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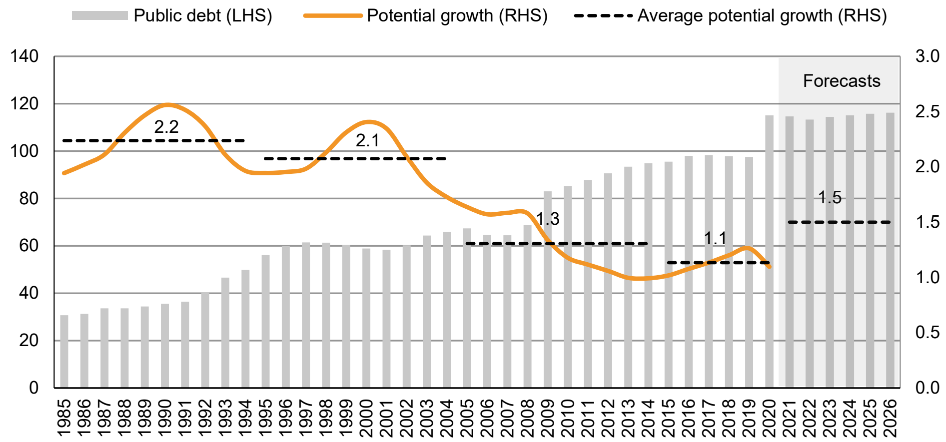
France: credit outlook hinges on decisive post-election action on structural challenges

France (AA/Stable) is set to elect a new president in April 2022. As presidential candidates put forth their campaign proposals, we highlight the multiple credit-relevant issues the incoming president will have to address during his or her tenure until 2027. We focus on France's main structural challenges including high public debt and expenditures, productivity and competitiveness bottlenecks, labour market rigidities, as well as delivering on ambitious climate targets. These challenges will require strong reform momentum while political fragmentation remains a major risk.

From a credit perspective, these multifaceted issues are pivotal for France's long-term outlook. Reforms and policies put forward by presidential candidates aim to tackle some of these challenges. Critically, it will be their ability to legislate and implement these that will ultimately determine whether they have a material impact on the country's growth potential and public debt trajectory, which have followed opposite trends over the past forty years (**Figure 1**). Looking ahead, public debt will remain broadly stable in a baseline scenario, reaching 116% of GDP by 2026 assuming annual GDP growth of 1.5% -- in line with France's potential – over the same period.

Figure 1. France's public debt and GDP growth potential
% of GDP (LHS); % (RHS)



Note: GDP growth potential estimates are from the OECD. Forecasts are from Scope Ratings
Source: OECD, IMF, Scope Ratings GmbH

The main credit challenges for France concern:

- **Public finances:** Sustained deficits and steadily rising debt, exacerbated by the Covid-19 crisis, highlight the need for gradual but ambitious fiscal consolidation. Elevated spending related to social welfare makes pension reform one of the most important elements in the presidential candidates' proposals.
- **Productivity and competitiveness:** Slowing productivity growth, weakening export performance, and deindustrialisation have progressively eroded potential GDP growth. Reviving that potential will require leadership on industrialisation and innovation policies.
- **Labour markets:** Structural rigidities and skills mismatches have led to high unemployment, particularly among the young. Supporting professional training and lifelong learning is critical to enhance economic opportunities and spur social mobility.
- **Green transition:** A widening gap between ambitious climate goals and current results requires forceful policy action which may be hindered by social risks attached to rising prices of fossil fuels. Candidates' plans for nuclear and renewable energy are crucial.

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Rebuilding fiscal buffers amid structurally high public expenditures

40 years of fiscal deficits have led to a steady rise in public debt

France's public debt has been on an upward trend since 1980. Countercyclical policies in response to shocks, followed by a lack of meaningful consolidation, even during sustained periods of growth, led to a steady deterioration in fiscal metrics over the past 40 years. France's fiscal balance remained in negative territory (**Figure 2**), even during 1980-90 and 1995-07 when average annual GDP growth rate was 2.4% and 2.3% respectively. Successive fiscal deficits led to a large increase in public debt, up more than 90 percentage points of GDP between 1980 and 2020, and around 20pp above the European average.

