BTMU Economic Brief

France – Macron's domestic reform agenda could result in more durable expansion

HENRY COOK
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1591
E: henry.cook@uk.mufg.jp

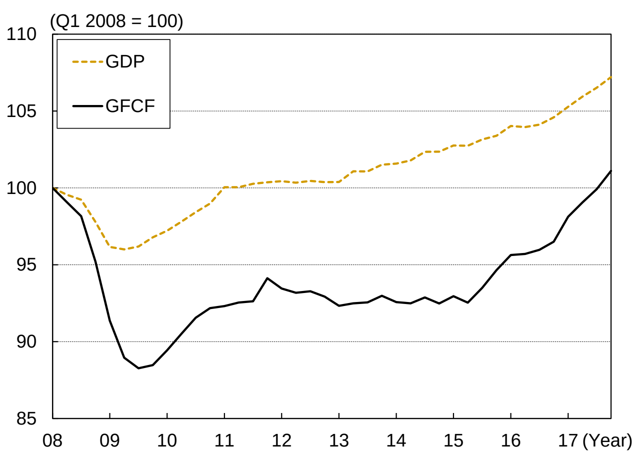
16 MARCH 2018

The Bank of Tokyo-Mitsubishi UFJ, Ltd.
A member of MUFG, a global financial group

1. Introduction

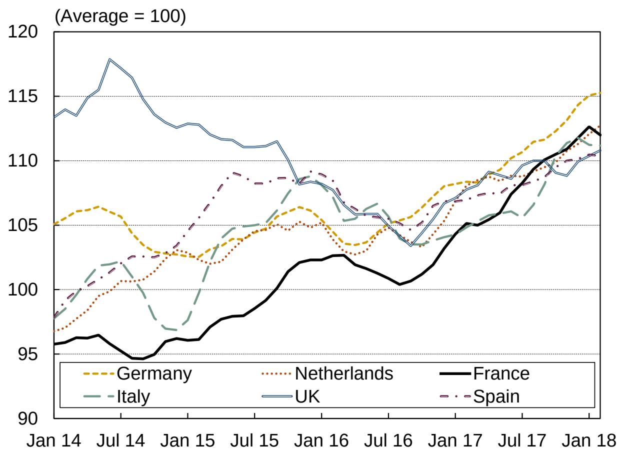
French president Emmanuel Macron has inherited an economy that is going from strength to strength. After three years of modest growth, France rounded off 2017 with robust 0.6% QoQ GDP growth leaving the annual average at 2.0%. This was the highest for six years and means a carry-over of 0.9% into 2018. As Chart 1 shows, activity has been driven in large part by stronger investment which has finally recovered above the pre-crisis level. Within this there are signs that construction, a long-time drag on growth, is finally bottoming out. The expansion is not just an investment story. Net exports also contributed significantly to Q4 2017 GDP growth, spurred on by the global pick-up in trade. This synchronised upswing is boosting confidence across Europe, but the improvement in France seems particularly pronounced. Chart 2 shows that French economic sentiment was lower than in other developed European economies at the end of 2016 then surged upward to be firmly in the middle of the pack. The labour market recovery is helping. The unemployment rate plunged from 9.6% in Q3 2017 to 8.9% in Q4, the lowest since 2009. Macron has also started with momentum and energy which could be improving both domestic sentiment and international investors' views on France.

