13 October 2015

Financial Institutions

Sovereign report France

Among larger European countries, Scope would categorise the credit strength of France as upper range with softening trends. France is one of the wealthiest economies in the world with a highly diversified economic structure and it weathered the financial and sovereign crisis reasonably well. Its private sector, especially households, is not overleveraged, indicating a quite tempered reliance on credit growth in the pre-crisis years. Moreover, the government enjoys a very low cost of funding, making its debt servicing highly affordable. The country's healthy demographics with a growing labour force, which distinguishes it from other major euro area (EA) economies, could contribute positively to the country's economic growth and alleviate the pressure on public finances. However, a number of structural issues - in particular an insufficient degree of competiveness, relatively rigid markets for labour, goods and services, as well as an inflated public sector contributed to economic slowdown in recent years. This slowdown is combined - with increasing public indebtedness, which is unlikely to stabilise, let alone decelerate, without deep structural reforms for the public sector as well as for the economy as a whole. Economic restructuring touches so many vested interests that multi-sector reforms launched by the current government may well stay incomplete or could be watered down. In turn, the prospects of a reversal of the trend in public finances, which undermines the country's creditworthiness, are uncertain.

This report is not a basis for a credit rating of France. Scope Ratings does not plan to assign public ratings to sovereigns at this time. However, we believe that an analysis of a country's credit fundamentals is relevant for our rating assessments of various issuers domiciled in France.

Strengths

- A wealthy and diversified economy with a high saving rate and strong and effective institutions
- Moderate indebtedness of the private sector
- High sovereign debt affordability
- Limited contingent liabilities

Challenges

- Weakening economic competiveness
- Relatively rigid and overregulated markets for labour, goods and services
- Oversized public sector and growing public indebtedness
- Risk of non-completion of the latest structural reform plan

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Macroeconomic outlook: a recovery in 2015 relies on factors that could fade in the mid-term

After three years of lacklustre growth, France's GDP picked up at almost 1% on year on year in H1 2015 though still lagging behind the EA average (1.5%). Scope estimates that for 2015 as a whole France's recovery should be stronger than in previous years, with a GDP growth rate of 1.0% in 2015; this should be followed by 1.3% and 1.5% in 2016 and 2017, respectively (table 1).

Table 1 : France: selected economic indicators

	2009	2010	2011	2012	2013	2014	2015e	2016f	2017f
Real GDP growth, %	-2,9	1,9	2,1	0,2	0,7	0,2	1,0	1,3	1,5
Nominal GDP (EURbn)	1.939	1.997	2.058	2.086	2.118	2.134	2.180	2.231	2.293
GDP per capita (USD)	42.317	40.668	43.472	41.583	42.849	42.158	36.686	37.302	38.162
Population (year-end, m)	64,4	64,7	65,0	65,3	65,6	65,8	66,2	66,5	66,8
C/A balance, % GDP	-0,8	-0,8	-1,0	-1,5	-1,4	-0,8	-0,7	-1,0	-1,1
Inflation, annual avg, %	0,1	1,7	2,3	2,2	1,0	0,6	0,2	1,0	1,4
Govt balance, % GDP	-7,2	-6,8	-5,1	-4,8	-4,1	-4,0	-3,8	-3,5	-2,7
GG gross budgetary debt, % GDP	79,0%	81,7%	85,2%	89,6%	92,2%	95,5%	97,3%	98,5%	98,6%
Unemployment %	9,1	9,3	9,2	9,8	10,3	10,2	10,3	10,0	9,8

Source : Eurostat, IMF, Scope calculations

Growth should mainly be supported by domestic demand – in turn having been boosted by lower energy prices strengthening households' disposable income and easing production costs for businesses. Firms should also see profitability improvements, thanks to tax credits and cuts in social contributions within the framework of Le Pacte de responsabilité et de solidarité (Responsibility and Solidarity Pact - RSP) and Le crédit d'impôt pour la compétitivité et l'emploi (CICE) - Tax Credits for Competiveness and Employment. Improved profitability could encourage investment and job creation.

Though a depreciated euro and the economic recovery of France's main trade partners should help to boost exports, its effect on economic growth could be muted. The primary reasons are the country's relatively low exposure to the external markets and very limited depreciation in real unit labour costs (ULC) against its main trade partners, largely EA countries. The public sector, which has been the most important contributor to growth in previous years, is likely to provide more modest input to the GDP growth rate, given the continuation of fiscal consolidation measures.

Despite the asset purchase program launched by the ECB the low inflation should persist driven by low commodity prices. We anticipate the CPI rate to stay at 0.2% in 2015 lower than in 2014 before it climbs up to 1.0% in 2016. Its acceleration should be curbed by a slack in the labour market and potentially by the effect of product markets reforms aimed at bolstering competition within the framework of the Growth, Economic Activity and Equal Opportunities Act known as Loi Macron (the Macron Law).

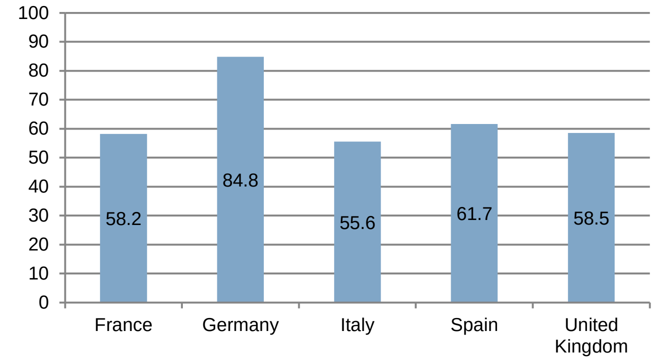
Some of the factors that have driven the strong recovery in early 2015 could be fading for the mid-term. First, energy prices could start creeping up beyond 2016 reflecting a re-balancing of the supply and demand in the crude oil market. According to Bloomberg consensus forecast, oil prices should rise gradually from current USD50 a barrel in 2015 to USD63 and USD70 a barrel in 2016 and 2017, respectively. Second, the ECB's asset purchase programme launched in March 2015 – which keeps the cost of EA sovereign debt and contributes to euro depreciation – may be tapered by 2017. As soon as support of temporary factors diminishes, France's structural problems may weigh again on its GDP growth and public finance balances.

France benefits from diversified structure of its GDP and its exposure to the external markets is relatively low

The French economy accounts for 21% of the EA countries' output and occupies the sixth position in the world by the size of its GDP[1]. At EUR 32,400 its GDP per capita is almost 8% higher than the EA average. France's economic structure is well diversified and does not reveal overreliance on any particular economic activity. We view these characteristics very positively.

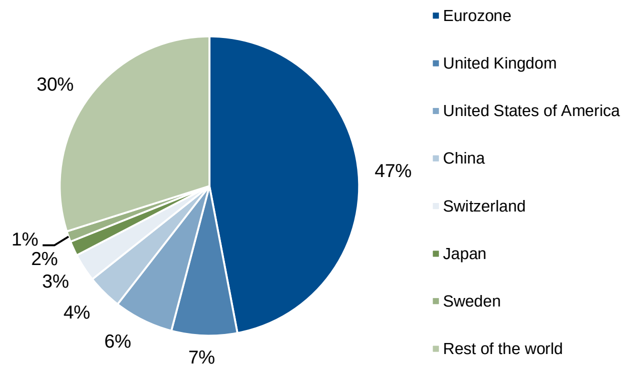
France's openness to trade is at the average level; it stood at 58% compared to 61% in Spain, 55% in Italy or 84% in Germany (table 2a). The country's relatively moderate exposure to the external markets managed to soften the economic downturn in 2009: its GDP contracted by only 2.9% vs 4.5% for the EA on average. The largest portion of French exports goes to the EA countries; however their share had diminished from 52% in 2004 to 47% in 2014 (table 2b).

