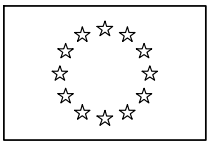

EUROPEAN COMMISSION

Brussels, 30.5.2012
SWD(2012) 155 final

**COMMISSION STAFF WORKING DOCUMENT**

**In Depth Review for FRANCE**

**in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances**

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## EXECUTIVE SUMMARY AND CONCLUSIONS

This in-depth review takes a broad view of the French economy in order to identify actual or potential imbalances and the possible macroeconomic risks which they may entail. The Alert Mechanism Report, published on 14 February 2012, pointed out risks of economic imbalances for France related to its loss of export market shares and to its high level of public debt. Based on the detailed assessment conducted below, the risks that these imbalances pose to future growth can be qualified and potential policy options to address them can be identified. The main observations from this review are:

- **The rapid losses of market shares in the past few years have resulted in an increasing deficit of the current account**. From a surplus of 3.1% of GDP in 1999, the current account recorded growing deficit from 2005 on, reaching -2.2% in 2011. The trade balance for goods accounts for most of this deterioration. The market share of French exports decreased by 19.4% between 2005 and 2010, one of the largest slumps in the EU.

- **Both cost and non-cost competitiveness have contributed to the deterioration in the French export performance since 2000.** While product specialisation and geographical orientation of exports had a negative impact, cost performance of French exports has decreased. Compared to its trade partners, the relatively rapid increase in nominal wages in France over the last decade, more dynamic than productivity developments would have allowed, resulted in a lower cost-competitiveness of firms. However, most of the deterioration comes from insufficient non-price competitiveness. In particular, a relative lack of innovation in the private sector compared to France's main competitors is among the main explanations for the negative development in export market shares. Besides, the limited number of exporting firms is another factor that would be behind a disappointing export performance.

- **While a number of measures have been adopted by the French authorities to address the adverse developments in both cost and non-price competitiveness, limited evidence exists to assess their impact on export performance.** Policies have been implemented to limit the development of labour cost, to foster innovation and to support exporting firms. In particular, the initiatives to shift tax from labour to less distortive sources, the broader tax credit on research expenditures and the efforts to develop linkages between research and industry (in particular through the pôles de compétitivité) are steps in the right direction. However, comprehensive assessments have not been conducted yet. While the review of existing policies provides an opportunity to redefine the current mechanisms and reallocate resources if needed it is worth considering further measures to boost competitiveness and potential growth. In particular, exporters would benefit from increased competition in services and in network industries, particularly in the energy and in the transport sectors.

- **The high public debt poses a threat to the sustainability of public finances, and the recent rise in bond spreads suggests that markets are concerned over the country's fiscal position.** Rising public debt reduces the space to tackle future

shocks and can crowd out private investment, thus lowering growth prospects. It inevitably implies high interest payments, which either go to the detriment of more productive growth-enhancing expenditure or need to be financed by higher revenues while the tax burden is already high in France. Budgetary developments are closely monitored under the Stability and Growth Pact and an excessive deficit procedure against France was launched in 2009

- **The financial situation of households shows a rather benign situation despite potential risks**. French households are comparatively less indebted than peers in the EU. The development of debt in the last few years has been mainly driven by the dynamic real estate market. In that respect, although prices are slowing down, fundamentals should contribute to keep them at a high level. In the meanwhile, the increasing unemployment, which already put revenues and creditworthiness of French households under pressure, is not expected to come down before 2013.

- **The financial situation of non-financial companies (NFCs) shows a gradually increasing level of indebtedness that calls for attention to prevent future imbalances.** The debt of NFCs as a share of GDP increased from 82% to 105% of GDP between 2000 and 2010. Leverage for French NFCs remains however lower than in the EU. The main concern for French companies actually relates to their low profitability. Evidence suggests that this low profitability could translate into lower investment, with negative long-term impact on non-price competitiveness. Furthermore the combination of a high public debt and increasing private sector indebtedness may also be a source of concern in the perspective of the funding of the economy.

In this context, **the in-depth review concludes that France is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed.** In particular, certain macroeconomic developments in the areas of export performance and competitiveness deserve attention so as to reduce the risk of adverse effects on the functioning of the economy.

France has suffered from losses in export market shares as the result of losses in competitiveness. Therefore, competitiveness of French economy would benefit from further measures that would address cost developments and strengthen firms' profitability and that would enforce as non-cost elements such as R&D and innovation.

## 1. INTRODUCTION

On 14 February 2012, the European Commission presented its first Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device, helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific "in-depth reviews" should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis,

the Commission will establish whether it considers that an imbalance exists and what type of policy follow-up it will recommend to the Council.

For France, an economic reading of the indicators shows that the main challenges relate to the external sector. The French trade balance has experienced a gradual deterioration in the last decade, facing a trade deficit from 2004 onwards, which reached a record EUR 73 billion in 2011. France's share of world exports decreased by 19.4% between 2005 and 2010 much above the 6% threshold. This puts France among the EU countries where the export market share has decreased the most, just behind the UK (-24%), Greece (-20%) and at par with Cyprus (-19%). On the internal side, France was flagged for the high level of public debt, which represented 82% of GDP in 2010, well above the 60% of GDP threshold. Private sector debt has also been rising steadily since 2000 to reach 160% of GDP in 2010, including 105% owed by non-financial corporations and 55% by households. Public debt dynamics can represent an impediment for future economic growth through crowding out effects and a high tax burden and for financial market stability. Moreover, in a country where growth is held back by competitiveness problems a reduction of the debt ratio will need to rely all the more on fiscal consolidation measures. This only reinforces the need for compliance with the deadline for correcting the excessive deficit set under the EDP.

Against this background, Section 2 of this review looks more in detail into these developments covering both the external and internal dimensions, followed by specific focus sections on the various dimensions of the deterioration of the French export performance in Section 3. Section 4 presents possible policy considerations.

## 2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

### 2.1. Macroeconomic scene setter

France is among the least open economies in the EU, in particular compared to other large euro area countries such as Germany or Spain. [1] The relatively low share of trade in the French economy has contributed to its rather good resilience throughout the economic crisis in 2008 and 2009. In 2011, the French economy rebounded to 1.7% despite rising uncertainties about the macroeconomic environment in the second part of the year. After a better-than-expected performance in the fourth quarter of 2011, the Commission services anticipate in their Spring forecast sluggish growth for 2012 (+0.5%), due to a sluggish domestic consumption on the back of increased unemployment, worsened business climate in the last quarter of 2011 and a morose European context.

In this vein, the present section reviews potential sources of imbalances in the French economy by considering first the external dimension, in particular focusing on sustainability of France's external position, the evolution of the export performance and

[1] Openness is measured by the share of (volume of) exports of goods and services in % of GDP. Source: "Surveillance of Intra-Euro-Area Competitiveness and Imbalances", European Commission (2010)

export market shares, and the competitiveness of the economy. The aspects relating to the internal dimension, specifically as regards corporates and public indebtedness are subsequently addressed.

## 2.2. Sustainability of the external position

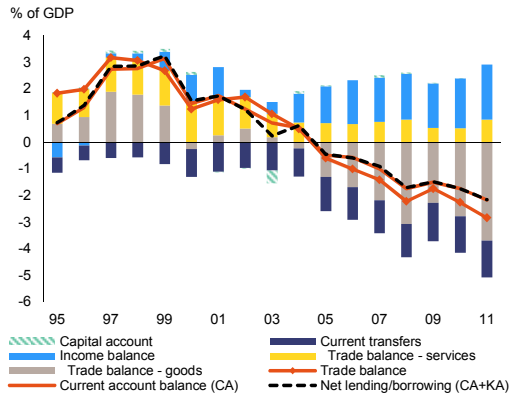
**The main concern about the French economy is related to the deterioration of its external position.** The current account has been worsening over the last decade, even if the deficit level remained below the indicative threshold. Indeed, there is a gradually increasing deficit of the trade balance for goods that is only partially compensated by a still positive surplus of the service balance. The contraction of France's market share in world exports is above the indicative threshold, and this decline is amongst the largest in the EU. The causes for the losses in export market shares appear to reside in weaknesses in both cost and non-price competitiveness.

### *2.2.1. Evolution of the current account*

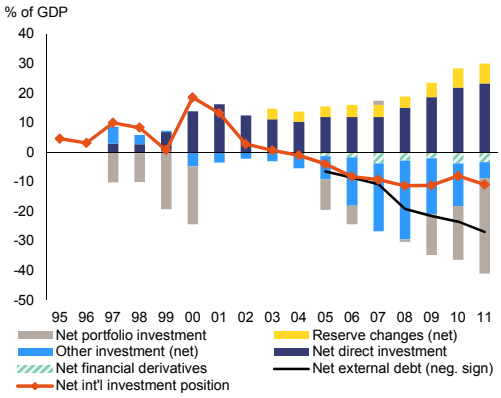
**France has cumulated structural imbalances that are reflected in the gradual deterioration of its current account over the last decade.** The 3.1% of GDP surplus in 1999 turned into a deficit in 2005 that has widened over the following years to reach -2.2% of GDP in 2011. Even though the current account deficit remains below the indicative threshold of - 4% of GDP, the persistent deterioration over the last decade is a cause for concern. This development is mainly due to the increasingly negative contribution of the trade balance for goods and services (see **Error! Reference source not found.** 1). The trade deficit reached a record EUR 73 billion in 2011 (-3.8% of GDP) against a surplus of EUR 19 billion in 1999 (1.4% of GDP), suggesting a strong deterioration of export market shares. Compared to the goods balance, the services balance was still performing relatively well, reaching a surplus of 1.0% of GDP in 2011. Relatively strong domestic demand in France combined with a lower foreign demand may partly explain the deterioration of the current account position. Moreover, France has lost export market shares.

The current account has deteriorated further since the last economic crisis as French internal public and private demand have remained relatively resilient, and as losses in competitiveness have not been corrected. In 2012, sluggish international demand, and in particular the poor economic outlook in the euro area, would limit potential for exports. Despite a somehow depressed domestic demand, the Commission therefore expects that the trade deficit will stabilise at 2.9% of GDP. In 2013, the stronger imports would be compensated by the rebound of international demand and by a stabilisation of export market shares. The trade deficit would therefore remain at 2.9% of GDP.

