France: Staff Concluding Statement of the 2022 Article IV Mission

November 21, 2022

Paris, France:

An International Monetary Fund (IMF) mission, led by Mr. Jeffrey Franks, conducted a staff visit during November 7-18 as part of the 2022 Article IV consultations. At the end of the visit, the mission issued the following statement:

After a strong economic recovery from the Covid pandemic, France was hit by an energy shock driven by Russia's invasion of Ukraine. While it has been less affected than most EU countries due to a lower reliance on Russian gas and a strong (but costly) policy response, France still faces high inflation and a sharp slowdown in economic activity. In 2023, the authorities should begin a multiyear process of expenditure-based fiscal consolidation to rebuild policy buffers and put the public debt ratio on a firmly declining path. Initially, this should include better focusing fiscal support to counteract the energy shock, and in later years be supported by structural expenditure reforms (such as in pensions). Continued efforts to boost worker skills and address inefficiencies in the educational system will be important, as will support for vulnerable populations. The energy price shock presents opportunities to accelerate the green transition. The financial sector has performed well, but risks are rising, and continued vigilance is warranted.

Economic Outlook: An Energy Crisis on the Heels of the Pandemic

After a robust recovery from the economic shock of the COVID pandemic, France is now facing the repercussions of Russia's invasion of Ukraine. In 2021, GDP rebounded by 6.8 percent and by the end of the third quarter, output had recovered to pre-crisis levels. The recovery was broad-based—consumption, investment, employment, and labor force participation all rebounded more quickly than in most other European countries. While France is less directly exposed to the energy shock due to its reliance on nuclear energy and low dependence on Russian gas, the energy crisis is dampening the recovery by reducing consumers' purchasing power, denting confidence, and exacerbating supply-side difficulties.

Russia's invasion of Ukraine will continue to weigh on growth into 2023. Inflationary effects, coupled with weakened confidence, will dampen household real incomes and consumption. Higher interest rates and lower confidence will likely slow investment growth. IMF staff now forecast GDP growth of around 2½ percent for 2022 and around ¾ percent for 2023, reflecting both lower domestic and external demand. While growth should recover somewhat thereafter, it will eventually converge towards the potential rate of 1.3 percent, with scarring from the pandemic and the energy shock leaving output some 2 percentage points below the pre-pandemic trend.

Inflation has surged over the past year, driven by supply chain bottlenecks and the energy price shock. The twelve-month inflation rate of consumer prices (HIPC) reached 7.1 percent in October and is expected to remain high in the coming months. However, inflation continues to be well below the EU average, largely due to energy price controls and subsidies, which has kept price increases an estimated 2-3 ppts lower. These controls also lowered the passthrough into food and goods prices. While services inflation has risen over the past year, wage increases remain below headline inflation and year-ahead wage expectations were below overall inflation expectations in Q3 2022. However, the automatic indexation of the minimum wage—and to a lesser extent pensions, and social benefits (and one-off indexation as part of recent purchasing power measures)—could create second-round pressures. Inflation is expected to peak in the coming months but will remain near 5 percent in 2023 on average as price controls ease. It will remain persistent in 2024 and will only gradually decline to around 2 percent in 2025.

Risks to the outlook are high and tilted to the downside. Main downside risks stem from a prolonged war and an escalation of sanctions. Gas and electricity prices could further spike, leading to another surge in inflation inflationary pressures could in turn weigh on the outlook and increase the risk of a wage-price spiral. Faster-than-expect monetary policy adjustments in Europe or elsewhere could further depress output. A deeper slowdown in the US or China could depress external demand. On the upside, swift adjustment to accelerate the green transition could ease energy shock risks and boost investment.

Fiscal policy: focusing crisis support and reducing the deficit

The large fiscal response to the energy shock has succeeded in cushioning its economic impact but comes at a steep cost. Measures implemented in 2021-22 totaled over 2 percent of GDP and included: gas and electricity price freezes (*bouclier tarifaire*), cash transfers to households (*chèque énergie*,*indemninité inflation*), a fuel price rebate (*remise carburant*), and support for enterprises. Two-thirds of this reflect untargeted price and purchasing power measures that helped cushion the impact but pushed up costs while reducing incentives to lower energy consumption. For 2023, the elimination of the fuel price rebate and higher price caps under the *bouclier tarifaire* are welcome, but gas and electricity price adjustments remain modest compared to a more than doubling in energy tariffs without price controls. IMF staff support better focusing energy support by accelerating the phase-out of price controls while increasing targeted assistance to the most affected. This would reduce fiscal costs and incentivize greater energy savings. In this context, IMF staff welcomes the additional upfront support through the *chèque énergie* foreseen by the end of this year. The authorities could also consider a tiered pricing mechanism, with the *bouclier tarifaire* only covering basic energy needs as a second-best option to a swift phase-out.

