European Economics

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France – Ready for Change?

The French economy is going through an air pocket... Business surveys and hard data for September point to negative growth in Q4 (p.2) . The fall in confidence has been particularly sharp since the Summer. We expect an improvement in 2013, given some signs of improvement in the global economy.

…But the debate on structural reforms is at least as important. While France has still significant strengths and its level of competitiveness is high, data over the past few years show a clear trend deterioration (p.3-9). Moreover, the fact that peripheral countries are implementing far-reaching structural reforms makes the relative standstill of the country increasingly visible. France needs to react.

The government has approved last week new measures to reduce labour costs – a clear positive, in our view. The new administration has announced a significant cut in corporate taxes, taking a first important step in addressing France's competitiveness problems. We summarise the measures in the main text (p. 10) and provide an assessment of the impact of the measures on – mainly 2014 – growth and inflation (p. 11-12).

Other key reforms are needed, and soon. Our analysis suggests that labour costs are not the only – and not even the main – problem for the French economy. As such, it is important that similar bold moves are enacted on the labour market and on social security. The government is working on both fronts and should come up with new measures by early 2013. A separate issue, but one that is also key for France, we believe, is that Germany starts boosting its domestic demand more systematically.

France=euro area. France is under market scrutiny, with some suggesting it will be the next shoe to drop in the euro area crisis. Spreads have, however, moved in the opposite direction to that view in recent months. For us, a key often overlooked strength is that France is the median euro area country in many respects. As such, area wide policies are most of the time "tailored" for France. A worsening economic situation in France will probably entail policy reactions at the euro area level that would suit the country.

Risks to our benign view on France. That's why we think that a deterioration in France would not automatically mean an escalation of the existing "periphery" problem. It would instead likely bring the euro area closer to the US or UK model, with likely outright QE, depreciation of the currency, and slower fiscal consolidation. Risks to our view would be related to much weaker – and France-specific – GDP developments in the coming quarters, a (multi notch) downgrade and/or a serious further deterioration in the euro area crisis. And clearly, France might lose its median status if reforms do not materialize.

The French economy is going through an air pocket

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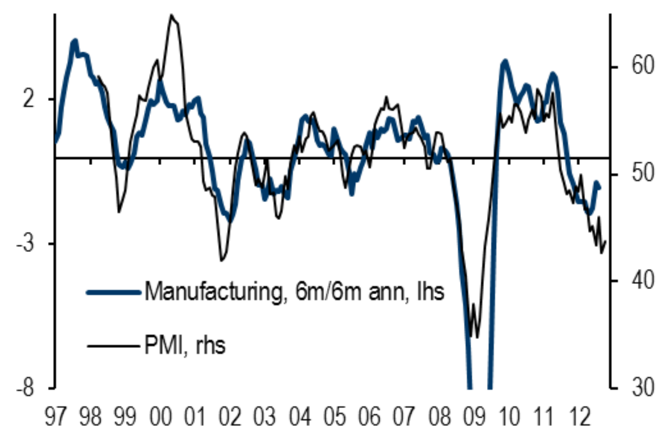
France has managed to skirt recession so far. Real GDP has been virtually flat for the past year. Despite PMIs suggesting a significant weakening in H2, consistent with negative growth rates, hard data have so far surprised on the upside. Overall, our monthly GDP indicator for France suggests that Q3 GDP growth could even be positive (Exhibit 2).

However, it will be difficult to avoid a GDP contraction in Q4. September industrial production figures were weak, providing a significant negative carryover for Q4. Meanwhile, surveys have continued to deteriorate in October. We view it unlikely that France will do better than our central estimate of a 0.2% q/q contraction in real GDP.

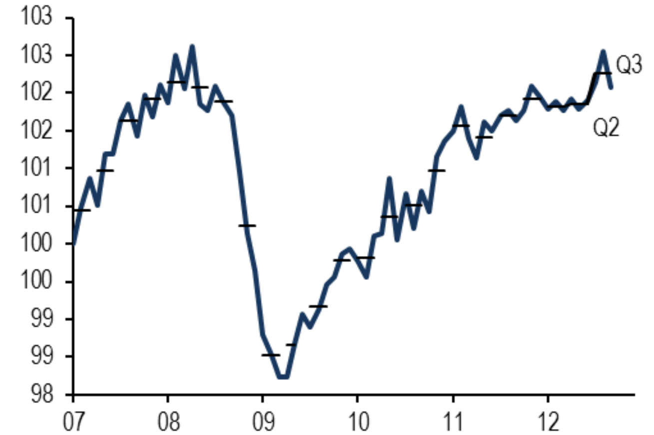
To see more forecasts for the French economy, click here (p14).

Exhibit 1: Manufacturing production vs. PMIs



Source: Credit Suisse, Markit Economics, Thomson Reuters DataStream

Exhibit 2: GDP monthly indicator



Source: Credit Suisse, Thomson Reuters DataStream

External imbalances are gradually building, but the fiscal adjustment is progressing as expected. Current account figures continue to paint a trend deterioration in external balances (Exhibit 3), while data on the budget front appear, on our estimates, broadly consistent with the official target of a 4½ % of GDP deficit.

