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France: Turn the music off to hear the bells tolling

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Ana Boata
Head of Economic Research
ana.boata@allianz-trade.com

Michaela Grimm
Senior Economist
michaela.grimm@allianz.com

Selin Ozyurt
Senior Economist
selin.ozyurt@allianz-trade.com

EXECUTIVE SUMMARY

After an election campaign dominated by the topics of dwindling purchasing power and surging energy prices, it is now time for an economic reality check in France. The first 100 days of Macron's second term need to establish a roadmap to tackle three issues in urgent need of reforms.

1. France's deteriorated fiscal position and mounting public debt. As the ECB sets the stage for tighter monetary policy, we estimate that 100bp increase in the key interest rate would raise France's debt-service cost by more than EUR30bn over 10 years (1.5% of GDP). In this context, pension reform needs to be quickly put back on the table: We estimate that increasing the retirement age by two years could reduce public pension spending by almost 2% of GDP per year, equivalent to around EUR40bn, which could be harnessed to spur sustainable growth and accelerate the green transition.
2. Record-high corporate debt alongside above-trend household savings. We estimate that non-financial corporates' margins need to increase by +1.5pp on average in order to absorb the remaining +8.7pp increase in the corporate debt-GDP ratio since the outbreak of Covid-19. However, margins are likely to fall by -2.3pp by mid-2023. At the same time, French households hold close to EUR250bn in excess cash compared to pre-Covid times, which should be increasingly directed towards long-term investments (decarbonization, digitalization, corporates' productive investments) rather than the housing market.
3. Increased external imbalances amid a widening trade deficit and growing reliance on financing from the rest of the world. France clearly underperforms its Eurozone peers when it comes to export performance and is highly exposed to supply-chain disruptions and shortages. The war in Ukraine has highlighted the urgency of achieving energy independence and speeding up the development of non-fossil energy sources, as well as re-thinking sectorial specialization. France's energy deficit could reach EUR75bn in 2022, or 2.9% of GDP (vs. 1.9% of GDP in 2019). In this context, it needs a clear roadmap to revise its industrial policy and upsize its manufacturing capacity via increased reliance on digital technologies, automated manufacturing and machining processes and clean energy sources.

Pension reform could put France's public debt trajectory back on track.

Public debt has been rising in France over the past decades, placing the country in a semi-core position within the Eurozone. In contrast to the core economies (e.g. Germany, Austria, the Netherlands), France's public debt grew between 2012 and 2019, as it did in Italy and

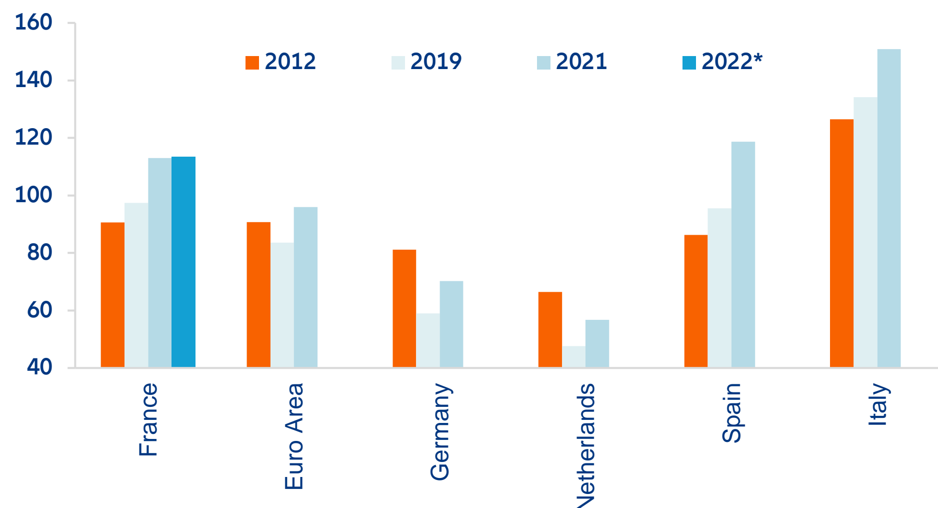
Spain.

