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RISK&OPPORTUNITIES

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Leveraging the French paradoxes

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Two years into his Presidency, Emmanuel Macron has delivered a flurry of reforms that aim to leverage the strength in the paradoxes of the French economy: high productivity yet improvable education, enviable demographics yet low labour utilisation, relatively low poverty rates yet surprisingly low social mobility…

Nonetheless, reform fatigue seems to have set in early with recent social discontent, and the government has responded with almost €17bn of measures to support purchasing power and ease concerns. Meanwhile, President Macron has promised to push ahead on further reform in a bid both to boost trend potential growth and build confidence across the Rhine to advance the European agenda. With global growth momentum slowing, reforms still too young to truly deliver and recent social unrest, delivering on future reform is a Jupiterian task.

This piece sets the stage with three salient features of the French economy before next taking stock of President Macron reform strategy to date. Next, we present our 2019-2020 growth outlook, with focus on the impact of the recent fiscal measures.

Paradoxes offer resiliency in crisis…

When Emmanuel Macron took office in 2017, the French economy was characterised (and still is) by three salient points, sometimes paradoxical: resilient demand but eroding supply; contained external imbalances despite faltering competitiveness; and rising public and private indebtedness.

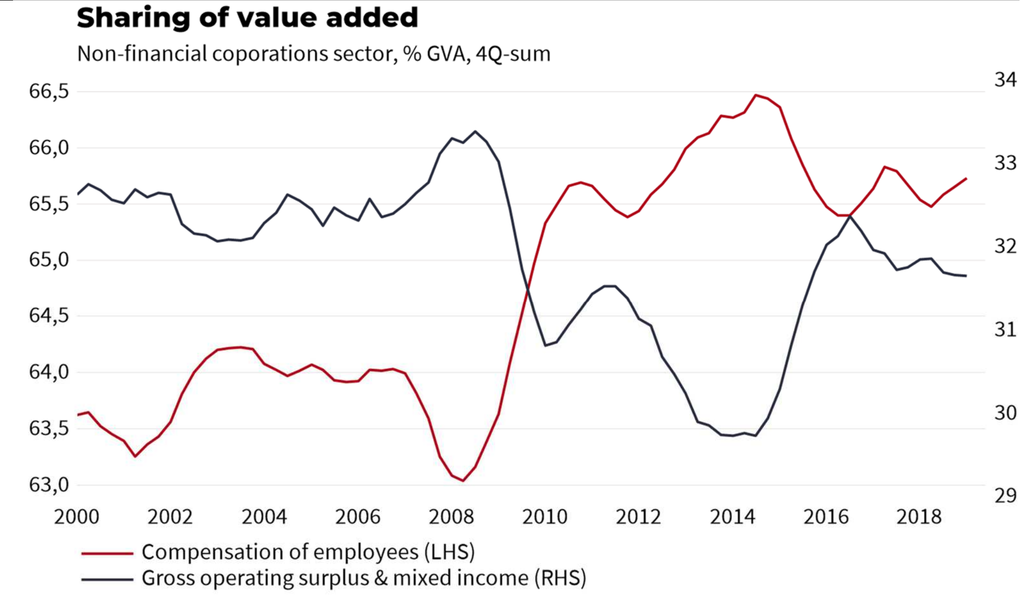
Resilient demand, eroding supply

Contrary to conventional wisdom, France has been growing at a relatively healthy pace over the past 10 years. Real GDP is now almost 10 points above the 2008 level, ahead of the euro area average and neck and neck with some of the zone's core economies (notably the Netherlands).

This performance stems largely from the resilience in both public and private consumption during the 2011-2013 euro area debt crises. During that period, the French economy stood in sharp contrast to those of its peripheral neighbours, which slide back into recession due to internal devaluation policies.

This resilience nevertheless came at a cost, bringing steep tax hikes and public debt to sustain government consumption. Meanwhile, household demand resisted (with difficulty) as wage income was protected by strict regulations on total payroll adjustments to the business cycle (via jobs and wages). On the flipside, companies saw profit margins under pressure, holding back much needed investment.

During the euro crisis, wages have increased at the expense of profit margins



Sources: INSEE, SG Economic and Sector Studies

In a nutshell, the resilience in demand was funded by an erosion of supply. The ensuing impact on companies and the economy was laid bare in the Gallois report commissioned in 2012, namely, a steeper decline in profitability, investment capacity, cost and non-cost competitiveness, and thus potential growth.

Faltering competitiveness, but contained external imbalances

Following on from the Gallois report, some of the reforms undertaken during François Hollande's presidency attempted to curb this erosion in supply, notably taking steps to lower labour costs (CICE tax credit, Responsibility Pact) and make the job market more flexible (Rebsamen Law, El Khomri Law).