**Graph 1: Decomposition of net lending/borrowing**




**Graph 2: Decomposition of net international investment position**




Source: Commission services

The increasing deficit of the current account resulted in a progressive deterioration of the French net international investment position (NIIP). The NIIP of France became negative in 2007and represented -10.0% of GDP in 2010 and -10.9% in 2011, still significantly below the indicative threshold of -35% of GDP. As Graph 2 shows, the various components of the NIIP had a contrasting evolution. Net direct investment increased steadily since 2000 due to the increasing internationalisation of French groups. The decrease in market prices explained most of the sudden deterioration of the NIIP in 2008. Since then, price recovered and FDI has returned -in market value- to its pre-crisis level. In 2009 and 2010, increasing portfolio investment in France by foreign residents, in particular in fixed income securities, compensated the progression of net direct investment outflows. As a consequence, French external debt has deteriorated persistently and reached 27% of GFP I, The share of securities issued by the State has increased sharply in 2007 to represent 37% of the overall portfolio investment claim by the foreign sector. This suggests that, as a result of the crisis, some international investors have shifted from securities issued by the private sectors to public bonds. Since 2007, the share of securities issued by the State has remained stable, representing 36% in 2010.

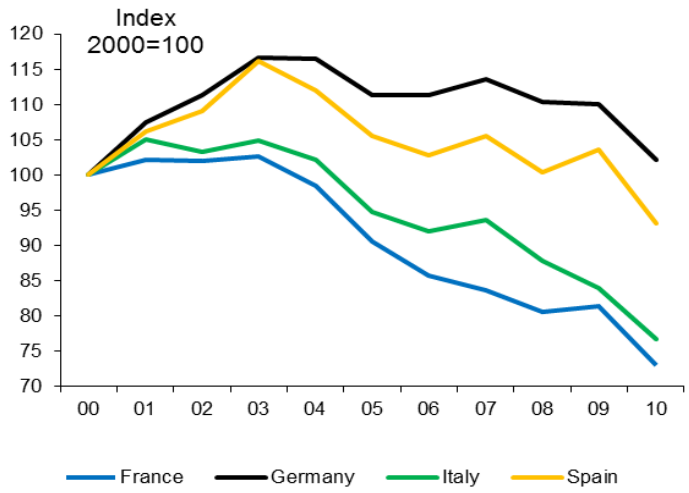
*2.2.2. Losses in export market shares*

**French exports have lost ground relative to the expanding world trade**. Although the rise on the world trade scene of export-oriented emerging countries has mechanically contributed to this situation for all advanced economies, exports have also grown at a slower pace in France than in the euro area as a whole (see Graph 3). As a consequence, France has lost market shares in world exports at a pace that is above the indicative threshold, and among the largest in the EU. The French export market share in goods and services has dropped by 27% since 2000, significantly more than the other main exporters in the euro area. .2 In particular, during the same period, Germany's market

[2] Export market shares are compiled by Eurostat based on balance of payment statistics

share rose by 8%. In 2009, when world trade contracted sharply, French exports showed some resilience and France regained some market shares. However, that improvement proved only temporary and was compensated by the losses seen in 2010 and 2011. In the Spring forecast of the Commission, export market shares are expected to stabilise in 2013, allowing French exporters to benefit from the rebound in international demand.

**Graph 3: Evolution of export market share**




Source: Commission services

Compared to peers of the same size in the euro area (Germany and Italy), French exports are more focused on countries within the euro area, with a relatively low share going to fast-growing export markets - such as Central and Eastern Europe, China and Middle-East. As can be seen from Table 1, the euro area accounted for about half (49%) of French exports while the BRICS represented 6% and China only 3%. While being on an increasing trend, this export share to BRICS is still lower than what can be seen for some of the other top exporters in the euro area.

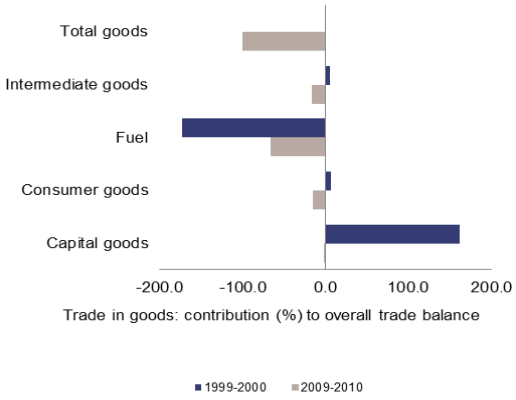
**Table 1: Share of exports to the EA and the BRICs of EA 4 top exporters (2010)**

| | Exports destinations (in % of total exports) | |
|---|---|---|
| | Euro area | BRICs |
| France | 48.5 | 6.1 |
| Germany | 41.0 | 10.4 |
| Italy | 43.1 | 7.0 |
| Spain | 55.5 | 4.3 |

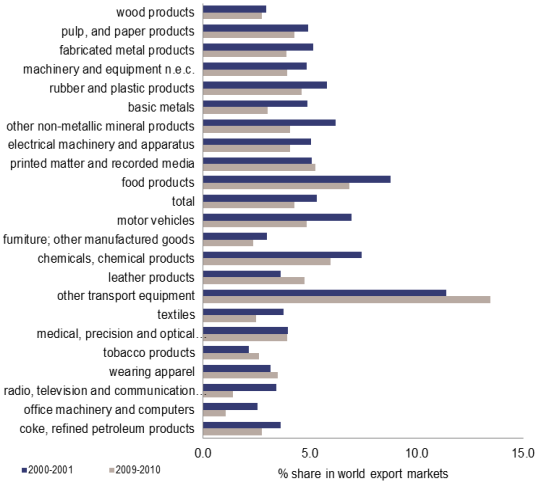
Source: Commission services

A closer view at the sectorial structure of the French trade provides additional insights about the French export performance. A breakdown of the trade by type of manufacture goods (see

**Graph 4: Sectorial export market shares**




**Graph 5: Trade balance contributions by broad category**

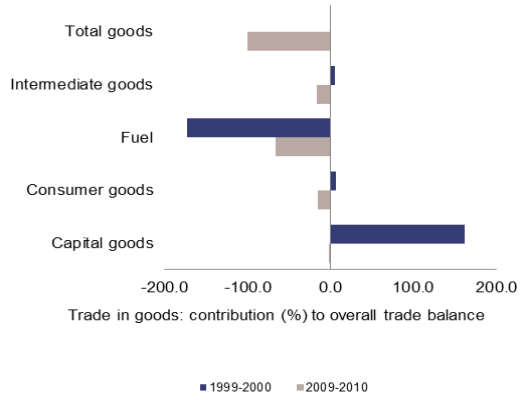


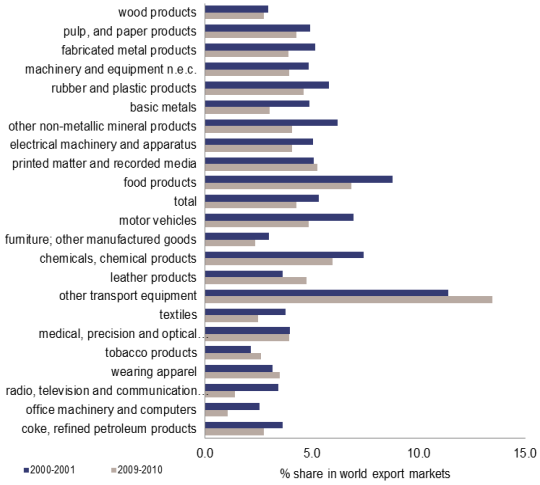

Source: Commission services

and Graph 5) and shows that the deterioration of the French trade balance is reflected in adverse developments for every category of manufactured products. With losses in market shares in 17 sectors out of 23, the balance on manufactured goods recorded a significant deterioration of its position going from a structural surplus in early 2000s to a deficit a decade later. The part of energy imports has decreased over time, although the recent rise in energy prices may partly have contributed in last year's deterioration of the goods trade balance but it cannot on its own explained the total deterioration.

**Graph 4: Sectorial export market shares**

**Graph 5: Trade balance contributions by broad category**




Source: Commission services

**In terms of product orientation,** French exports may be considered as "generalist" as they consist of some world leading high-tech sectors (i.e. in aeronautics, computers and pharmaceuticals) and large range of medium- and low-tech sectors [3] which are more exposed to the fierce competition of both industrialised and emergent countries. In this respect, France compares favourably to the euro area as a whole but remains below Germany (see Table 2). The French export structure has experienced only limited changes in the past few years, with transport equipment, electrical and optical equipment and chemicals products remaining the main export categories. For low and medium technology products, price competition is more intense. On those markets, French exporters may have more difficulties to maintain their market shares against countries with lower labour costs. French exports of services are mainly constituted of other services (business services in particular) and of travel services (linked to tourism industry).

**Table 2: Part of exports in "high" and "low" technology of EA 4 top exporters in 2011**

| Part of manufactured exports in (in %) | High and medium high technology products | Low and medium low technology products |
|---|---|---|
| France | 62,0 | 38,0 |
| Germany | 69,3 | 30,7 |
| Italy | 49,5 | 50,5 |
| Spain | 50,7 | 49,3 |

[3] In this section, technology-intensity of exports is defined based on classification of ISIC Rev.3 sectors according to the methodology used by the OECD.

| | | |
|---|---|---|
| Euro Area | 60,1 | 39,9 |

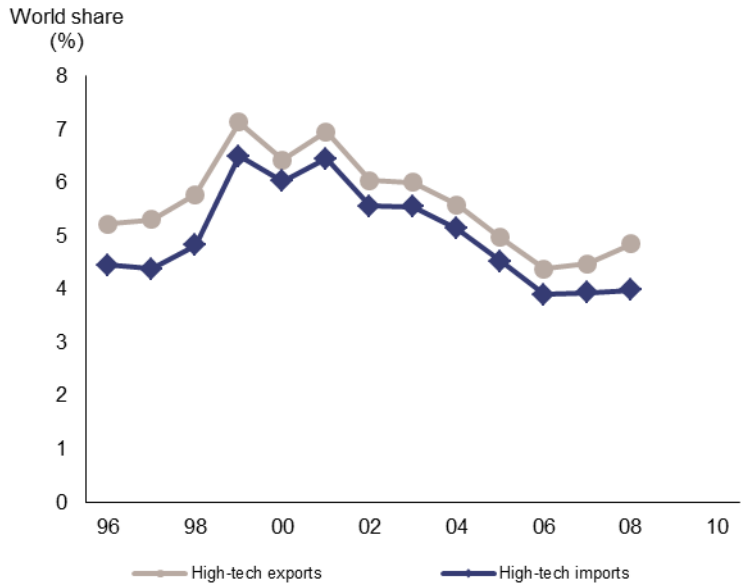
Source: Commission services

French market share in high-tech products between 1995 and 2005 fell by around a third in absolute terms, versus 15% for the EU-15 and slightly more than 10% for the EU-25. During the following years, French exports have shown some resilience and France regained some market shares (

Graph 6). French losses seem to have been rather limited in low-tech goods, but more significant in high-tech goods, in particular on the European market. Between 1995 and 2004, among the leading industrialised countries, only Germany saw its market shares progress in high – tech goods[4].

