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In-depth review for France

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European Commission

France

In-Depth Review 2023

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 – 2023 Spring Package" (COM(2023)600 final) that:

France continues to experience imbalances. Vulnerabilities related to high government debt, and competitiveness and low productivity growth, which have cross-border relevance, remain present but have shown signs of reduction. Government debt has been declining since the rebound in GDP in 2021, following an increase during the pandemic. In 2022, various fiscal measures significantly mitigated the impact of the energy crisis but slowed debt reduction. Debt is forecast to further decline this year and next, but it is projected to enter an upward trend again thereafter in the absence of policy action, remaining high and above pre-pandemic levels, and medium-term fiscal sustainability challenges remain high. Policy measures taken in recent years aiming at enhancing potential growth might help correct the projected increase in public debt in the medium term. Several reforms have been adopted to boost cost competitiveness. A small positive effect on competitiveness is already visible, and their full impact is expected to materialise over the coming years. Likewise, labour productivity is expected to benefit from the effective implementation of planned investments and reforms. The French economy displayed resilience over the last year, as cost competitiveness was less affected by increases in energy prices than in the rest of the euro area. Exports are improving owing to the further recovery of cross-border tourism and the aircraft industry, which were much affected by the pandemic. While private sector debt increased during the worst of the pandemic, higher corporate borrowing went hand in hand with increases in equity and accumulation of liquidity buffers. Higher interest rates may make public and private deleveraging more difficult. The policy response has been favourable, but there remain challenges, centred on public finance management. An effective implementation of recently adopted reforms remains central to further reduce vulnerabilities, namely the reform of public finances management and the new mechanism to conduct annual public spending evaluations. Both actions are crucial to continue to curb expenditure and keep public debt on a sustained downward trend. Moreover, the government has adopted a reform of the public pension system that is expected to help public debt sustainability.

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1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), the Commission identified “macroeconomic imbalances” in France. ([1]) These imbalances were related to high government debt and weak competitiveness, which carry cross-border relevance, in a context of low productivity growth. The 2023 Alert Mechanism Report published in November 2022 concluded that an in-depth review (IDR) should be undertaken also this year for France with a view to assess the persistence or unwinding of imbalances. ([2]) The AMR found that concerns related to cost competitiveness and the high government debt-to-GDP ratio remained. In addition, high private debt warranted close monitoring. Core inflation was lower than in many other euro area countries. Nonetheless, external sustainability and competitiveness concerns continued to warrant close monitoring. Albeit declining, the government debt-to-GDP ratio and government deficit remained high. Non-financial corporate debt was on a declining path following a sharp increase during the pandemic.

The French economy slowed down in 2022 and growth is expected to remain subdued over 2023, reflecting higher production costs and the uncertainties related to the evolution of prices. ([3]) The economic recovery from the COVID-19 crisis lost steam due to the continued disruption in supply chains and the surge in energy prices, with Russia’s invasion of Ukraine placing a further drag on the economy. France thus experienced a slowdown in GDP growth to 2.6% in 2022, compared to 6.8% in 2021. GDP growth is forecast at 0.7% in 2023 and 1.4% in 2024. Activity is expected to remain subdued, especially over the first half of 2023, due to low consumer confidence and high production costs weighing on investment, as a result of high inflation. At the same time, domestic demand is expected to be underpinned by a favourable labour market, with the employment rate projected to remain high relative to historical levels. Inflation picked up to 5.9% in 2022. The pass-through from energy and food prices to other goods and services has become increasingly visible in 2022 and is expected to lead to further increases in core inflation, especially over the first half of the year, and wages over 2023. Hence, despite the expected progressive moderation of energy prices, HICP inflation is expected to remain high, at 5.5% in 2023. Going forward, with inflation progressively moderating, the economy is set to gradually rebound, mainly driven by domestic demand. The increase in energy prices brought about a sizeable deterioration of the current account deficit in 2022, to 3.1% of GDP. While the expected normalisation of energy prices is expected to allow for some improvement, the return to current account deficits close to that registered in 2021 (0.8% of GDP) is projected to be gradual. The main risks relate precisely to the response of wages to current price developments and the evolution of still important supply shortages that might delay the expected gradual return to more moderate inflation rates.

This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for France. The MIP assessment matrix is published in the 2023 Country Report for France. ([4])

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

([2]) European Commission (2022), Alert Mechanism Report 2023, COM (2022) 381 final.

([3]) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

([4]) European Commission (2023), Country Report France 2023, SWD(2023) 610 final.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

The French economy has proved resilient to the major macroeconomic shocks of the past three years with limited disruptions to the economy, albeit at substantial fiscal cost. In the wake of the earlier 2008 economic and financial crisis, France faced the challenge to bring its high public debt under control in the face of a dismal productivity growth. From the early 2010s, productivity and overall competitiveness emerged as significant challenges. The French productivity challenges were not only reflected in structurally high unemployment, but also in weak export performance. Moreover, weak productivity growth and persistently high unit labour cost (ULC) growth contributed to erode cost competitiveness. The substantial progress in improving French competitiveness rests on numerous reforms the French authorities enacted over the past decade. The years of 2018-2019 had shown tentative signs of the reforms bearing fruit, yet progress was interrupted by the pandemic and the terms-of-trade shock from Russia's war against Ukraine. Despite the size of the shocks, France weathered these crises relatively well, also due to the deployment of sizeable fiscal packages to offset the effects of the COVID-19 and energy crises. Accordingly, France emerges from them with clear signs of improved potential growth, estimated at 1.1% in 2022 and expected to increase to 1.4% in 2023, a step change in the labour market, and restored export prospects. By contrast, the fiscal cost has been substantial, with public debt-to-GDP ratios at substantially above pre-pandemic levels.

