7 June 2021

Belgium and France: Different reform momentum underpin rating divergence

Belgium (AA-/Stable) and France (AA/Stable) share some common credit metrics. They benefit from wealthy and diversified economies, a record of macroeconomic stability, and favourable public debt profiles but are weighed down by heavy public and corporate debt burdens as well as subdued growth potential. Scope left France's AA ratings unchanged with a Stable Outlook 28 May, while downgrading Belgium to AA- with a revision of its Outlook to Stable. In this report, we explore how differing degrees of structural reform are determining the divergence in the countries' creditworthiness.

The growing gap in the credit quality of both countries despite similar economic and fiscal characteristics results from disparities in structural reforms undertaken in the years before the Covid-19 crisis. France maintained some reform momentum while Belgium's reform efforts ran out of steam. Unless Belgium resumes its reform efforts, structural economic and fiscal pressures will get worse and stand if the way of effective fiscal consolidation. By contrast, France's longer-term economic prospects are healthier given past and likely future reforms.

Figure 1. Overview of Belgium and France's credit strengths and weaknesses

Belgium (AA-/Stable)	
Credit strengths	**Credit weaknesses**
• Wealthy, diversified and stable economy • Strong market access and strong debt profile • Strong external position	• Structurally deteriorating fiscal fundamentals • Structural economic pressures; low productivity growth, lagging business dynamism and labour market rigidities • Elevated public and private indebtedness
France (AA/Stable)	
Credit strengths	**Credit weaknesses**
• Status as a core euro area member • Large, wealthy, diversified and stable economy • Track record of structural reforms	• Labour market rigidities weighing on potential growth • Elevated public and private indebtedness • Persistent fiscal deficits and poor track record of consolidation

Source: Scope Ratings GmbH

The main conclusions are:

- France and Belgium need to undertake structural reform to raise their economies' growth potential. Structural reform in France has outpaced that of Belgium over recent years, leading to divergence in medium-term economic and fiscal prospects.
- Both governments will need to formulate credible, well-calibrated fiscal consolidation programmes to stabilise public debt with the aim of reducing debt-to-GDP in the longer term. Belgium cannot repeat previous periods of successful debt reduction without accelerating structural reforms.
- Near term, the French government faces waning popular support for its reform agenda while President Emmanuel Macron is up for re-election in 2022. The country can reap economic dividends longer term if the reforms are pursued and provided next year's presidential and parliamentary elections lead to no adverse policy shifts.
- Political fragmentation in the context of Belgium's complex political system will continue to hamper the design and implementation of reforms to address structural bottlenecks, weighing on the ratings.

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Similar economic and fiscal positions

Similar economic and fiscal positions in structural and cyclical terms

Belgium and France were in similar economic and fiscal positions at the start of the Covid-19 crisis, in structural and cyclical terms (see **Appendix I**). They are euro area member states that benefit from wealthy, diversified and competitive economies experiencing moderate growth before the crisis. Similarly, they face elevated public debt and wide structural fiscal deficits. Public expenditure is high in proportion of GDP, while there are additional contingent risks due to government guarantees and high private-sector indebtedness (**Figure 1**, previous page). One of the main credit strengths of France over Belgium is its large economic size and systemic importance in the euro area, translating into greater influence at the European institutional level as well as enhanced resilience in global financial markets in crisis periods.

Covid-19 crisis impacts economic and fiscal positions to similar degrees

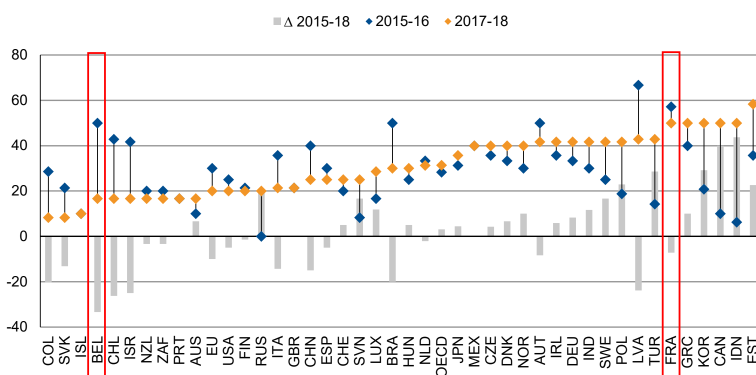
The Covid-19 crisis has had a severe impact on both economies. France's real GDP shrank 8.2% in 2020 while Belgium's recorded a 6.3% decline despite timely and sizeable fiscal stimulus. In addition to direct fiscal spending, the governments extended liquidity support measures (tax deferrals, government guarantees), amounting to nearly 15% of GDP. As a result, already high pre-crisis public debt stocks have risen substantially. The fiscal deterioration observed last year was similar in scale in the two economies with budget deficits reaching 10% of GDP in both countries and public debt rising by 15pps of GDP in France and 17pps of GDP in Belgium.

