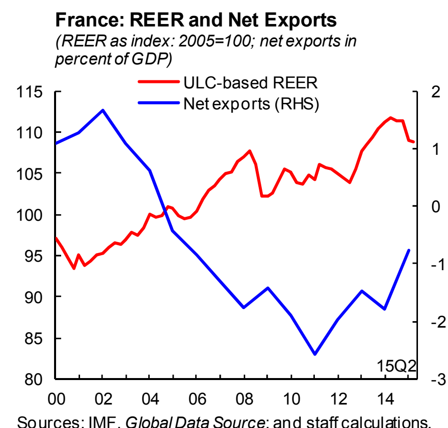
FRANCE[1]

External imbalances have narrowed on the back of weaker investment and some improvement in public saving, and are expected to narrow further reflecting the weaker euro and lower oil prices. However, the outlook for public debt has deteriorated in a context of slower activity, thus reducing fiscal vulnerabilities remains a key priority. Stronger expenditure-based consolidation is needed with support from fundamental spending reform. Policymakers should build on recent reforms of product and labor markets to continue strengthening competitiveness and raising employment.

IMBALANCES: OUTLOOK AND RISKS

1. **The external position has improved moderately on the back of weaker investment**. The current account deficit has narrowed since 2012, and is now smaller than projected at the time of the 2013 sustainability updates. Even though the ULC-based real effective exchange rate has appreciated by about 6 percent over 2011-14, net exports have rebounded since 2011. The improvement in the external balance has been mainly due to a further weakening of private investment, while national saving rate remained broadly flat as private and public saving rates moved in opposite directions. Private saving decreased with accelerating consumption from late 2014, while public saving recovered with fiscal consolidation (though less than previously envisaged). Nevertheless, France's external position in 2014 was weaker than the level consistent with medium-term fundamentals and desirable policy settings, and the real exchange rate was 5 to 10 percent overvalued in 2014 according to staff estimates. Developments as of May 2015 suggest some strengthening of the external position, but it is still moderately weaker than implied by fundamentals, given high unit labor costs and fiscal deficits.



2. **The recent euro depreciation and the fall in oil prices will help further improve the external balance, but additional action is needed for more durable rebalancing**. The favorable external environment is expected to lead to significant savings including in energy imports and to stronger export growth alongside rising global demand, which will lead to narrowing current account deficits. The negative output gap is also expected to narrow gradually, as the macroeconomic policy mix has become much more accommodative on account of the ECB's QE, the euro depreciation, and slower fiscal consolidation. Nevertheless, some of the underlying causes of

[1] Prepared by Seok Gil Park.

the external imbalance remain, in particular weak competitiveness resulting in continued loss in world export market share, elevated unit labor costs, and a still sizable fiscal deficit.

3. **The fiscal consolidation strategy has run into difficulties, and fiscal slippages remain a risk**. Although fiscal consolidation is ongoing, it fell short of the authorities' target with the headline deficit broadly unchanged at 3.9 percent of GDP. In early 2012, the authorities set out to bring the structural deficit to balance by 2016, with an adjustment equally divided between revenue and expenditure measures. However, the plan ran into difficulties in 2014 when spending freezes did not yield the envisaged savings in the context of low growth and inflation. Both the headline and cyclically adjusted deficits are higher than in the previous projections and this has led to record highs in public debt ratio. The public debt dynamics are particularly vulnerable to a growth shock, and the fiscal adjustment path is subject to implementation risks. A failure to further improve the fiscal position would impair efforts to reduce the current account deficit.

4. **A protracted period of sluggish growth, low inflation, and persistently high unemployment pose also a significant risk, which would affect the public debt dynamics**. While the baseline projections is for a solid short-term recovery supported by accommodative external conditions and robust domestic demand, the recovery could lose steam due to: (i) a less favorable external environment; (ii) insufficient progress in removing growth bottlenecks; and (iii) the re-emergence of financial volatility, including in wholesale funding on which French banks are highly reliant. Such a scenario would significantly affect the public debt dynamics. In addition, France's medium-term growth potential is much weaker than before the crisis, as crisis legacies have left their mark and structural rigidities continue to weigh on medium-term prospects and competitiveness.

POLICIES

5. **Stronger expenditure-based consolidation is needed to ensure that debt is placed on a firm downward trajectory by 2017**. While the European Council granted France two additional years, until 2017, to bring its headline deficit below the EDP threshold, the current fiscal strategy would only narrowly meet this objective, leaving little room for surprises. Primary general government expenditures should be kept flat in real terms, delivering a structural adjustment of about ½ a percent of GDP per year until structural balance is reached. This objective would adequately balance the needs to anchor debt sustainability and to smooth the impact of fiscal consolidation on demand. It would provide a safety margin to ensure that the headline deficit is reduced to below 3 percent of GDP by 2017 and debt is placed on a firm downward trajectory. It would also create fiscal space for growth-friendly fiscal rebalancing that lowers marginal taxes on labor and capital starting around 2020. In the near term, it is important to clarify the measures underpinning the announced 2015-17 spending package, identifying additional measures and spelling out that any windfall gains will be saved.

6. **Fundamental spending reforms are called for to underpin a lasting reduction in government expenditure**. Building on recent efforts, a broad review of expenditure programs and

processes at all levels of governments should be launched to prepare for deeper spending reform. For example, local government positions and institutions need to be streamlined by further cuts in transfers, tighter caps on local borrowing and tax rates. Also, the growth in public employment should be reversed, based on reviews of staffing at all levels of government. On the social security spending, there is room for improving the targeting and efficiency of social benefits, and for pension benefit reforms such as increasing the effective retirement age and streamlining special pension regimes.

