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Is France still on track to reduce its competitiveness gap vs. Germany?

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Germany clearly outperformed France on most macroeconomic metrics in the last two decades. Yet France has implemented many supply-side reforms since 2014. Despite the larger damage taken by France from the current Covid crisis, the lagged effect of these reforms can still help reduce the competitiveness gap with Germany after a few years. However, a key driver of medium-term relative performance will also be how both economies adapt to major “disruption”-related sectoral challenges.

Blatant French underperformance since 1999 and even more so since 2009.

France has underperformed Germany on most growth (at least in GDP per capita), labour market, external trade and public and private finance metrics since 1999 (the year the euro was introduced) with most of this relative movement occurring in the last decade (*see table*).

This underperformance coincided with a dramatic shrinkage of the weighting of the French manufacturing sector in GVA and total employment, as opposed to a much milder decline in Germany, where its weighting remains much larger than in most advanced economies.

A number of key French metrics had also fallen behind not only Germany’s, but also the Eurozone’s average by 2019, at least when it comes to the public deficit, current account and private debt, even though it could be argued that: 1/the current and public French deficits were not very large in absolute terms; and 2/ the large private debt level owed a lot to corporate debt numbers partly explained by internal lending within multinational corporations, and partly offset by large corporate cash balances[1].

This relative French-German trend is generally attributed to:

1. **differences in economic structure** that preceded the euro, with Germany having strong position in manufacturing sectors that were heavily exposed to global demand trends during the period, notably against the backdrop of China’s rapid expansion;
2. **economic policies**, notably major competitiveness-enhancing German reforms in the mid-2000s; and
3. **the interaction of the single currency with economic policies**, at least through two channels:
   a/France could not offset through external devaluation the competitiveness gains Germany achieved through internal devaluation thanks to its reforms[2].
   b/The perceived implicit German guarantee of French public debt through

[1] *See, notably, “Is the Increase in French firms’ indebtedness a cause for concern?”, M. Khder and C. Rousset, Insee, Dec 2017*

[2] *The euro conversion rates with the former German and French national currencies, and Germany’s access to a pool of relatively low-wage workers thanks to its reunification are also often mentioned.*

France has clearly underperformed since the creation of the euro

	Germany	France	Euro area
Manufacturing, % of GVA, 1999	22.18	16.17	19.29
Manufacturing, % of GVA, 2019	21.11	11.04	16.37
Exports of goods, % of GDP, 1999	23.2	19.9	-
Exports of goods, % of GDP, 2019	37.3	21.4	-
Real GDP growth, 1999-2019 average	1.4	1.4	1.4
Real GDP growth, 2009-2019 average	2.0	1.3	1.4
Nominal GDP/person growth, 1999-2019 average	2.5	2.2	-
Unempl. rate, %, 1999	*8.6*	*10.4*	*9.8*
Unempl. rate, %, 2019	3.1	8.5	7.6
Public debt, GDP %, 1999	*60.1*	*60.5*	*71.9*
Public debt, GDP %, 2019	59.8	98.1	87
Structural budget balance, GDP %, 1999	*-1.7*	*-1.6*	*-1.5*
Structural budget balance, GDP %, 2019	1.4	-3.0	-0.7
Current account, GDP %, 1999	*-1.4*	*4.4*	*-0.5*
Current account, GDP %, 2019	7.1	-0.8	2.7
Nonfin corporate debt, GDP %, 1999	*53.0*	*96.6*	-
Nonfin corporate debt, GDP %, 2019	58.7	151.6	-

Sources: IMF, Eurostat, Bank of International Settlements

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the euro architecture resulted in low French yields (notably in comparison with southern European countries) that acted as a disincentive to adjustment and allowed the persistence of a public, private and (to a lesser extent) external debt-fuelled growth model.

Nonetheless, years since 2014 have seen significant supply-side reforms by French authorities, while similar efforts have been largely paused in Germany.

In the past decade, Germany clearly exercised leadership in Eurozone politics, playing a very visible (and successful) role in keeping the currency area together. Conversely, Germany made few domestic supply-side reforms, with some observers even concluding that a number of measures, notably on pensions and the minimum wages, went in the opposite direction.

It was France that took the lead in terms of supply-side policies from 2014 on. This orientation was chosen, first under the Hollande presidency, yet without clear communication (as it represented a shift from Hollande's electoral pledges), then much more openly, from 2017 on, under the Macron presidency (in line with election promises).

