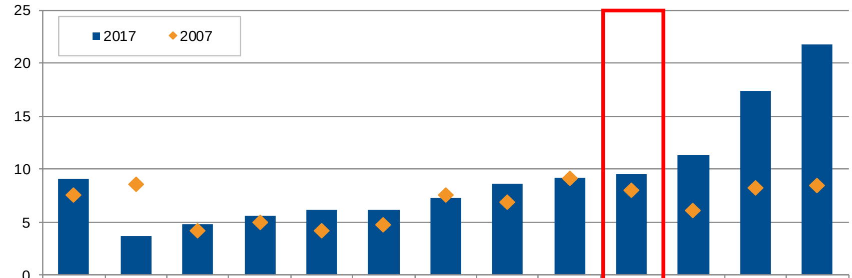
France: Macron’s labour market measures are likely to boost structural reform momentum

The enactment of labour-market reforms in France may lower unemployment and bolster growth potential, helping lower the ratio of debt to GDP towards 90% over the next 5 years. These reforms are a step in the right direction and support Scope’s assessment of France’s AA credit rating.

In Scope’s latest rating report on France (AA/Stable Outlook), we highlighted two major credit weaknesses: i) labour-market rigidity, which hinders the competitiveness of the French economy, in particular the manufacturing sector; and ii) public finances.

France has one of the highest unemployment rates in the euro area. At the same time, there are significant instances of labour shortages and difficulties in finding talent. This issue of labour-market bottlenecks ties into elevated structural unemployment, a core economic concern highlighted recently by President Emmanuel Macron.

Figure 1: Unemployment rates in the euro area and selected member states, %



	EA	DE	NL	AT	LU	IE	BE	FI	PT	FR	IT	ES	EL
2017	9.1	3.7	4.8	5.6	6.1	6.1	7.3	8.6	9.2	9.5	11.3	17.4	21.8
2007	7.5	8.5	4.2	4.9	4.2	4.7	7.5	6.9	9.1	8	6.1	8.2	8.4

Source: European Commission, AMECO

Macron’s emphatic electoral win in 2017 provided a mandate for the reforms proposed during his presidential campaign. In Scope’s opinion, the Macron reforms so far, formally approved in parliament in December 2017 and in force since January 2018, will enhance labour market flexibility and France’s economic competitiveness. The reforms built on earlier measures enacted during François Hollande’s presidency (2012-2017), The new policies allow greater room for wage negotiations and include active labour market policies that foster professional training and streamline diverse labour contracts.

The reforms hold the potential to partially address the two credit weaknesses:

#1: Competitiveness and growth potential: The economic impact of the reforms in the short term may be limited, with the measures only slowly having an effect. Scope anticipates, however, that higher firm productivity, better education of workers, together with greater negotiating flexibility will help reduce unemployment by up to 1.5pp as well as boost the level of real GDP by up to 1pp cumulatively over the next five years.

#2: Public finances: Furthermore, positive effects would be seen in the fiscal accounts, through reduced fiscal deficits as a result of lower unemployment benefits and accelerating growth. In turn, declines in France’s debt-to-GDP ratio will accelerate through 2022.

Rating considerations: The French government’s holistic approach to addressing structural economic weaknesses is viewed positively by Scope. On this basis, were current estimates to materialise as anticipated, the reforms strengthen France’s economic outlook, with potentially positive implications over the medium term. However, Scope emphasizes the degree of uncertainty surrounding the impact of the measures, and the need therefore to await clearer evidence of continued reform momentum and economic effects.