[4] Fontagné and Gaulier, 2008

**Graph 6: French high-tech world market shares**

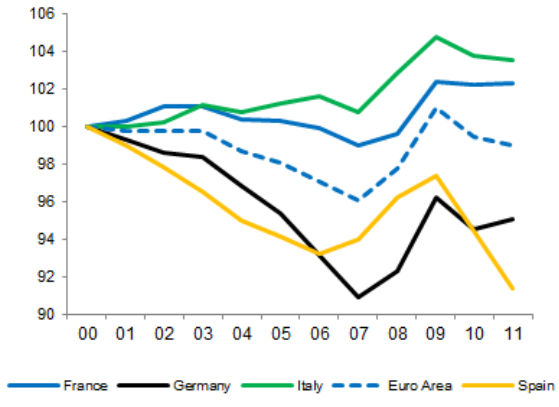



Source: Commission services

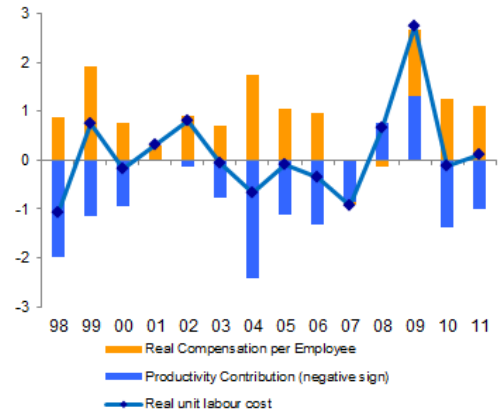
*2.2.3. Evolution of cost and price competitiveness*

**The losses in market shares have coincided with a degradation of cost competitiveness, as measured through the evolution of unit labour cost (ULC). As a consequence of the relatively stronger growth of real wage since 2000, ULC in France have increased at a slightly faster pace than in the euro area as a whole** (see Graph 7 and Graph 8). Some countries, such Italy, saw similar increases. By contrast, unit labour cost in Germany has remained relatively stable in the past decade. In the years to come, ULC in France would slow down in real terms, as rises in real wages would remain very limited.

**Graph 7: Evolution of real Unit labour cost in the 4 top EA exporters**




**Graph 8: Decomposition of real Unit labour cost in France**



Source: Commission services

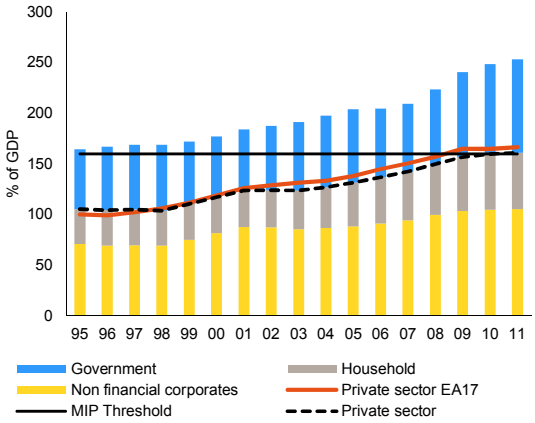
**The strong increase in ULC compared to trade partners resulted in a deterioration of France's real exchange effective rates (REER) based on ULC which increased between 2000 and 2010.** In particular, REER experienced a sharp rise between 2005 and 2008. In fact, only a minority of Member States, including Austria, Germany and Sweden, were able to improve their cost competitiveness between 2000 and 2010.

Overall, the deterioration of export market shares, together with the poor performance in terms of unit labour cost point toward a growing competitiveness imbalance.

## 2.3. Internal imbalances

**According to the scoreboard, only one indicator in the area of internal imbalances, the level of public debt, is flashing**. However, the level of private debt, which was less than a percentage point below the threshold value of 160% in 2010(see Graph 9), as well as labour market developments with unemployment figure reaching double digit, are also a sources for some concern. Quarterly data show that, in 2011, the level of private debt has continued to rise. This warrants a more detailed analysis of potential financial vulnerabilities of the private sector.

**Graph 9: Decomposition of debt excluding financial companies, in % of GDP**




Source: National accounts

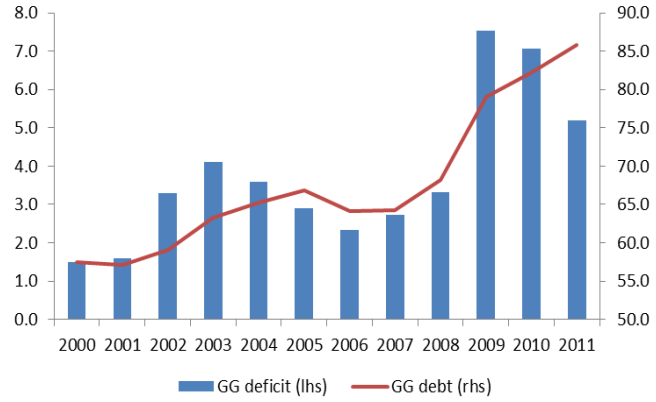
### *2.3.1. Public sector indebtedness*

**The high public debt is one of the major challenges France needs to address in the coming years.** At 85.8% of GDP in 2011, the debt ratio was slightly higher than the EU average of 83.0% and clearly above the reference value of 60% specified in the scoreboard and referred to in article 126(2) TFEU. The threshold was first exceeded in 2003 and the debt has been almost continuously increasing since then (see Graph 10).

**The deterioration of the debt ratio over the past decade was due to persistently high public deficits reflecting structural factors (including age-related spending) and weaknesses in fiscal institutions while stock-flow adjustments also played a role (0.4% of GDP on average over 2000–10).** The deficit stayed above 3% of GDP on

average over 2002–08, including a prolonged excessive deficit period, while relatively strong growth in 2004–07 would have allowed for a sizeable adjustment in structural terms[5].The fiscal position significantly worsened during the crisis with the operation of automatic stabilisers and the stimulus measures decided by the authorities. Together with declining growth, these pushed the deficit above 7% of GDP in 2009–10. An excessive deficit procedure was launched in 2009 and the Council recommended that France bring the deficit below 3% of GDP by 2013. The fiscal consolidation the authorities have started helped lower the deficit in 2011. Nevertheless, the debt ratio continued to rise to 85.8% of GDP at the end of the year.

**Graph 10: General government deficit and debt as % of GDP**




Source: National accounts

**Going forward, the public debt is expected to further increase mainly on the back of still high deficits**[6]. The authorities project it to start decreasing from 2014 on as a consequence of the on-going fiscal consolidation. However, risks to the debt path are clearly on the upside, mainly related to the lack of specification of the underlying budgetary measures. In the past, the debt targets contained in the successive stability programmes have regularly been revised upwards and often missed.

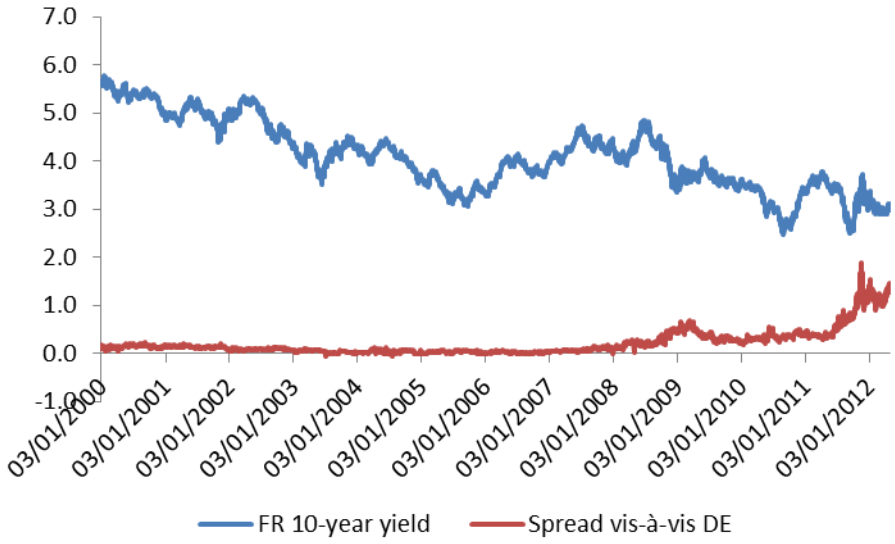
**Sustainability of public finances is one major concern related to high and increasing public debts**. As debt levels increase, market concerns over governments' creditworthiness are rising and may result in higher interest rates. France has recently experienced a widening in sovereign bond spreads vis-à-vis German bunds (see Graph 11). Whereas the spread was negligible until early 2008, it started to increase in the context of the crisis and rose sharply in the course of 2011; in the first quarter 2012, it has somewhat receded to about 120-130 basis points. Although interest rate levels are low by historical standards so far, this suggests that investors are somewhat concerned over France's fiscal position and its capacity to meet the planned budgetary targets, also

[5] The structural deficit was reduced by only 1% of GDP over this period.

[6] Higher debt levels will also reflect contributions to the European Stability Mechanism and direct loans to EA vulnerable countries.

in the light of the recent downgrade by one major credit-rating agency from AAA to AA+. Market confidence is critical especially as two-thirds of French public debt is held by foreign investors[7]. Moreover, the high degree of correlation between spreads in the euro area (see Box 1) suggests that the interest rates on French public debt could be impacted by difficulties met by neighbouring economies.

**Graph 11: French government 10-year bonds yields and spread vis-à-vis German bunds**




Source: Bloomberg

**Box 1: <u>Sovereign debt spillovers</u>**

The euro area sovereign debt crisis has shown the potential for spillover risks from debt accumulation in a monetary union. Highly interconnected financial markets, cross-border balance sheet exposures as well as the existence of bail-out provisions generally act as potential transmission channels. Indeed, developments over the past 3 years in the euro area highlight the link between market concerns over fiscal sustainability, increases in sovereign yields via risk premium effects and higher interdependence between Member States.

