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A fair look at France

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Since the onset of the financial crisis, France has been experiencing weak growth and a high level of unemployment. France is considered "the sick man of Europe" in public debate and gets deluged with proposals. But what is the real reason for the current weakness in growth? What does it mean for the eurozone? What would be an appropriate economic policy strategy for the French government? What kind of support should the European partner countries provide? We take a look at potential causes of the crisis, and suggest solutions that go beyond the usual, standard explanations.

Causes of weak growth

A closer look at French economic development in recent years provides us with six insights – some of them surprising:

1) France's annual productivity growth is actually quite solid when compared to the rest of the eurozone. Since the introduction of the euro, the growth rate of total factor productivity – an approximate indicator of an economy's technological and organisational progress – has been between 0.5% and 0.8% in Germany, between 0.2% and 0.6% in France, but around the zero mark in Spain, Italy and Portugal (figure 1). Even in the European Commission's less favourable estimate, productivity growth is still above the eurozone average (albeit by a very small margin).

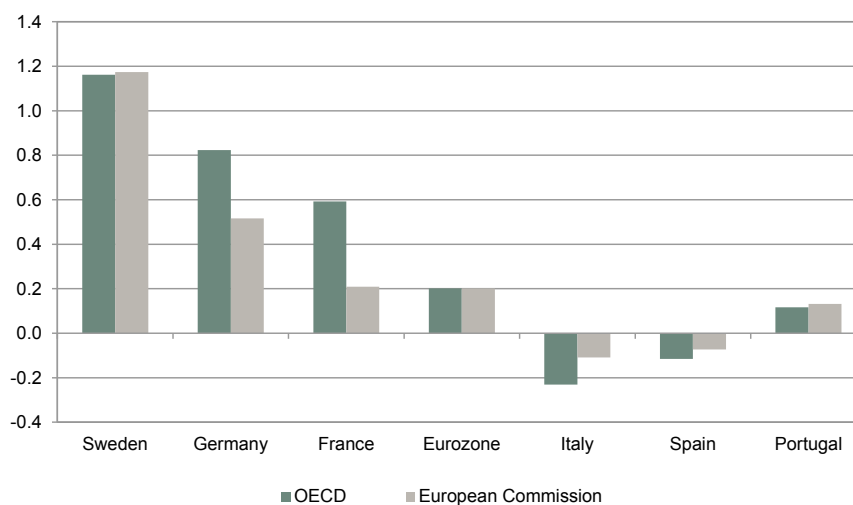
Solid productivity growth

As total factor productivity is the most important component of potential economic growth, the comparison could indicate that France's structural backlog is considerably less severe than in the Southern European countries.

2) Nevertheless, France currently suffers from a rather pronounced weakness in price competitiveness, which is reflected in a steadily declining current account position in the period 1999–2012. A remarkable aspect of this competitive weakness is that it is also a by-product of the strong divergence in wage policies in the eurozone. Table 1 compares the

growth of total hourly labour costs (wages+indirect labour costs) with the growth of labour productivity plus the ECB's target inflation rate for the four largest economies of the eurozone. The total of productivity growth and the target inflation rate is the scope for distribution for employment-neutral wage policies. While until 2008 labour costs in Italy and especially in Spain increased faster than productivity, which had already been low to start with, and the companies priced themselves out of the market, in France total costs were almost exactly in line with the scope for distribution. Moreover, labour productivity increased at a much more solid rate in France.

Figure 1: Total factor productivity, average annual growth rate 1999–2011, OECD and European Commission estimates



Sources: OECD, European Commission

Table 1: Annual productivity growth vs. increase in gross wages (per hour worked)

<i>Productivity growth + ECB inflation target ("scope for distribution")</i>	1999–2008	1999–2015*
Germany	3.1 %	2.8 %
France	2.9 %	2.7 %
Italy	2.0 %	1.9 %
Spain	2.1 %	2.9 %
Eurozone as a whole	2.9 %	2.6 %
Increase in gross wages (total compensation, i. e. including social security contributions)		
Germany	1.2 %	1.6 %
France	2.9 %	2.5 %
Italy	2.6 %	1.9 %
Spain	3.5 %	2.3 %
Eurozone as a whole	2.7 %	2.3 %

Source: OECD, author's calculations. * includes forecasts from the OECD Economic Outlook

Figure 2: Growth and unemployment, Germany vs. France



Source: OECD.

unemployment in France increased almost continuously and considerably. The employment threshold in France is considerably higher.

At the end of the day, the French state is functional

5) From a macroeconomic perspective, the economic weaknesses of the French state are somewhat less significant. Unlike Italy, an analysis of the productivity trend in the services sector does not indicate any major inefficiencies of the public sector.⁵ International comparative studies on the productivity of the public sector typically reveal that France, together with other Western European states, comes out mid-range, neither strikingly productive nor strikingly inefficient.⁶ This may come as a surprise, as the German public tends to hold the large state responsible for France's difficulties. However, it is not the size of a public sector that matters but its productivity. As regularly demonstrated by Scandinavian countries, a large public sector does not preclude strong economic performance (cf. figure 1). The French state certainly has some dysfunctional elements and inherent flaws that could be remedied to facilitate productivity gains. On the other hand, the French state has certain strengths that seem to offset its weaknesses. A good portion of state activity is due to higher public investment and far superior childcare structures, which is not least reflected in a higher birth rate. In summary, the performance of the public sector is not to blame for France's current problems.

