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FRANCE: WHY HAS THE CURRENT ACCOUNT BALANCE DETERIORATED FOR MORE THAN 10 YEARS?

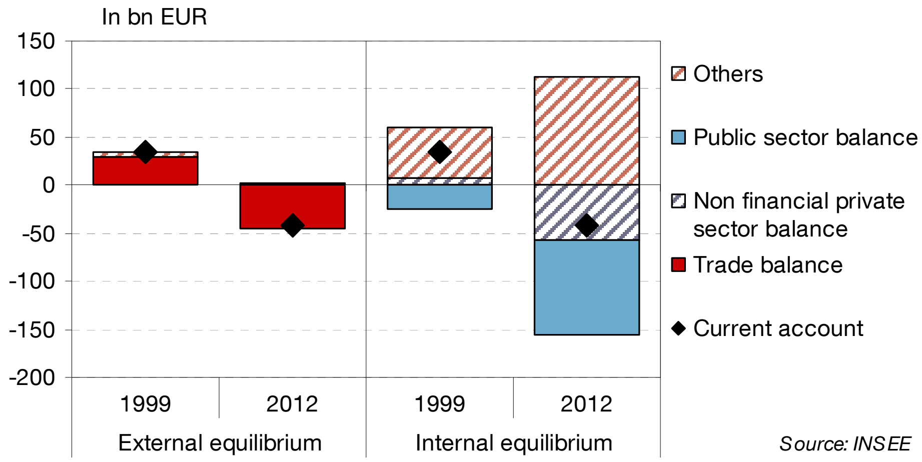
— Between 1999 and 2012, France's current account balance worsened markedly, going from a surplus of EUR35bn to a deficit of around EUR40bn.

— This change can be explained by the deterioration of France's trade balance. It can also be read through the prism of domestic sectors' financial imbalances: the deterioration of the current account balance has been due to the sizeable increases in the public deficit and financing needs of non-financial corporations.

— In particular, since the crisis, the funding needs of non-financial corporations have increased markedly: their investment and payrolls have only partially been adjusted to the slowdown in activity.

— Companies' slow reaction to the crisis thus far has benefitted to household income and consumption. However, this is a risk factor for growth: if companies had suddenly to make those adjustments, it could trigger a steep decline in private investment and employment.

CURRENT ACCOUNT AND ITS COMPONENTS



Source: INSEE

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SOCIETE GENERALE

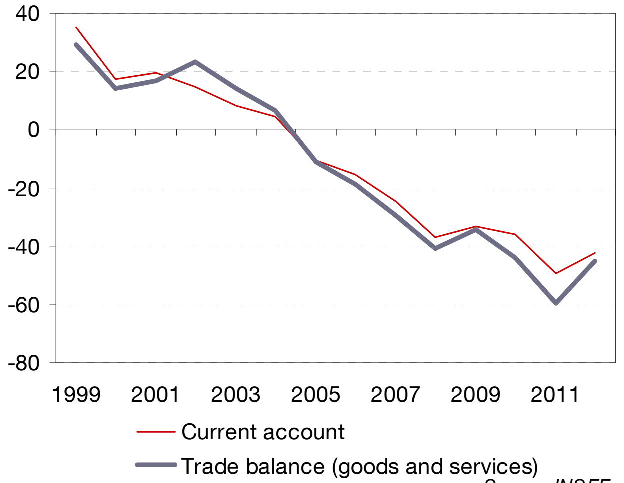
FRANCE'S CURRENT ACCOUNT BALANCE HAS CONTINUOUSLY WORSENED FOR THE LAST TEN YEARS

After reaching a high in 1999, France's current account has markedly deteriorated. It has gone from a surplus of EUR35bn in 1999 (i.e. 2.6% of GDP) to a deficit of EUR42bn in 2012 (-2.1% of GDP) according to national accounting standards[1].

ONGOING DETERIORATION OF THE TRADE BALANCE...

