N°31 | JUNE 2016

ECONOTE

Societe Generale
Economic and sectoral studies department

FRANCE: A PRIVATE SECTOR IN BETTER FINANCIAL HEALTH, DESPITE HIGHER DEBT

— Unlike the majority of other developed countries, the debt-to-GDP ratios of households and non-financial corporations have continued to increase in France since 2008.

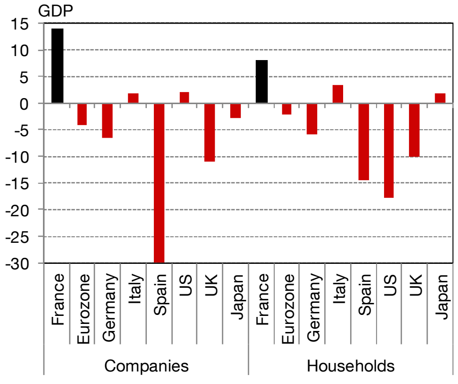
— In particular, companies suffered from the continued deterioration in their margins and therefore their self-financing capacity until end-2013. In the case of households, their debt has continued to be driven by the absence of a significant correction in housing prices and in activity in the secondary market. This has prompted them to take advantage of increased borrowing capacity generated by the decline in interest rates.

— That said, despite still modest growth, the financial situation of both households and companies has improved recently. In 2015 in particular, the profit margin ratio of non-financial corporations (NFC) rebounded, while the purchasing power of households' disposable income posted its sharpest rise since 2009.

— In fact, short-term supporting factors have been numerous: depreciation of the euro, decline in interest rates, plummeting oil prices. Targeted measures to reduce the taxes and social security contributions of companies and, to a lesser extent, of households, have also supported their financial situation.

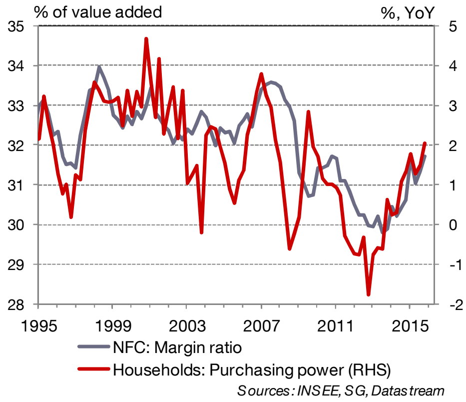
— The risks related to the increased debt of companies and households therefore have to be put into perspective, even if they cannot be entirely discarded. The risks relate notably to a sharp rise in interest rates or an upturn in taxes.

CHANGE IN DEBT RATIOS Q4 2008 - Q4 2015



Source: Bank of France

COMPANIES' MARGIN RATIO AND HOUSEHOLDS' PURCHASING POWER



Sources: INSEE, SG, Datastream

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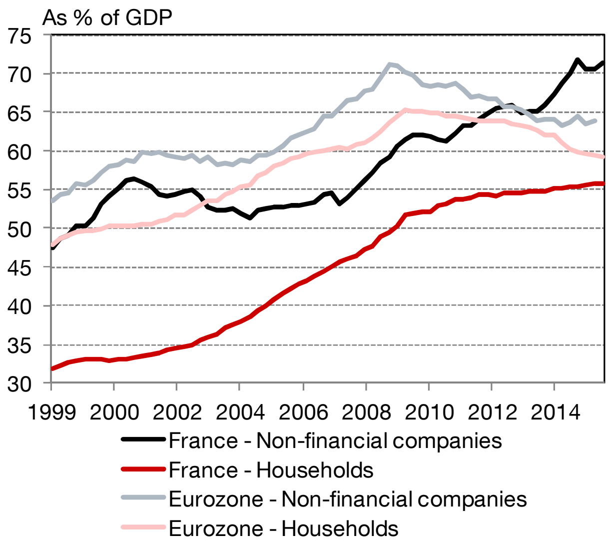
THE CONTINUED INCREASE IN DEBT RATIOS OF HOUSEHOLDS AND COMPANIES IN FRANCE…

The Great Recession of 2008-2009 marked the beginning of a debt reduction trend among companies and households in most of the major developed countries, including in Europe. However, France stands out from this global trend. Not only has there not been a reduction in the debt-to-GDP ratio of French non-financial private agents since 2008, but it has continued to rise recently.