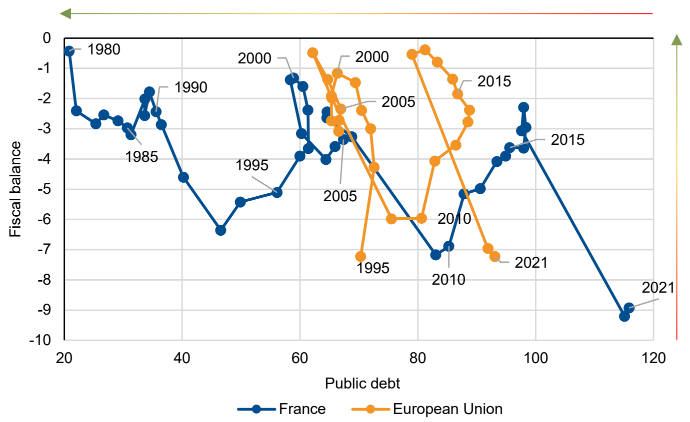
Covid-19: widening budget deficits have pushed further public debt at record highs

France's fiscal metrics have deteriorated significantly since the onset of the Covid-19 crisis, as the government introduced a large emergency fiscal package. Over 2020-2022, measures announced amounted to 28.0% of 2020 GDP[1]. As a result, the fiscal deficit and gross public debt ballooned, with a deficit of 9.2% of GDP in 2020 and 8.3% in 2021, and debt of 115.0% and 114.6% of GDP respectively.

Lowering high expenditure ratios to be challenging due to socially sensitive reforms

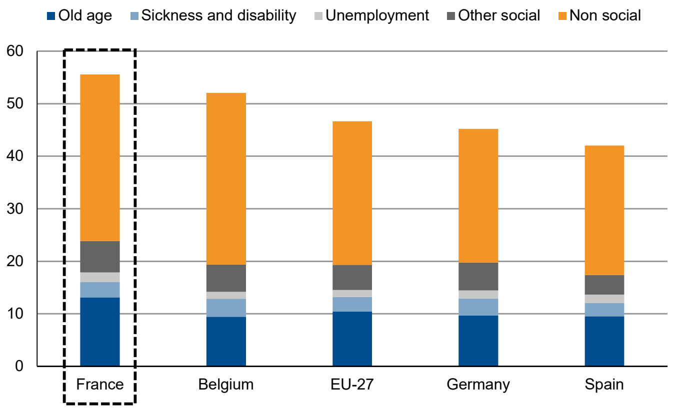
Elevated current expenditure has put pressure on public finances and constrains the government's ability to consolidate. Pre-Covid, public spending stood at around 55% of GDP in 2019, about 10pp higher than the European average. The challenge for French governments is also that spending tends to be rigid, absorbed mostly by social security, including pensions and unemployment benefits (**Figure 3**), while the government's wage bill at about 12% of GDP is higher than the European average of 10% of GDP. Reducing public spending inevitably involves politically sensitive and often unpopular reforms.

Figure 2. Sustained fiscal deficits vs European peers
% of GDP



Note: The arrows show the direction of fiscal consolidation for both axes
Source: IMF, Scope Ratings GmbH

Figure 3. Public spending vs selected peers
% of GDP



Source: Eurostat, Scope Ratings GmbH

Pension reform to remain central to lower public expenditures

France's pensions spending amounted to more than 13% of GDP in 2019. Assuming an unchanged policy scenario, this could weigh further on public finances given failed attempts to reform the pension system. Reform proposals aim to push back the retirement age or reduce the system's complexity and generosity. President Emmanuel Macron postponed long-awaited pension reform due to the pandemic and strong social opposition, leaving the challenge of reforming the pension system to increase fiscal leeway to the next administration.

