

FRANCE: RECONCILING SHORT-TERM AND MEDIUM-TERM CHALLENGES

Stéphane Colliac

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Over the next five years, French economic policy will have to continue to deal with structural issues, such as full employment, the delay of companies in terms of robotisation, the competitiveness of companies and the place of industry. It will most likely also continue to focus, at least in the short term, on supporting household purchasing power, as it has done since 2019. These projects, which will have to be carried out in parallel, will have to be reconciled with the cost of the ecological and energy transition against the background of public debt that has already risen sharply and interest rates that are moving higher, albeit in a controlled way.

France is beginning a new five-year term with a mixed outlook. The feeling of major progress (growth, employment, investment, company insolvencies) compared to the previous five years is confronted with structural trends that have not been reversed (trade deficit, deindustrialisation, burden of housing expenditure, public and private debt), even if exceptional circumstances (Yellow Vest crisis, Covid-19, war in Ukraine) have played an important role.

One of the major changes in the government's action was that the triggering of Covid-19 gave priority to demand-side policies and resulted in the sidelining of the previous economic policy path. The latter, implemented since the immediate post-crisis period in the euro zone, was based on two pillars: improvement of the competitiveness of companies and consolidation of public finances. One of the results of this policy has been to reduce the disadvantage in terms of unit labour costs as well as the tax burden (especially for companies).

However, this progress still seems to be too partial, or even reversible. France is an open country and, against this backdrop, has lost more positions in a number of areas than its euro zone partners, despite having the same currency. The trade deficit is one of the main markers of these declines, which have increased further in recent quarters (*Chart 1*).

Admittedly, the rise in energy prices has largely contributed to widening the trade deficit since mid-2021, but over an average period, the main change is the unparalleled size of the deficit on manufactured goods (nearly EUR 50 billion in cumulative terms over 12 months in 2021, compared with EUR 20 billion in 2016 and EUR 24 billion in 2011). This deficit reflects a decline in industry, which is greater than in other euro zone countries. This dual problem of the trade deficit and deindustrialisation is an important black spot in the picture of the French economy that can be painted today, in addition to fiscal imbalances.

At the start of a new five-year legislature, we should stop and take stock of the country's situation, as well as the challenges that will have

to be resolved over the next five years. As is often the case, but even more so than usual, it will be a question of combining and resolving contradictions between the long and short term in order to deal with the structural challenges that will mark out the next decade (energy transition and pension reform in particular), while at the same time responding to the consequences of numerous shocks that are by their very nature difficult to predict (Covid-19, war in Ukraine).

In the rest of this article, we will see in the initial section that growth over the last five years has mainly been the result of a process of an accumulation of factors (work, capital). In the following two sections, we will see that the keys for the next five years will be to reconcile a short-term priority linked to purchasing power while preparing for the future, whether in terms of climate or energy transition or France's position (competitiveness and budgetary challenges in particular).

More jobs, more investment, but not more productivity

French economic demographics are improving. More jobs, more companies, fewer company insolvencies: all remarkable dynamics seen between 2017 and 2022. All would be well in the best of all possible worlds if productivity gains were not absent and if the rise in corporate investment did not reflect a faster depreciation of capital (with a relatively moderate gain in capital stock).

An accumulation of production factors, as rarely seen in recent history

The first of the favourable developments from which France has benefited in the last five years is the dynamic nature of its labour market¹. The employment rate reached its highest level since the seventies and the unemployment rate is at its lowest since 2008 (*Chart 2*).

¹ For more information, see: Colliac Stéphane, "French labour market: keeping the momentum", EcoFlash No. 22-06, BNP Paribas

FRANCE: TRADE BALANCE BY SECTOR

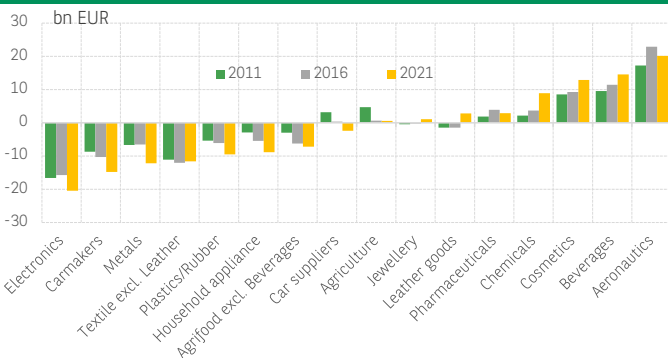


CHART 1

SOURCE: CUSTOMS, BNP PARIBAS CALCULATIONS

FRANCE: EMPLOYMENT AND UNEMPLOYMENT RATES (% OF ACTIVE POPULATION)

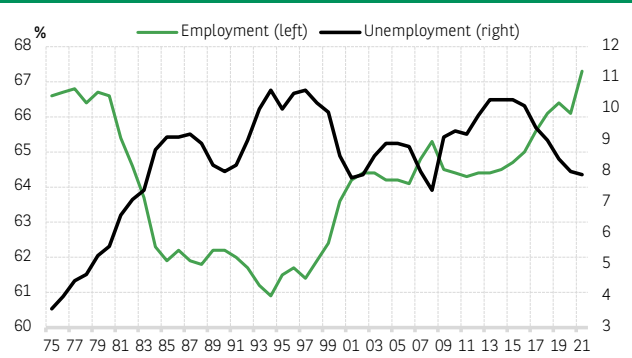


CHART 2

SOURCE: INSEE, DARES



Job creation has been high since 2017. The Covid period certainly interrupted the momentum, but the recovery seen thereafter was substantial, half of which was generated by the sectors most affected by Covid (temporary work, accommodation and catering, and the entertainment industry). By excluding these three sectors from the analysis (Chart 3), the recovery is all the more visible, allowing the impact of the 2008 crisis on the unemployment rate to be erased.

At the same time, the rise in the employment rate (Chart 4) can be explained by the correction, still partial, of two structural problems: the low employment rates of the youngest (15-24) and oldest (55-64) members of the population. While it has remained stable in recent years, the employment rate of young people has benefited from the increasing use of apprenticeship contracts (718,000 in 2021, twice as many as in 2019). As far as older people are concerned, it seems that France is on the same trajectory that was started by Germany in the mid-2000s and has led to a much higher employment rate in Germany today. Indeed, the forthcoming pension reform and the extension of the contribution period that it implies should have an upward effect on the employment rate of 55-64 years old, as have previous reforms in this direction.

However, the employment rate in France is still almost eight percentage points lower than in Germany, showing how far France still is from full employment.

