France: Staff Concluding Statement of the 2021 Article IV Mission

November 9, 2021

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France was among the most affected European countries from the COVID crisis, but robust policy support and high vaccination rates are fueling a strong economic recovery. Downside risks persist, justifying a continued supportive fiscal policy in 2022, particularly focused on boosting investment to raise medium-term growth and reduce scarring from the crisis. In 2023 and beyond, France should embark on a path of gradual expenditure-based fiscal consolidation to rebuild policy buffers and put public debt on a firmly declining path as a share of GDP. Critical investments to support the green and digital transitions should be protected in this process. Continued efforts to boost worker skills and reduce the inequality of opportunities for youth during this structural change will be critical, as will support for vulnerable populations. Reforms should also be pursued to boost France's international competitiveness and productivity growth. Overall, the financial sector has performed well during the crisis, but continued vigilance is warranted.

Economic outlook

Strong progress on vaccination has helped effectively contain the COVID virus and has supported a fast normalization of activity. After a slow start early in the year, France is now among the EU countries with the highest vaccination rates (88 percent of adults), driven by measures such as requiring a vaccine or test-linked health pass for participation at most public venues, or compulsory vaccination for certain jobs. While a fourth wave of infections linked to the spread of the Delta variant did materialize, widespread inoculation ensured that hospitalizations and fatalities remained low in contrast to previous waves. The link between health restrictions and economic activity is weakening over time, with mobility levels relatively unaffected during the third and fourth waves.

A robust economic recovery is underway, bolstered by public support and by solid private sector led investment. While output contracted by 8.0 percent in 2020—more than the European average—it has since rebounded, with the economy nearly regaining its pre-crisis level by 2021Q3. Investment is recovering more quickly than consumption, and already exceeds its pre-crisis level. Employment is robust and the unemployment rate has remained relatively stable. Notwithstanding some remaining slack in the economy, supply constraints from ongoing global supply chain disruptions, and recruitment difficulties are starting to weigh on production, particularly in manufacturing. Consumer prices are accelerating, mostly driven by one-off factors, notably a rise in energy prices, and wage pressures remain so-far muted with long-term inflation expectations still well anchored.

The economic outlook has improved sharply. IMF staff have revised up the 2021 GDP growth forecast to around 6¾ percent in 2021, driven by the strong consumption and investment rebound in Q2 and Q3. In 2022, growth is expected to moderate to 3.7 percent. This forecast depends upon continued containment of COVID, normalization of the current supply chain difficulties, and a continued accommodative policy environment. Over the medium term, output is projected to grow almost at par with potential but remain somewhat below its pre-crisis trend. Headline inflation is projected to increase to about 2 percent this year but drop to 1.7 percent by next year, as transitory factors gradually dissipate. The unemployment rate is forecast to decrease to 7.8 percent in 2021 on the back of buoyant labor market conditions for job seekers. The current account deficit is expected to narrow and gradually normalize over the medium term as temporary disruptions in the tourism and aeronautics sectors start to dissipate.

Near-term risks to the outlook are tilted to the downside. The possibility of increasingly virulent new strains of the virus, waning vaccine effectiveness, and more persistent supply-chain bottlenecks could slow the recovery and lead to higher inflation. Downside risks from disorderly transformations could also exacerbate the output loss from inefficient labor and capital allocation. On the upside, a faster rundown of accumulated savings or stronger demand recovery in hard-hit sectors could raise growth in the near term and reduce scarring in the medium term.

Fiscal policy for the recovery

Expansive fiscal support in 2020 and 2021 has played a critical role in cushioning the crisis and fueling the recovery. Early in 2021, the emergency program envelope was increased again in the context of the third partial lockdown, bringing the total envelope for crisis and recovery measures for 2020–22 to about 28 percent of 2020 GDP. The authorities have subsequently begun to scale down and focus support as the crisis has ebbed. Investment policies, such as those in *France Relance*, are well placed to help limit the scarring effects from the crisis, while greening the recovery.

