:

- **This IDR is informed by the 2021 spring forecast, which expects a recovery in economic activity in France with the easing of the COVID-19 crisis.** After the steep drop of 8.1% in 2020, real GDP is projected to increase by 5.7% this year and 4.2% next year, allowing the economy to recover its pre-pandemic level in the course of 2022.

- **Despite positive recent developments, the COVID-19 shock has brought about a temporary deterioration in competitiveness.** Cost-competitiveness improved in recent years in France thanks to a moderate growth in unit labour costs compared to most other euro area and EU countries, and the export market shares remained broadly stable, although competitiveness losses accumulated in previous years had not yet been regained. This trend halted with the outbreak of the COVID-19 pandemic, which led to a sharp increase in unit labour costs, and a drop of exports in crucial sectors such as aeronautics. While reforms in recent years aimed to improve the business environment and competitiveness, there is still a significant margin for improvement in research and innovation. The COVID-19 impact on cost competitiveness is expected to be partially reversed in the coming years.

- **The high level of public debt constitutes a vulnerability for the economy, as it reduces the fiscal space available to respond to future shocks and poses high sustainability risks.** As a result of the fall in economic activity and the measures put in place to address the COVID-19 pandemic and support the economy, public debt rose sharply in 2020. It is also set to increase further in 2021 due to a still high deficit, and set to remain above 116% of GDP over the period 2021-2022. High public debt weighs on growth prospects by crowding out productive public expenditure.

- **Private debt has kept rising, while firms have been weakened by the COVID-19 crisis.** The debt of both households and non-financial corporations was on an upward trend since the early 2000's. The COVID-19 crisis provoked a significant surge in indebtedness in 2020. Levels now stand above prudential benchmarks for both households and non-financial corporations. While rising indebtedness has been flanked by an increase in corporate liquidity buffers and non-performing loans remain low compared to the EU average, the phasing out of support measures presents a risk.

- **These vulnerabilities are reinforced by low productivity growth.** Several important measures have been taken in recent years to improve labour market efficiency and the business environment, which will take time to produce full effects. However, further efforts may be necessary to support productivity dynamics, which will be key for the sustainability of public and private debt.

1. ASSESSMENT OF MACROECONOMIC IMBALANCES

Introduction

In February 2020, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "macroeconomic imbalances" in France. These imbalances related to high public debt and weak competitiveness dynamics in a context of low productivity growth, which carry cross-border relevance. The 2021 Alert Mechanism Report published in November 2020 concluded that a new in-depth review (IDR) should be undertaken for France with a view to assess the persistence or unwinding of imbalances.

The context of the assessment of vulnerabilities this year is markedly different from last year's IDRs, which took place before the COVID-19 pandemic. The evolution of the pandemic, the strength of the recovery, and possible structural implications of the crisis are still surrounded by high uncertainty requiring caution in the assessment. Policy action over the past year focused on cushioning the impact of the COVID-19 shock and on facilitating the recovery. While this supports adjustment in the medium-term through stronger fundamentals, it also has added to indebtedness. Follow-up to country-specific recommendations from 2019 and 2020, including those that are MIP-relevant, is taking place in the context of the assessment of the Recovery and Resilience Plans (RRPs). The analysis of policies in the present report was finalised before the formal submission of RRPs and does not draw on information included in RRPs. It is therefore without prejudice to the Commission's assessment of RRPs, which is ongoing at the time of publication of this report.

The assessment follows a similar structure as the IDRs that were included in Country Reports in recent annual cycles. This chapter presents the main findings for the assessment of imbalances, also summarised in the MIP assessment matrix. The assessment is backed by selected thematic chapters that look more at length at competitiveness, public finances and private indebtedness. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, also assessments of structural issues made in previous IDRs and in the context of fiscal assessments are considered if relevant.

Macroeconomic context

Following the historic decrease of 2020 due to the COVID-19 crisis, real GDP growth is forecast to rebound, reaching its pre-crisis level by the beginning of 2022. Growth in France rebounded strongly in the third quarter of 2020, after the unprecedented contraction in the first half of the year. Overall, GDP fell by 8.1% in 2020 and growth is forecast at 5.7% in 2021 and 4.2% in 2022. Potential growth is forecast to gain momentum after the deceleration in 2020 and reach 1.3% in 2022. The output gap is set to improve, becoming slightly positive, at 0.1% in 2022. The current account deficit is forecast to gradually narrow, to -1.2% of GDP in 2022, supported by, inter alia, the rebound of net exports. The gross saving rate of households, which rose sharply as a result of the COVID-19 crisis and the restrictions on consumption, is forecast to reduce gradually to its pre-crisis level, of 14.6%, in 2022. The unemployment rate is forecast to rise to 9.1% in 2021, but to decline to 8.7% in 2022, remaining higher than in 2019. HICP inflation is set to increase to 1.4% in 2021, driven by the increase in the oil price and the gradual increase in the price of consumer services. Inflation is expected to slow down in 2022, to 1.1%, mainly because of a decrease in energy prices and the stability of excise duties on tobacco, after several years of sharp increases.

Economic recovery is expected across all demand components. Private consumption is forecast to rebound sharply in the second half of 2021, with the lifting of the most severe restrictions weighing in particular on the service sector. The recovery is set to be supported by the resilience of consumers' purchasing power and employment. Investment should also benefit from easing of restrictions as from the third quarter of this year, as well as favourable financing conditions and the plan 'France Relance' over the forecast horizon. Net exports are projected to gradually recover, but more slowly than the other components, as crucial export sectors (e.g. tourism and aeronautics) still suffer from longer lasting

restrictions on international mobility. Policy measures to protect jobs and to provide liquidity for firms are expected to remain in place until end-2021. A downside risk to growth is a possible surge in corporate insolvencies, as policy support measures are wound down. This could lead to an increase in unemployment and result in reduced productive capacity. Also, the tourism season in summer 2021 could be weaker than expected if the vaccination process is delayed or less effective than anticipated.

Imbalances and their gravity

General government debt remains high and is projected to increase further in 2021. At 97.6% of GDP in 2019, before the outbreak of the COVID-19 pandemic, public debt in France was already very high, due to protracted elevated structural deficits and a lack of sufficient fiscal consolidation in previous years. The pandemic has brought about a brisk increase in public debt, by almost 20 points, to 115.7% of GDP in 2020. According to the Commission 2021 spring forecast, France's public debt is set to increase further in 2021, before reducing by around one percentage point of GDP in 2022, on the back of still high public deficits. The latest debt sustainability analysis confirms that the country faces *high* risk in the medium-term. ([1])

The existing upward trend in private debt accentuated in 2020. Private debt is above 175% of GDP, with both households and non-financial corporations exceeding prudential thresholds. In particular, an increase in non-financial corporations debt in 2021 as a result of the COVID-19 crisis might result in an increase in the number of bankruptcies and thus in an uptick in non-performing loans (NPLs). In turn, while the banking sector's solvency has remained so far relatively solid, partly thanks to support measures, profitability has dropped and signs of credit tightening through 2020 and early 2021 due to deteriorating risk perceptions have been observed. In this context, an increase in non-performing loans following corporate bankruptcies could add additional pressure to the financial system.

Competitiveness remains an issue in France. The large losses of export market shares in the 2000s had not been regained before the outbreak of the crisis and both cost and non-cost competitiveness have constituted a concern. Complex administrative procedures and regulatory restrictions imposed on service providers continue to weigh on the business environment. Competitiveness deteriorated significantly in 2020. However, several reforms are either underway or have been introduced to improve cost-competitiveness. Further progress in cost-competitiveness is nonetheless hampered by the slow productivity growth trend, which poses a risk to France's long-term prosperity and prevents a faster deleveraging.

The large size of the French economy can be a source of cross border spillovers to other Member States. France is an important trade and financial partner for many EU countries and in particular to neighbouring countries (see Table1.1). Box 1.1 provides a quantitative estimate of how the COVID-19 pandemic has affected the French cross-border demand. It shows a very heterogeneous impact across the Member States, with Belgium, Portugal, Luxembourg and Spain being the most adversely affected.

Table 1.1: **Outward spillover heat map for France**

	EU partner																										
	AT	BE	BG	HR	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HU	IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK
Imports	2.1	15.3	2	0.7	0.2	4.5	3.9	1.7	1.6	1.4	4.9	1.1		3.8	3.8	3.4	3	22.1	1.5	2.1	8.2	2.9	6	2.3	1.8	4.5	6
Imports (in value added)	1.4	4.6	1.6	0.9	0.7	2.4	2.1	1.1	1.1	0.8	2.7	0.9		2.1	3.1	1.8	1.8	5.6	0.9	1.5	2	2	2.6	2.5	1.4	1.9	2.6
Financial liabilities	9	62.2	2.2	1.8	14.1	2.1	19.7	12.9	2.3	2.2	11.2	11		2	66	15	0.6	1403.2	2.6	39.2	49.2	1.5	9	0.8	5.6	7.9	2.1
Financial assets	11	74.4	4.6	1.7	17.4	7	10.8	11.8	1.3	9.8	24.3	13.7		4.2	55.9	31.1	1.8	986.3	2.4	17.7	66.4	7.9	20.8	4.1	9.1	7.1	4.8
Liabilities (to banks)	3.2	4.4					4.5			0.8	7.5	5			1.6	3.7					12.1	3.2			0.7		
Bank claims	3.4	54.7	1.4	1.2	5.9	20.5	5.4	3.3	0.1	1	10.3	5.9		2.1	14.8	19.6	0.5	249.6	0.1	6.8	12.4	8.1	10.1	6.2	6	1.5	2.4

Cross-border figures for France, expressed as a % of the GDP of the partner country. The darkest shade of red corresponds to percentile 95 and the darkest shade of green to percentile 5. The percentiles were calculated for each variable based on the full available sample of bilateral exposures among EU countries. The blank spaces represent missing data. Data refer to: Imports - 2018, Imports (in value added) - 2015, Financial liabilities - 2018, Financial assets - 2018, Liabilities (to banks) - 2020-Q3, Bank Claims - 2020-Q3.
Source: IMF, OECD, TiVa, BIS and Commission services

([1]) See Article 126(3) report (June 2021) and also European Commission (2021) for detailed methodological aspects.

