17 September 2020

France and C-19: Recovery plan to support economy but at cost of deteriorating public finances

France (AA/Stable) is set to return to its pre-crisis growth path after the economic shock from the Covid-19 pandemic. Structural reforms, fiscal stimulus, accommodative monetary policy and the government's EUR 100bn longer-term investment programme - "France Relance" - will support the recovery. However, sustaining growth comes at the price of significantly higher debt, likely to run at 115-120% of GDP in the medium term. France will have to fulfil its growth potential to help offset the greater vulnerability of public finances to future shocks.

The economic impact of the Covid-19 crisis, while unprecedented across Europe, has proved particularly severe in France. The French economy is headed for a contraction of around 10% in real GDP in 2020, followed by a robust recovery of around 7% during 2021. Strict containment measures, including a lockdown of around eight weeks (March-May), led to an abrupt standstill in most economic activities.

France's short-term economic recovery and medium-term growth depend on three main considerations: growth potential, labour market and public finances. The structural resilience of the economy and the government's policy response ensure that France could recover quickly from the pandemic-related shock. However, rebalancing public finances and meeting other credit-relevant challenges such as reforms to ensure a better-functioning labour market require decisive government action over the medium term.

Figure 1: France's short-run crisis absorption capacity vs medium-term challenges

	Short-term absorption capacity	Medium-term challenges to shock reversal
Growth Potential	Strong recovery potential underpinned by previous reform progress and the structural resilience of the economy	Stable growth potential above 1.5% is required over the medium-term to support sustainable public finances
Labour market dynamics	Extensive use of short-time work scheme and pre-crisis employment growth mitigate the Covid-19 impact on the labour market	Medium-term labour-market improvements involve structural adjustment to better meet firms' needs and decrease reliance of short-time workers
Public finance trajectory	Large increase in debt ratio is partially mitigated by favourable debt profile and monetary-policy support	Future debt sustainability requires constant reduction of primary deficits towards 1.5% of GDP and low interest payments supported by ECB monetary policy

Back to the future – with another new plan: "France Relance"

France has a long history of ambitious centralised economic planning, going back to the 17th century, responsible, in more recent decades, for the country's nuclear power stations, high-speed trains and Ariane space programme. "France Relance", the EUR 100bn stimulus programme (4% of GDP) focuses mainly on the supply side of the economy, in contrast with the more demand-oriented stimulus in Germany. The French stimulus programme concentrates on the corporate sector, with a planned EUR 20bn tax cut, EUR 30bn to support the transition toward a "green" economy, and EUR 35bn to subsidise job protection, skills development, and employment creation. We think that if the programme goes ahead as planned, it should enhance France's medium-term economic growth potential. At the same time, the stimulus will lead to a further deterioration in public finances.

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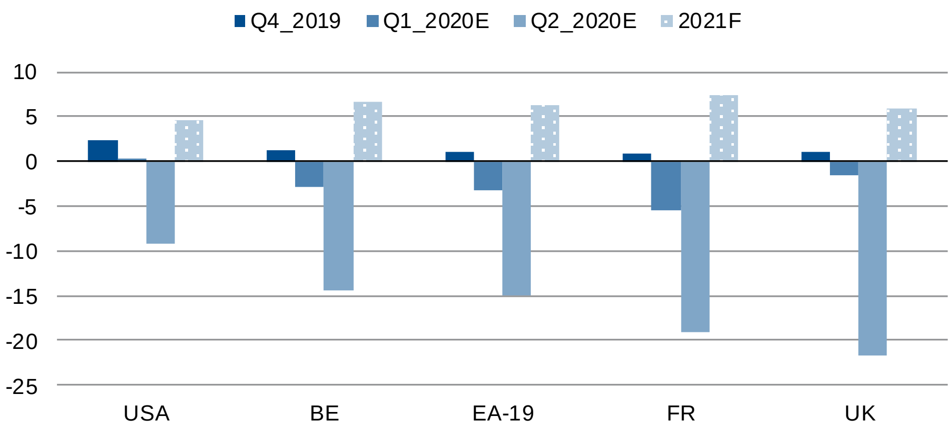
French economic structure and structural reforms support recovery

Severe 2020 output loss to be made up in two years

France and the UK are among Europe's advanced economies which experienced a deeper crisis compared to other developed countries (see **Figure 2**), with aggregate output losses of around 20% of GDP in the first half of 2020. The severity of this shock drives our assumptions for the economies' relatively strong recovery in 2021, with France showing an expected expansion in real GDP of 7%, compared with 5-6% in the euro area as a whole. We project a gradual return of the French economy toward its yearly growth potential, estimated at around 1.2% of GDP before the onset of the crisis.

