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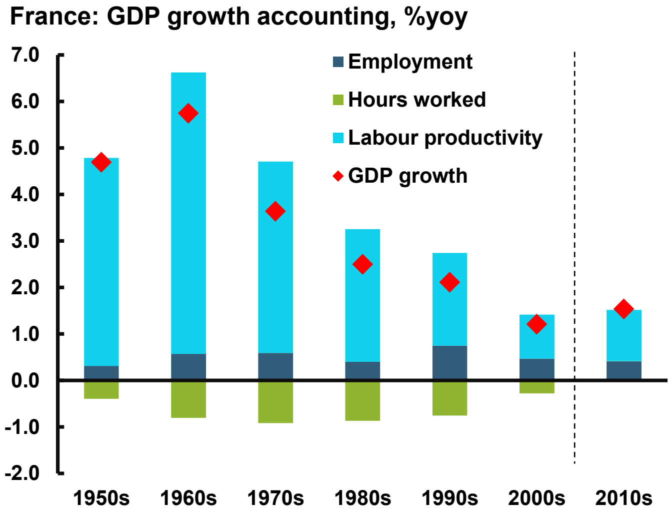
France: not yet out of the woods

The twin crisis seems not to have materially impacted the medium-term outlook for France. But this is no reason to cheer.

Key points

- France has weathered the crisis better than most of its peers. But the recovery remains sluggish and feels nearly as painful as the recession.
- A key impediment to growth is the poor shape of the corporate sector. Dynamic input prices and high taxation are weighing on profitability and fuelling a vicious cycle of competitiveness.
- Another impediment is labour market inefficiencies. Even if the crisis does not have long-lasting consequences, we estimate the structural unemployment rate at 9%.
- We expect potential growth for the medium term of around 1.5%, up slightly from the last decade. The output gap stands around 2%, and when it closes will provide modest support as from 2015.
- Structural reforms aside, economic policy requires clear choices. Having a model for France's integration into globalisation would help replace 'managing the decline' by 'making way for the future'.

Exhibit 1
Potential growth: down, down, down, up?



Source: INSEE and AXA IM Research

Lame duck forever

As the recovery takes hold and markets give a warm welcome to the former pariahs from the European periphery, an air of optimism is spreading across the euro area. But one country still stands out, France, where doom and gloom are firmly rooted. Although the country weathered the subprime and sovereign crises well compared with its peers, both from a market and an economic perspective, the recovery has been sluggish and feels nearly as painful as the recession. Outside observers point to the lack of reform and serial fiscal slippages. Inside, a sense of secular decline and structural inertia is undermining animal spirits and trust in the future.

In this article, we review recent developments affecting the medium-term economic prospects of the French economy, in particular firms' competitiveness, the labour market and productivity. In a subsequent analysis, we will take a closer look at the fiscal outlook and its impact on growth, and make the connection to the French sovereign bond spread.

French companies are breathing thin air…

A number of studies[1] have shown that French firms' competitiveness has been eroding continuously for the past two decades. This is evident in the decline of France's market share of global trade (from 6.7% in 1990 to 3.5% in 2012). French companies tend to specialise in medium- to high-technology goods but remain in the median in terms of quality. This has two consequences: i) **price-competitiveness is broadly in line with peers** across developed markets, although probably slightly lower than Germany's, but ii) **non-price competitiveness is weak**, due to the low level of innovation. The 2010 Community Innovation Survey shows that about 55% of French manufacturing firms introduce some kind of innovation into their products, compared with more than 80% in Germany and 60% for the EU15 average.

This vulnerability has to be seen in the context of quickly rising input prices. First, labour costs have risen faster than productivity: unit labour costs have grown about 45% since 1990. This is related to the structure of the labour market, with factors such as a minimum wage that is high and rising faster than inflation, a spill-over effect from the public sector, high employment protection for permanent workers, and the tax wedge (see below). But less well-known is the rise in prices for intermediate goods and services: French companies have faced a long-term scissor effect where output prices have not kept up with input prices. **The consequence has been a continuous compression of margins, hence a steady erosion in profitability – mostly in the industrial sector – since the early 1990s**.

