

CONJONCTURE

July/August 2017 : n°7

France: on the road to recovery

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By **Hélène Baudchon**

Egypt: impressive economic transition with strings attached

Egypt is implementing an ambitious programme of economic reforms. Macroeconomic imbalances are being reduced thanks to the pound flotation and some progress in fiscal reforms. Nevertheless, households' purchasing power is affected by a sharp rise in consumer prices, and the hike in interest rates is a threat for public finances.

By **Pascal Devaux**

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ECONOMIC RESEARCH DEPARTMENT



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France: on the road to recovery

Growth and competitiveness: definite progress, but problems persist

Hélène Baudchon

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Five years ago, the French economy was in bad need of repair, but it now seems to be in better shape. The slow economic recovery since early 2013 goes beyond a cyclical improvement and the simple return to growth, as mild as it has been. Progress has been made on three major economic fronts – competitiveness, public finances and the labour market – albeit to varying degrees, and there is still a long road ahead in certain areas (see table 1). Fundamental improvements are taking shape, albeit in small steps: the recovery has begun, but it must still be confirmed and built on.

In this article, we will examine in greater detail the problems of growth and competitiveness in France. We will review the dynamics at work, the progress that has been made and the problems that persist. We take the opportunity of the start of Emmanuel Macron's presidency to shed some light on these issues and challenges, just as we did in May 2012 following the election of François Hollande¹. We will try to answer two questions in particular: why isn't growth stronger (part 1), and what must be done to restore French competitiveness in a more tangible manner (part 2)?

2012-2017: France's trying recovery

To explain the title of this section, we must begin by looking backwards. The wording echoes the description of the previous 5-year period, from 2007 to 2011, which are crisis years. The French economy was hit by two major crises during the period: the financial crisis of 2008, which triggered the Great Recession of 2009², and then the European sovereign debt crisis, which began in late 2009 and climaxed between late 2011 and mid-2012, before repeated ECB and European interventions finally managed to calm the financial turmoil on bond markets. The sovereign debt crisis cut short the recovery that was just beginning to take shape in 2010, at the end of the Great Recession.

Table 1: Progress report for the French economy in a few key indicators (2012-2016)

	2012	2013	2014	2015	2016	2017(F)	Trend
Average annual GDP growth (adjusted for working days)	0.2%	0.6%	1.0%	1.0%	1.1%	1.6%	↗
Output gap, % of potential GDP	-1.1%	-1.4%	-1.7%	-1.4%	-1.3%	-0.8%	↘
Unemployment rate, % of labour force	9.8%	10.3%	10.3%	10.4%	10.1%	9.6%	↘
Employment rate, % of working age population	64%	64%	64.2%	64.3%	64.7%		↗
Fiscal deficit, % of GDP	-4.8%	-4.0%	-3.9%	-3.6%	-3.4%	-3.0%	↘
Public debt ratio, % of GDP	89.5%	92.3%	94.9%	95.6%	96.3%	96.3%	↗
Trade deficit, % of GDP	-3.2%	-3.0%	-2.7%	-2.0%	-2.2%	-2.5%	↘
Trade deficit for manufactured goods, % of GDP	-1.8%	-1.7%	-1.8%	-1.7%	-2.0%		→
Current account deficit, % of GDP	-1.2%	-0.9%	-1.3%	-0.4%	-0.9%	-1.2%	→
Export market shares	3.5%	3.6%	3.6%	3.6%	3.6%		→
Industry's share of gross value added (GVA)	13.8%	13.9%	13.9%	14.2%	14.1%		→
Unit labour costs, average annual change	2.3%	1.2%	0.9%	0.1%	0.5%		↘
Corporate profit margins, % of GVA	30.2%	29.9%	30.4%	31.9%	31.9%	31.6%	↗

Sources: INSEE, Customs Office, Bank of France, European Commission, Eurostat, OECD, BNP Paribas

When François Hollande succeeded Nicolas Sarkozy as president in May 2012, the economy was still shaky: the sovereign debt crisis was not over yet. Although it had already had a visible impact on growth for some time, we lacked the distance to measure its full impact or duration. With today's hindsight, we know that economic growth came to a halt from Q2 2011 to Q1 2013. This date marks then the beginning of a new

¹ Overhauling the French economy, Conjoncture no. 9, May 2012.

² In reference to the Great Depression of the 1930s, which it shares some features.



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cycle in France. After the false start of 2010-2011, the current recovery phase is still underway, and it has entered its fifth year.

"France's trying recovery" is also a direct reference to the shortcomings of the current recovery, which lacks the vigorous pace usually associated with an upturn. France effectively swung back into growth in early 2013, but the recovery has been sluggish, at least until 2016, with average annual growth of barely 1% during the period. The year 2017 could mark the end of this lacklustre pace however, with average annual growth forecast at 1.6%.

In our overview of the French economy in early June, we highlighted this sluggish growth in several manners³. Chart 1 also illustrates French growth from a historical perspective: the slow pace of growth in recent years fits within a general slowing trend. In the following section, we will take a more in-depth look at the cyclical reasons behind this sluggishness using a chronological perspective. And in a second section, we will look at some of the structural causes as well.

Growth timeline: a path strewn with obstacles

2012: growth falters but does not contract

This was the first in a series of five difficult years, each for its own specific reasons in addition to a few shared causes. Like 2011, it was marked by the fiscal consolidation efforts imposed by the European sovereign debt crisis, the first and biggest obstacle to growth over the course of the period under review. The fiscal adjustment's negative impact on growth was amplified by the fact that it occurred at the same time as austerity measures in other Eurozone countries. The OFCE estimates that between 2012 and 2017, fiscal consolidation (both the direct impact on the French economy and the indirect one via the contraction in activity of European partners) cost France an average of 0.8 points of growth each year⁴.

Even so, France weathered this difficult situation relatively well: growth simply stalled in 2012 and France did not fall back into recession, unlike its southern European partners (see chart 2). Part of this resilience can be attributed to automatic stabilisers (weight of social transfers) and a smaller degree of openness (making the French economy less vulnerable to external shocks). Above all, growth was preserved by less fiscal tightening in 2012. According to European Commission figures, fiscal tightening efforts in France were about two times smaller that year than the aggregate level for the Eurozone, with a narrowing in the structural deficit of 0.8 and 1.5 points, respectively (see chart 3). Note, however, that for the entire 2011-2016 fiscal consolidation period, the total efforts were similar, with a reduction in the structural deficit of about 3 points, even though they were divided up differently over time. In terms of reducing the primary structural deficit, in contrast, French efforts were somewhat smaller at 2.9 points, compared to 3.5 points for the Eurozone as a whole.

Concomitantly, and in a correlated manner (fiscal consolidation eroded the economic environment), activity in the construction sector dropped off again after an ephemeral rebound in 2010, creating another major

and protracted obstacle to growth, which persisted until mid-2015. On average, the decline in household residential investment alone slashed 0.1 points from growth each year between 2012 and 2015.

2013-2014: idling growth engine

In 2013, the recovery struggled to gain traction. The European sovereign debt crisis was brought under control, and the hardest hit countries entered a delicate period of convalescence. Growth slowly resumed, but continued on a sluggish pace in 2014⁵. Ongoing fiscal consolidation efforts hampered growth, as did the severe correction in the construction sector. Another increasingly important factor was the economic slowdown in the emerging countries, particularly Russia and Brazil, and to a more limited extent, China.

At the same time, the CICE competitiveness and employment tax credit, launched in 2013, took longer than hoped to produce its intended effects, and the announcement of the Responsibility and Solidarity Pact in January 2014 did not either shore up confidence as expected. To the contrary: business confidence surveys, which had picked up throughout 2013, stopped improving in 2014 (see chart 4), signalling that economic prospects in general lacked visibility, and economic policy in particular lacked clarity, which undermined the expected positive effects (see box 1 for a summary of these measures).

2015-2016: growth is still feeble but gains in solidity

In late 2014, hopes for stronger growth were shifted to 2015, but these hopes now seem to have been dashed (growth was identical in both years, at 1% according to the national accounts available so far⁶). Yet the lack of acceleration between 2014 and 2015 must be kept in perspective. First, it masks the more positive contribution from final domestic demand (see chart 5). Second, the ingredients for a self-sustaining recovery came together in 2015, with a rebound in employment coming in addition to the one in corporate investment (see chart 6). In other words, 2015 growth might not be very strong, but it did gain in solidity. Foreign trade was the only disappointing factor. Another slowdown in the emerging economies hampered export momentum, while imports continued to be surprisingly dynamic.

In 2015, the sluggish pace of growth was also surprising given the "alignment of the planets", a combination of very favourable factors: persistently low interest rates, the drop-off in oil prices from mid-2014 to year-end 2015, and the euro's depreciation throughout 2014 and early 2015. At the same time, several measures were launched to boost France's competitiveness and employment. But these favourable tailwinds ran up against some equally powerful headwinds (such as the ongoing fiscal consolidation and growth slowdown in emerging countries). According to INSEE estimates, these positive and negative effects perfectly cancelled each other out, leaving 2015 growth to follow its long-term trend (see table 2). In 2016, the INSEE expected to see a net positive impact of 0.3 points, thanks to the lifting of internal obstacles, which would have brought growth to 1.6% based on its assumptions.

³ Overview of the French economy, EcoFlash no. 8-9 June 2017.

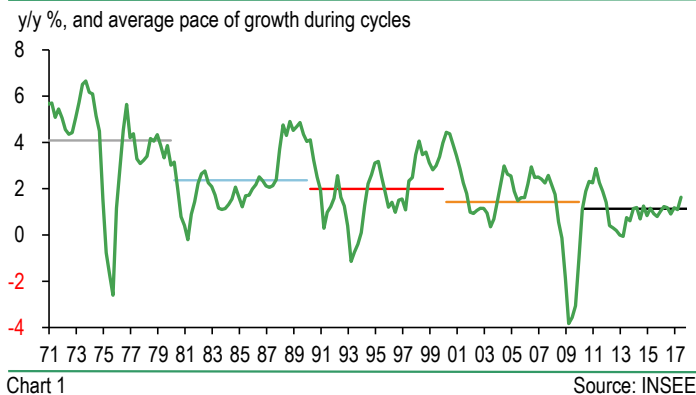
⁴ OFCE, Le quinquennat de François Hollande: enlèvement ou rétablissement?, Policy Brief, 5 September 2016.

⁵ The disappointing pace of 2014 growth improved significantly with each revision of the national accounts. From an initial growth rate of only 0.2%, the 2014 figure was later revised to 0.7% and then to 1%. In the end, growth accelerated compared to the 2013 figure of 0.6% (which was also revised upwards from an initial estimate of 0.3%).

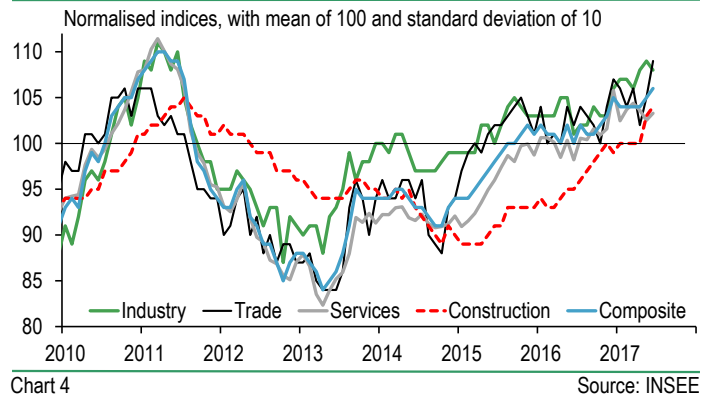
⁶ The semi-definitive figure for 2015 could still be revised.