Financial stress widened sovereign spreads with respect to the German benchmark in peripheral countries at first and then seriously affected some core Member States. The potential for spillovers increased as the crisis unfolded and reached its peak in May 2010

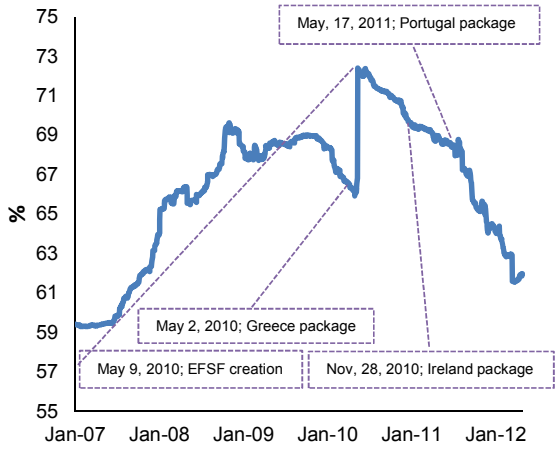
[7] As of December 2011, 65.4% of negotiable central government debt securities were held by non-residents.

[8] Spreads are calculated as the difference of the 10 year sovereign yield with respect to the German bond.

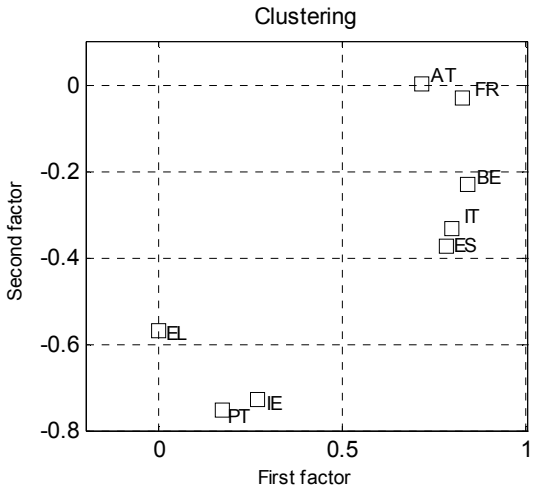
[9] Austria, Belgium, France, Greece, Ireland, Italy, Portugal and Spain.

with the creation of the European Financial Stability Facility (EFSF) as can be seen in Graph a by looking at the influence of common risks factors in explaining the variance in the daily changes of the spreads[8] for selected Member States[9]. The creation of the EFSF implicitly linked the different bond markets but also contributed to reduce the uncertainty around potential *domino* effects and the potential for contagion has dropped ever since.

**Graph a: Variance of daily sovereign spreads explained by the common risk factors (%)**



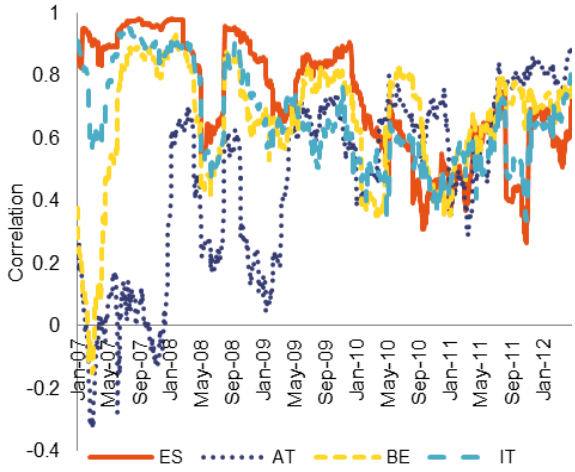

**Graph b: Factor analysis of daily sovereign spreads (03/2003-04/2012)**

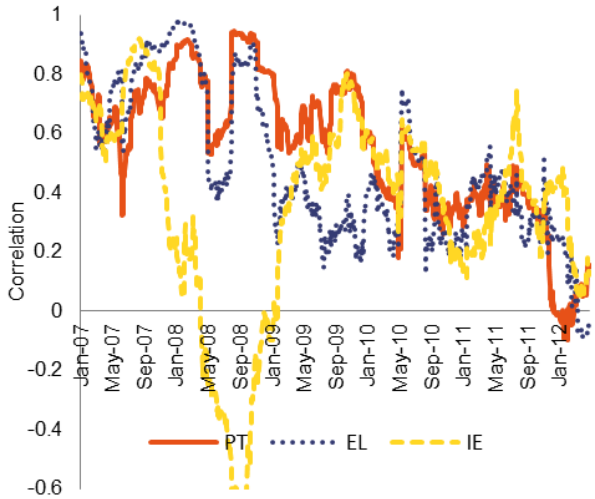



Source: Commission services

Countries witnessing hikes in their sovereign spreads are split into two groups according to factor analysis: programme countries on the one hand and other financially stressed countries on the other hand (Graph b). This picture is confirmed by looking at the correlations of the changes in the French spreads with respect to the other countries in the sample (Graphs c and d). French sovereigns are detached from programme countries as of April 2012, although the correlation with respect to the rest of the countries in the sample is high, signalling the potential for major spillovers through market reactions.

**Graphs c and d: Correlations with French sovereign spreads**




Source: Datastream

**Note: Correlations are calculated on 3-months rolling windows of daily changes in 10 year sovereign spreads**

**From this point of view, the risk that a rise in age-related and healthcare expenditure growth would deserve special attention.** The 2010 pension reform, which includes a gradual increase in the minimum retirement age and the full pension age, combined with the increase in the contribution period in line with gains in life expectancy, is thus a step in the right direction. The system is expected to be balanced by 2018, but it is likely to fall again into deficit afterwards in the absence of further measures. In addition, an unsustainable rise in healthcare expenditure cannot be fully

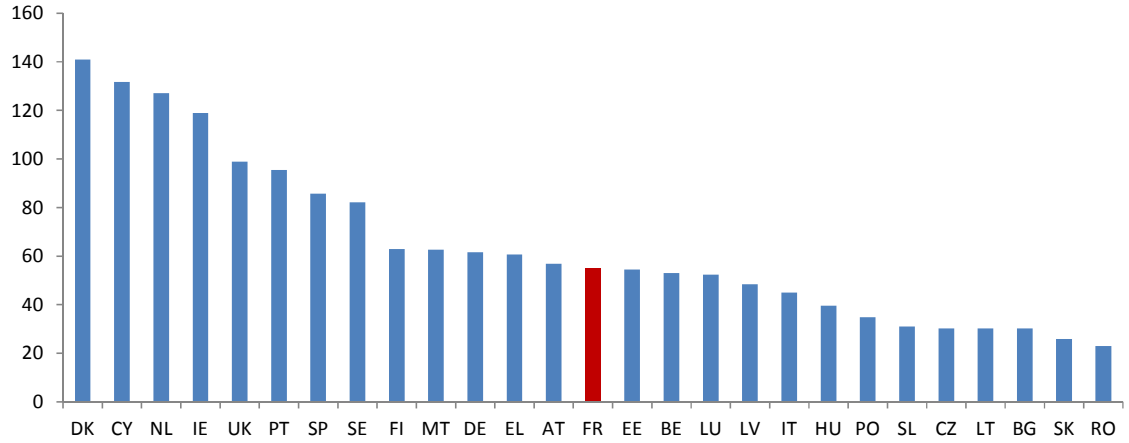
ruled out against the backdrop of increasing life expectancy and technical progress, although such costs are projected to increase less compared to the EU average.

**Apart from sustainability concerns, rising public debt may impact on growth prospects and competitiveness.** One of the traditional channels is the crowding out of private investment, with public debt competing with private debt for the allocation of savings. In addition, the fiscal space to tackle further shocks or severe private imbalances tends to decline with the level of public indebtedness. In particular, the French authorities do not seem in a favourable position if they were to address substantial recapitalisation needs in the banking sector. Another channel how high debt impacts on growth is through the debt service, which drives out more productive government expenditure but also tends to increase the tax burden which is a drag on competitiveness and growth. Conversely, losses of competitiveness render high debt levels even more problematic as they weigh on growth prospects, which in turn makes it more difficult to put the debt ratio on a downward path.

### *2.3.2. Financial situation of households*

**French households appear less indebted than peers in the EU although the level of debt has been increasing in the last few years.** With household debt representing 55% of GDP in 2010, France is clearly below the average for the EU (see Graph 12). In 2010, this debt represents over 79% of disposable income of households in France, compared to an average of 97% in the euro area. However, credit growth has accelerated in the last few years, with household debt as a percentage of GDP increasing by 12 percentage points between 2005 and 2010. Although in line with the general trend in the EU, it is high in historical terms. Furthermore, the most recent developments show that, compared to other Member states, France is among the economies where credit to households continued to increase, although at a slower pace, in 2010 and 2011. By contrast in the euro area, credit to household as a percentage of GDP started to decrease in Q2 2010. New credits to households in France, which rebounded strongly after 2009 went back in the first quarter 2012 to its 2008 level. As mortgage represents 77% of household credit in France, the financial situation of households is correlated with that of the housing sector. Indeed, higher real estate prices have pushed the volume of mortgage needed to purchase housing up. In order to assess the sustainability of the household debt dynamics, a review of the French housing market is therefore necessary.