Evolution, prospects and policy responses

Public deficits will remain high in the coming years. Efforts to consolidate government finances ahead of the crisis only modestly reduced the public expenditure ratio. The COVID-19 crisis has brought about a notable deterioration in French public finances. In 2020, the expenditure ratio increased by around 7 points, to 62.7% of GDP, remaining the highest in the EU. Curbing public spending and increasing its efficiency once the recovery is underway is essential to put public debt on a steady downward path. The Public Action 2022 ([2]) programme has however been put on hold and there are as yet no plans to contain the dynamics of public spending, including spending reviews, when economic circumstances allow. Moreover, the reform to unify the numerous pension schemes in France was put on hold after the outbreak of the COVID-19 pandemic and no forward-looking calendar has so far been announced. The complexity of the current French pension system undermines its transparency, puts in question its fairness and hampers labour mobility.

Private debt is set to keep rising in 2021. The public guarantee scheme set up by the state has played an important role in supporting lending during the crisis, especially to SMEs. However, the recent increase in corporate debt raises a risk of future bankruptcies and may lead to an uptick in non-performing loans, which added to the already low profitability and some credit tightening through 2020 and early 2021 due to increased risk perception, may represent a challenge to the financial system.

The deterioration in cost competitiveness in 2020 is expected to be temporary. Cost competitiveness remained broadly unchanged in 2019. Unit labour costs decreased in 2019, but mainly driven by one-off effects from the transformation of the tax credit for employment and competitiveness (CICE) into a permanent reduction in social contributions. Total export market shares remained flat, while the current account deficit remained broadly stable. In 2020 crucial sectors were severely hit (aircraft industry, beverages) as a result of the COVID-19 crisis and the unit labour costs increased sharply. However, these shocks are set to be temporary. Unit labour costs are expected to decline by 1.4% in 2021 and most of the COVID-19-associated export market share losses are expected to be regained by 2022. In addition, reforms have been introduced to improve productivity and cost competitiveness, which are set to produce positive effects in the years to come. Further reforms and investments are expected in the coming years (around EUR 45 billion expenditures embedded in the RRP or the reform of the unemployment benefit system), of which the implementation will be key to address the issue.

Overall assessment

The COVID-19 crisis has added to already-existing weaknesses of the French economy. France is characterised by high and rising public and private indebtedness and still weak competitiveness, in a context of low productivity growth. A negative shock hit crucial export sectors and increased unit labour costs via a fall in productivity. Public debt is set to increase further in 2021, before reducing by around one point of GDP in 2022. Fiscal sustainability risks have been aggravated following the outbreak of the COVID-19 pandemic and short and medium-term public debt sustainability risks are high. Private debt is also high and on the rise, with household and non-financial corporation debt in excess of prudential thresholds. New risks include a potential increase of NPLs in the short-term as bankruptcy rates increase. The risks stemming from high public debt are therefore compounded by high and growing private debt, which increase France's vulnerability and may limit the economy's ability to counter negative macroeconomic shocks, while low productivity growth aggravates the structural problems of the French economy. Improving the productivity dynamic will also be key to help reduce both public and private debt burdens.

Some elements contribute to dampening the risks associated with weak competitiveness and high indebtedness. The negative shock to competitiveness brought about by the outbreak of the COVID-19 pandemic is expected to be temporary. Important reforms were introduced in recent years and are expected to produce positive effects in the medium term. The implementation of these reforms and investments projects to come (including from the RRP) will be key to address the persisting structural

([2]) Public Action 2022 programme (Action Publique 2022), aimed at a general and coordinated overhaul of all public policies. In particular, the programme set three main objectives: the improvement of the quality of public services, the modernisation of public administration and the support to the reduction of the expenditure-to-GDP ratio by 3 percentage points by 2022. In this respect, the programme formally embedded and replaced the annual spending reviews introduced in 2014 and officially terminated at the end of 2017.

competitiveness challenges and slow productivity growth. In turn, the persistence of the high level of private indebtedness, mainly driven by the declining path of interest rates, in the corporate sector is mostly observed within large international firms. Besides, there is a parallel increase in liquidity buffers of NFC, whereas the households' saving ratio rose significantly in 2020.

Table 1.2: **Assessment of Macroeconomic Imbalances Matrix – France**

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
Competitiveness	Competitiveness in France has shown a mixed-picture for a number of years, with low productivity growth weighing on competitiveness. Export market shares have stabilised over the recent past after years of losses, as France has benefited from its geographical positioning. Unit labour costs have grown more moderately than in other euro area and EU countries as wage developments have been contained. However, the sluggish productivity growth makes it difficult to keep on improving the price-competitiveness. In terms of non-price competitiveness, while French exports of goods are overall of medium-high quality, France has continued to maintain the highest quality in the sectors in which France is mainly specialised, such as aeronautics, cosmetics and beverages. The relevance of exports to GDP increased less than in the rest of the euro area. The COVID-19 shock has brought about a deterioration in competitiveness, with a sharp increase in unit labour costs, and a large drop of exports in crucial sectors. The current account balance and the net international investment position (NIIP) have been slightly negative for several years, with a deficit of -0.7% of GDP and at -22.9% of GDP respectively, in 2019. The fundamentals of the French economy would however suggest somewhat higher readings on both dimensions.	The total export market shares remained flat in 2019, after several years of stabilisation, but are estimated that may have endured an important negative shock in 2020. However, the decrease would be mainly due to unfavourable specialisation and geographical orientation in respect of the COVID-19 crisis. In the central scenario, a large part of the losses are forecast to be regained by 2022. However, negative risks are clearly identified, like a more durable impact on some key sectors for French exports. Following a similar dynamic, the current account deficit deteriorated significantly in 2020, and is forecast to rebound in the following years. Nominal unit labour costs have exceptionally decreased in 2019 due to the one-off impact of the transformation of the CICE into a permanent reduction in social contributions. In turn, the crisis contributed to a sharp increase of the unit labour costs in 2020. However, this increase is set to be temporary and those losses are forecast to be reversed in the coming years. In the medium term, labour productivity is expected to remain subdued, which prevents significant progress of cost competitiveness. Non-cost competitiveness is expected to improve over the medium-term, when the effects of the recently announced and undertaken policy actions will fully materialise. However, several sectors where France exports high-quality products are facing downward risks (long-term impact of the COVID-19 crisis and environmental policies on the aircraft industry, or the impact of the introduction of custom duties on food and beverage).	The plan 'France Relance' aims at fostering France's competitiveness by encouraging the digitalization of the economy, the entry of the youth into the labour market or by diminishing taxes on production by € 10 billion. It also entails a specific support plan to aeronautic sector. Besides, an important range of measures had been taken before the pandemic to address the issue of low competitiveness, like the additional reduction of employers' social contributions for employees below 1.6 times the minimum wage. Importantly, several measures were introduced to address the issue of sluggish productivity. The PACTE Law adopted in May 2019, aims at fostering firms' growth by reforming firm size thresholds, improving the restructuring procedure and encouraging incentive compensation. Besides, action have been taken to the labour market more efficient by improving social dialogue and strengthening collective bargaining within firms. The unemployment benefit reform, adopted since November 2019 but not implemented yet, aims at reducing excessive reliance on temporary jobs in some sectors, and changed the eligibility criteria and compensation rules to make them more conducive to employment.
Public debt	General government debt rose sharply, to 115.7% of GDP in 2020 as a result of the COVID-19 crisis. Such a high debt level constitutes a vulnerability for the economy as it reduces the fiscal space available to respond to future shocks and weighs on growth prospects, by crowding out productive public expenditure and requiring a high tax burden. On the positive side, government debt management is of good quality and the government has benefited from the very low and even negative sovereign yields environment to lengthen the average maturity of sovereign debt, thereby mitigating refinancing risks. The investor base is diverse, both by type and geographically, with the government	The headline deficit rose briskly to 9.2% of GDP in 2020, partly due to the deficit-increasing temporary measures, adopted to fight the pandemic and its socio-economic impacts, which amounted to 3.5% of GDP. The Commission 2021 spring forecast projects the headline deficit to be at 8.5% of GDP in 2021 and to reduce further, to 4.7% in 2022. France's public debt is expected to rise further in 2021 due to the high French primary deficit after the COVID-19 outbreak, before declining slightly in 2022. Public debt is expected to remain at very high levels over the medium term. Short-term sustainability risks are assessed as high. In turn, at current trends for age-related expenditures, the simulated debt trajectory by year 2030	The budgetary strategy of France was considered as risky before the COVID-19 outbreak, with no structural adjustment efforts since 2015. Public finances deteriorated briskly in 2020, thereby aggravating the sustainability challenges in the short and medium term. The quantification of savings and efficiency gains in the context of the 'Public action 2022' programme is not available and thereby their macroeconomic impact cannot be assessed. After the outbreak of the pandemic, 'Public action 2022' has been put on hold. The pension reform, aimed at unifying the currently existing 42 different regimes, was put on hold too and no forward-looking calendar has so far

(Continued on the next page)

Table (continued)

sector crucially accounting for France's negative total NIIP.

Risks stemming from the high public debt are compounded by the also high and increasing private debt (153% of GDP in 2019 and rising further, over 175% in 2020). These risks have aggravated significantly after the COVID-19 outbreak. Both fundamentals-based benchmarks and prudential concerns point to significant deleveraging needs for households and especially for non-financial corporations.

points also to high medium-term sustainability risks.

Private debt is high and has keep rising. The COVID-19 crisis provoked a significant surge in indebtedness in 2020. Both households and corporate indebtedness are above prudential thresholds and levels suggested by their fundamentals. However, liquidity buffers have increased in parallel. The deployment of a sizeable envelope of State loan guarantees has prevented so far a spike in corporate bankruptcies. However, the possibility that these guarantees could be called on implies an upward risk for public debt.

Although the financial sector does not face immediate risks, partly thanks to support measures, pressures from the combination of high public and private debt, in particular of non-financial corporations, may increase in the future under adverse economic conditions. Moreover, the potential increase in bankruptcies and non-performing loans when support measures are phased out add up to the risks on the financial system.

been announced. This reform would contribute to enhancing the transparency and fairness of the pension system, as well as labour mobility. The latter may have also a positive impact on productivity. However, the reform should safeguard the sustainability of the pension system.