Table 2a : Openness of the economy in 2014 (exports & imports relative to GDP), %



Source: IMF, Eurostat, Scope calculations

Table 2b : Destination of France's exports in 2014,%

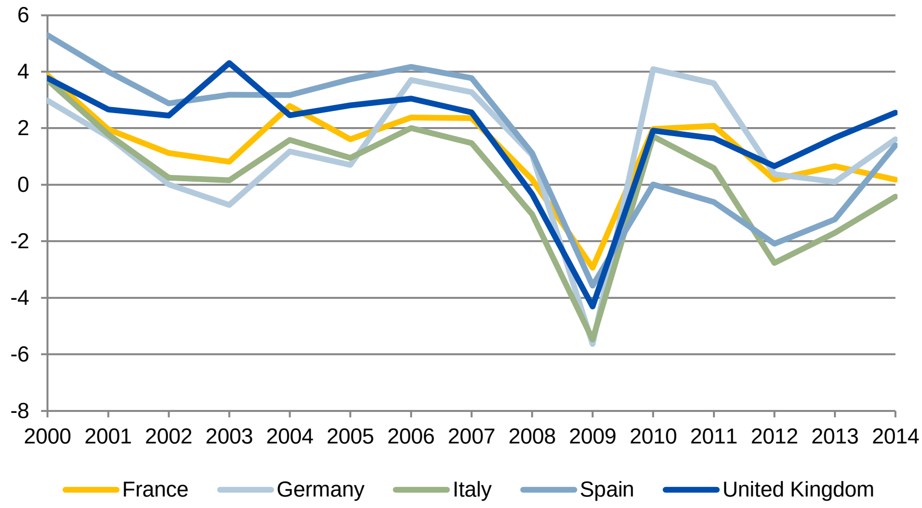


Source: Eurostat

France's traditional economic model no longer seems to assure economic growth

In the post-crisis period the growth rate of the French economy slowed down. Indeed, in 2000-2007 France had been growing at 1.9%, whereas in 2008-2014 it was stagnating - its average growth in this period was 0.3%. It should be noted that post-crisis slowdown is a feature of all EA economies, which grew by almost 2% before the crisis, fuelled by credit growth, albeit to a lesser extent in France, but virtually stopped growing in post-crisis years (table 3).

Table 3 : GDP real growth rate in 2000-2014, %



Source : Eurostat, Scope calculations

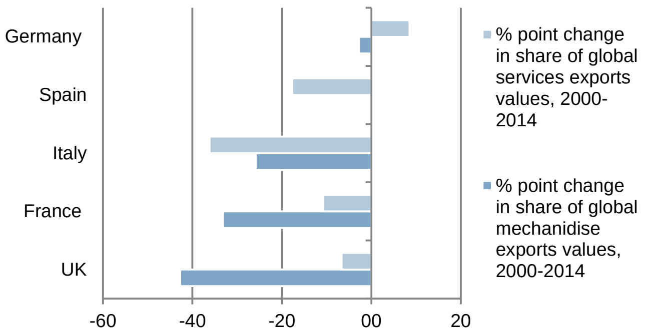
1 In 2014, France's GDP stood at USD 2.8 tn / EUR 2.1 tn

We view the economic slowdown as evidence that France's traditional economic growth model has come up against some natural buffers. Macroeconomic policies have focussed on supporting domestic demand by growing government spending, real wage growth and a steadily growing labour force. These policies have produced a mix of inter-connected structural issues, in particular weakening competiveness, rigid markets for labour, goods and services, as well as an inflated public sector. In turn, these challenges weigh heavily upon the country's long-term economic prospects. In recent years the French government has attempted to address these issues through a raft of reforms being implemented with different degree of success.

France's economic competiveness is weakening

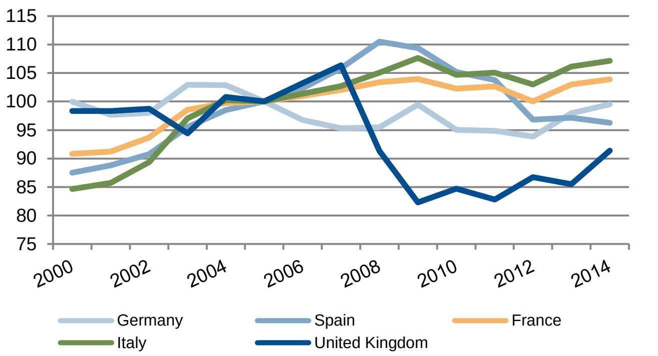
In the last 14 years the decline in France's share for the world goods and services exports, compared to that of the other large EU economies, has been quite noticeable. It was especially pronounced in merchandise exports (table 4). Though this decline is partially explained by slow economic growth in its main exports markets - France trades largely with the EA countries – its exports have been lagging behind even this modest growth[2]. This indicates weakening competiveness of French products as measured by the real exchange rate in relative unit labour costs (REER). The appreciation of the French REER had been one of the highest among the major EA economies, with exception of Italy, pointing to relatively high labour cost (table 5).

Table 4 : Change in goods and services exports world share,%



Source: IMF, Eurostat, Scope calculations

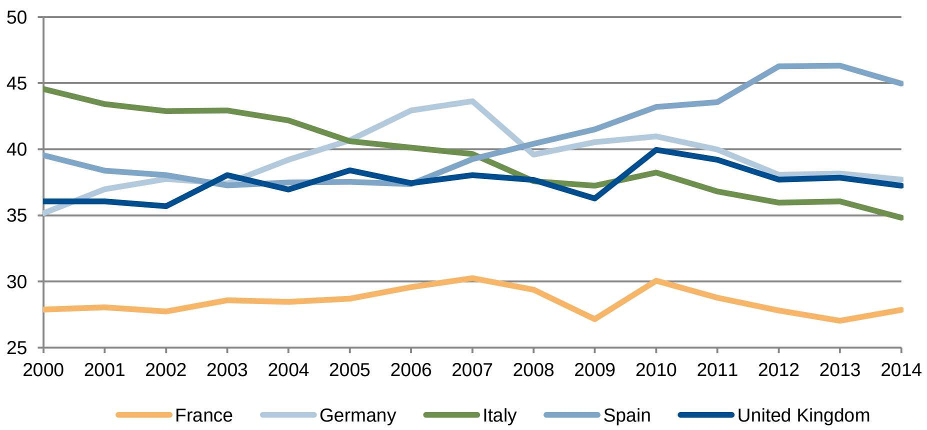
Table 5 : Real exchange rates in relative unit labour costs against 37 trade partners, index, 2005=1005



Source: Eurostat

High labour expenses undermine companies' profitability – on average French businesses have the lowest profit margins among the major EU countries (table 6). Profit margins of the exporting manufacturing sector are particularly affected. Exporters face limited pricing power internationally due to increased competition and low productivity in the non-tradable sectors (e.g. utilities), which inflated the cost of their goods and services[3].

Table 6 : Profit margin of non-financial companies, %



Source: Eurostat, Scope calculations

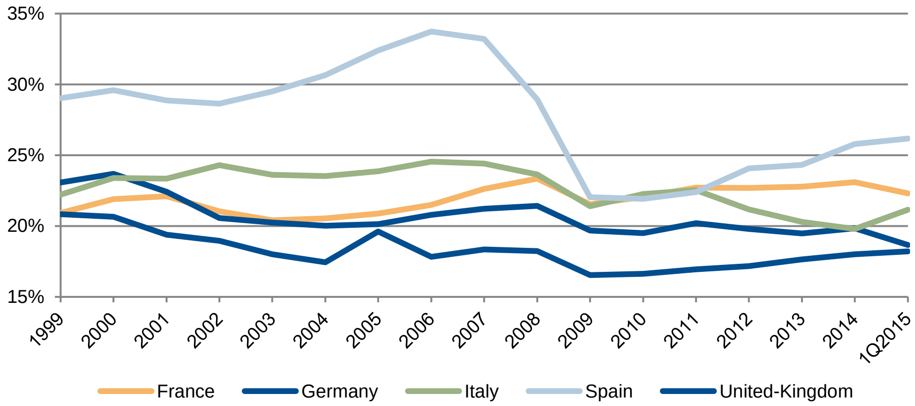
[2] "Macroeconomic imbalances. Country report- France 2015", EC occasional papers 217/June 2015, p.12.

