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In-depth review for FRANCE

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

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL AND TO THE EUROGROUP

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

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EXECUTIVE SUMMARY AND CONCLUSIONS

In last year's In-Depth Review (IDR), the Commission concluded that France was experiencing serious macroeconomic imbalances, in particular as regards developments related to export performance and competitiveness. In the new Alert Mechanism Report (AMR) published on 28 November 2012, the Commission found it useful, also taking into account the identification of a serious imbalance in May, to examine further the persistence of imbalances or their unwinding. To this end this IDR takes a broad view of the French economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **The resilience of the country to external shocks is diminishing and its medium-term growth prospects are increasingly hampered by long-standing imbalances.** In 2008 and 2009, the French GDP decreased by 0.1% and 3.1% a much smaller slump than in most euro area countries. Since then, in the midst of tensions on sovereign spreads and on the banking system, France has remained among the few EU Member States which avoided a recession in 2010 and 2011. However, the resilience of the economy has been put to the test and a number of imbalances, both internal and external, have built up in the last few years.

- **The on-going deterioration of export performance has resulted in increasing external vulnerabilities.** The trade balance has been decreasing since 1997 to a deficit of 2.5% of GDP in 2011. While the increasing energy bill has also contributed to this development, France has lost ground in non-energy goods and services. As a consequence, the current account balance, which was still at a surplus of 2.8% of GDP in 1998, recorded growing deficits from 2005 on, reaching 2.0% in 2011. The evolution of the current account is mirrored by a sharp increase in the external debt which reached 36% of GDP in 2011. Should these trends continue, they would increasingly push down France's medium-term growth prospects.

- **Both cost and non-price developments have contributed to important losses of export market shares.** The market share of French exports decreased by 11.2% between 2006 and 2011, still clearly beyond the 6% threshold. The appreciation in unit labour costs over the last few years has put the profitability of firms under pressure. To limit price hikes, exporters have reduced their margins, in particular in the manufacturing sector. This limited the resources they could dedicate to improve non-price competitiveness such as innovation. The reduced number of exporting firms, their relatively small size, as well as factors related to the business environment are also impediments for export performance.

- **Rigidities on the labour market hinder the adjustment capacity of the economy and slow down developments in productivity.** The high tax wedge has a negative effect on labour demand and on the number of hours worked. The increasing tax burden on labour has also contributed to rising labour costs. Furthermore, a highly segmented labour market results in uncertainties for a large share of employees, reducing incentives to increase their human capital and hence productivity. More generally, rigidities in the labour market may limit the potential for reallocation of workers across sectors and occupation. The recent agreement between social partners is a welcome step in the right direction and could have an impact on the way the labour market operates. Still, continued efforts to fully develop social dialogue are needed in order to implement further reforms that will tackle labour market rigidities.

- **The low profitability of companies, in particular in the manufacturing sector, together with their high indebtedness, represents a threat to the overall competitiveness of the French economy.** The profit margin of French companies is the lowest in the euro area. Specifically, operating surplus in the manufacturing industry has experienced a significant

drop in the last ten years as companies were unable to pass on production cost increases to final prices. Additionally, the increasing indebtedness in the private sector may affect the ability to invest and innovate. In that respect, the 3.1% contraction in equipment investment seen in 2012 is a worrying signal.

- **The high and increasing public debt is reducing the capacity of public finances to face potential adverse shocks and could result in negative spill-overs to the whole economy.** While risks to medium-term sustainability appear moderate, sensitivity tests show that adverse economic events may have a significant negative impact on debt dynamics. Rising debt levels could adversely affect the country's banking system and thus have a negative impact on firms' financing costs. More generally, rising debt service could drive out more productive government expenditure and result in higher taxes. Finally, France's public sector indebtedness represents a vulnerability, not only for the country itself but also for the euro area as a whole.

- **A consistent set of reforms, addressing both fiscal and structural imbalances, has been initiated by the government to restore competitiveness in the medium term.** The commitments of the French authorities to achieve a sizeable structural effort despite disappointing economic growth, together with withering tensions in the euro area, have contributed to strengthening market perceptions of the public debt. A wide set of initiatives has been launched to foster competitiveness, including through measures to reduce the cost of labour (the "*Pacte pour la compétitivité, la croissance et l'emploi*") and to further develop flexicurity. While these reforms are steps in the right direction, they will not be sufficient to solve the competitiveness issues and, in view of the challenges ahead, further policy response will be needed.

The IDR also discusses the policy challenges stemming from these developments and what could be possible avenues for the way forward. The measures included in the competitiveness pact recently adopted by the authorities represent a significant step in the right direction. Further efforts will need to be done, targeting in particular innovation capacity and export potential of companies. Specific attention should be also dedicated to ensure that increasing indebtedness of companies does not hinder their investment capacity. Further measures addressing the cost of production, for example through higher competition in service, should be considered. Finally, the agreement reached by social partners on flexicurity is an important first step, but still needs to be translated into law, a critical step to ensure the effectiveness of the reform.

1. INTRODUCTION

On 28 November 2012, the European Commission presented its second 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" (IDR) 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 follow-up it will recommend to the Council.

This is the second IDR for France. The previous IDR was published on 30 May 2012 on the basis of which the Commission concluded that France was experiencing macroeconomic imbalances, in particular as regards developments related to export performance and competitiveness. Overall, in the AMR the Commission found it useful, also taking into account the identification of a serious imbalance in May, to examine further the risks involved and progress in the unwinding of imbalances in an in-depth analysis. To this end this IDR takes a broad view of the French economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

2.1. Macroeconomic scene setter

Compared to peers in the euro area, the French economy weathered quite well the economic crisis in 2008 and 2009, but the resilience of the country would be diminishing. During those two years, GDP contracted by 0.1% and 3.1%, compared to a growth of 0.4% in 2008 and a contraction of 4.4% in 2009 for the euro area. Resilience of public and private consumption in particular helped alleviate the consequence of a strong contraction in international demand. In 2010 and 2011, GDP growth rebounded to 1.7% for both years. However, the continuing lack of confidence by both companies and households, in a context where room for fiscal stimulus dwindled, led to a gradual erosion of growth which came to a standstill in the last quarter of 2011. As a consequence of the slowdown, unemployment soared with the number of registered unemployed reaching 3 million people in August 2011.

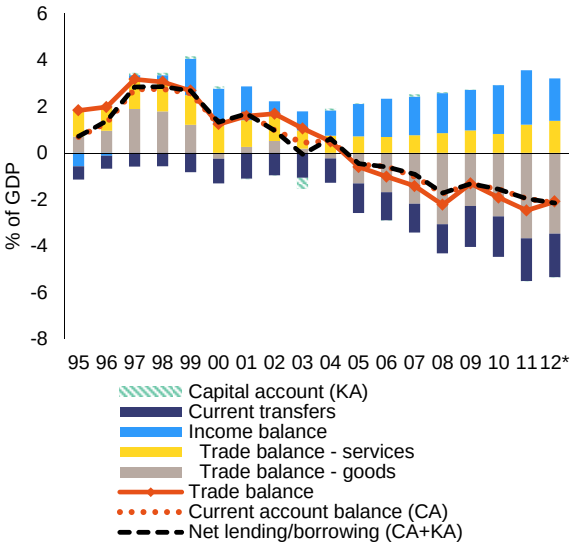
In 2012, GDP growth stalled and the increasing unemployment, together with a slow return of confidence and continuing fiscal consolidation, are expected to continue weighing on domestic demand and to postpone the recovery to the medium run. In its winter forecast, the Commission expects GDP to rise by a meagre 0.1% before returning to significant positive figures from 2013 on. The difficult situation on the labour market and tax rises implemented in the 2013 budget are set to limit the potential for rebound in private consumption. Despite the slowdown in international demand addressed to France, sluggish domestic demand is expected to contain imports and to translate into a moderate and one-off improvement of the external position of France. Symmetrically, in 2014 the gradual recovery of domestic demand would result in higher imports, therefore a widening trade deficit. Still, the measures that have been implemented to support export competitiveness in the last few months would contribute to somewhat limiting the deterioration of the external position in the outer year. Sustainability of external positions

The in-depth review published by the Commission in May 2012 concluded at the existence of imbalances linked in particular to the developments in the external position of France. Indeed, over the last few years, the current account and the trade balance have exhibited increasing deficits.

2.1.1. Evolution of the current account

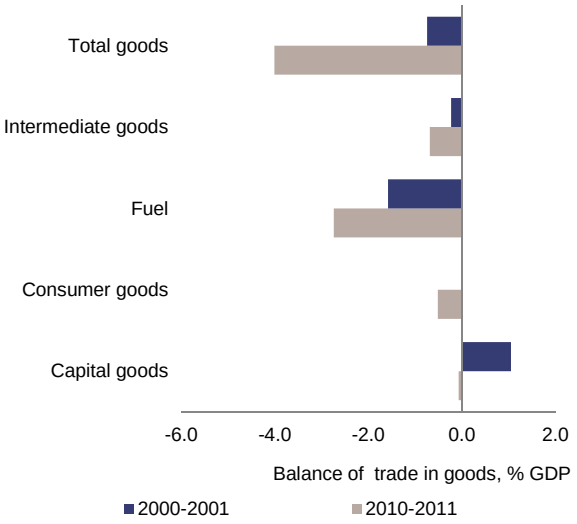
The current account has gradually deteriorated over the last decade to reach a record deficit of 2.0% of GDP in 2011, revealing weaknesses in the French adjustment to a persistent deterioration of competitiveness. Since 1997, the current account balance has been on a downward trend. It turned negative in 2005 and has deteriorated significantly since then. Only in 2009, in a context of decreasing GDP in France and of sharp reduction in world trade, did the current account deficit experience a significant contraction (from -1.7% of GDP in 2008 to -1.3% in 2009). However, as the economy returned to growth in 2010 and 2011, so did the current account deficit. Although its 2011 record level remains below the alert threshold (-4%) the negative dynamics is a cause for concern. In 2012, monthly balance of payments data suggest a further deterioration of the current account deficit, mainly due to lower income balance, and despite a slight improvement in the trade balance.

Graph 1: Components of Net Lending/Borrowing (% of GDP)



Data source: Commission services (Eurostat)

Graph 2: Trade Balance Contributions by Broad Category



Data source: Commission services (Eurostat)

The development in the current account mainly reflects the increasingly negative contribution of goods, and in particular energy to the trade balance. Trade for goods and services recorded a deficit of EUR 38.9 billion in 2011 (-2.5% of GDP) compared to a surplus of EUR 23.8 billion in 2001 (+1.6% of GDP). This was mainly driven by the deterioration of the net trade in goods. The comparatively stable domestic demand during the crisis translated into a steady imports expansion while goods exports as a share of GDP still remain below their level in the early 2000s. The growth in net imports of energy over the last 10 years has contributed to this development (see Graph 2). Between 2001 and 2011, exports and imports of energy[1] expanded at a rapid pace, due in particular to increasing oil prices. As a consequence, the already large energy goods trade deficit in 2001 swelled considerably, to represent EUR 62.1 billion in 2011, 2.7 times its level 10 years before. The energy-

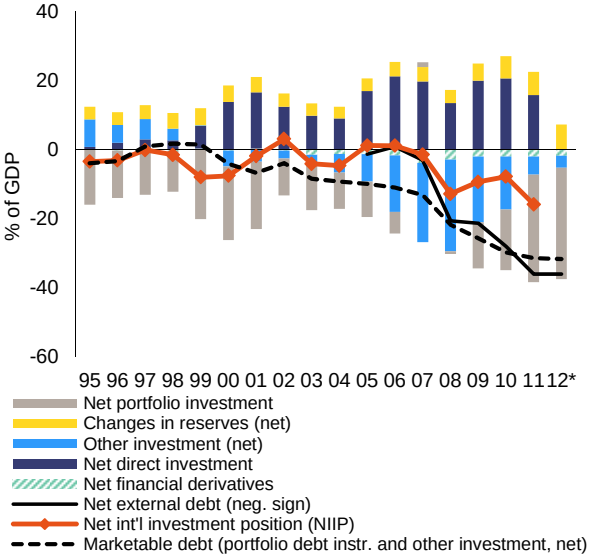
[1] Based on COMEXT data (SITC), including "Electricity", "Coal, coke and briquettes", "Gas, natural and manufactured" as well as "Petroleum, petroleum products and related material"

related trade deficit hence accounts for 70% in the merchandise trade deficit. This negative contribution of energy, which explains part of the trade deficit development, is not specific to the French case. In the EU-27 as a whole, net import of energy was multiplied by 2.9 between 2001 and 2011, representing a deficit of EUR 384 billion in 2011, hence leading to a total trade deficit of EUR 162 billion. However, while in the EU as a whole the increasing energy related deficit was met by higher trade surplus in other categories of goods, the French trade balance in non-energy products, including in particular capital goods, deteriorated rapidly (from a surplus of EUR 17 bn in 2001 to a EUR 26 bn deficit in 2011). On the other hand, net trade in services remained resilient throughout the last decade. After a decrease up to 2005, net trade in services has rebounded both in nominal terms and as a percentage of GDP since then.

A relative stabilisation of the trade deficit was seen in 2012, losses in competitiveness will continue to weigh on external balance in the medium term. Monthly balance of payment data for 2012 show an improvement of the goods balance EUR 2.2 bn in 2012 (EUR 6.6 bn based on custom data) mainly due to strong sales in the aeronautic sector (exports increased by 18%, leading to record surplus of EUR 20.3 bn for the aeronautic and spatial sector). The service balance also grew by EUR 5.5bn. Looking forward, the waning domestic demand, together with the carry-over of strong export performance in the second part of 2012 will result in a contraction of the trade balance deficit in 2013. These would however not result from an improvement in competitiveness. Once the economy returns to growth, notwithstanding the support from the aeronautical sector seen in 2012, the trade balance should continue to deteriorate as import growth would outpace that of exports. In the long term, recent measures taken to support competitiveness and develop a more flexible labour market should contribute to improving the competitiveness of exports. However, it is worth highlighting that a number of countries have also engaged in far-reaching structural measures to support competitiveness. In particular, France's southern peers, Spain and Italy, have implemented significant reforms, including on the labour market, hence putting additional pressure on France's capacity to regain market shares.

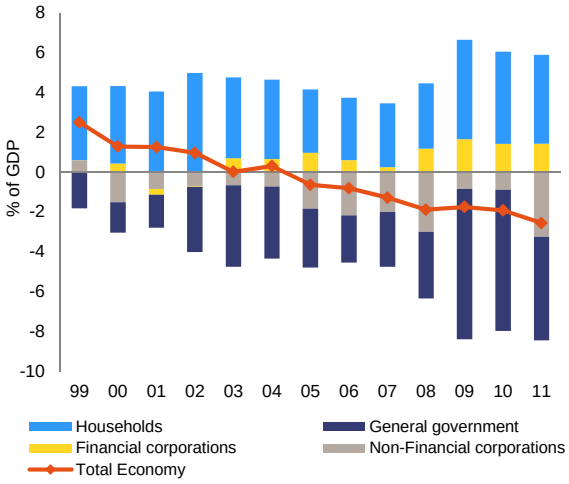
The recent deterioration in the income balance, although still in surplus in 2011, makes the rebalancing of the current account even more difficult. On the positive side, the income balance of the current account, which was stable between 2006 and 2009 at 1.7% of GDP, improved significantly in 2010 and 2011 to 2.4% of GDP. This development is linked primarily to increasing net revenues from French investment abroad (by EUR 10.5bn in 2010 and EUR 2.7bn in 2011). Current transfers include in particular workers' remittances and transfers of the government, in particular to the European Union. They presented a deficit of 1.8% of GDP in 2011 and have remained almost constant since 2009. Capital transfers are generally insignificant in the French balance of payment. Since 2005, the only significant contribution was recorded in 2007 (EUR 1.9 bn) when a French company sold oil developments permits. Based on monthly balance of payment data for 2012, the upward-trending income balance experienced a sharp turnaround: the overall balance decreased by 38% compared to 2011. This resulted from higher revenues paid by French residents on portfolio investments which outpaced the growth in revenues from French investment abroad. Payment on foreign portfolio investments in France have risen rapidly in the last few years (+39% between 2006 and 2011), reflecting the importance of these investments in the overall financing of the current account deficit. Such a development is not a surprise in an economy with a persistent current account deficit, and it is likely to prevail over time, with long-lasting negative consequences on the current account balance.