Once the recovery is underway, a significant fiscal effort would be needed to put French public debt on a sustained downward trajectory so as to ensure its sustainability.

Main takeaways

- France is characterised by very high and rising indebtedness and weak competitiveness, in a context of low productivity growth. Associated vulnerabilities have cross-border relevance.
- Competitiveness developments face downsides risks in the short-term due to the COVID-crisis: crucial high-quality sectors have been severely hit, and the scars of the crisis may dampen the productivity in the future, weighing on the labour costs. However, and despite a lot of uncertainty, the shock on competitiveness is set to be mainly temporary. Public and private debt ratios have increased visibly with the COVID-19 crisis. Low productivity growth hampers public and public deleveraging and a faster recovery of competitiveness losses accumulated in previous years.
- At the same time, several reforms adopted in recent years are set to improve the responsiveness and performance of the labour market. Besides, the French Recovery and Resilience Plan addresses the national weaknesses. His efficient implementation will be key to foster France's competitiveness, while ensuring a green and digital transition and addressing the social challenges. By bolstering competitiveness, an efficient implementation of the plan would also help public and private deleveraging. The deployment of a sizeable envelope of State loan guarantees are set to prevent a spike in corporate bankruptcies, but the possibility that these guarantees could be called on implies an upward risk for public debt. Moreover, insofar as these guaranteed loans prevent the restructuring of otherwise less viable firms may weigh on productivity growth.

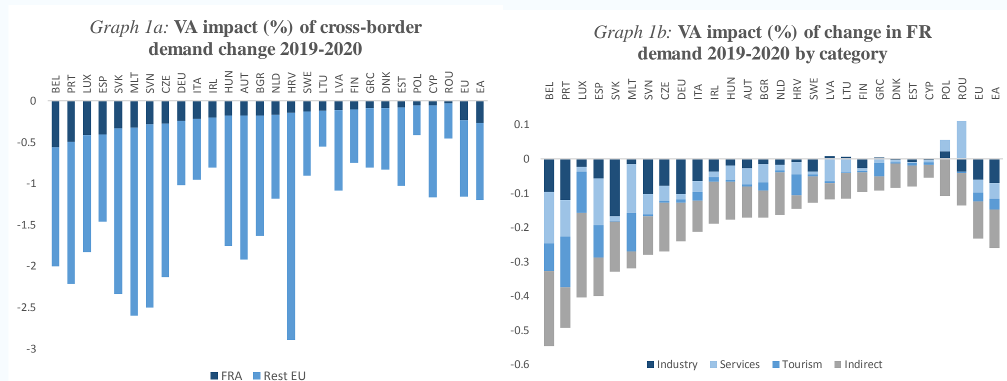
Source: European Commission Services

Box 1.1: Spillovers France

The pandemic recessions in EU Member States also reflected faltering cross-border demand from trade partners. The drop in French aggregate demand due to the pandemic and the containment measures played a significant role in the output declines of its closest partners. In the recovery, cross-border spillovers may undo their negative impact of 2020, yet the uncertain timing and extent of the recovery make a forward-looking assessment difficult. As a first step, this box thus aims to take stock of the heterogeneous spillovers of French demand to other Member States' value added in 2020. It quantifies cross-border effects applying latest production data to input-output estimates. ([1]) This allows for synthesizing supply chain effects, e.g. detailing how French consumption from domestic providers affected those providers' foreign suppliers, and their suppliers in turn. While these results allow for country-specific sectorial detail, note that they reflect partial equilibrium effects in the goods and services market only – they do not include any second-round effects on foreign wage income, interest rates, prices etc., which may be stronger.

Graph 1a shows the overall cross-border impact of the heterogeneous final demand changes during 2020, and highlights the French contribution therein. Overall, 1.2 pp of the 2020 EU output decline can be attributed to cross-border demand effects, with French demand accounting for over 0.2 pp thereof. Yet small open service-intensive economies were hit harder than the average. The importance of French demand varies significantly across partners. For instance, third of the VA impact in Spain due to intra-EU demand changes is driven by a reduction in French demand, whereas this share is almost negligible in countries like Cyprus or Romania.

Graph 1b highlights the heterogeneous effects of the pandemic by zooming in on the French contribution by sector (the dark-blue bar in Graph 1a). ([2]) The indirect spillovers, which captures supply chain interlinkages, seems to be most relevant across the trading partners. ([3]) Such indirect cross-border spillovers account for 0.1 pp of total impact of French demand on the RoEU output loss, on a par with industrial, service and tourist demand together. Changes in the final demand for industry products had a strong impact on Belgium, Portugal and some Central European economies in particular. The decline in French tourists accounted for a visible share of French demand spillovers to Portugal, Luxembourg, Spain or Malta. Demand changes for non-tourist services were more diverse, and even seem to have had a positive impact on Romania and Poland. Overall, 2020 French demand changes thus had a significant impact on the RoEU, with predominant role of indirect spillovers via French supply chains.



([1]) The estimates derive from a two-step analysis: 1) Compiling 2020 output declines at the sector-level across the globe. For the EU Member States, detailed information for 2020 is available in Eurostat. For non-EU countries, sectoral output changes in 2020 are approximated by IMF WEO GDP changes, thus implicitly abstracting from sectoral heterogeneity; 2) Using output changes in all country-sector pairs to trace back changes in final demand, based on global supply chain interlinkages as captured by the OECD ICIO tables. The resulting set of final demand changes can then be used to simulate the impact of the COVID-19 crisis on each country-sector's value added. Two important assumptions are made to allow for such a translation of output changes into demand changes. First, the technological coefficient matrix, which captures the required amount of supplies from any sector to produce a given sector's output, is assumed to have remained fixed since the latest ICIO data (2016). Second, the country allocation final demand for a specific sector is assumed to have remained proportional to 2016.

([2]) Distinguishing by the source of demand allows to quantify the impact of demand changes in a certain country on VA production in all its trading partners, by type of good or service. Given the particular nature of the COVID-19 crisis, with a strong impact on hospitality sectors, the analysis distinguishes between tourism (NACE sector I), all other services (G-N excl. I) and industry (A-F).

([3]) For example, a drop in French demand for German cars reduces Slovak production of engines, with a knock-on effect on Czech suppliers of engine parts.

Table 1.3: **Selected economic and financial indicators, France**

	2004-07	2008-12	2013-18	2019	2020	forecast 2021	forecast 2022
Real GDP (y-o-y)	2.3	0.4	0.9	1.5	-8.1	5.7	4.2
Potential growth (y-o-y)	1.8	1.2	0.6	1.1	0.8	1.2	1.0
Private consumption (y-o-y)	2.3	0.6	1.2	1.5	-7.2	3.4	5.6
Public consumption (y-o-y)	1.7	1.5	0.8	1.7	-3.0	6.0	-0.3
Gross fixed capital formation (y-o-y)	3.9	-0.9	1.8	4.2	-10.2	11.0	3.1
Exports of goods and services (y-o-y)	4.5	1.2	3.4	1.9	-16.0	10.0	9.6
Imports of goods and services (y-o-y)	6.0	1.2	3.9	2.5	-11.1	7.6	6.6
Contribution to GDP growth:							
Domestic demand (y-o-y)	2.5	0.5	0.8	2.2	-7.0	5.9	3.6
Inventories (y-o-y)	0.2	-0.1	0.2	-0.4	0.3	-0.7	-0.2
Net exports (y-o-y)	-0.4	0.0	-0.1	-0.2	-1.4	0.5	0.7
Contribution to potential GDP growth:							
Total Labour (hours) (y-o-y)	0.5	0.3	0.1	0.3	0.3	0.4	0.2
Capital accumulation (y-o-y)	0.8	0.6	0.3	0.6	0.2	0.5	0.5
Total factor productivity (y-o-y)	0.6	0.3	0.2	0.3	0.3	0.3	0.3
Output gap	1.9	-1.0	-0.6	1.8	-7.1	-2.7	0.1
Unemployment rate	8.7	9.0	9.8	8.4	8.0	9.1	8.7
GDP deflator (y-o-y)	2.1	1.1	0.7	1.2	2.2	0.5	1.1
Harmonised index of consumer prices (HICP, y-o-y)	1.9	1.9	0.8	1.3	0.5	1.4	1.1
Nominal compensation per employee (y-o-y)	2.9	2.4	1.1	-0.2	-2.7	4.2	2.8
Labour productivity (real, person employed, y-o-y)	1.5	0.2	0.4	0.4	-7.1	.	.
Unit labour costs (ULC, whole economy, y-o-y)	1.5	2.0	0.8	-0.5	4.8	-1.4	-0.2
Real unit labour costs (y-o-y)	-0.5	0.9	0.0	-1.7	2.5	-1.8	-1.2
Real effective exchange rate (ULC, y-o-y)	0.7	-0.3	0.2	-4.3	.	.	.
Real effective exchange rate (HICP, y-o-y)	0.0	-1.2	0.3	-1.4	1.6	0.6	-0.8
Net savings rate of households (net saving as percentage of net disposable income)	9.2	10.0	8.6	9.1	.	.	.
Private credit flow, consolidated (% of GDP)	8.6	5.6	5.1	8.0	.	.	.
Private sector debt, consolidated (% of GDP)	110.9	131.7	143.1	153.3	.	.	.
of which household debt, consolidated (% of GDP)	42.9	53.0	57.4	61.7	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	68.0	78.8	85.7	91.6	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	2.6	4.2	3.4	2.2	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	0.9	0.9	-0.4	-0.6	-1.5	1.5	1.0
Corporations, gross operating surplus (% of GDP)	18.0	17.4	17.1	18.5	16.6	18.9	18.6
Households, net lending (+) or net borrowing (-) (% of GDP)	2.3	3.7	2.8	2.8	8.0	5.1	2.4
Deflated house price index (y-o-y)	9.7	-0.2	-0.1	2.3	4.7	.	.
Residential investment (% of GDP)	6.3	6.4	6.2	6.4	6.1	.	.
Current account balance (% of GDP), balance of payments	0.2	-0.7	-0.7	-0.7	-1.9	-1.6	-1.1
Trade balance (% of GDP), balance of payments	0.1	-1.3	-0.8	-1.0	-2.2	.	.
Terms of trade of goods and services (y-o-y)	-0.7	-0.4	0.0	0.8	1.1	-1.0	0.1
Capital account balance (% of GDP)	0.0	0.0	0.0	0.1	0.1	.	.
Net international investment position (% of GDP)	-4.8	-11.9	-17.8	-22.9	-26.7	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (1)	-6.7	-23.8	-31.6	-35.6	-40.6	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	175.3	239.1	235.7	253.6	300.1	.	.
Export performance vs. advanced countries (% change over 5 years)	-4.3	-9.3	-5.3	-2.2	-3.8	.	.
Export market share, goods and services (y-o-y)	-4.4	-4.0	0.0	-1.4	-6.7	1.9	4.0
Net FDI flows (% of GDP)	1.7	1.5	1.0	0.2	1.0	.	.
General government balance (% of GDP)	-3.0	-5.5	-3.3	-3.1	-9.2	-8.5	-4.7
Structural budget balance (% of GDP)	.	.	-2.9	-3.3	-4.6	-6.7	-4.7
General government gross debt (% of GDP)	65.6	83.1	96.1	97.6	115.7	117.4	116.4
Tax-to-GDP ratio (%) (3)	44.6	44.9	47.9	47.1	47.5	46.2	46.1
Tax rate for a single person earning the average wage (%) (4)	28.2	27.9	28.7	28.0	27.3	.	.
Tax rate for a single person earning 50% of the average wage (%) (4)	17.6	19.2	18.9	12.2	11.1	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
(4) Defined as the income tax on gross wage earnings plus the employee's social security contributions less universal cash benefits, expressed as a percentage of gross wage earnings
Source: Eurostat and ECB as of 2021-05-05, where available; European Commission for forecast figures (Spring forecast 2021)