Fiscal policy should take advantage of the phase-out of pandemic support to begin reducing the deficit in 2023. France's fiscal response to successive shocks over 2020-22 has been swift and effective but costly, narrowing its fiscal space. The country's high public debt ratio, its widening debt and deficit gaps relative to Euro Area peers, and the domestic electoral cycle argue for consolidation to start in 2023, which would also support monetary policy efforts to stem inflation.

The 2023 budget does not target a reduction in the deficit, postponing fiscal adjustment to 2024. IMF staff project that the extension of energy measures, elimination of a distortive turnover tax (*CVAE*), and reversal of revenue windfalls seen in 2022 will keep fiscal policy modestly expansionary in 2023, likely producing a slight increase in the deficit. Instead, IMF staff recommends a modest fiscal tightening of ¼ ppt of GDP relative to 2022 (just above ½ ppt. of GDP compared to the current IMF forecast). This could be largely achieved by better targeting energy support (as outlined above) and limiting its size to the savings from lower subsidies and windfall revenues from renewable energy producers (under the *CSPE*). If additional savings are needed, they could come from postponing production tax cuts until compensatory measures are in place or by other measures. If, however, the economy deteriorates significantly below current forecasts, automatic stabilizers should be allowed to cushion the fall, but any discretionary support should be well-targeted and offset by compensatory measures to preserve policy credibility, fiscal sustainability, and consistency with monetary policy. Under an upside scenario, any revenue overperformance should be saved and support phased out faster to accelerate the deficit reduction.

Further efforts are needed to rebuild buffers over the medium term through a gradual but sustained fiscal consolidation. IMF staff projects the deficit to decline in the medium term, but to remain above its debt-stabilizing level. As a result, the public debt ratio will remain on an upward path, widening an already sizeable debt differential with European peers. To reverse this divergence and ensure long run fiscal sustainability, IMF staff recommend a sustained adjustment to bring the deficit down to 0.4 percent of GDP by the end of the decade—in line with France's pre-crisis medium-term objective (MTO). This is one year later than what staff advised last year, reflecting the need to accommodate the policy response to the energy shock. The adjustment path implies a cumulative effort of about 5 percentage points of GDP over 7-8 years, for an average annual effort of 0.7 percent of GDP.

Fiscal consolidation should center on reducing current spending growth, underpinned by structural reforms. To avoid adding to an already high tax burden, efforts should focus on rationalizing current spending while leaving space to accelerate green and digital investment. Initially, the needed expenditure reduction could come from fully saving the phase-out of temporary Covid and energy shock support measures, which could deliver up to a third of the required adjustment. Beyond that, efforts should be focused on structural reforms of expenditure, rather than mere belt-tightening, to ensure their sustainability over time. These could include:

- ***A comprehensive pension reform*** which should enhance the labor participation rate of older workers by gradually increasing the effective retirement age, improve the equity and sustainability of the system, while taking into account specific situations (e.g. interrupted careers, arduous jobs, etc.).
- ***Completion of the unemployment benefits reform.*** Introducing countercyclicality in unemployment benefits by varying eligibility and/or benefit duration with labor market conditions would strengthen automatic stabilizers and labor market incentives while generating savings.
- ***Rationalizing tax expenditures.*** Some tax expenditures could be rationalized (e.g., fossil fuels and housing); others could be redesigned (e.g., R&D).
- ***Others*** could include streamlining the public sector workforce; reducing overlap between different levels of government; and simplifying social minima schemes.

Adoption of the medium-term fiscal programming bill is critical to the implementation of new fiscal framework, which strengthens fiscal governance and the credibility of fiscal targets. The December 2021 organic budget law requires programming bills to include annual real spending targets and their corresponding nominal amounts for each level of government over the full 5-year horizon, with deviations to be reported in annual budgets and assessed by the Fiscal Council (HCFP). Notwithstanding the transposition of targets in annual budgets, the adoption of the medium-term programming bill is key for the new fiscal framework to become fully operational.

Maintaining financial sector stability in choppy waters

French banks have performed well, but financial stability risks have increased, amidst a worsening growth outlook and increased market volatility. Vulnerabilities in the corporate sector are reemerging, with some firms facing liquidity pressures from energy price volatility. Staff welcome the authorities' initiatives to support firms affected by the energy crisis via guaranteed loans and grants but encourage them to consider further targeted liquidity support for critically integrated energy producers to help cover margin requirements and operational needs should energy market volatility escalate. French banks posted higher profits at the beginning of 2022 but face weaker prospects from worsening growth and higher credit risk from energy- and inflation-affected sectors. Some of these effects could be offset by higher net interest margins from the rise in interest rates, but as the net effect will likely depend on bank-specific fundamentals, the authorities should remain vigilant and monitor closely the health of all banks.