Graph 3: Decomposition of Net International Investment Position



Data source: Commission services (Eurostat)

Graph 4: Net Lending / Borrowing by sector



Data source: Commission services (Eurostat)

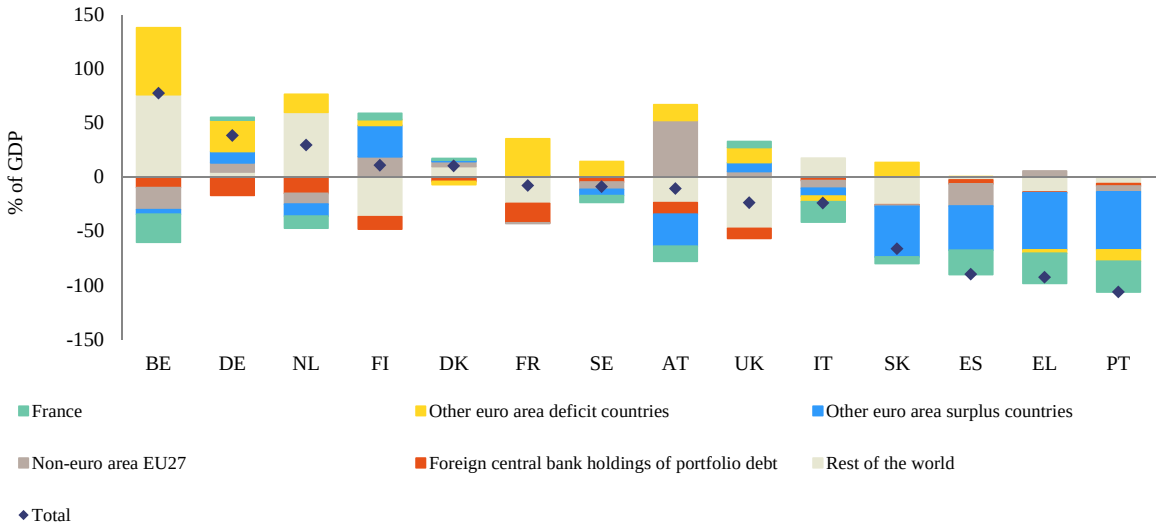
2.1.2. Financing of the current account deficit

The net international investment position (NIIP) of France showed a deficit of -15.9% of GDP in 2011, the most negative in the last 15 years. A clear deterioration can be observed since 2007, when it stood at -1.5% (see Graph 3). In 2011, as in 2008, most of the deterioration in the NIIP came from negative valuation effects which strongly impacted the value of foreign assets held by French residents. A decomposition of the financial account of the balance of payment shows that, while net direct investment by French companies remained higher than inflows of foreign direct investment, the current account deficit was financed by inflows of portfolio and other investments (thus mainly debt). The negative balance on portfolio and other investments has widened sharply since 2002 to represent -36.4% of GDP in 2011. Foreign holding of French bonds, and in particular treasury bonds, are the main contributor to the recent developments in net portfolio investment. This resulted in a rapid increase in external net debt in France, which represented 36.1% of GDP in 2011.

On top of the increasingly negative external position, the strong net exposure to peripheral euro-area countries remains as a risk. France appears to play an intermediary role in gross financial flows between the euro area and the rest of the world. An estimated breakdown of net foreign assets by partner regions in 2010 (see Graph 5) shows that France's net external liabilities towards non-euro area central banks and other non-EU creditors represents 17% and 25% of GDP respectively (see European Commission, 2012a). The net liabilities towards these two categories of foreign bond holders widened considerably since 2007, and reflect the foreign demand for French bonds as reserve and 'safe' euro-denominated assets. In particular, the net inflows of non-EU capital seem to have been mainly directed towards treasury bonds, hence contributing to financing the increasing budget deficit while keeping interest rates at a low level. On the other hand, France is a net creditor to the euro area 'deficit' countries for 34% of its GDP. Again, the net assets towards this group of countries are mainly composed of debt, mostly inter-bank loans or bonds. Taking into account the evolution in these positions since 2006, the economy thus received net inflows from both private and public creditors in non-EU countries and channelled them to euro area deficit countries. This development resulted in a significant exposure of French residents, and in particular of the main French banking institutions,

toward debt, both private and public, in peripheral euro-area economies, a situation that entails significant risks and requires further monitoring.

Graph 5: Decomposition of Net International Investment Position by partner (2010)



Data source: Commission services (Eurostat)

2.1.3. Contribution of the institutional sectors

The widening external deficit is fuelled by net borrowing needs of non-financial corporation and of the government. The contribution of the government to the overall external deficit increased with the eruption of the crisis. In 2009 and 2010, net borrowing by the government reached 7.6% and 7.1% of GDP respectively. In 2011, a better coverage of public expenditure by revenues resulted in a decrease in borrowing by the government. Public investment remained at a similar level compared to 2010. The lower borrowing needs from the government were however offset by the increasing needs of private companies. In addition, non-financial corporations resumed investment while displaying continued low corporate savings in line with low profitability. The indebtedness in the non-financial corporate sector thus continued to expand (after a temporary lull in 2009 and 2010). The weakening of the current account balance is thus reflected in the net lending/borrowing of two sectors: the government, in line with still high fiscal deficits, and non-financial corporations, due to weak profits and savings compared to investment. On the other hand, households and financial corporations continue to be net lenders to the economy. Their level of savings and investments changed only marginally in 2011, with households remaining important net lenders to the other sectors.

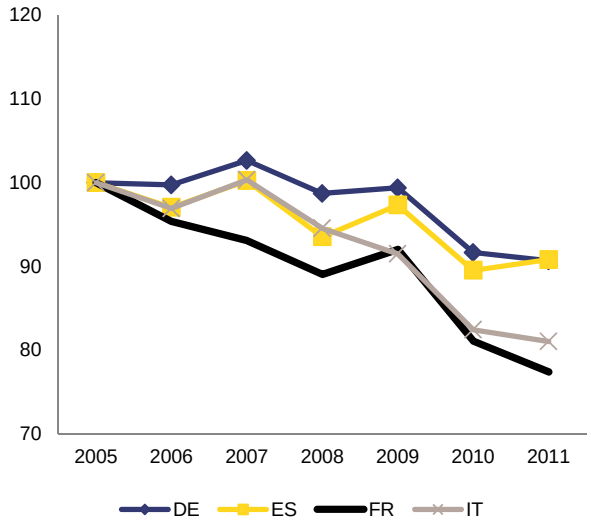
2.2. Competitiveness and trade performance

2.2.1. French market shares

The significant and long lasting contraction of the world export market shares of France since 2000, with its adverse impact on the current account remains a source of concern. The 5-year losses in export market share, the indicator defined in the AMR, have been above the 6% indicative threshold every year since 2000. Losses were most severe between 2003 and 2008, when market shares decreased by 21.5%. Since then, a relative stabilisation took place. The indicator has slightly recovered and, in 2011, the 5-year-change in market shares sets at a loss of 11.2%. Over the last few years, divergent trends can be observed between goods and services. While exports of goods have

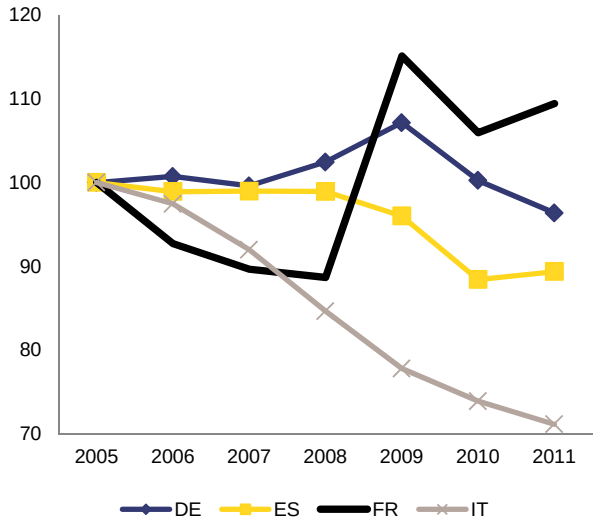
consistently underperformed compared to peers (see Graph 6), France gained market shares in services in the last 3 years. In particular, travels appear to have contributed significantly to this good performance, reflecting the strong tourism sector in France. Services contribute positively to the overall export performance, but their lower weight in world exports (services represented close to 20% of total world trade in 2011[2]) means that the impact is limited. Overall, the erosion in the export market shares since 2000 partly reflects the increasing weight of export-oriented emerging economies. However, the deterioration of the relative position of France compared to peers in the European Union shows that specific weaknesses weigh on French exports.

Graph 6: Export market share – Goods, index 2005=100



Data source: Commission services (Eurostat)

Graph 7: Export market share – Services, index 2005=100



Data source: Commission services (Eurostat)

[2] Source: UNCTAD data on total world exports

2.2.2. Geographic orientation

Compared to its main peers in the EU, French exports appear slightly more oriented toward the EU 27 and in particular toward the euro area (see Table **1**). Specifically, in 2011, they are quite close to the German and Italian performance as regards EU27, although the French bias towards the euro area is larger (about 8pp). This is probably partly the outcome of the different geographical position of each country, with France being a central country within the euro area, whereas Germany for example is closer to Eastern Europe, mostly outside the euro area. In France, as in peer economies, trade partners outside the EU represent an increasing share of exports between 2006 and 2011. Since 2006, the share of French exports toward other EU 27 Member States has decreased by 4.6 percentage points. However, it remains higher than in Germany and in Italy. Conversely, exports to emerging economies, and in particular to the BRICs is lower than in these two economies (+36% against +50% for Germany and +41% for Italy). Compared to peers, Spanish exports also remain very much targeted towards the EU. However, the pace of market expansion to other economies, and in particular towards the BRICs appears much faster than for France.

Table 1: Share of export in euro area top exporters by destination 2006-2011

	2011			2006		
	EU27	EA17	BRICs	EU27	EA17	BRICs
FR	**60.9**	**48.2**	**6.1**	**65.5**	**50.9**	**4.5**
DE	59.3	40.9	10.5	63.6	43.4	7.0
IT	56.0	43.7	7.0	61.2	46.6	5.3
ES	66.6	56.5	4.1	71.2	57.2	2.9

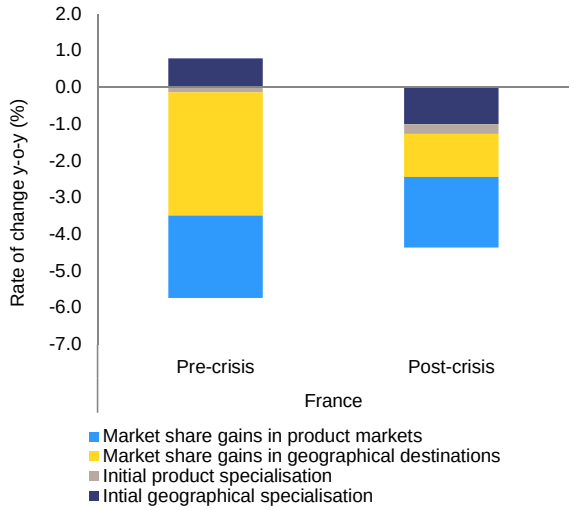
2.2.3. Product orientation

Exports are very much concentrated in five large export categories representing an important share of total exports. In 2011, as in 2006, the top 5 product categories (according to the classification of products by activity 2008 based on NACE rev 2) are (i) air and spacecraft and related machinery, (ii) motor vehicles, (iii) pharmaceutical preparations, (iv) parts and accessories for motor vehicles and (v) refined petroleum products. Together, they represent 29.5% of exports in 2011, compared to a similar 29.7% in 2006 (34.3% in 2001 a year when sales of aircraft were particularly strong). This is significantly higher than the contribution of the 5 largest exports categories for Italy (representing 17.3% of exports) and slightly above the figure for Germany (28.4%). More generally, out of the 253 product categories included in the CPA classification, 80% of French exports in goods are concentrated in 59 product categories (compared to 70 in Italy, 57 in Germany and 71 in the euro area).

Product specialisation played only a limited role in the export market share development in the last few years. In particular, France appears relatively well positioned on high-technology exports,

including in particular the aeronautic sector. An analysis of revealed comparative advantages, conducted in particular in Fortes (2012), confirms the importance of high-tech sectors in French exports. This may be a sign that losses in market shares in France do not come from insufficient exports of high-tech goods but rather from relative weaknesses in the other segments where competition could focus more on prices. France has actually been unable to keep up with the developments in the product markets in which it has a presence both before and after the crisis.

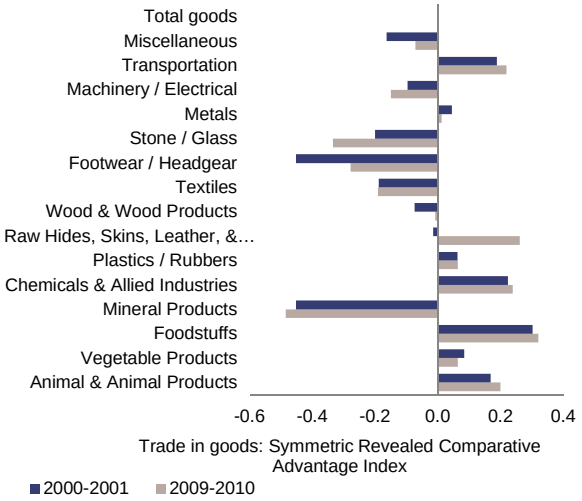
Graph 8: Decomposition of nominal export growth



Data source: Commission services (Eurostat)

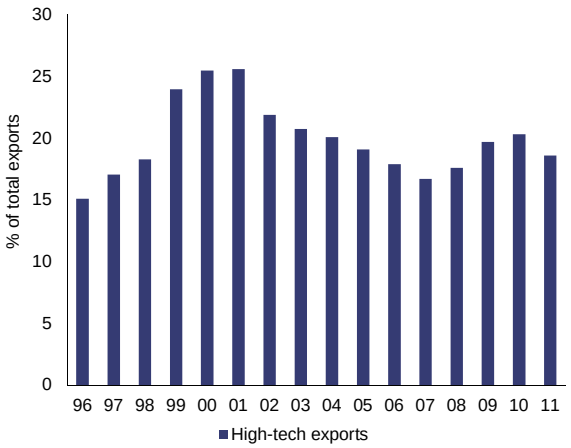
The action plan of the government for export promotion presented in December 2012 focuses efforts on 4 sectors deemed as promising. These sectors, identified on the basis of a prospective study conducted by the Ministry of Finance and Economy, are healthcare, agro-food, information and communication technologies (ICT) and durable cities (including utilities, railway transportation and energy efficiency). These sectors have been selected based on their growth potential by 2022 taking into account the competitive position of France. A review of revealed comparative advantage indices show that foodstuff, transportation equipment and chemical (including pharmaceutical) are indeed among the sectors where France already has a strong competitive positioning. One could note however that aeronautics is not among the four sectors, although it is one of the main export categories. Moreover, the focus on ICT, a sector that is neither among the top exporting sectors in France nor one of those where France has a revealed competitive advantage may be rather motivated by the importance of the sector in world trade. In particular, ICT also plays a crucial role as an "enabling technology" (European Commission, 2009) as developments in this sector are driving the evolution of the overall production process for other goods and services.