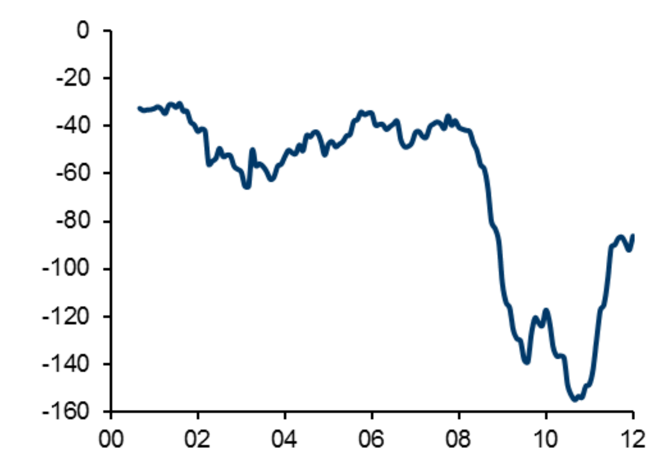
Exhibit 3: Current account balance

€ bn, 3month moving average, annualised

Source: Thomson Reuters DataStream, Credit Suisse

Exhibit 4: French state borrowing requirements

State borrowing requirements - 12 month rolling sum, € bn



Source: French Economy Ministry, Credit Suisse

Growth next year should be anemic, notably on the back of a larger fiscal adjustment than this year. Although France outperformed the euro area in 2012, we expect it to underperform it slightly next year. The 2013 budget is a key component in achieving what has been defined as France's "biggest fiscal adjustment in a generation." The aim of the government is to cut the budget deficit from about 4.5% of GDP in 2012 to 3% of GDP in 2013. Our real GDP growth forecast for next year (0.7%) is broadly in line with the government's 0.8% real GDP growth assumption, although we are slightly more optimistic on the global growth outlook, and we expect a somewhat smaller fiscal adjustment in France next year.

Structural strengths

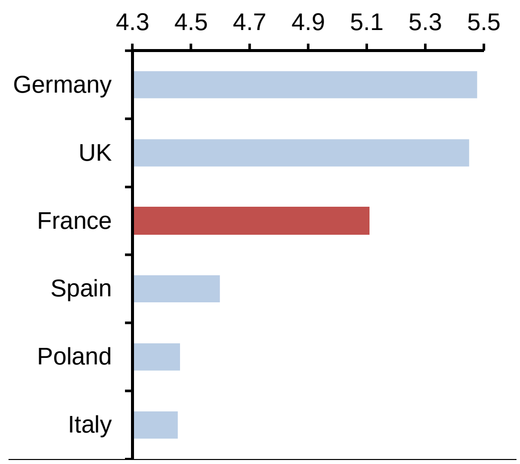
Before delving into France's structural fragilities, we point out some of its strengths that we believe should not be overlooked.

France is still relatively competitive with a high potential for innovation. France remains amongst the most competitive countries in the world, according to global competitiveness surveys, despite some deterioration in recent years (Exhibit 5).

France's production is strongly skewed towards high technology products – even more so than Germany (Exhibit 6). R&D expenditure, although lower than in Germany, is larger than in other key euro area countries (Exhibit 7). The quality of education and the number of engineers are high and the quality of the infrastructure is recognized globally.

Exhibit 5: Competitiveness Score

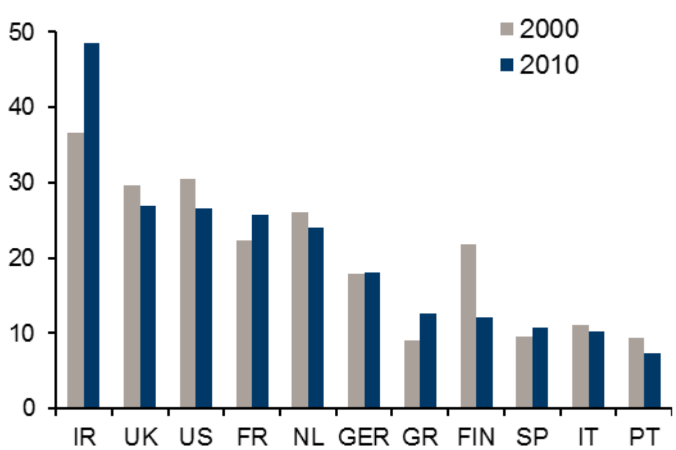
On a scale of 1-7, where 7=best



Source: 2012 World Economic Forum, Credit Suisse

Exhibit 6: Production of hi-tech goods

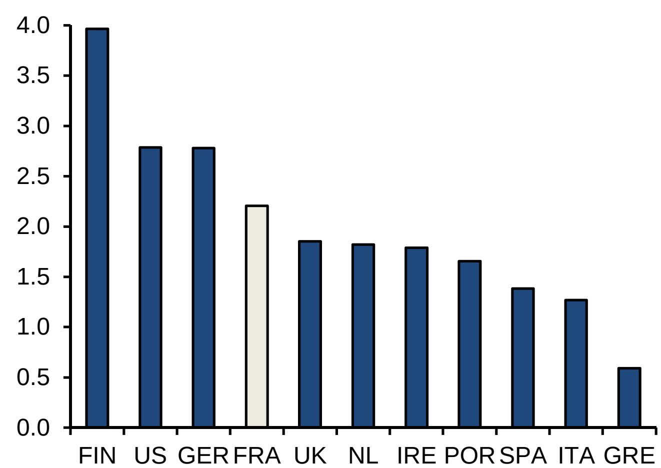
% of total industrial production



Source: OECD, Credit Suisse

Exhibit 7: R&D expenditure

% of GDP, 2009

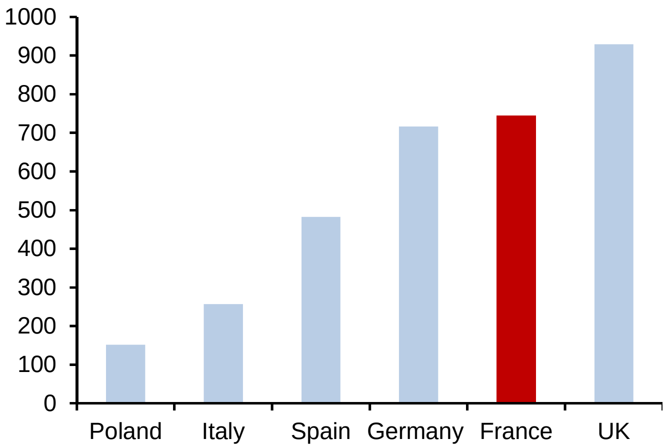


Source: OECD, Credit Suisse

The attractiveness of France in the above surveys is also reflected in high levels of foreign direct investment in the country (Exhibit 8).