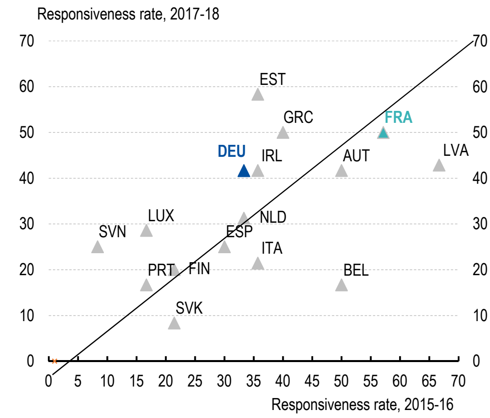
French supply-side reforms have been very positively assessed by international organizations

Beyond their details, the French reforms generally pursued two goals:

- **Shift part of the burden of taxation from corporations to households, at least until 2018** (and, within households, from employees to reasonably well-off pensioners);
- **Pursue a Nordic-style "flexi-security" model** by: 1/easing the protection enjoyed by incumbents and increasing competition on the labour, product and services markets; and 2/streamlining the welfare system to make it easier to steer and more suited to the mobility of professional careers.

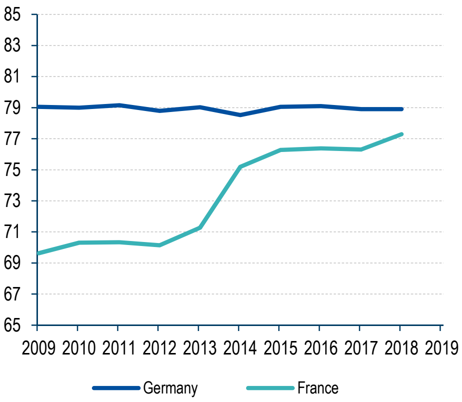
The prudent approach to fiscal consolidation (vs. other high-deficit euro countries) during that period was partly a political corollary of this supply-side momentum, reflecting the intention of not endangering the social acceptability of reforms by accompanying them with austerity measures. This was particularly

1/ Responsiveness to Going for Growth recommendations



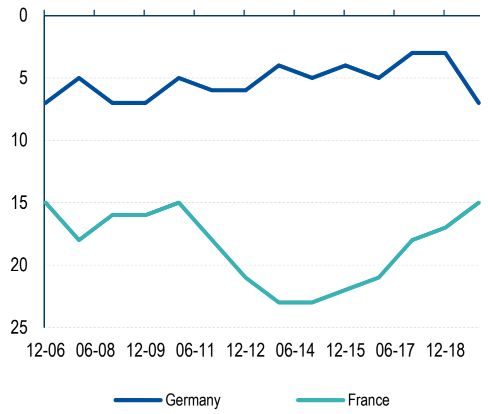
Source: Amundi Research - Data as of 2019

2/ World Bank's Ease of Doing Business Index distance to frontier



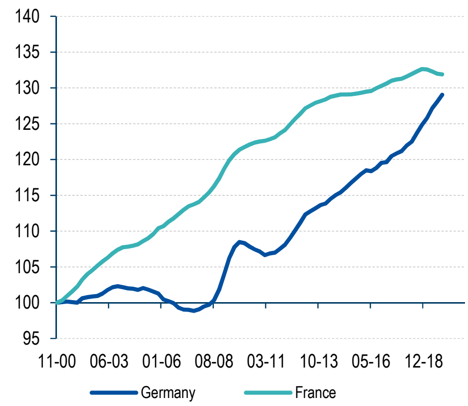
Source: World Bank, Amundi Research - Data as of 2019

3/ Global Competitiveness Index ranking



Source: World Economic Forum, Amundi Research - Data as of 2019

4/ Unit labour costs (base: 100 in 2000)



Source: Eurostat, Amundi Research - Data as of 2019

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France has been hit harder than Germany by the Covid crisis

blatant when, faced with the *Gilets Jaunes* social tensions in late 2018 and early 2019, the government yielded a number of demand-supportive measures, yet was capable of pursuing further supply-side reforms until the Covid crisis.

Supply-side reforms often take years to yield their effects. Whether results were already visible in 2019 is debatable. Nonetheless, market-friendly organizations identified the French efforts as promising.

A number of French metrics improved in absolute or relative (vs. Germany) terms in 2017 and 2018, yet this was first and foremost the effect of: 1/trade and manufacturing disruptions (US-China tensions, Brexit, and specific issues in the auto sector) that hit Germany much harder, due to the structure of its economy; and 2/a "normal" improvement of lagged economic variables (notably the unemployment rate) after several years of general Eurozone recovery.

