France: 2011 Article IV Consultation--Concluding Statement

Paris, June 14, 2010

The recovery of the French economy is progressing, and growth in 2011 is likely to exceed earlier expectations. Unemployment has started to decline, but it remains high, notably of the youth and the low-skilled. The sharp increase in house prices, partly induced by low interest rates and tax incentives, calls for increased vigilance. An unsettled external environment continues to pose risks, especially related to possible spillovers from continuing euro area sovereign debt problems, and uncertainty about energy prices. To sustain the recovery, and draw full benefits from recent and ongoing reforms, credible fiscal consolidation should anchor policies. This needs to be complemented by financial sector measures in line with ongoing international regulatory reforms and structural improvements in key economic areas, including growth-friendly reforms in the tax system and measures to support job creation through better functioning of labor markets.

1. **Supportive policy measures and key reforms contributed to a gradual recovery from the crisis**. The French economy started to expand in mid-2009, and 2011 outcomes to date surprised on the upside. France is expected to achieve robust growth at around 2 percent in both 2011 and 2012. The stronger growth in early 2011 was led by dynamic private consumption and stock-building, and supported by a recovery in investment, although net exports have remained lackluster. Employment is increasing and confidence also benefited from stronger activity in core Europe. Adoption of a key pension reform in 2010 and earlier structural measures to increase labor supply are starting to bear fruit. Macroeconomic risks remain, however, amid lingering problems on European sovereign debt markets, and uncertainty about energy and commodity prices.

2. **Economic policy should support the improved performance and enhance France's medium-term growth prospects.** Measures in three broad areas will be needed:

   a. Continue fiscal consolidation to ensure debt sustainability and market credibility;

   b. Support the resilience of the financial sector through higher capital and liquidity positions; and

   c. Implement tax, product and labor market reforms to improve competitiveness and achieve high and sustainable growth.

Anchor a credible consolidation in a strong fiscal framework

3. **The fiscal stimulus during the crisis was appropriate but debt sustainability and market perception now call for credible consolidation.** The impact of the crisis weakened France's fiscal position, bringing the debt burden above 80 percent of GDP. As an AAA-rated country, France's fiscal position remains subject to high scrutiny, while the rating itself is an important factor for keeping borrowing costs low. Market participants welcomed last year's pension reform, but French banks' strong exposures to some of the euro area crisis countries have renewed their attention to French sovereign debt. Against this background, a broad consensus among policy makers in support of consolidation has emerged.

4. **The consolidation targets set in France's Stability Program and the 2011-14 multi-year budget framework strike the right balance between speed and sustainability.** The overall budget deficit is to reach the Maastricht upper limit of 3 percent of GDP by 2013, and the structural balance would be brought down to below 1 percent of potential GDP by 2014. The planned adjustment is operationalized through binding multi-year restrictions on more than three-quarters of central government expenditures and minimum yearly targets for the reduction in tax expenditures. The fiscal outcome in 2010 was better than foreseen and a sizeable upfront adjustment is being made in 2011 to restore healthy public finances. However assumptions for next year's budget on growth and other key parameters should be realistic and not underestimate future adjustment needs (see below). The authorities' determination to maintain their fiscal path would be supported by preparing specific contingency measures that secure the targeted adjustment in case downside risks should materialize.

5. **Independent growth forecasts could help support the credibility of the budget process.** Growth assumptions, which are critical for determining overall tax revenue forecasts in the budget, are prepared by the Government. The official growth assumptions for 2012 and beyond are somewhat above consensus forecasts and the IMF staff baseline. While differences are at this stage small, it would help credibility if the budget could be based on forecasts issued by an independent agency, possibly a fiscal council. Moreover, the role of a fiscal council as an ex-ante source of independent advice on fiscal policy would be strengthened by making its recommendations subject to a mandatory follow-up procedure.

6. **A fiscal rule would guide budget policies and provide additional support for long-term policy credibility.** Fiscal rules are encouraged in the context of the strengthened European stability framework and have been implemented by other core euro area countries. A proposed structural balance rule, fully in line with the proposals by the independent high-level Camdessus working group, has passed the National Assembly and is now being considered by the Senate. This fiscal rule proposes to enshrine in the constitution the current practice of specifying multi-year fiscal frameworks and restricting new tax measures to budget laws. Passage of the legislation in Congress would provide a strong positive signal for France's long-term commitment to sustainable public finances.