Considering France's external balances, the reason behind the deterioration in the current external balance is clear: the worsening trade balance (of goods and services). In fact, the latter has gone from a surplus of EUR29bn in 1999 to a deficit of EUR45bn in 2012, thus accounting for nearly the entire EUR77bn decline in the external current account balance (see graph. 1).

GRAPH. 1: FRENCH EXTERNAL BALANCES



Source: INSEE

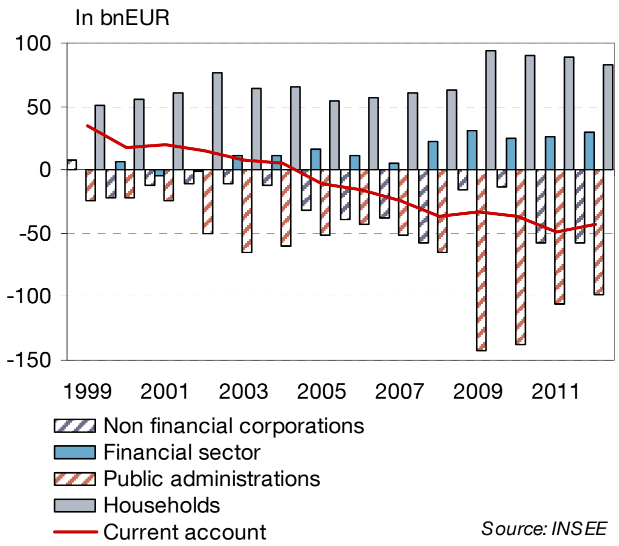
When we take a more detailed look at the trade balance in France, it becomes clear that the deterioration has resulted from two well-known factors:

- France's energy bill has gotten more expensive, due notably to the rise in the price of a barrel of oil (EUR17 in 1999 to EUR87 in 2012);
- Deterioration in the balance of trade of manufactured goods, which reflects French industry's loss of competitiveness.

... OR AN INCREASE IN THE FINANCING REQUIREMENTS OF THE GENERAL GOVERNMENT AND NON-FINANCIAL CORPORATIONS

In a second possible interpretation, a deterioration in the external current account balance reflects a drop in the national economy's net lending position. In this respect, this deterioration of the French current account derives from the sharp increase in the financing needs of non-financial corporations and public administrations, which have been offset only partially by the increase in savings of households and financial companies (see graph. 2).

GRAPH. 2: NET LENDING/BORROWING



Source: INSEE

In other words, the increase in the savings of households and financial companies was not enough to finance the expanding public deficit and the drop in non-financial corporations self-financing capacity.

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[1]*According to the balance of payments definition, the current account balance has gone from a surplus of EUR43bn in 1999 to a deficit of EUR47bn in 2012. In this study, we will use the national accounting definition, since it allows us to compare in a consistent manner the changes in the current account balance in two but equivalent ways: one is focused on external balances and the other on internal balances (see inset 1).*

INSET 1 - THE TWO VIEWS ON THE EXTERNAL CURRENT ACCOUNT

The current account balance of a country can be interpreted in two different ways, which are, from an accounting perspective, the exact mirror of one another. The first among them is based on external accounts and is a snapshot of a country's external balance. The second, which is more focused on the internal situation of a country, depicts the equilibrium between a nation's savings and its investments.

In the first approach, the country's current account balance is the difference between current payments (trade of goods and services, revenues and transfers) received by the rest of the world and the payments France makes to the rest of the world. It is usually composed of three items:

— The trade balance: the difference between exports and imports of goods and services.

— The balance of income and current transfers: the main transactions between France and abroad considered here are the payments from investment revenues (interest and dividends), employee wages (e.g. for cross-border workers) as well as transfers between the French public entities and European institutions.

— The current transfers balance: the balance includes, notably, the funds that migrant workers send back to their home countries (i.e. remittances), write-offs, sales of patents, land or mines.