Chart 1: Real GDP and GFCF



Source: INSEE, BTMU Economic Research Office

Chart 2: Economic Sentiment

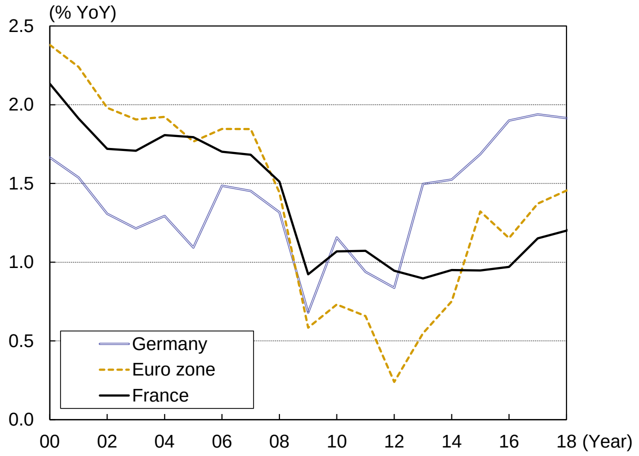


Source: European Commission, BTMU Economic Research Office

2. Challenges

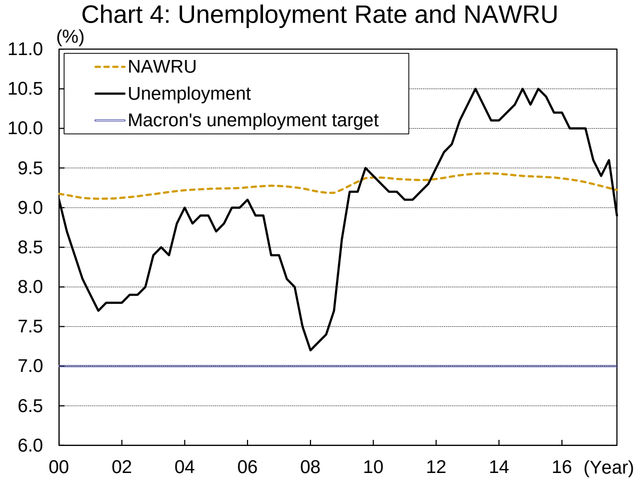
The French economy appears well-placed but the boost from the cyclical upswing could be limited. The European Commission estimates that potential GDP growth is just 1.2% YoY in 2018, lagging Germany and the euro zone as a whole (Chart 3). Structural unemployment remains stubbornly high. Macron has pledged to reduce the unemployment rate to 7% by the end of his term in 2022, but, despite recent progress, this seems a long way off. Chart 4 shows the non-accelerating wage rate of unemployment (NAWRU) estimate, a proxy for the structural rate, is over 9%. There are several key challenges to address.

Chart 3: Potential GDP Growth Estimates



Source: European Commission, BTMU Economic Research Office

Chart 4: Unemployment Rate and NAWRU



Source: INSEE, European Commission, BTMU Economic Research Office

(1) Labour market friction

Labour market friction is one of the most pressing issues facing France. Using the latest data from October, INSEE, the national statistical agency, reports that half of companies experienced barriers to hiring. 22% listed employment-related costs, and 17% listed regulations as the most significant barriers. Employment protection in France has historically been very high. Dismissals are subject to various requirements and procedure and severance payments can be especially costly, particularly if the dismissal is deemed unfair. Collective bargaining coverage stood at 98.5% in 2014. In addition, the average rate of employer's social security contributions is among the highest in the OECD.

This creates a significant incentive for firms to hire on temporary contracts. In 2017 just 15% of hires were on a permanent basis. The recent decline in the headline unemployment rate masks some gloomier figures. The number of involuntary part-time workers (working fewer hours than desired) has risen by 675k since 2012. The youth unemployment rate remains high at 22%. Eurostat reports that the rate of young people not in education, employment or training (NEET) is five times as high for those with a low level of education compared to those with an intermediate level.

(2) Education

Low educational attainment is another challenge. As unemployment improves, skills shortages are becoming increasingly apparent. France is outside the top 25 in both mathematics and science in the PISA 2015 rankings. The NEET rate remains above the pre-crisis average.

Participation in vocational programmes (apprenticeships) is below most other European countries in the OECD.

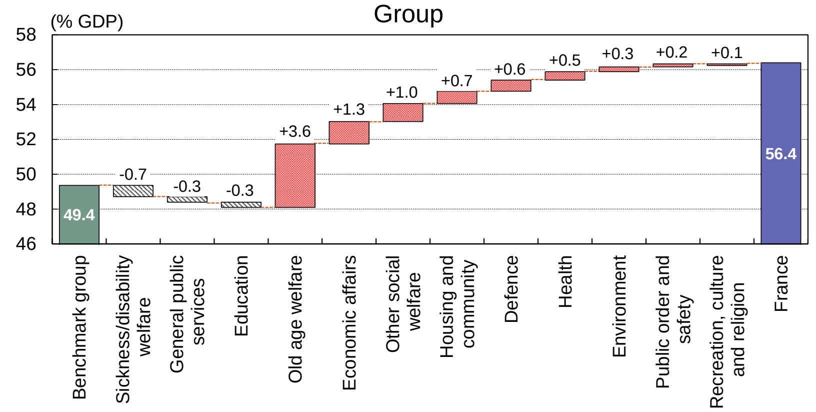
(3) Public finances

French public finances offer limited room for manoeuvre. The fiscal deficit improved to an estimated 2.9% of GDP in 2017, but it was helped by the favourable external environment rather than any meaningful change in policy. It is only just within the 3% Maastricht limit (and the first time it has been since 2007). The European Commission expects it to remain at 2.9% in 2018.