Chart 1: DEBT RATIOS

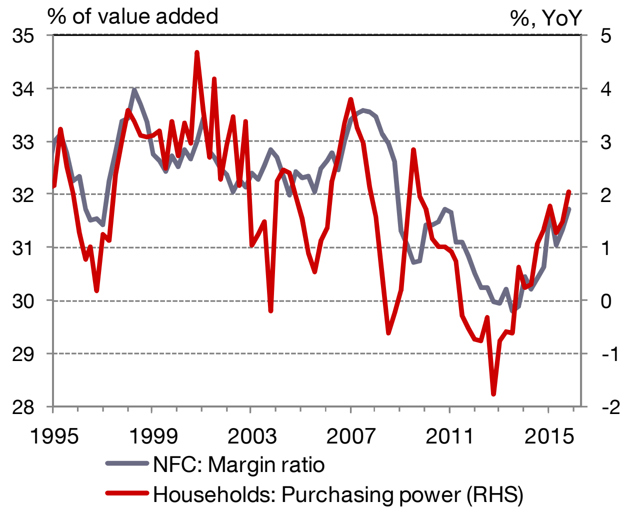


Source: Bank of France

The continued increase in the debt ratios of both households and companies has resulted from different factors.

- **Companies[1] have faced a major deterioration in their profit margins from 2008.** This deterioration has resulted from sluggish sales volumes, which have in turn increased competitive pressures. However, these effects have not been offset by reductions in costs and charges. Companies have therefore been forced to resort increasingly to debt in order to finance investment, which has remained relatively high given lacklustre activity.
  Weaker profit margin ratios contrast sharply with the trends observed over this period in Germany or even in Spain. In addition, the ratio of non-residential private investment to GDP declined generally more and then remained less dynamic in other Eurozone countries, including in Germany. In peripheral countries, this was accentuated by a credit crunch from which France was preserved.

Chart 2: COMPANIES' MARGIN RATIO AND HOUSEHOLDS' PURCHASING POWER



Sources: INSEE, SG, Datastream

- **For households however, the debt trend[2] has primarily reflected the absence of a full-blown property crisis and therefore prices remaining at a high level.** Second-hand transactions in the property market have indeed been broadly resilient despite the marked decline in construction. Households' debt capacity has also been underpinned, in recent years, by the decline in interest rates and the increase in the average maturity of new loans.
  Here again, the French situation has diverged from the situation in the rest of the Eurozone and, in particular, peripheral countries where housing crises have forced households to attempt to reduce their debt.

This continued rise in the debt of both households and non-financial corporations raises the issue of its sustainability and, in addition, the ability of French growth to accelerate without being dependent on increased leverage.

… NEEDS TO BE PUT INTO PERSPECTIVE DUE TO THE RECENT STRENGTHENING OF THEIR FINANCIAL HEALTH

The growth of debt in the non-financial private sector in France is striking compared with the trends in other developed countries, but the size of the debt needs to be put into perspective. Indeed, not only was its starting point moderate compared to peers, but more importantly the recent recovery in companies' profit

[1] *In this document, "companies" relates only to non-financial corporations.*

[2] *Nearly 80% of debt consists of home loans.*

margins and households' purchasing power is reassuring.

In fact, while the profit margin ratio of French companies reached its lowest level since 1985 in Q3 2013, it has recovered rapidly since (see chart 2). Apart from improved profit margins, other factors have also reinforced net profits, which enabled companies to increase their savings rate, in 2015, to the level of its previous peak in 2007. The capacity to self-finance investment has therefore improved. At the same time, for 2015 as a whole, households' purchasing power posted its sharpest rise since 2009.

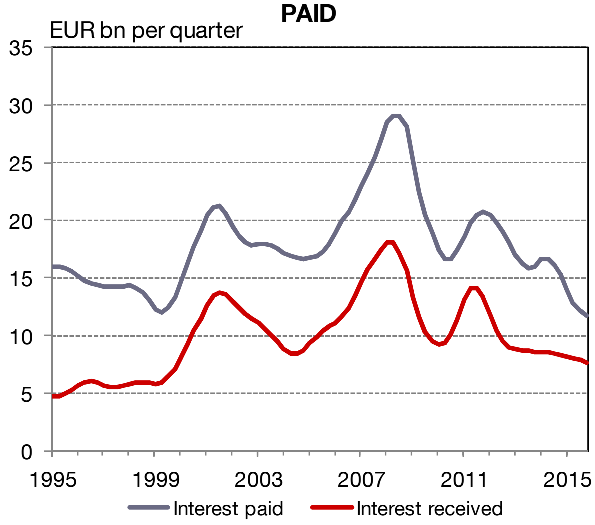
Indeed, several factors have helped to enhance these agents' ability to honour their debt and, ultimately, be less dependent on increased leverage.