[3] The same source

To address eroding competiveness, the current French government announced in 2013 a package of supply side reforms, which includes tax relief for enterprises (around 1% of GDP a year) comprising the CICE and RSP. All these measures are expected to create additional 600,000 jobs[4], increase profit margins of firms and boost investment. Apart from tax benefits for the firms the authorities introduced tax reduction for households, in particular those in the lowest tax bracket, to directly support demand.

According to the French authorities, the effect of the reforms should be fully realised by 2017. The IMF has noted that it may take longer[5]. So far, the effect on investment (table 7) and on the job market has been insignificant. According to INSEE, payroll employment in the non-farm market sector remained virtually unchanged in Q1 2015 (quarter-on-quarter) with some marginal uptick in permanent employment. On yearly basis almost 0.1% of jobs in the private sector were lost. The lack of impact is partially explained by timing - the bulk of the tax cuts are due to start in 2015 (except for CICE, for which the tax returns became available already in 2014).

Table 7 : Corporates' investment rates in major EA countries, %



Source: Eurostat

4 "France – 2014 article IV consultation- staff report", press release and statement by the executive director for France, July 2014.
5 The same source.

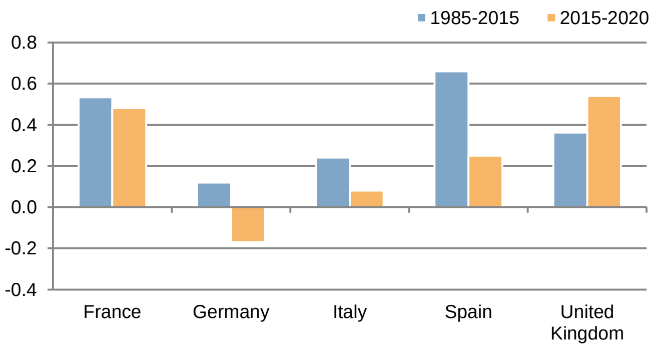
France is one of the EA countries that enjoys growing labour force

One of the strong features of the French economy is growing population thanks to the high fertility rate and immigration supplying the expanding pool of the labour force. It distinguishes France from other major EA countries, which see their population declining and the pool of the labour force shrinking (tables 8a,b,c).

This advantage allows France to rely on working age population growth as an important contributing factor to real GDP growth as opposite to Germany, Italy or Spain. France's low GDP growth rate is an evidence of low utilization of its labour force - which is closely connected with relative rigidity of its labour market – rather than a demographic issue.

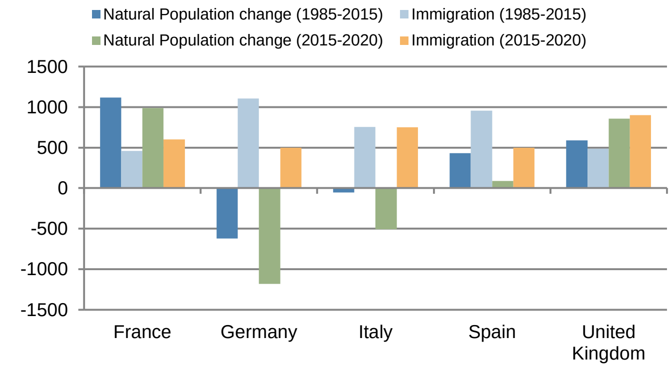
Besides, thanks to favourable long-term demographic conditions and therefore low projected pension costs, France does not need additional adjustment efforts to ensure that its debt-to-GDP ratio is not on a constant upward trend, unlike other EA countries with less favourable demographics.

Table 8a : Average annual population growth, %



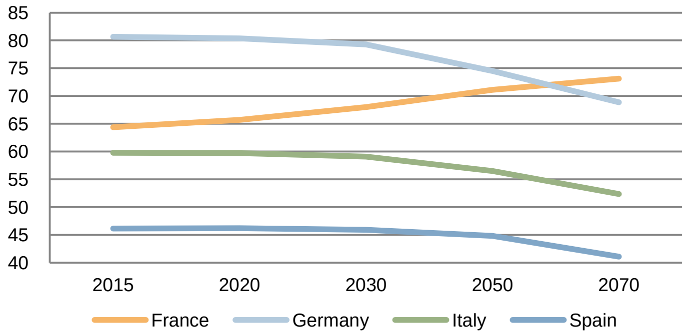
Source: UN, Scope calculations

Table 8b : Average annual natural growth and immigration, thousands



Source: UN, Scope calculations

Table 8c : UN total population growth forecast for selected countries

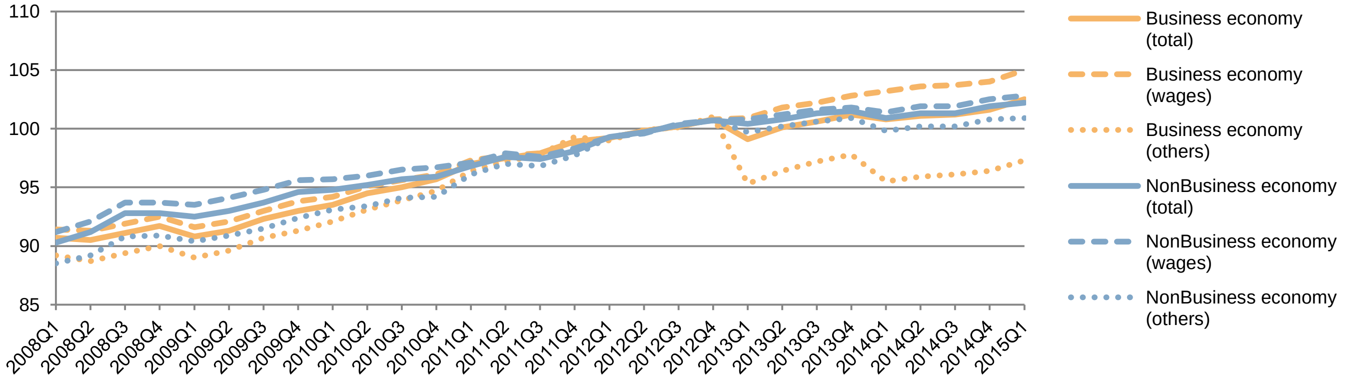


Source: UN

Overprotective regulation in labour and product markets dampens economic growth

Apart from relatively high labour cost, France's growth potential is constrained by its rigid labour market. Inflexible labour regulations, high and unpredictable dismissal costs, the strong bargaining power of trade unions often constrain labour mobility, rendering hiring and dismissal procedures cumbersome and contributing to stickiness of wages and salaries. Indeed, in the post-crisis period, despite the creep-up in unemployment and the decrease in inflation, wages and salaries continued their upward trend almost at the same speed as in the pre-crisis years outpacing productivity rate (table 9).

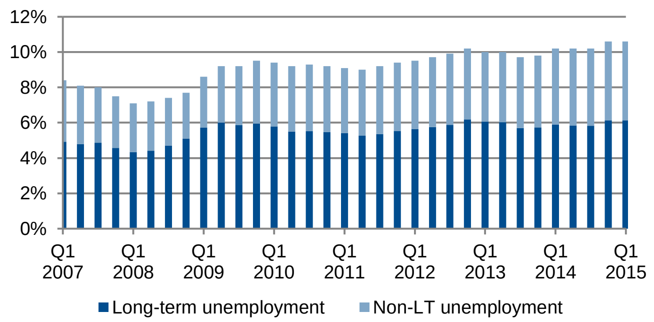
Table 9 : Hourly labour index, 2012 = 100



Source : Eurostat

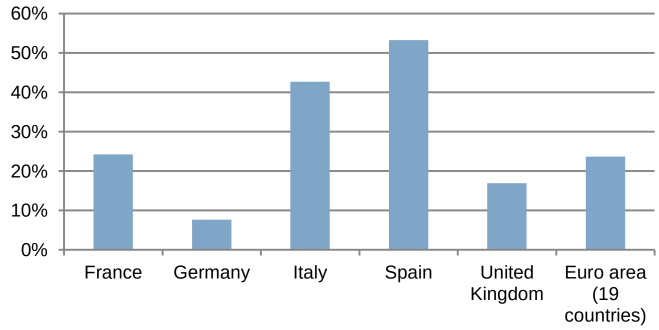
Interestingly, France was on par with Germany in terms of the unemployment rate in 2008 – it stood at 7.4% in both countries. Since then the unemployment rate climbed up and in 2014 amounted to 10.2% in France compared to 5.0% in Germany. Also, long-term unemployment is crawling up indicating some mismatch between companies' needs and available skills (table 10). Segmentation in the market manifests itself in high youth unemployment (table 11) and labour market duality, i.e in a sharp difference between so called insiders, who have high incomes, job security and good prospects for upward mobility, and outsiders who lack these and usually are taken on short-term contacts. A staggering number of new contacts in France - almost 85% of the total - are now the fixed term ones with very short durations[6]. However, unlike Germany, France does not and will not face shortage of the labour force due to demographic problems indicating again that it is rather rigidity of its labour market than the shortage of labour that pushes wages and salaries up.