Differences in reform momentum drive divergence in economic prospects

Similar credit profiles but reform momentum drives a structural divergence

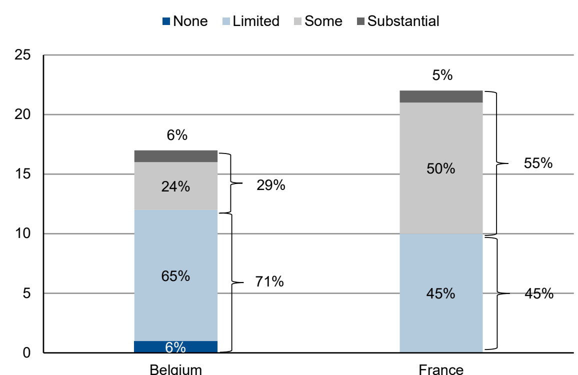
Against this backdrop, a first glance at Belgium and France's credit fundamentals might suggest similarities in outstanding credit risk profiles as well as the direction in which public finances are heading. However, important economic and fiscal metrics are diverging for structural reasons, hence the one-notch differential in our current ratings assignments. In the following sections, we argue that this differential reflects the countries' different pace of structural reform (see **Appendix II** for an overview of recent key reforms in both economies).

Figure 2. OECD reform responsiveness indicator, 2015-18
Index scores



*OECD in the diagram represents an average of the OECD's 36 member countries.
Source: OECD, Scope Ratings GmbH

Figure 3. Implementation of CSRs to date, 2015-2019
Number of CSRs (axis), % of total CSRs (labels)



Source: European Commission, Scope Ratings GmbH

France maintained strong momentum and remained one of the most reform-intensive OECD countries of 2018 (**Figure 2**), according to the OECD reform responsiveness indicator – which measures countries' progress on the implementation of structural reform. We have argued since 2018 that the Macron government's extensive supply-side reforms to lower wage costs, reform of corporate taxation and broadening of the tax base could support higher potential growth (see Scope research, Reforming France: Supply-side

"Macronomics" strengthen growth potential). Such reform continued over 2019-20, improving equity as well as the quality of education, reducing labour market segmentation and enhancing the competitiveness of the French economy.

Belgium is the OECD country in which reform progress, as measured under the OECD index, had slowed the most since 2015-16. In this respect, Belgium was also one of the least reform-intensive economies of 2018. A similar picture emerges from the countries' progress in implementing European Semester country specific recommendations (CSRs), with France recording some progress on 55% of CSRs compared with 29% in the case of Belgium over 2015-19 (**Figure 3**, previous page).

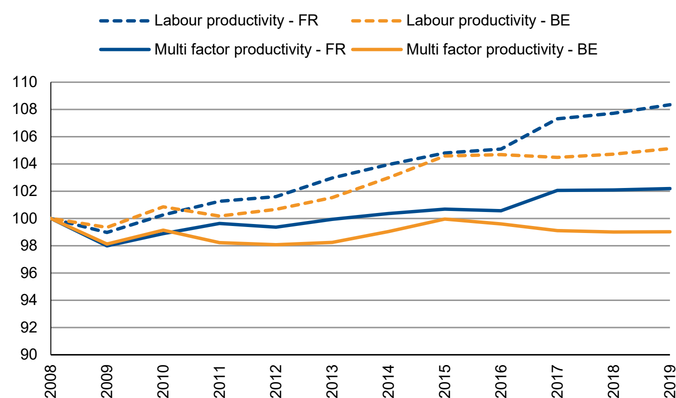
Previous key reforms adopted by Belgium support the growth outlook

Belgium has implemented some important reforms over recent years including gradual lowering of social security contributions and corporate income tax rates. The government also adopted changes to the pension system as well as competition and insolvency frameworks. We expect these reforms to contribute to more sustainable and inclusive growth, but more decisive policy action is needed to address challenges.