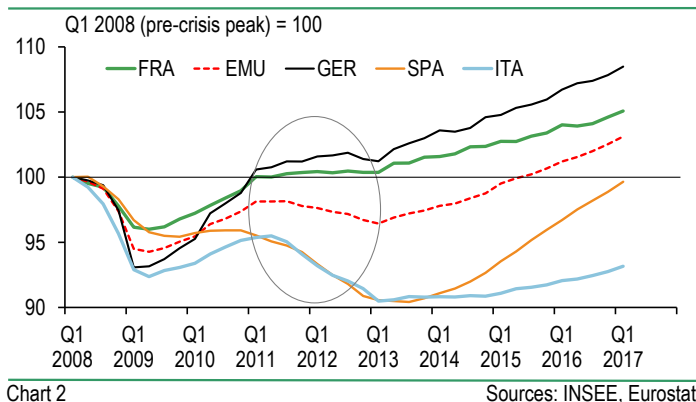
Putting into perspective France's currently sluggish growth



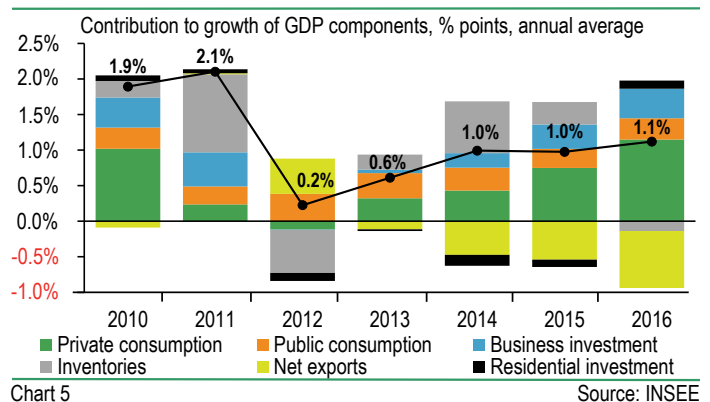
INSEE business confidence surveys



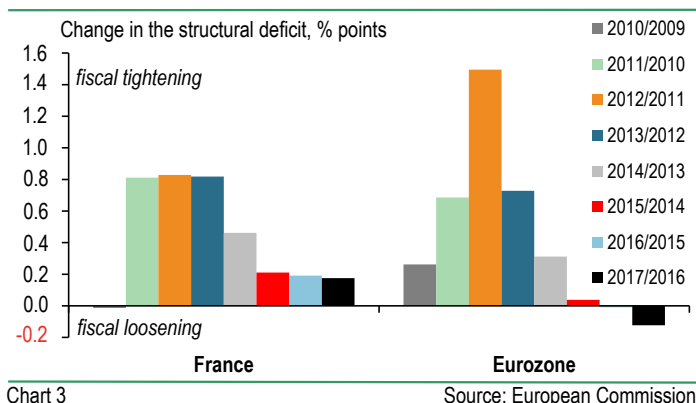
GDP level in France and the Eurozone



Breakdown of French growth



Structural efforts in France and the Eurozone



France – the keys to a self-sustaining recovery: the upturn in investment and employment

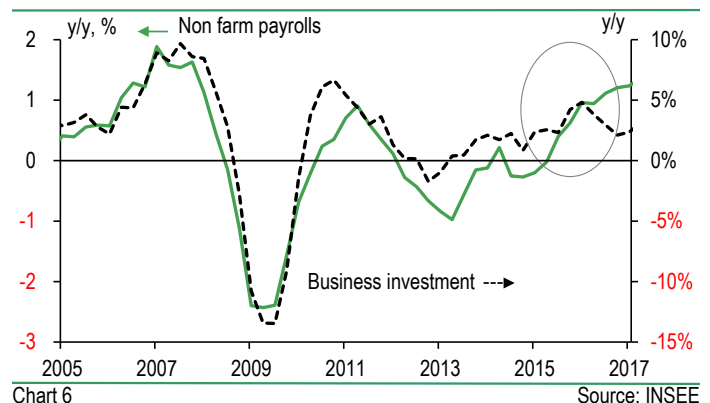


Table 2: Impact of internal and external shocks on French growth

	2015	2016 (forecast)
Total impact on growth	0.0	0.3
Impact of external factors	0.5	0.4
Decline in energy commodity prices	0.3	0.4
ECB's accommodative monetary policy	0.4	0.2
Interest rate cuts	0.2	0.2
Weaker euro	0.2	0.0
World demand	-0.1	-0.2
Recovery in southern Europe	0.1	0.0
Emerging market slowdown	-0.2	-0.2
Impact of internal factors	-0.5	-0.1
Past increases in taxes	-0.7	-0.4
Measures to reduce labour cost (CICE and Responsibility Pact)	0.4	0.3
Impact of spending savings measures	-0.1	0.0
Decline in household investment	-0.1	0.0

Note: the measured effects only take into account shocks observed through year-end 2015. Later shocks are excluded, including those in 2016, with the exception of demand from trading partners, spending savings measures and household investment. In particular, the impact of energy price fluctuations in early 2016 is not taken into account: the positive 0.4-point impact in 2016 is based solely on the decline observed through year-end 2015.

Source: INSEE, Note de Conjoncture, June 2016

In reality, things proved to be quite different: preliminary 2016 growth estimates fell well below INSEE forecast, to only 1.1%. This shortfall can be blamed on both positive and negative factors, with the tailwinds proving to be weaker than expected, and the headwinds much stronger. Among the unexpected factors in 2016, we must also mention the vote in favour of Brexit, even though it has not had a visible impact on French growth for the moment. Growth was also hit by a series of specific jolts and shocks in 2016 that held down the annual average⁷.

Special problems in three key sectors of activity also undermined growth: tourism (terrorist attacks), agro-food industry (very unfavourable weather conditions in the spring) and aeronautics (supply problems and delivery delays). According to INSEE estimates, the decline in tourism and the collapse in agricultural production each reduced growth by 0.2 points in 2016. These problems explain in part the dip in exports in 2016, which can also be attributed to the further easing of world demand for French goods and services (see chart 7). In turn, this poor export performance explains the very negative contribution of foreign trade in 2016, which was the main cause of weak French growth last year.

In other words, this growth weakness is only apparent, and masks the 2-point contribution of final domestic demand, which rose strongly

⁷ Three factors supported Q1 growth (+0.6% q/q): the extra depreciation measure, which bolstered corporate investment expenditure; early purchases of TV sets ahead of the Euro 2016 games and the switch to new digital television standards; and the rebound in household energy spending after the sharp decline the previous quarter due to unseasonably warm temperatures. The elimination of these factors in Q2 triggered a net payback in activity (-0.1% q/q), which was accentuated by strikes and the blocking of refineries in part of May and June, at the same time as protests against labour law reform. This payback was followed by a mild Q3 rebound (+0.2%). Although Q4 growth was robust (+0.5%), it was not strong enough to lift more the full-year average.

compared to 2015 (1.2 points), buoyed by the acceleration in household consumption (2.1% vs. 1.4%) and investment (2.4% vs. -2.1%, the first increase since 2011), and to a lesser extent, corporate investment (3.4% vs. 2.9%). These trends put France's 2016 performance in a much more favourable light.

French exports and world demand

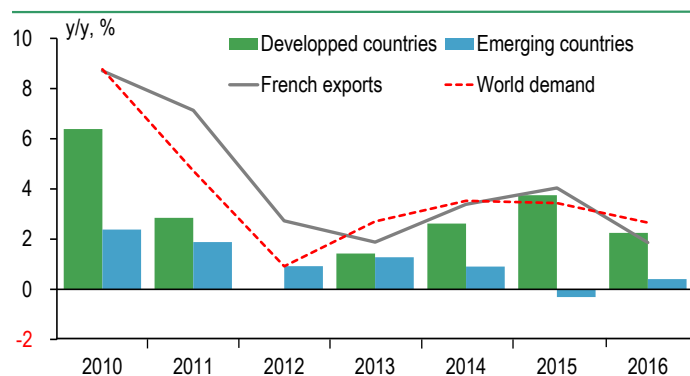


Chart 7

Sources: INSEE, IMF, BNP Paribas

Where are the sources of growth?

Despite some arguments for keeping in perspective France's poor 2016 performance based on a number of exceptional circumstances, in terms of fundamentals, French growth nonetheless lacks momentum. When growth is weak, the least shock becomes visible. If the underlying growth rate had been higher, the various shocks might not have been such apparent. Cyclical factors alone are not the sole cause of sluggish growth in recent years. Its roots run deep, as demonstrated by the similar low and eroding pace of France's potential growth. It fell particularly sharply in the year 2000s, when it was slashed in half, from about 2%, to 1% today (see chart 8)⁸.

Various estimates of French potential growth

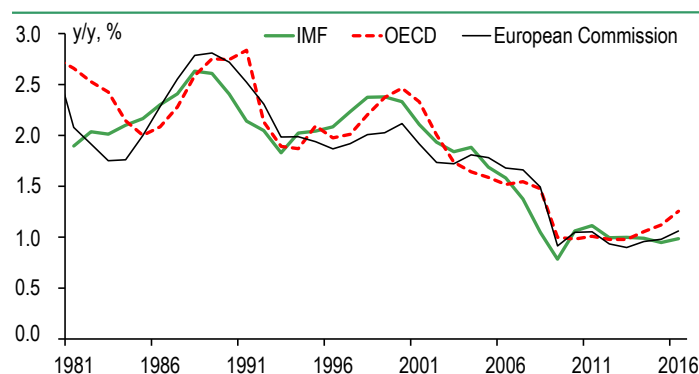


Chart 8

Sources: IMF, OECD, European Commission

⁸ For a more detailed analysis, see *Will little streams make a big river? Past erosion of French growth potential and its future revival*, Conjoncture no. 3, March 2014.



Box 1: 2012-2016: a series of reforms

A series of reforms and other measures were introduced between 2012 and 2016 to turn around the French economy. They strengthen each other and are a step in the right direction, each addressing a specific fundamental problem of the French economy. Yet they were introduced in an overly timid and confused manner, which failed to trigger a positive jolt in confidence and a tangible immediate uptick in growth. However, it is also still too early to obtain more visible results. The reforms have not been in place for very long, and by nature, they will take time to bear fruit. Moreover, they collide with fiscal consolidation's negative impact on growth. Without these stimulus measures, the situation probably would have been more deteriorated: for instance, the CICE tax credit may well have played a defensive role, serving as a buffer against cash flow problems. Below we list these reforms in chronological order, along with their broad objectives and star measures.

The first reform was the **National Pact for Growth, Competitiveness and Employment (PCCE)**, announced in November 2012. It aims to provide a comprehensive response to the economy's low competitiveness by acting on price competitiveness (via the EUR20bn CICE tax credit) and non-price competitiveness (funding for innovation, financing for SMEs, attractiveness, simplification measures...)⁹.

The **job security agreement** of January 2013 is another notable improvement. It promotes greater flexicurity, adding flexibility for companies to manage their labour force (via job retention agreements and the simplification of the partial unemployment system, greater simplicity and clarity in redundancy procedures) and security for employees thanks to new rights (complementary health insurance for all, rechargeable rights to unemployment insurance, personal training accounts, the right to a voluntary period of secured mobility, the redefinition of part-time work, a surtax on unemployment contributions on short-term contracts to fight against the abusive use of these contracts, accompanied by a 3-month exemption from charges for hiring a young person under age 26 with an open-ended job contract).

A new **pension reform** was concluded in September 2013¹⁰. A number of parameters of the general private sector regime were modified to reduce the deficit, notably by increasing employer and employee contributions, and by extending the duration of contributions. Heavy work accounts were created. Complementary pension schemes also underwent major reforms (agreement concluded in October 2015), the main goal of which is to push back the retirement age.

The **vocational training system** reform, enacted in late 2013, aims to better target funds for training programmes to those who need them most. It also activated new personal training accounts.

The **Responsibility Pact**, announced in January 2014, reinforces the supply-side policy initiated by the PCCE. It contains a cumulative total of EUR 20 billion in new cuts in taxes and contributions for companies, spread out over time through 2020 (reduced contributions initially targeted low-wage earners up to 1.6 times the minimum wage, which was expanded to 3.5 times the minimum wage in 2016; lower contributions for family allowances for the self-employed and craftsmen; elimination of the Corporate Social Solidarity Contribution; elimination of the corporate surtax; and the beginning of a decline in the corporate tax rate). It is coupled with the Solidarity Pact, which allocates EUR 5 billion in tax cuts to low-wage earners through 2017.

The **unemployment insurance agreement** was renegotiated on two occasions. The first agreement, signed in May 2014, contains measures tightening certain compensation rules to generate fiscal savings, as well as incentives to return to work (notably via the introduction of rechargeable rights)¹¹. The savings objective is also present in the second agreement, which was finally concluded in April 2017 and covers a three-year period. This agreement notably contains an increase in employer contributions in exchange for the quasi-total elimination of the surtax on fixed-term job contracts; a new change in the method for calculating unemployment benefits, to erase differences in treatment depending on whether there is a succession of very short-term contracts; and pushes back the age limit for qualifying for the maximum 36-months of compensation to age 53 from 50¹².

The first **territorial reforms** were announced in January 2014, with the emphasis on metropolitan areas. A second package followed in January 2015 that reduced the number of regions from 22 to 13. The third reform package, the NOTRe law enacted in August 2015, calls for a new territorial organisation of the Republic: it grants new powers to the regions and redefines those attributed to each territorial authority. The ultimate goal of this reform is to reduce the territorial layers and associated redundancies to boost efficiency and reduce costs.

Negotiations on the **modernisation of the rules for social dialogue** and employee representation were launched in early October 2014 with labour and management representatives. After failing to reach an agreement, the government took charge of the negotiations in January 2015, which led to the enactment of the Rebsamen law on social dialogue and employment in August. This law aims to simplify and streamline the social dialogue (notably by reorganising the employee representative bodies and mandatory consultations) and to better ensure employee representation in small businesses. It also officially creates the Personal Activity Accounts, an account designed to pool together various rights of employees and to make them more transferable from one job to the next (personal accounts for training, time and heavy work, so far). The text also creates a working premium (with the merger of the French version of the earned-income tax credit (PPE, *prime pour l'emploi*) and RSA-employment premium as of 1 January 2016).

Numerous measures were introduced to **boost employment**, directly via government-subsidised job contracts, and indirectly via supply-side policies to restore competitiveness and improve labour market flexibility. The previous administration's last set of measures was: the "Tout Pour l'Emploi" programme announced in June 2015, which targets small and very small enterprises (first-time hiring premium; increase in the number of renewals of fixed-term contracts to 2 from 1; simplification of company size thresholds, and the easing of job retention agreements) followed by the emergency plan deployed in January 2016 (new facilities to enter apprenticeship, new hiring premium for SMEs, vast training programme for the unemployed).

