INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/179

FRANCE

SELECTED ISSUES

July 2015

This Selected Issues paper on France was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on June 23, 2015.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

FRANCE

SELECTED ISSUES

June 23, 2015

Approved By
European Department

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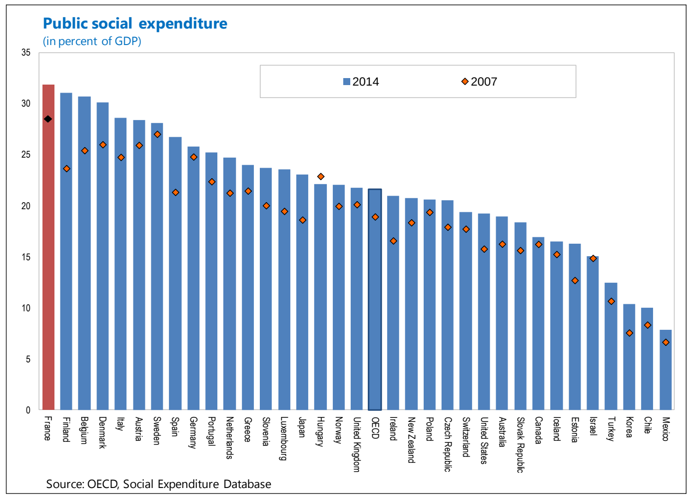
FIGURE

I. EXPENDITURE REFORMS[1]

After decades of rising public spending and successive tax increases, the medium-term fiscal consolidation path described in the 2015 Stability Program is now fully expenditure based. However, recent efforts of nominal spending containment have not delivered the intended savings in the context of low growth and inflation. A thorough review of the efficiency of public spending could help prepare more fundamental reforms of spending programs and processes to underpin a lasting reduction in expenditures, which reached a record high of 57½ percent of GDP in 2014.[2]



1. **Social spending**. Social spending has been a key driver behind France's rapid growth in public expenditure over the past decades. From about 25 percent of GDP in 1990, public social spending reached 30 percent before the crisis and almost 32 percent in 2014, the highest ratio in the OECD. While high social spending is associated with a significant redistribution of income,[3] it also suffers from inefficiencies and poor targeting. The OECD (2014) estimates that 27 percent of social benefits (in cash) go to the highest income quintile, and less than 17 percent to the lowest income quintile. If reforms to increase efficiency and targeting are combined with measures to boost employment, significant savings could be achieved in the longer term without reducing the social and redistributive benefits of the French social system. Reforming the social security system would be complex and require a coordinated strategy at all levels of government, as several social programs are jointly managed by the state, local governments, and the social security system.

2. **Pensions.** Pensions are by far the largest social expenditure in France, amounting to about 14 percent of GDP. No OECD country, except Italy and Greece, spends as much on pensions (Table 1).[4] The reason is not demographic but rather a relatively generous pension regime.[5]

[1] Prepared by Jean-Jacques Hallaert (EUR). This note builds on Hallaert (2013).

[2] The increase in the expenditure-to-GDP ratio in 2014 was fully due to rising tax credits (*Crédit d'impôt pour la Competitivité et l'Emploi* and, to a lesser extent, the *Crédit d'Impôt-Recherche*).

[3] Taxes and transfers reduce income inequality (measured by the Gini index) by about 40 percent. Over 60 percent of this reduction is achieved by transfers (INSEE, various years).

[4] This is true whether one considers only public spending only or public and private spending (OECD, 2011).

[5] At 17.6 percent, France's share of population of 65 and over is 2 points above OECD average but about 3½ points below Italy and Germany. The European Commission projects that the old-age dependency ratio will increase until 2040 and stabilize over 2040–60. In part due to the recent reforms, the cost of pension as a share of GDP is expected to remain stable until 2025 and decline steadily over 2025–60 (EC, 2015).

At 62,[6] the legal retirement age is the lowest in the OECD although some retirees receive full pension only at 65 (rising to 67 in 2022). Past pension reforms implemented in 2003, 2010, and 2014 raised both the pensionable age and the contribution period necessary to reach full pension and eliminated most early retirement schemes. As a result, the effective retirement age rose from 58.5 years in 2002 to 60 years in 2012, still one of the lowest in the OECD, and is expected to continue increasing following the 2014 reform. Adding to the cost of the system is the high life expectancy after pensionable age: in 2010, it reached 21.7 years, 3.2 years longer than the OECD average (OECD, 2011). Additional savings could be achieved by:

- Harmonizing the special regimes for civil servants, employees of state-owned enterprises, and employees of certain sectors (e.g., miners, notaries, railway workers, seamen, etc.) with the private sector regimes. The OECD (2012) estimates that the convergence of special regimes could save 1.3 percent of GDP.

- Simplifying the complex structure of the pension system would provide additional savings without reducing the social outcome. There are about 40 different compulsory schemes with different eligibility criteria and benefits (OECD, 2013).

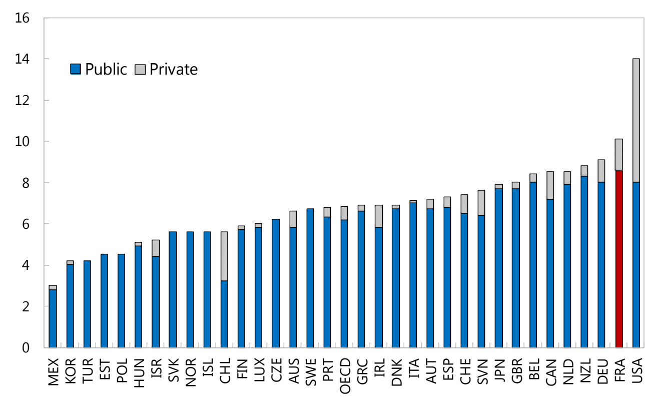
- Phasing out remaining incentives for early retirement including the longer unemployment benefit granted to older workers would provide additional savings (OECD, 2013; Unédic, 2012).

- Increasing the legal retirement age to at least 65 years and the age for full eligibility of benefits for the supplementary regimes.

3. **Health.** No OECD country dedicates more public spending on health than France and only the USA spends more on health when private spending is also considered. The OECD (2013) estimates that, because of multifaceted inefficiencies, public spending on healthcare could be reduced by some 1.3 percent of GDP without impairing quality.

Public and Private Social Expenditure - Health

(In percent of GDP in 2011)



Source: OECD Social Expenditure Database.

- To contain public health spending, an expenditure growth ceiling was created in 1996 (the *objectif national des dépenses d'assurance maladie - ONDAM*). The annual growth rate of the ceiling have been progressively lowered, and outturns have been in line with the ceiling since 2010. As a result, public health spending has been growing more slowly in France than on average in the OECD. For 2015–17,

[6] Following the 2014 reform, the legal age will gradually increase from 60 to 62 in 2017.

the government plans to limit the growth of *ONDAM* to less than 2 percent per year on average, down from 2.4 percent in 2014, and well below the trend growth of almost 4 percent.

- To achieve this ambitious target, the government is implementing a reform of hospitals and is promoting ambulatory procedures, the use of generic medicine, and a rationalization of prescriptions. These measures are expected to reduce spending (compared to trend) by over €3 billion in 2015 alone and about 10 billion during 2015–17 (about 0.15 percent of GDP each year).

4. **Unemployment benefits.** Unemployment benefits are generous by European standards (see Chapter II), and account for 3 percent of general government spending. The state has no direct control on the unemployment benefit system as it is managed by social partners. Changes to the system aimed at improving its financial sustainability are expected to be negotiated by social partners in the coming months based on a report on the current system by Unédic in June 2015.

Table 1. Public Social Expenditure by Broad Social Policy Area
(In percentage of GDP, 2011)

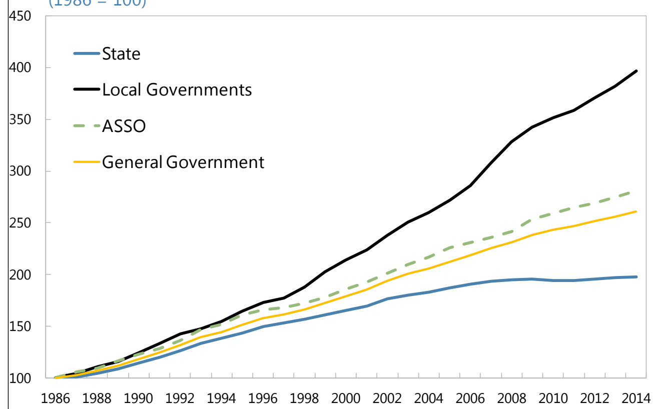
	Pensions (old age and survivors)	Health	Income support to the working-age population 1/	Other social services	Active Labor Market Programs	Total
France	**14.2**	**8.6**	**5.4**	**2.2**	**0.9**	**31.4**
Denmark	8.4	6.7	8.4	4.2	2.2	30.1
Belgium	10.3	8.0	8.4	1.8	0.9	29.4
Finland	11.5	5.7	7.9	2.3	1.0	28.3
Austria	13.9	6.7	5.6	0.7	0.8	27.7
Italy	16.0	7.0	3.2	0.9	0.4	27.5
Sweden	9.8	6.7	6.9	2.5	1.2	27.2
Spain	11.2	6.8	6.7	1.0	0.9	26.8
Greece	14.6	6.6	3.6	0.7	0.3	25.7
Germany	10.6	8.0	4.5	1.7	0.8	25.5
Netherlands	6.4	7.9	6.8	1.3	1.1	23.5
United Kingdom	6.2	7.7	5.7	2.9	0.4	22.7
Luxembourg	7.7	5.8	7.1	1.1	0.6	22.5
Ireland	5.8	5.8	8.3	1.4	0.9	22.3
Norway	7.4	5.6	6.3	2.0	0.6	21.7
Czech Republic	9.1	6.2	3.8	0.6	0.3	20.1
Poland	10.9	4.5	3.7	0.7	0.4	20.1
Switzerland	6.8	6.5	4.9	0.5	0.6	19.3

Source: OECD.
1/ Income support to the working-age population refers to spending on the following SOCX categories: Incapacity benefits, Family cash benefits, Unemployment and other social policy areas categories.