The general government debt ratio is projected to keep declining in the short term, although remaining at high levels. 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. The outbreak of the pandemic hit strongly economic activity and brought about a sizeable deterioration of public finances. The contraction in tax bases dragging down tax revenues and the sizeable fiscal response deployed by the French government to cushion the impact of the crisis pushed the general government deficit up to 9.0% of GDP in 2020, while the public debt ratio rose by some 17 percentage points, to 114.6% of GDP. In 2021, the strong economic rebound and the associated dynamism of tax revenues allowed for some improvement in public finances. Despite the economy slowing down due to the brisk increase in energy prices, public finances improved further in 2022, as the unwinding of most Covid-related emergency measures more than offset the fiscal impact of the measures adopted to mitigate the effect of the energy crisis. Accordingly, in 2022 France's public deficit declined to a still high 4.7% of GDP and the public debt ratio fell to 111.6% of GDP. According to the Commission's Spring 2023 Forecast, public debt is projected to keep falling, albeit at a slower pace due to still high public deficits, to reach 109.6% in 2023 and 109.5% of GDP in 2024 at unchanged policies. However, in the absence of any further policy action, public debt is projected to rise again in the medium term, to 125% of GDP by 2033 (graph 2.1 a). The Commission's assessment shows that France faces high fiscal sustainability risks over the medium term, and medium risks in the long term. (5) Public debt projections are especially sensitive to interest rate and growth developments. The possibility of higher future interest rates, also bearing a negative impact on GDP growth, represent a risk for debt projections, leading to significantly higher debt ratios over the medium term. Likewise, backloading the consolidation efforts currently embedded in the French medium-term plans would also jeopardise the reduction of public debt ratios.

Labour productivity growth in France is set to improve compared to the euro area and the EU. Since around 2005, France has been registering, on average, a negative labour productivity growth differential with the euro area and the EU (graph 2.1 d). However, this trend started to revert already before the outbreak of the COVID-19 crisis. While productivity growth has recently been reined in by still ongoing labour hoarding, labour productivity, measured in full-time equivalent jobs, is projected to gain momentum, growing in line with the euro area and EU averages in the medium term. Despite this, structural weaknesses remain, weighing on total factor productivity growth, mainly due to still prevailing skills shortages and skills mismatches, the lack of digitalisation among SMEs and a stagnating business R&D intensity. Going forward, labour and total factor productivity are expected to benefit from recent measures and upcoming reforms that are implemented under the RRP to foster innovation, digitalisation and labour force up- and reskilling, as well as by the effects of the investment plan France 2030.

The energy crisis weighed on some competitiveness indicators, in line with euro-area developments, but they are expected to improve in relative terms over 2023 and 2024. France's nominal effective exchange rate appreciated over 2020 and 2021. However, the lower inflation in France compared to peers allowed for a depreciation of price-based (both HICP and GDP deflator) real effective exchange rates in 2021 and – more so – in 2022. The growth in unit labour costs (ULCs) was moderate and significantly lower than in the euro area before the COVID-19 crisis (2.5% between 2013 and 2019, against 6.7% in the euro area), (6) when large cuts in social contributions were adopted (transformation of the tax credit on competitiveness and employment, CICE, cuts at the minimum wage level and the Responsibility Pact). While ULCs and productivity figures in 2020 and 2021 were difficult to interpret due to the massive deployment of partial unemployment schemes, wages and ULCs rose sharply in 2022 to partly offset the brisk increase in inflation triggered by energy prices. For 2023 and 2024, ULC growth in France is expected to remain robust, albeit more moderate than in the euro area or the EU as a whole. The dynamic labour market still weighs on labour productivity figures: Unemployment continues to shift down markedly, and in line with established patterns the addition of new job holders, notably low-skilled, decreases average productivity. Expanding employment has been favoured by a number of fiscal measures and efforts to promote apprenticeship contracts, and by labour hoarding in the aeronautic and automobile industries. However, employment growth is expected to start slowing down in the medium term, which would translate into faster labour productivity increases.

French export performance was especially exposed to the pandemic, but prospects are positive. The aircraft industry was strongly hit by the travel restrictions imposed after the outbreak of the COVID-19 pandemic, but their lifting and the subsequent recovery of world tourism are starting to impact order books positively. In turn, the automotive industry has been negatively affected by the disruptions in supply chains, in particular by those regarding electronic components. The negative contribution of the automotive sector to the external balance might have bottomed out, but the fading out of more recent shocks leaves significant uncertainty about the future of the sector in the country in a context of a structural shift of preferences towards electric vehicles. Part of the recent deterioration of export market shares witnessed since 2020 also related

(5) See the DSA in the Commission Country Report 2023 for the latest risk classification and Debt Sustainability Report 2022 (April 2023) for methodological details.

(6) Measured in terms of people employed.

to the chemical sector and pharmaceutical products as COVID-19 vaccines are produced in other countries. Recently, exports picked up strongly to above 2019 levels in nominal terms. They are expected to improve further over the next years, in line with the recovery of the tourism and the aircraft industry, the fading of supply chain disruptions and the expected improvements in productivity (graph 2.1 b).