Graph 9: Revealed comparative advantage index – Goods



Data source: Commission services (Eurostat)

Graph 10: Share of high-tech products in exports

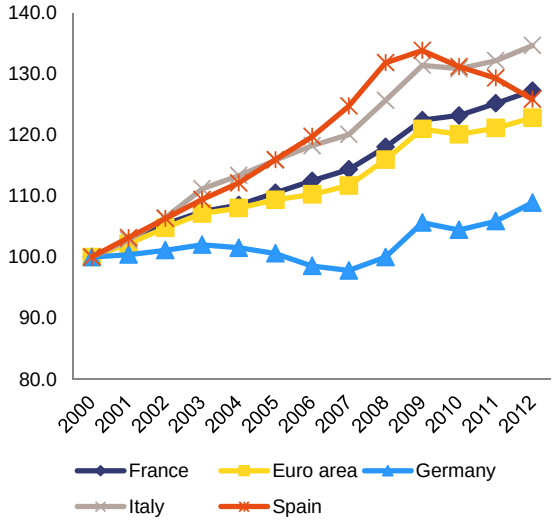


Data source: Commission services (Eurostat)

2.2.4. Price and cost developments

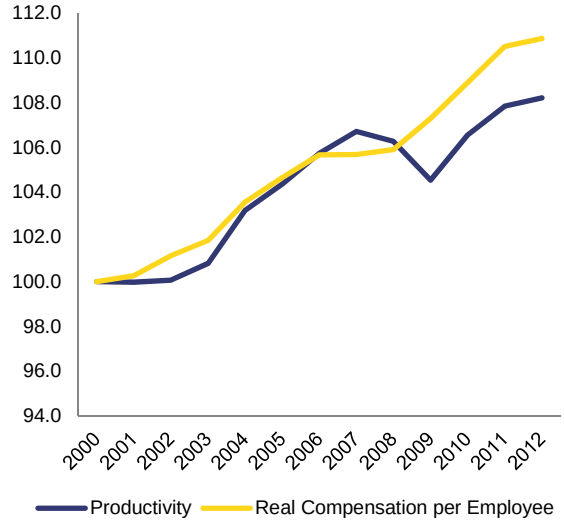
The losses in market share over the last decade have coincided with a deterioration of the cost competitiveness position, as measured through the evolution of unit labour cost (ULC) indicator. Since 2000, nominal ULC increased in France at a faster pace compared to that in the euro area and Germany in particular (see Graph 11) but still not as rapidly as in Italy and Spain, which have also experienced losses in market shares (-18.4% from 2006 to 2011 in Italy and -7.6% in Spain). While the rise in nominal ULC deteriorated cost competitiveness, the previous IDR noted that the upward trend in real wages outpaced productivity to the detriment of firms' profitability. This development is confirmed by the preliminary data for 2012 included in this year's vintage (see Graph 12).

Graph 11: Evolution of nominal unit labour cost in the four main euro area exporters



Data source: Commission services (Eurostat)

Graph 12: Real wages and productivity in France



Data source: Commission services (Eurostat)

Both nominal labour cost and productivity increased at a faster pace in France than in the euro area. Looking at the real effective exchange rate (REER) based on ULC allows assessing the impact of these developments on the actual cost competitiveness vis-à-vis trade partners. Although the evolution

of ULC aggravated developments in the REER, most of the evolution comes from variations in the nominal exchange rate (driven in particular by the Euro/USD exchange rate) as is the case for most euro area economies. The fact that REER based on ULC show similar developments in all euro area exporters, due in particular to the evolution in the nominal exchange rate, also points towards country-specific non-cost issues to account for the divergence in export competitiveness.

Graph 13: Decomposition of Real Effective Exchange Rate in France (against IC-35)

Data source: Commission services (Eurostat)

2.2.5. Labour market rigidities and competitiveness

Labour market rigidities can have a negative impact on export performance through various channels, beyond the effect of cost of labour on competitiveness. In a rapidly changing environment, labour market rigidities hamper reallocation of labour towards fast-growing sectors and make low-technology sectors less able to withstand price competition from more flexible emerging economies. The high level of protection provided by the employment protection legislation for permanent contracts may reduce the inter-sectorial adjustments which may need to take place between the tradable and the non-tradable sectors to correct current account imbalances. While the cost of economic dismissals in France does not stand out as particularly high, uncertainties associated with the procedure may induce companies to use more frequently interim workers. This increases flexibility but also contributes to labour market segmentation with less training offered and weak incentives to invest in human capital for some workers. Although efforts have been made by the authorities to develop partial unemployment to improve the flexibility for employers facing a temporary drop in activity, the complexity of the procedures and the lack of awareness of employers are key barriers to the development of these schemes. Finally, the high statutory minimum wage (representing 60% of the median wage) prevents downward wage adjustment, while its indexation formula may lead to both average wage pressure (Cette et al, 2012) and wage compression; both have an adverse effects on competitiveness and export capacity.

2.2.6. The role of non-cost competitiveness

Last year's IDR concluded that, although cost competitiveness is a contributing factor, most of the deterioration in exports market shares originates in the loss of non-cost competitiveness. Although cost competitiveness deteriorated when compared to competitors, French export price

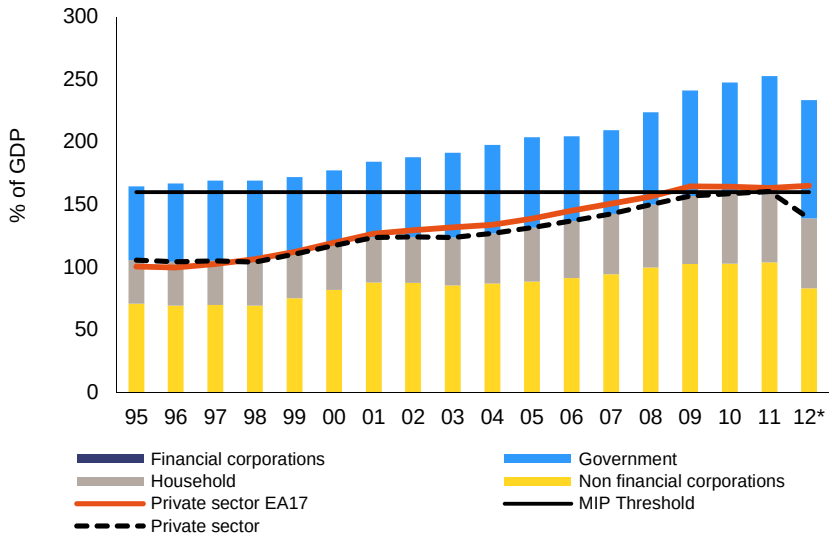
remained competitive, suggesting that losses in market shares might be also explained by quality related factors. However, given the increasing costs, exporters appear to have strived to maintain price competitiveness to the detriment of their operating margins. The deterioration in margin might be impeding companies' ability to invest and to innovate. As will be further reviewed in Section 3, although non-price competitiveness (including aspects such as the business environment, the propensity of French firms to export and to innovate) is considered as the primary driver for the poor export performance, cost issues may also have had both a direct impact, through prices, and an indirect one, through exporter's margins.

The continuous losses in export market shares have prompted the adoption of a number of policy initiatives. Policies supporting exports generally focus on improving access to finance, promoting and providing consultancy services to exporters and supporting companies signing important contracts. In particular, a public export guarantee scheme is operated by Coface[3] to cover potential risks associated with the financing of export contracts. Further actions are also considered as part of the creation of the "*Banque publique d'investissement*". While these policies facilitate existing current exports, they are not meant to help new companies reach the critical size to engage in export. To do so, the government has launched in November 2012 its *Pacte pour la competitivité, la croissance et l'emploi* which aims at fostering competitiveness of firms in general to help them engage in export activities (see Section 3.1).

2.3. Private sector indebtedness

The level of unconsolidated private debt which was just below the threshold of 160% of GDP in 2010 has continued to rise to 160.4% of GDP in 2011. The continuous increase over the last few years warrants a more detailed analysis of potential financial vulnerabilities of the private sector.

Graph 14: Decomposition of non-consolidated debt



Data source: Commission services (Eurostat)

[3] Coface is a private company providing credit insurance and trade risk expertise to exporters. Originally a public company, it was privatised in 1994 and now distributes its products through its direct presence in 66 countries

2.3.1. Households

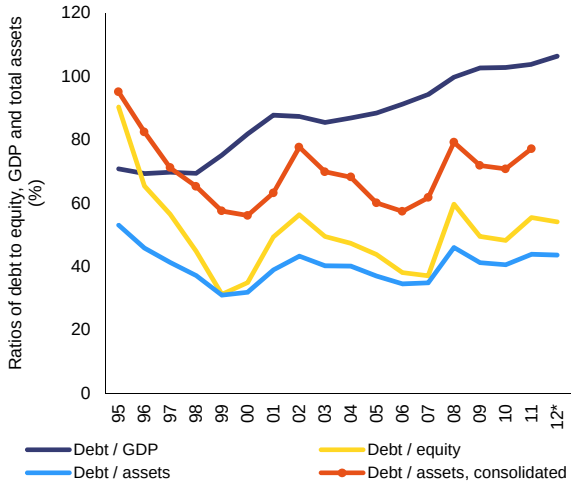
The indebtedness of French households has risen in the last few years, although it remains below the average in the euro area. With household debt representing 57% of GDP in 2011, France remains clearly below the euro area level (64.2% of GDP in 2011). The actual level of indebtedness of households, which represented 82.9% of their gross disposable income in France in 2011 compared to 97.3% in the euro area, is not particularly worrying. On the other hand, the dynamics cause some concern. While household's indebtedness in other euro area economies has been on a downward trend since 2009, it continued to increase regularly in France. The main driving force behind it is the continuous growth in real estate credit, sustained in particular by dynamic housing prices and low interest rates. Recent developments on the real estate market show that volumes have gone down in 2012 while prices have fallen somewhat. As a consequence, new real estate credit in 2012 fell by 32% compared to 2011. Due to the high duration of these instruments, the overall real estate credit volume has nevertheless continued to grow, although at a reduced pace, in 2012. As no significant recovery is expected in the short term on the real estate market, the low level of new credit could translate into a gradual decrease in real estate credit volumes.

The rising unemployment level weighs on the financial situation and prospects of households. The unemployment rate stood at 10.3% in the third quarter 2012. While this is still slightly below the EU average (10.5%), this level is getting close to the historical maximum observed in 1997 (11.2%). In the medium run, these downward pressures on gross disposable income are not expected to abate. Despite measures such as the creation of the *emploi d'avenir* and the *contrats de génération* taken to limit the rise in unemployment, in particular among youth, the Commission expects that unemployment will remain high in 2013 and 2014. As a consequence, households' gross disposable income is expected to contract slightly in 2012 and 2013 respectively. Thus, despite the expected stabilisation in the nominal credit volume, household indebtedness is not expected to go down in the medium term.

2.3.2. Non-financial private companies

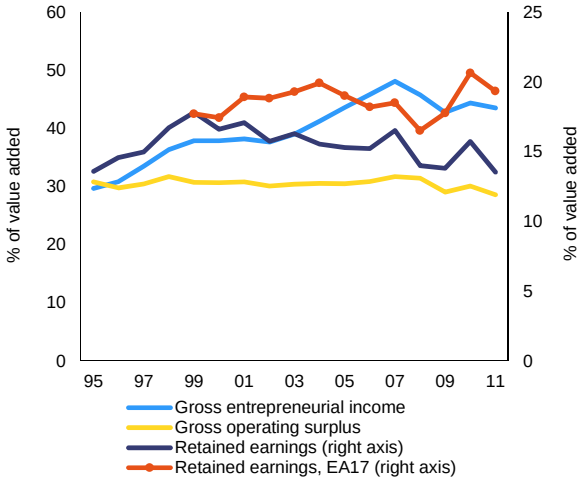
The non-consolidated debt of non-financial companies increased in 2011 to reach 103.8% of GDP, slightly above the euro area average (99.0%). A comparison of the consolidated debt, netting out inter-company loans, in France and in the euro area yields similar results: consolidated debt by non-financial corporations reached 82.7% of GDP in 2011, its highest level in the last 10 years (compared to 81.4% in the euro area). Despite the somewhat higher level of debt, the leverage of companies, measured in particular through the ratio between debt and equity, remains below the euro area average. In 2011, net financial assets of non-financial companies represented 105.9% of GDP in France and 90.4% of GDP in the euro area. Overall, the leverage of companies, which spiked in 2008 as a result of sharp decrease in equity, has somehow deflated since then despite the continuously growing debt.

Graph 15: Leverage, Non-Financial Companies



Data source: Commission services (Eurostat)

Graph 16: Profit margin of non-financial companies



Data source: Commission services (Eurostat)

The gross operating margin and retained earnings of companies have been on a downward trend over the last 10 years. Accordingly, although the actual financial structure of non-financial corporations does not point to specific weaknesses, the erosion of their profit margins in a context of relatively high indebtedness represents a cause for concern (see Graph 16). As a consequence of the crisis, profitability suffered particularly in 2008 and 2009. However, in 2010 and 2011, the margin recovered less in France than in other euro area economies. Overall the low and deteriorating profitability of French non-financial companies, reflected by the poor performance in terms of gross operating income and return on capital compared to the other euro area members, together with the increasing level of debt, point toward potential vulnerabilities.

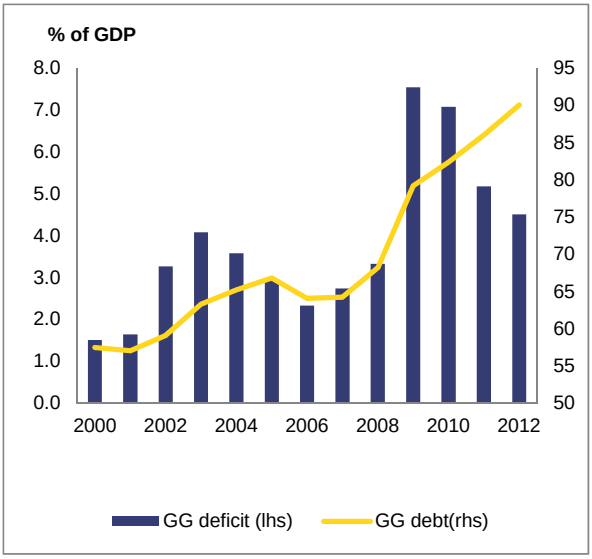
2.4. Public sector indebtedness

High public sector indebtedness is a major challenge that France still needs to address. At 90.3% of GDP in 2012, the debt ratio is forecast to be slightly higher than the EU average of 87.2% 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 on an upward trend since then (see Graph 17).[4]

The government has engaged in a strong fiscal consolidation since 2011, which helped lower the deficit to an estimated 4.6% of GDP last year from above 7% in 2009-2010. This is expected to further decrease in 2013, which is the excessive deficit procedure deadline for France, but to remain above the 3% of GDP reference value. **Nevertheless, the debt ratio continued to rise over 2011-2012 and is set to exceed 93% of GDP by the end of this year.** The government plans to put the ratio on a downward path from 2014 and bring it close to 80% of GDP by the end of its five-year term (2017). 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, debt targets contained in the successive stability programmes have regularly been revised upwards and often missed. In that respect, the recent transposition of the Treaty on Stability, Coordination and Governance (TSCG) into national law, which now provides for a correction mechanism in the event of slippages, is supposed to secure the planned fiscal adjustment and thus ensure a gradual reversal in debt dynamics.