The **Macron Law**, adopted in July 2015, was named after the then Minister of the Economy. Its official title is the law for growth, activity and equal economic opportunity. Presented in detail in December 2014, the proposal was subject to such fierce debate that it had to be adopted using Article 49.3 of the Constitution. The law seeks to remove a series of obstacles hampering growth and to liberate purchasing power. It comprises a wide range of measures targeting certain regulated professions (including the legal profession), bus transport, drivers' licenses, Sunday work, the social dialogue, labour arbitration tribunals, shareholders and employee. Lastly, the **El Khomri labour law** was adopted in July 2016, also using Article 49.3 (see box 2 for more details), which brings to an end this long series of reforms.savings.

⁹ For more information, see *France: in search of lost competitiveness*, Conjoncture no. 2, February 2013.

¹⁰ For more information, see *France: not so special pension reform*, Ecweek no. 13-33, 20 September 2013.

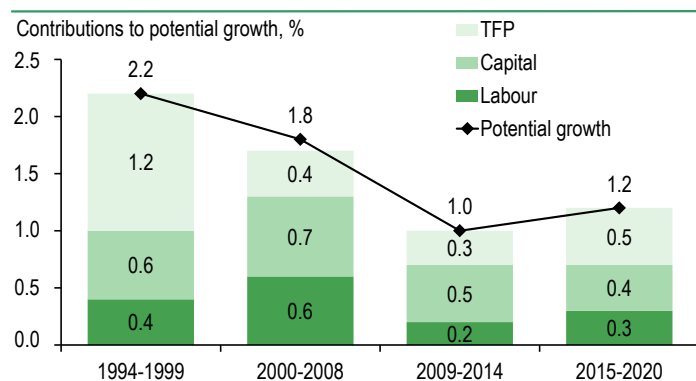
¹¹ For more information, see *France: Towards a stricter unemployment insurance scheme?*, EcoFlash no. 14-1, 3 November 2014.

¹² For more information, see *Unemployment insurance: the winners and losers of the new agreement*, Les Echos, 14 April 2017.



The first step downwards was due to the sharp slowdown in total factor productivity (TFP)¹³ and the second to the consequences of the financial crisis via its impact on investment and unemployment (see chart 9). Moreover, the expected improvement, a 0.2-point gain to a potential growth estimate of 1.2%, is very small if not insignificant. Of course, France is not an isolated case, but that does not reduce by any means the scope of the problem.

Breakdown of French potential growth

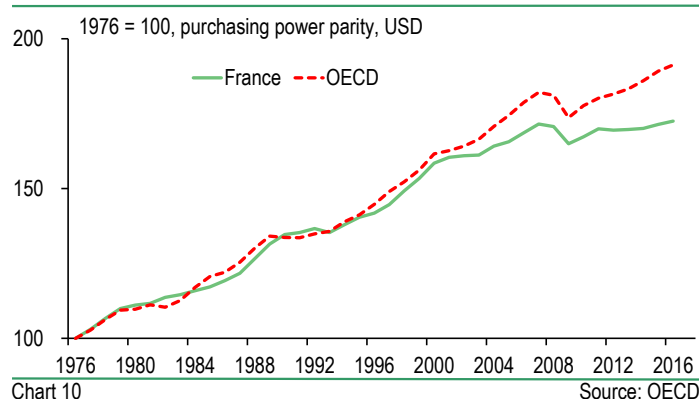


Per capita GDP trends also illustrate well the French economy's loss of momentum. French per capita GDP evolved in line with the average for the OECD countries from the mid-1970s to the late 1990s, but then decoupled, first in the 2000s, and again in the post-crisis years of the 2010s (see chart 10). Behind this loss of momentum, we naturally find the same ingredients that led to the slowdown in growth potential¹⁴, notably the low participation rate and feeble labour productivity gains. The OECD also points this out in the section on France in its 2017 report "Economic reform policies: going for growth". We are specifically interested in these two growth leverages because they are easy to identify.

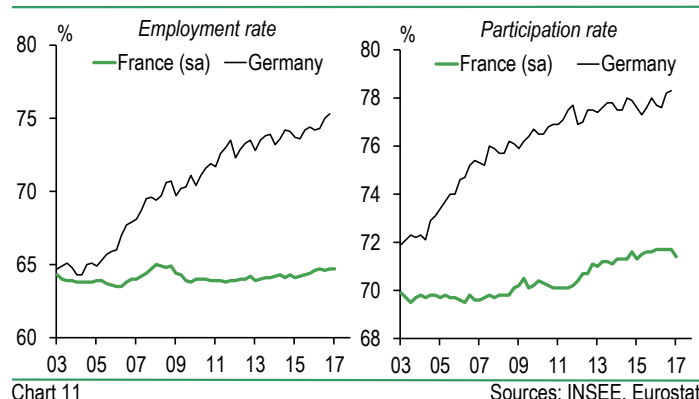
In France, the participation and employment rates¹⁵ are both relatively low and stable, especially compared to Germany, a well-known fact that is regularly singled out (see chart 11). These indicators have huge upside potential as part of a catching-up movement. This is good news because they also have the potential to boost growth significantly. Yet we should not let this automatic increase in growth give us the impression that the situation will easily improve: the transition from

theory to reality is not so simple. Reforms must be undertaken that result in a more optimal use of the labour factor. Clearly, the measures implemented so far have not sufficed¹⁶. The most recent attempt to date is the Labour Law reform (see box 2). It remains to be seen whether it will be any more successful.

Real GDP per capita in France and the OECD



Employment and participation rates in France and Germany



The waning of labour productivity growth is a characteristic shared by many advanced countries, and a source of intense, rich debate among economists¹⁷. In a January 2016 report, France Stratégie, the government's in-house think tank under the Prime Minister, examined France's specific case (see chart 12)¹⁸. The first reason for its decoupling from the United States (commonly used as a benchmark as the representative of the technological frontier) is that French companies have not invested enough in information and communications technology (ICT), which means their capital is not very modern.

¹³ Total Factor Productivity (TFP) is assimilated with technical progress. It is the residual part of growth that is not explained by capital or labour inputs. It is a function of such factors as education, infrastructure, R&D spending, and the organisation of production processes. This is the only place that we refer to TFP in this article. Hereafter, we will only refer to hourly labour productivity. As a reminder, TFP and hourly labour productivity are linked as follows: using the classic Cobb-Douglas function $Y = AK^\beta L^{1-\beta}$, where Y is real GDP, L is the labour factor (expressed in number of hours worked), K is the stock of capital, and β is the return on capital as a share of value added. When expressed as a growth rate this function becomes $y - \ell = \alpha + \beta(k - \ell)$, where $y - \ell$ is hourly labour productivity gains, a TFP gains, and $k - \ell$ a measure of capital deepening.

¹⁴ Camille Thubin, *The decoupling of per capita GDP in France over the past 40 years: why?*, Lettre Trésor-Eco no. 131, June 2014.

¹⁵ The participation rate is the ratio between the labour force (sum of people at work and looking for a job) and the working age population while the employment rate is the ratio between employed persons and the working age population.

¹⁶ See our overview of the question in *Unemployment in France: a deep-rooted problem*, Conjoncture n°2, February 2015, and *Unemployment in France: new medicine for an old disease*, Ecweek no. 13-24, 21 June 2013.

¹⁷ For an overview, see Raymond Van der Putten, *The waning of productivity growth*, Conjoncture no. 9-10, September-October 2016.

¹⁸ Arthur Sode, *Understanding the slowdown in productivity in France*, France Stratégie, La Note d'analyse no. 38, January 2016.



Box 2: Labour Law reforms: the scope of changes

The first labour law reform was initiated by Myriam El Khomri, labour minister under François Hollande. The “law on work, modernisation of the social dialogue and securing professional careers”, to use its full name, was launched in February 2016 and adopted in July of the same year.

Cumbersome red tape, complex labour laws and high job protections that contribute to the rigidity and duality of the labour market are highly debated but common explanations for France’s massive unemployment. The reform aims to give companies greater flexibility and visibility in managing their labour force, working hours and wages according to fluctuations in their business, with the ultimate goal of encouraging them to hire more, notably under open-ended job contracts (CDI). To achieve this, one of the reform’s aims is to give more room to collective bargaining and company agreements, so that decisions concerning the organisation of work are made as closely as possible to the actual situation on the ground.

For companies, several changes are worth noting. The rules governing layoffs on economic grounds are spelled out to reduce the uncertainty surrounding the redundancy process. The possibilities for waiving the 35-hour workweek were further expanded, and the terms for overtime pay were eased (the amount of overtime pay can be lowered and the threshold for triggering overtime pay can be raised). The Labour Law also extends the scope of job retention agreements: the original “defensive” version, introduced under the job security agreement of 2013, for cases of cyclical difficulties, was expanded to include an “offensive” version to face up to needs of business development. Collective bargaining agreements prevail over measures in individual contracts. Any changes must be agreed on by a majority vote, that is to say, signed by the employer and the unions that received more than 50% of the votes (up from 30% previously). In the absence of a majority, a referendum of employees can be held on the initiative of unions representing more than 30% of the vote.

For workers, the emphasis is on the creation of personal activity accounts. They are designed to secure professional careers thanks to the portability of rights (training, heavy work premiums). This is a potentially important, innovative scheme, the first step towards attaching social welfare coverage to the individual and not to the job, as is currently the case, but the content of this reform must still be defined.

Since early May 2017, a **second labour law** is being drafted by the new Labour Minister, Muriel Penicaud, to continue and complete the reforms engaged by the El Khomri law. This new labour law reform has three objectives: to define the appropriate level for negotiations (what is covered by law, company agreements and collective bargaining agreements by sector) and the suitable coordination between levels; simplify and strengthen social dialogue (notably by merging various employee representative bodies); and secure working relations (notably by scaling damages and interest paid as part of labour arbitration procedures).

This new labour law reform is **part of a more comprehensive project to renovate the social model**, which is built around five other reforms: boosting employee purchasing power (elimination of employee health and unemployment insurance contributions, funded by an increase in the CSG social tax), strengthening vocational training; expanding unemployment insurance to cover employees who resign and the self-employed; developing apprenticeships; renovating the pension system by transforming it into a single point-based system. All of these measures aim to develop and round out a French flexicurity system, thereby helping to restore France’s competitiveness and attractiveness.

It is not easy to evaluate the **expected impact** of these labour law reforms. First, it is not certain that they will streamline the labour law given the additional layers (what is decided by law, sector, or company, and what prevails in the absence of an agreement). The challenge is to gain in clarity. Yet like the expected strengthening of the social dialogue, it will not be an easy task. Second, the effects on employment are ambivalent. Although the goal is to encourage more hiring, we must also expect more layoffs, too, at least in the short term, with an uncertain net effect. Lastly, the effort to reduce unit labour costs is a double-edged sword. On the one hand, it is a support factor for competitiveness, and thus, in the end, jobs, but on the other hand, it also strains wage revenues and household consumption, and thus employment. Which impact will win out in the end? And within what timeframe? This is a hard issue to resolve given the numerous parameters that come into play. But it looks like the negative impact on demand dominates in the short term before the positive impact on supply wins out in the longer run.

This brings us to the more general problem of the quality of corporate investment in France, which is skewed more towards construction investment to the detriment of investment in machines and equipment, bigger sources of technical progress. Investment in France is also concentrated in the hands of a limited number of companies (in 2012, 1% of companies accounted for 75% of investment). Moreover, in industrial manufacturing, R&D investment is concentrated in sub-sectors whose economic value is waning as a share of value added¹⁹. All of this undermines productivity growth as well as corporate competitiveness.

The second reason identified for France’s weak labour productivity growth is a less intense creative destruction process.

Hourly labor productivity gains in France over the long term

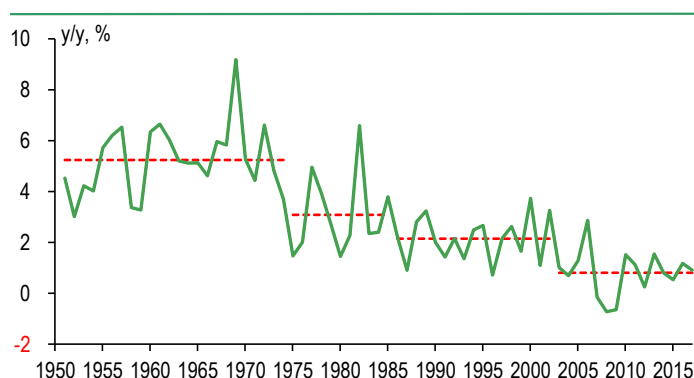


Chart 12

Source: Conference Board

¹⁹ Automobile industry, computer, electronics and optical devices, and pharmaceutical products (see European Commission, 2017 report on France).



In other words, the productive fabric is not renewed as much by eliminating the least productive companies and developing the most productive and innovative ones²⁰, the latter of which tend to be hampered more by barriers to growth than by entrance barriers²¹.

Yet like the employment rate, the correction of these weaknesses opens the door to a major source of growth, via an increase in hourly labour productivity gains. France Stratégie estimates the extra growth at about half a point a year for 10 years (similar to that observed in the United States during the dot-com bubble and new economy boom between 1995 and 2004). According to the think tank, this can be achieved by activating three key leverages: training, innovation and mobility.