5. **Other social benefits.** The government has launched a review of several social programs, notably family-related spending and housing allowances (*Aides personnelles au logement)* with a view to increasing their efficiency and targeting. Before the reform of 2014–15, family allowance was the third largest social spending item, accounting for about 3 percent of GDP, while social spending related to housing accounted for 0.8 percent of GDP in 2011. A reform of family is important because the system is financially unsustainable: family spending accounted for 20¾ percent of the Social Security deficit in 2014 (up from 7½ percent in 2009). A reform of housing will bring little saving but could have a positive impact on activation and labor market efficiency.

6. **Wage bill.** At 13 percent of GDP, France's public sector wage bill is the highest in Europe after the Nordic countries. The wage-scale freeze implemented since 2010 has allowed the state to keep its wage bill broadly constant. However, though the freeze applies to all levels of government, the wage bill of local governments and Social Security continue to grow faster than GDP. In 2014, local governments' wage bill increased by 3.9 percent, its fastest rate since 2009, due to continued rapid job creation and, to a lesser extent, to the wage drift resulting from generous promotion practices and an ageing work force. Between 2002 and 2009, local government created more than a quarter million jobs in addition to the job creation related to the decentralization process (*Cour des comptes* 2009, 2012). Broad-based reviews of staffing at all levels of government could help inform a strategy for a reversal in the growth of public employment.

Wage bill by level of government
(1986 = 100)



Sources: INSEE and IMF Staff calculation.

7. **Local government.** Local governments are constrained by a "golden rule", under which they can only borrow to finance investment. However, local spending has grown faster than nominal GDP by an average of one percent per year over the past two and a half decades. While some of this growth can be explained by decentralization of competencies, it also reflects loose budget constraints that allowed significant hiring, faster staff promotion than in other levels of government, investment, and social spending at the local level.

- Because of the constitutional fiscal autonomy of local governments, the government has relied on indirect containment measures such as lowering transfers.[7] These appear to have had an impact in 2014, although primarily in terms of delaying investment spending rather than reducing current spending on a more sustained basis or by improving targeting.

- Complementing the reduction in transfers, the authorities are implementing institutional reforms aiming at rationalizing overlapping structures of local government. The planned elimination of the "general competency clause", which allows local governments to spend in all areas without restrictions, could lead to a more immediate rationalization of spending and substantial savings.

- A new indicative target for the evolution of local public expenditure (*ODEDEL*, *Objectif d'évolution de la dépense publique locale*) became effective this year. While it aims at replicating the approach of the *ONDAM* for health spending, the *ODEDEL* remains indicative, and an important question will be whether local government will adhere to the target. The tool may need to be

[7] Transfers from the central government to local governments are being reduced by 12.2 billion (0.5 percent of GDP) during 2014–17.

developed further to incentivize reductions in areas of inefficient spending, especially staffing, and preserving important expenditures, such as infrastructure investment.

- In the face of declining transfers, local governments, notably municipalities, may increase taxes to finance higher expenditures. The state does not have direct control over local taxation, but can limit increases in tax rates.

8. **Spending reviews and rules.** The multiyear budget law approved in late 2014 has introduced the principle of targeted expenditure reviews. However, compared to other systems, for example the U.K., there are relatively limited tools for assessing the quality and efficiency of public spending. Moreover, while a range of spending targets and rules exist for various levels of government, there is no clear multi-year spending anchor for the general government, and there is no transparent system of burden sharing among levels of government.

Potential Expenditure Reforms

Institutional change:

- Launch a broad and regular spending review for all levels of government, including staffing
- Involve the Fiscal Council or the audit court in the evaluation of expenditure-saving measures
- Anchor general government spending growth to inflation, with burden sharing mechanism

Local government:

- Eliminate the "universal competency" clause for local governments
- Lower the cap on local tax rates
- Limit local government's capacity to borrow
- Reverse the growth in employment

Social and health:

- Increase efficiency of social spending through better targeting notably family and housing allowances
- Revising health reimbursement schemes
- Reform hospitals (merger and efficiency gains)
- Development of ambulatory procedures
- Rationalize prescriptions
- Increase the use of generic medicine

Unemployment:

- Tighten eligibility criteria
- Introduce degressivity

Pension:

- Raise effective retirement age
- Reduce the number of special pension regimes and harmonize their eligibility criteria and benefits
- Reform supplementary pensions to ensure their financial sustainability

Investment:

- Strengthen the *ex ante* analysis of the impact of public investment

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II. LABOR MARKET REFORM[1]

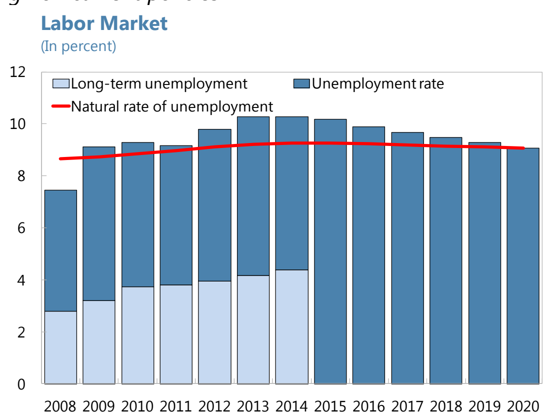
Institutional rigidities have contributed to the persistence of low employment rates and high unemployment in the wake of the crisis. Recent reforms have reduced the labor tax wedge but important challenges remain in a number of areas—including the minimum wage, job search incentives, and enterprise-level flexibility in wage negotiations.

A. France's Labor Market

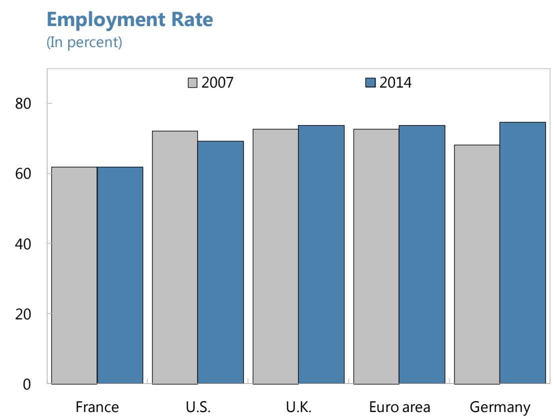
1. **High structural unemployment.** Notwithstanding recent reforms and economic recovery, high unemployment is projected to persist over the medium term. Weak economic growth during the crisis years, in combination with long-standing labor market rigidities, has hampered job creation and pushed unemployment to 10.5 percent in April 2015,[2] up from a trough of 7.5 percent in 2008. Structural unemployment has increased steadily since the onset of the crisis, and about two in five unemployed are now out of work for over a year. Employment rates have remained below those in many peer countries. Even with the sustained recovery projected under baseline assumptions, the unemployment rate would decline only very gradually, reaching 9 percent in 2020.

France: Labor Market Key Indicators

The unemployment rate and the NAIRU are set to remain high on current policies



France's employment rates are low relative to peers



Sources: OECD, Haver Analytics, and IMF Staff calculations.

2. **Segmentation.** The labor market remains segmented. Youth unemployment stands at around 24 percent, and more than 20 percent of 20−29 year olds are neither in employment nor education. Uncertainty surrounding the pace and strength of recovery, coupled with judicial constraints around dismissals, have contributed to labor market duality, with 55 percent of workers below 25 being hired on a fixed-term contract and 85 percent of all new contracts being fixed term, most with very short durations. The unemployment rate among the low skilled increased fast throughout the crisis, and came to almost three times that of skilled workers in 2012. There is also

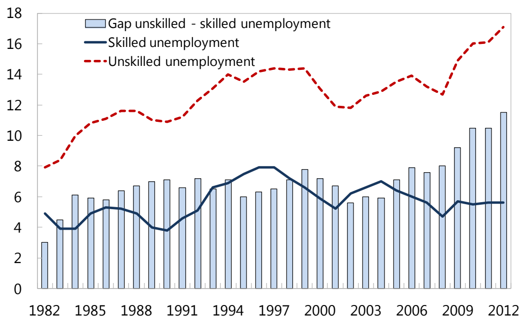
[1] Prepared by Esther Pérez-Ruiz and Michael Gorbanyov (both EUR).
[2] Harmonized unemployment rate, Eurostat.

evidence that people with an immigration background find it particularly difficult to enter the labor market (CEPREMAP, Edo and Jacquemet, 2014).

France: Labor Market Segmentation

Throughout the crisis, the gap between unskilled and skilled unemployment widened....

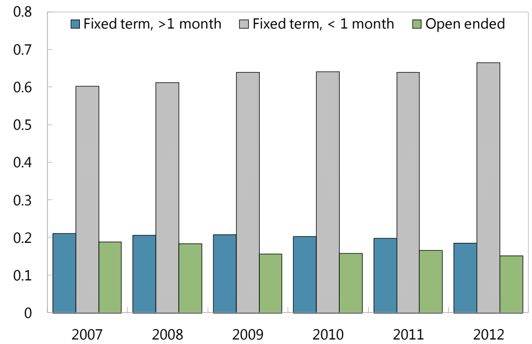
Gap between Skilled and Unskilled Unemployment
(In percent of the labor force)



Note: Skilled = Upper and post secondary education; Unskilled =No eduation.