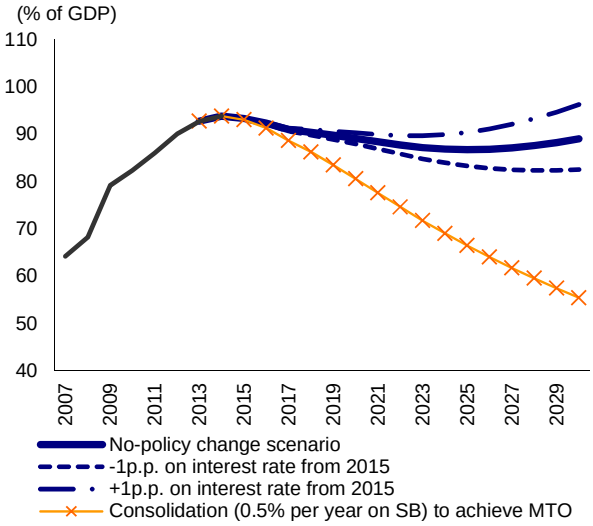
[4] See the 2012 In-Depth Review for a description of past trends.

Graph 17: General government deficit and debt as % of GDP



Data source: Commission services (Eurostat)

Graph 18: Public Debt as % of GDP - Medium- and long-term debt projections



Data source: Commission services (Eurostat)

Note: Shocks to interest rates are applied on short and long-term interest rates, on both maturing and new debt

According to the Commission 2012 Fiscal Sustainability Report, France does not appear to face a risk of fiscal stress in the short term. Nonetheless, there are some indications that the fiscal side of the economy continues to pose potential challenges in the medium term. Under a no-policy change assumption, public debt would not be reduced below 90% of GDP by 2030. Moreover, different sensitivity tests show that adverse economic events (such as a 1 pp. permanent increase in interest rates) may have a significant negative impact on debt dynamics in the long run (see Graph 18).

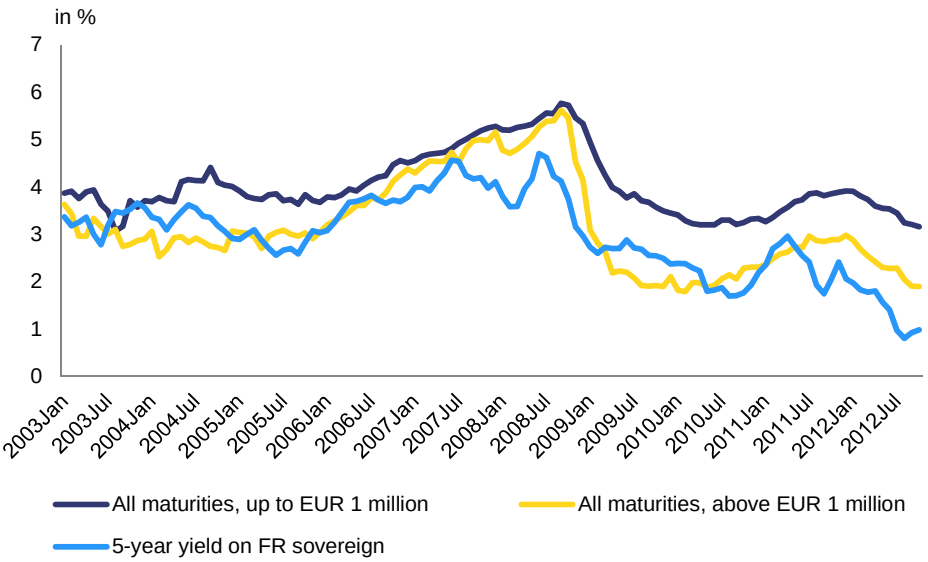
France's high public debt could adversely affect the country's banking system, which is largely exposed to French sovereigns. As of June 2012, the four major French banks had a total of EUR 115 billion in French government bonds according to figures from the European Banking Authority. The spread vis-à-vis the German bund has significantly decreased since its peak in November 2011 and French sovereign yields are currently at historical lows. This has prevented so far domestic banks from experiencing losses on national government bond holdings and additional funding and liquidity constraints. However, the significant drop in equity prices and financial stability concerns that the French banking sector experienced in 2011 due to its exposure to peripheral EU countries and in particular to sovereigns show how much this might be affected in case of a deterioration in the market perception on the sustainability of the country's public debt. Indeed, the re-pricing of peripheral government debt had a direct negative impact on the asset side of French banks and therefore on their own perceived riskiness (as also reflected in successive rating downgrades), which in turn made their refinancing harder. Moreover, such re-pricing eroded the volume of collateral available and thus further stressed the refinancing possibilities of French banks.

The negative impact on firms' financing costs is yet another potential drawback of the high government debt. Long-term sovereign bond yields are strongly correlated with corporate and bank bond yields, and thus with bank lending rates. This tie will remain strong in particular as long as bank resolution in the euro area remains the fiscal responsibility of national governments. As shows in Graph 19 the recent fall in sovereign yields has actually translated into lower cost of capital for non-

financial corporations (NFC). But, conversely, a (significant) increase in government bond premiums can become a major obstacle to granting loans to the real economy. As banks are the main source of financing in France, this could seriously jeopardise the flow of credit to enterprises and households. Small and medium-sized enterprises, which rely heavily on bank loans, would be particularly affected. In addition, a rising level of public debt could also potentially lead to the crowding-out of private investment, with public debt further competing with private debt for the allocation of savings.

More generally, rising public debt may impact on growth prospects and competitiveness through the debt service, which drives out more productive government expenditure but also often tends to increase taxes. It is worth mentioning that fiscal consolidation in France (as measured by the change in the structural deficit) has so far been very much revenue-based while the pre-adjustment tax burden was already high. On the other hand, losses of competitiveness render high debt levels even more problematic as they weigh on growth prospects, which in turn make it more difficult to put the debt ratio on a downward path. These two effects are mutually reinforcing and could turn into a vicious circle. In addition, the fiscal space to tackle further shocks or severe private imbalances tends to decline with the stock of government debt.

Graph 19: Interest rates to NFCs compared with 5-year yields on French sovereign bonds



Data source: Commission services (Eurostat)

France's public sector indebtedness represents a major vulnerability not only for the country itself but also for the euro area as a whole. Past tensions on peripheral euro area sovereigns have provided clear evidence for systemic risks. In particular, highly interconnected financial markets and cross-border balance sheet exposures have generally acted as transmission channels. Should the second largest euro area and core economy be put under intense market pressure, spill-overs to other Member States and to the euro area as a whole would be highly likely and could be amplified by confidence effects.

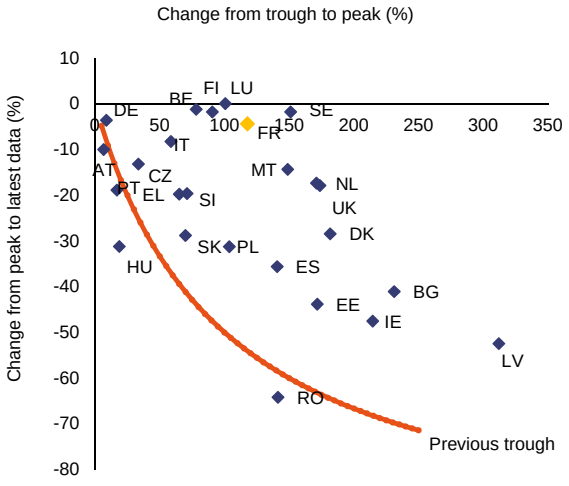
Increasing public debt and related future developments in sovereign yields warrant close monitoring in France. The debt stock will continue to rise in the short term due to the slow economic recovery and the gradual reduction in the general government deficit. As a consequence, higher interest rates in the short to medium run cannot be excluded, even though a credible medium-term

consolidation strategy can make an important contribution to averting this. In fact, some rebalancing in sovereign yields appears likely given current record lows, which are partly due to the risk aversion that has so far supported German bunds and filtered through to other euro area economies including France. Moreover, growing concerns from different stakeholders, including investors, international organisations, rating agencies and think tanks on the country's capacity to meet the planned budgetary targets and carry out much needed structural reforms might exacerbate pressures and reverse market sentiment, which then might overreact given the high debt ratio and especially after a protracted period of time that has not seen any extreme events affecting France materialising.

2.5. Asset market development

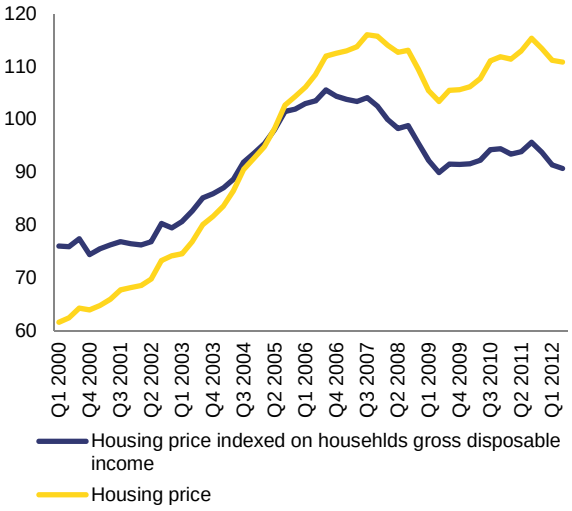
France stands out in the European Union as one of the few economies where real estate price did not contract significantly since 2007 despite a prolonged period of growth (see Graph 20). Housing prices more than doubled in the ten years leading to 2007. As a consequence of the financial crisis, asset prices plummeted. For example, the CAC 40 lost 50% of its value between Q2 2007 and Q1 2009. However, housing prices proved very resilient and, over the same period, they only decreased by 7%. In 2010 and 2011, prices actually recovered and reached in Q3 2011 their peak value of 2007, before slowly contracting by 2% since then.

Graph 20: House price cycle



Data source: Commission services (Eurostat)

Graph 21: Nominal house prices and household gross disposable income; 2005=100



Data source: Commission services (Eurostat)

Note: Trough/peak: BE 95Q2/10Q4, DE 10Q4/12Q2, IE 97Q1/07Q3, EL 00Q1/09Q1, ES 97Q1/07Q3, FR 97Q1/07Q3, IT 97Q4/09Q1, CY 05Q1/08Q1, LU 95Q1/12Q2, MT 00Q1/08Q3, NL 90Q4/08Q3, AT 05Q1/09Q1, PT 96Q4/01Q3, SI 03Q1/08Q1, SK 05Q1/08Q2, FI 93Q2/10Q3, BG 02Q2/08Q3, CZ 04Q3/08Q4, DK 93Q2/07Q3, EE 03Q3/07Q2, LV 00Q3/07Q3, LT 00Q1/07Q3, HU 01Q4/04Q4, PL 05Q1/07Q3, RO 05Q1/07Q3, SE 96Q1/07Q3, UK 96Q2/07Q3.

This limited correction of the real estate market, after years of very rapid growth, means that indicators based on price deviate significantly from their long-term average, possibly pointing towards an over-valuation of housing prices. In particular, real estate prices have increased significantly faster than

households' revenues. However, a number of factors, underlying this evolution, continue to reduce the potential for a strong downward price adjustment. First, the housing market in France confronts a rigid supply and growing demand fuelled both by rising population and lower size of households. Supply constraints are particularly pressing in specific areas (e.g. Paris and the Provence Alpes Côte d'Azur region), fuelling important discrepancies among regions. Moreover, financing conditions for real estate have contributed to limiting the correction in housing prices. Interest rates on housing loans have dropped from 5.2% in January 2009 to 3.5% two years after. On the other hand, despite these incentives, the expected erosion in real disposable income (by 0.3% both in 2012 and 2013 respectively according to the Commission Services' winter forecast), as well as the end of the first owners' credit tax, will likely weigh on prices.

The 17.8% decrease in the number of dwellings started in 2012 compared to 2011, together with the low volumes of sales recorded by market participants, may be signs that stakeholders anticipate further corrections to take place. The strict lending criteria, which rely on revenues rather than on wealth, together with the absence of a mortgage market, mean that owners will not be pressed to sell their property immediately if prices drop. On the contrary, they would have incentives to postpone any sale. As a consequence, a price adjustment would be gradual and would not have a strong impact on the purchasing power of households. On the other hand, volume would shrink even further, putting the construction sector under additional pressure.

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

This section builds on findings of the previous year's IDR to present the main imbalances that have contributed to the loss in external competitiveness and it is organized as follows. First, some selected elements of cost and non-price competitiveness are presented to set the scene. Second, the weak profitability of French firms is analysed in detail. Finally, the last part tries to shed some light on why the current labour market framework represents a brake for competitiveness.

3.1. Cost and non-price competitiveness

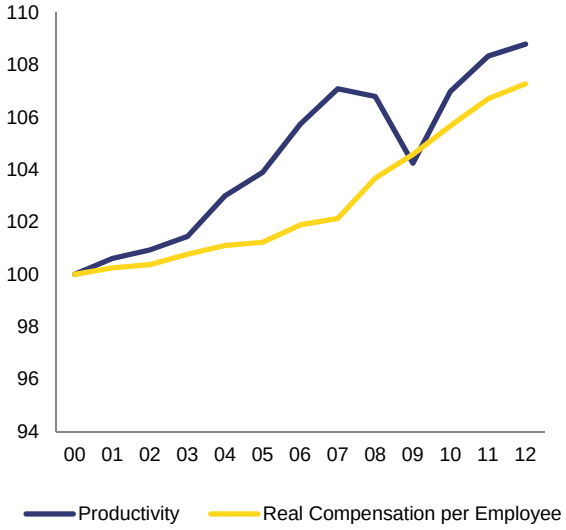
This sections draws on the findings of last year IDR to examine the main drivers of the deterioration in the export competitiveness. It focuses both on factors which contributed to cost and non-price competitiveness. It also summarizes the main reforms that have been taken since the release of the previous IDR.

3.1.1. Components of cost competitiveness

3.1.1.1. Labour costs

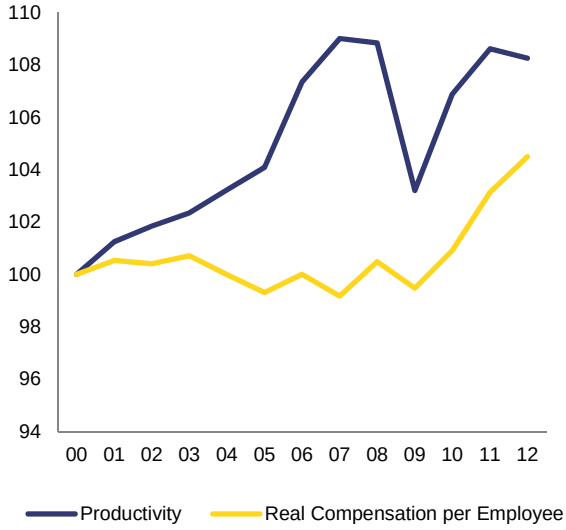
The real compensation of employees has risen quicker than productivity, particularly in 2009, leading to a rapid increase in nominal ULC (see Graph 11 and Graph 12). While this situation is common to many EU Member states, it is in stark contrast with that of Germany, where real wages stagnated or deflated between 2000 and 2007, resulting in a downward pressure on ULC (see Graph 23). While it affected the revenues of workers, impacting on living standards and contributing to sluggish domestic consumption, the decreasing labour costs made it possible for German companies to simultaneously improve their margins and reduce their prices in order to gain market shares. Since 2010, real wages in Germany have rebounded strongly, closing part of the gap with productivity.