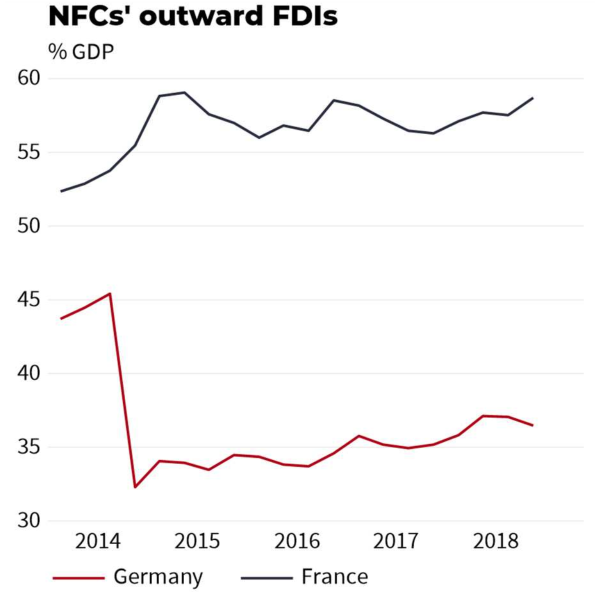
The CICE (Competitiveness and Employment Tax Credit) helped rein in growth in unit labour costs and revive margins (with an added boost from falling oil prices). However, there is no real consensus as to the impact of these measures on the economy yet. At present, competitiveness indicators (export market shares, weighting of manufacturing industry in GDP, etc.) still point to deteriorated conditions. The persistent trade deficit, and the fact it has deepened during a period of recovery, testifies to the supply's ongoing difficulties in meeting a rise in global demand.

That said, the erosion in supply has not led to a build-up in major current account imbalances. The profits repatriated by multinational companies currently exceed the structural trade deficit, thereby ensuring that the French current account is near balanced.

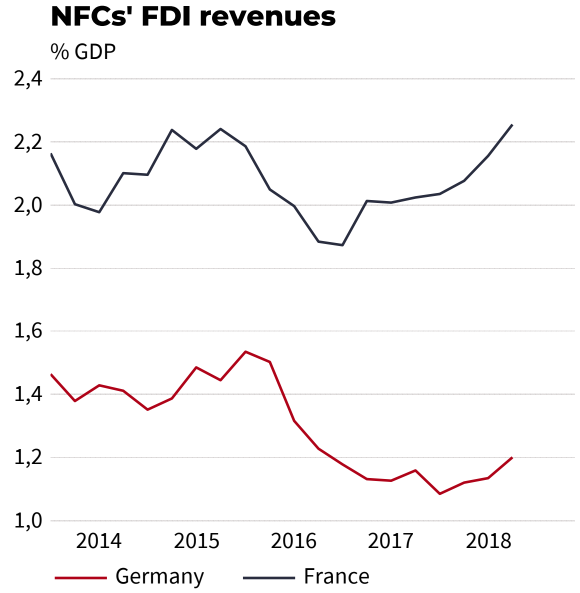
Indeed, the de-industrialisation witnessed in France over the past three decades has largely stemmed from substantial foreign direct investment (FDI) by French companies: in 2018, the stock of these accounted for some 60% of French GDP, compared with just over 35% in Germany. Instead of exporting[1], French companies have frequently opted to delocalise a sizeable chunk of their value chain[2], revenues from which (2.2% of GDP in 2018) now cover the country's trade deficit (1.9% of GDP in 2018). According to INSEE, outward sales generated by the foreign subsidiaries of French industrial multinationals accounted for 40% of national GDP in 2011, compared with 22% for exports.

Thanks largely to its multinational enterprises, the French economy therefore enjoys something of an "exorbitant privilege", as a net beneficiary of revenues from the rest of the world, despite its position as net debtor vis-à-vis the latter.

French corporates make significant revenues abroad thanks to large FDIs



Sources: Eurostat, SG Economic and Sector Studies



Sources: Eurostat, SG Economic and Sector Studies

INCREASING EXPOSURE TO A RISE IN INTEREST RATES

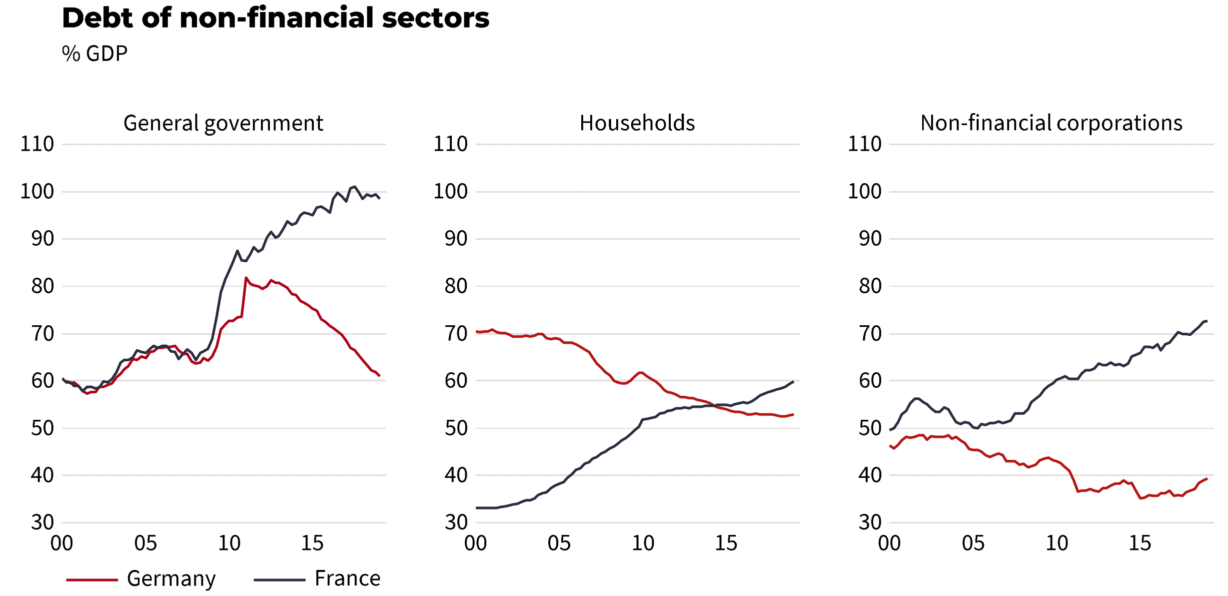
The steady rise in debt ratios since the financial crisis has made the French economy much more vulnerable to a lasting rise in interest rates. As discussed above, general government debt is up 33 points over the past decade to 99% of GDP. Moreover, its private non-financial corporate debt is also on an upward trajectory. On this latter