Figure 2: Real economic growth

(% change, y-on-y)



Sources: Eurostat, EU Commission, US Bureau of Economic Analysis, Scope Ratings GmbH

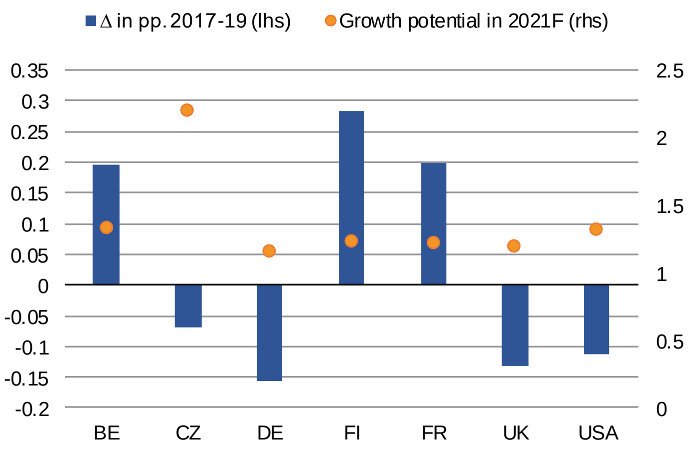
Past productivity gains, structural reforms aid recovery

President Emmanuel Macron's structural reforms of the French labour market and tax system have helped improve the economy's growth potential before the Covid-19 crisis. These reforms raised the economy's growth potential by 0.2 percentage points between 2017-2019. The structural economic impact of this public health crisis is likely to squeeze growth in the short-run through reallocations of capital and workers across sectors. However, current reform plans and general economic resilience to external shocks contribute to the country's better preparedness to deal with this crisis than some other advanced European economies (see **Figure 3**).

Continuation of structural reforms remains key to preserving fiscal sustainability

The health of France's public finances is linked to the country's high public spending, a rigid expenditure structure and limited space to generate additional domestic tax revenues despite high and stable real incomes (see **Figure 4**), with already high prevailing government levies. A continuation of structural reforms to preserve the tax base remains a priority to ensure the future sustainability of public finances.

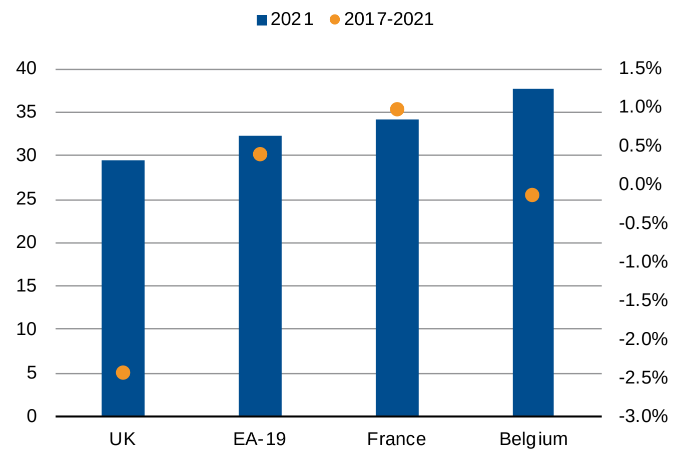
Figure 3: Evolution of growth potential



Sources: European Commission, Scope Ratings GmbH

Figure 4: Real GDP per capita levels

EUR thous. (lhs), % change (rhs)



Sources: European Commission, Scope Ratings GmbH

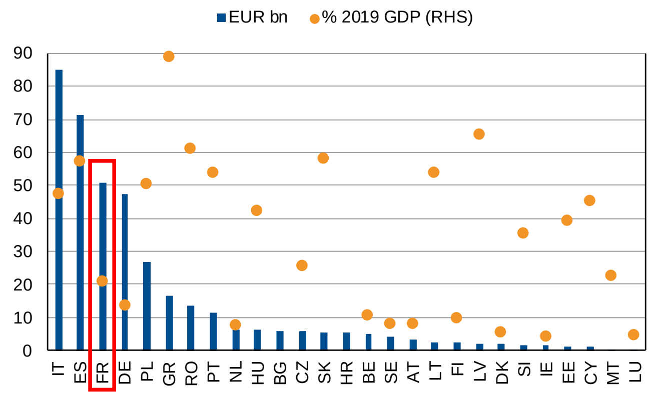
France to benefit from EUR 50bn in grants from the EU Recovery Fund

Final agreement on allocations from the EU's "Next Generation EU" Recovery Fund puts France in a favourable position as the third-largest expected recipient in nominal terms with around EUR 50bn in grants allocated (or around 2% of 2020 GDP) (see **Figure 5**). The government has announced that it will invest the funds in greening the economy and skills development. France has successfully absorbed EU funds in the past, with 49% of planned funds from the European Structural and Investment Funds spent in 2019, the highest share among larger European economies and the sixth-highest share among all EU-27 members (see **Figure 6**).