For 2022, a moderately expansionary fiscal stance is warranted but any additional stimulus should be targeted on supply-side measures to boost potential growth. Once one-off crisis measures are stripped out, IMF staff estimate that the draft 2022 budget constitutes moderate fiscal loosening, which is broadly appropriate given the downside risks. However, additional spending should be prioritized around measures to boost investment, alleviate recruitment pressures, and facilitate reallocation of resources to strengthen the recovery prospects and stimulate potential growth. In this respect, staff supports the investment policies contained in the *France Relance* and NextGen EU programs. The recently announced France 2030 plan could also boost critical innovation and investment; its governance structures (currently under definition) should include a significant independent private sector component to assure that the state's role remains limited and that investments are subject to market forces. Throughout 2022, fiscal policy should remain flexible and targeted additional relief support should be provided if downside risks materialize.

The recent spike in energy prices, along with supply chain bottlenecks, have pushed inflation higher and prompted a policy response . IMF staff expects this effect to be largely transitory, with price increases predicted to ease in the course of 2022. The authorities have implemented several temporary measures to reduce price volatility and protect households. Given the distributional impact of the recent surge in energy prices, staff supports compensating vulnerable households through targeted and temporary transfers, such as the recently announced *revalorisation du chèque énergie*. The authorities should, however, avoid broad-based transfers and long-lasting price-control measures, which are less well targeted and more costly. The cut in electricity taxes and the cap on gas prices reduce price signals, and the *indemnité inflation* program should be more targeted. They should remain strictly temporary. A further expansion of the *chèque énergie* would be more appropriate in case of further increases in energy prices.

As the recovery continues into 2023 and beyond, France needs to undertake a gradual but comprehensive fiscal consolidation to rebuild buffers and set the debt-to-GDP ratio on a firmly declining path. Under unchanged policies, IMF staff projects a modest decline in the fiscal deficit, but it would remain above 3 percent of GDP and the debt-to-GDP ratio would keep increasing over the forecast horizon. The gap between France's debt burden and that of its European peers would widen from already high levels. To reverse this trend and build fiscal buffers against future crises, IMF staff recommends a gradual adjustment path aimed at reaching France's pre-crisis medium-term objective (MTO) of a 0.4 percent of GDP structural deficit before the end of the decade. This target would require a cumulative fiscal effort of about 4¾ percentage points of GDP over seven years, assuming no further major shocks. To secure the recovery, fiscal consolidation could be somewhat backloaded, at an average annual reduction in the primary structural deficit of around 0.6 percent of GDP over 2023-26 and around 0.8 percent of GDP per year in the medium-term until the MTO is met. Staff's analysis suggests that this path would rebuild ample room for fiscal policy maneuver while leaving space for needed investment to boost workers skills and for the green and digital transitions.

The fiscal adjustment effort should be concentrated on reducing the growth rate of current public expenditure. Given the already high tax burden in France, IMF staff recommend focusing the fiscal adjustment effort on controlling current expenditures, while allowing some room for needed investment (such as that contained in the *France Relance* and NextGen EU proposals). Pursuing already planned reforms, such as in pensions, unemployment insurance, and the civil service, would significantly contribute toward the needed adjustment. Other potential areas for trimming include cutting tax expenditures (especially those that hinder achieving climate objectives), reducing overlaps between different levels of government, and simplifying and unifying social support schemes, which could improve targeting to those most in need while generating efficiency savings and improving incentives to increase activity. France should review the spending categories in which its expenditure is well above its peers, with scope for reforms to scale back without seriously impeding the delivery of public services. In the future, revenue from higher carbon pricing—critical to the green transition—could also help financing appropriate environmental investments and providing compensation for the most vulnerable.

The commitment to this fiscal adjustment path should be backed by a strong fiscal expenditure rule and enhanced responsibilities of the fiscal oversight body. IMF staff calculations suggest that a limit on expenditure growth of 1.7 percent per year (compared to 2.4 percent under the baseline) would achieve the recommended adjustment path. The fiscal rule should be based on a multiyear commitment for expenditure at the general government level, in line with recommendations by the *Cour des Comptes*, and should include a mechanism to clearly monitor deviations in previous years and assure compliance with the medium-term objectives. Strengthening the competencies and capacities of the Fiscal Council (HCFP) would also help ensure compliance. Of course, this rule (and the recommended fiscal path) should be adjusted as needed to be consistent with any revisions in the European fiscal framework. IMF staff believe, however, that France should not wait for European action to move ahead with its own fiscal rule.