This was followed by a "whatever it costs" approach in response to the Covid-19 crisis, which generated EUR325bn of additional debt. The direct debt induced by the Covid-19 crisis is estimated at EUR165bn while the indirect debt (i.e. tax revenues foregone) reached around EUR160bn. Consequently, French public debt increased by +18.7pp of GDP between 2019 and 2021 to reach 113% of GDP (versus 96% in the Eurozone overall). France's debt-to-GDP ratio is currently the fifth-highest in the EU, 43pp above that of Germany. In 2022, we expect public debt to hover around 113.5% of GDP without a significant reduction in the context of the presidential elections and sustained costly public support measures (above EUR20bn) to curb energy prices.

The large and recurrent primary deficit could also increase debt-sustainability issues. France's budget deficit as a percentage of GDP has been on an increasing trend since the outbreak of Covid-19, worsening from crisis to crisis and never returning to its initial level. On average, France's fiscal policy has been more expansionary than that of its Eurozone peers during and after the pandemic. Since the last Eurozone crisis and prior to 2020, France registered a primary deficit of -1.7% against +0.2% for the Eurozone. And France didn't manage to post a primary surplus since 2001 compared to 11 years over the same period for the Eurozone. As a side effect of the continued "whatever it costs" response, the budget deficit widened dramatically to -8.9% of GDP in 2020 and -6.5% in 2021, after 3.1% of GDP in 2019.

At the same time, after a few exceptional years due to the Covid-19 crisis and the war in Ukraine, the EU's fiscal rules will start to bite again in 2023. The French Court of Auditors finds that bringing the budget deficit in line with the current Maastricht criteria (i.e. below 3% of GDP) by 2027 would require EUR9bn in additional public savings each year compared to the trajectory observed between 2010 and 2019.

Figure 1: Government debt to GDP (%)



Sources: Banque de France, Allianz Research
Note : 2021 numbers show Q3 data (latest data point available).

To add to this, the context of rising policy interest rates will increase France's debt-servicing cost, which means a simple stabilization of current debt levels will not guarantee debt sustainability. Although the ECB has maintained its accommodative monetary policy for

now, the interest rate on 10-year French government bonds recently reached the highest level since 2017 (increasing from -0.1% in September 2021 to 1.4% in April 2022). High global and electoral uncertainty yielded some early signs of decoupling from Germany with a widening spread.
The market rate for the average maturity of French sovereign debt (eight years) is above the implied average interest rate on the debt for the first time since 2012. Should the ECB hike its key interest rates by the end of the year, we estimate that 100bp increase would push up France's debt-service cost by more than EUR30bn over 10 years (1.5% of GDP). In addition, abrupt policy interest rate hikes may also destabilize bond markets by triggering large sell-offs: More than 60% of French debt is held by non-residents compared to 56% in Germany, 36% in Italy and 37% in the UK.

Figure 2: Market yields vs implicit rate on debt

Sources: Refinitiv Datastream; Allianz Research

Increasing debt-servicing costs leave little room for other productive expenses to spur sustainable growth and meet the investment requirements to accelerate the green transition. In this context, the next finance law to be adopted in autumn 2022 needs to address the current public spending trajectory, which will require reforms in five key sectors: the pension system, health insurance, unemployment benefits, social minima and housing policy. Increasing the retirement age by two years alone could reduce public pension spending by almost 2% of GDP per year[1], which corresponds to around EUR40bn.

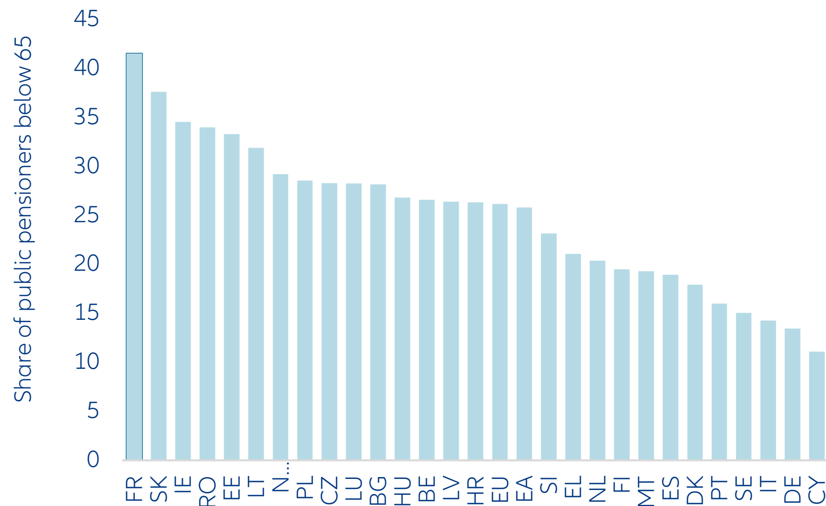
Facing a tough contest in the second round of the elections, President Macron announced a softening of his previously controversial pension reform project by adjusting the timing and age of retirement (to rise only from 62 to 64). With stronger resistance likely from the supporters of far left and right parties, the outcome of the legislative elections on 12 June will be decisive to provide the majority needed to push forward the pension reform agenda.