7. **Given a high-level of autonomy, controlling budget outcomes of sub-national authorities and of social security remains a challenge**. The current freeze on transfers to regional and local governments provides an important incentive for expenditure rationalization. In addition continued efforts to review responsibilities of departments, regions, and municipalities, including an extension of the public sector expenditure review *(RGPP)* to local governments and implementation of the recommendations of the Balladur committee, would help avoid duplication of tasks. A growing share of the financing of social security funds and other agencies falls on earmarked "social taxes" (reaching nearly 30 percent of total resources at end-2009). This results for the government budget in open-ended spending mandates. Strict enforcement of the existing health care spending growth norm (*ONDAM*) will help contain these expenditures. A more far-reaching reform, replacing "social taxes" by subsidies to strengthen the effective budget constraint faced by these agencies, could be considered.

8. **The emphasis on reducing or eliminating tax exemptions as part of the consolidation process should continue.** The fiscal stimulus measures added additional tax and social security exemptions to an already long list of such measures. While individual tax expenditures (*niches fiscales et sociales)* may be justified, their proliferation leads to high nominal tax rates (on those non-eligible for the exemption) and possible distortions. Among these the "*Loi Scellier"*, favoring investment in rental property, is widely seen as an important contributing factor to recent sharp house price increases and should be phased out. The authorities' efforts to address tax exemptions as part of the consolidation process are welcome, and parliament has over the past year already voted in favor of measures amounting to 0.6 percent of GDP in reduced tax expenditures. A planned comprehensive review of tax expenditures, containing a cost-benefit analysis of all measures, is currently under way and should guide further reductions.

9. **Like other advanced countries, France needs to prepare for long-term fiscal challenges.** France has a more favorable demographic outlook than most advanced European countries. Last year's pension reform is an important step to improve medium-term sustainability, and under current assumptions the reform is expected to eliminate the deficit of the pension system by 2018. Yet uncertainties remain and the already planned evaluation in 2013 of pension sustainability is important. In addition, technical progress in health care will lead to a structural increase in such expenditures and further steps are needed to keep health and long-term care spending under control. The regular publication by the national authorities of a report on long-term sustainability of public finances would increase the awareness of related challenges.

Strengthen the financial sector in the context of global regulatory reforms

10. **The French banking sector has overcome most of the crisis legacies and has returned to strong profitability.** While the results of this year's EU wide stress tests coordinated by the European Banking Authority (EBA) are not available yet, national stress

tests undertaken by the French authorities and shared with the mission attest to the overall resilience of the system, including to shocks that could emerge from exposures to European crisis countries. The unification of banking and insurance supervision and the addition of a consumer protection mandate in the *Autorité de Contrôle Prudentiel (ACP)* and the creation of a national systemic risk board have further strengthened the supervisory arrangements in France. The newly created European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB) will have additional benefits for the operating environment.

11. **Financial stability risks linked to rapid house price increases seem at this stage contained but vigilance is required.** House prices in France increased rapidly over the past year, particularly in urban areas where supply remains constrained. Risks to banks seem limited, as French households have comparatively low levels of debt, and lending standards are generally conservative. Yet in a highly competitive mortgage finance market, the authorities should stand ready to use appropriate micro-prudential tools to ensure sound lending practices and sound risk management. Should house price increases continue and cause broader concerns, the authorities' intention to use macro-prudential tools is appropriate. In this regard, further work to build a macro-prudential framework would be helpful. In the context of limited supply, public policies to support house purchases may need to be reviewed to avoid putting additional pressures on already high prices. Regulatory barriers and other disincentives to new housing construction should also be reviewed.

12. **French banks should adapt swiftly to emerging international regulations**. All French banks have increased capital since the crisis. But capital levels need to increase further, and should reach Basel III levels by 2013/14, a timeframe well before the end of the phase-in period, but nevertheless sufficiently long to avoid excessively negative impact on lending. Both banks and the supervisor support this timetable; the supervisor should continue to ensure that banks implement their announced capital augmentation plans. Liquidity risk should be limited by reducing reliance on wholesale funding markets. Finally, France's major banks are large and of global systemic importance. Ongoing international discussions point to the need to mitigate systemic risk through measures that are tailored and internationally consistent.