Overall, both cost and non-cost competitiveness are expected to improve going forward, but risks remain. The normalisation of energy prices might help alleviate the burden of production costs, especially amongst the most energy-intensive industries, while wage growth is expected to moderate by 2024 in view of gradual disinflation. In addition, recent reforms, including the reduction of production taxes, and investments should start paying off in the medium term via a positive impact on competitiveness and productivity, the increase of which would also stem from less dynamic employment growth. Accordingly, unit labour costs are expected to decelerate over the next two years, growing below the euro area and the EU on average, as well as the main EU trading partners. In turn, recent and expected reforms, as well as the full implementation of the investment plan France 2030 are set to further fuel investment over the next decade in the green transition, state-of-the-art R&D and the digital realm, while providing more favourable business conditions, thereby also enhancing non-cost competitiveness. However, the higher cost of energy and wage increases as a result of high inflation have narrowed mark-ups. The behaviour of mark-ups across sectors is so far very heterogeneous, with no significant correlation being observed between their behaviour and the direct exposure to the energy crisis. Yet, mark-ups remain high, above 30% on average, which shows that French firms weathered the crisis well and unveils their resilience to negative shocks. On the other hand, the narrowing of mark-ups, if pursued, could eventually weigh on investment and lead to an increase in bankruptcies, which might entail some damage to the economic tissue. Conversely, the decline in energy prices and the expected moderation of labour costs would create favourable conditions for mark-ups to be restored, at least partially.

Private-sector borrowing peaked in 2020, and left the private sector with high debt, above pre-pandemic levels. Private debt had been on an upward trend until the outbreak of the pandemic in 2020, when it peaked at 175% of GDP (graph 2.1 e). In particular, corporate debt levels are above those of most of France's euro area peers. During 2020, the debt of non-financial corporations increased by 10 points of GDP amid low interest rates, government guarantees and a brisk GDP contraction. With the economic rebound in 2021, corporate borrowing edged down, but the economic slowdown amid dynamic credit on the back of high investment, pushed corporate indebtedness up to 104.5% GDP in 2022. Household borrowing followed a somewhat different pattern, peaking in 2020, edging down slightly in 2021 and broadly stabilising in 2022 amid dynamic credit flows, although decelerating substantially by the end of 2022. Overall, the private-sector debt to GDP ratio thus saw a swing during the GDP decline and recovery of 2022-21, but at 171% of GDP in 2022 continues to exceed its 2019 level by almost 20 pp of GDP, as well as the levels suggested by economic fundamentals and prudential thresholds, for both households and non-financial corporations. (7) Going forward, the increase in interest rates and the overall tightening of financing conditions might bring about some deceleration in credit growth in the months to come. Moreover, credit standards for corporate and housing loans tightened since the summer of 2022.

The accumulation of sizeable liquidity buffers, concomitant to the increase in indebtedness, allowed non-financial corporations to maintain relatively solid balance sheets and corporate credit keeps flowing. The accumulation of corporate debt was accompanied by an even faster increase in equity and financial assets. Accordingly, the ratio of

(7) See European Commission, In-depth review for France 2022, staff working document SWD(2022) 632 final.

total liabilities over total financial assets or to equity have shown a downward trend since 2011 especially among large companies (cf. European Commission, In-depth review 2021). After a temporary uptick in 2020, this trend continued in 2021 and decelerated somewhat in 2022. In parallel, the upward trend in corporate leverage was accompanied by a continuous decline in its debt service, which bottomed out at 4.9% of gross value added in 2019 and remained slightly above 5% until 2021 thanks to historically low interest rates. This trend was halted in 2022 as the brisk pick-up in inflation triggered by energy prices led to quick interest rate hikes that involved an increase in corporates' debt service over the year. Nonetheless, according to the euro area bank lending survey, corporate credit flows remained dynamic over the year, although the tightening of financing conditions might lead to some deceleration. In turn, after decreasing by a cumulated 50% in 2021 compared to 2019, corporate bankruptcies rose sharply in 2022 and in the first quarter of 2023, but still remained around 24% below the pre-pandemic levels. ([8])

Risks related to the high household debt remain contained. Nominal credit to households decelerated in 2022, but their indebtedness as a percentage of their disposable income or assets rose slightly. The increase in household debt over the last two decades is mainly explained by loans for house purchases. Commission services' calculations suggest a potential overvaluation of housing prices between 12% and 30%. However, according to the Banque de France, ([9]) in 2022, the number of over-indebtedness cases was 7% lower than in 2021 and it halved since 2014, although it began to increase again in the first quarter of 2023 ([10]). Moreover, the size of the indebtedness of over-indebted households declined by 12% compared to 2021. In turn, savings accumulated during the pandemic have not been depleted and saving rates are projected to remain above pre-pandemic levels. While 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, the increase in interest rates has translated into an only slight uptick in the households' interest burden as a share of their gross disposable income in 2022, thereby remaining low for historical standards. This is mainly due to the fact that outstanding loans for dwellings acquisition are almost entirely at fixed rates (above 99%). Moreover, the share of non-performing loans kept falling.