At the same time, companies have invested heavily, following a long period (2008-16) where this investment remained significantly more moderate (Chart 5). This growth accelerated following the introduction of tax incentives (additional depreciation measure, allowing a 40% increase in the depreciation of an investment deducted from the result, introduced by the Hollande administration), as well as the increase in the rate of production capacity utilisation as a result of vigorous GDP growth from the second half of 2016. The Covid period temporarily interrupted the momentum, but did not break it: the two levers of investment in digital and in capacities did not fade away.

This development took place against a favourable economic backdrop, which saw both an increase in business creations and a decrease in company insolvencies². Thus, the cumulative 12-month figure for company creations increased by 42% in five years, at the end of 2021. Corporate insolvencies fell by 15% between the end of 2016 and the end of 2019, and even more with the implementation of the 'whatever it takes' approach: between the end of 2019 and the end of 2021, they fell by almost half again.

Capital stock and labour productivity: two missing links that adversely affect growth

However, despite a clear momentum in employment and investment, French growth has not increased as much as it might have.

An initial reason for this concerns corporate investment, which has not been transformed into capital stock with the same intensity as in the past. One explanation is the growing difference between gross corporate investment, which has actually reached a record level, and net corporate investment, which is far from it (Chart 6). This difference corresponds to the faster depreciation of assets, which reflects their earlier obsolescence and therefore a tendency for productivity to decline earlier. The larger share of investment in services, and particularly in information and communication, is not unrelated to this faster depreciation.

² For more information, see: Colliac Stéphane, "French companies: improved business environment but mind cyclical risks", EcoFlash No. 22-04, BNP Paribas

FRANCE: NET JOB CREATIONS IN THE PRIVATE SECTOR

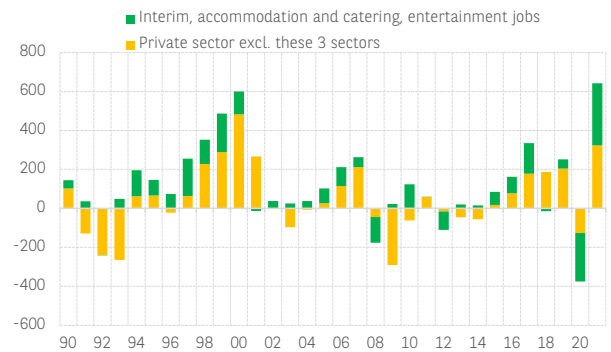


CHART 3

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

FRANCE: EMPLOYMENT RATE BY AGE

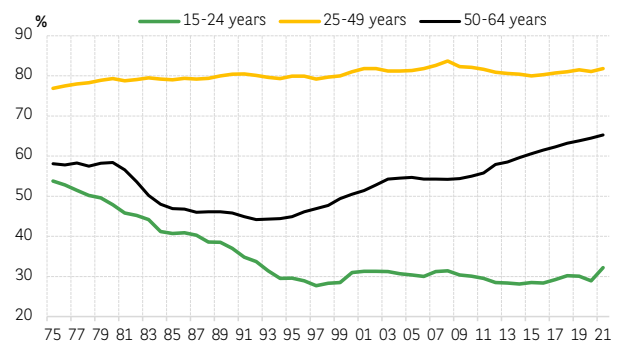


CHART 4

SOURCE: INSEE

FRANCE: CONTRIBUTIONS TO GROWTH OF THE INVESTMENT OF NON-FINANCIAL CORPORATIONS

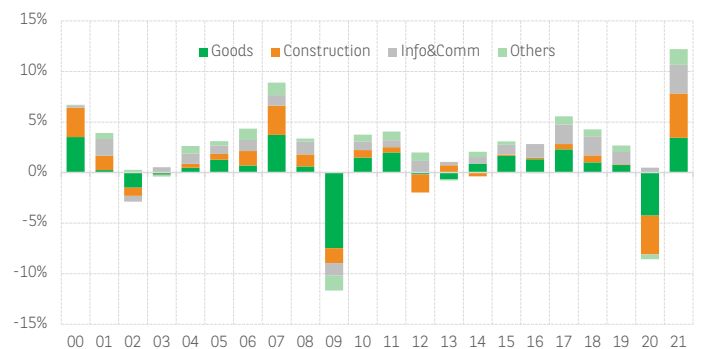


CHART 5

SOURCE: INSEE

The increasing importance of services in the economy can also explain low productivity growth in France³. Not only is France faced with a smaller share of its industry in its GDP than its euro zone neighbours, but this gap has also widened. The share of services in GDP, which is

³ See Sode Arthur, "Comprendre le ralentissement de la productivité en France" ("Understanding the slowdown in productivity in France"), note d'analyse No. 38, 2016, France Stratégie



a reflection of this, has therefore continued to rise. Ultimately, labour productivity (GDP per hour worked) in France even fell slightly behind that of Germany in 2021, something that has not happened since 1981 (Chart 7). This occurred in a context of enriching the job content of growth in France.

One element to explain the recent sluggishness of labour productivity in France is also the importance of sectors that are still under-producing today compared to their pre-Covid level of activity, mainly the automotive and aeronautics sectors, which has an impact on their labour productivity and, given the importance of these sectors, has an adverse effect on the overall average.

Addressing the 'end of month feeling' in a finite world

If there are two themes that have structured economic policy for the past five years (and are expected to continue to do so), it is the purchasing power of households and the adaptation to climate change. However, it can be difficult to reconcile these two issues: the rise in energy prices is the best incentive for energy frugality, but at the same time it is detrimental to purchasing power.

The issue of purchasing power against a backdrop of an inflationary shock

Since 2018, France has seen a one-off inflationary shocks (the price of oil reached USD 80 in 2018 and inflation peaked at 2.3% in August 2018), the Yellow Vest crisis, the Covid-19 pandemic and now an inflationary shock of a magnitude unseen for nearly 40 years. Economic policy has been forced to react urgently in order to support household incomes affected by this succession of difficulties, whether through direct subsidies or limits on rising energy prices.

The inflationary shock is not over, which should result in economic policy continuing to address its consequences. The return of inflation to such an extent was largely unanticipated. It is expected to reach 5.3% on average in 2022, a level not seen since 1985. This inflation is primarily energy-related. We simulated the impact of oil price rises on domestic inflation, using a markup model to describe the dynamics of the transmission from one to the other⁴.

This estimate suggests that the rise in the price of oil helps to explain 3.2 points of average inflation in 2022 and that inflation would therefore have reached 2.1% without this rise, a figure that would have enabled positive growth in household purchasing power to be maintained in 2022.