In the second approach, which is merely a different accounting description of the same data, we focus more on the internal balances of the economy. The current account is defined as being the difference between a country's savings and investment, which is typically broken down into the following sectors:

— Non-financial corporations

— Financial companies

— Public administrations, i.e. mainly the government, local authorities and social security bodies

— Households

— Non profit institutions serving households

For example, two different interpretations of a current account deficit are possible: in the first, the country pays more to the world than it receives, e.g. because it has a trade deficit; in the second, the country invests more than it saves, which means it will need to look overseas to fund itself.

THE FINANCIAL SITUATION OF THE CORPORATE SECTOR HAS WORSENED SINCE THE CRISIS

However, this broad trend over the period 1999-2011 actually conceals three distinct realities: pre-crisis, the 2008-2009 crisis and finally the phase spanning 2010-2011.

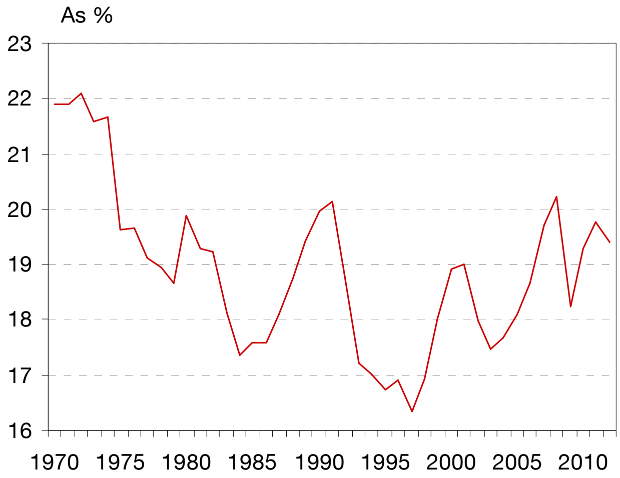
BEFORE THE CRISIS, A RISING BUSINESS INVESTMENT RATE AND A DEEPENING PUBLIC DEFICIT

Between 1999 and 2008, the deterioration of France's current account balance, which went from a surplus of EUR35bn to a deficit of EUR37bn, was the result of two distinct factors.

First, public deficit got significantly worse. Between 1999 and 2001 it was about 1.5% of GDP, it then fluctuated hovering around 3% between 2002 and 2008, peaking at 4.1% of GDP in 2003. In all, poor public finances resulted in a EUR40bn drop in the current account from 1999 to 2008.

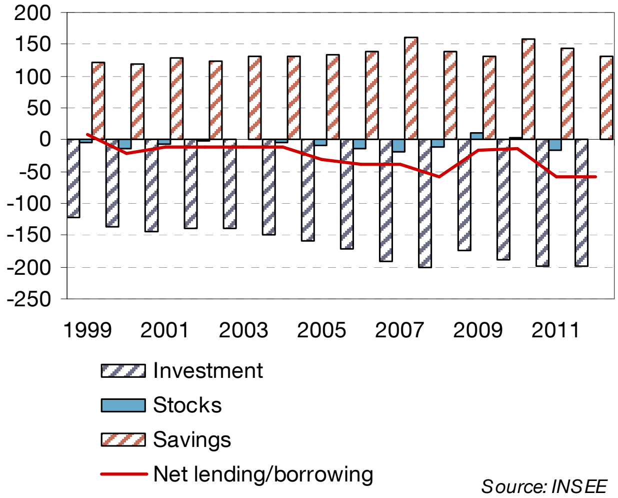
Second, non-financial corporations' funding needs grew markedly from 2004, under the effects of a rapid increase in their investment. In fact, during these years, the upward climb of corporate investing was significantly higher than the expansion of their businesses. As a result, this boosted their investment ratio, which, in 2008, reached a high France hadn't seen since 1974 (see graph. 3). The funding needs of non-financial corporations rose from EUR11bn in 2003 to EUR58bn in 2008.