Exhibit 8: Foreign direct investment stock

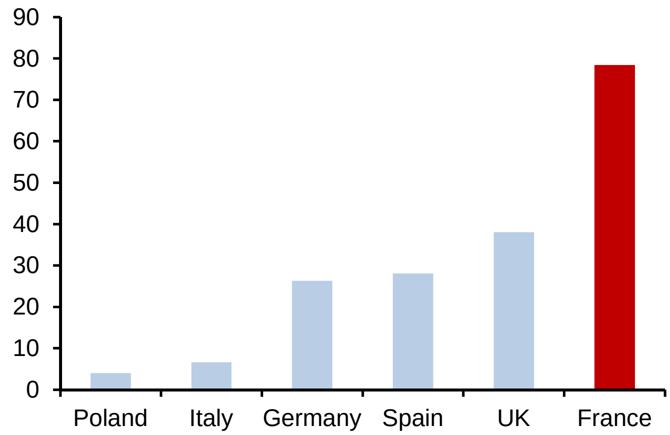
Total stock of foreign direct investment in the reporting economy end 2011, €bn



Source: Eurostat, Credit Suisse

Exhibit 9: Foreign direct investment flow

Gross FDI inflows Q3 2011-Q2 2012, €bn

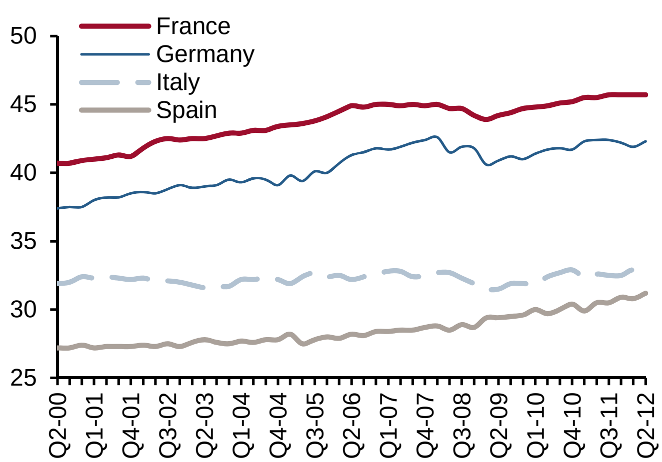


Source: IMF, Credit Suisse

While wages are high – as we explain more in detail below – France retains high levels of productivity (Exhibit 10). Although productivity growth might be slowing (Exhibit 11), this is also the case in other EU countries.

Exhibit 10: Labour productivity

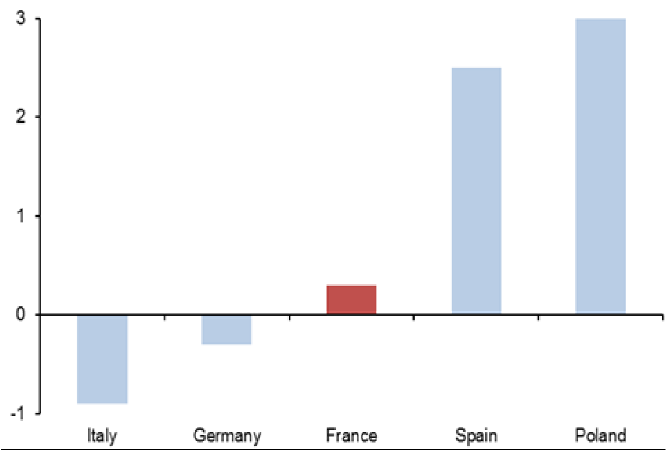
Euro per hour worked, sa



Source: Eurostat, Credit Suisse

Exhibit 11: Productivity growth

Change in real labour productivity, Q2 2012 compared to a year earlier, %

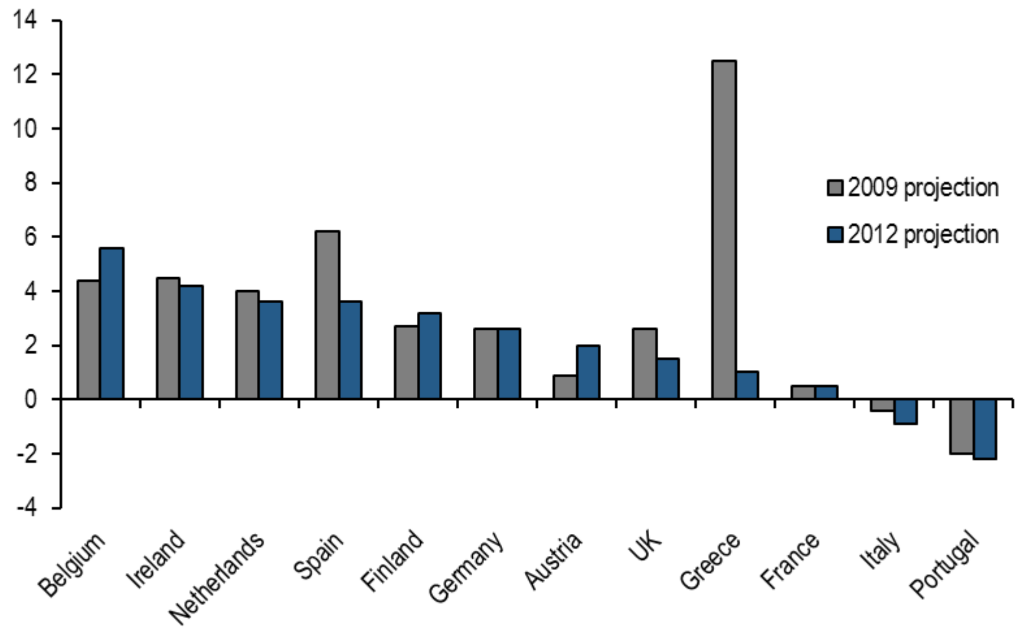


Source: Eurostat, Credit Suisse

Positive demographics compared to most European peers is also a key asset for potential growth and in terms of pension funding. On the latter point, simulations from the European Commission show that France is in a better position than most of its European peers (Exhibit 12).