Inflation is accelerating against a backdrop of wage growth moderation observed for almost a decade. By comparison, the 1970s were marked by a rise in purchasing power, despite often double-digit inflation, because wages were indexed (and often grew even faster). In 2022, the SMIC (French minimum wage, which continues to be indexed to inflation) will have been revalued three times (+0.9% in January, +2.65% in May and +2.1% in August). Industry wages are expected to increa-

4 The equation used is as follows (logarithmised to linearise it): $p = \ln(\mu) + \beta f$, with $\ln(\mu)$ being the constant (later noted as α), domestic prices (p), the oil price expressed in EUR (f). A statistical analysis shows the existence of co-integration. The following error correction model is used: $dpt = \Phi(\rho t - \beta t - \alpha) + \gamma dpt + \zeta dft + \epsilon t$ (this last term corresponding to the residual).

This formulation measures both the intensity and the speed of transmission by calculating the impact of an initial 10% increase in the price of a barrel of oil expressed in EUR from month to month. The coefficient ζ , attached to this dft change, gives the value of the instantaneous impact. Then, the interplay of the long-term relationship $\rho t - \beta t - \alpha$ and past inflation $dpt - 1$ adds additional inflation from month $T+1$, and will continue to do so in the following months, until cumulative inflation reaches the value of the coefficient β of the long-term relationship.

FRANCE: CORPORATE INVESTMENT RATIO (GROSS VS. NET)

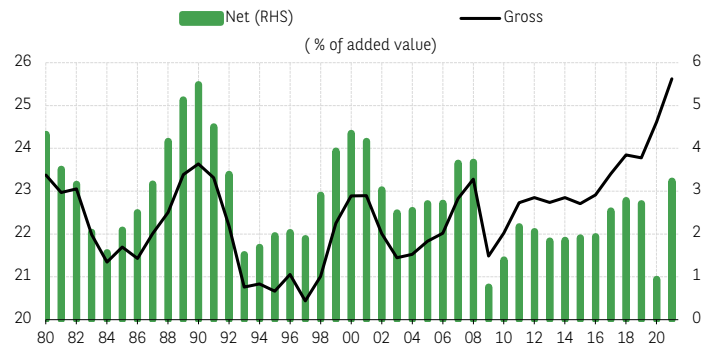


CHART 6

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

GDP PER HOUR WORKED): FRANCE VS. GERMANY

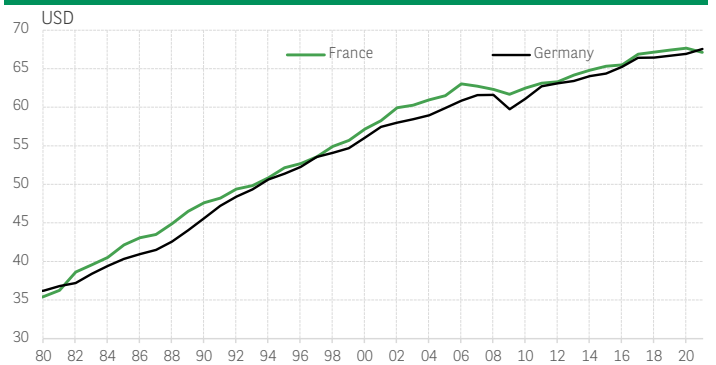


CHART 7

SOURCE: OECD

singly catch up with inflation. However, the Banque de France estimated in May 2022 that industry negotiations in 2022 should lead to a 3% increase in industry minimums, compared to 1% for negotiations in 2021⁵. However, this development is likely to be an afterthought, as the rise in energy prices (the main cause of inflation) occurred mainly between the summer of 2021 and March 2022. Moreover, the transmission of these minimum wage increases to all wages is expected to remain partial. The result is a loss of purchasing power in 2022, which we estimate at 0.8% (Chart 8)⁶.

The tariff shield on gas and electricity prices, the rebate on fuel prices, subsidies (energy and inflation vouchers) and the various measures to raise incomes (pensions, civil servants, social benefits), decided to counter this shock, should ultimately limit the loss of purchasing power more than in any other European⁷ country. Indeed, without these

5 Gautier Erwan, "Negotiated wage rises for 2022: the results so far", Bloc-notes Eco, post No. 269, Banque de France

6 The main measures of the EUR 20 billion plan announced by the government on 7 July in favour of purchasing power are included in our calculations (pensions, civil servants' salaries, social benefits, food aid, tariff shield). It should be noted that the government assumes that they will allow for a 0.5% increase in purchasing power in 2022.

7 Here, we are updating the estimate made for 2022 according to the methodology explained in: Colliac Stéphane and Derrien Guillaume, "Energy price inflation in the eurozone: government responses and impact on household purchasing power", EcoFlash No. 22-09, BNP Paribas. Estimates of changes in purchasing power with and without government measures for previous years are taken from: Colliac Stéphane, "French households: purchasing power is under pressure", EcoFlash No. 22-02, BNP Paribas



measures, we estimate that French households would have suffered a 3.1% decline in their purchasing power in 2022.

It should also be noted that the Covid period continues to affect the evolution of household purchasing power. Additional social benefits paid in 2020 under the short-time working scheme contributed nearly 4.4 points of purchasing power, preventing any loss for households, while the gradual cessation of these measures has, conversely, weighed statistically on this same purchasing power of households in 2021-22 (to the tune of 2.2 points in 2021 and 1.2 points in 2022, according to our estimates) through a reduction in social benefits. For 2022, the net effect between anti-inflation measures and the end of the ‘whatever it takes’ approach remains positive by almost 1.1 points (Chart 9).

In 2019, the implementation of measures in response to the Yellow Vest crisis (including the increase in the activity bonus) had already visibly supported household purchasing power. At the time of writing, the government had not yet announced its strategy for 2023, but it appears likely that some measures will be extended at least partially, such as the capped increase in electricity prices, while the rollout of a food voucher scheme would cost almost EUR 5.8 billion.

This situation of declining purchasing power is very different from that of 2012-13, when it was the increase in taxation adopted to reduce the public deficit (in the context of the euro zone crisis) that had an adverse effect on household purchasing power. However, the current context of tightening monetary conditions in the United States and the euro zone implies a rise in long-term interest rates. The extension of this movement could limit the government’s budgetary room for manoeuvre again in the long term.

Growth partly restrained

The term ‘growth’ is relatively absent from public debate. Nevertheless, it is more difficult to meet expectations without growth, whether in terms of job creation, wage increases, aspirations in terms of living standards or purchasing power, or the financing of the energy transition.