Belgium's 2019-20 political stalemate hampered policy making…

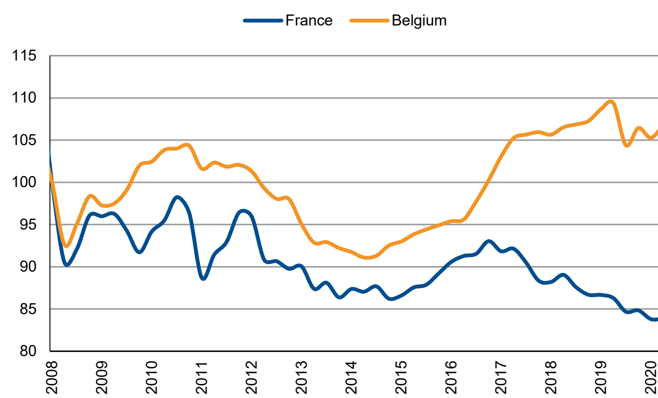
More recently, structural reform progress in Belgium has been hamstrung by the protracted political stalemate following the breakup of the Charles Michel government and the subsequent May 2019 general elections, when political groups failed to form a majority government until October 2020. This resulted in a temporary caretaker government and almost complete standstill in policy making at the federal level. France, meanwhile, advanced on a broad reform agenda, improving the labour market, education system, business taxation system, and pension system, though Covid-19 led to postponement of some measures.

Figure 4. Labour and multifactor productivity
2008 = 100



Source: OECD, Scope Ratings GmbH

Figure 5. Real effective exchange rate – unit labour cost based
2008 = 100



Source: European Commission, Scope Ratings GmbH

… leaving many structural challenges unaddressed.

The relatively slow progress of reform in Belgium means some critical long-standing structural problems have been left unaddressed. Among these is the economy's sluggish productivity growth which is the result of weak business dynamism, as reflected in low entry and exit rates a relatively high share of zombie firms and a low prevalence of high-growth firms; a lack of competition in product and service markets; and poor returns from R&D spending[1]. The government also needs reforms to raise labour-force participation and address skills shortages. Belgium's labour productivity growth has slowed since 2015 and multifactor productivity has declined (**Figure 4**).

[1] OECD (2019), In-Depth Productivity Review of Belgium.

In contrast, productivity in the French economy has improved in the same period, underpinned by measures in enhancing the business environment and fostering growth of firms such as via the PACTE law (2019), though companies operating in France still have to copy with a high level of red tape in services compared with other EU countries.

Low productivity growth weighs on Belgium's external competitiveness

Disparities in productivity growth have resulted in widening gaps in external-sector competitiveness (**Figure 5**). Belgium reformed its wage-determination process in 2017 to keep labour cost developments in line with that of main trading partners, with encouraging results thus far as reflected in more subdued wage growth. Still, the revised wage norm focuses on nominal wage trends, without accounting for productivity developments, thus leaving out a key determinant of cost competitiveness.

France is the leading European destination for inward foreign direct investment

Reform advancement and an improving business environment in France, together with a widening competitiveness gap (with Belgium), have made the country more attractive for foreign direct investment (FDI). France became Europe's leading destination for FDI in 2019, attracting 1,197 new projects, a 17% increase compared with 2018 (**Figure 6**), according to the EY 2020 FDI attractiveness survey[2].

Figure 6. Foreign direct investment performance of European countries

Rank	Country	Projects announced in: 2018	2019	Share of European FDI in 2019	Project growth rate
1	France	1,027	1,197	18.8%	17% ↑
2	UK	1,054	1,109	17.0%	5% ↑
3	Germany	973	971	15.0%	0% ↑
4	Spain	314	486	8.0%	55% ↑
5	Belgium	278	267	4.0%	-4% ↓
6	Netherlands	229	255	4.0%	11% ↑
7	Poland	272	200	3.0%	-26% ↓
8	Ireland	205	191	3.0%	-7% ↓
9	Russia	211	191	3.0%	-9% ↓
10	Turkey	261	176	3.0%	-33% ↓
11	Portugal	74	158	2.0%	114% ↑
12	Italy	103	108	2.0%	5% ↑
13	Hungary	101	105	2.0%	4% ↑
14	Serbia	119	103	2.0%	-13% ↓
15	Romania	109	78	1.0%	-28% ↓
16	Finland	194	75	1.0%	-61% ↓
17	Switzerland*		73	1.0%	
18	Austria*		69	1.0%	
19	Slovakia*		65	1.0%	
20	Sweden	73	63	1.0%	-14% ↓
	Other*		472	7.0%	
	Total		***6,412***		

*Data on FDI projects for 2018 are not available.
Source: Ernst & Young, Scope Ratings GmbH

Political instability in Belgium and high labour costs pose risks to attractiveness for FDI

At the same time, optimism over Belgium's capacity to attract such investment in coming years has declined to new lows. Relatively high labour costs, followed by political, regulatory and administrative instability are among the chief obstacles over the next three years highlighted in the EY survey. Without more FDI, Belgium faces more lacklustre growth given foreign-owned firms account for more than half of Belgian businesses' research & development expenditure versus around a quarter in France.