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Scope confirms and publishes France’s credit rating of AA and changes the Outlook to Stable
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Structural unemployment still elevated nearly ten years after the great financial crisis

Unemployment (based on EC data) is high compared with EA-12 peers

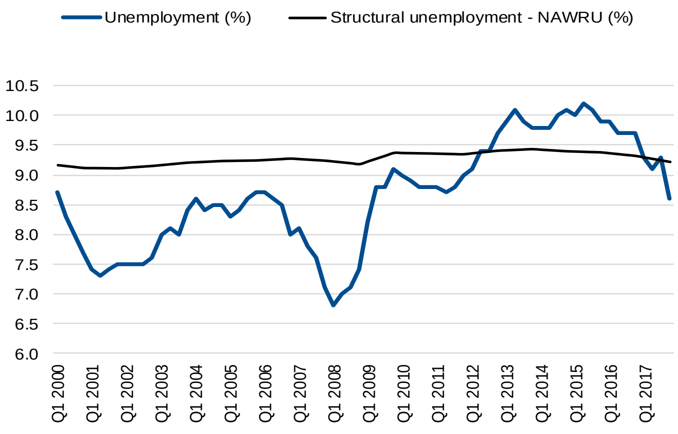
France has an elevated unemployment rate compared with its euro area peers, at 9% as of January 2018 (according to Eurostat[1] data). The only EA-12 nations that ended 2017 with higher unemployment rates were Greece, Italy and Spain – those most hurt by the crisis. Comparing 2017 with 2007, European Commission (EC) data (AMECO) also shows that French unemployment increased by 1.5pp. Overall, among the EA-12, only Germany (and, to a lesser extent, Belgium) managed to register a decrease in the unemployment rate over the last decade.

INSEE breakdown shows concerning signals on long-term and youth unemployment

In line with the European Commission, the local statistical office INSEE calculated the provisional unemployment rate at 8.6% in Q4 2017 – a sharp drop of 0.7pp on the previous quarter, and the lowest level since 2009. Looking at the breakdown, registered unemployment has increased by over 80% from 3.5mn persons (Q4 2007) to 6.3mn persons (Q4 2017). Only recently has a correction begun taking place, thanks to the economic recovery, the impact of earlier labour market reforms[2], and a decrease in the active labour force.

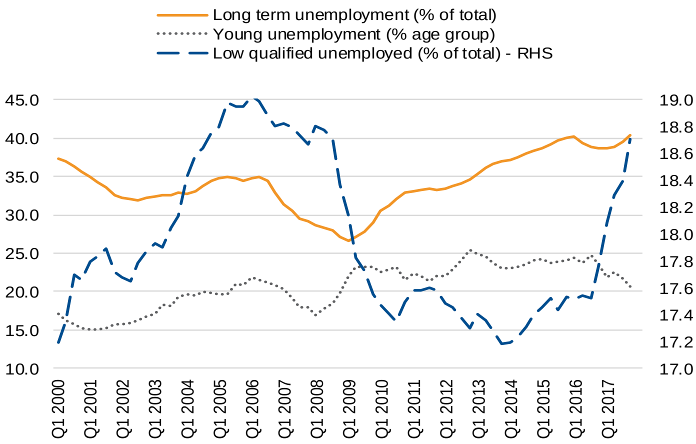
As shown in **Figure 2**, the crux of the French labour-market dilemma is the exclusion of long-term unemployed, young and low-skilled workers from the job market at a time when, many areas of the French manufacturing sector struggle to find qualified workers. In 2017, according to the national job agency Pôle emploi, 200,000 to 330,000 job offers went unfilled despite high unemployment. Since 2007, the issue has become more evident as long-term unemployment expanded in absolute terms by 144%, low-skilled unemployment by 77% and youth unemployment grew by 55%. The increasing proportion of long-term unemployed and persistently high share of low-skilled unemployed (**Figure 3**) bears negative implications, tying into the need to increase training and educational spending to counteract a depletion of skills.

Figure 2: Overall unemployment vs. structural unemployment, %



Source: INSEE, European Commission

Figure 3: Unemployment trends, %



Source: French Labour Ministry, INSEE, Scope Ratings GmbH calculations

[1] An unemployed person is defined by the European Commission, according to the guidelines of the International Labor Organization, as:

- someone aged 15 to 74 (in Italy, Spain, the United Kingdom, Iceland);
- without work during the reference week;
- available to start work within the next two weeks (or has already found a job to start within the next three months); or
- actively having sought employment at some time during the last four weeks.