GRAPH. 3: NON FINANCIAL CORPORATIONS' INVESTMENT RATIO



Source: INSEE

GRAPH. 4: NON FINANCIAL CORPORATIONS' NET LENDING/BORROWING



Source: INSEE

However, over this whole period, beyond sometimes sharp fluctuation, households' funding capacity remained mostly stable and financial companies' funding capacity only rose marginally.

AT THE CRISIS PEAK, BUSINESS INVESTMENT FELL AND THE PUBLIC DEFICIT JUMPED

In 2009, under the effects of the crisis, changes were very sharp for all economic agents. In the end, however, this halted the deterioration of France's current account balance.

France's public deficit shot up as income fell sharply due to the poor economic environment and the authorities' implementation of stimulus plans. The public deficit jumped from 3.5% of GDP to 6.4% of GDP, i.e. a nearly EUR80bn deterioration.

This sharp increase of higher public funding needs was compensated, however, by the improvement of the net lending position of the other sectors.

Faced with the crisis, households increased their savings by one point over the year, and significantly reduced their investment spending.[2] This freed up extra finance capacity of over EUR30bn.

Non-financial corporations were faced with the drop in their savings (because business was down) but, more importantly, they made deep cuts in their investments and reduced their inventories. Consequently, they reduced their financing needs over the year by more than EUR40bn (see graph. 4).

Lastly, financial companies increased their savings by nearly EUR10bn, as the drop in short-term interest rates improved their margins[3].

SINCE THE CRISIS, THE CORPORATE SECTOR'S FINANCIAL SITUATION HAS DETERIORATED CONSIDERABLY

Since the crisis, France's current account deficit has deepened once again, standing at EUR42bn in 2012, after a high at EUR49bn in 2012.

This deterioration is mainly attributable to the increase in non-financial corporations' increased financing needs (more than EUR40bn). It also comes from a decrease in households' net lending position (more than EUR10bn): their savings remained stable whereas their investment increased. However, it was limited by the improving public finances, which reduced the State's need for funds by more than EUR40bn.

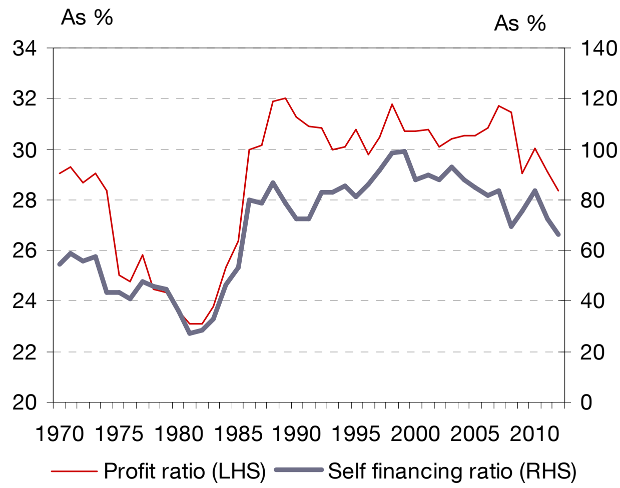
The sharp increase in non-financial corporations' funding needs stems from a scissors effect between, on the one hand, an erosion in their margins and, on the other hand, an investment level that has rebounded sharply and then stabilized in 2012 despite an unfavourable economic environment fraught with uncertainty.

Thus, in 2011, the investment rate of non-financial corporations returned to record highs from 2008 while their margin has been down sharply to its 1985 lows - as has their self-financing ratio (see graph. 5).

[2] *Primarily households' acquisition of new homes.*

[3] *This result is not contradictory with the sharp decline in financial companies' earnings over the same period. In fact, losses on investments (due to the crisis) did not have an impact (in national accounting standards) on their revenues or their savings but have had a direct impact on their assets.*