Most of the additional fiscal impulse from the Recovery Fund has been earmarked for financing the economic recovery. The Recovery Fund is also likely to support additional fiscal stimulus at the national level.

Figure 5: Grant allocationsn EU Recovery Fund

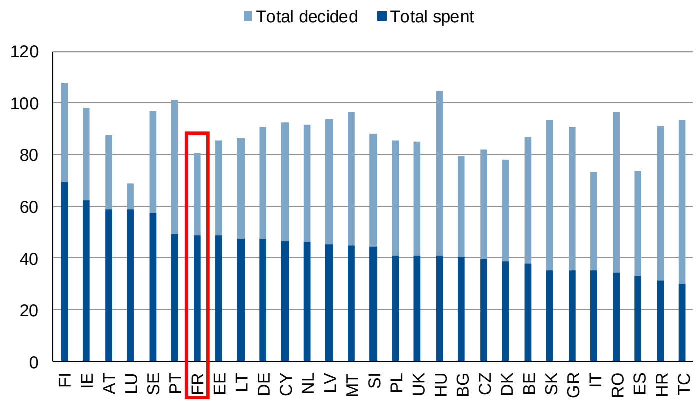
EUR bn and % of 2019 GDP



Sources: Bruegel, Scope Ratings GmbH

Figure 6: EU fund allocation absorption in 2019

% of total planned

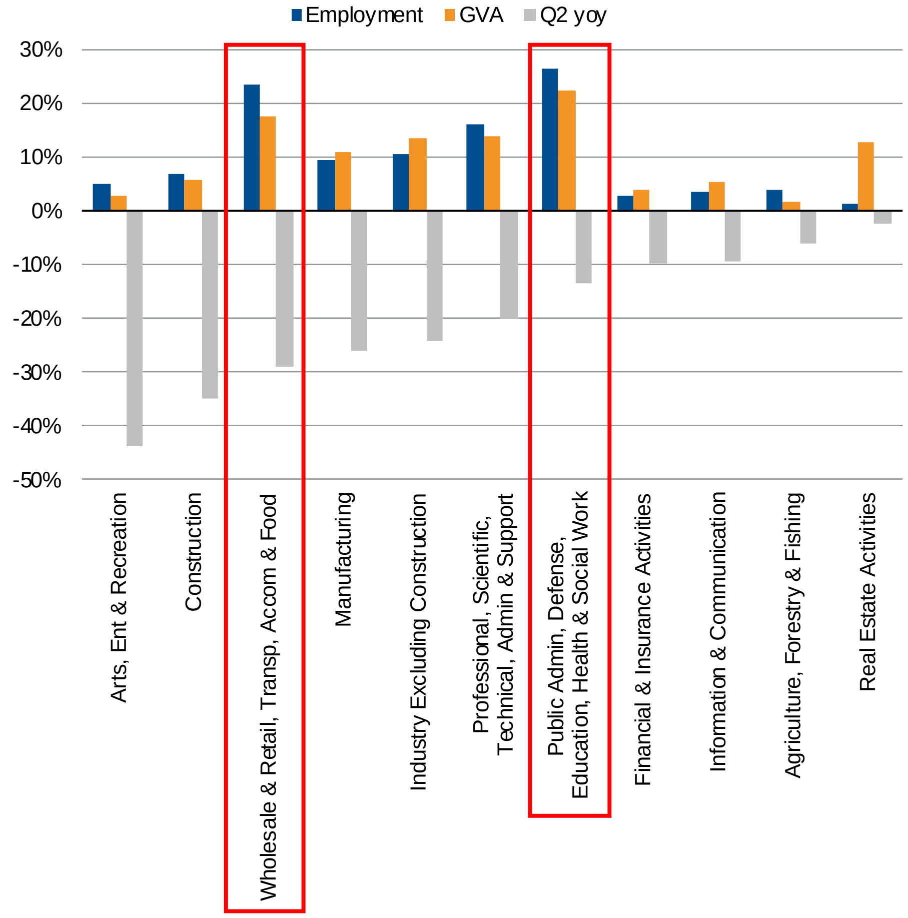


Sources: European Commission, Scope Ratings GmbH

Structure of the French economy favours robust recovery

The structure of the French economy could also moderate the longer-term impact from the Covid-19 shock. France's wholesale and retail trade, food & accommodation sectors were at the core of the economic crisis given their high shares of overall French gross value added (GVA) and employment: output declined nearly 30% year-on-year in Q2 2020 (see **Figure 7**). Other important economic sectors, especially the public sector, which is key for investment, have been hit less hard and have thus contributed to mitigating the aggregate shock to the general economy. In addition, the significant size of the French public sector automatically limits the expected impact from 2020's extraordinary labour market measures on the government's balance sheet: more than a quarter of overall employment is on the public sector payroll. Short-time pay work for civil servants would in fact lowers the overall public wage bill; only short-time work for private sector employees raises public expenditure.[1]

