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In-depth review for France

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

Accompanying the document

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

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On the basis of this in-depth review for France undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2022 Spring Package" (COM(2022)600 final) that:

France is experiencing imbalances. Vulnerabilities relate to high government debt and weak competitiveness, which have cross-border relevance, in a context of low productivity growth. The COVID-19 crisis brought about a sizeable increase in the already high government debt, but with the economic recovery, the government debt-to-GDP ratio edged down in 2021 and is forecast to keep falling this year and next, while remaining well above its pre-pandemic level. Private indebtedness has kept growing in recent years and is exceeding prudential levels, although risks relating to increased corporate indebtedness are somewhat mitigated by a parallel build-up of liquidity buffers. Underlying productivity dynamics have remained stable over time. Exports market shares, which had broadly stabilised in earlier years, decreased sharply during the pandemic with key export sectors being severely hit but a sizeable recovery is projected for 2022 and 2023. Cost competitiveness, as well as productivity, are set to benefit from recent and upcoming reforms, including a continued strong implementation of the RRP.

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1. INTRODUCTION

In 2021, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure (MIP), the Commission identified "macroeconomic imbalances" in France. ([1]) These imbalances were related to high public debt and weak competitiveness dynamics in a context of low productivity growth, which carry cross-border relevance. The 2022 Alert Mechanism Report concluded that a new in-depth review (IDR) should be undertaken for France with a view to assessing the persistence of imbalances or their unwinding. ([2])

After the sharp rebound in 2021, economic activity is set to expand strongly in the coming years. ([3]) Despite important headwinds including new waves of COVID-19, rising energy prices and supply bottlenecks, growth remained robust in the fourth quarter of 2021, with GDP expanding by 0.8% on the quarter and activity exceeding its pre-crisis level by 1.0%. Overall, after a rebound by 7% in 2021, annual GDP is forecast to increase by 3.1% in 2022 and 1.8% in 2023. The real GDP level in 2023 is forecast to be 3.4% above its 2019 level. Russia's invasion of Ukraine has placed a drag on the economy, due to the continuous disruption in supply chains and the surge in energy prices. HICP is set to peak in 2022, reaching 4.9%, as a result of the increase in energy prices and the delayed transmission of supply disruptions to industrials goods. In 2023, energy prices are forecast to contribute little to inflation. In turn, prices of services are expected to accelerate as a consequence of wage increases supported by past inflation and labour shortages. Overall, HICP is set to fall to around 3%, remaining however more dynamic than before the crisis. Risks to the economic outlook are elevated, as the evolution of the pandemic, the implications of the Russian military aggression against Ukraine and possible structural implications of the COVID-19 crisis are still surrounded by high uncertainty.

This in-depth review presents the main findings of the assessment of imbalances. The assessment is backed by a thematic section on private debt developments. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, assessments of structural issues made in previous IDRs and in the context of fiscal assessments are also considered if relevant. The MIP assessment matrix is published in the 2022 Country Report for France. ([4])

([1]) European Commission (2021), European Semester Spring Package 2021: economic coordination - Commission Communication, COM(2021) 500 final.
([2]) European Commission (2021), Alert Mechanism Report 2022, COM (2021) 741 final.
([3]) Forecast data are from European Commission (2022), European Economic Forecast: Spring 2022, Institutional Paper 172.
([4]) European Commission (2022), Country Report France 2022, SWD(2022)612 final.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

Assessment of gravity, evolution and prospects of macroeconomic imbalances

Despite the projected decline between 2020 and 2023, the general government debt ratio will remain high. At 97.4% 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. In 2020, the sharp fall in economic activity following the outbreak of the pandemic brought about a quick contraction in tax bases in 2020 that dragged down tax revenues. The fall in tax revenues and the sizeable fiscal measures deployed by the French government pushed the general government deficit to 8.9% of GDP, while the public debt ratio rose by some 17 percentage points, to 114.6% of GDP in 2020. The strong economic rebound in 2021 and the dynamism of tax revenues allowed some improvement in public finances. France's public debt ratio declined by almost 2 pps. in 2021, to 112.9% of GDP, and according to the Commission 2022 spring forecast is projected to keep declining, albeit at a slower pace due to still high public deficits, to reach 109.1% in 2023. The Commission's fiscal sustainability assessment shows that France faces high fiscal sustainability challenges over the medium term and medium challenges in the long term. ([5])

The already high private indebtedness increased further during the pandemic, partly due to corporate borrowing. After a continuous increase since 2000 and peaking at 174% of GDP in 2020, private debt declined by 6 percentage points in 2021 in spite of the strong economic rebound. While the debt ratio in non-financial corporations declined by 4 percentage points, households' debt declined only slightly. Indebtedness in nominal terms keeps being fuelled by dynamic credit flows. In the case of non-financial corporations, indebtedness has come along with even faster increases in equity and financial assets, including cash flow. In turn, the household saving ratio rose significantly in 2020 and remained above pre-pandemic levels in 2021. Yet, both households and non-financial corporations debt keep exceeding prudential thresholds. Moreover, high and growing public and private indebtedness have brought about a significant increase in external debt, notably strong foreign purchases of French public and corporate bonds, thereby leading to a sizeable deterioration in the net international investment position to -35% of GDP in 2021.

Competitiveness indicators took a hit during the COVID-19 crisis, but have begun to recover. The growth in unit labour costs (ULC) was moderate in the past few years before the COVID-19 crisis (2.5% between 2013 and 2019, against 6.7% in the euro area), when large cuts in social contributions were adopted (CICE and Responsibility Pact). 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. Against this background, total nominal export market shares stabilized over the 2013-2019 period. Export market shares deteriorated significantly more in 2020 than in most other large European countries, as several key export sectors were severely hit (e.g. aircraft industry and tourism). As with all countries, it is difficult to interpret the changes in unit labour costs in 2020, due to the negative shock on productivity caused by labour hoarding as a result of the partial activity work schemes. The negative shock due to the COVID-19 outbreak is set to be largely temporary. Cost competitiveness, as well as productivity, should benefit from measures recently implemented and upcoming reforms, namely the action plan for business growth and transformation (the PACTE law) adopted in May 2019, the changes to the labour market legislation, the EUR 10 bn cut in production taxes and those in the RRP, aimed to foster innovation, digitalisation and labour force re-skilling, in conjunction with Cohesion Policy Funds. Export market shares are also expected to rebound over the next years, in line with the recovery of the tourism and aircraft industry. Overall exports and competitiveness are thus unlikely to deteriorate further; rather, they are set to recover. However, several structural challenges remain, and this outlook is subject to substantial external risks, namely the developments of the war in Ukraine and the evolution of the pandemic in

([5]) See European Commission Country Report on France for the latest results and the 'Fiscal Sustainability Report 2021', Institutional Paper 171, 25 April 2022 for methodological details

China. Importantly, further progress in cost-competitiveness will crucially depend on the capacity to enhance the productivity growth trend.