And this is sorely needed as without reforms, France's pay-as-you-go financed pension system will only run further into deficit. Already in recent years the pension pay-outs of the *Caisse Nationale d'Assurance Vieillesse* (CNAV) and AGIRC-ARRCO have been higher than the contributions. To finance the deficits, AGIRC-ARRCO had repeatedly tapped into its long-term reserves, which are supposed to cover at least six months of pension payouts until 2033.

[1] Assumed that the 2019 share of GDP that was spent for public pensions per capita of the population aged 63 and older remains constant.

One key factor behind the current deficit is the comparatively low retirement age in France. According to the latest available data, the average effective retirement age in 2020 was 62.8 years for new CNAV pensioners and 62.7 years for new AGIRC-ARRCO pensioners.[2] In the EU, the average age of effective labor market exit for men was 64.0 years and that of women 63.5 years.[3] This made France the country with the highest share of public pensioners below the age of 65 across the EU[4] before the outbreak of the Covid-19 pandemic (see Figure 3).

Figure 3: France has the highest percentage share of young pensioners in the European Union



Sources: EU Ageing Report 2021, Allianz Research

At the same time, France has one of the highest life expectancies in the EU and worldwide. In 2020, the average further life expectancy at the age of 62 was 21.2 years for men and 25.6 years for women.[5] In neighboring Spain, it was 20.7 years for men and 25.0 years for women, and in Italy 20.1 years and 24.3 years, respectively[6] (see Figure 4).

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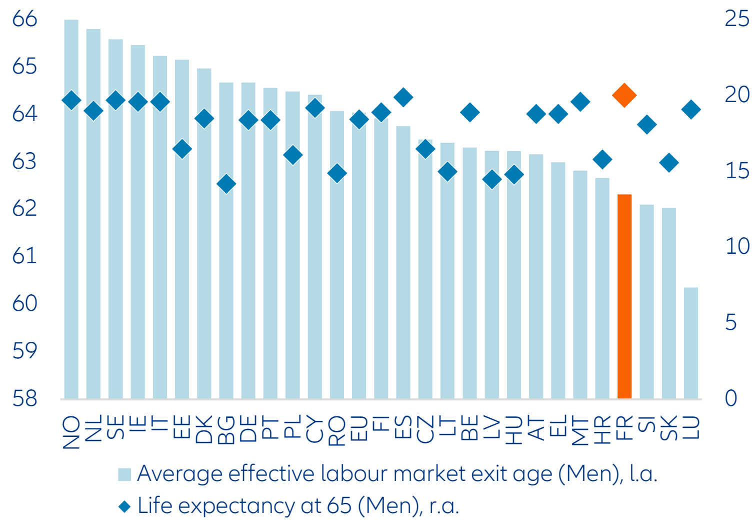
[2] See CNAV (2022): Âge de départ à la retraite | Statistiques, recherches et prospective de la Cnav and AGIRC-ARRCO (2022): https://www.agirc-arrco.fr/etudes-statistiques/donnees-chiffrees/nouveaux-retraites/
[3] Data refers to 2019, see European Commission (2021): The 2021 Ageing Report. Economic and Budgetary Projections for the EU member states (2019-2070), Brussels 2021; https://ec.europa.eu/info/publications/2021-ageing-report-economic-and-budgetary-projections-eu-member-states-2019-2070_en, cross-country tables.
[4] In 2019, the average share of pensioners below the age of 65 in the EU was 26%, in France it was 42%. See European Commission (2021): EU Ageing Report 2021, cross country tables.
[5] See INSEE (2021): INSEE, vital statistics and population estimates.
[6] See ISTAT (2022) Tavole di mortalità della popolazione residente - Serie storica per ripartizione/regione/provincia (istat.it) for Italy and INE (2022) Tablas de mortalidad por año, sexo, edad y funciones.(27153) (ine.es) for Spain.