Another factor weighing on companies is taxes. Considerable attention has been paid recently to employers' social contributions. And rightly so: in France they account for 11.6% of GDP (2012 figures), compared with 6.75% in Germany, 9.3% in Italy and 8.4% in Spain. But this is only part of the story: a study from Coe-Rexecode[2] shows that total taxes on production reach 17.5% of GDP in France versus less than 10% in Germany. These numbers bring some perspective to the recent €30bn in cuts to employers' social contributions, announced as part of President Hollande's "Responsibility Pact". **Bringing the level of taxes on production down to where they are in Germany would require cuts of no less than €150bn**.

Paradoxically, the delicate position of French companies has not translated into less investment. Quite the opposite: the corporate investment rate has tended to rise since the mid-1990s. But this does not necessarily mean good news. Because labour costs are rising faster than labour productivity, **companies are actually substituting capital for labour and moving toward more capital-intensive product mixes**. Also contributing to this substitution is a parallel decline in the cost of capital over the period.[3]

… and are highly leveraged

This shift in the production function, combined with low profitability, has led to a **strong increase in companies' leverage**. Financial liabilities of French non-financial corporations amounted to 120% of GDP in 1995, close to their German counterparts, but they now stand at 225% of GDP (vs. 150% in Germany). High levels of debt mean vulnerability to potential rises in interest rates in coming years, as higher debt service would hurt profitability further.

The other caveat to a high headline investment rate is that firms are not necessarily expanding or innovating. In fact, the INSEE investment survey shows that a large and increasing share of investment goes to renewing or rationalising existing capacity, while only about 20% is allocated to innovation and equipment modernisation (*Exhibit 2*). This is partly explained by the shorter investment life cycle, especially for IT. But that's not all. French companies give priority to investments aimed at optimising operations but are not profitable enough to make uncertain investments in innovation. Here starts **the vicious cycle: low profitability leads to low innovation, more pressure to rely on price competitiveness, and hence even lower profitability**.

[1] See for example Quel positionnement "hors-prix" de la France parmi les économies avancées ?, Lettre du Trésor, January 2014, or L'industrie : quels défis pour l'économie française ?, Lettre du Trésor, February 2014.

[2] Réforme fiscale et retour de croissance, Coe-Rexecode, February 2014.

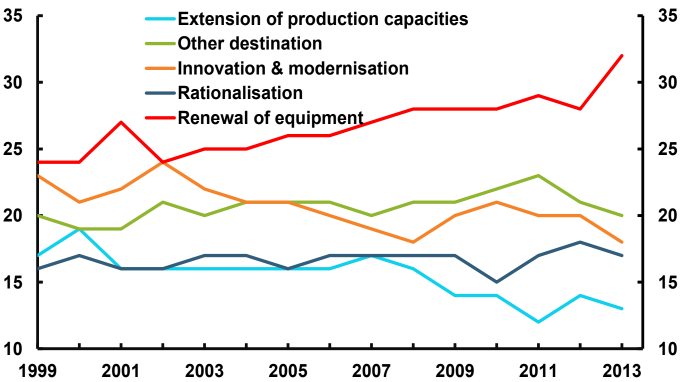
[3] For more details, see En France, l'investissement des entreprises repartira-t-il en 2014 ?, INSEE Note de Conjoncture, December 2013.

What could break this cycle? From a policy perspective, a narrow objective of job creation would ultimately make labour costs decline relative to the cost of capital. This can be achieved by cutting social contributions (the thrust of the “Responsibility Pact”) or through deeper labour market reforms. But a broader objective of making companies more profitable to stimulate both job creation and competitiveness has many more levers: corporate tax, deregulation in goods and services markets so as to reduce other input prices, and cutting red tape and administrative costs (the “simplification shock” launched by the government in 2013).