2. THEMATIC ISSUE: PUBLIC FINANCES

Deficit developments

The general government deficit rose sharply in 2020 and is projected to reduce again gradually until 2022. After reaching 3.1% of GDP in 2019, the general government deficit rose sharply to 9.2% in 2020. The sizeable drop in economic activity brought about by the COVID-19 outbreak and the lockdown measures adopted to address the health emergency weighed heavily on tax revenues and pushed up social transfers due to the response of automatic stabilisers. This cyclical impact was compounded by discretionary measures amounting to 3.5% of GDP, mainly on the expenditure side, adopted to fight the COVID-19 pandemic and to support employment and economic activity. ([3]) According to the Commission 2021 spring forecast, the phasing out of the emergency measures and the projected economic recovery are expected to largely offset the deficit-increasing effect of the measures contained in the French recovery plan. Accordingly, the general government deficit is set to decline to 8½% of GDP in 2021. The recovery and the unwinding of the emergency measures are expected to reduce the deficit further, to 4.7% of GDP in 2022.

France also adopted a sizeable package of measures, aimed at providing liquidity support to businesses, that is expected to contain a spike in bankruptcies. These measures, without any immediate budgetary impact, amount to 18.1% of GDP. They include tax and social charges deferrals for companies; an accelerated refund of tax and VAT credits; the creation of a dedicated reserve for direct support to strategic companies via equity investment (altogether amounting to 3.3% of GDP) and loan guarantees of 14.7% of GDP. The take-up rate of State guaranteed loans until February 2021 is estimated at 5.6% of GDP.

After the sharp increase in 2020, public debt is projected to increase further in 2021, before reducing by around one point of GDP in 2022. The high structural deficits, jointly with the lack of any material fiscal effort since 2015, kept public debt on a steady upward trend until 2018 (see Graph 2.1(a)). The public debt-to-GDP declined only marginally in 2019 to 97.6%. Therefore, public debt sustainability risks were assessed as high in the medium term. However, the outbreak of the COVID-19 pandemic, with the resulting economic contraction and the substantial deterioration of the general government deficit pushed the public debt ratio by almost 20 points, to 115.7% of GDP in 2020. The projected high deficits in 2021 and 2022 and fiscal measures aimed at reducing the impact of the COVID-19 pandemic and the economic recovery will keep public debt above 116% of GDP (see Graph 2.1(b)).

The measures adopted by France in 2020 in response to the COVID-19 pandemic were timely, temporary and well targeted. These temporary emergency budgetary measures, amounting to 3.5% of GDP, aimed mainly at increasing the capacity of the health system and providing relief to individuals and sectors hardest hit by the crisis. The expenditure measures amounted to around 3.2% of GDP and included the funding of a partial unemployment scheme, additional expenditure to strengthen healthcare services and subsidies providing direct support to small and very small enterprises as well as self-employed. Emergency measures also included exemptions of social security contributions amounting to 0.3% of GDP. Beyond the emergency measures in response to the COVID-19 pandemic, France also adopted measures under the umbrella of its national recovery plan *France Relance* worth EUR 1.8 billion (0.1% of GDP) in 2020 (out of an overall envelope of EUR 100 billion). These measures mainly included hiring bonuses, additional public investment and subsidies to businesses.

The French recovery Plan *France Relance* puts forward measures mainly for 2021 and 2022 aimed at supporting the envisaged recovery, including by providing a positive impact on aggregate demand and employment, improving economic fundamentals and supporting the green and digital transition. The plan is endowed with EUR 100 billion (4.2% of GDP), out of which EUR 39.8 billion

([3]) These discretionary measures comprised, among others, additional healthcare expenditure, transfers to cover partial unemployment schemes and subsidies under the sectoral compensation fund for SMEs, as well as tax exemptions, mainly on social security contributions.

(1.7% of GDP) are planned to be implemented in 2021. The Plan contains additional measures to reinforce the healthcare system, in particular investments worth 0.2% of GDP over the horizon covered by the Plan, foreseen under the so-called Ségur Agreement concluded in July 2020 with social partners. A number of measures in the Plan provide incentives for employment, including by increasing the employment opportunities of unemployed and inactive workers also via professional training. The green transition receives prominent attention, including in investments to develop green technologies and greener energy sources and a more widespread use thereof. The Plan also incorporates measures aimed to enhance potential growth and competitiveness, including measures to accelerate digitalisation of firms and public administration, reduce the technological dependence on other countries and to enhance business financing. The measures included in the Plan are mainly temporary and concern expenditure, a share of which is included in the proposed French Recovery and Resilience Plan. However, the most sizeable measure of '*France Relance'* (for which no support of the RRF was requested) to support competitiveness is a EUR 10.5 billion (0.4% of GDP) permanent reduction in taxes on production in 2021. This is achieved through a 50% reduction of the CVAE *(Contribution sur la Valeur Ajoutée des Entreprises*), which amounts to for EUR 7.25 billion, and a 50% decrease of the housing tax for industrial companies (*Cotisation Foncière des Entreprises,* CFE) (EUR 1.54 billion) and the land tax on built properties (*Taxe Foncière sur les Propriétés Bâties,* TFPB) (EUR 1.75 billion). By having a positive impact on productivity growth, the measures in the Plan would also contribute to reducing public debt in the medium term.

Debt sustainability analysis and fiscal risks ([4])

Fiscal sustainability risks have aggravated as a result of the COVID-19 crisis, especially in the short term. Short-term sustainability risks are assessed by the indicator S0 ([5]), which now shows high risk, rather than the no significant risk flagged in previous reports. This short-term risk increase is due to the financial competitiveness sub-index that has risen substantially, while remaining below the critical threshold. At the same time, the fiscal sub-index shows a slight reduction, although it continues to flag risks above the threshold. Short-term risks are mitigated by the diversification of the investors' base and the long average maturity of total outstanding debt, that has remained at 8.2 years in 2020, keeping short-term rollover risks under control. The currently negative interest rates linked to new issuances pose no problems for the French treasury in marketing its debt. In turn, the share of non-resident holders of government debt securities, broadly evenly distributed between euro area and non-euro area residents, has slightly decreased to around 51% in 2020. Nevertheless, the still high share of public debt held by non-residents reflects the continued appetite of investors to hold French public debt in their portfolios.

Medium-term sustainability risks remain high. Under the baseline scenario in the Debt Sustainability Monitor, at unchanged policies, the government debt level is expected to remain at very high levels until 2030, peaking in 2026. This is mainly due to the assumed lack of sufficient fiscal effort to reduce public debt, which is only partially offset by a favourable differential between the implicit interest rate on government debt and the growth rate of the economy until 2026. Thereafter, this differential is behind the projected decline in debt. In turn, the S1 sustainability indicator ([6]) shows a sustainability gap of 4.4 points of GDP, thereby indicating a high medium-term risk. This is mainly attributable to the high debt ratio and its distance from the 60% reference value, while the contribution of the projected increase in age-related expenditure is limited (see Graph 2.1 (c)).

France is deemed to be at medium fiscal sustainability risk when assessed over the next 50 years, but potential corporate bankruptcies stand to compound these risks. The long-term fiscal sustainability indicator S2 ([7]) has improved from previous reports and now stands at -1.1. It therefore

([4]) This section is based on European Commission (2021).

([5]) S0 is a composite indicator, consisting of two sub-indexes, aimed at evaluating the extent to which there might be a fiscal stress risk in the upcoming year, stemming from the fiscal (fiscal sub-index) and macro-financial and competitiveness sides of the economy (financial competitiveness sub-index). A set of 25 fiscal and financial-competitiveness variables proven to perform well in detecting fiscal stress in the past is used to construct the indicator. Countries are deemed to face potential high short-term risks of fiscal stress, whenever S0 is above an estimated critical threshold.

([6]) The S1 indicator measures the cumulative gradual improvement in the structural primary balance, relative to the baseline scenario, required over 5 years as of 2022 to reduce the debt ratio to 60% of GDP by 2034.