Table 3: Impact of measures on the labour market

Impact Measure	On employment	On the composition of the labour force	On hourly productivity, excluding composition effects	On the level of productivity
Reduction in employers' contributions & CICE tax credit	+	Inflow of unskilled workers	Neutral	--
35-hour work week	+	Neutral	++	+
Minimum wage increase	--	Outflow of unskilled workers	Neutral	++
Creation of auto-entrepreneur status	+	Inflow of unskilled workers	Neutral	-
Government-subsidised job contracts	+	Inflow of unskilled workers	Neutral	-

Source: France Stratégie (Sode, 2016)

Numerous measures launched to reduce unemployment, notably by enriching the job content of growth, have also played a role in labour productivity trends in France (see table 3). France Stratégie provides a clear understanding to these trends: *"The introduction of the 35-hour workweek in 2000 had an ambiguous impact on productivity. On the one hand, the reduction in working hours increased the hourly productivity of the working population. On the other, it also might have increased the labour intensity of growth, thereby reducing productivity. The continuous increase in the minimum wage over the past 15 years has increased the apparent level of labour productivity by reducing low-skilled workers' access to employment. The reduction in employers' contributions and the CICE tax credit had the opposite effect. The creation of a special entrepreneur status (auto-entrepreneur) and government-subsidised job contracts had a positive impact on the employment of low-skilled workers, but a negative impact on productivity."*

²⁰ Bartelsman E., Haltiwanger J. and Scarpetta S. (2009), *Cross-Country Differences in Productivity: The Role of Allocation and Selection*, NBER Working Paper n° 15490.

²¹ See OFCE, Department of Innovation and Competition, *The state of France's productive fabric: absence of a recovery or a veritable decoupling?*, Policy Brief no. 6, 9 November 2016.

Concerning future economic policy, the lessons that can be drawn from these observations are uneasy as reducing unemployment looks to be achieved at the expense of productivity growth, or vice versa. The solution would be to focus more effectively on boosting productivity growth via training, innovation and mobility, the key leverages emphasised by France Stratégie. In other words, by playing on the quality of the labour factor rather than on its quantity, making the two objectives (increasing labour productivity gains and lowering unemployment) complementary rather than interchangeable.

As to our question "where are the sources of growth?", one simple answer would be "in growth itself". On the one hand, an "automatic" source of growth exists by narrowing the output gap (which is significantly negative today) and catching-up the accumulated shortfall of growth in recent years (see chart 13). So far, this spontaneously higher growth – higher than the long-term growth potential – has not materialised yet for all of the reasons outlined above. It also raises the question whether the very weakness of potential growth is not acting as a constraint, with its weakness pulling down the effective growth rate under a reverse causal relationship opposite to the established one.

France – Measuring the output gap

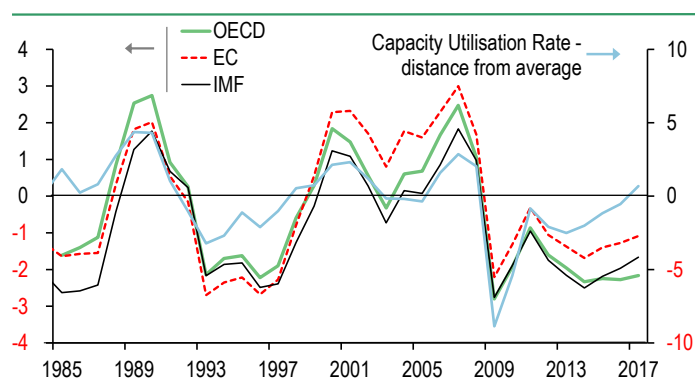


Chart 13 Sources: INSEE, European Commission, IMF, OECD

On the other hand, using this same causal relationship, but in the normal direction, a stronger upturn in real growth (as suggested by the improvement seen in H1 2017) might also trigger a new virtuous circle, with stronger effective growth fuelling an increase in potential growth through capital accumulation in particular. This would add a few tenths of a percentage point to potential growth, a necessary but insufficient improvement though. To raise potential growth in a more lasting and significant manner, there must be a joint rise in the labour force participation rate and in labour productivity growth.

Let us conclude with another way to obtain more growth: by measuring it better. There is nothing new about this debate. In 1987, Robert Solow was already worried about seeing "computers everywhere except in productivity statistics". This question is as pertinent as ever given the technological breakthroughs of the past twenty years. In recent research, Philippe Aghion highlights the creative destruction process, which may lead to overstating inflation (which would be lower if the higher quality of new products was taken into account better) and



understating growth²². According to his calculations, French growth was understated by about half each year between 2006 and 2013 ("true" growth of 1% a year instead of "observed" growth of 0.4% a year)²³.

Competitiveness: efforts pay off, at least in part

Boosting growth goes hand in hand with restoring competitiveness, a key factor in the development of exports, investment and employment. Restoring competitiveness is one of France's three major economic challenges (alongside cleaning up public finances and turning around the labour market), and the one in which the most progress has been made. Measures to restore competitiveness (CICE tax credit and the Responsibility Pact) are beginning to pay off. We will review these signs of improvement in the first sub-section. Yet we are still a long way away from concluding that France has restored its competitiveness.

Definite progress has been made in terms of cost competitiveness, but there is still room for improvement and for more in-depth progress. As to non-price competitiveness, special measures were introduced but they have failed to produce any results, or at least not in a manner that is visible so far. Nonetheless, the accent was placed on the need to improve non-price competitiveness to the same extent as price competitiveness. So it's back to the drawing board. In the second sub-section, we will look at some of these persistent problems.

The ins and outs of higher corporate profit margins

The French economy's loss of competitiveness can be measured in the light of numerous indicators. The main manifestations are the large trade deficit and the loss of export market shares. France's poor competitiveness is also associated with low corporate profit margins, the high cost of labour, and industry's small share of value added.

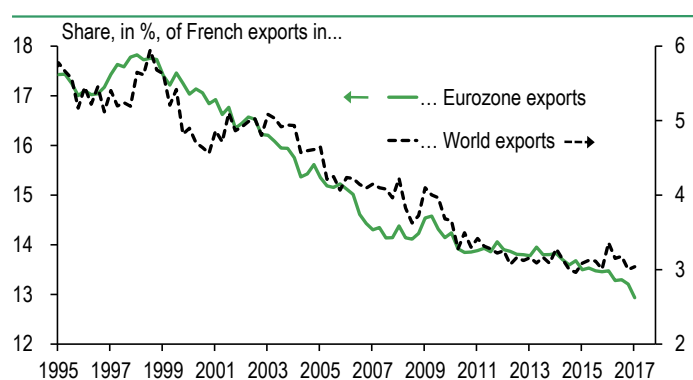
However, some indicators are showing the first signs of improvement, which is why we can start talking about a turnaround in France's competitiveness. By increasing importance, they are export market shares, which is virtually not declining anymore (see chart 14²⁴), unit labour costs, which are increasing much more slowly (see table 5 below), and corporate profit margins, which have picked up strongly (see chart 15).

In this section we focus on corporate profit margins. Boosting margins is a key factor in restoring competitiveness. It can break the negative feedback loop currently at work, which can be described as follows. On the one hand, companies face competitive pressures and in general

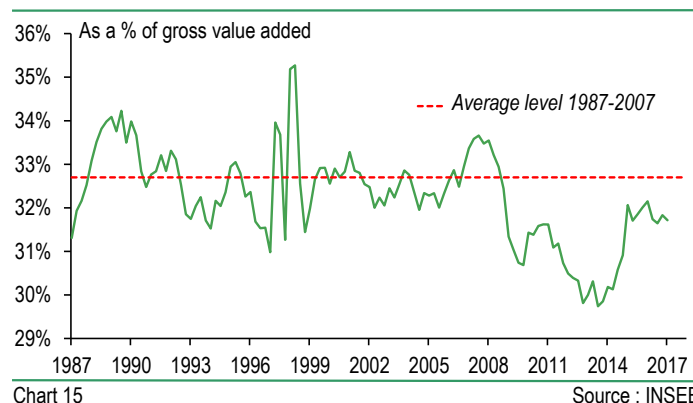
have adopted a mid-range positioning for production, which tends to pull down their sales prices.

On the other hand, they face a relatively rapid increase in unit labour costs. This places a tight squeeze on margins, which in turn strains their development and investment capacity in the broad sense of the term (physical, human, financial and intellectual capital; innovation, R&D, marketing; and international expansion), and thus on competitiveness, notably its non-price component. To say it differently, a poor price/quality ratio makes them lose market shares, which encourages them to lower prices and further squeeze margins, etc. There is a great interdependence between price and non-price competitiveness. The situation even seems to be inextricable. However, raising corporate profit margins is an important channel of transmission, and a good way to begin pulling out of this vicious circle.

France's export market shares



Corporate profit margins of French non-financial companies



This is why the big upturn in margins recently is so important: it is even the economic indicator that has shown the most visible improvement over the past five years. The corporate profit margins of non-financial companies (NFC) have regained a little more than two points after bottoming out at 29.7% in third-quarter 2013. At nearly 32% in first-quarter 2017, it has made up most of the ground lost during the crisis. In the light of these trends, we see a glass that is half full. However, we

²² Philippe Aghion, Antonin Bergeaud, Timo Boppart, Peter J. Klenow, and Huiyu Li, *Missing Growth from Creative Destruction*, mimeo, March 2017.

²³ Philippe Aghion, Antonin Bergeaud, Timo Boppart and Simon Bunel, *Missing Growth and Firm Dynamics in France*, inaugural address, AFSE Congress, 19-21 June 2017, to be published.

²⁴ The sharp decline, towards the end of the period on the chart, in the share of French exports in Eurozone exports is due to the marked, but temporary, fall in French exports in Q1 2017.



should not allow them to mask the road ahead, to return at least to the pre-crisis average, which is about a point higher, or even better, to clearly surpass this level and reach comfortable margins. The breakdown of corporate margins by sector also calls for caution: the net improvement in manufacturing margins is a positive signal, but it is offset by the lack of improvement in private services (see chart 16).

France - Corporate profit margins by sector, in the manufacturing industry and private services (all types of companies combined)

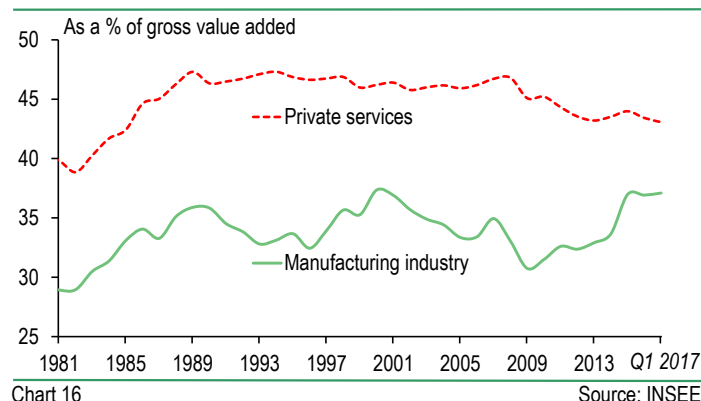


Table 4: Breakdown of French NFC margins*

	2012	2013	2014	2015	2016	2013/2016
NFC margins (level)	30.3	30.0	30.4	31.9	31.8	-
Change in margin	-0.9	-0.3	0.5	1.5	-0.1	1.9
Contribution to the change in margin						
- Productivity gains (+)	0.0	0.7	0.7	0.5	0.0	1.2
- Real per-capital wages (-)	0.3	0.5	0.7	0.6	0.9	2.2
- Employer contribution rate (-)	0.1	0.2	0.2	-0.2	-0.2	-0.2
- Value-added price / consumer price ratio (+)	-0.3	-0.1	0.0	0.7	0.6	1.2
- Other factors (+)	-0.2	-0.2	0.7	0.7	0.1	1.5

* The change in margin is broken down as follows:

- changes in productivity (Y/L), where Y is value added and L is employment, and the value-added price/consumer price ratio or terms of trade (P_v/P_c), which have a positive contribution;
- changes in real average wages per capita ($SMPT/P_c$) and the employer contribution rate (proxied by the ratio $W/SMPT$, where W is the per capita cost of labour), which have a negative contribution;
- other factors: mainly production taxes net of subsidies, including the CICE tax credit (reported as a corporate subsidy in the national accounts).

This breakdown can be formulated as follows:

$$TM = \frac{EBE}{VA} = 1 - \frac{W \cdot L}{Y \cdot P_{va}} + \text{other factors}$$

$$= 1 - \frac{L}{Y} * \frac{W}{SMPT} * \frac{SMPT}{P_c} * \frac{P_c}{P_{va}} + \text{other factors}$$

Source: INSEE

Various measures to reduce labour costs (CICE tax credit, Responsibility Pact, hiring premium for SMEs) have largely contributed to the upturn in margins, but the sharp drop in oil prices in 2014-2015 has also helped a lot, too. Table 4 shows the breakdown of NFC margins as calculated by the INSEE. The impact of measures to reduce labour costs can be seen in the decline in the employer contribution rate

variable and in the positive contribution of "other factors" (which include production taxes net of subsidies, of which the CICE tax credit, reported as a corporate subsidy in the national accounts). The impact of the decline in oil prices can be seen in the improvement in the value-added price/consumer price ratio, which is itself influenced by changes in the terms of trade (export price/import price ratio).