[1] IMF (2022), 2021 Article IV Consultation

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Responding to slowing productivity growth and competitiveness bottlenecks

Productivity slows on shared and idiosyncratic factors

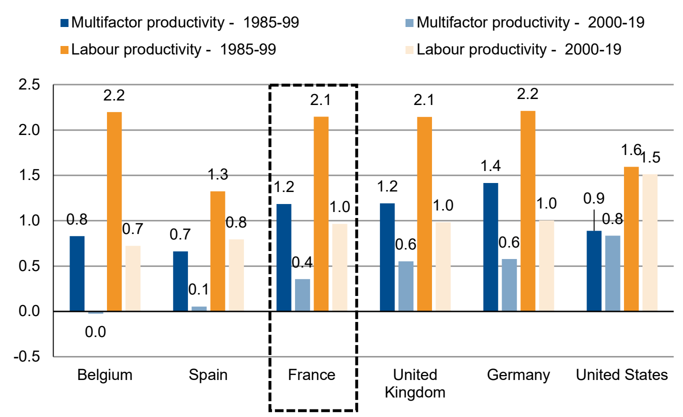
France benefits from high productivity but it has experienced a marked slowdown in productivity growth since the late 1990's, in line with other major European economies (**Figure 4**). France shares some of the same drivers of declining productivity growth, including a structural shift from industry to services, declining productivity gains from technological innovation in the ICT sector and a widening productivity gap between firms.

Yet, France also suffers from idiosyncratic challenges including: i) skills mismatches and labour market rigidities; ii) lagging adoption of digital tools – among smaller firms especially – and an ineffective translation of the country's high public and private R&D intensity into innovation[2]; and iii) regulatory bottlenecks in product and service markets.

Competitiveness: trade balance worsens on weak exports

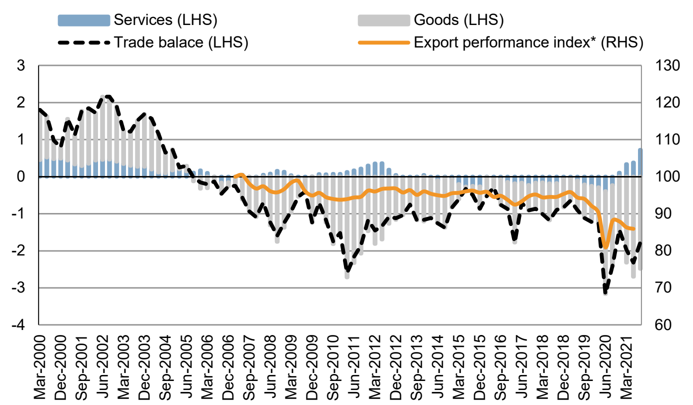
France's declining competitiveness is another challenge that multiple governments have tried to tackle and that remains salient in the public debate. The trade balance has deteriorated substantially since the early 2000's, mostly driven by rising goods imports (**Figure 5**). This, combined with a marked decline in world export market share compared to EU peers, has been associated with a loss in both non-price and price competitiveness[3].

Figure 4. Productivity growth vs selected peers
%



Note: Based on annual growth in GDP per hours worked (USD 2010 PPP).
Source: OECD, Scope Ratings GmbH

Figure 5. Trade balance and export performance
% of GDP (LHS), 2007Q1 = 100 (RHS)



* Difference between export growth and export markets' growth (in volume terms)
Source: OECD, INSEE, Scope Ratings GmbH

Productivity, competitiveness decisive for long-term growth

Productivity and competitiveness gains will be critical to offset the adverse impact on France's potential GDP growth rate, hence the importance of presidential candidates' proposed reforms and supply side policies, while addressing the related issue of deindustrialisation.

Beyond the impact of globalisation on domestic production capacities, supply disruptions triggered by the Covid-19 crisis have revived concerns over strategic supplies. Policies to boost productivity and competitiveness, through tax cuts, large scale investments and technological innovation, are expected to remain high on presidential candidates' agenda.

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[2] OECD (2021), Economics Surveys: France 2021
[3] Conseil national de productivité (2019), Productivity and competitiveness: where does France stand in the Euro zone?

Addressing labour market rigidities

Youth, long-term unemployment show structural rigidities

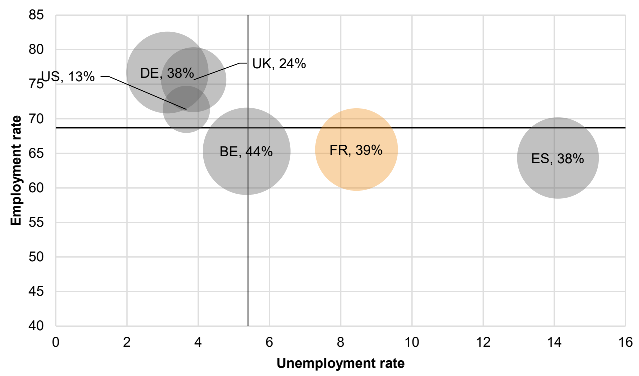
An inefficient labour market is one of the French economy's long-standing problems. Unemployment averaged almost 9.5% over 2010-20, having remained above 7% since the 1980's. France performs slightly better regarding part time employment (13.1% as of 2020) compared to OECD peers (16.7%), but it has recorded consistently elevated levels of youth unemployment (19.5% as of 2019, 8pp above the UK and 14pp above Germany) and in addition to long-term unemployment (**Figure 6**).