....and labor market duality persisted as the share of fixed-term contracts in total employment remained broadly unchanged

Hirings by Contract Modality
(In percent of total hirings)

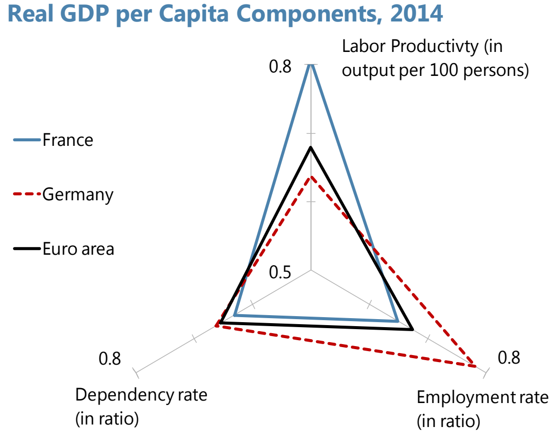


Sources: INSEE and IMF Staff calculations.

3. **Labor costs.** Real wages have continued to grow despite high and rising unemployment (see panel chart). Since the onset of the crisis, basic monthly salaries have grown steadily at around 2.1 percent per year, and real wages have increased cumulatively by 4.6 percent despite a 3 percentage point increase in the unemployment rate and cumulative GDP per capita loss of 0.8 percent. Labor costs have moderated somewhat, partly as a result of payroll tax reductions, and the authorities have advanced wage containment measures (a public service wage-scale freeze since 2010 and no discretionary increases in the minimum wage above formula since 2012).

4. **Productivity link.** France's steadily rising labor force requires strong employment growth to gradually reduce the unemployment rate. In particular, it would require significant job creation for the low skilled. Since the currently high level of labor productivity in France partly reflects the large employment gap between skilled and low-skilled workers, in contrast for example to Germany, the challenge will be to reduce unemployment while taking steps to preserve or improve productivity growth by building human capital.

Real GDP per Capita Components, 2014



B. Rigidities

5. **Causes.** The literature points to a broad range of institutional factors that contribute to wage rigidity and structural unemployment in France.[3] These include a high minimum wage, the labor tax wedge, costly and uncertain dismissal procedures, restrictions on firm-level bargaining, skill mismatches and inadequate training programs to address them, and unemployment and social benefits with insufficient job search incentives.[4] While the exact contribution of each of these factors to suboptimal labor market outcomes is difficult to estimate, a decisive reduction in structural unemployment would likely require a multi-pronged approach to labor market reform.

6. **Minimum wage.** In France, the minimum wage has long been an important social and political symbol. It plays a major role in the wage formation process and guarantees a basic living income for working people.

- ***Level.*** By 2013, France's labor costs at the minimum wage level were high by international comparison. The minimum wage has risen by 44 percent since 2001, including by 14 percent since 2007 (compared to 12 percent nominal GDP growth). France's minimum wage, relative to the median wage, is the highest among euro area countries, implying a significant degree of wage compression and discouraging employment of low-skilled workers (OECD, 2013 and 2015).

- ***Tax wedge.*** A string of reforms sought to alleviate the labor cost effects from the minimum wage, in particular by reducing the tax wedge for lower salary ranges. These efforts span from the Balladur and Juppé reforms in the 1990s through the Aubry and Fillon tax breaks in the 2000s to the more recent tax cuts introduced by the *CICE* tax credit and the Responsibility and Solidarity Pact (estimated at EUR 30 billion over 2013-17). Although these measures have borne fruit (see, for a review, Nouveau and Ourliac, 2012), the gap between unskilled and skilled unemployment rates has continued to increase, and the total labor costs for employer at the minimum wage level in France remained among the highest in the OECD in 2013.[5]

- ***Wage feedback loop.*** The automatic formula-based increases in the minimum wage, combined with the related broader wage bargaining process (see below), create a feedback loop that contributes to broader wage rigidity.[6] Minimum wage policy dominates wage formation for up to around the 45 percentile of the wage distribution (Aeberhardt and others, 2012; Goarant and Muller, 2012). As the minimum wage acts as a floor for pay grades, partial indexation of the minimum wage to increases in average real wage creates a feedback loop pushing up wages throughout the economy (Cette, 2012).

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[3] See for example, Thomas Philippon, 2007. *Le Capitalisme d'héritiers : La crise française du travail*, Paris.

[4] In addition, a *Banque de France* study points to a link between housing-related costs of living and wage pressures (Carluccio, 2014).

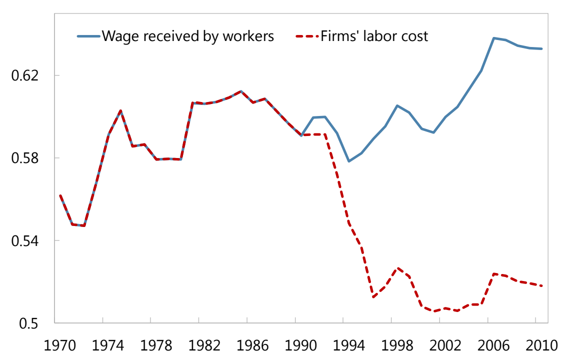
[5] The minimum wage is uniform across regions, professions and skill levels, with a small reduction of 10-20 percent for inexperienced young people under the age of 18.

[6] Each year, the minimum wage is automatically indexed to inflation and half of the average real wage increase in the economy. To this, the government can add a discretionary increase (*coup de pouce*), last applied in 2012.

Labor Costs at the Minimum Wage Level

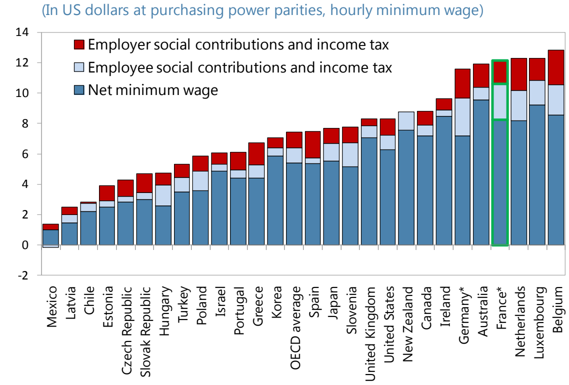
Although past tax wedge cuts have reduced low-skilled labor costs….

France: Minimum Wage
(In percent of the median wage)



…. total labor costs at the minimum wage level in France were still among the highest in the OECD in 2013

Total Labor Cost for Employer at Minimum Wage, 2013
(In US dollars at purchasing power parities, hourly minimum wage)



Sources: Nouveau and Ourliac (2012); and OECD, *FOCUS on Minimum wages after the crisis: Making them pay (May 2015)*.
* Minimum wage level in Germany is for 2015.

7. **Dismissals.** Costly and uncertain dismissal procedures have discouraged hiring into permanent jobs, contributing to labor market duality. France's employment protection legislation requires strong justification for any dismissals. Unjustified dismissals are subject to labor court review that can improve on the worker's separation package. Labor courts deliberations can be very slow, their prescribed conciliatory procedures are often ineffective, decisions are frequently subject to appeal, and jurisprudence across tribunals varies widely (National Reform Program, 2015). This system encourages the use of fixed-term contracts, where termination cost is set at 10 percent of the total gross pay since the beginning of the contract.[7] It also has led to the reliance on the so-called *rupture conventionnelle*, introduced in 2008, which allows for voluntary separation from employment leading to formula-based termination compensation.

8. **Wage bargaining.** At the enterprise level, there are limits on social partners' flexibility to agree on hours and wages. According to the labor code, company-level agreements must either match or improve upon the salary and job classifications embedded in the branch-level collective agreements. In this context, mandatory annual wage negotiations for medium and large companies, coupled with high dismissal costs, create pressure for wage increases even when productivity gains are tepid (Enderlein and Pisani-Ferry, 2014). On average over 2008–14, wages negotiated at the firm level increased by 1 percentage point above the rise in the minimum wage.

9. **Training and education.** The literature suggests that structural unemployment often reflects skill mismatches induced by structural change (see, for example, Ljunqvist and Sargent, 1998). Young people entering the labor market may not have the skills most in demand, while long-term

[7] Out of 4.6 million temporary private contracts that were concluded in the first trimester of 2014, 3.8 million were for less than a month, and most for less than eight days (Askenazy 2014). Very short contracts are widely used in some sectors as successive renewals are unconstrained unlike for fixed term contracts.

unemployed can progressively lose skills acquired in previous job. Vocational education and professional training could facilitate rapid reintegration of unemployed in the labor force. There is some evidence that these factors play a role in France. Each year, 140,000 young people leave the education system without completing school. The professional training system, which costs about 1.4 percent of GDP, has been slow to respond to the needs of job seekers. Its resources are often managed by social partners or at local government level and not targeted to the low skilled, the unemployed, and those most in need of training. Moreover, in contrast for example to Germany, most young people in professional education are not employed or in apprenticeships.

10. **Benefits.** Eligibility conditions for unemployment benefits are comparatively lenient while payouts are generous (Europ'Info, 2012). Workers become eligible for unemployment benefits after only 4 months of service (the shortest time to reach eligibility in Europe) and qualify for up to 24 months of benefits after working for just 2 years (the fastest among the largest European countries). While the replacement rate is broadly on a par with other European countries, the maximum monthly benefit is capped at about €7,000, well above peers. In the first year of unemployment, the salary of a "reasonable job offer" that the unemployed should accept is set as high as 85–100 percent of the previous salary. Moreover, the unemployed can reject the first such offer without penalties. The system also does not provide for a progressive reduction in benefits (degressivity) for long-term unemployed to encourage their rapid return to the labor market. While benefit recipients are required to conduct an active job search, this condition is not always strictly enforced for either welfare or unemployment benefits.