The unemployment rate is the number of people unemployed as a percentage of the labor force.

[2] Hollande's *Plan d'urgence pour l'emploi* included a reduction of the tax credit for employment and competitiveness (CICE) (valid from 2013 to 2018), Responsibility and Solidarity Pact (valid since 2014), hiring benefits for SMEs (expired in June 2017). In addition, a reduction of the impôts sur les entreprises was already introduced by Hollande, later amplified by Macron.

High structural component of unemployment…

France's high post-crisis unemployment level has been spurred by its significant structural component, defined by the European Commission as the NAWRU or the non-accelerating wage rate of unemployment. The structural unemployment rate increased in the 1990s to 9.1%, thereafter remaining fairly stable (the increase during the great financial crisis only amounted to 0.4pp). The recent recovery has yielded only a modest improvement of 0.16pp (**Figure 2**). NAWRU's low elasticity to growth is a constraint to further unemployment reductions, and exemplifies the need for deep labour market reform.

… but wage growth has not responded.

Despite high unemployment, French households have seen for years favourable wage gains. Since 1990, the differential between nominal wage growth and productivity growth has favoured workers, with a cumulative differential of nearly 21pp through 2016. Moreover, accumulation of this differential has been predominantly back-loaded, with 7pp ascribed to the first 17 years of the period (1990 to 2007), while nearly 14pp arose from 2007 to 2016.

Wages did not adjust because of job market duality

One of the reasons for rigid wage growth is the structure of the job market. Despite the increasing proportion of temporary contracts (CDIs), most workers have permanent positions, carrying greater benefits and unemployment protections. Banque de France highlighted how the duality of the job market translates into flexibility being concentrated in CDI contracts with little transition from temporary to permanent contracts. In terms of employment protection, training and wage levels, all aspects penalise temporary workers with few incentives for employers to switch them to permanent contracts. According to Tirole-Blanchard (2003)[3], a lowering of the differential in benefits would incentivise employers to less frequently use temporary contracts and limit the duality of the job market.

Macron's reform schedule in 2017 and 2018

Macron is enacting labour market reforms…

Since the summer of 2017, President Macron has signed 26 presidential decrees, later submitted to parliament. The process concluded in late December, with enforcement in January 2018.

Summarised in **Annex 1** are the major reforms, mostly tied to:

- Introduction of more flexible negotiations of working conditions, increasing the weight of firm-level agreements compared with trade union/national agreements
- Rationalisation of work contracts
- New dismissal procedures, aimed at a smoother process

In addition, changes were made to unemployment and retirement benefits, taxation, jobless training and the trade union framework.

… with more reforms in the pipeline in 2018.

The agenda for 2018[4] includes further reforms to apprenticeships, unemployment insurance schemes and eventually pensions[5], if not delayed into 2019. However, the extent to which additional reforms take place may depend on popular support as discussions continue this month, including with regard to unemployment insurance reform.

The government will seek to minimise opposition to the upcoming unemployment reforms by directly involving trade unions in the design of the new framework. However, recourse

[3] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=464282
[4] http://www.journaldunet.com/management/emploi-cadres/1197771-reforme-assurance-chomage-ce-que-prepare-macron/
[5] France has currently nearly 40 pension regimes, which makes the system complicated to manage. In addition, the pension system is redistributive, meaning that all contributions are redistributed to pensioners, but the age pyramid works against this scheme. The reforms so far announced would not tackle the overall payment structure, but mostly focus on a reorganisation of different schemes. Further changes are not excluded as the discussion progresses. http://www.cor-retraites.fr/IMG/pdf/doc-4087.pdf

to presidential decrees is not excluded if concessions demanded by trade unions are deemed unacceptable.

Slow-burning reforms underpin the recovery, taming unemployment

The objective of the reform agenda is to increase flexibility in the job market. However, material effects are not expected in the near term. Instead, many reforms may take time to work themselves through the economy. Domestic and external economic developments could, moreover, affect the cumulative impact of reforms.