[1] In Germany, companies only delocalised certain parts of their value chain (so-called "vertical" FDI), preferring to keep "core" operations at home (assembly, R&D, marketing, etc.) and export the final product. Accordingly, the weighting of industry in the German economy has remained stable since the early 2000s.

[2] Even if that means subsequently re-importing some of the goods produced. Buigues and Lacoste (2016) demonstrate that Renault became a net importer of vehicles during the 2000s, for instance.

point, France is swimming against the tide relative to the other major euro area economies, whose national debt is either in decline or stabilising. As regards households, the rise in debt (+12 points of GDP between 2008 and 2018) primarily stems from property, which only adjusted marginally to the financial crisis. However, given that most of their borrowings carry fixed interest rates and subject to strict loan ratios, households are well protected against a potential rise in interest rates.

Debt-to-GDP ratios have increased in all non-financial sectors



Sources: Banque de France, SG Economic and Sector Studies

Meanwhile, French companies have been relying on debt (+23 points of GDP between 2008 and 2018) to fund investments in France[3] and abroad. These borrowings have also gone towards strengthening company cash flows. Here, net debt (taking into account cash holdings) also increased (by six points of GDP), albeit at a slower pace than gross debt. Finally, many multinationals took advantage of the low interest rate environment to take on debt and lend to their foreign subsidiaries. Adjusting for these factors, the debt ratio comes to around a very manageable 25% of GDP. Nonetheless, French companies are now more exposed to rate rises.

… but hold back trend potential

As we move our discussion to structural reform and trend potential, we find the list of paradoxes expand. France is home to several of the world's major companies and enjoys excellent infrastructure yet has surprisingly few medium-sized companies. The demographics are enviable benchmarked against many of its European neighbours, yet labour utilisation is low. And while hourly productivity is high,

[3] Investment by non-financial companies has returned to pre-crisis levels, reaching an all-time high of 24% of value added by end 2018, or 1.3 points above the previous record in 2007. In Germany, Italy and Spain, rates of investment are trailing their 2007 levels by 1 point, 2.3 points and 4.6 points, respectively.

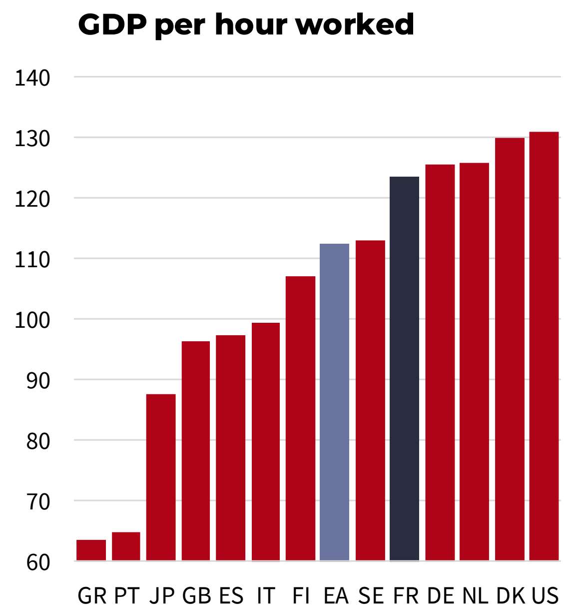
educational outcomes leave much to be improved. And while poverty rates are low by comparison to major advanced economies, social mobility is surprisingly low.

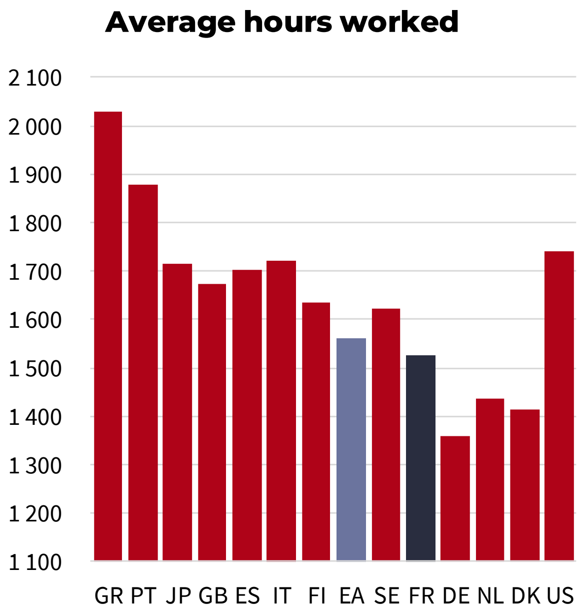
Two years into his Presidency, Emmanuel Macron has delivered a flurry of reforms that aim to leverage the strength in each of these paradoxes, with a key focus on flexibility and education.