C. The Reform Agenda

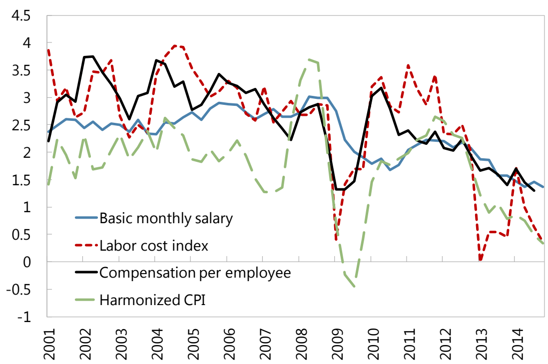
11. **Recent reforms.** In the early 2000s, strong economic growth combined with labor subsidies supported solid employment creation (1.2 percent on average over 2001–07). This coincided with the gradual introduction of the 35-hour workweek starting in 2000, whose impact is still debated—some studies show that it had barely any impact on job creation while raising labor costs for firms (Saint Paul, G., 2015; Cahuc, 2001), while others find positive employment effects from the reduced working week (Fiole and Roger, 2002, Askenazy, 2013). This partly motivated the Aubry and Fillon cuts in social security contributions for unskilled workers (Nouveau, C. and B, Ourliac, 2012. Since the onset of the crisis and the resulting stagnation in employment growth (0.1 percent on average over 2008-14) and marked increase in unemployment, a number of steps have been taken to improve the functioning of the labor market. Key labor market policies have included:

- The Job Security Act adopted in 2013 opened the door to a more collaborative relation between social partners and represented a first step toward "flexicurity" (Table 1). In particular, so-called "job preservation agreements" (*accords de maintien de l'emploi*) introduced in mid-2013 allowed companies in severe economic difficulty to renegotiate wages, employment, and working time for up to two years. However, the conditions of such agreements have proved restrictive, and only about a dozen of them were negotiated in two years.

Figure 1. Labor Market Structural Indicators

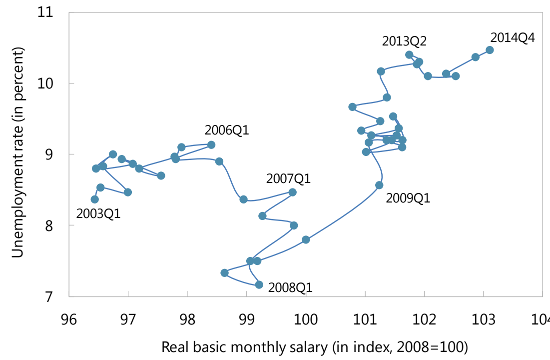
Real wages have remained dynamic during the crisis....

Selected Wage Indicators
(In y-o-y percent change)



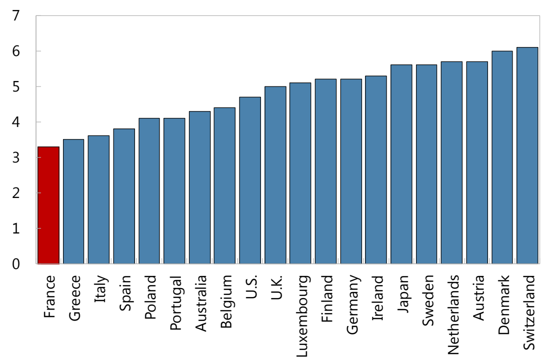
....despite the rising unemployment

Basic Monthly Salary and Unemployment Rate
(2005Q1-2014Q4)



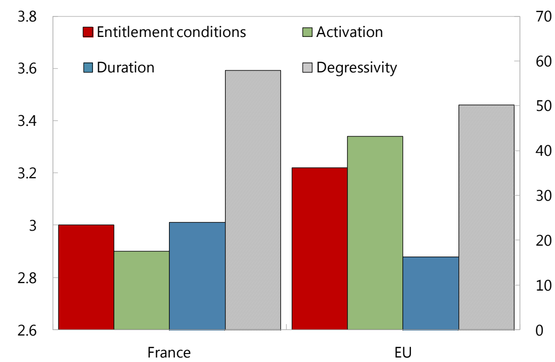
The quality of social dialogue is low.

Collective Bargaining - Cooperation in Industrial Relations
(Index number, 2012) 1/



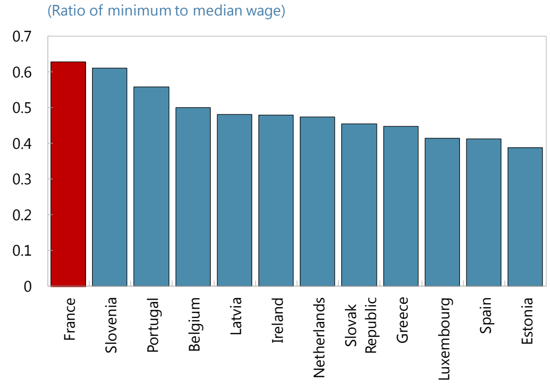
Unemployment benefits are generous.

Entitlement, Activation, Duration, Degressivity
(In index number, number of months, and ratio) /2



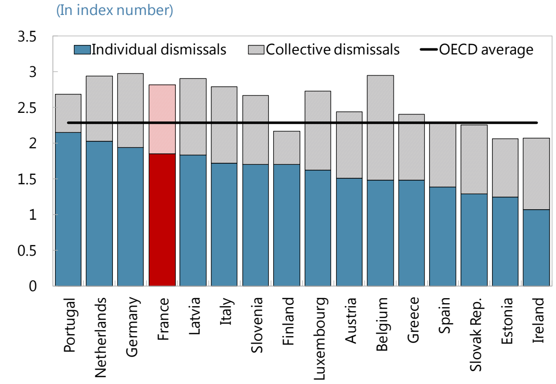
There is little wage differentiation among low skilled workers.

Minimum Wages, 2013
(Ratio of minimum to median wage)



Dismissal procedures remain costly.

Protection of Workers Against Dismissals, 2013
(In index number)



Sources: OECD and IMF Staff calculations.
1/ Index ranging from 1 to 7, based on a question posed to 14 000 business leaders (of which 129 in France), with 7 indicating the greatest possible level of co-operation.
2/ Entitlement and activation index from 1 to 5, where 1 is less strict (left scale). Duration is equal to months of benefits for an unemployed worker with 22 years of contributions (right scale). Degressivity is equal average net replacement rate in years 2 to 5 as percent of net replacement rate in year 1 (right scale).

- Recent reforms have attempted to contain labor costs directly (*CICE* and Responsibility Pact). While their impact on employment could be potentially significant, they are fiscally costly and estimates of their positive effects on employment are highly sensitive to assumptions (Espinoza and Pérez Ruiz, 2014). Moreover, the effectiveness of these measures appears to be lower than similar measures adopted in the past, partly because recent schemes are less targeted to low wages than past measures owing to other considerations that went into their design, such as ensuring that the tax cuts also benefit exporting firms that tend to employ skilled labor.

- To encourage labor mobility and employability of the most vulnerable workers, the 2014 reform introduced personal "training accounts" transferable across jobs and between employment and unemployment. Prior to the reform, the training rights acquired in one job were not easily transferred, leading to training mostly benefitting those already in permanent jobs rather than temporary workers or job seekers.

- The 2014 reform of the unemployment insurance system also introduced "rechargeable" unemployment benefits rights, whereby employees are allowed to carry their accrued rights to another job and from an unemployment situation to a job, effectively improving job search incentives.

- In May 2015, the employment agency announced deployment of nearly 200 inspectors in the coming months to verify and enforce job search requirements for the registered unemployed.

12. **Reforms underway.** The government is pursuing additional reforms on a number of fronts. The Macron law foresees a reform of the *prud'hommes* system aimed at reducing judicial uncertainty around individual dismissals. The draft *Rebsamen* law, aimed at improving the social dialogue, would streamline mandatory discussions between social partners in SMEs. In early June, the government announced a package (to be adopted over 2015–16) to promote employment by removing obstacles to job creation most constraining to SMEs. Labor market reforms include measures to: (i) facilitate "job preservation agreements" by extending their duration from two to five years, introducing fast-track dismissal procedures for workers that do not endorse the agreement, and providing for its possible suspension if the firms' situation changes; (ii) cap severance payments that can be awarded by labor courts in regular dismissal cases; (iii) increase to two the number of authorized renewals for fixed-term contracts (now they can only be extended once); (iv) increase by 40,000 the training slots aligned with company needs (adding to the 60,000 slots created in mid-2014); (v) grant a subsidy of up to EUR 4,000 for micro companies recruiting their very first employee for one year and over; and (vi) extend the trial period of apprenticeships contracts by counting towards it only the days of actual work in the company.

13. **Further reform options.** While the distortions underlying high unemployment and labor market segmentation are well established, it is less obvious what impact individual piecemeal reforms may have, in part because of synergies among them and with other structural reforms. This has prompted calls for a comprehensive employment overhaul (for example, see the *Jobs Acts à la française* advanced by a group of French economists, Box 1). The comprehensive reform proposals center on (i) better aligning wages to productivity developments and employment conditions (in

particular for low-skilled workers); (ii) using job preservation agreements preemptively (for example, by expanding their eligibility to companies facing challenging competition in the market, *accords offensifs*) and decentralizing the wage bargaining process with greater recourse to the special relief clauses in branch collective agreements; (iii) boosting job search incentives for benefit recipients; (iv) improving the efficiency of vocational training (Enderlein and Pisany-Ferry, 2014, Tirole and others, 2014); and (v) reducing duality by increasing flexibility of open-ended contracts. One proposal addressing labor market duality contemplated introducing a single open-ended contract with the same termination procedures applicable to all contracts (Blanchard and Tirole, 2003), and with compensation for layoffs being calculated according to a rate setting mechanism based on seniority.[8]

Box 1. Towards a Jobs Act à la Française

A group of French economists led by Nobel Laureate Jean Tirole has recently called for a comprehensive Jobs Act to combat unemployment, which would include four pillars:

- An upgraded occupational training system that would certify training for those seeking employment.
- A reform of the unemployment insurance to encourage job seekers to take up employment offers and to link firms' unemployment contributions to the total wage bill and a regressive factor to incentivize employment ("bonus-malus" or "tax dismissal" system).
- Further reduction in labor costs at low wages by targeting existing labor tax cuts around the minimum wage.
- Lower uncertainty on dismissals by broadening the definition of acceptable economic reasons for redundancy. This would allow firms to dismiss employees not only when they are in difficulty (economic redundancy) but also for those firms who would like to improve their competitiveness.