While the objectives linked to the ecological transition are expected to result in more modest growth, it may be interesting to note the barriers to growth already in place.

These are linked to an existing demand, but which remains partly latent because the supply is unable to meet it. This results in less activity than the demand could have generated. Residential construction is an area where these barriers are significant, whether it be the scarcity of available land or the cost and time associated with obtaining a building permit. Moreover, after the gradual implementation of local urban planning after 2000, the number of individual housing units under construction tended to decline, but without the upward trend in collective housing fully offsetting it.

Although these problems with new housing are structural, it seems that they have become more pronounced in recent years. Rarely have so many households wanted to buy a property, judging by the Insee household survey (Chart 10).

At the same time, transactions in existing homes exceeded the record level of 1.2 million transactions over a 12-month cumulative period in September 2021 and the proportion of households intending to spend on home improvements reached a record level of 28% in the same month. On the other hand, the gross fixed capital formation of households in construction has increased only marginally in parallel, in contrast to previous property booms (notably that of the 2000s), reflecting a less new-build-oriented activity (Chart 11).

HOUSEHOLD PURCHASING POWER OF THE GROSS DISPOSABLE INCOME CHANGE

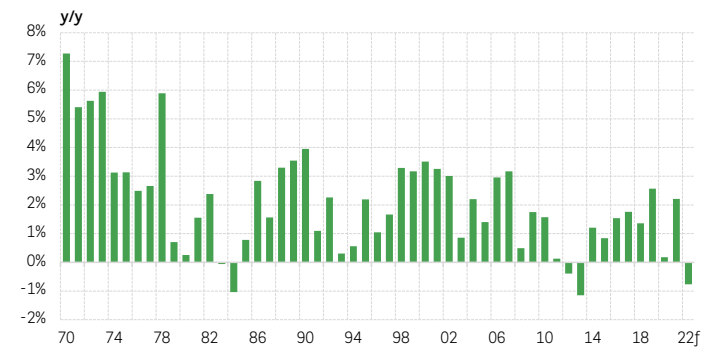


CHART 8

SOURCE: INSEE, BNP PARIBAS CALCULATIONS & FORECAST

FRANCE: PURCHASING POWER ANNUAL CHANGE EXCLUDING AND INCLUDING REDISTRIBUTION

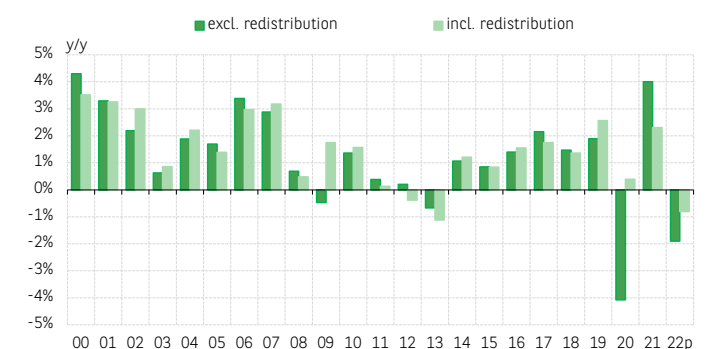


CHART 9

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

FRANCE: HOUSEHOLD HOUSING PURCHASE INTENTIONS

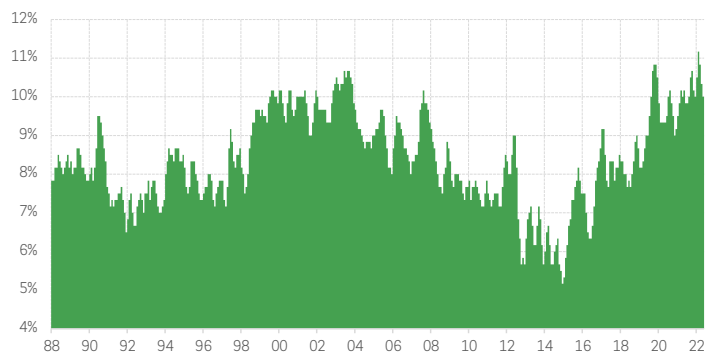


CHART 10

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

The automotive sector is another area where surveys show that household spending intentions remain relatively strong, even if they have been eroded. However, new vehicle registrations are still almost a third below their pre-Covid level. This problem is not specifically French, as it relates to manufacturers’ supply constraints, which have been reinforced by the switch to electric vehicles. Here again, households have turned to the second-hand market to make up for the



lack of and delays in delivery of new vehicles, even if this has its limits since recent second-hand vehicles are also becoming scarcer.

In these two areas, construction and the automotive sector, supply constraints therefore limit production. By comparing household investment in construction and automobile production (in value terms, in the sense of GDP) observed against counterfactuals⁸ associated in the past with the current level of demand, it appears that the loss of activity, which has increased over time, stands at almost 1.5 points of GDP in the first quarter of 2022 (Chart 12).

Short- and long-term challenges around the energy transition

One of the challenges in the face of climate change is to develop goods and a way of producing them that require less energy or less polluting energy, or even to transform existing goods so that they consume less energy. The same effort in terms of energy efficiency is also needed on the consumption side.

In this respect, the ratio of 1 to 3 that now exists between new housing starts and transactions in existing buildings shows that the issue of thermal renovation of buildings is essential, even though there is a certain delay at the moment. Indeed, although in 2021 644,000 thermal renovation projects were financed by the *MaPrimeRénov'* tool, only 2,500 homes have been upgraded from an E, F or G energy performance rating according to a report by the Cour des Comptes (compared to a target of 80,000). A penalising factor is the rise in the cost of building materials, which brings with it the rise in the cost of building maintenance and improvement work (+8.4% year-on-year in the first quarter of 2022).

More generally, the energy mix is a fundamental element of the ecological transition. Electricity generation must meet both a quantitative and qualitative objective. The qualitative aspect is obvious insofar as the reduction of CO₂ emissions is essential to limit global warming. The quantitative aspect is equally decisive. The additional electricity requirement is expected to increase electricity consumption to 645 TWh in 2050 according to the *Réseau de Transport d'Électricité* (RTE, "Electricity Transmission Network") reference scenario, compared with 468 TWh in 2021.