Reforms are designed to tackle structural unemployment in the medium term…

The reforms in **Annex 1** aim mostly at increasing labour market flexibility, allowing greater room for wage negotiations, fostering professional training and streamlining diverse labour-market contracts. These reforms support the supply side of the economy, and are meant to address structural unemployment.

… though there is also a boost to the shorter-term outlook.

In addition, further reforms relate to the reduction of labour taxation. These act on the demand side and help cut cyclical unemployment through an increase in disposable income and higher domestic spending over the near term. Tax changes also qualify as "passive" (or redistributive) labour policies, similar to increases in minimum wages, legal protection of contracts, financing of non-employment subsidies, and limitations to working hours. According to a study from Coe-Rexecode[6], the medium-term impact of the Macron reforms is positive, but the effect must be disentangled from the medium-term impact of earlier reforms in the *Plan d'urgence* signed into law by Hollande[7].

Positive effect on potential growth and employment

All things considered, Coe-Rexecode estimated that potential GDP growth could improve by a significant 1% to 1.5% per annum to the end of 2022 if the labour market reforms were accompanied by other assumptions, namely an increase in investment and an improvement in global productivity growth trends. The contributions of these three effects to potential growth are summarised in **Table 1**.

Table 1: Impact on potential growth (annually, 2018 to 2022)

Labour reforms	0.2 – 0.4
Capital accumulation	0.4 – 0.6
Global productivity	0.4 – 0.6
Overall impact on potential growth	**1.0 – 1.5**

Source: Coe-Rexecode

Coe-Rexecode looked into the breakdown of the labour market reform (which contributes overall a positive growth impulse of 0.2%-0.4%), identifying which measures were most growth-stimulative. Positively, the increase in company-wide negotiations allows salaries to link more closely to productivity and adds as much as 0.6% to potential growth through 2022, while other minor measures subtract 0.3%. In some cases, the inclusion in the reform package of measures with a negative growth impact occurred in order to ensure ongoing support from trade unions.

According to Coe-Rexecode, the impact of the Macron reforms translates to employment growth of 250k-300k by the end of 2022 (in 2017, total employment stood at 28.3mn, so an increase of approximately 1%). Supporting this, a second study by OFCE claims that measures are due to support job creation of 120k-250k per year from now to 2019. Finally,

[6] http://www.coe-rexecode.fr/public/content/download/37905/385886/version/5/file/Document-de-travail-65-Perspectives-2018-Premieres-reformes-structurelles+2017-10.pdf

[7] The plan d'urgence signed by Hollande included changes to capital taxation, environmental taxation for firms and a decrease in impôts sociétaires (company taxation). All of these measures will gradually expire.

Banque de France argued that employment is expected to grow by 150k-200k per year through 2022, while unemployment should fall by a cumulative 1.5pp.

Overall, Scope expects the labour market reforms to increase employment by at least 200k per year. Symmetrically, the incremental decline in the unemployment rate of 0.3pp per annum could cut, optimistically, the unemployment rate from an IMF baseline scenario of 7.8% in 2022 to 6.3%.

Scope notes, however, that the reforms are slow burning. The most liberalising measures affect French small- and medium-sized enterprises (SMEs), which account only for half of total employment and value added in the productive sector. Though many aspects of the French labour code will be simplified and important details of labour costs for dismissals improved, minimum-wage policies and working-hour limits remain in place, limiting the effectiveness of the current reforms somewhat.

Labour market reforms to boost public finances

Positive impact on fiscal accounts

In Scope's view, the reforms will strengthen the positive economic dynamics seen in France since 2017. The latest Q4 2017 data show that real growth accelerated markedly to a yearly average of 1.9% from 1.1% in 2016.

The growth momentum and positive stimulus generated by the labour market reforms will support France's public finances, the second major weakness of its economy. Specifically, Scope expects a cumulative increase in the level of real GDP of 1pp by the end of 2022 owing to the reforms and, as noted, a yearly reduction in the unemployment rate of 0.3pp. This will contribute to a reduction in the public debt-to-GDP ratio over the medium term.