Austerity: a eurozone problem

6) France is suffering from the decelerating effects of budget consolidation. The state was forced to cut expenditure much more drastically after the crisis than Germany. If we adjust French growth for the contractive effect resulting from the tougher austerity course compared to Germany, the growth gap relative to Germany is narrowed substantially, especially in most recent times (cf. figure 3).⁷ While a tough consolidation of finances could not be completely avoided because of the higher deficit at the outset in 2008, the price for this is substantially lower growth, which is affecting France today.

Competitiveness negatively affected by Germany ...

France's problem was Germany. The eastern neighbour, where many companies are active in similar industries, imposed – for understandable reasons (high unemployment since the reunification) – considerable wage restraint, with which it deflected demand away from French companies towards its own. It took France too long to respond to this development. Only recently the cost trends in the eurozone have gradually drawn nearer to the scopes for distribution and closer towards each other (cf. Table 1, column on the right). French wage restraint since 2012 has considerably stronger negative effects on consumer demand, investment and economic development than was previously the case in Germany. With an export share of around 28% (compared to around 40% in Germany, as early as at the start of the new millennium), the negative effects of wage restraint are substantially larger than the positive impetus from foreign trade activities.

3) However, the export weakness is not exclusively due to the diverging wage trends in the eurozone. In fact, France lost more market share on the global export markets than countries with a comparable trend in unit labour costs such as the Netherlands. This is likely to have two causes. Firstly, France has been more strongly affected by the crisis in

Southern Europe than other Western European countries.¹

... and the weak services sector

Secondly, input costs are much higher in France than in other countries. In particular, this pertains to costs of non-tradeable goods such as property and services rendered by local service providers such as management consultants, commercial lawyers, insurance brokers and civil engineers. As business services make up around one third of the input in French industry,² the high level of costs puts the sectors facing international competition under pressure.³ The most significant reason for the high price level is market power, as prices for non-tradeable services have risen at a higher rate than unit labour costs since 1999, an indication of economically "expensive" profit margins. Some of the structural reforms may therefore be in vain, if efficiency gains are generated in the powerful services sector and hence not passed on to the export industry.⁴

Labour market: high employment threshold

4) Weaknesses in the French labour market are also strikingly evident. Relative to growth, the unemployment rate in France has risen too much. As depicted in figure 2, the unemployment rate in Germany fell despite the economic slump in 2009 and despite somewhat feeble growth in 2012 and 2013, while

Figure 3: France's growth assuming less severe budgetary policies



Source: European Commission, IMF, own calculations

What can be inferred from these observations with respect to an adequate French policy strategy, and for the European partners?

In summary, France's current problems are essentially the result of strong fiscal consolidation during a phase of weak growth and the divergence of European wages as well as the weakness of the services sector and of the labour market. The most important conclusions for European and national policy strategy are as follows:

1) France's gradual reforms of state and welfare, structured to support people with low incomes, are by all means appropriate given the fact that the economic development is burdened anyway.

The pace of reform is entirely appropriate

It is not necessary for the welfare states of all countries in a monetary union to be the same size. If unemployment is to be avoided, it is only important that the development of labour costs is consistent with the productivity of the country in question. How this is achieved – through changes in the welfare state, through alliances for labour based on wage agreements, through (de-)regulation etc. – does not really matter at the end of the day and, in a democracy, should be decided by majorities.

2) In a monetary union, differences in unit labour cost trends cannot be offset by revaluation or devaluation. When setting wages, unions and companies there-

fore need to take into account the situation in other countries and assume responsibility for the monetary union as a whole. In particular, they need to avoid a strong divergence of unit labour costs caused by excessive wage increases in one country and a disproportionately weak wage trend in the other.

3) In agreement with the IMF, we also think it makes sense to support France's reform strategy by being prepared to accept much slower budgetary consolidation.⁸ In the current environment, austerity packages only have a limited positive effect on the fiscal situation, while the social costs are high. They contribute to even fairly competitive companies disappearing from the market and people losing skills, contacts and motivation because of long-term unemployment, which also weighs on the long-term productive potential.

Smarter consolidation

Consolidation policies that combine clear gains on budgetary targets and labour costs with small negative effects on economic trends are still prudent. The French system definitely offers some "easy pickings":

The latest austerity package in the social security system⁹ is aimed at rather obvious reform steps in the health system such as promoting outpatient treatment for simple surgical procedures. This is common in other industrialised countries and patients are unlikely to experience this as a dramatic cut. At the same time,

the package tries to protect lower incomes, for example by adjusting minimum pensions for inflation. The planned reduction in the number of "regions" (corresponds roughly to a German regional council) from 22 to 14 will cut personnel costs by 0.5% of GDP,¹⁰ and this can largely be achieved through natural attrition. In addition, the higher than average defence budget also offers potential for as-yet unplanned but simple consolidation measures. Spending cuts in defence projects affect an oligopolistic market with capital-intensive production. Declines in order volumes therefore only have minor negative effects on employment.