Figure 7: Sectoral activity in Q2-2020, shares of sectors in GVA and employment and yoy change in output
%



Sources: Eurostat, Scope Ratings GmbH

Labour market dynamics improve but remain a vulnerability for the growth outlook

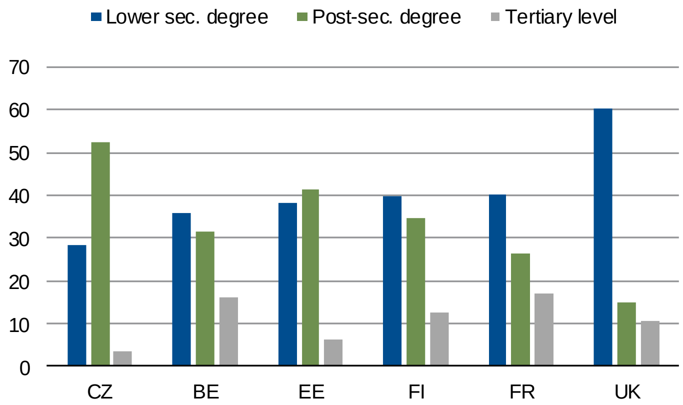
Unemployment remains high and weighs on growth

Our medium-term macro-economic outlook is based upon labour-market trends and the underlying structure of the French economy. Before the crisis, French labour market reforms and the general economic upswing had helped to lower the country's high unemployment rate to 8.5% in 2019 from 10.4% in 2015. Countries such as Spain or Germany have largely created jobs in low-wage sectors, but employment growth in France has been more broad-based across skill-levels (see **Figure 8**). This phenomenon could help to limit the expected jump in unemployment back to double digit figures when wage-subsidy measures expire (see **Figure 9**).

[1] In 2018, French public sector employment was 21% of total employment, which compares with 15% in the United States or 16% in the UK (Source: OECD, Government at a Glance).

Figure 8: Skill-levels of employees

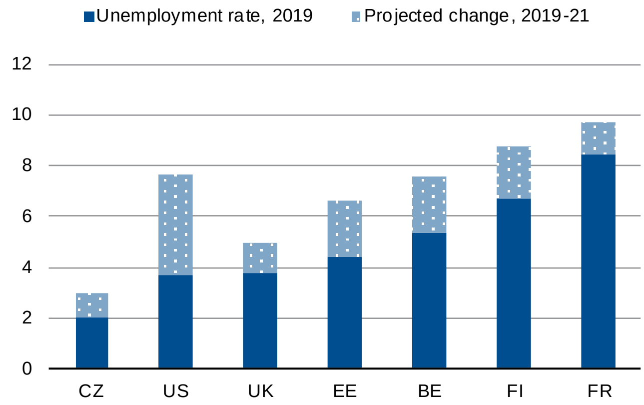
% of total employment



Sources: Eurostat, Scope Ratings GmbH

Figure 9: Unemployment rate projections 2020-21,

% of the active labour force



Sources: European Commission, Scope Ratings GmbH

47% of French employees covered by the short-time work scheme

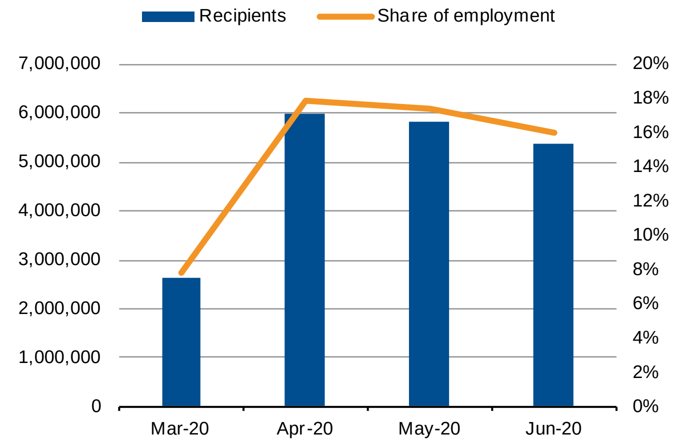
Currently, about 12 million or 47% of all employees have made use of the partial unemployment – or short-time work – scheme since the beginning of this crisis, significantly more than in Germany (24%) or Spain (23%).[2] In addition, the government has recently extended wage subsidies by introducing a new longer-term programme: "chômage partiel de longue durée". The fresh scheme will allow companies to apply for a longer-term short-time work arrangement that can last up to 24 months in total, albeit with a higher share to be paid out by employers. The overall impact of this subsidy prolongation is debatable: employees and employers benefit from better predictability in a still unstable economic environment, though the extension could also delay structural adjustments by keeping jobs artificially "alive" and discouraging a future shift to more productive roles.