Labour market frictions persist despite cyclical upturn

In recent years, the labour market has shown gradual but distinct signs of improvement, as extensive support measures mitigated the impact of the Covid-19 crisis, together with gradual economic reopening. The unemployment rate (8.1%) returned to its pre-crisis level by Q3 2021, and the employment rate (67.5%) reached a record high. Yet, France's unemployment figures are among the highest among European peers, reflecting persisting structural challenges.

Figure 6. Labour market performance vs peers, 2019

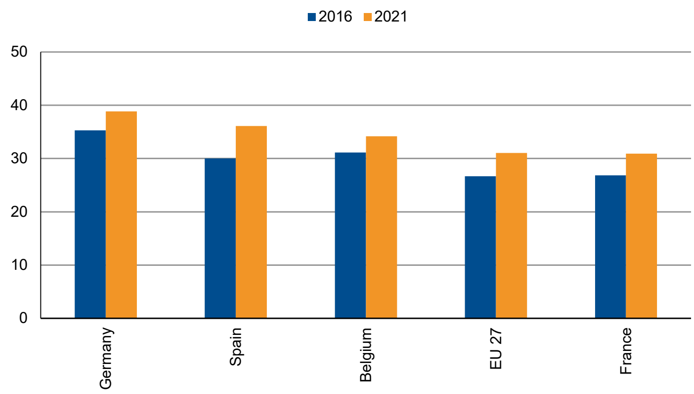
% of labor force (hor. Axis); % of 15–64-year-olds (ver. Axis); % of total unemployed (bubble size)



Note: The size of each circle represents the country's share of long-term unemployed. The axes represent the OECD average.
Source: OECD, Scope Ratings GmbH

Figure 7. DESI index, above basic digital skills

% of the population



Note: Digital Economy and Society Index
Source: European Commission, Scope Ratings GmbH

Labour shortages impact large sectors as the economy rebounds

France suffers from labour shortages, as illustrated by the share of vacant jobs to total jobs which has more than doubled over 2016-21. As the economic rebound intensifies, more than half of French companies encounter difficulties in finding new recruits as of December 2021[4]; an acute concern for some sectors such as ICT, engineering, and construction.

Skills mismatch represents a long-term constraint on growth potential

Labour shortages, despite elevated unemployment, point to a growing skills gap. It reflects the shortfalls of education and professional training systems to meet companies' demand for workers, even though expenditure on education (5.3% of GDP in 2019) exceeds the European average (4.7%). France's workforce skillset has been deteriorating relative to peers, as illustrated by declining marks in the OECD's Programme for International Student Assessment and relatively poor scores on digital skills (**Figure 7**). Presidential candidates' proposals to tackle skills shortages, strengthen vocational education and lifelong learning will be decisive, as the digital and green transformations highlight.

[4] Banque de France (2022), Update on business conditions in France

Delivering on climate commitments

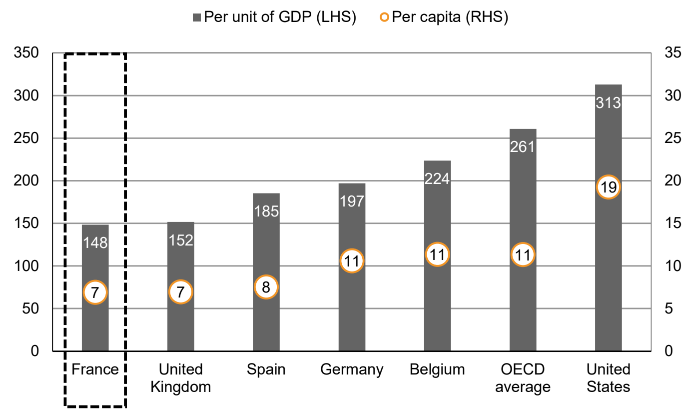
Low carbon intensity with ambitious environmental targets

France is one of the advanced economies with the lowest greenhouse gas emissions per unit of GDP and per capita (**Figure 8**). Its climate policy goals are considered among the most ambitious, with a domestic emissions reduction target of 40% by 2030 (compared with 1990 levels) and carbon neutrality by 2050. France has strengthened the governance of climate policymaking, enhancing its ability to assess its environmental performance and design long-term climate strategies[5]. This includes the 'Green Budget Framework', the 'Multiannual Energy Programme' and the 'National Low Carbon Strategy'.