FLEXIBILITY AND EDUCATION HOLD THE KEY

Starting with corporate structure, France boasts several leading large corporations, but future job creations is more likely to come from small and medium sized companies. Moreover, this is the base from which tomorrow's leaders should emerge (it's worth note that the GAFAs are all relatively new companies). OECD data show that 95% of French firms fall into the micro category of 1-9 persons employed compared to 82% in Germany and 93% for the euro area average. The fact that few of the micro firms grow into small, medium and ultimately large firms is a concern and is often attributed to the demands that come from the regulatory thresholds that see employers' obligations increase with the number of employees.

France enjoys high productivity, but average hours worked are low



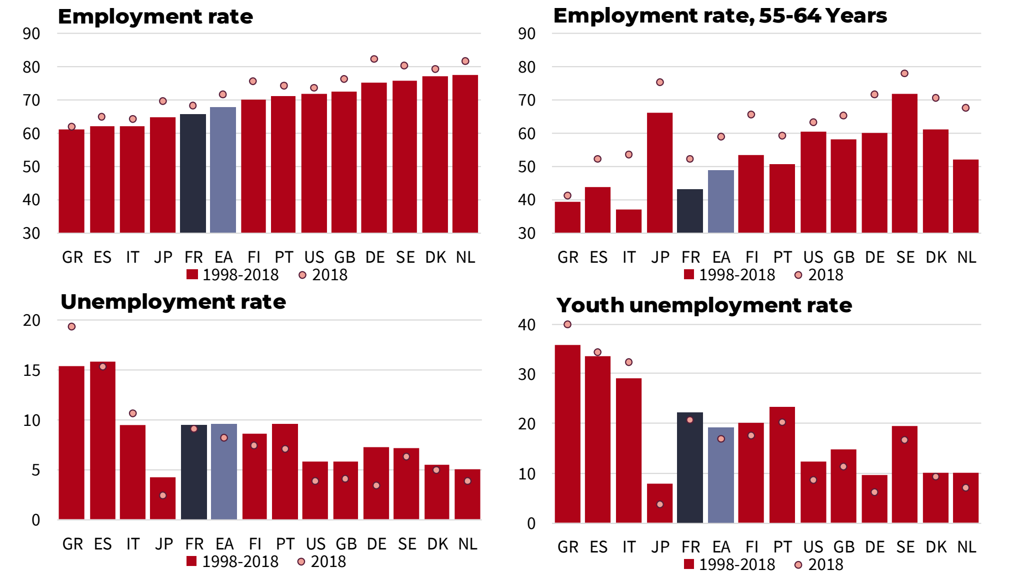


Sources: AMECO, SG Economic and Sector Studies

Sources: AMECO, SG Economic and Sector Studies

Studies have shown that firms just below 50 workers are less likely to hire new staff and prefer to expand capital instead, thus avoiding that higher cost of employment that comes with breaking above the threshold of 50 employees, be it in terms of work council requirements, less flexible and costlier lay-off conditions or higher employer contributions. This reality also helps to explain good productivity but low labour usage as reflected in both employment and unemployment rates. Low working hours presents an additional issue.