Substantial decrease in employees on short-time work from peak levels

The extensive lockdown in France earlier this year is reflected in the significantly higher share of short-time work pay recipients during crisis peaks (17% in Germany compared to 33% in France at April peaks) (see **Figures 10 and 11**). However, France saw a major decline in workers on the short-time pay scheme in June from 7.9m to 4.5m persons, with absolute figures falling now below those in Germany according to preliminary estimates (5.3m in June in Germany). If this trend has continued, we would expect the fiscal burden from the scheme to fall quickly by the end of this year unless the same workers lose their jobs, or the government imposes a second round of comprehensive economic restrictions. Nonetheless, the proportion of subsidy recipients remained at around 17.5% of full-time equivalent employment as of June, leaving a significant share of the workforce at elevated risk of entering formal unemployment once the scheme expires in 2022.

[2] https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202004_06~6b0e718192.en.html

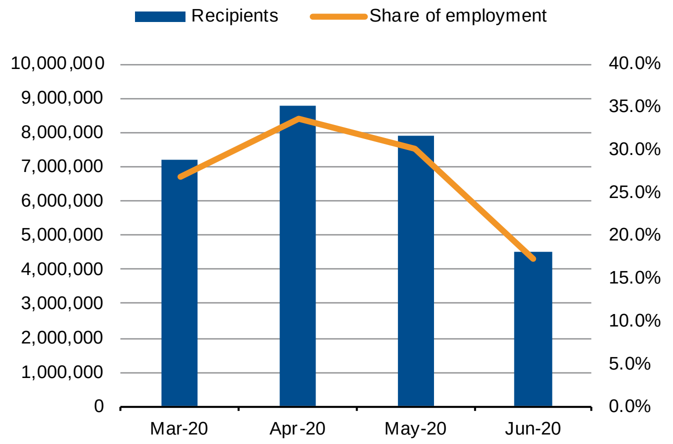
Figure 10: “Kurzarbeit”, short-time work in Germany
Numbers of recipients and % share in employment



NB: Employment defined as subject to full social security payments, recipients of short- time work pay related to the business cycle

Sources: Bundesagentur für Arbeit, Scope Ratings GmbH

Figure 11: “Chômage partiel” in France
Numbers of recipients and % share in employment



NB: Employment defined as full-time equivalent employment

Sources: French Ministry of Labour, Scope Ratings GmbH

High youth, structural jobless rates still long-term challenge

Irrespective of the Covid-19 crisis, a persistent weakness of the French labour market has been the poor integration of young persons into the workforce and significant numbers of long-term unemployed. The employment rate of the population aged 15-64 dropped by 1.6 percentage points in the second quarter to 64.4%, with a pronounced decline for young peopley (down 2.9 pts). Unemployment figures are expected to climb above 10% in 2021, but the government’s short-time work measures could help to mitigate longer-lasting damages to the labour market and structural repercussions for France’s growth potential. At the same time, wage subsidies have stabilised disposable incomes at a time of heightened economic uncertainty and prevented additional adverse spill-over to domestic consumption.

Further government investment in worker training

Previous labour market and tax reforms raised France’s economic potential, but sustained increases in employment require more investment in education and job training. As part of the programme “France Relance”, the government has announced EUR 20bn in investments in skills development over the next two years. The new short-time work scheme also includes the requirement for participating companies to continuously train employees. Such spending could prove increasingly important should unemployment rates rise more sharply, which would require re-orienting large sections of the workforce to reflect a profound reshaping in the economy. To this end, the government is reinforcing the administrative capacities of “Pôle Emploi”, the agency which registers unemployed persons and supports job-seeking activities. The agency is due to recruit 2,800 workers starting in September.