Exhibit 12: Projected increase in pension expenditure

Percentage points of GDP



Source: European Commission, Credit Suisse

Politics matter. Finally, we would like to stress an often overlooked aspect: France is, in many respects, the median country of the euro area. We illustrate this point in the series of charts overleaf, that show that France has been the closest country euro area average figures in all the key macroeconomic dimensions (Exhibits 14-19). This provides a key advantage, we believe: area wide policies are most of the time "tailored" for France.

In other words, a worsening economic situation in France will probably entail policy reactions at the euro area level that would suit the country. That's why we think that any deterioration in France would not mean an escalation of the existing "periphery" problem. It would instead most likely bring the euro area closer to the US and the UK model, with outright QE, depreciation of the currency, and slower fiscal consolidation.

Risks to our view would be related to much weaker – and France-specific – GDP developments in the coming quarters, a (multi notch) downgrade and/or a serious further deterioration in the euro area (political) crisis.

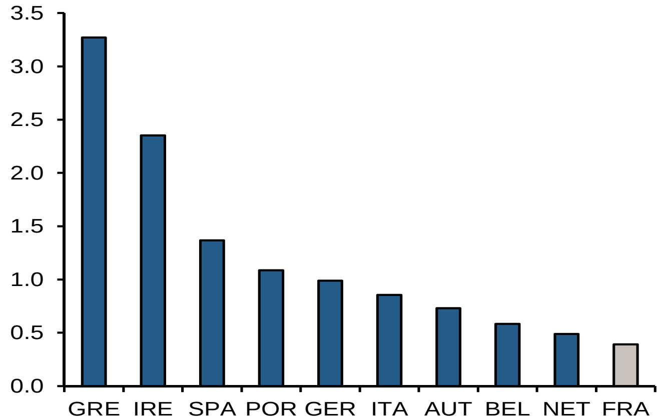
Exhibit 13: France's credit ratings

Agency Name	Rating	Outlook
Fitch	AAA	Negative
Moody's	Aaa	Negative
S&P	AA+	Negative
Agency Name	Rating	Outlook

Source: Credit Suisse

Exhibit 14: France=Euro area… GDP growth

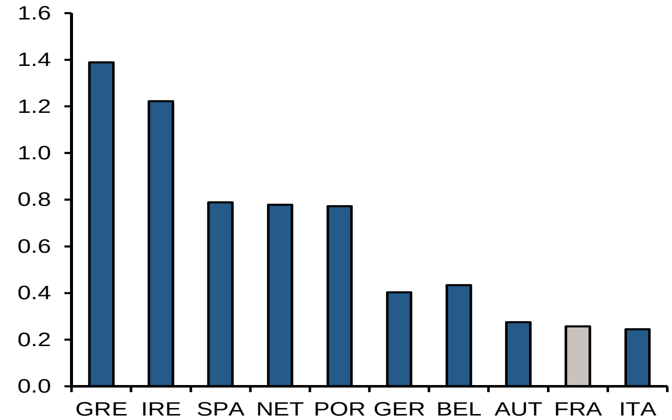
Average distance from EA figures (2000-2012), pp



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 15: France=Euro area… Inflation

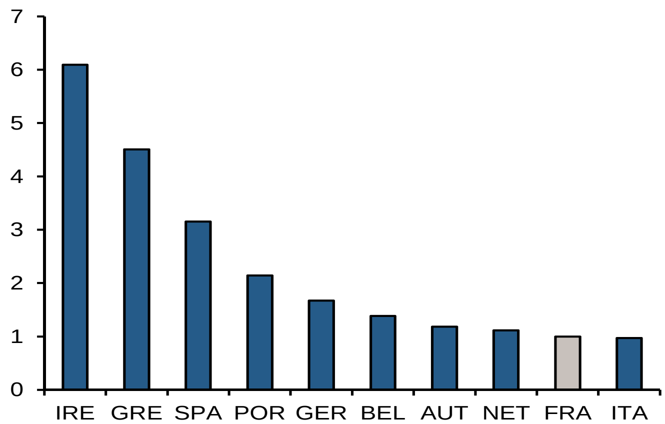
Average distance from EA figures (2000-2012), pp



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 16: France=Euro area…Government balance

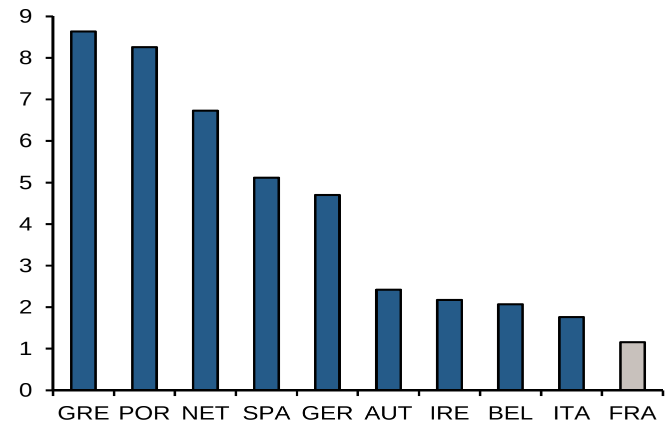
Average distance from EA figures (2000-2012), pp of GDP



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 17: France=Euro area…Current account