The COVID-19 crisis has not brought about any material increase in non-performing loans (NPLs). In 2021, corporate bankruptcies decreased with respect to 2020 and more so when compared to pre-pandemic years. While there is no sign of an imminent debt-linked resurgence of bankruptcies or a wave of insolvencies, some sectors could be severely hit by rising energy prices, supply chain disruptions and economic ramifications of Russia's invasion of Ukraine (see box 2.1). In turn, while the financial sector remains resilient and financing conditions continue to be favourable, structural challenges related to low aggregate bank profitability persist. A protracted rise in inflation could lead to higher market interest rates that would tighten financial conditions.

Assessment of MIP relevant policies

Some measures have been adopted to contain the dynamics of public spending and others are in the pipeline. Efforts to consolidate government finances before the crisis only modestly reduced the public expenditure ratio. The COVID-19 crisis has brought about a notable increase in the expenditure ratio, to 61.4% of GDP in 2020, the highest in the EU. While the economic rebound and the phasing out of the emergency measures is estimated to have reduced the public expenditure-to-GDP ratio by almost 2 pps. in 2021, public expenditure and the general government deficit will remain at very high levels in the short term. Curbing public spending and increasing its efficiency is essential to reduce the general government deficit and to put public debt ratio on a steady downward path. The French Recovery and Resilience Plan includes measures aimed to support the consolidation of public finances in the medium and long term. The organic law on the modernisation of public finances management has entered into force in 2022. It introduces a multi-annual expenditure rule applicable to total public spending, aimed at strengthening the multiannual dimension of budgetary decisions, alongside an extension of the prerogatives of the national fiscal council (i.e., High Council of Public Finances, HCPF). The contribution of this reform to ensuring a sustained reduction of public debt will depend on its implementation, which will warrant close monitoring. Preliminary steps were also taken to pave the way for the evaluation of public spending as of the fourth quarter of 2022, with the aim of identifying the most efficient expenditures favouring growth, social inclusion and the green and digital transition. However, the reform to unify the numerous pension schemes in France was put on hold after the outbreak of the COVID-19 pandemic. While the previous government announced in March 2022 the possibility of increasing the retirement age, no calendar for a reform of the pension system has been put forward yet.

Public support measures during the crisis, aimed to ensure an adequate provision of financing, supported lending growth. The public guarantee scheme set up by the state has played an important role in supporting lending during the crisis, especially to SMEs, and preventing corporate bankruptcies. Accordingly, bankruptcies declined in 2021 with respect to both 2020 and even with respect to pre-pandemic years. Moreover, non-performing loans remain rather stable for corporates and declined for households. The macroprudential measures adopted by the French authorities have contributed to ensuring an adequate provision of credit and credit standards for households' loans have modestly improved.

Recent reforms are set to improve cost-competitiveness and to support productivity. The permanent EUR 10 billion reduction in production tax (0.4% of 2019 GDP, or 0.7% of the value-added of NFCs), mainly targeted to the industry, is expected to support the country's cost competitiveness. Reforms have also been introduced to improve productivity and non-cost competitiveness, which are set to produce positive effects in the years to come. The PACTE law, which reforms firm size thresholds beyond which obligations about union's representation and organisational aspects are set and encourage incentive compensations, was adopted in May 2019. Several adjustments were brought to the labour market in order to improve its efficiency (e.g. the unemployment benefit reform introduced in 2021 or the September 2017 labour law ordonnances - fully entered into force in 2018 - making open-ended contracts more flexible and further promoting decentralised bargaining). Besides, significant productivity-enhancing investments to support the green and digital transition and research are underway and are expected to continue in the coming years. For example, the Recovery and Resilience Plan aims at fostering innovation in digital technologies, with projects in key sectors like cybersecurity, quantum technologies or cloud financed up to EUR 1.8 billions. The Plan also entails investment in up- and re-skilling the labour force (notably digital) in order to reduce the important skill mismatches in the labour market. By having a positive impact on productivity, these reforms should also contribute to enhancing public debt sustainability.

Conclusion

France is facing vulnerabilities relating to high public debt, as well as competitiveness challenges related to low productivity growth. The pandemic hit crucial export sectors. The pandemic brought a sizeable increase in public debt, but with the return of growth in 2021, it edged down. Public debt is set to decline further over the period to 2023, but will remain high and above pre-pandemic levels. Fiscal sustainability risks have been aggravated during the pandemic, with high fiscal sustainability challenges in the medium-term. While private sector debt surged during the pandemic, the increase in corporate borrowing came hand in hand with increases in equity and the accumulation of liquidity buffers. The current setting might facilitate a passive deleveraging, but risks to the overall economic outlook remain elevated. Private debt stocks compound to some extent the risks stemming from high public debt, reflected in a deteriorating net international investment position. Yet, private debt levels are also a consequence of the successful policy measures during the pandemic, which have so far contributed to stabilising corporate balance sheets and maintaining investment levels (see next chapter). Together, growing public and private indebtedness have brought about a significant increase in external debt and a sizeable deterioration in the net international investment position. Exposures to energy prices are of concern but unlikely to significantly affect macroeconomic vulnerabilities over the medium term (see box 2.1).

Recent policy measures are dampening the risks associated with weak competitiveness and high indebtedness. Important reforms, such as the substitution of the tax credit on competitiveness and employment by an outright cut in social contributions, the EUR 10 billion cut in taxes on production and the changes to the labour market legislation (notably to the unemployment benefit system), were introduced in recent years and are expected to produce positive effects in the medium term. The implementation of these reforms and of the planned investments will be key to address the persisting structural competitiveness challenges and the slow productivity growth. The macroprudential measures taken to address growing vulnerabilities, including in the residential real estate market are bearing fruit as credit standards have started to improve. A reform of public finances management entered into force in 2022, and an evaluation of public spending is planned, to identify the most efficient expenditures favouring growth, social inclusion and the green and digital transition. However, the implementation of this reform should be closely monitored in the future to ensure an effective contribution to improving the sustainability of public finances. The pension reform, aimed at unifying the currently existing 42 different regimes, was put on hold. Despite recent announcements of a pension reform, neither details, nor timeline has been provided.

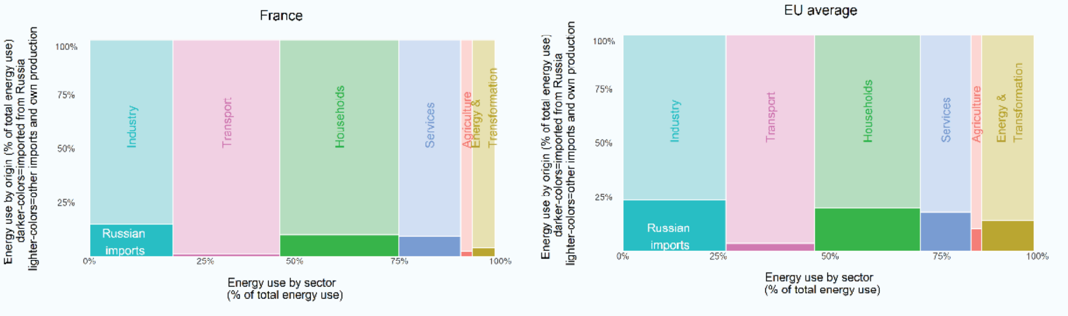
Based on the findings in this in-depth review, the Communication "European Semester – 2022 Spring Package" ([6]) sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in France, in line with Regulation 1176/2011.