Assessment of MIP relevant policies

Recent reforms have delivered some improvements to cost-competitiveness, mainly by reducing the cost of labour. Cost-competitiveness has been supported by a number of fiscal measures in recent years. They include the permanent cut in social contributions since 2019 (to replace the previously existing tax credit on competitiveness and employment, CICE), the permanent EUR 10 billion reduction in production tax (0.4% of GDP), the halving of the tax on the value-added of enterprises, mainly targeted to the industry, the support to apprenticeship contracts and the successive cuts in the corporate income tax. Some of these measures addressed long-lasting country-specific recommendations issued to France by the Council. These measures are deemed to have reduced the fiscal burden on labour and contributed to the recently dynamic employment performance, especially among the low skilled, and to a reduction of the unemployment rate that is underway. The slowdown in labour productivity, partly due to the employment dynamism, should gradually gain momentum as the labour market assimilates these reforms.

([8]) See Banque de France, Suivi mensuel des défaillances, Mars 2023.

([9]) See Banque de France, Enquête typologique sur le surendettement des ménages en 2022, Février 2023.

([10]) https://particuliers.banque-france.fr/sites/default/files/media/2023/04/13/barometre_avril.pdf.

A number of reforms and investments should deliver further improvements in non-cost competitiveness and productivity. Reforms aimed at enhancing productivity and non-cost competitiveness include the PACTE law, adopted in May 2019, which main objective was to enhance firms' growth and promote their innovation. Several initiatives were taken to improve labour market efficiency. In particular, the unemployment benefit reform that entered into force in 2021, or the September 2017 labour law ordonnances that fully entered into force in 2018, aimed to encourage the use of open-ended contracts, provided stronger incentives to work and promoted decentralised bargaining further. Besides, significant productivity-enhancing investments to support the green and digital transition and research have been made 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 billion. The Plan also entails investment in up- and re-skilling the labour force (including digital) in order to reduce the important skill mismatches in the labour market. ([11]) These reforms and investments are starting to bear fruit in view of the recent uptick in potential growth (graph 2.1 c) and are expected to entail a positive effect on productivity in the medium-term. Likewise, the investment plan France 2030, endowed with EUR 30 billion, is expected to foster investment over the next decade on the green transition, state-of-the-art R&D and on the digital realms, with the aim to provide a renewed impulse to reindustrialisation and reduce the external dependence on strategic areas. In addition, accelerating industry's transition towards net zero is expected to reinforce resilience and non-price competitiveness. By having a positive impact on productivity, these reforms should also contribute to enhancing public debt sustainability.

Some measures to contain public expenditure growth and to underpin public debt sustainability have been adopted, but their effects will depend on a sufficiently ambitious implementation. Efforts to consolidate government finances before the crisis only modestly reduced the public expenditure ratio. After a brisk increase in 2020 led by the COVID-19 crisis, public expenditure has declined by more than 3 percentage points, to some 58% of GDP in 2022. This level is the highest in the EU and, according to the 2022 Commission 2022 autumn forecast, it is projected to remain so and still around 1 point of GDP above pre-pandemic levels at least until 2024. 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. Some of the measures contained in the French Recovery and Resilience Plan are expected to support such consolidation. Specifically, the organic law on the modernisation of public finances management that entered into force in 2022 introduced a multi-annual expenditure rule applicable to total public spending and extended the prerogatives of the national fiscal council (i.e., High Council of Public Finances, HCPF). While the organic law was adopted, the objections by the opposition parties has prevented the public finances programming law from being approved so far. The latter sets out the multiannual fiscal targets, including the expenditure standard, which is essential for the proper functioning of the new framework. Moreover, the new mechanism aimed to conduct regular evaluations of public spending, with the aim of identifying the most efficient expenditures favouring growth, social inclusion and the green and digital transition, has also been approved. This mechanism foresees that the main conclusions of such annual evaluations should be presented to the Parliament before the 1st of June. A first set of saving measures based on past spending reviews conclusions has been incorporated in the 2023 budget laws on an ad-hoc basis. These measures represented savings of around EUR 2.5 billion (0.1% of GDP). The effectiveness of these measures to curb public expenditure and to put public debt on a sustained downward trend will

([11]) According to the French government, the French recovery plan France Relance, partly financed with RRF grants, is expected to bring about a positive effect on GDP of some 0.5% by 2025 and of 0.8% by 2023. Likewise, the Commission estimated that the French recovery and resilience plan (which is part of the broader plan France Relance) would lead to an increase of GDP of 0.8% in 2025 and of 0.4% by 2030. See European Commission, Analysis of the recovery and resilience plan of France, staff working document SWD(2021) 173 final. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021SC0173&qid=1624626969458.

crucially depend on the effective implementation and degree of ambition of the multiannual expenditure standard, strictly linked to the potential savings stemming from the revamped annual spending review mechanism.

A new reform aims to reinforce the sustainability of the pension system. Outside the scope of reforms in the RRP, the French government has passed a new pension reform, aiming at restoring the financial balance of the system by 2030. The main elements of the reform are the increase of the statutory retirement age from 62 to 64 years, the acceleration of a previous reform extending the required contribution period and the ending of some of the main special pension schemes, ([12]). According to the September 2022 projections by the pension advisory council (Conseil d'orientation des Retraites, COR), the current pension system would accumulate deficits in the long term of EUR 12.4 billion in 2027, EUR 13.5 billion in 2030 and EUR 21 billion in 2035. The measures envisaged by the reform are expected to bring the system back to balance by 2030, thanks to net savings ([13]) amounting to EUR 8.3 billion in 2027 and EUR 13.7 billion in 2030 ([14]) (0.3% and 0.5% of 2022 GDP, respectively; 2.4% and 4% of pension expenditure in 2021, respectively). However, there is a risk that after this date the system returns to deficit, especially if unemployment does not evolve in line with the government's projections. In any case, the reform is expected to have a positive impact on public debt sustainability.