Public debt is high at 97%, well above the total of 83% for the EU as a whole. Chart 5, below, shows how French public spending compares with a benchmark group of northern European countries. This is useful when considering which areas may be targeted for reform. Public spending is higher in France but education spending is lower. It is striking given the skills shortage and youth unemployment issues mentioned above. Meanwhile, France tends to spend considerably more on social welfare and defence. Old age welfare makes up a large chunk of this difference. We note that the demographic outlook in France looks relatively favourable when compared to Germany[1] and other large EU economies, but the pension burden is still set to increase. Reform will be required.

[1] See Box 1 at the end of our report on German inflation for a discussion on demographic headwinds in Germany: http://www.bk.mufg.jp/report/ecoeu2017e/BTMU-Economic-Brief-Germany20171023.pdf

Chart 5: Difference in Public Spending Between France and a Benchmark Group



Note: Benchmark group is Austria, Belgium, Denmark, Finland, Germany, Netherlands, Sweden, UK. The simple average is taken. Data is from 2016 or most recent available.
Source: Eurostat, France Stratégie, BTMU Economic Research Office

(4) Regulation

French businesses are very highly regulated, and not just in terms of hiring and firing. France ranked 115th of 137 countries for ‘burden of government regulation’ in the World Economic Forum’s 2017/18 Global Competitiveness Report. Among the most problematic factors for doing business are tax regulations and inefficient government bureaucracy. OECD data on product market regulation suggest it is more restrictive in France than most other European countries. Anecdotal evidence suggests this red tape burden weighs on small businesses which may not have dedicated legal and compliance teams. For larger firms, there are even more obligations. A statutory auditor is required for firms with over 20 employees if turnover or balance sheet criteria are met. Firms with over 50 employees are obliged to have a whistleblowing system and set up a committee on hygiene, safety and working conditions.

3. Reforms

Christine Lagarde, Managing Director of the International Monetary Fund (IMF) recently said now is the “ideal time” to pursue reforms in her native France. The window may be narrow but Macron is determined to push through a raft of changes. There are already some efforts underway to deal with the issues outlined above:

(1) Labour market reform

Macron’s aim is to move towards a Nordic ‘flexicurity’ model for the labour market. This combines relative ease in hiring and firing, but with a social safety net in place for job movers.

There have already been reforms in this direction. These build on the ‘El Khomri’ labour reforms which were passed in August 2016 but significantly watered down from initial proposals after opposition from labour unions. Macron has put liberalising labour markets at the forefront of his reform agenda and has managed to go further. Significant reform was passed in September 2017. Measures include:

- **Collective bargaining moved from industry to firm level.** This allows individual workers to negotiate agreements with an individual firm, rather than through sector-wide talks. It reduces the power of powerful large unions.

- **A company can cite weak domestic activity to justify terminating employment**, even if overseas revenues are strong. Previously, the global profitability of firms could be cited to block layoffs.

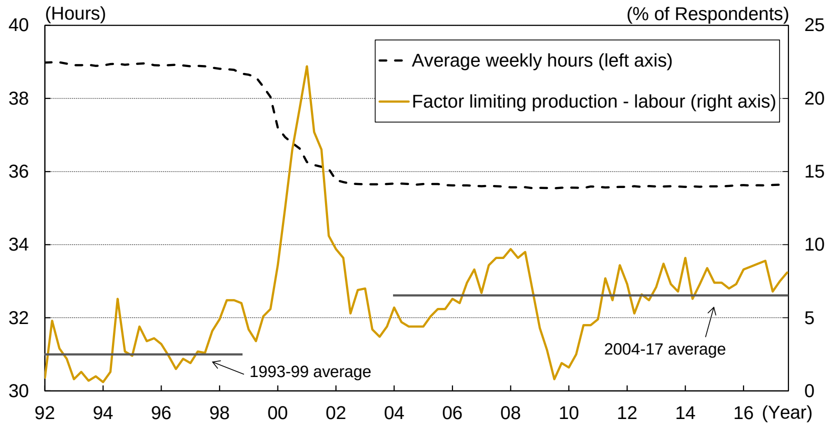
- **Payoffs for wrongful dismissal are standardised.** Previously, damages varied between professional sectors and the arbitration process was unpredictable. Macron’s reform standardises a set scale for payoffs (starting at three months’ salary per two years of employment). This reduces the risk for firms.