4) Judging by the growth of total factor productivity, the most important reform potential within the services sector lies in the areas of business services, regulated professions and the transport sector (logistics and public transport).¹¹ In particular, easing market access for regulated professions and a stronger role for anti-trust authorities when tariffs are determined (railway network, lawyer's fees) would reduce market power, which, in an oligopolistic market, tends to lead to higher production and higher employment as well as indirectly to higher investment in productivity development. Moreover, improving the chances of class action suits against anti-competitive business practices could promote lower market entry barriers.¹²

5) National policies are especially effective when it comes to the employment threshold on the labour market.

Hours worked in France are not very flexible compared to other countries. Short-time work used to be a largely unknown concept until the beginning of 2013, and temporary work arrangements were rare. Hence, when the crisis made adjustments necessary, this mainly affected the number of employees rather than the weekly working hours.¹³ Companies and unions therefore agreed the corresponding reforms in the *Accord National Interprofessionnel* in 2013. These will gradually work to relieve the labour market.¹⁴

Potential on the labour market

France's effort to trigger employment

growth by changing the social security financing structure is particularly laudable. By introducing various tax credits for companies when they make social insurance contributions for employees,¹⁵ a larger portion of social security benefits are now actually financed through taxes. This brings about a reduction in French labour costs and improves the chances of employment for low-skilled workers. Depending on gross income, the savings effect of the permanent measures is 8–25%. This could be expanded further if there is leeway for the corresponding fiscal measures.

Higher average per capita working hours

in France - compared to Germany - indicate potential for deregulation in the low-wage sector. While an expansion of the low-wage sector with lower average working hours does not serve to reduce poverty risks, it is conducive to relieving the labour market. Moreover, employment instead of long-term unemployment leads to improved qualifications and psychological well-being of those affected.

Last but not least, the system for retraining and further education is not very effective.¹⁶ This is a problem, as it makes it impossible to train people from obsolete professions in other roles. Improving this situation could boost employment

growth, but would require fiscal leeway.

Conclusion

France's problems are due to national (labour market, services) and European factors (austerity policy, wage policy). While French policy makers as well as unions and companies have already addressed some of the problems, the European factors call for better coordination. Some time will pass, however, before the positive effects will become apparent. ■

¹ cf. Stringa, M., *Why Italy and France lack competitiveness*, Deutsche Bank Euro Area Economic Focus, February 2013, p. 17.

² cf. Howat, J., *Is France resolving its problems?*, Capital Economics European Economic Focus, March 2014, p. 5.

³ cf. International Monetary Fund, *France 2013 Article IV Consultation*, IMF Country Report 13/251, August 2013, p. 33.

⁴ cf. Howat, J., loc. cit., p. 5.

⁵ cf. Hornberg, C. (2014), *Italien ist anders: Jenseits von Arbeitsmarktreformen*, KfW Economic Research, Frankfurt am Main.

⁶ cf. Kuhry, B., Pommer, F. and B. de Kahn, *Public sector performance: An international comparison*, Presentation at the National Institute of Economic and Social Research Fourth Public Sector Performance Conference, London 2006, quoted from: Boyle, R., *Measuring Public Sector Productivity: Lessons from International Experience*, Irish Institute of Public Administration CMPR Discussion Paper No. 35, 2006, p. 22.

⁷ We have assumed here the fiscal multiplier as estimated by the IMF which applies in a monetary union and for countries with fixed exchange rates that are not able to curb the negative effects of austerity policies through devaluation: cf. Guajardo, J., Leigh, D. and A. Pescatori, *Expansionary Austerity: New International Evidence*, IMF Working Paper 11/258, 2011, p. 23. The point estimate stated there postulates a contraction of 0.84 % of GDP in the first two years after expenditures have been cut by 1 % of GDP.

⁸ cf. International Monetary Fund, loc. cit., p. 21

⁹ cf. Zeuner, J. (2014), *Frankreichs Pläne verdienen die Umsetzung*, KfW Economic Research, Frankfurt am Main.

¹⁰ cf. <http://de.reuters.com/article/worldNews/idDEKBN0EF1B320140604>.

¹¹ cf. International Monetary Fund, loc. cit., p. 33 footnote 18.

¹² cf. OECD, *France: Restoring Competitiveness*, "Better Policy" Series, November 2013, p. 27.

¹³ cf. Howat, J., loc. cit., p. 4.

¹⁴ cf. International Monetary Fund, loc. cit., p. 28.

¹⁵ In more detail: *Crédit d'impôt pour la compétitivité et l'emploi* (CICE), also *Contrat de Génération* and the general reduction in contributions for low-wage employees.

¹⁶ cf. International Monetary Fund, loc. cit., p. 31.