Post-crisis recovery programmes are key for growth outlook

The size, composition and effective implementation of the governments' post-crisis fiscal recovery packages will prove key for the strength of respective recoveries. France announced a EUR 100bn (4.1% of 2019 GDP) economic recovery package in September

[2] Ernst & Young. (2020), How can Europe reset the investment agenda now to rebuild its future?

2020, with emphasis on supply-side measures aimed at greening the economy, enhancing competitiveness and supporting social cohesion. The 2021 budget included measures outlined under the recovery package, of which EUR 26bn were mobilised as of early March 2021. Overall implementation is expected to accelerate after the government starts deploying funds available from the Next Generation EU recovery programme[3].

Belgium started negotiations over its post-Covid-19 economic recovery programme with its regional governments and the European Commission in November 2020 after formation of a national government. It finalised and submitted a EUR 6bn (1.3% of 2019 GDP) recovery plan at the end of April 2021. The plan is based on six pillars including climate and sustainability, digital transformation, innovation and productivity, among other areas, and combines large-scale investment with structural reforms. If there are delays in the implementation of the national economic support package, this could lead to further economic divergence with France in the medium term, posing risk of deeper structural economic scarring from the Covid-19 crisis.

Reform progress is key to addressing inadequate potential growth outlooks

France's and Belgium's recovery plans represent significant opportunities to address structural challenges. The mobilisation of large-scale public investments could support the economic recovery and increase potential economic growth rates. This is critical given the current low potential economic growth, of between 1% and 1.5% for both economies. Still, we expect to see further divergence of potential growth rates and sovereign creditworthiness if France's reform effort continues to outpace Belgium's.

Prospects for fiscal consolidation: past experience and future challenges

Credible fiscal consolidation needed once recovery has been secured

Starting from already weak positions[4], Belgium and France's fiscal fundamentals have deteriorated further since 2020 due to knock-on effects from the Covid-19 crisis. ECB monetary policy is, however, significantly easing the pressure on euro area public finances. The governments' interest payment burdens should stabilise over coming years despite markedly higher public debt ratios.

However, Belgium and France require credible, well-calibrated fiscal consolidation given such high public debt and the associated constraints on fiscal flexibility. Future budgets should provide a clear vision of how long-term sustainability of public finances can be ensured after the crisis as economies recover, with the possibility of the reversal of today's ultra-low interest rates in the longer-term future. In this context, we highlight the countries' different records in fiscal consolidation.

France has a weak track record of budget consolidation…

In its recent economic history, France has a poor record in budget consolidation. Governments have achieved only temporarily stabilised or modestly reduced public debt ratios, mainly during years of high growth (see previous Scope research: France and C-19: Recovery plan to support economy but at cost of deteriorating public finances). In particular, the government failed to utilise an expansionary period in the years preceding the Covid-19 crisis to meaningfully reduce debt and build up a fiscal cushion, as governments have found it near impossible politically to rein in public spending. As such, France's public debt has risen steadily over the past 40 years (**Figure 7**, next page).

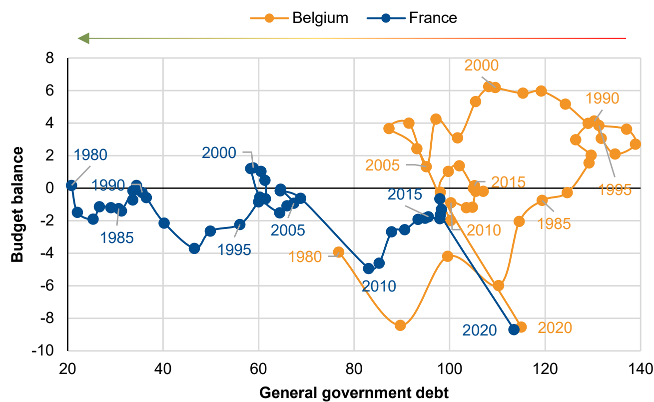
… while Belgium has a unique history of effective debt reduction.

