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GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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THEMATICS

Leveraging France's Key Strengths

In Pursuit of an Alternative Path

The French economy is undeniably in a bad way. But trying to overcome its shortcomings with the kind of shock therapy inflicted on Southern Europe would be the most dangerous response, both for France and the entire euro area. An alternative approach is therefore required—one that will necessarily involve leveraging more effectively the factors that set the French economy apart. This, then, is the value of taking a closer look at France's key strengths.

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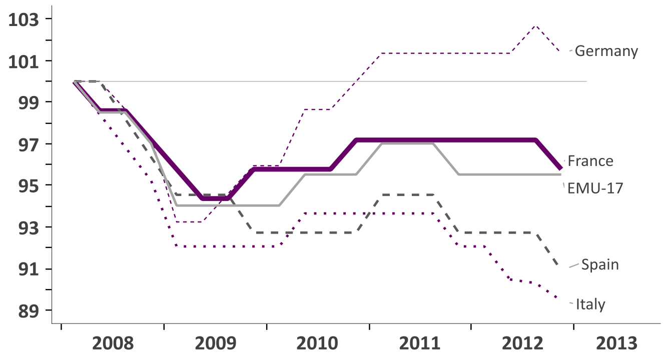
France is in a bad way, with a very real risk of lapsing into critical condition

After treading water for two years, France's economy looks increasingly like it's heading for an out-and-out slump. The ground lost by French industry in the 2009 recession, combined with a 6 percent falloff in production over the last 24 months, has driven output down to the lowest level in almost twenty years, not seen since spring 1994. Meanwhile, gross domestic product is 1 percent lower than prior to the 2008 financial crisis, and has decreased by 4 percent per capita. The jobless rate has likewise reached a record level, exceeding 10 percent of the labor force, and per capita consumer spending has been marking time for longer than at any point since World War II.

Comparative GDP at constant prices, Q1 2008=100

Sources: RichesFlores Research, Macrobond

Comparative GDP per capita at constant prices, Q1 2008=100



Sources: RichesFlores Research, Macrobond

This backdrop, along with the likelihood that fiscal tightening is here to stay, makes the prospects of a second recession particularly worrisome. With the situation already this dire, any additional contraction in GDP may well do near-permanent damage to France's growth potential and structural public finances.

What should be done? Now that painless remedies no longer seem workable and a mood of panic about the economy is taking hold, more and more pundits have begun advocating a "competitiveness shock." The underlying, "no-brainer" assumption being that "If the crisis gives you lemons, you might as well make lemonade." Drastic public spending cutbacks accompanied by reduced costs for businesses, we are told, will kick start an upsurge in exports and pave the way for a return to a balanced budget. In short, France should undergo the kind of shock therapy administered to Southern Europe for the past three years. Yet there are ample grounds for believing that competitive deflation would not only be a highly inappropriate response to the current crisis; it would also be the most dangerous one—for France and consequently for the entire euro area.

You can't cure debt with austerity

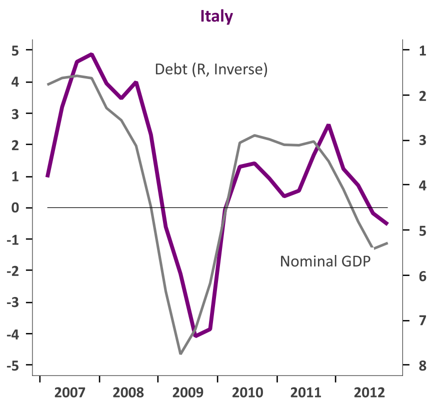
A first, common mistake is to assume that austerity policies are an effective way of deleveraging. Unfortunately, this recipe doesn't work and can't work, for reasons that will soon be clear.

The ability of any borrower, an individual or a government, to pay down its debt is contingent on its future income or revenue. An indebted individual with declining income is on the road to insolvency; just how far along will depend on how high his initial debt was and how fast his income is shrinking. The same goes for a government, whose revenue reflects that of the country it represents—in other words, gross domestic product. **By reducing GDP, austerity policies automatically reduce a government's revenue and consequently increase the risk of sovereign insolvency in the medium-to-long term.** That's the first reason why they can't work.

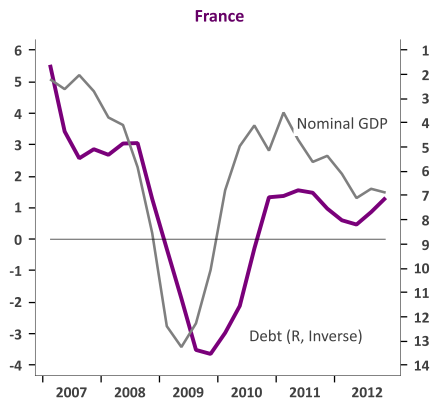
The second one has to do with the role of the public sector in the economy, the considerable impact of taxation and government spending on private sector income, and, conversely, the dependence of government revenue and spending on how healthy the private sector is. This close linkage creates a powerful negative correlation between economic growth and public debt that can't be escaped for very long: **whereas periods of high economic growth coincide with deleveraging, periods of low or no growth coincide with rising debt** (see graph below), during which a country's debt-to-GDP ratio automatically increases. Owing to this strong correlation, any attempt to deleverage via austerity is necessarily doomed to failure, especially when austerity policies are deflationary—as they almost invariably are.

Growth in nominal GDP and public debt (%)

Sources: RichesFlores Research, Macrobond



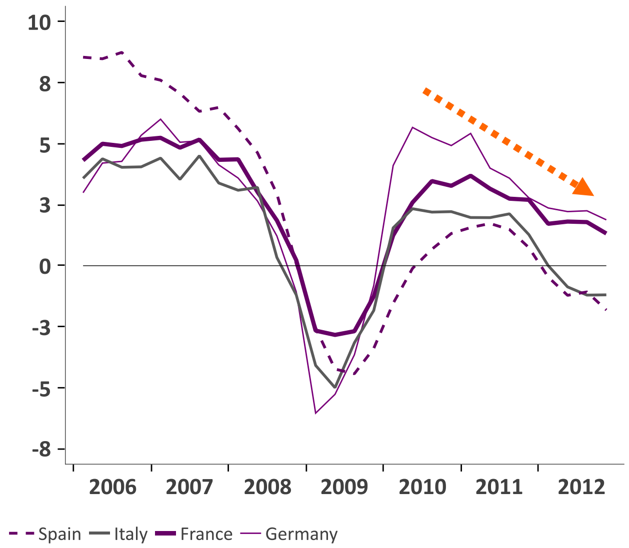
Sources: RichesFlores Research, Macrobond



Sources: RichesFlores Research, Macrobond

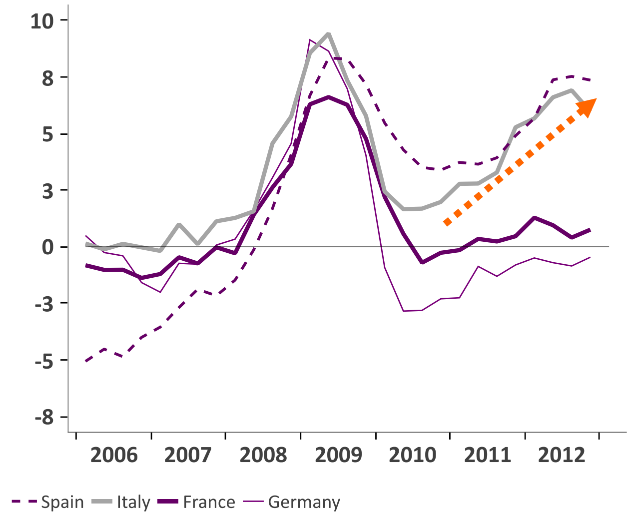
With nominal GDP growth still positive, France has managed so far to escape the debt trap in which the Southern European countries are mired, and have been virtually since the start of their austerity programs. But one year of economic stagnation and now a recession, accompanied by extremely low inflation, are pushing France dangerously close to the threshold beyond which the interest rates on its sovereign debt exceed its GDP growth, thereby setting off an inexorable increase in the country's debt ratio. This is the scenario that France must avoid at all costs.