Table 10 : Unemployment in France, % of the labour force



Source : Eurostat, Scope calculations

Table 11 : Unemployment rate in 2014, < 25 years old, annual average, %

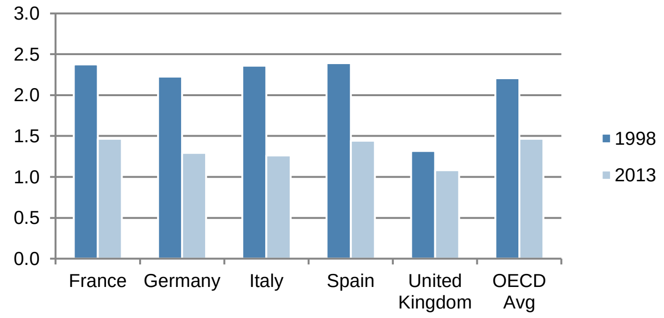


Source : Eurostat

Yet another obstacle to growth seems to be the rigidity in product markets. The level of regulation, barriers to entry and competition in service sector are among the highest in the OECD countries (tables 12a, b,c). This hampers not only the country's service sector, which accounts for 79% of France's GDP[7], but the non-service sector as well. The latter suffers because the services by far are the largest input for production in the manufacturing sector, which trades internationally.

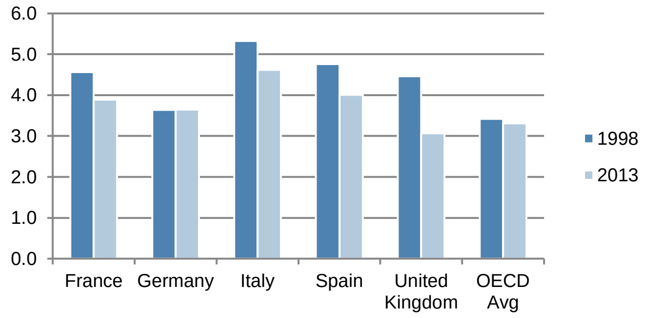
6 "France, selected issues", July 2015, IMF country report, p.9.
7 In 2013, http://www.economywatch.com/world_economy/france/industry-sector-industries.html

Table 12a : Product market regulation



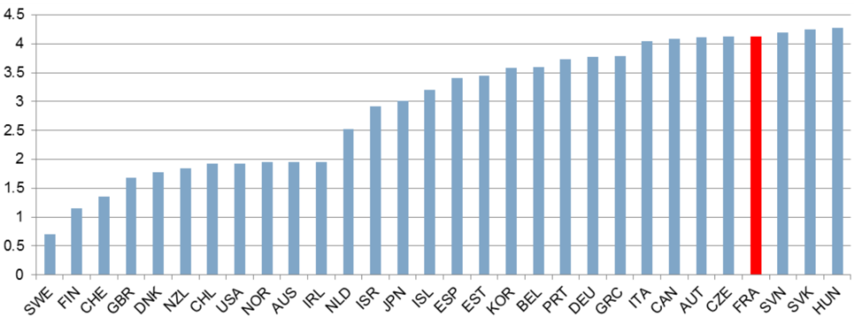
Source : OECD

Table 12b : Barriers in service sectors



Source : OECD

Table 12c : Barriers to entry in architectural, accountancy and legal services



Source : OECD
Note : Per indicator, index scale from 0 to 6 from least to most restrictive (tables 12a, b, c)

Various reforms to address rigidities in both labour and product markets have been launched by the current government. In May 2013 the 'job preservation agreements' (*accords de maintien de l'emploi*) were introduced allowing adjusting staffing, working hours and wages for up to two years in economic downturns. However, only nine big firms (including Renault) have used this option so far pointing out to the challenge in reforming labour market in France.

More recent government's efforts in reforming the country's labour market include the Macron and Rebsamen laws to be adopted over the rest of 2015 and in 2016. The Macron laws are aimed at reducing judicial uncertainty about individual dismissals by introducing measures to set up a ceiling for settling compensation for unfair dismissal. Other measures include subsidies to self-employed/single traders for the first employee, increasing by 40,000 the training slots targeted to companies' needs (adding to 60,000 slots created in mid-2014) and permission for companies to renew temporary contracts twice. These measures also include extension of 'job preservation agreements' beyond two years. The Rebsamen draft law calls for simplifying work councils[8] as well merging two back-to-work benefits to encourage the unemployed to work.

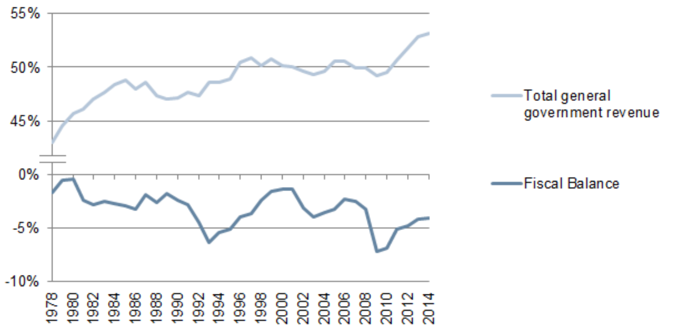
Another component of the Macron law is intended to accelerate product market reforms by introducing more competition in some regulated legal professions, liberalising intercity bus transport, extending opening hours on Sundays for retailers, reducing rents received by toll road operators and improving powers of the Competition Authority. Some reforms of regulated energy tariffs are expected in the energy sector. Moreover, an independent body, the Business simplification council, was established in 2014 to work out further measures to simplify administrative regulations and cut the red tape.

8 Though less than 8% of employees in France (vs 26% or 18% in the UK and Germany, respectively) belong to trade unions, the latter represent all employees in the firms with more than 50 workers regardless of a trade union membership. Employees are represented through work councils, which have to be consulted with by employers on a vast range of issues. A lot of firms prefer to limit the number of staff to 49 to avoid having to deal with the work councils.

An overextended public sector requires structural changes

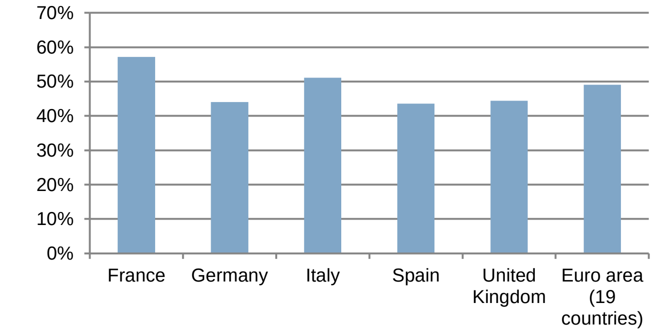
The current government's attempts to restore competiveness and encourage businesses to create jobs by reducing their tax and social contribution burden calls for deep restructuring of the country's public finance. For decades France has been balancing its budget by increasing the tax and social contributions burden on businesses (table 13). As a result by 2014 the proportion of general government expenditure to GDP - at 57.5% - was the highest among the major EA countries (table 14).