Public support measures during the COVID-19 crisis supported lending growth. The public loan guarantee scheme set up by the state has played an important role in supporting lending during the crisis, especially to SMEs, and prevented corporate bankruptcies. The latter declined in 2021 with respect to both 2020 and even with respect to pre-pandemic years. By the end of 2022 bankruptcies rebounded strongly, although they remained below pre-pandemic levels, which suggest some normalisation. In turn, in 2022 non-performing loans remained rather stable for corporations and declined for households. The macroprudential measures adopted by the French authorities since the outbreak of the COVID-19 crisis have contributed to ensuring an adequate provision of credit and credit standards for households' loans have improved. On 27 December 2022, the High Council of Financial Stability (*Haut Conseil de Stabilité Financière*, HCSF) decided to raise the countercyclical capital buffer up to 1.0%. ([15]) This decision is expected to provide further resilience to the financial sector without implying any rein in credit flow, in that the financial institutions have enough reserves.

Conclusion

In France, vulnerabilities relate to high public debt, and to competitiveness and low productivity growth challenges, although the latter continue to recede. These

([12]) The reform proposal assimilates the special schemes for all new recruits to the Paris public transport company (Régie autonome des transports parisiens, RATP), the electricity and gas industries (e.g. EDF), the Banque de France, clerks of notaries and CESE (French Economic, Social and Environmental Council), which altogether cover around 500 000 employees, to the general pension regime.

([13]) The increase of the statutory retirement age and the acceleration of the increase of the contribution period would lead to savings of EUR 10.3 billion in 2027 and EUR 17.7 billion in 2030. These savings in 2030 would more than compensate the expected deficits of the system (EUR 13.5 billion). However, the reform proposal also includes so-called 'accompanying measures', which imply a cost of EUR 2 billion in 2027 and EUR 4 billion in 2030.

([14]) The government's projections assume a productivity increase of 1 % per year and a long-term unemployment rate of 4.5 % (from 7.3 % today). An assumption of 7 % unemployment would increase the projected deficit at 2030 (before reform) from EUR 13,5 billion to almost EUR 20 billion.

([15]) Haut Conseil de Stabilité Financière (2022), Decision nº D-HCSF-2022-06. 27/12/2022.