**Graph 12: Household debt - as a % of GDP, 2010 –**

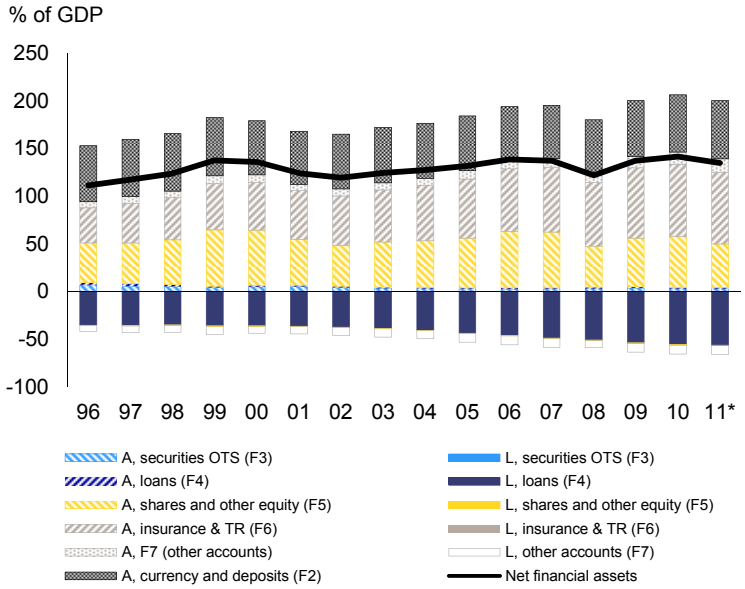



Source: ECB

**The decomposition of household credit shows that much of the growth since 2005 is driven by mortgage.** Credit to households increased by 7.2% p.a. between 2005 and 2011. However, detailed statistics by the Banque de France show that, over the same period, mortgages rose by 9.1% p.a.. While mortgages represented 69% of total household debt in 2005, this ratio increased to 77% by 2011 although new credit slowed down considerably. In contrast, consumer finance only progressed by a modest 2.5% p.a. between 2005 and 2010. Moreover, since 2009, the stock of consumer loans seems to have reached a plateau, and in 2011 the volume of new consumer loans granted decreased significantly. The increased uncertainties as well as concerns about the level of public debt, which inter-alia contributed to the high savings ratio, are the main causes for the sharp contraction in the demand for consumer credit seen since 2010.

**Although the level of debt of households increased in the last few years, they remain net lenders in terms of financial assets** (see Graph 13). Net financial assets of households represented 82% of GDP in 2010, compared to an average of 60% for the euro area. Moreover, while in 2009, net financial assets of French households contracted, as in the euro area more generally, they experienced a strong rebound in 2009 and 2010. The 2011 level of net financial assets is now above its pre-crisis level while it has remained below the respective average level for the euro area. This trend reflects the high level of precautionary savings that were constituted in response to increasing uncertainties, in particular linked to labour market developments and probably also to increased concerns about the high level of public debt. Furthermore, the high share of fixed interest rates loans mean that French households would be relatively insulated from a hike in interest rates.

**Graph 13: Household balance sheet - as a % of GDP, 1996-2010**




Source: Commission services

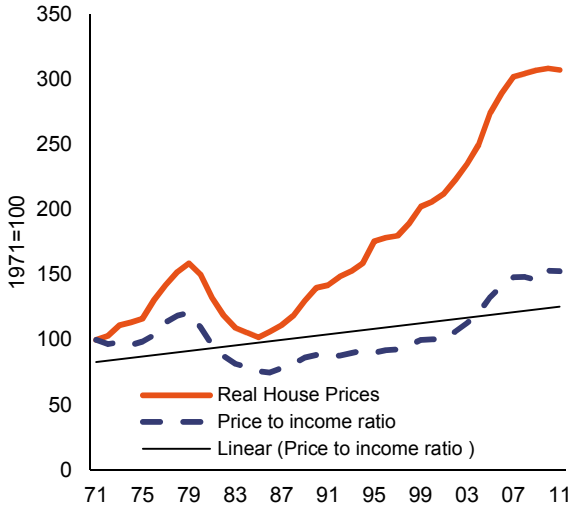
**Despite the relatively good solvency of French households, their financial situation has suffered due to the persistent level of unemployment in the last few years.** The level of unemployment in France in 2010 was below the indicative threshold of 10% defined in the AMR. The unemployment rate, which decreased between 2006 and 2008 started to rise from a low point of 7.5% (ILO definition) in Q1 2008. However, this level has been on an upward trend since then and it reached 9.8% on average in 2011. Similarly, the number of registered jobseekers increased by 5.5% y-o-y in December 2011. In its Spring forecast, the Commission expects that unemployment will continue to rise, though at a slower pace, to reach 10.2% in 2012 and 10.3% in 2013. In terms of creditworthiness, a high level of unemployment translates, on the one hand, into lower revenues for households that are affected by spells of unemployment and, on the other, into a lower negotiating power in the context of wage bargaining. As a consequence, households' net income which contracted sharply in the second half of 2008 has not yet reached the rates that used to be observed before the crisis and would only rise slowly in 2012 and 2013 (+1.2% and +1.5%). Although the level of unemployment in France is below the average in the euro area (10.0% against 10.9% in March 2012), the rising level calls for immediate policy attention, notably as regards market segmentation, the employability of youth and of senior workers, and the improvement of services offered by the public employment services.

**Structural weaknesses on the French labour market make it less resilient throughout temporary shocks.** The segmentation on the French labour market results in high employment risks for outsiders (e.g. workers on temporary contracts, youth and low-skilled workers) during periods of rising unemployment and in lower incentives for employers to hire when growth picks up. Measures were taken to improve the flexibility of the labour market. In particular several measures (e.g. partial unemployment, *accords de compétitivité*) are being discussed to allow companies to retain workers throughout activity dip. Although they do not address the labour market segmentation itself, they

could contribute to ensure that temporary reduction of activity do not translate into permanent loss in human capital. In order to bring down unemployment, efforts to reduce the labour market segmentation need to be complemented by efforts to improve employability. In that respect, the low level of participation in lifelong learning in France (5%, compared to 9.1% in the EU) represents a challenge.

**Due to the large exposure of French households to mortgage credit (77% of total credits to household in 2011), the main source of uncertainty relates to the evolution of the mortgage market.** As in the large majority of the Member states, housing prices increased strongly in the last few years preceding the global financial crisis. In France, real housing prices rose by 9% each year between 2000 and 2007, the year house price reached their peak. The price increase was particularly high between 2003 and 2005. In 2008 and 2009, a modest correction took place, with prices contracting by 7% between 2007 and 2009. Housing price inflation before 2009 was less pronounced than in several EU economies where housing bubbles were clearly observed. However, whereas in most EU countries housing prices have continuously decreased since 2008, prices in France experienced a swift recovery. Real housing prices in 2011 were above the level recorded in 2007. In the EU, France is the economy where housing prices have increased the most in real terms since the trough. Since the summer of 2011, a slowdown of real estate price increases has been observed. This has given rise to concerns that further adjustment may be imminent (see **Graph 14**).

**Graph 14: Real house prices and affordability of housing**




Source: Commission services, OECD

**Despite some indications that the real estate market is cooling down, fundamental factors at play limit the potential for a strong price correction.** In a context when purchasing power of households is depressed, with lower transaction volumes and, at least in some areas, stagnating prices, concerns have been raised over a potential large-scale correction of prices in this sector. However, a number of elements would suggest otherwise. Long-term demographic and social trends should continue to support housing prices. Indeed, due to a relatively high fertility rate (2%) and a positive net immigration (+77 000 in 2011), the population growth in France is among the highest in the EU (+0.5% per year). Moreover, as the household size tends to decrease, the number of households increases and tends to stimulate housing prices in the long run. Moreover, despite the rising price level, the efforts required from households do not seem excessive compared to the average in the euro area. In 2010, 58% of households owned their main home and 36% had no reimbursement expenditures. Only 15% of the tenants and 1% of owners in France dedicated more than 40% of their disposable income to housing. This compares with average for the euro area of 23% and 7% respectively. In specific geographical areas (in particular in the main French cities and along the coasts), supply and demand asymmetries have put prices under pressure. A general price correction in France cannot be ruled out in a context of lower purchasing power and depressed demand and as the latest housing figures seem to show. Although housing prices developments need to be followed carefully, any price correction would remain limited because the low level of indebtedness in France prevents households from being forced to sell. In any case, a correction of real estate prices would have a limited direct impact on consumption and on economic activity as wealth effect does not play an important role in the consumption pattern in France.

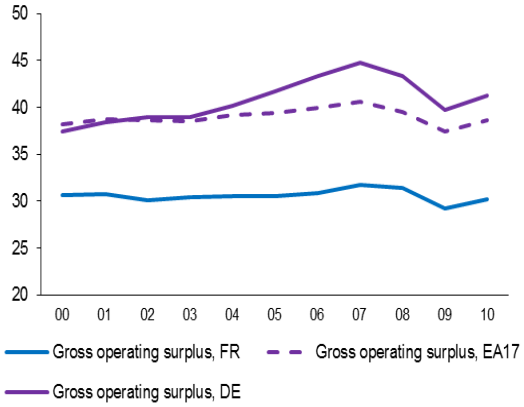
### *2.3.3. Financial situation of companies*

**The indebtedness of French non-financial corporations has increased rapidly between 2000 and 2010 from 82% to 105% of GDP**. This growth appears slightly below the general development in the euro area (+29 pps). A more detailed analysis of credit flows shows that credit to non-financial corporations in France increased rapidly

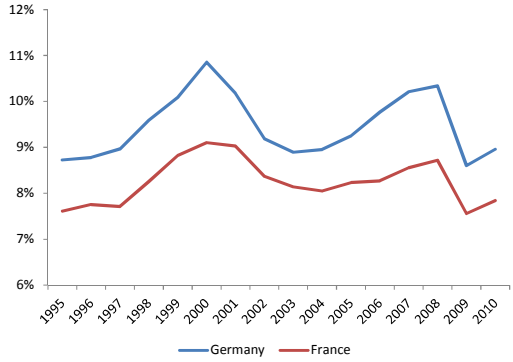
from 2003 to 2007 before significant deleveraging took place in 2009 and 2010. However, despite this increasing indebtedness, the leverage of French firms has remained below the euro area average. In 2010, debt represented 41% of total non-financial corporations' assets, above the 32% in 2000, but well below the 54% average in the euro area.

The main challenge faced by French non-financial companies, and a significant contributor to their increasing indebtedness, relates to their lack of profitability. In 2010, the gross operating surplus, which captures the excess production over intermediate goods and compensation of employees, represented 30% of value added, the lowest margin in the EU (see **Graph 15**). Similarly retained earnings, which have been on a downward trend since 2000, are also among the lowest in the EU. In comparison, due to wage moderation from 2004 to 2008, profit margins expanded strongly in Germany over the same period.