Table 13 : French government budget indicators, % of GDP



Source : Eurostat, Scope calculations

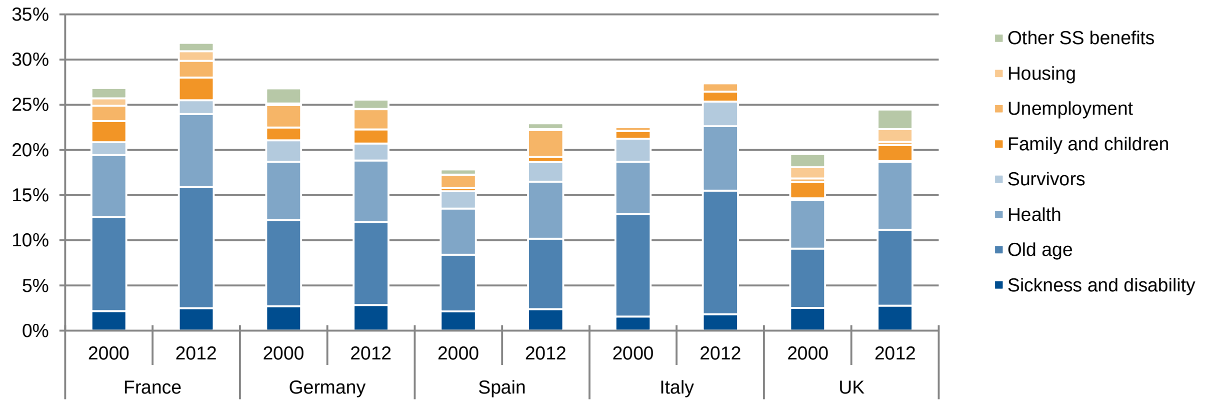
Table 14 : Total general government expenditure in 2014, % of GDP



Source : Eurostat, Scope calculations

A closer look shows that France's social expenditures, in particular healthcare, old age and social protection, are key drivers for the increasing budget expenditure. Indeed, these spending had jumped from almost 27% to GDP in 2000 to 32% in 2012 (table 15).

Table 15 : Social expenditures, % of GDP



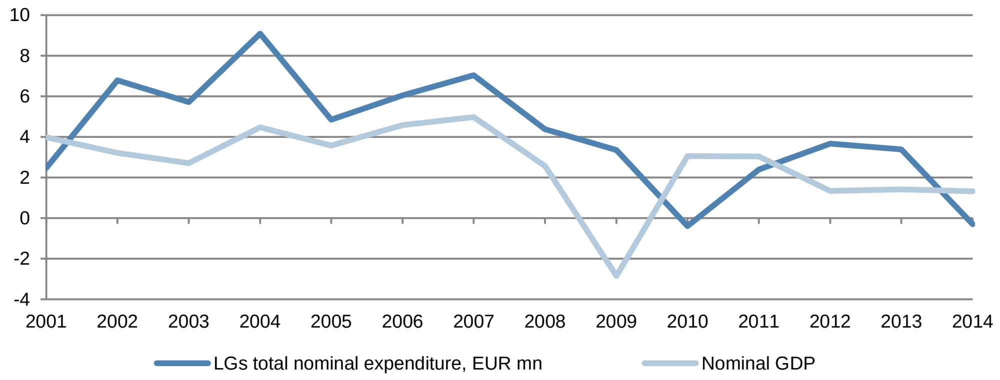
Source : Eurostat, Scope calculations

Whereas healthcare expenditure increases have slowed down since the introduction and gradual reduction of permitted annual growth rate of health insurance spending (*L'Objectif National des Dépenses d'Assurance Maladie - ONDAM)*, pension expenditures have remained on the upward trend. Ironically, France is not the country with the highest old-age dependency rate among major EA economies and its median age is one of the lowest. Its high and growing pension spending is associated with relatively generous retirement conditions. Thanks to low contribution period necessary to attain full pension rights and various early retirement schemes, France has had one of the lowest effective retirement ages – at 60 years[9], which is well below the legal retirement age at 65.

A breakdown of spending by various levels of government shows that the fastest growing expenditures have been associated with local governments (LGs). In nine of the past 14 years, LGs' expenditures have been growing faster than nominal GDP, driven by decentralisation of public responsibilities and relative independence in allocating budget resources enjoyed by the sub-sovereigns (table 16).

9 "Average affective age of retirement vs the official age", 2007-2012, OECD.

Table 16 : Local governments expenditure and nominal GDP, % year on year



Source : Eurostat, Scope calculations

To tackle the problem of the oversized public sector, the French government has resorted to unprecedented expenditure cuts to be undertaken within the period of 2015-2017. The magnitude of cuts is about EUR 50bn (2.2% of GDP), with almost half of it falling on 2015. The scope of cuts covers all levels of the government:

- LGs are supposed to save EUR 11bn by accepting cuts in state transfers and streamlining their expenditures through re-organisation (almost halving a number of regions by 2017, reducing a number of departments by 2021 and rationalising intercommunal structures) as well as introducing a target for LGs spending growth rate (ODEDEL, *Objectif d'Evolution de la Dépense Publique Locale*), which challenges the general clause of competence[10] (*Clause de compétence générale)* partially responsible for weak restrictions on LGs spending;
- Central government and its agencies will save about EUR 18bn through salaries freeze, increasing efficiency and control over its expenses.
- Further lowering the rate of growth (*ONDAM*) in healthcare expenditure should release EUR10bn;
- Almost EUR 11bn will be cut in social security spending involving temporary re-indexation of pensions, reform in family and unemployment benefits as well as efficiency gains in the management of social security funds;

Reforms face implementation and political risks

A successful shift away from the current economic growth model requires, in our view, synchronisation of the reforms. A reduction in the tax wedge would have to be combined with budget expenditure cuts to avoid further accumulation of already high public debt ahead of any possible rises in the currently low market funding for the sovereign. The IMF recently has estimated that the product-market reforms combined with the CICE and the tax cuts under the RSP over 2015-2017, if fully implemented, could raise GDP growth by 0.3% a year over next five years and 0.4% over 10 years[11]. This magnitude of GDP acceleration is unlikely to allow the country to reduce its public debt down to the Maastricht threshold without deep re-structuring of its public sector.

Moreover, timely adoption, let alone successful implementation of the reforms, is far from guaranteed. The government seems to have problems in having a broad-based political mandate for the reforms. It confronts strong opposition within its own Socialist Party as well as difficulty in winning support from social partners. The level of resistance is demonstrated by the fact that in February this year President Hollande had to invoke special constitutional powers to push through the lower house of Parliament a set of labour reforms allowing working on Sundays. Though the government survived a no-confidence vote, the limited scope of the reform stands in contrast with the intensity of the debates. The outcome of the Rebsamen law could be similar given mixed reaction of trade unions[12] and prolong negotiations on social dialogue reform in France[13].

10 Local governments are allowed to intervene in many fields of the economy as long as the action is of local public interest.
11 "France, selected issues", July 2015, IMF country report.
12 "Social dialogue reform in France: trade union reaction", 30 April, European trade union institute, http://www.etui.org/News/Social-dialogue-reform-in-France-trade-union-reactions
13 "France: talks on reform on social dialogue collapse", Eurofound, http://www.eurofound.europa.eu/observatories/eurwork/articles/industrial-relations/france-talks-on-reform-of-social-dialogue-collapse

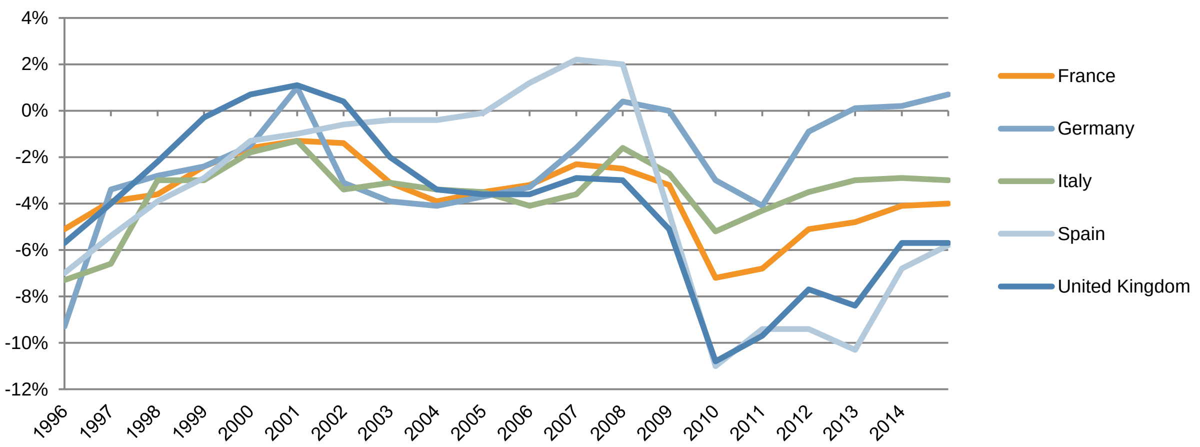
Meanwhile, certain reforms, especially social expenditure cuts, depend on the support of social partners, because some unemployment benefits are equally managed by the trade unions[14] and employers' association. Reduction in central government transfers to LGs pushes them to cover their widening budget deficits through debt financing contributing to overall indebtedness of the general government. All this increases the risk that the reforms will be either partial or watered down. Another risk is the government's diminishing appetite for the reforms due to approaching parliamentary and presidential elections in 2017.