In contrast, Belgium can boast of several episodes of successful large-scale fiscal consolidation and notable reductions in public debt. To ensure compliance with the Maastricht criteria after signing it in 1992, the government reduced its structural deficit by 9pps of GDP by the early 2000s while its fiscal deficit fell under the 3% of GDP threshold by 1997. As a result, the country achieved an impressive reduction in debt-to-GDP from

[3] Les Echos. (2021), Covid : Bercy a déjà engagé 26 milliards d'euros du plan de relance, 1 March 2021.
[4] The European Commission assesses medium-term fiscal sustainability risks as high in the case of both governments.

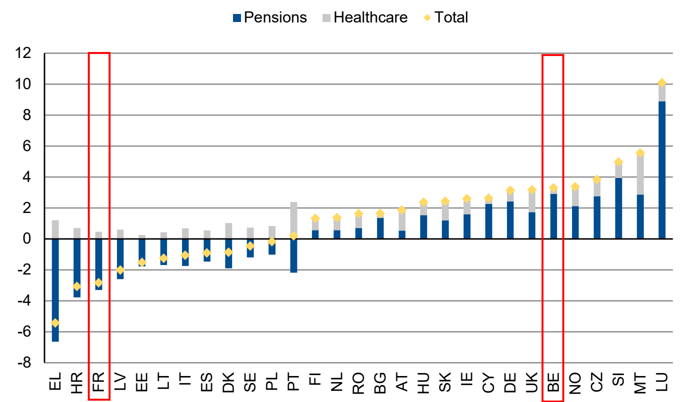
138% in 1993 to 87% by 2007. Belgium's public debt ratio also fell during 2014-19, albeit to a more modest extent.

Figure 7. France and Belgium's fiscal trajectories, 1980-2020
% of GDP



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

Figure 8. Change in pension & healthcare spending, 2016-70F
pps of GDP



Source: European Commission, Scope Ratings GmbH

Moving ahead, low growth, ageing costs and slow reform progress weigh on fiscal outlook

Belgium's relatively impressive record of fiscal consolidation might suggest the federal government in Brussels is better positioned than its counterpart in Paris to reduce budget deficits and pare back public-sector borrowing. However, the Belgian government faces three main obstacles:

- First, fiscal consolidation presently would take place in much more difficult economic and political circumstances. Belgium's potential growth was estimated at just above 1% before the crisis. When earlier budget consolidation episodes took place, it was almost twice this figure. Furthermore, like many other countries, the Belgian population may have limited appetite for fiscal consolidation now that it has got more used to extensive fiscal support.
- Secondly, Belgium faces significant ageing-related costs, which weigh on the fiscal outlook. Pensions and healthcare expenditure as a share of GDP is among the fastest increasing among EU countries, with an increase in spending estimated at 3.3pps of GDP over 2016-70 (**Figure 8**). Conversely, France will see its equivalent expenditure drop by 2.8pps of GDP over the same period despite similar demographic dynamics as a result of past reforms to the pension system.
- Thirdly, Belgium's earlier successful episodes of fiscal consolidation coincided with substantial structural reform, which contributed to a recovery in productivity growth, competitiveness and higher employment[5]. There is less chance of growth-boosting policymaking this time around.

Any credible debt consolidation plans in France or Belgium require reforms that support a higher economic growth potential. In Belgium, lifting potential growth would thus hinge upon the government's ability to reverse the recent slowdown in reform momentum and address not only direct competitiveness challenges but also the increase in ageing-related fiscal costs. In France, lowering the debt burden would require expense of substantial political capital and a government's willingness to implement unpopular measures given historical difficulty in gaining political support for fiscal consolidation.

[5] Bisciari et al. (2015), Analysis of policies for restoring sound Belgian public finances, National Bank of Belgium Economic Review.

Reform progress hinges on overcoming political fragmentation

Political and institutional factors are central to driving reform

Political dynamics and institutional factors will play a crucial role in determining the momentum of future reforms. The coronavirus crisis has halted reforms in France and Belgium as respective governments have focused on addressing the public-health and economic crises. Over the longer term, both countries will need to counter political polarisation and fragmentation, which could impede effective policy making.