**Graph 15: Non-Financial Companies Profit margins - as a % of Value Added, 2000-2010**




**Graph 16: Investment excluding construction in France and Germany - in % of value added, 1995-2010**




Source: Commission services

**Evidence suggests that, once investment in construction is netted out, investment by French firms was indeed constrained.** Investment by French non-financial companies since 2000 has been more dynamic than what could have been expected judging from their relatively low profitability. However, this result is driven primarily by the construction sector. In 2010, the investment ratio of French firms (investment as a percentage of value added) reached 18.7%. This is close to the 20.5% EU average and higher than the level observed in several countries where profitability of non-financial corporations is higher, including in particular Germany. A comparison of German and French investment patterns[10] reveals, however, that investment in France was driven by

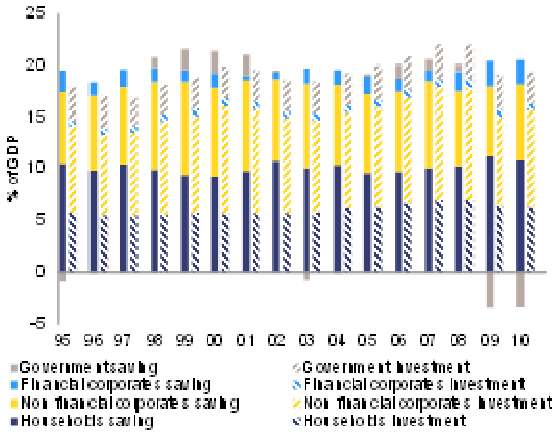
[10] As investment by non-financial corporation by product is not available for Germany, investment for the whole economy is used in this analysis and in Graph 16.

the construction sector. When construction is excluded, the overall investment rate in France appears significantly lower than in Germany (see Graph 16). This suggests that while their level of indebtedness increased, non-financial companies in France were not able to make productive investments to the level seen, for example in Germany, hence putting a downward pressure on non-cost competitiveness.

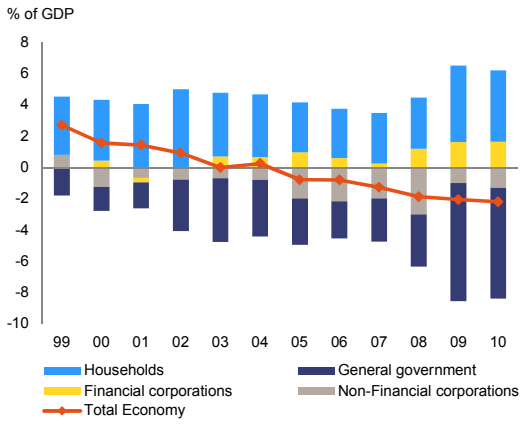
*2.3.4. Linkages between the sectorial imbalances and the external position*

**France's net borrowing position results mainly from increasingly negative balance of savings and investment by the government and non-private companies** (**Graph 17** and **Graph 18**). The development of the current account traces the exchanges between the various domestic sectors and foreign agents. In that respect, potential imbalances of the financial situation of the public sector, of households and of the private sector will reinforce one another and result in strong external imbalances. Conversely, a deficit in one sector may be compensated by surplus in another sector. In 2009 and 2010, lower tax revenues and increased public spending linked to stimulus measures resulted in negative savings by the government. Net borrowing by the government rose by 4.3 percentage points in 2009 and decreased only slightly in 2010. On the contrary, non-financial corporations, whose indebtedness had increased significantly since 2000, reduced investment sharply in 2009 and 2010, hence limiting net borrowing. During the same period, households, whose net lending position had somewhat eroded, increased their level of savings. This precautionary behaviour by households, together with increased savings by the financial sector limited the overall deterioration in net borrowing.

**Graph 17: Savings and investment by sector - as a % of GDP, 2000-2010**




**Graph 18: Net lending/borrowing by sector - in % of GDP, 2000-2010**




Source: Commission services

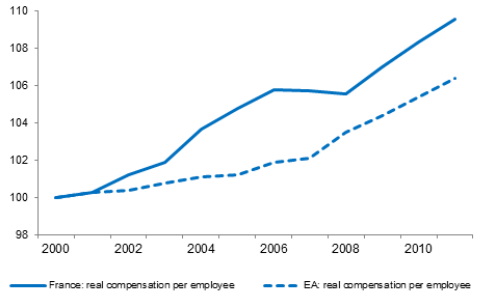
# 3. FOCUS ON COMPETITIVENESS

## 3.1. Price competitiveness

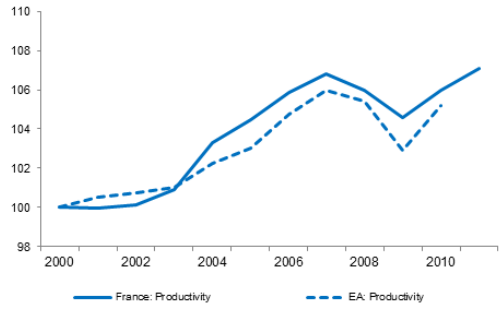
### *3.1.1. Comparison of cost of labour*

**One of the stylised facts related to the French competitiveness is the diverging developments in real compensation and productivity in France and in the euro area since 2000.** The growth of real compensation of employees has been consistently higher in France than in the euro area with the exception of 2007 and 2008 (see

**Graph 19: Real compensation in France and in the euro area - 100=2000**



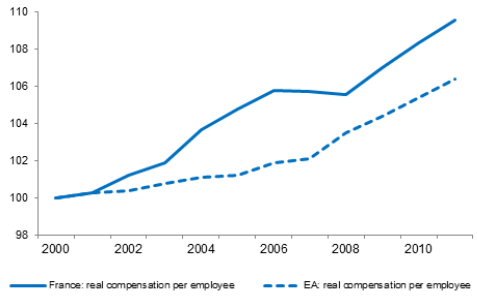

**Graph 20: Productivity in France and in the euro area – 100=2000**




Source: Commission services

**).** On the other hand, productivity in France increased at a pace similar to that of the euro area (see Graph 20). This contributed to ULC increasing faster in France than in the euro area. This situation is in stark contrast with that of Germany, where real wages stagnated or decreased between 2000 and 2007, resulting in a downward pressure on ULC. The decreasing labour costs made it possible for companies to simultaneously increase their margins and reduce their prices in order to gain market shares.

**Graph 19: Real compensation in France and in the euro area - 100=2000**




**Graph 20: Productivity in France and in the euro area – 100=2000**


Source: Commission services

**A comparison of the actual level of labour cost indicates that France is among the group of Member States where the cost of labour is highest, together with Belgium, Sweden, Denmark, Luxembourg, the Netherlands and Germany.** Hourly cost of labour in the manufacturing industry stands at EUR 33.2 per hour in France, compared to EUR 27.8 in the euro area, putting France into the group of Member States where the cost of labour is highest. In services, the difference is even higher with the cost of labour representing EUR 32.1 per hour in France, compared to a euro area average of EUR 25.7. Despite the different developments in unit labour cost over the past few years, the cost of labour in manufacturing remains higher in Germany (33.4 EUR/hour) than in France[11]. Therefore, to complement the picture on labour cost and particularly the comparison between France and Germany, it is important to also take into account the situation and developments regarding productivity.

**In order to limit the increase in the cost of labour, France has embarked on a number of reforms, targeting in particular less qualified workers**. These reforms have sought to limit the rise in the minimum wage and to reduce the tax burden on labour. Regarding the minimum wage, discretionary increases in the minimum wage on top of the regulatory adjustments that used to be implemented every year were stopped since July 2006. In 2008, the procedure for the annual review of the minimal wage level was improved by the creation of an advisory committee of independent experts. In order to reduce the tax burden on labour, one of the highest in the EU, the French authorities have created a number of measures, in particular for lower salaries (e.g. "*allègements Fillon*"). In January 2012, the government has announced a reduction of employers' social contributions by EUR 13 billion (0.65% of GDP). This will be matched by a 1.6 pp. increase in the standard rate of VAT to 21.2%.

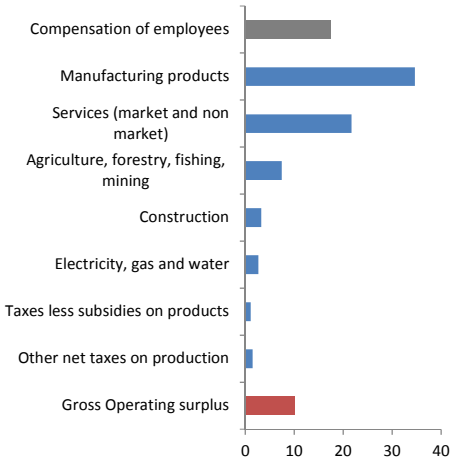
#### 3.1.1.1.Cost of other factors / Offshoring practices

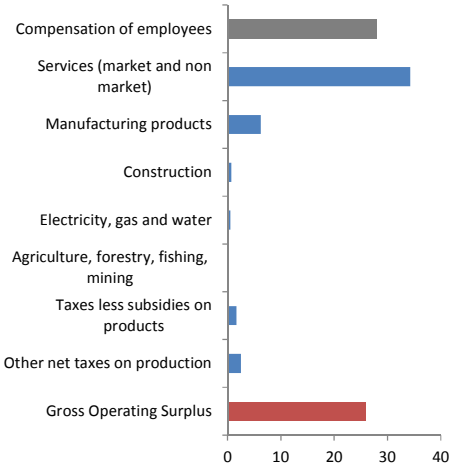
**Labour cost is not the only driver in the cost structure of industries that can influence the evolution of cost competitiveness.** The share of labour costs (measured by compensation of employees) in French industry represents 17.5% of total production costs, while its services content accounts for 22% (see

**Graph 21: Industry cost structure –% of output value at basic prices, in 2007**

**Graph 22: Market services cost structure – % of output value at basic prices, in 2007**

[11] However, cost of labour in services is lower in Germany (EUR 26.8 EUR per hour)

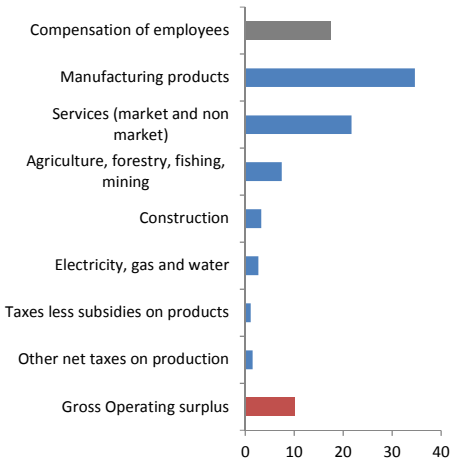


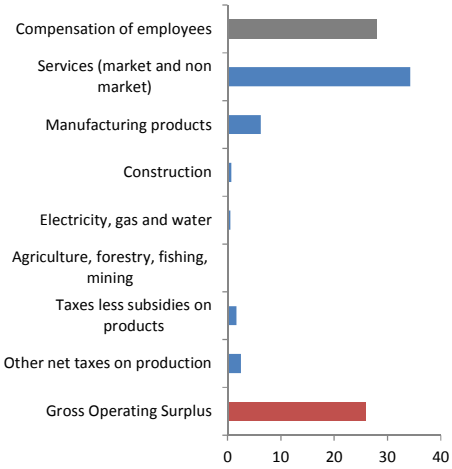

Source: Commission services

). In particular, other business services are the third most important cost component of output in industry. These facts hint at the potential role of some services in the total costs structure in France. When looking at the cost structure of market services, compensation of employees represents more than one quarter of total production costs (see Graph 22). While being more and more subject to external competition, market services still benefit from being sheltered sectors (network industries for example). A strengthening of competition in some sheltered market services could also help reduce industrial costs.