Short-term risks to public finances partially mitigated by monetary policy and favourable debt structure

France faces a 20pp rise in its debt-to-GDP ratio in the period to 2024

We expect an increase in France’s general government debt-to-GDP ratio of around 20 percentage points, rising towards 118% of GDP by 2024 from 98.4% of GDP at end-2019 (see **Figure 12**). The stabilisation of debt at new, higher levels results in higher annual refinancing needs, which are mitigated, first, by stable and very low refinancing costs at the moment, and, secondly, by a favourable public debt profile: bond redemptions are spread out with an average term to maturity of eight years. The bigger debt-to-GDP ratio makes public finances more vulnerable to future economic or fiscal shocks. The government still retains ample fiscal space given reliable long-term investor demand for

French sovereign debt. However, a stabilisation in the debt ratio beyond 2024 requires either additional cuts in interest payments towards 1% of GDP, a sustained lower primary deficit of around 1.5% of GDP or higher real annual growth of above 1.5%.

Moderate gross-financing needs, debt profile ease fiscal risks

Our projections for France's debt-to-GDP ratio and gross financing needs (**Figure 13**) in the period to 2024 assume stable interest payments of around 1.5% of GDP (slightly higher than a 2021 projection of 1.3% of GDP by the EU Commission) and a gradual return to potential growth at 1.2% of GDP by 2024 after higher growth from 2021-23, which support recovery in reaching 2019 pre-crisis output.

Gross financing needs should decrease to around 10% of GDP by 2024 from an elevated 19% of GDP in 2020 (the latter which includes additional funding needs for the France Relance plan), after assuming that a large share of the EUR 80bn in additional funding requirements in 2020 will be financed with medium- to long-term instruments. Higher debt redemptions will keep gross financing needs above the average of 10.6% of GDP of 2016-2019 at least until 2024, on the assumption that the primary deficit will gradually shrink toward 2.5% of GDP by 2024 from 8% in 2020. If fiscal consolidation post-crisis fails to materialise, gross financing needs would stabilise at even higher levels.

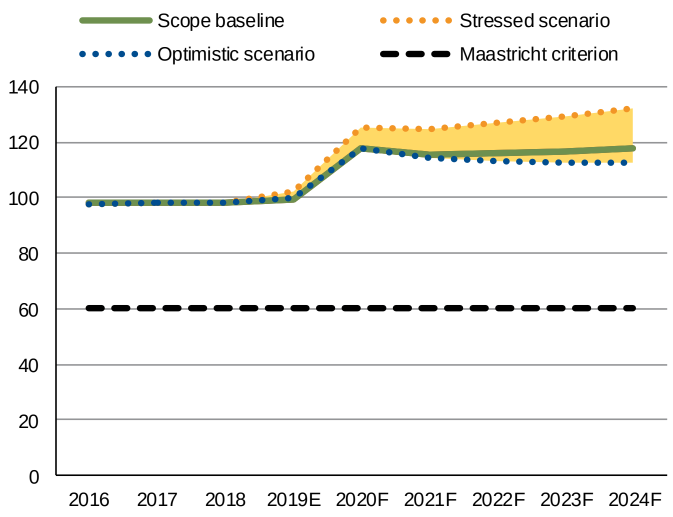
Wage subsidies, health spending have budget impact

The French government's priority to reform the pension system has resulted in substantial political and popular resistance. We expect further progress around the finalisation of such reforms before the presidential elections in 2022 at the cost, however, of substantial compensation pay-outs for some segments of the workforce, which place extra strain on public finances.

Compensation will likely include higher bonus payments for teachers, with a proposed EUR 500m subsidy for salaries in 2021, and a multi-annual law to improve teachers' working conditions, including higher salaries. In addition, the government will raise investment in the public health system, following negotiations with major stakeholders ("Ségur de la santé"). The key pillars of this agreement include EUR 19bn in investment in the health system, annual additional transfers of EUR 8bn for raising salaries plus recruitment of 15,000 added employees for public hospitals.

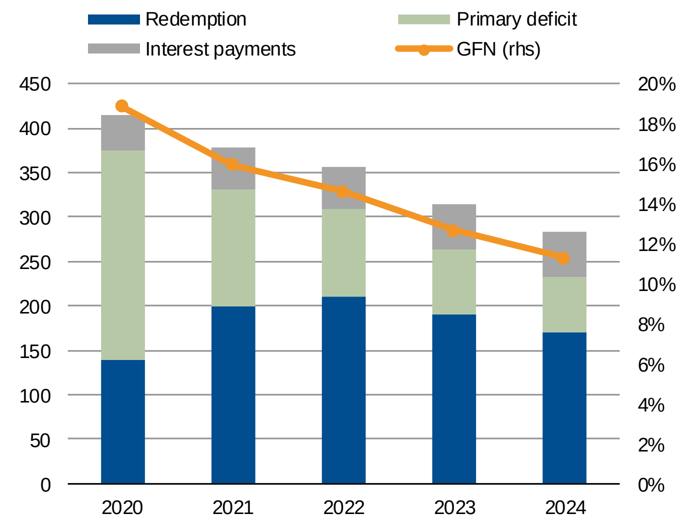
These measures have clearly have potentially favourable implications for society at large and may support skills development and productivity, but they will weigh down on the structural stability of France's public finances and constrain future fiscal consolidation.