The housing market is beginning to cool in the wake of interest rate rises and tighter prudential standards. All banks are complying with the regulation on borrower-based limits on loan maturity and debt-service-to-income ratio, which the *Haute Conseil de Stabilité Financier* (HCSF) made legally binding effective January 1, 2022. IMF staff strongly support these measures, which should help safeguard continued manageable NPLs in the real estate market in the wake of rising interest rates. Although banks are adequately shielded from housing-related losses, due to mortgage insurance and the preponderance of fixed-rate loans, risks from high inflation on borrower affordability remain elevated. While the ECB rate hikes are being gradually transmitted into the economy, there is some narrowing of the gap between effective interest rates on mortgages and consumer loans and the government-mandated cap (usury rate). This could increase constraints on banks to adequately price their lending. IMF staff takes note of the adjustment introduced by the authorities in April 2022 to more dynamically update the usury rate better reflects the changes in market conditions, but encourages them to consider additional modifications as needed to enable a full pass through of monetary policy and prevent an undue exclusion of marginal borrowers from access to credit.

Given the buildup of financial stability risks and still low cost of capital for banks, IMF staff support the authorities' plan to progressively tighten the counter-cyclical capital buffer (CCyB). The credit-to-GDP gap continues to exceed its pre-crisis level and credit growth resumed its increasing trajectory at the start of the year. Corporate lending remains dynamic and may increase further if liquidity pressures from the energy crisis intensify. IMF staff support the HCSF's decision to raise the CCyB rate (currently 0.5 percent) by 0.5 percent towards the end of the year. Staff believe that targeting a CCyB rate between 1 to 1.25 percent is appropriate at this juncture as the cost of raising additional capital for banks is currently low—given their high profitability—but could increase later if downside risks materialize. Raising the CCyB now leaves banks with ample buffers should financial stability risks materialize while creating room to lower it in response to future downturns. However, the HCSF should stand ready to reconsider the decision should there be a sudden deterioration of financial conditions. Given the concentration of debt vulnerabilities in the corporate sector, the authorities could also explore the deployment of a sectoral systemic risk buffer directed at corporate exposures.

Structural reforms to increase growth potential

Further efforts to reduce labor market frictions, increase labor supply, and improve worker training will help raise potential growth . The French labor market has performed very well in recent years, with historically high employment and labor force participation and historically low unemployment. Nevertheless, participation rates remain below many peer countries and there are still challenges, particularly among low-skilled and young workers. Policies should be aimed at alleviating skills shortages, such as combining job-search assistance schemes with training programs and improving the quality of training. In this respect, continued efforts by France Competence to enhance certification of training and professional qualifications will be important, also to contain fiscal cost. The apprenticeship system—which has had significant success in bringing more youth into the workforce—should be monitored to ensure the smooth transition of apprentices into permanent work. Steps to improve job-to-job and geographical mobility could also help reduce structural unemployment. Unemployment benefits and pension reforms (discussed above) will improve labor force participation and enhance growth.

Addressing weak educational outcomes and inefficiencies in education spending could help upskilling of the workforce. Educational attainment and student performance in France are relatively low compared to peers while spending is relatively high, suggesting room for efficiency savings. This could include rebalancing excess spending from upper secondary to primary education and rationalizing non-teaching staff spending. Reducing performance gaps in education could further be supported by improving teacher training and aligning compensation with performance, given low teacher salaries relative to peers. Disparities linked to socio-economic status could be reduced by incentivizing teachers to teach in disadvantaged areas, including through teacher pay. Giving more responsibilities and autonomy to school administrations could foster teaching innovations.

The energy price shock presents opportunities to accelerate the green transition. The rise in fossil fuel prices should be used to promote energy conservation and increase the use of renewables, with a positive effect on emission reductions. Investments in low carbon energy, in particular in renewables, should be accelerated in the coming years, to achieve an efficient and low-carbon energy mix over the medium-term. Incentivizing such investments will not only enhance France's energy security but also boost potential growth by offsetting the impact of depleted capital stock in fossil fuel assets. In this context, IMF staff supports draft legislation aimed at streamlining regulatory and judicial procedures to accelerate renewable energy development. Any future moderation in global energy prices could be used to increase carbon taxation without further hikes in retail energy prices. Scaling up carbon pricing will have to go hand-in-hand with support for vulnerable households. Financial support for capital-intensive conservation measures (e.g. thermal renovation, heat pumps) or renewables investments (e.g. rooftop solar) is also appropriate. In this context, the investments of the France 2030 plan are welcome. Non-pricing instruments, like feebates and regulations, can reinforce incentives for low-carbon investments, especially in the transport and building sectors which are less responsive to emissions pricing.