This implies breaking with the recent dynamic, which saw electricity generation reach a maximum level of 582 TWh in 2013 and 2018, in order to avoid France becoming a net importer of electricity (Chart 13). As regards nuclear power, there is even a decline in production, with a peak observed in 2005. Investment in new capacity has been rather limited and concentrated on renewable energies. In fact, the nuclear production potential is rather old, with plants built for the most part 30-50 years ago. As a result, the increase in renewable energies is already unable to compensate for the recent decline in nuclear power generation. The ageing of the nuclear production potential already represents a cost: it required the increased use of more polluting thermal energy (coal and gas power plants) during the winter of 2022 and pushed up the cost of kWh, an effect that could be repeated in the future and limit the competitive advantage that France had, thanks to nuclear energy, with regard to the production cost of its electricity.

⁸ With regard to household investment in construction, in 2017-22, the counterfactual replicates the increase observed in the early 2000s during a previous boom in the sector. The Chart shows the observed difference in the evolution of the investment and this counterfactual. For the automotive sector, what is shown in the chart is the difference between the production observed over 2020-2022 and its average level in 2019 (using production statistics in value terms in the sense of GDP).

FRANCE: HOUSEHOLD INVESTMENT IN CONSTRUCTION

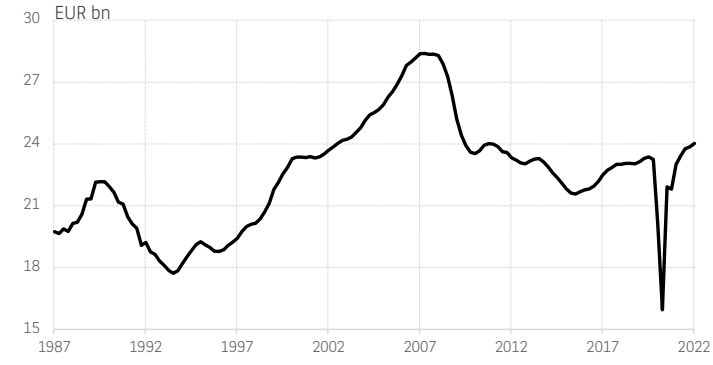


CHART 11

SOURCE: INSEE

FRANCE: CUMULATIVE GDP LOSS IN THE CONSTRUCTION AND CAR SECTORS AS A RESULT OF SUPPLY-SIDE CONSTRAINTS

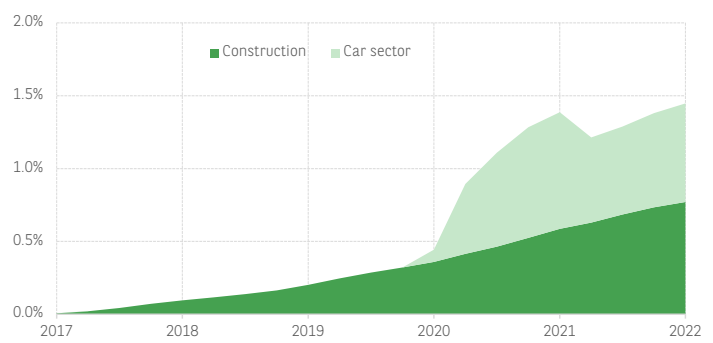


CHART 12

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

FRANCE: ELECTRICITY PRODUCTION (TWH)

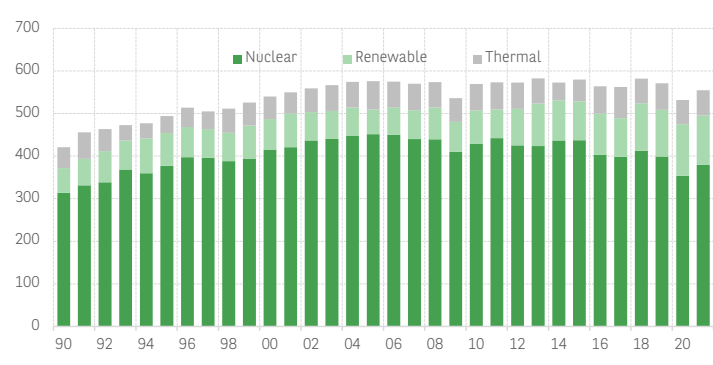


CHART 13

SOURCE: INSEE

France will therefore need to make substantial investments. For example, the planned construction of six new EPR nuclear reactors is expected to cost almost EUR 50 billion. At the same time, the current rise in construction costs may complicate investment efforts in renewable energies in the short term, with, for example, +33% y/y in April 2022 for maritime civil engineering works and +15.5% for land-based metal structures, according to Insee, complicating the implementation of these projects.

Maintaining France's position in the concert of nations

The feeling that France is in decline has often accompanied its history over the last 20 years. In fact, this period has seen a marked decline in the share of industry in GDP, which was seen as a driving force behind the success of the dominant exporting nations (Japan, Germany and South Korea in particular), all of which have retained a sizeable industrial sector. Among the elements that could justify a relative disadvantage for France, the cost of labour and corporate taxation have been cited in the past. Progress has been made but it is still partial. It may be necessary to reduce the tax burden on French companies even further in order to bring it closer to that of their European competitors, especially Germany. However, in order not to worsen the public deficit, this will require budgetary savings, which will be made possible by reforms capable of reducing the extent of public spending in the economy: an initial objective of the previous mandate in 2017, but that the 'whatever it takes' approach has forced to be put on hold.

Industrial renewal: a challenge of scale

Corporate investment is the demand item that has shown the earliest rebound post-Covid. This can be explained by the difficulty that companies have in meeting demand and by the need to develop their production capacities. Indeed, they are facing ongoing supply problems. Supply chain difficulties are one manifestation of these supply constraints, while recruitment difficulties are another.

As measured by order books, demand is now similar to 2018, despite the slight decrease in order books due to the decline in household consumption since the beginning of 2022. Industrial production capacity, on the other hand, is still quite significantly lower than in 2018 (Chart 14)⁹. The Covid-19 crisis has in fact undermined the initial results obtained between 2016 and 2018 in terms of reindustrialisation. The initial shock (from pre-crisis level to trough) generated by Covid-19 on production capacity appears to be of a similar magnitude to the 2008-09 crisis (a gap between the pre-crisis level and the trough of the curve that follows). Its ultimate net effect can be understood as the gap between the pre-crisis level of production capacity and what it is at the end of the crisis. Yet, this gap is smaller following Covid-19, compared to what had prevailed in 2009. This is a sign of the effectiveness of the 'whatever it takes' approach: in particular, the deferral of charges, cash-flow support and short-time working measures have helped to safeguard companies and thus reduce the risk that the mothballing of activities linked to the lockdowns will not be transformed into permanent destruction of capacities.