Employment rates are too low; unemployment too high

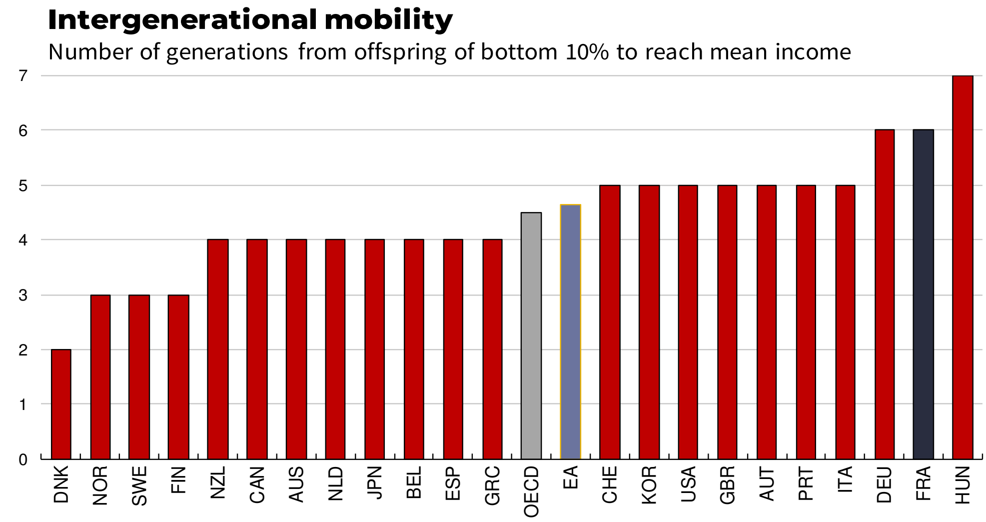


Sources: OECD, SG Economic and Sector Studies

Note: Euro area employment rate for older workers (55-65) only covers 2005-2018

A final issue relating to labour resides in the quality of education, be it schooling or life long-learning. Looking at the latest data from the OECD PISA study (2015), we note that while the overall score is close to the OECD median, France enjoys a score of 18.4% of top performers in science, reading and mathematics compared to the OECD average of 15.3% but also has a higher average of low achievers at 14.8% compared to the OECD average of 13%. Life-long learning outcomes are a further concern with almost a quarter of the workforce (23%) seen as under-qualified, placing France in the higher end of the range found by the OECD, stretching from 7% to 30%. This picture offers a first idea as to why France, despite relatively low poverty rates suffers low social mobility.

All too low social mobility



Sources: OECD, SG Economic and Sector Studies

With this backdrop in mind, it comes as no surprise that labour and education reform ranked high on Emmanuel Macron's electoral programme. Greater flexibility in product and service markets also figure and would further help lift the performance of the private sector, which in turn would alleviate some of the burden on public finances. Let's take stock of some of the major reforms put in place during the first two years of the Macron Presidency.

A FLURRY OF REFORMS

President Macron had barely taken office before he introduced **labour market reform (Ordonnances 2017)**, which sought both to introduce greater flexibility and to boost workers' rights, in a bid to lift overall employment levels and reduce the duality of the French labour market. Key aspects of the reform included (1) decentralisation of collective wage bargaining to allow a greater role at the individual company level, (2) easing contract termination clauses, notably lowering judicial uncertainty linked to terminations and placing both a floor and a cap on awards that labour tribunals can impose, (3) giving better conditions by increasing access to working from home, (4) lifting severance pay and (5) simplification of the social dialog by merging the representative various councils into a single body.

In the autumn of 2017, Prime Minister Philippe announced the "**Grand Plan d'Investissement"** of €57bn (2.5% of 2017 GDP) over the duration of the current government's mandate, running until spring 2022. The plan sets four priorities covering (1) carbon neutrality, (2) access to employment, (3) competitiveness and (4) digitalisation of public services. Note, the plan aims to be budget neutral.

In early 2018, tertiary education reform (**Loi sur l'orientation et la réussite des étudiants**) saw streamlining of (1) study selection (with the new Parcoursup platform) and (2) student contributions and social rights simplified. June 2018 delivered **reform of apprenticeship**, life-long learning and unemployment insurance (Loi pour la liberté de choisir son avenir professionnel), with the aim to boost life-long learning by (1) simplifying professional training programs and (2) allocating more funds to the low-skilled and unemployed. Apprentices will enjoy (1) better pay and (2) stronger certification of their training being phased in over the coming years. Finally, on **unemployment insurance**, the self-employment and employees who resign, will, under certain conditions, enjoy better benefits. The 2019 education reform (Loi pour une école de la confiance) made schooling compulsory from the age of three (compare to six previously) and reduces classroom sizes in underprivileged areas.

April 2019 saw new measures to lift SME competitiveness (**Loi PACTE**) by (1) simplifying the creation of new companies and various administrative procedures, (2) lightening the burden of employment thresholds with just three levels; 11, 50 and 250 employees (compared to 10, 25, 100, 150 and 200 previously), (3) strengthening public offices to help exports, (4) boosting corporate saving opportunities for SME employees and (5) various initiatives to encourage innovation.

To underpin the various structural reforms, the government has also announced a number of **changes to social allocations and taxes**, including (1) an increase in the generalised social security contribution (CSG) of 1.7pp, allowing a cut in employee social contributions of around 3pp, (2) the replacement of the fortune tax (ISF) with a tax focused only on real estate assets (IFI) and (3) a flat tax on capital income of 30%, phasing out of the residency tax for middle income households and an increase of in-work benefits (Prime d'activité). On the corporate side, measures include (1) a permanent reduction in employer social contributions by around 4pp, replacing the previous tax credit (CICE) and (2) a planned drop in the headline corporate tax rate to 25% by 2022.