([7]) The S2 indicator is used to assess the fiscal sustainability challenges in the long term under a baseline no-policy change scenario by gauging the necessary improvement of the structural primary balance to stabilise the debt-to-GDP ratio over the long term.

suggests that no improvement of the structural primary balance would be required to stabilise the debt-to-GDP ratio over the long-term. The favourable demographics in France help to mitigate sustainability risks. Specifically, age-related expenditure is projected to decrease by 2.8 pps. of GDP over the next 50 years. This is due to the projected decline in public pension expenditure by 3.2 pps. of GDP, whereas healthcare and long-term care spending are projected to rise only moderately, by 0.2 pps. and 0.5 pps. of GDP, respectively. While the S2 indicator is low, the implied fiscal adjustment may still lead to debt stabilising at very high levels, suggesting the need for some caution in interpreting this indictor for already highly-indebted countries. The vulnerabilities linked to the high debt burden, as captured by the debt sustainability risk assessment, suggest that French public debt faces a medium sustainability risk over the long term. More adverse scenarios, such as increased healthcare and long-term care spending, would imply a significant increase in sustainability gaps. Moreover, an increase in the rate of corporate bankruptcies and calls on state guaranteed loans leading to higher deficits and debt in the near future could increase debt sustainability risks in the short and medium term.

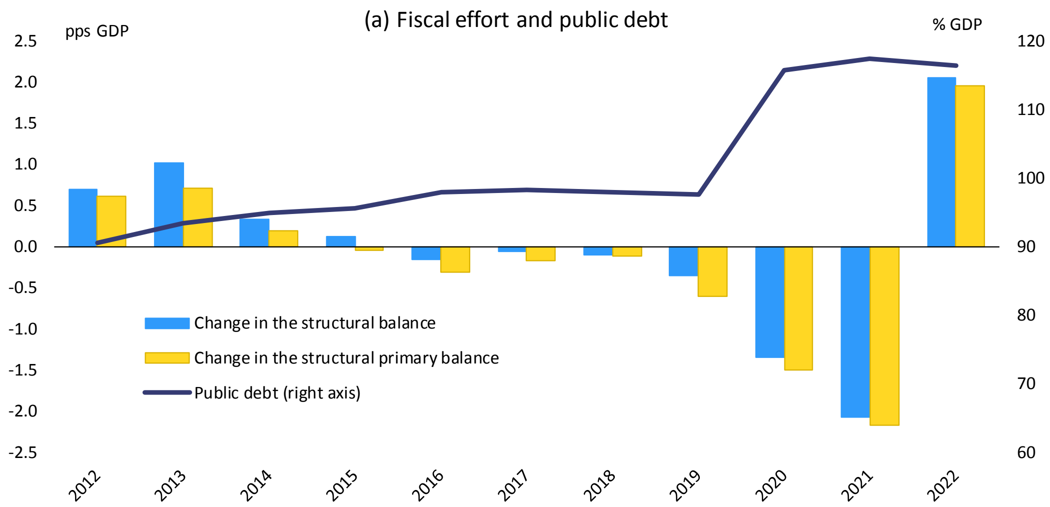
Pensions

The pension reform, originally announced for 2019 and already discussed in parliament, has been put on hold following the outbreak of the COVID-19 pandemic. This reform intended to introduce a universal points-based system to replace the current 42 co-existing pension regimes, but was put on hold after the outbreak of the COVID-19 pandemic. The reform proposed a universal system whereby contributions would give rise to equal rights regardless of profession or work category. This reform is generally expected to enhance the fairness, efficiency and transparency of the system, and improve labour mobility. Its potential effects on public debt sustainability are however unclear at this stage, mainly depending on the benefit indexation formulas that could be adopted.

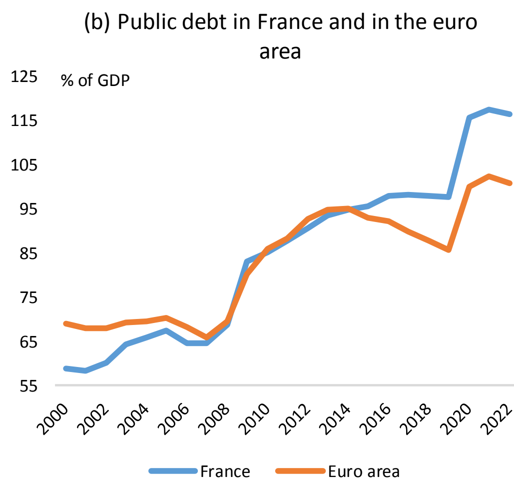
Public Action 2022 and spending reviews

After more than two years of implementation, the assessment of Public Action 2022 remains highly uncertain. The reforms undertaken on human resources management, streamlining of internal expenditure controls and procedures, simplifying regulation, rationalising and relocating services at the central and local level, and to accelerating deploying IT solutions are expected to produce some efficiency gains and to contribute to improving the transparency of, and accessibility to, public services. However, the contribution of the programme to fiscal consolidation was never clarified. According to the scarce information available, the actual expenditure savings attained under Public Action 2022 were limited. Despite the slowdown in growth rates over the last few years, the persistence of the high level of public expenditures in France raises concerns in terms of utility and efficiency, justifying assessing them via spending reviews. A lasting control and progressive reduction of public expenditure is key to mitigate public debt sustainability risks.

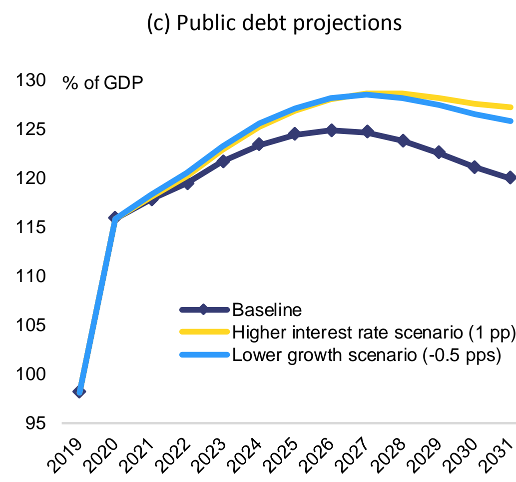
Graph 2.1: **Thematic Graphs: Public finances**



Source: Ameco. European Commission 2021 spring forecast



Source: Ameco. European Commission 2021 spring forecast



Source: European Commission. 2021 spring DSM

Source: European Commission Services

3. THEMATIC ISSUE: PRIVATE INDEBTEDNESS

Private debt has steadily increased since 2000, reaching 153% of GDP in consolidated terms in 2019. This increase has taken place against a backdrop of low and declining interest rates over this period. Private credit growth gained momentum in the aftermath of the financial crisis starting in 2008 and expanded by above 10% on average between 2017 and the outbreak of the COVID-19 pandemic (see Graph 3.1(a)) At the same time, the interest burden for both households and non-financial corporations kept declining (Graph 3.1(b)). The COVID-19 crisis has brought about a brisk increase in private debt-to-GDP ratios, to 175% of GDP, mainly due to the contraction in economic activity (see Table 3.1).

Households' indebtedness

Households' indebtedness has shown a steady upward trend, along with deteriorating lending standards. As a result, household debt reached 62% of GDP and 98.1% of gross disposable income in 2019. The outbreak of the COVID-19 pandemic accelerated this trend, with debt as a percentage of GDP picking up to 69% (see Graph 3.2(a)). Household debt has resulted mainly from dynamic credit flows (see Graph 3.2(b)). This dynamism is explained by loans for housing investment following a steady upward trend between 2014 and 2020. At the same time, credit standards have loosened across the board, with increasing maturities, loan-to-value and debt service-to-income ratios (Haut Conseil de Stabilité Financière, 2019a and 2019b). The *European Systemic Risk Board* (ESRB) issued a warning to France on 23 September 2019, inviting the national authorities to consider the need for additional pre-emptive actions such as explicit guidelines for credit standards.

Despite households' debt having remained broadly stable when compared with financial assets, the growing leverage has started to become a source of some concern, especially after the COVID-19 outbreak. While the household debt-to-GDP ratio has been in line with fundamentals over the last decade, it already started to depart from them in 2018. Moreover, the debt ratio to prudential thresholds gap of households, as estimated by the Commission, is widening (Graph 3.2(c)). Consumer spending loans increased marginally in 2019, up to 7.1% of GDP, but rose to 8.1% in 2020 as a result of the crisis. In turn, the mortgage stock expanded briskly from 42.8% of GDP in 2019 to 48.3% in 2020. Although households' interest payments as a share of their gross disposable income are at historical lows and in line with other euro area countries, the share of household income devoted to debt repayment continues to rise as a result of their higher leverage. In this context, the rise in debt due to the COVID-19 crisis might represent a heavier burden on households in case of negative shocks to employment.

Despite some signs of overvaluation in the housing market, some factors limit the existing concerns about high household leverage. Notwithstanding the relatively moderate increase in real estate prices since 2015, indicators continue to suggest risks of overvaluation ranging between 13% and 19% (see Graph 3.2(d)). Albeit significant, vulnerabilities in the residential real estate sector are mitigated by two main factors. First, the high proportion of fixed-rate loans, above 97% of outstanding loans, limiting interest rate risks. Second, in the event of housing price declines, the double-selection procedure of borrowers (evaluated by lenders as well as mutual guarantee societies) for most housing loans makes the value of the collateral less crucial. The French authorities have taken several macroprudential measures to address the growing vulnerabilities, including in the residential real estate market, regulating debt-service to income ratios and loan maturities. ([8])

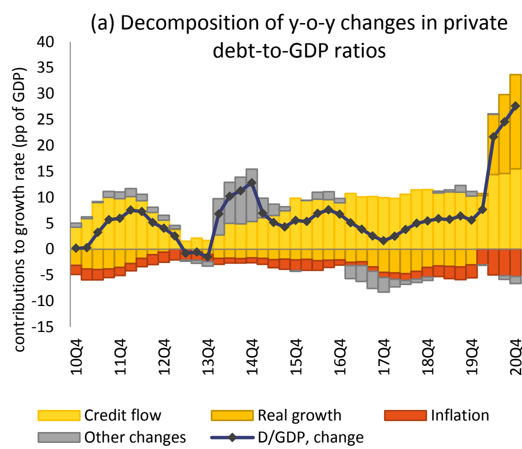
([8]) On 12 December 2019, the High Council for Financial Stability (HCFS) activated a non-binding borrower-based measure consisting in a debt-service to income ratio limit of 33% combined with a cap of 25 years on the initial maturity of the loan, with a margin of tolerance of 15%. On 27 January 2021 the HCSF amended the Recommendation (Haut Conseil de Stabilité Financière, 2021), raising the benchmark ceiling for the debt service-to-income ratio from 33% to 35%. In turn, the flexibility margin for the share of new loans that can diverge from best practices in terms of maturity and debt service-to-income ratio increased from 15% to 20% of the volume of total new loans. As part of the increase in the margin and in order to ensure that it benefits mainly households purchasing their main residence, the share reserved for the purchase of the main residence will be increased from 75% to 80% of the maximum flexibility margin and a share of 30% of the maximum flexibility margin is specifically reserved for first-time buyers.