Annual nominal GDP growth (%)



Sources: RichesFlores Research, Macrobond

Spread between 10-year bond yields and nominal GDP growth (percentage points



Sources: RichesFlores Research, Macrobond

Competitive deflation—a non-option

Taking the risk of crossing that threshold—with the rationale that a deflationary shock will clear the decks for future growth—is basically tempting fate. Moreover, it is absurd to expect competitive deflation to stimulate growth, and for several reasons.

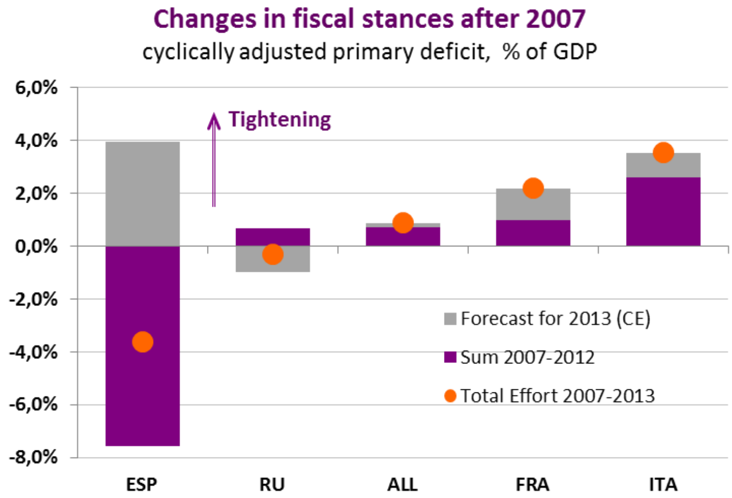
- To start with, the idea that the vast majority of Eurozone countries can simultaneously win by pursuing the same competitive policies defies elementary logic.
- In addition, it is a mistake to think that an austerity cure will eventually put a country on a better competitive footing. By slashing production potential, austerity limits the opportunities for taking advantage of the relatively lower costs of doing business brought about by a downturn.
- Last of all, Germany's competitive success has been widely misinterpreted. The evidence overwhelmingly suggests that it was above all attributable to a combination of extremely favorable conditions—booming demand in the region and beyond, and the high quality and specialization of German

industry—rather than to cost control. In any case, none of the conditions that made that success possible can be observed in other Eurozone countries today. Industrial specialization elsewhere in the E.M.U. is either limited or ineffectual, while the opportunities previously offered by a boom in world trade are gone, most likely for some time to come (see *"Quand la Chine se replie sur elle-même").*

- **With respect to France, there is another, compelling reason for not buying into the story about the virtues of competitive deflation: such a policy would be simply unmanageable in a country with a rapidly growing population. Whether induced for competitive purposes or not, deflation invariably has the effect of reducing wages, and therefore future income expectations. In this way, it creates self-sustaining stagnation that can last for years**. A deflationary spiral is costly but bearable in countries with declining populations, where future needs are likewise declining. But in countries with growing populations, it can only spell mass unemployment, widespread poverty, and an overall loss of economic substance.

With a population expanding by 300,000 a year, which equates to a 0.5 percent annual growth rate, France is one of the most demographically dynamic nations in the developed world. This means that when the country's overall disposable income stagnates, disposable income per capita actually falls by 0.5 percent. Since mid-2011, higher taxes (a 15-percent increase on pre-tax household income) have more than wiped out all gains in take-home pay, so that gross disposable household income has shed 1.2 percent. And given that the population has increased by 0.8 percent over the same period, per capita disposable income has in fact decreased by 2 percent.

Sources: RichesFlores Research, Macrobond



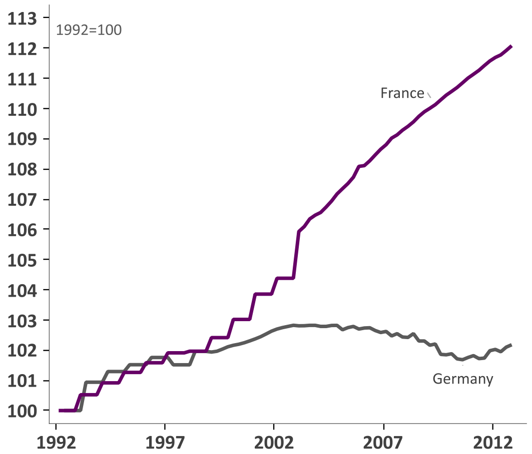
Sources: Ameco (winter 2012), RichesFlores research

Contrary to a widespread assumption, **French households have already tightened their belts substantially—**starting well before the tax hikes introduced by the current Administration. This goes a long way toward explaining the country's worsening economic situation in the past two years (see graph above). Any policy that throws greater wage restraint or labor force shrinkage into the bargain (in the hope of making France more cost-competitive) would unquestionably expose the French economy to serious danger.

France, Germany: two economies, two models

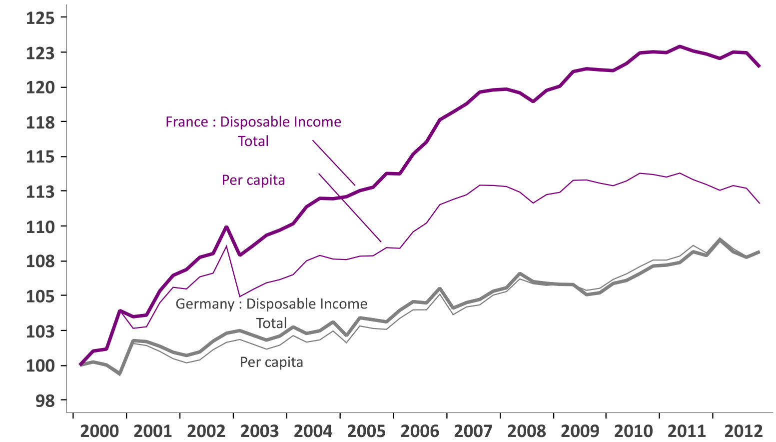
Although German economic policy in the 2000s is widely touted as a model to be copied, France today bears little resemblance to Germany at the time. Over the last two decades, Germany's population has increased by barely 2 percent—six times less than France's. As a result, a long phase of wage restraint and stagnant disposable income, from 2001 to 2006, proved bearable, because it didn't inflict major financial hardship on the average consumer. In France, however, a similar degree of stagnation would have reduced per capita disposable income in direct proportion to population growth—by some 10 percent—almost certainly with dramatic consequences.

Population growth in France and Germany



Sources: RichesFlores Research, Macrobond

Impact of demographics on disposable income in France and Germany



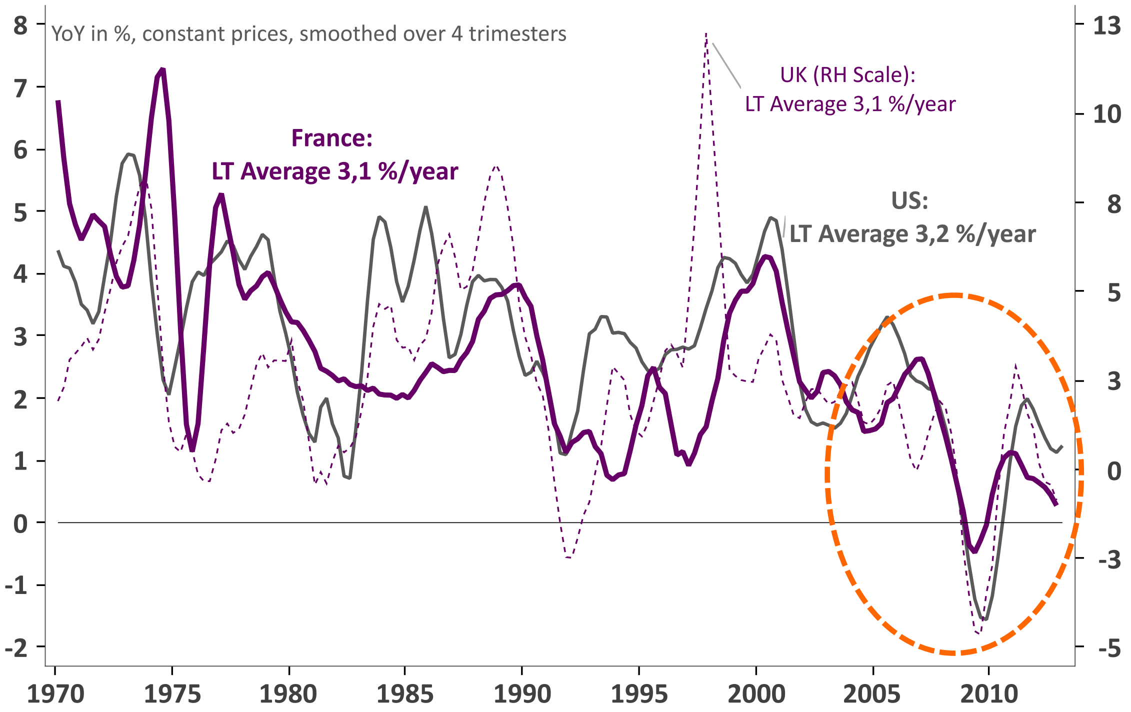
Sources: RichesFlores Research, Macrobond

This demographic gap between France and Germany has to a large extent shaped two economic models that basically stand worlds apart.