13. **With key parameters of regulatory reform still to be defined, France should continue to play a constructive role in the international and European debate.** The French authorities support improving global and European regulatory standards, including higher capital levels, but emphasize the key role of supervisory arrangements, the importance of an internationally level playing field, and the need for sufficient phase in time to allow systems to adapt without excessive economic costs. A range of rules under Basel III, in particular on liquidity, as well as the prospective Capital Requirement Directive 4 – the transposition of Basel III regulations to the EU level—remain to be defined. As a leader in these debates, France should continue to take a proactive stand, and help achieve early clarity for the French financial sector on the nature and scope of future regulations.

Lift structural barriers to enhance competitiveness, employment and growth

14. **The medium-term prospects for the French economy depend on improved competitiveness.** Exchange rate based measures of competitiveness suggest only a minor overvaluation, driven in part by the dynamics of the euro. Yet, the world market share of French exports has been declining and comparatively few new French products gain market share. The French authorities are right to place significant emphasis on a multipronged strategy to improve competitiveness of the economy and lift potential growth, including through keeping real wage increases in line with productivity improvements, increasing labor market participation and raising productivity growth.

15. **Structural unemployment, the lack of jobs for young and unskilled workers, and the low participation rates for seniors remain a concern.** Earlier reform, such as better targeting support for the unemployed (*Pôle Emploi*), was hampered by start-up problems, and by the sharp increase in the case load during the crisis. In the context of the recovery, focused support measures for the unemployed should be reinforced, and combined with the strict application of job search requirements. A reduction of the comparatively long duration of unemployment benefits or a lowering of the benefit level over time could strengthen incentives for job search and thus increase effective labor supply. Senior employment benefited from the elimination of pre-retirement benefits and the pension reform, but participation rates remain low and efforts in this area should continue. In view of the particular importance of integrating the young, the authorities' efforts to foster apprenticeship programs are well placed.

16. **Continued minimum wage moderation would help create employment for low-skilled workers.** France has a uniform minimum wage (SMIC) of 9 euro per hour (1365 euro gross or 1073 euro net per month for a 35 hour work week). Over the past 5 years the policy of not giving discretionary increases in the SMIC (*coup de pouce*) along with some tax relief and reduced social contributions has been used to reduce the effective wage for low skilled workers paid by employers. Given the French society's strong preference for a uniform minimum wage, continued minimum wage moderation should help reduce the negative labor demand effects. The indexation formula should be reviewed in order to prevent the SMIC from increasing more than the median wage.

17. **Further modernization of the French tax system could support growth.** Last year's reform of the local business tax (*taxe professionelle*) has strengthened competitiveness of French firms. Yet other concerns about the implications of the tax system for competitiveness and growth remain. In particular, the French tax system relies more than other countries on social security charges and taxes levied on labor income, which increases the cost of labor and discourages employment creation and labor participation. A revision of the tax system, shifting the burden toward indirect (in particular VAT), environmental, and property taxes could allow lowering labor taxes and provide a more "growth friendly" environment. There is also room to improve the efficiency of the personal income tax, and to

simplify and improve the neutrality of the corporate tax system. In any tax reform the impact on income distribution and the most vulnerable segments of society should be reviewed and cushioned as needed.

18. **Broader efforts are under way to strengthen research and foster innovation.** As a share of GDP, research and development (R+D) expenditures in France are lower than in some other European countries, and private and public sector research are not always well integrated. To enhance incentives for R+D the authorities have implemented a generous tax credit for enterprises, and the *"grand emprunt"* and university reform support a variety of university-based and other research efforts. The direction of these efforts is well placed, yet cost effectiveness needs to be evaluated within an appropriate time frame. In addition, other obstacles to innovation should be considered, such as those possibly arising from the relative paucity of medium-sized firms.

19. **More competition in growth-critical services would increase potential growth**. Welcome steps have been taken to increase competition in the electricity, telecommunications, retail, and banking sectors. In the context of the EU services directive, France is committed to transposing relevant deregulation steps into national law but has – like other European countries – not yet fully done so. Further progress in the area of services deregulation could help lower transactions costs for business and broaden the range of services available to consumers at lower cost.

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The mission would like to thank the French authorities for excellent preparations, stimulating discussions, and their hospitality.