([6]) European Commission (2022), European Semester Spring Package 2022, COM(2022)600 final.

Box 2.1: Exposures to the commodity price surge, and to Russia

This box summarizes risks and exposures regarding the commodity price surge, and the importance of direct links with the Russian economy. The surge of commodity prices since 2021 had been aggravated by the Russian military aggression against Ukraine. This box reviews the risks for the macroeconomic vulnerabilities in France. Available data suggests that exposures to energy prices are the most pressing concern, yet are unlikely to significantly affect macroeconomic vulnerabilities over the medium term. Although the sanctions imposed by the EU and its partners on Russia and Belarus will have side effects for the French economy, they seem limited compared to the rest of the EU. Economic links with Russia are relatively limited, and are likely to affect France rather via its impact on other Member States than directly.

Graph b.1.1: Sectoral distribution of energy use and of energy imported from Russia



Notes: The left panel displays the distribution of primary energy usage in France according to Eurostat energy balances. The horizontal axis displays the relative importance of energy-consuming sectors. The vertical axis displays the importance of energy from Russia in satisfying that need. Note that this dependence on Russia differs according to sector's use of natural gas vs oil and coal. For comparison, the right hand panels displays the same concept for the EU aggregate. Russian imports include oil and petroleum products, natural gas and solid fossil fuels.
Sources: Eurostat and European Commission services calculations

The French economy's exposure to the energy price surge seems quite limited. Graph b.1.1 shows that imports from Russia play a very limited role for energy provision, thus the crisis is felt mainly through its impact on prices rather than through potential supply line disruption. Energy is primarily used for transport, whereas the Energy and transformation sector uses comparatively less energy than in the rest of the EU. Overall, the reliance on nuclear energy means that the overall economy is likely somewhat less affected by the commodity price surge than other Member States. ([1]) Moreover, the French economy consumes relatively little natural gas (See Table b.1.1), and so is less exposed to natural gas price increases than the rest of the EU. The commodity price surge is still likely to have an impact on France: for instance, if fossil energy commodity imports remain at their typical levels, their high price means that the French trade balance would be about 1 pp of GDP lower in 2022 than in 2021, with a significant carry-over to 2023.

Table b.1.1: Selected exposures

Trade & financial exposures	unit	FR	EU
Domestic value added embodied in exports to Russia	% of GDP	0.3%	0.4%
Non-energy Russian import content in final demand	% of GDP	0.3%	0.4%
Russian tourist nights spent	% of total 2019	1.5%	2.7%
FDI assets held in Russia	% of 2020 GDP	0.8%	2.5%
Portfolio & other inv. assets held in Russia	% of 2020 GDP	0.3%	0.9%
FDI liabilities towards Russia	% of 2020 GDP	0.0%	1.2%
Portfolio & other inv. liabilities towards Russia	% of 2020 GDP	1.0%	1.1%
Consolidated banking exposures towards Russia	% of 2021 GDP	0.9%	0.5%

Energy mix	unit	FR	EU
Solids fossil fuels (incl. peat)	% of Gross inland Consumption 2020	2.3%	10.8%
Oil and petroleum products	% of Gross inland Consumption 2020	28.5%	32.7%
Natural gas	% of Gross inland Consumption 2020	15.3%	24.4%
Renewables and waste	% of Gross inland Consumption 2020	13.3%	19.0%
Nuclear	% of Gross inland Consumption 2020	40.5%	13.1%
Commodity exposures	**unit**	**FR**	**EU**
Net petroleum imports from all countries	% of GDP 2021	1.2%	1.2%
Crude oil imports from Russia '20	% of oil imports	8.8%	25.7%
Net gas imports from all countries	% of GDP 2021	0.6%	0.6%
Gas imports from Russia '20	% of gas imports	16.8%	43.6%

Notes: data source Eurostat for commodity exposures, European Commission Figaro for value-added exposures, BIS for consolidated banking exposures, European Commission FinFlows for other financial exposures. Energy gross inland consumption excludes net imports of electricity and derived heat.

Most direct economic links between France and Russia are quite limited compared to the EU average. Table 1 shows that exposure of the French economy towards Russia is generally fairly insignificant, and are of little importance to French value added. The key dependence relates to the 8.8% share that Russia accounts for in French oil imports. However disrupted oil imports can be more easily substituted from other origin countries than e.g. natural gas imports. While financial exposures towards Russia are likewise rather small, French assets in Russia concentrate on banking assets, notably the subsidiary of a major systemic bank, which seems broadly hedged against further losses in Russia (see Country Report).

([1]) France devoted less than 1 bn EUR annually to uranium ore imports during recent years, with imports from Russia estimated to account for significantly less than 10% of total uranium ore imports.