7. **A lasting reduction of external imbalances and strengthening of growth prospects would require additional reform efforts**. To this end, staff focused its recommendations on the need to underpin fiscal consolidation through deep spending reform, push ahead with broad-based reforms to foster employment creation, while maintaining the recent momentum on product market reforms.

- Labor market reform: Removing barriers to employment will be critical to reversing the rise in structural unemployment. Building on recent efforts such as the reduction of the tax wedge, further broad-based reforms should be implemented including expanding enterprise-level flexibility for social partners to adjust work hours and wages, limiting minimum wage increases to inflation as long as unemployment remains high, strengthening job search incentives for benefit recipients, and better targeting education and training resources to the young and the unemployed.

- Removing growth bottlenecks: France's low productivity growth can be attributed in part to a lack of competition and overregulation, which weaken incentives to innovate and invest. Recent reforms of product markets—including the *Macron* law to enhance competition—are welcomed, but more could be done to alleviate structural rigidities. For example, the authorities could strengthen the Competition Authority and further reduce disincentives for SMEs to grow above certain employee thresholds, and liberalize regulated professions not covered by the *Macron* law.

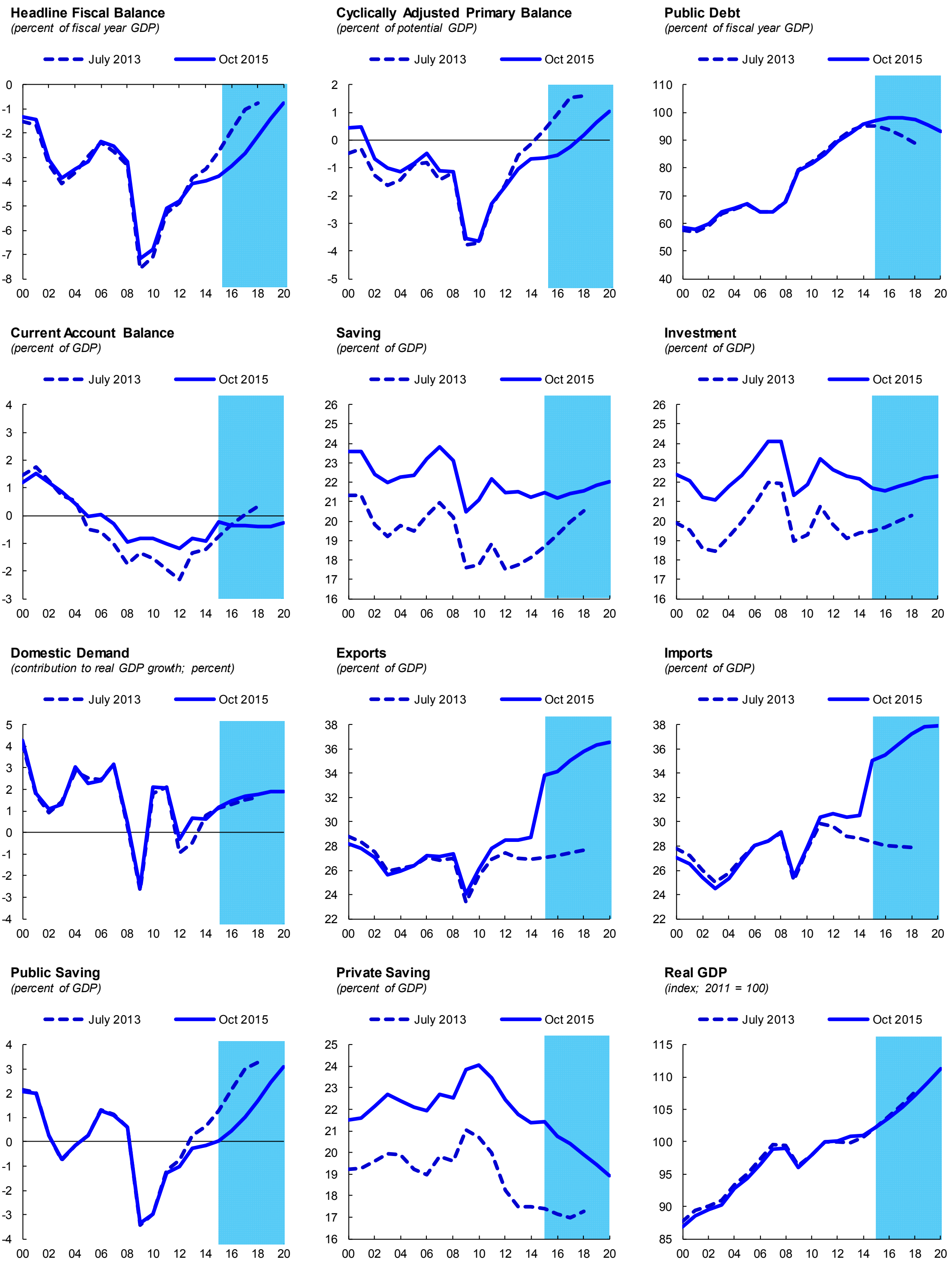


Figure 1. France: Selected Macroeconomic Indicators
Headline Fiscal Balance
(percent of fiscal year GDP)
Cyclically Adjusted Primary Balance
(percent of potential GDP)
Public Debt
(percent of fiscal year GDP)
Current Account Balance
(percent of GDP)
Saving
(percent of GDP)
Investment
(percent of GDP)
Domestic Demand
(contribution to real GDP growth; percent)
Exports
(percent of GDP)
Imports
(percent of GDP)
Public Saving
(percent of GDP)
Private Saving
(percent of GDP)
Real GDP
(index; 2011 = 100)
July 2013
Oct 2015
Source: IMF, World Economic Outlook.

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