Graph 22: Euro Area: Real wages and productivity; 100=2000



Data source: Commission services (Eurostat)

Graph 23: Germany: Real wages and productivity; 100=2000



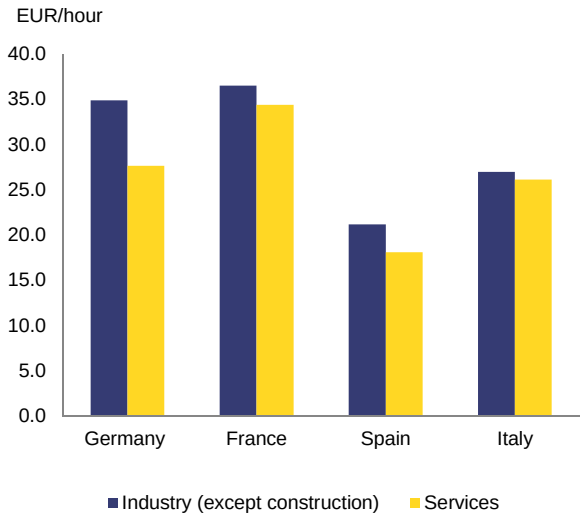
Data source: Commission services (Eurostat)

3.1.1.2. Costs of services

Business services are an essential input for the industrial sector and represent an important share of costs. Market services represent 23% of the cost of production in the industrial sector and 25% in the manufacturing sector. Rising wages in services would therefore affect all sectors, through the interplay of intermediary consumption. Based on the input-output table for France, and assuming that prices in all sectors adjust to reflect the increase in production costs linked to higher cost of services, a 10% increase in wages in the services sector would lead, *ceteris paribus*, to increases of 7.7% and 3.9% in the cost for services and the manufacturing sector, respectively[5]. While these figures do not reflect the actual adjustment that would take place – they overlook in particular the impact on demand of increases in wages, price setting mechanism by companies as well as labour market dynamics - they clearly illustrate the strong linkage between the level of wages in services and the overall costs in the manufacturing sector. As a consequence, the 20% increase in ULC in the service sector in France over the last decade (see Graph 25) had a strong impact on the overall cost competitiveness. In comparison to developments in France, unit labour costs in the service sector in Germany remained stable since 2000, as a consequence of reforms taken to open the sheltered sectors to competition and to reform labour market in order to make it more flexible (Hartz IV measures). Hourly cost of labour in services also appears particularly high in France compared to Spain and Italy (34 EUR/h against 28 EUR/h, 26 EUR/h and 18 EUR/h in Germany, Italy and Spain respectively). Although competition in services has become stronger, in particular as a result of the implementation of the Service directive, a number of sheltered sectors remain (including the retail sector, network industries such as transport or energy but also regulated trades and professions such as taxis, health sector, and some legal professions such as notaries). A strengthening of competition in these sheltered market services could contribute to lowering the cost of these services, hence indirectly improving cost competitiveness for exporting sectors.

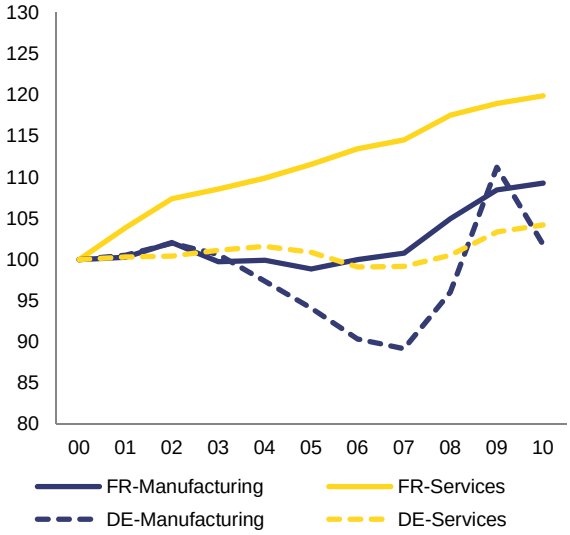
[5] By comparison, based on the same set of hypotheses, a 10% increase in wages the manufacturing sector would lead to an overall increase in prices in this sector of 3.8%

Graph 24: Hourly cost of labour in France, Germany, Italy and Spain



Data source: Commission services (Eurostat)

Graph 25: Unit labour costs by sector in France and Germany



Data source: Commission services (Eurostat)

3.1.1.3. Cost reduction through offshoring practices

The different models adopted by companies to establish their international presence are considered to have played a significant role in the relative cost performances of France and its main competitors over the last decade (see Fontagné and Gaulier, 2008). More specifically, to reduce their production costs, a number of French companies chose to outsource entire parts of their manufacturing process to countries where the cost of labour is lower in Central and Eastern Europe or in Maghreb. Conversely, German firms took advantage of foreign suppliers by outsourcing only portions of their production process, mainly in Central and Eastern Europe. This allowed them to reduce their costs while maintaining a share of value added in Germany and safe-guarding domestic skills and know-how. Accordingly, Direction générale des douanes et droits indirects (2012) observe that the turnover of subsidiaries of French firms abroad are 2.8 times larger than exports, possibly also reflecting the large share of services in the economy. This ratio is much lower in Germany and Spain (1.8 and 1.4 respectively).

3.1.2. Non-price competitiveness

Non-price competitiveness is the main factor explaining the poor performance of exports over the last decade. As further analysed in the 2012 IDR, the decreasing non-price competitiveness of the economy was the main contributor to the poor export performance since 1999. Such a development may be explained by the quality of products, the ability of some firms, and in particular SMEs, to engage in exporting activities and to invest, notably in R&D. The reduction of production costs and the restoration of profit margins may have a positive incidence in the medium term on investment and R&D, and therefore on innovation and non-price competitiveness in general.

3.1.2.1. A limited number of exporting firms

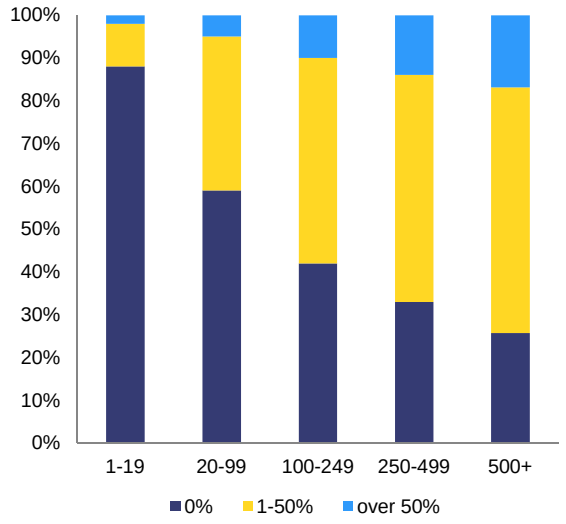
The limited number of exporting firms has contributed to the disappointing export performance in France. Comparing the structure of the industrial sector in France and in Germany shows that French companies tend to be significantly smaller. Based on data collected by the national statistical offices in France and in Germany (in 2006 and 2005 respectively), the proportion of micro industrial businesses

appears higher in France than in Germany (respectively 82% and 77%). Conversely, there is a higher proportion of larger (10 employees and over) industrial SMEs in Germany (21%) than in France (17%). As engaging in export activities entails significant fixed costs, French industrial firms may find themselves relatively handicapped when exporting, compared with their German competitors due to their relatively small size. Ceci and Valeirsteinas (2006) established at around 100 employees the critical size starting from which a firm can export to distant emerging countries without being constrained by size. This implies that French exporters will find it particularly difficult to exports to distant regions where the most dynamic markets lay.

3.1.2.2. A low propensity to export

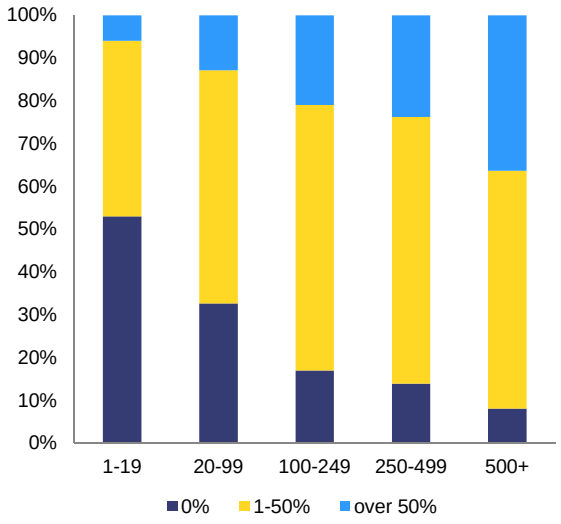
Beyond the smaller size of French exporting companies, their lower propensity to export also weighs on competitiveness. For a given size, the propensity to export (measured by the share of foreign sales in total turnover of exporting firms) of French firms is less than that of German firms. As Graph 26 and Graph 27 show, only 12% of the turnover of French small industrial firms (1-19 employees in industry, construction, trade and business services) is performed abroad, against 47% for their German competitors. The lower inclination toward exports, which could be explained by a relatively dynamic domestic demand and more microeconomic determinant (export promotion policies, role of chamber of commerce, cultural elements, etc.), has also contributed to the relatively lower export performance in France.

Graph 26: Percentage share of export revenues of French firms by size*



Data source: Insee, Institut für Mittelstandsforschung (2004 data)

Graph 27: Percentage share of export revenues of German firms by size



Data source: Insee, Institut für Mittelstandsforschung (2004 data)

***Scope: Industry, Construction, trade, and business services**

3.1.2.3. Linkage between cost and non-price competitiveness

Beyond the apparent opposition between the two approaches, cost and non-price competitiveness actually complement one another. In the last few years, despite increasing costs, a comparison of REER based on export prices shows that firms have reduced their margins to maintain export prices, in particular compared to Germany. These efforts to compensate for a reduction in cost

competitiveness were detrimental to long term non-price competitiveness as firms had less financial resources to invest in R&D, to develop quality, after sales services and other aspects of their products.

Conversely, a reduction in production costs, be it through the cost of labour or of other components, can allow firms to conduct the necessary adjustments to regain some of the ground lost in the non-price dimensions of competitiveness. In particular, if firms rather choose to restore their profit margins to the detriment of the reduction of their prices, a reduction in the taxes on labour can have a positive long-term impact on non-price competitiveness of companies.

3.1.3. Recent measures to strengthen competitiveness

The authorities have taken a series of measures specifically aiming at restoring competitiveness which seek both to lower costs of production while supporting innovation. In particular, the "National Pact for Growth, competitiveness and employment" represents a significant step to restore export competitiveness of firms.

A number of measures have been developed to foster innovation in the private sector. However, their impact will only be felt in the medium run. The tax credit on research expenditure has been broadened in 2008. Independent SMEs represented 72% of the tax credit beneficiaries in 2009 and they accounted for 18% of claimed R&D expenses but for 22% of the amount distributed. In addition, 71 clusters, the "*pôles de compétitivité*", were initiated in 2005 to foster linkages between public and private research. A 2012 evaluation of the clusters highlighted their mixed effectiveness, with only one third of participating companies have indicated that their membership enabled them to expand sales and improve their ability to export. Among the 71 clusters, a reorganisation of the less effective ones, and further focalisation or resources, could be relevant to ensure that critical size is reached to generate economies of scale and spill-over from research. Finally, a programme of targeted investments to promote innovation was launched in 2010: the "*investissements d'avenir*", which benefits from a EUR 35 bn funding to support research in strategic areas over 10 years.

The "National Pact for Growth, competitiveness and employment" which was launched in November 2012 includes a number of measures to restore both cost and non-price competitiveness (see Box 1). In particular, the pact includes a tax credit which shifts tax away from labour, a reform that had been called for in the Country Specific Recommendation issued by the Council in July 2012. The government estimate that this reform will create 300,000 jobs and increase GDP by 0.5% by 2017. While the assessment of this impact may be on the optimistic side, in particular with respect to timing, this measure is likely to have a positive impact on export performance. Companies will most likely use the tax credit to restore profitability, one of the lowest in the EU, rather than to decrease export prices. The competitiveness gains would therefore arise due to non-cost factors: higher profitability would allow exporting firms to invest in order to increase productivity and to improve the quality of their products. Such an improvement in non-price competitiveness will therefore only gradually translate into an improvement in the trade balance. While this would delay the impact on growth and employment, it would also lay the foundation for a more sustainable export dynamics.

Box 1: The government's pact for competitiveness

Responding to the Gallois report, Prime Minister Jean-Marc Ayrault, presented on Tuesday 6 November a "National Pact for Growth, competitiveness and employment", which would, according to him, help to create more than 300,000 jobs by 2017 and would boost the economy by 0.5% over the same period.

a) The main measure, a "tax credit for competitiveness and employment"

The creation of the EUR 20 bn "tax credit" (1.0% of GDP) on corporate tax indexed on the payroll, which will increase over three years: EUR 10 billion in 2013, therefore reimbursed on the corporate tax paid in 2014, and an additional EUR 5 bn for each of the two following years, 2014 and 2015, therefore reimbursed in 2015 and 2016. In the end the rebate amounts to a 6% cut in labour costs.

To finance this measure, the main VAT rate will be raised to 20% in 2014 from 19.6% today, and a reduced rate that applies to restaurant bills and property repairs will rise to 10 % from 7%, raising a total of EUR 6 bn (0.35% of GDP). The government announced plans to cut 0.5% of GDP from public spending in 2014-2015 and said it would introduce a new green tax from 2016 yielding 0.15% of GDP per year.

b) The other measures

The "National Pact for Growth, competitiveness and employment" includes 35 measures, some of which are taken from the report. The main measures are:

- Public guarantees for SMEs: the Public Investment Bank (BPI), whose creation was decided in 2012 and which results from the merger of three existing entities (OSEO, the CDC Enterprises and the Strategic Investment Fund), was included in the new Pact. It would provide more than 500 million euros to SMEs in 2013 via a new public guarantee.

- Four fiscal commitments: the credit research rebate, capital tax rebate for investments in SMEs, the "Madelin" status of young innovative companies as well as the "Dutreil" devices will be confirmed over the next five years.

- New commitment of the State to pay faster: The state will undertake to achieve a payment period of 20 days from its suppliers up to 2017. Public orders will also involve SMEs and innovative intermediate-sized corporates ("ETI") up to 2% in 2020.

- Future investments redirected: Redeployment of nearly EUR 2 billion of funding will be made in favour of five priorities (innovation and sectors, enabling technologies, energy transition, health and economy of living, training). This will facilitate the implementation of strategy courses, also carried by sectoral arrangements within the BPI.

- The research tax rebate (CIR) will be pre-financed by the BPI.

- Employees in Board of Directors: There will be at least two employee representatives in the board of directors as deliberating members in large companies.

- Support of SMEs on the international: 1,000 SMEs and intermediate-sized corporates will receive a "personalized" international help, performed by the BPI.

- Export financing doped: A direct public lender will be implemented in the next supplementary budget.

- 25% increase of international corporate's volunteers (VIE) in three years

- A "Brand France" will be launched to promote what is made in France.

- High Internet everywhere: The high-speed Internet will be deployed throughout the country.