GRAPH. 5: NON FINANCIAL CORPORATIONS' FINANCIAL RATIOS



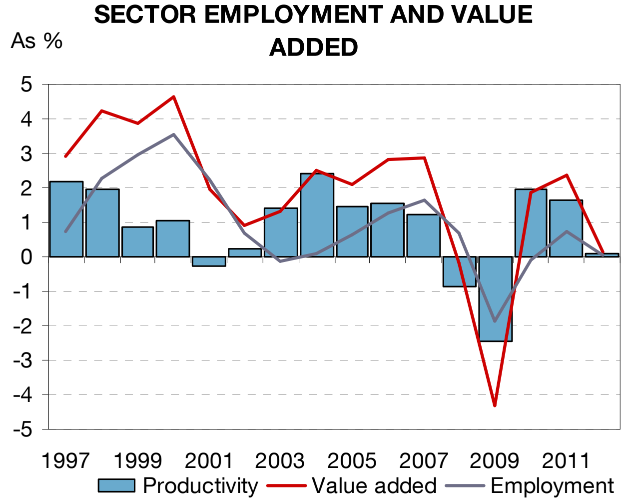
Source: INSEE

FINANCIAL IMBALANCES IN THE CORPORATE SECTOR ARE A KEY RISK WEIGHING ON THE ECONOMIC OUTLOOK

ONLY A PARTIAL ADJUSTMENT IN EMPLOYMENT AND BUSINESS INVESTMENT THUS FAR

This deterioration in the financial situation of the corporate sector derived from the only partial adjustment of two factors to the low levels of activity: one, non-financial corporations have been investing heavily relative to the weakness of their activity, which has resulted in record investment levels; two, employment adjustments were limited compared with the fall in economic activity and its weak rebound thereafter (see graph. 6).

GRAPH. 6: NON-FARM PRIVATE SECTOR EMPLOYMENT AND VALUE ADDED



Source: INSEE, calculs SG

From 2008 to 2012, the productivity of labour in the non-agricultural private sector stagnated for the most part, while it had increased an average of 1.3% per year over the previous decade. Consequently, employment in companies has only partially adjusted to lower activity and their profitability has suffered as a result. As a consequence, the value added split moved towards a higher share to remunerations (around 65% pre-crisis to nearly 68% in 2012).

A MORE MARKED ADJUSTMENT WOULD WEIGH HEAVILY ON THE ECONOMY

These maladjustments of investment and employment constitute a significant risk for the French economy.

Of course, one way to absorb them would be to return to strong growth. Measured job creation and a contained increase in investment would make it possible to gradually return to a more balanced situation, with companies steadily restoring their profitability. Unfortunately, given the current economic situation, such a scenario seems unlikely.

Another possible path would be far more painful. In fact, given current business activity, companies would need to pull back on investment and employment. Because companies failed to make substantial adjustments, these reductions could be large in scale. Thus, to bring their investment ratio back to pre-crisis levels, non-financial corporations would have to cut investment spending by nearly 7%, which is the equivalent to 0.7% of GDP. And to make up for the productivity lag accumulated over the past four years compared with the trend over the previous ten years, it would be necessary to cut non-farm private employment by more than one million positions.

THIS LACK OF BUSINESS ADJUSTMENT HAS SO FAR SUPPORTED HOUSEHOLD INCOME

Over the entire period, household income increased faster than nominal GDP (around 0.3% per year), which reflects the distortion, in favour of households, in how added value is shared. This distortion enabled household consumption to increase at a relatively strong rate compared with GDP - despite a simultaneous rise in the savings rate.

In addition, automatic stabilizer mechanisms and stimulus measures also supported household income.