Figure 4: Low effective retirement age despite high life expectancy (in years)



Sources: European Commission, Eurostat, Allianz Research

This combination of a low effective retirement age and high further life expectancy is one cause of the comparatively high cost of public pensions in France: Before the outbreak of the Covid-19 pandemic, public pension spending amounted to 14.8% of GDP, which was the third-highest ratio within the EU. Only in Greece and Italy was this share higher, while the EU average stood at 11.6%.[7]

Pension reform becomes all the more urgent when we consider the rising trend of life expectancy. In fact, according to preliminary INSEE data, the average life expectancy of women in France already increased by three months in 2021, and that of men by two months. Until mid-century, the average life expectancy is expected to increase by more than two

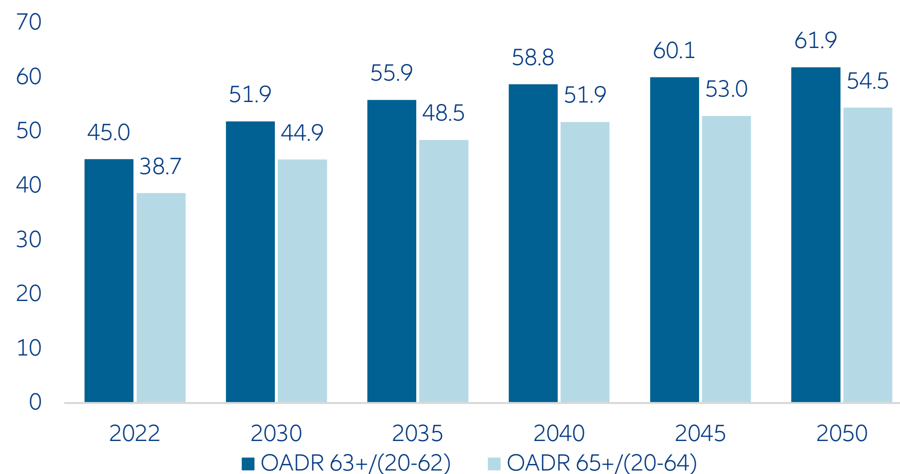
[7] *See European Commission (2021): EU Ageing Report 2021, cross-country tables.*

years[8] and the number of people aged 63 and older is set to rise from 15.4mn today to 20.4mn in 2050.

At the same time, the working age population aged between 20 and 62 years is going to shrink by almost 2mn to around 33mn.[9] This implies that the number of retirees per person in working age is set to increase markedly if there is no further reform of the statutory retirement age. Currently there are 45 retirees per 100 persons in working age between 20 and 62 years.

In this context, we find that increasing the low retirement age is the best – if not the only feasible – option that is left to put the finances of the pension system on a more sustainable footing. If the government fails to raise the effective retirement age by increasing the statutory retirement age, there will be 62 retirees per 100 potential contribution payers by mid-century. An effective retirement age of 65 years would markedly reduce this increase of the old-age dependency ratio to 54 % (see Figure 5).

Figure 5: France's old-age dependency ratio is set to deteriorate further



Sources: UN Population Division, Allianz Research

A higher retirement age would also dampen the demographic impact on the labor market by adding around an average 1.8mn people each year and thus keeping the total number of people in working age at almost at the same level as in 2021. However, to keep the old-age-dependency ratio, i.e., the ratio of pension receivers to contribution payers, constant at 45% would need a further increase of the retirement age to 68 years, or alternatively more than 12mn immigrants added into the labor market by 2050.[10]

Further measures to strengthen the pension system's long-term sustainability and adequacy could include a reduction of the pension benefit level, complemented by a strengthening of the capital-funded pillars, or an increase of the contribution rate and state subsidy. But leeway is very limited in those respects. Further decreases of the benefit ratio, for example, could jeopardize the adequacy and acceptance of the pension systems as the benefit level is

[8] See European Commission (2021): The 2021 Ageing Report, cross-country tables.

[9] See United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, Online Edition

[10] Calculation based on United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, Online Edition.

already set to decline in coming years, thanks to earlier reforms. Promises to increase the minimum pension hint at efforts to maintain the attractiveness of the pension system.