- **By definition, consumer spending affects the economy much more significantly in France than in Germany**, where the median age also happens to be nearly five years higher. Between 2000 and 2008, household consumption accounted for two thirds of French GDP growth, putting France roughly on par with the United States and the United Kingdom, countries with similar demographics. The contrast is striking with Germany, where only a third of GDP growth could be attributed to consumer spending.
- **Being younger on average, French consumers tend to spend more than their German counterparts on household equipment and services provided by the private sector**. The result is that in France, as in the U.S. and the U.K., the import penetration rate is higher and economic growth depends more heavily on private sector services, i.e., retail, transportation, restaurants, and other consumer services—the sectors that create the most jobs by far. And because the crisis has deprived France, along with the U.S. and the U.K., of these

traditional sources of growth, it has thrown the country's economy and labor market seriously out of kilter.

Real consumer spending on services

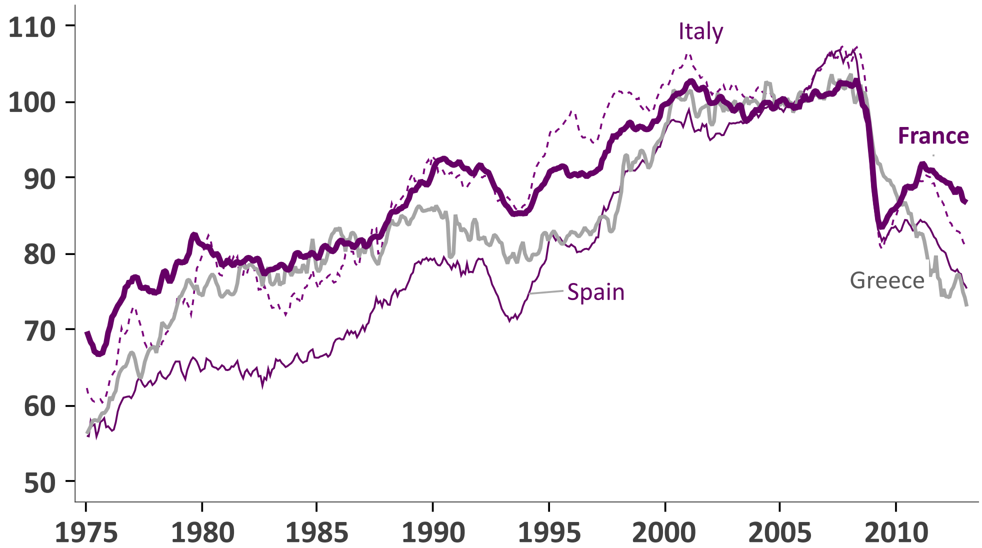


Sources: RichesFlores Research, Macrobond

In this kind of environment, austerity policies—which hurt working-age people first and foremost—create such hardship that they quickly become intolerable, since they collide with the needs of a growing population. France is quite unlike Southern Europe in terms of pre-crisis economic fundamentals and demographics, but if it were in turn subjected to the type of policies already inflicted on its neighbors to the south, the outcome would unquestionably be the same: a lasting recession, an even sharper drop in industrial output, and soaring unemployment. The alleged upside—a more cost-competitive economy—would probably be wiped out by the attendant hollowing-out of the country's industrial base, a risk that is all too real in Spain and Italy today.

Industrial Production

2005 = 100



Sources: RichesFlores Research, Macrobond

In pursuit of an alternative path

France therefore needs to take an alternative approach—and the best place to start is with the country's unique strengths. The French economy has a number of differentiating features. It is the fourth-largest G7 economy based on GDP per capita, with resources that are far from played out. Admittedly, France isn't an industrial heavyweight, and for quite some time now manufacturing has represented too small a share of French GDP to be considered a reliable growth driver.

But the country still possesses significant structural advantages with real potential to enrich its industrial base. **International rankings provide a faithful reflection of France's unique advantages, even highlighting a number of assets that the French themselves may not be aware of. These include strong R&D, high productivity, ease of starting a business, economic stability, geographic location, and high-quality education and training.**

France's ranking based on main attractiveness criteria (out of 14 countries,* 2012)

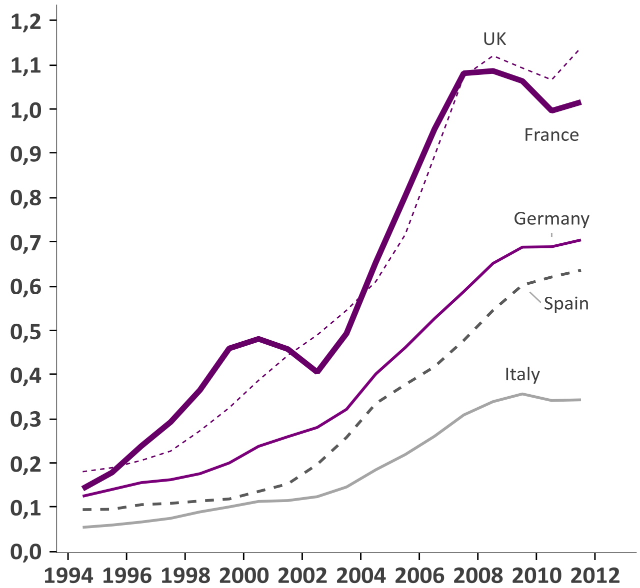
* France, Germany, Italy, Spain, Sweden, Belgium, Finland, UK, Ireland, Netherlands, Austria, Poland, U.S., Japan

*** research, *** professional skills , XXX geographical location, +++ competitiveness

Source: RichesFlores Research, France attractiveness dashboard, MEF 2012

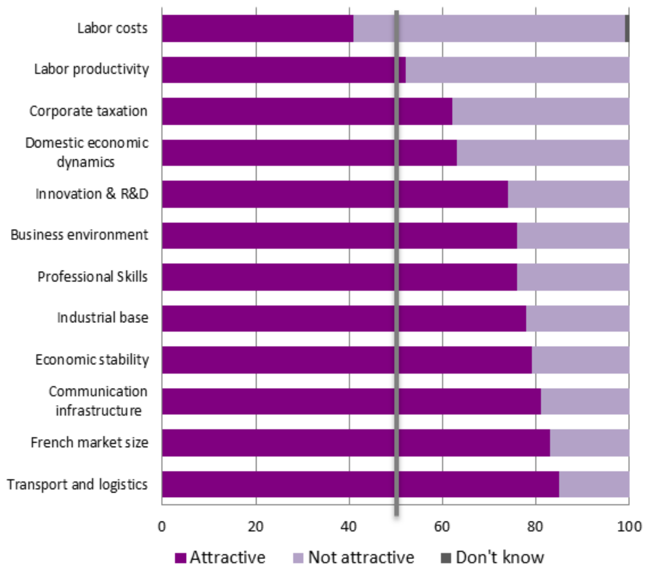
France thus stands out as one of the most attractive advanced economies, and was in fact the preferred Eurozone destination for foreign direct investment until 2012. This, by the way, was one of the three best years in the past fifteen, with 693 decisions taken by foreign firms across a broad range of industries to make job-rich investments in the country (on the back of 698 in 2011).

FDI stock ($trn)



Sources: RichesFlores Research, Macrobond

For each of the following criteria, is France attractive to foreign investors?



Source: Opinion survey Sofres -AFII, 2011.

Moreover, the type of foreign investment unquestionably bears witness to the French economy's excellent reputation, both for R&D and for world-class capabilities in such leading-edge sectors as information technology, aerospace, and pharmaceuticals.

Just what are France's key strengths?