- **Change to short-term job contracts.** Previously, short-term contracts could only be renewed twice. This led to firms rehiring workers after short periods of unemployment. The reform allows contracts to be renewed six times and allows for increases in the minimum duration (varying by sector).

In addition to this, there are also ongoing efforts to reform of unemployment insurance (with a law likely to be passed this spring). Based on Macron’s campaign promises, an expansion of unemployment insurance to the self-employed and those looking to move industry looks probable.

One aspect which has not yet featured is any reform of the 35-hour working week. This was established under the ‘Aubry Law’ in 2000 when the previous legal limit of 39 hours was reduced to 35 hours, and any hours worked in excess are considered overtime. Overtime payments were reduced under the 2016 ‘El Khomri’ reform. Macron vowed to do more during his election campaign but is yet to announce any measures. Chart 6, below, suggests that reform may help economic activity. There seems to have been a shift upwards in the number of firms (in the manufacturing sector) that report labour as a factor limiting their production after the change to 35 hours.

Chart 6: Average Hours Worked and Limits to Manufacturing Production



Source: French Ministry of Labour, European Commission, BTMU Economic Research Office

Another area currently undergoing reform is social security contributions. We look at elasticity estimates from the Mésange model, a large scale macroeconomic model developed jointly by the French treasury and the National Institute of Statistics (INSEE). In their estimate, a reduction in employers' social security contributions equivalent to 1% of GDP has a negligible effect on activity in the near term, but, over the long-term, it could boost real GDP by 1.7% and lift employment by 360,000. The Mésange model suggests that reducing employers' social security contributions by 1% of GDP could be combined with an increase in sales tax by the same amount. This would drag on growth over the first two years as household consumption is reduced. After three years, though, growth would be higher.

This is an example of the trade-off Macron's government will have to weigh up – short term pain for longer term gain. It can often be the case with structural changes that subsequent governments benefit more than the incumbent. However, given Macron's speed and proactivity thus far it is plausible that the effects of his reforms will be reflected in stronger economic activity by the time of the next election (April 2022). This could boost his chances of achieving another term in office.

(2) Education

Education is another area of priority for the government. It is perhaps the most urgent as the benefits to the economy will not be felt for several years. During this time, skills mismatches are likely to become more apparent as the labour market tightens further.

To address this, a €15bn five-year plan has already been announced which will help to reform education and apprenticeship policies. Young people up to the age of 30 (increased from the current 26) will be eligible to join apprenticeship programmes, and pay for apprentices will be increased. Firms and unions, rather than the education ministry, will have more say over budget allocations and qualification requirements. Wider changes are due to be revealed in April.

Meanwhile, Jean-Michel Blanquer, the education minister, has recently announced significant reform to the baccalauréat (the qualification taken by 17-18 year olds). The changes will encourage specialisation and give greater prominence to coursework and oral presentations rather than final exams.

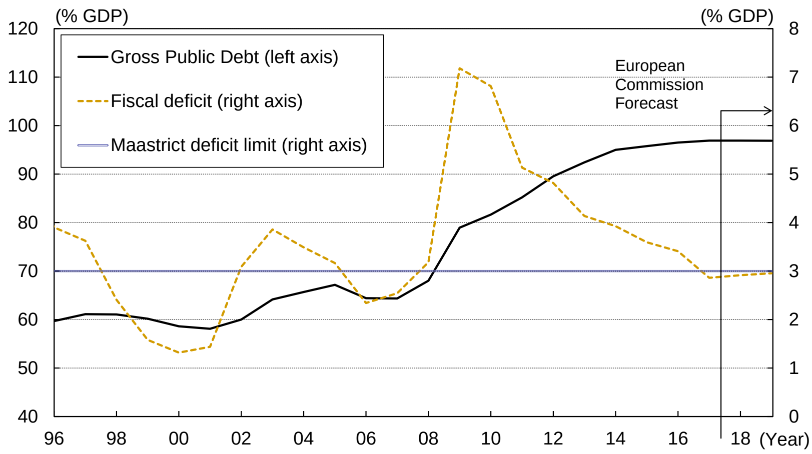
(3) Public finances

The amount of cash that can be thrown at active labour market policies and other areas, such as targeted infrastructure spending, is limited by France's public finance situation. Macron's party, *La Republique En Marche*, campaigned for fiscal consolidation and is very committed to complying with the Maastricht restriction (the fiscal deficit is not to exceed 3% of GDP). However, Macron needs to balance this desire for fiscal credibility with his instinct to reduce the tax burden.