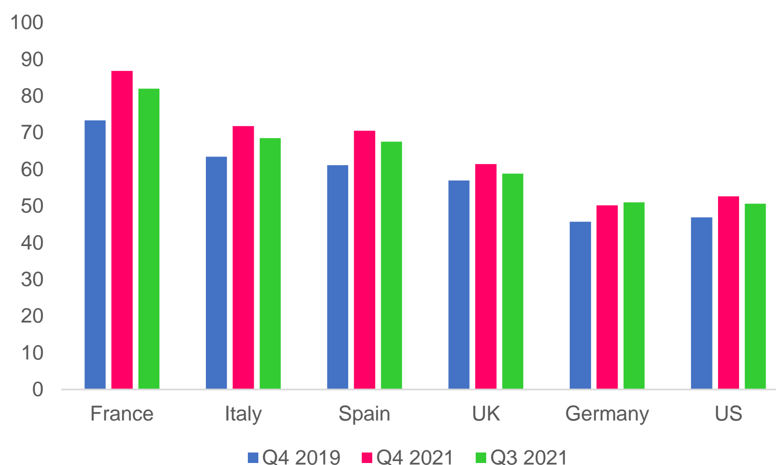
A further increase of the already high contribution rates would not only lead to higher financial burdens on younger generations, but also to higher labor costs, which would impair French companies' competitiveness and the country's attractiveness for sought-after high-qualified workers from abroad. A further increase of the state subsidies is also hardly an option, given the already stretched situation of public finances – and the new demands on the government, from defense to energy security and the green transformation.

Redirecting households' excess savings to corporate investment could address mounting debt, reducing the risk of financial instability.

Both consumption (+4.8%) and private investment (+6.1%) rebounded stronger in France compared to Eurozone peers. In fact, the dynamism of domestic demand was the key driver of France's quick and forceful post-Covid economic recovery (+7% GDP growth in 2021). At the same time, abundant public support to the corporate sector since 2020 — which shows no sign of reversing yet — has helped companies build solid cash buffers and ensure greater resilience amid a challenging international environment. Non-financial corporates held EUR206bn in excess cash as of February 2022, the highest level in Europe.

The flipside of the story is that French non-financial corporates are highly indebted. Since the 2008-09 crisis, we have seen a clear shift in corporate net lending in Germany, Italy and Spain, with corporates becoming net savers. However, in France, corporates have remained net borrowers (Figure 6), absorbing a significant part of (domestic and international) household savings. The high level of debt only increased during the Covid-19 crisis: Under the state-guaranteed loan (SGL) scheme (EUR140bn take-up), French corporates took on greater amounts of debt (+14pp of GDP) than the Eurozone average (+9pp of GDP).

Figure 6: Non-financial corporate debt to GDP (%



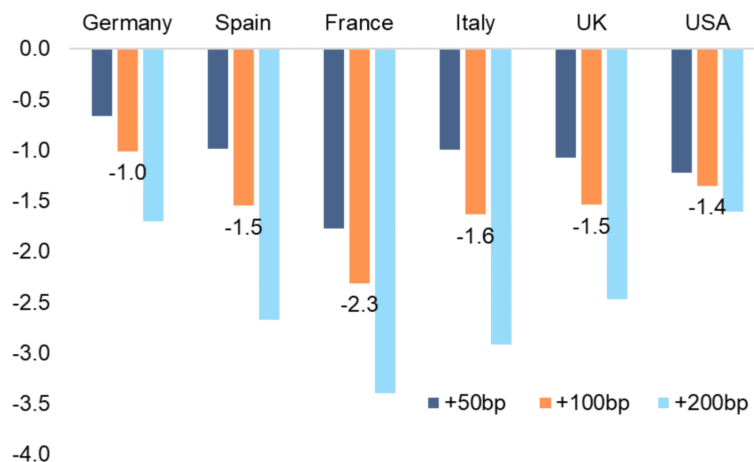
Sources: Banque de France, Allianz Research
Note : 2021 numbers show Q3 data (latest datapoint available).

The extension and increase of the SGL program in 2022 will push corporates to accumulate even more debt. We estimate that at least EUR60bn of additional loans could be taken up by corporates by year-end. This will add up to EUR206bn of corporate excess cash since the start of Covid-19. This debt accumulation could expose them to greater financial

vulnerabilities in the medium run, notably a confidence shock, creating greater need for deleveraging in anticipation of an economic downturn.