An estimate from ATD/Les Echos[8] showed that the total cost of unemployment ranged from EUR 70bn to 80bn per year through 2015. At the time, the unemployment rate was 10%, therefore an estimated cost for every 1pp decline in the unemployment rate amounted to EUR 0.76bn or 0.3% of GDP. This cost estimate is credible, in Scope's view, considering increased expenditures (subsidies, cost of reintegration of and training for the unemployed and the administrative costs to run job centres) and unrealised revenues (missing social contributions and income taxes paid) tied to unemployment.

In a conservative scenario, Scope believes public expenditures could decrease by about 0.1% of GDP per year due to the reforms through 2022, or 0.45% of GDP cumulatively.

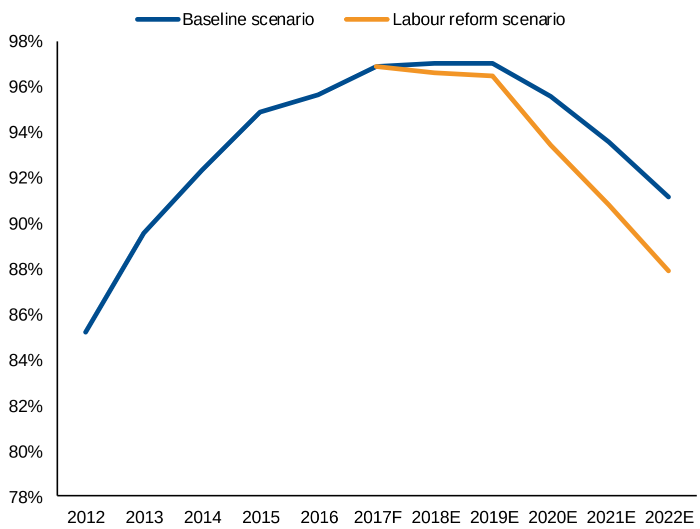
Additionally, the increased GDP would feed through to higher fiscal revenues: estimations lead us to believe that for every 1% increase in GDP growth, fiscal revenues to GDP would increase by 1.4%. Assuming this, the cumulative impact on the public debt ratio from higher tax revenues (owing to the Macron reforms) totals 1.4pp in the 2018-2022 period.

Scope forecasts debt to fall towards 90% of GDP going forward

Figures 4 and 5 below show public debt dynamics in this scenario (assumptions are summarised in **Annex 2**), which assumes a cumulative increase in the level of real GDP of 1pp by 2022 alongside improvements in the fiscal balance.

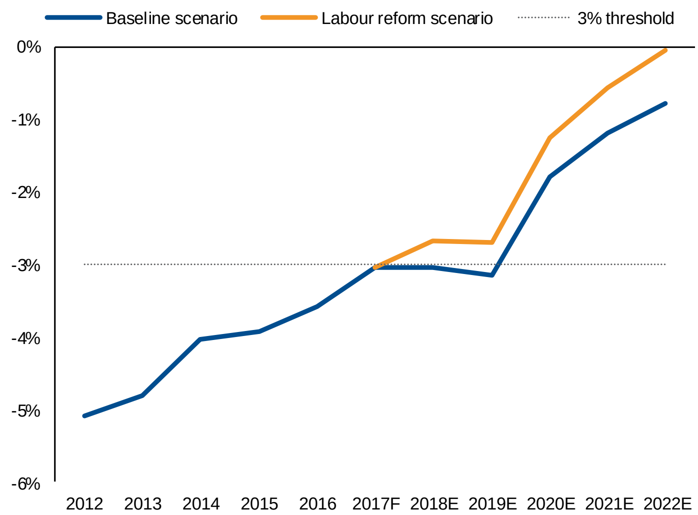
[8] https://blogs.alternatives-economiques.fr/gadrey/2016/06/19/le-cout-public-du-chomage-plus-de-100-milliards-d-euros-par-an

Figure 4: Debt to GDP ratio, IMF baseline versus Scope labour market reform scenario



Source: IMF, Scope Ratings GmbH calculations

Figure 5: Headline balance to GDP ratio, IMF baseline versus Scope labour market reform scenario



Source: IMF, Scope Ratings GmbH calculations

As shown, general government debt would fall more rapidly than in an IMF baseline scenario. In fact, with 2017's end-year debt ratio of 96.8% of GDP in mind, Scope expects the debt to GDP ratio to fall to 86.9% by the end of 2022 rather than only to 91.2%.