The role of crises in deindustrialisation and the difficulty of recreating these activities afterwards are such that they justify the policies implemented. However, production capacity has decreased and some sectors such as metallurgy, paper/cardboard, and plastics/rubber, have reported a lack of production capacity post-Covid in a context of high demand. This gap has resulted in a low inventory level, which still persists in the plastics sector (Chart 15).

Companies and competitiveness: in midstream

Competitiveness is a concept that has several meanings, including aspects linked to production costs and others that exclude costs. These are linked to the range of products, in particular patents, the rate of equipment in advanced technologies (robots for example) and more generally to the skills that enable countries that possess them to have

⁹ Production capacity is calculated according to the methodology used in Colliac Stéphane, "French industry: a challenge of scale", EcoFlash No. 22-01, BNP Paribas

FRANCE: PRODUCTION CAPACITY IN THE INDUSTRY

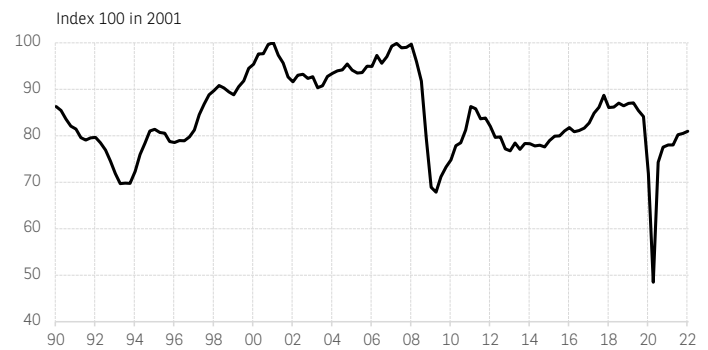


CHART 14

SOURCE: BANK OF FRANCE, INSEE, BNP PARIBAS CALCULATIONS

INVENTORY LEVEL IN FRENCH MANUFACTURING SECTORS

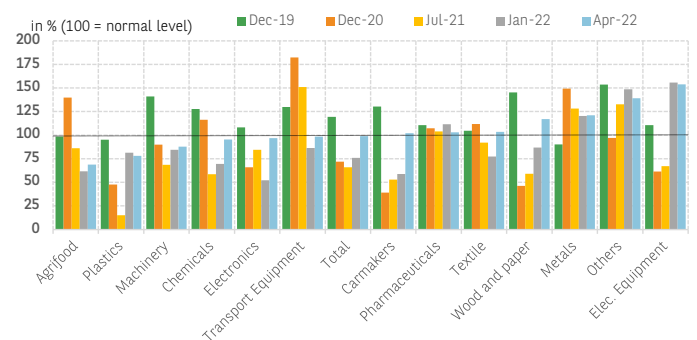


CHART 15

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

little competition on a significant portion of their exported goods (high value-added goods), of which Japan, Germany and South Korea are examples. Their exports are relatively complex goods, and therefore have little competition. This is less the case for France, which has even fallen back over the last 10 years in international rankings in this area (such as that of the Harvard Growth Lab), even falling behind Italy. This decline is reflected in a presence in goods more exposed to competition, which explains the fact that France's export market shares may have been further weakened by a disadvantage in terms of cost competitiveness.

The cost of labour has long been a disadvantage, particularly in relation to Germany (Chart 16). The gap has particularly increased in 2005-06, just before the great recession. This relative advantage of Germany, which has existed for almost 15 years, saw the German trade surplus grow sharply while the French trade deficit widened. Labour costs on both sides of the Rhine are now relatively similar, but the deindustrialisation that has occurred has a hysteresis effect: it is now difficult to rebuild industries in France that have been largely relocated.

Another important area of cost competitiveness is taxation. The tax burden on companies in France (employers' social security contributions, corporate taxes and production taxes net of operating subsidies) has been reduced over the last five years, with the implementation of the Employment Competitiveness Tax Credit (CICE) and the reduction in corporate taxes voted for under the Hollande administration, fol-



lowed by the reduction in production taxes. The latter, together with the increase in operating subsidies linked to the ‘whatever it takes’ approach, contributed to the fall in net taxation on companies in 2021, reaching 56% of gross operating surplus (GOS). However, this tax burden is expected to reverse in 2022, rising to 67% of GOS (Chart 17). This level is still higher than that prevailing elsewhere in Europe and mainly reflects the size of the wage bill. It is the strong job creation at the end of the Covid period, which implies a significant increase in the wage bill (and therefore in the wage-related contributions), that is leading to this upturn in the tax burden on companies.

Alongside an ongoing costly investment effort that will have to be continued (due to the backlog in terms of equipment and capacity), reducing the tax burden faced by companies could prove to be judicious so that they can respond to the following problems:

- An increase in net pay seems to be the best answer to purchasing power problems. However, this increase should be made on a relatively unchanged gross salary basis, so as not to damage cost competitiveness, and would therefore require a reduction in charges (employee or employer).
- In addition, a further reduction in production taxes would reduce the additional tax burden that remains in this area compared to other European countries.

A precondition for further tax cuts, however, will be to create the necessary space in public finances, a point to which we return in the next section.

Finally, companies may need room to manoeuvre to cope with the rise in commodity prices, which is beginning to have an impact on cash flow and margins. In this context, French companies could become more vulnerable to a rise in insolvencies. Insolvencies reached the level of 27,000 units in 2021, almost half the number in 2019, before the Covid crisis, mainly due to the positive effect of the ‘whatever it takes’ approach¹⁰. Two elements that could have a negative impact on companies in the future are two forms of debt that they face:

- Non-financial corporate debt: in France, it is structurally higher than that of neighbouring countries in the euro zone and the addition of loans guaranteed by the State has further widened the gap. An additional element is intra-group loans, which are not included in Banque de France statistics but are included in BIS statistics (Chart 18).
- Inter-company credit, through the payment terms that are granted, and more broadly the working capital requirements (which correspond to the difference between customer and supplier credits plus the financial need associated with the change in inventories). These working capital requirements are expected to increase and to have an increasing impact on cash flow as companies rebuild their inventories. In April 2022, according to our estimates, inventories in the manufacturing industry returned to a normal level (Chart 15), whereas they were still only three-quarters of that level in January. Inventories now represent 60 days of turnover compared to 45 at the beginning of the year, which is equivalent to an additional EUR 45 billion in working capital requirements according to our calculations. This helps to explain why, in addition to the rise in energy costs, corporate cash flow has gone from a high level at the beginning of 2022 to a slightly below normal level since April, according to both the AFTE-Rexcode and Insee surveys.