Reform takes time to pay off

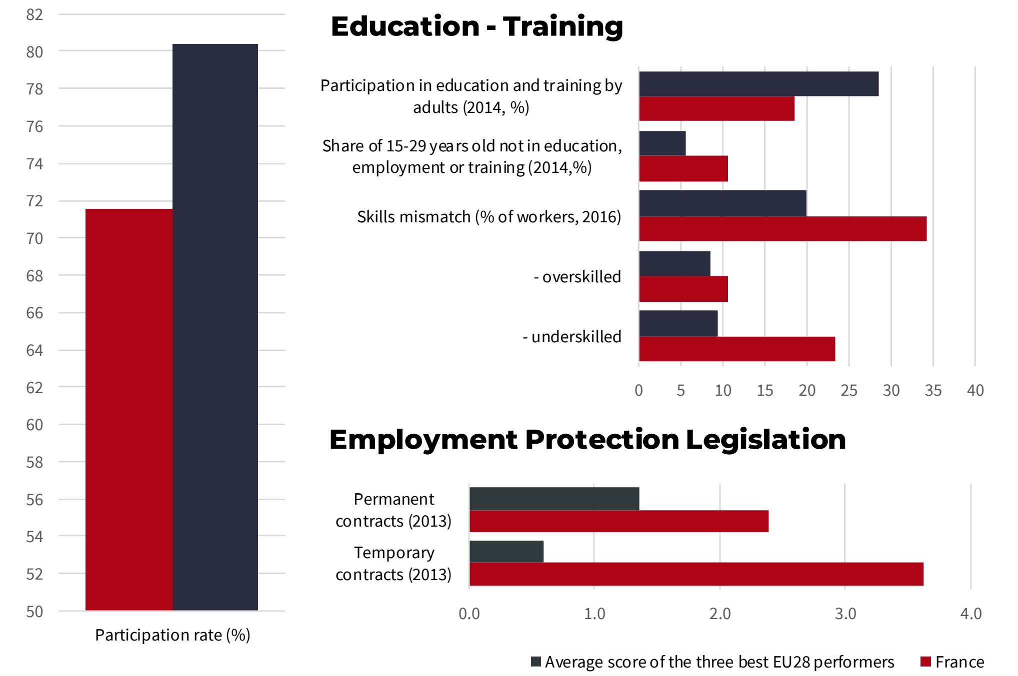
The economic impact of a given structural reform adopted by the legislator will depend critically on the reception by the public, effective implementation on the ground, the interaction with other reforms, the overall state of the economy as the reform is implemented and the reaction of financial markets. Emmanuel Macron's reform agenda has already run into criticism and social discontent, bringing a first headwind. On a more positive note, the reform process was initiated during an economic upswing and has been well received by financial markets, which should, in turn, dampen short-term downside effects.

A popular approach to gauging the economic impact of structural reform ex-ante is thus to benchmark to the best in class. Applying this approach, Varga and Veld (2014)[4] found that if France were to close its structural gap to the average of the best

[4] Varga, Janos and Veld, Jan in't (2014), The potential growth impact of structural reforms in the EU, a benchmarking exercise, European Commission, Economic Papers 541, December 2014

three performing EU member states in each category, then it could add 7.7% to GDP after 10 years relative to the baseline of no change. The OECD[5] applies a similar benchmarking framework and finds that the reforms implemented in France to date have the potential to lift GDP per capita by 5.1% after 10 years. As seen from the benchmarking shown on the chart below, France could win from catching up in several areas which also explains Macron's broad based structural reform plan.

France underperforms its best EU peers on employment and education



Sources: OECD, SG Economic and Sector Studies

As an alternative approach, we can also plug assumptions on reform effectiveness into a more traditional macro econometric model, such as NiGEM[6]. Taking the labour market participation rate as an example, the latest reading (2017) stands at 71.5% for the working age population (15-64 years of age) and INSEE estimate that this will increase to 75.7% by 2040 based essentially on pension reforms implemented by past governments. The average participation rate of the best three EU member states stands at 80.4% (2017) but may of course also increase in the future. Assuming the structural labour market reforms implemented to date lift the participation rate by 0.5pp each year over 5 years, we find that GDP is lifted by 2.0% at the 10-year horizon.

Just mechanically increasing the participation rate, however, increases unemployment. To avoid that effect, we find that we need to ensure an 7% lift to total factor productivity to increase revenue and make full use of the increased

[5] OECD (2019), France, OECD economic Surveys, April 2019

[6] The NiGEM model has been developed by NIESR and is estimated in a 'New-Keynesian' framework in that agents are presumed to be forward-looking but nominal rigidities slow the process of adjustment to external events.

participation. That's why implementing reforms while the economy is expanding is key, as well as making sure that reforms interact well with each other. Here reforms aiming at lifting skills, cutting red tape and sustain structural investment all have potential to further boost employment and productivity.

Pulling together the various observations above, we find that if Macron's agenda is successfully implemented, then this could lift French trend potential growth by around 0.5pp, from the current level of around 1.2% to 1.7%, on a long-term horizon.

We are just over halfway through the reform programme. But President Macron has expressed determination to deliver on the remainder of his agenda, including pension reform with the aim to move to a single regime in a bid to foster mobility, enhance transparency and lower administration costs, health care reform to improve prevention and coverage, institutional reform of the legislative bodies and transport and mobility reform as part of the climate agenda.

We have little doubt that the agenda will be pushed ahead, but a rather strong opposition to reforms is likely to force the government to pursue a much more expansionary fiscal policy than initially anticipated.

Fiscal boost to offset external headwinds

Purchasing power, the focal point of budget policy…

During the "yellow vests" crisis, the government decided to refocus its budgetary policy: initially founded on reducing public spending and transferring revenues from inactive to active people (to make up for the rising flexibility in the job market), it now has a broader aim of shoring up purchasing power.