[8] Lepage-Saucier and others (2013) nevertheless estimate high temporary employment costs from implementing a single labor contract in France.

Table 1. Key Labor Market Reforms

Measure	Impact
I. Recent Reforms	
Measures to foster competitiveness and employment via reduction of tax wedge	
Competitiveness and Employment Tax Credit (CICE, €20bn, 2013-15): tax credit on firms' payroll on wages up to 2.5 times the SMIC; Responsibility and Solidarity Pact (RSP, 2015-17): reductions in employers' SSCs for wages up to 3.5 times the SMIC	* In ppts. of additional GDP: +1.7 by 2020 (authorities)/+1.2 after 10 years (OECD) * High uncertainty sorrounding affectiveness (Alla, Espinoza, and Perez Ruiz, 2015) given instrument used (tax credit for CICE) and targeting scheme (RSP less targeted on low skilled workers than past cuts in SSCs)
Flexicurity	
Job security act (2013): Preseving jobs, combating duality, reducing uncertainty over collective dismissals x *Accords de maintien de l'emploi (AMEs)* : greater flexibility for firms over wages/hours (limited to two years) x Simplification of collective dismissals x Higher taxes on fixed-term contracts	Job preservation agreements have been sparingly used so far; 85 percent of hiring are fixed term contracts
Occupational training reform (2014): portable training rights across jobs and between employment and unemployment in support of mobility	* In ppts. of additioanl GDP: +0.1 after 10 years (OECD)
Unemployment benefits (2014): Longer benefits waiting period for laid-off employees in receipt of a generous separation allowance	Higher participation of older workers; 0.1 ppt. after 10 years (OECD)
Subsidized employment for the most vulnerable	
Contrats de génération: subsidized open-ended contracts for young workers; Emplois d'avenir: subsidized contracts for low-skilled involved in training	*Contrats de génération* fell short of target (33,000 signed against 75,000 targeted for 2013); *Emplois d'avenir* on target (150.000 jobs since 2012)
II. Reforms Underway	
Macron law - Reform of *prud'hommes* system	Speeding up procedures regarding individual dismissal disputes and improving the predictability of decisions, in particular by introducing ceilings on compensation
Macron law - Simplifying use of *AMEs*	Enhancing adaptability of firms with economic difficulties by extending the duration of such agreements from two to five years, introducing fast-track dismissal procedures for workers that do not endorse the agreement, and providing for its possible suspension if the firms' situation changes
Rebsamen law - Modernization of social dialogue	Streamlining mandatory discussions between social partners in SMEs and easing other labor-related regulations that hamper SME growth
Reform package *Tout Pour l'Emploi*	(i) increasing to two the number of authorized renewals for fixed-term contracts; (ii) increasing by 40,000 the training slots targeted to company needs (adding to the 60,000 slots created in mid-2014); (iii) grating a subsidy of up to EUR 4,000 for micro companies recruiting the first employee for one year and over; and (iv) extending the trial period of apprenticeships contracts by counting towards it only the days of actual work in the company
III. Additional Reform Options	
Reforming the minimum wage formula	Improving the employability of the youth and the low-skilled and tackling the feedback loop that contributes to wage rigidity. Minimum wage increases should be limited to inflation for as long as unemployment remains high
Reforming unemployment and welfare benefits to strengthen job search	Strengthening job search incentives by lengthening the period of work that is required for eligibility, introducing degressivity of benefits, and gradually reducing benefits if reasonable job offers are refused
Further enhancing firms' flexibility in negotiating hours and pay	Expanding flexibility for social partners to agree on hours and wages in all enterprises; broadening the definition of acceptable economic reasons for dismissals
Improving the targeting of professional education and training	Reducing the impact of hysteresis and structural unemployment by better targeting resources on quality training for the young, the low-skilled, and unemployed; and streamlining and upgrading the supply of training

Sources: OECD, G 20 commitments, Programme National de Reforme 2015, Enderlein and Pisany-Ferry report, and the *Jobs Act à la française.*

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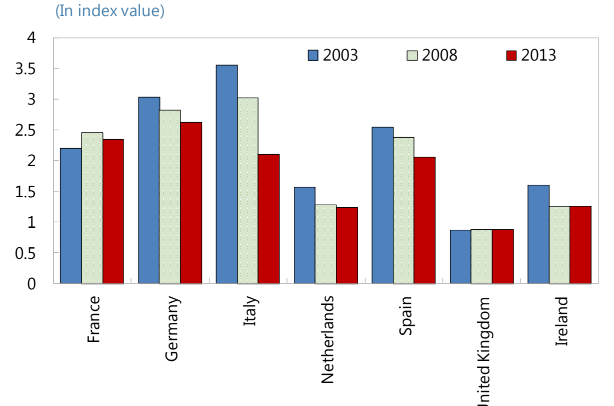
III. BARRIERS TO COMPETITION [1]

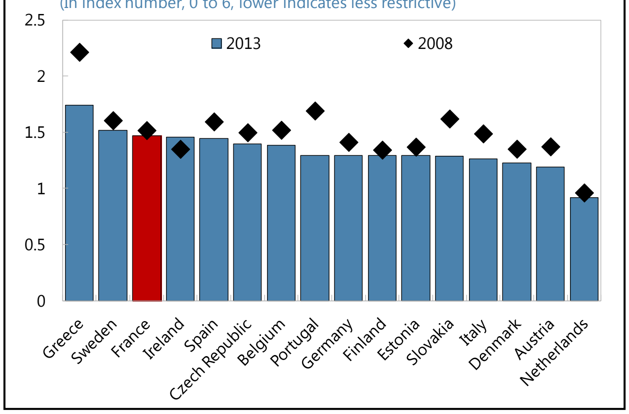
Though close to the OECD average, France's product market is more regulated than in comparable large European countries. Barriers to competition are particularly high in services, which now account for about 79 percent of the economy. The Macron law would be an important step forward, though rigidities remain.

1. **Barriers to entry and competition** remain an important constraint on France's growth potential. According to the OECD's indicators of product market regulation, the regulatory burden is high and, over 2008–13, little progress was made on product market reforms. Administrative requirements and legal protection of incumbents constitute barriers to entry that not only reduce competition but also hamper job creation and affect the growth of startups. Such entry barriers are particularly significant in the services sector (Figure 1). France is one of the few countries in the euro area where regulation of professional services became more stringent over the past decade.

Professional Services Regulation
(In index value)

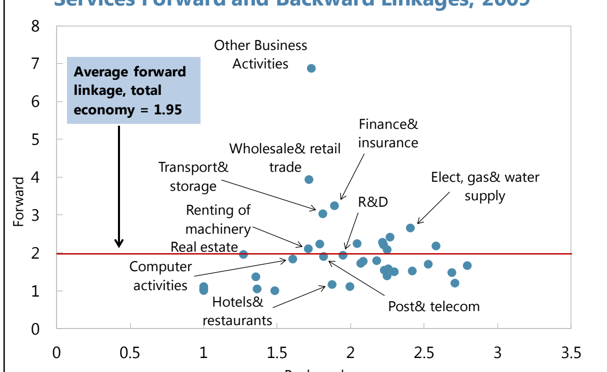


Overall PMR Indicator by Country
(In index number, 0 to 6, lower indicates less restrictive)



2. **Forward linkages.** Barriers to competition in services tend to limit incentives for innovation and quality, reduce productivity growth, and raise the cost of services. Because services are by far the largest input for production, this affects the rest of the economy, including the competitiveness of enterprises in the tradable sector (Hallaert, 2013). Services account for 54 percent of economy's consumption of intermediates. "Other Business activities", which covers many regulated professions, is the largest input for the economy as a whole and for the manufacturing sector, followed by wholesale and retail trade (Table 1).

Services Forward and Backward Linkages, 2009[1]



1/ Chart shows output rise in sector i due to unit increase in final demand of all other sectors (forward linkages) and output rises in all sectors due to a unit increase in j's final demand (backward linkages).
Source: Fernández Corugedo E. and E. Pérez Ruiz, 2014, "The EU Services Directive: Gains from further Liberalization," IMF WP 14/113.

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[1] Prepared by Jean-Jacques Hallaert (EUR).

As a result, their forward linkages (i.e., the impact that productivity improvements in these two sectors have on the cost of other sectors of the economy) are larger than for other services.

Table 1. Input as a Share of Gross Output
(in percent)

	All Economy	Agriculture, hunting, forestry and fishing	Mining and quarrying	Industry	Construction	Electricity, gas, and water supply	Services
All inputs	**48.8**	**54.8**	**58.7**	**73.1**	**56.0**	**61.8**	**37.4**
Agriculture, hunting, forestry and fishing	1.7	18.0	0.0	4.3	0.9	0.3	0.2
Mining and quarrying	1.4	0.2	4.1	4.0	0.9	11.7	0.0
Manufacturing industry	16.5	20.4	32.0	40.0	21.6	8.7	6.5
Construction	1.5	0.3	1.0	0.3	12.0	4.1	0.9
Electricity, gas, and water supply	1.4	1.5	2.2	1.4	0.3	20.3	0.7
Services	26.3	14.4	19.4	23.0	20.3	16.5	29.1
Other Business Activities	7.8	1.7	2.2	6.5	7.8	4.5	8.7
Wholesale and retail trade; repairs	3.6	6.1	7.1	6.4	4.7	1.0	2.3
Finance and insurance	3.6	3.0	2.0	1.6	3.0	1.9	4.5
Transport and storage	2.9	1.4	3.4	2.6	1.4	2.3	3.3
Real estate activities	1.9	0.0	0.3	0.6	0.1	0.3	2.7
Post and telecommunications	1.4	0.0	0.4	0.3	0.3	0.5	2.0
Other community, social and personal services	1.1	0.1	0.7	0.6	0.5	1.2	1.4
Computer and related activities	1.0	0.0	0.1	0.7	0.5	1.1	1.3
Research and development	0.8	0.3	1.3	2.1	0.1	0.5	0.3
Renting of machinery and equipment	0.7	0.9	0.8	0.5	1.1	1.9	0.6
Hotels and restaurants	0.7	0.0	0.0	0.3	0.1	0.2	0.9
Education	0.4	0.2	0.7	0.3	0.2	0.5	0.4
Public admin. and defence; compulsory social security	0.3	0.1	0.2	0.2	0.3	0.5	0.4
Health and social work	0.3	0.3	0.1	0.1	0.1	0.1	0.3
Private households with employed persons	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: IMF Staff and OECD.