Table 2.1: **Selected economic and financial indicators (Part 1), France**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Real GDP	2.0	0.4	1.2	1.9	1.8	-7.9	7.0	3.1	1.8
Potential growth (1)	1.8	1.2	0.9	0.9	0.9	0.9	1.2	1.4	1.4
Contribution to GDP growth:									
Domestic demand	2.3	0.5	1.3	1.5	2.1	-6.5	6.7	2.7	1.9
Inventories	0.1	-0.1	0.2	0.0	0.0	-0.2	0.0	0.1	-0.4
Net exports	-0.4	0.0	-0.3	0.4	-0.3	-1.1	0.2	0.3	0.3
Contribution to potential GDP growth (1):									
Total Labour (hours)	0.5	0.4	0.2	0.2	0.2	0.4	0.5	0.6	0.6
Capital accumulation	0.7	0.6	0.5	0.5	0.6	0.3	0.6	0.6	0.6
Total factor productivity	0.6	0.3	0.2	0.2	0.2	0.1	0.1	0.2	0.2
Output gap (2)	1.6	-1.1	-1.4	1.0	1.9	-7.0	-1.7	0.0	0.4
Unemployment rate	8.6	9.0	10.1	9.0	8.4	8.0	7.9	7.6	7.6
Harmonised index of consumer prices (HICP)	2.0	1.9	0.6	2.1	1.3	0.5	2.1	4.9	3.1
GDP deflator	2.1	1.1	0.7	1.0	1.3	2.5	0.8	2.2	3.0
External position									
Current account balance (% of GDP), balance of payments	0.3	-0.7	-0.6	-0.8	-0.3	-1.9	-0.6	-1.1	-0.1
Trade balance (% of GDP), balance of payments	0.4	-1.3	-0.7	-1.1	-0.9	-1.9	-1.2	.	.
Primary income balance (% of GDP)	1.7	2.4	2.1	2.3	2.5	1.9	2.2	.	.
Secondary income balance (% of GDP)	-1.8	-1.8	-2.1	-2.0	-1.9	-1.9	-1.6	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	0.1	0.8	0.9	1.0	1.0	1.0	0.6	0.6	0.5
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	0.0	-0.2	-0.6	-0.9	-0.9	-1.2	-1.6	-1.5	-1.5
Capital account balance (% of GDP)	-0.1	0.0	0.0	0.1	0.1	0.1	0.5	.	.
Net international investment position (% of GDP)	-4.4	-11.9	-15.6	-19.3	-25.3	-30.2	-34.5	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-6.4	-23.8	-30.3	-34.1	-34.8	-41.9	-40.6	.	.
Net FDI flows (% of GDP)	1.5	1.5	0.7	0.0	0.6	1.2	1.6	2.2	1.8
Competitiveness									
Unit labour costs (ULC, whole economy)	1.5	2.1	0.8	0.8	-0.7	4.4	-0.2	1.8	1.9
Nominal compensation per employee	3.0	2.3	1.4	1.7	0.0	-2.9	4.9	3.8	3.3
Labour productivity (real, hours worked)	0.9	0.2	1.1	0.4	0.4	0.4	-0.8	-1.2	1.0
Real effective exchange rate (ULC)	0.6	-0.3	0.1	0.4	-4.6	.	.	.	.
Real effective exchange rate (HICP)	0.0	-1.2	-0.2	2.6	-1.4	1.5	-0.4	.	.
Export performance vs. advanced countries (% change over 5 years)	-4.3	-9.3	-4.6	-1.7	-2.1	-6.4	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	109.5	131.7	142.0	148.4	152.6	173.6	167.9	.	.
Household debt, consolidated (% of GDP)	41.7	53.0	56.6	60.4	62.2	68.7	67.0	.	.
Household debt, fundamental benchmark (% of GDP) (6)	46.8	55.0	57.7	57.2	56.9	61.5	58.6	.	.
Household debt, prudential threshold (% of GDP) (6)	41.3	40.3	45.5	47.8	49.0	48.9	49.1	.	.
Non-financial corporate debt, consolidated (% of GDP)	67.7	78.8	85.4	88.0	90.4	105.0	100.9	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	60.5	65.0	70.0	70.6	70.2	76.0	72.5	.	.
Corporate debt, prudential threshold (% of GDP) (6)	44.6	46.2	53.6	52.9	53.6	54.0	54.2	.	.
Private credit flow, consolidated (% of GDP)	7.7	5.6	4.6	8.2	7.9	12.9	6.5	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	1.1	0.9	0.0	-1.0	-0.4	-1.4	-0.2	-0.8	-0.8
Households, net lending (+) or net borrowing (-) (% of GDP)	2.4	3.7	2.8	2.6	2.8	8.0	5.6	3.7	3.1
Net savings rate of households (% of net disposable income)	9.2	10.0	8.5	8.7	9.2	15.7	.	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2-5-2022, where available; European Commission for forecast figures (Spring forecast 2022)

Table 2.2: **Selected economic and financial indicators (Part 2), France**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	2023
Housing market									
House price index, nominal	11.9	0.8	-0.1	2.9	3.3	5.2	6.3	.	.
House price index, deflated	9.8	-0.3	-0.5	1.2	2.5	4.4	4.6	.	.
Overvaluation gap (%) (7)	8.2	15.3	6.9	8.4	10.7	15.1	20.5	.	.
Price-to-income overvaluation gap (%) (8)	6.3	14.6	11.5	10.9	11.3	16.2	20.3	.	.
Residential investment (% of GDP)	6.1	6.4	6.1	6.3	6.5	6.1	6.8	.	.
Government debt									
General government balance (% of GDP)	-3.2	-5.5	-3.6	-2.3	-3.1	-8.9	-6.5	-4.6	-3.2
General government gross debt (% of GDP)	65.4	83.1	96.0	97.8	97.4	114.6	112.9	111.2	109.1
Banking sector									
Return on equity (%)	9.5	4.8	6.0	6.7	6.4	4.5	.	.	.
Common Equity Tier 1 ratio	.	10.7	14.1	15.5	16.1	17.0	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances)	2.6	4.2	3.5	2.5	2.2	2.0	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	3.7	2.7	2.5	2.2	2.0	.	.
Cost of borrowing for corporations (%)	4.0	3.1	1.8	1.5	1.4	1.2	1.3	.	.
Cost of borrowing for households for house purchase (%)	4.1	4.0	2.2	1.5	1.2	1.2	1.1	.	.

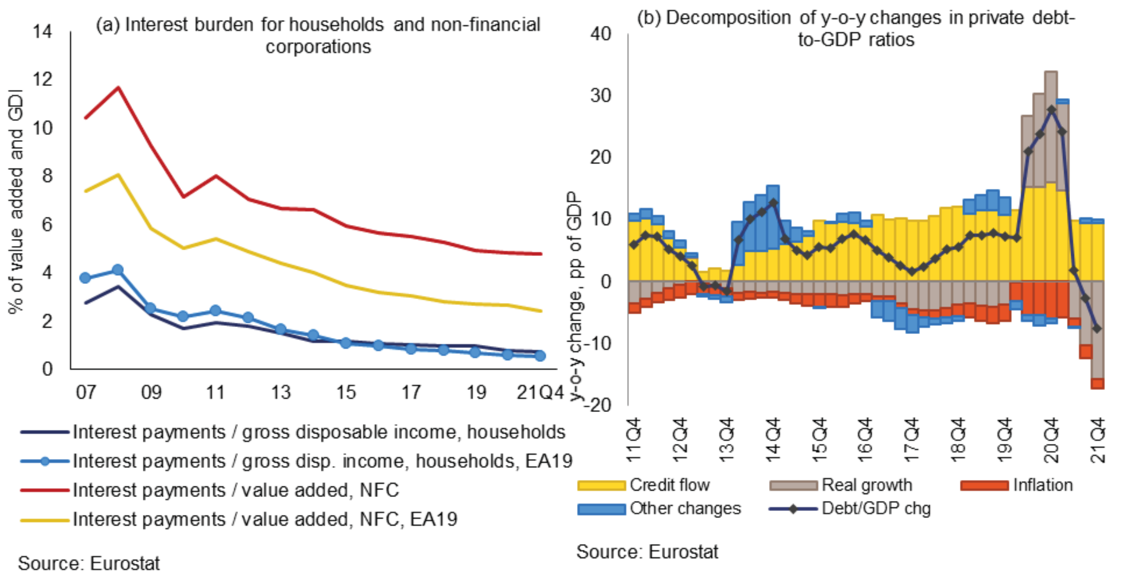
(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

3. THEMATIC CHAPTER: PRIVATE INDEBTEDNESS

The private debt-to-GDP ratio increased steadily between 2000 and 2019. This increase was partly due to the low interest rates that allowed for the decline in the interest burden for both households and non-financial corporations (Graph 3.1(a)). Private credit growth expanded by more than 10% on average between 2017 and the end of 2019 (see Graph 3.1(b)). The brisk increase in private indebtedness, by some 20 pps. of GDP, in 2020 resulting mainly from the contraction in economic activity will take some years to be absorbed. Despite the sound expansion in economic activity in 2021, when nominal GDP increased by an estimated 7.8%, the private debt ratio remained stable as credit flows remained very dynamic (see Table 3.1).