Figure 12: France's public debt forecast 2020-2024
% of GDP



Source: Scope Ratings GmbH

Figure 13: France's gross financing needs projection,
EUR bn (lhs), % of GDP (rhs)



Sources: Agence France Trésor, Scope Ratings GmbH

History of debt stabilisation in France essentially growth-driven

We acknowledge that the French government will benefit from low borrowing rates for some time to come while, more specifically in the context of the events of this year, the French debt management agency can borrow required additional funds to finance this year's deficit at low cost. However, higher future debt redemptions reduce fiscal flexibility over coming years. In its recent history, France has achieved only temporary periods of debt stabilisation, sometimes during exceptional episodes of fiscal consolidation, mainly in years of higher growth. Cuts in public expenditure have had only a minor impact on the debt ratio in the past, especially true during phases of weak growth (see **Figure 14**). This observation is in line with the convention of French governments to prioritise structural reform and fiscal stimulus over budget consolidation. Loose monetary policy from the ECB and long-term stimulus provided by the EU's Recovery Fund could support the future stabilisation of debt. At the same time, we note that previous periods of economic expansion were not sufficient to produce fiscal surpluses.

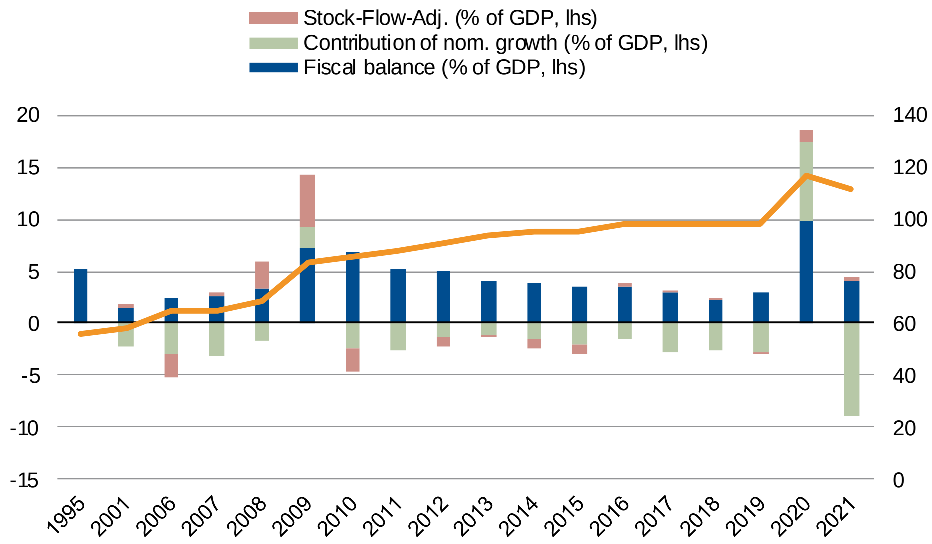
Fiscal consolidation proves difficult

The French government failed to make use of the last cycle of economic expansion to consolidate public finances. This reflects both a rigid expenditure structure and strong political and popular opposition to fiscal consolidation measures, which make material budgetary tightening difficult to implement in France.

The long-term public debt trajectory scenarios presented in **Annex I** show a stabilisation of the debt-to-GDP ratios at different levels, while even under a low-growth scenario, the debt-to-GDP ratio could be stabilised if monetary policy remains expansionary and fiscal deficits return to pre-crisis levels after 2022. Alternative more optimistic scenarios assuming balanced budgets by 2028 point to more sustained debt reduction towards of 106-111% of GDP by 2030 compared with 112-117% of GDP assuming pre-crisis levels of primary deficits.