International organizations, for their part, did assess French reforms very positively:

- **The *OECD's Going for Growth* ranking**, notably, identified France as the most reform-responsive large Eurozone economy in 2017-18 (on par with Greece, and only exceeded by Estonia) after it had already been one of the very top performers in 2015-16 (surpassed only by Latvia), while Germany's performance was only average (graph 1). **In quantitative terms,** the OECD estimated in its 2019 "*Report on France*" that the 2017-2018 changes alone could yield a positive effect of 3.2pp of GDP after 10 years.
- **Other well-known competitiveness indicators**, such as the World Economic Forum's *Global Competitiveness Index* of the World Bank's *Ease of Doing Business* index, also showed significant relative French progress, even though France remained below Germany in absolute terms (graphs 2 and 3).
- **A number of surveys showed that France was becoming a more attractive destination for international investment**. For instance, Ernst&Young's *Europe Attractiveness* Survey of May 2020 noted in that France had become Europe's top destination for FDI in 2019.

Relative French vs. Germany dynamics were also, to some extent, visible in classic unit labour costs metrics, which in 2019 showed a near complete reversal of the relative compression achieved by Germany in the 2000s (graph 4), even though the most recent narrowing had to do with 2018-19 short-term growth developments.

French supply-side momentum may even have some (residual) life left before the mid-2022 election, even though the Covid crisis has shifted priorities, as in all countries, to the stabilization and stimulation of demand,

- **The recently announced French fiscal stimulus (see next article) can be described as slightly more "supply-side" than its German counterpart.** Both plans amount to about 4% of GDP, yet the French version is more oriented towards corporations (incl. with permanent production tax cuts) and does not include untargeted support to consumption similar to the German VAT cut.
- **The French government has also stated its intention to pursue its planned corporate profit tax cuts, and even to conclude its major pension reform,** whose parliamentary approval process was interrupted by the Covid crisis. While not changing much over the short term (workers born before 1975 will remain in the current system), this latter reform sends out a powerful signal of adaptation of the economy to professional mobility across sectors, generally considered a positive for long-term growth.

The Covid crisis may delay the positive effect of French reforms, yet the ongoing general reassessment of public debt-related vulnerabilities and German "disruption"-related sectoral challenges must also be watched.

So far, the Covid crisis has hit France's economy harder than Germany's (i.e., a larger hit to GDP in H1 of -11.5% vs. 18.9%), due to a combination of luck (the location of early European clusters), health policies and sectoral exposures (although different statistical measurement choices may also have played a role in short-term GDP prints).

As France entered the crisis with much worse deficit and debt metrics than Germany, it is easy to see it as less capable of bringing further fiscal support to its economy without jeopardizing the stability in its public finances. While France may gradually reap the rewards of its recent reforms when the economy normalizes, part of these gains could thus be offset, in relative terms, by more intense public investment in Germany.

Yet the rapidly changing perception of the economic cost and vulnerabilities of "monetized" public debt may lead to some reassessment of available "fiscal space". As all Covid-related debt of Euro countries will be (indirectly) purchased by the ECB, "fiscal dominance" is likely to keep interest rates ultra-low for a prolonged period of time. Moreover, the Modern Monetary Theory paradigm is gradually gaining ground and raising doubts, among market participants, over the true fiscal cost of public debt. It is therefore a possibility (although far from a certainty), that a relatively high pre-crisis debt situation

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Germany must cope with major "disruption" challenges in some of its key industrial sectors

becomes no obstacle to borrowing more if really needed. Future stimulus plans could thus be much more constrained by operational bottlenecks (choice of projects, red tape, and "obstructive stakeholder" opposition, obstacles of which there are many in Germany) than by financing capacity. Moreover, with its recently decided "Next Generation EU" recovery fund, the Eurozone has just taken a new step in terms of debt mutualisation (even though modest, "one-off" in principle, and with France as a net contributor).

Finally, much of Germany's ability to maintain its outperformance may depend first and foremost on how it copes with "disruptive trends" at the sectoral level:

- **Germany, like France, has strong positions in sectors that are heavily exposed to global current trends** (both countries, for instance, are strong in the provision of large urban and transport infrastructure, which are essential to accompanying the development of "global cities" around the world).
- **Conversely, Europe in general is also described as losing its edge to the US and China when it comes to big tech and big data**.
- **However, while the services-oriented French economy faces innovation challenges that are broadly similar to those of other mid-sized advanced countries, Germany may face unusually large sectoral issues.** Indeed, the country stands out in its much larger share of its GDP and employment in manufacturing sub-sectors (notably autos and chemicals, which account for 6.4% of German GVA vs. only 1.7% in France, according to 2017 Eurostat data) where it is a world leader, yet that are heavily disrupted and, being capital-intensive, require well-planned strategic investment choices. A number of studies have pointed out, in particular, the large number of jobs that could be at risk in the car industry[3]. Whether Germany makes the right investment choices to adapt these sectors to new environmental, technological and trade challenges so that they remain world leaders will play a significant part in determining to what extent it can remain the unchallenged economic powerhouse of Europe.