The sharp increase in private as well as public debt contributed to a significant deterioration of the external position. While still within the scoreboard thresholds, the Net International Investment position (NIIP) declined from -8.9% of GDP in 2007 to -30.2% in 2020, with gross external debt reaching 50% of GDP in 2020. Valuation effects contributed significantly to the deterioration of the NIIP since 2007. In contrast, in national accounts terms, the current account balance has been only slightly negative after the financial crisis (-0.8% of GDP on average over the period 2013-2019). Although it deteriorated significantly in 2020 to -2.6% of GDP, it is set to largely recover after the negative shock of the pandemic.

Graph 3.1: **Private indebtedness**



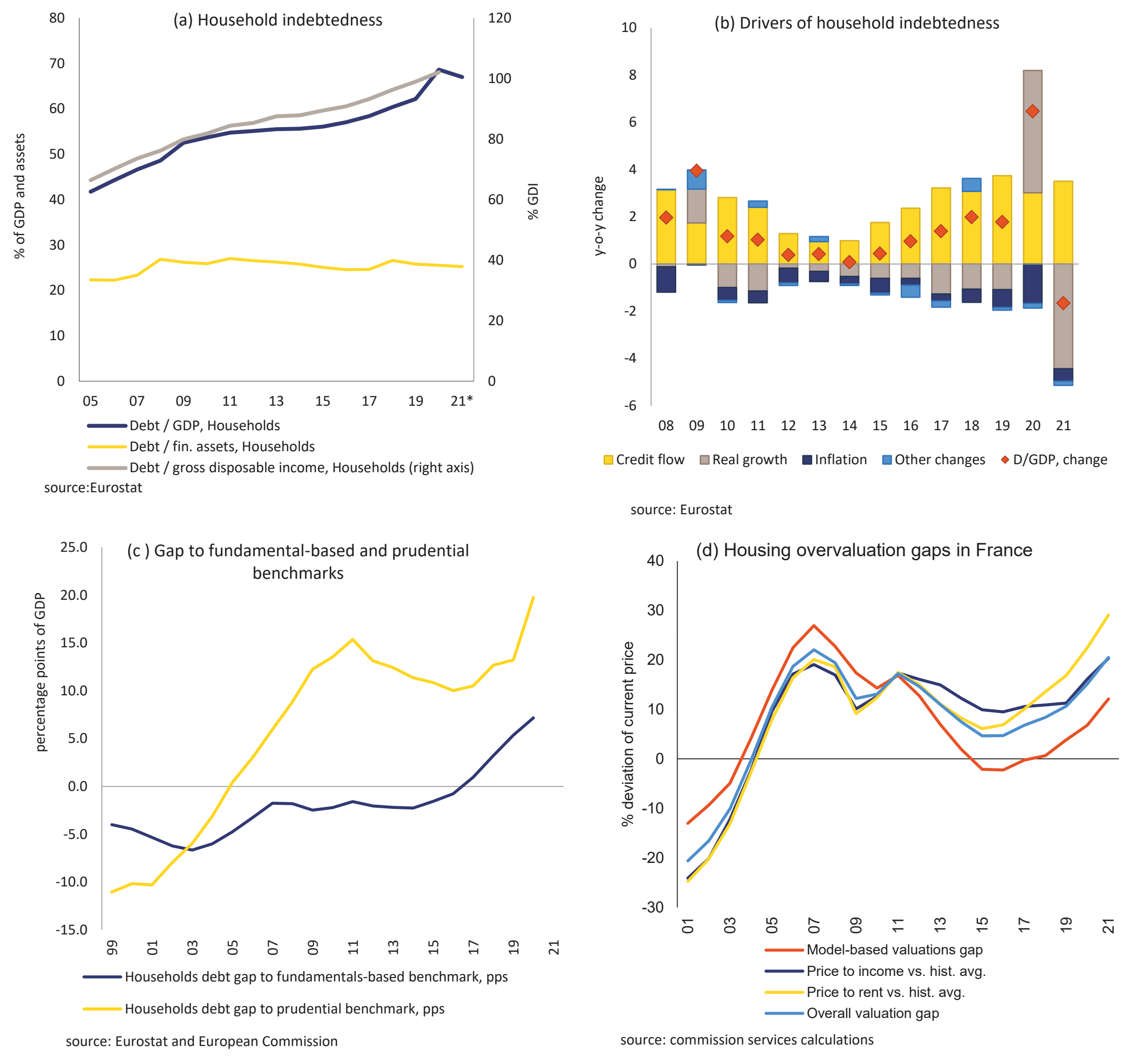
Source: Eurostat

Household indebtedness

Household indebtedness remains fuelled by dynamic credit flows. The upward trend of household debt as a percentage of GDP since the early 2000s was accentuated by the outbreak of the COVID-19 pandemic. After reaching 62.1% of GDP in 2019, household indebtedness peaked at 68.7% in 2020. Despite the strong economic rebound in 2021, the households' debt ratio declined by only two percentage points (see Graph 3.2(a)) as nominal debt continued to increase. As a percentage of gross disposable income household debt remained on the rise too and is set to have reached 103% in 2021. This upward trend in their leverage remains fuelled by dynamic credit flows (see Graph 3.2(b)), mainly loans for housing investment, which gained momentum in 2021. Such regained dynamism of housing lending can be partly explained by the sizeable accumulation of savings during the crisis and the continued increase in house prices, with new lending now above its pre-crisis level, and very favourable financing conditions with interest rates at historic lows.

Household debt remained broadly stable when compared with financial assets, but its increase raises concerns as it departs from fundamentals. The debt-to-financial assets ratio has remained broadly stable around 25.5% over the last decade. In turn, the households' interest burden as a share of their gross disposable income decreased to historical lows, in line with other euro area countries. However, the share of households' income devoted to debt repayment continued to rise as a result of an increasing leverage. In its February 2022 report, the European Systemic Risk Board (ESRB) shows that France is one of the few countries where the debt service ratio has increased between 2019 and 2021. The increase of the debt service ratio represents a particular risk in case of negative shocks to employment or interest rate increases. In this context, the household debt-to-GDP ratio has been departing from its fundamentals since 2018, and the gap with respect to prudential thresholds, as estimated by the Commission, keeps widening (Graph 3.2(c)). In spite of all these concerns, the share of non-performing loans keeps falling steadily (see Graph 3.3(c) below).