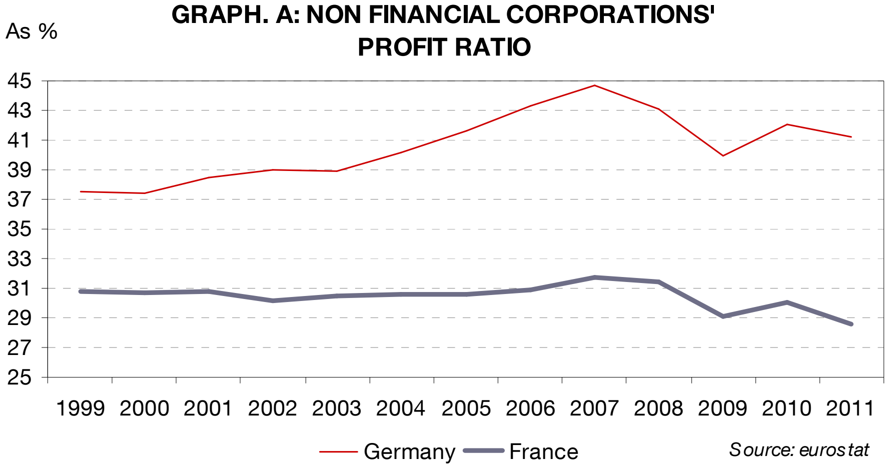
The relatively good resiliency of the situation of households therefore came at the detriment of corporations and public finances: corporate margins dropped significantly while public finances worsened.

This takes us back to the argument explaining the nation's deteriorating current account balance: it reflects a national savings deficit relative to investment. In the case of France, this mainly concerns an increase in consumption: over the period, consumption (private and public)/GDP rose 3pp and, to a lesser extent, investment/GDP also rose by 1.5pp. Mirroring the conclusions outlined previously, the counterweight has been a drop in the net external trade/GDP ratio, which went from being slightly positive to negative.

INSET 2 - OVER-CONSUMPTION IN FRANCE VS UNDER-INVESTMENT IN GERMANY?

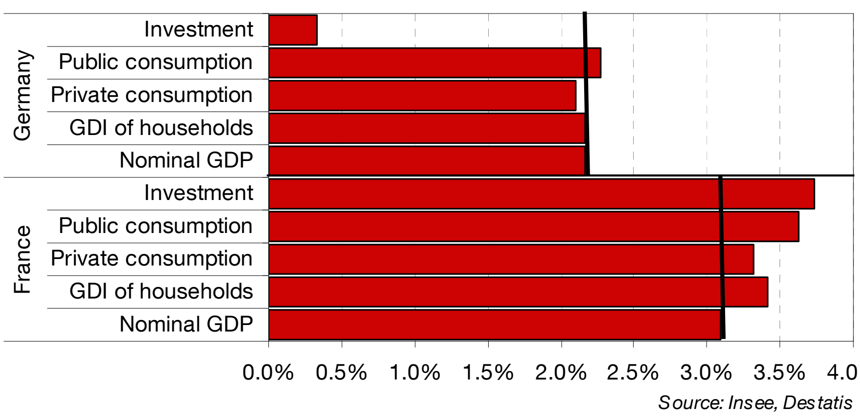
While France's current account balance was falling sharply, that of Germany improved markedly over the period 1999-2012 (see graph. A). It went from a deficit of 1.3% of GDP in 1999 to a surplus of 7.0% of GDP in 2012. Like France, this change came about mostly as a result of international trade. The interpretation that is usually made of this situation is that Germany's moderate payroll and low inflation enabled German companies to strengthen their financial health and make big strides in competitiveness, which boosted exports. Indeed, German exports have been strong, compared with those of France, and more broadly compared with other countries in the euro area. Unlike what is happening in France (see graph. A), the distortion in how added value is shared was made at employees' losses in Germany.

GRAPH. A: NON FINANCIAL CORPORATIONS' PROFIT RATIO



However, another interpretation is possible if we look at the balance between the country's savings and investment. As pointed out earlier, the deepening current account deficit in France was mainly due to higher private and public consumption, which was stronger than nominal GDP, and to a lesser extent to investment growth. In the case of Germany, the accumulation of surpluses is not fed by rising household savings: in fact household income and consumption increased broadly in line with GDP. Rather, it reflects weak investment, which is substantially lower than GDP (see graph. B). The consequence has been that the weight of investment/GDP in Germany dropped from 22% in 1999 to 17% in 2012, when it went from 18% to 20% in France.

Graph. B: AVERAGE YEARLY GROWTH RATE 1999-2012



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