These factors boosting corporate profit margins were nonetheless offset in part by changes in real per-capita unit labour costs (real per capita wages minus productivity gains), the contribution of which was negative more often than positive. Here again, we are confronted with the problem of low labour productivity gains.

This breakdown also helps us better understand why there has been a big upturn in margins in industry, but not in services. Both the transport equipment manufacturing and transport services sectors fully benefited from the decline in oil prices. The positive impact on the terms of trade was coupled by that of the euro's depreciation, which specifically benefited the transport equipment manufacturing sector. Indeed, in aeronautics, the majority of export contracts are denominated in dollars. When converted into euros, this automatically generates a big increase in the corresponding export prices. As to measures aimed at lowering the cost of labour, which are concentrated on wages of up to 2.5 times the minimum wage, they benefit the most labour intensive sectors in this wage range, which is mainly in the services sector. Yet the favourable impact of these measures is offset by wage dynamics, which left margins virtually flat.

The change in unit labour costs (ULC), which aggregate some components of corporate profit margins (the cost of labour, i.e. the sum of employers' contributions and wages and salaries disbursements, divided by productivity), sheds a somewhat more mixed light on the degree of improvement in the cost-competitiveness of the French economy. Let us begin with the positive points. The first is that ULC increased at a much slower pace, dropping from an average annual rate of 1.9% between 1999 and 2010 to 1% between 2011 and 2016.

This movement was triggered by the slowdown in the cost of labour, but was offset by the parallel slowdown in productivity gains (see table 5, page 12). The second positive point is that France regained cost-competitiveness with respect to Germany, where the increase in ULC accelerated strongly between the two periods. In contrast however, France's cost-competitiveness is now deteriorating relative to Spain, where ULC fell even more sharply. Compared to the Eurozone as a whole, France continues therefore to face a slight deterioration in its cost-competitiveness (see chart 17).

The hidden part of the iceberg

Despite these signs of improvement in terms of competitiveness, the main feeling is nonetheless one of incompleteness. Indeed, the positive assessment is limited to a partial turnaround in corporate profit margins and a slowdown in both ULC (but no decline) and market share losses (but no gains). The jury is still out on the overall impact of the CICE tax credit in particular, and the supply-side policies pursued since 2013 in general, to stimulate employment, investment, R&D and exports. The effects must still be identified and quantified.



This is the conclusion of the CICE monitoring committee's 2016 report, which presented a preliminary assessment of the effects of CICE alone in 2013-2014. Its mixed preliminary conclusions were confirmed in the follow-up report released a few months later²⁵.

Relative competitiveness

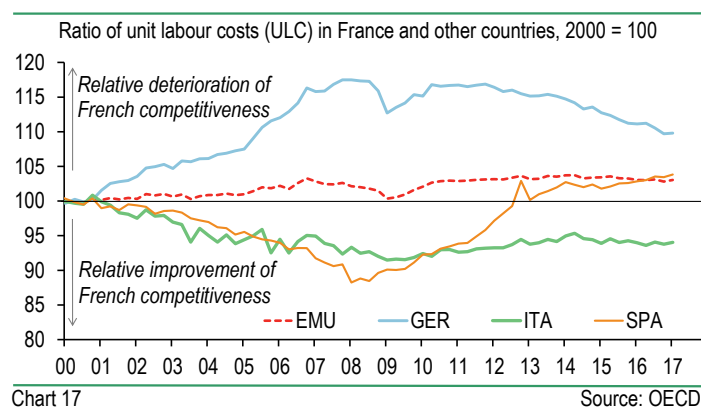


Table 5: Comparison of unit labour costs

		France	Germany	Euro zone	Italy	Spain
Unit labour cost	Average annual growth 1999-2010	1.9%	0.6%	1.7%	2.6%	2.8%
	Average annual growth 2011-2016	1.0%	1.8%	0.9%	0.8%	-0.8%
Hourly labour productivity gains	Average annual growth 1999-2010	0.8%	0.8%	0.7%	-0.1%	0.6%
	Average annual growth 2011-2016	0.5%	0.4%	0.5%	-0.5%	0.8%
Cost of labour	Average annual growth 1999-2010	2.8%	1.2%	2.4%	2.4%	3.2%
	Average annual growth 2011-2016	1.5%	2.5%	1.5%	0.4%	0.2%

Source: OECD

Considering the long response time, it is not surprising that the CICE tax credit did not have much of an impact at the beginning of the period. Moreover, other economic policy measures were also launched that interfered with and countered the effects of CICE²⁶. These "negative" measures can be divided into two categories: those that increased the

cost of labour²⁷ (which the CICE is seeking to lower) and those devoted to funding CICE (fiscal savings, higher VAT rate and green taxation). With the passage of time, as well as fewer negative measures and additional positive measures (notably the Responsibility Pact and Macron law), we can reasonably expect that the analysis of data for 2015, 2016 and beyond will be more conclusive. Yet just how conclusive remains to be seen. The first response will come this fall when the CICE monitoring committee releases its 5th assessment report.

Progress has been made, but a lot more still needs to be done to be more competitive: win back market share, shift production upmarket, increase productivity gains, improve R&D, return to the ranks of the leading countries in terms of innovation, build up and revitalise the productive fabric, increase the number of exporting companies of intermediate size (*ETI*), boost industry's share of value added, and reduce the structural component of the trade deficit (excluding energy). There is still a long road ahead and it is fair to say we are not even half way there yet. In response to the question "What remains to be done?"²⁸, we once again turn to France Stratégie's conclusions, which identify the following persistent problems:

- Control over relative labour costs must still be confirmed;
- The high cost of non-wage inputs, particularly real-estate and corporate services prices, which hurts the export sector (this is the hidden part of the iceberg, which we will discuss in greater detail below);
- The non-price competitiveness of companies (France ranks 7th among the OECD countries according to a CAE report²⁹). There is still room for improvement: close the skills deficit³⁰ in the labour force through youth training and continuing education programmes for the employed, improve the quality of corporate management³¹, accelerate the digital transition in the productive fabric, and reduce the complexity of the regulatory framework, which is not propitious for the development of companies, especially young innovative companies³².

²⁷ Calculation of exemptions for low-wage earners on an annualised basis (January 2011); reintegration of overtime work in the tax base for the calculation of Fillon exemptions (January 2012); elimination of the tax exemption for overtime work (September 2012); increase in the *forfait social* corporate social contribution (August 2012); increase in old-age insurance contributions (November 2012); increase in unemployment insurance contributions on short-term contracts (January 2013); and the annual increase in the minimum wage.

²⁸ Vincent Aussilloux and Arthur Sode, *Competitiveness: what remains to be done?*, France Stratégie Enjeux, March 2016.

²⁹ Maria Bas, Lionel Fontagné, Philippe Martin and Thierry Mayer, *In search of lost market share*, Les notes du Conseil d'Analyse Economique (CAE), no. 23, May 2015.

³⁰ The skills deficit can be seen in France's poor scores on PIAAC surveys, the OECD's adult skills assessment, which is essentially due to the belated arrival of mass education in France, the poor performance of initial education, as attested by the PISA surveys, and the weakness of continuing education, which helps accelerate the obsolescence of human capital over the course of professional life.

³¹ Recent literature on productivity concludes that a substantial part of the gap between countries lies in the quality of management and organisational practices. France seems to have accumulated a big lag in terms of good management practices, a weakness directly linked to the skills deficit of the labour force and the slower renewal of the productive fabric, in addition to more cultural factors (see Aussilloux-Sode, 2016).

³² The new government's corporate and capital income tax reform proposals address this issue and are another vector for boosting competitiveness.



Low competitiveness is a major, complex problem for France. The specific issue of cost-competitiveness has been fairly well identified, but it focuses on the export sector (the so-called exposed sector), which is only the tip of the iceberg. The hidden part of the iceberg is the sheltered sphere, i.e. the non-tradable goods and services sector. Of course, the question of competitiveness primarily concerns companies that produce tradable goods and services, but their competitiveness is also affected by the performance of companies in the sheltered sectors. Indeed, the production costs of an “exposed” company include the direct labour costs of its own employees, but we must also add an indirect component, incorporating the prices of intermediate consumables and other non-labour inputs used by the company. Since industry is a big consumer of services, it is also sensitive to the cost of labour in these sectors. In France, hourly labour costs are relatively high in the services sector, compared to the industrial sector as well as to the level in Germany (see chart 18). Its quick rate of increase, again compared to the pace of change in Germany, is also striking.

Higher costs are more easily carried over to service prices since competitive pressures are not as strong in the sheltered sphere. Chart 19 clearly illustrates the greater price fixation power of the non-tradable goods and services sector (strong increase in the GVA deflator) compared to the tradable goods sector (a flat or declining deflator). In the end, higher prices for non-tradable goods and services drive up the cost of inputs consumed by “exposed” companies, straining their competitiveness. Lowering the relative prices of non-tradable goods and services would thus help boost competitiveness. These prices can be lowered by reducing the cost of labour (through wage moderation and cuts in employers' contributions), increasing labour productivity gains, or reducing the income generated by the lack of competition.

This brings us to the question of targeting the reduction in employers' contributions. When the goal is to boost employment, and employment alone, the most effective solution is undoubtedly to target low-wage earners (up to about 1.5-1.6 times the minimum wage). When the goal is to boost competitiveness as well, the question is open to debate. Narrowly targeting low-wage earners can have a positive impact for the reasons outlined above, and might suffice. It would also offer the advantages of limiting the fiscal cost of such a measure, and reduce the risk of “irrigating” sectors that do not need it. Yet there is also the risk of fuelling a low wage trap (when the company limits its recruitments and wages increases in order not to surpass the threshold of 1.5-1.6 times the minimum wage and continue to benefit from the reduction in contributions).

It would also mean foregoing the effects of a broader targeting, which responds better to the goal of boosting competitiveness, by benefiting the sectors with the highest exposure to international competition (where wages are higher). These sectors also have a major gearing effect on job creations³³. Even the sheltered sectors paying low wages would stand to benefit, assuming it is true that they consume more

goods and services from high-wage sectors than the inverse³⁴. This reasoning has prevailed and led to the adoption of a broad target for the CICE tax credit (2.5 times the minimum wage) and the Responsibility Pact (3.5 times the minimum wage).

Hourly labor costs in the industry and services sector, in France and Germany (in euros)

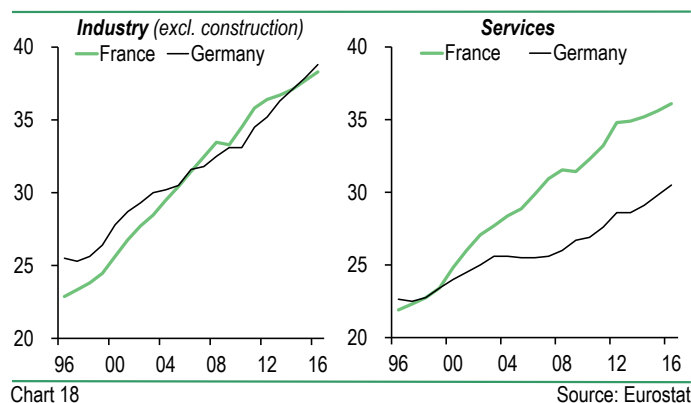


Chart 18

Source: Eurostat

Gross value-added deflator in the tradable and non-tradable goods and services sectors

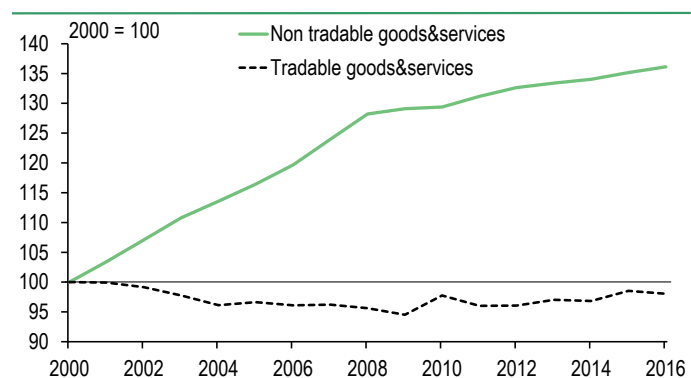


Chart 19

Sources: INSEE, BNP Paribas estimates on the basis of Sy (2014)³⁵

Conclusion

Although the new French administration inherits an economic situation in the midst of recovery, it nonetheless faces numerous challenges. The progress that has been made so far is limited in scope, and lots of problems persist. This is true for both growth and competitiveness, the two issues discussed in this article.

As to growth, the main characteristic of the recovery that began in 2013 is its lack of vigour until 2016 (average annual growth of barely 1% for the period). This sluggishness is partly cyclical, partly structural as evidenced by the weakness in potential growth, which current estimates put at just over 1%. The big task at hand is to boost growth potential.

³³ According to research by Philippe Frocain and Pierre-Noël Giraud for La Fabrique de l'Industrie, the creation of 100 jobs in the exposed sectors results in the creation of 64 jobs in the sheltered sectors. *Exposed and sheltered employment in France*, Les Synthèses de La Fabrique, no. 9, September 2016.