ECONOMIC FACTORS HAVE SUPPORTED THE FINANCIAL HEALTH OF HOUSEHOLDS AND COMPANIES…

In 2014 and, especially, in 2015, households and companies benefited from three economic developments which enhanced their financial health.

Firstly, interest rates fell markedly following increased monetary easing by the ECB in 2014 and 2015[3], benefiting companies and households.

Chart 3: NFC: INTEREST RECEIVED AND PAID

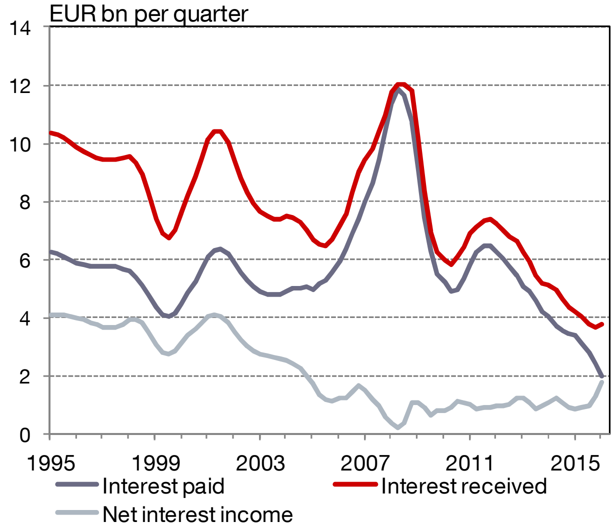


Source: INSEE

Accordingly, companies' net interest expense plummeted by -59% between its 2008 peak and 2015 (and by -39% during 2015 alone), despite the parallel increase in their debt.

Households receive more interest than they pay and therefore should have suffered from this situation. However, since 2014, interests paid by them have declined faster than interests received, due to the wave of mortgage renegotiations. In fact, in H1 2015, more than half of new housing loans was actually renegotiations, compared with barely more than 20% in 2014. In this respect, households' net interest income increased by EUR1.5bn between 2014 and 2015 (+33%)[4].

Chart 4: HOUSEHOLDS: INTEREST RECEIVED AND PAID



Source: INSEE

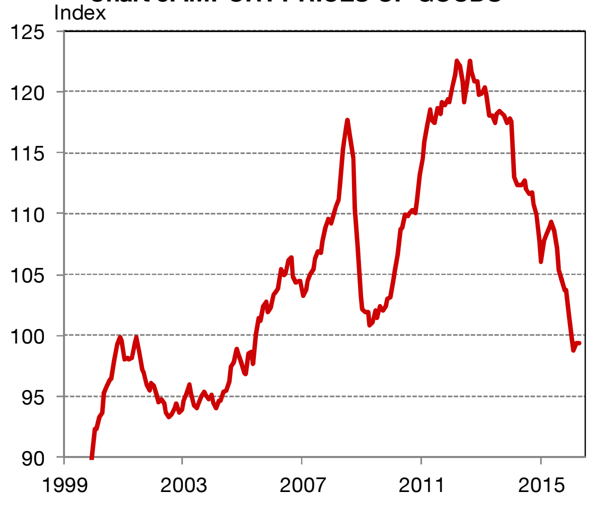
Plummeting commodity prices also had a very favourable impact for both companies and households. As a result, companies saved EUR14.2bn (or 1.3% of their value added) in 2015 on their spending on oil and gas products according to the INSEE[5]. For households, the saving amounted to EUR10.5bn, or 0.8% of their disposable income. Plummeting energy prices also helped reduce import prices to their lowest level since 2005.

[3] As from June 2014, the ECB again started to reduce its key interest rates (with a negative rate on the deposit facility rate) and launched very long term refinancing operations (TLTRO). In September 2014, ABS and covered bond purchases were announced, followed by the decision to extend these purchases to public securities in January 2015.

[4] If we include life insurance income, this net income stagnated in 2015 compared to 2014. Net interest income can also be partially bolstered by an increase in financial savings outstanding, or dampened by increased debt.

[5] French National Institute of Statistics and Economic Studies

Chart 5: IMPORT PRICES OF GOODS



Source: INSEE

The euro's weakness constituted a last supporting factor more specific to companies. It enhanced the price competitiveness of exporters, as well as that of producers facing international competition in the domestic market. Moreover, in 2015, French exports posted their biggest increase (+6.0%) since 2011, despite the slowdown in international trade. Admittedly, the depreciation of numerous emerging country currencies in 2015 and at the beginning of 2016 has reduced the profits generated by subsidiaries situated in these regions and repatriated to France, but this mainly concerns major international groups.