France combines high and growing public debt…

By year-end 2014 France's general government debt amounted to 95.5% of GDP; about 80% of GDP was accumulated by the central government and the rest is split between local governments and the social security fund. The accumulation of public debt has been quite rapid, from 58% in 2000.

The public debt increase is a result of long-standing public sector deficit and sluggish GDP growth, especially in the post-crisis years. Indeed, for the last four decades France has not balanced its accounts in any single year. In this regard France is similar to Italy, but different from Germany, the UK or Spain which run surpluses from time to time (table 17).

Table 17 : Budget balance of general governments, % of GDP



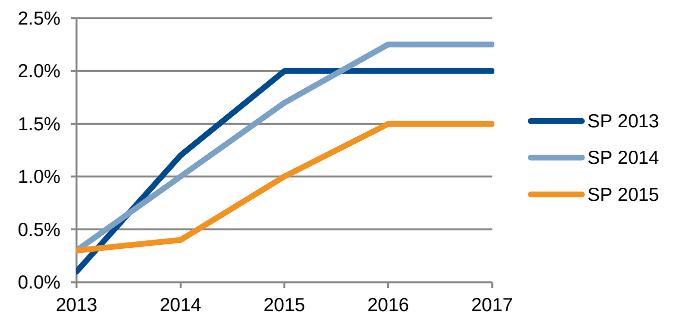
Source : Eurostat

The breakdown by the sub-sectors of the general government shows that neither sector of the general government –local governments, social security fund or central government – was able to balance their budgets. The central government accounts for the biggest share in the overall deficit. Long-standing budget deficit points to structural rather than cyclical issues in the country's public finance.

As a member of EU and especially EMU (European Monetary Union) France adheres to thresholds on its budget balance and debt as well as procedures to bring these ratios in line with the limits[15]. However its efforts to bring the budget deficit to 3% of GDP, let alone to reduce debt to 60% of GDP, have so far been unsuccessful. France had not succeeded to bring its budget balance down to 3% threshold in 2014 in line with its 2013 Stabilisation programme (SP) and in 2015 in line with its 2014 SP (table 18b). In 2015, on the third time[16], it had been given an extra time until 2017 by the European Commission to comply with the Maastricht budget deficit ratio.

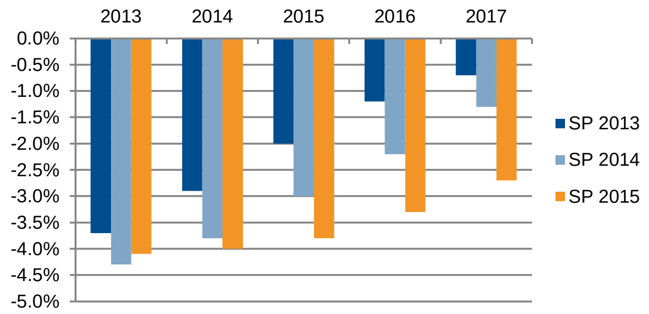
14 "France, selected issues", July 2015, IMF country report
15 Apart from Maastricht criteria, France ratified the EU 'Fiscal Compact', which requires that structural budget deficit of a country with debt exceeding 60% of GDP like France be improved by more than 0.5% of GDP a year under normal economic circumstances (interpreted as an output gap between -1.5% and +1.5%).
16 "Assessment of the 2015 Stability Programme for France", EC, Brussels, 27 May 2015.

Table 18a : Real GDP growth forecasts, %



Source : French stability programmes

Table 18b : Government balances forecasts, % of GDP



Source : French stability programmes

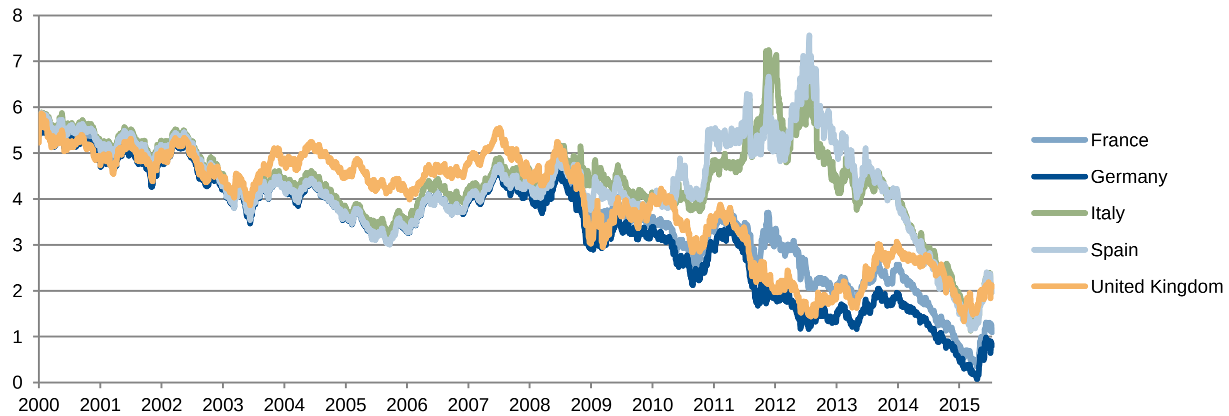
It should be noted that unlike previous ones, France's SP for 2015-2018 has more chances to be implemented. The budget target at 3.8% pencilled for 2015 in the April Stabilisation Programme (SP) for 2015-2018 seems to be achievable due to combination of factors. First, there are more conservative GDP (table 18a) and inflation[17] assumptions – the government plans 1% GDP growth in 2015 vs 1.2% by the Bloomberg consensus. GDP forecasts for 2016 and 2017 look more realistic as well. Second, France enjoys savings on interest payments stemming from decreasing cost of the sovereign funding induced by the QE programme.

However, even if it succeeds in reducing its budget deficit it will at best curb acceleration of public debt growth. To stabilise debt and start its reduction the country needs to at least succeed in delivering planned EUR 50bn in expenditure cuts over next years and unlock its potential economic growth. Given uncertainty in delivering reforms Scope forecasts that France is unlikely to avoid having its public debt approached very close to 100% of GDP in 2016 and 2017.

.. with high debt affordability metrics..

Currently France enjoys a very low cost of funding supported by the QE programme and 'flight for quality' trend, which sets Germany and France aside from 'periphery' economies (table 20). Favourable market conditions makes France's high public debt affordable: its interest payments accounted for 4.1% budget revenue in 2014 almost on par with Germany (3.9%).

Table 19 : 10-year government bonds yields, daily data



Source : Bloomberg

However, it should be noted that almost the same proportion of interest payments relative to budget revenue conceals different sizes of government revenue relative to GDP: 44.6% in Germany vs 53.2% in France[18]. We believe that negative news like another slippage in meeting the budget deficit and public debt targets could have adverse effect on the cost of funding.