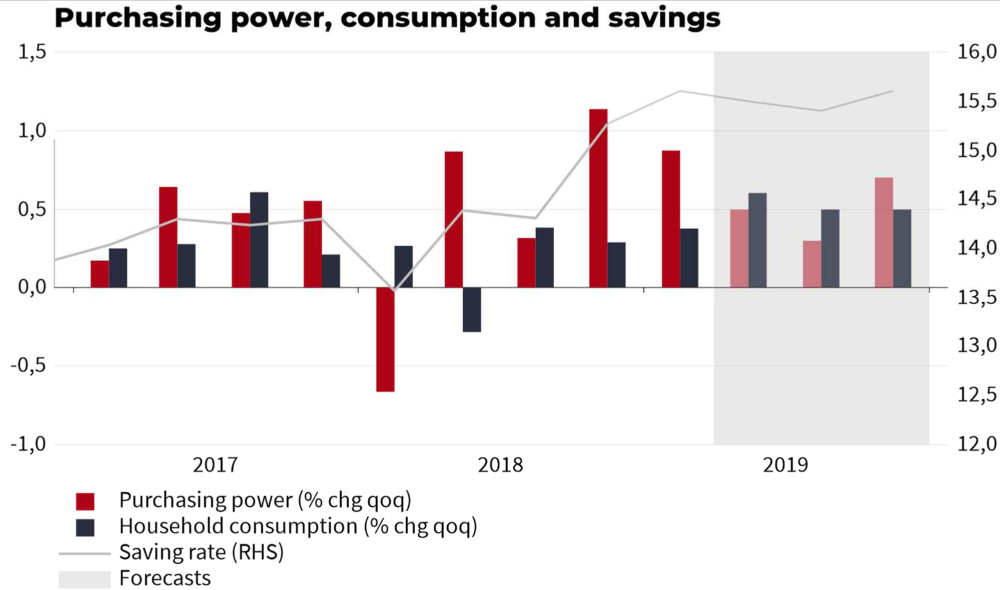
After a first fiscal package costing around €10bn (0.4 points of GDP) in December 2018, the executive announced a second set of measures, this time estimated at €7bn (0.3 points of GDP), following the "Grand Débat" consultation process. Details of how these initiatives are to be funded have yet to be specified, particularly for the second round of measures (see the box below).

FISCAL POLICY TO FUEL GROWTH IN 2019-2020

Once funding has been established, the first round of initiatives is expected to deliver an additional 0.2 points of growth in 2019, enough to compensate for the negative impact of the protests on business activity. Fiscal policy will therefore aim to smooth the predicted slowdown in activity over the forecast horizon: growth expected to narrow from 1.7% in 2018 to 1.4% in 2019 and 1.2% in 2020[7]. The impact on growth in 2020 of the second round of measures remains to be determined according to the funding selected but could amount to 0.1 point of GDP.

One of the working assumptions behind our scenario is that some level of social discontent will persist through much of 2019 as the government ploughs ahead on reform. This, combined with the uncertainty linked to global developments, is likely to keep consumers on the side of caution. Should political developments, both home and abroad, see a sharp turn for the better, it is worth noting that French households having a high savings level to unleash.

We don't expect the saving rate to decrease on our forecast horizon



Sources: INSEE, SG Economic and Sector Studies

Box – December and May fiscal packages

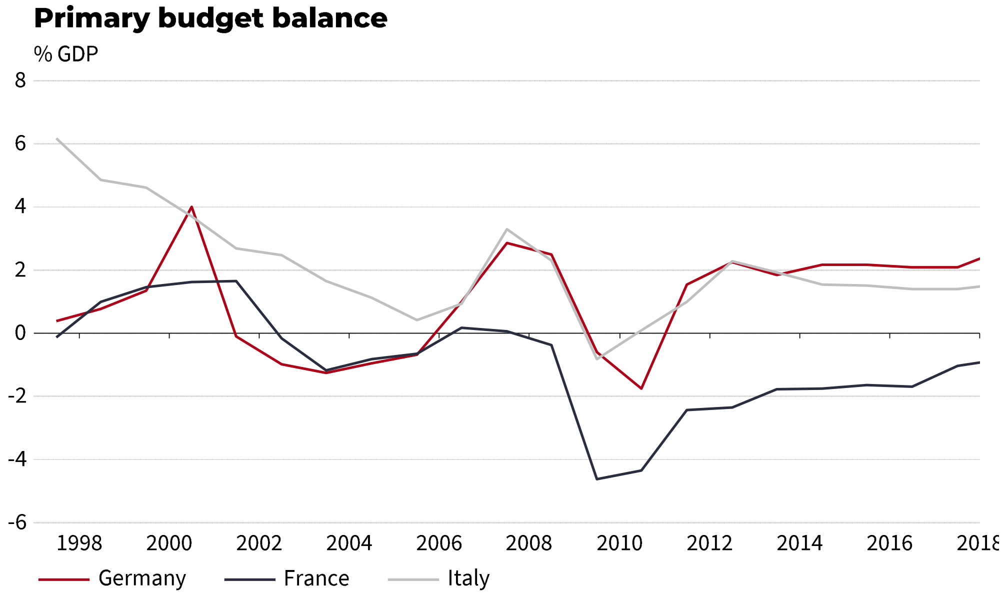
Back in December, Emmanuel Macron announced (1) the cancellation of the CSG hike on pensions between €1,200 and €2,000, (2) no taxes or social charges on overtime work in 2019, (3) no taxes or social charges on a 2018 year-end bonuses paid by employers subject to certain limits, and (4) a €100 increase on wages around the monthly minimum wage without placing any additional burden on employers, phased in by 2022.