**Graph 21: Industry cost structure –% of output value at basic prices, in 2007**




**Graph 22: Market services cost structure – % of output value at basic prices, in 2007**




Source: Commission services

**Besides the cost of labour, the industrial organisation model can have an impact on the price competitiveness development**. In particular, the use of suppliers' footprints is

considered to have played a significant role in the relative cost performances of France and its main competitors over the last decade[12]. For instance, German companies took advantage of suppliers by outsourcing portions of their production process in low cost countries (mainly in Central and Eastern European countries). Integrating the related components as intermediate input allowed them to reduce overall production cost and to increase the productivity of their own production plants (initially raising doubts about the benefit of such a "bazar economy") as well as their profitability. This allowed German companies to improve their costs while maintaining a share of value added in Germany and safe-guarding domestic skills and know-how. Conversely, French companies chose to outsource entire parts of their manufacturing process to low cost countries, a decision that may also have been partly driven by a less advantageous geographical location of France vis-à-vis Central and Eastern European countries. As a consequence, although these products are still sold by French companies, they do not appear as French "exports" anymore.

### 3.2. Non-price competitiveness

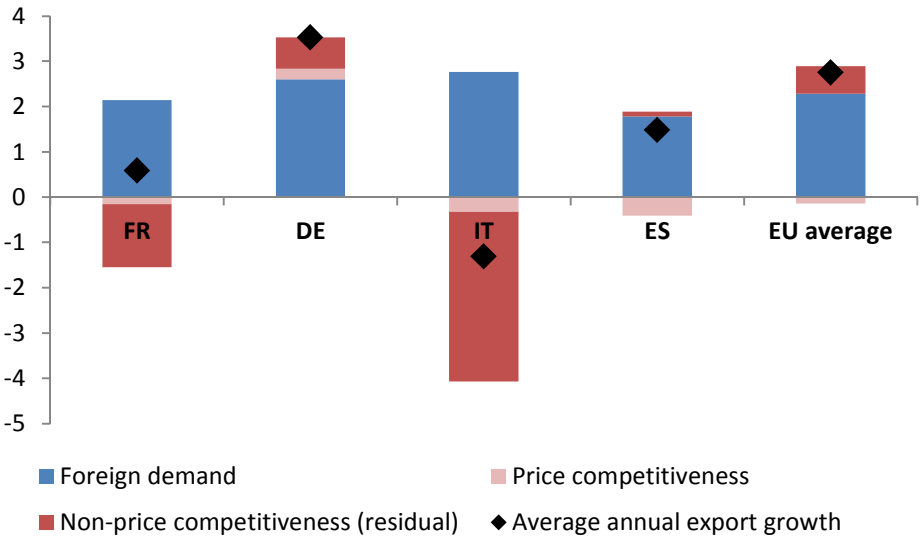
Standard trade equations, which use price competitiveness and external demand as the main export drivers, cannot fully account for the deterioration of France's market share since 2000[13]. **This points to the fact that additional factors would need to be taken into account. In a first approach, non-price competitiveness can be measured through this unexplained part of export performance. The Product Market Review 2010 (European Commission, 2010) suggests that non-price competitiveness losses have been the main factor behind the poor performance of French exports over the last decade (see**

[12] See Fontagné and Gaulier (2008)

[13] See for example Cochard (2008)

Graph 23). This contrasts with the development seen for some Member States, and in particular for Germany and Spain, and for the EU average. Several hypotheses have been made to explain the decreasing non-price competitiveness of the French economy. The quality of the products, the ability of firms, and in particular smaller ones to engage in exporting activities and the lack of investment, notably in research and development, are considered the main drivers. In that respect, the reduction of production cost and the restoration of profit margins may have a positive incidence in the medium term on investment in equipment and R&D, and therefore on non-price competitiveness.

**Graph 23: Contributions to export growth in manufactured goods – %, 1999-2009**




Note: EU average computed based on export volume

Source: Commission services

*3.2.1. Quality of French goods*

**Increasing competition from developing economies has resulted into pressures to increase the quality of products for companies located in more developed economies.** The dynamic export performance of developing economies and their increased share in world exports is one of the main factors driving the evolution of international trade. For developed countries, this has translated into decreasing market shares and in the search for new sources of competitive advantage. At the industry level, the similarities between export structures of countries at various stages of development suggest an intense competition. However, a more disaggregated analysis of trade data shows that, within the same product types, more developed economies tend to export goods of higher quality than that of less developed ones[14]. Increased competition in a product category provides an incentive for exporting companies to improve the quality of their products to differentiate.

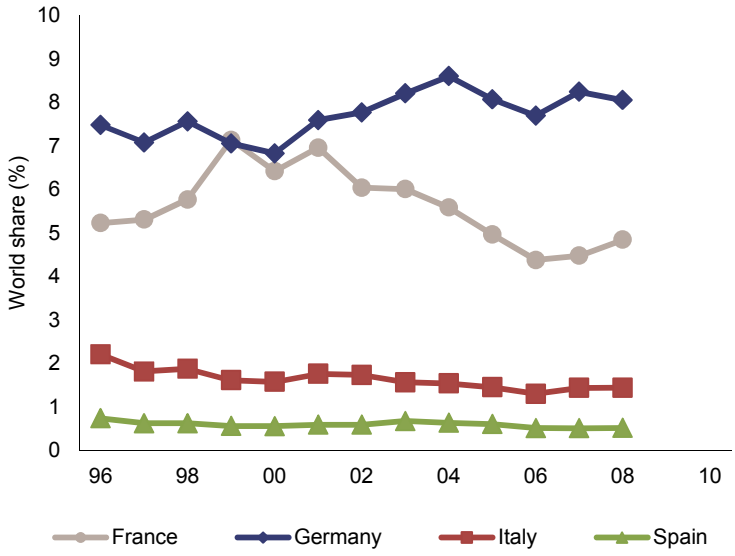
**Although French firms have increased their quality, efforts have not been sufficient, in particular in high-technology industry and knowledge intensive services.** Evidence based on firm level data, shows that the average quality of French products has increased between 1995 and 2005, particularly in sectors that are exposed to competition from low-cost countries[15]. More generally, the losses market shares by EU countries have

[14] See the Product Market review 2010 (European Commission, 2010) for a review methodology to assess product quality.

[15] The process for quality improvement can take several forms. Companies can innovate to improve the quality of their products. Market shares can be redistributed from low-quality to high-quality

been concentrated in market segments corresponding to the lower unit values[16]. However, despite their mitigating influence, the efforts made by French exporters to increase the quality of their products proved insufficient to maintain their market shares. A comparison with Germany, whose export structure is relatively close to the French one, sheds a light on the evolution of the quality of French exports. Dividing trade data into low, medium and high quality, Fontagné and Gaulier (2008) show that compared to Germany, French companies have mostly lost market shares for high-quality goods and in particular on the European internal market. The case of high-technology goods is symptomatic of the decreasing performance of French exporters since 2000 (see Graph 24). After an increase in the late 90's, the export market share of France in high technology products decreased sharply from 7.1% in 1999 to 4.4% in 2006.[17] While this trend is common to several OECD countries, and reflects in particular the 4.2 times increase in China's market share over the same period, the phenomenon was particularly severe in France. In 2007 and 2008, the last year for which data is available, French market share rebounded somewhat to 4.8%. Exports in knowledge-intensive services are also not particularly dynamic in France, representing close to 30% of overall services exports in France, compared to close to 50% for the EU.

**Graph 24: Evolution of high-tech export market shares of EA 4 top exporters (including intra-EU), 1996-2008**




Source: Commission services

companies within a country and new producers can appear to replace non-competitive firms. See Martin and Méjean (2011)

[16] Unit values are defined as the value of export divided by volumes shipped. They are routinely used as a proxy for unit prices. See Fontagné, Gaulier and Zignago (2008) for details

[17] High technology products include Aerospace, Computers-office machines, Electronics-telecommunications, Pharmacy, Scientific instruments, Electrical machinery, Chemistry, Non-electrical machinery, Armament. Due to change in methodology in 2007, more recent data are not comparable

*3.2.2. The size of French exporting companies*

**French exports are characterized by a lower number of exporting firms and a high level of concentration.** With 100,000 exporting companies, about 1 in 20, the share of exporting companies is lower in France than in Germany. Moreover, export volumes tend to be concentrated among a relatively small set of exporting companies. In 2007, the top 10% French exporting firms accounted for 94% of export revenues[18]. Moreover, in terms of corporate group, the phenomenon may be even stronger as many exporting companies belong to the same groups. This concentration is due to the fact that only the most productive firms, those who expect to benefit most from it, will engage in exporting activities. This could be linked in particular to the existence of fixed costs related to exporting activities.

**Although French firms have increased their quality, efforts have not been sufficient, in particular in high-technology industry and knowledge intensive services.** Indeed, exporting companies tend to be larger, more productive and more profitable than the others[19]. The productivity gap between exporting and purely domestic companies is particularly acute for SMEs. For larger companies, exports are associated with higher productivity only when markets outside the EU are served. Moreover, evidence show that exporting companies were already over-performing peers before they actually started to export. Such findings are consistent with the idea that fixed export costs exist that allow only the most productive firms to access foreign markets. These factors could be very diverse, including the cost of finding new customers, logistic costs or cultural aspects. Some threshold effects, due in particular to administrative burden or regulation, are often cited as reasons for the difficulties of SMEs to reach the size that would allow them to export.