Graph 3.2: **Household debt**



Source: European Commission services and Eurostat.

Some signs of overvaluation in the housing market persist, but there are also important mitigating factors. Dynamic demand for housing and relatively easy access to credit keep fuelling an acceleration of prices. Commission services calculations suggest a potential overvaluation of housing prices between 12% and 30% (see Graph 3.2(d)), which highlights risks in the residential real estate sector. However, these risks are mitigated by two main factors. First, interest rate risks are limited by the fact that outstanding loans are almost entirely at fixed rates (above 99%). Second, the double-selection procedure of borrowers for most housing loans (evaluated by lenders as well as mutual guarantee companies) makes the value of the collateral less crucial in the event of sharp housing price declines. In addition, the French authorities have taken several macroprudential measures to address the growing vulnerabilities, including in the residential real estate market, mainly by regulating debt-service to income ratios and loan maturities.

Macroprudential measures are bearing fruit and credit standards have started to improve, even as housing loans rose. In parallel to the rise in housing loans, credit standards declined continuously between 2016 and 2019, with increasing maturities, loan-to-value and debt service-to-income ratios (Haut Conseil de Stabilité Financière, HCSF, 2019a and 2019b). Following the warning issued by the European Systemic Risk Board (ESRB) on 23 September 2019, the HCSF issued a recommendation in December 2019 requiring credit institutions to respect best practices when granting housing loans, especially regarding debt-service-to-income ratios and loan maturities. ([7]) In December 2020, the HCSF decided to strengthen some of the terms of the recommendation and in September 2021, the HCSF decided to make the terms of the recommendation legally binding as of 1 January 2022. ([8]) As a result of these announcements, the share of loans with high debt-service-to-income ratios or long maturities started to fall without having any visible impact on new mortgages. ([9]) The February 2022 ESRB report concluded that the current policy mix in France is appropriate and sufficient, with the borrower-based measures assessed as appropriate and sufficient to address risk related to mortgage lending growth, loose lending standards and rising house prices. The report recommends banks to rebuild capital buffers once the economic recovery is on solid ground. Given the relatively low internal ratings-based (IRB) risk weights for mortgage exposures, the ESRB also recommends increasing these risk weights if the associated vulnerabilities increase further, along with rebuilding the counter cyclical buffers (CCyB) or replacing it with a sectoral systemic risk buffers (SyRB) in order to strengthen resilience against the potential materialisation of housing market-related risks. In response to that, on 24 March the HCSF has increased its CCyB from 0% to 0.5%. ([10])

Non-financial corporations' indebtedness

Non-financial corporation indebtedness remains high and credit flows dynamic. The fall in interest rates and the reduction of intermediation margins in the French banking sector in recent years led financial institutions to expand their balance sheets to safeguard their profitability. This supported a steady increase in corporate indebtedness that reached 90% of GDP in consolidated terms in 2019. The contraction in GDP following the outbreak of the COVID-19 pandemic and the sizeable envelope of state-guaranteed loans, worth EUR 300 billion, deployed to avert liquidity shortages and bankruptcies led to a further increase in the corporate debt to GDP ratio, by around 15 pps., in 2020. There is a risk that the pandemic has left a protracted legacy in terms of corporate debt overhang. The economic rebound in 2021, with real GDP expanding by 7.0%, helped reduce the corporate consolidated debt-to-GDP ratio by only 4 pps., while new credit kept expanding at pre-pandemic pace, at around 3.5% of GDP.

The gap between non-financial corporate debt and its fundamental and prudential thresholds keeps widening. According to Commission estimates, the gap of non-financial corporate indebtedness vis-à-vis its fundamental values widened during the COVID-19 pandemic to some 28 percentage points of GDP. In turn, when compared with the level of corporate indebtedness beyond which the risk of a banking crisis is comparatively high, this gap rose to above 50 percentage points (see Graph 3.3(a)). However, the upward trend in corporate leverage remains accompanied by a continuous decline in its debt service, which is

([7]) 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.

([8]) See Haut Conseil de Stabilité Financière (2021a), Communiqué de presse. 29/09/2021.

([9]) See Haut Conseil de Stabilité Financière (2021b), Rapport annuel 2021.

([10]) See Haut Conseil de Stabilité Financière (2022), Communiqué de presse. 24/03/2022.

estimated to have reduced further, to below 5% of total value added by the end of 2021 due to historically low interest rates (recall Graph 3.1(b)).

Corporate indebtedness was accompanied by an even faster increase in equity and financial assets. In the 2010s, the increase in corporate debt was mainly driven by large companies that also accumulated higher liquidity buffers (cf. European commission, In-depth review 2021). Accordingly, total liabilities compared to total financial assets or to equity have shown a downward trend since 2011 (see Graph 3.3(b)). The COVID-19 pandemic does not seem to have reverted this trend. After a small uptick in 2020, debt-to-equity and debt-to-financial assets ratios declined again in 2021, falling below the levels observed in 2019. This also results from the firms' accumulation of sizeable liquidity buffers, and thus an apparent strengthening of corporate balance sheets.

The support measures to assuage the effects of the COVID-19 pandemic helped to alleviate the financial impact of the crisis on firms. A study of company balance sheets for 2020 shows that only 14% of companies increased their debt and diminished their cash flow between 2019 and 2020 ([11]). In addition, Banque de France ([12]) finds that the distribution of net bank debt of very small enterprises (VSEs) and SMEs improved between December 2019 and September 2021. In particular, the proportion of firms with negative net debt increased while the proportion of enterprises with positive net debt decreased. This is consistent with the signals sent by companies in business surveys. In January 2022, 65% of SMEs considered their cash flow sufficient in view of the crisis (versus 63% last May and 53% one year ago) and only 1.5% declared to be facing insurmountable difficulties. Regarding the use of state-guaranteed loans, 52% of SMEs declared that they have spent little of it (22%) or indeed none (30%) thereof, while 37% will have repaid their loans, at least partially, by the end of 2021. Only 5% of the respondents in the survey feared not to be able to repay their loans (cf. 74th half-yearly SME business climate survey, BPI France, January 2022). The overall take-up rate of these state-guaranteed loans reached 47% at the end of December 2021. Finally, a large micro-simulation exercise ([13]) comparing the financial situation of firms before and after support measures implemented by the government during the pandemic found the support measures have significantly mitigated the overall magnitude and heterogeneity of the shock among firms. Taking into account the measures, only around half of the observed companies suffered from a negative liquidity shock in 2020, the same proportion as in 2018.