Exhibit 2

More investment does not mean more growth or jobs

France: business investment by destination, % of total investment



Source: INSEE and AXA IM Research

Labour market: inefficient but steady

The double crisis that started in 2008 has taken its toll on the French labour market. On Eurostat’s harmonised definition, the unemployment rate rose from 7.2% in early 2008 to 10.1% now. Arguably, the most shocking factor is not the increase over the past six years but rather the starting point: at the peak of the cycle, unemployment was still above 7%. This attests to the main issue facing the French labour market: **very high structural unemployment, probably around 9%.**

Reasons for this are well known and include the large tax wedge, substantial employment protection, a high and dynamic minimum wage, a large share of public employment, and a long eligibility period for unemployment benefits.[4] Last year’s reforms and this year’s Responsibility Pact are aiming at reducing some of these impediments to job growth, but they are modest in size and fail to address the multi-dimensional nature of the problem.

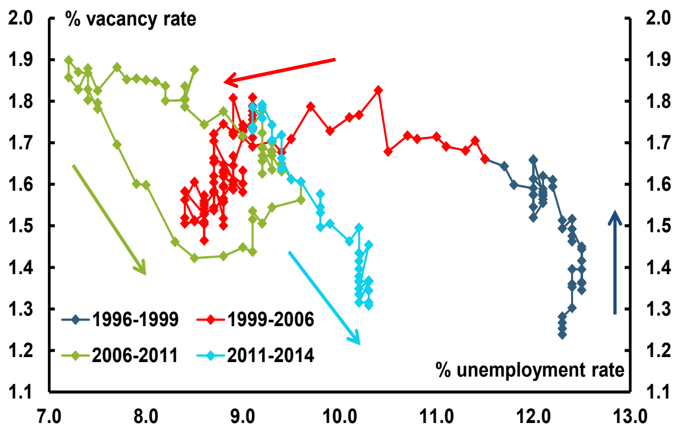
Interestingly, **recent developments do not suggest a structural deterioration of the French labour market.** First, drawing a Beveridge curve shows that the relationship between job vacancies and unemployment has been stable since 2008 (*Exhibit 3*). This suggests that the market’s job matching efficiency is not on the decline. Contrary to other countries in Europe, the crisis did not hit a single sector particularly hard, nor create larger imbalances between labour demand and supply. Job matching indicators such as the one constructed by the ECB[5] confirm this assessment: the labour force is as matched to labour demand today as it was before the crisis.

This is no reason to cheer, however. The situation may not have deteriorated since the onset of the crisis, but the starting point was poor in the first place. Also, two signs may prove worrying for the medium term. First, 22% of unemployed in May 2014 had been out of work for more than two years, the highest share ever; second, 22% of people in unemployment were aged over 50. When the job outlook brightens sometime in the second half of this year, or so we believe, the data will tell us more clearly how many permanent victims a temporary shock has made.

Exhibit 3

The labour market has not deteriorated since the crisis

France: Beveridge curve from 1996



Source: INSEE and AXA IM Research

Growing… potentially

Firms’ competitiveness and structural unemployment tie in closely with the question of potential growth, i.e. the economic growth that would materialise if all resources were used at full capacity. Using a variety of techniques to measure this unobservable concept, the IMF finds that **French potential growth rate has fallen from 1.75-2.0% in 1992-2007 to below 1% since 2008.**[6] Some of this marked deceleration has to do with the deep retrenchment in labour markets in recent years, but it remains to be seen how much of the decline is likely to be permanent rather than transitory.

A decomposition of GDP growth shows that most of the deceleration comes from steadily lower labour productivity

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[4] For details, see example OECD Economic Survey on France, March 2013.

[5] ECB, Euro area labour markets and the crisis, Structural Issues Report, October 2012.

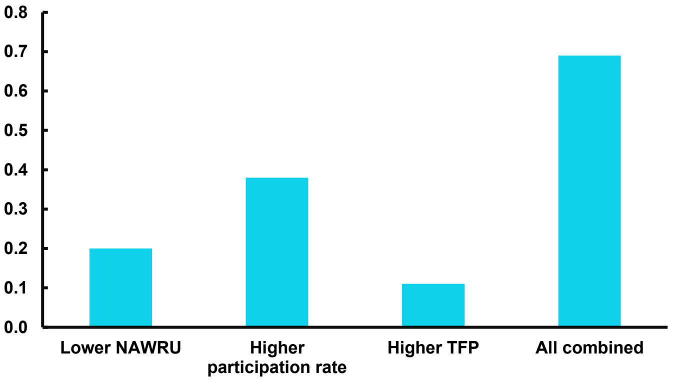
[6] IMF, France Selected Issues Paper, Potential GDP estimates for France: prudent (and calling for action), August 2013.