Our analysis highlights four key strengths of the French economy:

- Demographics
- Productivity, infrastructure, and a trained, qualified workforce
- French companies' international footprint and standing
- Geographic location, tourism, and agriculture.

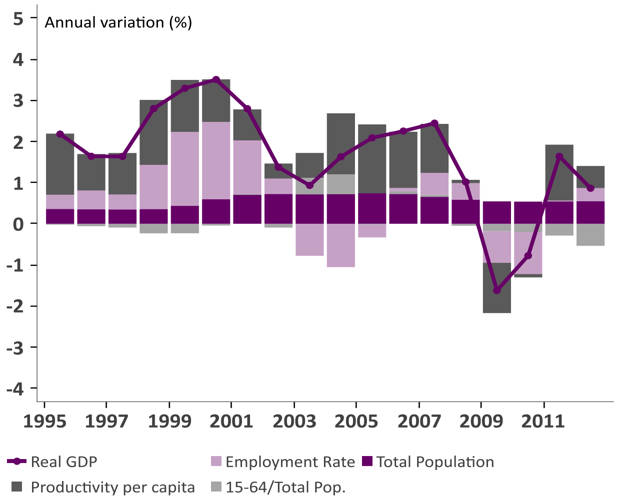
The benefits of favorable demographics for demand, investment, available capital, and personal wealth

Although France's favorable demographics are unanimously acknowledged, the full implications are rarely understood. A demographically dynamic country enjoys multiple advantages:

1- A constantly expanding population **naturally boosts economic growth.** All other things being equal, population growth of 0.5 percent per annum generates an equivalent annual increase in GDP. The contribution of demographics to GDP growth emerges even more clearly when GDP is looked at in terms of productivity, employment rate and also the working-age population as a percent of total population (as illustrated below).

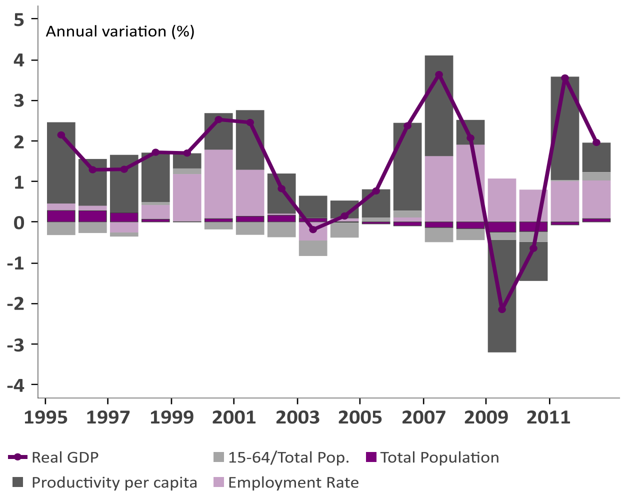
GDP growth in relation to demographic factors and productivity

France



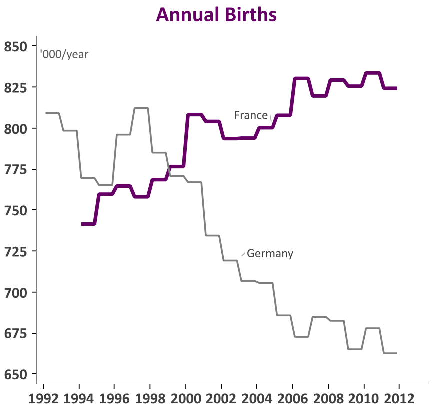
Sources: RichesFlores Research, Macrobond

Germany

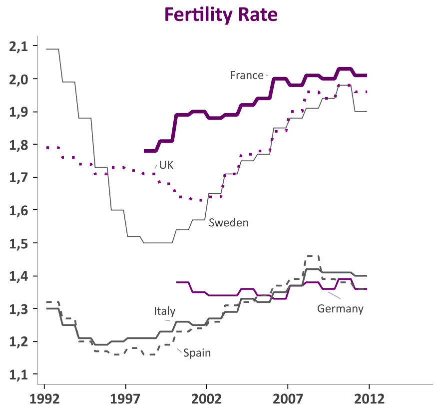


Sources: RichesFlores Research, Macrobond

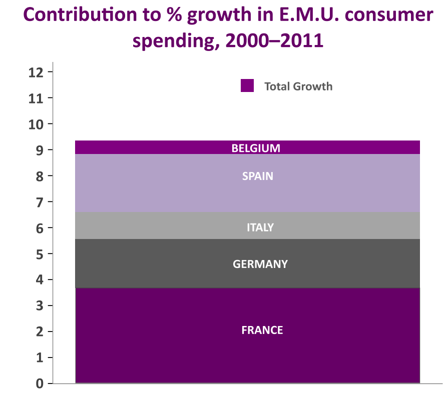
France's demographic profile makes it unique in its region and explains to a large extent why the country has been the leading contributor to consumer spending growth in the euro area since the start of the new century.



Sources: RichesFlores Research, Macrobond

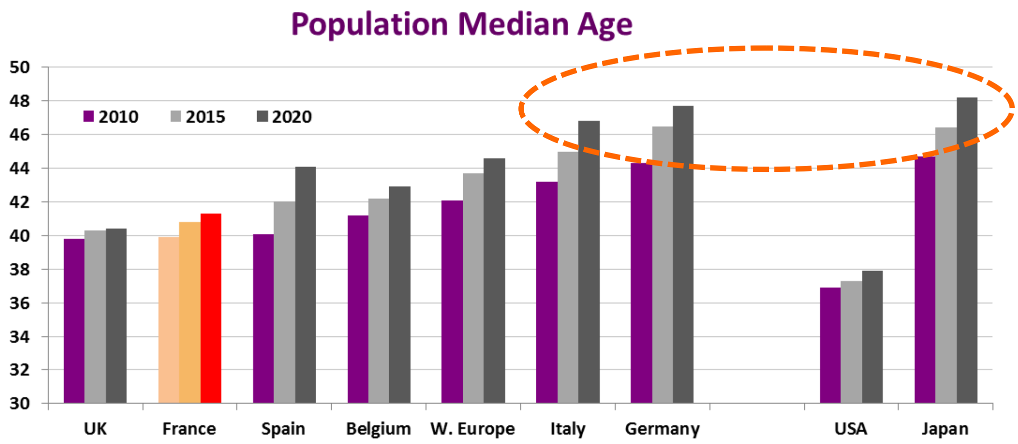


Sources: RichesFlores Research, Macrobond



Sources: RichesFlores Research, Macrobond

2- A youthful population naturally leads to **more diversified demand.** Consumer spending patterns vary considerably according to the age breakdown of a country's population, its fertility rate, and the resulting make-up of its households. As it turns out, not only is the median age in France the lowest in the euro area; it is expected to rise only slightly by 2020 thanks to the demographic renewal brought about by the country's high fertility rate—two children per woman, versus 1.4 in Germany, Italy, and Spain. Based on current projections, the median age in France will still be below 42 in 2020, whereas it is forecast to rise to nearly 48 in Germany, nearly 47 in Italy, and over 44 in Spain.