- Dual training: the number of people trained in alternation will double, with no fixed deadline.

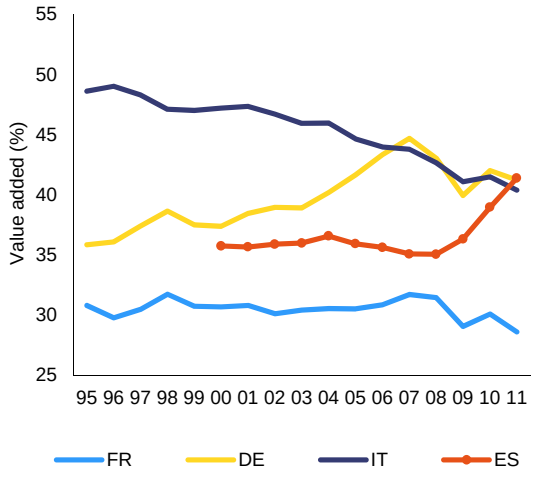
- Commercial courts will be reformed in order to improve the efficiency of the business justice.

3.2. Financial situation of non-financial corporations

3.2.1. The profit share of non-financial corporations

Profit margins of non-financial corporations, as measured by gross operating surplus as a share of gross value added, have decreased significantly since 2008 after being flat for 10 years (see Graph 28). In addition, NFCs' profitability is the lowest in the euro area, far below that of German, Italian or Spanish peers (28.6% in 2011 vs. 41.2%, 40.4% and 41.4%, respectively). While comparing levels across countries might partly mask country-specific factors, the relatively worse situation of French companies is also apparent in the gap between current profits and historical averages. Indeed, the profit share of German and Spanish NFCs is currently still above its long-term levels, unlike that of French companies.

Graph 28: Gross operating surplus of NFCs in selected Member States



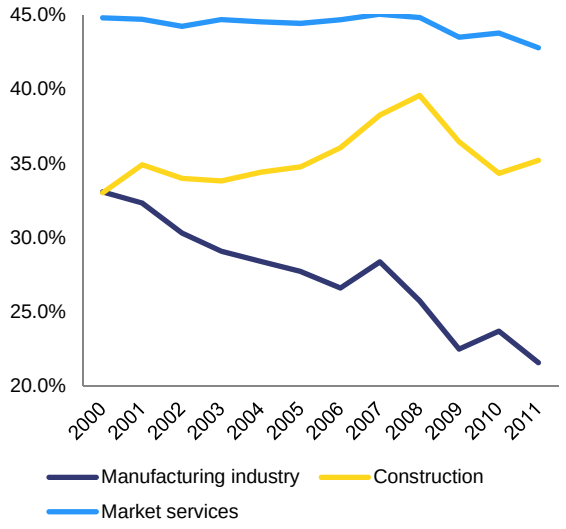
Data source: Commission services (Eurostat)

However, the deteriorating profitability of NFCs in recent years reflects divergent trends across sub-sectors. Based on national accounts (NACE rev.2 classification) and following the approach presented in Coe-Rexecode (2012a), it is possible to break profit margin developments down by broad activities. While differences in levels across activities are largely explained by different production structures

and market specificities, changes in profitability over time are clearly an indicator of the relative strength of companies operating in different sub-sectors.

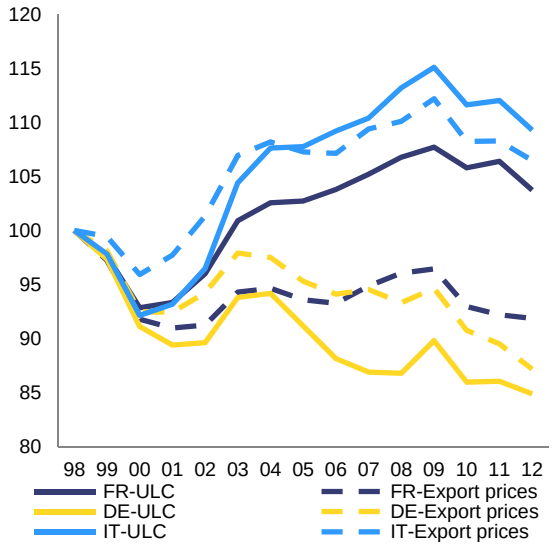
The construction sector experienced a continued improvement during the pre-crisis period before suffering a downturn in 2009-2010 (see Graph 29). However, it remained the only one large sector in the economy posting an increase in the profit share over 2000-2011. Profitability in the services sector has also witnessed a drop in recent years but this has remained relatively limited so far. However, the biggest fall has been in industry. The gross operating surplus of companies in the manufacturing sector shrank by an alarming 34.6% over 2000-2011 (as a share of gross value added) and the crisis seems to have aggravated this.

Graph 29: Gross operating surplus by broad activities



Data source: Commission services (Eurostat)

Graph 30: Evolution of REER deflated by ULC and by export prices for the euro area top 3 exporters compared to IC 35



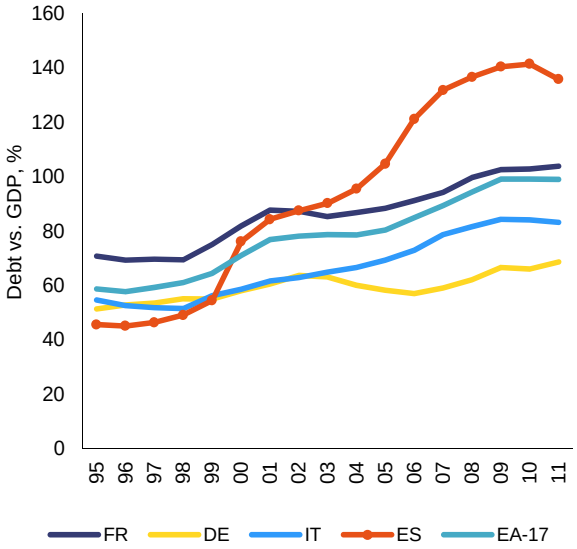
Data source: Commission services (Eurostat)

The drivers behind that deterioration can be assessed through the development of cost components. In particular, the price of intermediate consumption in industry increased by an overall 22.9% over 2000-2011 in industry, beyond the 19.9% hike recorded in services. The price of production rose by 13.6% and 19.9%, respectively, over the same period. This points clearly to the relative inability of the manufacturing sector to pass on higher production costs to the final price. Such outcome is quite intuitive given that industry is much more exposed to international competition than the services sector. It is also evidenced by REER developments based on export prices showing that companies have compensated the deterioration of cost competitiveness by adjusting prices and reducing profit margins (see Graph 30).

3.2.2. Non-financial corporations indebtedness

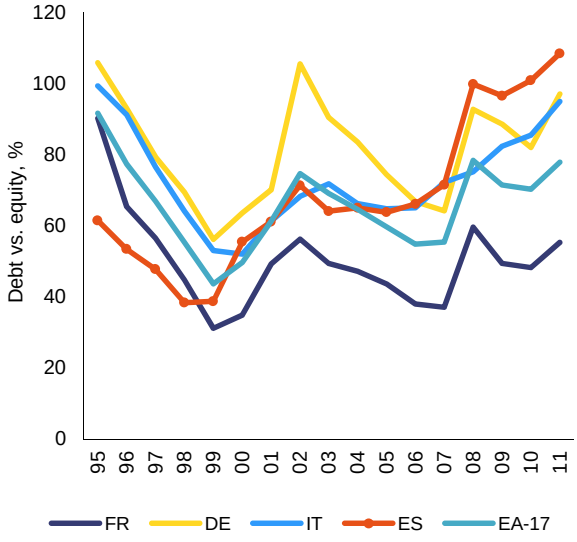
Concerns about the sustainability of debt, both public and private, are at the heart of the on-going crisis in the euro area. French NFCs' indebtedness increased almost continuously in the past decade to reach a new high of 103.8% of GDP in 2011, with the rise somewhat decelerating since 2008-2009 on the back of weak consumer demand and the financial crisis. The gap compared with the euro area average somewhat narrowed over that period while debt levels of German and Italian NFCs remained significantly lower (see Graph 31).

Graph 31: Debt as a % of GDP



Data source: Commission services (Eurostat)

Graph 32: Debt-to-equity ratio



Data source: Commission services (Eurostat)

While the MIP scoreboard has given prominence to the private sector debt-to-GDP ratio, it is relevant to use a wider range of macroeconomic indicators to assess the capacity of NFCs to manage their debt.

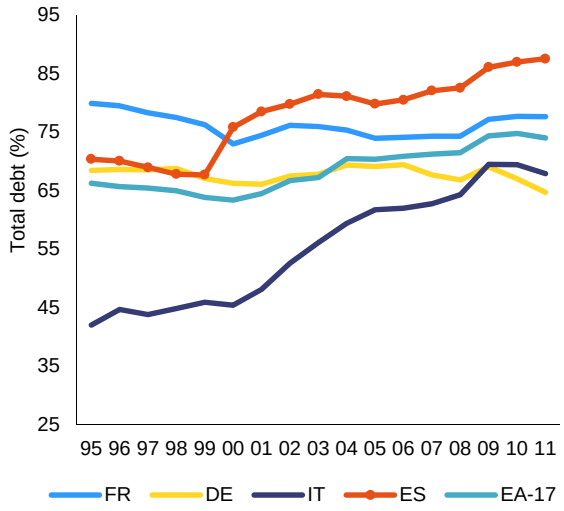
The debt-to-equity ratio of resident NFCs remained clearly below the euro area average and below that of their German, Italian or Spanish neighbours (55.4% in 2011 vs. 97.2%, 95.1% and 108.6%, respectively, see Graph 32). Although the structure of the private sector may play a role in the discrepancies observed among countries it also represents a signal that there is no specific risk linked to the financial structure of NFC's in France.

The financial situation of NFCs can also be assessed through the ratio of debt to financial assets. NFCs can employ financial assets to produce income or to repay debt in the case of liquid assets. Therefore, an analysis of debt relative to financial assets provides a more complete understanding of the NFC balance sheet and their capacity to service debt. Under this measure, NFCs had a ratio of 43.9% in 2011, clearly below the euro area average and the lowest among peers. This implies that the debt levels were less than half the sector's financial assets.

Another approach to assessing NFC debt is to compare the maturity of the types of debt used by the sector. If companies rely on short-term loans or securities, this may result in higher liquidity risks and greater sensitivity to increases in interest rates. The ratio of long-term to total NFC debt for selected Members States is shown in Graph 33. Higher ratios may be an indication of reduced vulnerabilities of NFCs to debt repayments. NFCs in France had the second highest ratio over 2000-2011 after Spain at around 75% on average.

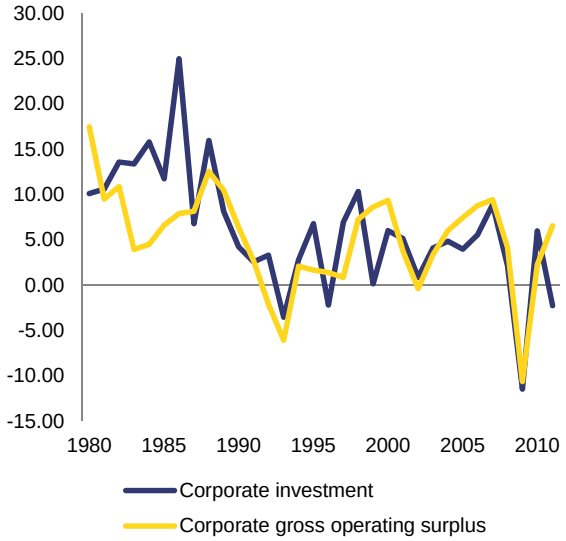
Overall, weak and recently deteriorating profit margins have weighed on NFCs' deleveraging capacity, as also evidenced by a relatively high level of investment despite weakening self-financing. However, the main driver behind the increasing NFC debt-to-GDP ratio appears to be an expansion of their balance sheets. Indeed, resident NFCs are relatively less indebted than peers when compared with the size of their financial assets.

Graph 33: Long-term debt vs. total debt



Data source: Commission services (Eurostat)

Graph 34: France: Corporate gross operating surplus and investment – growth rate



Data source: Commission services (Eurostat)

3.2.3. Low profitability and investment

The disappointing evolution of firms' profitability is particularly alarming because it may prevent companies from raising their investment in equipment, R&D, marketing, brand while penalizing their customer service capacity, before, during and after sale. In the end it may weigh on their potential development of productivity and competitiveness. While the overall level of R&D expenditures in the private sector is lower in France than in other developed countries ((1.4% of GDP against 1.9% in Germany, both in 2011), 2.0% in the US and 2.5% in Japan, both in 2009) the sectoral composition of the economy explains much of this variation. Le Ru (2012a) and (2012b) show that R&D expenditures in France are very much concentrated on a few sectors[6], in particular in the high-technology industries. In those sectors, the research effort (measured through the ratio of R&D expenditures to sales) is close to the one seen in Germany. Overall, although the research efforts by industrial companies has been maintained in the last few years, the stagnating R&D intensity at the national level stems from the declining share of these sectors in the value added. In particular, medium-high technology industries (including car manufacturers) contribute to a much smaller share of value added in France than in Germany. Beyond the level of R&D expenditure, the low profit margins in France have contributed to the declining weight of industry. Indeed, besides the high-technology sectors, where firms can benefit from substantial price premium, the poor economic performance in the French industrial sector weighs on firms' investment and on their ability to develop and market innovation. This hampers their non-price competitiveness and growth prospects.

[6] Including in particular Electronic and computer manufacturing, Transport material (excluding automotive), pharmaceutical industry and automotive.

Box 2: Main drivers of investments

In the usual theoretical investment models, investment decisions are determined by entrepreneurs' expected profitability. Two approaches have been developed to explain how these expectations are derived. The first "explicit" approach, initiated by Jorgenson (1963) links investment to expected profitability. The second approach aiming at explaining investment decision is more "implicit": it was initiated by Tobin (1969) and assesses the expected profits through the stock exchange value of assets.

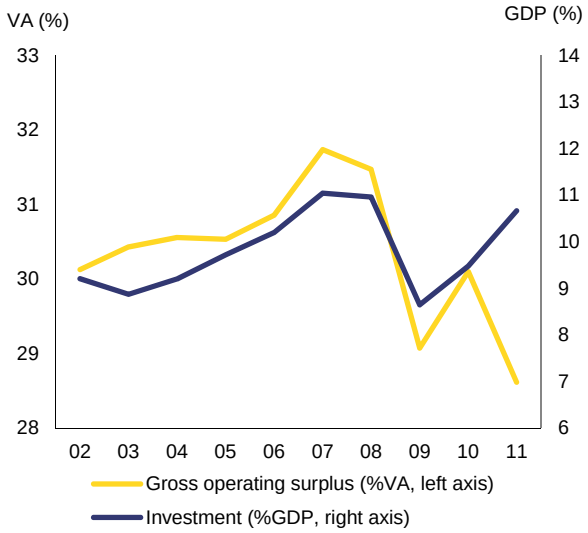
Both approaches derive from the production function and use the principle of the accelerator based on investors' anticipations of demand and growth, according to which, in a competitive situation, when demand is expected to grow, entrepreneurs increase their production either through additional investment or by using more intensively existing capital. This principle has long been considered as the major investment determinant (Muet, 1979, Artus and Morin, 1991).

However, as some recent studies have brought up, some developments in investment could not be explained by traditional determinants. For instance, the investment crisis recorded in France in the 1990s could not be explained by traditional determinants of investment. This unveiled the need for a closer look at investment determinants and indeed, more recent studies have brought out the existence of persistent gaps between actual investment and planned investment (Herbet 2001).