Figure 14: Contributions to annual changes in the public debt ratio in France

% of GDP



Sources: Eurostat, Scope Ratings GmbH

Annex I: Long-term debt sustainability assumptions

Our three projections for the public debt-to-GDP ratio in France derive from the following assumptions:

- **Growth achieved (optimistic)**: Government measures lead to a gradual increase of potential growth to 1.7% per annum by 2030, after a recovery of 7% real expansion in 2021 and 1.5% in 2022

- **Adverse shock to potential growth (pessimistic)**: Return to previous growth potential of 1.2% not before 2030, assuming average real growth to remain around 1% after the recovery in 2021 (+7%) and 2022 (+1.5%)

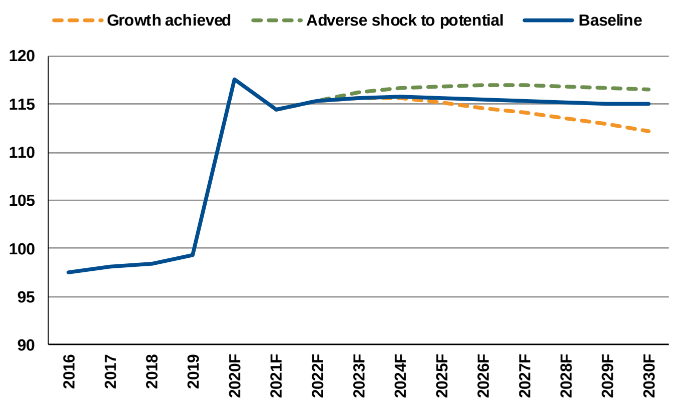
- **Baseline scenario**: Gradual return to the pre-crisis growth potential of 1.2% by 2024 following the recovery in 2021 (+7%), 2022 (1.5%), and 2023 (1.5%)

- **Other assumptions (constant across scenarios)**:

- Interest payments of about 1.5% of GDP, assuming continued support from monetary policies and pre-funding of long-term debt
- Inflation of 1.5%, assuming a continuous low inflation environment
- Two scenarios for the primary deficit (see Figures A1 and A2):
    a. Long-term primary deficit of 1.5% of GDP in line with pre-crisis levels
    b. Long-term fiscal consolidation with a gradual redressal of the budget deficit towards balanced budgets by 2028

Figure A1: Public debt scenarios under pre-crisis deficit level assumptions (1.5% primary deficit)

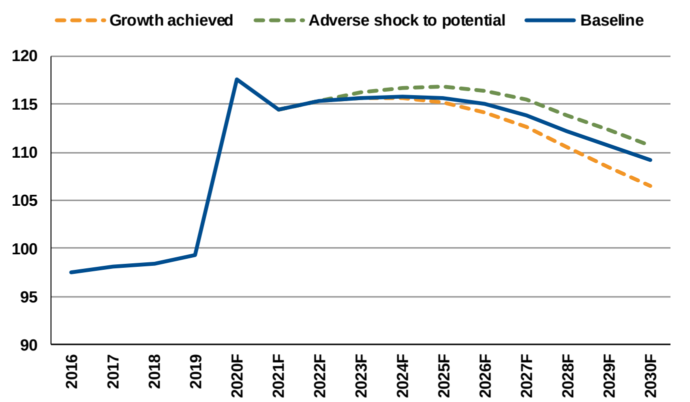
% of GDP



Source: Scope Ratings GmbH

Figure A2: Public debt scenarios under a medium-term adjustment to the primary deficit

% of GDP



Sources: Scope Ratings GmbH

Our debt projections assuming a return to pre-crisis fiscal deficits (**Figure A1**) derive from the following assumptions for real economic growth, primary balances, interest payments and inflation as displayed in the format of 2022-2030 averages:

Scenario	Baseline	Growth achieved	Adverse shock to potential
Real economic growth, % yoy	1.27	1.54	1.09
Primary balance, % of GDP	-1.83	-1.83	-1.83
Interest payments, % of GDP	1.55	1.55	1.55
Inflation, % yoy	1.5	1.5	1.5
Public debt at year-end 2030	**114.98**	**112.27**	**116.59**

In this first scenario, we assume a gradual return of the primary deficit to 1.5% of GDP through the end of the decade, assuming a 4% of GDP primary deficit in 2021 and a gradual decrease of the deficit to -1.5% by 2025.

Alternatively, our debt projections assuming medium-term adjustments of public finances (**Figure A2**) derive from the following assumptions for real economic growth, primary balance, interest payments and inflation as displayed in the format of 2022-2030 averages:

Scenario	Baseline	Growth achieved	Adverse shock to potential
Real economic growth, % yoy	1.27	1.54	1.09
Primary balance, % of GDP	-1.17	-1.17	-1.17
Interest payments, % of GDP	1.55	1.55	1.55
Inflation, % yoy	1.5	1.5	1.5
Public debt at year-end 2030	**109.14**	**106.45**	**110.75**

Under this scenario, we assume an annual reduction in the primary deficit of 0.5 percentage points beginning in 2022, assuming a 4% of GDP primary deficit in 2021, with attainment of balanced budgets by 2028.

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