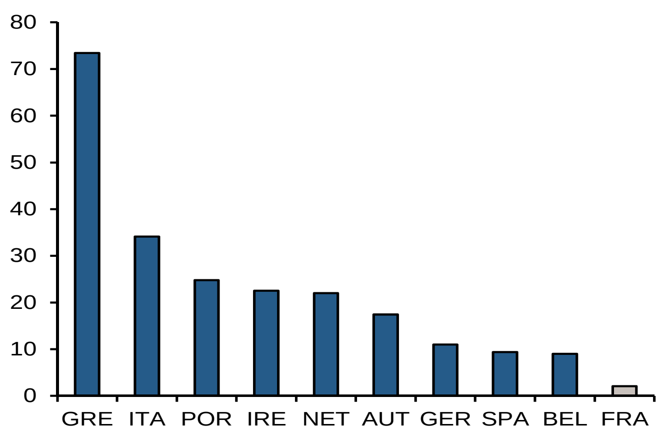
Average distance from EA figures (2000-2012), pp of GDP



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 18: France=Euro area… Government debt

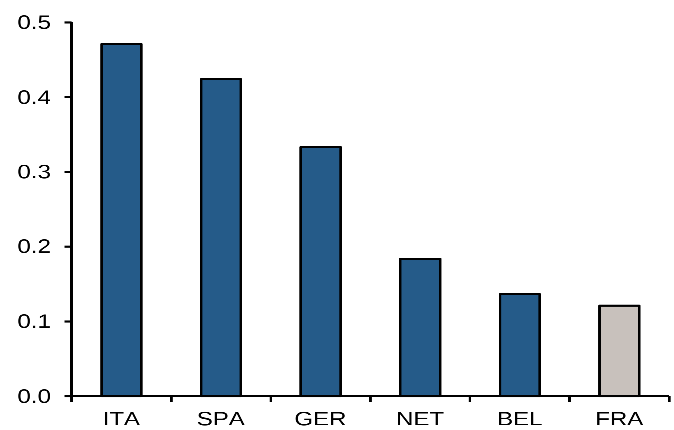
Average distance from 2012 EA government debt-to-GDP ratio, pp of GDP



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 19: France=Euro area… 10-year yield

Average distance from EA aggregate yield (2000-2012), pp



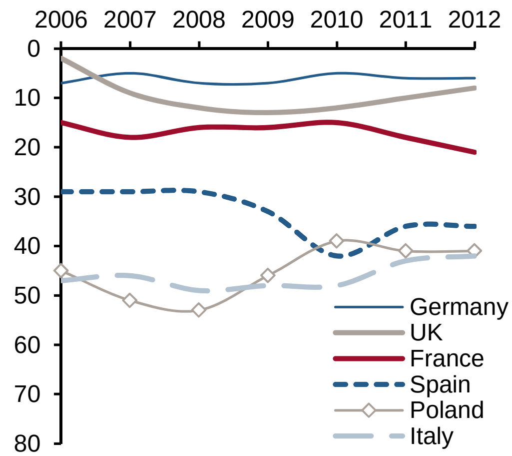
Source: Credit Suisse, Thomson Reuters DataStream

Structural weaknesses

Despite France's enduring strengths, it is undeniable that the country's relative position has been weakening. Although it is still easier to do business in France than in many of its peers within the EU, the business environment in France has been deteriorating rather than improving over the past few years. According to the World Economic Forum's Global Competitiveness Index (GCI) France's global competitiveness ranking declined from 15th in 2010 to 21st in 2012 out of 144 economies (Exhibit 20).[1] The World Bank's Doing Business Report depicts a similar picture; France's ranking is expected to weaken from 32nd in 2012 to 34th in 2013.[2]

Exhibit 20: Competitiveness Ranking

Global ranking out of 144, where 1=most competitive

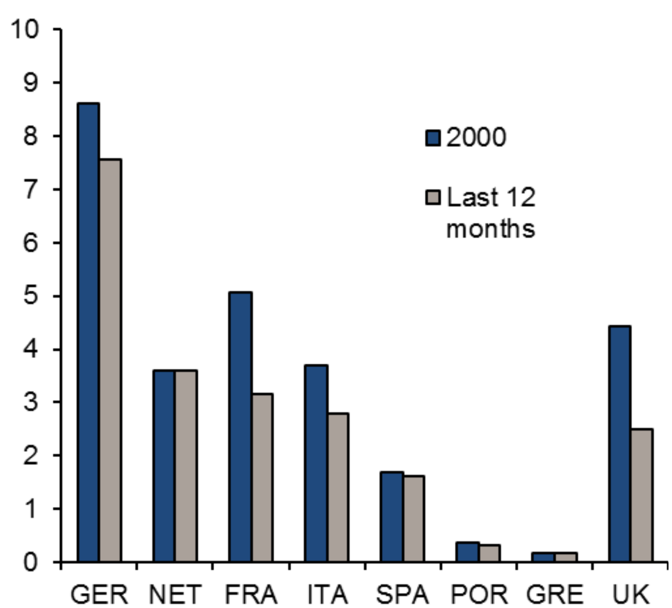


Source: 2012 World Economic Forum, Credit Suisse

Hard data also confirms weakening competitiveness. France has lost export market shares, probably more than any other country in Europe – with the exception of the UK – over the past decade. The share of its industry has shrunk over the same period, while companies' profit margins are low. These indicators suggest price and non-price competitiveness challenges.