³⁴ Gilles Koléda, *Reducing the cost of labour: a favourable path for competitiveness*, La Fabrique de l'Industrie report, June 2013

³⁵ Mouhamadou Sy, *Reducing France's trade deficit: the role of the internal exchange rate*, La note d'analyse, France Stratégie, September 2014



This seems to be within reach given the large room for increase in the labour force participation rate and productivity gains. It should be fairly easy to exploit these sources of growth, assuming the appropriate measures are taken, which could lift France's growth potential up to 2%. Training, innovation and mobility are the key leverages.

As to restoring competitiveness, which is essential for boosting growth, the process seems to be well underway, thanks notably to the upturn in corporate profit margins. Yet this alone is not nearly enough. The most progress has been made in keeping under control unit labour costs (ULC), but this still needs to be confirmed and amplified. Renewed efforts are needed to boost non-price competitiveness, by reinforcing the existing dedicated measures. The leverages are the same as those for restoring potential growth: training and innovation, as well as the development of a more business-friendly environment. Lastly, there is one challenge that has not been addressed yet: the high cost of non-

wage inputs, which is hampering the export sector. To reduce these costs, it will also be necessary to hold down labour costs and boost productivity gains – two remedies discussed above – but this time the target is the sheltered sectors. Greater competition is another leverage that must not be neglected.

These numerous topics (training, innovation, mobility, productivity, competition, risk-taking, entrepreneurship), which all relate to the idea of a greater liberty to act as well as, at the same time, a greater equality of opportunities, have often been mentioned by Emmanuel Macron during his electoral campaign. It's up to him now to turn words into action and results.

Completed on July 24, 2017
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Egypt: impressive economic transition with strings attached

Pascal Devaux

Egypt is implementing an ambitious programme of economic reforms. Macroeconomic imbalances are being reduced thanks to the pound flotation and some progress in fiscal reforms. Nevertheless, households' purchasing power is affected by a sharp rise in consumer prices, and the hike in interest rates is a threat for public finances.

After five years of sluggish growth and swelling fiscal and external deficits, the Egyptian economy has undergone major changes over the past two years. Three factors have helped the economy return to brighter prospects. First, the decision to float the Egyptian pound lifted a major constraint on activity and foreign-currency liquidity, which had fallen to alarmingly low levels. Second, major fiscal reforms were implemented with the support of international donor funds, checking the deterioration in public finances. Third, the accelerated development of natural gas resources is expected to trigger a significant reduction in the trade deficit and ensure the country's energy supply. Yet these economic adjustments have been very costly, both for the local population, due to record-high price increases, and for debtors – and above all the state – due to higher interest rates. Although reforms have created positive momentum for correcting macroeconomic imbalances, the size of the adjustments could become a source of greater vulnerability.

Floating the pound: a successful reform

In November 2016, the decision to float the Egyptian pound ended several months of tensions in the currency markets, which had fostered numerous restrictions on trade (blocking imports) and financial transactions (restricting international bank transactions), and encouraged the development of a parallel currency market. The floating of the Egyptian pound (which has depreciated by 50%) coincided with a significant increase in domestic interest rates and a 3-year USD 5.4 billion loan from the International Monetary Fund (IMF).

Net improvement in the banking system's foreign-currency liquidity

Floating the pound, international financial support, and the acceleration of public finance reforms restored confidence in the country's economic policy and triggered a massive inflow of foreign currency into the banking system. These included currency transfers previously outside of the official banking system, and foreign capital inflows. Resident capital flows were estimated at more than USD 20 bn in the eight months since the pound was floated.

Exchange rate: EGP/USD

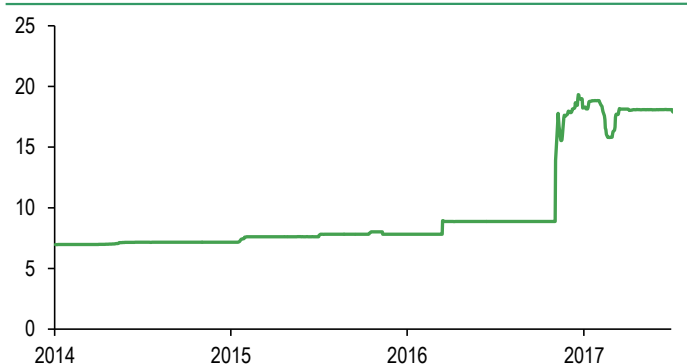


Chart 1

Source : CBE

International capital flows

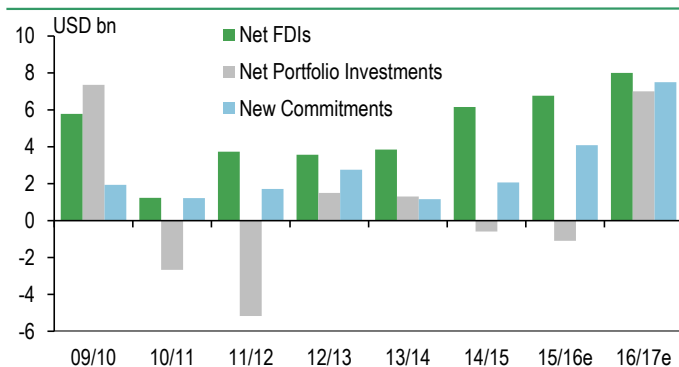


Chart 2

Sources: CBE, IMF, BNP Paribas

Non-resident capital inflows were also substantial, estimated at about USD 27 bn over the same period. In addition to the IMF's USD 2.7 bn pay out as part of its Extended Fund Facility, there was also about USD 3 bn in support from other multilateral donor funds (World Bank), and USD 7 bn from two government bond issues on international markets. Moreover, high yields on government bonds and renewed



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confidence in the currency market attracted about USD 10 bn in portfolio investment.

A little under USD 1 bn was invested in the Cairo stock exchange. Lastly, remittances have been sustained (USD 4.5-5 bn per quarter). All in all, about USD 57 bn has flowed into the Egyptian banking system since the decision to float the pound (equivalent to about 35% of M2 money supply at March 2017). A direct consequence of this inflow of foreign currencies was a significant improvement in the Central Bank of Egypt's foreign reserves. At the end of June 2017¹, CBE foreign reserves amounted to USD 31.3 bn, equivalent to 5.7 months of goods and services imports, compared to the alarming level of USD 15.5 bn, or only 2.9 months of imports, 11 months earlier.

CBE Forex reserves

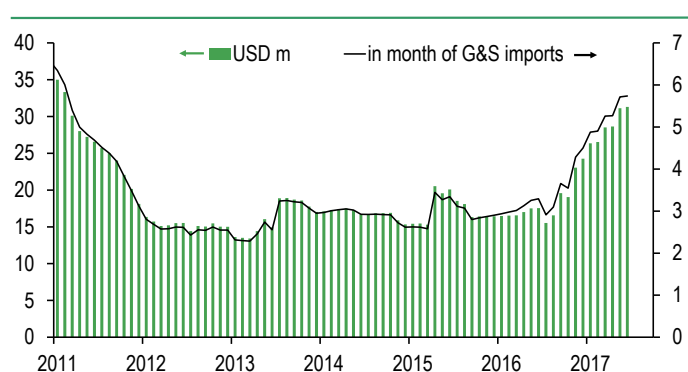


Chart 3

Sources: CBE, BNP Paribas

Reduction in external imbalances

More significantly, the net external debt of the entire banking system (CBE and commercial banks) narrowed sharply. Faced with a persistently high current account deficit and insufficient capital inflows, the banking system had to take on debt to cover part of the Egyptian market's hard currency needs. At the end of October 2016, the CBE's net external debt (comprised notably of deposits from the Gulf countries) hit a record high of more than USD 6.7 bn. In December 2016, the net external debt of banks reached a similar amount. By May 2017, the net external position of the CBE and the commercial banks had swung back into positive territory, at about USD 2.3 bn and USD 0.9 bn, respectively.

Once foreign currency liquidity had returned to much more comfortable levels, the restrictions on currency transactions were gradually lifted. Moreover, with the rebuilding of the CBE's foreign reserves, the national oil company EGPC is in the process of repaying its arrears to international energy companies, which have been reduced to USD 2.3 bn from about USD 3.5 bn at year-end 2016 (national estimates).

Despite higher oil prices in H2 2016, the current account balance improved. Yet this improvement is mainly due to a surge in private

transfers, due notably to the renewed confidence of non-resident Egyptians in the domestic currency market. These flows are expected to return to normal in the short term. For the moment, the pound's depreciation has not had a notable impact on the trade balance. Although imports are declining due to higher costs, exports have not yet benefited from the improved competitiveness of the exchange rate.

Banking system net foreign assets

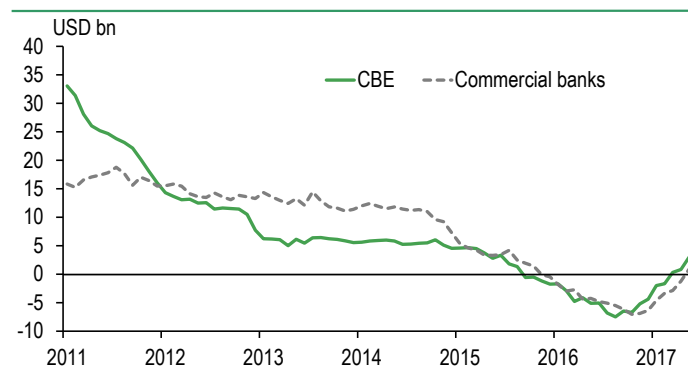


Chart 4

Sources: CBE, BNP Paribas

Claims on private sector as % of deposits

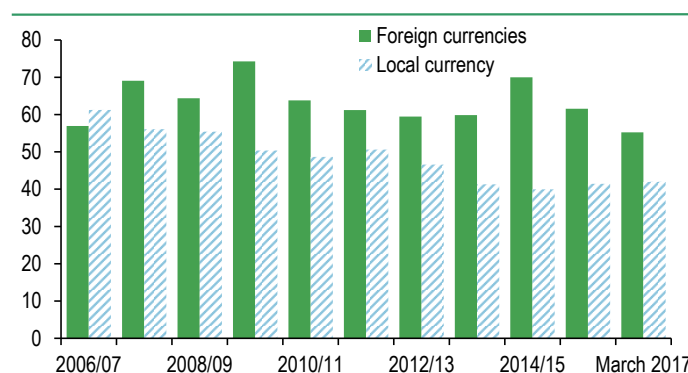


Chart 5

Source: CBE

Improvement in public finances remains constrained

Fiscal reform acceleration

Since 2011/12, public finances have deteriorated sharply. The fiscal deficit has swollen to an average of 12% of GDP over the period 2011/12-2015/16, compared to a 7.7% average during the five previous years. This deterioration is mainly due to the hard-to-curb and high current expenditures. In 2015/16, the public sector wage bill and subsidies (energy and food) amounted to 28% of fiscal revenues each,

¹ Fiscal year ends in June



while debt service also absorbed about 30% of revenues. Significant efforts have been made to clean up public finances since 2015/16. In keeping with the IMF support programme, these efforts were accelerated in 2016/17.

External accounts

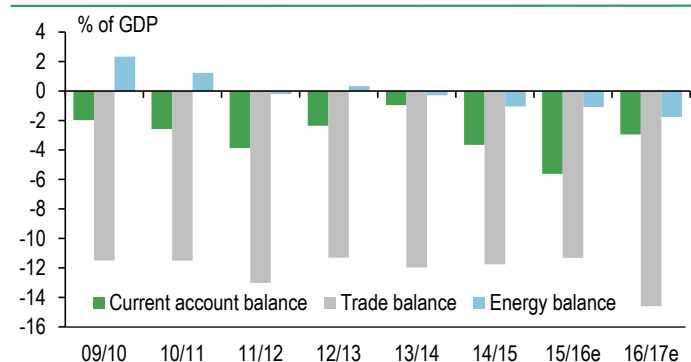


Chart 6

Sources: CBE, BNP Paribas

The main measures include the introduction of a value-added tax, currently at 14% (which replaces the previous 10% tax on goods), and cut in energy subsidies. Although these measures should help reduce the fiscal deficit in the medium term, their impact on the budget is limited for the moment. The currency effect combined with higher oil prices in international markets has increased the energy bill, doubling the amount of energy subsidies relative to the initial budget proposal. The amount of subsidies will continue to be extremely vulnerable to external factors, given the spread between consumer energy prices and market prices (currently estimated at 65%). Moreover, the need to increase social measures to offset the impact of higher prices is another factor driving up public spending. In terms of revenues, however, the introduction of VAT as of Q2 2016/17 helped boost fiscal inflows, which increased by about 30%. The increase in the total wage bill remained mild (+4%). The primary fiscal deficit has improved significantly in 2016/17. We estimate that narrowed by the equivalent of 1 point of GDP to 2.7% of GDP.