In addition, the primary balance would turn positive from 2020, one year ahead of the current IMF baseline, helping the government to meet the 3% deficit objective within this time horizon. The declining debt trajectory benefits moreover from the *snowball effect*, as growth accelerates above the average interest rate paid on government debt.

And the EDP will be closed

Finally, France is presently the last euro area country alongside Spain under Excessive Deficit Procedure (EDP) supervision, opened by the European Commission in 2009. To exit the EDP, the fiscal deficit must fall sustainably below the 3% of GDP threshold for two consecutive years. Scope's baseline expectation is that the deficit will remain just below 3% of GDP through 2019, and improve more significantly thereafter.

Rating implications

Growth and public finance improvements are credit positive over the medium term

The impact of the latest labour market reforms on the short term economic outlook will likely be limited, with the largest effect to be seen in the years after 2020.

Overall, Scope anticipates that, in the medium term, the French economy will benefit from the increased productivity of firms, better education of workers, and a higher job market participation rate, which together should reduce unemployment and boost potential GDP. Further beneficial effects could be seen in the fiscal accounts, through the achievement of a primary surplus and improved debt sustainability. Although Scope expects debt-to-GDP to still increase in 2018 to a peak of 96.8%, a decline should take hold thereafter.

In conclusion, the reforms bear potentially positive implications over the medium term. However, Scope is mindful of the degree of uncertainty with relation to their effects. Any upside to the current AA sovereign rating, while not imminent, would have to take into account a wide range of factors, including France's continued commitment to structural reform in comparison to its sovereign peer group.

Annex I: Major labour market reforms

Negotiations and working conditions	• Favouring the weight of company negotiations. Only in the case of no specific company-level agreement would national agreements with trade unions apply. This would effectively give more bargaining power to employers, as firm agreements can also deviate from national agreements (or be less convenient to workers). • Allow individual workers in SMEs to negotiate specific agreements with firms that would be valid for the whole company. • Soften the rules applicable to Sunday work and night work. • Allow workers to negotiate bonuses directly with employers.
Rationalisation of contract types	• Allow the employer to terminate a project contract when the project ends before the official deadline of the contract. • Merge apprenticeship and work-study contracts. • Underpin fixed-term contracts (CDDs) with rules corresponding to conditions specific to an economic sector.
New dismissal procedures	• Change the allowances paid to workers in the case of dismissal without a real and serious cause, limiting the uncertainty of court sentences and process delays, while increasing redundancy indemnities. • Toleration of minor procedural errors in communication with employees when made redundant. • No longer fine companies for unintentional irregularities • Set a procedure for collective contractual termination. • Widen the applicability of redundancy for economic reasons.
Unemployment and retirement benefits	• Payment of unemployment allowances to workers who voluntarily resign, but only once every five years. • Allow workers to accumulate credits for pensions in case of arduous work.
Trade unions and collective bodies	• Set a one-year notice for members of company-wide labour committee and unify various company committees.
Labour taxation	• Allow lower employee contributions for unemployment and sickness starting from January 2018.

Source: Scope Ratings GmbH

Annex II: Debt sustainability analysis assumptions

	2018E	2019F	2020F	2021F	2022F
Baseline scenario					
Real GDP growth	1.76%	1.90%	1.92%	1.86%	1.84%
Public primary balance (% of GDP)	-1.45%	-1.50%	-0.13%	0.49%	0.91%
Labour reform scenario (changes to the baseline)					
Real GDP growth	0.20%	0.20%	0.20%	0.20%	0.20%
Public primary balance (% of GDP)	0.37%	0.46%	0.55%	0.64%	0.73%

Source: Scope Ratings GmbH

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