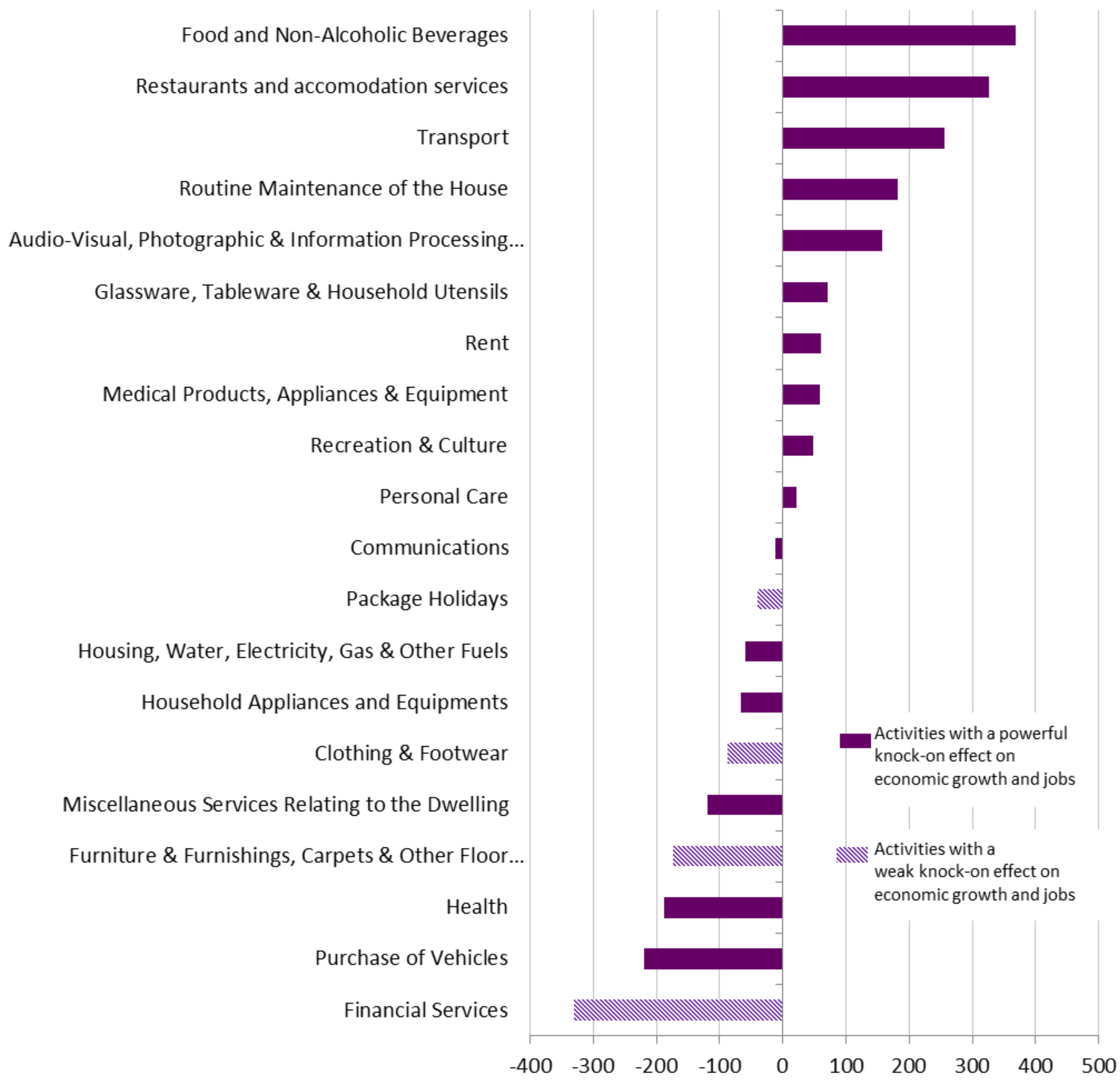


Sources: UN population division, RichesFlores Research

Age differences have major implications for household consumption, since younger families with children tend to spend a larger share of their income than older families on home appliances and electronics and consumer services. Unsurprisingly, this assertion is supported by a comparison of per capita spending by German and French consumers. French households devote a much higher percentage of their budgets to food, transportation, meals outside the home,

home appliances and electronics, maintenance and repairs, recreation, and cultural activities—a set of sectors with a powerful knock-on effect on economic growth and jobs. The Germans, in contrast, spend a much larger share of their income on health and medical expenses, financial services, and motor vehicles, a predominantly domestic group of sectors with less potential to boost domestic or foreign private sector growth.

Per capita consumption's spreads between France and Germany

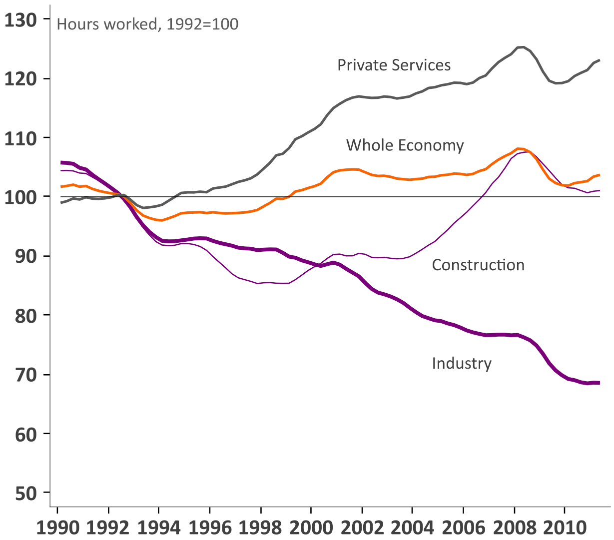


Source: Eurostat, RichesFlores Research

Several inferences can be drawn from these observations:

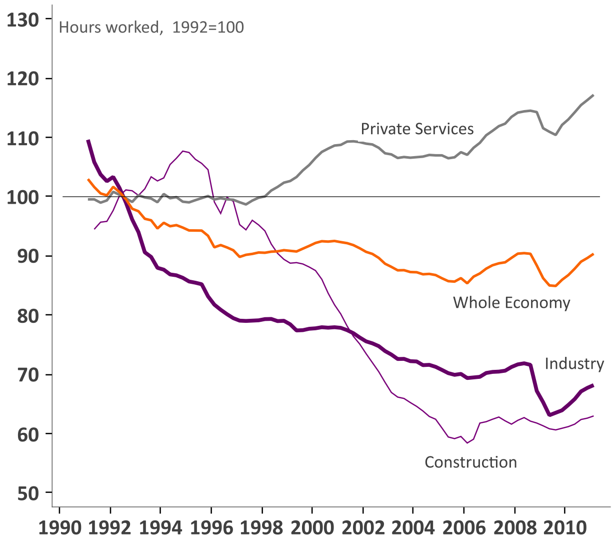
- First of all, France's vibrant demographics can support a wide range of private sector industries that also include construction, an industry inevitably stimulated by population growth. Moreover, in construction, France is unquestionably in a better position than its neighbors, generally facing an excess of supply. Comparative employment trends in France and Germany offer a striking illustration of this point.

Private sector employment by sector in France



Sources: RichesFlores Research, Macrobond

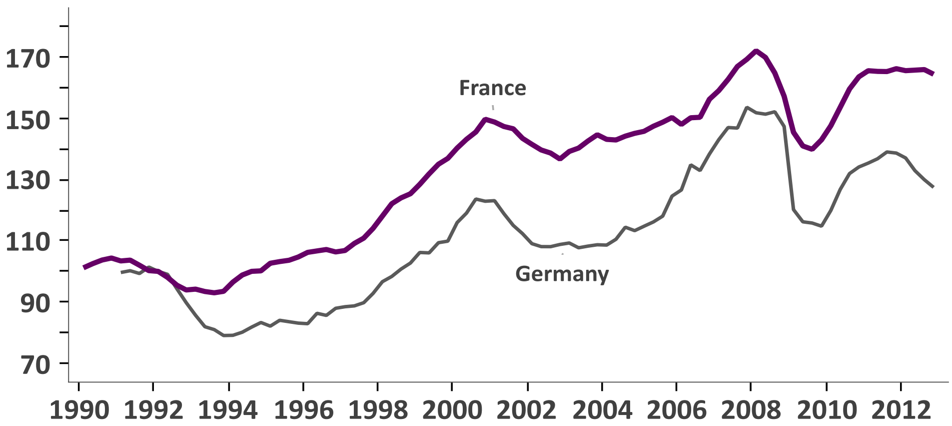
Private sector employment by sector in Germany



Sources: RichesFlores Research, Macrobond

- Second of all, buoyant consumer demand has a positive spillover effect on investment in manufacturing and real estate.