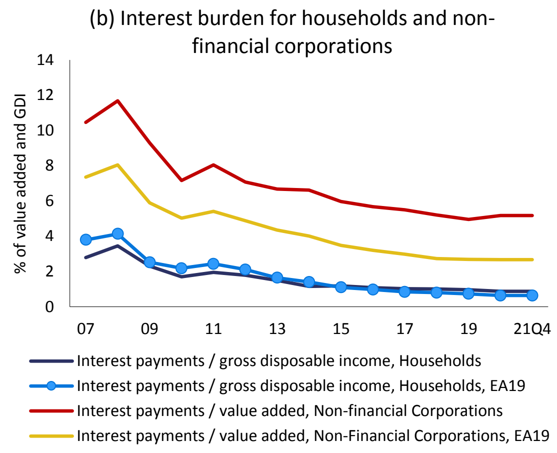
Table 3.1: **Private debt indicators, France**

	Source	2003-07	2008-12	2013-18	2019	2020	2021f	20Q2	20Q3	20Q4
Total private sector (Households and Non-financial corporations)										
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	109	132	143	153	175		167	172	175
Debt, consolidated (% of potential GDP)	*(a,b,d)*	111	130	142	156	163		162	163	163
Prudential threshold (% of GDP)(1)	*(c)*	87	87	99	103	100	100			
Fundamental benchmark (% of GDP)(1)	*(c)*	107	121	128	128	140	135			
Flows										
Private credit flows (transactions, % of GDP) (4)	*(a)*	7.7	5.6	5.2	8.0	13.1	1.0	27.4	11.5	10.8
Private credit flows (transactions, % of potential GDP) (4)	*(a,b)*	7.9	5.6	5.2	8.1	12.2	0.9	26.6	10.9	10.0
Benchmark for flows (% of GDP)(1)	*(c)*									
Households (HH)										
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	42	53	57	62	69		65	67	69
Debt, consolidated (% of potential GDP)	*(a,b,d)*	42	52	57	63	64		63	63	64
Prudential threshold (% of GDP)(1)	*(c)*	42	40	46	49	47	47			
Fundamental benchmark (% of GDP)(1)	*(c)*	47	56	58	57	63	61			
Debt (% of gross disposable income)	*(a,b,d)*	66	82	91	98	101		99	100	102
Interest paid (% of gross disposable income) (4)	*(a,b)*	2.0	2.2	1.2	1.0			0.9	0.8	
Debt (% of gross financial assets)	*(a,d)*	22.1	26.6	25.5	25.5			25.6	25.8	25.3
Share of variable rate loans for house purchase (%)	*(d)*	25.4	10.5	3.8	2.4	2.3				
Domestic loans in forex (% of dom. loans)	*(d)*	0.9	1.5	1.7	1.3	1.2				
Flows										
Credit flows (transactions, % of GDP) (4)	*(a)*	3.9	2.3	2.1	3.7	3.2	0.4	2.6	4.1	4.1
Credit flows (transactions, % of potential GDP) (4)	*(a,b)*	4.0	2.3	2.0	3.8	2.9	0.4	2.5	3.9	3.8
Benchmark for flows (% of GDP)	*(c)*	3.2	2.6	1.1	1.3	1.4	1.5			
Savings rate (% gross disposable income)	*(b)*	14.1	15.3	13.9	14.6	21.1	18.4			
Investment rate (% gross disposable income)	*(b)*	10.4	9.7	9.3	9.7	8.8	9.9			
p.m. Bank HH NPLs (% of HH loans) (2)	*(d)*			*3.9*						
Non-financial corporations (NFC)										
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	68	79	86	92	106		102	105	106
Debt, consolidated (% of potential GDP)	*(a,b,d)*	69	78	85	93	99		99	100	99
Prudential threshold (% of GDP)(1)	*(c)*	45	46	53	54	52	53			
Fundamental benchmark (% of GDP)(1)	*(c)*	61	65	70	70	77	74			
Debt, consolidated (% of value added)	*(a,b,d)*	123	143	155	163	194		184	190	194
Interest paid (% of gross operating surplus) (4)	*(a,b)*	25.5	25.3	17.5	14.0			14.3	15.1	
Debt, consolidated (% of gross financial assets)	*(a,d)*	60	69	60	56					
Domestic loans in forex (% dom. Loans)	*(d)*	2.4	2.8	1.6	1.4	1.2		1.8	1.4	1.2
Flows										
Credit flows (transactions, % of GDP) (4)	*(a)*	3.9	3.4	3.2	4.3	9.9	0.5	24.8	7.4	6.6
Credit flows (transactions, % of potential GDP) (4)	*(a,b)*	3.9	3.4	3.2	4.4	9.2	0.5	24.1	7.0	6.1
Benchmark for flows (% of GDP)(1)	*(c)*									
Investment (% of value added)	*(b)*	21.9	22.3	24.5	25.6	26.0	25.6			
Savings (% of value added)	*(b)*	23.0	22.2	22.3	23.0	21.0	25.3			
p.m. Banks NFC NPLs (% of NFC loans) (3)	*(d)*			*5.5*	*3.9*					

(f) European Commission forecast. (1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows. (2) Gross non-performing bank loans and advances to Households and non profit institutions serving households (% of total gross bank loans and advances to Households and non profit institutions serving households). (3) Gross non-performing bank loans and advances to Non-financial corporations (% of total gross bank loans and advances to Non-financial corporations). (4) Quarterly data is annualized.
Sources: Sources: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

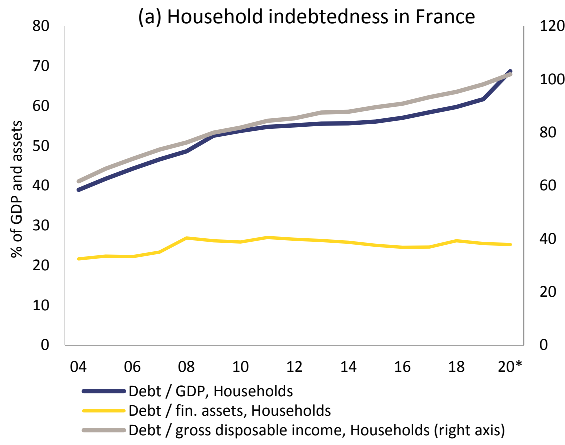
Graph 3.1: **Thematic Graphs: Private indebtedness**



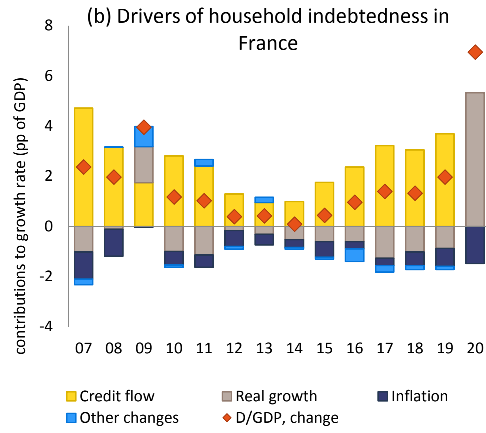


Source: Eurostat

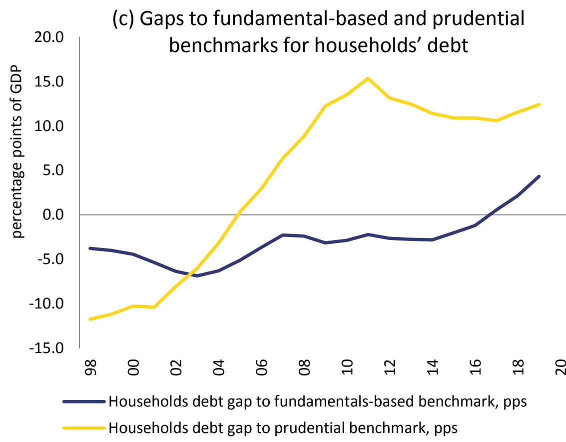
Graph 3.2: **Thematic Graphs: Household Debt**



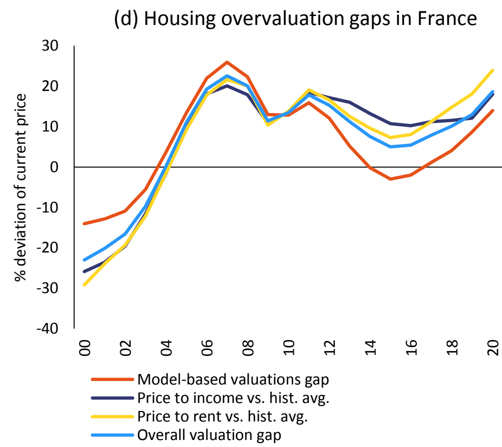
Source: Eurostat and European Commission



Source: Eurostat and Ameco



Source: Eurostat and European Commission



Source: Source: ECB Bank Lending Survey.

Source: European Commission Services

Non-financial corporations' indebtedness

Non-financial corporations leverage has continued to rise. Corporate indebtedness has steadily increased since the 2008-2009 crisis, reaching 91.6% of GDP in consolidated terms in 2019. This process was spurred by the fall in interest rates, which adjusted the trade-off between debt and equity and the reduction of intermediation mark-ups in the French banking sector. However, compared to other EU countries, the banking sector in France is more exposed to the real estate sector, which accounts for around 50% of total loans to non-financial corporations. Despite the high share of bank loans to construction and real estate sectors in France, as a percentage of assets, loans to those sectors are actually lower or broadly in line with the main EU countries.