The main conclusion of these studies is that the low profit margins between 1990 and 1997 as well as the financing conditions were the main explanatory factors behind the gap (see Graph 34). Besides, corporate investment in equipment was even lower than suggested by the graph, as the share of investment in construction has risen over the last decade due to the increase in estate prices.

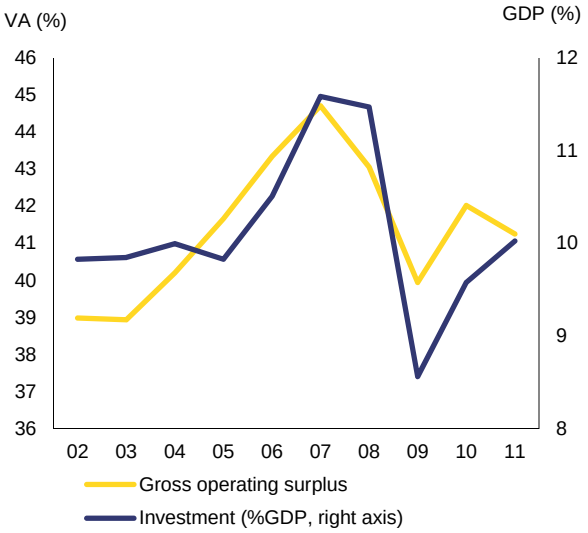
The German case in the 2000s illustrates how restoration of profit margins may also have contributed to fostering investment and the possible link between profit margins and investment and innovation. The reduction of production costs through labour costs, as well as intermediate service costs and partial off-shore practices, have significantly and durably restored profit margins from 2000 and may have strengthened entrepreneurs expectations due to improved competitiveness, that has translated into the recovery in investment (domestic and foreign) from 2005 that has led to their spectacular increasing performances in competitiveness.

Graph 35: France - Corporate gross operating surplus and investment



Data source: Commission services (Eurostat)

Graph 36: Germany - Corporate gross operating surplus and investment



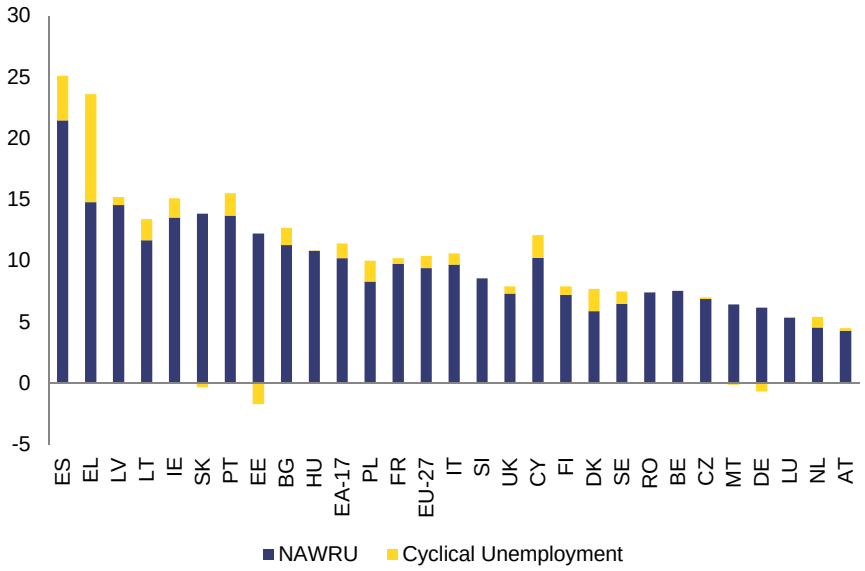
Data source: Commission services (Eurostat)

3.3. Labour market rigidities

Unemployment in France experienced a sharp rise since the beginning of the crisis. The level of unemployment rose from 7.8% in 2008 to 10.2% in 2012. In fact, the increase was more restrained in France than in most EU Member States. Over the same period, the unemployment rate increased by 3.8 pp. and by 3.4 pp. in the euro area and in the EU respectively. In that respect, leaving aside the case of Germany where the unemployment rate actually decreased since 2008, all euro area Member States recorded an increase in the unemployment rate. This higher unemployment in Europe went along with higher levels of structural unemployment (using the non-accelerating-wages rate of unemployment estimates or NAWRU). Developments in structural unemployment contributed 39% to the progression in actual unemployment in the euro area between 2008 and 2012 (36% in France). Hence, the NAWRU now reaches 10.2% in the euro area and 9.7% in France (see Graph 37). Such a high level of structural unemployment would suggest that significant reforms are needed to improve the situation on the labour market. Accordingly, a number of countries, including in particular France, Italy and Spain have engaged in reforms to develop a more flexible labour market.

The existing rigidities on the French labour market represent an obstacle to the recovery of the economy. They also contributed to the deterioration of export competitiveness in the last few years. First, rigidities in the nominal wage dynamics contributed to the relative disconnection between the evolution of labour costs and productivity observed in section 3.1. Second, the high segmentation of the labour market hampers the integration of new entrants, and the return of unemployed, into the labour market, hence harming average productivity. Finally, the lack of flexibility, both internal and external, may have hampered the ability of companies facing temporary difficulties to retain their workers, while limiting employment shift from low to high productivity sectors throughout the crisis.

Graph 37: Structural and cyclical unemployment (2012)



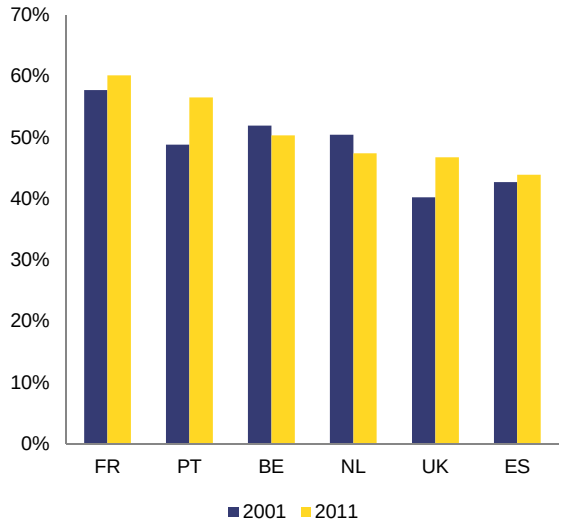
Data source: Commission services (Ameco)

3.3.1. Evolution of the labour cost

The cost of labour in France has increased a lot in the last few years. In particular, opposite to what could be seen in other economies, the cost of labour continued to rise during the crisis. The development in the cost of labour comes both from a dynamic level of compensation and from a relatively high tax wedge on labour.

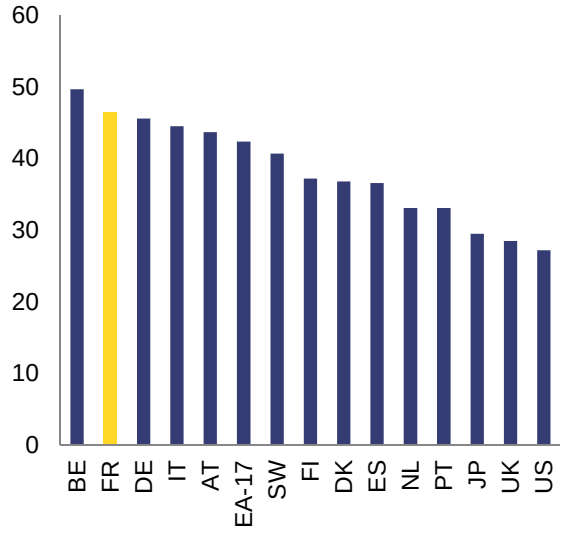
Compensation of employees experienced a continuous rise in the last 10 years. This evolution has been in particular explained by the important role that the minimum wage plays in the structure of wages in France. Indeed, at 60% of the median wage, the minimum wage is a key component of wages setting. Its level is adjusted by law at least once a year to keep up with inflation and to reflect half of the increase in the purchasing power of the basic monthly salary of a production worker. Although in a few EU Member States the nominal level of the minimum wage is higher (notably Belgium, Ireland, Luxembourg and the Netherland), France has the highest level when compared to the median wage. Moreover, the distance between the minimum wage and the median wage has decreased over the last 10 years. This development, which has contributed to reduce the inequalities between workers, has on the other hand led to a relative rise in the cost of workers at or close to the minimum wage, with a negative impact on employment. In order to limit the impact of the high minimum wage, a number of exemptions have been put in place to lower the cost of labour at the minimum wage. In particular, employers are exempted from social security contributions on workers up to 1.6 times the minimum wage. Similarly, the decision to implement a tax credit on labour cost will lower the cost of labour for workers with wages up to 2.5 times the SMIC.

Graph 38: Minimum wage as a share of median



Data source: OECD

Graph 39: Tax wedge on labour (for a single person at 67% of average wage) - 2011



Data source: Commission services (Eurostat))

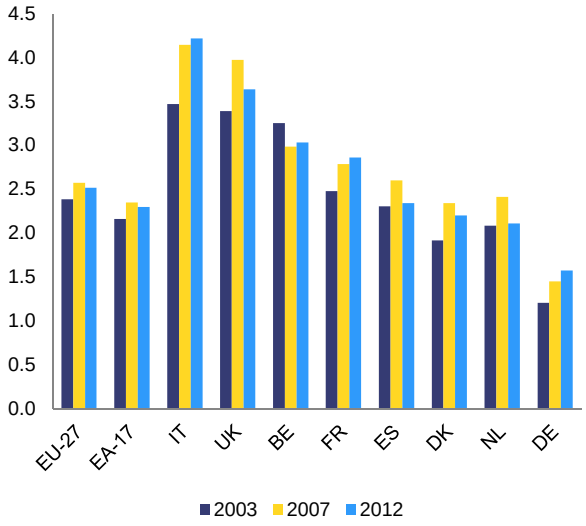
In addition to the high and increasing wages, the tax wedge on labour also contributes to the high cost of labour. Tax wedge in France represents 46.5% of the net earnings for a worker at 67% of the average wage. This ratio is second only to that of Belgium and much higher than the average for the euro area (42.4%). The tax wedge includes contributions that are paid both by the employer and by the workers. Only the part paid by the employers directly impacts on the cost of labour. However, the share contributed by the employees will also have an impact either on the nominal wage negotiated with the employer or on the supply of labour. In both cases, a higher tax wedge is detrimental to economic growth, as well as to competitiveness.

3.3.2. Segmentation of the labour market

The labour market shows a high degree of differentiation between insiders and outsiders. The relative protection that employed workers can rely on translates into important barriers to employment, in particular for population with low skills and young workers. The ratio between the unemployment rate of people below 25 and people above this age provides an indication of the difficulties met by young people on the labour market. In 2012, the unemployment rate of young people in France was 2.9 times that of people above 25. This is significantly higher than the average in the European Union (2.5). The unemployment ratio, which compares the number of unemployed with the total population between 15 and 24, stands at 8.4% in 2011, compared to 9.1% in the European Union, hence shedding a more nuanced light on the situation of young people. Actually, the relatively low activity rate of young people in France – 38.3% compared to 42.7% in the EU – partly explains their high unemployment rate as young people on the French labour market tend to be those with the lowest educational achievement. While the high participation to tertiary education in France is an explanatory factor for the low participation of young people to the labour market, limited prospects on the labour market may also provide an incentive for young people, who would otherwise seek employment, to remain in education In comparison, the German labour market appears much more favourable for young workers.

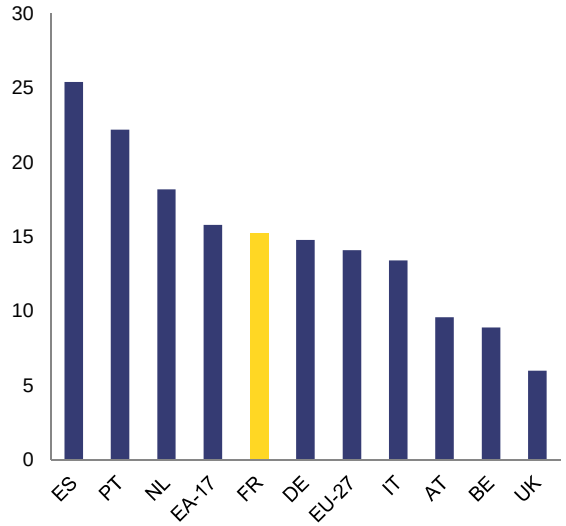
In addition to the difficulties experienced by younger workers, the protection provided to workers with permanent contracts creates incentives for employers to appeal to alternative forms of contracts. In particular, in 2011 the share of temporary contracts represents 15.2% of workers in France, compared to 14.1% in the EU (15.8% in the euro area). Although the share of temporary contracts does not seem particularly high compared to peers, France is among the few countries where both youth unemployment is high and temporary contracts are widely used. Employment in a temporary contract is the main entry point into the labour market for young workers, representing 55.1% of total employment for people aged 15 to 24. Moreover, contrary to what happens in other countries, these contracts do not represent a stepping stone for more stable forms of employment. Data on the mobility of temporary workers (OECD, 2013) shows that after one year, only 14% of French temporary workers obtain permanent work (compared to 45% in the UK, 29% in Italy and 23% in Germany) with 72% still in temporary employment.

Graph 40: Youth unemployment rate over prime age unemployment rate



Data source: Commission services (Eurostat)

Graph 41: Share of temporary contract



Data source: Commission services (Eurostat)

Note: 2011 figures are used for Italy and the UK in 2012

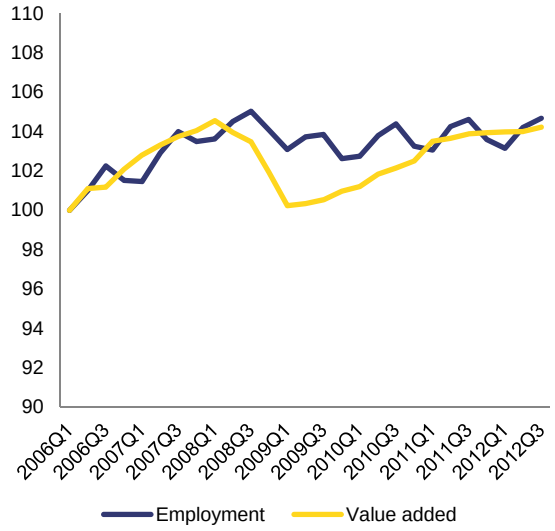
The difficulties to enter the labour market and the protection that workers with permanent contracts benefit from have an impact on competitiveness. First, difficulties to enter, or re-enter the job market can result in loss in human capital. In that respect, the sharp increase in long-term unemployment and in youth unemployment may limit the potential for future gains in productivity, a risk that the dearth of training for unemployed only makes more acute.