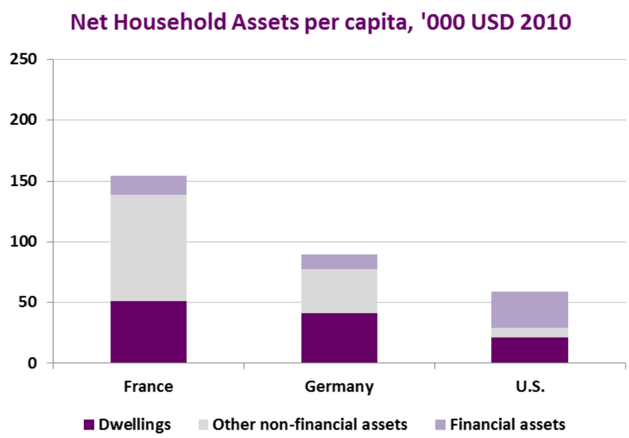
Investments in Machinery and Equipements, constant prices 1992=100

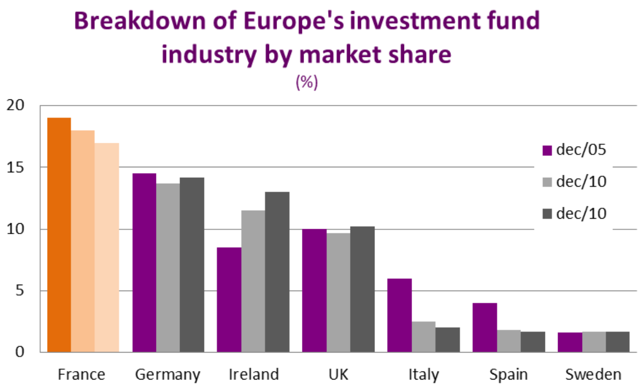


Sources: RichesFlores Research, Macrobond

- **Last of all, it would be a big mistake to rely on German consumers to revitalize demand in Europe.**

3- A country with a demographic advantage also has **a greater capacity for savings than countries with rapidly aging populations,** given that people are less likely to save after they leave the labor force. This suggests it is no accident that France shows one of the highest savings rates in the Western world and that it is Europe's leading market for investment funds, due in large part to the prevalence of investments in money market funds and mutual funds. Those who fret over high household savings rates—driven even higher today by consumer skittishness—seem to forget that those savings mean available capital that, with the right incentives, can be harnessed for business investment (an issue recently addressed in a report on long-term savings by two members of French parliament, Karine Berger and Dominique Lefebvre). They also constitute reserves that can be tapped into to stimulate demand, not to mention their undeniable contribution to financial stability, especially since France's households are among the wealthiest in the West. French households have comparatively low debt levels, as well as an average net worth almost twice as high as their German counterparts and almost three times as high as U.S. households, due in particular to extensive real estate and land ownership.





Source: RichesFlores Research, "Tableau de Bord de l'Attractivité de la France, MEF"

4- France's demographic profile at least potentially gives the country greater capacity **to withstand the effects of the redistribution policies needed to service an aging population,** since the old-age dependency ratio is projected to rise more slowly there than in the rest of Europe.

In sum, France's demographic vitality—a key factor in its appeal as an investment destination—should be an essential component of any policy for enhancing the country's growth potential. Yet it also has its downside: it leaves France more vulnerable to prolonged periods of job market stagnation and makes a toxic combination with deflation.

France's underrated productivity

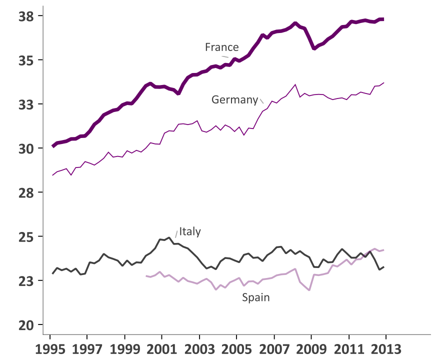
France's self-image has deteriorated to such an extent that many of its citizens take little notice of its most impressive achievements. A case in point is productivity. Even the official Eurostat numbers tend to arouse suspicion—that's how persuaded the French are that exorbitant labor costs have rendered their economy uncompetitive.

And yet France leads the large European economies for labor productivity, meaning output per hour. Moreover, this no new development; France's superior productivity was observable not long ago in all major sectors. Although recently outdistanced by Germany in manufacturing, France still enjoys a comfortable advance over its European peers for productivity in private sector services and scientific and technical fields.

A skilled, well-educated labor force (as underscored by many studies), high-quality infrastructure and maybe a specific production organization are almost certainly part of the explanation. While this high productivity is not enough to offset the wage differential with other countries in extremely competitive sectors like manufacturing, it still deserves recognition as one of the French economy's key strengths.

Productivity in private sector services

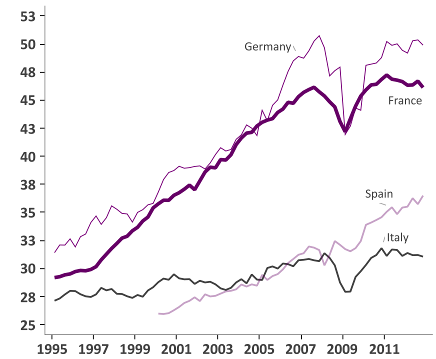
euros per hour worked, ex. real estate and public administration



Sources: RichesFlores Research, Macrobond

Productivity in industry (excl. construction)

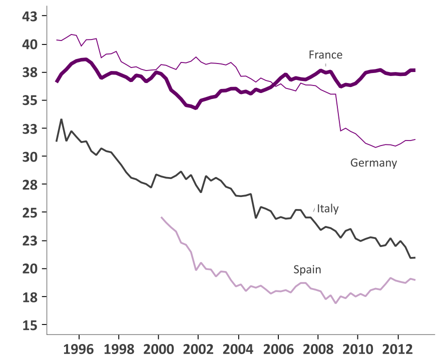
euros per hour worked



Sources: RichesFlores Research, Macrobond

Productivity in specialized, scientific, and technical fields

euros per hour worked

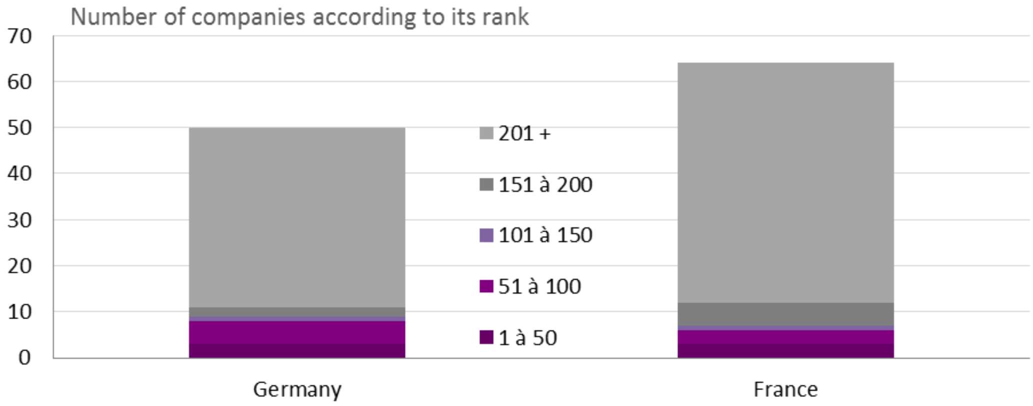


Sources: RichesFlores Research, Macrobond

French companies' international footprint and standing

The international standing of French companies is another example of an achievement all too often undervalued. As of early 2013, the Forbes Global 2000 included 64 French companies, 12 of which ranked among the top 200. In comparison, Germany had 50 companies on the list, 11 of them among the top 200. So France boasts an extensive, highly diversified corporate sector that spans banking, pharmaceuticals, food and retail, aerospace, chemicals, luxury goods, auto parts and tires, construction, IT services, media, and more.