**The diversity of exporting firms in France suggests that a two-tier approach is needed to provide effective support to exporters**. Indeed, for larger companies and affiliates of big groups, with better access to export market, the main challenge is to maintain their market shares. In comparison, the 78 000 smaller exporting firms have difficulties to overcome barriers to export. Indeed, specific measures have been taken to encourage exports of SMEs. The scope of Ubifrance, the public agency supporting French exporting companies, has been reformed with a special focus on promising emerging countries. The guarantees granted by Coface have been adapted to support exporting companies throughout the crisis. Finally, the cooperation between the various support schemes for exporting SMEs (Ubifrance, Oseo and Coface) have been strengthened.

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18 Source: Cancé (2009)

19 Crozet, Méjean and Zignago (2010)

**Table 3: Evolution of different type of exporters**

| Type of exporter | 2001 | 2010 | Variation |
|---|---|---|---|
| Independent SMEs | 93 000 | 78 000 | -15 000 |
| Affiliates of a French group | 6 000 | 6 000 | 0 |
| Foreign firms | 9 000 | 11 000 | 2 000 |
| **Total** | **108 000** | **95 000** | **-13 000** |

Source: French Parliament (2011), document 3807

*3.2.3. Innovation in the private sector*

**The decreasing high-tech export market share of French exports points toward a lack of innovation by French firms.** Innovative companies benefit from a favourable market position that allows them to improve their margin and to develop their market shares. Investment in research and development is hence generally considered a cornerstone of long-term competitiveness. The general limitations to the level of investment of companies have been discussed above (see 2.3.3). R&D spending in France represented 2.3% of GDP in 2010. This figure is among the highest in the euro area. However, while public investment is high, private investment in research and development is significantly below that of Germany. In 2010, R&D spending by companies represented 1.4% of GDP in France and 1.9% in Germany. Moreover, this ratio has not significantly increased in France since 2000 while it rose over the same period in Germany. Out of the 1,000 EU companies that invest the largest amounts in research and development, 125 are French (compared to 244 in the United Kingdom and 204 in Germany[20]). However, this reflects more the large size of French companies than their R&D orientation. Moreover, for these French "R&D champions", R&D investment represents 2.1% of sales, below the average of 2.2% for the overall sample and significantly below the top R&D companies in economies such as Denmark and Finland (4.4% of sales on average), Sweden (3.4%) or Germany (2.9%).

**The low contribution of French companies to R&D has resulted in relatively poor innovation outcomes for the French private sector.** The number of PCT patents applications per billion GDP (3.85) stands below the average in the EU (4.00) and France obtains only modest benefit from licence and patent revenues from abroad compared to countries with comparable research intensity. Such a difference in the innovativeness of companies translates in the medium term into a technological lag of French products. In

[20] European Commission (2011), The 2011 EU Industrial R&D Investment Scoreboard, European Commission, Brussels

order to support innovation, the French authorities have developed an ambitious reform of the national innovation system. In particular, a number of measures have been undertaken to promote research and development in the private sector. The existing tax credit on research expenditure has been broadened in 2008 to allow SMEs to benefit more from the incentives it provides. A set of clusters, the "*pôles de compétitivité*", have been developed to foster linkages between public and private research. Finally, a programme of targeted investments to promote innovation has been launched: the "*investissements d'avenir*", which benefits from a EUR 35 million funding to support research in strategic areas. These programmes have been developed recently and, at this stage, there is limited information on their impact. The Innovation Union Competitiveness report for 2011, which assesses progress made on the various dimensions of the innovation system, points towards an increasing efficiency of research and development. However, the impact on export performance will only be felt in the long term.

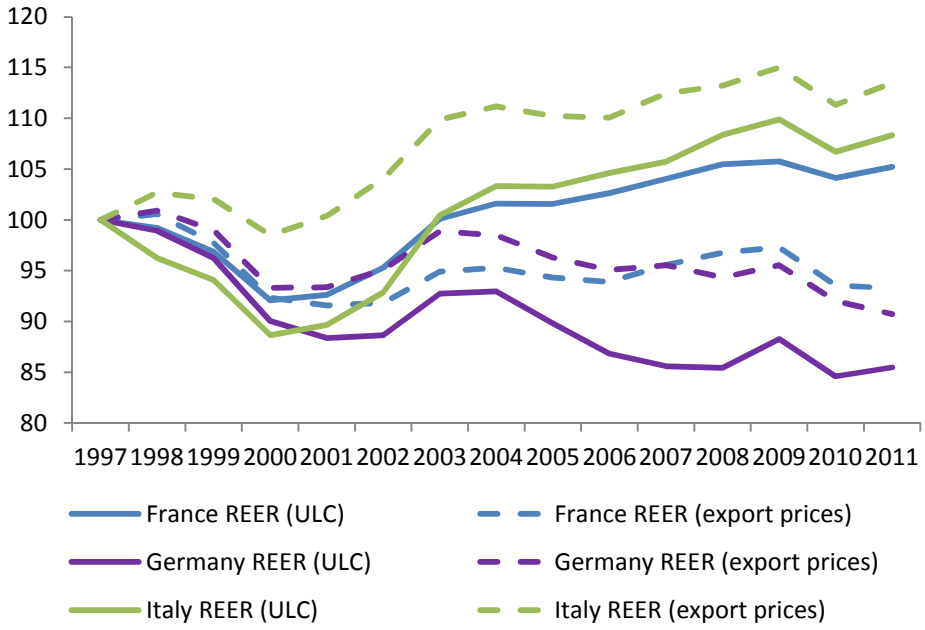
### *3.2.4. Linkages between price and non-price competitiveness*

The debate on the relative importance of price and non-price competitiveness on the deterioration of French exports is intense in France. In order to support price competitiveness, the main set of measures would focus on decreasing the cost of labour, in particular through a shift in taxation or through wage moderation. On the other hand, policies to foster non-cost competitiveness include support of export promotion programmes and of innovation capacities of companies. In order to maintain their market positions, French companies need to ensure that the price "adjusted for quality" is competitive. In that respect, both the price and non-price elements are to be taken into account.

Despite the apparent discrepancies between the two approaches, they are indeed complementary. Strong linkages exist between the policies related to price and non-price competitiveness. Despite the deterioration of cost competitiveness, the comparison with REER based on export prices shows that the French firms have compensated the gap in cost competitiveness between France and Germany by adjusting their prices and reducing their profit margins (see

Graph 25). This was done to the detriment of their ability to invest in R&D, to develop quality, after sales services and other aspects of their product offer, in a word, to the detriment of their non-price competitiveness. As a consequence, the long-term innovation capacity of the French private sector may have been impaired by a prolonged dearth of investment. Therefore, improving costs can allow firms to regain the ground lost in the non-price dimensions of competitiveness. Insofar as it allows companies to make the necessary efforts to build their non-price competitive advantages, an improvement of their cost competitiveness would have a positive long-term impact.

**Graph 25**: **Evolution of REER deflated by ULC and by export prices in EA top 3 exporters compared to IC 35**




Source: Commission services

## 4. POLICY CHALLENGES

The preceding analysis has shown that France is experiencing serious macroeconomic imbalances, which are not excessive but need to be addressed. In particular, certain macroeconomic developments in the areas of export performance and competitiveness deserve attention so as to reduce the risk of adverse effects on the functioning of the economy.

**French exports have been unable to keep up with the expansion of world demand since 2005.** This development resulted in increasing external imbalances, with a current account deficit from 2005 on. As a matter of fact, given the size of the economy, if this trend were to persist, the deterioration of the external situation of France could generate imbalances and represent a risk for the economic stability of the euro area as a whole.

With an aim to enhance the cost competitiveness of the French economy, **the authorities have implemented a number of measures.** Specifically, efforts have been made to contain the development of labour cost. On the one hand, the tax wedge on low wages had been reduced in three steps (1995, 2000 and 2003) and, more recently, a reduction of employers' social contributions, compensated by an increase in the VAT, was decided. On the other hand, additional discretionary hikes to the minimum wage have been stopped since 2006.

**Although these are steps in the right direction, the cost competitiveness of French exports could benefit from further measures.** A number of measures should target

labour costs, first of all by diminishing the **tax wedge on labour, shifting the tax burden towards** less distortive taxes such as environmental and consumption taxes. In the same vein, continuing efforts to contain the increase of the **minimum wage** would help control the rise in unit labour costs. Beyond labour cost, more action could also be conducted to lower other production costs and foster productivity. For example, exporters would benefit from further liberalisation of the regulated trades, beyond the efforts already undertaken, and of the network and transport industries, in particular on the electricity wholesale market and in the freight transport sector.

**Given the important role played by non-cost competitiveness in the development of French exports, specific attention is due to reforms in that policy area.** As the low profitability of French companies contributes to the moderate R&D investment level in the private sector, the above-mentioned initiatives to improve cost-competitiveness could help increase mark-ups and therefore **investment in R&D**. More specific measures, in particular the implementation of the *poles de compétitivité* (competitiveness clusters), the research tax and measures to support export potential of SMEs are welcome. However, while a comprehensive assessment of these measures is still to be performed, the authorities should insist that the need to improve competitiveness remains the overarching priority of these initiatives, and the guide to gauge their effectiveness. In particular, for the *pôles de compétitivité*, attention should be put on ensuring that the regional development dimension of the various clusters does not conflict with their efficiency in terms of innovation.

In order to further **develop human capital**, better consistency between education institutions and the private sector is needed. In particular, following the recent university reform, partnerships between private companies and tertiary education institutions should be reinforced. The further development of **lifelong learning** would also contribute to improve the skills of workers and develop productivity. More generally, measures targeted to the functioning of **labour market** would also contribute to a more dynamic economy. In particular, reforms to develop flexicurity and to reduce the segmentation of the labour market (in particular through a review of selected aspects of the employment protection legislation) would allow a more dynamic reallocation of labour employees towards more productive activities, with positive impact on competitiveness and on job creation.

The on-going **fiscal consolidation** strategy has helped reduce public deficits. However, these remain still high and the **debt ratio continues to rise unless further steps are taken**. With a view to bringing public debt on a downward path and to preventing possible crowding out of private investment, more productive government spending and a reduction of the tax burden that could support growth, it is important that France fully implement the planned budgetary adjustment and pursue a prudent fiscal policy thereafter, preferably on the expenditure side.

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