However, the financial situation of a small proportion of companies deteriorated significantly. Banque de France estimates that approximately 7% of the companies experienced debt increases along with parallel cash flow decreases, while not being identified in difficulty before the crisis. The above-mentioned micro-simulation exercise also shows that the share of firms that suffered from a significant negative shock has increased. While this has not yet led to an increase in NPLs, these firms, which represent a small but significant share of the undertakings, may require specific support, in particular during the first repayment instalments of state-guaranteed loans. The authorities have put in place a dedicated tool ('Plan d'action sur l'accompagnement des entreprises en sortie de crise') aiming at identifying companies at risk as soon as possible and offering them tailored solutions.

Despite the moratoria in 2020, corporate bankruptcies decreased by 12.7% in 2021 with respect to the previous year. The decrease was observed in most firm size categories and sectors, including those hardest hit by restrictions resulting from the health situation, among which accommodation and food service activities. When compared to 2019, before the outbreak of the COVID-19 pandemic, the decrease in the number of bankruptcies cumulated over 2021 amounted to 46.6%. According to Banque de France ([14]), there is no sign at this stage of a resurgence of bankruptcies or of a wave of insolvencies in the future. However, this evolution will have to be monitored in a context of gradual withdrawal of support measures.

There are several negative post-pandemic risks for both non-financial and financial corporations. First, given the amount of gross indebtedness, a quick and abrupt increase in interest rates could significantly impact the financial burden of firms. Besides, the financial sector could be exposed to a

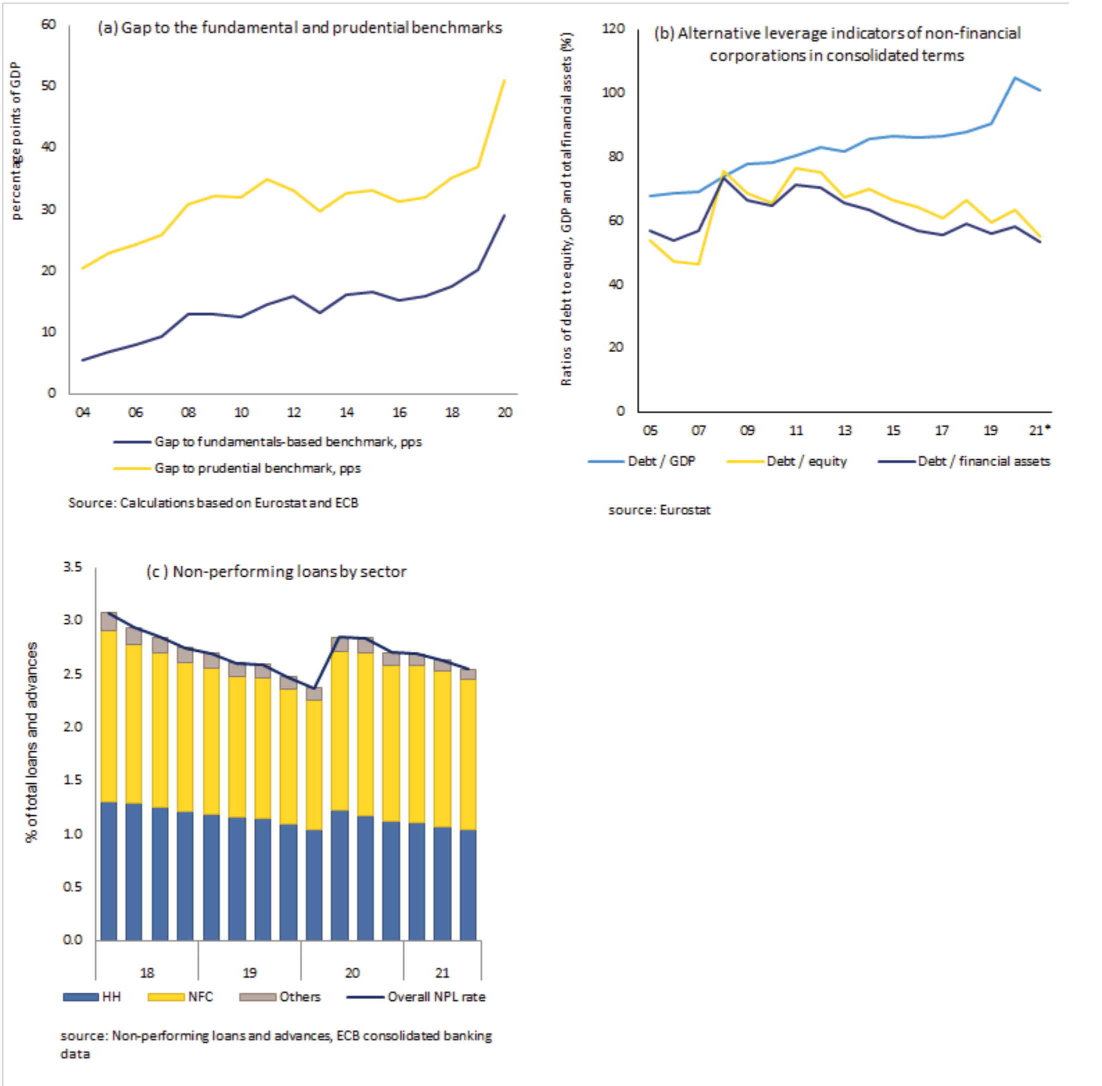
([11]) Banque de France (June 2021), L'impact différencié de la crise sur la situation financière des entreprises, Bloc-note éco 219.
([12]) L'impact de la crise du Covid-19 sur la situation financière des entreprises et des ménages, à fin octobre 2021 (Octobre 2021).
([13]) See Banque de France, Working Paper 84 (July 2021), What Individual Data tells us about the Covid-19 Impact on Corporate Liquidity in 2020
([14]) Banque de France (2021a). Business failures, December 2021.

negative and durable shock on the activity of the real estate sector (in particular the commercial one, weakened by the development of teleworking and online purchases). When compared to other EU countries, the banking sector in France is indeed relatively more exposed to the real estate sector, which accounts for some 50% of total loans to non-financial corporations. However, as a mitigating factor, loans to these corporations as a percentage of banks' assets are actually lower or broadly in line with most other EU countries. Moreover, when focusing on the commercial real estate (CRE), the situation is relatively more favourable in France: the total exposure collateralized by immovable commercial property amounted to 2.1% of the assets (against 3.5% in the EU).