[7] Please see our Economic Scenario for details.

In the May announcements following the "Grand débat", Macron further announced €5bn worth of tax cuts targeting middle income households and a boost to low income pensions worth a total of €1.4bn, setting the minimum pension for a full career at €1,000. Speaking to the press, Finance Minister Le Maire noted that he aimed to lower taxes on the around 12m households in the 14% tax bracket (covering income of €9,807 to €27,086) by €300 and by €180 for the around 3m households in the 30% tax bracket (covering income from €27,086 to €72,617).

The question remains open, however, as to how these measures will be financed. One idea is to remove certain tax breaks. At present, France has 474 tax breaks that cost an estimated €100bn in 2018, with around €40bn hereof benefitting corporates. Already, President Macron has promised not to touch the around €60bn of tax breaks that benefit households. On corporates, Finance Minister Le Maire has said he won't be touching the €6bn that goes to the research tax credit (CIR), nor the €20bn of the CICE (that is becoming a permanent cut in employer chares this year), nor the reduced VAT on restaurants. That essentially leaves the €7.4bn of tax breaks on the TICPE (Taxe Intérieure de Consommation sur les Produits Energétiques) as the main target. Note, that the Government had already planned certain reductions to this tax break, but they were cancelled along with the fuel taxes protested by the "Gilets Jaunes". Of course, public spending cuts may also be part of the equation. But since spending cuts is never a popular option (notably in the current social climate), it is very likely in our view that these measures are eventually financed with new taxes or an increased public deficit.

French public finances remain vulnerable despite economic expansion



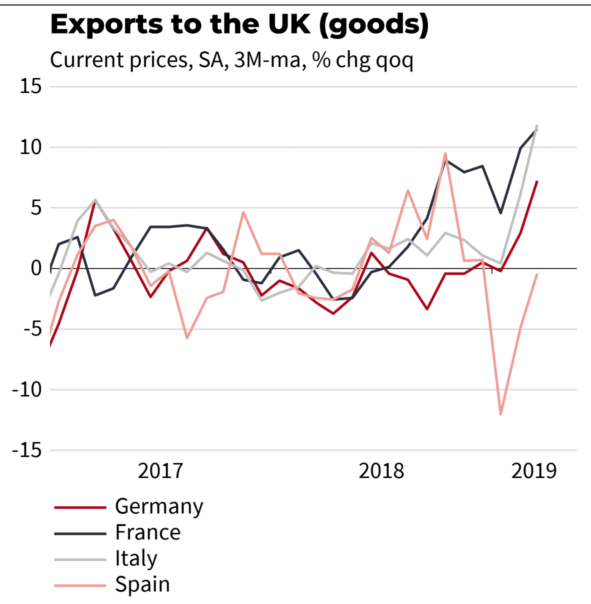
Sources: AMECO, SG Economic and Sector Studies

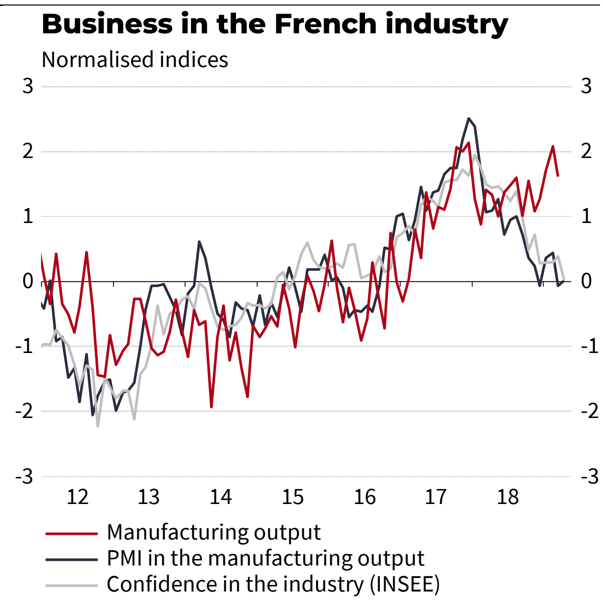
RISKS SKEWED TO THE DOWNSIDE

Nonetheless, several downside risks remain and currently weigh heavier in the balance than upside risks. Low openness and a relatively low weighting of industry in GDP (see above), mean that the French economy has so far managed to resist the slowdown witnessed across the globe since 2018. However, the escalating the trade tensions between China and the United States and persistent difficulties in German industry could take a toll on growth over time. Moreover, the sharp build-up in inventories in the UK in 1Q19, in preparation for Brexit, may well have provided an artificial boost to French production and exports, which could also explain the disparities between survey data and hard industry data. The impact of potential repercussions will be worth watching over the coming quarters.

For interest readers, we draw attention to the upcoming release of our new Economic Scenario due in mid-June.

Stockpiling in the UK may have temporarily supported growth in 1Q19





Sources: Eurostat, SG Economic and Sector Studies

Sources: INSEE, Markit, SG Economic and Sector Studies

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