The primary deficit is shrinking

In fiscal year 2017/18, the government expects these trends to continue: higher fiscal revenues, a mild increase in the total wage bill and an increase in social expenditures and subsidies, due in part to the increase in some social transfers. The decline in energy subsidies, which took effect in early July for fuel (prices rose by about 40%) should continue with the rise in electricity prices. These measures should help reduce the primary deficit, which we estimate at 1.3% of GDP in fiscal year 2017/18. However, the government's target of reducing the total deficit below 10% of GDP seems to be optimistic. Debt service is expected to rise sharply, which would call this target into question.

Debt servicing is hard to control, increasing the vulnerability of public finances

The very high cost of servicing public debt is a major reason for the increase in fiscal deficits. As a percentage of fiscal spending, debt service reached nearly 50% in 2015/16. The deficit is essentially financed on the domestic market, with high interest rates and short maturities. Since November 2016, despite the growing use of international financing in foreign currencies to contain the cost of financing, the sharp rise in domestic interest rates should drive up the apparent interest rate on the public debt.

Fiscal balance

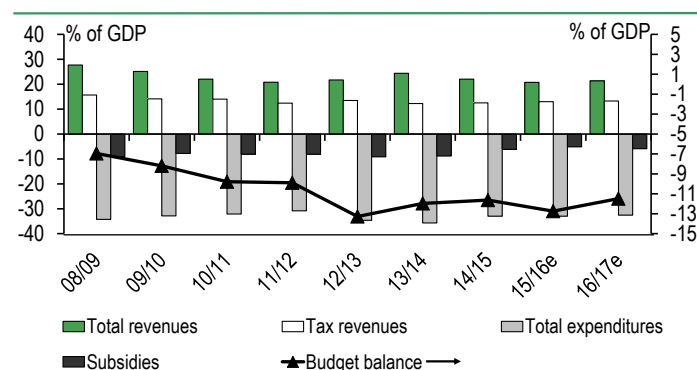


Chart 7

Sources: MoF, IMF, BNP Paribas

General government debt

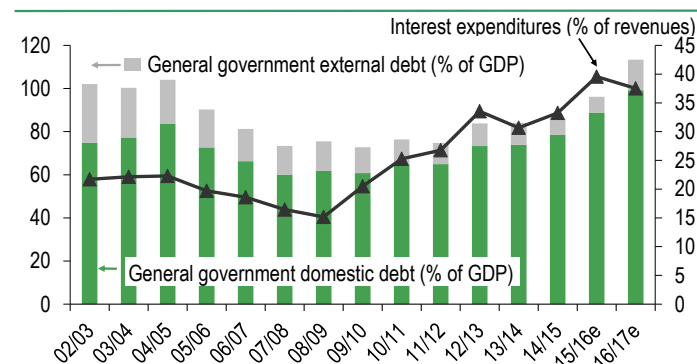


Chart 8

Sources: MoF, IMF, BNP Paribas

Since September 2016, the CBE's key rate has increased by 885 basis points (bp) to 19.25%. Interest rates were raised for two reasons: to combat inflationary pressures, and above all, to continue improving foreign currency liquidity in the banking system, by attracting currency still outside of the official banking system into bank deposits offering higher remuneration.



The latest 200 bp key rate increase, which caught numerous analysts by surprise, is only a temporary measure according to the CBE. Yet such a steep increase in the cost of debt threatens the goal of fiscal consolidation. Even though the CBE's key rate increase is not carried over in full to the yield on government securities, it sharply increases the cost of domestic debt for the government.

As a result, the interest rate on 3-month treasury bonds has increased from 15% in October 2016 to 22.5% during the latest auction on 9 July. Given that the government is expected to resort less to international financing this year (about USD 4-5 bn), a 200 bp interest rate hike increases the government's interest charge over a full year by about EGP 40 bn (1% of expected GDP in 2017/18). However, the net cost of interest rate hike for public finance will be lower. We have to take into account the various maturities of the debt portfolio and the fiscal income provided by the activity on the debt market. In 2015/16, the tax on T-bills and bonds' payable interest yielded EGP 23 bn.

Under these conditions, it will be difficult for the government to meet its target of reducing the fiscal deficit below 10% of GDP. We are forecasting a slight decline in the deficit, to 10.2% of GDP in FY 2017/18.

5Y Sovereign CDS

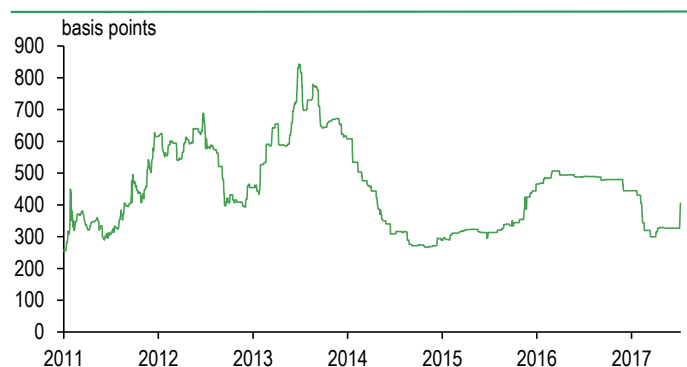


Chart 9 Source: Thomson Reuters

Interest rates

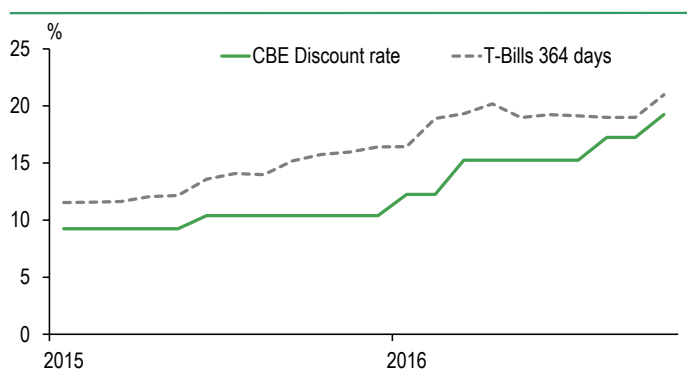


Chart 10 Sources: CBE, MoF, BNP Paribas

Public debt is expected to level off

Government debt has swollen to a high level (97% of GDP in 2015/16 according to the IMF). The majority is comprised of bonds issued on the domestic market with rather short maturities. The IMF loan and two bond issues in 2017 (USD 7 bn) have helped increase the percentage denominated in foreign currency, which currently accounts for about 15% of total debt. In fiscal year 2017/18, given the expected sharp increase in nominal GDP, we forecast debt to reach 94% of GDP, after peaking at an estimated 113% of GDP in 2016/17. The privatisation of some state-owned companies could further reduce the country's debt. The state-owned company Enppi is expected to float part of its capital in the short term. The government expects to raise USD 150 m, which would only have a marginal impact on public debt.

The energy sector outlook has markedly improved

The energy sector is crucial for macroeconomic stability. It contributes to fiscal and external balances and is a factor driving economic activity.

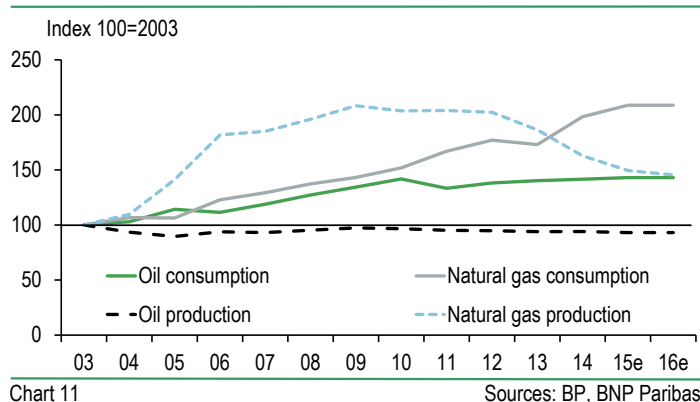
Some difficult times

Egypt's energy sector boomed in the early 2000s, driven by strong domestic demand and Liquefied Natural Gas (LNG) exports. Gas production increased more than three-fold to 6bcf/d between 1999 and 2009. Since 2010, however, sharp macroeconomic deterioration and structural natural resource trends have pushed the sector into difficulties. The first hit was the decline in offshore Mediterranean gas production as a result of reservoir maturity and stalled investments. The production of four of Egypt's major offshore gas fields started to decline in 2012 as they had been discovered and developed at the same time in the mid-1990s. The second hit was the accumulation of Egyptian General Petroleum Corporation (EGPC) arrears to upstream investors peaking at USD 6.3 bn in 2012 (2% of GDP) as a result of mounting fiscal deficits and deteriorating external liquidity during the political transition. The third hit came from the decline in crude prices in 2014-15, thereby discouraging foreign investment especially in high-risk deepwater exploration.

Egypt became a net gas importer in FY 2015/16 with a hydrocarbon external deficit of USD 3.6bn compared with a surplus of USD 5.1 bn in FY 2009/10. During that period, the current account deficit was largely driven more by the negative hydrocarbon balance than by the decline in tourism. Real economic activity was also impacted as households and energy-intensive industries suffered from occasional fuel and power shortages.



Energy balance



Major East-Med discoveries

In the short term, the government secured concessional fuel supply agreements with GCC sovereigns and launched LNG imports fulfilling around 25% of domestic demand. In the medium term, the government repriced gas offtake from new blocks by 40-120% and upwards to incentivise production and auctioned large exploration acreage at competitive terms to accelerate reserve replacement. On the financial side, the government allowed some onshore producers to increase exports in order to decelerate the build-up of arrears. That, combined with a series of material payments to targeted E&P operators, has indeed halved EGPC arrears to USD 3.5 bn (Dec 2016). However, outstanding receivables continue to be a major constraint for new E&P investments primarily in gassy portfolios.

The turning point was the discovery of the Zohr jumbo gasfield (Eni) in August 2015. This gasfield, with its recoverable reserves of 22tcf, has not only replenished Egypt's total gas resources by one third, but has also been fast-tracked to start production in H2 2017. Egypt is currently replenishing most of its gas production with new discoveries and is likely to achieve self-sufficiency by 2019. These new discoveries are comprised of two large offshore projects, Zohr and West Nile Delta (BP), in addition to the smaller Noroos (Eni) and Atoll (BP) fields that should jointly produce around 5bcf/d at plateau representing 1.1x Egypt's current total gas production.

More investments are needed

The first and foremost constraint is large domestic demand that caps the gas surplus available for export. The prime consumer of gas is electricity generation, which burns 60-65% of Egypt's gas output. Gas consumption is dependent on both structural trends in demand and availability of energy for end-users. While gas consumption markedly rose during the first half of the 2000s (+12% CAGR in 2000-05), it has been almost stable since 2011 given shortages (+1% CAGR in 2011-15). The key factor driving electricity consumption is population growth because two-thirds of power output is consumed by residential and commercial customers. Population growth (+2.2% annual average in

2000-15) is one of the highest in the MENA region, a trend that is likely to last beyond the medium term due to Egypt's youth boom (one-third of total population is under 14). Another source of gas demand is gas-intensive industry (steel, fertilizers), which is expected to return to full utilisation in step with the economic recovery. Here, Egypt has to choose between exporting surplus gas in either LNG in order to accumulate fx reserves or industrial forms in a way that maximises factors of economic development such as employment and industrial integration.

Pursuant to demand management, Egypt is challenged to manage gas supply. Some producing legacy gasfields suffer from high rates of decline in production (12% annual average). While the four key offshore discoveries are being fast-tracked, they have varying production plateaus ranging from 11-18 years (Atoll, Zohr) to much shorter 3-5 years (Noroos, West Nile Delta). Replacing declining offshore production necessitates further exploration investments to proactively sustain Western Desert production that should start naturally declining in 2-3 years, albeit at smoother rate.

Under the conservative assumption that gas consumption will grow by 4% per annum on average in the medium term and a production to peak in 2021 and decline afterwards, Egypt's capacity to export gas may not last beyond 2022. Even if such production forecasts are considered conservative, we believe that Egypt can sustain gas exportation only if further discoveries are made and subsequently developed. That is partly achievable if EGPC arrears are repaid on a regular basis to provide the needed certainty for private E&P investments.

CPI inflation is very high

CPI inflation is structurally high. Average inflation reached 10% on average during 2005-15. This is mainly due to several constraints on supply chains, to vulnerability to commodity prices (Egypt is the first world wheat importer) and exchange rate.

Exchange rate movements are crucial

There is significant exchange rate pass-through to inflation. Analysis of the period from 2003 to 2015 by faculty members of Cairo University and the CBE² showed that relatively little of this happens through a direct effect on the price of imported goods; more significant transmission occurs through an indirect effect via the increase in the prices of semi-finished goods and commodities, which feeds through into production prices and then consumer prices. This mechanism is particularly due to the existence of few sizeable domestic manufacturers across consumer goods segments. According to the authors, this transmission is not immediate, and persists over a two-year period. Moreover, the level of transmission is considered as incomplete, due to the existence of numerous goods for which prices are controlled.

² Omneia Helmy, Mona Fayed, Kholoud Hussein, 2017, *Exchange rate Pass-through to Inflation in Egypt: A Structural VAR Approach*, 37th Annual meeting of the Middle East Economic Association.



From November 2016, the increase in consumer prices has been incremental rather than immediate, but it has been substantial. The scale of the EGP depreciation is clearly a decisive factor. After the pound was allowed to float in 2003, its depreciation relative to the USD was fairly modest (13% after one year, and 25% after twenty months), whereas it immediately fell 50% following the decision to let it float in November 2016.