3. **Benefits of reform.** The literature indicates that services sector reforms in France, in particular when combined with regulatory simplification and labor market reforms, would substantially benefit the entire economy, by boosting employment, investment productivity, and exports. A study by Bourlès et al. (2010) estimated that reducing regulation to the OECD frontiers could increase productivity by 3 percent after 5 years. IMF staff has estimated that a 1 percent productivity gain in regulated services could raise GDP by 0.8 percent after two years (Fernandez Corugedo and Pérez Ruiz, 2014).

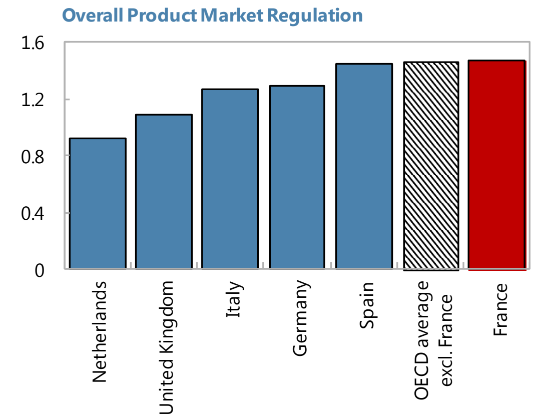
4. **Recent reform progress.** There has been a noticeable acceleration of reforms in recent years:

- ***Liberalization of regulated professions.*** A limited liberalization of regulated professions and health products retail took place in early 2014.
- ***The Law on Growth and Activity ("Macron law")*** is a significant step to accelerate product market reforms.[2] It intends to (i) liberalize retail trade (notably by extending the opening hours

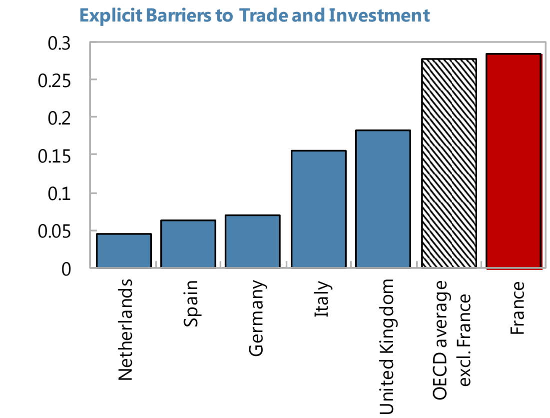
[2] The labor market reform component of the Macron Law is not discussed in this background note.

Figure 1. France: Product Market Regulation in 2013

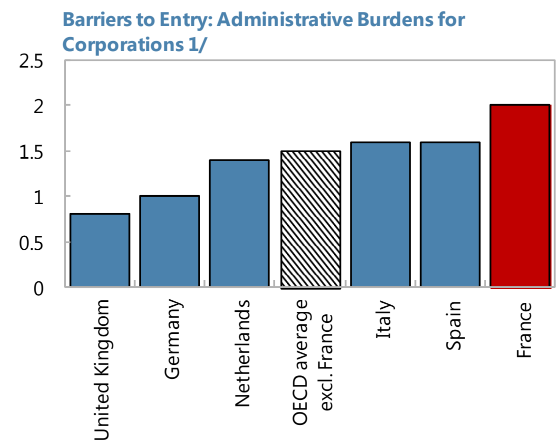
Product market is more regulated in France than in some large European countries because …



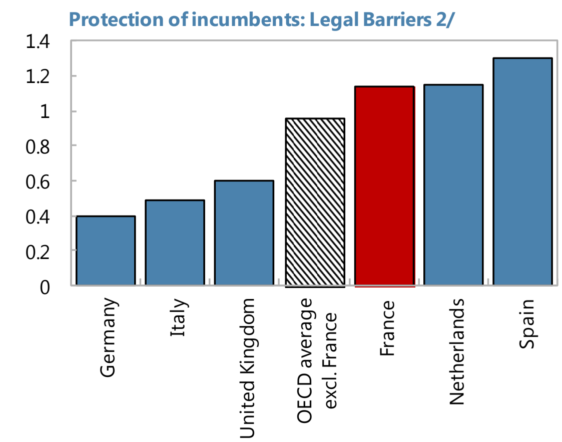
… barriers to foreign competition (through trade or investment), though small, are higher…



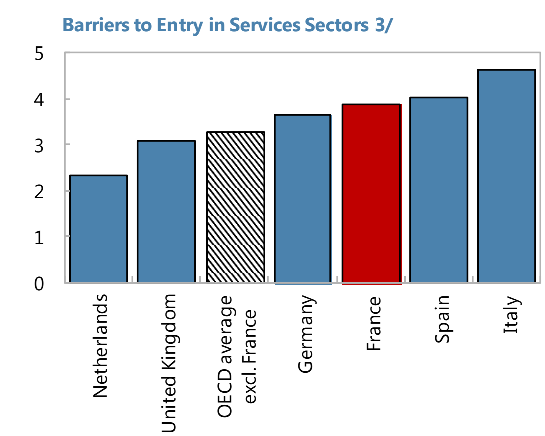
… creation of firms is hampered by red tape ….



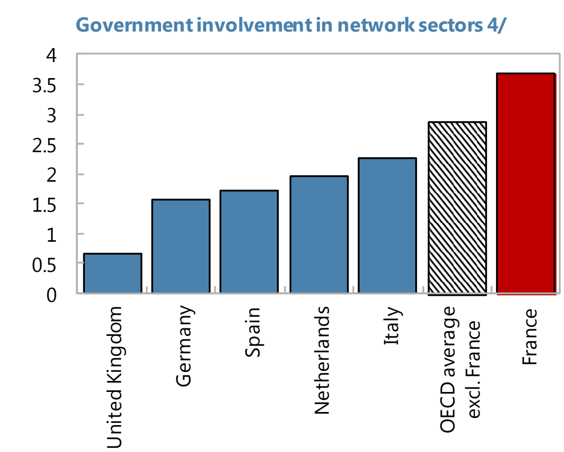
… and legal protection of incumbents.



Barriers of entry are particularly strong in services sector.



In network industries state involvement remains relatively strong



Sources: OECD
1/ Administive burdens on creating a public limited company.
2/ Pervasiveness of barriers to entry in 30 business sectors as a share of sectors in which there are explicit legal limitations on the number of competitors.
3/ Entry barriers in professional services, freight transport services, and retail distribution.
4/ Government stakes in the largest firms in electricity, gas, rail transport, air transport, postal services and telecommunication.

for specific zones) and regulated legal professions; (ii) reduce rents received by toll road operators and liberalize intercity bus transport; (iii) adopt simplifying measures to induce greater housing supply. The reform of the retail trade and of the regulated legal professions also leads to an increase in the mandate of the Competition Authority.

- ***Energy sector reform.*** Regulated tariffs will be phased out for businesses and local authorities. Regulated gas tariffs were reformed to better reflect supply costs in 2013 and, starting in 2016, the setting of regulated electricity tariffs will shift from the Ministers of Economy and Energy to the Energy Regulatory Commission. Moreover, a carbon tax was created in 2013 and hydroelectric operating concessions will be renewed through competitive procedures.
- ***Regulatory simplification.*** A process aiming at simplifying administrative regulations and cutting red tape was launched in July 2013 (*Modernisation de l'action publique*). An independent body, the Businesses Simplification Council, co-chaired by a Member of Parliament and a business leader was created in 2014. Every six months, this Committee announces new simplification proposals.

5. **Potential Impact.** These product-market reforms have potentially a significant macroeconomic impact. The OECD (2014) estimates that recent structural reforms and those considered as of end-2014 (including the *CICE* and the tax cuts implemented over 2015–17 as announced in the Responsibility and Solidarity Pact) would jointly raise GDP growth by 0.3 percent per year over five years and 0.4 percent per year over 10 years. Over the long term, this estimated impact is equally divided between an employment impact and a productivity impact.

6. **Remaining barriers.** The Competition Authority has highlighted several areas, not covered by the recent reforms, where the benefit of increased competition would be substantial, notably (i) barriers to entry (including qualifications) and price formation for regulated professions not covered by the Macron law;[3] (ii) anti-competitive practices and administrative barriers to entry in the retail sector that remain after recent reforms; (iii) transport, notably the railway sector. In addition, extending to SMEs the possibility to introduce a class action would help tackle cartel practices, which tend to be concentrated on intermediate goods. To reinforce the institutional setup and competition in services, it would be also important to ensure adequate resources for the Competition Authority and the effectiveness of the Businesses Simplification process.

[3] For details see Inspection Générale des Finances (2013).