Using panel data[11], we estimate that non-financial corporates' margins need to increase by +1.5pp on average in order to absorb the remaining +8.7pp increase in the corporate debt-GDP ratio since the outbreak of Covid-19. This is likely to be increasingly challenging in an environment of prevailing high cost inflation and slowing demand, which could lower corporate pricing power in the coming quarters. In a context of rising rates, French corporates are likely to post the highest losses in terms of margins: an increase of 100bp in key interest rates would translate into a -2.3pp fall in NFC margins in France compared to -1pp in Germany, -1.5pp in the UK and -1.4pp in the US (see Figure 7).

Figure 7: Impact of rising bank interest rates over a year, pp of margin for NFCs



Sources: Fred, ECB, Eurostat, ONS, Euler Hermes, Allianz Research

To help companies absorb the rise in debt, the French government should implement policies that redirect households' record-high excess savings towards productive investment. A good step in this direction would be rechanneling households' savings away from the real estate market towards equity participation in the capital of companies with high and sustainable growth potential. Using household savings to help accelerate the European economy's modernization and decarbonization would benefit long-term growth potential. To do this, the government needs to address the lack of attractive financial products and low financial literacy. One particularly intriguing option would be to breathe fresh life into the idea of European long-term investment funds (ELTIFs) as part of the European Commission's action plan to strengthen and complete Europe's capital markets union. ELTIFs have been around for years but so far have existed mostly in the shadows and largely failed to appeal to retail investors. In addition, governments could provide direct subsidies for a certain amount of saving invested. Channeling excess private savings into long-term investments can thus support France's green and digital transformation.

Export competitiveness is the Achilles' heel that requires bold structural reforms.

Deep-rooted structural shortcomings and political decisions for deindustrializing the country in favor of services have held back France's export performance. France deindustrialized faster than its European peers: At 9.7% of GDP, the size of the French manufacturing sector

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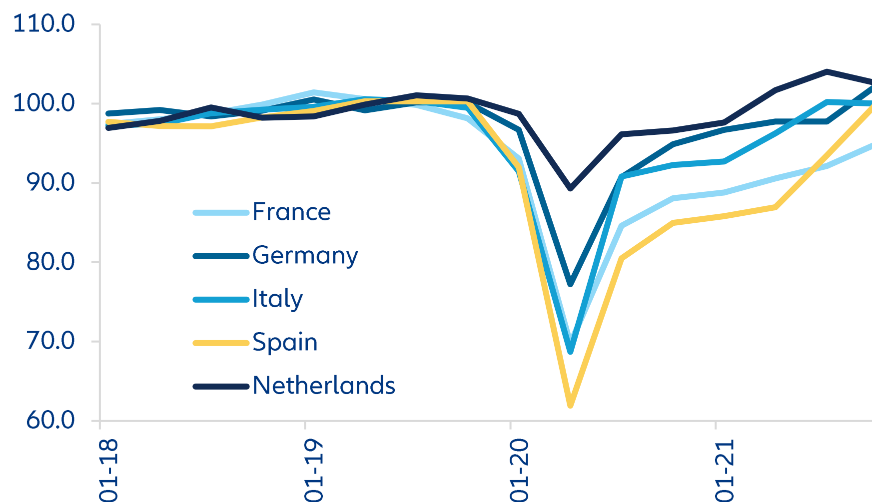
[11] *See our report European corporates: It could take 5 years to eliminate Covid-19 debt.*

is around half that of Germany. In fact, China's remarkable export expansion coincided with the dramatic decline of France's global export shares over the past two decades (around -2 points of global exports), a decline larger than that of Germany and Italy. France has been losing export market shares not only to China but also to other Eurozone countries, especially in flagship sectors such as aircraft, pharmaceuticals, vehicles, electrical machinery and equipment[12].

Moreover, France continued to lose export market shares (-0.2pp per year) amid the Covid-19 crisis, even as Germany and Italy managed to preserve theirs. French exports dramatically contracted (-16.1%) in 2020 before recovering by +9% in 2021. However, they still remained -5% below the pre-pandemic level, even as the Eurozone as a whole exceeded this level by 3% at the end of 2021 (Figure 8).