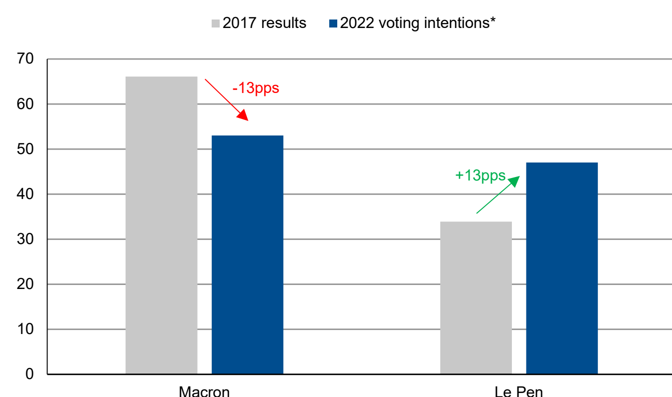
Macron's political support has waned

In France, formerly high levels of political support that President Macron enjoyed at the start of his term has waned. Some key reforms have faced fierce opposition from trade unions, sparked some of the largest strikes in recent history and had to be adjusted, postponed or dropped altogether[6].Since the start of Macron's term, 45 members of his party in the National Assembly have defected. This resulted in the President losing an absolute majority in the lower house, weighing on the government's ability to implement reform without support of coalition partner, Mouvement démocrate.

The elections in 2022 could result in leadership change or minority government

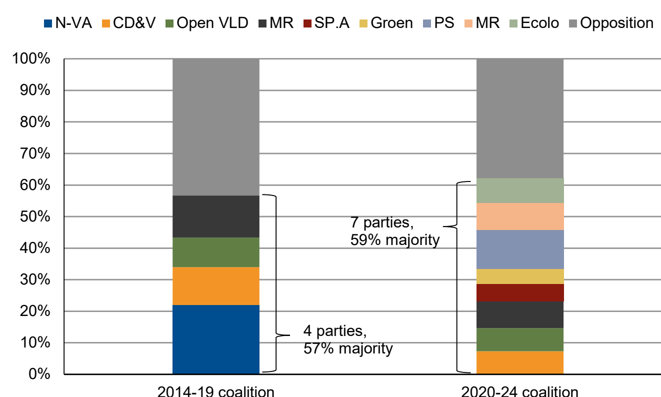
Macron's prospects for re-election in the 2022 presidential elections have worsened according to latest opinion polls. The president's lead, judged by voting intentions, has narrowed over main challenger, Marine Le Pen, leader of France's extreme right-wing National Rally party (**Figure 9**). National Rally has dropped exiting the euro from its political platform, eliminating a key economic tail risk for France, but a Le Pen presidential victory would nonetheless result in a substantial populist shift in French politics. Similarly, any significant loss of seats by the president's La République en Marche party in scheduled parliamentary elections could impair Macron's ability to reform France further should he win a second term.

Figure 9. Macron vs Le Pen: election results and prospects
% of votes



*Based on a March 2021 Harris Interactive opinion poll
Source: Ministère de l'intérieur, Harris interactive, Scope Ratings GmbH

Figure 10. Belgian coalition governments
% of lower house members



Source: Scope Ratings GmbH

Belgium faces polarisation and fragmentation challenges…

Political polarisation and fragmentation are also a threat to reform and social stability in Belgium, with a decline in mainstream political parties and rise of regionalist, green and anti-establishment groups[7].

… which are likely to constrain reform progress.

The prospect for coherent reform-based policy making is further reduced by Belgium's complex political system, with high degrees of autonomy for regions and communities and no formal hierarchy between different tiers of government. Coalition-building and consensus-based decision making are the norm in policymaking, tending to lead to slow

[6] This included the Yellow Vest movement, which led the government to back down on its proposed introduction of a fuel tax. More recently, the government made multiple concessions regarding its proposed pension reform in response to fierce opposition. The latter reform was placed on hold during the Covid crisis.
[7] See Dandoy and Joly. (2018), Party System Change in Belgium: From stability to fragmentation?

and intricate decision-making, further aggravated by political fragmentation and polarisation.

The difficulties Belgium's political parties had in forming a coalition government after the 2019 general elections are only the most recent example. The time it takes Belgium to form coalition governments has increased substantially over recent decades and they have proved increasingly unstable. The fragility of the current coalition administration, which includes seven political groupings (**Figure 10**), will constrain policymaking on wide-ranging economic reforms and could potentially lead to another political crisis.

Concluding remarks

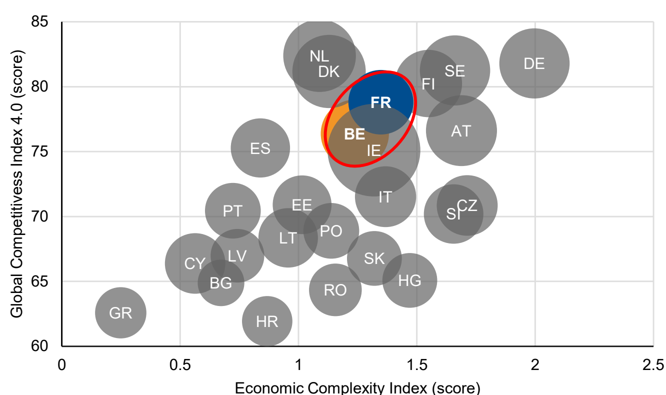
France and Belgium share similar credit characteristics and are both facing significant economic and fiscal challenges in the form of low potential growth and high public debt. In recent years, France has maintained a rather strong reform momentum while reform in Belgium was hindered by political gridlock at the federal level.