Exhibit 21: Export market shares

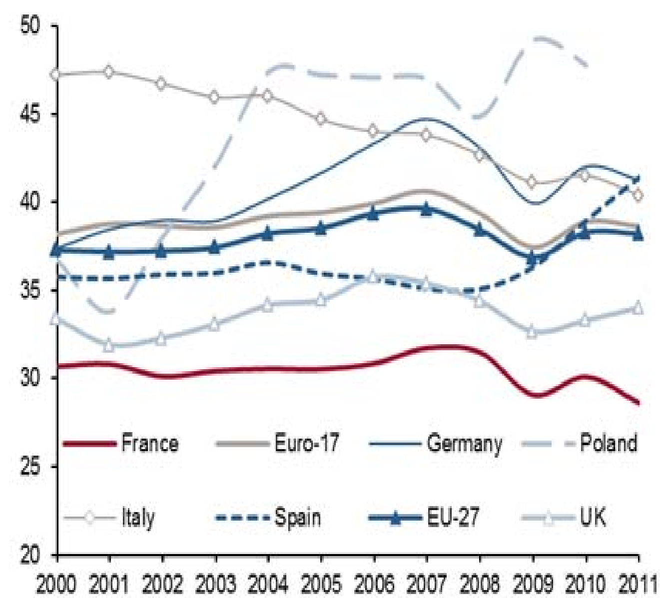
% of world exports



Source: IMF, Credit Suisse

Exhibit 22: Profit share of non-financial companies

Gross operating surplus divided by gross value added, %



Source: Eurostat, Credit Suisse

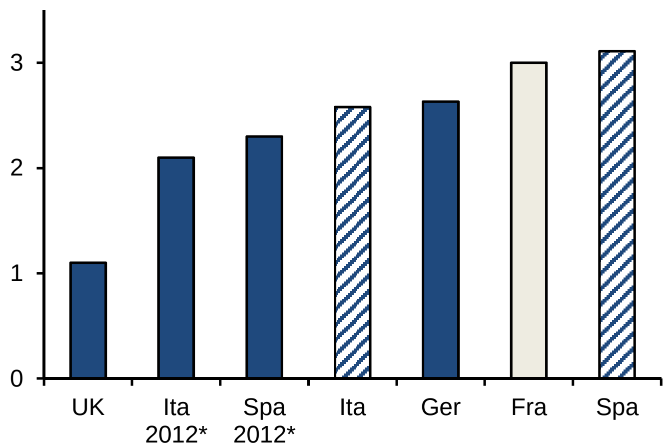
[1] The GCI is a comprehensive tool that measures the microeconomic and macroeconomic foundations of national competitiveness.

[2] The rankings are established by combining a series of indicators encompassing permits, registrations, protection of investors, taxation, and also easiness to get credit.

A key weakness is the rigidity of the labour market. This is exacerbated by the extent and effect of taxation and difficult access to financing, while the burden of government regulation also ranks poorly in global comparisons. France had one of the most rigid labour market within the euro area already ahead of the crisis according to OECD indicators, but it has also been lagging with reforms, while many of its peers have been implementing significant measures to address their rigidities. **France's standstill is becoming increasingly visible, as Italy and Spain are engaging in deep reforms (Exhibit 23).**

Exhibit 23: OECD employment protection index

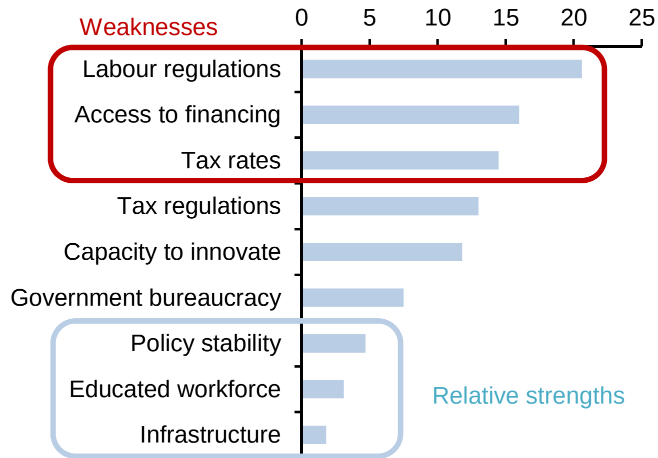
On a scale of 1-6, where 6=most restrictions, 2008 unless indicated otherwise



*Credit Suisse estimates. Source: OECD, Credit Suisse

Exhibit 24: Problematic factors for doing business

% of responses, 2012



Note: From a list of factors, respondents were asked to select the five most problematic for doing business. Source: World Economic Forum, Credit Suisse

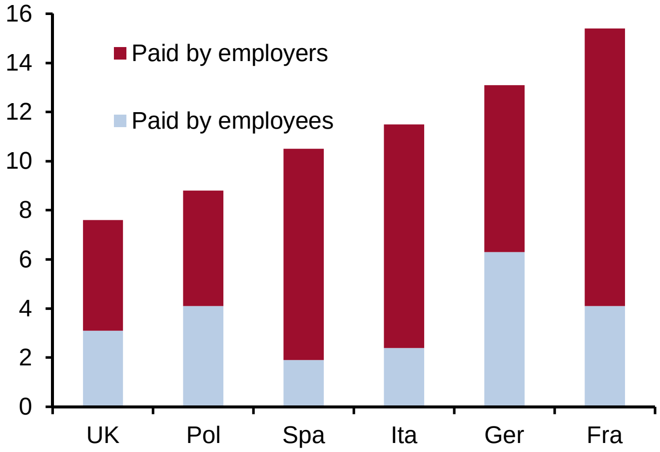
France's tax mix also represents a burden on the labour market, as it is heavily reliant on social security contributions. According to Eurostat data for 2010, the total receipts from taxes and social contributions (including imputed social contributions) in France were around 44.5% of GDP, which was above the EU-27 average and the ratio in Germany (both around 39.5% of GDP). In particular, social security contributions were around 18.7% of GDP in France, higher than the 16.9% of GDP in Germany and the EU-27 average of 13.9% (Exhibit 25). Although social security contributions are skewed towards higher wages in France – thanks to several measures to cut social contributions for the low skilled since the 1990s – suggesting that France is more cost competitive than it seems by just looking at aggregate data[1], the overall burden remains significant. **This tax structure leads to a relatively high labour tax wedge.**

Meanwhile, France's VAT rate is relatively low compared to its peers within the EU (Exhibit 28). As a consequence, many observers, including ourselves have suggested in the past that France should embark on some form of fiscal devaluation (i.e. cutting labour costs and rising VAT).