… AND HAVE BEEN REINFORCED BY FACTORS WITH MORE STRUCTURAL EFFECTS

In addition to these favourable factors (but whose effects are temporary), French households and companies have benefited from an *a priori* lasting reduction in the tax burden, especially since 2015.

For companies in particular, the ramping up of the CICE[6] and the cuts in employers' social security contributions on low wages within the framework of the Responsibility pact represented an additional saving in 2015 compared to 2014 equivalent to 1.1% of their value added[7].

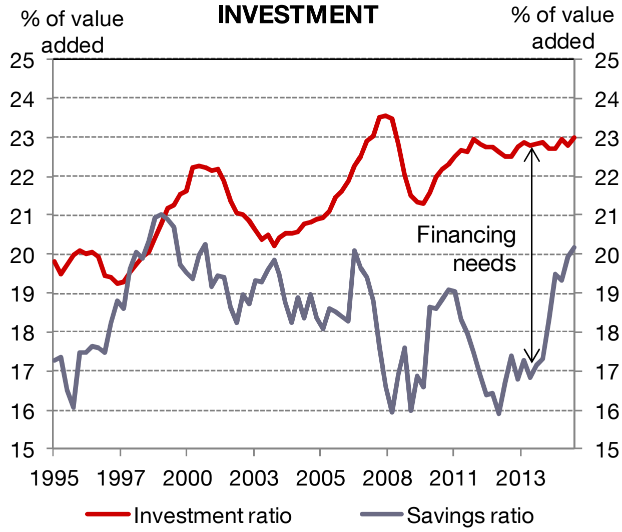
Not only are such measures longer-term by nature but they continue to be reinforced. Indeed, on 1 April, the second tranche of the cuts in social security contributions related to the Responsibility pact came into force, reducing by 1.8 percentage point the employers' contribution rate on wages between 1.6 times and 3.5 times the minimum wage (for a full year amount of EUR4.2bn, or 0.4% of value added).

For households, the change in taxation also bolstered their disposable income in 2015. In particular, low-income households benefited from the removal of the first tranche of income tax as from their 2014 income[8]. In this respect and despite the gradual strengthening of economic growth, income tax receipts increased by only EUR300m last year, i.e. their lowest increase since 2009.

TOWARDS A PROBABLE SLOWDOWN IN PRIVATE SECTOR INDEBTEDNESS

While the improvement in the financial situation of both companies and households reinforces the sustainability of their current debt, it could also reverse the upward trend in their leverage.

Chart 6: NFC: SAVINGS AND INVESTMENT



Sources: INSEE, SG

For companies in particular, the increase in their margin ratio and their savings improves their self-financing capacity and therefore reduces their need for credit, at an unchanged investment rate. As it happens, this investment rate is unlikely to increase significantly over the next few years since it is already at a high level.

This is less true for households. Indeed, they still seem to be inclined to use low interest rates to further increase their recourse to housing loans (see chart 7). As a result, indicators focusing on the property market (rise in building permits and housing starts in particular) suggest that new housing construction is set to start to gradually pick up in 2016. The property market would

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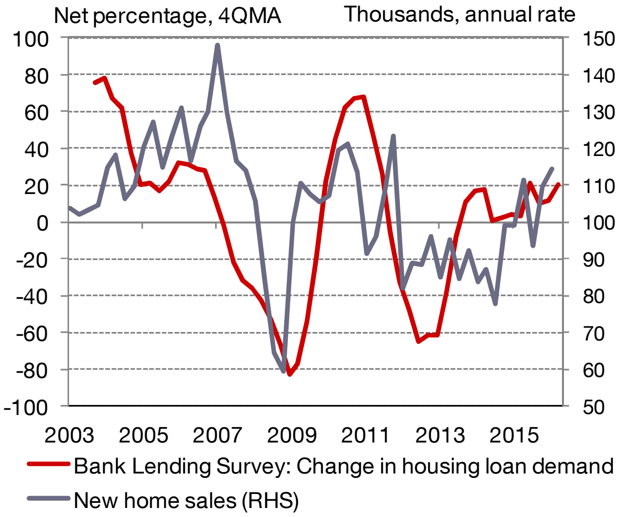
[6] *« Crédit d'impôt pour la compétitivité et l'emploi » or tax credit for competitiveness and jobs*

[7] *In particular, EUR12.2bn of CICE was consumed in 2015 by companies, or EUR5.8bn more than in 2014.*

[8] *This removal was made neutral for most other taxpayers through modifications of remaining income tranches.*

therefore no longer be only underpinned by transactions in the second-hand segment.