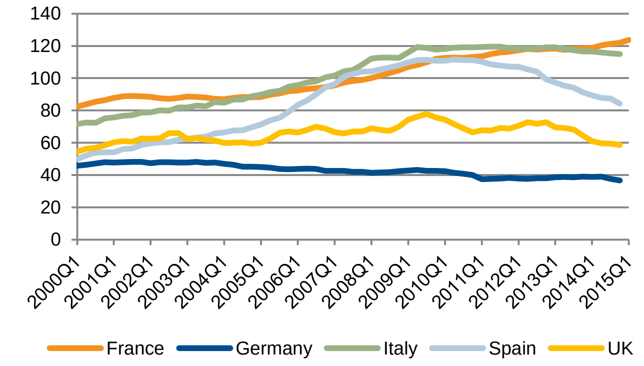
… and relatively moderate, albeit creeping up, indebtedness in the private sector

The French private sector does not appear to be overly indebted if measured on the consolidated basis, i.e excluding inter-corporate lending. According to the Bank of France data, non-financial sector debt stood at around 68% to GDP at the end of Q1

17 In fact acknowledging negative impact of low inflation on the budget revenue the government pencilled expenditure cuts on top of EUR 50bn already to be implemented within 2015-2017.
18 In 2014.

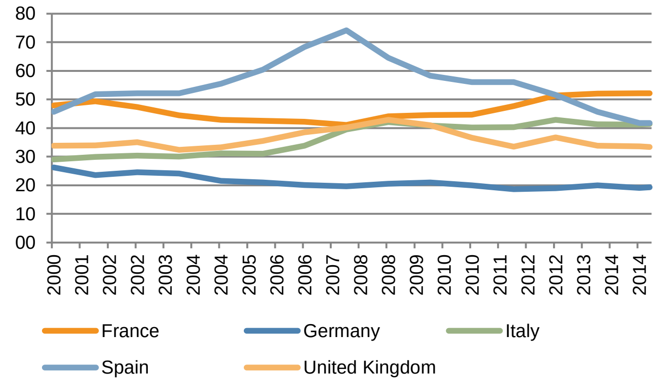
2015. Moreover, according to the IMF, earnings of around 87% of French firms more than cover their interest payments[19]. However, on a non-consolidated basis, French companies' debt is increasing, in contrast to other major EA countries (table 20a). Lack of private sector deleveraging is the flip side of the companies' deteriorating profitability and limited self-financing capacity. Moreover, since the end of 2012 the French non-financial sector has had to allocate the highest proportion of its income for debt servicing among the major EU economies, signalling increasing dependence on debt financing and deterioration of the businesses' self-funding capacity (table 20b).

Table 20a : Indebtedness of non-financial corporations, % of GDP



Source : Banque de France, Scope calculations

Table 20b : Debt service ratio of non-financial corporations, %



Source : BIS

As for the households, according to the Bank of France, their debt at 55.5% of GDP and 85.3% of disposable income at the end of Q1 2015 appears to be manageable. Less than 10% of indebted households have their debt service to income ratio more than 34%[20], which is partially explained by the banks' practice to provide mortgages based on the ability to repay debt rather than collateral value.

…however, there are signs of growing external vulnerability

A relatively high proportion of France's sovereign debt is held by non-residents – at 64.4% of market debt at the end of May 2015[21]. This external vulnerability implied by the statistics is mitigated by at least three factors:

i. long maturities for public sector debt (almost 7 years)

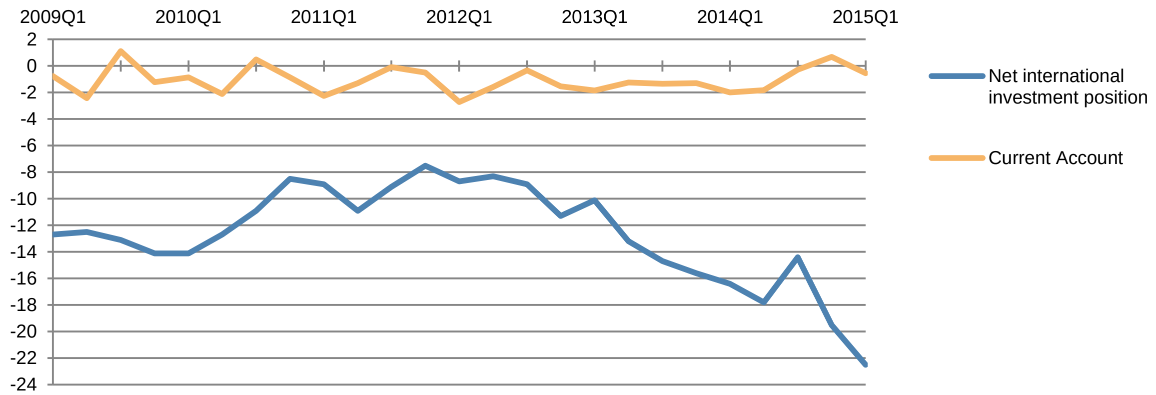
ii. an insignificant portion of FX debt[22]

iii. relatively high, albeit declining, pool of domestic funding resources measured by the gross national savings ratio, which stood at 17.7% at end-2013.

France's net international investment position (NIIP) has been deteriorating over the last years triggered by small, albeit persistent, current account (CA) deficit (table 21) and stagnating GDP, especially in post-crisis period. The CA deficit reflects weakening trade balance associated with faltering competiveness, which is only partially mitigated by surpluses in primary income (incomes from French investments abroad over pace non-residents' income within France) and services. Should the reforms aimed at boosting competiveness prove to be insufficient, the CA deficit could widen further with its ultimate negative impact on the NIIP. At present, however, France's CA and NIIP deficits are moderate compared to countries like Italy or Spain.

19 "France, selected issues", July 2015, IMF country report
20 "France, selected issues", July 2015, IMF country report.
21 Of negotiable government debt
22 " Monthly bulletin", Agence France Tresor, June 2015.

Table 21 : French NIIP and CA, % of GDP



Source : Eurostat

Main contributors to the CA deficits are the general government, which finances its budget deficit with external debt and the non-financial companies suffering from diminishing margins, which resulted in increasing borrowing needs partially covered by the external debt. Dependence on the external financing makes these two sectors of the economy vulnerable to swings in the market sentiments.

Contingent liabilities do not seem to pose a major risk

With its largest banks active internationally France's banking sector accounted for 490% of the country's GDP at the end of 2014[23]. During the financial crisis the French government had to provide support in three cases – Natixis, Dexia and Caisse Centrale du Credit Immobilier de France (3-CIF), which were severely affected by the bursting of a real estate bubble as well as rapid international expansion. This intervention took the form of capital injections and central government guarantees to keep access to wholesale funding. This cost the French taxpayer around 3% of the country's GDP, which is one of the more modest bail-out programmes in EU in the post-crisis period.

Since the crisis potential risk associated with the banking sector has diminished thanks to the following:

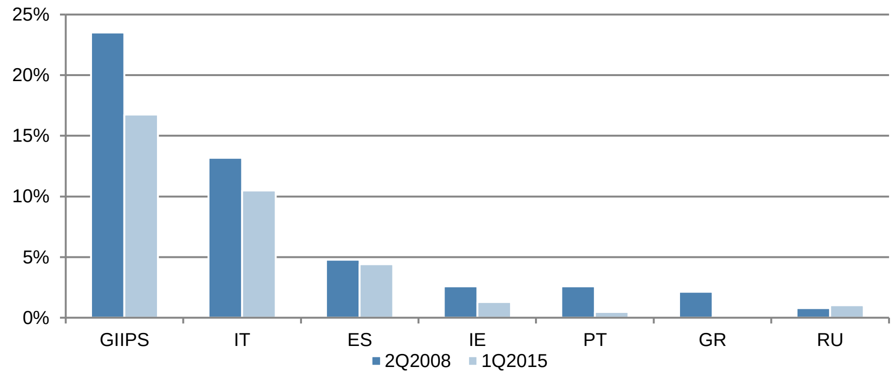
a) The sector was very nimble in reducing its exposures to 'periphery' countries of the EA (although the exposure of the sector to Italy through the strategic commitment to at least two of the banking groups remains substantial – at 10% of total claims); while Russia accounts for 1% (table 22).

b) All of the four large banking groups have been on an improving track in their capitalisation and liquidity ratios, while maintaining sound profitability; ECB's 2014 assessment did not reveal necessity to re-capitalise any of the big banks.

c) The EU Bank Recovery and Resolution Directive (BRRD), which takes effect on 1 January 2015, is likely to limit the government's liabilities associated with troubled banks by passing potential costs to the creditors in addition to shareholders.