¹⁰ See Colliac Stéphane, “French companies: improved business environment but mind cyclical risks”, EcoFlash No. 22-04, BNP Paribas

UNIT LABOR COSTS: FRANCE VS. GERMANY

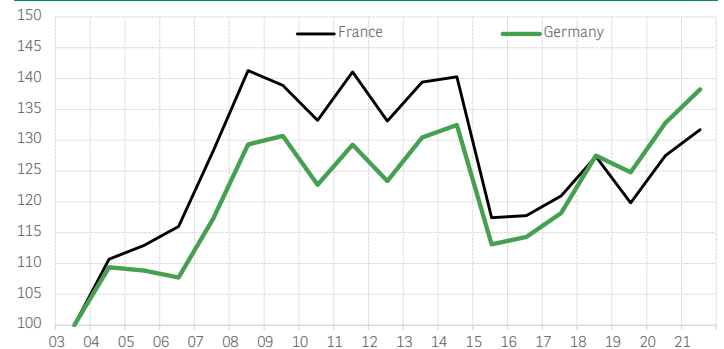


CHART 16

SOURCE: OECD

FRANCE: CORPORATE'S TAX CONTRIBUTIONS IN % OF THE GROSS OPERATING SURPLUS

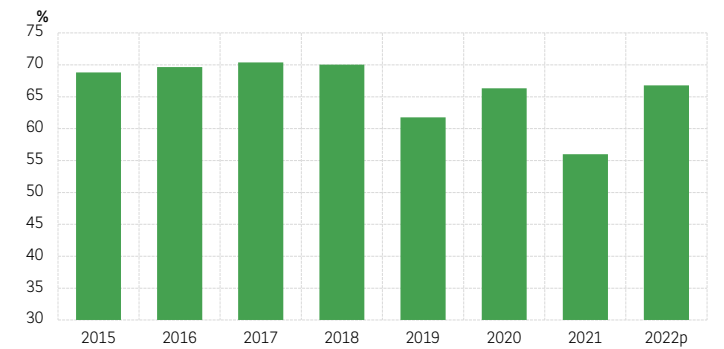


CHART 17

SOURCE: INSEE, BNP PARIBAS CALCULATIONS

FRANCE: BANK CREDIT TO THE NON-FINANCIAL CORPORATES EXCL. AND INCL. INTRACOMPANY LOANS (% OF GDP)

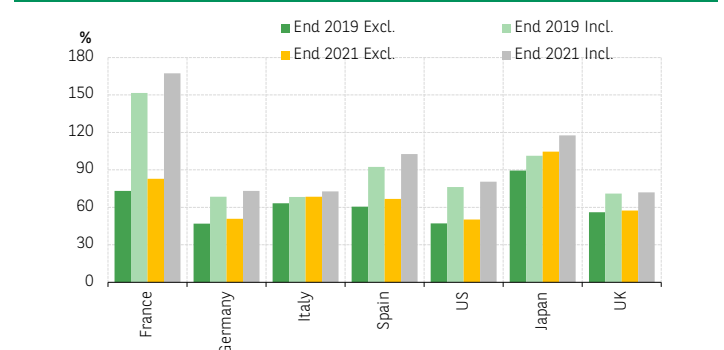


CHART 18

SOURCE: BANK OF FRANCE, EUROSTAT, BRI

Public finances: providing the means for a further tax cut

The State budget is subject to strong but simple constraints: any deficit increases the debt; any tax cut that is not balanced by an increase in another tax or an equivalent reduction in expenditure leads to an increase in the deficit.

Favourable economic conditions made it possible to reduce the public deficit between 2017 and 2019, while allowing for an overall reduction in taxes during the previous parliamentary term, to a similar extent between households and companies (*Table 1*).

The scale of the 'whatever it takes' approach between 2020 and the summer of 2021 has led to a sharp increase in public debt. With the Covid pandemic now having less impact on the economy, fiscal consolidation is back on the agenda. It will be a question of carrying out reforms that will help to reduce the structural deficit and the public debt ratio, while at the same time managing to lighten the heavy burden of taxation.

The reduction in debt servicing is a key feature of recent years. It has freed up budgetary room for manoeuvre, which has been used in particular to support household purchasing power. However, if debt servicing has been little affected by the increase in the level of public debt, it is because interest rates have fallen considerably. While interest rates are now rising, debt servicing is expected to increase again, the question being by how much.

The current rise in interest rates is remarkable because it comes after a very long period of downward trend, in parallel with, and even more than, inflation (*Chart 19*). The resulting decline in real yields reflects the downward trend in real growth also seen over a long period.

Today, the rise in inflation is such that monetary policy expectations are tightening, which is reflected in nominal interest rates (with a 10-year rate of 1.65% on 15 July 2022). In the short term, the impact of this increase in nominal rates on debt servicing is considerably alleviated by the fact that the average maturity of negotiable debt is 8.5 years according to the AFT. Moreover, the AFT issued its OATs at an average rate of 0.88% over the first six months of 2022, which is still below the average rate of 1.3% for the stock of French negotiable debt at the end of 2021. Finally, our interest rate and inflation scenarios imply that the curves should only cross (and the real interest rate become positive again) by the third quarter of 2023.

However, it should be noted that a permanent rise in interest rates cannot be imagined all other things being equal. It assumes a parallel increase in nominal growth: higher rates with unchanged nominal growth would imply the need to ease monetary policy later, which would push rates down at some point.

Under the assumption of a permanent 100 basis point rise in interest rates over the next five years, debt servicing would increase from 1.5% to 1.8% of GDP¹¹, a measured increase consistent with that of the apparent interest rate, which would only be gradually affected, reaching around 1.7% in 2027. It would then approach the inflation rate as we anticipate it (in the sense of the GDP deflator, a more relevant indicator for public debt dynamics than consumer prices), which implies an apparent real interest rate that moves from a negative level to a value close to zero. According to our forecasts, it would therefore remain well below the expected real GDP growth, which allows the automatic dynamics of public debt to remain favourable (*Chart 20*).

At the same time, it appears necessary to generate new budgetary room for manoeuvre to continue reducing taxation without damaging the major budgetary balances, which was foreseen in the programme of the Presidential candidate, Mr Macron, a task which is set to be difficult. In France, social expenditure as a percentage of GDP is above the European average, 31% in France compared with 26.9% on average in the EU according to Eurostat in 2019 (the last year in which the

11 The impact of inflation on debt servicing linked to inflation-indexed bonds, which is significant in 2022, should gradually dissipate later in a scenario of gradually normalising inflation (*Chart 20*).