gains since the 1960s (*Exhibit 1*). Several factors are playing out. First, **a sector reallocation has worked against productivity growth**. The sectors where labour productivity growth is highest (agriculture, industry) have fallen as a share of GDP, while services generally generate lower productivity growth. The good news is that this structural downward pressure is likely to fade in future since agriculture and industry now account for a very small share of the economy.[7,8]

Unfortunately, intra-sector productivity growth has also slowed, in particular since the 2000s. Several reasons can be put forward, including lower productivity growth globally and in particular at the technology frontier (the US economy), a major boom-and-bust cycle in some sectors (construction, financial services), globalisation and the downward pressure on value added in several industrial sectors, and an increasing share of low-productivity services.

We have combined several assumptions for the next decade to get an estimate for potential growth in the 2010s. We use the INSEE projection for the active population until 2020 (0.4% p.a.), assume stable structural unemployment and constant weekly working hours, and add labour productivity growth using our assumptions for each large sector. The result, as shown in *Exhibit 1*, suggests **potential growth around 1.5% in the next decade, up slightly from the 2000s.**

Exhibit 4
Where do the growth levers lie?
France: deviations from baseline potential growth, in percentage points



Source: IMF and AXA IM Research

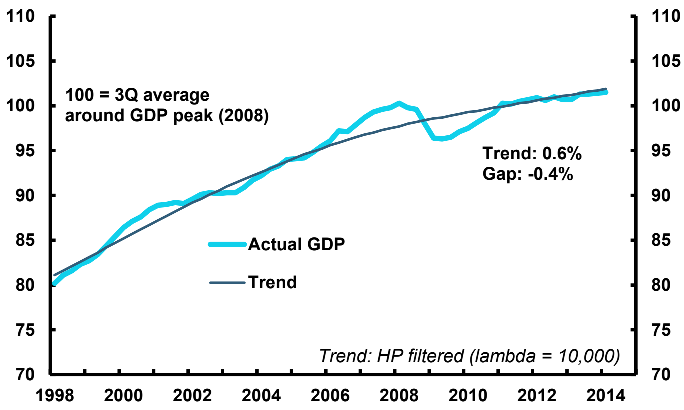
The risks around this baseline scenario are probably skewed to the upside, subject to reforms. The IMF, for example, whose central scenario envisages potential growth at 1.4% until 2018, highlights three reasons for a better outcome: lower structural unemployment, a higher participation rate and higher total factor productivity.[9] Interestingly, it sees the largest upside not in lowering unemployment but in bringing more people into the labour force (*Exhibit 4*).

How large is the output gap? Hard to say

The size of the output gap is far from just a theoretical question. Other things equal, a large (negative[10]) output gap suggests that GDP growth could exceed potential growth over several years without risks of overheating. The French Treasury's assumption for the government budget is that a 3.1% output gap by end 2015 will be reduced by half over 2016-2017, lifting GDP growth from 1.6% (potential growth) to 2.25% in both years. More conservatively, the EU Commission estimated the French output gap at 2.4% by the end of this year.

Unfortunately, the output gap is not directly observable and is highly model-dependent. One possible metric stems from estimates of trend growth by means of statistical filters. We perform these measures routinely on a large sample of countries for the sake of cross-country comparisons. On this measure, the French output gap looks negligible, at 0.4% (*Exhibit 5*). The main flaw of this methodology is that it depends not only on past but also on future data. If growth were to surprise on the upside in the coming years, a filter-based measure of the output gap in 2014 would increase, which obviously questions its robustness.