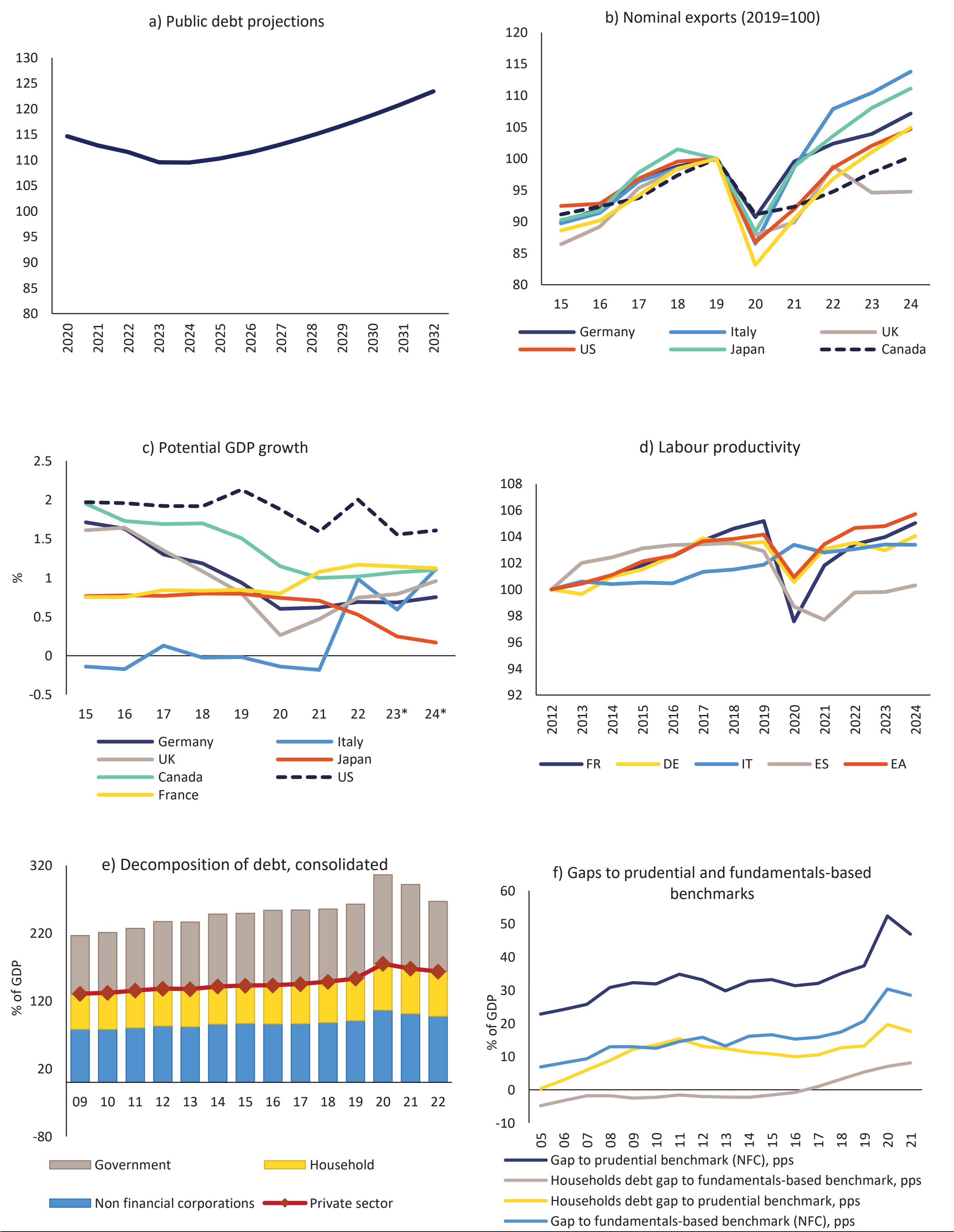
vulnerabilities have cross-border relevance. Public sector debt has been a long-standing vulnerability in France. As a result of the pandemic and the sizeable fiscal package deployed to assuage its socio-economic effects, public debt rose by some 17 points of GDP in 2020, but it edged down with the rebound in economic growth in 2021. The numerous fiscal measures adopted in the context of the energy crisis significantly mitigated the impact of the shock, but their sizeable budgetary cost (1% of GDP) prevented a faster public deleveraging in 2022. Public debt is projected to keep declining slowly until 2024, although it will remain high and above pre-pandemic levels. Moreover, in the absence of any further policy action, public debt is projected to rise again in the medium term. Accordingly, fiscal sustainability challenges remain high 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. There has been a gradual improvement in cost competitiveness over time, and associated indicators were less adversely affected by the increase in energy prices than in France's main EU trading partners in 2022. Labour productivity is reined in by the positive response of employment to a number of fiscal measures and reforms. However, it is expected to grow above the euro area and the EU in the short term, while benefitting form an additional impulse form investments and reforms in the pipeline. Despite the sharp negative impact of high energy prices on the current account balance in 2022, export prospects are positive, in line with the recovery of the tourism and the aircraft industry, which have been negatively affected by the pandemic. In turn, cost-competitiveness is expected to improve going forward, as some normalisation of energy prices might help alleviate the burden of production costs, and lower inflation should be reflected in contained wage rises accordingly. The response of wages to current price developments and the evolution of still important supply shortages emerge as risks for competitiveness. Moreover, higher future interest rates might weigh on GDP growth, making public and private deleveraging more difficult.

The policy response to imbalances has been broadly appropriate, but will require further sustained efforts. Important reforms have contributed to alleviating the fiscal burden on labour. By helping reduce the cost of labour, these measures have brought about a dynamic employment response, especially amongst the low-skilled, allowing for a gradual decline in the unemployment rate. However, this dynamism of employment has weighed on labour productivity. If fully and ambitiously implemented, the reforms and the productivity-enhancing investments in the RRP to support the green and digital transition and research would play an important role in addressing the persisting structural competitiveness challenges and the relatively slow productivity growth. Likewise, 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. In turn, the reform of public finances management entered into force in 2022, and a new mechanism to conduct annual public spending evaluations has been adopted, jointly with the 2023 budget laws. An effective implementation of these two reforms is crucial to address fiscal sustainability risks, as it would help to curb public expenditure and to put public debt on a sustained downward trend. Finally, the government has adopted a reform of the public pension system, aiming at ensuring the financial balance of the system by 2030. The reform is expected to have a positive impact on public debt sustainability.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in France, in line with Regulation 1176/2011. ([16])

([16]) European Commission (2023), European Semester Spring Package 2022, COM(2023)600 final.

Graph 2.1: **Selected graphs, France**



Source: Eurostat, Ameco, European Commission services

Box 1: Inflation exposures and cross-border pass-through

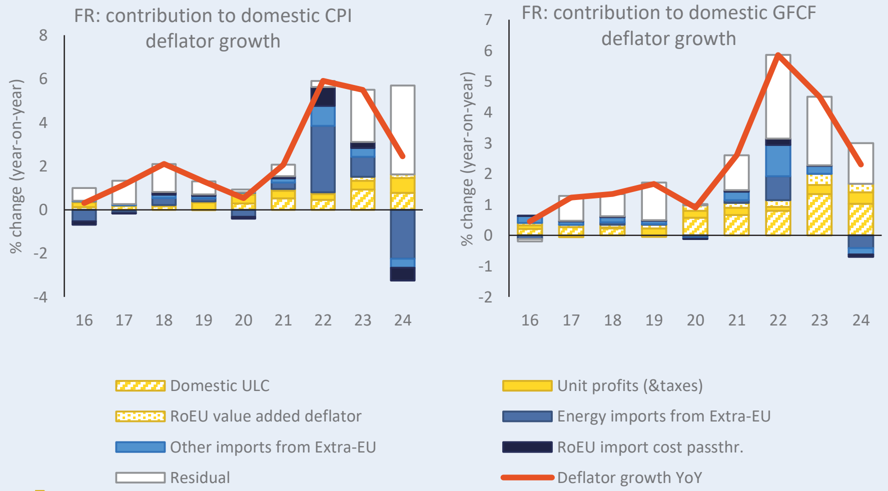
This box sheds light on the sources of inflation in France and its spillovers with EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in France surged to unprecedented levels. In response, wages and profits also picked up across the EU, which further added to price pressures in France. With input-output data, domestic inflation can be decomposed into the contribution from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from EU partners import costs ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([17])