[1] For details see: http://www.tresor.economie.gouv.fr/File/324545

Exhibit 25: Social security contribution aggregates

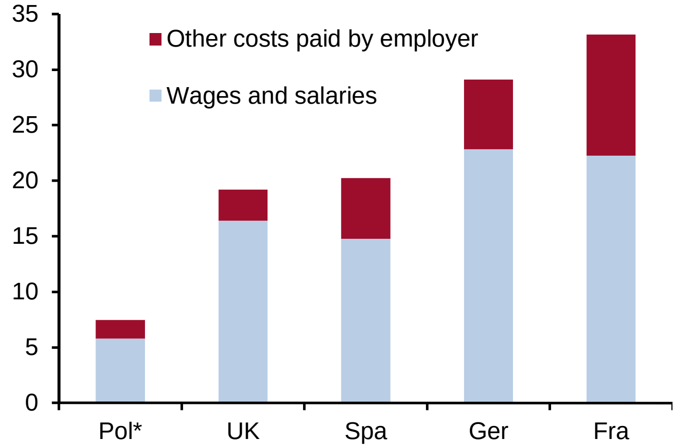
% of GDP, 2010



Source: Eurostat, Credit Suisse

Exhibit 26: Composition of hourly labour costs

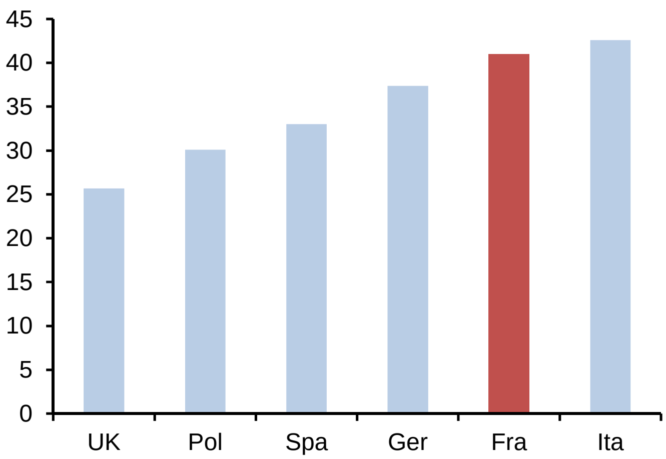
€, 2010



Source: Eurostat, Credit Suisse

Exhibit 27: Implicit tax rates on labour

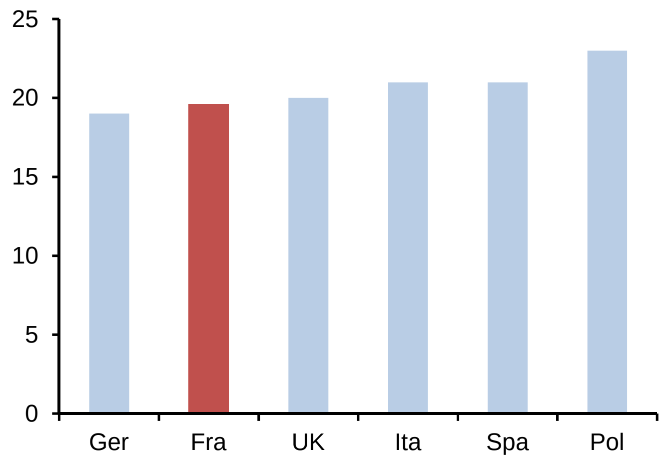
%, 2010



Source: Eurostat, Credit Suisse

Exhibit 28: Standard VAT rates

%, 2012



Source: Eurostat, Credit Suisse

Other key issues in France include access to financing and, to some extent, the capacity to transform fundamental research into (commercially viable) innovations, as Exhibit 24 suggests.

A reform pact

On 5 November, the commission on France's competitiveness appointed by Prime Minister Ayrault and led by Louis Gallois (ex-CEO of EADS) presented its report. The report provided a very similar analysis of the problems of the French economy to the one provided above. It also proposed 22 action points. The key proposals are summarized in the box below:

The Gallois-report on competitiveness – key recommendations

- **Cut labour costs** – Cut social security contributions by €30bn to lower labour costs – €20bn from the charges paid by employers and €10bn from those paid by workers – and compensate with spending cuts and extra consumer taxes, including higher VAT and a carbon tax.
- **Provide a stable backdrop for businesses** – Maintain, over the government's five-year term, the various business-friendly measures currently in place including tax credits and public financing for research and innovation, and special incentives for start-ups.
- **Create a French "Small Business Act"** – Reduce the legal and fiscal obstacles for small firms seeking to grow into mid-sized companies, to address the lack of an equivalent to the "Mittelstand" that are the backbone of Germany's economy.
- **Provide funding for innovative companies** – Alter tax rules for life insurance funds to provide incentives to invest more in shares over bonds, including stock in unlisted companies.
- **Increase the new public investment bank's capacity to invest in SMEs.**
- **Support exporting companies** – Align conditions of French export credit to the best practices prevailing in peer countries. Improve support for exporters by simplifying conditions to access export credits and creating a framework for smaller companies to group together to better access export markets.
- **Improve employees/unions-employers relations** – Allow four employees onto the boards of directors of companies with more than 5,000 staff, to improve decision-making and spread responsibility beyond management.
- **Improve the link between companies and the educational system** – Improve vocational training and set up more partnerships between educational centres and professional bodies to ensure companies can find the talent they need.
- **Improve the quality and training of the labour force** – Create a standard competences account for employees that is recognised across firms.
- **Increase the private share of R&D** – France R&D is strong at the public level, but less so at the private level and the public-to-private transfer of technology is unsatisfactory.
- **Improve cooperation at the regional level between firms in a same sector** –Condition state incentives to the involvement of providers of the same region or industrial district.
- **Push for collaboration between French firms to reveal synergies.**

Following the guidance of the Gallois-report, the government took a series of decisions on 6 November, in the "Pacte national pour la croissance, la competitivite et l'emploi" . We summarise the key decisions below.