Protecting financial stability

The banking sector has withstood the crisis well and provided ample credit to the economy. This reflects healthy capital and liquidity positions going into the crisis, and significant policy support during the crisis, including government measures to support households and the corporate sector. Widespread corporate defaults have not materialized, although some delayed, sector-specific solvency risk could still emerge as emergency support measures phase out. In this context, bank asset quality should continue to be monitored and banks should proactively engage with viable, but challenged corporates to design solutions, drawing on available options including the *prêt participatif*, which may need to be readjusted to be more attractive to firms. Any potential banking sector losses should be reflected by deploying provisions and capital buffers. Closely monitoring conglomerate intragroup transactions and developing concentration thresholds to limit risk from highly indebted firms will aid efforts in strengthening the sector's resilience further. As the recovery firms, incentives could be adjusted to reduce the extraordinary contingent liabilities of the State in a timely manner.

The macroprudential stance remains broadly appropriate but may require tightening if risks from debt-driven asset valuations increase . IMF staff supports a timely re-activation of the counter-cyclical capital buffer—possibly in 2023— conditional on the recovery unfolding at least as quickly as under staff's projections. Measures by the supervisory authority, HCSF, have limited and in part reversed a deteriorating trend in mortgage lending standards, but risks from the real estate market require continued vigilance. Fueled by low interest rates and a relatively inelastic housing supply, real estate price growth accelerated in 2020 and household debt to income remains elevated, reflecting the need for higher debt to cover increasing housing prices. If these trends continue, fine tuning existing borrower-based measures or deploying complementary measures may become appropriate to limit excessive risk-taking and smooth housing market dynamics.

Structural reforms to reduce scarring and ensure an equitable and resilient recovery

Continued action to proactively address labor-market frictions and ensure equitable opportunities for the youth will help achieve a speedy and durable recovery. Large scale employment losses were prevented by the extensive deployment of the short-time work scheme, which preserved employment relationships and limited a drop in labor force participation. Job creation rebounded quickly as containment measures were removed, perhaps reflecting dividends from earlier labor market reforms. Labor market conditions are now tightening, however, as reflected in the rise in vacancies, while long-term unemployment remains high. To prevent labor market mismatches from slowing the speed of the recovery, policies should be aimed at alleviating skills shortages, such as combining job-search assistance schemes with training programs. The programs targeted at youth out of work and education (*contrat d'engagement*) and at boosting training for activities with skill shortages (*mesures pour le développement des compétences et l'insertion dans l'emploi*) included in the 2022 budget can help in this regard. Further rectifying educational disparities that affect access to employment, through measures strengthening the schoolto-work transition, will also ensure that the growth dividends are equitably and sustainably distributed.

Policies to raise competitiveness will enable France to strengthen its external position and increase resilience to external shocks. After a marked deterioration since before the global financial crisis, France has managed to stabilize its export performance in recent years, but further improvement is needed. Additional product market reforms to ease regulation and entry barriers in non-tradable service sectors would help in this regard. Targeted efforts to foster innovation via human capital investment and funding for basic research, including in sectors at the technological frontier, would also enhance competitiveness and increase production capacities. If properly designed and managed, the France 2030 program could also help.

IMF staff welcomes the authorities' accelerated push for achieving carbon neutrality and reducing the emissions gap. The EU's "Fit for 55" policies introduced more ambitious emission reduction targets in line with the EU's objective of achieving carbon neutrality throughout the union by 2050. The objective of climate neutrality is enshrined in French law since the 2019 Climate and Energy Law. To achieve this challenging goal, France should pursue its efforts, implementing additional green policies to reduce emissions and strengthening the existing ones, including adequate carbon pricing with mitigating measures for low-income households. In this vein, leveraging French firms' strong presence in automobiles, power generation, and aeronautics to establish a technological lead in green energy generation and zero emission transportation would additionally aid the accelerated push. The push for improved worker training and skills matching will be particularly important to facilitate the green transition without generating employment losses.

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The mission thanks the authorities and our other counterparts for the constructive policy dialogue and productive collaboration.