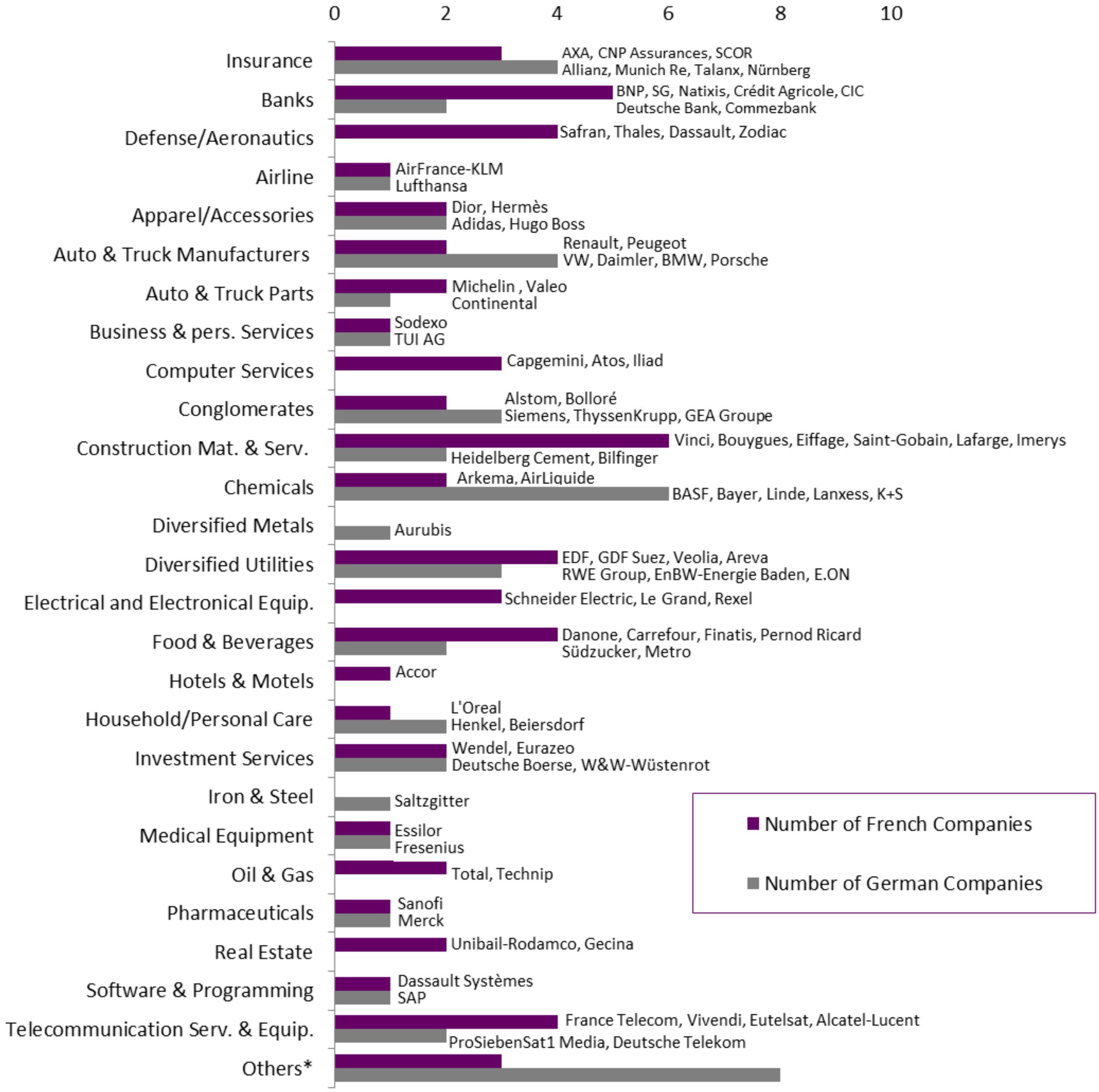
Number of French and German companies in the world's top 2,000, by ranking



Sources: RichesFlores Research, Forbes 2013

Despite their poor recent performance as exporters, these heavyweights are still powerful enough to give France a more-than-respectable global footprint. The country was the world's sixth leading merchandise exporter in 2011 (one rank lower than in 2007), and the number-three economy in terms of exports per capita. The spillover to France's manufacturing industry is both positive and extensive. In addition to providing business and jobs to countless smaller companies, France's large firms are well-represented in key areas of global demand, positioning most of them very nicely to reap the benefits of high-growth economies, especially in emerging markets.

Number of French and German companies in the world's top 2,000, 2013



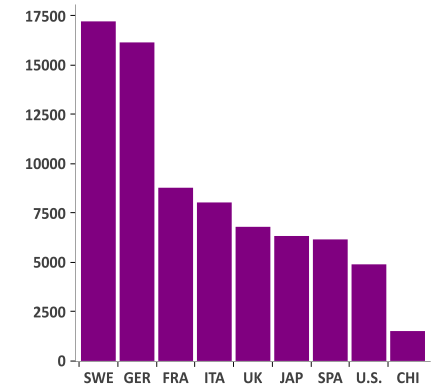
Sources: RichesFlores Research, Forbes 2013 * FR: PPR, Vallourec, Aéroport de Paris; ALL: Deutsche Post, BayWa, Aareal Bank, IKB Deutsche, DVB Bank, Celesio, Fraport, Infineon

Leading exporters' share of world merchandise trade, 2011 and 2007

2011 rank	Value, $bn	Share (%)	2007 rank	2011 rank	Value, $bn
China	1,898	10.4	Germany	China	1,898
U.S.	1,480	8.1	China	U.S.	1,480
Germany	1,472	8.1	U.S.	Germany	1,472
Japan	823	4.5	Japan	Japan	823
Netherlands	661	3.6	France	Netherlands	661
France	596	3.3	Netherlands	France	596
South Korea	555	3.0	Italy	South Korea	555
Italy	523	2.9	U.K.	Italy	523
Russia	522	2.9	Belgium	Russia	522
Belgium	477	2.6	Canada	Belgium	477

Sources: OMC, RichesFlores Research

Exports per capita, $, 2012



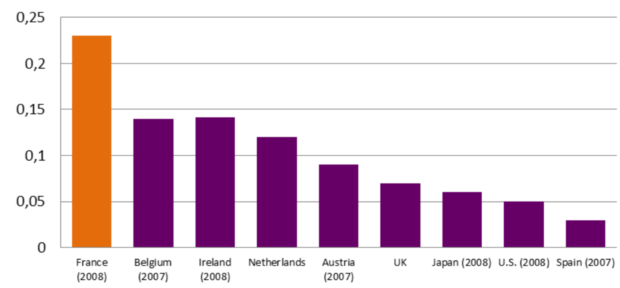
Sources: RichesFlores Research, Macrobond

Research and development

France's standing as an R&D capital is unquestionably related to the economic influence of its large firms. Another widely overlooked fact is that France is the world's third leading country in terms of the percentage of the labor force in R&D, behind Finland and Sweden, while the share of actual researchers is comparable. Powerful tax incentives—the most generous in the developed world—and highly qualified researchers have earned France a solid reputation abroad, along with a large chunk of the foreign direct investment received by Europe in several key areas of R&D.

Tax incentives for corporate R&D (2009)

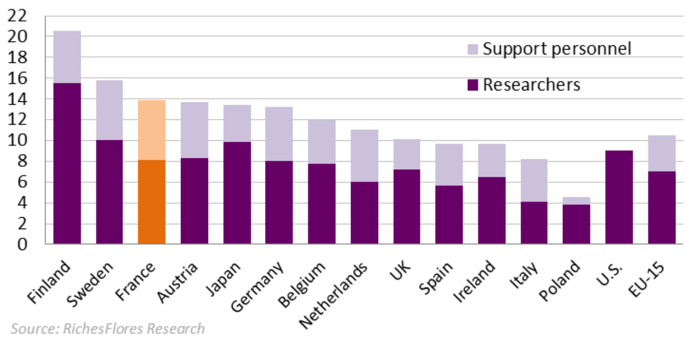
% of GDP



Source: RichesFlores Research, French Attractivity Dashboard, MEF 2012

R&D workforce (2010)

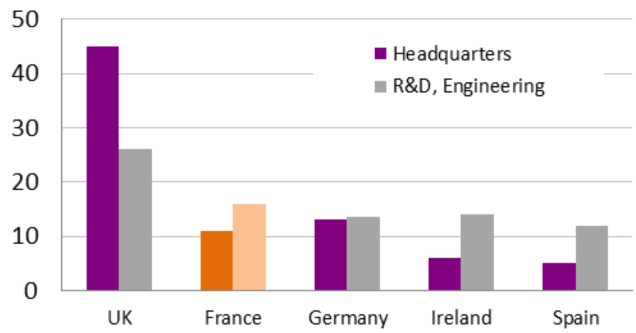
Per 1,000 people in the overall workforce



Source: RichesFlores Research

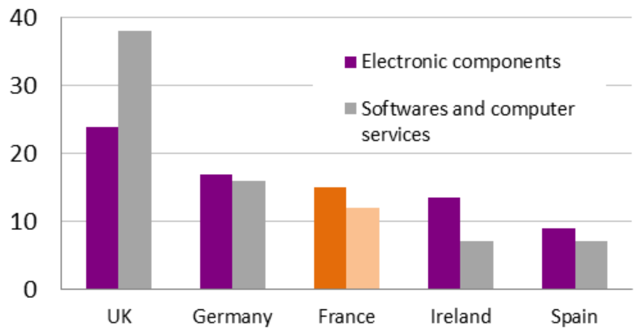
France’s share of foreign investment projects in Europe (%)