Exhibit 5
How large is the output gap? Not much, says the filter
France's GDP index



Source: INSEE and AXA IM Research

This is why we look at another measure, derived from labour market slack. Intuitively, a (negative) output gap should be consistent with an unemployment rate above its equilibrium

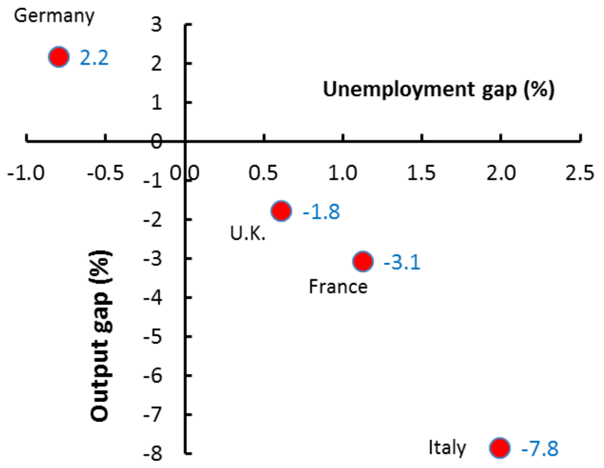
[7] By the way, the end of this inter-sector shift means that the trend decline in weekly hours worked should also fade.
[8] For more details, see Schreiber A. and Vicard A., La tertiarisation de l'économie et le ralentissement de la productivité entre 1978 et 2008, INSEE, 2011.

[9] IMF, France Selected Issues Paper, Potential GDP estimates for France: prudent (and calling for action), August 2013.
[10] In this note, we assign a positive sign to negative output gaps, for the sake of simplicity: a 2.0% output gap means that the economy is operating 2% *below* its capacity.

level. The link between the change in GDP growth and the associated change in the unemployment rate is broadly linear, an empirical observation made by Yale economist Arthur Okun back in 1962. If the Okun coefficient is stable, which it is according to a cross-country study by Laurence Ball[11], then the output gap can be easily derived from the unemployment gap. Following Ball's methodology[12] and using his own estimates of Okun's coefficients for France (as well as for Germany, Italy and the UK), we find that the French output gap was 3.1% at the end of 2013 (*Exhibit 6*), slightly wider than the EU Commission's estimate but narrower than reported by the French Treasury.

Exhibit 6

How large is the output gap? Around 3% says Okun's law



Source: Eurostat, EU Commission & AXA IM Research

Given the large divergence between the point estimates derived from the statistical and economic methodologies, **we believe the 'true' output gap should be somewhere in the middle, that is, it was around 2% at end-2013. For that reason, we are more cautious than the French Treasury about the medium-term prospects for GDP growth in France**.

Some soul searching to do

A concluding thought: France's structural problems are well known, and reports written over the years on how to address them could fill entire shelves. But what's lacking is perhaps the 'vision thing', a clear sense of direction to make sense of the changes so many experts demand. **A model for the next France would help replace 'managing the decline' by 'making way for the future'.**

A recent study on France in ten years' time gives a telling example.[13] Twenty-five years into globalisation, **France has not yet chosen between two alternative models of internationalisation**. On the one hand, the *industrial powerhouse* model is gaining plenty of traction in these times of everything-German-is-great. The idea for France would be to follow Germany's and Japan's examples in protecting and restoring its industrial base, reallocating resources, adapting the education system and returning to some sort of major projects based on economic dirigisme, as was the case in the post-war years. On the other hand, the UK and the US offer good examples of two of the world's *leading service economies*. Choosing that route would imply a very different set of policies: accepting the industrial decline and focusing on innovation, encouraging the brain drain, fostering competition in services sectors, reforming the healthcare and education systems and rethinking the administrative system to favour dynamic urban centres at the expense of the countryside.

In both cases, there is something to lose so that something can be gained. Call it creative destruction. But taking a particular direction makes the difference between choosing and enduring those losses.

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[11] See Laurence M. Ball, Daniel Leigh and Prakash Loungani, 'Okun's Law : Fit at Fifty ? ', NBER WP 18668, January 2013.

[12] The unemployment gap is the difference between the actual unemployment rate and the HP-filtered series (lambda = 100). In order to mitigate border effects, we have extrapolated the unemployment series using the EU Commission Spring 2014 forecasts. The Okun's coefficient estimated by Ball for France is -0.367.

[13] See Commissariat général à la stratégie et à la prospective, Quelle France dans dix ans ?, August 2013.

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