A cut in labour costs – the government decided a €20bn tax credit for companies: initial €10bn would be given in 2014 (via lower taxes on 2013 revenues), with additional €5bn in 2015 and again in 2016. This is equivalent to a significant tax reduction for companies, and will be based on the gross wages paid by a company to its employees (for wages up to 2.5 times the minimum wage, so up to around €3500). **The government estimates that this amount would correspond to a 6pp reduction in labour costs.**

Easier financing of SMEs – a new liquidity line will be provided to SMEs from 2013 through the new Public Investment Bank (BPI). The latter will also invest directly and provide various funding instruments for SMEs. Moreover, the government will provide incentives for households and life insurance companies to invest in SMEs' shares and will ease SMEs' access to capital markets.

Facilitating doing business – the government will maintain a series of key incentives for companies, such as the research tax credit, while simplifying administrative procedures and reinforcing the infrastructural backdrop.

Supporting innovation and exports – this will be done by the strengthening of the existing research districts and by supporting the transfer of technology from fundamental research to companies. Also, export financing will be reinforced and a new "Made in France" brand will be launched to promote French products abroad and also attract investment from abroad.

Improving labour relations – two employees' representatives will have to be on the boards of big companies; incentives will be introduced to improve on-the-job training and to help SMEs hire apprentices; and a new public agency will be established to guide job seekers and help in changing careers.

To compensate for the €20bn fiscal revenue shortfall, the government announced changes to the VAT rates, as well as spending cuts and an environmental tax. Changes to the VAT rates will be implemented from 2014: the new VAT rates will be 5% (down from 5.5%), 10% (up from 7%) and 20% (up from 19.6%). The expected revenue increase from remodeling the VAT is of around €6bn. The government has also announced additional spending cuts worth around €10bn, in 2014-2015. Finally, a new environmental tax will be introduced by 2016 to raise €3bn in revenues a year.

We expect the measures to be voted by Parliament in the coming months. Some modifications are still possible, and details are still required, notably on the specific expenditure cuts and on the costing of and funding of the whole package. We provide however our first assessment below.

Our view

Our initial assessment of the measures is broadly positive:

- The package includes a significant cut in labour costs;
- The tax credit offered appears simpler than initially expected;
- It will apply to all companies, even those not making profits/not paying taxes;
- The package also includes non-cost competitiveness measures;
- The increase in VAT to finance corporate tax cuts makes sense in our view, as it adds to competitiveness as we explain below;
- We also find positive that the government is planning additional spending cuts on the back of this package;
- Finally, the package has been generally well received by industrialists and unions alike, providing some social support to the measures. This is particularly relevant given the negative reaction – especially from businesses – to the government's first measures earlier this year, notably on taxation.

Some elements have ambiguous effects:

- **Timing of implementation –** The tax cut will be only introduced gradually and the positive impact on competitiveness and on employment may be delayed. However, this also means that the measures do not affect public finances until 2014, and the VAT hike will only start to dampen consumption in 2014, limiting the risk on domestic demand in the current fragile phase of the business cycle.
- **Not just for the industry –** Although it might have been more efficient to target the manufacturing sector specifically, the measures benefit the services sector too. Nevertheless, the manufacturing sector's cost for services is as large as its cost for labour. Thus, the cut in labour costs for the services sector should also support the competitiveness of the manufacturing sector to some extent and indirectly.
- **Politics –** The increase in the VAT to finance part of the measures is similar to what the previous government wanted to do (but was strongly contested by the then opposition), which may lead some members of the governing majority to object to the package.

On a more negative note, the package contains only initial elements of labour market reform, in our view. The cut in labour costs is a positive step, but it has to be accompanied by structural reforms, including changes in labour market regulation, to achieve tangible and lasting results, in our view.

Negotiations about further, more substantial labour market reform are under way. Since the beginning of October, the government has been holding regular consultations with employers' associations and worker unions to reach an comprehensive agreement by early 2013. However, we have yet to see evidence of meaningful progress, and hence the outcome of these talks remain uncertain.

Impact assessment

Impact on competitiveness. A VAT hike has generally a positive impact on a country's competitiveness, as it increases the price of imports but has no impact on exported goods' prices – similar to a devaluation. Furthermore, if the income from the VAT hike is allocated to a cut in corporate taxes or in social contributions paid by the employer then the effect on competitiveness will be even larger, as this lowers labour taxation. However, other European countries are implementing similar policies, which dampens the outright competitiveness gains for France compared to its European peers.

We believe that the reforms could help increase employment at the margin and in the medium term, through the lower cost of labour and the gains in competitiveness. However, the impact is likely to be small.

We would also expect a small positive for growth – the negative impact from likely higher inflation due to the VAT increase should be more than compensated for by the positive impact on employment and competitiveness, although the latter impact should appear somewhat later than the former. Moreover, in terms of timing, a small boost to 2013 GDP, before the VAT increase is enacted in 2014, (and a small negative effect afterwards) can be expected, in our view.

Impact on inflation. We estimate that the VAT rate changes in 2014 could add up to 0.5pp to HICP inflation in France, assuming a fairly high pass through of the VAT increases to domestic consumer prices.

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Disclosure Appendix

Analyst Certification

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