Data suggests that much of inflation in France in 2022 reflected surging energy prices, while the importance of domestic factors is projected to increase. In 2022, as shown in Graph 2.2, energy imports were key drivers of consumption inflation whereas the role of energy prices was minor for investment inflation. Extra-EU non-energy imports also contributed to the pick-up in inflation in France. Spillovers from other EU countries remained limited, however. Namely, import cost pass-through from EU partners increased domestic consumption inflation somewhat, whereas value added inflation in other EU countries had only a negligible impact. Consumption inflation was not markedly affected by domestic factors, wages and profits. However, the contribution from wages to investment inflation was sizeable. The impact of energy inflation is set to subside and to eventually dampen inflation in 2024. Similarly, the impulse from non-energy import prices is expected to fade. However, the contribution from both unit labour cost and unit profits is expected to increase in both 2023 and 2024 compared to 2022. Spillovers from inflation in other EU countries are set to remain marginal.

The impact of wage and profit growth in France on other Members States remains limited. Although France has a non-negligible impact on domestic demand in other Member States, spillovers from value-added inflation in France are set to remain contained vis-à-vis the significant impact from import prices (see Graph 2.3). Overall, value added inflation in France has contributed little to consumer inflation in the rest of the EU so far. Most exposed countries are Belgium and Ireland with inflation spillovers at just over 0.1 pps. p.a. over the forecast horizon.

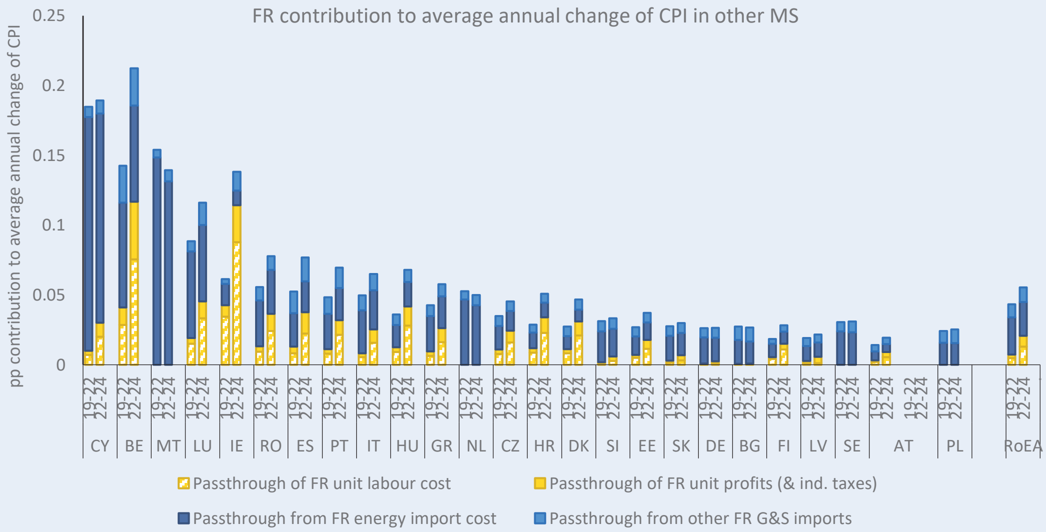
([17]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, which are combined through a 'Ghosh' matrix based on Eurostat's Figaro input-output available for 2015-2020. HICP is taken as the measure of the price of private consumption, including non-residents. Energy import prices from extra-EU reflect realised median prices until 2022, and energy price assumptions underlying the Spring forecast thereafter. Other goods prices reflect median Eureopan prices per industry until 2022, and forecast non-energy goods and service trade prices for 2023-2024. Value added deflators are assumed to affect all industries within a country to the same degree. Changes in import prices and value added deflators are assumed to affect demand prices with a delay of 7 and 5 months for consumption and investment inflation, respectively. For a similar analysis using an input-output-based methodology, see "Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews" European Commission 2023, Institutional paper 198.

Graph 2.2: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

Graph 2.3: **Impact of French value-added inflation on EU partners' consumer price inflation**