Looking ahead, reform prospects are more encouraging in France than in Belgium. Macron's early success in implementing crucial reforms underpins our view that the country can reap economic dividends longer-term provided the reform agenda is pursued and there are no adverse policy shifts following the 2022 elections. Risks of policy inertia in Belgium remain a key credit constraint given the fragmented political landscape and the persistent cultural and regional divide.

Appendix I. Belgium versus France – Similar structural and cyclical economic and fiscal positions

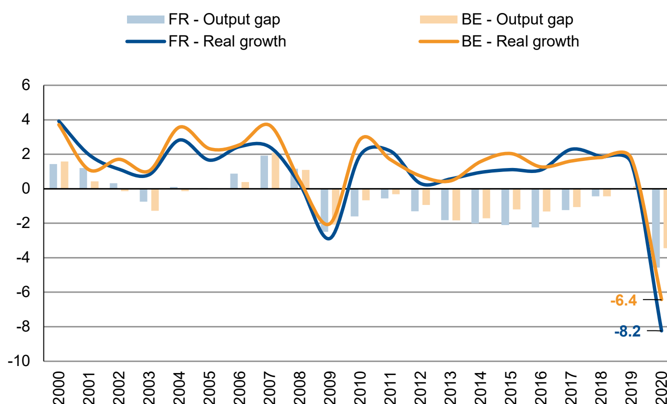
Belgium and France are euro-area sovereign states that share certain credit-related similarities. Both countries benefit from wealthy economies with similar GDPs per capita in purchasing power parity terms of USD 49,696 for France and USD 54,265 for Belgium compared with an EU average of USD 44,579 (as of 2019), according to the IMF. In addition, both display high levels of economic diversification and score comparably on the World Economic Forum (WEF)'s Global Competitiveness Index as well as on the Economic Complexity Index (**Figure 12**). The economies entered the Covid-19 crisis with similar economic circumstances, with both having experienced real growth moderation (to 1.5% for France and 1.7% for Belgium in 2019) due to a weakening external environment while domestic demand had remained buoyant (**Figure 13**).

Figure 11. Structural economic indicators, 2019
Index scores (axes), GDP per capita in int. USD (bubble size)



Source: WEF, Observatory of Economic Complexity, IMF, Scope Ratings GmbH

Figure 12. Real growth and output gaps
%

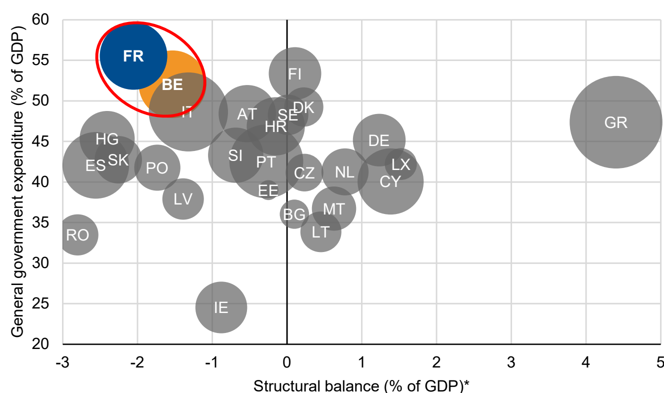


Source: IMF, Scope Ratings GmbH

Prior to the Covid-19 shock, France and Belgium had comparable structural fiscal positions with nearly equivalent public debt ratios (98% of GDP as of 2019), wide structural deficits (2%-2.2% of potential GDP over 2015-19) and the highest public expenditures among EU member states of 52%-56% of GDP (**Figure 14**). Similarly, budget balances (as a percentage of GDP) and interest payments (as a percentage of revenue) were converging in the years in advance of 2019 (**Figure 15**).