The pace of emissions reduction has so far lagged commitments

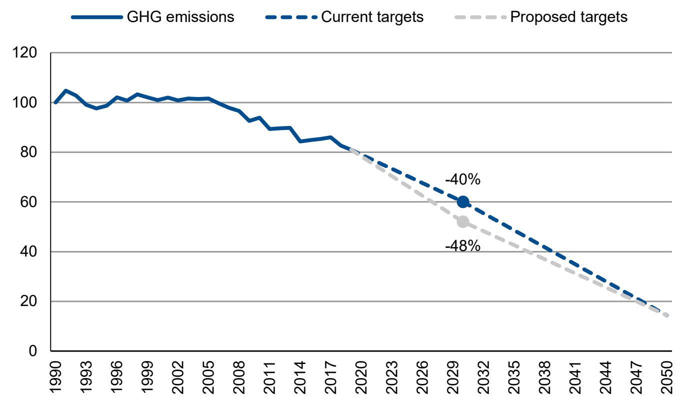
Yet, France is not on track to reach its targets for energy efficiency, renewable energy, or emissions reductions and the 'High Council on Climate' has indicated that efforts need to accelerate to meet long-term objectives[6]. In addition, France's climate targets may become even more demanding in response to international negotiations and pressure from civil society. France's emissions-reduction target for 2030 might be increased to 48% following the announcement of the EU's "Fit For 55" package (**Figure 9**).

Figure 8. France's GHG emissions vs selected peers
MtCO2e per 1,000 units (LHS); MtCO2e per capita (RHS)



Source: European Commission, Scope Ratings GmbH

Figure 9. France's emissions reduction targets by 2050
1990 = 100



Source: UNFCCC, Scope Ratings GmbH

Climate commitments have social consequences

Moving from ambitious strategic targets to change production and consumption patterns will require targeted policies to spur green private investments, increase environmental taxation and accelerate the development of renewable energies, among others. It will also require mitigating the social consequences of gradual decarbonisation of the economy as regulatory constraints become stricter, in a country where transport is still highly dependent on oil. Balancing forceful policy action, mitigating adverse social consequences for the most vulnerable and securing public support will be crucial to reach targets in a timely manner.

Nuclear power remains critical, contentious climate-policy issue

France's climate agenda is increasingly playing an important role in the public debate, against the backdrop of rising energy prices. A particularly contentious issue is the role of nuclear power, which generates close to 70% of domestic electricity production. There is a clear divide among presidential candidates, as those at the left of the political spectrum advocate dropping nuclear energy while those at the right push for more investments in the sector, with potential consequences for renewable energy investments. The EU's pending decision to include nuclear energy in the EU taxonomy will also be critical for France.

[5] Such frameworks include its Green Budget, the Multiannual Energy Programme or the National Low Carbon Strategy.
[6] IEA (2021), France 2021: Energy Policy Review; Haut Conseil pour le Climat (2021), Renforcer l'atténuation, engager l'adaptation.

Reform momentum could fall prey to political fragmentation

The above-mentioned issues will require a strong political leadership to reverse structural trends and address France's long-term challenges. Tackling all these issues at once will certainly prove difficult, and the question will be whether the government can address one challenge without jeopardising gains in the others. The incoming president will thus also have to count on a large parliamentary majority to deliver effective policymaking over the coming five years. In that respect, the results of the April presidential election as well as June legislative elections will indicate the future momentum behind reform. In this context, the current political landscape can be a source of fragility, given the years-long erosion of support for the mainstream right and the Socialist Party and the rise of far-right political forces. Political fragmentation could leave France with a weak leadership and diminish prospects for decisive reform in the country.

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