Conclusion

Underperforming France has made significant efforts to regain potential during the 2014-20 period. Despite the Covid crisis and its large costs on GDP and public finance, and assuming that the typical delays before seeing the positive effects of supply-side reforms still stand, the French economy, now slightly more flexible and competitive (at least in relative terms), is likely to reap some rewards during the rest of the 2020s. Germany, for its part, has made fewer supply-side reforms recently, yet remains ahead on most competitiveness indicators and with very deep pockets to invest for the future. Its main challenge, however, may be the strategic choices that its large manufacturing and export-oriented sectors will need to make to retain their edge against a backdrop of rapidly changing global demand trends.

Finalised on 30/09/2020

[3] *In January 2020, a study by the National Platform Future of Mobility, a research agency funded by the German government, estimated that as much as 400,000 auto jobs could be gone in the country by 2030 out of a 2019 total of 830,000)*

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France just announced a €100bn stimulus plan

VALÉRIE LETORT, *Fixed Income Strategist*

Main features of the plan:

The two-year, €100bn "Relaunch France" plan is in line with Emmanuel Macron's presidential program: it aims to restore the competitiveness of French companies, to facilitate the creation of companies and hiring through flexibility in the labour market, in order to lower unemployment and generate growth.

The plan is not accompanied by a policy of direct stimulus of demand as in the United States or Germany (check or lower VAT). However, the massive short-time work mechanism, also called the "anti-unemployment shield", should last until the end of the year, at least for sectors in the greatest difficulty, such as events, culture, restaurant and accommodation.

€30bn has already been allocated to this "anti-unemployment shield" under previous programs, and €7bn will again be allocated to it as part of the recovery plan.

In total, direct liquidity injections linked to Covid-19 have already reached €60bn (€8bn for the self-employed, €8bn for healthcare, and €10bn in various aid in addition to the aforementioned €30bn), not counting the sums allocated under form of business loans (€120bn at this stage). So, this plan comes in addition, but must above all make it possible "to invest in the future… to transform the France of tomorrow", according to Emmanuel Macron.

The plan would be 40% funded by Europe. Together with the other support measures, It would increase the country's debt from 100% to 120% of GDP.

It is based on three pillars of €30bn to €35bn each:

1/ €30bn is earmarked for the environmental transition, but in fact is being steered mainly towards green infrastructures (expanding freight traffic and bike paths and promoting thermal insulation of buildings) and green vehicles, such as green cars and green aircraft. This will be in the form of state-sponsored projects or buyer bonuses. The spending targets look relatively within reach, even though they will be spread out over time. Job market support will come mainly from the construction sector, which is one of France's biggest employers.

2/ €15bn will be spent on innovation and reshoring, targeting mainly the pharmaceutical and digital sectors, as well as the shortening of production chains. Although it will probably be easier to launch the work of digitising the state and targeting large companies, local and regional governments will be called upon to help leverage the impact on small and mid-sized companies, which collectively are France's biggest employers and those most interwoven into the social fabric. In fact, in 2019, these small and medium-sized enterprises accounted for 9% of GDP, and employed 49% of France's 14 million workers. They are mainly in the construction, restaurant and accommodation sectors. It should be remembered that France was the European champion in business creation in 2018 (+691,000). €20bn more will fund production and property tax cuts, with three quarters targeted at small and mid-sized companies (a key reason for the government to claim that its plan is also "supply-side").

3/ The remaining €30bn will be spent on social welfare, including €15bn for employment and training with the issue of retraining, almost €7bn on apprenticeships, more than €7bn for the short-time work mechanism, and €6bn for the health sector.

So, the stimulus plan's three pillars are consistent and intertwined and meant to unleash a virtuous economic circle through increased hiring and start-up creation[1], and the restoration of confidence that will allow French households to spend their savings, thus complementing government projects with physical or digital infrastructure.

Indeed, French households' precautionary savings reached a record amount of €100bn, the same amount as the stimulus plan.

The French government therefore wishes to encourage French households to spend. It pledged not to increase their taxes. While the purchase bonuses in the plan will help defray a little, restoring confidence as layoffs announcements from large French companies multiply and health conditions deteriorate is a difficult task that should require some time.

Though the timetable of the plan is ambitious, with €30bn earmarked for 2021 (allocated on a monthly basis by Prime Minister Jean Castex's Ministerial Committee). The plan could extend as far as into 2024.

[1] *160,000 jobs expected in 2021, thanks to this plan, +200,000 thanks to the resumption of activity after the lifting of the lockdown.*

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