Table 2. Potential Product Market Reforms
(GDP impact after five years, in percent)

	OECD	Authorities
I. Reforms implemented		
- Accelerate regulatory simplification	0.2	0.2
- Liberalize some regulated professions (legal and accounting) and the sale of some health products	0.1	0.1
II. Reforms announced		
Business environment		
- Streamline and cut business taxes (2015-2020)	0.4	0.4
- Reduce social and administrative threshold effects	0.4	...
- Modernize "droit des contrats" (contract laws)	...	...
Services sector and network industries		
- Liberalize services sector		
* Legal professions (Macron law)	0.2	0.3
* Coach transport (Macron law)	...	0.1
* Retail trade (shop hour) and strengthen the power of the Competition authority on commercial urban planning (Macron law)	...	< 0.1
- Reform the railway sector	...	...
- Reform the energy sector		
* End regulated tariff concession on gas and electricity and hydroelectric infrastructure concessions	0.2	...
* Energy transition for green growth	...	0.8
Accelerate amortization with a view to boost investment	...	...
III. Other reforms to consider		
Competition and barriers to entry and exit notably for services	...	...
- Further liberalize regulated services (architects, accountants, pharmacists, ...)		
- Strengthen and broaden the mandate of the Competition authority		
- Enhance the effectiveness of regulatory simplification through systematic selection criteria and well-defined implementation and follow-up procedures		
- Reform bankruptcy procedures to speed up reallocation of capital		
- Give SMEs the possibility to introduce class actions		
Reform innovation support schemes to promote private sector innovation	...	...

Sources: OECD, G20 Commitments, Programme National de Reform, Enderlein and Pisani-Ferry report.

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IV. FINANCIAL SECTOR, HOUSING PRICES, AND PRIVATE BALANCE SHEETS[1]

France's banks have weathered the crisis reasonably well, but will have to adapt to a changing macroeconomic and regulatory environment. As for insurers, prolonged low interest rates will put pressure on profitability over the medium term. Corporate and household debt appears manageable.

A. Banking System

1. **Comprehensive Assessment.** The ECB's 2014 Comprehensive Assessment did not result in any of France's banks needing to raise additional capital.[2] In the asset quality review, which assessed the adequacy of asset and collateral valuations, only small valuation adjustments were made to risk-weighted assets (less than 0.5 percent of starting risk-weighted assets). In the stress-testing component, which assessed the sector's capacity to absorb macro-financial shocks, the impact of the shocks reduced the CET1 ratio by around 3 percentage points, less than most other countries.

2. **Capital and Liquidity.** The four largest (and globally systemic) banks have raised core equity tier 1 ratios to above 10 percent (Basel III fully loaded basis), and their Liquidity Coverage Ratios all exceed 100 percent. However, staff analysis of the Comprehensive Assessment's stress test results suggests still low leverage ratios in some banks. And, despite progress since the crisis, banks remain structurally dependent on wholesale funding, with customer deposits accounting for only 45 percent of total liabilities in September 2014, well below the median 55 percent for European banks.

3. **Profitability.** Bank profitability, partly affected by a one-off settlement, is still below pre-crisis levels. The low interest environment is likely to have offsetting effects, with a squeeze on interest margins against rising credit demand and lower funding costs. Interest margins are pressured both by the flatter term structure and guaranteed deposit rates above the market rate on regulated savings (affecting around 10 percent of private nonfinancial sector deposits). Low rates have fed an uptick in mortgage refinancing, which generates fee income in the short term, but does not compensate for the longer-term reduction in interest income. Against these pressures, banks' funding costs have been further reduced by the ECB's Quantitative Easing (QE) policy, and some banks have accessed the ECB's targeted Long Term Refinancing Operations. Over the medium term, with an increasing share of loans extended at low rates, banks would be more exposed to a reversal of short-term rates, as funding costs would rise immediately while the income side would be more constrained, including by fixed rate mortgage loans (mortgages account for around 45 percent of loans to the non-financial private sector).

4. **Banking union.** The ECB currently exercises direct supervision over 10 French banks accounting for 92 percent of system assets. This leaves 153 "Less Significant Institutions" under the

[1] Prepared by Piyabha Kongsamut (EUR).
[2] One smaller bank was found short, but it had raised capital to above 9 percent CET1 ratio in the interim and hence no additional capital was required

direct supervision of the national supervisor. Priority areas for the Single Supervisory Mechanism (SSM) include strengthening governance, and harmonization of practices and national options and discretions. Some discretions are designated to phase out (such as deferred tax assets, less relevant for French banks), while others may remain in place for the time being (such as the treatment of capital in insurance subsidiaries, especially relevant for French *bancassurances*). An important area for supervision of European banks are bank-internal models of risk (credit risk in particular), which affect the calculation of risk-weighted assets and regulatory capital. Efforts at harmonization are in the early stages and will take some years to come to fruition (around 7,000 credit risk models are in use within the banking union, and around 600 in France).[3]

5. **Evolving regulation.** Some of France's banks may need to raise additional capital over the medium term as practices on risk-weighted assets are harmonized across the SSM and national discretions on capital requirements may be phased out. On the latter, the treatment of insurance subsidiaries is particularly relevant for some French banks, as capital in a bank's insurance business is currently partly counted toward the bank's capital, in line with the "Danish Compromise". In addition, the leverage ratio requirement to be specified at the European level will likely have an impact on some of the larger banks. Further, France's four globally systemic banks will likely be affected by a new global capital standard on Total Loss Absorbing Capacity (TLAC). Finally, there is ongoing Basel Committee work on interest rate risk in the banking book, which could have significant implications for French banks if the current practice of granting predominantly fixed-rate mortgages is called into question. The impact of these changes cannot yet be determined, as final decisions have not yet been made in any of these areas.

B. Nonbank Financial Sector

6. **Shadow banking.** With the banks under tighter regulatory requirements, some financial activity and risk may be migrating to "shadow banks." The authorities are monitoring various channels and are actively involved in the Financial Stability Board's efforts on shadow banking. These include banks' moves to set up asset management firms to separate these activities from banking, and some asset managers' moves to provide credit directly to borrowers. Both of these activities are regulated by the authorities, and a new database allows for tracking of exposures and shifts in holdings by asset managers. Furthermore, the Alternative Investment Fund Managers Directive brought more investment funds into the regulated sphere.

C. Insurance Sector

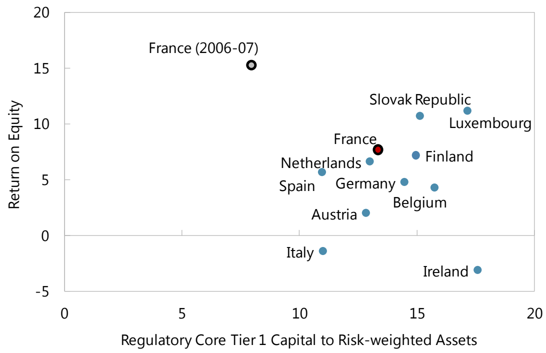
7. **Life Insurance.** Life insurance is an attractive investment product for French hosueholds due to tax advantages and guaranteed returns. Most life insurance policies have a guarantee on the initial investment and also on the return (e.g. "*contrats en euro*"; a minimum guaranteed return is set

[3] As standards are being developed, one interim approach is to construct hypothetical portfolios as a benchmark to see how the banks' internal risk models compare, and policy actions may be taken such as temporary capital floors and add-ons if it is determined that the use of certain models is unjustified.

Figure 1. Banking and Insurance Sector Developments

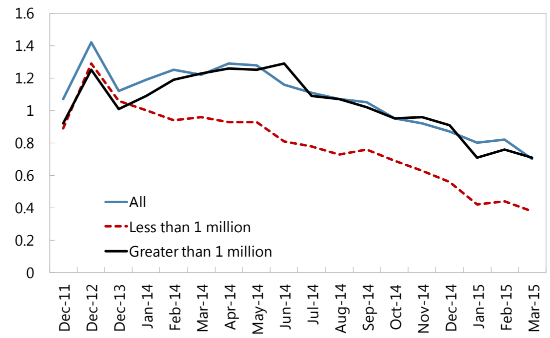
Capital has been strengthened, but profitability remains below pre-crisis levels …

Regulatory Capital and Profitability, 2012–14
(In average ratio over the period)



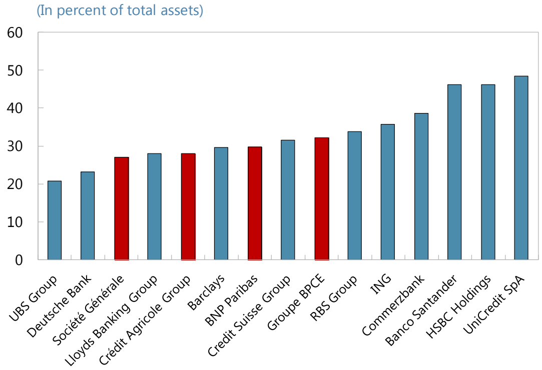
… partly reflecting a flatter yield curve.

Interest Rate Spread Between 5 and 1 Year New Business Loans
(In percent)



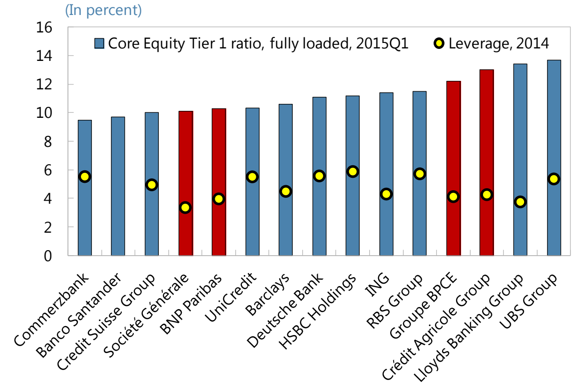
Even though no large adjustments were made in ECB's AQR, risk-weighted assets look relatively low …

Risk Weighted Assets in Selected European Banks, 2014
(In percent of total assets)



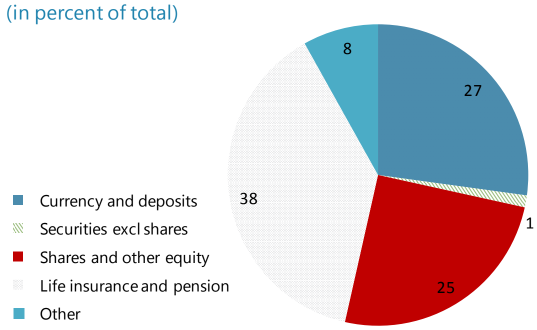
… and leverage ratios are above 3 percent Basel III requirement, but also look relatively low.