R&D and Headquarters



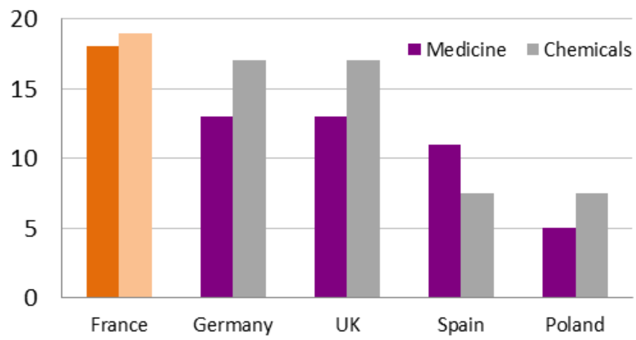
Source: AFII 2012, calculations AFII-CAS

Softwares and computer services



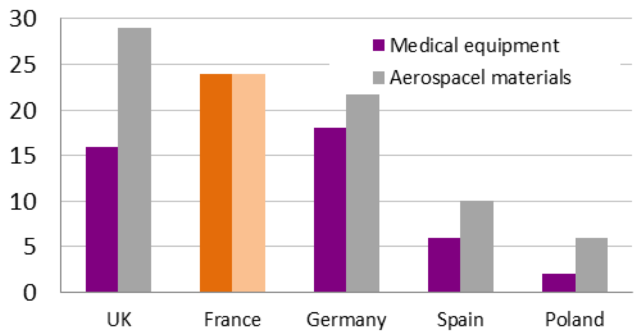
Source: AFII 2012, calculations AFII-CAS

Chemicals



Source: AFII 2012, calculations AFII-CAS

Aerospace mat. and Medical equip.

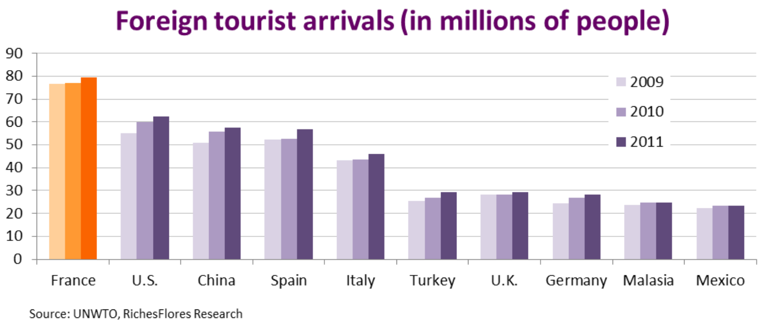


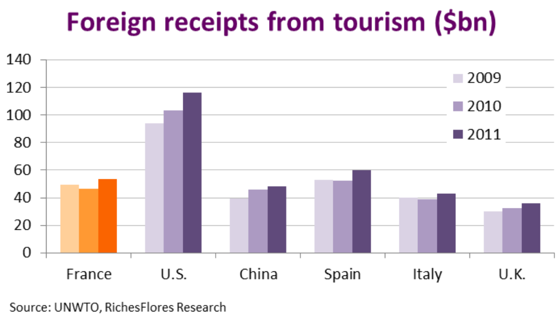
Source: AFII 2012, calculation AFII-CAS

Geographic location, tourism, and agriculture

France's central location in Europe, expansive coastline, and diverse geography are all additional plus points that should bolster two core sectors in particular: tourism and agriculture. Both of them achieve world-class performance today and offer opportunities for further expansion that likewise tend to be underestimated.

Not only is France the world's number-one travel destination; its tourist industry still has plenty of room for further growth, judging by how little it earns relative to other leading destinations. For example, total receipts are no higher than in China, although France draws twice as many visitors.





Another distinctive feature is France's presence across a broad range of agricultural sectors, in many of which it holds leading positions—despite the country's comparatively small total surface area. With the need for food and non-food products steadily on the rise today, agriculture is fast emerging as a new wellspring of business opportunity. It is one of the rare sectors in France to have created jobs in the past few quarters, and a large share of output gets exported.

France's rank among the top agricultural producing countries, 2009

	Output (millions of metric tons or hectoliters)	Global ranking	E.U. ranking
Wine	43	2	2
Wheat	39	5	1
Poultry	1.8	5	1
Milk	24	5	2
Pork	2.3	6	3
Corn	16	7	1
Sugar	4.5	8	1
Beef	1.8	8	1

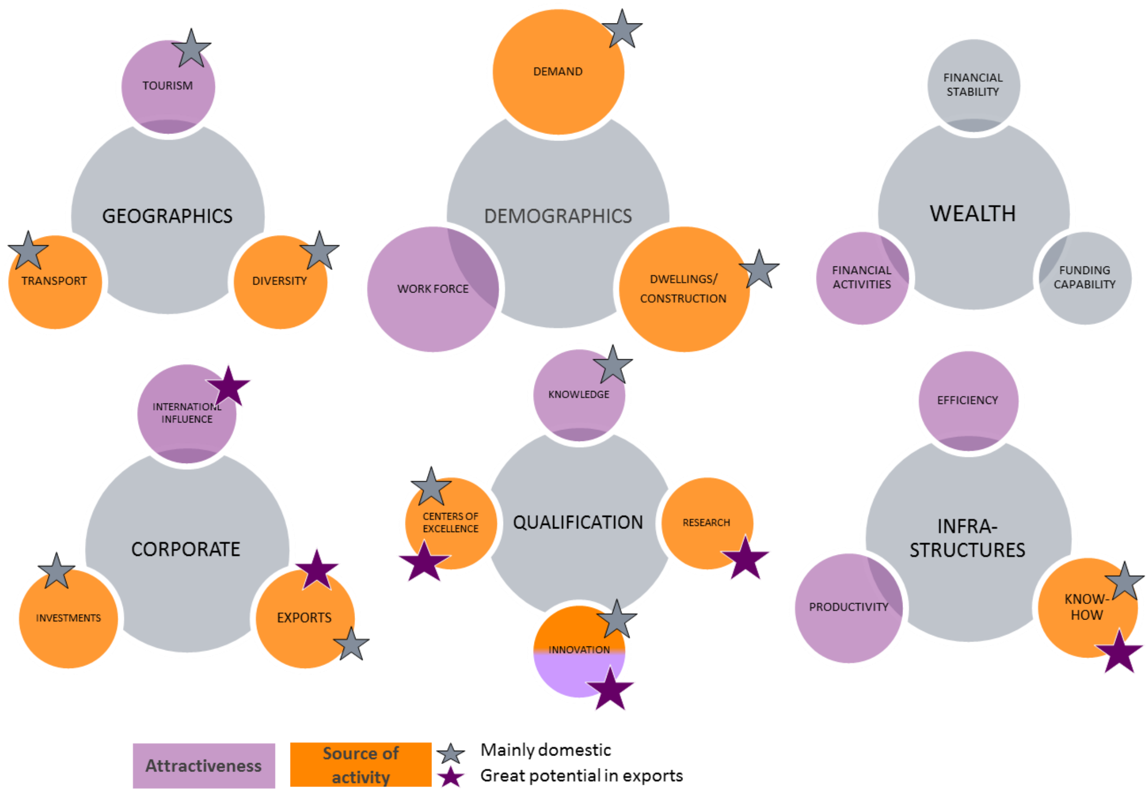
Source: French Ministry for Agriculture

Leveraging the French economy's strengths more effectively to tackle the crisis

France's unique strengths and resources, often under-appreciated, strongly suggest that it would be both dangerous and a terrible waste to stay the current European course—which boils down to hollowing out the French economy. Besides, France unquestionably has the means to follow an alternative path. In this respect, it is probably the Eurozone country with the best cards for raising its growth potential, re-igniting domestic demand in the E.M.U., and ultimately tackling its debt problem. But no such moves will be possible unless the country eases its deficit reduction timetable and works quickly to revive domestic demand—the only force that can make investment stimulus programs a success.

Economists and political leaders must recover the kind of confidence that bold action requires so that they can shift economic policy in new directions. This is also the only realistic option if France is to avoid further credit rating downgrades—an increasingly likely prospect at a time of impending recession.

Leveraging the French economy's strengths to follow an alternative path



Véronique Riches-Flores
contact@richesflores.com

Véronique Riches-Flores,contact@richesflores.com