The COVID-19 outbreak led the French authorities to relax one of the two macroprudential measures taken in 2019 to address vulnerabilities stemming from high corporate indebtedness. After its decision in April 2019 to raise the counter-cyclical capital buffer (CCyB) rate for banks from 0.25% to 0.5% of the total risk amount, the HCSF decided in January 2020 to lower the maximum exposure of systemic banks to 'high-indebted' enterprises from 25% to 5% of its equity. This measure originally aimed to preserve the resilience of the credit institutions vis-à-vis potential defaults of highly indebted private non-financial corporations. 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. Moreover, as of April 2020, the HCSF decided to lower the countercyclical capital buffer to 0%. ([15]) While this level was confirmed in January 2022, in response to recent ESRB recommendations, on 24 March the HCSF has increased its CCyB from 0% to 0.5% . The HCSF also recommended banks and insurers to behave responsibly regarding dividend distribution, share buybacks, and variable pay.

([15]) Haut Conseil de Stabilité Financière (2020), Communiqué de presse. 1/04/2020.

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



Source: European Commission services, ECB and Eurostat

Despite some vulnerabilities, the financial sector remains resilient and financing conditions continue to be favourable. The continued economic recovery has mitigated short-term risks for the financial sector, in particular in view of the stabilisation of corporate conditions. The banking sector's solvency has remained solid over 2021. The economic recovery has reduced the cost of risk and provisions have been withdrawn, thereby boosting banks' profits and pushing up their stock prices. In turn, after a very limited increase in the second quarter of 2020, non-performing loans of non-financial institutions have remained constant (see Graph 3.3(c)). Overall, financial conditions remain very favourable both in terms of volume and price. Bank credit growth remains dynamic at low interest rates, while bond spreads vis-à-vis the safest securities remain at historically low levels. However, some vulnerabilities exist: credit institutions' market valuations remain significantly below their book value, highlighting the structural challenges of profitability linked to the low interest rate environment and digital transformation. Moreover, while inflation expectations are still well anchored, a protracted rise in inflation would lead to higher market interest rates that would deteriorate financial conditions. ([16]) Finally, renewed lockdowns in China and the war in Ukraine might weigh on the financial situation of firms and lead to an increase in non-performing loans, which might also call for additional support measures.

In spite of having weathered the crisis well, the high indebtedness of non-financial corporations could weigh on medium-term growth prospects. France has gradually adapted support measures to the

([16]) See Banque de France (2021b). Évaluation des risques du système financier français, December 2021.

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

(Households and Non-financial corporations)	Source	2003-07	2008-12	2013-18	2019	2020	2021f	21Q1	21Q2	21Q3	21Q4
Stocks											
Private debt level (% of GDP)[1]	(a,d)	109	132	143	153	174	168	241	235	235	234
Private debt level (% of potential GDP)[1]	(a,b,d)	111	130	142	155	162	165	225	226	229	230
Prudential threshold (% of GDP)	(c)	87	86	99	103	103	103				
Fundamental benchmark (% of GDP)	(c)	107	120	128	127	138	131				
Flows											
Private credit flows (transactions, % of GDI	(a)	7.7	5.6	5.2	7.9	12.9	6.5	7.1	10.1	10.5	11.3
Private credit flows (transactions, % of pot	(a,b)	7.9	5.6	5.2	8.1	12.0	6.4	6.6	9.8	10.3	11.2
Benchmark for flows (% of GDP)	(c)										
Households (HH)											
Stocks											
HH debt level (% of GDP)	(a,d)	42	53	57	62	69	67	69	67	67	67
HH debt level (% of potential GDP)	(a,b,d)	42	52	57	63	64	66	64	65	65	66
Prudential threshold (% of GDP)	(c)	42	40	46	49	49	49				
Fundamental benchmark (% of GDP)	(c)	46	55	58	57	62	59				
Debt (% of gross disposable income)	(a,b,d)	66	82	91	99	102	103	102	103	103	103
Interest paid (% of gross disposable income	(a,b)	2.0	2.2	1.2	1.0	0.8		0.8	0.8	0.7	
Debt (% of gross financial assets)	(a,d)	22.1	26.6	25.5	25.8	25.6	25.3	25.2	25.1	25.3	25.2
Share of variable rate loans for house purcl	(d)	25.4	10.5	3.8	2.4	2.3	2.5				
Domestic loans in forex (% of dom. loans)	(d)	0.9	1.5	1.7	1.3	1.2	1.1				
Flows											
HH credit flows (transactions, % of GDP)[4]	(a)	3.9	2.3	2.1	3.7	3.0	3.5	1.8	4.9	4.0	3.7
HH credit flows (transactions, % of potentia	(a,b)	3.9	2.3	2.1	3.8	2.8	3.4	1.7	4.7	3.9	3.6
Benchmark for flows (% of GDP)	(c)	3.1	2.5	1.2	1.4	1.3	1.3				
Savings rate (% gross disposable income)	(b)	14.1	15.3	13.9	14.7	21.0	19.1				
Investment rate (% gross disposable incom	(b)	10.4	9.7	9.3	9.7	8.7	10.0				
p.m. Bank HH NPLs (% of HH loans)[2]	(d)			*3.9*							
Non-financial corporations (NFC)											
Stocks											
NFC debt (% of GDP)[1]	(a,d)	68	79	86	90	105	101	173	168	168	167
NFC debt (% of potential GDP)[1]	(a,b,d)	69	78	85	92	98	99	161	162	163	164
Prudential threshold (% of GDP)	(c)	45	46	53	54	54	54				
Fundamental benchmark (% of GDP)	(c)	61	65	70	70	76	73				
Debt (% of value added)	(a,b,d)	123	143	155	161	193	181	312	307	304	300
Interest paid (% of gross operating surplus	(a,b)	25.5	25.3	17.5	14.0	14.5		14.5	14.3	14.0	
Debt (% of gross financial assets)	(a,d)	60	69	60	56	58	53				
Domestic loans in forex (% dom. Loans)	(d)	2.4	2.8	1.6	1.4	1.2	1.2	1.3	1.2	1.2	1.2
Flows											
NFC credit flows (transactions, % of GDP)[4]	(a)	3.9	3.4	3.2	4.2	9.8	3.0	5.3	5.3	6.5	7.7
NFC credit flows (transactions, % of potent	(a,b)	3.9	3.4	3.2	4.3	9.2	2.9	4.9	5.1	6.3	7.6
Benchmark for flows (% of GDP)	(c)										
Investment (% of value added)	(b)	21.9	22.3	24.5	26.1	25.9	27.2				
Savings (% of value added)	(b)	23.0	22.2	22.3	23.7	21.1	24.0				
p.m. Banks NFC NPLs (% of NFC loans)[3]	(d)			*5.5*	*3.9*	*3.9*					

(f) European Commission forecast, . (1) Quarterly data is non-consolidated. (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.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

economic situation. While most of them have been phased out over the second half of 2021, it has extended the timeframe for State-guaranteed loans, especially for SMEs, until 30 June 2022. So far, the timing for the withdrawal of support measures seems to have been accurate. Bankruptcies over 2021 remained low compared to pre-crisis years and no significant wave of insolvencies is expected. Nevertheless, excessive indebtedness may limit firms' ability to undertake investment projects and ultimately put a lid on productivity growth.