The non-financial corporate debt-to-GDP ratio remains above the level suggested by the country's fundamental and prudential thresholds. According to Commission estimates, the debt of non-financial corporations in 2019 was around 22 percentage points above what fundamentals would suggest. When compared with the level beyond which the risk of a banking crisis is comparatively high, this gap widens to above 37 percentage points (see Graph 3.3(a)). On the other hand, the share of non-financial corporations' interest payments on their total value added continued to decline in 2019 to 5.0%, due to low and falling interest rates reaching their lowest level in decades. However, the interest burden is estimated to have increased slightly, to 5.2% in 2020 (recall Graph 3.1(b)). Moreover, the 30% share of short-term debt out of total debt is above the short-term level in most euro area countries.

The ratios of debt-to-equity and debt-to-financial assets, although more contained, will also be adversely affected by the COVID-19 pandemic. The increase in corporate indebtedness over the last decade came hand in hand with an equivalent increase in financial assets or cash-flow. Total debt liabilities compared to total financial assets showed a steady decline between 2011 and 2017 (see Graph 3.3(b)). Likewise, non-financial corporations' indebtedness as a share of equity followed a similar profile. The COVID-19 pandemic is expected to bring about a significant increase in the debt-to-equity ratio to close to 2007 levels, as firms incurred a significant amount of borrowing to address liquidity shortages. Debt-to-financial assets are expected to record a more moderate increase, as following the outbreak of the COVID-19 crisis firms keep accumulating sizeable liquidity buffers.

Up to 2015 the increase in corporate debt was mainly attributed to large companies, which accumulated higher liquidity buffers. Firms with the highest increases in liquidity buffers (mostly large industrial companies and groups: see Banque de France, 2021) were by far the main contributors to the growth of the long-term financial debt in the period 2010-2015 (Insee, 2017). Within this category, the distribution of the net debt-to-value-added ratio remained broadly stable. However, the HCSF shows in his last reports that net debt has been increasing since 2016, with a growing heterogeneity in the distribution. In particular, a few big groups with high leverage may have contributed importantly to the increase of net indebtedness (Haut Conseil de Stabilité Financière, 2017). Although SMEs, typically more vulnerable to a credit crunch, appeared until recently to be in a better financial situation than in 2007, mitigating the overall risks associated with high corporate indebtedness (Banque de France, 2020a), both the Banque de France (2020b) and the Haut Conseil de Stabilité Financière (2020) underlined the increasing heterogeneity among indebted companies over the past few years.

In response to the COVID-19 outbreak, the French authorities relaxed one of the two macroprudential measures taken in 2019 to address vulnerabilities stemming from high corporate indebtedness. After its decision to raise the counter-cyclical capital buffer (CCyB) rate from 0.25% to 0.5% of its equity approved in the Haut Conseil de Stabilité Financière meeting of April 2019, on 13 January 2020 the HCSF decided to keep that rate unchanged to enter into force as of 2 April 2020. Besides, the HCSF decided to lower the maximum exposure of systemic banks to 'high-indebted' enterprises from 25% to 5% of its equity. This measure aimed to preserve the resilience of the credit institutions vis-à-vis potential defaults of highly indebted private non-financial corporations and to improve market discipline by sending a preventive signal to avoid future excessive imbalances. The HCSF notified the Commission on 5 May 2021 of its intention to renew this decision for two years as of 1 July 2021. However, the outbreak of the COVID-19 pandemic led the HCFS to relax some requirements in order to allow banks to maintain their credit supply, especially to small and medium sized enterprises that are the most dependent on bank financing. On 1 April 2020, the HCSF decided to fully release the countercyclical capital buffer (HCSF, 2020). The release was implemented immediately, and the buffer

rate will remain at 0% until further notice. This decision was confirmed on 1 July 2020. The HCSF also recommended banks and insurers to behave responsibly regarding dividend distribution, share buybacks, and variable pay.

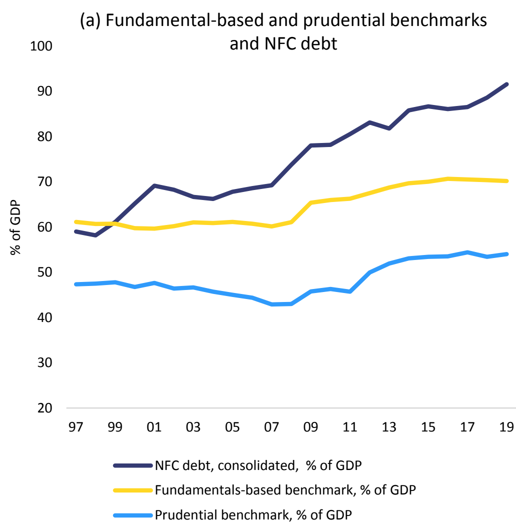
Non-financial corporations leverage accelerated after the outbreak of the COVID-19 pandemic. The outbreak of the pandemic and the contraction in economic activity, along with very dynamic credit flows brought about a brisk increase in corporate indebtedness in 2020. Debt of non-financial corporations is estimated to have reached 106% of GDP for the year as a whole. In turn, the fall of non-financial corporations' value-added amounted to 9.7%, and the gross operating surplus decreased by 20.4% (16.4% excluding the temporary effect of the CICE transformation in 2019). In the second quarter, activity levels for industry decreased by around 50% compared to the levels expected in absence of the crisis, with sectors such as aeronautics, clothing and metallurgy particularly strongly affected. Activity levels in the services sector also decreased sharply, with accommodation and catering services, as well as cultural and creative sectors seeing decreases in activity levels of more than 90%.

Part of the increase in the corporate sector leverage was related to state guaranteed loans. The crisis has brought about a sizeable and urgent need for liquidity, and the government took a range of measures aiming at supporting non-financial corporations's treasury, including State guarantees and payment deferrals of social security contributions. In particular, the sizeable credit flows observed in 2020 were partly due to the EUR 300 billion envelope of state guarantees deployed by the French government to ensure liquidity provision to firms, especially SMEs, and to prevent bankruptcies. The high take-up rate of state-guaranteed loans has been accompanied by a parallel increase in firms liquidity, such that the total consolidated net debt of non-financial corporations calculated by the Banque de France remained almost stable (+0.8% from December 2019 to December 2020). At a more micro-level, 35% of SMEs declared in November that they did not use their state-guaranteed loans, and 27% that they used only some of the loans (cf. 72nd half-yearly SME business climate survey, BPI France, January 2021). However, it is very likely that this global stabilization of net debt in 2020 conceals a lot of heterogeneity, especially because of the different incidence of the economic shock across sectors.

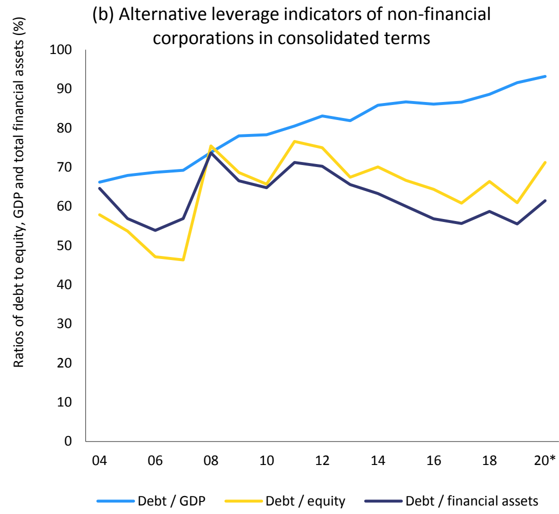
The financial sector remains resilient, but there are indications of credit tightening and asset quality may deteriorate. The banking sector's solvency has remained so far relatively solid, partly thanks to support measures, but profitability has dropped. Some increase in non-performing loans has already been observed since the second quarter of 2020, although still relatively modest, compared to the diminishing trend of past years (see Graph 3.3(c)). However, most of the consequences of the crisis are probably still to come and there have been signs of credit tightening through 2020 and early 2021 due to risk perceptions (ECB bank lending survey). In order to ensure an adequate provision of liquidity for firms, especially SMEs, the government has extended the timeframe for State guarantees on loans until 30 June 2021, granting firms with an additional one-year deferral to start repaying their government guaranteed loan. Promoting access to equity or equity-like finance, especially for SMEs, will be key to contain private indebtedness. The moratoria on forced insolvency proceedings and strong support measures have resulted in a marked decrease of 39% in the number of bankruptcies in 2020 compared to 2019, according to the Banque de France. However, the National Productivity Board (CNP) considers that this recent decrease in bankruptcies will be more than compensated in 2021, with expected increases in strongly affected sectors of more than 25% compared to 2019. Such an increase in bankruptcies, hand in hand with non-performing loans, might entail a negative impact on banks' balance sheets.

High indebtedness of non-financial corporations could weigh on medium-term growth. In relaxing its economic support measures, France will have to strike a balance between the risks related to extending these measures for too long, thereby wasting public resources and creating more "zombie firms", which would prevent the re-allocation of resources to firms with higher productivity levels, and the risks of ending them too quickly, leading to bankruptcies of productive and otherwise solvent firms and to a rise of the amount of non-performing loans. Likewise, excessive indebtedness may limit firms' ability to undertake investment projects and ultimately put a lid on productivity growth.

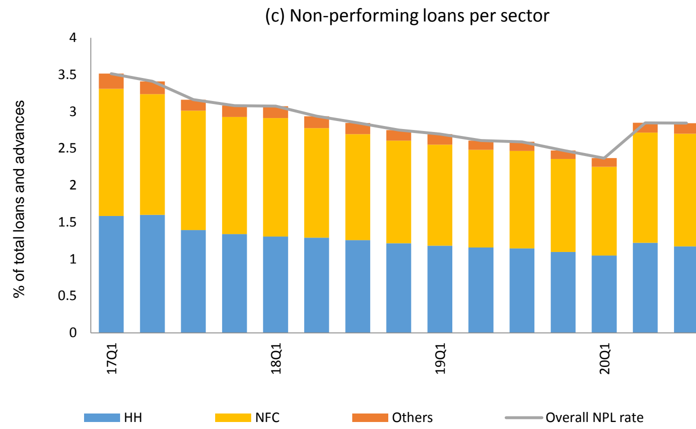
Graph 3.3: **Thematic Graphs: Non-financial corporate debt**



Source: Calculations based on Eurostat and ECB



Source: Eurostat



Source: Non-performing loans and advances, ECB consolidated banking data.