FRANCE: INFLATION RATE AND OAT 10-YEAR YIELD

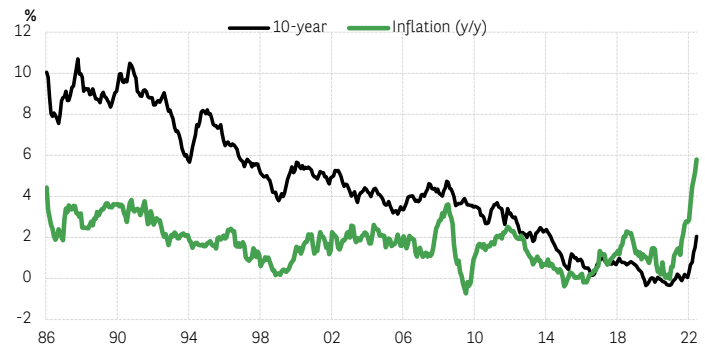


CHART 19

SOURCE: MACROBOND, BNP PARIBAS

FRANCE: NOMINAL GDP GROWTH, APPARENT INTEREST RATE AND GDP DEFLATOR CHANGE

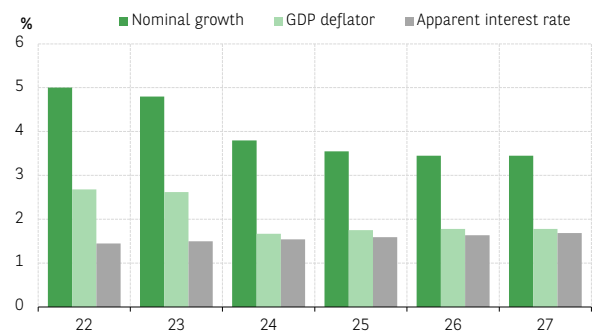


CHART 20

SOURCE: MACROBOND, BNP PARIBAS' FORECAST

data is not disrupted by the Covid period). Pensions are the largest item (13.5% of GDP according to Drees¹²), again among the highest in Europe, consistent with a legal retirement age among the earliest in Europe, but without this being the result of a lower average life expectancy. This legal age is set at 62 in France, compared with 65 in Germany (and due to rise to 67) and 67 in Italy, while life expectancy is respectively 82.3, 81.1 and 82.9.

The ageing of the population is likely to weaken the pay-as-you-go system, with France's ratio of active workers to pensioners falling from 1.8 to 1 in 2021 to 1.5 to 1 in 2035 according to COR (and to almost 1.2 to 1 in 2070 according to Insee's population projections). However, this balance is expected to deteriorate less than in other countries, for example in Germany, where the prospect of having 1 active worker for 1 pensioner in 2035 existed before the last reform.

A further extension of the contribution period in France would allow for an increase in the employment rate of 55-64 years old, as well as some budgetary room for manoeuvre: this could allow a reduction in taxation, which is still higher in France, particularly for companies. Social security contributions account for 70% of their tax contributions and, as they are levied on labour, they are detrimental to the latter in terms of cost (even if the financing of dependency has so far been cited by the government as having to benefit from the savings made through the pension reform).

12 Direction de la Recherche, des études, de l'évaluation et des statistiques du Ministère de la Santé



The period ahead is fraught with uncertainty, particularly as regards the longevity of current elevated inflation and consequently the extent of future monetary tightening and the level that long-term interest rates will ultimately reach. A more pronounced impact would complicate the resolution of the equation between short-term support

(for purchasing power and activity) and compliance with long-term objectives, particularly in terms of budgets and ecological transition.

Article completed on 15 July 2022 x
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SUMMARY OF FISCAL MEASURES 2018-22

EUR billion	2018	2019	2020	2021	2022
Total household measures	-1.1	-10.3	-10.0	-1.0	-3.4
Elimination of housing tax on primary residences	-2.9	-3.6	-3.8	-2.6	-2.8
Replacement of wealth tax (ISF) by real estate wealth tax (IFI)	-3.2				
Introduction of flat tax on capital income (PFU)	-1.4	-0.3	-0.1		
Increase in Agirc-Arrco supplementary pension fund rates		1.1	-0.1	-0.0	0.0
Social contributions / CSG switch	4.4	-4.0	-0.3	0.6	-0.4
Cancellation of CSG tax increase for low-income pensions		-1.6	0.1	0.0	-0.1
Tobacco tax (net effect)	0.9	0.4	0.7	0.3	
Energy tax increase (household share=66%)	2.4	0.0	-0.0	0.0	-0.0
Expansion of tax credit for household employees	-1.0				
Extension of energy transition tax credit (CITE)	-0.3	0.8	0.0	0.6	0.5
Tax exemption of overtime work		-3.0	-0.8	-0.2	0.4
Reform of income tax brackets			-5.0	-0.4	
Exemption from social security contributions for freelance workers			-0.8	0.8	
Replacement of CI SAP by a new scheme					-1.1
Total corporate measures	-8.6	0.0	-7.1	-12.1	1.8
Corporate tax rate reduced from 33% to 25%	-1.2	-0.8	-2.5	-3.7	-2.9
CICE tax credit – increase in scope and rate raised from 6% to 7%	-3.4	-0.5	-0.0	-1.3	-0.1
One-off corporate tax surcharge	-4.8	-0.0	-0.0		
Energy tax increase (company share=34%)	1.3	-0.1	0.0	0.0	0.0
Increase in Agirc-Arrco supplementary pension fund rates		0.7			
Gross long-term capital gains tax reform		0.4	0.2	-0.2	-0.0
Digital services tax		0.3	0.1		
Creation of tax credit for payroll taxes	-0.6		0.6		
Limitation of specific flat rate deduction (DFS) benefit in calculating the reduction in employers' contributions			0.4		
Immediate reimbursement of carry-back liabilities			-0.1	-0.4	0.6
Relaxation of carry-back parameters				-0.4	0.4
Exemption from social security contributions for sectors affected by the crisis			-5.8	3.2	2.6
Cuts in production taxes				-10.6	
Corporate tax clawback on production tax cuts				1.5	1.3
Tax credit for lessors				-0.1	0.1
Resources allocated to France Compétences contributing to financing skills investment programme (PIC)	0.3	1.3			
Total excluding transformation of CICE tax credit (excluding France Compétences)	-9.3	-9.0	-17.1	-13.1	-1.5
Temporary impact of transformation of CICE tax credit (impact on mandatory levies)		-20.1	14.4	0.5	1.7
Total including transformation of CICE tax credit (excluding France Compétences)	-9.3	-29.1	-2.7	-12.6	0.2

TABLE 1

SOURCE: BNP PARIBAS



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