Source: European Commission services

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

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Real GDP	2.0	0.4	1.3	1.8	-7.8	6.8	2.6	0.7	1.4
Potential growth (1)	1.8	1.2	0.8	0.8	0.8	1.1	1.1	1.1	1.1
Contribution to GDP growth:									
Domestic demand	2.3	0.5	1.3	2.1	-6.5	7.0	2.7	0.6	1.4
Inventories	0.1	-0.1	0.2	0.0	-0.2	-0.3	0.6	0.0	0.0
Net exports	-0.4	0.0	-0.2	-0.3	-1.2	0.1	-0.7	0.1	0.0
Contribution to potential GDP growth (1):									
Total Labour (hours)	0.5	0.4	0.2	0.2	0.5	0.7	0.7	0.7	0.6
Capital accumulation	0.7	0.6	0.5	0.6	0.3	0.5	0.6	0.6	0.6
Total factor productivity	0.6	0.3	0.2	0.0	-0.1	-0.1	-0.1	-0.1	0.0
Output gap (2)	1.5	-1.2	-0.9	2.2	-6.5	-1.2	0.2	-0.3	0.0
Unemployment rate	8.6	9.0	9.9	8.4	8.0	7.9	7.3	7.4	7.5
Harmonised index of consumer prices (HICP)	2.0	1.9	0.9	1.3	0.5	2.1	5.9	5.5	2.5
GDP deflator	2.0	1.1	1.1	1.3	2.8	1.3	3.0	5.4	2.6
External position									
Current account balance (% of GDP), balance of payments	0.3	-0.7	-0.7	0.5	-1.8	0.4	-2.1	-0.5	-0.3
Trade balance (% of GDP), balance of payments	0.4	-1.3	-0.7	-0.9	-1.8	-1.2	-3.3	.	.
Primary income balance (% of GDP)	1.7	2.4	2.2	3.2	1.8	3.3	2.8	.	.
Secondary income balance (% of GDP)	-1.8	-1.8	-2.1	-1.8	-1.9	-1.7	-1.6	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-0.2	0.3	0.4	0.5	0.4	0.1	0.1	0.0	-0.1
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	0.0	-0.2	-0.6	-0.9	-1.3	-1.2	-0.8	-0.8	-0.7
Capital account balance (% of GDP)	-0.1	0.0	0.0	0.1	0.1	0.5	0.4	.	.
Net international investment position (% of GDP)	-4.4	-11.9	-16.2	-24.6	-30.7	-32.1	-26.2	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-6.4	-23.8	-30.9	-35.2	-41.3	-37.2	-31.8	.	.
Net FDI flows (% of GDP)	1.5	1.5	1.0	1.1	0.2	-0.4	-0.4	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	1.6	2.1	1.4	-0.7	4.8	0.5	4.8	4.9	2.1
Nominal compensation per employee	3.0	2.3	1.5	0.0	-2.7	4.7	5.0	5.4	3.1
Labour productivity (real, hours worked)	0.9	0.2	1.0	0.4	0.5	-1.5	-1.9	0.2	1.0
Real effective exchange rate (ULC)	0.2	0.0	-0.3	-3.3	0.5	0.1	1.6	-0.6	-1.5
Real effective exchange rate (HICP)	1.3	-0.8	0.4	-1.4	1.0	-0.2	-4.1	.	.
Export performance vs. advanced countries (% change over 5 years)	-5.3	-9.1	-3.3	-2.4	-8.0	-7.4	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	109.5	131.7	143.0	153.1	175.0	167.8	164.2	.	.
Household debt, consolidated (% of GDP)	41.7	53.0	57.2	62.2	68.6	66.7	66.2	.	.
Household debt, fundamental benchmark (% of GDP) (6)	37.9	43.6	51.0	55.7	60.5	61.3	61.6	.	.
Household debt, prudential threshold (% of GDP) (6)	48.3	44.7	42.0	39.9	40.9	40.7	39.7	.	.
Non-financial corporate debt, consolidated (% of GDP)	67.7	78.8	85.8	90.9	106.4	101.1	98.0	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	52.2	54.6	56.2	57.3	61.4	62.1	62.5	.	.
Corporate debt, prudential threshold (% of GDP) (6)	49.7	47.2	45.3	43.1	46.2	46.6	45.6	.	.
Private credit flow, consolidated (% of GDP)	7.7	5.6	5.2	8.4	13.5	6.5	8.3e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	1.1	0.9	-0.1	-0.4	-1.1	1.3	-1.1	0.0	0.4
Households, net lending (+) or net borrowing (-) (% of GDP)	2.4	3.7	2.8	2.8	7.6	4.8	3.3	3.5	3.0
Net savings rate of households (% of net disposable income)	9.2	10.0	8.5	9.2	15.5	12.8	.	.	.

(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 halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. 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 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

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

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Housing market									
House price index, nominal	11.9	0.8	0.4	3.3	5.2	6.3	6.4	.	.
House price index, deflated	9.8	-0.3	-0.3	2.5	4.1	4.7	1.3	.	.
Overvaluation gap (%) (7)	7.6	15.0	6.7	9.9	14.0	18.2	20.3	.	.
Price-to-income overvaluation gap (%) (8)	5.5	13.8	10.6	10.7	15.5	18.5	20.0	.	.
Residential investment (% of GDP)	6.1	6.4	6.1	6.5	6.1	6.9	6.8	.	.
Government debt									
General government balance (% of GDP)	-3.2	-5.5	-3.4	-3.1	-9.0	-6.5	-4.7	-4.7	-4.3
General government gross debt (% of GDP)	65.4	83.1	96.3	97.4	114.6	112.9	111.6	109.6	109.5
Banking sector									
Return on equity (%)	9.5	4.8	6.1	6.4	4.5	7.3	.	.	.
Common Equity Tier 1 ratio	.	10.7	14.3	16.1	17.0	17.0	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	2.6	4.2	3.4	2.2	2.0	1.7	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	3.5	2.5	2.2	1.9	1.8	.	.
Cost of borrowing for corporations (%)	4.0	3.1	1.7	1.4	1.2	1.3	3.1	.	.
Cost of borrowing for households for house purchase (%)	4.1	4.0	2.1	1.2	1.2	1.1	2.1	.	.

(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 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)