Source: European Commission Services

4. THEMATIC ISSUE: COMPETITIVENESS

France faced an important and continuous decrease of its export market shares over the decade until 2012. This trend was common to most developed countries, as they integrated in international value chains, but the decrease was sharper for France than for most of its neighbouring countries, particularly Germany (Graph 4.1(a)). According to Camatte et Gaulier (2018) - corroborated by Blas et al. (2015), neither the sectoral, nor the geographical orientations can explain this.

In the years before the COVID-19 crisis, France's trade performance showed some improvement. Total nominal export market shares stabilized over the 2013-2019 period, accompanied by an improvement in cost-competitiveness. In particular, the growth in unit labour cost was moderate in the past few years before the COVID-19 crisis (Graph 4.1(b)), when large cuts in social contributions were adopted (CICE and Responsibility Pact). Unit labour costs increased by 4.6% between 2013 and 2018 (5.6% in the euro area). In 2019, its growth remained significantly lower than in the euro area, partly thanks to further social contribution cuts, targeted on workers close to the minimum wage.

In terms of non-price competitiveness, French products are currently of a medium-high quality. According to Burton and Kizior (2021), France ranked 11th among 37 countries in 2014-2016 (OECD and EU countries) in the non-price component of exports (a proxy for 'quality'). France is also characterised by an important degree of specialisation, with three sectors (aeronautics, beverage and cosmetics) accounting for around 20% of the total export value, where quality has remained particularly high.

France's exports were hardly hit by the COVID-19 crisis in 2020. Market shares fell by 7.7% in 2020. France's exports suffered from particularly its sectoral, and to a lesser extent its geographical specialisations. According to the OECD (Economic Outlook, December 2020), world demand for French exports decreased slightly more than global world trade (based on the assumption of stable market shares in every country). According to the French customs' data, aeronautics exports decreased by 45.5% in 2020 and contributed -5.9 percentage points to the growth of total good exports. France's exports also suffered from the sharp decline in services activities, especially tourism (around -50%). The magnitude of the shock is partly explained by the high level of specialisation of French exports.

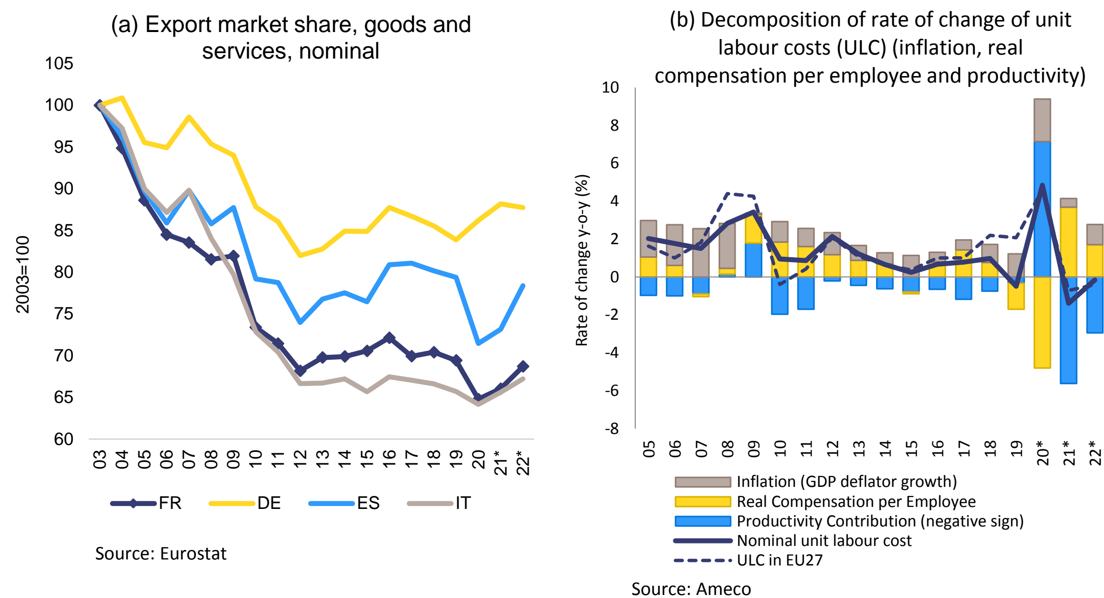
As in many other countries, also cost competitiveness deteriorated in France in 2020. Unit labour costs increased by 4.8% in 2020. The main driver was deteriorating labour productivity (-7.1%), reflecting labour hoarding in light of the COVID-19 crisis. This deterioration was only partially mitigated by support measures, in particular partial activity, which caused a drop in compensation per employee by 4.8% in real terms.

Some risks surround the evolution of export shares in the aftermath of the COVID-crisis. In the central scenario, export market shares lost due to the sectoral and the geographical orientations are set to be mostly regained by 2022, but some uncertainty persists about the potential long-lasting effects of the crisis on the aeronautics sector, both at the national (destruction of human or physic capital) and international (depressed demand) scales. The French authorities adopted specific support measures for the sector – as part of '*France Relance*' – including state-guaranteed loans and investment funds. The geographical orientation (mainly EU markets) represents another risk, with a rebound potentially weaker than in the emerging countries, for instance, in case of vaccination campaign less efficient than expected.

On the positive side, cost-competitiveness is set to improve in the coming years. The sharp rise in unit labour costs in 2020, mainly due to the negative shock on productivity caused by labour hoarding, is forecast to partially reverse in the coming years. After an increase of 4.8% in 2020, unit labour costs are forecast to decline by 1.4% in 2021 and 0.2% in 2022 (Table 4.1). Both labour productivity growth and real compensation per employee are expected to gradually rebound in 2021 and 2022. Additional cuts in social security contributions, targeting workers close to the minimum wage, and the permanent EUR 10

billion reduction in production taxes are expected to significantly support the country's cost-competitiveness.

Graph 4.1: **Thematic Graphs: Competitiveness**



Source: European Commission Services

Table 4.1: **Selected cost competitiveness indicators, France**

	03-07	08-12	13-17	18	19	20	21'	22'
Nominal ULC, yoy % change	1.6	2.0	0.7	1.0	-0.5	4.8	-1.4	-0.2
Labour productivity, yoy % change[1]	1.2	0.4	0.7	0.7	0.3	-7.2	5.6	2.9
Inflation (GDP deflator growth), yoy % change	2.0	1.1	0.7	1.0	1.2	2.2	0.5	1.1
Real compensation per employee, yoy % change	0.8	1.3	0.7	0.8	-1.4	-4.8	3.7	1.7
Nominal compensation per employee, yoy % change	2.9	2.4	1.5	1.7	-0.2	-2.7	4.2	2.8
Wage benchmark (nominal compensation growth)[2]	3.5	2.4	1.6	3.1	2.1	-4.8	-	-
Wage benchmark (constant ULC-based REER)[2]	1.3	2.7	1.3	1.1	3.8	4.1	-	-
REER_GDP, yoy % change	0.9	-1.5	-0.3	1.1	-1.7	2.5	-0.2	-0.7
REER_ULC, yoy % change	1.5	-0.3	0.1	0.6	-4.3	-	-	-
NEER, yoy % change	1.7	-0.5	0.7	2.7	-0.8	2.1	1.4	0.1

(1) Labour productivity contributes to ULC with a negative sign (not shown in the table): For instance, high productivity growth reduces unit labour cost growth.
(2) Wage benchmarks: DG EMPL provides two benchmarks for the growth rate of nominal compensation per employee. Benchmark 1 (Predicted nominal compensation growth) reflects wage growth as predicted by developments in inflation, productivity growth, and the unemployment rate. The prediction is estimated through a panel regression. Benchmark 2 (Compensation growth consistent w. constant ULC-based REER) reflects external competitiveness and is consistent with a constant value of the real effective exchange rate (REER), computed on the basis of unit labour costs (ULC).
Abbreviations: REER_GDP = Real effective exchange rate based on GDP deflator, Performance relative to the rest of 42 industrial countries; double export weights (2010=100), REER_ULC = Real effective exchange rate based on ULC, Performance relative to the rest of 37 industrial countries; double export weights (2010=100), NEER = Nominal effective exchange rate, Performance relative to the rest of 42 industrial countries; double export weights (2010=100).
Source: REER and ULC: AMECO; wage benchmarks: DG EMPL.

Table 4.2: **Selected trade performance indicators, France**

	03-07	08-12	13-17	18	19	20	21'	22'
Export market share (goods and services), yoy % change	-3.6	-4.0	0.5	0.7	-1.4	-6.7	1.9	4.0
Export market share (goods and services) - volume, yoy % change	-4.9	-1.7	-0.4	0.7	0.9	-7.9	-	-
Exports (goods and services), yoy % change	4.3	2.4	3.1	5.3	2.9	-17.1	12.4	10.6
Exports (goods and services) - volume, yoy % change	3.4	1.2	3.2	4.4	1.9	-16.0	10.0	9.6
Trade balance (services), % of GDP	1.0	0.9	0.6	-	-	-	-	-
Trade balance (goods, except energy products), % of GDP	1.1	0.6	0.4	-	-	-	-	-
Trade balance (energy products), % of GDP	-2.2	-2.8	-1.9	-1.9 p	-1.8 p	-1.2 p	-	-
GVA (Tradables), in % of total GVA	38.8	38.5	38.5	38.4	38.4	36.7	-	-
GVA (Non-tradables without construction), in % of total GVA	55.8	56.0	55.9	56.0	55.9	58.0	-	-
GVA (Construction), in % of total GVA	5.5	5.4	5.5	5.6	5.8	5.3	-	-

Source: GVA, Exports and imports, Terms of trade: AMECO; EMS growth and trade balance: Eurostat.

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