23 SNL and Scope calculations.

Table 22 : Consolidated French bank claims, % of total banks claims

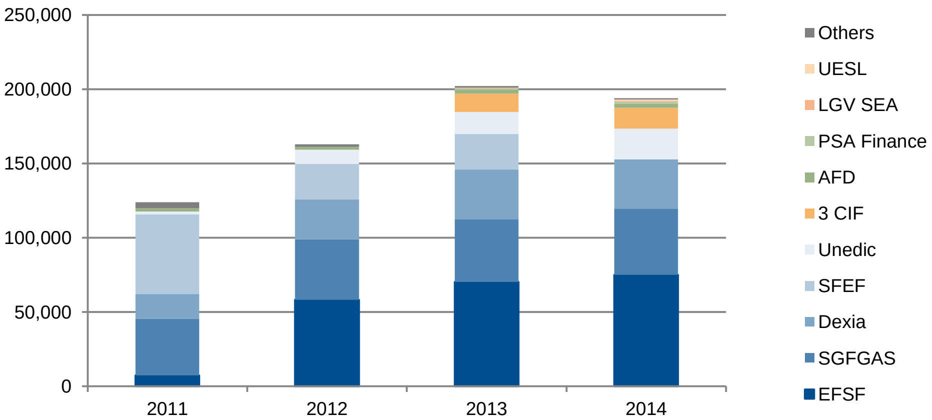


Source : BIS

Other contingencies including guarantees and EA related obligations are manageable

By end of 2014 the amount of guarantees issued by the central government and not included in the debt under the Maastricht definition stood at 4.5% to the country's GDP[24], down from 5.4% at end 2013. Almost a half of the total is split between two troubled banks – Dexia and 3 CIF – which were put through orderly resolution procedures and enjoy guarantees issued by the state on some of their borrowing. A bit less than a half is provided to Société de Gestion des Financements et de la Garantie de l'Accession Sociale à la Propriété (SGFGAS), which guarantees mortgages to low income families issued by the commercial banks. The minor part of the guarantees is associated with development institutions like Agence Française de Développement (AFD) (table 23).

Table 23 : Guarantees issued by the french central government (10 main beneficiaries)



Source : French government

The EA related obligations include France's guarantees and callable capital in the European Stability Mechanism (ESM) European Financial Stability Facility (EFSF)[25], and European Financial Stability Mechanism (EFSM) set up to rescue the EU trouble economies. If measured by drawndown or disbursed loans through these three facilities, France's total exposure to the EA's weaker economies amounts to a manageable 2.6% of GDP[26]. The Greek exposure alone accounts for 1.3% with the rest being distributed among Spain, Cyprus, Portugal and Ireland. The Greek exposure will be increasing given the EA countries commitment to provide a third bail-out package at around EUR 86bn to the country.

If measured by the country's total contribution (disbursed and non-disbursed) to paid-in and callable capital in the ESM, France's maximum exposure could amount to 6.7% of GDP. The ESM is due to become an EU permanent rescue and stability facility: the

24 "Compte general de l'Etat", 2014, p.175
25 France's liability through EFSF is included in the country's overall debt obligation reported by Eurostat (Maastricht debt definition).
26 As of 1 July 2015

EFSF could not issue any new loans since 2013, whereas the EFSM's lending capacity is limited to EUR 60bn, of which EUR 43.8bn has been granted to Ireland and Portugal, and backed by the EU budget.

France's strong government institutions are conducive to economic growth and commitment to honour its debt obligation is high

France's strong government institutions facilitate economic growth. For the last 10 years (since 2003) France has persistently occupied the highest percentile among 189 countries on the rule of law, control of corruption and government effectiveness components in the World Bank World Governance Indicators ranking.

I. Appendix

	2009	2010	2011	2012	2013	2014
Economy and Institution						
Real GDP grow th, %	-2.9	2.0	2.1	0.2	0.7	0.2
Total Population, td	64,775.0	65,095.6	65,419.2	65,718.0	66,017.0	66,259.3
CPI, % y/y	0.1	1.7	2.3	2.2	1.0	0.6
GDP per capita at the market rate, EUR	30,000.0	30,800.0	31,500.0	31,900.0	32,100.0	32,400.0
Unemployment rate, %	9.1	9.3	9.2	9.8	10.3	10.2
GDP per capita on PPP basis, EUR	36,297.4	37,284.3	38,657.2	39,292.5	39,818.2	40,374.5
Size of the economy, share in the w orld's GDP	2.7	2.7	2.6	2.5	2.5	2.4
Openness of the economy, % GDP	49.6	54.0	58.2	58.1	58.0	58.2
Domestic savings ratio, % GDP	20.6	20.2	19.9	20.3	20.2	19.7
Gross national savings ratio, % GDP	17.2	17.4	18.3	17.7	17.7	na
Real GDP volatility, %	1.8	1.6	1.6	1.6	1.6	1.5
Control of corruption index	1.4	1.4	1.5	1.4	1.3	na
Rule of law index	1.4	1.5	1.4	1.4	1.4	na
Government effectiveness	1.5	1.4	1.4	1.3	1.5	na
Real labour productivity (2010=100)	98.1	100.0	101.4	101.6	102.1	101.7
Nominal labour unit cost (2010=100)	99.0	100.0	101.0	103.3	104.3	105.9
Real effective exchange rate*	101.9	97.7	97.0	93.9	95.4	95.9
Banking sector						
Banking sector size (assets, %GDP)	460.0	433.1	449.0	462.5	490.4	491.0
Bank loans % of deposits	105.5	103.5	98.9	98.0	98.0	98.0
External vulnerability						
Current account, % GDP	-0.8	-0.8	-1.0	-1.5	-1.4	-1.0
Gross external debt, % GDP	191.7	200.8	196.0	194.9	190.4	206.8
Net external debt, % GDP	24.6	27.3	27.1	32.3	32.4	35.2
International investment position, % GDP	-14.1	-8.5	-7.5	-11.3	-15.6	-16.4

*Based on CPI against 42 trading partners

Fiscal Accounts and debt, % of GDP

	2009	2010	2011	2012	2013	2014	2015e
General government *							
Revenue	49.6	49.7	50.8	52.0	53.0	53.6	53.3
o/w social security contribution	18.3	18.1	18.3	18.5	18.9	19.2	18.9
Expenditure	56.7	56.4	56.0	56.8	57.0	57.5	57.0
o/w interest payments	2.4	2.4	2.6	2.6	2.3	2.2	2.1
o/w social transfers other than in k	19.1	19.2	19.1	19.6	19.8	20.2	20.0
Primary balance	-4.7	-4.4	-2.6	-2.2	-1.8	-1.7	-1.7
Overall balance	**-7.2**	**-6.8**	**-5.2**	**-4.8**	**-4.1**	**-3.9**	**-3.8**
General government gross debt	79.0	81.7	85.2	89.6	92.3	95.6	97.3
% of general government revenue	159.4	164.4	167.7	172.1	174.3	178.4	182.7
Central Government **							
Revenue	17.9	19.7	18.8	19.3	19.8	19.8	
Expenditure	24.0	25.3	23.2	23.3	23.1	23.2	
o/w interest payment	2.0	2.1	2.2	2.2	1.9	1.9	
Primary balance	-4.1	-3.5	-2.2	-1.9	-1.3	-1.5	
Overall balance	**-6.1**	**-5.5**	**-4.4**	**-4.0**	**-3.2**	**-3.4**	
Central government gross debt	n/a	n/a	69.8	74.3	76.7	79.4	
% of central government revenue	n/a	n/a	371.3	385.3	386.9	400.5	
Memo							
Nominal GDP,EUR bn	*1939.0*	*1998.5*	*2059.3*	*2086.9*	*2116.6*	*2132.4*	*2180.1*

Sources: Ministry of Finance, EC, Eurostat, Central Bank, Scope estimations
* including Central, state and local governments and social security fund
** excluding social security fund

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