Figure 8: Export volumes index, constant prices (2019 Q4=100)



Sources: Macrobond, Allianz Research

Rising energy and input prices widened France's trade deficit in goods to -EUR84.7bn in 2021 (+EUR20bn from 2020), the highest on record (Figure 9). Since then, the invasion of Ukraine and new lockdowns in China have pushed up energy prices even further and extended supply bottlenecks, worsening the terms of trade (i.e. import prices have increased more than export prices). We calculate that the contribution of the energy deficit could reach EUR75bn or 2.9% of GDP in 2022 (vs. 1.9% of GDP in 2019). We expect a significant diffusion of high energy prices to overall import prices through the year. Thus, a sizeable improvement of the overall current account deficit is unlikely in 2022, despite the increasing surplus of trade services, particularly from maritime freight.

As a direct consequence of the widening external deficit, a growing share of French national income has been transferred abroad. France's net international investment position (NIIP), which reflects the difference between the value of assets and liabilities vis-à-vis the rest of the world, widened to -EUR695.5bn (a deterioration of -EUR78.7bn since 2019), reaching -30.2% of GDP (-5 points since 2019). However, for now, despite the growing reliance on

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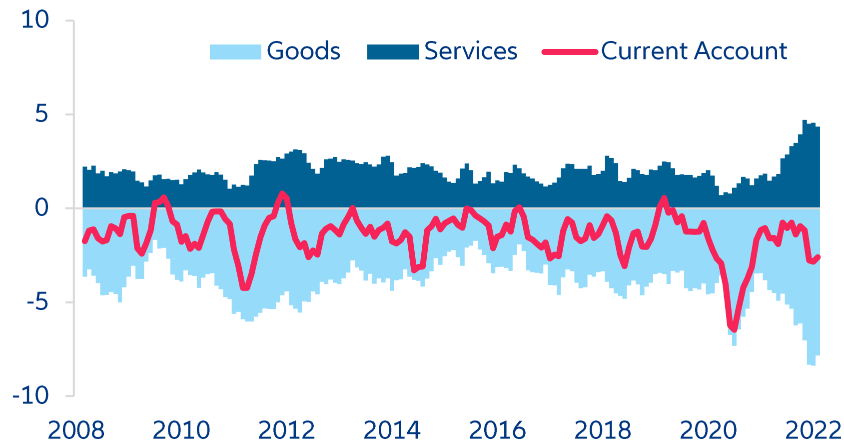
[12] *See our report [Export performance in Europe: a sink or swim game](#).*

financing from the rest of the world, France's NIIP remains below the alert threshold set by the European Macroeconomic Imbalance Procedure (-35% of GDP).

Figure 9: Current account balance (three-month moving average, EUR bn)



Sources: Banque de France, Allianz Research

France's wide trade deficit means that the country is not producing the goods that are consumed domestically. On the other hand, in flagship industrial sectors such as luxury goods and aircraft, above 80% of production is exported abroad. Domestic demand (consumption and investment) in France is more reliant on imported goods compared to other European peers, namely Germany and Italy[13]. This incapacity of domestic production to satisfy (domestic) demand exposes the economy to supply-chain bottlenecks and goods shortages in periods of global stress (e.g. a sanitary crisis or geopolitical tensions).

In the current context of escalating geopolitical tensions, Western sanctions against Russia have also raised the stakes for achieving energy independence by speeding up the development of alternative sources to fossil energies. Indeed, the recent developments of energy prices are set to reshuffle the comparative advantages of exporters even within Europe. France could possibly benefit from the changes related to the war in Ukraine, given its relatively smaller exposure to energy imports from Russia. But it still needs to actively invest in adapting its energy mix quickly.

In view of current global challenges, exporters face a fundamental transformation of their cost structures that will require a re-thinking sectoral specialization. France needs a clear roadmap to revise its industrial policy and upsize its manufacturing capacity. Obviously, re-industrialization does not mean bringing back the production of low value-added and polluting sectors back to France. To be fit for its purpose and create high-paying jobs, the new industrial policy ought to extensively rely on digital technologies, automated manufacturing and machining processes and clean energy sources. The new government should also continue with deep reforms of the labor market to address long-lasting weaknesses such as the lack of technical skills, low participation rates and the duality (fixed-term vs. permanent) and rigidity of work contracts.

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[13] See our report *France, Germany, Italy: Good fiscal stimulus, bad trade deficits?*

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