Bank Capital and Leverage Ratios
(In percent)



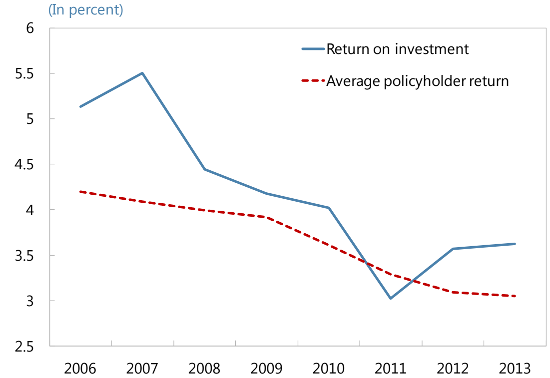
Households hold almost 40 percent of assets in life insurance and pensions.

Household Financial Assets, 2013
(in percent of total)



The return on investment for the large life insurers has exceeded average guaranteed returns for the most part.

Life Insurance Returns
(In percent)



Sources: IMF FSIs, ACPR, SNL Financial, ECB, Haver Analytics, and IMF staff calculations.

annually).[4] Some profit-sharing beyond the guaranteed minimum return is required by the Insurance Code. Insurers have a choice on when to distribute (within 8 years), keeping returns in a "profit sharing reserve" managed through the cycle. Life insurers hold mainly debt securities (e.g. sovereign and bank debt, around two-thirds of investments), and much less in equities (roughly 12 percent of their portfolio)[5].

8. **Low-interest environment.** The lower yields supported by QE will make it more difficult for insurers to earn returns, with the impact depending on how long the low interest rate environment will last. As indicated in the IMF's April 2015 Global Financial Stability Report, French insurers have significant duration and rate of return mismatches. The European Insurance and Occupational Pensions Authority has conducted stress tests for insurers, with aggregate results released in November 2014. While no country-specific data were released, the results indicate that, in general, mid-level European insurers may be vulnerable. The French authorities noted that average guaranteed rates are relatively low at 0–1 percent compared to 3–3½ percent in other countries, and that the duration gap is also not significant relative to peers (2–5 years, relative to 10 years in other significant jurisdictions). They are conducting further tests, for example projecting forward based on existing contracts the current low returns against committed payout rates linked to current guaranteed rates. They find a positive but diminishing gap on average between earnings and payouts for 2013–23, with a negative gap observed in 2023 for one insurer. Another possible risk is that of redemptions, as investors can easily withdraw their holdings and shift to other investments, as observed in 2012 when the regulated savings deposit rate and the maximum amount allowed were raised.

D. Housing Prices and Private Balance Sheets

9. **House prices.** House prices have continued to decline gently since their peak in 2011, but affordability metrics remain above long-run averages. House price overvaluation is currently estimated at around 10–15 percent.[6] Nevertheless, household debt appears manageable, at around 10–15 percent.[7] Nevertheless, household debt appears manageable, at 85 percent of gross disposable income and 55 percent of GDP. Less than 10 percent of indebted households have debt service to income ratios above 34 percent of their income. Banks' practice of providing mortgage loans based on ability to repay rather than collateral value mitigate concerns about banks' vulnerability to price movements. The gradual decline in prices has not had significant effects so far

[4] Non-unit linked investments account for 80 percent of the balance sheet of the 12 largest life insurers (e.g. *contrats en euros* or compartiments *euros des contrats* multi-support, which offer a permanent capital guarantee and can be redeemed easily though with possible tax implications), and unit-linked investments are 13 percent. Unit-linked policies do not provide capital or return guarantees—the risk is fully borne by investors.

[5] This figure does not reflect the asset allocation of insurers' mutual funds holdings.

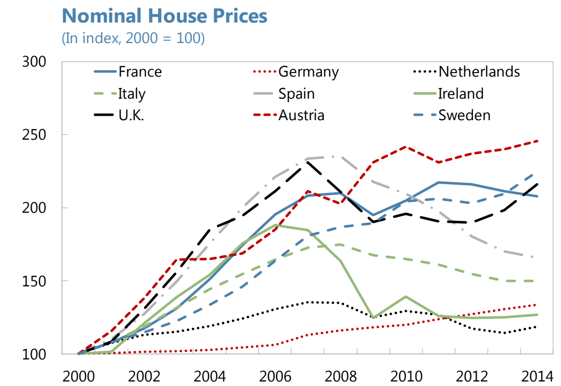
[6] Eugenio Cerutti, Jihad Dagher, and Giovanni Dell'Ariccia (forthcoming), Housing Finance and Real-estate Booms: A Cross-Country Perspective, IMF Staff Discussion Note

[7] Eugenio Cerutti, Jihad Dagher, and Giovanni Dell'Ariccia (forthcoming), Housing Finance and Real-estate Booms: A Cross-Country Perspective, IMF Staff Discussion Note

on banks or household balance sheets. More broadly, low interest rates will have offsetting effects on household balance sheets: an improvement to the extent households refinanced their mortgages, against declining wealth from lower prices as well as lower returns on financial investments, most of which are in bank deposits and life insurance. However, wealth effects have been estimated to be small in France relative to those found for the U.S. or U.K. (a 10 percent increase in wealth increases consumption by 0.8 to 1.1 percent), though one study found a role for expectations during the crisis period. More broadly, adverse effects on banks would be felt through indirect effects, such as through job losses, impeding households' ability to repay.

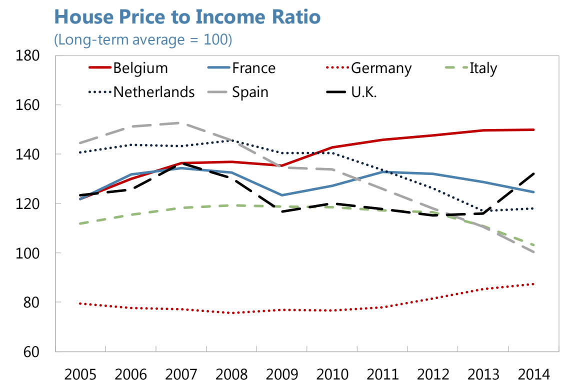
Housing Price Developments

House prices in France are declining gradually …



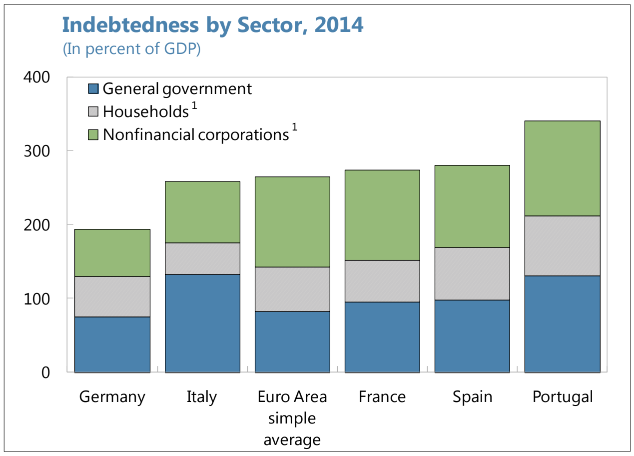
Sources: Haver Analytics, Global Insight, and IMF staff calculations.

while affordability remains an issue.



Sources: OECD and IMF Staff calculations.

10. **Corporate balance sheets.** Non-financial corporations' do not appear to be overly indebted. Headline non-consolidated corporate debt figures reach 120 percent of GDP, but adjusting for large inter-company lending (mostly intragroup) and for firms with group treasury operations in France brings this figure to 66 percent of GDP. As for debt service capabilities, the GFSR shows that the French corporate sector appears to be in a comfortable position, with 87 percent of firms whose earnings more than cover interest payments due. The further decline in interest rates under QE, in the context of improving macroeconomic conditions, could induce some firms to borrow more either from banks or from non-bank sources. These developments will need to be monitored to guard against corporate overindebtedness.



E. Macroprudential Issues

11. **High Council for Financial Stability.** In response to EU-level requirements for banking union and a recommendation from the European Systemic Risk Board, the High Council for Financial Stability was created by the 2013 Law on Separation and Regulation of Banking Activities as the macroprudential authority for France. Under the chairmanship of the Minister of Finance, its membership comprises the *Banque de France* governor who is also the president of the *Autorité de Controle Prudentiel et de Résolution (ACPR)*, the vice president of the ACPR, the president of the *Autorités des Marchés Financiers*, the president of the *Autorité des Normes Comptables*, as well as three external experts. It has the power to issue recommendations and can also require action on designated instruments, including a countercyclical capital buffer, systemic risk buffer, stricter regulatory requirements at the national level as prescribed by the European level Capital Requirements Regulation, as well as certain constraints on credit supply such as for loan-to-value, loan-to-income, or debt service to income requirements. The Council meets at least once per quarter and usually issues a press release after each meeting, as well as an annual report.

12. **Macroprudential policies.** While financial sector risks could build up over time in the context of the low-interest environment, the above analysis suggests that short-term risks appear relatively contained in the absence of major external shocks. The authorities do not consider that macroprudential measures are warranted at this stage. They are working to identify (domestically) systemically important banks and impose appropriate systemic risk buffers, with a decision due in the second half of 2015. The authorities have also stepped up monitoring of shadow banking activities.