The government's first budget was delivered in September and the headline measures were indeed tax cuts. The wealth tax was slashed and a flat rate for capital gains was introduced. These lower rates were partly offset by higher taxes on expensive properties and tobacco. There was also a temporary levy on the country's largest firms (further ahead, Macron wants to steadily reduce corporation tax from 33% to 25% over his five year term). Meanwhile, there was little in the way of significant structural changes to help bring France's public spending in line with European peers. Pension spending is a notably high in France but Macron has so far shied away from difficult decisions to address this. The statutory pension age is currently 62, gradually increasing to 67 by 2023. But, importantly, many public sector workers enjoy special retirement plans and stop working when much younger.

Overall, the European Commission was unimpressed by Macron's first budget. France is the only euro zone country for which it expects debt to GDP will increase in 2018 (albeit by a small amount – see Chart 7).

Chart 7: Public Debt and Fiscal Deficit



Source: European Commission, BTMU Economic Research Office

(4) Regulation

Some progress to deal with the high regulatory burden has already been made. The 'Macron Law' of 2015 (when he was Minister of Economy and Finance) was an important first step for the deregulation of goods and services markets. It was composed of a jumble of measures, including the deregulation of intercity bus services, lower barriers to entry to the legal profession and extended Sunday opening hours for retail services. These are relatively small steps and a greater push would be required to have a meaningful effect on a national scale, but we can expect strong conviction from Macron after his involvement in the initial changes. There has also been change as part of the labour reform. Previously, companies were obliged to comply with significantly more stringent regulation once it hired its 50th employee. Macron's plan streamlines the additional requirements.

4. Conclusion

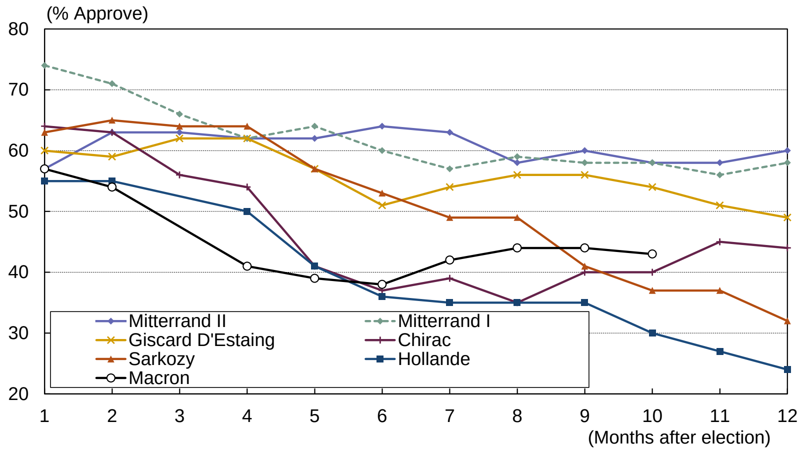
Macron's ambitions for euro zone reforms garner a lot of attention. For France, a domestic reform agenda is also important. France is enjoying relatively buoyant economic activity but the extent of the upswing may be limited. Numerous structural challenges, not least in the labour market, hold down potential growth.

There is unlikely to be a better time for reform. Very supportive external conditions are met with a president committed to wide-ranging structural changes. Several policies have already been announced. Some are bold, particularly changes to labour market regulation. But Macron may go further. France's public finances are vulnerable and, pension expenditure is particularly high compared to European peers. Increasing the retirement age for public sector workers is an example of the sort of politically tough decision that Macron may have to take over the remaining four years of his term.

Reforms will help to reduce vulnerability to shocks. If France manages to avoid a damaging downturn then there are upside risks to growth over the medium term. It is too soon to credit Macron for the improving unemployment rate. Investment has significant scope to expand further and France's demographics are relatively favourable compared to European peers. Given this, Macron's reforms could feasibly herald some golden years ahead for France.

However, success may hinge on how receptive the French public is to Macron's ideas. This is a challenge. Polling by BVA shows that a majority (54%) of French people think negatively about the government's economic policies. Only 45% agree that hiring and firing should be made easier (up by 18pp since 2005). However, after a jittery start, Macron's personal support has recovered somewhat (Chart 8). He will need to maintain this momentum.

Chart 8: French Presidents' Approval Ratings



Source: Kantar Sofres, BTMU Economic Research Office