3.3.3. Impact of the crisis on the labour market

Labour markets in various countries have weathered differently the impact of the contraction in output in 2008-2009 and the ensuing low level of GDP growth. Confronted with lower output, employers could either reduce employment to maintain productivity (external flexibility) or safeguard employment at the cost of lower productivity per employees. In the latter case, depending on existing schemes, employers could then limit the impact on margin through a reduction in the number of working hours and/or in wages (internal flexibility). Evidence collected on the various economies

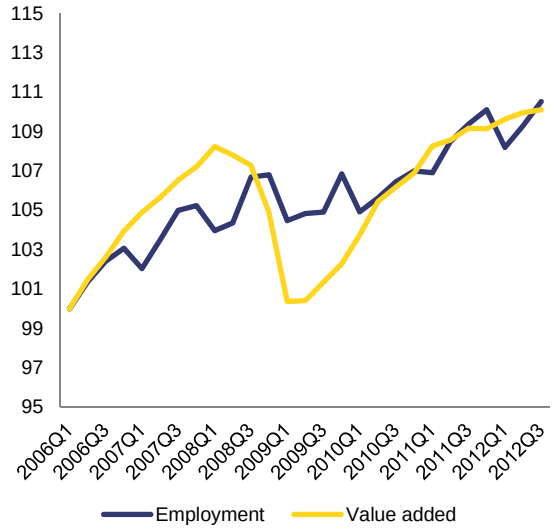
shows that Member States adopted very different strategies, with a potentially strong impact on competitiveness.

Graph 42: Employment and Value added – France



Data source: Commission services (Eurostat)

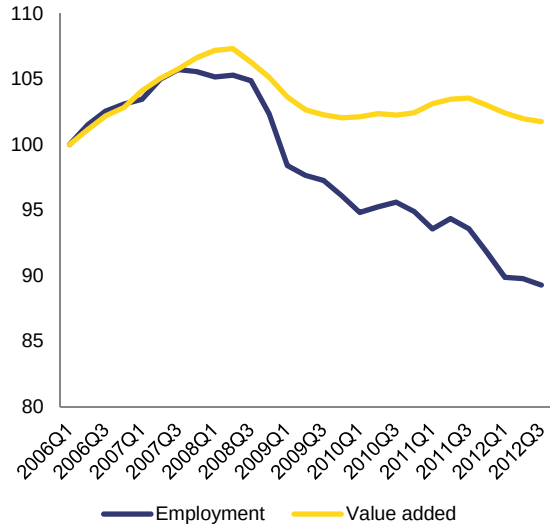
Graph 43: Employment and value added - Germany



Data source: Commission services (Eurostat)

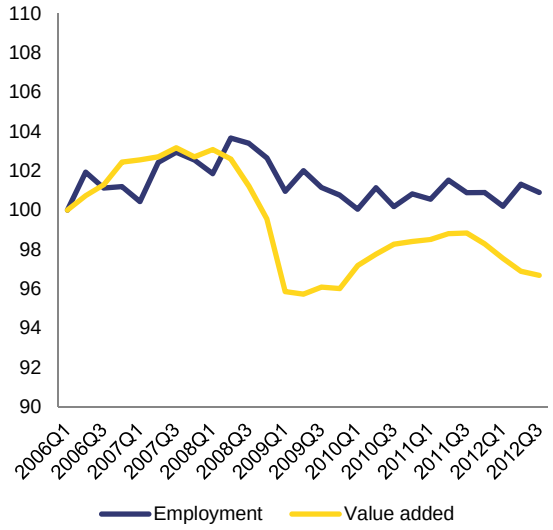
In France, the evolution of employment and value added suggests that significant labour hoarding took place when output started to decrease in 2008. Although employment shrunk, the correction was smaller than value added developments would have suggested. However, employment did not progress when value added returned to growth. In Germany, while value added contracted more than in France, no commensurate dip in employment was seen. This could be a sign that employers have appealed to flexibility instruments (in particular partial unemployment). Conversely, in Spain, adjustment in employment seems to have significantly over-shooted compared to what developments in value added would have initially suggested. Indeed, workers in low productivity sectors (and in particular in construction and associated branches) were predominantly impacted by the crisis, hence pushing up productivity per worker.

Graph 44: Employment and Value added – Spain



Data source: Commission services (Eurostat)

Graph 45: Employment and value added - Italy



Data source: Commission services (Eurostat)

On the one hand, the limited adjustment witnessed in France has translated into relatively mild impact of the crisis on employment. On the other hand, only limited rebalancing of workforce from low to high productivity activities can be seen based on data at sectorial level. As a matter of fact, only in Spain did one see significant rebalancing at branch level, with employment in the construction sector strongly contracting. In other economies, data suggest that only limited change in the industrial structure took place throughout the crisis.

Overall, evidence suggests that French firms have maintained production capacities and human capital to the detriment of their productivity in the short term. No rebalancing of workforce from low to high productivity activities has occurred either. This may well weigh on productivity developments at recovery and profit margins would probably not improve either.

3.3.4. Reforms engaged on the labour market

A number of reforms have been conducted in order to increase the flexibility of the labour market. Efforts have been done to develop both internal and external flexibility. In particular, the reform of partial unemployment, which entered into force in 2009, and the agreement with social partners reached in January 2013 are steps in the right direction.

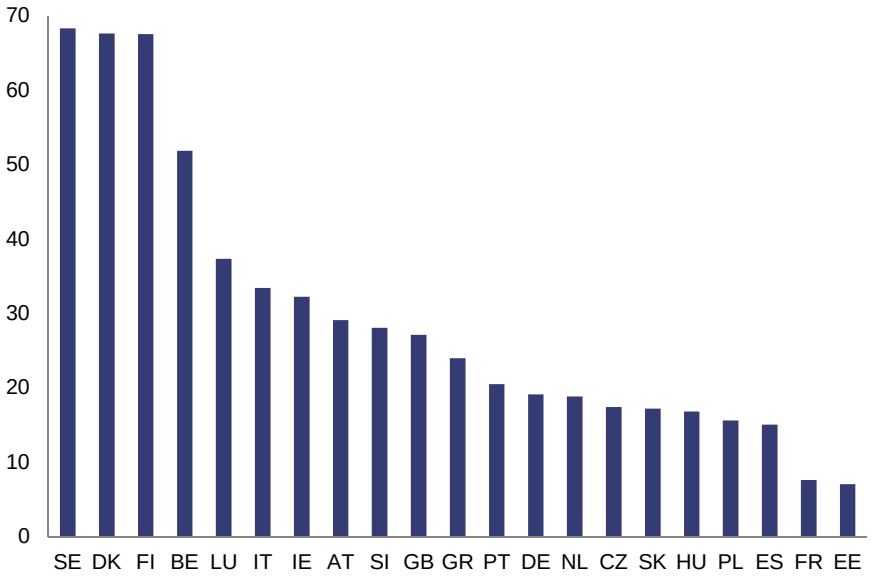
The development of partial unemployment in France has been developed to mimic the system in place in Germany. The purpose is to allow employers to reduce temporarily the labour force in order to weather a temporary decrease in activity. In such a case, and upon agreement with the administration, the employers can reduce the number of hours worked by employees. Employees are entitled to unemployment benefits on the hours not worked. Moreover, if the reduction in activity lasts more than 3 months, employees are encouraged to attend additional trainings. Such schemes can usefully maintain the workforce, and even improve productivity through training, during periods of inactivity. However, due to the complexity of the current system, only few companies, mostly the largest ones, use this scheme. Between 2007 and 2009, only 0.85% of the workforce in France benefited from partial unemployment, compared to 3% in Germany. The 2009 reform may have improved participation in the last few years. In order to further develop this scheme, social partners have agreed to work on a simplification of the system.

In January 2013, social partners signed a national agreement to reform the labour market. This agreement has the ambition to address the labour market segmentation and the rigidities of dismissal procedure while securing workers' transition between different jobs, hence paving the way for more flexicurity. The agreement is very broad and includes proposals to improve workers security and to reduce labour market segmentation and rigidities. The proposed measures to better secure employment for workers include in particular disincentives for temporary contracts of short duration and cuts on social security contributions for young adults recruited on permanent contracts and further promotion of adult lifelong training.

Significant efforts have also been made to develop both internal and external flexibility. Measures are proposed to (i) enhance exit flexibility by broadening the scope of individual and collective economic dismissal; (ii) broaden the scope of firm level adjustment through firm level collective negotiations allowing hours worked and wages to derogate from those agreed in sectorial contracts (iii) introduce a procedure to further develop pre-trial negotiations, thereby reducing the uncertainty of the labour process. These proposals address key weaknesses of the French labour market institutions.

While the impact of the proposed measures on the cost of labour is not clear yet, they may contribute to strengthening productivity as improving security for workers could translate into higher incentives to undertake trainings. However, the effectiveness of the reform will depend on how the agreement will be transcribed into the law. In particular, without a careful design of the system, a number of risks could materialise. First, the reform of the unemployment benefits may have consequences for the public finance. Second, while the hike in the social security contributions of fixed-term contracts of short duration may help reduce labour market duality, they could also shift job creation in favour of interim employment, whose contributions remain unchanged without a specific branch agreement deciding otherwise. Also, the increase in the minimum hours of part-time may potentially reduce the use of overtime (and their cost); but this effect is partly offset by an increase in the compensation for the first 10% of overtime. Finally, regarding the "accords de maintien de l'emploi", which promote the adjustment at the firm level without changes in employment, it is unclear from the agreement whether these agreements could allow for significant derogations at the firm level from the conditions set by contracts of higher levels.

Graph 46: Trade union density in selected EU Member States, 2008



Data source: OECD

While the process engaged to develop flexicurity is a step in the right direction, significant avenues for reform remain. In particular, it should be noted that, despite the success of the latest negotiation, the low density of trade unions in France, measured as the ratio of trade union members to the total number of wage and salary earners (see Graph 46), could act as a constraint for further reform as a number of studies link the quality of social dialogue, the representativeness of workers' union and the ability to reform the labour market (e.g. Cette et al, 2012).

4. POLICY CHALLENGES

The analysis in section 2 indicates that France has macroeconomic imbalances in the areas of export performance and competitiveness, as last year's IDR concluded. The sources of these imbalances are manifold, but issues related to non-price competitiveness are crucial to explain the poor export performance. Poor cost competitiveness in turn impedes a better enhancement of innovation. In this vein, section 3 sets the scene by discussing key aspects related to non-price competitiveness, and then analyses in detail (i) the low profitability of firms in the private sector, which hinders the potential for investment and innovation and (ii) labour market rigidities which, by pushing up labour costs, impact negatively not only on employment but also on competitiveness.

It should be recalled that the deteriorating export performance of France, together with rising indebtedness, was clearly identified as an emerging imbalance in last year's first IDR and relevant policy responses were reflected and integrated in the Council's country-specific recommendations issued for France in June 2012. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of the National Reform Programme and the Stability Programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the challenges identified in this IDR.

Non-price competitiveness: in last year's IDR the analysis already pointed to the crucial role of non-price/cost competitiveness issues to explain the external performance. Indeed, most of the deterioration in export market shares comes from lower non-price competitiveness. Specific efforts are therefore needed to support exporting companies and help them improve the quality of the goods produced. In order to regain the lost ground, the authorities have initiated an export promotion strategy focusing on selected product categories. So far, measures announced mainly aim to help exporters access finance. While this could help companies with a willingness to export to raise their capacity, the impact of these measures might be only limited. Additional efforts seem to be needed to ensure that companies in general and SMEs in particular gain access to export markets. An initiative such as the promotion of linkages between large companies with important export activities and local SMEs would be a promising avenue. Efforts to remove barriers to firms' growth and to better structure the network of export promotion agencies would also be welcome.

Beyond support to exporting firms themselves, the country could benefit from horizontal measures targeted to help companies increase the quality of their goods. One key aspect of this process is the support to innovative activities. It is worth highlighting that current overall R&D spending in France is in line with the EU27 average.

However, a large share of R&D spending is financed by public money. It will be important to review the effectiveness of the cluster policy, centred on the *pôles de compétitivité*. More precisely, a number of reports, including some commissioned by the authorities, have underlined the disappointing results of a policy that seems to pursue several objectives at the same time (including regional and local development), which potentially limits the impact on innovation itself. Resources available for this policy could be better targeted to the most innovative clusters, insisting on the need to develop and commercialise the outcome of the work conducted. The research tax credit, which has been maintained for three years to ensure continuity of the fiscal framework, is a positive measure which can contribute to fostering research activity. However, further studies would be needed to assess the extent of potential deadweight effect.

There is also a need to attract more young talent into science and engineering studies in order to avoid skill shortages, which may deter future private R&D investments. Moreover, entrepreneurial attitudes and innovation skills need to be fostered across the whole education system. Enhanced coherence between education, training and employment policies, in particular at the local level, would help better match skills with labour market demand.

Profitability in the private sector: The analysis in this IDR has pointed to the critical role that restoring the profitability of firms, currently among the lowest in the EU, can have in developing non-price competitiveness. In particular, the need to improve profits and R&D spending by firms establishes a strong link between costs of production, notably of labour, and non-price competitiveness. Wage developments, including those of the minimum wage, need therefore to be looked at closely to ensure that they do not contribute to a further erosion of the external price/cost competitiveness position. The overall cost competitiveness of the economy could also be enhanced by a further shift in the tax burden from labour to other sources of revenue. Accordingly last year's country-specific recommendations (CSR 4) called for a tax shift from labour to less growth-distortive tax bases. An effort has been made in this direction through the creation of a tax grant based on total payroll (the so-called tax credit for competitiveness and employment). This measure should impact positively on the profitability of companies from 2014 on (a scheme is considered to advance payments in specific cases). The mechanism selected, which is more complex than a decrease in social contributions weighing on labour, means that the measure will not actually reduce the cost of labour but will contribute to improve after-tax profitability. In this respect, it may not fully reach its objectives in terms of employment but will contribute to improving profits.

Rigidities in the labour market: The level of unemployment in France has been rising further in the last few months. The existing rigidities in the labour market clearly aggravate the competitiveness issues of companies. They may contribute in particular to delaying the reallocation between sectors and occupations, to reducing wage adjustment, and compressing wage distribution; the high tax wedge has a negative effect on labour demand and on the hours worked. At the current juncture, and given the expected slow recovery, it is important that policies focus on developing the adjustment capacity of the labour market rather than on safeguarding sectors where productivity is ailing. Depending on how the final scheme is translated into law, the current agreement between social partners to better define the process to be followed in case of economic dismissals and to develop agreements to safeguard employment in exchange for a temporary increase in working hours or a decrease in salary could have a significant impact on the way the labour market operates.

Further efforts are still needed however to better develop part-time employment and to ensure that reforms are conducted through a social dialogue. The agreement reached by social partners in January 2013 is a positive sign. The reform addresses key weaknesses of the labour market institutions, and as such, it moves in the direction set by the country specific recommendations addressed to France by the Council. However, it appears useful if these reforms, although significant, could be further complemented to enable firms to redress their competitive edge, in particular over their main southern competitors, notably in Spain and Italy, where labour costs have been reduced and significant reforms undertaken, including on the labour market, and where export performance has already significantly recovered.

Inter-linkages between the banking sector, the sovereign and the private sector: The currently high level of public debt in France has not resulted in significant tensions on sovereign bonds for the

moment. Indeed, despite the still rising level of debt, interest rates and spreads vis-à-vis the German bond have largely abated since early 2011. In that respect, the commitment taken by the authorities to respect the deadline set by the Council in the context of the Excessive Deficit Procedure, together with their resolution to bring public debt on a downward trend by 2017 contributed to comforting the trust of investors. However, as a number of institutions are currently revising their forecasts for economic growth and public finances, French bonds could become a central focus for investors. A hike in interest rates, possibly also against the context of a changed situation in global liquidity conditions, would not only endanger the sustainability of the public debt, but could also have spill-over effects into the real economy due to the expected increase in the financing costs for the private sector.

Putting the debt firmly onto a downward path would not only reduce the risk associated with sovereign debt but also the crowding out of investment by private companies, hence easing financing. In addition, it will also provide the authorities with more latitude to implement a fiscal policy aiming at improving the competitiveness of the country, as well as to face unexpected developments in other economic sectors such as financial markets.

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