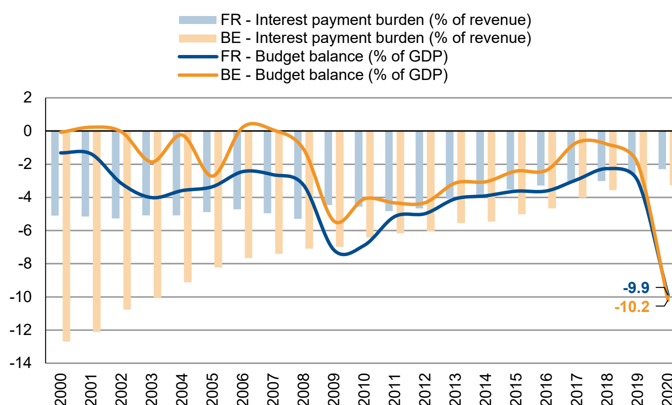
Government guarantees, amounting to around 8% of GDP for Belgium and about 12% of GDP in France, present additional contingent risks for the sovereigns. This should also recognise elevated levels of private-sector debt, which in 2019 stood at 153% of GDP in France and 181% in Belgium. Private debt has risen further during the crisis, exacerbating a 'sovereign-bank-corporate' nexus.

Figure 13. Structural fiscal indicators, 2019
% of GDP (axes), gen. gov. debt as a % of GDP (bubble size)



*The structural balance is calculated as a 2015-19 average.
Source: IMF, Scope Ratings GmbH

Figure 14. Budget balance and interest payment burden
% of GDP, % of general government revenue



Source: IMF, Scope Ratings GmbH

Appendix II. Overview of key recent reforms of Belgium and France

The following table summarises key reforms implemented by respective governments of Belgium and France and is adapted from the "key reforms" tables as presented in the OECD Economic Surveys for the economies.

Figure 15. Key recent reforms in Belgium and France

Belgium	France
Labour market reforms (2017)	**Labour market reforms (2017)**
Reforms aimed at strengthening incentives to work and improving labour market flexibility, including short notice periods at the beginning of employment, extension of 'flexi-jobs' and some tax exemptions for first hires	A series of executive orders in 2017 to facilitate collective bargaining and firm-level negotiation reduced legal uncertainty surrounding dismissals for permanent contracts and lowered labour taxes
Reform to wage-setting system (2017)	**Education reforms (2018-19)**
Wage-setting system amended in 2017 to better safeguard competitiveness and correct for past divergences in wage growth evolution between Belgium and its neighbouring countries	Several reforms implemented to promote initial education and adult learning, enhance the apprenticeship and vocational training systems, and address educational inequality
Competition and insolvency law reforms (2018)	**Business environment and product market reforms (2019)**
Redefined the concept of enterprise to include liberal professions, farmers and non-profit sectors; insolvency law was enhanced to include all enterprises	PACTE bill eased regulatory and administrative burdens to boost firm growth and opened up domestic rail transport sector to competition
Pension reform (2015)	**Unemployment benefits reform (2019)**
Reform to increase the statutory retirement age from 65 to 66 in 2025 and to 67 by 2030, stricter eligibility requirements and better valuation of actual work periods	Reform to reduce structural unemployment while helping to generate fiscal savings by incentivising use of fixed-term contracts, imposing stricter rules for access to unemployment benefits and increasing support for job seekers; the reform was approved but its implementation has been delayed due to Covid-19 crisis
Tax shift (2015)	**Pension reform (pending)**
Adopted in 2015 and phased in over 2016-20, lowers social security contributions for employers and employees as well as personal income taxes; other revenues were raised on some non-labour income, via excise duties as well as the alignment of reduced value-added tax rates	The government initiated a pension reform to simplify the system, foster greater labour mobility, and ensure the long-term financial sustainability of the system. The reform faced substantial obstacles to approval and has been postponed until the crisis moderates.
Corporate income taxation (2017)	**Tax reforms (2017-20)**
Progressive reduction in corporate income tax rate from 33.9% to 25% between 2018 and 2020, enhancing the tax system to limit tax avoidance	Increase in proportional personal income tax (CSG), reduction in the scope of wealth tax to real estate assets only, introduction of flat tax on capital reduction of the corporate income tax rate, phasing out of the residency tax
Post-crisis consolidation plans (pending)	**Cuts to production taxes (2020)**
Stability Programme for 2021-24 includes plan to limit expenditure growth, gradually reduce the deficit; debt expected to continue rising through 2024	Recovery plan includes a permanent reduction in three distortive production taxes
	Post-crisis consolidation plans (pending)
	Stability Programme for 2021-27 includes plan to limit expenditure growth, gradually reduce the deficit and stabilise public debt by 2027

Belgium and France: Different reform momentum contributes to credit rating divergence

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