Chart 7: NEW HOME SALES AND LOAN DEMAND



Sources: Datastream, Bank of France, SOeS

THE SUPPORT OF THE ECB WILL REMAIN KEY AS LONG AS ACTIVITY AND INFLATION HAVE NOT TAKEN OFF

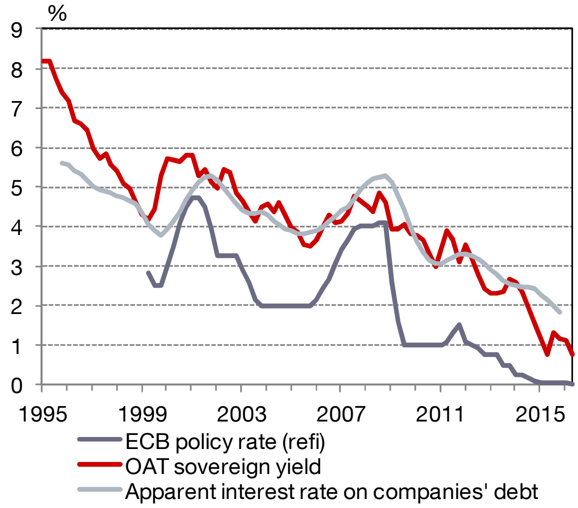
However, the current improvement in the financial situation of French companies and households must not obscure the longer-term risks related to the now larger size of their debt.

Indeed, a reversal in the temporary supporting factors mentioned above remains possible: substantial rebound in oil prices, rise in interest rates, etc.

Admittedly, if such a rise in interest rates occurred as a result of an acceleration in growth and inflation, boosting the income of households and companies, it would not necessarily be worrying. Moreover, the prevalence of fixed-rate mortgage contracts limits households' exposure to the interest rate risk.

That said, in the event of a shock on risk premiums or too early withdrawal of monetary support by the ECB, there could be an upturn in interest rates without a parallel rise in the nominal income of households and companies. Companies are actually sensitive to the interest rate risk as an important part of their debt is short-term and it is more frequently at variable interest rates. Indeed, the apparent interest rate on their debt has, historically, moved in line with the ECB's key rates and the interest rates on French sovereign debt.

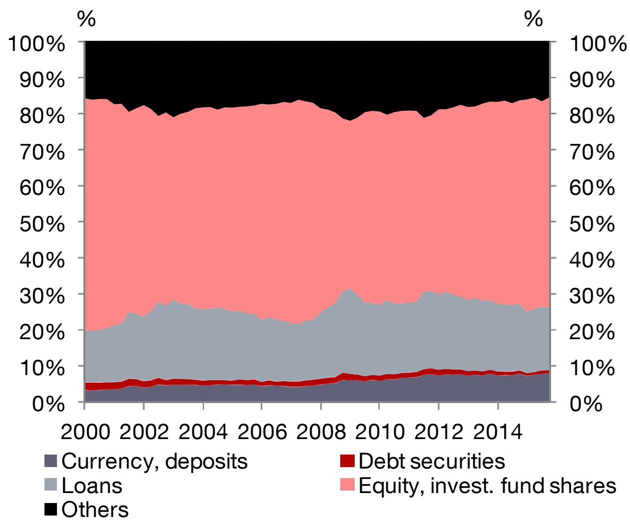
Chart 8: APAPRENT INTEREST RATE FOR COMPANIES AND POLICY RATE



Sources: Datastream, INSEE, SG

For French companies, the presence of such risks, in addition to uncertainties over growth and global political risks, also strengthens their propensity to save for precautionary reasons. This precautionary saving translates into increased preference for liquid assets. Indeed, whereas the proportion of liquid funds[9] in companies' financial assets was 7.2% in 2007, it had climbed to 9.4% (EUR618bn) at end-2015.

Chart 9: NFC: OUTSTANDING FINANCIAL ASSETS



Source: Eurostat

However, this increase was much less significant in Germany since it went from 10.8% to 11.3% (EUR465bn) over the same period. That said, it is important to highlight that the constitution of such liquidity buffers, which have also been facilitated by favourable borrowing conditions, reduces the financial

[9] *Currency, deposits and money market fund units.*

vulnerability of companies, by moderating their net debt.

In light of this increased precautionary saving, the consolidation of the recent trend towards an improvement in the financial situation of these companies is essential to bolster their confidence and therefore their propensity to invest.

In particular, given the sensitivity of these companies' debt burden to the ECB's key rates, the clear commitment of the ECB to maintaining an extremely accommodative monetary policy is therefore particularly important. Similarly, any withdrawal of recent measures to cut taxes and social security contributions, against a backdrop of continuing modest economic growth, would represent a significant risk for the financial health of French companies.

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