In addition, the level of transmission has varied since 2003 due to more structural factors. The share of imports in GDP is currently much higher at 21% compared to 14% in 2003 in real terms. We can also assume that over the medium term this figure will be higher, given the tight restrictions on the availability of foreign currencies that hampered importers over the quarters preceding the EGP liberalisation in November 2016.

Another factor affecting the degree of transmission is the reaction of companies to the currency depreciation. Schematically, faced with higher import costs they need to choose between maintaining their margins or their market share. One determiner of this choice can be the scale of any depreciation. A modest change would be easier to absorb in terms of costs, and the depreciation in March 2016, of around 13%, did not result in a significant rise in inflation. After the depreciation in November 2016, on top of the increase in prices for imported factors of production, most private corporates in the formal sector raised wages (by 10-20%), making an increase in selling prices necessary. Another more structural factor influencing inflation relates to market organisation, and specifically the level of competition in the consumer goods sector.

Contributions to CPI inflation

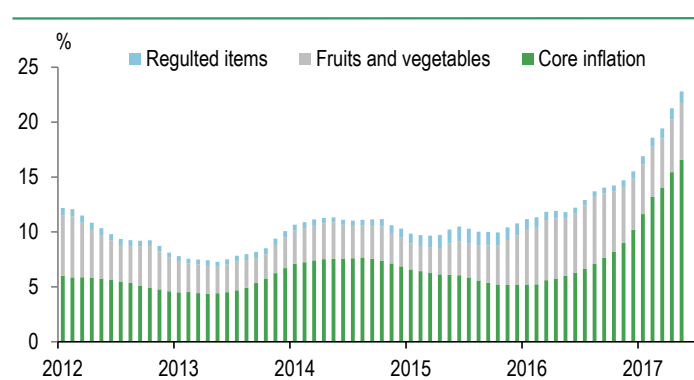


Chart 12

Sources: CBE, BNP Paribas

Limited competition in the consumer retail market

We believe that limited competition in the consumer goods market, and specifically food retail, is a major driver of inflation. Food is a crucial item as it represents circa 34% of average household expenditure as well as 31% of the inflation basket (excluding seasonally-fluctuating fruits and vegetables). It appears that control over distribution channels (up to and including a certain level of integration) is a key determining factor for producers in setting their pricing strategies. Companies may have direct control over part of their distribution channels and/or be

mainly distributing through traditional circuits (local shops) in which they have higher control over selling prices. The modern retail sector (e.g. super- and hypermarkets) is expanding rapidly as demonstrated by recent entry of major regional supermarkets to Egypt³. However producers tend to favour traditional distribution channels. Their products are present in supermarkets, but there is a real desire to limit the share that this represents, in order to protect pricing power. This strategy is made possible due to relatively low competition in the domestic market. According to the latest World Economic Forum report on global competitiveness, Egypt ranks 112th (out of 138) in terms of the efficiency of the market for goods and 127th on the "intensity of domestic competition" sub-component. In a certain number of markets for consumer goods, particularly food, local producers hold the bulk of market share and the role of multinationals remains fairly marginal. Following the EGP depreciation there is anecdotal evidence that some price hikes in certain consumer good categories may have gone beyond covering the rising cost of intermediate imported goods allowing producers to make up lost ground after several years of relative price stability. Limited competition in the consumer retail market may also explain the persistence of high inflation over a long period, even when production capacity is not fully utilised. The expansion of modern supermarkets in Egypt may therefore promote competition and relieve inflation, but also threaten producer margins.

Trends in fiscal policy

In H2 2016, the reduction in energy subsidies was another important factor of consumer inflation. Petrol prices were more than 100% higher than in 2014, whilst increases in electricity prices ranged from 29% to 124% depending on the consumption tier. The monetisation of the budget deficit, by expanding the money supply, may be inflationary, but this factor does not appear decisive. This monetisation⁴ was fairly substantial in 2015 but was reduced in 2016. In more general terms, we are not seeing an uncontrolled expansion of money supply. The M2 aggregate as a percentage of GDP rose only slightly – from 76% to 80% – between late 2014 and March 2017.

In the short term, consumer price inflation is likely to remain elevated. CPI inflation reached 23.7% in FY2016/17 and almost 25% is expected in FY2017/18. Further subsidy cuts, the persistence of imported inflation and a possible upturn in domestic demand are all likely to continue driving inflation. Higher energy and farm product prices on international markets should also be considered, although oil price recovery is likely to be subdued in the medium term. The resources available to the government and the CBE to tackle inflation are currently limited. The effectiveness of the interest rate lever is limited by the low adult bankability ratio (less than 15%), whilst, up to now, the CBE's exchange rate policy focuses on building up forex reserves in order to protect against possible tensions. The recent EGP appreciation could signal a change in this policy.

³ In 2013-2016, leading MENA supermarket groups entered Egypt such as Lulu, Panda, Al Othaim and BIM in addition to the expansion of existing foreign players such as Carrefour and Spinney's.

⁴ CBE gross claims on the government reached 70% of GDP in 2015/16 against 52% in 2012/13. They currently reach 66% of GDP



Recovery to be confirmed

Investment and exports fuel growth

In a restrictive fiscal environment, economic activity in the second half of fiscal year 2016/17 was driven by the positive dynamics created by economic reforms. According to the government, real GDP growth is expected to reach about 4% in 2016/17, compared to the previous year's performance of 4.3%. One growth engine was investment, bolstered notably by foreign investment in the energy sector, and by a very buoyant construction sector. Private consumption, the main growth engine, remained rather resilient, even though it was curbed by high inflation.

This momentum is expected to be confirmed in the short term, albeit without fuelling a real acceleration in activity. Although the impact of inflation on the disposable income of low income households can be partially offset by social welfare transfers, it severely erodes the purchasing power of the middle class. This category of the population is a big spender on imported consumer goods (such as cars), but also on education and healthcare services in the private sector, the costs of which are rising rapidly. This means they will have to hedge their purchases, which could end up having a negative impact on the overall level of consumption.

As to investment, sharply higher interest rates will scale back the investment decisions of national companies, at least in the short term. For the moment, the increase in foreign direct investment is still concentrated in the energy sector. Excluding the energy sector, non-resident investment decisions are generally made by companies that are already present in the Egyptian market, and many foreign companies are taking a wait-and-see approach. An increase in public investment, which is one of the government's priorities, could provide additional support. Investment expenditure accounts for only about 10% of total fiscal spending, or 3.5% of GDP. Lastly, the net export contribution could provide non-negligible support for activity in 2017/18. Non-oil sector exports should regain competitiveness, but above all, imports are likely to contract for three reasons: 1) the unfavourable currency effect, 2) government restrictions on importers, and 3) the start-up of production at natural gas fields, which should reduce hydrocarbon imports. All in all, we expect growth to accelerate to more than 5% in the medium term.

Mixed medium-term prospects

Yet, looking beyond short-term trends and the rebound in growth since 2011, there are reasons to doubt the Egyptian economy's capacity to reach sustainable growth strong enough to create sufficient jobs and to reduce the role of the informal sector. According to the International Institute of Finance (IIF)⁵, Egypt's potential growth rate has been declining for the past ten years, to 3.5% presently, from 4.4% over the period 2007-10. This decline can be attributed to both the slowdown in

investment (even though it has picked up as a share of GDP since 2014) and the significant decline in total factor productivity. Reforms to the business climate are currently underway, including a new investment law, and major capital expenditures have been made, notably in infrastructure and energy production. Even so, some key factors for boosting productivity, such as improving employability through spending on education, seem to be missing, at least for the moment, from the economic reform programme.

Contributions to real GDP growth

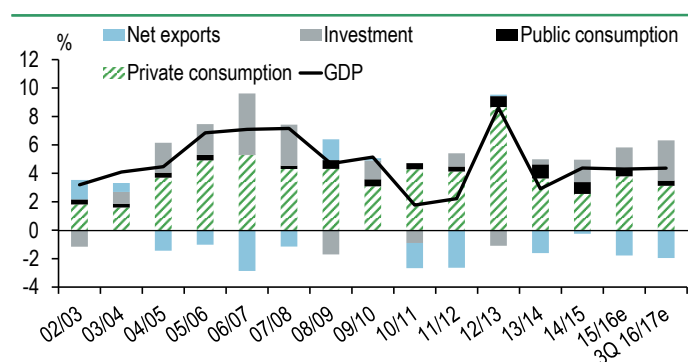


Chart 13

Sources: Ministry of Planning, BNP Paribas

What are the main vulnerabilities?

The year 2017 is a transition year for the Egyptian economy. Through major economic reforms, the authorities are aiming to foster a sustained recovery in a stabilised macroeconomic environment. Three factors threaten this scenario: persistent political risks, the difficult coordination of economic policy, and international market fluctuations.

Political tensions

Egypt, like the Middle East region as a whole, is plagued by political tensions. The tourism sector has virtually collapsed since 2011. The number of tourists has plunged from 15 million a year in 2010 to 5.4 million in 2016. We can see a timid recovery in this sector (+11% at an annualised rate in Q3 2016/17), thanks notably to the reopening of certain air routes. Some routes have not reopened yet (Russia, for example), and the development of new tourism business (China) is a very gradual process.

For the moment, the political crisis between the Gulf States (Egypt is a partner in the coalition behind the Qatar embargo) is having only a limited impact on the Egyptian economy. Yet the crisis represents a potential economic risk given Egypt's strong presence in Qatar (about 250,000 Egyptians work in Qatar, mainly in skilled jobs). Tighter sanctions could trigger retaliation from Qatar. Yet the relative dependence of the two economies limits such an outcome: Qatar is present in certain key sectors of the Egyptian economy (industry,

⁵ G. Iradian, Y. Yakhshilnikov, B. Markovic, 2017, Egypt research note. "Major adjustment is underway", IIF.



banking), and needs Egypt's skilled workforce to keep parts of its economy running smoothly.

The right balance for economic policy is difficult to find

Over the course of fiscal year 2017/18, it will be no easy task to coordinate short-term monetary policy goals (boosting bank liquidity and reducing inflation) with medium-term fiscal reforms. The fiscal situation is still fragile, and a sharp increase in CBE interest rates could have a very negative impact on debt service, and in turn on the dynamics of consolidating public finances in the medium term. For the moment, foreign investors are attracted by higher yields on government securities. But 2018 is an election year, which tends to encourage the easing of fiscal consolidation, as can be seen in numerous countries under similar circumstances. It will be important to monitor the duration of monetary tightening, which a priori should be only temporary.

Tourism activity

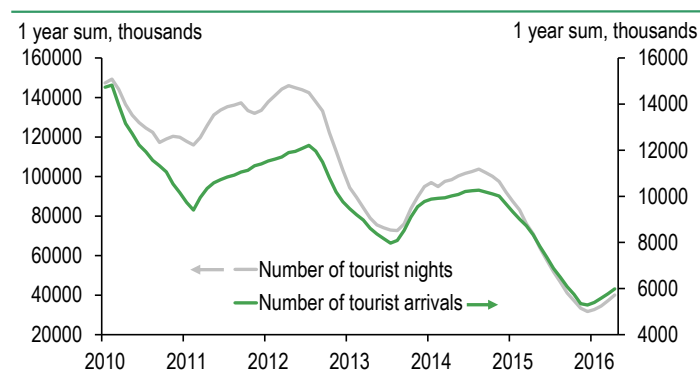


Chart 14

Sources: CBE, BNP Paribas

Vulnerability to international markets is changing

Egypt's vulnerability to fluctuations in global hydrocarbon prices has ebbed due to the big increase in natural gas production and investments in electrical power generation, which has improved its energy efficiency. Moreover, the reduction in energy subsidies, with the goal of recovering costs in the medium term, will reduce the vulnerability of public finances to oil price fluctuations.

Yet, floating the pound and raising interest rates expose external accounts to the volatility of international capital flows. Currently, Egypt is the second most attractive country for carry trade operations, after Argentina. These flows could become more volatile if the pound continues to appreciate in the quarters ahead, or if interest rates begin to decline.

Conclusion

Faced with an increasingly alarming macroeconomic situation, the Egyptian authorities have opted to launch massive, rapid reforms with the support of the international financial community. The first goals have been met: to restore the country's foreign-currency liquidity and reverse the deterioration of public finances. Yet other imbalances have emerged: in an economy with a low level of bank penetration, the massive increase in interest rates did not bring down inflation, but increased the cost of servicing the public debt.

During this transition year, there is a risk that too many incompatible reforms will be launched all at once. The key is to strike the right balance between monetary policy goals and fiscal reform targets. For the Egyptian economy, the way out of this delicate situation is to return to sustainable, diversified growth. This can only be achieved through the combination of strong household consumption and accelerated productive investment.

Completed on July 13, 2017

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 Registered Office: 16 boulevard des Italiens – 75009 PARIS
 Tel: +33 (0) 1.42.98.12.34 – Internet :
www.group.bnpparibas.com
 Publisher: Jean Lemierre. Editor: William De Vijlder
 Printed in France by: Ateliers J. Hiver SA – October 2015
 ISSN 0224-3288 – Copyright BNP Paribas



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